Invesco

Quarterly Economic Outlook
Q4 2017

John Greenwood
Chief Economist, Invesco

Overview

- The US business cycle expansion is continuing, as reflected in rising employment, moderate real GDP growth, and rising equity and real estate prices. With inflation below target there are good prospects of this expansion achieving a record length.

- The main risk to this scenario is that the Federal Reserve tightens credit too sharply, not so much by raising rates, but by curtailing credit growth in the private sector. Already private sector credit growth is as low as 3-4% p.a. When the Fed starts shrinking its balance sheet by as much as $50 billion per month in late 2018, private credit markets could face a challenge in absorbing this volume of Treasury and agency securities.

- In the Eurozone economic activity is at last expanding at a momentum close to the economy's potential. This is largely a result of the asset purchase programme started by the European Central Bank (ECB) in March 2015, and the associated acceleration of M3. To ensure momentum is sustained, commercial banks need to create credit more rapidly than at present, otherwise when the ECB starts to taper its purchases, credit growth could weaken substantially.

- Inflation in the single currency area remains below target, reflecting the slow growth of nominal aggregate demand. Following the recent strength of the euro it seems likely that inflation will remain below target for much of 2018.

- With the German election completed and Mrs Merkel now working to create a new coalition between her Christian Democrats (CDU), the Free Democratic Party (FDP) and the Greens, the next big event on the European calendar is the Italian election next year.

- In Britain the growth of the economy has slowed as a consequence of the weaker pound raising inflation and eroding real wages. In addition, there has been some slowdown of investment and capital inflows, but export order books are buoyant.

- In addition to imported inflation there is a danger that accelerating money and credit expansion in the UK could add locally generated inflation to the imported inflation. For this reason it is highly likely that the Bank of England will raise rates in November. Beyond that growth is likely to settle at around 1.5% until the uncertainties of the Brexit negotiations are overcome.

- The Japanese economy has seen slightly better growth in 2017, but inflation remains well below 2%, despite the implementation of a massive Quantitative Easing (QE) programme from the Bank of Japan ever since March 2013.

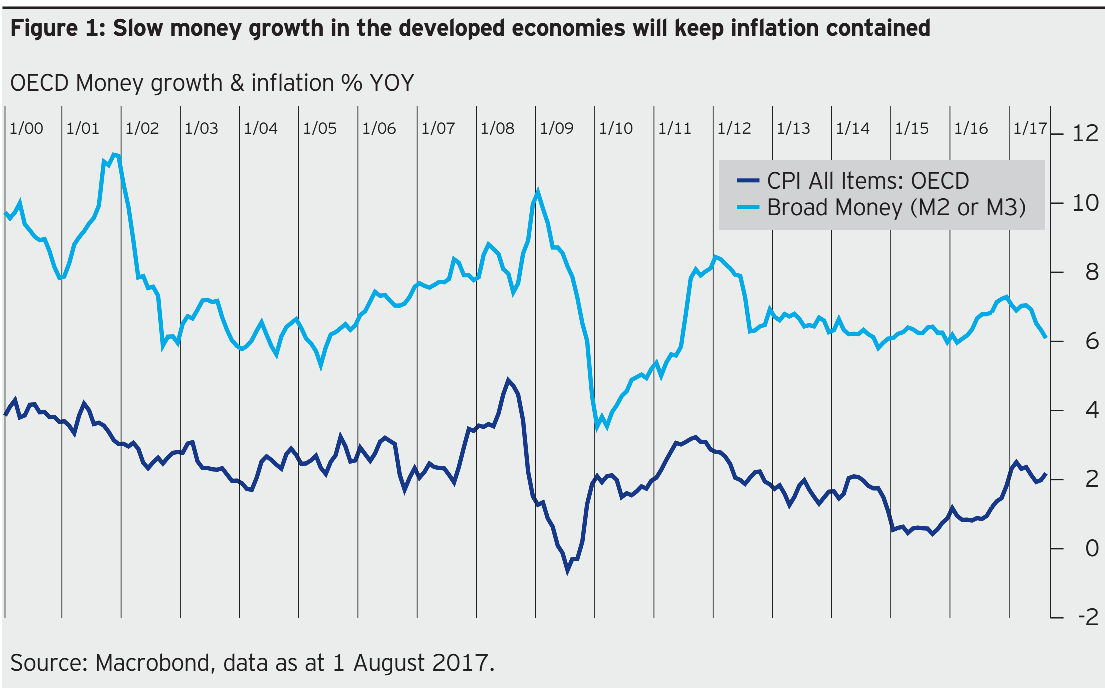
- To strengthen his hand in dealing with the North Korean threat and to boost spending on education and child care Prime Minister Abe has called a general election for October 22. Although he started with a strong lead, the election could prove risky for Mr Abe, particularly due to opposition from the charismatic Tokyo governor, Mrs Yuriko Koike.

- China has continued to alternate between squeezing and easing credit with the aim of keeping the economy on the rails ahead of the autumn congress of the Chinese Communist Party. However, no great change – either in SOE reform or in monetary policy – will follow from confirming President Xi at the congress.

- On the external side the restrictions on capital outflows and the encouragement of more inflows have enabled the currency to stabilise in recent months.

- Improved performance of the leading economies and some upturn in the emerging economies have resulted in a mild increase in world trade. This in turn has led to some improvement in commodity prices, but not enough to translate into a commodity boom. Aside from some individual commodities responding to sector specific measures, such as trade sanctions or capacity cutbacks in China, the upside for commodities in 2017and 2018 is distinctly limited.

Figure 1: Slow money growth in the developed economies will keep inflation contained



Source: Macrobond, data as at 1 August 2017.

