Global Macro Views

"The World Still Spins"

April 2018

By: The Global Macro Committee

Rebecca Braeu, PhD, CFA; Rowena Geraghty;
Aninda Mitra; Vincent Reinhart; Nicholas Tocchio

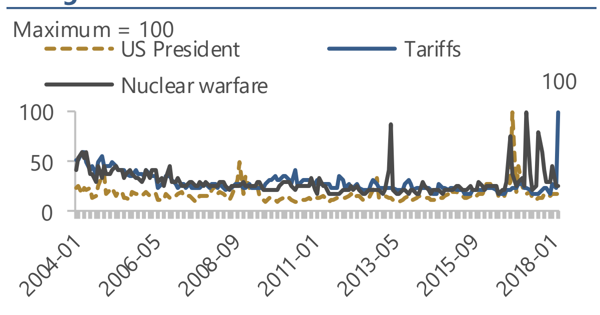
World:

	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	3.6%	3.7%	–	3.5%	–
Inflation	9.0%	8.4%	–	7.6%	–

Source: BNY Mellon AMNA, as of March 31, 2018

Running an economy with a market system or governing a country with checks and balances is hard to top as a principle of design. Prompted by action (and threat of more) on trade sanctions by President Trump, apparent worries about the global trading system are off the high end of the chart. News of high-level administration personnel separations (both voluntary and forced) clutter national headlines. And the supreme leader of an impoverished but nuclear-armed state traveled back and forth from Pyongyang to Beijing in an armored train to talk, perhaps, about summit meetings on arms control that subsequently were on, off, and on. Enumeration may help. Google web searches for "nuclear warfare," "tariffs," and "US government," with each normalized to 100 for its own maximum interest, are shown in the chart. The high-interest readings all cluster of late, hitting peaks in worrying succession.

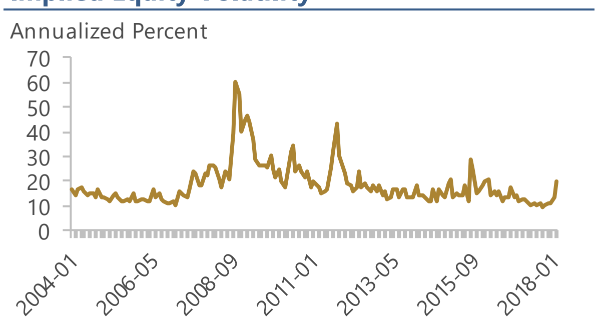
Google Search Interest



Source: Google Trends, accessed 3/31/18.

Still, the world reliably turned on its off-centered axis. Global equity markets traveled a rocky road, and their volatilities were volatile. On net, the S&P 500 Index® is off on the year but remains substantially higher than one year ago; its implied

Implied Equity Volatility



Source: CBOE, accessed via Bloomberg, 3/31/18.

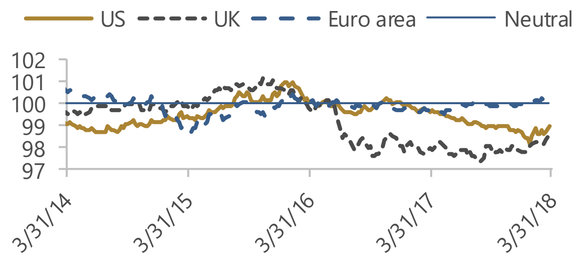
↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months – no bias
Inflation forecasts are yearly annual averages of headline CPI.

STANDISH
BNY MELLON AMNA

volatility is high in its five-year range but is not so forbidding further back than that. Financial conditions remain accommodative in the US and some other advanced economies and only recently moved barely to firm in the euro area.

Financial Conditions Indexes

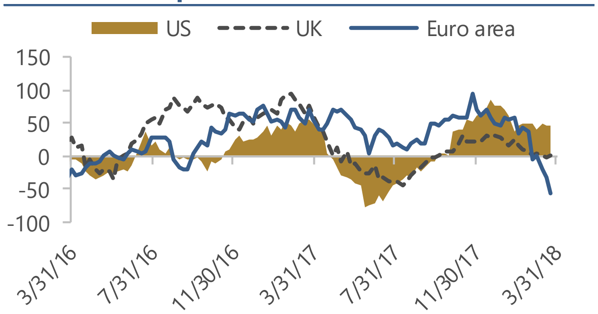
Neutral = 100



Source: Goldman Sachs, accessed via Bloomberg, 3/31/18.

