Degroof Petercam

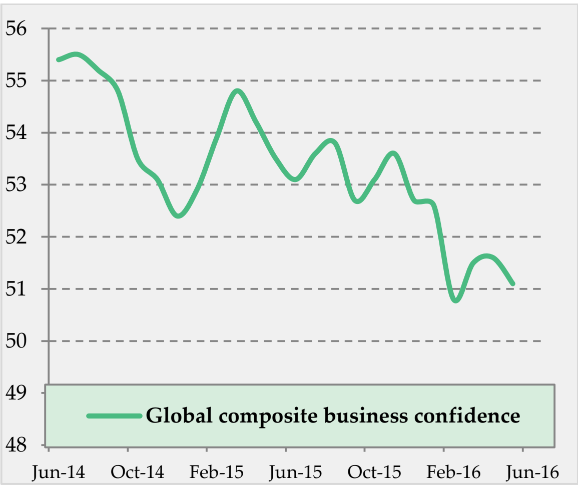
MACRO RESEARCH

June 2016

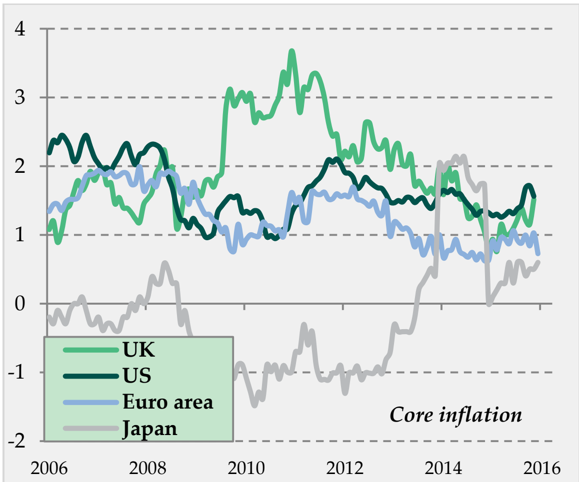
GLOBAL ECONOMIC OUTLOOK

- ✓ Global recession fears have eased over the past three months. That said, our global composite confidence indicator suggests that global economic activity is still weak. What's more, downward risks remain substantial. The global economy still seems stuck in a catch 22 situation as explained here.
- ✓ Monetary policy rates are hovering near zero in the Western world. The same goes for real yields on longer term bonds. At the same time, confidence indicators suggest global economic activity remains weak following what has been a very lackluster recovery since the Great Recession thus far.
- ✓ Looking beyond the short-term, we think the chances of a prolonged period of relatively slow growth (in combination with interest rates around the zero lower bound) are high against the back of strengthening demographic headwinds and less scope for debt accumulation going forward. That said, budgetary and monetary policymakers have not lost all ammunition to fight this extremely challenging situation. There is still room to do more (see here for example). Encouragingly, there is a growing awareness about the need for more expansive budgetary policies. At the same time, statements remain vague implying that actual implementation might take time.

Global economic activity remains weak



Underlying inflation still modest for now



Source : Datastream, Degroof Petercam

- ✓ Meanwhile, despite record low policy rates and huge expansions in the size of their balance sheet, most central banks are still looking for higher inflation prints.
- ✓ Even with the low level of commodity prices in place, however, base effects will send headline inflation higher in the second half of 2016. Core inflationary pressures look set to remain fairly modest for now, implying that global monetary policy will stay very loose for the time being. The outlook for inflation in a medium to longer-term perspective, on the other hand, is still subject to major uncertainty as explained here in more detail.

