Northern Trust

GLOBAL ECONOMIC OUTLOOK FOR 2015

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Re-entry to the workplace after the holiday season isn't exactly like a satellite descending from earth's orbit. But both involve returning to normal temperatures after a period of chilling out, and both can therefore be very disorienting.

On the positive side, both situations offer the benefit of perspective. Taking a step back and considering things from additional distance provides a fresh view of the landscape. It is for this reason that we opt to issue our annual economic outlook after January 1.

Upon reflection, several main themes are central to the forecast for 2015.

- **Uneven economic growth.** With the exception of the United States and the United Kingdom, there are few economies of any size that are on the upswing. And there are quite a few facing significant challenges.

  In situations like this, the global nature of trade and markets typically leads performance into synch. Either the locomotives will pull the other cars along, or the weight of the freight will work to slow progress at the front. We're betting on the former this time around, but the outcome will depend on the skill of a few key engineers.

- **The consequences of low inflation.** Many areas struggled to keep inflation at targeted levels before oil prices fell by half in the last six months of the year. That task has now become even more difficult.

  The immediate effects of energy price realignment will be an important short-term focus. But in the long term, low inflation is very damaging to debtors, from consumers to countries. Six years after the financial crisis, there remains an excess of leverage in many places.

- **Political stability.** Poor economic performance has led to disillusionment among the populace in many areas. Protest parties that oppose markets, trade coordination and immigration have gained influence. Insurgency is the most extreme manifestation of this.

  We open 2015 with active conflict in some parts of the world and important elections on the schedule in others. The outcomes will bear importantly on economic achievement.

Following is our usual tour across the globe to examine prospects for the new year.

United States – Engine of Global Growth

The U.S. economy is in a sweet spot at the moment, as both forward economic momentum and subdued inflation co-exist. The recent growth of U.S. gross domestic product (GDP) has been exceptional. We expect that momentum will be sustained, with the U.S. economy predicted to grow at an above-trend pace of roughly 3.0% in 2015. The main drivers of economic growth in the United States – consumer spending, residential investment expenditures, business spending, government spending and exports – are each expected to make positive contributions of varying strengths.

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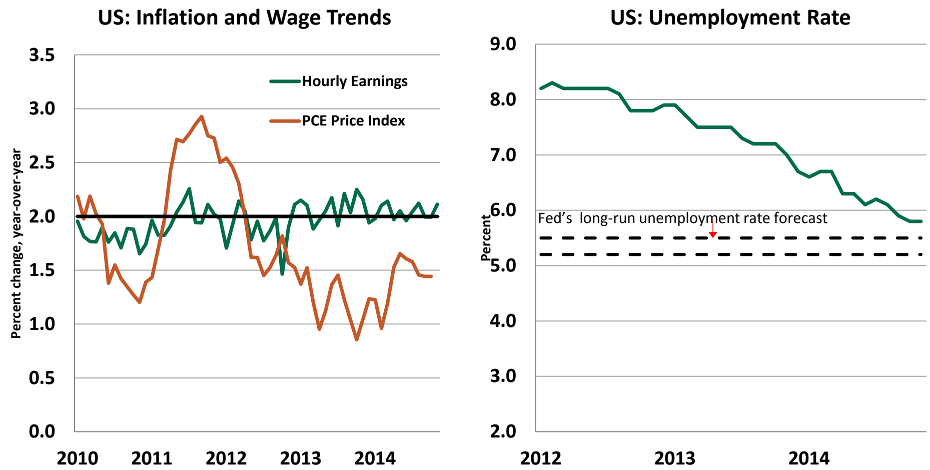
Further improvements in the U.S. labor market are nearly certain in 2015. The jobless rate (now at 5.8%) is forecast to move down gradually, and wages are expected to show stronger gains. These favorable developments for U.S. consumers, abetted by lower energy costs, should boost the consumption on which the rest of the world relies.

The United States enters 2015 carrying a lot of economic momentum.



