Degroof Petercam

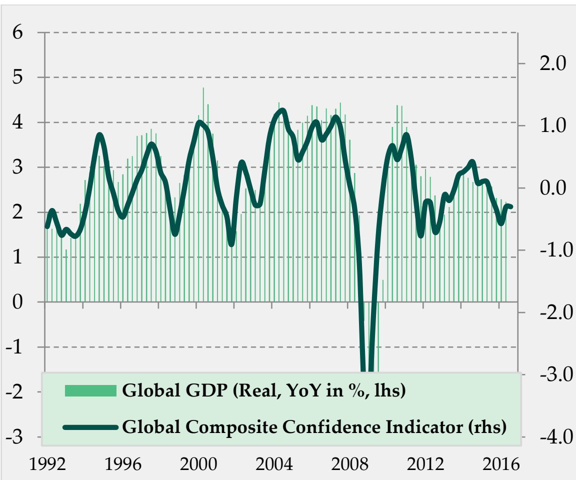
# MACRO RESEARCH

August 2016

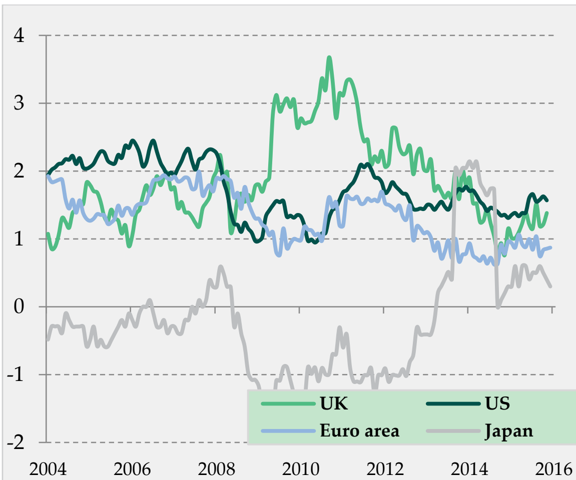
## GLOBAL ECONOMIC OUTLOOK

- ✓ Global recession fears have eased over the past three months and the wider Brexit fallout remains limited, at least so far. That said, our global composite confidence indicator suggests that global economic activity is still weak. What's more, downward risks remain substantial. The global economy still seems stuck in a catch 22 situation as explained here.
- ✓ Monetary policy rates are hovering near zero in the Western world. The same goes for real yields on longer term bonds. At the same time, confidence indicators suggest global economic activity remains weak following what has been a very lackluster recovery since the Great Recession thus far.
- ✓ Looking beyond the short-term, we think the chances of a prolonged period of relatively slow growth (in combination with interest rates around the zero lower bound) are high against the back of strengthening demographic headwinds and less scope for debt accumulation going forward. That said, budgetary and monetary policymakers have not lost all ammunition to fight this extremely challenging situation. There is still room to do more (see here for example). Encouragingly, there is a growing awareness about the need for more expansive budgetary policies. This should translate in stronger economic activity and higher inflation prints. At the same time, statements remain vague implying that actual implementation might take time.

