Quarterly Macro Insights: July 2016

By James Balfour, CFA, VP, Senior Global Economist

Surprising and unsettling as the UK's June 23 vote to leave the EU is, we encourage patience as the implications become clearer. For now, we expect the UK and EU economies to slow as a result and think anti-EU risks are rising in periphery politics. Brexit could spark political and referendum contagion across the euro zone, which could increase downside risks. Moreover, currency and market volatility will likely remain elevated, while central banks stand ready to provide liquidity. What is also clear now is Brexit introduced yet more uncertainty into an already less than stable world economy.

Seven years into the recovery, the US and much of the global economy still find themselves in a hesitant, halting, frustrating economic dance. It's frustrating because all they really want to do is dance—they're impatient to get their economies moving after years of plodding along to the same dreary beat of quantitative easing and mediocre or non-existent growth.

There are, however, still some upbeat notes in a stagnating global economy. There's plenty of money around to lend to businesses and households in an effort to spur an economy's growth but not enough borrowers even though low, low interest rates could hardly be more attractive. The global appetite for saving remains high. While monetary policy is increasingly less effective, it still appears to be working. However, in developed economies a shift to more fiscal stimulus may be in order. Moreover, the general outlook has become more stable with the plunge in oil prices, the effect of a strong dollar and China fears having been discounted in the markets.

And in the US, the profit recession that ensued in the wake of these factors, along with weak industrial production, appears to be at its end, with a profits rebound likely to materialize. We believe there will be a profit bounce in the 5 to 10% range this year and next as production and export growth recover.

MACRO THEMES FOR JULY 2016

1. Brexit and Beyond
2. Too Much Saving, Too Little Investment
3. Monetary Policy is Losing its Pop
4. Recovering from the US Profit Recession

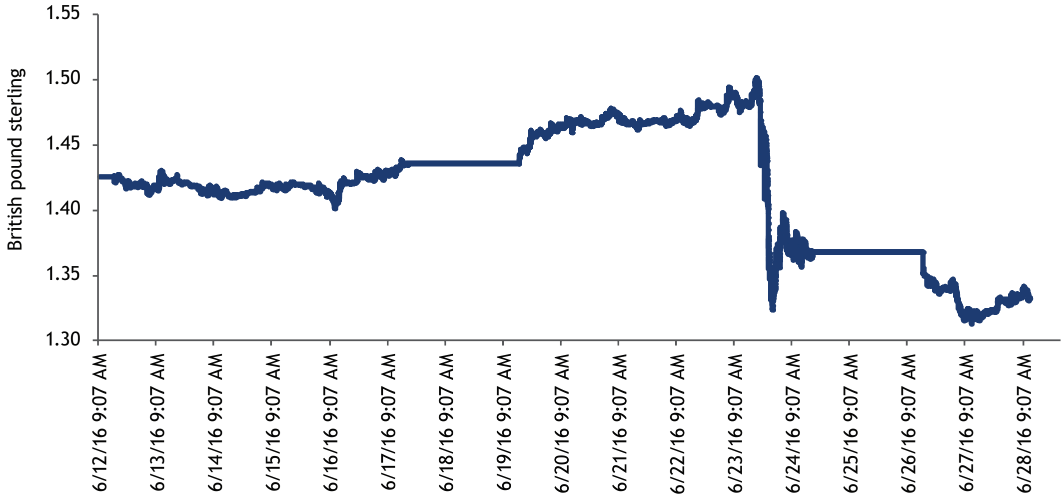
1. Brexit and Beyond

POUND PLUNGED MORE THAN 11% IN ONE DAY

Post-Brexit Vote on 6/23/2016

Source: Bloomberg, as of 6/29/2016.

