



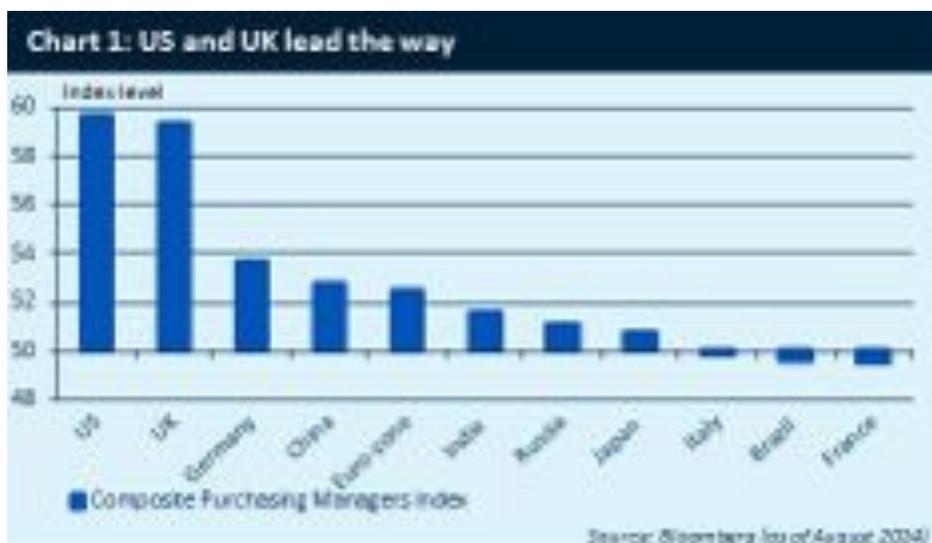
## Weekly Economic Briefing Global Overview

### More ups than downs

09 September 2014

With all the negative headlines coming out of the Ukraine and Middle East in recent weeks, it has been easy to forget that the global economy is actually in fairly good shape. Helped by generally loose financial conditions, as well as pent-up demand in most developed economies after years of tepid growth, the global composite Purchasing Managers Index (PMI) held up at 55.1 in August. That reading is a little lower than the levels recorded in June and July, but it is still the third highest outturn since the beginning of 2011. Helpfully, the global recovery is becoming less dependent on manufacturing activity to drive growth. Whereas the global manufacturing PMI is currently at 52.6, signalling healthy though not spectacular growth, the global services PMI is sitting at 55.5, not far from a post-financial-crisis high. Taken at face value, such levels of business sentiment are consistent with above trend global output growth, although there has been a tendency for the PMIs to overstate official GDP growth in recent quarters.

While the global backdrop is undoubtedly positive, not all countries and regions are sharing in the wealth equally (see chart 1). Among the world's largest economies, the US and UK continue to lead the way, reinforcing our view that the Federal Reserve and Bank of England will be the first central banks to begin raising short-term interest rates. The US in particular appears to be accelerating into the second half of the year, led by vehicle sales and business investment. Sentiment is also holding up fairly well in Japan, although it is well below the levels recorded at the beginning of the Abe revolution and the rebound from the sales tax hike has been weaker than hoped. However, the biggest disappointment is the Euro-zone, where the recovery is in danger of petering out before it even began. The biggest drags are still France and Italy, although even German growth has moderated of late; no prizes then for guessing why the ECB announced new easing measures last week. The BRICs remain a mixed bag. The Chinese authorities are pushing to hit their 7.5% growth target, despite the related financial risks being generated. Meanwhile, Russia is sinking under the weight of sanctions and Brazil has fallen into recession. Indeed, only the Indian economy seems likely to accelerate in the second half of the year.



