QUARTERLY ECONOMIC FORECAST

TD Economics

June 18, 2015

GLOBAL OUTLOOK: EARLY OPTIMISM DENTED BUT PICKUP NOW UNDERWAY

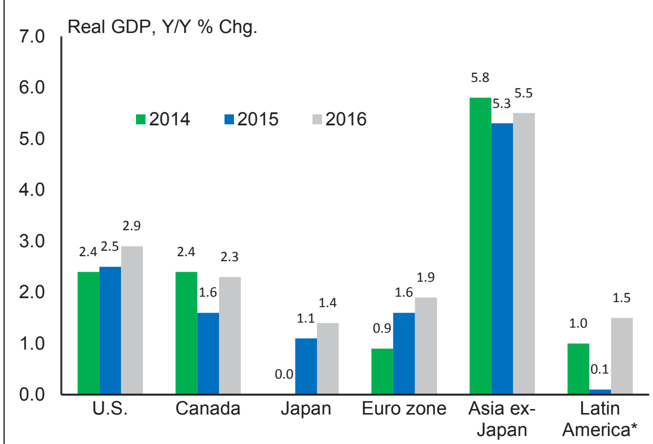
Highlights

- The global economy continues to move in fits and starts. Excitement turned to disappointment in the first quarter of this year, particularly in the world's largest economies of China and America. Due to the weak start, TD Economics now anticipates global economic growth to decelerate from 3.4% last year to 3.2% in 2015. However, rising momentum as the year progresses supports a world economic outlook of 3.6% growth in 2016.
- Among advanced economies, the euro area and Japan have been bright spots, supported by lower currencies and improved financial conditions, due in part to their respective programs of quantitative easing. In contrast, economic activity has disappointed in the U.S., UK and Canada.
- The setback in the U.S. and improvement in the euro area has challenged the narrative of central bank divergence. But, with the unemployment rate at 5.5% in America versus a persistently-elevated 11.1% in the euro area, the need for continued monetary stimulus in the euro area is clear. Meanwhile, stronger economic momentum should allow the Fed to raise rates in September.
- This year will be a difficult one for emerging markets. For a number of them, idiosyncratic features are further exacerbated by the negative impact of the slowdown in China, as well as low oil and non-energy commodity prices. The prospect of tighter policy by the Fed could lead to further financial market turbulence for EMs with greater external vulnerabilities.

The global economy continues to move in fits and starts. Just as it seems that break-out growth has been achieved, something throws it off course and expectations are revised down. This pattern held again early this year. Excitement turned to disappointment in the first quarter, particularly in the world's largest economies of China and America. As these economies slowed, emerging markets also sputtered, moving their own idiosyncratic challenges to the fore.

Still, there have been bright spots and even some upside surprises. Among advanced economies, the euro-zone and Japan have been quietly picking up momentum, supported by weak currencies and improving financial conditions. This seeming reversal of fortunes has called into question what had been a clear cut policy narrative. Namely that economic outperformance in the United States would lead the Federal Reserve to finally wean the economy off zero interest rate policy, while in Europe, deflation and stagnant growth meant that policy support from the European Central Bank would continue in full force. By March, the talk among investors was that the Fed would forestall raising interest

CHART 1. EMERGING MARKETS STRUGGLE



Source: TD Economics. Forecast as at June 2015. *excludes Mexico.

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rates after all and that maybe the European Central Bank wouldn't need to be as ambitious with its asset purchase program. As a result, the dollar's year-long rally ceased and the euro regained ground.

The devil, of course, is in the details. Despite the disappointment stateside, the U.S. economy continues to make headway in reducing unemployment. With some of the headwinds that slowed U.S. growth early in the year lifting, economic momentum is now swiftly improving. All of this has occurred in a post-quantitative easing environment, in which the central bank has made clear its aspirations to (gradually) tighten monetary policy.

Meanwhile in Europe, the pickup in activity that has occurred has been largely dependent on monetary policy support. What is more, there is no getting around the fact that with unemployment still north of 11%, the euro area economy is much farther from normal than America, where unemployment sits at 5.5%. Temporary outperformance in the European economy relative to the United States must be seen in the context of an economy that still has a whole lot more catch-up to do. This, in turn, will be reflected in continued monetary policy divergence.

All told, due to the weak start, global real economic growth is on track to decelerate from 3.4% last year to 3.2% in 2015, the weakest non-recessionary showing in more than a decade. However, rising momentum as the year progresses supports a world economic outlook of 3.6% growth in 2016.

