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Final Third of 2014: A Time of Transition

Markets' Suspended Disbelief Likely to Encounter Tough Tests

*Based on an August 2014 client bulletin.

Despite all of the political tensions, violent conflicts, and spotty economic news around the world, many global stock markets have risen this summer, suggesting that investors think they see better times on the horizon. Unfortunately, what they think they see and what is actually approaching probably do not overlap much. Indications of economic acceleration are hard to find outside of the United States. Markets seem to be rallying more on hope—and on pressure to do something with zero-return cash—than on tangible signs of better times to come. The next few months are likely to put these hopes to a real test.

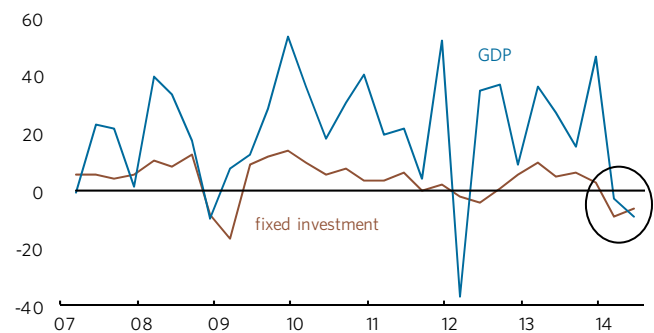
- In the euro area, markets hope that quantitative easing will arrive soon, strengthening the persistently weak economy.
- In Japan, markets hope that Japan's economic improvement, which was interrupted by the second-quarter VAT rate hike, will resume and that Abe will fire his "third arrow"—that is, he will push through labor and regulatory reforms.
- In China, markets hope that Beijing will provide new stimulus that will keep the economy moving at some Goldilocks rate above 7% while protecting the stability of real estate markets.
- In Australia, markets hope for a reacceleration of the Chinese economy and its appetite for Aussie minerals, especially for iron ore.
- In India, markets hope that still-new Prime Minister Modi really is an economic "miracle man" and that he is moving swiftly to fix their nation's ailing economy.
- In Brazil, markets hope that the president elected in October, whoever he or (more likely) she turns out to be, will not be the incumbent and will halt the economic hemorrhaging that has Brazil teetering on, if not over, the line between expansion and recession (chart 1).

In the eurozone, although the European Central Bank (ECB) probably will institute some QE policies, they are not likely to have much effect on the economy, which has softened in recent months. What really *might* help the euro area economy is a general relaxation of fiscal policy, which seems likely to slip onto the scene in the form of missed targets rather than as liberalized targets. On the other hand, if deficits are to widen enough to outweigh weakness in exports to the emerging markets, they may also widen enough to raise new sovereign debt concerns and thus disturb financial markets.

In Japan, we do believe that the economy will bounce back following the VAT. The domestic economy has a rising tide of capital spending behind it, regardless of how much of the third arrow Abe is willing and able to push through soon. Our biggest immediate concern for Japan is the Japanese economy's heavy export exposure to China and the rest of the emerging market sector. Still, improvement in Japan is likely during the balance of the year.

Brazil GDP and Fixed Investment Falling CHART 1

IBGE: Brazil GDP and Gross Fixed Capital Formation, reais billions, seasonally adjusted by Haver Analytics, quarter-over-quarter change, last data point Q2 2014



Another likely positive development in the short term is continuing efforts by the Chinese government to foster growth, although the difficulty of steadying home prices may undermine government efforts. Meanwhile, the long-term costs of such stabilization measures keep rising, and at some point the economy will undergo some difficult corrections.

We are less sanguine on markets' other hopes.

- One downside to Chinese government stimulus efforts is that a large part of the effort will probably take the form of more aggressively mercantilist policies, so China's gain in profits, and therefore growth, will be at least partly balanced by other countries' losses (especially other emerging market economies' losses). Such efforts may already be visible in the sharp re-widening of the Chinese trade surplus in recent months (chart 2).
- Beijing's stimulus efforts may successfully stabilize domestic growth, but they will not likely reestablish a strong uptrend in demand for Australian iron ore, coking coal, or other minerals. In any case, a Chinese demand pick-up will not halt the ominous decline in mining sector capital spending that is just beginning to weigh on Australian growth and profits.
- In India, even if Modi achieves a surprising amount of reform in a surprisingly short period of time, it will have little economic effect in the near term. The capital spending slump in India reflects stagnant production (chart 3) and the resulting overcapacity rather than red tape. Indeed, following the big bang reforms in 1991, capital spending continued to slump for two more years (chart 4).
- In Brazil, where the hopes of many are tied to the October election results, no election outcome, no matter how cheering to markets in the short run, will soon relieve the country's worsening overcapacity and falling capital investment.

