# Economic Outlook – August 2017

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# Synthesis

- There is a global recovery. Since the end of 2016, world trade is growing at a stronger pace (5%). This creates a virtuous loop with economic activity.
- In recent months, this improvement comes mainly from the Euro area where GDP growth is now close to 2%.
  This new momentum reflects a stronger global environment, a low and stable oil price and accommodative economic policies. The fiscal policy stance is now neutral and the ECB monetary policy is expected to remain accommodative for an extended period. Economic policies do not weigh negatively on the private sector momentum. Therefore there is a catch up effect on employment and on corporate investment.
- The momentum is weaker in the US. Two reasons for that: one is that the business cycle duration is high (the third longest since WWII) – There is a need for an impulse to boost growth. But, and this is the second reason, the absence of economic policy will create uncertainty and will limit investment. We expect growth to be close to 2% in 2017.
- Robust recovery in Japan based on internal demand.
- Asia is the other source of the recent recovery in world trade under the impulse of China
- The Chinese economy is managed by the government and the central bank to converge to a stable growth trajectory. There are a lot of dangers in China. Corporate indebtedness is too high, there are overcapacities in many manufacturing sectors and the real estate market is still buoyant in large cities. All these sources of imbalances are managed by the government and the central bank.
  If it was not the case, the risk is a high social cost that Chinese authorities do not accept.

# Synthesis and Risks

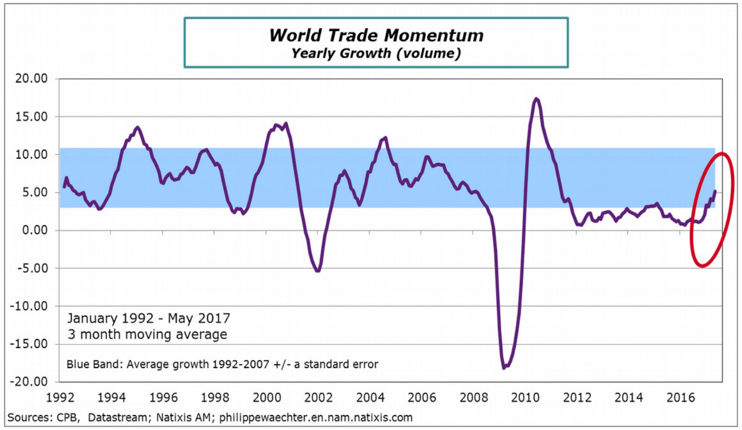
- The low level of the oil price will limit the risk of inflation rates higher than central banks target (2%). We expect that the oil price will remain close to 50 USD in coming months
- We expect monetary policies to remain accommodative. In a foreseeable future we do not expect higher central banks' rates in the Euro area, in Japan and in the United Kingdom
- The situation is more complicated in the US as the Federal Reserve wants at the same time to normalize its level of interest rate and to manage its balance sheet in order to reduce its size.
  The Fed's target is to have the lowest impact on financial markets. It just wants to gain leeway in the management of its monetary policy in order to be able to react in case of an adverse shock on the economy

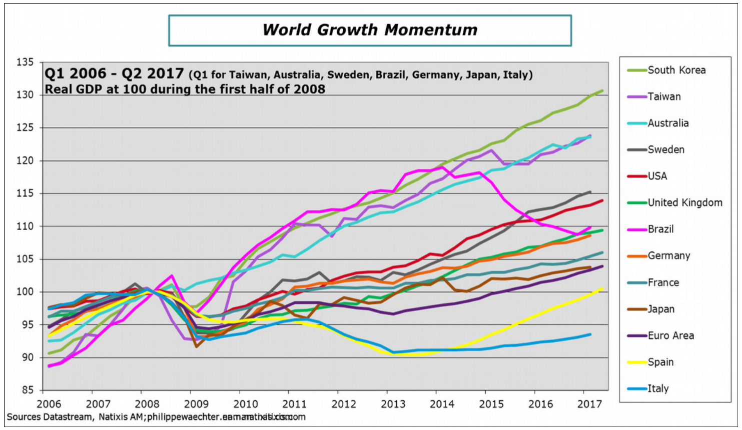
**What are the risks?**

- The US strategy on world trade is still at risks. Recently Donald Trumps has taken sanctions on Russia and it has spoken on trade sanctions on China. The risks is to limit the world trade recovery. Tensions with North Korea is also a source of concern.
- The other main risk is the Brexit. Theresa May doesn't know which strategy to adopt. We are now far from a hard Brexit. A soft Brexit could be positive for the UK economy but it would be the denial of the political will that was behind the referendum.
  The economy is on a lower momentum since the beginning of this year because domestic demand is weaker (HH purchasing power is negative for the last three quarters). As there is still a risk on external trade due to the outcome of the Brexit negotiation, the Bank of England strategy will be to remain accommodative.

