

# Economic Insights

## Second quarter economic outlook

April 2014



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### Introduction

The outlook for developed economies is for a gradually strengthening recovery led by the US, with the UK and Japan as an intermediate pair, but with the euro-area lagging considerably behind (see Figure 1). In the emerging world, economic conditions have worsened over the past year, and growth in 2014 is expected to be slower than in the past couple of years.

Global developed equity markets endured a choppy first quarter. Having remained stable over the first 20 days of January, there was a sell-off in late January before global equity markets rebounded in February and then sold off again in March. Among the background factors were heightened geo-political tensions over Russia's annexation of the Crimean peninsula, and intensely cold winter conditions and heavy storms in much of the northern hemisphere in January and February. The latter initially depressed numerous economic indicators, but by February and March their effects were starting to be reversed.

With the rapid decline of official unemployment in both the US and the UK over recent months the central bank policy committees in both countries abandoned simplistic, quantitative forward guidance in favour of weaker qualitative guidance during 2014 Q1. In addition, at her first post-Federal Open Market Committee (FOMC) news conference in March the newly appointed chair of the US Federal Reserve (the Fed), Janet Yellen, made it clear that the window for the current 0-0.25% Fed funds rate would probably not last beyond mid-2015, an earlier date than market participants had previously assumed.

In the emerging world the news-flow was not as helpful since several key emerging market (EM) economies had allowed permissive credit conditions in 2009-12, and the consequences of that exuberance are still playing out. China, Brazil, India, Indonesia, and Turkey are all dealing with the consequences of previous excess money and credit expansion; several emerging economies have had to devalue their currencies; and many need to reduce their rates of inflation.

These macroeconomic adjustments are necessarily slowing growth among the EM economies. Continued credit problems in China, weak growth in India and Brazil, generally weaker currencies and abrupt devaluations by Argentina (on 22nd January) and Kazakhstan (over the week-end of 11th-12th February) have reinforced the message that emerging economies are in need of an extended period of consolidation after the strong upswings of 2010-2012. That adjustment is complicated by the fact that as monetary conditions normalise in the developed economies, the withdrawal of carry-trade funds and other short-term capital from emerging markets will continue, putting more pressure on EM authorities to tighten policy measures.

The combination of modestly better growth in the developed world but slower growth in the emerging arena points to slower growth for the global economy in 2014. The underlying problems of balance sheet repair in the developed economies and structural rebalancing in the EM economies are expected to continue to restrain overall activity.

As I have previously predicted, there are two important bright spots ahead: sustained low inflation (especially in the developed world), and a longer-than-normal business cycle upswing. The common reasons for both these developments are that balance sheet repair implies lower than normal rates of growth of money and credit, and that sub-par growth will ensure excess capacity persists for several more years.

**Figure 1: Inflation and growth forecasts**

Consensus Economics	2013 Actual		2014 Consensus Forecast	
	Real GDP	CPI Inflation	Real GDP	CPI Inflation
US	1.9%	1.5%	2.8% (2.7%)	1.7% (1.5%)
EU-17*	-0.4%	1.4%	1.1% (1.0%)	0.9% (0.8%)
UK	1.8%	2.6%	2.7% (2.6%)	2.0% (1.6%)
Japan	1.6%	0.4%	1.4% (1.3%)	2.6% (1.0%)
Australia	2.4%	2.4%	2.8% (2.7%)	2.8% (2.9%)
Canada	2.0%	1.0%	2.2% (2.5%)	1.5% (1.3%)
China	7.7%	2.6%	7.4% (7.5%)	2.9% (2.7%)
India	4.7%	9.7%	5.4% (5.2%)	8.0% (7.9%)

\*Without Croatia.  
Source: Consensus Economics, Survey. Data as at 10 March 2014.  
Invesco Forecast in brackets

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### United States

Severe winter weather disrupted economic activity in the US across a wide range of sectors in January and February, but those problems appear now to have passed and there are growing signs that the US is returning to more normal rates of economic growth. In January headline retail sales (-0.6%), non-defence capital goods shipments (-1.0%), and manufacturing production (-0.8%) all fell, as did total housing starts (-11%) and existing home sales (-5%) (see Figure 2). Although it is still not fully clear that the weather was the only factor slowing the economy, and there may have been some loss of underlying economic momentum, stronger recent data releases are building a picture of a return to normality. Moreover, assuming no further negative surprises, forward-looking survey indicators such as consumer confidence, and manufacturing and ISM indicators from those areas not affected by the big freeze have held up well, implying that the winter weather was the main explanation of the weakness in January and February.

As examples of the bounce-back in economic indicators since the worst of the weather conditions, manufacturing production was up 0.8% in February, total housing starts recovered to register no change, while new private housing permits jumped by 7.7% in February.

