GLOBAL GROWTH – KEY JUDGEMENTS IN A TIME OF TURBULENCE

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Some economic variables are so fundamental that they determine the outlook for almost every asset class. Amongst these, the GDP outlook for the world's major economies surely tops the list of systemically important variables. Indeed, this variable is the central determinant of inflation, real interest rates, corporate earnings growth, and currency markets – consequently the expected return for every major asset class. In a world of big governments, policy developments increasingly dominate the economic landscape. US trade policy ("trade war") and the Italian elections have won the recent headlines. There are also shifts taking place in global monetary and fiscal policy that will profoundly affect markets in coming years. While we are in a time of transition and turbulence, we think the fundamentals still justify a basically optimistic and pro-growth bias in asset allocation. This section explores a few key judgements that support this view.

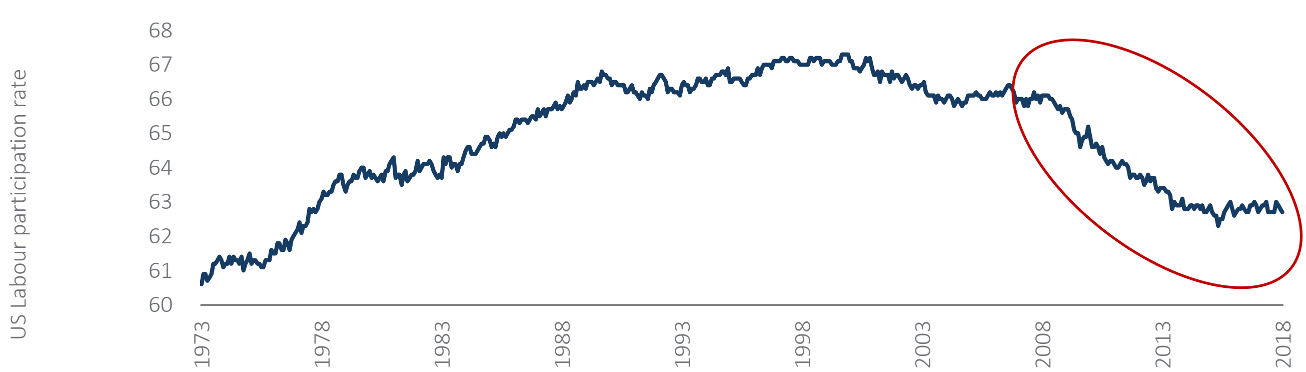
US GDP growth

In formulating an outlook for US GDP, there are a number of key judgements investors will need to make at present. These include: (i) an evaluation of the divergence between US potential GDP growth, which is quite low, and current trend growth, which is somewhat higher; (ii) an estimate of the output gap; (iii) a consideration of whether the current US fiscal policy represents a policy error, or whether it portends positive structural change in the US; and (iv) the likely impact of tightening monetary policy on US growth. Signally, we think that recent US fiscal policy has meaningfully upped the ante, both raising the risk of a stagflationary medium-term outlook, while holding out the hopeful possibility of genuine structural reform that could boost flagging labour-productivity.

The outlook for US GDP growth has reached a crucial threshold during the past few months. First, the economy appears to be operating at, or even slightly beyond, its potential level. This is most evident in the labour market, which is running at "full employment". Although it could be argued that the low participation-rate (Figure 1) suggests significant latent slack capacity, much of its recent decline is due to ageing and hence less likely to reverse. Thus, while there may still be some labour-market slack (a few percentage points are not due to demographics, and retirees now have a higher propensity to take on part-time work), it is nevertheless being mopped up rather rapidly at the current economic growth rate.

Operating at or beyond GDP capacity, as this dwindling slack suggests, indicates a transition to an inflationary, or "overheating," kind of economic environment, associated both with "late-cycle" dynamics and policy tightening, thus with a higher risk of recession. US GDP growth is currently running at about 4.7%, as seen in the Atlanta Federal Reserve's (Fed's) real-time forecast ("nowcast"). This is materially higher than long-term average potential growth, which the US Congressional Budget Office (CBO) estimates to be about 1.9% p.a. over the next decade. The current strength reflects strong growth momentum, amplified by consumers having spent a large proportion of the disposable income flowing from the US tax cuts. The tepid long-term outlook, however, reflects an extrapolation of deteriorating demographics (Figure 2), and low levels of productivity growth (Figure 3).

