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GLOBAL MACRO OUTLOOK • MARCH 2018

Macro uncertainty on the rise



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We see greater economic uncertainty ahead after a stretch of unusual calm. Hefty U.S. fiscal stimulus brings positives but also a wider array of possible outcomes – especially the risk of overheating and an inflation overshoot. Stronger capital spending and productivity growth can spur upgrades to potential growth and contain any overheating, yet such an outcome is far from certain and will take time to materialise. On top of these unknowns, US trade protectionism could mark a major reversal in the US-led opening up of global trade over the past 70 years. Trade wars would chip away at a core pillar of the post-war economic architecture. Confidence plays a big role spreading the growth benefits of open trade, we find. Protectionism is an important risk to the outlook for growth and inflation – with implications for financial risk premia. Highlights:

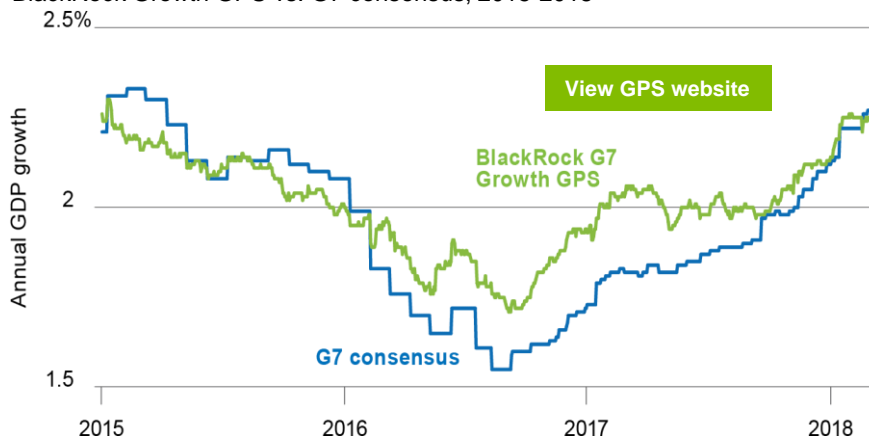
- The one-way opening up of global trade is under threat. Understanding trade’s role in growth spillovers helps break down the risks. We find swings in global trade activity tend to be determined by investment – and greater developed market (DM) investment spurs emerging market (EM) export growth.
- Trade is important, but its influence on global growth goes beyond the physical exchange of goods and services. Sentiment plays an outsized role: The confidence channel tied to trade serves as the conduit for shocks to spread across countries.
- Confidence manifests itself in the safety premium we have described in core government bonds – with implications for the term premium in long bond yields and the US dollar (USD). The USD’s recent behaviour seems dominated by broad risk appetite.

Growth GPS: Consensus catches up

The [BlackRock Growth GPS](#) for G7 economies is holding at levels that point to above-trend growth, but consensus expectations have inched above the GPS. We see the robust absolute levels of the GPS as more important for the growth outlook. Solid US and eurozone growth can help offset possible cooling in China.

Economic snapshot

BlackRock Growth GPS vs. G7 consensus, 2015-2018



Sources: BlackRock Investment Institute, with data from Bloomberg and Consensus Economics, March 2018.
Notes: The GPS in green shows where the 12-month consensus GDP forecast may stand in three months’ time for G7 economies. The blue line shows the current 12-month economic consensus forecast as measured by Consensus Economics.

Champion no more?

