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INVESTORS

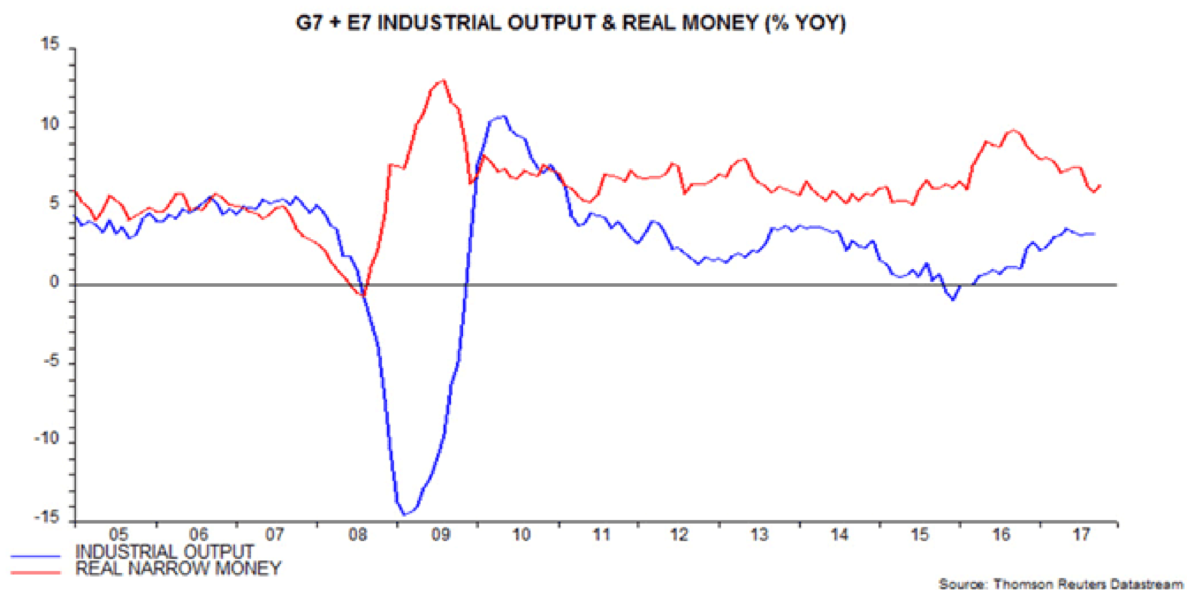
2018 economist's view: moderating growth and a squeeze on profit margins

Simon Ward, Chief Economist, argues that monetary trends are giving a less upbeat message for global economic prospects than a year ago, while labour markets may have reached an inflationary tipping point.

Markets face a less favourable economic backdrop in 2018. Monetary trends and cyclical analysis suggest that the global economy will lose momentum as the year progresses. Labour markets in the US and several other major economies, meanwhile, have tightened to an extent historically associated with a pick-up in unit labour cost growth. Faster labour cost growth would put upward pressure on core inflation and interest rates while applying downward pressure on profit margins.

The equivalent article a year ago predicted that 2017 would be a strong year for the world economy. Growth of the global real (i.e. inflation-adjusted) narrow money stock* typically leads economic growth by six to 12 months and had risen significantly into late 2016. In addition, the US stockbuilding cycle, which has a duration of between three and five years, had bottomed out earlier in 2016 and was entering an upswing phase. Prior troughs in this cycle in 2009 and 2012 were followed by robust US and global economic expansion over the subsequent year to 18 months.

Monetary trends are now giving a less upbeat message
Annual growth of global real narrow money has cooled since late 2016 and, at the time of writing, was back around its average level in 2014-15, as shown in the chart below.



The US stocks cycle upswing has further to run – inventories are low relative to final sales – but may peak in the first half of 2018. A reasonable expectation, based on these considerations, is that global economic growth will remain strong in early 2018 but moderate later in the year.

Could a loss of momentum develop into a recession? Current monetary trends are still consistent with respectable economic growth but a further slowdown into early 2018 would raise a warning flag for late in the year.

According to cycle analysis, a recession is unlikely in 2018 but a realistic prospect for 2019-20. Recessions typically occur when a downswing in the stockbuilding cycle coincides with weakness in one or both of the other two key cycles – the seven- to 11-year business investment cycle and the longer-term (15-years plus) housing cycle. All three cycles hit bottom in 2009, explaining the severity of the US / global recessions in that year.