# Global Economic Activity

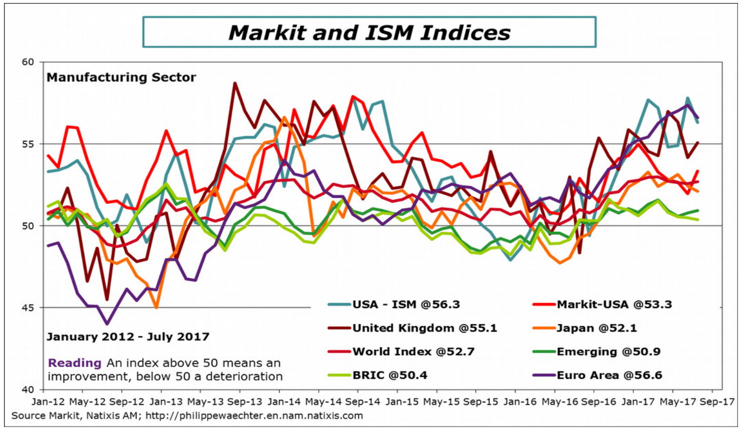
- The global recovery can seen by looking at the world trade momentum. Since the end of 2016, its annual change is back in the pre-crisis corridor (blue band in the first graph).
- In the recent past the world trade slow momentum was not able to create an impulse on economic activity as it used to do before the crisis.
- The world trade recent recovery has been dependent on developed countries dynamics and specifically on the Euro Area. In emerging countries, the momentum is strong with Asia playing an important role.
- Higher trade will create an impulse on economic activity that will feed trade. This loop will be the source of the virtuous dynamic at the global scale.
- The second graph shows that the Asian economic activity is following a rapid pace with China as the main engine. The Brazilian recession was stopped during the first quarter of this year after a two year slide.
- The US is doing well but only at a 2% pace which is weaker than what was seen in former cycles. Germany and the United Kingdom (until now) are doing well. The Euro Area follows a 1.7% trend growth since the beginning of 2013 but is pulled down by Italy for which the recovery is limited. Its GDP is still 6.5% below its 2008 first half level. This is no longer the case of Spain for which the GDP level is back to its pre-crisis level during the second quarter of 2017. The French recovery continues.

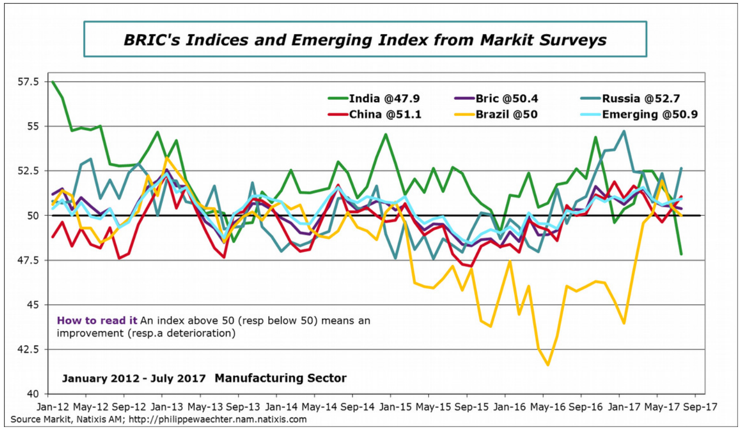


# Short term momentum on the economic activity

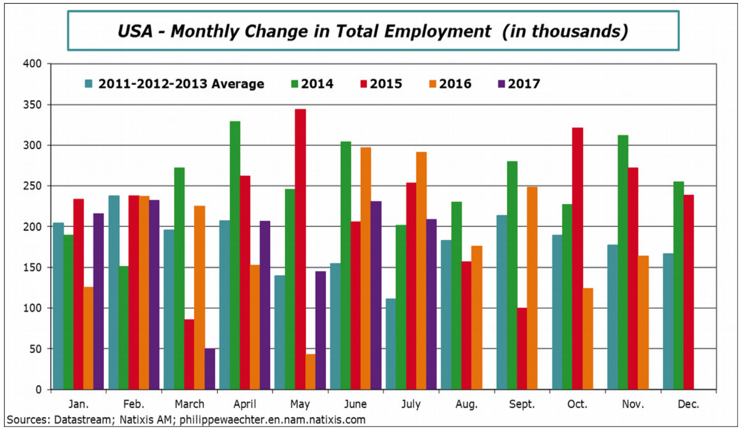
- The recovery is confirmed by corporates' surveys.
- The first graph shows that all the indices are above the threshold of 50 showing an expansion in the manufacturing sector. The world index is clearly in the positive territory.
- This improvement is a reason for the stronger outlook of world trade as the majority of trade is done with manufactured products.
- The Euro Area is doing particularly well with an index close to 2010 level. US and UK indices are also very high but in the short term the correlation with the GDP growth is not strong contrary to what is seen in the Euro Area.
- In emerging countries, indices are above but close to 50 on average.
- In July, weakness has been seen in India after the government has launched a new tax on goods and services. This could have a persistent effect. (This has led the Bank of India to reduce its main rates)
- China is still close to 50 as it has been for the last 12 months. The economic authorities are managing the Chinese economy to maintain a robust growth. But there are still a lot to do with corporate debt and overcapacities in many manufacturing sectors