Figure 1: Declining US labour participation is mostly due to demographics ("ageing")



Source: Anchor estimates; St Louis Fed

The widening fiscal deficit, associated with the recent tax cuts, is highly unusual at this point in the economic cycle (Figure 4). Typically, fiscal deficits are extended during recessions, and when unemployment is high; i.e. the opposite of the present environment. Current fiscal policy effectively creates a broader spectrum of possible outcomes, suggesting both a route to stagflation, and the possibility of a higher level of structural growth. It all depends on how private investment responds to a new suite of incentives.

The outlook for wider fiscal deficits should be GDP stimulative in the short term, but come with the risk of "crowding out" both investment and consumer spending, as higher interest rates (associated with a deteriorating budget outlook), disincentivise both kinds of spending. This risk is more extreme in a late-cycle environment, like the present one. The US fiscal deficit is currently around 3.5% of GDP, but could rise by about 0.5% p.a. under the current fiscal regime, reaching 5% by 2021. If there is indeed crowding out, these fiscal deficits may be associated with a drift towards a stagflationary environment (inflation coupled with the stagnation of GDP growth). This is the bearish side of the current outlook.

Figure 2: Soft labour-force growth is not likely to change...

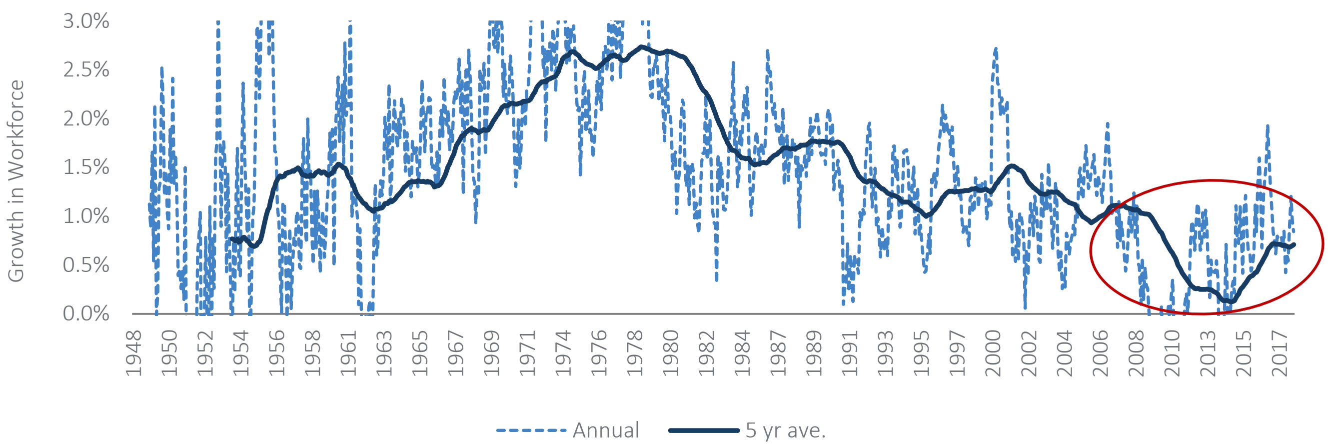


Figure 3: ...But weak productivity growth could get a boost from tax reform

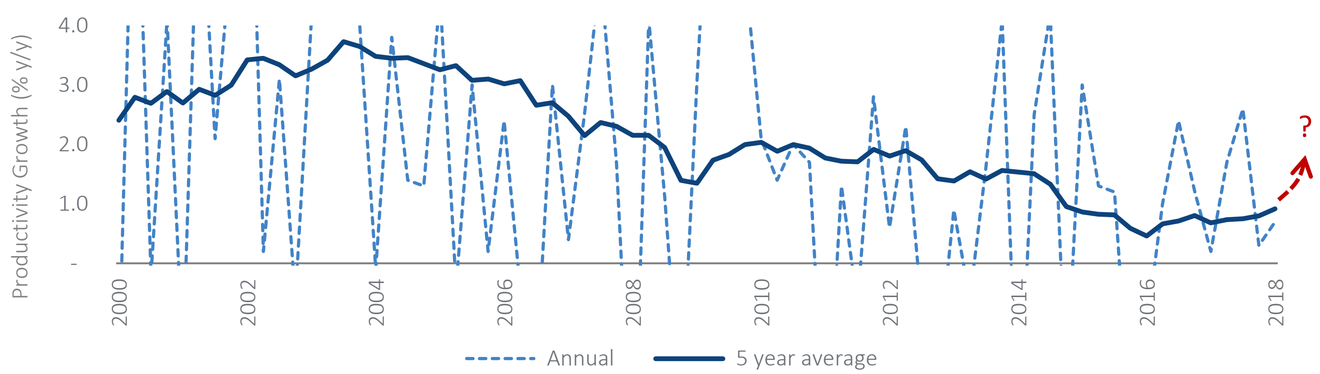
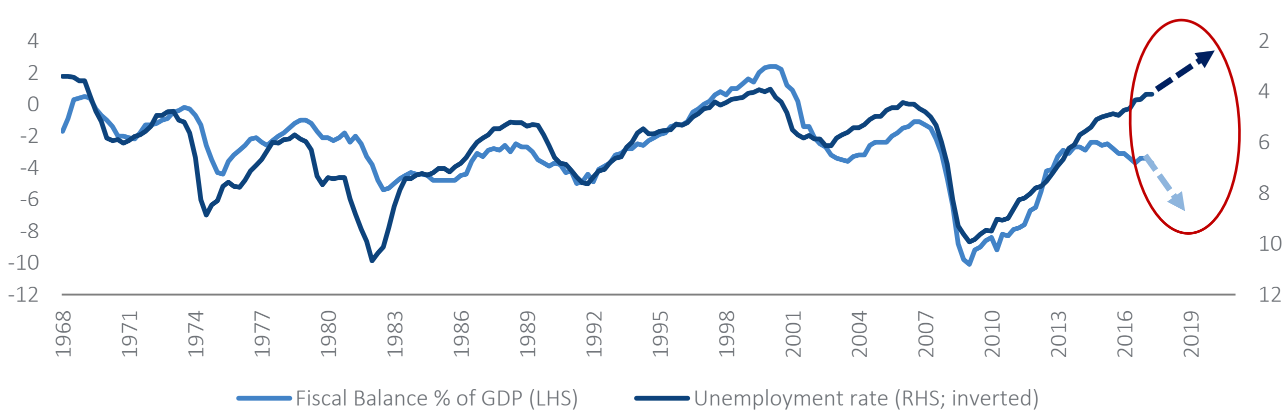


Figure 4: Widening US fiscal deficits are unprecedented at this point in the cycle



Source (Fig 2-4): Anchor estimates; St Louis Fed; Bloomberg

The more bullish scenario, however, would regard US tax cuts as structural in character, rather than standard Keynesian policy stimulus. The US tax reform was, to a significant degree, designed to make the US a more attractive investment destination. This was understood both in terms of relative global tax rates, and in terms of specific write-off provisions directed at investment spending. If successful, this policy has the potential to increase not only GDP (through higher investment spending), but labour productivity (the result of higher capital formation), and consequently to raise the outlook for potential GDP growth. That is, while GDP potential is being held back by weak demographics, which are unlikely to change, the drag coming from weak productivity growth may indeed change materially under this scenario. This would present a more auspicious outlook for the US fiscal balance, the US bond market, and indeed for global equity markets as well.