**Global economic activity remains weak**




**Underlying inflation still modest for now**




Source : Datastream, Degroof Petercam

- ✓ Meanwhile, despite record low policy rates and huge expansions in the size of their balance sheet, most central banks are still looking for higher inflation prints.
- ✓ Even with the low level of commodity prices in place, however, base effects will send headline inflation higher in the second half of 2016. Core inflationary pressures look set to remain fairly modest for now, implying that global monetary policy will stay very loose for the time being. The outlook for inflation in a medium to longer-term perspective, on the other hand, is still subject to major uncertainty as explained here in more detail.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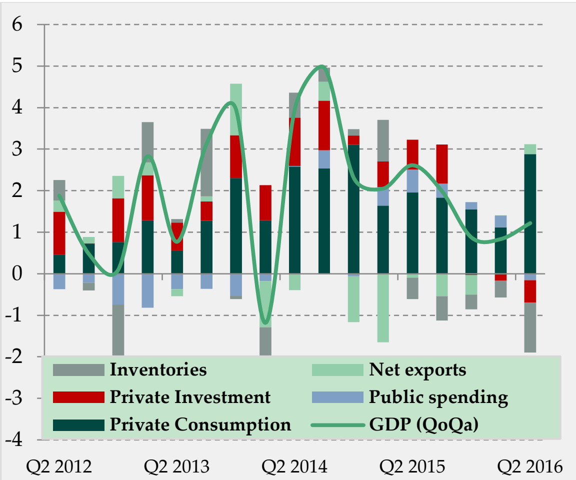
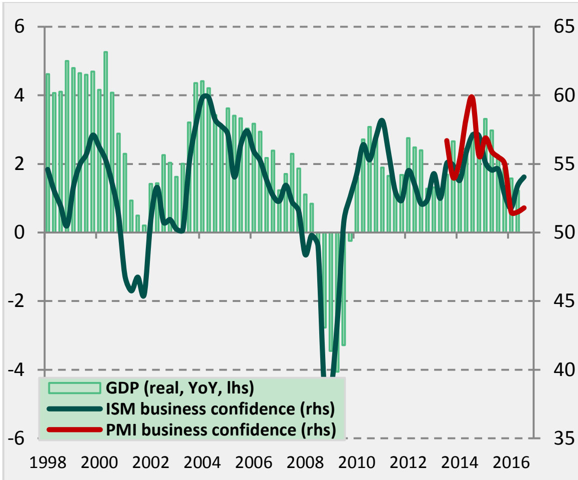
**United States**

- Following a very weak start of the year, growth in Q2 disappointed again. That said, when corrected for inventories, GDP growth came in above 2% annualized. The manufacturing sector still suffers from the stronger USD and problems in the energy sector. The service sector, on the other hand, holds up better in line with healthy consumer spending. Overall productivity growth remains very disappointing and the outlook for investment remains weak against the back of negative profit growth and relatively low capacity utilization rates. This is a key risk factor for the US economy.

**Big drag from inventories on GDP in Q2**



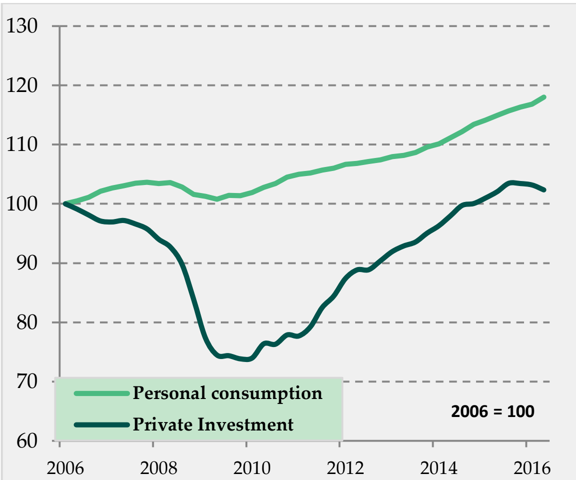

**Confidence indicators pointing to modest expansion**

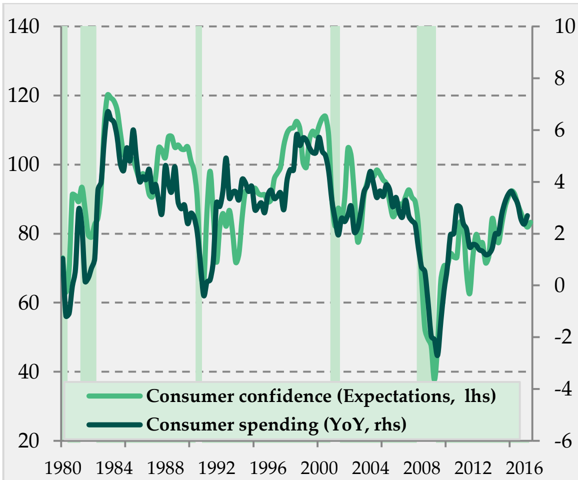



Source : Datastream, Degroof Petercam

- Household consumer spending is growing at around 2% in year-on year terms and several factors, including disposable income growth, consumer sentiment and the relatively favorable housing and labor market backdrop, all suggest consumption growth should hold up.

