Economic and Strategy Viewpoint – Pt.1

Global 1: Careful what you wish for…

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Global 1: Careful what you wish for… (page 2)

- **Investors have welcomed the decision by the ECB to launch sovereign QE and there will be benefits to the economy, primarily through a lower euro. However, QE will also create acute shortages of risk-free assets in the region, increasing the likelihood of spill-overs to international bond markets. Projects such as the Juncker plan now stand a greater chance of being funded by asset starved investors, but the main effect from ECB QE is to further increase the financial repression of savers in the Eurozone and beyond.**

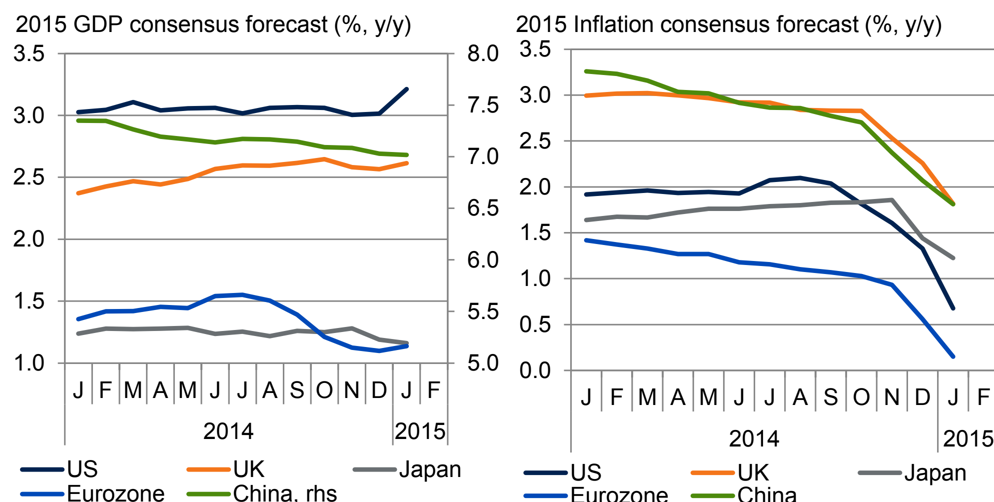
Global 2: Lower inflation is only half the story (page 4)

- **Markets remain gloomy about the outlook for the world economy and whilst we recognise the structural headwinds which challenge growth, we believe that the consensus is not fully accounting for the benefits to activity from lower inflation via real incomes and consumer spending. Energy industry cuts to capex and employment are not sufficient to derail this conclusion given the size of the sector relative to the rest of the economy.**

Views at a glance (page 6)

- **A short summary of our main macro views and where we see the risks to the world economy.**

Chart: Inflation forecasts downgraded, but growth forecasts are unchanged



Source: Thomson Datastream, Consensus Economics, Schroders. 29 January 2015.

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Global 1: Careful what you wish for…

ECB QE will exacerbate asset shortage

One of the key developments this month was the well-trailed announcement by the European Central Bank (ECB) of a sovereign quantitative easing (QE) programme. We look at the details of this below, where we note that planned purchases of €60 billion per month until September next year would soon absorb the sovereign issuance in the Eurozone which is put at just under €300 billion. From this perspective, the strength of Eurozone bond markets - where, for example, the German yield curve is below zero in bonds with a maturity of up to 5 years - is quite understandable. The demand-supply balance in the Bund market will be particularly acute as Germany intends to run a budget surplus this year making investors less willing to sell their holdings as the Bundesbank/ ECB seeks to fulfil its QE quota.

The effect of QE on growth in the Eurozone remains an open debate and we see the principal transmission mechanism to the economy as being through the exchange rate. On this metric the ECB has already been successful, with the euro depreciating to 1.13 having traded above 1.30 as recently as September. However, if the experience of the Eurozone mirrors that of the US, UK or Japan then much of the extra liquidity being created will find its way onto bank balance sheets rather than increased lending. This in turn will boost asset prices, but unlike the US and UK, the wealth effect in the Eurozone is likely to be relatively muted given the smaller capitalisation of the equity markets.