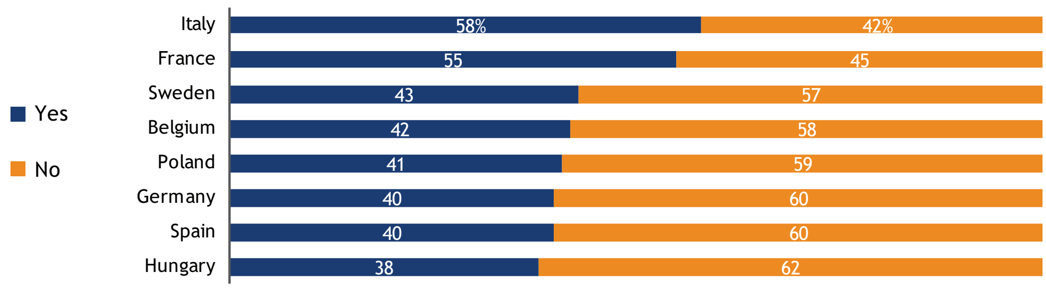
British pound sterling



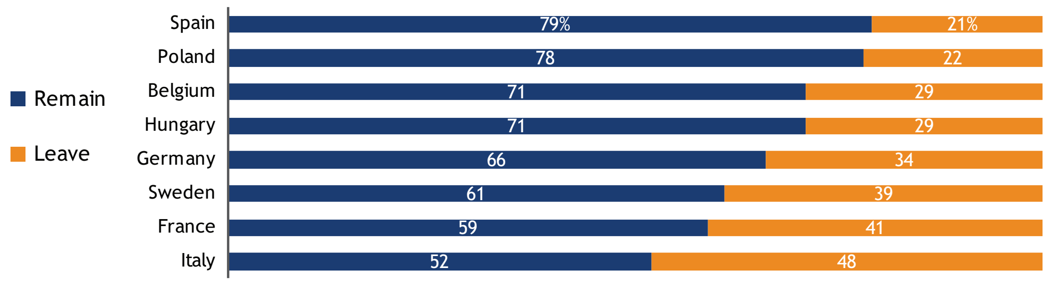
WHO WANTS A REFERENDUM ON THE EUROPEAN UNION?

Source: Ipsos MORI Brexit Poll, as of 5/9/2016.

Do you think your own country should hold an EU referendum? (%)



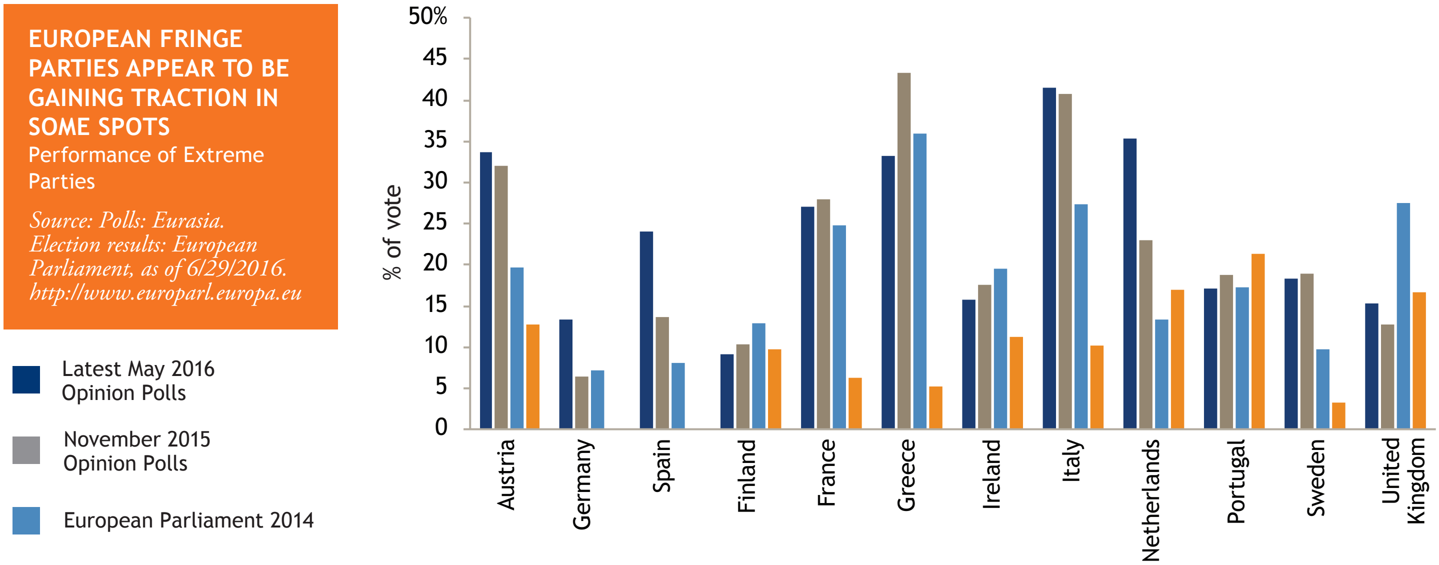
In the event of an EU referendum in your own country, how would you vote? (%)



