Petercam

Macro Research
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The world economy: clear signs of hesitation but doom predictions seem overdone

Recent worries about the Chinese economy have caused a lot of financial market turbulence (graph 1) with some observers warning for a major economic downturn. Even though the downward risks are substantial, we believe the global recovery will not end abruptly and instead continue at a moderate pace. This is also consistent with the picture portrayed by current global confidence indicators (graph 2). The decline in global trade witnessed during the spring has been reversed and the recent evolution looks set to continue (graph 3). The fall in commodity prices, while painful for several countries, should support economic activity in many others. Core inflation is still modest (graph 4) and a swift acceleration is unlikely. Therefore, despite the upcoming first policy rate hike in the US, global monetary policy will remain very loose in the foreseeable future.

US economy continues its steady recovery

- Following the growth stall in the first months of the year (largely due to temporary factors), economic activity accelerated during the spring (3.7% QoQa) Leading indicators have held up nicely over the summer with solid consumer and service sector confidence. Moreover, incoming data continue to confirm our ongoing recovery scenario **(graph 5)**.
- The recovery in the labor market continues. In the first half of the year 211K monthly new jobs were created on average. Survey indicators remain upbeat in this respect **(graph 6)**. In addition, other indicators including initial jobless claims and job openings all point to further labor market strength.
- Headline inflation, currently at 0.2%, looks set to mimic the witnessed volatility in oil prices **(graph 7)**. It's actually more useful to look at underlying measures of inflation. At 1.8% and 1.2% for core inflation and core PCE (personal consumption expenditures) inflation respectively, underlying inflation remains below the Fed's 2% target **(graph 8)**. In fact, over the last five years the Fed has failed to deliver on this front. Looking forward, however, underlying inflation is set to pick up modestly from current levels. Importantly, leading indicators suggest that wage growth will accelerate further **(graph 9)**. Without seeing acceleration in productivity growth at the same time (an assumption which remains to be tested) this will translate into both higher unit labor costs and core inflation **(graph 10)**.
- Against the back of a continuing recovery and upward inflation pressures the Fed is still on course to start hiking interest rates before the end of the year. Fed officials are not in a hurry though. Recent market turmoil and the fact that inflation remains below the Fed's target imply that the Fed will adopt a cautious approach. As things currently stand, an increasingly tighter monetary policy stance can be expected in the years thereafter but the Fed is likely to proceed gradually and only if the underlying economic momentum remains strong enough.

Eurozone economic rebound remains tepid

- Earlier ECB stimulus measures resulting in lower interest rates and EUR depreciation, reduced budgetary tightening efforts and lower oil prices are driving a cyclical recovery. This is encouraging following years of stagnation. Business confidence indicators hold up nicely for the Eurozone **(graph 11)** as a whole but with significant regional divergence. Other leading indicators are softening a touch. All in all, despite the improvement witnessed in recent months, the recovery is still nothing to cheer about **(graph 12)**. Moreover, the positive effects stemming from temporary tailwinds may soon start to fade.
- The Greek situation remains problematic in several ways. A third follow-up program for Greece has started and will make sure that the country's funding issues are resolved at least temporarily. That said, the agreement between Greece and its creditors still looks very unbalanced. Against the back of a deepening economic depression **(graph 13)**, it's very unlikely that Greece will be able to meet the conditions. Unless Greece's creditors loosen their stance and allow for more budgetary flexibility (an assumption that seems not very plausible at the moment), a Geek exit from the monetary union is close to inevitable.

Macro Research Contact
Hans Bevers | Senior Economist | + 32 2 229 62 33 | hans.bevers@petercam.be

- Headline inflation in the Eurozone will pick up in the second half of the year as the base effects linked to the decline in energy prices slowly fade. Underlying inflation, although set to pick up from the current 1%, is likely to stay low by historical standards. The ECB has been completely missing its 2% inflation target over the last couple of years and it remains unlikely that the ECB will achieve it anytime soon **(graph 14)**.
- In the Eurozone, the ECB's QE program has already had a substantial impact on equity markets, interest rates and the euro. Criticism about the negative consequences of this policy has been increasing. In combination with improving economic data, this has put pressure on the ECB to reduce the program prematurely. However, given the still fragile recovery and the presence of massive challenges in the Eurozone, the chances that this will happen remain small. If anything, the main risk is that QE efforts will have to be increased **(graph 15)**.

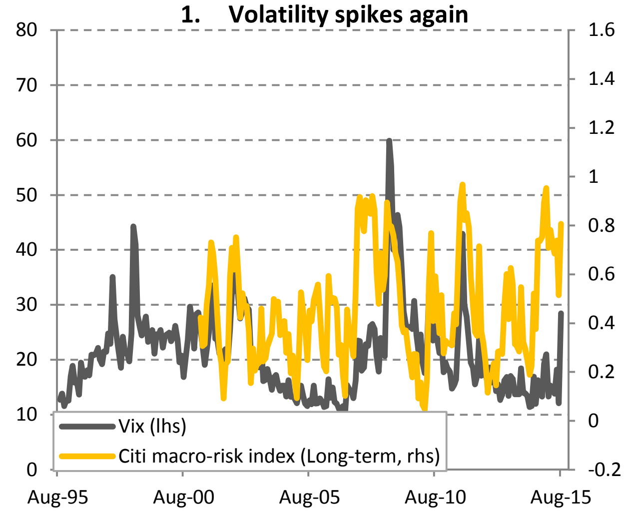
Japanese economy lacks momentum and EM growth still disappointing

