Perspectives
Economics

SwissLife
Asset Managers

October 2018

Key messages

- US: Peak in inflation cycle is left behind despite higher tariffs
- Brexit: Better prepare for more uncertainty
- Swiss economy losing support from major drivers of recent boom

Comparison of forecasts

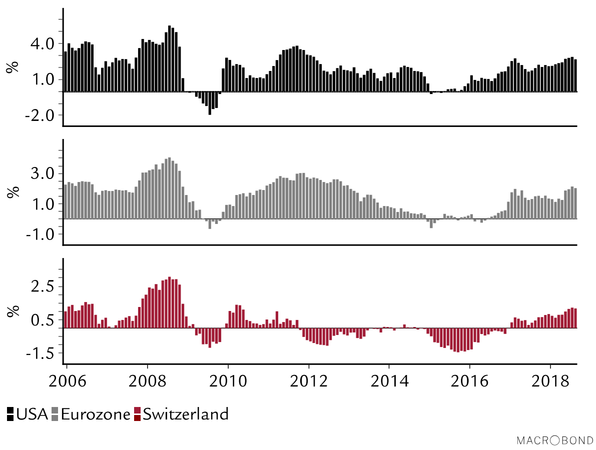
	GDP growth 2018		GDP growth 2019		Inflation 2018		Inflation 2019	
	Swiss Life AM	Consensus	Swiss Life AM	Consensus	Swiss Life AM	Consensus	Swiss Life AM	Consensus
US	2.7%	2.9%	2.2%	2.6%	2.5%	2.5%	2.1%	2.3% ↑
Eurozone	2.0%	2.1%	1.4%	1.8%	1.8% ↑	1.7%	1.6%	1.6%
UK	1.2%	1.3%	1.2% ↑	1.5%	2.6% ↑	2.4%	2.3% ↑	2.1%
Switzerland	2.9% ↑	2.6% ↑	1.2%	1.8% ↑	1.0%	1.0%	0.8% ↓	1.1% ↑
Japan	1.1% ↑	1.1%	1.2% ↑	1.2%	0.9% ↑	0.9%	0.7% ↑	1.1%
China	6.5%	6.6%	6.1%	6.4% ↑	2.1%	2.1%	2.3%	2.3%

Arrows indicate difference from previous month
Source: Consensus Economics Inc. London, 10.09.2018

Consensus Economics
Forecast Accuracy
Award Winner
Switzerland 2017

Consensus Economics, one of the world's leading economic survey organisation, has announced the recipients of its 2017 Forecast Accuracy Award (FAA) in June 2018. Swiss Life Asset Managers' economic research team has won this year's Forecast Accuracy Award for Switzerland.

Chart of the month



After the great recession of 2008, fears were widespread that high inflation will be the price for the massive monetary policy response by central banks. Such fears were misleading. Rather, the developed regions were at the brink of deflation in the years 2015 and 2016. The synchronous upswing of the global economy which started by mid-2016 and continued loose monetary policy ensured the return of inflation rates back to around the central banks' declared target ranges.

US
Smallbiz is in party mood

GDP growth	
Swiss Life Asset Managers	Consensus
2018: 2.7 %	2018 : 2.9 %
2019: 2.2 %	2019 : 2.6 %

As much as President Trump is a controversial person, as much is his economic policy welcomed by his domestic clientele: Consumer confidence improved to its highest level for the past 18 years according to the Conference Board. Meanwhile, sentiment among small and medium sized firms has never been more buoyant since the NFIB (National Federation of Independent Business) introduced its Small Business Optimism Index in 1974. Trump's tax reform and the tight job market boosted households' disposable incomes. Meanwhile, the corporate sector has strong incentives to invest as most of non-residential fixed investments are immediately deductible from the tax bill. Tracking estimates suggest the US economy continued to grow at around 4% in annualised terms during the third quarter 2018. As the economy runs on the drugs of the tax reform, we think that the outcome of the midterm elections to Congress remains uncertain. Should the Republicans secure their majority in both houses, we expect pro-cyclical fiscal policies to continue, with a focus on infrastructure spending. The quality of growth would deteriorate since this year's private sector investment boom is unlikely to be repeated however strengthened or weakened the President's status turns out to be after the election on November 6.

