Economic Outlook – March 2017

The original document in French was posted on March the 6th. The text is the translation but graphs have been updated

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GROUPE BPCE

Summary

- Global growth is gathering pace more evenly across the industrialised countries, although trends have nonetheless remained highly divergent since the crisis
- The growth rate in the eurozone is gathering pace and increasing in strength
- This reflects a more stable environment in terms of economic policies and a more incentivising financial context with the oil price remaining stable at a low level
- Budgetary policy is neutral and monetary policy has remained accommodating for some time now and is set to remain so particularly in the eurozone
- Companies and households can adjust to their internal constraints without having to react to the whims of unanticipated budgetary policies
- A temporary increase in the inflation rate due to the stabilisation of the oil price. Convergence towards core inflation during the second half of the year
- Stability in terms of monetary policies which will not react to this temporary uptick in inflation - The ECB will maintain its current strategy
- The Fed will increase its base rate 3 times in 2017. Its resolution to find some leeway and a more proactive budgetary directed by the Whitehouse (tax cuts) accounts for this choice
- High political risks
    - the implementation of the Brexit will weigh on the UK economy
    - risk of international tension in reaction to US strategy
    - risks in France from the presidential election

What are the issues? (1/5)

- **What are the signs of growth in early 2017?**

  Business leaders have been more optimistic since the fourth quarter of 2016. The Markit survey synthetic eurozone index is at its highest level since spring 2011. This is also the case for France. In the US also the ISM global index is strong. It is generally believed that there is now less downside risks in economic activity.

  The significant factor is that an improvement in the manufacturing sector is clearly discernible. This element leads to a probable improvement in global trade dynamics as manufacturing goods represent the majority of traded products. This implies the existence of strong global dynamics, which is a positive point for the global economic climate. The other key point is that all eurozone countries have seen an increase in business surveys. This should lead to an increase in economic activity and higher trade within the Euro Area. As countries in the zone trade a lot one with each other this will create an positive and persistent impulse on activity. The increase in manufacturing activity will add weight to this trend and stimulate growth.

- **What are the main causes of this improvement?**

  Since 2014/2015, economic policies have remained relatively stable and legible. Budgetary policies are close to neutral and some are even pro-cyclical. This is particularly the case in Germany where the contribution of public spending to GDP growth has been 0.7% on average since early 2015, whereas average GDP growth has been 1.5%. Public spending accounts for almost half of growth, which is a direct consequence of refugee inflows.

  The recent period contrasts with 2011/2013 when budgetary adjustments were brutal. This factor profoundly changed the behaviour among protagonists in the broader economy who were obliged to take the whims of budgetary policy into account as well as their own internal constraints. This also led to incertitude which spawned a wait-and-see attitude.

  Current monetary policy is incontestably accommodating and will remain so for the foreseeable future. Even in the US where the monetary strategy is no longer over-accommodating since the rate increases in December 2015 and December 2016.

  This situation enables the broader economy to behave according to its own constraints rather than react to the whims of economic policy. This reduces uncertainty. Therefore companies and households are more likely to be willing to take risks. Economic horizons are extended. Consequently, outlook is more visible and easier to predict.

  Furthermore, global conditions are also favourable: interest rates are low which provides opportunities. The oil price has stabilised at a reasonable level.

What are the issues? (2/5)

- **How is the eurozone economy faring?**

  It is becoming more autonomous. Stable economic policy has enabled growth to establish a trend of 1.6% since the beginning of 2013. Each country is improving except Greece which is still in major difficulty. This improvement can be observed particularly in business leaders' surveys and also in the pace of growth in economic activity.

  Stronger dynamics in the manufacturing sector can be observed in particular. This factor encourages trade within the eurozone. Economic activity will accelerate, boosting employment and mitigating the constraints weighing on the zone. The growth rate is becoming more autonomous and the risk of a downturn in economic activity is diminishing. The economic cycle has become more virtuous and it is this factor which is causing us to upgrade our growth outlook.

- **How is the French economy faring?**

  It is on a similar trend to the eurozone although the growth rate is slightly lower. Since the start of the recovery in the first quarter of 2013, the growth trend has been 1.6% in the eurozone and only 1% in France. The employment market is coherent with the sluggish rate of growth. However, the market is clearly sufficiently reactive to create 191,000 new jobs in 2016.

  Some leeway is progressively being restored in the French economy, as discernible in the dynamic level of capital goods orders. The economic profile implies an uptick in capex over the next few months. This factor alone is nonetheless not yet satisfactory.

- **How is the US economy?**

  There are two distinct views: households and business surveys are highly positive, suggesting a high level of optimism in the broader economy. On the other hand, hard data available are less upbeat. Household consumer spending contracted in January, industrial production is on a sluggish upward trend and there are few clear signs of an uptick in investment.

  Meanwhile, the economic policy measures promised by Donald Trump have yet to materialise. A more resolute expansionist policy was promised, whereas for the time being we have received only rhetoric. This is particularly the case regarding tax cuts, which have been promised, but no specifics whatsoever have been announced. Regarding infrastructure spending, announcements are not enough and also appear somewhat excessive.

  This is a problematic issue as real household income is slowing down. There is therefore a risk of domestic demand waning, which will weigh on household spending strategy. We are awaiting a policy mix rebalancing.

