Quarterly Economic Outlook
Q2 2018

This marketing document is exclusively for use by Professional Clients and Financial Advisers in Continental Europe (as defined in the important information), Qualified Investors in Switzerland and Professional Clients in Dubai, Ireland, Jersey, Guernsey, Isle of Man, Malta and the UK. It is not for consumer use.

John Greenwood
Chief Economist, Invesco

Key Trends

Continued business cycle expansion in prospect

After a period of weakness in 2015-16, exacerbated by the decline in oil prices and by a downturn of investment in that sector together with over-capacity in Chinese basic industries, global manufacturing production picked up strongly in 2017 and into early 2018. Overall GDP growth has been less volatile, though with good performances in the US in Q2 and Q3 2017, and a steadily improving performance in continental Europe throughout 2017. In China, however, economic momentum has been weakening, led by a mild slowdown in the raw materials processing industries and in the housing sector. Looking forward from this period of strong growth, there are now starting to be signs that momentum is weakening in the US, in Europe and in China. As yet this does not spell the end of the recovery, only a slowing in the pace of recovery.

Two potential headwinds to growth

Mid-course corrections or slowdowns during economic expansions are quite common – the most notable being those associated with the interest rate increases in the US in 1994-95 and in 2004-05. On this occasion there appear to be two potential headwinds to growth.

First, with the US Federal Reserve (Fed) raising interest rates and simultaneously reducing the size of its balance sheet the US economy will become critically dependent on the ability of the banking and financial system to create new credit, particularly under the more restrictive Basel III regime. It is not the decline in the size of the Fed's balance sheet that is critical, but the impact that the shrinkage has on the funds in the banking system as a whole. The key risk here is that US money and credit growth have already slowed to around 4% and any further slowing could restrict the economy's growth.

Second, the trade confrontation with China initiated by President Trump could have a temporary destabilising effect on economic activity. At the headline level there is widespread concern that a "trade war" could precipitate a global slowdown, but in reality this is unlikely. Tariffs, if implemented, will certainly raise the price of imports for both US and Chinese consumers, but the damage to overall GDP growth would be limited. Much more damage would come from a credit contraction or an unintended monetary tightening as occurred in 1929-33 (at the time of the Hawley-Smoot tariffs) or in 2008-09.

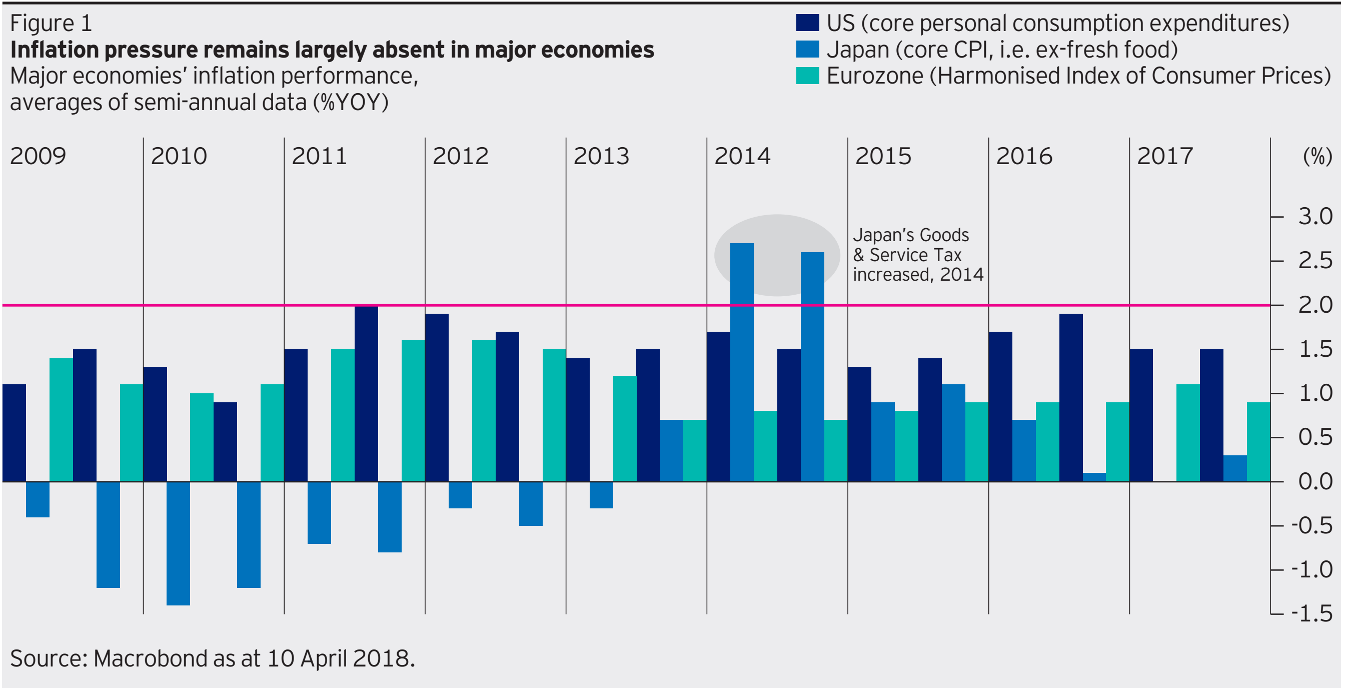
Inflation still subdued and not yet a threat to expansion

The consensus of economic forecasters expects inflation to pick up significantly in the US this year. However, for the past eight years inflation has been running below the central banks' target rate of 2% in the US, the Eurozone and Japan. Against a backdrop of unconventional monetary policy measures (via quantitative easing or QE), exceptionally low levels of interest rates and continuing budget deficits, below-target inflation has created a puzzle for conventional analysts. With labour markets tightening they have expected inflation to rise in conformity with the "Phillips Curve" or output gap analysis, which asserts that as labour markets tighten and capacity utilisation rises, inflation is inescapable. However, the problem with this view is that inflation is a monetary phenomenon, not solely a result of a tight labour market. The fact is that the underlying monetary growth rate has remained low in most major developed economies – well below what is needed to generate a surge in inflation. As long as this remains the case, there is no reason to expect an inflation outbreak that would warrant a monetary policy tightening of the kind that would threaten to end the business cycle expansion.

The recent stock market correction

After the strong rally driven by US tax cuts in December and January, equity markets faced a series of setbacks in February and March prompted by three main factors. First, there was an inflation scare triggered by the publication of average hourly earnings data for January (released in early February) which jumped to 2.8% on a year-on-year basis. Subsequent figures for February (+2.6%) and March (+2.7%) have shown no sustained acceleration of wages, laying to rest, for the present, concerns about a wage-led or "Phillips Curve" inflation spiral. Second, the tech sector, which had led the market upwards through most of 2016 and 2017, has been hit by a series of mishaps affecting some of the biggest names in the market, including Facebook and Amazon. Third, there has been President Trump's escalating protectionist trade war with China which has hit sentiment across a wide spectrum of industries. After the stock markets surged in December and January in the wake of Mr Trump's tax cut, some correction was both inevitable and desirable.

