

Macroeconomic Outlook – November 2015

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Global Framework

- I. World trade is growing at a slow pace since summer 2011.
 - This reflects the absence of a real growth driver at the global scale..
 - Neither the US, nor China or Europe are potential drivers of global growth.
 - Their momentum is not strong enough to push the world expansion on a higher trajectory
- II. This means that each country or zone will have to focus on its own internal demand to grow rapidly. The possibility of waiting an impulse from outside, as it was done in the past, is no longer available
- III. Therefore, economic policies will have to remain very accommodative .
- IV. That's why I don't think that a Fed's lift off of its interest rates could be a good idea in an immediate future. Nevertheless, the probability of a Fed's rate hike in December is high
- V. The ECB will probably extend its QE beyond September 2016 and fiscal policies will not constrain private behaviors. There is a need for more coordination in economic policies.
- VI. In China, the situation is still complicated. The change in the growth model leads to balance of strength between those who currently have the power (regional governments and State Owned Enterprises) and those who will be the future of China (services) – China will follow the same pace than Japan and South Korea before it. The difference is high indebtedness in China
- VII. One main consequence will be a low oil price for long. It will be a catalyst for a stronger dynamics in industrialized countries (remember the end of the 80's and of the 90's)
- VIII. This is not a good moment for emerging countries – China is no longer a key driver for than and commodity prices are low.

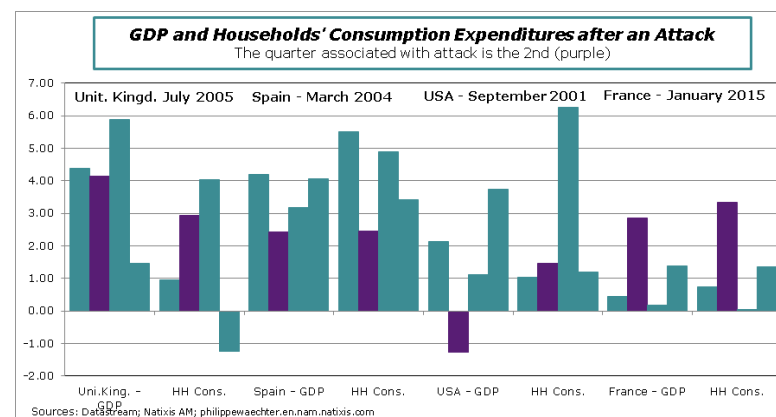
The main points to look at

- A. Growth in the Euro Area will be circa 1.5% in 2015 – Carry over for 2015 is at 1.4% after the third quarter
- B. The ECB wants to be more supportive for the Euro Area in order to converge to a stronger business cycle. It will reconsider its monetary policy tools at its next meeting (December 3).
- C. After the October labor market report, the Federal Reserve is expected to increase its interest rate at its 15/16 December meeting – But its decision remains data dependent
- D. China data for October still show weakness in investment, real estate, exports and industrial production. Adjustment on its internal market is not compensated by a support coming from the global economy.
- E. Japan is in recession after its second GDP fall in the third quarter. Japan still suffers from its VAT rate hike in April 2014 and from the Chinese low dynamics
- F. Mark Carney, head of the Bank of England, suggests that a rate hike could be seen in 2016.
- G. The oil price is now below USD 50 per barrel. We expect it will stay at this level in 2016.

Consequences of the Paris attacks

From past similar situations (New York in September 2001, Madrid in March 2004, London in July 2005, Paris in January 2015), the macroeconomic impact of attacks is limited. We cannot see break in GDP or in households' expenditures. In the case of the USA in 2001 the economy was in recession and exit from it in November 2001.

From the past, there is no persistent effects even if in the short-term, there are negative impacts on tourism and for the retail trade sector.



How to read the graph: In the UK the attack was in July 2005. The second bar in purple is the third quarter of 2005. For Spain, the bar in purple is the first quarter as the attack was in March.....

What about monetary policies?

The current growth momentum is low, inflation rates are close to zero and core inflation rates are way below central banks' target of 2%.

The business cycle is not back to normal even with very accommodative monetary policies.

Central banks in the USA and in the Euro Area said that they prefer to act a bit too late than too early. In the current context, they do not want to take any risks as they think that a negative shock could have a persistent effect on the business cycle.

As far as inflation is muted, central banks will not act in a hurry: acting a little too late is probably less harmful than acting too rapidly

That's why the ECB quantitative operation will be extended after September 2016 (for technical reasons the deposit facility rate will be down by 10bp to -30bp)

What about the Fed?

At September meeting the US central bankers were afraid of the long lasting effect that an external shock could have on the business cycle profile. This shock could come from China and the Fed doesn't want to add a interest rate shock

At September and October meetings the US central bank was expecting a slow convergence to its 2% inflation rate (2018)