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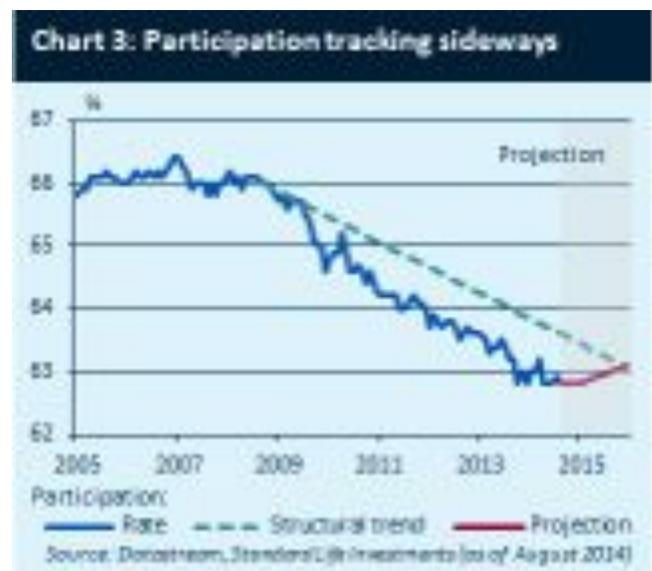
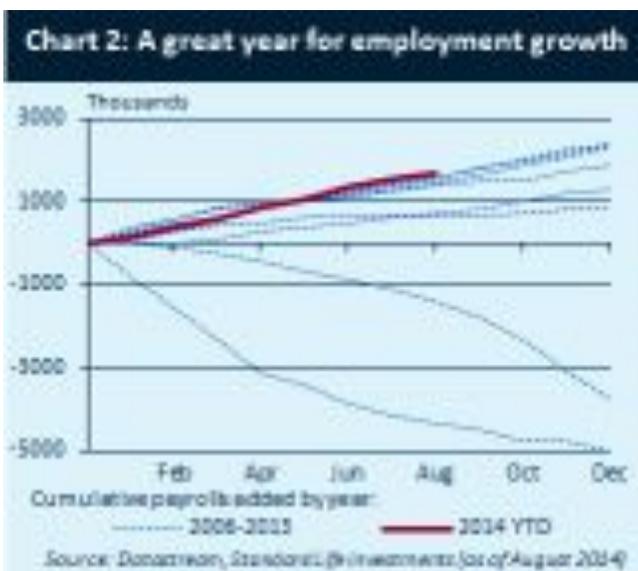


## Fading the payroll report

**Key data released over the past week gave off conflicting signals.** On the positive side of the ledger were the August Institute of Supply Management (ISM) and Purchasing Managers Index (PMI) surveys, which pointed to an economy growing well above trend. On the negative side was the employment report, which showed nonfarm payrolls increasing by the smallest amount this year. Which to believe? We are not normally ones to put excessive faith in measures of business sentiment but, on this occasion, we think that they are providing the more accurate signal. Let's step through the reasons why.

Firstly, and most importantly, **the business sentiment indicators correspond better with other economic indicators.** For example, official core capital goods orders have been on a strong upward trend of late, in line with the new orders component of the ISM manufacturing index. Vehicle sales also surged to a new post-recession high in August, suggesting very strong underlying demand for consumer durables. Contrast that with the payrolls report, which (somewhat unbelievably) suggested that employment in the auto sector contracted in the same month. The second reason is more conceptual. It is fairly well established that employment growth is a lagging, or at best coincidental, indicator of economic activity. As such, it seems unlikely that firms would begin scaling back their hiring plans before the economy weakens. A third reason is that the payroll survey can be noisy. There is a 100k confidence interval around the monthly change in employment and the initial estimate is subject to regular, large revisions. One counter argument is that the ISM indices are being distorted by seasonal adjustment problems, with proponents pointing to the similar surge in the ISMs at the same time last year. While this cannot be ruled out, it seems like an incomplete story. Last year, when the manufacturing and non-manufacturing ISM surged, the PMIs remained more subdued. This year all are at very high levels. Besides, the big increase in the manufacturing ISM last year accurately foreshadowed a rapid pick-up in inventory accumulation. Even if the pull-back in employment growth is genuine, its importance should not be overstated. Not only have **more jobs been created so far this year than to the same point of any other year since 2005**, but weaker employment growth may simply indicate that productivity growth is finally improving (see chart 2).

**Otherwise, the employment report implied further gradual tightening in the labour market.** The unemployment rate fell back to 6.1% as the participation rate declined to 62.8%. We have been of the view that the participation rate would mostly track sideways over the next couple of years, as the positive impact of improving job availability is offset by deteriorating demographics. So far, that is how things are playing out (see chart 3). Meanwhile, the U6 measure of labour underutilisation dropped another 0.2 percentage points to 12% - a new post-recession low. Underlying wage growth is also edging up. Although aggregate average hourly earnings growth remained at 2.1%, earnings growth for production and non-supervisory workers increased to 2.5% - a 4-year high. Janet Yellen has indicated that wage trends will not necessarily be decisive in determining when rates rise but firming wages will certainly embolden the Fed's hawks in coming meetings.

