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The global economic outlook – implications for investors

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Oliver's Insights

Key points

> The global economy is still on the mend, but it's still a two steps forward, one step back affair. Of the major regions the US is doing the best, but Europe is lagging.

> This means occasional bouts of uncertainty, but it's not such a bad thing if it keeps central banks supportive.

> The main implications are: we are still in the sweet spot of the global economic cycle, which is good for growth assets; the lack of global synchronisation means that fundamentals for individual regions, assets and stocks matter; constrained global growth will mean constrained returns; and the big event to watch for is when the Fed starts to hike rates – but it still looks a way off at present.

Introduction

We are having yet another year where investors started off optimistic about the global economic outlook with talk of synchronised growth only to find that the global growth story remains patchy. In fact, so much so that it's possible to paint wildly different pictures as to the outlook – some are worried about growth and inflation taking off, whereas others warn of imminent collapse. The truth is likely to remain somewhere in between these extremes. But, in a way, this is not a bad thing as it keeps central banks supportive.

This note looks at the major regions in terms of growth, inflation and interest rates and what it means for investors.

The US – looking good but not booming

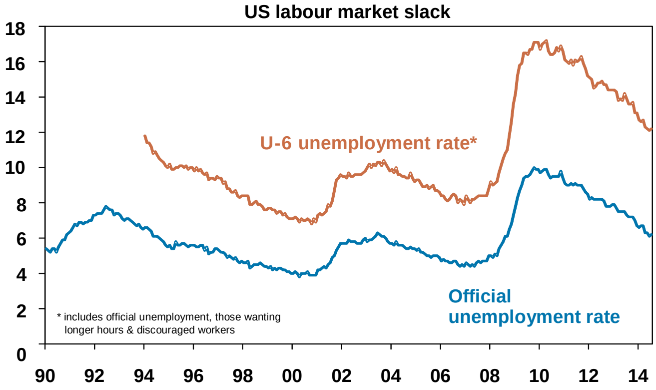
After a contraction in the March quarter driven by mostly temporary factors, the US economy rebounded in the June quarter and looks on track for growth of around 3% in the current quarter. The jobs market and business investment are improving and the shale oil boom is providing a long term boost both directly and indirectly via cheap electricity costs for business. However, while the US is looking a lot stronger it's a long way from booming, let alone overheating, with growth seemingly stuck in a 2-3% range as the housing recovery and consumer spending have slowed a bit of late.

US GDP growth

Source: Bloomberg, AMP Capital

Which brings us to what the Federal Reserve will do. On the one hand US growth has improved enough to allow the Fed to continue "tapering" its quantitative easing program which means it's on track to end probably in October. On the other hand it's unclear that conditions are strong enough to warrant interest rate hikes just yet. This is something the Fed is grappling with, but the conclusion seems to be that - with inflation remaining low at just 1.5% on the Fed's preferred measure, wages/labour cost growth stuck around 2% and broad measures of labour market slack (ie allowing for the unemployed, underemployed and discouraged workers) remaining high - its unlikely to rush into raising rates.

US labour market slack



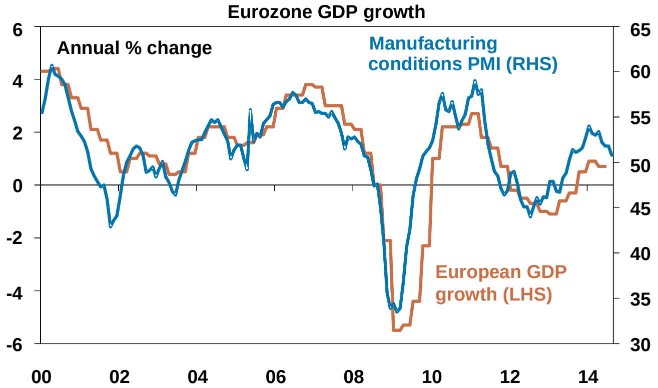
Source: Bloomberg, AMP Capital

Our assessment is that the Fed is gradually inching towards an interest rate hike, but it's probably not going to occur until sometime in the June quarter next year.

The Eurozone – better but not great

The Eurozone returned to growth about a year ago but it is far from robust and stalled in the June quarter with weakness in Germany, Italy and France. Uncertainty regarding Russian sanctions and Ukraine are not helping. What's more bank lending growth has remained negative and inflation has fallen to just 0.4% year on year. This has all led to concerns that Europe is sliding into Japanese style stagnation and that the ECB needs to do more.

