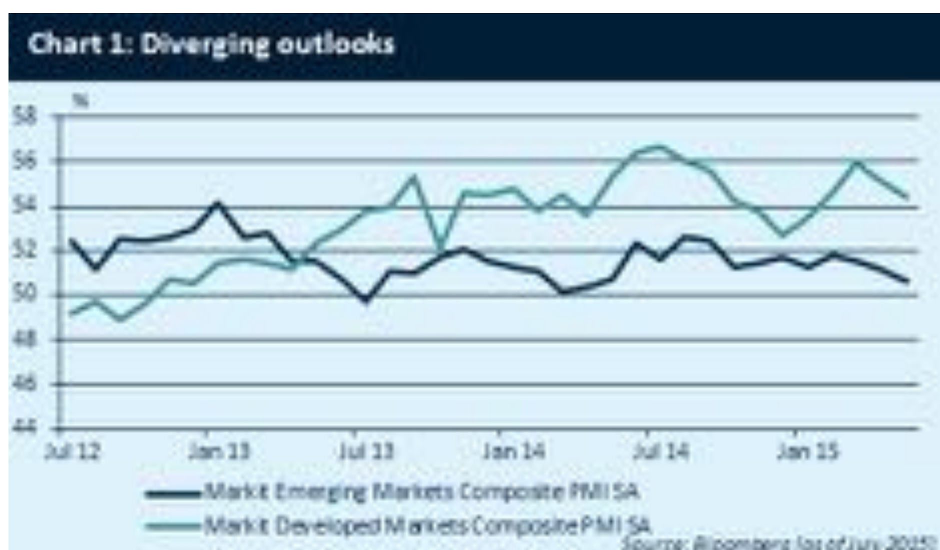
Standard Life Investments

Weekly Economic Briefing
Global Overview

Half Year Report
28 July 2015

Looking back on the first half of 2015, it is clear that the divergence in performance between developed and emerging economies is more than a temporary phenomenon. With the weakness of Q1 growth in the US now behind us, we expect a solid and broad-based strengthening of growth in the developed countries in H2. US growth is likely to track close to 2.5%, which is low compared with historical cyclical recoveries but above its current potential. However, there is ample room for improvement. The labour market, though in better shape, is not yet at full health and labour productivity growth remains anaemic. Sluggish capital spending is mostly to blame for this and the government could do more to address public investment shortfalls. We are markedly more upbeat on the Eurozone economy; our 2015 growth forecast is 1.5%, which would represent the best year for the currency union since 2011. Cyclical momentum continued to build over the first half, underpinned by a significant easing in financial conditions. Growth in Q1 accelerated to 0.4% quarter-on-quarter (q/q), driven predominately by domestic demand and data indicators over Q2 suggest that this growth rate will be maintained, or even exceeded.

Despite long-term headwinds, Japan has provided one of the biggest positive growth surprises so far this year. Q1 GDP came in at 3.9% q/q annualised, versus consensus expectations of just 1.6%. However, because improved growth came largely from temporary factors such as inventory investment it is still too early to call this a sustained recovery. Further policy measures are required to ensure that growth potential rises and inflation hits the Bank of Japan's 2% target over the next few years. Emerging markets growth was the biggest disappointment over the first half of 2015. Recessions in Brazil and Russia were expected, but the broad-based weakness in EM domestic demand, particularly in Asia, defied expectations for a consumption boost on the back of lower commodity prices. After a weak first quarter where China posted a 1.3% q/q growth rate, economic activity rebounded in Q2 following government stimulus. The growth outlook remains challenged, however, as continued deceleration in property investment and slower growth of financial services will weigh on growth.



Contributors

Authors:
Jeremy Lawson
James McCann
Govinda Finn
Alex Wolf

Editors:
Jeremy Lawson
Stephanie Kelly

Chart Editor:
Stephanie Kelly

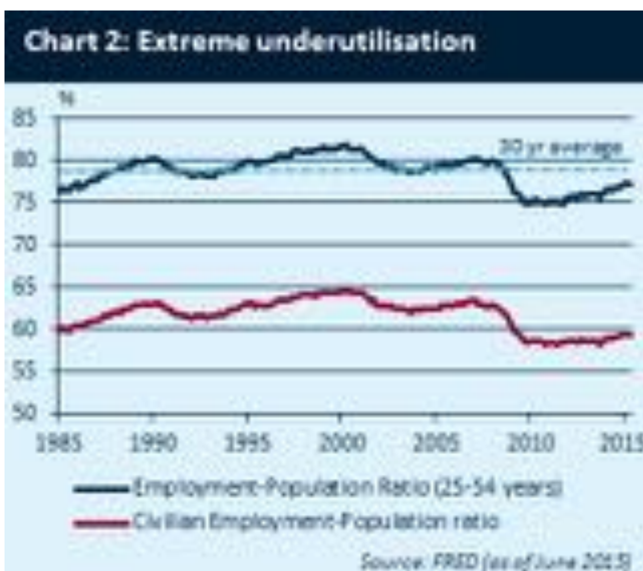
Contact:
Jeremy Lawson,
Chief Economist
jeremy_lawson@standardlife.com

