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GLOBAL MIDYEAR MARKET OUTLOOK 2015

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Global Economics: DIVERGENT MONETARY POLICIES STILL DRIVING THE GLOBAL ECONOMIC OUTLOOK

EXECUTIVE SUMMARY

More than six years after the global financial crisis, economies around the world are still reckoning with its consequences—with just about every nation's growth rate significantly lower than it was prior to the downturn. Unlike the synchronized global credit boom of the pre-crisis years, however, a moderate global growth rate masks considerable differentiation. The United States and United Kingdom have deleveraged enough that they are preparing to raise ultra-low interest rates. European economic data have improved versus six months ago as fiscal tightening dissipates, while Japan's outlook is better as a result of delaying a tax hike. Emerging markets with relatively low inflation and low debt have had room to ease monetary and fiscal policy; others that have improved their policy frameworks and tackled structural shortcomings also have better economic outlooks. Global economic risks include volatility following unpredictable geopolitical events around the world.

More than six years after the global financial crisis, economies around the world are still reckoning with its consequences—with the United States leading the recovery but still afflicted with slow growth relative to the pre-crisis norm.

Unprecedented central bank stimulus has had progressively less impact as the world endures a disappointing recovery from the crisis. Just about every nation's growth rate is significantly lower than it was prior to the downturn.

The latest projection for 2015 by the International Monetary Fund forecasts 3.5% growth in the world's gross domestic product (GDP), slightly higher than in 2014. Unlike the synchronized global credit boom of the pre-crisis years, however, this moderate rate masks considerable differentiation.

The United States and United Kingdom have deleveraged enough that they are preparing to raise ultra-low interest rates. European economic data have improved versus six months ago as fiscal tightening dissipates, while Japan's outlook is better as a result of delaying a tax hike. Both regions are easing monetary policy aggressively.

Varying policy responses to the crisis have led to a decoupling between improved conditions in developed nations awash in liquidity and slowing growth in emerging nations. In aggregate, growth in emerging markets is decelerating faster than in developed markets, though growth rates in emerging markets remain higher.

Among emerging markets, there also is dispersion because of policy responses. Emerging markets with relatively low inflation and low debt have had room to ease monetary and fiscal policy; others that have improved their policy frameworks and tackled structural shortcomings also have better economic outlooks.

Global economic risks include an unlikely hard landing as China's growth rate falls, a possible breakdown between Europe and Greece, and volatility following unpredictable geopolitical events around the world.

MODEST U.S. EXPANSION

Though headwinds still linger, the U.S. cyclical expansion is intact. A very weak first quarter means a 2015 GDP growth rate in the range of 2.50% to 2.75%[1], down from the 2.75% to 3.00% predicted at the start of this year. At the same time, the United States is growing faster than its currently reduced potential growth rate of less than 2.0% (based on labor force and productivity growth).

A year ago, many economists thought 3.0% growth was possible, but U.S. growth cannot reach that level without a more certain investment environment, an improved housing market, and a better global outlook.

Given where the United States is in the business cycle, recession is a low probability without an unforeseen shock. Indeed, economic tailwinds are evident: a still easy monetary policy; household sector deleveraging; the upsides implied by the low level of housing production relative to the population's needs and low capital spending relative to GDP; low gas prices; recently increased government spending; signs of wage growth; and, most important, continuing job growth.

U.S. job growth may be lower this year than last, but it's still strong enough to bring the unemployment rate down—to about 5.0%[1] by the end of the year, though with more under-employment than typically is seen at that level. Job growth has been driving income growth but, as unemployment falls, wage growth will become more important.

The U.S. core inflation rate—running this spring at a 1.3%[2] annual rate—likely will remain stable over the next three to six months. But it could rise sooner than anticipated, possibly to 1.6%[2], not far below the Federal Reserve target of 2.0%.

