Global economy watch – May 2013

Global economic recovery is uneven

Key messages:

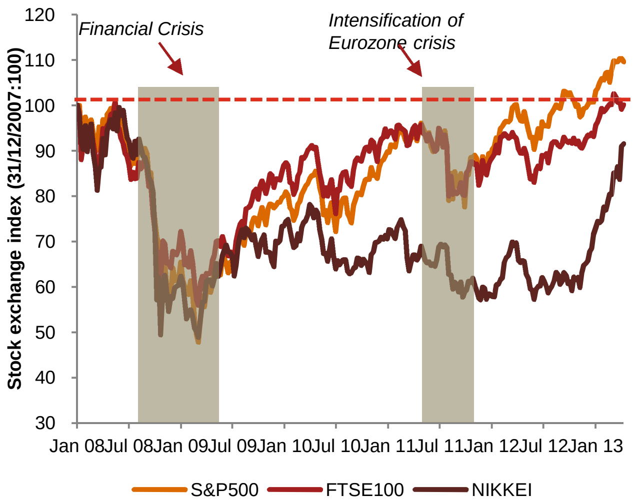
1. *The global economy is recovering but the pace of economic growth is disjointed with emerging markets growing quickly and the Eurozone lagging behind*
2. *In our interview with the former President of Cyprus he says that Europe needs to integrate even more to overcome its debt crisis*
3. *Equity markets have exceeded their pre-crisis levels as the Fed and the Bank of Japan continue to pump $150 billion per month into the markets*

At a glance

- Economies around the world are recovering at different speeds. Six months ago, we highlighted the rise of a 'two speed' economy, with emerging markets growing faster than advanced economies. But whilst the Eurozone continues to focus on crisis management and Japan puts the finishing touches to its reforms, the US appears to be breaking away from the pack and gradually returning to trend growth. As pointed out by the IMF, we are now seeing the rise of a 'three speed' economy.
- Emerging and developing economies continue to occupy the 'fast lane'. Our projections suggest that the BRIC economies will be growing around three times as fast as the G7. The release of the first quarter GDP data for China confirmed our view that it will continue to grow slightly faster than the 7.5% government target rate (actual growth was 7.7% year on year), whilst gradually rebalancing from investment to consumption-led growth.
- The US economy is in the 'middle lane' and is projected to grow close to its trend rate of around 2% in 2013. Sustained job creation is helping households gradually reduce their debt exposure from a peak of 106% of GDP in 2008 to around 94% in 2012. The US now accounts for most of the growth in the G7 economies – had it not grown at all, G7 growth would drop from our projected 1.2% to just 0.3% in 2013.
- The Eurozone is firmly in the 'slow lane'. As our interview with the former President of Cyprus highlights, this is partly because of institutional gaps in dealing with the links between a weak banking sector and governments. We project that the Eurozone will contract for a second consecutive year in 2013.
- The shift in focus of the major central banks from inflation to growth has helped to push US and UK equity markets back up above their pre-crisis levels. The main drivers have been the US Federal Reserve and the Bank of Japan. Together they are injecting around $150 billion per month into the global financial system, roughly equivalent to the size of Vietnam's annual output.
- But despite trading at pre-crisis levels, equity markets do not immediately seem overpriced. The S&P 500 and FTSE 100 are trading on a forward P/E basis of 16 and 13.9 respectively, which is below average on a ten year basis.
- The US earnings season indicates a relatively healthy business environment, with most companies reporting rising profits. However, the key theme still continues to be cost-cutting, rather than expansion and revenue growth.

