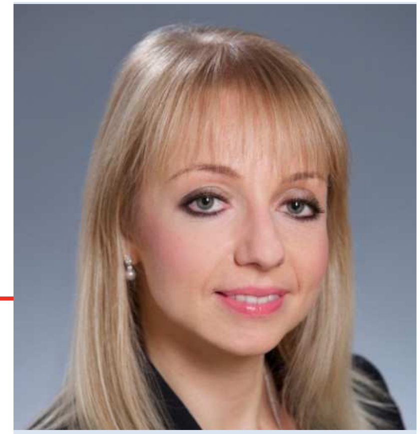
MARCH 2015

Macro update: March 2015

GLOBAL GROWTH

Data: Global growth remains subdued overall. The Global Leading Indicator (Chart 1) pointed to broad-based weakness, with a particularly large deterioration in trade-related components, driven by lower commodity prices and a slowing China. Global manufacturing activity remained anaemic (as shown in Chart 2). The US and China continued losing steam, Japan's recovery paused, but the Euro area clearly gathered more pace. Emerging market growth figures diverged, as recessions in Brazil and Russia deepened, while activity elsewhere remained sluggish.



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Global leading indicators vs OECD IP

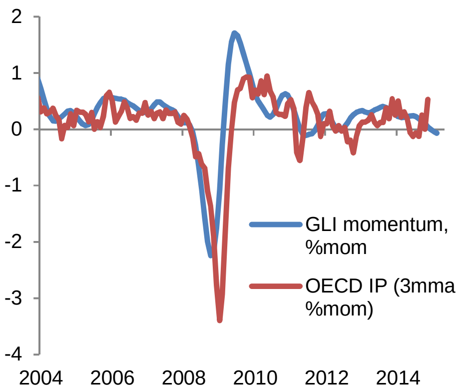

Chart 1. Source: Goldman Sachs Economics Research, Haver Analytics

DM vs EM manufacturing PMIs

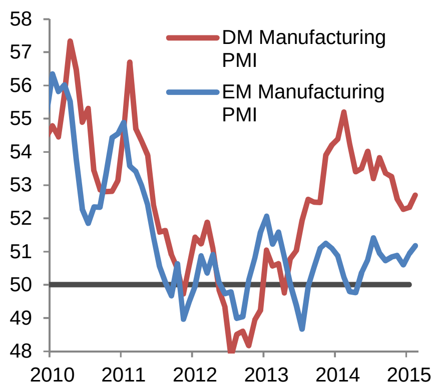

Chart 2. Source: Markit, Haver Analytics

View: The global growth picture will remain mixed in the first half of this year, with the Euro area and Japan picking up momentum, US and China growth gradually stabilising after some initial Q1 weakness, and EM diverging further. As the benefits of lower oil prices and more supportive policy become more visible around mid-2015, the global economy could see a more synchronised (albeit subdued) growth improvement in the second half of the year. The strong disinflationary trend should carry on at least for the next few months, allowing many EM central banks to ease further and preventing DM central banks from withdrawing liquidity support for now (see Chart 3). As for 2015 growth, I think consensus seems a little too optimistic on Russia, Brazil, Japan and US, and too pessimistic on the Euro area.

Developed market (DM) financial condition indices (FCIs)

