

# Global Economic Outlook

Global Economic Research

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## Contents

Global	2
US	2
Europe	3
Japan	4
Australasia	6
Canada	6
Emerging Markets	7
Global Forecasts	13

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## Overview

**Global Economy**—Growth trends remain moderate, but the speed and breadth of gains are expected to improve throughout 2014, and even more so in 2015.

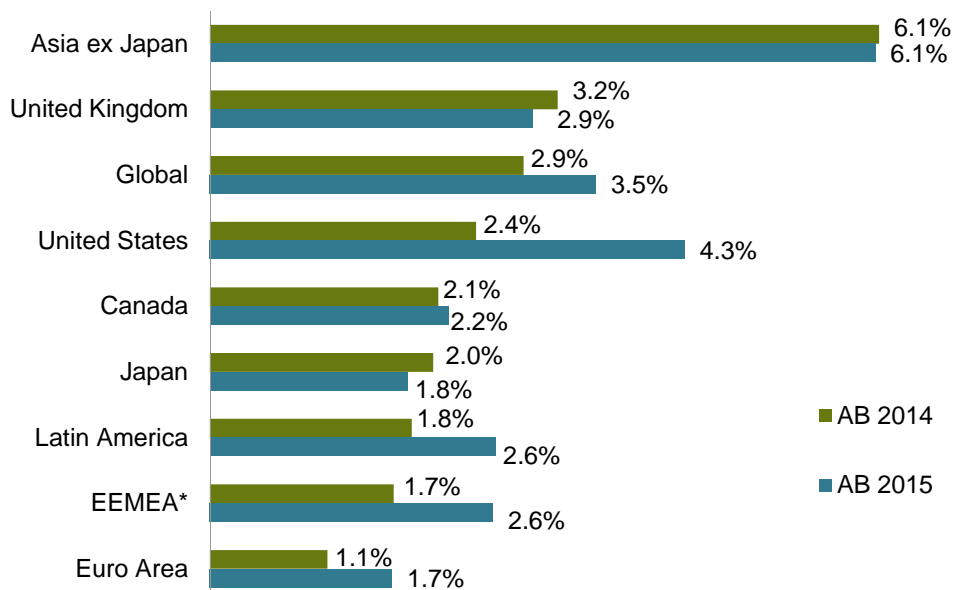
**United States**—Payroll-jobs and hours data point to a strong rebound in growth in the second quarter, but consensus estimates don't reflect its full magnitude.

**Europe**—The recovery continues, but earlier signs of upward momentum have been lost. The ECB is likely to maintain an easing bias for the foreseeable future.

**Japan**—Abenomics still gets a tentative tick mark for effectiveness, but a number of questions remain.

**China**—2014 GDP forecast is revised up marginally on increased policy support.

## AllianceBernstein World Economic Growth Forecasts\*\*



As of July 2, 2014

\*Emerging Europe, Middle East and Africa

\*\*Calendar year

Source: AllianceBernstein

## Global Outlook

**Global growth trend remains moderate but improving**

Global growth estimates were marginally lowered for 2014, down to 2.9% from the prior estimate of 3.0%, while estimates for 2015 were lifted slightly to 3.5% from 3.4%. The revisions were centered in the US. Following the surprisingly weather-related decline of 2.9% annualized in the first quarter, the lower-than-expected starting point will result in calendar year 2014 growth coming in about 0.5% below the initial estimate, even though robust quarterly gains were projected for the rest of the year. A portion of that lower 2014 growth has been pushed into 2015.

**Broad rebound in 2Q, following weak 1Q**

The robust second-quarter gross domestic product (GDP) gains don't appear limited to the US. The Global Purchasing Manager's Index (PMI) of manufacturing activity showed very strong output and order gains in June, indicating that the global manufacturing sector has started to re-accelerate. Faster gains in manufacturing were one of the reasons there was a slight upside revision to China's growth estimate for 2014, from 7.1% to 7.3%.

In Japan, the second-quarter Reuters Tankan survey had a modestly positive tone, as firms raised capital-spending plans. Firms also cited "labor shortages" that could lead to much-anticipated wage gains, which should help propel growth and alter inflation expectations. Notwithstanding these positive developments, we still expect continued monetary easing by the Bank of Japan (BoJ).

**Key policy decisions ahead for FOMC, BOE and ECB**

Financial markets will be watching key policy decisions in the second half of 2014 that involve the Federal Reserve (FOMC), Bank of England (BOE) and European Central Bank (ECB). Despite the first-quarter GDP disappointment, gains in labor markets have exceeded the Fed's expectations, while core consumer price inflation has moved up to the 2% mark well ahead of schedule. We think the combination of a rapid rebound in GDP growth and better-than-expected gains in labor markets will force the FOMC to change its communication policy and shift the timing of its first rate hike to early 2015. BOE Governor Mark Carney has hinted of an early rate hike as well, given the strong series of rapid GDP advances and solid gains in labor markets. On the other side of the spectrum will be the ECB maintaining a very low (if not negative) rate policy to counter the low inflation trends within Europe. The prospective changes on the policy front should lead to a much weaker euro versus major currencies.

