Economic Outlook – September 2016

Philippe WAECHTER Chief economist
Twitter: @phil_waechter or http://twitter.com/phil_waechter
Blog: http://philippewaechter.nam.natixis.com

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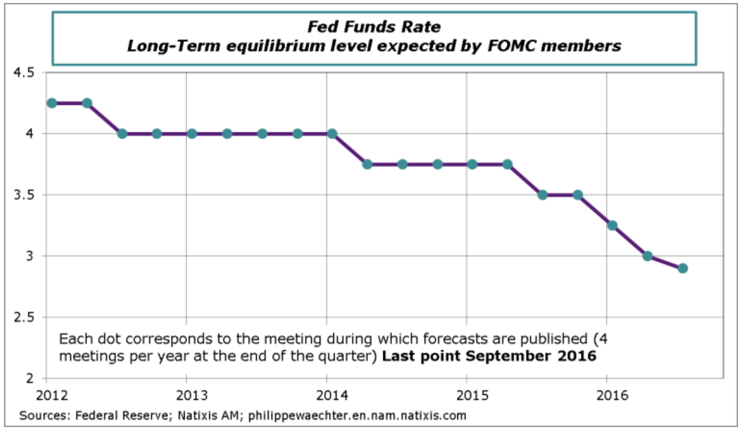
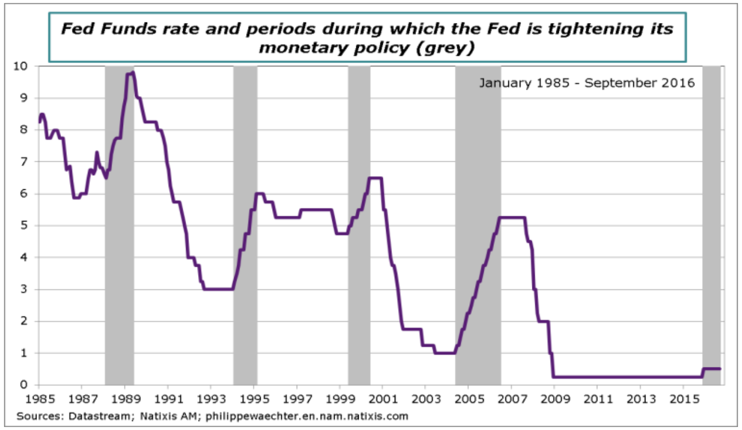
Global cycle dynamics

- Current US monetary policy reflects the overall cycle in which the global economy is situated.
- In chart 1, monetary policy committee members indicate that the cycle is not following the same parameters as preceding cycles. In 2012, the expected long-term value of the fed funds rate was 4.25%. This level was compatible with the level observed before the crisis. The Fed then believed that the economy could resume the same momentum as before the crisis.
- In June 2016, the expected long-term value of the fed funds rate was only 3%, which is far below the level observed in the past.
  The cycle is perceived as not being as wide and as fast than in the past. Growth will durably be weaker and inflation lower.
- Against this backdrop, the interest rate dynamics is conditioned by the strength of these macroeconomic indicators. As long is there is no persistent acceleration in growth and inflation, interest rates will remain desperately low across all maturities.
- Chart 2 shows a very different Fed rate hike profile. Previously rate-hike cycles occurred rapidly and almost systematically and averaged 300 bps. This is no longer the case. This factor illustrates the Fed's hesitation in today's very particular environment.





Structural dynamics

Four sources of imbalance that are changing the nature of the global macroeconomic situation

- Slower dynamics among industrialised countries – the question of secular stagnation and the incapacity of developed countries to rekindle strong durable growth. They are no longer a major driver for the global economy. Secular stagnation reflects the ageing of the population and an excess of private debt which weighs on private demand during the recovery phase. The role of monetary policy is to encourage an increase in private demand by limiting the transfer of wealth over time. As long as the private demand remains low, the central banks will not be pressed to raise their rates.

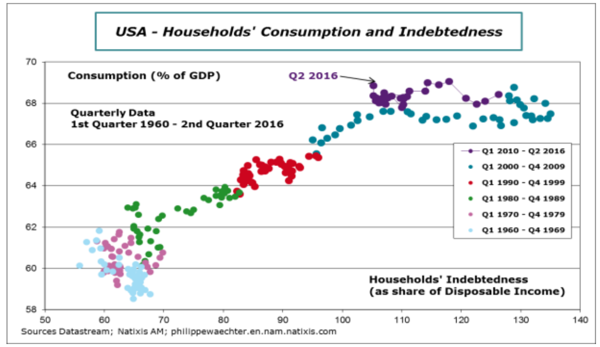
- The rebalancing of global production. Industrial production is now in Asia. Starting from a 100 basis in H1 2008, global industrial production stood at 115 in June 2016 and the US, Latin America and Africa & the Middle East and Central Europe were at around 100 at the same date, with the eurozone lower and Japan lower still. On the other hand, Asia is at 178. Why invest in low growth areas when other regions are expanding rapidly? This factor has weighed on industrialised countries.

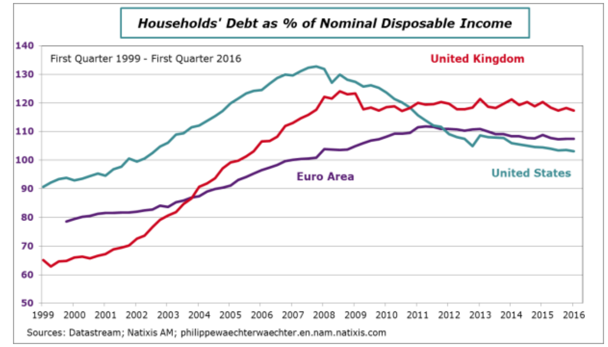
- Innovation leads to radical change but without triggering strong productivity gains. The economy is changing shape, but dynamic innovation is not yet generating strong durable macroeconomic gains, as innovation is not yet complete. Patience is required given that innovation differs from in the past. Although this does not reflect Schumpeter-type cluster dynamics, innovation is very quickly available everywhere. Unlike during the industrial revolution, productivity gains will not necessarily be generated where innovation is occurring. Productivity will ultimately increase, but we do not currently know at what point in the future (in 2 years, 5 years or 10 years?).

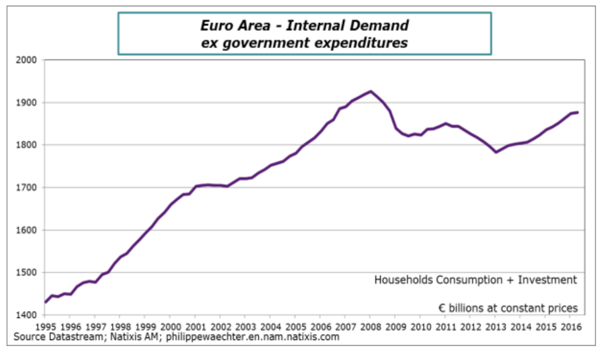
- Fresh political dynamics resulting from weak growth and demographic growth outside of the industrialised countries. A drift towards less cooperative and less coordinated behaviour can be observed at every election or vote in industrialised countries.

