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GLOBAL GROWTH TO CONVERGE WITH THE U.S.

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Although we have been reasonably positive on non-U.S. growth, we have long believed that U.S. growth will come in below consensus—however, the consensus view is now closer to ours. We expect global growth to decelerate further, but more importantly, we see a convergence in growth momentum between the U.S. and the rest of the world.

Over the past six months, the non-U.S. world has benefited greatly from a growth spurt in China. Confident about the country's pace of growth, Chinese authorities have launched a campaign to curb credit creation by the shadow banking system. This has led to a meaningful tightening of financial and credit conditions, and we believe it will result in a growth slowdown across emerging markets. Indeed, the sharp correction in metals and oil prices over the past few months is a sign that this process has already begun. We also expect some moderation of growth in the eurozone.

We are bearish on oil based on the pace of productivity growth in the sector—the amount of oil that can be produced by one oil rig grows rapidly, and the market continues to underestimate this. We believe the U.S. will easily be able to produce enough oil to fill any growth in global demand. Given our expectation of a growth slowdown in China, this means that downside risk to the price of oil comes from both the supply and the demand side.

After a great run for risky assets, especially in emerging markets, the mood music has started to change. Given the low level of unemployment in the U.S., the Fed is intent on continuing the tightening cycle—and we do not believe it will be dissuaded from doing so by softer global growth. The U.S. yield curve implies a very benign path for policy rates, which leaves plenty of scope for the Fed to surprise the market on the hawkish side. This, combined with the convergence in growth between the U.S. and the rest of the world, will likely result in some strengthening of the U.S. dollar.

In emerging markets, additional consideration should be given to the trajectory of commodity prices: The softening of prices over the past few months has left the currencies of the commodity republics somewhat exposed, and we expect the commodity importers (central Eastern Europe and parts of Asia) to outperform the producers. On the interest rate side, the U.S. yield curve is likely to continue to flatten: As the Fed hikes interest rates, the short end of the yield curve will likely rise to more adequately price the path of Fed tightening.

Meanwhile, soft global growth and low inflation are likely to keep the longer end of the yield curve more anchored, and we expect softer emerging market currencies to lead emerging market interest rates higher. Where could we be wrong? The list is long, but the main risk to our prediction is that we head into a boring summer in which a lack of progress on the U.S. trade agenda fails to generate headlines and non-U.S. growth holds up better than expected. In an environment in which money is already flowing into emerging markets, this would probably encourage investors to continue searching for yield and chase emerging market asset values even higher.