Figure 2: Consensus Economics (%)

	2016 Actual		2017 Consensus Forecast			
Economies	**Real GDP**	**CPI Inflation**	**Real GDP**		**CPI Inflation**	
US	1.5	1.3	2.2	(2.1)	2.0	(1.9)
Eurozone	1.8	0.2	2.1	(2.2)	1.5	(1.7)
UK	1.8	0.7	1.6	(1.5)	2.7	(2.7)
Japan	1.0	-0.1	1.6	(1.5)	0.5	(0.4)
Australia	2.5	1.3	2.2	(2.3)	2.1	(2.0)
Canada	1.5	1.4	3.0	(3.1)	1.6	(1.8)
China	6.7	2.0	6.7	(6.8)	1.7	(1.3)
India	7.1	4.5	7.0	(6.3)	3.5	(2.8)

Source: Consensus Economics, Survey Date: 11 September 2017. Invesco forecasts in brackets.

United States

After completing three quarters in office, President Donald Trump's agenda of economic and other reforms has fallen far short of expectations. His executive orders on immigration have been partially countermanded by the courts while his reform of the Affordable Care Act (Obamacare) failed in the Congress. He is now "proposing" a tax cut, but it is for the Congress to "dispose". The Senate's recently announced plans for personal and corporate tax cuts amounting to $1.5 trillion over years must first be agreed with the House, and there are numerous procedural, substantive and other hurdles to overcome. Trump's infrastructure spending plans (originally $1 trillion over 10 years to be financed one quarter by the federal government, three quarters by private participation) are still in gestation. The President's only significant achievements so far are his executive orders allowing the go-ahead for the Keystone and XL pipelines, the appointment of Judge Neil Gorsuch to the Supreme Court, his withdrawal from the Trans Pacific Partnership trade plan, and the start of renegotiation of the NAFTA trade agreement, while blocking the closure of a number of coal-fired power stations. Despite all these setbacks, he is nevertheless maintaining support among his core voter base.

Meantime, the near-20% rally in the S&P 500 from early November 2016 to the end of September 2017, though boosted initially by Mr Trump's accession and the expectations generated by his agenda, has not owed much at all to the new administration in Washington. The real driver, in my view, has been the gradual upswing of the business cycle expansion. This is in line with historical experience which teaches that the broad movements of asset prices – bonds, equities and real estate prices – are dominated by business cycle trends.

In the early days of the Trump presidency numerous "soft" indicators such as those for consumer and business confidence, small business hiring and investment, and the PMIs all showed strong upward surges. However, the majority of these peaked out in March and have subsequently softened. At the same time, far from responding to Mr Trump's campaign promise to raise the real GDP growth rate to 3.5-4.0%, the "hard" indicators such as profits and revenue growth, industrial production or real GDP growth have remained distinctly lacklustre.

Unfortunately for the President's team, the soft indicators are probably converging towards the hard indicators, not the other way around. Viewed from the supply side, the US potential real GDP can grow at the growth rate of the labour force (including any improvements in educational attainment) plus the rate of growth of productivity. Going forward, the US Department of Labor forecasts growth of the US labour force to be only about 0.5% p.a. Estimating future productivity growth is much more problematic. Over the past 20 years productivity has averaged almost exactly 2% p.a., but over the past five years it has averaged only 0.7% p.a. Even assuming a doubling to 1.5% p.a. growth of productivity still implies a real GDP growth rate of only around 2.0% p.a.

Against this backdrop the Federal Reserve has continued with its policy of gradually normalising – not tightening – interest rates, and on September 20th announced the start of a plan to shrink its balance sheet. The plan will follow the scheme laid out in June, and the "dot plot" released with the FOMC statement suggested another rate hike in December plus three further hikes of 0.25% next year, taking the Fed funds rate to 2.0-2.25% by the end of 2018.

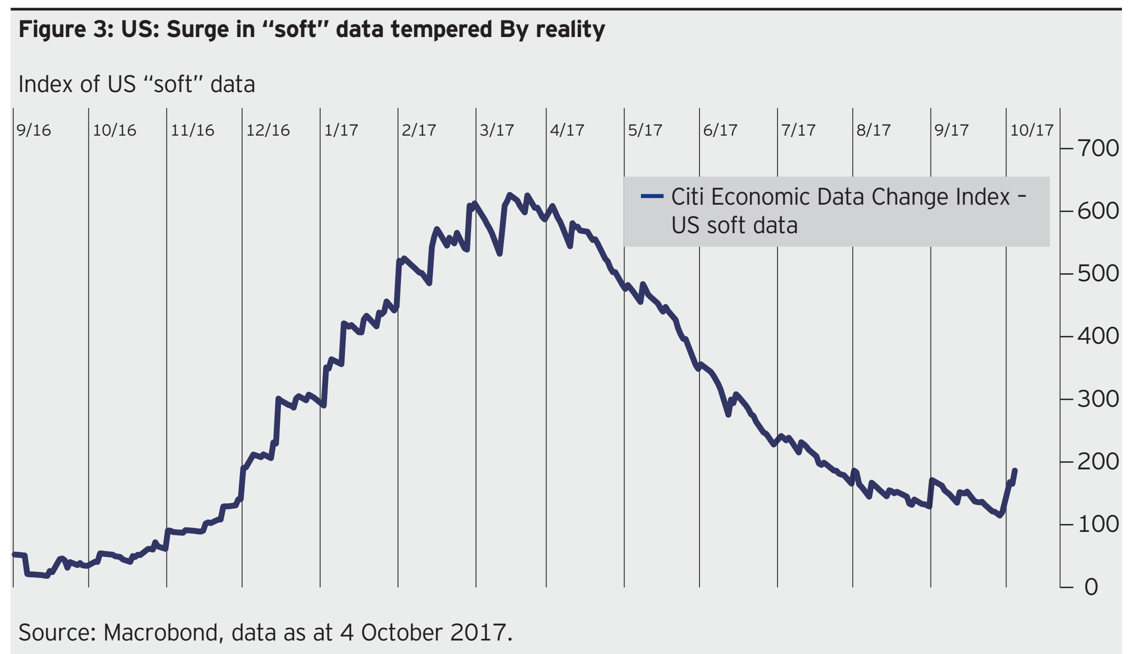
The plan to shrink the Fed's balance sheet avoids any outright sales of Treasury or Mortgage-Backed Securities (MBS) but allows a gradually growing volume of Fed holdings to mature and not be reinvested. Initially the runoff will start at $10 billion per month (from October to December), and over the course of 2018 this amount will rise by $10 billion per quarter until it reaches $50 billion per month in the final quarter of 2018. This means that private sector investors will need to replace the Fed as a holder of these securities, and therefore the US Treasury and the government agencies will need to increase the size of their auctions accordingly. In her news conference on June 14 and at other events Fed Chair Yellen optimistically stated that all this can occur "in the background" as the Fed continues with its rate hikes. In other words there would be essentially no market impact. In my view this is very unlikely. Selling an additional $50 billion of debt securities per month risks raising long term rates, tightening financial conditions, and squeezing bank credit and money growth. In my view the Fed will need to proceed with caution.