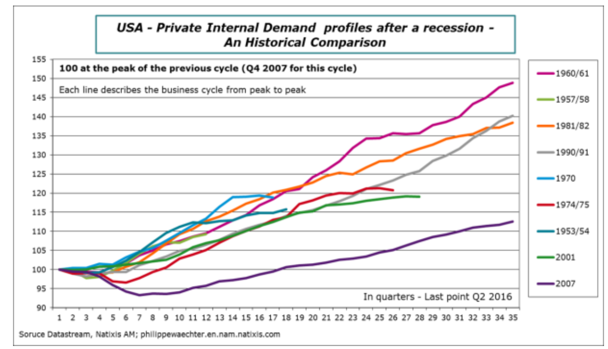
A radical change in consumer habits

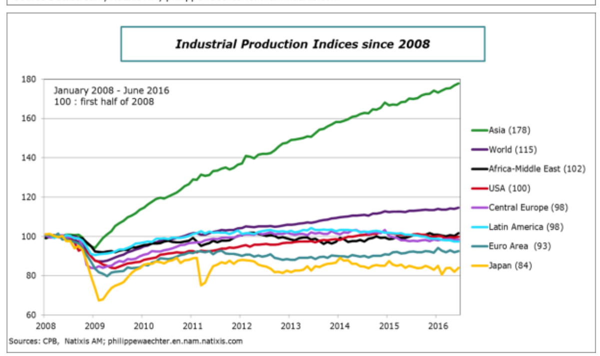
- Consumer habits have habitually depended on debt levels. This logic no longer applies however as household debt is still very high.
- This is reflected in less dynamic and weaker domestic private demand than in the past. Monetary policy is partly driven by this factor. As long as private demand, which represents 80% of GDP, is not increasing, the central banks will find it difficult to tighten their strategy.
- Asian industrial dynamics are dominating the world
- Low productivity gains in the US and in industrialised countries. Innovation does not feed through to macroeconomics.

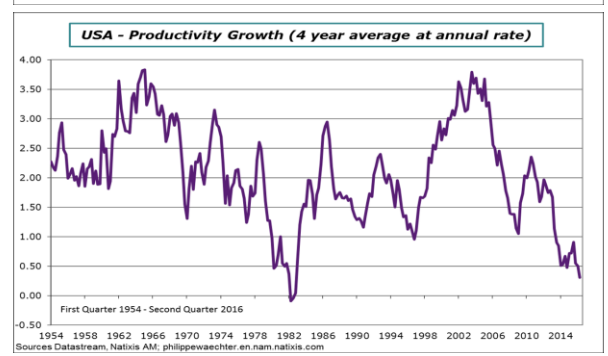












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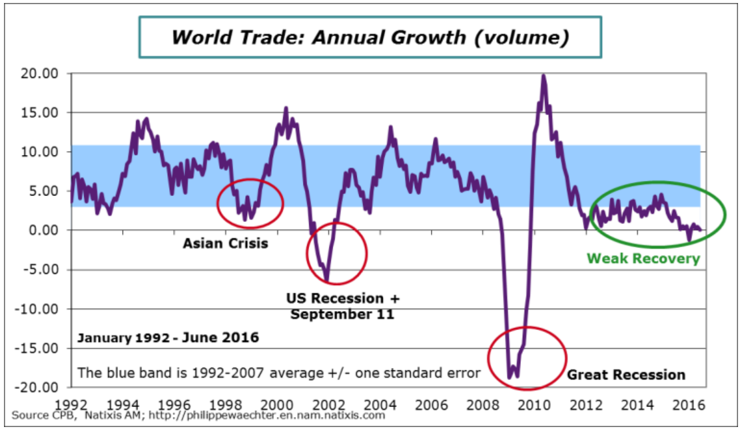
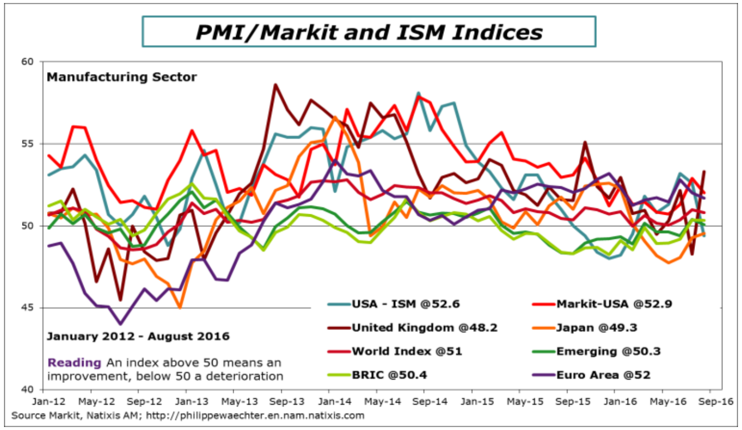
Summary

- Global growth is not taking off – global trade dynamics are waning, while surveys in the manufacturing sector are showing no signs of an imminent recovery.
- Challenging conditions in the US in 2016. The growth rate will be sharply lower than in 2014 and 2015 with no real acceleration in inflation.
- The eurozone is in a top-end of cycle phase which is limited by reduced growth potential. The high point in the cycle is possibly now behind us.
- China is no longer a source of concern in the short term despite latent threats (corporate debt).
- The French economy is struggling to find further momentum. The scope of the cycle is reduced by the growth rate of below 1.5%.
- The inflation rate will increase for technical reasons. Since mid-August, the oil price has been comparable with the same period during 2015. The energy contribution to the rate of inflation is trending towards zero and inflation is converging towards the underlying inflation rate.
- Monetary policies remain unchanged, with the Fed ultimately relatively pessimistic, although I believe that it will hike rates in December as it did in 2015, but without triggering a hawkish trend for 2017 (unlike in December 2015 for 2016).
- Brexit? What is happening? A mini-boom because the Brexit has not been set in motion.

