GLOBAL ECONOMIC OUTLOOK

July 2014

UNITED STATES

The U.S. economy stumbled in the first quarter, largely due to bad weather, and inventory adjustment and weak exports also played a role. A solid rebound in economic growth is predicted for the rest of the year. But the weakness of the first quarter will trim the annual average growth for 2014 to only 1.5%. Developments in the labor market will continue to drive the course of monetary policy. The Federal Reserve views the large percentage of long-term unemployment and elevated part-time employment as pockets of unused capacity that have held back wage growth. The subdued trend of wages is, in turn, seen holding back aggregate demand. Until there is an acceleration of wage growth, the Fed will maintain the current low interest rate policy stance after winding down the asset purchase program by October 2014. There are constructive forces in place in the U.S economy to support expectations of a stronger dollar in the next 12 months. The housing sector is a source of domestic risk that the Fed is watching closely, while the Eurozone's sluggish performance and China's financial sector risks remain potential headwinds.

EUROZONE

Moderate global economic growth is predicted for the second half of 2014, with geopolitical challenges raising the level of uncertainty.

The Eurozone remains in recovery mode, but the 1.0% real gross domestic product (GDP) growth expected this year masks considerable differences. France and Italy remain weak (0.5% and 0.2% growth, respectively) while Germany will see expansion of close to 2.0%. Unemployment across the Eurozone will remain in double digits through 2015, but Germany's jobless rate will remain below 7.0%. Very low inflation will continue to raise the real value of debt, which will add to the challenges of Europe's highly indebted countries. Eurozone banks are focused on boosting their capital accounts, with the results of the first Asset Quality Review and stress test by the European Central Bank (ECB) due at the end of the third quarter.

In June, the ECB acted to try to stave off deflation, boost lending and unofficially weaken the euro. It cut the policy and deposit rates to 0.15% and -0.10%, respectively. It also announced a targeted longer-term refinancing operation to encourage bank lending. These steps should boost credit provision into the real economy heading into 2015, but it is unclear by how much. The ECB will likely "watch and evaluate" through the end of 2014, adding quantitative easing (QE) only if the Eurozone economy shows signs of significant new deterioration. So far, sovereign bond yields – including previously "stressed" sovereigns – have shown the clearest impact, hitting record lows in several countries in recent weeks. It seems that only a very marked economic or political deterioration could trigger an adverse shift in investor sentiment.

More broad-based economic sanctions triggering a deeper, longer-lasting Russian recession than our base case (real GDP down 1.0% in 2014 with a subdued recovery in 2015) would have a negative impact on Eurozone firms heavily exposed to trade with Russia. But the EU as a whole sends only 2.5% of annual exports to Russia – not enough to seriously derail its own recovery. A disruption in energy supplies from Russia would not have a significant impact unless the problem continued into the winter months.

UNITED KINGDOM

The U.K.'s recovery continues to deepen and broaden, with real GDP growth likely to reach 3.0% this year. Inflation continues to abate and should be just below 2.0% by the end of the year. The Bank of England (BoE) has started to sound more hawkish in recent weeks, hinting that a policy tightening could come before the end of the year. Nevertheless, the pace of tightening is likely to remain gradual through 2015. The United Kingdom is less likely than the Eurozone to experience adverse effects from a disruption in trade flows with Russia. Real GDP growth would likely be only marginally weaker and inflation slightly higher in such a scenario.

Signs that the housing market recovery has spread outward from London have raised concern that another housing bubble could be in the making. The BoE's Financial Policy Committee has toughened affordability tests and will look into other options to take the froth out of the market.

JAPAN

The Japanese economy will likely contract in the second quarter. Domestic demand is likely to falter in response to the Value-Added Tax (VAT) increase that took effect at the beginning of April. However, contrary to previous estimates, the economy is expected to record moderate growth in the first half of the year, assisted by very strong expansion in the first quarter. The second half of the year will see a pickup in economic activity as the initial shock of the tax increase wanes. Private consumption is vital to the recovery as the government focuses on fiscal consolidation and export growth continues to disappoint. Real GDP is forecast to expand 1.5% in 2014 as fiscal stimulus offsets weaker consumer spending due to the consumption tax hike.