US economic data mostly ran stronger than expected, and the list of policy stimuli is lengthening. There may be a drag from economic policy uncertainty, but the known headlines of tax reform, budget expansion, and regulatory relief have an obvious and material heft.

Economic Surprise Indexes



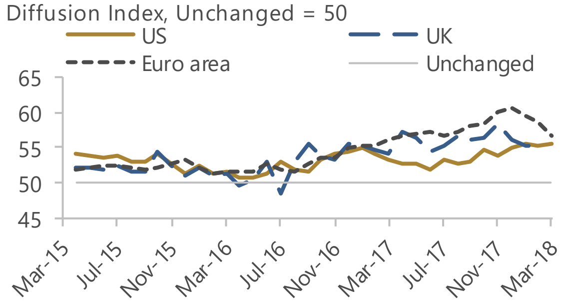
Source: Citigroup Markets, accessed via Bloomberg, 3/31/18.

Economic data in the euro area tended to disappoint, but this may be because forecasters got over this skis in light of the strong level of activity. Purchasing managers' spending intentions in advanced economies are decidedly upbeat.

The leadership of China is firmly settled and centralized to one person, President Xi. This political design matters over the medium- and longer-run pace and character of reform and the varieties of risk. For now, concentrated control can deliver economic expansion at or above target—remembering that the target is lofty. Enough global activity and finance (especially for commodity complexes and emerging market economies) gravitates to steady global growth. Perhaps this is how it starts, in that the longer-term consequence of a US looking more inward is that the rest of the world looks less to it.

Manufacturing Purchasing Manager Intentions

Diffusion Index, Unchanged = 50



Source: MARKIT, accessed via Bloomberg, 3/31/18.

↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months — no bias
Inflation forecasts are yearly annual averages of headline CPI.

STANDISH
BNY MELLON AMNA

Developed Markets:

United States	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	2.3%	2.6%	–	2.3%	–
Inflation	2.1%	2.3%	–	2.2%	–

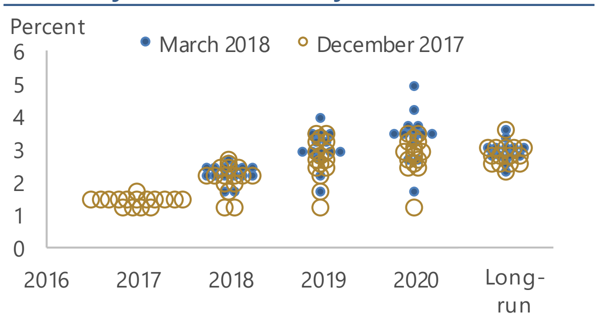
Source: BNY Mellon AMNA as of March 31, 2018

Work with economic data long enough and a certain acceptance creeps in. For reasons not obvious to anyone, including the agency responsible for collecting the information, real GDP growth slows markedly in the first quarter. As a measure of the stumbling at the gate, first-quarter growth averages 0.8 percentage points slower than the four-quarter growth ending that same quarter over the past twelve years. It is what it is, and it means GDP now casts in the neighborhood of 2 percent, consistent with underlying strength for the year. We had a first-quarter pothole in our outlook forever and finding it a little less jarring leads us to bump up the annual outcome, with real GDP expected to expand 2.6 percent this year.

Accommodative financial conditions, fiscal stimulus, and the synchronous pull of global growth supports US activity. Tax reform and regulatory relief may help the long-run growth of potential output, but such effects are slow to build, at best. In the interim, pressures on resources will intensify, and the unemployment rate will dip to close to 3.5 percent this year and next.

Cost pressures have also been slow to build, but it requires rewriting too many tenets of macroeconomics to forecast that they stay muted. True, inflation has been slow to materialize, but the US has not tarried in the region of excess demand for all that long. If our forecast of aggregate demand is right, the wrinkles and lines of age will show. We think consumer price inflation overshoots the Federal Reserve's goal of 2 percent by year-end.

