momentum
investments

The Macro Research Desk

Herman van Papendorp
(Head of Investment Research and Asset Allocation)

Sanisha Packirisamy
(Economist)

Economic outlook for 2018: The global economy is flying, but politics could induce turbulence

Highlights

- The stage looks set for a synchronised expansion to continue in the world economy in 2018.
- Political instability could upset the global growth apple cart should geopolitical risks materialise.
- Modest monetary policy tightening is anticipated, in response to closing output gaps and stable inflation expectations.
- United States: Gradual monetary policy tightening is needed to match improving growth dynamics and a modest rise in inflation.
- Eurozone: The monetary policy stance is likely to become less dovish, in line with firm growth momentum. Nonetheless, muted inflation expectations are expected to delay interest rate hikes to 2019.
- United Kingdom: Stagflation conditions, amid Brexit uncertainty, should result in a more hawkish central bank.
- Japan: Without sustainably higher inflation, satisfactory growth prints will not be enough to redirect policymakers from a path of ultra-easy monetary policy.
- Emerging markets: A mild commodity price upturn and improving fundamentals should underpin a stabilisation in growth, as long as developed market central bank intentions are clearly signalled.
- China: A gradual growth slowdown is expected, as authorities shift their focus to improving growth quality. Officials have sufficient policy space left in the event of a negative growth shock, but they will remain careful to prevent financial vulnerabilities from turning into systemic financial risks.
- South Africa: The outcome of the ruling party's 54th National Conference has rekindled hope for sufficient reform to propel the economy to a higher growth plane over time. Resilient global growth and a modest recovery in commodity prices should help real growth reach close to 1.5% in 2018, with the domestic demand trajectory relying heavily on the extent of the recovery in sentiment. Even after factoring in a mildly depreciating currency trajectory from current levels, inflation should still remain comfortably within the target band in upcoming months, potentially leaving room for further modest monetary policy easing in 2018.

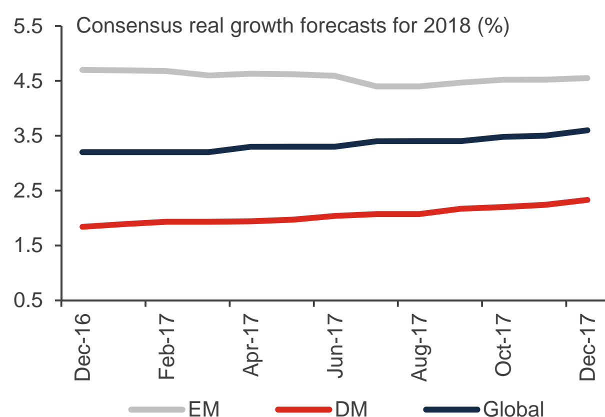
The global economy is likely to remain resilient in 2018

One of the biggest surprise factors for investors in 2017 was the strength and resilience of the global economy. Investors ended 2016 on a gloomy note, expecting the world economy to expand at only 3.1% in 2017. However, by December 2017, expectations had improved to 3.6% (see chart 1), largely owing to a more robust growth outcome in developed markets (DMs).

Global growth broke out of the doldrums in 2017, recording its best return since 2010. 2017 was characterised by a perfect 'Goldilocks' combination of improving global growth, low inflation and accommodative monetary policies, which led to robust returns from risky investments, while volatility remained close to all-time lows.

The stage looks set for a continued, broad-based expansion in the world economy in 2018. Falling unemployment, diminishing output gaps, reduced deleveraging pressures, more supportive fiscal policies and well-behaved inflation are expected to boost many DMs, despite a gradual removal of the monetary stimulus punchbowl, while improving fundamentals and firmer global trade should further contribute to a stabilisation in emerging markets (EMs).

Chart 1: Better DM prospects contribute to uplift in global growth estimates



Source: Bloomberg, Momentum Investments

Even without the Republicans' first legislative victory (namely drastic changes to the tax code) under United States (US) President Donald Trump's administration, growth looks robust. Despite a maturing business cycle, Bloomberg estimates the risk of an imminent recession at only 15%. A further improvement in wealth conditions, favourable growth in real wages and encouraging jobs growth (higher than what is needed to counter inflows into the labour pool) remain supportive of consumption spend, while high capacity utilisation rates should drive up capital expenditure.

