Global Outlook: Dangerous times!

Executive Summary

- The global economic outlook has worsened significantly. The latest data point to a slowdown in economic activity in the spring and summer. Our baseline forecast sees world GDP rising by 2.8% in 2011 and 3.1% in 2012 (at market exchange rates). There are significant risks to global growth coming from three different fronts: i) an escalation of the Eurozone debt crisis, ii) the possibility that the US falls back into recession, and iii) a hard landing in the emerging economies.

- The Eurozone debt crisis continues unabated. With apparently no political will to implement significant reforms in the Eurozone's structures that would contribute to a permanent solution to this crisis, there is a risk that policymakers are overtaken by financial markets. The risk of disorderly default is a real threat that could cut world GDP by around 3% by 2012 compared with our baseline forecast, with the Eurozone in recession and the US very close to it.

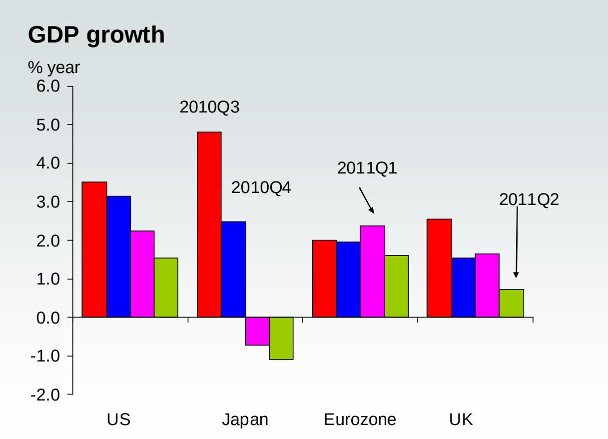
- Independent from developments in the Eurozone, the risk of recession in the US has increased in recent months. The weak labour market continues to weigh on households' spending. Furthermore, financial stress has taken its toll on business confidence. If the US economy slipped back into recession, we estimate that world growth next year would be just above 2%.

- Emerging economies face a series of challenges from different angles. While the risk of overheating has subsided, a hard landing in emerging markets could still take place in the context of weak global demand, coupled with a surge in risk aversion and a sharp correction in asset prices. But policymakers in emerging countries, unlike their peers in the Eurozone and the US, do have significant room to offset negative growth developments.

- On the upside, credible plans to cope with fiscal and financial troubles, coupled with continuing lower commodity prices, would enable cash-rich corporations to engage more actively in investment and hiring. This would enable advanced economies to lead the path to growth.

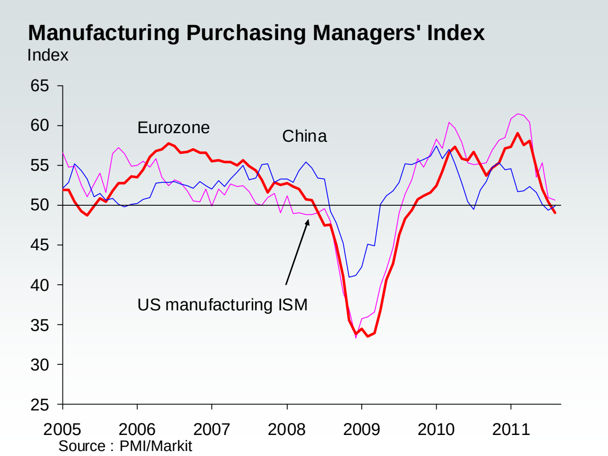
Global growth is losing momentum…

The latest data point to a loss of momentum across a wide range of countries following the post-crisis recovery in 2010. We estimate that world GDP growth (at market exchange rates) decreased from 4% year-on-year in 2010Q4 to 3.2% in 2011Q1 and further to 2.7% in Q2 on the back of a slowdown in economic activity in the advanced economies. The Eurozone and the US nearly stagnated in Q2, with growth at 0.2% and 0.3% quarter-on-quarter respectively. Growth was similarly weak in the UK, while Japan's GDP was down in the aftermath of the disasters that hit the country in March.



