Global Growth: Rocky Mountain High

Douglas Porter, CFA, Chief Economist • douglas.porter@bmo.com • 416-359-4887

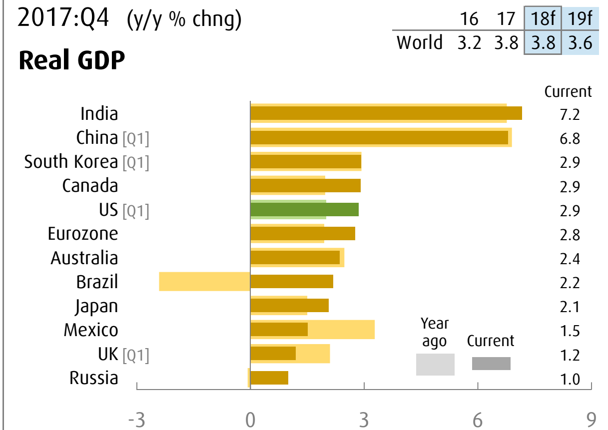
The global economy is running at its fastest pace since the very early days of this long economic recovery, in a classic case of the cycle finding its second wind. The IMF recently upgraded its outlook for this year and next, and calls for the world economy to clock in at almost 4% growth in that period, nearly matching the blistering pace set in the prior decade. Beyond the impressive headline tally, the details reveal that every major economy is expected to remain in expansion mode, a synchronicity not seen since the heady 1990s (*Chart 1*). This broad strength is a key factor driving global yields and commodity prices higher. In a nutshell, **world output has powered through trade uncertainty, initial Fed tightening, rising fuel costs, and a return of some market volatility.** The key questions now are: Is this sustainable? What are the implications, and the risks?

Sustainability: Despite the gaudy headlines, global growth may already be topping out, and could moderate over the next two years. Looking at our quarterly estimates, we see growth ebbing somewhat in Q1 from a hot 4.0% y/y clip at the end of 2017. And, the OECD's **leading indicator points to a modest cooling in coming quarters** (*Chart 2*). Some moderation is no big concern, as the underlying trend for the global economy is likely closer to 3½%. Indeed, in its latest Monetary Policy Report, the Bank of Canada estimates global potential growth to be between 3.25%-to-3.50%, well shy of the recent heated trend in the world economy.

One potential support factor for growth, and a rare wildcard at this advanced stage of the cycle, is the currently unfolding U.S. fiscal stimulus. The IMF estimates that the structural budget deficit among advanced economies will widen 0.3 percentage points as a share of GDP this year, and another 0.6 ppts in 2019—a rough measure of the net fiscal stimulus to growth, with almost all coming from the U.S. tax and spending steps (*Chart 3*). In fact, the IMF warned of *"unnecessary stimulus"* at this stage of the cycle, a point we—and others—have raised many times in recent months.

Implications: The sustained bout of solid late-cycle global growth—and the tightening output gap for the world economy—is making an impact through a variety of channels. The uptick has played a role in **firmer commodity prices**, most notably for oil (*Chart 4*). The BMO Commodity Price Index is now expected to be 20% above year-ago levels for all of Q2, with gains spread across all four major categories of goods. In particular, crude oil prices have now climbed nearly 40% from year-ago levels, with solid underlying demand growth and surprisingly tight OPEC discipline more than compensating for record U.S. production.

Chart 1
Global Growth I: Solid and Synchronized

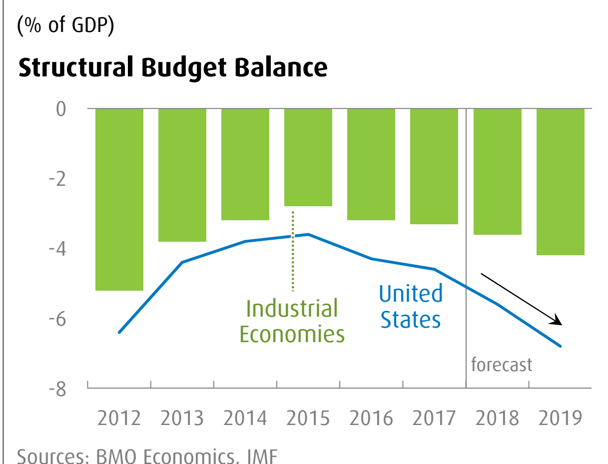


Sources: BMO Economics, Haver Analytics

Chart 2
Global Growth II: Topping Out?

[1] (lhs : index : s.a. : amplitude adjusted)
[2] (rhs : PPP weights : y/y % chng)
Sources: BMO Economics, Haver Analytics