**Figure 2: US housing starts were held down by freezing weather**



Source: Thomson Reuters Datastream, data as at 15 February 2014.

In the monetary policy sphere Janet Yellen took over from Ben Bernanke on 1 February as chair of the Federal Reserve Board, and quickly made it clear in testimony to Congress that the recovery in the labour market was "far from complete". She repeated the Bernanke line that the Fed would continue to keep interest rates near zero well past the time that unemployment reaches the 6.5% threshold. Nevertheless, she would lead the FOMC to continue reducing its pace of asset purchases, in line with the plan laid out by her predecessor. This was confirmed by the minutes of the January FOMC meeting which reported that "in the absence of appreciable change in the economic outlook, there should be a clear presumption in favour of continuing to reduce the pace of purchases by a total of \$10 billion at each FOMC meeting". The main risk to this plan, in my view, comes from the fact that commercial banks are only expanding money and credit very slowly, and the economy will not keep expanding unless there is more ample credit growth. Based on recent data, almost all the growth of money (i.e. deposits) and banks' assets is due to Fed asset purchases. Without Fed asset purchases broad money growth would slump. In consequence I would expect some slowing of the "taper" during the year.

Of course the FOMC's assertion in favour of continued tapering came just at the time when economic indicators were faltering due to the intense cold, and it remains to be seen how much of the recent weakness was due solely to the weather.

In the fiscal arena many of the previous uncertainties were lifted when Congress agreed to a bipartisan deal that extended the debt ceiling until March 2015, and passed the financial year (FY) 2014 budget as well as tentatively agreeing some figures for FY 2015. Although this represents good news in the short run, the impartial Congressional Budget Office revised down both its estimate of GDP in 2014 and its estimate of potential GDP growth, resulting in a deterioration of its projections of the US medium-term fiscal position.

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Yields on the 10-year US Treasury bond declined from their year-end levels of 3.0% to a range of 2.6%-2.7% in mid-March, reflecting the weaker economic performance, the fiscal deal done between the Republicans and Democrats, and the continuing very low rates of inflation. In my view, despite improved levels of economic activity, yields will continue to be held down by the anchoring of interest rates at the short end by the Fed, and lower-than-expected inflation rates.

In sum, the recovery is continuing on a slow, but improving path, with lower than expected inflation. I expect real GDP growth to reach 2.7% for 2014 as a whole but CPI inflation to remain around 1.5% - well below the Fed's unofficial target of 2% - due to sustained low money and credit growth interacting with the continued existence of spare capacity. I also expect the US central bank to start raising the Fed funds rate target during the second half of 2015, and longer term interest rates to rise modestly over the next two or three years, constituting a mild bear-steepening of the yield curve.

More broadly the extended period of sub-par growth implies that the business cycle upswing will likely be longer than otherwise - perhaps a decade-long upswing as in the 1990s. The reason is that it will take longer to absorb the excess capacity in equipment and labour. If this is correct, equities should benefit as continued GDP growth is reflected in moderate growth of earnings over several years ahead.

#### The Eurozone

In Europe the recovery continued in 2013 Q4 with growth rising to 0.3% quarter-on-quarter (see Figure 3) - still only a very modest pace of expansion, but better than the 0.1% rate in 2013 Q3. Most core and peripheral economies registered positive growth, including Italy which experienced its first increase in real GDP after nine successive quarters of decline. Since then, economic indicators in 2014 have continued to record slow but positive rates of growth. The Eurozone's Purchasing Managers' Index (PMI) for February was 53.2, the eighth successive month in excess of the 50 level that points to expansion, confirming that the Eurozone emerged from recession in mid-2013, and suggesting that the moderate recovery should continue in 2014. The weakness of the upswing is reflected in the data for unemployment which remains at 12% (in January), virtually unchanged over the past year, in contrast with steeply declining unemployment rates in the US and the UK.

Other symptoms of weak domestic demand in Euroland include the swing to a substantial current account surplus of 2.2% of GDP over the past two years - which largely reflects weak imports and static exports - and the very low inflation rate. The CPI for the euro-area as a whole increased at just 0.7% year-on-year in January and 0.8% in February - both well below the ECB's target of "below, but close to, 2% over the medium term" - while three of the peripheral economies are currently experiencing deflation. Given the weak trend in labour compensation in the euro-area (1.4% year-on-year in 2013 Q4) and the strength of the euro, together with the weakness in commodity price trends, the inflation rate is dangerously low.

