Degroof Petercam

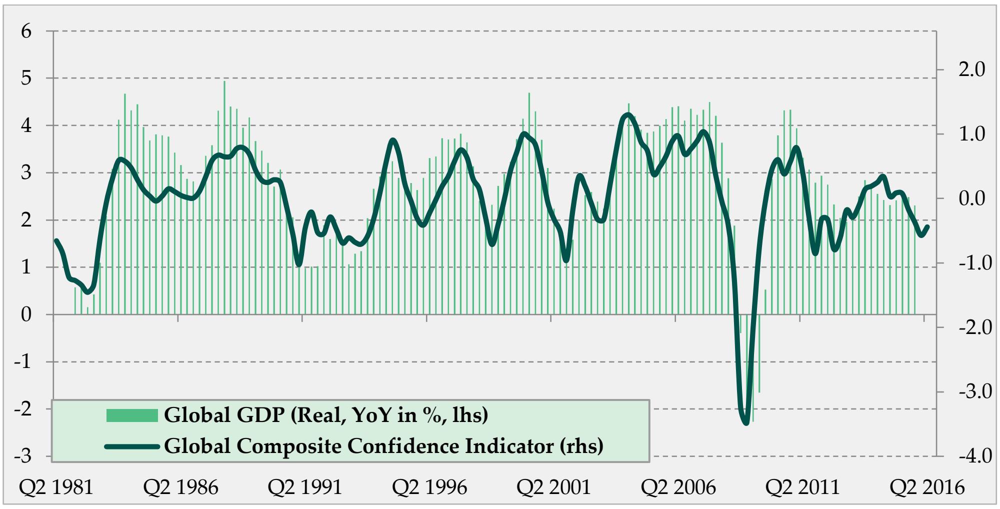
MACRO RESEARCH

April 2016

GLOBAL ECONOMIC OUTLOOK

- Despite the improvement witnessed in recent weeks, our global composite confidence indicator still suggests that global economic activity remains very weak. What's more, downward risks remain substantial.
- 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 lacklustre recovery since the Great Recession thus far. Meanwhile, despite huge expansions in the size of their balance sheet, most central banks are still desperately looking for higher inflation.
- Uncertainty looms large against the back of China's difficult economic rebalancing exercise, the future path of the RMB, increased awareness among international investors that monetary policy can only do so much when interest rates are near zero, geopolitical risks, signs of hesitation in the US economy, disruptive effects of the earlier steep fall in oil prices, the shape of the global financial system, the risk of Brexit, the European refugee crisis and high levels of private and public debt,…

Global economic activity remains very weak



Source : Datastream, Degroof Petercam

- A severe economic crisis in China is still a key risk. Our scenario that China will avoid a hard landing in 2016 remains in place even though the challenges that stem from rebalancing the economy loom large and hard landing fears are likely to continue to linger around. (https://insights.petercam.com/emerging-markets/crossing-the-chinese-river)
- Despite the general very low level of commodity prices, base effects will send headline inflation higher in late 2016. Core inflationary pressures look set to remain modest, implying that global monetary policy will stay very loose in the foreseeable future.
- The USD has appreciated significantly since the summer of 2014 and this has come with serious challenges. (https://insights.petercam.com/developed-markets/more-thoughts-on-the-state-of-the-

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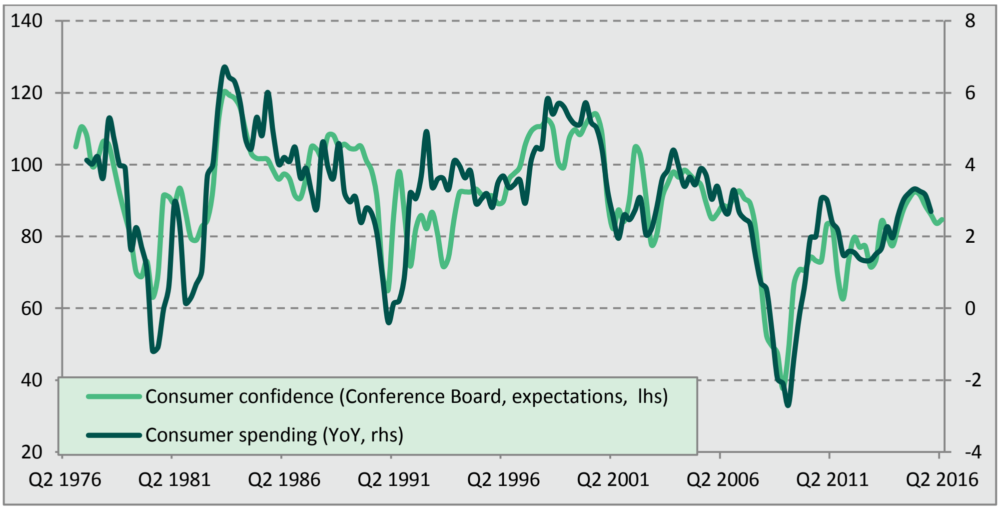
world-economy). A further sharp appreciation from current levels, however, looks unlikely.

