Global Economic Outlook - July 2016

August 3, 2016

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In late June, the United Kingdom elected to initiate the process of leaving the European Union. In the immediate aftermath of the referendum, pessimists were predicting significant collateral damage to global markets and global economic growth. Some were even predicting a chain of separations that would redraw the global economic order.

For now, those dire outcomes appear unlikely. In fact, a tour through the world's major economies finds few ill effects from Brexit. Even the United Kingdom might work through the coming year constructively, given support from the Bank of England and a long timeline for any changes to trade and immigration terms.

UNITED STATES

The U.S. economy is projected to grow close to its potential capacity during the rest of 2016 and continue at a similar pace during 2017. Consumer spending is the main driver of economic growth, followed by positive contributions from the housing and government sectors. Exports and business spending are on the watch list. A moderate hiring momentum should prevail and hourly earnings are likely to accelerate as labor market conditions tighten. Inflation is expected to move closer to 2.0% as economic activity registers further improvements.

The Brexit vote initiated a rally in interest rates, which have been mostly retraced. The proportion of U.S. exports to the United Kingdom is small, limiting the overall Brexit impact on the U.S. economy. For now, the Federal Reserve is in a watch and wait mode, although it is expected to consider raising the policy rate later in the year after economic data confirm that underlying fundamentals are solid. The latest Fed message confirms that external risks have diminished, which enhances expectations of policy tightening.

EUROZONE

The eurozone appears to have been fairly resilient to the Brexit vote thus far. The sell-off in the aftermath was similar to that seen at the start of 2016, when concerns around China were high. Encouragingly, consumer demand remained strong during that period, and it looks to be the same now.

German business morale fell only slightly in July compared to June, dropping by 0.5 points, and consumer confidence stayed broadly flat. Confidence in Italy, retail sales in Spain and economic sentiment across the eurozone all increased in July, suggesting the impact of the U.K. vote has been contained. Ireland's leading export destination in the EU is the United Kingdom, and as a result the Irish economy may take a growth hit in the coming years. German car manufacturers are also concerned. However, lending to companies and households continues to increase at a reasonable clip, suggesting the European Central Bank's (ECB's) quantitative easing program is contributing positively to growth. Concerns around the Italian banking sector will remain and could be exacerbated by a negative outcome in the autumn constitutional referendum. We still expect eurozone growth of 1.5% this year and, recognizing the ongoing challenges the bloc faces, a slightly slower expansion next year of 1.4%.

Unemployment will continue its downward trend, but at a slower pace, hitting 10.2% this year and 9.7% in 2017. Trends will continue to differ by country. Inflation pressures are still muted given the low price of oil, and prices are likely to rise only 0.4% this year and 1.6% in 2017. Because we think the ECB will maintain its current policy stance, we are leaving rate forecasts unchanged from April. We anticipate some tweaks to the unconventional monetary policy measures currently in place.

UNITED KINGDOM

The electorate delivered a shock on June 23, voting by a margin of 52% to 48% to leave the EU. The process to leave will be long and arduous, and the uncertainty will hurt the economy. It is too early to identify all the potential effects, but we certainly need to amend our April forecasts.

GDP growth in the first half of the year was strong. The expansion in the second quarter was 0.6% (at the first estimate), translating to year-over-year growth of 2.2%. Since the Brexit vote, survey-based indicators have taken a dive, suggesting the second half of 2016 will look much different. Consumer confidence, retail sales and the services purchasing manager index (PMI) all fell in July. Additionally, it is widely expected that investment levels will fall. While we predict the period of lower investment after Brexit to last longer than the one after the financial crash, the downturn should be less severe. The plunge in the value of sterling may provide some respite and net trade may start to contribute positively to growth. Due to the strong performance in the first half of the year, we expect growth of 1.5% in 2016, falling back to 0.8% in 2017 as uncertainty starts to take more of a toll.

While the number of job advertisements posted online appears to be down, in other areas, employers are stating an intention to maintain unchanged staffing levels. Thus, we expect a small reversal in the downward trend of unemployment. The unemployment rate is likely to hit 5.3% this year and 5.5% in 2017. Inflation will pick up slightly more quickly as a result of a weaker value of sterling leading to higher import costs and eventually higher food costs. We expect a 0.8% inflation rate in 2016 and 1.9% in 2017.

