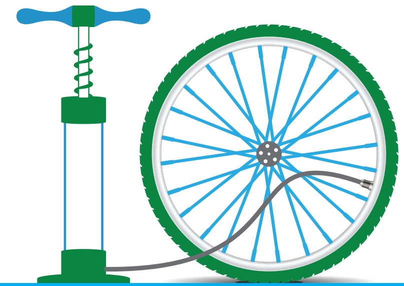
FUNDAMENTALS

Is 2017 the year of Trumpflation?

Although the cycle is maturing, global growth should hold up well next year. However, increasing inflationary pressure and a withdrawal of central bank liquidity pose risks for asset prices.



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In this edition of Fundamentals, LGIM's Asset Allocation team examines the outlook for 2017. Head of Economics Tim Drayson and Global Equity Strategist Lars Kreckel look at the growth and inflation trade-off and what this implies for equities over the coming year.

GLOBAL GROWTH IN 2016 – AS EXPECTED, DESPITE THE UNEXPECTED

The first part of this year was characterised by sluggish growth, further commodity price weakness and the Fed scaling back projections for interest rate rises. This, alongside easing from other central banks, seemed to calm market nerves. The rest of the year unfolded largely as we expected despite the twin economic shocks of the Brexit vote and the Trump victory. Consumers around the globe continued spending, labour markets tightened further and global industrial production recently returned to a more 'normal' rate of growth.

REFLATION AHEAD – WILL ECONOMIES RISE ON POLITICAL TIDES?

As we head into 2017 we see steady global growth and reflation continuing, aided by increasingly supportive US fiscal policy. So far risk assets have been buoyed by diminishing deflation concerns, but the perception of a 'goldilocks' economy might prove short lived. With several economies at full employment, most notably the US, the sharp move higher in headline inflation could lead to a more rapid increase in wage growth, stronger core inflation and a faster-than-expected pace of Fed hikes.

*Source: http://www.investopedia.com/terms/t/trumpflation.asp

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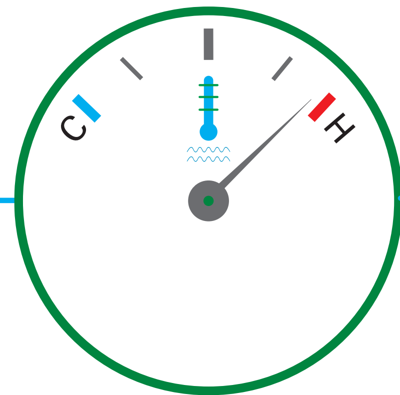
Emerging market economies appear to have adjusted to the negative terms of trade shock created by the fall in commodity prices and should perform better in 2017. The main concern remains the alarming increase in China's debt, yet there appears little appetite to slow growth to address these imbalances. Euro area growth prospects appear reasonable, and could lead to the European Central Bank (ECB) considering a taper of bond purchases later in the year.

Near-term growth risks appear relatively balanced. However, we are becoming more cautious about asset prices as we believe that we are moving towards the latter stages of the current economic cycle. Upside growth surprises are not necessarily good news at this point given capacity constraints and market expectations for ongoing liquidity support.

To the downside we are concerned by the building pressure on global funding conditions via rising real rates and a strengthening US dollar. Given the vast amount of excess dollar debt, this dynamic could prove stronger and faster acting than the positive impact from higher wages and rising headline inflation. As a result, this could drive growth and inflation below expectations in 2017.

