Global Asset Management

NEW YEAR 2018

Economic outlook

Secular stagnation ebbs

Global economic growth is travelling at the highest altitude in seven years. The expansion is highly synchronized, encompassing the bulk of developed and many emerging-market nations. Measures of confidence and risk appetite are also robust, benefiting from this macroeconomic strength and simultaneously helping to sustain it. At the same time, there are considerable risks to this rosy narrative, such as the fairly late-stage U.S. business cycle, tightening central banks, U.S. protectionism and geopolitical risks. For now, markets remain uncannily calm.

Macro strength persists

The synchronized acceleration that began in the middle of 2016 has mostly transformed into steady, robust growth. There are even tentative signals that it may have sped up again in the latter half of 2017. This quickening of growth was not the work of policymakers as the global fiscal impulse remains roughly flat and several prominent central banks have begun the gradual removal of monetary stimulus. Instead, several other factors are at play, including:

- Strong momentum,
- Friendly financial conditions thanks to still-low government yields, narrow credit spreads, rising equities and oil prices,
- Classic late-cycle behaviour,
- Fading secular stagnation and
- Rising confidence following the 2016 U.S. election.

But not everything is perfect. These financial conditions, while still helpful, are no longer actively improving. Similarly, the global credit impulse appears to be in negative territory, meaning that global credit is growing less quickly than before. This exerts a theoretical drag on growth, though little repercussions are visible in the economy to date. Nevertheless, we expect above-consensus economic growth in 2018.

Inflation to sneak higher

Optimism has hardly been a winning bet for inflation during the post-crisis period. However, we see several things beginning to change in favour of higher inflation:

1. Market expectations are no longer being revised downward from month to month,
2. The commodity shock has ended and oil prices have recently risen,
3. Developed-world economies are finally approaching their full potential and
4. We detect rising wages and still believe that a declining unemployment rate must eventually lead to faster wage growth.

Working against higher inflation are adverse demographics, globalization and some deflation in the technology industry caused by decreasing prices, increasing automation and growing industry disruption. Inflation can still rise and likely will, but not by quite as much as expected.

A new project for central banks

As growth has picked up, economies tighten and inflation begins edging higher, central banks are responding with a slow pivot away from extreme monetary stimulus. This is momentous for three reasons: reversals of this sort are a roughly once-a-decade occurrence, this particular version is in uncharted waters given the need to simultaneously shrink distended central-bank balance sheets and the occasion likely also marks the end of a 34-year bull market in bonds.

The U.S. Federal Reserve (Fed), the Bank of Canada (BOC) and the Bank of England (BOE) have all begun down this tightening path, although the BOC elected not to raise interest rates again in October 2017 after two such rate hikes in the year. The Fed has led the charge with another quarter-percent interest rate hike in December 2017, its third in 2017 alone. Others, such as the European Central Bank (ECB), are still some distance away but are beginning to at least reduce their rate of stimulus delivery.

U.S. economy stays strong

As with the global economy, U.S. GDP has continued to gallop and the country's leading indicators remain unusually strong. Confidence is high, and business investment intentions signal further health ahead. Hurricane-related depressants in the third quarter were smaller than feared, suggesting a modest rebound in the fourth quarter.

In assessing the many and varied economic effects of a Trump presidency, we continue to believe that the U.S. economy can grow faster in the short run to the tune of an extra 0.4% to 0.5% of growth per year above normal, though slower over the medium run as constraints on trade and immigration begin to accrue. The short-term effects are supported by the spike in confidence since the election, growth-friendly deregulation and tax reform. Highlights of the recently approved tax reform bill include a substantially lower corporate-tax rate, accelerated depreciation on capital investments and several lower personal tax brackets, which could expand the U.S. economy further.

On the other hand, we continue to point to a roughly 25% chance of a U.S. recession over the next year, motivated in large part by the late stage of the business cycle, the high degree of policy uncertainty regarding the tax, trade and foreign-policy outlooks as well as diminishing competitiveness caused by currency strength.

U.K. challenges ahead

The British economy has exceeded expectations since the surprise Brexit vote in June 2016. The weak pound has been instrumental in buffering the initial negatives associated with this British decision to part from the European Union. The actual severing won't begin until 2019 at the earliest, but the interim uncertainty, prospective loss of finance jobs and reduced business investment have all cast a chill.

It would appear that the negatives are starting to outmuscle the positives. Various macroeconomic signals in the U.K. have begun to weaken even as other countries have managed a coordinated economic acceleration. The U.K. continues to run a large current-account deficit and the personal savings rate has fallen sharply, suggesting unsustainable spending.

We anticipate further depreciation of the pound, which should alleviate a portion of the economic damage, but that still leaves us with an underwhelming on-consensus forecast of just 1.5% GDP growth in 2018. Given this growth, coupled with prior economic progress and pound-induced inflation, the BOE has tightened its policy rate once recently and may deliver another increase in the coming year.

Eurozone on the ascent

The Eurozone has continued to impress, clocking in at a 2%-plus growth with a persistence that would have been hard to fathom several years ago. The majority of the region's leading economic signals are absolutely on fire, at least by European standards. The breadth of the growth is also good. The great majority of countries have strengthened, though Catalonia's recent pursuit of independence is likely to undermine Spanish growth temporarily and some of the Italian leading indicators are wobbling. All in all, we have upgraded the Eurozone 2018 outlook to 2.0% GDP growth. Inflation should be in the vicinity of 1.5%.

