



IS THE END OF THE EXPANSION IN SIGHT?

MAY 2018

Nikolaj Schmidt

Chief International Economist

WHAT WAS BEHIND THE RECENT U.S. YIELD CURVE FLATTENING?

Typically, yield curves flatten when a central bank tightens monetary policy, so in that sense the recent flattening has been quite normal. The important question is: Is the Fed able or willing to do anything about it? So far, its operating principle can be described as “behind the curve is ahead of the curve”—in other words, it has deliberately been slow to tighten to allow the economy to gain sufficient momentum before proceeding to reduce the monetary stimulus.

The risk of this approach is that the labor market overheats to an extent that a recession is required to rein wage pressures back in. At the moment, there’s not much evidence of rampant wage demands, but U.S. unemployment is very low, and that will eventually put upward pressure on pay. Ultimately, the choice comes down to either controlling inflation or managing the yield curve—and the Fed will always choose to focus on inflation. My sense, however, is that it is slightly behind the curve and will struggle to deliver a smooth slowdown.

SO IS THE END OF THE ECONOMIC EXPANSION IN SIGHT?

In sight? Yes. In near sight? No. I think the expansion will end in around two years’ time or shortly after that. The U.S. administration has launched a procyclical fiscal expansion, and this should support growth through to 2019. China seems to have learned its lesson following the currency devaluation debacle in 2015, and I think the authorities will do whatever they need to ensure that growth does not slow too rapidly. Europe has slowed, but I see this as a moderation in the data rather than a meaningful downturn—parts of the Continent are still in the early stages of recovery, and monetary policy remains fairly loose.

The bell usually rings for the final stage of an expansion when there is significant wage inflation, and I don’t think we’re there yet. However, the seeds of future wage inflation have been sown by the low unemployment rate. So while we’re clearly in the latter stage of the business cycle, the end of the expansion is not imminent.

IS A U.S.-CHINA TRADE WAR A LIKELY PROSPECT?

President Trump’s approach to negotiations seem to follow the principles he laid out in his book “The Art of the Deal”: Begin by punching your opponent in order to gain leverage. This is exemplified by his threats to withdraw from NAFTA, his proposed tariffs on trade with China, the steel and aluminum tariffs (that were later rolled back for the most significant trade partners), etc. At the same time, Beijing’s “Made in China 2025” agenda (to dominate a large number of global industries through superior technology) seems to have rung alarm bells all across Capitol Hill. I think that putting their longer-term strategic objectives so bluntly may have been a bit of a policy mistake by China—“Made in China 2025” sounds like an industrial declaration of war, and nobody in the U.S. is going to like that.

Although both the U.S. and China have drawn firm battle lines, it's possible that this is mostly posturing and that they will eventually agree to a mutually beneficial trade deal. While it may help Trump to look tough on China ahead of the forthcoming U.S. midterm elections, it will probably be better for him to have agreed to a deal in time for the next U.S. presidential election in 2020.

WHAT IMPACT WILL THE RECENT RISE IN OIL PRICES HAVE?

A rise in oil prices can be regarded as a redistribution of wealth from oil consumers to oil producers. This is important because the eurozone, Japan, and China are very large oil importers, so any price increase will be a headwind for them; on the other hand, Middle Eastern countries, Russia, and Colombia are net oil producers and will benefit from a price increase in the form of stronger external balances.

Historically, recessions have often coincided with meaningful increase in oil prices, but the structure of the U.S. economy has changed meaningfully over the past years: The U.S. has shifted from being a very large oil importer to having a roughly balanced oil account. Today, the impact of rising oil prices in the U.S. is more about redistribution from consumers to producers than a direct transfer from the U.S. to the rest of the world. However, this redistribution across sectors can also be disruptive, as we saw in 2015.

Important Information

This material is being furnished for general informational purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, and prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

Australia—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

Canada—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

EEA—Issued in the European Economic Area by T. Rowe Price International Ltd, 60 Queen Victoria Street, London EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

Hong Kong—Issued in Hong Kong by T. Rowe Price Hong Kong Limited, 21/F, Jardine House, 1 Connaught Place, Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

Singapore—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

USA—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

T. ROWE PRICE, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks of T. Rowe Price Group, Inc. © 2018 T. Rowe Price. All rights reserved.