Underwhelming performances in much of the Anglosphere

Buffeted by several headwinds, U.S. domestic demand has been more subdued than expected so far this year. Harsher-than-usual winter weather, port disruptions on the West Coast, and a negative front-loaded impact of the collapse in oil prices on drilling investment all weighed on the economy in the first quarter. What's more, robust real income growth and savings at the gas pump failed to materialize into higher consumer spending.

That being said, a slow start does not preclude a stronger finish. Some of the transitory factors have ebbed, and U.S. economic momentum appears to have turned up a notch. Improvement can be observed in consumer spending, housing and the labor market. Further supporting growth, the negative impact of lower oil prices on investment should cease being a drag by the end of the second quarter. Because of the weak start to the year, overall U.S. economic growth will not show a material pick-up from last year (2.4% in 2014 versus 2.5% in 2015). But, this annual average masks the rise in momentum that is taking place to produce a stronger print for 2016 of 2.9% (see U.S. report here). All this to say, the weak start to the year should prove to be largely an aberration that will not stay the Fed's hand in raising rates as the year rolls forward.

The weak start to the year in the U.S. was mirrored in the North. The plunge in oil prices and a soft patch in the U.S. economy also led to a contraction in Canadian economic activity. This too should prove temporary. Rising export demand, a firming oil price environment and diminishing headwinds to investment, alongside a resilient consumer are expected to pull real GDP growth higher in the months ahead. After slackening to an estimated 1.5% this year, Canadian real GDP is expected accelerate to 2.3% in 2016 (see Canadian report here).

While not immune to early-year softness, the UK economy still managed to grow by 1.2% in the first quarter (and likely to be revised up on final reading). Near-term prospects for the UK remain fairly strong, although its growth remains too dependent on domestic demand. Headline inflation has been weaker than expected, but this is largely chalked up to declining energy and food prices. While the weakness in prices is likely to extend until the beginning of the fourth quarter, inflation should then begin to grind up towards 2% by mid-year 2016. This pickup, along with the low level of unemployment – which stood at 5.4% in February – should allow the Bank of England (BoE) to follow the Fed with a first rate hike in early 2016.

PMI's pointing to modestly stronger growth than three months ago

Purchasing Managers Indexes across regions, 3mth MA	Developed Europe	Developed North America	Asia	Latin America	Eastern Europe	Africa and Middle East
Current	54.4	56.7	51.3	48.2	50.5	54.6
3 months ago	53.0	54.7	51.7	52.1	48.8	54.1

Source: Markit. Composite PMI's used where available, Manufacturing PMI's used otherwise.
PMI's weighted by share of regional GDP in PPP terms. Turkey included in Eastern Europe.

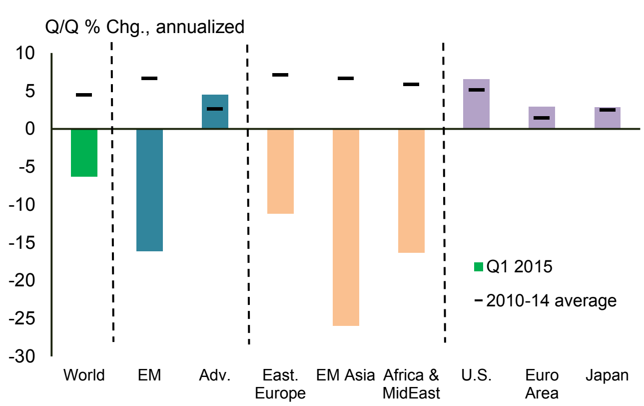
Euro area and Japan dodge early year disappointment

The Fed and BoE will be out of step with the central banks in the euro area and Japan. Although economic performances in both economies have been among the few positive surprises so far this year, this largely reflects the success of past aggressive monetary policy measures that are stoking credit growth and supporting trade through low interest rates and currencies.

In particular, euro area real GDP grew by 1.6% (annualized) in the first quarter, its fastest pace since the first quarter of 2011. More importantly, this lofty pace of growth (by European standards) is expected to be maintained, with real GDP gains of 1.6% in 2015 and 1.9% in 2016. Importantly, growth is increasingly being observed in countries where it is needed most – Spain, Portugal, and Italy. The easing in credit constraints should continue to allow these countries to experience above trend growth and alleviate some of the extreme divergence in unemployment rates across the euro area.

Unfortunately, as it has been for the last several years the evolving situation in Greece remains a wildcard. Frustration between Greece and its creditors over negotiations on the bailout agreement have recently come to a head. Our view remains that both sides will eventually come to an agreement; however, in the meantime, more volatility is likely, with a growing possibility of capital controls and a referendum on euro area membership in Greece. While spillovers to other countries are expected to be relatively limited in our base case, an outright Greece exit from the euro could trigger severe global financial turbulence and put a significant damper on European growth.