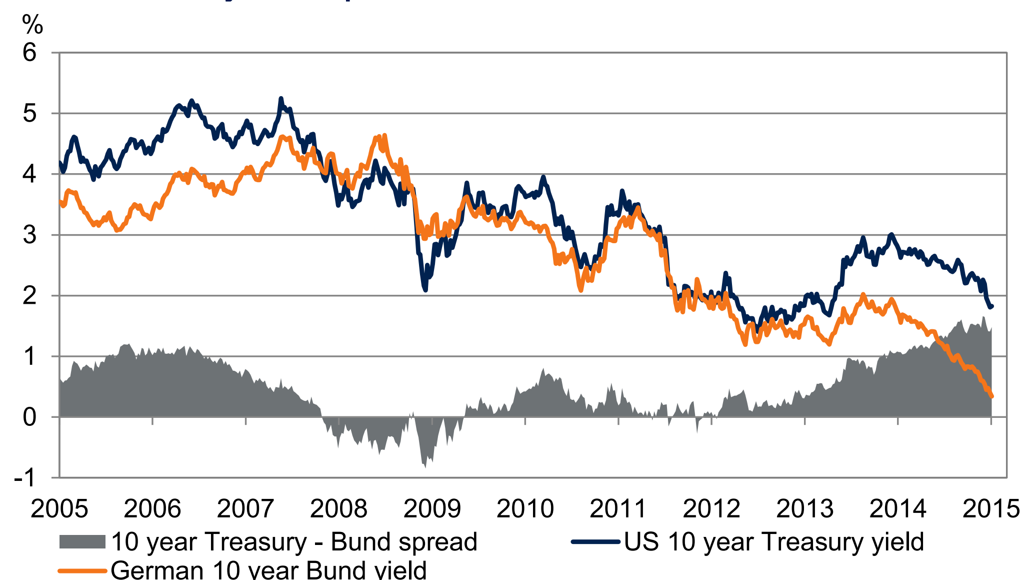
As indicated above, QE also means that the supply of investible assets will be reduced, thus creating a problem for institutions such as pension funds and insurance companies who need risk-free or low risk, high quality assets to match their liabilities. Consequently, it seems likely that many Eurozone funds will begin to look outside the region in a search for yield. The same process is occurring in Japan led by the Government Pension Investment Fund (GPIF).

Two consequences follow from this.

Spill-over effects from the ECB will be widely felt

First, we are likely to see spill-over effects with bond markets outside the Eurozone experiencing inflows from yield seeking investors fleeing QE. The spread between US Treasuries and Bunds remains attractive even after the recent rally in the former indicating the incentive to shift funds remains high (chart 1 on next page). ECB QE could be very widely felt and differs from QE in the US and UK where, for most of these programmes the domestic government was running a substantial budget deficit.

Chart 1: Treasury-Bund spread remains wide



Source: Thomson Datastream, Schroders. 29 January 2015.

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Increasing the prospects for projects such as the Juncker plan

Second, there is an opportunity for high quality issuers to raise funds. Of course we have already seen this in credit markets as firms have restructured their balance sheets. However, the latest move by the ECB also means that projects such as the Juncker plan (which intends to leverage €21 billion of public money into €315 billion of private investment) stand a much greater chance of being funded by asset-starved European funds.

Perhaps we might then see a stimulus to growth as spending on public-private projects across Europe pick up with QE being the initial catalyst. This would be great news, but until then the main effect from ECB QE is to further increase the financial repression of savers in the Eurozone and beyond. Those cheering Mario Draghi last week should be careful what they wish for.

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Global 2: Lower inflation is only half the story

