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2018 Economic Outlook
Real strength of the global economy challenged– can it justify soaring asset prices?

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Looking back to the global macroeconomic condition up to the end of October

1. Advanced economies remain robust, headed by the US that recovers from the summer doldrums

In the early summer, troubling indicators, like weak consumer spending, and a series of hurricanes cast a dark cloud over the US economy. It has since made a turn-around and is once again very robust. Consumer spending has also recovered, while capital investments and imports remain strong. 3Q growth was pushed as high as 3% SAAR, on the heels of 3.6% in the previous quarter. The current economic expansion is gradually approaching the longest period of growth in the post-World War II era. With all of this as background, US stock prices continue to set record highs.

The European and Japanese economies also continue to trend positive. The European PMI posted its highest levels since 2011, while Japan's Tankan survey revealed that among large manufacturers the business sentiment diffusion index (DI) is at its highest level in 10 years. Japanese stock prices have also soared to a 21-year high that now exceeds the post-bubble recovery levels. In both Europe and Japan, external and internal demand are on the move upwards, with internal demand being driven by consumer spending and investment.

The current strong economy may be underpinned by rising real estate and asset prices. These asset prices in turn sustain private consumption and investment. There may indeed be a rise in the potential growth rate if strong stock and real estate prices are in fact based on strong corporate earnings and a rise in rents (which are supported by sustainable real demand). Discussion over secular stagnation has become more prominent in the face of fears over the prolonged sluggishness in the economies of the developed world. However, strong corporate earnings would prove otherwise. As well, GDP statistics may not adequately reflect the growth associated with innovation.

On the other hand, many have pointed out that current asset prices are showing strong signs of a bubble, and that this same bubble may be the actual cause of the recent temporary economic strength. Looking to the CAPE (Cyclically Adjusted Price-to-Earnings Ratio, developed by economist Robert

Schiller) we can see that it has ticked up well beyond the bubble levels directly proceeding the global financial crisis. In fact, it is now fast approaching the post-Great Depression levels (Chart 1). In the US and Japan, the real investment in real estate to GDP ratio is reaching record highs. I am somewhat inclined towards the latter view that an asset bubble is underpinning the current, temporarily, robust economy.

<Chart 1> Cyclically Adjusted Price-to-Earnings Ratio (CAPE)

Source: Homepage of Robert Schiller

Meanwhile, prices have yet to budge. In the US, the unemployment rate has declined to 4.1% - as low as it was in 2001. However, the core PCE deflator (a price index on consumer spending favored by the FRB) is hovering around just 1.3%, and has recently started trending downwards. Similarly in Europe, the core HICP (a consumer price index favored by the ECB) remains slightly over 1% with no signs of upward movement. Japan's core CPI is currently increasing, but this can be attributed to soaring energy prices. As the price of household goods continues decline, the Japanese index is expected to stagnate following the end of 2017.

2. Central banks of major nations proceed towards the normalization of monetary policy

Price increases remain stagnant and the movement of the central banks of major advanced nations towards monetary policy normalization continues. At the FOMC in October, the FRB confirmed balance sheet reductions starting from November, and appeared positive about a rate hike in December followed by an additional three hikes in 2018. This stance reflects a view that the recent deflation is largely affected by temporary factors (although many elements as yet remain unknown), and that prices will certainly rise come 2018. Also, some see this rather hawkish stance as a sign of alarm at the ever rising stock prices, or as central banks scrambling to secure a margin for future monetary easing should the economy suffer a slowdown. The FRB is expected to retain this policy direction even when current FRB Governor Jerome Powell assumes his new post as chairman in February 2018.

However, the market's perspective on interest rates continues to diverge from the FRB's. While the prevailing view in the futures market is that a rate hike in December 2017 is over 80% likely, this same view anticipates only one or two hikes in 2018. Consequently, 10-year long-term interest rates hang low, around 2.3%, despite the assumption that federal funds rates will rise to just shy of 3% (should the rate hikes be executed in accordance with the FRB's current outlook). It would seem that the market view is that prices will not rise in the way predicted by the FRB. And thus, that same body will be unable to subsequently raise rates to plan. It is this market view on low interest rates which continues to sustain the current high stock prices.

