‘Tisn’t the Season to be Jolly: Another Dismal Economic Year Ahead

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A sobering view for the New Year: some global highlights

2016 will be the seventh year of economic expansion following the great recession in 2008-2009. Thus, the expansion is wearing old in historic comparison. Most of the early expansion year’s synergies have been played out.

Employment in the US is on the cusp of being considered full, the Federal Reserve has begun tightening monetary policy, corporate profit opportunities are diminishing along with full employment. Bond returns beat stock returns in 2015 and will probably do so again in 2016, in spite of Fed tightening.

The unfolding bad-debt dilemma in China’s banks has halted because the government has started to pour more credit into them and through them to prevent China’s economic growth from decelerating too fast.

In Japan, Prime Minister Abe has run out of Abenomics’ tactics, and the Bank of Japan has had to create billions more yen. Indeed, based on revised third quarter GDP data, Japan barely escaped a technical recession by the skin of its teeth.

Sovereign budgets in the EU are treading closer to acceptable levels and sovereign interest costs remain historically trivial. However, business confidence remains mired in the doldrums.

Depressed commodity prices will not have any new support in 2016. It is too soon for inflation to make a serious comeback. The earth is getting warmer with more intense and costly climatic consequences, which destroy value and increase tariffs for owners, governments, and insurers. Measures to slowdown the warming process will add expenses in the short-run and reduce demand for old sources of fuel. The world will have to wait for new enterprise to
ignite new approaches to neutralize this global hazard.

The world is sadly waiting for the next terror outbreak to occur, and as fear builds capital is invested in the safest places.

**2015 was a year to forget**

Looking back over 2015, I thought it would be instructive to read what I wrote about 2015 one year ago.*

- The IMF world growth forecasts look too optimistic again.
- The EU and Japan have too much to overcome without sufficient macro policy incentives.
- Deflation is more likely in both areas than an improvement in their growth rates.
- China is a quagmire with official growth targets likely to be greater than the economy is able to achieve.
- ASEAN countries will be looking internally for growth, as external sources are all retreating.
- The US is forecast to grow faster than in 2014, but it does not have the private sector strength to reach 3% growth.
- Currencies are anticipated to keep adjusting in favor of the dollar.
- Global growth should rise minimally to a projected 3.4% in 2015.
- The gentle rise in US interest rates, appreciation of the US dollar, and determined policy action to deflate real estate prices in many Asian capitals, should reduce the inflow of capital to all Asian markets.
- Present geopolitical tensions will not disappear, may intensify, and new ones might develop. All will add to uncertainty and create more volatility in financial markets.

As we learned in 2015, nearly all of these events occurred in this year and they subdued investment returns, especially equity returns.

However, there were other major shocks to the global markets that took the edge off gently rising markets. The most notable was the surprise decision by the Chinese authorities to devalue the Yuan. It sent shock waves through financial markets and intensified the heightened volatility in the Chinese stock market. It left many emerging market economies in Asia vulnerable, and in time all watched their currencies depreciate. Finally political turmoil erupted in many locations sending tremors through financial markets and fear throughout the world.

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Growth forecasts proved too optimistic again

Sanguine thoughts and sugar-plum fairies dancing and prevailing in the minds and models of the global economic growth forecast community, dominated their opinions during the end of year forecasts. For example, the IMF had forecast that growth in 2015 would accelerate to 3.8% from 3.4% in 2014. Global growth didn’t. It sank to an estimated rate of 3.1%. This was the fourth consecutive year in which the IMF forecast proved to be much too optimistic (see Global Growth & Forecasts Chart). I too was over-optimistic in 2014, albeit less so than the IMF. Once again in 2015 my global growth forecast is lower than the IMF’s, and less than the estimated actual growth for 2015: my global growth forecast for 2016 is 3%. A few years ago the IMF considered that 3% world growth would be equivalent to a global recession.

Things to look forward to in 2016

The US-inspired Asia trade agreement (the Trans-Pacific Partnership) should create some growth opportunities for many of its smaller Asian members. Similarly, the creation of a deeper ASEAN Economic Community in 2015 should increase trade in the region. In addition, the Chinese-inspired proposal of ‘One Belt, One Road’ should stimulate trade and produce significant amounts of investment throughout the Central Asian nations. As the two global hegemons compete for the attention of Asian nations, they will create added economic growth to the region in 2016 and beyond, but their efforts will not replace the lost trade from significantly slower economic growth in China in 2016.

