International scene

# Steady enough growth for central banks to adjust course, but very slowly

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**Going into the fourth quarter, the world economy and international markets appear to be on a steady, little changed, track.** Stocks are moving up, making or nearing new highs in some cases (US, Germany, UK). Interest rates may be trending gradually and slowly higher, though they are lower than at the beginning of the year in some advanced economies. The USD remains under pressure, especially against the euro, and oil prices have stabilized somewhat in recent weeks, though they are lower on the year, and analysts are divided on their direction ahead.

**Volatility in stocks, which had drifted lower all year, remains near record lows.** It did move up significantly in August and September following political uncertainties in the US, North Korean threats, hurricanes and the like, but it has since returned to its lows. (Chart 2.)

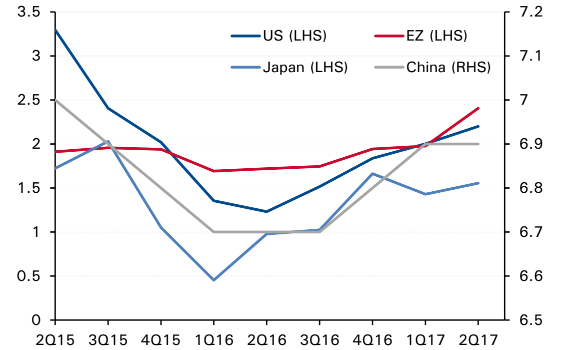
**The Fed, after raising rates twice this year, is ready to raise them once more this December or perhaps early next year.** It is also signaling, via its "dot plot" chart, that it expects three further moves up next year. This position is supported by steady growth in the US, tightening labor markets, and inflation that appears to be headed toward 2% according to the Fed.

**Beyond supporting the Fed's sanguine interest rate outlook, the environment was finally deemed ripe for a long-overdue reduction in the Fed's balance sheet.** Recall that the Fed's balance sheet went from under $1 trillion prior to 2008, to the current $4.3 trillion. At its September FOMC meeting, the Fed confirmed its well-telegraphed plans to start reducing its holdings of Treasuries and mortgage-backed securities. At the pace announced by the Fed, it will take three years (October 2020) to bring the balance sheet down to $2.8 trillion, still three times the size of the balance sheet of 2008. The Fed, of course, wants to be extremely cautious, and may alter that schedule in either direction, depending on circumstances.

**Nonetheless, the very slow reduction in the Fed's balance sheet should initially have little impact on interest rates; and it is likely the Fed may try to fine tune things should rates rise unduly.** Markets should get more concerned when, and if, other central banks start following suit (ECB, BOE). The latter still seems a way off for the time being. With the Fed about to start this "tapering", the 10-year Treasury note stands at 2.3%, 10 bps lower than in January 2017, and still well above 10-year Bunds yielding 45 bps. (Chart 4.)

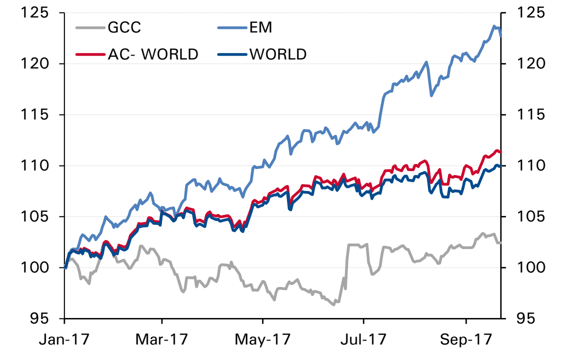
**The USD, which was famously supposed to rise further this year, went down and did not seem to benefit much from the favorable yield spreads above.** (Chart 5.) Some of the factors weighing against the USD were: better world and European economics, thus shifting ECB expectations to "more hawkish" (very relative), and US politics. The latter, after a bout of strong Trump-related optimism for aggressive growth stimulus and tax cuts, is still seen as a "plus", but these expectations have been revised to the downside. The Trump administration has so far been unable to pass any major legislation, raising doubts about future

