September 21, 2015

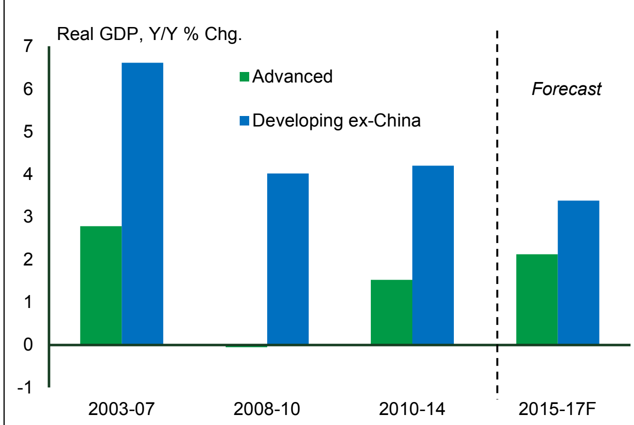
GLOBAL OUTLOOK: ADVANCED MARKETS GEAR UP, BUT HIT EMERGING MARKET SPEED BUMPS

Highlights

- Elevated financial market volatility and emerging market woes have defined the global economy over the past few months. Just as Greece-related concerns were put to rest, attention shifted to policy and communication missteps in China. Developing economies more broadly are facing significant challenges and are expected to record their slowest growth since the financial crisis in 2015.
- Amidst tumbling commodity prices, resource-exporting advanced economies, Canada and Australia, have been hard hit. Larger developed economies including the U.S., euro area, and U.K. have held up better, supported by strengthening domestic fundamentals.
- The global economy is undergoing a challenging phase, but the outlook further out appears brighter. Led by the U.S. and euro area, a further pickup in advanced economies is expected for next year. Meanwhile, marginal improvement in certain EMs such as Brazil and Russia should offset the continued slowdown in China, generating a modest bounce-back in EM growth in 2016-17.
- With subdued global economic growth, risks abound. Much rests on the ability of Chinese policymakers to ensure a soft landing for their economy, and the Federal Reserve delivering a slow and gradual pace of tightening.

Elevated financial market volatility and emerging market woes have defined the global economy over the past few months. Indeed, just as Greece-related concerns were put to rest, attention shifted over to China. Mixed Chinese data as well as policy and communication missteps on the part of authorities have raised worries concerning the pace of its economic slowdown. These worries have severely weighed on the price of commodities, which, on average, have hit their lowest levels since the 2008-09 financial crisis. All this, in addition to a strengthening U.S. dollar and the prospect of tighter monetary policy from the Federal Reserve, have placed enormous pressure on emerging markets (EMs) as a whole.

CHART 1. GROWTH RATES IN EMERGING MARKETS AND ADVANCED ECONOMIES CONVERGING



Source: IMF. Forecast by TD Economics.

The fears surrounding China and other EMs have also rippled down to commodity-linked advanced economies. This includes previous growth leaders such as Australia and Canada. In contrast, larger advanced economies including the U.S., euro area, and U.K. have held up better. Supported by strengthening domestic fundamentals, these countries are expected to see sturdy growth over the forecast horizon.

Still, few economies will be immune to some of the

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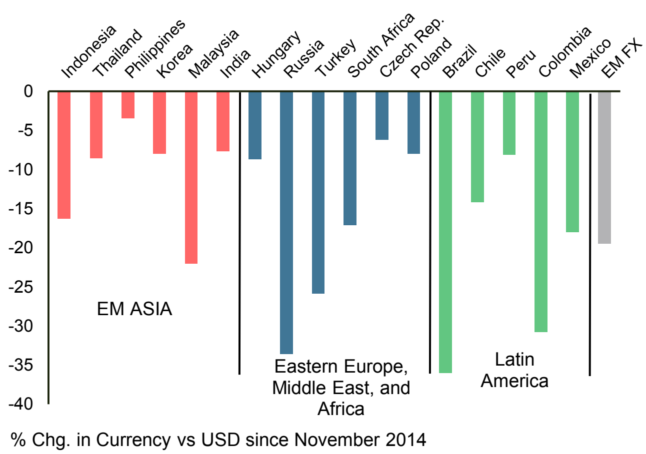
CHART 2. EM COMMODITY-LINKED ECONOMIES AND THOSE WITH POLITICAL TURMOIL HAVE BEEN HIT WORSE



