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Introduction

After the unexpectedly sharp downturn of the US economy in 2014 Q1 due to severe winter weather, US growth has resumed a more normal trajectory, with the economy growing at a pace closer to its potential than we have seen for several years. The US Federal Reserve (Fed) is on course to end its asset purchases by year-end, but rate hikes will probably not occur until mid-2015.

In the Euro-area growth is still anaemic, and although the European Central Bank (ECB) announced a series of stimulatory initiatives in early June, the prospects for a strong upturn in the single currency zone are still remote. Meantime consumer prices are approaching deflation (Figure 1).

The UK recovery has continued to be strong, although there have been signs of cooling in the housing market and as yet real wage increases remain elusive.

Japan's economic upswing has paused following the imposition of the consumption tax hike in April. Ahead of the tax increase spending was very buoyant in 2013 Q4 and 2014 Q1, but since then spending has slowed abruptly. Thanks to the tax hike and previous yen depreciation, inflation is temporarily elevated.

The outlook for China depends heavily on the prospects for global trade - which remains stalled - and domestic spending - which is constrained by the understandable reluctance of the authorities to ease monetary policy. Elsewhere in the EM arena growth has been generally weak, notably in the largest emerging economies of Brazil, India and Russia.

Figure 1
Inflation and growth forecasts

Consensus Economics	2013 Actual		2014 Consensus forecast (Invesco forecast)			
	Real GDP (%)	CPI inflation (%)	Real GDP (%)		CPI inflation (%)	
US	1.9	1.5	2.2	(2.0)	1.8	(1.5)
EU-17	-0.4	1.3	1.1	(1.0)	0.7	(0.6)
UK	1.7	2.6	3.0	(2.7)	1.8	(1.8)
Japan	1.5	0.4	1.5	(1.8)	2.6	(2.7)
Australia	2.4	2.4	3.1	(3.0)	2.7	(2.8)
Canada	2.0	1.0	2.2	(2.2)	1.8	(1.9)
China	7.7	2.6	7.3	(7.2)	2.5	(2.5)
India	4.7	9.5	5.4	(5.2)	7.8	(7.5)

Source: Consensus Economics, Survey Date: 9 June 2014. EU-17 became EU-18 on 1 January 2014.

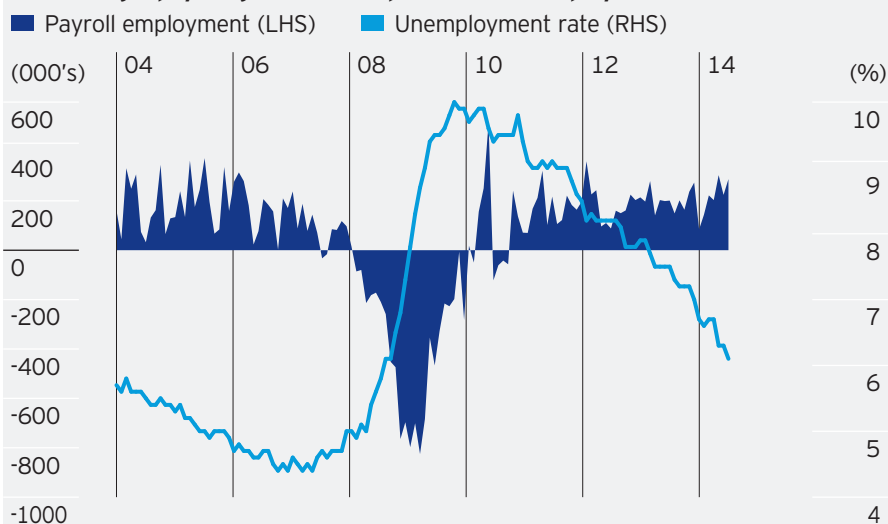
As I have previously predicted, there are two important bright spots ahead: sustained low inflation (especially in the developed world), and a longer-than-normal business cycle upswing. The common reasons for both these developments are that balance sheet repair implies lower than normal rates of growth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

