Developed Markets to Lead Global Growth in Second Half, Creating Credit Opportunities

By Thomas D. Higgins, PhD
Chief Economist
Standish Mellon Asset Management Company LLC

EXECUTIVE SUMMARY

- We expect global growth momentum to shift from emerging markets to developed markets during the second half of 2013.
- The rise in U.S. Treasury yields has coincided with a broad sell-off in risk assets that should partially reverse as the market comes to the view that tapering is not tightening.
- We believe that the recent market shake-out will eventually create buying opportunities in investment grade credit and high yield.
- There is always a risk that another policy mistake could heighten market volatility and tighten credit conditions at a time when growth remains subpar.

"Today is only one day in all the days that will ever be. But what will happen in all the other days that ever come can depend on what you do today."

—Ernest Hemingway

We expect the global economy to strengthen in the second half of 2013, but growth is likely to be uneven and risks remain. In developed markets (DM), the headwind from fiscal consolidation in the United States and Europe should begin to fade. The spending cuts associated with the budget sequestration in the U.S. were largely frontloaded and should have their largest impact at the beginning of the summer. At the same time, European leaders are beginning to show greater leniency on debt and deficit targets for eurozone members as they struggle to bring down high jobless rates across the continent.

We expect the global economy to strengthen in the second half of 2013, but growth is likely to be uneven and risks remain.

However, the upside to global growth may be capped by recent developments in emerging markets (EM). Soft global demand has resulted in lower commodity prices and a slower pace of foreign direct investment in EM economies. Moreover, some of the larger EM countries, including China and Brazil, are coping with structural issues that may lower the long-term trajectory of growth. Therefore, while EM economies will continue to grow at rates that are multiples of their DM counterparts, there may be a temporary shift in growth momentum toward DM countries in the latter half of the year.

Overall, we expect the global economy to expand 3.1% this year and accelerate to 3.6% in 2014. The greatest risk to our outlook remains a policy error. Officials at the Federal Reserve appear to be concerned about the potential overheating in U.S. credit markets and have begun talking about tapering asset purchases sooner than economic conditions might warrant. At the same time, the lack of progress on the reform agenda in the eurozone threatens to undermine a potential second half recovery. We were already disappointed by the frontloaded nature of the fiscal consolidation in the U.S. and Europe. Now we are concerned that another policy mistake could heighten market volatility and tighten credit conditions during a period of subpar growth.

Exhibit 1

June 2013	Standish						IMF					
	Real GDP			CPI			Real GDP			CPI		
Survey	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
United States	2.2	1.8	2.2	1.8	1.8	1.8	2.2	1.9	3.0	1.8	1.7	1.8
Japan	2.0	2.2	1.8	-0.2	0.7	3.0	2.4	1.6	1.4	-0.2	0.7	3.6
United Kingdom	0.2	0.6	1.5	2.6	2.8	2.4	0.2	0.7	1.5	2.6	2.6	2.4
Eurozone	-0.6	-0.7	1.0	2.2	1.4	1.4	-0.6	-0.3	1.1	2.2	1.6	1.4
Developing Asia	6.6	6.9	7.0	4.7	4.3	4.6	6.6	7.1	7.3	4.7	5.1	4.8
Eastern Europe & CIS	2.6	2.5	3.2	5.6	4.8	4.8	2.6	2.9	3.5	5.6	5.4	5.2
Latin America	3.0	3.4	3.5	5.9	6.9	6.8	3.0	3.4	3.9	5.9	6.1	5.5
Global	3.1	3.1	3.6	3.8	3.5	3.7	3.3	3.6	4.6	3.8	3.7	3.7

F= Forecast

Source: Standish and The International Monetary Fund forecast as of January 2013 based on purchasing power parity.

TIMING FED TAPERING

The U.S. economy started 2013 on a positive note, with real GDP growth of 2.4% in the first quarter. Yet, the combination of the payroll tax hike and the budget sequestration are beginning to weigh on the more recent data. Our base case scenario is that economic growth will soften to a 1.5% pace in the second quarter before recovering back toward 2.5% in the second half of the year as the fiscal drag subsides. We believe the main driver of growth will continue to be the U.S. consumer, as employment gains begin to translate into faster wage growth. The housing sector should also be supportive of the economy, though the recent back up in mortgage rates may temper activity. Corporate spending is expected to contribute to growth in the second half, but is unlikely to be the primary driver of economic activity. Profit growth has slowed and there is little incentive for businesses to build up inventories in anticipation of future consumer demand.

At its June policy meeting, the Federal Reserve indicated that it expects to begin tapering its asset purchases sometime during the second half of 2013 depending on the evolution of the labor market. Up until May, we had been under the impression that the Fed was going to wait until it was clear that the economy had weathered the fiscal drag before stepping down its asset purchases. However, recent Fed commentary seems to suggest that they have lowered the bar for tapering. Quantitative easing (QE) has exhibited diminishing returns over time and the central bank may be worried about fueling another asset bubble. At the same time, Fed officials have discounted softer economic data and the recent downtrend in inflation characterizing it as temporary.

