Northern Trust

# GLOBAL ECONOMIC OUTLOOK FOR 2014

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Here in Chicago, we've just survived what was called a "Polar Vortex." Shifts in prevailing winds brought northerly temperatures down upon us and chilled just about everyone and everything. When the mercury finally rose back above zero (Fahrenheit), it felt like a heat wave.

As we thawed out and got back to our business, it appeared that an economic warming trend was at hand for several key world markets. We've been at this point several times in the last three years, only to have the flames flicker. On this occasion, though, the risk case could be too much heat.

Once again, we have pooled our thoughts with those of our colleagues from the Country Risk Unit for a whirlwind economic tour around the world. First, though, here are some broad themes that bear watching across jurisdictions:

- **Financial Reform.** While the United States continues to refine its re-regulation, Europe and China are dealing with more elemental banking issues. Creating transparency around institutions and strengthening capital and confidence will be important goals for 2014.
- **Politics and Economics.** The lingering economic malaise has produced a considerable degree of discontent. How this is expressed at the ballot box and on the floor of legislatures could have quite a bearing on market performance.
- **Central Bank Coordination.** The Federal Reserve and the Bank of England (BoE) are moving toward a reversal of the extreme stimulus offered after the financial crisis. This may fit local economic circumstances, but may be detrimental to markets still struggling to recover.

Following are specific thoughts on how major markets are expected to fare.

## United States – Transition to Higher Growth

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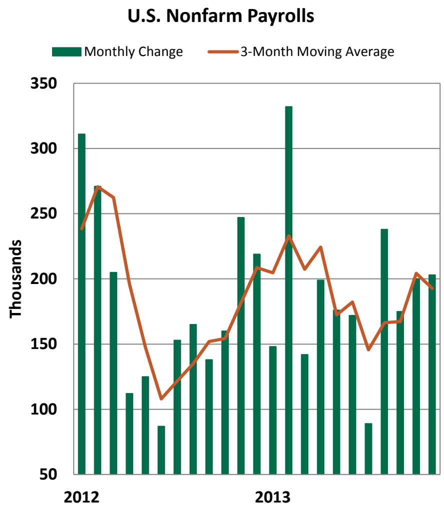
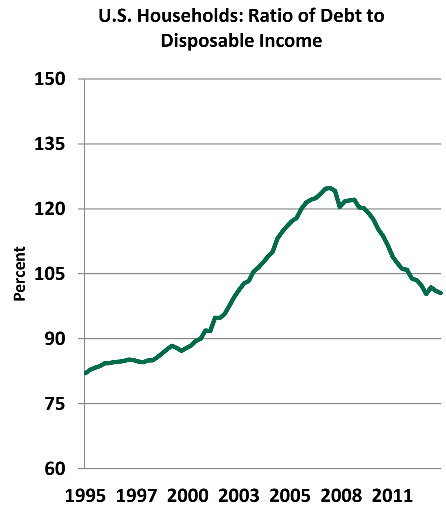
Are the requirements in place for a pickup in economic growth during 2014? We think so. Stronger consumption, reduced drag from fiscal policy, better business investment, and very accommodative monetary policy provide considerable cause for optimism.

For perspective, the economy is on track to record a 2.7% gain in real gross domestic product (GDP) on a Q4-to-Q4 basis in 2013. The unemployment rate touched 7.0% in November, down from 7.8% at the end of 2012. Inflation is well below the Fed's 2% target; equity prices posted record-high readings to lift the net worth of households.

Factors that determine consumer spending, the largest component of U.S. GDP, are in favorable position. Real disposable income grew 1.8% from a year ago in the third quarter of 2013, a meaningful turnaround following the slowing trend related to the expiration of payroll taxes in the early part of 2013. The pace of hiring picked up in the last three months after a temporary deceleration in the middle of the year. U.S. household debt as a percentage of GDP, at nearly 78%, is the lowest in 10 years.




*Sources: BLS, BEA, FRB, Haver Analytics*

Forward momentum is predicted for sales and construction of homes in 2014. However, a moderation of home price increases should not be surprising in 2014, given the near certainty of higher mortgage rates.

