GLOBAL MARKET OUTLOOK MID-YEAR 2017

Macro Insights

Growth Surprises in Europe, China and Japan Upstage US

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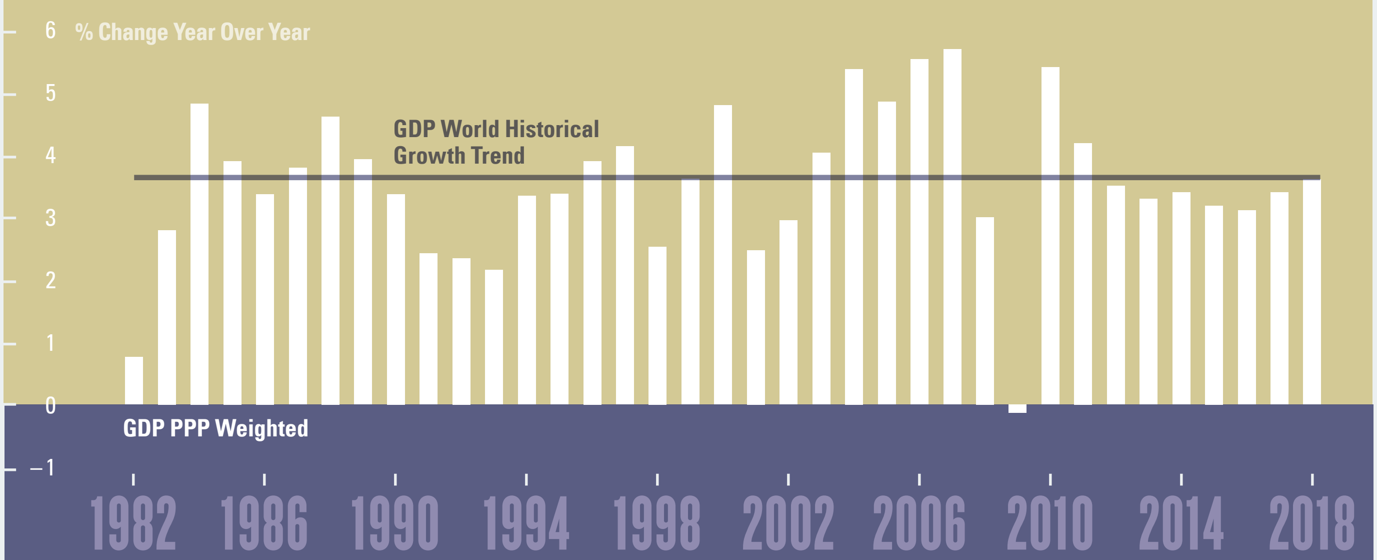
Global economic conditions are evolving slightly better than we anticipated at the end of last year. Overall global growth is now projected to accelerate to 3.4% in 2017 (up from 3.2%), which would be the best performance since 2014. The International Monetary Fund (IMF) has also slightly raised its forecast, projecting a 3.5% expansion in April, compared to 3.4% last October.

Incoming data suggest gross domestic product (GDP) will expand somewhat faster than currently projected in China, Japan, and the Eurozone. China started 2017 stronger than anticipated, with GDP rising 6.9% year over year. And while we do not expect this pace to continue, it seems likely that growth will now exceed the 6.5% target, thanks largely to policy-induced demand. Japan also surprised to the upside, with GDP rising 2.2% (annualized) in the first quarter. Growth will almost certainly slow over the coming quarters, but will now probably exceed 1.0% this year. Meanwhile, the Eurozone maintained its momentum into the first quarter, with GDP rising another 0.5%. Even if growth slows slightly from here, it could now match last year's 1.8% pace. In both Japan and the Eurozone, improvements in manufacturing and exports have largely driven stronger growth.

Figure 1: World GDP Growth Slated to Improve for First Time Since 2014



Source: Macroband, SSGA Economics, Oxford Economics. Updated as of June 13, 2017.

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Figure 2: Measures of Global Real Activity Have Improved

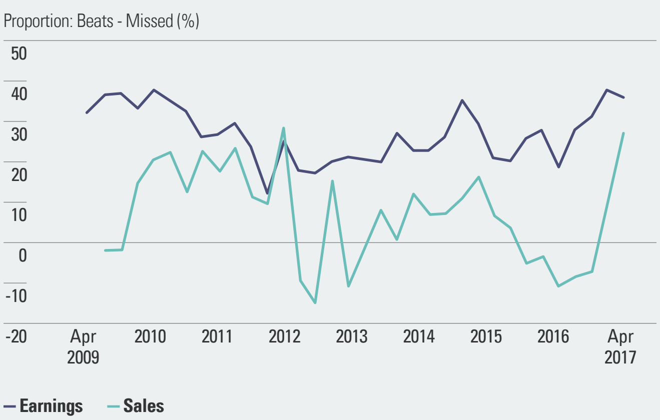
Source: Macroband, SSGA Economics, Netherlands Bureau for Economic Policy Analysis (CPB). Updated as of June 13, 2017.

Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index.

Mixed Signals in the US

In the list of upside growth surprises, the US is conspicuous by its absence, given another weak first quarter. But that might be caused by residual seasonality, which will be offset by a subsequent rebound. In any event, the weakness in the first quarter largely reflected an unsustainable slowdown in consumer spending which seems likely to reverse in short order. Indeed, the Atlanta Fed's Nowcast is currently forecasting GDP to rise 4.1% (annualized) in the second quarter.

Figure 3: Strong US Sales and Earnings



Source: State Street Global Markets, Bloomberg.