Source: Haver Analytics, Federal Reserve Board

Inflation in the United States is roughly 50 basis points below the Federal Reserve's 2.0% target. Further gains in output and employment should lift inflation closer to target in 2015. The Fed sees the recent decline in oil prices as a transitory factor.

The recent drop in U.S. long-term rates is largely the product of safe-haven movement. As global concerns ease, expect a steeper yield curve in the months ahead. The Fed has signaled it will be patient in applying monetary policy brakes; we expect the first rate hike in September but slow escalation thereafter.

This sanguine outlook is not without risks. Slowing in China and Europe, along with stress in some emerging markets, could cool markets and confidence. But the American economy is presently enjoying a number of tailwinds that should carry it forward.

Eurozone – Another Difficult Year

The eurozone's economic outlook remains weak, with sentiment and investment still well below pre-crisis levels and provision of credit to the private sector still contracting (albeit at a slower pace). Although real GDP growth should edge past 1.0% for 2015, there remain deep divisions among the members.

Germany, which accounts for about 28% of eurozone GDP, is looking at real growth of around 1.6% this year. However, the next three largest economies – which together account for about 55% of eurozone GDP – are in a very different place. Spain has finally returned to growth after a period of fiscal austerity and structural reform, but its very high unemployment rate (24%) and even higher youth unemployment (40%+) continue to weigh on the economy.

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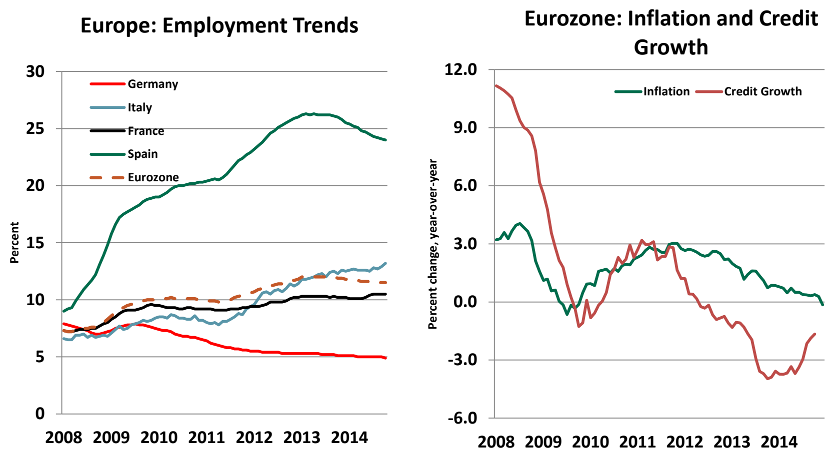
France and Italy stand in marked contrast. Having avoided politically unpopular reforms to labor markets and welfare systems, they continue to struggle with rising levels of public sector debt and increasingly uncompetitive economies. Both Paris and Rome will be challenged to maintain investor confidence by implementing structural reforms.

The eurozone desperately needs a powerful monetary policy response to its current malaise.



Source: Haver Analytics

Low oil prices will be a positive for eurozone growth by lowering the cost of energy imports but will also increase the risk of outright deflation. This will not be helpful to the European Central Bank (ECB), which has pledged to "do whatever it takes" to keep the eurozone from following Japan into a lost decade. This promise will be tested in 2015, as the ECB struggles to find ways to grow its balance sheet.

It seems to some that the ECB's best bet will be to launch full-blown quantitative easing and purchase sovereign debt. But it is not clear that this will have much of a positive impact. Credit demand remains very weak, and unease about the outlook is keeping a lid on investment. Meeting new capital requirements will continue to challenge the eurozone banks and limit the translation of monetary ease to new lending.

ECB President Mario Draghi's promises have already brought eurozone sovereign yields down to record lows. If the ECB's actions continue to fall short of expectations – a significant risk, given the political resistance to sovereign debt purchases from some countries – then the market reaction could be severe, pushing up yields and threatening a renewal of the 2010 tensions.

