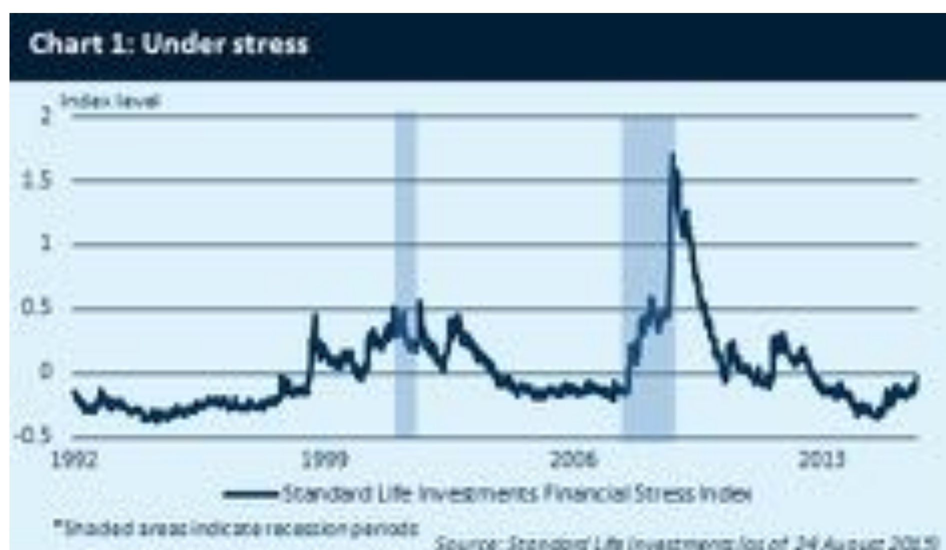
Standard Life Investments

Weekly Economic Briefing
Global Overview

Broken Eastern Promises
01 September 2015

It has been anything but a quiet end to the summer. On August 10th, the People's Bank of China (PBOC) announced a move towards a more flexible exchange rate regime and allowed the yuan to depreciate by just under 4% over the next three days. Then, on August 18th, when the motives of the Chinese authorities were already being questioned, the Shanghai stock market fell 6.2%, sparking a broad sell-off in risk assets. This reached a crescendo on August 24th, when global equities suffered their worst day of trading since 2011. Share prices may have staged a partial recovery at the end of last week but the scars remain. This summer storm has forced investors and policymakers alike to reassess their views on the underlying health and stability of the global economy and financial markets.

It is tempting to argue that the latest bout of financial volatility has few implications for either the economic or policy outlook. Indeed, there have been few signs in the data flow of a sharp and broad-based deterioration in global economic conditions. Emerging markets are certainly struggling against a backdrop of cyclical and structural headwinds. While this has been the case for most of the past year, there does appear to have been a worsening recently. However, the latest data suggest that most of the developed economies are growing at quite a healthy clip. US GDP growth for Q2 was revised up to 3.7% on the back of stronger investment spending; Japanese activity appears set to stage a rebound in Q3; and there are strong indications that long-moribund credit demand in the Eurozone is stirring, with the region finally achieving consistent above-trend growth. However, we advise caution for two main reasons. First, economic data is released with a lag and thus it is possible that the gyrations in financial markets partially reflect a deceleration in global economic activity that we are yet to see in the official data. Second, periods of financial stress can themselves cause economic activity to slow, or even fall, if they persist at a high level for long enough (see Chart 1). We suspect that the latest episode will be short-lived, but we will be monitoring economic and financial conditions closely for signs of something more malign. In the meantime, we doubt that the Fed will begin tightening monetary policy until financial stress subsides.



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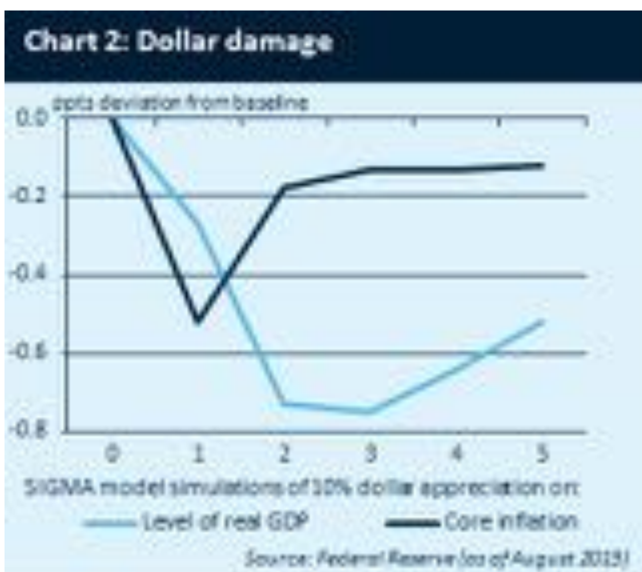
US

