Global Macro Update: Geopolitical Tensions Won't Slow Growth

By The Standish Global Macro Committee

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EXECUTIVE SUMMARY

Geopolitical risks have increased with political upheaval in Ukraine and rising tensions between Russia and the West taking center stage. However, Ukraine is only a $175 billion economy (in nominal GDP) and is not likely to have much impact on the $73 trillion global economy. Furthermore, the Europeans do not appear to want to escalate the confrontation with Russia given their dependence on Russian energy and it is doubtful the United States will push much beyond sanctions. Therefore, our base case is that the crisis will not intensify, though it will continue to be a source of potential volatility in global financial markets. Overall, our forecast for world GDP growth remains unchanged at 3.5 percent in 2014 and 3.7 percent in 2015.

UNITED STATES	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.7%	–	2.9%	–
Inflation	1.8%	↑	2.0%	↑

↑ positive surprise more likely over next six months ↓ negative surprise more likely over next six months – no bias

Source: Standish as of March 4, 2014

The U.S. economy began 2014 on a soft note with reports on consumer spending, business investment, and housing uniformly disappointing. Adding to worries were downward revisions to Q4 2013 GDP, which was reduced from 3.2 percent to 2.4 percent on the back of weaker consumption. However, we believe there will be light at the end of the tunnel as the harsh winter weather fades and we head into spring.

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Indeed, the February employment report, which showed a gain of 175,000 jobs, may be the first sign of a rebound. While we expect Q1 GDP growth to come in below trend at around 2 percent, we anticipate a quick bounce back in Q2. Overall, we have not altered our full-year forecast for growth of 2.7 percent in 2014. Later this year, expect to see the improving labor market translating into somewhat faster wage growth, which should help stabilize inflation. Given this backdrop, we believe the Federal Reserve will end its quantitative easing program by October and the focus will shift toward the central bank's timing for normalizing short-term interest rates.

There are upside risks to the 2014 consensus forecasts

EURO AREA	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.2%	–	1.0%	–
Inflation	0.7%	↑	1.2%	↓

Source: Standish as of March 4, 2014

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Eurozone purchasing managers' indices (PMIs) were a bit of a mixed bag in February. Germany outperformed France but the German manufacturing PMI underperformed the services PMI, as global financial volatility and extreme U.S. weather conditions took a toll on world manufacturing output. Going forward, broader measures of confidence point toward growth through Q2 2014. In our view, there are upside risks to the 2014 consensus forecast of 1.0 percent. We estimate real output will increase 1.2 percent in the euro area this year before slowing back to 1.0 percent in 2015 as the fiscal drag resumes in France and Spain and contracting real money supply affects domestic demand at a lag. Credit is a drag, as banks retain earnings and pay down their Long Term Refinancing Operation (LTRO) money to the European Central Bank (ECB) in order to window dress for the asset quality review this year. The ECB has allowed its balance sheet to contract, which we believe is a mistake during a deleveraging cycle. The ECB is likely to grow its balance sheet again but not until realized inflation falls further toward zero percent in the second half of 2014.

UNITED KINGDOM	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.6%	–	2.5%	–
Inflation	2.2%	–	2.2%	↑

Source: Standish as of March 4, 2014

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The U.K. growth story continues to remain strong and the composition of growth may be improving. The second estimate of Q4 2013 GDP remaining unchanged at 0.7 percent quarter-on-quarter (q/q), but the component breakdown showed some unexpected upside surprises. Gross fixed capital formation increased 2.4 percent q/q due to an increase in business investment, such as buildings and machinery. While this was from a relatively low base and includes some inventory accumulation, it does suggest the sources of growth may be broadening out from the heavy reliance on household consumption. Thus, we will be watching this closely to see if it continues. Healthy confidence levels amongst business leaders have led to robust employment growth as well. Indeed, it is the sharp decline in unemployment during the second half of 2013 from 7.8 percent in June 2013 to 7.2 percent in December 2014, that led the Bank of England to augment its forward guidance strategy towards a more fuzzy form of guidance based on a collection of quantitative indicators, rather than just a single measure of unemployment in its February Inflation Report. This augmentation was designed to calm market expectations about immediate increases in the policy rate, although recent comments from external members of the Monetary Policy Committee have suggested that rate hikes are to be expected from the outset of 2015.

Chinese data releases have been mixed over the past month.

CHINA	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	7.2%	–	7.0%	–
Inflation	3.0%	↓	3.2%	–

Source: Standish as of March 4, 2014

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The Chinese data releases have been mixed over the past month. The purchasing managers' index declined, yet credit supply and trade data were broadly stronger than expected. The data has been heavily distorted by seasonality around the Lunar New Year and we will need to wait until mid-March data to get a clear reading on the near term macro outlook. The Peoples' Bank of China (PBoC) latest monetary policy report confirmed that policymakers view rising and more volatile interest rates as a natural outcome of financial liberalization. Moreover, it helps prevent credit and monetary growth from rising too fast. This suggests that PBoC will tolerate the current high interest rates and maintain a tightening bias. We expect policy to remain tighter relative to last year and maintain our view that GDP growth will slow to 7.2 percent this year. With inflation prints looking soft the past few months due to slower growth, we now see some downside risks to our 3 percent inflation forecast for this year. This should give some maneuvering room for the PBoC to inject liquidity and give support should growth slow more than they expect.

