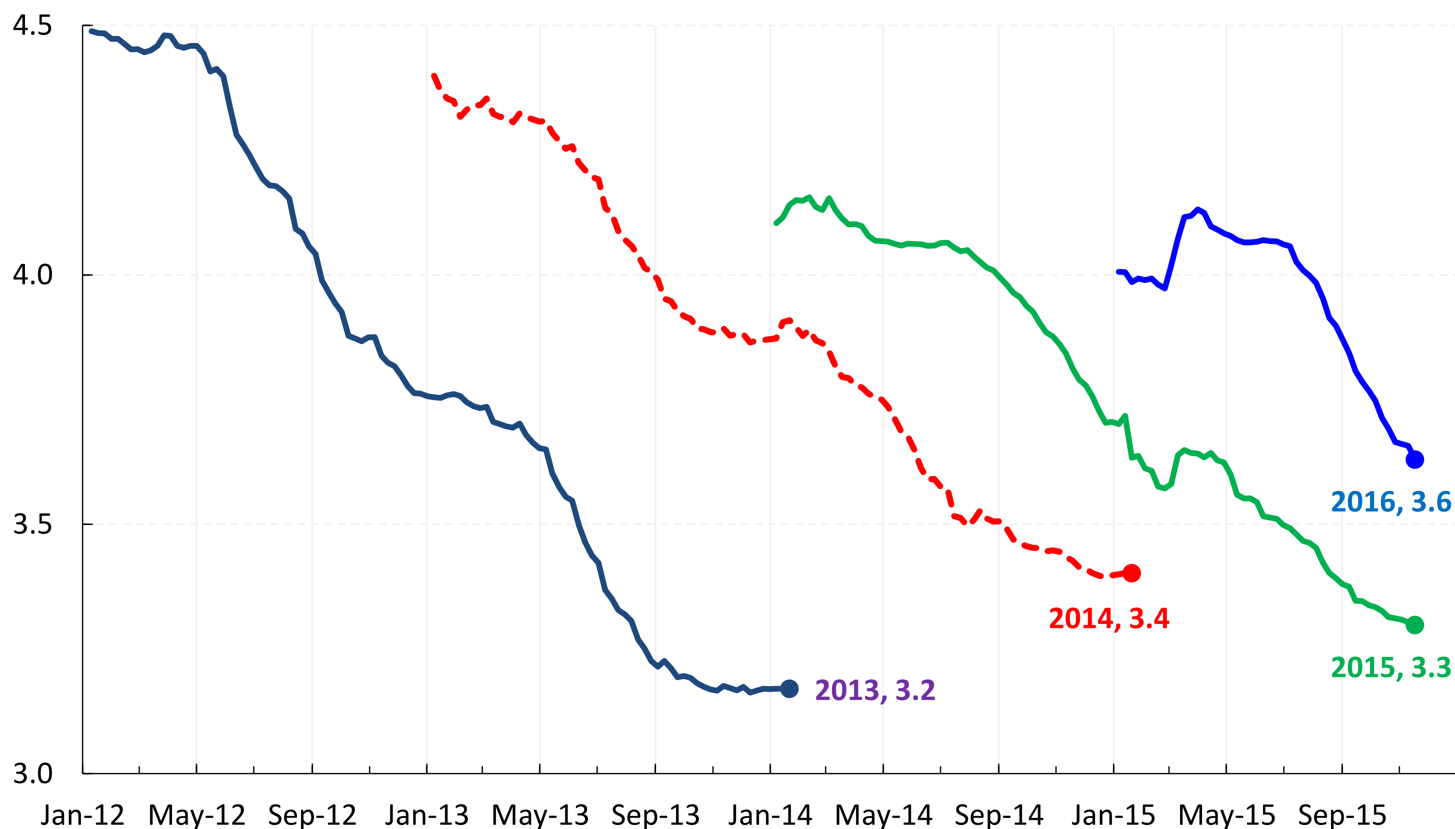
Economic and Financial Markets Outlook

Gavyn Davies

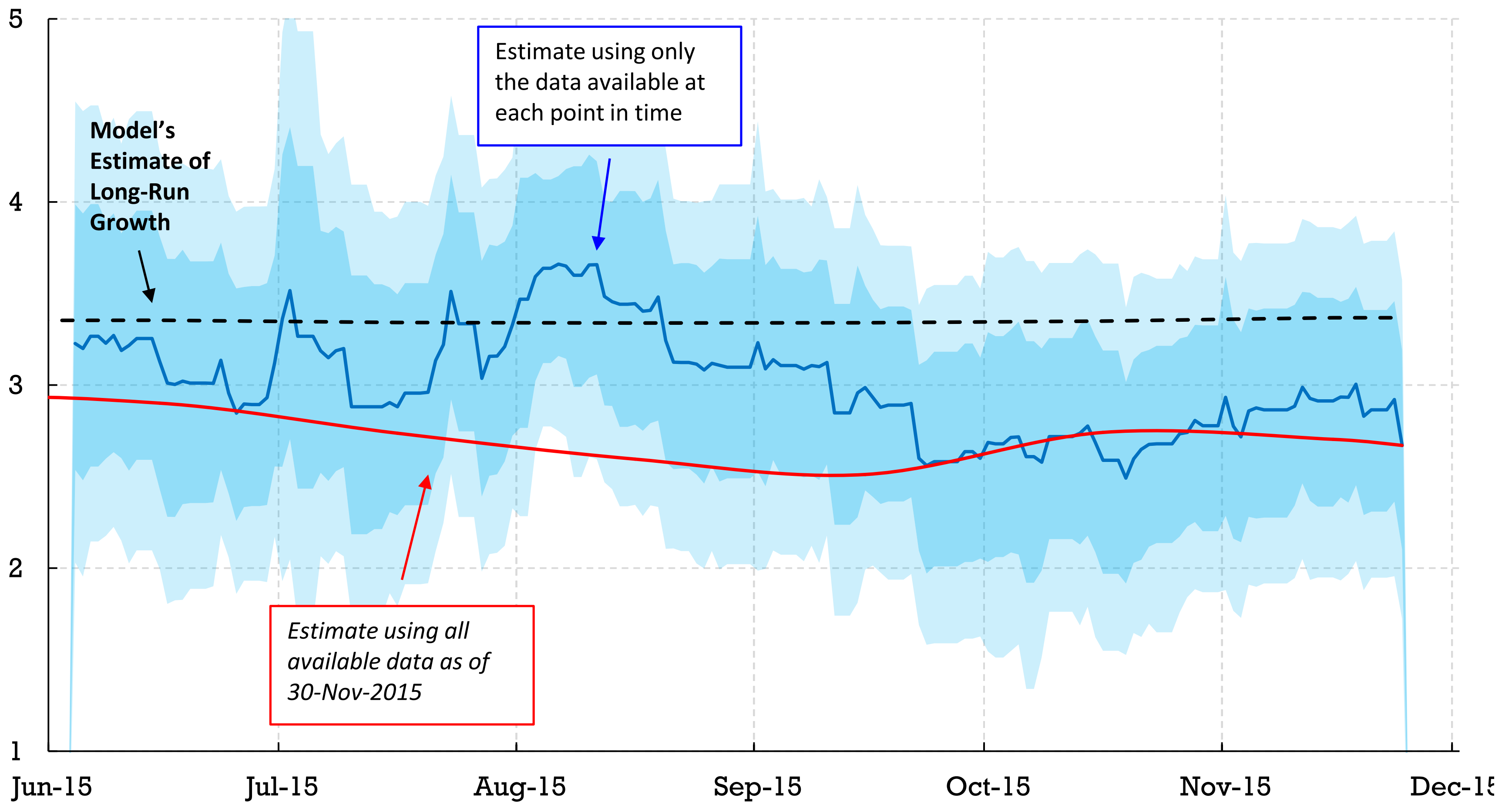
December 2015

The continuing pattern of downgrades to global GDP forecasts has been remarkable, and is showing signs of happening again in 2016. This pattern of moderate growth has surprised economists but has actually been good for risk assets – except in the emerging markets.



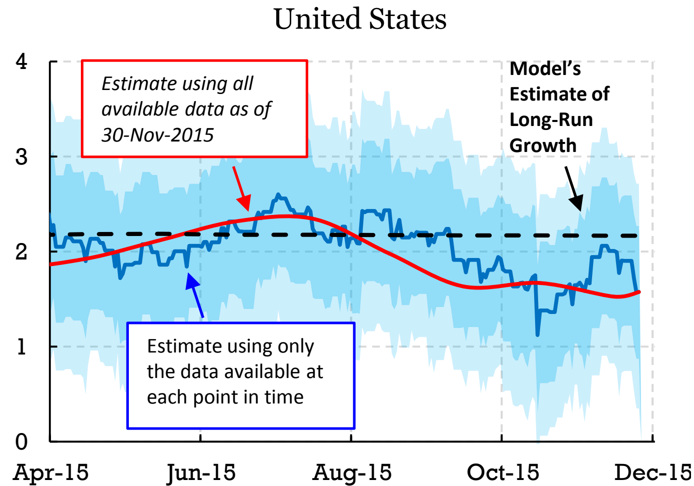
Notes: The lines represent the evolution over time of 2013, 2014, 2015 and 2016 annual forecasts.
Source: Consensus Economics

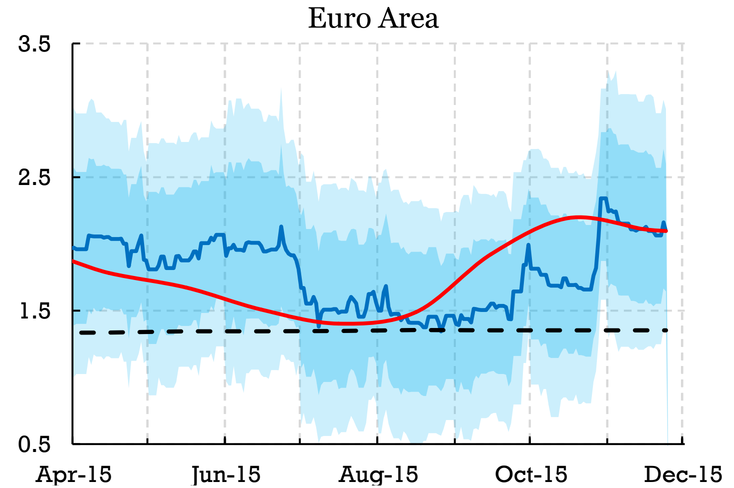