Figure 1
Inflation pressure remains largely absent in major economies
Major economies' inflation performance, averages of semi-annual data (%YOY)



Source: Macrobond as at 10 April 2018.

Figure 2
Consensus Economics

(%)

	2017 Estimate		2018 Consensus forecasts (Invesco forecast)			
Economies	**Real GDP**	**CPI inflation**	**Real GDP**		**CPI inflation**	
US	2.3	2.1	2.8	(2.5)	2.4	(2.3)
Eurozone	2.5	1.5	2.4	(2.3)	1.5	(1.5)
UK	1.7	2.7	1.6	(1.8)	2.6	(2.4)
Japan	1.7	0.5	1.4	(1.4)	1.0	(1.0)
Australia	2.3	1.9	2.7	(2.8)	2.2	(2.1)
Canada	3.0	1.6	2.1	(2.0)	2.1	(1.5)
China	6.9	1.6	6.5	(6.7)	2.3	(1.2)
India	6.7	3.7	7.4	(6.4)	4.9	(4.0)

Source: Consensus Economics, Survey Date: 12 March 2018.

United States

During the first quarter of 2018 Jerome Powell has taken over from Janet Yellen as chairman of the Federal Reserve Board of Governors, and the Trump administration has ratcheted up its trade threats vis-à-vis China designed to force the Chinese to open up their markets to US products and firms. Meantime the domestic US economy has continued to grow at a moderate rate with low inflation, despite widespread – but in my view mistaken – expectations that inflation would pick up significantly.

The first of these developments, the appointment of a new Fed chairman, seems unlikely to change the course of events materially over 2018. Jerome (Jay) Powell has been a Governor of the Fed since 2012, and in his testimonies to Congress he has made it clear that there will be no dramatic shift in monetary or credit policy under his leadership, aside from possibly easing lending conditions for smaller banks. The chairman, after all, is only one of up to 12 voting members at the Federal Open Market Committee (FOMC) meetings, and Powell had long endorsed the current strategy of the Fed to raise interest rates slowly and gradually while simultaneously reversing QE by shrinking the Fed's balance sheet. However, the real concern should be with the slowing growth of money and credit. Already M2 and proxies for M3 have slowed to just 4% year-on-year, and bank credit on the asset side of banks' balance sheets is growing at a similar 4% only, compared with 7-8% growth rates in late 2016. If this slowdown persists and is not offset by an upswing in shadow banking activity, not only would inflation remain lower than current Wall Street expectations, but economic activity could weaken abruptly as liquidity tightens.

The second area of focus is the administration's escalating trade war with China. Following President Trump's proposed 25% tariff on steel imports and 10% on aluminium imports announced on 1 March (although Canada, Mexico, the European Union, Argentina, Australia, Brazil and South Korea were later exempted), these were quickly countered by proposals from China and the EU to impose tariffs on US exports to those markets. On 22 March, Trump proposed retaliatory 25% tariffs for IP infringement on up to US$60 billion of Chinese imports, including components used in the aeronautics, technology and energy industries. Over the weekend of 31 March – 1 April the Chinese responded to the US tariffs with a plan to levy 25% tariffs on US exports of meat, wine, fruit, nuts, ethanol and other products. On 3 April, the US Trade Representative released a list of 1,300 product categories covered by the 25% tariffs to be imposed on Chinese products. It includes parts used to make a variety of household products, from flat-screen televisions to dishwashers, snow-blowers and even vaccines. On 4 April, China responded again with its own plan to impose 25% tariffs on a longer list of American goods, including aircraft, autos, soya beans and whiskey.

On the US side none of these measures will come into force for 60 days, and it is currently not clear if the US really intends to implement its threats or whether China will offer any compromise. The rapid escalation on both sides has reminded investors of the damage supposedly done by the Hawley-Smoot Tariff Act of June 1930, and the subsequent imposition of similar tariffs by other nations. According to some economic historians those tariffs were a fundamental cause of the Great Depression of the 1930s. However, as we now know, largely due to the monumental research of Milton Friedman and Anna Schwartz (in "A Monetary History of the United States") this is not correct; the main cause of the Great Depression was the US monetary contraction of 1929-33, not the Hawley-Smoot tariffs. The implications of this result are that a tariff or trade war today will, if sustained, slow the growth of trade but will probably only have a marginal impact on the growth of overall GDP, provided that domestic demand levels can be maintained in major economies.

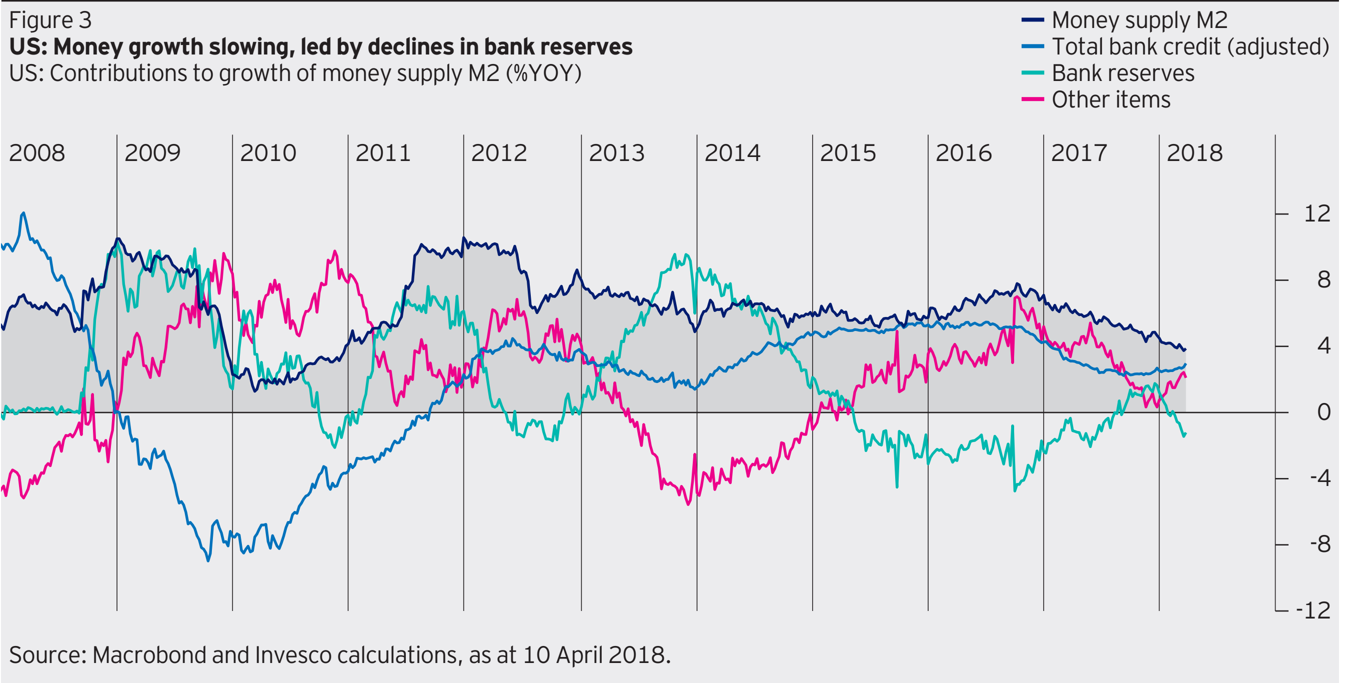
Finally, economic growth has shown signs of cooling during the January-March quarter, which will come as a relief to those who have been concerned about the US economy becoming overheated and generating inflation as a result. For example, manufacturing output, as measured by the IHS Markit Purchasing Managers' Index (PMI), was 55.6 in March 2018, marginally above February's 55.3. Although the index pointed to the highest level of output by the manufacturing sector since March 2015 - thanks to the corporate tax cut in December, which has encouraged investment and new orders to grow - the rate of growth softened to a four-month low. The smaller increase of payroll employment in March (+103,000) may also imply that the US is approaching its economic growth potential.

