ARCANO

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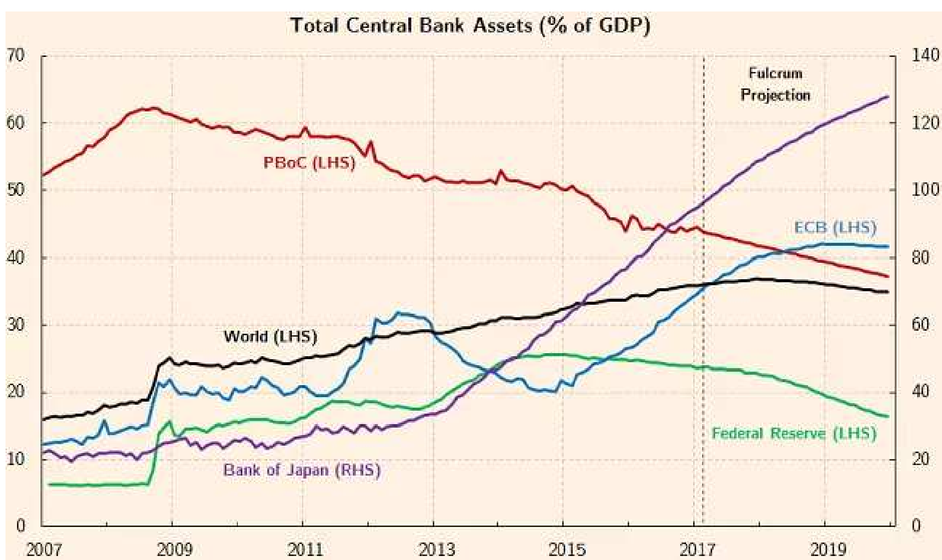
Global Macro: Reflation on the march

Global growth is accelerating at above 4%. For this reason, inflation is also gaining traction in almost all major countries, although at the moment the rates of increase are still moderate. More expensive oil compared to levels at the beginning of 2016, is also helping to push inflation (due to the base effect). However, as the months pass this year, this base effect is being significantly mitigated....

In order to avoid excessive overheating of the economy that stems from the already growing inflationary trends, the main central banks (Fed and ECB) are already showing signs of a change in their monetary policies. In fact, the Fed has already raised interest rates twice since the election and the ECB decided to reduce the amount of asset purchases for the rest of 2017.

In any case, the monetary policy of quantitative expansion followed by the main central banks, which has contributed in recent years to liquidity close to 2% of the GDP of the major countries, is coming to an end (Figures 1 and 2). This policy has led to a sharp increase in the size of the balance sheets of these central banks, creating new money to acquire bonds, especially sovereign ones. Central banks expanded their balance sheets at a rate of 2% of world GDP per year, however this figure will be zero at the end of 2018, and will be negative (-1.5%) from 2019 onwards for many years, which will mean a deflationary force in the price of many assets.