## US Outlook

**Strong job and hours data point to robust economic rebound in 2Q**

In June, payroll employment rose by 288,000, and the prior gains for April and May were revised upward, lifting the average monthly job gain for the second quarter to 272,000 per month. If we include the lift from hours worked and wages, which increased by an annualized 4.4% and 2.3% in the second quarter, respectively, overall labor market data points to solid gains in personal income for the period.

Prospective gains in operating profits appear promising as well. Indeed, corporate tax payments, a good proxy for earnings growth, rose by 7% in June, which is broadly consistent with equity analysts' estimates of a 6% year-over-year gain in second-quarter operating profits. Personal income and operating profits account for the lion's share of Gross Domestic Income (GDI). Based on the combined estimated gains of personal income and profits, second-quarter GDI looks to have increased by approximately 10% annualized. That's a relatively large gain, but it shouldn't come as

a surprise, since GDI (and GDP) contracted in the first quarter due to bad weather that disrupted commerce across the Midwest, South and Northeast.

**Consensus estimates for 2Q seem too low**

What is surprising is that consensus second-quarter real GDP estimates remain stuck at 3% annualized (with nominal GDP at about 5%), far below the gain in GDI. This is surprising, since data usually flows from jobs/income data to sales and production. In other words, if firms are hiring and making money, firms' sales and production (GDP, in other words) should be rising equally fast.

**Consensus was off track in 1994 and 2004...**

It's quite possible that the consensus could be off track just as it was in 1994 and 2004, two other periods that marked a key turn in monetary policy. In 1994, a relatively large gain in inventory building led analysts to conclude the economy was slowing and that policy tightening by the Fed would soon end. But that view proved to be incorrect, and financial markets quickly changed course when then-Fed Chair Alan Greenspan testified that he thought the higher inventory build was justified by corporate growth and demand expectations.

In early 2004, the consensus view of economists was that monetary policy tightening was far in the future, given the relatively low readings on core inflation. Then, some monthly data readings came in modestly higher. Greenspan and then-FOMC member Ben Bernanke stated that core inflation had bottomed and that accommodative monetary policy would be required at a measured pace. Analysts were forced to quickly change their call on both the economy and official rates.

**...could they be off again in 2014?**

Could there be another "oops moment" for the analyst consensus in 2014? History shows that GDI has been a better predictor of cyclical turns in the economy than GDP has (research conducted by Federal Reserve staff supports this view). Also, the first-quarter decline in nominal GDI and GDP included a near-record decline in productivity (the initial estimate of -3.2% will be revised to between -5% and -5.5%, given the revisions to GDP). The odds of productivity declining again in the second quarter would be very low even if the economy were in recession. Also, if the first-quarter productivity decline was driven in part by weather, history suggests that a lot, if not all, of that decline will be recovered in the second quarter. This suggests that upcoming reports on (and revisions to) retail sales, construction, services and shipments should collectively exceed the consensus estimates, and that second-quarter real GDP estimates could prove to be too low, just as first-quarter estimates proved to be too high.

## Europe Outlook

**Disappointing data show little evidence of earlier momentum**

Recent euro-area data have surprised slightly on the downside. In June, the composite PMI for manufacturing and services fell back to 52.8, the second consecutive monthly decline and the lowest reading since December. At current levels, the composite PMI is still broadly consistent with quarterly economic growth of 0.3%, but there's now little evidence of the upward momentum seen earlier in the year. This is important: without a further pickup in growth, underlying inflation in the euro area is likely to remain anchored near its current 0.8%. Given the ECB's concerns about a protracted period of low inflation, this would raise the risk of further monetary easing.

**ECB still has an easing bias**

This is consistent with the message from the ECB's July press conference. Although the outlook was left broadly unchanged, the softer tone of recent data was

acknowledged by ECB President Mario Draghi, who described the recovery as “very gradual,” as opposed to “moderate” or “gradual” a month earlier. The ECB hopes that the package of measures announced after its June Council meeting will have a big impact on the economy and help drive inflation back up toward its target. However, Draghi also made it clear that the ECB won’t hesitate to launch a broad-based asset purchase program, if the measures announced last month fail to deliver and there’s a further deterioration in the medium-term outlook for price stability.

So, how effective are the measures announced last month likely to be? In our view, the key is how successful the ECB’s new targeted longer-term refinancing operations (TLTROs) are likely to be. The TLTROs will offer euro-area banks access to cheap long-term funding in a series of auctions to be held between September of this year and March 2016, as long as they boost their lending to the real economy (excluding housing loans). According to the ECB, the total amount borrowed at all eight TLTRO auctions could be as high as €1 trillion.