United States
(continued)

On the price front, cost burdens faced by goods producers rose in March at the fastest rate since November 2012, with companies stating that price rises often stemmed from recently announced tariffs and higher raw material costs. Firmer demand conditions in specific sectors drove the strongest expansion in buying activity since September 2014, encouraging some companies to stockpile raw materials and components. Consequently, greater pressure on supply chains has led to lengthening delivery times. While these pressures and an unfavourable base effect from April to July will push some year-on-year comparisons higher, the monetary and credit fuel necessary to drive a substantial rise in inflation is simply not present. We should therefore expect only modest increases in overall inflation, not a fundamental upward shift. In short, inflation will be heading back towards the Fed's target but not overshooting it in any serious degree.

I forecast real GDP growth to be 2.5% in 2018 and consumer price (CPI) inflation to average 2.3%.

Figure 3
US: Money growth slowing, led by declines in bank reserves
US: Contributions to growth of money supply M2 (%YOY)



Source: Macrobond and Invesco calculations, as at 10 April 2018.

Recent economic and political developments point to downside risks for the euro area, but it is too early to take a strong view. The political stalemate resulting from the Italian election on 4 March means that it is likely to be several months before a resolution is achieved; in France the rail unions are staging a prolonged series of strikes to protest President Macron's plans for labour market reform; and in Germany although a "grand coalition" consisting of Chancellor Merkel's Christian Democrats (CDU), its Bavarian sister party - the CSU - and the Social Democrats (SPD) was agreed on 4 March there have been several signs that economic activity is slowing after a strong year in 2017.

In Italy, the process of forming a government is complicated first by the difficulty of achieving a coalition of traditional and anti-establishment parties, and second by the internal rivalries on both the left and the right. The anti-establishment 5-Star Movement which won the largest number of seats (222) could form a coalition with the centre-right Lega (125 seats) but only at the cost of splitting with PD (111) and Forza Italia (104). An extended period of negotiation followed by another election cannot be ruled out.

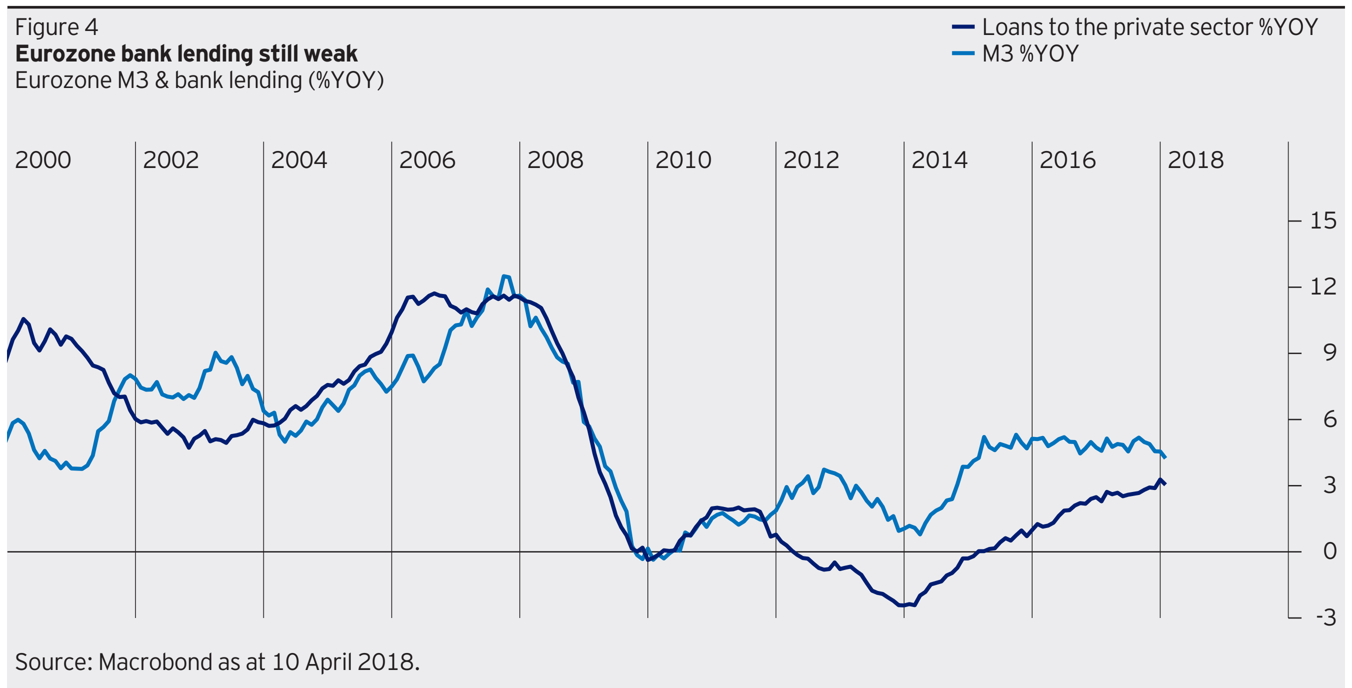
In France, protests are mounting as President Macron's reforms confront the privileges of the railway workers - the "cheminots" - which include lifetime employment, retirement as early as 52 for certain workers and free family travel. During his ascent to power Macron consistently opposed the entrenched rights of insiders that have cost consumers and taxpayers dearly. Thus he has extended Sunday trading, supported ride-hailing apps such as Uber against the taxi lobby, and reduced barriers to entry in long-distance coach travel and legal services. In the case of the SNCF, the nationalised railway company, France has already agreed with the EU to open the sector to competition by 2021, but the company is struggling under €46 billion of debt, and its deficits are growing by the month. Elsewhere, Macron's plans to reduce union control over professional education schemes and to reform unemployment relief and healthcare funding are all likely to heighten social tensions this spring and summer, but with the public mostly backing Macron's reforms it seems unlikely the reforms will be derailed.