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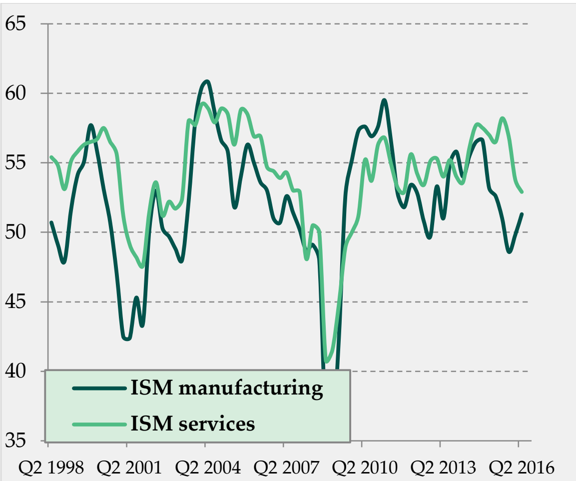
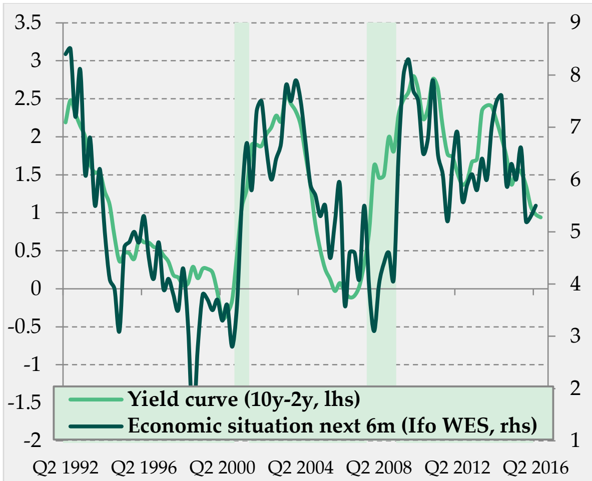
United States

- ✓ Following a very weak start of the year, growth in Q2 should come in somewhat better. However, US economic activity remains modest. The manufacturing sector still suffers from the stronger USD and problems in the energy sector. Confidence in the service sector, on the other hand, holds up better but has also come down in recent quarters. What's more, in line with the evolution seen over the past years, overall productivity growth remains very disappointing and the outlook for investment remains weak against the back of negative profit growth and relatively low capacity utilization rates.

Business confidence at modest level



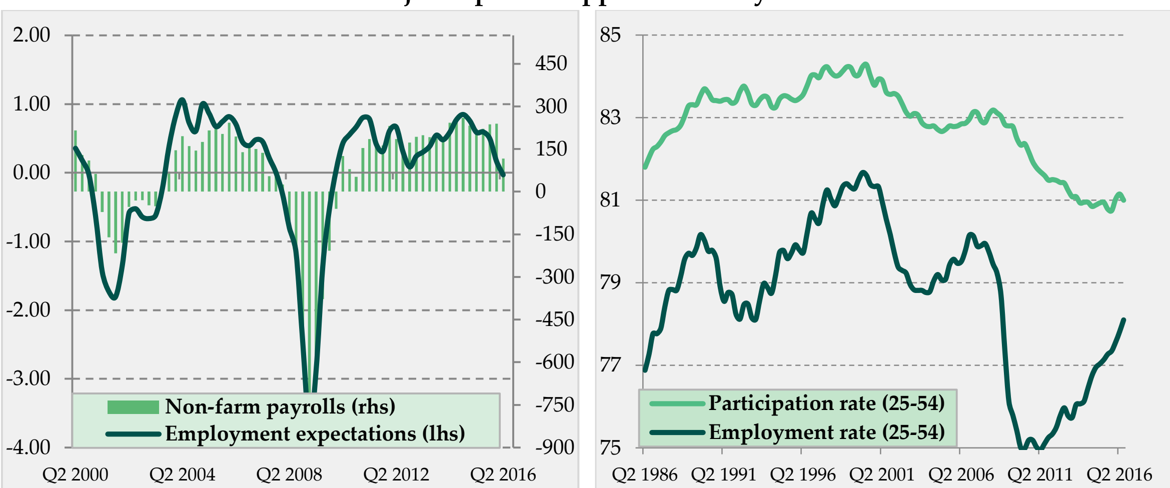
Yield curve flattening in line with slower growth



Source : Datastream, Degroof Petercam

- ✓ Though still in line with real consumption growth of around 2%, consumers' expectations about the future are softening a touch. All in all, consumer spending should hold up against the back of low energy prices, the continuing recovery in the housing market and decent job growth, although doubts about the latter are rising following a very weak job report in May.