- 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. We would not agree that budgetary and monetary policymakers have lost all ammunition to fight this extremely challenging situation.
- Policy action really could make a difference and consensus is slowly building around the need for more infrastructure spending. Whereas most policymakers have been (wrongly) focusing on balancing public budgets in the aftermath of the Great Recession, they now seem to recognize that more investment could help to spur growth. As resources are idle in a liquidity trap, a crowding-out effect from higher interest rates should not be expected, making this policy (fiscal expansion) more effective. It's not entirely clear whether policymakers are ready to adopt this approach. The G20 Summit held in Shanghai last month did produce some encouraging results in this respect but remain vague at the same time.
- Our view on helicopter money going forward? If governments do spend more as we approach the ZLB, the insurance policy of helicopter money may not be needed. At the same time, even if governments want to do the right thing, lack of good projects or information delays may mean they cannot do enough. As a result, the very quick action that central banks could take with helicopter money could be a useful compliment. That said, it is far from clear whether policymakers are ready to think more 'out of the box' in this respect. (https://insights.petercam.com/developed-markets/unconventional-monetary-policy-pushing-on-a-string).

United States

- Even though most important confidence indicators improved in March, the US economy is not in great shape. Confidence in the manufacturing sector is suffering from a stronger USD and low oil prices, respectively weighing on exports and investment in the energy sector. That said, survey data from March were more upbeat again with the ISM manufacturing recording the highest figure since last summer. Moreover, the deterioration in service sector confidence witnessed since last October came to a halt in March.

US consumer expectations softening a touch

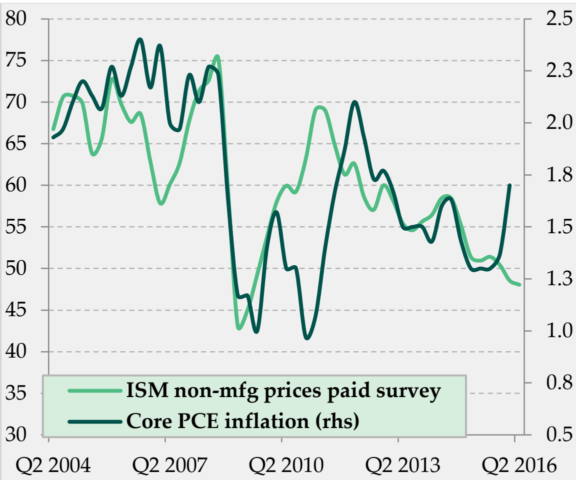


Source : Datastream, Degroof Petercam

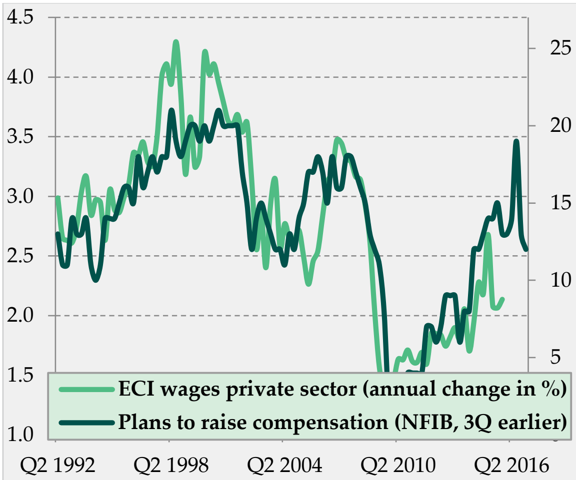
- Though still in line with real consumption growth of around 2%, consumers' expectations about the future are also softening a touch. All in all, consumer spending should hold up against the back of low energy prices, the continuing recovery in the housing market and decent job growth.