What are the issues? (3/5)

- **What is the role of the Chinese economy?**

  The Chinese economy was particularly robust in 2016 delivering growth of 6.7%. The downturn feared in early 2016 did not occur. This factor reflects the implementation of a pro-cyclical economic policy with a relatively flexible credit policy. This has led to stronger domestic demand, leading to more dynamic spending and a relatively stable pace in economic activity. This situation is likely to drive global growth particularly given the stronger import trend.

  The risk associated with excessive gearing nonetheless remains, although the highly resolute attitude adopted by the authorities has limited the probability of a brutal turnaround. The government is forecasting growth of 6.5% in 2017.

- **What about the Brexit?**

  It would appear that Theresa May plans to trigger article 50 on 29 March, which will open two years of intense negotiations to organise the exit from the European Union and all of the other agreements with the rest of the world.

  I remain convinced that this change in the functioning of the UK economy will have a lasting negative impact.

  The single market will no longer be a component of UK economic dynamics. This factor will lead to a negative shock on UK exports (the single market adds a extra 10% on trade which will disappear rapidly for UK companies). This ongoing shock on economic activity will weigh on the jobs market and therefore on nominal wages. Meanwhile, rising inflation will hinder spending power among households.

  There is a risk that external and domestic demand decline in the UK which will weigh on the long-term growth trend.

  Three further comments: foreign investors remain highly cautious vis-à-vis the UK market as they will no longer have access to the single market if they are located in the UK. Secondly, UK exports do not appear to be highly sensitive to the value of sterling, so the fall in the currency will not have a major impact. Thirdly, since 2008, 85% of the increase in the workforce has come from outside of the UK. This particular issue is of major importance as the main reason for a clean break with the European Union is the UK government's desire to manage migration policy nationally. If this policy becomes too restrictive, a significant proportion of the jobs created will disappear and this factor will weigh heavily on growth.

  Growth is effectively the net sum of the variation in productivity and the variation in employment. Until now, productivity was very weak but this factor was offset by the high number of job creations. If employment growth now contracts, or even turns negative in the worst case scenario, the UK economy will be lastingly impacted.

What are the issues? (4/5)

- **What about inflation?**

  The inflation rate has increased across the board. This essentially reflects the rise in energy prices, which were extremely low a year ago creating at this time a risk of deflation. Energy prices have rallied this year and the contribution to inflation, which had been negative since the summer of 2014 in the eurozone, turned positive at the end of 2016 and gathered pace in January and February 2017. In the Eurozone, fluctuations in the inflationary trend are driven exclusively by oil price volatility. The core inflation rate in the eurozone has been stable at 0.8 - 0.9% for the past few months. This reflects an absence of tensions in the Euro Area. There is therefore no excessive wage price pressure which would otherwise be likely to drive the inflation rate higher.

  I do not believe the oil price will increase further and will remain around USD 55 and may even trend lower given the level of stocks and US production. The recent catalyst behind the increase in eurozone inflation to 2% in February 2017 will therefore wane and price increases will converge towards core inflation.

  Inflation will be slightly stronger in the US and the UK for different reasons. In the US because government measures are expected and because the cycle is already very mature and should ultimately lead to further tensions. This factor remains limited for the time being however, as the inflation rate monitored by the central bank was still at 1.9% in January and therefore below the Fed objective of 2%. In the UK inflation will probably drift higher as the currency depreciates.

- **What must the central banks do in this case?**

  The best response is to do nothing. Restrictive measures would be counterproductive since inflation will be lower in the near future. There are also other considerations relating to monetary policy.

  For the ECB, the objective is to create a more virtuous economic cycle with greater autonomy. For this reason, it will maintain its current strategy, particularly in terms of asset purchases, despite reducing the total monthly amount from 80 to 60 billion on 1 April. Furthermore, can we imagine the ECB modifying its asset purchase strategy at a time when the fixed-income markets are tense due to looming political risks? Certainly not

  The UK and Japan will maintain their current policies.

  In the US, the Fed wishes to hike its base rate. All of the monetary policy committee members have adopted a more hawkish tone, even those who were against hiking rates a few months ago, such as Lael Brainard. The Fed may wish to hike its rates in order to give itself more leeway in the event of risk in the US economy. The Fed believes that it is close to the objectives that it has been assigned in terms of business activity and inflation and that it is therefore justified in doing so.

What are the issues? (5/5)

- **US monetary policy (continued)**
  There is another reason behind the Fed members' wish for higher interest rates. They believe that a higher base rate is required prior to starting streamlining the central bank's balance sheet. There will therefore be a normalisation of interest rates before the balance sheet is streamlined.
  The Fed is currently continuing to buy assets as it is reinvesting the revenues from the securities that it already holds. This factor is having a major impact on fixed-income markets. Balance sheet management will therefore start with the repurchase programme being halted. This will have a heavy impact on fixed-income markets.
  Two potential strategies are being considered: either the Fed uses balance sheet management in order to deploy a more restrictive interest rate policy, or it adopts a neutral attitude by holding securities until maturity without intervening. Although it is unknown at this stage which strategy will be adopted by the Fed, the board members are suggesting a passive approach.
  Although the shift in strategy will perhaps take place in 2018, interest rates can be expected to rise by the end of 2017 in anticipation. The ensuing period will be interesting as Janet Yellen's tenure as Fed president will come to an end in February 2018 and her successor, nominated by Donald Trump, will be managing the new strategy.

