What I'm Watching?

Rachel Ziemba
February 12, 2018

The recent market selloff with its multiple linked triggers (inflation, fiscal expansion, past FX adjustment) and amplifiers (program trading, volatility funds and instruments, pricey valuations and desire to take profits in tax-mitigating way), seems a good time to take stock of the drivers of the macro and market environment going forward, to update you all on some of the themes/topics/opportunities I'm tracking in 2018 and beyond. Many of these are longstanding topics that have driven macro and market sentiment in recent years (trade policy, fiscal stance), some may be well choreographed (CB balance sheet adjustment, energy rebalancing), even if likely to be over-estimated as exits approach. Others warrant some additional consideration in a global context (infrastructure development and finance).

I touched on many of these in my 2018 look-ahead in November, and will be updating my views as the months go on. This framework may help me and others identify how the different themes interact. No doubt, new topics will emerge or some of these topics interact.

Bottom line: Macro environment in 2018 still looks set to be relatively benign, with a pickup in global growth, and greater synchronicity of major economies (as laggards begin to catch up). Looking ahead, policy uncertainty (around trade and FX policy) suggest challenges for business planning, and greater costs to consumers, contributing to a slowdown in global growth in 2019-20, suggesting profits should follow suit. Coupled with higher rates and greater competition for capital, debt servicing issues should come more into the fray as the end of expansionary monetary policy facilitates a closer look at sovereign and corporate fundamentals. County selection matters. Price pressures are still likely to be manageable, but greater issuance of debt and equity suggests profit outlook matters. In several EM/Frontiers expect government dominated or secured investment to retain its key place.

I'll talk more about risk scenarios in the days to come. I look forward to hearing about what I missed, what your signposts are and what scenarios you're preparing for.

Issue	Why we care?	Triggers, Signposts and Sub-factors to watch	Likely outcome
Trade and FX policy uncertainty (especially in Asia/North America)	Global trade outstripped global growth in 2017, reflecting the broader growth acceleration that was resilient to many political shocks. Will they do so in 2018 and beyond? Perhaps not if threats turn into actions (especially on tariffs) or as growth begins to moderate. In 2018, trade reviews launched in 2017 will need to be addressed.	- NAFTA, KORUS timeline, FTA progress – unilateral vs multilateral. - Plan B measures (eg CPTPP, EU-Japan etc) - Treasury FX report (April) – any willingness to impose trade sanctions - link to DPRK sanction and other policy (quid pro quo deals vs risk of escalation/Chinese banks)	Targeted tariffs and trade frictions likely to boost cost to consumers but massive policy changes unlikely. USD weakness and policy uncertainty may dampen U.S. import, only slightly helping U.S. growth (net exports) but little to global demand. NAFTA talks likely to drag on though 2018 and be an intermittent source of volatility across local markets

Infrastructure plans	Successful programs might redress underinvestment, reduce transport/logistics costs and increase resilience Funding structure can result in unsustainable debt service (watch BRI, ARG, GCC) -impact on metal demand, manufacturing, and labor. - may offset trend to intangible investment in DM and some EM.	-major projects in U.S. BRI, GCC (especially Saudi), Argentina -Link to low emission growth -link to inflationary pressure via local wage costs - government vs private sector involvement (local vs foreign), impact on other investment, debt vs equity finance vs fees - who provides imputs (materials and labor) – eg steel, cement etc (impacts feed through to local economy vs foreign suppliers contractors (political economy) - who sets institutions – legal, investment, procurement.	-focus on private sector financing likely to dampen actual investment growth (U.S.) - plans likely boost global fixed investment (vs consumption) but underdeliver. Only marginal rebalancing global economy. Chinese companies likely to benefit more from OBOR contracts etc than competitors.
U.S. /Global Inflation	Global economy has exited deflation and inflation is approaching target. If it rises more quickly it would entail sharper rate adjustments (driving short-end), while pricing in stronger growth. End of EM easing cycles as disinflation ebbs.	-wage growth -oil prices (especially in EM and US where taxes lower, distillate vs other product, links to theme on energy supply) - credit growth and availability, broad money (especially DM, China/Asia)	Moderate rise in inflation triggers 3 rate hikes this year… and compensatory rise in EM rates. Limited feed through to core inflation.
Relative Fiscal stance.	Sizeable increase in US debt issuance adds supply when global CBs provide less of a bid. Will it create greater pricing signals (more based on fundamentals)? Greater competition for capital	-local issuance plans - composition of U.S./other plans and impact on growth -fiscal multipliers based on coordination of macro policy, sectors of focus, propensity to spend. -countries with big issuance plans -	Sizeable fiscal position when economy already strong increases inflation risks and limits further growth reacceleration. Risk is shift to sectors with lower fiscal multipliers especially in U.S. as funds transferred to companies/others with less
Potential Transitions of power in EM/ prospect of policy change	Several key elections/power struggles are slated for 2018. While every year brings elections, the scale of some of the ongoing reforms or prospect of shift may be an issue. How much policy shift/impact on growth? How will In some cases (Mexico, Russia), relatively limited change is most likely and whether they will provide a more predictable environment for business.	- South Africa (Zuma exit standoff), Brazil (where nationalist Bolsonaro is rising in power), Mexico (AMLO in lead, with questions on continuity) - ongoing power consolidation/reform agenda: Saudi Arabia (aggressive foreign and economic policy stance). India (modi move towards majority, use of nationalism). Impact of anticorruption crackdowns. - sanctions policy and role in changing foreign behavior: Iran, Venezuela, Qatar, North Korea.	Many likely increase the risk of stagnation. Only a few places with meaningful policy change. These lack of policy change may have more impact in time of greater competition for capital and demand and as inflation edges up.