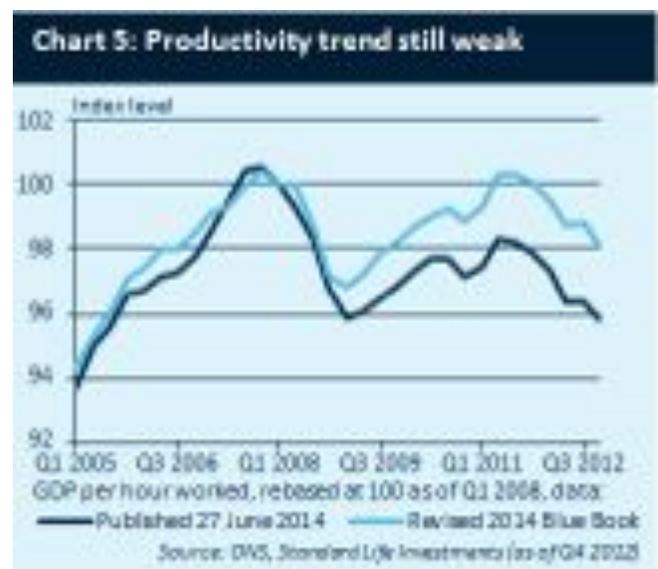
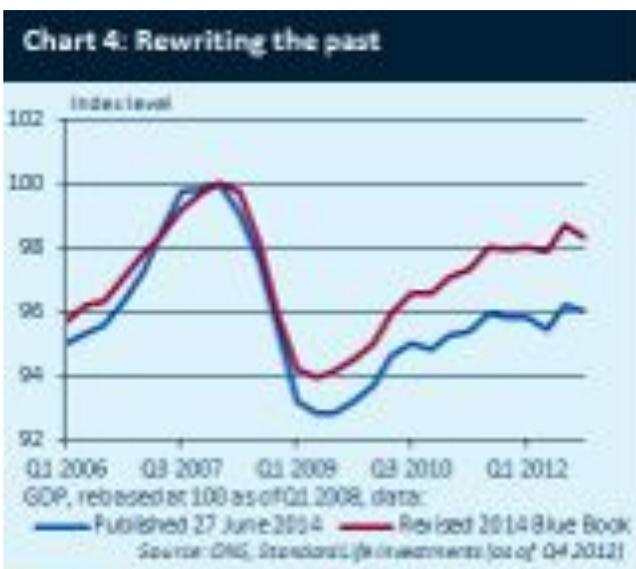


## Servicing the recovery

The UK economy continues to grow strongly, although **there are signs that the recovery is becoming more unbalanced**. Let's start with the good news. The service sector, which accounts for almost 80% of economic activity, is motoring along nicely; the Purchasing Managers' Index for the sector jumped to 60.5 in August, the third highest reading over the course of the 16-year record for this series. Some of the sub-components of the survey were slightly less upbeat, with new business and employment increasing at a slower rate. Overall, however, these data suggest further robust growth in Q3. The construction survey was similarly upbeat at 64, representing the fastest growth seen in the sector since the start of the year. The fly in the ointment was manufacturing, with PMI data for this sector showing a marked slowdown in activity over recent months. Some of this looks to be related to the indirect impact of geopolitics, with the Euro-zone accounting for close to 50% of UK exports. While this slowdown is disappointing, the survey remains fractionally above its long-term average. Overall it looks like the manufacturing sector will provide a smaller contribution to UK growth over the second half of the year. This more unbalanced recovery should not prevent the UK achieving growth above the 3% mark in 2014. It does however put the onus more squarely on domestic demand to drive the recovery.

New data released from the ONS last week casts the UK recovery in a slightly different light. The statistics agency has updated its GDP measurements to include methodological changes between 1997 and 2012 (figures from 2012 onwards will be released in late September). **The recession in 2009 is now deemed to have been shallower than previously reported, while the recovery since has been more pronounced** (see chart 4). Indeed, the level of GDP was revised up by 2.3 percentage points at the end of 2012, with further upward revisions likely in the update of the more recent GDP data. This has implications for productivity, which was revised up over the post-crisis period. While this suggests that the shortfall in productivity has been smaller than previously feared, the trend remains extremely weak (see chart 5).

