2017 Themes to Watch

ECONOMIC GROWTH: TRADE POLICY

Is China the new champion of globalization? They may be leading the way for the global economy, and these insights share how. China's economic development over the last generation has been staggering. The recent announcement of over 40 international-contracted projects in 60 countries along the Belt and Road Initiative route worth a cumulative $90 billion is striking … and potentially very economically dynamic.

Chris Bailey, *European Strategist, Raymond James Euro Equities**

The Chinese people refer to their own country as "zhongguo," which directly translates to "Middle Kingdom." Around 3,000 years ago, the Chou people adopted the belief that their empire occupied the middle of the earth, surrounded by barbarians. Back then, the Chou people would have been astonished at the simultaneous development of the Greek and subsequently Roman Empires, but, in their splendid isolation, the phrase stuck.

A BURGEONING INITIATIVE

Returning to the modern world, China has steadily increased its share of global economic interaction over the last 30 years. The World Bank and International Monetary Fund now show China's share of the global economy at 17.2% (in real GDP terms), exceeding the United States' equivalent statistic of 15.7%. Such is the benefit of a population of well over a billion people and a progressive series of economic reforms over the last generation that have seen a largely agrarian economy become the world's manufacturing powerhouse. In regard to the latter, the economy has been augmented by policy initiatives designed to expand consumption and the service sector.

> "A lot of people, including business leaders, think the future belongs to China. Globalisation is not a zero-sum game, but we need to hone our skills to stay in play."
>
> – Jon Meacham

These changes have given the country a new political and diplomatic confidence that would have been alien to the inward-looking Chou people, or even the first 50 years of Chinese Communist Party leadership. President Xi Jinping's inaugural appearance at the World Economic Forum in Davos, Switzerland, occurred the same week as the inauguration of President Donald Trump. Xi's message of "whether you like it or not, the global economy is the big ocean you cannot escape from" has been followed up by an even bigger global economic and trade play: the Belt and Road Initiative, a modern reworking of the old Silk Road trading route between China and Europe.

China's economic development over the last generation has been staggering. The recent announcement of over 40 international-contracted projects in 60 countries along the Belt and Road Initiative route worth a cumulative $90 billion is striking … and potentially very economically dynamic. This was supplemented by the Middle Kingdom signing bilateral investment treaties with 104 countries involved in the Belt and Road Initiative and gives a feel for its potential medium-term significance.

The economics and politics of geography and topology are absolutely fascinating. Centuries ago, the Silk Road trading route was, for a long time, the only link between a distant Western Europe and a distant East Asia, with its path defying all terrain supremely dangerous and difficult to traverse. Modern transportation by sea and air provide alternatives, but land-based road and rail will inevitably bear the biggest burden. So, any modern infrastructure benefits that can facilitate this more easily is a win-win, and the Chinese understand this.

DEALING WITH TRADE

Of course, none of this is done out of pure charity. It makes complete sense for an evolving Chinese economy to engage with the rest of the Eurasia land mass to trade more and generate mutual wealth. The difference is China's pre-eminent role in driving such engagement … and that I have not mentioned the United States once in the last three paragraphs.

There will be many twists and turns in the foreign policy initiatives of the United States, but it is likely that a "fair trade" rather than "free trade" focus will be central. A quick glance at average tariff levels

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> The global economy is the big ocean you cannot escape from.
>
> **– President Xi**

> China's Belt and Road initiative would have an underappreciated uplifting effect on many of the emerging markets.
>
> **– Pavel Molchanov,** Senior Vice President, Energy Analyst, Equity Research

shows China imposing much higher barriers than either the United States or Western Europe. Globalization by China has some distinct differences, and an expectation that tariff levels will be sharply and rapidly reduced to the levels seen in these other geographies is probably wishful thinking.

"Capitalism with Chinese characteristics" is an evolving reality, but just like the "dollar diplomacy" of yesteryear, money always talks, especially in many poorer and/or significantly smaller Asian nations that increasingly rely economically on China. Expect Chinese globalization to be suitably mercantilist in nature; to help generate surpluses, keep the domestic nation state strong, and build power and influence to support these objectives.

However, before we slide into loose talk about emerging trade blocs and material interruptions to the current level of trade flows, remember this: the Chinese economy is currently undertaking a lot of transitions, and stability remains the most prized characteristic for its political leadership. The Chinese are still in building mode, and this means championing, not blowing up, global trade flows. However, in another decade or so, matters may be different, giving the United States a window of opportunity. Is it time to force change, or just live with changes over time from the East?

2017 Themes to Watch (cont.)

US CENTRAL BANK POLICY

With the US job market nearing full employment and inflation showing signs of picking up, Federal Reserve (Fed) officials are more comfortable with a pace of rate increases that is still gradual, but less "glacial."

Scott J. Brown, Ph.D., *Chief Economist, Equity Research*

Since taking over as chair of the Fed, Janet Yellen's primary goal has been to normalize monetary policy. The Fed lowered the federal funds target range to 0 - 0.25% in December 2008, and held it there for seven years. As the Fed initially raised the target range in December 2015, officials generally expected to raise rates four times in 2016. A slowing in the pace of job market improvement and a more modest inflation outlook countered those expectations, and the Fed raised short-term interest rates only once that year, in December. This year, Fed officials are more comfortable raising rates, but it should still be a gradual pace.

Inflation figures are often a bit choppy in the first few months of the year. Many firms will try to raise prices to see if they stick. That may have been the case in January and February. Core inflation was mild in March and April, partly reflecting an unusually large one-time drop in the price of wireless telecom services. Reflation expectations in commodity prices have softened in the last couple of months (outside of oil prices, it takes a gigantic increase in the price of raw materials to have much of an impact at the consumer level). While factory sector activity has improved, we are seeing few signs of the type of bottleneck production pressures that would lead inflation higher; by contrast, we are still seeing mild deflation in prices of consumer goods excluding food and energy. The labor market is the widest channel for inflation pressures, and wage growth has remained generally moderate.

The US job market has been the primary focus for Fed policy. It's unclear how much slack remains, but the broad range of indicators suggests that we are at or near full employment. Monetary policy is still accommodative. Hence, the Fed wants to move closer to a "neutral" policy position. The best analogy is that the central bank is not hitting the brakes so much as gradually taking the foot off of the accelerator.

During the financial crisis and its aftermath, the Fed increased the size of its balance sheet by more than $3.5 trillion through its three large-scale asset purchase programs. The Fed has been reinvesting principal payments (maturing Treasuries and mortgage-backed securities), keeping the size of the balance sheet steady, but officials expect to change the policy later this year. The Fed will set a $10 billion cap, or limit, on the dollar amounts of Treasury and agency securities that will be allowed to run off each month ($6 billion for Treasuries, $4 billion for MBS), and only the amounts of principal payments that exceeded the caps would be reinvested. The caps will be increased every three months, eventually reaching $50 billion per month. The Fed reserves the right to resume the reinvestment policy or to increase the size of the balance sheet if economic conditions warrant.

The end of the reinvestment policy should not be unsettling for the financial markets, but there is some potential for confusion. Recall the "taper tantrum" turmoil of 2013, when long-term interest rates shot up on concerns about the Fed scaling back the pace of asset purchases in the third round of quantitative easing. By starting slow, markets shouldn't become unsettled, and officials will be able to observe how the markets react as the balance sheet drawdown increases.

Of course, none of this is written in stone. Fed policy will adapt to changing conditions. There is one additional caveat. The Fed's Board of Governors will see a lot of personnel changes in the coming months, adding some uncertainty for the financial markets.

DISCLOSURE

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