- In Japan, most leading indicators point towards a small improvement in economic sentiment. That is reassuring following the decrease in confidence witnessed since begin 2014. As a result, industrial production growth is likely to jump back into positive territory **(graph 16)**. That said, economic momentum is still modest at best. The 3.6% annualized growth rate seen in the first three months of the year was followed by negative growth in the second quarter (-1.6% QoQa). Growth figures in the next couple of quarters are likely to make clear that growth is still fairly weak.
- In Japan, inflation has come down quite significantly as the base effect from the April 2014 tax hike has disappeared from the numbers. On the other hand, household's expectations about future inflation remain clearly positive and survey indicators suggest wage growth will accelerate somewhat in the next couple of quarters. Despite all this, we remain far from convinced that the Bank of Japan will structurally achieve its 2% inflation target **(graph 17)**. Therefore, it's a clear possibility that monetary policymakers will scale up the pace of the current asset purchase program.
- Disappointing Chinese economic data, the recent stock market crash and especially the (still minor) RMB devaluation **(graph 18)** have all caught the attention of international investors. To be sure, there are reasons to worry about economic activity in China. On the other hand, this is not new and policymakers have acknowledged this since they started to ease monetary policy late last year. Confidence in the manufacturing sector slides down further **(graph 19)** but consumer and service sector confidence hold up nicely **(graph 20)**. Moreover, the housing market is showing clear signs of stabilization **(graph 21)**. Both earlier and additional policy measures should soon ease the current hard landing fears. The recent RMB depreciation is probably not the start of a broad based attempt to boost exports, in turn triggering monetary retaliation efforts by other central banks. As market forces will be allowed to play a more important role in the future, it cannot be excluded however that the RMB will see further minor and gradual depreciation in the foreseeable future.
- Economic activity in EM is still very sluggish **(graph 22-26)**. Several observers argue that the ongoing market turbulence will trigger a 1997-style crisis. However, this is not our scenario because there are several important differences. But a full-blown emerging market crisis seems unlikely for several reasons: (a) more flexible exchange rates (overcoming the "fear of floating"), (b) less pro-cyclical fiscal policies allowing larger budget deficits in times of crisis, (c) less debt in foreign currency (the original sin) avoiding a currency and maturity mismatch between domestic revenues and foreign liabilities, and (d) significantly more international reserves that can be run down to mitigate currency depreciation. The latter is important because for heavily indebted countries with liabilities in foreign currency, FX depreciation can be contractionary instead of expansionary.
- Further EM currency depreciation would of course increase inflation and FX debt risks. Several EM deal with above target inflation (Brazil, Russia, Turkey) while inflation stays below target in many others including Thailand, Poland, Hungary, Korea, Philippines and China **(graph 27-28)**. For reasons explained earlier, we think most of the EM (except Turkey and S. Africa which remain vulnerable in this respect) will embrace currency weakness and will not (need to) tighten monetary policy in order to stem capital outflows. At the same time, this implies that in general there is not much scope to loosen monetary policy either **(graph 29-30)**.
- In general, the currency depreciation seen in most EM should have expansionary effects over time. China's slowdown, the backslide on structural reforms seen in many countries and low commodity prices, on the other hand, are likely to make sure that economic activity will remain subdued for the time being.

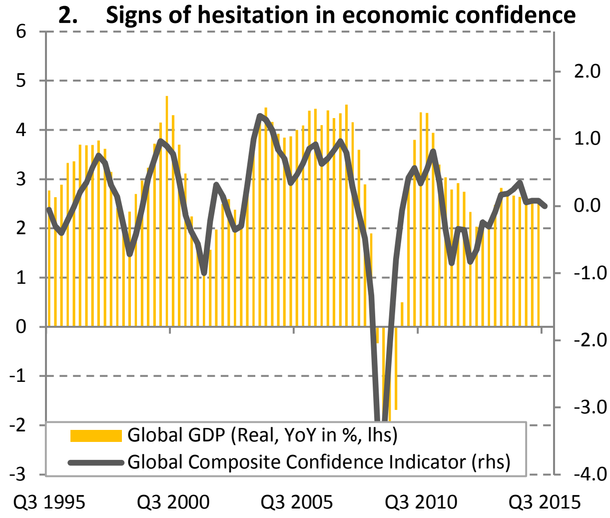
Macro Research Contact
Hans Bevers | Senior Economist | + 32 2 229 62 33 | hans.bevers@petercam.be