Despite these adverse developments the ECB's Governing Council chose to take no action at its March meeting. The ECB refused to sanction the de-sterilisation of its previous SMP (Securities Market Programme - or purchases), presumably as this would have required an outright injection of new funds and an expansion of its balance sheet. President Draghi said the ECB would only act in response to trends in the money markets or the outlook for inflation. Since the euro overnight interbank rate had recently eased, and the ECB's forecast for inflation was for a gradual increase to 1.0% in 2014 and 1.3% in 2015, no stimulus was deemed necessary.

On the political front the main change within Europe was brought about by the resignation of Prime Minister Enrico Letta in Italy and his replacement by 39-year-old Matteo Renzi, formerly mayor of Florence, and now Italy's youngest ever prime minister. His 100-day economic plan includes a tax cut of €1,000 for ten million Italians with net earnings of less than €1,500 per month, to start in May. The regional labour tax on companies is to be cut by 10% in a bid to encourage hiring, and energy bills are to be cut for smaller companies. The private sector will also benefit from central and local governments paying back over €60 billion in arrears by July. At the same time he proposes cutting government spending by €7 billion over a year, while raising taxes on financial gains - a blow to Italy's middle class savers. With anti-European sentiment running high in Italy this programme will be an important test of Eurozone cohesion.

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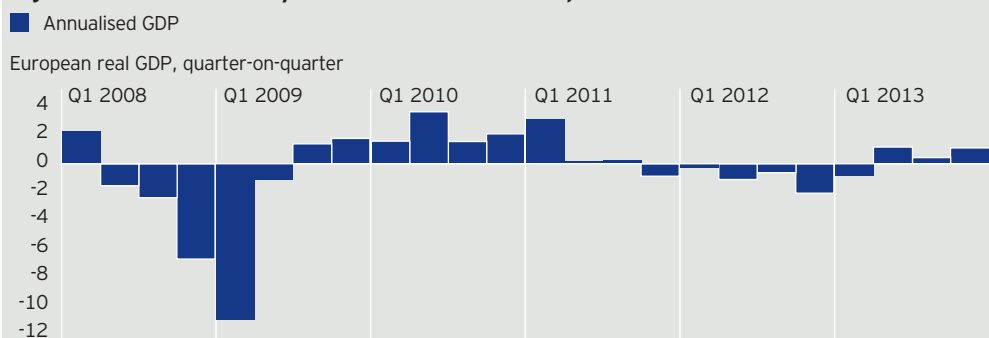
In the light of these changes Moody's raised the credit rating outlook for Italy, and also raised Spain's credit rating. Sovereign bond auctions in the periphery continue to see very strong responses as they offer substantially higher yields than on 'safe-haven' German Bunds, but the margin for further yield declines is becoming very slim.

Outside Europe the Ukrainian crisis may lead to some retaliation against Europe for the sanctions it has imposed on Russian politicians for annexing the Crimean peninsula. The most damaging threat to Europe would be curtailment of Russian gas supplies, but with winter easing and Russia seemingly having achieved its short-term objectives without conflict such counter-sanctions seem unlikely at present.

As I have argued previously, given that the normal policy tools to generate a recovery (such as faster money and credit growth, fiscal stimulus or currency devaluation) are not being utilised by Eurozone leaders, prospects for further improvement during 2013 and 2014 rest primarily on better export data. But partly due to the stagnation in Europe and the weakness of key emerging economies such as Brazil, India and China, the upswing in world trade is not occurring.

I forecast Eurozone real GDP growth for the year as a whole to reach just 1.0%, while the inflation rate will undershoot the ECB's target again, remaining at 0.8% at best. I maintain my long-standing forecast for deflation in the Eurozone.

**Figure 3: Eurozone recovery since 2013 Q2 has been tepid**



Source: Thomson Reuters Datastream, data as at 31 December 2013.

#### United Kingdom

The recovery of the UK economy has continued during the early months of 2014 despite some setbacks from storm-related damage to roads, rail, farmland and other infra-structure. In 2013 Q4 real GDP grew at 0.7% quarter-on-quarter (or 2.9% annualised), and that growth rate seems likely to be matched by developments in 2014 Q1. The manufacturing PMI remained as high as 56.9 in February, and the services PMI stayed at 58.2, both levels consistent with continued growth of over 2.5% annually. If the current pace of activity continues the UK should at last exceed its pre-crisis peak level of GDP in real terms by year end.

