Economic Perspectives

## Global themes: October 2017

In our September ***Global Inflation Perspective***, we assert that inflationary pressures are regaining strength after a summer lull. The rebound of the crude oil price last year sounded the starting pistol, but the hard running in the inflationary race was always going to be taken up by **extreme, sustained monetary accommodation, operating through traditional labour market dynamics, incremental demand pressures in energy and raw materials and through global supply chains, political responses to aching disappointment over living standards and the inevitable weather and climate-related supply disruptions.**

**Food price inflation is also on the move in China, India and Korea. Emerging markets are expected to drive an inflationary resurgence in the coming months.** The importance of producer profitability and operating cashflow is frequently neglected: the US shale companies' headlong rush to raise output has been indulged by the US credit markets, but not for much longer. **The prospect of significantly lower oil prices has faded in recent weeks as oil inventories reflect a tightening crude market.**

In the furious debate between those for whom tightening global labour markets have disconnected from faster wage growth and those for whom a powerful delayed reaction awaits, we side with the latter. Acute difficulties in filling vacancies and heightened job mobility help to sustain our **expectation of global wage and unit labour cost acceleration**.

The long-awaited **acceleration in global nominal GDP** leans heavily on the Chinese contribution but the improvement spans 33 of the 53 countries included in our analysis, **including US, Canada, Australia and much of Scandinavia**. Whether the bias is to stronger inflation, a faster pace of real activity or a combination of both, remains an open question. However, t**he stagflationary narrative is spreading its tent.**

**The gradual weakening of global credit metrics, particularly in real terms, poses a material threat to the global economic expansion in 2018-19.** Central bankers often speak as though this is the beginning of a cyclical upturn: far from it. **A fast-maturing credit cycle is about to tighten credit conditions more abruptly than policymakers or investors expect.**

The increasing use of macro-prudential measures, mainly aimed 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.**

Any setback for still-buoyant global equity markets is a credible trigger for corporate credit spread widening and an associated outflow of institutional and retail money from bond funds. **There is some unfinished business from the global financial crisis to accomplish.**

In our September ***Global Credit*****,** we examined the implications of an **unexpected rise in interest rates.** Is the reallocation of expenditures from debt service to household consumption and business investment permanent? An unanticipated rise in borrowing costs by even 200 basis points would bring **material economic disruption to households in some countries, with Canada, Australia and Sweden among the most vulnerable.**

**Central banks** have signalled the withdrawal of powerful monetary stimulus in the shape of accumulated asset purchases whilst asserting that this will have no adverse economic impacts. **Financial markets are justifiably wary of the latest central banking experiment.**

Our March ***North America EP*** explored the theme of **US Dollar vulnerability**. We argued that the US Dollar has been a safe harbour for international capital during the storms of European financial crises and Chinese stock market turbulence but that these threats have abated. The growing prospect of a **reversal of extreme monetary accommodation in Europe and Japan, combined with the severe difficulties president Trump has encountered in implementing his agenda, have duly weighed on the US currency.**

**The trade-weighted appreciation of the Euro, reaching 7.5 per cent between May and August**, betrays an increasing expectation of **ECB policy reversal**. While the October focus is understandably on the tapering of asset purchases, there are many other dimensions of policy adjustment that will be required. In our latest ***Eurozone EP***, we assert that Draghi et al have been overtaken by events. Expect Merkel's re-election in Germany to herald a **crescendo of objections to the ECB's over-ripe policies, culminating in Draghi's replacement in 2019 by a hard-line German or Dutch incumbent.**

As described in our ***UK Economic Perspective***, cheap credit continues to buoy financial intermediaries and large companies, but the **real economy has derived little benefit** from the strength of credit and money aggregates over the past year. **Household credit conditions have begun to tighten, closing off an important channel of support for the consumer economy.**

By far the **greatest beneficiaries** of easy credit conditions, made even easier in August 2016 in response to the EU referendum result, **are UK financial intermediaries and large private non-financial corporations**. The proceeds of opportunistic bond issuance are being held substantially as cash and short-term assets on financial and corporate balance sheets. The additional £60bn of quantitative easing helped to drive down gilt yields to absurd levels, **from which they have since rebounded. The gilt market is slowly waking from its slumbers.**

**The outlook for global private sector capital spending remains miserable.** The experimental monetary policies deployed by central banks over the past 8 years are killing off companies' desire to invest, other than for rapid payback. Corporate cash hoarding is a rational response to an economic environment in which **the prospective real returns to business investment are falling and highly uncertain**.

We prefer our **Financial Stress Index** to the popular financial conditions indexes, which misleadingly include currency movements. Stresses receded over the summer but are rising gently again, evidenced by the weakening relative performance of US insurance companies, flatter government yield curves, wider mortgage and swap spreads and rising commercial bankruptcies. ***There is no magic moment for financial stress: it will break on the unsuspecting world when it is good and ready.***

***Peter Warburton***
***27 September 2017***

Economic Perspectives Ltd
AW House, 6-8 Stuart Street, Luton, Beds, LU1 2SJ
T: 01582 696999
W: www.economicperspectives.co.uk E: peter@economicperspectives.co.uk