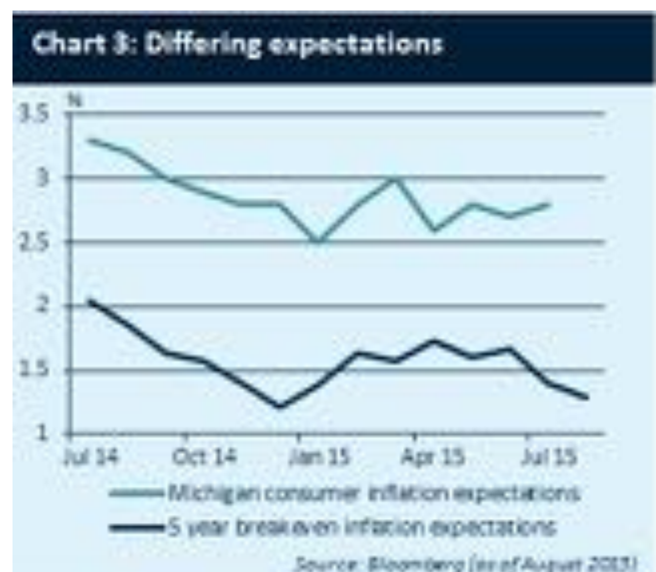
A Hole in one

The Federal Reserve Bank of Kansas City's annual policy symposium at Jackson Hole rarely passes quietly and this year's meeting was no different. Although nominally the topic of the forum was inflation dynamics and monetary policy, **investors were mostly interested in how Federal Open Market Committee (FOMC) members were interpreting the financial ructions of the past two weeks.** On Wednesday, New York Fed President William Dudley admitted that "the decision to begin the normalisation process at the September FOMC meeting seems less compelling to me than it was a few weeks ago", though he also added that "normalisation could become more compelling by the time of the meeting" if financial markets stabilised and economic conditions continued to improve. He also said that while he still hopes to raise rates this year, the ultimate decision will depend on how the data evolve. Not exactly a strong endorsement of imminent tightening then.

Some press reports did their best to exaggerate the differences between Dudley's message and the tone of Stanley Fischer's (the Fed Vice Chair) at Jackson Hole, but **in truth the sentiments expressed were very similar.** The main thrust of Fischer's speech was the inflation outlook, arguing that inflation would track back towards the Fed's 2% inflation target over the next couple of years, allowing the gradual removal of monetary accommodation. Fisher started by highlighting the temporary impact of commodity prices on headline inflation, arguing that it was better to focus on measures of core price growth. While these underlying measures of inflation are also well below target at present, Fisher highlighted Fed staff simulations which suggest that a large proportion of this undershoot can be explained by the surge in the dollar (see Chart 2). Finally, he observed that the sharp fall in bond market implied inflation expectations since oil prices began falling appears to reflect changing liquidity and other risk premia; with alternative measures of inflation expectations much more stable (see Chart 3). With the labour market continuing to improve, Fischer remains confident that forecasting models which rely on a negative relationship between slack and inflation remain valid, even if the relationship is smaller than it used to be.

Fischer's comments have been interpreted as downplaying the risks emanating from China and the increased volatility in financial markets, and perhaps even giving a green light to a tightening in policy at the September meeting. We think that is a misreading of his speech. For a start, he did say that the Fed is "following developments in the Chinese economy and their actual and potential effects on other economies even more closely than usual". If those comments were brief, that will be more because he and other Fed officials are still monitoring the situation rather than dismissing its potential seriousness. It should also be remembered that Fischer was simply preparing the ground for an eventual policy move, not stating a preference for September. **Our own interpretation of Fischer and Dudley's comments is that as long as the recent stress in financial markets abates and the economic data do not roll over, September will be a live meeting.** However, we ultimately think that lingering uncertainty will prevent an actual change in policy and that therefore December is the more likely timing for lift off.





Symptoms, not causes, of stress

The facade of economic policymaking infallibility has begun to crumble for China's technocrats and global markets are suffering as a result. Last week's market reaction following the recent sell-off in Chinese equities was a belated global recognition that there are risks and weaknesses in China's economy.**While risks to emerging market growth have been evident for some time - namely depressed commodity prices, historically weak trade growth, low productivity growth and increasing political risks - there may have been a view that Chinese growth would continue with the remarkable stability it's shown over the past three decades.**

