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MOMENTUM IN GLOBAL ECONOMIES AND TRADE

*Recent data support the view that global economies ended 2017 with significant momentum and that global trade volumes have accelerated.

*Elevated confidence measures in the US, Europe and Japan point toward sustained healthy economic expansion in 2018. US momentum will be boosted by tax reform and fiscal policies.

*The impact of the stock market correction on confidence is not expected to make much of a dent in economic growth, but the confidence measures deserve close scrutiny.

*Global bond yields throughout 2017 were too low relative to improving economic performance. The rise in US bond yields that have spread globally reflect stronger growth and renewed concerns about US inflation and complacency about central bank monetary policies. Bond yields are projected to rise further.

*Monetary policies remain excessively easy and moderate increases in bond yields will not adversely affect positive growth trends.

Real GDP growth remains well above estimates of potential in the US, EuroArea and Japan while it has struggled somewhat in the United Kingdom. Economic performance in China, India and other emerging nations are improving.

United States. Year-over-year real GDP grew 2.5% in the year ending 2017Q4, well above the Fed's 1.8% estimate of potential growth, but underlying performance was even stronger: momentum in consumption and business investment lifted real final sales 2.8% while slower inventory building subtracted from GDP; in Q4, final sales to private domestic purchasers (that is, private consumption plus business fixed and residential investment jumped 4.6% annualized, lifting its yr/yr gain to 3.3%. Businesses begin 2018 with healthy momentum in product demand, low inventories and the prospects that the Tax Cuts and Jobs Act and additional government spending on defense and infrastructure will provide an additional boost. The IRS is changing taxpayers' withholding schedules to implement the individual tax cuts, which is increasing take home pay for most households, and businesses are setting plans for responding to the tax cuts, incentives to invest and assets held abroad that they are now able to repatriate. High corporate profits and very strong gains in durable goods orders and shipments suggest positive responses.

Europe. EuroArea economies have been growing significantly faster than potential, averaging 2.7% in the last five quarters, with a firm end to 2017. Private consumption continues to grow at a healthy rate and gross business capital formation—less the extremely volatile measure of intellectual property products—is rising at a healthy 4.2% pace, contributing positively to GDP and signaling business confidence in the future. Importantly, exports rose 5.6% in the year ending 2017Q3 (Q4 data are not yet available), despite the stronger Euro, reflecting stronger global growth. The outlook for the EuroArea remains healthy as EU nations distance themselves from earlier financial crises and confidence builds, and as more EU nations benefit from pro-growth reforms while fewer struggle.

United Kingdom. The UK stands alone as the only large advanced nation that has experienced sluggish economic expansion, presumably reflecting Brexit-related uncertainties. Domestic expenditures have stalled, reflecting softer growth of real

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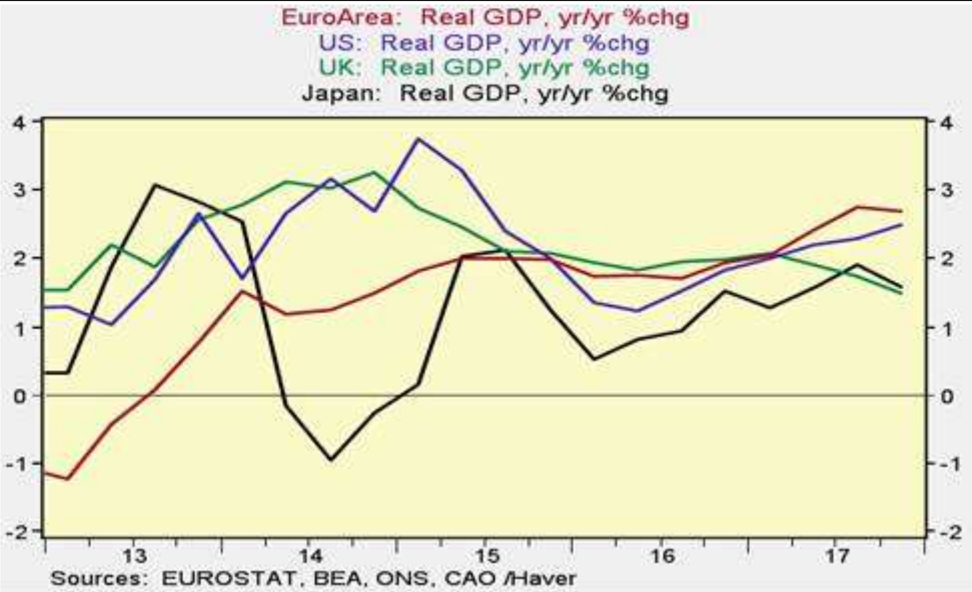
private consumption and gross business capital formation. This has been partially mitigated by the strengthening in exports (up 8.4% in the year ending 2017Q4) relative to imports (up 3.5%), reflecting the sharp depreciation of the British pound following the Brexit vote. Looking forward, UK economic performance hinges critically on Brexit negotiations, which we expect will be favorable. The recent significant strengthening of the pound is expected to dampen exports from their recent pace.