IMF downgrades global growth…

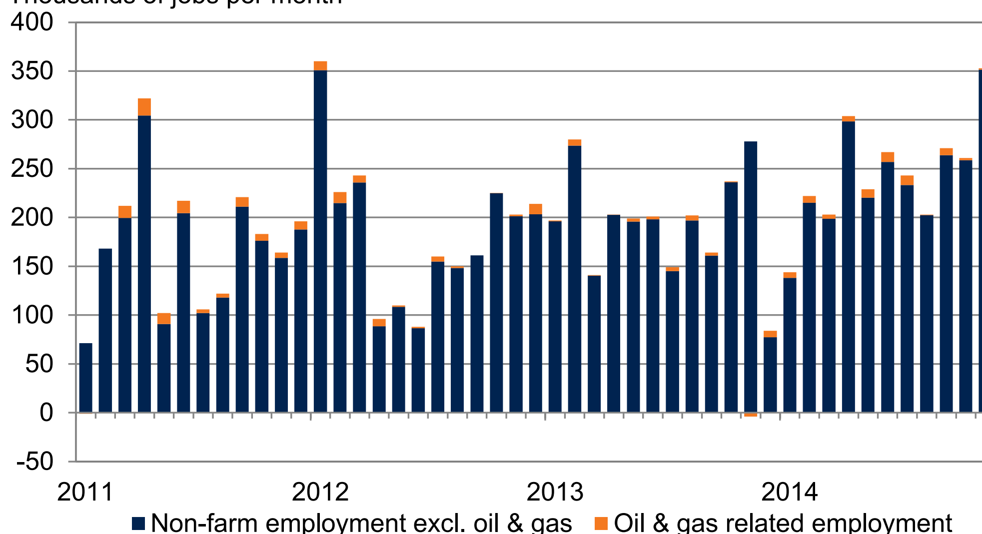
Sentiment towards the world economy remained poor in the first month of 2015 with the IMF welcoming in the New Year by downgrading its forecast for global growth. It now expects global growth of 3.5% in 2015, compared to 3.8% in October. Whilst acknowledging that lower oil prices will help support activity, the benefits are expected to be offset by a deterioration in the Eurozone and emerging markets. An element of this reflects a correction to an overoptimistic view of China's growth prospects and the IMF forecast for this year is now in line with our own at 6.8%. There have also been cuts to growth forecasts for oil producers such as Russia, which is now expected to be in recession in 2015. Nonetheless, the overall IMF view is in line with that of the consensus, which shows that economists have downgraded their inflation projections, but made little change to their growth forecasts (chart front page). Financial markets seem to agree, with long-dated bond yields falling to new lows and equities struggling to make progress.

…but we remain positive on oil price effect

Our own forecasts will be updated next month, but we are likely to take a more optimistic view, with a strong possibility of an upgrade to our growth projections. We continue to see the fall in oil prices as a boost to growth being driven by positive supply side developments rather than a response to a collapse in global demand. The main criticism of our view is that we are not fully taking account of the adverse impact on the energy industry itself, which is seen by some as a principal driver of the US recovery. It is certainly true that the shale boom has added to US growth, but this vastly overstates the importance of the sector in the overall economy. For example, the energy sector added 270k jobs since the economy turned in mid-2009, compared with a 9.15 million total. Even if all these jobs in energy were now lost, they would be offset by one month of payroll growth. The monthly totals for non-farm payrolls with and without energy are shown below (chart 2).

Role of energy sector in recovery has been modest

Chart 2: Change in oil and gas jobs vs. total payrolls (ex. oil and gas)



Source: Thomson Datastream, Citi, Schroders. 28 January 2015.

It is likely that the hit from cuts in capex will be more significant from an economy perspective than employment particularly in the short-term and may account for some of the recent weakness in durable goods orders. However, as argued last month, we would expect some offset as the non-energy sector benefits from lower energy costs and raises capex. Clearly there will also be a regional impact and the Dallas Fed reported that Texas is *"…likely to grow but not nearly as strong as last year"*, with the amount of drilling rigs beginning to fall. However, even the Dallas Fed is of the opinion that *"…if energy prices remain low, (the) US economy should pick-up further in 2015"*, indicating lower oil prices are a positive overall.

