More of the Same in 2018, But Not for Long!

By Brian Fabbri
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2017 was much better than expected

There were several important surprises in 2017 that fooled forecasters and pleasantly surprised investors.

- The doomsday forecasts by many informed savants was that China would plunge into the depths of debt abyss and take the rest of Asia with them into the gloom of deep recession. They were wrong.

- Similarly, the prevailing sentiment about Europe trapped in the doldrums - doomed to less than 1% economic growth forever - tragically waiting to discover economic life without the UK, and struggling to accommodate all the unwanted who were crowding their shores, was equally incorrect.

- Finally, the pundits projected a new normal growth rate of less than 2% for the United States economy. Now they will have to re-explore their sense of limitations to economic growth to discover why actual growth surged above 3%.

A good example of such underestimation of this year’s economic growth is seen in the December 2016 FOMC GDP forecast of 2.0% for 2017. At the end of this year the FOMC raised its estimate for 2017 to 2.5%.

Forecasts revised higher for 2017 and lower for 2018.

In the end economies around the world grew faster than the experts predicted and global stock markets boomed, sporting double-digit gains in 2017. Stock market returns ranged from a depressed UK of 7.4% in 2017 to a stratospheric 37% in the Hang Seng.

At the start of 2018 the experts are again toning down most of their forecasts for economic growth from their upward-revised estimates for 2017. Economists are timidly predicting that global growth will inch higher from its surprisingly strong pace of 3.6% in
2017 to 3.7% in 2018. The only exception to this faint-hearted forecast is from President Trump’s fantasy Dream Merchant team. They prophesied an implausible rate of 4% growth per annum for the US over the next 10 years, which was made in an effort to sell his new “Cut, Cut, Cut” tax plan to fiscally conservative congressmen. And, Congress bought the dream.

Is there no end to this business cycle?

Momentum is a very tough force to bet against. Expansions are getting longer and more synchronized. The last 4 business expansions have lasted an average of 97 months, and were followed by recessions that lasted less than 12 months on average. Cycles are a natural phenomenon in all capitalist, market-driven economies. Fear and greed have and will continue to dominate rational decision-making and therefore will ultimately lead to excesses and recessions. In addition to fear and greed, we have learned from past experience over the last century that macro policy makers’ decisions also contribute greatly to undermine business expansions and sometimes prolong recessions.

The longest cycle

This very long business expansion in the US will become the second longest expansion in the post war era in three more months, it will probably surpass its previous record for longevity in 2019. With a very compliant Federal Reserve that is committed to a gentle return to normal monetary policy in keeping with an announced goal of tolerating inflation above its long-term target of around 2%, the expansion should not be derailed by excessively tight monetary policy. Therefore, the Federal Reserve would not become an active impediment to extending the present economic expansion into at least another year forward. They have guided us into anticipating that they will raise their official rate three times in 2018, raising the funds rate to 2%.

Breaking on through

Economic growth in the US economy broke through the expert’s estimated natural growth rate barrier in 2017. It was more remarkable considering that the economy is at, or through it’s estimated full employment rate. Therefore, with employment relatively fixed, businessmen must have improved the productivity they derived from their present workforce in order to boost US growth above its estimated natural rate. Can it continue?
Non-farm productivity did jump in the past two quarters and accounted for most of the surprisingly rapid rate of GDP growth. It increased by 3% in the third quarter of 2017, which contributed to a 1.5% year on year increase.

Follow the leader

The Federal Reserve’s tactics (zero bound policy rates, balance sheet expansion, a very gradual and extended reduction in portfolio assets) and aggressive use of forward guidance have become standard policy actions adopted by all the major central banks around the world. The UK began tightening its policy rate, and the EU indicated that they would soon stop buying securities. Hopefully central banks will continue to follow the leader and gradually turn their present aggressive monetary stimulus around and slowly remove the stimulus in 2018 and beyond.

If we can take central banks seriously about their commitment to pursuing above target inflation, then easy monetary policy can be expected to prevail for months to come. Inflation in the entire developed world will continue to rise at rates below the conventional policy target of 2%. Moreover, in China core inflation is hovering just above 0% per annum.

Inflation remains below convention targets

Aside from in the US, there remains plenty of spare capacity in global production facilities. In the US employment has reached its estimated full employment level, and in the industrial sector capacity utilization has climbed significantly in the past two years. Therefore, the prospect for higher core inflation looms as a serious development in 2018 and beyond.

It is quite different in the EU and in Japan where unemployment rates remain relatively high and measures of capacity utilization relatively low. Unemployment in the EU ended 2017 at 7.4%, down from its recession highs, but well above perceived full employment levels. Moreover, official unemployment rates probably do not adequately measure the condition of the present labor force in the EU since they do not count the thousands of unemployed migrant workers who probably would/do add to the real supply of labor. Therefore, labor costs pressures should emerge very slowly in the EU.
In contrast, utilization rates in the EU are rising rapidly and closing in on their previous highs. It suggests that core prices in the EU should begin to rise in 2018.

**US economic growth is forecast to settle back to 2.5%**

After accelerating up to 3% in several quarters of 2017, the US economy is expected to retreat to 2.5% in 2018. Nevertheless, it is still faster growth than many economists believed possible one year ago. Even the Federal Reserve in their December assessment of economic growth for the next year or two has projected faster growth than the conventional long-run sustainable path of 1.8% estimated by most academics and the Fed’s own internal forecast team. To some extent this somewhat faster growth rate is attributed to the Republican tax plan and the President’s decision to reduce regulatory hurdles for business.