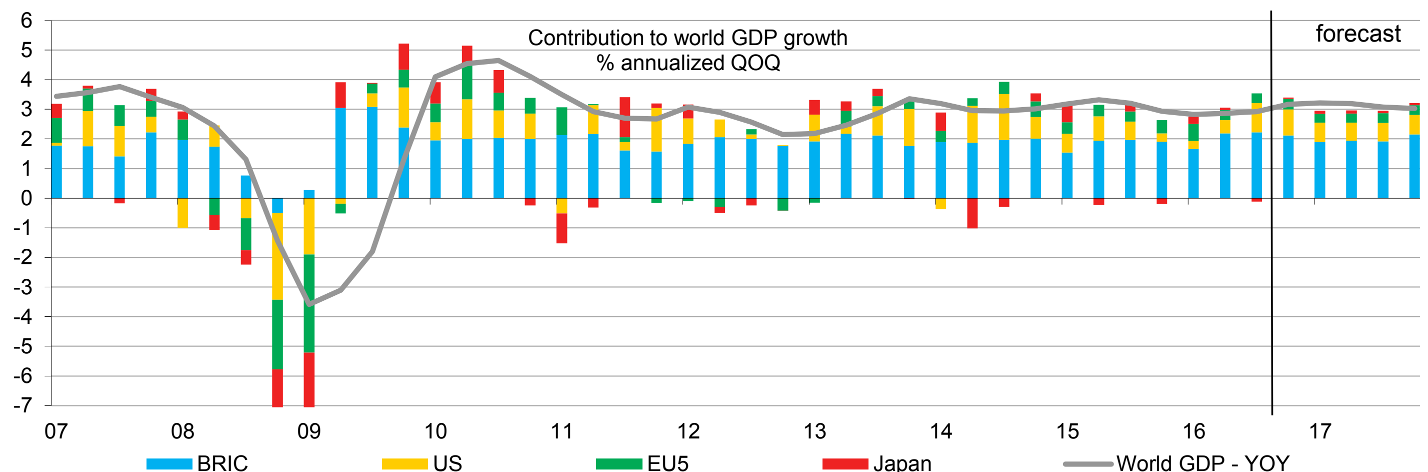
We also worry about political developments. The Trump presidency raises the spectre of increased protectionism which could further damage already weak productivity growth. There is also increased concern about the direction of US foreign policy. Across Europe, meanwhile, there are a number of important elections. So far, the anti-establishment vote has not appeared to dent confidence, but a repeat in France could expose the underlying frailties of both the euro and the European Union.



IS THE US ECONOMY ABOUT TO OVERHEAT?

The surprise US election result has been greeted favourably by financial markets, in anticipation of fiscal stimulus, pro-business policies and strengthening growth. At this stage there is little clarity around the timing and magnitude of policy changes, but the numbers are potentially large on both the tax cut and

Figure 1. Our central case is for steady global growth in 2017



Source: LGIM and Macrobond

spending side. Even if only a portion is approved by Congress and the multiplier from the increase in the budget deficit is relatively small, some boost to growth seems likely.

Unfortunately, the timing of this stimulus could hardly be worse. In our view, the US economy is already close to full capacity and was set to grow above potential in 2017. Earlier drags from energy investment and inventories are in the process of reversing, the housing recovery remains on track and consumers, aided by a buoyant labour market, are set to continue spending.

Additional demand as the US moves 'late cycle' will likely lead to overheating, particularly if some of Trump's negative supply elements, such as reduced immigration and protectionism are implemented. In the short run this will help the Fed achieve its inflation target sooner, but it might also lead to a reassessment of the gradual pace of rate hikes projected for the next couple of years. We expect little initial reaction from the Fed (beyond the widely expected rate hike in December), but the message could change once there is greater clarity around US fiscal plans.

EURO AREA – EASY MONEY SUPPORTING GROWTH

Monetary conditions remain exceptionally loose in the euro area, with the ECB expected to announce an extension to its asset purchase programme in December as core inflation is uncomfortably low. Sentiment surveys suggest that growth will remain at a reasonable pace, while unemployment is falling in most countries. If inflation expectations can continue to move back towards levels that are consistent with their mandate, the ECB might be in a position to consider tapering later in 2017 (in the absence of a major election shock to confidence).

