STATE STREET GLOBAL ADVISORS

The Major Economies in 2015

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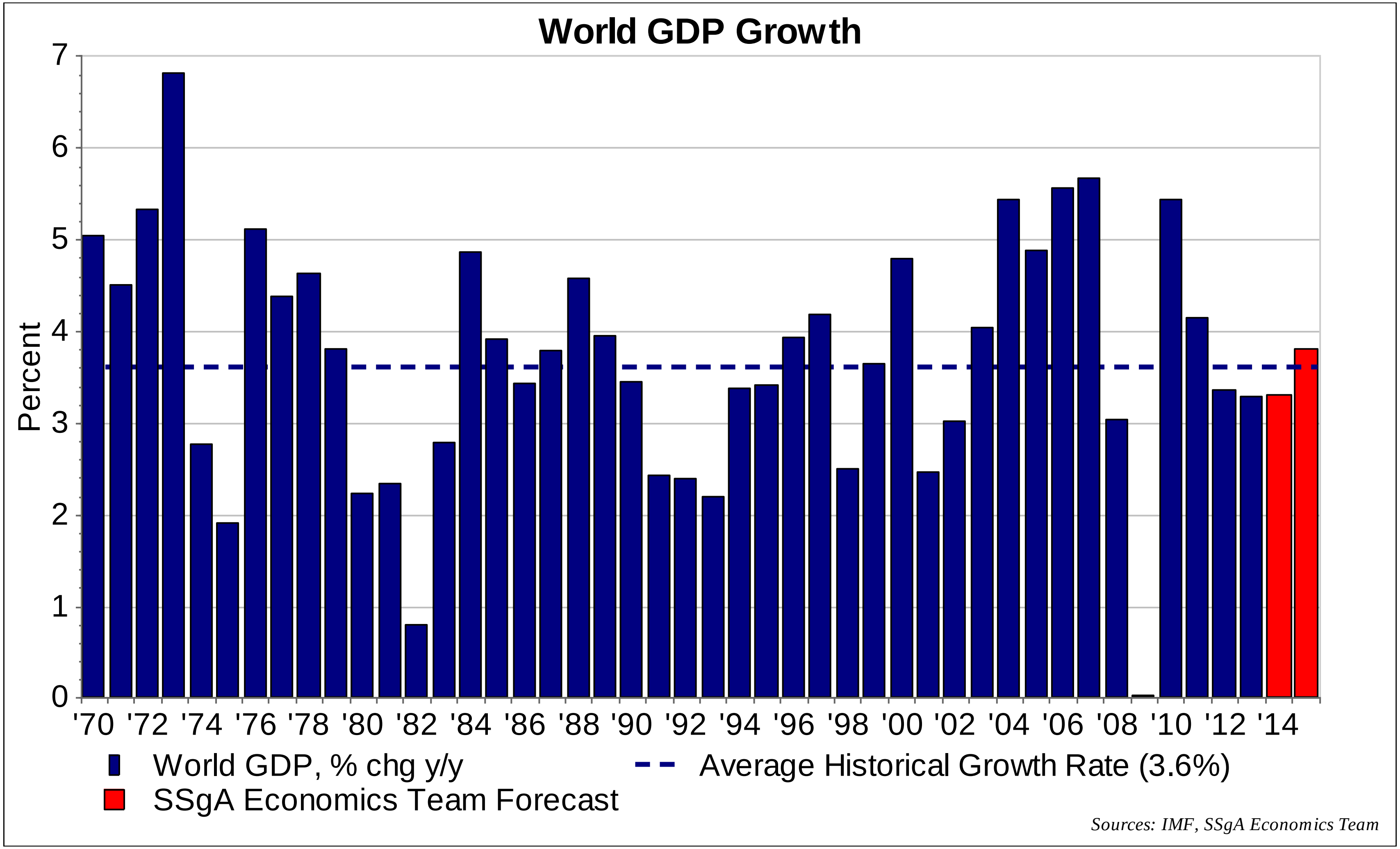
SSgA

Overview

- Three themes for 2015:
  - Improvement
  - Divergence
  - Decoupling
- The global recovery reaccelerates to its fastest pace since 2011
- Economic growth diverges:
  - Accelerating meaningfully to more than 3.0% in the US
  - Languishing near 1.0% in Japan and the Eurozone
  - Slowing to 7.0% in China
- Monetary policy decouples:
  - Tightening in the US (the UK, Canada and Australia)
  - Easing in China, Japan and the Eurozone