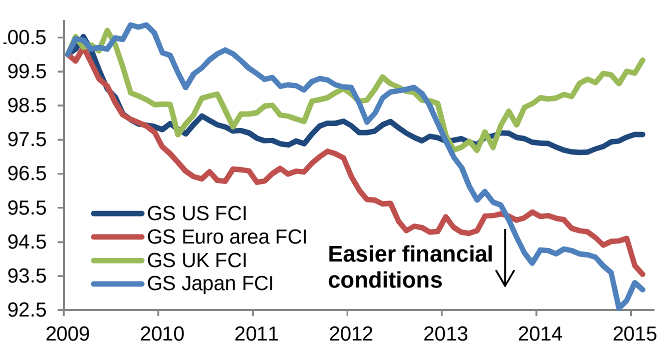

Chart 3. Source: Goldman Sachs Economics Research

Goldman Sachs US financial conditions Index

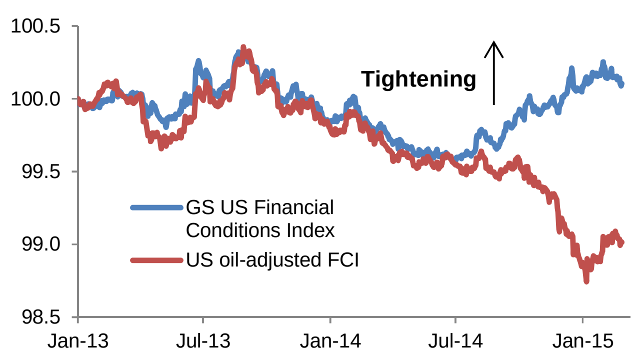

Chart 4. Source: Goldman Sachs Economics Research

Risks to the outlook: Three main risks continue to dominate the macro and markets outlook: the Greek situation, Russia-Ukraine and the Fed. I continue to believe that Greek debt negotiations are unlikely to undermine the recovery at this point. Moreover, given the systemic risk is fairly contained, the related market volatility should also remain controlled. The Russia/Ukraine conflict continues to pose serious risks to the global economy but the timing is highly uncertain. Russia's recession has the potential to spill over, particularly through the financial transmission channel as the government's policy options run out through the year. Credit events in Russia's corporate sector thus need to be closely monitored. Finally, the risk of a June hike by the Fed has now risen: in fact, it is now consensus, although I remain in the later hike camp. If it does take place in June, I believe that the resulting dollar strength and broader tightening in global financial conditions will be disruptive to the global economy and markets. This will remain a key focus over the next few months.

US

Data: Data continued to come in somewhat softer over the past month, consistent with a growth pace below 3% year to date. While the employment report was strong once again, earnings growth remained sluggish, dipping below 2% for production and nonsupervisory workers (see chart 5). The ISM manufacturing headline continued edging down, with the breakdown by component showing broad-based weakness, driven by lower employment, new orders and production, rather than falling prices as in previous months. Consumer confidence came off softened and housing data remained mixed. Headline inflation continued falling while core remained stable.

US Earnings growth remained sluggish, dropping below 2%

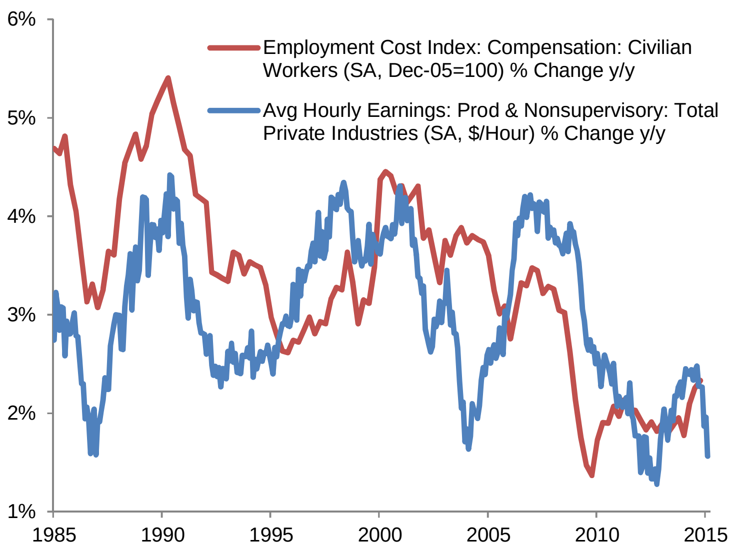

Chart 5. Source: Bureau of Labor Statistics/Haver Analytics

View: The pace of US growth slowed visibly this month, which might have been in part due to adverse weather conditions and disruptions related to the west coast port strike. While it is hard to disentangle different factors, the effect of lower energy prices on related production and capital expenditure as well as a stronger dollar are almost certainly playing a role too. This weakness is likely to be temporary, and as the one-off factors phase out over the next couple of months and consumption picks up further, growth should stabilise towards the second half of 2015.