Limited business activity dynamics

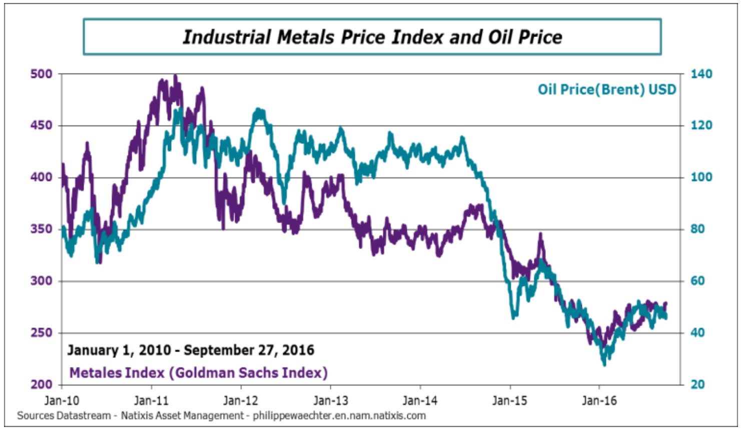
- Momentum in global business activity remains very muted as reflected in the absence of growth in global trade.
  There are no strong dynamic trends to cause a shift in trade profile. This is a problem, as gains from global trade are falling short of expectations, countries may wish to refocus their business activity within their own borders.
- Global trade, historically considered to be the key factor in a context where all parties are winners, tends now to be perceived as zero-sum game. This is not good news in a global economy in which the production of manufactured goods is internationalised.
- Recent discussions to renegotiate trade relations between the US and European Union, beyond some specific points, are based on this approach.
  The global economy is trying to fragment, but the transition towards this new geography will produce a negative shock on business activity.
- Business leaders' surveys are downbeat and did not reflect any fresh momentum over the summer which could imply faster growth in the short term. The US ISM index dipped below the 50 threshold in August.
  The recovery staged by the UK, despite strong fears of a negative impact in July after the referendum, simply reflects the fact that the Brexit has not been implemented.

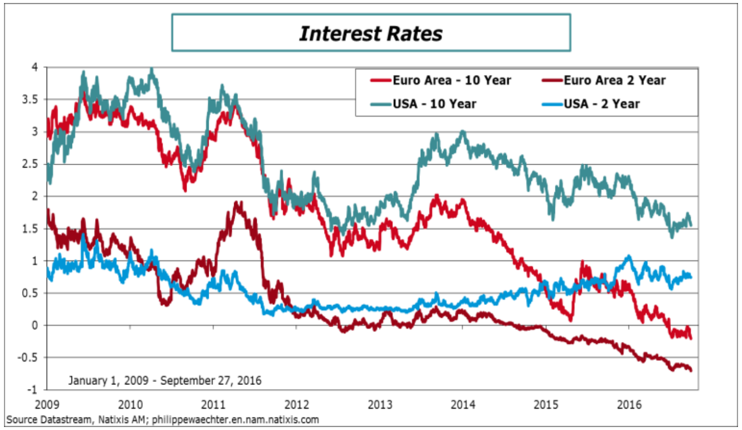




Marginal nominal pressure

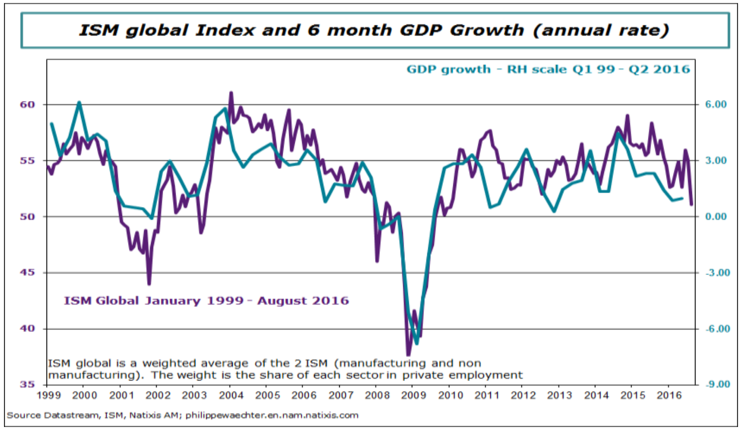
- Price trends among commodities reflect sluggish global growth.
- Since their lows at the beginning of 2016, which reflected fears of a disaster scenario, prices have stabilised. In the case of oil, this is reflected in the price of crude fluctuating between 40 and 50 dollars per barrel.
- The key point is that this price is comparable with 2015 at the same period. This will lead to a sharp reduction of the negative contribution from energy to the inflation rate over the next few months. Having been negative since mid-2014 it will trend progressively towards zero and may even turn positive during the final months of the year.
  The inflation rate will therefore firstly converge towards the underlying inflation rate and perhaps even further.
- Interest rates globally remain very low. This reflects limited growth forecasts and inflation outlook, as well as the accommodating monetary policy implemented by all of the central banks.
- In the chart, 10-year US yields are marginally above 1.5% and the German 10-year Bund is close to 0%.
- 2-year rates reflect anticipated shifts in monetary policies.

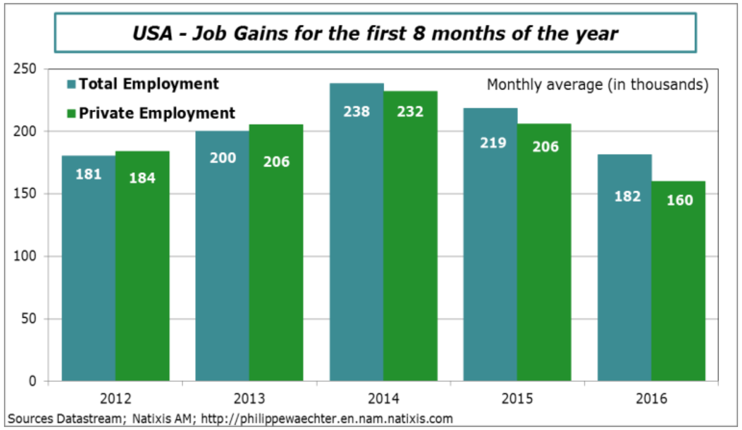




Sluggish US growth

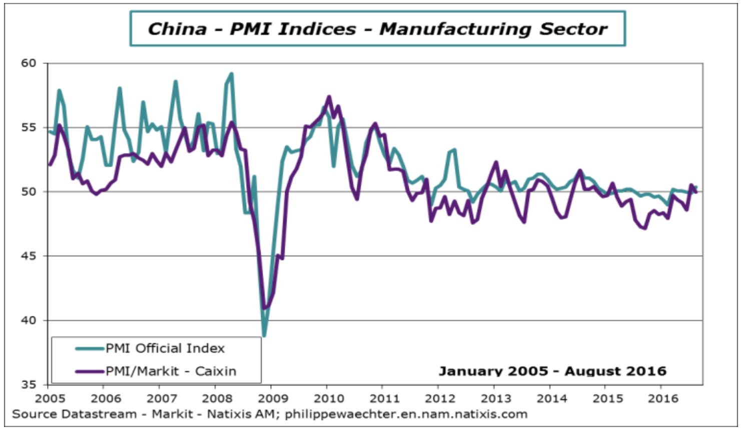
- US economic data is ambivalent. Growth indicators were weak for the first two quarters of the year (0.8% in Q1 and 1.1% in Q2 annualised). However consumer spending appears less dynamic over the summer, whereas this factor had provided strong support since the beginning of the year. Employment continues to increase. Job creations nonetheless remain less dynamic than in 2015.
- The US economy, in this long cycle which began in Q2 2009, remains insufficiently dynamic to trigger tensions in the means of production, in the jobs market or in terms of prices and wages.
- In the short term, surveys are implying a possible downturn in business activity. The ISM indicators in August reflected a sharp fall, amid less dynamic domestic demand. US growth is unlikely to exceed 1.5% this year.
- Employment, in August, also slowed compared to the bullish figures in June and July (151,000 jobs in August). Wages are rising only moderately, at an annualised rate of 2.4%.
- This absence of pressure is discouraging the Fed from intervening.