The impact from more Yuan-related transactions in the wake of the Yuan becoming a global reserve currency should create more financial transactions and possibly create some additional trade.

Relative stability in commodity prices should return to global commodity markets after several years of extreme volatility. This should bring some better balance to the economies of the commodity producers.

More monetary easing is certain throughout most of the world, especially in Europe and Japan. China, too, will probably embark on additional stimulus packages, involving both monetary and fiscal policies, so as to prevent economic growth from decelerating too much.

Things that may get in the way of growth

Non performing Chinese bank liabilities are estimated to total over US$1 trillion, and could easily become a major drag on future Chinese growth, unless China absorbs these loans into its copious reserve funds and credits Chinese banks with fresh funds. While China could afford such a swap, it would immediately return their banking system back to the pre-2008 situation, which
led to the free flow of credit to unnecessary and unproductive state-run projects.

In the present, tense global environment, political turmoil is an ever-present threat and must always be assumed. Its impact on affected economies weighs in both directions. Heightened turmoil raises financial risk preferences, which shifts funds to perceived safe centers. It also raises production of military hardware in the global race for military supremacy. In areas of actual combat, destruction of physical capital and population migration, in addition to the human calamity and misery, lead to lost economic output and growth. Burden sharing for migration will in the short run be very costly, while in the long run may add to growth of the host countries.

In 2016 the adjustment from the wealth shift from oil exporters to oil importers will subside. This one-time transfer in income from oil exporters boosted consumption in the oil-importing countries during early 2015. Now the effect on consumption is long past. Therefore, assuming no further collapse in oil prices during 2016, there will be no new benefit to the importing country’s consumers. Many marginal energy producers, from extraction to refining, will probably have to drop out of business as the expense of producing energy far exceed the present global price of energy.

Cyber security breaches and prevention add serious levies to global corporate business. Adding prevention staff, plus the systems that they create to reduce the risk of security breaches, add cost and time to revenue-generating operations. While security is important, the measures taken to shrink security risks do not bring in new revenue, but they do absorb productive time and raise non-productive expenditures. Thus, they are a net negative for productivity and for global economic growth.

The outlook for 2016

Looking ahead to 2016 global economic growth it is again likely to disappoint forecasters and politicians. Global growth is predicted to remain subdued expanding at an annual rate of 3%, marginally slower than the 3.1% growth estimated for 2015. There are very few leaders in this year’s outlook.

The advanced economies will not all grow

Economic activity in the advanced economies is very unlikely to accelerate in 2016 and will more than likely decelerate from their 2.6% growth in 2015 to an estimated 2% in 2016. The US will be entertaining (no pun intended) another presidential election. And while this is likely to stimulate much wasteful spending on advertising, it is unlikely to energize additional rounds of consumer spending or business investment. Furthermore, expectations for monetary tightening throughout the year will dim some investment, even though interest rates will remain exceeding low by historical standards.
The US economy is now operating at close to full employment. It has already priced the Fed’s estimated NAIRU level. The presumption is that if business demand for labor continues to expand at its current pace, the excess demand relative to available supply of labor will raise wages and therefore inflation. Nevertheless, with inflation extremely low, income growth will be shallow. Consequently, the engine of growth behind the US economy, consumer spending, will be restrained.

The Fed raises rates several times

The Federal Reserve will probably cautiously raise its policy rate several times in 2016 bringing it to an estimated 1% by year-end 2016. Compared with inflation, which is expected to be hovering slightly below the Fed’s intended target of around 2%, this will leave real short-term interest rates at or below zero. This is clearly not a sign of restrictive monetary policy, however, it represents the beginning of the prospect for tighter policy going forward, which might inhibit some business plans.

Moreover the most growth-inhibiting factor associated with the Fed’s decision to raise rates is the effect it has had, and will continue to have, on the dollar. The trade-weighted dollar has already appreciated by 20% over the past 18 months. It will probably appreciate further in 2016 against nearly all currencies especially those associated with easier monetary policy: like in most of the world. The stronger dollar is already making US tradable goods more expensive and it is shrinking real US export growth and manufacturing activity.