- **Have political risks in Europe abated?**
  In Germany certainly, as the far-right AFD party is below 10% in the opinion polls and the new issue is the contest between the former European Parliament president Martin Schultz and Angela Merkel the incumbent chancellor, so there will be no sea-change in theory. The results of the Dutch elections on 15 March will be important even though it will probably be relatively difficult for the far-right to secure power.
  In France the situation remains confused. Although the likelihood of a Front National victory seems limited, investors fear that this may be the case. This result would effectively incur the risk of France leaving the eurozone and the European Union. This factor would destabilise France and the rest of Europe. The Front National's programme promotes the return to a national currency, but without providing any indications of the framework of its implementation. Regarding public debt, the question would be raised as to who would cover the adjustment to payments in a different currency. Would France's creditors pay if the debt is redenominated in the new national currency or would it be the French taxpayers if reimbursements are maintained in euros? In the first case, non-resident investors will be tempted to exit from the French debt ahead of the election results. France would then run the risk of being incapable of securing funding in the international markets and be obliged to print money to finance government spending. This is the type of risk which spooks investors the most as they perceive a strong source of persistent instability.

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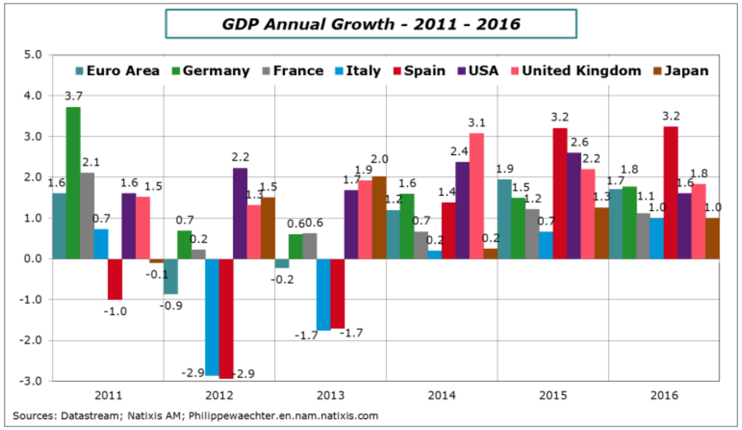
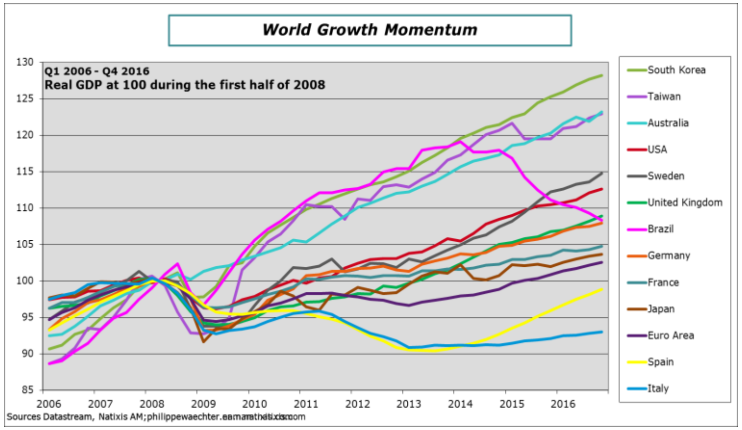
Global trends

- Global growth is now more stable and more balanced than in 2015 and 2016, as demonstrated in chart 1.
- This factor results from greater stability among economic policies and a more accommodating environment. Budgetary policies have been neutral since 2014 having imposed stringent constraints on eurozone economies in 2011 - 2013. This was also the case in Japan in 2014. Monetary policies have been highly accommodating for a long time now (December 2008 in the US) except in the eurozone where in 2011 two rate hikes destabilised investors. The ECB will maintain its accommodating policy for the foreseeable future.

  The global context comprising advantageous financial conditions and a stable oil price has contributed to the overall improvement.
- Global growth is nonetheless imbalanced, with Asian countries expanding rapidly, while the US is in an intermediary position and eurozone countries and Japan are the least dynamic. Italy and Spain have not even resumed the same level of business activity as in 2008.
- Brazil has fallen spectacularly since 2014 on account of slower growth in China, which is a major trading partner, combined with lower commodities prices, persistently low capex and corruption issues.





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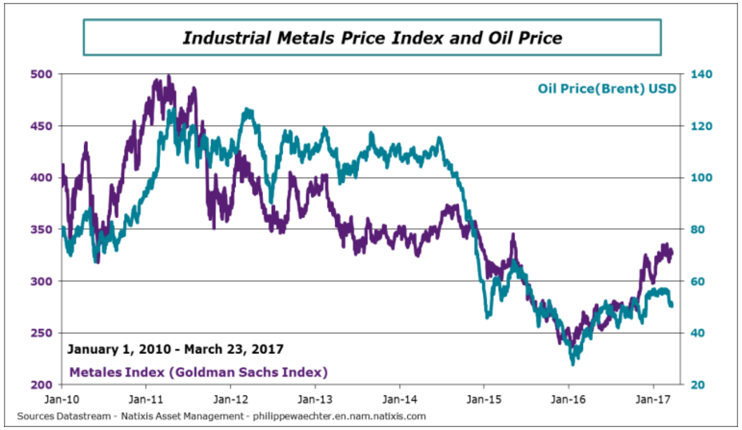
Commodities and interest rates

- Commodities prices hit a low in early 2016 and have rallied slowly since, reflecting slightly stronger global growth and the resolve of producer countries to restore higher revenues.
- Furthermore, since 2014 investments have fallen causing a more limited momentum in supply.
- Rapid price increases are not expected however, particularly in the case of oil.

