GLOBAL MACRO VIEWS

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By: The Standish Global Macro Committee

Rebecca Braeu, PhD, CFA; Cathy Elmore; Thomas Higgins, PhD;
Nathaniel Hyde, CFA; Rowena Macfarlane; Aninda Mitra;
Javier Murcio

World:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	3.0%	–	3.5%	–
Inflation	3.7%	↓	3.5%	–

Source: Standish as of November 4, 2014

This month, we have further downgraded our world GDP forecast for 2014 from 3.2% to 3.0% primarily due to weaker growth in emerging markets (EM). Specifically, we have become more pessimistic on the outlook for growth in the Commonwealth of Independent States, Latin America, the Middle East, and Sub Saharan Africa. Part of the weakness is the result of cyclical factors such as lower commodity prices and slower growth in Europe and Japan. However, some of it is likely structural in nature and will persist even as the economic cycle picks-up. The good news is that the U.S. economy continues to perform well, which should aid the recovery in some of these markets. Moreover, the Bank of Japan (BoJ) and European Central Bank (ECB) continue to increase the level of accommodation in order to stimulate their flagging economies. Most recently, the BoJ surprised the markets with a further expansion of their balance sheet. We anticipate that the ECB will likely follow suit in the coming months. Therefore, we still expect an acceleration in world GDP growth to 3.5% in 2015.

↑ positive surprise more likely over next six months.

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

United States:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.2%	–	2.5%	–
Inflation	1.7%	↓	2.5%	–

Source: Standish as of November 4, 2014

The U.S. economy expanded at an annual rate of 3.5% in Q3 2014, but recent data on trade and inventories suggests this is likely to be revised down to around 3%. A large increase in federal defense spending contributed 0.7 percentage points to the headline GDP increase. While this is unlikely to be repeated, there are other reasons to be optimistic that the economy can sustain a 2.5% to 3% pace into next year. First, the composition of growth remains healthy. Indeed, all of the major sectors of the economy contributed positively to the Q3 gain. Second, while growth in consumer spending was modest, increasing at an annual rate of just 1.8% in Q3, the 70 cent/gallon decline in regular unleaded gasoline prices since June should give households a boost as we head into the holiday shopping season. Third, private inventories, which subtracted from Q3 growth, now appear to be better aligned with demand and should be neutral for growth going forward. Given this backdrop, the Federal Reserve ended its asset purchase program as expected at the conclusion of its October meeting. Overall, the policy statement had a more hawkish tone than the market had anticipated with no mention of the recent slowdown in global economic activity. Instead, the Fed focused on domestic indicators, stating that the "underutilization of labor resources is gradually diminishing." The Fed also added language that made its forward guidance data dependent rather than time dependent. Thus, if the incoming information indicates faster progress toward the Fed's employment and inflation objectives than anticipated, then increases in the fed funds rate would occur sooner. We continue to expect the Fed to begin hiking short-term interest rates around the middle of next year.

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Euro Area:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	0.7%	–	1.0%	–
Inflation	0.5%	↓	0.8%	–

Source: Standish as of November 4, 2014

We are shifting our view on near-term European Central Bank (ECB) policy. Specifically, we believe that the odds that the ECB announces measures aimed at further balance sheet expansion have increased materially over our investment horizon. What has changed? First, the outlook for the German economy has deteriorated significantly, as a 25% year-over-year drop in Russian exports continues to weigh in on industrial confidence. We expect German growth to increase at an annual rate of around 1% in Q4, which is not sufficient to ease disinflationary pressures quickly. Second, the recent drop in global commodity prices is likely to weigh on the inflation outlook. Consequently, we revised down our forecast for inflation to just 0.5% through year-end with a negative balance of risks. Money supply and lending dynamics have improved but this takes time to feed through to inflation. Third, the targeted longer-term refinancing operations take-up in September was a disappointment and inflation expectations have weakened recently. Indeed, the ECB's inflation profile is the most positive predictor of inflation expectations and this has been consistently revised downward. Finally, as the Bank of Japan (BoJ) demonstrated, central banks still have room to surprise markets – this is likely the biggest card the ECB has to play. Going forward, the timing of the ECB's reaction function is quite uncertain. However, the outlook for the economy is poor enough that the inflation profile is more likely to deteriorate than improve. This is cause for further easing.

