



Conference Call – The Global Economy – Top of the Cycle?

The good news is that the global economy continues to expand. The bad news is that this expansion is getting less even and more fragile. The risks, as economists like to say, are mainly to the downside. Trade, of course, is the big one, especially if the numbers of tariffs imposed escalates. But there are also monetary conditions to worry about -- and geopolitics, where the risks may manifest themselves most acutely in energy markets, especially oil. So are we approaching, at the top or even past the peak of the current cycle? And what will be the longer-term costs if economies fail to take advantage of the current expansion to implement structural reforms and tackle the increasing worries about sluggish productivity and wage growth, and the impact of automation on jobs?

President Donald Trump is selling the strength of the US economy as you would expect with mid-terms coming up in November. But has he primed the pump too much?

The US economy has been strong for the past year and a half. The consensus view is that second-quarter GDP growth will come in at about 4%, the fastest in a couple of quarters and a slight acceleration from the first quarter, which was a disappointing 2%.

So far, the biggest driver is coming from investment -- both manufacturing and services. Government spending is also rebounding after contracting for several years. There has been an uptick in both federal non-defence and defence spending. It also reflects the expanded budget of more than 1 trillion dollars and the improved state of local budgets. States and local governments are bringing in more; thus they can spend more. Consumer spending also has strong momentum.

Why are businesses and consumers alike so confident about the economy? There is surprisingly little concern about the threats we see on the horizon. Consumer spending is about 70% of US GDP and is cushioning broader economic activity.

It is too early to assess how much of the GDP growth we are seeing is the result of tax cuts, especially as business investment was already strong last year. Most of the strength could just be general confidence in the overall economic environment.

Wage growth is still muted despite strong employment growth. This poses a big puzzle to economists, who would by now be expecting to see faster wage gains and stronger inflationary pressures. How can the US economy be standing at 4% unemployment and monthly job gains consistently come in at around 200,000, but wage gains are so weak?

These three things don't fit together. Beyond this, other factors will also influence how fast the Federal Reserve can raise rates. One large headwind for the US economy is the housing market, which faces several headwinds -- widespread labour shortages may be exacerbated by Trump's immigration policies as 25% of the construction workforce is immigrants. Secondly, input costs are rising rapidly, especially for lumber as Trump has imposed tariffs on imports of lumber from Canada, which is where the United States sources most of its lumber. A third headwind is the threat of rising interest rates, which may put a dampener on housing and business investment.

The Fed has been hiking rates for more than a year. It is not clear that this has had a particularly large impact on the economy except possibly the housing market. Industry leaders are not concerned. Confidence is winning out against these other threats at this point. However, we are keeping an eye out for the point when the potential for faster interest rate rises starts to weigh on business confidence.

The point when everyone seems confident but there are obvious risks is precisely the point when we should start to worry that the economy has the potential to overheat. It is worth remembering that we are ten years into this economic expansion.

Then there is trade. At this point, it is an existential question for the US economy. There is no historical precedent for the trade policies that the Trump administration is pursuing. Industry leaders know that it matters a lot, but it is not affecting their business plans yet. So they are not doing anything different yet. There is still a widespread perception that Trump is bluffing when he says that he will slap 500 billion dollars of tariffs on Chinese imports and that it is simply a negotiating tactic. Increasing numbers believe that Trump is ready to pursue the stricter tariffs but given the nature of complex global supply chains, it is difficult to disentangle the potential impact to understand how it will affect the US economy versus other economies.

The risks to global growth from tighter monetary conditions and costlier trade costs will weigh heavier on emerging markets and other economies across the world than on the United States.

How different is the outlook for Europe and Japan and emerging markets?

As we move away from US economic activity, the uncertainties grow. This is partly to do with internal issues and politics. Europe has run a tighter policy but is moving towards tightening monetary policy.

In China, there is more flexibility on fiscal policy. The authorities are prioritising GDP growth. But despite loosening policy in some areas, they are continuing to deal with the overhang of loan problems within the economy.

