

Global Economic Outlook

IFoA Pensions Conference 2013

7 June 2013

Neil Williams

Chief Economist
Global Government & Inflation Bonds
Hermes Fund Managers Ltd

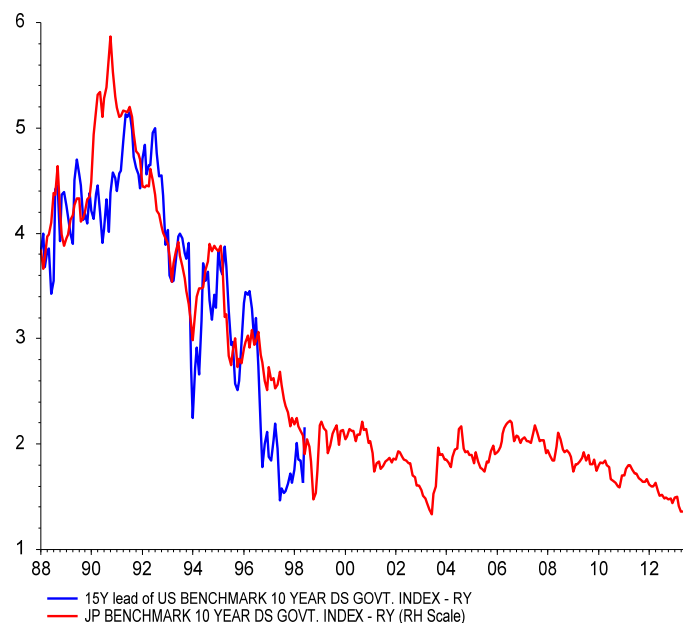
Outline



- Where are we now?
- Policy environment
- Economic outlook for 2014...

In Japan leading the way? Ten-year JGBs *versus* lagged...

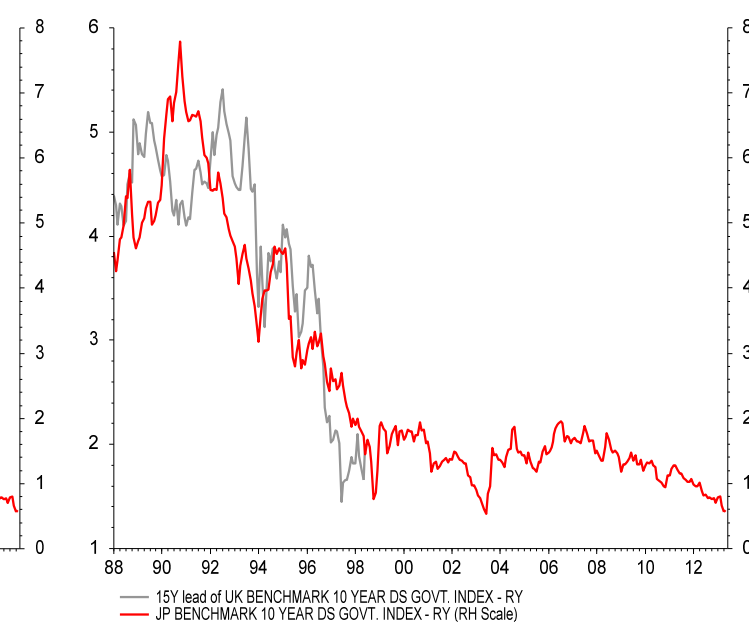
...10-yr US Treasury...



...& 10-yr Bund



...& 10-yr Gilt

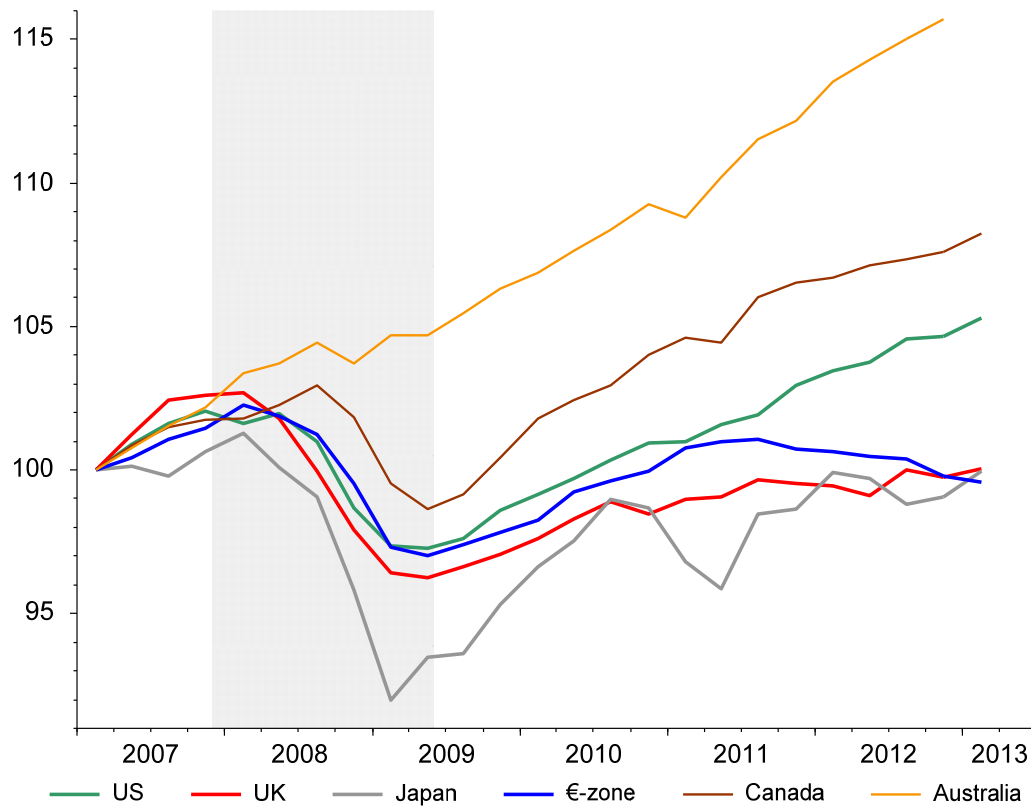


Source (all three charts): Thomson Reuters Datastream

Major economies slow to recoup output lost during the crisis...

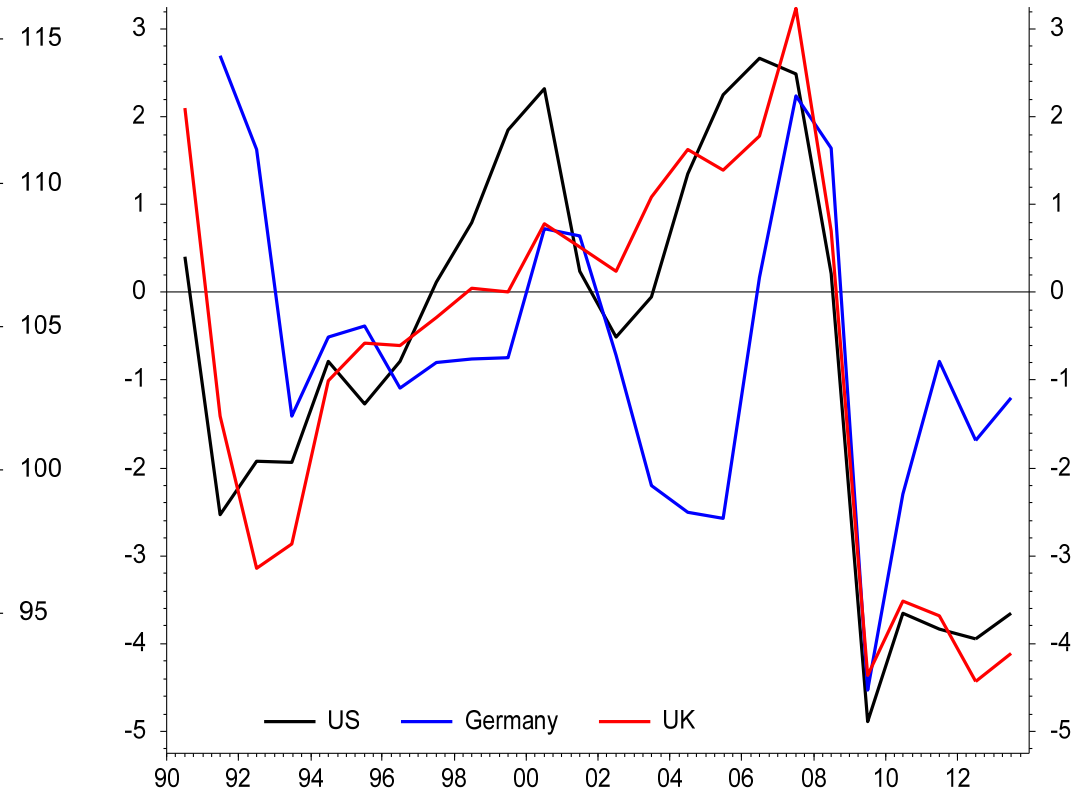
Real GDP levels, rebased to Q1 2007... ...and, there's a lot of ground to make up

Q1 2007 = 100. Grey denotes US recession



Source: Thomson Reuters Datastream, based on national data

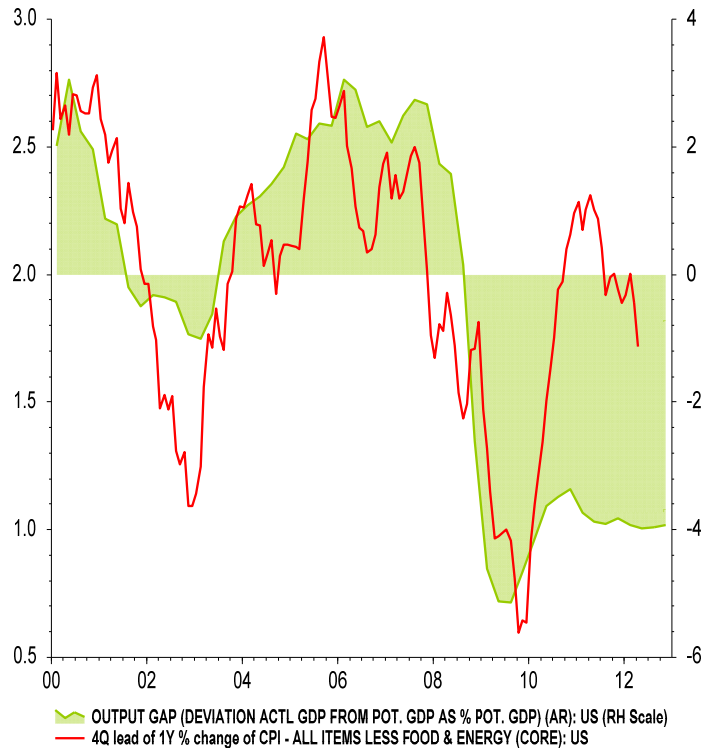
Deviation of a country's actual from potential GDP, as % of potential