Summary of Economic Projections



Source: Federal Reserve, https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20180321.htm

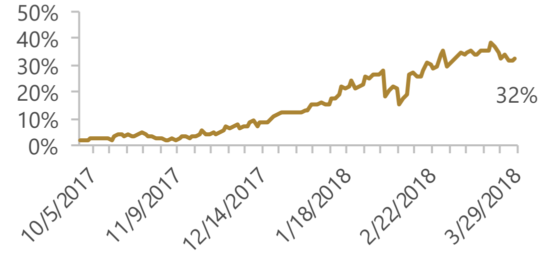
The news of late is that the Federal Reserve (Fed) thinks so too. In the latest Summary of Economic Projections, the median PCE inflation forecast almost touches 2 percent by the end of 2018 and then runs faster subsequently. Given the statistical wedge between the CPI and the Fed's preferred gauge, this implies that the former overshoots its mark. This must explain why so many Fed officials see their policy rate as also overshooting it long-run value. With all of the shifting of dots representing the appropriate year-end funds rate, the Fed was one participant away from a median of four moves this year. Moreover, the median answer for 2019 is the same as the long run. In 2020, the median fixes rates above its long-run value—they see policy as firming to the point of being firm.

↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months — no bias
Inflation forecasts are yearly annual averages of headline CPI.

Events of late make us more comfortable with our long-held call that the Fed tightens four times by 25 basis points each this year. After the last meeting, one is in the bag, but market participants are not quite there on three more. If our forecast works out and inflation materializes, that one-third probability in markets will head north will little need for Fed officials to work hard on guidance.

Probability of Four or More Fed Moves In 2018

Implied from Interest Rate Futures, Percent



Source: CME, accessed via Bloomberg, 3/29/18.

Euro Area	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	2.5%	2.2%	–	1.9%	–
Inflation	1.5%	1.4%	–	1.5%	↓

Source: BNY Mellon AMNA as of March 31, 2018

The euro area is growing robustly from the bottom up, as 2017 marked the quickest pace of expansion since 2007. Real GDP growth of 2.5 percent in 2017 is remarkable, as estimates indicate that potential GDP is growing at roughly half that pace. Still, despite the euro area having grown above potential for around four consecutive years, there remains little evidence of inflation pressures. To be sure, core inflation sits at just 1.0 percent as economic slack continues to weigh down price pressures. However, some marginal strength in underlying inflation exists in the industrial sector, as non-energy industrial goods (NEIG) sector price inflation marked 0.7 percent, which is 0.2 percent above the 10-year moving average. NEIG inflation is highly correlated with the exchange rate, and the 8.5 percent annual average appreciation of the euro on a trade-weighted basis by February will eventually weigh on inflation. For now, the strong manufacturing cycle dominates. The other weak link is wage pressures, which have been muted. However, given the outcome of recent negotiations, we expect some of the headline wage indicators to be more robust at the end of the year, supporting some price pressure from Germany at the margin. On the economic cycle, trade has been supportive of the manufacturing base in Europe and should remain so in 2018. We have confidence in the economic cycle in 2018; however, it was bound to slow down, as fiscal policy is no longer easing, and the exchange rate tightens financial conditions. Still, growth closes the output gap. Looking forward, the global risk and economic sentiment are likely to be drivers of the surveys, which have recently surprised to the downside.

The European Central Bank (ECB) is shifting policy to safeguard the path of inflation toward their goal of below, but close to, 2% over the medium term. According to Mr. Draghi, this convergence is increasingly uncertain, as cost pressures remain nascent at best and financial conditions tighten due to external factors. Moving forward, the ECB will place added emphasis on

↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months — no bias
Inflation forecasts are yearly annual averages of headline CPI.

backward-looking labor market data. Further, the Governing Council will recalibrate forward guidance to the *path* of short rates in order to strengthen the legacy guidance on timing the first rate hike, or the "well past" qualifier. This added dovish stance is likely to temper interest rate volatility in 2018, but we expect labor market conditions consistent with higher rate expectations emerge in 2019.

On a related note, the ECB is setting up to taper its net monthly purchases to zero by the end of the year. In fact, the ECB took firmer steps to policy removal as the Governing Council agreed unanimously to shift their language on forward guidance slightly to de-link the inflation outlook to the size and duration of the monthly asset purchases. This was a solid first step, and one that we expected.

Japan	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	1.7%	1.5%	↓	1.2%	↓
Inflation	0.7%	1.4%	–	1.7%	↓

Source: BNY Mellon AMNA as of March 31, 2018

Increasing domestic momentum amid a broadening, though maturing, global economic cycle should continue boosting private capital expenditure and household consumption. Moreover, recent (Shunto) wage negotiations indicate a larger, 2.2% year over year, upturn in wages than in recent years. These trends should remain underpinned in coming months by strong external demand, rising corporate earnings, and historically tight domestic labor markets. If so, this ensures another year of above potential GDP growth, and raises headline inflation to above the half-way point of the Bank of Japan's (BOJ's) 2 percent target Additionally, proactive fiscal spending, to offset adverse impacts from a further increase in GST, in October this year and the persistence of highly accommodative monetary policies should protect against cyclical setbacks.

