Global

2017 outlook

- Donald Trump's election as president of the United States opens a vast range of possibilities, including a possible surge in activity in the short-term.
- We have raised our outlook for US growth, inflation and interest rates for the horizon 2017 and 2018.
- Upcoming tax cuts will occur at a time of quasi full employment, which is bound to accentuate wage and price pressures.
- Inflation is likely to rise above the official 2% target, which would encourage the US Federal Reserve (Fed) to raise its key rates a bit faster.
- In Europe, everything suggests that growth accelerated in late 2016 and that 2017 has got off to a good start.
- Eurozone growth could nevertheless slow a little, partly because of a pick-up in inflation.
- The ECB's quantitative easing (QE) will continue for a longer period, calming tension over yields, although monthly asset purchases will decrease from March 2017.

Of the apparently numerous consequences of Donald Trump's election as president of the United States, one is already taking shape: higher interest rates. At around 2.40% today, the average cost of public borrowing has increased 50 basis points since the self-proclaimed "King of Debt" was named the winner of the US presidential elections on 8 November 2016.

Arising tensions from Trump's election

Market players moved into equities, esteeming that the economic proposals of the White House's new occupant, as vague as they may be, were more likely to stimulate growth and increase inflationary pressures. The latest minutes of the US monetary policy committee meeting suggest that the central bankers have reached a similar conclusion. John Williams, president of the San Francisco Fed, told the Financial Times recently that he doubted the need for a fiscal stimulus at a time when the economy was close to full employment (the jobless rate slipped to 4.7% in December) and inflation was approaching the official target rate of 2% (1.7% in November).

Of course, any fiscal hand-outs by President Trump will have to be approved first by Congress, and they might not be as generous as those promised by candidate Trump. Most have not been funded (via equivalent spending cuts), and certain seem to be outright unrealistic. One example is the proposal to allow companies to remove the receipts from exports in calculating their taxable base, a unilateral protectionist act that violates World Trade Organisation rules. Nonetheless, if only a third of the promised tax cuts were enacted, it would be equivalent to transferring 1 point of GDP to households and companies in 2017 and 2018[1]. Although the measures primarily target the wealthiest, whose propensity to consume is not very high, it would nonetheless have a non-negligible impact on spending.

From this perspective, at a time when growth, employment and wage indicators are all looking upbeat, there is no reason to halt the normalisation of monetary policy. Indeed, it could even accelerate. Our scenario calls for six key rate increases of 25 basis points each over the next two years, which would bring the Fed funds rate to 2.25% at year-end 2018. Moreover, now that the Fed is through with

Summary of forecasts

	GDP Growth			Inflation		
En %	2016 e	2017 f	2018 f	2016 f	2017 f	2018 f
Advanced	**1.6**	**1.7**	**2.1**	**0.8**	**1.7**	**1.9**
U. States	**1.6**	**2.4**	**2.8**	**1.3**	**2.4**	**2.5**
Euro Area	**1.7**	**1.5**	**1.5**	**0.2**	**1.6**	**1.2**
Germany	1.8	1.8	1.9	0.4	2.0	1.4
France	1.1	1.3	1.5	0.3	1.0	0.9
Italy	0.9	0.6	0.7	-0.1	1.1	0.9
Emergings	**4.3**	**4.6**	**5.1**	**4.8**	**4.4**	**4.2**
China	6.7	6.2	6.4	2.0	2.3	2.5
India	7.1	7.4	8.0	5.0	5.7	4.9
Brazil	-3.5	1.0	3.0	8.2	4.5	4.4
Russia	-0.5	1.0	2.5	7.0	4.6	4.2
World	**3.1**	**3.3**	**3.8**	**3.1**	**3.3**	**3.3**

Interest rates		2017f				2018f
End of period		q1	q2	q3	q4	q4
U.S	Fed Funds(*)	0.75	0.75	1.00	1.25	2.25
	T-Notes 10y	2.55	2.75	2.85	3.00	3.50
E.Z	"Refi" ECB	0.00	0.00	0.00	0.00	0.00
	Bund 10y	0.40	0.50	0.60	0.70	1.20
	OAT 10y	0.90	0.90	1.00	1.10	1.70

Exchange rates		2017f				2018f
End of period		q1	q2	q3	q4	q4
USD	EUR / USD	1.04	1.02	1.02	1.00	1.09
	USD / JPY	115	120	125	128	135
EUR	EUR / GBP	0.84	0.82	0.82	0.80	0.76
	EUR / JPY	120	122	128	128	147

Source: BNP Paribas Group Economic Research / Global Markets
(e: Estimates, f : forecasts)
(*) The Fed targets a range. Here are the forecasts for the upper end of the 25 basis points range.

[1] Based on estimates by the Tax Policy Center. See *"An analysis of Donald Trump's revised tax plan"*, Tax Policy Center, Oct.18, 2016.

quantitative easing, sooner or later the question of reducing the size of its balance sheet is bound to come up. This environment is propitious for higher bond yields, and we estimate the yield on 10-year government bonds at about 3% by year-end 2017 and at 3.5% at end-2018.