Source: Bloomberg.

broader spill-over effects caused by EM economic and financial turbulence. These include increased risk aversion, declining equity markets and renewed global disinflationary pressures. The implication is that interest rates will remain low for even longer, as further evidenced by the decision of the Federal Reserve to stand pat at its meeting in September. Overseas, the Bank of Japan and European Central Bank will continue with their respective quantitative easing programs, dampening upside risk to rates in the U.S.

All told, the global economy is undergoing a period of heightened uncertainty and modest economic growth. The extent of the slowdown in China and the knock-on effect to emerging markets from tighter U.S. monetary policy stand out as key risks for the outlook. Overall, global economic growth in 2015 is expected to come in at 3.1%, its weakest pace since the financial crisis. Afterwards, a modest rebound to 3.4% in 2016 and to 3.5% in 2017 is expected, significantly lower than the 2000 to 2008 average of 4.3%.

America and Britain are the furthest along the road to recovery

Seven years after the financial crisis, the U.K. and the U.S. economies are among the furthest along in their respective recoveries. This is no surprise. Both countries were early adopters at aggressively cleaning up their banking systems and easing monetary policy in the aftermath of the financial crisis. Indeed, the unemployment rate currently sits at 5.1% in the U.S. and 5.5% in the U.K., close to what is considered full employment. Robust job gains and tightening labor markets are already leading to rising wage growth in the U.K. and America is likely on the cusp of faster labor compensation gains as well (see our U.S. forecast). This, alongside tepid consumer price growth, underpins our expectation for continued strength in domestic demand.

There is still room for improvement. In the U.S., the steep fall in the labor force participation rate suggests that labor market slack is greater than indicated by the headline unemployment rate alone. Meanwhile, the recovery in the U.K. has been overly dependent on domestic spending and rising home prices. At 5.8% of GDP, the U.K.'s current account deficit is roughly in line with the peak witnessed in America in 2005. Meanwhile, average home prices are 4.2% above their previous bubbly highs[1]. By comparison, home prices are still 6.5% below that mark in the U.S.[2]

Nevertheless, expectations are high that central banks in both countries will soon begin raising interest rates – the Fed by the end of this year or early 2016, followed by the Bank of England in May 2016. The one fly in the ointment is the low level of inflation in both countries. This has been exacerbated by rising currencies. The trade-weighted dollar and trade-weighted sterling are up 19% and 18%, respectively since early 2013[3], with further strength expected ahead.

Europe and Japan still fighting disinflation with monetary easing

In contrast to Britain and America, the euro area and Japan waited several years before tackling their respective issues and applying aggressive monetary policy. With the risk of deflation still elevated in both areas, quantitative easing programs will remain in place for at least the next year. Moreover, there remains the possibility that monetary stimulus measures will be broadened, even further as hinted by recent central bank comments. If so, the divergence in monetary policy between the four economic pillars – U.S., U.K., Euro area and Japan – will become even more pronounced.