Over the past year US bank lending growth has slowed from 9% p.a. to 3.3% p.a. in September, while M2 growth has slowed from 7.0% to 5.2%. These are not yet dangerously low figures, but the direction of change is disquieting. The Flow of Funds tables released on September 21st show that non-financial corporate borrowing was growing at 5.7% in the first half of the year, while household borrowing was growing at just 3.6%. While all these data are re-assuring on the inflation front – implying continued low inflation – they do not promise any growth resurgence in the months ahead.

Inflation has continued to undershoot the Fed's targets for most of the year. Fed governors and presidents have attributed the below-target inflation rates to one-off reductions in cellular phone contract prices and other exceptional events, asserting that the underperformance of inflation relative to the 2% target is "transitory". However, after nine months of price weakness the claim that these price changes are temporary is starting to lose credibility. A key moment will come next spring when this year's price declines will fall out of the year-on-year comparison. The core CPI was 1.7% in August while the core PCE deflator was only 1.4% in July. My view is that the underlying problem is slow growth of money and credit. However, no great harm is going to come from this modest degree of price weakness, provided that core inflation starts to pick up again next year.

I forecast real GDP growth to improve slightly (compared to 2016) to 2.1% in 2017 and 2.2% in 2018; and I expect consumer price (CPI) inflation to average 1.9% in 2017.

Figure 3: US: Surge in "soft" data tempered By reality



Source: Macrobond, data as at 4 October 2017.

The Eurozone

With the re-election of Angela Merkel as Chancellor in the German Bundestag elections on September 24th the current round of political elections in Europe will pause until the Italian elections next year. Looking across Europe as a whole, despite the entry of the extreme right-wing AfD party into the Bundestag in Germany, populist pressures for a break-up of the Eurozone or the EU have been contained. However, it has to be acknowledged that in Italy the 5-Star Movement still enjoys about a 25% support level, and may disrupt the dominant, orthodox politics of centre-right and centre-left parties. In the wake of the German election French President Macron has made a series of proposals for strengthening the EU, and it is possible that Mrs Merkel will be sympathetic to some of them, but not until she has completed a lengthy period of bargaining with two minority German parties (the Free Democrats and the Greens) whose support she will require to form an effective coalition.

On the economic front the European economic situation has at last been gradually improving, although, as in the US after the election of Mr Trump as President, sentiment has been running ahead of reality. It is worthwhile to recap Europe's difficulties in reaching this stage of recovery. It should be recalled that between 2009 and 2014 there was a complete failure of Eurozone or ECB monetary policy to revive economic activity on the continent. Broad money growth (M3) slumped to average only 1.3% p.a. through this five year period, resulting in anaemic real GDP growth (averaging only 0.2%) and below-target inflation (of 1.5%) over the period, with two episodes of deflation. Opportunities to re-capitalise and restructure the banks were missed, the ECB's LTRO measures in 2012 completely failed to restore credit growth to the economy, and Europe endured a major debt crisis in 2011-12. It was not until March 2015 that the ECB finally got around to making asset purchases under a QE programme. Even though it was a significantly weaker programme than those adopted in the US and the UK (based mostly on asset swaps with banks instead of asset purchases from non-banks), the economy at last began to revive slowly and gradually about a year later. The data show that since January 2015 Eurozone M3 growth has accelerated to an average of 4.8% p.a., enabling real GDP to recover to 2.3% in the year to 2017 Q2, its best and most consistent showing since 2005-08.

Even so, within the Eurozone there are still wide disparities of performance, with Germany averaging 1.8% year-on-year since 2014 and accelerating to 2.1% year-on-year in 2017 Q2, whereas France had been trailing with real GDP growth averaging only 1.2% p.a. since 2014, but at last seeing an upturn in 2017 Q2 to 1.8% year-on-year. Italy is still struggling with the threat of bank failures – a direct consequence of prolonged weak growth, although the 1.5% year-on-year real GDP in the second quarter represented a significant improvement compared with the miserable 0.7% average real GDP growth experienced since 2014. Elsewhere, Spain has surged since the back-to-back recessions of 2008-10 and 2011-13, with real GDP averaging 2.7% p.a. since 2014. Similarly, since the crisis and deep recession of 2008-10 Ireland has roared back, averaging an astonishing 11.9% p.a. real GDP since 2014, although this is mainly due to Ireland's unusual tax structure which brings huge amounts of FDI relative to the size of the economy and has also attracted numerous corporate "inversions" (takeovers which shift the domicile of a company from one jurisdiction to another, and result in big jumps in the investment figures reported as part of the GDP or GNP).