Fulcrum's nowcasts of global activity combine all of the relevant economic data published around the world into a single measure of activity growth, which we track daily. Global activity dipped slightly in Q3, but it has now stabilised at a growth rate roughly 0.5% below trend.

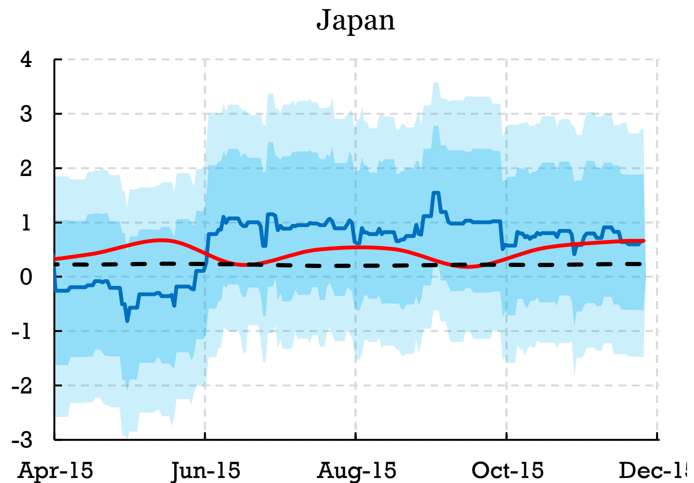


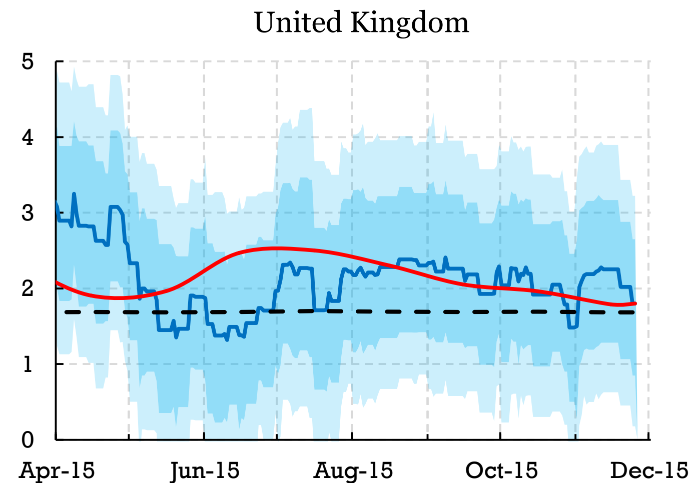
Among the major advanced economies, the main feature at present is the relatively rapid growth in the euro area compared to the US. Japan and the UK are both growing close to trend. Overall, the AE bloc is also growing at trend rates. US manufacturing data seem to have broken lower in the past week.

Real-time estimate of underlying activity growth (% MoM Ann.)