Lower risk of a downturn in business activity in China

- The Chinese economy is stabilising. Although it has not staged a rally, the persistent risks of a sharp downturn since summer 2015 now appears to have abated.
- Economic policy has become more accommodating, through a less rigid approach to excessive corporate debt.
- This nonetheless remains a transitory situation, as the Chinese economy remains on a slower growth trend.
- There is still a long way to go in the transition towards a service-driven economy, which will lead to a slower growth rate. This reflects lower productivity among services compared to industry, which has so far been the major source of Chinese growth.
- This transition is creating a risk of increased corporate debt as certain sectors and major companies will disappear. Debt levels in these sectors or companies may be heavy, which would incur major financial risks.
- In order to limit the impact of this risk, many companies and banks are seeking to diversify their risk by expanding abroad, which is causing heavy capital outflow.



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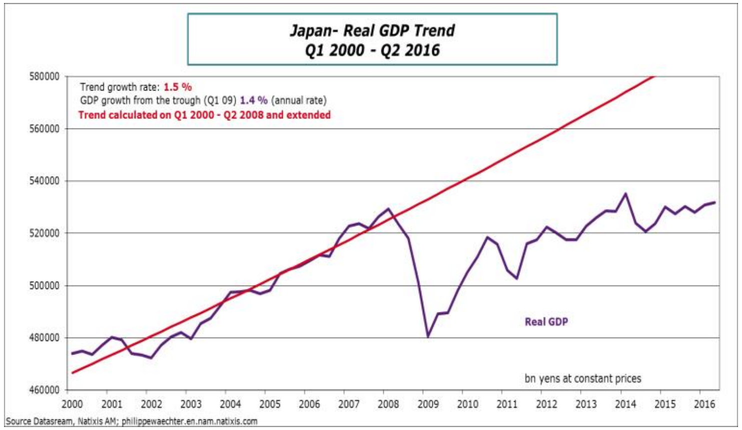
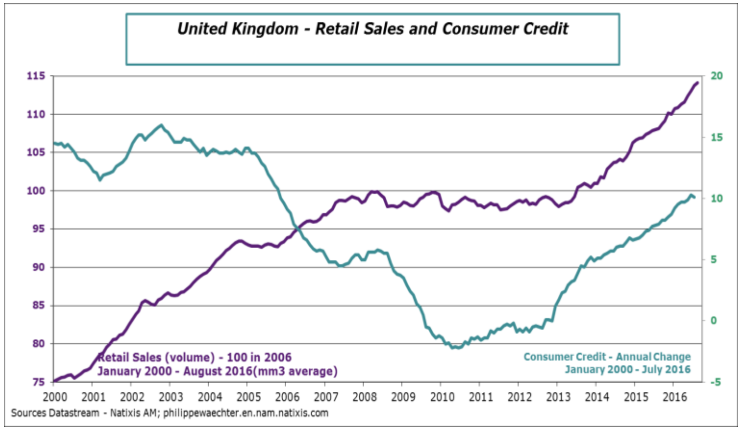
No take-off in growth in Japan

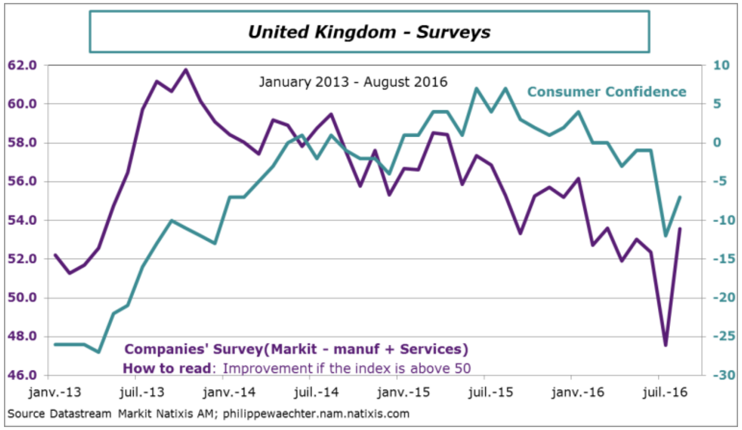
- The Japanese economy is in an unprosperous phase. Since the first quarter of 2015, GDP has remained in a very tight horizontal corridor. Growth has been very weak during this period (0.1% annualised).
  Domestic demand is lacklustre in Japan and exports are not increasing.
- Within domestic business activity, household spending (retail sales) is stabilising at a low level, below the levels seen before the VAT hike on 1 April 2014. Investments have not acted as a growth relay.
- In its relations with the rest of the world, the fall in the yen has not had a strong impact on exports. Chart 2 shows that the depreciation of the yen will have only had a temporary minor impact on exports.
- Japan is faced with the challenge of generating stronger growth in domestic demand. The bank of Japan, which is already implementing highly accommodating policies, intends to introduce further measures, according to its governor Haruhiko Kuroda at the beginning of September. Likewise, the Prime Minister Shinzo Abe is also putting in place stimulus package focusing on the domestic market. Although greater details of the proposed plan are required before its likely effects can be assessed, this type of budgetary policy is needed to rekindle more sustained growth.



UK - pending Brexit implementation

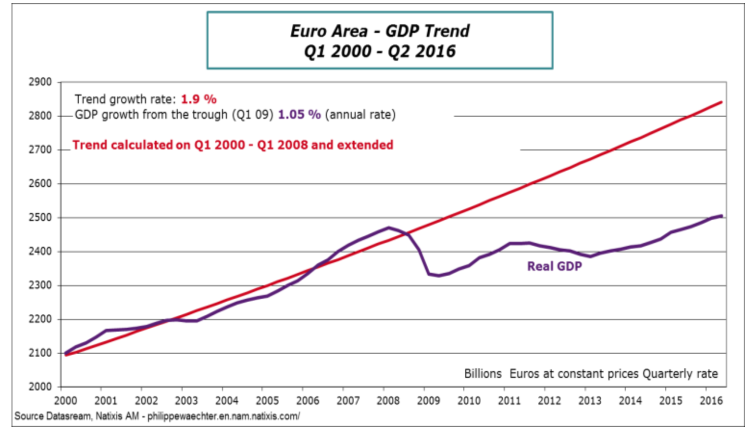
- The UK economy is in a unique situation.
- The domestic economy was faring well when the country's electors voted for the government to trigger the procedure to exit the European Union. This was the question posed by referendum on 23 June.
- Although economists had warned of high risks to the UK economy, including a possible recession, this has not been the case. On the contrary, consumer spending remained on a strong trend during July and August, with industrial production gaining 0.1% in July. Furthermore, households and companies, which were deeply concerned in July over the impact of the Brexit, are now more optimistic. Chart 2 demonstrates how the indices nosedived in July and then recovered in August.
- The main reason for this favourable economic situation is the fact that the Brexit has not yet been implemented, whereas the tourist industry was boosted by the fall in the currency, which drew new visitors to the UK, while the Bank of England adopted a more accommodating policy at the beginning of August. These factors have generated a mini-boom. However, once article 50 (EU exit) has been triggered, the accompanying change in the rules following negotiations, regarding access to the single market and the European passport, will rapidly represent the shock which was expected after the referendum, and which led to such pessimism. Although Theresa May does not seem to be in a hurry to implement the Brexit for the time being, the shock will inevitably occur.