Returning to monetary policy the European Central Bank (ECB) continues to purchase securities at a rate of €60 billion per month under its version of QE, but seems likely to start tapering its purchases from January 2018. However, there are two problems with this consensus view.

First, even though the economies of the single currency area may have recovered, the basis for sustained M3 growth of 5% or more in the Eurozone – which I believe to be the minimum needed to ensure 2% real growth and 2% inflation after allowing for a 1% annual decline in income velocity or the turnover of money relative to income - is distinctly fragile. Bank lending to households and private sector companies was only growing at 2.7% year-on-year in August, not enough to support a 5% growth of deposits on the other side of bank balance sheets. The risk, therefore, is that tapering QE purchases will lead to a renewed and damaging slowdown in M3 growth.

Second, the inflation rate for the Eurozone remains well below the target figure of "below but close to 2%". The headline rate in August was still at just 1.5% year-on-year while the core rate (which excludes the volatile food and energy components) was even lower at 1.2% in the same month. This means that if the ECB does start tapering and M3 growth slows, the inflation rate could decline even further below its target.

For the Eurozone as a whole I forecast real GDP growth in 2017 of 2.2%, and inflation of 1.7%. However I expect inadequate M3 growth to continue, resulting in inflation remaining below the 2% target figure for the year ahead.

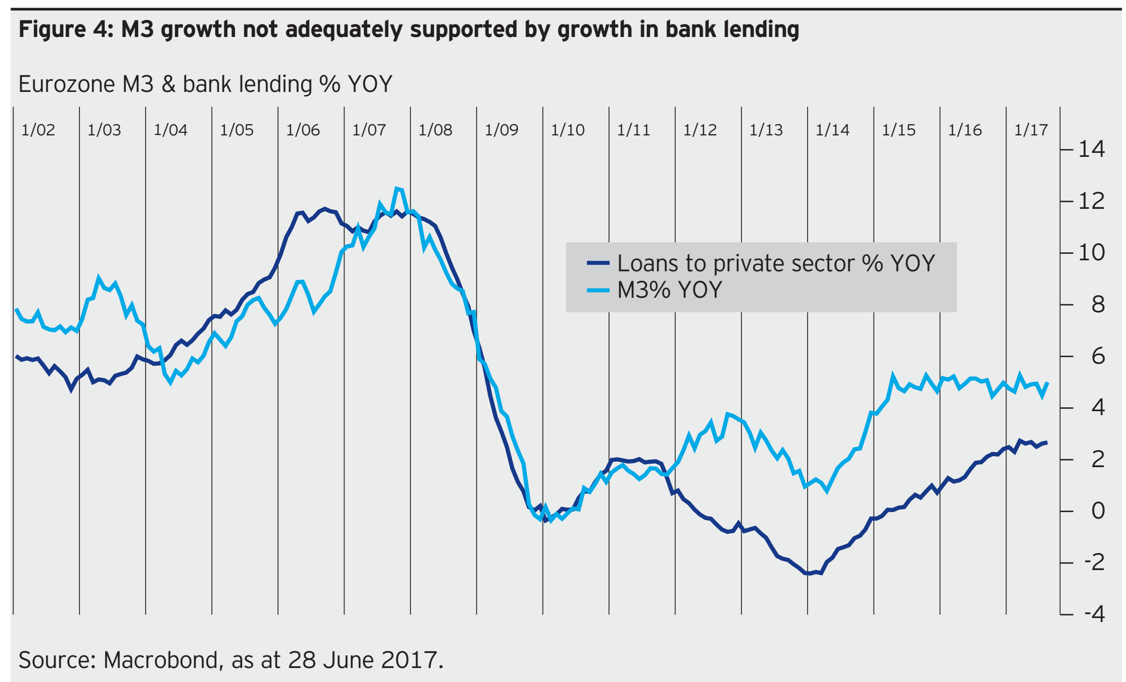


Figure 4: M3 growth not adequately supported by growth in bank lending

Source: Macrobond, as at 28 June 2017.

United Kingdom

The British economy has slowed in 2017 compared with 2016 and particularly compared with the period from 2013 Q1 until the referendum in June 2016, when real GDP growth averaged 2.4% p.a. In effect it has slowed from an "American" growth rate of 2.0-2.5% to a "European" growth rate of around 1.5%. Nevertheless it is notable how buoyant certain elements of consumer and business spending have remained. For example, although real GDP increased just 0.3% quarter-on-quarter in the second quarter of 2017, it grew by 1.4% over the preceding year. Also, in August the retail sales figures were up by no less than 5.0% in nominal terms and 2.2% in real terms compared with August 2016.

There are two main reasons for growth holding up better than the pronounced weakness forecast by consensus economists a year ago. First, monetary policy has been highly stimulatory, and second the weaker pound has enabled the manufacturing export sector to be much more vigorous than expected.

Monetary policy was already very expansionary at the time of the referendum. Commercial bank lending and money growth had accelerated from 4-5% growth rates in the year to March 2016 to 6-8% by the end of the third quarter, well ahead of their growth rates over the preceding three or four years. Then in the aftermath of the referendum the Bank of England's Monetary Policy Committee added fuel to the fire by cutting the Bank's base rate from 0.5% to 0.25%, adding a further £60 billion of Quantitative Easing, and setting up a Term Lending Facility to encourage additional commercial banks to lend to industry. M4x (a measure of money supply that best reflects the spendable funds available to households and businesses) averaged 4.5% year-on-year in January-March 2016, but subsequently accelerated to average 7.0% in the year from July 2016 to June 2017. Similarly, bank lending growth, especially for consumer credit and to the financial sector, surged to double digit growth over the same period. These more rapid growth rates of money and credit are the primary source of faster spending growth in nominal terms since mid-2016.