Figure 1. Central bank balance sheets as % GDP



Source: Haver Analytics, Fulcrum Asset Management, Financial Times

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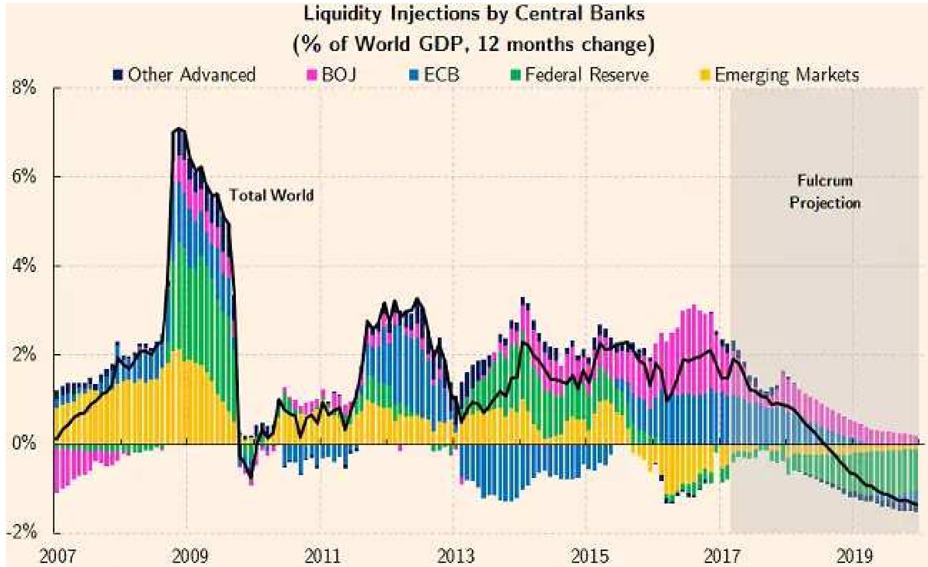
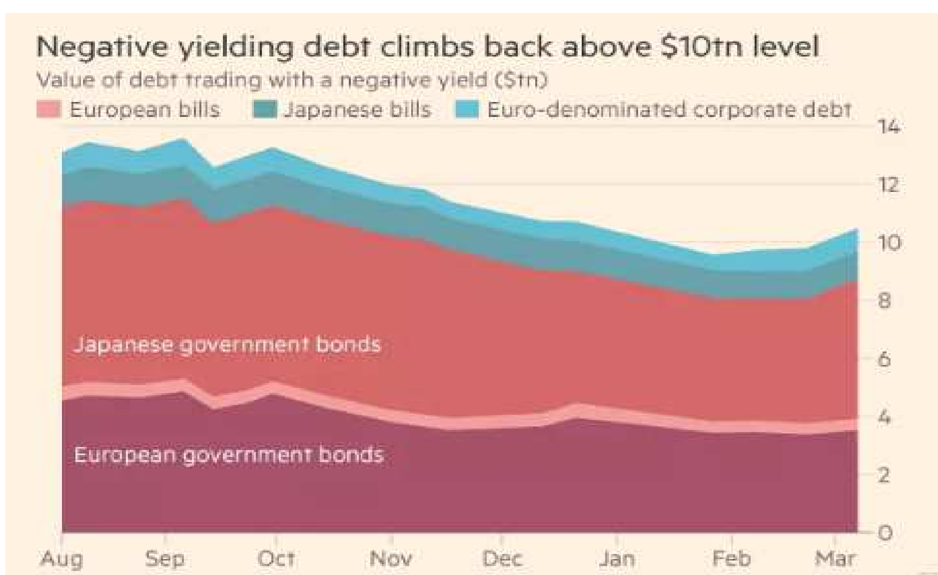
Figure 2. Liquidity injections of central banks (as % GDP)



Source: IMF, National Data, Haver Analytics Fulcrum Asset Management, Financial Times

As the demand for sovereign bonds increased, its price has risen very significantly in recent years, thus reducing its return. As this is often the base for valuation of multiple assets (financial and real estate), very sensitive bubbles have been created in most financial markets (sovereign bonds, corporate debt of all credit ratings and maturities,...) and in the real estate sectors of some major countries (Canada, France, United Kingdom, ...). Figure 3 clearly shows the bubble in the bond market. This situation makes these markets particularly vulnerable, since in the future there will be an increase in official interest rates (now at historic lows in general) and given a reduction in the demand for sovereign bonds by central banks, the price of these could fall, their return would rise and therefore, adversely affect the aforementioned bubble in multiple assets.

Figure 3. Listed debt with negative rates



Source: Tradeweb, Financial Times

In the US, expected growth in the first quarter of 2017 is close to 0.5% year-on-year, according to the Atlanta Fed (which updates real-time projections according to the battery of indicators generated at all times). However, in previous years the first quarter has also been especially weak and as the year advanced, the data was more positive. Consumption is slowing down its growth (for example, car sales show discrete data), as it is very difficult to maintain high rates of durable consumer goods (car replacement, appliances, etc.), after an expansionary phase that already lasted many years. In addition, investments continue without recovering reasonable levels of growth (significantly hurting the productivity growth of the country). The external balance, on the other hand, is trying to compensate for the added difficulty of the persistence of a strong dollar over time. Finally, credit is showing signs of a clear slowdown in recent months, in a sign of possible prudence by local commercial banks.

On the positive side, housing prices are growing by 6% a year, and demand for housing is rising at a rate of 10%, and this despite the increase that has occurred in recent months in interest rates for 30 year mortgages (above 4%, having increased by one percentage point in the last months). In many states, prices are already at levels very close to those observed before the explosion of the real estate bubble of 2007. In any case, the positive evolution of the real estate sector is good news because it has a significant positive drag effect on other sectors and also feeds the wealth effect (due to house price rises), which in turn has a positive effect on consumption (this usually increases by one-tenth of the increase in real estate prices; house prices grow at 6%, consumption increases by 0.6%).

