RICHES FLORES RESEARCH

GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

January 17, 2014

FORECASTS

# Scenario 2014–2015 : The Roller Coaster Economy

2014 is off to a positive start: U.S. growth is trending upward, the euro area is pulling out of recession, Japan is reaping the benefits of its competitive strategy, and world trade is picking up. All these bright spots should be enough to end two years of global deceleration and bring about a return to growth of over 3 percent this year. But while this is certainly good news, it doesn't tell us much about the key challenges ahead. To understand them, we need to address the much more complex question of whether 2014 will usher in a second leg of the global recovery—one that is sufficiently sturdy to ensure a lasting upswing and leave five years of convalescence well behind us. As things now stand, we feel we still have two good reasons for assuming it won't:

1. The deleveraging process is still producing dysfunctional effects around the world.
2. Five years of crisis have seriously eroded the global economy's growth potential and its ability to handle the higher interest rates the current upturn will inevitably entail.

This suggests that we are in for a period of economic instability. We are therefore forecasting that after 3.5 percent growth in 2014, global GDP will increase by only 3 percent in 2015.

The upturn, then, is likely to be short-lived, yet it's still a reality—meaning it will necessarily affect market expectations.

We are sharply raising our long-term interest-rate forecast for the first half of 2014, but we predict backsliding before the year is out. Needless to say, there will be timid attempts at returning to normal monetary policy in the first few months of the year, but because they are unlikely to get very far, our outlook up to mid-2015 does not involve increases in key rates by the leading central banks—the Federal Reserve, the ECB, the BoJ.

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Although initially encouraged by the improved economic climate to press ahead with tapering, the Fed may soon find itself overwhelmed by largely uncontrollable jumps in long-term Treasury yields.

All in all, this should be a highly volatile year.

## Key Macroeconomic Assumptions

### Global Scenario - January 2014

| | 2013 | | 2014 | | 2 015 |
|---|---|---|---|---|---|
| **Real GDP Growth Rate, %** | Jan-14 | *Oct-13* | Jan-14 | *Oct-13* | Jan-14 |
| **WORLD*** | **3.0%** | *2.8%* | **3.5%** | *3.0%* | **3.0%** |
| **US** | **1.9%** | *1.4%* | **2.6%** | *1.7%* | **2.2%** |
| **EMU** | **-0.3%** | *-0.3%* | **1.1%** | *0.9%* | **1.1%** |
| - Germany | 0.5% | *0.4%* | 1.8% | *1.5%* | **1.5%** |
| - France | 0.2% | *0.3%* | 1,0% | *0.8%* | **1.1%** |
| - Italy | -1.8% | *-1.8%* | 0.5% | *0.3%* | **0.5%** |
| - Spain | -1.4% | *-1.4%* | 0.5% | *0.5%* | **0.7%** |
| **JAPAN** | **1.8%** | *1.9%* | **2.1%** | *1.9%* | **1.3%** |
| **CHINA** | **7.5%** | *7.3%* | **7.5%** | *7.0%* | **7.0%** |
| **BRAZIL** | **2.1%** | *2.9%* | **2.7%** | *2.5%* | **1.8%** |

*At 2011 PPP exchange rates

Source: RichesFlores Research

| | | | Forecast | |
|---|---|---|---|---|
| | At 1/17/14 | **Jun-14** | **Dec-14** | **Jun-15** |
| ***10-year government bond yields*** | | | | |
| **US** | **2.9%** | **3.0% - 3.3%** | **2.8% - 3.0%** | **2.5%-3.0%** |
| **EMU** | **1.9%** | **2.0% - 2.2%** | **1.8% - 2.0%** | **1.3% - 2.0%** |
| ***Key interest rates*** | | | | |
| **Fed funds** | **0.0%** | **0.0%** | **0.0%** | **0.0%** |
| **ECB** | **0.30%** | **0.25%** | **0.25%** | **0% - 0.25%** |
| ***Exchange rates*** | | | | |
| **…$/ EUR** | **1.35** | **1.32** | **1.35-1.40** | **1.40 +** |
| **…JPY/$** | **104** | **115** | **110** | **120** |