Goldman Sachs estimates the changes to US fiscal policy (including changes to the tax legislation) could boost growth by 0.4% in 2018 and 2019. There is a risk, however, that instead of boosting business investment, firms could redirect these savings into higher corporate dividends or expensive merger and acquisition (M&A) activity. Momentum Investments expects real growth in the US to improve to around 2.5% in 2018 from a projected 2.3% in 2017.

Although the changes to US tax legislation should add to private consumption, they have been criticised by many, given that the bulk of the tax cuts benefit big business and families in the top-earning quintile, contributing to a more unequal society in the long run. Additionally, the Joint Committee on Taxation predicts the tax changes will contribute US$1 trillion to US public debt in the next decade, dampening longer-term growth prospects.

A solid expansion is expected in the Eurozone (from an estimated 1.8% in 2017 to around 2.2% in 2018), supported by similar factors that boosted conditions in 2017. Lead economic indicators in the Eurozone point to an ongoing recovery, even in those economies that had to be rescued during the Eurozone debt crisis. Should Greece exit its bailout programme, as intended in August 2018, Pricewaterhouse Coopers (PwC) notes this year will mark the first, since 2009, where no Eurozone economy is under International Monetary Fund (IMF) surveillance.

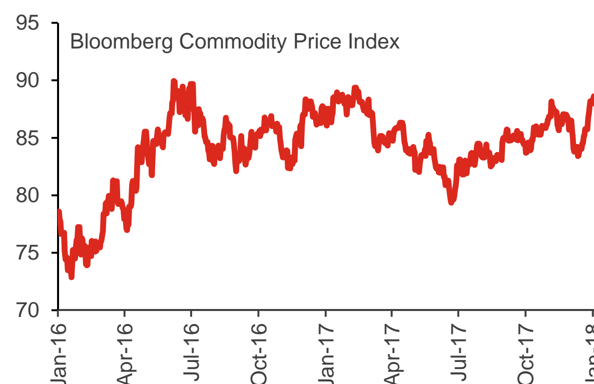
Although Brexit uncertainty lingers and rising inflation continues to squeeze household incomes, the strength of the global economy will likely limit growth weakness in the United Kingdom (UK) to just above 1% in 2018 from a projected 1.5% in 2017.

Japan's growth could slow somewhat from an estimated 1.7% in 2017 to around 1.5% in 2018, should government decide against renewing its fiscal stimulus and as structural headwinds persist. However, resilient private demand, continued exports and infrastructure projects ahead of the 2020 Olympic Games should prevent a sharp slowdown.

Meanwhile, a recovery in EMs is likely to be sustained by a further improvement in fundamentals, a smooth normalisation in DM monetary policy and a 20% increase in the Bloomberg Commodity Price Index since January 2016 (see chart 2). Nonetheless, countries experiencing political unrest, including the Middle East, parts of Latin America and Sub-Saharan Africa, will likely continue to lag the global growth performance.

Growth in China slowed since 2013, consistent with authorities acting on overcapacity in highly polluting industries and overheating construction and housing markets. Growth is expected to slow in coming years, as policymakers work to prevent financial vulnerabilities from turning into systemic financial risks. Momentum Investments expects growth to average around 6% in the medium term, with a reasonable likelihood government will employ macroeconomic stabilisation tools if growth threatens to trend below this level. Ongoing efforts to address structural reforms and cultivate innovation (research and development spend has more than doubled as a share of gross domestic product (GDP) since 2000) are likely to produce healthy growth returns in the medium to long run.

Chart 2: Global commodity prices are 20% higher than their January 2016 lows



Source: Bloomberg, Momentum Investments

Despite an ongoing improvement in world growth, global income inequality continues to rise and productivity growth remains weak. Without sufficient reforms improving gains in productivity, longer-term global growth is unlikely to sustainably reach levels seen before the global financial crisis, and the worldwide challenge of youth unemployment is likely to remain unresolved.

