The global economy has been under intensive care since 2008. All three major developed markets—the U.S., Europe and Japan—have maintained low interest rates and received liquidity injections from their central banks to support their ailing economies over the past several years. The serum: Quantitative easing (QE). In late 2014, the U.S. withdrew its QE stimulus programme and followed this later with interest rate hikes. Europe and Japan may soon follow, making this a good time to check on the patients.

Due for a check-up
Aside from a couple of complications—stubbornly low inflation in Japan and negative bank deposit rates outside the U.S.—the prognosis is good. All three regions are logging positive growth in real terms. The U.S. and Japan are operating at near-full employment, and Europe’s 8% rate of unemployment is also at or below historical norms.1 (Display 1)

PMI indicators are also strengthening, and inflation in the U.S. is starting to pick up. Ongoing QE in Europe and Japan is acting to stimulate demand for goods and services, business investment and consumer spending, whilst keeping yields low. On balance, this is a good environment for risk assets.

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1 Source: Tradingeconomics.com; Eurostat. "Unemployment Rate in the Euro Area averaged 9.78% from 1995 until 2017, reaching an all-time high of 12.10% in March of 2013 and a record low of 7.30% in November of 2007"
Easy does it
Market participants have taken the Federal Reserve’s (Fed) willingness to raise rates as a credible sign of confidence in the U.S. economy. In fact, from January 2010-March 2017, market performance was best when real interest rates rose in tandem with rising inflation expectations. During such periods, the S&P 500 rose an average of 5.4% in the two-month period surrounding a rate hike. When rates fell due to falling inflation expectations, equities fell by an average of -0.3%. *(Display 2).* It appears that rate hikes are not disruptive if they are delivered in gradual doses that are in line with prevailing economic conditions.

Relapse risk
At some point, interest rates become a hurdle for equities. In principle, future equity earnings are discounted by real rates to arrive at current valuations. All else being equal, higher discount rates translate into lower present values. If rates increase too quickly, equities will fall in value.

The reason doctors have careful protocols for withdrawing medication is that the weaning process poses a risk to the patient. There is often a risk of relapse, particularly if the withdrawal is too abrupt or too early. Similarly, sharply rising rates tend to be negative for risk assets and the overall

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**DISPLAY 1**
Check-up: Vital signs of major economies

<table>
<thead>
<tr>
<th>Economic Indicator</th>
<th>Europe</th>
<th>Japan</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth</td>
<td>1.9%</td>
<td>1.6%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>8.0%</td>
<td>2.8%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Inflation rate</td>
<td>1.6%</td>
<td>-0.4%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>Bank deposit rate</td>
<td>1.6%</td>
<td>-0.1%</td>
<td>2.4%</td>
</tr>
</tbody>
</table>

Source: Bloomberg. GDP data is real year-over-year growth. For the US and Europe, data is Q1 2017; for Japan, it is Q4 2016. Unemployment data as of April 2017 for the US; for Europe and Japan it is March 2017. Inflation data as of March 2017 for the US and Europe; for Japan, it is April 2017. The central bank deposit rate and quantitative easing status are as of May 2017.

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**DISPLAY 2**
Perfect pair: Inflation expectations and real rates rise together

**Scenario: Real rates fall**

<table>
<thead>
<tr>
<th>Falling inflation expectations</th>
<th>1.1%</th>
</tr>
</thead>
</table>

**Scenario: Real rates rise**

<table>
<thead>
<tr>
<th>Falling inflation expectations</th>
<th>5.4%</th>
</tr>
</thead>
</table>

Source: Bloomberg (30 November 2009 through 31 March 2017). Real rates are measured by the 10-year real yields and the inflation expectations is measured by the 10-year breakeven movement. This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See disclosure section for index definitions.
The Bank of Japan's (BoJ) decision to lift rates in August 2000, while economic conditions were still uncertain, is often used as an example of this relapse risk (Display 3).

In the U.S., where QE life support was removed gently and gradually, the economy managed to get back on its feet. Last year, when the Fed governors mentioned the prospect of raising target interest rates, the market dropped significantly. Arguably, the economy was too weak too endure the Fed’s tighter policy. This year, that has reversed: Market participants now seem to think that the economy no longer needs coddling.

**Co-dependent behaviour**

With QE still in full swing in Europe and in Japan, U.S. interest rates cannot rise too much without consequences. Should U.S. bond yields get too far ahead of their counterparts, European and Japanese investors would sell bonds to their local central bank and buy cheaper U.S. bonds, which would eventually depress the yield of U.S. bonds. It is as though the U.S.—though no longer on QE life support—shares a hospital ward with Europe and Japan, inhaling the same QE-infused air as its two roommates.

So, it is somewhat misleading to look at U.S. bond yields as representing market sentiment. They are only partially representative, because they are being artificially depressed by QE in Europe and Japan.

**Lingering side effect: Bloated balance sheets**

The Fed’s balance sheet, currently at about $4.5 trillion, is still well in excess of its historical average of $700 billion. Bringing it back to a more normal level would require that the Fed stop buying bonds. Since there is no sign of the U.S. government halting its

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selling of bonds, this should reduce the net demand for bonds and put upward pressure on interest rates. So whilst it has removed QE, the Fed still has a significant amount of normalisation to achieve before it can say that the U.S. has fully recovered from the financial crisis of 2008.