The second source of higher activity has been the weaker pound which has enabled export order books of British manufacturers to surge to their strongest growth rates since the mid-1990s. Thus the CBI monthly surveys of domestic and export orders have both shown the strongest results since 1995. Also, PMI figures for manufacturing moved upwards from an average of 51.2 in the six months before the referendum to average 55.2 in the first nine months of 2017. Although actual exports have not yet shown distinctly stronger growth rates, this is typical of the delayed "J-curve" response of the external accounts to exchange rate depreciations, initially worsening and only improving after a lag of up to two years.

Another positive for the British economy has been the continued strength of the labour market, reflected in very low unemployment, good job growth, and a record high participation rate. The unemployment rate fell to 4.3% in the three months centred on July, down from 4.9% a year earlier and the lowest rate since 1975. Similarly the employment level increased by 379,000 over the year, reaching 32.14 million and giving a participation rate of 75.3% (i.e. the fraction of people aged 16-64 who were in work), the highest such figure since comparable records began in 1971.

The flip side of these figures is that although average weekly earnings were up by 2.1% (both including and excluding bonuses) in the three months June-August, due to the rise in the inflation rate real weekly earnings were down by 0.4%.

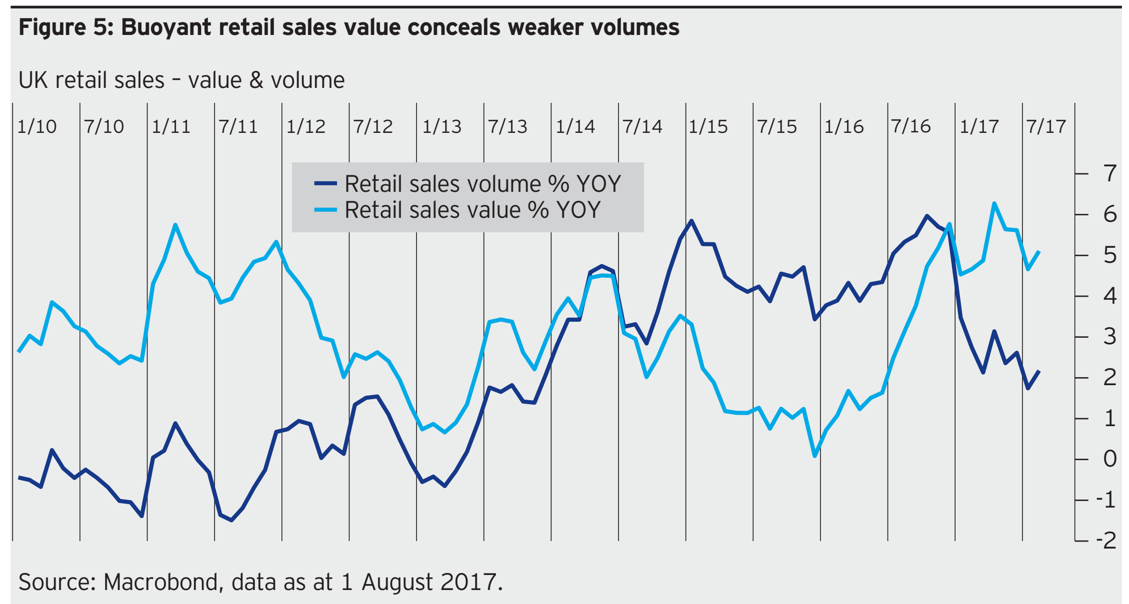
In response to the higher inflation rate the Bank of England had kept its settings unchanged since last August, viewing the inflation as imported and therefore not something that it could control. However, as the evidence of a domestic spending surge accumulated, the Bank has changed its attitude. First, on June 27 it decided to raise the "countercyclical capital buffer" or capital requirements of banks by 0.5% of riskweighted assets, equivalent to £11.4 billion. Second, the minutes of its September MPC meeting reported that a majority of members felt "some withdrawal of monetary stimulus was likely to be appropriate over the coming months". This is a clear signal that a rate hike is coming, probably at the November meeting of the MPC.

The announcement comes against a backdrop that sees the Bank of England on the horns of a dilemma. On the one hand consumer price inflation increased to 2.9% in August from 2.6% in July on the back of higher clothing and petrol prices, very close to exceeding the Bank's primary mandate to maintain inflation at 2% and within the range of 1-3%. If the inflation rate exceeds 3% the Governor is obliged to write a letter to the Chancellor explaining why it has exceeded the target. This clearly suggests the Bank should have been raising rates and slowing money and credit growth already. On the other hand the Bank would also like to keep interest rates low to support investment spending and jobs during the Brexit negotiations. The minutes of the August MPC meeting indicated that business investment was flat in the second quarter, probably influenced by companies' concerns over Brexit. The Governor went out of his way to explain that the Bank could do little to prevent delays to capital spending decisions in the business sector that were affected by the UK-EU negotiations, and that this was a government responsibility.

For the year as a whole I forecast 1.5% real GDP growth and 2.7% consumer price inflation.

Figure 5: Buoyant retail sales value conceals weaker volumes

UK retail sales – value & volume



Source: Macrobond, data as at 1 August 2017.

Japan

In 2017 Q2 Japan's real GDP increased by 0.6% quarter-on-quarter and 1.4% over the previous year (after 0.3% quarter-on-quarter and 1.5% year-on-year in 2017 Q1). Contributing to this recovery was a 0.8% qoq increase in private consumption, and a strong 6.0% jump in public sector investment. Business investment increased by 2.8% on a year-on-year basis while exports soared by 6.8%. Real GDP has now increased for six successive quarters, the first such extended run of growth for over a decade. However, considering Prime Minister Abe's much-touted "Three Arrows" recovery plan (consisting of monetary expansion, fiscal stimulus and structural reform), in particular the huge scale of Japan's QE programme – which forms one of the Three Arrows and has already expanded the Bank of Japan's balance sheet to 92% of GDP – the results should have been evident much sooner and should have had a much greater impact on nominal GDP. This raises the basic question of why the programme has been so weak.

