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Timely intelligence and analysis for our clients.

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Global Economy
BROAD EXPANSION CONFRONTS WITHDRAWAL OF MONETARY ACCOMMODATION

KEY POINTS

- We expect the global economy to carry much of its recent momentum into 2018, although growth is likely to be slower, overall, than observed in the middle of 2017.
- Capital expenditures have become the main driver of growth.
- A more balanced global economy is well positioned for the tapering of monetary accommodation.
- Tighter labor markets in the U.S. and other advanced economies are likely to lift wage growth and solidify a gradual inflation uplift.

GLOBAL GROWTH SOLIDIFIES

Nikolaj Schmidt

Global growth solidified in 2017, with all major regional economies accelerating in unison for the first time in almost a decade. The pickup in growth was most impressive among commodity exporters, such as Brazil, Mexico, and Russia, but Japan and major developed economies in Europe also performed well—especially relative to recent history. Although we expect that growth will decelerate in 2018, we expect the global economy to carry much of its momentum into the new year.

While China's surprising resilience deserved most of the credit early in 2017, the global economy's strong showing in recent months has been due largely to a rebound in capital goods expenditures (Figure 1, page 2). Energy- and metals-related investment, in particular, has provided an important boost, not only to emerging market exporters but also to Germany, the U.S., and other major developed markets.

Global trade has accelerated alongside increased capital spending, suggesting that improvement has been broad-based.

REDUCED IMBALANCES SET THE STAGE FOR SELF-SUSTAINING GROWTH

It is particularly encouraging that growth in Europe has become more self-sustaining and less vulnerable to imbalances. With unemployment down and incomes growing, European consumers are beginning to unleash several years of pent-up demand, putting the Continent squarely in the early stages of a cyclical recovery. European consumers have been somewhat vulnerable to higher oil prices, but the energy environment remains benign compared with earlier in the decade.

In Japan, Abenomics continues to show signs of progress. Labor shortages have emerged as Japan's unemployment rate has declined to a 23-year low, and the ratio of jobs to applicants has climbed to its highest level since 1974. While broad-based wage increases remain modest, workers are moving to higher-paid positions, especially in the part-time segments of the economy.

We expect China's growth rate to slow in 2018, but we are optimistic that its leaders can keep the economy expanding at a pace that does not threaten growth for its trading partners. The country's leadership, now exceptionally concentrated under President Xi Jinping, has shifted its focus from top-line growth to boosting the quality of life for Chinese citizens, chiefly by reducing pollution. Even as they pursue this new "China Dream" plan, Chinese officials are likely to step in with accommodation as needed in order to meet their other promise of doubling incomes over the current decade—implying an average annual growth rate of 6.3% until 2020.

Chinese officials have been adept, to date, at tightening regulation in the financial sector without strangling credit growth in the real economy, but the possibility that they may move too aggressively is one of the major risks to our outlook. Given that President Xi will probably remain in office well beyond the traditional two terms, he has an incentive to ensure that the financial system is built on a solid and lasting foundation.

THE REMOVAL OF CENTRAL BANK ACCOMMODATION WILL BE A TEST—BUT A MANAGEABLE ONE

On a broader level, the withdrawal of global central bank liquidity may be the main test facing financial markets in 2018. While only the Federal Reserve, the Bank of England, and the Bank of Canada have begun raising rates, a number of major central banks will take the first steps in reducing monetary accommodation.

We currently expect the European Central Bank to wind down its asset purchases by the end of 2018, with rate hikes probably following in 2019. When the Bank of Japan (BoJ) will make the turn away from accommodation remains less certain, but we expect moderation next year in the thrust of policy stimulus. The BoJ is likely to declare the end of deflation in the relatively near future, which it likely would follow with a reduction of its exchange-traded fund purchases. The BoJ is also likely to announce changes to its overall yield curve control policy, raising the target on the 10-year yield above 0% and perhaps targeting other points on the curve.

The wind-down of central bank balance sheet expansion should not necessarily pose a significant headwind to global growth. Worldwide, quantitative easing—not tightening—will likely continue through 2018, if at a reduced pace: from roughly USD $2 trillion in 2017 to USD $500 billion in 2018. Furthermore, the slowdown in accommodation will come against the backdrop of a much more balanced global economy. Fiscal conditions have made progress in the eurozone periphery, and current account balances in emerging markets have improved, while credit growth has moderated meaningfully.

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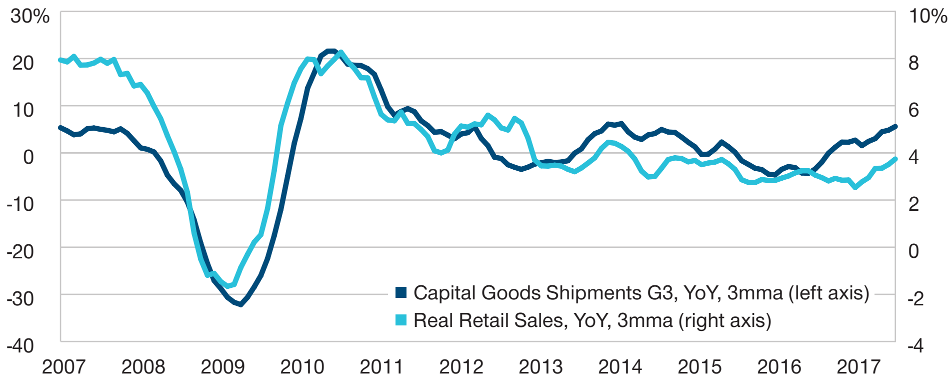
>
> **—NIKOLAJ SCHMIDT, CHIEF INTERNATIONAL ECONOMIST**

FIGURE 1: **Capital Expenditures Have Driven the Global Acceleration**

Final demand: sales and capex, as of August 31, 2017.



