Global Economic Research

Global Economic Outlook

December 2015

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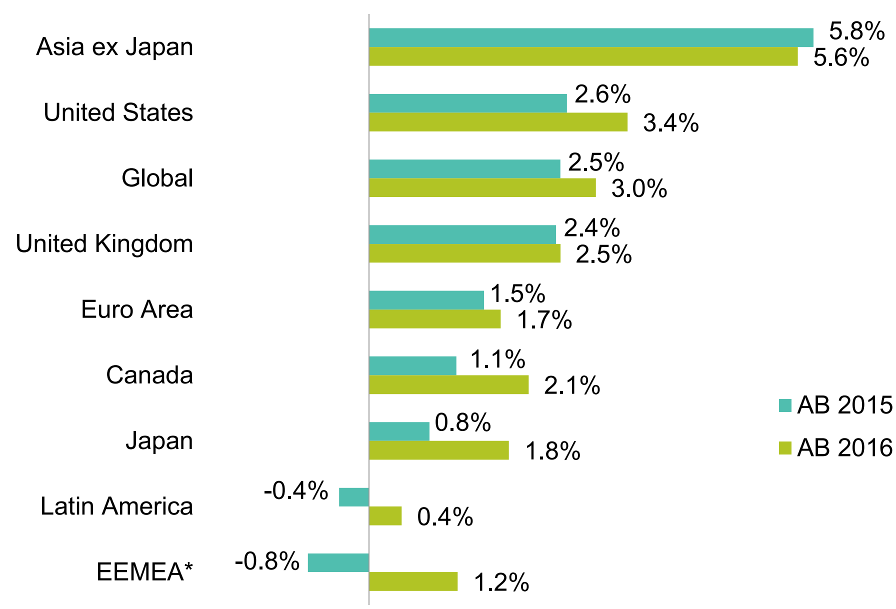
AB World Economic Growth Forecasts



As of December 1, 2015; calendar-year forecasts
*Emerging Europe, Middle East and Africa
Source: AB

Global Outlook

Global growth remains modest

We still expect gross domestic product (GDP) growth of 2.5% in 2015 and 3% in 2016. The world economy continues to grow at a modest pace, with manufacturing generally underperforming the services. The consistent underperformance of the manufacturing sector is unusual. It would have to rebound in 2016 and lead a recovery for our forecast to prove correct.

Manufacturing is the key to faster growth

The trend for the global manufacturing sector did not change in November. The J.P. Morgan Global Manufacturing Purchasing Managers Index was little changed on the month and remained at near its midyear level. The good news is that inventory positions look normal—or only slightly below normal—compared to new orders, so any increase in demand would generate more production and employment gains.

Policy divergence in 2016

The biggest uncertainty that markets face has to do with the divergence in monetary policy. The European Central Bank (ECB) more or less promised additional monetary accommodation at its December 3 meeting, while the Federal Reserve has hinted strongly that it will start normalizing interest rates when it wraps up its last meeting of the year on December 16. While the financial markets were expecting this divergence, the impact on market interest rates and currency will depend on how wide the deviation of offical interest-rate paths turns out to be. The fundamentals still favor a stronger US dollar.

US Outlook

GDP revised higher – again

3Q real GDP was revised to an annualized rate of 2.1%, up from the initial estimate of 1.5%. So far, all the initial quarterly estimates for GDP in 2015 have been revised upward. Through the first three quarters of 2015, real GDP growth has averaged 2.2%, with the private sector advancing 2.5%.

Some of the components of the report showed downward revisions. Real consumer spending rose by 3%, down slightly from the initial 3.2% estimate. Personal spending on consumer services was revised to an annualized rate of 2.2%, down from an initial estimate of 2.6%. The revision in consumer services was concentrated in cellular telephone services and utilities.

Business investment revised higher

But business investment for equipment and software was revised sharply higher. 3Q business spending on equipment and software now stands at 9.5% annualized, up from the initial estimate of 5.3%. The revision was in business software spending and transportation equipment. The latter reflects a shift in the composition and mix of vehicle purchases. More complete data shows that a higher percentage of 3Q purchases occurred in the business or fleet segment; therefore, there was a corresponding downward revision to consumer spending on motor vehicles.

