Global Macro Views

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By: The Standish Global Macro Committee

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World:

	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	2.9%	2.9%	↓	3.3%	–
Inflation	3.9%	4.0%	↓	3.6%	–

Source: Standish as of April 4, 2016

"Global growth picks up in 2017, as the recent pothole recedes in the rearview mirror and monetary policy remains very accommodative."

The year opened on a softer note for economic activity than we expected last month. Strains in financial markets set off by the commencement of Federal Reserve tightening in December, concerns about the sustainability of the Chinese economic expansion, and softness in commodity prices set back household and business spending, especially in developed market economies. The response of monetary policy makers, with the Fed scaling back its tightening intentions and the ECB and BOJ stepping more heavily on the accelerator, and a steadying of the outlook in China incline us to believe the weakness will be short lived. Accordingly, we trimmed our assessment of global GDP growth 0.2 percentage points, implying an advance this year at the same 2.9% pace of 2015. Global growth picks up in 2017, as the recent pothole recedes in the rearview mirror and monetary policy remains very accommodative. We have tempered our enthusiasm on the extent of the increase, however, in light of the challenges to the expansion of aggregate supply among developed economies. We also view this outlook as more clouded than usual. After all, the 2016 calendar is chock full of political events of material importance and great uncertainty not the least including a referendum in the UK, a possible impeachment in Brazil, and elections of representatives in Japan and a president in the US.

The scaling back of growth outcomes this year is matched by a trimming to our inflation forecast for 2016. But, with the commodity price decline mostly absorbed and growth resuming at a quicker (albeit not quick) pace, inflation nudges up subsequently in developed market economies. Expected stabilization in a few key emerging market economies, however, removes some double-digit readings from our 2017 tally, pulling global inflation down a tad in that year.

↑ positive surprise more likely over next six months. ↓ negative surprise more likely over next six months – no bias
Inflation forecasts are yearly annual averages of headline CPI.

Developed Markets:

United States	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	1.8%	1.6%	–	1.9%	↓
Inflation	0.1%	1.4%	↓	2.0%	↑

Source: Standish as of April 4, 2016

"We take the Fed at their word and expect two quarter-point hikes in the federal funds rate this year. Moreover, given their expressed caution, it would not take much of a renewal of financial market strains to take one tightening, or even two, off the table."

The drumbeat of downcast data quieted in March, as forward-looking indicators mostly pointed to a pickup in spending and production and steady job creation. Add to that a Federal Reserve seemingly determined to keep accommodation in place and other major central banks straining to increase their accommodation and it appears likely that US real GDP growth over the balance of the year will return to the 2 percent growth channel it had been over this decade. Consumption remains the main spur to spending, boosted by the dividend provided to households from low energy prices. Those energy prices, however, imply continued consolidation in the oil and gas exploration industry, restraining fixed investment. Goods inventories will likely be pared some, pulling the expansion of production below that of spending for a time.

Data are data, though, and the soft patch to activity as 2016 opened likely pulled real GDP growth to below 1 percent in the first quarter. Doing the arithmetic, we have penciled in real GDP growth of 1.6% this year. The underlying momentum to economic expansion will show through more clearly next year, with growth at a near 2% pace. With an important election looming midway through the forecast period, a bit more uncertainty than usual surrounds the outlook.

While sluggish by the standards of the past few decades, this growth of aggregate demand is above that of aggregate supply. Slowing population growth, a downward demographic tug to labor-force population, and an inexplicable stalling of productivity growth translates into potential output growth around 1.5 percent. Thus, resource use will become strained over the next few quarters, putting core inflation on an upward incline. Headline inflation is still absorbing the effect of the downdraft in the prices of oil and other commodities, holding CPI inflation to 1.4 percent this year. As this effect wanes, inflation settles at 2 percent in 2016. This assumes that the public's inflation expectations remain well anchored, an issue that may be more contested over time, suggesting upside risks to the forecast.

With resource slack about gone and inflation headed to 2 percent, the Fed will squarely hit both parts of its dual mandate by the end of the forecast period. As a result, officials will be leaning toward removing accommodation for the foreseeable future. Recent guidance from Fed officials, however, revealed that they do not intend to lean that far forward. We take them at their word and expect two quarter-point hikes in the federal funds rate this year. Moreover, given their expressed caution, it would not take much of a renewal of financial market strains to take one tightening, or even two, off the table.