Graphs

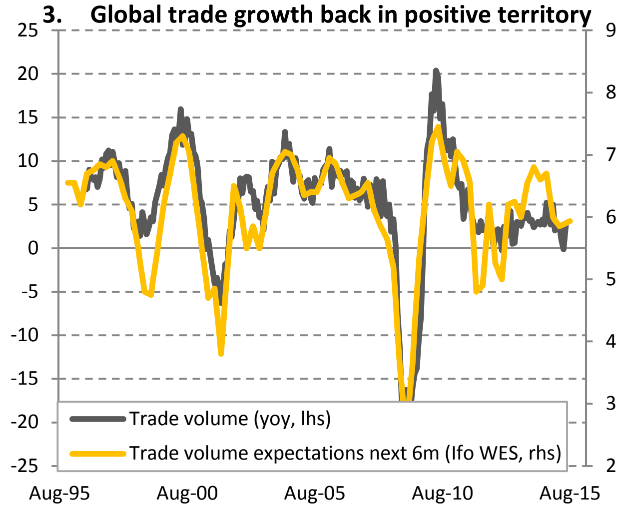
1. Volatility spikes again



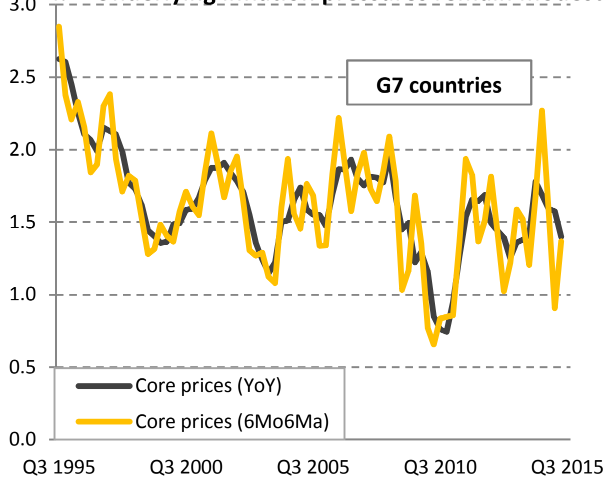
2. Signs of hesitation in economic confidence



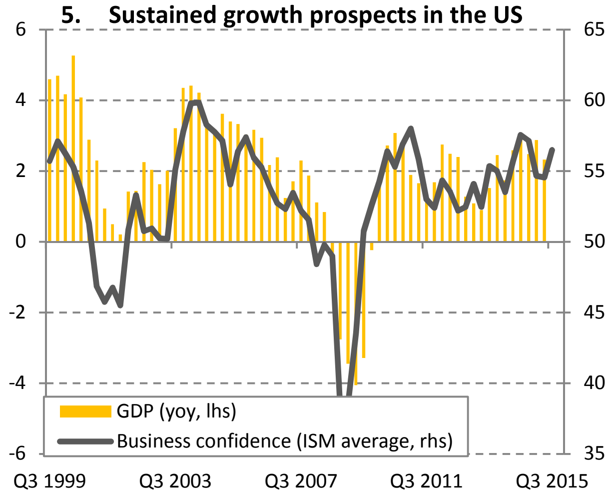
3. Global trade growth back in positive territory



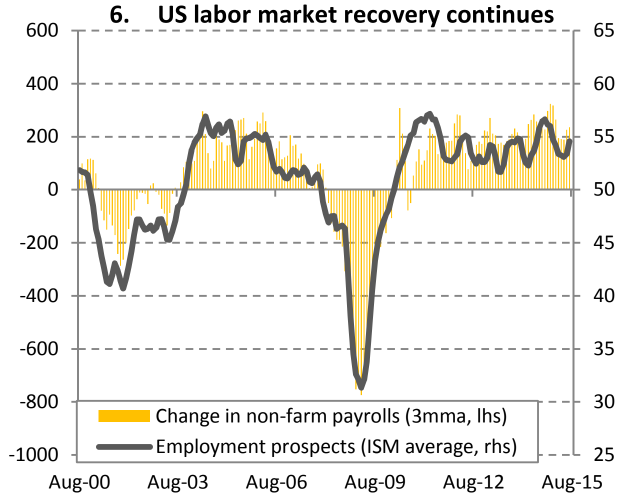
4. Underlying inflation pressures remain modest



