"A truly stable system expects the unexpected, is prepared to be disrupted, waits to be transformed"

Tom Robbins

Economic Outlook – June 2017

Monthly highlights: Global activity and trade remain robust, with some nuances

Our forecast for 2017 global GDP* growth of 3.5%, up from 3.1% in 2016, reflects strengthening global trade across a number of regions. As a result, we have raised our 2017 trade growth forecast to 5.4% (from 5.0%) – a sharp pick-up from a 1.6% pace in 2016. Global indicators also continue to point to strong activity, with the composite Purchasing Managers' Index (PMI) close to a two-year high. Beneath the headlines, there are some nuances. US 'soft' data have cooled, as expectations of major tax reform and infrastructure spending have ebbed. Growth still looks likely to pick up in 2018, reflecting a modest fiscal boost, but the risks are tilted to the downside. The global upturn also remains vulnerable to moderating Chinese growth and to a slippage in commodity prices. On our baseline view, however, growth should remain healthy and inflation is expected to pick up gradually. Against this backdrop, the US central bank looks set to proceed with further gradual rate rises and balance sheet normalisation.

After a typically slow start to the year, the US economy looks to have rebounded in Q2. Income growth should continue to support consumer spending, given the strength of the labour market. Business investment is rising, thanks to the global backdrop and a pick-up in energy activity. We anticipate GDP growth of 2.2% this year, rising to 2.7% in 2018 on the back of a modest fiscal stimulus package. After peaking in February at 2.1%, annual inflation on the Federal Reserve's (the Fed's) preferred personal consumption expenditures (PCE) measure has softened. In our view, a significant share of the recent deceleration is due to the impact of a steep drop in the prices of wireless telephone services. We expect headline PCE to rise to just below 2% in 2018, as this transitory drag dissipates and remaining spare capacity is used up. With gradual balance-sheet normalisation likely to begin in September, we anticipate a further rate rise in December and three more next year.

In the UK, we have lowered our 2017 GDP growth forecast to 1.7% (from 1.8%). Annual consumer price inflation (CPI) has risen to 2.9%, a four-year high. Partly as a result, three of the Monetary Policy Committee's (MPC's) eight members voted to raise rates this month. But signs that the forces underpinning inflation are gradually retreating, with producer price inflation and activity both slowing, point to a likely peak in CPI inflation of just above 3% shortly. So we continue to expect the MPC to remain in 'wait and see' mode on rates through to end-2019. The general election resulted in a hung parliament, with the Conservatives the largest party but lacking a majority. Increased uncertainty may weigh on activity, but the possibility of more growth-friendly fiscal policies and a 'softer' Brexit could represent upsides – though it is still too early to draw firm conclusions on either count.

The Eurozone's economic recovery has gained further momentum, as suggested by the survey data in May. The prospects for GDP growth this year and beyond remain upbeat. We expect growth to be more broad-based than in 2016, when household spending was the key driver. Healthier global demand should continue to benefit exports over the rest of this year, though a stronger euro is likely to temper any further significant gains. Meanwhile, business confidence and investment are likely to be supported by a perceived reduction in 'populism risks' following President Macron's election successes in France. Relatively low and stable core inflation continues to ease pressures on the ECB to adopt a faster path for policy normalisation, despite the improving economic outlook. We still expect the ECB to taper asset purchases around the turn of the year and to keep interest rates on hold at current levels until end-2019.

In Japan, we still expect the economy to grow 1.4% this year and 1.3% in 2018. While the rebound in household spending was more muted than previously estimated, business investment was revised higher. Moreover, the solid outlook for exports remained intact, supported by momentum in global demand and a weaker yen. Encouragingly, business confidence and capital investment intentions have been improving steadily since the beginning of this year. We also expect domestic demand to become an increasing driver of growth, reflecting a boost to government infrastructure spending and rising cash handouts. Despite tighter labour market conditions, real earnings fell in April and the inflation outlook remains subdued. With inflation forecast to miss the Bank of Japan's 2% inflation target in both the short and medium term, we expect the central bank to maintain its 'easing' policy bias and 10-year government bond yield target of 0%.

Emerging markets (EMs) are continuing to benefit from the global upturn in trade since mid-2016. China lies at its heart, accounting for up to 70% of the recovery when both direct and indirect effects are accounted for. On the latter, stronger Chinese demand has contributed to an improving trade performance by its Asian trading partners, commodity exporters and the developed world. But while most EMs are more resilient than in the past, there are risks. These include high corporate debt and non-performing loans in some countries. China-related risks also present a headwind to EM prospects. China's authorities have responded to their own financial-sector risks with some policy tightening, but we do not expect substantial moves in this direction ahead of the National Congress – a leadership transition event – in the autumn.

Luke Bartholomew
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1. GDP=Gross Domestic Product, the total value of all the finished goods and services produced in a country annually.

