Global economic outlook

Towers Watson Research Article

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The following article is taken from a recent publication by our global colleagues at Towers Watson.

Overview

Global growth in the next three to five years is expected to be moderate but divergent across countries. Moderation in developed economies over the medium term is a result of continued deleveraging forces, while a Chinese slowdown, uncertain global liquidity conditions and a host of other idiosyncratic issues mean that some Emerging Markets ('EM') will face growth headwinds over the next few years. Overall we maintain our base case of modest but acceptable global growth, low inflation, but with important differences between countries. The divergence in growth conditions is being dictated by the nature of policies adopted (monetary and fiscal as well as structural reforms) by authorities around the globe in response to this new growth environment, and the build-up of accumulated pressures.

Interest rates are at historic lows in most countries and risky asset prices have increased as a result of central bank balance sheet expansion. As a result, the amount of 'dry powder' monetary policymakers have to respond to unforeseen negative shocks is unusually low. This leads us to believe that risks will be skewed to the downside over the medium to long term.

US

The US economy has seen a slight moderation in growth over the course of the year. However this was more or less expected by forecasters as Quantitative Easing ('QE') was gradually brought to an end. The underlying strength in the broader economy remains intact and is in line with our base case outlook. Overall consumption growth has been strong, which coupled with easy monetary policy creates an environment conducive to a pick-up in business investment. A consequent pick-up in hiring and gradual erosion of labour market slack will likely cause a moderate increase in wages which further reinforces demand. Such favourable dynamics produce a self-sustaining recovery, one that the US is beginning to experience. We expect this to continue to play out over the next one to two years.

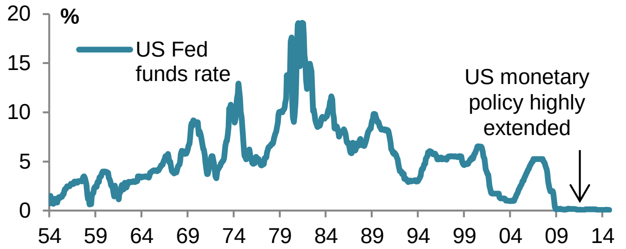
Downside risks grow beyond this horizon, principally due to a continuing weak credit environment, interest rate sensitivity and the inability of monetary policy to respond to negative shocks. Despite improvements witnessed over the past few years, considerable slack currently exists in the economy, which should keep inflation subdued in the near term. Further out, inflation pressures may begin to emerge as wage growth picks up pace, but we expect this to take place slowly.

Figure 07. TW global forecasts: Real GDP (%y/y)

	2014		2015		5Yr Avg.
	TW	Consensus	TW	Consensus	TW
Global	2.7-2.9%	2.8%	3.0-3.5%	3.2%	2.5-3.4%
Emerging Mkts	4.6-4.8%	4.6%	4.5-5.5%	4.8%	4.5-6.3%
Developed Mkts	1.5-1.7%	1.7%	1.8-2.3%	2.3%	1.2-2.1%
United States	2.1-2.3%	2.2%	2.6-3.2%	3.1%	1.6-2.5%
United Kingdom	2.9-3.1%	3.1%	2.3-3.0%	2.6%	1.6-2.6%
Euro area	0.7-0.9%	0.8%	1.0-1.4%	1.2%	0.7-1.3%

Source: Towers Watson

Figure 08. With interest rates at historic lows, there is an increasing risk that monetary policy may be ineffective in dealing with future negative shocks

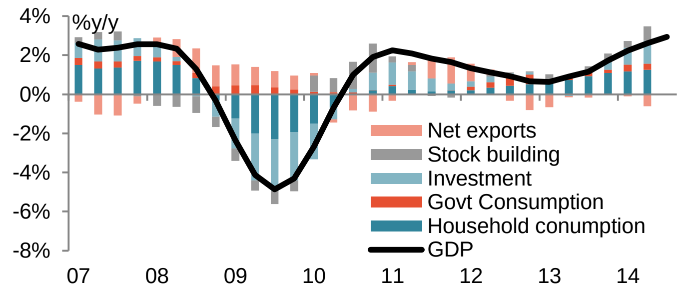


Source: Thomson, Towers Watson

UK

In many respects, economic conditions in the United Kingdom are similar to those in the US. Creative credit easing policies have boosted asset prices and helped catalyse a self-sustaining recovery primarily driven by stronger household consumption. Business investment, production and employment conditions are robustly responding to this healthy demand environment.