To support faster than long-run sustainable growth in the US economy will require maintaining higher growth in non-farm productivity. This will be dependent upon continued rapid growth in private investment and further applications of IT innovation in the US. It will also become the acid test for President Trump’s economy policy proposals: do they encourage innovation and business investment?

Brisk economic growth is also due to the recent synchronization of the global economic expansion. All major sectors of the global economy - China, Europe, Japan and the emerging market economies - are experiencing accelerating economic growth. This leads to much greater international trade and it contributes to boost business confidence.

**EU growth to remain around 2% in 2018**

The acceleration in EU economic growth was one of the big surprises of 2017. And the surprise is expected to last through 2018. Although long-run labor demographics and productivity look to restrain potential economic growth in the EU to about 1%, the improvement in global trade, the trade agreement signed with Japan, the avoidance of political election disruptions, improved business confidence, (see following chart of climbing PMI index) ultra-low interest rates, and the continued support from a central bank committed to pursue economic
growth, will bolster faster economic activity for another few quarters. Moreover, the subtle suspension of conservative, fiscal management rules enhances the opportunity for better growth in Europe, at least in the short run.

In this macro policy setting, where political frictions have been eased and election uncertainties resolved, economic growth in the EU of 2% should be sustained through 2018 before slipping down closer to its long-run potential.

Can Japan’s economy sustain its present success?

Faster economic growth in Japan during 2017 has been attributed to three main factors: ultra-low interest rates and massive quantitative easing, second, the acceleration in global economic growth and international trade (supported by a weak yen), and finally, the fiscal support derived from President Abe’s economic policy. In 2018 fiscal policy will become less supportive and therefore economic growth is projected to diminish to about 1%. Of course Mr. Abe could surprise everyone with another round of economic support, which would keep the economy growing at about 1.5%, as it has in 2017. Monetary policy will be very gradually withdrawn over the next few years as Japanese monetary policy leaders follow the lead of the US Federal Reserve.

China’s economy rebounded from deceleration to acceleration in 2017

Somehow the Chinese economy sidestepped the building mountain of debt, which many analysts believed would create a meltdown for the economy. In 2017 China’s economy re-accelerated after a few years of rapid deceleration. Growth is estimated to increase to 6.8% in 2017 and probably tick higher again in 2018 to 6.9%. These growth rates seem moderate by comparison to the annual rates of growth from a decade ago, however, they greatly exceed anything in the developed world.

Chinese authorities have kept their foot down on the monetary and fiscal accelerator in 2017 and are likely to maintain a similar degree of pressure through 2018. Of course more public investment by the central government spent through its provincial governments raises the debt mountain in China and increases the level of risk to the overall economy. The Beijing government maintains that it is capable of supporting this level of debt, and higher, and thus far they have avoided any serious defaults.

As China goes, so does ASEAN

Swift economic growth in China and faster economic growth in the developed world
have increased the vigor of growth in all of the ASEAN economies. More international trade during 2017 already boosted GDP growth throughout the region, it should push growth up to an estimated 5.5% in 2018.

**India: The fastest growing big economy**

India should also benefit from increased trade activity, but mostly because the negative economic effects from the currency exchange provision declared in 2016 will diminish. India is also expected to benefit from more aggressive domestic fiscal spending initiatives, including infrastructure. As a result, India’s economy, which is the fastest growing among all large country economies, should swell to over 7% in 2018.

**Conclusion: the global economic expansion carries on for another year**

Global economic growth surprised in 2017 growing 3.6% up from 3.2% in 2016 and was significantly more than most had forecast. In 2018 global economic expansion is forecast to continue to accelerate slightly quicker than it did in 2017, at 3.8%. Slightly more growth will be led by many Asian economies as they benefit from greater international trade from the developed world and the acceleration in growth in China and India. Both large Asian economies will benefit from increased fiscal spending.

Most developed economies will shed the lethargic economic activity that prevailed over the past several years as plentiful and inexpensive financial conditions promote private investment and as conservative fiscal strategies slip away. Political risks in the developed world seem to have faded slightly as the ISIS crisis abated, and as voters in the EU voted for a status quo in their new governments. Thus, business confidence climbed to very high levels throughout the developed world, and they are now buoyed by hopes that the tax cuts in the new-year add further to stock price appreciation.

**Buffett stock index Peaking?**

Stock markets around the world boomed in 2017 and for several years before. They are likely to keep appreciating in line with further projected global economic growth. A subtle reminder to the greedy investors who are cheered by this forecast: according to the Buffett Index Stocks it now appears to be overvalued. More importantly, the index indicates that stocks are now more overvalued than they were in early 2008, and nearly as overvalued as they were in the dot-com boom/bust of 2000.

The economic risks in 2018 are simple: new fiscal stimulus added to a 9-year old expansion and starting when the economy is
at or through its estimated full employment rate, together with a synchronized global economic expansion, strongly imply that core inflation will rise significantly either before the end of 2018, or in 2019. When it does, monetary policy will shift from a gradual return to normal to monetary restraint. Thus, the 2017-2018 period will probably prove to be the peak in this business cycle.

For more information, please contact camri@nus.edu.sg
KEY INDICATORS TABLE (AS OF 30 NOVEMBER 2017)

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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 (CMCIP)
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 (IY8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IY8 – 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

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