Politics could upset the global growth apple cart

An upside scenario to Momentum Investments' base case (outlined above) is one in which US tax cuts and a boost in infrastructure spend trigger a reflationary environment. While Momentum Investments' base case and upside scenarios suggest good news is set to continue on the economic front, politics could create some turbulence in a downside scenario and may derail the momentum behind the global economic recovery.

Though globalisation, free markets and free trade have persisted for decades, rising populist sentiment threatens this status quo. The victory of centrist French President Emmanuel Macron and the re-election of German Chancellor Angela Merkel may have suggested the populist wave had receded in 2017, but Bloomberg suggests election results across 22 European countries show populist support at its highest in the past thirty years.

With a number of anti-globalists coming into office during the past months, talk of increasing trade barriers and deporting migrants has increased, threatening the growth outlook for the global economy.

Although 2017 proved to be a tumultuous year for elections, the election calendar looks equally busy for 2018. Italy kicks off the political year in March, while Germany has not yet managed to form a governing coalition since its elections in September 2017. Voters in the Netherlands and Italy will also go to the polls in March, followed by elections in Hungary and Paraguay in April. Colombian elections are scheduled for May, while South Korean and Mexican electorates have a chance to vote in June and July, respectively. The election calendar will remain hot in the fourth quarter of 2018, with corruption-ridden Brazil expected to hold an election in October, followed by scheduled US mid-term elections

in November. Finally, although Turkish elections are set for 2019, there is a significant risk elections could be brought forward into 2018.

Rising protectionism could raise inflation more sharply through more onerous tariff arrangements, while geopolitical instability could dash consumer and business sentiment, weighing negatively on growth. The standoff between Trump and North Korean leader Kim Jong Un could result in further conflict, while power struggles could flare up again in the Middle East.

Moreover, the unpredictability of the direction in governments' trade policies increases the downside risk to trade growth, which has resumed in recent months (see chart 3). In the US, Trump clearly favours a more protectionist future. He abrogated the Trans-Pacific Partnership (TPP) agreement in early 2017 and is forcing a renegotiation of the North American Free Trade Agreement (NAFTA), in what he believes is an effort to save US manufacturing jobs.

In Europe, the UK still requires a reasonable Brexit deal with the European Union (EU) to preserve trade relations.

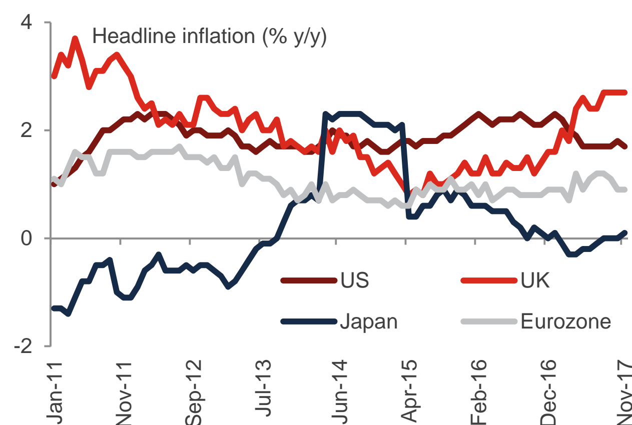
Chart 3: More protectionist behaviour poses a threat to the recent uptick in global trade activity

Source: Bloomberg, Momentum Investments, data up to September 2017

Global policymakers moving towards a reduction in monetary policy accommodation

Low inflation prints have confounded DM policymakers (see chart 4), but even though it is likely it will be a few years until inflation (in particular core inflation, which excludes food and energy costs) exceeds the 2% target of DM central banks, policymakers are expected to take away the punchbowl slowly without disrupting the party.

