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Schroders

Economic and Strategy Viewpoint

The US leads the recovery, but the world's locomotive is fading

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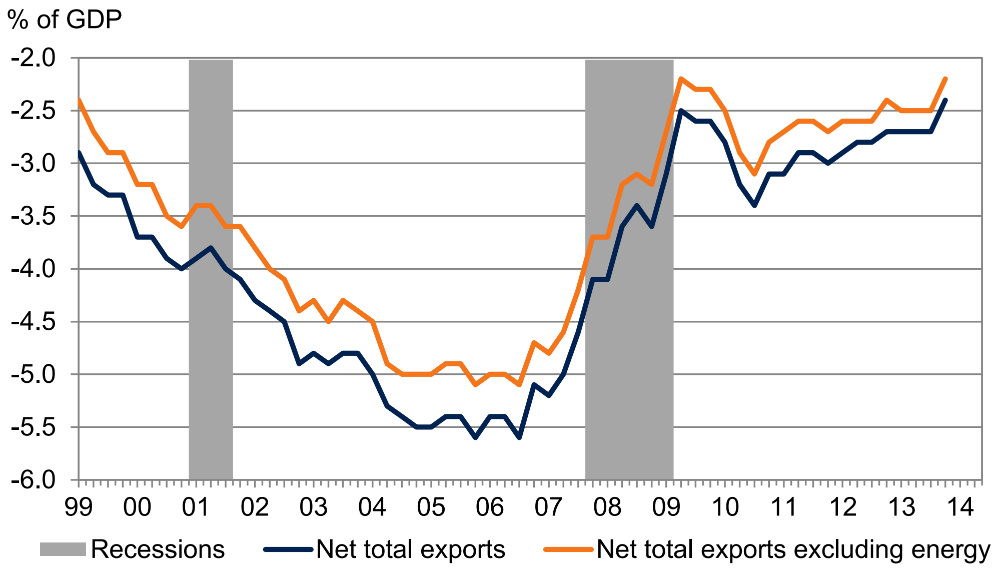
- **US economic activity is strengthening after a harsh winter and the economy is leading the global upswing in the developed world. Whilst good news for global growth, the US economy which is emerging from the financial crisis will make less of a contribution to the rest of the world. Signs of this are already apparent as despite leading the upswing, the US trade deficit has not deteriorated as in the past.**
- **This is not a US "stagnation" forecast as although weaker consumer spending is an element, we also see better trade performance from the US. Instead the greater pressure will be felt in the rest of the world particularly the emerging markets. Deflationary pressures which have been apparent in recent CPI figures are also likely to persist.**

Views at a glance (page 8)

- **A short summary of our main macro views and where we see the risks to the world economy.**

Chart 2: US net exports, narrowing despite recovery



Source: Thomson Datastream, Schroders. 24 April 2014.

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The US leads the recovery, but the world's locomotive is fading

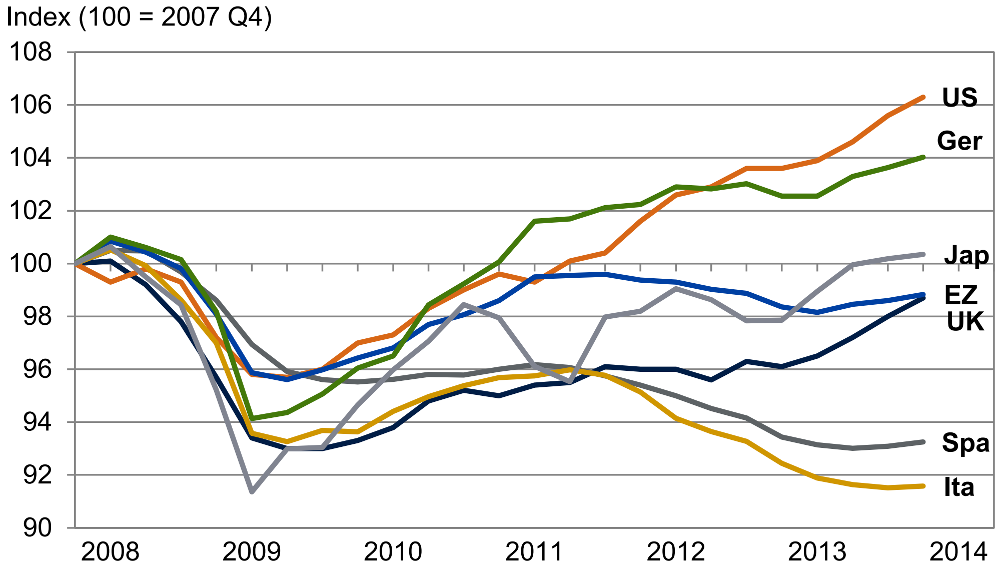
US growth is picking up again and the economy is leading the upswing in developed market activity

For all the talk of the US losing its pre-eminence and influence, its economy is leading the recovery in the developed world and its equity market continues to outperform the global index. Growth in the world's largest economy now seems to be picking up again after a harsh winter and activity looks set to accelerate as we head into the summer.

