Is This As Good As It Gets?

By Brian Fabbri
Visiting Senior Research Fellow, CAMRI & President, FABBRI Global Economics

Economies are growing and stock prices are rising

The economies of the developed world have finally regained their momentum. In most of the developed world’s economies, employment has been rising well above previous highs, and unemployment rates have been depressed down to full employment estimates. Perhaps in anticipation of these positive economic developments, equity markets throughout the developed world have climbed to new record heights.

Of course global investors in the economically-developed world have had few alternatives to invest in. Bond rates have been meager everywhere and offer unattractive returns relative to stocks. This positive global economic performance has been partially dependent upon the unnaturally low central bank rates, which have supported economic growth, stimulated equity price appreciation, and anchored long-term interest rates at uncommonly low levels.

Sovereign bond yields are very low
Growth in spite of Trump

The US economy and its equity markets have performed admirably in spite of the failure of the Trump administration to legislate any of his improbable economic agenda. The equity markets continued their long upward march throughout this year brushing aside the many international and political risks that have been manifest since the beginning of the year. It would seem that the US economy and the US equity markets have become immune to the daily outpouring of political drama currently emanating from Washington.

Ironically, equity market measures of risk have been subdued in defiance of the recent provocative media pronouncements. Consequently, stock price volatility has been depressed. Investment gurus, who had predicted rising equity returns in 2017 based upon the legislation of the Trump economic program look quite foolish. Had the upward surge in equity prices in 2017 truly been dependent upon Trump’s economic policies, they would have plummeted months ago when the dysfunctional government failed to legislate any of Trump’s proposals.

US Economy at equilibrium

The US economy seems to be proceeding at its new long run growth equilibrium. GDP has grown over the past several years at an annual average rate of approximately 2%. During that interval, employment has increased at an annual rate of 1.7%, and this has contributed to knock the unemployment rate down to 4.3%, or through its estimated full employment rate.

The uncanny result from this positive labor market improvement is the relatively stable and low inflation rate that has persisted for the past several years. In the past labor costs have increased substantially as unemployment rates declined to and through their estimated full employment level. Prominent economists have argued that persistent economic growth above estimated potential rates would raise the demand for workers and eventually create a scarcity that would drive wages, and therefore prices higher. This relationship hasn’t happened during this expansion.

Growth without inflation

Recent research on the Phillips curve (the relationship between wages and employment) implies that the tradeoff between wages and labor scarcity may be significantly flatter than previously believed.* Oliver Blanchard’s estimate of this relationship implies that the US
unemployment rate could fall substantially below its present low level without putting upward pressure on the rate of inflation.

Economic growth materializes in the EU

After years of stagnant economic activity, destabilizing high unemployment, and punitive fiscal budget policies, growth in the EU economy has finally accelerated. After years of disastrously high unemployment rates and a lack of new employment opportunities job growth finally materialized. Recently EU policy makers have indulged in some fiscal policy laxity and supported aggressively simulative monetary policy. Businesses and consumers responded positively.

There are several theories proposed that could explain this atypical economic conundrum. For example; first, there maybe many more workers who could work than are measured in the traditional labor force data. Second, international companies could be offshoring more production work instead of using domestic labor. Outsourcing production is a mainstay of globalization. Third, supersized multinational technology companies have been entering new businesses in large scale and driving down prices in order to establish themselves in new markets and grab market share. A final explanation may be that years of persistently low inflation have created low inflation expectations, which have influenced demand and supply in the goods and investment markets. Unfortunately there is not sufficient data available to support any of these theories and to resolve this important conundrum.

The EU harmonized unemployment rate dropped from a peak of 10.9% to 7.7% and this created some positive consumer confidence. Growth hasn’t been universal: it has been concentrated most in the northern members of the EU, but enough to overwhelm lackluster results among southern members. Investors too gained confidence in the EU and pushed stock prices higher, particularly in 2016, and that drove the Euro upward in 2017.
Abe’s program finally delivers

After years of a stop-and-go economy, the Japanese economy has begun to advance at a consistent rate slightly above that of the rest of the developed world. The economy has finally benefitted from a pro-growth fiscal policy and astoundingly stimulative monetary policy. Years of zero interest rates and central bank asset purchases (Quantitative Easing) have finally convinced Japan’s business community to initiate new investment. A more controversial federal government decision to engage in a defense buildup also helped to stimulate domestic economic growth.

Despite higher GDP growth, inflation in Japan remains stubbornly low, at or under zero. Moreover, wage growth is, and has been weak. Consequently, the BOJ must continue to engage in asset expansion in order to convince investors of their determination to propel inflation higher. In addition, the federal government needs to prioritize support policies to drive aggregate demand higher and engage in labor market reforms to keep the party rolling.

PMI’s are pointing to faster growth

An improvement in global trade growth also boosted Japanese GDP growth. The Japanese stock market responded positively as institutional investors in Japan have had to shift investments from JGBs to equities because the central bank of Japan has monopolized purchases of JGBs, leaving too few available in the public capital market for private institutions.