As in the US, in Europe the ECB also decided at the October board meeting to scale back quantitative easing by reducing bond buying (known as "tapering"). This measure, to be implemented by September 2018, will cut the current EUR 60 billion per month purchase level by half. If this goes well, suspension of quantitative easing, balance sheet downscaling, and rate hikes may proceed around 2019. While price trends are also sluggish in Europe, the overall macro-economy is robust, and certain countries are eager to normalize their monetary policies as soon as possible considering that some bonds (e.g. German bonds) are in short supply. The BOE has also decided to raise interest rates at a policy meeting late October.

Meanwhile, only the BOJ continues to hold to its quantitative easing policies. The monetary policy framework was modified in October 2016, which directs the BOJ's focus away from "quantity" towards "interest rates." In fact, the BOJ has already begun tapering (the monthly bond purchases were decreased from JPY 80 trillion to JPY 60 trillion). However, the BOJ is still hesitant to promote "normalization" as a policy direction given that the current inflation trend is still weak. In the past, the BOJ once made a serious misjudgment and rushed to end quantitative easing to secure a margin for future monetary easing. These actions actually sparked an economic turndown. Additionally, the BOJ may be required to show "cooperation" with the Abe administration - which increasingly leans towards expanding fiscal expenditures. In this context, it should be noted that BOJ Governor Haruhiko Kuroda's term will expire in April 2018.

3. China moves to address imbalances

The Chinese economic growth rate continues its gradual deceleration. The 2Q GDP growth rate was 6.9%, with the 3Q at 6.8%. These figures alone might seem well within the margin of error to those accustomed to the data from developed countries. However, in the world of (somewhat pre-coordinated) Chinese statistics, this 0.1 difference can sometimes imply a grand policy agenda. In particular, real estate investment and production growth rates have recently been showing clear deceleration. However, this deceleration has been partly offset by continued strong consumer spending and public investment into infrastructure.

Slowing pace of growth in real estate investment and production are mainly due to the impact of monetary tightening, aimed at containing a housing and real estate bubble. Over a long period of time, the debt-to-GDP ratio in China has exceeded its trend. – on this point, both the IMF and the BIS have issued alerts to the Chinese government. Beijing is well aware of this situation – the PBOC governor have even stated that China is potentially facing a Minsky Moment (a sudden collapse of an asset bubble after a sustained period of growth). The Chinese government implemented monetary tightening through various measures, which successfully drove down the M2 growth to the lowest level since these statistics were released. Housing prices are similarly cooling down. As a consequence, however, public investment (particularly in real estate) is plummeting. The tangible fixed asset formation (capital investment) amounts to over 40% of the China's GDP growth, and was therefore critically impacted. Simultaneously, a number of plants that produce raw materials (e.g. low-quality iron and steel) and others with high environmental impact were forced to shut down. While these movements contribute to reducing the unworkable capital stock, they also deteriorate business sentiment, particularly among small- and medium-sized enterprises.

Upon the successful end of the National Party Congress, the power of the Xi administration seems to have been further reinforced. One of the most important issues for the administration now is to what depth and at what speed imbalance corrections (to address asset bubble and reduce excess capacity) should be executed. The government is reaching the limit of being able to depend on the infrastructure investments of local governments to sustain the current growth rate. The future trend of consumer spending, which remains as strong as ever, is one of the critical elements that will influence the government's stance.

Other emerging economies have been trending steadily robust, thanks to strong external demand, high resource prices, and internal demand stimulated by monetary easing. Lately, even countries with political instability (e.g. South Africa, Turkey, and Brazil) are experiencing stable growth while stock prices rise and foreign exchange stabilizes. These countries have established a solid institutional framework for macroeconomic policy management, represented by an independent central bank, which partially enables the decoupling of politics and the economy. The low level of the US long-term interest rate has also contributed to these favorable conditions.