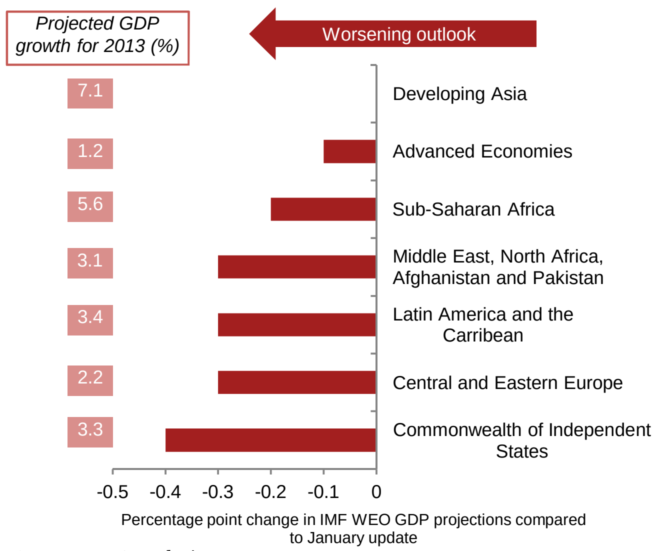
Charts of the month

Figure 1 – UK and US equity markets have recently surpassed their pre-crisis peaks (and Japan is making up ground)



Source: Datastream

Figure 2 – The latest projections from the IMF show that growth prospects for most parts of the world have slowed down



Sources: PwC analysis, IMF

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Status update on the global economy

Six months ago we pointed out the rise of a two speed economy with the emerging economies growing faster than the advanced. The US has gradually broken away from the pack, with growth picking up back towards trend. In this section we have taken stock of the world economy within a new three speed economy framework.

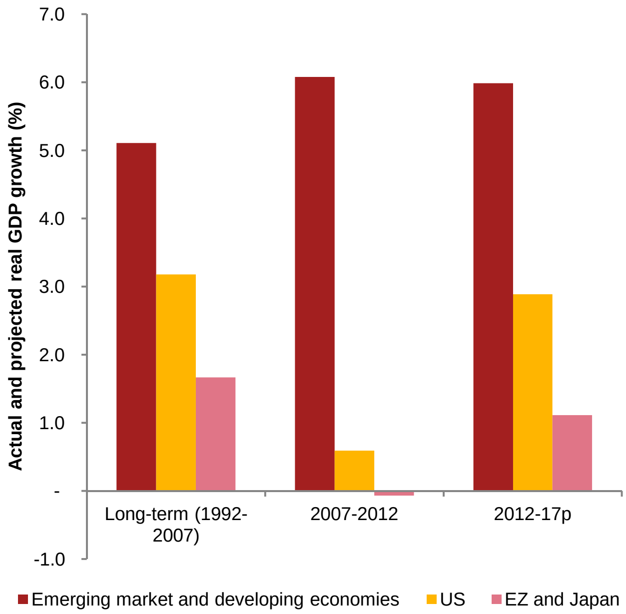
Slow Lane: *Eurozone/Japan* – The Cyprus crisis showed that more needs to be done to transform Eurozone institutions in order to sever the link between governments and the banks (e.g. via a banking union). In the absence of such institutions and with ongoing public and private sector deleveraging (particularly in the peripheral economies), our main scenario projection is for the Eurozone to shrink by 0.4% in 2013.

Japan is also in a similar position; its output has remained virtually the same since 2008. But this could all change if the recently announced monetary expansion (see April Global Economy Watch) is coupled with fundamental structural reform of its economy.

Middle Lane: *US* – On the back of unprecedented monetary and fiscal stimulus, the US economy continues to grow close to its trend rate of 2%. Modest growth is expected to continue to fuel employment growth: in the past 12 months alone 1.9 million jobs were created.

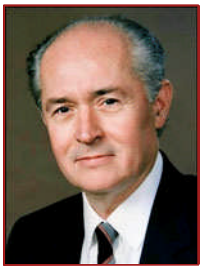
Fast lane: *Emerging economies* – These economies are projected to exhibit buoyant growth rates on account of pro-market policies, robust domestic demand and relatively healthy financial sectors. The China GDP growth figures, for example, showed 7.7% growth in the year to the first quarter of 2013, with service sector growth outstripping industrial production growth.

Figure 3– In the aftermath of the financial crisis, a three-speed global economy has emerged



Source: IMF, PwC analysis

Interview with the former President of Cyprus



George Vassiliou *was the President of the Republic of Cyprus from 1988 to 1993. He also served as the chief negotiator for the accession of Cyprus into the European Union.*

How would you summarise the Cyprus crisis?