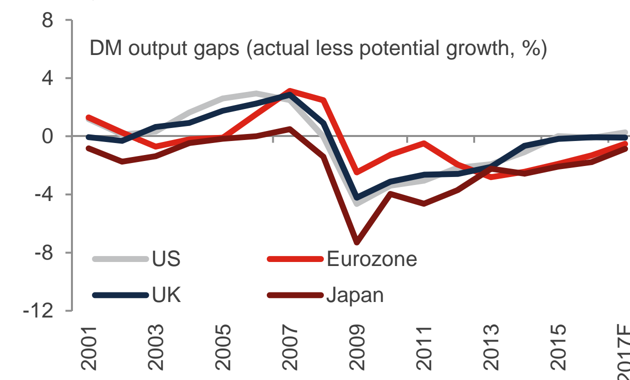
Chart 4: With the exception of the UK, DM inflation remains low despite improving growth and employment



Source: Bloomberg, Momentum Investments

Growth has performed better than expected, contributing to closing output gaps (see chart 5), and inflation expectations have stabilised. Import price weakness, positive shocks to aggregate supply and the effect of lower commodity prices, which drove inflation lower previously, are diminishing. However, factors such as automation should create a ceiling for rising inflation. Global Purchasing Managers' Index readings show input and selling prices are lifting. Although the increase in wage growth has been sluggish, impressive employment growth, in the US in particular, suggests wages should underpin higher inflation. Moreover, closing output gaps should contribute to higher core inflation during 2018.

Chart 5: Improved growth has led to a narrowing in DM output gaps



Source: Bloomberg, Momentum Investments

As such, this is a period PwC dubs "the beginning of the end of easy policy". This will be accentuated further if the European Central Bank (ECB) likely joins the US Federal Reserve (Fed) by the last quarter of 2018 in not expanding its balance sheet any further. The Fed, although guided by a new chair, is likely to continue along its path of monetary policy normalisation. Momentum Investments expects up to three 25-basis point increases in the Fed funds rate in 2018 and a further shrinking of the balance sheet.

In response to solid growth, the ECB is halving its asset purchases to €30 billion a month in 2018, but, given low inflation and the likelihood price pressures will remain low for most of 2018, the ECB will likely only tighten interest rates in 2019.

Stubbornly low inflation points to lower interest rates for longer in Japan. However, there is a chance the Bank of Japan (BoJ) may choose to reconsider its ten-year target under its yield curve control policy, in reaction to firmer growth.

Contrary to inflation dynamics within the remainder of the DM composite, inflation pressures have increased considerably in the UK (see chart 4), owing to Brexit-induced sterling weakness. Despite a soft growth outlook, the Bank of England (BoE) may be forced to hike interest rates at least once in 2018 to combat rising inflation, which has eaten into consumers' purchasing power.

Similarly, financial conditions are tightening in China. Policymakers have clamped down on shadow financing and credit growth has fallen to its lowest rate in almost a decade. Monetary policy is expected to remain stable in 2018, although Chinese authorities could step in should growth slide below 6%.

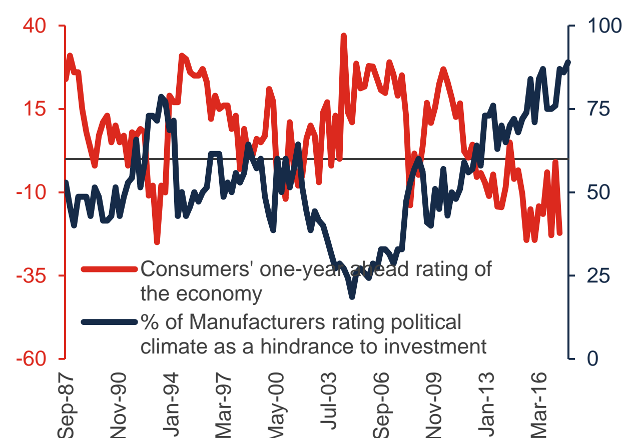
A cross-slate top leadership team could delay structural reform in South Africa

Cyril Ramaphosa's victory in the December 2017 African National Congress (ANC) presidential race at the 54th ANC National Conference was widely welcomed by investors. However, a draw for the top-six positions between Ramaphosa's camp and that of opponent Nkosazana Dlamini-Zuma renders an uncertain outcome for the timing and extent of structural reforms necessary to avert a further ratings downgrade.