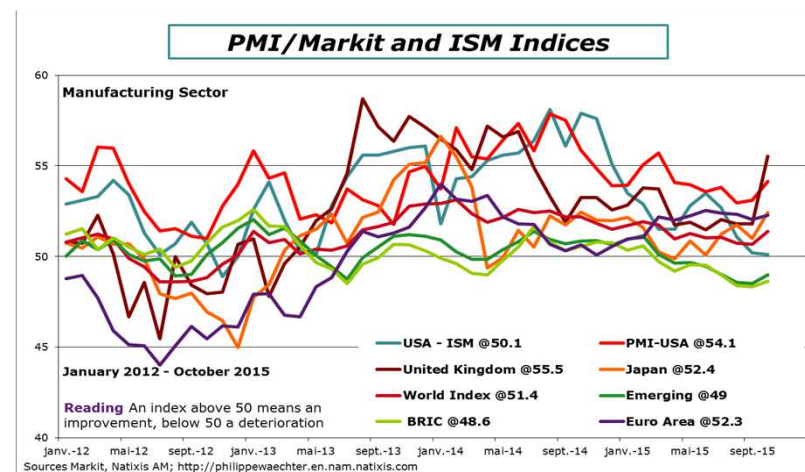
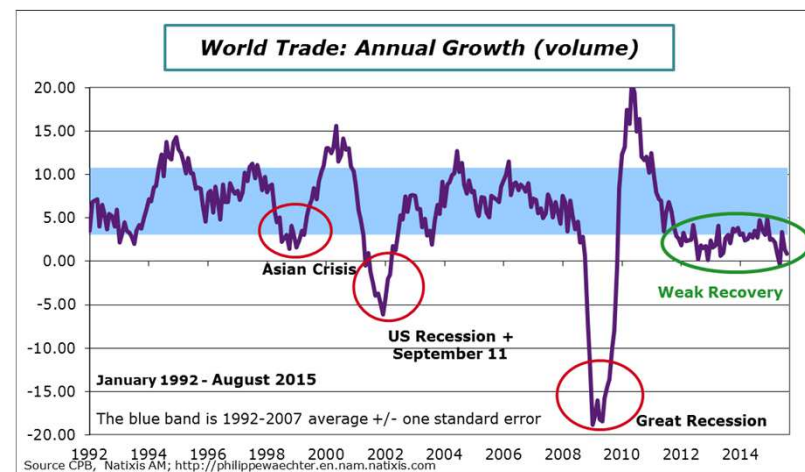
Therefore, the Fed has decided not to move in September and October

Recent changes on the US labor market may be perceived as an opportunity for the Fed to increase its rates. Fed's minutes of the October meeting suggest a hike with a high probability

Nevertheless even in the case of a rate hike at the December meeting, the rate's trajectory in 2016 remains highly uncertain. The US economy is not too strong as there are few tensions and the dollar is expensive.

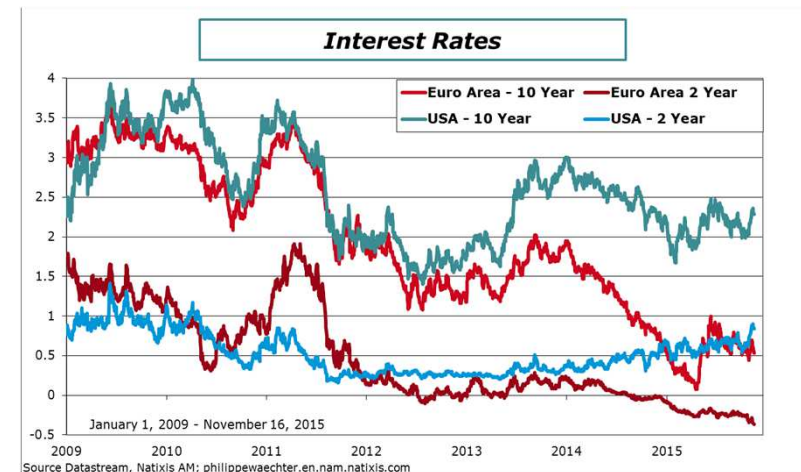
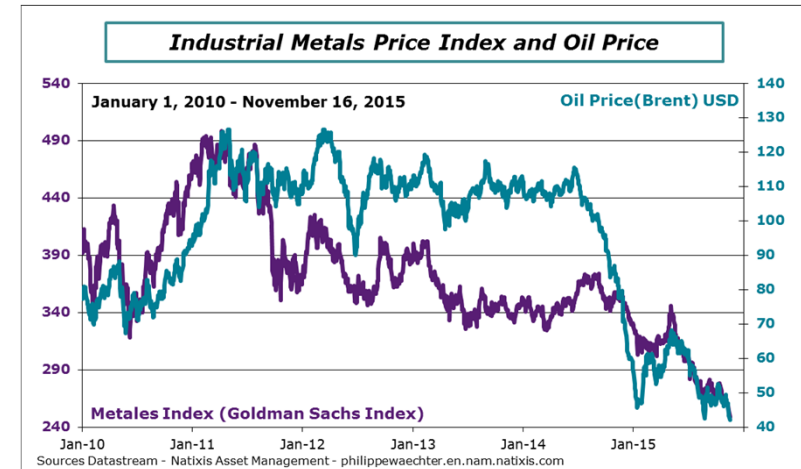
Global Economic Momentum

- The global economy can be characterized by two elements:
The first is the low dynamics seen in world trade
The second is the absence of locomotive at the global level
- One immediate consequence is that no strong and long lasting impulse from outside can be expected.
- This is problematic for developed countries, Europe cannot expect a stronger economic environment to converge to a higher growth profile. This is also harmful for emerging countries.
- The other consequence is that growth momentum will depend mainly on internal demand. This implies that with the current low momentum everywhere, economic policies will remain accommodative for an extended period.
- Companies' surveys do not show a strong rebound, but is a bit stronger in October due to developed countries (UK, Japan notably). Emerging countries are still in negative territory.
- The uncertainty is on the US economy as the two surveys, ISM and Markit, show opposite results. That's a puzzle