Inflation	
Swiss Life Asset Managers	Consensus
2018: 2.5 %	2018: 2.5 %
2019: 2.1 %	2019: 2.3 %

The total impact on inflation stemming from higher tariffs on goods coming from China should not exceed 0.2%. Yet, the announced implementation of tariffs on another 200 billion Dollar worth of goods poses an upside risk to inflation in the short-term as do sticky energy prices. Medium-term, we expect accelerating wage growth to boost price setting power of domestic suppliers of services. Yet it remains unlikely that annual headline inflation will be higher on average next year compared with 2018 as the base effect from higher energy prices is starting to fall out of the statistics.

Eurozone
Back to a more sustainable pace

GDP growth	
Swiss Life Asset Managers	Consensus
2018: 2.0 %	2018 : 2.1 %
2019: 1.4 %	2019 : 1.8 %

Since 2014, the Eurozone enjoys a period of firm growth above its long-term potential. That allowed labour markets to improve in all member states. On aggregate, the unemployment rate dropped from 11.9% by February 2014 to currently 8.1%. By now, this process has gone far enough to allow accelerating wage growth which forms a robust support to domestic demand going forward. Faster wage growth is a late cycle phenomenon and the Eurozone is no exception to this rule. GDP growth has already slowed markedly in the first half of 2018. Compared with the five quarters between October 2016 and December 2017, quarterly GDP growth rates have come down from 0.7% to slightly less than 0.4%. In annualised numbers, economic activity is still slightly outpacing the region's potential growth rate of around 1.4%. Yet, preliminary readings for the French and German manufacturing purchasing managers index suggest that industrial activity has slowed further towards the end of the third quarter. In our view, the consensus forecast for 2019 is overly optimistic as it would require growth rates to return back to the pace of the boom year 2017. This seems unlikely given the recurrent political uncertainties and the prospects of gradually less accommodative monetary policies in all major developed economies.

Inflation	
Swiss Life Asset Managers	Consensus
2018: 1.8 %	2018: 1.7 %
2019: 1.6 %	2019: 1.6 %

Headline inflation eased slightly to 2.0% in August. The oil price remains a major driver of headline inflation with the energy component contributing 0.9 percentage points to current inflation. Back in January 2017, Mario Draghi made it clear that the ECB would consider a rise of inflation towards or even above their policy target of "close to, but below 2%" only as sustainable when not caused by volatile components such as energy of food prices. This condition remains far from being met even if headline inflation in 12 of the 19 EMU member countries currently exceeds 1.8%.

UK
A "Blind Brexit"

GDP growth

Swiss Life Asset Managers	Consensus
2018: 1.2 %	2018: 1.3 %
2019: 1.2 %	2019: 1.5 %

As this paper was written, the Labour congress was still ongoing and the Conservative Party convention had not even started. We do not expect much clarity on the form of Brexit before January 2019. Thus, one remains well advised to prepare for more political turmoil to come even after the party gatherings. Scenarios discussed range from a "No Deal Brexit" to no Brexit at all. In our view, the risk that Britain leaves the EU without a treaty remains elevated as hard core "Brexiteers" have incentives to challenge Theresa May's Tory party leadership. A parliamentary rejection of the negotiated treaty which the prime minister will bring home from Brussels is another plausible scenario. Both developments would probably end in yet another general election before spring 2019. Meanwhile, our base case remains a "Blind Brexit" with an agreement on the duration of the transition period, but not much visibility on all other aspects of the future relationship. In this scenario, we expect subdued growth as reluctant corporate investments and falling net migration are reducing potential growth by 0.2% to 0.3% of GDP over the short-term. The more clarity a treaty would offer with respect to access to Europe's single market, the more favourable the short-term outlook. Yet, we currently give such a best case scenario not more than 10% probability. The costs of a "No Deal" outcome over the next two years could be as much as 2 percentage points less GDP growth relative to our base case, with a recession in the first half of 2019 highly probable.

