Global Macro Views

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By: The Standish Global Macro Committee

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World:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	3.1%	–	3.5%	–
Inflation	3.4%	–	3.5%	–

Source: Standish as of September 1, 2015

Global financial market volatility increased dramatically in August as the Chinese revalued their currency and speculation about the timing of the first interest rate increase by the Federal Reserve began to rise.

Despite the heightened policy risks in the world's two largest economies, Standish growth and inflation forecasts went little changed over the month. Pockets of upgrades to our forecasts, such as growth in the U.S., were more technical in nature; however, large emerging markets, such as Brazil and South Africa, continue to face remarkable downside risks. Going forward, the balances of risks are more biased to the downside spanning 2015 and 2016 across the regions for growth and inflation. There are slight glimmers of upside potential, such as in Japan; however, these upside risks are more idiosyncratic in nature.

We look to an improvement in the global commodity and trade cycle to upgrade our world growth outlook. We are not there yet.

United States:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	2.5%	↑	2.5%	–
Inflation	0.5%	–	2.0%	–

Source: Standish as of September 1, 2015

U.S. real GDP growth rose at a revised annual rate of 3.7% in the second quarter, which was significantly higher than the 2.3% gain that was previously reported and the 3.2% increase anticipated by the Bloomberg Consensus. The poor first quarter performance, during which the U.S. economy grew at an annual rate of just 0.6%, was clearly an anomaly related to temporary factors. The upward revision to real GDP growth was broad based with consumer spending, business investment, residential investment, and government spending all higher. The improvement in fixed business investment was most notable adding nearly half a percent to real GDP growth from the prior report. Although private inventories continued to accumulate and will likely subtract from growth in the second half, the good news is that the July report on new orders for durable goods suggests the turnaround in business investment was sustained into the third quarter. Overall, the report has prompted us to revise up our full-year real GDP growth forecast by one-tenth of a percent to 2.5% in 2015 and modestly raises the risk to growth to the upside. However, we are leaving our 2016 forecast unchanged at 2.5% based on our belief that potential GDP is only running between 1.5% and 2% due to weaker readings on nonfarm productivity and labor force participation growth in this economic cycle.

Therefore, we believe that the Federal Reserve is still in play for the second half. While the likelihood of a September move may be lower than it was prior to the recent bout of global financial market volatility, it is our view that the market is underpricing a hike in the fed funds rate before year end. Indeed, the fed funds futures have not only lowered the likelihood of a 25 basis point (bp)move in September from a coin toss to 1:3, it places only a slightly higher probability on a move by December assuming the current level of the target fed funds rate. In our opinion, a rate hike is currently justified by the strength of economic growth and

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Inflation forecasts are yearly annual averages of headline CPI.

labor market conditions and these fundamentals will push domestic inflation higher over the medium term in line with the Fed's expectations. Though the Fed may not want to lift rates off the zero bound in the face of significant financial volatility; we believe they are equally concerned about waiting too long to hike rates. Hence, we think the market is underpriced for a rate hike before year-end.

Euro Area:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	1.5%	↓	1.6%	↓
Inflation	0.1%	–	1.1%	↓

Source: Standish as of September 1, 2015

The euro area economy continues to expand above potential, or 1.3% at an annualized rate in the second quarter with little to suggest much quicker expansion from here. This is stabilizing core inflation and dropping the unemployment rate. Leading indicators from the composite PMI (purchasing managers index) point to a diverging growth pattern in Q3 with France being the laggard and the periphery economies picking up steam. On balance, all signs point to steady growth with very balanced risks. Based on recent leading indicators, risks to the downside have emerged to our forecast, which may lead to slight downward revisions in the coming month. On the inflation front, the volatility in the oil market has pushed our inflation outlook down in both 2015 and into 2016. We are now firmly below the European Central Bank's (ECB) inflation outlook, which is unlikely to be revised down materially in the near term due to their outlook for global growth and lagged inflationary impacts of the 7% decline in the euro on a trade-weighted basis. The only upside risks to inflation – lower euro and a near-term bounce back in commodities – are all but gone. Therefore, we do expect the ECB to announce new measures to ease monetary policy further, possibly this year.

