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MACRO RISKS: KEY CHARTS TO KEEP AN EYE ON

Berenberg Macro Flash

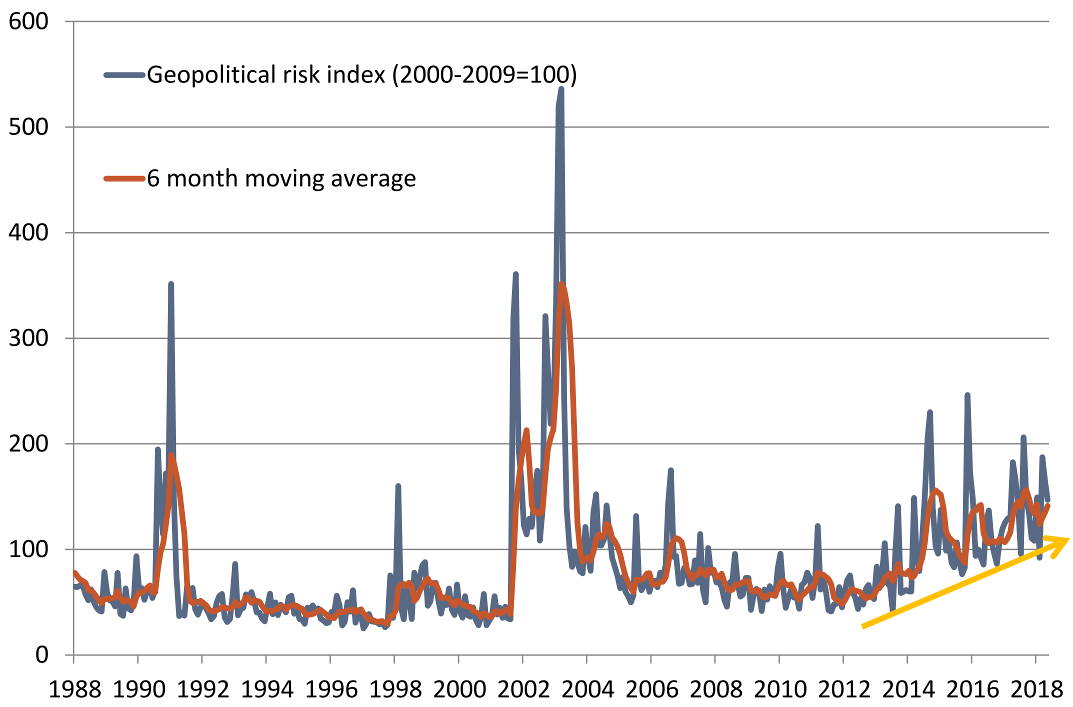
In one fundamental respect, 2018 remains similar to 2017: Demand growth is still in the goldilocks zone. Demand gains are not so slow that the upswing feels sluggish and central banks need to worry about deflation as in 2011-15. But the growth is not so fast either that supply cannot keep up. These are key earmarks of a long cycle that is not in its final stage yet. In the absence of major excesses in credit, production, inflation or investment, we see no reason to expect a corrective recession soon. The US, with its more advanced cycle than Europe, may reach that stage eventually – possibly by 2021 on current trends. But we are not there yet.

However, in another fundamental respect, 2018 differs from 2017: Last year, political waters turned mostly calm as the year progressed. With no major elections to worry about in Europe after May, markets were riding high on the back of the Macron win in France. Upon taking office, US president Trump did not follow up on the trade war threats he had campaigned on in 2016. However, from US-led trade tensions and Trump's decision to withdraw the US from the Iran nuclear agreement to the election of a populist government in Italy, risk has returned to the agenda in 2018.

Risks are a part of life. When fundamentals are healthy, we can weather the occasional headwind. The advanced world is in better shape now than it was before the 2008/09 financial crisis. Below we outline eight key risks - with accompanying charts – that are worth keeping an eye on. Chances are that few, if any, of these risks will materialise in a major way.

