DAVID HALE GLOBAL ECONOMICS

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# Predictions for the Second Half of 2014

By David Hale

## KEY CONCLUSIONS

- Growth in the US economy will be 3% or more during the final three quarters of the year
- Accelerating inflation and a swiftly declining unemployment rate will force the Fed to consider rate hikes earlier than Janet Yellen would prefer
- The nomination of more sensible candidates has increased the likelihood that the Republican Party will regain control of the Senate in the upcoming elections
- Strong growth and the emergence of a nascent housing bubble will both play a role in causing Mark Carney to be the first G-7 central bank chief to raise interest rates this year
- While growth will remain positive, the disappointing outlooks for growth and inflation will force the ECB to engage in quantitative easing
- In an effort to ensure that the planned VAT hike next year occurs, the BOJ will ease monetary policy further this fall
- Although a weak property market will continue to be a concern, Chinese growth will still be around 7.5% for the year as a result of improving exports and government stimulus
- Upcoming elections could result in new political leadership in Indonesia and Brazil by the end of the year in addition to the new leadership in India
- The odds are strongly against hostilities ending in Syria and Iraq later this year

546 LINCOLN AVE, 2ND FLOOR, WINNETKA, ILLINOIS 60093 USA
*phone* 1.847.386.6009 *fax* 1.847.386.6011

## THE US ECONOMY'S DECISIVE REBOUND WILL FORCE FED TO ADDRESS TOUGH QUESTIONS

The US economy should produce a growth rate exceeding 3.0%. Employment will continue to grow by over 200,000 per month, bolstering personal income and consumption. Firms will respond to rising capacity utilization rates by expanding capital spending. Steady employment growth will increase housing demand and boost housing starts to 1.1 million by year end. The unemployment rate could drop below 6.0% during the next few months and approach 5.5% by year end. The current expansion is now fifty-nine months old compared to an average life of seventy-one months for the seven expansions since 1961. Output growth in this recovery has been only 10.2% compared to an average of 21.1% for previous expansions, so there is still enough slack in the economy to prolong the expansion for at least two or three more years.

The US inflation rate has bottomed and will move irregularly higher during the next twelve months. In May, the CPI inflation rate rose 0.35% month on month and 3.3% on the basis of the three-month moving average. The core CPI excluding food and energy rose 0.26% and 2.8% on the basis of the three-month moving average. The PCE deflator rose 0.23% in May and 2.5% on the basis of the three-month moving average. The PCE deflator excluding food and energy rose 0.17% month on month during May and 2.1% on the basis of the three-month moving average. Fed Chair Janet Yellen dismissed the latest inflation uptick in her recent press conference, but it is clear that the risks in the US inflation outlook are now on the upside. There is no danger of low inflation evolving into deflation.

The sharp decline in the unemployment rate and rising inflation will produce further controversy about when the Federal Reserve should raise interest rates. Janet Yellen will focus on the large number of long-term unemployed, but some district presidents will argue that it is time to raise interest rates. The wildcard will be new Fed Vice Chairman Stan Fischer. As central bank governor of Israel, he favored decisive policy changes and not waiting for ambiguous economic data to provide clear guidance. He could join the monetary hawks if he perceives that growth will continue to exceed 3.0% next year.

## REPUBLICANS ARE WELL-PLACED TO TAKE BACK THE SENATE THIS FALL

The odds are high that the Republicans will capture control of the Senate in the November mid-term elections. The Republicans have nominated competent center-right candidates independent of the tea party movement, so they should not suffer from the embarrassing sort of extreme candidates who cost the party seats in Delaware, Missouri, Colorado, and Nevada in 2010 and 2012. The Republican victory will further weaken the president's position in Washington and probably force him to focus more on foreign policy despite the limited opportunities for achieving anything. The one positive for the president will be his attempt to negotiate new free trade agreements in Asia and Europe. The Senate Republicans will support these initiatives whereas the Democrats did not.

## MARK CARNEY WILL LEAD THE G-7 ON INTEREST RATE HIKES

The Bank of England could be the first major central bank to raise interest rates late this year. It is concerned about the signs of a new property bubble while output growth this year could exceed 3.0%. The Bank will not raise interest rates very much because inflation has declined and will average only about 1.0% next year. The pound could weaken when the Bank makes it clear that it will tighten very slowly. The British current account deficit now exceeds 5.0% of GDP, but the markets have ignored it because of their pre-occupation with monetary policy. The current account could become an issue if it continues to expand in response to strong domestic demand.

