



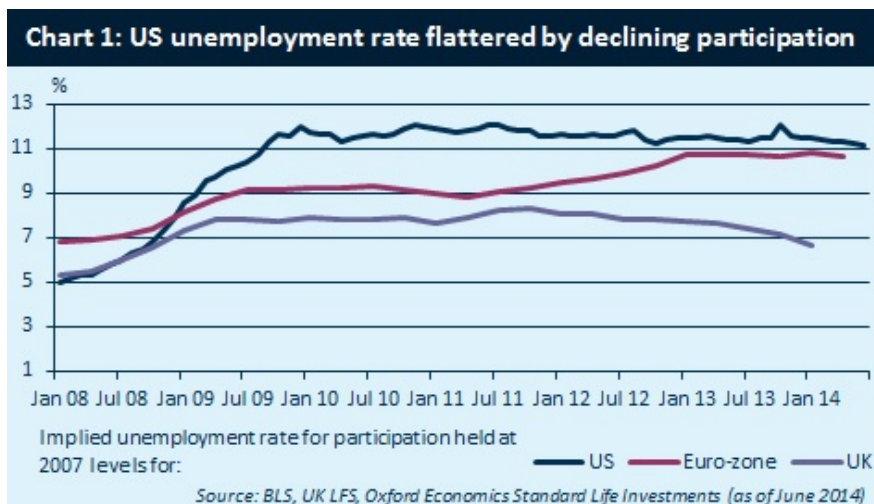
Weekly Economic Briefing Global Overview

Gathering momentum

08 July 2014

As we outlined last week, although global potential growth has weakened since the global financial crisis, the business cycle has not been banished. June's Purchasing Managers' Index (PMI) data not only confirmed that global growth will pick up solidly in Q2, but that this cyclical improvement will likely continue into the second half of the year. That said, the world's major economies are at very different points in their business cycles. In the US and UK, the business sentiment indices are at levels consistent with significantly above-trend growth, reinforcing our view that they will be the first of the large advanced economies to tighten policy. Business sentiment in Japan appears to be bouncing back quickly after the April sales tax hike, which augers well for second half growth, although it does imply that further Bank of Japan stimulus is some way off. Less positively, sentiment in the Euro-zone has fallen back of late, underlying just how much is riding on the ECB's latest round of stimulus helping to boost credit growth and hence the nascent recovery. Unusually, in the Euro-zone it is the core countries that are currently the biggest drag on confidence. Meanwhile, in emerging markets, sentiment remains fragile. The best news came from China, where sentiment indicators have increased markedly since Q1, although the improvement has been overly reliant on government stimulus measures. Elsewhere, manufacturing confidence in emerging Europe ebbed in line with those economies' reliance on the Euro-zone, while policy tightening lies behind the low levels of Brazilian confidence. Korean firms continue to be hurt by the weak yen.

In other news, the US labour market is gathering steam as we move into the summer, with the trend pace of employment growth hitting an 8-year high in June. The unemployment rate also fell to a post-crisis low of 6.1%, compared with the Euro-zone's unemployment rate of 11.7%. However, the better relative position of the US is flattered by the massive decline in labour force participation. Indeed, when we hold both economies' participation rates constant at their 2007 levels, the unemployment gap declines to 0.6 percentage points. On that score, the UK comes out on top, having seen the smallest decline in labour utilisation since the crisis (see chart 1).



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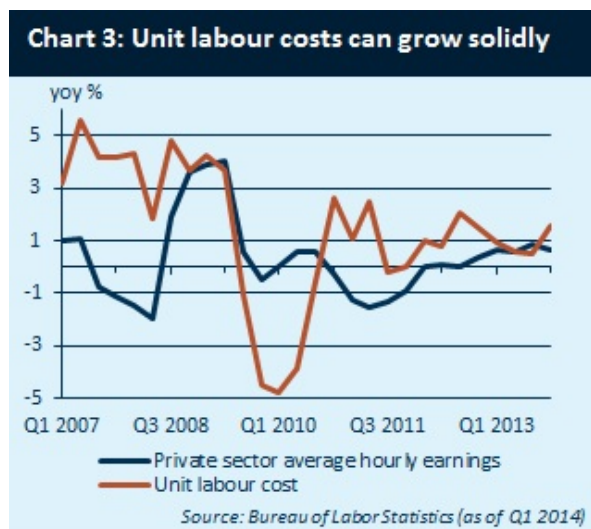
A rising tide

From a cyclical standpoint, last week's data were universally positive. The new orders component of the manufacturing Institute of Supply Management (ISM) index increased by two points to 58.9, its highest level since December 2013, while the same component of the non-manufacturing ISM index increased by 0.7 points to 61.2. Capital goods shipment data were already pointing to a strong rebound in business investment in Q2 and these sentiment readings are consistent with that continuing into Q3. Although net exports are on track to subtract from GDP growth again in Q2, real goods imports are growing in excess of a 20% annualised pace in the quarter, which is suggestive of healthy underlying domestic demand.

Then there was what can only be described as an exceptionally strong employment report. Nonfarm payrolls increased by 288k in June, leaving the six-month average at 231k. That is the fastest rate of growth since April 2006. **With employment growth so strong, all the measures of labour underutilisation are falling.** The unemployment rate declined to 6.1%, its lowest level since September 2008. U6 (a measure which includes regular unemployment, marginally attached workers and part-time for economic reasons) fell to 12.1% and is down two percentage points (ppts) over the past year. Meanwhile, hours worked increased at a 3.7% annualised pace in Q2.