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Euro Area	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	1.5%	1.5%	↓	1.7%	–
Inflation	0.1%	0.2%	–	1.1%	↑

Source: Standish as of April 4, 2016

The European Central Bank (ECB) surprised markets at their March meeting. Entering the meeting, market participants generally expected some expansion of monetary policy (specifically 10 basis points of further deposit rate cuts and a small increase in quantitative easing purchases). The ECB engaged in more considerable expansion, with a package including a 10 basis point Deposit Rate Cut, an expansion in quantitative easing (QE) purchases from EUR 60 billion to EUR 80 billion, inclusion of non-Bank Investment Grade Corporate Bond Purchases in QE purchases (alongside sovereigns) and an enhanced Long Term Refinancing Operation (LTRO) program. At upcoming ECB meetings, the focus will be on the details of the non-Bank Investment Grade Corporate Bond QE purchases and the enhanced LTRO program which will both begin operation in June 2016.

"We remain concerned that despite additional easing measures, the Eurozone recovery will remain shallow and inflation will stay significantly below the 2% inflation target during the forecast period."

The ECB's package focus was clearly on credit easing rather than interest rates, as Draghi wishes to expand credit flow to the real economy rather than engineer further Euro depreciation to support the recovery. While this package beat expectations, Draghi did make it clear that the bar for further action on deposit rates was now considerably higher. This presumably reflects the concern that without a tiered deposit rate for banks (which Draghi says would be very complex), any further cuts in the deposit rate will harm bank profitability.

We remain concerned that despite these additional easing measures, the Eurozone recovery will remain shallow and inflation will stay significantly below the 2% inflation target during the forecast period. Thus, we do expect further easing measures from the ECB from September onwards. These would likely include a further six month extension to the QE program to September 2017, increases in QE purchase amounts, and the buying of higher risk non-bank corporate bonds.

Japan	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	0.7%	0.6%	–	0.6%	–
Inflation	0.8%	0.2%	–	1.6%	–

Source: Standish as of April 4, 2016

The outlook for the Japanese economy is mixed. It is not that any sector in particular is underperforming dramatically; rather, with a shrinking local population and weak global demand, nothing drives growth. The near-term trajectories of growth and inflation are difficult to discern, as both are highly sensitive to upcoming decisions around the implementation of a 2% consumption tax hike in the spring of next year. Despite Prime Minister Abe's current assurances, we anticipate that the consumption tax hike will be delayed and that a modest supplementary budget will be announced within the next 6-8 weeks. While we expect only modest fiscal and monetary stimulus over the next six months, the apparent inability of Japanese

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officials to generate inflation on a sustained basis suggests that more dramatic policy action cannot be ruled out.

United Kingdom	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	2.2%	2.0%	↓	2.1%	–
Inflation	0.2%	1.0%	–	2.0%	–

Source: Standish as of April 4, 2016

"The U.K. government has opted for further departmental spending cuts to plug the fiscal hole, rather than raising revenues."

The budget was the main event in March and came in line with expectations. Growth was downgraded so that it is now in-line with our own forecasts, whilst the revisions to inflation are even more bearish than our own. The U.K. government has opted for further departmental spending cuts to plug the fiscal hole, rather than raising revenues – although as these get pushed further out, there will continue to be implementation concerns. Fiscal deficits have been revised up slightly in intermediate years, but the Chancellor still expects a budget surplus by his stated goal of 2019/2020 (the end of this current Parliament). His other fiscal goal – to get government debt/GDP on a downwards trajectory this year – will, however, be missed, as it won't be reached until 2017/2018. Gilt issuance in 2016/2017 is relatively unchanged, which is a positive surprise to those who were expecting significant increases. Overall, the general sentiment is that George Osborne did not wish to do anything radical in his eighth budget and risk the ire of either his own party or the greater British public ahead of the Brexit referendum. Almost needless to say, the referendum adds considerable uncertainty to the outlook.