Source: Haver Analytics; analysis by T. Rowe Price.
G3: U.S., Germany, and Japan. YoY: Year-over-year. 3mma: Three-month moving average.

U.S. REACHES FULL EMPLOYMENT

Alan Levenson

After some modest volatility in the first half of 2017, the U.S. economy appears to be settling back into the moderate growth path that it has followed over the past several years. We expect growth to run at an annualized rate of around 2% to 2¼% in early 2018, fed by moderate gains in nominal wages and the recent pickup in capital expenditures. Similarly, inflation appears to be stalled at around 2%, which should keep the Federal Reserve on its current gradual-tightening path.

Growth statistics for the third quarter of 2017 seemed to show little impact from the hurricanes in August and September, with annualized GDP growth of 3.0% nearly matching its second-quarter pace. Inventory building and an increase in net exports helped compensate for the hurricanes' impact on manufacturing and consumer spending in the affected regions. It is further notable that there was an increase in inventory building despite a liquidation of retail auto dealer stocks—light vehicle sales spiked to a cyclical high in September as consumers replaced vehicles flooded in Hurricane Harvey. Less encouragingly, consumers dipped into their savings to pay for the new cars, which sent the saving rate to a cyclical low. The saving rate is unlikely to go any lower in coming months, but consumer spending should receive some offsetting support from hurricane-related insurance payouts.

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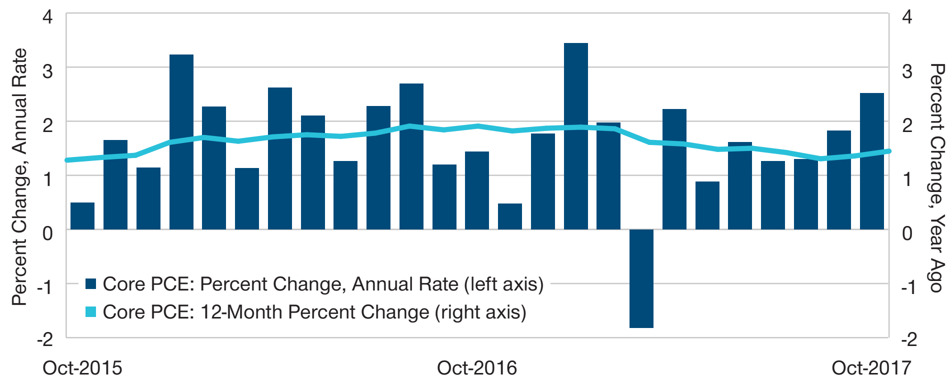
—ALAN LEVENSON, CHIEF U.S. ECONOMIST

FIGURE 2: Core Inflation Has Stalled at Around 1.5%

Core PCE Price Index from October 2015 to October 2017.



Source: Bureau of Economic Analysis.

U.S. UNEMPLOYMENT RATE MAY FALL BELOW LATE 1990S TROUGH

While causing significant temporary disruptions in payroll growth, the hurricanes seemed to have little lasting impact on the overall labor market. Indeed, the unemployment rate has now fallen below its trough during the moderate expansion of the previous decade. We expect the economy to extend its overshoot of full employment in coming months, even as job gains slow, with the unemployment rate falling to 3.7% by the end of 2018—below even its trough during the robust expansion of the late 1990s.

Nevertheless, we are skeptical that a tightening labor market will lead to sharply higher nominal wage growth and push the economy out of its low inflation and moderate growth track. Productivity growth remains well below its levels in the 1990s. Aside from the housing sector, most segments of the economy are seeing minimal price pressures, while the durable goods segment continues to experience outright deflation, fed by global competition, automation, and other pressures. As a result, it seems increasingly plausible that inflation may not reach the Fed's target of 2% in the personal consumption expenditures (PCE) price index in the current cycle (Figure 2). Notably, policymakers have recently revised inflation forecasts to show a later arrival of inflation at the 2% target.

TRIPLE MANDATE SUGGESTS FED WILL KEEP RAISING RATES DESPITE LOW INFLATION

Messaging will become a larger challenge for monetary policymakers if inflation continues to disappoint, but we do not expect the Fed to stop raising rates in response. In part, this is because we recognize the importance of the Fed's mandate to maintain moderate long-term interest rates—the less discussed third leg of its *triple* mandate, alongside stable prices and maximum employment. Fed officials are aware that abnormally low long-term interest rates are fostering inflated asset prices and may pose risks to financial stability if they are sustained. Thus, the Fed is likely to tolerate sub 2% inflation while nudging rates higher, at least until the unemployment rate stabilizes.

While the recent nomination of Jerome Powell as Federal Reserve chair signals little change in rate policy, we will keep an eye on whether he guides the Fed to adjust its approach to bank regulation. The new chair may loosen regulations for small banks, but we caution that investors should not expect Powell to be an advocate for wholesale deregulation.

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