Perspectives
Economics

January 2019

Key messages

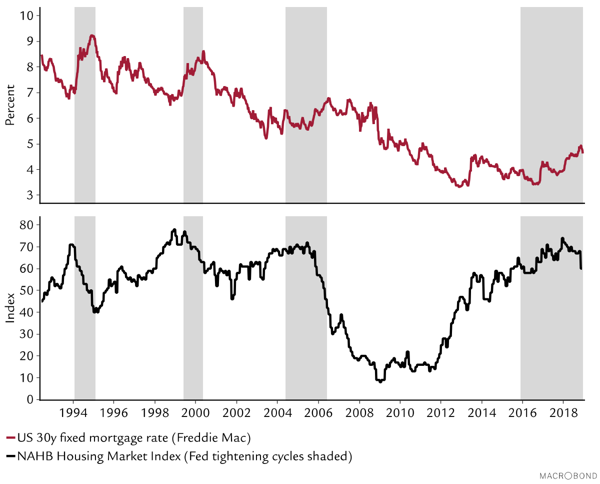
- Headline inflation rates moving lower in response to sharp fall in oil price
- Core inflation still expected to rise as wage growth gathers momentum
- Purchasing managers' indices hint at stabilising dynamics in cyclical industrial sectors

Comparison of forecasts

	GDP growth 2019		GDP growth 2020		Inflation 2019		Inflation 2020	
	Swiss Life AM	Consensus	Swiss Life AM	Consensus	Swiss Life AM	Consensus	Swiss Life AM	Consensus
US	2.3%	2.6% ↓	1.5%	n.a.	1.8%	2.3% ↓	2.1%	n.a.
Eurozone	1.3%	1.6% ↓	1.1%	n.a.	1.6%	1.6% ↓	1.5%	n.a.
UK	1.4%	1.5%	1.3%	n.a.	2.0% ↓	2.1% ↓	2.0%	n.a.
Switzerland	1.2%	1.6% ↓	1.4% ↑	n.a.	0.6% ↓	0.9% ↓	0.7%	n.a.
Japan	1.2% ↓	1.1%	0.6%	n.a.	1.2%	0.9% ↓	1.7%	n.a.
China	6.2%	6.3%	6.0%	n.a.	2.4% ↓	2.3% ↓	2.2%	n.a.

Arrows indicate difference from previous month
Source: Consensus Economics Inc. London, 10.12.2018

Chart of the month



The rate hiking cycle by the US Federal Reserve has led to tighter financial conditions for both companies and households. The average interest rate on a 30-year fixed mortgage – the most popular instrument to finance a home in the US – has reached almost 5% lately, levels last seen in 2011. The increase over the past quarters has left its mark on the US housing market. Sentiment among homebuilders has deteriorated and activity data such as housing starts or home sales levelled off or even declined.

US
Feeling good, but slowing down

GDP growth	
Swiss Life Asset Managers	Consensus
2019: 2.3 %	2019 : 2.6 %
2020: 1.5 %	2020 : n.a.

The US economy is set to end the year on a weaker footing following extraordinarily strong two quarters. Based on the available data at the time of writing, the Atlanta Fed's "nowcast" model foresees US growth in the final quarter to come in at 2.4% annualised, close to our 2.3% estimate. Nevertheless, sentiment among consumers and corporates remains buoyant. The ISM survey is hovering at elevated levels for both the manufacturing and the services sector, while consumers not only benefit from higher wages, but also reduced costs on their gasoline bill following the collapse in oil prices. Working against these tailwinds are tighter financial conditions (see chart of the month), a weaker external environment, as well as the fact that the fiscal stimulus will fade in the course of 2019. Hence, we expect the US economy to gradually slow toward potential growth over the next two years, without falling into outright recession. Key to this forecast is our assumption that the Federal Reserve will take a data-dependent and thus rather cautious stance on their future monetary policy path.

Inflation	
Swiss Life Asset Managers	Consensus
2019: 1.8 %	2019: 2.1 %
2020: 2.1 %	2020: n.a.

Headline inflation in the US is past its peak and rapidly falling due to lower energy prices. This negative energy base effect will extend into 2019 and should keep headline inflation below the 2% mark for most of the year. Meanwhile, the November data confirmed our view that the weakness in core inflation was temporary. Core inflation edged up due to another surge in used car prices as well as healthy rises in shelter costs and health care inflation. We expect core inflation to remain on a moderate uptrend next year as wages keep rising amid tight labour market conditions.

Eurozone
Worrisome news from France

GDP growth	
Swiss Life Asset Managers	Consensus
2019: 1.3 %	2019 : 1.6 %
2020: 1.1 %	2020 : n.a.

2018 started in euphoric mood, and ends with a growing basket of concerns: Emmanuel Macron's push to reform the French economy first seemed to earn success when he was confronted with strikes in the area of public transport. But later, the wave of unorganised opposition against the fuel tax hike forced his government to bow to the "gilets jaunes" protesters and abandon the plan. This weakens Macron's stance as regards other projects yet to be implemented. Obviously, the European elections next May will become a referendum on his entire reform agenda. Incoming economic data do not bode well for him, since the improvement on the labour market remains unimpressive and is a side effect of the global upswing rather than of reform efforts. Over the last twelve months, unemployment rates dropped at a similar pace or even faster elsewhere in the Eurozone. What adds insult to injury for Mr. Macron, was that the purchasing managers' index for the manufacturing sector fell below the 50 points line that separates expansion from contraction for the first time since September 2016.

Inflation	
Swiss Life Asset Managers	Consensus
2019: 1.6 %	2019: 1.6 %
2020: 1.5 %	2020: n.a.