Source: RichesFlores Research

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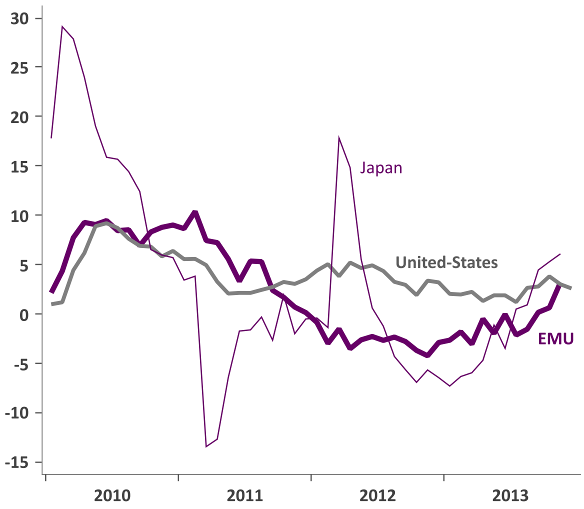
# Acceleration Under Way

The global economic outlook has improved substantially in the past few weeks—so substantially in fact that we are updating our forecasts, against a far more encouraging backdrop than the last time around in October.

Although the U.S. recovery has probably gotten the most airplay, similar trends can be seen in countries like Japan, South Korea, Germany, and now most euro area Member States as well, including France—despite the conflicting messages conveyed until recently by PMI surveys.

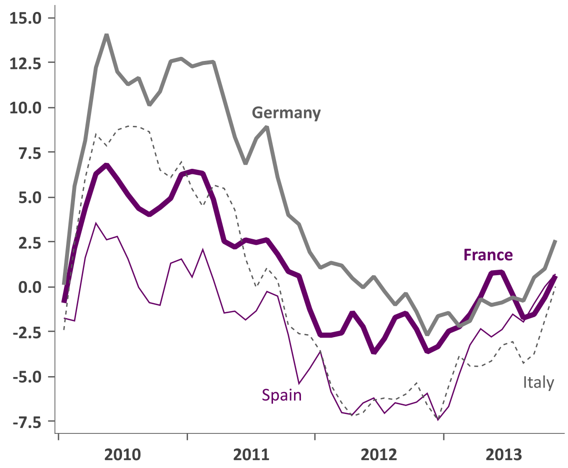
**Manufacturing Output, YoY (%)**




Sources: RichesFlores Research, Macrobond

**Industrial Production, excl. Construction**

YoY (%), 2MMA

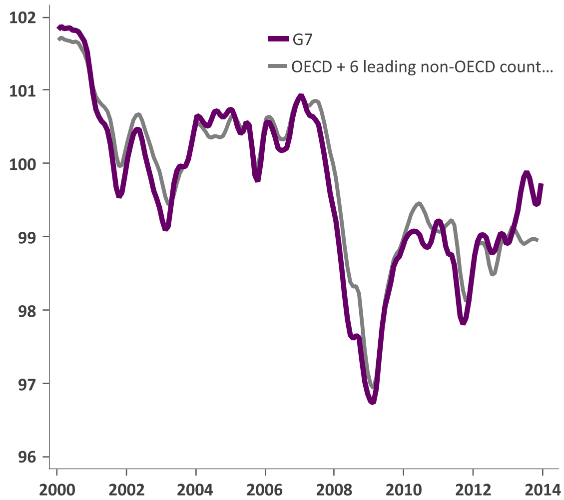



Sources: RichesFlores Research, Macrobond

Contrary to expectations, emerging market economies aren't the ones powering the acceleration under way. The impetus is instead coming from advanced countries, where corporate CEOs have brighter outlook for their domestic economies, which is lifting both business confidence and business activity.

That renewed corporate optimism is being driven by encouraging consumer trends. Households have started loosening their purse strings—witness the large-scale rebound in sales of cars and other durable goods, and the steady improvement in consumer sentiment. Low inflation can take part of the credit for these developments in Western countries, while expectations of higher inflation have boosted consumer spending in Japan. More importantly, the rosier employment outlook is beginning to yield tangible results. In the U.S., household sentiment toward the labor market has gradually picked up, despite an ongoing decline in the labor force participation rate. In the euro area, surveys of manufacturers' hiring plans point to increased hiring—an improvement corroborated by decreasing household concerns over future unemployment.