## SUBDUED GROWTH OUTLOOK WILL FORCE ECB TO ENGAGE IN QUANTITATIVE EASING

The European Central Bank (ECB) will finally resort to quantitative easing by purchasing asset-backed securities. The ECB will act because inflation will remain low as Europe experiences a very modest rebound in output growth. Germany will lead the recovery while France and Italy will languish. Prime Minister Matteo Renzi could boost Italian growth late this year by finally paying the €70 billion of arrears which the government owes to the private sector. France and Italy used the election of Jean-Claude Juncker as the new EU president to negotiate more flexibility for their fiscal policy. Both countries want to reduce fiscal drag in order to spur faster growth.

## WEAK GROWTH REBOUND WILL NECESSITATE FURTHER BOJ EASING THIS FALL

The Bank of Japan (BOJ) will expand its asset purchase program during the autumn because of the subdued recovery from the value-added tax (VAT) hike during April. As Japanese wage growth remains subdued outside of the large multinational companies, the VAT hike will squeeze real incomes and depress consumption. The economy's weakness will provide renewed debate about whether Japan should defer the value-added tax hike now scheduled to occur on October 1st, 2015. As the Ministry of Finance (MOF) is determined to carry out the tax hike, it will encourage the BOJ to pursue a more stimulative policy. The BOJ governor, Haruhiko Kuroda, is a former MOF official and will respond to these pleas by expanding purchases of both government debt and exchange-traded equity funds. There should be solid gains in Japanese capital spending during the year ahead because of the recent recovery in profits and the large amount of cash on Japanese corporate balance sheets.

## EXPORTS AND STIMULUS WILL ALLOW CHINA TO MEET ITS GROWTH TARGETS

China will achieve a growth rate close to 7.5% this year as exports respond positively to the upturn in American and European growth. China's major problem sector is residential real estate. Developers built too many homes in second- and third-tier cities last year. The government's anti-corruption campaign is discouraging demand from local government officials who often use bribes to buy apartments. The People's Bank is encouraging the major banks to make more loans to first-time home buyers while local governments are phasing out the restrictions they imposed three years ago on investors buying more properties. China's high rate of urbanization will eventually reduce the excess supply of housing, but building activity will decline this year. More small developers will also go bankrupt and create losses for the trust banks which securitized their debt. These defaults will slow the growth of the shadow banking system.

China is going through structural changes which will have the potential to depress output growth, but senior government officials continue to insist that growth should remain above 7.0%. As the stock of government debt is modest by international standards, they can pursue more stimulative policies if necessary.

## IMPORTANT POLITICAL CHANGES COULD OCCUR IN INDONESIA AND BRAZIL THIS YEAR

The emerging market countries will follow a diverse path this year and be heavily influenced by elections. India will benefit from the decisive victory of the BJP Party in its recent parliamentary election. Prime Minister Narendra Modi will attempt to boost growth by increasing infrastructure spending, attracting greater FDI, and liberalizing the labor market. Indonesia will benefit if Joko Widodo wins the upcoming presidential election. He represents a new post-Suharto generation in the country's politics and has been an effective governor of Jakarta province. Brazil's economy is languishing, but the bad news could become good news if its poor performance reduces the odds of Dilma Rousseff winning reelection. The election will occur in October and the opinion polls will start to become a major factor in the Brazilian markets during August and September. Investors hope that if the center-right opposition leader, Aecio Neves, wins the election, Arminio Fraga could become the finance minister.

## MIDDLE EAST CONFLICTS WILL DRAG ON THROUGHOUT 2014

There will be no clear resolution to the current political conflicts in Syria and Iraq. The Shiites will be able to defend Baghdad and the country's south. ISIS will remain dominant in the north and the adjoining areas of Syria. As 90% of Iraq's oil exports flow through the southern ports, there should not be a major disruption of oil supplies, but foreign oil companies are likely to become more cautious about investing in Iraq, and thus will lessen the prospects of Iraq achieving the 6 million barrels per day of output in 2018 which the government thought was possible a few months ago. The Obama administration will offer only limited military aid to the Iraq government, so Iran will become even more dominant as the country's major ally. The Sunni-Shiite conflicts in Syria and Iraq are undermining the borders drawn up by the Pico-Sykes agreement in 1918. It is not yet clear what will take their place.