Japan. Even with the soft headline growth in Q4, real GDP advanced 1.6% in the four quarters ending 2017Q4, roughly double the Bank of Japan's upwardly revised estimate of potential growth. Overall, private consumption (up 1.1% annualized) and investment in plant and equipment are growing moderately while exports have been strong, despite the appreciating yen. Japan has been a clear beneficiary of stronger global growth and international trade. On a highly favorable note, the labor force participation rate and employment of working age women has been rising rapidly, and wage gains are picking up (particularly for temporary workers), reflecting the lowest unemployment rate since 1994, lifting personal income. The infrastructure buildout for Tokyo's 2020 Olympics is adding to government investment and adding jobs. These solid fundamentals and high confidence point toward sustained economic momentum in 2018.

Chart 1: Real GDP growth in foreign economies



Sources: EUROSTAT, Bureau of Economic Analysis, UK Office for National Statistics, Cabinet Office of Japan and Haver Analytics

Canada. The Canadian economy has been the fastest growing of all large advanced nations, with 3% growth in the year ending 2017Q3. Consumer spending has advanced at a heathy pace, reflecting robust gains in employment, while industrial production in manufacturing and oil/shale drilling and business investment have been strong.

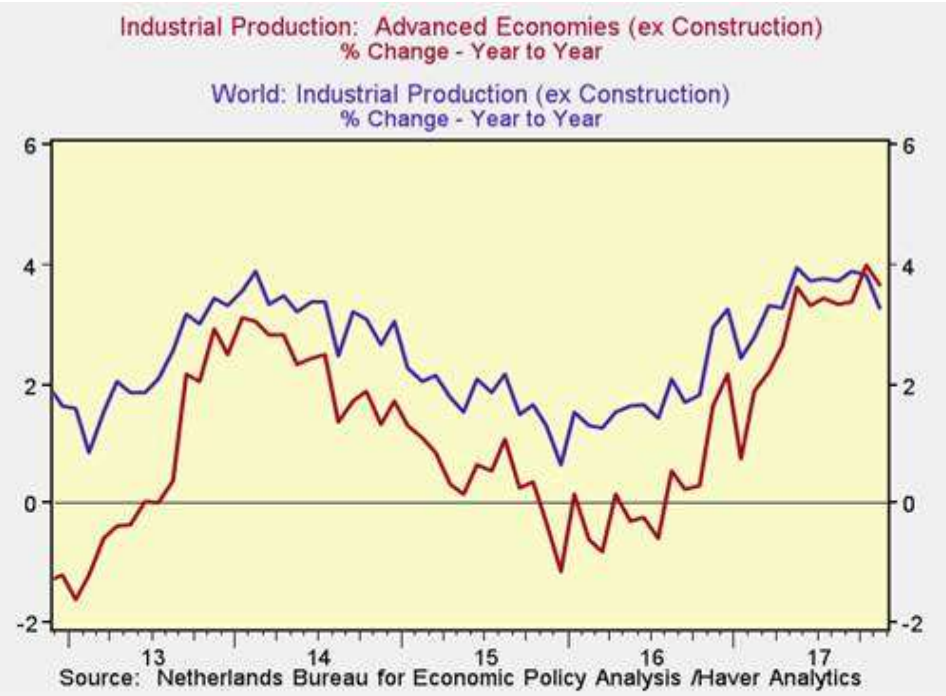
Emerging nations economies. China and India continued to expand rapidly in 2017, with growth exceeding 6%, and other important emerging nations are improving or stabilizing. China's renewed strength in export-related manufacturing industries has lifted both exports and imports and contributed to healthy growth in domestic consumption and investment. China's sustained strong growth and its sizeable contributions to international trade are lifting global commodity prices and emerging nation economies, particularly those with heavy reliance on exporting commodities and industrial materials.

