

WEEKLY ECONOMIC COMMENTARY

December 18, 2015

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• Main Themes of 2015

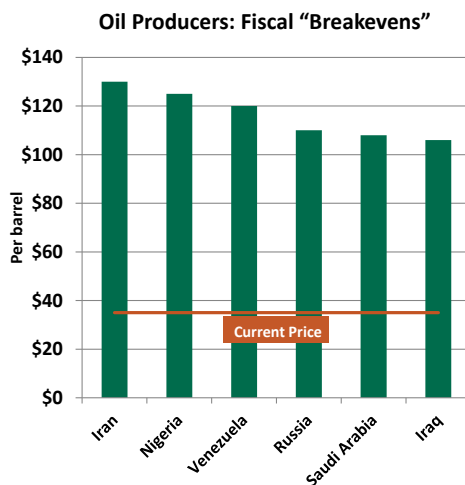
Editor's Note: This will be our last commentary of the year. We wish you the very best for the holiday season and a happy new year.

As we all looked back on the past year, the word “eventful” came up often in conversation. Following are our reflections on the main events that influenced economic performance in 2015.

Oil's Not Well

There are certain things that people of my generation never thought we'd see. Homes without land-line telephones. Cars that drive themselves. Apps.

After this week, you may be able to add America as an oil exporter to the list. A generation ago, Western countries were in OPEC's vise grip. Today, the United States has become a top producer, OPEC is in disarray, and energy prices are plummeting. Oil stocks are so high that the Congress is moving towards allowing some U.S. reserves to be sold to other countries.



Source: IMF, Haver Analytics

The persistence of cheap oil has taken a tremendous toll on the industry: investment in development and equipment has dwindled, and some key world producers are in precarious fiscal condition. It is unclear whether any of them can play “the long game” for much longer.

The consumption “dividend” from low gasoline prices has not been very strong, and the unpredictability of this widely-used commodity has vexed central banks seeking to normalize inflation. The cost of oil to the economy goes well beyond the per-barrel price.

The Fed as Hamlet

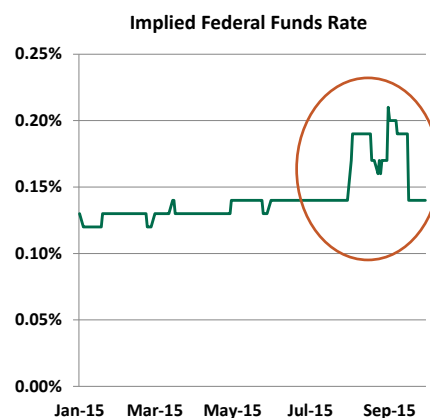
Central banks set the tone for market and economic performance. A firm message gets best results; indecision can sow the seeds of confusion. For most of the past year, the Federal Reserve's communication strategy left a lot to be desired. The run up to the Fed's September 16 meeting was especially clumsy.

Prior to that meeting, incoming economic data and Fed rhetoric had raised market expectations of a first rate hike. But international market developments clouded the Fed's focus and raised uncertainty as the date grew near. The decision to hold was widely renounced at the time; given what has transpired since, it is a decision that the Fed may wish it could revisit.

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Policy is always “data dependent,” but that phrase isn’t particularly instructive to markets. What data is key, and what are the thresholds sought? Data can be subject to different interpretations, and the 24-hour news cycle allows all of those interpretations to reach the public domain. And does data include asset prices, which some would still argue are the true target of post-crisis monetary policy?

The Fed’s first hike is now in the past, but attention will quickly turn to what it might do next. We do trust the Fed will endeavor to increase its clarity in 2016.



Source: Haver Analytics

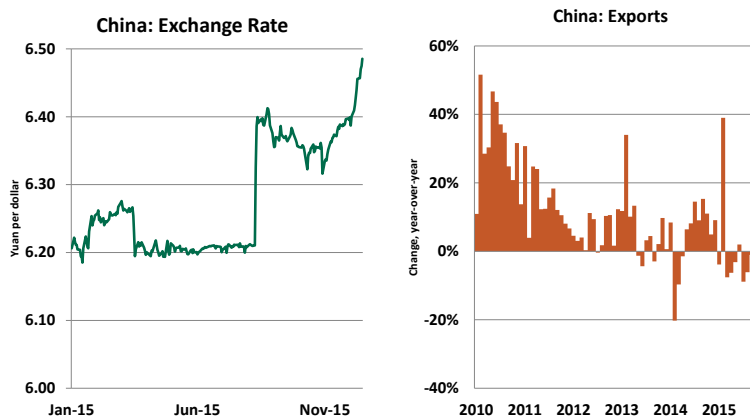
Is China’s Future Smoggy or Clear?

The images of heavy pollution obscuring the Beijing skyline were among the more poignant images of 2015. The limited visibility provided an apt metaphor for the world’s impressions of China during the past year.

We started the year concerned about the approaching economic slowdown and the state of the financial sector. The unease turned to outright worry in mid-June when attempts to reduce margin financing triggered a sharp drop in the frothy stock market. Then came the mid-August currency “correction,” when the People’s Bank of China shifted its strategy and rattled the markets anew. The whole July and August period had investors questioning whether the policymakers had any idea what they were doing.

In the final weeks of the old year, it has become clear that there may have been some method to the madness. The currency gyrations were part of a longer-term plan to gain access to the IMF’s Special Drawing Rights currency basket, which was granted last month. This key symbolic achievement for Beijing will boost the offshore use of the yuan.

China remains the main risk to the global outlook.