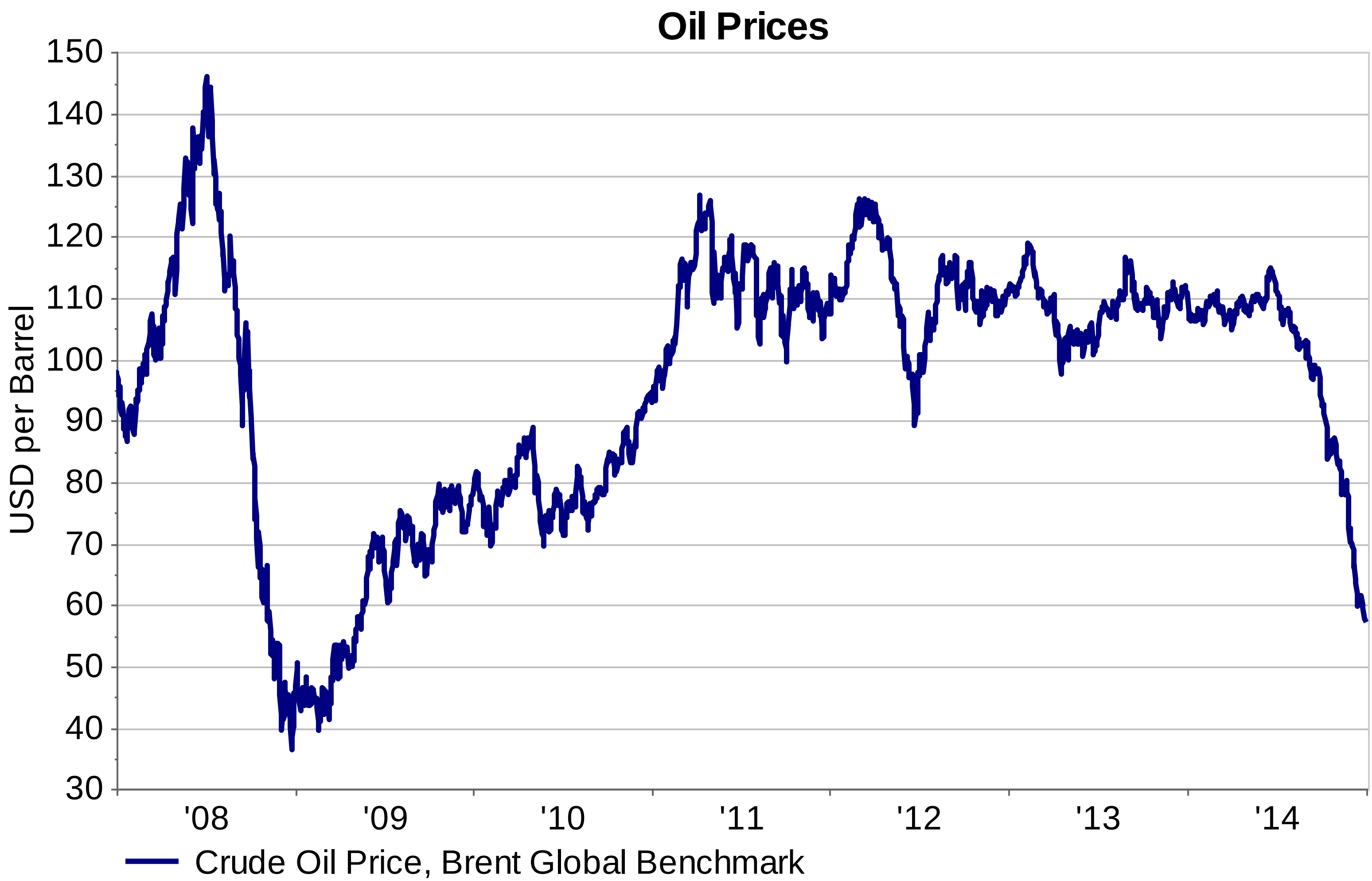
Overview


World GDP Growth
7
6
5
4
3
2
1
0
Percent
'70 '72 '74 '76 '78 '80 '82 '84 '86 '88 '90 '92 '94 '96 '98 '00 '02 '04 '06 '08 '10 '12 '14
World GDP, % chg y/y
Average Historical Growth Rate (3.6%)
SSgA Economics Team Forecast
Sources: IMF, SSgA Economics Team

Overview

- There are some downside risks
  - Geopolitical tensions
  - Greek exit from the Eurozone
  - China property and shadow banking problems
- But, the forecast is based on Brent at $70 a barrel in 2015
- And, Brent is currently well below $60, which if sustained could raise global growth by another 0.2 percentage point this year
- Oil prices could settle below $70 over the next few months
- But the chances that is sustained diminish progressively over the course of 2015, as North American supply begins to fall
  - US oil exploration is already slipping
  - Fracking wells deplete rapidly

Oil

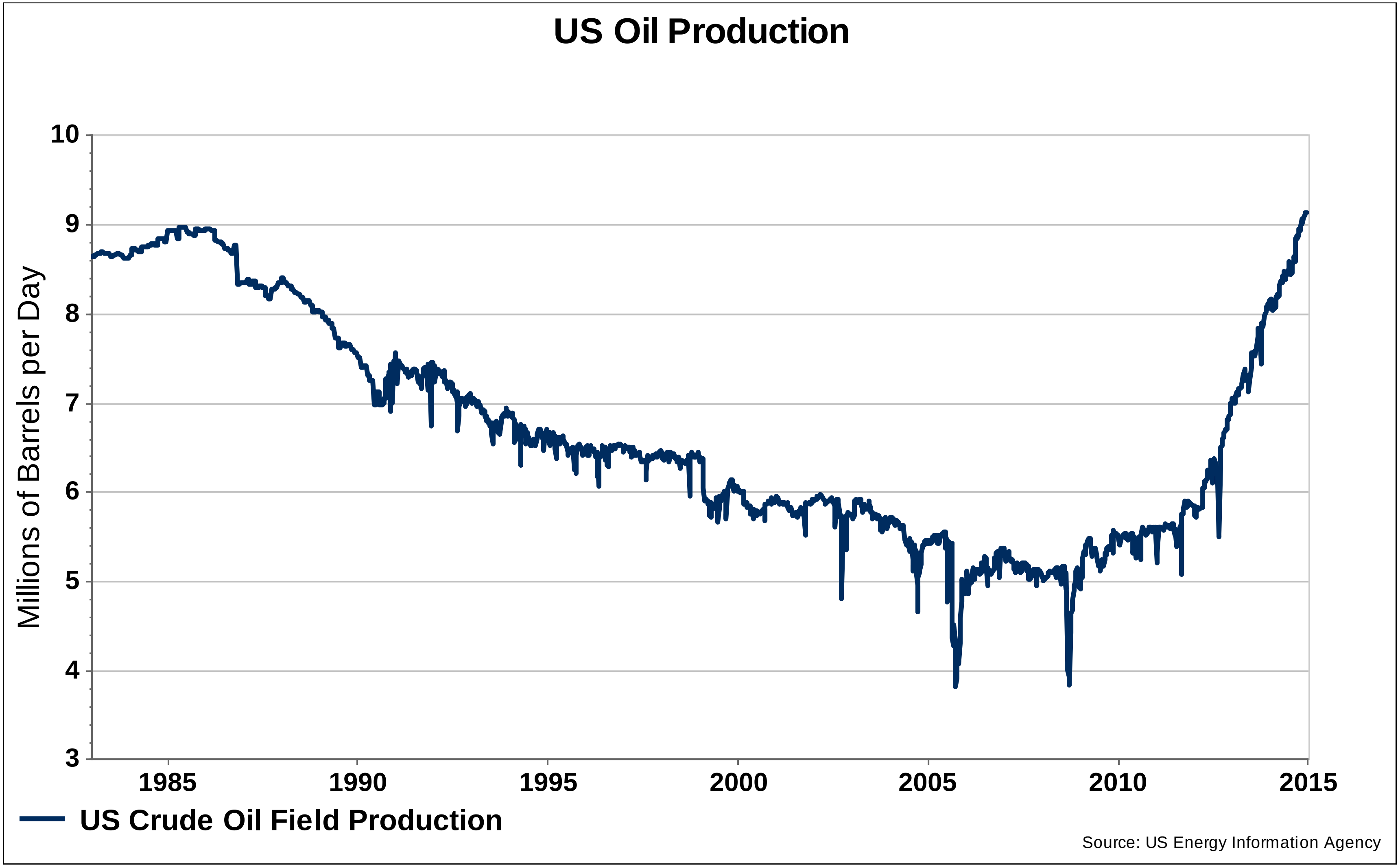


Source: Factset

Oil

- Why did oil prices fall by almost 50% in the second half of 2014?
- Many analysts stress supply factors:
  - Growth of North American production
  - Rebound of Libyan output over the summer
  - Russia's decision to keep pumping despite sanctions
  - OPEC's decision not to cut its output quota in November
- But such a large move suggests some reduction in demand
  - Removal of a "precautionary" motive caused by a potential Russian reaction to sanctions and fears of an ISIS advance on the southern Iraqi oil fields
  - Downward revisions to growth of the global economy in general and the energy hungry Chinese economy in particular