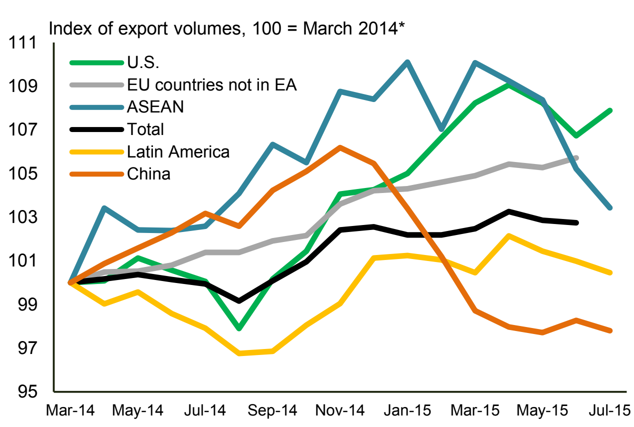
That said, monetary policy is having the intended effect on helping to lift economic activity within the euro area. Although economic growth decelerated to 1.4% in the second quarter, it posed an impressive 2.1% gain in the prior quarter. This is a far cry from the previous 4 years when the economy posted average quarterly growth of just 0.3% (annualized). The hope is that with a new Greek bailout deal in place, the economy can finally move out from under the shadow of the sovereign debt crisis. Bank loans are on the rise – +1.4 Y/Y in July[4] – and household pockets are being lined with savings from the fall in commodity prices. As a result, economic activity is being underpinned by stronger consumer spending. Net exports on the other hand have been mixed, with the slowdown in emerging markets posing an additional challenge. Exports to Russia have unsurprisingly fallen off a cliff, but the direct impact of China's slowdown is also a dampening influence, offsetting increased exports to North America and other European countries (see chart). Fortunately, Germany – the major euro area country with the greatest exposure to China[5] – is the most capable of withstanding any external drag, given robust job growth and rising wages.

Progress in the euro area has been made towards reducing unemployment (10.9% in July, down from 12.1% in early 2013) and raising inflation (headline at 0.1% in August, but core is up to 0.9% from 0.6% in March). Overall, we expect euro area growth to grind higher from 1.6% in 2015 to 1.8% in 2017-18. Should growth suffer a setback and disinflationary pressures rise, the ECB stands ready to expand its QE program, which is currently slated to end in September 2016.

Easy monetary policy in Japan is also finding some success, but to a lesser degree and it's still early days on whether recent improvements can be sustained on a longer term basis. The challenge for Japan does not have to do with the unemployment rate, which at 3.3% is close to a 20-year low. Rather, the problem is persistently weak inflation. Core inflation has risen to 0.6% (year-over-year) in recent months, but headline inflation fell to just 0.0% in July. As in other countries, the decline in the headline index is largely due to the fall in oil prices. Nonetheless, two and a half years after setting an inflation objective of 2%, the target remains elusive.

Abenomics is contributing to higher wages, with scheduled earnings rising to 0.6% (year-on-year) in July, the fastest pace since May 2005. However, these limited gains are at risk if the economy weakens unexpectedly. Economic activity has been volatile in 2015, rising an impressive 4.5% in the first quarter, but contracting 1.2% in the second. Moreover, with external trade remaining difficult and domestic activity disappointingly subdued, the risk of a setback is very real. Economic growth is expected to grind higher over the forecast horizon, but in early 2017, the second of the planned consumption tax hikes is slated to be imposed, which will weigh on consumer spending if it's put in place. Overall, the Bank of Japan's inflation target is unlikely to be hit over the forecast horizon, suggesting a very extended period of QE.

CHART 3. WEAKNESS IN EMERGING MARKETS LEADING TO MIXED EURO AREA TRADE DATA



Source: Eurostat. *Local peak in value of the euro, prior to ECB-driven

Commodity-linked advanced economies are struggling

The year has been more challenging for key commodity exporters, such as Canada and Australia. Coming out of the financial crisis, both were among the strongest performers in the advanced world, benefitting from rising commodity prices on the back of a stimulus-driven Chinese recovery. But with commodity prices tumbling, both have suffered terms of trade shocks and sharp reductions in investment. These impacts have been partially offset by ongoing strength in housing activity and modest advances in consumer spending. Looking ahead, weak commodity market conditions will remain a near-term impediment to investment, but other sectors are expected to continue to take up the slack. Canada's large export sector is expected to reap the benefits from growing demand in its largest trading partner, the U.S. (see our Canadian forecast). In Australia, large-scale production of LNG coming online over the next few years will help buoy economic growth. Accordingly, economic growth is expected to rise modestly in both economies in the second half of 2015 and into 2016.

China's economy is slowing, but also changing shape

China's current round of stimulus measures has less to do with external factors and more to do with internal imbalances, created in part by previous stimulus programs (see this report for more on this). Whether one believes the official statistics of 7% growth or not, there is little doubt that China's economy is slowing. New real estate construction is down -16.8% year-to-date (YTD), electricity consumption is up a mere 1.0% YTD, and motor vehicles sales through August show zero growth relative to last year.

