June 26, 2013

# ECONOMIC & FINANCIAL OUTLOOK: A 10,000 FOOT VIEW

## GLOBAL OUTLOOK

- Global economic growth started on a soft note this year, as major economies performed below expectations. International trade and industrial production data suggest that some of that weakness has continued.
- Momentum will pick up in the second half of this year, as the global economy regains confidence on the back of a stronger U.S. recovery. A 2.9% expansion in the world economy this year should be followed by a more convincing 3.6% pace in 2014.

## UNITED STATES

- Despite considerable fiscal drag, the U.S. economy has continued to recover. Real GDP grew by 1.8% (annualized) in the first quarter of 2013. Beneath the headline, private spending rose by 2.7%, but was offset by a 4.8% decline in government spending.
- The outlook for the U.S. economy is framed by the increasing resiliency and confidence of its private sector up against ongoing fiscal consolidation and relatively weak global growth. The result is an economy that is likely to grow by 1.9% in 2013. Growth should accelerate to 2.8% in 2014 as these weights ease.
- Automatic spending cuts will result in the furlough of millions of federal workers over the summer months. Fiscal consolidation is likely to subtract 1.4 percentage points from economic growth in 2013. The drag will diminish in 2014, but the expiry of temporary tax provisions alongside ongoing spending restraint will still subtract around 0.8 percentage points from economic growth.
- Weak global growth and a rising U.S. dollar will lead net-exports to be a modest drag on economic growth over the forecast horizon.
- The housing market will remain a source of support to the economic outlook over the next two years. Home prices were up 12% from a year-ago in April. While home price growth is likely to decelerate over the year, this should come alongside an increase in housing construction.
  - At their current level, housing starts are still 40% below their demographically-supported trend of 1.5 million. Starts should rise to slightly over 1 million by the end of 2013 and further to 1.3 million by the end of 2014.
  - Residential construction investment is likely to add an average of 0.4 percentage points to economic growth over 2013 and 2014.
  - Rising household wealth from higher home prices should add an additional 0.2 percentage points to annual economic growth over the next two years.

## EMERGING MARKETS

- China's economy will grow 7.6% this year, which is 0.3 percentage points lower than our previous forecast. This reflects not only the impact of a weaker-than-expected first quarter, but, most importantly, the apparent willingness of the recently inaugurated administration to tolerate slower economic growth in exchange for addressing mounting financial imbalances and pursuing structural reforms.
- In Brazil, domestic consumption will move ahead at a solid clip, supported by low unemployment and modest real wage gains. In addition, an acceleration of economic growth in the U.S. should more than offset the hampering effects on Brazilian exports of modestly weaker growth in China and Argentina. In all, Brazilian real GDP will likely

grow at 2.5% in 2013.

- Other developing economies will also enjoy the benefits of stronger global trade and sturdy domestic demand.

## DEVELOPED ECONOMIES

- The euro zone economy will contract by 0.5% this year. High and still rising unemployment and household deleveraging will continue to hamper domestic demand across the region. This, combined with idle production capacity will hinder fixed investments by non-financial corporations, especially in the periphery.
- Japanese real GDP will grow by 1.4% this year, supported by expansionary fiscal and monetary policies. Next year, economic growth will stay at 1.4%, as the improvement in Japanese exports and investments that will stem from stronger global growth is partially offset by higher value added taxes weighing on household consumption.
- Canada's eocnomy shook off last year's growth slump in Q1 2013, as real GDP grew at a healthy 2.5% annualized pace driven by a stronger trade performance.. However, the remainder of 2013 looks more uneven, as a sub-par external backdrop and subdued domestic demand should hold growth in Canada's economy to a modest 1.7% pace this year.
- Next year, one of the biggest positives for Canada is a strengthening U.S. economy. As fiscal drag in the U.S. abates later this year, better U.S. demand for Canada's exports should help underpin a healthier 2.4% growth rate in 2014.
- A cooling resale Canadian housing market should curb the pace of household debt growth per year, keeping to the debt-to-income ratio stable, but constraining consumer spending growth over the medium term.
  - Amid rising inventories of newly completed homes, residential construction is expected to be a soft spot.

## FINANCIAL MARKETS

- The Federal Reserve's exit from quantitative easing hinges on the progression of the economic recovery. Benign inflationary pressures over the medium term and an acceleration in growth should allow the central bank to begin paring back its large scale asset purchases in the coming months.
  - We anticipate that by September, the worst of the impact from sequestration will be in the rear-view and the Fed will have sufficient evidence to start tapering its asset purchase program, with the goal to end purchases outright in the first half of 2014.
- Long-term interest rates have already risen considerably on anticipation of the Fed's exit from QE. We do not expect much more of an increase over the remainder of this year, but as the recovery becomes more instilled, rates will continue their trek upward. We expect the U.S. 10-year Treasury yield to reach 3.0% by the end of 2014.
  - The path of adjustment is unlikely to be smooth, as markets re-calibrate expectations on the Fed's actions and the impact on the economy.
- Doubts remain regarding the effectiveness of the recently launched quantitative and qualitative monetary easing program by the Bank of Japan. Initially, it was greeted favorably by financial markets, as the ensuing depreciation of the Japanese yen caused the Nikkei to rise on the expectation that Japanese companies would see their profits rise. More recently, however, disappointment about economic reforms announced by Prime Minister Abe have compounded investors' skepticism on the outlook for the economy, and this has led to financial volatility in Japanese assets.
- There is little upside in our overall commodity price forecast, but that conceals a mixed performance across resources For example, strength in natural gas and lumber prices will be offset by weakness in industrial commodity prices.