Back to the Future – Expectations for Global Growth

Introduction

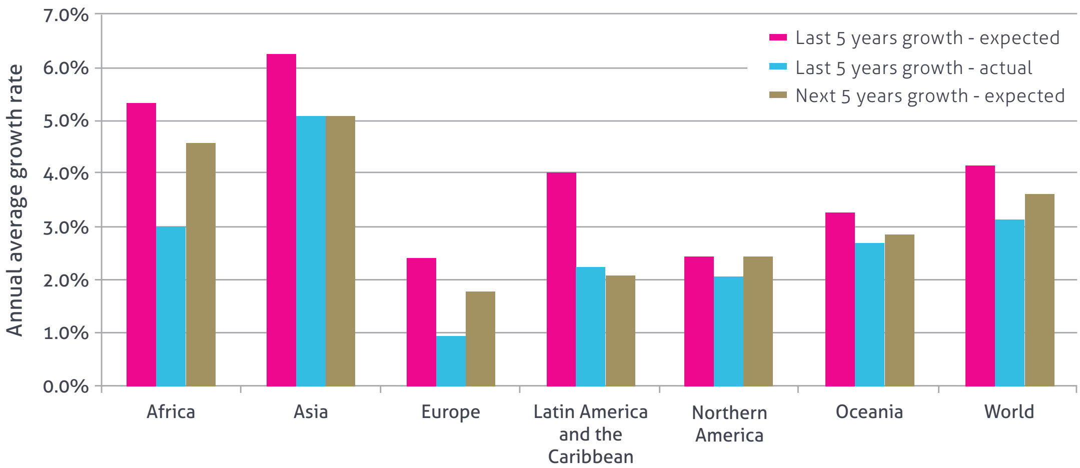
In April and October each year the IMF publish their World Economic Outlook (WEO). This is a country by country assessment of the world economy and its prospects for the next five years. Niels Bohr tells us that prediction is very difficult especially if it's about the future, so it is no surprise that the IMF's forecasts are often inaccurate. However, the IMF's forecasts are rarely controversial, which suggests that they are very close to consensus expectations: reviewing the IMF's forecast record tells us whether the world economy has performed as we all expected.

In the following we compare how the global economy has fared to the expectations in 2010 of the consensus (as defined above) and consider the performance of currency and bond markets in the light of this experience.

Growth has disappointed

In 2010 global growth expectations for the next five years were modest owing to the lingering effects of the Global Financial Crisis (GFC). However as Figure 1 shows, global growth over those five years disappointed even those modest expectations. Moreover, growth in each major region was below expectations and the forecasts for the next five years are less optimistic than those in 2010.

Figure 1: Regional and Global Growth: 2010 to 2015



Source: Cameron Hume Limited calculations using IMF WEO database releases of April 2010 and 2016

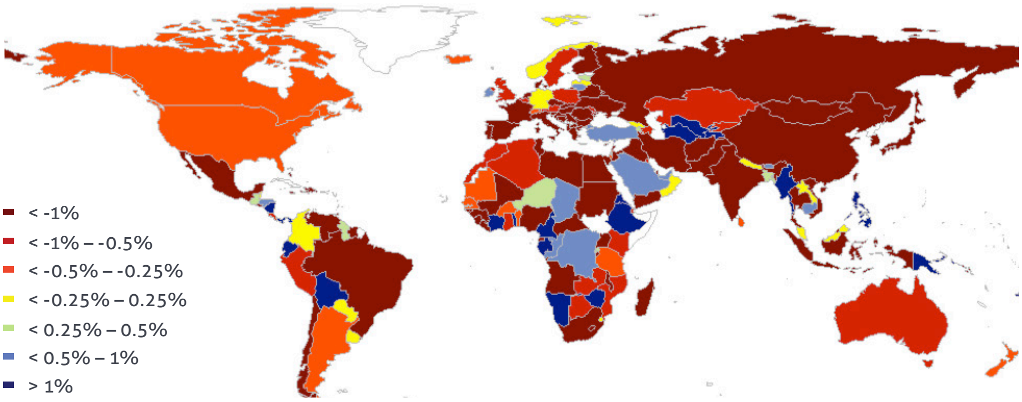
- The reasons for the disappointing outcome are easily identified:
- the lingering effects of the GFC, which have been greater than predicted;
- the Eurozone's pedestrian and poorly coordinated response to its fiscal and banking crises has undermined the recovery; and
- the shift of the Chinese economy from manufacturing and investment to consumption led growth bringing an end the commodity boom. (This has had a direct impact on growth in some economies and in others has revealed misallocated resources and poor governance.)