The other advanced economies

Each of the other major advanced economies will struggle to grow more than 1% in 2016. The depression in commodities will continue to undermine growth in Canada, especially in the oil and gas sector. It was this sector that had been the major inspiration for investment and employment growth before the plunge in crude oil prices. Now cutbacks in output, employment and a halt to new investment will dent Canada’s economic growth in 2016.

No inflation and no income growth in Japan

In Japan, a new economic incentive proposal by Prime Minister Abe may prevent investment spending from diminishing. Corporate tax cuts associated with domestic investment has been tried unsuccessfully in other economies when domestic demand was flagging. In Japan the central bank will continue to pursue quantitative easing and
maintain a near zero-based interest rate policy. While supportive of economic growth, this strategy is losing its spark. No inflation, no positive income growth and an aging and socially-dependent population will prevent economic growth from reaching 1% in 2016.

The EU must adjust to a growing impoverished population

The debt crisis in the EU is rapidly becoming last year’s story, and it is taking second place to the flood of impoverished refuges migrating through Europe. In the long run this addition to population may be valuable as they find work and settle into new communities. However, in the short-run they are an economic burden, and will strain government resources and widen budget deficits.

The European Central Bank has committed itself to near zero rates and in essence unlimited QE. These tactics should weaken the Euro further and boost manufacturing and exports. However, business confidence is feeble and not vibrant enough to stimulate more investment. Governments must step up fiscal spending to augment inadequate domestic demand. Thus far, governments have been reluctant to expose their budgets to additional deficit financing and instead they have focused on fiscal austerity. Unfortunately any real accelerator-type fiscal spending will have to compete for funds with the outlays going to the refugees.

Consequently, economic growth in the EU is forecast to stagnate at around 1.5% in 2016.

The developing world slowing down

The key to understanding growth prospects in the developing world is to forecast the contribution coming from the colossal Chinese economy. According to the IMF, China accounts for 30% of all developing economies’ growth. When Chinese economic growth was growing at double digits, it fostered very rapid economic growth throughout ASEAN, whose economies account for another 11.3% of the developing world’s growth. As China’s economic growth declines, its demand for commodities supplied by ASEAN economies diminishes. Moreover, China’s demand for supply chain, semi-finished manufacturers will also contract. Thus growth in over 40% of the developing world’s economies will slow significantly.

The risk is that China’s growth rate continues to stumble throughout 2016 as the restructuring of the economy and “political purges” sap economic activity. The government has recently begun to use fiscal policy to supplement monetary policy. The six rate cuts in 2014-2015 failed to slow the deceleration in growth. The government then devalued the Yuan in August 2015 by just 1.9%, and later changed its peg to a basket of 13 currencies, instead of being strictly to the dollar. All of these moves caused the Yuan to depreciate, and by the end of 2015, some manufacturing and trade
data began to exhibit some signs of bottoming.

China’s most ambitious plan is to provide fresh funding for large Chinese construction firms to initiate infrastructure schemes overseas through the “One Belt, One Road” program. Thus the government will attempt to divert frustration with diminishing domestic opportunities with overseas projects.

It is therefore expected that China’s economic growth will slow to about 6% in 2016, slightly lower than in 2015 and well below the government’s target. Because China has the fiscal power and monetary reserves to once again open its coffers and help its indigenous businesses, it is highly unlikely that economic growth will slow significantly below 6% in the near future.

**ASEAN’s growth must and will slow, too**

With China’s economic activity relatively sluggish, ASEAN’s economic growth will decelerate further in 2016. Many of the countries that were major commodity exporters will be attempting to restructure their economies to make up for lost export transactions. These transitions will take significant amounts of time, and therefore they will not have significant impact on ASEAN economic activity in 2016. Economic growth in ASEAN is predicted to decelerate to 5.5% in 2016, down from 6.5% in 2015.

**India is the fastest growing nation in Asia**

The fastest expanding economy in Asia is its other giant, India. India’s economic growth has exceeded 7% for the past several years, and it should again achieve 7% growth in 2016. Their biggest problem, in contrast to most of the rest of the world, is inflation. Inflation in India is the highest in the Asian region, averaging about 5.5% over the past several years. This has inhibited the monetary authorities from engaging in more aggressive monetary easing. Nevertheless, the Indian Rupee has consistently depreciated over the past several years. Domestic demand in India is finally building and this should keep its growth rate quite high as it belatedly catches up to the other emerging economies in the region.