Whilst this is good news for global growth, there are signs that the US economy which is emerging from the financial crisis is playing less of a role in driving global growth than in previous cycles. The engine which drove the world economy for much of the past two decades has become more orientated toward domestic producers and is likely to be weaker than in the past. Clearly such an outcome has important implications for global trade, the emerging markets and inflation.

Taking the last quarter of 2007 as a starting point, the US economy regained its pre-crisis level of activity in 2011 and real GDP is now some 6% higher than at the end of 2007. Only Germany of the major developed economies has come anywhere close to this performance, but having led the US for much of the period it now finds itself some 2% behind (chart 1).

Chart 1: Recession and recovery (real GDP since the start of the global financial crisis)



Source: Thomson Datastream, Schroders. 24 April 2014.

UK may be about to regain its pre-crisis level of GDP, but is some three years behind the US

On this basis, the UK, which may be about to celebrate a return to pre-crisis levels of activity, is some 3 years behind the US. Before looking at the prospects for the US as a global locomotive, it is interesting to briefly reflect on the reasons for this gap. Despite popular perceptions, one argument which does not fit the facts is greater austerity in the form of public spending cuts in the UK. From the trough in 2009q2 all of the recovery in the US can be attributed to the private sector with consumption and investment driving the increase in output. Government spending has been a drag of 1.6% of GDP. Meanwhile, the weaker recovery in the UK was *supported* by government spending to the tune of 0.7% of GDP (see table 1 on next page).

Table 1: Recovery drivers in the US and UK

2009 Q2 - 2013 Q4	US		UK	
	% change	Contribution ppt	% change	Contribution ppt
GDP	11.2	11.2	6.2	6.2
Consumer spending	10.5	7.2	5.7	3.8
Private Investment	24.3	3.4	0.4	0.7
Government	-7.3	-1.6	2.3	0.7
Inventory (real $m, £m)	317.3	2.2	5147	1.4
Exports	34.8	3.7	18.4	5.2
Imports	28.7	-3.8	-14.9	-4.5
Net exports (real $m, £m)	*-10.0*	-0.1	2552	0.7

Note: Government includes public consumption and investment.
Source: BEA, ONS. 24 April 2014.

It is more likely that the lag in performance reflects the UK's greater dependence on the banking sector in terms of share of GDP, which helped make the UK recession deeper than in the US, and then made the upswing weaker as firms and households have struggled to obtain finance.

Both governments had to take stakes in their banks, but whereas the US has now largely off-loaded these, the UK taxpayer still has a substantial stake in Lloyds and looks like being stuck with RBS for some time to come. More generally, the UK's bank-based system of finance contrasts with the market-based system in the US where much of the private sector's funding ends up being quoted in equity and debt markets. The latter system may be more brutal, but its transparency means that lenders have to take their losses upfront and hence can either close or be recapitalised more rapidly. The net result is that US banks resumed lending activity sooner. Contrast this with the long period taken to recognise losses, recapitalise and resume lending in the UK (or the Eurozone).

The improvement in US trade performance

The US net trade position has not deteriorated despite the US leading the global recovery

Coming back to the global picture, despite leading the recovery the US has not suffered a deterioration in its trade position. This is unusual as normally one would expect the economy leading the upswing to suck in imports and experience a drag on GDP growth from the trade sector. Instead, the gap between exports and imports (net exports) in the US has been roughly stable (see table 1 above) and has been running at -2.5% GDP during the recovery phase from 2009 onward.

This is in contrast to the recovery from the last recession when the US trade deficit steadily deteriorated from -3.5% to -5.5% of GDP, where it stood in 2006. Thus, there has been an improvement of some 3% of GDP in the US net export position since the crisis. Such an outcome is made more remarkable by the sluggishness of global demand during this period which will have hampered export growth.

Part of the explanation for this performance lies with the fracking revolution and increase in oil production in the US which has reduced demand for imported oil. However, oil is not the whole story as the non-oil deficit has also narrowed significantly (see chart 2 on next page).