Figure 2 shows the extent of the growth disappointment country by country. The most prominent features are the pattern of growth in the Eurozone and the growth disappointment in Brazil, Russia, India and China, the BRIC countries.

Ireland, the Baltic States and Germany have had a notably better experience than the rest of the Eurozone. In the case of the Baltic States they started with their own currencies, which took some of the burden of dealing with the GFC, but they were also quick to reform and reduce indebtedness. Ireland had a particularly severe banking crisis, but dealt with it decisively, reducing government spending, public sector wages and benefits and recapitalising the banking sector. Germany's growth has been in line with expectations and this may have shaped its attitude to the causes and remedies of the Eurozone crisis. Germany has been unsympathetic to the pleas of other Eurozone members, being a consistent advocate of fiscal austerity and economic reform, and has been slow to accept the ECB's various stimulus measures. The very different experience of Germany from the other Eurozone members is one reason why policy coordination has been so poor.

China's growth has slowed materially as it has sought to change the emphasis of its growth policies from infrastructure investment and industrialisation to consumption. The difficulties of this were under-estimated and the implications for commodity exporters missed. The sharp fall in commodity prices has exposed weaknesses in the Russian and Brazilian economies and resulted in poor growth, weak currencies, and deteriorating government finances. The case of India is one of hope deferred: the central bank, the Reserve Bank of India, under Raghuram Rajan has been intent on reducing inflation and the government has been seeking to reduce both its budget deficit and the country's current account deficit. In the meantime, other nations with high dependence on non-oil commodities such as such as Canada, Australia, South Africa, Chile and Peru have also seen growth disappoint.

Figure 2: Difference between actual and expected annual average growth: 2010-2015

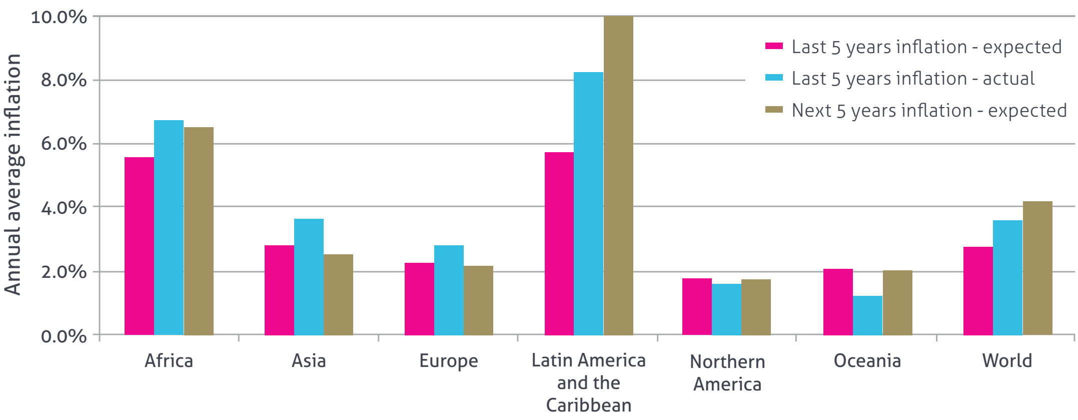


Source: Cameron Hume Limited calculations using IMF WEO database releases of April 2010 and 2016

Inflation has exceeded expectations

Although growth has been less strong than expected, over the last five years global inflation has been higher than forecast. Figure 3 shows that global inflation has been roughly 0.75% points higherthan expected in 2010. This broad figure masks very different country by country experiences. Most of the countries described as 'Advanced' by the IMF had modestly lower than expected inflation, which given the already low expectations was a cause for concern. However, inflation has been materially higher than expected in emerging markets.

