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The secular stagnation that never was?


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US fiscal stimulus will fuel a faster global expansion – we see it adding about 1 percentage point to US growth in 2018 – yet it also raises the risks of the US overheating and swelling budget deficits, as we laid out in our last *Global macro outlook*. Markets are waking up to this change, with bond yields surging and equities suffering a brief swoon. How markets further adapt to these developments depends crucially on potential growth. We see two reasons why potential growth may get upgraded – even if it stays well below pre-crisis estimates. First, potential growth may be higher than is widely assumed. The sluggish post-crisis expansion has made the cyclical headwinds appear structural in nature and lent credence to secular stagnation arguments for permanently low growth. Second, robust technology spending and a budding recovery in business investment should revive productivity growth. Highlights*:*

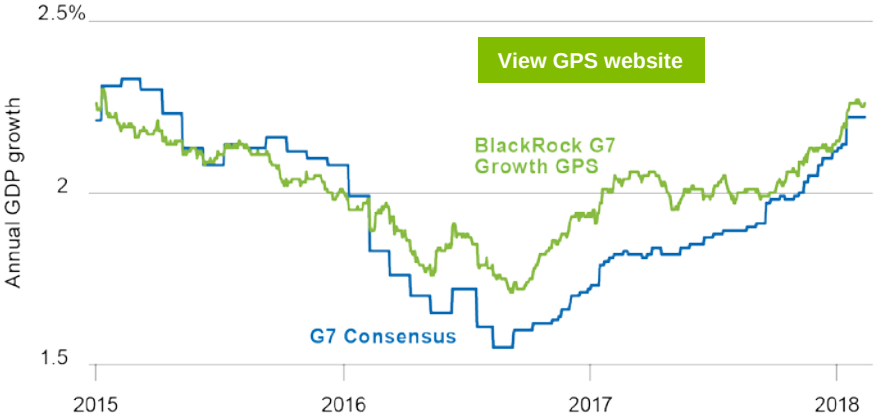
- We find that estimates of potential growth are sensitive to cyclical conditions. The snail's pace of the recovery made it harder to separate cyclical from structural forces – and the cyclical drags were interpreted as permanent damage. Estimates and perceptions of potential growth may now turn more positive as actual growth enjoys a sustained acceleration.
- Productivity – an important driver of potential growth – has not kept pace with solid spending on research and development (R&D), implying pent-up gains that may soon be realised. Global integration also fosters productivity growth.
- Better long-run growth should further lift real yields. Equities can still do well: Improved growth should also boost earnings in tandem, while abundant global savings should limit how high yields go.

Growth GPS: US leads the pack

The BlackRock Growth GPS for G7 economies is being led by strength in the US. Consensus views have mostly caught up with the GPS on expected US fiscal stimulus. In Europe and Japan, the consensus runs slightly above the Growth GPS, but both are at elevated levels signalling robust, above-trend growth.

Economic snapshot

BlackRock Growth GPS vs. G7 consensus, 2015-2018



Sources: BlackRock Investment Institute, with data from Bloomberg and Consensus Economics, February 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.

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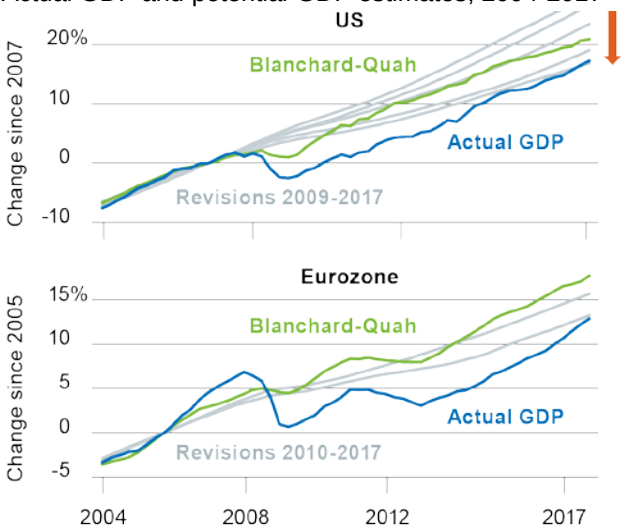
Measuring potential

Gauging the degree of overheating in an economy – or how much output is running above full capacity – depends on your view of potential growth. Since the crisis, cuts to potential growth have been an annual exercise. We believe this is largely warranted due to overly optimistic views of trend growth pre-crisis and global demographic changes. Yet the downward revisions appear overdone. Potential growth estimates are sensitive to cyclical swings: We find that changes in the CBO's estimates co-move with surprises in actual GDP. The long, slow recovery after the Great Recession made it harder to distinguish cyclical from structural factors. That perhaps gave too much credence to secular stagnation arguments of an economy persistently stuck with spare capacity. Excessive pessimism about potential growth would help explain why inflation has been subdued in recent years. The landscape has now changed. With actual GDP picking up and fiscal stimulus kicking in, potential growth may earn an upgrade.