Source : Oxford Economics/Haver Analytics

And data available for Q3 show few signs of a rebound. The manufacturing ISM and PMIs in the US, Europe and China have fallen to or below the 50 threshold debt ceiling that separates expansion from contraction.

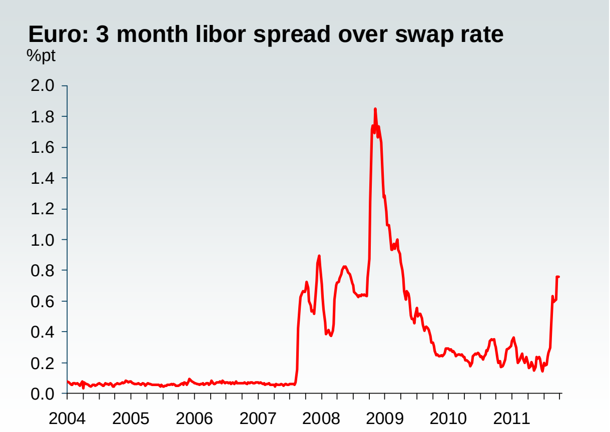


Source : PMI/Markit

In addition, August figures show that US unemployment continues to linger at 9.1% while net job creation has ground to zero. Elsewhere, the latest labour market data tells a similar story; in Europe and Japan unemployment has yet to recede.

… and financial stress is rising

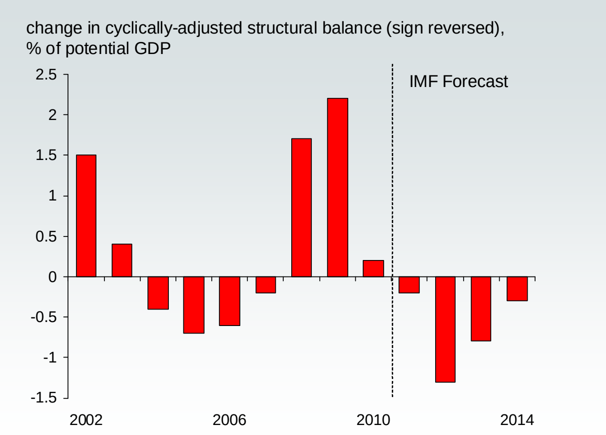
The evident slowdown in global economic activity, combined with a series of events (protracted negotiations on the US debt ceiling, the risk rating downgrade of Italian and US debt, rumours about French banks' ability to access funding and the Italian government's U–turn on a draft austerity package), have sent financial markets into a tailspin since July. By mid-September, share prices in the US were down almost 15% from their early July peak, while European stocks were down 25-30%. The sell-off has also hit financial markets in emerging economies; Brazil and Malaysia's equity markets fell by more 18% during August for example. And risk aversion increased across all instruments. For instance, the spread between BB and AAA corporate bond yields has increased by about 200 bps since mid-July. Stress is also visible in Eurozone interbank markets, with the spread between Euribor and overnight swap rates rising to around 80 basis points, compared to around 20-30 basis points earlier this year.



Source: Oxford Economics; Haver Analytics

Fiscal tightening across markets

One factor accounting for the slowdown in economic activity is the change in policy stance across most countries and regions. In particular, following the period of fiscal expansion that took place during the 2008/09 recession, fiscal policy was broadly neutral in 2010 and has turned restrictive this year. Fiscal tightening is particularly sharp in the UK and the peripheral Eurozone countries. But it is also taking place in core Eurozone countries and, to a lesser extent, in emerging markets. Brazil and Turkey for instance, have adopted measures to reduce the deficit by at least one full percentage point to 1.5% and 2.4% of GDP respectively by the end of 2012.