US job report disappoints in May



Source : Datastream, Degroof Petercam

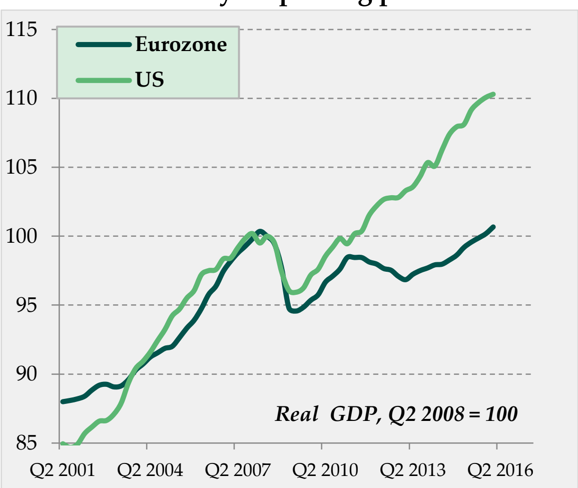
- ✓ Adding 200K jobs on average over the past 12 months, the labor market performed very solidly. But May's payroll report (only adding 38K jobs) was quite disappointing. Although the latest figure is not truly reflecting the underlying state of the labor market (because of the Verizon strike), the weaker number is consistent with what surveys had been suggesting for quite some time already. Jobless claims on the other hand remain very low and the headline unemployment dropped further towards 4.7%. That said, the latter was mainly due to another big drop in the labor force.

- ✓ Wage growth plays a key role with regard to the future path of inflation and is slowly picking up. At 2.5%, however, the level remains below its 30-year average of around 3%.
- ✓ Base effects linked to energy prices will make sure that headline inflation (now at 1.1%) will trend higher towards the end of the year. At 2.1% and 1.6% for core inflation and core PCE inflation (which is more important for Fed) respectively, underlying inflation is moving up.
- ✓ Looking forward, however, evidence is mixed with the evolution in unit labor costs suggesting that core inflation should pick up further (accelerating wage growth in combination with slow productivity growth) while price surveys paint a more modest outlook in this respect.
- ✓ May's disappointing job market report implies that a June rate hike is off the table. All in all, US policymakers are not in a hurry to raise interest rates. Modest growth in combination with below target inflation means that the Fed continues to adopt a very cautious wait-and-see approach as has been the case for several years now.

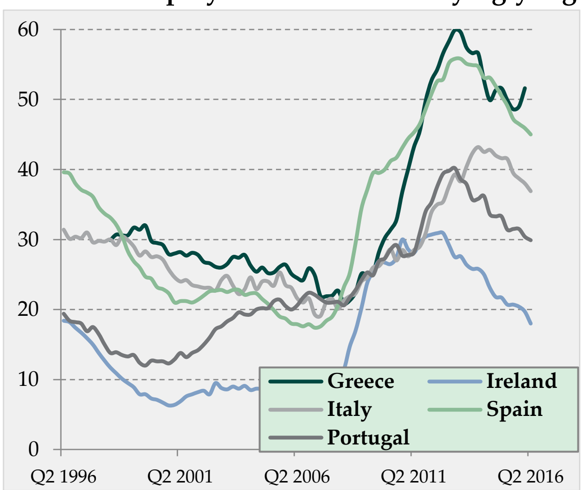
Eurozone

- ✓ The eurozone economy expanded solidly at the start of the year (2.1% QoQa, 1.5% YoY). In doing so economic activity has now just passed its pre-crisis peak level, a very disappointing run so far.
- ✓ Looking forward, economic activity should hold up in the near future against the favorable backdrop of low energy prices, the current low yield environment and EUR weakness. That said, this recovery is still far from spectacular. What's more, confidence indicators are not pointing to further growth acceleration and structural headwinds remain strong.
- ✓ In line with the improvement witnessed in economic activity, the labor market is also recovering. Unemployment rates have been coming down throughout the region. Importantly, however, youth unemployment remains worryingly high, especially in Greece and Italy.

