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TRUMP, TRADE, AND INFLATION—SHOULD WE WORRY?

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1. What is the key risk facing the global economy at present?

I think the main risk originates from growing frictions in international trade relationships. There has been a lot of noise from the Trump administration about imposing tariffs on China, and the fact that the U.S. now seems willing to entertain discussions between North and South Korea, reducing China's usefulness as a strategic ally, may make this more likely. Trump also continues to talk about demanding a better deal for the U.S. through the North American Free Trade Agreement (NAFTA) or pulling out of it altogether. This tough talk on trade may increase as we get closer to November's midterm elections, but I suspect the rhetoric will ultimately exceed the reality—it is not in Trump's interests to capsize the U.S. economy—the Republicans need a tailwind for the midterm elections and the president needs to build support for his own reelection (admittedly a long time from now).

2. Will inflation make a comeback?

This is an important question. Many people, myself included, expected falling U.S. unemployment to lead to inflation last year, but that didn't happen. The traditional inverse relationship between unemployment and inflation (as described by the Phillips curve) broke down, and it is still not clear why that happened. Ultimately, I believe that the law of supply and demand embedded in the Phillips curve is correct and that lower unemployment does lead to rising wages and, in turn, inflation. However, it is important to remember that economics is a soft science: If you expect it to predict timing or exact relationships, you are asking for more than it can deliver. It is unrealistic to expect the Phillips curve to tell you how much inflation there will be or when it will occur, but over time it is reasonable to expect low unemployment to put upward pressure on wages and prices.

The new U.S. tax bill may have some deflationary impact by reducing mortgage interest deductibility (house prices tend to drive shelter inflation and reduced interest deductibility will be a headwind to house prices). Ultimately, however, as the output gap closes wage pressures will increase, and this will lead to a rise in headline and core inflation.

Europe is a different story. On average, there is more slack in the eurozone economy, and, therefore, inflationary pressures are more muted. We do expect wage pressure to gradually rise in Germany, where both unions and companies seem open to rising wages (until recently, high immigration has helped to keep German wage pressures at bay). We also expect to look for some wage pressures in Japan, where there is very little slack in the labor market.

3. Are you positive about global growth prospects?

Europe looks very encouraging at the moment. It is undergoing a cyclical recovery primarily driven by forces within the Continent rather than by growth elsewhere. Unemployment is coming down, financial conditions remain relatively loose, and the euro is cheap. Some of these tailwinds are fading, but I think the recovery remains firmly on track and that there are resources available that will allow the eurozone to grow without generating the inflationary pressures that prompt a monetary policy response.

China is slowing, although the authorities seem to be managing the slowdown better than they have done in the past. The risk is that they seek to regulate the shadow banking too aggressively, but I think they will be cautious and remain supportive of growth—it's just a question of how and when they decide to do it. Does there have to be a growth scare before they step in? Possibly—this has been their previous modus operandi, but it seems that they did act preemptively to support growth around mid-2017. We should also remember that China drives commodity prices, which means that commodity prices will probably be fine for now—they tend to go where China goes.

I am more concerned about the U.S. Capital expenditure, which is soft outside of energy and mining, and the tailwind in those two sectors is set to fade. I worry that housing affordability will continue to erode, leading to continued softness in residential investments. In addition, the rebound in oil prices has caused some erosion of consumer purchasing power. Until now, this erosion has been offset by a fall in the savings rate, which has dropped to quite a low level. Replenishing of household savings could turn into some headwind for consumption (which accounts for roughly 70% of U.S. gross domestic product).

I suspect President Trump's tax cuts will provide much less of a boost for the economy than expected and may initially end up just lifting the savings rate. Overall, however, I do not think there will be a sharp slowdown in the economy or in equity prices—the risk is more that we do not see the strong rebound that many expect.

4. What is your overall view of financial markets for the next few months?

Financial conditions remain benign overall. Investors, households, and companies are very long in cash as a result of quantitative easing, interest rates remain very low, macroeconomic volatility is muted, and overall growth remains stable and reasonably strong by post-global financial crisis standards. There are risks present, including trade uncertainty, U.S. inflation, a slowdown in China, and the possibility that Trump's tax cuts turn out to have a disappointing impact on growth—however, I do not expect any of these to be the source of major asset market corrections in the near future.

In terms of opportunities, I think emerging markets have the most potential at the moment. Russia, for example, offers good value, although there are risks in relation to sanctions. Brazil and Mexico are also attractive, but there are forthcoming elections in both countries, and Mexico has the added risk of an uncertain future for NAFTA. I would avoid places such as Hungary and Turkey, where there are rewards available but the risks are too great.