US DOLLAR RALLIES AS GROWTH AND INFLATION EXPECTATIONS RISE

JOHANN **ELS** | CHIEF ECONOMIST

ABOUT **THE AUTHOR**

As Head of Economic Research, Johann is responsible for all local and global macroeconomic research. Specific focus areas include the rand, inflation, interest rates and fiscal matters.

The global economy has continued to perform well recently, as it has done over the past year or so. Strong and synchronised growth and upward revisions to growth forecasts have been the order of the day. This is especially true in the US – where growth has been revised up for 2018 more than in the other major economies. The table below compares actual growth in the major areas in 2016 and 2017 to the Economist magazine's consensus growth forecasts for 2018 and 2019.

STRONGER GDP GROWTH FORECAST FOR THE US

	2016 (actual)	2017 (actual)	2018 (forecast)	2019 (forecast)
US	1.6%	2.3%	2.8%	2.5%
Eurozone	1.7%	2.5%	2.4%	2.1%
China	6.7%	6.9%	6.6%	6.4%

Sources: FactSet, Economist

Some recent data highlights include strong first quarter GDP growth in the US and China. Recent high frequency data suggests that growth remains strong. Although higher interest rates and worries about trade policies are now impacting the stronger growth that was seen throughout last year in Europe and some emerging economies, there is still support from a rebound in profits and sentiment. This should help the sustainability of growth through stronger employment and investment spending.

KEY TAKEOUTS

- STRONG GDP GROWTH IN THE US AND CHINA
- UNEMPLOYMENT DROPS, BUT WAGE GROWTH IS SLUGGISH
- RISING US TREASURY YIELDS SIGNAL HIGHER INTEREST RATES
- DOLLAR FIRMS AS US GROWTH OUTLOOK IMPROVES

LOWER UNEMPLOYMENT, BUT WAGES SLOW TO RISE

The latest US employment report bears mentioning, as wage inflation is being closely watched as a lead indicator of potential US Federal Reserve (Fed) action. While job gains in April were below expectations, the unemployment rate declined further to 3.9% – down from a global financial crisis peak of close to 10%. Hourly earnings growth (that is, "wage" growth) is still hovering around 2.6%, despite the strength in the labour market. This is markedly lower than the peaks of around 4% reached in previous cycles – a level where the US Fed has, in the past, said it will be more comfortable in attaining its 2% inflation target on a more sustainable basis.

However, stronger growth has already had some impact on inflation. Apart from headline inflation increases, the Fed's preferred inflation measure – core PCE deflator – recently rose to within a whisker of the 2% target when it reached 1.9%. However, the Fed has been clear recently in highlighting its stance being willing to accept core inflation of "around" 2% – indicating that they are more than willing to accept inflation higher than 2% as well. In fact, in the most recent policy meeting statement they indicated that "inflation on a 12-month basis is expected to run near the Committee's symmetric 2% objective over the medium term". The key here is the word "symmetric", which indicates the acceptance of some inflation overshoot.

Recent upward moves in the oil price have again given rise to inflation fears – and thus expectations of a faster interest rate hiking pace. This has resulted in US 10-year Treasury yields rising to above 3% for the first time in four years. However, higher issuance of US bonds, due to fiscal expansion, has played a role in the rise in bond yields.

After weakening since late 2016, the US dollar has surprised to the upside recently – strengthening on the back of better relative growth expectations in the US versus mainly Europe, stronger inflation expectations (including the aforementioned oil price rise), the consequent firming rate hike expectations and the shortening of US dollar positions (which has been increasingly bearish). While currencies tend to overshoot – and the US dollar could thus again first move stronger still – we are of the opinion that the next big move in the US economy is a growth slowdown. This, combined with the fact that US inflation is, in any case, unlikely to become a major problem, means that the outlook for the US rate cycle should eventually soften, leading to a weaker US dollar. We thus continue to expect a weaker US dollar, but acknowledge that the very short-term trend could indeed mean a stronger US dollar for a while. ■