Standard Life Investments

Weekly Economic Briefing
Global Overview

An unlikely leader
07 April 2015

The first quarter is shaping up to be a disappointment for the global economy. After industrial production and trade growth picked up speed at the end of 2014, both have slowed through the first months of 2015. Consensus forecasts will need to be revised down again this year, in what is becoming a familiar pattern. Fortunately, much of the near-term weakness reflects temporary factors. The negative effects of lower oil and other commodity prices have been front-loaded as weaker global commodity investment has not yet been counterbalanced by accelerating consumption. This should reverse in the second half of the year. The US economy has also been hit (again) by unusually severe winter weather, which will shave nearly a percentage point off growth in Q1 and explained some of the downward surprise to nonfarm payrolls in March. Even Chinese industrial data has been distorted by new-year effects. However, other forces acting as a drag on global growth will prove more persistent. Productivity is mired in a longer-term slump because there are few countries addressing structural barriers to growth. Global trade is proving less responsive to growth because globalisation itself appears to be slowing down, and demographics continue to deteriorate. Meanwhile, most countries are still struggling under the weight of excess public and private sector debt. All that means that the new normal for global growth is lower than it was before the crisis.

Somewhat ironically, one of the few parts of the world where growth has not faltered is the Eurozone (see Chart 1), where the European Commission's Economic Sentiment Indicator hit its highest level since mid-2011. Although some of the lift in sentiment is explained by the weaker currency, we are especially encouraged by the fact that domestic demand indicators have also improved. Lower oil prices have helped but the ECB's monetary easing is also bearing fruit in terms of easier financial conditions for households and businesses alike. To ensure that this cyclical pick-up is durable we need to see even more reform, especially in France and Italy, coupled with governments taking advantage of the ECB's policies to bolster public investment. A benign resolution to Greece's crisis would not hurt either but that may be too much to ask.

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US

Labour pains

There is no doubt that recent economic news coming out of the US has been disappointing. Business investment, exports and consumer spending have all slowed significantly at the beginning of the year, leaving overall economic growth tracking below 1% in the first quarter. Although the economy should still expand more quickly in 2015 than last year's 2.3%, the consensus forecast of 3% growth looks too optimistic and we have trimmed our own forecast to 2.6%. One reason why economists have been reluctant to lower their growth forecasts is that the labour market data had continued to go from strength to strength, with employment increasing at its fastest pace since the late 1990s in the year to February. That changed in March as the preliminary estimate for nonfarm payrolls increased by just 126k, which was the smallest increase since December 2013, while January and February's gains were also revised down (see Chart 2). **It is never a good idea to over-interpret one month's employment data, and the labour market is still in good shape overall but it is consistent with the economy having genuinely slowed in the first part of the year**.

The key question is whether this loss of economic momentum will prove to be temporary or sustained. The somewhat complicated truth is that it is likely to be a bit of both. Business investment is a case in point. The plunge in oil prices has hit investment in oil wells and rigs hard, as well as the manufacturers that have been supplying the sector's rapid expansion in recent years. As a result, core capital goods orders have fallen 5% since June last year and further weakness is likely into the spring. Sentiment indicators suggest that **business investment should gradually recover in the second half of the year but there seems little doubt that the next phase of the economic recovery will need to be tilted more towards consumption**. The other sector of the economy where there is little improvement in prospect is exports. Although the west coast port strike has weighed on foreign shipments in recent months, the dollar's rapid rise against a modest global trade backdrop means that export growth will probably be sluggish over the next couple of years.

The one component of growth where a significant improvement is likely over coming quarters is personal spending. Since June last year, real personal spending has grown at an annualised rate of just 2.7% despite real disposable income increasing at a 4% rate over the same period (see Chart 3). As a consequence, the household saving rate has increased from 5.1% to 5.8%, with all of the increase coming in January and February. We think that relative weakness in consumer spending has been mostly due to weather effects and will therefore prove temporary. Wage growth and consumer sentiment have both improved over that period and the longer oil prices stay low the more confident households will feel about increasing their spending. The rebound in vehicle sales in March was a positive indicator in this regard. Nevertheless, the latest data suggest that the Federal Reserve made the right decision to signal a later lift-off in interest rates. **The US economy may be healthier than most but is not yet ready to carry the rest of the world on its shoulders**.