US

Improving; could do better

The US economy deserves a modest pass mark in our half yearly report card, with several areas requiring improvement. Most positively, there is strong evidence that spare capacity in the economy is being gradually eroded. Although GDP contracted in the first quarter, we expect a solid rebound in Q2, with growth over the past 12 months coming in at around 2.5%, similar to its average since the recovery began. This is low compared with longer-term norms, but it is still around 0.75 percentage points (ppts) above our estimate of the economy's current potential growth rate. While employment growth has slowed a little over the past few months, both the standard unemployment rate and broader measures of labour underutilisation are trending down. Meanwhile, **our preferred measures of labour costs - the employment cost index and the Atlanta Fed's median wage index - are both growing at their fastest rates since the recession ended.** That said, the labour market has not yet returned to full health. The proportion of the labour force working part time for economic reasons is still much higher than it was during the peak of the early 2000s recession and the employment-to-population ratio for prime-aged workers is below its 30-year average (see Chart 2). Meanwhile, there is little sign that underlying inflation is picking up. Both core goods and core services inflation are well below their pre-crisis averages and rents are the only major component of the index trending up. Core PCE inflation, the series the Federal Reserve targets most closely, is only 1.2% at present and has actually declined over the past year.

Whereas the demand side of the economy is on a gradually improving trajectory, the supply-side remains in poor shape. Labour productivity growth began slowing in the early 2000s and has fallen away further since the global financial crisis, averaging less than 1% since 2011. Since the crisis, the slowdown is mostly attributable to a broad-based deceleration in investment spending, with little sign that a major upswing in capital spending is about to take place. Energy investment has fallen with commodity prices and manufacturing investment is being hit by the stronger dollar. The political and policy environment is also not conducive to productivity improvements. Congress has expended a lot of energy giving the president fast-track authority to complete the Trans-Pacific Partnership negotiations, but further trade liberalisation will likely have only modest effects on aggregate productivity growth. Meanwhile, there is little appetite to address public investment shortfalls, the inefficiencies of the tax code and the failings of the education system. As a consequence, living standards are growing slowly and inequality is rising. Finally, there has been mixed progress on private, public and external imbalances. The ratio of household debt to GDP has fallen meaningfully since the crisis, as have the liabilities of the financial sector. However, **the ratio of non-financial corporate debt to GDP has increased and general government debt has exploded, leaving the total private and public sector debt ratio little changed and currently trending up** (see Chart 3). The current account deficit is below pre-crisis levels, but it has widened over the past 12 months, in spite of a narrowing petroleum trade deficit. We have the rising dollar against a backdrop of weak global growth to thank for that, showing once again that the burden of global adjustment tends to fall most heavily on America.