# USA

- The economic trend in the US remains close to 2% still far from the 3% that was Donald Trump credo during his campaign.
- The ISM index and some others indices were probably too optimistic after Trump's election. This was based on structural measures from the president-elect that could change the GDP and employment momentum.
- May be the drop in July 2017 is the start of the normalization as there is no economic policy at the White House. The repeal of Obamacare has failed therefore there is no possibility to fund lower tax rates (The tax reform would not be able to fund itself as it would favor high incomes from people that already save a lot)
  This lack of economic policy from the current administration is not necessarily negative for the economy because of the income distribution bias it would have created on the top of the large current bias already seen on income distribution.
- Households remain optimistic but their expenditures is now very volatile. During the first half of 2017, March figure has been spectacular but the average of the other five months change is just 0.04%.
- The current business cycle has been very long (the third longest since WWII) but now lacks of impulse. Economic policy was supposed to create this impetus. It hasn't and this change the expected profile for growth (no strong upside) and the way monetary policy will be managed.

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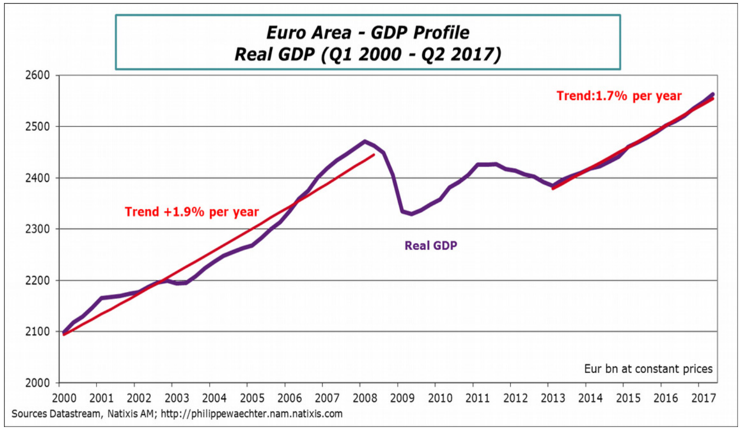
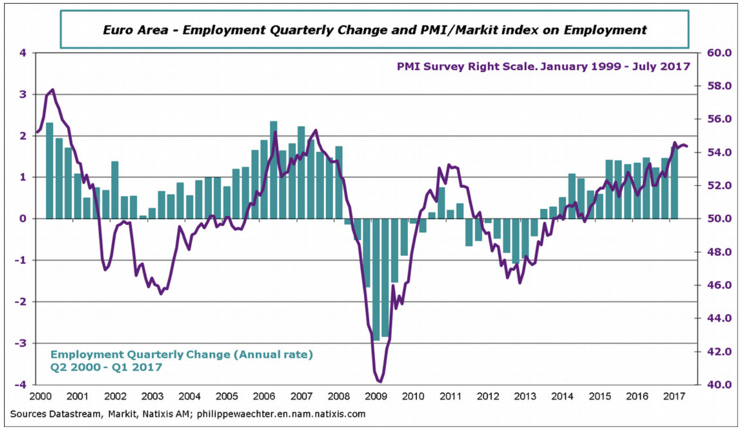
# Eurozone growth

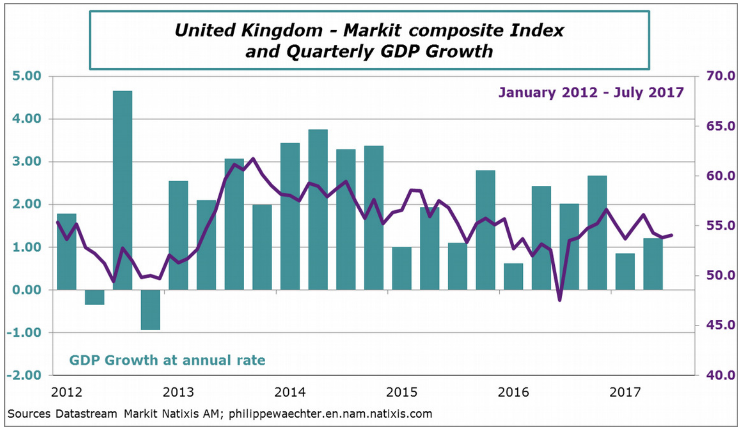
- The growth momentum is now strong in the Euro Area.
- Since the beginning of the recovery (the through was in the first quarter of 2013), the growth trend is 1.7%. This is a bit lower than the 1.9% seen before the 2008 crisis.
- The current dynamics is driven by the private domestic demand. Companies spend more on capital accumulation and households' consumption has been robust (real retail sales were up by 3.6% at annual rate during the second quarter of 2017)
- The catch up seen in corporate investment is also seen in employment. Since the beginning of 2013 almost 5.7 millions of jobs have been created. The income associated with these jobs feeds consumption and the virtuous cycle seen in the Euro Area.
- The main reasons for this growth trend is the more neutral fiscal policy and a monetary policy that is easy to read after Mario Draghi went to the ECB.
- The other important point is that every country in the Eurozone is getting better. This fuels trade within the area improving the domestic momentum.
- The current growth phase is self-sustained. It will improve corporate investment leading to higher potential growth in the future.