## OECD Consumer Confidence indicator




Sources: RichesFlores Research, Macrobond

## US Household Spending, Constant Prices

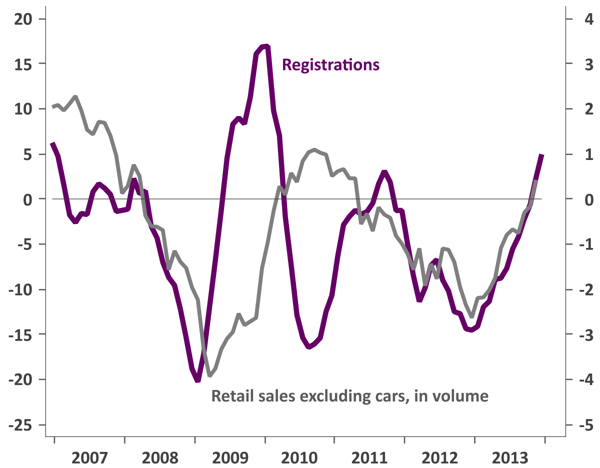

Sources: RichesFlores Research, Macrobond

## Employment Outlook in Industry

Centered-standardized


Sources: RichesFlores Research, Macrobond

## Retail Sales and New Car Registrations in the EMU, YoY (%)

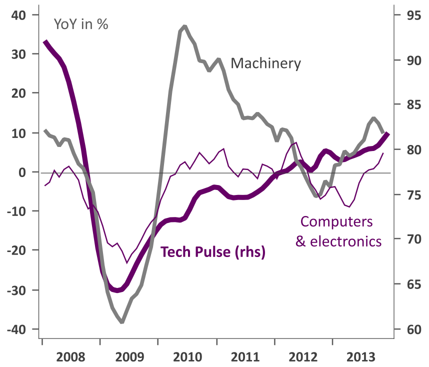



Sources: RichesFlores Research, Macrobond

The corporate investment outlook also shows signs of recovery. After two disappointing quarters, U.S. indicators like orders for capital goods, the San Francisco Fed's Tech Pulse Index, and capacity utilization rates have all taken a turn for the better. Meanwhile, a weaker yen has boosted corporate margins in Japan, thus sparking renewed capital spending by the country's firms. Dmestic orders for capital goods jumped 18 percent in 2013—the highest increase since the early 2000s. And while the recovery is more tentative in Europe, it is apparently strong enough to stimulate an uptick in corporate spending, as demonstrated by the surge in capital goods orders recorded by German manufacturers over the past few months.

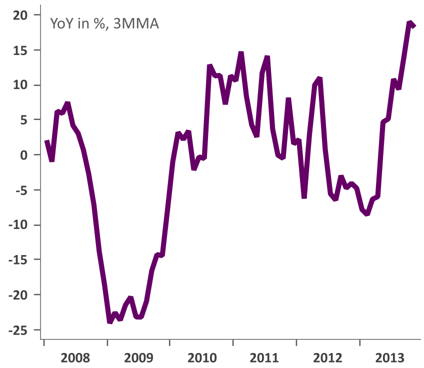
## Leading indicators of Corporate Investment