**Other developing economies face dim export prospects**

Big commodity producers will have to find another way to stimulate slumping global demand in 2016. Although countries like Russia will probably not have to go through the same negative shocks to its economy and experience the same quantity of capital outflow that it did in 2015, they will still face excess supply conditions and insufficient demand for its commodity products. Excess oil supplies will continue to build throughout 2016, putting downward pressure on oil prices. Western nations’ political sanctions against Russia will remain and they will impose additional constraints to economic growth in Russia in 2016. Consequently,
Russia’s recent recession is predicted to last for at least another year, and quite possibly longer.

Australia and New Zealand, too, will face the same downward pressures from decreased demand for their raw material exports. Further monetary ease is anticipated, along with fresh fiscal initiatives in 2016 to revive domestic demand. Nevertheless, economic growth prospects will be unexciting for these Australasian island nations.

Capital markets response to this economic forecast

The key influence on world capital markets will be the divergence in monetary policy between the Fed and the rest of the world. The Fed began a series of increases in their policy rate while most of the rest of the world will continue to indulge in monetary stimulation.

• The second conclusion is that short-term interest rates will rise in the US relative to long-term rates. Thus the US yield curve will flatten as the credit market adjusts to expect future rises in the policy rate. US long-term rates will also attract increased foreign capital inflows given their relative superior return and the added prospect of a stronger currency.
• Profit growth in the US will shrink as the labor force reaches full employment and labor costs rise perhaps faster than inflation. Therefore, prospects for equity returns in 2016 will be quite meager.
• In Europe slow economic growth, no inflation and the added costs associated with the refugee crisis will impede profit growth. Moreover, the associated costs of increased security, border controls, and cyber-attack prevention will add to costs and obstruct improvements in the corporate bottom line. Consequently, equity returns in Europe will also be quite miniscule.
• In Asia decelerating economic growth and more aggressive fiscal and monetary policy stimulation will depreciate their currencies. Any new terror tremors will cause more currency volatility and greater capital outflow.

The most immediate consequence for markets and investors is that the dollar should continue to appreciate against all currencies, especially emerging market ones.
Conclusions

Global growth is forecast to disappoint again in 2016 and probably not achieve even the insipid growth that occurred in 2015. Returns to invested capital will reflect that uninspiring economic outcome. Commodity prices will probably not fall as much as in 2015, but they will not rise either. Thus they will be another drag on economic growth, especially for the commodity-producing countries. The new rage in serious business investment throughout the world will be cyber defense. Cyber-security is considered the number one risk to financial market stability according to a recent survey of investors. And 72% of investors who responded said their firms and others that they invest in are adding resources to cyber-security. Governments and individuals will also invest copious quantities of money to keep their data private and undistorted by foreign viruses.

For more information, please contact camri@nus.edu.sg
**KEY INDICATORS TABLE (AS OF 17 DECEMBER 2015)**

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**Source: Bloomberg**

**GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)**

**S&P500**: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)

**FTSE**: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)

**NIKKEI**: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)

**HANG SENG**: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)

**STI**: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)

**EUR**: USD/EUR exchange rate: 1 EUR = xx USD (EUR)

**YEN**: YEN/USD exchange rate: 1 USD = xx YEN (JPY)

**CMCI**: Constant Maturity Commodity Index (CMCIP)

**Oil**: West Texas Intermediate prices, $ per barrel (CLK1)

**3MO LIBOR**: interbank lending rate for 3-month US dollar loans (US0003M)

**10YR UST**: 10-year US Treasury yield (IYC8 – Sovereigns)

**10YR BUND**: 10-year German government bond yield (IYC8 – Sovereigns)

**10YR SPG**: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)

**10YR SGS**: 10-year Singapore government bond yield (IYC8 – Sovereigns)

**US ISM**: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)

**EU PMI**: Purchasing Managers’ index for the 17 country EU region (PMITMEZ)

**JP TANKAN**: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)

**CHINA IP**: China’s Industrial Production index, with 1-month lag (CHVAIOY)

**LC**: Local Currency

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