Figure 3: Regional and Global Inflation: 2010 to 2015



Source: Cameron Hume Limited calculations using IMF WEO database releases of April 2010 and 2016.

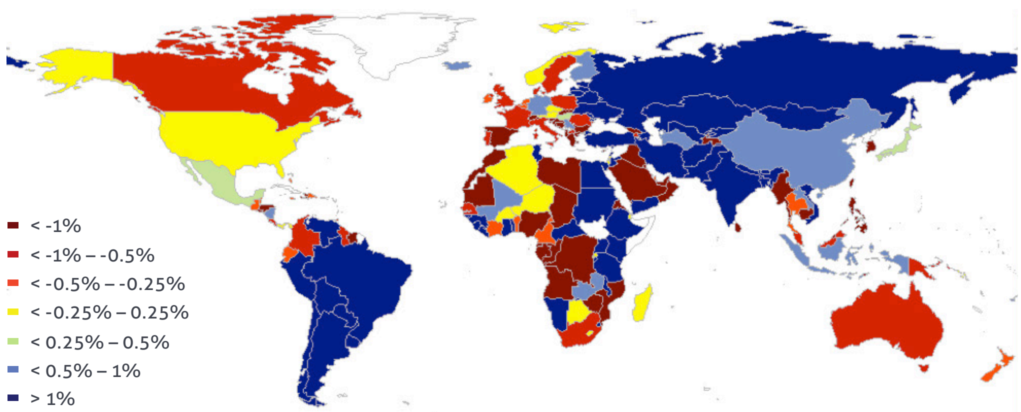
N.B. the chart has been truncated at 10%: owing to exceptionally high expected inflation in Venezuela the average annual inflation rate for Latin America and the Caribbean is 22%.

The reasons for inflation being lower than expected are generally the same as those that produced the weaker than expected growth: the lingering effects of the GFC and the fiscal and banking crises in the Eurozone. Where inflation has been higher than expected it has generally been because of poor economic governance: monetary or fiscal authorities seeking to avoid the short term consequences of falling commodity prices.

Figure 4 shows the extent of the difference between actual and expected inflation country by country. The most prominent features are the inflation overshoot in Latin America, Asia and Eastern Europe and the weak inflation in the rest of Europe and North America.

In the Eurozone, it is again notable that Germany's inflation experience has been very different from the rest of the Eurozone, which once again may have shaped its attitude to the causes and remedies of the Eurozone crisis.