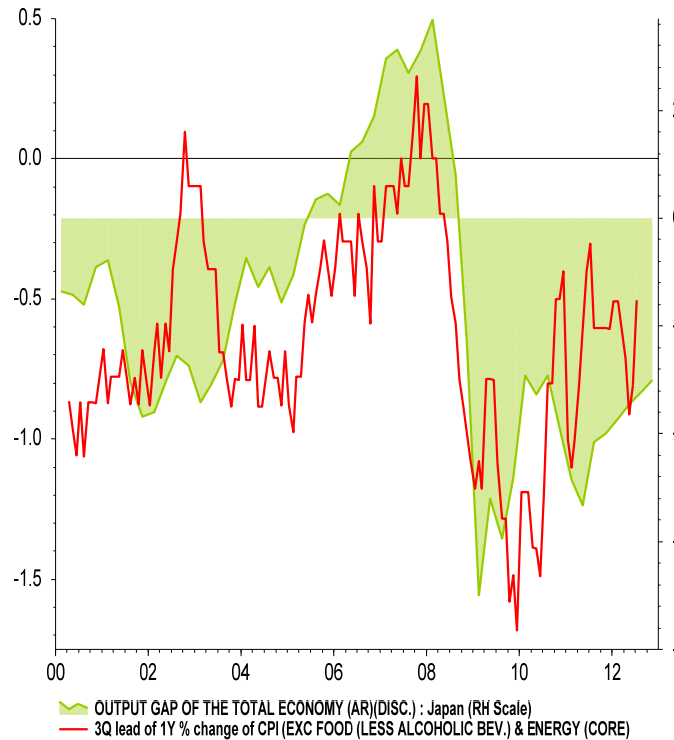
Source: OECD

...So, core inflation should stay tame

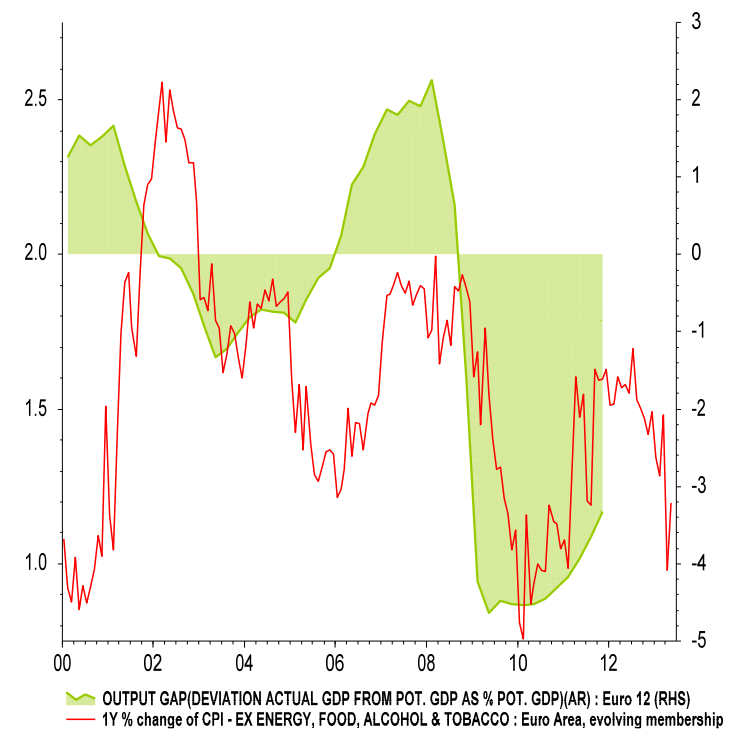
US



Japan



Euro-zone

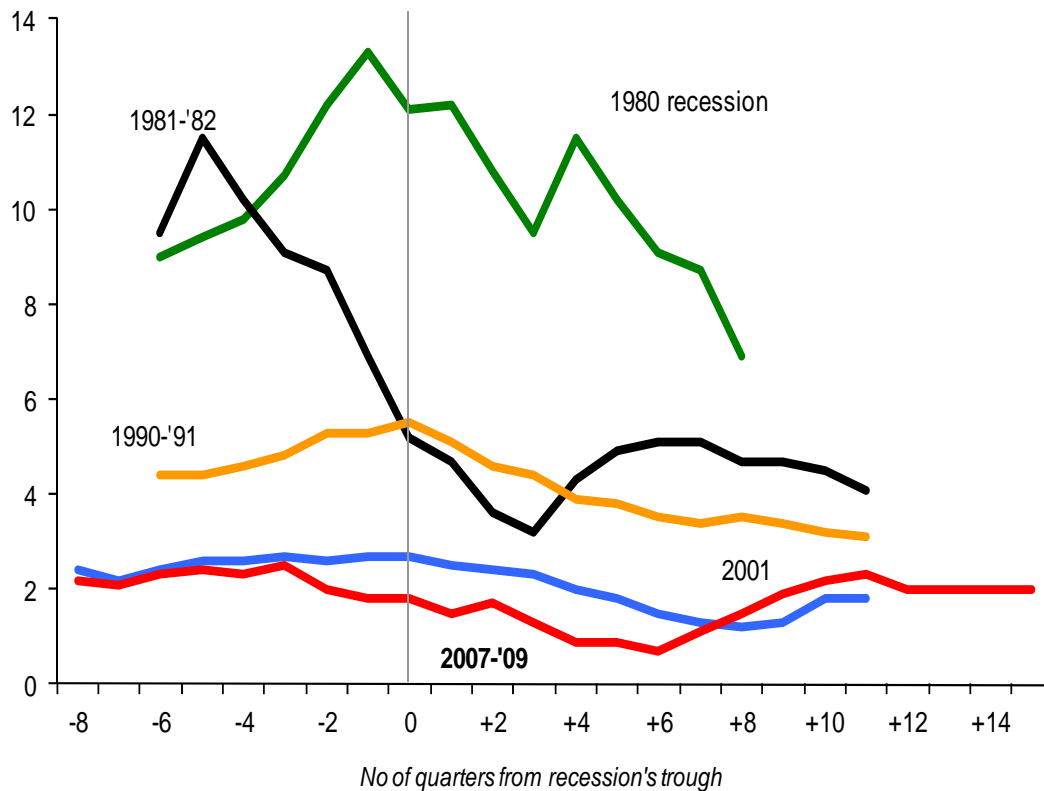


Source (all charts): Thomson Reuters Datastream, & OECD

US – it's different this time

Core CPI in US recoveries

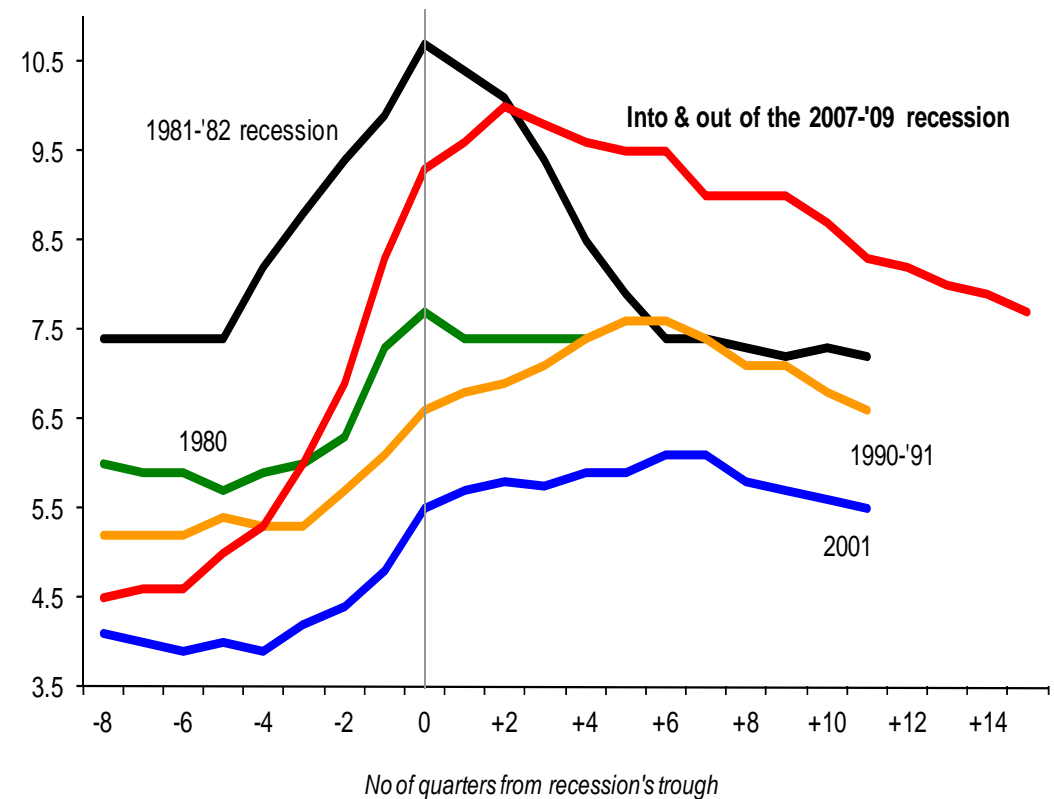
Core CPI (%yoy) into & out of recessions. Years shown are recessions



Source: Hermes Fund Managers Ltd, based on BEA, FRB, & NBER

Unemployment in US recoveries

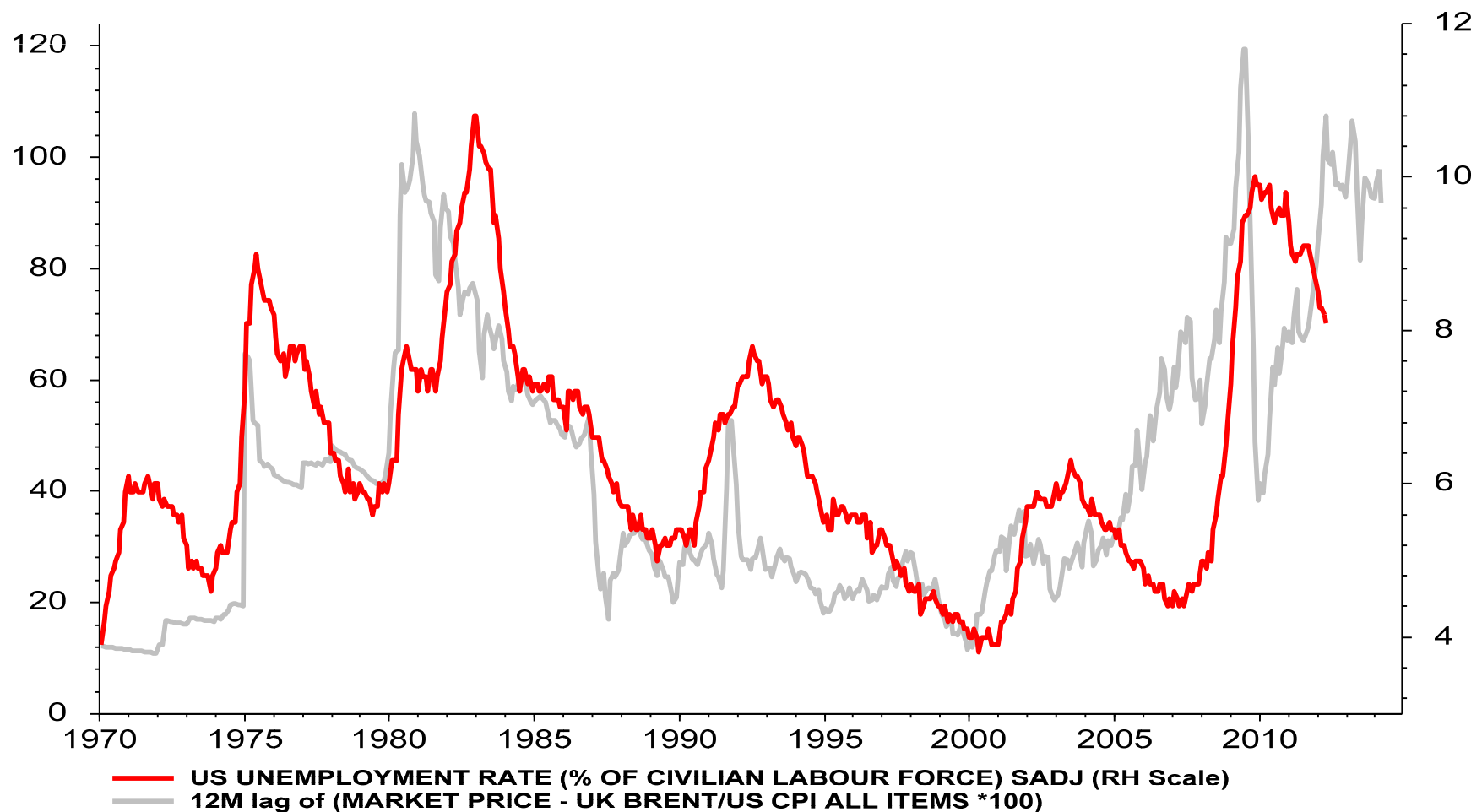
Unemp rate (%) into & out of recessions. Years shown are recessions