On the other hand, Trump's coalition with the Republicans is weakening (visible with the withdrawal of the Obamacare reform bill). This has called into question Trump's ability to implement a high percentage of ambitious planned reforms in tax, regulatory, infrastructure investment, customs tariffs, etc.

On the other hand, official unemployment has practically disappeared, with the rate below the frictional rate and, more importantly, the NAIRU rate, which would be the one from which risks of inflationary acceleration would be generated up to rates higher than the 2% structural target of the Fed.

Thus, inflation continues to rise sharply, with the general price index (CPI) increasing annually to 2.4%, with core CPI (eliminating more volatile effects such as food and energy) rising by 2%, PCE increasing by 2.7% (this concept, personal consumption expenditure, is often followed by the Fed as an inflation indicator), the core PCE is increasing by 1.8% and wages are increasing by 2.9% per year, Figure 4 (this factor is usually very important in the generation of inflationary accelerations, and is already growing well above the 2% inflation target of the Fed).

Figure 4. U.S Wages (annual variation, %)

Source: FactSet, Financial Times

The Fed maintains a paced response to the level of inflation, and since the November elections last year it has raised interest rates twice, and has given future guidance based on the gradual rise of official rates from current levels of about 1% to levels close to 3% from the end of 2019, Figure 5 (which would imply neutrality of monetary policy, that is to say, it would neither be expansive nor contractive nor would it generate inflation or disinflation). The increases forecast by the Fed are gradual, around three increases of 0.25% each year.

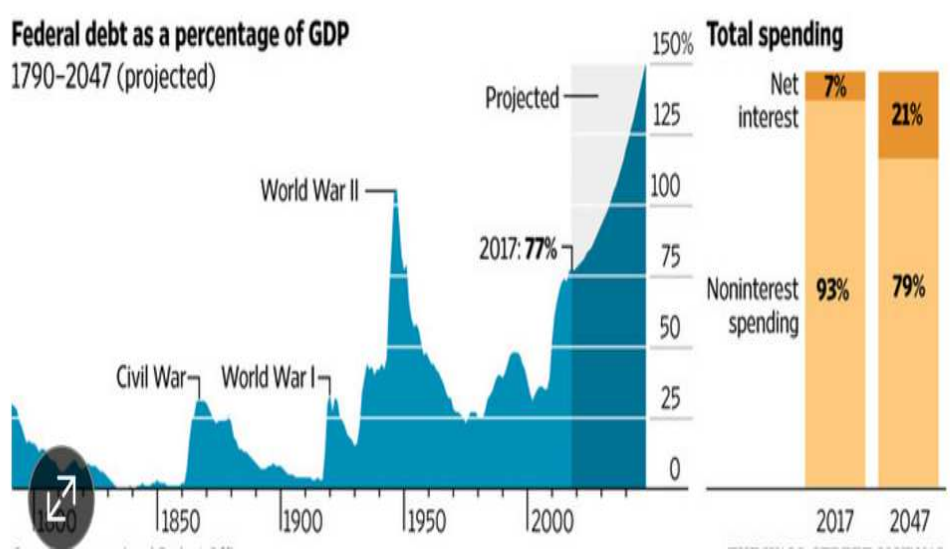
Figure 5. Official interest rates projections by the Fed

Source: Fed, Financial Times

The Fed has not yet begun to reduce its balance sheet (mostly sovereign bonds), but whispers have begun to emerge saying that by the end of 2017 it should begin to abandon the reinvestment of coupons and maturities of assets. This process could lead to downward pressure on prices in the sovereign bond market (and therefore an increasing return), as the demand for this type of asset would be reduced with an offer not only stable but potentially increasing (if Trump implements part of his planned fiscal reforms, which would generate theoretically increasing public deficits).

It is notable, from the standpoint of macroeconomic imbalances, the high level of public debt in the United States (Figure 6). Only federal (not including State) debt accounts for 77% of GDP, but the Congressional Budget Office estimates that, with the current inertia of income and expenditure, it may double in the next 30 years up to 150% (with interest paid on debt rising to 7% of total current expenditure, and to 21% in 2047).

Figure 6. Federal debt as % GDP. Composition of federal expenditure



Source: Congressional Budget Office, Wall Street Journal

Finally, with regard to the US, we are in a situation where the main future risk in sight would be stagflation (low growth like the current level, but with high inflation), reasonable growth but generating high inflation, or recession (due to higher Fed rates than required by the economy).

