

# GLOBAL MACRO VIEWS

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By: The Standish Global Macro Committee

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## World:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	3.3%	–	3.6%	–
Inflation	3.7%	↓	3.5%	–

Source: Standish as of August 5, 2014

Geopolitics has once again taken center stage as alleged Russian involvement in Ukraine prompted the U.S. and Europe to step up economic sanctions. The sanctions are still targeted at individuals and specific corporates so their impact on the global economy should be limited. Moreover, Russia only accounts for around 3% of world GDP further dampening the effects on global growth. However, certain regions will likely be affected more than others. Specifically, in Eastern Europe, the Baltic States ship roughly 15% of their exports to Russia. By contrast, other countries in the region, such as Poland, have reoriented their economies toward the euro area.

Overall, our forecast for global GDP growth remains largely unchanged at 3.3% in 2014 and 3.6% in 2015. A key risk to our outlook would be an escalation in tensions between Russia and the West that leads to sanctions against the oil and gas industry. Russia is the second largest producer of natural gas (18% of gas production) and the third largest producer of oil (13% of oil production) in the world. Hence, such sanctions could lead to sharply higher energy prices which may have global consequences.

## United States:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.9%	–	2.5%	–
Inflation	2.0%	↑	2.2%	–

Source: Standish as of August 5, 2014

The Federal Reserve tapered its quantitative easing program by another \$10 billion to \$25 billion per month at its July meeting while acknowledging that U.S. “economic activity rebounded in the second quarter.” Indeed, the U.S. economy expanded at an annual rate of 4% in the second quarter and first quarter growth was revised up to -2.1% from -2.9%. The recovery was driven by consumer spending, private inventories, business investment, and government spending. The large increase in inventories during the quarter likely overstates the improvement in the economy and this may be a bit of a headwind to growth in the second half of 2014. However, the pick-up in business investment, particularly equipment and software spending, which increased at an annual rate of 7%, bodes well for the future. Therefore, we continue to anticipate that real GDP growth will average roughly 3% in the second half of 2014 and that the economy will expand 1.9% for the full year. From our perspective, this implies continued improvement in the labor market with the unemployment rate likely declining toward the upper end of the Fed’s long term 5.2% to 5.5% range by early 2015. At the same time, we expect inflation to drift back toward the Fed’s 2% target, which will make it more difficult for the central bank to stick to its promise to maintain the 0 to 0.25% range on the federal funds rate for “a considerable time after its asset purchase plan ends.” We continue to anticipate that the Fed will begin raising short-term interest rates by June 2015.

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

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## Euro Area:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.0%	–	1.3%	↑
Inflation	0.7%	–	0.8%	↑

Source: Standish as of August 5, 2014

The pace of the euro area recovery is expected to remain subdued for the rest of 2014, as recent measures of confidence are showing signs of stabilization. In July, the euro zone composite PMI (purchasing managers' index) increased to 53.8 from June's reading of 52.8, as the manufacturing and service sectors expanded for their 13th consecutive month. The positive momentum in the soft data has been mirrored by the hard data, as the unemployment rate dropped further to 11.5% and retail sales increased 0.4% in June. On balance, economic surprises have become more positive since the middle of July but remain negative overall, as demonstrated by the -26.1 level on the Citigroup Economic Surprise index. Inflation has consistently surprised to the downside, and we don't expect that to change over the near term. However, as the output gap slowly closes, wage growth re-emerges, and exchange rate weakness prevails, we do expect inflation to start turning upward in the latter part of 2014. As such, we do not expect the European Central Bank (ECB) to take further action in 2014 given that they materially downgraded their inflation forecast in June, which is now in line with our own forecast. Next year, we see upside risks to the inflation outlook, based on the view that the credit cycle improves and the euro depreciates against the dollar as the market further prices in tightening by the U.S. Federal Reserve.

## Japan:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.3%	–	0.9%	–
Inflation	2.1%	–	1.4%	↑

Source: Standish as of August 5, 2014

We have made no changes to our Japan forecast for inflation or growth. Industrial production increased 0.7% in the month of May and the all-industry activity index improved at a 0.6% pace over the month. In contrast, the trade data came in significantly worse than expected in June, as exports to Asia slumped 0.4%. The closelywatched measure of prices, the national CPI (consumer price index), rose 3.6% in June from the year before and core prices increased slightly to 2.3%. On balance, the data is consistent with a recovery from the 3.5% annualized drop in Q2 output caused by the consumption tax hike. However, the outlook is sufficiently uncertain that further action by the Bank of Japan cannot be ruled out at their October meeting when they revise their forecast. The central bank's reaction function is data dependent in coming months.

## United Kingdom:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.9%	↑	2.5%	↑
Inflation	2.0%	–	2.2%	↑

Source: Standish as of August 5, 2014

Once again, data during July continued to point to a sustained economic recovery in the United Kingdom. The initial estimate of Q2 GDP met expectations at 0.8% quarter-on-quarter (q-o-q), and was equal to the Q1 data. Although official components were not released, initial indications suggest that it is very much 'business as usual' for the UK economy with services (particularly business and finance) continuing to support growth. This Q2 GDP print now means that the UK economy is for the first time 0.2% larger than its pre-crisis peak (2008 Q1). Services are also above their pre-crisis levels – while manufacturing, production and construction continue to drag. Despite regaining the pre-crisis level of economic output, the UK has endured its slowest economic recovery since the 1930s and continues to lag all other G7 economies (excluding Italy).