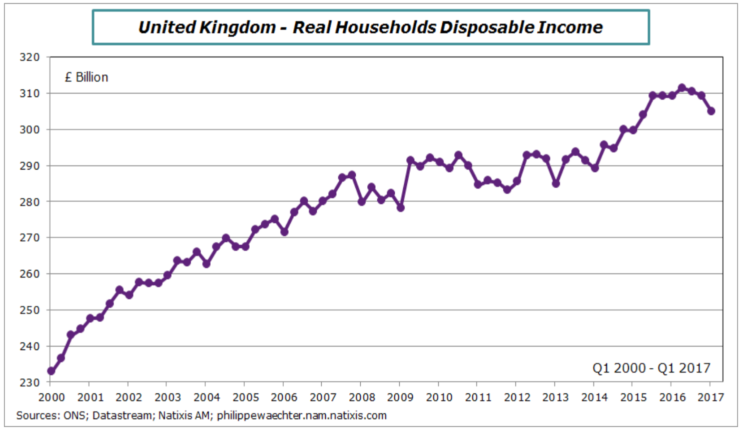


# United Kingdom

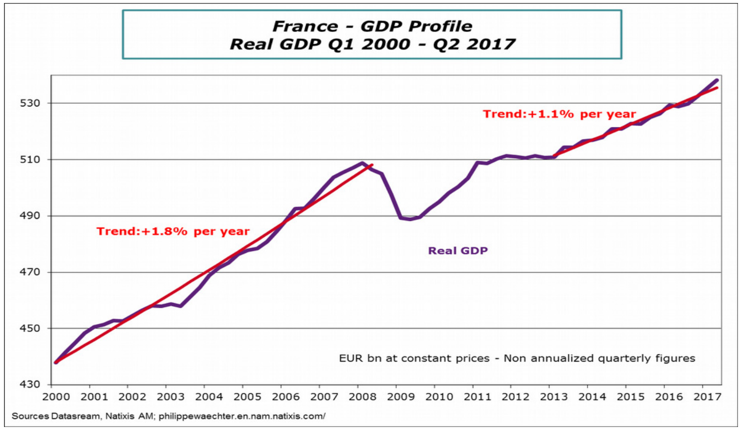
- The question on UK is about the impact of the Brexit, notably on the uncertainty the negotiation provides on the real economy.
- In the short run, surveys show that the economy remains strong. But hard date do not deliver the same message.
- GDP growth has been halved during the first half of 2017 compared to the 2016 average. Investment is following a weaker trajectory and consumption is at risk.
- Three reasons for that
  - Real disposable income has dropped dramatically during the last three quarters.
  - Households' saving rate is at its lowest level during the first quarter of 2017 at 1.7% of their disposable income. It was at 5.15% on average during 2016
  - The consumer credit change is high but no longer increasing.
- If there is no strong boost in employment we can expect a drop in consumers' expenditures as household resources are constrained by the three elements mentioned above. It will push down corporate investment.
- This will the main source of lower growth. That's why I do not believe in higher rates in the UK.