United States

Following the disruptions due to severe winter weather, lower-than-expected healthcare spending and disappointing export performance, US economic growth in 2014 Q1 was revised sharply downwards to -2.9% annualised. However, growth appears to have rebounded across a broad front since then, resuming a much more normal trajectory of close to 3%. A revival in business capital spending combined with moderate growth of housing activity and continued steady growth of consumption has buoyed domestic demand. For example, core capital goods shipments increased by 0.4% in May, and manufacturing output increased by 0.7%, while survey indicators of consumer confidence, as well as regional and ISM surveys of manufacturing and services continue to register healthy expansions, all suggesting solid underlying momentum. Unemployment has fallen to 6.1%, and non-farm payroll growth has averaged 231,000 per month since December (Figure 2).

Figure 2

US: Stronger payroll gains have helped reduce unemployment



Source: Thomson Reuters Datastream, based on latest data as at 10 July 2014.

Thus although overall GDP forecasts for the calendar year have been revised down due to the very weak first quarter (e.g. the consensus for the year is now 2.2%), the performance of the three subsequent quarters looks likely to approach a vigorous average of 3.5% annualised.

In response to this buoyant backdrop the Fed has continued to reduce its asset purchases at the measured rate of US\$10 billion per FOMC meeting, implying an end to its quantitative easing (QE) operations by yearend. Fortunately for Chair Janet Yellen and her colleagues the commercial banks have been taking up the baton of credit creation from the Fed by increasing their lending at a rate of 8.7% annualised so far this year, or 5% year-on-year. As yet this pace of credit growth is modest, giving support to the economy but not so much as to threaten inflation. On the contrary, even though the amount of slack in the economy will steadily be reduced, inflation is likely to remain subdued through 2014 and 2015.

For the year as a whole I expect 2.0% real GDP growth and 1.5% consumer price inflation.

The Eurozone

Real GDP growth for the Euro-area slowed to 0.2% quarter-on-quarter in 2014 Q1, down from 0.3% in 2013 Q4, registering only 0.9% year-on-year. The recovery is at best bumping along the bottom, and remains acutely vulnerable to a rise in global oil prices or even a mild financial shock. Markit's Purchasing Managers' Index (PMI) for manufacturing across the Eurozone slowed to 51.8 in June, the lowest level so far this year, with Greece (49.4) and France (48.2) both showing contractions. Consensus expectations for real GDP growth this year amount to just 1.1% - well below the 2.5% rate experienced between 2004 and mid-2008 before the crisis erupted in 2008-09.

There are three broad reasons for the failure of the Eurozone to resume normal economic growth in the aftermath of the financial crisis of 2008-09. First, the fiscal and monetary authorities have not provided sufficient stimulus to promote economic recovery. Austerity programmes on the fiscal side and the ECB's reluctance to engage in pre-emptive balance sheet expansion on the monetary side have held back any possible growth of spending. Second, the failure to repair private sector balance sheets - especially among those households, companies and financial institutions that became over-leveraged going into the crisis - has meant that even with low interest rates it is proving very difficult for private sector entities to repay loans and clear up balance sheets. Finally, the strength of the euro has inhibited any possibility of an export-led recovery.

