Monthly Letter

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Marc-Antoine COLLARD
Chief Economist, Head Economic Research

Economic environment

The central banks of Japan (BoJ), the Eurozone (ECB), the United Kingdom (BoE) and the United States (Fed) recently held their monetary policy meetings. The Fed seems prepared to stay the course on a gradual normalization of its monetary policy. The BoE decided to raise its key rate for the first time in a decade while the ECB announced a reduction in its monthly purchases from €60bn to €30bn starting January 2018 until at least September 2018. These actions further isolate the BoJ which, given inflation staying stubbornly far from its official target, is the last of the major central banks to keep a very accommodative monetary policy despite improved growth prospects and the highest output gap since 2008.

In the Eurozone, economic activity remains buoyant and GDP grew by 0.6% q/q in Q3 2017, after 0.7% in Q2. On a year-over-year basis, the Eurozone grew by 2.5%, outpacing both the US (2.3%) and the UK (1.5%) for the first time in several years. This favorable situation explains the decline of the unemployment rate to 8.9% in September, its lowest level since January 2009. The challenge now for the ECB is that this trend in the labor market has not yet translated into an uptrend in wage growth that would fuel inflation. In that regard, recent statistics might have reinforced the ECB's prudent choice, given how slowly labor market tensions are affecting remuneration in a context where unused capacity remains otherwise important. In fact, the inflation rate remained unchanged at 1.5% in October, but at only 1.1% excluding food and energy. In short, aware of the significant gap between the economic recovery and the sustained rise in inflation, the ECB has adopted a prudent, patient and persistent approach in the conduct of its monetary policy, and the process of standardization of interest rates seems rather unlikely before 2019.

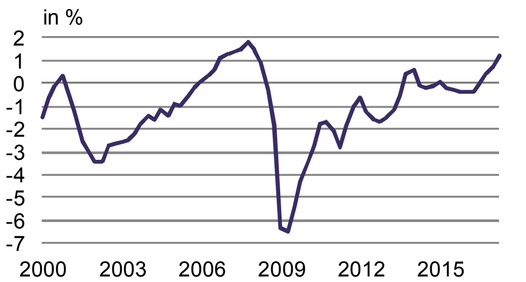
Conversely, the rise in inflation in the UK has forced the hand of the BoE which raised, as promised, its key rate to 0.50%. Indeed, the Monetary Policy Committee considered that the dynamic of inflation was too strong and, at 3% in September, it ran too high compared to what remains of the overcapacity available to sufficiently control the risk of inflation overshooting. Even though Governor Carney has indicated that two additional increases may be needed in the next 24 months for inflation to return to target, he added that these hikes are uncertain. Indeed, the BoE made clear that the need for tighter policy was a result of the reduced potential GDP rather than due to strong economic growth. Also, political developments related to both the UK's future trade relationship and a transitional deal with the EU are likely to warrant a revised assessment of the economy and a

Performances in local currency

	Price as of 10/31/17	1 month % change	2017 % change
Equity markets			
CAC 40	5 503	3.3%	13.2%
Eurostoxx 50	3 674	2.2%	11.7%
S&P 500	2 575	2.2%	15.0%
Nikkei 225	22 012	8.1%	15.2%
Currencies			
1 € = ...USD	1.16	-1.5%	10.4%
1 € = …JPY	132.00	-0.6%	7.0%

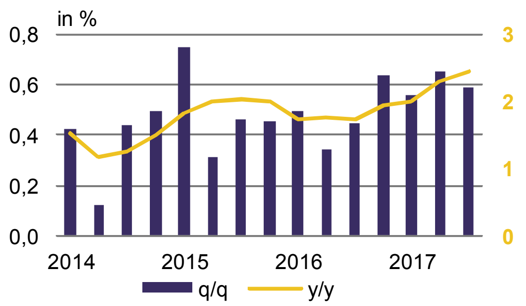
		Price as of 10/31/17	1 month bp	2017 bp
Government bonds				
3 M	Euro zone	-0.68%	-9	22
3 M	United States	1.13%	9	63
10 Y	Euro zone	0.36%	-10	16
10 Y	United States	2.38%	5	-6

Japan – Output gap



Sources Macrobond, BoJ, Rothschild Asset Management

Eurozone – GDP growth



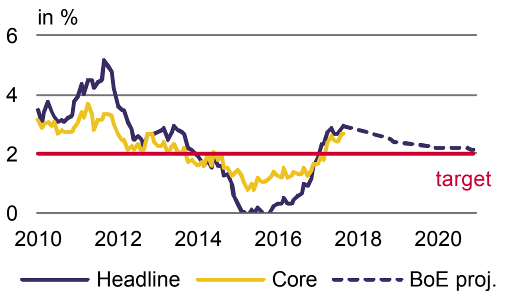
Sources Datastream, Rothschild Asset Management recalibration of monetary policy. The upshot is that future monetary policy will hinge on the outcome of Brexit negotiations.

In the US, despite the downturn in the housing sector, economic growth was 0.7% q/q in Q3 2018. Rather than having hindered activity, it seems that hurricanes have boosted consumer spending, with replacement purchases – in particular automobiles – largely offsetting the partial paralysis of economic activity in the affected areas. The ISM indexes on business confidence remain very high, especially in the services sector. For several months, these indices have pointed to an acceleration growth, which, however, has so far failed to materialize. In fact, final sales to domestic purchasers – which exclude trade and inventories, the two most volatile components of GDP calculation – increased in Q3 at the slowest pace since early 2016.

Meanwhile, President Trump has finally decided in favor of continuity by choosing Jerome Powell as the new Chair of the Fed. Having worked since 2012 in collaboration with Janet Yellen, who will step down in February 2018, Powell is unlikely to put into question the direction of US monetary policy. It is nevertheless the first time in nearly four decades that a Fed Chair is not an trained economist.

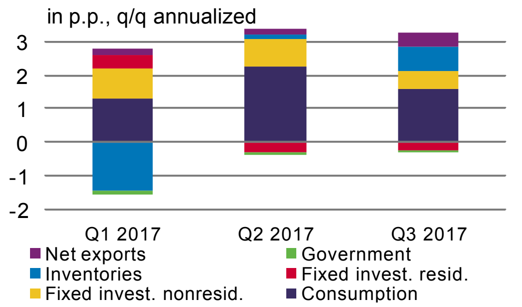
The Republican leaders of the House of Representatives detailed their tax plan, the main elements of which were already known: cutting the corporate tax rate from 35% to 20%, as well as a reducing the number of tax brackets for households. However, the Senate Republicans will unveil a plan of their own that’s likely to significantly differ in some places from the House legislation. Therefore, reconciling the differences between the two chambers could be one of the biggest challenges in the tax overhaul. What’s more, several questions remain unanswered, in particular the financing of this tax project. In fact, the US – like many other countries – today faces three central problems: widening income inequality, increased job insecurity, and low productivity growth. It is not clear that the tax plan as presented is an effective response to these challenges.

United Kingdom – Inflation rate



Sources Datastream, BoE, Rothschild Asset Management

United States – GDP growth contribution



Sources Bloomberg, Rothschild Asset Management