China’s GDP growth ebbs at 6.5%

After several years of restructuring, the Chinese economy is again in growth mode. The widely heralded GDP growth slowdown in 2016 seemed to have ended at 6.5%. Economic growth in China had diminished from an unsustainable 10% plus per annum a few years ago and tumbled down to approximately 6.5% last year, in spite of the massive debt problem that hung over China’s largest banks and local governments. Evidence that the Chinese economy has regained its upward momentum is seen in the recent surge in industrial production and
in their purchasing managers’ index. Both indexes reflect greater international trading activity and possibly some initial demand from Chairman Xi’s $1 trillion Belt and Road initiative. The Belt and Road program promises to bring more trade and raise activity along its planned route throughout central Asia and beyond. The acceleration in economic growth in China spreads good fortune for most of China’s Asian trade counterparties. Their economic growth had subsided when China’s growth decelerated.

**Conclusion: Let the good times roll**

In spite of the many serious global political risks, ill-guided threats of trade wars, and natural disasters, economic growth throughout the developed world is materializing, and it should spread economic benefits to members of the less developed world. Stock prices are appreciating in concert with economic growth in all the developed capital markets creating wealth and buying power. Ironically, inflation has stubbornly persisted at very low rates of increase in all of the developed economies confounding policy makers and economists alike.

If the Phillips curve is much flatter than traditional economic thought espoused, then central banks motivation to raise policy rates needs to be amended.

Fortunately low inflation rates should extend the nurturing power of ultra low interest rates as monetary policy makers concede that there is little pressure to raise policy rates quickly higher.

All economic cycles have a beginning and an end. Cycles dissolve when excesses in credit or price increases develop and central banks respond to control the excesses and terminate the expansion. At present there are no obvious excesses and therefore monetary policy makers throughout the developed world can continue to act with great restraint letting the good times roll on.


For more information, please contact camri@nus.edu.sg
<table>
<thead>
<tr>
<th>INDEX</th>
<th>LEVEL (LC)</th>
<th>%1MO (LC)</th>
<th>%1MO (USD)</th>
<th>%1YR (LC)</th>
<th>%1YR (USD)</th>
<th>INDEX</th>
<th>LEVEL</th>
<th>%1YR</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P500</td>
<td>2471.65</td>
<td>0.31%</td>
<td>0.31%</td>
<td>16.23%</td>
<td>16.23%</td>
<td>3MO LIBOR</td>
<td>1.32</td>
<td>57.00</td>
</tr>
<tr>
<td>FTSE</td>
<td>7430.62</td>
<td>1.65%</td>
<td>-0.63%</td>
<td>14.00%</td>
<td>11.85%</td>
<td>10YR UST</td>
<td>2.12</td>
<td>33.99</td>
</tr>
<tr>
<td>NIKKEI</td>
<td>19646.24</td>
<td>-1.34%</td>
<td>-1.11%</td>
<td>18.54%</td>
<td>11.15%</td>
<td>10YR BUND</td>
<td>0.36</td>
<td>659.02</td>
</tr>
<tr>
<td>HANG SENG</td>
<td>27970.30</td>
<td>3.06%</td>
<td>2.86%</td>
<td>26.66%</td>
<td>25.54%</td>
<td>10YR SPG</td>
<td>1.56</td>
<td>54.18</td>
</tr>
<tr>
<td>STI</td>
<td>3277.26</td>
<td>-0.45%</td>
<td>-0.51%</td>
<td>20.10%</td>
<td>20.48%</td>
<td>10YR SGS</td>
<td>2.09</td>
<td>15.66</td>
</tr>
<tr>
<td>EUR</td>
<td>1.19</td>
<td>0.57%</td>
<td>6.74%</td>
<td>US ISM</td>
<td>58.80</td>
<td>19.03</td>
<td></td>
<td></td>
</tr>
<tr>
<td>YEN</td>
<td>109.98</td>
<td>-0.25%</td>
<td>6.33%</td>
<td>EU PMI</td>
<td>57.40</td>
<td>11.03</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CMCI</td>
<td>1175.54</td>
<td>1.01%</td>
<td>13.20%</td>
<td>JP TANKAN</td>
<td>12.00</td>
<td>200.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oil</td>
<td>47.23</td>
<td>-5.86%</td>
<td>5.66%</td>
<td>CHINA IP</td>
<td>6.40</td>
<td>1.59</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)

S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers’ index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China’s Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency

Disclaimer: All research digests, reports, opinions, models, appendices and/or presentation slides in the CAMRI Research Digest Series is produced strictly for academic purposes. Any such document is not to be construed as an offer or a solicitation of an offer to buy or sell any securities, nor is it meant to provide investment advice. National University of Singapore (NUS), NUS Business School, CAMRI, the participating students, faculty members, research fellows and staff accept no liability whatsoever for any direct or consequential loss arising from any use of this document, or any communication given in relation to this document.