Australia	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	2.3%	2.4%	–	2.4%	–
Inflation	1.5%	1.9%	–	2.1%	–

Source: Standish as of April 4, 2016

While below potential, Australian growth appears to be stabilizing into 2016. Although the market is pricing in further easing, additional cuts hinge upon deterioration in activity-level data and a sustained overvaluation of the Australian dollar (AUD). The AUD has been the best performing G10 currency in March, up over 7% against the U.S. dollar amidst a perfect storm of rising commodity prices, a dovish U.S. Federal Reserve, and some settling of the balances-of-risks around Chinese growth. Models suggest that the AUD is not yet acutely overvalued, and a retracement of commodity prices and gradual tightening by the Fed in the second half of 2016 should put a cap on AUD, moving it backs below 75 cents.

Domestic indicators are far from reassuring. While the labor market has been trending better despite questionable data quality, wages continue to decelerate. Household lending is moderating, and core inflation is settling at the bottom of the RBA's target band.

The Reserve Bank of Australia (RBA) met on April 5th and decided to keep the policy rate at 2%. The RBA has been quite reactive this easing cycle, and we feel that they will remain on hold unless we get some combination of persistent overvaluation of the AUD, deterioration of activity level data, and/or a significant downside surprise in core inflation.

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Emerging Markets:

Asia:

China	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	6.9%	6.2%	–	6.1%	–
Inflation	1.9%	1.6%	–	1.9%	–

Source: Standish as of April 4, 2016

"The reduction of Fed rate hike expectations and a more benign USD are also sustaining more policy space for the Chinese authorities to weaken their trade-weighted FX rate without driving large shifts in the USDCNY exchange rate or un-anchoring domestic and regional FX expectations."

The abatement of currency market pressure prompted a cut in the banks' required reserve ratio (RRR) in early March. The lagged effects of monetary and credit easing undertaken in 2015 coupled with relaxation of property market restrictions and more fiscal easing are all prompting a cyclical rebound in activity after the end of the Lunar New Year holidays in late February. The reduction of Fed rate hike expectations and a more benign USD are also sustaining more policy space for the Chinese authorities to weaken their trade-weighted FX rate without driving large shifts in the USDCNY exchange rate or un-anchoring domestic and regional FX expectations. This is setting a favorable backdrop for limiting FX reserve losses and, thereby, also forestalling a drain on domestic liquidity. Alongside better regulation of the equity market, these are also the key reasons why the downside risks to China's GDP growth now appear to be stabilizing in the rest of this year.

A more stable financial and firmer cyclical backdrop also provides an opportunity to advance structural reform. However, notwithstanding official rhetoric, we think it remains unlikely that the authorities are about to undertake path-breaking reforms, such as large-scale restructuring of state-owned enterprises to cut excess capacity; efforts to sustain housing inventory reduction; or much greater allowance of market forces for risk-based allocation of credit to limit further run-up in leverage. This is because ironing out of the details of the shared objectives, and joint responsibilities, of reforms—between central and local governments, and SOEs and the banks—will take more time and political negotiation before a credible program can be ready for implementation. In the meanwhile, policy-driven credit activity will continue growing at twice the pace of nominal GDP. Indeed, this may provide a cyclical boost to the economy. But slower re-balancing and rising leverage raises credit risks as underscored by the recent lowering of the sovereign credit outlooks, to negative, though not the (Aa3/AA-) ratings themselves, at Moody's and S&P.

South Korea	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	3.0%	2.7%	↓	2.9%	–
Inflation	0.8%	1.4%	↓	1.8%	–

Source: Standish as of April 4, 2016

Korea will fall short of its potential rate of (around) 3.3% real GDP growth this year and next. Business sentiment and consumer confidence remain weak. The one-off upturn in activity from shopping vouchers and consumption incentives at the end of 2015 has faded. Moreover, the large exposure of Korean exports (and investment) to China and other emerging markets -where activity has slowed- will remain a drag. Additionally, structural headwinds such as the country's ageing demographics, high household debt—despite, its improving composition—look set weigh on domestic consumption

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going forward. A bit more fiscal spending could help, but any such stimulus is not yet imminent. Central bank authorities have been reticent in signaling any imminent easing of monetary policy, fearing the financial and balance-of-payments impact of policy divergence from that of the U.S. Following heightened market concern about geo-political risks with regard to North Korea, the Korean Won has appreciated. However, rising domestic inventories and household and corporate leverage, alongside export competitiveness pressure, will maintain some structural pressure on the Won despite the improvement in China's cyclical macro and FX story.

