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GROWTH IMPROVES...BUT RISKS LOOM

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Nikolaj Schmidt
Chief International Economist, T. Rowe Price

In line with the signals from our leading indicators, global growth has shown some signs of acceleration. In my opinion, however, this will be a short-term phenomenon. The improvement in the growth data owes much to the loosening of financial conditions engineered by the Fed and the European Central Bank (ECB) toward the end of the first quarter: Once capital reaches the end of its one-way journey from the periphery of the financial system to the center, the pressure eases on periphery financial systems to deleverage. This provides some breathing space for growth to rebound.

Many of the forces that hamstrung growth earlier in the year still lurk underneath the surface. The deleveraging of emerging markets has come to a halt, but emerging markets are unlikely to see leverage in the coming years (i.e., credit growth remains muted). The U.S. economy remains in late cycle, with profit margins under pressure as labor costs are rising faster than the price of final output. And China is still mandated to bring credit and investment growth to a sustainable pace.

Where does this leave financial markets? In my opinion, the improvement in the data flow presents a challenge to the benign outlook currently priced in for monetary policy. In the U.S., growth is accelerating against a backdrop of (gradually) rising wages, low unemployment, and a core consumer price index inflation of more than 2%.[1] If August's employment report is strong, we could find ourselves in a situation where, as in May, Federal Reserve Chair Janet Yellen is talking about raising interest rates. As of today, financial markets are pricing in a cumulative increase of the policy rate of 25 basis points over the coming two years.[1] Not much.

In the eurozone, the combination of gradually improving data and a full-capacity German economy will likely result in ECB President Mario Draghi disappointing those hoping for additional easing in the near term. Although the UK and Japan offer scope for additional monetary easing, the prospect of moderately tighter monetary policy in the two largest economic zones could present challenges for the global reach for yield. Another challenge to the benign outlook comes from growing uncertainty as the date of the U.S. presidential election approaches. The market can probably ignore election-related uncertainty for another month or so, but the window is closing.

In Italy, Prime Minister Matteo Renzi has tied his political future to the outcome of a referendum on constitutional reform, scheduled to be held in the last months of the year. The risks related to the referendum are rising as Renzi is under pressure from the EU to force retail bondholders to foot part of the bill for the recapitalization of Monte dei Paschi. This raises the prospect of a protest vote that could see the exit of Renzi and the entry of the anti-establishment Five Star Movement. The introduction of an anti-establishment government in the third-largest eurozone economy undoubtedly would elevate frictions between the north and south of Europe.

What could further extend the strong pro-risk environment? A clear commitment from Yellen at her Jackson Hole appearance that U.S. monetary policy will not be tightened anytime soon and that any policy tightening, when it starts, will be gradual and measured. This would accelerate the scramble to avoid owning assets with a negative nominal yield. Watch that space.

[1]Source: FactSet.

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