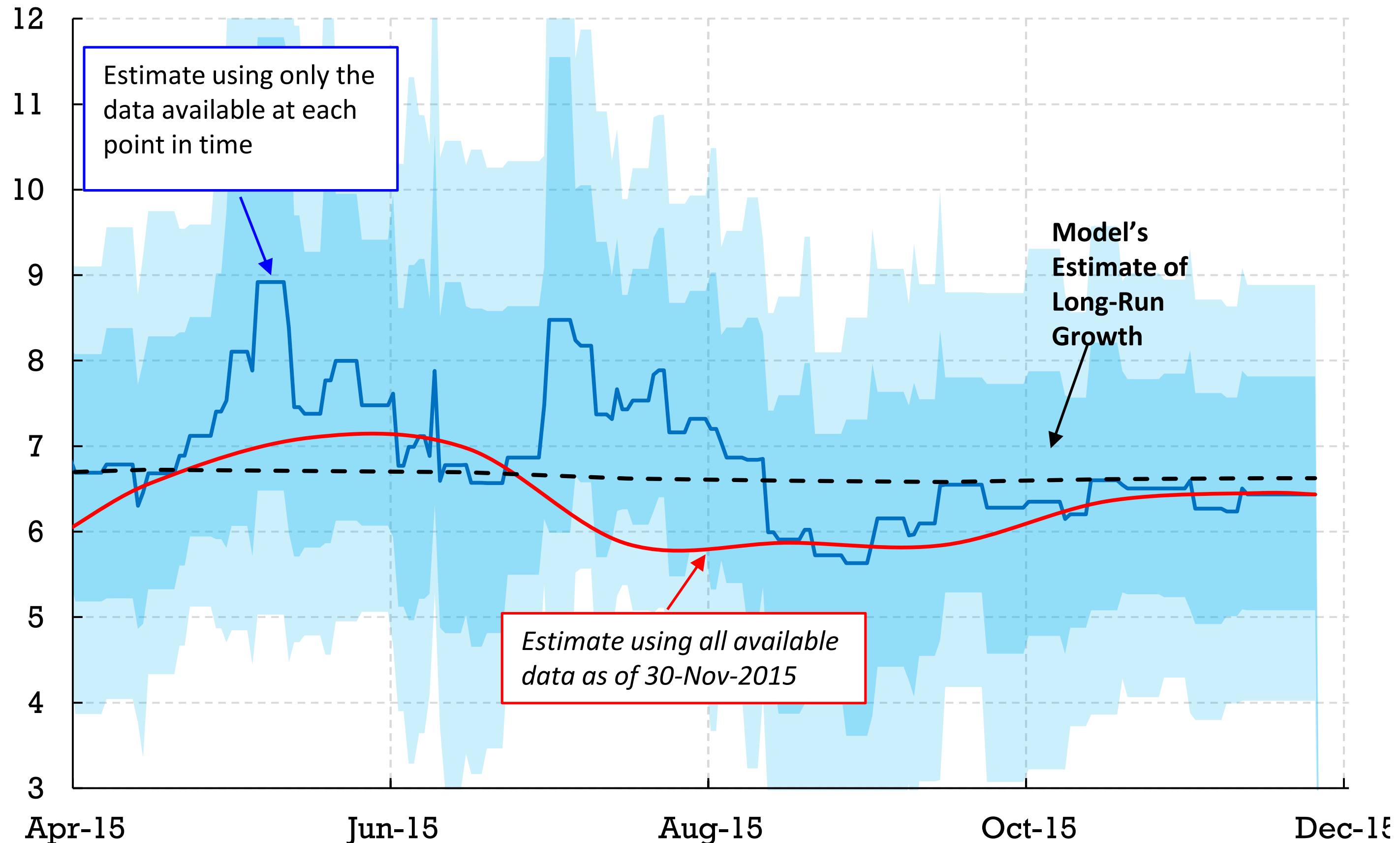








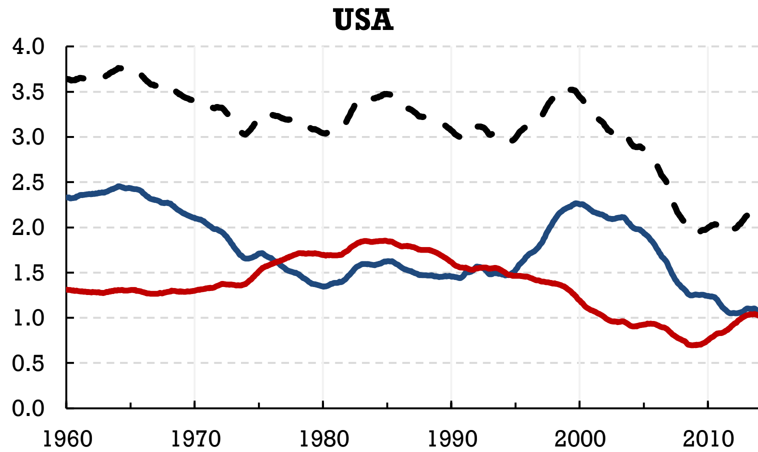
Market fears about a hard landing in China peaked in September, at which point the activity growth rate had dipped to about 6%. Since then, activity has stabilised as a result of progressive easing in both fiscal and monetary policy, and the growth rate has risen to 6.6%. The risk of a hard landing has diminished, for now.