China's economy, however, is also undergoing vast changes, with services today representing more than 50% of GDP, relative to less than 40% in early 2000. This has made tracking Chinese growth more difficult. Encouragingly, what indicators there are of service-related spending seem to point to continued growth. For instance, air passenger traffic is growing over 14% (Y/Y) in person-kilometer terms, while real estate sales are up 7.2% YTD.

Still, with the overall economy slowing, Chinese authorities have unleashed a number of stimulus measures. In terms of the near-term outlook, more recent stimulus measures have led to an uptick in broad (M2) money growth – up 13.3% over the last two months – which is usually a leading indicator of stronger construction spending ahead.This suggests that economic activity may tick up over the coming months. However, the stimulus is also becoming less effective (see chart). China's traditional method of boosting its economy involves providing credit to fund additional infrastructure spending or other investment projects. With non-financial sector debt to GDP up 90pp since early 2008 to roughly 250% (about the same as in America), the ability to take on additional debt is now limited. A simple solution is to target a lower level of growth, thus reducing the need to stimulate as much in the first place.

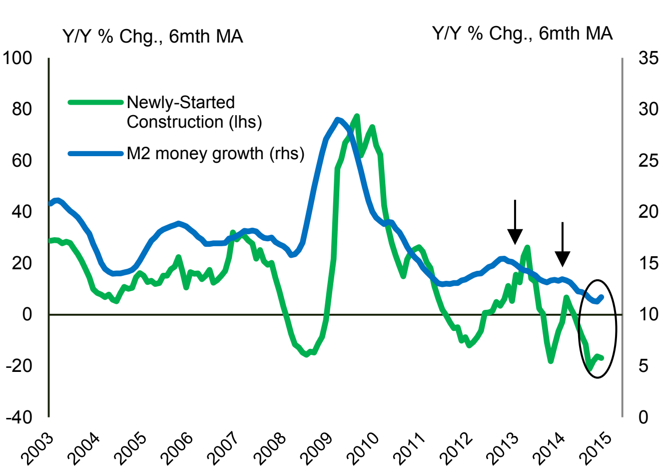
A continued slowdown in China over the medium term appears inevitable, but the speed and pace remain highly uncertain, given that so much depends on the policies implemented by authorities in a centrally-planned economy.

EMs slowing amidst gale force headwinds

Not all of the woes facing emerging markets are related to China, but it is playing an outsized role. The direct impact of China's slowdown is most apparent on commodity-producing countries and manufacturing-oriented economies located in China's vicinity where exposure is greatest.

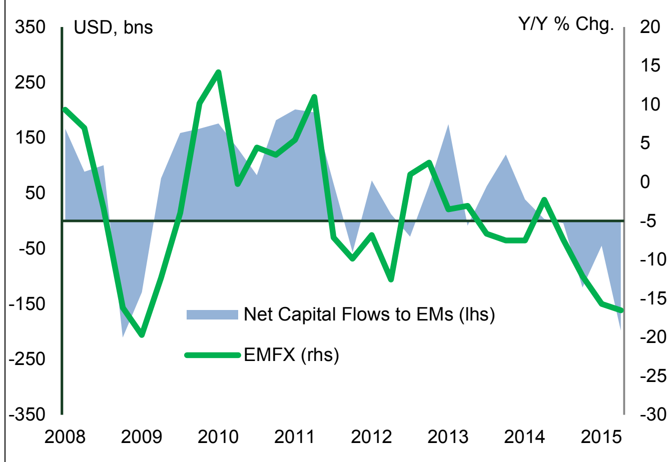
A second challenge facing emerging markets is rising capital outflows, estimated at roughly \$370bn over the past four quarters[6]. The outflows are partly driven by the prospect of higher interest rates in America, which makes emerging market assets less attractive relatively speaking[7]. Concern over the slowdown in EMs is another factor driving outflows. For many EMs this leads to a vicious cycle. Outflows lead to depreciating currencies (see chart), which increase external borrowing costs and lead central banks to apply tighter monetary policy than they would otherwise, further weighing on domestic activity. The challenge of high interest rates and falling currencies is exacerbated by the run up in both domestic and foreign-denominated private sector credit– a phenomenon that is not unique to China (see chart).