5. Sustained growth prospects in the US



6. US labor market recovery continues



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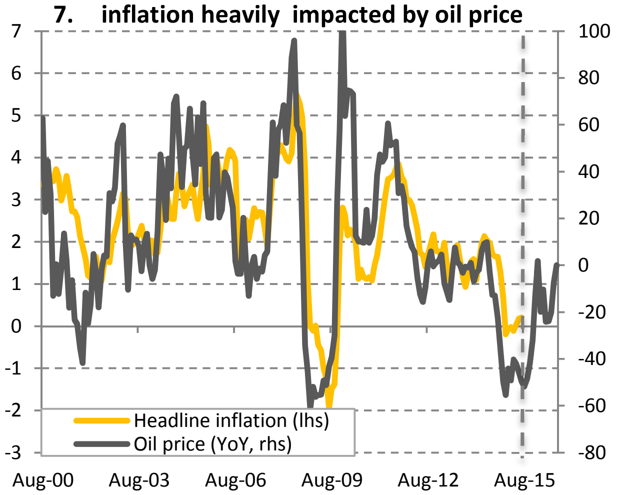
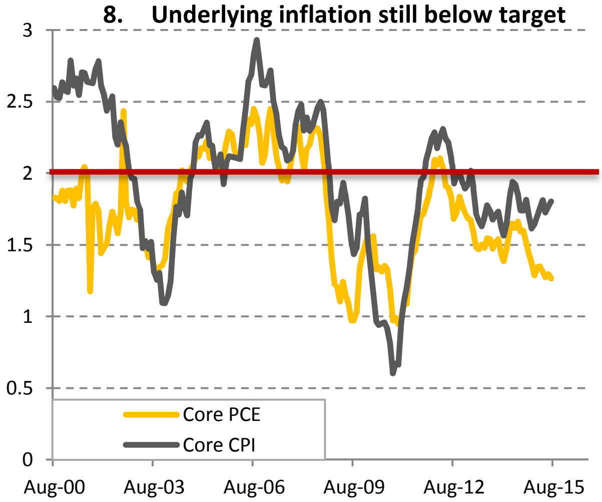
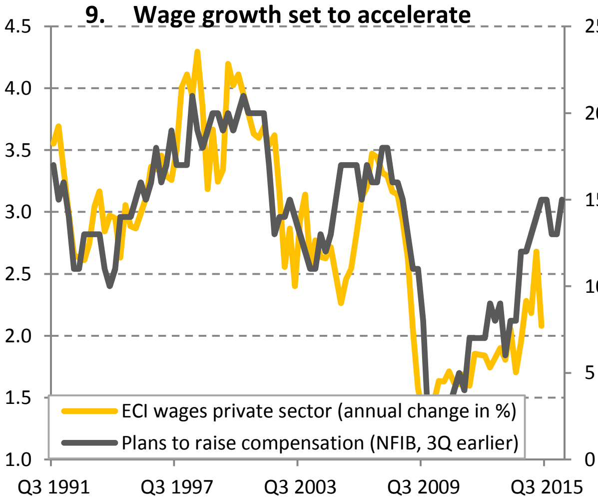
7. inflation heavily impacted by oil price



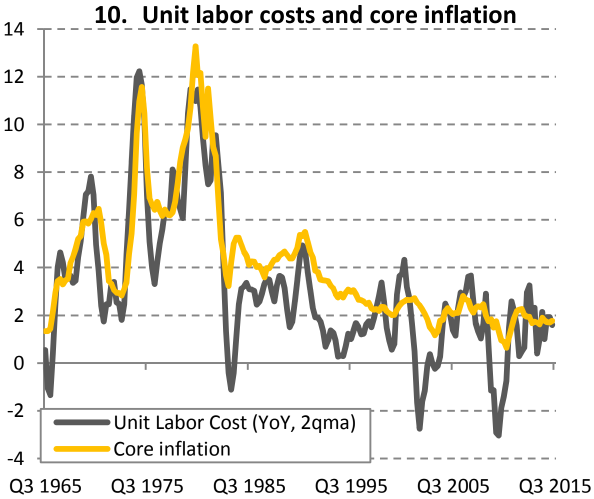
8. Underlying inflation still below target



