Global Macro Update: Passing Through a Soft Patch

By The Standish Global Macro Committee

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EXECUTIVE SUMMARY

World economic activity was mixed at the beginning of 2014 with geopolitical risks dominating the global landscape. The U.S. economy was among the worst performing developed markets due mostly to adverse weather conditions. However, high frequency indicator data suggest that the soft patch is already ending and stronger growth lies ahead. Chinese growth slowed as well, though targeted fiscal measures, continued low interest rates and a weakening of the yuan exchange rate are likely to prevent a sustained loss of momentum. Despite slower growth elsewhere, the euro area has managed relatively well at the beginning of 2014. We expect European growth to remain positive, though it is likely to be capped by public and private sector deleveraging in the peripheral economies. Eastern Europe has been the primary beneficiary of the strength in the euro area, yet tensions between Ukraine and Russia continue to pose risks to the region. Our forecast for world GDP growth remains unchanged at 3.5 percent for 2014 and followed by a modest pick-up to a 3.7 percent growth rate in 2015.

WORLD	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	3.5%	↓	3.7%	–
Inflation	3.5%	↓	3.4%	–

Source: Standish as of May 6, 2014

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

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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 May 6, 2014

Europe's economic growth has surprised to the upside despite a slowdown in the global economy.

The U.S. economy grew at an anemic annual rate of just 0.1 percent in Q1 2014 after expanding at a 2.6 percent pace in Q4. The weakness was broad based with an increase in consumer spending largely offset by a contraction in most other sectors of the economy. Nevertheless, we believe the soft patch is largely weather related and we continue to anticipate a rebound in real GDP growth to an annual rate of 2.5 percent to 3 percent in Q2. Higher frequency data on the labor market supports our view. The U.S. economy generated 288,000 jobs in April and job growth in the prior two months was revised higher by 36,000 jobs. The job gains were broad based with 67 percent of the 264 industries surveyed hiring during the month. Consumer spending should get support from the improving labor market and we expect business investment to pick up modestly in line with the latest new orders data. The Federal Reserve gave greater weight to the more recent data than the backward looking GDP report when it decided to continue a measured pace of tapering of its quantitative easing (QE) program at its April 29-30 policy meeting. The Fed reduced its purchases by $10 billion, which leaves it on course to end QE later this year.

EURO AREA	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.4%	–	1.1%	↑
Inflation	0.7%	↓	1.2%	–

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

Source: Standish as of May 6, 2014

Leading indicators, such as the purchasing managers' surveys, point to ongoing expansion in the Euro area. Economic growth has surprised to the upside despite a slowdown in the broader global economy. That suggests a low risk that Europe will relapse into recession. With fixed investment still 6.4 percent below its 2011 peak, there is little economic reason for the business cycle to turn downward. Therefore, we forecast positive but relatively slow growth in 2014 and 2015 due to public and private deleveraging across the peripheral economies, including Spain, Italy and Portugal. German domestic demand is stable and growing, but not by enough to close the output gap across the euro area. Consequently, inflation continues to fall despite growth. The European Central Bank (ECB) seems willing to trade low inflation and low growth for the longer-term push of structural reform and higher potential growth. However, the ECB is likely to ease further as their inflation forecast is still too high, in our view. In June, we expect the ECB to cut its inflation forecast and policy rates, taking the deposit rate below zero. This underpins our bias toward being short the euro over the near term.

JAPAN	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.0%	↑	1.0%	–
Inflation	2.1%	–	1.4%	↑

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Source: Standish as of May 6, 2014