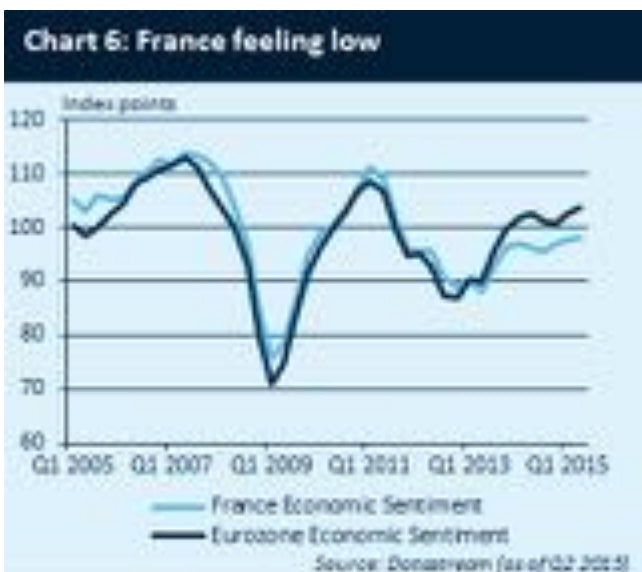
Europe

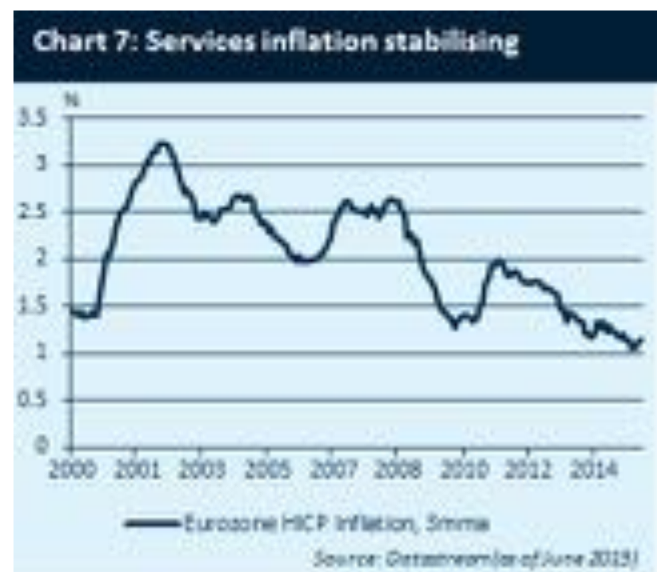
Getting on its bike

At the start of this year, we became markedly more upbeat on the Eurozone economy, raising our growth forecast for 2015 to 1.5% - which would represent the best year for the currency union since 2011. Fiscal headwinds had clearly abated, the banking sector was looking healthier, lower oil prices were feeding through to consumers and there were early signs of cyclical momentum building. The icing on the cake was the announcement of a surprisingly bold quantitative easing programme in January. To date, the region has met these raised expectations. Growth in Q1 accelerated to 0.4% quarter-on-quarter (q/q), driven predominately by domestic demand. Partial data and survey indicators over Q2 suggest that this growth rate will be maintained, or even exceeded. Crucially, there are further signs of a prolonged cycle setting in, which should further add to confidence. Employment has increased for five consecutive quarters, equating to 1.5 million more jobs in the region. The brightening outlook and a very gradual increase in capacity utilisation is encouraging investment, which was up 0.8% q/q in Q1. Households are purchasing big ticket items, with new car registrations hitting 14.7% year-on-year (y/y) in June, the strongest reported in a number of years. These indicators suggest that the recovery is becoming more entrenched. Rising activity is creating jobs and investment, which should in turn promote higher spending and growth in the economy.

Addressing the composition of Eurozone growth is always important. **The pick-up in activity looks to be encouragingly broad-based, although there are some laggards.** Spain continues to set the pace, growing by a punchy 0.9% q/q at the start of the year and looks set to grow around 3% this year. Italy grew by a more muted 0.3% q/q, but this still represents the best growth seen in this economy since the start of 2011 and is probably well above potential. Germany also grew by 0.3% q/q, although this was dampened by sizeable inventory and trade drags that should partly reverse over coming months. The Eurozone's largest economy is expected to grow 1.7% this year. Q1 growth in France was eye-catching at 0.6%q/q, but, beneath the surface, things were less rosy. Inventories contributed 0.5 percentage points (ppts) of this growth and survey data for France continue to lag the broader Eurozone pickup (see Chart 6).

Inflation has bobbled around with the oil price over recent months. Over 2015 as a whole, we expect headline price growth to average 0.3% y/y before accelerating to 1.4% next year as oil effects fade. **The path for core inflation is harder to predict, but will be more important.** Services inflation, which accounts for around two-thirds of core inflation, has stabilised at low levels (see Chart 7), illustrating the dampening impact of a large output gap on domestic price growth. A cyclical recovery should start to eat into this spare capacity and in time support a rise in underlying inflation. However, this will be slow, with core price growth to remain well below target this year and next. **Accordingly, we see little chance that the European Central Bank will end its QE programme early and may continue slightly longer than its September 2016 waystation.** However, we do think this policy will prove successful in reflating the Eurozone and that the central bank will be able to withdraw stimulus in 2017.





Against the odds

Japan appears an unlikely candidate to be the poster child of global growth. With the workforce set to decline 0.6% per annum this decade and 0.8% per annum in the 2020s, estimates of potential growth are rightly low, at around 0.5%. For this to rise significantly labour productivity growth will need to do more of the heavy lifting – and having already exceeded the G7 average over the past decade, it is difficult to see where the extra gains will be made. Yet, **despite the considerable long term impediments, the economy provided one of the biggest positive growth surprises so far this year.** Q1 GDP came in at an impressive 3.9% quarter-on-quarter (q/q) annualised, versus consensus expectations of just 1.6%.