Turning to economic growth in the Eurozone as a whole, the upswing of 2017 will carry over into the first half of 2018, but there are clear signs that growth is peaking out, notably in the German economy. Consumer spending growth in Germany slowed in Q3 and Q4 2017, and German industrial output shrank in February (-1.6% month-on-month), driven by a fall in construction (-2.2%) and manufacturing (-2.0%). Both the IFO and ZEW business surveys weakened in March, particularly the latter which fell by 12.7 points to 5.1 compared to its long-term average level of 23.6. For the Eurozone as a whole the consensus forecast is for real GDP growth to slow from 2.7% in Q4 2017 to 2.2% by Q4 2018 and to 1.8% in Q4 2019.

Against this background the European Central Bank's (ECB) plan to taper its asset purchases to €30 billion per month – and probably terminate them altogether from September - while keeping its main repurchase rate at zero may appear appropriate on a superficial view. After all, the region has returned to a reasonable rate of economic growth and inflation is now above 1%. However, the Euro-area banking system remains an area of vulnerability. Bad debt ratios are high in several countries, while lending growth is anaemic across the Euro-area as a whole. If the ECB ceases to conduct asset purchases altogether it is likely that the growth of deposits and hence M3 across the region will relapse to lower rates which would potentially damage GDP growth and cause inflation to fall back towards zero.

For the Eurozone as a whole I forecast real GDP growth in 2018 of 2.3%, and headline consumer price inflation of 1.5%, still below the 2% target due mainly to inadequate M3 growth.

Figure 4
Eurozone bank lending still weak
Eurozone M3 & bank lending (%YOY)



Source: Macrobond as at 10 April 2018.

United Kingdom

The British economy slowed from 2.4% in 2015 to 1.9% in 2016 and 1.8% real GDP growth in 2017, but by far less than the forecasts published by HM Treasury and other official forecasters such as the IMF at the time of the June 2016 referendum. The Treasury forecast had predicted declines in real GDP (relative to what would otherwise have happened) even under a "cautious" Brexit scenario, and a larger decline if Britain shifted to trading under WTO terms. Moreover, they projected large job losses, a big rise in unemployment and house price declines. As it was known that the withdrawal process from the EU would take at least two years under Article 50 of the Lisbon Treaty, the presumption that these declines would begin immediately was somewhat unrealistic, but this was the exercise required by the then Chancellor, George Osborne. Compared to what was expected to happen under a "Remain" scenario, the Treasury forecasts called for a net decline in real GDP of almost 2% between mid-2016 and yearend 2018, whereas what has actually happened is that the economy has grown by 3.2% between the start of 2016 and the end of 2017, and will likely expand by a cumulative 5.0% by yearend 2018.

Although the economy has slowed from an "American" growth rate of 2.0-2.5% to a "European" growth rate of around 1.5-2.0%, employment has continued to rise and unemployment has continued to decline. Nominal retail sales in February were up 4.0% year-on-year, with sales in volume terms up 1.4%. In addition, the CBI (Confederation of British Industry) survey of order books is showing its highest positive balance since the boom of the late 1980s.

Several factors explain the fact that the economy has performed far better than the pronounced weakness forecast by consensus economists in 2016. First and by far the most important is that the UK is a highly competitive, market-driven economy that does not depend on favours from bureaucrats in Brussels for its success. A whole range of institutions and incentives, combined with a highly skilled and adaptable labour force, a long history of the rule of law and strong system of regulation in many sectors have all enabled standards of living to rise over the last four decades. These attributes are likely to be strengthened rather than eroded when the economy leaves the EU.

A second source of success has been the UK's independent monetary policy. In recent years monetary settings have been highly supportive for economic recovery. This is in strong contrast to the policy of the ECB which was far less accommodating than the Bank of England (BoE) - at least until March 2015 when the ECB finally started QE. British monetary policy was already very expansionary at the time of the referendum, but in its aftermath the BoE's Monetary Policy Committee (MPC) added fuel to the fire by cutting the Bank's base rate from 0.5% to 0.25%, adding a further £60 billion of QE, and setting up a Term Lending Facility to encourage additional bank lending to industry. The growth of M4x (a measure of money supply that best reflects the spendable funds available to households and businesses) averaged 4.5% year-on-year in January-March 2016, but subsequently accelerated to average 7.0% in the year from July 2016 to June 2017. Similarly, consumer credit growth and lending to the financial sector surged to double-digit rates over the same period. These more rapid growth rates of money and credit were the primary source of faster spending growth in nominal terms from mid-2016. Fortunately for the inflation outlook money growth rates over the past year have decelerated to the 4-5% range since early 2017.

A third source of higher activity has been the weaker pound which has enabled export order books of British manufacturers to surge to their strongest growth rates in three decades. Thus the CBI monthly surveys of domestic and export orders have both shown the strongest results since 1995. Also, the composite PMI (Purchasing Managers' Index) figures for services and manufacturing has remained firmly in positive territory, averaging 53.5 in the first three months of 2018. Nominal exports have surged since February 2017, reaching an all-time peak in September 2017 (£53.88 bn), and a very similar level in January 2018 (£53.65 bn). In line with the typical delayed "J-curve" response of the external accounts to exchange rate depreciations, further improvements can be expected during 2018.