United Kingdom - Continuing to Recover, but Uncertainty Looms

The U.K. economic recovery continued in 2014, with strong growth figures and momentum looking to continue into 2015. This year, real GDP growth looks set to slow slightly to 2.6%, down from an estimated 3.0% at the end of 2014, due primarily to moderation in business investment before this year's general election.

With the lower oil price set to stay for the short run, consumer spending may pick up in the first quarter as residents find themselves with more disposable cash. However, low inflation levels

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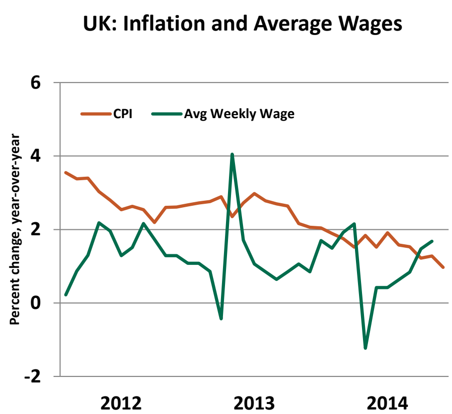
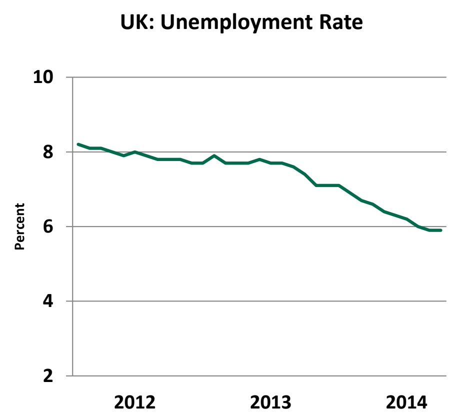
remain a concern. It is highly likely that at some point in the first quarter of this year, Bank of England (BoE) Governor Mark Carney will have to write a letter of explanation to the Chancellor of the Exchequer as to why the consumer price index is growing by less than 1.0%.

Concerns about this and continued downside risks from stagnation in the eurozone have led to speculation that the BoE will not raise rates until the end of 2015 or early 2016. However, our baseline is still that they will go up sometime in the second half of this year. Despite indications that fiscal austerity will continue until 2018-19, unemployment has fallen to just below 6.0%, and as long as real wage growth firms in the first half of this year (of which there are tentative signs) the rate rise should not be put off much longer than this.

This year's U.K. elections will be critical for Britain and for Europe.





Source: Haver Analytics

May 2015 will be an important month in British politics. Uncertainty around a general election has never been so high, and the outcome is hard to predict. It is unlikely that one party will win an outright majority, and so the public may have to get used to the idea of another coalition government. How that will be composed is, at the moment, anyone's guess. The rise of euro-skeptic UK Independence Party, or UKIP; demise of the Liberal Democrats; and probable loss of Labour seats in Scotland to the Scottish National Party mean the landscape next year could be very different.

If David Cameron is to remain in power, he has promised a referendum on European Union membership in 2017, which would do nothing but add to uncertainty in the interim.

Nordics – Outperforming the Eurozone But Not Without Jitters

With the exception of Norway, Scandinavian economic growth is set to improve modestly in 2015. Sweden and Denmark have shown improving trends, while Finland may finally post positive annual GDP growth after three years of intermittent recession. In Norway, lower oil prices will exacerbate already-weak oil-sector investment, likely affecting employment, housing and consumer sentiment. If growth slows more than anticipated, the government has room to step up stimulus.

The threat of European deflation and further ECB stimulus will likely prompt Nordic central banks to remain aggressive. Sweden's Riksbank could implement further easing measures as