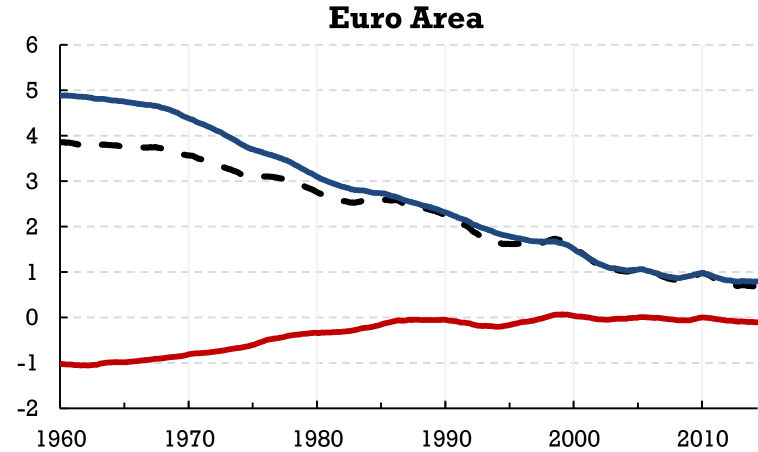


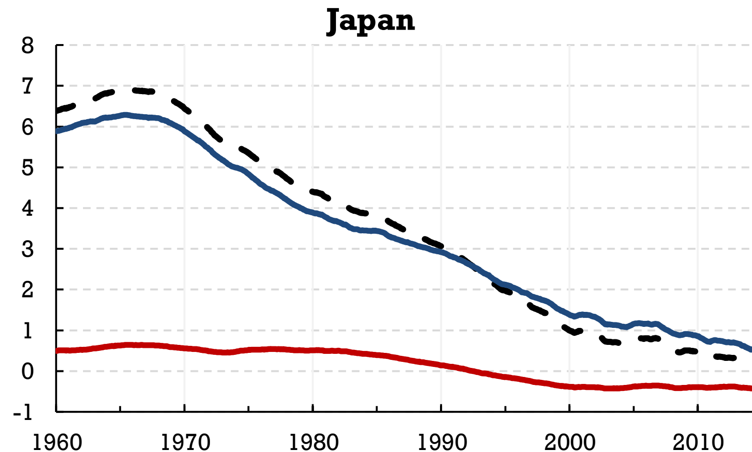
Productivity growth has slowed progressively in all the advanced economies. In most countries, this has been a continuous feature since the early 1970s. Even in the US, the slow-down pre-dated the Great Financial Crash in 2008. There is no reason to believe that this productivity slowdown will suddenly reverse itself.

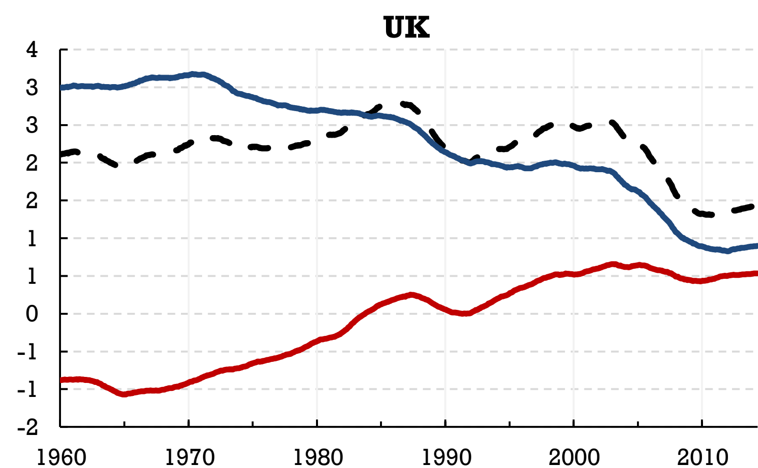
Decomposition of Long-Run Output Growth (% Ann.)

Real GDP, of which — Productivity — Labour Supply



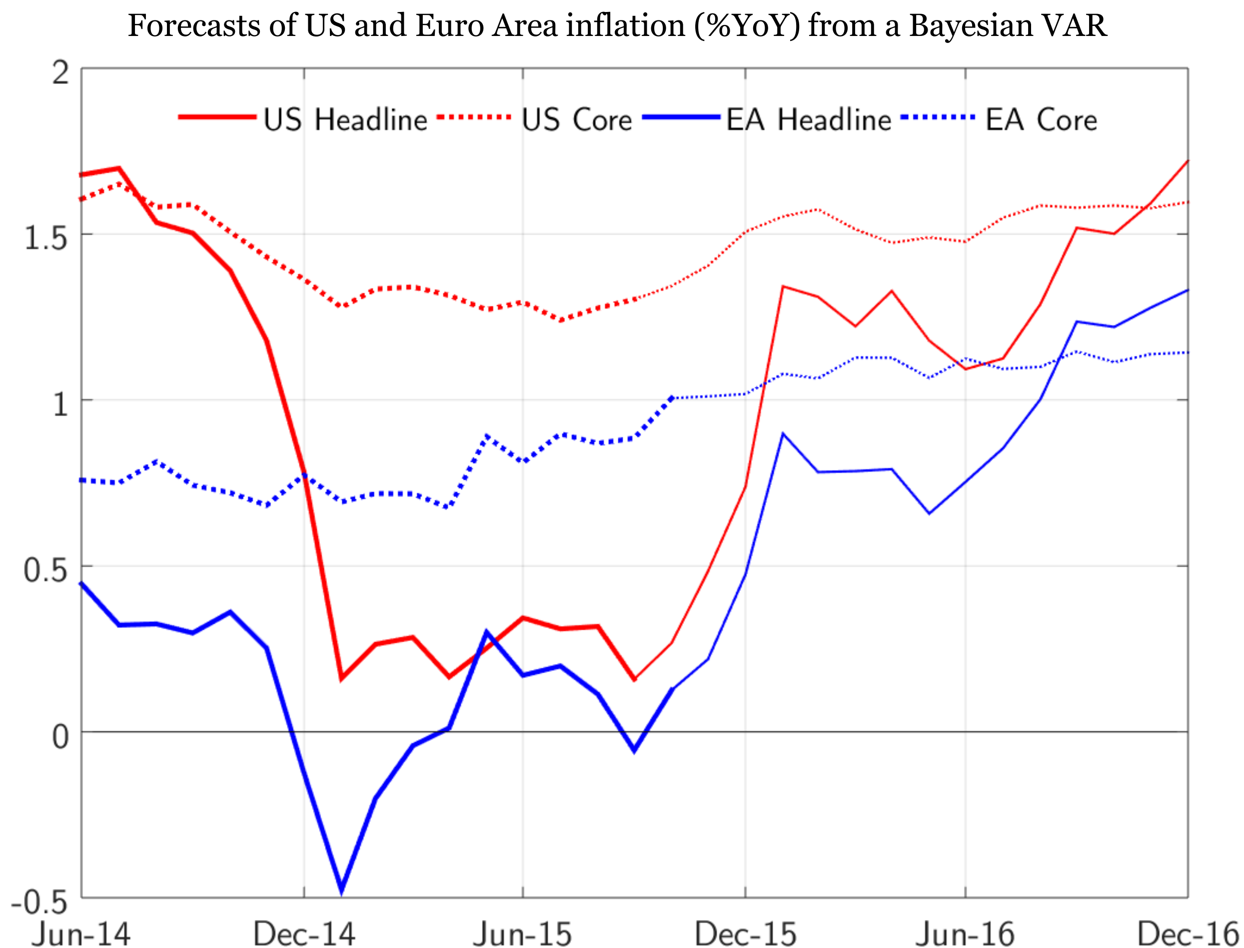






Source: Antolin-Diaz, Drechsel and Petrella (2014), "Following the Trend: Tracking GDP when Long-Run Growth is Uncertain".