Source: Hermes Fund Managers Ltd, based on BLS, & NBER

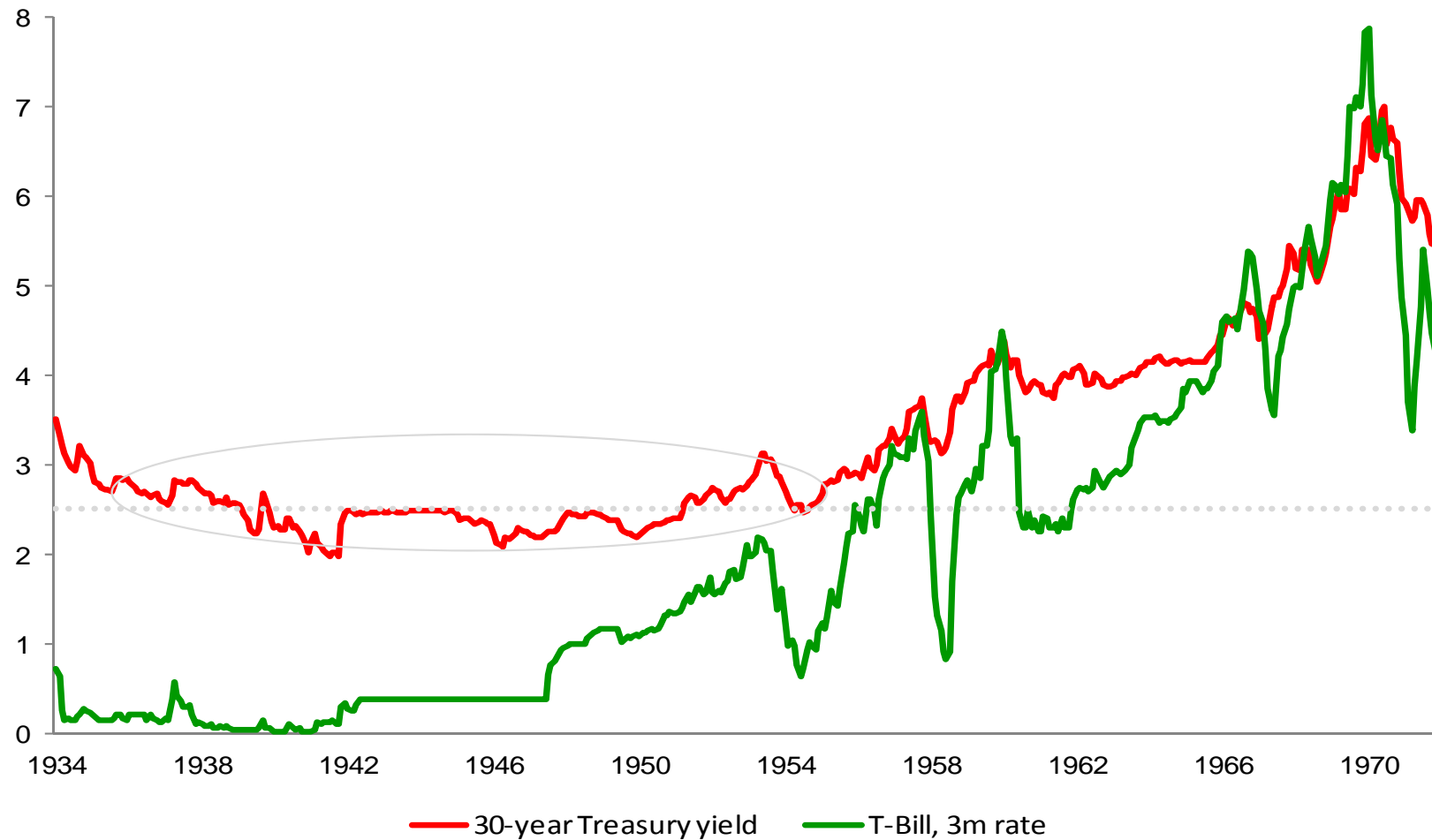
US – loose policy extended if unemployment-falls thwarted

US unemployment rate (%) versus real Brent crude oil price (\$ p/b, deflated by US CPI) lagged 12m



Source: Hermes Fund Managers Ltd, based on Thomson Reuters Datastream

QE – as in the 1930s – is no ‘flash in the pan’



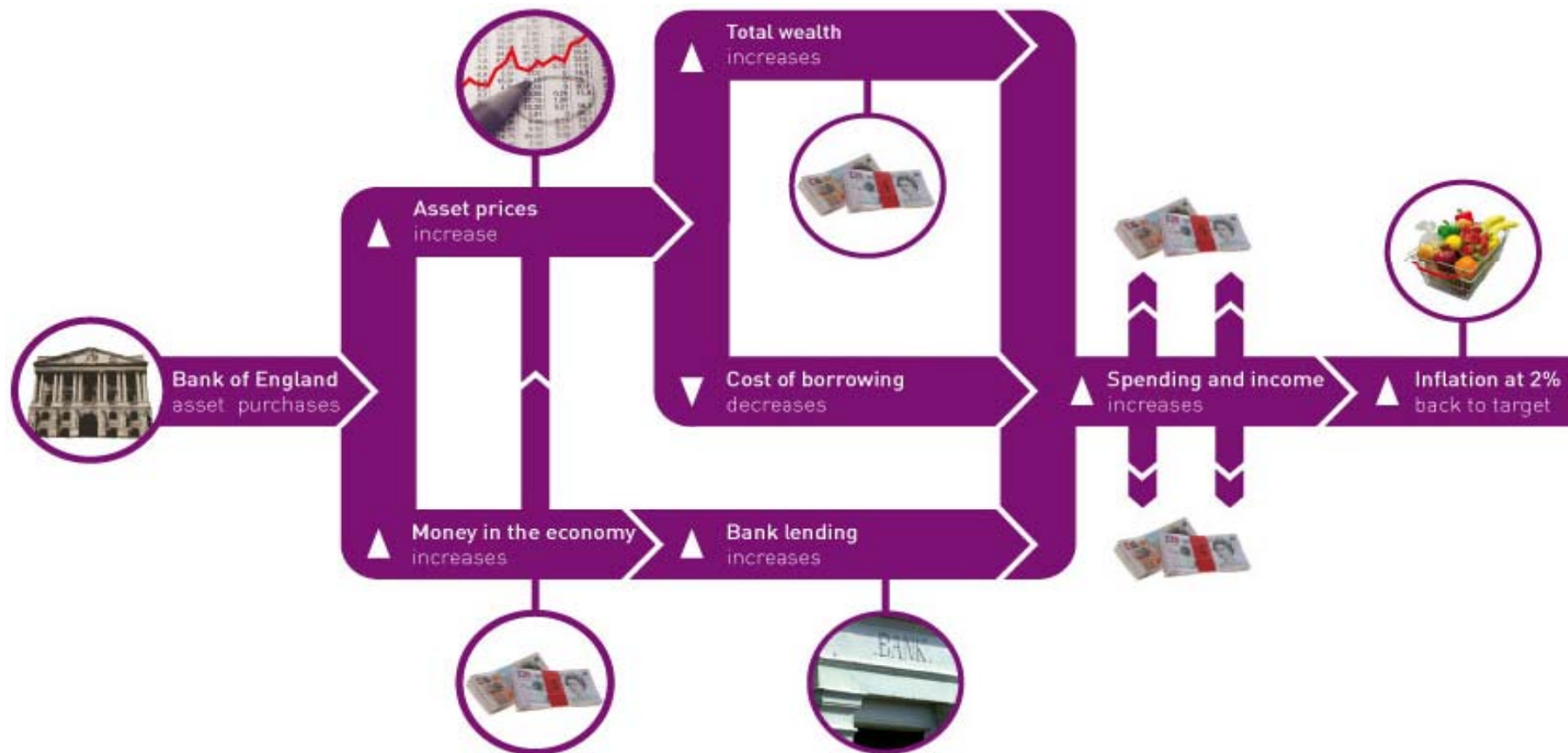
Source: Thomson Reuters Datastream, & Federal Reserve Board

UK - remember QE1?...



...Cash went down the *asset* route...

- This is how QE is supposed to work...



Source: Hermes Fund Managers Ltd, adapted from BoE

UK – BoE's 'likely wish list' when it started QE

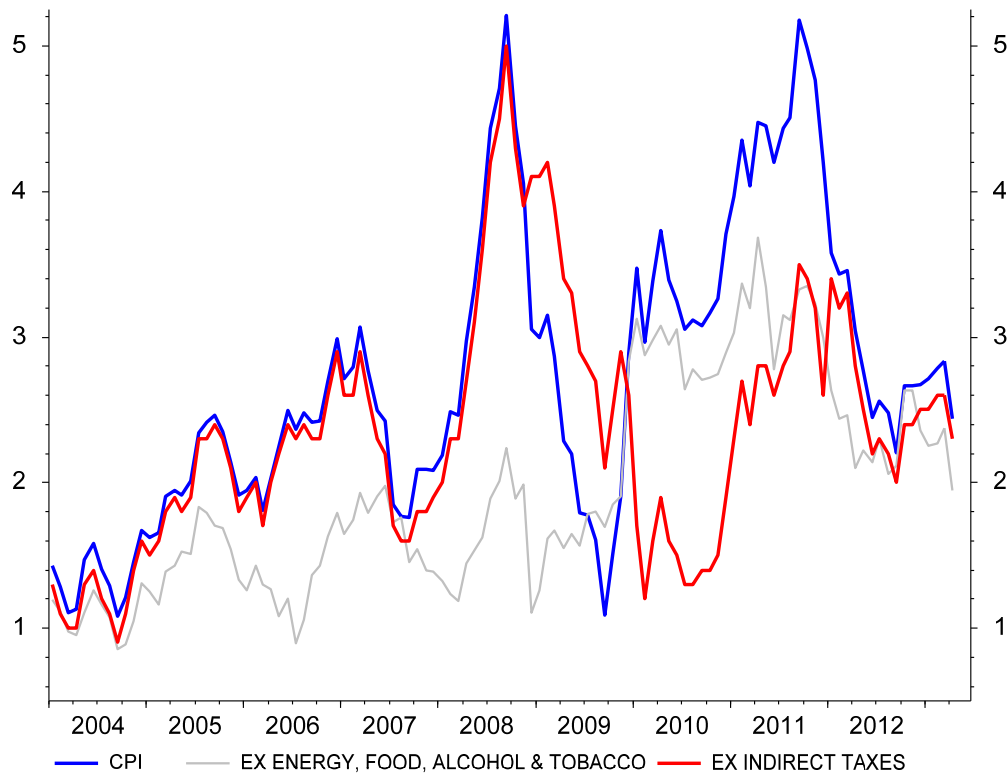
Objective	Our view
Expand the money supply	Little success so far. M4 growth only now reversing four-year <i>downtrend</i> since Feb '09
Keep gilt yields down	Successful - though 10yr yield did quickly go back up to pre-QE levels
Improve the functioning of corporate credit markets	Will have helped sentiment, though BoE corporate buy-backs were small
Higher corporate bond & equity prices	Will have helped, though how much of rallies was down to QE?
Increased capital market issuance	Will have helped - 2009 supply was way up on 2008
Higher real economic output	GDP recession ended in Q3 2009, but started again in Q4 2011
Higher inflation	Uptrend in targeted CPI started in Sept '09, but had as much to do with VAT <i>etc</i>

Source: Hermes Fund Managers Ltd, based on BoE

UK – CPI ex indirect taxes...

