Weekly Economic Commentary

October 14, 2013

Gauging Global Growth in 2013 & 2014: **Stability**

John Canally, CFA
Economist
LPL Financial

Highlights

If the U.S. government remains shut down, news from corporate America on the health of the U.S. and global economies may take on even greater significance than usual for market participants and policymakers in the coming weeks.

The stabilization in growth forecasts for 2014 is a sign that perhaps the market is much more confident now that the global economy is in the middle innings of an expansion.

It's a healthy sign for global growth prospects that Japan's long-dormant economy, and the world's third largest, is finally starting to gain some momentum.

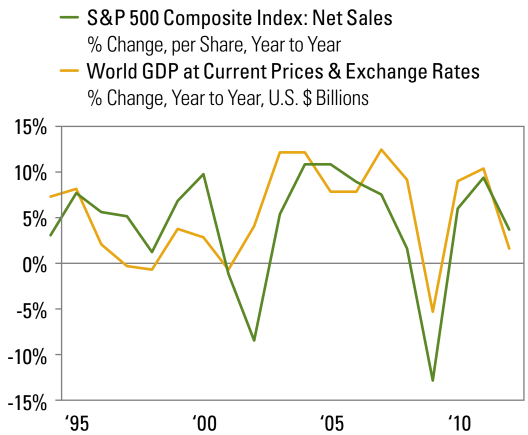
Please see this week's *Weekly Market Commentary, The Six Trends to Watch This Earnings Season,* October 14, 2013 for a full preview of the third quarter corporate earnings reporting season.

The shutdown of the U.S. Federal government since October 1, 2013 has sharply curtailed the amount of information the market is getting about the health of the U.S. economy as we transition from the third quarter into the fourth quarter of 2013. This week (October 14–18, 2013), financial markets will get an indirect update on the health of both the U.S. and global economies via the earnings reports and guidance from more than 70 firms in the S&P 500. Between now and the end of October 2013, nearly 350 S&P 500 firms will report their results for the third quarter, and many are likely to provide guidance on business activity in the fourth quarter, as well as the outlook for 2014. If the U.S. government remains shut down, this news flow from corporate America on the health of the U.S. and global economies may take on even greater significance than usual for market participants and policymakers—notably the Federal Reserve (Fed)—in the coming weeks.

The outlook for global growth is important to investors, since it defines the ultimate pace of activity that creates value for countries, companies, and consumers. The October 22, 2012 edition of the *Weekly Economic Commentary, Gauging Global Growth in 2013,* discussed the outlook for global economic growth in 2013, as 2012 drew to a close. In the May 28, 2013 edition of the *Weekly Economic Commentary, Gauging Global Growth in 2013: An Update,* we detailed the changes in the global economic outlook between the fall of 2012 and mid-2013. In this week's commentary, we will examine the evolution of the consensus forecasts for global inflation-adjusted (real) gross domestic product (GDP) for 2013 and 2014 since the spring of 2013.

Early last week, the International Monetary Fund (IMF) released the fall edition of its semi-annual global economic outlook. Although the release garnered plenty of headlines in the media (quite an achievement given the intense media coverage of the government shutdown and debt ceiling debacle in Washington), for the most part, financial market participants took little notice of the report. Why? Because consensus forecasts for global GDP growth are available monthly from sources like Bloomberg News, and because markets react to changes in projected paths of economic growth every day amid the daily, weekly, and monthly drumbeat of economic data and events from around the globe.

