

Global Economic Outlook

SCI Annual Conference

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For professional investors only

Outline

▶ Where are we now?

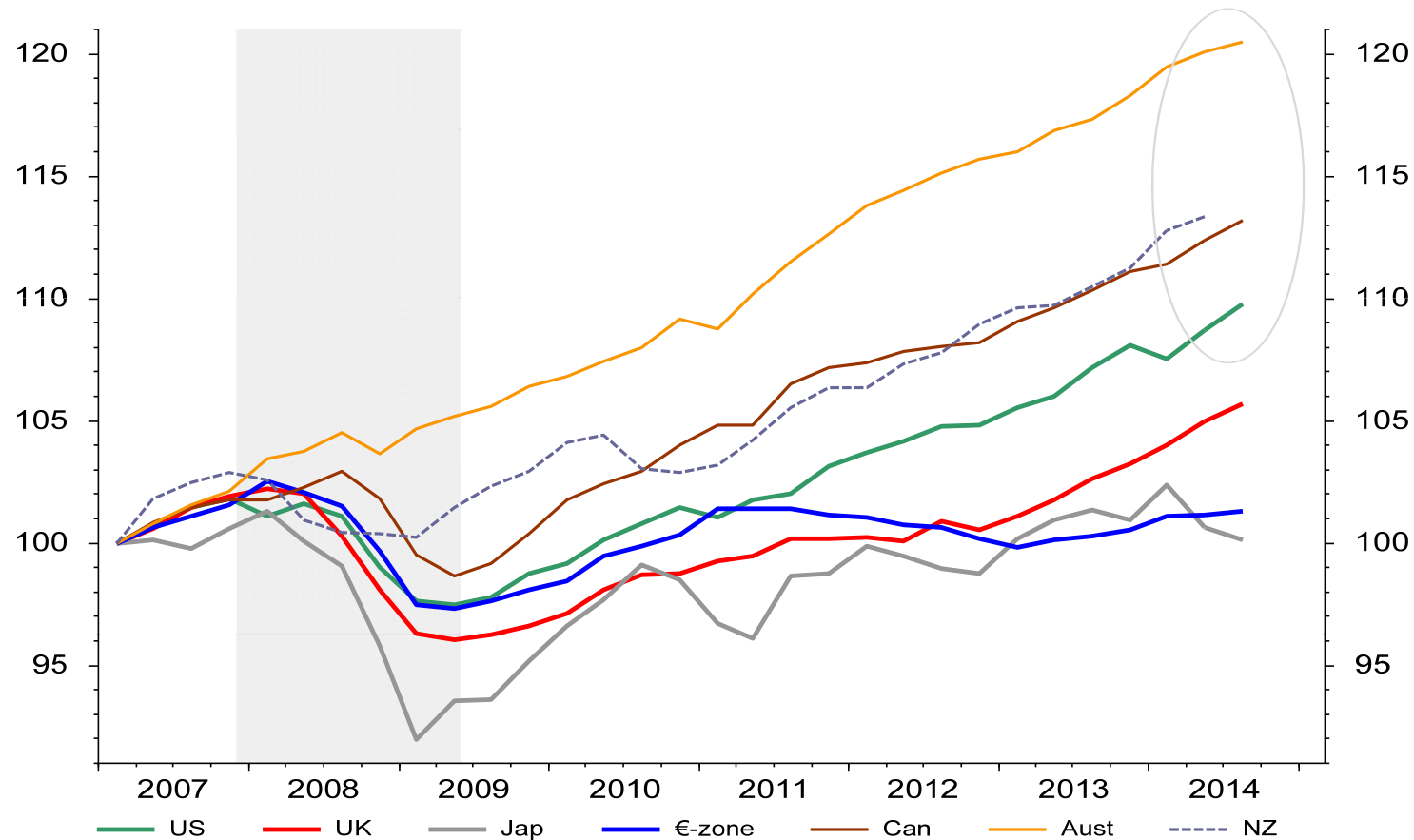
▶ Outlook for 2015

▶ Policy implications

Seven years on, and there's only a three-speed recovery...

Real GDP levels, rebased to Q1 2007...