Japan:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	0.9%	–	1.7%	↓
Inflation	2.9%	–	2.7%	–

Source: Standish as of November 4, 2014

Two major and unexpected announcements occurred within days of each other. First, the Nikkei newspaper reported that the Government Pension Investment Fund (GPIF) would shift its target allocations to increase risk within its portfolio. Second, the Bank of Japan (BoJ) increased the size of its Quantitative and Qualitative Monetary Easing (QQE) program. The goal of the asset allocation shift by the GPIF is to raise domestic consumption through positive wealth effects and to increase expected returns of the pension system. The goal of the BoJ announcement was to shore up inflation expectations, ease the drag from the value added tax (VAT) hike next year, flatten the government yield curve, and ensure demand for GPIF bonds that may be sold. Under the second QQE program, the BoJ increased the size of their monetary base targets by roughly 3% of GDP (10-20 trillion yen) to 80 trillion yen per year by accumulating more risk assets such as exchange traded funds and real estate investment trusts. The BoJ also substantially increased its purchase of Japanese government bonds to offset a decline in holdings by GPIF. The BoJ will be moving out the curve "with a view to encouraging a decline in interest rates across the yield curve". In contrast to the first QQE program, which was scheduled to end in April 2015, the second QQE program will continue as long as "it is necessary for maintaining that [2%] target in a stable manner." In sum, this was a material shift in policy and one backed by just a slim majority on the board, so highly contentious. On the back of both measures, we have increased our forecast for inflation and growth for 2015. The offset to the positive economic momentum is that Abe will very likely move forward with his scheduled VAT hike from 8%-10% next year.

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

United Kingdom:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	3.0%	↑	2.5%	↑
Inflation	1.8%	↓	2.0%	↑

Source: Standish as of November 4, 2014

Third quarter UK GDP was estimated at a robust 0.7% quarter-on-quarter earlier this month, in-line with our expectations and just slightly down from the 0.9% quarter-on-quarter growth seen in Q2. A modest slowdown in growth was expected given the continued poor economic performance of the eurozone, the UK's key trading partner. Growth continued to be driven by services, particularly those related to leisure activities, communications and business/finance. Looking forward, expectations are for growth to slow slightly into Q4 given a variety of external headwinds. Nevertheless, the UK will continue to outpace the eurozone in its economic recovery. Headline CPI inflation came in unexpectedly weak at 1.2% year-over-year in September, down from 1.5% in August. Core CPI excluding energy, food, alcohol and tobacco was also down to 1.5% year-over-year, from 1.9% previously. While some softening in the data was expected due to lower petrol prices, the slowdown was larger than anticipated as a result of broad based weakness across sectors. We await confirmation of a continuation in this trend before changing our forecast given that some of the volatility was attributable to large moves in air and sea fares.

China:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	7.3%	–	7.0%	↓
Inflation	2.4%	–	2.5%	↓

Source: Standish as of November 4, 2014

Chinese authorities have continued to keep up a steady dose of accommodation through targeted monetary policies, while avoiding a broader, untargeted easing. This, alongside the firming of net exports, limits the risks to headline GDP growth this year. However, the scale of the easing, though supportive, will be insufficient for turning around China's growth prospects in 2015. In particular, the property sector, which is undergoing a multi-year adjustment, will continue weighing on the economic outlook. Moreover, although both credit and economic activity have decelerated, the growth of nominal credit continues to outpace that of nominal GDP, thereby underscoring the lengthy de-leveraging process which still lies ahead. Amidst this backdrop, the Chinese yuan (CNY) continues to appreciate gradually against the US dollar, as monthly trade surpluses have recently surprised on the upside. A firmer CNY has also been an important backstop for other Asian currencies, amid the strengthening value of the dollar. However, capital outflows and valuation losses on the People's Bank of China's (PBOC) foreign exchange reserves have been substantial. Although we don't expect the authorities' currency management policy to undergo an imminent shift, recent capital outflows have curtailed the pace of foreign exchange reserve accumulation. As increases in net foreign assets are a key component of the PBOC's base money creation, slower sales of foreign exchange to the central bank have prompted additional liquidity easing – such as the extension of 'standing facilities' to the country's larger banks, and ensuring ample interbank liquidity –so as to limit the risk of a broader credit crunch. Nonetheless, as China's 'basic balance' (current account + foreign direct investment) remains at a relatively healthy 3-4% of GDP, we doubt if capital account developments are likely to mount a large or imminent challenge to the policy framework.