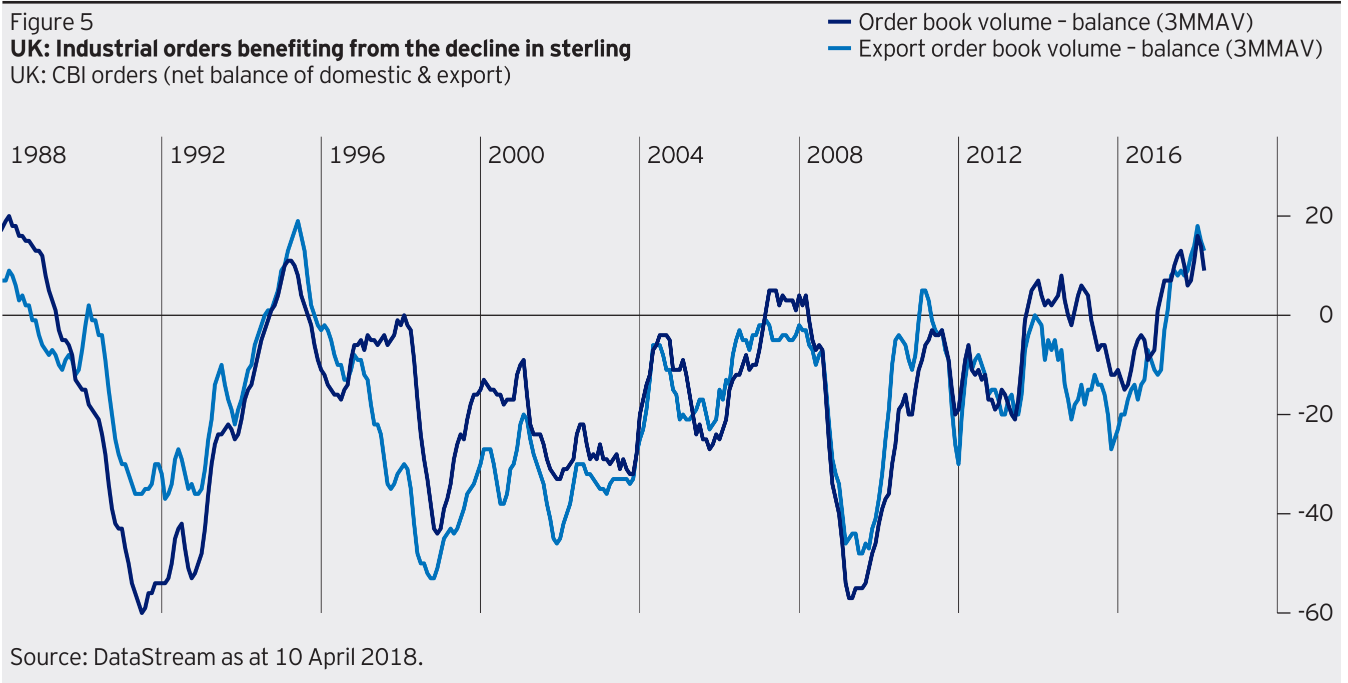
Another positive for the British economy has been the flexibility of the labour market compared to its EU counterparts. This is directly reflected in very low unemployment, good job growth, and a high participation rate. The unemployment rate remained at a low 4.3% in the three months November-January, down from 4.7% a year earlier and the lowest rate since 1975. Similarly in the same three-month period total employment increased by 402,000 over the year, reaching 32.25 million and giving an employment rate of 75.3% (i.e. the fraction of people aged 16-64 who were in work), up from 74.6% a year earlier and the joint highest level since comparable records began in 1971.

The flip side of these figures is that although average weekly earnings were up by 2.8% (including bonuses) in the three months November-January, total real weekly earnings were down by 0.2% due to the rise in consumer price inflation to 3.0% year-on-year.

In response to the higher imported inflation rate and the increase of domestically-generated inflation the BoE has been shifting its position. Initially it viewed inflation as imported and therefore not something that it could control. However, as the evidence of a domestic spending surge accumulated, the BoE has changed its attitude. First, on 27 June it decided to raise the "countercyclical capital buffer" or capital requirements of banks by 0.5% of risk-weighted assets, equivalent to £11.4 billion. Second, the minutes of its September MPC meeting reported that a majority of members felt "some withdrawal of monetary stimulus was likely to be appropriate over the coming months". Third, at the 2 November meeting of the MPC the BoE finally raised interest rates by 0.25% to 0.5%. Finally, Governor Carney indicated in February that interest rates would need to rise "earlier" and by a "somewhat greater extent" than the MPC members had thought at their last review in November.

For the 2018 as a whole I forecast 1.8% real GDP growth and 2.4% consumer price inflation.

Figure 5
UK: Industrial orders benefiting from the decline in sterling
UK: CBI orders (net balance of domestic & export)



Source: DataStream as at 10 April 2018.

Japan

Real GDP grew at 0.4% quarter-on-quarter in Q4 2017, which translates to 1.6% annualised. This was a marked increase over the preliminary release, which had indicated a 0.1% expansion in the final quarter. The strength in the fourth quarter was mainly thanks to an upward revision of capital expenditure and inventory data. Global demand for technological products has encouraged higher capital expenditures in many of the country's most productive sectors such as autos, semiconductors and precision machinery, mirroring trends seen in other major Asian exporting nations. Exports of goods and services also grew robustly in Q4. While it is not always wise to extrapolate a trend from a few quarters, it is worth nothing that there has been greater stability in the Japanese growth figures in the last two years; the economy has now grown for eight consecutive quarters, the longest run of uninterrupted growth in nearly three decades.

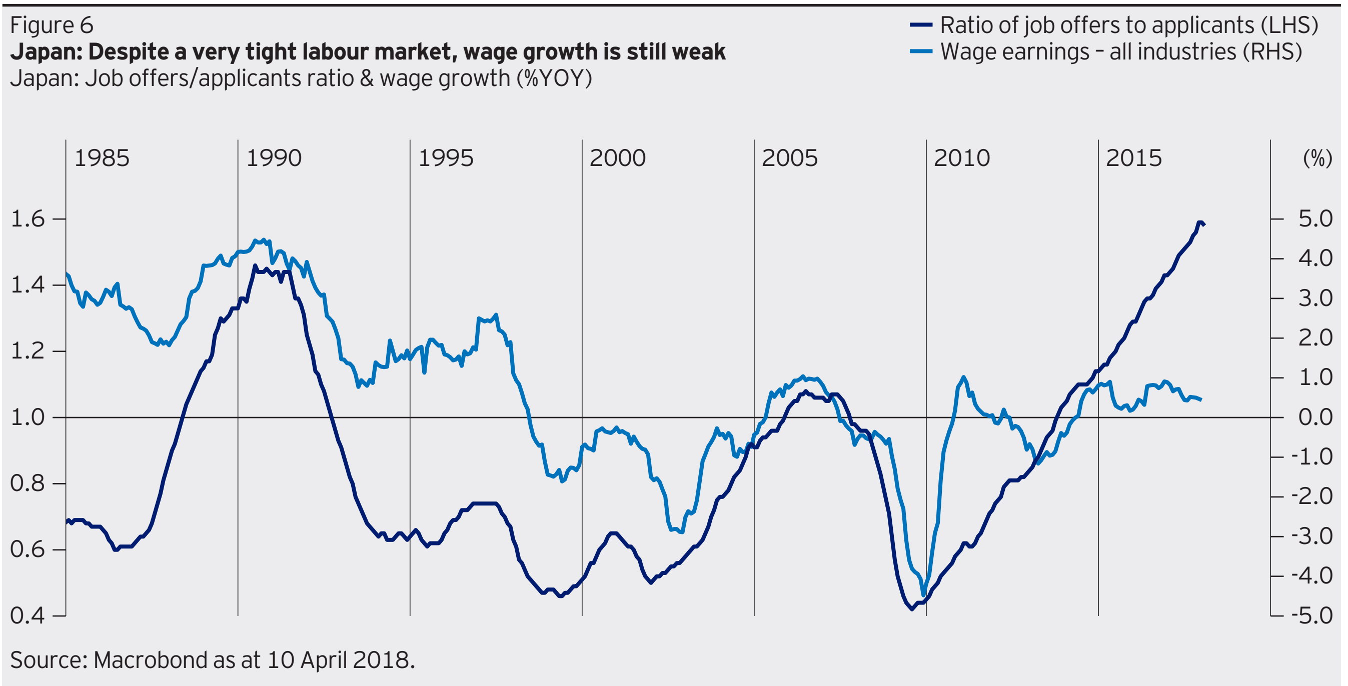
Japan's labour market remains tight; unemployment was just 2.5% in February 2018. The ratio of job offers to applicants has risen to 1.6, its highest level since the mid-1970s. Yet wage growth is still flat, measuring just 0.3% year-on-year in January 2018. Consumer price growth has seen an uptick; the headline CPI inflation was 1.5% in February 2018. Core CPI inflation – ex fresh food – has also accelerated, rising to 1% in February, while the core-core (ex food and energy) nudged higher at 0.5%. While there is some price growth, it is nowhere near as strong as proponents of the Phillips Curve explanation of inflation would expect. As in a number of other countries, weak wage growth in Japan continues to be accompanied by a record low unemployment rate. Japan's broad money growth is not yet strong enough to generate sustained price growth. The consequence of the sub-par wage growth is that consumer spending remains weak. Underscoring the fragility of consumer spending, service sector confidence worsened in February for a third straight month to a ten-month low.