**Strong consumption vs weak investment**




Source : Datastream, Degroof Petercam

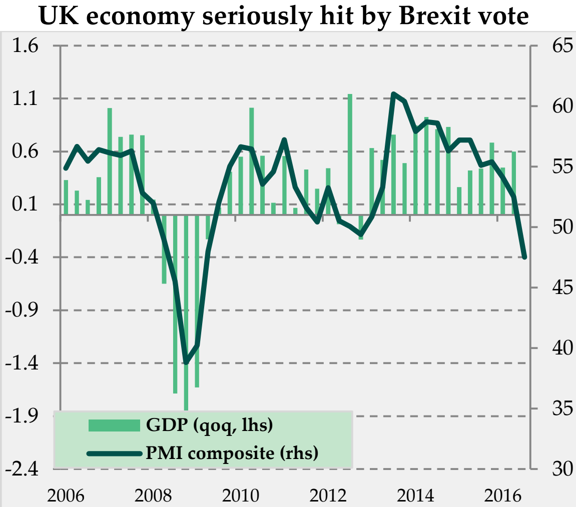
- Adding 204K jobs on average over the past 12 months, the labor market has been performing solidly. Leading indicators suggest future job gains will come in somewhat lower. Initial jobless claims, meanwhile, remain at very low levels, indicating that the labour market is doing fine overall.

- ✓ Wage growth plays a key role with regard to the future path of inflation and is slowly picking up. At around 2.5%, however, the level nevertheless remains below its 30-year average of around 3%.
- ✓ Base effects linked to energy prices will make sure that headline inflation (now at 1.1%) will trend higher towards the end of the year, albeit less because of the latest oil price drop. At 2.2% and 1.6% for core inflation and core PCE inflation (which is more important for Fed) respectively, underlying inflation has been stabilizing over the last 3 months. Looking forward, however, leading indicators paint a mixed picture with the evolution in unit labor costs suggesting that core inflation should pick up further (accelerating wage growth in combination with slow productivity growth) while price surveys point to only very modest upward price pressure.
- ✓ All in all, Q2's disappointing GDP number implies that a summer rate hike is off the table. US policymakers are not in a hurry to raise interest rates. Modest growth in combination with below target inflation means that the Fed continues to adopt a very cautious wait-and-see approach as has been the case for several years now.
- ✓ The November Presidential elections are drawing lots of attention. As things stand, according to election polls, Mrs Clintion is very comfortably leading the race to the White House. That said, political experts advise not to pay not too much attention to polls at this stage because of the typical convention bounce ahead of the elections later this year. Polls later this month are expected to paint a clearer picture but should still point to the prospect of a Democratic win.

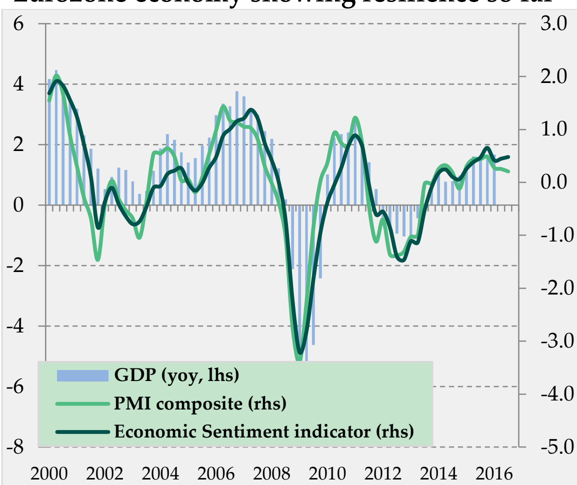
**Europe**

- ✓ Following a solid start of the year (with GDP growth at 2.2% QoQa), Eurozone economic growth moderated in Q2 (1.2%QoQa). Encouragingly, most confidence indicators in the immediate aftermath of the Brexit vote are holding up. This suggests that the fallout on Eurozone economic activity remains limited, at least so far.
- ✓ This recovery is still far from spectacular. What's more, confidence indicators are not pointing to further growth acceleration and structural headwinds remain strong (more here)
- ✓ Moreover, trade negotiations between the UK and the EU still need to start and this looks set to be a complex and prolonged negotiation process against the back of a challenging political calendar with Dutch, French and German elections in 2017.