Therefore, as long as average growth in nonfarm payroll employment remains in the 200,000 per month range through the fall, we believe the Fed will taper the pace of asset purchases while emphasizing that monetary policy remains highly accommodative. Initially, we expect the Fed to reduce its asset purchases from roughly $85 billion/month to approximately $65 billion/ month with proportional reductions in their purchases of mortgages and Treasuries. We do not expect the Fed to end its purchase plan until the labor force participation rate begins to increase and the unemployment rate drops closer to 7% in the first half of next year. The Fed will want to see evidence that the recent downtrend in inflation and inflation expectations has reversed course before ending QE.

We do not expect the Fed to end its purchase plan until the labor force participation rate begins to increase and the unemployment rate drops closer to 7% in the first half of next year.

The Fed's tapering talk has increased the uncertainty about the future path of interest rates and raised market volatility. We believe the Fed probably intended to insert some volatility in order to dampen the "reach for yield" in fixed income markets. However, there is a risk that tightening financial conditions could stall the economic recovery at a time when the fiscal drag is likely at its greatest. Thus, it would not surprise us to see the Fed push out the date for ending its asset purchases should the rise in Treasury yields begin to negatively affect economic growth.

IS EUROPE FINALLY BOTTOMING?

The flash estimate of eurozone real GDP showed the economy contracting at a 0.9% annual rate in the first quarter of 2013. Although the official details have not yet been released, regional statistical agencies hint at a sharp contraction in investment spending and domestic demand with little offset from net exports. Going forward, we expect the pace of contraction to moderate and for growth to resume in the second half of this year, albeit at a modest rate. Yet, inflation is likely to continue to trend lower and possibly dip below 1%.

Despite disagreements on the ECB Governing Council about the efficacy of further easing, we believe the downdraft in inflation will trigger a policy response, given the central bank's 2% inflation target. We expect the ECB to first cut the refinance rate from 50 basis points to 25 basis points and then lower the deposit rate into negative territory later this year. From our perspective, this action should help ease credit conditions in the peripheral economies as lower sovereign bond yields begin to push down business and consumer borrowing rates.

The near-term outlook for the Japanese economy is positive and over the next six months it is likely to be the strongest of the major developed economies.

One of the key risks to the eurozone outlook has been piecemeal progress on the reform agenda. Specifically, banking union – which encapsulates common bank supervision, resolution, and deposit guarantee funds across all eurozone countries – is a crucial element in restoring financial stability and market confidence in the single currency bloc. It seems unlikely that the single bank supervision mechanism will be in place by mid-2014 due to both logistical and political challenges. For example, there is a low probability that the ECB will be able to recruit 800 suitable bank supervisors, as well as lead on conducting in-depth asset quality reviews across eurozone banks before the end of 2013.

More fundamentally, political divergence regarding the various elements of banking union is likely to continue to inhibit progress. Core countries are reluctant to have their taxpayers foot the bill for bank bailouts beyond their borders, while peripheral economies are hesitant to have foreign bank supervisors shut down domestic banks. The lack of resolution on these issues has the potential to increase volatility in peripheral European spreads and dampen economic activity.

JAPAN TO BE THE BEST PERFORMING DEVELOPED MARKET

The near-term outlook for the Japanese economy is positive and over the next six months it is likely to be the strongest of the major developed economies. The Japanese economy began the year with a bang, printing an annualized growth rate of 4.1% due to strengthening private final consumption and rising net exports.

Looking forward, we expect growth for the balance of the year to remain robust as the impact of the supplementary budget passed in January filters through the economy and household consumption is frontloaded ahead of the hike in the value added tax (VAT) which is scheduled to take effect in the first quarter of 2014. Additionally, we expect private sector investment to turn upward as capacity utilization rises and demand for Japanese exports increases.

Given this backdrop, the Japanese labor market should continue to improve and worker compensation should gradually rise. Despite the Bank of Japan's (BoJ) commitment to achieve a 2% annual growth rate in the consumer price index by 2015, and our expectations for upward pressure on wages, we do not expect inflation to reach 2% on a sustained basis over the medium term. The depreciation of the yen and the hike in the VAT will provide a temporary upward boost to the inflation rate, but excluding these one-off effects, we expect the inflation rate to be slightly below 1% in 2013 and slightly above 1% in the following year.

Given the strength of the BoJ's commitment to the 2% inflation target and our expectations for the path of the inflation rate, we believe that additional stimulus by the Bank of Japan will be forthcoming either in the fourth quarter of this year, or the first quarter of 2014. We believe this stimulus will likely include additional purchases of longer maturity Japanese government bonds as well as domestic equities.

EMERGING MARKETS DECELERATING, THOUGH SUB-SAHARAN AFRICA BUCKING THE TREND

Over the past four years, emerging markets have led the global recovery accounting for nearly three-quarters of global growth. However, looking ahead, we expect EM economies to lose some of their momentum in the second half of 2013 due to the combination of lower commodity prices, a slower pace of capital inflows, and structural issues including diminishing returns to investment in certain countries. In recent years, a moderation in growth may have brought more pump priming by EM governments or central banks, but this time around they seem reluctant to take such action given that the tail risks to global growth are lower.