The answer is that the QE programme (or "QQE" for qualitative and quantitative expansion as it is known in Japan) has been subject to two types of dilution.

First, like the ECB, the BOJ has reduced the effect of its asset purchases by buying a large portion of the securities for its portfolio directly from commercial banks' portfolios, which means that the purchases do not immediately create new deposits or money in the hands of firms and households. Therefore if banks are risk averse or short of capital and do not increase their lending, there is no guarantee that the asset purchases will create new deposits or money to fuel an economic upswing.

Second, as much as 15-20% of the BOJ's monthly purchases have been in the form of short-term financing or treasury bills (*tegata*) – mostly held by the banks - that have had to be rolled over when they matured. These operations therefore amount to little more than a continuous rolling asset swap between the BOJ and the commercial banks. Hence although Governor Kuroda at the Bank of Japan has been implementing "QQE" for four and a half years, broad money (M2) has only grown at an average rate of 3.6% p.a. since March 2013, instead of the 5-6% p.a. minimum that would be needed for sustained real GDP growth of 1.5-2.0% with 2% inflation.

Frustrated at the failure of the economy to recover more vigorously, the Abe administration has tried to boost incomes and break free from long-standing deflationary pressures by persuading companies to grant higher wage increases. However, even here the response has been mediocre to weak. Total nominal cash earnings for July were reported at an unexpected -0.3% (year-on-year) in July, the first negative figure in over a year due to reduced bonus payments, in turn pressured by weak corporate earnings. Looking forward the consensus expectation is for total earnings to rise by just 0.5% in 2017, less than the 0.6% achieved last year. In other words, no near term solution is in sight.

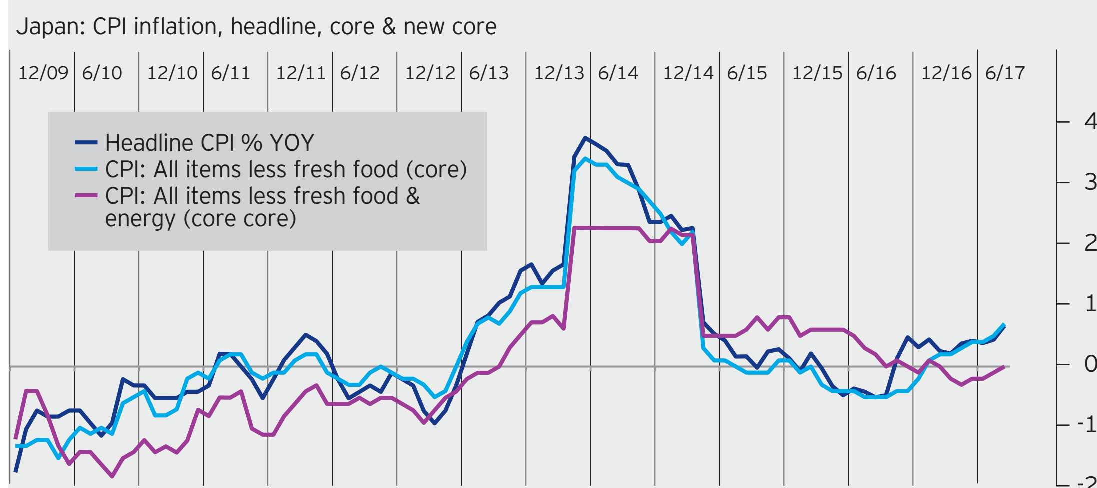
As explained here last quarter, all this is occurring despite prolonged tightness in the labour market. With unemployment at 2.8% in August and the job offers-to-applicants ratio at 1.52 (the highest level since the boom of the early 1970s), it is clear that wagepush alone is not going to cause inflation. The current experience in Japan of a tight labour market but low wage growth is strong evidence that the Phillips curve is not a dependable theory of inflation. The relationship is in reality no more than an empirical observation that appeared to work under certain conditions in the past, but is failing at present (not only in Japan but also in the US, Germany and elsewhere) because the underlying driver of both more rapid wage growth and higher inflation – namely faster money growth – is not present.

The result is that Japanese consumer price inflation has remained stubbornly below the BOJ's 2% target. Headline CPI inflation was 0.6% year-on-year in August, while core inflation (excluding fresh food) was 0.7% and core-core inflation (i.e. excluding fresh food and energy) was 0.2%.

I expect Japanese real GDP growth to average 1.5% in 2017, while some weakening of the yen (not domestic monetary growth) will raise headline inflation CPI to 0.4% for 2017 as a whole.

Figure 6: Despite huge QQE by BOJ, Japan's core inflation is still zero

Japan: CPI inflation, headline, core & new core



Source: Macrobond, 1 August 2017.

China and Emerging Asia

Ahead of the 19th National Congress of the Communist Party to be held in Beijing during the autumn, the political imperative is to keep everything stable, and above all to maintain the economic momentum of the economy. The Congress is widely seen as a key opportunity for President Xi Jinping to consolidate his power, reshuffling the members of the State Council and nominating his loyalists to the top posts. Maintaining stability has necessitated a series of measures, sometimes easing and sometimes tightening, to prevent short term economic problems from developing into full-blown crises. This is the reason why the authorities have at times put their foot gently on the accelerator (for example, reducing banks' reserve requirement ratios at the end of September), and at other times tapped on the brakes (for example local governments imposed purchase restrictions and tighter mortgage conditions in the first half of the year to cool the property market).

Stepping back to gain some perspective and view the longer term developments, China has in the past few months succeeded in slowing the huge surge of domestic credit that had developed in 2014-16 and had averaged 21% p.a., far faster than either China's M2 growth rate or the growth of "total social financing" which includes shadow bank lending as well as corporate bond issuance and other forms of non-bank financing. The Chinese debt-to-GDP ratio has therefore abruptly stopped rising. This is not to say that China is actively de-leveraging yet, but at least the huge increases in indebtedness that began in 2009 have slowed decisively.