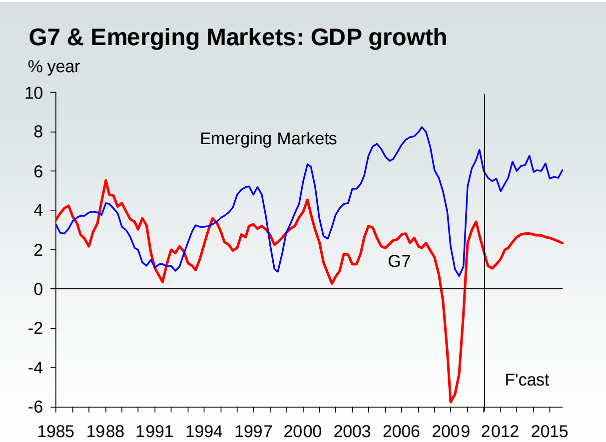


Source : Oxford Economics/Haver Analytics

Baseline forecast revised down

Overall, we have revised down our global growth forecast to 2.8% in 2011 and 3.1% in 2012 (at market exchange rates). Advanced economies are forecast to growth by 1.5% this year and 2.1% in 2012, while emerging markets growth is expected at just under 6% in both years.

Risks to this forecast are skewed to the downside, coming from three different fronts: i) an escalation of the Eurozone debt crisis, ii) the possibility that the US falls back into recession, and iii) a hard landing in the emerging economies.



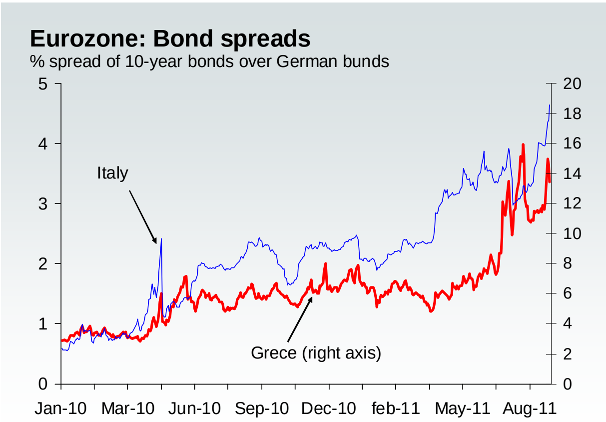
Source: Oxford Economics

i) Eurozone debt crisis unabated

We have long argued that the most likely scenario is that the Eurozone 'muddles through' the current debt crisis, avoiding messy defaults and remaining intact as a currency area. In particular, we have taken the view that even if debt defaults do take place, the weaker countries would engage in a very risky path by also leaving the Eurozone as this would result in major financial disruption. The stronger countries would also have a lot to lose in a very likely sharp appreciation of their currency that would wipe out previous, painful, competitiveness gains. Realising this, policy markers would take appropriate decisions to keep the Eurozone in its current form.

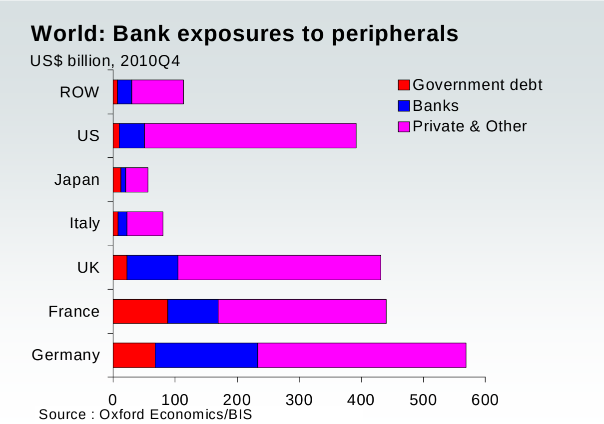
However, developments in recent months are raising doubts that policymakers will act quickly and effectively to resolve the crisis and head off the risk of worst-case outcomes such as a fracturing of the Eurozone. Risks lie with national and Eurozone-wide decisions. First, at the national level, there is a risk that the successive rounds of fiscal austerity become self-defeating. Austerity packages are already facing stiff opposition in Greece and Italy for instance. The combination of massive expenditure cuts and tax increases is putting significant pressure on business and households.