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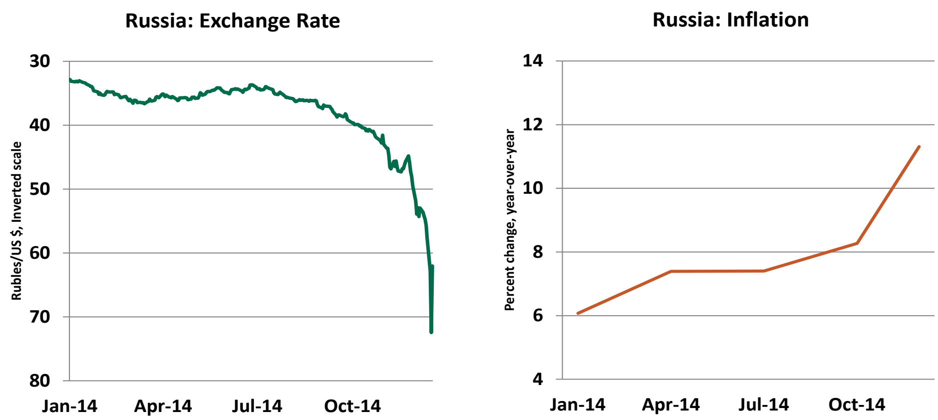
soon as February. Downside risks for the area stem from increased regional aggression from Moscow and reining in inflated property market values in Norway and Sweden. Despite these tests, we expect Nordic economies to outperform eurozone peers in 2015.

Russia – The Costs of Putin's Course to Become Clearer

Russia's adventures and geopolitical positioning in 2014 will have knock-on effects this year as GDP looks set to contract sharply from a stagnant level last year. The Central Bank of Russia predicts a contraction of 4.5% – 4.7%, but it could well be much deeper than this, depending on developments throughout 2015.

Will Vladimir Putin capitulate or come out swinging?

Absent a policy shift in Ukraine or a rise in oil prices, the ruble will remain very susceptible to changes in investor sentiment. Escalation on any front would see a further fall and higher inflation (which hit double figures at the end of 2014). The emergency 650-basis-point rate hike from the Russian central bank in mid-December set the precedent for further sizeable increases this year. And if reserve levels diminish more quickly than expected, the next hike could be much larger. Knock-on effects for the eurozone should be minimal, as trade relationships are not massive. Banks with large Russian exposures will continue to be hit the worst.



Source: Haver Analytics

China – Managing a Decline in Expectations

Beijing has a challenge in managing expectations this year and setting attainable goals without going through too many contortions to do so. The obstacles ahead are not insignificant, but they can be handled if the government is willing to take the hard steps necessary. This will require Beijing to be more aggressive on several fronts and to accept some unpopular consequences.

The Chinese economy has been slowing since 2010 and will likely post annual GDP growth for 2014 below the official target of 7.5%. The target for 2015 is likely to be 7.0% but could be as low as 6.5% to account for the weak global trade outlook. Managing the composition of growth will continue to be difficult, balancing public investment in labor-intensive sectors with reforming weaker economic sectors. This suggests reducing overcapacity in economically

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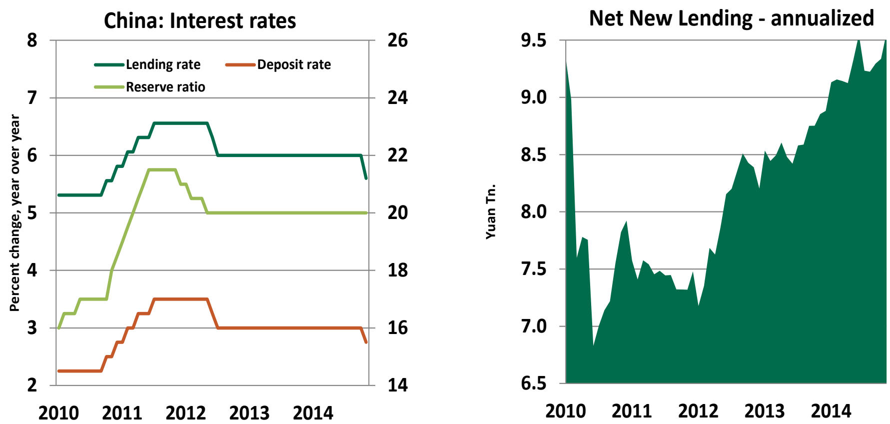
important industries, which would be politically unpopular but potentially crucial to long-term stability.