- If a chart can be worth a thousand words, the top chart above depicting the more than 11% plunge in the British pound's value versus the dollar does its job well. It tells how utterly surprised and rattled world markets were by the Brexit vote and shows their jet-speed flight from the pound, pushing its value down to a level not seen since 1985.
- Brexit could spark political and referendum contagion across the euro zone, which could increase downside risks. For example, Scottish First Minister Sturgeon has announced her intention to propose a new independence referendum. The Spanish elections on Sunday, June 26 ended in another stalemate, which could result in a weak coalition government and continued political uncertainty. Similarly, Italy has a referendum vote in October.

EUROPEAN FRINGE PARTIES APPEAR TO BE GAINING TRACTION IN SOME SPOTS
Performance of Extreme Parties

Source: Polls: Eurasia. Election results: European Parliament, as of 6/29/2016. http://www.europarl.europa.eu

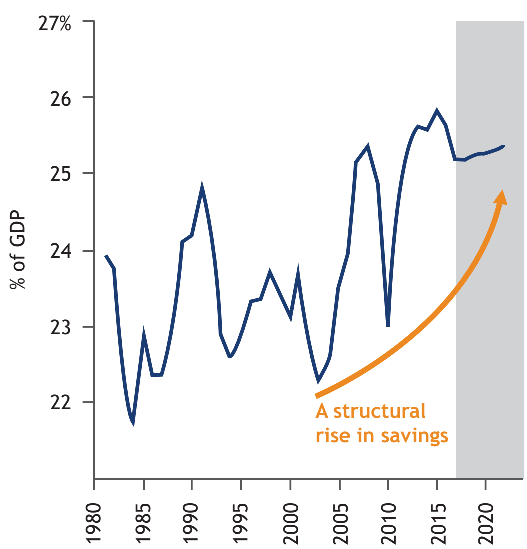


- European fringe parties are gaining traction in some spots. We think anti-EU risks are rising in periphery politics.

2. Too Much Saving, Too Little Investment

GLOBAL SAVING APPETITE IS HIGH

GLOBAL NATIONAL SAVINGS



THE RETURN OF THRIFT

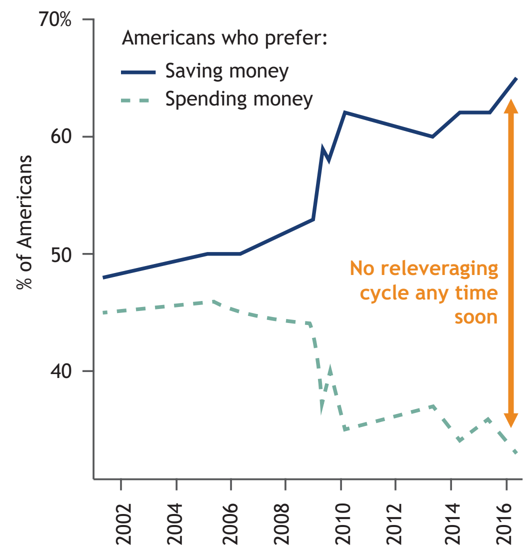


Chart at left: Source: International Monetary Fund and Haver Analytics, as of 4/12/2016. Shaded area represents forecast.