Now, following the bungled attempt to rescue the stock market, poor communication surrounding the renminbi devaluation, flawed handling of the Tianjin disaster and a souring of relations with most of its neighbours following aggressive actions in the South China Sea, there are growing doubts about China's leadership and the direction of the economy. Indeed, some have even begun to question whether the Chinese government has "lost control" of the economy. Cracks are emerging but it's important to recognise that most of the global reaction was a belated response to slowing Chinese growth, which is not a recent phenomenon. Amidst all the panicked commentary, recent data has actually painted a mixed picture. The July manufacturing PMI was certainly weak, as was trade data, but the Caixin Services PMI was the strongest print in almost a year and property prices have continued rebounding (see Chart 10). China's transition from investment-led growth to an economy driven by consumption and services will not occur without periods of pain. Indeed, three of China's provinces are in outright recession and growth is flat in two others (see Chart 11). Construction, manufacturing and heavy industry are slowing sharply and the more resilient parts of the economy - consumer spending and services - are not growing fast enough to make up the difference. Short of meaningful reforms, China will slow further and the pace will not be smooth. The government has injected a level of economic uncertainty unforeseen in China and as scepticism over official statistics continues to grow, financial volatility will likely result. Nevertheless, although growth is slowing, it's too early to claim the Chinese economy is in for a hard landing. Chinese leaders still exert large influence over the economy, and as evidenced by rapid infrastructure investment growth, the recapitalisation of policy banks and reports of additional stimulus measures being prepared, policymakers still have room to cushion the downturn.

While events in China may have been the primary trigger behind last week's market upheaval, broader EM weakness is also a contributing factor. As mentioned above, emerging market countries appear set for a prolonged bout of sluggish growth, and recent volatility is a clear symptom of the broader problems in the EM economic outlook. The previous drivers of growth in the form of growing leverage, high commodity prices and rapid trade growth are no longer evident. Even countries that were supposed to be clear beneficiaries of low commodity prices have suffered growth downgrades. As the Fed approaches monetary policy normalisation, the growing divergences between developed and emerging market growth prospects are becoming more apparent. Equally important, political stability is also diverging. In addition to China, institutional weakness in Brazil, Mexico, Russia and Turkey will increasingly weigh on growth prospects. As the Fed hikes, protracted EM weakness could result.

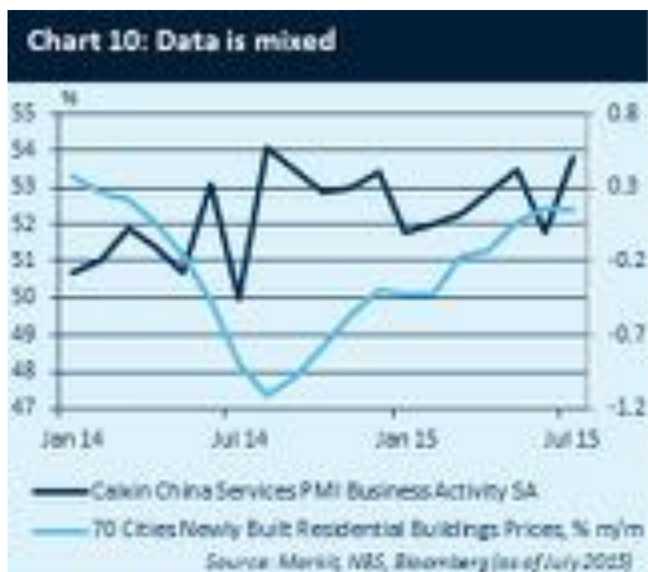


Chart 10: Data is mixed

Source: Markit, NBS, Bloomberg (as of July 2015)

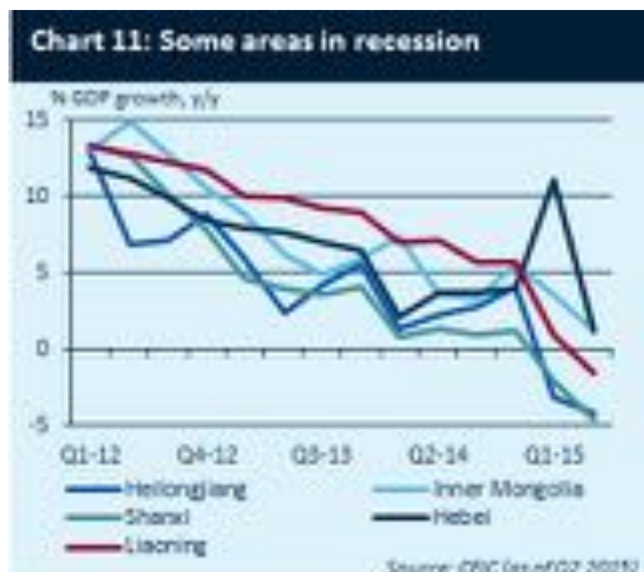


Chart 11: Some areas in recession

Source: CEIC (as of Q2 2015)

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