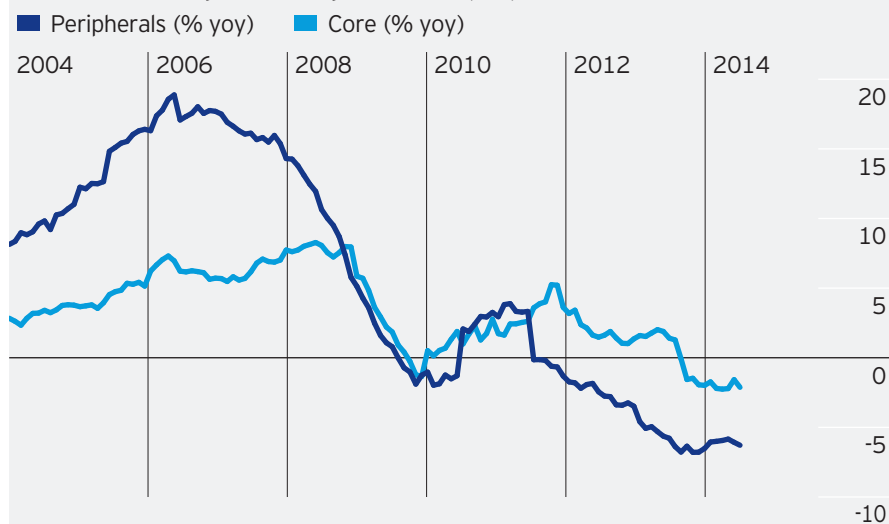
The composite PMI for June was 52.8, suggesting a slightly better rate of real GDP growth in Q2 of perhaps 0.4%. However the signals continue to be very mixed. While costs have been falling and competitiveness has been improving in the periphery, bank lending in the core area has been declining (Figure 3). Also, the risks of longer-term disruption to oil and gas supplies from Russia through Ukraine remain significant unless some kind of geo-political settlement can be reached in the coming months. The weakness of the upswing is reflected in the data for unemployment which remains at 11.6% (in May), only slightly down from 12.0% over the past year, in contrast with steeply declining unemployment rates in the US and the UK.

Against this background of weak GDP growth and inflation falling well below the ECB's 2% target, the ECB finally acted at its June meeting to implement a broad-ranging programme of expansion. The package of measures included a 0.1% charge (or negative deposit rate) on commercial banks' funds held at the ECB above required reserves, a euro 400 billion targeted lending plan to be implemented in stages over the next four years, the de-sterilization of prior bond purchases under the Securities Markets Programme, an announcement that the ECB will explore purchases of asset backed securities, forward guidance implying the anchoring of interest rates until 2016, and, perhaps most importantly, a promise (dependent on macro developments and, critically, inflation) that the ECB is not yet finished. ECB President Draghi signalled that this could even include the purchase of sovereign government debt if inflation fails to pick-up.

Since the ECB's plan was well discounted in financial markets ahead of the actual announcement it did not have any dramatic impact on bonds, equities or the currency. Moreover, as we saw with the previous LTRO programme in 2011-12 (which coincided with a decline in bank lending), lending to banks is far less effective in increasing money and credit growth than purchases of government securities from non-banks – as conducted by the Bank of England. It will therefore be surprising if this plan is enough to revitalise the stumbling Eurozone economy.

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, falling to 0.6% at best. I maintain my long-standing forecast for deflation in the Eurozone.

Figure 3
Eurozone: Lending is declining in both the peripherals & in the core



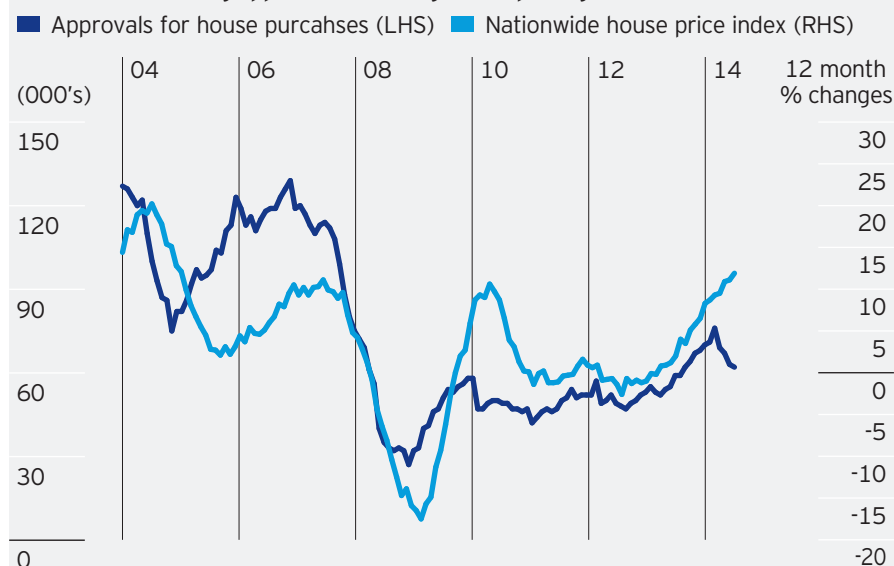
Source: Thomson Reuters Datastream, based on latest data as at 10 July 2014.

