Global Asset Management

SUMMER 2017

ECONOMIC OUTLOOK

Synchronized expansion continues

The synchronized global economic expansion continues, with leading indicators pointing to a faster-than-normal clip across much of the world. That said, the initial acceleration phase has arguably come to an end. As a result, risk assets such as equities are still rising, but with less vim than at the turn of the year.

Growth signals peak

The economic uptick that took root in the summer of 2016 has continued to bloom. Leading indicators remain consistent with solid growth of the sort not regularly achieved during the post-crisis period.

There are a number of plausible reasons for this stretch of superior growth:

- A natural bounce after the economic swoon from late 2015 through mid-2016
- The lagged effect of past monetary stimulus
- Positive spillover from an accelerating Chinese economy
- Optimism in response to the U.S. election
- The fading gravitational pull of the financial crisis

The last of these drivers may have staying power and the U.S. election boost won't peak until 2018, but the rest should fade with time. The global credit impulse is already becoming a bit less helpful. Alongside tentative evidence that various macro signals are already peaking, we suspect the acceleration phase of this mini-cycle has come to an end. In fact, we budget for a slight deceleration from recent robust figures over the remainder of 2017.

Delaying and diluting

President Trump's various economic proposals are looking somewhat feebler for a few reasons. While Republican officeholders dominate the executive and legislative branches of government, they seem less capable of coordinating for bold action than previously imagined. This relates partially to ideological divides within the party, partly due to the unpopularity of Trump himself (Exhibit 1) and partly because it is difficult to legislate cleanly without a supermajority in the Senate. In addition, there is a non-trivial risk that President Trump's agenda will be tripped up by various accusations of political misdeeds that could distract from policy plans.

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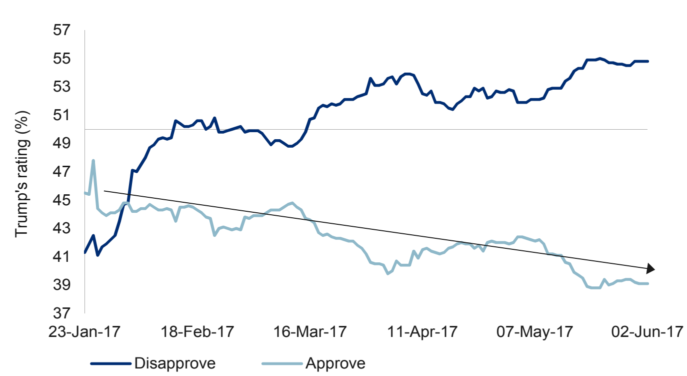
Digging into some of the specific policies, the outline of a U.S. tax-cut plan is beginning to form. Some of the more exotic aspects of earlier proposals – such as the concept of a border-adjustment tax – have seemingly fallen away. The backbone, consisting of large corporate and moderate personal-tax cuts, remains. The precise details will remain a

Exhibit 1: Trump's approval rating sliding



Source: FiveThirtyEight, RBC GAM

mystery for some time, as the White House continues to be vague on specifics and because it is ultimately Congress that sets the fiscal tune.

Inflation to take a breather

> *Having accelerated from rock-bottom to slightly low levels, inflation readings are now set to go mostly sideways over the next few quarters.*

Inflation has made a giant leap forward over the past year, exiting a multi-year period of deflation fears in favour of a somewhat more normal inflation environment. There are several reasons why this revival has occurred. The end of the global commodity shock has surely been the most visible contributor, with a partial recovery in resource prices now pushing inflation higher. Less forceful, but ultimately more persistent, is the gradual abatement of economic slack around the world and the effect that this is having on wages and inflation. The recent burst of populism around the world is also theoretically inflationary, though this factor often takes several years to build. Lastly, most developed countries are importing a bit of extra inflation from their depreciating exchange rates against the U.S. dollar. The United States is naturally an exception given the dollar's general strength over the past few years, though its prices are set to be boosted by populism and fiscal stimulus. Having accelerated from rock-bottom to slightly low levels, inflation readings are now set to go mostly sideways over the next few quarters (Exhibit 2).

U.S. economy tightening up

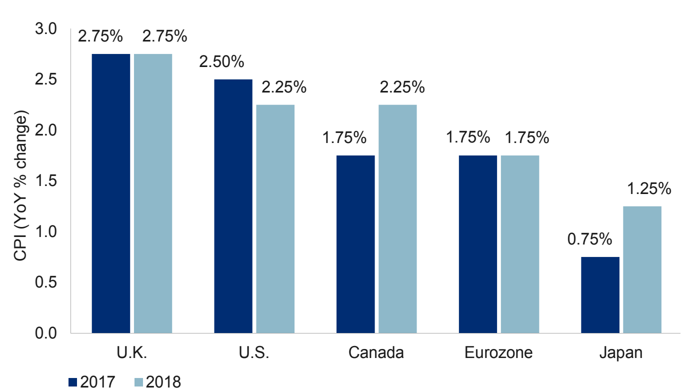
The U.S. economy shows considerable economic strength, though there are hints that growth has peaked. The U.S. ISM Manufacturing Index is now moderately lower than its February high, but still consistent with solid growth. Economic surprises are no longer as consistently positive as before. While first-quarter GDP was weak, this was partly a function of seasonal distortions and the second-quarter is tracking to a welcome offset.

