Ibbotson Associates Economic Commentary

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Summary

I expect a modest acceleration of global economic growth in 2014. World Gross Domestic Product (GDP) might advance 3.5%-4% this year, up from 3% in 2013. This improvement will be most noticeable among advanced economies. Four factors are behind this acceleration: (1) moderate energy prices, as the shale oil and gas boom expand supply and China's slowdown holds back demand; (2) a reduction in the pace of fiscal consolidation; (3) supportive monetary policy; and (4) waning of the deleveraging process in the private sector.

By region, the eurozone will probably consolidate its expansion, coming out of the 2012-2013 recession, but I do not expect annualized GDP gains to exceed 2%. Japan's growth could be more volatile than the eurozone's, but still strong overall in 2014. GDP should register a solid advance in the first quarter and lower gains thereafter, as the consumption tax is raised in April. Finally, in the U.S. I expect output to grow at 2.5%-3%, up from the 2% pace of 2013. I expect consumer spending to be the main driver of growth, as housing and equity prices reach new highs, and in spite of modest job creation.

The cyclical upswing in advanced economies will be in any case quite moderate, as it stands against a long-term context of lower growth. Slow productivity gains and stagnating populations continue to reduce the growth rate of potential GDP.

Inflation will probably remain low, allowing for a continuation of ultra-loose monetary policy in all four major currencies. There is scope for further stimulus by the European Central Bank and the Bank of Japan, while the Federal Reserve is likely to gradually reduce the pace of asset purchases. Barring any negative surprises, the Fed's quantitative easing program will probably be terminated in 2015, whereas short-term interest rates will continue to be pegged near zero for at least six months beyond that.

The outlook for emerging market (EM) economies in 2014 is more challenging and heterogeneous. A handful of countries with large current account deficits and high external debt are vulnerable to capital outflows. Turkey tops my list of risky markets. Whenever turbulence rises in one of those markets this year, most EM's will experience swings in exchange rates and equity prices, as negative sentiment (unfairly) engulfs most countries. The actual reduction of the Fed's asset purchases might be less disruptive than the taper talk of mid-2013, which triggered a sell-off of EM assets. I believe that the gradual and predictable tapering will allow for a smooth adjustment of asset prices.

China is a big concern, due to its large size and the gravity of its imbalances. Bad debt, rampant speculation and the unregulated shadow financial system could precipitate a financial crisis. Alternatively, Chinese authorities might be able to reign in credit growth and engineer a gradual reduction of investment growth. I certainly hope for the second outcome. But one thing I have little doubt about is, as China deleverages one way or another, GDP growth over the next five years will be substantially lower than the consensus forecast.

United States

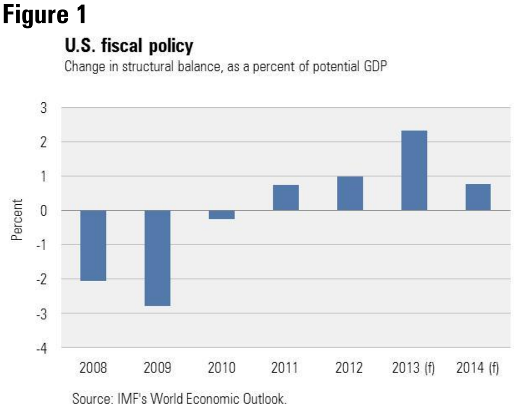
I expect real gross domestic product (GDP) to grow somewhat faster in 2014 (2.5%-3%) than it did in 2013 (about 2%). This modest uptick will be supported by an easing of fiscal austerity, expansionary monetary policy, continued improvement of credit growth and of general financial conditions, and elevated valuations in the equity and housing markets.

In the fourth quarter of 2013 the purchasing manager indexes suggest that output growth probably declined a little from a surprising 4.1% (annualized) in Q3. The first quarter of 2014 will be little affected by the extremely cold weather, barring new storms. The main effect will be a temporary shift across spending categories, away from, say, leisure and construction and towards energy and weather-related goods. The extreme conditions may also bring about a temporary decline in economic activity, followed by a compensating mini-surge, in the weeks following the cold spell. Even the headline payrolls number for January may not be greatly affected, as the weather had improved during the reference week used by the BLS survey.

