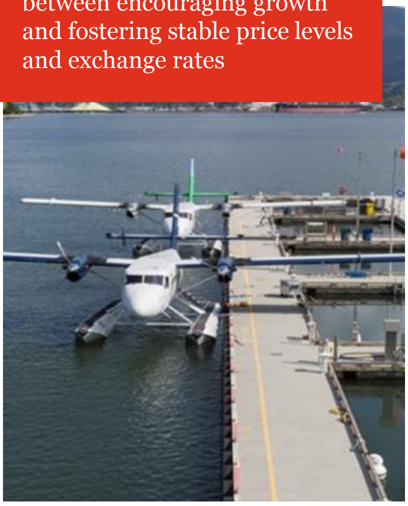
Global economy watch – August 2013

The summer holiday issue: are the southern European economies becoming more affordable?

Key messages:

- Headwinds stemming from a slowdown in emerging markets are dragging down global growth prospects
- Peripheral Europe is regaining competitiveness, but a lack of substantial reform suggests that some of the progress could be temporary
- Risks are building in emerging markets, and central banks are facing a delicate balance between encouraging growth and fostering stable price levels and exchange rates



At a glance

- The global economic recovery is still struggling to gather momentum. Over the last few months we have been lowering our growth projections for some of the larger emerging markets. And in July, the IMF downgraded its projections of global economic growth to 3.1% for 2013. This is now their fifth consecutive downgrade of 2013 global growth prospects since early 2012.
- While still outpacing growth in advanced economies, a slowdown in Asia and other emerging markets is contributing to this deteriorating outlook.
- This month, we take a closer look at the good, the bad and the ugly in the peripheral Eurozone countries.
- On the bright side, Portugal, Ireland, Italy, Greece and Spain have all made significant progress in regaining some of the competitiveness lost in the years before the crisis.
- Tourism is an important sector for most of these economies, accounting for up to 5% of GDP, and it has been a beneficiary of falling costs and prices. in Spain for example, foreign tourist arrivals have increased by 23% since the financial crisis began.
- The state of public finances across the peripheral economies remains bad. Progress has been made in reducing government spending – in Portugal spending has decreased by around 20% since 2011. However, the lack of economic growth has meant that the size of the stock of government debt relative to the economy continues to increase.
- The status of the labour market in peripheral Europe remains ugly. Unemployment in Greece and Spain is roughly double the Eurozone average of 12%, while high and rising youth unemployment poses a risk to future productivity and medium term growth.
- Finally, we take a look at how stock markets have performed over the summer months.

Charts of the month

Figure 1 – *Tourism is more important to peripheral economies than other economies in the Eurozone*

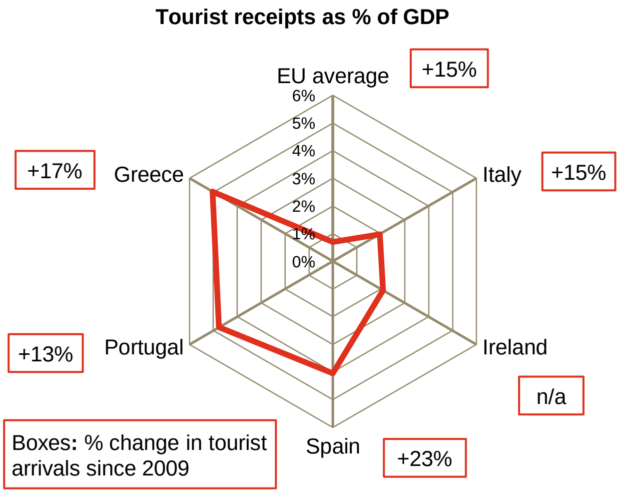
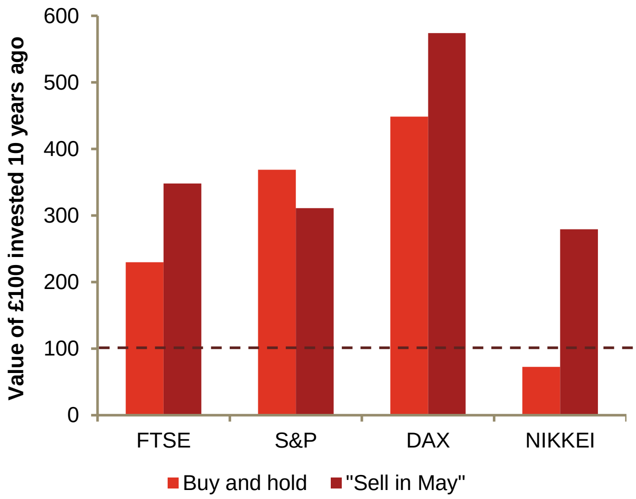


