AQUILA

Flash

World economy will do fairly well this year

The impetus for growth in the world economy is coming from the US and the fast-growing economies in Asia. But the Eurozone should beat the low expectations of investors regarding this year's growth rate, thanks to a low oil price and the push towards a weaker euro. The bond markets don't believe the world economy can show strong growth on a sustained basis. They doubt the willingness of politicians to press ahead with structural reform, without which current growth rates are not sustainable.

Markets remain fearful as to the strength of the growth dynamic.

The bond markets have a good feel for the strength of the business cycle and are indicating their skepticism by marking yields at record lows. There is no doubt that the fixed income markets are more sensitive to the outlook for growth than are their equity counterparts. However, today's interest rates not only reflect macroeconomic developments, they are also being influenced to a significant extent by the policies of the central banks. The collapse of the oil price is widely cited as an indicator of deterioration in the economic outlook. But the price weakness seems rather to be the result of supply factors as opposed to demand levels. Sustained excess production - some 1.5 million barrels a day above global demand – has an inevitable impact on the oil price.

Conditions are in place for 3% growth in the US.

Growth skeptics in the US argue that the strong dollar will hit US exports and hence the overall US growth rate. This reasoning is at least partially correct. Certainly, the strong dollar has played a part in the recent disappointing earnings reports of very large US multinational companies. But one should remember that less than 20% of the profits of US companies come from their overseas operations. Moreover, not all companies have been strongly impacted by the dollar's strength. Thus, while Caterpillar disappointed investors, the results of Apple were very pleasing. There is a rule of thumb which states that a 10% rise in the value of the dollar will lead to a near 1% decline in US economic growth. But this relationship does not take proper account of the ability of American companies to adjust to changing circumstances. The weak oil price is also being cited as a brake on US growth due to its impact on investment and employment in the energy sector. While correct, this argument needs putting into perspective. Investment in the US oil and gas industry is only around 1% of US GNP and the sector represents less than 1% of total employment. We believe the low oil price has a beneficial overall impact on the US economy as it boosts real disposable incomes (or purchasing power) and will more than offset both the negative effects of cheap oil on the energy sector and the deflationary impact of a higher dollar. The momentum in the US economy is being confirmed by macro data. Confidence indicators are moving higher and the trends are decent regarding the labor market, industrial production, the consumer and developments on inflation. Indeed, the latest labor market data have more than matched expectations. On average, 336'000 jobs have been created on a monthly basis over the last three months. Easier credit, very low interest rates, the low oil price and a less restrictive fiscal policy all serve to provide a favorable environment for healthy growth.

An improving outlook for the Eurozone.

The Eurozone suffers under high debt ratios aggravated by a negative debt dynamic, especially in Italy and France. Disinflation is also a contributing factor. Europe's increasing debt problem is the main reason why discussion about falling prices tends to take on a slightly hysterical tone. Certainly, debt is an important factor tending to limit Europe's growth. But also important is the inability of the political process to implement liberalizing economic reform. That said, Europe's economy is currently benefitting, at least temporarily, from a number of positive factors. Much lower oil prices serve to increase consumer purchasing power. The ECB's bond purchase program will tend to weaken the euro, which should not only limit the risk of deflation by making imports more expensive but also improve the competitiveness of Europe's export sector. Germany's manufacturers are benefitting in particular from a more competitive currency. All in all, Europe's growth rate in 2015 is likely to be higher than many now expect.

Japan returns to life, at least temporarily.

Japan's problems have long been recognized. Record levels of public indebtedness, government funding via the printing press as well as a declining population do not combine to produce an encouraging environment for investors. Falling real wages hurt consumers yet to recover fully from the rise in the consumption tax. On the other hand, the Bank of Japan now has an aggressive bond buying program which is also leading to a much more competitive yen. This and the lower oil price are boosting the economy as is indicated by recently published statistics, which record at least a temporary upswing.

The process of rebalancing China's economy continues.

China suffers from overcapacity in its industrial and property sectors. The recasting the economy so that it is more consumer-based is resulting in a lower overall growth rate. It is encouraging, however, that in 2014 China's consumer sector for the first time contributed more than half (51.2%) of the overall growth rate. The same trend is apparent in the faster growth of the service sector relative to the industrial sector. Unlike many other countries, China has scope to shift policy – not only in terms of its monetary and fiscal stance but also in matters of regulation – in a way that can stimulate the overall growth rate. Even though growth might fall to the 6.5% - 7% range this year, China will remain the world's most important growth engine.

2015 should be a decent year for the world economy. But if acceptable growth rates are to be achieved on a sustained basis, structural reform must be addressed.

We forecast an overall growth rate for the world economy this year of 3%. But special factors such as the sharp fall in the price of oil, extraordinary monetary stimulus and currency manipulation will play a significant role in achieving this result. Without market liberalizing reform in the major economies, we doubt that this growth rate can be sustained. In this context, the bond markets are showing a skepticism which is likely to be justified by events. For the equity markets, however, current growth rates are probably good enough to support further gains in the near-term.

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