For 2014 as a whole I believe that there will be a reduction in fiscal drag. In the first few years of the current economic cycle the fiscal deficit ballooned. From 2009 to 2013, the urge to cut the public deficit led to reductions in discretionary spending and tax hikes. The fiscal deficit declined rapidly, from 13% to a projected 5.8% in 2013, according to the International Monetary Fund (IMF). Fiscal tightening has contributed to keeping economic growth under 2%. Under current law the fiscal drag will diminish rapidly, as no new expenditure cuts or tax increases are to happen. The pace of fiscal consolidation will slow by 1.1 percentage points relative to 2013, according to data from the IMF (see **Figure 1**).

Democrats and Republicans still need to reach a compromise to keep the government open and lift the ceiling in early 2014. The experiences from 2011 and 2013 tell us that such common-sense legislation should not be taken from granted. Those episodes, however, ignited a negative political reaction, so I expect a swift debate and agreement in Congress.

Figure 1



Business investment has advanced at a moderate rate over the past few months. In the medium term the main determinants of capital expenditures are positive: input costs are subdued, interest rates are low, cash flows are high and stable, balance sheets in the non-financial sector are in good shape, and short-term fiscal policy is a little less uncertain than it was last year. One negative is the slow growth of bank loans to businesses, but it is possible that that is a reflection of weak demand in the past, not of a tight supply of credit.

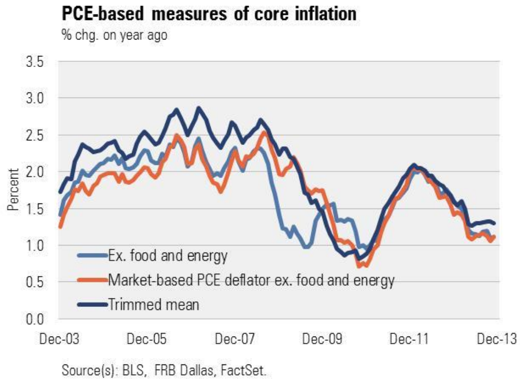
Given my expected pick-up in growth, both at home and abroad, and the outlook for subdued commodity price inflation, especially energy, higher profit margins are possible. However, there are risks to the downside. Margins are already at long-term highs, regardless of how one measures them. Corporate profit margins have exhibited mean-reversion over the business cycle for decades, and I do not expect that pattern to disappear. Eventually wage growth will catch up with sales growth, eroding margins. It is highly uncertain, I admit, whether that "eventually" will come as early in 2014.

Residential construction should also power stronger growth. Residential investment as a percent of GDP, housing starts, and new home sales were all up in 2013, but are still near the historical minimum. The current pace of construction is too slow to house newly formed households, compensate for depreciation, and meet the demand for second homes. Total housing starts will probably be around 1.1 million, up from around 940k in 2013. The threat to this improvement is that mortgage interest rates –which I expect, given the Fed's tapering—is not matched by a meaningful improvement in the job market.

Regarding employment, my GDP growth expectation has historically been matched by an average payroll increase of 200k to 250k per month. I believe unemployment will decline over the year, but modestly: job creation will stabilize the labor force participation rate, which had been falling till now, and hold back the decline of the jobless rate. All things considered, then, the unemployment rate could end 2014 near 6%.

Both headline and core inflation have been declining lately. Most measures of the inflation rate are clearly below the Fed's 2% target (see **Figure 2**). The improvement in economic activity during 2013 will push core inflation a little higher, particularly in late 2014 or in 2015, given the typical lags between economic activity and inflation. In any case, I do not expect a major surge, given where wage growth and inflation expectations are.

Figure 2



In 2014 I expect a relatively dovish stance by the Fed. The risks of doing too much, in the eyes of the Federal Open Market Committee (FOMC), seem to outweigh the risks of doing too little. Plus, Janet Yellen believes that aggressive monetary policy can help the U.S. reach the goal of full employment faster. She has also stated that the Fed's 6.5% threshold for unemployment should not be an automatic trigger of tighter monetary policy. I expect, then, a gradual tapering out of Quantitative Easing (QE). A reduction of $10 billion worth of purchases at each FOMC meeting is a reasonable expectation. Such pace would essentially terminate the program by the end of the year.

