

AQUILA FLASH



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The synchronized global upswing has gained strength in the third quarter

The world economy is doing well. The EU now looks more stable politically than the US. Mrs. Merkel is going to win Germany's elections. And the Fed is about to start reducing its balance sheet.

The synchronized global economic upswing has gained strength in the third quarter.

Leading economic indicators as well as ISM indices suggest a real growth rate for the world economy of 3.5% this year, in line with our forecast. (2017 looks like being the first year of the current decade in which the 3% growth trend will be exceeded by a significant margin). The upswing is synchronized globally and there are few areas of disappointment. The weaker oil price has kept the lid on inflationary pressure and provided stability to the emerging market world. And faster real economic growth means stronger corporate earnings.

Strong growth in the Eurozone is powering the euro.

The economies of the US and Germany are on the borders of overheating. Germany's IFO index recently hit an all-time high. Unfortunately, Europe's positive growth shock is playing out in a rising value for the euro rather than in appreciating European stock markets. With the euro this strong, the ECB cannot meet its inflation target. In fact, with the exception of Germany, there is not much sign of inflation in Europe and significant underused capacity in Europe's peripheral countries. We forecast 2% growth for the Eurozone this year.

The CDU is set to win Germany's federal elections

Mrs. Merkel will win the German federal elections. Indeed, these elections could turn out to be "the most boring of all time". One internet commentator has even suggested wedding bells for Mrs. Merkel and Mr. Schulz as their televised debate suggested agreement on everything. When the elections are over we may see cautious moves towards strengthening the EU's Paris-Berlin axis. Thus, the EU may move further in the direction of a centralized European "super state", although some will quibble about the word "super". But an unexpectedly good performance by Germany's FDP in the upcoming election could upset such plans.

Switzerland benefits from the improving European business cycle

KOF's business cycle barometer fell 3.9 points in August to 104.1, erasing the gains of the previous month. Taken together, the data show Switzerland continuing to enjoy above-average growth, but with a weakening dynamic.

The construction sector looks likely to be particularly weak. Sentiment among architects is weakening.

Although the euro's gains have made the SNB's task easier, dollar weakness is offsetting this, tending to undermine Swiss competitiveness.

The US economy grew 3% in the second quarter. Very strong growth in Japan

Stronger investment is an encouraging feature of the GDP report. Tropical storm Harvey will probably only depress the economy temporarily. And, as it will trigger significant reconstruction activity in coming months, its longer term impact could be positive.

With Europe now looking more stable than the US, the dollar is under pressure

Will Washington's establishment win its war with Donald Trump? The legislative process is stalled thanks to some Republican rebels in Congress and the obstructionist tactics of the Democrats.

The controversy surrounding White House relations with Putin's Russia and the Korea crisis are also weakening the Administration, hurting the chances that Mr. Trump can implement key policies such as tax reform, infrastructure and slimming down the Federal government. For investors this suggests disappointment so far as the "Trump reflation trade" is concerned.

Among the casualties of greater US political instability is the US dollar.

In the medium-term, i.e. by end of December, the US Federal debt ceiling needs to be raised, a process which could unsettle markets. It seems likely that politics will mean trying to delay an agreement for as long as possible.

Fed to start reducing its balance sheet soon

We think there is a 75% chance that the Fed will announce a date for starting to reduce its balance sheet directly following the September 19/20 FOMC. We also expect a further US rate rise in December. The dollar's weakness should make it easier for Fed policy-makers to take these decisions. We intend to assess these events as they unfold an "Aquila Deep Thought" publication.

But a serious deterioration in the Korean situation or sharp declines in stock markets could cause the Fed to stay its hand.

Japan grew at an annualized 4% rate in the second quarter, surpassing both the US and Europe and recording its sixth consecutive quarter of positive growth. Encouraging is the fact that investment rose 2.4%. The yen has been strengthening, supported by these good numbers, as well as heightened geopolitical risk, notably in Korea.

The Korean crisis

Here are some thoughts, but first a question. Is the regime in Pyongyang a useful monster for China in that it distracts the US from Peking's expansion in the Sea of China? Indeed, should we allow ourselves to be distracted?

1. It is too late for preventive military action. The regime has already achieved the goal of credible nuclear deterrence. The world will probably have to accept an additional nuclear power.

2. We should want precise North Korean weapons rather than flying scrap! What is behind this provocative statement? Well, the risk of catastrophic accidental damage increases if it is "not just water that is hit". "Firing an unproven missile with an unproven warhead in an unproven re-entry vehicle with unproven accuracy and reliability at these ranges against a major nuclear power goes from stupidity to insanity". *Tony Cordesman, veteran US strategic analyst. Cited from the BBC.*

3. Sanctions don't work. Think about Cuba.

4. A trade war between the US and China over North Korea would be so self-defeating that it just won't happen.

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