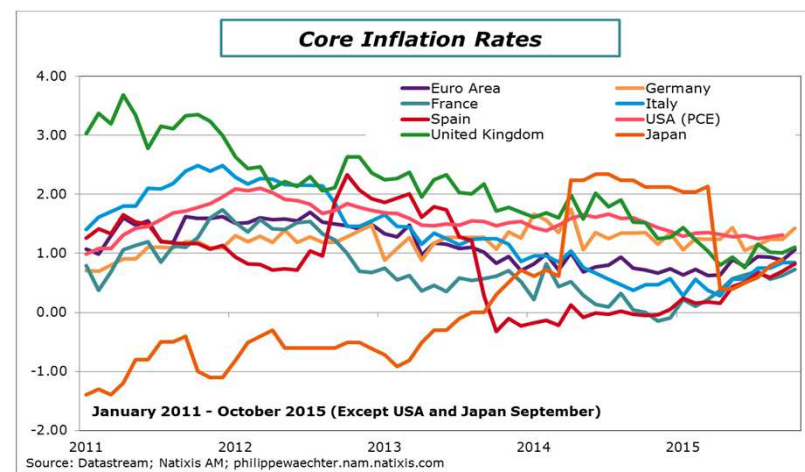
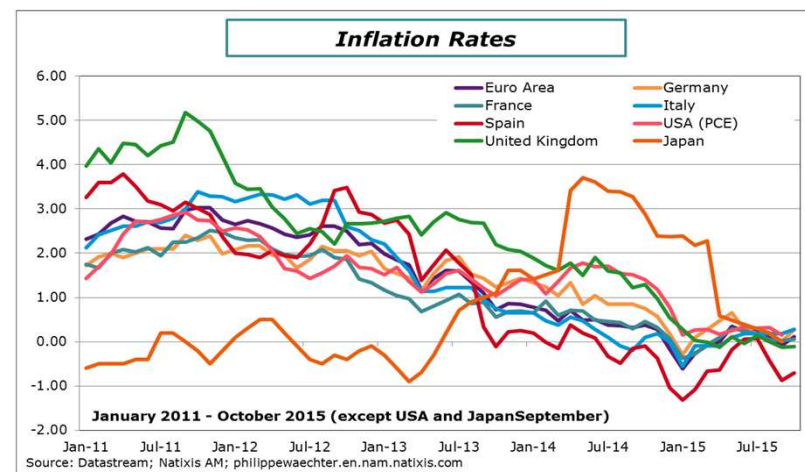
Sources of adjustments

- Slow global growth implies low commodity prices.
- Global demand follows a slow momentum and as investment has been important recently, supply is now very important. This imbalance leads to lower prices
- It is here to stay as usually in this type of situation (counter oil shock after the mid 80's and at the end of the 90's) there is no rationality for a country to reduce its production because it would probably have a low impact on the price profile. Its revenues would then be lower. The best strategy is then to keep its production
- Reduction in oil production will occur with a stronger demand. Therefore we can expect that oil price will remain low for an extended period.
- It will be profitable for developed countries as a lower price for long is associated with a huge transfer from producing countries to consuming countries. Price going from USD 110 to USD 50 is a transfer of USD 2000bn to consumers. That will be a support for growth.
- Interest rates will remain low even in the case of a Fed's lift-off



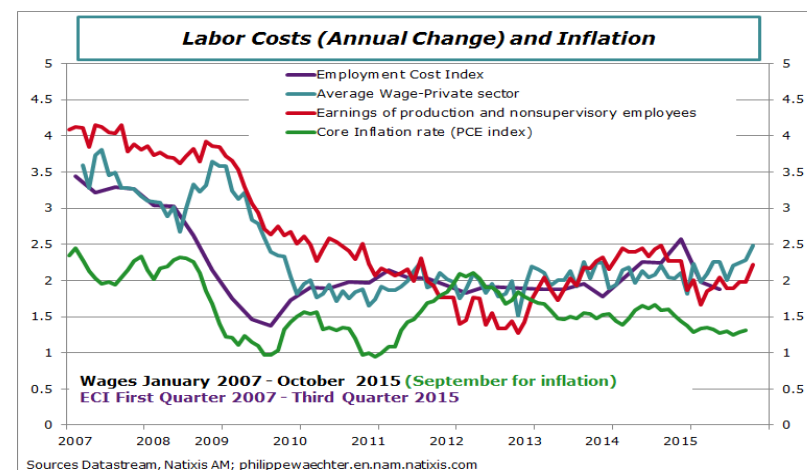
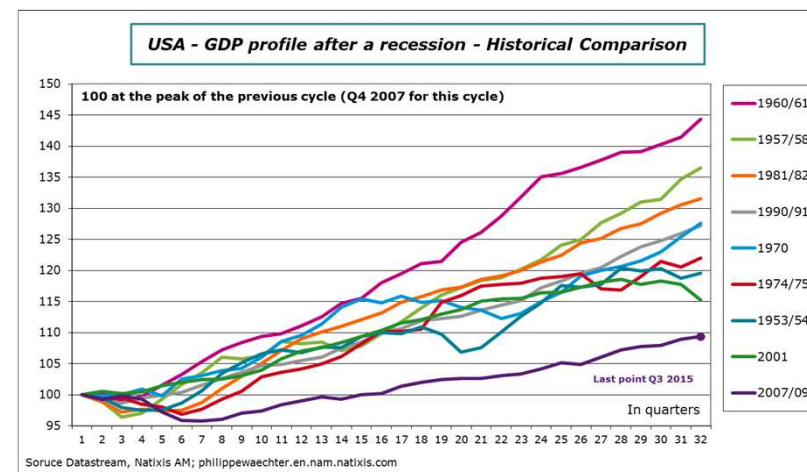
Low inflation rates

- Inflation is too low at 0%. It shows the limited impact of monetary policy measures.
- It's a drag for a global recovery as wage indexation is close to 0%. This changes consumers' behavior because there is no nominal illusion
- It's also a drag for consumers' expenditures. Households in developed countries still have a high level of debt, notably in the Euro Area where households' indebtedness (as % of disposable income) is a little above its pre-crisis level. A 0% inflation rate means that his liabilities do not depreciate, taking a large space in his budget.
- Core inflation rates are also far from central banks target of 2%. This is the biggest puzzle for economic policymakers
- With the expected stabilization in oil price, inflation rates will converge to core inflation rates circa 1%.