Business spending has been surprisingly modest in the first three quarters of 2013. Incoming data point to a pickup in business equipment outlays in the final months of the year. The latest CEO surveys of capital spending plans are stronger than readings at this time last year, thus raising expectations of improved performance in 2014.

Export growth of the United States has shown surprising strength in the last few months, and the current share of exports as a percentage of GDP is larger than what prevailed before the financial crisis. Interestingly, although U.S. economic performance stands out among the G7 countries, imports as a share of GDP remain below the readings posted prior to the onset of the Great Recession. (Reduced oil imports account for much of this.) If these trends persist, the trade deficit could be less of a drag on GDP growth.

**Government spending is expected to add to U.S. GDP growth for the first time since 2010.**

The sequester-related decline in federal government spending was a significant setback to GDP growth in 2013. The reduction in government spending should be noticeably smaller this year, which augurs positively for headline growth. Also, state and local government spending is expected to move up after an extended period of contraction in the post-crisis period. Overall, government spending is projected to add to GDP in 2014, the first such occurrence since 2010.

These details suggest an optimistic forecast for 2014, with U.S. real growth expected to be around 3.2%. Inflation was subdued in 2013; stronger business momentum in 2014 should propel inflation readings closer to the Fed's 2% target.

The U.S. unemployment rate has declined noticeably, partly due to new hiring and partly stemming from a drop in the participation rate. The unemployment rate is projected to decline to 6.6% at the end of the year, just short of the Fed's threshold of 6.5% for considering a rise in short-term interest rates. We expect the Fed's purchases of assets to wind down completely in the second half of the year, a major transition for global markets.

## Europe – Fragmentation Endures

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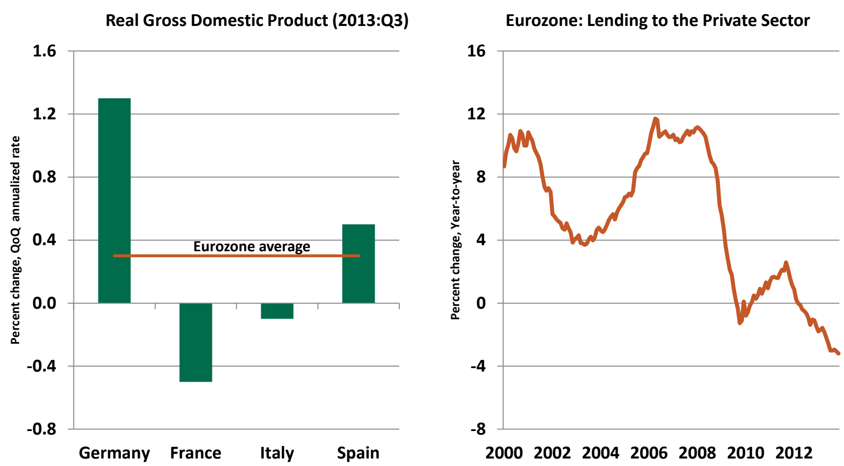
The eurozone's economic outlook is slowly improving with even the likes of Greece showing signs that the worst is over. However, Europe's economic fundamentals are fragile, with deep divisions in performance among nations.

Germany, which accounts for about 28% of eurozone GDP, is looking at real growth of around 1.8% this year. However, the next three largest economies – which together account for about 55% of eurozone GDP – tell a different story. Growth in France and Italy will barely reach 0.5% this year, and Spain will likely be flat. Overall, real GDP growth of the eurozone should come in at around 1.0% this year.




*Source: Haver Analytics*

The European Central Bank (ECB) surprised the markets by cutting its policy rate to 0.25% in November. Since then, Governing Council members have repeatedly said that "all options" are on the table, but they seem limited in what they can do to boost lending and to stimulate the eurozone economy.

The eurozone-wide unemployment rate appears to have stabilized at 12.1% at the end of 2013, but Germany's jobless rate is just 5.2%, Italy's is 12.5%, and Spain's is an outsized 26.7%. Dispersion like this is seen in many other metrics, leading to the broad characterization that Europe is "fragmented." Meanwhile, with the year-over-year change in the eurozone Consumer Price Index at just 0.7%, there is a risk that the ECB will need to take further action in 2014 to get the rate of inflation closer to the "just below 2%" target rate.

