Tax Cut Will Drive Global Growth: Chao

By Philip Chao *Thu, Feb 1, 2018*

'The likelihood of an inverted yield curve in 2018 has been reduced, so the likelihood of a recession has been pushed out further into 2020 and beyond,' writes Chao, principal and Chief Investment Officer of Chao & Co., a consulting firm in Vienna, VA.

Eight years after the end of the financial crisis, the global economy is much healthier and now growing in sync for the first time since 2010. The superb performance in equities/risk assets globally reflects the positive business and consumer sentiments, increased economic activities and more employment.

New tax law. The new U.S. tax law passed in December is not popular with those who are deficit hawks or who believe that the late-stage organic growth of the economy does not require pro-cyclical fiscal policy.

However, the law's business-focused tax cuts and preferences for foreign asset repatriation have given a turbo boost to the economy for 2018, and their positive impact is rippling through the rest of the global economy. IMF credits 50% of the global economic upward revision to the impact of the U.S. tax bill.

Employment. Unemployment (U3) is at 4.1% and 8.1% for the broader U6 measure and we expect the U3 to be in the mid 3% range by the end of 2018 with a sub 8% U6.

Gross Domestic Product. The advance estimate of 2.6% for fourth-quarter GDP came in below the consensus estimate of 2.9%, and 2017 ended at 2.5%, which is at the upper range of the post-financial crisis era. With the new tax cut, we expect the GDP for 2018 to be at the 3% level.

Inflation. Inflation has been the missing ingredient, and indicators are showing its return. Some of the improvements in inflation may be statistical (i.e. a change in value from a very low starting point), but much will be "pushed" to our economy under a lower US dollar, increased and sustained energy prices, and other commodities regime. When wage inflation picks up, overall inflation will likely be "pulled" as well.

Interest rates. The 2017 FOMC has been signaling three interest-rate hikes in 2018. We expect four hikes under the new FOMC due to pro-cyclical effects from the new tax bill. Our projection is also due to a possible upside surprise in inflation expectation. The likelihood of an inverted yield curve in 2018 has been reduced, so the likelihood of a recession has been pushed out further into 2020 and beyond.

Securities markets. The seeming parallel universe that we have been traveling in (i.e. risk assets continue to advance despite geopolitical and other systemic risks) will continue, and as such, we are constructive/positive on equities globally.

Due to FOMC rate normalization (bad for short end), possible inflation surprises and the less attractiveness of U.S. long yields as other yields begin to move higher, fixed income will likely be delivering a lower to no return in 2018. Commodities have performed well, as they typically do at the late stage of an economic cycle.

Risks. Downside risks remain: geopolitical risks from rogue states, findings from the Mueller's investigation into Russia's meddling in the 2016 election and the possible Trump campaign's collusion, and the mid-term 2018 U.S. election outcome.