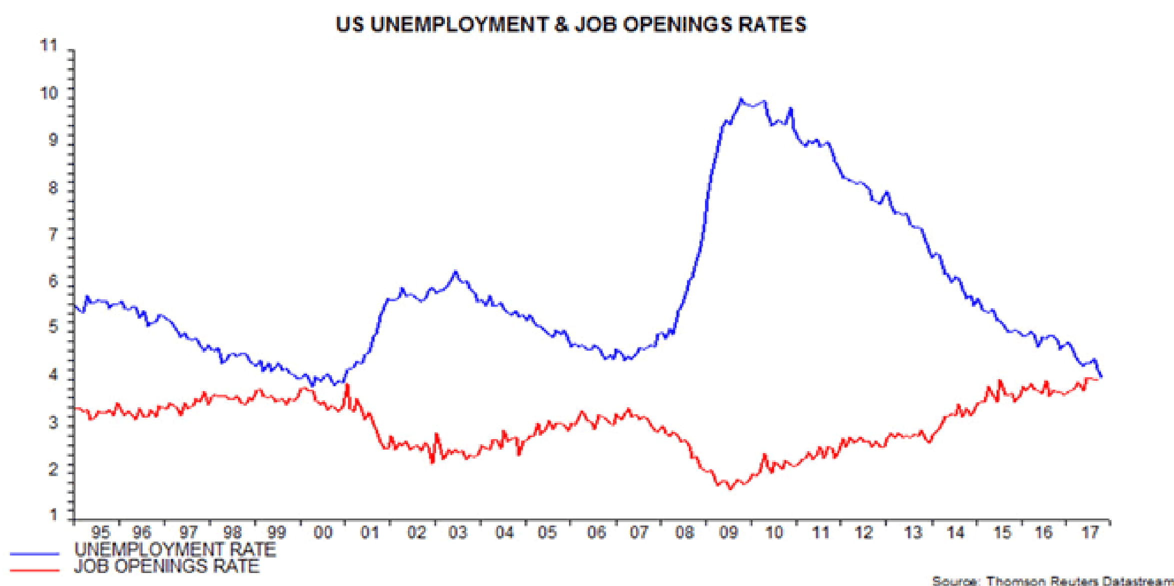
The last stocks cycle trough was in 2016 so another low is scheduled over 2019-21. The business investment cycle last bottomed in 2009 so is due to fall into another trough by 2020 at the latest. The longer-term housing cycle will remain in an upswing phase. Weakness in the stocks and investment cycles, therefore, could combine to produce a recession in 2019-20. Any recession would be expected to be of modest severity, reflecting support from the housing cycle and the relatively subdued nature of the current business investment upswing.

US and Japan to lead, China and Europe to lag?

Cross-country monetary trends at the time of writing suggest that a moderation in global economic growth during 2018 will be driven by China and Europe, with the US and Japan performing relatively strongly.

Global core consumer price inflation (i.e. excluding food and energy) was stable in 2017 despite strong economic growth. The consensus may be underestimating inflation risks in 2018, just as growth prospects were underestimated a year ago.

In the US, the unemployment rate fell to 4.1% in October 2017, close to a job openings or vacancies rate of 4.0% in September, as shown in the chart below.



The gap between the two fell below 0.5 percentage points on only four prior occasions since the early 1950s: 1955, 1965, 1972 and 1999. Annual unit labour cost growth picked up strongly over the subsequent year in all four cases. Labour markets are also historically tight in Japan, Germany and the UK.

Faster labour cost growth would boost core inflation while squeezing profit margins. Either would be negative for markets but the balance would affect the relative attraction of equities and government bonds. A scenario in which margins took more of the strain, for example, would imply deteriorating economic prospects and rising recession risk, suggesting support for bonds despite higher near-term inflation.

A simple investment rule that would have worked well historically is to switch from equities to cash if annual G7 real narrow money growth moves below 3% or falls by 3 percentage points or more over six months. While monetary trends have softened, neither condition has yet been met. The rule may provide guidance on whether and when to adopt a fully defensive investment stance in 2018.

*Narrow money = currency in circulation plus demand deposits or equivalent.

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