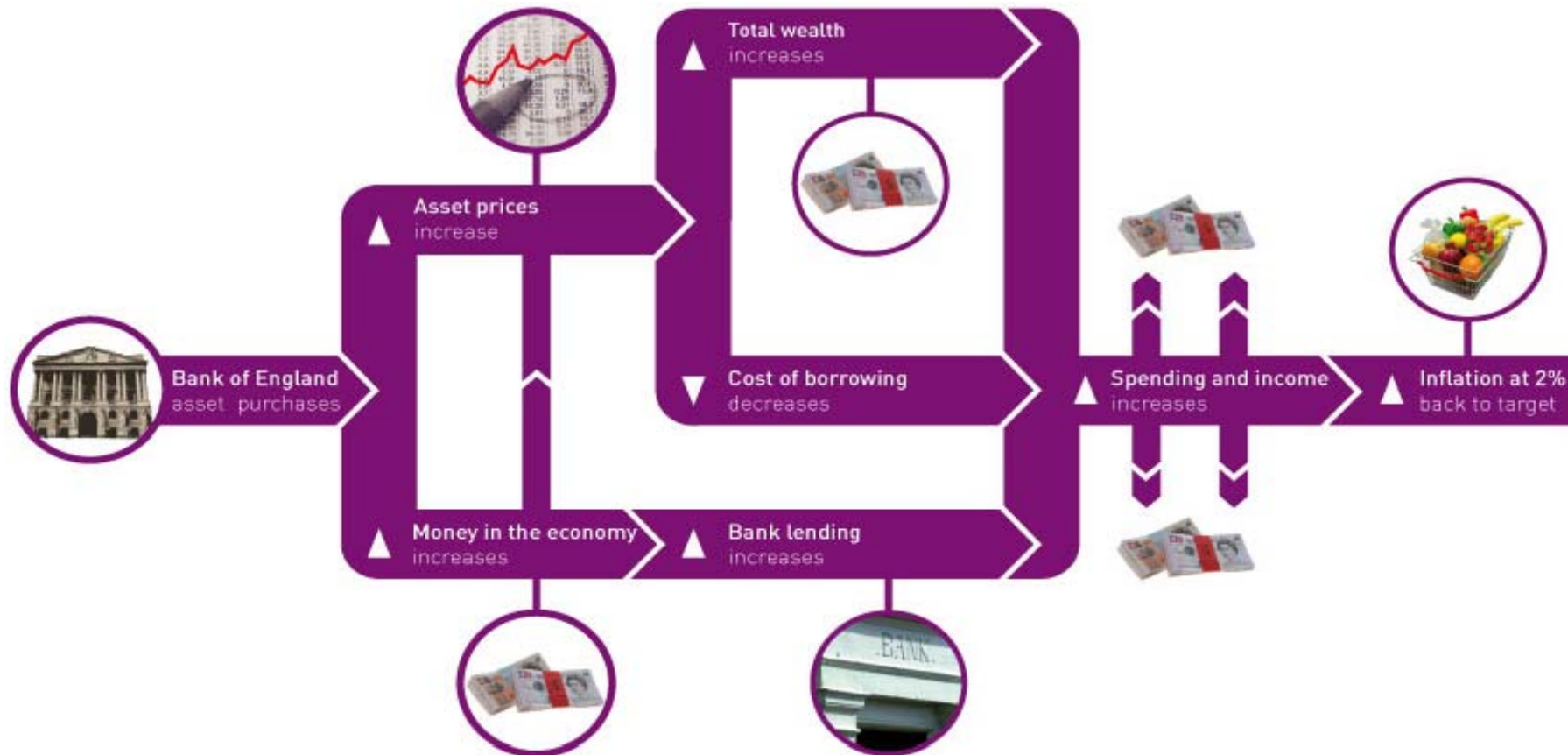
Q1 2007 = 100. Grey denotes US recession



Source: Thomson Reuters Datastream, based on national data.

QE...cash went down the asset route...

This is how QE is supposed to work

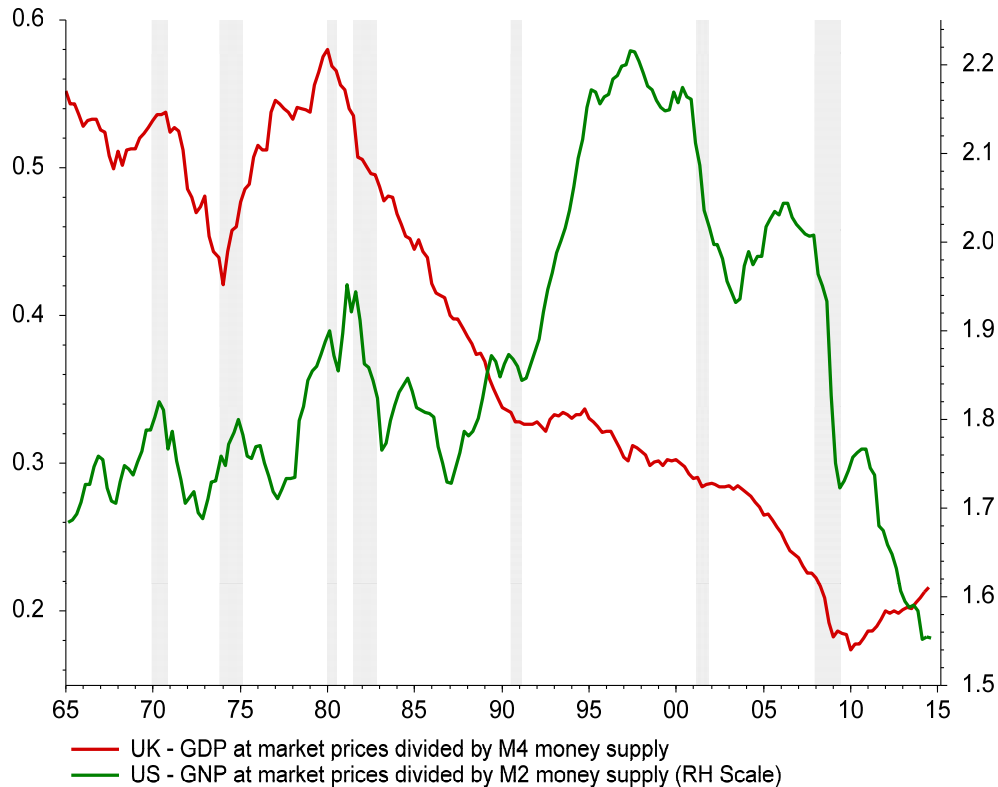


Source: Hermes Fund Managers Ltd, adapted from BoE.

...but, QE's transmission mechanism has been imperfect

Velocity of money in US & UK...

