Perspectives

Economics

Swiss Life Asset Managers

November 2018

Key messages

- US: High gasoline prices weigh on disposable incomes and result in moderating consumption growth
- Eurozone: Markedly slower industrial dynamics
- Looking through the noise in the energy price component, inflation cycle has peaked in Switzerland

Comparison of forecasts

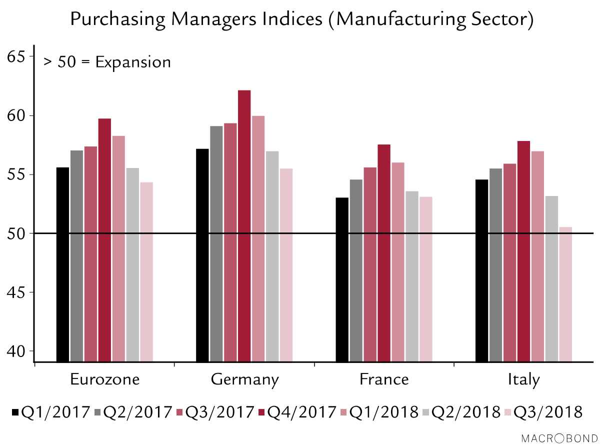
	GDP growth 2018		GDP growth 2019		Inflation 2018		Inflation 2019	
	Swiss Life AM	Consensus	Swiss Life AM	Consensus	Swiss Life AM	Consensus	Swiss Life AM	Consensus
US	2.8% ↑	2.9%	2.2%	2.6%	2.5%	2.5%	2.0% ↓	2.3%
Eurozone	2.0%	2.0% ↓	1.3% ↓	1.8%	1.8%	1.7%	1.6%	1.7% ↑
UK	1.4% ↑	1.3%	1.3% ↑	1.5%	2.5% ↓	2.5% ↑	2.3%	2.2% ↑
Switzerland	2.9%	2.9% ↑	1.2%	1.7% ↓	1.0%	1.0%	0.7% ↓	1.0% ↓
Japan	1.1% ↓	1.1%	1.3% ↑	1.2%	0.9%	0.9%	1.0% ↑	1.1%
China	6.6% ↑	6.6%	6.1%	6.3% ↓	2.2% ↑	2.1%	2.5% ↑	2.3%

Arrows indicate difference from previous month
Source: Consensus Economics Inc. London, 08.10.2018

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



The purchasing managers index (PMI) for the manufacturing sector is one of the best indicators to gauge growth dynamics in most of the developed world. For the Eurozone, the PMI's message is clear: The cycle has peaked by the end of last year. Accordingly, GDP growth forecasts have been lowered as of late: Back in April, the consensus GDP growth forecast for 2018 was 2.4%, while we expected 2.1% average annual growth. Most recently, the consensus forecast as well as our own assumption have come down to just 2.0%.

US
The “gasoline tax” at work

GDP growth	
Swiss Life Asset Managers	Consensus
2018: 2.8 %	2018 : 2.9 %
2019: 2.2 %	2019 : 2.6 %

We finished this text prior to the release of the advanced GDP report. Our assumption for growth in the third quarter 2018 was comparably prudent: While we anticipated 2.8% quarterly growth, a poll among 64 economists published by Bloomberg resulted in a median consensus forecast of 3.4%. High frequency GDP growth trackers like the Atlanta Fed’s “GDP now” indicator suggested an even stronger pace of 3.9%. What our assumption on growth dynamics in the second half 2018 had in common with the general consensus or with quantitative models is the conviction that the US economy continues to grow faster than its potential rate, boosted by President Trump’s tax reform. Most of all, non-residential fixed investments by the corporate sector are strongly contributing to domestic growth. Yet, we differ when it comes to the assumption on consumption: Given inelastic demand for fuels in the short-term, the 11% rise in retail gasoline prices since the first quarter reduces disposable incomes of households for other goods and services by an amount of approximately 0.25% worth of US GDP.