The trade weighted yen has strengthened moderately in the year to date, up 4%. The yen is likely to see continued support as long as US-China trade tensions remain elevated. Bank of Japan (BoJ) Governor Kuroda shook markets in March 2018, when he indicated for the first time the prospect of an exit from qualitative and quantitative easing (QQE) - Japan's monetary stimulus - if 2% inflation was met in the 2019 fiscal year. Inflation at that rate remains an unlikely prospect given the current rate of monetary growth in the economy. M2 grew at 3.3% year-on-year in February 2018, whereas M2 growth of 5-6% p.a. would be required for sustained 2% inflation. In the meantime, the BoJ's monetary policy is likely to remain unchanged, given inflation is well below the 2% target.

Prime Minister Shinzo Abe's reform agenda suffered a blow in February 2018 when he was compelled to abandon, at least temporarily, a key labour law reform aimed at boosting productivity after admitting data used to support the change was flawed. This was an embarrassing political climb-down that is likely to undermine his support among businesses and investors. The change would have expanded a system of "discretionary labour" where employees are regarded as having worked a certain number of hours and are paid a fixed wage regardless of how long they actually work. The flawed data related primarily to this proposal.

Overall, while 2017 ended on a stronger note, it is unlikely that the momentum in the economy will fully carry over to this year. Weak consumer demand is holding back the economy and the boost from stronger investment spending is likely to wane as industrial production has seen a slowdown in January and February 2018. We forecast real GDP growth to be 1.4% in 2018 and headline CPI inflation to average 1%.

Figure 6
Japan: Despite a very tight labour market, wage growth is still weak
Japan: Job offers/applicants ratio & wage growth (%YOY)



Source: Macrobond as at 10 April 2018.

China

China's economy grew in line with official targets at a pace of 6.9% in 2017 as a whole and according to the consensus of economists it is expected to average 6.5% in 2018. Three factors have been holding back its performance compared with the significantly higher growth rates of the decade 2000-09. First, the economy has become much more highly leveraged with the result that official attention is now being directed to de-leveraging the more heavily indebted companies and local government entities. No economy can deleverage and grow at its full potential simultaneously. Second, the housing market has been undergoing a cooling phase following the boom in home prices in 2015-16 – the third such slowdown since the Global Financial Crisis in 2008-09. Third, the heavy industrial sectors remain plagued by excess capacity, which is in large measure a direct result of earlier decisions not to reform the state-owned enterprises (SOEs). As yet the trade confrontation with the US has not showed up in China's trade statistics.

Between 2008 and the end of 2016 China's economy was boosted by a massive increase in debt. The ratio of debt-to-GDP for that part of the economy not controlled by the central government increased from 120% to 265%, much of it being drawn down by local government financing vehicles or by SOEs which embarked on huge investment programmes financed through their privileged access to funds through the banking system. By contrast, genuinely private sector enterprises have been obliged to fund much of their expansion by means of equity and internally generated funds.

The first steps towards deleveraging were taken last summer. In August the National Development and Reform Commission announced that agreements had been reached with over 70 highly leveraged companies in the steel, coal, chemical and equipment manufacturing industries to begin debt-for-equity swap programmes amounting to one trillion yuan. In February Premier Li announced a decision of the State Council (effectively the Cabinet) to rein in debt risks further by extending market-based debt-to-equity swaps, prioritising the reduction of debt in the SOE sector. At the end of 2017 the debt-to-asset ratio of all large industrial enterprises (with revenues exceeding 20 million yuan) was 55.5%, down 0.6 percentage points over the year, while the same figure for the more indebted SOEs was 60.4%, down 0.9 percentage points. The debt control campaign may take several years, but a start has been made, although inevitably the growth rate of the economy will be constrained while the deleveraging continues.

Second, the housing market has been cooling down following the mini-boom of 2015-16. Home-building has wide linkages with a number of key sectors of the economy such as steel, copper, aluminium, cement, the financial sector and the home-furnishing sector. In addition construction has been a large employer of labour. As a consequence it is imperative that China should stabilise its housing market to minimise the knock-on effects on these other sectors. However, since 2008 there have been no less than three housing booms (2009-10, 2012-13, and 2015-16) and corresponding episodes of abrupt downturns (2011, 2014 and 2017).

One important improvement in overall management of the economy and hence the housing market in recent years has been that aggregate money and credit growth rates have become more stable, but even so this has not eliminated the cyclicality that has plagued the sector. To deal with the remaining instability the authorities have actively used macro-prudential measures such as varying the maximum loan-to-value ratios (LTVs) or adjusting permitted loan-to-income ratios (LTIs), and imposing controls on speculators through limiting access to second or third mortgages. The situation now is that housing prices in key Tier 1 cities such as Beijing and Shanghai have been falling, and price increases in lesser (Tier 2 and Tier 3) cities have been cooling. Until the authorities are better satisfied with the degree of de-leveraging in the economy as a whole it seems unlikely that another housing bubble will be allowed to start inflating.