		Role of international consensus. Progress - Chinese policy stance – willingness to de-risk, policy shift	
Geopolitical Challenges (especially nuclear)	Military posture and challenges especially in Asia and Middle East can make it harder for businesses and individuals to plan. Increases in tensions and (still-new leaders) risks unintended escalation and accidents.	-status of Iran deal (renegotiation). Coercive policies and impact on investors. Global cohesion (divides between US and key allies may add uncertainties for investors, increase risk premia and exacerbate domestic political constraints. - role of government investors actors in offsetting impact of coercive policies (eg Europe/Asia support of interests in Iran. - DPRK talks – sanctions escalation - Russian challenges (in Americas etc)	NK issues remain a big wildcard as negotiation periods offset with sanctions tightening. Consensus on Iran, Russia, Venezuela sanctions is moderating suggesting uncertainty for business and higher risk premia, supporting sectors that can benefit from popular support.
Energy Fundamentals: balance and resilience?	After supply cuts, energy fundamentals are coming more into balance, reducing resilience to underlying supply shocks	Demand: consumer price elasticity (US, EM, impact of subsidy removal), policies (low emission etc. (link to EM policies, trade and infrastructure), fiscal stance of producers -Supply(shale price flexibility, coherence of OPEC+) - flexibility for fuel switching -related infrastructure buildout (pipelines) -impact on fiscal positions (less austerity in producers).	Likely to underperform market expectations of plus 70 (Brent). Volatility likely to remain high as demand and cost structure uncertain. US supply demand and OPEC+ to remain important. Coal still unfavored, natural gas glut partly absorbed.
CB balance sheet adjustment: Set to be a drag	CB bond purchases set to become negative in late 2018, reducing bid for risk assets.	-interaction with higher bond issuance and impact of new US corporate tax (move out of corporate bond portfolios) - Asian CB portfolios may compensate (link to FX issue). Impact of split between sovereign investors. - interaction with conventional monetary policy	Likely to interact with other themes to boost LT yields in a spiky volatile manner. End of super easy policy one of several reasons for synchronized global slowdown in 2019-20.
Digital/ crypto assets blockchain	Proliferation of digital assets and their volatility means they are too large to be ignored. 2018 likely to be a year where links to other assets come more into focus. Volatility undermines store of value.	-regulatory response from financial institutions and governments KYC, links to national security, closing sanctions loopholes, energy use.	- CB sanctioned digital assets (Asia) likely to take on more means of exchange role. - key place to watch in frontier markets where

		- links with other asset classes, impact of leverage, focus on transactions costs	other stores of value questionable.
Defense (spending)	Defense and security share of spending still rising in 2018 – lower fiscal multiplier. Increased risks and reactionism increase chance of escalation/military posture especially with Saudi/Iran proxy conflict and in East Asia.	-split between labor and equipment. Impact on exports for major producers -technology transfer and broader quality of investment	Geopolitical and regional risks suggest that defence share of spending likely to remain high or rise across many jurisdictions and it's a sector privileged for local production/technology transfer.