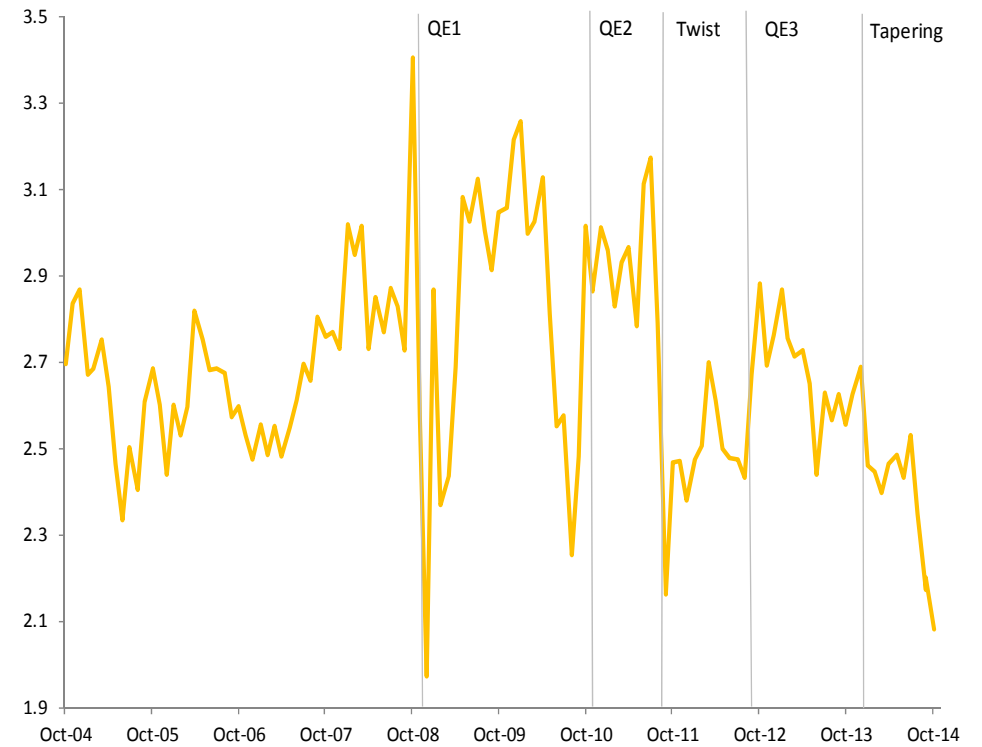
US (GNP/M2) & UK (GDP/M4) ratios. Grey denotes US recession



Source: Thomson Reuters Datastream, based on FRB, BEA, BoE, & ONS.

Inflation expectations back to 'square one'

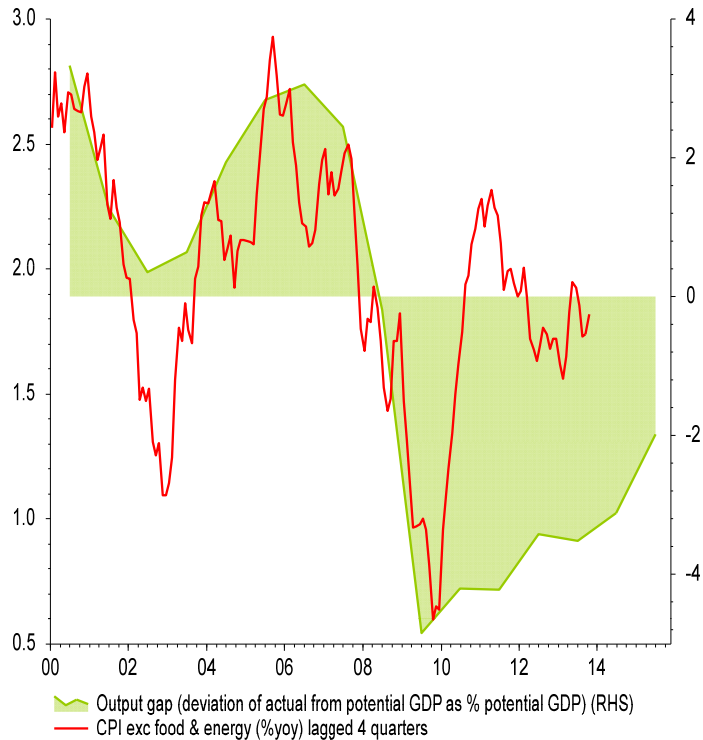
US Fed's 5-year forward breakeven inflation rate (%)



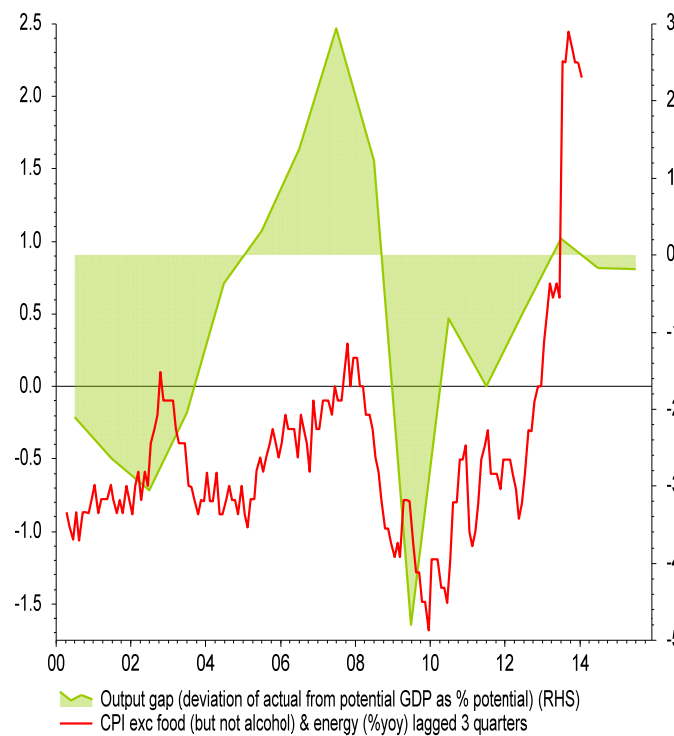
Source: Thomson Reuters Datastream, based on FRB, & Bloomberg data.