Oil

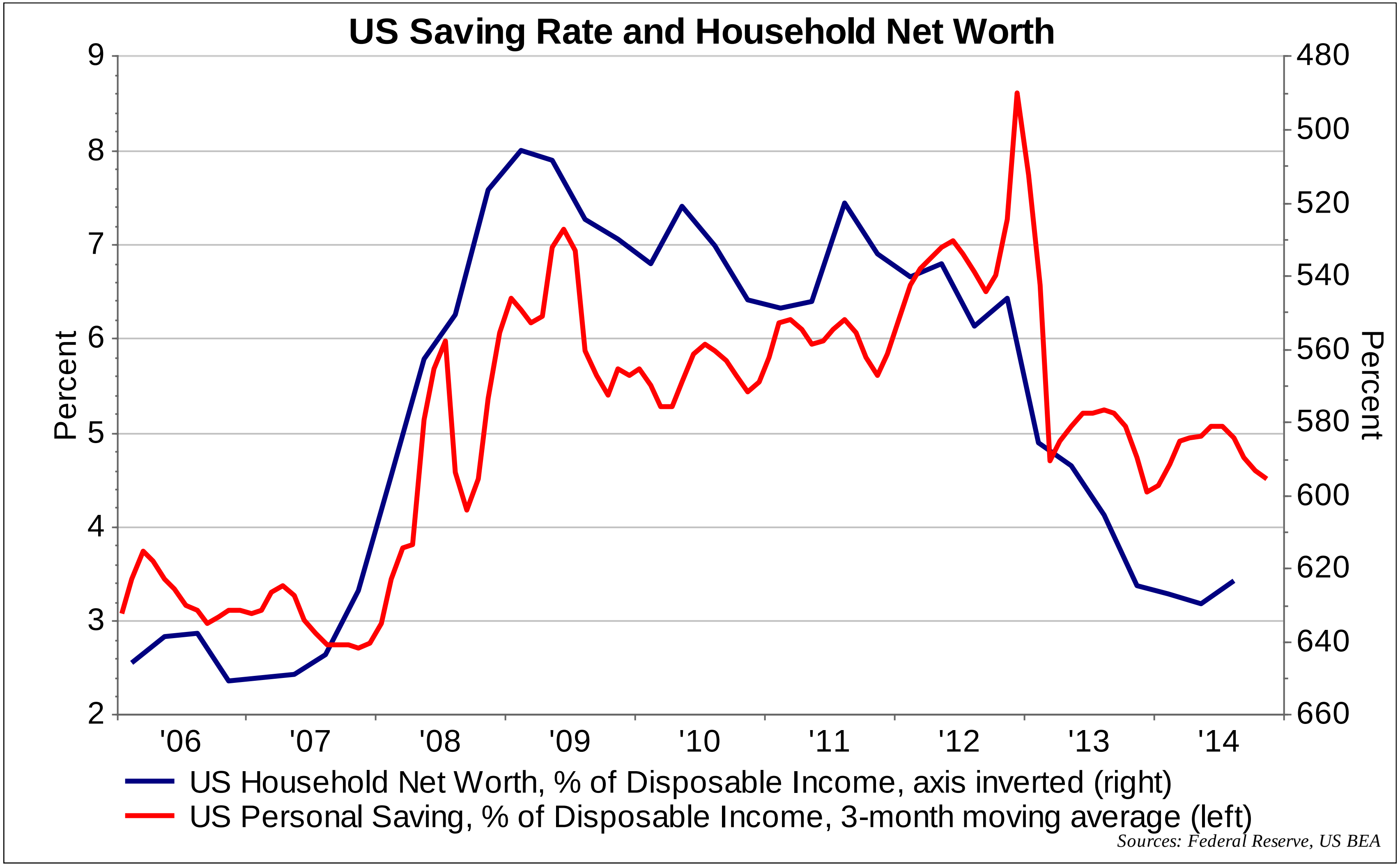

US Oil Production
Millions of Barrels per Day
10
9
8
7
6
5
4
3
1985
1990
1995
2000
2005
2010
2015
US Crude Oil Field Production
Source: US Energy Information Agency

US

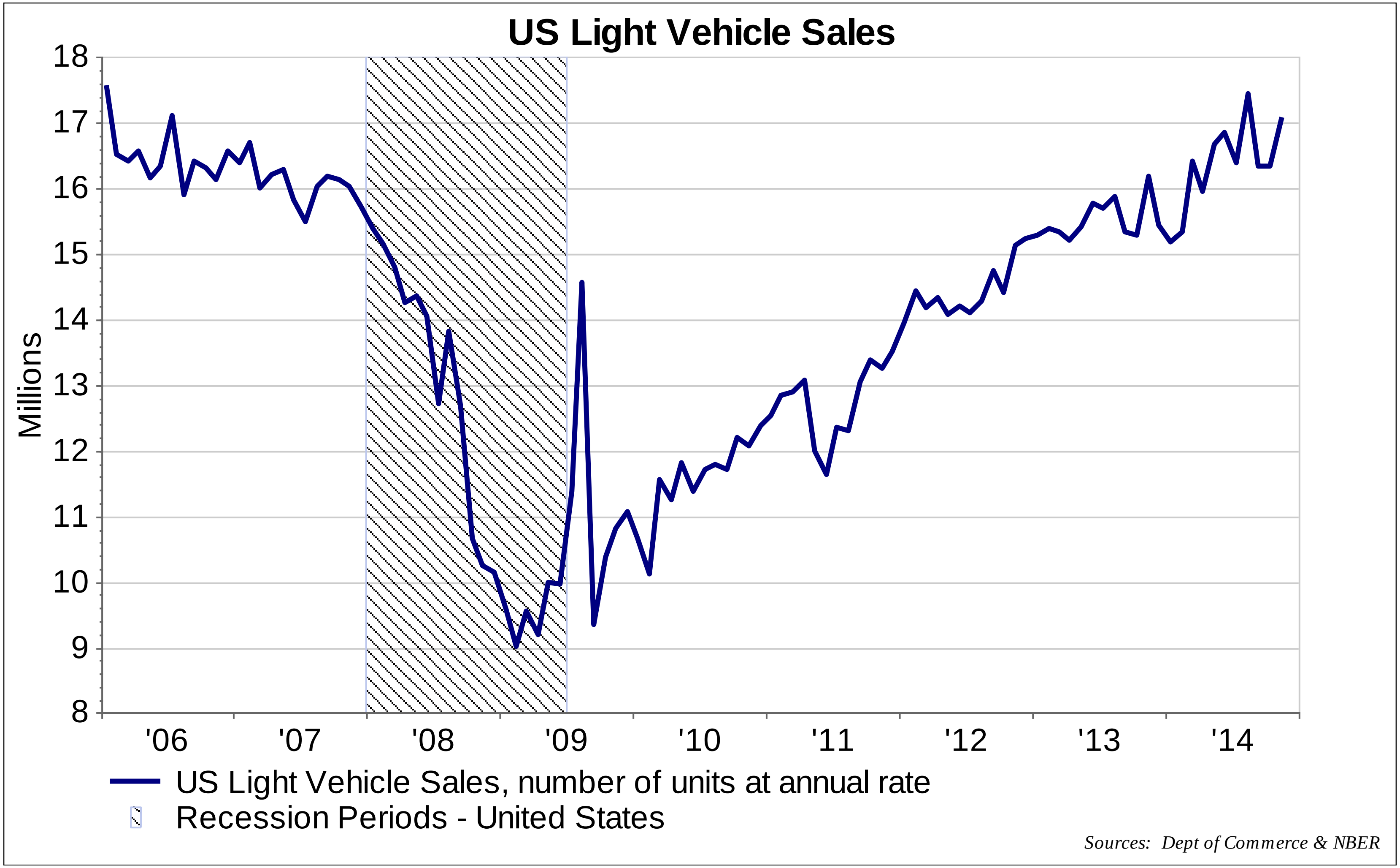
- Fundamentals are generally sound
  - Household balance sheets are strong and confidence high
  - Companies remain highly profitable and capital spending has revived
  - International trade is less of a drag than usual
- Recent data have been strong
  - Manufacturing and non-manufacturing ISMs are at boom-like levels
  - Payroll gains are now consistently exceeding 200,000 a month
  - Light vehicle sales are hovering around 17.0 million a year
- Fiscal drag will be reduced at least slightly and possibly more substantially if the sequester is relaxed
- Admittedly, the housing sector is lagging, but that should not prevent growth from accelerating to more than 3.0% in 2015