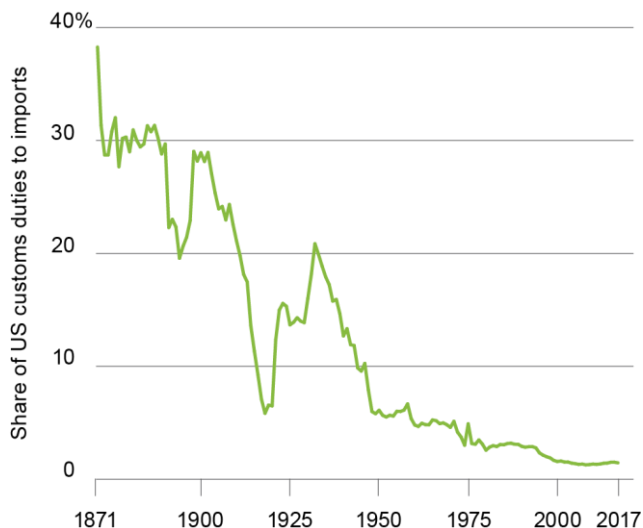
The risk of a trade war is front and centre. This month's US tariffs on steel and aluminium – and planned tariffs on China – are targeted. Yet they are prompting calls for retaliation. In our January [Global macro outlook](#), we laid out how a global economy deeply integrated via trade can help keep the US expansion from overheating. That is now coming under attack from an increasingly protectionist US – the champion of free trade in the post-World War Two period. The *Open doors* chart below shows how the US slashed trade barriers over the past century by cutting import duties. The last notable increase came with the infamous Smoot-Hawley Tariff of 1930 that slapped tariffs on more than 20,000 products. That is why the White House's more aggressive and transactional approach, counter to the rules-based system the US helped set up, is so worrisome – even as other countries press ahead with free trade deals such as the Trans-Pacific Partnership.

Trade helps redistribute demand across regions and limits inflation pressures from heating up in any one region. What drives global trade ups and downs? We find that trade is more sensitive to investment than consumption in DM economies. This happens through capital spending. The *Knock-on effects* chart at right shows the elasticity of EM exports to DM capex. A positive 1% shock in DM capex leads to a 0.4% increase in EM exports – about twice what it was in the mid-2000s, as the orange arrow highlights. The bands show the result is significant even allowing for potential statistical error. This is global integration at work. We find little such sensitivity of EM exports to DM consumption.

Capex drives trade, consumption less so. Consumption is mostly about services, and services tend to be more local than global. Capex is all about goods. We indeed find that world trade growth is mainly driven by the machinery component. Open trade makes global supply chains viable, allowing them to upgrade and re-tool at multiple points across different countries.

Open doors

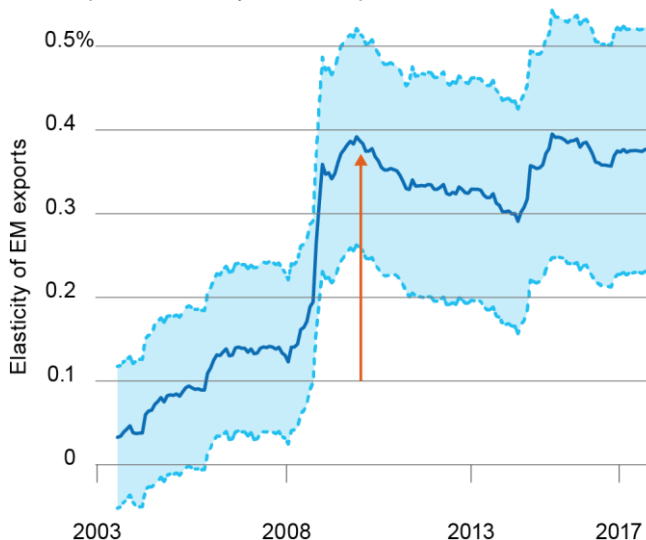
Share of US customs duties to imports, 1871-2017



Sources: BlackRock Investment Institute, with data from the US Bureau of Economic Analysis and the National Bureau of Economic Research, March 2018. Notes: This chart shows US federal customs duties as a share of total imports.

Knock-on effects

EM export sensitivity to DM capex shock, 2003-2017



Sources: BlackRock Investment Institute, Netherlands CPB, US Census Bureau, German Federal Statistics Office, Japan Cabinet Office, with data from Haver Analytics, March 2018. Notes: This chart shows the estimated cumulative percentage change in EM exports 12 months following a 1% rise (or fall) in DM capex demand. The estimates are derived from a vector autoregression of DM capex growth, consumption growth and EM export growth on a rolling 10-year period. The bands represent 2 standard deviations from the result: The estimated impact is still positive even when accounting for this potential error.