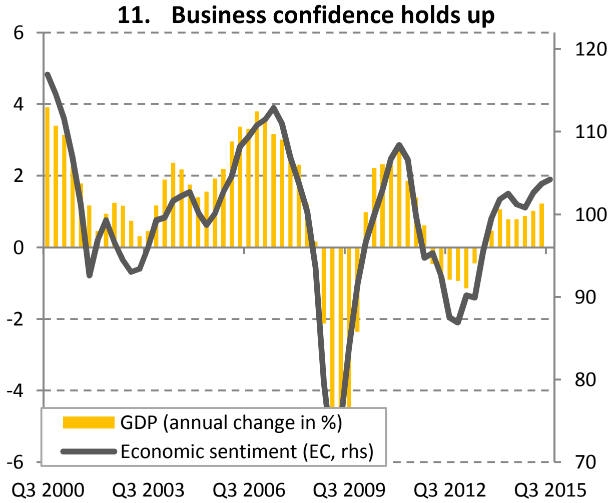
9. Wage growth set to accelerate



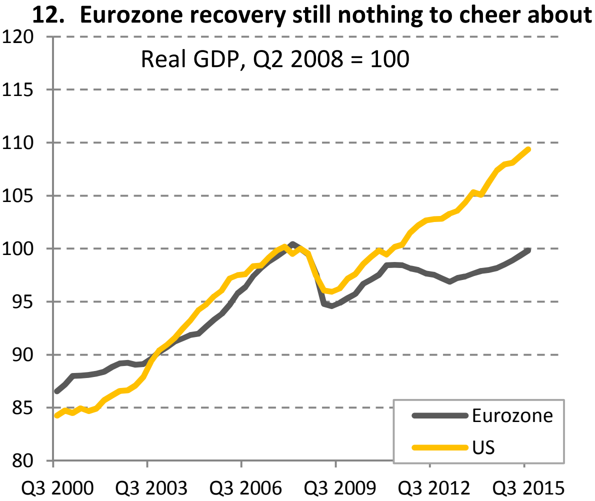
10. Unit labor costs and core inflation



11. Business confidence holds up



12. Eurozone recovery still nothing to cheer about



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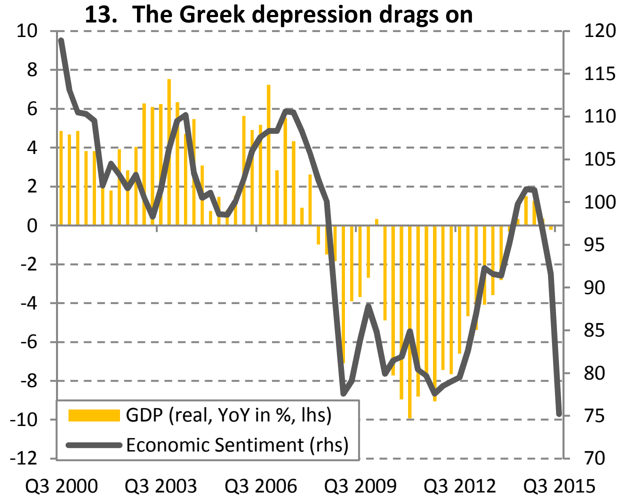
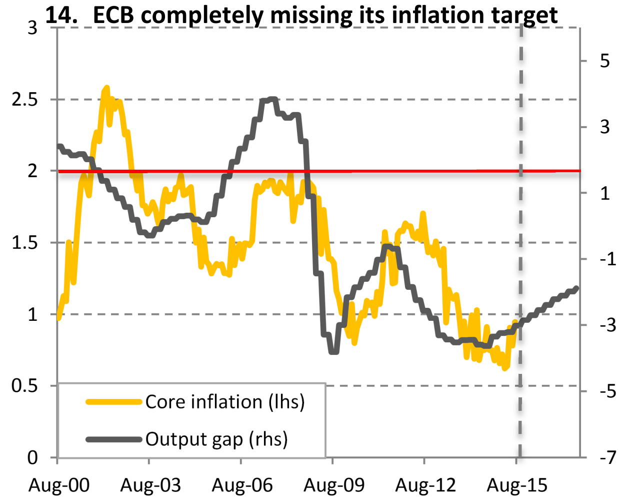
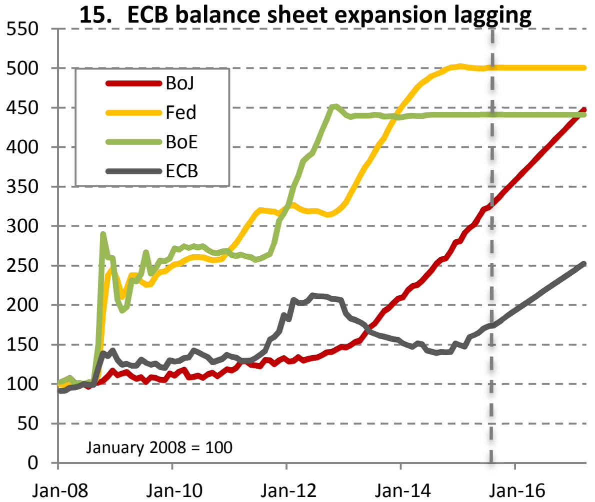
13. The Greek depression drags on



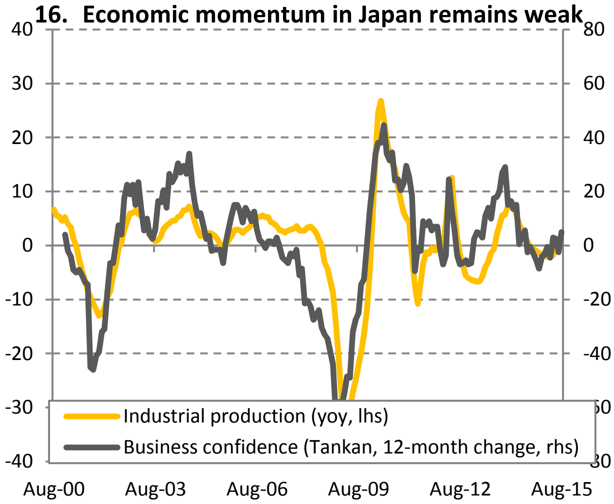
14. ECB completely missing its inflation target