1 Global GDP Has Been a Good Proxy for Corporate Revenue Growth



Source: Standard & Poor's, Haver Analytics 10/11/13

Why Global GDP Growth Matters

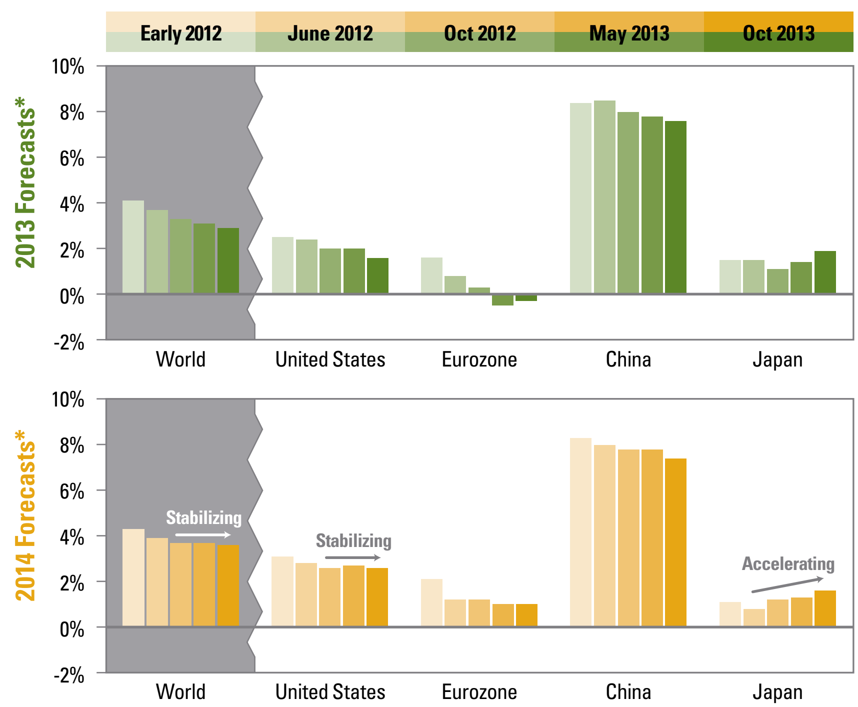
While prospects for U.S. economic growth have generated the most headlines, in recent years, markets have focused more on the prospects for global GDP growth. Why does global GDP growth matter? As we have noted in prior *Weekly Economic Commentaries*, financial markets—especially equity markets—focus intently on earnings. Broadly speaking, earnings growth is driven by "top-line" growth, or revenue growth, less the costs incurred earning that revenue, with labor accounting for more than two-thirds of total costs. A good proxy for global revenue growth is global GDP growth plus inflation. Thus, the pace of growth in the global economy is a key driver of global earnings growth, and ultimately the performance of global equity markets.

The latest (mid-October 2013) Bloomberg-tracked economist consensus forecast for 2013 global GDP growth stands at 2.9%, down from 3.1% in May 2013 and the 3.3% forecast made in October 2012. At the start of 2012, the consensus was expecting 4.1% world GDP growth in 2013. For 2014, the consensus now expects 3.6% growth, little changed from the forecasts made in both October 2012 and May 2013. The stabilization in growth forecasts for 2014 is a sign that perhaps the market is much more confident now that the global economy is in the middle innings of an expansion, rather than still in, or lurching toward, another recession.

The pace of growth in the global economy is a key driver of global earnings growth, and ultimately the performance of global equity markets.

2 Stability in Global Growth Forecasts for 2014 Is a Positive Sign for Markets

Progression of 2013 and 2014 GDP Forecasts for the World, the U.S., the Eurozone, China, and Japan



Source: Bloomberg 10/11/13

*Forecasts for 2013 and 2014 made in 2012 and 2013

Although global growth forecasts have stabilized in the past year or so, they are still below forecasts made at the start of 2012. The downgrade to growth expectations for 2013 and 2014 since early 2012 reflects several factors:

- The ongoing slowdown in China's economy in response to the series of monetary and fiscal tightening implemented over 2010 and 2011;
- The ongoing transition in China's economy from an export- and infrastructure-led growth profile to a more consumer-oriented growth profile;
- The ongoing uncertainty in Europe surrounding the future of the Eurozone, and the strains those concerns are having on the European financial system and European economy, which remains mired in slow-growth mode; and
- The drag from fiscal policy in the United States.

Impact of Japan's Government and Central Bank's Efforts: The Three Arrows Plus One?

Over the past 20 years, Japan's economy has grown, on average, just 0.9% per year.

Partially offsetting the factors above that are weighing on global growth are the actions taken by the Japanese government and central bank (sometimes referred to as the"three arrows") beginning in late 2012 to combat decades-old deflation (prices and wages falling over a prolonged period of time). The consensus forecast for Japanese GDP growth for 2013 stood at just 1.1% in October 2012. By May 2013, the consensus expected real GDP to grow by 1.4% for 2013. Today, the consensus expects Japanese GDP growth of 1.9% in 2013. While the mark-up to the consensus view of Japan's 2013 growth prospects is noteworthy, the shift in the consensus view for 2014 is even more stunning. In June 2012, the consensus expected just 0.8% real GDP growth in Japan in 2014. Today, the consensus expects 1.6% real GDP growth in Japan in 2014. To put that in perspective, over the past 20 years, Japan's economy has grown, on average, just 0.9% per year.

Before the Japanese economy actually accelerated, Japanese financial markets reacted to this upgrade of growth prospects for 2013 and 2014. The value of the Yen declined 20% between the fall of 2012 and mid-2013, helping to make Japan's exports more attractive to global markets, while Japan's Nikkei stock market index surged by more than 80% from mid-November 2012 through mid-May 2013. Since then, Japanese economic data have largely fallen short of those elevated expectations, and Japanese equities have pulled back in response. Looking ahead, the Japanese economy could get a lift from a "fourth arrow." Earlier this year, the International Olympic Committee awarded the 2020 Summer Olympic Games to Tokyo. In the past, the build out of infrastructure ahead of Summer Olympic Games has provided a boost to economic activity in the host nation. On balance, it's a healthy sign for global growth prospects that Japan's long-dormant economy, and the world's third largest, is finally starting to gain some momentum.