Chart at right: Source: Gallup poll, as of 4/25/2016, question asked: "Are you the type of person who more enjoys spending money or who more enjoys saving money?"

- It's a global predicament. There's plenty of money available for households and businesses to borrow and spend to spur economic growth. Yet despite availability and low, low interest rates, the demand is not there. Quite the reverse is true—the global saving appetite is high. In the case of the US, over 60 percent of Americans say they prefer saving money over spending it, according to a Gallup poll. In such an environment, interest rates should remain low until a new driver of demand emerges, and growth will be mediocre with inflation low.

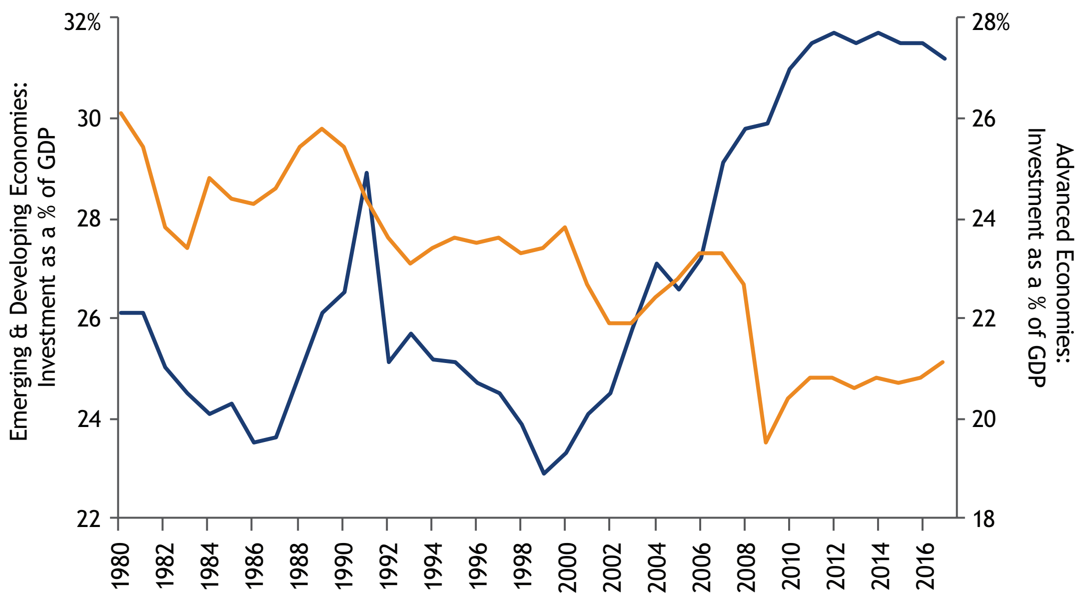
MAJOR INVESTMENT DRIVERS OF THIS CYCLE APPEAR TO BE SLOWING

Emerging & Developing Economies vs. Advanced Economies: Investment as a % of GDP

Source: International Monetary Fund, Haver Analytics, as of 6/17/2016.

Emerging & Developing Economies: Investment as a % of GDP (left scale)

Advanced Economies: Investment as a % of GDP (right scale)

