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Global Economic Perspective: June

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US Economy's Fundamentals Remain Strong, but Potential Geopolitical Risks are Increasing

The fundamental picture for the US economy appears healthy and may improve further over the rest of the year, in our view, as the potential stimulus from tax cuts seems likely to offset any headwinds from increases in energy prices and interest rates. As expected, the US Federal Reserve (Fed) lifted interest rates at its June meeting, coupling an upbeat economic assessment with comments that were a little more hawkish than generally expected. The main clouds on the horizon are geopolitical, as the recent spike in global market volatility demonstrated. So far, the Fed has been able to maintain a broadly measured and predictable approach, focusing almost exclusively on the US economy's increasing momentum. But if any of the geopolitical risks were to escalate sufficiently to threaten this positive economic backdrop, Fed policymakers may consider it necessary to adopt a more nuanced stance.

Global economy Still Has Positive Momentum, Though More Market Volatility Likely

The broad outlook for the global economy remains positive, in our view, with the robust US economy underpinning momentum around the rest of the world. Nevertheless, we expect more patches of financial market volatility, similar to the one recently triggered by the Italian crisis. After a long period in which globalization was the organizing principle driving much of the world's growth, the risks to this agenda have increased. The rise of populism has made the political landscape far less predictable, making it difficult to determine, for example, the impact the Trump administration's trade policies could have on global growth. How much of a risk premium is priced in for such geopolitical uncertainty remains a central issue, although we would argue that, due to the positive momentum of the global economy, on balance a moderately short duration stance remains appropriate for us.

An End Date for European Bond Purchases Comes with Significant Caveat

We would agree with European Central Bank (ECB) policymakers' views that the region's rate of economic growth remains healthy, despite a recent softer patch and a political crisis in Italy. But their announcement at the central bank's June meeting that bond purchases would cease at the end of 2018 has come with a significant caveat, allowing a reversal if data deteriorate sufficiently over the second half of the year to alter their expectations on inflation. Taking this and references to heightened levels of uncertainty into account, our overall impression is that ECB President Mario Draghi remains reluctant to risk repeating past mistakes, when the central bank was too quick to tighten monetary policy.

US Economy's Fundamentals Remain Strong, but Potential Geopolitical Risks Are Increasing

The fundamental picture for the US economy appears healthy and may improve further over the rest of the year, in our view, as the potential stimulus from tax cuts seems likely to offset any headwinds from increases in energy prices and interest rates. Consumer spending looks to be on track for a solid rebound, after a relatively weak start to the year, and recent data have calmed concerns that inflation was set to pick up pace. Though there are signs of mounting shortages of labor and materials, it remains an open question whether such cyclical pressures are sufficiently strong to overcome more persistent disinflationary forces, including globalization and technology. The main clouds on the horizon are geopolitical, ranging from the Trump administration's idiosyncratic trade policies to potential threats elsewhere in the world, as the recent spike in global market volatility over Italy demonstrated. So far, the Fed has been able to maintain a broadly measured and predictable approach to tightening monetary policy, focusing almost exclusively on the US economy's increasing momentum. But if any of the geopolitical risks were to escalate sufficiently to threaten this positive economic backdrop, policymakers at the central bank may consider it necessary to adopt a more nuanced stance. As expected, the Fed lifted interest rates at its June meeting, coupling an upbeat assessment of the US economy with comments that were a little more hawkish than generally expected.

Domestic data indicated the US economy had made a solid start to the second quarter, and supported forecasts that recent tax cuts could increase the pace of growth. Having emerged from a soft patch at the start of the year, April's retail sales continued the positive trend seen in March. This pattern was mirrored in consumer spending data, which beat consensus expectations with a strong monthly gain of 0.6% in April, and a further slight upward revision to the previous month's healthy rise. Surveys from business also generally struck an upbeat note. The Institute for Supply Management's purchasing managers' indexes (PMIs) for services and manufacturing for May came in ahead of consensus forecasts, both recovering from dips in April and suggesting the economy's strong underlying momentum remained intact. However, the manufacturing survey contained a great deal of anecdotal evidence that companies were being squeezed by labor shortages and rising costs of raw materials, which were described as leading to "price-increase discussions" among respondents.

A buoyant labor market report for May provided another strong set of data, with an increase of 223,000 jobs keeping the average monthly gain over the last 12 months close to 200,000. The sustained pace of job creation has surprised many market participants, given the concurrent fall in the unemployment rate, which reached a new cycle low of 3.8% in May. Average hourly earnings grew by 0.3% from the previous month, slightly ahead of consensus expectations.