In the meantime, markets have so far ignored this loss of momentum, focusing exclusively on the strong labour market. But despite solid payroll gains in the latest employment report, earnings growth clearly remained a weak spot. This, combined with subdued inflation currently and its likely downward trajectory over the next few months, as well as the uncertainty about the NAIRU itself (the non-accelerating inflation rate of unemployment, below which inflation would rise), suggests to me that the Fed is unlikely to raise rates in June. I do believe the 'patient' guidance will be removed from the FOMC statement in March to allow for more policy flexibility, but the first hike will not occur until at least September 2015.

EURO AREA

Data: Data remains consistent with early stages of recovery. The manufacturing PMI was stable in February, with the Italian PMI rising above expectations. The services PMI rebounded strongly, driven by robust gains in France and solid forward-looking components (see Chart 6). Consumer confidence improved, with notable gains in Italy. Retail sales and consumer spending was particularly strong in Germany. Area-wide lending to nonfinancial corporations declined, while lending to households continued to expand. Broad money grew at its strongest pace since April 2013. Headline inflation continued falling, although at a slower than expected pace, while core inflation was stable.

Euro-zone services PMIs rebounded strongly

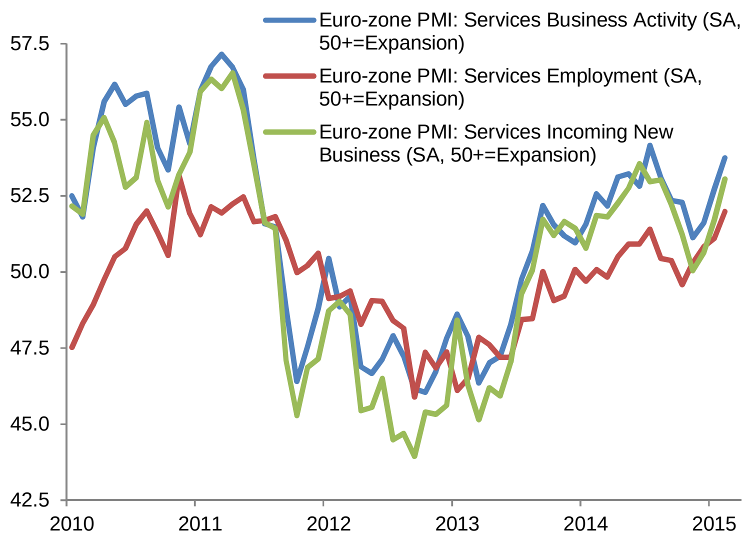

Chart 6. Source: Markit/Haver Analytics

View: The recovery is broadening out across countries and sectors at the time when the ECB is embarking on its long-awaited QE programme. The tailwinds of lower energy prices, a weaker EUR and easier policy will remain the driving forces behind the cyclical upturn. Rising employment and solid wage growth in Germany should continue benefitting consumers. But France, Italy and Spain will likely see the biggest acceleration in growth relative to last year (from a low base).

In terms of the main risks to this outlook, the risk around Greek debt negotiations is unlikely to undermine the recovery at this point. Russia's recession, however, could remain a small drag on growth for now, but further sanctions related to Russia's involvement in Ukraine would have the potential to derail the growth story, but to what extent would depend on severity of sanctions and the timing. Credit events in Russia's corporate sector need to be closely monitored for any signs of spillover.