CHART 2. REAL IMPORT VOLUMES WERE REMARKABLY WEAK IN EMERGING MARKET ASIA



Source: Netherlands Bureau for Economic Policy Analysis, TD Economics.

Meanwhile in Japan, economic growth surged to 3.9% (annualized) in the first quarter. The caveats are that roughly half of the gain was due to inventory buildup, while the rate of expansion is still down from a year ago before a consumption tax hike was implemented. Still, business investment has recorded some renewed life, while consumption has grown at a steady pace over the past three quarters. With real wage growth turning positive on a year-over-year basis for the first time since mid-2013, consumer spending should receive a further boost in the months ahead. For the Bank of Japan, continued ultra-low inflation remains a concern, as it attempts to rid the country of its deflationary mindset. Still, with slowly improving growth prospects amidst stronger nominal wage growth – base pay at +0.6% (Y/Y) in April was the highest since 2005 – the Bank of Japan is unlikely to further expand its already-sizeable program of quantitative easing over the near future.

Growth is as bad as expected in EMs and then some

This year was expected to be a difficult one in emerging markets, and these expectations are playing out, beginning with the woes in China. Chinese industrial production has materially slowed to 6.4% (year-over-year) in the first quarter from 8.3% in the fourth quarter of 2014. By extension, real GDP grew 7.0% year-over-year, which may seem strong relative to other economies, but for China it marks the weakest pace since the financial crisis. On a quarter-to-quarter basis, growth is estimated to have increased by just 5.3% (annualized). When we stack this up against the performance of real goods imports, which tumbled by an estimated 9% from the previous quarter, even these reported estimates seem a little lofty. While some variation between imports and other key barometers of activity is normal, the extent of this divergence suggests that either China is rapidly substituting towards domestic production, or there are measurement errors inherent in the data.

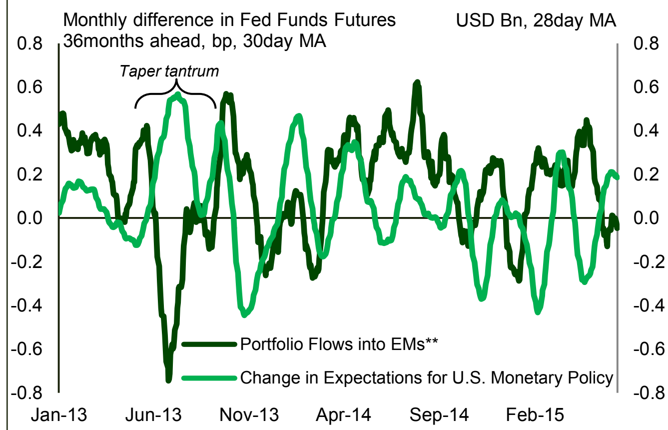
Regardless, the slackening in economic conditions in China is leaving an indelible footprint on trade and activity within the broader Asian region, given the high reliance on these economies for trade. Real imports within Asian EMs have been faring considerably worse than other EMs recently (see chart 2). In contrast, real imports to the U.S. continued to grow in early 2015, implying that the United States still managed to deliver a positive economic impulse to the rest of the world despite recording no economic growth.

Fortunately, China has announced a number of additional stimulus measures that should lead to modestly stronger growth over the next two quarters. Monetary policy has been loosened through three interest rate cuts and two cuts to bank reserve requirements. There is some uncertainty as to how much of this easing will translate into stronger real activity, given that demand for credit appears subdued. However, government expenditures have also been ramped up and should provide a direct boost to growth. Recent backtracking on reforms at the local government financing level suggests that additional near-term infrastructure spending is in store.

Overall, China is likely to provide enough stimulus measures to keep Chinese real GDP close to its 7% growth target (+6.9%) in 2015. Stronger quarterly growth in China should also lead to less contraction in imports, alleviating some of the drag to other countries. Nevertheless, even as policymakers pull out the stops to support activity over the remainder of this year, the economy is likely to continue along a managed path to gradually slower growth. Ultimately, China's credit-fuelled imbalances will limit the extent to which it can be stimulative. As such, we expect real GDP growth to decelerate further to 6.5% in 2016.

In addition to the negative impact through trade channels of Chinese weakness, many other emerging markets have struggled under the weight of low oil and non-energy commodity prices, as well as idiosyncratic issues. In particular, Brazil is expected to enter a recession this quarter, partially as a result of tight fiscal and monetary policies. Meanwhile, the Russian economy contracted 5.1% in the first quarter, due to a combination of lower oil prices and sanctions from the West. Our growth forecast for Russia has been revised upward to "only" -3% in 2015, largely due to the recent upward bounce in oil prices. The prospects for both countries remain difficult, with only modest growth expected next year.