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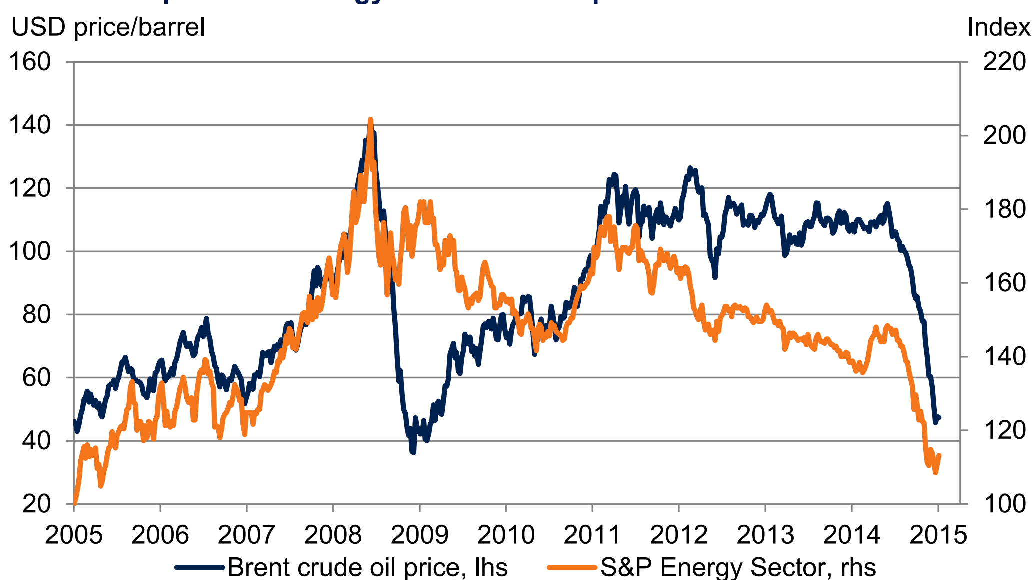
One reason investors are more concerned by the impact on the energy sector is that it has a greater weight in markets than the economy. For example, according to Bloomberg, energy accounts for 8.2% of the S&P500 and 14.1% of the FTSE-100 whilst the sector is only 3% and 2% of the US and UK economies. The relative underperformance of the energy sector in the US has been significant, but not out of line with the move in the oil price (chart 3). Similar concerns have dominated sentiment in the credit markets where, for example, energy is the largest sector in US high yield, constituting 13.4% of the index.

Greater weight on energy in the markets than the economy

Chart 3: Oil price and energy sector relative performance



Source: Thomson Datastream, Schroders. 29 January 2015.

On balance, our conclusions are unchanged: there are offsets to the boost to growth brought by lower oil prices and these may be felt in the near term via lower capex and employment in the energy sector. Increased volatility in oil-related currencies and credit can have adverse effects on growth. Losses in the banking sector might also result, although our US analyst reckons these should be contained with the caveat that it is difficult to fully assess exposure via derivatives (taken on by banks as part of a hedge trade). Despite some commentary to the contrary, bank exposure to energy is not on the scale of sub-prime mortgage loans. Overall, we still believe the benefits to consumer spending and business through lower energy costs are set to outweigh these further out, with the result that global growth will be stronger and inflation lower. Economists have been quick to assess the effect of lower oil prices on inflation, but so far have failed to recognise the benefits to growth.

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Schroder Economics Group: Views at a glance

