H2 2013: World economy remains on track for recovery

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Key issues for H2 2013

1. The Fed

As has been confirmed in its recent communications, the Fed remains on track to scale back monetary stimulus, starting after the Summer. As the US recovery continues to strengthen, the Fed will reduce its monthly amount of bond purchases from this Fall onwards with the objective to end purchases by the middle of next year (when the unemployment rate falls below 7%). The first rate hike will happen in the course of 2015. This is by no means aggressive monetary tightening. If anything, the Fed is moving to tighter monetary policy significantly slower than its usual reaction function implies. The Fed is still happy to take a risk on higher inflation, rather than risk killing off the recovery.

In June, markets finally adjusted to the idea that QE will not continue indefinitely. This resulted in a clear shift in expectations and a significant uptick in bond yields. This move has further to go, even though the pace will slow down as markets have taken an advance on what is to come. A normalisation of economic activity and monetary policy should see bond yields return to 3-4%, but this process is likely to take years. Labour market indicators will be key in this. That said, the continuing global demand for safe assets and the reduction in the supply of such assets and the efforts of the Fed to manage this process will keep US bond yields from increasing too rapidly.

2. German elections and the eurocrisis

Germany will hold federal elections on September 22. These will be closely followed, but are unlikely to have a significant impact on the eurozone outlook. Current polls suggest a clear win for Merkel's CDU/CSU. The current coalition partner FDP is set to be hammered as it is currently polling below the 5%-threshold. Although Merkel may have to change her coalition partner, the broad lines of German policy, and especially the stance on the eurocrisis, are unlikely to change. Hopes of a significant relaxation of the German stance on key euro-issues are likely to be disappointed. Overall, the German election will generate a lot of press coverage, but in the end it will probably not have a major impact.

Meanwhile, the eurocrisis will remain an issue in coming months: the German constitutional court will declare its position on the OMT, Portugal and Ireland will need to negotiate new bailout plans as the initial plans end in the next ten months, and the eurozone economies will remain under pressure. On top of that, the continuing economic malaise holds the risk of political 'accidents'. In all, the eurocrisis is still far from over, and the risk of occasional flare-ups remains very real.

3. China's financial situation

Concerns about credit developments in China have been increasing for some time now. The remarkable mid-June spike in the overnight rate has only increased these concerns. Some people have even been warning about an imminent collapse of the Chinese financial system. These warnings are overdone. Chinese authorities are trying to reduce credit growth in shadow banking. These efforts are likely to impact overall economic growth. However, an overall financial crisis remains unlikely in China. For one, China cannot have a classic EM debt crisis as it does not have important debts in foreign currency. On the contrary, China has been building up foreign currency assets for many years. Secondly, although the banking sector is clearly on shaky foundations, it is closely linked to the public sector. In essence, the government stands behind the banking sector, and the consolidated debt position of the two remains manageable. As such, the main question for the Chinese outlook is reduced to whether or not the authorities are willing to push the economy into a hard landing. The October Party Plenum should bring more clarity on the intentions of the Communist Party. A further growth slowdown is likely as the authorities continue to tackle shadow banking, but a hard landing or financial collapse remain unlikely.

OUTLOOK

US

Activity

- The housing market is firmly in recovery mode with both construction activity and house prices clearly picking up. This is set to continue in H2. Rising house prices and the recent jump in mortgage rates (+100 bps in the past two months) are affecting affordability, but there is still a huge buffer. Although there are obviously limits, the housing recovery will not be derailed by the recent rise in interest rates. Moreover, the Fed will be very keen to prevent such a risk from developing.
- The labour market seems set to continue adding jobs at 200k a month, the average of the past 2.5 years. This will result in a further decline in the unemployment rate, although the pace of decline should decrease as more people return to the labour market. Wage growth should pick up somewhat (from currently 2%), although it will remain rather modest. In all this adds up to a modest increase in income growth. On the other hand, household deleveraging is probably over as the balance between household assets and liabilities has been broadly restored.
- The impact of important fiscal tightening in 2013 (2.2% of GDP) will ease in H2. The fiscal policy debate will see a comeback of the debt ceiling issue in October/November, but this will probably be managed better than in 2011.
- The improving outlook, healthy corporate finances and easier access to credit should push companies to gradually increase investment spending. In a second phase this should have a positive impact on job creation.