In retrospect it appears that at least a portion of this credit surge was in effect refinancing the $1.2 trillion of credit that Chinese companies had borrowed abroad between 2010 and 2014 (based on BIS data).That borrowing had built up because the Chinese authorities had pursued a policy of steadily appreciating the Chinese RMB, thereby creating an opportunity for mainland companies to borrow dollars and other foreign currencies at very low interest rates, convert the proceeds to RMB, and enjoy the double benefits of higher returns in RMB and the appreciation of the Chinese currency – in short, a classic carry trade. However, when the RMB stopped appreciating in 2014-15 and started depreciating, it no longer made sense to borrow US or HK dollars or Japanese yen, and as much as $600 billion of these loans were repaid. However, to maintain the investments embarked upon, domestic funds needed to be raised. Much of it came from banks via lending to provincial and local government entities, as well as to non-bank financial companies.

Going forward the Chinese authorities appear to have learned the folly of providing a one-way bet on their currency, and, following two years of reversing their capital market liberalisation by clamping down on capital outflows (and enticing capital inflows from foreigners) to preserve the value of the RMB, there are tentative signs that the RMB may be allowed to fluctuate more freely. This would also reduce the incentive for Chinese entities to build up leverage in future. In addition, based on recent data, the overall growth of money (M2), domestic credit and total social financing are all converging on a range of 10-12%. If this is maintained it has considerable significance for China's macroeconomic stability in the next two years, for this would finance a growth rate of real GDP of 6-7%, an annual decline in velocity of 3-4% (based on trends over the past decade) and an inflation rate of less than 2%.

Domestically the growth of real GDP was reported at 6.9% in both the first and second quarters, in line with targets set by the leadership. However, following the reduction of excess capacity in numerous state-owned sectors of heavy industry, most Li Keqiang-style estimates of real GDP - named after China's premier and based on readily available data – have surged since late 2016 reflecting the temporary recovery of a number of basic industries such as steel, coal and electricity.

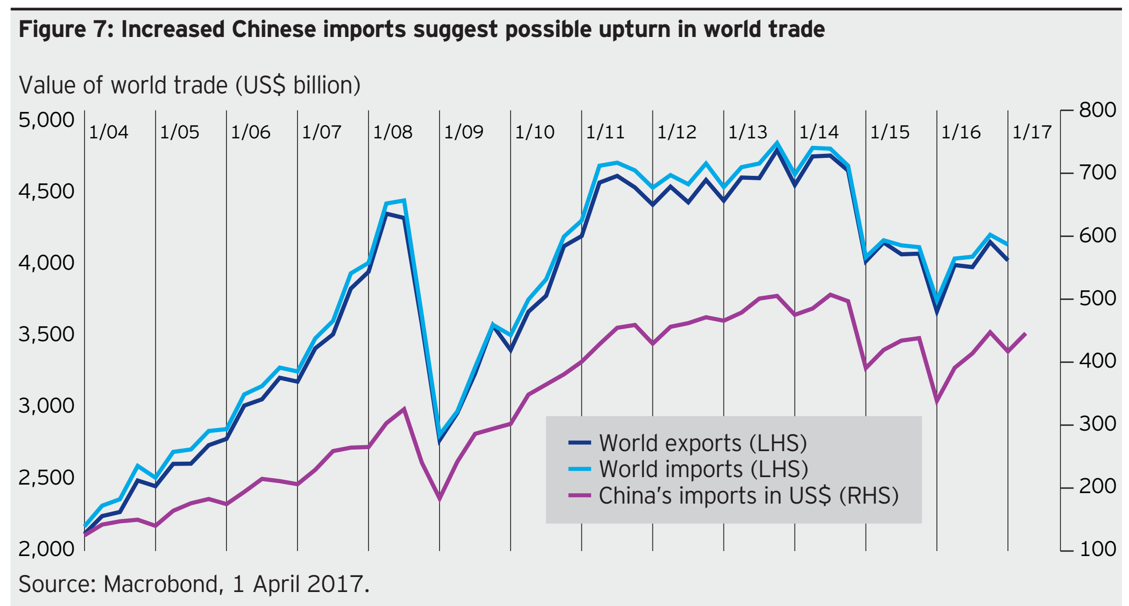
On the external side China's exports have also recovered from declines a year ago to 8% year-on-year in the period June-August. Imports have recovered even more sharply to a peak of 25% in March, and slowing to 14% in June-August. With both Chinese exports and imports recovering it does seem that the prolonged slump in world trade may at last be shifting to expansion.

Since China is by far the largest emerging market and also the biggest buyer of commodities on world markets, the growth of China's imports matters immensely to numerous commodity exporters, both developed and emerging, around the world. If China can engineer a steady domestic recovery over the next year or two, the outlook for those commodity exporting economies will improve considerably. However, in light of the continuing moderate recovery in the developed western economies, it may not be possible for China alone to act as a global locomotive for all commodity producing economies.

For the year as a whole I expect 6.8% as the official real GDP growth figure and 1.3% consumer price inflation.

Turning to the smaller, manufacturing economies of East Asia which are heavily involved in regional supply chains that include China, the outlook for their exports will depend primarily on the continuation of business cycle upswings in the US and Europe and only secondarily on the domestic Chinese economy. This is because China imports mainly raw materials and capital goods (not made by these economies), and relatively few manufactured goods for its own end-use. By contrast, North America and Western Europe are major importers of the manufactured goods produced by Asian supply chains. In 2017 Korea, Taiwan and Hong Kong are only expected to grow at 2-3%, while the ASEAN economies are expected to grow at 4-5%. Although these real GDP growth rates are generally below past trends, nevertheless the smaller, export-oriented Asian economies have enjoyed large stock market increases so far this year in response to signs that global trade growth may be starting to pick up.