**UK economy seriously hit by Brexit vote**



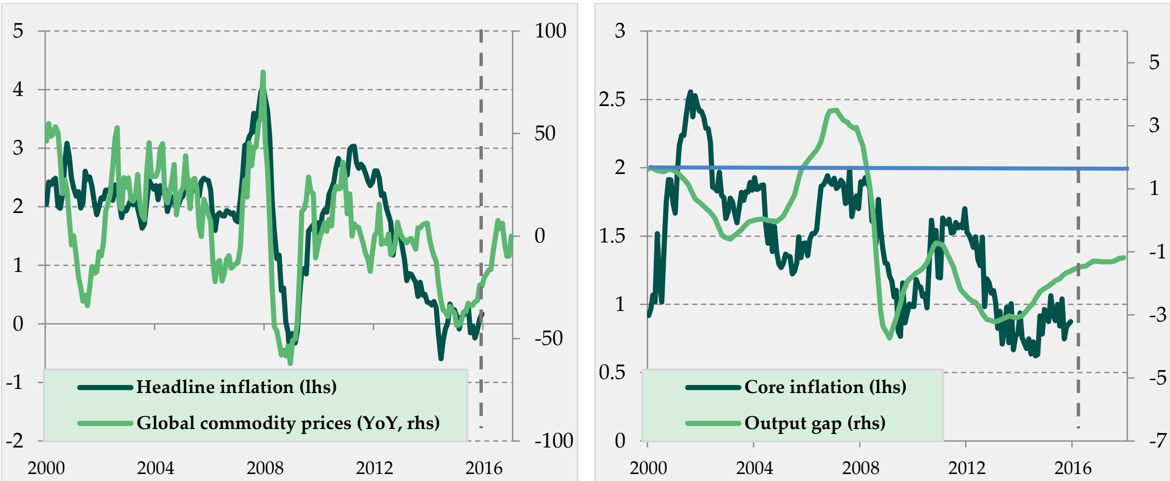

**Eurozone economy showing resilience so far**




Source : Datastream, Degroof Petercam

- Sentiment in the UK has been hit hard pushing the Bank of England towards more stimulus in the form of a rate cut and more asset purchases. But it can only do so much when interest rates are near zero. A more expansive fiscal policy has a better chance to counter the effect of the Brexit vote on economic activity. It remains to be seen whether the UK government comes up with a convincing stimulus package later this year.
- Headline inflation (0.2 % yoy in July) is held down by the earlier steep fall in energy prices but base effects will send it higher in the second half of the year. With core inflation hovering around 1% for several years, underlying price measures remain very weak reflecting the slack in the labour market.
- Given the persistence of the large negative output gap, core inflationary pressures are expected to stay very weak. All in all, despite the latest easing measures taken in March, the ECB still looks to experience major difficulties in getting inflation up to its target of 2% anytime soon (see here for more information), keeping monetary policy in easing mode for longer.
- It should be clear, however, that opposition to more monetary easing is rising and also that it is no panacea in a liquidity trap situation. Indeed, a more expansive budgetary stance is likely to prove more helpful in this respect. The ECB has also been hinting in this direction more recently.