Figure 09. UK is experiencing a broad-based recovery, but the economy is faced with a rising number of challenges



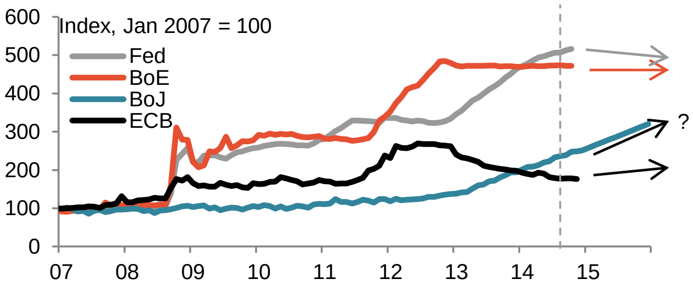
Source: Thomson, Towers Watson

But the UK also faces its own set of challenges which sets it apart from the US. The economy is faced with political uncertainty given elections next year and fiscal austerity will be a persistent drag on growth from now until at least 2017. In addition, trade linkages with continental Europe continue to weigh on UK exports and manufacturing prospects. Despite years of deleveraging, household balance sheets remain much larger than those in the US and because UK mortgages tend to be floating rate in nature, consumption is sensitive to interest rate rises. We expect these to begin in the second half of 2015. For these reasons we believe that whilst growth should remain strong over the next year or two, downsides risks rise beyond that horizon and are more pronounced than in the US.

Japan

Aggressive QE adopted in Japan since 2013 has so far led to positive outcomes in asset prices and some macroeconomic data. The additional measures announced by the Bank of Japan (BoJ) last month raise the total asset purchases by the central bank to $700bn a year (similar in magnitude to the latest round of QE in the US) and demonstrate the continued willingness of the BoJ to play its part in 'Abenomics'.

Figure 10. Bank of Japan is currently the only major central bank aggressively easing



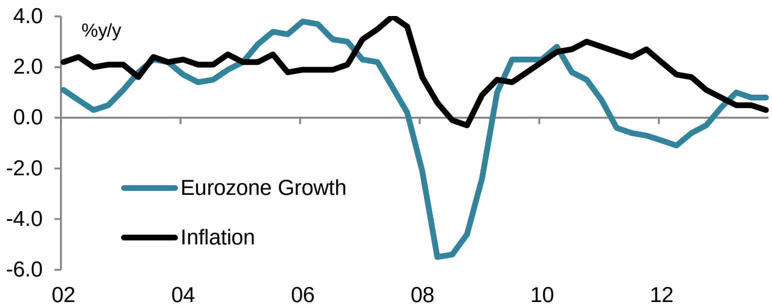
Source: Thomson, Bloomberg LP, Towers Watson

However, a lot of uncertainty still exists around Japan's growth prospects and we are inclined to caution. Planned fiscal consolidation has already resulted in two quarters of negative growth this year, and looks likely to cause the second consumption tax hike planned for next year to be deferred. Various structural headwinds must be addressed by Japan's government. A shrinking workforce, resistance faced in reshaping corporate governance regulations and high public debt levels remain significant issues. Whilst there has been notable progress on some fronts (for example in increasing female labour force participation rates) it remains unclear whether sufficient action and robust execution will overcome these hurdles.

Euro area

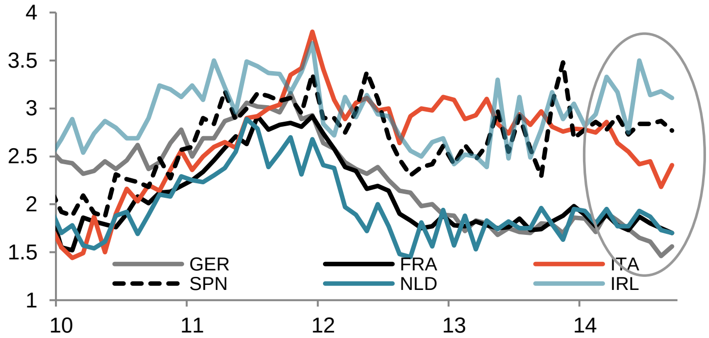
Economic conditions remain depressed in much of Euro area outside Germany The Euro area continues to face extremely depressed economic activity with slack at very high levels, weak growth and a strong disinflationary inertia. Recent Euro area growth concerns were centred around Germany, which has been the engine for the region. Growth has indeed moderated, but the timing of German summer holidays created artificial volatility in the data, which subsequently recovered. Whilst not immune from weak demand elsewhere in the Euro area, Germany continues to benefit from easy financial conditions and should continue to grow at a reasonable pace.

Figure 11. Weak growth environment and low inflation continues to plague the economy



Source: Thomson, Towers Watson

Figure 12. Financial conditions still vary widely in the Eurozone



Source: Thomson, Towers Watson

Programmes announced not enough to increase central bank's balance sheet by €1tn The ECB has made several policy announcements over the past few weeks in an effort to counter the depressed conditions outside Germany including a negative deposit facility rate, a new Targeted Long-term Refinancing Operation (TLTRO) through which banks can borrow up to €400bn of term financing and a quantitative easing program aimed at purchasing covered bonds and asset-backed securities. Additionally, the joint release of the results of the Asset Quality Review and stress tests was designed to allay investor concerns over European banking system risks.