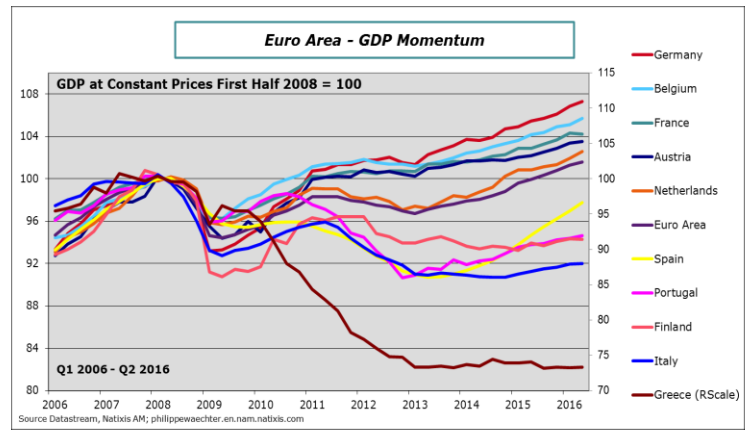




More robust growth in the eurozone…

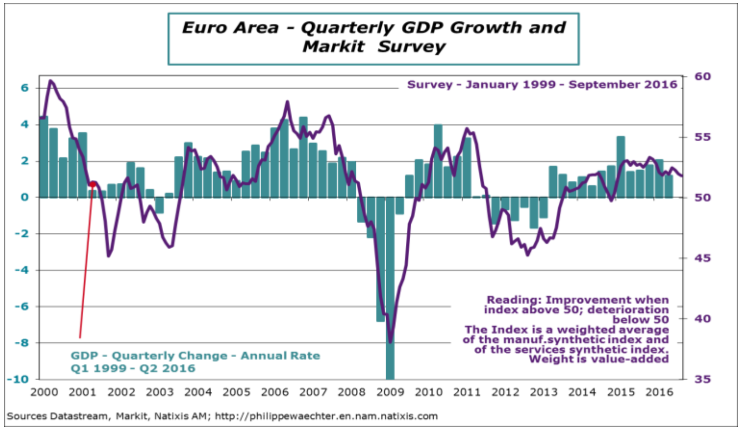
- Although the eurozone economy is growing more steadily, its member countries are expanding at divergent rates.
- Average growth in the eurozone since the beginning of 2015 stands at 1.3%. At the end of Q2 2016 the annual rate was 1.6%. This chiefly reflects a recovery in household consumption driven by very low interest rates, which encourage immediate spending, combined with an improvement in the jobs market, which has led to a decline in the unemployment rate (10.1% in July).
- Investment is more volatile and is not contributing as steadily as domestic demand. This factor has been a source of volatility within recent growth statistics.
- Chart 2 shows that not all countries have benefitted from the same conditions. Countries in the north are following relatively similar trends, whereas Spain can be seen to be catching up rapidly, while Finland is stagnating, like Portugal, following a recovery period, and particularly Italy. Greek GDP has flatlined since 2013 at a very low level (but 27% below its level in H1 2008).
- In the short term, the sharp rally in GDP observed across the board during Q1 subsequently slowed down in the spring. Consumer spending declined and corporate investment fell back. 2016 growth stood at 1.3% at the end of H1.

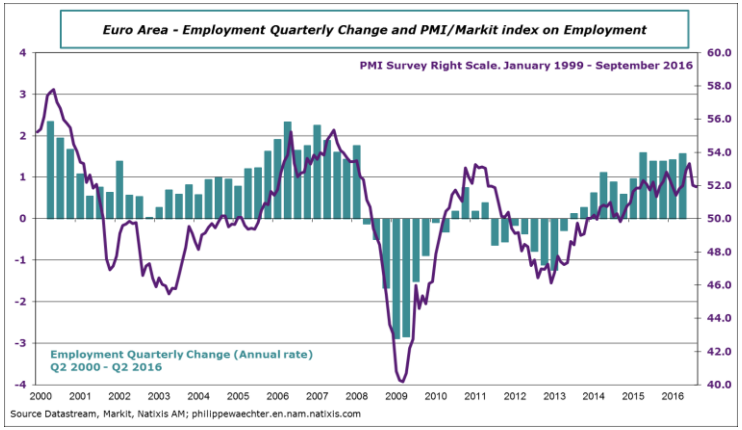




…but no further take-off

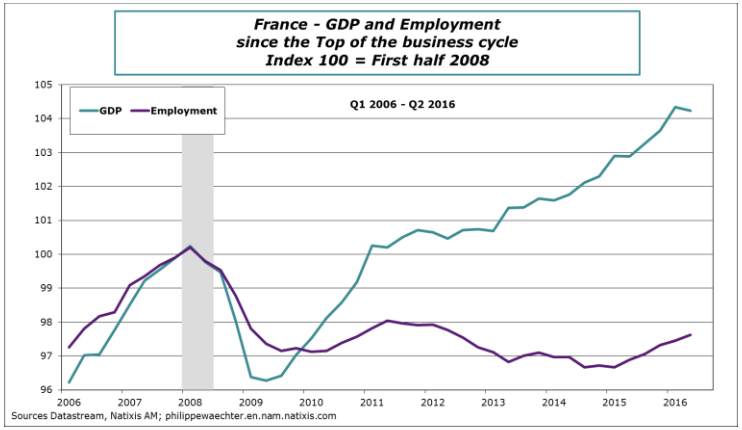
- Since the beginning of 2015, the Markit index for the broader eurozone economy has been stable, reflecting an increase in business activity, but without showing any signs of breakout on the upside.
- This implies that the eurozone economy is incapable of moving beyond the current growth rate. It appears unlikely to durably exceed the 1.5/1.6% threshold. The most likely scenario is a slowdown in business activity, converging towards its long term trend, which is closer to 1%.
- The global situation reflects the trend also observable in France and Germany and also more markedly in Italy. Growth is not being driven by external factors, as global trade is not increasing, so it is therefore more dependent on the domestic market. As such, the expected surge in trade, following the introduction of highly accommodating monetary policies, did not materialise.
- Further measures are therefore needed (budgetary policy) in order to set the economy on an upward trend.