India	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	7.5%	7.6%	–	7.8%	–
Inflation	5.6%	5.3%	–	5.0%	–

Source: Standish as of April 4, 2016

"The political crisis continues to pose downside risks to Brazilian growth."

The Reserve Bank of India cut the repo rate 25 basis points to 6.5% on April 5th in response to easing inflation and some signs of a mid-cycle weakening in investment. The central bank also simultaneously raised the reverse-repo (deposit) rate and thereby narrowed the policy corridor to 50 basis points, down from 100, and took a few steps to ease onshore liquidity. Ongoing efforts to improve liquidity and policy transmission should be beneficial over the long-term as it should lower the time lag of real economic impacts, and leave the policy framework potentially less vulnerable to shifts in the external environment or to supply-side developments. Such steps highlight an incremental pace of reforms, even as big-ticket items (such as the goods and services tax) remain stuck in parliament. India will undertake five regional, state-level elections in April-May. The ruling BJP is expected to eke out small gains. Meanwhile, the Congress is expected to lose power in a few states. If these trends materialize, it should go some ways in clearing residual political opposition to key reform legislation, especially in the upper House where the BJP lacks an absolute majority.

Latin America:

Brazil	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	-3.8%	-3.6%	↓	0.5%	–
Inflation	10.7%	7.3%	↓	6.0%	–

Source: Standish as of April 4, 2016

Mexico	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	2.5%	2.6%	↓	3.1%	–
Inflation	2.1%	3.2%	↑	3.2%	–

Source: Standish as of April 4, 2016

The political crisis continues to pose downside risks to Brazilian growth. The recession this year may be as deep as in 2015 and only base effects and some stabilization in the political arena produce flattish growth in 2017. Business and consumer

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confidence continue to revisit historical lows and chances of passage of some fiscal adjustment are low given the preoccupations of a legislature consumed by the impeachment process, criminal investigations, and a deeply unpopular and weak president. Near-term, there is still a 50/50 chance that President Rouseff could manage to escape impeachment and end her mandate, with consequent disappointment to the market and continued volatility. A bright spot is the reduction in inflation expectations, which could lead to cuts in the policy rate later this year. In the meantime, deteriorating debt dynamics suggest further ratings downgrades could still take place, although the market overreaction in Q4 2015 still leaves some (declining) room for spread compression.

Meanwhile, Mexico, dependent on economic activity in the U.S., should continue to grow at a sluggish pace. The end of one-off administered price reductions last year and base effects should result in rising inflation to above the mid-target, but this should still remain relatively contained. Monetary policy will remain highly dependent on moves by the U.S. Fed, mostly driven by potential pressure on the Mexican peso. A near-term concern is the restructuring of PEMEX and the support from the government, although the latter should come at little fiscal cost thanks to operating profits from the central bank. Although the marginal deterioration in debt dynamics caused by pressures on the public sector accounts and the revealed vulnerability to oil prices has led to a negative outlook in Moody's A3 rating, no significant downgrades or loss of investment grade rating are in the medium term horizon.

"Meanwhile, Mexico, dependent on economic activity in the U.S., should continue to grow at a sluggish pace."

For Chile and Peru, the relative stability in commodity prices should help to maintain moderate growth with declining current account pressures. Colombia, however, faces the triple challenge of weak oil prices and their effect on fiscal and external accounts, expected completion of peace talks before the middle of the year, and the postponement of the fiscal reform till the second semester. Finally, Argentina will benefit from the approach of the final resolution of the holdout saga and the regained access to the voluntary international capital markets. The regime change, chances for automatic ratings upgrades when the technical default ends, and index inclusion bode well for Argentine credit in the near term, but the macroeconomic challenges of recession, high inflation and a depreciating currency will become the focus of attention later this year.

Central and Eastern Europe:

	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	3.4%	3.1%	–	3.0%	–
Inflation	-0.1%	1.0%	–	1.4%	–

Source: Standish as of March 1, 2016

The dovish actions of global central banks – and in particular the ECB – have provided central banks in Central and Eastern Europe with the 'space' to engage in their easing of monetary policy, alongside already looser fiscal policy. Significant downgrades to inflation expectations, and low realized inflation relative to central bank mandates justifies such actions at a time of slowing global growth.