US

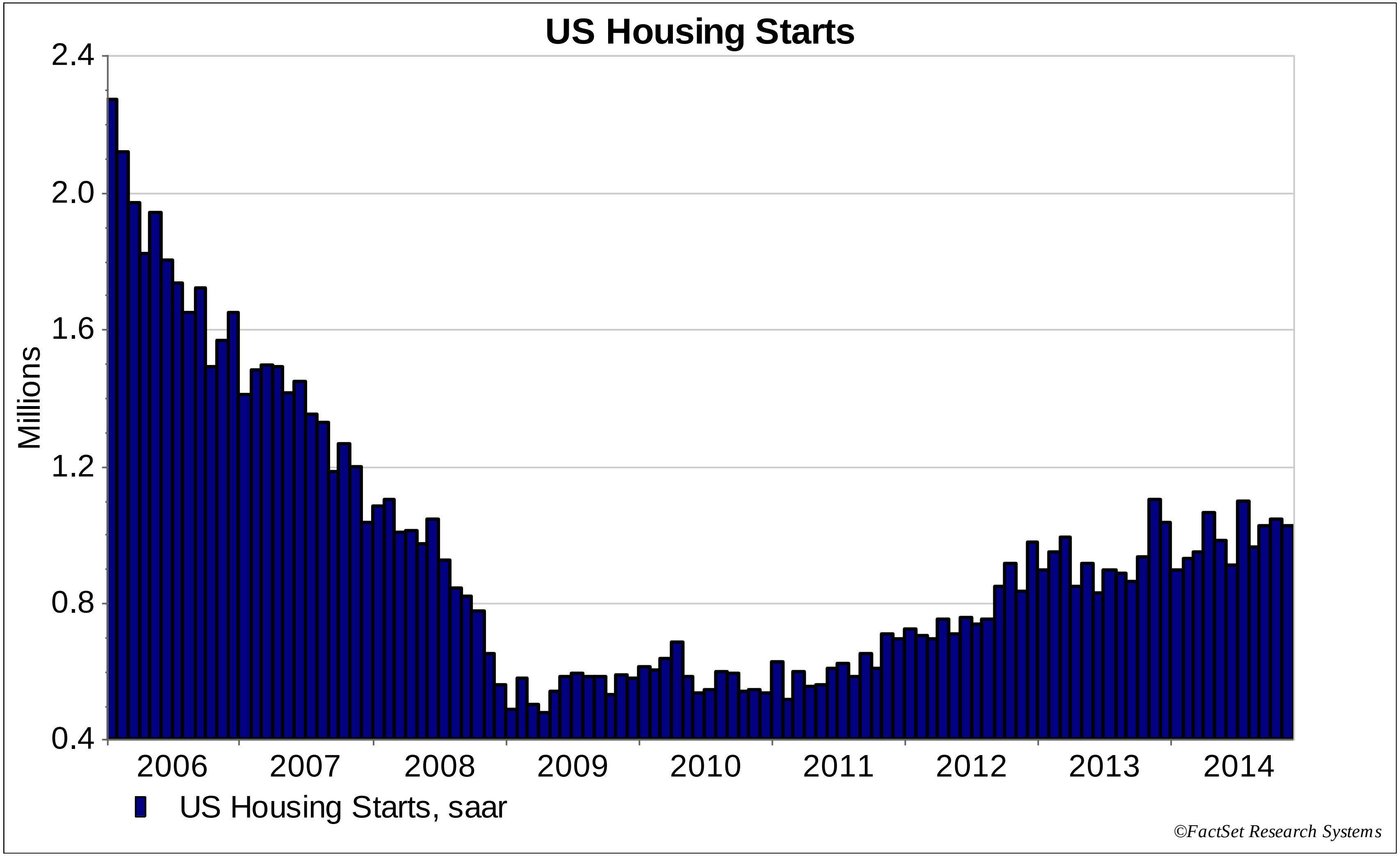
US


US Saving Rate and Household Net Worth
9
8
7
6
5
4
3
2
Percent
480
500
520
540
560
580
600
620
640
660
Percent
'06
'07
'08
'09
'10
'11
'12
'13
'14
US Household Net Worth, % of Disposable Income, axis inverted (right)
US Personal Saving, % of Disposable Income, 3-month moving average (left)
Sources: Federal Reserve, US BEA

US


US Light Vehicle Sales
Millions
18
17
16
15
14
13
12
11
10
9
8
'06
'07
'08
'09
'10
'11
'12
'13
'14
US Light Vehicle Sales, number of units at annual rate
Recession Periods - United States
Sources: Dept of Commerce & NBER