Looking at the overall global picture, trade looms large as one of the dividing factors as to how economies might fare in the coming year. Trade in some ways is a zero-sum game at the global level. In other words, what one country exports is another country's import. If we look at the total around the world, these two must match, although we know that there are some deficits in world accounts. If an escalation in the trade tariffs squeezes back both imports and exports, the net effect on GDP is zero in one sense.

The problem with this picture is the secondary effects. If we have a fall in imports and exports, it may be neutral for GDP but not for jobs. Labour markets will begin to react if the United States continues assertive trade actions and its partners continue to retaliate. We will expect job creation to slow. This will impact not only the United States but also the major exporting economies – most notably Europe and China. The labour market effect will feedback to consumers, and there will be a more immediate effect through investment. US investment is firm because the damage from the trade disputes is not expected to be large, but this could reverse.

In Europe, there is not much scope for fiscal or monetary policy to be helpful. They are about to start tightening monetary policy next year. There is very little money to increase fiscal spending, and there are still bailout problems in a couple of economies. We are likely to feel quite large effects from the higher trade costs onto exports as Europe is a major exporting region.

China, as a leading exporting economy, will feel the impact of higher trade costs. This adds another reason that growth will slow on top of other internal issues including the cooling of the construction boom and tighter policies to deal with the debt overhang. The proposed fiscal policy is not strong enough to offset all those factors but will be for the time being as it takes time for the investment effect to work through and for job losses to show. How much will this impact over the next year? It will have more effect in a couple of years but minimal effects next year. We have definitely seen peak growth. We are likely to see some further slowdown next year. However, a steady slowdown is likely as significant tools are available to prevent a crash.

If we take this picture of cooling growth, worries will centre on Europe and China, on commodity markets and on internal struggles that we have seen in many emerging markets to overcome the problems of the past few years. It is hard to see very much upside growth in the world economy. Some economies will still be able to accelerate growth, but these will be unusual. It looks like growth will soften steadily next year barring any major shocks in the autumn. A weaker scenario would be more turbulence in certain economies. The United Kingdom is a particular concern but will not tip the world into turbulence.

What are the current dynamics of the energy market?

An important factor in the energy market is Venezuela. The markets have digested over the last three or four months the potential impact of the re-imposition of US sanctions and the United States withdrawing from the Iran nuclear deal (the Joint Comprehensive Plan of Action, JCPOA). This has been done from an analytical framework, and the odd outburst on Twitter from Trump does not significantly raise the risk of a major situation with Iran developing. It is certainly a reminder of how potentially volatile the situation could be. Most calculations are based on more mundane factors of supply and demand factors.

The basic questions are, how much is demand likely to increase, what impact will Iran and Venezuela losses have on supply and where any extra oil may be forthcoming to fill the gap. The International Energy Agency (IEA) is predicting an increase in demand of about 1.4m barrels per day (bpd) for 2018 and similar for 2019 -- that will place growth at around 1.5%.

This is in the context of the agreement between OPEC and Russia to cut back production. We are now promised some extra supply but the details of what is factored into the OPEC agreement are a bit fuzzy.

In the non-OPEC plus Russia world, essentially the United States, we are seeing slightly higher prices and continuous strong increases in US production from about 1 million bpd to 12 million bpd towards the end of 2019, which will put the United States more or less on a par with Russia and slightly ahead of Saudi Arabia. The likelihood of increased US production was always factored in. US oil does not yet have a large impact on the global market although the United States importing less has reduced demand for its key fuel trade partners.

When sanctions were removed in 2016 after the nuclear deal was agreed, Europe went from importing 1 million bpd of oil from Iran to 2.2 million bpd (plus 300,000 bpd of condensate). If we assume that the European market gets knocked out again but Iran retains its main customers – China, India, Korea and Japan -- Iranian exports would go down by around 1.2 million bpd.

Venezuela is now down to production below 1.4 million bpd. It is assumed that Venezuela will go down by a further 500,000 bpd by the end of 2019. To balance markets, 1.5 million bpd of extra supply may be needed -- excluding US oil. Out of the OPEC members, primarily Saudi Arabia, we can get 1.1 million bpd, mostly from Saudi Arabia and an extra few hundred thousand bpd from Russia. This will keep the market reasonably stable. However, it will reduce stocks and spare capacity, providing less of a cushion for shocks along the way.