My view is that the weight of QE on bond yields has already been lifted now that the timing and pace of the taper seems clear. There is room for even higher yields in 2014 if economic growth and inflation rise, as I expect them to do. And I expect yields will rise even higher when the Fed changes its forward guidance, sometime in 2015, and stops declaring that it expects zero short-term rates for an extended period of time.

The policies of the Fed over the last four years have reduced the value of the dollar vis-à-vis other major currencies, in spite of aggressive easing by the central banks in the other three major currencies. Seeing that neither the Fed nor the Bank of England are likely to ease further, I expect the pound-dollar exchange rate to move sideways in the short term. The European Central Bank (ECB) and the Bank of Japan (BoJ), on the other hand, have room for more easing, allowing for appreciation of the greenback. Relative to emerging market, floating currencies, I think that generally the dollar should gain value in 2014.

Beyond the cyclical upswing, which I expect to continue for at least another year or two, the long-term outlook is dominated by a structural slowdown. The slow rise of the working-age population and stagnant productivity gains will make it difficult for the U.S. to grow faster than 2% over the next 20 years.

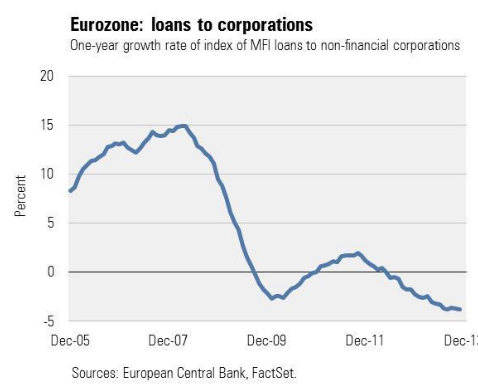
Eurozone

Real GDP rose by 0.4% in Q3 (annualized), following a 1.2% advance in Q2. Survey data (PMI and confidence) for Q4 point to a small acceleration in Q4. Output is expected to recover at a slow pace, in the 1% to 2% range, supported by accommodative monetary policy and mild energy price inflation. Fiscal consolidation in the periphery, one of the headwinds for growth in the area, will proceed at a slower pace than in 2013. Deleveraging of the private sector, however, is still far from completed. The unemployment rate will not fall significantly from the current 12%, as output growth remains sluggish and corporations reduce their debt levels.

The core inflation rate slid to 0.7% as of December, the lowest ever for the eurozone. The ECB is worried that this disinflation turns into outright deflation, which would raise the real value of public and private debt. Deflation would also delay the recovery by discouraging spending. The bank, in any case, expects price pressures to remain subdued over the medium term. I think, then, that the ECB's will maintain its guidance that interest rates will remain at present levels (0.25%) or lower for an extended period. That extended period covers, in my opinion, the entire year, as both headline and core inflation are expected to remain well below the central bank's target.

Annual growth of aggregate money (M3) remained at 1.5% in November, supported mainly by the increase in the net external asset position of banks. The growth rate of loans to the private sector is still low. The growth of loans to households stood at 0.3%, essentially unchanged from early 2013. The rate of change of loans to non-financial corporations was a negative 3.1%, highlighting the active deleveraging still occurring in that sector (see **Figure 3**).

Figure 3



The euro is trading at $1.36 as of the writing of this commentary, a big appreciation from the $1.22 in the dark days of the summer of 2012. Over the next couple of quarters the exchange rate will be more sensitive to news about economic growth than about monetary policy. The eurozone's recovery is still wobbly, and France is taking longer than the rest to shake off the recession. In the latter part of 2014 monetary policy will become more relevant to the exchange rate, as the Fed possibly starts nuancing its forward guidance, but the ECB probably stays on course. My central scenario calls for an initial further appreciation of the European currency, bringing it north of $1.40 or even $1.45, followed by a stabilization or slight depreciation.