Figure 2 – *£100 pounds invested in most stock indices a decade ago would have grown substantially more if investors followed the 'Sell in May' principle*



Visit our blog for periodic updates at: pwc.blogs.com/economics_in_business

Economic update: The global economy, not out of the woods yet

Three months ago we highlighted a 'three speed' economic recovery, with emerging markets in the fast lane, the US in the middle lane, and the Eurozone lagging behind in the slow lane.

Latest projections show a similar picture, although with some worrying risks on the horizon. In particular, a new headwind is developing in emerging markets where the outlook for both exports and domestic demand is more uncertain now than it was just a few months ago.

Exporters are struggling

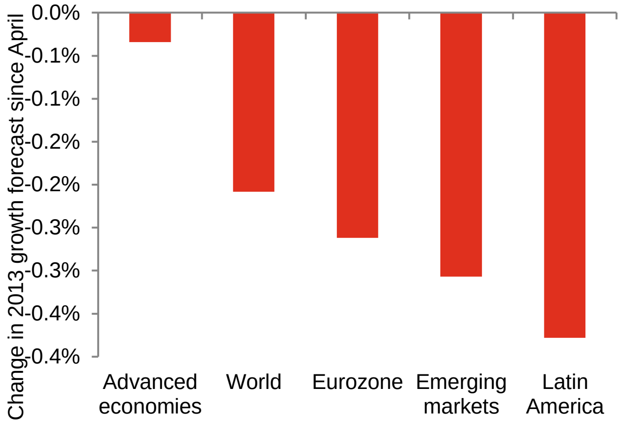
Lacklustre export growth, caused by subdued demand in the developed world is causing problems in export focused emerging markets. China is in the spotlight, after June export figures recorded a 3.1% fall over the previous year. Our projections indicate that China will still meet its 7.5% target GDP growth in 2013, albeit with support from the government through measures including looser credit conditions.

Central banks face a delicate balance

The outlook for other emerging markets running current account deficits is problematic. Yield seeking investors have driven up exchange rates. As a reversal of this trend approaches, central banks are facing tough choices.

Allowing sustained depreciation risks importing inflation, but raising interest rates would hurt domestic demand. The central bank of Turkey has already been forced to intervene directly in currency markets and also raise interest rates. Other economies with comparable problems, such as India and Brazil, may soon have to make similar choices.

Figure 3 – *Latest projections are showing a less optimistic outlook for global growth this year, especially in emerging markets*



Latest IMF 2013 GDP growth forecasts

Advanced economies	World	Eurozone	Emerging markets	Latin America
1.2%	3.1%	-0.6%	5.0%	3.0%

Source: IMF, PwC analysis

Focus box: 'Sell in May and go away'? How does the evidence stack up

Old stock market proverb: 'Sell in May and go away…'

An old stock market saying advises investors to 'sell in May and go away' to avoid weak returns during summer months and get back in to the market in the autumn. But in an era of supposedly efficient markets, could this strategy still be profitable?

So far this year, investors might have done well to heed this advice; most stock indices around the world have gone through a weak patch (see figure 4). The main reason for this however, is uncertainty over tapering of QE (see our July edition for further analysis), a one-off event.

Academic explanations for this global phenomenon have been varied, ranging from a 'holiday effect' as senior investors leave junior personnel to man the decks, to risk aversion being affected by the weather.

So far, however, no explanation has been conclusive and academics are still puzzled as to why, despite being common knowledge for nearly 50 years, it is still profitable to follow this rule while other investment 'anomalies' cease to be profitable once they become common knowledge.

Looking at the data, a calculation of the average monthly return in the months October – April ('Sell in May') compared with a simple buy and hold strategy over the last 10 years shows that there is a marked difference between the two periods. It seems that if smart investors could capitalise on the 'growth months', they could earn outsize returns.

From a returns perspective, Figure 2 looks at how £100 invested in an index in the last decade would have grown under a 'Buy and hold' strategy or adopting the 'Sell in May' strategy. Of the four leading indices, with the exception of the S&P500, a 'Sell in May' approach clearly outperforms a passive 'Buy and Hold' strategy.