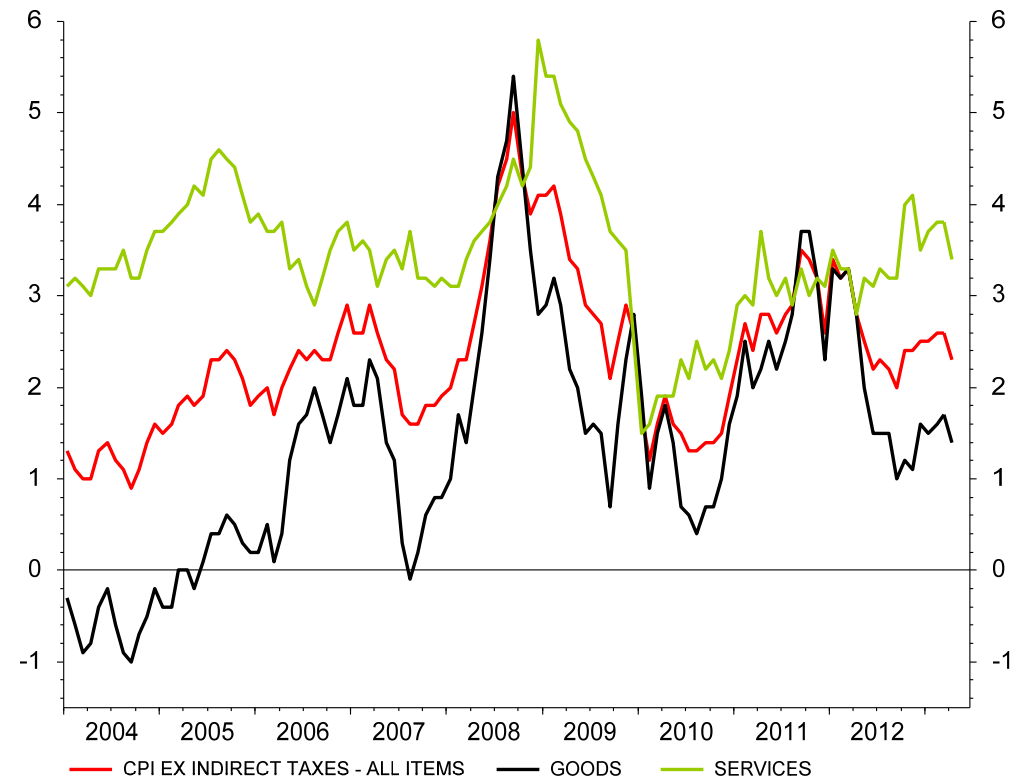
VAT undoubtedly lifted the CPI...

CPI, core CPI, & CPI ex indirect taxes; all % yoy



...but, ex-VAT, services remain sticky

Ex indirect taxes CPI by sector; all % yoy

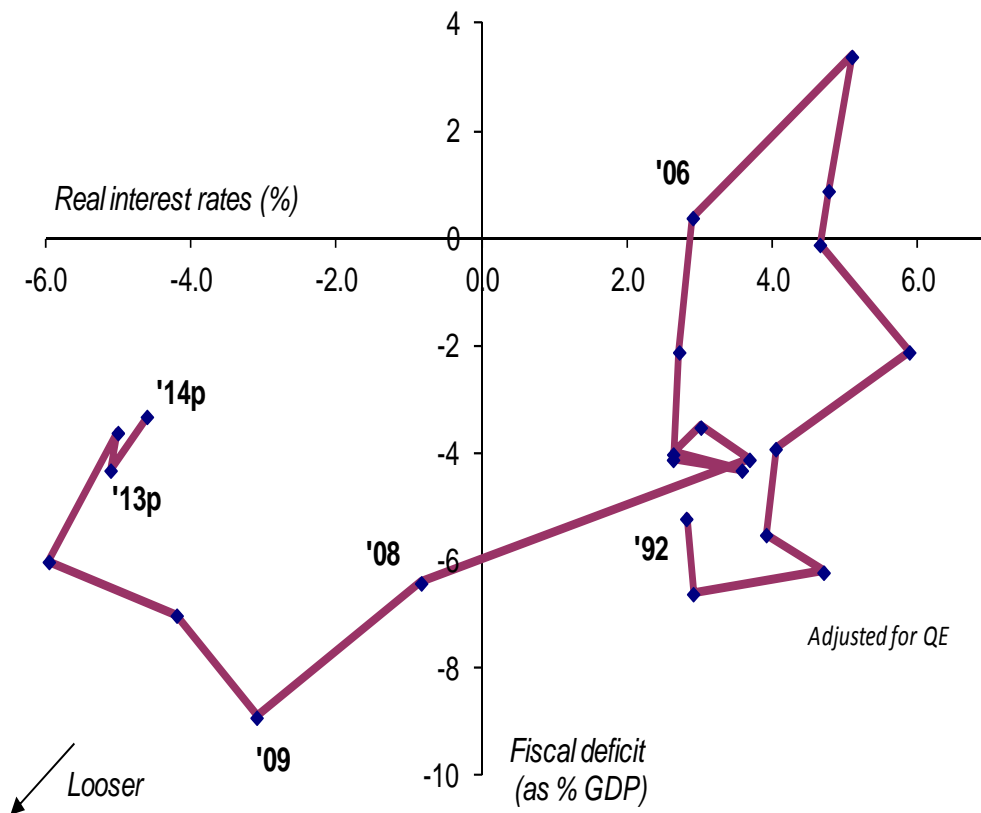


Source (both charts): Thomson Reuters Datastream, based on ONS data

UK's policy mix *adjusted for QE*

This is how UK policy is shifting...

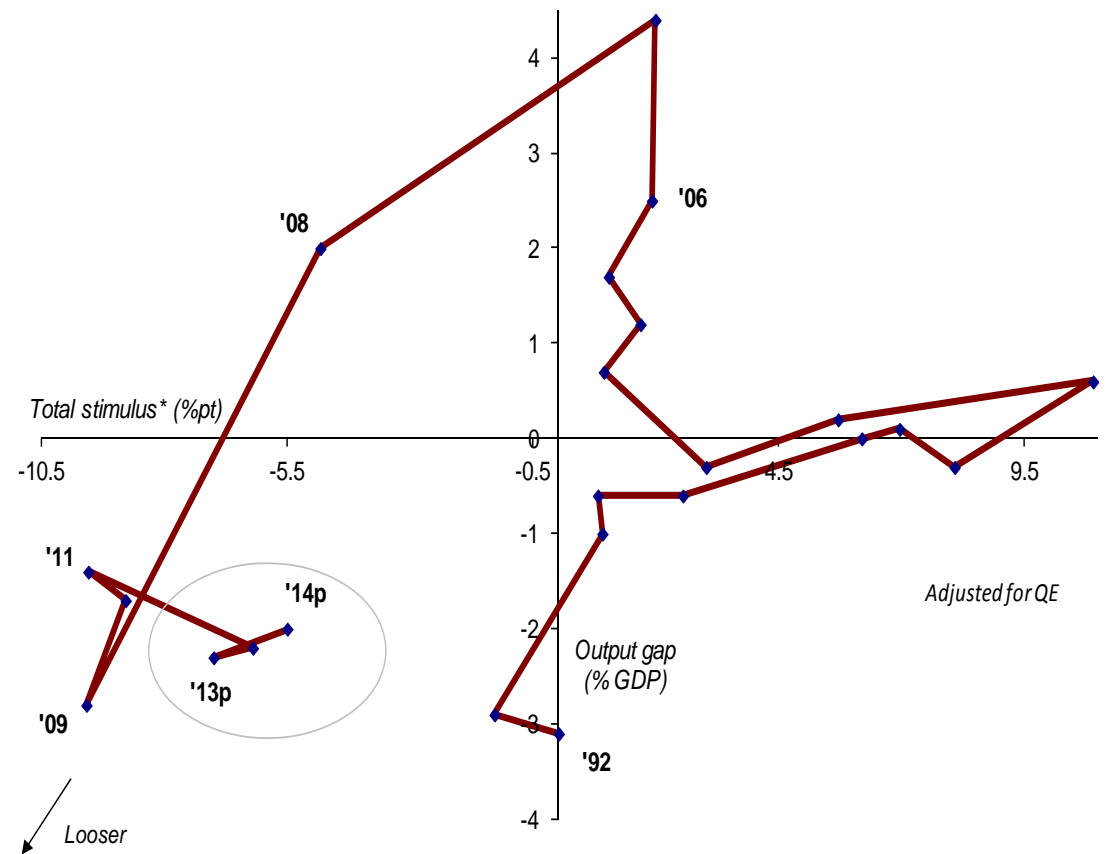
Using QE adj 3m rates, CPI & cyclically adjusted fiscal balance as % GDP



Source (both charts): Hermes Fund Managers Ltd, based on OBR, & OECD data, & Bloomberg

Total stimulus* vs output gap

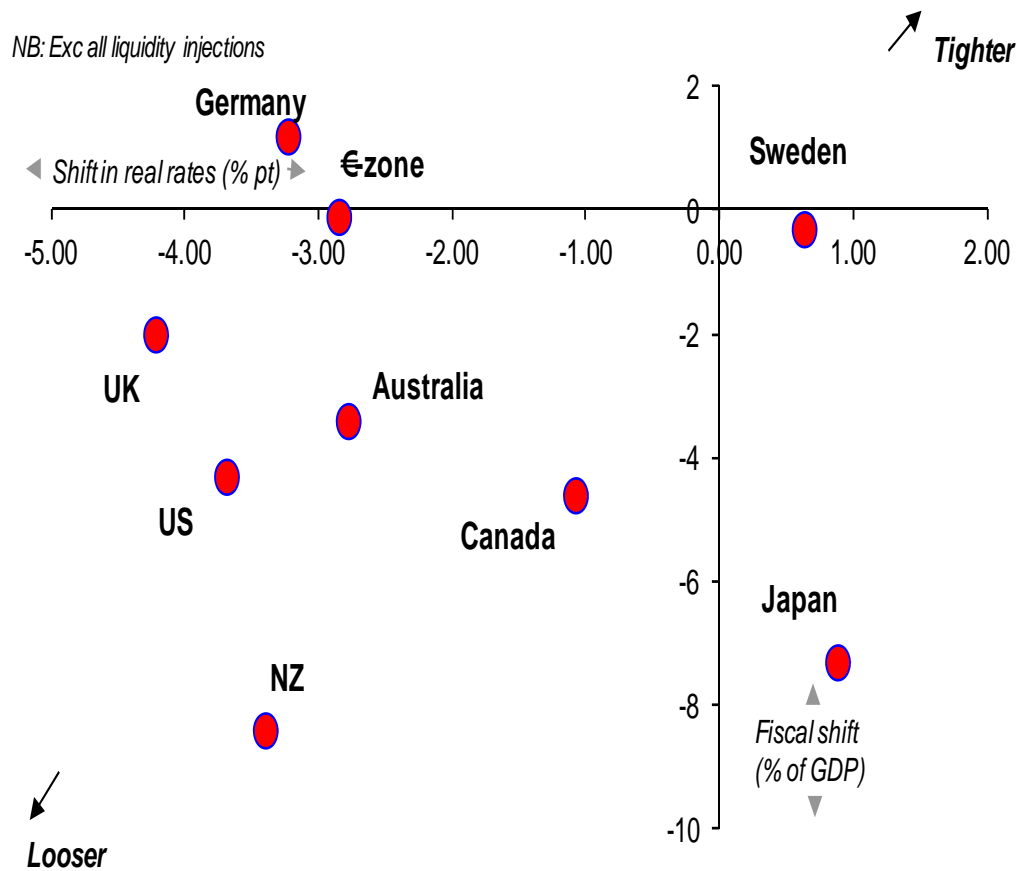
$\{ (QE \text{ adj real rate} - \text{its long-run av}) + (\text{cyc adj fiscal bal as \% GDP} - \text{its long-run av}) \}$