Capital Goods Orders & Tech Pulse in the U.S



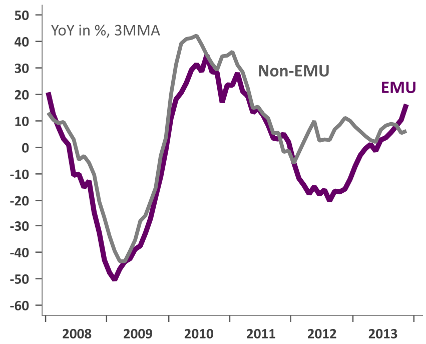

Sources: RichesFlores Research, Macrobond

New Domestic Orders for Capital Goods in Japan




Sources: RichesFlores Research, Macrobond

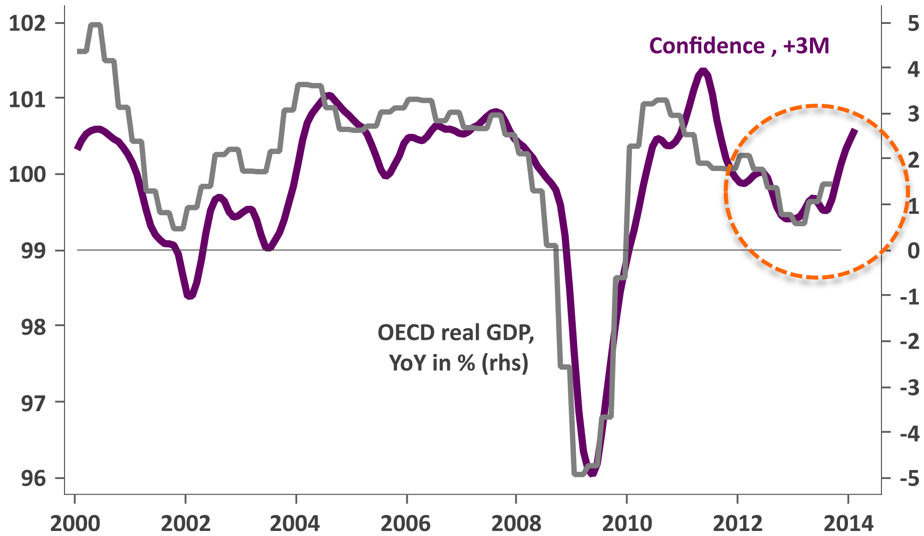
New Orders for German Capital Goods, by Destination




Sources: RichesFlores Research, Macrobond

If things keep up like this, economic growth should soon gain traction. The numbers for Q4 2013 may well prove to be the run-up to a return to growth in most industrialized countries, given that we can expect current trends to pick up in earnest in the first half of 2014.

Industrial Confidence Indicator and GDP Growth in




Sources: RichesFlores Research, Macrobond

Will this promising start to the year make it possible to turn the page on five years of crisis, and put the world economy on track for more robust, more sustainable growth? The idea is certainly appealing enough. The prospects at this stage look good, and global growth will in any event exceed previous estimates—averaging 3.5 percent in 2014. However, fits and starts are an inherent feature of an economy on the mend—like ours today. A review of the structural impediments still with us might therefore help us avoid getting carried away.

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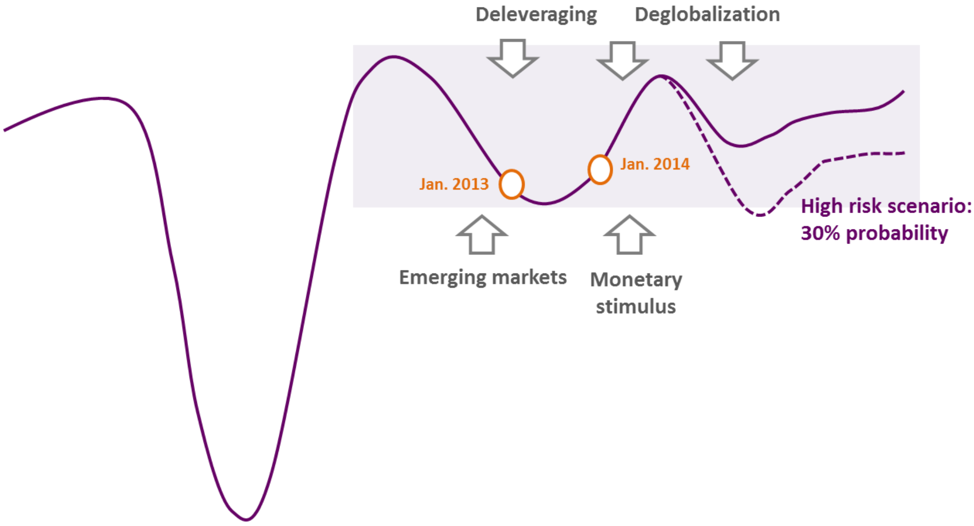
# Reviewing the Fundamentals

