INVESTMENT research

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Research & Investment Strategy

Global growth: and yet it accelerates

Global GDP forecast cut to 3.3%. New risks emerging

With the benefit of hindsight…

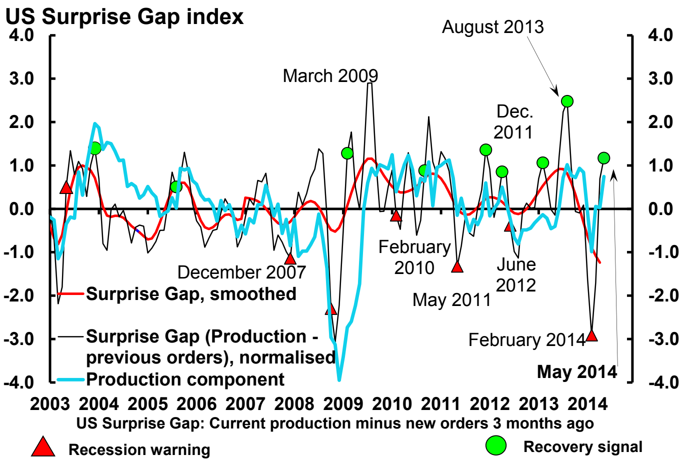
… the global recovery bumped into a couple of roadblocks in the first few months of this year, and even though it is now rapidly recovering, the loss of output will not be fully recovered. Against this backdrop, we have cut our global GDP forecast for 2014 from 3.5% to 3.3% and our US forecast from 2.8% to 2.2% *(p. 28 of the Blue Book)*. One roadblock, extreme weather conditions in North America, was non-economic. Although neither weather nor climate scientists would go so far as to link these hardships with the ongoing effects of human-made climate change, it is probably best to acknowledge that either the frequency and/or the magnitude of extreme weather events is increasing and that we should get used to this unpleasant reality, including when it comes to our macro-economic assessments. How to do this is another question.

There were also more traditional economic drags, starting with the sharp rise in bond yields and mortgage rates in the US last year, which had a negative impact on housing investment and, possibly, on corporate investment *(p.18)*. Defensive policies implemented in several emerging countries to stem capital outflows and support fledging currencies may also have had an impact on global demand. Lastly, the Chinese government's crackdown on the shadow banking system and on corruption was tantamount to a joint monetary and fiscal tightening and may have cooled domestic demand and therefore global trade. Bear in mind that China is the second largest importer in the world, with 10% of global imports (vs. 12.5% for the US): in other words, what cools China cools the world.

Looking forward

That was then. The most recent news items point to a re-acceleration of growth in the US *(Exhibit 1 and p.17)* and to a pickup in capital expenditure in Japan, a sign that 'Abenomics' have started to bear fruit in the domestic economy. In China, policy makers have taken out an insurance policy to prevent growth from falling below 7% (by means of a limited fiscal and monetary stimulus) and we feel comfortable with our 7.2% growth forecast this year. Last but not least, the emerging economies that had been hit by the announcement of tapering last year have passed the test – a good omen regarding their intrinsic resilience – and are likely to gather steam again, probably later this year.