UK – THE ONE CERTAIN FACTOR IS UNCERTAINTY… PROBABLY

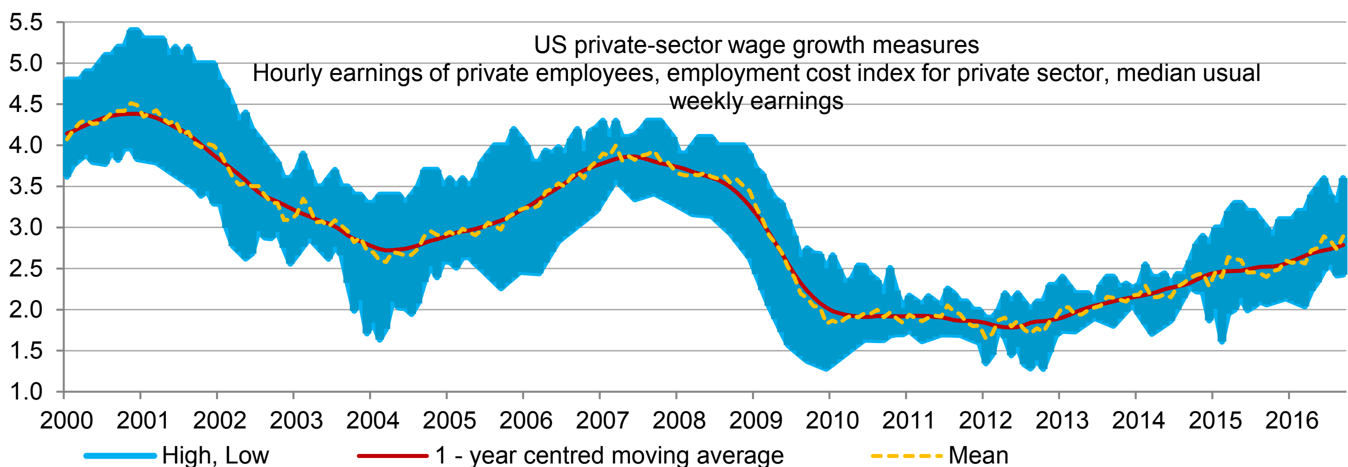
The UK economy has been surprisingly resilient following the Brexit vote, but the consequences of the fall in the exchange rate could be felt more strongly during 2017. As inflation rises, real incomes will come under pressure and consumer spending should soften. We also expect weak business investment and less employment growth as uncertainty around the UK's future relationship with the EU leads to a deferral of expansion plans. In this environment the Bank of England (BoE) is likely to be faced with a combination above-target inflation but sluggish growth. As a result, they are likely to opt to do very little. If we are wrong and growth does not slow, then inflation could become a more serious concern, especially if wages respond to a relatively tight labour market. In this scenario, the BoE would probably be slow to admit a major forecasting error before ultimately raising interest rates.

THE EMERGING WORLD – CAPITAL TAKEAWAY FROM INDIA AND CHINA

Emerging markets have stabilised alongside commodity prices. Combined with a more favourable political situation, this should lead to economic improvement in Brazil. The global manufacturing cycle is also finally gaining traction and should support parts of Asia. However, growth in the emerging world is hampered by the need to slow private sector credit growth after years of global easing. Emerging countries also face the prospect of tighter financial conditions, assuming US policy leads to higher global interest rates and weaker domestic currencies.

Growth should remain relatively stable in China as earlier stimulus greases the wheels of the power transition, but the failure to reign in credit growth means the medium-term outlook is becoming increasingly precarious. In addition, capital continues to flow out the country. Our base case is that China will manage a gradual depreciation at the cost of lower reserves and tighter capital controls. But the risk of a faster depreciation remains. India could disappoint in the short term due to Modi's radical currency reforms and cash shortages, but longer term this should help reduce the black economy and raise tax revenues.

