Press Release

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Divergent growth: Western versus growth countries

Macroeconomic and investor outlook 1H2016

- **Growth countries limiting global growth, but no emerging markets crisis**
- **Domestic consumption remains main driver of the economy**
- **First rate hike expected as soon as 2015**
- **Cautiously positive about shares; avoiding bonds**

Growth countries limiting global growth

The concerns about a possible hard landing by the emerging countries led during the summer to market nervousness. These anxieties ebbed away in recent months. At +1.8% quarter-on-quarter (QoQ), the slowdown in China – easily the most important growth country – was better than had been expected. It meant that the Chinese economy had grown equally as fast as it had in the previous quarter. In addition the postponement in September of an initial rate hike by the US Federal Reserve put a (provisional) end to the capital outflow from the emerging markets.

The near future looks like being more o the same: **a global economy that is determined by two conflicting forces. Growth in the euro area and the US will be sustained and could even strengthen a little. In the emerging countries, by contrast, growth remains vulnerable.** The reasons for the negative climate in the growth countries differ widely. China does however play a key role.

No emerging markets crisis

China continues to grapple with the reorientation from an investment-driven economy to a consumption-driven model. **Asian countries with important trading and financial links to China are sharing the pain. Commodity prices have also felt the impact.** China imports more iron ore and metals than the US, Japan and Germany combined. Industrial metals have lost 46% of their value since their peak in May 2011. Exporters of commodities such as Brazil, Chile, Venezuela and Russia have been badly hit. The same pain is being felt by oil producers where, according to the IMF, the negative impact on GDP growth could rise to several percentage points between 2015 and 2017.

A final potential danger for the emerging markets is the looming US rate hike. The anticipation of this increase saw a capital outflow surge during the summer months. The Fed's decision to postpone an initial increase stemmed the flow. The outflow is, however, likely to resume in the run-up to the first rate hike, which could be as early as mid-December.

Is there a risk of a new emerging markets crisis? The substantial build-up of (private) debt and the sensitivity of US interest-rate policy are in line with the earlier crises. There are, however, also some important differences. The currency regimes are now based on floating exchange rates instead of the previous and unsustainable peg to the dollar. The Asian emerging markets recorded substantial current account surpluses over the past decade and so have a buffer. Apart from that, their government indebtedness is now a good deal lower, **thereby limiting the risk.**

Domestic consumption

At present there are barely any signs that the euro area or the US is seriously troubled by the slowdown. Exports to emerging markets account for only a small proportion of European and US GDP, apart from which the negative effect via trading channels is more than offset these days by the lower commodity prices. Consumers in Western countries are consequently left with more money to spend on other things.

This in combination with falling unemployment is ensuring that **consumption remains the main driver of the economy in both the US and Europe**. In the case of the euro area, budgetary policy will be providing a slight stimulus in 2016 (for the first time since 2010), together with a gradual recovery of the credit cycle, positive effects from implemented reforms (e.g. in Spain, Italy and Ireland) and of course an ongoing flexible monetary policy. **We are expecting growth to pick up from 1.6% in 2015 to 1.9% in 2016, clearly above the long-term growth potential.**

We are also assuming a positive growth dynamic in the US, with 2.9% growth in 2016 compared with 2.5% this year. While very gradual, the first signs of overheating are also emerging in the US. The latest jobs report indicated very strong job creation and an unemployment rate of 5%. Such a low level will normally spark off competition for the dwindling pool of potential employees, with rising wages in consequence. Wage inflation rose in October from an annual 2.1% to 2.5%.

First rate hike as soon as 2015

In combination with the return of calm to the financial markets and the stabilisation of Chinese growth, the conditions for the first rate increase after six years of zero interest rates would appear to be in place. Such an increase could already take place at the next meeting in December. The timing of the first rate increase is in fact not particularly important, but the interest-rate path is. **And the way the Fed governors see this path at the present time implies an increase of 1% in each of the next three years,** i.e. a very gradual process. The median duration of upward rate movements over the previous 12 interest-rate cycles since 1950 has amounted to just 14 months.

This means that the monetary policy of the Fed will become diametrically opposed to that of the ECB. The latter is almost bound to announce an expansion of its stimulus policy in early December. A possible driver of this policy difference is that the underlying core inflation in the euro area (1.1%) is a good deal lower than in the US (1.9%) and still well short of the medium-term target of 2%. The markets have already clearly anticipated the divergent courses being steered by the two central banks and have been pushing the dollar up sharply. There is, consequently, little margin for any further appreciation of the dollar. We expect the dollar to be trading at parity with the euro at the end of 2016.

Cautiously positive about shares

The favourable economic prospects in the West in combination with the continuation of a generally accommodative monetary policy make us cautiously positive about shares. A strong overweighting of shares

in a diversified portfolio is not, however, justified at this stage. **The situation in the growth countries is too gloomy and corporate earnings remain too low.** Given the high stock market valuation levels at the present time, earnings growth is crucial if share prices are to rise. The past results season in the US was, however, the third quarter in a row without any growth. European companies too are failing to build on the recovery in profits, despite the cheaper euro, low oil price and recovery of the credit markets.

Within the share portfolios we are opting for a combination of growth and stability. We see growth **in the consumer discretionary sector and Japanese shares**. We continue to believe that the Japanese economy will ultimately pick up, with strong exports based on the weak yen. Domestic consumption will also rebound once companies implement the long-awaited pay increases. Stability is incorporated into the portfolio via **companies that distribute a high proportion of their profits and family businesses.**

Alternatives to bonds

We are continuing to avoid bonds. They offer little if any return and the least uptick in interest rates is accordingly translated into a low or negative bond yield. The heavy underweighting of bonds is making way for a number of alternative investments. In the first place **we are spreading the cash holdings over a selection of currencies** that either pay higher interest or are in our view likely to appreciate against the euro. In addition we are holding a **direct participation in real estate projects** such as retirement homes. And finally an **investment in commodities** also provides an interesting alternative. With prices having fallen by over 60% since their peak in 2008 we think that the bottom is gradually coming into sight.

For more information, please contact:

Koen De Leus, senior economist KBC-groep
Tel +32 2 429 37 07 – E-Mail: koen.deleus@kbc.be

Dirk Thiels, senior strategist KBC Asset Management
Tel +32 2 429 44 14 – E-Mail: dirk.thiels@kbc.be

Viviane Huybrecht, General Manager, Corporate Communication/Spokesperson, KBC Group
Tel +32 2 429 85 45 - E-mail: pressofficekbc@kbc.be