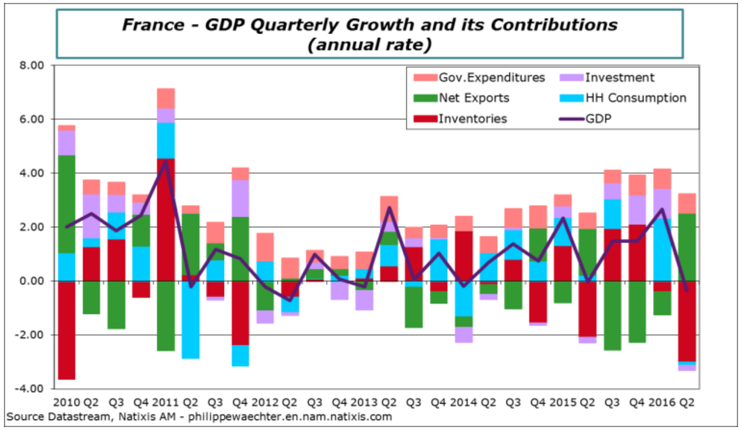




France - growth will not reach 1.5%

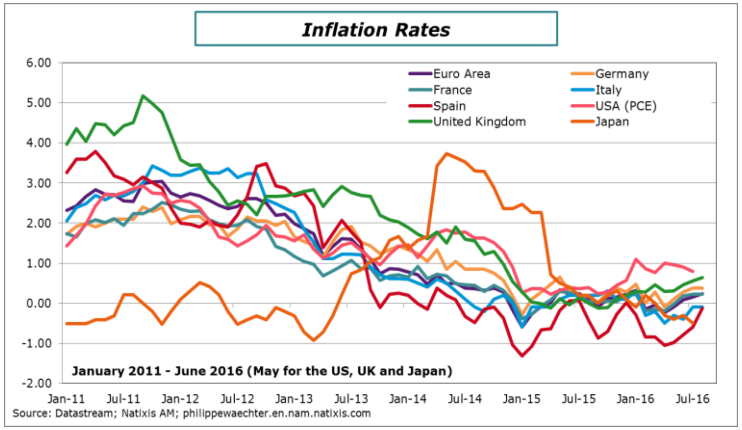
- After two years of near-stagnation, French growth has been picking up since the beginning of 2013, as clearly shown in chart 1.
  Its pace is nonetheless still limited, with annual average growth of only 0.9% since the beginning of 2015, but 1.4% year-on-year at the end of Q2 2016. The French economy is probably not very fear from its cyclical peak. Growth of 1.5% is unlikely for 2016 (1.1% in 2016 at the end of Q2)
- This increase in business activity has led to a recovery in the jobs market. Merchant sector employment has now increased over the past 5 quarters (+156,500 since Q1 2015). Although this increase is insufficient, it nonetheless represents a first step.
- In the short term, business surveys reflect the difficulty in perceiving an acceleration in business activity beyond a growth rate of 1 - 1.5%. For this reason budgetary policy should boost public investment, in order to encourage private investment, which could then potentially accelerate the growth rate.
- Household consumption is another cause for concern. Its contribution to GDP growth was zero in Q2. This reflects a decline in household equipment purchases after the boom in Q1. Household spending should resume however, in the wake of the strong rise in new home sales during Q2. The new houses will have to be equipped over the next few months.

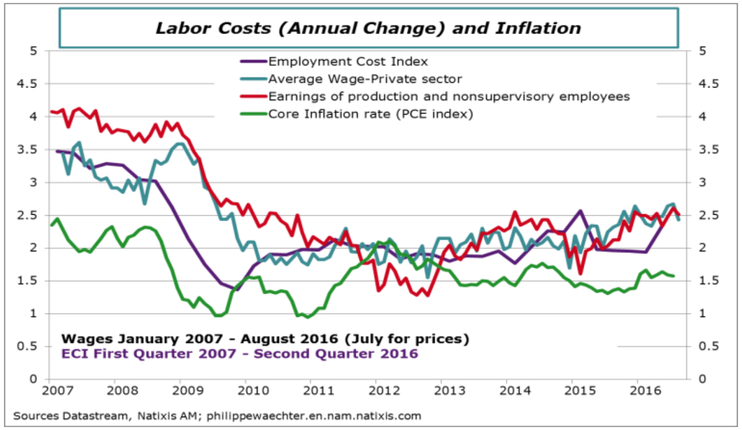




Although inflation risk remains low…

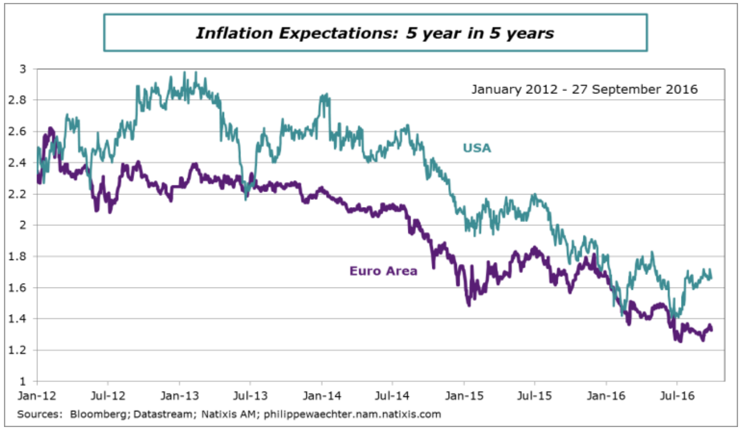
- Inflation still lacks momentum, at below 1% within industrialised countries and close to 0% in the eurozone.
- The underlying inflation rate also remains below the 2% target defined by the central banks
- Although US inflation is generally higher than in Europe and Japan, it remains below the 2% target. This situation reflects the difficulties encountered by the US economy, which has not managed to generate nominal tensions, even after a growth cycle lasting 8 years. Pressure from the jobs market is limited, as wages rose only 2.4% in August. There are two gauges of inflation in the US, one based on personal consumption expenditure (PCE) and the other associated with the consumer price index (CPI). The two indicators are weighted differently and underlying inflation associated with the CPI is over 2% (2.2% in July). This reflects the strong impact of rental charges in the index calculation, illustrating that underlying inflation accounts for two-thirds of the inflation rate. There are therefore no overall price rises.
- In the US, nominal pressures remain muted, although a slight acceleration in wage costs has been observed since the spring. This factor is not yet strong enough to generate inflationary momentum which the Fed would immediately need to control.

