Standard Life Investments

Weekly Economic Briefing
Global Overview

Five forces that will shape 2016

As is typical for this time of year, markets are priced for a benign 2016. Forecasters anticipate a broad-based, though modest, improvement in real global growth, with the disinflationary pressures that dominated 2015 gradually fading through the year. Monetary policy is expected to remain accommodative, even as the Fed begins to normalise rates. Few analysts foresee runaway gains in equity prices but most hope that better top-line earnings growth underpins higher returns than this year. Meanwhile, forward curves are pricing in higher yields but certainly no bond rout.

Although we share many of these views, we also recognise that economies and markets rarely evolve in such predictable ways (see Chart 1). As a consequence, we have identified five key forces that will shape the coming year. The first revolves around the Fed and how the US economy and those emerging markets heavily influenced by dollar liquidity are able to absorb higher interest rates. Early signposts that things are playing out benignly would include resilient domestic sentiment and lending conditions, stable capital flows to and from emerging markets and a gently rising dollar. The second is whether Europe and Japan can finally generate stronger inflation; rising underlying inflation would instil confidence that QE polices are working, support higher global interest rates and limit the monetary policy divergence that has underpinned the long dollar trade. The third centers on China. Sluggish but rebalancing Chinese growth is now priced into markets; a hard landing with the attendant impacts on currency policy, capital flows, commodities and social stability is not. The fourth concerns emerging markets more generally. Many are analysed primarily through the filter of China or the Fed, but as Brazil's malaise demonstrates, domestic policy and political considerations are equally important. If governments can do more to restore internal balance, it would do wonders for risk sentiment. Finally, Europe's integration project will be challenged by the UK's in/out referendum, surging migration inflows from the Middle East, and domestic security concerns. The EU does need reform but few would be made better off by Brexit or a more segregated internal market.

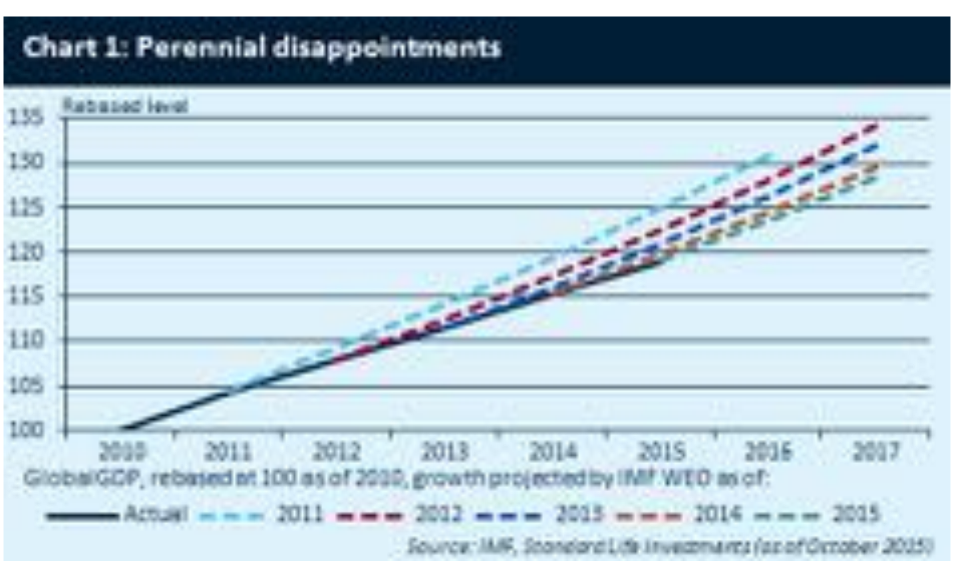

Chart 1: Perennial disappointments

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Taking hiking in stride

As 2015 draws to a close, it is time to look ahead to next year and consider the forces that will shape the economy and markets. **In many ways, we expect 2016 to look similar to 2015** (see Chart 2). We are forecasting real growth of 2.4%, a fraction less than the 2.5% that is likely for this year. That is above our estimates for potential growth and therefore should be enough to secure further improvement in the labour market; we anticipate that the unemployment rate will fall to around 4.5%, with broader measures of underutilisation also declining. **Private consumption should continue to power the economy, though the driver is expected to change from falling oil prices and strong employment growth, to faster nominal wage growth** as the tightening labour market raises the bargaining power of workers. While the near-term outlook for non-residential investment is subdued, we look for some improvement through 2016. That is because the drag from the plunge in oil prices will fade and higher wage costs and the increasingly scarcity of quality workers ought to encourage firms to substitute capital for labour. Healthy residential investment will be underpinned by rising household formation rates, amidst improving income prospects and a growing shortage of housing, despite the prospect of rising mortgage interest rates. Government spending is set to provide a small boost to growth as Congress loosens the country's fiscal straightjacket. Meanwhile, net trade is likely to drag growth down as further appreciation of the dollar against a backdrop of tepid external growth keeps export growth below import growth.

The real side of the economy may not be changing much but **there will be considerably more flux on the nominal side of the accounts.** The growth rate of the personal consumer expenditure deflator was held down in 2015 by the plunge in oil prices and the pass-through of the stronger dollar into consumer prices. Both effects will fade in 2016 unless import prices fall by the same amount again, which seems implausible given that their 9.3% decline over the past four quarters was the largest, outside of the global financial crisis, since the 1952 (see Chart 3). The same forces should push up the investment deflator. We also expect domestic consumer price pressures to gradually pick up in the face of the tightening labour market.

Above-trend growth, a sub-5% unemployment rate and rising inflation pressures imply that **the optimal federal funds rate is finally above zero and rising.** Therefore, barring a large shock, the Fed will lift its policy rate for the first time since 2006 next week. The bigger question is how many rate rises we will see next year. Our baseline projection has the Fed lifting rates four times, though that comes with important conditions. One is that the dollar appreciates only modestly; another 10% rise would trim the number of rate rises to two or three. The second is that there are no large external shocks that further dent exports and financial markets. A third is that there is a genuine improvement in domestically-generated inflation such that the Fed remains confident that rising interest rates are consistent with their 2% medium-term inflation target. Finally, **we will be watching closely for evidence that households and firms are taking rate rises in their stride.** If business and consumer sentiment indicators roll over and lending standards tighten amidst weakening demand, the tightening cycle will prove short-lived.

Chart 2: Growth to remain above potential

Chart 3: Import prices to normalise?

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