Petercam

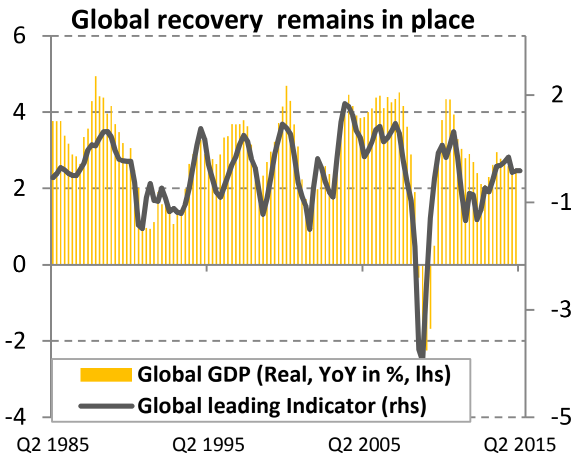
Macro Research
28 May 2015

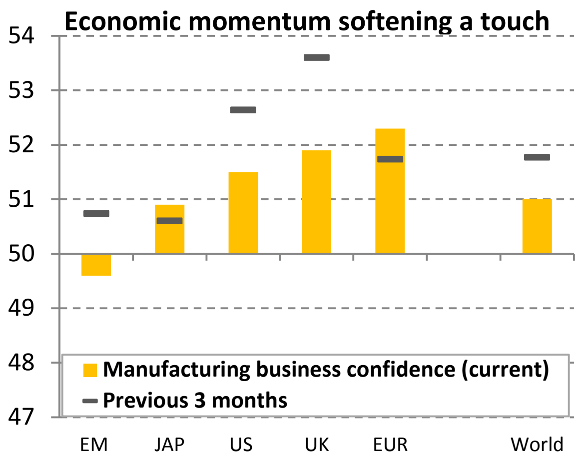
Global recovery remains in place despite recent signs of hesitation

Almost seven years after the start of the 2008-2009 Great Financial Crisis, the world economy is still dealing with its legacy. This situation is unlikely to disappear anytime soon. Recent doubts about the strength of the US recovery, fears about a hard landing in China and difficult negotiations between Greece and its creditors, have questioned the global recovery once again. However, while the risks are real, we think that too much pessimism about the state of the global economy is currently not warranted.

- In most parts of the developed world the pace of economic activity following the "Great Balance Sheet Recession" of 2008-2009 has been lackluster over the last couple of years. Despite record low interest rates, economic growth in the developed world was too slow to quickly address the problems in the labor market. The US has now made the most progress on this front but in the Eurozone the labor market situation is still alarmingly weak. And even though the recent improvement in economic sentiment will translate in an acceleration of employment growth, unemployment in Southern Europe looks set to stay near-depression levels for years. Emerging markets led by China, on the other hand, spectacularly recovered from the 2008-2009 crisis but they are now clearly on a slower growth path.

- More recently, several factors including a very weak Q1 growth figure in the US, Greek issues threatening to undermine the early Eurozone recovery and more alarming sounds from China have contributed to doubts about the strength of the world economy. We would certainly not dismiss these risks as futile. But even though the downward risks are substantial, we have good reasons to believe that the global recovery will not end abruptly and instead continue against the background of very loose monetary policy, less budgetary tightening and lower energy prices. This is alos consistent with the picture portrayed by current global confidence indicators.