Inflation

- Headline inflation looks set to increase in coming months, heading back towards 2% by early next year. In any case, in the near term inflationary pressures are likely to remain subdued.

Policy

- The Fed is on track to start reducing its monthly amount of bond purchases after the Summer, with an aim to end QE altogether by mid-2014. The first rate hike should follow about a year later. The Fed will manage this exit in line with the economic recovery, with special attention to the labour market data. If the recovery surprises on the positive (negative) side, the agenda for the exit can be accelerated (slowed down). The Fed will continue to communicate this strategy carefully.
- The US Treasury hit the debt limit mid-May. Since then the Treasury has been using extraordinary measures to stay under the limit. This can continue until October/November. By then there must be a deal to raise the limit. This will generate another difficult debate after the Summer. However, it seems unlikely that this debate will be played out as hard as during the Summer of 2011.

EUROPE

Activity

- In recent months, eurozone consumer confidence has improved significantly. Business confidence also improved, but mainly in the periphery. These indicators suggest a somewhat more positive outlook for the second half of the year.
- Exports outside the eurozone have been the sole growth factor in recent quarters. The combination of a strengthening recovery in the US and a weaker euro could deliver a significant push to economic activity.

- Fiscal tightening has been weighing on economic activity. However, European authorities have (finally) become slightly more relaxed on this giving several countries more time to reach their fiscal targets. This implies less of a drag of fiscal policy on the economy going forward.
- In all, the eurozone seems on track to escape from recession by the end of the year. That said, any growth will remain modest. In any case, economic growth will not be high enough to substantially ease the current debt and unemployment issues.

Inflation

- Headline inflation is expected to move back up to about 2%, with core inflation remaining significantly lower. Upward inflation risks are basically non-existent in today's eurozone.

Policy

- The ECB recently moved to forward guidance (light) stating that it will not increase interest rates for at least another year. However, this is unlikely to be enough. The credit mechanism is still broken in the eurozone and more initiatives by the ECB are likely to be necessary to really tackle the crisis. Unfortunately, there is a distinct possibility that the ECB will use the return to positive growth as a reason not to add further monetary stimulus. On the other hand, any move toward monetary tightening should still be a very long way off.
- There is still quite some fiscal tightening to come in the eurozone as in most countries government debt dynamics are not under control. That said, there is a tendency to take more time to reach the fiscal targets. As such, the negative impact of fiscal policy on growth should ease.
- In the course of the next ten months, the initial bailout programs for Ireland and Portugal run out. It is highly unlikely that these countries will be able to make a full return to markets. It is far more likely that they get a new assistance package. On top of that, there is a significant probability that Greece and Cyprus will need more money. In any case this sets the scene for some tough euro-negotiations.

JAPAN

Activity

- The spectacular shift in policy by new prime minister Abe has delivered a substantial boost to both consumer and business confidence. This was already reflected in strong Q1 growth (an annualised 4.1%) and leading indicators suggest this can continue in the near future.
- The significant depreciation of the Yen provides important support for Japanese exports.
- Whether the new policy will be successful in a longer term perspective remains to be seen. It is still highly uncertain whether or not policy can really offset the implications of an ageing society. That said, the initial results look promising.

Inflation

- For now, Japan remains in deflation. However, inflation will turn positive again in the next few months as Yen depreciation feeds into higher import prices. Moreover, inflation expectations have increased significantly. It remains to be seen whether this is more than just a temporary shock. However, changing expectations is the first step towards an escape out of deflation.

Policy

- The BoJ has announced a massive increase in its balance sheet and is currently going through with this program. However, although the initial results have been promising, the BoJ will probably have to add more monetary stimulus to reach (and sustain) its objective of 2% inflation.
- Besides the shift in monetary policy, Abe has also added important fiscal stimulus. However, this will be offset by a VAT hike in 2014 and again in 2015. This risks reversing the initial results of the new policy.
- In light of Japan's huge government debt pushing for higher inflation holds the risk of rising interest rates, which could rapidly lead to a fiscal crisis. However, if the authorities manage to generate nominal GDP growth above long term interest rates, debt dynamics will be positive. To accomplish that, the BoJ will probably have to increase its purchases of government bonds even further. The only risk in doing so would be an inflation risk, which is the objective of the new policy.