Macro summary – January 2015

Key points

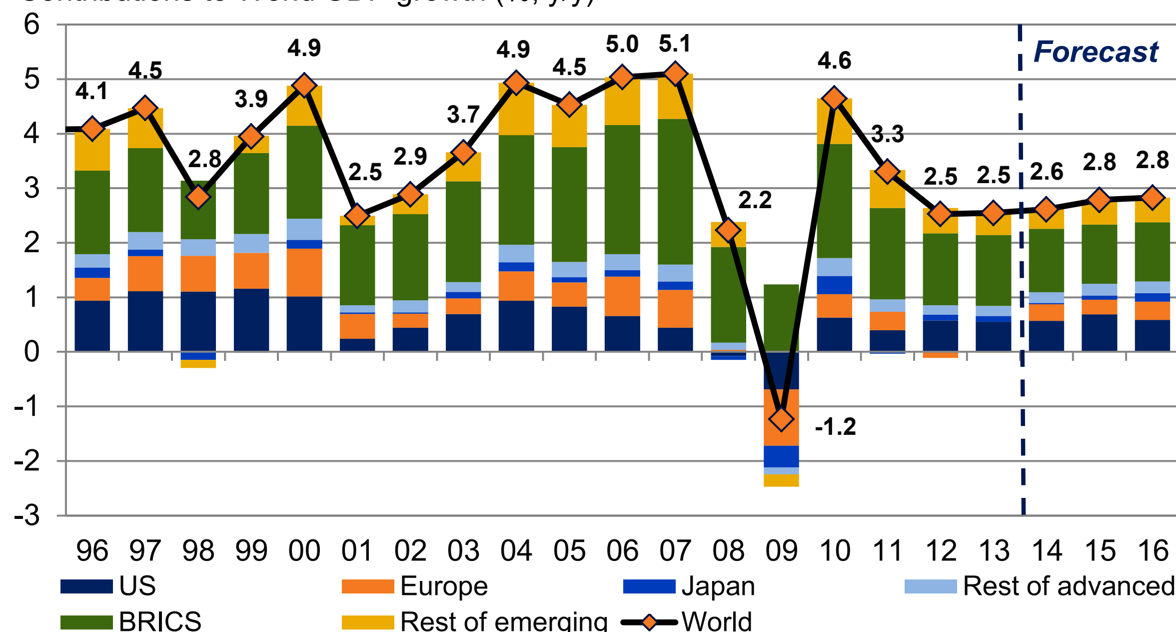
Baseline

- Global recovery to continue at sub par pace as the US upswing is offset by sluggish growth in the Eurozone and emerging markets. Lower energy prices are weighing on inflation, but will also boost growth in 2015.
- US recovery continues and unemployment is set to fall below the NAIRU in 2015 prompting Fed tightening. First rate rise expected in June 2015 with rates rising to 1.25% by year end. Policy rates to peak at 2.5% in 2016.
- UK recovery likely to moderate next year with general election and resumption of austerity. Interest rate normalisation to begin in 2015 with first rate rise in November.
- Eurozone recovery becomes more established as fiscal austerity and credit conditions ease whilst lower energy prices help consumption. ECB to monitor effects of recent easing, but we now expect sovereign QE in 2015 in response to deflation fears.
- In Japan, the consumption tax pushed the economy into recession prompting further easing by the BoJ and a snap general election. Weaker JPY to support the recovery, but Abenomics faces considerable challenge to balance recovery with fiscal consolidation.
- US leading Japan and Europe. De-synchronised cycle implies divergence in monetary policy with the Fed tightening ahead of ECB and BoJ, resulting in a firmer USD.
- Tighter US monetary policy and weaker JPY weigh on emerging economies. EM exporters to benefit from US cyclical upswing, but China growth downshifting as the housing market cools and the authorities seek to reign in the shadow banking sector. Generally, deflationary for world economy, especially commodity producers.

Risks

- Risks are still skewed towards deflation, but are more balanced than in the past. Principal downside risks are Eurozone deflation and China hard landing. Some danger of inflation if capacity proves tighter than expected, whilst upside growth risk is a return of animal spirits and a G7 boom. Increased prospect of stronger growth/ lower inflation if oil prices continue to fall.

Chart: World GDP forecast



Source: Thomson Datastream, Schroders 25 November 2014 forecast. Previous forecast from August 2014. Please note the forecast warning at the back of the document.

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Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2013	2014		Prev.	Consensus	2015		Prev.	Consensus	2016
World	100	2.5	2.6	↑	(2.5)	2.6	2.8	↓	(2.9)	2.8	2.8
Advanced*	63.0	1.3	1.7	↑	(1.6)	1.7	2.0		(2.0)	2.2	2.1
US	24.8	2.2	2.3	↑	(2.0)	2.2	2.8	↑	(2.6)	3.2	2.4
Eurozone	18.8	-0.4	1.0	↑	(0.8)	0.8	0.9	↓	(1.2)	1.1	1.4
Germany	5.4	0.2	1.5	↓	(1.6)	1.4	1.2	↓	(2.0)	1.4	1.8
UK	3.7	1.7	3.1	↑	(3.0)	3.0	2.5		(2.5)	2.6	1.8
Japan	7.2	1.5	0.3	↓	(0.8)	1.0	1.1	↑	(0.9)	1.2	2.2
Total Emerging**	37.0	4.7	4.1		(4.1)	4.1	4.1	↓	(4.3)	3.8	4.1
BRICs	22.8	5.7	5.1		(5.1)	5.1	4.8	↓	(4.9)	4.4	4.7
China	13.6	7.7	7.3		(7.3)	7.4	6.8		(6.8)	7.0	6.5