Demand ('core') inflation has thus been slow to accelerate

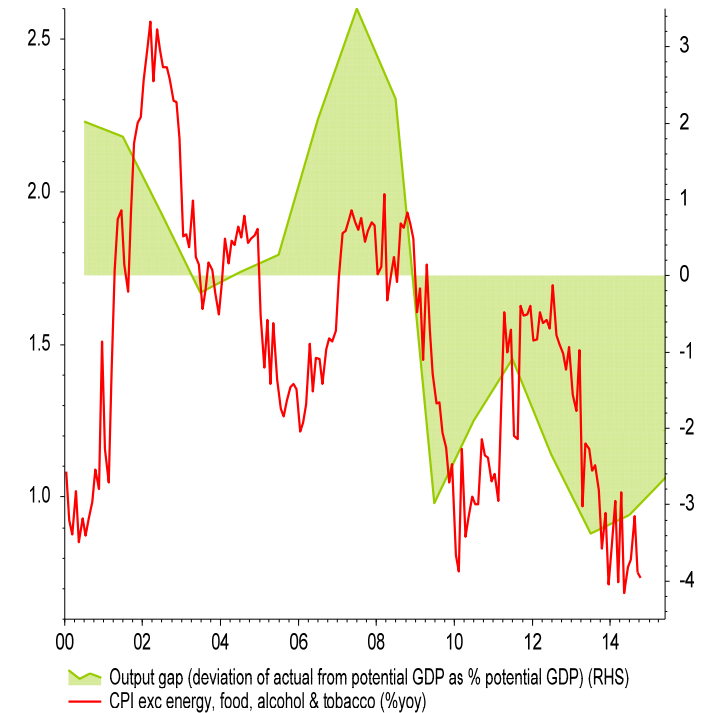
US



Japan



Euro-zone

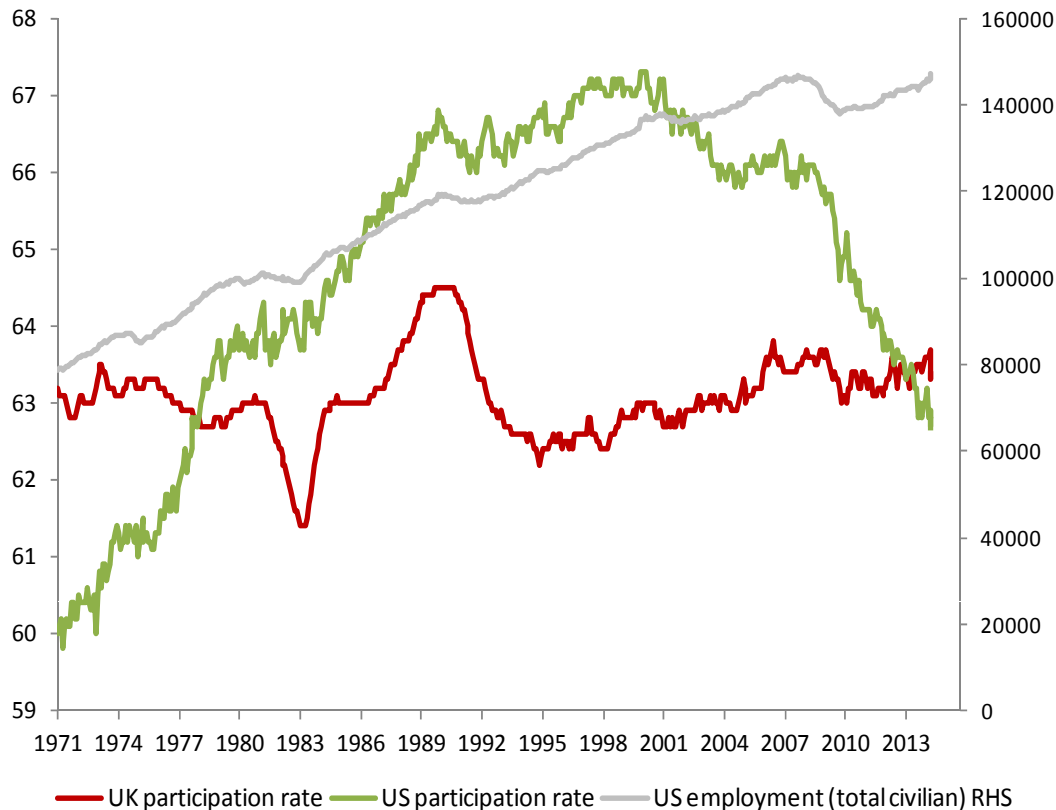


Source (all charts): Thomson Reuters Datastream, & OECD.

Chances of wage inflation are better in the US

US labour participation falls as UK's rises...

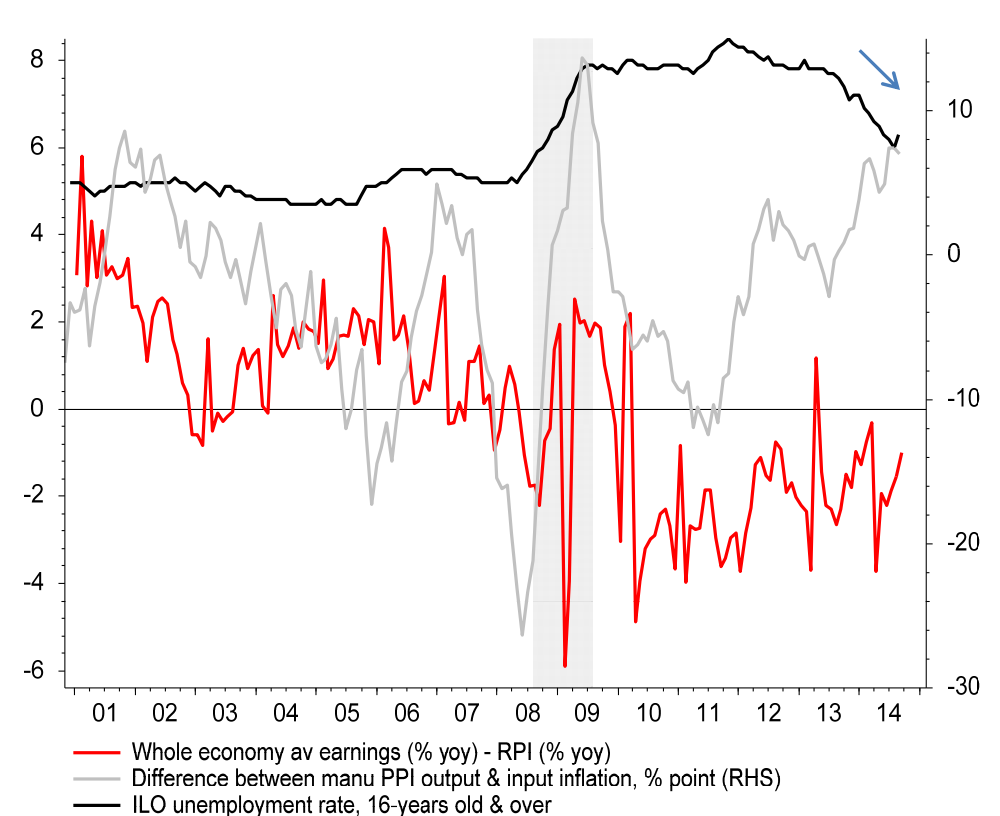
UK & US participation rates (labour force as % of working age pop'n)