In early 2009, when economists were being asked to summarize their macroeconomic trajectory forecasts in a letter (V-shaped or L-shaped?) or symbol (single- or double-dip?), we at RichesFlores opted for the square root symbol. To us, this shape best reflected our outlook for future economic growth. We believed in a swift global recovery followed by a prolonged period of sub-par growth marked by serial instability and recurring crises. At the time, we emphasized three main structural challenges to world growth: deleveraging, the attendant deglobalization, and structurally high commodity prices. Expansionary monetary policies and emerging market growth, we argued, were all we could count on to keep the global economy on its feet, avert a wave of deflation, and lay the groundwork for an eventual inflationary exit from the crisis.

## Medium-Term Trend Scenario for the World Economy



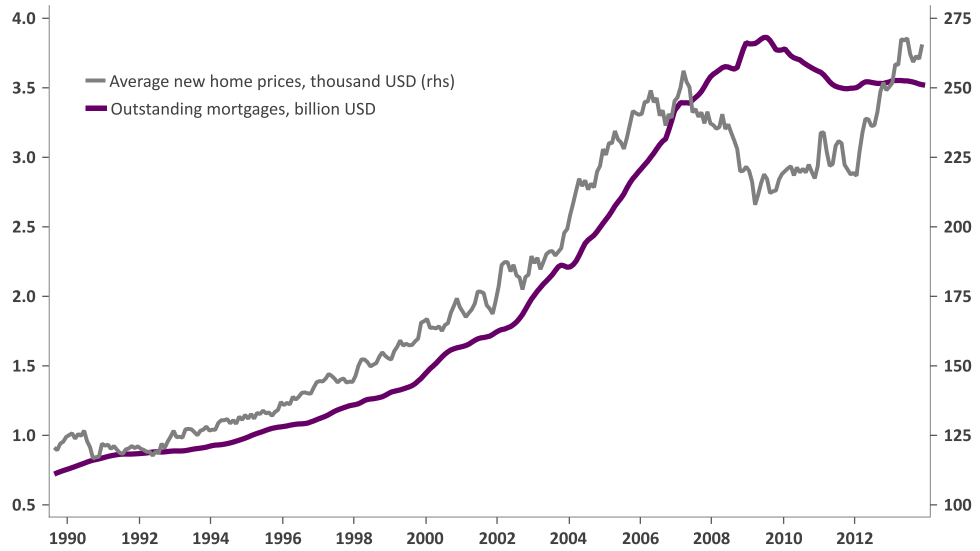

Source: RichesFlores Research

So nearly five years on, how far along are these medium-term adjustments?

The financial clean-up process—an aspect of deleveraging—has been sending shock waves through the world economy. And while these are not as intense as they initially were, they still pack quite a punch.

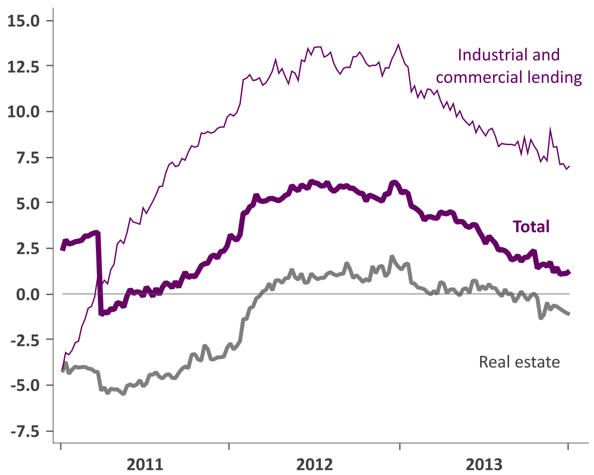
- The first and most obvious effect has to do with financing the real economy. And by this measure, we still haven't made it to first base. Both in the U.S. and in Europe, lending to businesses is still inordinately low—and getting lower. At the same time, corporate debt levels, while not as high as before the crisis, are stuck well above their long-term average. Some pundits cite the current U.S. real estate rally as proof that the damaging effects of deleveraging are over; we take a much less sanguine view. Sure, housing prices have risen close to pre-crisis highs. But with the volume of outstanding mortgages still at the same level as two years ago, there are serious grounds for wondering whether the recovery is all it's cracked up to be. Europe's economy is unquestionably giving off the most encouraging signals we've seen in over two years. Yet the channels for financing the real economy still aren't working properly, and the banking system in several countries gives us further cause for concern.