Source: Haver Analytics

China will seek to balance short-term goals for growth with long-term reform.

The People's Bank of China (PBoC) will have a difficult mission in 2015. It will want to lower lending rates to spur credit, maintain a deposit rate supportive of high savings and allow enough of a spread between those rates to avoid significant strain on bank balance sheets. Through all of this, the bank wants to support investor confidence during a time of potential instability – and it might need more tools to accomplish that.

Most important will be a rigorous monitoring of the financial sector, particularly at the provincial level. There is a possibility that some smaller banks might need to be bailed out or consolidated to maintain overall stability. This would be politically controversial and could shake confidence in the banking sector, but a lack of action could be the first step toward sector-wide contagion.

Japan – Abenomics Redux

While not as exciting as 2013, 2014 was definitely a busy year for Japan and its prime minister. The government implemented the first phase of its consumption tax hike, outlined a wide-ranging but yawn-inspiring structural reform package and massively expanded its already-huge quantitative easing program. Yet in spite of all that activity, the economy still found itself in technical recession, and it is likely to eke out only 0.9% growth in 2015.

On the policy side, the decision to delay the second phase of the consumption tax will almost certainly result in Japan missing its goal of halving its primary deficit by fiscal year 2015. As a result, Japan finds itself in a negative ratings cycle, with Moody's downgrading the sovereign debt rating one notch and downward movement from Fitch considered imminent. However, Japan has more than 90% of debt held locally and is a net external creditor, so its bond yields are relatively insulated from changes in global investor sentiment. In addition, Bank of Japan purchases of government bonds absorb a substantial fraction of new debt issues.

Japan's trade balance will be a bright spot as lower energy prices provide some relief and exports continue the solid recovery witnessed in the latter portion of 2014. The restart of

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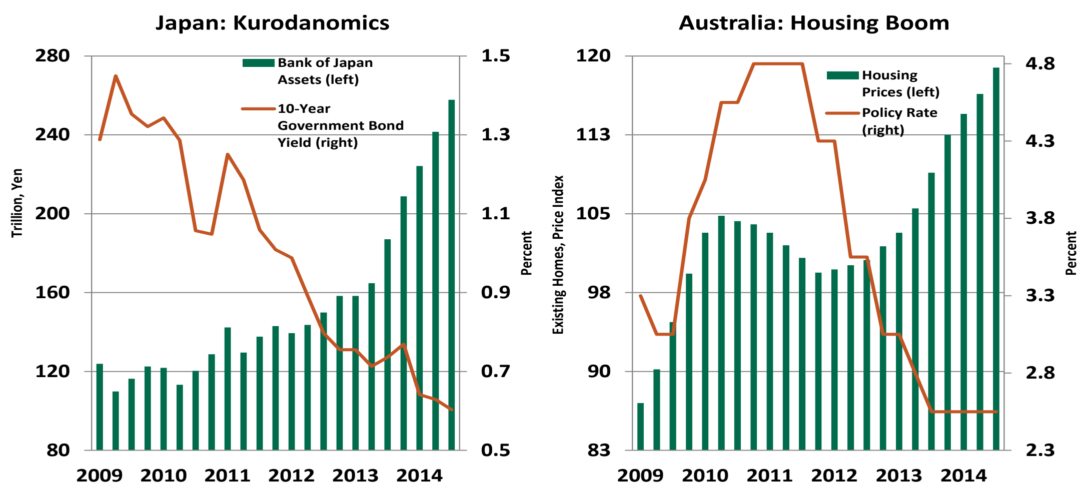
nuclear reactors, which is very likely this year, would reduce oil imports and have a positive impact on the trade balance. A key concern in the external outlook is the economic prognosis from China, which currently takes 18% of Japanese goods exports; continued weakness in its largest trading partner will weigh on a sustained recovery in exports.

Prime Minister Shinzo Abe's triumph in December elections should provide the firepower needed to push through some of his structural initiatives, especially agricultural reform and membership in the Trans-Pacific Partnership. Abe will probably use some of his renewed clout to pressure companies to raise wages – a key to improving consumption. In addition to measures already announced, the government could also inject additional stimulus into the economy if needed.