Source: Thomson Reuters Datastream, based on BLS, & ONS data.

...deferring UK wage growth

UK unemploy' rate (%), vs profit-margins proxy, & real earnings growth



Source: Thomson Reuters Datastream, based on ONS data.

US & UK – the ‘cost’ of keeping the peak rate down...

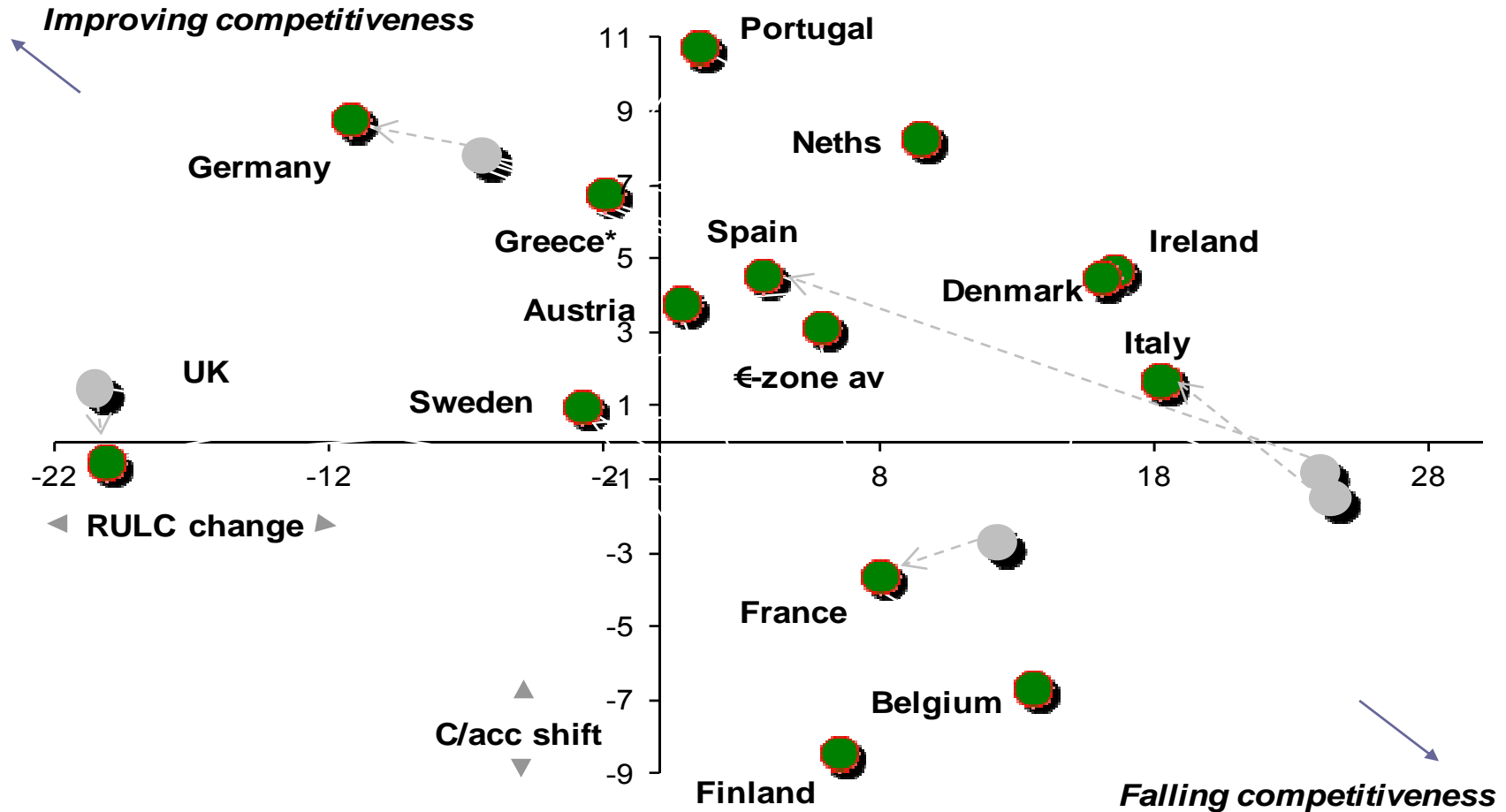
Market	Current policy rate (%)	Our expected peak rate	*Rate needed to 'normalise'	*Extra tightening required	Implication for QT?
US	0.25% max	4.0% <i>(e.g. Plosser)</i>	<i>circa 5.0%</i>	100bp	\$800bn <i>(= 18% of QE stock)</i>
UK	0.50%	3.0% <i>(e.g. Carney)</i>	<i>circa 4.0%</i>	80bp	£107bn <i>(= 29% of QE stock)</i>

**Derived from our Policy Looseness Analysis*

Source: Derived from Hermes Investment Managers 'Policy Looseness Analysis', which is based on OECD data, & Bloomberg.