India's growth has been driven by strong domestic demand: private consumption has been solid and gross fixed capital formation has been strong. Its ongoing reforms point toward sustained longer-run growth and improving standards of living.

Latin America's economic performance has been lifted by Brazil's highly favorable stabilization and early-stage recovery from political derailment and Argentina's stronger pickup in response to pro-growth economic reforms. Mexico's economy has continued to grow, but is has been dragged down by declines in private gross fixed capital formation. While the slump in investment spending likely reflects the fallout from concerns about the Trump Administration's trade and immigration policies, in reality, it began in early 2016.

Industrial production. Reflecting these trends in synchronized global growth, global industrial production accelerated in 2017 to 3.3%, led by 3.7% growth in advanced nations. While industrial production in the US, Europe and Japan grew close to the worldwide average, the pace of advance was much stronger in other advanced nations like Switzerland and Sweden. Industrial production in emerging markets remained solid.

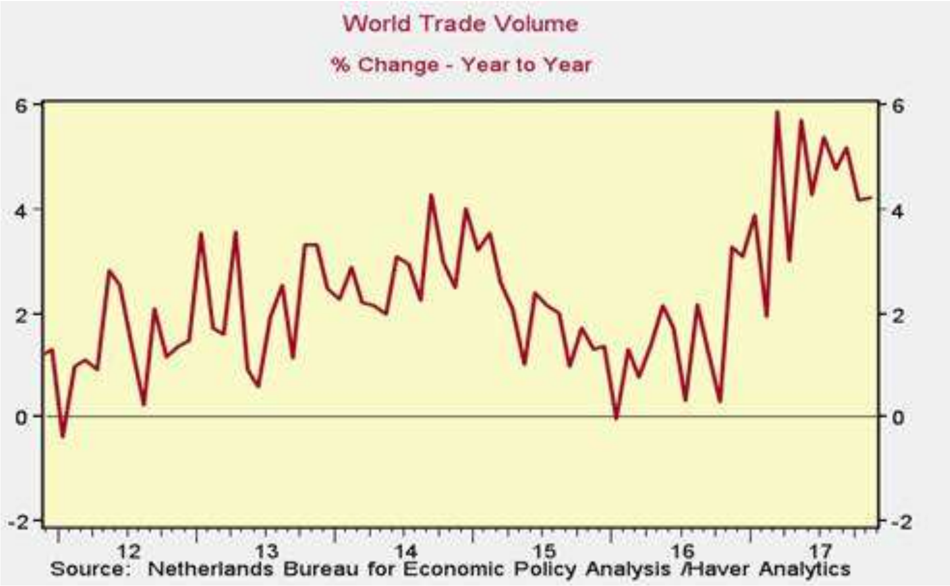
Chart 2: Industrial production: global and advanced economies



Source: Netherlands Bureau of Economic Policy Analysis and Haver Analytics

Global trade volumes. Trade volumes picked up significantly in 2017, with firm 4.2% growth to all-time highs, confirming the recovery from the 2015 to mid-2016 slump. Among advanced economies, international trade picked up the most in the US, where the weak US dollar benefited exports while strong domestic demand growth fueled imports, and in Japan, whose imports were similarly lifted by domestic demand while exports were boosted by economic strength in China, Asia and global markets. The gains in global trade volumes have contributed significantly to strong performance in business activities and profits.