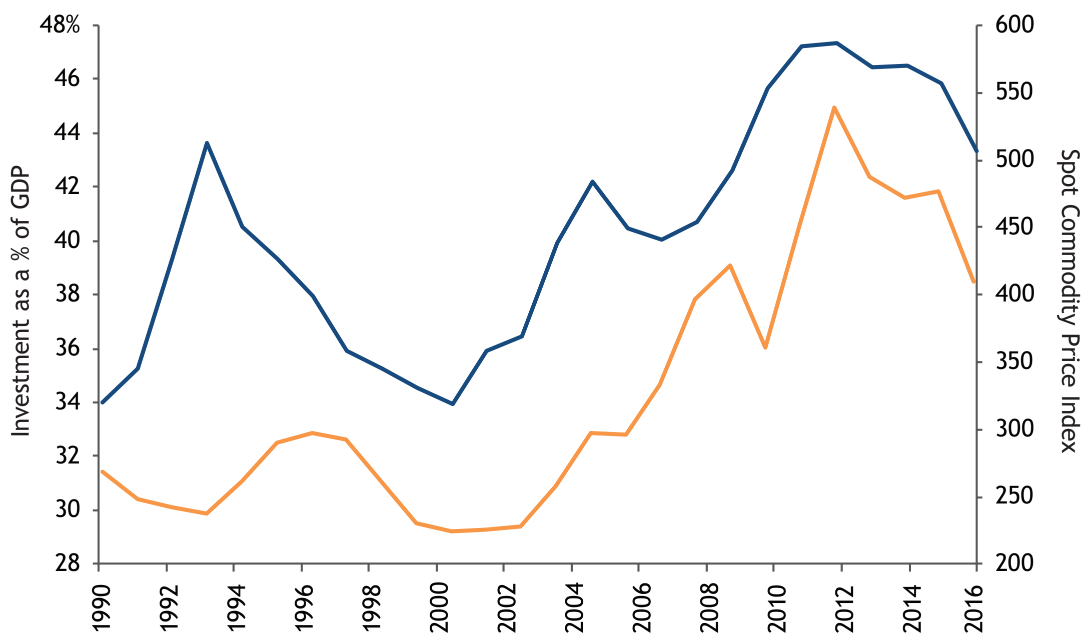


INVESTMENT BOOM IN CHINA IS, IN LARGE PART, RESPONSIBLE FOR THE COMMODITY BOOM

Source: International Monetary Fund, Haver Analytics, as of 6/21/2016.

China: Investment as a % of GDP (left scale)

Commodity Research Bureau Spot Commodity Price Index: All Commodities (right scale)



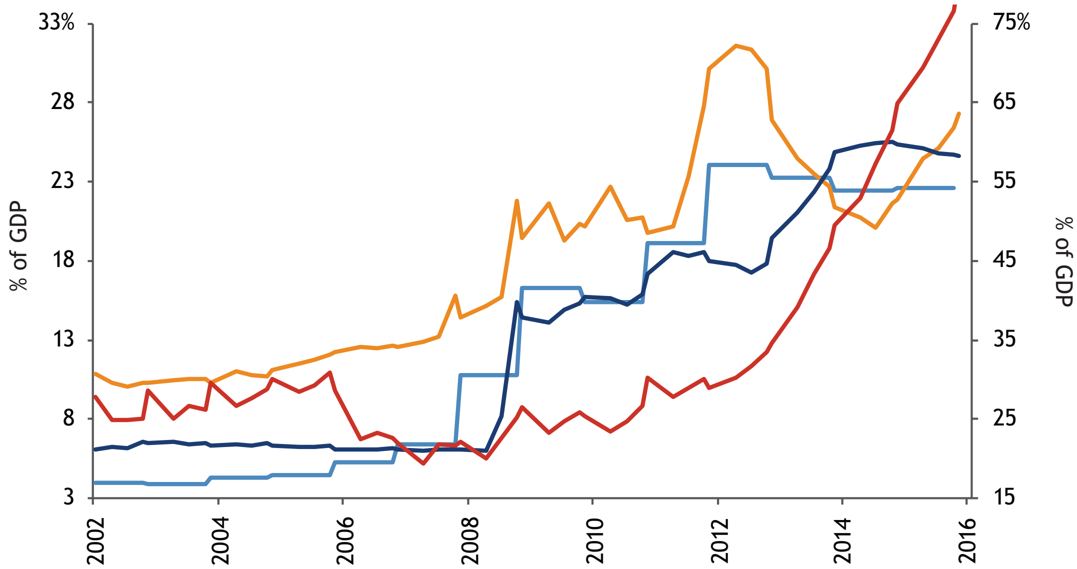
- Globally, major investment drivers for this investment cycle are slowing in both emerging and developing economies, as well as in the advanced economies. China and much of emerging markets borrowed heavily to fund investment infrastructure and others in the emerging markets followed. Meanwhile, advanced economies are still struggling to recover from the prior housing investment bust.
- The investment boom in China is in large part responsible for the commodity boom. Now, another big investment driver of this cycle is fading, and as capital expenditures have shrunk, commodity prices have taken a similar downward path.