Nowhere is the slowdown in EM growth more apparent than in China where we expect economic growth to average 7.5% in 2013, which is down from 7.8% last year and an average of more than 10% over the prior decade. The Chinese economy has been too reliant on investment and infrastructure spending in recent years and the new government, led by President Xi Jinping, is determined to have the private sector play a greater role in the future. At the same time, the Chinese are hoping to rebalance growth away from investment, which is exhibiting diminishing returns, and toward consumption. Unfortunately, consumption tends to grow at slower rates than investment and thus the trajectory of Chinese growth is likely to be lower in the future.

Slower Chinese growth has implications for other EM economies. For example, growth in Latin America has disappointed during the first quarter partly due to weaker Chinese demand for commodity exports. Inflation expectations are stable, but they are at the upper end of the target bands for most of the regional central banks. As a result, central banks are mostly on hold and the tone has turned more neutral. Brazil is the one exception given the unusual combination of weak private demand and high inflation expectations. Authorities in that country are struggling to restart faster growth but some policy tightening is taking place. By contrast, central banks in Colombia and Mexico may remain more dovish given benign inflation rates and the sluggish pace of economic activity. Overall, we expect Latin American growth to be just under 4% this year.

Central and Eastern Europe (CEE) remain the fundamentally weakest EM region, as the banking, corporate and household sectors continue to repair balance sheets.

Central and Eastern Europe (CEE) remain the fundamentally weakest EM region, as the banking, corporate and household sectors continue to repair balance sheets. The recession in the eurozone is a headwind to growth and we expect EM Europe to grow below trend at 2.1% in 2013. Inflation will come down as domestic demand remains weak and commodity prices, including food, are generally lower than last year. This will allow a few central banks to cut policy rates. Governments will continue to run sizeable budget deficits, typically around 3-4% of GDP although further fiscal austerity over the next few years is anticipated as European Union member countries in the region strive to move towards fulfilling the Maastricht criteria.

Lastly, we anticipate that the improving growth outlook in DM will gradually filter through to EM economies, which should be supportive of EM dollar and local currency bonds.

Sub-Saharan Africa is bucking the slowing growth trend underway in other EM regions. We anticipate growth of 5.6% in 2013 versus 4.8% in 2012. Economic activity has been supported by better terms of trade and a gradual improvement in macroeconomic policies. We expect inflation to come down some, but it will remain relatively high in a global context. Central bank policy will vary from country to country. Nigeria is benefitting from high oil exports and has recently seen large capital inflows into the bond market, largely as a result of being included in a bond index. One exception to the strong African growth story is South Africa, where the growth outlook remains quite weak, partly due to the stronger links to Europe and other developed markets. At the same time, structural weaknesses, current account imbalances and labor relations remain worrying. However, the overall institutional quality in South Africa remains better than in the rest of the continent.

MORE SUPPORTS FOR GLOBAL GROWTH

We believe the global economy will gradually accelerate in the second half of 2013 as developed markets begin to pick up momentum. Yet it is important to remember that the DM economies are still heavily dependent on central bank liquidity to keep their economies afloat and further fiscal consolidation is necessary in order to put these economies on a sustainable debt path in the long term. The good news is that the underlying economic fundamentals in EM countries are still compelling and we would expect EM capital and trade flows to pick up as demand strengthens in the United States, Europe and Japan.

The shift in growth momentum may present opportunities for investors in the near term. For example, faster U.S. economic growth and Fed tapering talk should be supportive of the U.S. dollar later this year. The rise in Treasury yields that accompanied the change in Fed rhetoric has coincided with a broad and indiscriminate sell-off in risk assets that we expect to partially reverse as the market comes to the view that tapering is not tightening. As long as the economic data hold up through the summer, we believe investors will begin looking for opportunities in investment grade credit and high yield bonds. A recovery in eurozone growth later this year should improve the debt dynamics in some of the peripheral economies and may open up pockets of value in these bond markets as well. Lastly, we anticipate that the improving growth outlook in DM will gradually filter through to EM economies, which should be supportive of EM dollar and local currency bonds.

[THIS PAGE INTENTIONALLY LEFT BLANK]

The Alcentra Group
BNY Mellon ARX
BNY Mellon Cash Investment Strategies
BNY Mellon Western Fund Management Company Limited
The Boston Company Asset Management, LLC
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Insight Investment
Mellon Capital Management Corporation
Meriten Investment Management
The Newton Group
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Urdang Capital Management, Inc.
Urdang Securities Management, Inc.
Walter Scott & Partners Limited

BNY MELLON

BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited

金融商品取引業者：関東財務局長（金商）第 406 号
〔加入協会〕一般社団法人　投資信託協会
　　　　　　一般社団法人　日本投資顧問業協会