These revisions are unlikely to change the Bank of England's (BoE) current thinking. The Bank already factors in upward revisions to ONS data given the tendency of the statistics office to adjust its growth estimates over time. More importantly these revisions will do little to change the BoE's view on slack in the UK economy, which is mostly based on labour market indicators. On this front, the REC survey of labour market conditions last week recorded a new high for demand for permanent and temporary staff, alongside declining candidate availability. This has pushed surveyed pay growth to the third highest on record. However, **the Bank is putting more weight on hard wage data as opposed to survey indicators**. We would need to see a clear acceleration in these official statistics in order to change the BoE's mind that there is a good deal of slack left in the labour market. The central bank left interest rates unchanged this week, although it is likely that the committee remained split along the lines seen in July. We expect the first rate hike to come in early 2015, barring any big surprises in the data.

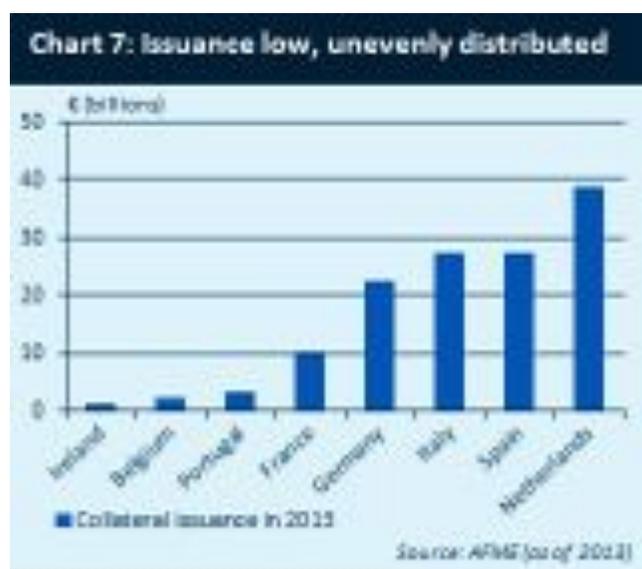
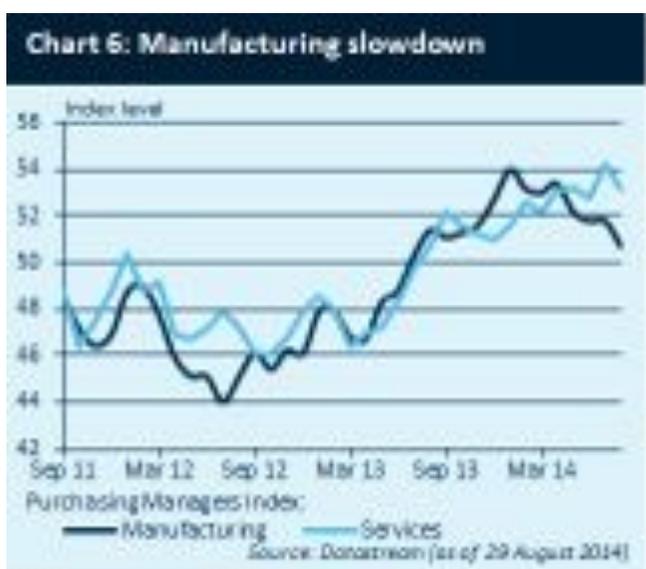


## Limping along

We are seeing few signs of improvement in the Euro-zone economy. Indeed, after a weak start to the year, **activity indicators suggest that the currency union is losing rather than gaining momentum.** This is particularly apparent in the manufacturing sector, where Purchasing Managers Index (PMI) surveys indicate that growth has slowed markedly since the beginning of 2014 (see chart 6). New manufacturing orders, particularly those from export markets, have weakened with geopolitical uncertainty, as highlighted in the survey. Ominously, the data indicates that firms in the manufacturing sector have started to trim payrolls again. Policymakers will hope that the recent depreciation seen in the euro exchange rate, combined with an improving global growth backdrop, will help to reverse this trend and that surveys are overstating the weakness in the real economy. Meanwhile, the less internationally exposed service sector has been more resilient. The PMI reading for the service sector declined in August to 53.1 from a three-year high of 54.2 in July. There were more alarming signals in the details; business confidence slipped to its lowest in 12 months, while job creation slowed to marginal rates. Overall, these data point to muted growth over Q3 with scarce signs of any imminent acceleration. Such weak momentum indicates clear downside risks to the ECB's forecast for 1.6% growth in 2015.