**Targeted support for bank lending or quantitative easing?**

But is this likely to reignite bank lending in the euro area? We’re skeptical, at least as far as the near term is concerned. Part of the reason is that the conditions attached to TLTRO loans are extremely loose. While this should help maximize TLTRO borrowing, it also means there are no real safeguards to ensure the money is actually used to support the real economy. In fact, the only penalty a bank would face for participating in the TLTROs and investing the money in government bonds is that it would have to pay the funds back two years early, in 2016. All this suggests that the TLTROs will be more effective in helping to boost the size of the ECB’s balance sheet (quantitative easing) than in supporting bank lending to households and firms (credit easing).

Of course, this doesn’t mean the TLTROs will have no impact. The provision of significant quantities of cheap long-term funding to the banks should, over time, contribute to the healing of the financial system in the euro area. Meanwhile, the expansion in the ECB’s balance sheet should help support asset prices throughout the region and provide further support to the periphery. But this is likely to be a slow process. Barring a drop in the euro or unexpected rise in inflation, pressure for further monetary easing is likely to build in coming months.

## Japan Outlook

**Abenomics still gets a tentative tick mark, but a number of questions remain**

As we hit the halfway mark in 2014, the Abenomics policy push still gets a tentative tick mark, in our view, but a number of questions remain. The answers that emerge during the second half of the year will be crucial in determining whether the potential transformation remains on track. Here are the four most pressing questions:

First, how close is Japan to defeating deflation? A year ago, headline and core inflation were running at –1% annualized. Actual inflation has now jumped sharply. Both headline and core are well into positive territory, even abstracting from the increase in the value-added tax (VAT), or consumption tax, on April 1.

However, most of the increase in inflation is transitory—a function of the sharp depreciation of the yen between late 2012 and mid-2013 as well as the hike in electricity prices necessitated by a protracted nuclear power plant shutdown. Those factors are starting to fade, and it’s highly likely that inflation (excluding the effect of the tax hike) will drift lower over the second half of the year. We’re closely watching

wage data to gauge whether rising inflation expectations have begun to influence actual behavior.

Second, can above-trend growth continue into 2015? The current economic debate centers on the impact of the VAT increase. Much of the “hard” economic data is closely tracking the experience of the 1997 VAT-hike episode. But expectations surveys show a recovery. Focusing on this debate, however, risks missing the bigger picture. Once the VAT-related volatility has faded, can above-trend growth be maintained? And with that, can there be a further tightening in the labor market?

There are four key pressure points, in our view: One, can consumer spending hold up, even as growth in nominal wages remains sluggish? Two, is there room to deliver more (effective) fiscal stimulus? Three, will export volume growth recover? And four, can the recent improvement in business-capital spending, which rose 11% year over year in the first quarter, be sustained? Our above-consensus growth view is contingent on a positive outcome in all four pressure points. They remain crucial markers to watch.

Third, can the “third arrow” of Abenomics help boost long-run growth expectations through its structural reforms? In the post-bubble period, labor productivity growth (measured as GDP per worker) has averaged around 1% annualized—a marked slowdown from prior decades, to be sure, but not too far out of line with the experience of other high-income economies. Can structural reform initiatives improve on this outcome and underpin an increase in domestic production capacity? So far, the reform effort has been a source of disappointment. But it's encouraging to see the emergence of a more coherent narrative centered on governance reform, labor-market initiatives and a set of industry regulatory reforms—agriculture, energy, tourism and healthcare. The clearer the narrative, the more likely it is that we'll see a resetting of expectations about medium-term growth prospects.

Last, can the BoJ continue to walk the tightrope? After delivering the “bazooka” easing last April, the BoJ has done little new, apart from tweaking Rinban bond-buying operations. We had thought that the central bank would continue down the path of over-delivering—after all, the task of dramatically resetting inflation expectations shouldn't be underestimated. But it's now increasingly looking as if nothing will be done in the second half of the year, either. BoJ governor Haruhiko Kuroda seems content to argue that things are largely on track—and to continue to do so even as inflation ebbs a little.

However, the lack of action is likely to throw a brighter spotlight on a number of risks. Without the “demonstration effect” of further easing, can the BoJ continue to push inflation expectations higher? Can the idea of tension between the first and third arrows be contained? And can the BoJ maintain control of the Japanese government bond (JGB) market, particularly with talk of the GPIF, the gigantic public pension fund, shifting its asset allocation more toward equities at the cost of JGBs, and with increasing chatter about the BoJ's exit from its current policy regime? With JGB yields heading to new lows, and with volatility continuing to compress, the emergence of these types of questions has the potential to set alarm bells ringing.

**The return of big trade deficits illustrates need for more rebalancing**

## Australasia Outlook

The latest Australian trade numbers showed a much larger deterioration in the nation's trade balance than anyone expected, much of it attributable to weaker commodity prices coupled with a stubbornly strong Australian dollar (AUD). But it also illustrates that much more “rebalancing” is ahead.

Instead of recording another near-balanced outcome, Australia's trade deficit blew out to nearly A\$2 billion in May. Revisions to historical data compounded the nasty picture. After a brief foray into surplus territory, Australia's deficit has returned and is almost two-thirds of the way back to its widest levels. Of course, it wasn't supposed to be like this; the rebalancing process was supposed to yield sizable trade surpluses.