With no sign of improvement in economic conditions, governments in peripheral countries will find it increasingly difficult to implement the austerity measures. Commitment to redress public finances could also waver at the government level as hinted by the U-turn by Italy's Prime Minister attempting to water down the draft of the latest set of austerity measures. Fiscal targets are likely to be missed, fuelling pressure on bond markets and possibly triggering a negative spiral of ever higher bond yields, ever tighter fiscal policy and lower growth.



Source : Oxford Economics/Haver Analytics

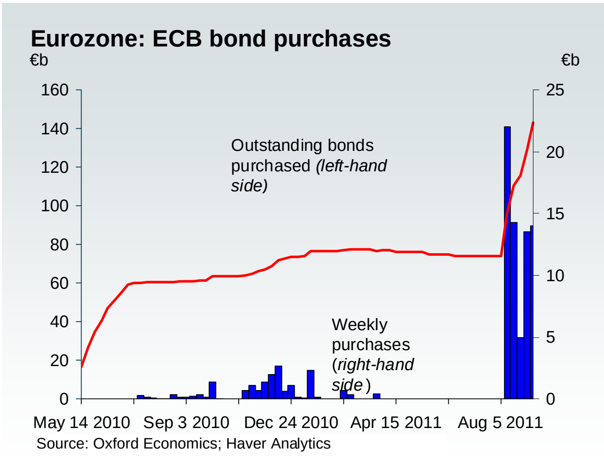
At the Eurozone level, political will to 'do what it takes' to effectively tackle the crisis seems to be lacking. Finland's insistence on getting collateral from Greece in exchange for its share of funding for the July bailout package is just one sign that a common view on shared responsibility to ensure the future of the Eurozone is still missing.



Furthermore, some of the tools available at the disposal of Eurozone policymakers have limited efficiency and adjusting them requires a consensus that currently does not exist. First, while the European Financial Stability Facility (EFSF) should be able to rescue one of the 'small' peripheral economies if needed, it cannot support Italy or Spain. At the moment, there is no agreement on extending the size of the EFSF to cope with an escalation of the crisis that would engulf Spain and Italy.

Overall, there is a significant risk that political or economic accidents tip the Eurozone into a less favourable path than our baseline forecast assumes. Disappointing fiscal developments or awkward communication from some Eurozone governments could make financial markets conclude that the current crisis will ever be brought under control. Greece would be pushed into a disorderly default that would quickly spread to other Eurozone countries. In addition, significant holdings of peripheral government debt by banks in core Eurozone countries imply that the whole region would quickly be drawn down to a much weaker growth path than assumed in our baseline forecast. Investor sentiment would slump, causing equity markets to do likewise. This, coupled with the loss of business and investor confidence, would drive the Eurozone into recession.

Policy-makers in the Eurozone are ill-prepared to cope with the fall-out from a disorderly default. A taxpayer bail out of banks and financial institutions, similar to that witnessed after the collapse of Lehman Brothers, would carry a hefty political cost – not to mention a massive financial burden. In terms of monetary policy, the ECB's bond buying programme can only be a stop gap measure. In the five weeks to 9 September, the ECB bought €68.8 billion worth of Eurozone bonds, more than it had bought since the start of this programme in May last year. But Italian and Spanish debt, which totals around €2.3 trillion, is larger than the ECB's total balance sheet. Expansion of the latter would, quite likely, be sterilised i.e. offset by sales of other (short-term) assets, given the ECB's reluctance to expand the monetary base. But even if the ECB could find enough short-term paper to sell, this could push up short-term borrowing cost, affecting regional growth.