RISK 1 – PERCEIVED GEOPOLITICAL RISKS ARE RISING

Chart 1: Geopolitical risk index

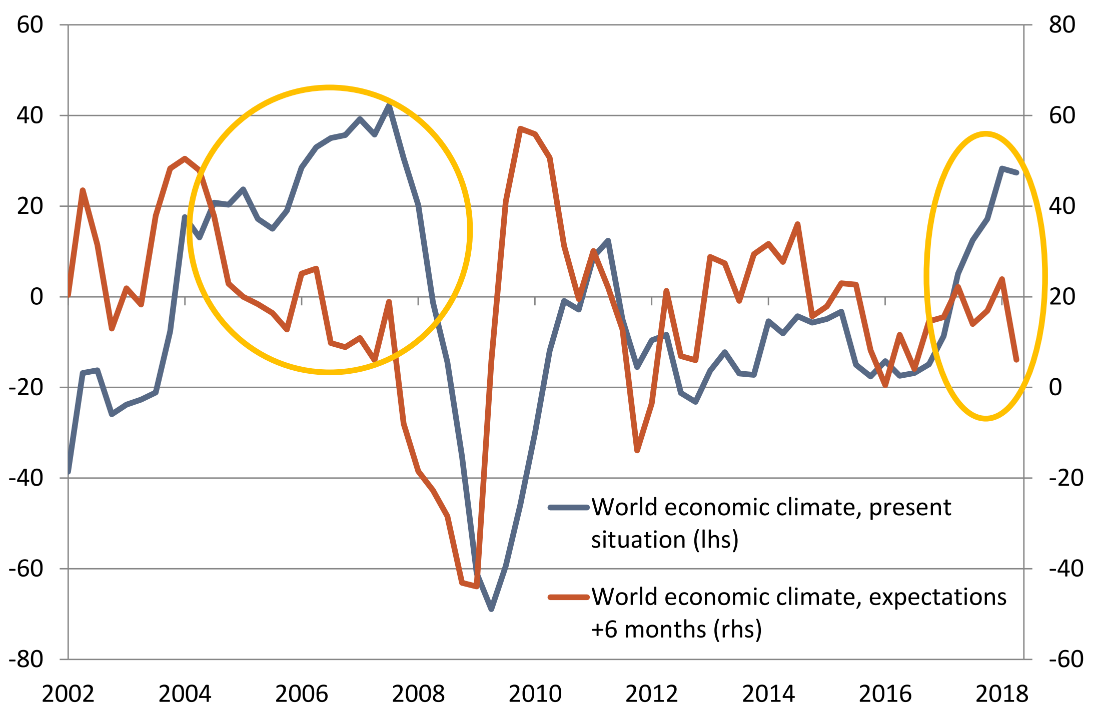


Source: Monthly data. Source: Dario Caldara and Matteo Iacoviello. The index is calculated by counting the number of articles related to geopolitical risk in newspapers (The Boston Globe, Chicago Tribune, The Daily Telegraph, Financial Times, The Globe and Mail, The Guardian, Los Angeles Times, The New York Times, The Times, The Wall Street Journal, and The Washington Post) for each month (as a share of the total number of news articles). The index is then normalised to average a value of 100 in the 2000-2009 decade. Geopolitical risk is defined as the risk associated with wars, terrorist acts, and tensions between states that affect the normal and peaceful course of international relations. Last data point is May 2018.

- The perception of geopolitical risk has trended up since 2013. According to a measure that counts how often such risks are mentioned in the news, these risks are now close to a 14-year peak – Chart 1.
- Even if such risks lay dormant and do not materialise, the mere fact that they are increasingly in focus can weigh on sentiment and confidence over time.
- Key current risks include: US-led trade wars; populism on both sides of the Atlantic; tensions in the Middle-East and on the Korean Peninsula; posturing by a US that is losing some of its relative global influence; the rise of an ever-more confident China; the threat from terror in the western world; and - to a lesser extent - the migrant crisis in Europe.
- As confidence is a key driver of productivity enhancing capital investment, persistent uncertainty about the future can lower long-term growth in worker output-per-hour and living standards.