To be sure, the pieces of the puzzle are there. The transition from the construction phase of the mining boom to the production phase is delivering a solid rise in export volumes. And imports—particularly for capital goods—are now falling rapidly as investment spending plunges. So, in volume terms, the trade balance is clearly improving, and net exports are delivering a big (mathematical) contribution to GDP growth.

But—and here's the missing piece—the additional output is putting downward pressure on export prices. Spot iron-ore prices are down 30% over the last six months in US-dollar terms, and coal prices are off sharply, too. These commodities now dominate Australia's export basket. Compounding the impact of these declines is that the AUD isn't playing its typical role as a shock absorber. Given how much export prices have fallen and the compression in the spread of the Australian interest-rate structure versus its global counterparts, the AUD should be materially lower. It's not—indeed, it has rallied over the past half year. The combination of a rising AUD and falling prices has been large enough to offset any volume gains.

What does this mean? It's another great illustration of the notion that the transition from a mining boom to non-mining growth is likely to be a rocky one. It highlights that there's much more work to be done in rebalancing the Australian economy, and that a weaker AUD is pivotal in that process.

## Canada Outlook

**Inflation is now above the 2% target...**

Inflation has accelerated markedly in the second quarter, quickly surpassing the 2% target in April and reaching 2.3% in May from an average of only 1.4% in the first quarter. To be fair, the Bank of Canada (BoC) predicted a pickup in headline inflation. But the magnitude and timing of the acceleration caught both the BoC and the market off-guard. In previous communications, the BoC pointed to muted core inflation as a sign that rising headline inflation should be viewed as only temporary, but that argument can no longer hold, given that core inflation has risen significantly, too.

**...but the BoC appears unconcerned**

To date, the BoC has expressed much greater concern over downside inflation risks than it has over the potential for above-target inflation numbers. But in the upcoming Monetary Policy Committee Meeting, the bank will very likely be forced to adjust its inflation forecast upward to be more consistent with the recent trend. Still, we don't expect that the pickup in inflation will be a sufficient motivation for the BoC to reverse its dovish stance.



### Employment and survey data remain soft

One reason is that employment data hasn't caught up to inflation or the limited GDP gains so far this year. Net hiring has been negative, and the unemployment rate is at 7%, unchanged from January 2013. The bank doesn't have to look any further than recent job numbers for disappointing data to support its dovishness.

### No change in our rate-hike forecast

Also, the recently released Business Outlook Survey, which we believe serves as an important signal for policymakers, suggests that firms are anticipating a slowdown in inflation from current rates. In fact, the biggest change in the survey was reflected in expectations for input prices. For the first time since the recession, firms expect input prices to rise more slowly over the next 12 months than they did over the past 12 months. Expectations for output-price inflation also fell slightly, with most firms expecting international competition to continue imposing constraints on raising prices. Finally, more respondents expect inflation to remain below 2% over the next two years than did in the last survey, despite inflation reaching a two-year high. In fact, two-thirds of firms expect inflation of only 1%–2% over the next two years.

Given the combination of softness in employment and production data, and the business community's belief that higher inflation is only temporary, we don't believe that the recent pickup in inflation will be enough to move the timing of the first rate hike forward—especially not before the US Fed's first move.

## Emerging-Market Outlook

**Latin America:** Emerging-market assets continued to perform well during the past month, driven by inflows into both equity and fixed-income funds. The strong showing came despite evidence that the US economy is on the recovery track and that US yields may edge higher—sooner than initially expected.

### Argentina: Negotiations with holdouts likely, timing of settlement unclear

In Argentina, the government missed the June 30 deadline for the payment of New York law Discount bonds, and it has entered the 30-day grace period before a sovereign default takes place. Recent price action, however, continues to suggest that the market remains confident about a settlement agreement between Argentina and holdout bond investors before July 30. In the past couple of weeks, Economy Minister Axel Kicillof made presentations at the United Nations (UN) and Organization of American States (OAS), reiterating that Argentina "wants to pay 100% of its bondholders" and that it wants to negotiate with holdout debt investors "under reasonable conditions."

The UN's Group of 77 and the OAS issued communiques in support of the Republic, although the US and Canada didn't endorse them. Instead, the US indicated that the dispute should be solved within the realm of US law. Argentina vowed legal action against international financial intermediaries who fail to pay holders of Discount bonds after Argentina deposited the funds at its central bank on June 26. US Second Circuit Court Judge Thomas Griesa ordered the Bank of New York (BoNY) to return those funds to Argentina, but Argentina's government has maintained the dollars in BoNY's account, arguing that it no longer owns the money and that BoNY has the fiduciary obligation to pay bondholders as per the bonds' indenture.

Argentina sent a delegation to New York to meet with Special Master Daniel Pollack, the attorney appointed by Griesa to handle the settlement negotiations with holdout investors. The delegation reportedly asked for the stay order that allows Argentina to make payments on exchanged debt to be reinstated (although Griesa had already

denied that move in recent weeks), and/or for Griesa to state clearly that a possible settlement with holdouts will not be a “voluntary” action of Argentina but rather one forced by the legal ruling. This would provide a way to avoid triggering the Right Upon Future Offerings (RUFO) clause, thus preventing exchange bondholders from benefiting from the same ruling that benefited holdouts. Recent statements by top policymakers in Argentina suggest that more work is necessary to reach an agreement, so we can’t yet rule out a scenario in which the settlement occurs after the July 30 deadline, triggering a sovereign default.

