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Global Economic Perspective: October

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More Positive US Data Build Hopes for Better Performance in Second Half of 2016

There were some encouraging signs the US economy remained on course to deliver a better showing over the second half of 2016, and we would concur with this broadly positive outlook, in large part due to the contribution from US consumers. The strength of job creation is likely to slow as the economy nears its perceived level of full employment, and thus we think the boost to growth from consumer spending may moderate a little in future quarters, but we are encouraged uncertainty surrounding the forthcoming US elections has not appeared to weigh on consumers thus far.

IMF Downbeat on Global Growth, but OPEC Delivers a Surprise

The International Monetary Fund's (IMF's) prediction for global growth of 3.1% in 2016 remained subdued, and though it still expects a gradual recovery to follow, the IMF envisages this pickup will be driven almost entirely by emerging economies, as advanced economies grapple with headwinds such as changing demographics and declining productivity. OPEC (Organization of the Petroleum Exporting Countries) announced a surprise draft agreement to cut oil production that boosted energy prices, but any significant further rally would seem to us to require a far more vibrant global economy.

ECB Facing Difficult Decisions About Next Steps in Monetary Policy

Growth in most of the eurozone has remained tepid and reliant on continued central bank stimulus, though the European Central Bank's (ECB's) bond-purchasing program has been hampered by a scarcity of eligible bonds, as issuance from member governments is restricted by their austerity-driven policies. We do not believe the ECB will contemplate a major change in direction, since in the continued absence of a significant fiscal stimulus, the region's economic performance is too weak for the central bank to risk measures that could create, however inadvertently, a degree of tightening in monetary policy.

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More Positive US Data Build Hopes for Better Performance in Second Half of 2016

As the third quarter ended, there were some encouraging signs the US economy remained on course to deliver a better showing over the second half of 2016, after the sub-trend growth seen since late 2015. Though September's employment report came in a little shy of consensus expectations, the pickup in data elsewhere added further weight to speculation the US Federal Reserve (Fed) could announce a rise in US interest rates at its December meeting, a move that has seemed increasingly likely ever since the dissenting votes by several Fed policymakers in favor of an immediate rate hike at September's meeting.

We would concur with this broadly positive outlook for the economy over the rest of the year, in large part due to the contribution from US consumers, whose well-being—thanks mainly to a robust labor market—was apparent in one measure of consumer confidence during September, which hit its highest level in nine years. The strength of job creation is likely to slow as the economy nears its perceived level of full employment, and thus we think the boost to growth from consumer spending may moderate a little in future quarters, but we are encouraged uncertainty surrounding the forthcoming US elections has not appeared to weigh on consumers thus far.

Just as August’s weakness in the Institute for Supply Management’s purchasing managers’ indexes (PMIs) for services and manufacturing had unsettled investors, their strong rebound in September boosted confidence that the US economy was not entering a soft patch. The services PMI was particularly healthy, jumping to its highest level in nearly a year. The details within the services report hinted at ongoing strength in future months, as new orders rose significantly, while the employment component of the index for this part of the economy climbed at its fastest rate of growth in 12 months. The equivalent report for manufacturing also beat consensus expectations, moving back above the 50 level that divides expansion from contraction. New orders were again the standout, regaining most of August’s hefty fall, and overall the report suggested the manufacturing sector could be modestly strengthening after its previous difficulties caused by lower overseas demand, a stronger US dollar and a decline in energy investment. As a result of the positive data on both areas of the economy, many market participants concluded the weakness in the August reports was likely to have been an outlier and unreflective of the economy’s underlying strength.

September’s employment report was a touch softer than forecast but did little to move the dial on interest-rate expectations. Jobs added from a month earlier totaled 156,000, with the below-expectations result partly due to the largest drop in government employment in a year and as education jobs were scaled back. The unemployment rate inched up to 5.0%, but the 0.1% rise from the prior month was due to a positive move in the labor force participation rate, which rose to a six-month high of 62.9%. Wage data again failed to reflect the robust job market, as average hourly earnings rose by 0.2% from August, undershooting expectations of a 0.3% increase. However, there was better news from the annual figures, which showed wage growth quickening from 2.4% to 2.6%.