Hungary has by far led this movement, in terms of both pace and easing measures. Hungary's central bank not only surprised by cutting the main policy rate by 15 bps to

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1.2%, but also cut both deposit and lending rates significantly – with the overnight deposit rate now in negative territory.

Essentially the ECB's moves earlier this month provides the Hungarian National Bank (MNB) with cover from which to re-start its policy easing cycle – with the MBH's downgrades to inflation providing the domestic rationale. Finally, MNB continue to be extremely dovish in their communications and thus we expect the main interest rate to go sub 1% in the near future as well as unorthodox easing measures.

Other Central and Eastern European central banks are also likely to engage in some forms of easing monetary policy, albeit at a far slower pace than the MNB. The Czech central bank will likely ease next, with the need to engage in negative interest rates to maintain its floor against Euro. On the other hand, Poland will be slower in delivering rate cuts given political volatility while Romania will likely use other measures to ease monetary policy.

Russia and Commonwealth of Independent States:

"The Russian central bank is one of the few in emerging markets which has not turned more dovish following the Fed and ECB developments in March."

Russia	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	-3.7%	-2.0%	↓	0.0%	↓
Inflation	15.5%	8.5%	↑	6.5%	↑

Source: Standish as of April 4, 2016

CIS	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	-3.4%	-2.0%	↓	0.0%	↓
Inflation	15.0%	10.0%	↑	7.0%	↑

Source: Standish as of March 1, 2016

The Russian central bank is one of the few in emerging markets which has not turned more dovish following the Fed and ECB developments in March. It continues to keep rates on hold and has only communicated a slightly softer stance on the need for potential tightening. Given that inflation has declined dramatically already in 2016 (at 8.1% in February, from double digits end 2015) this highlights the central banks wish to continue to pursue conservative monetary policy. Such conservatism is justified given the dependence of RUB on oil, and the volatility of oil in recent months. Whilst the market has priced in just 100 bps of interest rate cuts in 2016, our inflation forecasts suggest there are rooms for 200 bps of interest rate cuts during the course of the year.

In Ukraine, we await the announcement of a new government in coming weeks – with changes in Prime Minister, Finance Minister and the wider cabinet all likely. The risk of early elections has receded as it is not in the Presidents or external creditors interest (but still remains a tail risk). Such changes in government would assist in getting IMF disbursements back on track. In Belarus, a $2bn loan from the Russian led EFSD (10yrs maturity, 5 year grace period) has been announced. Whilst this is positive for the bonds as it reduces risk of default, is does also reduce the need for an IMF program which could have bought about structural reforms.

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Turkey	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	3.2%	3.3%	↓	2.5%	↓
Inflation	8.0%	9.0%	↑	8.0%	↑

Source: Standish as of March 1, 2016

The Turkish central bank has also taken the opportunity provided by dovish global central banks to ease monetary policy. At their March meeting, the upper bound of the interest rate corridor was lowered in what was framed as a first step in the move to a simpler monetary policy. However, as the central bank closely administers the cost of bank funding through a complex system, it has been seen as a symbolic rather than meaningful change at this point. Post the appointment of a new central bank governor in mid-April, we will likely see a more dovish monetary policy as part of the road to simplification – with potential hurdles ahead. Overall though, easier monetary policy is far less justified than in CEE – given that inflation is significantly above the central bank target and indeed expected to rise before the end of 2016.

"The Turkish central bank has also taken the opportunity provided by dovish global central banks to ease monetary policy."

South Africa	2015	2016	Balance of Risks	2017	Balance of Risks
Real GDP Growth	1.3%	0.0%	↑	1.5%	–
Inflation	4.6%	6.3%	–	6.0%	–

Source: Standish as of April 4, 2016

The outlook for the South African economy remains poor. Not only is the country struggling to absorb simultaneous shocks from higher interest rates, pro-cyclical fiscal policy, and the terms of trade, the political climate has deteriorated markedly, impacting both business and household confidence. Forward-looking indicators suggest a meaningful pick-up in growth is extremely unlikely as business confidence and, notably, hiring and investment intentions have fallen to multi year lows. Going forward, fiscal policy will exert an increasing drag on growth as the most recent budget backloads consolidation heavily. At this point, it is difficult to see medium-term growth driven by much other than base effects.

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