Standard Chartered

press release

Global Focus: When perception is not reality

07 **July 2015, London –** As the first half of 2015 comes to a close, the discrepancy between market perceptions and reality is clear. The consensus view at the beginning of the year was that this would be the year when the US economy rebounded strongly and the West would dominate growth, with emerging economies underperforming.

Standard Chartered's Q3 Global Focus explains that the reality is quite different. The consensus US growth forecast has been revised lower for the fifth consecutive year. Europe's fundamental issues have not gone away. Meanwhile, economies in Asia, Africa and the Middle East are performing more or less as expected. Yet the dominant narrative remains the same. The emphasis is still on the Western recovery, however elusive, and on problems in emerging markets.

While we acknowledge the risks facing emerging economies, we expect them to outperform. We project global growth of 3.1 per cent this year, lower than our initial expectations. We expect economies in Asia (excluding Japan), Sub-Saharan Africa, the Middle East and Latin America to contribute more than half – about 1.85 percentage points – of this 3.1 per cent growth. We see the US and the euro area adding only about 0.8 percentage points.

Although emerging markets are outperforming developed economies, the two are linked. The US and the euro area are the world's largest economies, and their performance impacts the rest of the world. We have to be aware of the risks emanating from these two economies, and their potential impact on emerging markets.

Currently, the outcome of Greece's potential default is unclear. A resolution looks likely, with a Greek exit from the euro area avoided. However, euro-area growth, even if it recovers to around 1.5 per cent this year as we expect, is still too low for a region emerging from a prolonged recession. This weak growth is a problem for the global economy. Europe's large current account surplus means current account deficits elsewhere in the world, which will weaken growth dynamics in other economies.

Emerging economies have responded to this challenging environment by cutting interest rates; 29 countries cut rates in H1, a textbook response to an exogenous shock. This was made possible by low US interest rates and the drop in oil prices, which kept inflation subdued.

The Fed seems to be preparing financial markets for an interest rate hike this year; we expect the first hike in September. We think it will be difficult for emerging economies to continue to reduce interest rates as the Fed begins to hike. A Fed hike, following years of close-to-zero interest rates and three rounds of quantitative easing, will be a significant development.

Currencies are the ‘shock absorbers’ in emerging economies. If the Fed begins to hike, volatility in currency markets is likely to increase, although this is not necessarily a bad thing. Most Asian countries now have flexible exchange rates, which adjust constantly, protecting the domestic economy against exogenous shocks. A weak currency becomes a problem when a country has high levels of foreign-currency-denominated debt with short-term maturities. We do not see this as a major risk for Asian countries, although Turkey is more vulnerable.

The impact of Fed hikes on the rest of the world is receiving a lot of attention, and rightly so. But the market seems to be ignoring the risks of Fed hikes to the US economy itself. The IMF has warned that hiking prematurely could lead to a reversal of interest rates later on.

We see an additional challenge. According to broad divisia monetary aggregates published by the Center for Financial Stability (CFS), US M4 broad money supply grew only 2.8 per cent year to year in May, suggesting that actual monetary conditions in the US are tight. The risks associated with hiking interest rates in an economy that demonstrated negative growth in Q1 and where monetary conditions are already tight are underappreciated, in our view. We see this as a key risk for H2.

Marios Maratheftis, Chief Economist, commented: “The market is right to be concerned about the impact of Fed hikes on the rest of the world. But it is wrong to ignore the risks to the US economy itself. This is yet another year when consensus views on the US have been revised lower and existential threats to the euro area are strong. Slower growth in emerging markets is a result of the true problem facing the world economy – inadequate demand in Europe and the US. Yet many in the markets remain focused on the perception rather than the reality.”

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Notes to Editors

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