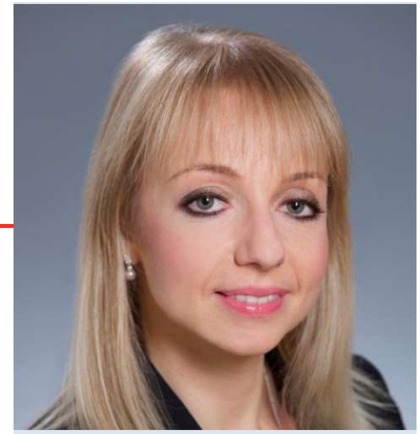
FEBRUARY 2015

Macro update: February 2015



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GLOBAL GROWTH

Data: Global growth momentum remained subdued, but the pace of deceleration seems to have slowed down somewhat over the past month. Consumer confidence improved on aggregate, likely driven in part by lower energy prices and more supportive policy. Business confidence remained mixed, but the Euro area, UK and parts of EM saw some improvement. Inflation continued to fall across the board.

Global leading indicators vs OECD IP

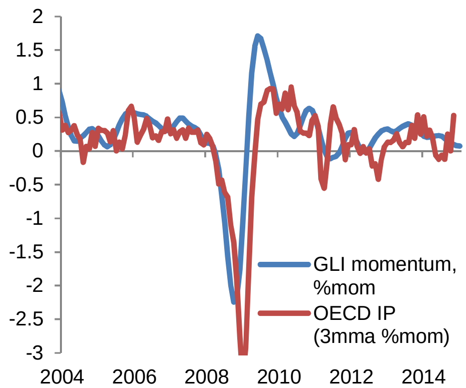

Chart 1. Source: Goldman Sachs Economics Research, Haver Analytics

DM vs EM manufacturing PMIs

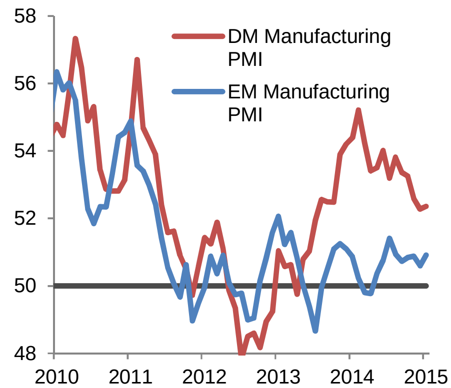

Chart 2. Source: Markit, Haver Analytics

View: Global growth still looks set to rebound moderately over the next few months, with the benefits of lower oil prices and more supportive policy becoming more visible around mid-2015. The strong disinflationary trend should carry on at least throughout the first half of this year, with the second-half outlook conditional on the oil price trajectory. In this respect, the growth picture is likely to be mixed in the coming months, with central banks injecting more liquidity, easing financial conditions. The second half of 2015 will then see a more synchronised growth improvement, with the US Federal Reserve inching closer towards hiking rates around year-end.

Developed market (DM) financial condition indices (FCIs)