The Bank of England left its rates on hold in July, but is likely to cut rates in August. Due to concerns about the impact on banks and mortgage lenders, a further cut may not be forthcoming; another round of asset purchases is more probable. Thus, we expect the policy rate to be 0.25% for 2016 and 2017.

JAPAN

Japanese industrial production and household consumption have contracted this year while business confidence continues to falter. Prices remain in the red, and the Bank of Japan (BOJ) is far from meeting its inflation target of 2% annual inflation.

Recently announced fiscal stimulus is expected to boost Japan's GDP by only 1%, that too spread over several years. The BOJ disappointed the markets in its latest policy announcement by changing only the composition of its annual monetary base expansion and not increasing the overall quantum of asset purchase. It further dashed expectations of deeper negative interest rates or so-called "helicopter money." However, problems such as Japan's aging population, weak (and at times negative) productivity growth and a rigid labor market cannot be addressed by monetary policy.

Looking ahead, we expect GDP growth to quicken slightly to 0.5% in 2017, reflecting the impact of a moderate fiscal stimulus and higher wage pressure due to labor market tightening. The possibility of a more substantial than expected fiscal stimulus presents upside risk, while a stronger yen presents the key downside risk.

CHINA

A combination of strong public sector capital spending, real estate investment and household consumption was able to cushion against the secular decline in corporate investment, keeping GDP expansion steady at 6.7% in the second quarter. The government has signaled that as part of economic rebalancing, policy stimulus, particularly credit expansion and public investment, may be muted in the near future.

We expect that moderation in public infrastructure spending will highlight the sharp deceleration in private sector investment. Furthermore, the real estate sector is expected to have peaked due to macroprudential policy measures taken earlier this year. Overall, receding policy support, debt overhang and spare capacity will put downward pressure on economic expansion. Therefore, we expect Chinese GDP growth to slow to close to 6.4%.

Despite the talk of rebalancing, officials could be tempted to use fiscal stimulus, especially government consumption, to meet growth targets. Furthermore, the central bank is likely to allow the yuan to fall further when the Federal Reserve finally tightens policy. Neither of these measures will help with the necessary rebalancing of the economy.

Global Economic Forecast – July 2016

	2014	2015	2016F	2017F
United States				
Real GDP (% change)	2.4	2.4	1.5	2.1
Unemployment Rate (%)	6.2	5.3	4.8	4.6
Inflation (%)	1.6	0.1	1.2	2.1
Policy Rate, EOP (%)	0.13	0.38	0.43	1.18
Eurozone				
Real GDP (% change)	0.9	1.6	1.5	1.4
Unemployment Rate (%)	11.6	10.9	10.2	9.7
Inflation (%)	0.4	0.0	0.4	1.6
Policy Rate, EOP (%)	0.25	0.05	0.00	0.00
Deposit Rate, EOP (%)	0.00	-0.30	-0.40	-0.40
United Kingdom				
Real GDP (% change)	3.1	2.3	1.5	0.8
Unemployment Rate (%)	6.1	5.3	5.3	5.5
Inflation (%)	1.5	0.0	0.8	1.9
Policy Rate, EOP (%)	0.50	0.50	0.25	0.25
Japan				
Real GDP (% change)	-0.1	0.6	0.4	0.5
Unemployment Rate (%)	3.6	3.4	3.2	3.2
Inflation (%)	2.8	0.8	0.0	0.5
Policy Rate, EOP (%)	0.10	0.10	-0.10	-0.10
China				
Real GDP (% change)	7.3	6.9	6.5	6.4
Unemployment Rate (%)	4.1	4.0	4.1	4.1
Inflation (%)	2.1	1.5	2.0	2.0
Policy Rate, EOP (%)	2.0	1.5	1.75	1.75

Exchange rates (EOP)	Jun-2016	Sep-2016F	Dec-2016F	Mar-2017F
EUR/USD	1.10	1.12	1.10	1.08
GBP/USD	1.32	1.30	1.33	1.30
USD/JPY	103.2	103.0	105.0	108.0
USD/CNY	6.64	6.70	6.80	6.90