CENTRAL BANKS FACE GROWTH-INFLATION TRADE-OFF

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ABOUT **THE AUTHOR**

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The correction in global equity markets was the big news in February. Concerns about US inflation and the consequent pace of US interest rates were the main driving forces. The US 10-year bond yield had already moved substantially higher from a year ago (from 2.44% at the start of 2017 to 2.85% by early February 2018) when their labour market report in early February showed an acceleration of wage growth to 2.9% (the pace over the past year was in the range of 2.0% to 2.5%). This raised fears that US inflation was about to take off and that the Federal Reserve Board (the Fed) was behind the curve.

MARKETS GRIPPED BY RATE HIKE FEARS

The Fed's so-called "dot-plot" (reflecting each Federal Open Market Committee, or FOMC, member's forecast) had shown three interest rate hikes of 25 basis points each this year. However, the market consensus was that the Fed will actually only hike rates twice in 2018. Thus the markets were suddenly faced with the distinct possibility that the Fed might hike rates not twice, but four times in 2018. That said, we believe this market reaction to be a short-term correction and, for reasons discussed below, not the start of an equity bear market.

KEY TAKEOUTS

- US BOND SELL-OFF AMIDST INFLATION AND RATE FEARS
- GLOBAL GROWTH FORECASTS ARE ON THE UP
- US TRADE TARIFF RETALIATION A RISK TO GROWTH OUTLOOK

GROWTH WELCOMED, BUT LESS SO INFLATION

Optimism over the short-term outlook for the global economy has continued to rise. Global growth is still strong and more synchronised than at any time since the global financial crisis. Consensus growth forecasts for 2018 for the three major areas (the US, Eurozone and China), as measured by the Economist magazine's monthly survey of economists across the globe, have moved up – from 2.3% last July to 2.7% currently in the case of the US, from 1.7% to 2.4% for the Euro area and from 6.3% to 6.5% for China. Within the US, the fiscal boost from both the Tax Cuts and Jobs Act and the Bipartisan Budget Act will likely lead to further growth upgrades for the country. The buoyant labour market and strong services sector sentiment in the Euro area will continue to support growth there. Japan's economy continues on a recovery path and China is still supported by the favourable external environment.

However, in tandem with strong and synchronised global growth, inflationary pressures have increased. This is no surprise, as it is rare for inflation to stay subdued in the face of such robust and widespread growth. The perceptions of

risk are thus shifting in the global economy. While the positive feedback loop between activity, sentiment and financial conditions is a key driver of growth, the issue at hand is now whether this shift in risk perception will hurt sentiment or tighten financial conditions enough to hurt growth prospects. While we do expect higher core inflation in the key regions over the course of the year, we believe it will be contained below targets. Central banks will be cautious as they will not want to hurt the underlying economy. There are already signs that higher mortgage interest rates in the US are having some impact on consumer sentiment and on the housing market.

Another risk that has become somewhat more elevated recently is that of a trade war. Recent trade tariffs announced by the US – whilst small in terms of impact on US GDP or global trade – might open the door to retaliation with potentially more serious consequences for the global growth picture. For now, though, we are of the opinion that strong, synchronised growth is set to last a while still, that core inflation will rise further (but not blow out) and that central banks will continue with gradual policy normalisation. This gradual pace may have to include four interest rate hikes in the US this year, as the new Fed Chair, Jerome Powell, seems to have alluded to in his recent Congressional testimony. We are mindful, though, that central banks do not want to hurt their economies, but need to balance the growth-inflation trade-off.

Figures sourced from FactSet