Economic Insight

Three questions on the global economic cycle

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Executive Summary

- **Where are we in the global economic cycle?** Since the recovery from the Global Financial Crisis, the global economy has been stuck in a post-crisis malaise characterized by low economic growth, deflationary pressures in some regions and ultra-low interest rates in the context of very accommodative monetary policies in advanced economies. We believe that we are gradually moving away from this "too slow for too long" phase and are entering a stronger cyclical development where output growth is improving, deflationary fears are dissipating and interest rates are about to normalize.

- **How long can we go?** We argue that the current economic cycle still has legs for another year of expansion. Fiscal policies will support growth in China and the United States. In Japan and the eurozone, a burgeoning positive credit cycle helps to sustain the improvement. Emerging markets are in a sweet spot with supportive macro-policies and positive investor sentiment supporting growth. Sources of macroeconomic and financial instability have declined with stronger financial regulation and a reduction in macro-imbalances. Yet overall improvement will likely be lower than previous cycles due to unfavorable demographics, and modest productivity growth.

- **What could possibly go wrong?** Three economic risks could jeopardize the cyclical uptick. First, the high leverage in some emerging markets (e.g. China) could become a deterrent for demand growth and trigger default in case of capital withdrawal. Second, a negative shock to already high financial asset prices (US e.g.) and real estate prices (Malaysia, Thailand, Canada, Australia and South Korea, e.g.) could create negative wealth effects. Third, higher (geo) political risks (e.g. North Korea) could alter confidence.

Where are we in the global economic cycle?

Since the recovery from the Global Financial Crisis, the global economy has been stuck in a post-crisis malaise characterized by low economic growth, deflationary pressures in some regions and ultra-low interest rates in the context of very accommodative monetary policies in advanced economies.

We believe that we are gradually moving away from this "too slow for too long" phase and are entering a stronger cyclical development where output growth is improving, deflationary fears are dissipating and interest rates are about to normalize.

Global economic growth is improving with all major economies in expansion

Global economic growth is picking up speed with a rate of +3% expected in both 2017 and 2018 (compared to +2.6% in 2016) supported by a rise in global trade. This contrasts with average growth of +2.7% between 2011 and 2016. This phase of the cycle is quite unique. All major economies are in expansion, albeit at a different phases of the business cycle.

The United States is at a mature phase of its business cycle. The economy is in its ninth year of expansion and real GDP will likely grow by +2% this year. The unemployment rate has reached its pre-crisis level, but wage growth is still moderate. Sentiment is positive with consumer confidence, business and investor sentiment at a high level. Profit margins in the nonfinancial corporate sector are still relatively high and business investment is picking up progressively. Monetary policy is adjusting, but at a measured pace.

In China, although overall economic growth remains firm (+6.7% in 2017), the economy is home to two cycles. Services and high tech industries continue to blossom with the support of favorable macro-policies (e.g. tax incentives, fiscal spending) while old industries (e.g. basic materials, heavy machinery, cheap manufacturing) continue to adjust capacity. Strong monetary easing in 2015 and 2016 helped avert a sharp downturn in the traditional sector in 2016 but this momentum is set to slow as authorities move to reduce financing risks.

As for the eurozone and Japan, both are in the middle of their business cycle. The eurozone recovered from recession in the course of 2013 after the sovereign debt crisis. In Japan, signs of a clear recovery emerged in 2015 after a poor 2014 due to the hike in sales tax. In both markets, strong monetary easing and less fiscal consolidation helped to put growth back on a stronger footing. We are now reaching a sweet spot where growth drivers, especially consumption and investment, start to move in sync helped by improving labor markets and higher demand for credit. In 2017, both economies are set to grow above average of the past six years with growth of +2.1% in the eurozone (compared to +0.9% p.a. in 2011-16) and +1.5% in Japan (+1.0%).