Figure 4: Difference between actual and expected average inflation: 2010-2015

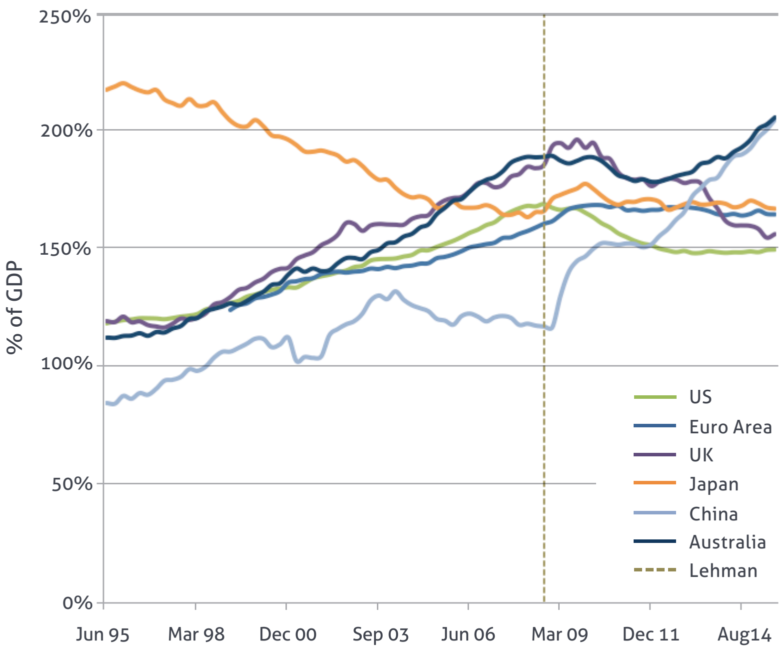


Source: Cameron Hume Limited calculations using IMF WEO database releases of April 2010 and 2016

Private sector credit trends

One of the contributory causes of the GFC is thought to have been the increase in private sector credit in the preceding years. It was believed recovery from the crisis would require the private sector to reduce leverage and that this would mean that post crisis growth would be slower, as we saw in the aftermath of the Japanese bust of the late 1980s. Figure 5 shows the trend of Private Sector Non-Financial Credit growth over the last twenty years for selected countries.

Figure 5: Private Sector Non-Financial Credit Trends



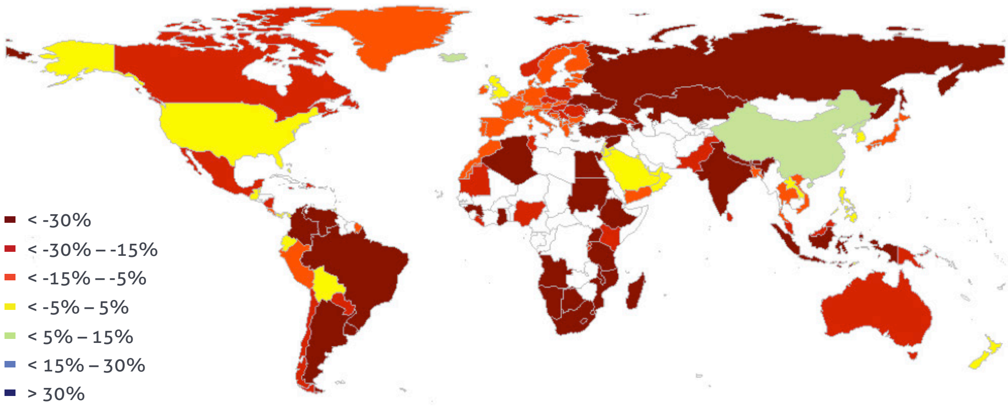
Source: BIS – credit issued to the Private sector non-financial sectors: households and non-financial companies

The Japanese private sector has been forgoing investment and consumption in order to save and reduce indebtedness for much of the last twenty years. They have been successful, but at a material cost in terms of weak output and possibly only because the Japanese government has been doing the opposite. The response of the UK and the US private sectors to the GFC fits the pattern and was broadly as expected, which was one of the reasons growth was expected to be weak. In contrast private sector indebtedness in the Eurozone has neither increased nor contracted, which is symptomatic of the region's malaise. The Eurozone has been in a limbo created by indecisive policy, weak banks and tight fiscal policy. The result, somewhat ironically, is that private sector indebtedness in the Eurozone is now greater than the consumerist economies of the UK and US.

China responded to the GFC with a fiscal expansion and a substantial increase in credit growth. This was spectacularly successful and China has been the engine of the global economy since the GFC, but Figure 5 shows why the growth in private sector credit is now a concern. The pace of credit expansion has been so rapid that lending standards must be poor and the reliance on credit growth to drive growth exposes a vulnerability should credit growth stall. Finally, it is interesting to see the recent trends in Australia where private sector indebtedness is comparable to that of China and credit growth is as rapid.