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Economic Outlook – June 2017

Monthly issue: Curve ball

Governments aren't the only things proving to be less than strong and stable these days. Take the Phillips Curve, which describes the relationship between unemployment and wage growth. As unemployment falls, using up spare capacity in the labour market, it makes intuitive sense that wage growth starts to pick up. Given the key role played by wage growth in economy-wide inflation, central banks look to the Phillips Curve when they set interest rates. Over the past few years, however, the curve has been remarkably flat: unemployment has fallen but pay pressures have remained very subdued. In the UK, the pace of wage growth is similar now to when unemployment peaked in 2011, despite the fact that 2.7 million jobs have been created in the meantime. Unemployment rates in the US, Japan and Germany have also fallen to historic lows without sparking a rapid pick-up in pay pressures.

So why is the Phillips Curve flat? Three explanations spring to mind. First, the move by central banks to inflation-targeting, alongside a prolonged period of subdued inflation, may have "anchored" workers' inflation expectations at low levels even as labour markets have tightened. Contrast this with the 1970s, when very high rates of inflation and lack of policy-making credibility steepened the Phillips Curve. Back then, workers factored high rates of expected future inflation into pay bargaining, underpinning strong wage growth despite rising unemployment. Second, productivity growth – a key determinant of companies' ability to reward employees – has been persistently weak. Finally, there are structural reasons behind the flattening of the curve. Technology and globalisation may have weakened workers' bargaining power. Increased "casualisation" of the labour market may also have played a role. 13.5 million UK workers, accounting for 43% of the labour force, are now self-employed, in part-time or temporary work or on zero-hours contracts. This is an increase of 3.5 million workers since 2000, according to Bank of England estimates. Similar structural trends can be observed in other economies.

So far, central banks have responded to the flat Phillips Curve by holding interest rates at historically low levels. After all, in the absence of an obvious acceleration in wages and prices, why do anything else? But there are signs that some, at least, may be changing their tune. The Bank of England's Monetary Policy Committee surprised observers recently when three of its eight members voted for an immediate rate rise. European Central Bank (ECB) President Draghi has become more confident about the Eurozone's prospects, declaring that "deflationary forces have been replaced by reflationary ones". And at its latest meeting, the US Federal Reserve (Fed) increased interest rates for the second time this year, while maintaining its prediction of another rate rise by end-2017. It also unveiled a detailed plan to begin unwinding its balance sheet in the months ahead. This was despite a run of weak inflation numbers, which the Fed has put down to temporary factors.

How are investors reacting to this apparent change of tone? So far, they have remained fairly sceptical. Following the Fed's 14 June announcement, the market-implied probability of another rate rise this year remained below 50%. In a sign that the inflation data are weighing on markets' minds, break-even rates – giving a measure of the inflation rates expected by investors, as implied by the difference between inflation-proof and conventional government bonds – fell sharply. At the same time, the US yield curve flattened. Following Mr Draghi's comments, bond markets have sold off a little, raising yields, but the moves have so far been modest.

You can hardly blame markets for their caution. After all, the Fed has undershot its inflation target consistently over the past five years. Investors may also be sceptical of Fed Chair Janet Yellen's assertion that the 'normal' Phillips Curve "remains at work". In their favour, some of the structural reasons for a flat curve – technology, casualisation – appear persistent. However, Ms Yellen can draw on two arguments. First, there is the "give it time" argument: that the official unemployment rate is an imperfect measure of developments in the labour market, and other, broader measures (such as the difficulty that firms report in hiring workers, or the rate at which workers are quitting their jobs) are taking longer to tighten. Second, there is the "just around the corner" argument: if unemployment falls much further, the curve could steepen sharply as the lack of spare resources triggers a sudden burst of wage and price inflation. This is all very well in theory, investors might counter, but for now the reality is that the curve remains stubbornly flat.

So what are the implications for investors? Given the divergence between the Fed and markets, the latter are vulnerable to 'unexpected' monetary tightening if central banks' determination proves stronger than markets currently bargain for. Even if the Fed is wrong on the Phillips Curve, there could be a sting in the tail for investors over the longer term. In a world where labour remains surprisingly cheap, firms have less of an incentive to invest in capital. If future investment trends disappoint, productivity and economies' growth potential may do the same. **As unemployment rates continue to fall, therefore, we should all be watching the curve: remain flat, normalise or steepen?**

Lucy O'Carroll
Chief Economist – Aberdeen Solutions

Economic Outlook – June 2017

Headline forecasts

	2016	2017	2018	2019	2016	2017	2018	2019
	GDP Growth (annual % change)				Consumer Price Inflation (annual % change)			
World[1]	3.1	3.5	3.7	3.6	2.7	3.0	2.9	2.9
US	1.6	2.2	2.7	1.8	1.3	2.1	1.9	2.0
Eurozone	1.7	2.0	1.6	1.4	0.2	1.6	1.5	1.8
UK	1.8	1.7	1.4	1.6	0.6	2.8	2.0	1.6
Japan	1.0	1.4	1.3	1.0	-0.1	0.5	0.8	1.2
China	6.7	6.6	6.1	5.8	2.0	1.9	2.6	2.8
World trade volumes	1.6	5.4	3.4	3.7				
Brent Crude Oil price ($pb)	44	52	52	59				

1. Measure based on 2005 purchasing power parities, a technique used to determine the relative value of different currencies.
$pb refers to US dollars per barrel.