Figure 2. The US labour market is tightening

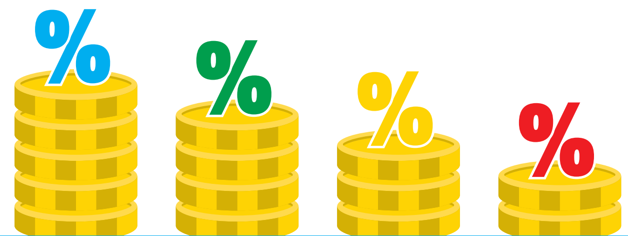


Source: LGIM and Macrobond

EQUITIES – MAY YOU LIVE IN INTERESTING TIMES

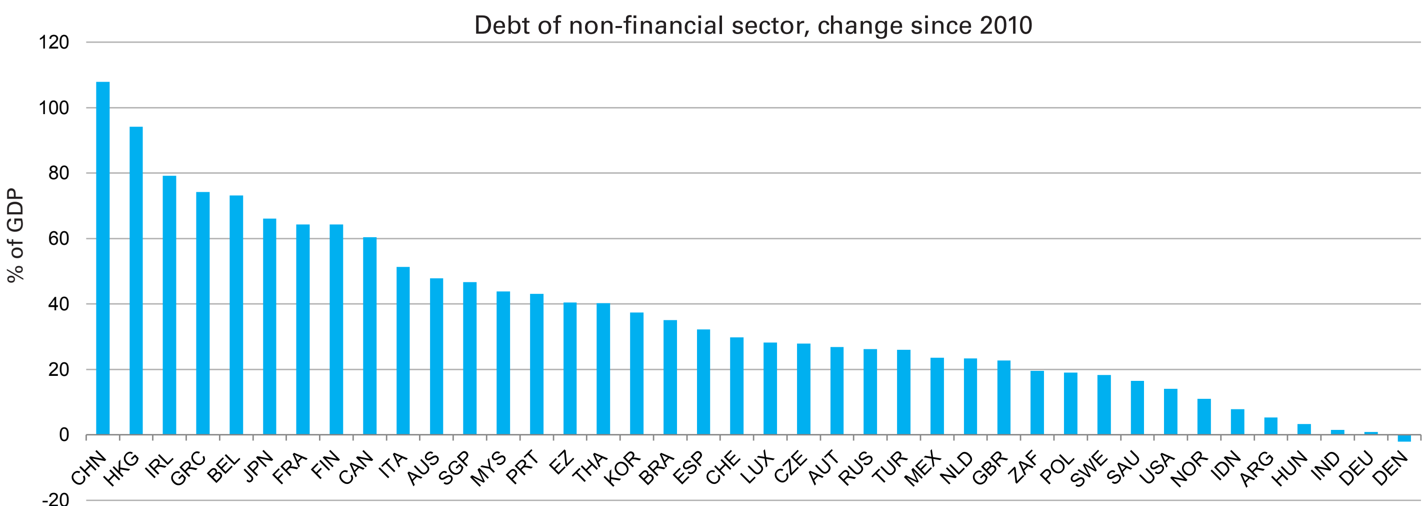
On equities, the highest conviction view is that it won't be another year of boring low single digit returns. 2017 is shaping up to be a year of +15%, -15% or both. The bull case is one where a significant fiscal stimulus boosts earnings growth well into double-digit territory. From a starting point of cautious investor positioning, this could squeeze equity prices significantly higher and prevent the valuation de-rating that tighter Fed policy would normally induce.

But a fiscally induced bout of growth euphoria could end up with a nasty hangover by the end of 2017. As argued above, fiscal stimulus is the last thing a US economy operating at close to full capacity needs.



With overstimulation and accelerating Fed hikes, markets could be well on their way to anticipating the next recession by year end. It is equally likely that the market's current focus on 'Good Trump' underprices the risk that he follows through on his anti-trade and anti-immigration campaign slogans. We would also not discount the risk of ill-advised comments causing a few geo-political risks over the course of 2017. In the US alone, there are plenty of reasons to expect anything but a boring year for equities.

Figure 3. The danger of an eventual hard landing in China is increasing



Source: LGIM and Macrobond

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