An upward revision to US potential growth would give the expansion a longer lifespan by containing the degree of near-term overheating and inflation. How much slack could there be? An October 2017 paper by Coibion et al. finds that a technique developed by Olivier Blanchard and Danny Quah in the late 1980s better estimates potential growth than the most widely cited measures. This is achieved by cleanly separating transitory and supply-driven shocks. The *Stagnation fears in action* chart below compares published potential output estimates with Blanchard-Quah's. The latter shows a sizable output gap remains: up to 3% in the US and 4% in the eurozone. We are sceptical the output gap could be that large. Potential growth is not observable and is tricky to gauge in real time: Historically, overheating was underappreciated at this point in past expansions. Yet we believe the potential growth downgrades have gone too far this time.

Stagnation fears in action

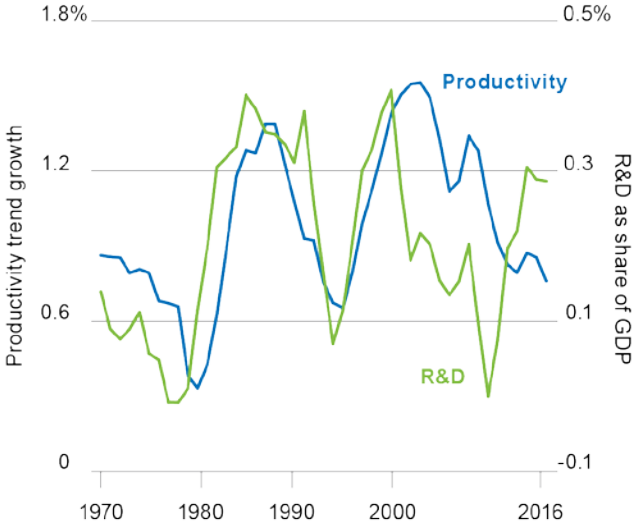
Actual GDP and potential GDP estimates, 2004-2017



Sources: BlackRock Investment Institute, with data from the Congressional Budget Office, International Monetary Fund and Thomson Reuters, February 2018. Notes: The charts show actual GDP in blue and potential output estimates for the US (CBO) and the eurozone (IMF) in grey. We anchor each estimate of potential output by showing it as a percentage change since the output gap closed in the prior cycle: 2007 for the US and 2005 for the eurozone. We add a potential output estimate derived from the Blanchard-Quah methodology.

Puzzling split

US productivity and R&D spending, 1970-2016



Sources: BlackRock Investment Institute, with data from the Bureau of Labor Statistics, Federal Reserve, Bureau of Economic Analysis, National Science Foundation and Thomson Reuters, February 2018. Notes: The chart shows the sequential growth rate of multi-factor productivity as reported by the BLS and smoothed by the Fed. R&D spending is a 10-year change relative to GDP.

Pent-up productivity

Potential growth is determined by labour supply, capital deepening and productivity – and productivity trends are shaped by investment in innovative technology.

US companies have deepened investment into R&D – especially tech – even as the recovery in capital spending has lagged. The current ratio of R&D investment to GDP is 10% above tech-bubble highs. The *Puzzling split* chart shows multi-factor productivity has mostly tracked the 10-year change in that R&D investment ratio over the past half century. But in the post-crisis period, productivity has failed to keep pace.

This is one of the big economic puzzles of the day: Why is productivity growth so meagre despite the ongoing tech revolution? In a May 2017 paper, Byrne & Corrado estimate that overall investment in tech should have boosted productivity in recent years by as much as 1.4 percentage points per year. Yet a big chunk – 1.1 percentage points – was unrealised despite the greater diffusion of tech into other economic sectors (cloud services, for example). Byrne & Corrado suggest these productivity gains are pent-up due to temporary factors that may fade as the expansion progresses. These include: 1) the Great Recession's hit to output and the subsequent slow recovery held back these productivity gains, and; 2) the costs from adapting to fast-changing technology offset the benefits. A separate explanation? Productivity is being mismeasured, a topic we have previously addressed.

The US tax overhaul lifts expected returns on capital via lower tax rates and the immediate capex expensing. We use the Federal Reserve's main model, FRB/US, to quantify the stimulus' possible effect. We find that the overall stimulus could increase US potential growth by 0.15 percentage point per year over the next five years via higher labour productivity. The end of capex expensing in five years should see that tiny potential growth pickup fade.

Shared know-how

Productivity growth is not just a domestic story. An important driver of stronger productivity is free trade across developed (DM) and emerging markets (EM).

The gains can be sizable. A March 2016 IMF working paper shows a 1 percentage point cut in input tariffs lifts productivity by 2 percentage points. This reinforces the message from several academic studies: Greater trade openness leads to improved long-run productivity.