While the Q2 GDP print was very much in line with Bank of England expectations, inflation and the labor market diverged. CPI came in higher than expected at 1.9% year-on-year (y-o-y) in June (up from 1.5% in May). Although the rise in inflation was broad-based, by far the biggest driver was attributable to a lack of seasonal discounting – and thus the technical nature of this increase may be slightly mitigated in July's data. Meanwhile, labor market data showed that employment remains strong, causing further declines in the unemployment rate (to 6.5%, from 6.6%). Interestingly it is full-time employment which is the source of jobs – a change from the part-time/self-employment growth we have seen previously. We continue to expect that the Bank of England will begin to raise policy rates starting in Q4 2014 due to the continued strength of the economic recovery and potential upside risks to inflation forecasts.

## China:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	7.3%	–	7.0%	–
Inflation	2.7%	–	2.8%	↑

Source: Standish as of August 5, 2014

China's GDP growth of 7.4% y-o-y in Q2 exceeded expectations and the outlook for the balance of the year has steadied with a firming trend in economic data underpinned by targeted policy stimulus. We are raising our full year growth forecast, marginally (one-tenth of a percent) to 7.3%, to incorporate the near-term effectiveness of timely and targeted policy support from the authorities as well as a more favorable external environment – which is boosting net exports. However, the effects of recently undertaken stimulus measures are unlikely to outlast the housing market correction which looks set to persist through 2016. In this context, the main challenge for the authorities will remain: maintaining enough domestic demand to prevent growth from slowing too much, without undermining structural adjustments and reforms. For now, activity indicators and PMI readings signal a healthy pace of expansion in coming months. The authorities could also remain on the path of targeted and differentiated policy easing for a while more, though stronger domestic demand and diminishing labor supply could raise inflation risks in 2015. An area of growing concern is that targeted policy support measures ultimately run counter to the reform objectives of introducing market mechanisms for allocation of credit and determination of risk. In view of this, we continue to hold on to our medium-term view of a “long-landing” as the space for and effectiveness of policy support gradually diminishes.

## ASEAN-5 Emerging Markets:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	4.9%	↓	5.3%	–
Inflation	4.4%	–	4.4%	–

Source: Standish as of August 5, 2014

ASEAN-5 emerging markets – consisting of Indonesia, Malaysia, the Philippines, Thailand and Vietnam – looks on course to slow this year, before GDP growth momentum picks up in 2015. The election of Jokowi, in Indonesia's presidential polls is now near certain. A relatively greater pro-reform stance in policies and heightened legislative vigor should hasten much needed, and growth supportive, structural and fiscal adjustments towards the end of this year. Meanwhile, the passage of a new constitution in Thailand and a firmer track record of effective policy implementation should boost Thai growth, considerably, to around 5% y-o-y in 2015, up from around 1% this year. Together, Indonesia and Thailand are seen as the principal drivers of a growth pick-up which we believe should be sustained through next year. Output in Malaysia and the Philippines is expected to remain around potential, despite ongoing monetary tightening in both countries. Finally, Vietnam could see a firmer pick-up in activity as banks accelerate the pace of lending following a multi-year slowing of credit. Incrementally firmer demand in developed markets and China will help the region, but the absence of a broader improvement in the terms-of-trade will likely weigh on economic prospects.

## Latin America:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.8%	↓	3.1%	↑
Inflation	6.4%	–	5.7%	–

Source: Standish as of August 5, 2014

Recent news has been dominated by the technical default in Argentina. At the time of this writing, many legal questions remain unanswered and a favorable solution to all parties involved is several months away. What is notable, however, is that this time around, risk of financial contagion is essentially nonexistent, as the market has correctly identified this as a uniquely Argentine problem. This is not to say that there may not be some economic contagion to a few countries in the region, particularly the close neighbors Brazil and Uruguay. A protracted impasse which cuts off capital to Argentina and results in higher inflation and a deeper recession could have some economic spillover mostly on those two countries because of their trade links. This is not good news to Brazil, which continues to decelerate and will likely end the year in recession, afflicted by a collapse of investor and consumer confidence and the dynamics of the October presidential election. Among the majors, small signs of acceleration are showing in Mexico, but we believe these will continue to be dependent on U.S. economic activity during the rest of the year. Only Colombia continues to surprise on the upside. Overall, the region is likely to have a repeat of last year's slowdown in 2014. In the meantime, the direction and level of U.S. Treasury yields will continue to be the main determinant of asset prices, including local rates and exchange rates.