CHART 4. CHINESE STIMULUS LOSING EFFECTIVENESS



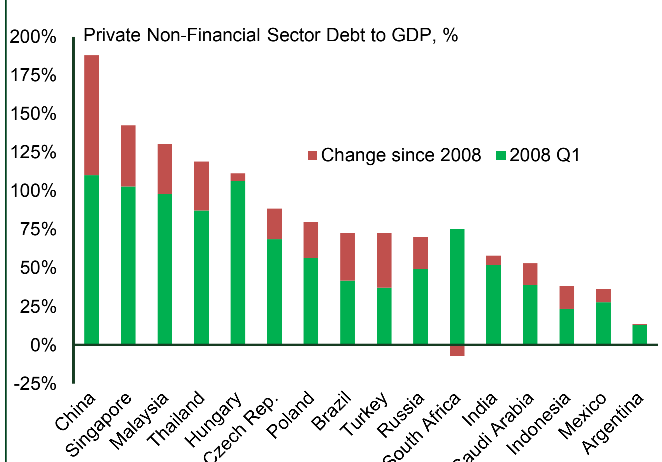
Source: China National Bureau of Statistics , PBOC.

CHART 5. EM CAPITAL OUTFLOWS LEADING TO TUMBLING CURRENCIES AND CRIMPING DOMESTIC DEMAND



Source: National Statistical Agencies, TD Economics estimates.

CHART 6. PRIVATE SECTORS IN A NUMBER OF EMERGING MARKETS HAVE BINGED ON DEBT



Source: BIS, National Statistical Agencies.

The path out will involve some measure of deleveraging or, at the very least, slower credit growth than in the past. Both imply a lesser pace of domestic demand.

Finally, idiosyncratic political risks are an additional challenge in a number of emerging markets. Western sanctions on Russia on top of tumbling oil prices explain much of why Russia's economy is expected to contract almost 4% this year, and remain in recession next year. For Brazil, political challenges to President Roussef are delaying much needed reforms, while the corruption scandal at Petrobras is embroiling a company responsible for an estimated 8% of total Brazilian investment[8]. The Brazilian economy is slated to tumble over 2% this year and remain in recession next year.

As a result, economic growth in emerging markets will likely slump to a post-financial crisis low of 4% this year. A modest rebound to 4.3% and 4.6% is expected in 2016-17. This pace falls well short of the 2002-2014 average of 6.2%.

Bottom line

The bottom line is that the pace of economic growth in advanced economies and emerging markets will converge to its smallest level since 2000, and remain roughly flat over the forecast horizon. Fragility and structural issues in EMs is being met with general improvement in more diversified advanced economies.

While the global economy is undergoing a challenging phase, the outlook further out does appear marginally brighter. Led by the U.S. and euro area, a further pickup in advanced economies is expected for next year. Meanwhile, less weakness in certain EMs such as Brazil and Russia should offset the continued slowdown in China, generating a modest bounce-back in EM growth in 2016-17.

Still, the pace of growth will remain subdued and global risks abound. Much rests on the ability of Chinese policymakers to ensure a soft landing for their economy, and the Federal Reserve delivering a slow and gradual pace of tightening.

The U.S. is expected to grow by roughly 2.5% over the forecast horizon, but slow global growth will weigh on the prices of commodities. These two factors frame the outlook for Canada's economy, where growth is likely to be modest to moderate.

End Notes

1. Nationwide House Price Index. Source: Nationwide Building Society.
2. Freddie Mac House Price Index. Source: Federal Home Loan Mortgage Corporation.
3. February 2013 to August 2015.
4. Bank loans to the non-bank private sector, adjusted for sales and securitization. Source: ECB.
5. Goods exports to China as a share of GDP is higher for Slovakia and Malta, than for Germany. Goods exports to China represent ~3% of German GDP.
6. Computed as the valuation-adjusted change in FX Reserves minus current account balance, summed across 29 of the largest emerging market countries.
7. Unless EMs then choose to raise their own interest rates, which would slow domestic activity, thus hurting growth prospects.
8. Refers to 2014.