Hiring is still good, if decelerating moderately. The unemployment rate is now an impressively low 4.3% and wage growth is grinding higher (Exhibit 3). Whereas the consumer has long been a source of strength, business investment has lately revived. Part of this is due to recovering U.S. oil producers, but some may also reflect a broader sense of optimism. The housing market continues to roll along, with room for further moderate gains. On the other hand, the U.S. credit situation is a source of middling concern. The banks themselves appear quite sound, but sub-prime auto loans in particular appear to be struggling.

Europe's good-news story

Both core and peripheral Europe are accelerating, meaning this is not a rehashed version of the "Germany versus the rest" narrative. We continue to forecast Eurozone growth of 1.75% in 2017 followed by a solid 1.50% in 2018. Providing further support, the European Central Bank is maintaining a highly stimulative stance and the region has a lower risk of bumping into economic constraints given the material slack

Exhibit 2: RBC GAM CPI forecast for developed markets



Source: RBC GAM

Exhibit 3: U.S. wage growth ascending steadily

Note: 3-month moving average of median of year-over-year percent change of wages for job stayers. Source: Federal Reserve Bank of Atlanta, Haver Analytics, RBC GAM left to run through. We continue to forecast a helpfully softer euro, targeting 1.02 versus the U.S. dollar in a year's time.

Political risks have declined significantly, at least in the short run. A wave of potentially populist elections has recently managed to avoid trouble in Austria, the Netherlands and France. The German election this fall remains unconcerning. In fact, it would seem that the combination of Brexit and the new U.S. president's isolationist tendencies have prompted Europe to fuse together more tightly.

Sterling to the rescue

The British economy has also happily partaken in the global economic acceleration. Despite the expected onset of economic problems linked to the U.K.'s plan to secede from the EU, few problems have shown up in the data so far. Businesses of all kinds are still feeling surprisingly good, and money-supply growth has picked up nicely. A key reason for this defiant economic strength can be found in the soft currency, which has done its job as a shock absorber to augment British competitiveness at precisely the time when the help was needed most. Even so, it remains a mystery why the extreme level of public-policy uncertainty in the U.K. – due to Brexit and the country's recent electoral surprise – is not having a more palpably negative effect on the economy.

Japan stilling missing structural reforms

The Japanese economy has managed to stitch together an unusually long stretch of decent economic growth. While some domestic considerations are at play, the main narrative is again one of a stronger global economy, as reflected in faster exports, higher profits, stronger credit growth and an improved purchasing managers' index (PMI).

The knock on Japan remains that it is delivering too few structural reforms. That aspect of Prime Minister Abe's bold stimulus package has had a few tentative successes – higher female labour-force participation rate, for instance – but has failed to truly shake up Japan's insular business culture. The long delays and eventual abandonment of the Trans-Pacific Partnership trade deal with the U.S. is an unfortunate blow for the country. As such, we believe Japan's structural economic speed limit is still quite low.

Emerging markets march to their own drum

Emerging-market economies collectively suffered through a multi-year period of decelerating economic growth, before righting themselves in recent years. They are now on track to grow at a solid 5.25% in both 2017 and 2018.

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Beneath the surface, individual emerging-market economies are marching to their own drum. In the short run, China appears to be moving a bit faster than previously envisioned and so we have upgraded the country's 2017 outlook to 6.5% growth. Mexico has also received a slight upgrade as it benefits from a weaker currency without yet suffering the ill effects of U.S. protectionism. India, Brazil and Russia have had their near-term forecasts downgraded slightly.

Canada races into the unknown

The Canadian economy finds itself racing forward at its fastest rate in several years, having shrugged off the worst of the oil shock and set to benefit from a further moderate appreciation in the price of crude oil over the remainder of 2017. Lingering fiscal stimulus is also providing a helping hand. In defiance of the international frame of mind, Canada has bucked the anti-trade trend by signing a European trade deal and starting the process of tearing down trade barriers among provinces.

Canada's regional economic convergence is running ahead of schedule, with the economy in Alberta growing at a faster pace than Ontario after lagging for several years. This doesn't mean that the country's oil-exporting provinces are no longer suffering, given still-high unemployment rates, but it does mean that the pain is starting to ease.

Regulators are now getting serious about tackling the excesses that have formed in the housing market. The market has responded to these efforts, but the Vancouver experience suggests that the effect of such policies may be short-lived. It is difficult to say how all of this plays out, but we suspect additional actions by regulators are likely and the result should eventually be an end to white-hot home prices. There may well be material economic consequences when this happens.

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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