UK

Data: Data has been somewhat mixed over the past month. The manufacturing PMI rose by more than expected in February, and the component breakdown was broadly positive. Mortgage approvals increased in January and lending growth remained solid. The labour market report was strong overall, pointing to a notable pick-up in headline wage growth (but this was entirely driven by bonuses, as shown in Chart 7). The services PMI edged down, however, with forward-looking components remaining relatively stable. Retail sales were weak and house prices were softer. Headline inflation fell to record lows and core remained subdued.

UK headline wage growth picked up, entirely driven by bonuses

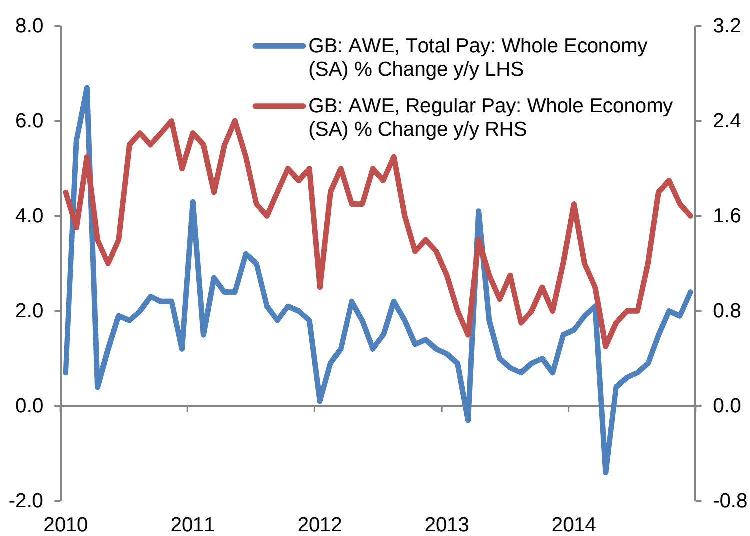

Chart 7. Source: Office for National Statistics/Haver Analytics

View: On the upside, the economy is growing at a stable pace. Benefits of lower energy prices are set to continue gradually feeding into real wage growth and consumption. The housing sector indicators could be close to bottoming out, although price weakness could persist for a few months as suggested by leading indicators. The headwind of political uncertainty will continue weighing on confidence in the run-up to elections (and potentially afterwards especially if a Brexit referendum becomes more likely). Given the strong disinflationary trend, political and external uncertainties, the BoE is unlikely to hike rates until later in the year.

JAPAN

Data: Data continued to point to subdued recovery, deteriorating relative to last month. While January wage data surprised on the upside, real wages remained in negative territory recording a smaller decline. Consumer spending, retail sales and labour market indicators all deteriorated. Q4 GDP was revised down on lower capex and inventory contributions. Both headline and core CPI continued falling. One positive data point was February Econ Watchers survey which improved sharply across most sectors, partly driven by tourist spending as well as lower energy prices (see Chart 8).