United States

- With regard to the situation in the US, the complete growth stall in the first quarter is almost surely not representative for the actual state of the economy. Even though most forward looking confidence indicators have softened a touch and momentum slowed down following the spectacular growth rates seen in the spring and summer of 2014 (around 5% annualized), almost all indicators point to a continuing recovery (albeit to a somewhat slower pace of around 2.5%). Indeed, there are good reasons to believe that growth in the first quarter (0.2% QoQa) was largely held down by transitory factors. The unseasonably cold winter, the

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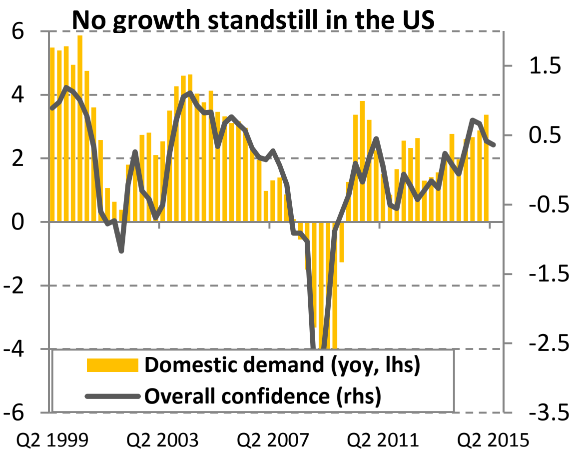
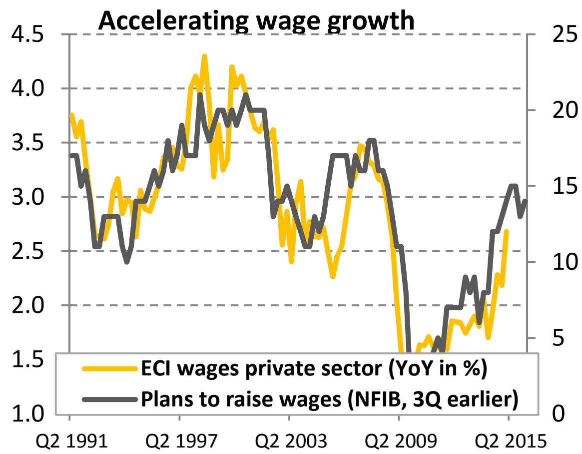
scaling back of investment in the shale oil industry following the fall in the oil price and the stronger USD have all weighed on economic activity. While the negative effect of the first two factors will soon disappear, the recent dollar appreciation is still not large enough to derail the fairly closed US economy. Moreover, over the last five years, economic activity in the first quarter of the year has always been significantly below other indicators of economic momentum suggesting that some seasonal adjustment problems are at play.





- Headline inflation, currently at -0.1%, will increase quite significantly in the coming months as the drop in energy prices seen earlier starts to have less of a negative impact. All else equal and assuming the oil price remains unchanged at current levels, inflation would automatically jump up to around 1.5% this time next year. At 1.8%, underlying inflation is currently higher but still below the 2% inflation target. On most leading indicators, wage growth is about to accelerate to around 3%. Against the back of the slow productivity growth seen in recent years, this would be consistent with core inflation moving back to around 2%. The upshot is that the Fed is still on course to start hiking interest rates before the end of the year. Tighter monetary policy 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

- In the Eurozone, leading indicators suggest economic momentum is improving. Earlier ECB stimulus measures resulting in lower interest rates and EUR depreciation, reduced budgetary tightening efforts and lower oil prices are driving this cyclical recovery. This is encouraging following years of stagnation. That said, the economic recovery is still nothing to cheer about and could easily be derailed if the negotiations between Greece and IFKAT (institutions formerly known as Troika) fail.

- Headline inflation in the Eurozone will increase significantly in the second half of the year as the base effects linked to the decline in energy prices fade. Underlying inflation, although set to pick up from the current 0.6%, 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. Despite improving confidence, recent speculation about reducing the announced QE program is ill-considered and still very premature. If anything, the most prominent risk is that the ECB will have to do more beyond the current stimulus program.