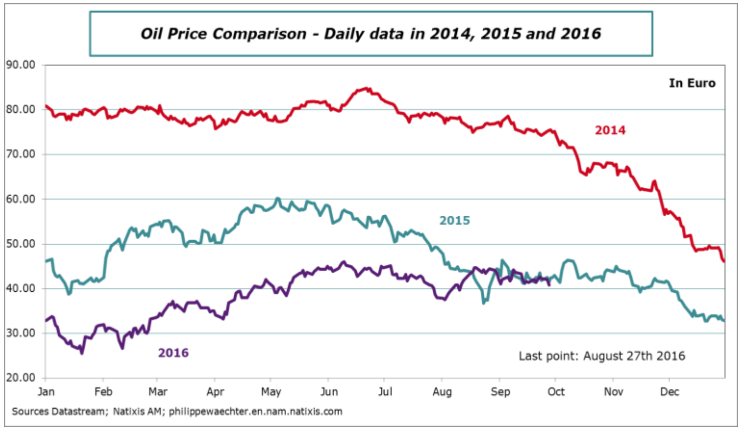




…inflation will accelerate

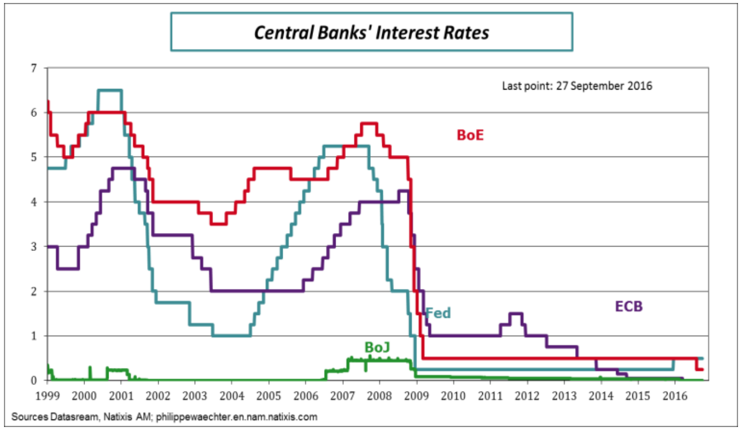
- Inflation outlook, implied by the markets, remains muted in the US and in the eurozone, which will not encourage any spontaneous shift in monetary policy.
- The eurozone is trending away from the ECB target of 2%. The ECB has undertaken to cease its asset purchase programme once this long term indicator has converged towards the target. As this is not the case, the programme is widely expected to be extended beyond its scheduled close in March 2017.
  The situation is complicated however, as the ECB is faced with a lack of liquidity in the German markets, where most of the yield curve is below the deposit facility rate (-0.40%) and also in Portugal and Ireland, where there are insufficient bonds circulating in the market. The ECB is expected to introduce new rules to break the deadlock. The extension of the programme beyond March 2017 would further complicate the situation however.
- Chart 2 plots the relative oil price during 2014, 2015 and 2016. 2016 is now comparable to 2015. This will mean an increasingly less negative contribution from energy prices to the inflation rate, which could trend towards 0%, triggering the convergence of inflation towards the underlying inflation rate.

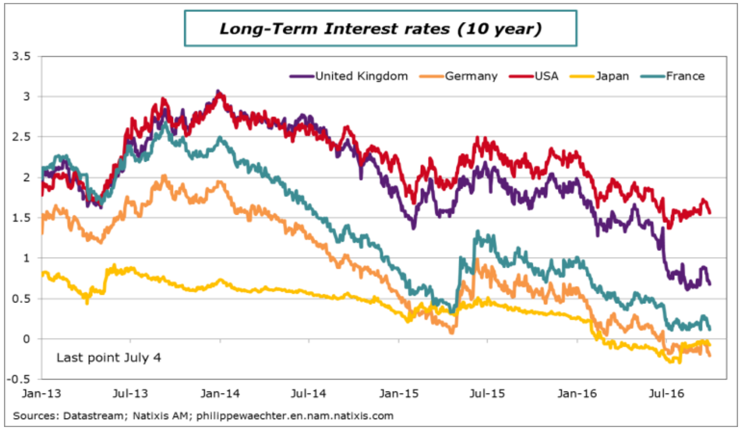




Monetary policies remain accommodating

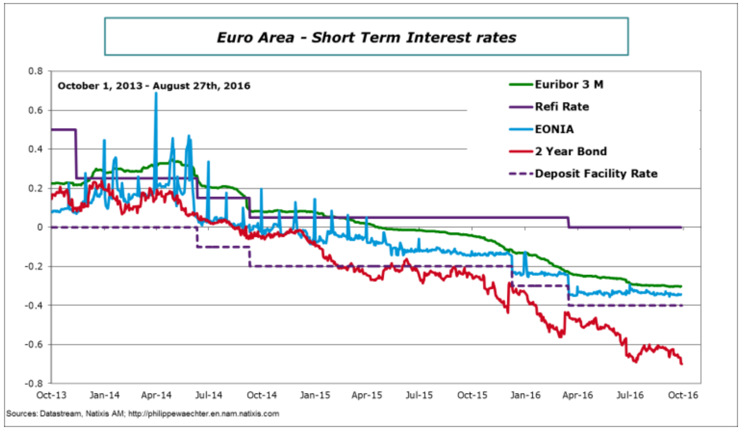
- Central banks are unlikely to tighten monetary policy given the absence of any inflationary pressure and the slower momentum in business activity.
- In the US, the conditions are not in place for a rapid shift in interest rates. Full employment has not been achieved, despite the low unemployment rate of 4.9%. A significantly higher proportion of part-time workers wish to work longer hours than during the preceding cycles. The 0.8% inflation rate in July (underlying rate at 1.6%) is not inciting the monetary authorities to act quickly. Furthermore, the impact of a rate hike is asymmetrical. The immediate cost of higher interest rates on business activity outweighs the cost of higher inflation later on. As the US economy has not succeeded in creating tensions despite an 8-year upward economic cycle, there is clearly no need to hurry.
- Long term rates nose-dived across the board as accommodating monetary policies were maintained following the Brexit referendum and as the UK also adopted a more accommodating policy.
  Rates remain on a downward trend amid anticipation of accommodating strategies being maintained or even stepped up if necessary. Difficulties could arise when the central banks indicate that they will go no further. This factor would spontaneously disrupt investor outlook for the future, which would clearly drive interest rates higher.