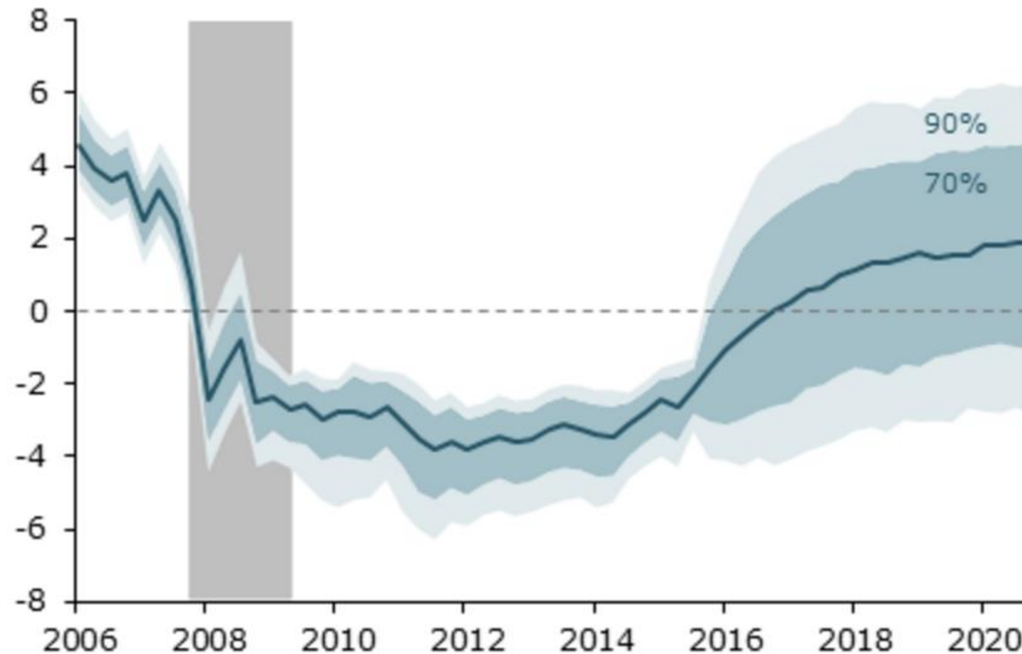
The 2014/15 decline in both core and headline inflation has been driven mainly by the collapse in commodity prices. The maximum impact of the commodity crash is now in the inflation data, and we expect to see increases in headline inflation rates in the very near future.



Note: The thin lines are forecasts. We consider PCE inflation for the US and HICP inflation for the Euro Area.

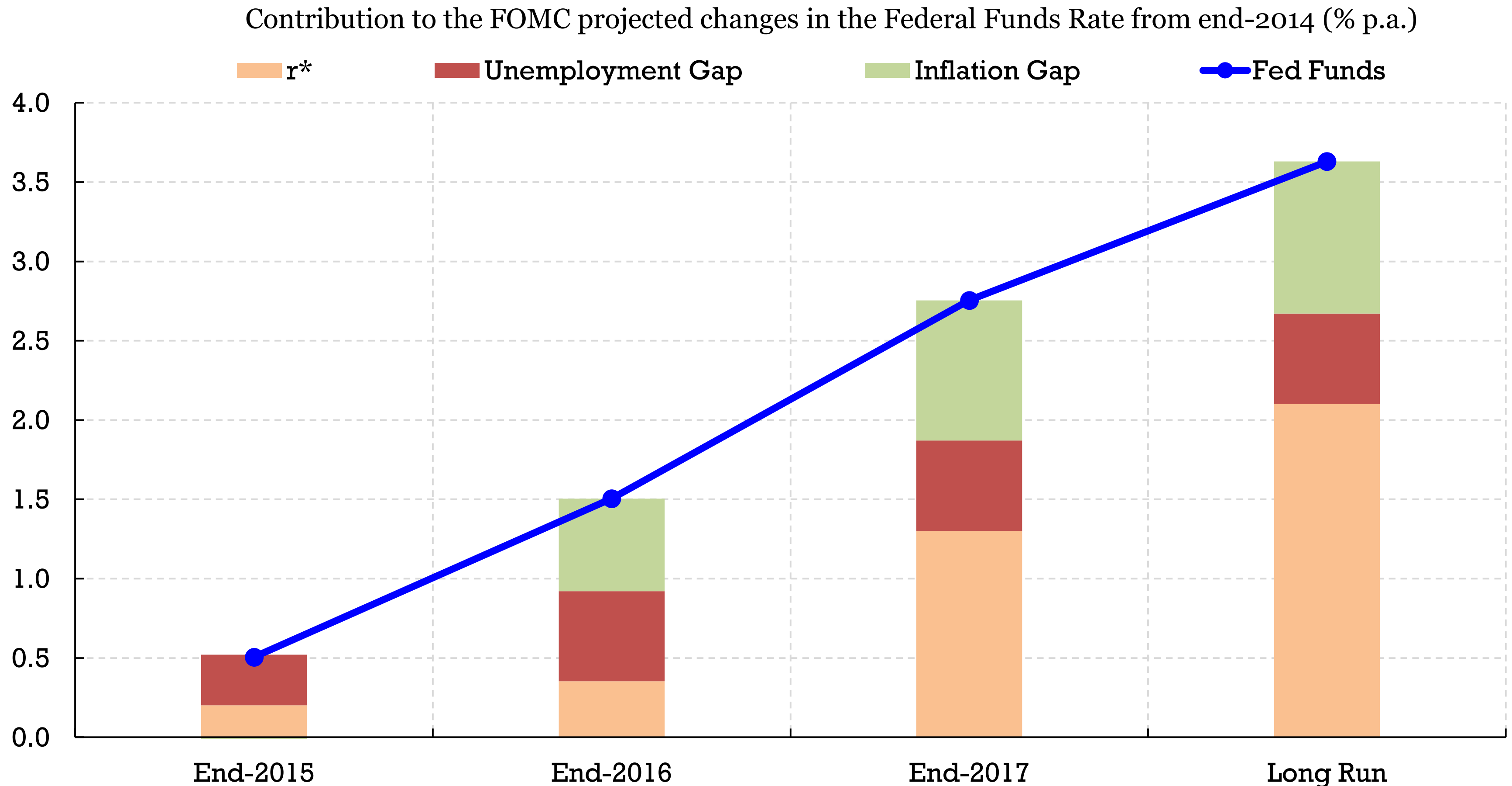
The FOMC has been projecting a rise in US short rates at a pace of around 100bp per annum in the next 3 years. This is mostly driven by a rise in the natural real rate of interest – though there is much uncertainty about this concept.