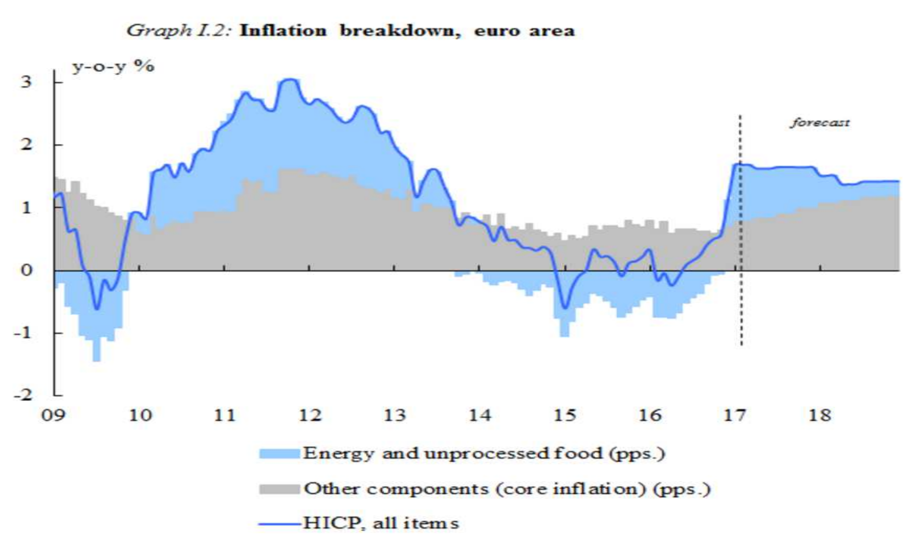
In Europe, growth is surprising positively, and accelerating, which in annualized terms, is already clearly surpassing 2%. Economic data is very strong in Germany and Spain, positive in France, is improving in Italy (from persistent weakness for some time), while in the United Kingdom the messages from indicators are mixed (although tending to show an acceleration of the slowdown, especially in retail sales and real estate). Consumption, which is the most relevant variable in European GDP, benefits from increased consumer confidence (maximum of two years), which is in turn favoured by job creation that is taking place continuously. In short, the survey of composite PMIs (which measures business activity at all times), and which is the most traditionally reliable advance indicator, truly reflects the strength of the European economy (Figure 7).

Figure 7. Eurozone: Composite PMIs

Source: HIS Markit, Financial Times

As a consequence, inflation has clearly accelerated at the beginning of the year compared to the rates observed in 2016, showing annual increases of 1.5%, Figure 8 (although the core CPI is only growing by 0.7%, the difference is given by the base effect of the oil price, clearly higher in the first half of 2017 compared to the first part of 2016). Usually, a notable and lasting acceleration of economic growth leads to an acceleration of inflation, especially if financing is also abundant (the money supply is growing at 5% annual rates, and bank credit, at 2% in balances). In any case, the aforementioned inflation acceleration is also closely related to the degree of utilization of productive capacity, since with a greater use of the same, an increase in final demand tends to move to a large degree towards higher inflation (since supply, because of its greater inflexibility, is not able to respond with the same intensity as the demand for goods and services). And in Europe unemployment is already at 9.5%, the lowest since 2009.

Figure 8. Eurozone: Annual inflation (%)



Source: Eurostat

In view of the above, the ECB changed its bias recently with a less expansive tone, given the improvement in the economy and the reluctance of Central Europe (especially Germany) for an excessively lax monetary policy in an environment of clear macroeconomic improvement (something to which the ECB may be especially sensitive to in an election year in Germany after the summer).