Markets ought to be reasonably well supplied over the next couple of years. Screening out the geopolitical volatilities including what might happen in Iran, it is not clear if the United States is going to very aggressive about stopping Iranian oil going to India.

Iraq is potentially problematic as disturbances are ongoing in the southern part where most of the oil is produced. Another risk is regional military tensions spilling over between Iran and Saudi Arabia. However, that political risk has always been there.

We have seen increasing rhetoric from the Trump Twitter feed. The most likely point of physical confrontation would be a naval clash in the waters of the Gulf. What is the risk of naval friction in the Strait of Hormuz, a key sea lane for oil?

This scenario has been around for the last 40 years. Generally, the conclusion is that there could be some sort of action in the Strait of Hormuz but the view is that the Strait would not be closed for long because there are so many vital interests that could be damaged. Maybe one day everyone will be proved to have been complacent about this. Until then complacency will continue.

Why are we not seeing prices and wages rising faster despite robust economic activity and strong labour markets?

For the last two years, this has been an eternal puzzle and debate amongst economists. Almost all signs point to higher levels of inflation than we now see. Are companies eating rising input costs? Producer prices are rising faster than regular consumer prices. With tariffs, there has been a notable rise in producer prices for steel and aluminium. In the metals sector, companies are eating the rising costs. There is a thought that the tariffs may be temporary or the effects of them may be temporary, so it is not worth the risk of losing market share by passing the price onto consumers. In other sectors, high numbers of share buybacks are fuelling stock markets, especially in the United States -- money that otherwise could have been allocated to wage increases.

There is also the secular problem that we have seen over recent decades. We have seen a decline in inflation since the 1970s. It is hard to pin down, but it is part of the productivity puzzle. The innovation we have seen coming out of the United States and most developed economies has not been matched by productivity gains. Companies see no reason to raise wages for workers when their labour productivity is not growing.

There may also have been a decline in workers' leverage to negotiate for higher wages. At this point in previous cycles, you would have seen more strikes and more demands for higher wages. There is also increasing evidence that increasing automation of tasks is becoming a factor in the US economy and exerting downward pressure on wages. This hypothesis is the idea that workers do not feel that they have enough leverage to demand higher wages when they know that there is a high risk of being laid off and replaced by

automation. Five years ago there was a lot of slack in the labour market. We are now reaching a point when we are running out of workers. Job gains are likely to start to slow later this year. Automation will explain some of this.

The rationale for lower productivity is not quite as bad an issue as it is portrayed in the media. After the global financial crisis, employment first recovered in low productivity sectors, making the productivity figures look worse. Recovery from the crisis and its long tail is taking time.

Figures from last year suggest that we were getting some pickup, assuaging some of the fears about the loss of productivity growth. Wage gains would be able to pay for themselves provided there were matching productivity gains. Then economies could edge themselves back to what might be considered normality.

We are in pause again. We are not sure whether the direction of the advanced economies will continue to be quite as favourable. We have gone into 'mediocre mode'. Some of the productivity gains will start moving off the table, and we will go back to slow productivity growth. Possibly we may see the end of employment growth. All of these factors are on a knife-edge. Moreover, inflation rates have picked up across the world. In Europe and the United Kingdom, the central banks are behind the curve; interest rates should be higher. Policy rates of 3% and market rates of 4% would be 'normal' for 2% inflation and 1.5% GDP growth.

Will the Fed be browbeaten by Trump?

The Fed's plan for raising rates and reducing its balance sheet is clearly mapped out. However, uncertainty has increased about how much growth could slow over the next few months. The fear is that there that things could get more turbulent in the autumn especially if you have US rates continuing to rise at the same time as some of the other risks play out. This could lead to turbulence in bond and equity markets as in 1987. There are reasons to be concerned about US policy, whether it is changing tack and how the Fed itself can assess its policy and how quickly it should react.

It is not clear that Trump has a strategy to try to influence US Federal Reserve Chair Jerome Powell. The consensus is that Powell, a Trump-era appointment, would be more hawkish than his predecessor Janet Yellen and that the others that Trump nominated would generally be more hawkish.