3. Monetary Policy is Losing its Pop

CENTRAL BANKS' BALANCE SHEETS STILL EXPANDING IN THE EURO AREA AND JAPAN
% of GDP

Source: Federal Reserve, ECB, BoE, BoJ, Morgan Stanley Research, as of 3/31/2016.

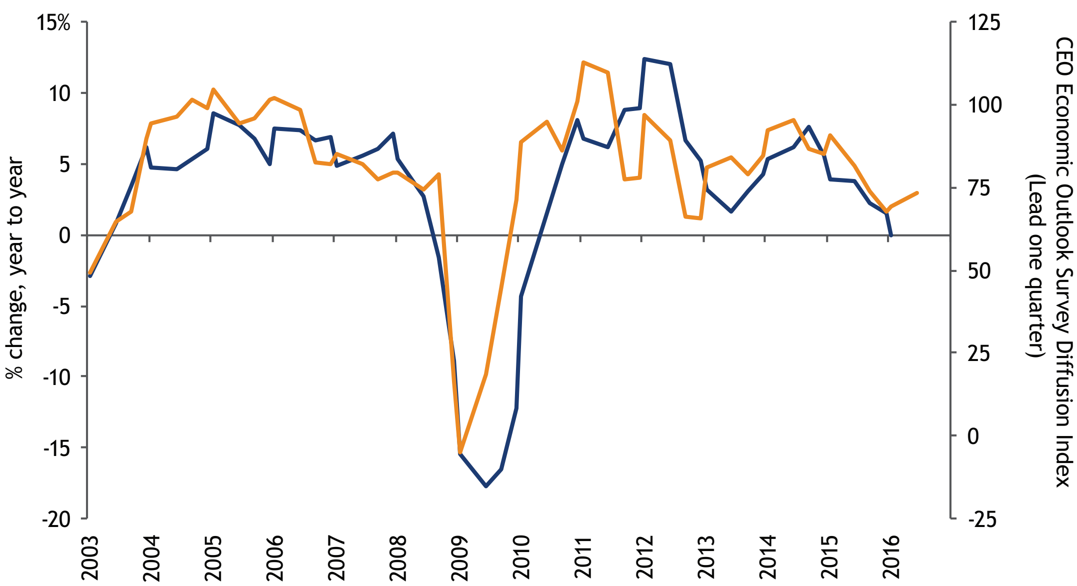
- United States (left scale)
- United Kingdom (left scale)
- Euro area (left scale)
- Japan (right scale)



BUSINESS CONFIDENCE APPEARS PARTICULARLY TENUOUS

Source: Bureau of Economic Analysis, Business Roundtable, as of 6/30/2016.