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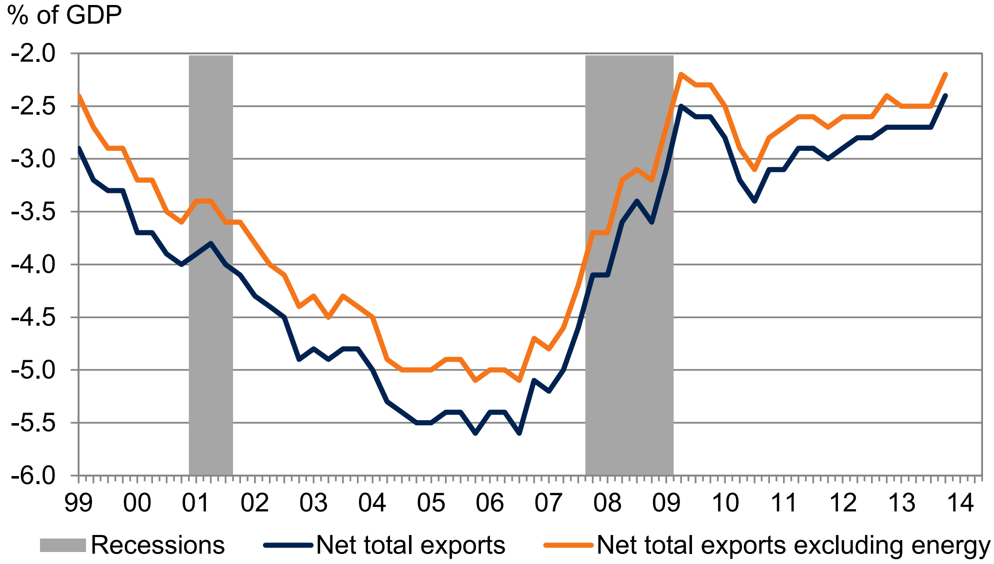
Chart 2: US net exports, narrowing despite recovery

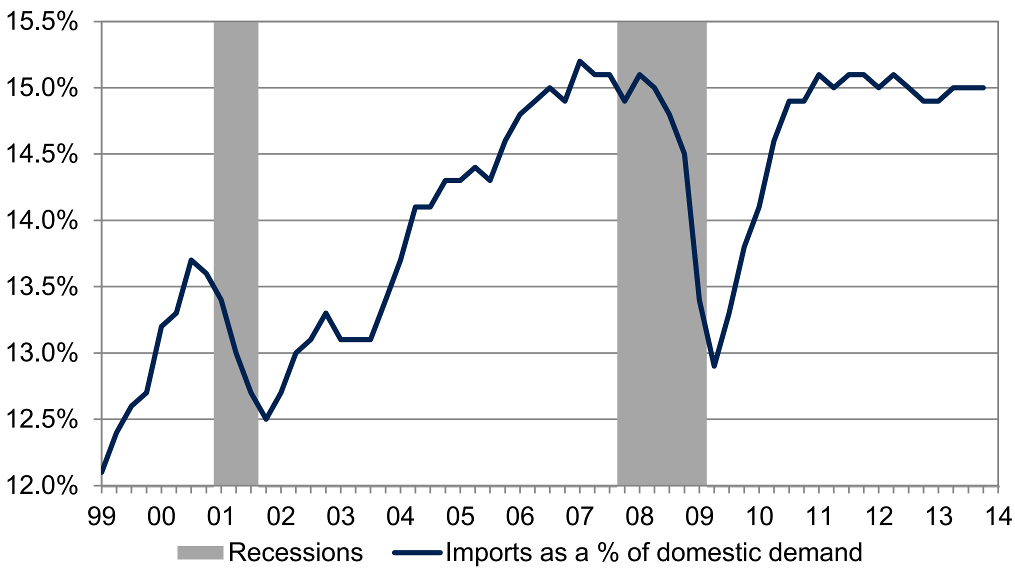


Source: Thomson Datastream, Schroders. 24 April 2014.

Import penetration has stopped rising in the US and exports are gaining market share

The improvement in US trade performance is also apparent in metrics such as import penetration which measures the level of imports relative to domestic demand. Between 2002 and 2007 this rose from 12.5% to 15% as imports outpaced domestic demand. The ratio collapsed during the recession as trade finance dried up post Lehman, but then recovered back to 15% where, rather than continuing to increase, it has stabilised (chart 3). Meanwhile, exports as a share of GDP have continued to move ahead and figures from the OECD suggest that the US has increased its share of world trade after years of decline.