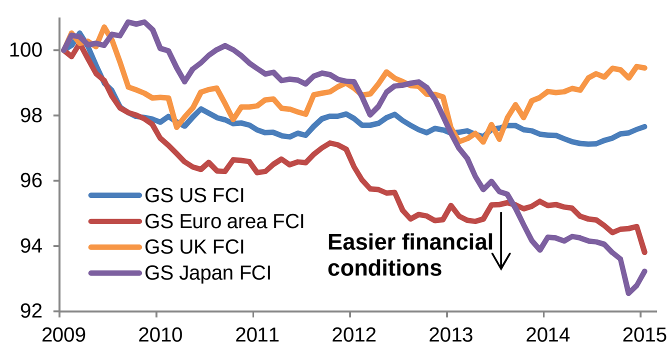

Chart 3. Source: Goldman Sachs Economics Research

Goldman Sachs US financial conditions Index

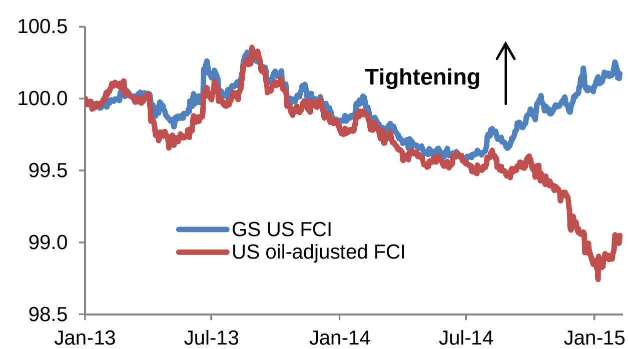

Chart 4. Source: Goldman Sachs Economics Research

Risks to the outlook: The probability attached to key risks has shifted somewhat. While the uncertainty around Greece will keep markets volatile, it seems that systemic risk is limited for now, and should not jeopardise the recovery at this point. The risk around the Russia/Ukraine situation is, however, rising: apart from a serious security challenge in Europe and globally, it also brings higher likelihood of spillovers through the financial/market channels, as well as through tougher sanctions in the coming weeks (perhaps going as far as a full trade embargo). An earlier-than-expected Fed hike is still a key risk, but the likelihood seems to have diminished due to a number of external factors.

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US

Data: Data continued to be mixed over the past month, pointing to some slowdown in momentum relative to the second half of 2014. Consumer confidence posted another post-recession high, and housing data were generally better than expected (with December new home sales particularly strong). While the January employment report surprised on the upside, earnings growth remained below historical averages. ISM manufacturing declined again in January, but, as before, some of the weakness came from the prices paid component, implying lower energy prices continue to contribute to data weakness.

US ISM manufacturing declines despite strong non-farm payrolls

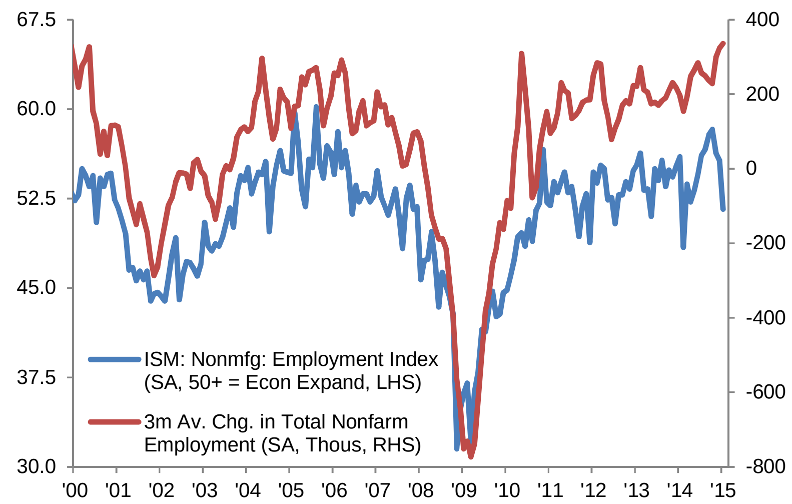

Chart 5. Source: Institute for Supply Management (ISM), BLS/Haver

View: The US recovery continues, although at a slower pace than in the second half of last year, as expected. While lower energy prices account for some softness in nominal indicators for now, a related boost to consumption and downward pressure on production costs should gradually start becoming more visible in the data over the next few months. Rising consumer confidence is one of the first signs of this dynamic.

Despite the strong non-farm payrolls report this month, a number of labour market indicators – such as the employment component of the nonmanufacturing ISM (chart 5), and various measures of unemployment and earnings – point to some spare capacity remaining. This, combined with lower energy prices and a stronger dollar, means inflationary pressures are still some time away. Low inflation and a number of external risks (Greece, Russia, China FX move) mean the Fed is unlikely to raise rates in mid-2015. My baseline forecast for the first hike remains towards year-end of 2015.

EURO AREA

Data: Incremental improvement in the data continued over the past month, with the area-wide composite PMIs edging higher in January, driven by notable increases in manufacturing indices in France and Italy and in services indices in Germany, Italy and Spain. December IP came in stronger than expected in Germany, France and Italy. Inflation fell further into the negative territory, while core edged down slightly.