Inventories weighed on 3Q growth rate

The rate of inventory investment was also revised up. Inventories accumulated an annualized rate of $90 billion, compared to an initial estimate of $57 billion. The inventory component still subtracted 0.6 percentage points from the 3Q GDP quarterly growth rate.

Initial 4Q data shows an economy expanding in the 2.5% to 3% range. Real consumer spending is moving forward at a rate of 3% or more, led by strong gains in motor vehicles. Overall construction spending is running relatively fast, rising in the 5% to 6% range, and external trade looks to be adding a bit as well.

FOMC to lift off this month

Based on the continued gains in GDP and the steadily tightening labor markets, we expect the Fed's rate-setting committee to raise official rates by 25 basis points at the December meeting.

Europe Outlook

Survey data still solid

Despite concerns about rising headwinds from abroad, the euro-area economy has performed well in recent months. This is evident in key survey data, such as the composite Purchasing Managers' Index (PMI) for manufacturing and services, which rose to 54.2 in November from 53.9 in October. That's close to the high for the year (54.3 in August) and is consistent with GDP growth of about 0.4% a quarter.

French weakness

The country split of the PMI data showed solid gains in Germany (55.2 from 54.2), Italy (54.3 from 53.9) and Spain (56.2 from 55.0), but weakness in France (51.0 from 52.6). This continues the recent theme of French underperformance, but in this case, the French data are also likely to have been adversely affected by the terrorist attrocities that took place in the middle of November. If, as we surely hope, this turns out to be an isolated event, the negative impact on French and euro-area growth is likely to be modest and temporary.

Core inflation slips

November inflation data were weaker than expected, with the headline rate holding steady at 0.1% and core inflation (excluding food and energy) slipping back to 0.9% from 1.1% in October. Although base effects should push headline inflation markedly higher in coming months, the outlook for core inflation is less obvious. Indeed, the gradual upward trend that seemed to be emerging when the October data were published has now given way to a much flatter profile, and the ECB's core inflation forecast for 2016 (1.4%) is starting to look like a distant goal. To put this in perspective, if the average monthly gain in core inflation over the coming year is the same as it was over the last six months, core inflation will average just 0.9% next year, after 0.8% both this year and last.

ECB disappoints

With inflation rising more slowly than expected and downside growth risks rising, there was never any doubt that the ECB would ease policy again at its December council meeting. For once, though, markets were disappointed by President Mario Draghi's offerings. The central bank opted "only" to reduce its deposit rate by 10 basis points to -0.30% and extend its quantitative easing (QE) program by six months to March 2017. In our view, this is an appropriate policy response at this stage, especially as the ECB is still only halfway through its existing QE program. In this sense, market disappointment in large part reflects the unrealistic expectations that had built up ahead of the announcement (partly fanned by some Governing Council members, including Draghi himself).

Further easing possible

The question now is whether or not the ECB is done. We are not convinced, primarily because we think inflation will rise very slowly in coming quarters—especially if any downside growth risks crystallize or market disappointment with the ECB's actions leads to a sustained tightening of financial conditions. The ECB is likely to have an easing bias for some time to come, and further measures are possible in 2016.

Japan Outlook

Recession talk wide of the mark, despite negative 3Q GDP

Japan's GDP contracted in 3Q for the second straight quarter. That sparked plenty of discussion about whether the economy had entered a "recession" again. In our view, those concerns are wide of the mark.

Yes, Japan has recorded two negative quarters in a row, but given that the economy is pretty much fully employed (at 3.1%; the unemployment rate hit a 20-year low in October), and the potential growth rate is close to zero, stringing a couple of negatives together should be a regular occurrence. Remember, these statistics can be quite volatile. In this context, the standard definition of a recession—two consecutive quarters of contraction—seems silly.

More importantly, the higher frequency data, including employment, retail spending, industrial production and various PMIs, all point to a stronger economy, not a weaker one. Also, the surprisingly strong capital spending figures in 3Q—the Ministry of Finance survey of corporations showed an 11% year-over-year increase in capital expenditures—suggest that preliminary GDP estimates will be revised upward. That should provide some comfort about the shape of the economic recovery in 2016.