**Brazil: Rouseff’s  
slide in the polls  
stops—at least  
temporarily**

In Brazil, the latest Datafolha electoral poll, with data through July 2, shows that President Dilma Rouseff would obtain 38% of the votes in the October 5 presidential election, up four points relative to the previous survey, while her main contender, Aécio Neves from the Social Democracy Party (PSDB), would receive 20%, up one point. All opposition candidates combined would obtain 38%, making it still unclear whether the election would be decided in a second-round vote. According to Brazil’s electoral laws, the winner needs either 50% plus one vote or the combination of a simple majority and more than all the combined votes of the contenders combined.

The second-round simulation shows that Rouseff would get 46% of the vote (the same as in the previous survey) versus 39% for Neves (up one point). Interestingly, Neves is now ahead of Rouseff in large metropolitan areas of over 500,000 people in terms of second-round voting intent. Local political analysts have suggested that the successful World Cup has benefitted Rouseff, whose support had been in a free fall until now. The tournament has been largely free of logistical problems, the much-feared social protests never materialized and the Brazilian team made it to the quarterfinal round. The Datafolha poll shows that 60% of Brazilians are proud of the way the World Cup has proceeded so far, up from 45% a month ago.

It remains to be seen how quickly voters’ attention is directed back to economic problems after the World Cup ends, especially since economic activity is undershooting even the most conservative expectations. And the dramatic fashion in which the national team was ousted from the tournament may require some strategic change on Rouseff’s part, as the government may need to disassociate itself somewhat from the Cup. May’s industrial production contracted by 0.6% month over month, a 3.2% year-over-year contraction, suggesting an industrial drop during the entire second quarter of 2014 and a significant drag on GDP during the period. The latest Central Bank Focus expectation survey shows that the market consensus for 2014 GDP growth is now at 1.1%, and some private estimates are currently below the 1% mark. May’s fiscal results were disappointing, evidencing a lack of fiscal-adjustment effort so far this year. The central government generated a R\$10.5 billion deficit versus expectations of no fiscal imbalance. It was the largest monthly deficit for May on record. On a 12-month basis, the primary surplus is now running at 1.2% of GDP, down from the official 1.6% target.

Even worse, when extraordinary revenues are excluded, the surplus is only 0.5% of GDP. At the consolidated public-sector level, the primary fiscal imbalance was R\$11 billion and the nominal deficit was R\$32.4 billion. Net public debt/GDP rose 40 basis points to 34.6%. Because economic activity is likely to undershoot official projections, it appears that the government may miss its primary fiscal target for the year. The large fiscal imbalance explains why—despite high nominal and real interest rates and sputtering activity—inflation remains near the ceiling of the target range. Put a



different way, it will be very difficult for Brazil to lower inflation simply with tighter monetary policy, if no fiscal adjustment is implemented.

**Colombia:  
Santos  
reelected  
President**

In Colombia, President Juan Manuel Santos, who lost the first-round election to former Finance Minister Ivan Zuluaga by 460,000 votes, won reelection in the second round, beating Zuluaga 51% to 45% (a margin of more than 900,000 votes). Among the most populated areas, Santos won in Bogota, Cali, Barranquilla and Bucaramanga, while Zuluaga won in Medellin. Bogota, where Santos established an electoral alliance with the center left Polo Democrático, as well as Barranquilla and the Caribbean coast districts, was key to the president's victory. The outcome of the election was unlikely to generate significant short-term changes in economic policy: Santos and Zuluaga were former finance ministers in the administrations of Alvaro Uribe and share common views about the economy. Their main difference is related to the peace process with the FARC guerrillas, which Zuluaga opposed and that would have stalled under his presidency, with possible medium-term consequences for the economy and for governability. Therefore, Santos's victory is market-positive.

The peace negotiations have been underway for almost more than a year; so far preliminary accords have been reached on agriculture development, the reinsertion of the FARC in the formal political structure of the country and the fight against drug trafficking. Both parties are discussing treatment and compensation for victims of the conflict. The final topic for discussion will be demobilization, disarmament and the end of the conflict. The hope for peace after decades of virtual civil war bolstered Santos's popular support for a second term, so we expect the government to accelerate the dialogue with the FARC to complete the negotiations this year. A peace accord should pave the way for increases in productivity over the medium term, especially in agriculture.

**Mexico:  
Surprise  
interest-rate cut**

In Mexico, the Banco de Mexico (Banxico) delivered a significant surprise by easing monetary policy with a 50 basis-point interest-rate cut to 3%. Not only was the cut itself unexpected, but the magnitude was unusual. Banxico argued that global growth moderated during the first quarter, and that economic activity in the US, although expected to accelerate gradually the rest of the year, will be softer than initially expected. That reinforces the bank's view that the normalization of US monetary policy will proceed methodically. Banxico also referenced monetary policy relaxation by the ECB, which could have helped determine the need for the rate cut. Banxico expects monetary policy to remain lax both in developed and emerging markets "for a long period."