Economic activity surpassing pre-crisis level



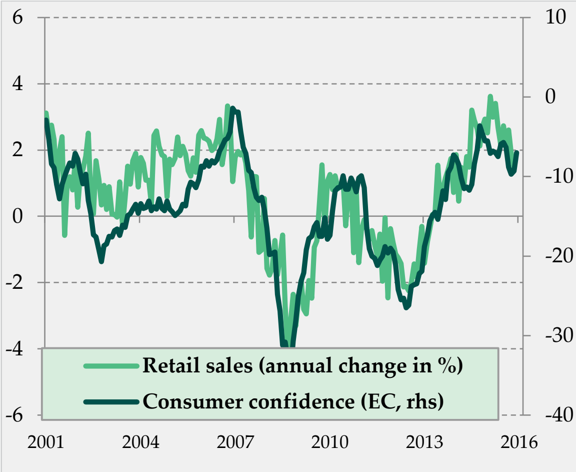
Youth unemployment remains worryingly high



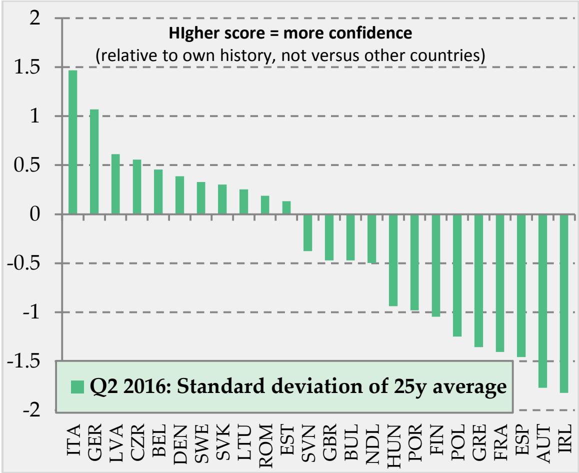
Source : Datastream, Degroof Petercam

- ✓ European politics remain worrying in the sense that the currency union still faces existential challenges against the back of rising populism and waning appetite for further fiscal integration. Confidence in government economic policy is very low in a significant number of European member states.

Consumer spending holds up



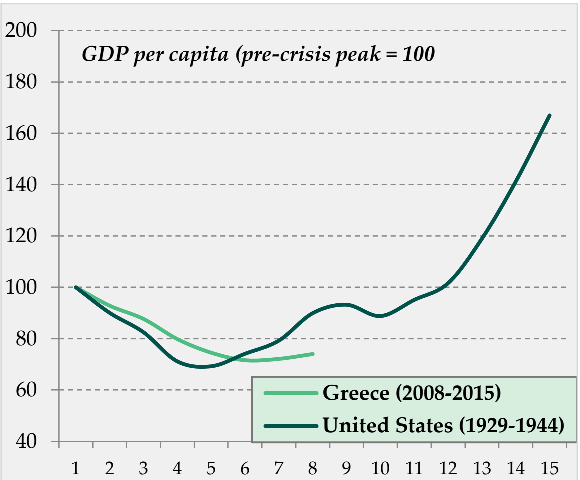
Confidence in government economic policy



Source : Datastream, Degroof Petercam

- Even though a new political agreement was found in late May, the Greek situation remains structurally unresolved and the can has been kicked down the road once again. Imposed budgetary tightening keeps Greece stuck in recession with unemployment and public debt levels at very high levels. The economic and social situation remains unsustainably weak. Therefore, political risks remain high.
- The political situation in Spain is still uncertain. New elections will be held later this month but the formation of a coalition could still prove very difficult. The ECB's QE program, however, is likely to prevent that government bond spreads widen sharply.
- The Brexit risk is real and the debate has intensified in recent months. Our scenario is that Brexit will ultimately be avoided (see here for example). That said, risks remain high. In case Brexit were to happen, the immediate market reaction could prove very negative. Afterwards, the reaction will be more path dependent. In a short to medium term perspective, the market reaction will depend on how hostile or friendly the exit from the EU would be organized. In a medium to longer-term perspective, the critical factor is whether Brexit would lead to further EU integration or disintegration.