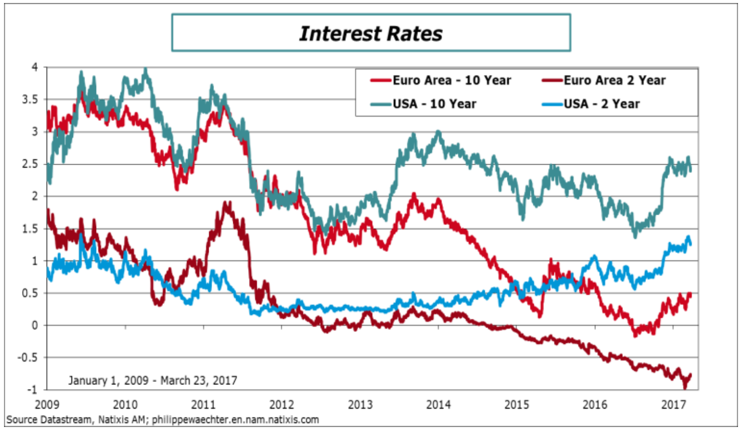
  Stocks are at very high levels.

  US production, which was reduced when the oil price was weak, is now increasing again.

  The terms of the OPEC agreement provide no real leeway for a sharp rise in prices as participating countries nonetheless frequently surpass their quotas to improve revenues which destabilises the market and prices.
- More stable oil prices have moderated the rate of inflation globally and more particularly among developed countries.
- This factor has caused inflation outlook to increase and steepened long-term interest rates.



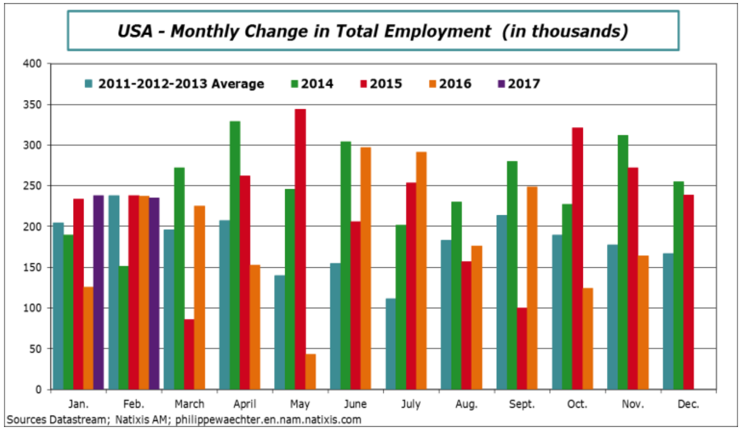
Sources Datastream - Natixis Asset Management - philippewaechter.en.nam.natixis.com



Source Datastream, Natixis AM; philippewaechter.en.nam.natixis.com

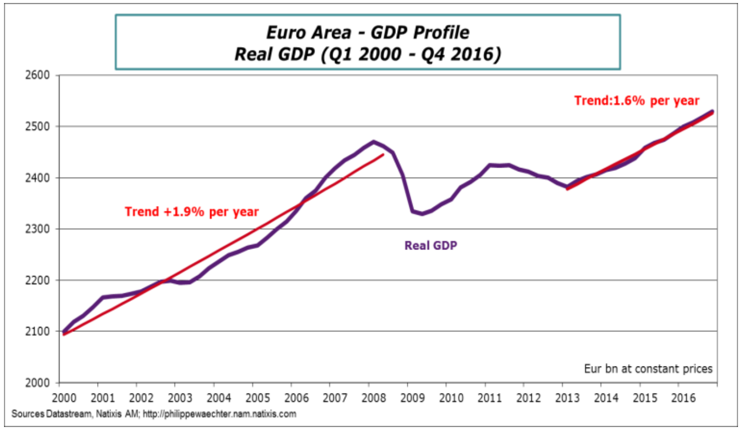
The US

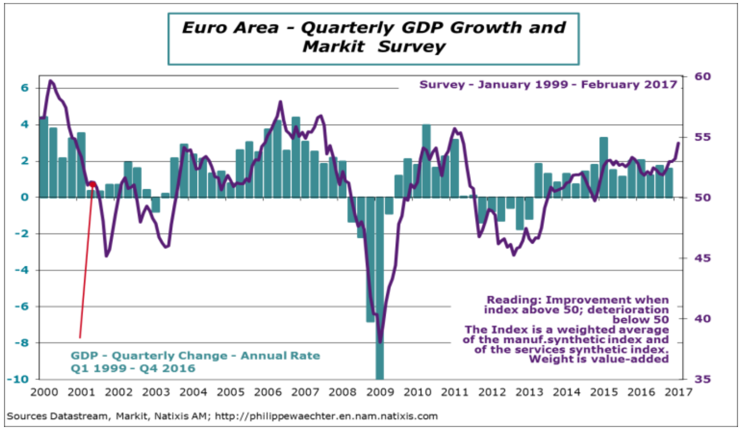
- The US situation is relatively robust although the 2016 growth rate of 1.6% was disappointing.
- Economic activity was more volatile during the year, particularly in terms of household spending and investment.
- The employment market remains on a firm trend, albeit less dynamic in 2016 compared to the two previous years. In 2016, 187,000 jobs were created on average each month compared to 226,000 in 2015 and 250,000 in 2014.
- Despite the unemployment rate falling to below 5% of the active population, there were no tensions in the economy likely to trigger wage pressures.
- This factor is one of the characteristics of the US cycle, which although it is very mature, nominal pressures (prices, wages) remained limited. For this reason, the Fed has not been in a hurry to hike its base interest rates.
- During 2017, planned tax cuts of around US 6,000 billion over 10 years are expected to be split between companies and households.
- There is a risk of tensions in terms of trade between the US and the rest of the world as the Whitehouse is now running a zero-sum economic policy.