Mexican economic activity also undershot official expectations, especially domestic demand, which wasn't offset by the mild evidence of improvement in net exports observed toward the end of the first quarter. Banxico now expects the negative output gap to widen further, so inflationary pressures from the demand side should be absent. The bank indicated that the balance of risks affecting economic growth has deteriorated, while the balance for inflation has improved. It now believes that the chances of seeing headline inflation at nearly 3% by early 2015 and core inflation below 3% have increased. Banxico concluded that given the softer global activity, a 3% funding rate is consistent with convergence towards the medium-term inflation target. However, it also highlighted that no further rate action should be expected "in the foreseeable future"—in other words, this is probably a floor for the funding rate. The minutes of the meeting showed that the decision wasn't unanimous, but rather a close 3–2 vote, with the dissenters voting for no changes to the reference rate.

Meanwhile, the Senate approved the telecommunications bill geared toward increasing competition in the sector, six months after the framework legislation was endorsed by Congress. The Senate vote was 85 to 12, rejecting proposed changes to the version of the bill approved at the committee level. The initiative now heads to the Lower House, where it's expected to be endorsed quickly and signed into law by President Enrique Peña Nieto. Focus now turns to the approval of secondary legislation on energy reform, which would shape the contractual structure of ventures between Pemex and private companies. We expect it to be approved before the start of the next ordinary congressional session in September. Implementation of energy reform, including the first sizable inflows of strategic investment into the sector, may take another year.

**China's 2014 GDP forecast has been raised marginally, but growth should slow again next year**

**Asia ex Japan:** We've marginally raised our 2014 GDP forecast for China by 20 basis points to 7.3%, in light of increased government policy support to protect the downside of the current economic slowdown. Our GDP growth projection for the second half of 2014 is now at 7.2% year over year (versus 7% previously) thanks to the stepping up of "selective" credit easing to certain priority development areas such as agriculture, infrastructure and public housing projects. However, we still think these are short-term measures that will have limited impact on the slower long-term growth path caused by economic rebalancing, deleveraging and the growing tightness in labor supply. We've maintained our 2015 GDP forecast at 6.8%. We still see the current consolidation in housing and the intensified anti-corruption campaign continuing to be the two main drags on China's growth in the coming year.

**Property consolidation and anti-corruption are the two major drags on China's growth**

As for property, recent trends in housing demand and investment continue to point to a major market correction. We expect the current downturn to accelerate, but buying interest may return if prices correct. In fact, this phenomenon has been common in China's previous housing cycles. Uncertainty about the anti-corruption drive—which has gained in breadth and depth—is much more difficult to gauge. The crackdown has now extended from provincial officials to leaders of state firms, and, recently, to top-ranking military officials. The economic effect was obvious, as the fear factor has resulted in the suspension of local investment projects and significant underspending in most local government budgets. On the latter point, the situation has become so severe that China's Premier, Li Keqiang, has recently asked local governments to revive investment spending, especially on key development projects under the current five-year economic plan. We suspect that this kind of investment vacuum will persist unless the crackdown on corruption starts to fade.

**Asia is vulnerable to another oil shock, but weak local demand and inflation could offset this**

For Asia, we see the potential risk of rising global oil prices, induced by the Iraq crisis, as a negative factor to the growth outlook. Asia is heavily reliant on foreign oil supply, and an oil crisis would represent a shock to its trade balance, inflation and economic growth. However, so far it seems that global oil prices remain well-contained. And, unlike the upswings in oil prices in the 2010–11 and 2007–08 cycles, there's no sign of an upturn in the broad commodity index and global food inflation cycle. Moreover, Asia's domestic demand remains weak at this juncture and inflation has stayed benign in most countries. So, we see little risk of a major inflation pass-through effect that causes more economic weakness triggered by policy tightening.

**More EEMEA growth weakness**

**Emerging Europe, Middle East and Africa:** EEMEA's 2014 growth outlook has been steadily deteriorating since the end of last year. The ongoing geopolitical crisis in Russia and Ukraine, monetary policy tightening and political uncertainty in Turkey (until the end of March), and a protracted mining strike in South Africa all had an

impact. These three factors more than offset the recovery that had been gaining momentum in central Europe—benefiting from rising core European demand, especially from Germany.

**Consumer spending in Russia to slow**

Although some economic indicators in Russia improved during April and May (namely industrial production and investment spending), others deteriorated (construction and retail sales). Based on all available information for the second quarter, we think real GDP may have stabilized after the sharp first-quarter sequential contraction. However, we don't see economic growth in Russia exceeding 0.5% this year. Despite what currently appears to be a meaningful de-escalation in the Russian-Ukrainian conflict, at least at the highest political level, we believe that the crisis is far from over and that the threat of further material sanctions from the West, including those against Russian corporations and banks, remains elevated.