Despite the tightness of the labor market and hints of mounting pricing pressures on companies, measures of inflation showed little sign of breaking out of their trend of incremental, but extremely slow, gains. The Fed's favored gauge of inflation, the core personal consumption expenditures price index, increased by 1.8% year-on-year in April, while the previous month's reading was revised down by 0.1% to the same level. Notwithstanding the recent rise in energy costs, prices in the TIPS (Treasury Inflation-Protected Securities) market—which give insight into investors' expectations about the potential trajectory of inflation—generally fell back from the recent highs seen in April.

The move in the TIPS market occurred in step with a strong rally in US Treasuries in late May, after benchmark Treasury yields had spent much of the first half of the month above 3%, at one point reaching their highest level since 2011. Initially, Treasuries moved higher in response to the release of the minutes from the Fed's May meeting, which appeared slightly more dovish on inflation than had been widely expected. But the rally quickly gathered pace on concerns about the deepening political crisis in Italy, as well as fears of a further escalation of tensions related to US trade policies. Amid a general rise in risk aversion and volatility, market forecasts for future interest-rate increases were scaled back, although May's strong jobs report refocused attention on the economy's underlying strength, and to some degree restored a more positive outlook among investors.

At the end of May, the Trump administration hardened its stance on trade by imposing tariffs on steel and aluminum imports from the European Union, Canada and Mexico, having previously exempted these trading partners when first announcing the measures earlier in the year. The move prompted limited retaliatory measures from the affected countries. Citing the same grounds of national security, the US government also announced an investigation into trade in autos and auto parts, raising the prospect of a sizable tariff on auto imports that would severely impact Asian and European producers, including those with production located in the United States. Elsewhere, the latest trade talks between US and Chinese government officials ended with no sign of progress, bringing closer a mid-June deadline set by President Trump for the United States to start levying tariffs on $50 billion worth of Chinese imports.

Judging the possible effects of a more aggressive US stance on trade appears a near-impossible task, in our view, given the lack of clarity between the administration's negotiating tactics and actual policies. In the near term, the Fed looks to have more pressing issues to focus on, such as taking into account the impact of a sizable fiscal stimulus at a time of robust economic growth. However, further out, potential threats to the global trading system could represent another of the growing list of geopolitical risks and uncertainties for policymakers to consider.

Global Economy Still Has Positive Momentum, Though More Market Volatility Likely

The rise in risk aversion resulting from concerns over the Italian political crisis increased selling pressure on the currencies and bonds of many emerging-market countries, already strained by the resurgence of the US dollar in recent months. By early June, a leading index of emerging-market currencies had fallen to its lowest level since the election of President Trump in late 2016. Several countries were forced to act as declines in their currencies gathered pace, with Turkey's central bank eventually raising interest rates twice to arrest a fall of nearly 25% in the Turkish lira against the US dollar in the previous three months. The tightening came despite the previous vocal opposition of the Turkish president, Recep Tayyip Erdogan, to higher interest rates ahead of elections at the end of June.

As in past emerging-market selloffs, to some extent investors focused more on countries like Turkey, with large current account deficits and significant energy imports, which were seen as vulnerable to both a stronger US dollar and the recent rise in oil prices. However, the selling was broad-based, and even a significant oil producer like Mexico saw its currency fall to a 15-month low against the greenback. Elsewhere, the new head of Indonesia's central bank moved quickly to support the Indonesian rupiah, raising interest rates twice in as many weeks. India also tightened monetary policy, for the first time since 2014, citing mounting inflationary pressures. The Indian economy depends on imports for around 80% of its energy needs, and the Reserve Bank of India estimated that the cost of imported oil had risen by more than a tenth over the previous two months.

The Brazilian real was another currency affected by the less favorable investment conditions, falling to a two-year low against the US dollar. Its weakness was amplified after concessions made by the country's government to end a truckers' strike, which were seen as a move away from market-friendly policies and prompted the resignation of the head of Brazil's state-owned oil company, a well-known proponent of market reforms. The government's climbdown increased fears about the potential outcome of the country's presidential elections in October, with polls showing a lead for populist candidates. Rather than changing interest rates to influence foreign-exchange markets, Brazil's central bank has generally preferred to use derivatives as a form of indirect intervention, and the real regained some of its losses after the central bank pledged to intensify such measures to support the currency.

Argentina's precarious finances received a boost after the country agreed to a $50 billion stand-by arrangement with the International Monetary Fund (IMF), as well as additional support from other international financial institutions. In return, Argentina agreed to speed up the improvement of its fiscal position and strengthen the independence of its central bank. The size of the IMF package was larger than widely expected and was spread over three years, meaning that the government would not have to return to international markets until after the next presidential elections in late 2019. In a sign of international backing for President Mauricio Macri's reform program, the deal was concluded much quicker than anticipated, and the immediate reaction was a stabilization of the country's bond prices, although the Argentine peso remained under pressure, as the country's central bank complied with IMF calls to allow it to float freely.