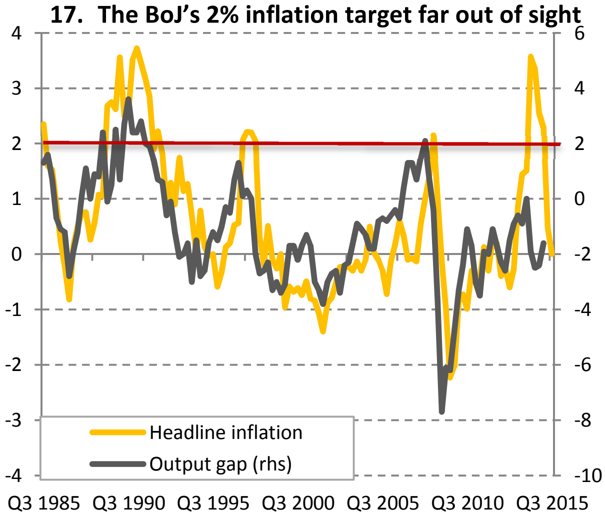
15. ECB balance sheet expansion lagging



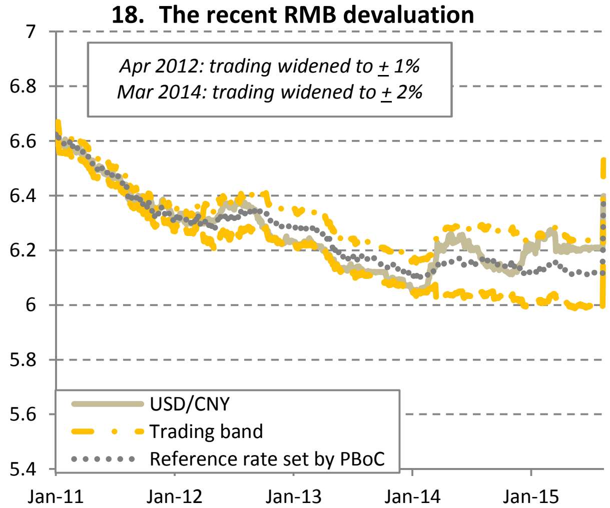
16. Economic momentum in Japan remains weak



17. The BoJ's 2% inflation target far out of sight



18. The recent RMB devaluation



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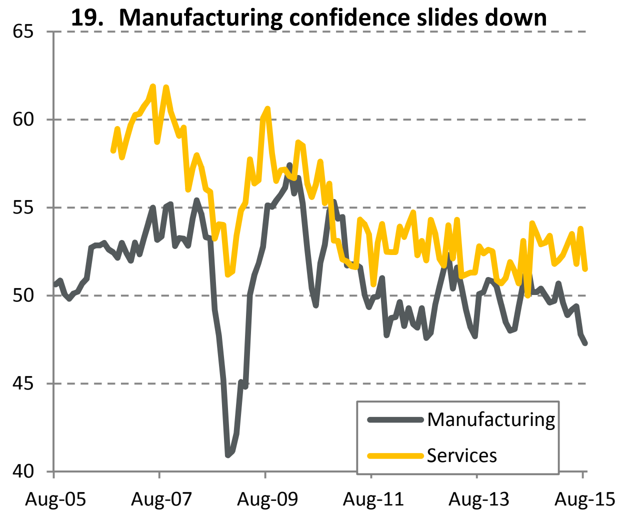

