GLOBAL ECONOMIC OUTLOOK

October 2014

Our latest discussion around the global outlook occurred during a period of significant market volatility. Nonetheless, we focused our discussions on fundamental trends that are driving economic achievement.

What emerged was something of a bifurcation. The United States and the United Kingdom are doing well, while China moderates and the eurozone struggles. Perhaps this unevenness has something to do with the renewal of investor concern. Apart from this, geopolitical challenges in the Middle East and the continued Russia-Ukraine standoff have raised the level of uncertainty a few notches compared with the situation three months ago.

UNITED STATES

Strong job growth, an improved fiscal situation and an accommodative monetary policy support expectations of slightly above-trend growth in the United States during the next few quarters. Nonetheless, we continue to hold that the first increase in the Federal Reserve's policy rates remains almost a year into the future. Labor market slack and disinflationary pressures create some distance between current conditions and the Fed's goals of full employment and 2.0% inflation.

The recent strength of the dollar is not expected to have a substantial impact on growth, while lower oil prices should be a boost for consumers. (It is worth noting, however, that the net impact of falling energy prices for the United States has decreased as U.S. energy production has increased.) Government will remain divided after upcoming mid-term elections, so no significant changes to fiscal policy are anticipated.

The unevenness of current performance is a source of concern.

EUROZONE

The outlook for the eurozone has weakened in recent months, thanks to a combination of factors. The lack of reform in the second- and third-largest economies (France and Italy) is dampening overall growth and also keeping unemployment in those countries stubbornly high. Output from the German export machine is slipping as demand softens from the rest of Europe and China and as Russian trade sanctions influence sentiment negatively. A marked level of disinflation in recent months raises the risk of outright deflation, although for now that risk appears to be confined only to those peripheral countries such as Greece that are undergoing an internal devaluation.

Meanwhile, markets are beginning to fear that the European Central Bank (ECB) is running out of options to stimulate the eurozone economy. Interest rates have reached their lowest effective level, and staunch resistance from Germany will likely stymie attempts to unleash full-blown quantitative easing (QE). The ECB has thrown the ball back into the court of national governments, effectively urging fiscal reform in some nations and stimulus in Germany. But France has thrown down the gauntlet with yet another budget that avoids the kind of structural reforms that would boost its competitiveness, and Berlin insists that German fiscal stimulus measures would do nothing to stoke demand in other countries.

All told, it appears that real gross domestic product (GDP) growth for the eurozone as a whole will reach only 0.7% this year and perhaps 1.3% in 2015, with inflation still well below the ECB's near-2.0% target. Risks to the outlook are firmly to the downside. Renewed market anxiety about fiscal sustainability could boost sovereign yields anew in the peripheral countries; Greek domestic political challenges could trigger another round of debt default fears in that country; and geopolitical challenges will continue to weigh on sentiment.

UNITED KINGDOM

The U.K. economy has seen a firm recovery this year, with real GDP growth likely to come in just over 3.0% and the unemployment rate falling steadily. Inflation remains well under control and may end the year at no more than 1.4%. Weaker demand from the eurozone will weigh on the outlook for 2015 but will be countered somewhat by improving demand from the United States. Although the Bank of England's Monetary Policy Committee had seemed ready to start tightening in early 2015, market jitters and weaker inflation pressures will likely delay that event. The first rate hike is now penciled in for the second quarter of next year.

Central banks around the world are expected to remain very accommodating.

Political debate will start to dominate the headlines in the coming months, with the next general election due in May 2015 and the populist U.K. Independence Party garnering attention for its antipathy toward the European Union (EU). Prime Minister David Cameron will campaign on his pledge to hold a referendum on EU membership if the Conservative Party is returned to government. While his party is behind in the opinion polls for now, the outcome of the election remains uncertain – the tighter the race becomes, the more markets may feel uneasy about the medium-term outlook.

