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International scene

Global growth is upgraded to 3.9%; US inflation is on the rise

The broad-based global economic recovery gained further steam, including in the US, where the inflation narrative appeared to shift toward a more hawkish scenario. After months of solid data, the IMF raised its 2017 growth estimate for the world economy to 3.7% and upgraded its forecast for 2018 and 2019 to 3.9% (Chart 1). This upgrade mostly reflected stronger growth momentum in advanced economies (especially the US, eurozone and Japan) and the expectations of a fiscal stimulus in the US from tax cuts. The upward revisions were mostly unsurprising and the strong economic fundamentals – combined with the softer inflation – helped equity markets make strong gains in 2017 (Chart 2). However, more recently, a shift in views on US inflation have rattled financial markets and pushed yields higher.

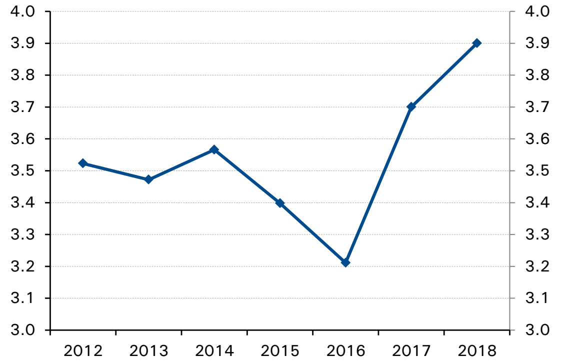
The outlook for the US economy improved further in recent weeks, with expectations of a healthy boost coming from tax cuts and the recent expansionary spending agreement. The IMF expects the US economy to grow by 2.7% in 2018, up from 2.3% in 2017; this is 0.4 percentage points higher than its forecast in October 2017. The upgrade of the forecast is largely the result of a $1.5 trillion stimulus expected over ten years from tax cuts passed before the end of 2017 in a key win for the Trump administration. It also comes at a time when the economy has been topping expectations. Leading indicators, including capital goods orders and the ISM manufacturing index, suggest an accelerating pace of growth. Indeed, GDP growth averaged 2.9% in the last three quarters of 2017. The labor market has also been tightening.

After months of softness, prospects for US inflation appear to be turning, boosted by the strength in the economy. Inflationary momentum was lackluster during the best part of 2017. After peaking at 2.3% y/y in January 2017, core inflation slipped to end the year at 1.8% y/y. However, more recent data suggests that inflation may be gaining momentum. Core prices rose by an annualized 2.5% during 4Q17, with December seeing the strongest gain. Inflation in the core PCE index has also been rising, though at 1.5% y/y it remains well below the 2% target. These improvements are reflected in January's FOMC statement with the Fed suggesting that inflation could reach its 2% target sooner than had been previously thought. Average wages have since also indicated further strength, as they gained 0.3% m/m in January and pushed the annual pace to 2.9% y/y, well above expectations.

The shift in the outlook for US inflation has boosted expectations of more rapid monetary tightening, lifting yields. With inflation seen gaining momentum, markets are now expecting the Fed to respond by increasing rates more rapidly in 2018. The chances of three or more hikes in 2018 were just 40% at the start of the year, according to the CME Group; they have since risen to over 60%. At the same time, yields have been climbing. The 10-year US Treasury yield rose to 2.85%, up around 44 basis points since the start of 2018 (Chart 3). Yields in Germany and the UK followed suite, seeing similar gains.

Chart 1: Global GDP growth

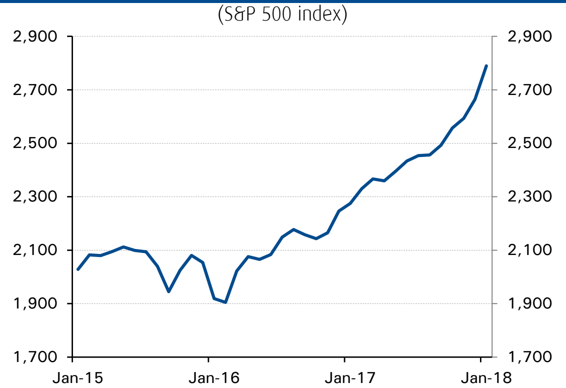
(% y/y)



Source: IMF

Chart 2: Equities

(S&P 500 index)



Source: Thomson Reuters Datastream

Chart 3: US 10-year Treasury yield

(%, weekly)

Source: Thomson Reuters Datastream

In the eurozone, the economy has continued to improve. The economy grew at its fastest pace in eleven years, and with average growth of 2.5% in 2017, it outperformed other advanced economies including the US and the UK (Chart 4). There has also been an increasing perception that the improvement in growth will be sustained in the medium-term. Indeed, the IMF recently upgraded eurozone growth by 0.3 percentage points in this and next year, though it is still seen slowing from 2.4% in 2017 to 2.3% in 2018 and 2% in 2019.