United Kingdom

The recovery of the UK economy continued during the first half of 2014 with numerous indicators suggesting that the UK's recovery is stronger than any other leading developed economy. For example, the PMI for manufacturing in June recorded 57.5, well ahead of any Euro-area economies, Japan, and even slightly ahead of the US.

In 2014 Q1 real GDP grew at 0.8% quarter-on-quarter and 3.0% year-on-year, and expectations remain firm for the remainder of the year. Private consumption spending also expanded by 0.8% over the quarter, and this has been echoed in continuing strong growth of retail sales (up 5.0% year-on-year in volume terms in the three months to May). Meanwhile fixed capital formation expanded by 2.4% in Q1, showing that the recovery is by no means limited to consumer spending only. In effect the economy is firing on all cylinders with manufacturing, services and construction all growing strongly. If the current pace of activity continues the UK will exceed its pre-crisis peak level of GDP in real terms during Q2 or Q3.

Figure 4
UK: Weaker housing approvals & strong house price gains



Source: Thomson Reuters Datastream/Fathom Consulting, based on latest data as at 10 July 2014.

Progress in the labour market has been particularly encouraging with employment rising strongly from 28.8 million at the trough in 2009-10 to over 30.5 million in the three months ending in April, an increase of 1.7 million jobs. At the same time unemployment has fallen rapidly to 6.6%, below the level at which the Bank of England's Monetary Policy Committee had previously said they would start to consider raising interest rates. The housing market has also shown strong buoyancy with the Nationwide index of house prices increasing 11.9% in the year to June (Figure 4), although most of the price increases have been concentrated in London and the south-east. In addition, housing starts in England increased to 36,450 in both 2014 Q1 (up from lows of 17,000 in 2009 Q1), but still below the pre-crisis peak of almost 49,000 in 2007 Q1.

To cool the housing market the Bank of England's Financial Policy Committee introduced in June macro-prudential restraints on mortgage loan-to-income ratios – setting a maximum of 4.5 times income for 85% of new residential mortgages – and required banks to conduct stress-testing of householders' ability to repay in the event of a 3% rise in mortgage rates. Already mortgage approvals had fallen from 76,000 in January to 62,000 in May, and there have been signs that prices in London are softening.

Reflecting strong economic activity, rising property prices, and the expectation that UK interest rates would be raised before year-end, the pound has appreciated to the highest levels since 2008, retracing about one half of its depreciation during the crisis.

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 around 2.5%- 3.0%. The available spare capacity in the economy and in the labour market, combined with the appreciation of sterling and moderate rates of money and credit growth, should ensure that inflation risks remain minimal through 2014 and 2015.

Turning to monetary policy, the Bank of England's once clear forward guidance has been overtaken by a series of mixed messages not only from MPC members, but also from the Governor himself. After abandoning the 7% unemployment threshold in February in favour of a set of eighteen indicators, but promising that rates would stay low for an extended period, the strength of the economy has forced a recent volte-face. In June Governor Carney advised that interest rates could rise by year-end. Inevitably this chopping and changing has undermined the Bank's credibility in the eyes of market participants. Forward guidance now means little more than that the Bank will rely on its own discretion in assessing the timing of rate hikes.