EMERGING MARKETS

Activity

- Economic activity throughout EM has been slowing down in recent quarters, fuelled by developments in the BRICs. These have been facing structural issues for quite some time, but the latter are hurting current activity more than expected.
- In China the authorities are cracking down on too rapid credit growth, which will affect economic activity. However, the risk of a hard landing in China remains limited as the government is managing this process. Chinese authorities have demonstrated in the past that they have more effective tools at their disposal to manage the economy than authorities in DM. That said, some further slowdown in economic growth towards 6.5% in 2014 looks likely.
- The economic cycle in EM is still closely linked to the one in EM. A strengthening recovery in the US will support activity throughout EM.

Inflation

- In most of EM (with the notable exceptions of Brazil and Russia), inflation has been easing in recent quarters on the back of lower commodity prices. This picture is not about to change in the near future. For most EM, inflation is not an issue.

Policy

- EM monetary policy has been supportive and this will remain the case for quite some time. Weak economic activity and relatively low inflation create room to stick to the current monetary stance. Risks related to the currency and to credit growth probably prevent additional stimulus.
- Fiscal policy is modestly supportive and likely to stay that way. For most EM, government debt is not an immediate concern.
- Structural reforms remain key for the longer term outlook of EM. There is substantial potential there, however us usual the politics of such reforms are rarely easy, especially with upcoming elections in Brazil and India. In China, the October Party Plenum should bring more clarity on the intentions of the Communist Party.

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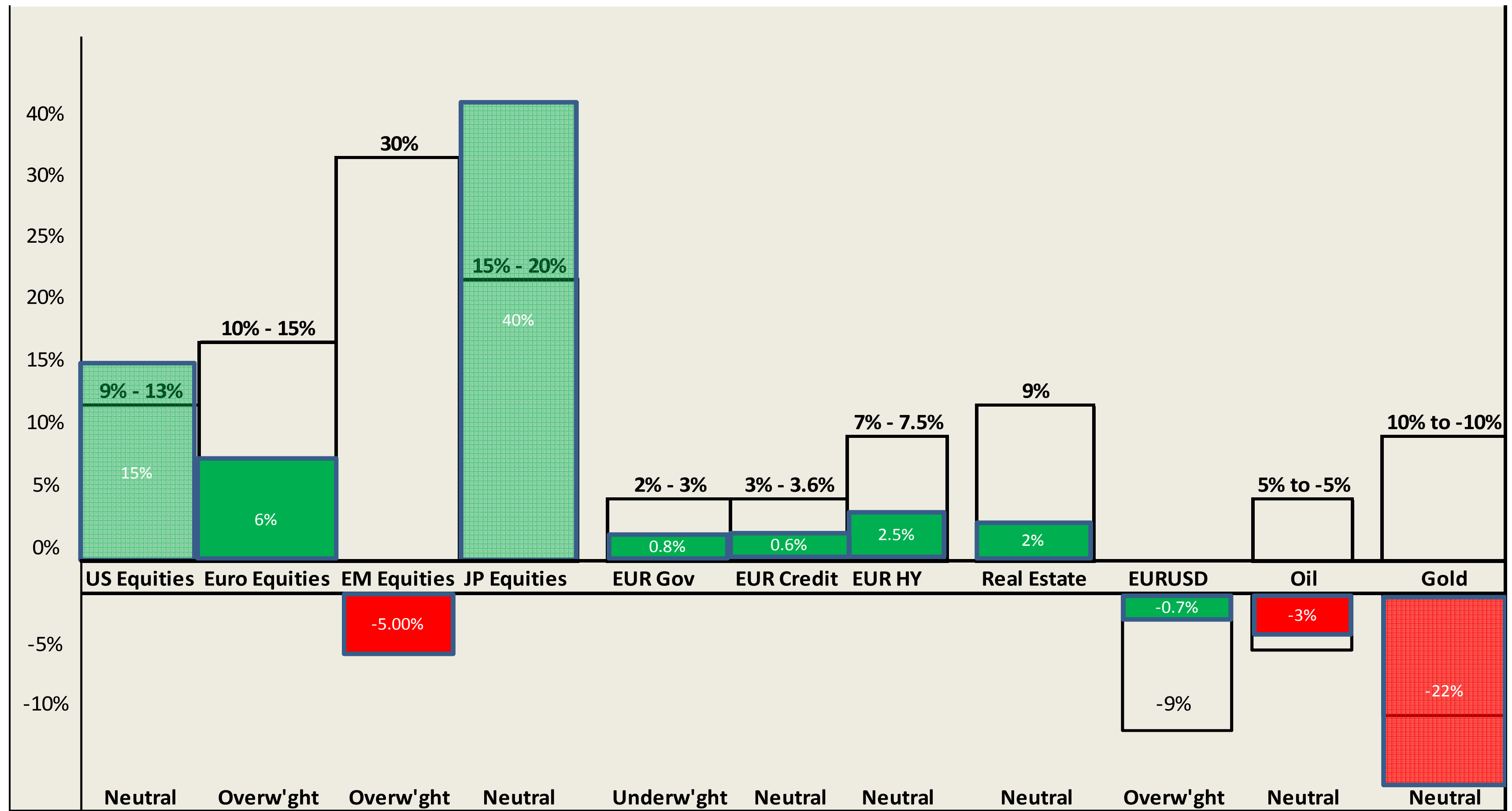
Global asset class outlook 2013, update for H2 2013