So global growth has disappointed, raising concerns about the efficacy of the monetary policies of the big economies and exposing weaknesses in the policies and governance of the BRICs in which we had pinned our hopes for global growth. As a consequence there are signs that investors have sought safe havens. When this happens the currencies that tend to do well are the US dollar, the Swiss franc and the Japanese yen. Figure 6 shows the change in the dollar based exchange rates of most countries since 2010. While the strength of the dollar, those currencies pegged to it and the Swiss franc is notable, the yen has been weak. It is likely that this is because of the scale of quantitative easing under Abenomics, but it is interesting that this year the yen is once again strengthening.

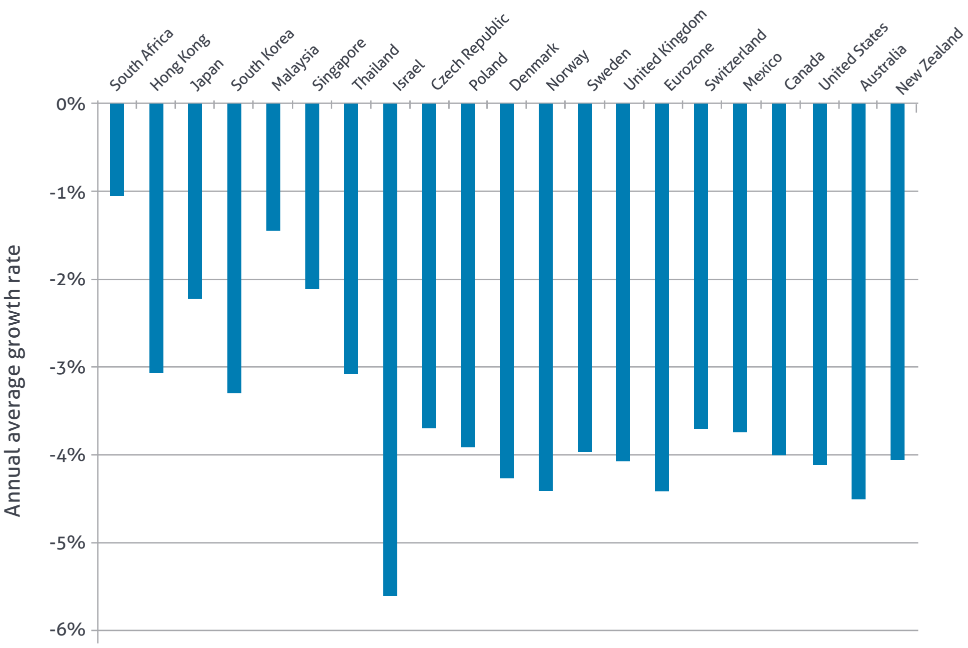
Figure 6: Currency movements relative to US dollar April 2010 – April 2015



Source: Cameron Hume Limited and Northern Trust

The dollar has not been consistently strong throughout the period, but it is likely that its strength is attributable to confidence in its relatively robust economic performance. Elsewhere, the desire for a safe haven is most obvious in bond yields. Figure 7 shows the difference between current five year yields and the five year rate five years forward in April 2011, for swaps in currencies where the government has an investment grade rating. The striking feature is how similar the declines have been: Swiss rates and Mexican rates have fallen by an equal amount, despite very different economic performances and monetary policies; and the yields payable in the Eurozone and those in Australia have fallen by the same amount despite rates being negative in the Eurozone and 2% in Australia.