Our analysis suggests that these differences are statistically significant and that the 'May effect' is a more significant factor in explaining monthly returns than 'harder' economic indicators like business confidence.

So remember to come back in September.

Figure 4 – *Leading stock index returns since the start of 2013*

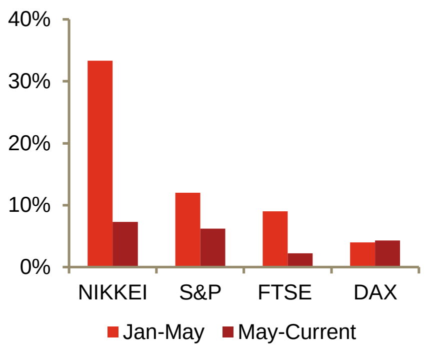
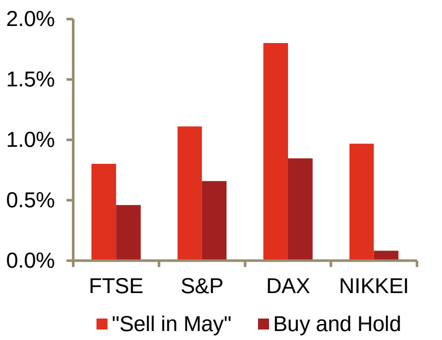


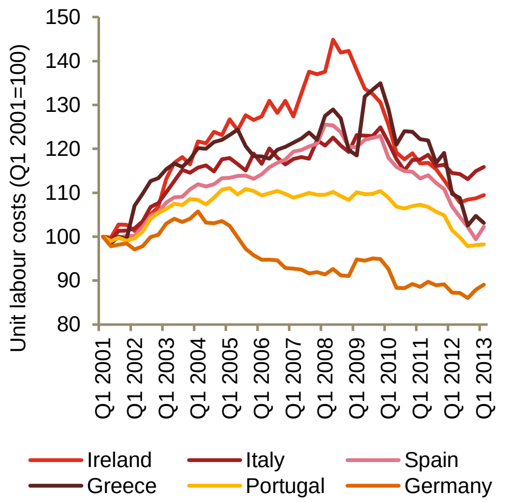
Figure 5 – *Average monthly returns are higher for investors avoiding the summer months*



Source: Datastream, PwC analysis

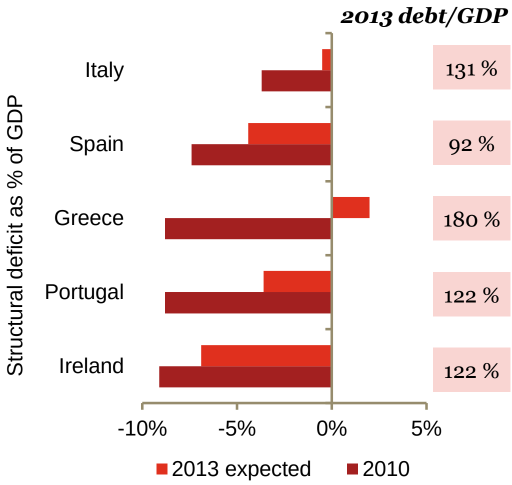
Peripheral Europe: Summertime… but the living is not easy

Figure 6 – *The 'Good', peripheral Europe has regained most of the labour competitiveness lost since joining the Euro*



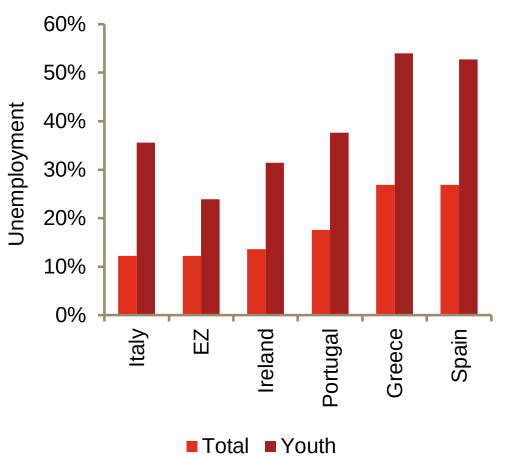
Source: OECD, PwC analysis

Figure 7 – *The 'Bad', although progress has been made in deficit cutting, total government debt is high and climbing*



Source: Eurostat, PwC analysis

Figure 8 – *The 'Ugly', the labour markets of peripheral economies are causing problems now and storing problems for the future*



Source: Eurostat, PwC analysis

Peripheral economies are no longer in crisis mode, but that does not mean that all is well

For the first summer in three years, there is not an apparent crisis brewing in the Eurozone. That this is good news is a measure of how far perspectives have shifted over that time period.