- With an average of almost 250K jobs created over the last 6 months, the labor market continues to perform solidly. At 5.0% the unemployment rate is in line with estimates of the NAIRU. Meanwhile the U6 unemployment rate stands at 9.8%, down from more than 11% since the start of 2015 though still higher than the average of 8.9% seen between 1994 and 2007. Surveys measuring employment expectations have been weakening more recently. Moreover, wage growth remains lacklustre.
- Base effects linked to energy prices will make sure that headline inflation (now at 1%) will trend higher towards the end of the year. At 2.3% and 1.7% for core inflation and core PCE inflation (which is more important for Fed) respectively, underlying inflation is moving up. Looking forward, however, evidence is mixed with unit labor costs suggesting that core inflation should pick up further while other survey based price expectations are pointing in the opposite direction. The Fed's board of governors is also struggling with this. While Stanley Fischer sees the first "stirring" of higher inflation, Lael Brainard for example remains skeptic. Overall, the inflation outlook remains highly uncertain.
- Wage growth plays a key role with regard to the future path of inflation. At this point, despite the acceleration witnessed in recent quarters, wage growth is still subdued at around 2.3% yoy. Interestingly, earlier survey evidence of upward wage pressure now seems to be fading more recently.

Doubtful whether recent rise in inflation is for real



Weakening prospects for wage growth



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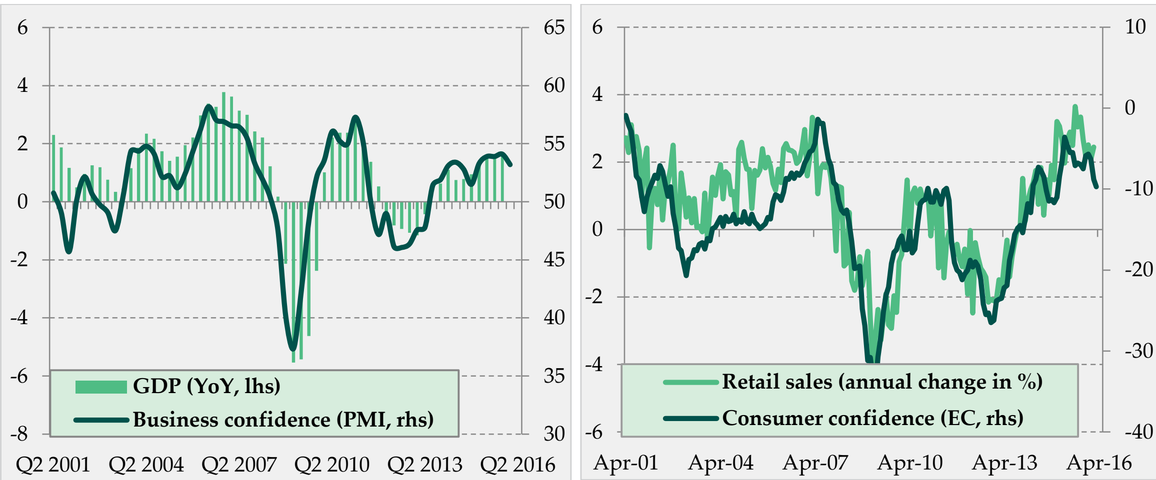
- All in all, US policymakers are not in a hurry to raise interest rates. Clearly, recent market turmoil, signs of hesitation in the US economy and the fact that inflation remains below the Fed's target imply that it is likely to adopt a very cautious approach. The most important message is that monetary policy looks set to remain accommodative in the foreseeable future because the US economy is not doing all that great. The Fed is likely to proceed gradually and only if the underlying economic momentum remains strong enough. The recent stabilization in commodity prices, the recent USD depreciation and decreased worries about China could provide a window of opportunity to hike interest rates in June.

Eurozone

- The European economy recovery remains highly disappointing against the favorable backdrop of low energy prices, the current low yield environment and EUR weakness. What's more, leading indicators suggest economic activity is showing signs of hesitation.
- Looking ahead, household consumption should continue to increase at a modest pace supported by the slow but gradual improvement observed in the labour market and low oil prices.
- Headline inflation (-0.2 % yoy in February) is held down by the recent steep fall in energy prices but base effects will send it higher in the second half of the year. Underlying price measures on the other hand remain very weak reflecting the slack in the labor market. Given the persistence of the large negative output gap, core inflationary pressures are expected to stay very weak. All in all, the ECB is likely to experience major difficulties in getting inflation up to its target of 2%.