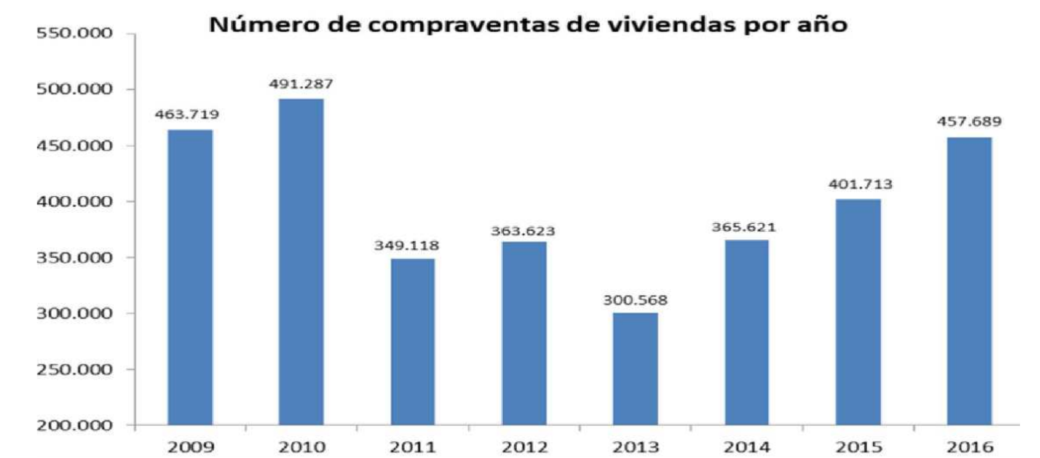
Finally, it should be noted that, as the economic context improves, the risk of populism should decrease (as was have seen in recent elections in the Netherlands, where the most populist party performed well below initial expectations). In fact, the result of the first round of the French elections has reassured economic agents, as it has shown centrist Macron's victory against extremist and anti-European Le Pen (the clear favorite being the first to win in the second round). This result, by significantly removing political uncertainty in Europe, is positive for the euro and could even lead to a tightening of the tone of the message and monetary policy of the ECB.

Spain again is surprising with its upward trend, with strong quarterly growth of 0.8% expected in the first quarter of 2017 (according to Airef, an independent fiscal authority). Again Spain has extrapolated annual growth of more than 3% (confirmed by strong PMIs in the services sector, Figure 9). There is continued strength in industry, services (with tourism growing at double-digit levels again) and exports. There is some weakness in hotel overnight stays (following the persistent price hike in recent years) and in retail sales (probably associated with the inflation rebound at the beginning of the year, which in any case was mitigated in the last month due to the decrease in the base effect of the higher oil price). In any case, Spanish growth shows high levels of equilibrium, with consumption favoured by job creation, investment in capital goods continuing to increase its contribution to GDP (after clearly surpassing historical averages during the crisis), construction taking advantage of the benign residential real estate cycle (with prices and demand of houses growing at significant rates, Figure 10) and exports benefitting from the recovery of Europe and competitiveness gains produced by the crisis. All this, without showing dependence on external financing (showing positive current account surpluses of around 2%) and without depending too much on the acceleration of domestic financing (bank credit, new credit flows, although there are segments showing high growth, levels are still clearly below historical averages).

Figure 9. Spain: PMIs of Service Sector

Source: Markit, INE

Figure 10. Spain: House Sales



Source: Ministry of Development (Notaries)

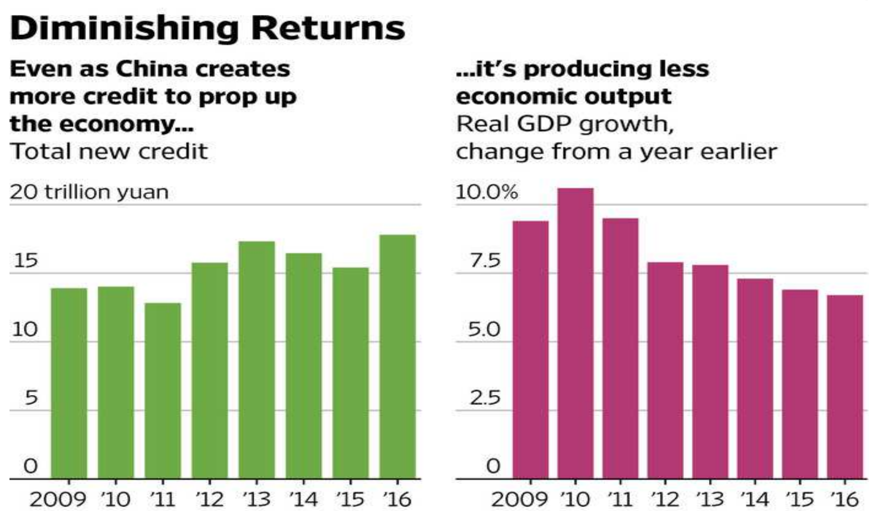
Inflation is up 2.3% year-on-year (after touching 3% at the beginning of the year), with core inflation at around 1%. High unemployment continues to weigh on wage growth, although this, as the use of available resources (employment) increases, tends to accelerate. In fact, the labour market continues to benefit from very positive trends (growing by 2.3% per year according to EPA data, + 3.5% according to INEM).