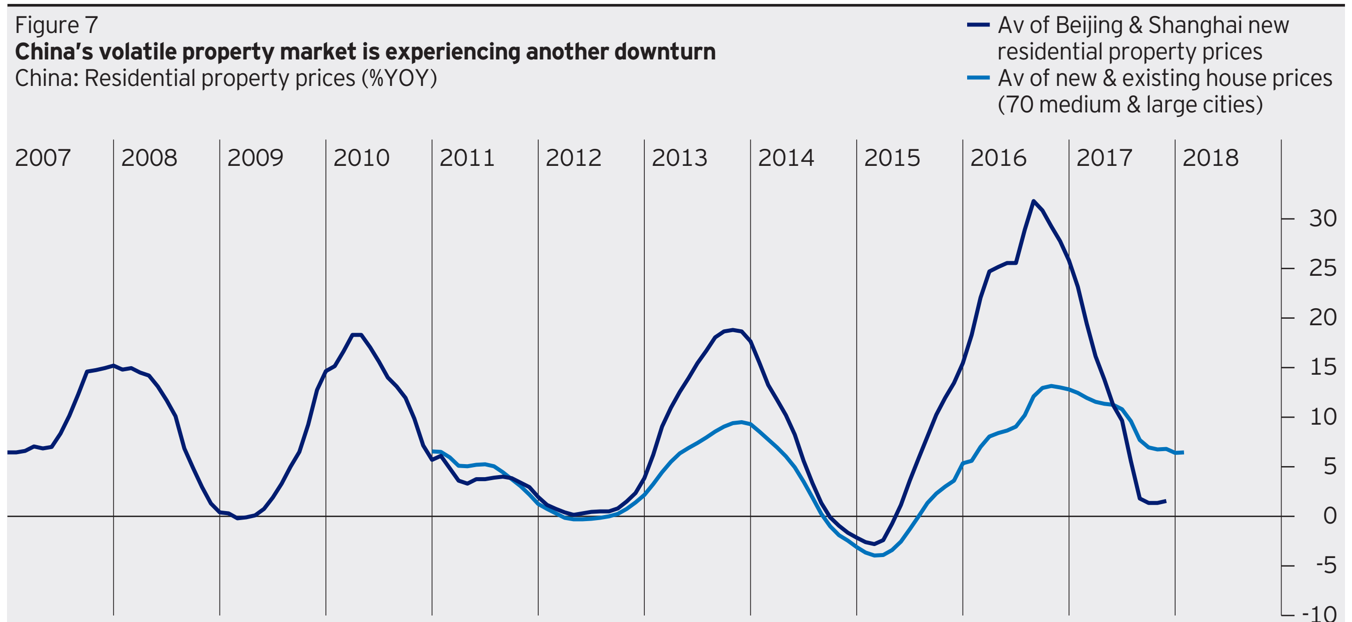
China
(continued)

Initially the excess capacity problem in China's state-owned basic industries was dealt with by imposing output controls on different companies. Famously the coal sector was instructed in 2016 only to produce for 276 days in the year, causing coal production to fall by 8%. The resulting shortages drove up domestic prices of coking coal (which quadrupled) and coking coal (which doubled), forcing the authorities to relent and allow the mines to operate for 330 days per year. Subsequently in 2017 the authorities switched to managing prices, setting an upper limit of RMB 600 per tonne and a lower limit of 470, with a mid-range target of 500-575, but no satisfactory solution seems in sight. Compared with the 1960s and 1970s when Japan's MITI enforced a "recession cartel" on private companies whenever there was a serious downturn, the Chinese have not yet discovered the magic formula to resolve the problems of their volatile basic industry sectors.

No centrally managed economy from the Soviet Union to China under Mao – or more recent cases such as Chile under Allende or Vietnam until Doi Moi (economic reforms) in 1986 – has ever solved the inherent contradictions between public ownership and control of resources, companies and prices on the one hand and running a successful, growing economy on the other. China will therefore continue to grapple with the problems of fixing its SOEs and excess capacity in a variety of industries as long as the country's leaders continue to postpone fundamental reforms in favour of preserving a part-state owned, part-state managed economy.

For 2018 I expect 6.7% as the official real GDP growth figure and 1.2% consumer price inflation.

Figure 7
China's volatile property market is experiencing another downturn
China: Residential property prices (%YOY)



Source: Datastream as at 10 April 2018.

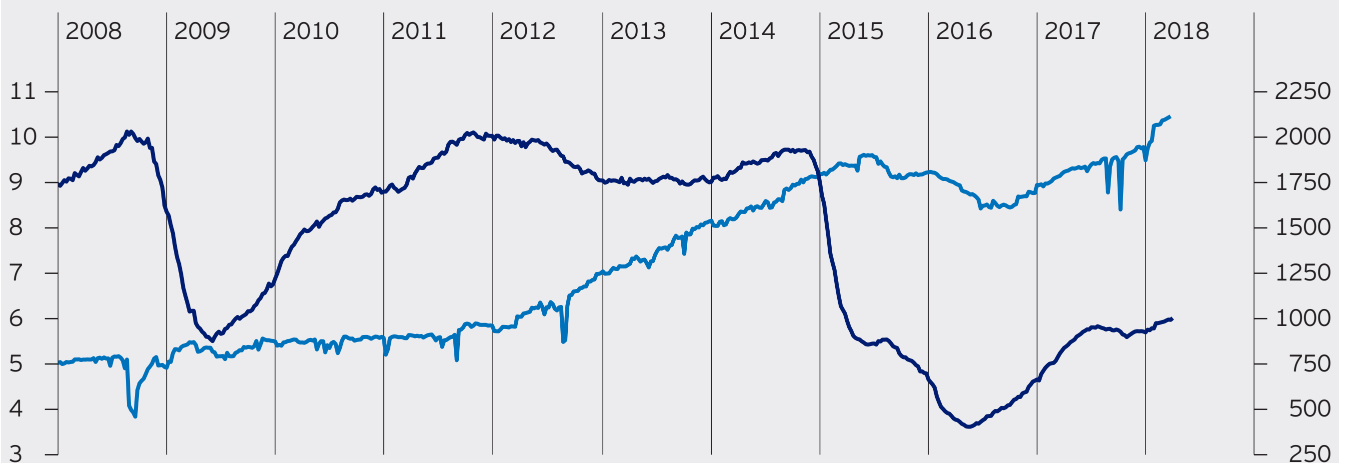
Commodities

The current environment of broadening global economic growth, increasing world trade, and a weaker dollar is moderately supportive of commodity markets but a surge in prices remains unlikely too. The two main indices we use as commodity benchmarks, the S&P GSCI and the CRB index, have both risen over the last year, but to varying degrees. The GSCI is up 14% since April 2017 and the CRB is up a modest 2%. This is largely explained by the larger weighting of energy commodities in the GSCI (over 50%) compared to the CRB.

The Brent crude oil price is up 20% since this time last year, but more stable so far in 2018 although it is seemingly unable to stay above the US$70 per barrel mark for any prolonged period. Although increased US-Iran tensions along with other conflicts in the Middle East could have a greater influence on oil supplies than they have had in recent years, output looks set to rise in 2018. Thus the International Energy Agency raised its forecast for oil demand this year to 99.3 million barrels per day (bpd) from 97.8 million bpd in 2017. Yet once again the US is seeing strong crude output growth, enough to supply the bulk of the increased global demand. US crude production is up 10% since the start of 2018 and is rising at a rate of 14% year-on-year. The US rig count is also growing, even though the growth rate has slowed substantially. The latest data shows the rig count is up 16.7% from a year ago compared to a growth rate of 125% in April 2017. The current rig count is just over 1000, roughly half the number of active rigs prior to the oil price collapse in 2014 when there were over 1900. Global crude inventories have fallen over the last year which removes some of the buffer for oil markets from geopolitical shocks.

