Economic outlook

Market turbulence, macro calm

The recent flare of financial-market turbulence is a useful reminder not to become too complacent after a long period of uninterrupted growth and market gains. While the stock market's decline has since been partially unwound, other potentially challenging developments have stuck, including the aging business cycle, rising yields and inflation as well as protectionist threats. Nevertheless, the global economy continues to grow at its fastest rate in years on the back of strong and, we think, sustainable momentum and fiscal support.

Strong macro conditions

The global economic environment remains positive, with exuberant macro indicators providing their best readings in almost a decade. We continue to flag many reasons for this growth:

- A strong economic handoff from 2017,
- Decent financial conditions,
- Classically fast late-cycle growth,
- A burst of fiscal stimulus and
- Retreating secular stagnation.

While some tailwinds are less encouraging (i.e., less positive economic surprises and tightening financial conditions, mainly caused by rising interest rates), others have strengthened. Global growth is currently supported by increasing European and U.S. fiscal stimulus as well as reviving risk appetite and productivity growth as the grit that constrained the post-crisis economy starts to wash away.

For all the talk about faster growth, several structural constraints remain, namely worsening demographics, maturing emerging-market economies, populist inclinations and high debt loads. Future growth appears set to be better than the post-crisis norm, but still less than the pre-crisis standard.

New inflation regime

For a significant part of the post-crisis era, markets have been on "deflation watch" – concerned about falling rather than rising prices. Even as economies began to recover, inflation remained stubbornly low.

However, we were always dubious of the deflation narrative. It is indeed harder for inflation to rise now than in the past because of structural depressants related to demographics, globalization, technological change and sector-level shifts. But focusing only on depressants could neglect equally relevant stimulative factors: less economic slack in developed-world economies, higher inflation expectations, rising commodity prices and an inherently inflationary wave of protectionism.

Markets have finally abandoned their deflationary mindsight, recognizing that an inflation regime shift is underway. But, *in contrast to the idea that a deflationary environment is abruptly transitioning to a high-inflation one, we view the ongoing transformation as a rather gentler shift from a low-inflation regime to a normal one.* As such, we anticipate an orderly increase in developed-world inflation measures as well as continued low levels of inflation in emerging markets.

The year of protectionism

Protectionism has been a risk for some time, but particularly so in 2018. Brexit's contours must be hashed out this year in advance of an early 2019 deadline and, with U.S. tax cuts now delivered, the White House appears to be turning toward trade issues. As such, protectionism is not merely a risk, but also an economic drag.

One hopes that the U.S. protectionist bark will be worse than its bite, but the U.S. has already imposed tariffs on softwood lumber, aerospace products, solar panels, washing machines and steel and aluminum. Furthermore, the United States is not alone in evincing protectionist tendencies – the United Kingdom is heading down a very similar path in its plan to secede from the EU, Canada is experiencing interprovincial trade wars and non-tariff trade barriers are subtly rising in many countries.

Some are fighting against this protectionist wave and globalization is not in complete retreat. In fact, world trade increased nicely over the past year, though entirely because of stronger global demand rather than fewer trade frictions. Although all is not lost on the trade front, some big chips are on the table in 2018.

A dose of fiscal stimulus

Fiscal stimulus is not usually sought or delivered when economies are already strong enough to require central-bank rate hikes, but political considerations have nevertheless unleashed fiscal stimulus in several jurisdictions today. The U.K. budget has become more expansive due to concerns about Brexit damage; the new German grand coalition has been struck largely on the promise of government largesse; and President Trump was elected in significant part on his promise of major tax cuts.

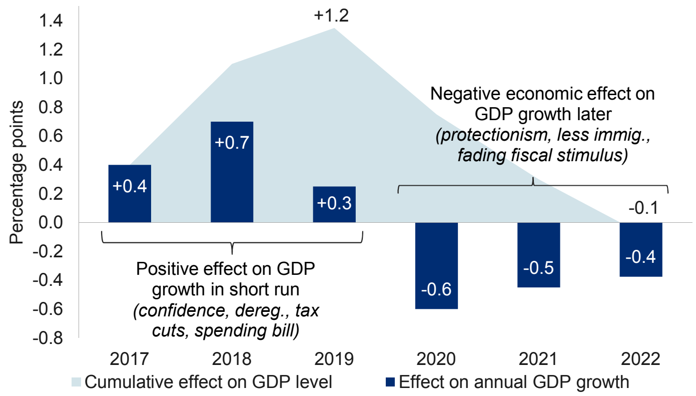
The main fiscal thrust comes from the United States. We budget for notably more U.S. growth in 2018 thanks to this, and for some extra growth in 2019 (Exhibit 1). Underlying this assessment are a confidence boost following the last U.S. election; dividends of a deregulatory push; prominent tax cuts delivered several months ago; and further fiscal spending from a recent budget pact.