Source: Haver Analytics

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Meanwhile, President Xi's crackdown on corruption continues to trigger headlines. This is part of a longer term plan to consolidate the Communist Party's power during a time of macroeconomic change, and to advance Xi's economic reform agenda. 2015 was a year in which China stepped more into the international arena. The November meeting of President Xi with his Taiwanese counterpart – the first such since 1949 – was a major piece of pragmatism over ideology.

We end the year still concerned about Chinese authorities' ability to guide incremental progress toward rebalancing the economy, and still leery of the marked build-up of debt in nonfinancial corporations and the extent of shadow banking activities. And despite its recent recovery, the stock market remains challenged by high leverage, a slowing economy and stretched valuations.

And over-arching all of this is the biggest challenge of all – the demographic time bomb. The authorities are rapidly running out of time to prevent China becoming the first country in modern history to grow old before it grows rich.

The Endless Campaign

The 2016 U.S. Presidential election is still 11 months off, but many are already weary of the process. Candidate debates have long on invective and short on ideas, and personality seems to be trumping policy (pun intended). The events have provided material that is more useful for late-night comics than voters.

Other countries manage to elect leaders with much shorter lead times. The official portion of this year's U.K. election season lasted just six weeks, for example, and cost much less. We are therefore adopting a policy of not commenting on the campaign until next September. Someone has to stop the madness.

Europe: Who's In and Who's Out?

This year has posed multiple challenges for European unity. The never-ending saga surrounding Greece and its place in the eurozone came to the fore once again after the election of a far-left anti-austerity populist party at the start of the year. Promises to free the country from the stranglehold of creditor institutions and protracted bargaining over yet another bailout deal ensued. Capital controls were imposed, but default was avoided.

The question is, for how long? One could argue that "Grexit" is as much a possibility next year as it was this year, with tougher reforms to pass down the road and a very slim government majority with which to do it. Yet another parliamentary reshuffle and further uncertainty looks likely, which could weigh on an economy that was just starting to recover.



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Europe's divisions have been more apparent than European unity.

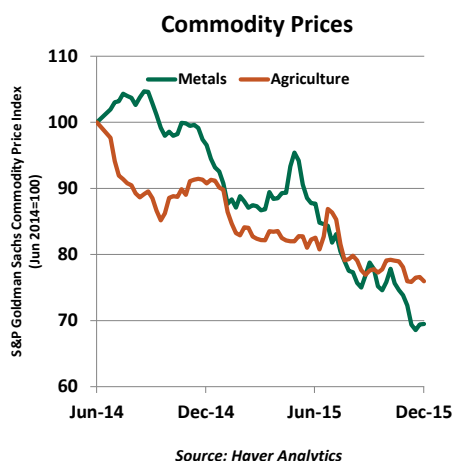
The global decline in heavier industry has hit some emerging markets especially hard.

Then there is the migrant crisis, which has strained the Schengen area of passport-free travel to its limit. German Chancellor Angela Merkel's stance that there will be no upper boundary to the number of refugees Germany will welcome has angered other European leaders. The erection of border fences and outright refusal to accept assigned quotas of migrants by some countries is emblematic of the unprecedented level of the disagreement between nations. And terrorist attacks in Paris just poured fuel on the fire.

Rising populism is present in numerous countries, with parties pushing to re-take control of their borders and their budgets. The United Kingdom may conduct a referendum on membership in the European Union in 2016. A united solution is still the best solution for Europe, but divisions are certain to remain.

The Great Commodities Bust

Heading into 2015, commodity prices were not a major worry. While oil prices had plunged in 2014, metals and agricultural goods fared better. In 2015, however, prices for agricultural commodities have fallen by some 15% and metals by 25%. China's slowdown and shift away from heavy industry to services has taken a serious toll.



The effects have been wide-reaching. Economies heavily reliant on commodity exports have experienced currency depreciation, growth headwinds and, in many cases, deteriorating government finances as revenues shrink. Those who maintained sound fiscal and monetary policy during boom years (Peru, Chile, Indonesia) have fared better. Others (Brazil, South Africa) have little room for a counter-cyclical policy response. Economic challenges have brought political challenges and increased voter appetites for change. For the rest of the world, that has meant lower growth and rising risk.

Britain Exports Sporting Success

New Zealand triumphed over Australia in the Rugby World Cup in October, becoming the only team in history to win back-to-back championships and be crowned winners three times since the competition's inception. Earlier in March, Australia beat their Kiwi rivals in the Cricket World Cup, meaning that the subcontinental wing of the British Empire have become masters of their former masters' games.

Meanwhile, economic performance in Australia and New Zealand was less cheerful, as falling commodity prices hit exports and weakened the respective currencies. The competition for the best economic growth in 2015 will go down to the wire; Australia holds the slightest edge through the first three quarters.

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Brazil: Up a Creek, Without a Paddle

Preparations for hosting the 2016 Summer Olympic Games in Rio de Janeiro hit a snag at midyear when thousands of dead fish turned up in Guanabara Bay where sailing, rowing and canoeing events are to be held. Perilously high levels of bacteria and pollution have organizers scrambling and Olympians worried.

Perhaps the affected athletes will be able to sympathize with Brazilian policymakers, who also find themselves in dangerous waters. The economy has been hit by a perfect storm of falling commodity exports, fiscal crisis, rising inflation and political disarray. With real GDP expected to decline 3.5% in 2015 and impeachment proceedings set to begin against President Dilma Rousseff, Brazil is running out of time to clean up its act.

These situations have proven challenging for those who manage them, and for those who cover them. Nonetheless, we've enjoyed corresponding with you on these and other fronts, and hope you've found our analysis helpful. We'll look forward keeping you current on the issues of the day in 2016.

All the best,

Vicki

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