CHART 3. EM PORTFOLIO FLOWS MOVE INVERSELY TO CHANGES IN EXPECTATIONS FOR FED POLICY

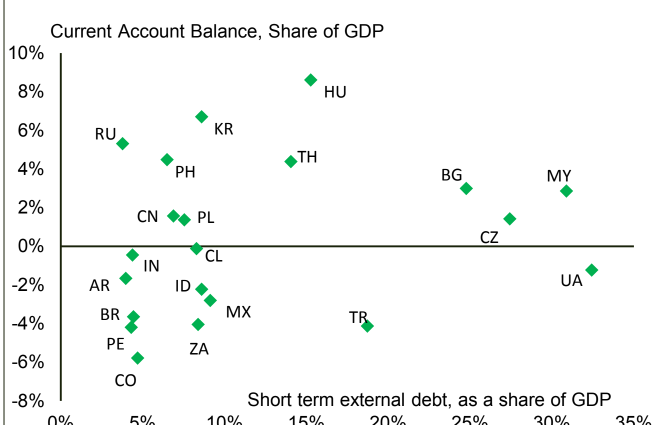


Source: IIF, Bloomberg, TD Economics. **Proxied as capital flows into bonds and equities of Brazil, Korea, India, Indonesia, South Africa, Thailand and Turkey.

Prospect of U.S. rate hikes loom for EMs

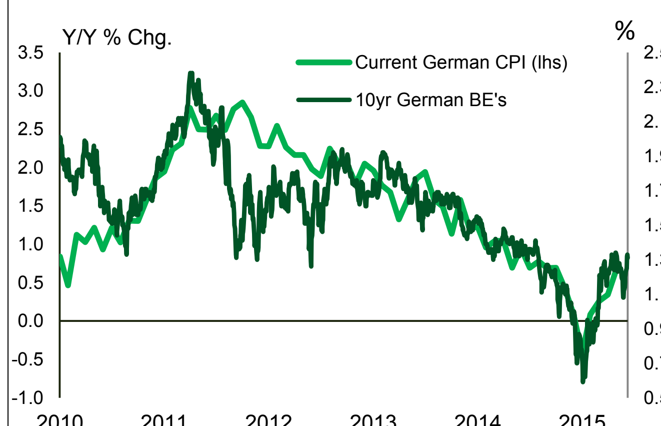
The prospect of tighter monetary policy by the Fed is set to lead to further financial market turbulence in emerging markets. While far from the sole determinant, expectations for U.S. monetary policy are one of the primary drivers of shifts in capital flows to EMs (see chart 3). Generally speaking, the likelihood of a first rate hike by the Federal Reserve this year has already been priced in by markets. In this regard, the impact of a lift-off in U.S. rates on emerging markets should be smaller than that of an unanticipated shock, as during the taper tantrum of 2013. EMs are (and will continue to) experiencing capital outflows as market expectations adjust to the Fed's guidance. Some of the coun-

CHART 4. EXTERNAL VULNERABILITIES TO FED HIKES



Source: IIF 2015 Forecasts. AR: Argentina. BR: Brazil. BG: Bulgaria. CL: Chile. CN: China. CO: Colombia. CZ= Czech R. H: Hungary. IN: India. ID: Indonesia. KR: Korea. MY: Malaysia. MX: Mexico. PE: Peru. PH: Philippines. PL: Poland. RU: Russia. ZA: South Africa. TH: Thailand. TR: Turkey. UA: Ukraine.

CHART 5. BUND YIELDS TO GRIND HIGHER AS INFLATION FIRMS THIS YEAR



Source: Bloomberg.

tries most likely to be affected are the ones most dependent on capital inflows to service their current account deficits, as well as those with the largest short term external debt. According to these metrics, Turkey, South Africa, and Colombia are among the larger EMs most at risk (see chart 4).

Bottom Line

Global economic growth is set to disappoint again in 2015, before modestly rebounding next year. Subdued global economic activity at the start of the year should give way to stronger growth ahead, led by improving performances in the advanced world.

Risks to the global economy for this year appear relatively balanced for advanced economies. Greece is in the middle of the radar in terms of potential downside risks to Eurozone and global growth. However, assuming a deal is reached on a bailout; the euro area economy could continue to surpass market expectations. For emerging markets, risks remain skewed to the downside. EMs could suffer as a result of Fed hikes, while the Chinese economy could buckle unless authorities continue with short-term policy support.