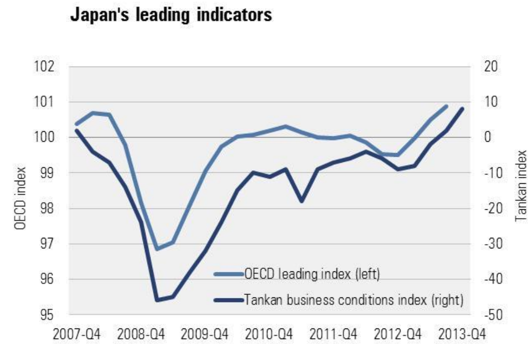
The long-term outlook is still clouded by the difficulties of forcing a common currency onto a disparate economic area. From Germany's perspective, the euro is undervalued; for the periphery's, it is overvalued. Since the internal exchange rate is fixed, the adjustment is done via wages: the labor cost in the periphery must decline, or that in Germany increase. Given the distribution of power within the area, the adjustment is largely being pushed on to the periphery. Because nominal wages are rigid on the downside, the adjustment takes longer and partly takes place through the level of employment. Persistent unemployment and political resentment are the visible consequences.

In my opinion, in the future Europe will experience convulsions similar to those of 2011-2012. Europe's economic institutions are still inadequate to defend itself from a financial crisis, especially if the torpedoes are directed to Italy or France. The supra-national quality of the currency clashes with the deeply national nature of politics, the government-banks symbioses, and a fragmented labor market. Another crisis is thus very likely. But I find it impossible to predict whether the next tumult will happen in 2014, in 2015 or beyond. The catalysts in 2014 could be a political crisis in Italy or Belgium, another restructuring of Greece's debt, or a faltering of the cyclical upturn.

Japan

Economic output has consolidated a rebound, after the brief contraction experienced in mid-2012. Over the four quarters to 2013:Q3 real GDP rose 2.4%. Survey data from Q4 forebodes an acceleration to an annual rate of 2.5%-3%. Suggesting even faster growth in early 2014, both the Organisation for Economic Co-operation and Development's (OECD) leading index and the Tankan business sentiment survey are at multiple-month maximums (see **Figure 4**). In April, however, the consumption tax hike will probably reduce consumption growth and temper the pace of overall GDP growth.

Figure 4



Sources: OECD, Bank of Japan, FactSet.

Prices are also advancing at solid rates after decades of deflation: 1.6% for the all-item index in November, and 1.2% excluding fresh foods. Rising inflation expectations should feed the reflationary process for the next few months.

The yen, which had been overvalued since at least 2008, has depreciated 35% since the end of 2011. There is room for further depreciation, as I expect the Bank of Japan (BoJ) to keep buying bonds apace during the year, while the Fed starts tapering. Breaking the barrier of Y110/$ is within reach, from the current Y105/$, and an exchange rate higher than Y120/$ is feasible in 2014.

The impetus behind Japan's turnaround comes mainly from the regime shift at the BoJ. Under a new governor in early 2013, the BoJ committed to doubling its holdings of government bonds and to more than doubling the average maturity of those holdings. The policy has led to buying 7.5 trillion yen worth of bonds every month, almost as much as the Fed's purchases in an economy a little more than a third the size of the U.S. The first objective of Abenomics –to beat deflation—has been a success. However, other accomplishments (to revive growth and to reduce the fiscal deficit) will probably prove short lived.

On the growth front, the main challenge is demographic. The population of working age is falling by 0.7% per year, so to achieve even modest GDP growth of 2%, output per worker would have to rise at a 2.7% pace. No advanced economy has experienced that kind of productivity growth in 20 years. In fact, trend output per worker has been increasing by less than 1.2% (at purchasing power parity) in virtually all advanced economies since 1990. Moreover, given that Japan's capital and technology are comparable to those of the richest countries, room for catch-up growth is limited. The Japan Center for Economic Research, for instance, is projecting economic growth near 1% through 2025.

Tokyo's fiscal and structural policies will not help beyond the short term. The main measures under implementation – raising the consumption tax, putting downward pressure on the currency, repressing interest rates, restraining wage growth—will restrain consumption. They will also fail to raise domestic investment, because the expected returns on capital are lower than in other parts of Asia. Perhaps without realizing so, the success of those policies depends on the trade surplus. But Japan's rising surplus is the rest of the world's rising deficit, and herein lies the problem: none of the main economic areas in the world (U.S., China, eurozone) is likely to see a shrinking of their external balance.