Exhibit 1
Growth reaccelerates in the US

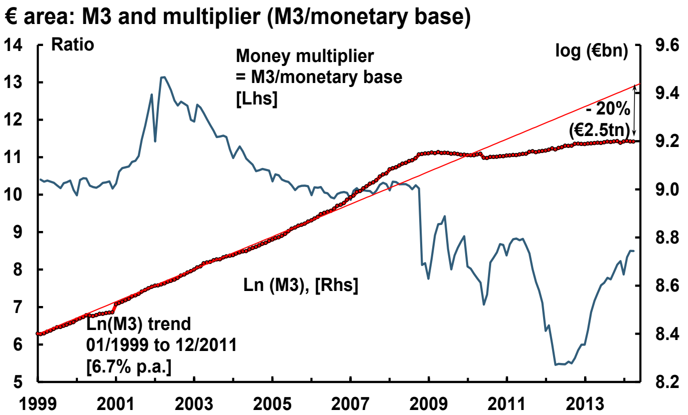


Source: ISM, Fed and AXA IM Research

The euro area remains the weak link in the global economy *(p. 23-27)*. With a very sluggish recovery – the Center for Economic Policy Research posits that the euro area 'might be mired in a recession pause'– growth dynamics won't be enough to fend off deflationary forces. The best single indicator of the strength of these forces is money supply, which I have been tracking monthly since 2009. Compared to its pre-crisis trend, broad money supply in the euro area is running 20% lower, which amounts to a staggering 2.5tn euro gap *(Exhibit 2, p.26)*. Most of the gap is explained by the ongoing deleveraging of the banking system and the contraction of loans to non-financial companies. True, the restrictive fiscal policies, part of the quid-pro-quo which warranted financial assistance to countries having lost the confidence of the markets during the sovereign crisis, had a strong negative impact on real demand and thus on demand for credit. Yet, as fiscal policies become neutral on average, supply-side flaws are becoming serious obstacles to growth. This is why the European Central Bank (ECB) has added one arrow to its monetary policy weaponry, namely, targeted Long Term Refinancing Operations, which should be seen as complementing the restructuring of the banking system that is expected to result from the asset quality review and subsequent stress tests. The case for 'pure quantitative easing', as now officially envisaged by the IMF in its Article IV statement, is weak in my view, in a context of already very low bond yields, unless the ECB opted for purchases of foreign assets, a red line no one but a couple of US academics (and yours truly at the shadow ECB Council), are ready to cross.

Exhibit 2

Broad money supply in the euro area is running below its pre-crisis trend



Source: ECB monthly bulletin and AXA IM Research

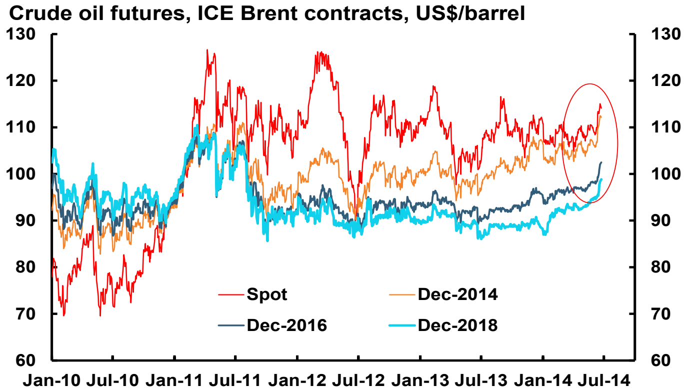
The bottom line is this: don't expect interest rates and bond yields to rise any time soon in the euro area *(p. 31)*, unlike what is in the pipeline in the UK (the Bank of England is #1 on our central banks exit calendar on *p.3*).

New political risks are emerging

We have added three geo-political risks to our risk radar *(Exhibit 5, p.4)*. First, chaos in Iraq has already added US$10/bn to spot and future crude oil prices (*Exhibit 3, p.10*). Since Iraq has the potential to be the second marginal producer, a full-blown civil war followed by a break-up would cause a much larger spike, with limited but negative consequences on global growth. Depending on the management of the crisis by the US, Saudi Arabia and Iran, geopolitical risks might also emerge, with the potential for unsettling the financial markets.