In the late 1970s, Nixon put pressure on then Fed Chair Arthur Burns to keep rates low and inflation rose to about 20%. When the subsequent Fed Chair Paul Volcker assumed his position, he was forced to raise rates rapidly which drove the US economy into recession to curb inflation.

Other presidents have privately complained when the Fed has raised rates because they know that it usually happens at the late stage of the business cycle, and that recession is on the cards. What is different about Trump is the fact that he has done it openly on Twitter.

It is unlikely that Powell will change policy direction as he would lose market confidence and his reputation would be on the line. More of a concern is the possibility that Trump's comments about the Fed will undermine it as an institution as Trump has done with the FBI and CIA. Previously US institutions did not attract much scrutiny. Trump's attacks on institutions have contributed to an erosion of confidence in those institutions and their legitimacy to do what they do. There is a risk of an erosion of public trust and legitimacy in the Fed. This would happen gradually over a couple of years but is worth monitoring.

What is the impact of raising US rates on emerging markets?

The Fed has been raising rates for some time now without damaging equity markets or emerging market assets too severely. The recent problems we have seen in emerging economies' financial markets are more to do with commodity prices.

Having seen the first US rate rises and a soft approach to eliminating quantitative easing, if US rates now go further and the ECB makes louder noises about joining in, economies most exposed to external financing will be at more risk.

More concerning would be a fall in commodity prices. If that transpires on the back of worries about global growth next year and if US and ECB rates go up in unison, that would be a twin-pincer movement. When there are two factors, there is more of a problem.

A third factor would be trade and slowing Chinese growth. Investment must also not be overlooked as all the factors that loom large in the world economy such as productivity are off the table without investment increasing.

Will higher US rates and the strong dollar push emerging markets towards a financial crisis?

Solid growth has enabled most emerging markets to improve their macroeconomic fundamentals since the global financial crisis. Compared to the late 1990s' Asian financial crisis, countries have much more price stability and have more foreign exchange reserves and other buffers. This substantially reduces the risk of contagion and a widespread emerging-market 'crisis'.

However, in parallel with these improvements, debt burdens have surged. There are places where debt distress could sharply reduce growth. Turkish reserves cover just 90% of debts due in 2018; in Argentina, Malaysia and Ukraine, reserves are close to the 'safe' 100% ratio. In Africa, 15 countries are struggling to service their debts. Along China's Belt and Road Initiative, countries are concerned that the benefits from debt-funded development will not come fast enough to ease the pain of repayments.

What is the impact of renewables on fossil fuel producers?

Renewables are most relevant when looking at electricity rather than oil. It is relevant for the Middle East because of the impact on the natural gas market.

There is an important aspect when we look at the increases in Saudi Arabian oil production over the last couple of months. This has not translated into increased exports yet as Saudi Arabia uses a lot of oil for air conditioning at this time of year. This is a huge waste and can reach up to 1 million bpd at the height of the summer and averages 500,000 bpd over the summer. The Saudi Prince has said, let there be solar, but Saudi Arabia has been slow to adopt it. It will take five to ten years to build significant production.

The role of solar and wind is growing fast in the world economy. BP's statistics show solar consumption for power rose by 35% in 2017 and wind consumption for power by 17%. Solar and wind accounted for about 6% of global electricity generation.

What is being displaced is primarily coal. In 2017, 38% of the world's electricity came from coal, and 23% from natural gas. The coal share went down and then back up but is now dropping again. Natural gas is still being heavily used for residential heating.

If we look at oil markets renewables are not particularly important -- they are more relevant for natural gas. The outlook for natural gas is robust, growing strongly last year. China's imports of liquefied natural gas imports rose by 40% last year and 50% year-on-year so far this year. Natural gas is in the early stages of replacing coal in the power sector before solar and wind significantly displace fossil fuels. The IEA reported that capital investment in renewable power fell by 7% in 2017 -- due to lower investment in wind and hydro. This was a break in the sequence as most of the scenarios modelled show investment in renewables increasing.