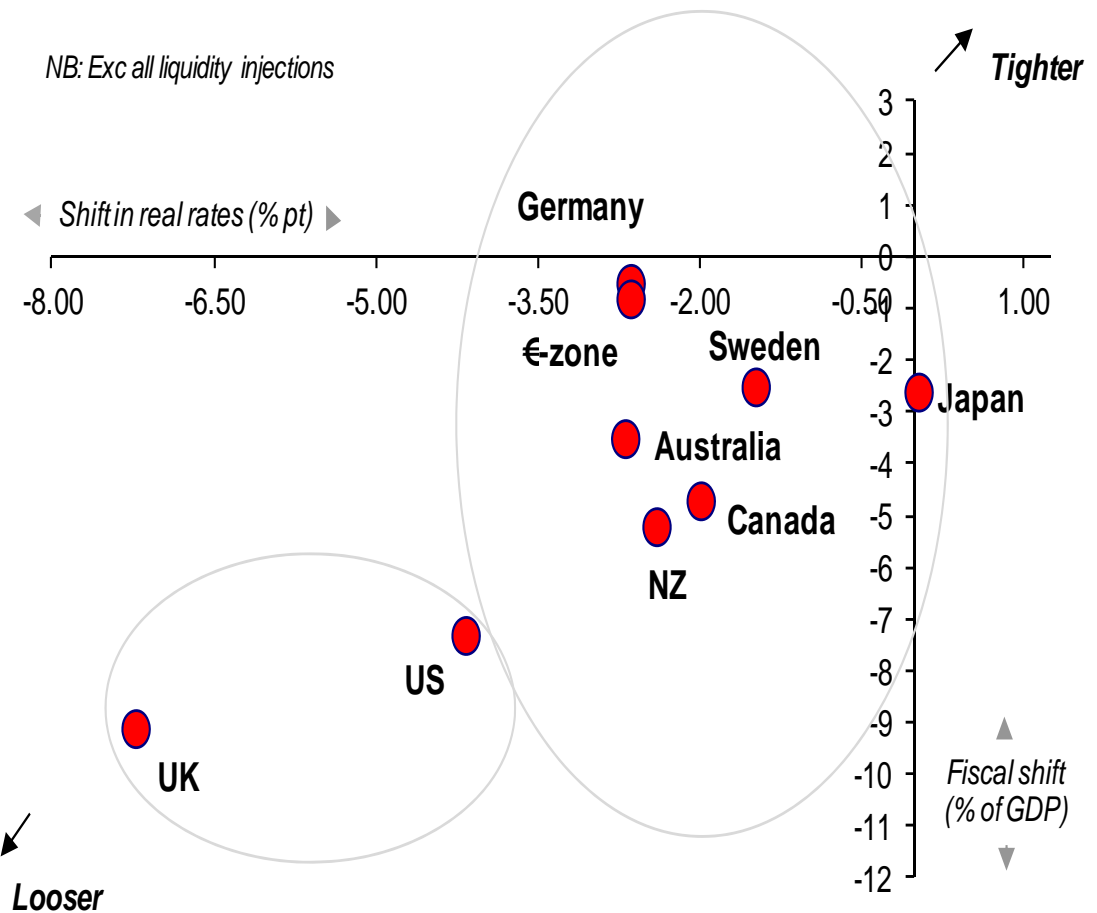
No G7 country has loosened its policy more than the UK...

Shows shifts in real rates (using CPI, 3m Libor) & 2012 cyclically-adjusted budget deficits

...during the crisis (since Dec '06)



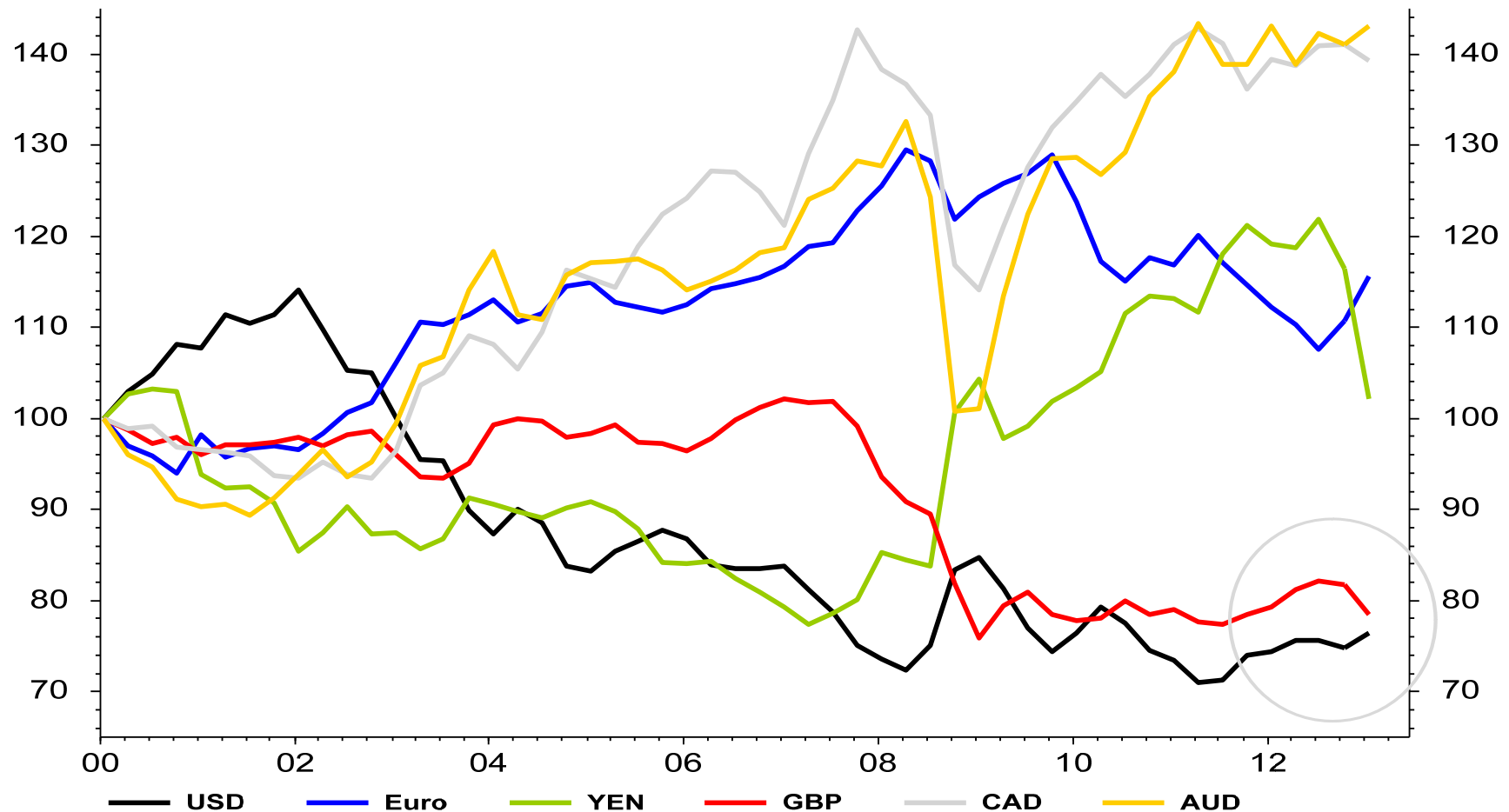
...and since 2000



Source: Hermes Fund Managers Ltd, based on OECD, IMF, & Bloomberg

...Which helps explain the pound's weakness

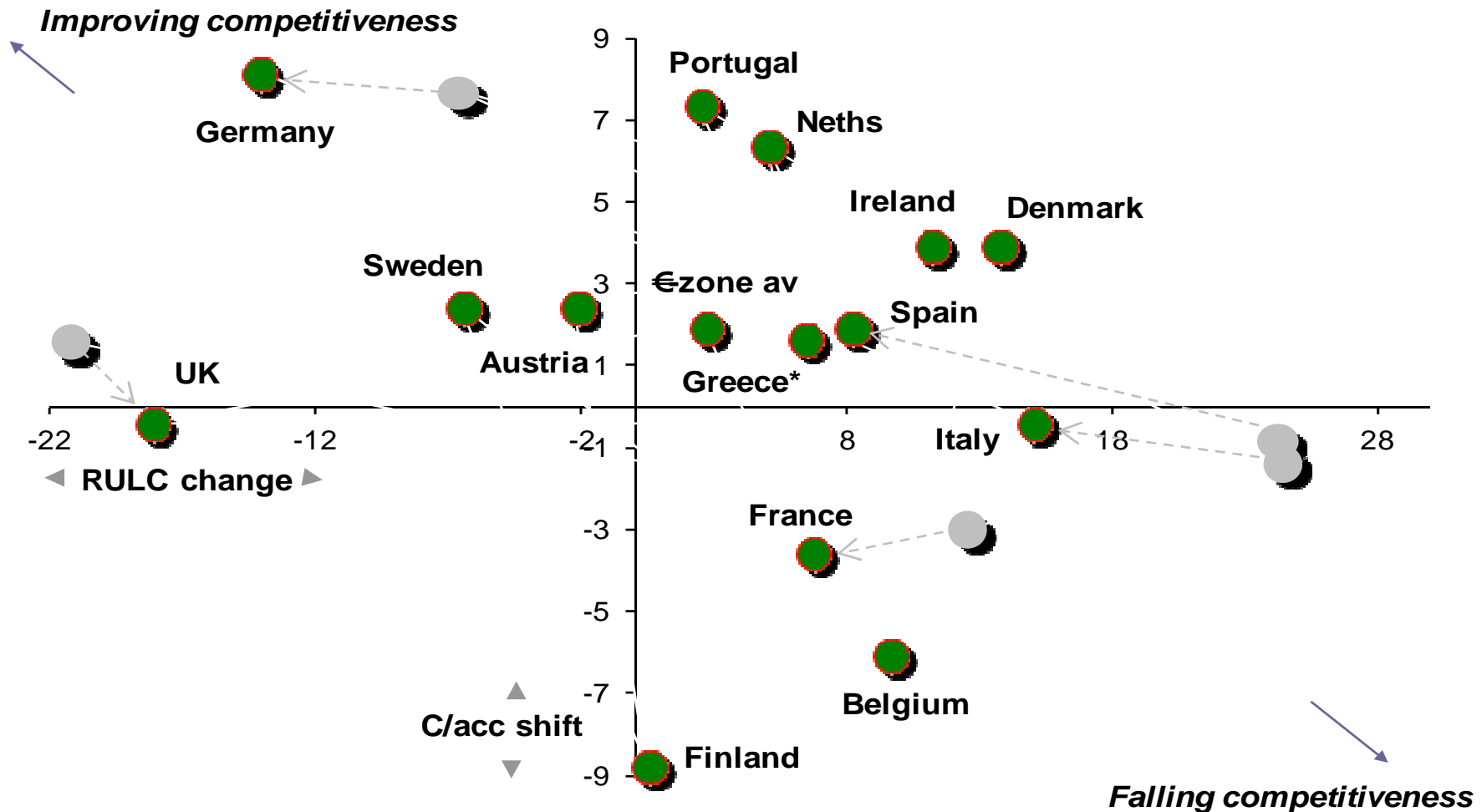
Shows trade-weighted exchange rates, re-based to Feb 2000 (= 100)



Source: Thomson Reuters Datastream

Still mixed competitiveness since the euro...