The Bank of Japan (BoJ) will likely maintain the current 0.1% target policy rate while signaling its commitment to QE beyond 2014. Better-than-expected economic resilience to the VAT hike lessens the possibility of an expansion of the asset purchasing program this year. The BoJ is expected to reach its 2.0% inflation goal this year as the consumption tax increase push prices up by 2.5%; however, price increases are likely to fall out of range next year. Nevertheless, the BoJ likely will be pleased with its progress in defeating deflation, as it has already come close to proclaiming, "Mission accomplished." Meanwhile, the yen is expected to continue weakening moderately to 104/USD by the end of 2014. The economy will hover around full employment, with the unemployment rate at a benign 3.7%.

CHINA

A series of one-off economic boosts – front-loading of government spending projects and a 2.1% depreciation of the yuan, to name but a couple – brought GDP growth up to 7.5% year-over-year, in line with the government's target for 2014 as a whole. The official line from Beijing is that more attention should be paid to job creation; in fact, 7.4 million jobs were created in the first half of the year versus a target of 10 million for

2014 as a whole. These figures are being played up more than GDP, which is not surprising since the headline year-over-year figure is likely to take a marked base-effect fall in the coming quarters.

A government keen on shoring up confidence also is touting price stability. Inflation closed the second quarter at 2.3% on the year and looks to remain calm as the year progresses because weak demand and particularly strong monthly figures during the second quarter of 2013 distorted the headline figure. While stability at the consumer price level will be an important factor for the People's Bank to consider if it discusses lowering interest rates, it is more indicative of economic weakness. The yuan is being slowly used to settle international trade activity, but speculative and periodic volatility make the exchange rate for any given period very difficult to predict. The currency's depreciation in the second quarter this year assisted export growth and propped up GDP, but this competitiveness would be difficult to sustain throughout the balance of 2014.

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Global Economic Forecast – July 2014

	2012	2013	2014F	2015F
United States				
Real GDP (% change)	2.8	1.9	1.5	3.2
Unemployment Rate (%)	8.1	7.4	6.3	5.8
Inflation (%)	2.1	1.5	2.0	2.0
Policy Rate, EOP (%)	0.15	0.15	0.15	0.50
Eurozone				
Real GDP (% change)	-0.6	-0.4	1.0	1.5
Unemployment Rate (%)	11.3	12.0	11.7	11.3
Inflation (%)	2.5	1.4	0.7	1.3
Policy Rate, EOP (%)	0.75	0.25	0.15	0.15
United Kingdom				
Real GDP (% change)	0.3	1.7	3.0	2.8
Unemployment Rate (%)	7.9	7.5	6.3	6.0
Inflation (%)	2.8	2.6	1.5	2.0
Policy Rate, EOP (%)	0.50	0.50	0.50	1.25
Japan				
Real GDP (% change)	1.4	1.5	1.5	1.4
Unemployment Rate (%)	4.3	4.0	3.7	3.6
Inflation (%)	0.0	0.4	2.5	1.7
Policy Rate, EOP (%)	0.10	0.10	0.10	0.10
China				
Real GDP (% change)	7.7	7.7	7.3	7.1
Unemployment Rate (%)	4.1	4.1	4.1	4.1
Inflation (%)	2.6	2.6	2.5	2.3
Policy Rate, EOP (%)	3.5	3.5	3.5	3.5

Exchange rates (EOP)	Jun-2014	Sep-2014F	Dec-2014F	Mar-2015F
EUR/USD	1.37	1.33	1.31	1.29
GBP/USD	1.71	1.68	1.66	1.65
USD/JPY	101.3	103.0	104.0	105.0
USD/CNY	6.20	6.19	6.17	6.17

F: Forecast
EOP: End of period