Estimated natural rate of interest (annual rate, percentage pts)



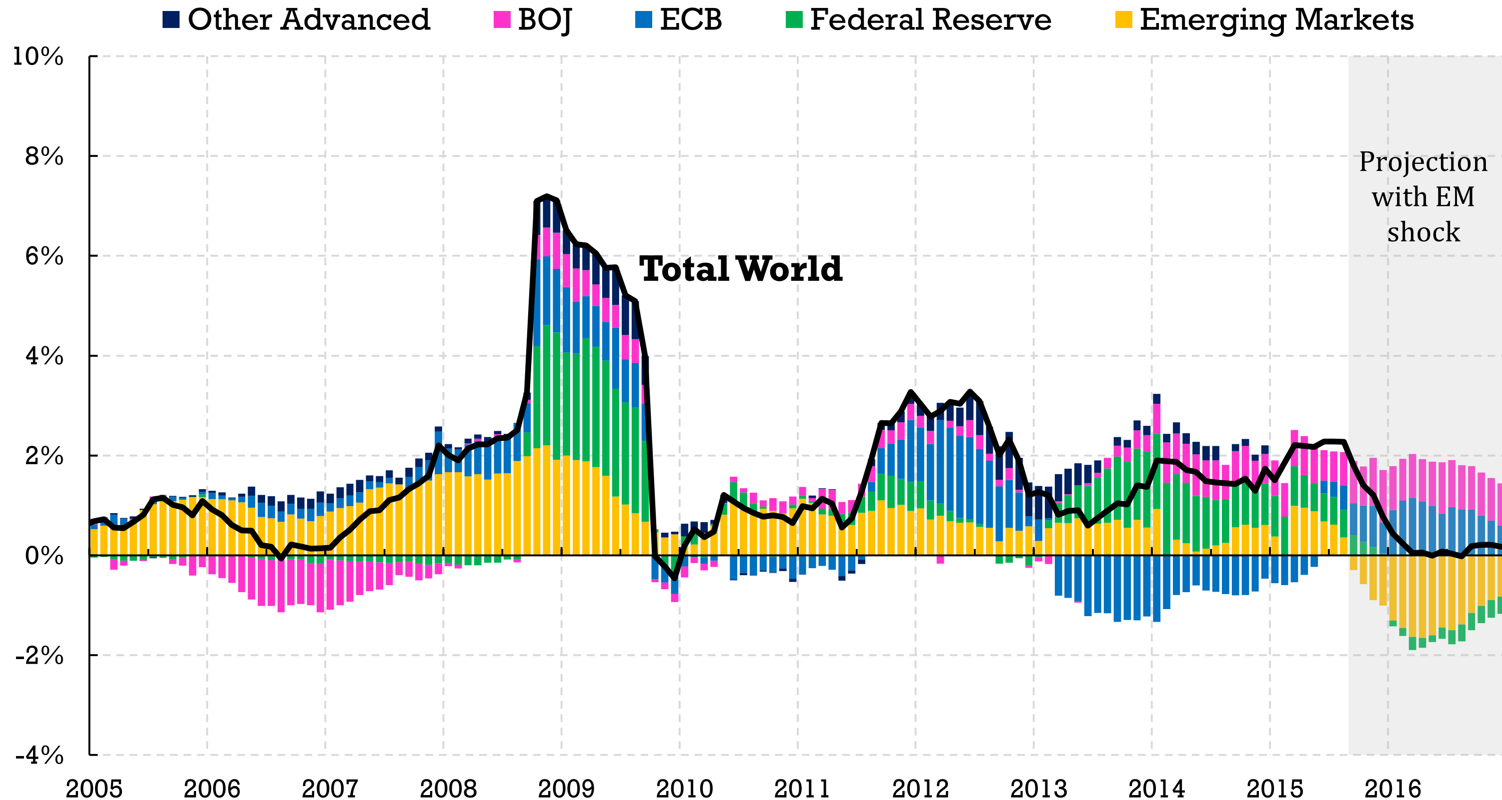
Source: Vasco Curdia, Federal Reserve Bank of San Francisco, Economic Letter 12 October 2015.

The Fed's projected increase in US short rates after 2016 is largely due to a rise in r*, the assumed equilibrium Fed funds rate in the economy. The US bond market does not believe that this rise will take place.



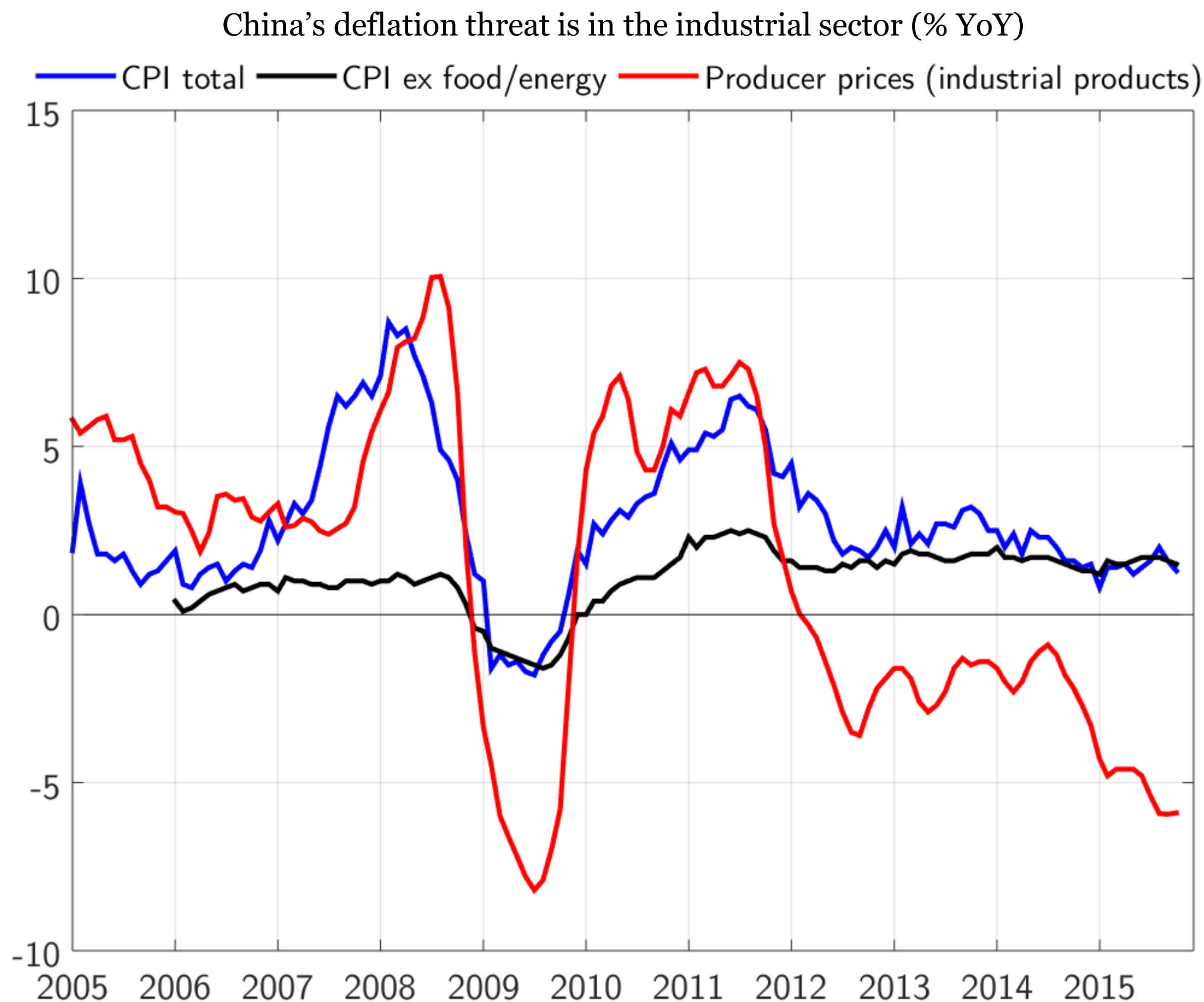
Notes: r refers to the real equilibrium interest rate. This has been derived from the FOMC projections for PCE core inflation, unemployment and the Federal Funds Rates and the Taylor rule described by Yellen (2015).*
Sources: Federal Reserve