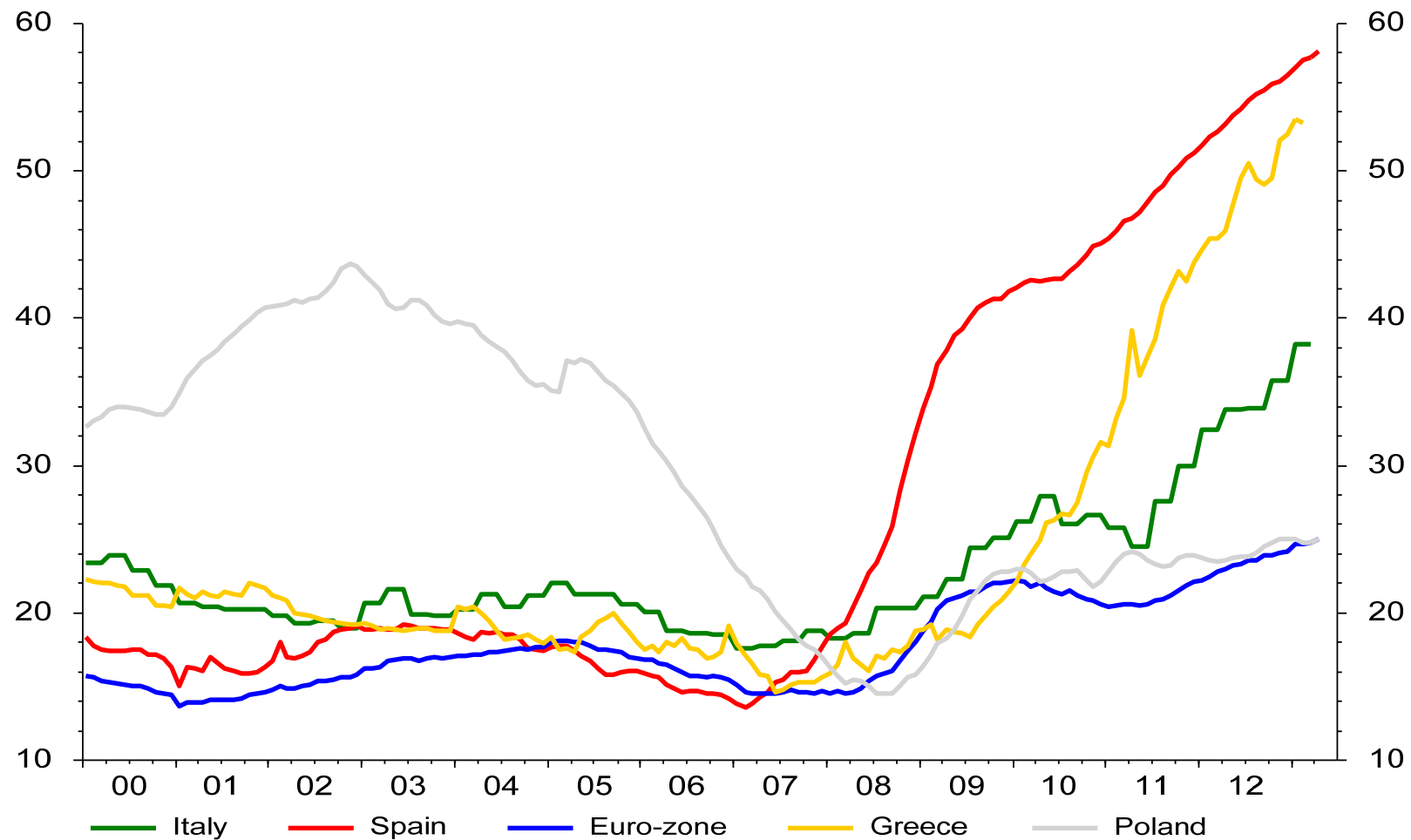
Change since 2000 in a country's relative unit labour costs (RULC), vs c/acc shift as % GDP. Grey denotes shift since 2010 austerity



Source: Hermes Fund Managers Ltd, based on national sources & OECD. (*NB: Greece's from 2001 when it joined the euro)

...But, Spain – damned if they do, damned if they don't?

Shows unemployment rates – males under 25 years old



Source: Thomson Reuters Datastream, based on Eurostat data

Euro-zone – our ‘Misery Indices’ (MIs)...

The method & sample data behind our Misery Indices. The higher the MI, the greater the expected economic hardship

	2013p ¹		Unemployment rates						Misery % point ^{2, 4}	
	U rate	CPI	2008	'09	'10	'11	'12	5-yr av	2013	2014
Greece	26.8	-0.1	7.7	9.5	12.6	17.7	24.3	14.4	15	12
Cyprus	16.5	-2.0	3.6	5.3	6.2	7.8	12.1	7.0	14	11
Spain	27.0	1.8	11.4	18.0	20.1	21.7	25.1	19.3	8	6
Portugal	18.0	0.4	8.5	10.6	12.0	13.0	15.8	12.0	8	7
Ireland	15.4	0.4	6.3	11.9	13.7	14.5	14.9	12.3	5	3
Italy	11.9	1.6	6.8	7.8	8.4	8.4	10.7	8.4	4	4
Netherlands	6.4	3.0	3.1	3.7	4.5	4.4	5.3	4.2	3	2
France	10.9	1.2	7.8	9.5	9.8	9.7	10.2	9.4	3	2
Belgium	8.2	1.2	7.0	7.9	8.3	7.2	7.6	7.6	2	1
Luxembourg	5.4	2.1	4.9	5.2	4.6	4.8	5.0	4.9	1	1
Germany	7.0	1.6	7.5	7.8	7.1	6.0	6.8	7.0	1	1
Austria	4.7	2.1	3.8	4.8	4.4	4.1	4.3	4.3	1	1
Finland	8.0	2.2	6.4	8.2	8.4	7.8	7.7	7.7	0	0
<i>Unweighted av</i>	12.8	1.2							5	4
Weighted av³	11.6	1.5							3	3

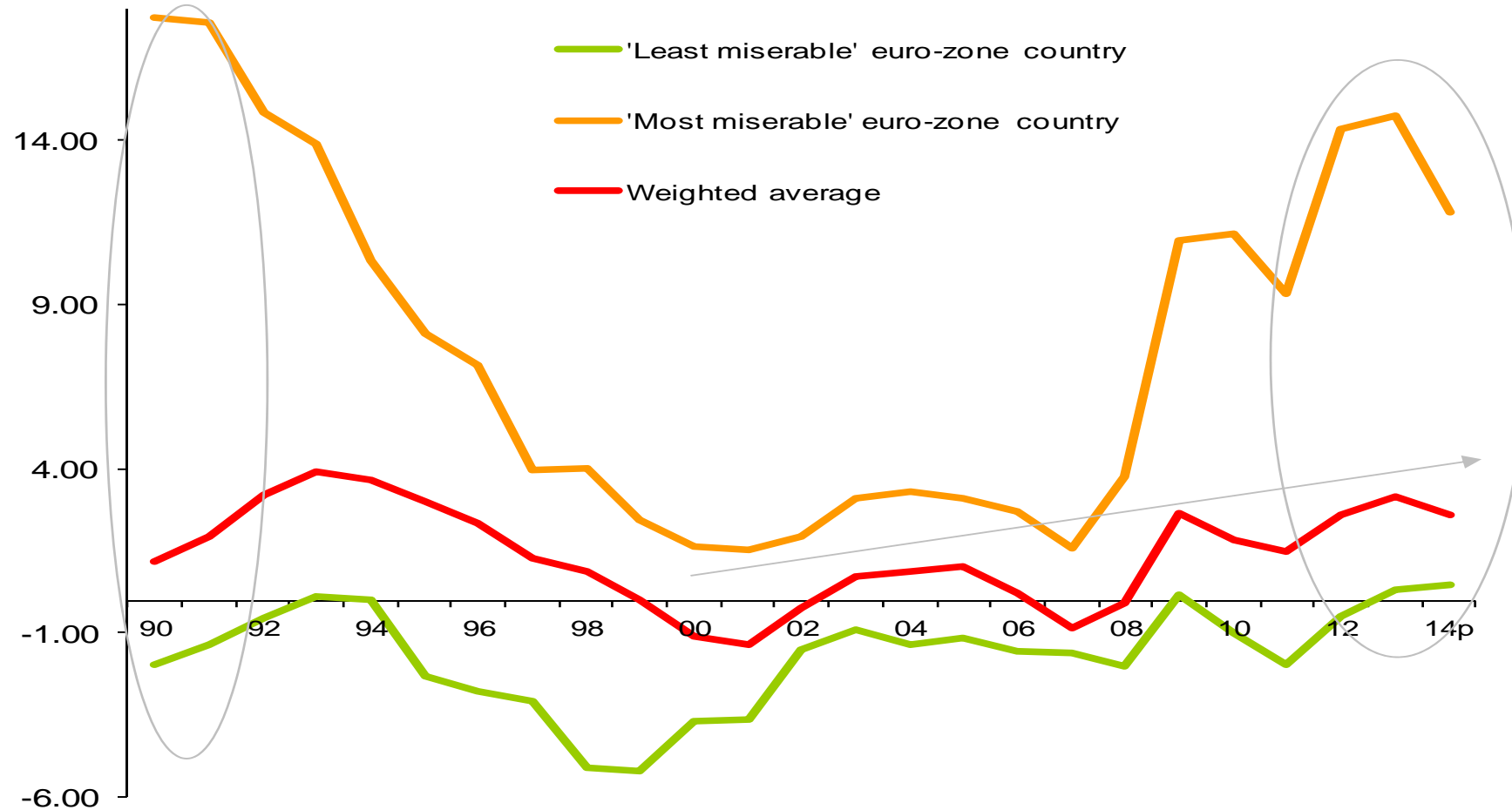
¹ Standardised unemployment (%), & HICPs (%yoy)

³ Using adjusted GDP weights. Excludes Cyprus

² Absolute CPI deviation from 2.2% (+) added to u rate deviation from 5-yr av (+/-)

⁴ Orange shaded areas show 'above-average misery'

Euro-zone – converging on the weakest



Source: Hermes Fund Managers Ltd, based on Eurostat data, & Hermes/Nomura International projections (p)

Euro-zone – disparate real rates

Using ECB refinancing rate, & spot CPIs, %

	Latest HICP (% yoy)	Real policy rate*	U rate*
Greece	0.1	0.4	27.0
Portugal	0.2	0.3	17.8
France	1.2	-0.7	11.0
Ireland	1.2	-0.7	13.5
Germany	1.8	-1.3	5.4
Belgium	1.8	-1.3	8.4
Malta	1.8	-1.3	6.4
Cyprus	1.8	-1.3	15.6
Italy	2.0	-1.5	12.0
Slovakia	2.2	-1.7	14.5
Luxembourg	2.4	-1.9	5.6
Finland	2.5	-2.0	8.2
Austria	2.6	-2.1	4.9
Spain	2.9	-2.4	26.8
Slovenia	2.9	-2.4	10.2
Netherlands	3.2	-2.7	6.5
Estonia	4.0	-3.5	8.7
Median	2.0	-1.5	10.2