Despite stronger growth, inflation in the eurozone remained well below target, though there are some early signs of upward momentum. Inflation in the eurozone slipped to 1.3% y/y in January according to the preliminary flash estimate, falling further below the 2% European Central Bank target. While inflation is higher in some of the stronger economies like Germany, even there it continues to fall below the target. Still, January's data saw an uptick in core inflation, which rose to 1.0% y/y, though it is too early to say whether this will be a sustained trend.

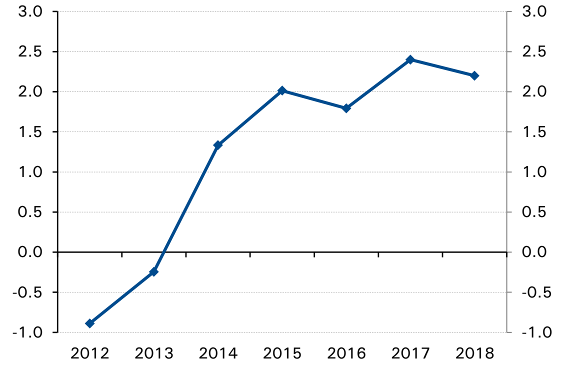
Inflation in Japan also remains subdued despite a more promising economy. Growth in Japan surprised analysts to the upside in 2017. This has broadly been driven by exports, which were boosted by a stronger global economy and a weaker yen. As a result, growth is expected to have accelerated to 1.8% in 2017, more than double the pace that was forecast a year ago. The outlook for 2018 has also improved, with the IMF hiking its growth forecast for the year by 0.5 percentage points to 1.2%. Despite this, inflation remains weak. The preferred core inflation measure, excluding food and energy, stood at 0.3% in December.

Emerging markets have been seeing robust growth, with the pace there seen accelerating slightly in 2018. Emerging economies are expected to continue to recover in 2018, with growth picking up to 4.9% (Chart 5). Most of the gains are expected to come from India, Brazil and Mexico; indeed, the latter two have had their growth upgraded by the IMF on improving commodity prices. Emerging Europe is also expected to continue to do well, supported by better demand from the eurozone. Meanwhile, growth in China continues to decelerate though not quite as rapidly as previously expected.

The robust global economy and OPEC-constrained supply have provided significant support to oil prices since mid-2017, but downside pressures remain. Brent rallied as much as 60% since June 2017, even surpassing $70 per barrel briefly in January (Chart 6). Prices benefited from the OPEC-led agreement to reduce production, which was extended through the end of 2018. Despite the strength, the outlook for prices remains constrained by the prospects for US shale oil production. Indeed, total US production recently exceeded 10 million barrels per day for the first time since 1970, boosted by gains in shale oil.

Chart 4: Eurozone growth

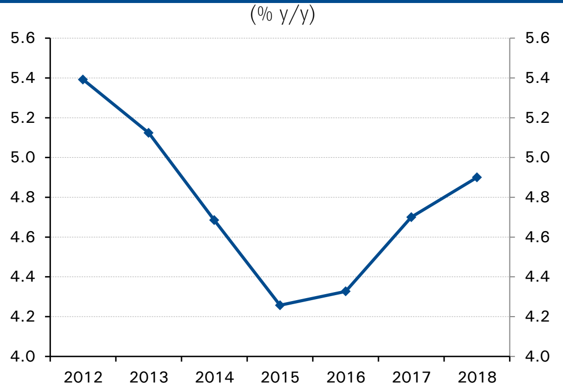
(% y/y)



Source: IMF

Chart 5: Emerging market growth

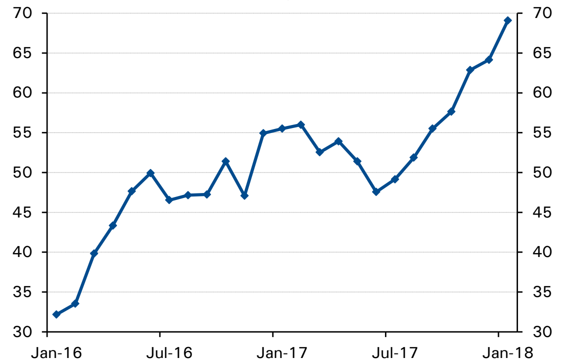
(% y/y)



Source: IMF

Chart 6: Brent oil price

(US dollars per barrel)



Source: Thomson Reuters Datastream

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