Can this be replicated in the second quarter? Unfortunately, much of the strength in Q1 came from temporary factors. Inventory investment in particular contributed 2.0 percentage points (ppts) to growth in the quarter, which will reverse in Q2. Even more worryingly, the main pillars of growth in Q1 have begun to look increasingly fragile. The steady improvement in the Cabinet Office's synthetic consumption index have reversed in recent months, with consumer sentiment data also displaying signs of rolling over (see Chart 8). Whether this develops into a more sustained retrenchment is likely to depend on consumers' reaction to rebound in real income trends, as base wage rises start to outstrip core CPI. However, even if growth stumbles in the second quarter, consensus expectations remain elevated, with Japan expected to exceed its potential by a greater margin than most of its developed market peers over the next few years (see Chart 9). So why are hopes for growth in Japan so high and is it capable of meeting these expectations?

The conventional answer is that, while supply side reforms are being given time to raise trend growth, the government is pump-priming aggregate demand through aggressive monetary and fiscal stimulus. **Where things become more contentious is the question of whether these demand-side policies can drive up potential growth.** In Japan's case, it is argued that a sustained period of mild price declines resulted in a deflationary mindset that has dampened risk taking. If this mindset was changed, i.e. by an aggressive fall in real interest rates, then entrepreneurial activity would again be rewarded, reviving animal spirits and resulting in more than just a one-off impact on the economy. The problem with this argument is that it is extremely hard to quantify the motivations behind investment and consumption decisions, so gauging the success or otherwise of policies designed to influence these decisions is also difficult. For that reason, perhaps **the best gauge of progress in Japan is not the pace of growth but, rather, the composition.** The latest signs suggest that private sector demand is playing an increasingly important role in driving GDP, as the temporary effects of a weaker yen and fiscal stimulus fade. However, while the preconditions for a recovery in domestic demand are in place (easy financial conditions, higher real disposable incomes), the improvements remain moderate. This augurs for further supportive action, with monetary policy again likely to be used to seek to eradicate what remains of the deflationary mindset.

Chart 8: Consumption recovery fragile

Chart 9: Over-achiever

Falling behind

With very few exceptions, growth in emerging markets (EM) over the first half of 2015 was weaker than expectations. Following the oil price collapse at the end of 2014, it was widely anticipated that commodity exporters would suffer as their terms of trade deteriorated. However, by the same token, commodity importers were expected to reap the benefits from lower oil prices, and increased household consumption was expected to boost GDP growth. Unfortunately, this has yet to materialise. Weak external and domestic demand has held down growth, even in commodity importers such as Taiwan, Korea and Thailand. Furthermore, EM growth is likely to continue disappointing. Productivity is weakening across most EM countries, external demand (especially intra-EM demand) remains weak, credit conditions are tightening and profits are continuing to fall (see chart 10). **With the Fed on the cusp of normalisation, the biggest risk to global growth will remain centred in emerging markets.**

Latin American countries are still suffering from collapsing commodity prices and a bad situation in Brazil took a turn for the worse. The Brazilian economic situation was understood to be dismal following combined monetary, fiscal, and public credit tightening but much hope was pinned on Finance Minister Joaquim Levy's ability to improve the fiscal accounts. **Last week, the government took the unexpected step of cutting their fiscal surplus target from 1.2% of GDP to 0.15% of GDP, representing a blow to the fiscal adjustment process.** While it was widely expected that Brazil would not reach the target, consensus assumed they would make enough progress to maintain investment grade status. Now that assumption is being questioned. As part of the revision, the government also lowered the surplus targets for the next three years, pushing back their target of 2.0% of GDP surplus until 2018 (an election year). To stabilise the net debt-to-GDP ratio Brazil needs a primary surplus of 2.0-2.5%. With the target now pushed back to 2018, if growth continues to fall below forecasts or political pressure in 2018 causes the government to increase spending, Brazil's ability to stabilise its public debt becomes more uncertain.

Despite consecutive quarters of year-on-year growth registering 7.0%, the Chinese economy is resting on increasingly shaky foundations. Sequential growth in Q1 was the weakest quarter in many years, and **although the economy appeared to improve in the second quarter following stimulus measures, disappointing manufacturing data, weak corporate profits and slowing investment growth point to continued pressure on headline growth.** China's wild stock market swings stole most of the headlines over the first half of the year but the most important (and overlooked aspect) of China's economy under Xi Jinping has been the lack of any genuine state-owned enterprise reform. As industrial China slowed more rapidly than most expected, Chinese leaders responded with traditional support for infrastructure, instead of using the opportunity to push ahead with reforms. Indeed, there are signs of rebalancing as consumption and services makes up a greater share of GDP, but in order to truly improve the growth outlook, Beijing will need to decrease the state's influence in the economy and allow new entrants into more dynamic service sectors (see Chart 11).

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