U.S. economy soars

Several negative forces are buffeting the U.S. economy, including higher interest rates (raised by the U.S. Federal Reserve most recently on March 21, 2018, by 25 basis points) and creeping protectionism, but the positives related to the weaker U.S. dollar, a high level of economic optimism and fiscal stimulus appear to be winning out. Consumer spending is strong and housing still has room to improve. Business investment is impressive thanks to tax cuts and a resurgent energy industry. Government spending is now on the ascent and the weak currency brightens the trade picture, though protectionism casts a shadow.

We therefore look for a muscular 3.00% advance in real GDP in 2018, followed by a 2.75% increase in 2019. The slight economic deceleration in 2019 is due to our belief that the U.S. dollar could temporarily reclaim some of its lost ground, monetary tightening should continue, fiscal stimulus will become less powerful as time goes on and protectionist

EXHIBIT 1 – Effect of Trump policies on U.S. GDP



Source: RBC GAM assumptions and calculations

actions will mount. For business-cycle reasons, recession risk also arguably rises over time.

U.K. stares Brexit in the face

The British economy continues to grow, but has failed to partake in the synchronized global acceleration. This appears to relate to the uncertainty and potentially negative outcomes from the Brexit negotiations. Business investment is palpably weaker and we figure the economy has already underperformed its erstwhile trajectory by at least one percentage point of GDP. The pound has also weakened since the Brexit vote, though the currency has stabilized recently. The resultant import inflation has British inflation running considerably higher than in other countries.

The most likely scenario for Brexit is a "middling Brexit" that permits the free flow of goods, but not of services or people. This outcome would reduce U.K. GDP further and we anticipate underwhelming growth to the tune of a 1.5% gain in both 2018 and 2019.

Eurozone growth persists for now

The Eurozone economy continues to cruise along, accelerating as notably as the United States. Europe could extend this performance longer than the United States as the European Central Bank is still actively delivering monetary stimulus and the region's economy is not as tight as the U.S. economy. Credit growth is accelerating as Germany prepares to deliver additional fiscal stimulus while others, like France, are amid important structural reforms that should unleash additional growth. This adds up to a strong 2.25% GDP gain in 2018.

However, European financial conditions have tightened recently. The region's bond yields have increased and the euro is much stronger than one year ago. In turn, it is no longer as clear that European equities will outperform other regions in 2018. While the euro's strength will likely fade over the coming year, we have downgraded our 2019 growth forecast to 1.75%, which is still higher than the post-crisis norm.

The European political environment also remains complex. The recent Italian election was a messy affair and several Eastern European countries have elected nationalist governments that challenge some of the EU's basic principles, but the Netherlands, France and Germany all held major elections in 2017 that cemented centrist control in key economies for years to come.

China addresses its debt

The Chinese economy pleasantly surprised over the past year, stabilizing after a long period of deceleration. We budget for it to begin slowing again to 6.25% in 2018 and 6.00% in 2019, but for good reasons. One key goal from China's National Congress summit last fall was a shifting focus from the nation's obsession with the quantity of economic growth to maximizing the quality of growth, which crucially argues for less reliance on credit. This is a welcome initiative as China's spiraling debt load had become concerning.

Fortunately, that debt profile is now changing as a result of slowing credit growth; significantly reformed heavy industries, previously the main source of China's non-performing loans; considerably lower local-government debt, thanks to a debt swap and further restrictions; and less-dangerous shadow financing owing to rules that improve transparency and reduce uncertainty. It is perfectly natural for China's economy to slow over time, but its growth will remain the envy of many.

Canadian turbulence to come

The Canadian economy enjoyed a stellar 2017, buoyed by stabilizing oil prices, strong global demand and support from domestic fiscal and monetary policy. Some of these supports remain as the global economy is still strong, but the fiscal and monetary environment is not as stimulative as a year ago.

EXHIBIT 2 – Big improvement in Canadian job market recently

Source: Statistics Canada, RBC GAM

Thanks to earlier heroics, the Canadian economy now sports its lowest unemployment rate in four decades (Exhibit 2), but without as much help from oil and with several key headwinds on the way, 2018 and 2019 appear set for less growth. We anticipate just 1.75% growth in 2018 and a decline to 1.50% in 2019, well short of anticipated U.S. readings.

Canada's future growth challenges revolve around competitiveness and housing. Canadian competitiveness is deteriorating quickly due to falling U.S. tax rates, rising Canadian minimum wages, tougher Canadian environmental regulations, new American tariffs that restrict Canadian exports and NAFTA risks, which amount to a softer Canadian dollar in 2018. The Canadian housing market may also experience a more intense slowdown, given the recent rapid rise of Canadian household debt and poor affordability coupled with increased regulations. Housing will likely not continue to drive growth over the next decade as it did over the past decade.

For more on our current view and outlook, please consult the full version of *The Global Investment Outlook* posted on our website at http://www.rbcgam.com/investment-insights/investment-outlook/index.html

Global Asset Management

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