**Further downside risks in South Africa due to strikes**

In South Africa, the first-quarter collapse in mining output and the contraction in the volatile manufacturing sector delivered the first sequential GDP decline since 2009. This, combined with a softening of retail sales, made us further pare back our 2014 GDP forecast to 1.7%. This is close to the current underlying growth rate of South Africa's economy (after smoothing out industrial volatility caused by frequent strikes). The five-month-long strike in the platinum mining sector finally ended in late June, but if the new strike (which began July 1) in the engineering and metals industries gains similar momentum, we see further downside risks to both our 2014 growth forecast and the expected recovery to 2.7% growth during 2015.

**Turkey probably slowing as well (although less than expected)...**

In Turkey, the first-quarter GDP estimate wasn't published until a few weeks ago—and it surprised on the upside. Domestic demand contracted substantially, as expected, but was more than offset by a large positive contribution from net exports as imports collapsed (due to exchange rate weakness) and exports grew strongly. Based on detailed foreign-trade statistics, strong export performance was almost entirely due to exports to the European Union. This, together with some upward revisions to 2013 data, implies that our original forecast for Turkey's 2014 growth of 2.5% would be too conservative; we've decided to raise it to 3.5%. This would still be a slowdown from 4.1% growth last year, but it wouldn't be as dramatic as we had initially assumed. However, the composition of this year's growth will be significantly different, reflecting successful rebalancing away from domestic demand and toward foreign demand as the key driver of economic expansion.

**...while central Europe gains momentum**

In contrast, the economic recovery has gained momentum in central Europe. The combined GDP of Poland, Hungary and the Czech Republic expanded at an annualized rate of 3.8% in the first quarter, after a similar performance in the last three months of 2013. We now expect central Europe's growth to accelerate to 2.9% this year from 0.9% in 2013, and to maintain this pace in 2015. This estimate is predicated on a sustained growth recovery in the euro area and a further strengthening of domestic demand locally. First-quarter GDP numbers were encouraging from that perspective, showing particularly robust growth in fixed investment.

**Intra-regional divergence in growth and inflation...**

In summary, our EEMEA growth forecast for this year and 2015 reflects a continued divergence within the region. The same is true for inflation dynamics, although the signs are a polar opposite of what the underlying growth story would imply. Namely, the economies slowing the most (Russia, South Africa and Turkey) have the highest inflation rates, which currently stand above their central bank target ranges. This is primarily because of the exchange-rate pass-through from local-currency

depreciation until at least January of this year. Meanwhile, the economies with the strongest recoveries (central Europe) have exhibited barely any inflation, and inflation there continues to surprise on the downside. Despite a likely pickup over the next several quarters, inflation rates in central Europe won't reach central bank targets before mid-next year at the earliest.

**...shapes  
divergent  
outlook for  
monetary policy**

This, in turn, has shaped a divergent outlook for monetary policy across the region. In central Europe, central banks have only recently started to debate the possibility of policy-rate normalization, but stronger-than-expected cost-push disinflation in recent months and renewed efforts by the ECB to increase monetary accommodation have pushed that debate further into the future. In fact, Hungary's central bank will now likely reduce its policy rate by another 30 basis points to 2.00% by September, while Poland's central bank recently withdrew its forward guidance for unchanged policy rates, giving rise to speculation that more cuts may still be coming. We don't think they'll come, unless economic activity falters substantially—which we don't expect.

**...underpinned  
by continuation  
of the more  
favorable global  
risk backdrop**

In contrast, pressure on exchange rates in Turkey, Russia and South Africa earlier this year forced their central banks to tighten policy—most significantly in Turkey. But now that the pressure on exchange rates has reversed and currencies have appreciated back to levels seen before policy-tightening moves, central banks have become more dovish. Again, this is most apparent in Turkey, where the Monetary Policy Committee has delivered two rate cuts since March: the first (in April) was completely unexpected; the second (in June) was larger than expected. Both were most likely premature, given the still-elevated inflation that exceeded 9% as recently as in June, compared with the central bank's target of 5%.

However, sustaining the ongoing shift toward greater accommodation will critically depend on the continuation of the current very favorable global-risk environment, underpinned by ECB easing and the discounting of a less-hawkish US Fed. On balance, we see more easing in Turkey, which happens to have the highest policy rate in the region—but no cuts in Russia or South Africa. In fact, the central bank in South Africa is still more likely to hike this year (we've penciled in 25 basis points for November) than to reverse its 50 basis point hike from late January.