Capex connection

Looking back, we can better understand why the hefty investment declines in 2008-09 (global financial crisis) and 2015-16 (oil and commodity plunge) dealt sharp blows to global trade activity, with USD strength also playing a role. This also explains why strong DM consumption growth in the latter period contributed less to a revival of global trade.

DM capex is enjoying an upswing and EM exports have bounced back in the past year, showing this dynamic in action. This is on top of the lingering investment shortfall we have found previously in both the US and eurozone, suggesting there is pent-up demand for capex that should reinforce the rebound. Strong export data for South Korea and Taiwan at the start of 2018 suggest this is playing out. China is a big part of this story – about half of its goods exports are machinery and equipment, and it is by far the largest such exporter of such equipment in EM Asia.

The threat from protectionism casts a shadow over this dynamic. The chart above shows that if global integration were to slip back to the levels seen in the mid-2000s, the EM export boon from DM capex would shrink by half. Such a disruption has the potential to weaken EM growth while stoking more overheating and inflation in cyclically advanced economies – especially if rising trade barriers mean less DM demand leaks abroad via imports.

Trade is important – and yet its influence on the strength of economic linkages between countries goes beyond bilateral activity. We find a very large global co-movement in growth. A simple example: Using the IMF's [GPM6 model](#) on cross-country linkages, we see that a 1% shock to US GDP leads to a 0.7% increase in eurozone GDP. Yet eurozone exports to the US are a tiny share of GDP. Even assuming a very high level of US import elasticity, the full effect can't be accounted for.

The confidence channel

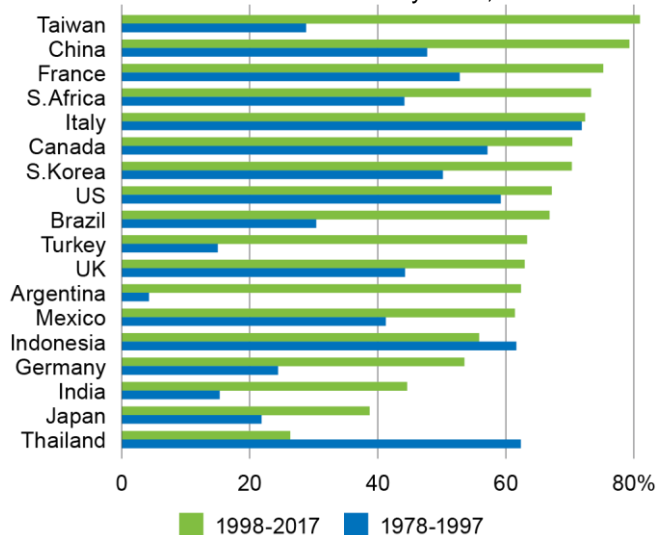
What explains the strength of these GDP interlinkages between different economies besides trade? The *Much in common* chart below shows how much of the co-movement of 18 of the largest DM and EM economy growth rates can be explained by a common global factor rather than a country-specific one. Somewhat surprisingly, about half of all the individual country variance can be explained by a *single* common factor. We break the past 40 years into two 20-year periods – the latter coincides with the latest bout of globalisation, such as the European Union’s expansion and China’s inclusion into the World Trade Organization. For many countries, the common factor influence has increased remarkably to explain 60-80% of GDP growth shifts. Thailand’s exception reflects how the 1997-1998 Asia crisis became the global factor.

Confidence matters a lot for this common factor. In a [2012 paper](#), Barsky and Sims show that “news shocks”, or changes to expectations about future growth from new information, have notable effects on consumption. More recent literature, such as this [2018 paper](#), confirm the confidence channel’s importance and that the co-movement captured is not just driven by common factors. This fits with [our view](#) that the hit to animal spirits dulled corporate investment in the 2015-2016 period and hobbled global trade activity.

Confidence serves as the conduit for shocks to spread across countries. Growth conditions are shaped by animal spirits. That makes protectionism a bigger danger to the growth prospects of many countries, going well beyond the direct impact of simple bilateral trade exposures. Protectionism can hurt sentiment and growth via both the trade and confidence channels.

