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OUTLOOK 2018: ALMOST TOO GOOD TO BE TRUE?

Berenberg Macro Flash

"A compelling story; but isn't it almost too good to be true?" Some clients are responding to our upbeat macro outlook for 2018 with this question. Almost all seem to agree that the world made progress in 2017, that the starting situation for 2018 looks auspicious, and that the inevitable risks do not loom larger than usual. However, can it really last? Very few clients probe the upside to our above-consensus forecasts for growth. Most want to discuss the risks that it may all go wrong instead. After ten years of worrying about one crisis after another, I very much understand this inclination. In a roundabout way, it actually brings out our key message nicely: That we discuss the downside risks so much illustrates the upside potential for economies and markets: we are not yet in the late-cycle stage of exuberance when consumers and businesses, borrowers and financial investors throw all caution overboard – which would pave the way for the inevitable correction thereafter. We will probably get there in – say – two to three years. But we are not close to such an inflection point yet, in my view.

BACK TO THE OLD NORMAL
Our 2018 growth forecasts for the US (2.9%), the Eurozone (2.5%), Japan (1.5%) and the UK (1.8%) are well above consensus. For three reasons, these calls do not strike me as outlandish, though:

1. They are roughly in line with the actual GDP growth reached over the course of 2017 already.
2. Survey data – for what they are worth – project faster rather than just stable growth for 2018.
3. Before the 2008/2009 financial crisis, such growth forecasts would have been considered absolutely normal for this stage of the cycle.

As we are gradually escaping the shadow of the great financial crisis, we should bid farewell to the over-hyped notion of a "new normal". In many respects, it is back to the "old" normal: with a few tweaks here and there (especially including real bond yields that are likely to remain below historic norms for a while), we are returning to more normal cyclical dynamics. In the last cycle, GDP growth peaked at 3.8% in the US (2004), 3.3% in the Eurozone (2006), 2.2% in Japan (2004) and 3.3% in the UK (2003). Our calls for 2018 are not close to past peaks in growth. Instead, we are projecting demand gains that – although above trend – economies can sustain for a while. Across the Western world, we are not yet seeing the excesses in business investment, housing construction, credit growth or wage inflation that would herald the need for a cleansing recession within a year or two. The party would need to get crazy first before the hangover would be due eventually.

WILL INFLATION SCUPPER IT ALL?
After an upside surprise in real GDP growth in 2017, it makes sense to worry about a potential upside surprise in inflation in 2018. Firm labour markets will probably underpin stronger wage gains, the recent rebound in oil prices could trigger faster inflation and less subdued inflation expectations. We look for some pick-up in wage inflation that will feed into service prices. Many companies may also manage to pass cost increases fully onto consumers and to expand margins somewhat. Nonetheless, it remains unlikely that inflation will rise so much as to scare central banks into tightening policy by more than is required to prevent a premature overheating of the cycle.

Low inflation is not a new story. The cycle of the noughties had already brought us downside surprises on inflation as well as Greenspan's bond yield "conundrum" despite above-trend growth in real GDP. The China factor behind the strong growth/low inflation mix of the last decade is probably less relevant now than

it used to be as China has matured and moved up the wage and productivity ladder. However, technological factors (internet, information technologies, the rise of robots) as well as the ease of shifting production abroad are probably constraining inflation at least as much as they did ten years ago. At 8.7%, unemployment in the Eurozone is still above the 7.3% trough of early 2008. Some labour market reforms in Spain, France, Italy, Greece and elsewhere raise the chance that the next trough in Eurozone unemployment could be lower than the last one. Although US unemployment at 4.1% is now well below the 4.5% trough of early 2007, the lower participation rate in the US suggests that the US could still mobilise some labour reserves.

Annual wage inflation may well accelerate by roughly 0.5 percentage points on both sides of the Atlantic this year, to just above 3% in the US and 2% in the Eurozone. Central banks are more likely to celebrate this as a return to more normal conditions than to view this as a threat to their 2% inflation targets. Faster gains in productivity could offset, say, about 0.2 percentage points of a possible 0.5 point acceleration in wage inflation. So far, the post-Lehman recovery has been unusually rich in employment as firms have been ready to hire but reluctant to sink capital into fixed investment. As firms shed some of their post-Lehman caution, they are likely to step up their investment spending. Firmer business investment now bodes well for some gains in labour productivity.

As a result, we expect core inflation to advance by less than wage inflation. Central banks will see that as another reason to remain cautious. They are responding to the gradual return to normal cyclical dynamics with a return to a more normal policy stance. They will want to proceed so gradually that they do not restrain economic growth very much in the process. Looking ahead, central banks may well want to take the punch bowl away after two or three further years of growth above trend. For the time being, the party is not yet hot enough for that.

LIFE IS ALWAYS FULL OF RISKS

Of course, risks abound. They always do. Italian politics may go badly wrong, Trump may still start a major trade war, geopolitics could throw up a nasty surprise, wage inflation could take off by more than we project. With the possible exception of wage inflation, I find these risks less pronounced than they were a year ago. The last cyclical upswing was killed not by a central bank reaction to excessive inflation – there was none – but by the implosion of a credit bubble and an initially insufficient policy response to that calamity. As aggregate rates of credit growth in the US (around 5%) and the Eurozone (less than 3%) remain far below their pre-2008 excesses, this particular risk looks rather well contained this time. The good times won't last forever. Despite the usual risks – and the probability of some occasional hiccup on the way – 2018 and perhaps even 2019 could still be years in which a risk-on mode pays off.

For our more detailed 2018 projections, see Global outlook 2018: coping with the boom.

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