Nonetheless, the medium-term sustainability of these trends is coming under a cloud. To be sure, early parliamentary elections in October 2017 had secured a crucial victory. This enabled the LDP party to maintain its supermajority status. It also assured investors of political continuity and open-ended support for reflationary "Abenomics" policies. Moreover, the re-appointment of Governor Kuroda at the helm of an even more dovish BOJ board underscored policy continuity until the expiration of his second term in 2023.

The recent resurgence of a corruption scandal involving the prime minister and his wife is likely, in our base case, to become a source of political distraction and cover-ups. In a worst case, it could undermine the government and the very foundation of Abenomics. It has already resulted in a plunge in the prime minister's approval ratings. Moreover, an unabated worsening of the trade conflict between the US and China could also spill over to Japan by way of supply chain linkages. Either of these risk trends could result in a much larger appreciation of the US dollar relative to the yen. These factors pose significant downside risks to growth and eventually to inflation as well (in 2019.) In this context, and on a risk-weighted basis, we now think it will take longer for yield curve control policies to attain the 2 percent inflation target. Therefore, any tweaks to yield curve control targets, or lowering "real negative" market rates, will not materialize

↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months — no bias
Inflation forecasts are yearly annual averages of headline CPI.

till 2019, or until it becomes clearer that domestic wage-price dynamics can de-couple from global risk factors and the dollar-yen cross.

United Kingdom	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	1.8%	1.6%	–	1.6%	–
Inflation	3.0%	2.5%	↑	2.5%	–

Source: BNY Mellon AMNA as of March 31, 2018

Following a hawkish signal at the February inflation report, we expect the Bank of England (BOE) to raise the key rate 25 basis points in May 2018. While in February the BOE kept rates on hold at 0.5 percent with a 9-0 vote, the MPC signalled that "rates may need to rise earlier, faster than seen in November." This was supported by upwards revision to growth, and some mechanical adjustments to inflation.

We continue to expect the BOE to hike four times over the next two years at 25 basis points each time—May 2018, August 2018, May 2019 and then November 2019. The timing of these hikes is deliberately chosen to avoid key Brexit crunch moments and would take the key rate to 1.5 percent. We also expect a timeline to unwind of the stock of QE holdings. This is more than currently priced by the market, particularly in 2019.

Our Bank of England view is predicated upon our Brexit base case where a deep and comprehensive trade agreement is put in place with the European Union (EU) when the UK exits the EU single market and customs union. However, such a deal is unlikely to be fully detailed and agreed by October 2018 (the logistically required deadline), so we instead focus on the transition phase, which we expect to be agreed on by end March 2018. We anticipate that this transition to be 3 to 5 years in duration (starting in 2019) and based on the status quo.

Australia and New Zealand:

Australia	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	2.3%	2.6%	↓	2.5%	↓
Inflation	1.9%	2.0%	–	2.1%	–

Source: BNY Mellon AMNA as of March 31, 2018

New Zealand	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	2.9%	2.6%	–	2.3%	–
Inflation	2.0%	2.2%	–	2.2%	↑

Source: BNY Mellon AMNA as of March 19, 2017

In Australia, the current environment of low wage growth and high household debt creates challenges for the Reserve Bank of Australia (RBA) to move monetary policy in either direction.

↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months — no bias
Inflation forecasts are yearly annual averages of headline CPI.

We expect the next move in the RBA cash rate to be up, not down; however, we don't expect a hike anytime soon.

Despite robust jobs growth in 2017, wage growth is not signaling a pickup. Even in territories with tight labor markets, like New South Wales where the unemployment rate has been below the estimate of NAIRU for a year, wage growth remains benign. Meanwhile, lower retail sales and savings rates may indicate downside risks to consumption. The RBA is reliant on public infrastructure spending and business investment to deliver on its growth expectations in 2018.