Eurozone recovery remains extremely fragile



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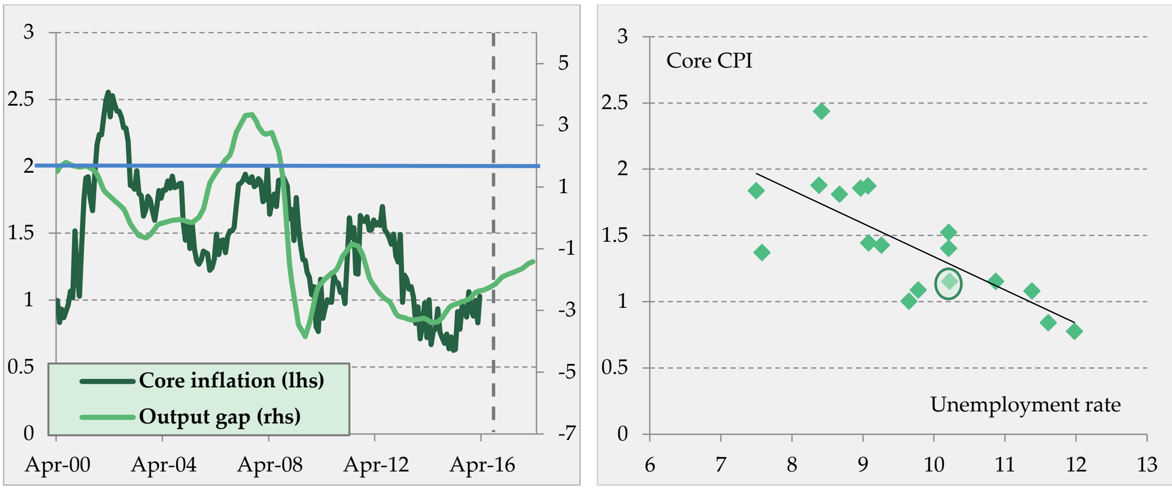
- Our long-held stance that the ECB would eventually be forced to do more was proven right again in March. The key policy rate was cut by 5bp to 0.0% and the interest rate on the deposit facility was decreased by 10bp to -0.4%. Furthermore, the amount of monthly was expanded to €80 bn (from €60 bn) and the list of eligible assets was increased with IG euro-denominated bonds. Finally, the ECB's March meeting saw the introduction of a new series of 4 LTRO's each with a maturity of 4y. Irrespective of what was announced, we still believe the ECB faces huge challenges to structurally achieve its goal of 2% inflation.
- The Greek situation remains unresolved. Imposed budgetary tightening keeps Greece stuck in recession with unemployment and public debt levels at unsustainably high levels. In this context, political risks remain high.
- In a longer term perspective, European politics remain worrying in the sense that the currency union still faces existential challenges. Further integration, while still very much needed, looks far from evident at this point. Both the refugee crisis and rising popularity of extreme political parties in recent years is likely to make things only more complicated in this respect.
- The political situation in Spain is now increasingly drawing attention because, unlike in the past, no single party has an absolute majority and forming a coalition is difficult. The ECB's QE program, however, is likely to prevent that government bond spreads widen sharply. The Catalan issue

should not be a major problem at least for now. First, Catalans are highly divided. Second, EU membership would not be possible without all other EU members approving it (highly unlikely).

- The Brexit risk is real and the debate has intensified in recent months. All in all, our scenario is that Brexit will be ultimately avoided. That said, risks remain high. The tense situation, however, once again underlines the very challenging European political context. (https://blog.degroofpetercam.com/en/article/brexit-fears-likely-intensify)

Will the ECB ever hit 2% again?