Last, apart from India which is still adjusting from the demonetization shock, large emerging markets (e.g. Brazil, Russia and South Africa) are gradually making their comeback. Yet, the upswing is at an early stage, supported by a rise in global demand, a progressive improvement of commodity prices and accommodative monetary policies.

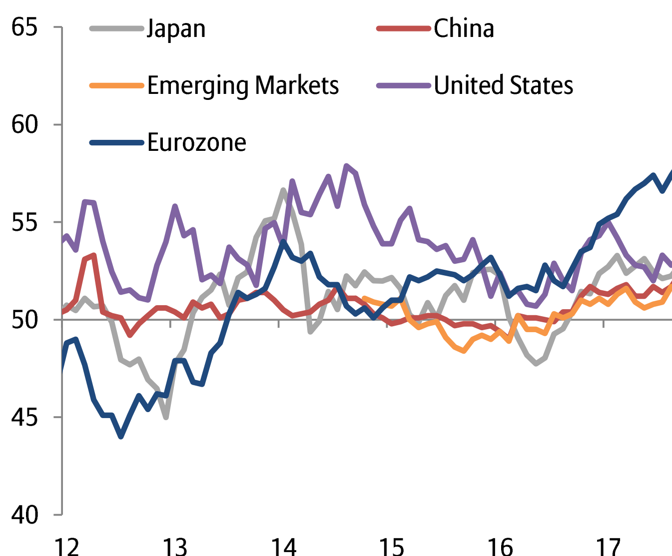
Figure 1: GDP growth (y/y, %)

	11-16 average	16	17f	18f
World	2.7%	2.6%	3.0%	3.0%
United States	2.1%	1.5%	2.0%	2.2%
Eurozone	0.9%	1.8%	2.1%	1.8%
China	7.7%	6.7%	6.7%	6.3%
Japan	0.9%	1.0%	1.5%	0.9%
Brazil	0.3%	-3.6%	0.8%	2.0%
Russia	1.1%	-0.2%	1.5%	1.9%
India*	6.6%	7.1%	6.5%	7.3%

* Fiscal year

Sources: Euler Hermes, Allianz Research

Figure 2: Manufacturing PMI's



Sources: IHS, Euler Hermes, Allianz Research

Global inflation: The outlook is improving, albeit at a slow pace

Global inflation is set to rise gradually to +2.7% in 2017 (from +2.1%) in 2016. Further acceleration is prevented especially by disinflationary pressure stemming from technological changes and prevailing overcapacities.

We expect inflation to be supported by a continued moderate rise in industrial commodity prices. Our scenario envisions an upward movement of Brent prices to USD 52 per barrel in 2017 (from USD 45 in 2016) and USD 56 in 2018 in particular. This trend should be nurtured by an improvement of global industrial production which is itself supported by (i) a rise in global trade growth (see Figure 3) and (ii) an improvement of the construction sector.

The pickup in industrial commodity prices should be reflected up the value chain and gradually feed overall consumer inflation. Producer prices have already started to recover

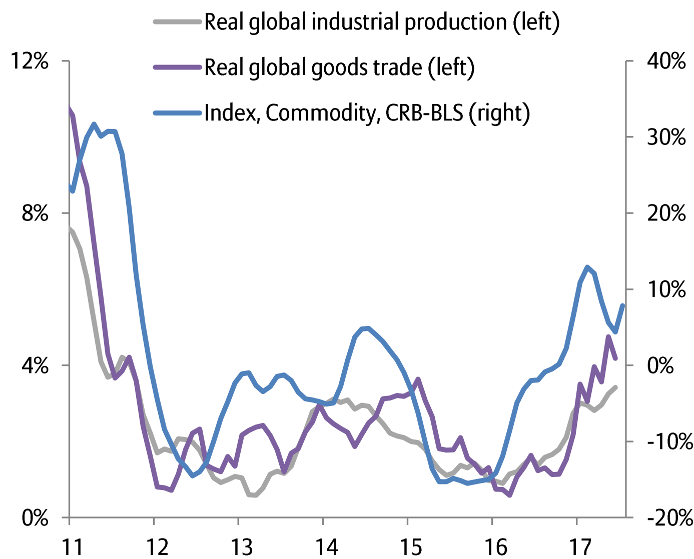
all around the world. We expect a gradual pass-through to consumer prices going forward.