So, what does all of this mean? The strong trend growth in hours worked would be consistent with a strong rebound in GDP growth in Q2 (see chart 2), while rapidly declining labour underutilisation suggests that the amount of slack in the labour market is eroding. At the same time, there are no signs that strength in employment growth is encouraging people back into the labour force and there are still more than 7 million people working part-time for economic reasons. That, and the subdued pace of wage growth, should be telling Janet Yellen that slack has not been eliminated yet. The data also raise difficult questions about the underlying rate of productivity growth. Productivity declined last quarter, as hours worked continued to grow and GDP contracted. The expectation was that a strong rebound in growth in Q2 would be accompanied by a more modest improvement in hours worked. Instead, hours worked look like they will increase at least much as GDP in the quarter, implying another very weak quarter of productivity growth. In that environment, unit labour costs can grow at a solid pace, even if nominal wage growth remains subdued (see chart 3). Of course, there is also a possibility that the BEA is simply mismeasuring GDP at present and that some of this apparent productivity puzzle will be resolved with the annual national accounts revisions at the end of July.

From the Federal Reserve's perspective, the Committee's unemployment forecasts will have to be revised down again in September, which will probably lead to another upward revision to the median Fed Funds rate projection. That said, Yellen will still want to convey a dovish attitude at her press conference, at least until tapering is concluded. **Overall, the latest data are consistent with our view that the first rate hike will occur at either the June or September meetings next year.**



Stuck in 2nd gear

Survey data in the Euro-zone stumbled slightly at the end of Q2. The composite Purchasing Managers' Index (PMI) for the currency union, incorporating both manufacturing and services firms, slipped for a second consecutive month to 52.8 in June. This is the weakest reading seen over 2014, providing some concern that the upturn in Euro-zone activity is starting to flag. Growth in output and new orders for the manufacturing sector slowed over the month and is the weakest seen since autumn of last year. There was some slightly better news in the breakdown of the services survey. While current business activity slowed, there was an acceleration in new orders to a three-year high. Unusually, the weakness was not confined to the periphery, with Germany and France stuttering while Spain gained momentum. **It is too early to become overly alarmed by the slip in survey data.** Indeed, PMIs continue to point to solid growth in the region over the second quarter of 2014. However, it is something of a concern that we are seeing few signs of a further acceleration in this sluggish recovery.

It is important to take some of these survey data with a pinch of salt, given that the headline PMI survey slightly overstated Q1 growth in the Euro-zone. This disconnect has been even more pronounced at the national level and is best seen in comparing Italy and France (see charts 6 and 7). The composite PMI reading for Italy is currently running at a three year high of 54.2, suggesting robust growth. This contradicts hard data which show an economy that contracted in Q1 and hasn't grown over the past year. In this case, the survey data may be partly capturing improving sentiment related to the new Renzi Government, as opposed to increasing activity. Meanwhile, the French composite PMI is currently at just 48.1, and over the past year has only rarely reached above the 50 point mark which separates expansion from contraction. While the French economy has not performed particularly well over this period it has expanded by 0.7%. In this case, weak domestic sentiment over the political environment and longer-term economic prospects for France could be painting an overly negative picture of underlying activity.

If we were to see the recent slip in activity develop into something more long-lasting there would be even more onus on the ECB to support the economy. Last week, President Draghi provided some more detail on how the targeted long-term repo operations (TLTROs) will work in the Euro-zone. In order to access additional cheap funding, banks will need to have improved their lending sufficiently. The benchmark against which the central bank will determine whether this has occurred looks to be relatively generous. Over the first year, banks which are currently deleveraging will be able to access funding if they slow the pace of this balance sheet reduction. This suggests that the overall take-up of TLTROs could be significantly larger than the initial €400bn offering. However, the pace of deleveraging will not be fully under the control of banks and much of the success of this policy will depend on the demand for credit from Euro-zone businesses. With the first offerings of the TLTROs due to commence in Q4, we will be well into 2015 before we can judge the impact of this stimulus. If this and the broader recovery disappoints, the ECB should launch a full-blown asset purchase programme without further hesitation.

Chart 6: France lagging Italy on PMIs...

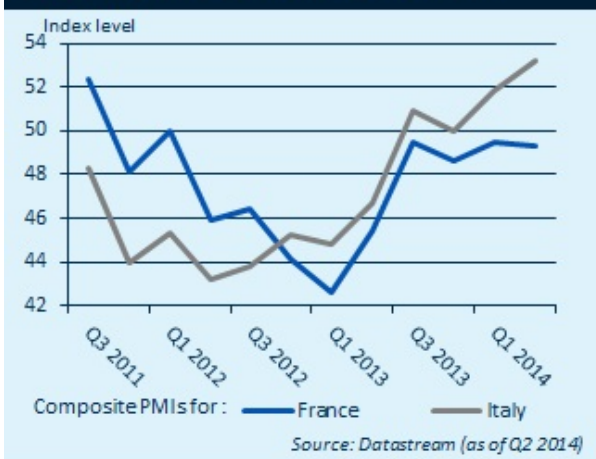


Chart 7: ...despite a stronger recovery



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