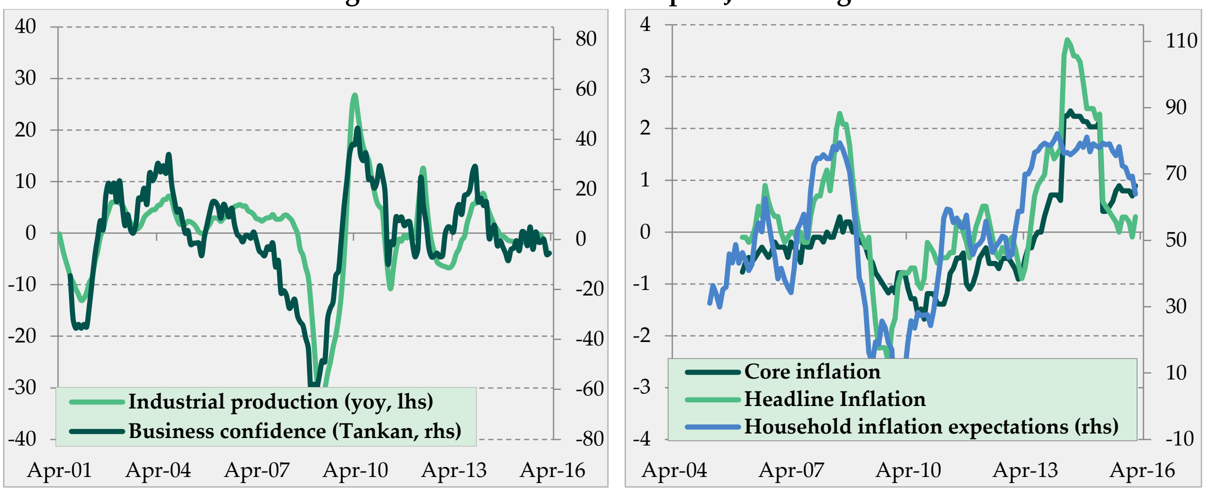


Source : Datastream, Degroof Petercam

Japan and Emerging Markets

- Economic activity in Japan is still weak. The tightening labor market points in the direction of accelerating wage growth though other evidence paints a more nuanced picture. Inflation, meanwhile, remains significantly below the Bank of Japan's 2% target.

Slow growth and lowflation keep BoJ in easing mode



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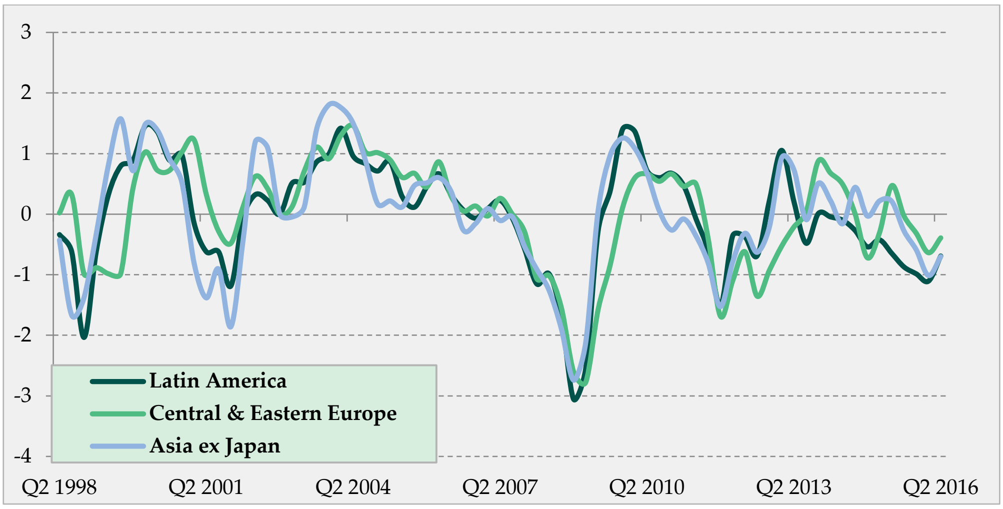
- The combination of weak economic activity and below target inflation, as we argued before, would eventually prompt the BoJ to expand its monetary stimulus program. Indeed, in its January policy meeting the BoJ applied a negative interest rate of -0.1% to current accounts that commercial banks hold at the BoJ (three-tier system). The BoJ also made clear that it will not hesitate to cut interest rates further into negative territory if necessary. Serious doubts remain, however, whether this can deliver the desired results. Meanwhile, the JPY has been strengthening again more recently.

- More broadly in EM, the slowdown witnessed over the last few years reflects several factors including the negative effect of lower commodity prices, tighter external financial conditions linked to the prospect of the first rate hike in the US, economic rebalancing in China, structural bottlenecks as well as distress related to (geo)political factors.