It is too early to determine which of these more extreme prospects will take hold. The credible potential attached to this more favourable outcome, however, reinforces our existing view that it is too early to turn negative on the US growth story. Indeed we are not yet seeing actual signs of overheating (e.g. spikes in inflation), however much these are intimated and anticipated by recent developments.

In addition to this important shift in fiscal policy, US monetary policy is also in the midst of a historically significant “normalisation”. The resultant rising interest-rate outlook is, on balance, likely to weigh on GDP; this is particularly so for such developed economies that are significantly more indebted than in previous cycles. And yet, this debt load has shifted dramatically from interest-rate sensitive households to governments. Indeed households in both Europe and the US have delivered quite significantly since the global financial crisis (GFC). The latter are not commercially motivated in the same way, and thus respond differently to interest rate incentives. Thus, again, in spite of reasons to be worried (debt levels have risen sharply in recent years), we think it would be overly prudent to conclude that one should turn bearish on growth.

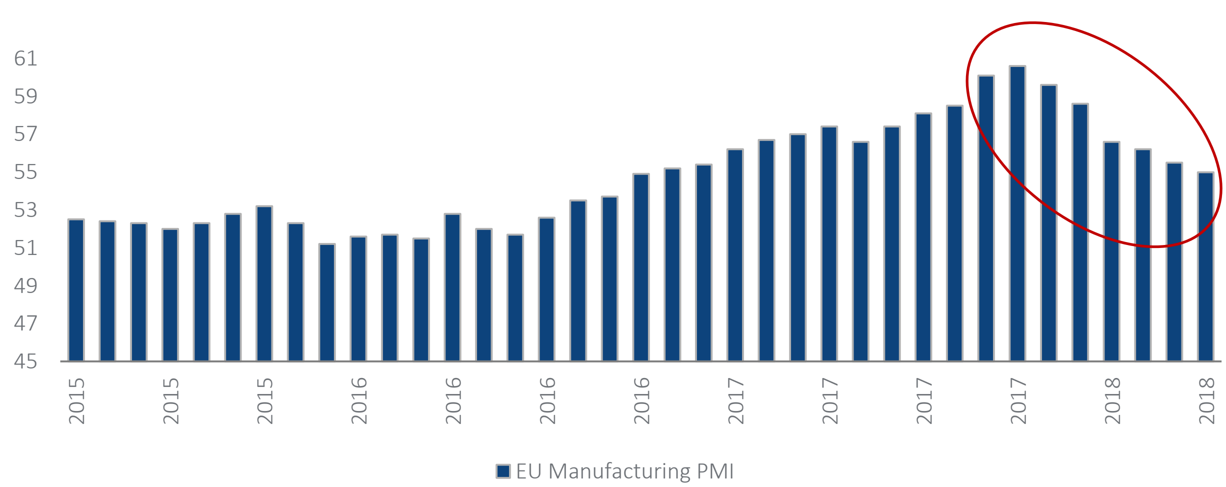
Taken together, and in light of our thoughts on the risk of a possible “trade war” (see below), we think the above factors suggest a growth slowdown in the US, in 2019 and 2020, following a strong CY18. Our base-case expectation, therefore, is for US growth to ratchet down to its long-term potential level, at just under 2%, by the latter half of 2019.

European GDP growth

Although European growth remains comfortably in positive territory, it has softened in 2018 relative to 2017’s notable strength. This softening has been most evident in high-frequency data like the purchasing managers indices (PMIs) (see Figure 5). Is this trend likely to continue, or are there yet reasons to remain optimistic on Europe’s growth outlook? We are somewhat optimistic on Europe’s cyclical recovery, and we think the key to interpreting the recent softness lies in the euro vs US dollar exchange rate, which has followed a similar pattern to that seen in the US when it similarly reached the end of its monetary easing cycle a few years ago.

With the end of that cycle in sight, the US dollar surged in 2H14 through to the end of CY15. This strength was part of the cause of a notable softening in US PMIs during and shortly after that period. The same pattern may currently be in force in the EU, but it is likely to be more pronounced. For, while the US is a relatively closed economy, European economies are typically very “open”: German GDP, for example, is 40% exports. Thus, it is not puzzling that the euro surge seen last year (+20% from December 2016 to early January 2018) has resulted in a softening of certain growth indicators. The recent weakness in the euro, seen in 2018 so far (EUR/$ is down 7% from its early January high), is likely to revive some of these flagging growth numbers.