Expected returns January 2013 vs realized returns (updated to July 16)



Equity markets

- Equity markets still have room to perform in the 2nd half of 2013
  - US has delivered most of its full year return
  - Japan also delivered already the bulk of its expected annual return
  - Emerging markets have not delivered and we have lowered their expected full year returns
  - European markets inline, more return left for the rest of the year

Asset class	Expected return *1/01/2013*	Current return *16/07/2013*	Expected return Revised	Expected return *NEXT 6 Months*
US Equities	9% - 13%	15%	**15% - 20%**	**5%**
Euro Equities	10% - 15%	6%	**15%**	**9%**
EM Equities	30%	-5%	**15%**	**20%**
JP Equities	15% - 20%	40%	**45%**	**5%**

Equity markets, rational for adjustments

- US equities
  - US recovery is gaining momentum, earnings will benefit (+)
  - FED very careful not to tighten too quickly (+)
  - But valuations are getting expensive (-)
  - Small gains left (+)
- Emerging market equities
  - Large EM economies are not benefitting (yet) from US recovery (-)
  - Structural headwinds are rising (-)
  - Flows have been very negative (due to higher US rates and some growth disappointments) (-)
  - Valuations are very cheap and economic momentum should improve cyclically (+)
- Japanese equities
  - Abenomics gaining traction (+)
  - Earnings are being revised upwards (+)
  - Economic momentum is strong (+)
  - Some room left, but much priced in (-)

Fixed Income markets & Currencies

- Fixed Income markets
  - Higher rates in the core and lower rates in the Periphery
  - Returns are on track to achieve expected returns set out at the beginning of 2013
  - Expected returns unchanged

- EURUSD
  - EUR is still relatively strong, we expect further weakness
  - Expected return unchanged

Asset class	Expected return *1/01/2013*	Current return *16/07/2013*	Expected return Revised	Expected return *NEXT 6 Months*
EUR Gov	2% - 3%	1%	**2%-3%**	**2%**
EUR Credit	3% - 3.6%	1%	**3% - 3.6%**	**3%**
EUR HY	7% - 7.5%	3%	**7% - 7.5%**	**5%**
EURUSD	-9%	-1%	**-9%**	**-8%**

Other markets

- Real Estate
  - European Real Estate performance is slightly behind, but we keep our expected return target
- Oil
  - Oil price has been relatively stable, we keep our expected return target
- Gold
  - Gold moved aggressively lower on the back of less systemic risk & slow normalization of monetary policy
  - We lowered the bandwidth on the back of this

Asset class	Expected return	Current return	Expected return	Expected return
	1/01/2013	*16/07/2013*	Revised	*NEXT 6 Months*
Real Estate	9%	2%	9%	7%
Oil (USD)	5% to -5%	-3%	5% to -5%	0%
Gold (USD)	10% to -10%	-20%	-10% to -20%	0%

Gold, rational for adjustment

- Gold
  - Exit policy indicated (and clarified) by the Federal Reserve
  - Systemic pressures have eased on the back of small progress in Europe
  - Real yields are rising
  - Lower demand from Emerging markets
  - Momentum in Gold has reversed

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Expected returns July 2013 vs realized returns