Impact of China on Global Growth

China has been a global growth engine since the early 2000s, as China's economy posted 10–12% real GDP growth between 2001 and 2007.

China's economy was one of the first to turn around after the global financial market meltdown in 2008, and its economy grew 11% in 2009, reviving hopes that China's decade-long run of 10% GDP growth would resume. Chinese authorities, however, who were worried about a spike in inflation — especially food inflation — began to ratchet up reserve requirements and interest rates in early 2010 and continued to tighten monetary policy until mid-2011.

Since then, investors waiting for a re-acceleration in Chinese economic growth to the 10%-plus pace seen in the early to mid-2000s have been disappointed, and market participants continue to mark down their 2013 and 2014 GDP growth outlooks for China. The consensus GDP growth estimate for 2013 now stands at 7.6% versus the 7.8% forecast made back in May 2013 and the 8.0% forecast made a year ago, in October 2012. As recently as mid-2012, markets were expecting 8.5% GDP growth in China in 2013. Looking out to 2014, the consensus now expects the Chinese economy to grow at 7.4%, down 0.4% from the forecast made in May 2013 (7.8%). As recently as early 2012, the consensus was looking for 8.3% real GDP growth in China in 2014.

Despite the slowdown in its pace of growth, China's economy remains the second largest in the world. While we do not expect a "hard landing" (a sharp deceleration to 5–6% GDP growth) in China over the next few years, our view remains that investors who expect China to return to the 10%-plus growth rate of the early to mid-2000s will likely continue to be disappointed.

Growth Estimates Have Stabilized in the Eurozone

As we have noted in several recent *Weekly Economic* and *Weekly Market Commentaries*, the Eurozone's economy has stopped getting worse. However, our view remains that the Eurozone is unlikely to improve significantly until its leaders can repair the region's broken financial transmission mechanism and address the banking, regulatory, and labor issues that are severely hampering growth. After bottoming out at -0.5% in May 2013, the consensus forecast for GDP growth in 2013 has now stabilized at -0.3%. In early 2012, markets were expecting 1.6% GDP growth in the Eurozone this year. Growth prospects for 2014 have stabilized as well, and currently stand at 1.0%, the same as the forecast made in May 2013. Note that the consensus growth estimates for the Eurozone for 2014 have been cut in half since early 2012. The key for markets here is the stability of the recent forecasts. In turn, that stability likely stems from the notion that the odds of a breakup of the Eurozone, while not zero, seem remote given the actions taken by Eurozone officials over the last 12–18 months.

Government Shutdown Hurting U.S. Growth Prospects in 2013, but Stabilization in Government Spending Could Help Boost Growth in 2014

Our long-held forecast for real GDP growth for the full year 2013 — which had been well below consensus in 2012 — remains at 2.0% and is now above the latest consensus forecast of +1.6%. The impact of the government shutdown and the slowdown in housing as a result of the recent rise in interest rates, along with a still cautious consumer, have contributed to the markdown of consensus GDP growth forecasts for 2013. Turning to the forecast for 2014, the consensus for 2014 real U.S. GDP growth now stands at 2.6%, down just 0.1% from the 2.7% expected by the consensus back in May 2013, but the same as the forecast made in October of 2012. When Bloomberg first began tracking consensus estimates for 2014 U.S. GDP growth back in early 2012, the estimate was 3.1%. The impact of the sequester—the fiscal drag imparted by the tax increases and spending cuts put in place earlier this year—and the slowdown in Europe and China help to account for the modest markdown in 2014 economic growth prospects for the United States over the past 18–24 months.

Similar to the recent stability of the consensus forecasts for global growth, the stability of the 2014 GDP forecast for the United States over the past year is informative. In our view, it is a sign that most market participants are comfortable that the U.S. economy is firmly in the middle part of the economic recovery, with little chance of recession in the next two years. LPL Financial Research will provide our 2014 GDP forecast in our upcoming *Outlook 2014* publication, which is due out in late November 2013.

We will continue to monitor these trends in the global economy and provide frequent updates on the pace of global growth. ■

INDEX DESCRIPTIONS

The Nikkei Index is short for Japan's Nikkei 225 Stock Average, the leading and most-respected index of Japanese stocks. It is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S. In fact, it was called the Nikkei Dow Jones Stock Average from 1975 to 1985.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.