Inflation	
Swiss Life Asset Managers	Consensus
2018: 2.5 %	2018: 2.5 %
2019: 2.0 %	2019: 2.3 %

September was the second month in a row which saw inflation numbers surprising to the downside. Earlier in 2018 year, we wrote that headline inflation should be peaking by July regardless of energy price moves. Yet, the fall in annual inflation from 2.9% to 2.3% in just two months came faster than we thought. One reason for soft inflation data were falling prices for used cars. This should be considered as temporary and expected to reverse in coming months. Seasonal factors applied for gasoline prices hide the actual price increases at the pumping station in September. Again, this will revert this month. Yet, elevated gasoline prices are impacting households’ disposable incomes and restrict price setting power of suppliers of other goods and services.

Eurozone
The same old problems

GDP growth	
Swiss Life Asset Managers	Consensus
2018: 2.0 %	2018 : 2.0 %
2019: 1.3 %	2019 : 1.8 %

What a difference a year makes: One year ago it seemed as if optimism returned to the Eurozone. GDP growth exceeded the region’s potential and labour markets improved in all member states. Twelve months later, the old problems are resurfacing: Growth momentum has slowed substantially since spring with purchasing managers indices in steady decline since the last quarter 2017. In Italy, where a populist government challenges EU fiscal rules in an unprecedented way, the purchasing managers index hints at stagnation in manufacturing. Higher credit costs for Italy’s private sector suggest that the government’s projected 1.5% GDP growth in 2019 are out of reach. We stick to our prudent assumptions for the entire Eurozone. The release of third quarter GDP data on October 30 will show by how much growth has slowed over the summer months: While the consensus forecast stands at 0.4% quarterly growth, we expect momentum to have cooled to a 0.3% quarterly pace, which would be consistent with the region’s annual potential growth rate of around 1.2%.

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

At first glance, the 2.1% headline inflation rate for the Eurozone suggests that the ECB misses its inflation target of “close to, but below 2%”. If so, the ECB should normalise monetary policy beyond ending its asset purchase program and consider interest rate hikes earlier rather than later. Yet, investors should not jump to such conclusions: Back in January 2017, Mario Draghi explained which conditions need to be fulfilled for the ECB to eventually see the inflation target met on a “self-sustaining base”. As long as energy prices contribute almost half to annual inflation, Draghi’s criteria of a self-sustained trend is certainly still not matched. Meanwhile, our newly developed indicator to measure home-grown inflation pressure has gathered momentum on the back of accelerating wage growth.

UK
No news on Brexit

GDP growth	
Swiss Life Asset Managers	Consensus
2018: 1.4 %	2018: 1.3 %
2019: 1.3 %	2019: 1.5 %

Neither the conventions of two major political parties, nor the sequence of top level meetings with the EU added more clarity on the form of Brexit. In our view, it remains the most likely scenario that the negotiating partners will reach a final agreement on very few concrete items, including the Irish border, and agree on a transition period for all other remaining issues. Like in other dramatic episodes of Europe's younger history, such an agreement will be reached only by the very last moment. Thus, we do not expect more clarity before the end of this year. Given these uncertainties it may surprise our readers that we lift our growth forecast for the current year. Yet, the unusual warm weather triggered a series of positive surprises in the data covering the third quarter 2018. We thus raised the forecast for the period from July to September 2018 to 0.6% quarterly growth. This forecast is consistent with the new ONS (Office for National Statistics) data series measuring GDP on a monthly basis.

Inflation	
Swiss Life Asset Managers	Consensus
2018: 2.5 %	2018: 2.5 %
2019: 2.3 %	2019: 2.2 %

Like in the US, Canada or Switzerland, inflation data for September surprised to the downside in the UK. The downward trend was broad-based and did more than compensate for the August spike in some of the more volatile components. Headline inflation dropped from 2.7% to 2.4%, while core inflation fell to 1.8%, the lowest rate since March 2017. Energy prices will trigger a renewed increase in headline inflation to 2.7% this month. We continue to expect headline inflation to hover around 2.6% until the second quarter 2019 and to gradually slip to around 2% until the end of 2019. The recent appreciation of the Sterling versus most other currencies poses a downward risk in our forecast as imported inflation could turn out lower than what we anticipate. A "No Deal" Brexit resulting in a sharp Sterling depreciation on the other hand would trigger higher inflation numbers for most of 2019.