For this calendar year I now expect 2.7% real GDP growth and 1.8% CPI inflation.

Japan

In Japan consumer spending picked up strongly ahead of the 3% increase in the consumption tax on 1 April. This spending surge drove up real GDP by 1.6% quarter-on-quarter or 6.7% at an annualised rate in 2014 Q1. Since then spending has slowed abruptly, and the critical question is when will Japan return to a more normal growth rate? Given that the initial impetus from "Abenomics" had already been starting to fade, the real test of the policy will be how quickly the economy returns to a sustainable trajectory over the coming months.

Retail sales dropped an astonishing 13.6% in April as consumers stayed away from department stores and supermarkets, and the declines continued into May. Vehicle sales plunged in April, May, and June, while industrial production fell 2.8% in April, but recovered by a respectable 0.5% in May. However, it is widely expected that in the aftermath of the tax hike real GDP growth will fall by 3.2% quarter-on-quarter in Q2 and 0.8% in Q3, pulling down the year-on-year growth rates to 0.7% and 1.1% respectively. For the year 2014 as a whole I expect 1.8% real GDP growth.

From a longer-term perspective the success of Abenomics is still in doubt. Although there has been a temporary growth spurt, much of this was due to the depreciation of the yen in 2012-13 and the spending surge ahead of the April tax hike. A stronger yen and a continuation of the spending slump after April and May would raise doubts about the sustainability of the programme. During the annual spring negotiations between unions and larger companies wage increases were moderate, with the result that wages at smaller firms did not increase much. Consequently the May index of wage earnings in all industries increased by just 0.6% year-on-year, implying a continuing decline in real terms.

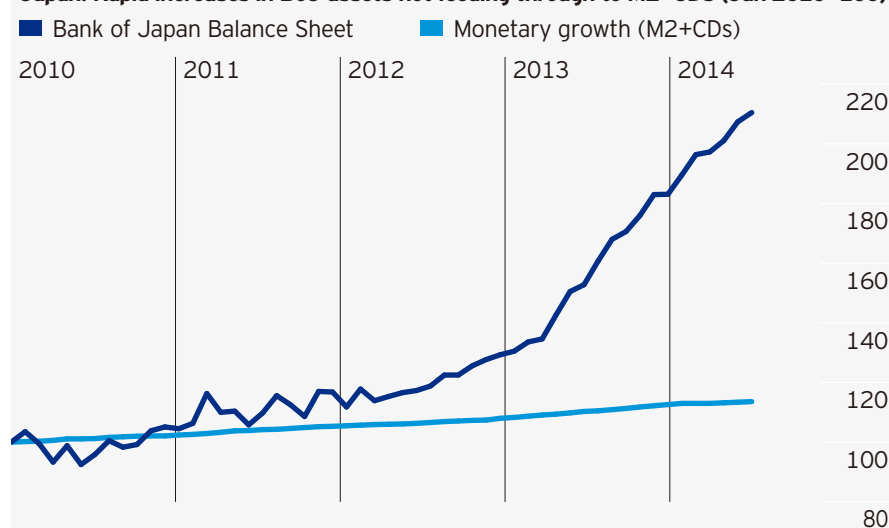
Moreover, the deterioration of the external trade and current accounts is continuing to act as a drag on growth. This is due mainly to increased imports of oil and gas to replace the power lost from Japan's nuclear energy providers whose plants were closed down following the tsunami damage to the plant 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.

So far most of the inflation can be attributed to the weaker yen and higher imported commodity prices – especially energy products and food items – not 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.

On the monetary policy front the Bank of Japan has refrained from any significant action since it announced two enhanced lending schemes on 18 February – the "Growth-Supporting Funding Facility" and "Stimulating Bank Lending Facility" – both designed to encourage more bank lending. Since then there have been few signs that commercial bank lending has picked up much, but the whole period has been disrupted by the surge in spending followed by the slump in spending in reaction to the consumption tax. In this atmosphere of uncertainty, the authorities have understandably announced that if growth were to weaken persistently they would be prepared to adopt further easing measures.