Without fast growth, lowering the debt-to-GDP ratio will be a challenge. Moreover, if the current account surplus does not grow, as I expect, and without a shift in incomes from corporate profits to households, the government deficit cannot be eliminated. Japan's failure to boost wage growth also jeopardizes the 2% price stability target.

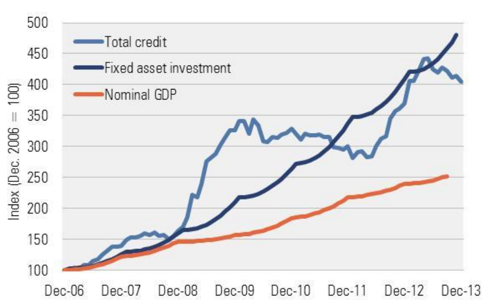
My expectation, then, is that Japan's revival will prove temporary. GDP will grow faster than trend for the next 4-8 quarters. In the medium term, however, I expect a return to sub-1% growth. Deflation will be defeated in the short term, but a long-term 2% inflation rate seems far-fetched.

Emerging market economies

In the years since the 2008 financial crisis **China** has posted impressive growth in GDP in spite of a lackluster global recovery. The country managed to do this by creating an investment boom, which in turn was powered by a surge in credit (see **Figure 5**). Total debt, private and public, rose from 125% of GDP in 2008 to 215% in 2012. Corporations alone have racked up debt worth 111% of GDP.

Figure 5

China: credit, investment, and output



Sources: People's Bank of China, National Bureau of Statistics, FactSet.

A lot of that capital has been misallocated. China has built more ports, railways, smelting plants and residential complexes than it should have, given its productivity level. Because those projects will not deliver significant returns for a long time, if ever, bad debt is piling up. The balance sheets of Chinese banks, in particular, are laden with dubious assets.

The official reported rate of non-performing loans (NPL) is less than 1%, which belies the actual quality of bank assets. Financial institutions can use all kinds of maneuvers to inflate profits and dress up their balance sheets. The upshot is that balance sheets, especially those of mid-sized banks, are increasingly opaque, and the groundwork for a bank run has been laid out.

The financial system may be reaching a breaking point. Twice in 2013 the interbank interest rate spiked above 10% when the central bank initially provided less funds than the wholesale loan market initially expected. Each time the liquidity crisis could have set off a domino of defaults, resulting in a systemic solvency crisis. Both times the central bank saved the day, pouring more money into the system, and allowing the economy to keep investing, borrowing, re-financing and accumulating bad debt. China is unable to stop this merry go-round.

Stories of financial excess seldom have a happy ending, as Carmen Reinhart and Kenneth Rogoff documented extensively in their book "This Time is Different." It is hard to characterize the end of an episode of financial excess, because so much depends on how debt was accumulated in the first place. A financial crisis, in particular, may or may not occur, depending on monetary and fiscal responses by policymakers. But at a very minimum history suggests that China's economic growth should decline sharply as the economy starts mopping up the excess debt, whether a hard landing happens or not. A deleveraging China would not generate output growth higher than 4%, much below "consensus" forecasts of 6%-7% over the next five years.

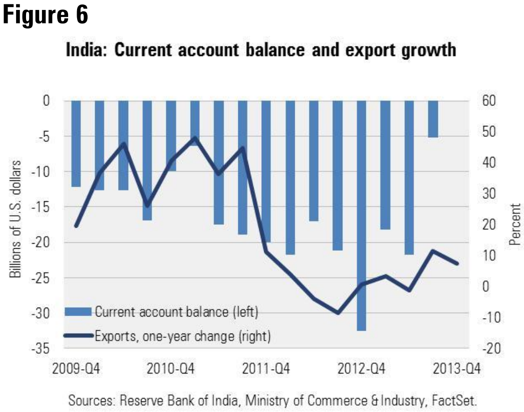
The first decade of the 21st century was also a period of exceptional growth for **Latin America**. The region's GDP growth rate was about twice the long-run average. The main drivers of this bonanza were high commodity prices and foreign capital inflows. Macroeconomic policies were sound enough to allow growth and contain inflation. Rising income per capita was accompanied by a reduction in poverty rates and the blossoming of the middle class.

