Slowing economic growth lessens chance of September rate hike

By Ian McGugan
July 30, 2016 – *The Globe and Mail*

Growth slowed across a large portion of the global economy in recent months, for reasons ranging from cooling business investment to wildfires.

The disappointing readings on Friday from Canada, the United States and Europe underscore concerns about the lacklustre pace of expansion and put a damper on expectations that the U.S. Federal Reserve Board will raise interest rates in September.

For holders of gold and bonds, that is good news because rising rates tend to hurt both investments. But it's not an encouraging message for those who were hoping the world is poised to begin a vigorous recovery.

Canada's gross domestic product shrank 0.6 per cent in May, the fastest contraction in more than seven years. In the United States, GDP growth trudged ahead at a meagre 1.2-per-cent annualized clip in the second quarter – less than half the rate that economists had predicted. Meanwhile, the euro zone economy also expanded at a mere 1.2-per-cent annualized rate in the quarter.

The most positive way to view the numbers is to see them as a result of temporary factors that will be reversed in months to come.

That explanation seems to fit the facts in Canada, where Alberta wildfires resulted in a record plunge in non-conventional oil production. Emanuella Enenajor, North American economist at Merrill Lynch, predicted a strong bounce back in the third quarter.

However, she kept her muted outlook unchanged for the full year. "The backdrop remains challenging given low energy prices," she wrote in a note Friday. "We see the economy expanding at a mere 1.3-per-cent pace this year."

Temporary factors are harder to blame for the dismal numbers in the United States and Europe. It's not just the GDP data that suggest global growth is slowing. Look at the yield curve – a measure of the difference between long-term government bond rates and their shorter-term cousins.

A yield curve that slopes strongly upward, with bonds that mature in 10 years yielding far more than ones that mature in two years, signals that investors expect an economy to grow strongly over the next decade.

In contrast, a flattening yield curve – one where the difference between two-year and 10-year bonds is small and shrinking – suggests growth expectations are falling. Bond buyers don't mind getting a miserly return on a 10-year bond because the alternatives look even worse.

Yield curves in most major markets are now at their flattest levels since the financial crisis. This does not bode well for what lies ahead.

Diehard optimists will argue that central bank tactics are distorting yield curves with unconventional tactics, but that argument only goes so far.

The U.S. data published on Friday include not only an ugly number for the second quarter, but downward revisions to the previous two quarters as well. The numbers now show that the U.S. economy has expanded by only 1.2 per cent over the past 12 months.

That "close to stagnant" pace of growth makes a September rate hike by the Fed far less likely, according to Steve Murphy of Capital

Economics. He noted that while consumer spending expanded at a vigorous 4.2-per-cent rate in the quarter, business investment contracted. Companies' reluctance to invest in new factories, equipment and construction is being reflected in lacklustre productivity growth.

Following Friday's numbers, Mr. Murphy revised down his forecast for U.S. growth in 2016 to 1.5 per cent from 2 per cent. "Productivity growth, the single biggest driver of real living standards, has been even weaker than we previously feared," he said.