Significant headwinds remain: ongoing fiscal austerity in most countries (albeit at a slower pace); still-high unemployment rates; weak consumer finances; and very tight credit conditions, especially for small businesses. With the major banks focused on shoring up their capital positions for this year's Asset Quality Review (AQR) by the ECB, credit conditions will remain tight.

**European banking reform will be critical to improving the flow of credit.**

An initial agreement has been reached on creating a Single Resolution Mechanism (SRM) for the banking sector, and the principle of a shared resolution fund is in place. Recapitalization steps have been clarified for banks that come up short in this year's AQR and stress testing. However, Germany has succeeded in keeping national governments responsible for bank recapitalization costs not met via bail-ins, until the joint recap fund has reached its initial €55 billion target (likely to take a decade as levies are collected from banks). In other words, any problems thrown up by the stress tests later this year could once again affect sovereign funding costs.

On the political front, we continue to see the rise of Euro-skeptic protest parties across Europe, usually on the political right. Many of these may enjoy a surge in support in the May European Parliament elections, potentially causing headaches for governments back home as they struggle to convince voters of the value of austerity and reform.

Outside of the eurozone, the U.K. economic recovery is on a firmer footing. This year's real GDP growth looks set to come in around 2.4%. Inflation is finally easing, coming in at a four-year low of 2.1% in November; credit conditions are improving (to the extent that some fear policies designed to boost the housing market may have created a mini-boom); and key export markets are reviving. Although fiscal austerity will continue to weigh on domestic demand and sentiment this year, the unemployment rate has fallen to its lowest in four years.

All of this is changing expectations of when the BoE will shift its policy. The bank's forward guidance is that it does not intend to raise interest rates or unwind the quantitative easing (QE) program until the unemployment rate is down to 7%. With the rate falling to 7.4% in the three months to October, upward revisions to GDP growth in the first half of 2013, and inflation easing more rapidly than the bank initially expected, markets are starting to expect a rate hike by late 2014. However, the Monetary Policy Committee has emphasized that although the data suggest a "burgeoning" recovery, the economy still faces serious headwinds. We continue to see the BoE waiting until 2015 to move.

Nordic economies are set to gain momentum in 2014 on the back of slowly improving global growth while inflationary pressures remain muted, but headwinds from the cooling housing sector will threaten business momentum in Norway.

Growth in Finland will likely return to positive territory after nearly two years of recession, while a stabilizing housing sector should help the Danish economy get into a higher gear.

Sweden's Riksbank ended 2013 by cutting its policy rate to 0.75% and lowering its rate path projection, citing a more moderate inflation outlook. Although the domestic labor market remains resilient, and corporate and consumer sentiment are improving, the central bank is still fretting that high household debt levels will need to be addressed by other policy measures. Although real GDP growth in Sweden is likely to reach 2.0% this year, the Riksbank's rate path implies a small chance of another rate cut in 2014 and no hikes until early 2015. The Financial Supervisory Authority may further tighten rules for borrowers and lenders in a bid to curb household indebtedness.

In Norway, the pace of economic growth slowed significantly in the second half of 2013, especially household consumption. The trend will carry into the beginning of 2014, if falling real estate prices lead to consumer caution and a more permanent shift in saving behavior. GDP growth could slow to 1.0% compared to an estimated 1.8% growth in 2013, and the Norges Bank may cut rates before mid-year.