**Base effects will send inflation higher but ECB still facing major challenges to boost inflation**



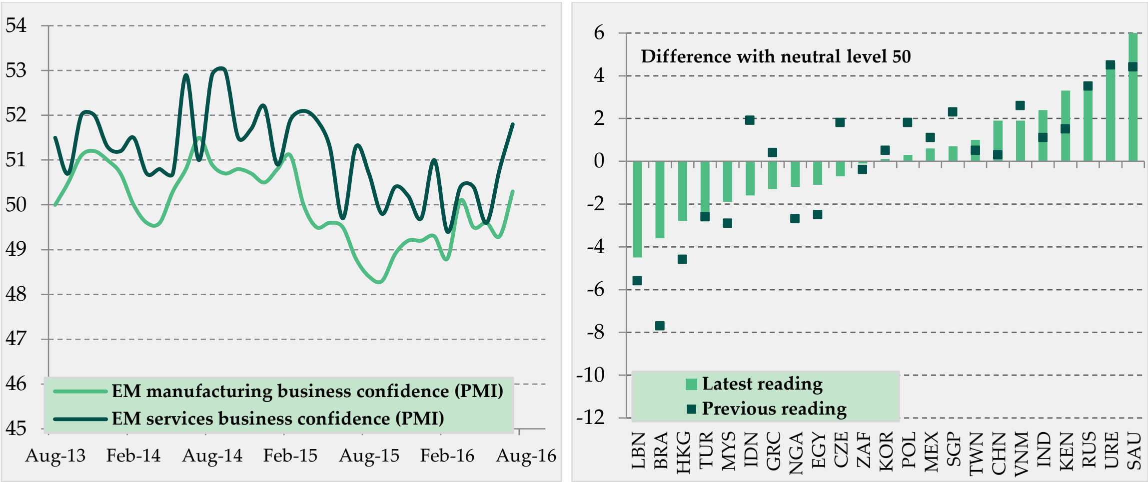

Source : Datastream, Degroof Petercam

## Japan and Emerging Markets

- In Japan, despite sluggish economic activity, JPY appreciation and falling stock prices, the BoJ basically refrained from adding stimulus in its late July meeting. Meanwhile the Abe government announced a new fiscal stimulus package of 28.1 trillion JPY (around 5.6% of GDP). That said, only a fraction of that constitutes fresh public spending (7.5 trillion JPY of which 4.6 JPY in 2016), so that all talk of big fiscal stimulus is vastly exaggerated. It should nevertheless translate in somewhat higher GDP numbers next year.
- At the same time, indicators suggest it remains very doubtful whether inflation will pick up meaningfully going forward so that the BoJ is still likely to add monetary stimulus in the near future.
- More broadly in EM, the slowdown witnessed over the past few years reflects several factors including the negative effect of lower commodity prices, tighter external financial conditions linked to the prospect of the hiking cycle in the US, the private sector debt overhang, economic rebalancing in China, structural bottlenecks as well as distress related to (geo)political factors. Moreover, there are signs of premature

deindustrialization in several important EM which is worrying in a medium to longer term perspective.

**EM economic activity showing signs of improvement**




Source : Datastream, Degroof Petercam

- Sentiment towards EM has improved in recent months against the back of reduced USD strength and stabilization in commodity prices. But EM are not out of the woods yet. China's challenging rebalancing exercise and uncertainties linked to monetary policy tightening in the US could easily expose more EM weakness (see here for more information). Additionally, recent developments in Turkey remind that political risks are real in some EM. And more recently, commodity prices are experiencing downward pressure again.
- Chinese hard landing fears have been receding over the past three months and a large one-off depreciation has been avoided, at least for now. This is completely in line with the scenario we described earlier (see **here** and **here** for example). The combination of monetary and budgetary measures is driving a cyclical recovery. But while we were right on this call, we are still convinced that the medium to longer term outlook for China will prove extremely challenging.
- Moreover, it would not be surprising that worries about the sustainability of the current recovery soon pop up again. Indeed, the background of inaccurate growth figures, soaring house prices and continued rapid credit growth is far from comfortable and will give rise to more and more concerns about the state of China's economy. How will Chinese policymakers reconcile the ambition of strong growth and the need for further economic rebalancing while at the same time avoiding the stop-and-go policies seen in recent years? The short answer is that this will prove close to impossible. That's why, despite the recent calmness, concerns about China look set for a comeback in the not so distant future as also explained here.
- From an EM wide perspective, inflation remains under control. That said, significant differences between countries exist. While inflation in countries like Brazil and Turkey is still at uncomfortably high levels, inflation in other countries including Korea, the Philippines, Poland or Hungary remains below target. All in all, the combination of subdued economic activity, stabilization in EM currencies and commodity prices should make sure EM inflation remains in check.