	Real Growth (%)				Inflation (%)				Official Rates <sup>1</sup> (%)		Long Rates <sup>1</sup> (%)	
	4Q/4Q		Calendar		4Q/4Q		Calendar		EOP	EOP	EOP	EOP
	2014F	2015F	2014F	2015F	2014F	2015F	2014F	2015F	2014F	2015F	2014F	2015F
Global	3.1	3.5	2.9	3.5	3.3	3.1	3.1	3.1	2.02	2.43	3.65	4.13
(PPP Weighted)	(3.5)	(3.9)	(3.0)	(3.9)	(3.7)	(3.0)	(3.0)	(3.4)				
Industrial Countries	2.3	2.8	2.0	2.9	2.0	2.1	1.7	2.0	0.32	0.77	2.23	2.82
Emerging Countries	4.5	4.8	4.4	4.7	5.7	4.9	5.7	5.1	5.30	5.63	6.46	6.73
United States	3.1	4.2	2.4	4.3	2.5	2.5	2.0	2.6	0.13	1.00	3.00	3.75
Canada	1.8	2.5	2.1	2.2	2.2	2.1	1.8	2.1	1.00	1.75	2.60	4.00
Europe	1.7	1.9	1.5	1.9	1.1	1.3	0.8	1.3	0.26	0.46	1.75	2.25
Euro Area	1.3	1.7	1.1	1.7	1.0	1.2	0.7	1.1	0.10	0.10	1.50	2.00
United Kingdom	3.3	2.8	3.2	2.9	1.4	1.9	1.5	1.9	0.75	1.75	2.75	3.25
Sweden	1.9	2.6	2.4	2.7	0.7	1.5	0.2	1.3	0.50	1.25	2.00	2.50
Norway	2.0	2.4	2.0	2.3	2.1	2.1	1.9	2.1	1.50	2.00	2.65	3.15
Japan	2.2	1.4	2.0	1.8	3.0	3.0	2.7	2.3	0.10	0.10	0.75	1.00
Australia	1.8	1.9	2.3	1.8	2.4	2.4	2.8	2.4	2.50	2.50	4.00	4.25
New Zealand	3.7	2.4	4.0	2.7	1.7	1.9	1.6	1.9	3.50	4.25	4.50	4.75
Asia ex Japan	6.1	6.0	6.1	6.1	3.5	3.4	3.4	3.4	4.29	4.45	4.87	4.99
China <sup>2</sup>	7.2	6.7	7.3	6.8	2.5	2.7	2.4	2.5	3.80	4.00	4.30	4.50
Hong Kong <sup>3</sup>	3.1	3.8	2.6	3.8	4.1	4.7	4.0	4.5	0.50	1.00	2.06	2.80
India <sup>4</sup>	5.4	5.5	4.9	5.6	7.9	6.0	8.0	6.6	8.50	8.50	8.90	8.50
Indonesia <sup>5</sup>	5.7	5.8	5.4	5.7	5.7	5.8	6.0	7.0	7.25	6.75	7.80	7.00
Korea <sup>6</sup>	3.7	4.4	3.8	4.1	2.1	2.7	1.7	2.5	2.50	3.00	3.40	3.75
Thailand <sup>7</sup>	2.9	2.1	1.0	4.0	3.8	2.5	2.9	3.1	2.00	2.25	3.95	4.30
Latin America	2.1	2.9	1.8	2.6	6.0	8.6	6.0	7.8	7.42	8.18	9.76	10.08
Argentina	0.0	1.2	-0.6	1.0								
Brazil	1.2	2.2	1.3	1.7	6.5	6.3	6.3	6.5	11.00	12.00	13.10	13.35
Chile	3.2	3.9	3.0	3.7	3.0	3.0	2.9	3.0	3.75	4.50	5.50	5.75
Colombia	4.8	4.9	5.2	4.8	3.0	3.0	2.6	3.0	4.25	4.75	6.80	7.00
Mexico	3.3	3.9	2.6	3.8	3.7	3.2	3.7	3.2	3.00	3.50	5.90	6.40
EEMEA	1.8	2.7	1.7	2.6	6.2	5.3	6.2	5.4	6.65	7.10	8.61	9.43
Hungary	2.1	2.2	2.5	2.0	1.4	3.0	0.2	2.8	2.00	3.00	5.00	5.95
Poland	3.4	3.7	3.3	3.5	0.4	2.3	0.3	1.9	2.50	3.50	3.75	4.55
Russia	0.8	2.0	0.5	2.0	7.0	5.4	7.0	6.0	7.50	7.50	9.50	10.25
South Africa	1.6	2.9	1.7	2.7	6.6	5.8	6.4	5.9	5.75	7.00	9.00	9.75
Turkey	3.6	4.0	3.5	3.5	8.2	7.0	8.5	6.1	8.25	9.00	9.75	10.75

1) Official and long rates are end-of-year forecasts.

Long rates are 10-year yields unless otherwise indicated.

2) China: Official rate is considered the 7D repo rate and 10-year government bond yield.

3) Hong Kong: Base rate and 10-year exchange funds yield

4) India: Overnight repo rate and 10-year government bond yield

5) Indonesia: Intervention rate and 10-year government bond yield

Source: AllianceBernstein

6) Korea: Overnight call rate and 10-year government bond yield

7) Thailand: 1-day repo rate and 10-year bond yield

Note: Real growth aggregates represent 31 country forecasts, not all of which are shown.

Note: Blanks in Argentina are due to the distorted domestic financial system so we do not forecast.

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