Euro weakness raises level of euro area real GDP

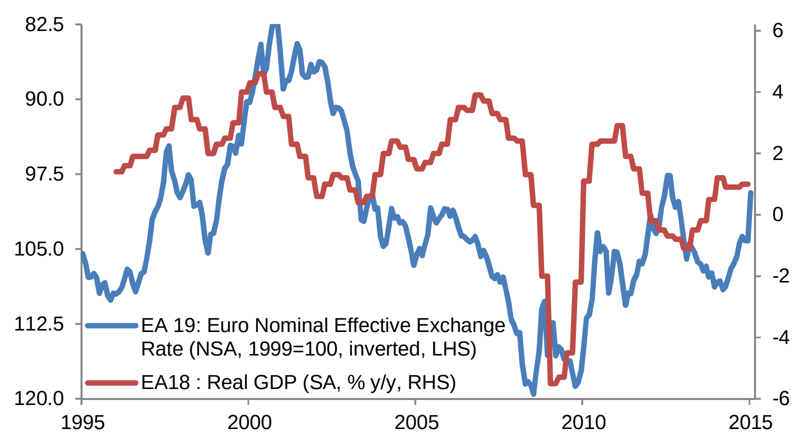

Chart 6. Source: European Central Bank, Eurostat/Haver

View: A cyclical pick-up is set to gradually gain pace over the next few months, helped by lower commodity prices, EUR weakness and easier policy. In terms of numbers, estimates suggest that a 10% depreciation in the effective EUR exchange rate raises the level of euro area GDP by around 50-60bp after two years. A 10% fall in oil prices lowers CPI by 20bp and raises the level of real GDP by around 30bp over two years. Given the 10% EUR NEER depreciation and the 40% fall in EUR price of oil since mid-2014, the euro area growth could be boosted by around 1.8% over the next few quarters, all else being equal. As noted before, while the impact of lower oil prices is already feeding into inflation and nominal indicators, the impact on growth will be felt with a lag and is likely to take another 3-6 months to become visible.

The main risks to the outlook are still related to Greece and Russia. Given developments over the past month, the latter has now become the key risk. While the uncertainty around Greece will keep markets volatile, it seems that systemic risk is limited for now and should not jeopardise the recovery at this point. The risk around the Russia/Ukraine situation is far more concerning and it is rising, with the potential to pose serious security challenges and an increasing likelihood of spill-overs through financial and market channels. Tougher international sanctions over the coming months could go as far as a full trade embargo.

UK

Data: Some stabilisation in the data emerged over the past month, with January PMIs rising above expectations. Construction PMI ticked up, mortgage approvals rose, house prices accelerated for the first time since June 2014. December industrial production data remained weak.

UK housing data stabilised somewhat in January

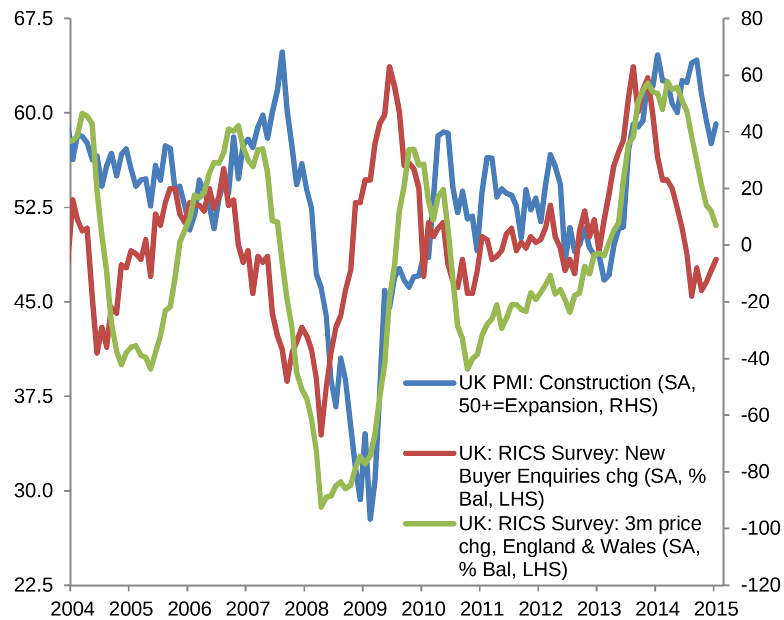

Chart 7. Source: CIPS/MKT, RICS/Haver

View: Accelerating real wage growth, helped by lower energy prices, should stimulate consumption over the next few months. In terms of numbers, the fall in oil prices since mind 2014 is likely to boost the level of GDP by 1-1.5% over a period of two years.

The housing sector indicators could be close to bottoming out, although price weakness could persist for a few months as suggested by leading indicators (chart 7), capping growth upside. The headwind of political uncertainty will also weigh on confidence in the run-up to elections. Interestingly for investors, whoever wins will have to do much more fiscal tightening than has been done so far. Given the strong disinflationary trend and external uncertainties (Europe/Greece, Russia/Ukraine), the BoE is unlikely to start thinking about hiking rates, at least until later in the year.