The rate of increase in the central banks' global balance sheets ("global QE") could decline sharply in 2016 if there is a major capital outflow from the EMs. Without this EM shock, however, expansionary policy by the BoJ and ECB will keep global QE close to present levels.

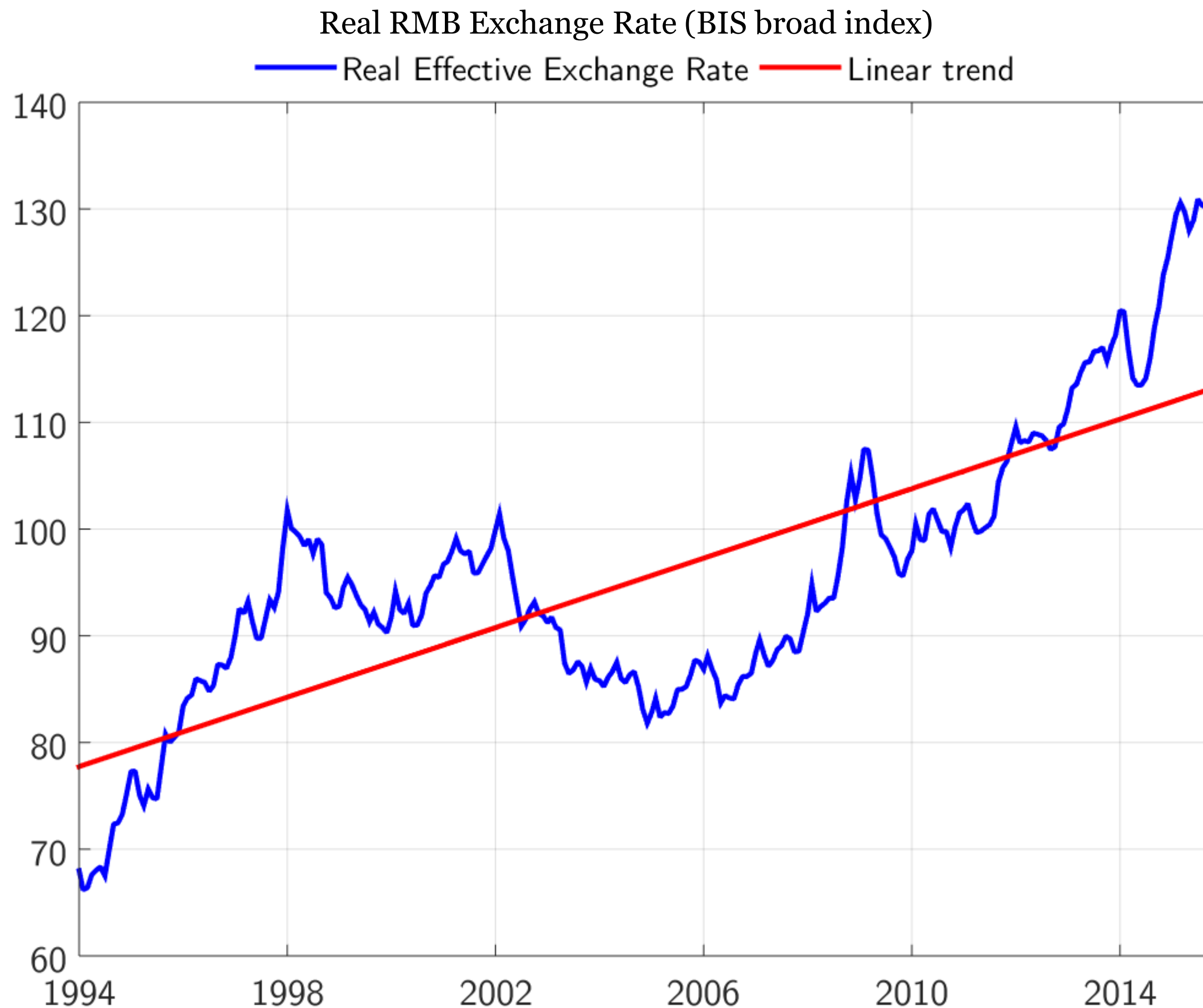


Source: IMF, National Data, Haver Analytics

Although recent activity growth rates have stabilised in China, the risk of a hard landing in 2016 has not entirely disappeared. Deflation is now severe in the industrial sector, in part because of the rising real exchange rate.