Abe will seek to use his renewed mandate to restore the momentum behind his agenda.



Source: Haver Analytics

Australia – Is This the Year?

With deteriorating trade prospects and the end of the mining boom placing a drag on the economy, speculation has increased that this could be the year when Australia's two decades without a recession will come to an end. Adding to the somber mood is an unemployment rate that sits at a 12-year high and shows no signs of narrowing in 2015. However, we think that Australia's economic winning streak will continue, thanks to low oil prices, the depreciating Aussie dollar and record-low interest rates.

The Reserve Bank of Australia (RBA) is currently tasked with balancing the need to spur the non-mining economy while keeping the surging real estate market from overheating. Except for Victoria, the property market is still not technically overvalued in the low-interest-rate environment; however, under a neutral 4.0% policy rate, house prices would be 12% overvalued on a national level. Taking in all domestic factors, including still-lackluster consumer demand, the RBA is likely to maintain rates at 2.5% during 2015. With elections due in 2016, the government would be loath to break from its fiscal consolidation agenda; however, there is ample room for stimulus should the economy sputter.

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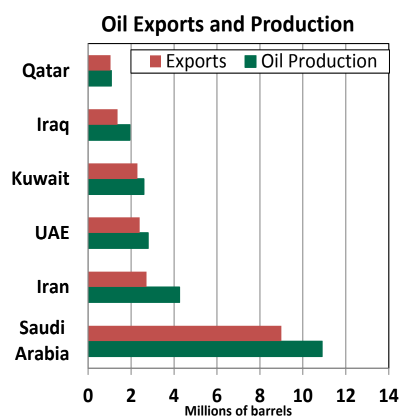
Emerging Asia – Waiting on the Export Recovery

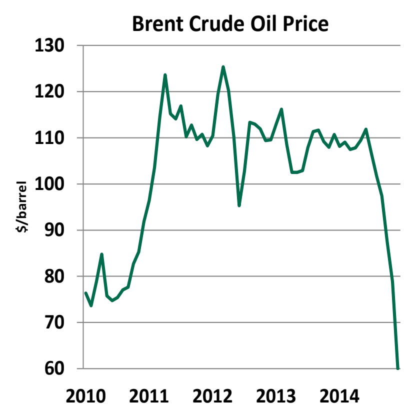
Emerging Asian economies are still waiting for an elusive export recovery, especially as Chinese demand ebbs. However, the region should still manage a 4.6% expansion in 2014. The economies have performed well in the face of global uncertainty and fears surrounding interest rate normalization in the United States, but vulnerabilities remain. The Philippines maintains its status as a development story darling, but with 37% of its debt denominated in foreign currencies, the country could come under exchange rate pressure. In addition, Malaysia and Thailand must tread carefully to ensure that monetary tightening does not put added pressure on already-elevated household debt levels, which could then lead to a spike in non-performing loans. Finally, Indonesia is riding high on the reform euphoria its new president has generated; however, it still has fiscal and current account deficits, which leave it vulnerable to change in investor sentiment.

Middle East – The Impact of Cheaper Oil

The continuing disintegration in the unstable Levant region will carry into 2015, but the other pole of the Middle East/North Africa (MENA) axis is clearly shifting from political consolidation in North Africa toward a Gulf region feeling the pressure of a prolonged decline in oil prices. OPEC's decision – deliberate or otherwise – to leave production levels unchanged will affect every Gulf country.

The large drop in oil prices could transform the economic landscape in the Middle East.





Source: Haver Analytics

The 49.2% decline in oil prices during 2014 will create a significant fiscal burden for almost all countries bordering the Persian Gulf, as revenues from the hydrocarbon sector can constitute as much as 90% of the government's budget. The major oil producers have significant sovereign wealth funds that could be accessed to fill short-term budget gaps, along with access to international capital markets. However, financially strapped countries such as Iran and Iraq, which are managing a number of other geopolitical problems, can ill afford such a fall in government revenue. While Iraq receives some support from wealthier benefactors, Iran could see a significant deterioration in conditions this year.