A number of factors have helped to reduce short term risks facing the peripherals including QE3 and the ECB commitment to 'do whatever is necessary' using the OMT bond buying programme. As a result, yields on peripheral government bonds are 2-3% lower than this time last year.

However, that does not mean that the peripheral economies of Portugal, Ireland, Italy, Greece and Spain in particular, are out of danger yet. Their economic situation remains a decidedly mixed case of the good, the bad and the ugly.

Good progress in competitiveness, but 'low hanging fruit' has already been picked

A key aspect of restoring balance within the euro area involves peripheral economies regaining competitiveness. Figure 6 shows that good progress has been made in this area. Labour costs have fallen by around 20-30% over the past 4 years. However, one-off factors like falling wages and rising unemployment account for most of the change.

While costs have fallen, reforms to labour markets to boost wage flexibility have been lacking. This poses a risk that competitiveness will be eroded through the next growth cycle as labour markets recover in line with economic growth.

Falling costs have proved good news for tourism, a key industry for several economies. Figure 1 shows that receipts from tourism can make up almost 5% of GDP, and growth in tourism (as high as 23% since 2009 in Spain) provide a good news story.

Continued recession and rising debts are bad news for peripheral governments

Peripheral governments have made reasonable progress in reducing their deficits, albeit from a poor starting point (see figure 7). However, continued recession is working against them. Our forecasts show the peripheral economies shrinking by 1% or more in 2013. This is aggravating debt problems through two channels. Total debt levels will continue to rise until deficits are closed, and at the same time debt/GDP levels increase as the economy shrinks further.

Debt is also an issue for the private sector, and the banking system remains frail. An upcoming ECB asset quality review will hopefully remove some uncertainty over the health of many banks operating in the periphery.

The labour market situation is having ugly effects now and storing more for later

The most visible area of pain continues to be the labour market, with unemployment continuing to rise (see figure 8), in some cases at twice the rate of the Eurozone average. In the short term, this represents a major drag on domestic demand and business and consumer confidence. Look past the headline rate and further problems are apparent. Long term unemployment and the elevated levels of youth unemployment risk a scarring of the economy and productivity as skills are permanently lost.

Short term risks are high, but recovery could reward businesses who are prepared to take a long view

While peripheral European economies are still highly stressed, the tail risks of defaults and exit have receded dramatically over the previous 12 months. Recent confidence indicators like the Purchasing Managers Index (PMI) suggest that the rate of contraction is slowing, and a stabilisation could come later in the year.

Businesses which are looking to invest for the long term, and are willing to ride out further short term risks, could find themselves well positioned as these economies start to recover.