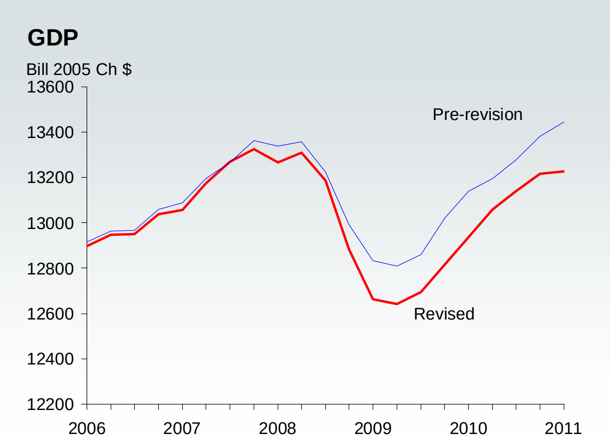


Given the size of the Eurozone economy, such a scenario would significantly affect growth in other parts of the world. Beside trade linkages, there would be a flight to low-risk assets (US dollar, the Swiss franc and German bonds), similar to what has been observed in recent weeks, although far more severe. The US dollar would likely appreciate which would exacerbate unresolved imbalances in the US.

We estimate that there is a 20% probability of disorderly default unfolding. The level of world GDP would be cut by 3% by 2012 compared with our baseline forecast, with the Eurozone in recession and the US very close to it.

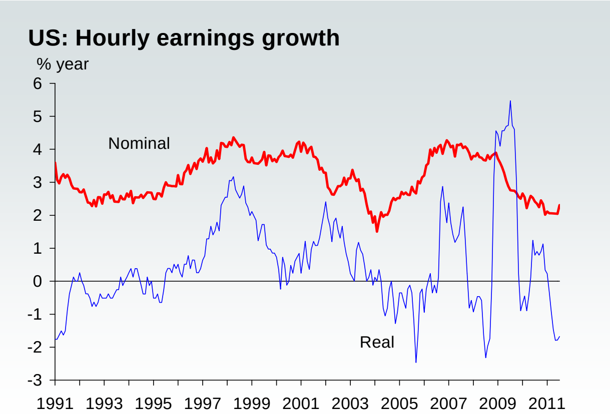
ii) US teetering on recession

Independent from developments in the Eurozone, the risk of recession in the US has increased in recent months.



Source: BEA/Haver Analytics

First of all, large revisions to historical data now show that the recession was worse than originally thought. More importantly, economic activity has picked up at a very moderate pace. As mentioned above, net job creation has come to a halt in recent weeks. Furthermore, households' purchasing power has been hit hard; nominal wage growth was 1.7% on the year in August, lagging well behind inflation.



Source: Haver Analytics

In addition, fiscal cuts have been biting. On average, Federal outlays shrank by 11% on an annual basis from May to July, and only recovered in August (although this was expected due to a sharp decline a year before). Also, the debate on the debt ceiling added to the uncertainty among businesses and consumers about the stance of future fiscal policy.

The upshot is that weak labour conditions, exacerbated by fiscal cuts, have taken their toll on consumer confidence, which plummeted in August to lowest level since April 2009.

If these conditions persist, and growth is too weak to induce a significant improvement of labour conditions, then households' consumer spending could be more subdued than we currently expect, tipping the US economy into recession. We estimate that there is a 15% probability to this scenario.

If GDP growth falls into negative territory, US policymakers' room for manoeuvre would be limited. In terms of fiscal policy, the political deadlock between Democrats and Republicans would cause any aid package to be delayed, at best, given the degree of polarisation and entrenchment of the two parties before a presidential election year.

In terms of monetary policy, the Fed would response with another wave of quantitative easing (QE). But, with the central bank having already tried a vast and wide-ranging an expansion of its balance sheet, the efficiency of yet more QE is in doubt. More QE would also put downward pressure on the US dollar which could drive commodity prices upwards in the short term.

