Global recovery

16 October 2014

Markets have gone through a significant correction in recent days with equity and commodity markets, as well as interest rates falling sharply. These market moves have been accompanied by some weaker macro-economic data, and seem to be reflecting renewed concern about the global recovery. That said, the global recovery scenario still seems intact.

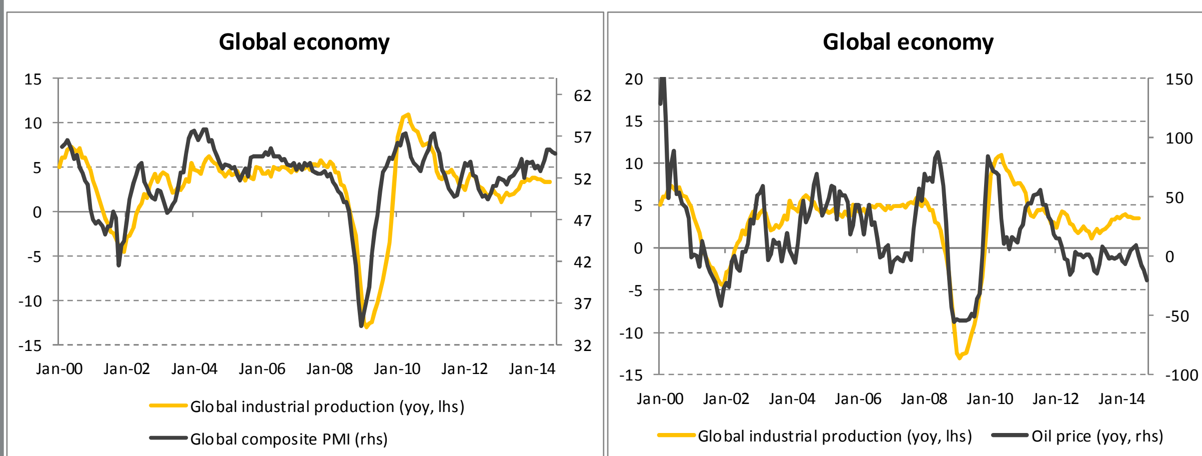
Recent weeks have brought several economic data disappointments, mainly out of Germany (which had an awful month of August) and Japan. However, the main drivers for the global economy still seem to be supportive for continued recovery.

Main drivers for the world economy:

- Monetary policy: remains very supportive for growth, even though the end of QE by the Fed could be a source of some uncertainty
- Fiscal policy: the obsession with fiscal tightening, mainly in Europe, but also in the US, has eased, which means fiscal policy has become less of a drag on economic activity then it was in 2012-13
- Commodity prices: the fall in commodity prices is obviously a negative for commodity exporters, but a clear positive for commodity importers. Overall, the impact on the global economy should be positive
- Credit cycle: improving in some regions (mainly the US), while still disrupted in the Eurozone, in any case no material change in recent months

Overall, these drivers are still in line with a continuing gradual recovery of the global economy.

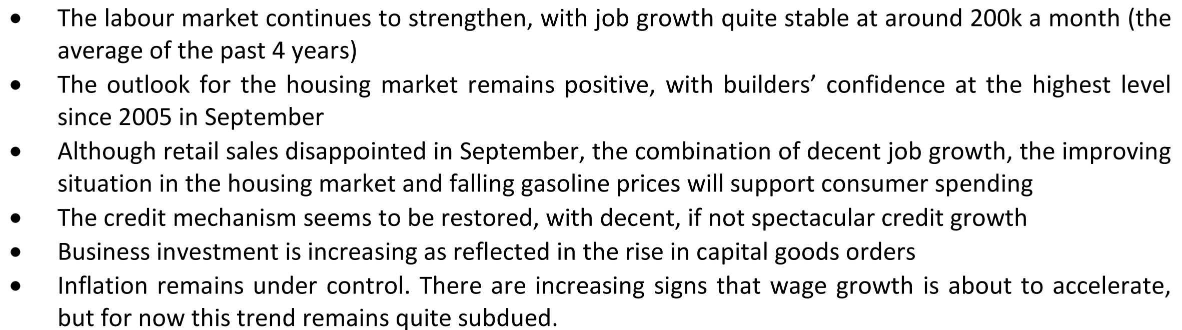
The broad decline in commodity prices clearly raises doubts about this scenario, as commodity prices tend to be an early indicator for economic activity. However, business confidence (another leading indicator for the global economy) is showing a very different picture. The latter continues to confirm the global recovery. In the past, business confidence (PMIs) was a better leading indicator than commodity prices.



US: continuing recovery

Recent economic data in the US broadly confirm the continuing recovery:

- Leading indicators had raced ahead in recent months to suggest economic growth of 4% or more, which seemed a bit overdone. Some easing seems likely, but still the US economy is firmly on track for about 3% growth.



- The labour market continues to strengthen, with job growth quite stable at around 200k a month (the average of the past 4 years)
- The outlook for the housing market remains positive, with builders' confidence at the highest level since 2005 in September
- Although retail sales disappointed in September, the combination of decent job growth, the improving situation in the housing market and falling gasoline prices will support consumer spending
- The credit mechanism seems to be restored, with decent, if not spectacular credit growth
- Business investment is increasing as reflected in the rise in capital goods orders
- Inflation remains under control. There are increasing signs that wage growth is about to accelerate, but for now this trend remains quite subdued.

The Fed is moving towards a first rate hike, but will continue to take it easy on this until the labour market recovery really shifts into higher gear. If anything, the current turbulence is likely to result in even more caution on this path towards monetary policy normalisation. The end of QE could cause some uncertainty, but as this has been a gradual process for more than a year now, it is hard to imagine this would have a significant impact. Even though LT-inflation expectations derived from financial markets have fallen significantly (to levels that saw the announcement of previous QE operations), it is quite unlikely that the Fed would change direction on this alone.

Eurozone: stuck in low growth

August data out of Germany have been dismal, but it still seems unlikely that the Eurozone is falling back into recession. That said, growth will remain subdued (around 1%) for a long time:

- Leading indicators have eased in recent months, but are still suggesting growth just below 1%
- August data on the German economy were very bad, but the weakness was probably somewhat overstated by temporary factors (Ukraine tensions have been easing)
- The combination of a weaker euro, low interest rates, falling energy prices, reduced fiscal tightening and decent growth in important trading partners (US-UK) should support growth in coming months
- Financial markets' LT-inflation expectations have fallen significantly. In combination with weaker economic data, this is likely to force the ECB to become more aggressive on fiscal stimulus again

The Eurozone remains dangerously close to a deflation scenario, which will force the ECB into more significant action. The Eurozone economy should be supported by external demand, while domestic demand is likely to remain subdued. In all, panic on the Eurozone outlook seems overdone, even though growth will not be able to move much above 1% in coming years.

Emerging markets: mixed

As has been the case already for quite some time, the situation in EM is very mixed with significant divergence between commodity exporters and commodity importers and between BRICs and non-BRICs. However, in recent weeks nothing much has changed in the outlook for EM:

- Leading indicators have moved sideways in recent months, with decent numbers for commodity importers. The outlook for commodity exporters is deteriorating in line with falling commodity prices
- China continues its managed slowdown. Lower inflation numbers are mainly a result of falling commodity prices, which is a positive, rather than an indication of economic weakness
- Brazil and Russia continue to flirt with recession, while India is doing quite well
- Overall, Asia seems on track for decent growth

The outlook for EM hasn't materially changed in recent weeks. Quite a number of countries (Turkey, South-Africa) remain vulnerable for the upcoming change in monetary policy in the US.