But, euro-zone is still a monetary union bereft of economic union

Change since 2000 in a country's relative unit labour costs (RULC), vs c/acc shift as % GDP. Grey denotes shift since 2010 austerity

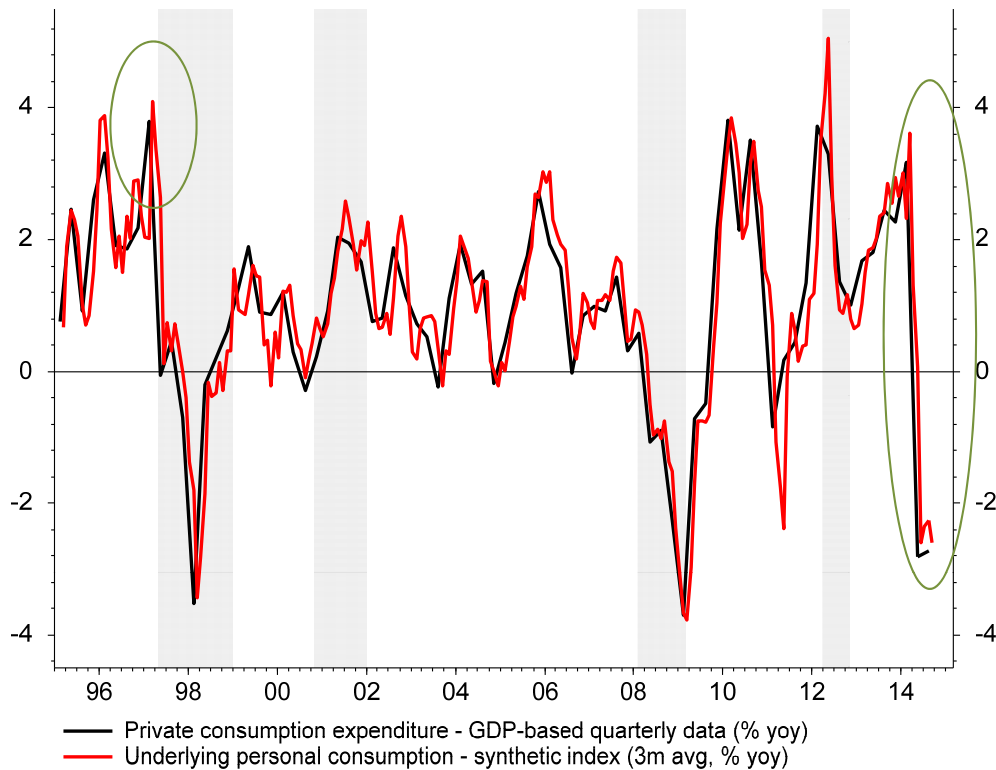


Source: Hermes Fund Managers Ltd, based on national sources & OECD. (*NB: Greece's from 2001 when it joined the euro).

Japan – even more aggressive monetary easing...

Personal consumption – front loading...

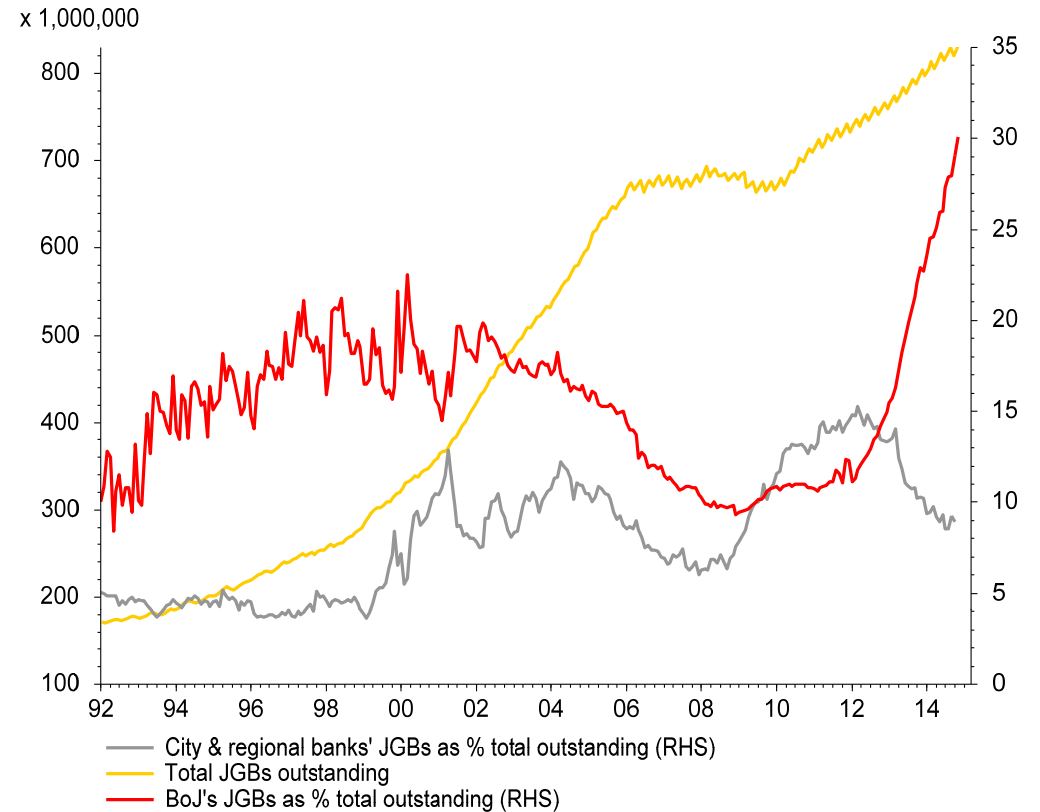
Synthetic & GDP-based real consumption, % yoy. ESRI recessions



Source: Economic & Social Research Institute.