Inflation CPI

y/y%	Wt (%)	2013	2014		Prev.	Consensus	2015		Prev.	Consensus	2016
World	100	2.7	3.0	↓	(3.1)	3.0	2.9	↓	(3.3)	2.6	3.2
Advanced*	63.0	1.3	1.4	↓	(1.5)	1.4	1.3	↓	(1.7)	0.7	1.8
US	24.8	1.5	1.6	↓	(1.7)	1.7	1.5	↓	(2.2)	0.7	2.4
Eurozone	18.8	1.3	0.5	↓	(0.7)	0.5	0.8	↓	(1.1)	0.1	1.1
Germany	5.4	1.6	1.0	↓	(1.1)	1.0	1.4	↓	(1.8)	0.7	1.7
UK	3.7	2.6	1.5	↓	(1.6)	1.6	1.3	↓	(2.2)	0.9	2.0
Japan	7.2	0.4	2.8	↑	(2.7)	2.8	1.3	↓	(1.5)	1.2	1.4
Total Emerging**	37.0	4.9	5.7	↓	(5.8)	5.7	5.6	↓	(5.8)	5.8	5.6
BRICs	22.8	4.6	4.1	↓	(4.4)	4.2	4.0	↓	(4.4)	4.3	4.0
China	13.6	2.6	2.2	↓	(2.3)	2.1	2.2	↓	(3.0)	1.8	2.7

Interest rates

% (Month of Dec)	Current	2013	2014		Prev.	Market	2015		Prev.	Market	2016	Market
US	0.25	0.25	0.25		(0.25)	-	1.25	↓	(1.50)	0.69	2.50	1.43
UK	0.50	0.50	0.50		(0.50)	-	0.75	↓	(1.50)	0.73	1.50	1.11
Eurozone	0.05	0.25	0.05	↓	(0.15)	-	0.05	↓	(0.15)	0.03	0.05	0.09
Japan	0.10	0.10	0.10		(0.10)	-	0.10		(0.10)	0.10	0.10	0.10
China	6.00	6.00	5.60	↓	(6.00)	-	5.20	↓	(6.00)	-	5.00	-

Other monetary policy

(Over year or by Dec)	Current	2013	2014		Prev.		2015		Prev.		2016
US QE ($Bn)	4498	4033	4486	↑	(4443)		4594	↑	(4443)		4557
UK QE (£Bn)	365	375	375		(375)		375		(375)		375
JP QE (¥Tn)	276.2	224	295		(295)		383		(383)		383
China RRR (%)	20.00	20.00	20.00		20.00		19.00	↓	20.00		18.00

Key variables

FX	Current	2013	2014		Prev.	Y/Y(%)	2015		Prev.	Y/Y(%)	2016	Y/Y(%)
USD/GBP	1.51	1.61	1.56	↓	(1.68)	-3.1	1.50	↓	(1.63)	-3.8	1.48	-1.3
USD/EUR	1.13	1.34	1.23	↓	(1.32)	-8.2	1.18	↓	(1.27)	-4.1	1.14	-3.4
JPY/USD	118.1	100.0	117.0	↑	(105.0)	17.0	125.0	↑	(110.0)	6.8	130.0	4.0
GBP/EUR	0.75	0.83	0.79	↑	(0.79)	-5.3	0.79	↑	(0.78)	-0.2	0.77	-2.1
RMB/USD	6.25	6.10	6.12		(6.12)	0.3	6.20	↑	(6.05)	1.3	6.35	2.4
Commodities												
Brent Crude	47.2	109	100.4	↓	(101)	-7.9	82.1	↓	(89)	-18.3	85.5	4.2

Source: Schroders, Thomson Datastream, Consensus Economics, November 2014
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 29/01/2015
Previous forecast refers to August 2014

* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, Sweden, Switzerland, United Kingdom, United States.

** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

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Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