Whereas the U.S. will struggle to continue outpacing its normal growth speed limit for much longer, the Eurozone can sustain a few more years of relatively fast growth without running into trouble. The ECB can gradually scale back its bond-buying plan, but is unlikely to pivot toward outright tightening until 2019. We expect a fairly quiet euro-U.S. dollar exchange rate.

The Eurozone is grappling with more than its fair share of banking-sector woes and political challenges, but both areas have improved somewhat. Eurozone banks are steadily increasing their capital buffers and they now benefit from the ECB's oversight. Also, several of the most troubled have now been bailed out. Although the European political environment is imperfect, the past year has been a story of trouble avoided as populist bids to gain control of several major Eurozone nations have failed. It is not surprising, then, that the perceived risk of a Eurozone breakup is the lowest it has been in years.

China sets a new course

The Chinese economy remains a central consideration for investors, generating as it does nearly a third of global growth. Fortunately, the country has been cruising along at a remarkably steady clip over the past 18 months, exceeding expectations. We anticipate a moderate slowdown to a below-consensus 6.0% of growth in 2018 for a mix of reasons including a naturally maturing economy, U.S. protectionism, deteriorating competitiveness and a new policy goal that focuses on quality of growth rather than quantity.

China's biggest risk has long been its heavy debt load. Fortunately, our concerns are lessening thanks to several welcome developments, such as the overall rate of credit growth converging downward toward the rate of economic growth (Exhibit 1), heavy industries reducing excess capacity thereby cutting non-performing loans and local governments continuing to be reined in, reducing their longstanding debt risks.

Emerging-market expansion intact

The emerging-market story is also a positive one, though the acceleration in growth has been less pronounced than in the developed world. Broad-based tailwinds for emerging markets include the strong expansion of global demand and "risk-on" market sentiment that tends to translate into inflows for emerging-market assets. A number of emerging markets with a history of chronically high inflation have also made progress toward solving this problem. Russia, Brazil and India are prominent beneficiaries and their economic speed limits could increase accordingly.

On the other hand, a few broad-based headwinds include our forecast for a moderately stronger U.S. dollar, the prospect of central-bank tightening and the possibility that a deleveraging China might compromise demand for emerging-markets products and services from other Asian countries.

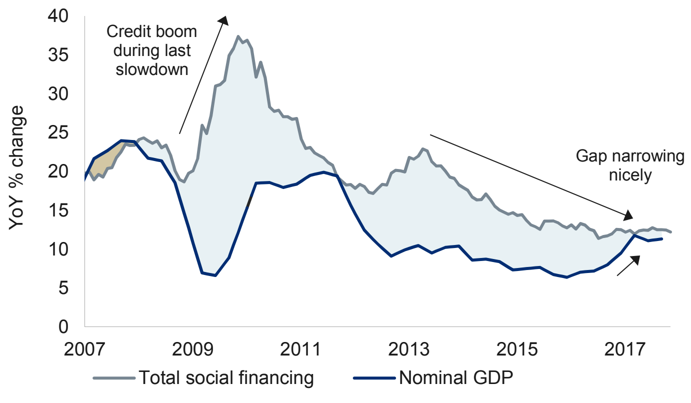
Canadian moderation ahead

The Canadian economy is on track to record its most impressive performance in seven years for 2017, growing by roughly 3.0%. This white-hot performance was sustained by strong global demand, rising commodity prices, generous government spending and monetary-policy support.

However, we can already see that the Canadian economy is starting to decelerate, both in terms of GDP and our own leading indicator (Exhibit 2). The BOC has raised rates twice and fiscal spending will no longer actively add to growth in 2018. As a result, the country is likely to settle back into a more subdued rate of growth, with a below-consensus 1.5% gain in 2018. Inflation should alight around 2.0%. Supporting this cautious Canadian outlook, the country's competitive landscape is arguably deteriorating as Canada now suffers several disadvantages versus the U.S., including moral suasion from the White House, a sharp increase in Canadian minimum wages, tightening environmental rules, rising regulations and a general increase in tax rates for highly mobile workers. There are also ever-present housing risks.

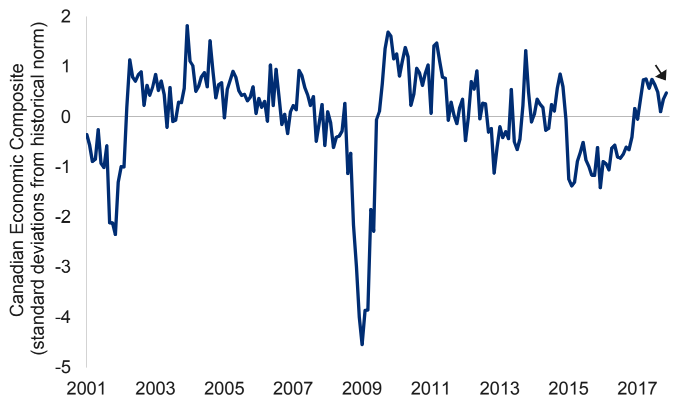
None of this is to say that Canada has serious trouble immediately ahead of it, especially given minor victories such as a new free-trade deal with Europe, an interprovincial trade deal and rising immigration. But the overall backdrop is distinctly less friendly than it has been. In this environment, we anticipate no more than two BOC rate hikes over the next year. The Canadian dollar should decline to partially offset the brewing competitive challenges.

EXHIBIT 1 – China's credit and GDP growth finally converging



Source: IMF, Haver Analytics, RBC GAM

EXHIBIT 2 – Canadian growth to dip



Note: Composite constructed using four leading indicators from surveys on Canadian businesses. Source: CFIB, Haver Analytics, RBC GAM

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

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