The most prominent development in the market for soft commodities is the burgeoning trade war between the US and China. China's Ministry of Commerce has announced plans to impose 25% duties on soya beans in addition to other US agricultural produce including wheat, corn, cotton, sorghum, tobacco and beef. US soya bean producers would have the most to lose from such a move as China accounts for nearly a third of US soya exports and is its biggest export market. China has targeted this commodity because of the importance of the crop to the Trump supporters in his rural heartland. While it is hard to quantify accurately the negative impact on US growers, it would likely mean that US soya bean trades at a discount to comparable South American crops. Therefore Brazilian and Argentinian producers have the most to gain from tariffs; China last year bought more soya beans from Brazil than from the US. Tariffs may also have negative impact on Chinese food producers since soya bean meal is the main feedstock for China's pork producers and a rise in the cost of the raw material will likely increase the price of pork, which is a component in the Chinese consumer price index.

Figure 8
Commodities: Increases in US oil production continue to ease price pressures
US rig count & oil output



Source: Macrobond as at 10 April 2018.

Conclusion

The two main risks to the global business cycle expansion come from potential mistakes in US and Eurozone monetary policy, not from the Trump administration's drumbeat of protectionism.

In the US, although interest rates are still low and monetary or "financial conditions indices" still point to a situation of monetary ease, the growth rates of money and credit in the official banking system have roughly halved over the past year. This squeeze has not been offset by any resurgence of growth in the shadow banking sector. Potentially exacerbating the squeeze is the Fed's shrinkage of its balance sheet, which this year will amount to $420 billion. Unless the commercial banks step up to the plate and create a comparable amount of credit, there is a significant risk of a slowdown in both nominal and real GDP. Although a credit crunch is not inevitable not inevitable - the banks could be induced to buy substantial amounts of Treasury bills, thus creating credit for the government to replace their reduction in their excess reserves at the Fed - the situation is serious enough to sound a warning.

In the Eurozone the problem arises from the failure of European banks to create adequate credit (in contrast to the situation in the US in 2014 when the Fed started tapering its purchases and US banks were expanding credit at 8% p.a.). If the ECB ends its asset purchases in September - as its announcements to date suggest - it needs to be sure that the banks are in a position to be able to create enough credit to ensure continued growth of M3 of at least 4-5%. In other words, given the fragility of the European banking system, the monetary squeeze could come well before the ECB even starts to shrink its balance sheet. In this sense the Eurozone today is more vulnerable to the ending of QE than the US was in 2014.

The recent headlines have been full of the tit-for-tat trade measures announced by the US and China. In my view Mr Trump's threats are intended to persuade China to level its domestic playing field for US and other foreign businesses, particularly in the areas of intellectual property and technology, and that we are therefore likely to see some compromises on both sides that will avert a serious trade war. There is no doubt that tariffs are bad news for consumers and businesses alike, but since merchandise imports are only about 12% of US GDP and 15% of Chinese GDP, even if an escalation of tariffs on both sides were to be implemented, the damage to real economic activity would only amount to around 0.1-0.2% of GDP. In my judgment, this implies that the warnings, such as those spelled out by Christine Lagarde of the IMF, suggesting that a trade war would cause a global economic collapse are a grave exaggeration.

John Greenwood
Chief Economist, Invesco
11 April 2018.

Important information

This marketing document is exclusively for use by Professional Clients and Financial Advisers in Continental Europe (as defined in the important information), Qualified Investors in Switzerland and Professional Clients in Dubai, Ireland, Jersey, Guernsey, Ireland, Isle of Man, Malta and the UK. It is not for consumer use.

This document is marketing material and is not intended as a recommendation to invest in any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication. The information provided is for illustrative purposes only, it should not be relied upon as recommendations to buy or sell securities.

The value of investments and any income from them will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

While great care has been taken to ensure that the information contained herein is accurate, no responsibility can be accepted for any errors, mistakes omissions or for any action taken in reliance thereon.

Where John Greenwood has expressed opinions, they are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco professionals.

For the distribution of this document, Continental Europe is defined as Austria, Belgium, Finland, France, Germany, Greece, Italy, Luxembourg, Malta, Netherlands, Norway, Spain and Sweden.

All data provided by Invesco, unless otherwise stated.

Data as at 11 April 2018, unless otherwise stated.

By accepting this document, you consent to communicate with us in English, unless you inform us otherwise.

This document is issued in:
Austria by Invesco Asset Management Österreich-Zweigniederlassung der Invesco Asset Management Deutschland GmbH, Rotenturmstraβe 16-18, 1010 Vienna, Austria.

Belgium by Invesco Asset Management SA Belgian Branch (France), Avenue Louise 235, B-1050 Bruxelles, Belgium.

Finland, France, Greece, Malta, Norway and Luxembourg by Invesco Asset Management SA, 16-18 rue de Londres, 75009 Paris, France.

Germany by Invesco Asset Management Deutschland GmbH, An der Welle 5, 60322 Frankfurt am Main, Germany.

Italy by Invesco Asset Management SA, Sede Secondaria, Via Bocchetto 6, 20123 Milan, Italy.

The Netherlands by Invesco Asset Management S.A. Dutch Branch, Vinoly Building, Claude Debussylaan 26, 1082 MD Amsterdam, The Netherlands

Sweden by Invesco Asset Management SA, Swedish Filial, Stureplan 4c, 4th Floor, 114 35 Stockholm, Sweden.

Spain by Invesco Asset Management SA, Sucursal en España, C/ GOYA, 6 - 3º, 28001 Madrid, Spain.

Switzerland by Invesco Asset Management (Schweiz) AG, Talacker 34, 8001 Zurich, Switzerland.

Dubai by Invesco Asset Management Limited, Po Box 506599, DIFC Precinct Building No 4, Level 3, Office 305, Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority.

Jersey and Guernsey by Invesco International Limited, 2nd Floor, Orviss House, 17a Queen Street, St Helier, Jersey, JE2 4WD. Regulated by the Jersey Financial Services Commission.

Isle of Man and Ireland by Invesco Global Asset Management DAC, Central Quay, Riverside IV, Sir John Rogerson's Quay, Dublin 2, Ireland. Regulated in Ireland by the Central Bank of Ireland.

UK by Invesco Asset Management Limited, Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire RG9 1HH, UK. Authorised and regulated by the Financial Conduct Authority.

CEUK2997/63692/PDF/200418