RISK 2 – GLOBAL EXPECTATIONS AND CURRENT CONDITIONS ARE DIVERGING

Chart 2: Global economic sentiment – current versus expected 6 months

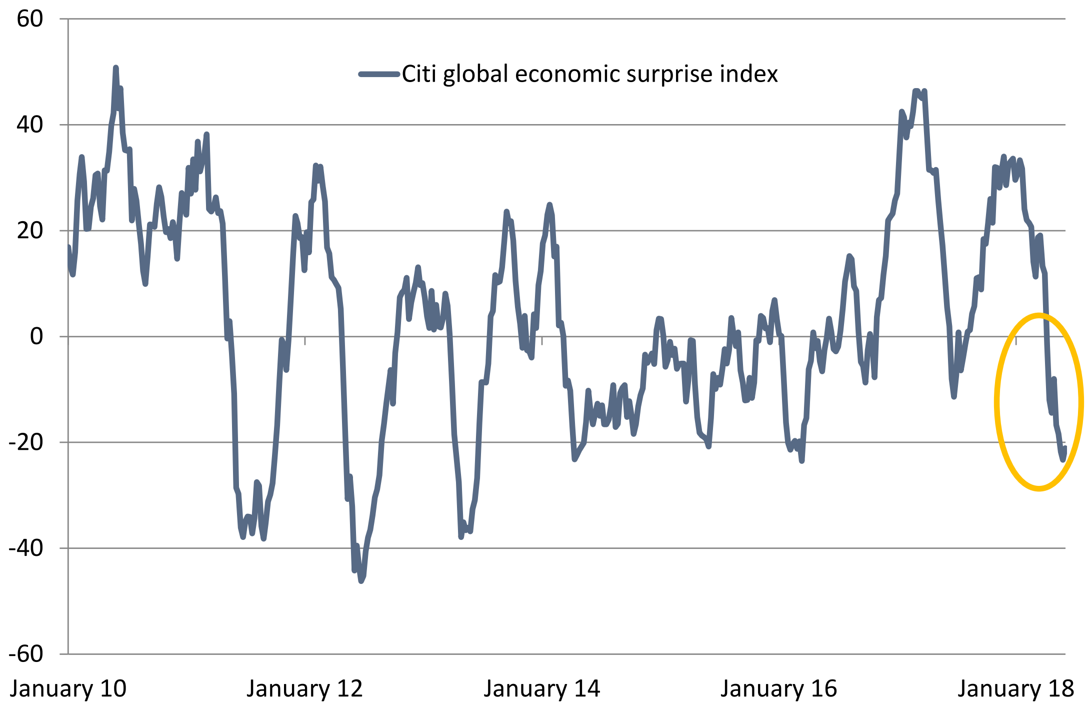


Source: Quarterly data. Source: Ifo Institut - Leibniz-Institut für Wirtschaftsforschung. Last data point is 2018 Q2. Chart shows % balance of respondents – balance > 0% indicates a rise in expectations.

- Expectations tend to rise and fall with the ebbs and flows day-to-day economic activity, as they did from 2012 to 2016. In many cases such as in 2009, 2010 and 2011, turning points in expectations lead turning points in economic activity by some 3-6 months.
- Since early 2017, the Ifo global survey shows a solid rise in current conditions but a sharp fall in expectations – Chart 2. The last time current conditions and expectations started on such a trend was in 2004. The divergence lasted until the crisis struck in 2008 - some four years later.
- The current divergence has lasted for a little over a year. Could this be a signal that economic agents believe the cycle is entering a late stage with only a few years left? Possibly. It would fit with our other analysis which suggests we might expect the next downturn some three years from now – see Can productivity growth keep inflation at bay?