Japan Economy Watchers Survey improved sharply in February

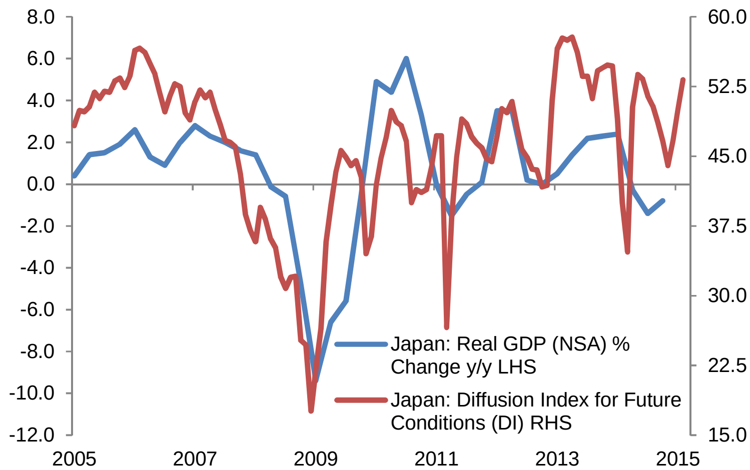

Chart 8. Source: Cabinet Office of Japan/Haver Analytics

View: Growth improvement year-to-date has mainly been export-led as benefits of the weaker yen and somewhat better external demand are starting to feed through to trade numbers. At the same time, recovery in the domestic economy remains disappointing as negative wage growth continues to weigh on consumption. Spring wage negotiations are important to watch as the growth trajectory will depend on the outcome. A nominal wage hike of around 1% in combination with falling inflation could finally force real wage growth out of the negative territory. As inflation continues to fall, the BoJ will be carefully watching inflation expectation dynamics and might need to ease more in case of de-anchoring.

CHINA

Data: Data was mixed over the last month, overall pointing to a slow pace of activity. The official manufacturing PMI edged up (but remained below 50) on higher new orders and input prices, while the production component declined. House prices continued falling in February, at a faster pace relative to the previous month. Exports rebounded sharply while imports continued falling, resulting in another record high trade surplus, but much of that is likely to have been driven by the Chinese New Year distortion. Inflation picked up in February, but this is likely to prove temporary.

PBOC policy action contributed to easier financial conditions in China

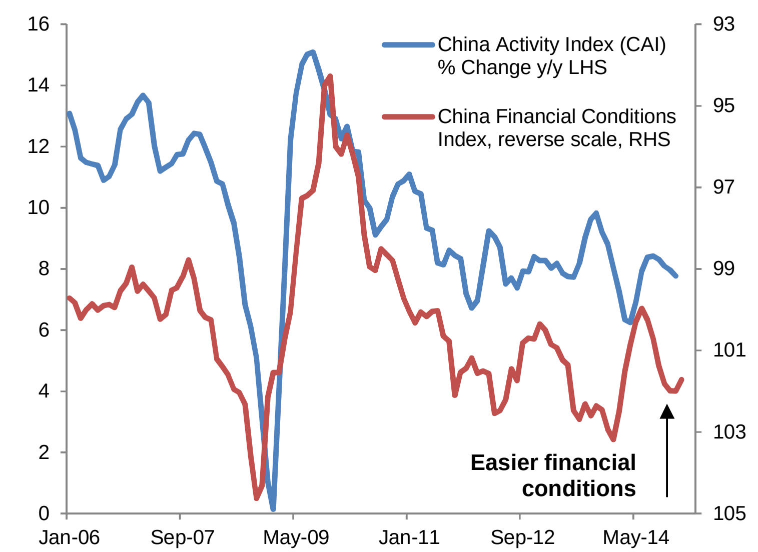

Chart 9. Source: Goldman Sachs Economics Research

View: China's growth continues to disappoint, despite a number of easing measures in Q4 of 2014 that should have supported some stabilisation in the cycle. The PBOC policy action in February (RRR, benchmark lending and deposit rate cuts) further contributed to some easing of financial conditions (see Chart 9). But while distortions related to the Chinese New Year make the current picture even more clouded than usual, it is clear that more policy action is needed to avoid a sharper slowdown.

More RRR cuts (for liquidity management to avoid tightening) and interest rate cuts, as well as infrastructure investment and further measures to arrest the housing market downturn are likely over the next few months. It still seems that weakening the currency (adjusting the trading band) could be a better shorter-term solution in the current environment given the dollar appreciation trend. Any reversion in the trend of dollar strength, however, would improve the outlook.

Overall, given the government's focus on growth stability, a hard landing remains unlikely at this point (barring a policy mistake), but at the same time the focus on reform means stimulus can be withdrawn quickly with any signs of growth improvement.