- A last minute compromise on the final payment of the second bailout plan still seems the most likely scenario. But even in this case, given the scheduled debt repayments and the fact that the Greek government cannot tap financial markets, a third bailout program will still be needed. Preferably, this would give the Greeks considerably more fiscal leeway. This would allow the economy to gain momentum which, in turn, would translate into better budget figures over time. The opposite approach clearly has its limits as

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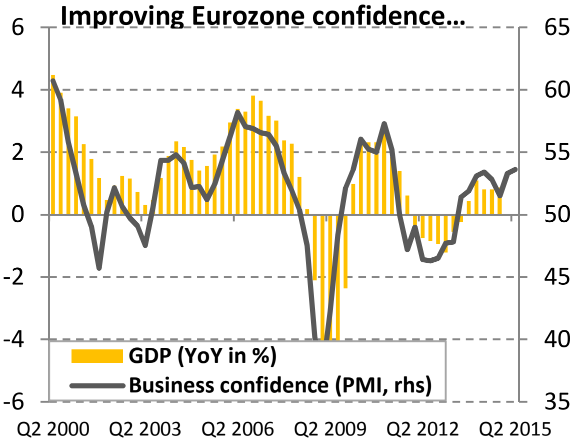
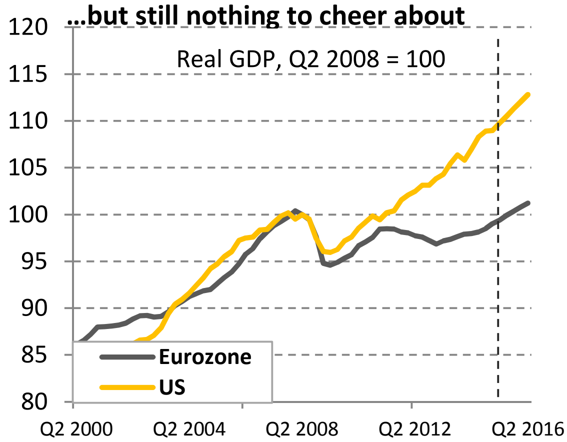
illustrated by the fact that Greek living standards have decreased dramatically and unemployment is still extremely high.

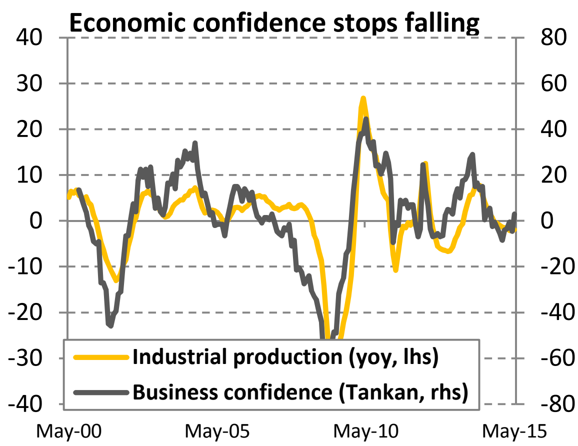


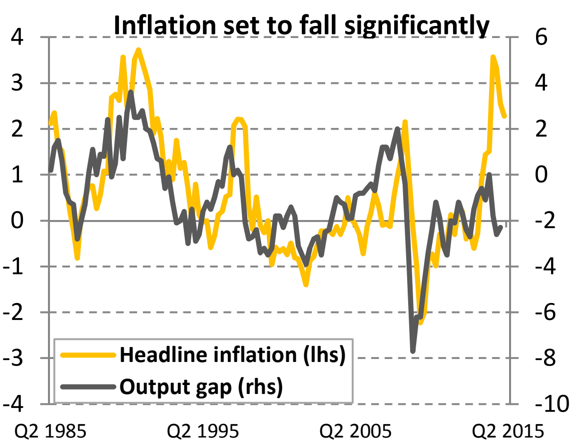


- What's more, the latest confidence indicators suggest Greece is sinking back into recession. Pushing Greek out of the Eurozone after years of internal devaluation would still come with significant political and economic risks as this would clearly show that membership of the monetary union is reversible. Let's assume for a moment that the Greek economy outside the Eurozone starts to revive after an initial additional hit, a plausible scenario. Other countries might then decide to follow the same path if economic prospects inside the Eurozone would not improve materially. The latest local and regional election outcome in Spain should once again underline this risk.