**Outstanding Mortgages and House Prices in the US**




Sources: RichesFlores Research, Macrobond

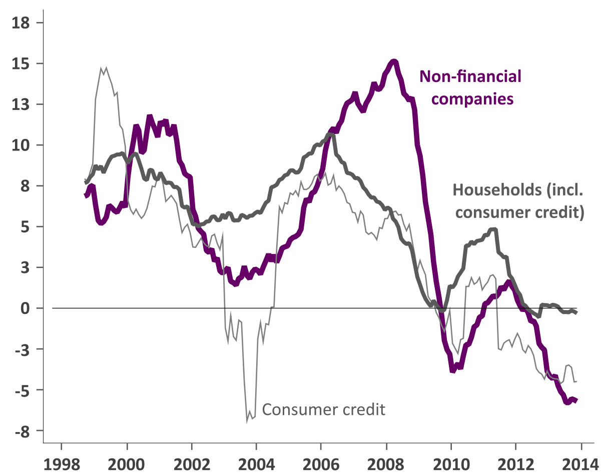
**Bank Loans to the U.S. Private Sector, % change YoY**




Sources: RichesFlores Research, Macrobond

**Loans to the EMU Private Sector**

YoY in %

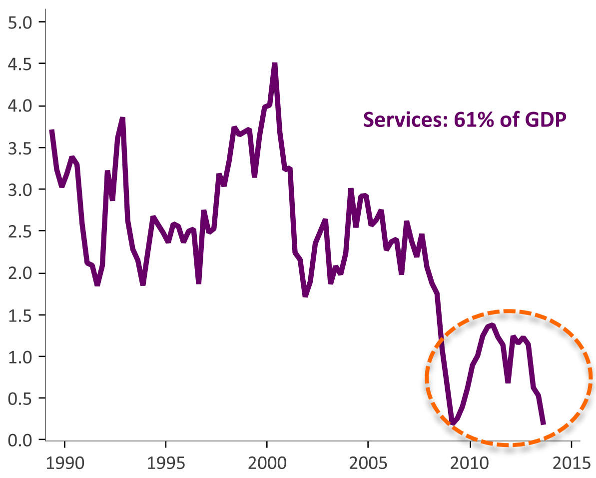



Sources: RichesFlores Research, Macrobond

- Deleveraging affects more than just the property market, however. The balance-sheet shrinkage it has imposed on companies, households, and governments alike has also meant less business for the service sector. As a result, the primary engine of growth and job creation in advanced economies is virtually idle in most countries. In the U.S., the service sector grew by only 0.2 percent between Q3 2012 and Q3 2013, compared with growth of nearly 5 percent in the rest of the economy. In many European countries as well, service activity has been so anemic that it is exerting worrisome deflationary pressure, as evidenced by steeply declining labor costs and falling core inflation. The economic upturn under way will of course give service businesses a welcome breather, but it will take a lot longer than a few good quarters for them to recover their role as drivers of GDP growth and employment—and for the deflationary trends currently influencing price formation to go away.

**Valued Added in US Services**

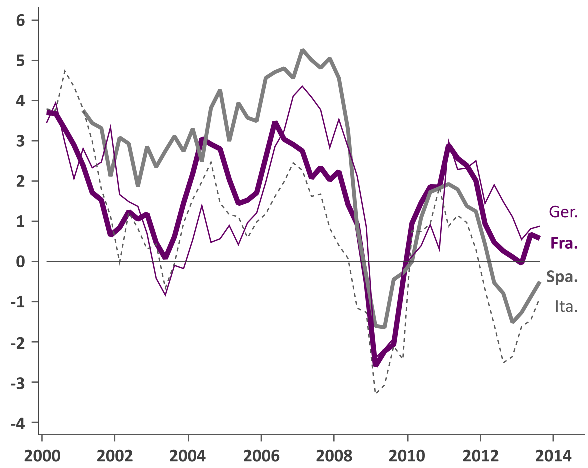
Constant prices, YoY (%)