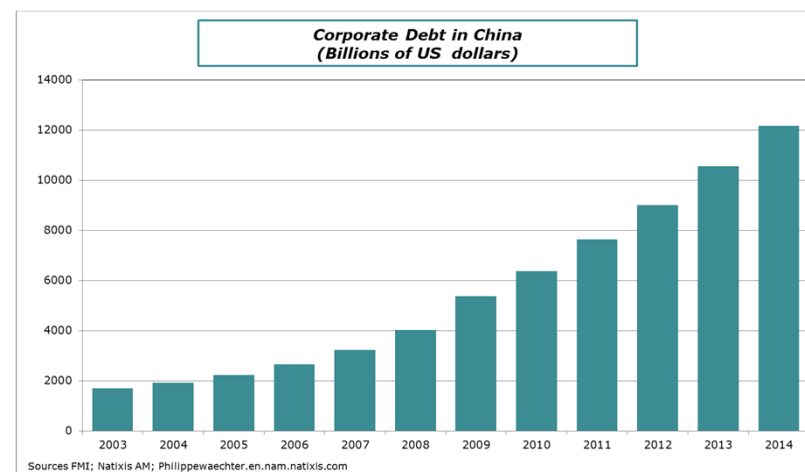
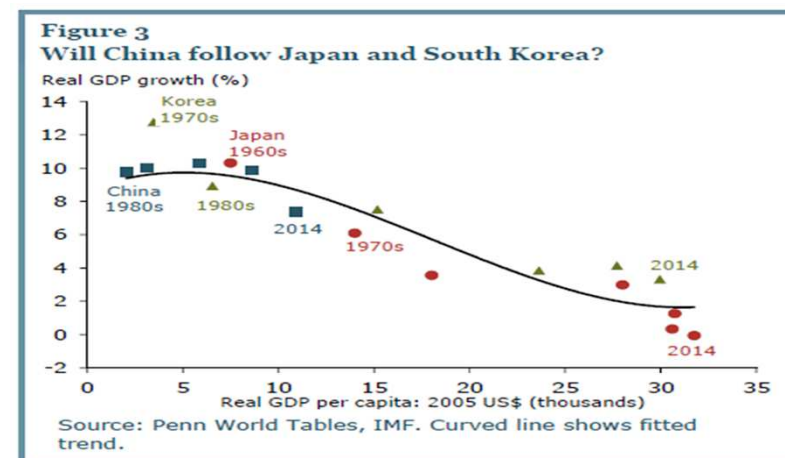
No tensions in the United States

- Current cycle in the US is the slowest since WWII. That what can be seen on the first chart
- The level of the current curve and its slope are more limited than in the past
- This doesn't create tensions within the U.S. economy. That's the main reason for low inflation rates (headline and core).
- If internal demand is supportive, it is not strong enough to converge to a higher trajectory. Therefore, the U.S. economy cannot be a strong source of impulse for the rest of the world
- Recently stronger figures were published on the labor market with a surge in wage growth rate.
- It's an interesting signal that must be confirmed.
- Nevertheless, the risk of high inflation rate (largely above Fed's target of 2%) is not high.
- The share of compensation in the value added is trending downward. This means that companies' share is growing. In a competitive world, companies' strategy cannot be consistent with a higher expected inflation rate.



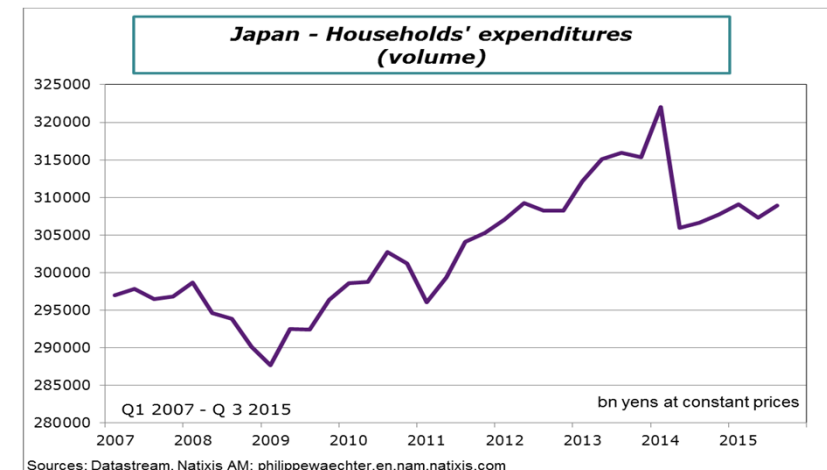
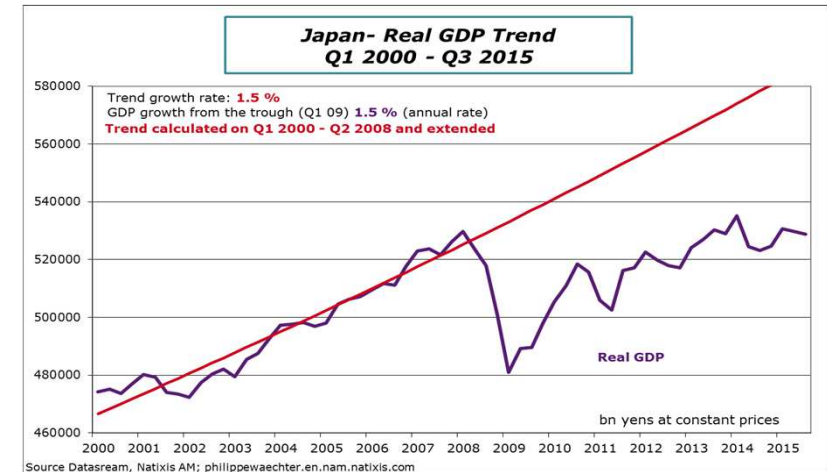
Risky transition in China

- China is in a transition period from a manufacturing led growth model to a service led model. This implies lower growth rate in the future as productivity in the service sector has a lower momentum than in industry. In a five to ten years period, we can expect a 2 to 5% GDP growth rate .
- In the short-run, the economic outlook is weak. May be the adjustment to the new profile is faster than expected.
- The main risks is related to corporate indebtedness. In recent years, the main support for growth has been a larger corporate debt. This has helped to increase capacity in many industrial sectors and to boost the real estate sector.
- Now there are overcapacities in many sectors and the real estate prices are still trending downward. Except Shenzhen and Shanghai prices are lower than at the beginning of 2014
- This means that the stock of bad loans is important leading to fragilities in the financial and banking sector.
- Supports from the government and the central bank are just necessary to avoid a break but they are not supportive for growth.