### Central and Eastern Europe (excluding Turkey):

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.2%	↓	2.8%	↓
Inflation	1.5%	–	2.4%	↓

Source: Standish as of August 5, 2014

Growth across Central and Eastern Europe (CEE) may come under pressure in the coming months due to the escalation of EU economic sanctions against Russia. While Poland and the Baltic nations were amongst those EU sovereigns arguing most vocally for increased sanctions, they are also the most economically vulnerable due to their reliance upon Russia as an export destination. Lithuania and Latvia export between 15% and 20% of total exports to Russia, while 5% of Polish exports go to Russia (and a further 3% to Ukraine). Already we have seen Russia ban pork, fruit and vegetable imports from Poland – and further ad hoc bans may occur. A key caveat to this will be the extent to which Baltic and Polish exporters can realign their exports towards other markets. In addition, Baltic nations (as well as Slovakia and Bulgaria) are highly reliant upon Russia for their imported energy needs. Reductions in exports and/or potentially higher energy costs have led us to downgrade growth forecasts for Poland, Latvia and Lithuania in 2014 and 2015.

CEE's central banks have also continued with their easing bias in July following the ECB's package of measures announced in June. Firstly, Hungary where the National Bank of Hungary announced a 20 bps cut in policy rates to 2.1% noting that policy rates would likely remain at these levels until the end of 2015 due to anticipation of subdued inflation pressures. Given that we expect upwards inflationary pressures to return more quickly in 2015 – policy rate rises during the second half of 2015 are expected. The National Bank of Poland left rates on hold at 2.5%. However, they also dropped their forward guidance commitment to keep rates stable until Q3 2014 – increasing speculation of an impending rate cut in Q4 2014. All in all, the ECB's mega package has left CEE central banks with the room to ease monetary policy so as to support growth during a period of subdued inflation pressures. The recent escalation in EU sanctions may also tend to increase their easing bias.

### Russia and Commonwealth of Independent States:

Russia	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	0.5%	↓	1.3%	↓
Inflation	6.5%	↑	6.0%	↑

Source: Standish as of August 5, 2014

CIS	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	0.3%	↓	1.6%	↓
Inflation	6.5%	↑	6.0%	↑

Source: Standish as of August 5, 2014

Although sanctions have been stepped up from both the U.S. and the EU, they are expected to have a limited direct short term impact on the Russian economy. Yet, in the longer term, there could be reduced access to foreign capital, a lower level of foreign direct investment, and reduced international trade. The central bank hiked rates by another 50 basis points (bps), ostensibly to counteract still high food prices that are driving inflation higher, but in practice just as much to help maintain the stability of the ruble. Foreign exchange reserves have been maintained around \$470 billion. For now, economic growth has been surprising somewhat on the upside based on investment and construction rather than consumption. However, our 2015 forecast has been pared back slightly on the expectation of prolonged conflict and further sanctions. We have also reduced our projection for Ukrainian GDP growth as the conflict continues, limiting the ability to normalise the economic activity, and the inflation forecast has been raised. Despite significant international support, the situation in Ukraine remains extremely difficult on both the political and economic fronts.

### Turkey:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	3.0%	↓	4.0%	↑
Inflation	8.5%	↓	7.5%	↑

Source: Standish as of August 5, 2014

Presidential elections will take place this month, but at this time the market has internalized the almost certain election of Prime Minister Erdogan as the first president elected by popular vote (and most likely one with extended powers). Economic activity remains soft and growth is likely to remain in a 3% to 3.5% range this year and next. Inflation has begun to decelerate, as expected, but a significant retracement to the 7% area by year-end remains in question. Nonetheless, the central bank has continued its monetary easing by cutting the policy rate to 7.5% in July, from 8% previously. This highlights the priority given to growth over reaching the inflation target anytime soon. A temporary setback has been the reversal in the trade deficit in June, which was slightly wider than the month before. The basic scenario remains, however, that the current account deficit will continue to narrow this year. This, in addition to lower perceived geopolitical risk, should help to firm up asset prices in the near term following their recent selloff.

## South Africa:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.5%	–	2.7%	–
Inflation	6.5%	↓	5.7%	↑

Source: Standish as of August 5, 2014

The outlook for the South African economy remains highly uncertain. While widespread strikes in the manufacturing and mining sectors have been resolved, they will nevertheless significantly constrain total South African economic output for 2014. Furthermore, the likelihood of further labor unrest is high as the underlying cause of the strike, elevated levels of inequality and an inflexible labor market, have not been addressed. Looking at the economy more broadly, it appears that inflationary pressures are nearing a peak with producer

price index (PPI) moderating and survey based measures of future inflation stabilizing. To this end, the South African Reserve Bank (SARB) hiked rates by 25 bps at their late June meeting. This hike was largely anticipated by the market and, given the high debt burden of South African household, will likely have a significant dampening effect on disposable income and consumption. We continue to believe that the market is overly aggressive in its pricing of rate hikes and that, given the underlying weakness of the economy, the SARB will hike rates as little as possible. A key upside risk to inflation, and hence the cash rate, is the extent to which the generous (10-15%) wage hikes associated with the resolution of the mining and manufacturing strikes flow through into the broader labor market.

All sources are Standish as of August 2014

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

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