Greek society under severe pressure

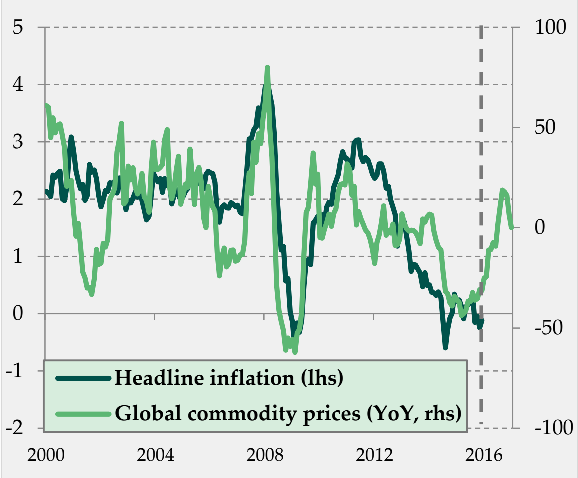


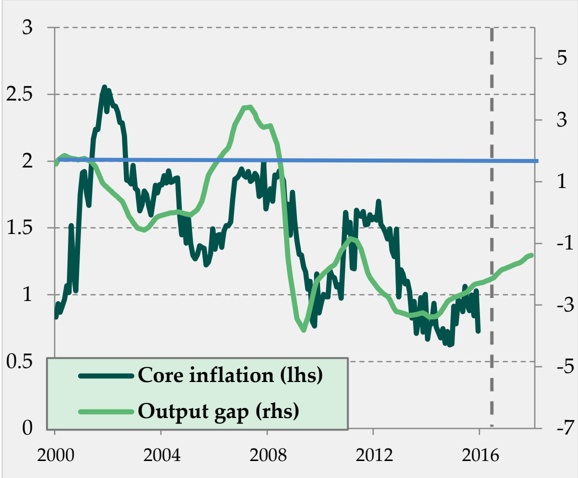
Source : Datastream, Degroof Petercam

- Headline inflation (-0.1 % yoy in April) is held down by the earlier steep fall in energy prices but base effects will send it higher in the second half of the year. Underlying price measures remain very weak reflecting the slack in the labor market. Given the persistence of the large negative output gap, core inflationary pressures are expected to stay very weak. All in all, despite the latest easing measures taken in March, the ECB still looks to experience major difficulties in getting inflation up to its target of 2% anytime soon (see here for more information).

✓ In its June press conference, the ECB stood pat while it awaits the effects of the policy measures announced in March. President Draghi, meanwhile, left the door open to further policy action at a later stage but it should be clear that opposition is rising and also that more monetary easing is no panacea in a liquidity trap situation. Indeed, a more expansive budgetary stance is likely to prove more helpful in this respect. The ECB has been hinting in this direction more recently.

Base effects will send inflation higher but ECB still facing serious difficulties to structurally reach target