Chart 2: A soggy labour market report

Source: Bureau of Labor Statistics (as of March 2015)

Chart 3: Saving... for now

Source: Bureau of Economic Analysis (as of February 2015)

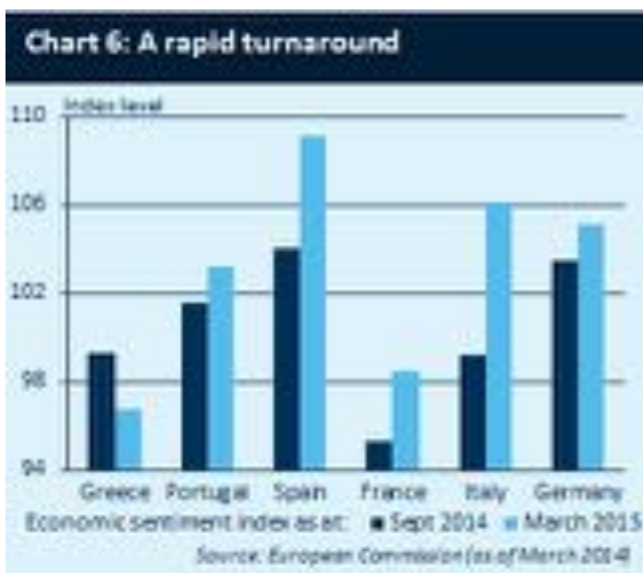
The comeback kid?

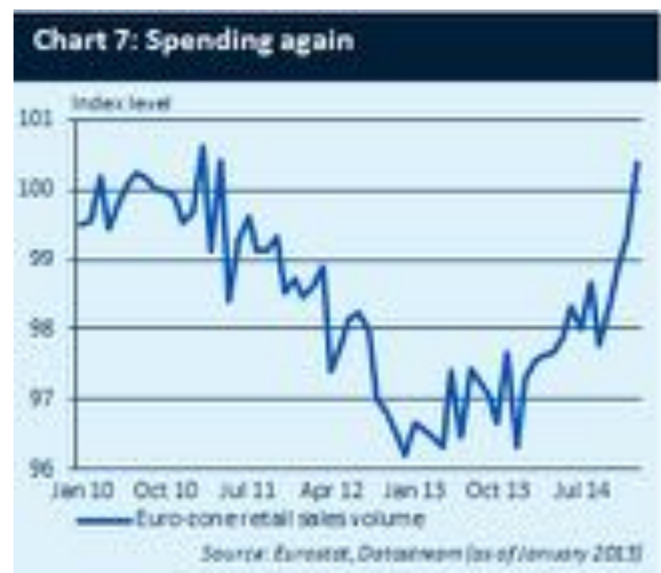
Thus far 2015 has probably gone better than Mario Draghi had dared hope. **We have seen clear evidence of a pick-up in Eurozone activity over Q1, despite a sluggish global growth environment**. The European Commission's Economic Sentiment Indicator (ESI) has jumped to a four year high, supported by rising confidence in retail, services, construction and, in particular, industry. This has been corroborated by upside surprises in Purchasing Managers' Indices (PMI). There are signs that this fledgling recovery is feeding through to the labour market. Unemployment edged lower to 11.3% in February and is now down 0.5 percentage points over the past year. On the price side, inflation looks to have bottomed with the headline rate down 'just' 0.1% year-on-year (y/y) in March from -0.3% y/y in February and -0.6% y/y in January. Furthermore, the weaker euro is starting to feed through to inflation. The manufacturing PMI survey showed a rise in input prices in the sector for the first time in six months. This is being passed through to consumers, with output prices falling at their slowest rate since autumn last year.

The upturn is not just a northern European story, with the improvement in data having been broad based over recent months (see chart 6). Germany continues to show signs of robust growth following the strong 0.7% quarter-on-quarter GDP print at the end of 2014. In France, the composite PMI reading has jumped above the all-important 50 mark while the ESI in Italy has reached its highest level since August 2007. Meanwhile, Spain, Ireland and Portugal all continue to report robust activity levels, partly reflecting the reform progress they have made in recent years. The one notable laggard has been Greece, where political uncertainty has weighed on business and consumer sentiment over recent months.

There have been a number of drivers of the recent upturn. One outside of Mr Draghi's control has been the decline in oil prices which has helped support a pronounced improvement in retail sales (see chart 7). **However, monetary policymakers can take credit for the increased support they have provided (albeit after a painful delay)**. There are clear signs of an improvement in the credit channel as the cocktail of the ECB's Comprehensive Assessment, Targeted Liquidity Operations and Asset Purchases supports the financial sector. The weaker euro meanwhile has boosted the competitiveness of Eurozone firms and orders have improved markedly according to PMI data. Finally, the hard to quantify concept of confidence; the ECB policy action should have contributed to the improvement in sentiment among firms and business while inflation expectations have risen slightly.

However, one swallow does not make a summer. The improvement in economic conditions is encouraging, but will need to be sustained to make marked dents into spare capacity. Indeed, core inflation measures remain alarmingly low and the region is still vulnerable to any shock. **Therefore, the ECB should not consider rowing back on its stimulus measures anytime soon**. Moreover, other policymakers should use this cyclical upturn as an opportunity to strengthen reform efforts. Progress in early 2015 shows the value of decisive policy action - it should not provide cause for complacency.





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