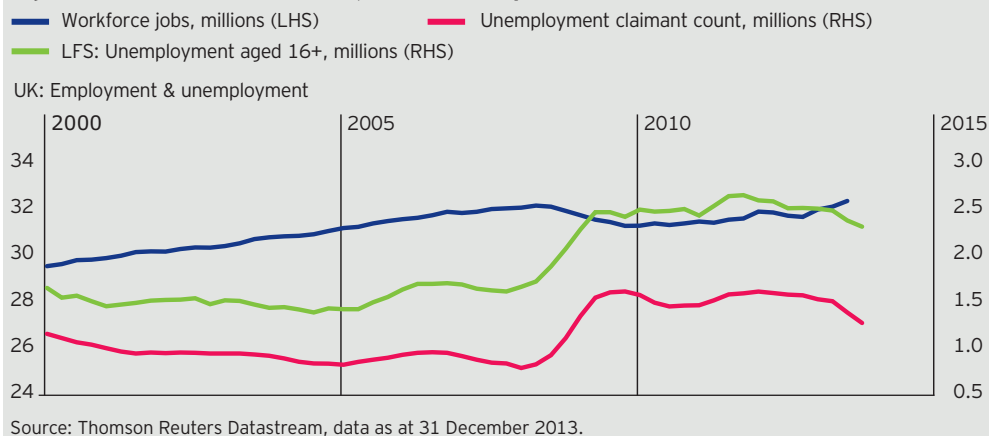
Progress in the labour market has been particularly encouraging with employment rising strongly by about 1.5% throughout last year to almost 30.2 million in December (see Figure 4), and unemployment falling rapidly towards the 7.0% level where, last summer, the Bank of England's Monetary Policy Committee had said they would start to consider raising interest rates. The housing market has also shown strong buoyancy in London and the south-east, though much less so outside these areas. Most of the action has been in London house prices which increased 12% over the year to 2013 Q4, according to a government index, but only 5.5% across the country as a whole. In addition, housing starts exceeded 32,000 in both 2013 Q3 and Q4 (up from lows of 17,000 in 2009 Q1) while mortgage approvals increased from 54,000 in January 2013 to 77,000 in January 2014. Reflecting the strength of consumer spending, retail sales increased by 6.1% year-on-year in volume terms in December and 4.8% in January - astonishingly strong figures considering their vulnerability to winter conditions.

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**Figure 4: UK labour market has improved markedly**



Looking ahead the pace of economic growth is unlikely to accelerate much from here, but various indicators suggest that the growth will be maintained at somewhere between 2% and 3%. In my view there is still ample spare capacity in the economy and in the labour force for further increases in output, and with money and credit growth having been very subdued for a long period of time the inflation risks are very low at present.

Turning to monetary policy, the key policy development in the quarter was the Bank of England's abandonment in February of its 7% unemployment threshold for considering increases in Bank rate. From his arrival in July Governor Mark Carney had tried to convince financial market participants that forward guidance based on an unemployment rate of 7% was a new weapon that - subject to three provisos - would enable the Bank and market participants to calibrate precisely the timing of interest rate increases. At the same time the Bank forecast that the 7% threshold would not be met until 2016 at the earliest. However, as a result of the unexpectedly strong economic recovery the unemployment rate fell steeply over the following months - from 7.8% in June to 7.1% in November - bringing forward the Bank's threshold far ahead of previous projections. Inevitably when the Bank released its Inflation Report in February it had to abandon the 7% threshold. It did so by replacing the single unemployment rate target with a broad set of eighteen indicators that it said it would monitor. In effect the markets know the game is up; forward guidance means no more than that the Bank will revert to relying on its own discretion in assessing the timing of interest rate hikes.

On the fiscal front progress in bringing down the budget deficit has been painfully slow despite the resurgence of growth. Normally one would expect strong growth to lead to a surge in government revenues from higher tax payments, but so far this benefit has been elusive. The Government's Budget announced on 19th March showed that in the financial year 2012-13, public sector net borrowing had been £114.8 billion and it only declined to an estimated £107.8 billion in FY 2013-14, or from 7.3% to 6.6% of GDP. The Office for Budget Responsibility forecasts budget deficits on this basis out to FY 2017-18. This, in turn, means that government spending will necessarily be subject to extended restraint during this period (unless a future government is prepared to raise taxes substantially). Furthermore, even with this measure of restraint and under a favourable scenario of 1% annual budget surpluses, and assuming no future shocks, government debt will peak at close to 80% of GDP in 2016 but will not return to pre-crisis levels of 40% until about 2030.

The Budget also contained numerous measures to boost savings such as increasing the tax-free ISA allowance and ending the requirement that pension savings be converted to annuities. In addition the Chancellor extended the export financing scheme and expanded the capital allowances for company investment. Although the first two steps may help to slow the decline in the savings rate, they will not be enough on their own to ensure higher growth through more investment. Firms need to step up their rate of business investment. The government also proposed to bring in a cap on welfare spending, but it is doubtful if it can bind future governments or that it will prevent the continuing growth of entitlement claims.