JAPAN

Data: Consumer confidence improved for the second month and Economy Watchers survey edged up. Employment grew sharply in December, but mainly driven by part-time workers. Nominal wages increased on winter bonuses, while real wage growth remained negative. Trade data pointed to a gradual recovery in export volumes. Inflation continued slowing further (as shown in the chart 8).

Japanese inflation slows further

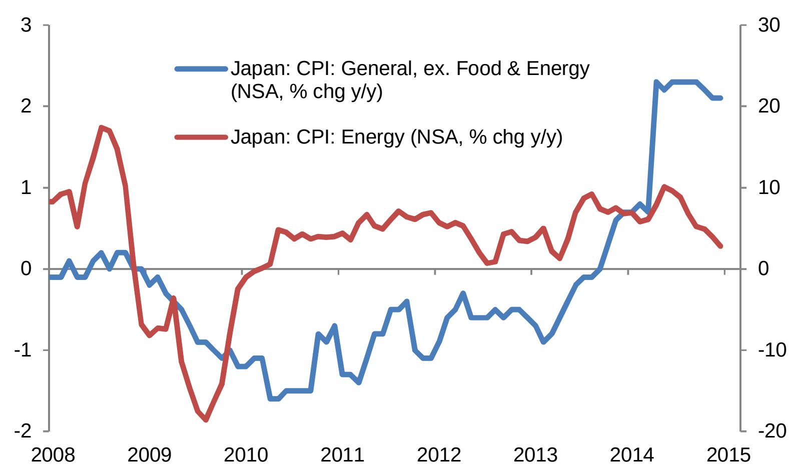

Chart 8. Source: Ministry of Internal Affairs and Communications/Haver Analytics

View: Tentative signs of data stabilisation are emerging, but it will take another few months for growth acceleration to come through. As inflation continues to fall, the BoJ might need to do more in the spring – the risk is they decide not to, which would likely disappoint the market. The spring wage negotiations should boost nominal wage growth (like in 2014) and, in combination with lower inflation, should also help real wage growth recover. However, as before, structural reforms aimed at boosting productivity are key in ensuring wage increases are sustainable.

CHINA

Data: China's January official PMI posted its lowest reading in more than two years and profits in the industrial sector declined 8% year-on-year in December. January inflation fell to its lowest level since 2009, driven by lower food prices as well as by Chinese New Year distortions (relative to 2014). Trade surplus posted a record high, with exports falling moderately, and imports contracting sharply (as shown in chart 9). Following strong RMB appreciation in trade-weighted terms, exports to Europe and Japan fell sharply.

Record high Chinese trade surplus as exports fall and imports contract

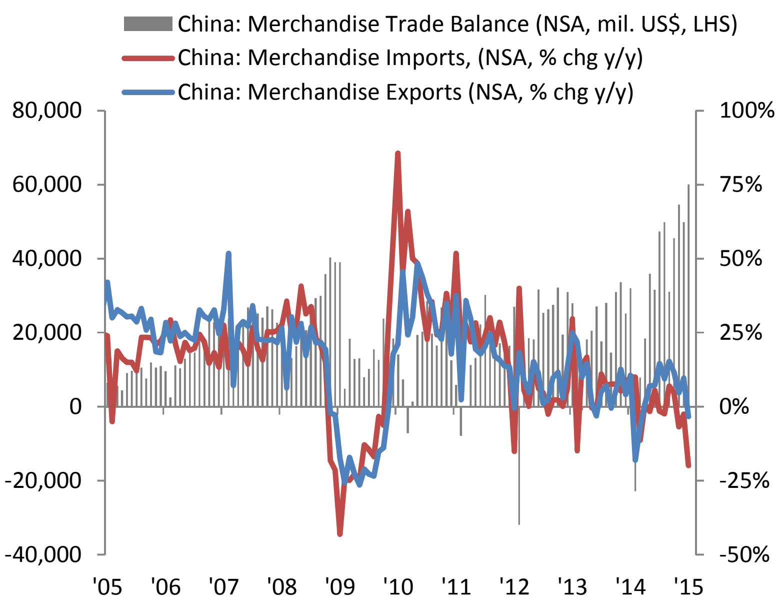

Chart 9. Source: China Customs/Haver

View: Latest data prints pose a number of policy dilemmas for the government. The fall in inflation and collapsing imports are partly driven by commodity price weakness, but also partly indicative of sluggish domestic demand. This explains the PBOC's RRR cut at the start of February. But while broader rate cuts are good news for shorter-term growth, it is bad news for longer-term growth sustainability.