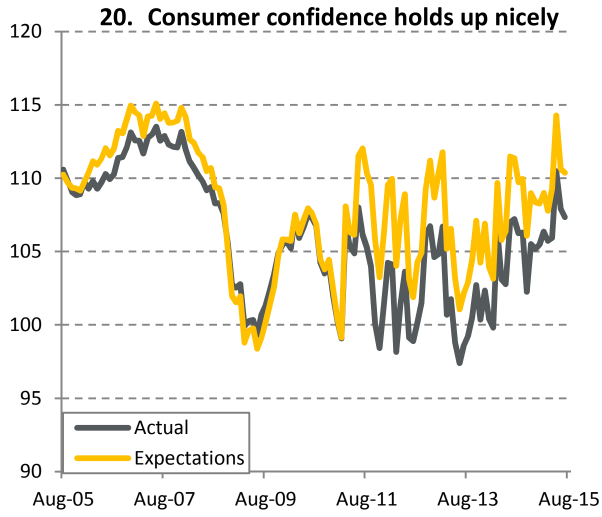

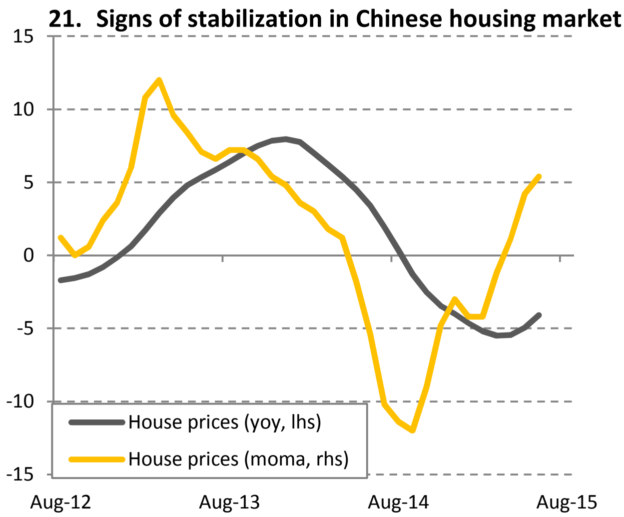

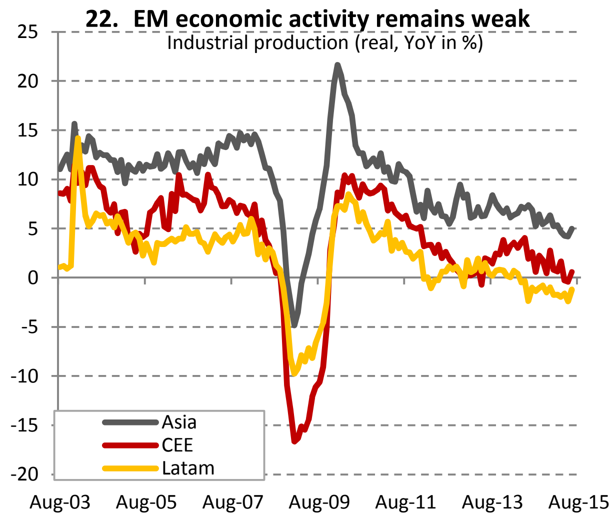

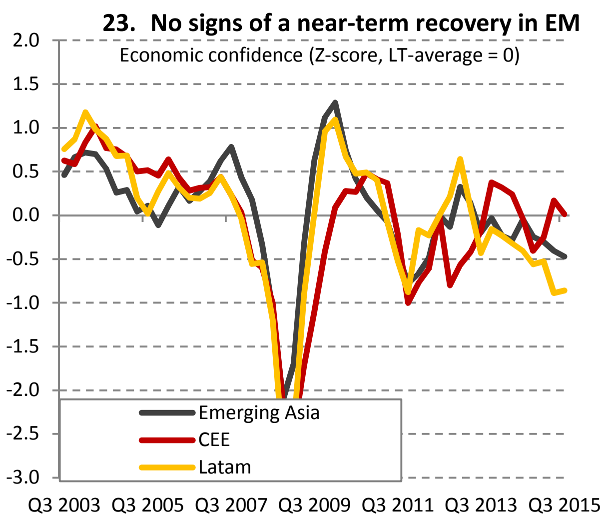

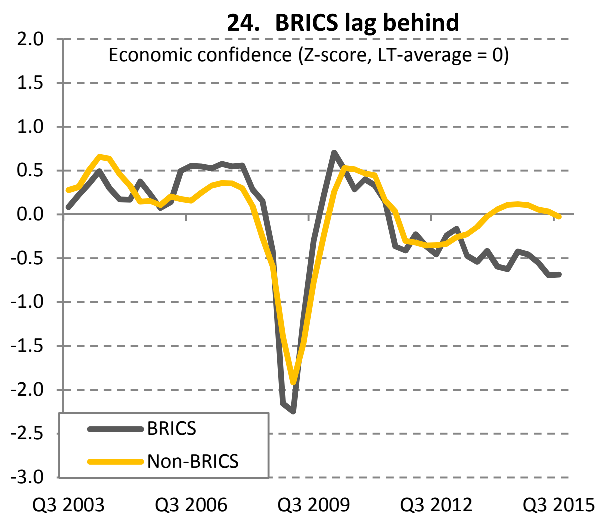

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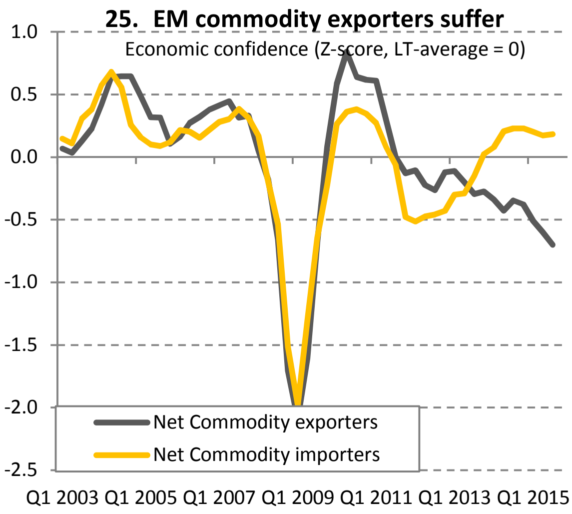

