Global Macroeconomic Outlook
June 2014
Global Economic Outlook

For the remainder of 2014, economic growth in the developed world is expected to be somewhat higher than the average growth over the last ten years. Emerging market economic growth is projected to be higher than that for developed markets, but lower than the average growth over the last ten years.

- Continued low interest rates globally, improvements in the U.S. labor market, and stimulus in Japan and Europe should all improve GDP growth in developed economies.
- Improvements in developed economies could help demand for emerging economy goods. China’s ability to pivot from growing through investment to growing through consumption remains a key outstanding issue.
- Forecast for GDP in major economies recently increased, while estimates for emerging markets excluding China fell. The recent U.S. GDP (1Q14: -2.9%) stumble could weigh on the final 2014 U.S. GDP growth rate.
- Most projections for inflation over the next year declined, particularly in Europe. Excluding Japan, near-term global inflation is projected to trail the ten-year average.

<table>
<thead>
<tr>
<th>Country</th>
<th>Real GDP (%)</th>
<th>Inflation (%)</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>IMF 2014 Forecast</td>
<td>IMF Revised 2014 Forecast</td>
</tr>
<tr>
<td>U.S.</td>
<td>2.6</td>
<td>2.8</td>
</tr>
<tr>
<td>European Union</td>
<td>1.3</td>
<td>1.6</td>
</tr>
<tr>
<td>Japan</td>
<td>1.2</td>
<td>1.4</td>
</tr>
<tr>
<td>China</td>
<td>7.3</td>
<td>7.5</td>
</tr>
<tr>
<td>Emerging Markets (ex. China)</td>
<td>4.1</td>
<td>3.7</td>
</tr>
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Source: IMF. “IMF 2014 Forecast” represents the IMF’s October 2013 projections and the “IMF Revised 2014 Forecast” represents the IMF’s April 2014 projections.
The U.S. Federal Reserve plans to continue to decrease their bond buying program, while in Europe further monetary stimulus is likely in light of deflationary pressures. Continued fiscal and monetary stimulus is likely in Japan.

- The head of the U.S. Federal Reserve, Janet Yellen, recently suggested that the central bank could maintain its low interest rate policy for some time after the end of its bond buying program. The Fed also predicted a slightly faster pace of increasing short-term interest rates, while reducing its long-term rate projections.

- The U.S. Federal Reserve continues to reduce its monthly bond purchase program (i.e., quantitative easing) announcing its fifth $10 billion reduction in June and bringing its monthly purchases to $35 billion. It is likely that the Federal Reserve will end its purchases by year-end.

- A low interest rate policy, as well as government programs aimed at encouraging home purchases, has led to a housing market boom in Britain. Policy makers intend to respond by implementing macroprudential tools (e.g., regulating mortgage terms), as opposed to increasing interest rates.

- In an effort to encourage banks to lend more, the European Central Bank (ECB) recently implemented negative interest rates on reserves held at the Central Bank, and lowered its key interest rate from 0.25% to 0.15%. Also, the ECB announced plans to inject liquidity into Eurozone banks with the goal of boosting lending to businesses.

- Despite a weakening yen, due in part to the Bank of Japan’s stimulative efforts, Japan continues to run a trade deficit. Weak demand from the U.S. and Europe, and higher import demand leading up to the consumption tax increase in April and for fuel imports, have weighed on Japan’s trade balance.

Several issues remain of primary concern: 1) continued economic sluggishness in developed markets; 2) the normalization of interest rates globally; 3) the potential for a rapid slowdown in China hurting the global economy; and 4) increased geopolitical tensions.
Macroeconomic Risk Matrix

- Normalization of Interest Rates Globally
- European Bank/Sovereign Debt Imbalances
- Europe/Japan Aging Demographics
- Resource Scarcity
- Geopolitical Tension
- China Potential Shadow Banking Defaults
- Potential Failure of Abenomics

Duration of Event:
- Instantaneous
- Multi-Generational

Estimated Severity of Event:
- Mild
- Moderate
- High
- Very High
## Macroeconomic Risk Overviews