Eurozone trends

- Growth has been stable in the eurozone since the beginning of 2013, on an annualised trend of 1.6% per year on average, representing a lower rate than before the crisis in 2008. (Look at the two trend lines on the graph)
- The combined shocks of 2008 and 2011/2012 (austerity policies) have had a strong persistent impact.
- The economic climate nonetheless seems to be becoming more dynamic. Business leaders are more optimistic, as can be observed in chart 2.
- Since the beginning of the year, the Markit survey indicator has returned to levels not seen since the spring of 2011.
- National surveys are also sending out positive signals. The INSEE business climate survey and the IFO in Germany both reflect more dynamic and more durable economic activity.
- This factor also reflects a more stable macroeconomic environment.
- Strong growth is expected, given the coherence between the quarterly GDP indicator, probably beating current forecasts of 1.6%/1.7%, extending the trend observed in chart 1.





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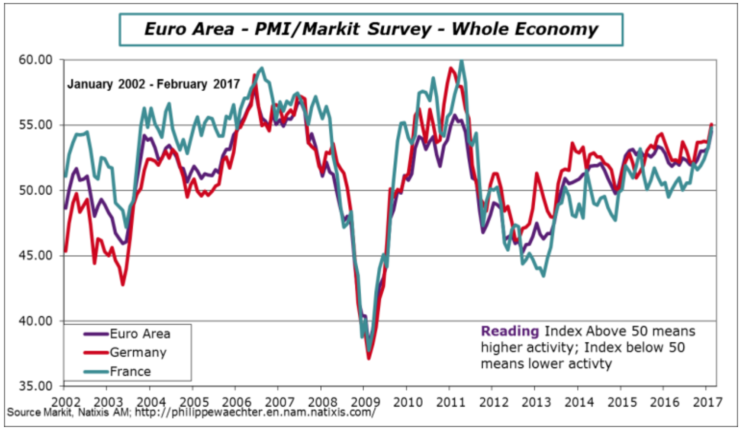
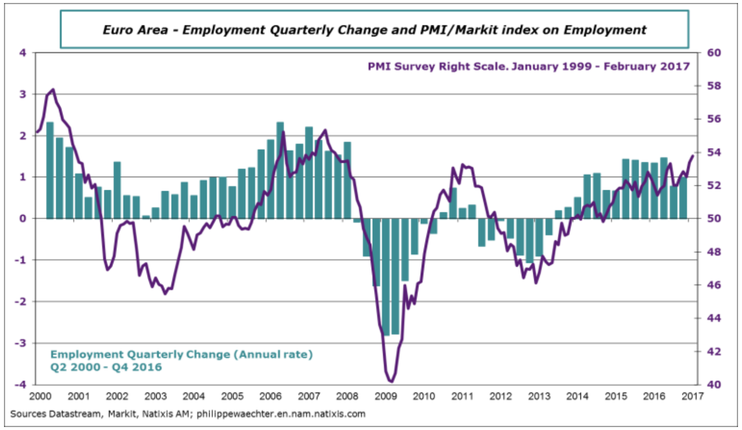
A more virtuous cycle in the eurozone

- The increase in the eurozone index is also observable in France and Germany.
- More generally, the perception of economic activity in the eurozone is highly positive at the start for the year.
- This factor is important as the countries in the zone trade heavily together and economic activity is therefore expected to pick up as trade intensifies.
- This trend could also create a more dynamic employment market and trigger a more virtuous economic cycle.
- In other terms, economic activity stimulates employment and income which boost domestic demand, which in turn drives economic activity.
- This more autonomous trend is virtuous
- This factor suggests a relative stability in budgetary policy, although slightly heavier public investments could be hoped for to drive private investment higher.
- These factors will not incite the ECB to modify its strategy.