On the inflation front, the Bank of Japan (BoJ) has started to publish their preferred CPI ex-fresh food and energy index along with some additional metrics. The index came in at 1.2% year over year—still short of the 2% inflation target. But it has accelerated swiftly under Prime Minister Shinzō Abe's policy framework, and continues to let BoJ Governor Haruhiko Kuroda's express confidence in the outlook.

It still seems like officials have a fairly limited appetite for further BoJ easing. If anything, the market is underestimating the probability of early asset-purchase tapering. Any policy stimulus over the coming months is likely to be fiscal (by way of a supplementary budget), not monetary.

Australasia Outlook

Focus of downside risks in Australia swings to housing

In Australia, the positive GDP print (up 0.9% quarter over quarter, 2.5% year over year in 3Q) obscures the underlying weakness in the economy. Net exports were a big contributor, adding 1.5 percentage points, but domestic demand actually fell. That's a reflection of the decline in domestic purchasing power (as commodity prices fall).

In our view, the commodity bust will remain a drag. But the focus on risks should swing to the housing sector. To date, housing construction and price increases have helped to cushion the impact of a recent mining downturn. But there are plenty of signs that housing is close to a peak, and in 2016 the sector will move from being a growth positive to a negative.

Some of this turnaround reflects supply-demand dynamics, as housing completions have picked up. But this impact is being reinforced by macroprudential policies, which are tightening both the price and availability of credit, particularly for the investor sector of the market. Given the exposure of the banking system to residential property, this is clearly one of the key areas to watch in the coming months.

RBNZ still likely to ease further

Some of the downside risks for New Zealand's economy have eased, thanks to a modest recent recovery in dairy prices and some upbeat econmic data. That said, with inflation remaining low, the Reserve Bank of New Zealand (RBNZ) still seems set to cut rates a little more, probably in the upcoming review in December.

Canada Outlook

3Q rebound, but weakness in September

After two consecutive quarterly declines, the economy rebounded in 3Q with real GDP expanding 2.3% annualized. The rebound was broadly expected and was driven by export growth (+2.3%)—the result of a strong US economy and a more favorable Canadian-dollar exchange rate.

However, we don't think this rebound is sustainable. A weak energy sector—particularly in oil and gas extraction—sparked a 0.5% contraction in GDP on the month. Manufacturing and non-energy-related mining sectors also saw weakness. Furthermore, consumer debt remains high, the labor market weak and the manufacturing sector uncompetitive as a result of low commodity prices.

BoC likely to remain on hold into next year

Despite the drop in September, the bounce in third-quarter GDP was enough to keep the Bank of Canada (BoC) on hold. Growth dynamics have been largely in line with the BoC's latest Monetary Policy Report outlook. The recovery in the US, a lower Canadian dollar and the monetary policy easing are helping the economy adjust to the terms of trade shock. The BoC anticipates growth to be moderate in the last quarter and inflation to remain in line with the outlook. Considering these developments, we still expect the BoC to leave the overnight rate at 0.5% for the foreseeable future. And, we still see the currency trading near C$1.35 per US dollar over the next several months.

Emerging-Market Outlook

Latin America: While economic activity remains subdued across Latin America, focus is now on recent political developments that could alter the regional landscape. This could change the tone of many economic policies as well as the main country alliances both inside and outside the subcontinent.

Argentina: Change has arrived

In Argentina, market favorite Mauricio Macri was elected president in a tight second-round victory. Since being elected on November 22, Macri has had to move rapidly on many fronts because of a very short government transition period. He has already confirmed the composition of his Cabinet, though he won't be inaugurated until December 10.

While his early approach toward economic policy implementation was to front-load announcements and adjustments, more recently he has adopted a less aggressive stance, possibly because of uncertainties regarding the magnitude of the imbalances left behind by the administration of President Cristina Fernández de Kirchner. What's more, Fernández has not helped during the transition, a possible sign of things to come for Macri regarding the political opposition he will have to face.

