

Global outlook: Papering over the cracks

As trade tensions mount, is the global economy heading into a storm? Read our latest economic update to see what our economists and strategists are thinking



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Papering over the cracks

2017 provided plenty of upside growth surprises, which may have led to some over-optimism about the prospects for 2018. But the story isn't helped by growing trade tensions, with China and Europe so far rebuffing US demands to do more to cut the latter's trade deficit. The coming weeks will be critical for the negotiations, with deadlines of May 22 for China and June 1 for Europe, after which tariffs may well be implemented. Markets will have to hope the pattern of Trump making big demands as an opening gambit before accepting more modest moves repeats itself.

The US economy experienced a slightly softer Q1 than hoped, but despite the political noise, the story remains positive. Growth is supported by tax cuts, a robust jobs market and growing evidence of rising pay. While the dollar has strengthened recently, it remains competitive, which will help exports in an environment of healthy global demand. Nonetheless, there are concerns about the fiscal deficit and rising inflation, which we believe will push longer-dated US Treasury yields higher.

Trade tensions may intensify in the coming months if Europe and China fail to respond to demands to help cut the US trade deficit. This bold strategy is lifting Trump's approval rating but is doing little to benefit the Republicans ahead of the November mid-term elections. Defeat in the House and/or the Senate would severely curtail Trump's legislative ambitions for the second half of his Presidency.

The slowdown in the Eurozone has been more marked than in the US, but the big difference is inflation. Rather than pushing higher, inflation in Europe has actually fallen, which is leading markets to re-appraise the outlook for monetary policy. Domestic politics is also proving to be more challenging than expected while Italy could be forced into new elections. In this environment, we have pushed back our call for the first European Central Bank (ECB) rate hike to September 2019.

Following a dreadful first quarter for the UK economy, the Bank of England has put its tightening plans on ice. Cracks emerging in consumer-facing sectors need to be watched closely. But assuming things don't deteriorate any further, we think markets might be underestimating the odds of an August rate rise as wage growth continues to pick-up.

The possible collapse of trade talks would increase uncertainty surrounding production in China. We, therefore, expect a slower appreciation path of the yuan. But we keep our GDP growth forecasts unchanged as we expect investment in sectors related to "Made in China 2025" to offset any potential loss from net exports, and related production and services activities.

In Japan, growth is set to pick up after a soft start to the year. However, since inflation is unlikely to trouble the Bank of Japan (BOJ)'s 2% target, a move to tighten monetary policy may have to wait. Indeed, with PM Abe under a political cloud, the risk is that the fiscal stimulus to the economy will fade, forcing the BOJ to ease again.

The dollar has dramatically re-connected with interest rate spreads over the last month. While we cannot rule out a temporary EUR/USD dip to the 1.15/17 area this summer, maintaining those levels will be difficult on a multi-quarter basis.

by our Global Economics team

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