Despite the likelihood of near term volatility in the data, the longer term outlook for Japan remains relatively positive. As the population continues to age, an increasingly large percentage will shift from being "wealth accumulators" to "wealth consumers." This should bolster domestic consumption, particularly of services. Additionally, the first widespread increases in the base wage rate in over a decade have taken place this spring. It remains to be seen if wage growth will be sufficiently robust to prevent the erosion of purchasing power in a higher tax and inflation environment, but the key metrics are moving in the right direction. Over time, we are likely to see structural upward pressure on wages as supply and demand dynamics in the labor market become increasingly tight. In the near term, we expect the Japanese economic landscape to be dominated by the 3 percent increase in the consumption tax that went into effect on April 1. That will almost certainly lead to a significant retrenchment in private sector consumption in Q2. The uncertainty is primarily around the size of the pull-back, and the speed at which the economy rebounds in the second half of the year. Given the relatively weak performance of the Japanese external sector over the past six months, negative growth in Q2 cannot be ruled out. We continue to expect the Bank of Japan to deliver additional easing in the second half of the year.

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UNITED KINGDOM	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.7%	↑	2.5%	–
Inflation	2.1%	–	2.2%	–

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

Source: Standish as of May 6, 2014

The U.K. economy has continued to expand at a healthy pace with the initial estimate of Q1 2014 GDP coming in at 0.8 percent quarter-on-quarter (slightly higher than the 0.7 percent print in Q4 2013). Data suggests that both services and manufacturing are contributing to growth and construction is no longer acting as a drag. This strong GDP print confirms that the U.K. recovery remains very much on track, despite some concerns about slightly softer leading indicators recently. Nevertheless, we expect GDP growth to slow during 2014 as the U.K. economy transitions from its relatively fast-paced recovery to a more sustainable rate of growth. Healthy economic growth has helped push down the unemployment rate more than expected with the 3 month ILO rate now at 6.9 percent, which is below the 7 percent threshold the Bank of England (BoE) set in its forward guidance. The BoE will now move into phase 2, leaving the markets increasingly reliant upon Monetary Policy Committee communications to gauge when policy rates will rise.

CHINA	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	7.2%	–	7.0%	–
Inflation	2.8%	↓	3.0%	–

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

Source: Standish as of May 6, 2014

We see greater downside risk to China's inflation outlook.

China's economy slowed to 7.4 percent year-over-year growth in Q1 2014 from 7.7 percent a quarter ago. A sustained loss in economic momentum is unlikely, though, due to targeted countercyclical fiscal policies and a differentiated easing in the required reserve ratios of rural banks that is intended to ease credit conditions in agriculture. Moreover, market interest rates remain low on account of the central bank's accommodative open market operations. Finally, the higher fixing and band widening of the Chinese yuan (CNY) has resulted in depreciation of the CNY, which lowered speculative positioning on sustained appreciation. The weaker yuan bias ought to limit downside risks to net exports and is likely to persist until domestic demand firms in the second half of 2014. Maturing wealth management and trust products will elevate the risk of defaults. In this context, the government will have to balance the maintenance of financial stability with a sustained reduction in moral hazard. We stand by our call for GDP growth to soften to 7.2 percent this year and 7 percent in 2015. We also see greater downside risk to the inflation outlook.

LATIN AMERICA	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.5%	↓	3.2%	↑
Inflation	6.4%	–	5.7%	–

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Source: Standish as of May 6, 2014

Latin American growth started the year on a sluggish note, mostly due to weak domestic demand, though mining was also responsible for slower economic activity in countries such as Peru. Real export growth has recovered, but only modestly. In general, economic surprise indices for the region have declined this year, lagging the slowdown in the U.S. With high frequency U.S. economic data rebounding, some economic acceleration should take place in Latin America during the rest of the year. In the meantime, inflation remains under control, with the exception of Brazil, where expectations remain high and where forecast monthly inflation is beginning to pierce the top of the target band. Overall, only Colombia and Brazil are likely to hike their policy rates this year, while the other major regional economies are expected to remain on hold.

CENTRAL AND EASTERN EUROPE	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.5%	↓	3.0%	↓
Inflation	1.5%	–	2.5%	–

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

Source: Standish as of May 6, 2014

Leading indicators for Central and Eastern Europe continue to point to a gradual economic recovery in the region, mostly due to the improving macroeconomic outlook in the eurozone.