Still, we expect Macri to make several announcements early on, possibly even on inauguration day. They include the initial guidelines of a gradual liberalization of the foreign exchange market; the reform and streamlining of the INDEC official statistical bureau; the partial dismantling of electricity, gas and water subsidies; and several changes to tax policy. Given the multiple and sizable economic disequilibria his administration will face, a holistic rather than piecemeal approach to reform is necessary. Macri is expected to improve bilateral relationships with the US, and his closest Latin American allies will probably not be the same as the ones who stood by Fernández. Macri indicated that he will invoke the so-called democratic chapter of the Organization of American States to force Venezuela to respect human rights, and also said that he will request that Venezuela be suspended or ejected from the Mercosur common market.

Brazil: Impeachment procedure now ongoing

In Brazil, the speaker of the Lower House formally accepted the petition for presidential impeachment presented by a group of opposition legislators and legal experts, based on alleged violations of legal fiscal rule. The speaker, accused of accepting bribes, may also be impeached, but that does not invalidate his decision to kick-start President Dilma Rousseff's impeachment procedure. The legal process leading to impeachment is lengthy and cumbersome, and in some stages it requires a qualified majority of congressional seats, which at this juncture remains uncertain. Chances are good that the ruling Workers Party coalition will fight the impeachment initiative, which may lead to even more delays.

In the meantime, these developments are likely to result in further polarization in Congress, which does not bode well for the prospects of fiscal adjustment. This suggests things will remain challenging in the short run. The real economy is in free fall; GDP contracted by 4.5% year over year during the third quarter and is projected to shrink by almost 4% for the full year. The economic contraction has damaged tax collection and widened the fiscal imbalance. This, along with a sharp currency depreciation, has pushed inflation toward double-digit territory.

Venezuela: Changes on the horizon

In Venezuela, the December 6 legislative elections resulted in a sound opposition victory. At the time this report goes to press, uncertainty still remains about the margin of that victory, namely whether it will deliver a simple or a qualified majority. The opposition has secured at least a simple majority and it could even reach a qualified majority when all the votes are counted. This election represents a step forward towards political change, but the ruling party (known widely as "Chavismo") controls institutions, which suggests that said change may not happen fast. Still, the solid margin in favor of the opposition provides the preliminary basis for gradual improvements in policy design and implementation.

Forward-looking indicators remain dull…

Asia ex Japan: Economic activity across the region remains lackluster. In key manufacturing countries, exports have continued to decline even as the PMIs have shown stabilization or a modest rebound. This suggests there are no catalysts to jump-start growth for the time being. Domestic demand remains soft, as reflected in the PMIs' corresponding GDP components, as well as data on credit and import demand for capital goods.

…but there's room for additional support

Overall, the growth outlook for 2016 remains challenging. If momentum doesn't improve, regional central banks will probably continue easing policy. The silver lining to this cloud is that most regional economies have room to implement additional supply-side measures to bolster support.

Growth rather than inflation to be central banks' key concern

There's a risk that a rebound in food or oil prices could distort this low inflation outlook, especially as geopolitical tensions increase in the Middle East. The market is also keeping an eye on El Niño. But with regional growth falling farther below potential and core inflation benign, we doubt second-round inflation impacts will be the same concern they were when oil and food prices rose in 2011. Policymakers will probably look beyond any noise in CPI readings and focus on protecting growth.

For China, the latest activity data shows no sign of improvement. After rising by 16.7% year over year in September, housing starts relapsed in October, falling by

24.4%. Land sales, a leading indicator for future investment, were also down by 34% year over year.

If housing investment does not pick up, we are worried that the noticeable slowdown in infrastructure investment growth will further slow overall investment next year. Despite all the hype about government support for infrastructure projects, the scale of projects approved remains relatively small.

Further signs of recovering investments in India and Indonesia

On a positive note, India's stalled investment projects showed some signs of revival, reflected by the 6.8% year-over-year growth in fixed capital investment in 3Q GDP data. For Indonesia, the fiscal position has been improving after subsidy reform, and the monthly budget data also shows increasing outlays in capital spending to kick-start infrastructure projects. Continued investment momentum in India and Indonesia would provide some support to intraregional demand over the next few quarters.