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The situation with the Islamic State in Syria (ISIS) will continue as a humanitarian disaster but is unlikely to expand beyond its current boundaries and could well be pushed back. While ISIS claims allegiance from groups in Egypt and Saudi Arabia, the movement itself does not have the breadth or capacity to claim and occupy targets of strategic importance, much less develop a power base while facing multinational forces. The group will, however, create a perceived risk premium throughout most of MENA until it is finally contained.

Sub-Saharan Africa – Still Riding the Wave

For the most part, Sub-Saharan African (SSA) countries continue to log impressive growth. A series of economic rebases to correct the undercounting of the services sector boosted reported growth in a number of countries, including Nigeria, Zambia and Kenya. The trend should continue this year as other countries follow suit.

SSA countries made little progress toward fiscal consolidation in 2014. This is especially true of Ghana and Zambia, both of which will require International Monetary Fund support this year. In spite of their ability to tap the international market for funding, borrowing costs are already on the rise and should continue to increase as the United States moves to normalize interest rates. Falling commodity prices and the specter of credit agency downgrades will also force spending cuts.

The continent's two largest economies face a number of political challenges this year. In South Africa, wage negotiations with public-sector unions will take center stage and set the tone for private-sector contracts amidst increasingly militant and intractable wage disputes. In Nigeria, elections in the first quarter could see the ruling party lose power for the first time since the return to democracy in 1999.

Canada – Continued Growth Despite Lower Oil Prices

The Canadian economy is entering the new year on sound footing and will gradually strengthen in 2015 despite lower oil prices. While Canada is a top-five energy producer, the nation's diversified economic and export base means that falling oil prices will not substantially impair growth this year. Rising export demand (due to U.S. growth and a weaker Canadian dollar); strengthening investment in non-energy industries; and higher consumer spending as gasoline costs fall will largely offset declining energy investment.

The diversity of the Canadian economy should limit the damage from lower oil prices.

Oil-sector weakness will be felt hardest in western provinces where drilling has boomed. Employment and provincial finances are at risk of deterioration in these regions, and the hot property markets in these areas will likely cool as worries of layoffs increase. Overall, however, the labor market should continue to gradually improve, albeit at a slower pace than the U.S.. Consequentially, we expect the Bank of Canada will keep the overnight policy rate on hold at 1.0% until the fourth quarter, slightly lagging the Fed's first hike.

General elections scheduled for October will test conservative Prime Minister Stephen Harper's hold on parliament. The economy has performed well, and government finances have improved under his leadership. But corruption scandals have dented enthusiasm for his party, and young voters may yet rally around Liberal Member of Parliament Justin Trudeau.

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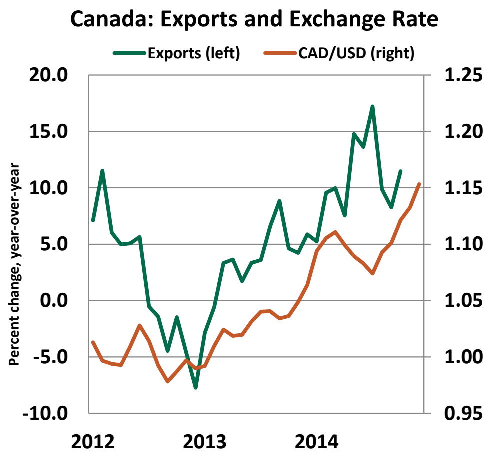

