DUFF & PHELPS
Real Estate Advisory Group

Steady Growth (for the Moment)

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The judgment expressed in the last quarterly note, namely that "the world economy continues to expand at a healthy pace, buoyed by strong growth in most emerging markets and by steady growth in most advanced economies" remains broadly valid. In the emerging world the favourable picture has changed little. In the OECD countries, if anything, growth this year looks more robust, with a forecast upgrade for the United States. 2019 and 2020 should see further expansion, but at a decelerating rate. This year, in other words, may be seeing the peak of the cycle.

In most emerging markets conditions look relatively benign. Despite rising U.S. interest rates and large levels of external debt, exchange rates against the dollar have hardly budged. Inflation seems also contained, particularly in Brazil and Russia, and monetary policy remains broadly accommodating. Chinese growth is also solid and the fears of a debt-induced hard landing have gradually receded. Should a trade war with the United States emerge (on which more below), then China, but also other East Asian countries, would undoubtedly suffer. Rough simulations suggest, however, that even in a worst case scenario, China's GDP growth over 2018-20 would be curtailed by not much more than 1½ percentage points.

America's economy has picked up speed. Some of this reflects inherited momentum from earlier trends. Some is a consequence of the recent incautious fiscal package centred on regressive tax cuts. A further injection of demand is now likely following the increase in government expenditure that was approved by Congress. The fear is that demand pressures will increase and that inflation will take off given the present very low rate of unemployment. This, in turn, would prompt the Federal Reserve to raise interest rates more aggressively, thus endangering growth prospects (and Wall Street). Yet, inflation so far has remained relatively subdued and there may be more labour market slack than suggested by the unemployment data given that the labour force participation rate is still well below what it was before the "Great Recession".

The more worrying trend is America's turn towards protectionism (possibly the biggest cloud on the world horizon). This began with the imposition of tariffs on imports of washing machines and solar panels, continued with further tariffs on steel and aluminium imports, was followed by, as yet, not fully specified threats to some $ 150 billion worth of U.S. imports from China, and might even encompass restrictions on European exports and a withdrawal from NAFTA. Judging by early Chinese reactions, this could easily lead to a trade war and trade wars, contrary to some people's opinion, are "not good" and "not easy to win". History shows that everybody loses from such events, even large and powerful economies like the United States. Rough simulations of what protectionism and retaliation by China (as well as a NAFTA withdrawal) would do, suggest that growth over the next three years could be up to 1 percentage point lower in the U.S.. Luckily, truculent pronouncements have, so far at least, not been followed by similarly bellicose action and a negotiated peace settlement is still possible. Trump's main aim, after all, may not be the protection of domestic industry, but the reduction of barriers to U.S. exports, an outcome that would, in fact, promote freer trade.

Growth in Europe is still healthy. It is true that recent indicators have shown some weakness, suggesting that the peak has probably been passed and that a deceleration is setting in, but such a sequence of events seems almost inevitable. The pace of expansion in the second half of 2017 was very rapid, particularly in Eastern Europe, but also in Germany and some other smaller Northern European countries. The only laggards have been Britain, slowed down by the uncertainties surrounding Brexit, and Italy which, together with Greece, remains the Eurozone's weakest member country.

Three major uncertainties colour the West European picture. The first relates to the protectionist threats mentioned above. So far Europe has hardly been hit since the steel and aluminium tariffs imposed by the U.S. have been waived. But Trump has taken issue with, particularly, Germany and, particularly, car exports to America. Should threats be followed by U.S. action and U.S. action by EU retaliation, the potential for a trade war could sharply increase. This, in turn, while not leading to recession, would trim growth rates of investment and output in 2019-20.

The second issue relates to monetary policy. A gradual tightening by the European Central Bank looks almost certain. Most official statements, by Mario Draghi and others, suggest that this tightening will be modest, with short-term interest rates not expected to turn positive until mid-2019 and to remain very low well into 2020. Such cautious moves are hardly likely to have a strong impact on growth. What could, however, have an effect would be continuing euro appreciation. Despite rising U.S. interest rates, the dollar has been falling against the euro for nearly a year now and many expect further dollar weakness in the future. Should this materialise, growth prospects would, inevitably, worsen somewhat.

Finally come political uncertainties. Markets seem to have shrugged these off, following relief at Macron's victory in the French presidential elections last year. The Spanish-Catalonian problems went unnoticed and the inconclusive results of the Italian parliamentary elections caused barely a ripple on financial markets. Yet that electoral outcome, in particular, could stoke future problems. As mentioned above, Italy, with its high public debt level and very low productivity growth, is the weak link in the Eurozone. At present, there is no certainty as to what government will run the country. Should a coalition emerge between the two populist and broadly euro-sceptic parties (the *5 Star Movement and the Lega*) with their fiscally irresponsible programmes, one could well see a resumption of tensions on financial markets, with unforeseeable, but inevitably negative, consequences for interest rate spreads and hence growth not only in Italy, but also in other weaker Eurozone members.

GDP GROWTH RATES (%)

	2016	2017	2018	2019	2020
Eurozone	1.8	2.5	2.3	1.8	1.5
United Kingdom	1.9	1.7	1.8	1.6	1.9
United States	1.5	2.3	2.9	2.5	1.6
China	6.7	6.9	6.4	6.0	5.7
World	2.4	3.0	3.2	3.0	2.7

Source: Oxford Economics