From the point of view of relevant structural factors, after 5 years of declines, the population stabilized during 2016 (at 46.5 million), and the fiscal deficit finally also fell below the estimates in 2016 (it was 4.3%). It should be noted that the high public debt (around 100% of GDP) is one of the most important structural risks of the economy.

Regarding China, growth is still reasonable, around 6.9%, but imbalances persist (especially excessive corporate borrowing, Figure 11, high levels of overinvestment in the economy and a strong housing bubble). The Chinese central bank is trying to reduce the overweight shadow[1] banking sector in the economy by draining liquidity in the money market (as nearly $4 trillion of assets held by shadow banks are funded by the Money market, ie by banks in particular, Figure 12). Interest rates are increasing, with the 10-year bond already at 3.3%, the maximum in two years. This could have a negative impact on Chinese companies (with corporate debt being around 100% of GDP). Meanwhile, the central bank's dollar reserves have already fallen below 3 trillion, due to the persistent capital outflows that have occurred in recent quarters (caused, on the one hand, by investors' fear of the aforementioned imbalances will end up making a dent in the Chinese economy, and on the other hand, by the central bank's defense of the local currency, which is implemented by selling dollars and buying yuan). In any case, capital outflows seem to be stabilizing.

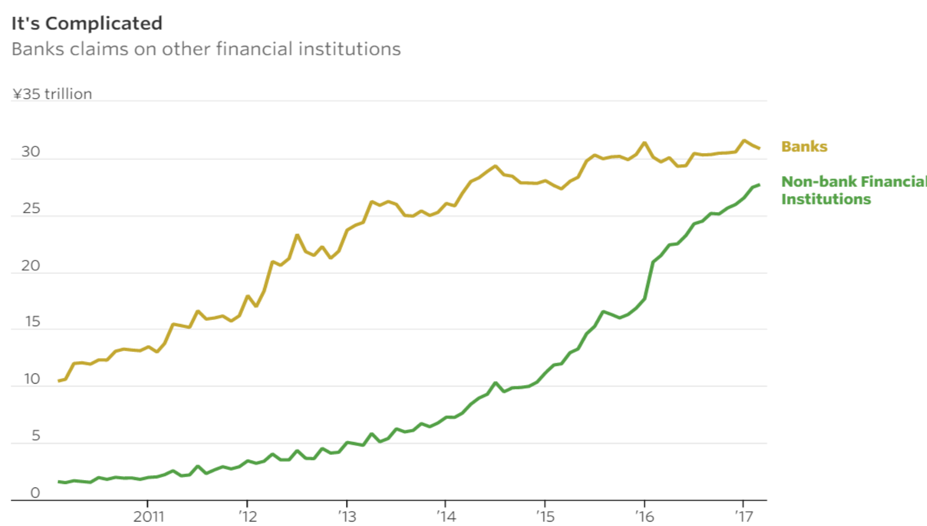
[1] Shadow banking: non-bank financial entities (unregulated) that participate in the financing of the economy, especially companies (for example, structures designed by banks, in many cases, whose assets are loans to SMEs, being the liability both high-income private client investments and financing granted by banks to increase investment capacity)

Figure 11. China: Marginal return on debt, declining



Source: The Wall Street Journal

Figure 12. China: Exposure of regulated banks to financial institutions



Source: Wind Info

With regard to other emerging economies, there are notable inflows of capital in some countries, strengthening their currency again (especially Mexico and Russia). Mexico raised its rates to 6.5% to control rising inflation from the previous depreciation of the currency. Brazil, faced with lower inflation, reduced its rates progressively and GDP hit the ground after falling 2.5% year-on-year. Indonesia has fallen into a recession, India grew annually to 7% in the fourth quarter of 2016, Turkish inflation reached 11.3% (with high risks due to its heavy reliance on external financing) and South Africa surprisingly replaced the finance minister (with a worsening credit rating to "junk bond").

Conclusion

The world economy is growing more than in the last seven years, something we should all welcome. However, higher growth implies an increased risk of inflation, and in this context central banks will begin to change the aggressive monetary policy implemented in recent years. It has been precisely this policy that has led to huge expansions in the prices of many assets. The great unknown is what will occur with such prices in an environment in which its main monetary support

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