Everyone knows that the banking crisis in Cyprus originated in Greece. If the Greek economy had not collapsed nobody would have complained about Cyprus.

When the decision for the Greek PSI (Private Sector Involvement) was taken the Europeans had not realised the repercussions for Cyprus would be huge. This decision resulted in losses of around 5 billion Euro for the banks, which was practically all of their capital base.

Furthermore , the collapse of the Greek economy meant that loans worth around €26 billion, extended by Cypriot banks to Greek businesses, had to be written off, so hiking their recapitalisation needs. So from one day to the next you were faced with a banking sector that was practically bankrupt.

Also, in the last stages before the Eurogroup decision, the € 16-17 billion that Cyprus had initially requested was suddenly limited to only € 10 billion, citing debt sustainability issues whilst completely disregarding the future prospects for the Cypriot economy, including the recently discovered gas reserves.

So, in the case of Cyprus, when Europeans realised they could not impose a 'haircut' on Cypriot government bonds on account of debt sustainability issues, as they are held mainly by Cypriots, they resorted to a deposit holders haircut. This was the first time such a measure was implemented in the history of the European Union.

What do you think are the implications of this decision on a European level?

The message this has sent around the world is to not trust banks in the south, only banks in the north.

In other words, if a bank in southern Europe like Portugal, Spain, Greece or Cyprus is well-run, then it has to suffer. If a bank is not well run but is in the north, then it's OK.

So where does Cyprus stand right now and what are the key policy measures it needs to implement to overcome its issues?

First of all, let me point out that there is no question about Cyprus not being in the Eurozone. Cyprus is in the Eurozone and will prove to its friends that it will be a small but valuable member of the European Union.

Secondly, I am dead against a Eurozone exit or a break-up of the bloc. Devaluation has been used in many countries and has failed. You can only become more competitive by increasing your productivity through the use of better technologies etc, rather than by devaluing your currency. If any of the peripheral economies exit the Eurozone, they will become even more uncompetitive, and the Eurozone will disappear. That will certainly not be to the benefit of the rest of the world.

Having said that, the policy measures that Cyprus needs to implement need to focus on the two legs it stands upon: the tourism and business services sectors.

On tourism there is broad agreement on what needs to be done to grow the sector.

On the business services sector we need to do more work. First of all, it's been a month since the Eurogroup decision was taken and capital controls are still in place. It made sense to enforce these controls at the onset of the crisis, but they should be relaxed immediately, as the longer you keep them in place, the more you ensure that troubles emerge once you relax the controls.

Secondly, we also have one of the highest proportion of graduates in Europe, so we need to put in place specific measures to attract industries specialising in areas like IT development, in the manufacturing of generic medical products and so forth to make best use of our graduates.

And, finally, we need to make sure that everything that is in the Memorandum is speedily implemented. I don't think that there is any other country in Europe that has acted as swiftly as Cyprus in passing the related legislation through parliament.

Given where we are now, how do you see Europe evolving?

In the aftermath of the two World Wars, the dream of the European founding fathers was to avoid conflict and war. Their dream was that Europe had to be united and that's when the European Union became a reality.

In the current globalised world, if there is no European Union, there is no Europe.

A movement towards a closer European Union is absolutely necessary if we want to avoid a future crisis. This is why the Europeans established the Eurozone and the Euro hoping that this would be the beginning.

But, as you know, you cannot have monetary union without fiscal union . And while everybody was happy to have the same currency in the past, they didn't want to adjust their domestic policies and borrowing practices up until the crisis started developing.

So in my opinion, if we want to overcome the crisis we need to move in the quickest possible way to a closer European Union. If we don't do that we are going backwards. We cannot stay stagnant. Either you move forward or you move backwards. You can stand still for some time, but not forever.

In a recent article, Professor Timothy Gordon Ash pointed out the old phrase used after Italian unification that "we now have Italy, what we need is to make Italians". Now we have Europe and we need to make Europeans.

