Global economy kicks off 2018 in strong form, though risks remain

The global economy entered 2018 in strong form, with several major economies experiencing solid improvement in activity in recent months. Tax cuts in the US promise to give further impetus to an economy that had already been performing well. In the eurozone, the recovery continued to appear robust, with data surprising to the upside. Japan, too, has seen positive developments, while China and other emerging market economies have maintained steady or improving outlooks. In this environment, equities have continued to do well, with indices hitting new highs. Meanwhile, inflation has remained subdued across the board, something that could slow the pace of monetary policy normalization in advanced economies.

Tax cuts in the US will add further impetus to an already strong economy. The stimulus is estimated to be around $1.5 trillion over ten years, and could boost economic growth by 0.3-0.5 percentage points in 2018 and 2019. Of course, this comes on top of already solid growth, which has been visible in a number of leading indicators, including capital goods orders and the ISM manufacturing index, which show increased optimism and rising investment. The labor market has also been tightening. Though non-farm payrolls increased by a lower-than-expected 148,000 in December, this followed two strong months; the 3-month average remained solid at 204,000, the highest figure recorded in 2017.

President Trump’s agenda could bring more gains for the US economy in 2018, including further deregulation and a possible infrastructure deal. After the recent success of tax reform, additional business-friendly policies and fiscal stimulus can be expected this year. Indeed, Trump’s promised infrastructure spending initiative could prove easier to achieve than previous policy proposals, especially if the president is able to work with Democrats to achieve it. If it materializes, it could boost economic growth still further.

Nonetheless, the risks of political dysfunction continue to cast a shadow on the US, though the recent passage of tax reform has seen these recede somewhat. Indeed, most will remember the difficulties faced by the administration in getting its agenda through Congress last year. While tax reform was a success, it may have been the exception and not the rule. Indeed, markets continue to await agreement on spending allocations for fiscal 2018 and the government debt ceiling, after this was postponed by Congress last month with a temporary bill. A deal on a budget bill, required to avoid a government shutdown, is expected in January along with other pending issues, including immigration and healthcare.

The eurozone economy ended 2017 strong, having already surprised markets to the upside throughout the year. The PMI continued to increase, rising to 58.1 in December, a nearly 7-year high. Strength has also been broad-based. Indeed, strong data from the “core” countries has more recently been supported by improving data in some “peripheral” economies, including Italy and Portugal. Economic and business sentiment...
has also been improving, with some metrics hitting new highs. Unemployment fell to a nearly 9-year low of 8.7%. Retail sales for the region were also buoyant in December.

**In the eurozone too, political risks remained front-and-center, though they had receded significantly from their levels this time last year.** Indeed, one of the positives for 2017 was the ability for Europe to weather the significant political risks it faced at the start of the year. Far-right populism was largely held at bay in elections. Still, populism’s challenge was far from defeated. Germany is yet to form a new government after the historic advancement of the far-right party there. In Spain, the question of Catalan independence remains unresolved and could add to uncertainty. Meanwhile, an Italian election in March could again introduce uncertainty for the EU.

**Despite solid economic performance, inflation in advanced economies remained subdued.** While core CPI inflation in the US was stronger than expected in December, rising to 1.8% y/y, it is still too early to say whether momentum has picked up. A firmer monthly gain in average wages of 0.3% in December could portend some acceleration in wage inflation, but it is too early to say, and at 2.5% y/y, wage growth remains subdued. In the eurozone too, inflation remains soft, with core inflation slipping to 0.9% in December.

**Weak inflation, if it persists in 2018, could begin to weigh on the pace of monetary policy normalization.** The Fed did not allow softer inflation since mid-2017 to hold it back from hiking the federal funds rate three times in 2017, though some had their doubts. However, the persistence of low inflation in 2018 could make that more difficult. Indeed, the Fed currently expects 3-4 hikes in 2018; markets already have a slightly more sanguine view, expecting 2-3 hikes. The case is still more relevant for the eurozone, where the recovery is more recent and inflation weaker.

**Oil prices have been making further gains thus far in 2018, extending a more than 50% rally since the middle of last year.** Brent rose to $68 per barrel recently, up from a low of around $45 in June 2017. Prices have certainly benefited from the OPEC-led agreement to reduce production by 14 member and 10 non-member producers, which was extended through the end of 2018. However, despite current strength, 2018 could see some downward pressure on prices from more modest global oil demand growth, especially during the first half of the year, and higher non-OPEC supply growth led by resurgent US shale production.