Inflation

Swiss Life Asset Managers	Consensus
2018: 2.6 %	2018: 2.4 %
2019: 2.3 %	2019: 2.1 %

In August, one-off effects like a surge in prices for theatre shows triggered a rise of annual inflation to 2.7% from 2.5%. A "No Deal" Brexit bears the risk of further Pound weakening and thus higher inflation in 2019. In case of an agreement with the EU, we would expect a stronger Pound and continued monetary policy normalisation to dampen inflationary pressure.

Switzerland
Rewriting recent history

GDP growth

Swiss Life Asset Managers	Consensus
2018: 2.9 %	2018: 2.6 %
2019: 1.2 %	2019: 1.8 %

Last month, we mentioned the risk that our forecast of 0.5% GDP growth in the second quarter 2018 may prove too prudent. Firm GDP prints seen in Switzerland's most important trade partners and licences earned by FIFA posed upside risks. Since then, we learned that GDP grew by 0.7% in the second quarter. Yet the biggest surprise in the numbers published by SECO (State Secretariat for Economic Affairs), were revisions to historic data: It turns out that GDP grew 1.7% in 2017 rather than the initially reported 1.1%. We thus have to rewrite economic history as Switzerland benefited faster from the global upswing since 2016 than previously thought. The new data also trigger revisions to the forecasts for 2018, as the basis for all growth calculations is totally different to what it was one month ago. In our case, the forecast now stands at 2.9%, instead of 2.1% previously. Despite the rosier picture of the past, we see no reason to revise our assumptions of a less dynamic future: For 2019, we project growth to slow to around the economy's potential as major drivers of the strong performance in the past will contribute significantly less to growth in the quarters ahead. Among such sponsors losing a bit of their magic are the ultra-low interest rates, net migration, rising disposable incomes, the synchronous global upswing between 2016 and 2018 and the temporary weakening of the Swiss Franc. A survey conducted by KOF suggests that industrial and construction firms prepare for substantially less new orders going forward.

Inflation

Swiss Life Asset Managers	Consensus
2018: 1.0 %	2018: 1.0 %
2019: 0.8 %	2019: 1.1 %

July's 1.2% annual headline inflation print marked the peak in the cycle. Our forecast for 2019 is well below consensus: The Franc's trade weighted value has again appreciated by around 5% compared to 2017. Given a rising number of vacant apartments, we expect the rental component in the consumer price index to contribute negatively to inflation over the coming quarter.

Japan
Beneficiary of the trade dispute?

Never since Japan is a democratic country did it enjoy such a long period of political stability: With Shinzo Abe winning a third term as head of the LDP, he is set to become the longest-serving prime minister. In Abe's first years in office, we were sceptical whether his policies labelled „Abenomics" will succeed in reflating the economy and reform some of the highly regulated sectors. Admittedly, it was difficult to pursue a reflation strategy at the time when most of the developed world underwent austerity measures and stood at the brink of deflation. But more recently, Abenomics get better marks: In the two years since mid-2016, average annualised GDP growth reached 1.5% compared with 0.3% in the first years of Abe's tenure. Most importantly, wage growth starts to accelerate and with it also inflation. The trade dispute between the US and China could turn out as a surprise support for Japan's economy: As long as the US trade policy remains focussed on China, Japan's machinery and chemicals exporters could be beneficiaries of trade diversion measures.

China
Fiscal support for export sectors

Since September 24, half of China's goods exports to the US are affected by punitive tariffs. As China runs a trade surplus with the US, its authorities have little room left to retaliate with reciprocal increases of tariffs on goods from the US. Yet, other tools remain at hands: US firms already fear restricted access to China's consumer market. Despite the trade dispute, most forecasters remain reluctant to revise their GDP projections for China to the downside. According to Consensus Economics, the consensus forecast for GDP growth in 2019 currently stands at 6.4%, compared with 6.3% at the start of the year. Our own, a bit more prudent, forecast was unchanged throughout the year and remains at 6.1%. China's government tries to offset the drag on growth with fiscal measures. Tax cuts for the corporate sector and subsidies for exporting firms are the most important measures under evaluation. So far this strategy seems to be credible with purchasing managers indices staying in expansion territory and export growth slowing only moderately.

Economic Research

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