Offsetting the strong consumer confidence and PMI data were some weaker numbers, with consumer income and spending for August coming in softer than generally expected. Income rose just 0.2% from the previous month, and consumer spending was unchanged over the same period. Retail sales fell 0.3%, and once adjusted to exclude autos and gasoline, they also shrank by 0.1%, the second consecutive monthly decline for this core measure.

Market sensitivity to inflation data remained minimal, suggesting the long period of negligible pricing pressures had persuaded most investors any risks from inflation were well contained. Nevertheless, in August the core personal consumer expenditures price index—the Fed's favored inflation measure—inched closer to the US central bank's 2% inflation target, ticking up to 1.7% year-on-year (y/y). Based on the Consumer Price Index, US core inflation showed the largest monthly rise since February, pushing the annual rate up to 2.3%.

Despite the potentially hawkish inference from September's split vote among Fed policymakers, Fed Chair Janet Yellen pointed out at the meeting the economy showed little sign of overheating, adding to perceptions dovish members of the rate-setting committee retained their sway. The Fed reduced its forecasts for growth and the federal funds target rate, and in doing so underlined how policymakers' perceptions of the likely appropriate monetary policy setting have shifted lower during the year-to-date. Growth predictions for the current year were cut from 2.0% to 1.8%, while the longer-run growth rate was also trimmed to 1.8%, and the Fed's median interest-rate projections for 2017 and 2018 were accordingly reduced from 1.6% to 1.1% and from 2.4% to 1.9%, respectively. Some analysts have noted any dovish tilt to Fed policy may receive further support following the rotation of committee members scheduled for later this year, due to the seemingly dovish tendencies of the new joiners.

With November's elections and December's critical Fed meeting on the horizon, clearly both the fiscal and monetary backdrop for the United States could change, perhaps significantly, before the end of the year. But the recent positive tone of data increases our optimism the US economy is on solid ground going into this period, underpinned by the enduring strength of the labor market and the healthy contribution to growth from consumers.

IMF Downbeat on Global Growth, but OPEC Delivers a Surprise

The latest update on the global economic outlook from the IMF saw a slight trimming of its growth forecasts. Overall, the IMF's prediction for global growth of 3.1% in 2016 remained subdued, with the institution citing the uncertainty created by the United Kingdom's decision to leave the European Union (EU) and slower-than-expected US growth as restraining factors since its last set of forecasts in April. It still expects a gradual recovery to follow, but the estimated 1.8% rate of growth in 2017 for advanced economies underlines how the IMF envisages this pickup will be driven almost entirely by emerging economies. The largest adjustments were related to the United States, where growth forecasts were marked down from 2.2% to 1.6% for the current year, and from 2.5% to 2.2% for 2017.

There was brighter news from China, where data covering August indicated the country's growth was stabilizing, soothing fears the economy was experiencing a sharp slowdown. Industrial production grew by 6.3% y/y, the fastest growth since March, while retail sales also accelerated over the same period and August's official PMI reached 50.4, its highest reading in some time, remaining at this level in September. The stronger data increased the likelihood China would achieve its 2016 gross domestic product (GDP) growth target of 6.5%–7.0% and underlined the impact of policy measures implemented earlier in the year, aimed at stimulating the Chinese economy. However, during September some global institutions voiced concerns about the speed at which China has accumulated debt—which has risen from 147% of GDP in 2008 to 255% in March of this year according to the Bank for International Settlements—could hamper the country's ability to maintain its current level of growth.

Elsewhere, the September meeting of OPEC resulted in a surprise draft agreement to cut oil production, the first such deal in eight years. Most investors were wrong-footed, having assumed long-standing differences between Saudi Arabia and Iran, two of the main producers in OPEC, would prevent any such deal. But in a major shift away from the previous Saudi-led policy of maintaining production to squeeze high-cost US shale-oil producers, OPEC countries agreed to target a lower level of 32.5–33.0 million barrels a day, although there was some skepticism about the absence of details on which members would curb output and by how much, which were delayed until the next meeting in November. News of the deal pushed oil prices sharply higher to around the US$50 per barrel level.