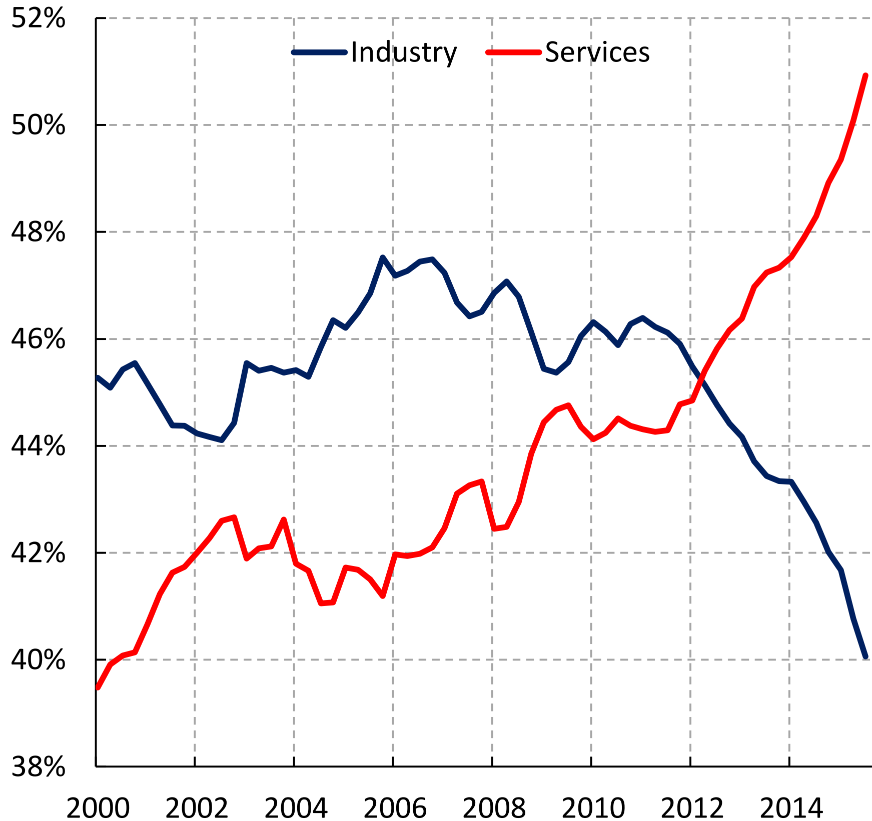


The real RMB exchange rate has risen sharply with the dollar since mid 2014. Although the Chinese authorities have not been willing to devalue the RMB, partly because of entry into the SDR, there is a risk that they will have to change their minds, imparting a global deflationary shock that could shake markets.

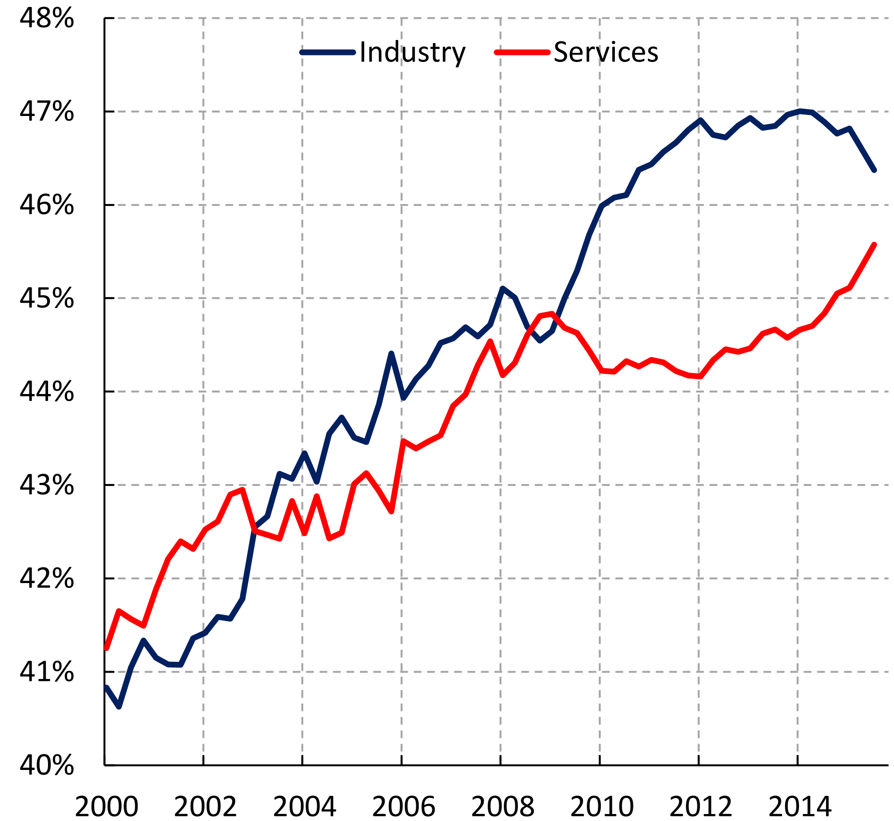


Source: BIS

Some observers, including the IMF, have praised China for its successful rebalancing between industry and services. But this has occurred mainly because of the collapse in inflation in the industrial sector. There has been little shift of real resources into the service sector.



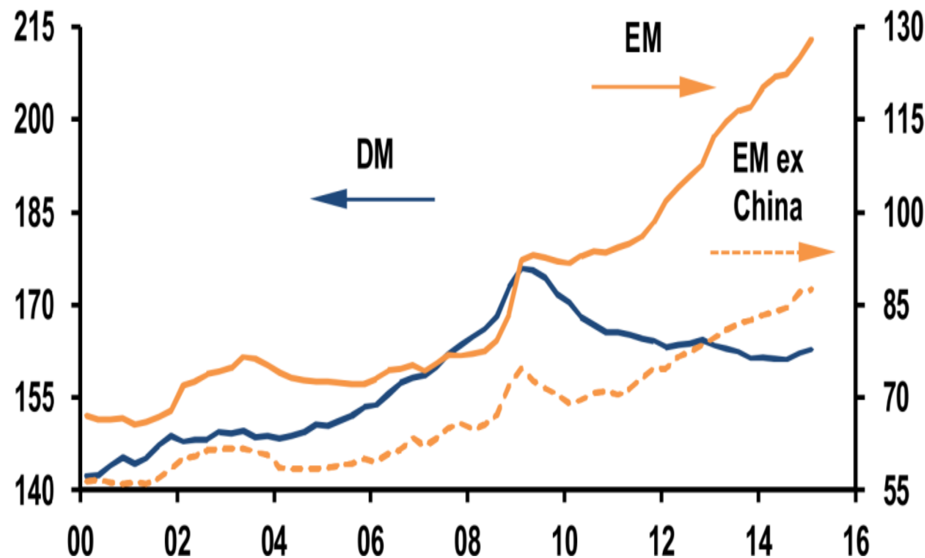
Note: Ratio of industry or services output to GDP in current prices.
Source: NBS



Note: Ratio of industry or services output to GDP in constant prices.
Source: NBS

Apart from the deflationary risks in the Chinese industrial sector, the main downside risk to the global economy in 2016 stems from the deleveraging cycle following the credit bubble across the emerging world. This has only just started and could become severe.

Broad Private non-financial credit (% GDP, both scales)



Note: DM & EM country sample is limited to JPM GDW forecast universe. Data are quarterly through 2015-Q1.
Source: BIS, IMF, JP Morgan.

Experiences after strong leverage upswings (%QoQ saar)

Sample	Number of epi-sodes	Number experiencing crisis	Number experiencing recession (likelihood)	Implied EM growth rate next 3 years
Whole sample	**53**	**15**	**38 (72)**	**2.6**
ex. crises	38	...	23 (61)	3.6
Deleveraging	**33**	**14**	**26 (79)**	**1.9**
ex. crises	19	...	12 (63)	3.1
crisis	14	14	14 (100)	-0.1
No deleveraging	**20**	**1**	**12 (60)**	**4.3**
ex. crises	19	...	11 (58)	4.4

Source: BIS, JP Morgan.