Since 2011, however, the region has cooled off. Economic activity in commodity-importing countries, especially China, slowed down and commodity prices leveled off. In 2013 the mere suggestion of a Fed taper prompted a reversal of capital inflows and raised the cost of capital. Countries with a sizable current account deficit –for instance, Brazil, Peru, and Colombia-- could soon experience a correction in the rate of growth of investment, consumption, and public spending. Given their levels of external debt and foreign exchange, I do not expect a crisis, at least not imminently. Others, which were already in a precarious external position –Argentina, Venezuela—are already in crisis mode.

Growth in **southeast Asia** is expected to rise slightly in 2014, but the risks are on the downside. Political tensions in Thailand will probably take their toll in the short term. Commodity exporters such as Indonesia and Malaysia will be adversely affected by the lukewarm outlook for commodities and China's slowdown. In Indonesia, where private consumption represents a larger share of total expenditure than in other countries in the region, the recent tightening of monetary policy should be a headwind in 2014. The typhoon in the Philippines undermined growth in the latter part of 2013 and probably in early 2014 as well, but reconstruction activity should power a rebound by mid-2014.

India's GDP growth rate accelerated an annual pace of 4.4% in Q2 to 4.8% in Q3. It is early, however, to call a bottoming out. The Markit composite PMI index in Q4 was only marginally higher than in Q3. The business optimism index was roughly flat between the two quarters. The decline of industrial production accelerated in October and November. Both consumption and investment are growing slowly. Exports, on the other hand, have accelerated, bringing about a narrowing of the current account deficit (see **Figure 6**). I think that India's slowdown is mostly structural, and I am skeptical about forecasts that put 2014 growth above 5%. Inflation continues to accelerate, probably in response to the recent depreciation of the rupee. The exchange rate has not stabilized. Barring a repeat of 2013's currency crisis, inflation should decline by mid-2014.

Figure 6

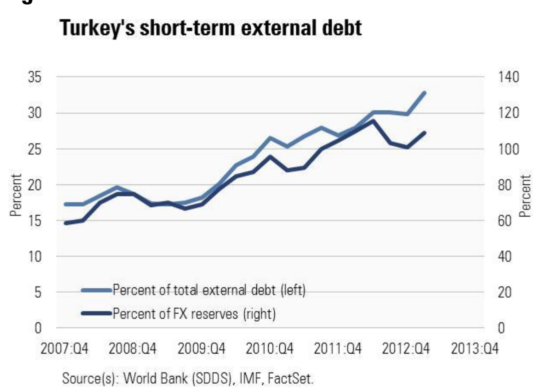


Sources: Reserve Bank of India, Ministry of Commerce & Industry, FactSet.

The announcement in mid-May that the Federal Reserve might start reducing asset purchases triggered massive outflows of capital from emerging markets. Since then the outlook for the Fed's medium-term monetary policy has become a lot clearer, and financial tensions in EMs have receded. Nonetheless, countries with large current account deficits and large levels of external debt are still vulnerable to capital outflows.

Turkey is the lone leader of the risk league—other than Venezuela and Argentina, which are arguably already in crisis. Over the past decade Turkey has enjoyed political stability and output growth of 5% per annum on average. Unfortunately, in that period the period also developed a key vulnerability: borrowing in foreign currency. In early 2013, short-term external debt exceed the entire stock of foreign exchange reserves (see **Figure 7**). Most of those liabilities correspond to the corporate sector. If creditors lose confidence in Turkey, a solvency crisis would easily ensue.

Figure 7



Source(s): World Bank (SDDS), IMF, FactSet.

Catalysts for such crises are varied, and not always financial in nature. In Turkey a recent corruption scandal might just do the trick. In recent weeks it has been revealed that several high-level officials, top businessmen and mayors were involved in extensive graft. Large bribes supposedly were received in the process of developing real estate projects in Istanbul and other major cities. Since the news, the lira has plunged by 10%, on top of the depreciation already suffered during 2013. Turkey's central bank has intervened to prop up the value of the local currency, but it is unclear how long it can hold up, given the limited level of foreign exchange reserves.

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