Chart 3: World trade volume



Source: Netherlands Bureau of Economic Policy Analysis and Haver Analytics

Several trends in global trade flows stand out. First, European exports to emerging nations, including those in Eastern Europe, have risen sharply. Strengthening economies in emerging nations have increased the demand for European goods and services, despite the appreciation of the Euro. Second, China's and Japan's rising trade volumes are feeding off each other's economic strengths; China's export-related manufacturing sectors require sizeable imports, and Japan has been exporting large amounts of capital goods as well as consumer goods to China. Third, despite heightened tensions between US, Canada and Mexico amid NAFTA negotiations and protectionist rhetoric of the Trump Administration, total trade volumes between the US, Mexico and Canada increased in 2017 following the 2015-2016 slump in US production and business investment.

Bond yields rise: no threat to economic performance. As global economic growth picked up markedly in 2017, bond yields remained very low. This reflected the confluence of factors: excessive central bank monetary ease—very low and in some cases negative policy rates (ECB, BoJ, Swiss National Bank, Sweden's Riksbank), quantitative easing (ECB, BoJ) and large central bank holdings of sovereign bonds and their forward guidance that emphasized that they would be very slow to unwind their excessive monetary ease--and general complacency of private bond holders about the possibility that yields would rise.

At year-end 2017, US 10-year Treasury bond yielded 2.4%, the same as a year earlier despite four Fed rate hikes totaling 100 basis points. German 10-year Bunds yielded 0.43%, far below inflation, while 10-year Swiss bonds, anchored by the SNB's -0.95% deposit rate, yielded -0.15% and Japanese JGB's, constrained by the BoJ's yield curve control (YCC) program, yielded 0.05%. All of these yields were strikingly inconsistent with the stronger, above potential economic growth.

Since then, US yields rose steadily in January and spiked in early February, reflecting heightened expectations of stronger growth stemming from tax reform and fiscal stimulus and renewed inflation concerns. US yields have risen roughly 50 basis points, while yields of German bunds and other sovereign bonds have risen by lesser amounts and Japan's JGB yields have remained close to December levels, constrained by the BoJ's YYC program.

Table 1: 10-year government bond yields

10-Year Government Bond Yields (%)

	29-Dec-17	15-Feb-18	Change	Core inflation	Inflation-adjusted (latest)
US	2.41	2.89	*0.49*	1.5	1.37
Germany	0.43	0.76	*0.34*	1.7	-0.89
UK	1.19	1.65	*0.46*	2.3	-0.69
Japan	0.05	0.07	*0.02*	0.1	-0.03
Switzerland	-0.15	0.18	*0.33*	0.5	-0.31
Canada	2.05	2.37	*0.33*	1.6	0.77

Sources: Bloomberg, Bureau of Economic Analysis, UK Office for National Statistics, Deutsche Bundesbank, Japan Ministry of International Affairs and Communications, Swiss Federal Statistical Office, Statistics Canada and Berenberg Capital Markets

Insofar as these bond yield increases reflect the stronger economic growth nd monetary policies remain excessively easy, their impacts on economic performance should be imperceptible. Financial markets remain flush with liquidity, bank lending is generally firm and uninterrupted, and the real costs of capital remain very low.

In the US, bond yields remain far below their historical averages in inflation-adjusted terms, and yields remain below inflation in Germany, the UK, Japan and Switzerland. Global bond yields are expected to rise further as economic momentum is sustained and leading central banks follow the Fed and begin to gradually normalize monetary policies to “new normals”. Even as monetary policy normalization unfolds, central banks will remain accommodative by standard measures of their real policy rates, balance sheets and financial conditions. Bond yields would need to rise significantly further in order to impinge on economic growth.

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