The Global Outlook

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Outline

- All major global engines are now firing.
  - US recovery is the longest post war expansion but recoveries don't die of old age. Typically, comes to an end with tightening.
  - Europe growing above potential – lending picking up from low levels and offsetting ECB tightening. Still plenty of slack in periphery.
  - China managing its slowdown to sustainable growth.
  - Commodity-intensive EMs like Russia, Brazil, and South Africa stabilizing. EMs better placed with lower trade deficits and higher reserves but political developments critical.
    - Brazil pensions

- Investment should pick up as labor markets get tighter.
- Apart from hard-to-gauge geo-political risks, key risks include
  - Disruptive monetary policy normalization – either too fast and too slow
  - Trade frictions
  - Clean-up in the Chinese financial sector
  - Risk of populist excess

United States

- Consumption has been leading growth so far.
- Business investment looking up as labor market tightens.
- Reforms
  - Bonfire of regulations, lighter enforcement
  - Tax reform– adds to corporate profitability, already growing by double digits
  - Infrastructure investment?
- Recovery long in the tooth. Typically ends with significant monetary tightening. Is that likely?

Should we expect higher rates?

- Labor market tight
  - Unemployment down, and across the world.
  - Shortage of skilled labor
  - Wage growth up 2.9 percent
  - Core inflation up 0.35 % m/m in January
- Tax reforms good for long term, but timing poor, and worse on fiscal discipline: fiscal deficit 6% in 2019 and 2020
- Fed likely to continue tightening
  - Front of mind – growing inflationary pressures
  - Back of mind – financial sector risk taking

Market adjustment

- Leverage high because of long period of accommodation:
  - Covenant lite loans
  - Withdrawal of liquidity could create financial stress
- Markets not fully absorbed change in central bank behavior
  - Risk spreads widen as search for yield lessens. Risky asset prices will adjust.
  - Central bank put less needed as growth picks up.
- Volatility as the market adjusts

Risks

- Monetary policy will normalize steadily, with greater risk that central banks will fall behind than they will move too fast
  - Asymmetric aversion to moving too fast
  - Not hyperinflation but some disruption

- Trade
  - US tax reforms add to stimulus
  - Trade deficit will grow
  - Blame it on unfair trade
    - Section 201 safeguards: Tariffs against solar cells and washing machines
    - Section 232 national security: Tariffs/quotas against aluminum and steel
    - Section 310 unfair trade practices: China forcing firms to share IP
    - NAFTA: 3-4%
- Retaliation?
- Other protectionist moves to raise tariffs...

Risks

- China
  - Shift towards sustainable growth
  - Deleveraging financial sector especially shadow financial system
    - Many bonds issued by local government vehicles due from this year
    - Raising cost of short term financing to curb issuance of wealth management products curbed
    - Fast growing private companies – Anbang, Dalian Wanda, Fosun, and HNA curbed
  - Once again risks of moving too fast or too slow
  - Growing authoritarianism may be problem for medium term

Risks

- Growing inequality and rise of populism
  - Solutions are hard and long term
  - Political pressure for solution is today
  - How do we prevent the present from becoming the enemy of the future.

Bottom Line

- Recovery broad based
  - Investment picking up
  - Productivity growth still tepid
- Interest rates will go up
- Elections (Italy, Brazil) will make year interesting
- Fix the house while the sun is shining.