International scene

International: Tax cuts could boost US growth; Brexit deal marks progress

An already robust global economic picture improved still further in recent weeks. Data in Europe and Japan firmed noticeably, and continued to come in strong in the US. The outlook in the US also benefited from the Senate’s passage of an historic tax reform bill, though a final reconciled measure will require some additional work. Meanwhile, the UK made significant progress on a Brexit agreement with the EU, removing some of the dark clouds on the horizon. With that, equities continued to perform well, hitting fresh highs. Despite the robust outlook for growth, inflation continued to lag behind.

The figures on the US economy continued to come in strong. The latest employment report showed labor conditions continuing to tighten. Nonfarm payrolls rose by 228,000 in November, though the unemployment rate stayed put at the 17-year low of 4.1%. A number of leading indicators have been particularly strong, including capital goods orders and the ISM manufacturing index, showing increased optimism and rising investment. GDP growth also remained solid. 3Q17 GDP growth was revised upward to a solid 3.3% q/q annualized, from 3.0% in 2Q17.

Optimism in a more business friendly White House and a GOP controlled Congress paid off this month, as legislators passed landmark tax cuts. The Senate passed long-awaited tax reform, though it will still need to be reconciled with the House version. While most Republicans believe the cuts, estimated to cost around $1.4 trillion over ten years, will generate enough growth to pay for themselves, many economists do not see them resulting in a large fiscal stimulus. Nonetheless, they are expected to be a boon for corporate earnings and could boost growth in the medium term.

Meanwhile, markets continue to await a budget deal in the US as the government debt, again, approaches the mandated ceiling. In an effort to avert a government shutdown, Congress passed a 2-week stopgap-spending bill, giving legislators more time to agree to new spending levels for the 2018 fiscal year. A broad bipartisan effort is currently underway with hopes an agreement can be reached before Christmas. However, with some expecting agreement on other pending issues, including immigration and healthcare, a deal is unlikely to be straightforward, especially given the need to have something ready before the end of 2017.

Performance in the eurozone has increasingly mirrored the strength seen in the US, with recent data indicating growth picking up pace. The PMI rose to a more than 6-year high of 57.5 in November, showing solid activity across the eurozone. Strength continued to be broad-based, with France (60.3), Ireland (57.7), and Germany (57.3) seeing the best performance. The data pointed to further strengthening in 4Q17 GDP growth. Meanwhile, the final revision to 3Q17 confirmed growth at a robust 2.6% y/y. Consumer confidence for the area also beat expectations, increasing to a post-Great Recession high after its fourth consecutive monthly increase.
The solid economic recovery took place even as the EU grappled with a series of existential political crises that threatened to upset the status quo; in November, it was Germany’s turn. After several EU members survived a wave of anti-EU challengers earlier in 2017, the German national election weakened Angela Merkel, the longest serving EU leader, as the anti-EU far right made marked inroads. With a government yet to be formed, the initial uncertainty subsided after the Social Democrats agreed to talks to form another coalition with Merkel’s Christian Democrats.

Brexit-related uncertainty subsided slightly as the UK reached an agreement with the EU over Brexit divorce terms, which should pave the way for negotiations on the trade relationship. The UK agreed to pay €40-60 billion to settle existing commitments to the block. The deal also included a settlement on the rights of EU citizens in the UK post-Brexit and the question of the Irish border. Now the UK and EU will embark on the more important part of the talks, their trade relationship immediately after Brexit and further in the future.

In Japan, a strong showing by Shinzo Abe in the October election now appears to have coincided with an improving economy. Indeed, Japan’s economy appears to be seeing its best performance in years, with GDP recording the longest growth streak in decades. GDP growth in 3Q17 was revised upwards to an annualized 2.5%. The question remains whether this pace can be sustained in 2018, something markets will be looking out for.

While advanced economies enjoyed solid economic growth, they continued to see inflation below target and failing to pick up. In the US, core CPI inflation stood at 1.8% but did not appear to be gaining momentum after a bout of soft figures in the summer. This was confirmed once again in November’s wage growth, which despite a tight labor market was not gaining pace. The story was similar in the eurozone, where the flash core inflation rate came in at 0.9% for November.

While the Fed has not allowed soft inflation to get in the way of a third hike in 2017, continued softness could begin to weigh on central bank tightening schedules in 2018. Virtually everyone expected the Fed to hike their policy rate by another 25 basis points in December, which they did, especially given the solid economic data and assurances markets received that soft inflation will not hold them back from normalizing. Next year, markets see the Fed moving 2-3 times. In the eurozone, things could be more complicated; given the structural limitations of QE there, the ECB has little credibility continuing with that program past 2018.

Boosted by a solid global economy and the recent OPEC agreement, oil prices climbed for a fifth consecutive month in November, and are holding above $60. Brent rose to $63 per barrel in November, up 32% from where it was six months ago. The recent agreement reached between OPEC and some non-OPEC countries to extend production cuts through the end of 2018 provided additional support to prices, though US production growth from Shale oil will continue to weigh on prices in the medium term.
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