The latest move in the oil price supports our assumption that the spike in headline inflation in the Eurozone was temporary only. This removes pressure from the ECB to normalise monetary policy at a faster pace. The number of member states in which inflation exceeds 1.8% dropped to 10 out of 19 in November, from 14 in October. We expect Eurozone inflation to fall below 2% in December 2018 and to drop further to 1.5% until mid-2019. Most importantly, German headline inflation will also likely settle in below the critical threshold of 2% by the second quarter 2019.

UK
"No Deal" less likely

GDP growth	
Swiss Life Asset Managers	Consensus
2019: 1.4 %	2019: 1.5 %
2020: 1.3 %	2020: n.a.

Ever since summer 2018, we expressed our advice that one should attach significant probabilities to extreme scenarios related to the outcome of Brexit negotiations with the EU. While a "Blind Brexit" has always been and still is our base case scenario, we gave a combined likelihood of 30% to the "No Deal" scenario and a second referendum scenario with no Brexit in the end. Our interpretation of the most recent developments, and most importantly Theresa May's survival of the Tory leadership confidence vote, is that the "No Deal" has become less likely. We interpret parliamentary majorities and the result of public opinion polls such that there is no mandate to lead the United Kingdom out of the EU without a treaty. Shortly after the EU referendum in 2016, the National Centre for Social Research (NatCen) started a poll asking Britons on whether or not Brexit was the right decision with hindsight. The number of respondents saying that Brexit was the wrong decision rose to 49%, its highest level ever, while support for Brexit fell to just 38%. Meanwhile, economic data covering the fourth quarter suggest that dynamics in the UK slow in sympathy with the trend in other developed regions.

Inflation	
Swiss Life Asset Managers	Consensus
2019: 2.0 %	2019: 2.1 %
2020: 2.0 %	2020: n.a.

Lower energy prices suggest that there is further downside risk to the inflation outlook in the short-term. We expect inflation to drop to 2.1% by year-end 2018. That is significantly lower than the 3% rate seen at the start of the year. Going forward, we expect inflation to stabilise. This should even hold in the case of an extreme Brexit outcome. In a "No Deal" scenario, temporarily moderating economic activity should weigh on price setting power of domestic suppliers and dampen wage growth which has gained momentum as of late. This would balance the impact from higher import prices should Sterling weaken again.

Switzerland
Fast decline in inflation

GDP growth	
Swiss Life Asset Managers	Consensus
2019: 1.2 %	2019: 1.6 %
2020: 1.4 %	2020: n.a.

Third quarter GDP data surprised negatively, showing a contraction by 0.2% compared to the previous quarter. According to the State Secretariat for Economic Affairs (SECO), most of the decline was attributable to weak exports. Additionally, the dry summer led to a production downtime at hydropower plants. Both drags should be seen as temporary. One can already observe firmer data in these areas during the fourth quarter. Switzerland's purchasing managers' index (PMI) recovered to 57.7 points in November, a decent level in historical comparison. According to KOF's survey, the net number of firms expecting their orders intake to rise over the next three months recovered in the final quarter 2018 after a steady decline since the start of the year. The unemployment rate fell to 2.4%, the lowest number since 2002. Given the softer dynamics of the world economy and this year's strengthening of the Swiss Franc, we still expect growth to slow to around its long-term potential. Compared to our peers, this assessment stands out as extremely prudent: of all 16 houses contributing to the poll conducted by Consensus Economics, our forecast of 1.2% GDP growth in 2019 is the lowest to be found.

Inflation	
Swiss Life Asset Managers	Consensus
2019: 0.6 %	2019: 0.9 %
2020: 0.7 %	2020: n.a.

Inflation peaked back in July when producer and import prices rose by 3.8% from year ago levels and consumer price inflation reached 1.2%. Until November, the two measures dropped to 1.4% and 0.9%, respectively. We expect consumer price inflation to fall further to 0.7% this month and to 0.5% until mid-2019. The decline is broad based and not solely explicable by lower energy prices. According to official data, costs for health care have decreased modestly over the past twelve months. The stronger Swiss Franc eases import costs. And also rents are expected to contribute negatively to inflation next year.

Japan
Tight capacities, rising wages

We have a rather constructive view on the Japanese economy close to consensus expectations. To be sure, we are past the cyclical peak, and the economy is set to slow over the next two years. Much of the recent weakness in hard economic data was, however, excessive, and the latest Tankan survey – by far the most important gauge of corporate sentiment – surprised on the positive side. Sentiment especially improved in the non-manufacturing sector, and firms reported the strongest capital expenditure plans since the early 1990s. In addition, capacity constraints are increasing and base wages thus rising at the fastest pace in twenty years. This should support consumption as a trend, even though the scheduled consumption tax hike in October 2019 is set to inject renewed volatility in the data. The transmission mechanism of wages into inflation is, however, weak in Japan. We thus expect core inflation to remain contained. The increase in headline inflation in 2019 and 2020 is mainly attributable to the consumption tax increase from 8% to 10%.

China
Truce in US-China trade dispute

In a working dinner following the G20 summit in Argentina, US President Donald Trump and China President Xi Jinping concluded a temporary truce in their trade dispute. The US will not increase tariffs on imports from China to 25%, as was originally announced, while China agreed to increase imports of US agricultural, energy and industrial goods. Moreover, there will be a 90-day negotiation period to address China's structural issues, such as the country's alleged property rights theft and forced technology transfers. However, if no deal on China's structural issues can be reached within the three-month period, a new escalation of tariffs would arise. Therefore, although the temporary ceasefire is positive for the short-term outlook, the threat of a future escalation is likely to continue to weigh on sentiment in both countries. Hence, there is little doubt whether China will increase stimulus over the coming months, with a conventional toolbox of fiscal and monetary policy measures trying to offset the drag on economic growth.

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