Click here to read a longer version of this interview or listen to a podcast via our website on pwc.co.uk/GEW

Figure 4: Japan's NIKKEI has been roaring ahead this year on the back of the policy shift announced by the Bank of Japan

Nikkei 225 (Jap): **30.5%**	Shanghai Comp (Chi): **-1.9%**
Merval (Arg): **23.7%**	Bombay SE (Ind): **-2.2%**
Jakarta Index (Ind): **15.8%**	Hang Seng (HK): **-2.7%**
S&P 500 (US): **9.6%**	Bovespa (Bra): **-12.3%**
FTSE 100 (UK): **6.5%**	RTS (Rus) : **-13.0%**

YTD Return since 31/12/12 as of 22/4/13

Source: Datastream

Figure 5: Central bank easing measures are providing significant amounts of liquidity, providing a base for equity market growth

£375 bn

Outstanding size of UK QE program

$85bn per month

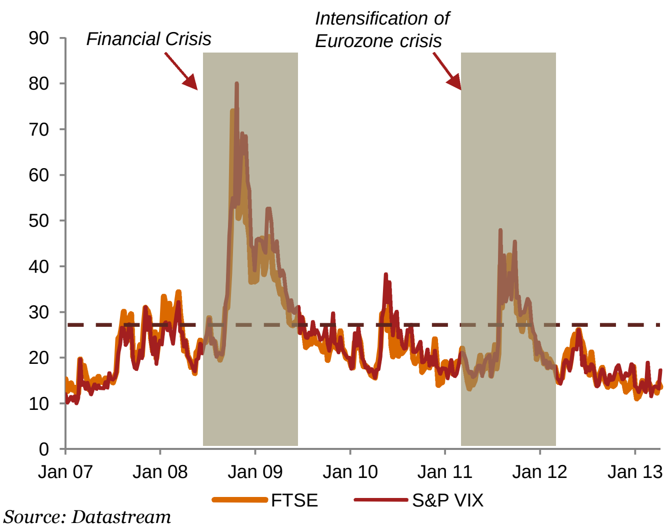
US Fed injections as part of QE3

¥7 tn per month (~$70bn)

BoJ injections as part of its easing program

Source: National Central Banks

Figure 6:Volatility has fallen to pre-crisis levels in the US and UK



Source: Datastream

Equity markets have hit new post crisis highs

Since the beginning of the year developed markets have outperformed emerging markets, primarily due to more direct exposure to easing, as well as some short term concerns over growth in some developing economies. Figure 4 shows the effect of Japan's new monetary regime[1] on the Nikkei, which has posted a return of 30.5% (or around 13% in dollar adjusted terms) since the start of January.

A much more mixed picture appears for emerging markets, but this has more to do with the inherently volatile nature of emerging market equities than with unhealthy fundamentals.

Central bank action has minimised volatility, improved sentiment and boosted returns

Underpinning these gains are the major central banks who continue to inject massive amounts of liquidity into the global financial system (see Figure 5). Since early 2009, when the Federal Reserve (Fed) and Bank of England (BoE) first launched quantitative easing, markets have seen gains more than 50%.

As yields on safer assets have been severely compressed, equity markets have benefitted from investors looking to achieve real returns on their investments. For example, the FTSE 100 currently offers a dividend yield of 3.5%, compared to a 1.8% yield on gilts and a projected inflation rate of 2.8%.

Despite strong gains, markets do not appear overpriced. The FTSE 100 trades on a forward Price/Earnings (a measure of how expensive a company is) ratio of 13.9, slightly below its 10-year average of 14.3, and other developed markets (e.g. S&P 500) also offer attractive dividend yields at below average valuations.

Reassured by central bank action, investor sentiment seems to be improving. With volatility at a five year low (Figure 6), investors are increasingly willing to take on risk. Given that growth forecasts remain subdued, this will remain a key factor in driving returns.

For the time being, the easy monetary stance is here to stay. The BoE and Fed are shifting their focus more towards growth than inflation targeting, and most central banks have explicitly committed support until economic conditions have markedly improved.