Figure 7: Increased Chinese imports suggest possible upturn in world trade



Source: Macrobond, 1 April 2017.

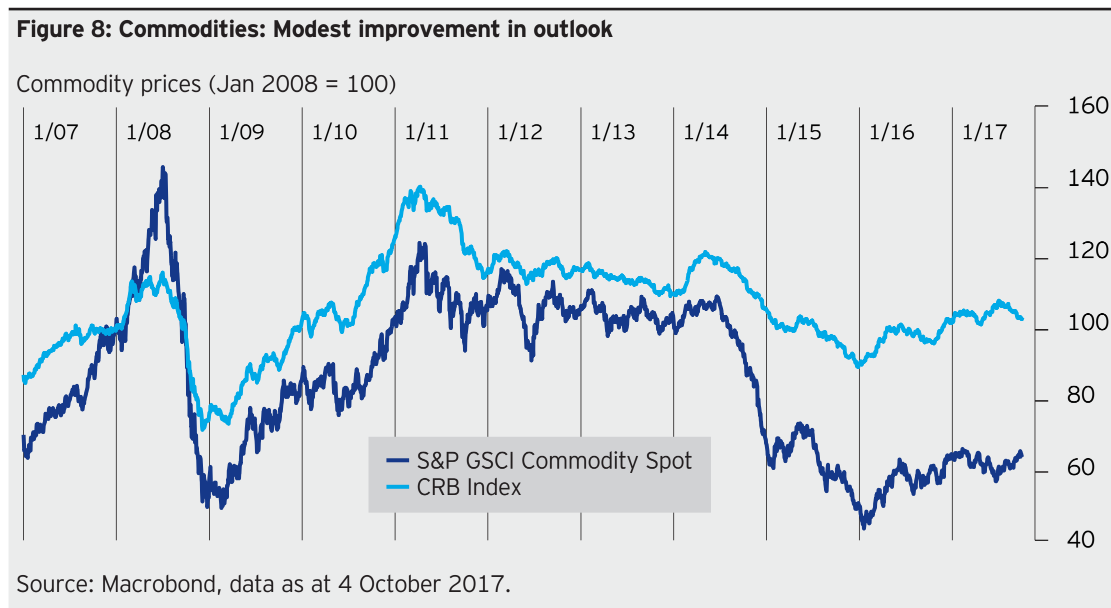
Commodities

Three fundamental factors that had kept me bearish on the outlook for commodities may at last be shifting. In particular, the continuing recovery in the United States economy, the gradual improvement of activity in Europe, and the signs of an upturn in world trade argue for at least the possibility of a stabilisation in commodity prices. The continuation of the global expansion (which is my base case) argues for stronger aggregate demand in the quarters ahead, reflected in the upturn in world trade, and in turn showing up in stronger commodity prices. If this is correct, the upturn in commodities would be nevertheless be limited during the phase of monetary policy normalisation in the US and in the Eurozone.

The main risks to this improvement in the backdrop for commodities are threefold. First is the possibility that the Fed over-tightens monetary policy – not so much by interest rate hikes but by shrinking its balance sheet – in turn leading to an unintentional slowdown in US growth or even a recession. Second, there is a non-negligible risk that when the ECB starts to taper its asset purchases that bank credit and money growth slow down again, causing growth in the Eurozone recovery to falter. Third, there may yet be adverse consequences deriving from China curbing its credit expansion.

However, for the present I regard these three risks as slight. Indeed, the mild recovery of oil and metal prices in recent weeks and the nascent recovery in world trade rather suggest that the bear phase for commodities may at last be coming to an end.

Figure 8: Commodities: Modest improvement in outlook



Source: Macrobond, data as at 4 October 2017.

Conclusion

The global business cycle expansion is still intact, supported by continuing growth in the US, joined now by a gathering upturn in the Eurozone and the start of a renewed upswing in global trade. The expansion among the developed economies is in turn is having beneficial effects on the export-oriented, manufacturing economies of East Asia, the Americas and some of the commodity-producing emerging economies.

There is good reason to expect that the current expansion will be an extended one, perhaps even the longest business cycle expansion in US financial history. This would imply a continuous upswing that exceeds the record trough-to-peak expansion of 120 months between March 1991 and March 2001 (as measured by the NBER) and presided over by Alan Greenspan. The only real threat to this prospect is the possibility that central banks make a mistake and tighten too much during the current or coming phase of monetary policy normalisation. If they overdo the tightening, there is a real risk of a slowdown in 2018-19, and a continuation of below-target inflation rates across many major economies. This is not my base case, but investors need to be mindful of this possibility.

John Greenwood
Chief Economist, Invesco
2 October 2017

Important information

This marketing document is not subject to regulatory requirements that ensure impartiality of investment recommendations and investment strategy recommendations. Therefore, the prohibition of trading before the release of investment recommendations and investment strategy recommendations does not apply.

The value of investments and any income from them will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

While great care has been taken to ensure that the information contained herein is accurate, no responsibility can be accepted for any errors, mistakes omissions or for any action taken in reliance thereon.

Where John Greenwood has expressed opinions, they are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco professionals.

All data provided by Invesco, sourced from Macrobond, unless otherwise stated.

Data as at 2 October 2017, unless otherwise stated.

This document has been prepared only for those persons to whom Invesco has provided it for informational purposes only. This document is not an offering of a financial product and is not intended for and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any person without the consent of Invesco is prohibited.

This document may contain statements that are not purely historical in nature but are "forward-looking statements", which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

- may contain references to amounts which are not in local currencies;
- may contain financial information which is not prepared in accordance with the laws or practices of your country of residence;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address local tax issues.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.