The size of the US economy in the global context means a recession would have a significant impact on world growth. Overall, by 2012 world GDP would fall by more than 1% vis-à-vis our baseline scenario.

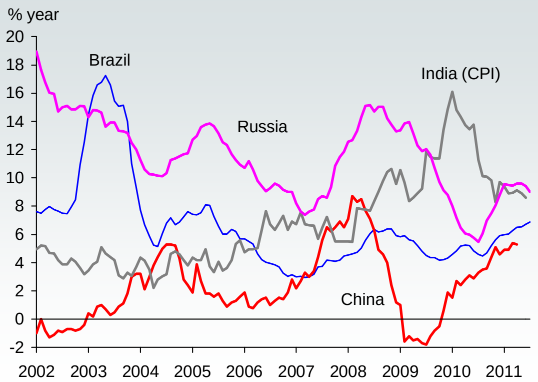
iii) Hard landing in emerging economies

So far emerging economies have performed well. However, there are a series of risks that could change that, deteriorating the global economic outlook.

The first of these risks comes from inflation rising beyond acceptable levels to monetary policy makers. Admittedly, inflation has eased in recent weeks but upside risks still exist, for example related to developments in commodity prices. A sudden deterioration of political stability in large oil-producing countries could cause commodity prices to rise again, which would unavoidably drive inflation upwards. A similar assumption can be made in case of a severe drought affecting the production of grains such as corn, wheat or soy beans. Given large weights for energy and food in emerging markets' consumer baskets, such developments would drive inflation up sharply in these countries.

When inflation was at the top of the agenda, central banks responded aggressively to increases in inflation across emerging markets. Since January 2010, the central banks of India and China have raised their reference rates by 325 bps and 125bps, respectively. Although Brazil and Russia's central banks have cut rates by 50bps as economic activity has slowed down in recent quarters, in Brazil the move was unexpected and came after the central bank had increased rates by 375bps during the previous 18 months. And, in many emerging markets, reserve requirements have been increased sharply as well. For instance, China has raised the reserve requirements for large banks by 600 basis points

BRICS: Consumer prices



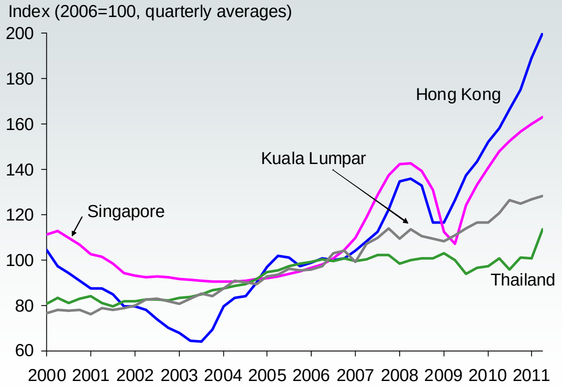
Source: Oxford Economics

With economies operating near or at capacity, the risk that commodity-driven inflation spills over onto increases in core inflation and wage growth persists. A surge in inflation would force an even more rapid tightening of monetary policy.

The second threat to emerging economies comes from subdued global demand; weaker than currently expected growth in advanced economies would put export-reliant companies in emerging markets under significant pressure. In addition, as global demand softens, a surge in risk aversion could reverse capital flows, drying up credit markets. This would hit some emerging markets such as Turkey, which are heavily reliant on external financing to fund large current account deficits.

Furthermore, the flight from risk could see a correction in asset prices with sharp falls in equity and property prices. Asian markets would be particularly affected as residential property prices have been raising steadily since the recession in 2009. Accordingly, investment in the Chinese construction sector could dry up, affecting employment and hence consumption.