## China: The New Regime Seeks to Make Its Mark

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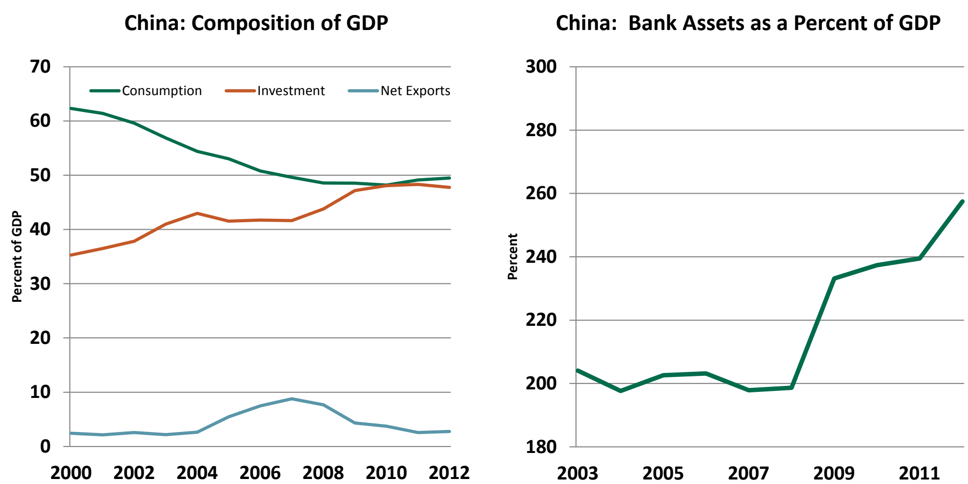
After a year filled with nervous nights, China enters 2014 facing high expectations from its own people and growing concerns from the outside world. Now that Beijing's once-a-decade leadership change is out of the way and the Communist Party Third Plenum has set the tempo for the tenure of President Xi Jinping and Premier Li Keqiang, expectations are now for tangible results.

The slogans are firmly established: the days of double-digit GDP growth are over and 7% – 8% will be the status quo, market forces will have a greater role in the allocation of capital, and progress will shift from export-driven to consumption-driven. These broad points offer a foundation for moving forward with the many changes proposed at the Third Plenum, though the actual pace and implementation of reform will ultimately rely on political will.

To that point, several levers of power over reform are being moved to the executive branch, giving President Xi greater command over the pace and process of change. This centralization of power is unusual in that typically it is the premier who carries out the more arduous labors of the state – such was very much the case with previous premiers Wen Jiabao and Zhu Rongji. Xi's heightened control gives this next year the potential to witness dramatic change.




*Source: Haver Analytics*

Our concerns for this year, however, are notable. At this time last year we discussed a laundry list of reservations about the financial sector that has only grown. While financial-sector reforms such as depositor insurance and forcing banks to carry more responsibility for credit risk were offered, local media has stepped around the real estate bubble and related bank exposures. After June interbank market turbulence raised concerns about just how much strain banks could withstand, financial news fell ominously quiet.

The issues behind all these concerns – the creditworthiness of loan portfolios, profitability of underlying assets, ability to offer returns in a slowing economy – remain difficult to assess through official channels. We do not believe that any of these problems have been resolved, and their specters will loom over China's 2014 outlook.

## Middle East: As Change Unwinds Reforms, Risks Rise

While political transformation has occurred to varying degrees throughout the Middle East, the main axis of concern is anchored by Egypt and Syria. In the former, the ouster of President Morsi last July set off six months of reversing past reforms and reverting to the pre-Arab Spring political environment. This has come with social instability, a heavy response by the military, and a clear message from the interim leadership that Morsi's Muslim Brotherhood backers would no longer be welcome in the halls of government. The final changes will be initiated in 2014, when the country adopts a new constitution and holds legislative and presidential elections.

While this may instill some order within the Arab world's most populous country, it is worth noting that the interim government has done nothing to remedy the problems that led to the 2011 Arab Spring uprisings in Cairo. The main socioeconomic imbalances – youth unemployment, widespread poverty, income inequality – remain entrenched within Egypt's urban heartland, and the government has limited resources to counter these sources of discontent. A new administration t and a fresh outlook will do something to restore local confidence, but unless it is met with structural reforms, 2014 could merely be a break between periods of deep unrest.

**Instability in the Middle East casts a shadow over the global outlook.**

Syria marks the other end of the spectrum – growing instability and the continuing threat of drawing other powers into a terrible civil war. Lebanon and Iran have become involved, but so far major powers have kept from direct engagement. While we believe that this conflict will not spill outside Syrian borders, our greater concern is that the ongoing hostilities will cast a shadow throughout the region and add an element of uncertainty to other unresolved matters – resuming talks in Israel, Iran's enrichment program, unrest in the Saudi Peninsula. This civil war has already become a humanitarian disaster, and shows no signs of abating in the near-term.