Japan

- 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 growthis likely to jump back into positive territory. That said, economic momentum is still modest. Moreover, the 2.4% annualized growth rate seen in the first three months of the year is flattered by a build-up in inventories. Growth figures in the next couple of quarters are likely to make clear that growth is still fairly weak.



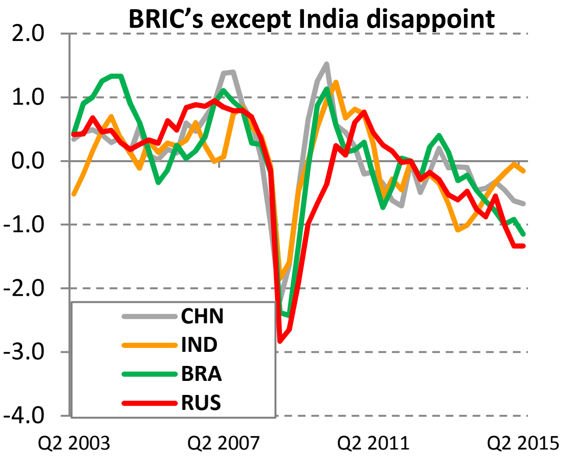


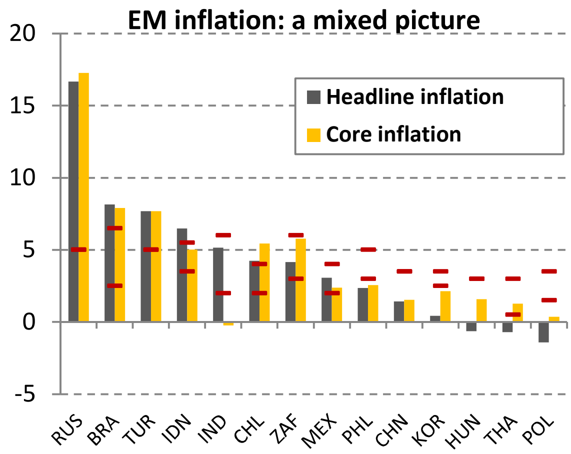
- In addition, it can be expected that inflation in Japan comes down quite significantly in the next couple of months as the base effect from the April 2014 tax hike disappears from the numbers. On the other hand, household's expectations about future inflation remain clearly positive and survey indicators 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. Therefore, the most likely scenario is that monetary policymakers will scale up the pace of its current asset purchase program.

Emerging markets

- EM are clearly on a slower growth path. The divergence between EM remains large with confidence in net commodity exporters significantly below the levels seen in the net commodity importing countries. Russia and Brazil will even see negative growth this year while future prospects remain grim against the back of deep structural problems. This stands in contrast to the situation in India where overall confidence has improved and inflation has come down since new policymakers took office. In China, economic growth in the next couple of years will continue to slow from current levels as the gradual switch from investment and export-led growth towards consumption economy takes place. As things currently stand, ample monetary and budgetary room for maneuver substantially reduces the risk of an imminent hard landing.

- Inflation in EM remains a mixed picture. Inflation is still uncomfortably high in several EM including Russia (largely due to temporary factors), Brazil and Turkey while policymakers in countries like Poland, Thailand, Hungary, Korea and China are confronted with below target inflation. The downward pressure on inflation stemming from lower commodity prices looks set to ease over the coming months. This means that overall inflation in EM will accelerate somewhat in the months ahead so that most of the monetary policy easing seen in EM over the past year is probably behind us. But with core inflation staying modest in most parts of the emerging world, there is good reason to believe that monetary policy will stay relatively loose in the foreseeable future. Central banks in Russia, India and China are likely to cut interest rates further. In China, policymakers have already responded to the deteriorating economic momentum by cutting interest rates and bringing down the required reserve ratios for commercial banks. More easing can still be expected but a massive stimulus program should not be expected given the huge financial imbalances built up since 2008.





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