Global Overview

Setting the course

Global growth will improve after its weak start in 2014, helped by central banks keeping global monetary conditions relatively loose, leading to some inflationary pressures.

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Global growth faltered

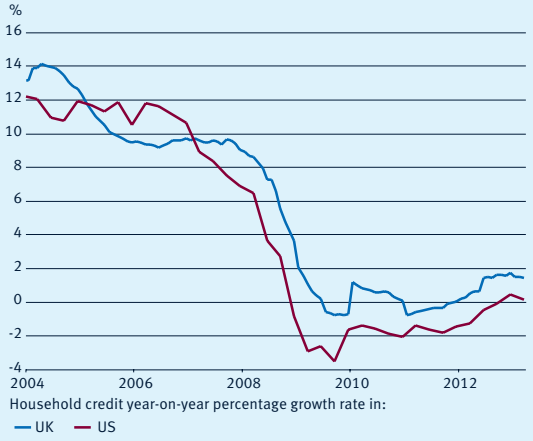
At the start of the year, market participants were pinning their hopes on a strong and broad-based acceleration in global growth. Although the US was again expected to lead the way, the consensus was also anticipating the Euro-zone recovery would strengthen, while a rebound in the global trade cycle was supposed to more than offset structural headwinds in the emerging world. Thus far, these hopes have been disappointed. The combination of bad weather, an inventory correction and the adverse reaction of housing activity to last year's rise in mortgage rates caused the US economy to contract in Q1. Consensus US growth expectations for 2014 have fallen from 2.9% to 2.5% and even that is looking like a stretch. This pace of growth would still be an improvement on 2013, but not by as much as we and other investors would like. Little wonder then that long-term interest rates have fallen back in the first half of the year.

There have been growth disappointments elsewhere too. The performance of the Euro-zone economy was tepid in the first quarter, with Germany still accounting for the lion's share of activity. Indeed, for all the excitement about Renzi's accession, the Italian economy is barely growing, while France also remains stuck in the doldrums. China is still struggling with the unwinding of its property bubble, while elevated inflation and tight policy are weighing on growth in other emerging market economies as diverse as Brazil, India, Turkey and Russia. The latter, of course, has also shot itself in the foot through its incursions into Ukraine's internal politics. Among the world's largest economies, only the UK is really going from strength to strength.

Secular stagnation fears are overblown

With investors having to deal with yet another year of downward growth revisions, secular stagnation is the buzzword of the day. According to this thesis, real and nominal potential growth have permanently declined due to deteriorating demographics, weak productivity growth and the long-term need for ongoing private and public sector deleveraging. In turn, this implies that neutral real interest rates will remain much lower than in the past and that central banks will find themselves unable to exit from their unconventional policies. Pessimists also see a rough few years ahead for the emerging market complex as they combat their own imbalances that have developed since the crisis and can no longer rely on strong growth in the developed world to propel exports and investment.

Chart 1
Deleveraging is finally over in the US and UK



Source: Bank of England, Federal Reserve (as of Q1 2014)

Elements of this story seem right. Economists have lowered their estimates of US potential growth by 0.5 percentage points or more since the crisis, and the downgrades have been even larger in most other OECD countries. There are three main culprits for this erosion of potential. The first is that labour utilisation rates will remain permanently lower over the coming decades, thanks to population aging. Another factor is the long-lasting scars from the financial crisis itself, which has undermined the credit and investment allocation process, creating widespread dislocations in product and labour markets. Increases in the financial regulatory burden have not helped either.

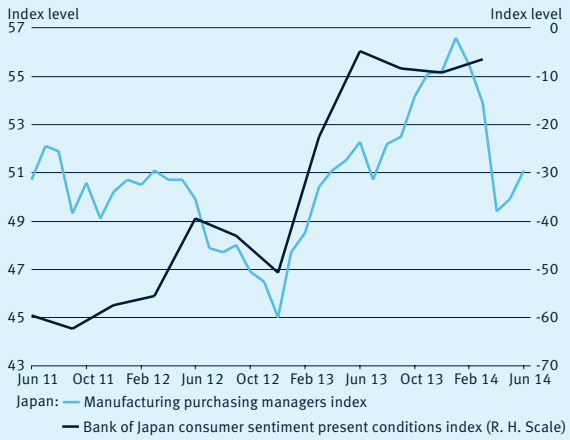
More ominously, underlying labour productivity growth has faded across the developed and emerging world in recent years as the prolonged weakness in business investment has reduced the efficiency of the capital stock, technological innovation has slowed down and there has been little appetite for structural reforms. The after-effects from the financial crisis will fade over time, but others will persist unless governments grab the reform bull by the horns.

Nevertheless, we do think that some of the market's pessimism has gone too far and that lower potential growth does not mean that a strengthening cyclical recovery is out of reach. In the US and UK, the household deleveraging process is over (Chart 1) and household wealth is being boosted by rising house prices and equity markets. Key business cycle indicators are also turning up. For example, consumer spending on motor vehicles and other consumer durables is rising solidly. Business equipment investment, which is a key driver of long-term productivity growth, has turned the corner. Just as importantly, labour markets are continuing to heal. Unemployment has fallen decisively over the past 18 months and real wage growth is finally starting to rise. As long as the Federal Reserve and the Bank of England are able to exit gradually from their emergency policy settings without disrupting the recovery, the seeds of a virtuous cycle are being sewn.