Figure 5

Japan: Rapid increases in BoJ assets not feeding through to M2+CDs (Jan 2010=100)



Source: Thomson Reuters Datastream, based on latest data as at 10 July 2014.

For the year as a whole I expect Japan's national consumer prices to rise by 2.7% (including the effects of the consumption tax hike).

China and non-Japan Asia

The momentum of the Chinese economy remained subdued in the first half of 2014 as policy-makers tried to support the economy with modest fine-tuning measures on the one hand while taking care not to engage in large-scale stimulus measures on the other. Among the easing moves the deliberate depreciation of the Chinese Yuan from around 6.05 per US\$ in January to 6.25 in April and May was probably the most important. Although the depreciation was widely considered to be an attempt by the authorities to inject some two-way uncertainty into the Yuan/Dollar exchange rate, it came at a time when Chinese exports were continuing to struggle, growing at low single-digit rates in an environment of weak world trade growth and rising wage costs in China. Since May the currency has resumed a mild recovery, strengthening to CNY 6.20 (Figure 6), but the prospects for a sustained recovery of exports depend more on the revival of overseas demand than anything the Chinese government can do in the short term.

At home the housing market has weakened from its recent peak in 2013, and excess capacity problems in various parts of the manufacturing industry have persisted, adding to the pressure on banks' asset quality. The overall official non-performing loan (NPL) ratio of the banks as published by the China Banking Regulatory Commission (CBRC) is just 1%, but sectoral data suggest a more worrying picture, with NPLs rising to 2.5% in key manufacturing sectors such as steel. The practice of ever-greening non-performing loans (i.e. lending more to enable borrowers to pay interest due), especially to SOEs is widespread, and the growing involvement of cash-rich SOEs in shadow-bank lending to financially vulnerable SMEs have also contributed to the general perception that Chinese corporate and financial balance sheets are less healthy than the official ratings suggest.

Figure 6

China: Yuan weakness has partially reversed

■ Chinese Yuan to US\$



Source: Thomson Reuters Datastream, based on latest data as at 10 July 2014.

Against this background, economic activity in China showed further signs of moderation. After real GDP growth of 7.4% in 2014 Q1, the official manufacturing PMI which focuses on larger, state-owned firms remained barely above the 50% threshold between expansion and contraction in April and May, though it did improve to 51.1 in June. HSBC's PMI which focuses on smaller, private companies fell below 50 from January to May and as low as 48 in March, returning to 50.7 in June. At the same time aggregate house prices in 70 cities declined in May (month-on-month) for the first time since mid-2012, while property transactions volumes remained sluggish. These indicators suggest China continues to work through a growth adjustment phase.

I expect China's real GDP to continue to soften towards 7% by year-end (averaging 7.2% for 2014), while CPI inflation will remain calm at 2.5% for the year as a whole.

The remainder of non-Japan Asia is suffering from the same weakness in world trade that has been holding back China. However, with only a few exceptions (such as India, Indonesia and possibly Korea) the regional economies do not have large enough domestic markets to provide a locomotive effect. Consequently the entire region is watching and waiting for progress in the developed economies, and especially the Eurozone to begin a more vigorous upturn.