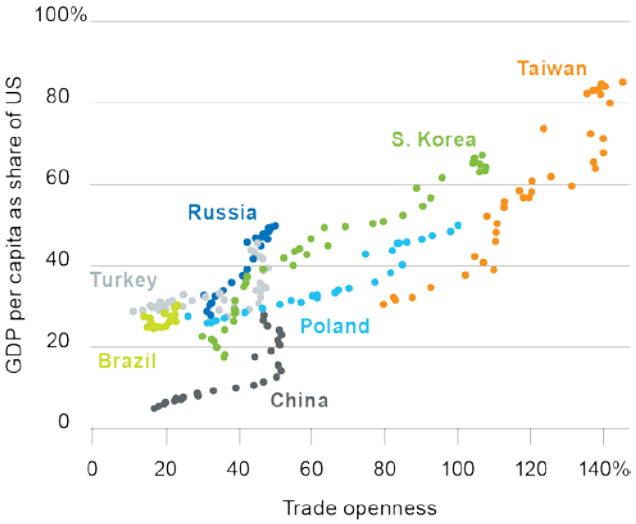
Openness spurs more efficient use of resources in different ways. Increased specialisation means labour and capital are channelled into the most productive and profitable sectors. When companies compete internationally, they pick up know-how on new technologies, invest more in productivity-boosting tech and are forced by foreign competition to step up their game and become more efficient. New technology has historically originated in DM and spread to EM through these linkages.

The *Path to riches* chart shows the relationship between trade openness for some EM economies and their level of economic development (per capita GDP relative to the US). There is a strong link between opening up and the productivity-driven progress that takes EM economies towards the DM frontier. Taiwan and South Korea epitomise this. China's experience since the crisis is an exception: The chart shows a kink starting in 2008 as growth became more homegrown, led by investment, after its initial export-led boom in the 1990s and 2000s.

The global economy has never been as integrated during an expansion. This allows the growth impulse from US fiscal stimulus to spill over to other regions, with the demand boost leaking abroad via bigger US imports. That's why protectionism represents a double threat: it hampers a key driver of productivity and the short-term growth spillovers from an upswing in any one region.

Path to riches

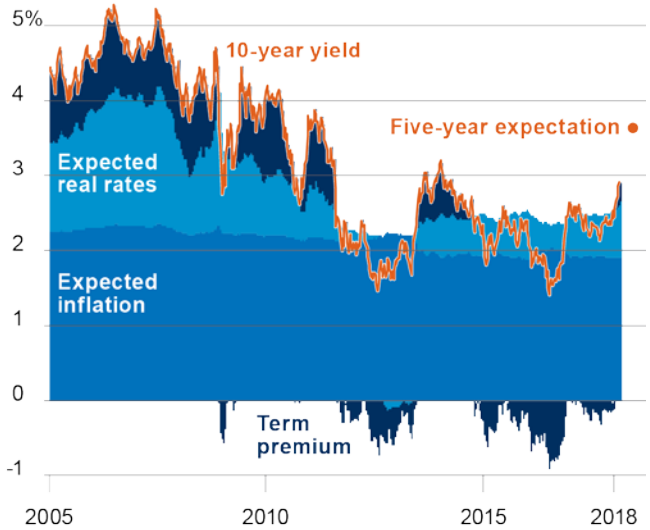
EM trade openness and development, 1980-2017



Sources: BlackRock Investment Institute, with data from OECD, World Bank and Thomson Reuters, February 2018. Notes: This chart compares the annual trade openness of select EM economies and their GDP per capita relative to the US in that year. Trade openness for each country is defined as real exports and imports relative to GDP. The start year for each country varies based on data availability.

Yields also rise

US yield drivers and five-year expectation, 2005-2018



This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise – or even an estimate - of future performance. Past performance is not a reliable indicator of current or future results. Sources: BlackRock Investment Institute, with data from Thomson Reuters, February 2018. Notes: The chart shows an estimated decomposition of the 10-year US Treasury yield based on market pricing of expected inflation, expected real rates and the term premium. The term premium is based on a model similar to Andreasen et al. (2017). The orange dot on the right marks our expectation for the 10-year Treasury yield at 3.6% in five years.

Embracing stronger growth

The quick run-up in US Treasury yields in the past few months was initially tied to rising inflation expectations – an adjustment we thought was long overdue given the market's overly pessimistic pricing of disinflation risks. But the bigger story is what happens to real yields as the market digests heftier budget deficits and possibly higher long-run growth expectations. If potential growth does accelerate, overheating and inflation will be more contained.

The *Yields also rise* chart breaks down the 10-year Treasury yield into its underlying drivers. The latest surge is mainly about higher real rates: The market is embracing a higher real neutral rate over the long run due to a brighter growth outlook, a far cry from the secular stagnation story that played a role in driving down yields in 2011-2012. Bigger US fiscal deficits also represent the first swelling of government funding needs since the immediate crisis response. We could see yields push even higher on expectations for more robust growth. Yet we see limits to how high yields could climb. We see potential growth staying below pre-crisis levels due to demographic changes. Even with the heftier deficits, substantial global savings are putting a safety premium on core sovereign bonds, holding down interest rates and term premia, in our view. That means yields can climb further but settle well below pre-crisis levels. Our capital market assumptions put the 10-year Treasury yield at 3.6% on a five-year horizon.

The bottom line: Risk assets may wobble while adjusting to a world where yields also rise – but they can still do well. Stronger growth will lift company earnings and help offset a higher discount rate. The risk? Yields surge in a move unrelated to the growth outlook, such as a spike in the term premium or market fears of aggressive monetary tightening.

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