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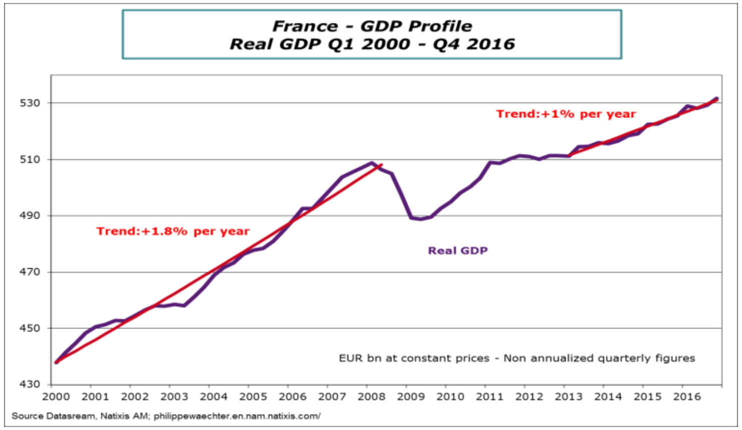
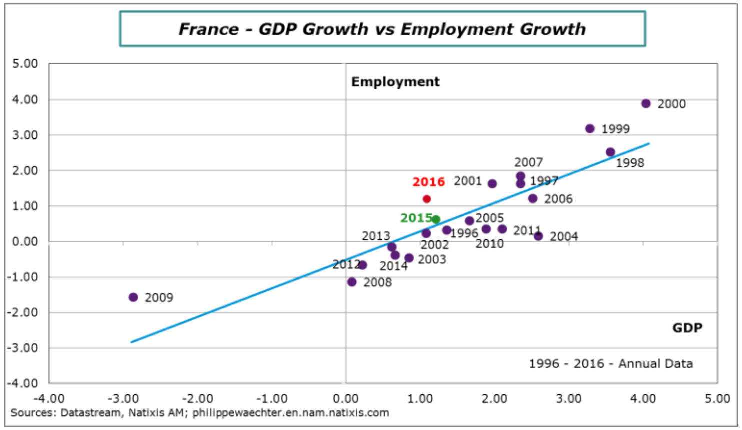
France

- The French economy is keeping pace with the eurozone.
- The growth trend has fallen nonetheless to 1% since 2013, which is insufficient to sustain the French social model.
- Eurozone membership should enable the French economy to benefit from a strong uptick in growth as trade intensifies.
- Chart 2 demonstrates that the relationship between the increase in economic activity and growth in the employment market has been stable over the past 20 years.

  The proximity of all of the points to the blue positive trend line reflects the relationship between the two indicators.
- Stronger growth is required to create more jobs

  Although the CICE tax credit incentive introduced to stimulate employment represents a step in the right direction, it is insufficient to establish a strong growth trend.
- For this reason, I referred to the issue of public investment and its role to boost the economic momentum.





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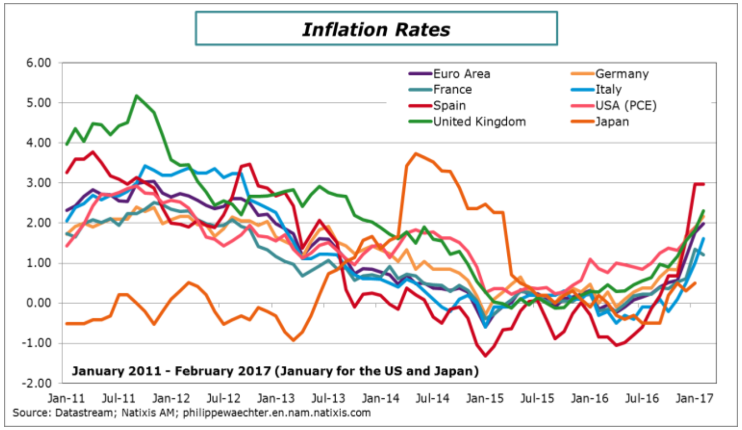
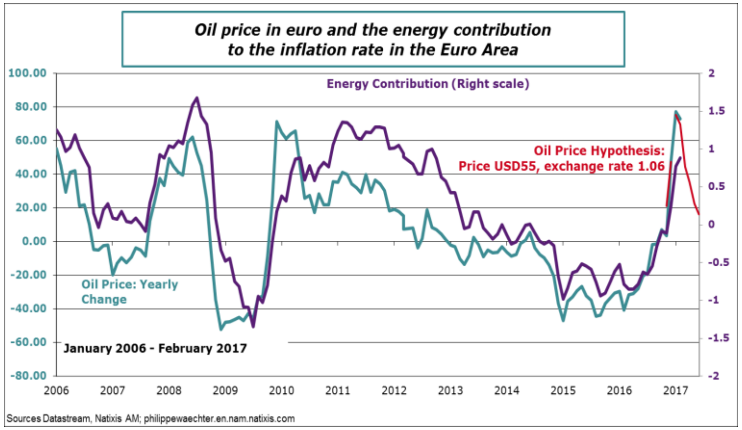
Higher inflation rate

- Inflation has been accelerating among developed countries since the end of autumn 2016.
- The main reason is the stabilisation in the oil price above USD 50 per barrel. The year-on-year price trend meant that the energy contribution was negative, driving the inflation rate lower.
- Since the summer of 2016, prices have reached the same level as in 2015 or even slightly higher.
- The energy contribution has therefore turned positive, driving inflation higher.
- Other prices have recorded only slight increases and are therefore not the cause of the higher inflation rate. Core inflation in the eurozone stands at only 0.9%. This factor is due to limited pressure on wages.
- Chart 2 illustrates the coherence between year-on-year oil price trends and the contribution of energy prices to inflation.

  Recent data is in-line with trends observed in the past.

  The more stable oil price should lead to a progressive reduction in the energy contribution to the inflation rate, as illustrated by the red line.
- Headline inflation will converge towards the core inflation rate.