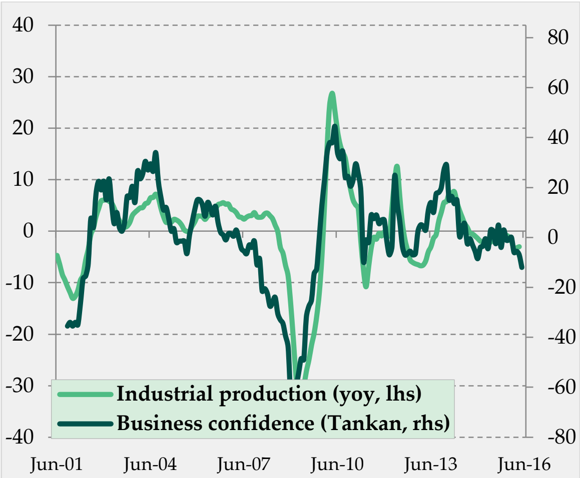


Source : Datastream, Degroof Petercam

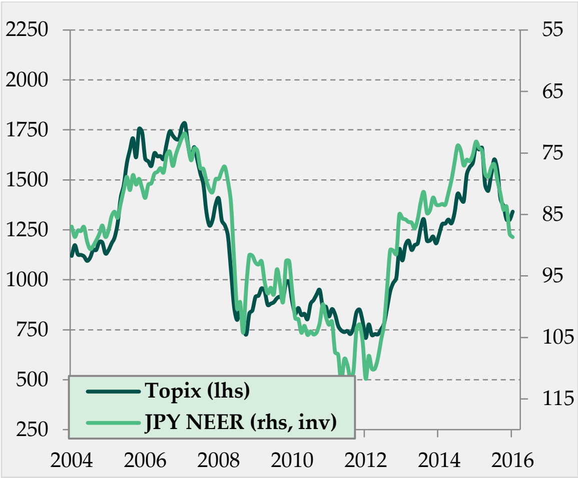
Japan and Emerging Markets

✓ Economic activity in Japan is still weak and business confidence indicators are turning south again. Wage growth remains subdued despite the tightening labor market. Inflation, meanwhile, remains significantly below the Bank of Japan's 2% target. What's more, JPY has seen substantial appreciation in recent months, in turn weighing on Japanese stock prices. All this implies that the BoJ firmly keeps its bias towards further monetary easing.

Sluggish economic activity



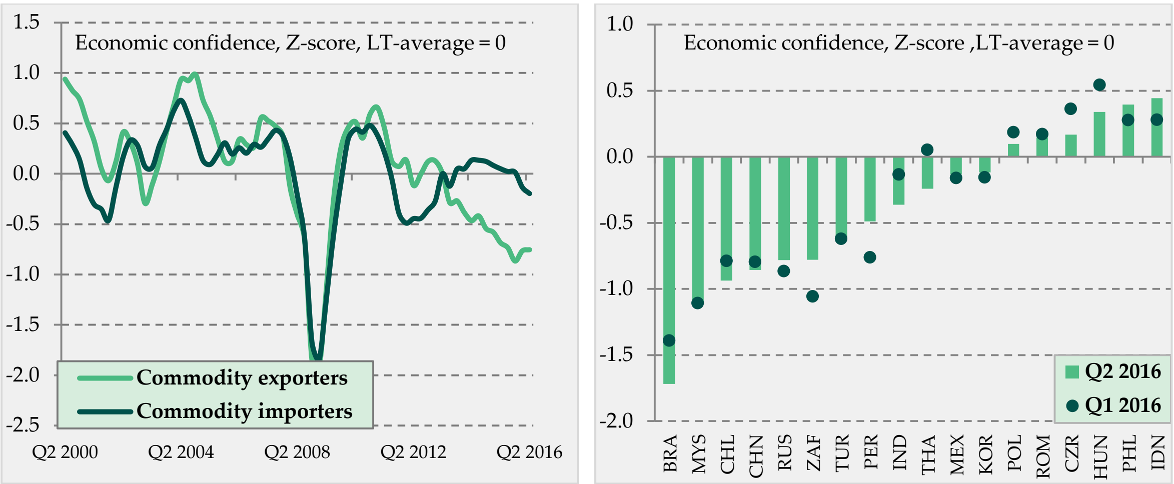
JPY appreciation weighing on stock prices



Source : Datastream, Degroof Petercam

- More broadly in EM, the slowdown witnessed over the past few years reflects several factors including the negative effect of lower commodity prices, tighter external financial conditions linked to the prospect of the hiking cycle in the US, the private sector debt overhang, economic rebalancing in China, structural bottlenecks as well as distress related to (geo)political factors. Moreover, there are signs of premature deindustrialization in several important EM which is worrying in a medium to longer term perspective.