Figure 7: Difference between current 5 year yields and expectations in 2011



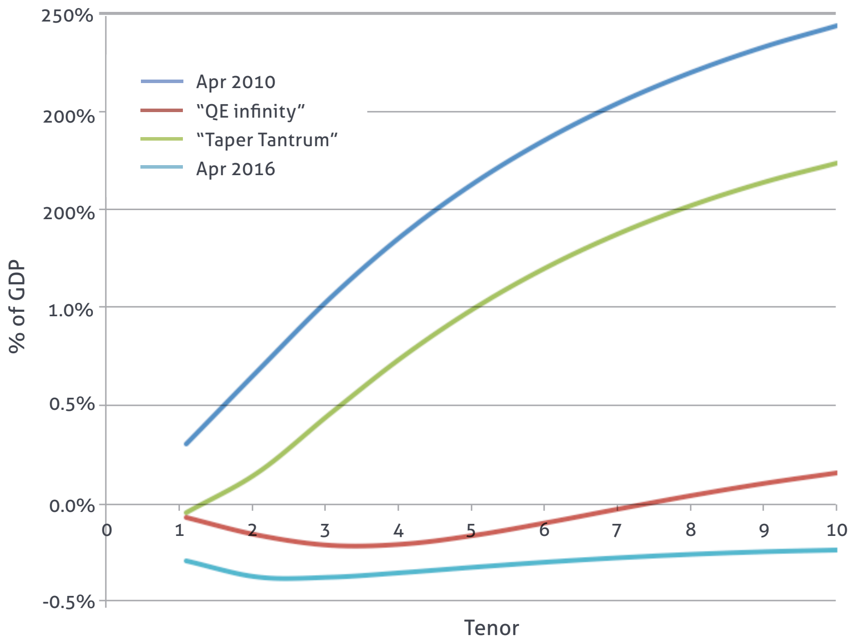
Source: Cameron Hume Limited. Chart shows the difference between 5 year swap rates on 6th April 2016 and 5 year swap rates 5 years forward rates on 6th April 2011.

Disappointing growth, inflation below target and pessimism about future prospects have encouraged investors to seek safety in bonds, regardless of whether the central bank has been engaged in QE. The New York Federal Reserve produces an estimate of the compensation investors require for holding, say, a 10 year bond rather than making a series of investments in 1 month bonds for 10 years. Their estimates at various times since April 2010 are shown in Figure 8.

In April 2010 the term premium for a 10 year bond was close to 2.5%. This meant that at that time the 4% yield on a 10 year bond consisted of an average interest rate expectation of 1.5% and a risk premium of 2.5%. In the final quarter of 2012 the Federal Reserve announced its third Quantitative Easing programme, QE3, in which it gave an undertaking that it would continue to buy bonds until it achieved its objectives. As this was an open-ended commitment, it became known as "QE infinity". As intended, this caused term premia to collapse, encouraging investors to invest in other, riskier assets.

As unemployment in the US began to fall, the Federal Reserve was sufficiently confident about prospects to indicate that they might consider reducing the scale of their asset purchases. This precipitated the 'Taper tantrum' in which yields rose and the US curve steepened. Today, the Federal Reserve has raised rates once and is talking about further rises in 2016. The bond market however, has the same risk premia today as it did in 2012 when the Federal Reserve announced QE infinity.

Figure 8:



Source: Federal Reserve Bank of New York, based on paper by Tobias Adrian, Richard Crump and Emanuel Moench – ACM model

Summary

Over the last five years consensus expectations for global growth, as reflected in the IMF's predictions, have proved too optimistic. Today, the outlook for the next five years is thought to be less bright than we thought in 2010. Part of the reason for this has been the slow healing after the GFC, but at least as important have been the scale of the unforeseen problems in the Eurozone and the weaknesses exposed in the economic models of the BRIC countries. Given this, it is unsurprising that safe haven currencies and bonds have appreciated.

Just as consensus expectations proved to be inaccurate in 2010, today's expectations are likely to be wrong over the next five years. On that basis alone, we should expect the term premia in bond markets to be greater and yet yield curves are much flatter today than they were in April 2010. This seems to us to be an over pessimistic assessment of the global economy and US economy in particular. Yield curves ought to be steeper than they are.

Generally, the differing economic performances and monetary policies of countries creates opportunities for active management and we expect the next five years to offer as many opportunities for global bond managers as the last five.

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