Chart 3: Import penetration has stabilised in the US



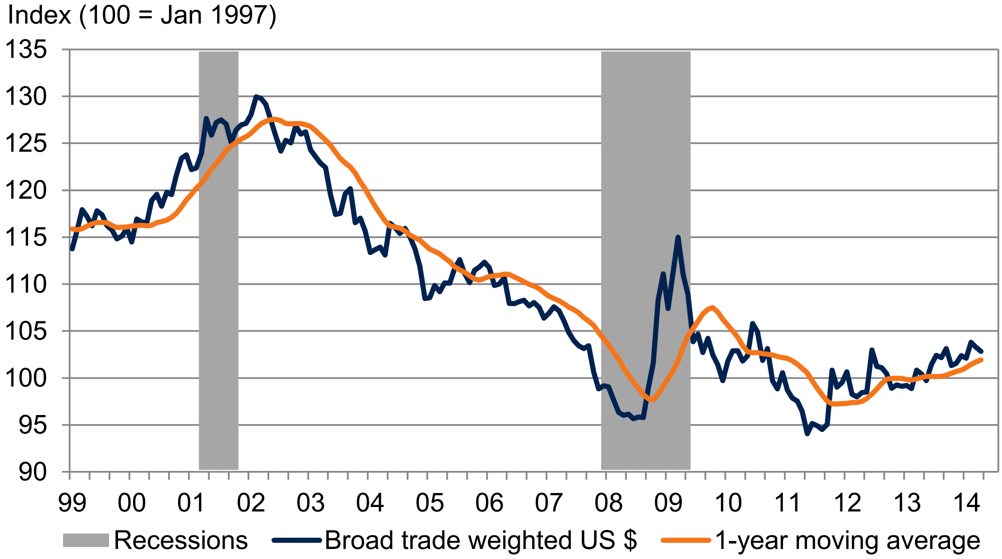
Source: Thomson Datastream, Schroders. 24 April 2014.

Several explanations have been put forward to explain the change in trade behaviour. These include the shifting pattern of US demand with consumption being increasingly driven by a small group of wealthy consumers (who tend to spend more at the margin on domestically produced services than goods), the shift from PC's to tablets and mobile phones (which tends to mean more value added resides in the US with firms such as Apple) and the argument that trade finance has never fully recovered (forcing companies to source more from home).

All have merit, however, one over arching explanation is that the US dollar is more competitive today than during the last recovery. Since 2002, the dollar is down by one third in both real and nominal terms and the competitiveness of the US is reflected in the growing phenomenon of on-shoring (bringing production back from overseas to the US).

A competitive USD is a factor

Chart 4: Competitive gain, the USD



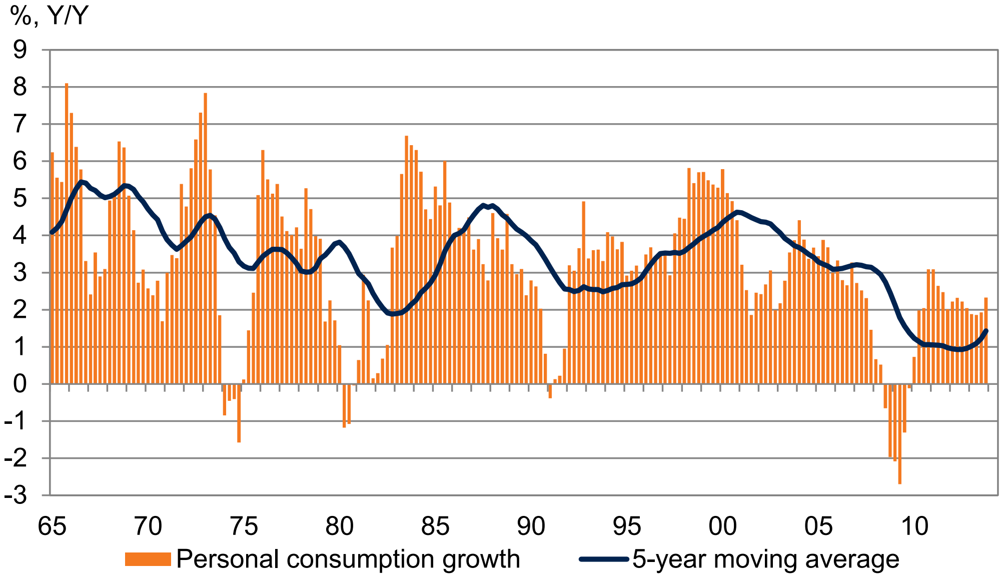
Source: Thomson Datastream, Schroders, 25 April 2014

The evidence so far points to a world where an increase in US demand has less effect on growth elsewhere as more of it is staying within the economy. However, the impact on the rest of the world will also depend on the growth of that demand. If US demand rose strongly enough it could still drive global growth. Unfortunately the prospects for this look remote in the post financial crisis economy.

Long run consumer spending drivers

Focusing on the consumer, real expenditure was weakened by the recession, but the trend has been slowing for some time. For example, the five year trend is currently less than 2% per annum compared with around 4% in the past (chart 5).