Turning to the United States, the economic data in recent months have largely reflected the second quarter post-winter bounce-back, and while some indicators have begun to ease again, others—notably those that lag business conditions, such as capital spending and possibly employment—may exhibit strength through much of the third quarter. Nevertheless, the overall buoyancy of the economic news is likely to slowly and unevenly sink during the late summer and autumn. The third release of second-quarter GDP on September 30 could show a big upward revision—potentially much bigger than the adjustment from 4.0% to 4.2% released yesterday—because of the potential for a major revision in health care spending. After that, we expect mostly indications of moderate growth, with risks coming chiefly from exports.

Clearly, both the global economy and domestic housing market have benefited from the decline in U.S. Treasury yields, which we believe have continued to decline through the summer largely because of fears arising from the world's collection of violent conflicts and associated worries. Bond yields may well snap back if the Russian-Ukrainian conflict calms down but

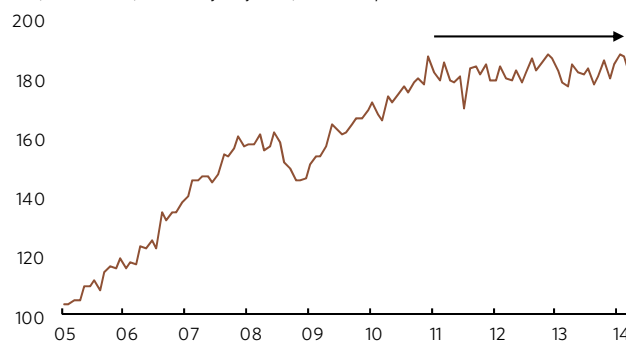
Chinese Trade Balance Widening Again CHART 2

China Customs: Merchandise Trade Balance
\$ billions, seasonally adjusted by Haver Analytics, last data point July 2014



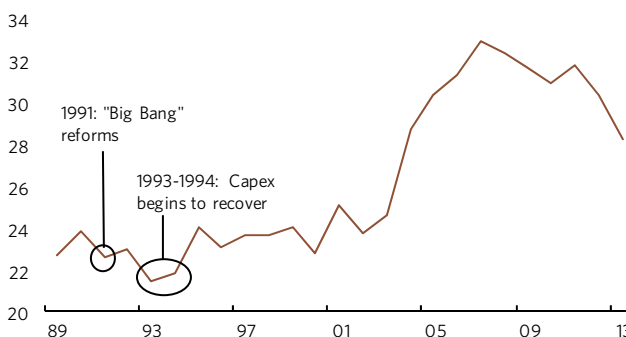
India's Production is Stuck in a Rut CHART 3

Central Statistical Office of India: Manufacturing Production index, 2005=100, seasonally adjusted, last data point June 2014



Indian Reforms May Take Time to Have Effect CHART 4

Central Statistical Office of India: Gross Fixed Capital Formation as % of nominal GDP, annual data, last data point 2013



drop further should a full invasion occur. Middle Eastern conflicts also have the potential to relieve or intensify the safe haven demand for Treasuries. However, we remain convinced that the ultimate lows for yields are still ahead and that a large correction in bonds would provide an excellent entry point.

There are a lot of moving parts here, and a general worsening of the global economy in the next few months is not a slam-dunk certainty, just a solid possibility, at least 50%. The most likely alternative would be a continuation of the mixed, sluggish, and

unsatisfactory—but hardly alarming—global economic performance. A marked improvement of any duration is not likely. We still assign a 65% probability to a global recession developing during 2015 and dragging down the U.S. economic expansion before yearend. Be prepared for disappointing news from the euro area and emerging markets especially, and be wary of any sizable pullback in Treasury bond prices as a catalyst for international instability.



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