Sources: RichesFlores Research, Macrobond

**Valued Added in EMU Services**

Constant prices, YoY (%)

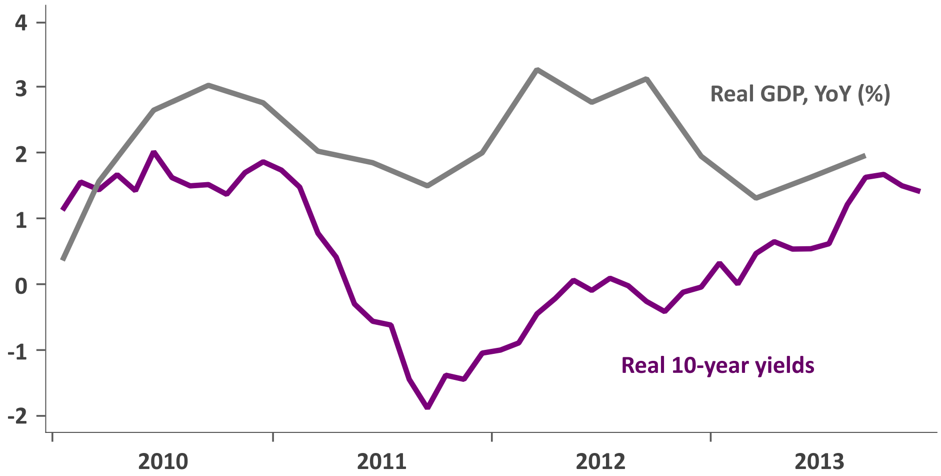



Sources: RichesFlores Research, Macrobond

- Last of all, the current-account rebalancing that comes with deleveraging has eliminated one of the crucial sources of global growth in the two decades preceding the crisis: the explosion in world trade. The volume of world exports increased almost three times faster than output between 1990 and 2008, whereas in the past five years, the percentage of global growth attributable to imports hasn't budged. Nor is there much chance that international trade will "return to its former self" any time soon. Exactly how large is the shortfall caused by the loss of this vital mechanism for transmitting growth among world regions? Hard to say, but it leaves the emerging economies in a particularly vulnerable position (see our latest monitor report on world trade).

So the structural impediments to growth still cast an imposing shadow—just when the factors supporting growth are eroding. For one thing, monetary stimulus policies are on the way out: at end-2013, real long-term yields stood at 1.8 percent; i.e., practically on par with GDP growth. For another, emerging economies currently seem unable to live up to the high hopes placed in them until recently.

## US: Real GDP Growth Rate and Real 10-Year Yields

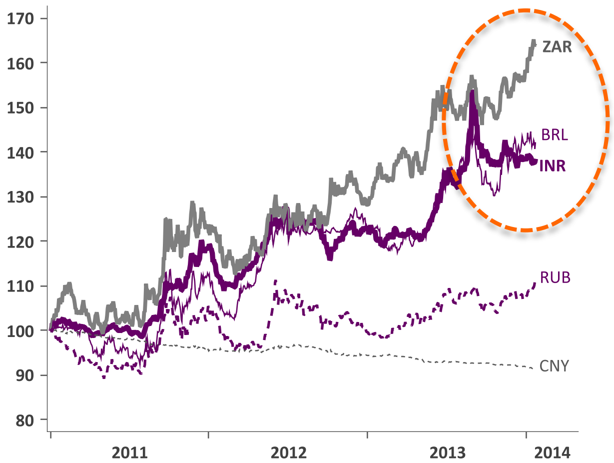



Sources: RichesFlores Research, Macrobond

China's new course since 2011 has considerably diminished its role as powerhouse for other emerging economies. It has saddled the country's Asian neighbors with excess manufacturing capacity—a major growth inhibitor—and deprived leading emerging countries elsewhere of a key outlet for commodity exports—without which they have no way to pay for their catch-up process. Not only have the resulting imbalances led to widespread turmoil in forex markets outside of Asia, but the nascent recovery in the developed world is likely to make matters worse in the short run. **Viewed until recently as a global growth driver of last resort, the emerging world is rapidly turning into the primary locus of future risk.**