While heartened by the bounce in oil prices after the multi-decade lows reached early in the year, any significant further rally in energy prices would seem to us to require a far more vibrant global economy. As the IMF’s (and the Fed’s) relatively subdued outlooks make clear, it is hard to anticipate such a scenario occurring anytime soon, and indeed easier to build the case for a structurally lower rate of global growth, as advanced economies grapple with longer-term headwinds such as changing demographics and declining productivity.

ECB Facing Difficult Decisions About Next Steps in Monetary Policy

The IMF’s economic forecasts underlined the weak outlook for the eurozone. Even after a marginal increase in its latest numbers, the IMF still believes the region’s growth in 2017 will be only 1.5%, which would be 0.5% lower than in 2015. The eurozone’s lack of organic growth and its reliance on continued central bank stimulus likely increased market sensitivity to a report claiming the ECB might be considering tapering its €80 billion monthly purchases of bonds, though the claim was quickly dismissed by the ECB. The effect of the story was magnified since there had been some predictions among market participants the ECB’s next move would be to extend or widen the scope of its bond purchases.

Ironically, the story emerged shortly after another report predicted the fourth quarter of 2016 would see the highest level of quantitative easing (QE) by central banks around the world since shortly after the global financial crisis, largely due to the Bank of England’s expansion of its bond purchases following the UK referendum result. But the sense some central banks might be reviewing the effectiveness of their QE programs was given credence by the Bank of Japan’s (BOJ’s) policy shift in September to target yields rather than bond purchases. Since the BOJ already owns close to half of all outstanding Japanese government bonds of a 10-year maturity and below, its move was viewed by some market participants as, in effect, a tacit admission the BOJ had reached the limit for QE and possibly the first stage of a taper of its bond purchases.

Many analysts have long flagged a similar pitfall for the ECB's purchasing program, namely a scarcity of eligible bonds, as issuance from member governments has been restricted by their austerity-driven policies. The problem is particularly acute in the German Bund market, the region's largest sovereign debt market, since the German government has moved to eliminate its budget deficit entirely, reducing Bund issuance to a trickle. According to the terms of the ECB's program, it has to maintain a fixed national distribution of purchases, and is further constrained in scope by being unable to buy any issues trading at a lower yield than its deposit rate. Politically, however, it may be difficult for the ECB to gain agreement for a redistribution of purchases, since some German policymakers might seek to block such a move.

Among recent data releases, Germany's Ifo Business Climate Index, which measures business confidence, rose to its highest level in September since May 2014. This healthy rebound from a poor August reading suggested German companies had shaken off any uncertainty created by the UK referendum result. Underlining the health of the German economy compared with much of the rest of the eurozone, an independent bi-annual report produced by a range of economic institutions for the German Economics Ministry raised its forecast for the country's growth in 2016 from 1.6% to 1.9%, citing the strength of the labor market and private consumption. If the report's forecast proves accurate, it would represent Germany's best economic performance since 2011. News flow from Germany's financial sector was less positive, as one of the country's largest banks endured a difficult month, rocked by an unexpectedly large claim from US regulators related to past mis-selling of mortgage products.

The adjustments faced by the United Kingdom after its voters' decision to leave the EU were brought into sharp relief by the weakness of the British pound, which fell following the UK government's announcement it would seek to start negotiations with the EU about the terms of the UK's departure early in 2017. The news of this relatively advanced start date for negotiations increased speculation the UK government was leaning toward a settlement that prioritized a clean break with the EU, rather than one that maintained the country's access to the EU's single market. In early October, the fall in the British pound culminated in a so-called "flash crash," with the currency rapidly losing more than 6% of its value against the US dollar before regaining most of its losses. Though a final deal on the United Kingdom's departure from the EU remains years away, the British pound has already experienced a significant adjustment, a stimulus which we believe should go a long way toward offsetting the potential negative effects of the uncertainty surrounding the country's relationship with Europe.

Regarding the path ahead for ECB policy, it seems likely adjustments to the central bank's bond-purchasing program will be discussed by policymakers at meetings in coming months, given the technical difficulties and political risks involved. But we do not believe the ECB will contemplate a major change in direction, since in the continued absence of a significant fiscal stimulus, the region's economic performance remains too weak for the central bank to risk measures that could create, however inadvertently, a degree of tightening in monetary policy.

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