4. Politics: The pendulum of the market sentiments continue to swing between the ecstasy of US tax reform and the agony of North Korean provocations

Political and geopolitical risk continues to have a large effect on the global economy. This is especially true of US politics, which is affecting the longevity of the current risk-on in the financial markets. A concreate proposal for the long-awaited US tax reform has finally taken shape and a budget proposal may be passed through congress by Republicans. In fact it is looking more and more likely that these matters may be settled by the end of the year. It certainly goes without saying that a permanent reduction of corporate taxes from 35% to 20% would have a huge impact on the US macro-economy. Conversely, it may also be the case that the current high stock prices are already reflective of such policy measures. It would therefore be wise to take such a reality into account, as was suggested by

US Treasury Secretary Steven Mnuchin when he stated that a failure to pass the above bill will have a large negative impact on stock prices that has already assumed the event be realized.

Turning now to the situation in North Korea, it seems that the hermit kingdom has recently backed away from is provocative actions. However, there is also the view that the "starvation tactics" of economic sanctions (which is now bolstered by China) are only now beginning to take effect. Time is now the main issue as North Korea slowly reaches the end of its foreign currency reserves, oil, and food supplies. Should North Korea be backed into a corner, what kind of reaction will this engender? As well, how in-sync will the US-Chinese response be to such actions by North Korea? I believe it is actually quite difficult to imagine a scenario where North Korea is so beaten down that it raises a white flag in surrender. Should this come to pass, such a situation will also have a large impact on the course of the current risk-on in the markets.

Finally, turning to Japanese politics (which were noted with some trepidation in the previous article), Prime Minister Shinzo Abe has won a decisive victory in the recent general election. Previous concerns that the opposition parties would reorganize around the Party of Hope did indeed come to pass, but said party's election tactics were a failure. Digging deeper, we can see how such a large victory for the ruling party has brought stability to Japanese politics. However, should the current administration has sacrificed structural reforms for a constitutional amendment and continues with its loose fiscal policy. In fact, the mid to long-term risk that Japan must eventually confront may have only gotten larger.

5. **Re-cap of 2017: Events unfolded largely as predicted but with no change of the situation where a risk-off trigger events could easily set off a massive turnaround**

The global economy has largely followed the predictions made in the previous edition (published at the end of July, 2017). Overheated stock prices and the longevity of low long-term interest rates were slightly different than predicted, but their directions were still in line with our expectations. Regarding Japanese political risk, the results of the election and the strengthening of the Abe administration were well outside previous predictions.

Additionally, we also suppose that the situation laid out above may be unsustainable in the long term. In other words, this situation persists only because no trigger events occurred to address or correct mounting imbalances. Therefore when making an economic outlook for 2018, it is imperative to consider when and what kind of trigger could tumble this unsustainable situation, and what is the likelihood of such an event occurring?

Outlook for the year ahead

1. **Four trigger events to break the current risk-on trend**

The current risk-on trend is based on several factors – 1) strong consumer spending and investment based on high stock prices, policy expectations, and low prices in developed countries; 2) high economic growth sustained by government policy in China; 3) the steady growth of emerging economies underpinned by stable external demand and low US interest rates. If these conditions persist, the existent robust economy and rising asset prices will carry on. If any of the factors collapses, however, the situation might deteriorate to where the moderate growth of the global economy or asset prices largely wind back and this therefore poses a systemic risk.

Toward 2018, the principal trigger events that could undermine the current risk-on trend are; 1) growing disappointment and political confusion concerning the US government's inability to implement policies such as tax reform, 2) further development of economic adjustment policies in China, 3) rising prices in the US, and 4) outbreak of military confrontation with North Korea.