In Turkey, the focus will turn to politics as local elections in March will determine the fate of embattled, yet defiant, Prime Minister Recep Tayyip Erdogan. If Erdogan can deliver a convincing victory, he will likely be the party's presidential candidate in elections (the first for the post) due in July. However, anything less will open the door to party infighting and the possibility that President Abdullah Gul becomes the AKP candidate, effectively ending Erdogan's political career. Recent corruption allegations spurred by a rift in the alliance between Gulenists and the government, continued crackdowns on protestors, and references to a shadowy interest-rate lobby have succeeded in the taking some of the patina off the Turkish miracle and highlighted deep structural and governance issues.

## Japan – Where is the Third Arrow?

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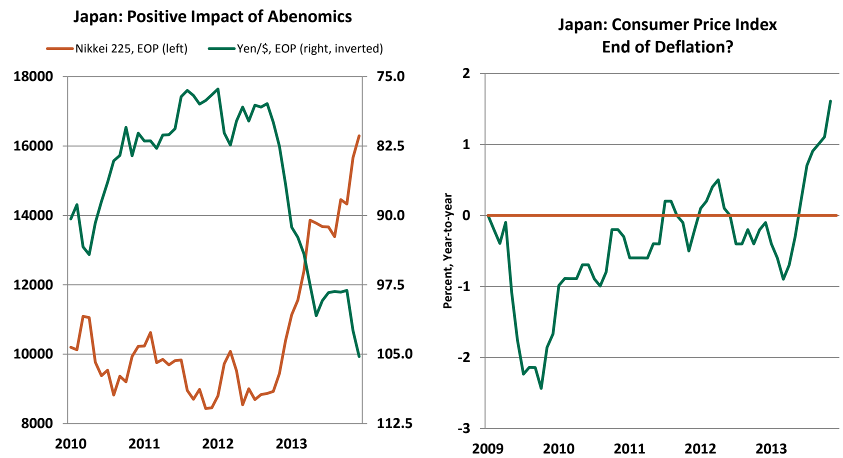
By any measure, 2013 was a whirlwind year for Japan and Prime Minister Shinzo Abe as both attempted to become "comeback kids." The Nikkei 225 surged more than 50%, while the government was successful in pushing the yen down nearly 20% year-over-year. The turnaround is premised on what has become known as Abenomics – a three-arrowed (monetary, fiscal and structural) amalgamation of policies aimed at achieving an average 3% nominal and 2% real GDP growth over the next 10 years.




*Source: Haver Analytics*

Monetarily, the Bank of Japan's quantitative easing was bold to say the least; and the government's decision to implement a consumption tax increase from 5% to 8% is a step in the right direction on the fiscal front. However, the fate of the project lies in the government's ability to implement structural reforms.

Thus far, the ruling Liberal Democratic Party has outlined a broad range of reforms –most set to culminate when Tokyo hosts the 2020 Summer Olympics – yet very few have actually been implemented. Membership in the Trans Pacific Partnership, and the agriculture liberalization it requires, would be a tangible step in the right direction. But the government also needs to address other matters, including rigid employment regulations, female labor-force participation and the rapid aging of the population.

Key themes to watch economically include the impact of the consumption tax increase in April and the ability of fiscal stimulus to offset the decline in consumer demand and keep the recovery on track. In addition, wage negotiations in the spring should give some insight as to whether PM Abe has been successful in convincing companies to raise wages – a prerequisite to spurring growth and ending the deflationary cycle.

On the trade front, economic forecasts will be negatively affected if a recovery in exports driven by an uptick in global demand fails to take hold. Conversely, the trade account would benefit from the resumption of nuclear power generation and the corresponding decrease in hydrocarbon imports.

Politically, the issue of the disputed Senkaku/Daioyu islands will remain an impediment to the normalization of relations with China. While the situation is not likely to boil over into full blown conflict, the risks of a miscalculation have increased with China's decision to extend its Air Defence Zone over the islands. Abe's visit to the contentious Yasukuni shrine also ensured that relations with South Korea would be frosty for the foreseeable future.

## Emerging Asia – Growth Is Important, but Politics Will Be the Story

Emerging Asian economies should perform well in 2014 as an expected recovery in global demand and Chinese economic stability lead to increased demands for exports which will buoy growth. This is especially the case in South Korea, as the economy looks to break out of a recent rut and surge toward 4% growth. The recent darling of the region, the Philippines, will expand by nearly 7% despite the impact of Typhoon Haiyan. However, politics and elections – both planned and unplanned – will rule the year.