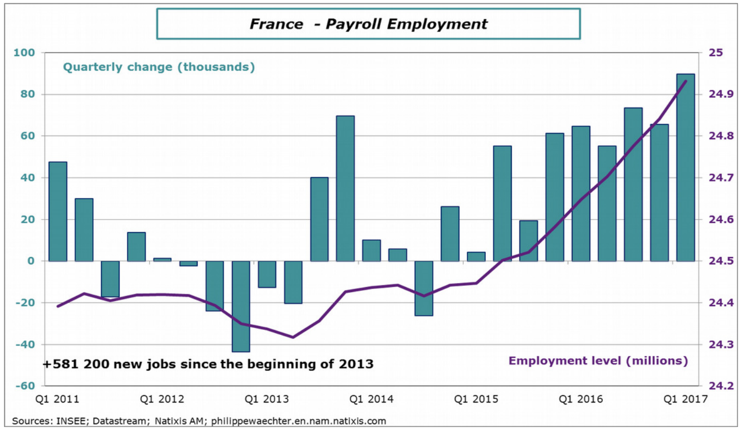


# France

- The French economy is doing well. During the last three quarters GDP growth was between 2% and 2.2% at annual rate. It means that the average growth for 2017 will probably be at 1.7%, its best performance since 2011.
- The change in trend started in 2013 as it can be seen on the first graph. In 2011 and 2012 GDP growth was close to 0%, since then its trend is 1.1%.
- This reflects a more neutral fiscal policy when the ECB was very accommodative. There were less uncertainties from the economic policy side and therefore the possibility for companies and households to adapt their behavior to their own constraints.
  In a more robust growth environment at the European level, low interest rates and a more business friendly economic policy at the French level (notably to boost companies' margin) the private sector became more optimistic.
- Jobs creation was strongly on the upside in the private sector after 2015 and their was a revival in corporate investment after this date. The dynamics is more virtuous.
- The main weakness comes from the external trade where the deficit shows a lack of competiveness in price and in quality. In the Euro area, where growth is now close to 2% French exports are not doing well enough.
- One task for Emmanuel Macron, the French new President, will be to boost this competitiveness through structural reforms (first the labor market in September this year)



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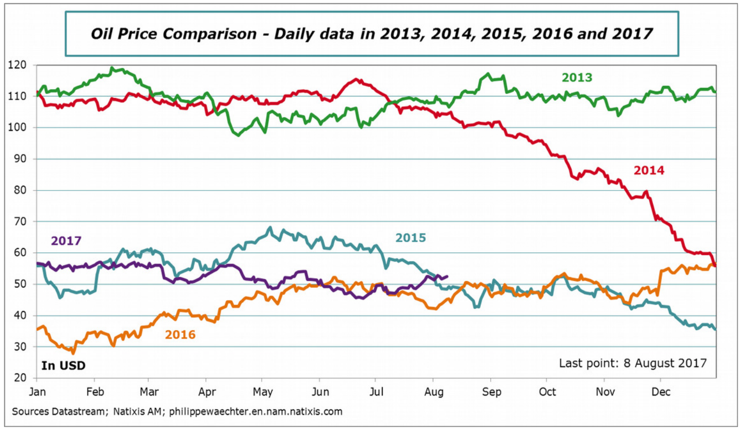
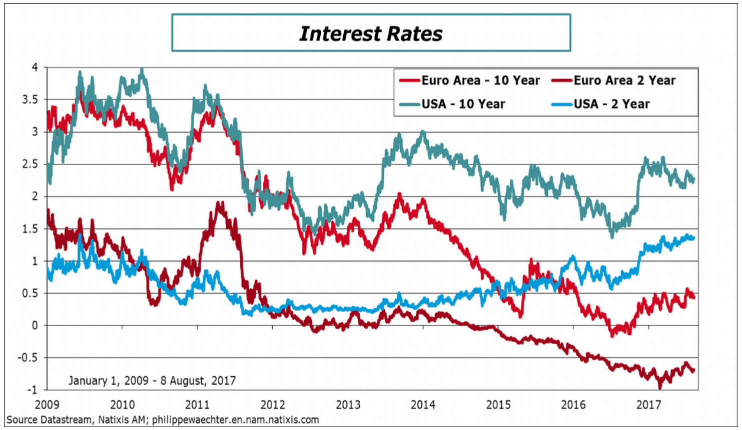
# Oil price and interest rates

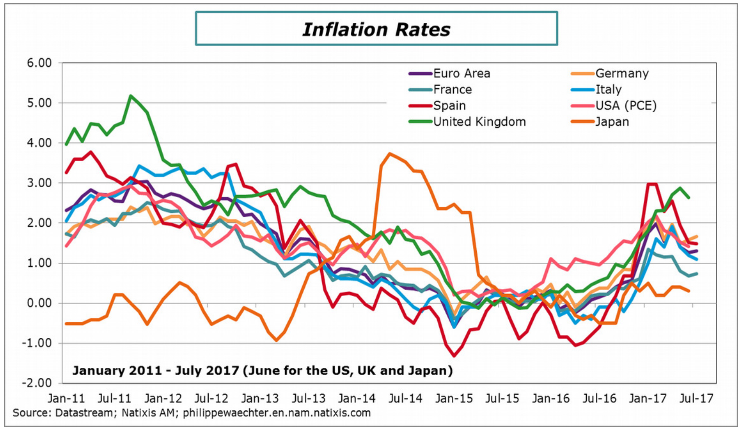
- The oil price is stabilized at a level close to 50 USD.
- We anticipate that it will remain at this level in a foreseeable future. This hypothesis is associated with large oil inventories and a high production level even after taking into account the impact of the OPEC agreement.
- The oil price is important as volatility on the inflation rate comes mainly from it. A stable oil price means that the energy contribution to the inflation rate will be close to zero. Therefore, the inflation rate will converge to the core inflation rate.
- In the Euro Area, the core inflation rate is marginally close to 1% (above 1% in July for seasonal reasons) and at 1.5% in the US.
- These figures are below central banks' inflation target at 2%. Inflation rates will not push monetary authorities to adopt a less accommodative monetary policy.
- This perception and the way investors anticipate the central bankers' behavior can be seen on the low level of interest rates.