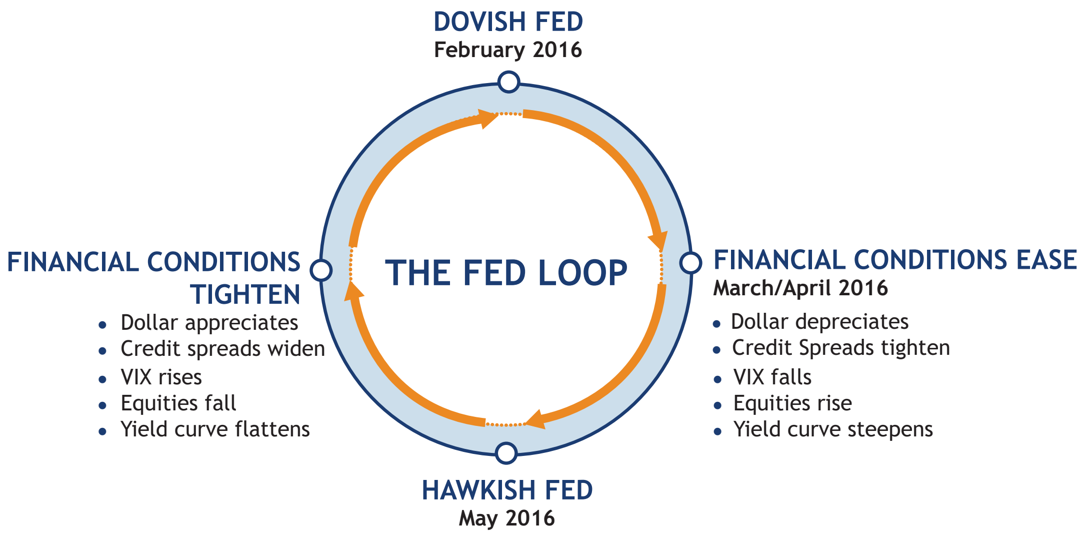
- Real Private Non-Residential Fixed Investment, % change, year to year (left scale)
- CEO Economic Outlook Survey Diffusion Index, Lead one quarter (right scale)



- The more and more central banks seek to ease credit—each time they implement quantitative easing—the harder it gets. They will likely have to do a lot more and the effect is likely to be progressively smaller. Still, the euro zone and Japan can be expected to continue expansionary monetary policies to spur growth albeit with diminishing benefits. We also expect the UK will resume expansionary policies, while the Federal Reserve (the Fed) will delay any rate hikes. If the Fed does hike, it should hike very slowly.
- At this point, the world economy seems very fragile. The US profit recession has made business confidence particularly tenuous. With businesses not yet embracing risk and showing caution about investing in the future, this is not a good time for the Fed to hike rates.

THE FED POLICY LOOP: WHEN WILL FINANCIAL CONDITIONS TIGHTEN?

Source: Information from BCA Research, as of 5/26/2016, Loomis Sayles illustration.



- The Fed is caught in a tough spot balancing domestic versus foreign financial conditions and demands. Fed hawks who are too focused on traditional domestic conditions have been driving the so-called Fed loop or vicious circle. Hiking while the rest of the world has a strong bias to ease is proving difficult. Recently, when the Fed hiked rates or suggested a hike may be in the offing, financial conditions seemed to get worse. The dollar appreciated, credit spreads widened, the Vix CBOE Volatility Index rose, equities fell and the yield curve flattened.

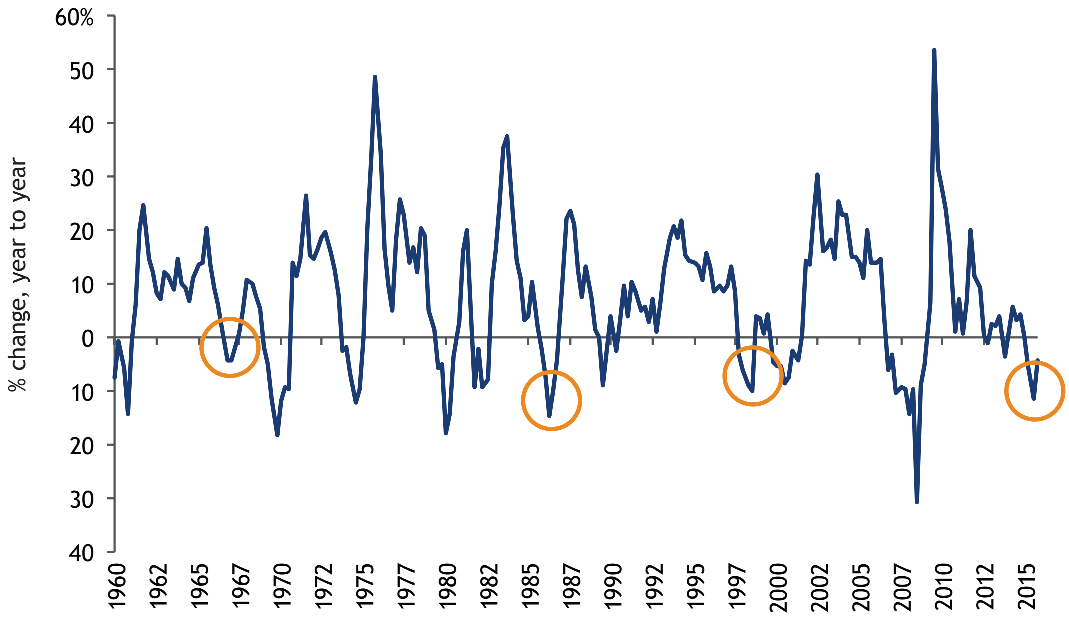
4. Recovering from the US Profit Recession