In yet another example of the increasing unpredictability of political outcomes, the Malaysian election saw opposition parties combine to defeat the ruling coalition that had governed the country for more than 60 years. The new prime minister, Mahathir Mohamad, had previously led the country for 22 years, before stepping back in favor of one of his proteges, Najib Razak. But after Razak's administration had become tainted by a corruption scandal, the veteran Mohamad switched his support and led the opposition to a largely unexpected election victory. Despite the political upheaval, investors generally remained sanguine, and the impact on the country's bonds and currency was limited.

The broad outlook for the global economy remains positive, in our view, with the healthy state of the US economy underpinning momentum around the rest of the world. Nevertheless, we expect more patches of financial market volatility, similar to the one recently triggered by the Italian crisis. After a long period in which globalization was the organizing principle driving much of the world's growth, the risks to this agenda have increased. The rise of populism has made the political landscape far less predictable, making it difficult to determine, for example, the impact the Trump administration's trade policies could have on global growth. How much of a risk premium is priced in for such geopolitical uncertainty remains a central issue, although we would argue that, due to the positive momentum of the global economy, on balance a moderately short duration stance remains appropriate for us.

An End Date for ECB Bond Purchases Comes with a Significant Caveat

The main driver of European financial markets during May was a deepening political crisis in Italy, where benchmark government bond yields rose around 100 basis points overall during the month. Deadlock between Italy's main populist parties and its president about the composition of a new government initially pointed toward a further round of elections. As a consequence, investors grew fearful of a more decisive mandate for policies that could raise questions about the country's participation in the eurozone. At the end of May, a compromise was reached to allow a new administration to be formed, sparking a limited recovery in Italian assets. But after a period of calm since the last Greek debt crisis in 2015, the events in Italy served as a reminder of the continued political risks within the eurozone, pushing investors toward perceived safe havens and driving down German Bund yields.

Although somewhat overshadowed by Italy's troubles, Spain also saw the appointment of a new government after the previous administration of Mariano Rajoy lost a vote of confidence in parliament as a result of a corruption scandal. Pedro Sánchez, the head of the country's socialist party, took over as prime minister of a minority government, even though his party held only around a quarter of the parliamentary seats. Such a seemingly weak position immediately raised questions about how long the new administration could remain in power, although the increased leverage for regional parties—including those from Catalonia seeking independence—over the central government suggested the new political alliances could last for longer than some market participants expected. Among Prime Minister Sánchez's appointments was a Catalan-born political ally as regional minister, the previous director-general for budget at the European Commission as finance minister and a former head of the European Parliament as foreign minister. The latter picks were widely seen as an attempt to underline the contrast between the political and economic positions of Spain and Italy.

Data releases for the eurozone were generally somewhat subdued and, combined with the elevated political uncertainty, raised further questions about whether growth in the region might continue to slow after a dip in 2018's first quarter. In May, a leading PMI covering both manufacturing and services in the region reached its lowest level in 18 months—though it remained well above the expansion threshold—and German factory orders fell in April compared with the prior month, the fourth consecutive monthly decline. But there was better news from a gauge of German business sentiment, which moved slightly higher in May after consistently weakening in previous months.

Against this backdrop of slightly softer economic data and political concerns, hawkish comments from several ECB officials in early June attracted significant attention. Among them, the ECB's chief economist emphasized the underlying strength of the eurozone economy and his belief inflation would rise to the central bank's objective, an apparent shift from his more cautious stance previously. In the event, such comments foreshadowed the announcement at the ECB's June meeting soon afterwards that the central bank would reduce its bond purchases in September and then cease them completely at the end of 2018.

At the meeting, ECB President Mario Draghi said that domestic cost pressures were increasing, contributing to a more certain outlook for inflation. But he was at pains to emphasize that the decision to end quantitative easing was subject to data releases over the next few months that confirmed policymakers' predictions inflation would start to converge with their target. The central bank's updated inflation forecasts for 2018 and 2019 were increased, but much of this was due to higher energy prices. The ECB president also struck a dovish note on interest rates, signaling that any rise was unlikely to occur before September 2019.

We would agree with ECB policymakers' views that the region's rate of economic growth remains healthy, despite a recent softer patch and a political crisis in Italy. But their announcement of an end date for bond purchases has come with a significant caveat, allowing a reversal if data deteriorate sufficiently over the second half of the year to alter their expectations on inflation. Taking this and references to heightened levels of uncertainty into account, our overall impression is that ECB President Draghi remains reluctant to risk repeating past mistakes, when the central bank was too quick to tighten monetary policy.

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