<table>
<thead>
<tr>
<th>European Bank/Sovereign Debt Imbalances</th>
<th>The crisis is rooted in structural issues in the Euro-zone related to the combination of a single currency (euro) combined with 17 fiscal authorities. Several negative outcomes are possible from the sovereign debt crisis, including sequential sovereign default, a break-up of the euro, bank failures, political regime change, and rapid de-leveraging/deflation.</th>
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<tbody>
<tr>
<td>Potential Failure of Abenomics</td>
<td>Japan has embarked on a historic stimulus program, commonly referred to as “Abenomics” in an effort to fight its decades of deflation. The plan includes monetary, fiscal, and structural components. If Japan overshoots with its policies, or dramatically changes them unexpectedly, it could prove to be very disruptive to markets and growth.</td>
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<td>Europe/Japan Aging Demographics</td>
<td>In Japan and Europe birth rates have declined, resulting in populations becoming older and smaller relative to the rest of the world. These demographic trends will have a negative long-term impact on GDP growth and fiscal budgets, amplifying debt problems.</td>
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<td>Geopolitical Tension</td>
<td>Recently, tensions increased in Iraq as the Islamic State of Iraq and Syria (ISIS), a radical offshoot of al-Qaeda, seized the cities of Mosul and Fallujah. The takeover of Mosul dramatically increased the groups funding as they seized hundreds of millions of dollars from the area’s branch of the central bank. Additionally, the group took control of oil fields in northern Iraq creating a revenue stream going forward and causing volatility in the energy market. An escalation in the circumstances in Iraq could prove to be disruptive to energy and commodity markets. There also remain other unresolved geopolitical issues including tensions between Russia and Ukraine, China’s maritime expansion, the civil war in Syria, and the on-going conflict between Israel and Palestine.</td>
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<td>China Potential Shadow Banking Defaults</td>
<td>Since the Global Financial Crisis, China’s debt burden has increased dramatically, particularly in the “shadow banking” system. Companies looking for financing that have been deemed a high risk by traditional banks have been turning to non-bank institutions for funding. Traditional banks have been offering clients higher yielding products issued by “shadow banks” and backed largely by loans to high risk borrowers. Although these products are offered through traditional banks, they do not ultimately back them. Recently, investors in one such product backed entirely by equity in and loans to a major coal mining company learned that they may not receive their principal back. Ultimately, it was announced that investors would receive their full investment back, but would not receive a portion of the interest expected. Little details were provided on the last minute source of the rescue capital. Going forward, additional bailouts could be required if other similar products default.</td>
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Macroeconomic Risk Overviews, Continued

| **Normalization of Interest Rates Globally** | After the Global Financial Crisis, the developed world, particularly the U.S., injected massive amounts of liquidity into the financial system in an effort to prevent depression-like declines in growth. Additionally, the world’s central bank reduced short-term interest rates to record lows. As the global economy continues to improve, and monetary stimulus is withdrawn, it is likely that interest rates will normalize. An increase in interest rates could weigh on growth globally, particularly in emerging markets. |
| **Resource Scarcity** | The increasing world population, urbanization, and a growing middle class, particularly in emerging economies, could all lead to a scarcity of resources going forward, including food, water, land, energy, and minerals. As demand continues to grow and supply declines, it is possible that commodity prices will skyrocket, hurting the living standards of many and increasing the risk of geopolitical conflicts. |
Positive Macroeconomic Trends Matrix

- Developed World Monetary Stimulus
- U.S. Stable Growth
- Enhanced Energy Extraction Technologies
- Growth of Emerging Markets Middle Class
- Improvements in Health Care
- Improvements in Education
- Increased Multilateral Global Trade

Duration of Event:
- Instantaneous
- Multi-Generational

Projected Impact of Event:
- Mild
- Moderate
- Significant
- Enduring
### Positive Macroeconomic Trends Overviews

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
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<tr>
<td><strong>U.S. Stable Growth</strong></td>
<td>Despite the first quarter decline in growth, the U.S. economy has shown signs of improvement with GDP growth stabilizing and unemployment declining. Continued stabilization in the world’s largest economy should lead to improvements in employment and growth domestically, as well as increased demand for goods and services from abroad.</td>
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<td><strong>Growth of Emerging Markets Middle Class</strong></td>
<td>In emerging economies, the size of the middle class is projected to grow significantly over the next twenty years. The growing middle class in the emerging economies should increase consumption globally, which in turn will drive GDP growth and create jobs.</td>
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<td><strong>Increased Multilateral Global Trade</strong></td>
<td>The pace of globalization has accelerated, particularly in emerging economies. Increased trade and investment, as well as access to foreign capital and export markets for corporations, should lead to lower costs, higher efficiencies, and higher global growth.</td>
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<td><strong>Improvements in Education/Healthcare</strong></td>
<td>Literacy rates and average life spans have increased globally, particularly in the emerging economies. Higher literacy rates will likely be a driver of future growth, as the ability to read helps people learn new skills and improve existing skills. When people live longer it increases incentives to make long-term investments in human capital (i.e., education and training), resulting in a more productive work force and ultimately more growth.</td>
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<td><strong>Enhanced Energy Extraction Technologies</strong></td>
<td>Hydraulic fracturing (i.e., fracking) technologies have allowed large new supplies of natural gas and oil to be extracted from shale rocks, predominantly in the U.S. The large new supply of natural gas has decreased U.S. prices to levels considerably below the rest of the world. Going forward, it is likely that other countries will work to improve their fracking technologies, further increasing the supply of oil and gas globally.</td>
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<td><strong>Developed World Monetary Stimulus</strong></td>
<td>Developed market central banks have embarked on a massive monetary stimulus campaign in the aftermath of the Global Financial Crisis. The U.S., European, and Japanese central banks continue to maintain interest rates at record lows. Japan has embarked on an unprecedented asset purchase program (quantitative easing), while the U.S. recently has begun reducing its stimulative efforts. Going forward, if central banks continue to provide liquidity and keep interest rates low this should stimulate growth.</td>
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Since the post Global Financial Crisis recovery, real GDP growth has slowed globally with emerging economies continuing to grow at a faster pace than developed economies.