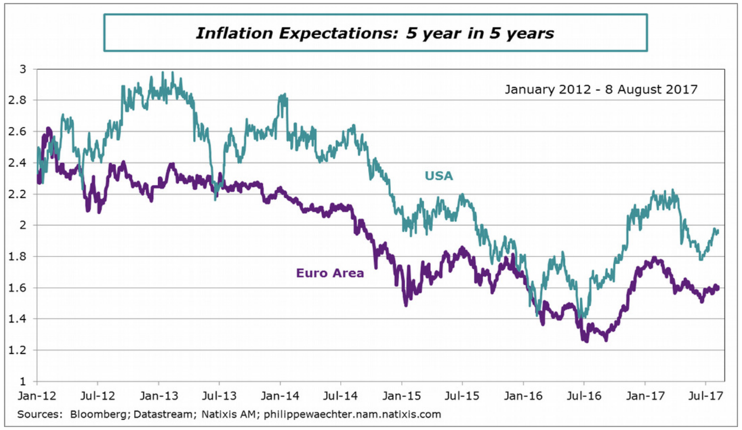


# Inflation is still low

- The inflation rate is below 2% in every developed country except in the United Kingdom.
- The hump shaped inflation rate see at the end of 2016 and the beginning of 2017 is due to the large difference in the oil price level when comparing prices at these periods and one year before.
- At the end of 2015 and at the beginning of 2016 the oil price was low, sometimes below USD 30 as in January 2016. At the end of 2016 and at the beginning of 2017 it was close or above USD 50. The difference between the two levels of price has led to a strongly positive contribution of the energy sub-index to the inflation rate.
- This is no longer the case as prices are comparable this year to one year ago. As we expect an oil price close to USD 50 for the months ahead, inflation rates will not rebound.
- Long term inflation expectations are low as it can be seen on the second graph even after the recent rebound.



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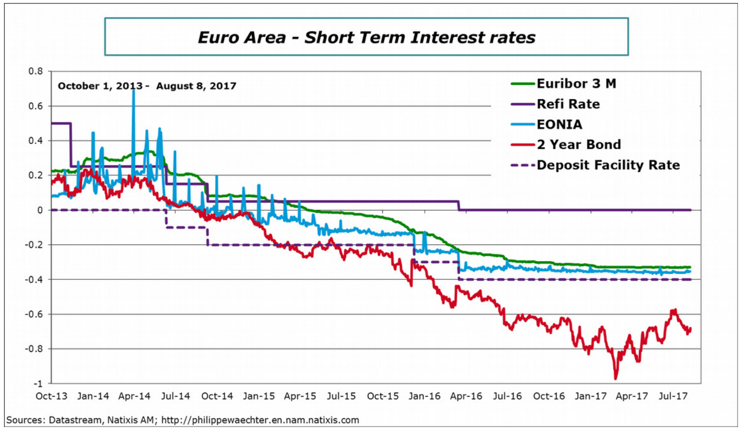
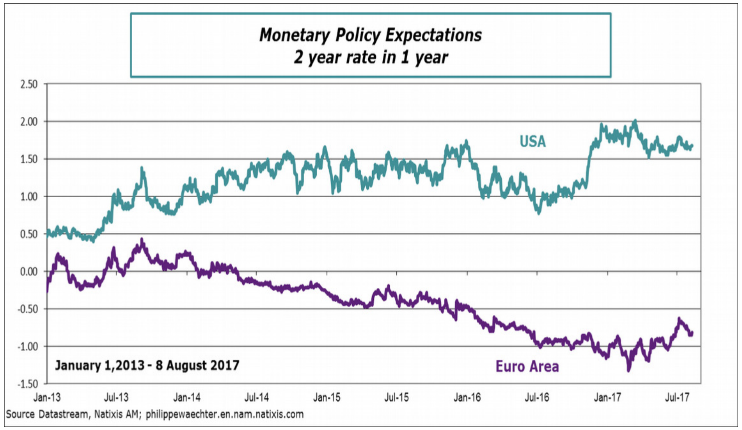
# Accommodative monetary policies

- In this environment of low inflation rate for an extended period without tensions in the economy, there are no reasons for central bankers to hurry in the normalization of their monetary policy.
- This is why we anticipate that the ECB will maintain its low interest rates in 2018. We expect a refi rate à 0% until the end of 2018 as we do not forecast the convergence of the inflation rate to 2%.
- We do not expect change in the Bank of Japan monetary policy. The target is an inflation rate (which is currently just above 0) at 2% and the instrument is to target long term interest rate at 0%. The BoJ will purchase long term rates to keep this rate at 0%. In recent months they bought less assets than what was expected because global rates were low and there was no need to buy large amount of JGBs.
- We expect that the Bank of England will not change its rate (currently at 0.25%) in 2017 and in 2018. The current episode of inflation will be temporary implying that it is counter productive to push interest rates higher. But the negative shock on the economic activity due to the Brexit episode will be permanent. That' why we expect low interest rates.
- In the US, the mood has changed as it can be seen on the second graph. Expectations of higher rates in the future are milder. This reflects the low momentum of the economic activity and the below target inflation rate.