**Chart 1: GDP growth**
(quarterly, % y/y)



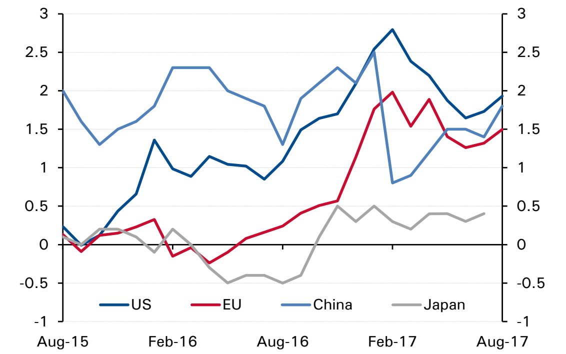

Source: Thomson Reuters Datastream

**Chart 2: Equity markets**
(MSCI, rebased, 30/12/2016 = 100)




Source: MSCI, Thomson Reuters Datastream

**Chart 3: Inflation**
(% y/y)




Source: Thomson Reuters Datastream

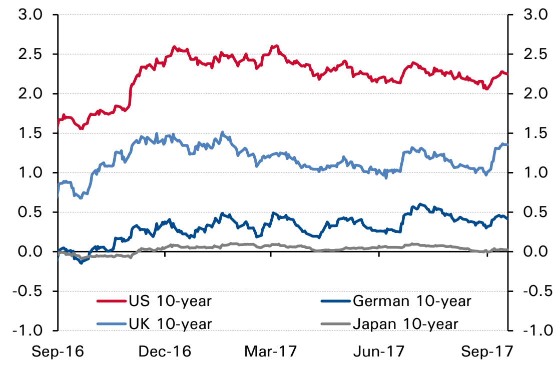
successes. The USD is trading near 1.18 to the euro, and many analysts have revised their end-of-year forecasts, suggesting the euro's rise has run its course for now. The turmoil in Spain, following the Catalan referendum weighed on the euro as well. Revived reform prospects in the US (taxes, budget, and health care) will likely need to be advanced in order to relieve some of the pressure on the USD. Higher rates would also help, though the financial markets do not quite believe the Fed that four rate hikes are forthcoming between now and December 2018.

On US taxes, after months of anticipation, the Trump administration outlined its plans for a major tax overhaul, which would significantly reduce taxes on businesses and some individuals. The proposal would cut the corporate tax rate to 20% from 35% and reduce the top rate for individuals. More details should be forthcoming and the markets will be focusing on the ability of the Congressional majority to pass anything significant (this year).

**Consensus and IMF projections for world growth this year are about 3-3.5%.** The US is expected to grow 2-2.5%, the eurozone a little under 2.0%, China 6.5%-plus, and Japan 1-1.5%. They all posted over 2% growth y/y in the second quarter of the year, with China posting 6.9%. (Chart 1.) Countries seem to be in line with expectations if not somewhat above. The Chinese are trying to control debt while leaving growth intact; so far, so good. The EU has surprised on the better side this year, leading many to believe that the "extra-easy" ECB stance is about to end. The ECB, of course, is still conducting QE; it is buying 60 billion euros worth of bonds each month through December 2017. After that, the ECB is expected to "taper" the monthly amount purchased gradually over 2018.

**Oil prices, after dividing forecasters in mid-year between bulls and bears, seem to be stabilizing nicely above $50 per barrel (Brent basis) and are actually showing signs of further strength for the year-end.** (Chart 6.) We still expect prices will average $55 pb this year. After weighing somewhat on GCC equities, oil prices could be a bit of a plus ahead. We see stronger oil demand, and stronger OPEC/non-OPEC resolve shoring up prices. In that light, GCC equity markets have perked up somewhat recently, also aided by less austerity as well as by the recent upgrade of Kuwait to "emerging market" status by FTSE (and perhaps down the road by MSCI). KSA equities are on track for the same upgrade, though their turn seems to have been delayed by six months to March 2018. Qatar remains, of course, under pressure, given the diplomatic row within the GCC that shows no signs of relief ahead.

**Chart 4: Benchmark yields**




Source: Thomson Reuters Datastream

**Chart 5: US dollar index**

(index)


Source: Thomson Reuters Datastream

**Chart 6: Brent oil price**

(US dollars per barrel)


Source: Thomson Reuters Datastream

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