Chart 5: US consumer spending trending lower

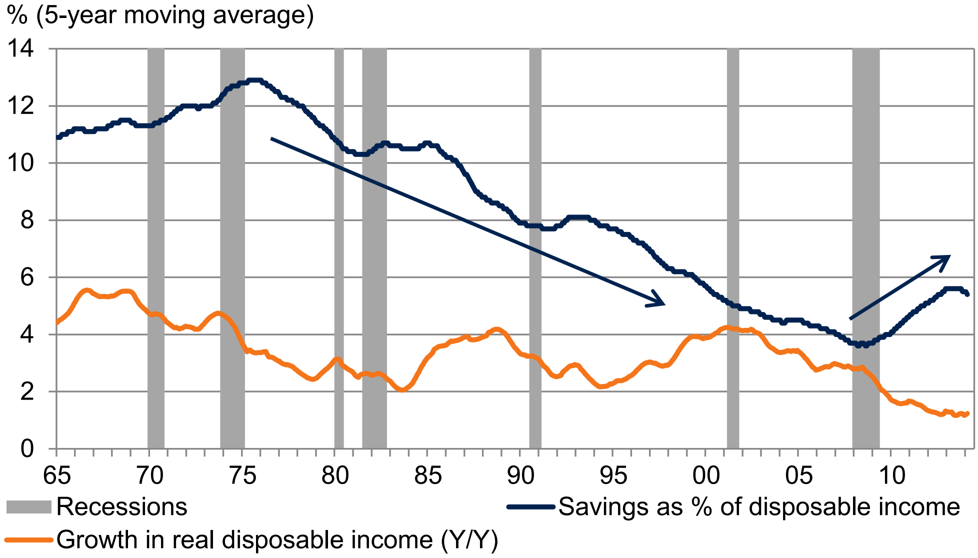


Source: Thomson Datastream, Schroders, 25 April 2014.

The financial crisis has exposed the underlying weakness in US consumer spending

Underlying this is a very weak performance from real income and upward pressure on the savings ratio as households lost access to credit (see chart 6). Going forward, incomes should get a boost from better employment and a tightening of the labour market, whilst rising wealth will encourage/ enable households to borrow again. However, although they have fallen, debt levels remain high in the household sector and the economy's overall debt has been boosted by the surge in government borrowing, indicating that household borrowing and income growth will remain subdued.

Chart 6: Fading drivers, real income and savings rate



Source: Thomson Datastream, Schroders, 25 April 2014.

This outlook would have been with us sooner had we not had the boom in credit which masked long running weakness in wage and salary growth in the US. From this perspective the boom in sub-prime lending only masked an inevitable slowdown in consumer incomes and expenditure. And, arguably the Fed is now trying to trigger a return to borrowing through boosting asset prices and wealth with the risk that they create another bubble.

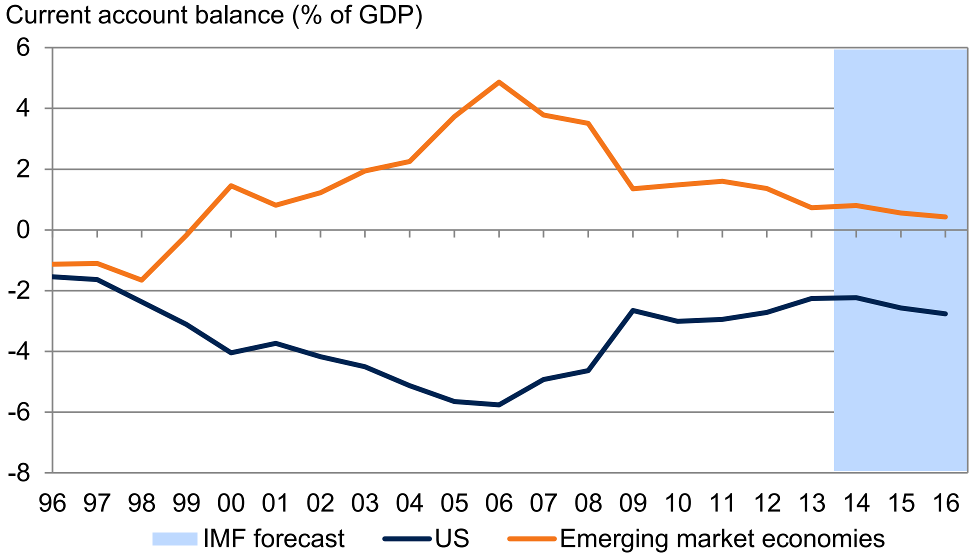
Conclusion

Pulling this together the conclusion is that the US is likely to be less of a locomotive for global growth than it has been in previous cycles. Consumer spending is likely to be more lacklustre and, of the demand generated by the US, more is likely to be met by domestic rather than overseas production. This is not necessarily a "*stagnation thesis*" as the US could perform well as it trade performance drives growth.

