‘Subdued Demand’ Meets Perpetual Frustration

The title of the International Monetary Fund’s latest outlook, “Subdued Demand,” emphasized the IMF’s continued disappointment with the global economy’s performance. In July, the fund lowered its 2016 growth forecast for the sixth time in two years, essentially abandoning expectations of a growth acceleration this year. In fact, the summer update projected global growth slowing to just 3.1% in 2016, even below the prior year’s rate, to the weakest pace since the global recession in 2009. Advanced world growth forecasts slipped again in October, entirely due to disappointing first-half growth in the US. On a more positive note, the IMF lifted emerging market growth forecasts slightly on the back of further improving expectations in Russia and India.

The lack of improvement in global growth expectations reflects the prevailing demand concerns. The local currency MSCI All Country equity index was virtually unchanged in September. UK and Chinese stocks were up strongly, while Japan and Andean markets posted bigger losses. The US dollar lost ground against both the major developed and emerging market currencies. If currency markets are affected by the approaching US presidential election, early October’s strong rebound suggests a Clinton win would be positive for the dollar, possibly because it would make a Federal Reserve rate hike in December or January more likely.

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Volatile US growth and politics cloud the Fed’s policy outlook

The third-quarter growth trend was more volatile than expected. After a strong start to the quarter, consumer spending and industrial output stalled in August. Yet, significant improvements in consumer confidence and business sentiment suggest that growth momentum picked up again at the end of the summer. Meanwhile, the latest jobs report affirmed the weaker pace of job creation this year, which seems mainly the result of diminished supply as the economy reaches full employment. Still, companies are not willing to offer higher wages to fill the record open positions.

Overall, the state of the US economy supports those on the Federal Open Market Committee wanting to take another step in the direction of policy normalization. In fact, we may be starting to see a shift back toward investment spending to improve productivity of existing workers, which would help push US GDP growth back up toward 3%. However, the Fed’s next meeting will occur just six days before the elections, and politics is the last thing monetary policymakers want to get involved in. So the Fed is left with the December meeting. A Hillary Clinton win would make it easier for the Fed to raise rates. Given a Donald Trump win, we expect the Fed to hold for a while longer amid greater uncertainty.

Colombia’s “peace dividend” requires more work

As we’ve learned with Brexit, never underestimate political risk. In Colombia, the government’s peace agreement with the Revolutionary Armed Forces of Colombia (FARC) promised significant positive economic gains, only to be rejected by voters. Colombian equity markets seem unaffected, but the peso traded notably weaker in early October. A resumption of the armed conflict seems unlikely; rather, the Santos administration will have to renegotiate a deal that’s more acceptable to the public. The Norwegian Nobel Committee awarded this year’s Nobel Peace Prize to Colombian President Juan Manuel Santos despite the referendum setback as a gesture of encouragement to continue to search for peace.

PineBridge Investments Global Macro Forecasts

	2016	2017
Global GDP Growth	2.9%	3.4%
US	1.6%	2.5%
China	6.6%	6.4%
Eurozone	1.6%	1.6%
Japan	0.8%	1.4%
Emerging Markets	3.9%	4.5%

Source: PineBridge Investments forecasts, as of 13 October 2016.

ECB taper talk is premature

Earlier this month a Bloomberg story indicated the European Central Bank (ECB) was contemplating how to eventually wind down its current €80 billion-per-month asset purchase program. German government bond yields rose about 20 basis points in response – not much of a “taper tantrum.”

The program is set to expire in March, but given the heightened political risk next year, we expect a formal extension in one of the upcoming meetings through at least the end of next summer. Only then will tapering really become an issue.

However, the growing realization that central banks have reached the limits of what they can do should start to reduce the attention policy meetings have attracted in the past few years. Political risk is increasing in Europe, with elections scheduled in Germany, France, possibly Spain, and the Netherlands next year, and Italy looming in 2018. The thought of new and untested governments in some (or all) of the biggest eurozone member states is a scary prospect. Brexit, the rise of anti-EU parties, and the refugee crisis pose the greatest challenge yet to the future of the eurozone.

Brexit details are coming into focus in the UK

At the annual Conservative party conference, UK Prime Minister Theresa May reaffirmed the party's commitment to a clean break with the European Union. She poured cold water on dreams of retaining open access to the single market, while regaining control over immigration and regulation, and set out a more realistic UK negotiating position. The devil will be in the details, since we haven't seen what the true cost of giving up market access will be. She also committed to triggering Article 50 before the end of March 2017, which suggests the UK would leave the EU in the spring of 2019. While more clarity is a good thing, the higher odds of a hard Brexit have put further pressure on the British pound, which fell below $1.22 in early October.

The Bank of Japan managed to steepen the yield curve

The BOJ's new policy framework is starting to show the desired effect. The decision to prevent 10-year government bond yields from rising above 0%, while at the same time shifting bond purchases away from the long end toward shorter-dated assets, has led to the desired steepening of Japan's sovereign yield curve. The BOJ apparently understands that QE and negative interest rates are starting to do more harm than good and that banks need a steeper yield curve to prevent further erosion of profitability. Meanwhile, Japan's growth momentum remains weak. Purchasing managers' indexes show manufacturing back in expansion territory for the first time in seven months, while the service sector index fell to its lowest level in more than two years. All that while inflation is slipping back deeper into deflation.

A case for optimism

Like the IMF, we believe the underlying growth potential of the world economy is higher than the 3.3% average in the past five years. If the number of growth-depressing shocks – such as the collapse in commodity prices – can be reduced, global economic growth should trend back toward a more buoyant 3.5%-4% range, something we expect to see in the next few years.