At the same time there also signs of improvement in two sectors that have lagged so far in this recovery: housing and business investment. Residential construction surged 13.7% (annualized) in the first quarter, following a 9.6% advance in the fourth. And while the last two reports have been somewhat disappointing, there is some indication that housing starts — the key drivers of residential investment—are threatening to break above their recent 1.1–1.2 million unit range. Meanwhile, business fixed investment jumped 9.4% (annualized) in the first quarter to record its fourth consecutive gain. Moreover, core manufacturing shipments — a coincident indicator of capital spending—has turned up as the rebound and subsequent stabilization of oil prices has rekindled exploration in the mining sector. Core manufacturing orders—a leading indicator of capital spending — continue to rise, suggesting that this recovery has further to go. Earnings are rebounding after hitting a soft patch from 2015 through the first half of 2016. The first quarter was a particularly strong earnings season, with year-over-year earnings growth touching its highest since 2011. Roughly 70% of companies in the S&P 500 beat earnings estimates.

While oil prices have been slightly weaker than expected, the threat of broad-based deflation has continued to recede, making central bankers more optimistic, particularly in Europe. However, inflation (especially core inflation) will remain comfortably below target in both the Eurozone and Japan for the second half. Moreover, nowhere is there any real sign of an acceleration of wage inflation — a critical component of a sustained pickup in overall inflation.

The Fed has picked up the pace of monetary tightening and following its June rate hike, now seems poised to hike about every other meeting unless the data scream "stop." The ECB slowed the pace of asset purchases in April, and will taper further over the course of 2018, before starting to raise administrative rates in 2019. Given the lack of progress on inflation, we do not expect any moves from the Bank of Japan.

Reflationistas vs Cautionistas

Debate continues around whether the better-than-expected signs of growth outside the US could lead to a genuine global reflation. We put ourselves in the more cautious camp. A Trump fiscal stimulus package provides the potential for a pickup in the world's largest economy. But global reflation likely depends more on emerging markets than advanced economies, even with the caveat that a newly empowered President Xi may turn his attention to debt rather than job creation in China. Indeed, we have long argued that the optimal scenario for China is not growth acceleration, which would only be possible at the expense of future stability. The better course would be well-managed deceleration that aligns with the economy's diminishing growth potential and occurs in tandem with structural reforms and regulatory changes aimed at ensuring the sustainability of that growth.

This is what appears to be on the table in China. Of course, it helps if such difficult adjustments are pursued deliberately rather than being forced through in a disorderly manner. We are therefore reassured that concerns of an antagonistic US-China relationship haven't materialized; although we feel that Commerce Secretary Wilbur Ross' recent assertion that "US-China relationships are now hitting a new high especially in trade" is something of an exaggeration. However, the relationship has evolved more smoothly than it might, giving the Chinese leadership time to pursue needed reforms at a pace that does not threaten stability.

For other emerging markets, it is not the improvement in growth per se (minimal so far) that makes us more hopeful, but the noticeable qualitative improvement of macroeconomic policies. Admittedly, our more upbeat view on Russia partly reflects expectations of higher oil prices (despite recent volatility) and also the gradual healing in domestic demand as inflation retreats and monetary policy settings become more supportive for growth. There is no sign of genuine reform or move toward diversification that the economy desperately needs, making it the one BRIC where the upturn appears mostly cyclical in nature and hence vulnerable to erosion over time.

By contrast, a new bankruptcy law and recent agriculture reforms in India carry considerable potential for boosting productivity. While the demonetization move will have some negative consequences on growth in the shorter term, it stands to facilitate broader policy goals in the longer term, including broadening the tax base ahead of the upcoming GST implementation.

Brazil's progress in the first half had been encouraging, before President Temer's graft scandal put both the country's ambitious reforms and the underlying economic improvement at risk. The Brazilian government has made considerable progress with fiscal management. While the most contentious reforms on pensions will probably end up being diluted, it would still represent the most comprehensive reform in decades and an important step towards long-term fiscal sustainability.

The Brazilian economy has shown signs of improvement over the last year and a half. Inflation has fallen from over 10.0% in early 2016 to just 4.1% in April, allowing the Central Bank to cut its policy rate from 14.50% to 11.25% over the same period. Moreover, GDP is projected to increase in the first quarter of this year following eight consecutive declines.

So while we see some small steps in the right direction for the global economy, we think it is too early to make a strong case for global reflation.

Glossary

CPB World Trade Monitor Total Index
A monthly time series that aggregates and summarizes data on both international trade and industrial production.

CPB World Trade Monitor, Industrial Production Excluding Construction Index
A monthly time series that aggregates and summarizes data on industrial production excluding construction data.

Core inflation
An inflation measure which excludes transitory or temporary price volatility as in the case of some commodities such as food items, energy products etc.

Goods and Services Tax (GST)
A value added tax that will be implemented in India later in 2017.

Gross Domestic Product (GDP)
The monetary value of all the finished goods and services produced within a country's borders in a specific time period.

GDP PPP Weighted
Gross domestic product converted to international dollars using purchasing power parity rates.

International Monetary Fund (IMF)
An international organization created for the purpose of standardizing global financial relations and exchange rates. The IMF generally monitors the global economy, and its core goal is to economically strengthen its member countries.

Nowcast
A forecasting model that provides an official estimate of the growth rate of real gross domestic product (GDP) prior to its release.

Purchasing Power Parity (PPP)
An economic theory that compares different countries' currencies through a market "basket of goods" approach. According to this concept, two currencies are in equilibrium or at par when a market basket of goods (taking into account the exchange rate) is priced the same in both countries.

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