Eurozone GDP growth

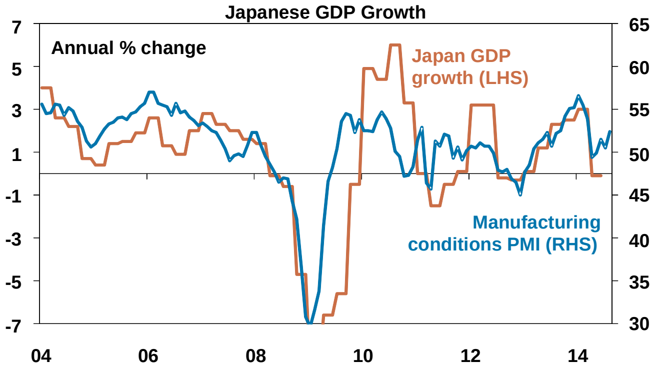


Source: Bloomberg, AMP Capital

Our assessment though is that Europe is gradually mending: growth has returned to Spain, Ireland, Portugal and Greece; these countries have all made significant structural reforms to their economies and France and Italy look to be gradually heading down that path; the troubled countries have all seen their bond yields collapse, eg Spain's 10 year bond yield is now just 2.17%; the ECB announced further stimulus in June, but looks to be ready to launch into quantitative easing involving the purchase of private debt in the next few months; and bank lending should improve once the ECB's bank stress tests are out of the way in a few months.

Japan – Abenomics on track

Japan's growth was hit in the June quarter by the pull- forward effect of the April sales tax hike. However, a range of indicators suggest that despite the volatility the Japanese economy has weathered the sales tax hike well with ultra-easy monetary policy and economic reforms providing confidence growth will bounce back from the current quarter.



Source: Bloomberg, AMP Capital

However, given the uncertainty, the Bank of Japan will either have to maintain its very easy monetary conditions or possibly have to ease further.

China running hot and cold

For the last three years now Chinese economic data has been running hot and cold every six months leading to periodic worries about growth. Another slowdown in the Chinese property market is adding to these concerns.

Source: Bloomberg, AMP Capital

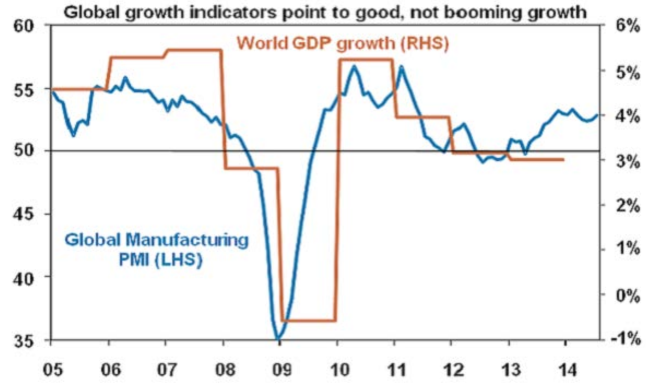
With the Chinese Government repeatedly indicating that there is a floor to growth of around 7%, and supporting this by mini-stimulus measures as they have done this year, our assessment remains that the Chinese economy is on track for growth of around 7.5%. But don't count on more.

Emerging world

The emerging world more generally is a lot messier than it used to be. Of the major's, China and Mexico look ok and the election of reform oriented governments in India and Indonesia is positive, but Brazil looks to have lost the plot under the current Government, and Russia already weakened looks to have shot itself in the foot over Ukraine. A lack of structural reforms over the last decade has led to lower growth potential in the emerging world. That said it's still on track for growth around 4.5% this year and next.

Global growth – two steps forward, one back

Bringing this together, global business conditions indicators are consistent with good but not booming growth.



Source: Bloomberg, AMP Capital

Although global growth is likely to pick up, it's hard to describe global conditions as synchronised and the global economic expansion remains very much a process of two steps forward, one step back. This was clearly evident in the first half of the year with the US and Japan both having negative quarters, China slowing in the first quarter and Europe stalling in the June quarter. And of course geopolitical events continue to wax and wane and the threat from Ebola remains in the background – all of which impart a deflationary impact in terms of their dampening impact on confidence and spending. Against this backdrop it is hard to see the Fed wanting to rock the boat prematurely with talk of interest rate hikes, let alone actual hikes, and the ECB, Bank of Japan and People's Bank of China are likely to maintain ultra-easy policy or ease further.

Investment implications

There are several implications for investors. First, gradually improving global growth, still benign inflation and easy monetary conditions tell us we are still in the sweet spot of the economic cycle which augurs well for growth assets.

Second, the desynchronised global economic and monetary cycles confirm that the "risk off, risk on" phenomenon of a few years ago where all growth assets move up and down together has faded. This should make it easier for fund managers and investors to benefit from opportunities in individual regions, assets or stocks. Eg we think there is currently good value in Chinese shares, European shares and commodities. The divergence in monetary cycles is also likely to mean upwards pressure on the $US but downwards pressure on the Yen and Euro.

Thirdly, the constrained global growth cycle provides a reminder not to expect double digit gains from growth assets year after year. It will still be a relatively constrained world in terms of sustainable returns.

Finally, the big thing globally to keep an eye out for will be when the Fed will start to raise interest rates. This, or rather its anticipation, will likely cause a few bumps (just like last year's taper tantrum did), but it's still a fair way off and when it does come its unlikely to spell the end of the cyclical bull market in shares as it will be a long while before monetary conditions actually become tight.

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