For this calendar year I expect 2.6% real GDP growth and 1.6% CPI inflation.



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#### Japan

In Japan growth has picked up in recent months mainly due to the increase in spending ahead of the 3% hike in the Consumption Tax from 1st April - a spending "rush". The initial impetus to growth from "Abenomics" had been starting to fade in the second half of 2013, but instead spending on consumption and housing investment both benefited. Real GDP grew 0.2% (quarter-on-quarter, or 0.7% annualised) in 2013 Q4, driven by a 0.7% contribution from domestic demand but with a negative (-0.5%) contribution from external demand. However, it is widely expected that growth will weaken in 2014 Q2 and Q3 in the aftermath of the tax hike. Due to the probable slowing momentum of growth the authorities have been considering further stimulus measures (such as additional asset purchases by the Bank of Japan).

From a longer term perspective the success of Abenomics is still in doubt. Although there has been a temporary growth spurt, much of this is due to the depreciation of the yen and spending ahead of the imminent tax hike. If the yen were to strengthen and spending was to slump after April, the sustainability of the programme would be open to question. One problem is that wages are still growing at a slow rate, equal to the rate of inflation at best. Unless some of the larger companies agree to bigger wage gains during the annual spring negotiations with unions it is not clear that the wage gains will flow down to the many medium- and small-sized enterprises or Japan's growing army of part-time workers.

The other major drag on growth has been the deterioration of the external trade and current accounts. This is due mainly to increased imports of oil and gas to replace the power lost from Japan's nuclear energy providers whose plants were closed down following the tsunami damage to the plant at Fukushima. Despite the yen's 30% depreciation against the US dollar the current account has switched from a surplus of 4% of GDP in 2010 to deficits since 2012, and now running at about 1% of GDP. Meanwhile the trade balance has also switched to large and persistent deficits.

Inflation had been gradually rising from mid-2013, driven mainly by the lagged effect of the sudden depreciation of the yen in 2012-13. By December the headline CPI had reached 1.6% year-on-year in November, and the CPI ex-food and energy had reached 0.7% in December, moving upwards in line with earlier yen depreciation (see Figure 5). However, since then the yen has strengthened marginally and Japan's inflation rates have declined slightly. In the past couple of months it appears that the acceleration in prices has paused, suggesting most of the inflation so far is yen-related. This is confirmed by examining the constituent components of the inflation indices. Those with the largest import content such as fuel, transport, or imported foods have risen the most, while those that are purely domestic such as medical and other services have continued to decline.

In other words, none of the inflation so far is due to stronger domestic demand. While the weaker yen may help to achieve Prime Minister Abe's goal of 2% inflation in the short run, unless wages and personal incomes rise more than 2% on a continuing basis, the result could simply be an episode of temporary imported inflation, followed by a resumption of weak domestic spending and growth as inflation subsides again.

In response to weaker growth in late 2013 the Bank of Japan (BOJ) announced enhancements of two lending schemes on 18 February - the "Growth-Supporting Funding Facility" and "Stimulating Bank Lending Facility" - both designed to encourage more bank lending. The former is similar to the Bank of England's Funding for Lending scheme and will enable banks to borrow funds from the Bank of Japan up to an amount that is twice the net increase in their lending, while the latter enables banks to borrow 7 trillion yen compared with 3.5 trillion previously. Under both these facilities, banks may borrow at fixed rates of 0.1% p.a. for four years instead of 1-3 years previously. The Bank of Japan also extended its special post-earthquake disaster lending facilities. As mentioned above, further monetary measures should be expected if domestic demand does not respond to the stimulus applied so far.

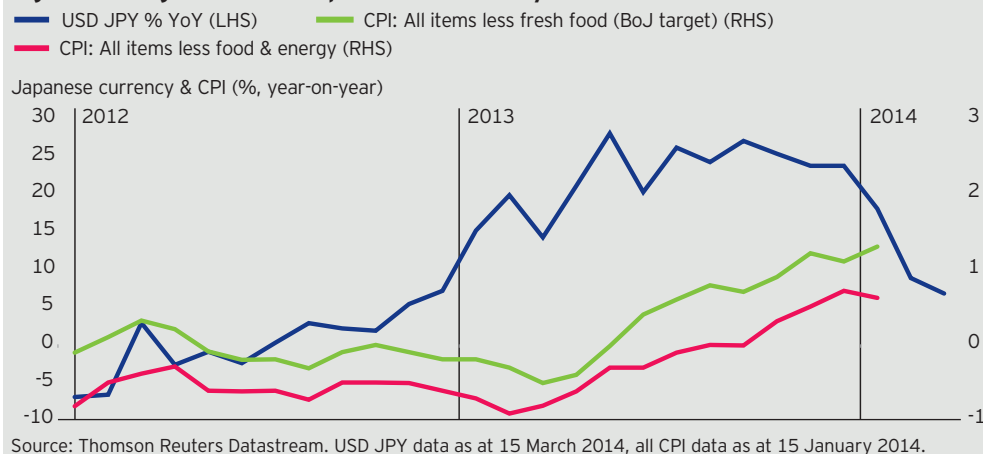
For the year 2014 as a whole I expect 1.3% real GDP growth and 1.0% increase in the national consumer price index.