Are eurozone interest rates likely to follow this trend? Yields have already bottomed out across the board, notably in Germany and France, where the period of quasi-free long-term public borrowing has come to an end[2]. In Italy, bond yields are nearing 2%. Looking beyond the contagion of a "Trump effect" in Europe, higher interest rates can also be attributed to genuine improvements in the economic environment:

Europe delivers positive surprise

The eurozone's economic upturn is continuing, and has been surprisingly resilient. Although GDP growth slowed a little in mid-2016, to 0.3% sequentially in the second and third quarters, year-on-year growth remained impressively stable at 1.7%[3]. Consumer spending remained fairly firm, although its growth flagged slightly as the year wore on, falling from 1.9% year-on-year in Q1 to 1.6% in Q3. Investment expenditure and foreign trade rebounded strongly in Q2 before taking a breather in the summer, but year-on-year growth figures remained good at 3.0% for investments and 2.2% for exports.

Observers have repeatedly been surprised by the strength of Q4 economic data, proving that the economy's engines are up and running. Judging by figures from the start of Q4, industrial production growth should easily exceed 1% q/q in Q4 while retail sales growth should be close to that figure, a significant improvement on Q3. The eurozone's composite PMI ended 2016 at its highest level since mid-2011, rising more than one point compared with the previous quarter. European Commission surveys have confirmed the trend, with confidence indicators showing clear positive momentum in all sectors over the last few months.

Overall, all the indications are that growth accelerated substantially on a quarterly basis in late 2016, and that 2017 has got off to a good start. Beyond Q1, we continue to forecast moderately slower growth this year. Clearly, several of the factors that supported growth last year – first of all the absence of inflation, but also extremely low interest rates and low oil prices – are fading.

However, the economy is up and running, and appears capable of overcoming those reversals, at least in part. In addition, the decline in the euro against the dollar since Donald Trump's election victory, along with the prospect of downward pressure on the euro in the next few quarters, mean that European exports will be able to take full advantage of global growth, which is likely to accelerate to 3.4% in 2017 after 3.1% in 2016 according to the International Monetary Fund's latest estimates.

The ECB continues to calm things down

If interest rates have not rebounded as strongly on this side of the Atlantic (an average increase of 25bp for government bonds since 8 November 2016), the European Central Bank (ECB) is much to blame. While the Fed has launched its first key rate increase, the ECB continues to hold the cost of borrowing below zero. It is also extending its quantitative easing policy (QE).

Having accepted the need to extend the asset purchase programme beyond March 2017, the Governing Council also had to address the risk of eligible securities being in short supply. In the end, it decided to extend the minimum duration of QE by nine months, i.e. until December 2017, while reducing monthly purchases from EUR 80 bn to EUR 60 bn from April 2017. As usual, it left the door open to increasing the length and/or scale of the QE programme if the situation deteriorates between now and December 2017. Finally, to ensure that the programme runs smoothly, it altered two of its parameters regarding the short end of the yield curve: it reduced the minimum maturity of eligible securities from two years to one year, and is now allowing the purchase of securities that yield less than the deposit facility rate (currently -0.40%).

In the next few months, the ECB could therefore seek, as it did in its January meeting, to keep things as they are while maintaining a clearly accommodative tone. In December, the ECB's inflation projections were a long way short of its price stability target (1.5% in 2018 and 1.7% in 2019). The next update expected in March 2017 will be an opportunity to assess how better-than-expected activity levels and the new global economic environment have affected that situation.

At the moment, we believe that the scale of asset purchases planned in 2017 is sufficient to contain the increase in yields seen since November 2016. Given its weighting in the ECB's capital key, Germany makes up the lion's share of purchases (27%), even though its debt is drying up (it runs a budget surplus). Yields on 10-year Bunds are unlikely to rise much – we are forecasting 0.70% at end-2017 – and, in any case, much less than US Treasuries. Although France, Italy and Spain have substantial net financing needs, they still fall short of the amounts the ECB plans to purchase on the secondary debt market: except in the extreme case of an abrupt liquidation, we do not see any reason why their interest rates should soar.

The transatlantic yield spread has been the main reason for the weak euro in recent years, and it is now poised to widen even further. The euro, which is currently trading at USD 1.07, is already strongly undervalued relative to its purchasing power parity (USD 1.30). This gives European exporters a precious advantage that is bound to persist.

[2] The yield on 10-year French government bonds rose to 0.80% on 16 January 2017, from barely 0.10% on 27 September 2016, an all-time low. Source: Thomson Reuters.
[3] At first glance, aggregate eurozone figures suggest that growth was over 1.9% in 2015 before slowing in 2016. However, that was largely due to a distortion arising from Irish GDP, which jumped more than 26% for accounting reasons in 2015 (see "Ireland: beyond revisions", Ecoweek 11/18/2016). Restricting the analysis to seven large eurozone countries (FR, GE, IT, SP, NL, PT, BE), aggregate year-on-year GDP growth has been running at between 1.5% and 1.7% since the spring of 2015.