2. Growing disappointment and political confusion concerning the US government's inability to implement policies such as tax reform

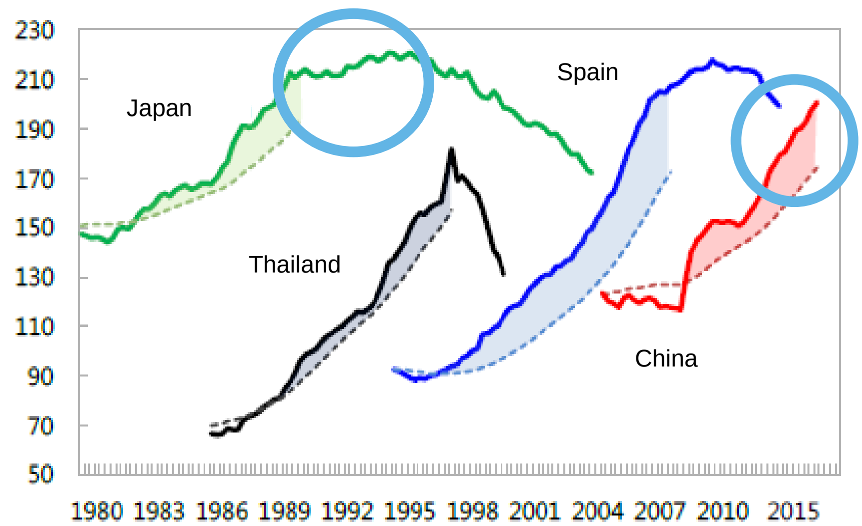
The failure of the US tax reform is still a reasonably likely scenario, even after the draft budget was approved, although the tax reform bill only requires the Senate's approval. The Republican party traditionally emphasizes fiscal discipline and many have voiced concerns in protest over the drastic corporate tax reduction and its consequent fiscal deficit. While discord continues between the Trump regime and the GOP, it may be less than previously supposed if Republicans can come together and break the current impasse.

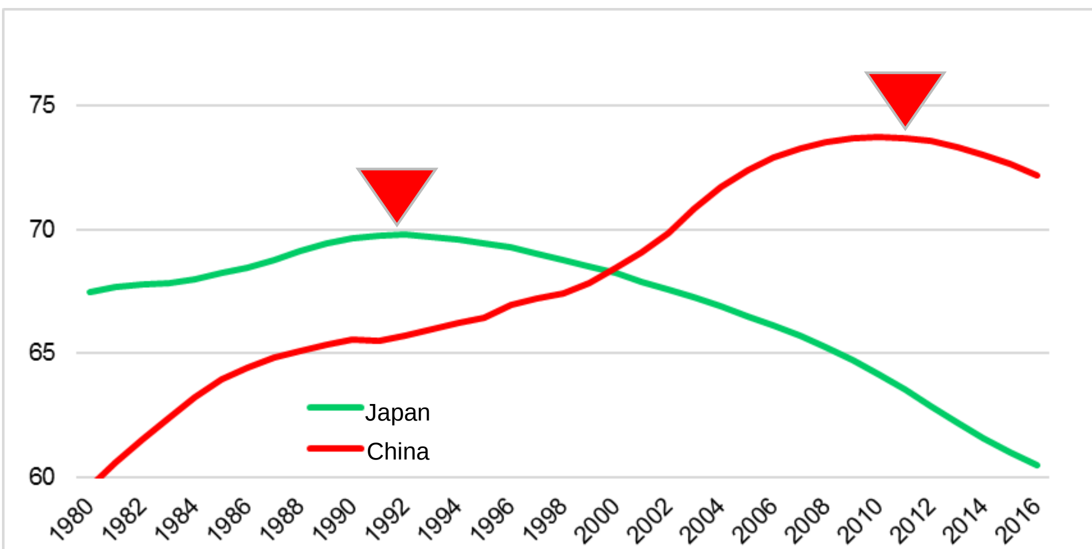
Nonetheless, even if tax reform legislation fails to pass, the risk-on trend may not completely wind back. This is because substantive economic expansionary policies have already been put into place through monetary easing. Therefore, the impact might simply be a moderate adjustment of asset prices (gradual deceleration in growth). My subjective prediction of the probability for this scenario occurring within 2018 is roughly 30%.