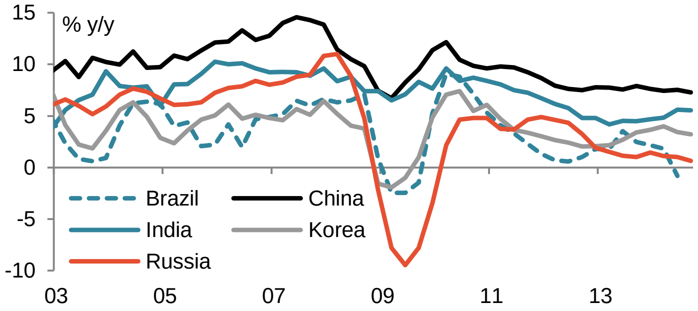
The ECB also formally announced its intention to expand its balance sheet by €1tn from its current level of €2tn. However, we find it unlikely that this will be achieved over the next 12-18 months under the current range of policies. European banks are expected to take up only half of the funds on offer under the latest TLTRO. We also believe that the ECB will only be able to buy at most €100bn a year in ABS and covered bonds due to the size of the existing market. In addition, rolling-off of previous LTROs is a contractionary force on the ECB's balance sheet.

Current programmes ineffective at boosting demand and stemming disinflation In general we believe monetary policy remains too tight relative to aggregate underlying economic conditions. The ECB tacitly acknowledged this in making its pledge to expand its balance sheet. There may therefore be some material changes in policy looking forwards. The ECB could broaden the scope of purchases by including corporate bonds or lower tranches of ABS. Full sovereign QE could also be implemented, but President Draghi has tied this to efficient structural reforms and fiscal stimulus to boost demand conditions. Slow progress on the latter two means that adopting a fully-fledged sovereign debt QE does not seem likely at the moment, absent another crisis.

Emerging markets

Lower Chinese growth expected as rebalancing continues; risks facing the economy are significant but manageable The slowdown being observed in China should be put in the wider context of rebalancing towards a more sustainable growth model that is currently taking place in the economy. Near term concerns centre on weaning the economy off rapid credit growth and beginning to address the bad debts that have built up due to excessive investment. We believe that policymakers possess the resources and ability to execute a relatively smooth landing to a lower growth path, although the risks around this are material. Commodity exporters like Australia, Brazil, Chile, Indonesia, South Africa etc which have been historically reliant on Chinese domestic investment growth are expected to face headwinds as the focus shifts to a more consumption-based growth model. Interestingly, this rebalancing also creates opportunities for economies well positioned to provide services and consumption goods that China will increasingly demand.

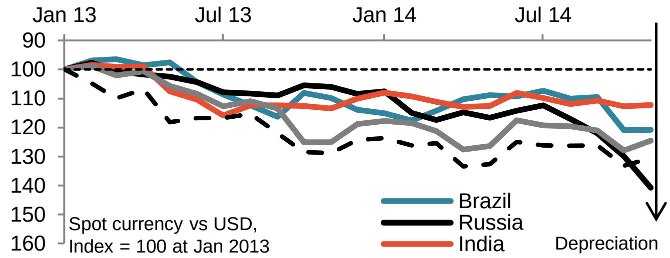
Figure 13. Emerging market Real GDP growth rates



Source: Thomson, Towers Watson

Difference in how last year's balance of payment crisis was handled has led to varied growth prospects After last year's balance of payment issues, India has actively implemented reforms emerging with stronger growth prospects. Whilst those, like Turkey and South Africa, which have made limited progress still face balance of payment pressures and a structural need to improve competiveness. These economies continue to face a situation requiring tight monetary policy relative to underlying weak domestic demand in order to shore up their currencies and contain inflation. Looking beyond the Chinese growth slowdown and balance of payment concerns, another set of emerging economies have suffered from 'idiosyncratic' issues. Notably Russia, whose economy has been hit by geopolitical tensions and subsequent international sanctions, whilst, another example is Argentina which has suffered technical default on its debt and has poor growth and inflation prospects.

Figure 14. Currency moves as a proxy for investor confidence in different EM country's growth prospects



Source: Bloomberg LP, Towers Watson

A number of cyclical and structural factors underpin our constructive outlook for medium-term EM growth However, we maintain a relatively constructive stance on aggregate emerging market growth prospects over the medium term. Low oil prices will be a boon for countries like India and Turkey (which are heavily reliant on energy imports) and other non-commodity exporters. In addition, exposure to buoyant US demand should support major exporting economies and recent US dollar strength should lead to increased competitiveness. A few economies like Mexico (and tentatively India) are also introducing structural reforms which will boost medium term growth prospects. Economic conditions are divergent across the set of emerging economies, and whilst we do not understate the risks that some face, we believe that the positives will increase aggregate growth over the medium term.

TOWERS WATSON
Global and Australian Investment Committee Research

ABOUT MELVILLE JESSUP WEAVER

Melville Jessup Weaver is a New Zealand firm of consulting actuaries. The firm was established in 1992 and has offices in Auckland and Wellington. The firm is affiliated to Towers Watson, a global professional services firm that helps organisations around the world optimise performance through effective people, risk and financial management. Towers Watson has offices in 25 countries and the business covers human resources services, reinsurance and Tillinghast.

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