JAPAN

The Japanese economy remains sluggish as the effects of the April tax increase lingered longer than expected. Japan's GDP growth for the first half of the year was essentially flat; however, the economy should experience moderate expansion during the second half of the year. A pick-up in private consumption remains vital to the recovery as soft global demand constrains exports volumes. A decision by Prime Minister Shinzo Abe to implement the second phase of the tax increase next spring would be a drag on household demand. To compensate, this step could be accompanied by another, possibly larger, round of fiscal spending to offset the negative impact. All told, real GDP is forecast to expand 0.9% in 2014 and 1.0% in 2015.

The Bank of Japan (BOJ) has signaled its willingness to respond with additional stimulus if necessary to keep the recovery afloat, but thus far the bank has held its fire as it maintains a relatively optimistic economic outlook. The baseline outlook is for the BOJ to maintain its 0.1% target policy rate and maintain its commitment to the QE program as outlined last year. However, if third quarter data comes in weaker than expected, it could be enough to persuade the BOJ to increase its massive QE program. At 2.8% in 2014, prices will exceed the 2.0% targeted by the BOJ this year but should fall to 1.3% by the end of next year.

CHINA

Finding the middle ground between too much and too little credit is a global challenge.

The past three months have brought a series of disappointing indicators from China and increased concerns about the stability of its financial sector, particularly at the regional and provincial level. The stimulus from one-off budgetary adjustments and fiscal front-loading has largely faded, and economic performance is easing. The government has not changed its official GDP target of 7.5% for 2014 as a whole, and it is downplaying the increasing number of softening indicators. The government's increasing utilization of a variety of lending facilities to inject liquidity into the markets through various banks is also drawing attention. An initial 500 billion yuan were placed with the top five banks in September to support quarter-end liquidity. Now, with another 200 billion to 300 billion yuan facility being suggested for China's provincial banks, some are wondering whether this might be a quiet form of support for troubled institutions.

Price pressures are not an issue right now; rather, weakening demand and the recent slide in commodity prices suggest inflation could stay below 2.0%. The government is skeptical about cutting rates at a time when excessive credit extension is a concern, but it also recognizes that a rate hike could force a sharp economic slowdown. The strengthening yuan is also factoring into low inflation, but further appreciation would reduce export competitiveness at a time when the export sector is needed to support growth. The currency will face resistance as the end of 2014 approaches, with exporters demanding a softer currency to shore up sales in the last months of the year. While the currency is still perceived as undervalued, domestic pressures could put a lid on its potential to rise.

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Global Economic Forecast – October 2014

	2012	2013	2014F	2015F
United States				
Real GDP (% change)	2.3	2.2	2.2	3.2
Unemployment Rate (%)	8.1	7.4	6.2	5.6
Inflation (%)	2.1	1.5	1.8	1.8
Policy Rate, EOP (%)	0.15	0.15	0.15	0.50
Eurozone				
Real GDP (% change)	-0.6	-0.4	0.7	1.3
Unemployment Rate (%)	11.3	12.0	11.6	11.1
Inflation (%)	2.5	1.4	0.5	1.0
Policy Rate, EOP (%)	0.75	0.25	0.05	0.05
United Kingdom				
Real GDP (% change)	0.7	1.7	3.1	2.8
Unemployment Rate (%)	7.9	7.5	6.0	5.5
Inflation (%)	2.8	2.6	1.4	1.8
Policy Rate, EOP (%)	0.50	0.50	0.50	1.00
Japan				
Real GDP (% change)	1.4	1.5	0.9	1.0
Unemployment Rate (%)	4.3	4.0	3.5	3.4
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	7.0
Unemployment Rate (%)	4.1	4.1	4.1	4.1
Inflation (%)	2.6	2.6	2.0	2.5
Policy Rate, EOP (%)	3.00	3.00	3.00	2.75

Exchange rates (EOP)	Sep-2014	Dec-2014F	Mar-2015F	Jun-2015F
EUR/USD	1.26	1.28	1.24	1.20
GBP/USD	1.62	1.62	1.63	1.60
USD/JPY	109.7	108.0	109.0	111.0
USD/CNY	6.15	6.12	6.12	6.12

F: Forecast
EOP: End of period

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