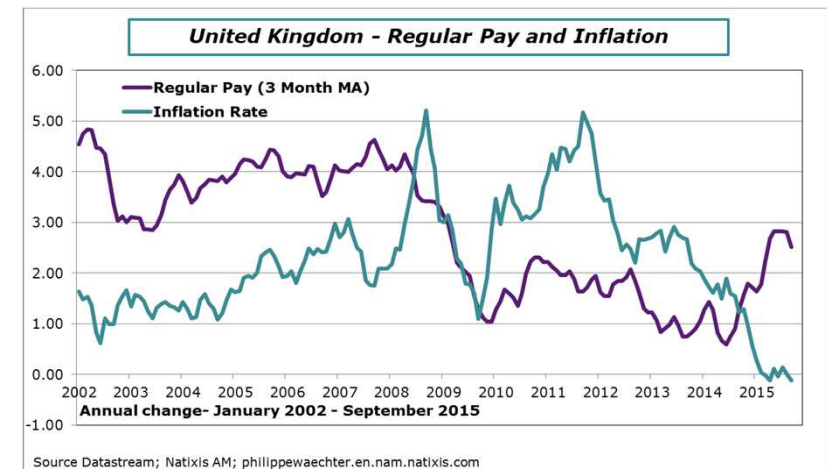
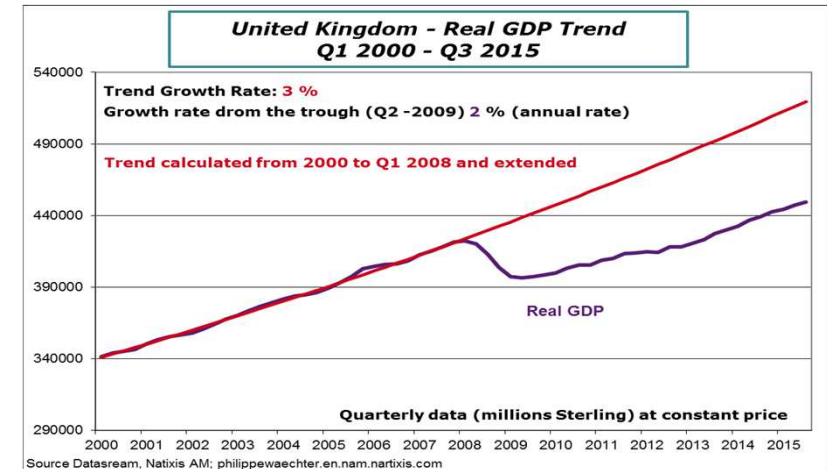
Japan: Now in recession

- The Japanese economy is in recession. The GDP was decreasing in the second and the third quarters.
- The carryover growth for 2015 is just 0.5% at the end of the third quarter.
- There are two reasons for this situation
- The persistent impact of the VAT rate hike is still seen on households' expenditure profile. The recovery has been stopped by the VAT rate hike.
- At the same time, exports momentum is low even after the yen depreciation.
- Internal demand is weak and external demand is not strong, therefore there is an downside adjustment on investment.
- Monetary policy has been accommodative for years now and there is a need for a more accommodative fiscal policy to support internal demand.
- Instead, as global growth remains on a low profile and because the Japanese population is aging rapidly there is a strong risk of a persistent low growth rate.



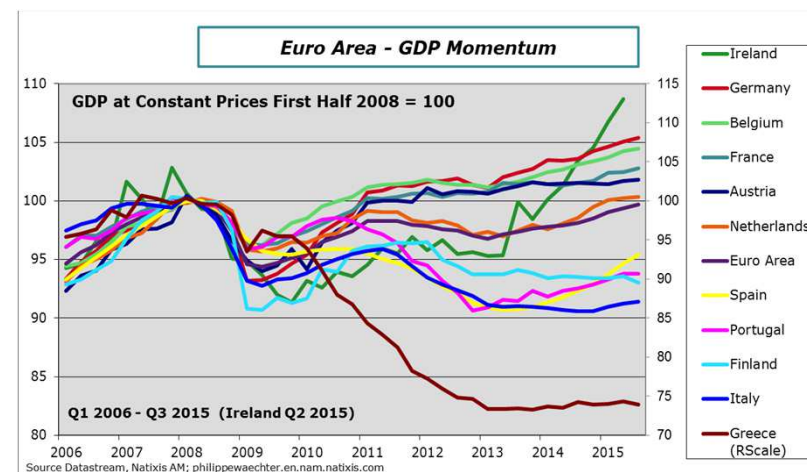
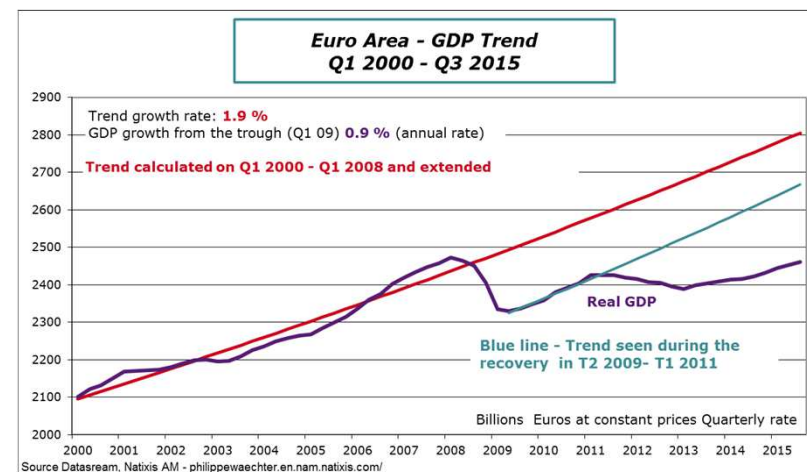
UK: Recovery