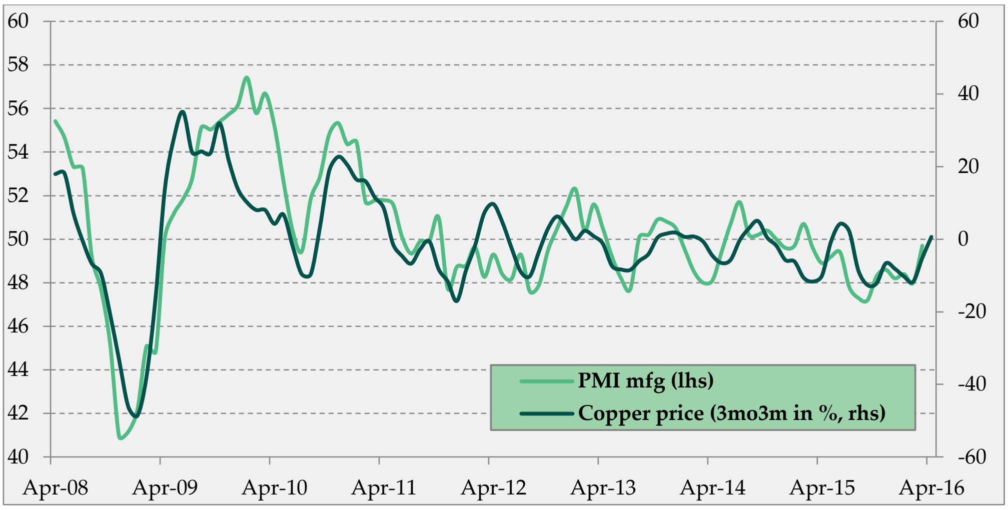
Despite most recent uptick, EM leading indicators still point to sluggish economic activity



Source : Datastream, Degroof Petercam

- Economic activity in EM is still very sluggish and this is unlikely to change soon. More flexible exchange rates, lower levels of external debt in general and significant amounts of international reserves should protect most EM against a full-blown financial crisis. Moreover, China's stimulus measures are likely to make sure that imminent hard landing fears will diminish somewhat, at least for now. Finally, the currency depreciation seen in many EM since 2013, should eventually translate in improved competitiveness when combined with further productivity enhancing reforms. To be clear, as mentioned earlier, current financial and economic conditions as well as structural issues will make sure that EM are not up for a rapid recovery. Risks remain on the downside

Manufacturing confidence rises in line with recent uptick in copper prices



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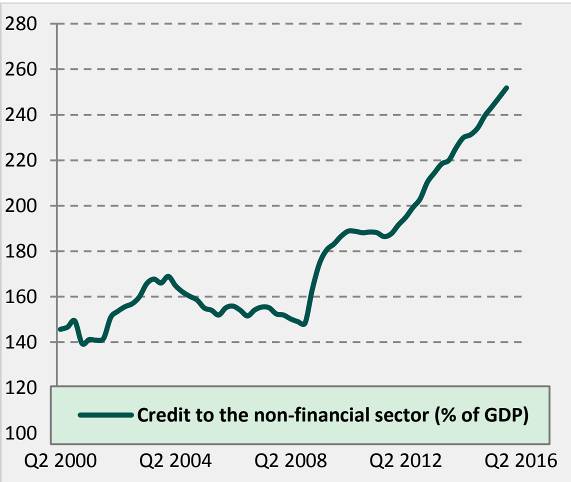
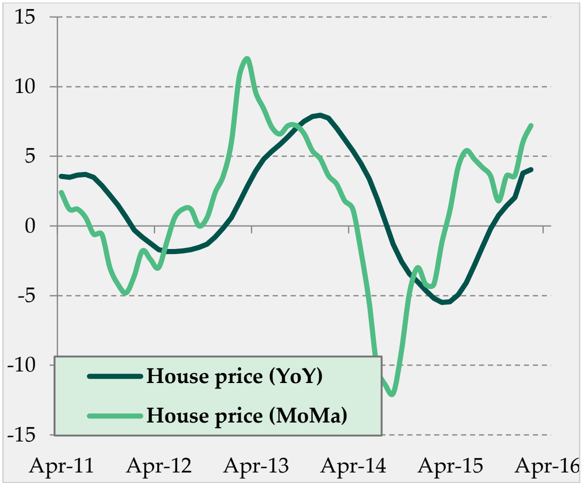
- An imminent Chinese hard landing will probably be avoided as the stabilizing effect of earlier stimulus measures slowly starts to kick in. The latest confidence data show early signs of stabilization. The latest confidence indicators have risen in line with commodity prices and the recent RMB/USD appreciation seems to have reduced the general concern about a near term growth collapse.
- However, the medium to longer term outlook still looks incredibly challenging against the back of the huge Chinese debt overhang, ageing population, less potential to catch up from behind and difficulties linked to further economic rebalancing. Hard landing fears, therefore, are likely to stay with us for many more years. (https://insights.petercam.com/emerging-markets/6-graphs-illustrating-our-current-view-on-chinas-economy). More recently Chinese policymakers have set their new growth target between 6.5% and 7% for the next 5 year. However, meeting these targets while continuing to make significant progress with regards to structural reforms looks simply impossible. Credit growth remains unsustainably high and house prices are rising fast again, which adds to concerns about the Chinese economy.