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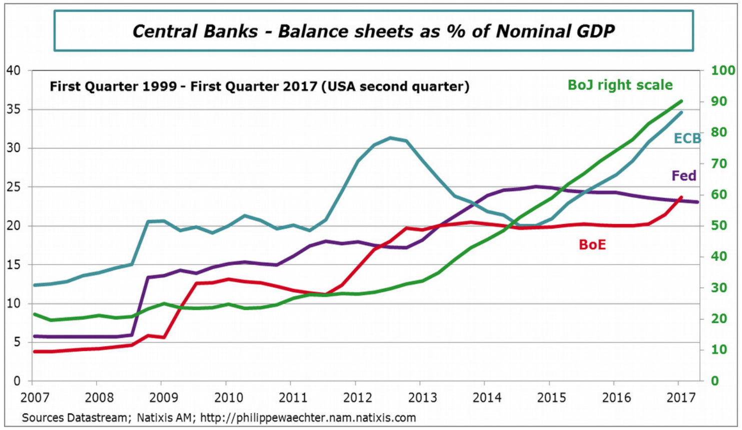
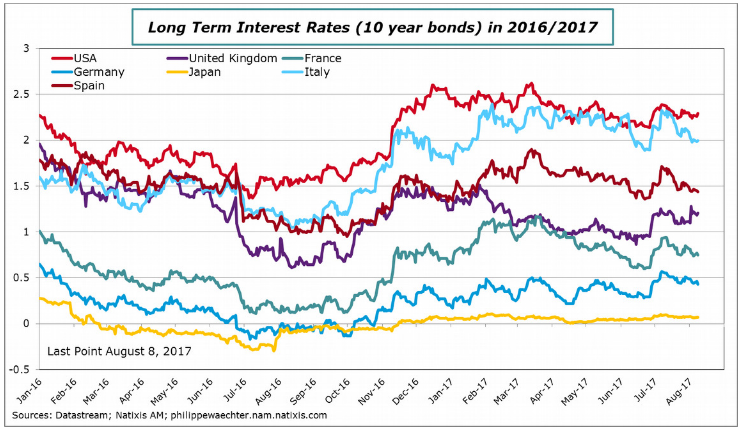
# The Fed will manage its balance sheet

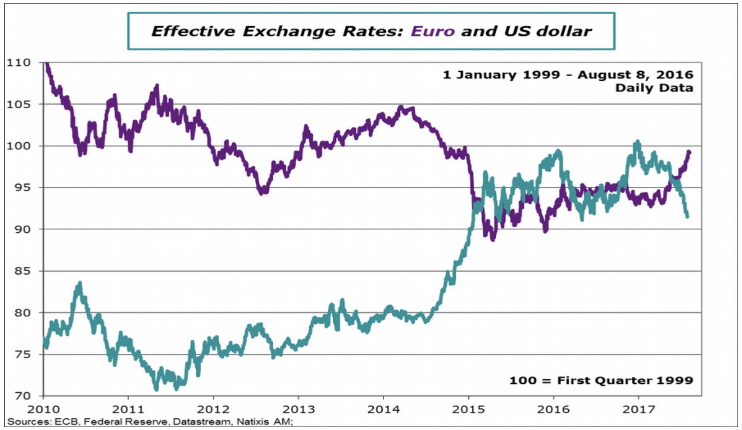
- We still expect that the Federal Reserve will increase its main rate but it will not be associated with too much tensions in the economy. The US central bank wants to have the possibility to lower its rate in case of a negative shock or of a recession. To limit the impact on the economy, the Fed's board members have clearly indicated the timing of their operations. Therefore investors can adjust progressively their portfolio to the Fed's strategy. Then when the Fed rate is pushed up the impact on long term rate is null.
- The other important issue for the Fed will be to manage its balance sheet. The FOMC will probably announce in September that it will change the way the Federal Reserve reinvests the proceeds of its portfolio. Until now, they were systematically reinvested. This will not be the case when the management will start. After one year, the US central bank will reduce its monthly reinvestment by an amount of USD 30bn in Treasuries and USD 20bn in Agencies assets and in RMBS. The objective is to be neutral and to have a very low impact on the bond market. But the Fed doesn't know what will happen. That's why it want's to have the possibility to drop the fed fund rate. Just in case.
- This operation can be a game changer on the US Treasury market. According to Fed's calculus, the impact of the US Quantitative Easing operation has been a net -90bp on the 10 year interest rate. This could be reversed but the Fed expects a smooth reversal. It would be better for the global financial stability.