This will certainly somewhat undermine all the efforts to reign in credit over the past year or so as lower rates will continue fuelling up debt. But because banks, businesses and consumers know that tightening is still ahead, the lending channel transmission is unlikely to be as efficient as before, capping the growth upside.

It still seems that weakening the currency (perhaps by adjusting the trading band) could be a better shorter-term solution in the current environment, given the USD appreciation trend (helping exports and inflation domestically but further supporting disinflation globally). Overall, given the government's focus on growth stability, a hard landing remains unlikely at this point, but at the same time the focus on reform means stimulus can be withdrawn quickly with any signs of growth improvement.

EMERGING MARKETS

Data: EM aggregate PMI edged up slightly in January, mainly driven by improvements in Mexico, Poland and South Africa, while Russia, Turkey and China saw weaker PMI numbers in the below-50 territory (chart 10). Korean exports growth, a leading indicator for global industrial production, remained suppressed. A strong disinflationary trend continued.

EM PMIs edged up, driven by Mexico, Poland and South Africa

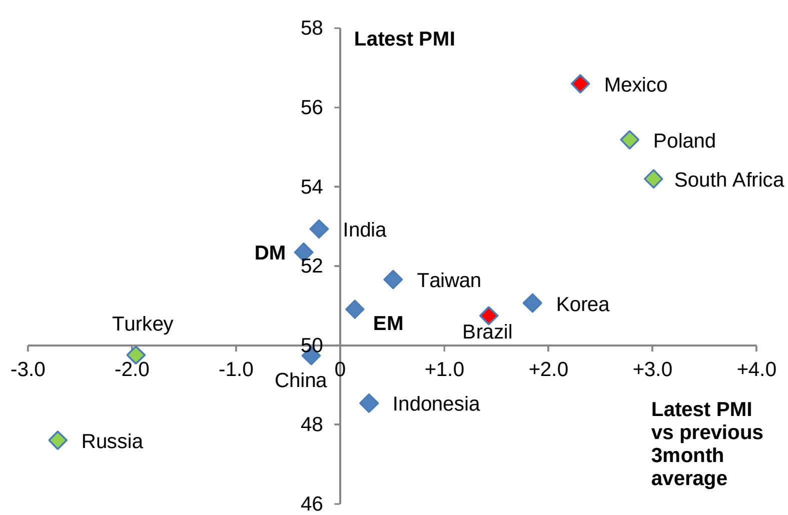

Chart 10. Source: Markit, Haver Analytics

View: Falling inflation is good news for EM, giving central banks room for policy easing. Over the past month, India, Egypt, Peru, Turkey, Romania, Pakistan and China saw rate cuts (as well as Russia but for different reasons). Together with easier policy, lower commodity prices will lend some support to growth in commodity importing countries over the next few months. A pick-up in developed markets, driven by the euro area and Japan, should bode well for small open economies such as Korea.

The headwind from a slowdown in China could recede somewhat on the back of policy-induced growth stabilisation there. But commodity exporting countries will continue facing headwinds, with Russia and Brazil still in the most vulnerable category.

RISKS FOR 2015

- **Russia-related risks**
  - Russia's deep recession/crisis spills over to Europe via trade and financial channels.
  - No peace agreement with Russia results in tougher sanctions, including a full trade embargo (Iran-style), leading to a complete economic collapse, spilling over to the global economy. This is becoming increasingly likely.
  - US agrees to provide military aid to Ukraine, provoking Russia further with war spreading across Ukraine (and perhaps the Baltics).
  - A regime change ends the Ukraine conflict and brings about a democratic government in Russia (still unlikely at this point, but this would be a very bullish scenario).
- **EU/Greece negotiations** break down, leading to Grexit.
- **The Fed hikes earlier and faster than expected**, jeopardising growth prospects elsewhere (via tighter financial conditions globally).
- **Faster-than-expected slowdown in China.**
- **Policy stimulus in Europe and/or Japan proves insufficient** to escape the low growth/low inflation equilibrium (e.g. BoJ steps back from pursuing the inflation target).
- **EM currency weakness vs USD** puts pressure on EM corporate whose liabilities are USD-denominated.

THINGS TO WATCH IN FEBRUARY

- Yellen's Congressional testimony (24-25 Feb)
- BoJ (Feb 18)/ECB (5 Mar)/FOMC (17-18 Mar)
- Greece-related negotiations
- Russia/Ukraine ceasefire observance and implementation

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