The combination of rapid credit growth and soaring house prices adds to concerns of sustainability





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- Although it's impossible to exclude the scenario of a large one-off RMB depreciation, we don't think this will happen in the coming months (https://insights.petercam.com/developed-markets/sharp-cny-depreciation-just-around-the-corner). A gradual managed depreciation remains our base case scenario for now.

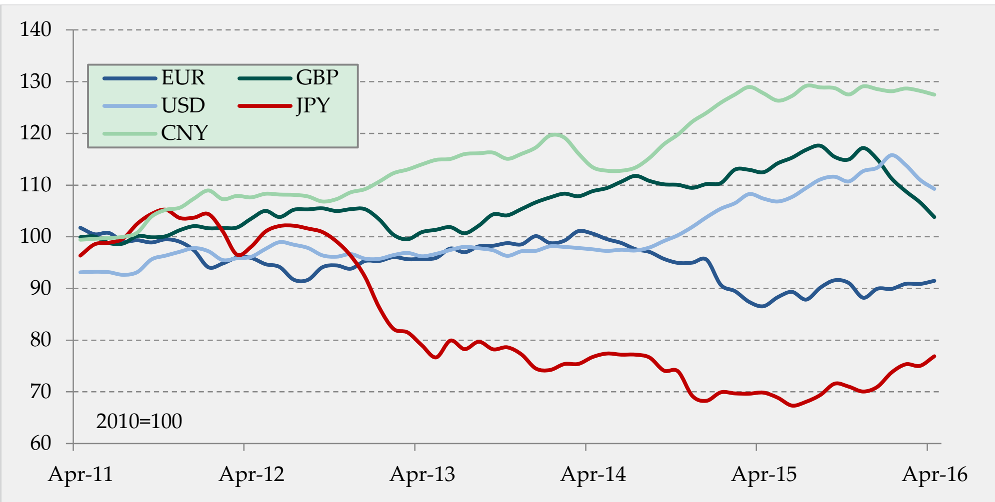
Currencies

- 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. 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 from a LT-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.
- With inflation pressures still very modest and growth prospects weakening, the BoE is not in a hurry to hike interest rates. The risk surrounding "Brexit", an issue that has gained more attention in recent months, poses downward risks for the GBP. That said, the GBP has already depreciated

significantly since late 2015. A "remain vote" is likely to result in some GBP appreciation although to a limited extent.

- The JPY has been strengthening more recently. From a LT-perspective, it seems that the JPY has now become a 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 both sides.
- EM currencies experienced serious downward pressure since the May 2013 taper tantrum. Investor appetite for EM assets has waned and sustained EM currency weakness is likely given the subdued growth outlook. That said, given the depreciation already seen since the spring of 2013, the risk of another sharp hit now looks smaller. Indeed, in real effective exchange rate terms, EM currencies (weighted by GDP ex China) have depreciated around 10% since May 2013. For some currencies, including the BRL or RUB the depreciation has been almost 30%.

Real effective exchange rate



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GDP and CPI Outlook

	GDP			Inflation		
	2015	2016	2017	2015	2016	2017
US	*2.4*	**1.5**	**1.7**	*0.1*	**1.3**	**2.0**
		2.1	*2.4*		*1.3*	*2.2*
Eurozone	*1.5*	**1.1**	**1.4**	*0.1*	**0.6**	**1.3**
		1.5	*1.6*		*0.3*	*1.4*
Japan	*0.5*	**0.3**	**1.0**	*0.8*	**0.3**	**1.5**
		0.7	*0.6*		*0.0*	*1.6*
China	*6.9*	**5.5**	**5.0**	*1.5*	**1.9**	**2.2**
		6.4	*6.2*		*1.5*	*1.7*

Degroof Petercam forecasts as of 11April 2016, *Consensus forecasts*

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