US


US Housing Starts
Millions
2.4
2.0
1.6
1.2
0.8
0.4
2006
2007
2008
2009
2010
2011
2012
2013
2014
US Housing Starts, saar
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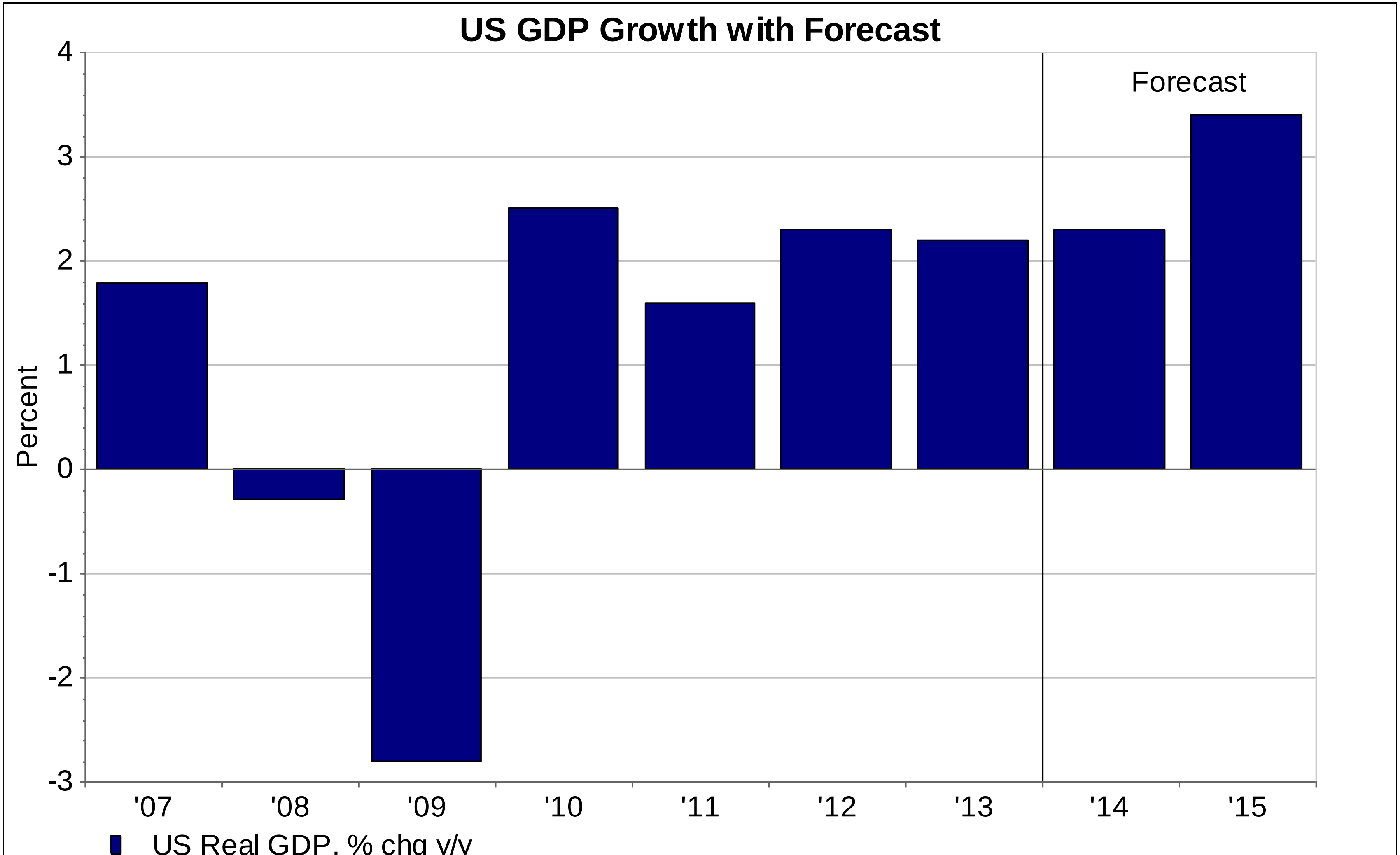
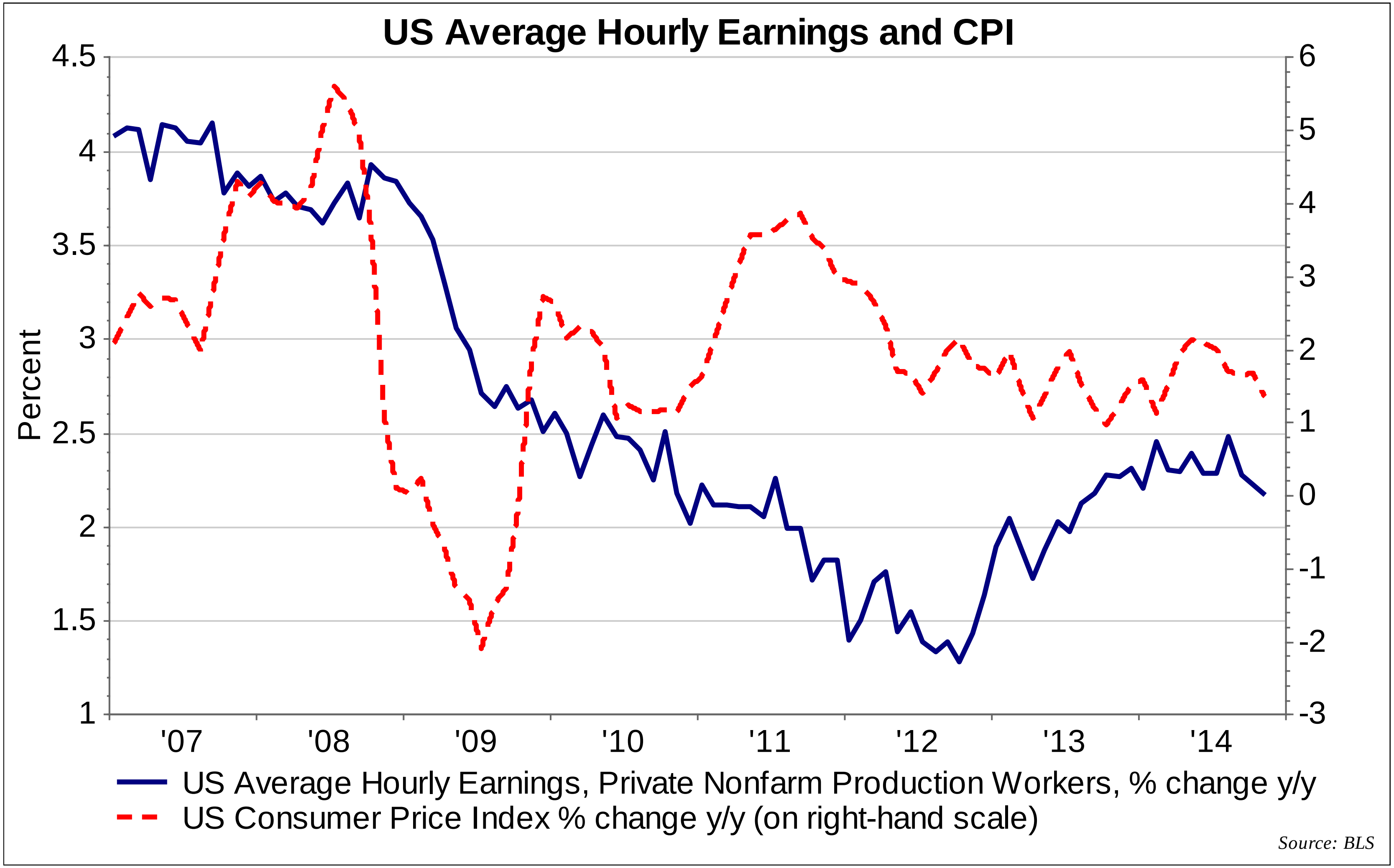
US



Sources: Oxford Economics, SSgA Economics Team

- The only downside to faster growth is monetary tightening
  - The Fed will likely allow the funds rate to drift to the top end of its 0-25 basis point range over the summer
  - Hike to 50 basis points in September, 75 basis points in October and 100 basis points in December
- But the FOMC is stressing data dependency
  - Tightening will come sooner if growth surprises to the upside
  - Or later if it disappoints
- Is there a danger the Fed will "fall behind the curve?"
  - It does not appear so
  - Despite steady labor market tightening, inflation is not an issue