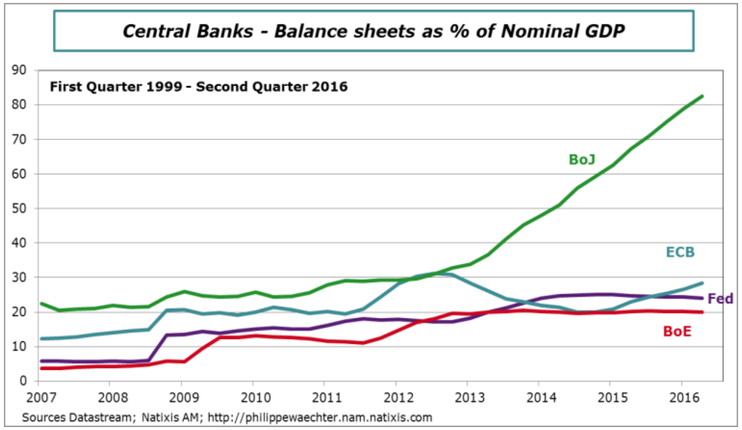




No tightening in the foreseeable future

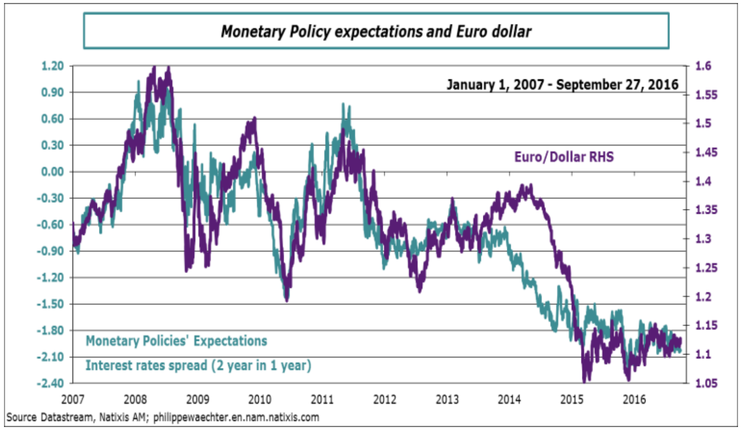
- Central bank interest rates will remain low for the foreseeable future.
- The objective of the central banks is to boost domestic demand and create the conditions for the inflation rate to rise.
  Regarding the first point, in Q2 2016, domestic private demand in the eurozone has not returned to its pre-crisis high point (Q1 2008). In Japan inflation is only 1% higher than its pre-crisis level, while in the US, it is at its lowest level since WW2.
- As long as domestic private demand stays sluggish, monetary policies will remain accommodating, unless more resolute budgetary policies are implemented. Although the budgetary policy theme via public investment is frequently evoked, it is rarely implemented. As such, policy will remain the key factor in macroeconomic regulation and will therefore remain durably accommodating.
- Central bank balance sheets will continue to expand, particularly in the UK, where a supplementary asset purchase programme was put in place after the Brexit referendum, targeting 60bn of government securities and 10bn of corporate bonds.

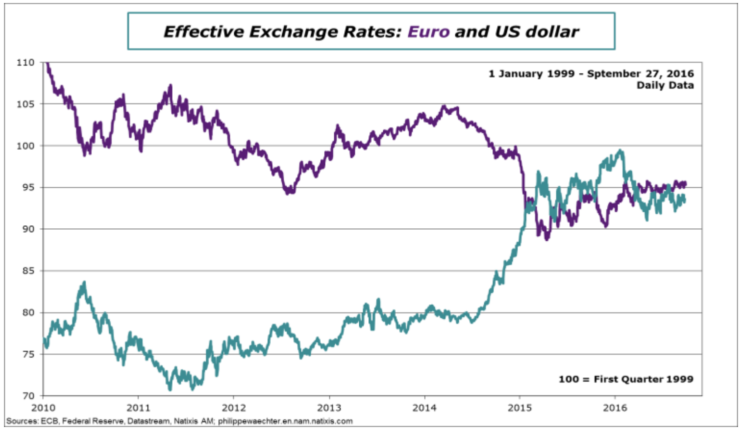




Stability in the euro vs dollar exchange rate

- Anticipated monetary policies, as gauged by expected 2-year interest rates in 1 year's time, have remained stable since the beginning of the summer in the US and in the eurozone.
- The monetary policy outlook spread (blue line in chart 1) has been stable since the beginning of 2015 and has trended in-line with a euro vs dollar exchange rate of between 1.1 and 1.15.
- Chart 2 shows that the sharp adjustment observed since mid-2014 is over. The euro is at an effective exchange rate which is comparable to the rate at the time of its introduction. Meanwhile, the stabilisation of the effective dollar exchange rate reduces its impact on the economy. The transition towards a stronger currency can weigh on growth. This is less the case when it remains stable. This is no longer a valid argument for limiting adjustments to monetary policy.
- The stabilisation of the yen at just above 100 against the dollar reflects the perception of the bank of Japan's deadlock situation. It cannot adopt a much more accommodating strategy. The BoJ policy has been caught in stalemate since 2013. As such, the yen has appreciated and subsequently stabilised since the end of winter.





Forecasts

	Average growth						Average Inflation					
	2012	2013	2014	2015	2016	2017	2012	2013	2014	2015	2016	2017
USA	2.2	1.7	2.4	2.6	1.4	1.8	1.9	1.3	1.5	0.3	0.8	1.5
Japan	1.7	1.4	-0.1	0.6	0.6	0.8	-0.1	0.3	2.8	0.8	-0.2	-0.3
Euro Area	-0.8	-0.2	1.1	1.9	1.5	1.4	2.5	1.4	0.4	0.0	0.2	1.0
U.Kingdom	1.3	1.9	3.1	2.2	2.1	0.8	2.8	2.6	1.5	0.0	0.5	2.5
China	7.8	7.5	7.4	6.8	6.6	6.2	2.6	2.6	2.0	1.4	2.2	1.8
France	0.2	0.6	0.7	1.2	1.3	1.1	2.0	0.9	0.5	0.0	0.2	0.9

Year end	Monetary Policy						Long Term Interest Rates (10 year)					
	2012	2013	2014	2015	2016	2017	2012	2013	2014	2015	2016	2017
USA	0-0.25	0-0.25	0-0.25	0.25-0.5	0.50-0.75	0.75-1.00	1.7	3	2.2	2.27	1.3 -1.7	1.3-1.7
Japan	0.1	0.1	0.1	0.1	-0.1	-0.1	0.8	0.7	0.3	0.25	-0.3;0	-0.3;0
Euro Area	0.75	0.25	0.05	0.05	0	0	1.2	1.95	0.5	0.63	-0.2; 0.2	-0.2; 0.2
U.Kingdom	0.5	0.5	0.5	0.5	0.25	0	1.8	3.1	1.8	1.96	0.4-0.8	0.5-0.9

Source Economic Research
Natixis Asset Management

Based on the premise that the Fed will raise its rates in December 2016, as it did in December 2015
Also based on the hypothesis that the UK will trigger article 50 during the first part of 2017.

Mentions légales

Natixis Asset Management
21, quai d'Austerlitz - 75634 Paris cedex 13 - Tél. +33 1 78 40 80 00
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