No major Latin American economy is expected to dip into recession.

JAPAN	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.5%	↓	1.4%	↑
Inflation	3.0%	↓	2.2%	–

Source: Standish as of March 4, 2014

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The outlook for the Japanese economy remains positive, although less so than in prior months. The preliminary reading on Q4 2013 GDP came in much weaker than market expectations at an annual rate of 1 percent versus expectations of +2.8 percent. Despite some disappointment with the headline print, the underlying data was not bad with private sector domestic demand growing strongly and the external sector acting as a drag on overall growth. The underperformance of the external sector was a function of high demand for imported consumer goods ahead of the April 1 consumption tax hike and unusual weakness in exports to Asian markets. We continue to expect lower private sector consumption in the second quarter of this year to be followed by consistent modest growth in the second half. One risk to our outlook is that corporate fixed asset investment growth may slow. The majority of large Japanese corporations have extensive overseas operations and increased investment in these subsidiaries represents a key near term risk to onshore capital investment and a longer term risk to exports. Prime Minister Shinzo Abe's popularity remains high, but his government appears to have shifted it policy focus from economic to geopolitical issues. The long term success of Abenomics depends on the Abe government more aggressively pursuing structural reform.

LATIN AMERICA	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	3.2%	↓	3.6%	↑
Inflation	6.4%	↓	5.7%	↓

Source: Standish as of March 4, 2014

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Global risk aversion during the first quarter will postpone the expected rebound in Latin America. We do not expect to see stronger domestic demand or net export drivers pick up speed until market volatility subsides. Having said this, no major economy in the region is expected to dip into recession. Inflation should remain well behaved in most countries, with the exception of the highly idiosyncratic Argentina and Venezuela. Asset prices have cheapened substantially, but their value will be highlighted only after the market has experienced a period of relative stability with firm economic data from developed and other emerging market economies.

EASTERN EUROPE (INCLUDING TURKEY)	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.6%	↓	2.9%	–
Inflation	3.8%	–	4.1%	–

Source: Standish as of March 4, 2014

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The growth picture in Central and Eastern Europe (CEE) continues to improve. In Poland, Q4 2013 growth numbers saw not only a solid growth contribution from net exports, but domestic demand is picking up as well. Private consumption increased from 1.0 percent year-on-year (y/y) in Q3 to 2.1 percent in Q4. Investment also accelerated from 0.6 percent y/y to 1.3 percent. We expect the positive momentum to continue, supported by both exports and domestic demand. Although we expect some pick-up in inflation, we believe underlying inflationary pressures will remain muted through this year.

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Politics continue to cloud the outlook for the Turkish economy and assets. More political pressure was put on Prime Minister Erdogan as YouTube recordings allegedly suggested that he asked his son to hide a vast amount of cash. Mr. Erdogan maintains his innocence, and says that the recordings are fake, and an effort by the Gulen movement to remove him from power. As of now, the evidence is not conclusive. What is clear is that the government has moved to tighten control of the judiciary, the police force, and the internet. The municipal elections at the end of March will be key factor in determining whether Erdogan still has the support of the population.

On the economic front, there are some early signs of external re-balancing, which would reduce Turkey's external financing requirement. Growth is in the process of slowing, and we expect only a 1.8 percent growth rate this year. At the same time, exports are starting to pick up, January exports were up 6.8 percent y/y.

SOUTH AFRICA	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.9%	↓	3.4%	–
Inflation	6.0%	–	6.0%	–

Source: Standish as of March 4, 2014

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South Africa came out with a new budget, which was well received by the market. The fiscal deficits for this year and the next two years are now projected to be slightly lower than outlined in October's Medium Term Budget Policy Statement. For fiscal year 2014-2015, the government now expects a deficit of 4.0 percent, with some projected tightening in 2015/2016 to 3.6 percent. It was reassuring to see that the national treasury aims to keep the fiscal consolidation on track even in a challenging economic environment and political pressures in the run-up to elections later this year. On the growth front, Q4 2013 data showed a pick-up in growth to an annual rate of 3.8 percent. Growth was in particular helped by strong performance in the manufacturing and mining sectors. The improvement in the manufacturing sector was partly a result of an end to strikes that hurt production in Q3. For 2014 as a whole, we forecast growth at 2.9 percent.

RUSSIA	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.2%	↓	2.5%	–
Inflation	5.6%	–	5.0%	–

Source: Standish as of March 4, 2014

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Economic indicators continue to soften at the beginning of 2014 following subpar growth last year. Industrial production posted another fall in January, business confidence remains low, and retail sales stalled to their lowest pace since early 2010. This combination of slow growth coupled with elevated inflation and the weak ruble prompted the Central Bank of Russia to hike interest rates by 150 basis points. Ruble depreciation year-to-date is expected to add around a half percentage point to inflation while the headline rate at 6.1 percent in January was already well above the end year target. Russia's incursion into the Crimean region of Ukraine has further stoked the fire, sparking investor concern that Russia's economic growth will wane as the U.S. and Europe threaten the country with sanctions.

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