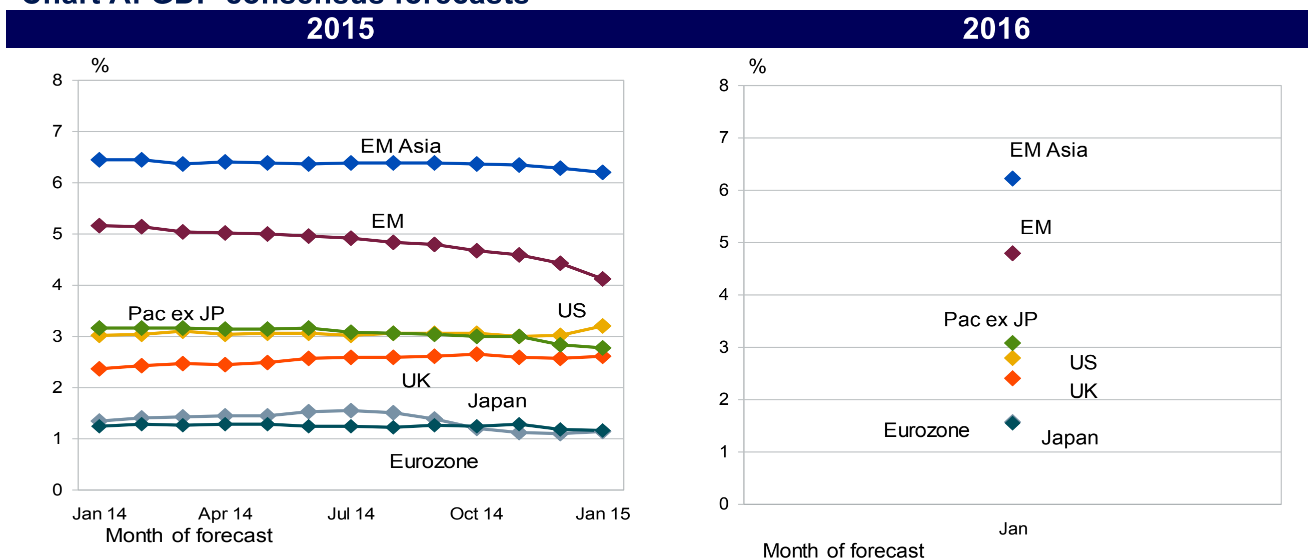
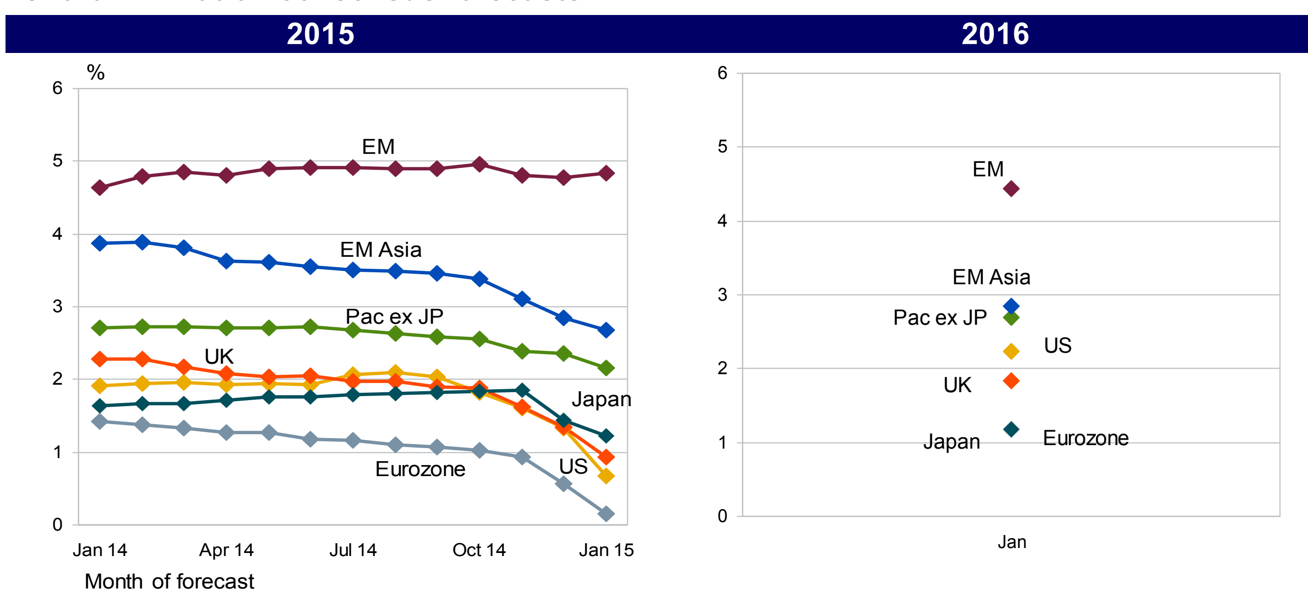


Chart B: Inflation consensus forecasts



Source: Consensus Economics (January 2015), Schroders
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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