US

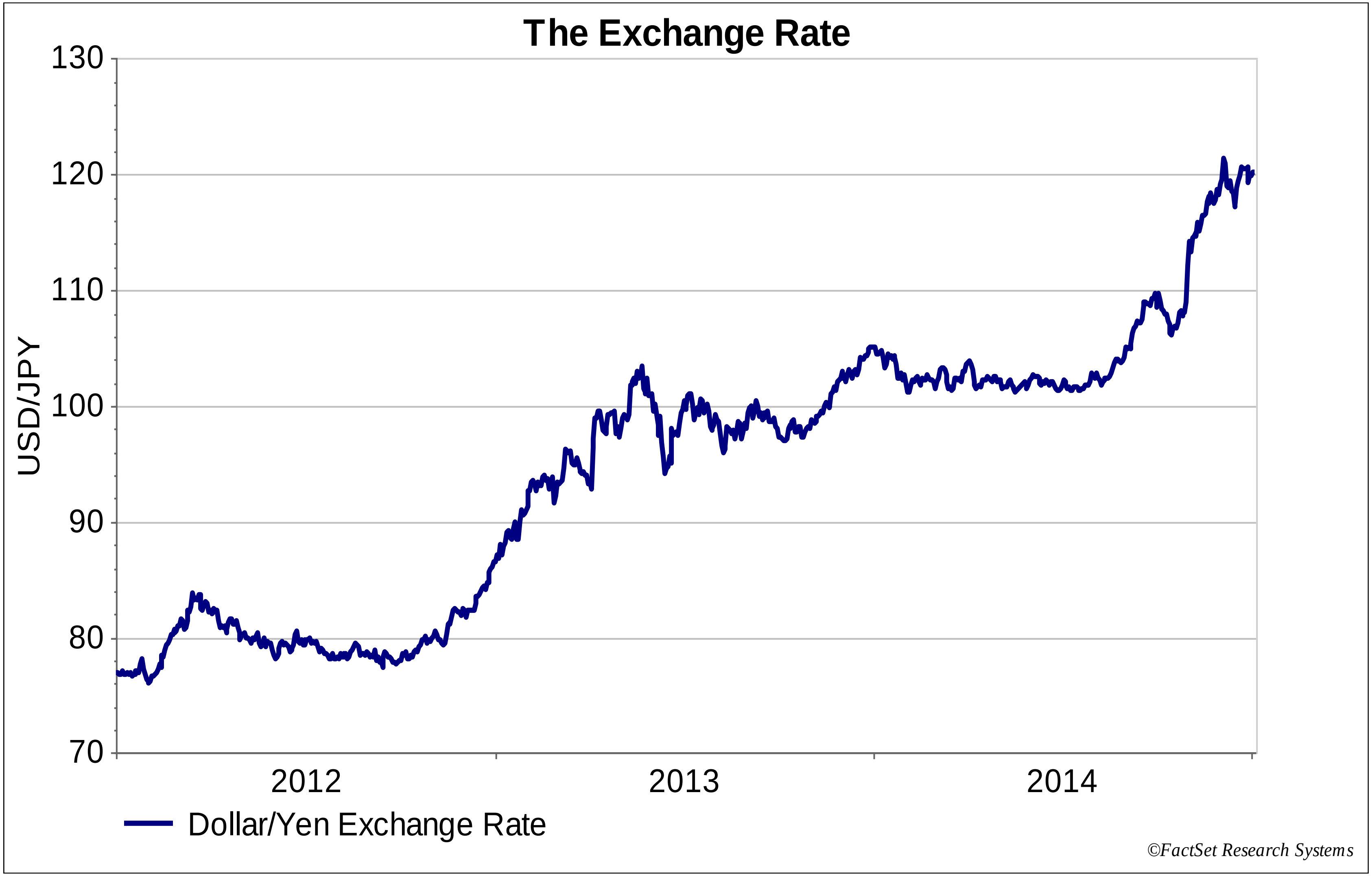


US Average Hourly Earnings and CPI
Percent
4.5
4
3.5
3
2.5
2
1.5
1
6
5
4
3
2
1
0
-1
-2
-3
'07
'08
'09
'10
'11
'12
'13
'14
US Average Hourly Earnings, Private Nonfarm Production Workers, % change y/y
US Consumer Price Index % change y/y (on right-hand scale)
Source: BLS

Japan

- Faith in “Abenomics” is waning
- It effects appear limited to the financial markets
- The economy certainly disappointed in 2014:
  - The recovery proved fragile
  - Inflation did not continue to accelerate
- The first quarter was strong because of spending and production ahead of the VAT hike
- But the second quarter was appalling and the third quarter weak, as the VAT hike sent the economy into a tailspin
- Core inflation has stabilized, while headline has decelerated on falling oil prices