EMERGING MARKETS

Data: The growth picture remains mixed, with no notable signs of a more synchronised recovery. The aggregate composite PMI was slightly stronger, but the forward-looking components were weak, especially for manufacturing. In terms of manufacturing PMI headlines, China, Russia, Taiwan saw the largest improvement, while South Africa, Brazil, India and Indonesia dropped the most. Russia's services PMI continued collapsing. Broader data out of Brazil and Russia pointed to deepening recessions and accelerating inflation rates. Elsewhere, the strong disinflationary trend continues (see Chart 10).

Emerging Market inflation and inflation momentum

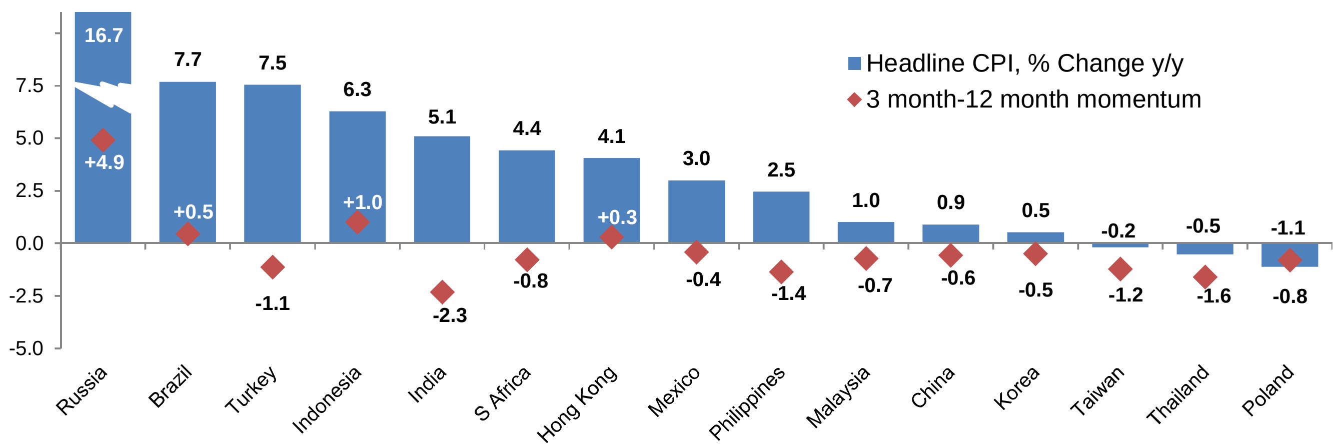

Chart 10. Source: Haver Analytics, National Sources, FWI calculations

On the other hand, commodity exporters will continue to find it difficult to ease given the shock to the terms of trade and risks of large capital outflows. Despite the ongoing slowdown in China, with all the policy options available to it , Asia is still the most resilient in the current environment. The headwind from a slowdown in China could recede somewhat on the back on policy-induced growth stabilisation there. Moreover, a pick-up in developed markets driven by the Euro area and Japan should bode well for the small open economies in the region. Other regions remain vulnerable, particularly as recessions in Russia and Brazil deepen through the year. Political and social risks are also on the rise, especially in LatAm.

RISKS TO THE OUTLOOK FOR 2015

- **Russia-related risks including** (1) a deep recession/crisis spills over to Europe via trade and financial channels; (2) conflict escalation results in tougher sanctions and further economic troubles; (3) geopolitical tensions spread to the Baltics.
- **EU/Greece negotiations break down** leading to a Grexit.
- **The Fed hikes earlier and faster than expected** (for instance, in June), 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 (and, for example, the BoJ steps back from pursuing its inflation target).
- **EM currency weakness relative to the dollar** puts pressure on EM corporates, whose liabilities are dollar-denominated.
- **A sovereign or corporate credit event** (for example, in Venezuela or among banks).

THINGS TO WATCH IN MARCH

- BoJ (Mar 17)/FOMC (17-18 Mar)/ECB (Apr 15)
- ECB QE (size and impact)
- UK election campaign
- French local elections (Mar 22), which could be a leading indicator for the presidential election in 2017
- Russia-Ukraine conflict and related sanctions

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