Face to Face: TrackMacro and a Gavekal Economist

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TrackMacro ™ is a software tool providing equity risk signals in 40 countries

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On November 30th, 2017, TrackMacro flashed "red" on many equity markets.

The two types of markets remaining in an equity "risk on" mode for December (hence "blue" in the heatmap) are:

- Commodity exporters, because of oil price pressure since the middle of the year.
- A few European countries, for reasons that need to be further detailed.

I have asked **Cédric Gemehl**, the Gavekal economist based in Paris and covering Europe, to comment on TrackMacro's differentiated views on the Euro zone.

The reason I did, is that TrackMacro is a neural network with a longstanding memory of risks but with limited analytical capabilities. Furthermore, December's views on European equity risks result from contradictory forces. In such a case, TrackMacro sometimes diverges from economists' understanding.

Following are Cédric's conclusions:

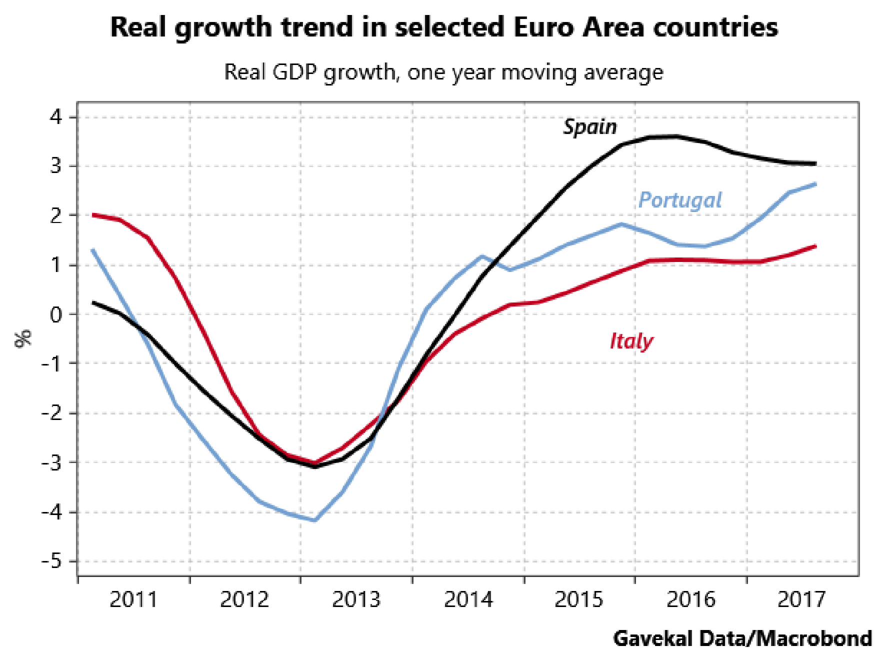
"On a country-by-country basis, the TrackMacro discriminating factor was the 'four quadrants' rule (the crossing of inflation and growth). Countries with a positive inflation-growth mix ended up with global 'risk on' signals for equities. The reverse being also true.

In macroeconomic terms, this means that in Italy, Portugal, Ireland and Belgium, a positive growth-inflation mix offsets the negative impacts from the deteriorating World USD liquidity and rising commodity prices. While the growth-inflation mix did not necessarily deteriorate in the rest of the Eurozone, it did not improve either, and, thus, was not able to offset the negative impacts from the two factors mentioned above.

This result looks broadly in line with the macroeconomic analysis.