JGBs outstanding, banks' & BoJ

JGBs outstanding in ¥ m on LH Scale, & % shares on RH Scale

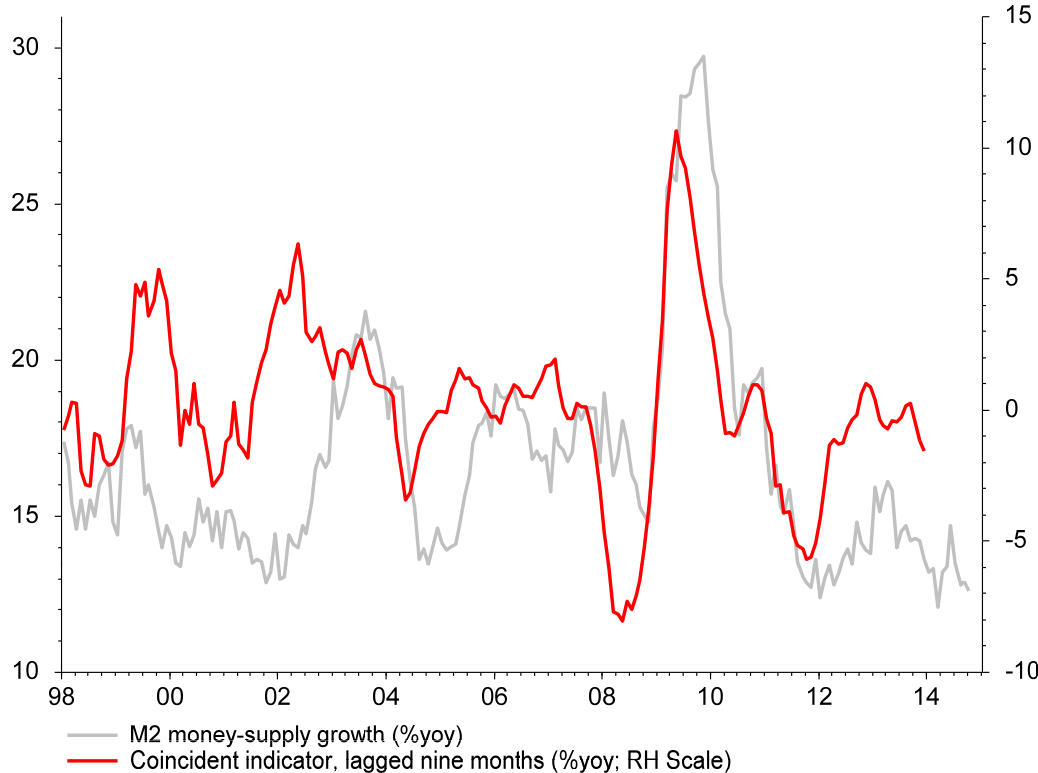


Source: Thomson Reuters Datastream, based on BoJ.

China - soft landing, but disincentive to revalue currency

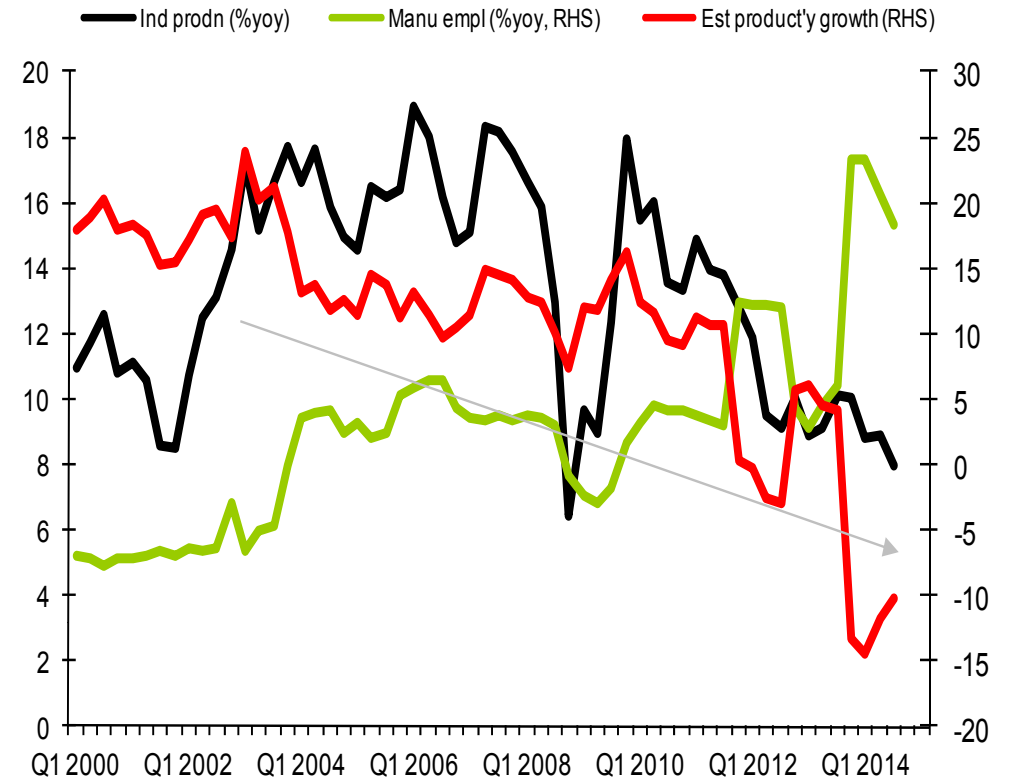
More slowing to come?...