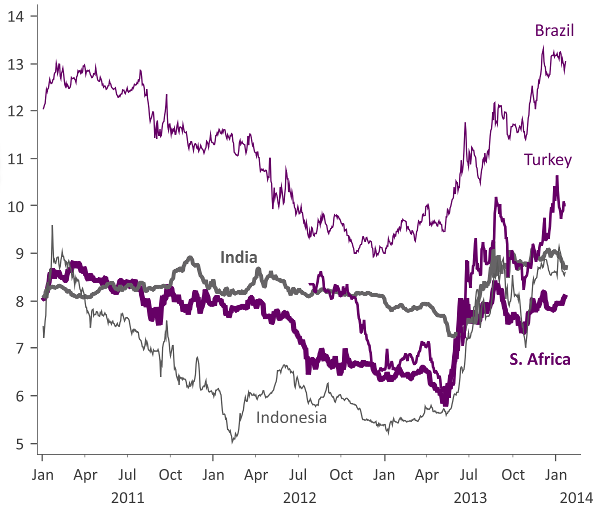
### Exchange Rates Against the USD

Jan. 1 2011 = 100




Sources: RichesFlores Research, Macrobond

### 10-Year Government Bond Yields




Sources: RichesFlores Research, Macrobond

**All this makes it hard to be resolutely optimistic. Despite the encouraging trends taking shape, there is little reason to bet on a lasting improvement in the global growth outlook.**

# Riding the Roller Coaster

The preceding analysis strongly suggests we are in for a bumpy ride. Here's what we see in store for each half of 2014.

## H1 2014: Recovery

Developments in the coming months should confirm the perception that a lasting recovery is under way—which, combined with the Fed's change of course on monetary policy, will likely send market expectations on interest rates into reverse. We expect to see the following main trends in the first half of 2014:

- The upswing in industrialized countries will become further entrenched. The U.S. jobless rate will sink to 6.5 percent by spring, oil prices will rise, and consensus forecasts for growth in 2014 and 2015 will likely be revised throughout the six months

- The markets will be increasingly betting on an acceleration in Fed tapering and will be pricing in a first rate hike in early 2015. This renewed enthusiasm is likely to spill over to expectations as to European Central Bank policy, with the result that shortly no one will be anticipating further easing from the ECB. Some market operators may even start planning for a first increase in ECB key rates.

- Long-term yields will rise significantly: in the U.S. by 20 to 50 basis points to between 3.00 and 3.30 percent; and in Germany to between 2.00 and 2.20 percent versus 1.80 percent today. At the same time, the French-German spread should narrow slightly, while Spain's and Italy's spreads should shrink to somewhere around 190 basis points. This, however, could prompt a spike in long-term Treasury yields; a great deal will hinge on how swiftly the Fed scales back its asset purchases. In any event, we should brace ourselves for considerable instability.

- The dollar will appreciate against the euro to 1.32 USD/EUR. This is likely to suit the Bank of Japan just fine, since the yen looks set to slide even further against the greenback and the euro.

- Large amounts of capital will flow out of emerging economies—even if the short-term economic outlook improves—and those countries' currencies will steadily lose ground. On the other hand, the global upturn should mitigate the risk of a currency crisis, which the current imbalances might otherwise trigger.

## H2 2014: Disillusionment

We expect the economic climate to eventually take a turn for the worse. But it is impossible at this stage to predict exactly when. To a large extent, the timing will depend on how fast market expectations shift and long-term yields rise. The most likely scenario is that things will start to go south during the second half of this year—once monetary stimulus is over and done with, and the cyclical catch-up phase has run its course. At that point, we may well be confronted with the following sequence of events:

- The recovery will peter out, giving way to disillusionment. Economic forecasts will be revised downward.

- Market expectations will revert to where they stood before. Long-term U.S. yields will fall to between 2.8 and 3.0 percent, European yields will likewise decline, while spreads relative to the German bund will widen.

- The dollar will lose ground once again, pressure on emerging market currencies will increase, and there will be heightened danger of a currency crisis.

- There might even be a global slump, with mounting instability in emerging economies.

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