RISK 3 – PERSISTENT DISAPPOINTMENTS ON ECONOMIC DATA COULD DRAG ON CONFIDENCE

Chart 3: Surplus index shows disappointing global data since start of 2018



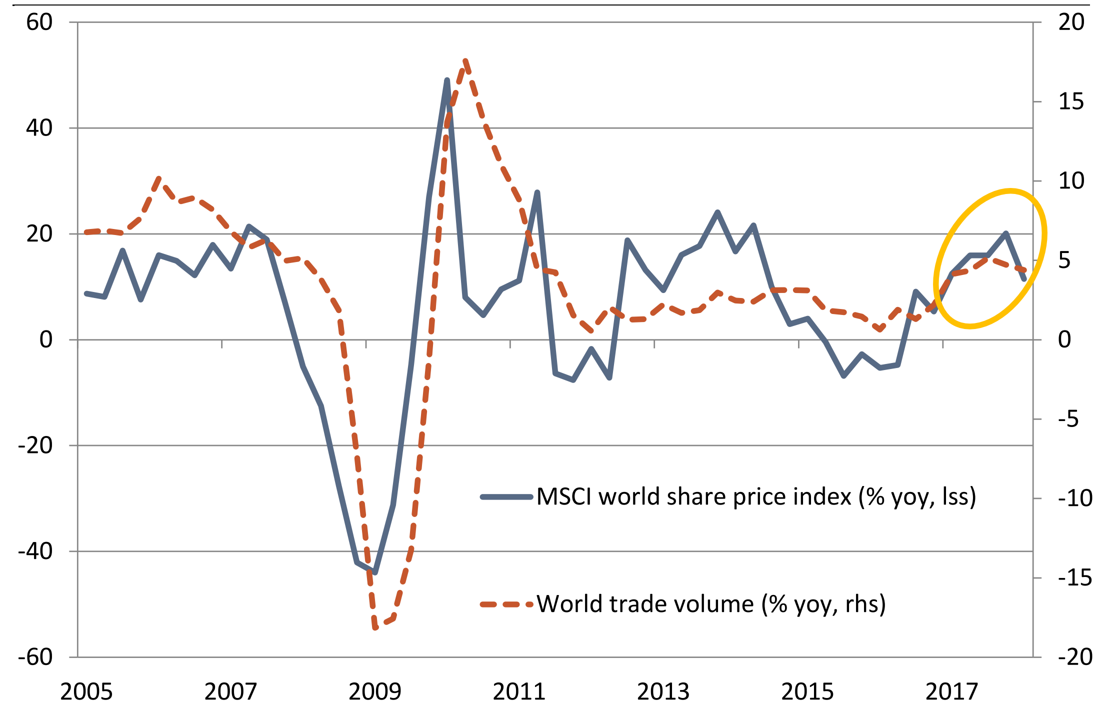
Source: Weekly data. Source: Citigroup Global Markets Inc. Last data point is 1 June 2018

- Short-term economic data are volatile. Even during a healthy upswing, it is quite normal for economic activity to soften temporarily before bouncing back.
- A number of temporary factors have weighed on economic activity since the start of the year. GDP growth was soft in Q1 across several key regions including the US, the Eurozone, the UK and Japan.
- But the acceleration in global growth during 2017 has raised expectations for the future. Because of the weakness at the start of the year, markets have been underwhelmed by the turnout of the data relative to elevated expectations – see Chart 3.
- The economic surprise index for the global economy has fallen further in Q2. To some extent, this reflects the fact that expectations are still elevated and thus easy to disappoint. However, it also suggests that, outside the US, economic activity may not be not bouncing back yet from the Q1 dip.

- No need to panic yet. The surprise index dipped sharply in early 2016 and in mid-2017 only to recover strongly thereafter. The pace of global growth was barely affected by these dips.
- The risk to watch is that expectations can occasionally become self-fulfilling. To the extent that companies and households are less confident about the future, they may decide to invest and consume less than otherwise, hence paving the way for weaker hard data.

RISK 4 – THE CRITICAL LINK: RISING TRADE, GDP GROWTH AND FINANCIAL MARKETS

Chart 4: World share prices versus world trade volumes (% yoy)