CEE outlook remains robust…

Emerging Europe, Middle East and Africa: The 2016 EEMEA real growth outlook remains relatively favorable. Recent data have showed robust activity in Central and Eastern Europe (CEE) and stabilization in Russia. The latest manufacturing PMIs have remained strong, while CEE 3Q real GDP data actually surprised mostly to the upside. While industrial production figures pointed toward some general softness in July and August across the region, real exports and investment turned out to be stronger than expected in the end. Steady eurozone activity and loose domestic monetary conditions will remain the main drivers of CEE growth next year. Also, the Polish economy is expected to benefit from fiscal stimulus as the new government under the leadership of the Law and Justice Party (PiS) makes good on its election promises.

…while Russia's economy shows stronger signs of stabilization

In Russia, 3Q real GDP data pointed toward an end of quarter-on-quarter contraction, and key headline indicators such as industrial production and investment saw some modest improvements in October. At this stage, Russian private consumption stays weak, as consumer spending remains constrained by double-digit inflation and an ongoing decline in credit extension to households. Strong disinflation in the first half of 2016 and expected central bank easing should brighten the outlook for private consumption next year. That said, tangible improvements are likely to take time, and we still expect Russia's full-year growth to be roughly flat in 2016.

As highlighted previously, South African activity is likely to remain constrained by weak commodity prices and further monetary policy tightening. Indeed, against ongoing FX weakness, lingering inflation risks and prospects of US Fed tightening, the South African Reserve Bank (SARB) continued its hiking cycle by raising its benchmark rate by 25 basis points to 6.25%. While positive for policy credibility, this will do little to support the economy going into 2016 against already very limited fiscal space.

Russian sanctions will not cause a crisis and may lead to disinflation near term

In Turkey, the AKP's election victory reduced uncertainty over domestic political stability and potential fiscal slippage, but the downing of a Russian jet and the ensuing diplomatic fallout and Russian sanctions on Turkey created a new set of uncertainties. While unlikely to induce a crisis, Russia's recent measures against Turkey, in particular travel and import restrictions, are likely to have some negative impact on real activity over the coming year. There remains uncertainty over the scope and duration of these measures, and any growth weakness is likely to materialize toward the end of 2016, given the strong seasonality in tourism over the summer months. Although not our base case, a severe disruption in bilateral trade, such as a cut-off in Russian gas supply, would have large negative growth implications. Perhaps more immediately, Russia's proposed ban on Turkish food items is likely to lead to a decline in Turkish food inflation, in line with the dynamics witnessed in Central and Eastern Europe in 2014. Depending on the extent of food-price disinflation, this is likely to ease the pressure on the central bank to raise interest rates over the near term. This, combined with election-related fiscal stimulus, is expected to at least partly offset the negative impact from sanctions.

Some countries have turned to central bank financing, as budgetary pressures have increased

Frontier Markets: Concerns in Sub-Saharan Africa still rest primarily on commodity prices and each respective government's ability to finance capital expenditures amid budgetary pressures. Some countries have turned to their own central banks to begin financing their budgetary expenditures—a worrying sign. In the case of Nigeria, Africa's largest economy, an order-based FX policy meant to maintain the dollar peg has made it more difficult for companies to access dollars for imports. As a result, growth has slowed and many industries are technically in recession, defined as two consecutive quarters of negative GDP growth.

In response, the central bank has lowered the cash-reserve requirement and the policy rate to increase liquidity in the market in hopes that banks will begin to lend and support growth instead of simply parking the money in government securities. In addition, the central bank has continued to expand its balance sheet as it takes over liabilities and overdrafts from the government at all three levels—local, state and federal. The intention of the Buhari administration seems to be to close off the economy and force import substitution, but without foreign capital (scared due to the prospect of a significant devaluation) and with only a limited amount of time to make the transition, we believe there is more pain to come as a result.

Even if banks go along with the plan and increase their lending to the private sector, our concerns would turn to the quality of these loans. We believe loan quality has already deteriorated but has not shown up in the figures. It seems Nigeria has turned to an unorthodox policy mix that now places it on an uncertain path.

INSERT FORECAST TABLES HERE