Economic Perspectives

Global themes: April 2018

In our new quarterly publication, ***GDP heatmaps***, we note that the pace of nominal GDP growth has picked up almost everywhere over the past 2 years, transporting us from a 4 per cent world to a 6 per cent world. **This acceleration has favoured inflation over real growth, especially in Asia,** posing a clear threat to the 'New Normal' characterisation. Forty of the 53 countries monitored report an increase in the annual pace of nominal growth over the past 12 months, with the strongest net balance of risers over fallers since the end of 2010.

In the March ***Global Credit Perspective,*** we draw out the implications of this faster nominal growth for benchmark government bonds. Our statistical analysis suggests that bond yields tend to adjust to their nominal environment, implying scope for further increases. **Specifically, we think that US 10-year yields could reach 3.75 per cent this year.** The slowing in broad money aggregates appears to be a lagged response to other financial and economic developments, and is not indicative of global economic deceleration.

Strengthening nominal and real global growth offers protection to investment-grade corporate credit, even in the face of rising government bond yields. However, the global credit cycle is fast-maturing and corporate credit conditions could tighten abruptly later in the year. **The gradual weakening of global credit metrics poses a material threat to the long-running buoyancy of global equity markets and to the global economic expansion in 2019.**

Our *30 November* London seminar, entitled "*The Real Reason Real Rates Are So Low*", argued that very low real interest rates are a financial market distortion enabled by lax monetary policy settings, not an equilibrium response to an *ex ante* savings glut. As interest rates normalise and QE programmes are wound down or reversed, **the appearance of central bank control of the yield curve will evaporate, giving rise to a potential spike in real yields**.

The increasing use of macro-prudential measures, aimed mainly at the restraint of property market appreciation, is a curious response to credit excesses that are focused elsewhere – in the use of **opaque and dangerously-leveraged financial structures, in sub-prime corporate bonds and unsecured consumer loans.**

The replacement of Janet Yellen by Jerome Powell at the helm of the US Federal Reserve was marked by a surge in some measures of asset price volatility. In our ***February North America EP,*** we highlighted the fact that Powell inherits an unsuitable Fed model, a flawed analysis of equilibrium real interest rates, an overheated labour market and a wonky inflation measure (PCE). **The new Fed chair has some urgent repair work on his hands to restore the international credibility of the Fed as the guardian of price stability.**

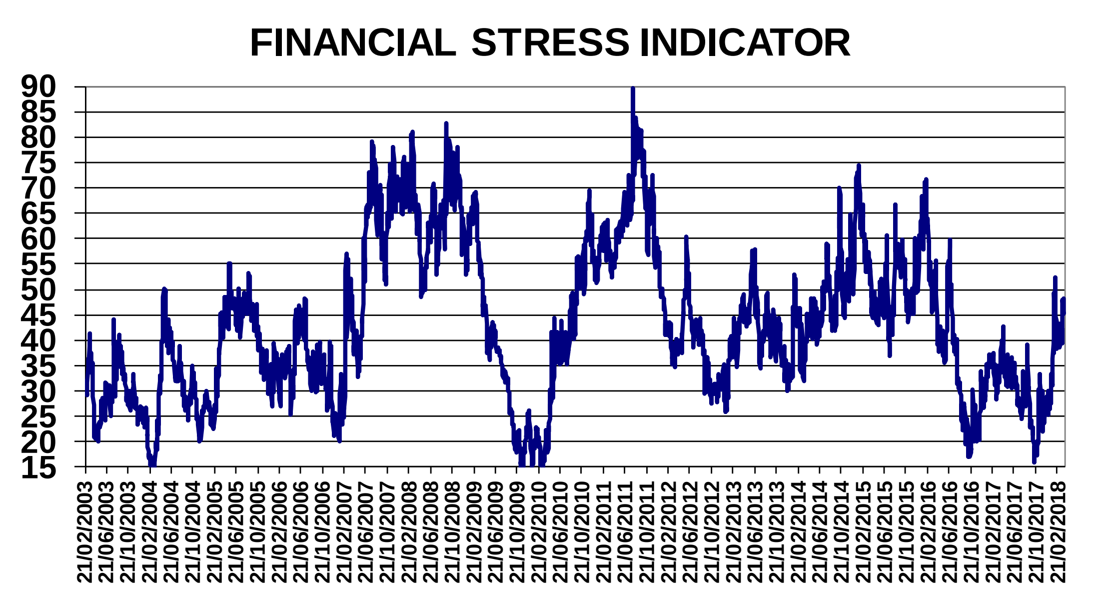
The February ***Eurozone EP*** concluded that, despite increasing economic optimism, the **Eurozone still bears significant sources of risk for the coming year, which are largely unpriced**. An array of financial risk indicators, including sovereign and corporate credit spreads, fails to reflect some serious short- and medium-term threats, including the formation of an unfriendly government in Italy, Greece's slow implementation of tax measures and reforms and the uncertain impacts of the ECB taper.

In our January ***UK Economic Perspective***, we highlighted the hard road ahead for consumers in the wake of an unrelenting real wage squeeze and ongoing fiscal tightening. With employment-hours levelling out, there is no compensating force to push up the wage bill. Having drawn down the savings rate in recent years to fund a faster pace of spending, **future consumption growth must be funded out of real after-tax income gains**. The retail economy faces a tough year. The Chancellor's Spring Statement did nothing to relieve the pressure.

In our March ***Global Inflation Perspective***, we addressed the sluggish reaction of wage and unit labour costs to tightening labour market conditions. The ongoing disintegration of the traditional labour contract has driven a wedge between hourly pay growth and whole-economy inflation. **The global inflationary race is on, but led by margin expansion and other forces.**

We maintain that a multifaceted and multi-year global inflationary process is underway: in the uplift of global inflation (on a GDP deflator basis) from 1.2 per cent to 2.7 per cent over the past 2 years**, Europe and Asia have punched above their weight while the Americas – North and Latin – have dragged their feet**. This ordering is about to change, as primary-product-induced supply chain inflation combines with adverse currency movements to lift US and Canadian inflation this year.

We prefer our **Financial Stress Index** to the popular financial conditions indexes, which misleadingly include currency movements. Stresses returned with a vengeance in February, evidenced by surging bond and equity volatility measures, wider high yield bond spreads, and relative share price weakness of US diversified banks. As we concluded 6 months ago: "***There is no magic moment for financial stress: it will break on the unsuspecting world when it is good and ready."***



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