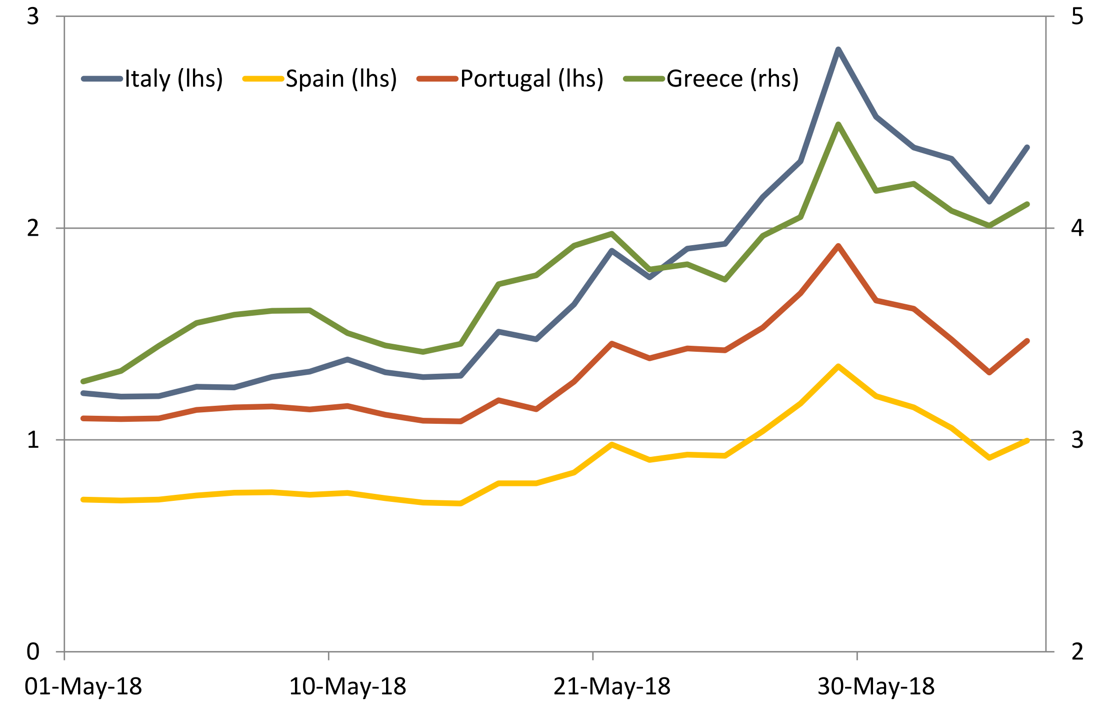


Quarterly data. Source: Morgan Stanley Capital International, Netherlands Bureau for Economic Policy Analysis. Last data point 2018 Q1.

- US president Donald Trump seems ready to upset the global order, taking aim at China and the EU due to his misguided concerns about bilateral trade imbalances, but not sparing the US's neighbours north and south of its borders either.
- In March 2018, Trump announced US tariffs on steel and aluminium. See Trump's proposed tariffs: the economic implications of wrong-headed policies.
- Initially, Trump had exempted the EU, Canada and Mexico – delaying the imposition of these trade barriers until the end of May. By holding the tariff threat over the heads of the US's allies, Trump was hoping for concessions. After none of them budged much, Trump imposed the tariffs last Friday. China, the EU, Canada and Mexico have all promised a measured retaliation.
- The current global upswing depends on continued global trade growth – the two are closely linked. As global equities reflect expectations for global economic growth, unsurprisingly, growth in global trade and global equities follow similar trends too – Chart 4. A threat to trade and hence economic growth is a threat to markets, especially for risk assets including equities.

RISK 5 – ITALY: HOW SERIOUS IS THE RISK OF CONTAGION TO PARTS OF EUROPE?

Chart 5: Spread of peripheral government bonds over German (ppt)



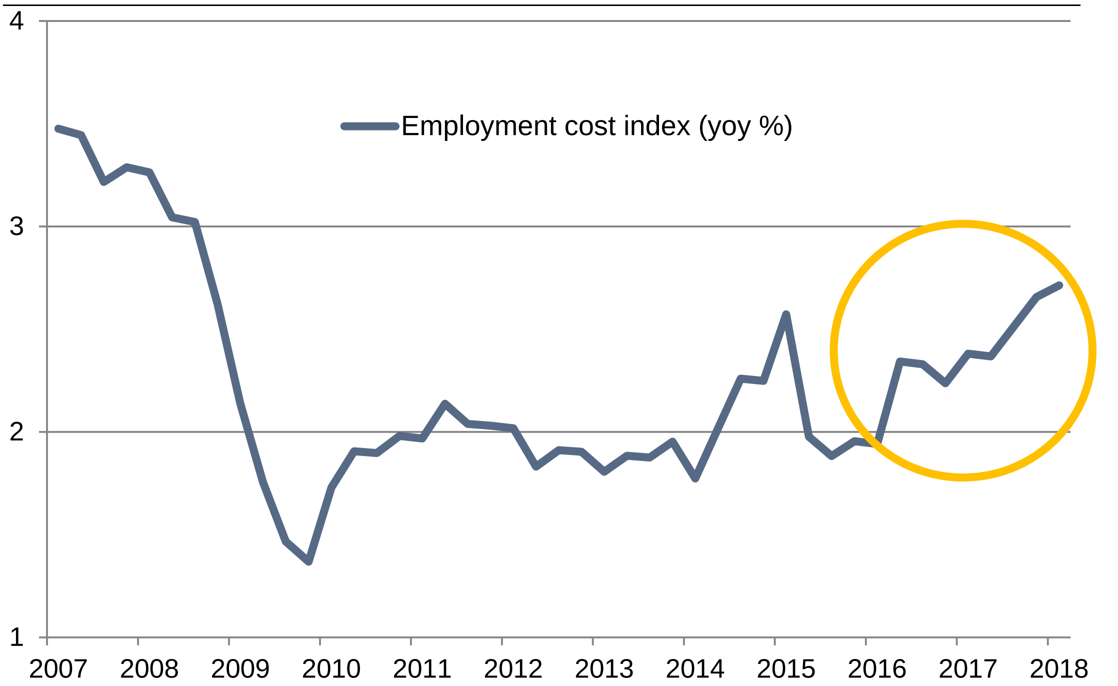
Daily data. Source: Tullett Prebon Information. Chart shows spread on 10 year government mid yield. Last data point 5 June 2018

