Global Growth Resynchs as EM Economies Stage Modest Recovery: Standish Global Economic Outlook for 2014*

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"Without continual growth and progress, such words as improvement, achievement, and success have no meaning."

— Benjamin Franklin

EXECUTIVE SUMMARY

In his global economic outlook for 2014, Standish Chief Economist Tom Higgins expects a pick-up in global growth from 3.0 percent to 3.5 percent as a rebound in developed markets (DM) filters through to emerging market (EM) economies. Tom sees a "resynchronization" of global growth in 2014 as EM economies stage a modest recovery and DM economies continue to move ahead. While he anticipates that EM economies will do better in 2014 than in 2013, idiosyncratic risks may make country and security selection more important than ever. Tom expects U.S. Treasury yields to gradually move higher as inflation begins to stabilize due to improving wage growth. The U.S. dollar should strengthen, he says, as monetary policy diverges between the U.S., Europe and Japan. The main risks to his 2014 outlook include potential further weak EM growth due to structural factors; intensifying disinflationary forces in the U.S.; and rising U.S. interest rate volatility.

Overall, our projections for global GDP growth in 2013 were reasonably accurate.

THE RESYNCHRONIZATION OF GLOBAL GROWTH

As we begin the New Year, we reflect back on the past year and look ahead to challenges we see in 2014. Overall, our projections for global GDP growth in 2013 were reasonably accurate, with the world economy expanding 3.0% compared to our expectation of 3.3%.

Yet, we were generally too optimistic on the prospects for emerging markets (EM), where the surprises were almost universally negative. Chinese economic growth slowed more than anticipated, commodity prices trended lower, and the U.S. Federal Reserve's talk of tapering quantitative easing (QE) led to a reversal of EM capital inflows. Consequently, our forecast for EM GDP growth was a little wide of the mark at 5.5% versus 4.5%, with disappointments spread evenly across regions.

*Standish CIO David Leduc will provide his 2014 market outlook in a forthcoming report.

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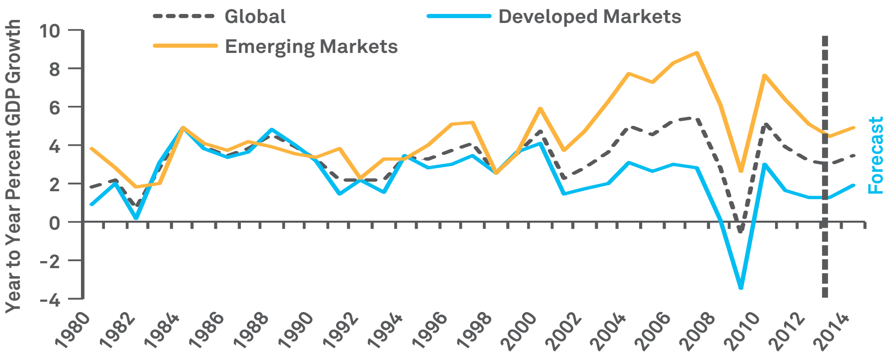
These negatives in EM contrasted with some positive surprises in developed markets (DM). The Bank of Japan (BoJ) launched a massive QE plan of its own to stimulate growth and end deflation, economies in peripheral Europe rebounded more quickly than anticipated from recession, and the U.S. economy turned out to be more resilient than expected to the spending cuts associated with the budget sequestration. Growth in DM economies came in more or less in line with our expectations at 1.3% for the year.

In 2014, we are projecting a pick-up in global growth from 3.0% to 3.5% as the rebound in DM economies filters through to EM economies. We expect inflation in DM economies, with the exception of the euro area, to stabilize and gradually increase as growth accelerates and unemployment rates decline. We are also anticipating some divergence in monetary policy between DM economies as the Fed scales back unconventional policy measures, while the European Central Bank and the BoJ continue to ease.

While we have a high degree of conviction in our 2014 outlook, unforeseen events could increase our forecast error.

Resynchronization of Global Growth



Source: Standish, International Monetary Fund (IMF) as of December 20, 2013.

WHERE COULD WE BE WRONG?

While we have a high degree of conviction in our 2014 outlook, unforeseen events could increase our forecast error. We see three primary risks to our forecast: 1) EM growth remains sluggish due to structural factors; 2) disinflationary forces in DM economies intensify given the large output gap; and 3) U.S. interest rate volatility increases with Treasury yields moving sharply in either direction.

First, there are both cyclical and structural components to the EM slowdown. The cyclical slowdown is most evident in countries such as Mexico, where weak external demand and cutbacks in government spending weighed on growth. We expect this to reverse in 2014 as a stronger U.S. economy and reforms to the banking and energy sectors begin to lift economic activity. Cyclical factors have also weighed on the performance of economies in Eastern Europe with the exception of Turkey. We anticipate that countries like Poland, which has strong ties to the German manufacturing sector, will benefit from improving demand in the euro area in 2014.