Leading indicators for Central and Eastern Europe continue to point to a gradual economic recovery in the region, mostly due to the improving macroeconomic outlook in the eurozone. However, these indicators are starting to soften due to both dependence upon demand from Western Europe and growing concerns about the potential impact of tensions in Ukraine upon the region. Those trends are more evident in Poland and Hungary than in the Czech Republic which is more closely aligned with Germany.

The Hungarian central bank reduced rates to 2.5 percent from 2.6 percent at its April policy meeting. This is expected to be the final rate cut as the easing cycle comes to an end with the economic recovery looking slightly more broad-based and sustainable. In addition, the Hungarian central bank has announced changes to a variety of policies, including FX reserve requirements. The aggregate impact on Hungarian forint remains to be determined, as further changes are expected.

RUSSIA AND COMMONWEALTH OF INDEPENDENT STATES

RUSSIA	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	0.5%	↓	2.0%	↓
Inflation	5.0%	↑	4.5%	–

CIS	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	0.5%	↓	2.3%	–
Inflation	5.8%	↑	4.7%	–

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

Source: Standish as of May 6, 2014

Recent events in Ukraine and their impact on Russia have resulted in scaled back growth projections. The 200 basis point increase in official rates in Russia so far this year is mainly to support the ruble, though inflation remains higher than target and there is clearly a risk that it will overshoot. Higher interest rates as well as the impact of potentially more onerous sanctions on investment decisions point to further downside risk for growth. Ukraine is facing a severe recession and there are many uncertainties regarding the composition of the country in the future and the impact that it could have on growth and productivity. The recently agreed IMF program (which is significant in size and front-loaded) will give support, but exceptional challenges lie ahead. Further economic sanctions on Russia and the potential for further regional volatility point to a difficult year for both countries. Forecasts for Kazakhstan have been scaled back slightly, but from this point the impact on the Kazakh economy appears muted.

TURKEY	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.0%	↓	3.5%	↓
Inflation	8.5%	↑	7.5%	↑

Source: Standish as of May 6, 2014

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

Political volatility remains high following local elections as Turkey moves through the year-long election cycle.

Political volatility remains high following local elections and as Turkey moves through the year-long election cycle. That volatility touches a variety of institutions, from the President and the Prime Minister to the central bank to the judiciary. Aside from the obvious negative impact of investor sentiment, there is also pressure from the government on the central bank. Monetary policy remains relatively tight, but political pressure continues for the central bank to bring policy rates lower. Growth is set to slow in 2014, as domestic demand weakens, but rebalancing towards export-led growth should partly offset this. Thus, the current account deficit should decline to 6 percent of GDP from 7.4 percent in 2013 mainly due to lower imports. Headline inflation is expected to peak in Q2 2014 at close to 10 percent year-over-year given the weakness in the lira before trending lower towards 8.5 percent late this year. However, food prices and the need for regulated energy price increases means there are upside risks to these inflation forecasts.

SOUTH AFRICA	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.8%	–	2.7%	↑
Inflation	6.2%	–	5.7%	↑

Source: Standish as of May 6, 2014

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Growth in 2014 will likely remain poor, at a year to year rate of 1.5-2.0 percent. The fiscal impulse will be moderately negative as the government works to arrest the deterioration of its balance sheet. Private sector consumption will remain sluggish as households are relatively highly levered and consumer confidence remains low. Structural reforms of any significance are unlikely over the near term and the outlook for domestic demand is weak, so private sector fixed asset investment should not contribute to growth in a meaningfully positive way. To the extent that weak private sector demand reduces imports of consumer goods, net trade represents a possible upside surprise for growth. The major electricity company Eskom's program of rolling blackouts and ongoing labor unrest in the mining sector will likely continue to constrain industrial output. Over the balance of the year, inflation is likely to continue to edge higher with currency depreciation driving the headline consumer price index towards 7 percent and core inflation gradually approaching 6 percent. In an environment characterized by rising inflation and sub-trend growth, we suspect the South African Reserve Bank will not respond aggressively to a period of above target inflation and only hike rates gradually.

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