Shows coincident indicator (lagged 9m), & M2 growth (%yoy)



Source: National Bureau of Statistics, & People's Bank of China

China's collapsing productivity



Source: National Bureau of Statistics, & Ministry of Human Resources & Social Security

The legacy is debt build-up

Gross & net, as a % GDP. *'98 data; **'00 data

	<i>Moody's local ccy</i>	<u>1997</u>		<u>2015p</u>	
		Gross	Net	Gross	Net
US	<i>Aaa</i>	65	47	107	84
Japan	<i>A1</i>	102	34	233	145
Euro-zone	<i>n/a</i>	81	53	107	70
UK	<i>Aa1</i>	52	29	103	81
Greece	<i>Caa1</i>	101	75	188	128
Italy	<i>Baa2</i>	130	104	147	118
Iceland	<i>Baa3</i>	52*	17*	91	31
Ireland	<i>Baa1</i>	63*	43*	132	93
Latvia	<i>Baa1</i>	53**	<i>n/a</i>	75	<i>n/a</i>
OECD av		73	43	111	71

Source: OECD, Thomson Reuters Datastream, OBR (UK), & Moody's Investor Services.

2015 – growth, but only ‘baby steps’ to the policy exits

Forecast summary from our ‘Looking into 2015’, Q1 2015 Economic outlook quarterly

US	% yoy unless stated	'09	'10	'11	'12	'13	'14e	'15p	JAPAN	% yoy unless stated	'09	'10	'11	'12	'13	'14e	'15p
Real GDP		-2.8	2.5	1.6	2.3	2.2	2.3	3.0	Real GDP		-5.5	4.7	-0.5	1.5	1.5	0.9	1.1
Personal consumption		-1.6	2.0	2.3	1.8	2.4	2.3	2.9	Private consumption		-0.7	2.8	0.3	2.1	2.0	-0.3	0.5
Business investment		-15.6	2.5	7.7	7.2	3.0	5.8	5.0	Business investment		-14.2	0.7	4.1	3.6	-1.4	5.0	2.3
Industrial production		-11.3	5.7	3.3	3.8	2.9	3.8	3.6	Industrial production		-21.6	15.6	-2.6	0.2	-0.6	3.0	3.0
Consumer prices (nsa)		-0.3	1.6	3.2	2.1	1.5	1.8	1.9	Consumer prices		-1.3	-0.7	-0.3	0.0	0.4	2.6	1.3
Unemployment rate (%)		9.3	9.6	9.0	8.1	7.4	6.2	5.8	Unemployment rate (%)		5.1	5.1	4.6	4.4	4.0	3.7	3.5
Current account (% GDP)		-2.6	-3.0	-3.0	-2.9	-2.4	-2.3	-2.3	Current account (% GDP)		2.9	4.0	2.2	1.0	0.7	0.5	0.8
Fed budget balance (% GDP)		-10.2	-8.5	-8.1	-6.6	-3.3	-3.0	-2.8	Gen budget balance (% GDP)		-8.8	-8.3	-8.8	-8.7	-9.3	-8.3	-7.0
Funds target (yr-end, %)		0.25	0.25	0.25	0.25	0.25	0.25	0.75	BoJ target rate (yr-end, %)		0.10	0.10	0.10	0.10	0.10	0.10	0.10
EURO	% yoy unless stated	'09	'10	'11	'12	'13	'14e	'15p	UK	% yoy unless stated	'09	'10	'11	'12	'13	'14e	'15p
Real GDP		-4.5	2.0	1.7	-0.7	-0.4	0.7	0.9	Real GDP		-4.2	1.9	1.7	0.7	1.7	3.0	2.5
Private consumption		-0.9	0.8	0.2	-1.3	-0.6	0.4	0.5	Household consumption		-3.3	0.5	-0.1	1.5	1.6	2.5	2.3
Fixed investment		-12.7	-0.6	1.5	-3.2	-2.4	0.8	1.2	Fixed investment		-14.3	6.2	2.4	0.8	3.2	7.6	5.3
Industrial production		-15.1	7.3	3.5	-2.4	-0.7	0.8	2.0	Manufacturing production		-9.3	4.7	1.8	-1.3	-0.1	3.3	2.2
Consumer prices (HICP)		0.3	1.6	2.7	2.5	1.3	0.5	0.8	Retail prices index		-0.5	4.6	5.2	3.2	3.1	2.4	1.9
Unemployment rate (%)		9.6	10.1	10.1	11.3	12.0	11.7	11.9	Consumer prices		2.2	3.3	4.5	2.8	2.6	1.5	1.2
Current account (% GDP)		-0.2	0.0	0.1	1.4	2.2	2.4	2.5	Unemp, ILO rate (3m av, %)		7.5	7.9	8.1	7.9	7.6	6.3	5.5
Gen budget balance (% GDP)		-6.4	-6.2	-4.1	-3.6	-2.9	-2.5	-2.5	Current account (% GDP)		-2.8	-2.6	-1.7	-3.7	-4.2	-4.1	-3.6
ECB refi' rate (yr-end, %)		1.00	1.00	1.00	0.75	0.25	0.05	0.05	Gen budget balance (% GDP)		-11.2	-10.1	-7.9	-5.1	-5.6	-5.0	-4.0
									BoE Bank rate (yr-end, %)		0.50	0.50	0.50	0.50	0.50	0.50	1.00

Source: National data, Hermes Fund Managers Ltd, OECD, & Consensus Economics.

Summary

- ▶ US is leading a three-speed recovery, with UK in the middle, & euro-zone/Japan in the slow lane. Inflation driven more by cost than demand
- ▶ US & UK rate hikes from H2 2015 - but gradual as central banks await final piece (real wage growth). ECB to capitulate on sovereign QE
- ▶ Peak rates after 2015 will turn out lower than before, capped by central bank bond sales ('QT')
- ▶ Conventional government bonds may no longer be a 'low-risk' asset, but correction will be slow

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