3. Further development of the economic adjustment policies in China

The economic adjustment policies in China, if pursued further, would bring the largest impact on the global economy. With a working age population that peaked out a few years ago, the Chinese economy stands in the headwinds of a rewinding demographic bonus just like Japan's did in the early 1990s (Chart 2). In Japan's case, people failed to move away from a mindset based on the demographic bonus the country had enjoyed for several generations. A gap continued to grow between the grand expectations for the future economy and the reality of a demographic bonus that had already turned into a burden. This devolved to the point where it led to formation and rupture of an asset bubble, and consequently the two "lost decades" following poor policy measures.

<Chart 2>
(Upper) Shift in debt-to-GDP ratio and gap from trend lines (dotted lines)
(Lower) Proportion of working age (15 to 67) population in total population





Source: (Upper) BIS, IMF / (Lower) the United Nations

Caught in the midst of the headwinds of a shrinking working age population, China today seems to be opting for similar policies to the Japan of the past: gradual capital stock adjustment, leaving (potential) non-performing loans untouched, sustaining high stock prices by public interventions, and boosting economy by fiscal policy. If the Chinese government truly believes the current situation to be a Minsky Moment, it would be no great surprise for them to move towards new lower, but sustainable growth, rates on a mid- to long-term horizon at the price of short-term pain. However, once this policy direction is seen as serious by the market, this could spark wind down of the ongoing risk-on trend and also fumble those who have benefited from China's rapid growth (e.g. emerging economies and Japan). The probability for this scenario occurring is also about 30%.

4. Rising prices in the US

The possibility of rising prices in the US must also be monitored very carefully. Even if the market still strongly doubts this possibility, one should not discount that it is "the best and brightest economists" at the US FRB who believe strongly that prices will soon rise rapidly. So long as the bond market does not support the FRB's view, long-term interest rates will be kept low and high stock prices will be warranted. Should this view be suddenly overturned, however, long-term interest rates will spike upwards and stock prices will plummet.

The strengthened financial system of today is not as vulnerable to an asset price correction (where the systemic risk leads to a large decline in the real economy) as it was during the global financial crisis. However, we now have other new vulnerabilities in the global economy that need to be watched carefully. One such vulnerability is the debt piling-up in emerging economies after the previous crisis. This debt could be turned into a series of defaults should a global risk-off trend occur. Thus, together the debt and defaults could spark a major decline in these economies. The probability of such an event occurring is about 20%.

5. The break out of military conflict connected to North Korea

The impact of this last trigger, a military clash between North Korea and the US/South Korea, could be devastating to Asian economies - particularly to South Korea but possibly to Japan as well. And in this case, the current risk-on trend would, at least temporarily, wind-back significantly. However, the actual size of the impact on the global economy is quite hard to imagine given so many uncertain factors. Considering that the North Korea might finalize its ICBM within the year, and also that the Trump administration will face the mid-term election in November 2018, the probability of this scenario is not nothing, but is perhaps around 5%.

6. Summary of scenario probabilities

The simple sum of the aforementioned scenarios amounts to approximately 85%. Considering the correlation among the scenarios, I conclude that 1) the scenario of moderate stock price adjustment / gradual deceleration in growth is about 30% likely, 2) the scenario of drastic asset price adjustment and severe economic downturn are also 30% likely, and the reamaining 40% lies in 3) the scenario of the continuation of the current risk-on trend. 2018 could be a highly uncertain year. The market and the corporate sector therefore need to prepare for two extremely opposite scenarios at once: an overheated market, and/or its collapse.

In this uncertain world, one thing that does remain certain is that the current overheated market is not sustainable in the long run. 2018 (10 years post the global financial crisis) might be remembered as a year when the market and policymakers once again believed (and then was betrayed) that “this time is different”.

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