We believe that better employment conditions will gradually stir prices through rising wages. Corporates have replenished their balance sheets over the past few years and have enough financial space to spend on job creation and wages. Corporate profits have improved in the US (+7.2% y/y in Q2) and China (industrial profit up +21.6% YTD y/y in the first 8 months) especially.

Unemployment has improved considerably over the past months in major economies. We expect wages to trend higher gradually as job markets get tighter.

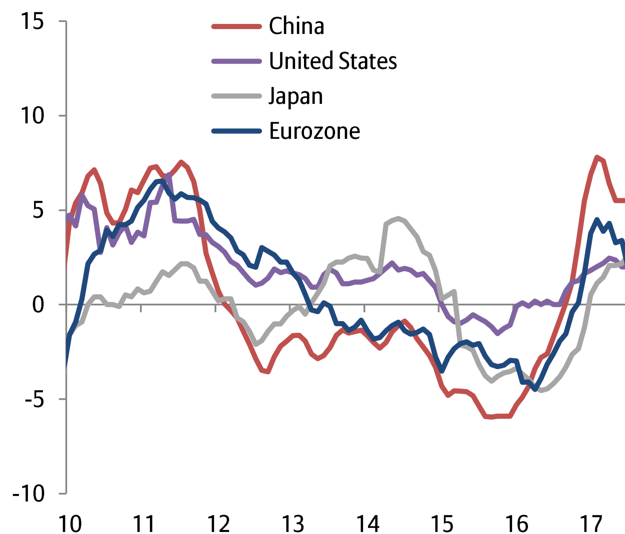
Last, we see the demand outlook to be positive for future inflation. Both consumer and business sentiment are improving. And key macroeconomic aggregates such as lower household saving rates in the US and China, and improving investment in advanced economies suggest a positive momentum going forward.

Figure 3: Global Trade, Industrial Production and commodity prices (3m, y/y)



Sources: CPB, World Bank, Euler Hermes, Allianz Research

Figure 4: Producer prices (y/y)



Sources: IHS, Euler Hermes, Allianz Research

Interest rates: higher long-term interest in advanced economies

Stronger economic momentum suggests a normalization of yields in advanced economies, as it allows central banks in advanced economies to tighten gradually.

The US 10-year government bond yield is expected at 2.9% at the end of 2018, the German 10 year government bond yield is forecast at 1.5% by the end of 2018 in particular.

Apart from higher inflation expectations, a less expansionary monetary policy stance would be a key driving factor. The Fed has already embarked on a tightening of its policy with a total of four rate hikes since 2015. We expect another hike by the end of this year. Two or three could follow next year. Moreover, the Fed has already indicated that it will start balance sheet normalization from October onwards.

In the eurozone, we expect policy rates to remain stable in 2017 but the deposit rate could see a hike from -0.4% to -0.2% in the second half of next year. The refinancing rate would remain at 0%. The ECB is set to announce a reduction in its monthly purchases from EUR 60 to 40bn at most before the end of the year, to be implemented in January 2018.

How long can we go?

We believe that the current economic cycle still has legs for another year of expansion. Yet the improvement will likely be lower than previous cycles.