Japan:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	0.8%	–	1.9%	↓
Inflation	0.5%	–	1.3%	–

Source: Standish as of September 1, 2015

In Japan, we've downgraded the outlook for 2015 based on a few factors. First, the private consumption has been less robust compared to our expectations with Japanese consumers being more cautious despite the ongoing employment growth. We expect wage and income data to improve steadily on tight labor markets throughout the term of 2015 and into 2016, which will support domestic demand. The equity market volatility and weak trade statistics coming out of the rest of Asia are also giving us more of a cautious stance on the Japanese outlook over the next six months. Steady improvements in the U.S. should help; but until global trade improves more markedly, the Japanese economy is set to steadily improve but at a more "domestic" pace. Finally, we did not revise downward the growth rate for 2016. While the lower base from 2015 does make the 2016 1.9% bounce back a little less notable, we do expect policy responses – either fiscal or monetary, if needed – to support growth in 2016 amid an important upper-house election year for Abe. Our base case of no new monetary policy measures in 2015 remains, although we are a bit more skeptical amid the losses in the Nikkei and weakness in Asia ex Japan.

United Kingdom:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	2.5%	–	2.3%	–
Inflation	0.2%	–	1.5%	–

Source: Standish as of September 1, 2015

The much anticipated 'Super Thursday' on August 6th saw the simultaneous publication of the Bank of England (BOE) Monetary Policy Committee (MPC) decision (no change to base rates or quantitative easing holdings), the MPC minutes (8-1 in favour of maintaining the base rate, 9-0 previously with McCafferty the well-known hawk dissenting) and the quarterly Inflation Report. We continue to expect the BoE to raise rates in Q1 2016, however we believe they will move gradually until 2017 when stronger wage growth places upwards pressure on inflation. This view is supported by the Q2 GDP print, which came in at a healthy 0.7% quarter-on-quarter (q/q) despite expectations for a slight dip in GDP given a downturn in PMIs. Broad components show both services (particularly business/finance) and importantly manufacturing (oil/gas extraction due to tax relief) supporting growth. Looking deeper, there was an unexpected pick up in business investment and exports. And finally, the humble U.K. household continues to chug along supporting the economy.

China:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	6.8%	–	6.4%	↓
Inflation	1.9%	–	2.0%	↓

Source: Standish as of September 1, 2015

China's currency devaluation and a shift to a market determined FX regime last month caught the markets by surprise. This is an intensification of the authorities' efforts to make the renminbi

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more 'market determined' and thereby fulfill an important yardstick for inclusion in the IMF's Special Drawings Rights basket (or the SDR which would confer upon the Chinese yuan (CNY) the status of a reserve currency.) This policy shift and a further USDCNY depreciation, possibly to round 6.8, will also address the growing challenge posed by the 'impossible trinity' of propping up a fixed exchange rate, maintaining an independent monetary policy, and ensuring stable capital flows. We do not think the currency devaluation is an effort to eke out more exports or GDP growth as the risks to China's growth profile are internal in nature. Monetary policy was also eased towards the end of the month to grapple with the liquidity drain from daily FX intervention following the CNY fixing regime change and the confidence shocks from the renewed downturn in the equity market. We think the authorities will maintain a measured pace of easing through the coming 9-12 months, and will increasingly prioritize market-based tools and measures following their earlier haphazard administrative intervention in the equity market. Notwithstanding the stock market and FX volatility, and the short-term setbacks to policy credibility, we still believe Chinese authorities have enough policy space to provide counter-cyclical support and keep headline GDP growth between 6.5% to 7% in the remainder of the year. The main risk is that the authorities' unwillingness to accept a lower growth path may pose greater challenges to policy buffers and overall financial stability in 2016 and beyond.

South Korea:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	2.6%	–	2.9%	–
Inflation	0.8%	–	1.4%	–

Source: Standish as of September 1, 2015

The economy is showing signs of a shallow cyclical upturn following the end of the MERS scare, expansionary fiscal measures and the lagged effects of the monetary easing undertaken by the Bank of Korea since late last year. However, the downdraft from sluggish export growth and domestic excess capacity and leverage are firmly entrenched and should limit Korean GDP growth to below 3% in this year and the next. A depreciation of the CNY, should it occur, as we now fear it will, could impose further strain on Korea's trade weighted real exchange rate and necessitate further weakness in the won. Such currency pressure is likely despite the expected 100-200 basis point increase in Korea's current account surplus to nearly 8% of its GDP, and despite a sizable hoard of FX reserves (nearly US$400 billion.)

India:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	7.5%	–	7.8%	–
Inflation	5.8%	↑	5.5%	↑

Source: Standish as of September 1, 2015

The Indian economy continues its gradual cyclical upswing driven by favorable terms of trade windfalls from another down leg in commodity prices as well as an incremental pick-up in government fiscal spending. However, the public-sector banks remain reluctant to lend. It remains to be seen if a recent package of reforms and recapitalization funds for stricken state-owned banks will begin to unclog credit channels. The government failed to overcome political obstacles to push through with important goods and services tax and land reforms at its last parliamentary session, but, efforts are still underway. The Indian rupee has not been immune to the broader trend of Asian emerging market FX weakness following the CNY depreciation. But relatively robust growth drivers, lower leverage, and an improving external position provide fundamental support. A slackening rainfall trend as the monsoon season approaches its end has raised modest food price pressure, but the risks to overall inflation are likely to be offset by lower energy and commodity prices.

Latin America:

Brazil	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	-2.3%	↓	-0.5%	↓
Inflation	9.0%	↑	5.2%	↑

Source: Standish as of September 1, 2015

Mexico	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	2.4%	–	3.0%	↑
Inflation	3.2%	–	3.4%	–

Source: Standish as of September 1, 2015

Growth disappointment in the region is already a given for this year. Official figures are being revised downward, such as in Mexico, where the central bank and the finance minister have already introduced more than three corrections since the beginning of the year. The two main laggards in terms of expectations are Brazil and Colombia, the former because of policy and political uncertainty and the latter because of the large impact of low oil prices on the fiscal accounts. Chile and Peru may muddle through, despite the damage from declining mineral prices. Important to note, with the exception of Argentina and Venezuela, the big outliers, only Brazil is expected

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to experience a recession this and next year, while the rest will still achieve growth in the 2.5-4% range. Although fiscal accounts have suffered in the low growth environment, the real victim is monetary policy, which remains hostage to the U.S. Fed decision. Most of these countries' central banks are ready to hike policy rates in view of the inflationary impact of currency weakness and in order to provide some support to their exchange rates, and we believe many will do so before the end of the year if the Fed finally decides to start the process of rates normalization. Even Brazil may continue to tighten despite the recessionary environment. In the meantime, the strong USD environment is likely to continue putting pressure on the regional currencies, most of which are already in oversold territory. The benefit of this depreciation has not become fully apparent because of sluggish global demand and weak commodity prices, therefore, we do not expect significant improvements in the current account balance this year. On the basis of a moderate global recovery and more certainty about US monetary policy, countries such as Mexico could show better performance in 2016, while Brazil will continue to suffer from deteriorating macro fundamentals. Colombia and Brazil are both candidates for ratings downgrades over the next 12 to 18 months.

Central and Eastern Europe (excluding Turkey):

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	2.6%	–	2.8%	–
Inflation	-0.2%	↓	1.6%	–

Source: Standish as of September 1, 2015

Highlights were the Q2 GDP data, and the story is very much 'steady as she goes' with Central and Eastern Europe continuing to meet (and in some cases exceed) macroeconomic expectations. This is in contrast to much of the rest of emerging markets. At a country level, the Czech Republic, Poland and the Baltics continue to lead the way whilst Hungary is finally showing signs of slowing. Romania's growth continues to be erratic. Components show that it is domestic demand driving growth again, whilst net exports drag a little given higher demand for imports. The recent drop in oil – as well as continued improvements in the labor markets and consumer confidence – will continue to support domestic demand across the region.