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**Figure 5: Rising inflation has depended on a weaker yen**



### Emerging Market Economies

The broad shake-out in emerging market economies that started in May 2013 with Bernanke's hint of tapering continued in the final weeks of 2013 and the early part of 2014. The adjustments have affected exchange rates, interest rates and economic growth in emerging market economies. Some have been abrupt - like the devaluations in Argentina (in January) and Kazakhstan (in February) - but for the most part they have been gradual, persistent and necessary. The problem for many emerging economies is that in 2010-12 they had allowed inflows of capital (prompted by the global transfer of funds from the developed West to earn more attractive yields in the emerging arena via the carry trade) to translate into excessively rapid growth of money and credit.

The result was a widespread increase in the rates of spending and inflation, and an associated widening of current account deficits. Four economies epitomised these conditions: Brazil, India, Indonesia and Turkey. (South Africa is sometimes put in the same category but this is not justified. Although South Africa has been running a current account deficit, the monetary authorities at the South African Reserve Bank never allowed the rates of growth of money and credit to accelerate into double digit rates.) For the rest, they now need to slow domestic spending and inflation, but to do that they must tighten monetary conditions. Moreover, this adjustment cannot be achieved in a matter of weeks; it will require sustained tightening over an extended period if it is to be successful.

Looking ahead, the two key questions are; whether the scale of the outflows from emerging market economies since late May has already been sufficient to reverse the build-up of current account imbalances since 2009-10; and how long the domestic squeeze will need to be applied. The postponement of the Fed taper between September and December provided a brief respite for investors and emerging economy authorities alike to adjust their positions before a further phase in the unwinding of the global carry trade kicked in. The early months of this year have seen renewed pressure on EM economies, compelling them to make further adjustments.

Without such macro-economic adjustments the prospect of rising US interest rates implies greater risks of renewed outflows from EM economies. Conversely, if emerging economies are to operate without the scale of inflows they previously enjoyed, they will need to make significant adjustments in growth, inflation, current accounts and currency values.

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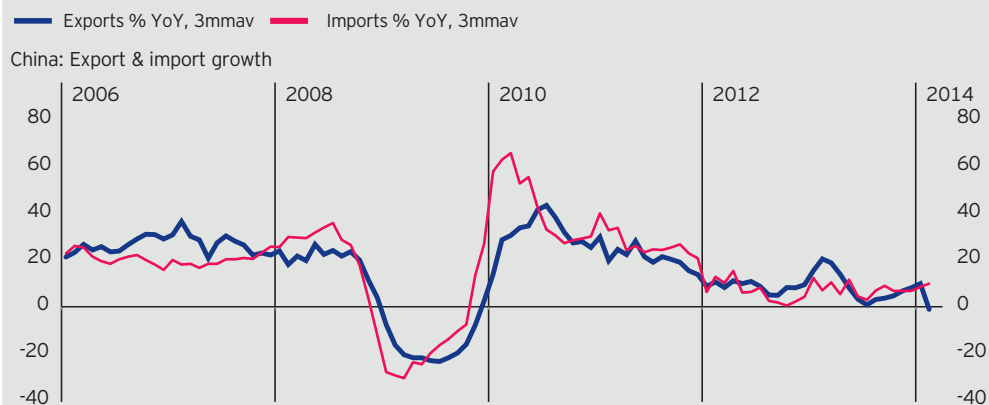
#### China and non-Japan Asia

Following the Third Communist Party Plenum last November, China's new leaders under President Xi Jinping released an extended document entitled "Decision on Deepening Reform". This included a lengthy agenda of major initiatives, including statements of intent to make a decisive shift in favour of markets (in economic reform), relaxation of the one child policy, ending the notorious "education through labour" camps, and big reforms of taxation, land tenure, state owned enterprises, and the hukou system of urban registration. Yet another campaign against corruption was launched. The President and his team in the politburo clearly have the ambition along with some concrete plans to deal with some of China's deep-seated governance issues, and they are working to create the bureaucratic machinery to overcome opposition. At the same time the plans are authoritarian and highly centralised, and it is too early to judge whether a dynamic market economy can be successfully managed by a narrow, secretive elite.