Switzerland
Dry River Rhine and the oil price

GDP growth	
Swiss Life Asset Managers	Consensus
2018: 2.9 %	2018: 2.9 %
2019: 1.2 %	2019: 1.7 %

Ultra-strong economic growth numbers as seen in 2017 and during the first half of 2018 are yesterday's news. A series of supportive factors are all losing their magic at about the same time: The synchronous global upswing shifts to slower gear as can be seen in purchasing managers indices (PMI) in neighbouring economies. Last month, Switzerland's PMI fell significantly from 64.8 points to 59.7 points. This confirms earlier information from think tank KOF: According to their data, the number of firms expecting rising order inflows over the next three months is in steady decline since January this year. Additionally, net migration into Switzerland continues to slow in 2018, which means comparably less additional impulses on domestic activity in the form of consumption or construction spending. Compared with the average of the years 2013 to 2015, some 33'000 persons less (approximately the number of inhabitants of the city of Neuchâtel) will migrate to Switzerland on balance this year.

Inflation	
Swiss Life Asset Managers	Consensus
2018: 1.0 %	2018: 1.0 %
2019: 0.7 %	2019: 1.0 %

The inflation rate for September came in below our expectations as the stronger Swiss Franc had a dampening impact on import prices. Despite this downside surprise, we abstain ourselves from lowering the forecast for full year 2018 inflation on the back of rising energy prices until mid-October: Energy prices are up everywhere around the globe, but disproportionally so in Switzerland: Due to the extremely low water level on the river Rhine, shipping costs are currently exceptionally high. As a consequence, the retail price for heating oil rose by 10% in October from the previous month. This effect is temporary only and the faster the situation on the Rhine normalises or underlying energy prices moderate, the faster headline inflation rates will come down. Looking through volatile prices for energy, we lower the forecast for 2019 on the assumption of slightly falling residential rental costs.

Japan
Time for Abe's third arrow

Over the summer months Shinzo Abe secured himself a third term as head of the LDP. After a period of disappointing cabinet approval ratings, Abe has won back sufficient room to manoeuvre in order to pursue his political and economic visions for Japan. Apart from the heavily disputed constitutional reforms, we expect Abe to accelerate the implementation of the "third arrow", the missing elements of "Abenomics" his policy mix of fiscal, monetary and reform measures to reflate the economy and to find a response to Japan's demographic challenges. We do now see a high probability for another increase in the consumption tax rate from 8% to 10% by October 2019. As a consequence, we expect consumers to advance purchases of major durable goods into second quarter and early third quarter and have adjusted our assumptions on growth accordingly. Inflation will rise temporarily and exceed 2% between November 2019 and March 2020. We base our assumption on the observations made in 2014, when the consumption tax was raised from 5% to 8%.

China
Monetary policy loosening

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. Third quarter GDP data revealed that GDP growth has slowed to 6.5% from year ago levels, the slowest pace since the first quarter 2009, when the great financial crisis triggered a recession of the World economy. Growth was slightly above our own forecast of 6.4%, but disappointed market expectations by coming in short of the consensus forecast of 6.6%. China's government continues to try to offset the drag on growth with a conventional toolbox of fiscal and monetary policy measures: Last month, the People's Bank of China cut the required deposit reserve ratio for major domestic banks by 100 basis points to 14.5%, bringing this policy tool to its lowest level since January 2008. Tax cuts for the corporate sector and subsidies for exporting firms are other policy measures under evaluation.

Economic Research

Marc Brütsch
Chief Economist
marc.bruetsch@swisslife.ch
@MarcBruetsch

Francesca Boucard
Economist Real Estate
francesca.boucard@swisslife.ch
@f_boucard

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