Japan


The Exchange Rate
130
120
110
100
90
80
70
USD/JPY
2012
2013
2014
Dollar/Yen Exchange Rate
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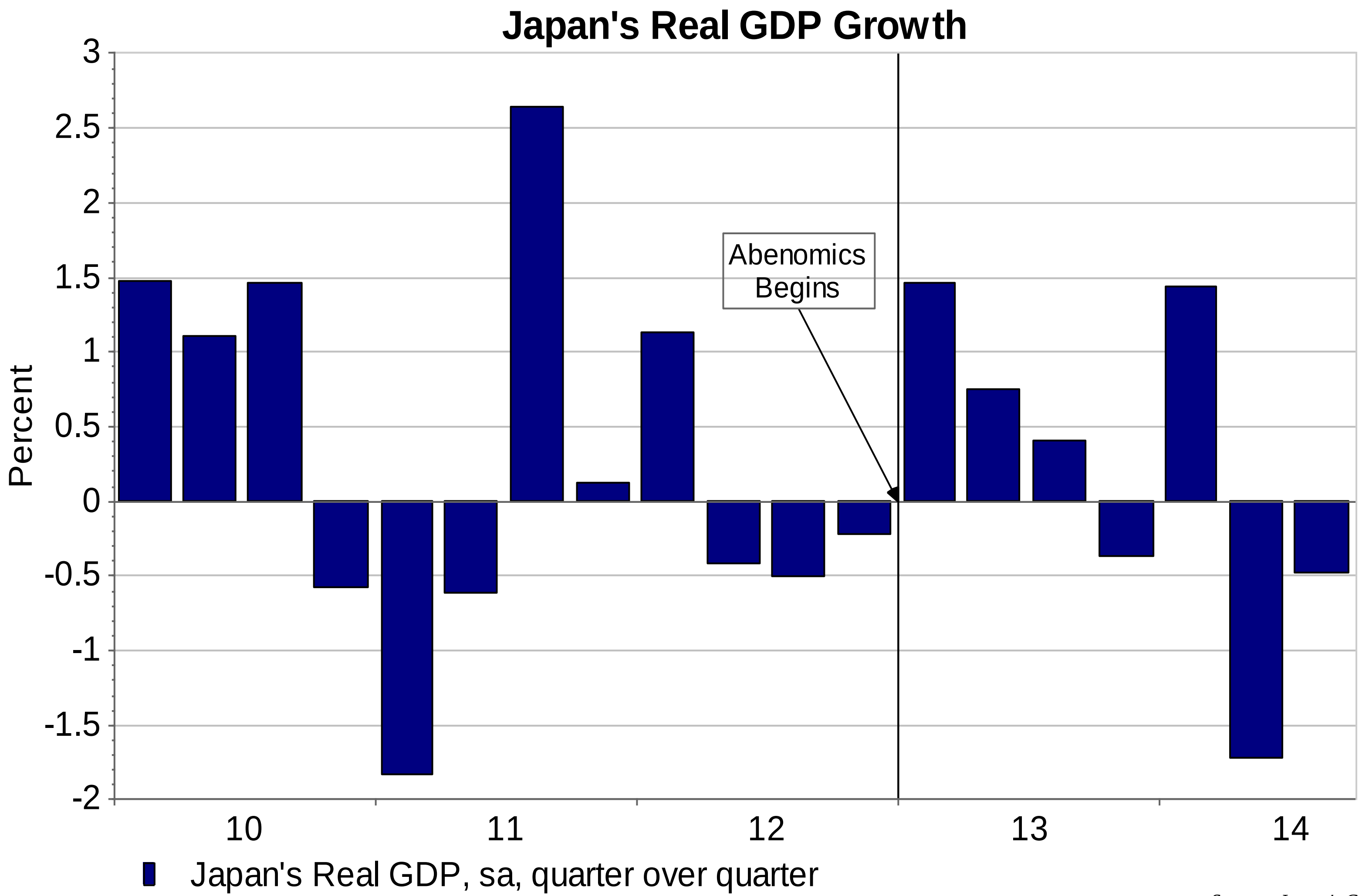
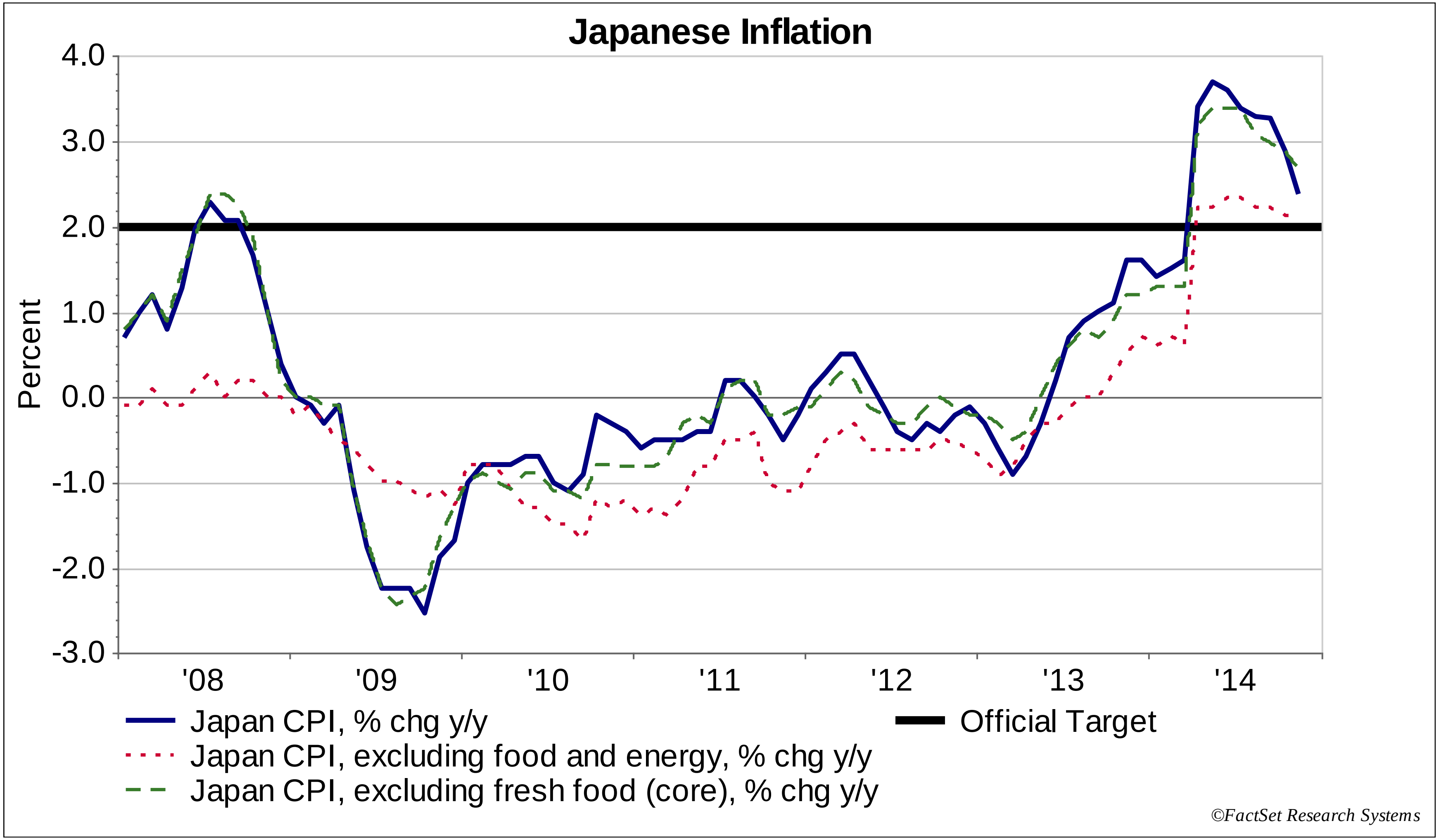
Japan



Source: Japan's Cabinet Office

Japan



Japanese Inflation
Percent
4.0
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
'08
'09
'10
'11
'12
'13
'14
Japan CPI, % chg y/y
Official Target
Japan CPI, excluding food and energy, % chg y/y
Japan CPI, excluding fresh food (core), % chg y/y
©FactSet Research Systems

Japan

- There are now signs that the recovery is regaining traction and we expect growth to resume in the fourth quarter
- But despite that, GDP is unlikely to rise more than 0.2% in 2014
- Moreover, we expect growth to languish below 1.0% this year
- Because of this, the BoJ will at least remain on hold and may well ease further

Japan

- Will Abenomics ultimately work?
- There are two goals:
  - Speed up growth
  - End deflation
- Success on speeding up the underlying growth rate of the economy depends on structural reforms… and the commitment to these remains unclear
- The acceleration of inflation has stalled, but the unemployment rate is at a level where an acceleration could be sustained… **if wages pick-up**