- There is smooth recovery in the United Kingdom with an acceleration since 2013.
- This reflects the fact that from this date, efforts to reduce the public deficit has been less intense.
- With a very flexible labor market and support from government expenditures, the number of new jobs has improved very rapidly. Part time jobs have increased first, now full time jobs are the bulk of new contracts.
- Progressively this dynamics led to a recovery in earnings. With an inflation rate close to 0%, households' purchasing power has increased rapidly since mid-2014. Households' expenditures are up rapidly in recent quarters with higher incomes.
- Now investment has taken the relay with a rapid improvement.
- Very accommodative monetary policy is here to stay. Mark Carney, the head of the Bank of England, has said that 2016 could be the year of a lift-off. Before that the inflation rate has to be higher.



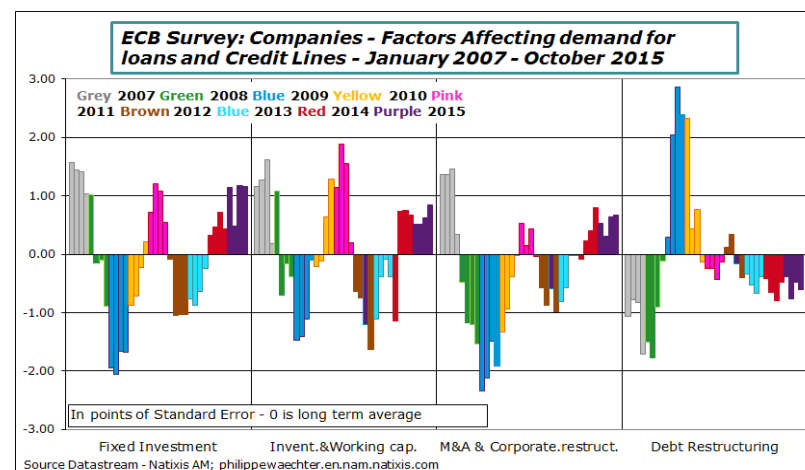
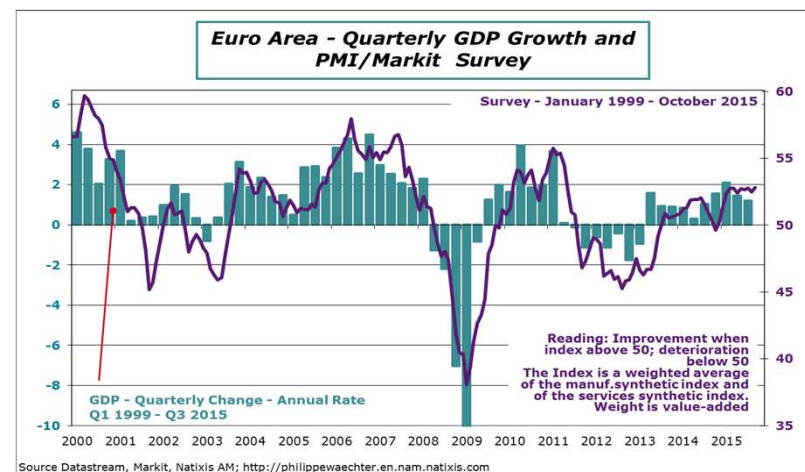
Expected recovery in the Euro Area

- Since mid-2014 there is an improvement in the Euro Area GDP profile. Growth in the third quarter is consistent with it.
- The Euro zone has had a long period of recession linked to austerity policies from fiscal and monetary side. Too rapid reduction in budget deficit and 2 hikes in interest rates from the ECB in spring 2011 were the recipe for a recession.
- This is no longer the case and one target of the ECB is to improve the consistency of the Euro Area business cycle.
- Since 2011 GDP trajectories have been divergent in the Euro Area. The ECB under Draghi wants to take advantage of an improved competitiveness and from the fact that countries trade a lot. Therefore a positive shock in one country has a spillover effect in the rest of the area.
- This will lead to a more consistent behavior between countries. This can create a wider horizon for companies as this intra-zone dynamics improves flows of orders. With stronger expectations on demand, companies will increase their investment reinforcing the robustness of the business cycle.



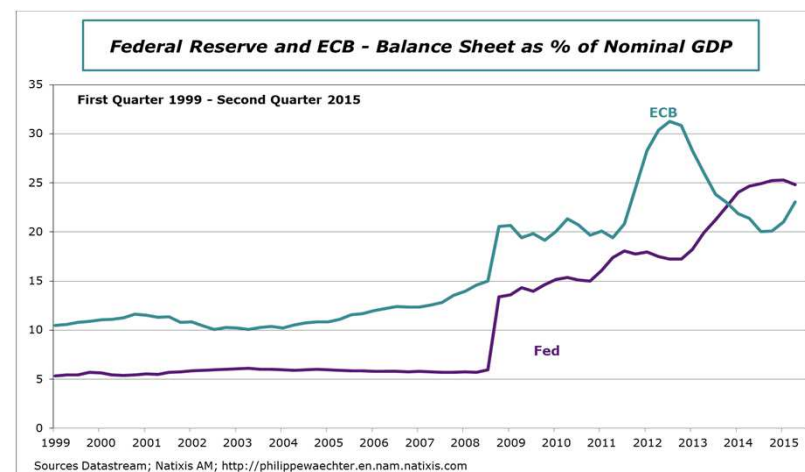
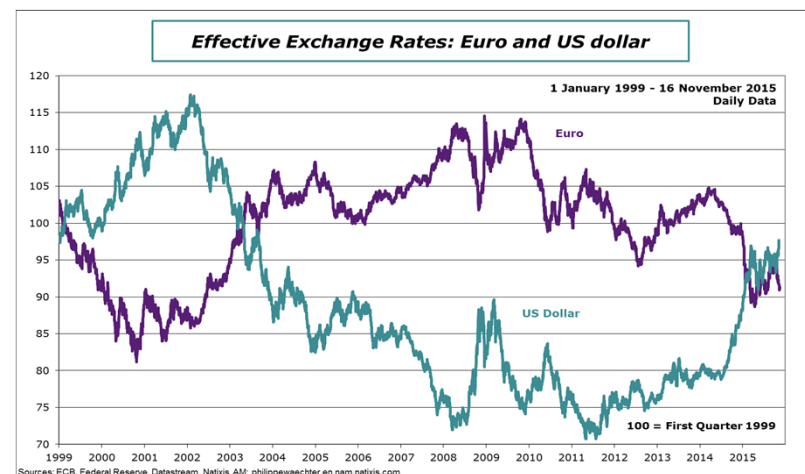
With a improvement for investment