Russia and Commonwealth of Independent States:

Russia	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	-3.0%	–	0.0%	↑
Inflation	13.0%	↓	7.0%	–

Source: Standish as of September 1, 2015

CIS	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	-2.6%	–	0.4%	–
Inflation	13.0%	↓	7.2%	–

Source: Standish as of September 1, 2015

Given the poor monthly activity in Russian data for Q2, it was not a surprise that real GDP contracted 4.6% year on year, with the worst quarterly contraction since 2009. July data pointed to some improvement - an increase in oil and gas output, stronger mining activity – but the outlook for the economy with low oil prices and sanctions continues to be challenging. Inflation ticked up in July to 15.6% thanks to a rise in administered prices, and the Central Bank of Russia's key rate has remained unchanged at 11% while the ruble depreciated 8% in August on the back of falling oil prices. Ukraine announced the terms of its bond restructuring on 27th August, including a 20% haircut on the eurobonds but overall on terms very favourable to creditors. The eurobond issued to Russia that matures in December 2015 has been included in the debt to be restructured, which is contentious. Ukraine's Q2 data show a very weak economy, with GDP contracting 14.7% although inflation tempered somewhat, to 55% in July. Tensions with Russia have been rising, such that the Minsk II ceasefire is again under question. Thanks to the pressures from the renminbi's devaluation on top of the ruble's weakness, the Kazakhs moved to a floating exchange rate regime on 20th August. The Kazakhstani tenge is now 28% weaker versus the U.S. Dollar, a welcome move for the sovereign as it preserves the FX reserves (assuming they do not step in with intervention) and boosts competitiveness, but there will be some impact on inflation, and bank/corporate foreign currency liabilities will be under pressure.

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Turkey:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	3.2%	↓	3.5%	–
Inflation	7.4%	↑	7.0%	–

Source: Standish as of September 1, 2015

As expected, repeat Parliamentary elections have been called for November 1st given the failure of parties to agree on a coalition government. Polls are broadly similar to the result of the June 7th election, and thus suggest another result of a hung Parliament. However there will be far greater incentives for President Erdogan's AKP party to form a coalition government, or a minority government in the worst case scenario. A return to elections does pose risks of a further uptick in violence with the PKK/ISIS, with relations already under immense strain. Aside from politics, the central bank has set out plans to normalize and simplify its monetary policy regime. A technical road-map has been produced, although deadlines have not been communicated. And finally, the expectations of normalized global relations with Iran has the potential to be positive both for increased Turkish exports and lower energy import costs.

Australia:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	2.3%	↓	2.7%	–
Inflation	1.7%	–	2.1%	–

Source: Standish as of September 1, 2015

Housing investment has continued to prop up otherwise unimpressive growth in Australia. Despite the strong contribution from housing investment, leading indicator data for construction such as building approvals appears to be softening. Ordinarily this would not be a large concern, but given that no other sector of the economy appears capable of driving growth, it may factor into the RBA's (Reserve Bank of Australia) decision-making if housing investment slows significantly. The RBA kept rates on hold at 2% at their September decision and it appears they haven't changed their core thinking since last month. While recognizing recent developments in China and volatility in markets, the RBA is unlikely to jump at shadows when it comes to cutting rates further. We maintain our view that the RBA is comfortable keeping rates on hold in the near-term, and is closely watching key domestic developments such as housing prices, business investment, and the external sector's sensitivity to a depreciated AUD before making another rate decision.

South Africa:

	2015	Balance of Risks	2016	Balance of Risks
Real GDP Growth	1.5%	–	1.3%	–
Inflation	5.0%	–	6.0%	–

Source: Standish as of September 1, 2015

The South African economy remains in a state of chronic malaise. Q2 GDP data for this year came in significantly below expectations. Generally, weak South African economic data isn't really notable, however the broad-based nature of the weakness is a cause for concern. Recently, the South African economy has been negatively impacted by a series of one-off shocks ranging from drought, to strikes, to fiscal consolidation, to power outages. Generally these negative shocks have had a large, but narrowly focused impact on a particular sector of the economy. In Q2 however, there was no specific culprit for the widespread slowdown in growth, it was simply poor. Looking forward, save flattering base effects, it is difficult to see much cheer on the horizon for the South African economy. The South African Reserve Bank remains in a gradual tightening cycle (although this may soon change), the government is working to reduce the deficit, businesses have little reason to invest or hire, the consumer is over-levered and the external environment is weak at best. The precise nature of the interaction between the negative terms of trade shock, fiscal consolidation, and tighter policy is unclear, but the risks to 2016 are decidedly to the downside.

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