Exhibit 3

The whole spectrum of crude oil prices is rising on Iraq chaos

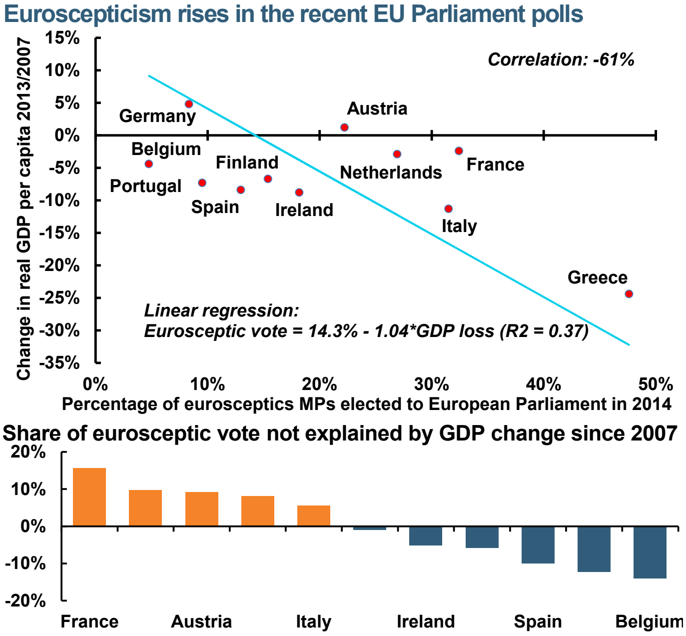


Source: Datastream and AXA IM Research

Second, the rise of euroscepticism visible in the recent EU Parliament polls (*Exhibit 4, p. 42*), together with referendums planned in Scotland and Catalonia, not to mention a possible vote on UE membership in the UK, may raise uncertainties about future business conditions in the EU. For almost 60 years, European countries have worked hard to open their borders and create a level playing field for businesses. The mere possibility of a reversal of this historical process would not be conducive to stronger investment, one of the missing links in Europe. Lastly, we are carefully watching the tensions building up in the South China Sea. The secular rise of China as a global economic powerhouse and the key regional political power may or may not be managed smoothly by the concerned parties, China, Japan, India, Vietnam, the Philippines… and, of course, the US. One thing looks sure in my view: just as China joining the global market economy was the most important economic driver of the post-Berlin-wall world, its emergence as a political and military power will be the main driver of geopolitics in the decades ahead.

Exhibit 4

Euroscepticism rises in the recent EU Parliament polls



Source: EU Parliament and AXA IM Research

Exhibit 5

The global macro outlook

Global GDP forecast trimmed from 3.5 to ≈ 3.3% ; US GDP from 2.8 to 2.2%

- Global trade and the US are recovering from the first quarter dip, not fast enough to plug the gap.
- China has taken out insurance on GDP growth, with a 7.0% floor.
- The emerging markets cycle is lagging behind but should benefit from US growth.

US Federal Reserve (Fed): perceived as more dovish under Yellen than under Bernanke

- The new Chair is more focused on the labour market than on financial stability.
- Some Federal Open Market Committee (FOMC) members are ready to let inflation overshoot after having undershot.
- Vice chair Stanley Fisher may take a more conservative view.

The recovery in Europe is too sluggish to fully offset deflationist forces

- Weak and uneven, the cyclical recovery is nevertheless supportive for equities.
- The ECB has delivered an easing package; targeted liquidity injection is the new plan.
- Absent QE (unlikely), bank restructuring is a necessary condition to the recovery.

Emerging markets: net capital inflows and market sentiment again positive

- Tapering being fully priced in, the Fed's dovish stance is –again- positive for Ems.
- Country-specific political risks made things worse. They look less acute now.
- The good news: emerging markets have proved resilient to capital flow gyrations.

Main macro risks

Short term (3 to 6 months)

Markets challenging the Fed on its very dovish policy stance
Yellen's Fed has become ever more dovish. A rise in inflation may call this stance into question. **Political instability in the Middle East sending crude oil prices through the roof**

Two conflicts remain unresolved: Israelis vs. Palestinians and Sunnis vs. Shias.

Political instability in Europe caused by votes on independence or EU membership
The rise in eurosceptic votes shows that tensions within the EU are building.

Policy mistakes by Chinese policymakers causing an unexpected hard landing
China has to reform on several fronts while keeping GDP growth above 7%. Challenging!

Medium to long term:

Very low inflation becoming entrenched in the euro area if bank restructuring is too slow
Following a large debt build-up, excessively low inflation would raise solvency issues.

Further French / German growth and fiscal divergence, markets testing France
France is now moving toward supply side reforms – at a snail's pace.

Ill designed 'exit strategies' by big central banks (Fed/Bank of Japan/BoE)
Inflating monetary bases to prevent deflation was easy. The opposite won't be.

Mismanagement of the rise of China as regional superpower
From India to Japan through The Philippines and Vietnam, worries are building.

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