Chart 3
Budget Deficit Growing



Sources: BMO Economics, IMF

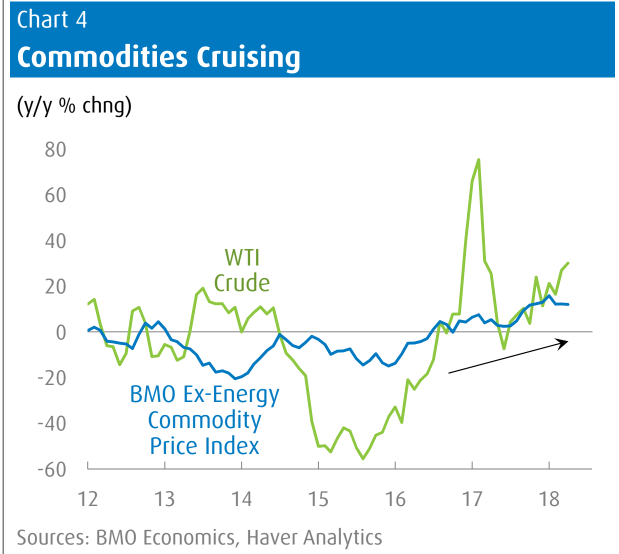
In turn, the strength in commodities, especially oil, and a fading global output gap are putting gradual **upward pressure on inflation**. In a major change from recent years, headline consumer price inflation in the OECD has spent most of the past year above 2%, with each of Britain, the U.S. and Canada now running above that threshold. Core inflation among the industrialized world remains notably calmer just below that mark; but, even by that metric, there is a subtle drift higher (*Chart 5*). While we are not in the camp looking for a big break-out for inflation, it's also pretty clear that deflation risks have been deflated. To wit, the IMF now pegs the risks of deflation in the U.S. over the next year as next to nil.

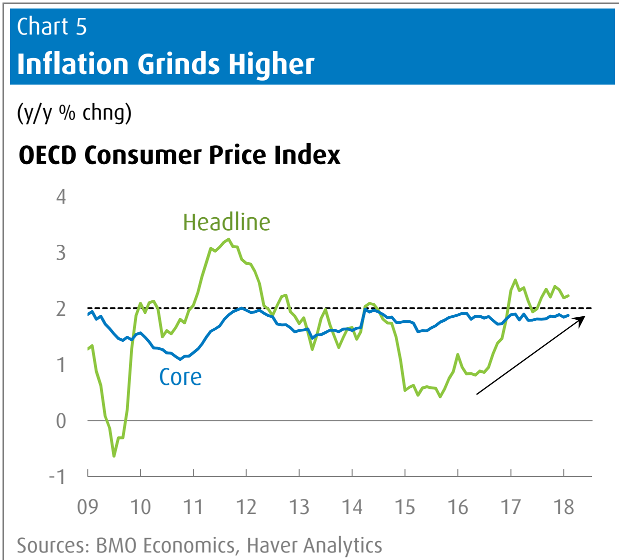
The combination of a slow upward tilt in headline inflation, a widening structural budget deficit for developed nations, solid growth, and a tight output gap have put renewed upward **pressure on bond yields**. Of course, rumbling away in the background has been the slow, but steady, Fed tightening campaign, the beginning of a reversal of QE, and even some small sporadic moves by other major central banks to move away from ultra-loose policy stances. Against the challenging backdrop for bonds, the benchmark 10-year Treasury famously hit the 3% threshold this week (*Chart 6*). True, we visited these levels earlier in the cycle. The difference between now and the 2013 Taper Tantrum is that global growth is on a firmer footing, the output gap is smaller, headline inflation is higher, and the Fed is actually tightening policy (not just talking about the abstract possibility). While much of this news is likely built into today's rates, we see yields continuing a push higher toward 3.5% by late 2019.

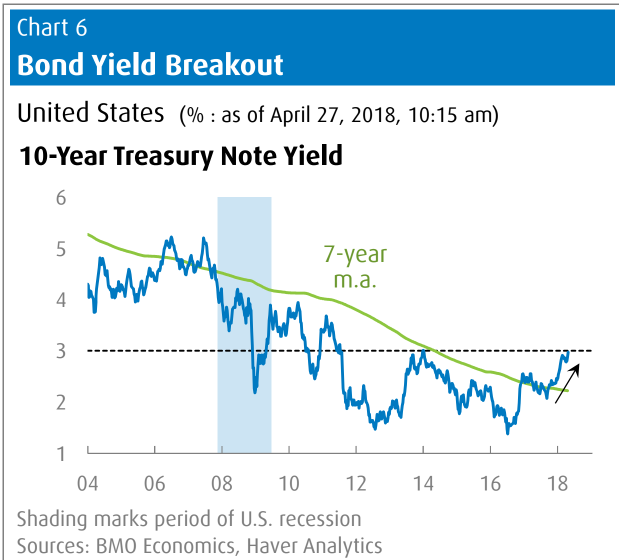
Risks: The one thing that could up-end our call on yields is if global growth cools faster than expected. And, despite the sunny IMF outlook, there is no shortage of risks surrounding the world economy. Briefly, the biggest are: (1) threat of protectionism, trade tiffs; (2) restraining impact of higher energy prices, higher yields and/or tighter financial conditions generally; (3) an overly aggressive Fed; (4) renewed market volatility, perhaps due to concerns in a specific sector (e.g., tech); and, (5) geo-political tensions.

Despite the long list of potential threats, we would note that the global economy has been remarkably resilient to an array of moderate shocks and uncertainties in recent years, and suspect that growth will ultimately remain buoyant through next year.

The Bottom Line: The world economy is now as healthy as at any time since the start of this cycle. While there are early indications that growth may be topping out, it will be supported over the next year by U.S. fiscal stimulus. Still-solid global growth will keep the slowly grinding upward pressure on commodity prices, inflation, and bond yields. That combination will, in turn, likely eventually sow the seeds of the next economic setback, in the years after 2019.







General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such Information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site http://economics.bmocapitalmarkets.com. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

® Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group