Figure 5: EU PMI has softened in 2018 – we expect a rebound following recent euro weakness



Source: Bloomberg

A real challenge, however, is likely to come when the European Central Bank (ECB) starts to unwind QE. This has the potential to cause very significant euro strength, and thus risks derailing the growth recovery. It seems, consequently, that the ECB's QE unwind will be a very gradual and protracted affair. A second major challenge to the EU is structural, and relates to euroscepticism and a lack of fiscal integration. These two factors flared up in Italy's recent elections. The country represents yet another major economy changing gears on the fiscal front, and moving decisively towards larger fiscal deficits. Lastly, note that Europe would be particularly vulnerable to any future "trade war", should tensions between the US and China not only escalate, but spill over into more generalised trade barriers.

While these structural concerns do pose certain risks, they should not be overestimated. Although there is a lack of fiscal integration in the EU, the region has for the most part still been able to contain its finances, with its fiscal deficit at only 0.9% of GDP in FY17. Even Italy has remained within the EU-imposed limits, running a fiscal deficit of less than 3% of GDP since 2012. Furthermore, factors like cyclical momentum and slack capacity remain, on balance, in clearly positive territory. All things considered, we expect EU GDP growth, consistent with ECB forecasts, in the range of 1.7% to 2.2% over the next three years (see table below for details).

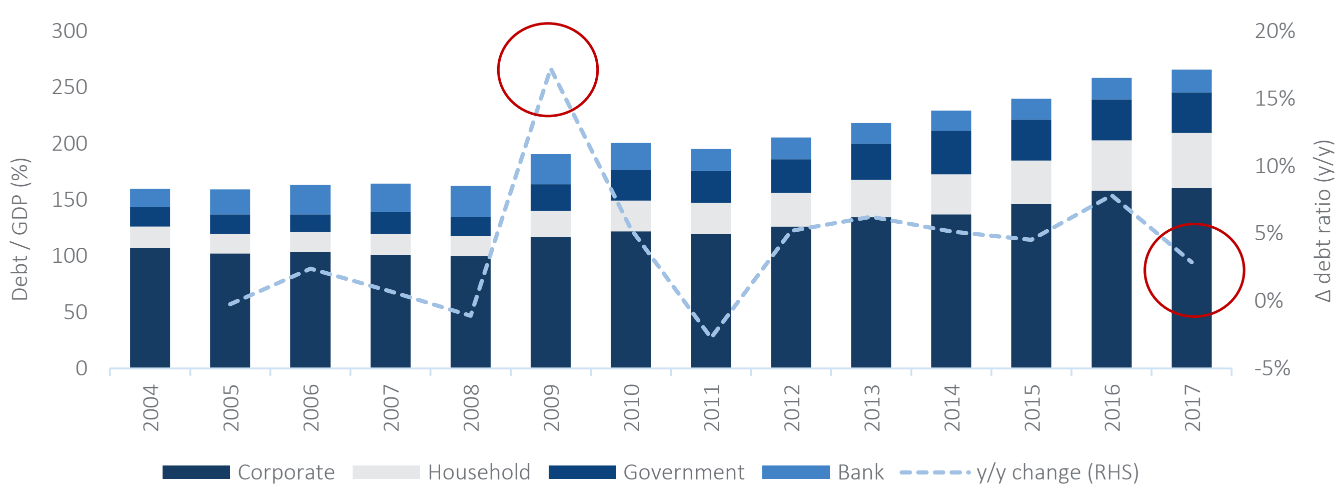
World GDP outlook

In this section we touch upon China and India as major drivers of world growth. We also consider the risks to growth posed by the possibility of a trade war between China and the US. China remains the largest contributor to global GDP growth, accounting for 34% of 2018's estimated increase in global GDP (the US, by contrast, accounts for c. 19%). The country has recently shifted its policy emphasis from "deleveraging" to "boosting domestic demand", a welcome sign for the world's growth outlook.

