Allianz SE – Group Economic Research

The MacroBriefing

March 15, 2016

www.allianz.com/economic-research/en

Dr. Michael Heise
Phone +49.89.3800-16143
michael.heise@allianz.com

The **US economy** can cope with a monetary policy turnaround

Since last summer, concerns about the strength of the global recovery have been rising again. While the focus was initially on emerging markets, in particular China, more recent worries have centered around the US. Expectations for Fed rates have been revised downward accordingly. Federal funds futures, which reflect these expectations, now signal that the markets see only one interest rate hike this year.

RECESSION UNLIKELY

Analysts and investors are gloomy about the US partly because they feel that the current upswing, now in its seventh year, might have run its course and will start flagging soon. Since the Second World War, the US economy has enjoyed only three expansions that lasted longer. And yet, the notion of 'the longer the recovery, the more likely a recession' is too simplistic.

There are good reasons why the current recovery might last much longer than previous ones. The recession from early 2008 to mid-2009 was unusually deep, and the rebound since the end of the crisis much slower than in previous cycles. The fallout from financial crises typically lingers for several years, as businesses, private households and the public sector are forced to reduce their debt to sustainable levels. Banks, meanwhile, cut their risk exposure and raise capital in order to repair their balance sheets. In the wake of a financial crisis, they will avoid loading new risks onto their balance sheets and their lending criteria will be stricter. All these factors weigh on growth for a considerable period of time.

In the meantime there are clear signs of progress, however. Lending standards in the US have eased substantially in recent years – a clear sign that consolidation in the banking sector and deleveraging in the private sector have made considerable headway.

The main argument against a looming recession in the US is the state of the labor market: month after month, new jobs are being created – approximately 1.25m since August 2015 – and wage increases are also starting to edge up. New jobs and higher wages stimulate consumer demand, which makes up almost 70% of the economy.

For years, wages in the US had hardly budged despite falling unemployment – now at 4.9%. But a turnaround now looks likely. However, this does not mean that aggressive wage increases are on the cards in the next months as there is a sizeable pool of workers who withdrew from the labor market in the years of soaring

unemployment but who will re-enter the market when job opportunities arise. Somewhat faster wage rises will eat into corporate profit margins. The latter, however, had climbed to record levels during the years of wage restraint. A moderate correction in distribution of national income is therefore normal and does not pose an acute risk to the economy.

RISKS FOR THE US ECONOMY MANAGEABLE

The real risks for the US economy lurk elsewhere. First, the marked appreciation of the US dollar since mid-2014 is weighing on exports and the manufacturing sector. Moreover, the collapse of oil prices has led to sharp cuts in energy investments, write-downs and losses on high-yielding energy-sector bonds. However, this collateral damage should not conceal the fact that the drop in oil and energy prices also means a massive boost to household purchasing power as well as lower production costs for many companies, both of which will drive domestic demand growth.
Another risk to the US economy currently stems from financial market volatility. Triggered by rising risk premiums on energy bonds, refinancing conditions have also tightened in other sectors. This, together with heightened volatility on equity markets (and exchange rates), highlights a growing anxiety, which could prompt investors to cut back on capital spending. Nevertheless, the indicators that measure such financial market stress are well below the levels typical for a recession. Slightly elevated risk premiums on corporate bonds also appear manageable because the overall interest rate level, thanks to government bond yields, has fallen back sharply of late.

MONETARY POLICY SHOULD REMAIN ON NORMALIZATION TRACK

For a long time already, the Fed has been communicating its intention to shift course, provided this is justified by the incoming economic data. Faced with the recent slowdown and, more importantly, an inflation rate still well below its 2% target, the Fed is unlikely to raise rates again in March. Although the labor market situation would warrant a hike, declining import prices – due to the slide in oil and energy prices and the stronger dollar – suggest that the Fed will remain on hold.

The risks to the US inflation outlook, however, are not all on the downside. If, based on brisk consumption growth, the US economy proves robust as the year progresses, domestic inflationary pressure will ultimately rise. Core consumer-price inflation (excluding energy and food) already rose to 1.7% year on year in January. We are therefore sticking to our assumption that the Fed will nudge its key rate up to a range of 0.75% to 1% by year-end.

The US economy could doubtless stomach such an increase, not least since it would lift returns on the pension savings and assets of US households. However, even such a moderate hike in the second half of the year would entail risks for global financial markets. The dollar could strengthen, at least temporarily, capital outflows from emerging markets could pick up again and the volatility of stock markets could increase again. The global financial system has simply grown accustomed to ultra-low interest rates, and – despite years of warning – any sign that central banks are shifting out of their crisis mode could trigger panic. The risk of temporary adjustments, however, is not a valid argument for perpetually delaying the normalization of monetary policy. Otherwise the withdrawal symptoms will be even more gut-wrenching when the medicine is finally withdrawn.

These assessments are, as always, subject to the disclaimer provided below.

About Allianz

Together with its customers and sales partners, Allianz is one of the strongest financial communities. About 85 million private and corporate customers insured by Allianz rely on its knowledge, global reach, capital strength and solidity to help them make the most of financial opportunities and to avoid and safeguard themselves against risks. In 2015, around 142,000 employees in over 70 countries achieved total revenues of 125.2 billion euros and an operating profit of 10.7 billion euros. Benefits for our customers reached 107.4 billion euros.
This business success with insurance, asset management and assistance services is based increasingly on customer demand for crisis-proof financial solutions for an aging society and the challenges of climate change. Transparency and integrity are key components of sustainable corporate governance at Allianz SE.

Cautionary note regarding forward-looking statements

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.
Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the euro/US-dollar exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

No duty to update

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.