While the results of the National Conference could resuscitate downtrodden consumer and business sentiment (see chart 6), sustainably higher confidence levels will depend on the ability of the new leadership to rebuild trust between government and the private sector. Ramaphosa's involvement could prove beneficial in restoring confidence, given his background in trade union movements and his previous participation in the private sector. Higher confidence will further be subject to a commitment to fiscal discipline and raising fiscal credibility through improving the efficiency of public spending, tackling state capture and addressing the governance and financial problems in South Africa's (SA) state-owned enterprises.

With the party under the control of Ramaphosa and government under the control of President Jacob Zuma at the time of writing, the two centres of power could disrupt policy and economic progress, leaving SA in a state of policy paralysis. Potential trade-offs between key policy objectives supported by the two factions could further compromise SA's economic trajectory.

Chart 6: SA consumer and business confidence dashed by political and economic uncertainty



Source: Bloomberg, Momentum Investments, data up until December 2017 (consumer data up until June 2017)

While an early recall of Zuma before the end of his term would likely be viewed as positive by the market, this would require the consent of the Zuma faction. Moreover, the stakes remain high in the run up to the 2019 national elections, where the ruling party faces

threats from opposition parties, including a more populist left led by the Economic Freedom Fighters (EFF).

Although SA still has the ability to hold free and fair elections, an assault on democracy has occurred through a violation of public trust in the form of rampant state capture and a deterioration in some of SA's key democratic institutions, including the finance ministry, the state prosecutor, the public protector and the country's tax authorities.

The extent of the anticipated growth recovery in 2018 and the outlook for SA's sovereign ratings will depend on whether or not officials will adopt and enact policies to enhance the country's creditworthiness. Unfortunately, even if fiscal consolidation efforts are announced in the February 2018 national budget, significant fiscal challenges remain. Moreover, a higher growth path is still needed to curb SA's debt-to-GDP profile in the medium term, as well as to make inroads into high levels of unemployment and poverty, suggesting the country could remain in sub-investment grade for some time.

A worse outcome of the National Conference (namely a slate solely comprised of Dlamini-Zuma's supporters) would have likely tumbled confidence. However, the actual mixed bag result (particularly with the appointment of Ramaphosa in the top position), as well as a number of institutional strengths (including independent courts, a respected central bank, good infrastructure, a lively political opposition and free media) suggest SA is unlikely to face a rating downgrade spiral.

Resilient global growth and a modest recovery in commodity prices, underpinned by firm Chinese growth activity, should help real growth in SA reach close to 1.5% from below 1% in 2017 through a lift in exports, whereas the domestic demand trajectory will rely on the extent of the recovery in sentiment. A more convincing pick up in business confidence could provide an upside risk to investment growth, although this is more likely after the 2019 national elections, when policy uncertainty should recede somewhat.

A Ramaphosa victory led to a significant strengthening of the rand, on raised hopes of a growth revival through a greater chance of economic reform. With the rand likely pricing in a fair amount of good news already, a delay in the implementation of structural reform could see a reversal in the rand's recent rally. Given the reality of a split top six in the ANC National Executive Committee, there is a reasonable likelihood of more compromised outcomes in economic policy decision-making.

The local unit remains vulnerable to negative swings in global and local sentiment. A sharper-than-expected slowdown in China or a faster pace in DM monetary policy tightening could trigger EM-wide currency weakness, whereas a perception of a shift to the left in SA policy, to appease a disgruntled electorate, could see the rand weakening in isolation. Taking this and the expectation of a resilient global economy into account, Momentum Investments expects some depreciation in the currency during 2018 and 2019.

Even after factoring in a mildly depreciating currency trajectory from current levels, inflation should still remain comfortably within the target band in upcoming months. Although the SA Reserve Bank already reduced its repurchase rate from a recent 7% peak to 6.75% in July 2017, falling inflation potentially leaves room for further modest monetary policy easing in 2018. Momentum Investments only sees space for up to 50 basis points worth in interest rate decreases (two cuts of 25 basis points each, at the most), given the medium-term outlook for inflation and political uncertainty, as the 2019 national elections draw near.

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