	2016	2017	2018	2019	2016	2017		
Official Interest Rates (end period, %)[2]					Q4	Q1	Q2	Q3
US	0.50	1.25	2.00	2.75	0.50	0.75	1.00	1.00
Eurozone	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
UK	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
China	4.35	4.35	4.60	5.60	4.35	4.35	4.35	4.35

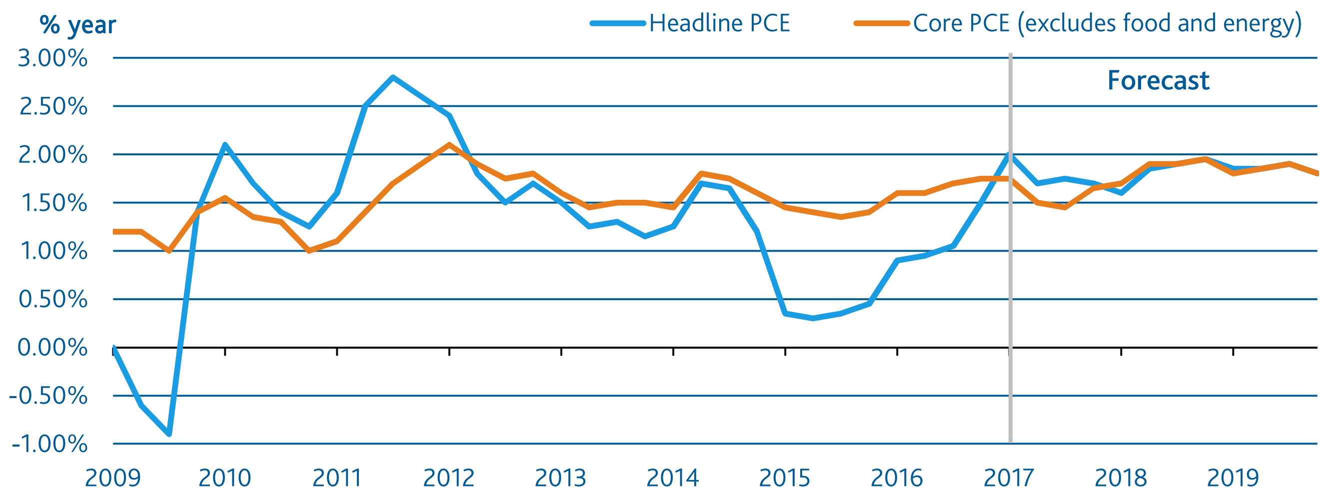
2. US: Federal Funds rate lower bound; Eurozone: European Central Bank interest rate on deposit facility; UK: Bank of England Bank Rate; Japan: interest rate on the 'policy-rate balance' component of the current accounts held by financial institutions with the Bank of Japan; China: People's Bank of China one-year benchmark lending rate.

	Overall policy bias	Short term interest rates	Balance sheet policy (size and flow)	Credit policy (e.g. term lending)	Other instruments
Dimensions of monetary policy[3]					
US	Tightening	Higher	Smaller	N/A	N/A
Eurozone	Easy	Neutral	Bigger (but slower expansion)	Neutral	Forward guidance
UK	Neutral	Neutral	Neutral	Neutral	N/A
Japan	Easy	Neutral	Bigger (but slower expansion)bias	Neutral	Yield curve control unchanged
China	Tightening	Higher	N/A	N/A	Macro-prudential tightening

3. Central banks are using a plurality of tools to influence monetary conditions. These tools include short-term interest rates, balance sheet policy, credit policy such as subsidised lending to banks, and a range of other instruments including macro-prudential policy and yield curve control. Table illustrates our opinion of the bias of central banks along these dimensions, over the next year.

Forecast source: Aberdeen Asset Management as at 13 June 2017. Forecasts are to the end of the calendar period. Forecasts are opinion only, cannot be guaranteed and should not be relied upon when making investment decisions.

Chart of the month: Headline and core personal consumption expenditures (PCE) prices



Source: Oxford Economics, 13 June 2017.

US fundamentals still healthy, prompting further gradual Fed tightening

- After a typically slow start to the year, the US economy looks to have rebounded in Q2. Economic fundamentals are reasonably healthy. Income growth should continue to support consumer spending, given the strength of the labour market. Business investment is rising, thanks to the global backdrop and a pick-up in energy activity.
- After peaking in February, annual inflation on the Fed's preferred PCE measure has softened. In our view, two-thirds of the recent deceleration is due to the impact of a steep drop in the prices of wireless telephone services.
- We expect headline PCE to rise to just below 2% in 2018, as this transitory drag dissipates and remaining spare capacity is used up.
- Against this backdrop, the Fed raised interest rates by one-quarter of one per cent on 14 June. With gradual balance sheet normalisation likely to begin in September, we anticipate a further rate rise in December and three more next year.

Contact details

Should you require any further information, please visit **aberdeen-asset.com** for details of your local Aberdeen representative.

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