- Misguided economic policies in one major country of Europe can potentially cause problems for its neighbours. Consider the up and down in Italian bond yields during the recent political turmoil. Markets are reacting to the risk that the new coalition government of left and right-wing populists may eventually break the rules which underpin the Eurozone. The radicals may even flirt with an exit from the single currency.
- Inside the Eurozone, support from the ESM or the ECB's OMT programme is contingent on members sticking to the rules. This makes sense as a key check against moral hazard. But as a result, misbehaving governments in the Eurozone can pay a price in bond markets quicker than in other places where growing market distrust can also show up in currency devaluation rather than just in bond yields – think Brexit and sterling.
- Relative to German 10-year bonds – considered the safest asset in the Eurozone - Italian 10-year yields have increased – and subsequently eased a bit – by almost 200bps in the past month – Chart 5. Spanish, Portuguese and Greek yield spreads have followed to some extent as markets judged that Italian risks could seep to other vulnerable Eurozone members.
- Bad memories take time to fade. The recent moves in bond yields in peripheral Europe were a faint echo of the trends during the euro crisis of 2011-12. However, the risk that the current Italian problems could turn into a systemic crisis for the Eurozone system as a whole seems low. The Eurozone has powerful instruments to contain contagions risks if need be. See What if: could Italy spark a new euro crisis?
- Nonetheless, an Italian crisis would have repercussions for its neighbours. Until the Eurozone deploys its tools to contain contagion, any future flair up of Italian risk could jolt European markets and retard

economic growth in Italy's neighbours for a while, possibly even causing a potential – but temporary - pause in growth in the Eurozone in the highly unlikely case that Italy were to leave the euro.

RISK 6 – US FISCAL POLICY AND WAGES – A CHALLENGE FOR THE FED

Chart 6: US employment cost index (yoy %)



Quarterly data. Source: Bureau of Labor Statistics. Last data point in Q1 2018.

- The Tax Cuts and Jobs Act and the Trump administration's deregulation policies have lifted disposable incomes and confidence. These positive initiatives are raising consumption, production and investment. However, along with some of the reform-oriented tax provisions and the business-favourable regulatory environment, the deficit-financed tax cuts may stimulate aggregate demand faster than the pickup in productive capacity. This comes at a time of low unemployment and tightening labour markets.
- The excess demand seems likely to push up inflation. While the Fed has indicated that its 2% inflation target is a longer-run average that it will treat symmetrically, a material increase in inflation pressures would post a big challenge to the Fed. Simultaneously, rising wage growth may trigger higher inflationary expectations – Chart 6.
- The policy-induced deterioration in the budget deficit juxtaposed with the upward pressure on wages at this stage of a mature economic expansion highlights the challenge facing the Fed and financial markets. Stronger productivity gains would mitigate the impact of the higher wages on unit labour costs and inflation, but the sustainability of the current momentum in business investment is uncertain. This presents two potential risks:

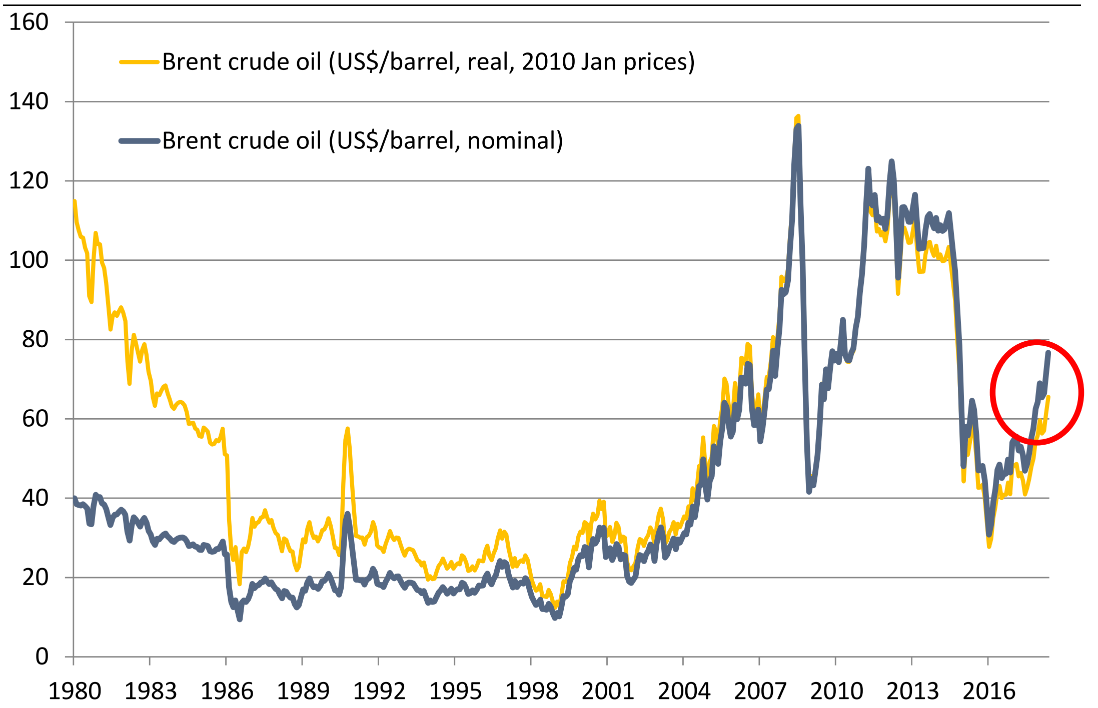
1) Compare the US to the situation in Europe where wage growth is modest and fiscal deficits are falling. While the ECB and BoE could still justify slowing their policy normalisations should confidence drop unexpectedly, the Fed is facing more serious inflation risks and would have less room to slow its policy normalisation. If the fiscal stimulus helps to raise inflation over an above the rate Fed sees as tolerable – which is

probably above the 2% target after the prolonged period of below-target inflation in recent years – it might bring forward the horizon at which the Fed is induced to dampen the expansion through a quicker pace of policy tightening in order to bring inflation to target.

2) In the long run, the US could be adding to its long-term fiscal challenges. The challenges posed by the scary projections of rising government debt are widely known. Markets tend to let countries get away with fiscal profligacy when times are good. Markets may even reward the US now as a result of the extra demand growth it enjoys from the fiscal stimulus and the hedge this may provide against the trade war risk for the US. But if and when underlying fiscal imbalances are exposed by the next cyclical downturn, countries with less fiscal headroom to support a quick recovery risk falling out of favour with markets.

RISK 7 –RISING OIL PRICE – HOW HIGH IS TOO HIGH?

Chart 7: Oil price (Brent crude $ per barrel) – nominal versus real prices



Monthly data. Source: World Bank, Bureau of Labor Statistics. Last data point is May 2018.