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ASEAN-5 Emerging Markets:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	4.9%	–	5.3%	↓
Inflation	4.4%	–	4.3%	↓

Source: Standish as of November 4, 2014

China's ongoing slowdown, sharply weaker commodity prices and idiosyncratic country developments are beginning to cloud the outlook for ASEAN-5 emerging markets—Indonesia, Malaysia, the Philippines, Thailand and Vietnam. Most ASEAN economies are increasingly reliant on Chinese demand for commodities and intermediate goods. We continue to think that the drag from weaker Chinese demand and lower prices of commodity exports will be offset, to some degree, by stronger G-3 demand in 2015. However, country specific growth risks are rising. For instance, despite the forthcoming implementation of a long-delayed fuel subsidy reform, Indonesia's parliamentary politics have turned for the worse. This could prove inimical to the broader outlook for supply-side reforms and the overall business outlook. Malaysia is expected to undertake tax reforms and tighten monetary policy in coming months. But the authorities have begun signaling a dilution of structural and policy adjustments amid rising concerns about a larger than expected adverse economic impact from falling commodity (export) prices. Even Thailand, widely expected to sustain a strong rebound, and benefit from falling commodity prices, has witnessed -at best- only an anaemic recovery, since the army-backed government took over. The feeble Thai recovery could reflect continuing doubts about political and policy stability, and growing leverage in the private sector. Meanwhile, activity remains reasonably healthy in the Philippines and in Vietnam, both of which should also gain from the drop in fuel and commodity prices. However, as these two economies account for only around 18% of the region's GDP, we see growing downside risks to the ASEAN-5 aggregate outlook for 2015.

South Korea:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	3.7%	–	3.8%	–
Inflation	1.6%	–	2.1%	↓

Source: Standish as of November 4, 2014

Low inflation, a slow cyclical recovery in domestic demand and weakening commodity prices induced the Bank of Korea (BoK) to cut its policy rate yet again by 0.25% to 2.0%, at its October meeting. The lagged impact of the BoK easing and the Korean government's recent supplementary budget should place a floor beneath growth risks in the remainder of this year and in 2015. However, inflation continues to ease and it is running well below the BoK's inflation target. Lower prices of oil imports are likely to intensify downward pressures on the headline inflation rate. Meanwhile, Korea's trade weighted exchange rate has become expensive and its export growth has remained sub-par relative to the rest of the region, fuelling the authorities' concern about growth risks from external channels should the Japanese yen or the euro weaken even further. This is likely to prolong the maintenance of a very accommodative policy stance, and it could heighten South Korean won volatility and weakness. Additional rate cuts, however, will have to take into account the systemic risks of high household debt, which continues to ease only slowly.

Latin America:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.6%	↓	2.9%	↑
Inflation	6.4%	–	5.7%	–

Source: Standish as of November 4, 2014

The re-election of Brazil's incumbent president, Dilma Rousseff, has removed a major source of uncertainty in that country. Her margin of victory was narrow, which seems to create confidence that she will introduce some reforms to the current economic model in order to improve business sentiment and stimulate private investment. Nonetheless, Brazil is unlikely to grow by more than 2% in 2015, following growth below 1% this year. Meanwhile, the ongoing recovery in the U.S. is helping to fuel a rebound in industrial production in Mexico, though we believe next year will still be relatively weak. Beyond that, structural reforms should begin to translate into faster growth. In other countries in the region, Colombia remains on track for growth close to potential, while base effects should help Peru accelerate next year to about twice the growth rate expected in 2014. Nonetheless, the overall theme of global sluggishness and soft commodity prices will remain a limitation to faster growth in most countries. While no recession is predicted at this point, it will prevent Latin American economies from returning to the average growth rate experienced over the last ten years.