If we see a slowdown in growth in emerging markets many of these countries will fail to make the hoped-for progress. Many of the oil coal-powered stations are still operating in Africa and it is expensive to make the switch to renewables. Bringing electric vehicles to the mass market is costly because of the installations. This shift could get delayed if global growth weakens as this would hurt the environment and energy saving.

How far will Trump go with China and trade, and what is his end game?

This is the perennial question. There is so much uncertainty as to how much is being driven by Trump himself versus other broader factors. Trade and the idea that the United States is being 'taken advantage of' by other countries who impose higher tariffs is one of the few things that Trump has believed in for decades.

It is not a whim. Trump has been preoccupied by the decline of the US auto industry in the latter half of the 20th century. It is likely that he will escalate the disputes by imposing the tariffs on imports of automobiles and parts. There is not much that the EU can do about it.

Looking beyond Trump's biases, it is clear that the role of the United States in the world is changing. There has been pressure on previous presidents to disengage the United States from the global role that it took on during the 20th century. Trump believes that the United States should be focusing on bilateral deals, should stop underwriting multilateral trade systems and should not be spending money on the global defence architecture that underpinned the substantial globalisation of recent decades.

There is a broad shift in opinion among the public. The American public does not normally pay much attention to trade and foreign policy, but polls suggest a good majority now believe that the United States has been too committed abroad and that there is a need to retreat. Trump's method of delivering on that popular sentiment is pulling the rug from under the world trading system.

This is a secular trend. One should not expect the United States to reverse on this even if Trump loses in 2020. The world should be prepared.

To what extent can China offset US tariffs by depreciating its currency?

Renminbi weakness is likely to persist in the short to medium term. If the exchange rate depreciates to close to 7 renminbi to the dollar from around 6.8 now, China's central bank will likely tighten capital controls. However, longer term this will erode progress made on promoting the international use of the currency and integrating China's capital markets with the world markets.

Nearer term, currency weakness will not fully offset the tariffs, likely increasing costs and reducing demand. Product competitiveness is as important as price competitiveness, as is infrastructure, ease of doing business and exposure to external shocks and firms will consider all these factors when making decisions about sourcing their supply chains or longer term, relocating.

The overall impact of tariffs will be small; global growth and trade flows have momentum, and the merchandise exports involved account for much less than 1% of Chinese GDP, limiting the impact. Even if a 10% tariff is imposed on another 200 billion dollars of China's US sales, this is less than 9% of China's 2017 goods exports.

Trump can accuse China of currency manipulation to prolong talks and encourage concessions, but he cannot label China a currency manipulator unless China meets the three conditions specified under US law. China meets the first condition, running a trade surplus with the United States above 20 billion dollars (293.7 billion dollars in the year to June). It does not meet the other two. It does not run a current account surplus of 3% of GDP and rather than rising, its foreign currency purchases have trended downwards.

What role will new industries play in maintaining global growth?

In the near term, global growth is near the peak of this cycle and likely to slow in 2019 and 2020. The new industries cannot reverse this trend. However, the importance of these industries will grow substantially, effectively acting as a non-cyclical cushion mitigating peaks and troughs in global growth. Productivity could potentially rise sharply depending on how technologies advance.

In electric vehicles (EVs), standardising and expanding charging infrastructure is key to wider adoption and efforts are rising. Government policy will continue to be supportive but reaching the tipping point of more EVs than internal combustion engine cars on the roads could take decades.

The renewable energy transition is further ahead. Estimates now suggest that the cost of all commercialised renewable energy technologies will compete with fossil fuels in the power generation sector by 2020, led by wind and solar. The pressure to reduce costs will fuel research and development into technologies and ensure that the research is rapidly deployed. Solutions will gradually emerge to increase the reliability of renewables and to provide a greater range of storage options.

As artificial intelligence capabilities expand, although specific jobs will disappear, technology will, for now, continue to have a positive impact on wealth creation. Employees and society will have to adapt to take advantage of opportunities that create new jobs and higher wages. Higher job churn and technological stranding will increase political pressure for remedies to give individuals security. Services are ripe for adopting more capable robots, creating job opportunities and threats and reducing prices; new sectors may emerge. Digitalisation will accelerate well-prepared developing countries' growth prospects. The under-prepared will lose out.