The U.S. balance sheet is now 24% of Gross Domestic Product (GDP) and Europe’s is 32%—both very high numbers. Japan’s balanced sheet has expanded dramatically and is now a staggering 83% of their GDP (Display 4). Together, these add up to significant extraordinary measures that remain in effect while the global economy is getting back to normal.

**Europe: Election fever has subsided**

Macron’s win in the French elections neutralised a potential source of volatility. Indeed, even before his election victory, it appeared that investors’ relief in the reduction of political risk was palpable. After the first round of the elections, the euro immediately strengthened against the dollar. This would usually be a negative for equities, yet European equities climbed higher (Display 5). Clearly, investors are now focused on a strengthening European economy and positive earnings expectations. Bond deals are starting to pick up, but there’s a limit to how much bond issuance can increase while QE is in place.

We expect the European Central Bank (ECB) will soon be under considerable pressure to start removing its extraordinary monetary policies. It could choose to raise rates, which are currently negative. Banks need positive interest rates to earn profits, so higher rates would likely boost the banks’ income, tighten monetary policy and still preserve the ECB’s ability to buy bonds if spreads start widening. Banks need positive interest rates to earn profits, so a higher rate would likely boost banks’ income, tighten monetary policy and still preserve the ECB’s ability to buy bonds if spreads start widening.

**June 8: A temperature check**

The 8 June 2017 ECB meeting will be critical. So far, Mario Draghi, the ECB’s president, has not provided any obvious indication of a change in monetary policy, despite the improving European economic data. However, with the French election out of the way and 2018 only months away, we think there is a strong chance that he will indicate whether he intends to tighten interest rates and taper QE.

If Draghi does make a strong announcement on 8 June, we will be closely watching the market’s reaction. If he is relatively hawkish and the market goes up—as it seems to be doing in the face of Fed interest rate increases—this suggests that the market is confirming European economic strength. On the other hand, if the market starts becoming jittery, that would suggest that rising interest rates are burdening the economy by making business more costly.

**Japan: Could be pressured to withdraw stimulus**

The third patient in the hospital ward is Japan. The Fed seems to think the U.S. economy is returning to significant growth. If Europe and Japan also start growing, it is going to be hard for the Bank of Japan to maintain an aggressive QE programme. At some point, they’re also going to have to start withdrawing QE. We plan to keep an eye on how quickly that is likely to occur and whether there are signs of a relapse.

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**Display 4**

Japan’s balance sheet: The big gorilla

- BoJ assets/Japan GDP: 83%
- ECB assets/eurozone GDP: 32%
- Fed assets/US GDP: 24%


**Display 5**

Relief rally after the first round of the French elections

European equities climbed with euro

Source: Bloomberg data as of 5 May 2017. This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See disclosure section for index definitions.
**Potential flare-up: Fiscal stimulus**

The favourable outlook is dependent on the central banks removing these extraordinary measures in a very slow, measured fashion. Although that is certainly their intention, there may be obstacles, such as potentially extraordinary fiscal stimulus coming in the U.S. via a massive infrastructure building programme or very substantial tax cuts. Too much stimulus could push the temperature up and cause the patient to relapse—it would create excess demand greater than the economy can absorb with low levels of productivity, leading to inflation. This could change the diagnosis substantially.

Currently, the U.S. headline inflation rate is at 2.4%, with Europe at 1.6% and Japan at negative 0.1%. We do not see inflationary pressures in Europe, and evidence suggests that it is not likely to pick up strongly by the end of the year. We’ve also seen a dramatic fall in the price of oil recently, which is favourable for inflation outlooks and likely to enable the G3 central banks to remain on a moderate path for removing stimulus.

Central banks seem intent on removing monetary stimulus in a gradual and measured way. If markets are allowed to behave on their own, particularly while oil prices drop, the resulting outlook for equities should be quite favourable.

**China: A positive contributor**

Investors see China’s growth as a government policy decision: If growth slows too much, the government simply channels money to its preferred sectors. However, China has recently started allowing “zombie companies” to go bankrupt while also clamping down on some over-levered wealth management products.

These policies have made some investors nervous. In our view, these are positive developments, though they could temporarily depress the market. There’s an important distinction between the Chinese government losing control of the economy—as they did in 2015—and their current attempts to address specific weaknesses in the economy.

We certainly do not see China as an imminent threat to the recovery of the global economy. We expect to see continued growth in China, with a rebound in industrial metals that have fallen on sentiment-related decline.

**Modern treatment seems to be working**

Post-war, we would have to go back to the Great Depression to find a comparable banking crisis to that which we experienced in 2008. In that crisis, the rate hike of 1937 is instructive. Responding to what is now an old fashioned view of equilibrium, the Fed felt that it had to raise rates while the economy was still weak. This reduced liquidity in the system, plunging the economy into the depths of the Depression.

Today’s scenario is very different. We believe global markets’ positive reaction to recent Fed rate hikes indicates that the global economy really is recovering. We will be watching the ECB closely on 8 June for more indicators. Stay tuned for our next prognosis.

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4 Source: Bloomberg. Inflation data as of March 2017 for the US and Europe; for Japan, it is April 2017.
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