Time for Japan to accelerate reforms

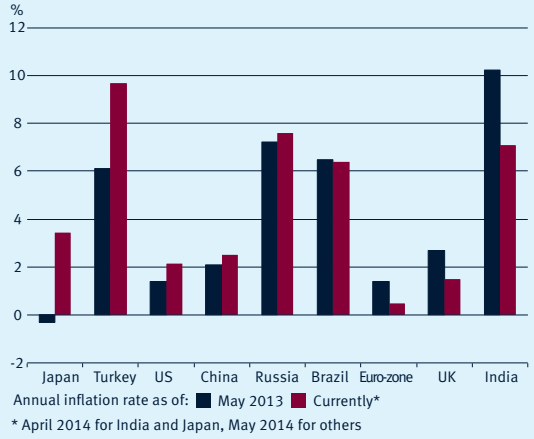
The picture in Japan is harder to read due to the distorting impact of the April sales tax hike on the timing of economic activity. Nevertheless, household and business sentiment has held up better than expected over recent months (Chart 2), reinforcing our view that there will be few lasting effects on the economy. We also anticipate further policy stimulus from

Chart 2
Resilient confidence



Source: Bank of Japan, Bloomberg (as of June 2014)

Chart 3
Deflation fears overstated



Source: Datastream (as of May 2014)

the Bank of Japan before the year is out as Governor Kuroda realises that not enough has been done yet to get inflation up to 2%. Japan's longer-term problems are, of course, primarily on the supply side, as potential growth is below 1% and falling. Here it is fair to say that the third arrow agenda of structural reforms has been somewhat of a disappointment so far. However, while the reform effort has fallen short of the big bang that was promised, investors should not give up on Abe yet. A lot of preparatory work is going on beneath the surface and the legislative programme should accelerate over the next 12 months. The recently announced corporate tax cuts that will be implemented in 2015 were a good start.

The global inflation cycle is turning

Another manifestation of market pessimism is the widespread fears over disinflation. In our view, these too are overdone (Chart 3). Recent data show that inflation is on the rise again in the US, as spare capacity is slowly being eroded. Meanwhile, policy in Japan is firmly inflationary, over the medium term, and as mentioned before, a number of emerging markets are still struggling with excess inflation. The outlook for commodity prices is also more stable than is widely believed. Oil prices have edged up this year while global food prices will rise significantly if an El Niño forms over the summer as many meteorologists are forecasting.

The part of the global economy where deflationary risks are highest is Europe. Monetary policy there is simply too tight, as evidenced by the fact that even Germany has inflation well below the ECB's 2% target. Excessively low inflation leads to a number of problems. It makes deleveraging more difficult and relative price adjustment within the currency union more painful. It slows real wage adjustment, which in turn prevents labour markets from clearing. It also leaves economies more vulnerable to outright declines in the price level in the face of negative shocks. The ECB loosened policy along a number of fronts in June, including pushing its deposit rate below zero and announcing a conditional LTRO to support lending to non-financial corporates. In our view, this is too little too late and a proper asset purchase programme will eventually be necessary.

Headwinds to growth but no crises in EM

Emerging markets are another source of excessive pessimism. We agree that there are more headwinds to growth than in the past. Chinese growth is on a downward trend structurally and it will be difficult for the authorities to rebalance the economy away from its reliance on credit and investment smoothly. Countries such as Turkey, Ukraine and Venezuela also have significant imbalances and therefore related crises cannot be ruled out, particularly if there is a rapid rise in global interest rates. Widespread structural reforms are necessary to drive the next wave of convergence now that China and the commodity super-cycle are providing less support.

However, investors should not lose sight of the real progress that has and is being made. Current account deficits have declined in India, Turkey, South Africa and Indonesia and, most importantly, all have allowed their exchange rates to bear more of the burden of adjustment than in the past. More generally, systemic financial risks are far less pronounced than before the Asian crisis. In most countries, the build-up in leverage has been fairly restrained, while currency and maturity mismatches are far less pronounced than in the years leading up to 1997. Meanwhile, Modi's resounding electoral victory gives grounds for optimism that India can finally make progress on structural reforms, while Dilma Rousseff's declining popularity may, somewhat paradoxically, help drive policy in a more helpful direction in Brazil. The possibility of a hard landing in China is our biggest concern, but there is little evidence yet that the property and debt bubbles are unwinding disruptively; for now the authorities appear to be in control, as long as the current and capital accounts are not liberalised too rapidly.

Better days ahead

For all these reasons we expect global growth to improve as the year goes on and continue into 2015. Precisely how much will depend on a range of factors, including whether central banks are able to keep global monetary conditions relatively loose and whether the global trade cycle picks up. On the latter front, the recent acceleration of US import growth has been particularly encouraging. Not only will that give a short-term boost to the global economy but it will help build a bridge for demand while countries continue down the difficult path of implementing structural reforms.

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