The country breakdown of the PMI surveys showed some familiar trends. The composite reading of manufacturing and services for France remains below the 50 mark, pointing to economic contraction. Hard economic data have shown a stagnating rather than contracting economy, but these surveys do reflect the underlying pessimism in France at present. Italian PMIs look to be catching up with the economic reality of the 2014 recession; the composite PMI sits below 50, having fallen from 54 as recently as June. More unusually, PMI data from Germany indicates that activity is at a 10-month low. Spain remains the star performer among the larger member states. The composite Spanish PMI reading is currently at a post-crisis high with the performance of the service sector particularly positive. This will reinforce the message from ECB President Draghi that structural reform pays off, although we should acknowledge the role that an easing in financial conditions has played in boosting domestic activity.

**The ECB has responded to the disappointment in growth and, perhaps more pertinently, the weakness in inflation and inflation expectations.** The central bank last week cut interest rates by 10 basis points, providing a small discount on funding for the upcoming TLTROs. It also re-announced its private sector asset purchase plan, which will start in October and will include residential mortgage-backed securities and covered bonds. **This broader swathe of securities will help increase the potential size of the programme but there are limitations.** Firstly, issuance remains weak in the aftermath of the crisis, although there are hopes that this programme will help support activity (see chart 7). Second, there is an uneven geographical concentration of securitised loans, limiting the scope for implementing a broad stimulus. We expect continued disappointment in the ECB's growth and inflation forecasts to eventually require a larger programme, including a move into government bond markets.



## A modest post-tax hike rebound

It is rather difficult to define the true state of the business cycle in Japan at present. After a relatively strong upturn in 2013, the sales tax increase clearly affected activity in Q2, with the most recent revisions estimating that the economy contracted at an annualised rate of 7.1%. We expect a recovery in the second half of the year, although the latest data imply that this may be more strongly evident in Q4 than Q3. Meanwhile, the Bank of Japan appears content to monitor the state of the economy before acting any further to ensure that inflation (excluding sales tax effects) quickly reaches the 2% target.

Turning to the detail, **many economic indicators have been weak of late**. This appears to be, primarily, a domestic demand issue, with overseas demand showing a moderate, if belated, improvement that may have been helped by the strength of the US business cycle. Japan's industrial production edged up by only 0.2% month-on-month (m/m) in July, far from reversing the sharp 3.4% drop seen in June, and well below market expectations. Inventories rose (by 0.8%) for the third straight month – potentially a sign that firms have been too optimistic about how quickly domestic demand would recover. Vehicle sales, for example, were down 5% in August from a year earlier, returning to the 2012-2013 trend of marginal year-on-year (y/y) declines before the sales tax hike incentivised households to bring forward their spending on big ticket items (see chart 8). **Companies also remain cautious about further capital spending**; at least until the state of the business cycle is clearer. Private-sector core machinery orders (excluding more volatile orders for ships and from electric power companies) saw only a weak rebound in June, rising 8.8% m/m compared with the cumulative decline of 26.8% seen in Apr-May. That said, domestic demand is still expected to come good in the coming months. Business surveys, on balance, improved further in August, so industrial production should at least stabilise into the autumn. The Markit manufacturing sector survey is again trending higher from its sub-50 low in April, reaching 52.2 in August, although this is still well below the peak of 56 at the start of the year. Its services counterpart did dip modestly to 49.9 last month although things should improve as recent wage gains start to bolster consumer spending.