- GDP for the third quarter was up by 0.3% (1.2% at annual rate) after 0.4% in the second.
- Carry over growth for 2015 is 1.4% at the end of the third quarter. For the whole year, 1.5% is probable.
- We see on the first chart that 1.5% is consistent with the Markit survey index level.
- The source of the recovery is the impulse coming from the ECB and a less tight fiscal policy.
- The ECB has dropped interest rates and has convinced European citizens that they will persistently remain low. This change the intertemporal arbitrage. With interest rates close to 0%, there are no incentives to transfer wealth from the present to the future.
- Associated with a low energy price, this has changed the picture within the Euro zone
- Moreover has taken advantage of the competitiveness shock specifically in Spain but also in Italy and France.
- This less constrained perception of the future increases the probability of a surge in investment. That's a signal from the ECB survey (2nd chart)



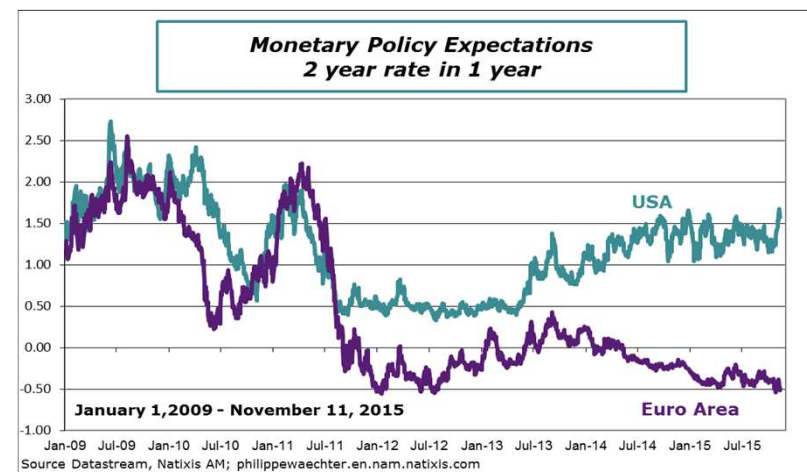
Deep changes in monetary policy stances

- On deep change in recent months has been the drop of the euro and the improvement of the US dollar.
- This can be seen on the first graph.
- This is a positive situation for the Euro Area where the strength of the currency was a real constraints to improve growth prospects. This is no longer the case but there was a transfer from the euro to the dollar since mid-2014.
- We can see the difference between the two regions in the second graph. The balance sheets' dynamics has changed.
- A higher dollar is a factor that could limit the possibility for the Fed to increase its interest rates. Currency is an indirect tool for monetary policy.
- This has deep consequences for emerging countries as a lot of them had their currency pegged on the greenback. The strong dollar is a puzzle for most emerging countries as world trade momentum is weak. They converge to accommodative monetary policies but without success yet on growth nor on inflation



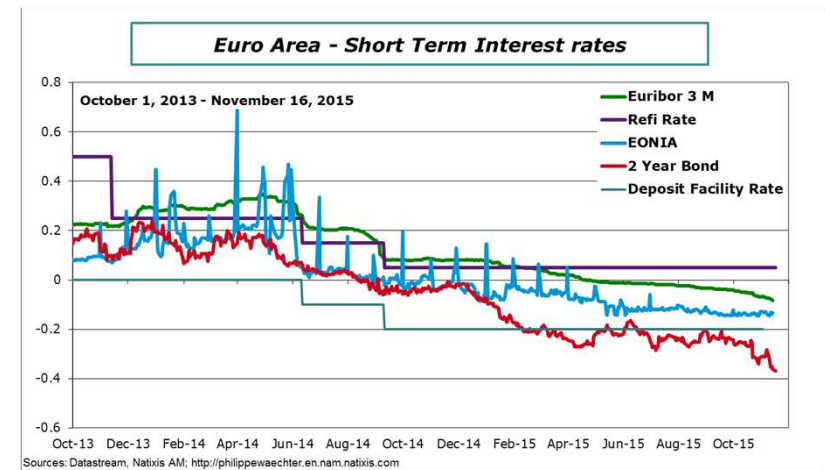
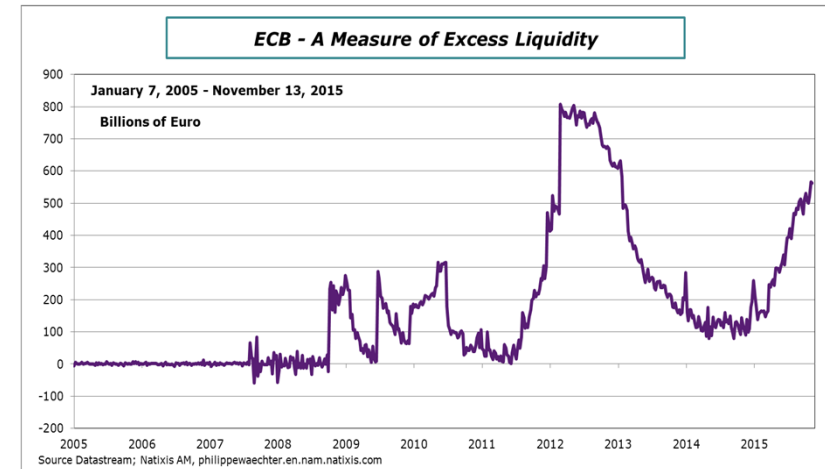
The euro/dollar is at its price