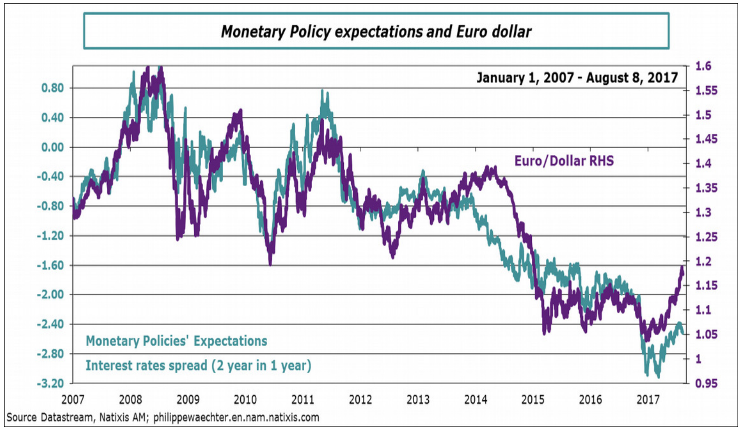


# Exchange rates

- The euro has been boosted recently. At the beginning of the year, expectations were on the parity between the US dollar and the euro.
- At 1.18 (current exchange rate), we don't expect anymore the convergence to 1.
- The main reasons are
  - Political: after Trump election a proactive fiscal policy was expected in the US. In Europe, populism was expected to be the rule at the different elections. It has not been the case. At the beginning of August there is still no economic policy from the White House and populism has not won an election in Europe. The political equilibrium has changed
  - Expectations on monetary policies have changed. After Mario Draghi's speech in Sintra at the end of June, investors believe that the accommodative monetary policy will end sooner than formerly expected. At the same time, anticipations on the Fed's strategy are less sanguine. The monetary policy equilibrium has changed
  - With Trump and the Brexit, the Euro Area is now perceived as a area of stability.
- The euro at 1.18 is already a constraint or the Euro Area. That's why we expect an accommodative message from the ECB rather than the expectation of a more restrictive strategy.



# Forecasts

## growth and inflation

| | Average growth | | | | | | | Average Inflation | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
| USA | 2.2 | 1.7 | 2.4 | 2.6 | 1.6 | 2 | 1.8 | 1.9 | 1.3 | 1.5 | 0.3 | 1.1 | 2.1 | 2.1 |
| Japan | 1.5 | 2.0 | 0.2 | 1.2 | 1 | 1.4 | 1.1 | -0.1 | 0.3 | 2.8 | 0.8 | -0.1 | 0.3 | 0.3 |
| Euro Area | -0.9 | -0.2 | 1.2 | 1.9 | 1.7 | 2.1 | 2 | 2.5 | 1.4 | 0.4 | 0.0 | 0.2 | 1.2 | 1.4 |
| U.Kingdom | 1.3 | 1.9 | 3.1 | 2.2 | 1.8 | 1.1 | 0.8 | 2.8 | 2.6 | 1.5 | 0.0 | 0.7 | 3.0 | 2.5 |
| China | 7.8 | 7.5 | 7.4 | 6.8 | 6.7 | 6.4 | 6.4 | 2.6 | 2.6 | 2.0 | 1.4 | 2.1 | 2.5 | 2.5 |
| France | 0.2 | 0.6 | 0.7 | 1.2 | 1.1 | 1.6 | 1.6 | 2.0 | 0.9 | 0.5 | 0.0 | 0.2 | 1.1 | 1.3 |

## interest rates

| Year end | Monetary Policy | | | | | | | Long Term Interest Rates (10 year) | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
| USA | 0-0.25 | 0-0.25 | 0-0.25 | 0.25-0.5 | 0.50-0.75 | 1.25-1.50 | 1.75-200 | 1.7 | 3 | 2.2 | 2.27 | 2.45 | 2.3-2.8 | 2.5-3 |
| Japan | 0.1 | 0.1 | 0.1 | 0.1 | -0.1 | -0.1 | -0.1 | 0.8 | 0.7 | 0.3 | 0.25 | 0.05 | -0.2;0.2 | -0.2;0.2 |
| Euro Area | 0.75 | 0.25 | 0.05 | 0.05 | 0 | 0 | 0 | 1.2 | 1.95 | 0.5 | 0.63 | 0.3 | 0.3-0.7 | 0.6-1 |
| U.Kingdom | 0.5 | 0.5 | 0.5 | 0.5 | 0.25 | 0.25 | 0.25 | 1.8 | 3.1 | 1.8 | 1.96 | 1.2 | 1-1.3 | 1.4-1.7 |

*Source : Economic research / Natixis AM*

# Mentions légales

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