On 16 March, soon after the completion of a meeting of the National People's Congress (NPC), the plans for urbanisation together with reforms to the system of hukou urban registration were disclosed. These proved to be rather timid, promising only 200 million people (or two-thirds of existing, not future, rural migrants) full city-resident status by 2020. While this should enable them to obtain full access to urban welfare and public services like health and education, in sixteen cities with over five million inhabitants a points system will be applied to determine who wins the coveted *hukou* status. Disappointingly, the entire discriminatory system will not be scrapped, thereby restricting labour mobility and personal freedoms far into the future.

Against this background, economic activity in China showed further signs of moderation. Taking January and February together, exports declined by 1.6% year-on-year, down from 4.2% growth in December (see Figure 6). The official manufacturing PMI (which focuses on larger and often state-owned firms) has weakened for three months in succession, though remaining in expansionary territory. Similarly the HSBC/Markit PMI for March (which focuses more on smaller and private firms) declined to 48.1, the third successive month below 50, suggesting continued weakness in growth. These indicators suggest China is indeed in the midst of a growth adjustment phase.

**Figure 6: China's growth has been hit by the slump in world trade**



Source: Thomson Reuters Datastream, data as at 15 February 2014.

Also released at the opening session of the NPC were the government's targets for economic growth (7.5%), inflation (3.5%) and M2 growth (13%) in 2014 - all unchanged from 2013. In my view, growth will probably achieve this target, though it may require some additional easing measures during the year. I expect 7.5% real growth and 2.7% inflation in 2014.

China's residential property market has remained broadly firm with house price indices for major cities such as Beijing and Shanghai increasing by an average of 15%, but alongside that there are some smaller cities where prices have been slashed in response to exceptionally rapid build-up of supply. In the absence of a sustained monetary squeeze it seems likely that China's enthusiasm for new housing investment will continue.



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During the past year there have been three brief episodes of monetary tightening in the money markets, each followed by easing. Shadow banking products have continued to grow rapidly, implying that it will be difficult for the People's Bank to ease significantly. More disturbingly, China has seen several of these shadow banking or trust management products fail in recent months. In addition, the country saw its first official bond market default – all signs that stresses from excessive credit growth in recent years are building up in the financial system.

The second half of February and the first half of March also saw wide movements in the Chinese yuan (CNY). Initially the authorities deliberately weakened the currency from around 6.06 per USD to 6.14, abruptly reversing the strengthening trend that had been in place since mid-2010. Beginning on 17th March the trading band for the onshore yuan was widened from 1% to 2% on either side of a daily reference rate set by the People's Bank of China (PBC). After several years of one-way movement in the currency, these steps appear to set the stage for the possibility of more two-way movement and for potentially less foreign exchange market intervention by the central bank, though it does not guarantee it. The consensus on market direction is for renewed strengthening within the wider bands during 2014, but given the growing pressures in China's credit markets on the one side and the Fed's continuation of its tapering measures on the other, it seems quite conceivable that the upward movement may pause for a more extended period.

In 2014 Q1 the authorities again appear to have moved towards some degree of easing. In addition to allowing the CNY to weaken, and amid increasing evidence of weaker growth and falling inflation, the PBC did not conduct the repo operations needed to bring interest rates back to their Q4 levels – a de facto easing. Finally the State Council (or cabinet) announced on 19th March that they intended to accelerate previous construction spending plans for key projects and allocate budget expenditure more promptly. With estimates of sequential GDP tracking below 5%, and bond and trust defaults becoming more frequent, additional stimulus is needed.

The outlook for the remainder of non-Japan Asia outside China has been affected by two of the same broad trends that have been operating in China: the stagnation of world trade volumes over the past two years and the failure of many economies to diversify their economies away from dependence on export-led growth. World trade has been stalling since the beginning of 2012. Following a strong recovery in 2009-11, led mainly by EM economies, especially China, India and Brazil, the momentum of world exports and imports has faded completely over 2012 and 2013. The slowdown is accounted for by weakness across both developed and emerging economies. By area, among the Asian emerging economies, only China and India have seen any trade growth, while most of the smaller economies have suffered zero net trade growth accompanied by declines in manufacturing export prices. Aside from awaiting upturns in the developed world, the emerging economies are constrained in their response on the domestic side because they know that stronger domestic expansions risk adverse effects on inflation and the balance of payments. Even so, Asia's smaller economies are in much better shape than some of their counterparts in South America or in EMEA. Accordingly, East Asia's smaller economies should be able to respond quickly when the world economy starts to grow more vigorously again.