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

Central and Eastern Europe (excluding Turkey):

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	2.2%	↓	2.8%	↓
Inflation	1.2%	↓	2.2%	–

Source: Standish as of November 4, 2014

While Poland surprised the market with a larger-than-expected 50 basis point (bp) reduction in the policy rate in October, a restarting of the easing cycle was expected before the end of 2014. A longer than anticipated period of deflation, increasing risks of a slowdown in growth related to both the eurozone manufacturing cycle and Russia, and the prospect of further easing by the ECB provided the National Bank of Poland with a suitable and justified opportunity to reduce the policy rate. We expect to see a further 25bps cut in November, though 50bps is also a possibility. However, that should mark the end of the brief easing cycle. Romania is also expected to reduce its key policy rate by another 25 bps prior to the end of 2014.

Russia and Commonwealth of Independent States:

Russia	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	0.0%	↓	0.5%	↓
Inflation	8.0%	↓	6.0%	↓

Source: Standish as of November 4, 2014

CIS	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	-0.4%	↓	0.6%	↓
Inflation	8.9%	–	6.1%	–

Source: Standish as of November 4, 2014

The situation between Russia and Ukraine has not changed materially over the last month, though an agreement on gas transit is reported to have been made with the help of the European Union. The ruble has been weak throughout the month, and the central bank had to resume intervention, spending almost $27 billion and culminating in a rate hike of 150 bps on October 31st. While the weaker ruble will support exports and boost oil revenues in local currency, the sharp drop in oil prices and higher rates will have an impact on overall activity. Thus, GDP forecasts for both 2014 and 2015 have been scaled back and inflation will likely remain elevated over the coming months. With parliamentary elections completed on 26th October in Ukraine, the two main parties of the President and the Finance Minister are expected to form a coalition and continue reform implementation as per the IMF. However, the economic situation remains extremely weak given the ongoing impasse in the Donbas region. If oil prices remain at current levels, Kazakhstan will also see an impact on activity and fiscal accounts, and may push through another devaluation of the Kazakhstani tenge.

Turkey:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	3.0%	↓	4.0%	–
Inflation	9.0%	↓	6.3%	↓

Source: Standish as of November 4, 2014

Inflation expectations have declined thanks to lower food and oil prices. Nonetheless, inflationary pressures persist in 2015 and this will continue to complicate the policy mix. The government puts pressure on the central bank to cut interest rates in order to stimulate the economy, despite inflation remaining above the target. This, in turn, has removed an important support to the currency, which therefore feeds back on expectations. Growth, in the meantime, is suffering from weakness in the agricultural sector, despite better performance in industries. Geopolitical risk is another factor negatively influencing the outlook, as Middle East conflicts coincide with euro area weakness and pressures on Russia. Having said this, growth should be faster in 2015 than this year, as some of the imbalances in the external and fiscal side begin to improve and the negative influence of local politics fades.

South Africa:

	2014	Balance of Risks	2015	Balance of Risks
Real GDP Growth	1.4%	–	2.7%	–
Inflation	6.0%	↓	5.8%	–

Source: Standish as of November 4, 2014

Continuing the trend seen last month, the South African economy is showing signs of stabilization and, in some areas, outright improvement. PMI's are comfortably above 50 and various measures of confidence are trending gradually higher. In general, coincident data remains mixed with the manufacturing sector showing signs of improvement, but the mining sector continuing to underperform. The pace of economic activity will almost certainly accelerate over the coming quarters, though growth is unlikely to exceed potential on a sustained basis. Over the next six months, inflation will likely continue to moderate as falling fuel and food prices put downward pressure on the headline rate. High wage growth and administered price hikes will likely keep core CPI elevated. We believe that this will give new South African Reserve Bank Governor Lesetja Kgahnyago cover to leave rates on hold. Further tightening over the near term cannot be rule out, but given the fragility of the underlying economy and the projected decline in the headline inflation rate, we do not believe it is likely.

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

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BNY Mellon Asset Management Japan Limited

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