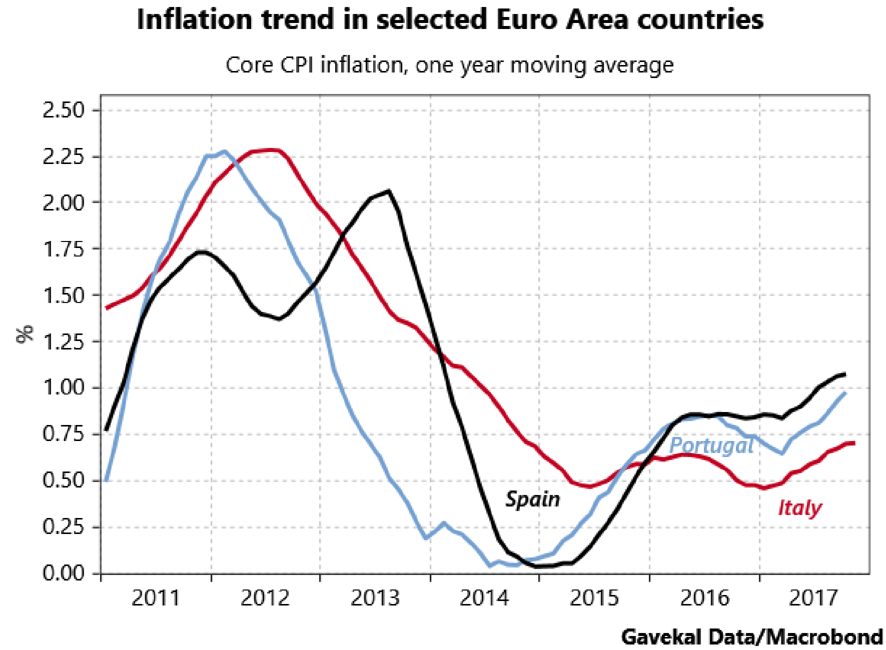
To understand why, let's first consider the differences between Italy, Portugal (showing a 'risk on' signal for equities) and Spain (showing a 'risk off' signal for equities). The first chart below shows that the Spanish economy has already passed peak growth in 2016. This is consistent with economic growth forecasts showing a clear deceleration in economic growth ahead. By contrast, the Italian and the Portuguese economies are still in the growth acceleration phase and are only expected to reach peak growth in the course of next year.

Fig 1. Growth in Spain, Portugal, and Italy



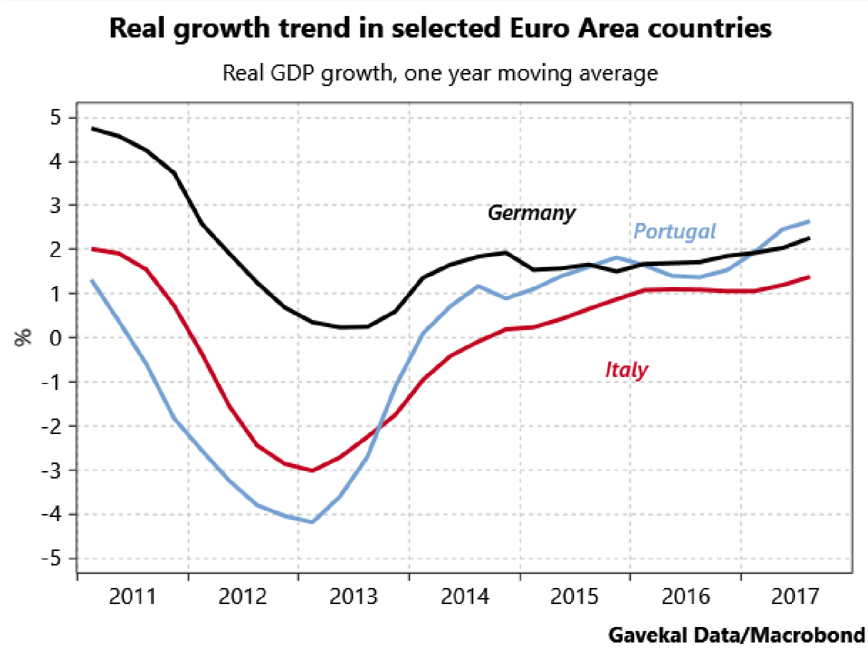
Accelerating growth in Italy and Portugal can therefore more than offset the moderate acceleration in inflationary pressure shown in the second chart below. Thus, the growth-inflation environment can remain supportive. This is not the case in Spain, where an acceleration in inflationary pressure, even if moderate, results in a deteriorating inflation-growth mix.

Fig 2. Inflation in Spain, Portugal, and Italy



Now, let's consider the differences between Germany (showing a 'risk off' signal for equities in TrackMacro) and Portugal, Italy (showing a 'risk on' signal for equities). The first chart below clearly shows that the Germany economy is still accelerating. Unlike Spain, Germany has not reached peak growth yet, so peak growth does not explain why Germany flashes red and Italy, Portugal blue.

Fig 3. Growth in Germany, Portugal, and Italy



Here, the explanation lies in the different positions in the economic cycle. The second chart below shows that the output gap – the difference between actual and potential output – in Germany is above zero, while it is negative in Italy and Portugal.

Practically, this means that the German economy is in a situation where the overutilization of productive capacities is feeding inflation, while this is not the case in the Italian and Portuguese economies still operating below capacity. Even though Germany is accelerating like Portugal and Italy, it does not result in an improving growth-inflationary mix, since inflationary pressure is higher. “

Fig 4. Output Gap in Germany, Portugal, and Italy