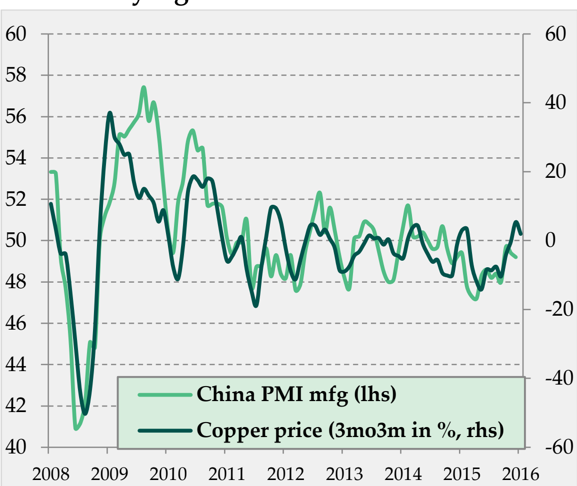
EM economic activity in EM remains weak



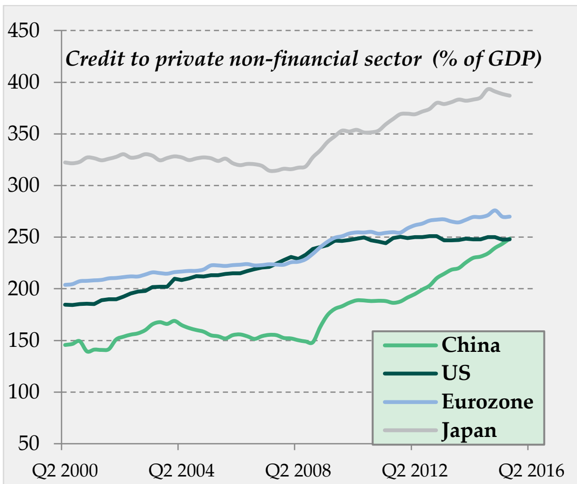
Source : Datastream, Degroof Petercam

- Sentiment towards EM has improved in recent months against the back of reduced (slightly) USD strength and uptick in commodity prices. But EM are not out of the woods yet. China's challenging rebalancing exercise and uncertainties linked to monetary policy tightening in the US could easily expose more EM weakness (see here for more information).

Early signs of stabilization in China



The Chinese debt explosion



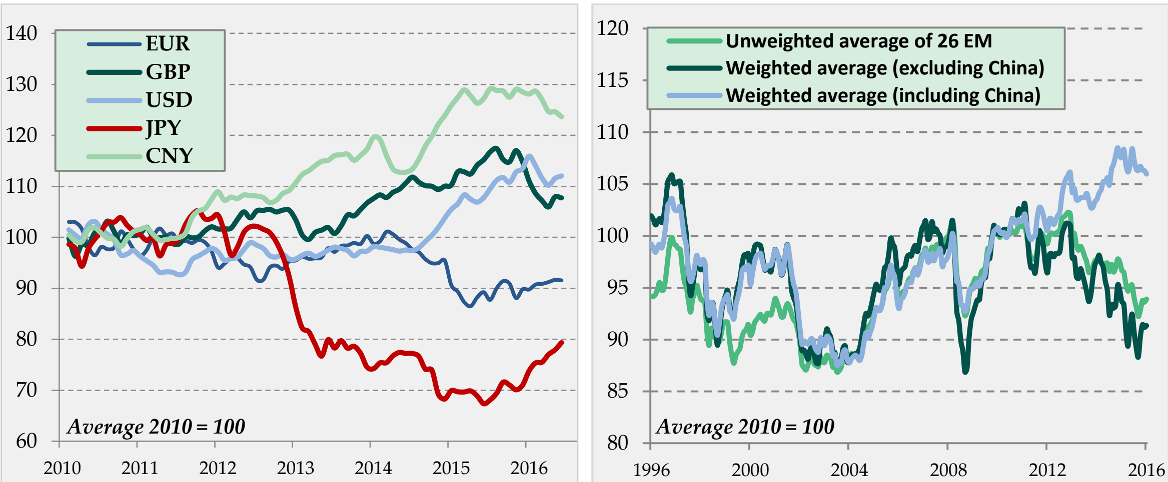
Source : Datastream, Degroof Petercam

- Chinese hard landing fears have been receding over the past three months and a large one-off depreciation has been avoided, at least for now. This is completely in line with the scenario we described earlier (see **here** and **here** for example). The combination of monetary and budgetary measures is driving a cyclical recovery. But while we were right on this call, we are still convinced that the medium to longer term outlook for China will prove extremely challenging.