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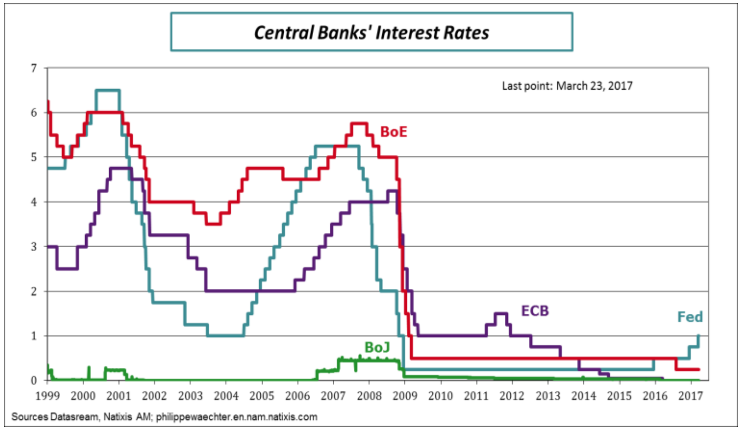
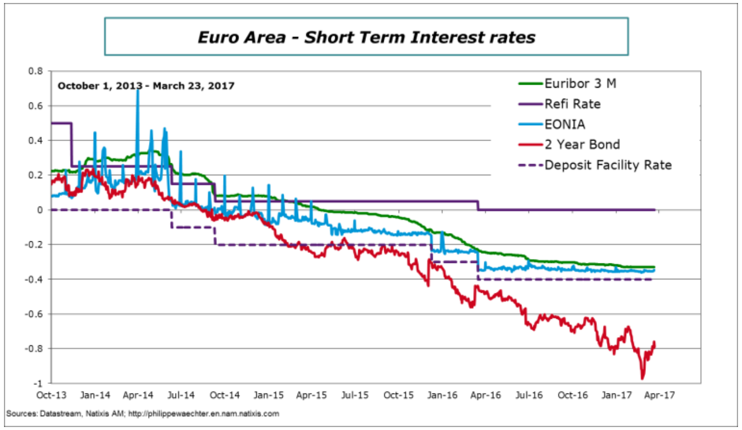
Monetary policy stability

- Despite the two interest rates hikes in December 2015 and December 2016, by the US Federal Reserve central bank rates have been very low for a long time.
- The Fed wants to gain greater leeway in managing its monetary strategy. The economic cycle in the US is very mature and, in the event of a negative shock, the central bank lacks firepower.

  Janet Yellen made it clear that a rate hike is planned for the meeting on 14 and 15 March.
- A more resolute budgetary policy (via tax cuts) will rebalance the impact of budgetary and monetary policies. This factor will provide the Fed with the opportunity to hike its base rates at least two more times in 2017.
- The ECB is expected to leave rates unchanged, with the refi rate remaining at 0%, and maintain quantitative easing until December 2017 at least. The scope of the QE programme has been broadened and this factor has led to a significant fall in two-year rates as demonstrated by the chart.





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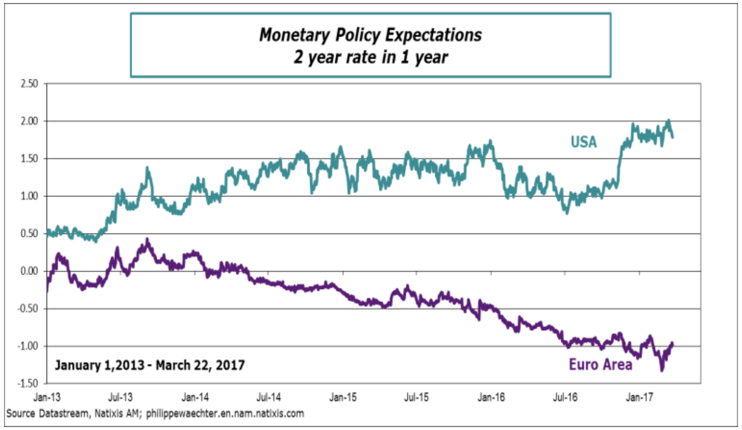
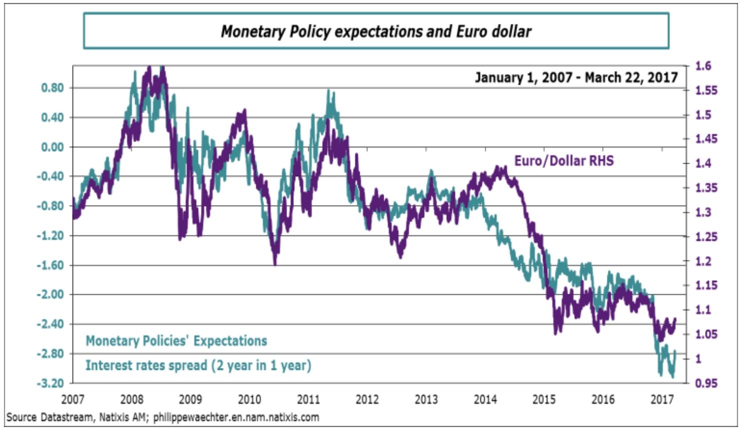
Sharp divergence between the US and the eurozone

- Chart 1 illustrates changes to expected US monetary policy after the election of Donald Trump. Meanwhile, ECB policy is expected to remain accommodating.
- The divergence between the two central banks' monetary policy outlook indicators is highly correlated to the dollar vs euro exchange rate.
- The recent trend would imply that the exchange rate will fall below 1 over the next few months. More generally, I am anticipating dollar strength in the context of all other monetary policies remaining accommodating.
- The main point to watch over the next few months will be the tapering of the Fed purchase programme. For the time being, even if it halts its formal quantitative easing policy, the Fed continues to buy assets by reinvesting the revenues from its portfolio of holdings bought under the programme. For the time being, the Fed is in a phase of normalising its base interest rates, but once the desired level is achieved, it will manage its balance sheet more proactively. The Fed could either adopt an aggressive policy which would amplify the impact of the rate hikes, or a more neutral management approach by letting its balance sheet adjust over time. The second option would be preferable.
- Anticipation of these changes in 2018 should cause US interest rates to steepen across the entire yield curve.