**Sustained growth and sustained peace between Asia's giants will be critical for the region's performance.**

In Thailand, the recent political unrest appears set to continue in spite of February elections due to an opposition boycott. The crisis has the potential to cause havoc and bring the military out of its barracks, in addition to the impact of lost economic output. Indonesian elections are expected to pass with minimal disruption; however, with no clear frontrunner, the contest is shaping up to become a battle between the old guard and reformists. The Korean Peninsula is a perennial hotspot, and a resumption of bellicose rhetoric from North Korea is expected as annual military exercises between the United States and South Korea draw near. A nuclear and/or ballistic missile test is likely.

## Australia – The Aussie Must Go Lower

Economic growth has not been a problem for Australia in more than 20 years, but the country is in danger of falling into a pattern of sub-trend growth, especially as non-mining investment fails to take up the slack as mining capital expenditure falls. In addition, overall global economic conditions and the feeling of decline at home continue to negatively affect consumer demand, and retail sales and the unemployment rate is expected to creep up as job creation fails to keep pace with population growth.

The Reserve Bank of Australia (RBA) has attempted to spur the non-mining economy by pursuing an aggressive easing cycle and reducing rates to a historic low of 2.5%. However, while there were positive outcomes, including increased real estate demand, cuts have failed to produce sustained exchange-rate depreciation – the largest impediment to non-mining growth. Statements from the RBA appear to realize that the strength of the Aussie dollar is dependent on external factors, namely investor confidence in the orderly end of QE in the United States and proof of a sustained recovery in advanced economies. Ultimately, a return to the long-term range of A$0.75-0.85/USD would be ideal.

## Sub-Saharan Africa – Onward and Upward, But Consolidation Beckons

The majority of Sub-Saharan African countries will continue impressive growth, with International Monetary Fund estimating regional growth at 6% in 2014. The region continues to benefit from its relative insulation from the crisis in the eurozone due to its underdeveloped financial sector and commodity-driven exports. However, headwinds loom as the task of fiscal consolidation affects a number of countries, especially non-oil exporting countries. The region will also see borrowing costs rise as the winding down of QE in the United States proceeds.

South Africa's prospects will improve as the Eurozone recovers, but the economy will continue to be plagued by structural issues and industrial action. The ruling African National Congress is likely to collect less than the symbolically important 60% of the vote in national elections in the second quarter. In Nigeria, President Goodluck Jonathan is in danger of becoming a lame duck president as intra-party feuding may sideline him for elections due in 2015. Such an outcome would put the nascent reform process at risk.

### Canada – Progress on the Long Road to Becoming an Export Economy

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Despite an accelerating economy in the second half of the year, 2013 marked another year of mediocre growth due to the weak performance of the export sector. The shale oil production boom in the United States has driven down demand for Canadian crude, and politicians and producers alike are desperate to gain access to new international markets. In the absence of Keystone XL pipeline approval from the United States, Canada will continue to push ahead with alternative pipeline projects to the Pacific and Atlantic, as well as transport by train. This will highlight the political divide between business and environmental interests. Prime Minister Stephen Harper has been weakened by a series of scandals in his Conservative Party, while Liberal leader Justin Trudeau will attempt to reform and energize his party ahead of 2015 federal elections.

The economy will strengthen in 2014 despite slight cooling of housing market, with some risk of a sharper correction in Toronto and Vancouver. GDP growth will improve slightly to 2.3% in 2014, on the heels of the U.S. economy. The Bank of Canada will balance concerns over low inflation and a real estate bubble, keeping interest rates on hold at 1.0% throughout the year, and the Canadian dollar will weaken slightly versus the U.S. dollar. The weaker Loonie, along with firmer global demand, will boost the Canadian export sector.

### Latin America – Diverging Economic Fortunes as Key Elections Loom

Latin American economies will benefit from the smoother global economic panorama in 2014. China avoiding a hard landing means an extension of the commodity boom that favors the likes of Chile, Peru, Colombia and Mexico – all of which had somewhat sub-trend years in 2013. Meanwhile, Brazil will continue to struggle to shift out of first gear. Macroeconomic imbalances are set to deteriorate in Argentina and Venezuela as policymaking remains ad-hoc and unorthodox.