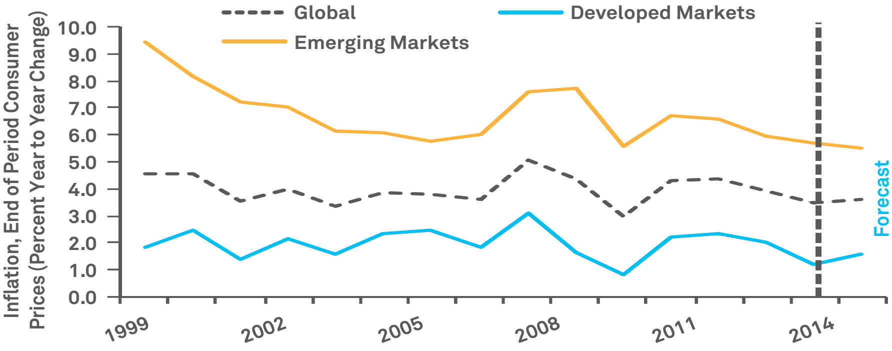
By contrast, the slowdown in other EM economies may be more structural. China's export and investment-led growth model has been exhibiting diminishing returns with each new unit of investment returning less than a unit of GDP. The country unveiled an ambitious reform plan at its Third Plenary Session in November to address some of the economic and financial sector imbalances that have accumulated over the past few years, but such reforms may take time to bear fruit. In the meantime, resource-based EM economies — such as Brazil, Russia, or Indonesia — may face challenges given their reliance on Chinese demand and their failure to implement supply side reforms during the commodity boom over the last few years. Although we do not believe these structural issues will result in a widespread EM crisis, they pose downside risks to our forecast for a modest pick-up in EM growth from 4.5% to 4.9% in 2014.

The second risk would be an intensification of disinflationary forces in the U.S. For instance, key measures of U.S. inflation have drifted lower over the past year due in part to temporary factors such as declining prices for apparel, prescription drugs, and financial services and insurance. Indeed, the core personal consumption expenditures (PCE) deflator, the Fed's preferred inflation gauge, has declined from 1.6% in November 2012 to 1.1% in November 2013. We expect the core PCE to stabilize in the first half of 2014 and begin to increase as some transitory factors fade and a tighter labor market begins to fuel faster wage growth.

The contrarian view would be that excess global capacity will continue to exert downward pressure on prices in DM economies during 2014. The disinflationary impulse is probably greatest in the euro area where inflation is already running below 1%, but inflation is also below central bank targets in the U.S. and Japan. Should disinflation persist in the U.S. economy, the Fed could be forced to reverse course on tapering QE and Treasuries could rally dramatically given that most investors are positioned for higher U.S. interest rates.

Should the U.S. economy improve more quickly than anticipated or should inflation surprise on the upside, investors may fear the Fed is falling behind the curve and send Treasury yields sharply higher.

Developed Market Inflation to Stabilize



Source: Standish, International Monetary Fund (IMF) as of December 20, 2013.

A third and related risk for 2014 would be a spike in U.S. interest rate volatility due to a policy error. After the disruptive increase in U.S. Treasury yields between May and September, rates have settled into a gradually rising trading range and volatility has declined as the Fed has emphasized that tapering QE does not reflect a tightening of monetary policy. Indeed, the Merrill Lynch Option Volatility Estimate (MOVE), which measures interest rate volatility, has fallen by half since the summer.

This has encouraged investors to engage in a "reach for yield" with many increasing their exposure to U.S. investment grade (IG) and high yield (HY) bond where valuations have tightened. Should the U.S. economy improve more quickly than anticipated or should inflation surprise on the upside, investors may fear the Fed is falling behind the curve and send Treasury yields sharply higher. The increase in volatility could trigger an exodus from fixed income markets with severe consequences for IG, HY, and EM debt markets.

LOOKING FOR VALUE IN FIXED INCOME MARKETS IN 2014

Despite these risks to our forecast, we remain comfortable with our call for a resynchronization of global growth in 2014 as EM economies stage a modest recovery. We expect U.S. inflation to bottom and increase somewhat as wage growth accelerates prompting the Fed to end its QE program by Q4 2014. Given this backdrop, we expect 10-year U.S. Treasury yields rise to a range between 3.25% and 3.75% by year-end. We also anticipate that the U.S. dollar will strengthen, particularly against the Japanese yen, Aussie dollar, and Canadian dollar.

Some of these views are shared by the consensus and are likely reflected in current market pricing. Indeed, two of the most crowded trades in the market today are those based on rising U.S. interest rates and a strengthening U.S. dollar. Therefore, we believe it is important to explore areas of the market where our view differs from the consensus. One such area is where we are a bit more constructive than the consensus and valuations are attractive. However, country and security selection will be critical to performance given idiosyncratic risks in the EM asset class. In the forthcoming second installment of our 2014 Global Investment Outlook, our CIO David Leduc will expand on the sectors of the fixed income markets we believe hold the most value in 2014.

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