China’s growth has declined from double-digit levels, but it remains well above other emerging economies. The planned transition to a consumption-based growth model from the current investment-focused model could further weigh on China’s growth in the short-term.
In the first quarter, GDP fell by 2.9% in the U.S., driven by declines in private inventory purchases and exports.

The final estimate of GDP came in 1.9% below the prior estimate, marking one of the largest downward revisions on record.

Source: U.S. Bureau of Economic Analysis. Data is as of March 31, 2014.
Recently, the U.S. unemployment rate declined, but the percentage of the population that is employed is less than 50%.

Improvements in the U.S. economy could lead to the unemployment rate increasing, as those currently not looking for work return to the job market and are included in the unemployment calculation.
The U.S. Federal Reserve’s preferred measure of inflation remains well below its tolerance level (1.5% versus 2.0%) allowing for flexibility in their monetary policy, if needed.

When accounting for food and energy, prices recently increased due respectively to poor growing conditions and tensions in Iraq and Ukraine.

If prices continue to climb it could create pressure on U.S. consumers particularly due to stagnant wages.
Despite continued economic sluggishness and financial risk, bond yields on peripheral European countries have declined to levels close to the U.S.

In Greece, yields have declined from their peak of close to 35% to 6%, a level only 3.4% above the U.S.
The risk of deflation in the region, along with the strengthening euro, led the European Central Bank (ECB) to recently announce further monetary stimulus including a reduction in interest rates and increased liquidity to banks.

If deflationary pressures persist and growth remains low it is likely that the ECB will introduce further monetary stimulus.
Japan continues to run a trade deficit, despite the weakening of the yen by historic monetary stimulus.

The continued need to import energy after the Fukushima nuclear disaster and weak export demand have weighed on Japan’s trade balance.
• Although emerging market investment returns have recently trailed those of developed markets, the long-term growth thesis remains intact.

• Lower debt levels, along with a growing middle class and higher ratios of working age people, should help bolster emerging economy growth.
China’s debt level has reached 240% of GDP when the “shadow banking” sector is included.

The growing amount of loans to higher risk borrowers outside the traditional banking system could require large scale bailouts by the Chinese government and ultimately weigh on growth.
India’s current account deficit has recently declined and its currency strengthened as exports have increased and the government has imposed several tax hikes on gold imports.

With the recent election of pro-business Narendra Modi as prime minister, and the government’s recent efforts to improve the current account balance, India’s equity market has increased.
Summary

For 2014, four primary concerns face the global economy: 1) continued economic sluggishness in developed markets; 2) the normalization of interest rates globally; 3) the potential for a rapid slowdown in China hurting the global economy; and 4) increased geopolitical tensions.

- Growth remains sluggish in the major developed market economies including the U.S., Europe, and Japan. Additionally, all three economies are at varying stages of historic monetary stimulus. Any unexpected changes to monetary policy could prove disruptive to markets and global growth.

- The normalization of interest rates from historic lows will likely create headwinds to global growth. Emerging economies could particularly be hurt by this trend, especially those with current account deficits.

- China’s recent growth has been mainly driven by debt-fueled investment, a lot of which came from the “shadow banking” system. The planned transition from an investment based growth model to a consumption based growth model could prove to be difficult in the short-term, as the targeted rate of debt growth could weigh heavily on economic growth. Further, the high level of debt outside the traditional banking system creates the threat of large scale defaults and the need for government bailouts.

- If the situation in Iraq continues to deteriorate it could be disruptive to energy markets and weigh on growth. The conflict between Ukraine and Russia, the civil war in Syria, and China’s maritime expansion are other issues that remain unresolved.