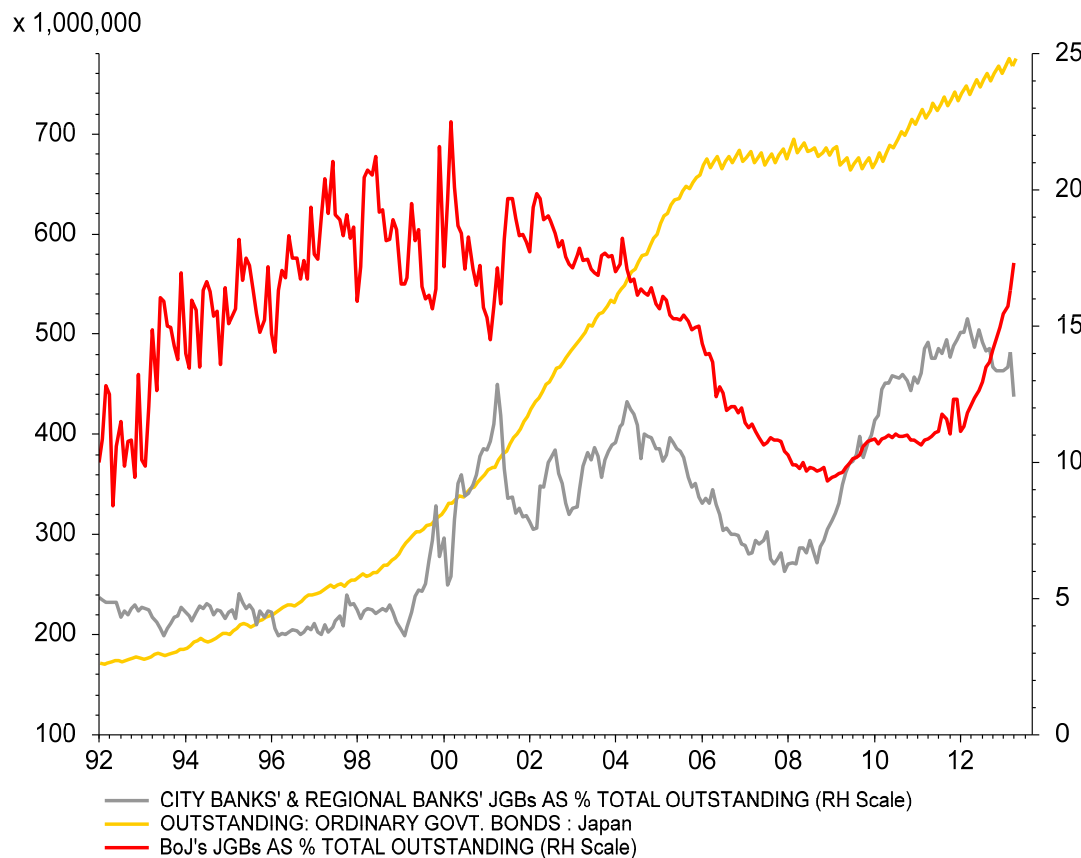
*Orange flash denotes higher-than-median out-turns

Source: Hermes Fund Managers Ltd, based on Eurostat, & ECB

Japan will need more aggressive monetary easing

JGBs outstanding, banks' & BoJ

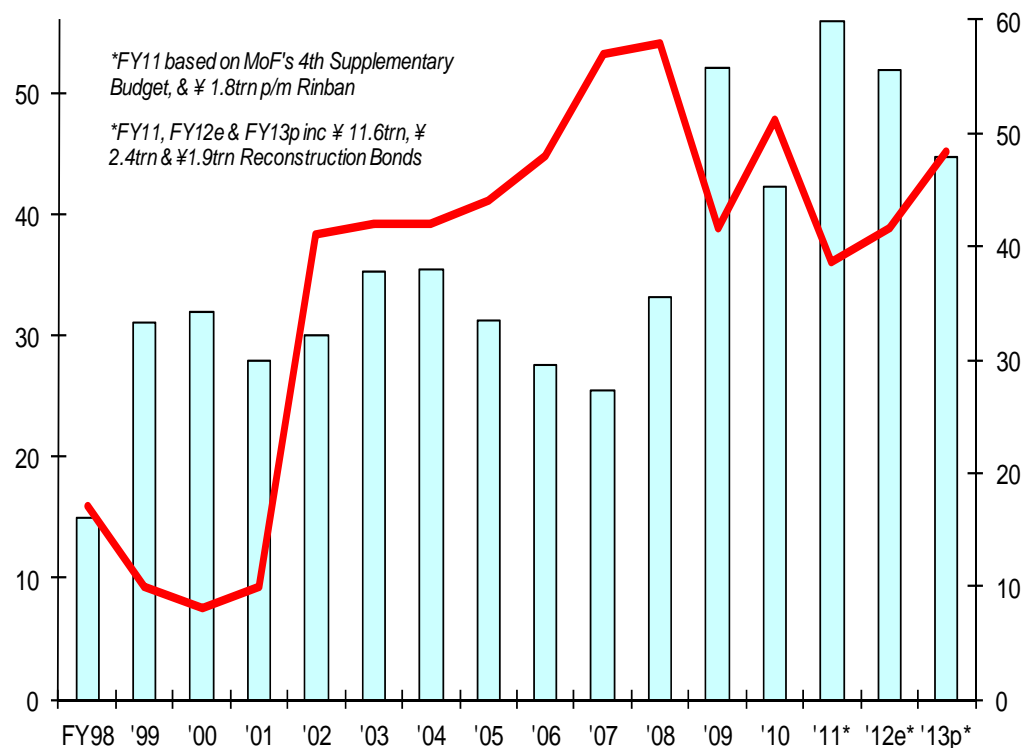
JGBs outstanding in ¥ m on LH Scale, & % shares on RH Scale



Source: Thomson Reuters Datastream, based on BoJ

BoJ has to mop up more JGBs

Net new JGB issuance (¥trn) Rinban as % net new issuance (rhs)

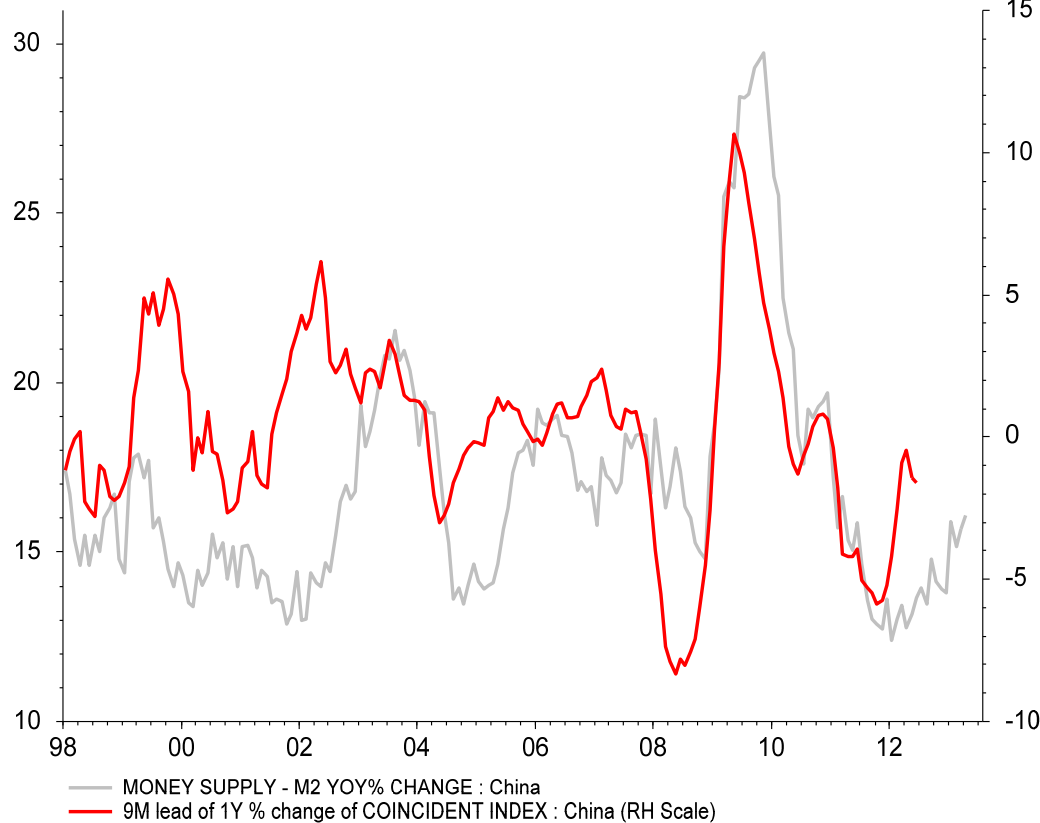


Source: Hermes Fund Managers Ltd, based on MoF, & BoJ

At least China is delivering a soft landing...

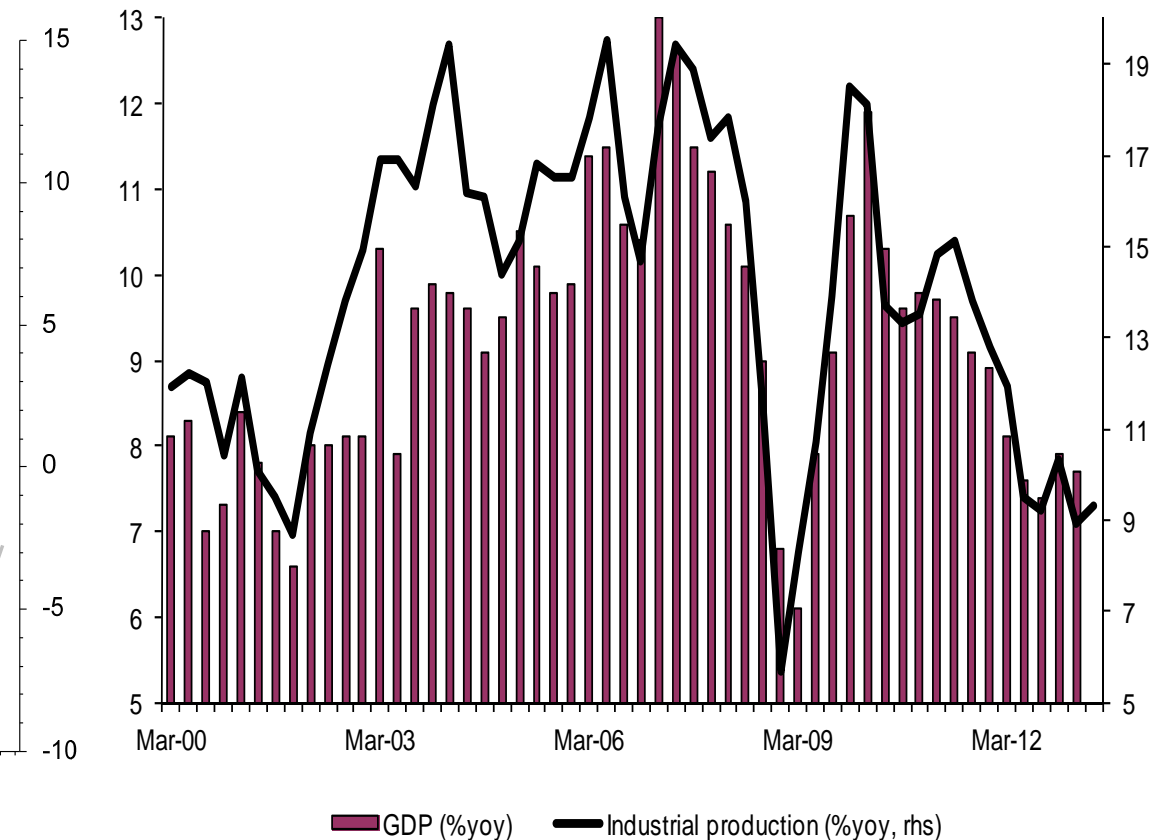
Signs of bottoming...