Turning to external demand, there are more helpful signs (see chart 9). In June, Japan's exports increased in both value (1.5% m/m) and volume (3.1% m/m). Looking ahead, the new export orders index within the manufacturing PMI rose to 52.8 in August, from 50.8. This was the third consecutive monthly increase, tying in with evidence that the global trade cycle is picking up. The renewed depreciation of the yen should also help this trend in the second half of the year. Within the machinery orders report, it was interesting to observe the big jump in overseas orders (up 62.8% m/m), bucking the lacklustre trend for core orders (only up 8.8% m/m compared with a market forecast of 15.3%). Further out, much depends on the government's progress on structural reforms. The labour market has tightened substantially over the past year, suggesting that monetary and fiscal policy have done most of what can be done to boost real demand in the economy. **More now needs to be done to boost the economy's supply potential**; a good start would be to announce an accelerated timetable for lowering the corporate tax rate.



# Emerging Markets

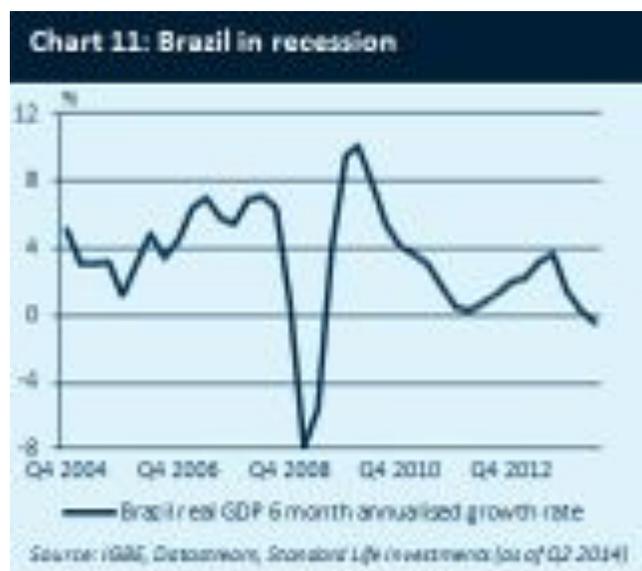
## Divergence the order of the day

It is common to hear analysts talk of an emerging market business cycle, as though each economy was following a similar path. In truth, however, **there is often more divergence within the emerging universe than there is among the developed economies.** The most recent round of PMIs illustrates this point well; manufacturing sentiment is strong in Taiwan and the Czech Republic, healthy in India and Mexico, while it is subdued in Turkey, South Korea, Brazil, Indonesia, South Africa and Poland (see chart 10).

Although there is not a strong common business cycle at present, we can identify some common themes among the three groups of countries listed above. Taiwan, the country with the strongest manufacturing sector relative to its history, is benefiting from the current upswing in US imports and business investment. The Czech Republic is one of Europe's most open economies and has been bolstered by its links with the German economy. **Mexico and India are the two large emerging markets where reform expectations are strongest**, although the fact that sentiment has improved but not surged suggests that firms are waiting for promises to translate into action.

Where sentiment is weaker, we usually find a country undergoing political tumult, often spiced with disappointing progress on structural reforms. That is certainly the case in Brazil, South Africa, Turkey and Indonesia. **Brazil's economy has deteriorated particularly rapidly this year, falling into outright recession in Q2** (see chart 11). Although this has been partly due to the sharp tightening of monetary policy in 2013, there has also been a substantial worsening in the trade off between growth and inflation, as well as the terms of trade. Investors are currently betting that October's election will start to turn things around, but the list of necessary structural reforms is discouragingly long. Sentiment in Russia is actually holding up fairly well, although we think that it is only a matter of time before the tightening of sanctions pushes the economy into recession. Meanwhile, the weakness in the Korean manufacturing sector is mostly attributable to the won's loss of competitiveness vis-a-vis the Japanese yen.

China, as ever, continues to move in its own orbit. Growth was weak at the beginning of the year, as the housing sector weighed on growth, before strengthening on the government's fiscal stimulus and stronger US import demand. The erratic pattern to the data reflects the difficult trade offs the authorities are facing. **The Chinese government recognises that the economy needs to delever and rebalance away from its reliance on investment but they also want to hit their 7.5% growth target.** The upshot is that quarterly growth oscillates around the target, but at the cost of delaying the changes that are necessary to achieve rebalancing. Thus, while total social financing is not growing as quickly as it was through most of 2013, it is still significantly outpacing nominal GDP growth. This certainly makes it hard to argue that overall monetary and credit policy is too tight. China's strong external balance, as well as the current US economic upswing afford the authorities time to get their financial house in order but every year that they delay, the risk that domestic imbalances unwind in a disruptive way grows.



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