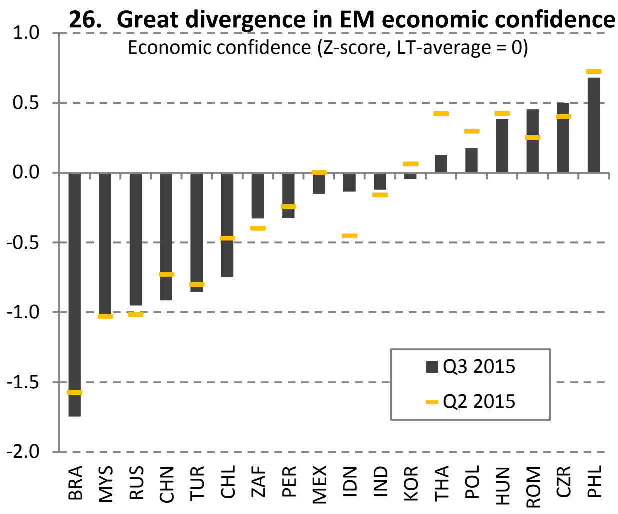

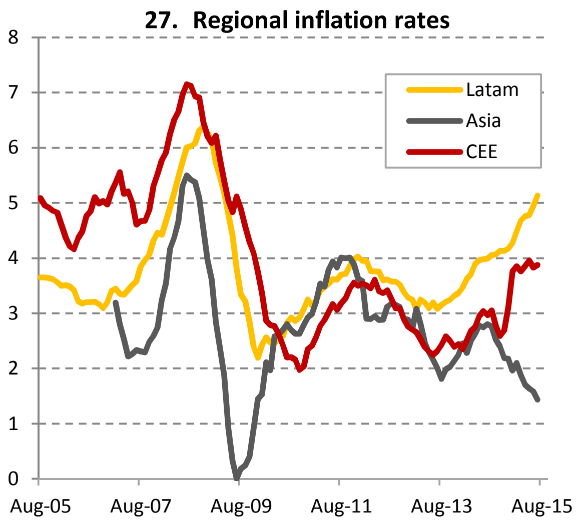

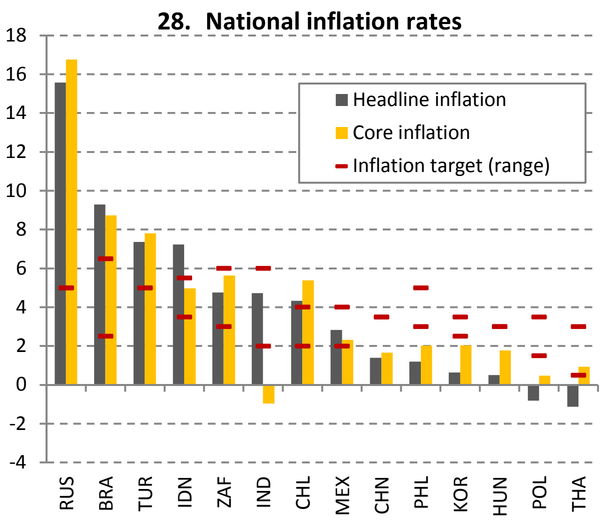

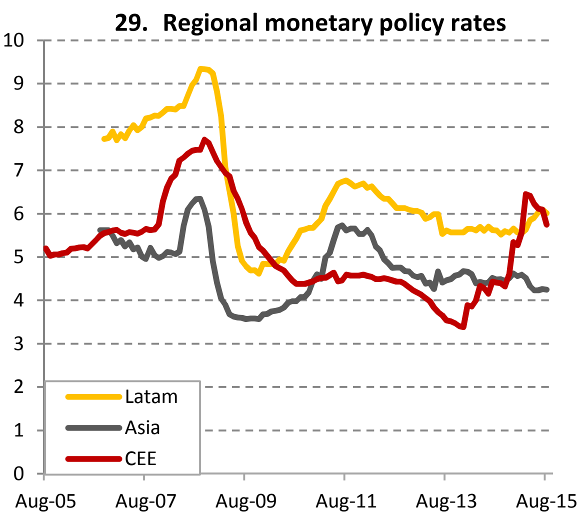

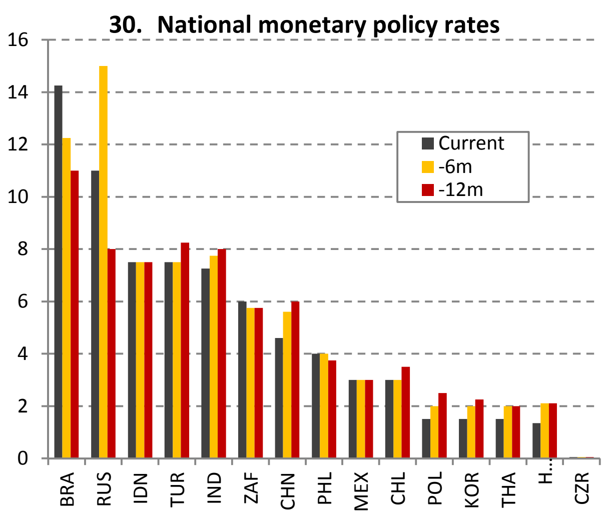

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Economic forecasts

	GDP			Inflation		
	2014	2015	2016	2014	2015	2016
US	*2.4*	**2.2**	**2.3**	*1.6*	**0.1**	**1.8**
		2.3	*2.7*		*0.3*	*2.1*
Eurozone	*0.9*	**1.4**	**1.3**	*0.4*	**0.1**	**1.2**
		1.4	*1.7*		*0.2*	*1.3*
UK	*3.0*	**2.2**	**2.2**	*1.5*	**0.1**	**1.6**
		2.6	*2.4*		*0.2*	*1.5*
Japan	*-0.1*	**0.9**	**1.0**	*2.8*	**0.8**	**0.9**
		0.9	*1.4*		*0.8*	*1.1*
China	*7.4*	**6.5**	**6.0**	*2.0*	**1.4**	**1.7**
		6.9	*6.7*		*1.5*	*2.0*
Brazil	*0.1*	**-1.6**	**0.5**	*6.3*	**8.4**	**5.7**
		-1.8	*0.4*		*8.8*	*6.1*
Russia	*0.6*	**-3.4**	**0.5**	*7.8*	**15.2**	**7.8**
		-3.6	*0.5*		*15.0*	*7.0*
India	*7.1*	**7.4**	**7.7**	*6.7*	**5.6**	**5.7**
		7.4	*7.6*		*6.2*	*5.3*

Petercam forecasts, consensus forecasts between brackets

Macro Research Contact
Hans Bevers | Senior Economist | + 32 2 229 62 33 | hans.bevers@petercam.be