Projections

	Share of world GDP		Real GDP growth				Inflation			
	PPP*	MER*	2012	2013p	2014p	2015-9p	2012	2013p	2014p	2015-9p
Global (market exchange rates)			2.4	2.4	3.1	3.1	4.7	4.7	5.1	4.6
Global (PPP rates)			3.0	3.0	3.7	3.7				
United States	19.1%	21.7%	2.2	2.0	2.7	2.4	2.1	1.6	2.0	1.9
China	14.3%	10.5%	7.8	7.6	7.7	7.0	2.7	3.0	3.4	3.4
Japan	5.6%	8.4%	1.9	1.6	1.4	1.2	-0.0	0.2	1.4	1.5
United Kingdom	2.9%	3.5%	0.2	1.0	2.0	2.4	2.8	2.7	2.4	2.0
Eurozone	14.2%	18.8%	-0.6	-0.6	0.9	1.5	2.4	1.7	1.7	1.9
France	2.8%	4.0%	0.0	-0.1	0.9	1.6	2.2	1.4	1.6	2.0
Germany	3.9%	5.1%	0.9	0.3	1.3	1.5	2.1	1.6	1.8	2.0
Greece	0.4%	0.4%	-6.4	-4.2	-1.0	2.5	1.0	-0.3	-0.5	1.0
Ireland	0.2%	0.3%	0.9	0.9	2.0	2.7	1.9	1.3	1.2	1.7
Italy	2.3%	3.2%	-2.4	-1.5	0.8	0.8	3.3	2.0	1.8	1.7
Netherlands	0.9%	1.2%	-1.0	-0.8	1.0	1.6	2.8	2.6	2.0	2.1
Portugal	0.3%	0.3%	-3.2	-2.4	0.8	1.8	2.8	0.8	1.2	1.5
Spain	1.8%	2.1%	-1.4	-1.4	0.4	1.7	2.4	1.9	1.6	1.7
Poland	1.0%	0.7%	2.3	1.1	2.4	3.9	3.7	1.3	2.3	2.5
Russia	3.0%	2.7%	3.6	2.9	3.5	3.8	5.1	6.1	5.7	5.6
Turkey	1.4%	1.1%	2.2	3.6	4.8	5.3	8.9	6.9	6.3	4.8
Australia	1.2%	2.1%	3.6	2.5	2.8	3.1	2.4	2.3	2.6	2.7
India	5.7%	2.4%	5.1	5.5	6.6	7.0	7.5	5.2	5.9	6.0
Indonesia	1.4%	1.2%	6.2	6.1	6.2	6.3	4.3	5.5	5.1	5.1
South Korea	2.0%	1.6%	2.0	2.7	3.2	3.8	2.2	1.8	2.7	2.9
Argentina	0.9%	0.6%	2.0	2.5	2.4	3.3	10.0	10.8	11.5	9.7
Brazil	2.9%	3.6%	0.2	2.8	3.5	4.0	5.4	5.8	5.3	4.8
Canada	1.8%	2.5%	1.8	1.6	2.5	2.2	1.5	1.4	1.9	2.1
Mexico	2.1%	1.7%	3.9	3.5	4.0	3.6	4.1	3.8	3.8	3.6
South Africa	0.7%	0.6%	2.5	2.2	3.5	3.8	5.7	5.9	5.7	4.8
Saudi Arabia	0.9%	0.8%	6.8	4.4	4.2	4.3	2.9	4.0	4.6	4.0

Interest rate outlook of major economies

	Current state (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	On hold to 2015	17-18 September
European Central Bank	0.5% (May 2013)	On hold at least until 2014	5 September
Bank of England	0.5% (March 2009)	On hold at least until end of 2013	5 September

Sources: *PwC analysis, National statistical authorities, Thomson Datastream and IMF. All inflation indicators relate to the CPI, with the exception of the Indian indicator which refers to the WPI. Note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend our clients look at a range of alternative scenarios, particularly for the Eurozone. *PPP refers to Purchasing Power Parity and MER refers to market exchange rates.*

Richard Boxshall

T: +44 (0) 20 7213 2079
E: richard.boxshall@uk.pwc.com

William Zimmern

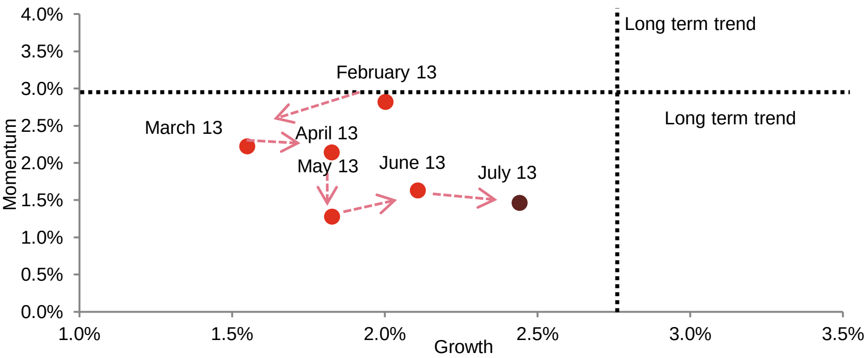
T: +44 (0) 20 7212 2750
E: william.zimmern@uk.pwc.com

Barret Kupelian

T: + 44 (0) 20 7213 1579
E: barret.g.kupelian@uk.pwc.com

PwC's Global Consumer Index – June 2013

The GCI remains below trend. Growth picked up to 2.4%, but momentum fell back. Global equity markets and consumer confidence have weakened recently. Commodity prices have continued to decline. Recent industrial production figures suggest economic activity and consumer spending may pick up later this year.



The Global Consumer Index is a leading indicator of global consumer spending, it is based on a series of economic and market indicators, including equity market performance, consumer and business confidence, credit markets and commodity prices. For additional commentary on our methodology please visit: http://www.pwc.co.uk/economic-services/publications/pwc-global-consumer-indicator/index.jhtml Growth refers to the year-on-year change. Momentum is calculated as the 3 month annualised growth rate.

130723-182340-MS-OS