- There is a deep divergence in monetary policy expectations between the Fed and the ECB.
- This can be seen on the first graph.
- The Federal Reserve is expected to increase its rate in the coming months (may be in December 2015) while the ECB is expected to maintain its low interest rates at least until the end of 2016 but probably at least until the end of 2017.
- This divergence is a support for a weaker euro as it is shown on the second graph.
- In this environment and except if there is a strong negative shock in the USA, this balance of strength between the two countries will imply a stronger US dollar. The convergence to the parity mustn't be excluded.
- We do not expect a reversion to a stronger euro. It would be damaging for Eurozone growth and the ECB will probably not accept such a situation.



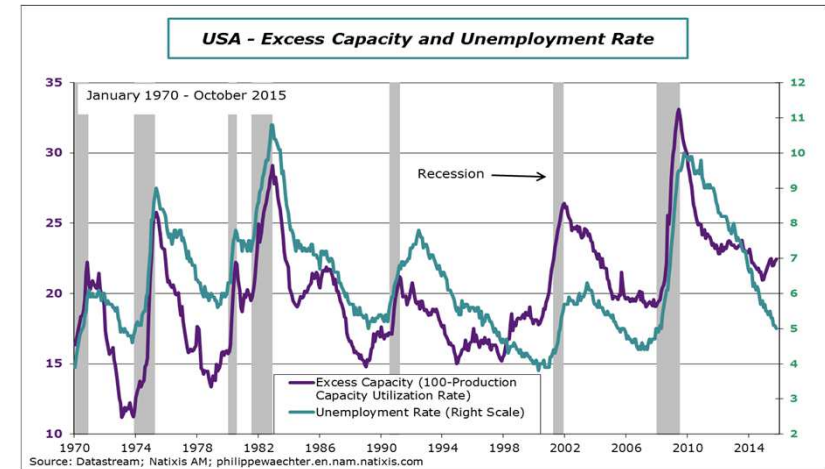
The ECB will maintain a very accommodative for an extended period

- The ECB monetary policy can be characterized by large amounts of asset purchases (EUR 60bn per month). It will go at least until September 2016 but it is expected that at the December 3 meeting Mario Draghi will announce an extension of these purchases after September 2016.
- The other instrument is low interest rates for an extended period.
- We expect that the refi rate which is currently at 0.05% will remain at this level until at least the end of 2016. It will probably be 2017 or later.
- During the ECB next meeting, December 3, Mario Draghi will probably announce a drop in deposit facility rate. It is currently at -0.2% and will fall to -0.3%.
- This will be done to reinforce monetary policy instrument, avoiding a confusion if the EONIA rate converges closely to this level.
- EONIA (blue line on the second chart) is close to -15bp. Converging to -20bp is probable with the increase of the excess liquidity associated with the asset purchases.



No tensions for the US economy: no need to change rates rapidly

- On risk is the fact that the peak of the US business cycle was touched during the first quarter of 2015.
- One of my favorite graph is the first on this page. The excess capacity (purple line) shows a reversal in January 2015. This indicator is not volatile and this type of reversal is associated with a change in the unemployment rate 12 to 18 months later.
- The second issue is that inflation expectations are still very low in the USA. This will be a signal for the Federal Reserve not to increase its rates too rapidly.
- That's why there is no hurry in the USA to adopt a tighter monetary policy.
- It's better to act a little too late than a little too early. In the first case the risk is on higher inflation, in the second case it is lower economic activity.
- As there are no tensions in the US economy the Fed mustn't be in a hurry to change its monetary policy stance even after a probable first movement in December.



Forecasts

	Average growth					Average Inflation				
	2012	2013	2014	2015	2016	2012	2013	2014	2015	2016
USA	2.3	2.2	2.4	2.4	2.4	2.1	1.5	1.6	0.2	1.5
Japan	1.7	1.6	-0.1	0.6	1.2	0.0	0.4	2.7	0.7	0.6
Euro Area	-0.7	-0.4	0.9	1.5	1.9	2.5	1.4	0.4	0.1	0.8
U.Kingdom	0.7	1.7	2.8	2.4	2.4	2.8	2.6	1.5	0.1	1.3
China	7.8	7.5	7.4	6.8	6.4	2.6	2.6	2.0	1.3	1.3
France	0.4	0.4	0.4	1.1	1.6	2.0	0.9	0.5	0.1	0.7

Year end	Monetary Policy					Long Term Interest Rates (10 year)				
	2012	2013	2014	2015	2016	2012	2013	2014	2015	2016
USA	0-0.25	0-0.25	0-0.25	0.25-0.5	0.5-1.00	1.7	3	2.2	2.2-2.5	2.3-2.7
Japan	0.1	0.1	0.1	0.1	0.1	0.8	0.7	0.3	0.2-0.5	0.3-0.6
Euro Area	0.75	0.25	0.05	0.05	0.05	1.2	1.95	0.5	0.4-0.8	0.7-1.3
U.Kingdom	0.5	0.5	0.5	0.5	0.50-0.75	1.8	3.1	1.8	1.6-2.2	1.8-2.2

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