Commodities

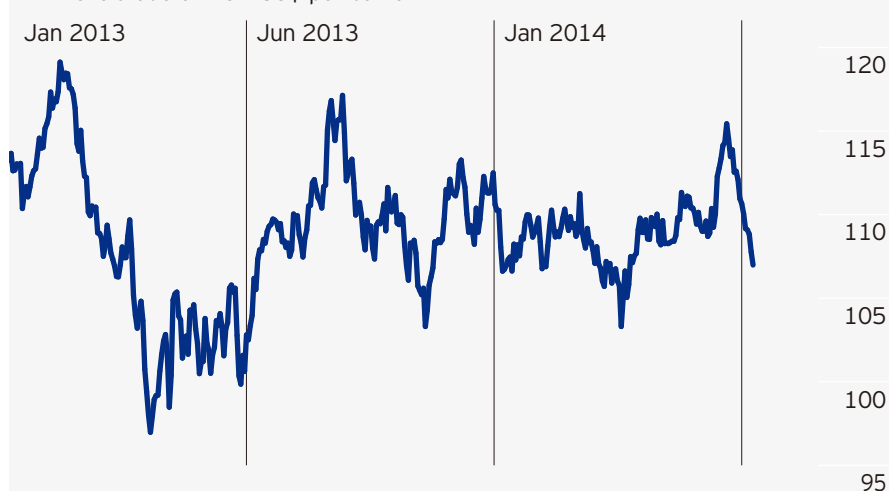
Readers of this report will know that I have been somewhat bearish on the outlook for commodity prices for the past year. The second quarter of 2014 has been notable for further falls in iron ore prices (from US\$113 to US\$90 per metric ton), Australian coking coal, and the copper price. All three commodities basically reflect weak economic activity in China, other emerging economies and the developed world. This weakness of prices has been echoed by the flatness of the Reuters-CRB index and the range trading in the S&P Goldman Sachs Commodity Price index.

Another event in the April-June quarter, which temporarily drove energy prices higher, was the ISIS- or jihadist-led attack on numerous towns and cities in Iraq, prompting a brief spike in Brent from US\$108 per barrel to US\$115 in June (Figure 7), as well as in other internationally traded crude oil prices. The failure of this and earlier food price surges to be sustained is further evidence of the weakness of global demand, specifically 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.

Figure 7

Commodities: Oil price spike was short-lived

■ Brent crude oil FOB US\$ per barrel



Source: Thomson Reuters Datastream, based on latest data as at 10 July 2014.

Although central banks have been promoting faster credit and money growth with near-zero interest rates, my view has been that as long as balance sheet repair remains the order of the day among commercial banks and their customers then rapid growth of mass purchasing power will not happen. 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 remain in balance sheet repair mode, commodity price surges can only result from local or temporary supply disruptions -- such as occurred with oil prices in June. This broad diagnosis remains intact. A broad surge in commodity prices is neither imminent nor likely.

Conclusion

In the financial markets there is a recurrent debate about the apparent disconnect between high bond and equity prices and the contrast with weak global economic activity. In my view this reflects two broad misunderstandings. First, asset prices are driven primarily by the business cycle, with monetary conditions at the forefront. Currently near-zero central bank interest rates have been effective in promoting equity and other risk asset prices, but, have not yet been effective in ensuring repair of private sector balance sheets or restoring normal growth. On this basis it will be a long time - perhaps several years - before the business cycle and asset prices peak. Second, financial markets are principally reflecting the favourable effect on long duration assets of abnormally low short-term interest rates. As normality returns to household and bank balance sheets enabling growth to resume, higher short-term interest rates will be counter-balanced by stronger economic activity underpinned by recovering wage and profit growth. In other words, a PE- or multiple-driven equity market will give way to an earnings-driven environment.

Naturally there are risks in such an outlook, but low money and credit growth provide some assurance that we are not in the same environment as in 2005-07 when rapid credit growth and high leverage made balance sheets acutely vulnerable to any adverse shocks. In short, this is not a financial bubble of the kind that occurred before the financial crisis. On the contrary, a key feature of the current environment is the gradual healing of household and financial sector balance sheets, to be followed later by the healing of public sector balance sheets.

Thanks to the slow growth of money and credit, inflation should also stay lower for a longer period of time than in previous business cycle upswings. In addition, a more gradual profile for interest rate hikes is expected to at least partially insulate longer duration risk assets from downward shocks. In short, continued moderate GDP growth implies that larger exposures to risk assets may be warranted for several years ahead,

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