Fiscal stimulus in China and the United States, a positive credit cycle in the eurozone and Japan to drive economic growth

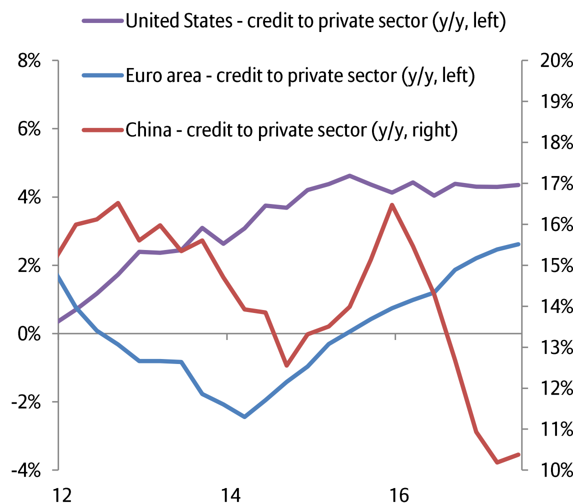
In the short term, measures to cushion the side effects of a monetary tightening in China will be needed. Credit growth began to slow in China as the authorities recently stepped up financial measures to reduce credit risk. While the policy rate remained unchanged,

macro-prudential measures and banking supervision have been reinforced in order to curb shadow banking activities, a bubbly property market and high corporate debt. Against this background, we see a fiscal stimulus of 2 points of GDP in the form of additional infrastructure spending as part of the One Belt One Road strategy and tax incentives to support the emergence of new economy-related industries.

In the US, the policy mix will be broadly supportive. We assume a fiscal stimulus of +1.2 GDP points based on tax cuts and extra spending promised by the Trump administration which will help lift economic growth to +2.2%. Monetary policy will gradually tighten as the economy gets closer to potential. Yet, credit conditions will still remain supportive as both short-term and long-term interest rates would remain below nominal GDP growth.

In the eurozone and Japan, we expect a positive credit cycle over the next year. Broadly positive election results have enabled a rise in investor confidence. Bank credit growth should be sustained by a continued rise in new orders.

Figure 5: Credit to private sector growth (y/y)



Sources: IHS, Euler Hermes, Allianz Research

Emerging markets: Better autonomy and more room for maneuver will be the driving force

Our scenario envisions an again stronger contribution from emerging markets to global economic growth. Emerging markets are likely to contribute +1.6pp in 2016 and +1.8pp in 2018. While China will continue to account for 1pp of global growth, other emerging markets are set to pick up speed.

Exports will improve with solid demand from advanced economies and China. Domestic demand growth should pick up speed thanks to favorable credit conditions. Domestically, inflation has returned to safer levels, currency pressures have reduced. This provides some leeway to central banks to cut policy rates. Externally, positive interest rate differentials with advanced economies, and better economic prospects would support a rise in foreign investment.

In the medium term, a sustainable improvement will hinge on stronger internal demand and continued efforts to decouple from the US business cycle through export diversification. This will help mitigate the impact of US trade policies, that have implemented 388 harmful measures in the last four years, with a big share of them directly aimed at China (16%) and emerging markets (8% for Brazil, Russia, India and Mexico combined).

Sources of economic and financial instability have declined

The global financial system is becoming more resilient. After the global financial crisis, the G20 launched a comprehensive set of reforms in order to build a safer financial system. The Financial Stability Board has coordinated the development of these reforms and is accompanying their implementation. Key measures were aimed at: reinforcing bank capital and liquidity requirements; increasing standards for risk management; strengthening macro-prudential tools; improving accounting standards; and enhancing the regulatory perimeter.

Global macro-economic imbalances have diminished. Excessive borrowing has usually been an important early warning of a crisis. The current account balance is a measure of an economy's net lending. A positive (negative) balance indicates that the country is a net lender (borrower) to the rest of the world. Current account balances in major economies have normalized. The United States especially went from a net deficit of -4.9% of GDP in 2007 to -2.4% of GDP in 2016. In emerging markets, the trend has improved recently with lower current account deficits in deficit countries thanks to prudent macro policies (India, Indonesia), a global trade recovery (emerging market commodity exporters).

Yet, the momentum will likely be lower than previous cycles

GDP growth will probably remain below previous cycles' average at +3.6% in 2003-2007. Long-term growth determinants include demographics and productivity growth.