China's debt increased rapidly following the credit crisis (Figure 6), as global final demand collapsed, exposing China's reliance on external demand (i.e. exports). The strong synchronised global growth we have witnessed since late 2016 reinvigorated global final demand, and allowed China to focus on improving its balance sheet. It is a positive sign that the economy has successfully navigated a period of monetary tightening. This, however, still leaves the deeper challenge of relatively soft domestic demand, outside of debt-funded capex. We are bullish on the outlook for the Chinese consumer, and consequently the prospects for domestic Chinese demand. Thus, we think the Chinese growth story will prove sustainable. The at times unsettling fits and starts, associated with debt and domestic demand, are to be expected in the kind of development path China is following. They are also, to a degree, associated with China's response to the credit crisis - that is, excess debt is for China what QE and zero interest-rate policy (ZIRP) are to the US and EU: a response to the post-GFC malaise which now needs to be unwound.

All things considered, we expect China to continue on its path of a measured deceleration from a growth rate of 6.9% seen in FY17 to at or just below 6% by 2020. This slowdown is a normal part of a transition from a market that is clearly "emerging" to one that is increasingly approaching a "developed" condition.

Figure 6: China's debt/GDP ratio spiked following the GFC, but was contained in 2017



Source: Bloomberg; Anchor estimates

Indian GDP is far smaller than China's in absolute terms but, as the world's fastest-growing major economy, it is still a material contributor to the global growth outlook. India has fantastically sound drivers of GDP: these include strong domestic demand, excellent demographics (a young and growing population), and a very low GDP/capita starting point (about $2,100/capita, vs the US at $62,500/capita and China's $10,000). A low GDP/capita level means that technology transfer, financial penetration, and institutional deepening have a high chance of bearing significant fruit, as the country can grow merely by adopting what already exists, without needing to push the boundaries of technology. We expect India to grow at over 7.5% for the next three years.

Lastly, the global growth outlook will be affected by whether or not the current trade dispute between the US and China spirals into a trade war. At present, enacted tariffs are still very small and unlikely to have a noticeable impact on global GDP. There is, however, a risk that current rhetoric, which may be connected to the upcoming US mid-term elections, spirals through tit-for-tat into a quantitatively significant shift in trade policy. We think it makes sense to evaluate this situation in terms of incentives.

As a relatively closed economy (in trade terms), the US would be less affected by trade-barriers than its more open counterparts (China and the EU, in particular). On the other hand, US equity prices are very much affected by global growth dynamics, and hence the drivers of US wealth make the country somewhat open. In this sense, US trade statistics perhaps understate the country's dependence on the drivers of global growth. In tension with this incentive, Trump has a substantial commitment to putting the US first, hence we may see meaningful follow-through on proposed tariffs. Escalating trade tensions, however, even if they mutate into a severe "trade war", are unlikely to dampen global GDP by more than 0.5%. Relative to the 2018 run-rate, this would leave global GDP at a level still higher than what was observed in 2016.

There are, therefore, clearly political and policy risks on many fronts. These include shifting fiscal, monetary and trade policies that risk creating additional turbulence for financial markets. Yet, in spite of these concerns, the global growth outlook remains robust and positive. The table below summarises our GDP growth expectations for the global economy. These forecasts inform the expected returns of all asset classes considered in this report.

Figure 7: Global GDP growth outlook – still robust in spite of the risks

GPD GROWTH	2016	2017	2018	2019	2020
US	1.5	2.3	2.9	2.2	1.9
EU	1.8	2.4	2.3	2.0	1.7
China	6.7	6.9	6.5	6.3	6.0
India	7.9	6.4	7,.5	8.1	8.0
SA	0.6	1.3	1.8	2.1	2.3
World	3.2	3.8	3.9	3.8	3.3

Source: Anchor estimates; Bloomberg