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MARKETS 2015

Global outlook: Rates, recession and recovery

By Kira Nickerson, BNY Mellon IM EMEA

The US Federal Reserve (Fed) is likely to raise rates by September, according to economists at Boston-based Standish.[1] The group's chief investment officer, David Leduc, says US growth will continue for the remainder of 2015 albeit at a slower pace than originally forecast as the headwinds faced in the opening quarter of the year will prove difficult to shrug off entirely.

It is déjà vu all over again, quotes Standish's chief investment officer David Leduc in describing the US market's opening quarter of the year. Noting in the first quarter of 2015, the US market was negatively impacted by inclement weather – with Standish's home town of Boston receiving more than 100 inches of snow in the opening months. "So it is no surprise the weather took a bite out of US first quarter GDP," Leduc says. "However, despite this we expect the US to continue to grow throughout the year buoyed by a strengthening labour market."

Leduc makes this assertion even as March's US economic figures showed weaker than expected jobs data. "Unemployment still held steady at 5.5%," he counters. "We'll be closely watching such trends but we believe the slowdown in economic activity was temporary and there will be tighter labour conditions, which will result in higher core inflation in the second half of the year." Leduc expects US inflation to drift up to 2% before the end of the year.

Still a positive outlook for the remainder of 2015 doesn't negate the impact the first quarter had on US growth and as such Standish has lowered its full 2015 GDP forecast for the US from 3% to 2.4%. Yet the group continues to believe growth in the economy will lead the Fed to stay on course and raise rates no later than September this year. Leduc says he does not anticipate the Fed will move quickly with rate rises and as such they are unlikely to derail the positive momentum in the US market.

According to David Bowser, senior portfolio manager at Standish: "From a real impact perspective, the pace of hikes should be more important than timing and we believe the pace - and the resulting level - will be slower and lower by historical standards and as such should not have a lasting negative effect on economic activity or risk assets."

In this environment Standish expects to see a modestly flatter yield curve in the second half of the year and potentially some increased volatility in risk assets, which the group believes will be short lived. Leduc says he also expects continued dollar strength as the year progresses, particularly versus other developed market currencies, such as the euro. While this may sound critical of Europe, Leduc is increasingly sanguine about the growth prospects on the continent. Positive US growth is a boon for global growth optimism, particularly in the eurozone, he says, pointing out Europe's easy monetary policy and the weaker euro have been nourishing green shoots of activity.

With the exception of the UK and US, monetary policy in much of the rest of the world remains quite accommodative, Leduc highlights, pointing out that in the opening half of the 2015 some 24 different countries eased rates, including China, Japan and Europe. "By country they represent more than half of global GDP," he adds.

He goes on to note the European Central Bank (ECB) is unlikely to end its quantitative easing (QE) programme until it is confident it has "stamped out" the risk of deflation. Additional demand for eurozone bonds, resulting from the QE programme is likely to only exacerbate Europe's supply/demand imbalance, in turn pushing rates even lower, he contends.

He adds: "We expect the upturn in credit growth in Europe to support higher levels of consumption. Recent activity and money supply measures indicate conditions are improving and supportive for potential growth upside in 2015."

Emerging markets

Unlike the more positive sentiment with respect to growth in US and Europe, Standish is less constructive on the situation with emerging markets. In fact, Leduc says China and Latin America present the largest risks to Standish's full 2015 growth outlook.

Leduc notes the group is maintaining its below consensus growth outlook for China, expecting it to achieve GDP growth of 6.7% this year. This, he says, is because structural reforms taking place there are creating a sizeable fiscal drag on the economy. "This will only be partially offset by counter cyclical monetary policy easing," he adds.

Standish has also revised down expectations for all major Latin America economies. "Brazil leads the pack in terms of disappointments and looks set to experience a recession this year," Leduc says. However, he adds that global growth combined with stability in the commodities markets could lead to better growth prospects for Brazil later on in the year.

With respect to emerging market debt, Leduc notes the asset class has struggled due to persistent geopolitical risks and weak growth but now pockets of value have been created.

Overall, Leduc concludes: “Risk markets will remain concerned about energy and commodity prices, Fed policy changes and geopolitical risks. However, potential periods of spread volatility caused by these factors should create opportunities to add beta risk in credit markets more broadly as we move through the year.”

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