HOW BIG OF A POSSIBLE PROFIT BOUNCE IN 2016 & 2017?

% change, year to year

Source: Bureau of Economic Analysis, Haver Analytics, as of 1/29/2016. Corporate profits before tax with inventory valuation and capital consumption adjustments.

Corporate Profits

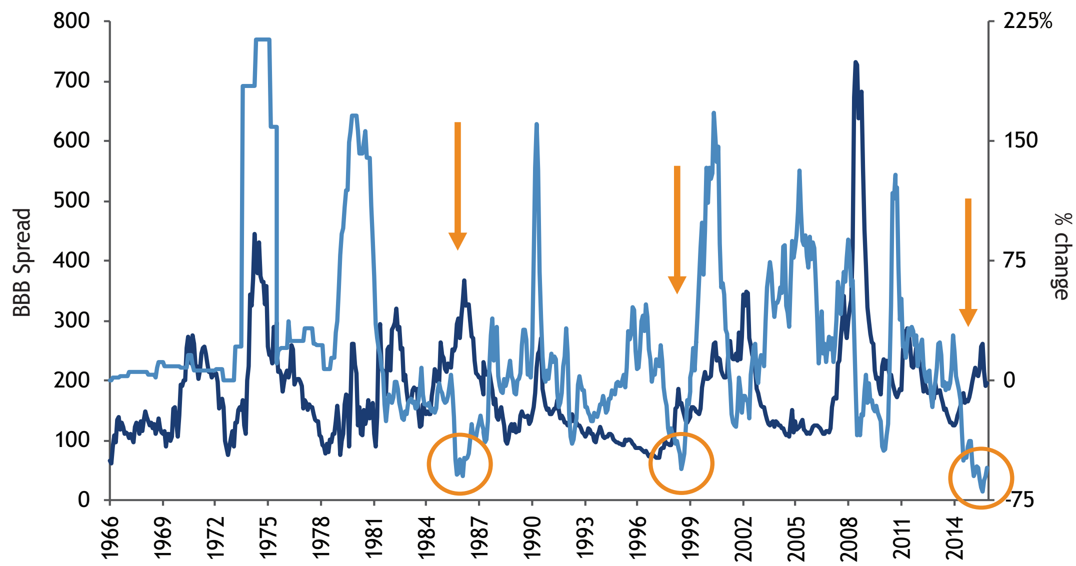


LOW OIL PRICES SHOULD SUPPORT FUTURE GROWTH AND PROFITS

Source: EIA, CME, Haver Analytics, as of 6/10/2016.

BBB Spread: Splice of Moody's, Barclays, Barclays OAS (left scale)

Spot Oil Price: West Texas Intermediate, 24-month % change (right scale)



- How big of a profit bounce might we see in 2016 and 2017? In the 5-10% range, we believe. It doesn't look like a 1987-sized bounce is in the cards; rather it should look more like a smaller 1999 or 1967 rebound. We are watching a wide array of indicators, such as oil and commodity prices, the growth of production and exports, and the strong dollar as the bounce unfolds.
- The US profit recession is a result of weak growth in emerging markets, a strong dollar and the drop in oil prices. The good news is we have seen this move before. Low oil prices should support growth and profits going forward.

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Disclosure

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