Inflation remains benign and should be tempered in 2018. The on-line retailer Amazon has only just entered the Australian marketplace, which will put downward pressure on prices for a time. We think Governor Lowe is sufficiently sensitive to financial stability and household debt such that he will not tighten on a theory that inflation will eventually pickup. With macroprudential already doing a degree of tightening for the RBA and a mortgage market that would be sensitive to higher rates, an "on-hold" stance seems appropriate over the balance of this year. In such circumstances, the Australian economy is allowed more time to generate better wage growth.

We think the economic fundamentals look stronger across the Tasman Sea. In New Zealand, a surprise election outcome resulted in a ruling Labour-Greens-NZ First coalition. As the new government has settled in, rhetoric has become more pragmatic and coherent. We expect business confidence to rebound from its slump late last year. Fiscal policy will be expansionary, the dairy industry is on better footing, and the labor market is tight. The Reserve Bank of New Zealand (RBNZ) estimates the economy to be operating at a slightly positive output gap, around 0.5 percent, and the unemployment rate is below NAIRU. We expect minimum wage increases to put upward pressure on income growth. On the whole, inflationary pressures look to be building. We would not be surprised to see the RBNZ begin to pull forward its timing for hikes.

Emerging Markets:

Asia:

China	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	6.9%	6.5%	↓	6.1	↓
Inflation	2.0%	2.6%	–	2.0	↓

Source: BNY Mellon AMNA as of March 31, 2018

China continues to benefit from last year's macro tailwinds, as well as improved global demand and an unexpected pick-up in real estate investment at the beginning of this year. Despite tight regulatory and credit conditions and the ongoing crackdown on shadow banking, PMIs remained stable and activity indicators surprised to the upside in the first two months of 2018. Moreover, the private sector seems to have repaired its balance sheet in the last 2 to 3 years and seems poised to benefit from the upturn in global trade and manufacturing activity. Due to these reasons, we are raising China's GDP growth forecast for this year by 0.2 percentage points to 6.5 percent year over year.

To be sure, our upward growth revision still constitutes a measured slowdown as the authorities have prioritized lowering financial risks and cleaning up the environment. In this structural

↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months — no bias
Inflation forecasts are yearly annual averages of headline CPI.

context, further capacity cuts in polluting industries, alongside slower lending activity and decelerating M2 growth to even below the pace of nominal GDP growth, should weigh on headline growth and keep liquidity fairly tight. However, a rotation in growth toward more labor-intensive services, high value-add exports, and more private manufacturing should keep China's economy from slumping. The recent National People's Congress (NPC) meetings underscore a tightening bias in regulatory and financial policies. In particular, the merger of banking and insurance regulatory bodies streamline wider oversight, and the appointment of Dr. Yi Gang, a protégé of Zhou Xiaochuan, as People's Bank of China (PBOC) governor highlights continuity in tight liquidity and gradual capital markets liberalization for ensuring balance of payments and overall financial stability.

The balance of risk to growth in 2018 and to inflation in 2019 remains stacked to the downside. This is because of a likely broadening of trade conflict and geopolitical contention with the US. In particular, the conclusion of section 301 investigations, on violations of intellectual property, could result in the imposition of tariffs of up to $60 billion on Chinese imports. So far, the Chinese response to protectionist rhetoric has been muted, even conciliatory behind closed doors. Nevertheless, a much more aggressive trade and geopolitical stance by the US (for instance, on the status of Taiwan) is unlikely to go unanswered by China, especially so in the aftermath of the additional political powers aggrandized by President Xi.

South Korea	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	3.0%	2.9%	–	2.8%	↓
Inflation	1.6%	1.9%	↓	1.7%	↓

Source: BNY Mellon AMNA as of March 31, 2018

Improving external, and especially tech, demand continues to spur a strong upturn in exports and investment. However, the external demand cycle is maturing and the offset from net exports to sluggish consumption spending, and construction activity will wane in coming quarters. High household debt and slow job growth continues to weigh down domestic consumption spending. Despite a large, 16 percent, increase in minimum wages at the start of the year, the lack of broader labor market reform will slow hiring and the economy-wide growth of wages. The recent thaw in relations with the North—following the PyeongChang Winter Olympics and expected de-nuclearization talks between Washington and Pyongyang—could buffer domestic sentiment. Moreover, a gradual reduction of tourism restrictions by China, in response, to earlier THAAD deployment by Seoul, would also boost tourism activity. But corporate investment is still set to slow on let-of-center policies pertaining to governance, taxation and investment. Alongside South Korea's aging demographics and the rising risk of Sino-US trade conflict, it will remain difficult for consumer prices to rise to the Bank of Korea's headline inflation target of 2 percent year over year. As such, we think the central bank will likely hike only one more time, against the 2 to 3 hikes priced in by the market.

↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months — no bias
Inflation forecasts are yearly annual averages of headline CPI.

India	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	6.6%	7.4%	–	7.6%	↑
Inflation	3.8%	4.4%	–	4.5	↓

Source: BNY Mellon AMNA as of March 31, 2018

The headwinds from the twin shocks of de-monetization and GST implementation continue to wane, and a domestic capital expenditure cycle is firming. However, we are marking down the country's growth rate by 0.2 percentage points, to 7.4 percent year over year in 2018, as export from volatile GST rates and higher oil prices result in a larger drag on net exports than previously anticipated. For the foreseeable future, lingering output gaps and better-managed food prices should keep inflation pressure well contained a bit above the Reserve Bank of India's (RBI's) 4 percent inflation target. We are penciling in a small increase in inflation to 4.4 percent year over year in 2018 and to 4.5 percent in 2019 on an anticipated pick-up in aggregate demand and slightly higher minimum support prices for key agricultural products. Notwithstanding the domestic political noise around GST implementation, a local bank fraud scandal, and recent growth setbacks, India's economic reforms are raising the level of formal activity, improving the business environment and, by the second half of this year, should begin speeding up insolvency procedures and shoring up tax revenues (as a percent share in GDP). The recent public sector bank re-capitalization package was well received by the markets and will set the stage of a sustained recovery of actual as well as potential growth.

Russia, Turkey, South Africa, CEEMEA:

Russia	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	1.8%	1.8%	↑	2.0%	↑
Inflation	3.8%	3.5%	↓	3.5%	↓

Source: BNY Mellon AMNA as of March 31, 2018

Turkey	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	7.0%	5.0%	↑	5.0%	↑
Inflation	11.0%	9.0%	↑	8.5%	↑

Source: BNY Mellon AMNA as of March 31, 2018

South Africa	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	0.9%	1.5%	↓	1.6%	–
Inflation	5.0%	5.0%	↓	4.5%	–

Source: BNY Mellon AMNA as of March 31, 2018

↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months — no bias
Inflation forecasts are yearly annual averages of headline CPI.

Poland	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	4.2%	3.5%	↑	3.0%	–
Inflation	1.8%	2.1%	↓	2.2%	–

Source: BNY Mellon AMNA as of March 31, 2018

Within CEEMEA, the main focus has been on South Africa. We have upgraded our growth forecasts for South Africa following Rhamposa's installation as President and delivery of both an impressive budget and cabinet reshuffle. While improvements in growth are mostly cyclical in nature (better sentiment amongst business and investment in the mining sector as the charter is removed), questions still remain on whether structural improvements may occur in the medium term. We await further clarifications from the new ministers to assess this. Fiscal finances look on a more assured footing as Rhamposa's first budget closed the fiscal gap left exposed under his predecessor Zuma and pointed to further actions on state-owned enterprises (SOEs) to be announced shortly. As inflation is likely to continue to undershoot South African Reserve Bank (SARB) estimates, we expect the SARB to act more dovishly than is currently priced by the market.

Russia will return Putin to office for another six years until 2024 after winning 77 percent of the vote. The key focus will be on Putin's choice of Prime Minister (PM) and whether he will signal a focus on structural reform. As per choice of PM, it is likely Putin will ask Medvedev to stay. And as Putin has yet to endorse any of the more radical reforms suggested by his advisor Kudrin, it doesn't seem that he will embark on wholesale structural reforms during this final term. Given that we expect political and policy stability following the election, we are not expecting much—if any—financial market reaction to this election. We continue to expect Russian local currency government bonds to outperform given we expect the central bank to react more dovishly than is currently priced by the market and our longer-term positive views of improving Russian macroeconomic fundamentals.

Latin America:

Brazil	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	1.0%	2.3%	–	3.0%	–
Inflation	3.1%	4.0%	–	2.2%	–

Source: BNY Mellon AMNA as of March 31, 2018

Mexico	2017	2018	Balance of Risks	2019	Balance of Risks
Real GDP Growth	2.0%	2.3%	–	3.0%	–
Inflation	6.4%	4.0%	–	2.2%	–

Source: BNY Mellon AMNA as of March 31, 2018

↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months — no bias
Inflation forecasts are yearly annual averages of headline CPI.