Much in common

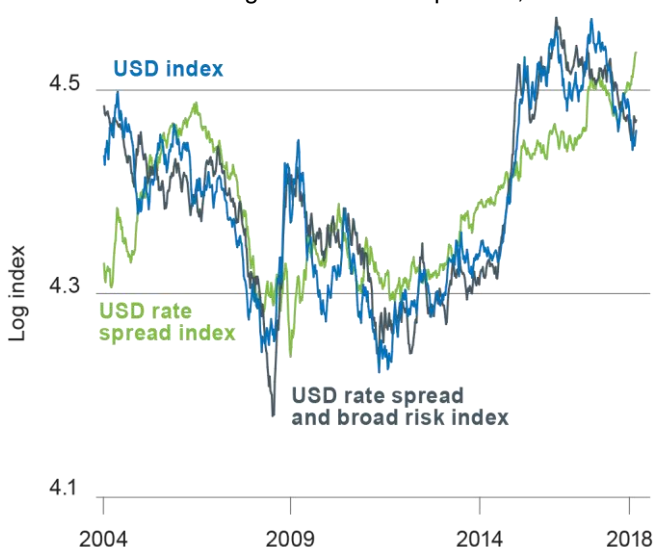
Common factor influence on country GDP, 1978-2017



Sources: BlackRock Investment Institute, with data from the World Bank and Thomson Reuters, March 2018. Notes: This chart compares the influence of common factors on the GDP profiles for 18 of the world’s largest economies. The estimates are derived from a common factor that explains GDP growth for the countries over a 40-year period divided in two to highlight how the common factor has evolved. For example, in 1978-1997 only 5% of Argentina’s GDP could be explained by factors common to the GDP trends in all 18 economies but from 1998-2017 that jumps to above 60%. When excluding data from crisis-related volatility of 2009, the 1998-2017 results show the same common factor strength.

Risk seeking

US dollar trade-weighted index and proxies, 2004-2018



Sources: BlackRock Investment Institute and Federal Reserve, with data from Bloomberg, March 2018. Notes: This chart shows a log index of the trade-weighted US dollar against major trading partners (Fed version) in the blue line and two other versions. The green line shows the level of the USD index implied by rate spreads based on a regression of US yields spreads with major trading partners. The dark line shows the level of the USD index implied by yield spreads plus a basket of risk proxies – our estimate of the term premium in long-term US Treasuries, eurozone peripheral spreads and oil (representing commodity prices).

Risk and the USD

Financial conditions are a prime transmission mechanism for changes in confidence. Common factors apply to financial markets as much as economic growth. A [January 2018 IMF](#) paper shows that about 40% of the variation in individual country financial conditions can be explained by global financial conditions. We have previously discussed how core government bond markets have become [more integrated](#), partly due to global savings seeking the perceived safety of these government bonds. The term premium – or the extra yield investors demand for holding long-term debt – reflects the waxing and waning of this [safety premium](#). Demand for perceived safe havens means money flows into long-term Treasuries, holding down the term premium while pushing up the USD. On the flip side, reduced demand for perceived safe havens should mean higher long-term yields via the term premium, a weaker USD, relaxed financial conditions – and heartier investor confidence to take risk.

The factors driving exchange rates are ever-shifting in importance and intensity. For now, the risk mood seems to matter more for the USD. The *Risk seeking* chart shows the trade-weighted USD versus two proxies: one based on yield spreads alone and another including other risk gauges. The USD is currently much weaker than would be implied by yield spreads alone. Our work also finds that USD swings not explained by rate spreads tend to correlate with the term premium – a representation of risk sentiment.

Bottom line: We see heightened macro uncertainty ahead and the potential for higher risk premia across assets. An escalating trade war can create widespread damage through the confidence channel. This may renew a safety premium in core bonds that pushes down the term premium, lifting the USD and other assets that benefit from risk-off markets. Yet perceptions of safety can change – even for US assets.

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