Shows coincident indicator (lagged 9m), & M2 growth (%yoy)



Source: National Bureau of Statistics, & People's Bank of China

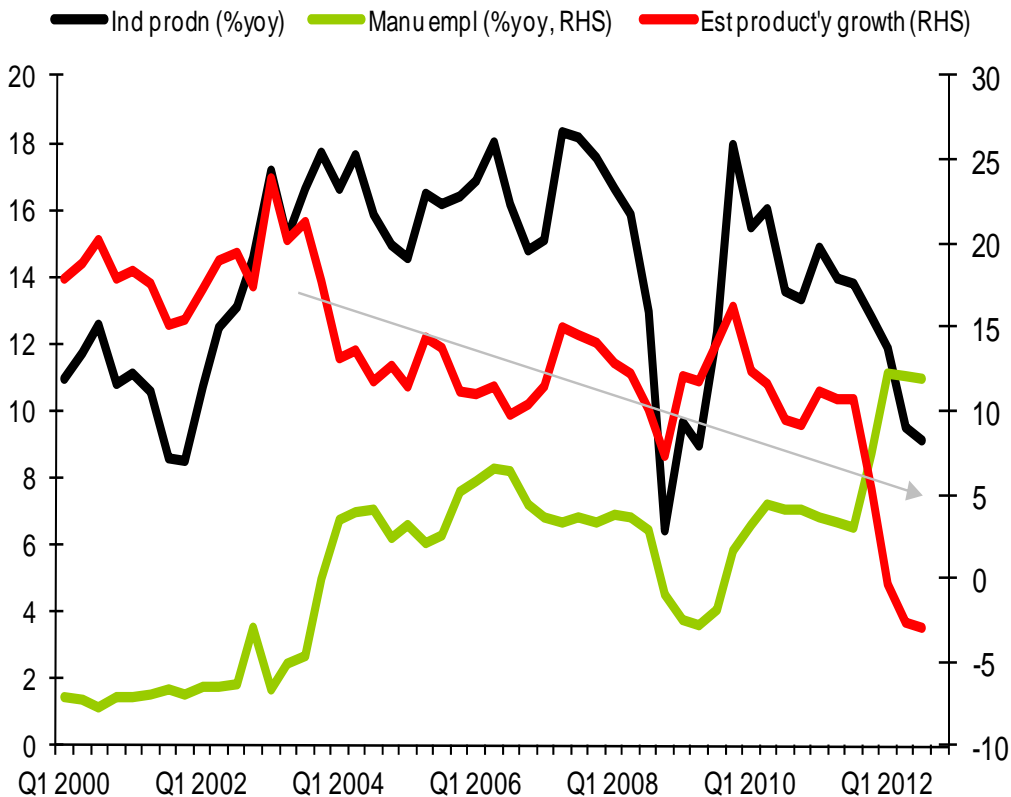
...And, ways to sustain growth



Source: National Bureau of Statistics

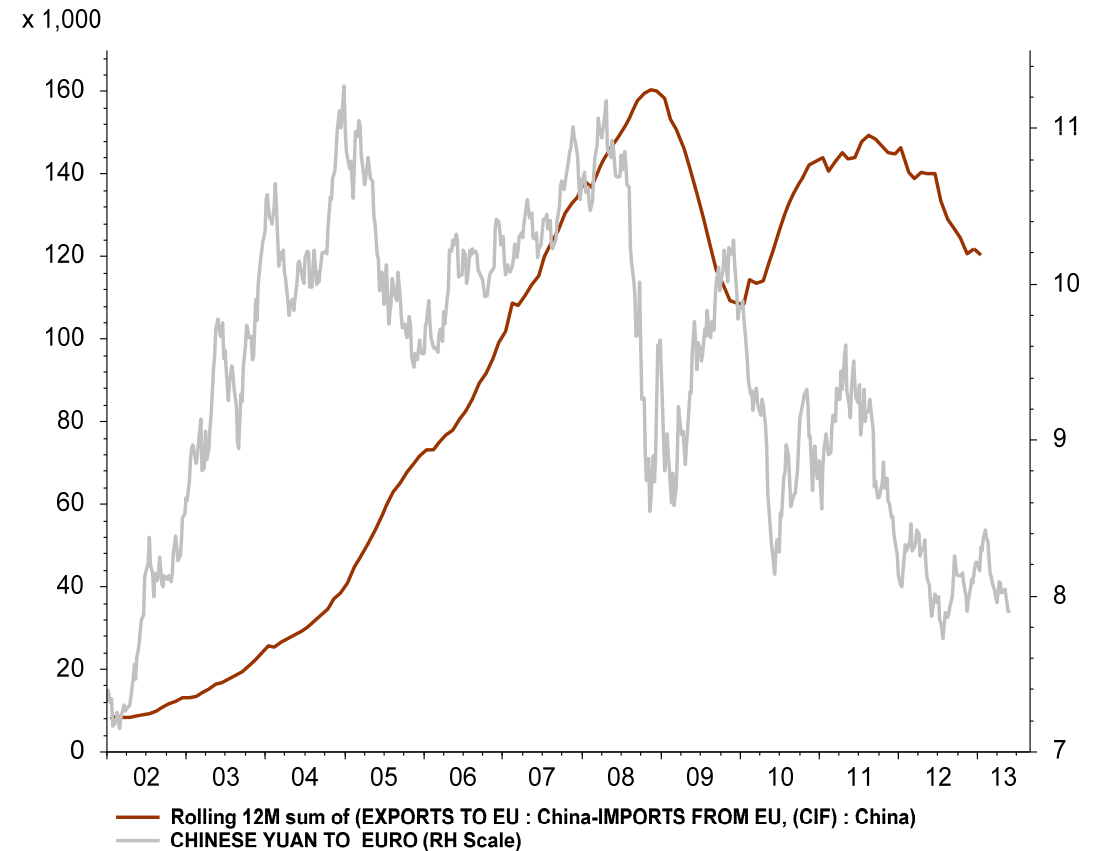
...Hardening reluctance to revalue the currency

China - slowing productivity?



China's surplus with the EU vulnerable

China/EU bilateral surplus, 12m rolling total, \$m, versus RMB per €



But, the legacy is debt build-up...

*Gross & net, as a % GDP. *'98 data; **'00 data*

	<i>Moody's local ccy</i>	<u>1997</u>		<u>2013p</u>	
		Gross	Net	Gross	Net
US	Aaa (-ve)	67	49	113	90
Japan	Aa3	102	34	224	144
Euro-zone	n/a	81	54	103	65
UK	Aa1	52	31	110	79
Greece	C	100	78	193	159
Italy	Baa2 (-ve)	130	104	130	101
Iceland	Baa3 (-ve)	77*	43*	121	46
Ireland	Ba1 (-ve)	62*	42*	128	86
Latvia	Baa2	53**	n/a	75	n/a
OECD av		74	43	111	73

Source: OECD, Thomson Reuters Datastream, & Moody's Investor Services

...Until economies fire again

Our economic & interest rate forecast, as published in our Q3 2013 'Economic outlook' quarterly

US	% yoy unless stated	'08	'09	'10	'11	'12	'13p	'14p	JAPAN	% yoy unless stated	'08	'09	'10	'11	'12	'13p	'14p
	Real GDP	-0.3	-3.1	2.4	1.8	2.2	2.2	2.7		Real GDP	-1.1	-5.5	4.7	-0.5	2.0	1.2	1.2
	Personal consumption	-0.6	-1.9	1.8	2.5	1.9	2.1	2.5		Private consumption	-0.9	-0.7	2.8	0.5	2.3	0.8	0.6
	Business investment	-0.8	-18.1	0.7	8.6	8.0	5.5	6.5		Business investment	-2.9	-14.2	0.7	3.3	1.9	-0.3	2.5
	Industrial production	-3.5	-11.3	5.7	3.4	3.6	3.3	3.7		Industrial production	-3.4	-21.8	16.6	-2.4	-0.9	1.0	3.5
	Consumer prices (nsa)	3.8	-0.3	1.6	3.2	2.1	1.6	2.1		Consumer prices	1.4	-1.3	-0.7	-0.3	0.0	-0.2	1.5
	Unemployment rate (%)	5.8	9.3	9.6	9.0	8.1	7.6	7.2		Unemployment rate (%)	4.0	5.1	5.1	4.6	4.4	4.2	4.0
	Current account (% GDP)	-4.7	-2.7	-3.0	-3.1	-3.0	-3.1	-3.2		Current account (% GDP)	3.4	2.9	3.7	2.1	1.1	1.2	1.5
	Fed budget balance (% GDP)	-6.6	-11.6	-10.7	-10.0	-9.3	-8.3	-6.8		Gen budget balance (% GDP)	-2.2	-8.7	-7.8	-8.9	-8.9	-9.5	-7.8
	Funds target (yr-end, %)	0.25	0.25	0.25	0.25	0.25	0.25	0.25		BoJ target rate (yr-end, %)	0.10	0.10	0.10	0.10	0.10	0.10	0.10
EURO	% yoy unless stated	'08	'09	'10	'11	'12	'13p	'14p	UK	% yoy unless stated	'08	'09	'10	'11	'12	'13p	'14p
	Real GDP	0.3	-4.3	1.9	1.5	-0.5	-0.4	0.0		Real GDP	-1.0	-4.0	1.8	1.0	0.3	0.7	1.1
	Private consumption	0.4	-0.9	1.0	0.1	-1.3	-0.8	-0.2		Household consumption	-1.6	-3.0	1.3	-1.1	1.2	0.5	1.0
	Fixed investment	-1.6	-12.7	-0.5	1.6	-3.9	-2.5	0.5		Fixed investment	-4.6	-13.7	3.5	-2.9	1.5	1.7	2.3
	Industrial production	-1.8	-15.1	7.3	3.2	-2.3	-1.3	0.4		Manufacturing production	-2.5	-9.7	3.9	2.2	-1.5	0.0	1.3
	Consumer prices (HICP)	3.3	0.3	1.6	2.7	2.5	1.3	1.3		Retail prices index	4.0	-0.5	4.6	5.2	3.2	3.1	3.0
	Unemployment rate (%)	7.7	9.6	10.1	10.2	11.4	12.3	12.6		Consumer prices	3.6	2.2	3.3	4.5	2.8	2.9	2.5
	Current account (% GDP)	-1.6	-0.2	0.0	0.1	1.2	1.3	1.4		Unemp, claimant count (%)	2.8	4.6	4.6	4.7	4.9	5.0	5.1
	Gen budget balance (% GDP)	-2.1	-6.4	-6.2	-4.2	-3.7	-3.0	-2.8		Current account (% GDP)	-1.0	-1.3	-2.5	-1.9	-3.3	-2.8	-2.5
	ECB refi' rate (yr-end, %)	2.50	1.00	1.00	1.00	0.75	0.25	0.25		Gen budget balance (% GDP)	-4.8	-11.2	-10.1	-7.9	-5.6	-6.8	-5.9
										BoE Bank rate (yr-end, %)	2.00	0.50	0.50	0.50	0.50	0.50	0.50

Source: National data, Hermes Fund Managers Ltd, OECD, & Consensus Economics

Summary

- **Despite a firmer US, it's too soon to allow aggressively higher bond yields. Inflation largely benign - driven more by cost than demand factors.** More QE to help growth assets, but could backfire
- **Consumer balance-sheet re-building needs more time.** US is expanding after five years of ultra-loose policy. QE-adjusted US policy rate is near -5%; the UK's is -2¼%. Exit strategies a long way off
- **Most governments deferring repair of their own balance sheets - storing up problems for later.** In euro-zone, default risk is not dead
- UK & euro-zone are taking the biggest risks with growth, & will hit/return to recession. When rates do rise, only shallow tightening cycles
- **But, with deficits high, most governments unready to repair fiscally, & central banks encouraging inflation, bonds no longer a low-risk asset**

Disclaimer

The views and opinions contained herein are those of Neil Williams, director, chief economist & strategist, and may not necessarily represent views expressed or reflected in other Hermes communications, strategies or products. The information herein is believed to be reliable but Hermes Funds Managers does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This material is not intended to provide and should not be relied on for accounting, legal or tax advice, or investment recommendations.

This document has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. This document is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments.

This communication is directed only at recipients who are eligible counterparties or professional clients, as defined in the Glossary to the Financial Services Authority's Handbook of Rules and Guidance. This communication is issued and approved only for the purposes of section 21 of the Financial Services and Markets Act 2000 by Hermes Investment Management Limited. ("HIML"). Hermes Investment Management Limited has its registered office at Lloyds Chambers, 1 Portoken Street, London E1 8HZ. Hermes is a multi-boutique asset manager, independent of any broader financial services organisation. Each Hermes operating company is either a subsidiary of, or is otherwise affiliated to, Hermes Fund Managers Limited. [CM100322 UK 11/10]

Figures, unless otherwise indicated, are sourced from Hermes.