Emerging Asia: Residential property prices

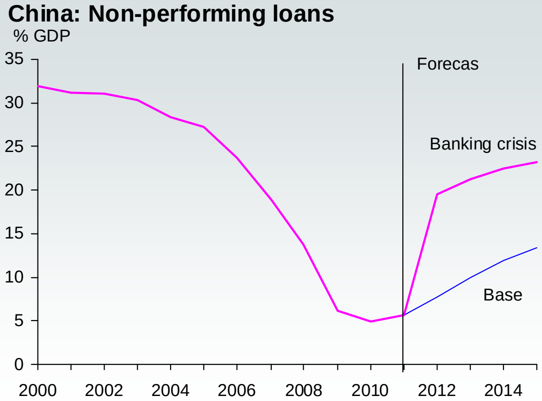


Source: Haver Analytics

Reduced revenues from abroad and weaker domestic demand could lead to a sharp increase in non-performing loans (NPLs), which would undermine banking systems. This is a risk for China in particular because of the scale of the credit stimulus implemented by the Chinese authorities during 2009 and 2010 that has raised concerns regarding the robustness of the banking sector. Accordingly, a surge in NPLs would deteriorate banks' balance sheets, constraining credit available for investment.

Such banking sector stress could lead Chinese GDP to expand by only 4.9% in 2012. Growth would be weaker in all global regions and we estimate that by 2012, world GDP would be nearly 2% below our baseline forecast.

China: Non-performing loans



Source : Oxford Economics

Of the downside risks discussed, we think that the probability of a Chinese or emerging market hard landing is lowest, around 10%. This is because policymakers in emerging markets (unlike their peers in advanced economies) would be in a position to offset some of the negative growth developments with looser fiscal and monetary policy.

But there is hope

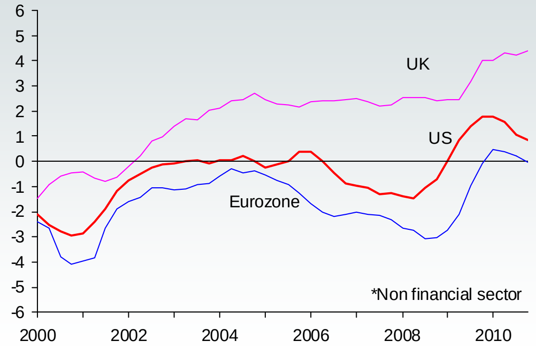
While the last four years have been disappointing in terms of growth and economic development, one positive change has been in businesses' cash balances that have risen to sizeable surpluses.

If tensions in the Middle East ease, allowing oil prices to continue to fall, and the fiscal and financial consolidation in advanced economies takes place successfully, business confidence could improve rapidly enabling firms to invest their reserves. Accordingly, growth would be driven by the G7 members with clear benefits spilling over to emerging markets.

We estimate that there is a 10% probability to this scenario, in which world GDP would surpass our baseline scenario by nearly 1.5% in 2012.

World: Corporate sector* financial balance

% of GDP, 4-quarter average



Source : Oxford Economics

Conclusion – Caution, sharp turn ahead!

After the recovery from the economic crisis caused by global financial turmoil, the world economy is threatened with another possible recession. In our view, global economic growth and stability face clear and present dangers from at least three fronts. The most worrying is the Eurozone debt crisis, an escalation of which could be triggered by policymakers not responding quickly and decisively enough to stem a disorderly default. Similarly, a US recession would dampen world growth. Like their European counterparts, US policymakers have used much of the arsenal at their disposal and would have limited policy options to contain a recession. Another source of downside risks lies in emerging markets and in particular China where a hard landing, possibly triggered by a stiff policy response to rising inflation, is a possibility. In these countries however, the authorities arguably have more tools at their disposal to offset negative growth developments.

We also continue to think that a corporate reawakening is possible but it depends on the ability and commitment of policy makers to deliver the reforms needed in order to restore business confidence. Companies that have been building up reserves could then lead the way to growth through investment.