Through all of this, the implications of ongoing monetary policy divergence loom large. With ongoing policy easing in Europe and tighter policy by the Fed, the euro is likely to weaken further. Ditto for the Canadian dollar as the Bank of Canada is expected to remain on hold until the end of 2016. Meanwhile, emerging markets will face greater risks of capital outflows and may have to react with their own rate hikes in order to defend their currencies.

All this argues for a go-slow approach to monetary tightening in order to quell market concerns. A tightening Federal Reserve alongside slowly rising inflation suggests that the path for bond yields is upward (see chart). However, easy monetary policy by the ECB and the BoJ as well as a “go slow” U.S. Fed will dampen any movement at the long-end of the curve.

GLOBAL ECONOMIC OUTLOOK					
Annual per cent change unless otherwise indicated					
	2013 Share*		Forecast		
Real GDP	**(%)**	**2013**	**2014**	**2015**	**2016**
World	99.9	3.4	3.4	3.2	3.6
North America	19.8	2.1	2.4	2.4	2.9
United States	16.3	2.2	2.4	2.5	2.9
Canada	1.5	2.0	2.4	1.6	2.3
Mexico	2.0	1.4	2.1	2.5	3.3
European Union (EU-28)	17.5	0.1	1.4	1.9	2.2
Euro-zone (EU-17)	12.4	-0.5	0.9	1.6	1.9
Germany	3.5	0.1	1.6	1.7	1.8
France	2.5	0.3	0.4	1.4	1.7
Italy	2.0	-1.7	-0.4	0.8	1.5
United Kingdom	2.4	1.7	2.8	2.5	2.6
EU accession members	2.7	1.3	2.6	2.8	2.9
Asia	41.1	5.5	5.2	4.9	5.1
Japan	4.6	1.6	0.0	1.1	1.4
Asian NIC's	3.4	2.9	3.3	3.0	3.1
Hong Kong	0.4	2.9	2.5	2.4	2.7
Korea	1.6	3.0	3.3	2.9	3.2
Singapore	0.4	4.4	2.9	3.1	3.1
Taiwan	1.0	2.2	3.7	3.3	3.4
Russia	3.4	1.3	0.6	-3.0	0.6
Australia & New Zealand	1.2	2.1	2.8	2.6	2.9
Developing Asia	28.6	7.0	6.8	6.7	6.5
ASEAN-4	4.7	5.1	4.5	4.8	4.9
China	15.7	7.8	7.4	6.9	6.5
India**	6.6	6.9	7.4	7.6	8.0
Central/South America	6.8	3.4	1.0	0.1	1.5
Brazil	3.1	2.7	0.1	-1.0	0.7
Other Developing	13.6	3.5	3.2	2.7	3.3
Other Advanced	1.0	1.9	2.2	1.6	1.7

*Share of world GDP on a purchasing-power-parity basis.
Forecast as at June 2015. **Forecast for India refers to FY.
Source: IMF, TD Economics.

ECONOMIC INDICATORS FOR THE G-7 AND EUROPE				
		Forecast		
	2013	**2014**	**2015**	**2016**
Real GDP (Annual per cent change)				
G-7 (32.7%)*	1.5	1.6	2.0	2.3
U.S.	2.2	2.4	2.5	2.9
Japan	1.6	-0.1	1.1	1.4
EZ	-0.4	0.9	1.6	1.9
Germany	0.1	1.6	1.7	1.8
France	0.7	0.2	1.4	1.7
Italy	-1.7	-0.4	0.8	1.5
United Kingdom	1.7	2.8	2.5	2.6
Canada	2.0	2.4	1.6	2.3
Consumer Price Index (Annual per cent change)				
G-7	1.3	1.5	0.3	1.9
U.S.	1.5	1.6	0.2	2.2
Japan	0.4	2.7	0.7	1.1
EZ	1.3	0.4	0.3	1.6
Germany	1.6	0.8	0.6	1.9
France	1.0	0.6	0.4	1.7
Italy	1.3	0.2	0.3	1.6
United Kingdom	2.6	1.5	0.1	1.9
Canada	0.9	1.9	0.8	2.2
Unemployment Rate (Per cent annual averages)				
U.S.	7.4	6.2	5.4	5.1
Japan	4.0	3.6	3.4	3.2
EZ	12.0	11.6	11.1	10.7
Germany	5.2	5.0	4.7	4.5
France	10.3	10.3	10.5	10.3
Italy	12.2	12.7	12.4	12.0
United Kingdom	7.6	6.2	5.3	5.0
Canada	7.1	6.9	6.8	6.7

*Share of 2013 world gross domestic product (GDP)
Forecast as at June 2015
Source: National statistics agencies, TD Economics