The spotlight will be on Brazil in 2014 as the nation hosts the World Cup in June andJuly before presidential elections in October. President Dilma Rousseff’s popularity has recovered since widespread protests in mid-2013, but her re-election is far from assured. Higher-than-desired inflation and lower-than-desired growth will characterize 2014, and the current administration will struggle to earn the confidence of foreign investors as large infrastructure and energy projects are auctioned off. Government spending will be expansive in order to support growth, but fiscal accounts will suffer and may lead to a downgrade from ratings agencies.

In Colombia, President Juan Manuel Santos has staked his May 2014 re-election bid on the success of peace talks with the FARC. While negotiations over the past year have been painfully slow, a deal will likely be reached by the end of this year, ending the Western Hemisphere’s longest standing insurgency.

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Mexico will be characterized by increased political divisions in 2014 as the economy improves. Last year we saw an unprecedented political cooperation in Mexico as members of right-leaning National Action Party (PAN) and the left-leaning Party for the Democratic Revolution (PRD) supported President Enrique Peña Nieto and his Pact for Mexico reform agenda, producing key legislation of education, telecommunications, tax and energy sectors. However, the energy reform was particularly divisive, and the alliance is broken entering the new year. Key secondary legislation is slated to be passed, and Peña Nieto will need to depend on support from PAN to give teeth to implementing last years' reforms, as opposition from PRD will stiffen. Meanwhile, GDP growth will improve to 3% on the back of U.S. exports and increased government expenditure.

## Global Economic Forecast – January 2014

| | 2012 | 2013F | 2014F | 2015F |
|---|---|---|---|---|
| **United States** | | | | |
| Real GDP (% change) | 2.8 | 1.9 | 3.2 | 3.4 |
| Unemployment Rate (%) | 8.1 | 7.4 | 6.8 | 6.3 |
| Inflation (%) | 2.1 | 1.5 | 1.6 | 2.2 |
| Policy Rate, EOP (%) | 0.25 | 0.25 | 0.25 | 0.50 |
| **Eurozone** | | | | |
| Real GDP (% change) | -0.5 | -0.4 | 1.0 | 1.5 |
| Unemployment Rate (%) | 11.4 | 12.2 | 12.0 | 10.8 |
| Inflation (%) | 2.5 | 1.2 | 1.4 | 1.5 |
| Policy Rate, EOP (%) | 0.75 | 0.25 | 0.20 | 1.00 |
| **United Kingdom** | | | | |
| Real GDP (% change) | 0.3 | 1.4 | 2.4 | 2.1 |
| Unemployment Rate (%) | 7.9 | 7.7 | 7.3 | 6.9 |
| Inflation (%) | 2.8 | 2.4 | 2.2 | 2.0 |
| Policy Rate, EOP (%) | 0.50 | 0.50 | 0.50 | 1.25 |
| **Japan** | | | | |
| Real GDP (% change) | 2.0 | 1.9 | 1.7 | 1.3 |
| Unemployment Rate (%) | 4.4 | 4.0 | 3.9 | 3.7 |
| Inflation (%) | 0.0 | 0.2 | 2.1 | 1.7 |
| Policy Rate, EOP (%) | 0.05 | 0.10 | 0.10 | 0.10 |
| **China** | | | | |
| Real GDP (% change) | 7.8 | 7.6 | 7.6 | 7.5 |
| Unemployment Rate (%) | 4.1 | 4.2 | 4.1 | 4.1 |
| Inflation (%) | 2.6 | 2.5 | 2.0 | 1.9 |
| Policy Rate, EOP (%) | 3.50 | 3.50 | 3.50 | 3.50 |

| Exchange rates (EOP) | Dec-2013 | Mar-2014F | Jun-2014F | Sep-2014F |
|---|---|---|---|---|
| EUR/USD | 1.37 | 1.33 | 1.31 | 1.28 |
| GBP/USD | 1.66 | 1.64 | 1.63 | 1.60 |
| USD/JPY | 105.3 | 104.0 | 106.0 | 108.0 |
| USD/CNY | 6.05 | 6.01 | 6.00 | 5.97 |

*F: Forecast*

*EOP: End of period*