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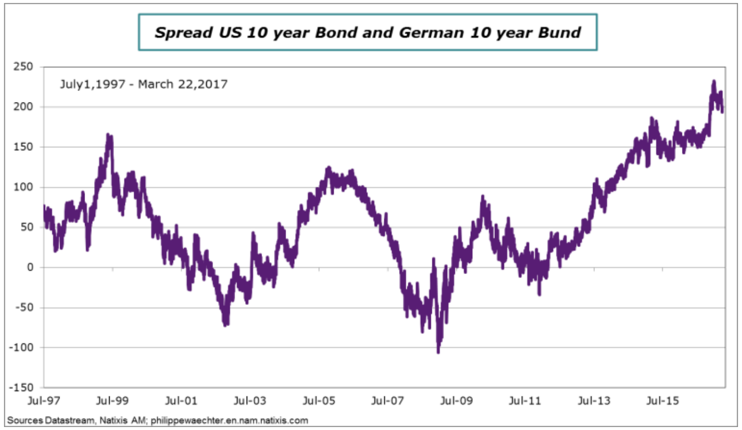
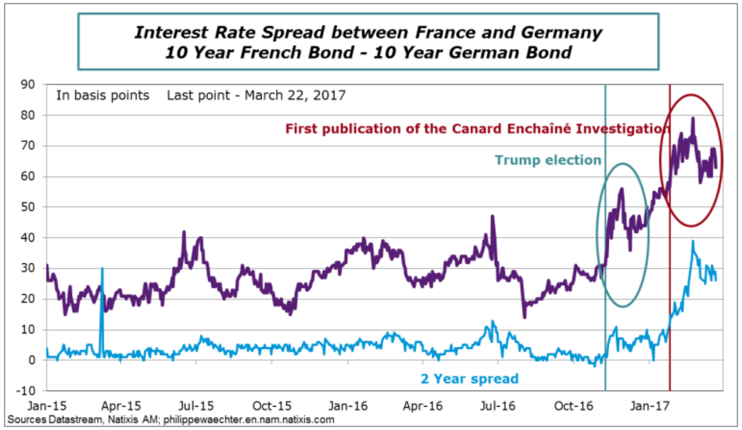
Interest rate spreads should be monitored

- The adjustment in the euro vs dollar exchange rate reflects the wide spread maintained between US and European rates.
- The spread, illustrated on chart 1, has widened sharply since the election of Donald Trump on 8 November.
- This reflects divergent monetary policy outlook.
- The interest rate spread between France and Germany should also be watched carefully.
- It was relatively stable but widened after Trump's election. The initial widening reflects the possibility of a populist candidate winning the presidential elections this spring in France.
- The second phase of widening corresponds to the date when the centre-right candidate was brought into the spotlight by a press article.
- Since this date, although the crisis has abated somewhat, the interest rate spread has remained wide. This reflects investor fears regarding the result of the French election and the situation regarding the French economy within Europe and the eurozone.





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Forecasts

growth and inflation

	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	1.6	2.3	1.9	1.3	1.5	0.3	1.1	2.3
Japan	1.5	2.0	0.2	1.3	1	1.1	-0.1	0.3	2.8	0.8	-0.1	0.3
Euro Area	-0.9	-0.2	1.2	1.9	1.7	2	2.5	1.4	0.4	0.0	0.2	1.2
U.Kingdom	1.3	1.9	3.1	2.2	2	1.3	2.8	2.6	1.5	0.0	0.7	3.0
China	7.8	7.5	7.4	6.8	6.7	6.4	2.6	2.6	2.0	1.4	2.1	2.5
France	0.2	0.6	0.7	1.2	1.1	1.5	2.0	0.9	0.5	0.0	0.2	1.1

interest rates

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	1.25-1.5	1.7	3	2.2	2.27	2.45	2.5-3
Japan	0.1	0.1	0.1	0.1	-0.1	-0.1	0.8	0.7	0.3	0.25	0.05	-0.2;0.2
Euro Area	0.75	0.25	0.05	0.05	0	0	1.2	1.95	0.5	0.63	0.3	0.3 - 0.8
U.Kingdom	0.5	0.5	0.5	0.5	0.25	0.25	1.8	3.1	1.8	1.96	1.2	1.8-2.1

Source : Economic research / Natixis AM

Legal information

Natixis Asset Management
Registered Office: 21 quai d'Austerlitz – 75 634 Paris Cedex 13 – Tel. +33 1 78 40 80 00
Limited Liability Company - Share Capital of 50 434 604,76 euro
Regulated by AMF under n° GP 90-009
RCS number 329 450 738 Paris

> Further information: www.nam.natixis.com