- ✓ Moreover, it would not be surprising that worries about the sustainability of the current recovery soon pop up again. Indeed, the background of fake growth figures, soaring house prices and continued rapid credit growth is far from comfortable and will give rise to more and more concerns about the state of China's economy. How will Chinese policymakers reconcile the ambition of strong growth and the need for further economic rebalancing while at the same time avoiding the stop-and-go policies seen in recent years? The short answer is that this will prove close to impossible. That's why, despite the recent calmness, concerns about China look set for a comeback in the not so distant future as also explained here.
- ✓ From an EM wide perspective, inflation remains under control. That said, significant differences between countries exist. While inflation in countries like Brazil, Turkey or Russia is still at uncomfortably high levels, inflation in other countries including Korea, the Philippines, Poland or Hungary remains below target. All in all, the combination of subdued economic activity, stabilization in EM currencies and commodity prices should make sure EM inflation remains in check.

Currencies

Real effective exchange rate



Source : Datastream, Degroof Petercam

- ✓ Our long-held stance that the consensus view of a continued USD appreciation should not be taken for granted, has been proven right so far (more here). We continue to think that a sharp appreciation from current levels should not be expected. Despite the latest depreciation the USD still looks rather expensive from a long term theoretical perspective. That said, more evidence of the Fed moving towards another rate hike could lead to a slightly stronger USD in the next couple of months.
- ✓ With inflation pressures still modest and growth prospects weakening significantly, the BoE is not in a hurry to hike interest rates. The risk surrounding "Brexit", an issue that has gained more attention in recent months, poses downward risks for the GBP. A "remain vote" is likely to result in only limited GBP appreciation given the weaker growth outlook and large current account deficit.
- ✓ The JPY has been strengthening in recent months. From a LT-perspective, it seems that the JPY has now become a little bit too expensive versus the EUR. A further sharp appreciation from current levels looks unlikely. That said, this will largely depend on upcoming central bank moves from BoJ and ECB.
- ✓ EM currencies experienced serious downward pressure since the May 2013 taper tantrum but entered calmer waters more recently. Investor appetite for EM assets has waned and sustained EM currency weakness is likely given the subdued growth outlook. That said, given the depreciation already seen since

the spring of 2013 and the recent stabilization in leading indicators, the risk of another sharp hit now looks smaller. Indeed, in real effective exchange rate terms, EM currencies (weighted by GDP ex China) have depreciated around 10% since May 2013 on average (strong difference from country to country).

- ✓ In contrast to what many observers have feared since the summer of 2015, the RMB has not seen a large one-off depreciation so far just like we had expected (see here for more details). More recently, following the latest G20 meeting in Shanghai late February, there seems to be more consensus on this call. That said, we would certainly not rule out the possibility of a big depreciation altogether. The reason is that we have become even more concerned about the sustainability of China's economy as explained higher.

GDP and CPI Outlook

	GDP			Inflation		
	2015	2016	2017	2015	2016	2017
US	*2.4*	**1.6**	**1.7**	*0.1*	**1.1**	**2.1**
		1.8	*2.3*		*1.2*	*2.3*
Eurozone	*1.5*	**1.5**	**1.4**	*0.0*	**0.3**	**1.3**
		1.6	*1.6*		*0.2*	*1.3*
Japan	*0.5*	**0.5**	**1.0**	*0.8*	**0.0**	**1.4**
		0.5	*0.5*		*0.0*	*1.5*
China	*6.9*	**5.5**	**5.0**	*1.5*	**2.1**	**2.2**
		6.5	*6.3*		*1.9*	*1.8*

Degroof Petercam forecasts as of 7 June 2016, *Consensus forecasts*