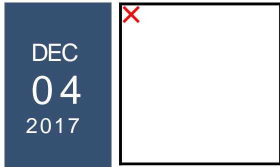

2018: Only the Calendar is Changing, Not Our View

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Looking toward the first half of 2018, we believe the current broad-based global economic expansion should continue into next year. The global economy has positive inertia—I like to cite an International Monetary Fund (IMF) statistic I recently heard at a conference to support this: 192 countries are growing and only six are contracting. Those six countries are either in Africa or Caribbean, the latter of which was impacted by a destructive hurricane season. Maybe 2017 marked the highs in terms of the dispersion of global growth, but we're not tracking anything which suggests a sharp slowdown. The pillars of support for continued global economic expansion are the U.S. and Chinese economies, stabilizing commodity markets, low inflation, and still easy monetary policy worldwide. The Federal Reserve (Fed) is of course an exception to central bank accommodation as it continues to normalize, but they continue to remind us that the neutral rate isn't that far from current levels. We view China through the lens of economic stability—it should remain a significant positive contributor to global growth in 2018. However, we've blogged extensively on China following the 19th Party Congress, so let's focus on the U.S. as a pillar of support.

New Fed Leadership

The next Federal Open Market Committee (FOMC) meeting is December 14. A 25 basis point rate hike is already baked into market expectations, so the bigger stories this meeting will be about the incoming Fed chairman and policymaking in 2018. This meeting will also mark outgoing Chair Janet Yellen's final press conference as Fed chief, so we will be listening to her swan song closely. The Fed's communication style has been an under-discussed topic in the markets. Recently Yellen has noted her frustration with the difficulty in keeping fellow FOMC members on message and conveying monetary policy through one voice. Her predecessor, Ben Bernanke, ushered in a new era of Fed communication by letting other FOMC members speak on his behalf. Bernanke's style was a departure from former chairmen Alan Greenspan and Paul Volcker, both of whom controlled the Fed's messaging. So it will be very interesting to see what communication style incoming chairman Jay Powell adopts.

So far, markets have not reacted to Powell's appointment, probably because he was viewed as a "safe" pick—meaning, he would not derail the current Fed policy of slowly removing stimulus. The decision on a Fed chair removed one level of uncertainty from the markets. I personally think it will be nice to have a non-Ph.D. at the helm of the Fed, as most Ph.D.s think everything can be explained by models. Not true! The Fed still can't explain why inflation remains low despite firmer growth and a tighter labor market. How do economic models capture the "Amazon Effect" on inflation? The Powell era will also include new FOMC members since there are a few vacancies that will need to be filled. Only time will tell how the collective FOMC will work together to unwind an era of the experiment of unorthodox monetary policy. These growing pains for the FOMC pose an additional risk, along with a good amount of uncertainty that remains regarding quantitative tightening (QT). And, there's always the risk that the Fed could tighten too aggressively on cyclical inflation influences while underemphasizing the secular disinflationary forces.

Policy Normalization

How many Fed rate hikes are warranted in 2018? I'm leaning toward 2 - 3, which is reflected in the dot plots. The number of rate hikes in 2018 will likely be influenced by cyclical versus structural inflationary forces, the direction of the U.S. dollar and tax policy. We think cyclical inflation will be contained by secular disinflationary influences. As for the dollar, we continue to believe that a stronger currency would tighten financial conditions—which wouldn't go unnoticed by this Administration. The fate of tax reform hangs in the balance. If it isn't passed, there will be some volatility in financial markets over the short term. Absent any impact from those factors, we think 2 - 3 rate hikes seems plausible, but keep in mind we will also be watching for the implicit tightening from balance sheet reduction. Shedding assets is expected to accelerate next year, so QT may not exactly be like watching paint dry, but it shouldn't spark volatility like the taper tantrum either.

U.S. Outlook

We expect positive U.S. growth momentum to continue with or without tax reform, with the consumer well-positioned to drive economic activity higher. While the U.S. corporate sector stands to gain a lot from reform, we still see companies benefitting from a weak dollar environment, which would accelerate on a failed attempt at a tax overhaul. We still believe that the dollar is on a multi-year downtrend.

The Fed's preferred gauge for inflation, core personal consumption expenditures (PCE) is at 1.4%, and inflation expectations remain well anchored. If the U.S. Treasury curve flattens, it will be because of lower inflation expectations, and not necessarily due to growth concerns. U.S. treasuries should remain range bound in this environment. Generally, financial market volatility should remain subdued in this type of global environment.

Final Thoughts

We think many of these positive factors emanating from the U.S. should create a positive tailwind for risk assets, including emerging markets. As long as there is positive nominal economic global growth, risk assets should do fine—yes, even if the Fed continues to tighten. There could be stress in financial markets if global growth peaks or if the Fed tightens too aggressively. Central bank policy missteps could be one of the biggest risks either late in 2018 or early 2019, whether it's the Fed, or the European Central Bank shifting away from its own quantitative easing too quickly. From a legislative standpoint, a broad-based race toward protectionism also poses a risk, so we'll be closely watching the North American Free Trade Agreement renegotiations and trade discussions between the U.S. and China. We're facing a number of key elections in 2018 in the developing countries, so the role of populism and its impact on policymaking will continue to factor into the market's risk appetite. We think emerging markets have been playing catch up with higher quality assets all year—a trend that should extend into the first half of 2018 and probably beyond. The unique situation of broad-based global growth with low inflation should supports capital gravitating toward regions offering higher returns.

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