Global Economic Overview

Spring 2016

The world economy stumbled in 2015, amid weak aggregate demand, falling commodity prices and increasing economic volatility in major countries. The world GDP grew by 3.1% vs. 3.4% in 2014. In light of disappointing data, IMF has downgraded global GDP forecasts to 3.4% in 2016, the slowest expected annual growth in the last five years. The downgrade in the forecasts reflected a broad range of weaker economic data and increased markets volatility. It was widespread and apparent in both advanced and emerging economies. In advanced economies, a modest, but uneven recovery is expected, whilst in the EM, the slowdown and rebalancing of the world's second largest economy - China remains the key issue.

In summary, the main concerns for 2016 are:

✓ **China's transitioning economy and its influence on world growth prospects.**

Overcapacity, debt overhang and slowing growth are posing downside risks to China's economy and, indirectly, hitting economic activity of the EM nations and the rest of the world. This situation is exacerbated by still-weak dynamics in the EU and Japan, while growth in the US seems unable to shift into higher gear. China's weakening economic performance and possible currency devaluation heighten fears of a 'hard landing' which would weaken global growth. With an annual economic growth of 7.8% in the past five years the official data is likely to be upward biased. It compares with alternate metrics figure of 4% only. Moreover, the composite PMI index, as a leading measure of internal strength, slowed over the year and was in contraction territory in February. Therefore, although Beijing forecasts an annual 5year growth of 6.5%, we expect to see more cautious figure of 5.9%. In the short term weakness in China will result in spillovers to the world economies, whilst in the long term it poses a question on the integration of a financial powerhouse.

✓ **Depressed commodity prices to dampen near term inflation outlook.**

Commodity prices have fallen significantly since the beginning of 2015, with the oil price declining by more than one-third, its lowest level since 2003. While the drop in oil prices is helping to improve the external position of some countries through lower fuel prices it is also fanning deflationary pressures across the globe. So far headline inflation has broadly moved sideways in most countries. In the emerging market economies varied inflation developments reflected conflicting implications of weak

domestic demand and lower prices against the backdrop of variations in the currency movements over the year. However, with renewed declines in commodity prices and competitive currency devaluations, prices are likely to fall again.

✓ **De-synchronised monetary policy stance across world economies.**

As the prolonged weakness in oil prices continues to keep inflation low, many central banks in wealthier economies are expected to loosen monetary policy further. Weakening of the Chinese Yuan and the decision by the Bank of Japan to cut rates into negative territory in January highlights the tail risk of a currency war in 2016. Recently, most of the world's key central banks have expanded their stimulus programs and/or cut interest rates. Central banks in China, Japan and Europe continue to pump money into the system in the hope that the economy will benefit from the additional monetary stimulus and low interest rate environment. In contrast, the Federal Reserve of the United States has adopted a more cautious stance, but have paused its tightening cycle since the first rate rise in December 2015. Nonetheless, with the loosening in policy by the ECB announced at the end of last year, followed by a first Fed rate rise only two weeks later, we had decisive confirmation that monetary policy on both sides of the Atlantic could be on divergent paths. Many developed central banks have tried to raise policy rates since the global financial crisis, however none have been able to make that rate rise stick. If the US continue on their path to raise interest rates, this is likely to exacerbate emerging markets currency volatility, reignite slowdown in commodities markets and help precipitate a global slowdown.

✓ **Political uncertainty to overshadow business confidence, investment activity and growth.**

In 2016 we expect political decisions to play a key role in the Global economy. An escalation of ongoing geopolitical tensions in a number of regions will continue to affect confidence in capital markets, disrupt global trade and tourism flows. In Europe, the UK's June referendum poses the possibility of a Brexit that is raising fears of potential disintegration of the European bloc. The latest FT Brexit tracker reported 42% in favour of an exit. In the United States, the rise of disgruntled voters ahead of the 8th November elections is casting doubts about the future economic policies in the world's superpower and its strength, especially due to Donald Trump's recent popularity.

Global Risk Appetite (USD/JDY)

Source: Yahoo Finance

SUMMARY

Overall, despite the global economy remaining volatile, it is believed that the UK is relatively well placed to ride out the storm. It is often stated that some of the gloom on the world economy has been overdone. If we begin to see some stability in the Chinese Yuan, soothing comments from the US Federal Reserve and better growth figures in the coming months, the backdrop for markets should brighten. Therefore on balance, while there are a range of downside risks, there is also a good reason to suspect a cautious global growth in the coming years.

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