Continued easing helps businesses, but may hurt consumers

There are benefits to this stance, but risks remain. Although there has been no clear effect yet, concerns around inflation persist. Households are most at risk from rising inflation, which has depressed real wages in many countries in recent years, notably the UK.

Good quality corporates are in a strong position. With strong cash flows and access to cheap finance, the resources are there to increase earnings. On the other hand, continued loose monetary conditions enables 'zombie' firms who would otherwise fail to survive, hoarding capital that could be more effectively deployed elsewhere and so delaying a sustainable economic recovery. Are there signs that companies are returning to profitability? In the US, still the largest and most important economy in the world, the current earnings season (when companies report Q1 performance) has been gently encouraging so far.

Global banks have generally reported rising profits, beating estimates and indicating that the financial system continues to heal, a prerequisite for a sustained economic recovery. However, other broader economic 'bellwether' firms, particularly consumer facing businesses, have struggled to grow, indicating that a recovery in the wider economy is yet to take hold.

Significance of equity markets in the real economy

Stock markets can be leading indicators (at least for the US)

Stock markets are often held to be leading indicators of the economy, so while rising equity markets may look strange against a backdrop of sluggish economic growth, they could be indicating expectations of better conditions to come.

In our recent paper '*What stock markets can tell us about the real economy*'[2], we assessed how well UK and US stock markets predicted future economic growth over the past 40 years. Our results, as summarised below, indicate that forecasting ability is weak for the UK, but better for the US. Even then, the predictive power of the US market only extended to a short 1 quarter horizon, hardly sufficient for business planning purposes. So signals from stock markets need to be treated with some caution.

Table 1– The stock market is not always a good leading indicator

	UK		US	
	GDP	Unemployment	GDP	Unemployment
Strength of stock market price effect	Moderate/ weak	Weak	Strong	Strong
Price effect lag time	3 quarters	1 year	1 quarter	1 quarter

Key findings

- Businesses hoping that buoyant equity markets are indicating a recovery in the real economy may, in some cases (e.g. in the Eurozone as opposed to the US), be disappointed.
- Rising equity markets can be a positive factor shaping consumer and business confidence. But economic data still indicates a slow and painful path to growth for many advanced economies.
- A key factor underpinning equity market gains has been the extreme monetary easing by central banks, which has improved investor sentiment and willingness to tolerate risk.
- Businesses should not forget that while these loose monetary conditions are unlikely to be withdrawn in the short term, they not meant to be permanent and assess their funding strategies accordingly.
- Interest rates are unlikely to rise in the next few years, but future decisions to slow or wind down easing programs could have a material impact on investor confidence and business financing conditions.

1. For more analysis of the importance of Japan's new monetary policy regime, please see our previous April issue of the Global Economy Watch.

2. For the full paper please see: www.pwc.co.uk/the-economy/publications/stock-markets-and-the-real-economy or our 'Economics in Business' blog