Despite much anticipation, the Fed's first interest rate hike since 2006 should not have much of an economic impact, though global markets could react in the short term. Our base case is a hike of 0.25% by September, followed by a meeting-by-meeting assessment that should result in a very gradual path of further hikes.

EUROPEAN GREEN SHOOTS

Growth in the eurozone is recovering faster than many expected, the result of lower oil costs and a weaker euro spurring exports. Eurozone GDP grew 0.4%[3] in the first quarter, and consensus GDP forecasts for 2015 and 2016 likely will be revised upward. Meanwhile, deflation fears have receded.

The 19-nation bloc also is benefiting from moves away from fiscal austerity, although late starters such as France are still maintaining tighter policies. The European Central Bank has taken several steps since last summer to increase the degree of policy accommodation, including an expansion of its bond-buying program this year. The quantitative easing effort, likely to run through September 2016, should promote cyclical recovery by keeping the euro weak and encouraging banks to lend. Stronger global growth also would be positive for Europe.

Short-term risks to Europe's recovery include a potential for a flare-up in the Ukraine conflict and uncertainty from Greece's debt situation. To grow longer term, Europe needs structural reforms to increase competitiveness and counter negative demographics.

JAPANESE REFORMS

Japan emerged from a mild recession at the end of 2014, and some signs of stronger growth are evident. Lower commodity prices are helping and exports are picking up, with the country producing a trade surplus in March for the first time in almost four years.

Prime Minister Shinzo Abe has continued to press his economic reform agenda after his party's reelection in December. A new fiscal plan is to be released this summer, aimed at balancing the budget by 2020. Among developed nations, Japan has the largest deficit as a percentage of GDP.

On the monetary front, the Bank of Japan has continued with very accommodative policies: a 0% interest rate and purchases of Japanese government bonds and other assets. The central bank remains committed to eventually reach its 2% goal on inflation.

Structural reforms, the "third arrow" of Mr. Abe's agenda, have been difficult to carry out, but there has been progress. Parliament has passed a corporate tax cut aimed at increasing economic growth, and an enhanced corporate governance code has been implemented.

EMERGING MARKETS DISPERSION

In China, more local government austerity measures, weak corporate profits, and slower housing construction have reduced growth prospects to slightly below the government's 7% target for 2015.

Policymakers have responded by stepping up monetary easing in a series of rate cuts starting last year through this spring. After relatively timid responses in the past, this new injection of liquidity has a better chance at success. As a result, second-half growth prospects look better, but structural problems persist as China transitions to a more consumer-oriented economy and its workforce ages.

[1]T. Rowe Price
[2]Core Personal Consumption Expenditure Index
[3]Bloomberg, European Central Bank, WSJ

In other emerging markets, growth prospects vary. Lower oil prices benefit oil importers and hurt producers, and nations face a wide range of geopolitical and structural risks:

- India now appears to be growing faster than China, although a new method of computing its GDP has created confusion about its true growth pace. After taking office last year, Prime Minister Narendra Modi's government has set a course for steady economic reforms. With weakening inflation, the central bank has scope for additional rate cuts.
- In Turkey, economic momentum is slowing, with GDP growth likely to fall below 2.5% this year after 2014's 2.9%[4] pace. The central bank eased its policy rate lower in February to stimulate growth.
- Russia entered into recession in the first quarter, and recent data point to an economic contraction for the full year. Sanctions remain in place amid risks from potential reescalation of tensions with Ukraine. Fiscal conservatism allows the central bank to loosen monetary policy.
- Brazil faces multiple challenges. Its central bank is near the end of a series of rate hikes designed to cut inflation from over 8%—the highest level in more than 10 years—to below 6.5%, the upper level of the official target range. President Dilma Rousseff's government appears committed to fiscal adjustment to maintain the country's investment-grade credit rating, but slow growth could weaken its resolve.

As a result of such variations, emerging markets, once viewed as homogeneous, now must be viewed case by case.

[4]Turkish Statistical Institute, Trading Economics web site, various news reports.

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