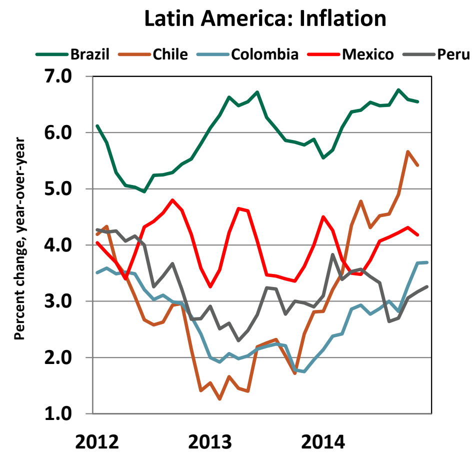

Source: Haver Analytics

Latin America – End of Commodity Boom to Test Diverging Economies

Commodity-rich Latin American economies have boomed over the past decade as the price of raw materials surged. Combined with the normalization of U.S. monetary policy, the reversal of this commodity trend will test resiliency across the region. Peru and Colombia will lead the growth charge. The Colombian government's infrastructure program will help offset lower oil prices, and we are cautiously optimistic that a peace accord will be reached with Revolutionary Armed Forces of Colombia, or FARC, insurgents. Similarly, fiscal strength and lower inflation in Peru give policymakers tools to support growth and ride out potential market turbulence as mining exports decline.

The drop in commodity prices will complicate fiscal affairs in Latin America.

Growth will also come in Mexico and Chile, but political intrigue limits the upside. Mexican manufacturing exports will enjoy a boost from the strengthening U.S. economy. But July legislative elections loom, compounding the importance of the first round of oil-field auctions to be finalized the same month. A renewed bout of emerging market risk-aversion, further drops in oil prices or rule of law concerns at mid-year could threaten both economic growth and President Peña Nieto's legacy in office. Similarly, President Michelle Bachelet of Chile will be challenged to implement her reform agenda amid a slowdown in the nation's massive copper-mining industry, but the nation's solid fundamentals limit downside risks.

Brazil will suffer another year of tepid growth, as sliding commodity prices, high inflation, fiscal austerity and the growing Petrobras corruption scandal will weaken the Brazilian real and act as headwinds to the economy in 2015. New Finance Minister Joaquim Levy will hope his economic adjustments restore investor confidence soon, but it may take more than a year. If investors' emerging-market jitters compound to a crisis, Brazil will be in deeper trouble.

Mired in recession ahead of October elections, both Argentina and Venezuela will struggle in 2015. Oil's plunge is a game-changer for Venezuela, which may face major economic and political disorder.

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Global Economic Forecast – January 2015

	2012	2013	2014F	2015F
United States				
Real GDP (% change)	2.3	2.2	2.4	3.2
Unemployment Rate (%)	8.1	7.4	6.2	5.6
Inflation (%)	2.1	1.5	1.6	0.7
Policy Rate, EOP (%)	0.15	0.15	0.15	0.50
Eurozone				
Real GDP (% change)	-0.6	-0.4	0.8	1.2
Unemployment Rate (%)	11.3	12.0	11.6	11.4
Inflation (%)	2.5	1.4	0.5	0.6
Policy Rate, EOP (%)	0.75	0.25	0.05	0.05
United Kingdom				
Real GDP (% change)	0.7	1.7	3.0	2.6
Unemployment Rate (%)	7.9	7.5	6.1	5.5
Inflation (%)	2.8	2.6	1.5	1.2
Policy Rate, EOP (%)	0.50	0.50	0.50	0.75
Japan				
Real GDP (% change)	1.4	1.5	0.1	0.9
Unemployment Rate (%)	4.3	4.0	3.6	3.6
Inflation (%)	0.0	0.4	2.8	1.4
Policy Rate, EOP (%)	0.10	0.10	0.10	0.10
China				
Real GDP (% change)	7.7	7.7	7.3	6.7
Unemployment Rate (%)	4.1	4.1	4.1	4.1
Inflation (%)	2.6	2.6	2.0	1.8
Policy Rate, EOP (%)	3.00	3.00	2.75	2.25

Exchange rates (EOP)	Dec-2014	Mar-2015F	Jun-2015F	Sep-2015F
EUR/USD	1.21	1.19	1.16	1.16
GBP/USD	1.56	1.55	1.52	1.57
USD/JPY	119.7	122	124	125
USD/CNY	6.20	6.23	6.26	6.29

F: Forecast

EOP: End of period

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