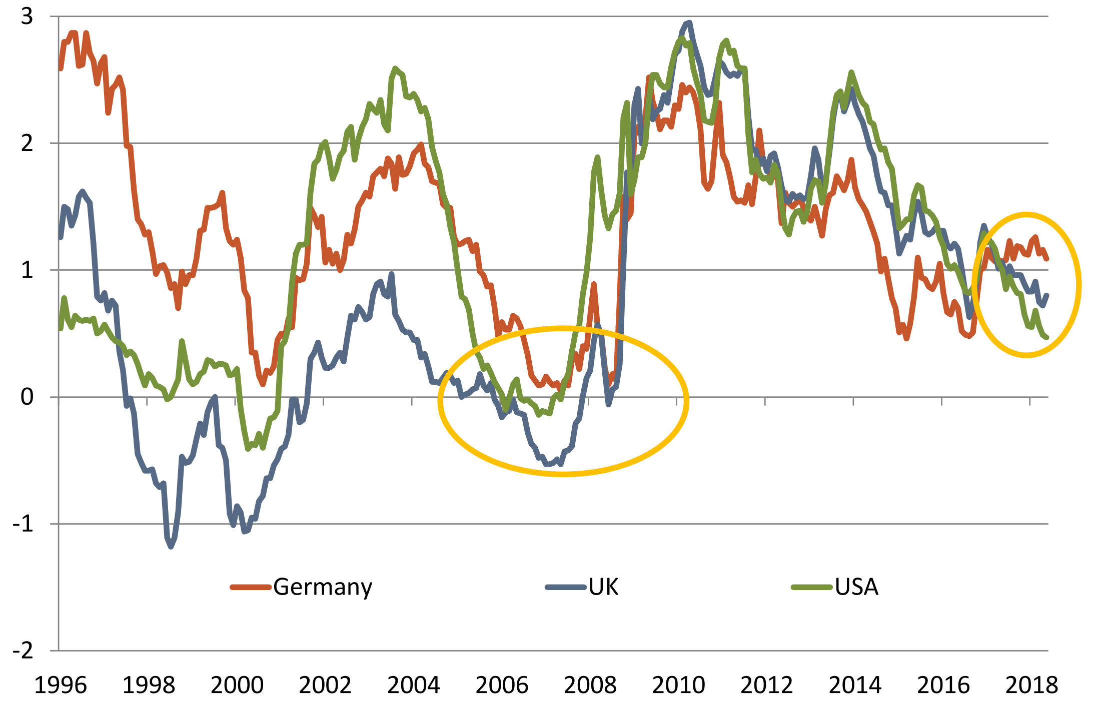
- The current price of oil is bordering on a level that could be considered ‘high’ in real terms. It thus makes our list of potential risks. So far, however, we do not see the rebound in the oil price since 2016 as a major risk yet – Chart 7.
- The rise of the price for one barrel of Brent crude to $70 was mainly due to strong global demand and an effective effort by OPEC to constrain its own production. Growing tension in the Middle East, centred on US President Trump’s decision to withdraw the US from the 2015 Iran deal, has pushed the oil price up further to a current price of around $76 dollars for a barrel of Brent crude.
- When the economic backdrop is strong, demand growth typically remains resilient if the oil price rises modestly. A further to, say, $80 or even $85 a barrel, could shave a mere 0.2pt from annual rates of consumption growth in advanced economies over the next year relative to a baseline scenario with oil

around $70 per barrel. As most major economies are currently growing above their potential rates, this is not a huge worry. See How much of a headwind is the rising oil price?

- A sudden rise in the oil price to, say, $100 per barrel would be a bigger cause for concern. It could put a sizeable squeeze on real income growth and dampen demand growth. But that seems unlikely as long as tensions between Saudi Arabia and Iran do not escalate far beyond the current proxy wars in Yemen and parts of Syria, and the Strait of Hormuz remains open.
- As global oil supplies are more price elastic in the age of fracking than before, prices may come down a bit towards the end of 2018, as the higher price makes more oil sources profitable and production rises.

RISK 8 – GETTING CLOSE TO YIELD CURVE INVERSION AGAIN

Chart 8: The shape of the curve (spread of 10- and two-year gov. bond yields, ppt)



Monthly data. Source: Federal Reserve Board, ECB, BoE

- Markets often look to the flattening yield curve as a signal that an economic expansion is coming to an end. To some extent, this is right. The flattening yield curve served as a useful tip-off to the dotcom bubble and bust, and the real estate boom and financial crisis thereafter.
- Back in the early 2000s, a series of rate hikes by the Fed, the ECB and the BoE did not cause a proportional rise in benchmark yields. As a result, financial conditions did not tighten by as much as central banks may have intended. In the US, this was dubbed the "Greenspan conundrum". This "conundrum" is illustrated by the flattening and eventual inversion of the yield curve (Chart 8).
- The gradual flattening of the curve suggests a change in underlying fundamentals rather than a sudden and potentially disruptive change in expectations. One major factor could be the structurally high global demand for the safe assets of – mostly - advanced economies. Global savings have risen from c21% of global GDP in 1983 to c26% in 2017. Measured in 2010 US dollars, global savings have nearly tripled over this period to now close to $20trn.

- As a result, long-term yields in advanced countries can remain low even as growth and inflation improves and their central banks raise short-term interest rates. By dampening the transmission mechanism of monetary policy, these factors can make it more difficult for central banks to tighten monetary conditions sufficiently to stabilise the hot phase of the cycle with standard policy rate changes alone. After a time, cheap credit and strong growth allow excesses to build up that may eventually lead to a recession.
- If history is to repeat itself, one concern in the coming years should be that borrowing costs in the advanced world rise by too little as central banks normalise their monetary policies. This would be visible in the further flattening of benchmark yield curves as growth momentum is maintained and central banks raise rates - and as credit growth rises towards unsustainable rates. See Conundrum: what if bond yields stay too low again?

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