Nonetheless, it is not good news for the rest of the world particularly those economies which have relied on selling to the US. The emerging markets are vulnerable in this respect and it is notable that the surplus in these economies has declined significantly from 5% to 1% of GDP since the crisis according to figures from the IMF (chart 7). It is also notable that much of the improvement in US trade has been with the fragile 5 of Brazil, India, Turkey, Indonesia and South Africa. These economies are now adjusting, but this analysis suggests that there will be no return to pre-2007 export growth.

__Weaker demand and a better trade performance indicate that the US will be less of a locomotive for global growth, keeping pressure on emerging market growth and inflation__

Chart 7: Mirror image, the US and emerging market current accounts



Source: Thomson Datastream, IMF, Schroders, 25 April 2014.

Clearly such a conclusion means there will be continuing pressure on emerging economies to restructure and re-orientate their economies toward domestic rather than external demand. However, this takes time and in the interim there will be excess capacity and slack as the world economy moves to a new configuration. Consequently the deflationary pressures which have been apparent in recent CPI prints around the world are likely to persist.

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Schroder Economics Group: Views at a glance

Macro summary – April 2014

Key points

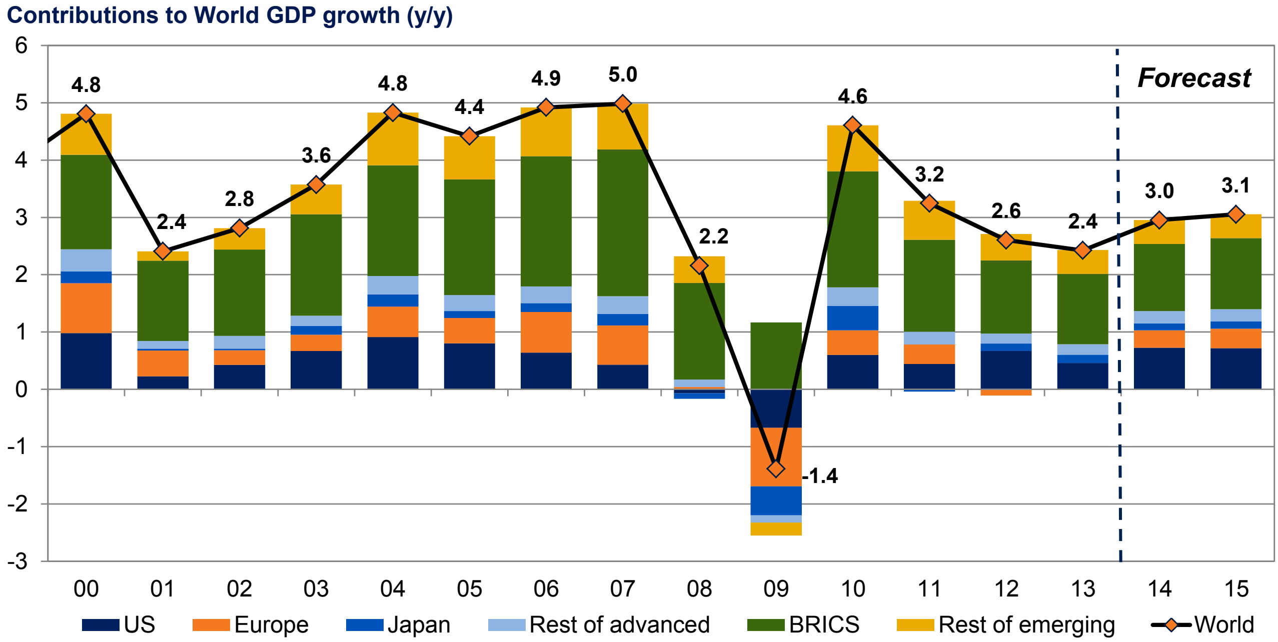
Baseline

- World economy on track for modest recovery as monetary stimulus feeds through and fiscal headwinds fade in 2014. Inflation to remain well contained.
- Recent upswing driven by lower inflation supporting real incomes and consumption, the manufacturing inventory cycle and, in the US and UK, reviving housing markets.
- US economy still faces fiscal headwind, but gradually normalising as banks return to health and private sector de-leverages. Fed to complete tapering of asset purchases by October 2014, possibly earlier, with the first rate rise expected in the third quarter of 2015.
- UK recovery risks skewed to upside as government stimulates housing demand, but significant economic slack should limit any tightening of monetary policy. No rate rises 2014 or 2015.
- Eurozone recovery becomes more established as fiscal austerity and credit conditions ease in 2014. Low inflation likely to prompt ECB to cut rates in coming months, otherwise on hold from then on through 2015. More LTRO's likely in 2014.
- "Abenomics" achieving good results so far, but Japan faces significant challenges to eliminate deflation and repair its fiscal position. Bank of Japan to step up asset purchases to offset consumption tax hikes in 2014 and 2015. Risk of significantly weaker JPY.
- US leading Japan and Europe. De-synchronised cycle implies divergence in monetary policy with the Fed eventually tightening ahead of others and a stronger USD.
- Tighter monetary policy weighs on emerging economies. Region to benefit from current cyclical upswing, but China growth downshifting as past tailwinds (strong external demand, weak USD and falling global rates) go into reverse, and the authorities seek to deleverage the economy. Deflationary for world economy, especially commodity producers (e.g. Latin America).