Demographics will likely act as a drag on growth as aggregate demand is limited by lower fertility rates and lower growth in working-age population. On productivity, we expect the declining trend to reverse in the longer term. This would be supported by: (i) a progressive pickup of investment; and (ii) stronger R&D expenditures and (ii) more positive spillovers from the digital revolution.

The trend will likely be gradual due to legacy from the crisis: investment growth has been subpar over the past seven years and it will take time to retie with pre-crisis growth. More importantly, new technologies and recently developed concepts such as AI (*Artificial Intelligence*), robotics and automation still have a long way to go before being efficiently integrated and embedded into companies' work processes and supply chains.

What could possibly go wrong?

Three risks could jeopardize the current cyclical uptick.

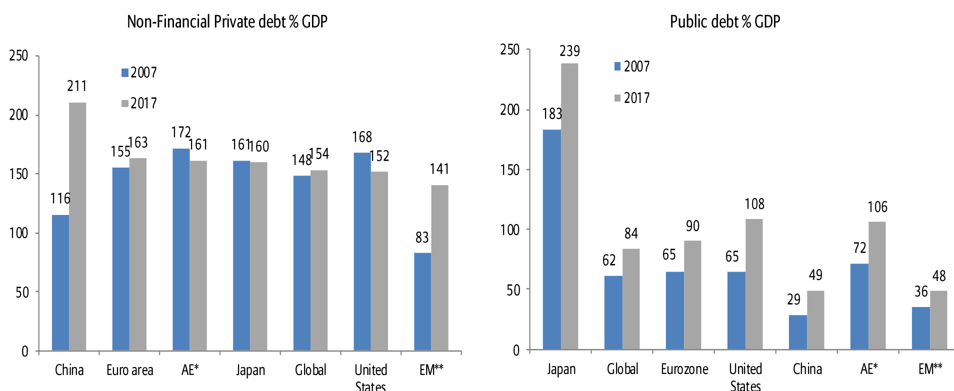
High debt levels as a deterrent for future demand growth and trigger of default

The first risk relates to debt dynamics. High private debt, especially in emerging markets, could become a deterrent to demand growth in the context of higher interest rates as private agents deleverage and defaults rise.

Total global debt (non-financial private and public) has increased from 210% of GDP in 2007 to an estimated 238% of GDP in 2017. Global private leverage was broadly stable but remains at a high level due to a rise of leverage in emerging markets (see Figure 6). China was the driving force with a strong increase between 2007 and 2017 from 116% of GDP to

211% of GDP. This strong increase was driven by a rise in corporate debt which went from 97% in 2007 to 165% in 2017. Global public debt has increased rapidly to an estimated 83% of GDP in 2017 (from 62% in 2007). Advanced economies also showed a strong public debt increase: in Japan (+56 points of GDP between 2007 and 2017), the United States (+44 points of GDP) and the eurozone (+25 points of GDP). In emerging markets public debt has increased led by China, but the level remains relatively contained.

Figure 6: Debt indicators (% GDP)



* AE refers to advanced economies; **EM refers to emerging markets

Sources: BIS, IMF WEO, Euler Hermes, Allianz Research

Asset correction and negative wealth effects

Financial asset prices are high - especially in the United States. A confidence shock could undermine valuations if the government fails to honor its promises.
Apart from that, we see pockets of risk in real estate markets in emerging Asia (e.g. China, Malaysia, and Thailand) and some advanced economies such as Canada, Australia and South Korea. These markets have heavily benefited from the easing of global monetary conditions. Real estate prices have risen rapidly and went hand in hand with a fast increase in household debt.

High political risk could act as a toll on investment and trade flows

The third shock could come from a rise in (geo) political risk. A further escalation of the conflict in the Korean Peninsula is presently the main concern as a physical confrontation between the US and Pyongyang could disrupt the current trade recovery and trigger a drop in global investor sentiment. Also, on a national level, the rise in populism and protectionism in many advanced economies continues to pose a long-term risk to global trade flows and thus to the sustainability of global economic growth.

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