#### Commodities

Readers of this report will know that I have been rather bearish on the outlook for commodity prices for some time. This past quarter has been notable for sharp falls in copper and iron ore prices (see Figure 7), both basically reflecting weak economic activity in China and other emerging economies. This weakness of prices has been echoed by the downtrend in broad indices such as the Reuters-CRB or the Goldman Sachs Commodity Price index.

Both can be linked to the sub-par growth rate witnessed until recently in the US, the Eurozone and the UK, together with the slowing trend of growth in the leading emerging market economies – China, India and Brazil. The sharp falls in copper prices in particular have exposed loans in China that were collateralised against copper inventories. This has led to some forced liquidation, and may yet drive further price declines. In addition, the commodity weakness reflects the unwinding of financial and speculative positions taken in commodity funds; positions that were often based on the mistaken notion that the solution to the global financial crisis would be found in highly inflationary policies by central banks. Although there is still room for commercial banks to promote faster credit and money growth, my view has been that as long as balance sheet repair remains the order of the day then rapid growth of bank balance sheets will not happen.

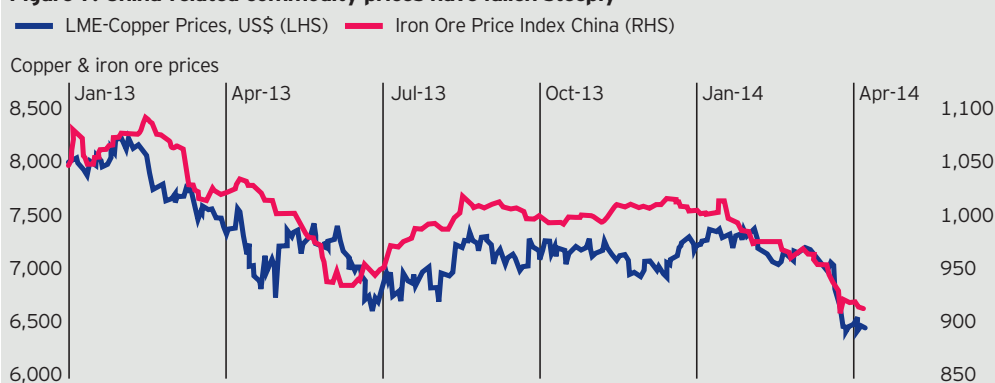
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### Second quarter economic outlook

April 2014

As central bankers often say, inflation expectations are well-anchored. The fundamental driver behind this trend is that balance sheet repair is inherently disinflationary, or even deflationary. Consequently as long as the major economies are in balance sheet repair mode, commodity price surges can only result from local or temporary supply disruptions such as occur from time to time in agricultural commodities. This broad diagnosis remains intact. A broad surge in commodity prices is in my view neither feasible nor likely.

**Figure 7: China-related commodity prices have fallen steeply**



Source: Thomson Reuters Datastream, data as at 24 March 2014.

#### Conclusion

In Q1 2014 both the Fed and the Bank of England abandoned naive forms of forward guidance that linked the maintenance of low interest rates to a single indicator of unemployment. Both central banks, together with the ECB and the Bank of Japan, are now merely promising to keep policy rates low for extended periods of time. In the case of the Fed, Janet Yellen's March press conference made it clear that this promise does not extend much beyond mid-2015. There is therefore a narrowing window when markets can be optimistic that easy monetary conditions will be maintained.

Although household and financial sector balance sheets are still under repair in some of the key developed economies, the global economy is gradually healing and growth should normalise over the next two or three years. This is already occurring in the US and the UK, but not yet in the Eurozone. Inevitably the repair process is taking longer than most people envisaged, implying headwinds to growth. The fact is that balance sheet repair is a slow and painful process. First consumption and investment must be curtailed in order to repay debt, especially when income growth is sluggish. Second, as we repeatedly see with the large banks, there are many skeletons from the crisis that keep emerging from the closet that require write-downs, new capital raisings and a further postponement of new hiring or expansion plans.

I therefore expect the next stage of the recovery to feature improving growth rates - albeit still sub-par - and for central banks gradually to reduce their injections of quantitative easing. Once more stable, sustainable growth rates have been established, the central banks can then contemplate embarking on a gradual and measured pace of rate increases. In the past these kinds of rate-normalising episodes have extended for two or three years as in the US in 2004-06. This time weaker growth and more vulnerable balance sheets mean that the rate hikes may be more gradual and end at lower levels.

The upside from all this is that thanks to excess capacity persisting for longer, inflation should also stay lower for a longer period of time. In addition, the extended period of sub-par growth implies that the business cycle upswing will likely be longer than otherwise - perhaps a decade-long upswing as in the 1990s. If this is correct, continued GDP growth will likely show up as moderate growth in earnings over several years ahead, and that in turn should be good for equity values.