GLOBAL ECONOMIC OUTLOOK					
Annual per cent change unless otherwise indicated					
	2014 Share*		Forecast		
Real GDP	(%)	2014	2015	2016	2017
World	99.9	3.4	3.1	3.4	3.5
North America	19.6	2.4	2.4	2.6	2.4
United States	16.1	2.4	2.5	2.6	2.4
Canada	1.5	2.4	1.2	2.0	1.9
Mexico	2.0	2.1	2.3	3.0	3.5
European Union (EU-28)	17.2	1.5	1.9	2.1	2.0
Euro-zone (EU-17)	12.1	0.9	1.6	1.8	1.7
Germany	3.4	1.6	1.6	1.9	1.7
France	2.4	0.4	1.1	1.6	1.6
Italy	2.0	-0.4	0.8	1.3	1.2
United Kingdom	2.4	3.0	2.5	2.4	2.1
EU accession members	2.7	2.6	2.9	2.8	2.9
Asia	41.8	5.2	4.6	4.8	4.9
Japan	4.4	-0.1	0.7	1.1	0.4
Asian NIC's	3.4	3.3	2.0	2.4	2.6
Hong Kong	0.4	2.5	2.4	2.4	2.5
Korea	1.6	3.3	2.4	2.7	3.0
Singapore	0.4	2.9	2.1	2.0	2.0
Taiwan	1.0	3.7	1.2	2.0	2.1
Russia	3.3	0.6	-3.8	-0.3	1.5
Australia & New Zealand	1.2	2.8	2.3	2.7	2.9
Developing Asia	29.5	6.8	6.6	6.3	6.3
ASEAN-4	4.7	4.5	4.4	4.6	4.8
China	16.3	7.3	6.8	6.2	5.9
India**	6.8	7.3	7.6	7.9	8.2
Central/South America	6.7	1.1	-0.5	1.0	2.1
Brazil	3.0	0.1	-2.5	-0.3	1.2
Other Developing	13.6	3.2	2.8	3.3	3.5
Other Advanced	1.0	2.2	1.6	1.8	1.8

*Share of world GDP on a purchasing-power-parity basis.
Forecast as at September 2015. **Forecast for India refers to FY.
Source: IMF, TD Economics.

ECONOMIC INDICATORS FOR THE G-7 AND EUROPE				
		Forecast		
	2014	2015	2016	2017
Real GDP (Annual per cent change)				
G-7 (32.7%)*	1.7	1.9	2.1	1.9
U.S.	2.4	2.5	2.6	2.4
Japan	-0.1	0.7	1.1	0.4
EZ	0.9	1.6	1.8	1.7
Germany	1.6	1.6	1.9	1.7
France	0.2	1.1	1.6	1.6
Italy	-0.4	0.8	1.3	1.2
United Kingdom	3.0	2.5	2.4	2.1
Canada	2.4	1.2	2.0	1.9
Consumer Price Index (Annual per cent change)				
G-7	1.5	0.3	1.7	2.2
U.S.	1.6	0.1	2.2	2.7
Japan	2.7	0.6	0.5	1.8
EZ	0.4	0.2	1.5	1.5
Germany	0.8	0.3	1.6	1.5
France	0.6	0.2	1.6	1.5
Italy	0.2	0.3	1.4	1.2
United Kingdom	1.5	0.1	1.8	2.1
Canada	1.9	1.0	1.9	2.1
Unemployment Rate (Per cent annual averages)				
U.S.	6.2	5.3	4.9	4.8
Japan	3.6	3.4	3.2	3.2
EZ	11.6	11.0	10.7	10.6
Germany	5.0	4.7	4.5	4.4
France	10.3	10.3	10.2	10.0
Italy	12.7	12.3	11.9	11.7
United Kingdom	6.2	5.5	5.4	5.3
Canada	6.9	6.9	6.9	6.7

*Share of 2014 world gross domestic product (GDP)
Forecast as at September 2015
Source: National statistics agencies, TD Economics