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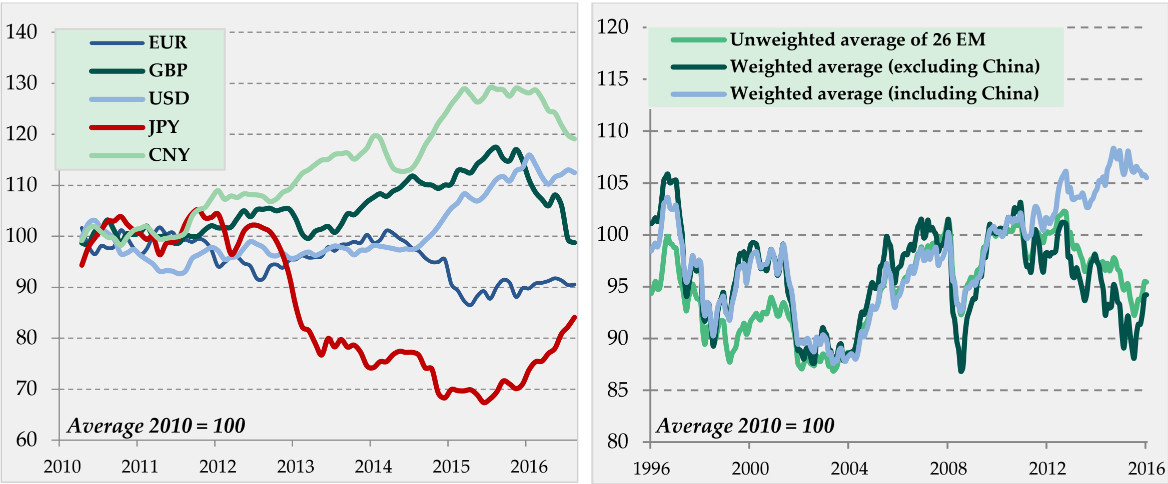
## Currencies

**Real effective exchange rate**




Source : Datastream, Degroof Petercam

- ✓ Our long-held stance that the consensus view of a continued USD appreciation should not be taken for granted, has been proven right so far (more here). We continue to think that a sharp appreciation from current levels should not be expected. Despite the latest depreciation the USD still looks rather expensive in a long term theoretical perspective. That said, more evidence of the Fed moving towards another rate hike could lead to a slightly stronger USD in the next couple of months.
- ✓ The BoE loosened monetary policy after its August meeting in response to the effects of Brexit. GBP is currently trading more than 16% below its 20-year average real effective exchange rate but there is still room left for depreciation towards its PPP-level. Moreover, at 6% of GDP the current account deficit remains pretty big. Another rate cut is still likely over the coming months. Downward risks prevail for now.
- ✓ The JPY has been strengthening in recent months. From a LT-perspective, it seems that the JPY has now become a little bit too expensive versus the EUR. A further sharp appreciation from current levels looks unlikely. That said, this will largely depend on upcoming central bank moves from BoJ and ECB.
- ✓ EM currencies experienced serious downward pressure since the May 2013 taper tantrum but entered calmer waters more recently. Investor appetite for EM assets has waned and sustained EM currency weakness cannot be ruled out given the subdued growth outlook and political risks. That said, given the depreciation already seen since the spring of 2013 and the recent stabilization in leading indicators, the risk of another sharp hit now looks smaller.
- ✓ In contrast to what many observers have feared since the summer of 2015, the RMB has not seen a large one-off depreciation so far just like we had expected (see here for more details). More recently, following the G20 meeting in Shanghai late February, there seems to be more consensus on this call. That said, we would not rule out the possibility of a big depreciation altogether. The reason is that we have become even more concerned about the sustainability of China's economy as explained higher.

## GDP and CPI Outlook

| | GDP | | | Inflation | | |
|---|---|---|---|---|---|---|
| | 2015 | 2016 | 2017 | 2015 | 2016 | 2017 |
| **US** | *2.4* | **1.3** | **1.6** | *0.1* | **1.2** | **2.1** |
| | | *1.9* | *2.2* | | *1.3* | *2.3* |
| **Eurozone** | *1.6* | **1.5** | **1.2** | *0.0* | **0.3** | **1.3** |
| | | *1.5* | *1.3* | | *0.3* | *1.3* |
| **Japan** | *0.6* | **0.7** | **1.6** | *0.8* | **-0.1** | **1.0** |
| | | *0.5* | *0.8* | | *-0.1* | *0.6* |
| **China** | *6.9* | **5.5** | **5.0** | *1.5* | **2.2** | **2.3** |
| | | *6.5* | *6.3* | | *2.0* | *2.0* |

**Degroof Petercam forecasts, August 2016,** *Consensus forecasts*