Risks

- Risks are still skewed towards deflation, but are more balanced than in the past. Principal downside risk is a China financial crisis triggered by defaults in the shadow banking system. Upside risk is a return to animal spirits and a G7 boom (see page 17 for details).

Chart: World GDP forecast



Source: Thomson Datastream, Schroders 24 February 2014 forecast. Previous forecast from November 2013. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2013	2014		Prev.	Consensus	2015		Prev.	Consensus
World	100	2.4	3.0		(3.0)	2.9	3.1		(3.1)	3.2
Advanced*	64.0	1.2	2.1		(2.1)	2.0	2.2	↑	(2.1)	2.2
US	24.0	1.9	3.0		(3.0)	2.7	3.0		(3.0)	3.0
Eurozone	18.7	-0.4	1.1		(1.1)	1.2	1.4		(1.4)	1.5
Germany	5.2	0.5	1.9	↓	(2.1)	1.9	2.2	↓	(2.3)	2.0
UK	3.7	1.9	2.6	↑	(2.4)	2.8	2.1	↑	(1.9)	2.4
Japan	9.1	1.6	1.4	↑	(1.3)	1.3	1.3	↑	(0.9)	1.3
Total Emerging**	36.0	4.6	4.5	↓	(4.7)	4.4	4.7	↓	(4.9)	4.8
BRICs	22.2	5.5	5.3	↓	(5.5)	5.3	5.6	↓	(5.9)	5.5
China	12.8	7.7	7.1	↓	(7.3)	7.3	7.3	↓	(7.5)	7.2

Inflation CPI

y/y%	Wt (%)	2013	2014		Prev.	Consensus	2015		Prev.	Consensus
World	100	2.6	2.8	↑	(2.7)	3.0	2.8		(2.8)	3.0
Advanced*	64.0	1.3	1.4	↓	(1.5)	1.6	1.5	↓	(1.6)	1.7
US	24.0	1.5	1.5		(1.5)	1.7	1.4	↓	(1.5)	1.9
Eurozone	18.7	1.4	0.8	↓	(1.0)	0.9	1.2	↓	(1.5)	1.3
Germany	5.2	1.6	1.3	↓	(1.5)	1.4	1.7	↓	(1.9)	1.8
UK	3.7	2.6	2.3	↓	(2.9)	1.9	2.7	↓	(3.0)	2.1
Japan	9.1	0.1	1.9		(1.9)	2.6	1.5	↑	(1.4)	1.7
Total Emerging**	36.0	4.9	5.3	↑	(4.8)	5.4	5.1	↑	(4.9)	5.1
BRICs	22.2	4.7	4.3	↑	(4.0)	4.3	4.1		(4.1)	4.3
China	12.8	2.6	2.7	↑	(2.6)	2.6	2.9	↓	(3.0)	3.0

Interest rates

% (Month of Dec)	Current	2013	2014		Prev.	Market	2015		Prev.	Market
US	0.25	0.25	0.25		(0.25)	0.32	0.50		(0.50)	0.96
UK	0.50	0.50	0.50		(0.50)	0.74	0.50		(0.50)	1.52
Eurozone	0.25	0.25	0.10	↓	(0.25)	0.25	0.10	↓	(0.25)	0.45
Japan	0.10	0.10	0.10		(0.10)	0.21	0.10		(0.10)	0.23
China	6.00	6.00	6.00		(6.00)	-	6.00		(6.00)	-

Other monetary policy

(Over year or by Dec)	Current	2013	2014	Prev.		2015	Prev.
US QE ($Bn)	2864	4033	4443	-		4443	-
UK QE (£Bn)	325	375	375	(375)		375	(375)
Eurozone LTRO	NO	YES	YES	YES		YES	YES
China RRR (%)	20.00	20.00	20.00	20.00		20.00	20.00

Key variables

FX	Current	2013	2014		Prev.	Y/Y(%)	2015		Prev.	Y/Y(%)
USD/GBP	1.67	1.61	1.63	↑	(1.58)	1.2	1.55	↑	(1.50)	-4.9
USD/EUR	1.38	1.34	1.34	↑	(1.32)	0.0	1.27	↑	(1.25)	-5.2
JPY/USD	102.2	100.0	110.0		(110)	10.0	120.0		(120)	9.1
GBP/EUR	0.82	0.83	0.82	↓	(0.84)	-1.2	0.82	↓	(0.83)	-0.3
RMB/USD	6.08	6.10	6.00		(6.00)	-1.6	5.95		(5.95)	-0.8
Commodities										
Brent Crude	110.9	109.0	107.6	↑	(104)	-1.3	102.7	↑	(99)	-4.6

Source: Schroders, Thomson Datastream, Consensus Economics, April 2014
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 19/02/2014
Previous forecast refers to November 2013

* **Advanced markets**: Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, Sweden, Switzerland, United Kingdom, United States.

** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

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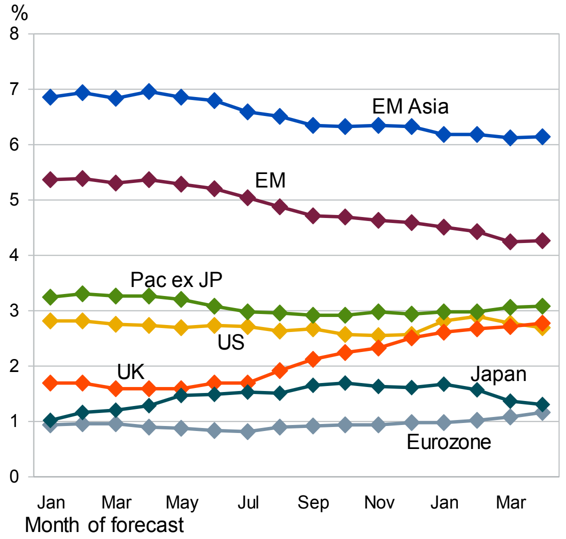
I. Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

2014 | **2015**



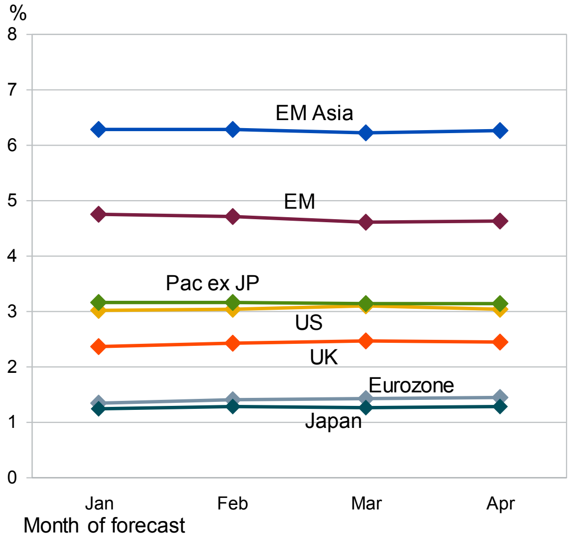
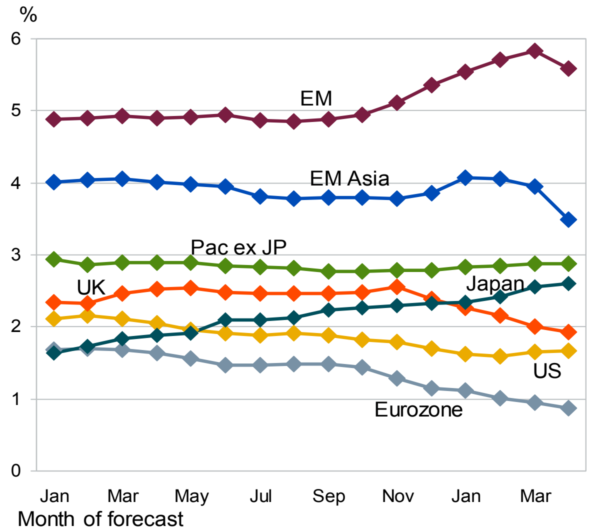
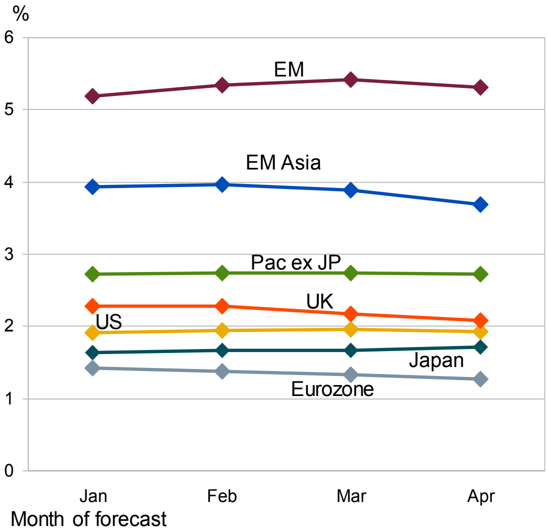


Chart B: Inflation consensus forecasts

2014 | **2015**





Source: Consensus Economics (April 2014), Schroders
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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