Projections

	Share of world GDP		Real GDP growth				Inflation			
	PPP*	MER*	2012p	2013p	2014p	2015-9p	2012p	2013p	2014p	2015-9p
Global (market exchange rates)			2.4	2.5	3.2	3.1	4.7	4.6	4.8	4.6
Global (PPP rates)			3.0	3.2	3.8	3.7				
United States	19.1%	21.7%	2.2	2.1	2.8	2.4	2.1	2.0	2.1	1.9
China	14.3%	10.5%	7.8	8.0	8.0	7.0	2.7	3.2	3.5	3.4
Japan	5.6%	8.4%	2.0	1.2	1.2	1.0	-0.0	0.3	1.5	1.5
United Kingdom	2.9%	3.5%	0.3	1.0	2.0	2.4	2.8	2.8	2.4	2.0
Eurozone	14.2%	18.8%	-0.6	-0.4	1.0	1.5	2.4	1.6	1.7	1.9
France	2.8%	4.0%	0.0	0.2	1.1	1.6	2.2	1.4	1.6	2.0
Germany	3.9%	5.1%	0.9	0.4	1.6	1.5	2.1	1.6	1.9	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	1.0	1.2	1.7
Italy	2.3%	3.2%	-2.2	-1.2	0.5	0.8	3.3	1.9	1.8	1.7
Netherlands	0.9%	1.2%	-0.9	-0.5	1.0	1.6	2.8	2.4	2.0	2.1
Portugal	0.3%	0.3%	-3.2	-2.0	0.8	1.8	2.8	0.8	1.2	1.5
Spain	1.8%	2.1%	-1.4	-1.4	0.4	2.0	2.4	2.1	1.8	1.9
Poland	1.0%	0.7%	2.3	1.4	2.6	3.9	3.7	1.5	2.4	2.5
Russia	3.0%	2.7%	3.6	3.3	3.8	3.8	5.1	5.9	5.8	5.6
Turkey	1.4%	1.1%	2.2	3.6	4.8	5.3	8.9	6.8	6.1	4.8
Australia	1.2%	2.1%	3.6	2.5	3.0	3.0	2.4	2.5	2.8	2.7
India	5.7%	2.4%	5.1	6.0	6.9	7.0	7.5	6.2	6.8	6.0
Indonesia	1.4%	1.2%	6.2	6.2	6.3	6.3	4.3	5.4	5.2	5.1
South Korea	2.0%	1.6%	2.0	2.7	3.2	3.8	2.2	2.3	2.7	2.9
Argentina	0.9%	0.6%	2.0	2.8	2.5	3.3	10.0	10.0	10.1	9.7
Brazil	2.9%	3.6%	0.2	3.0	3.9	4.0	5.4	5.7	5.3	4.8
Canada	1.8%	2.5%	1.9	1.6	2.5	2.2	1.5	1.5	1.8	2.1
Mexico	2.1%	1.7%	4.0	3.8	4.0	3.6	4.1	3.8	3.9	3.6
South Africa	0.7%	0.6%	2.5	2.7	3.8	3.8	5.7	5.7	5.7	4.8
Saudi Arabia	0.9%	0.8%	6.8	4.4	4.2	4.3	4.0	4.4	4.5	4.0

Interest rate outlook of major economies

	Current state (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December2008)	On hold to 2015	18-19 June
European Central Bank	0.75% (July 2012)	Cut expected in 2013	2 May
Bank of England	0.5% (March 2009)	On hold to end of 2013	8 and 9 May

*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. *Note that PPP refers to Purchasing Power Parity and MER refers to market exchange rates. The arrows indicate how our growth projections have changed compared to our view in the previous month.*

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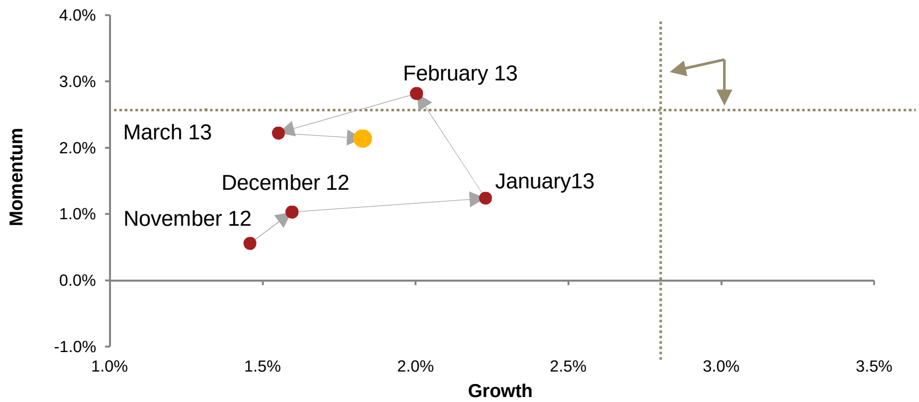
PwC Global consumer index – April 2013

Consumption growth remains in positive territory but is below its long-term average. This can partly be explained by the continued uncertainty in the Eurozone which continues to weigh down on global consumption growth



The Global Consumer Index is a timely 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: pwc.co.uk/globalconsumerindex for more details.
Growth refers to the year-on-year change. Momentum is calculated as the 3 month annualised growth rate.

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