Japan

Source: Ministrial of Internal Affairs and Communication

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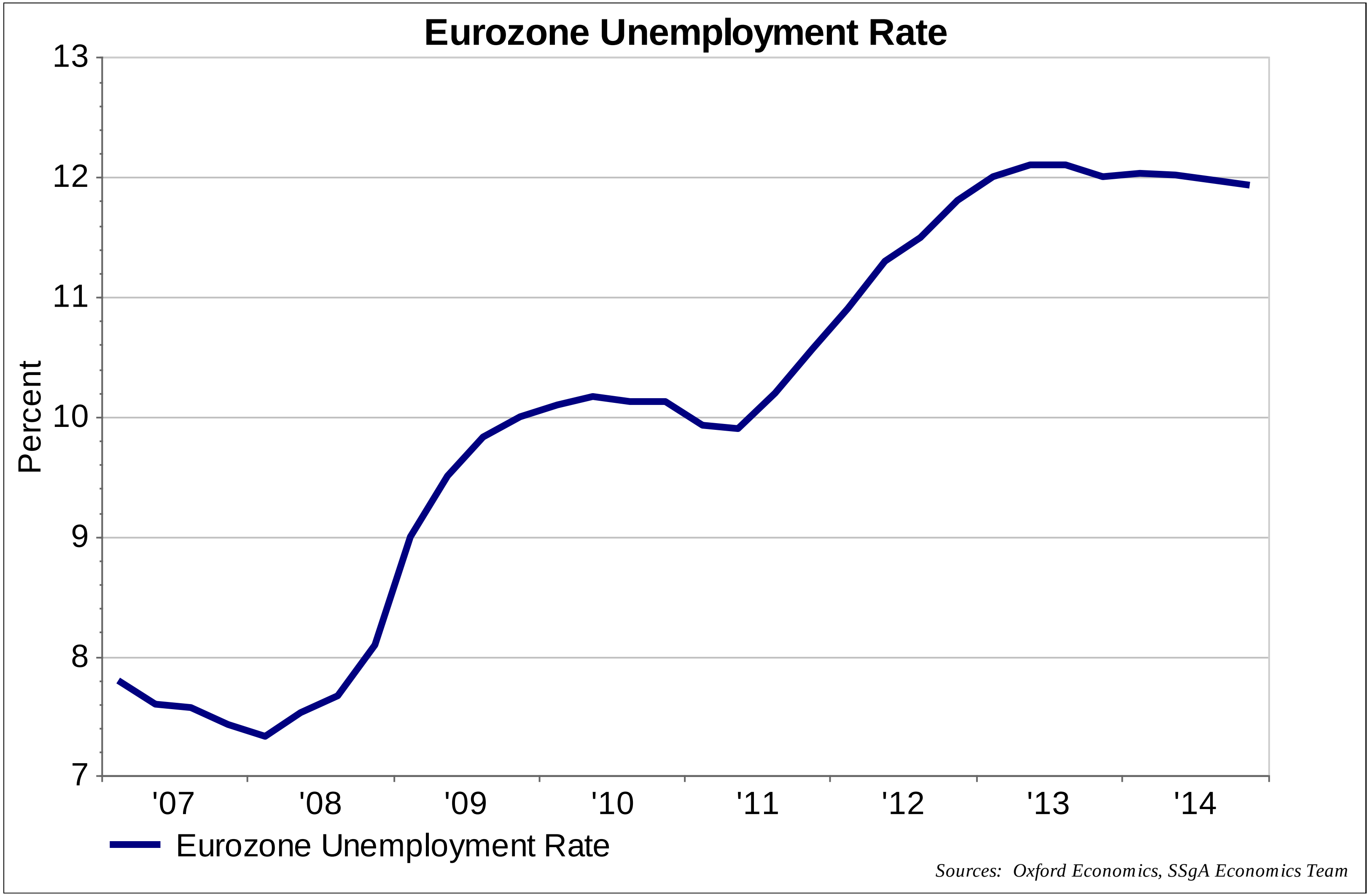
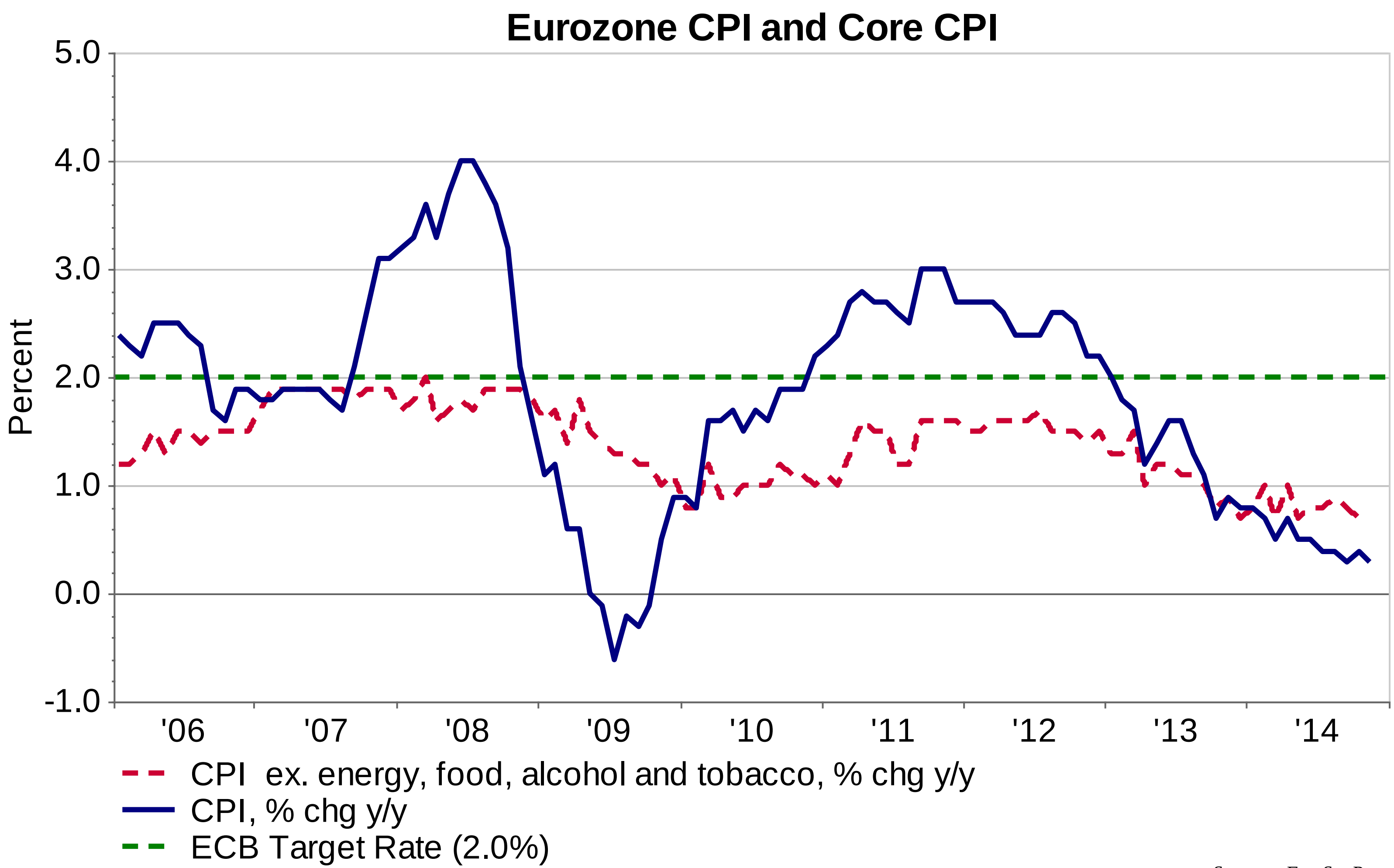
Eurozone

- The malaise continues and will likely persist
  - Geo-political tensions in Eastern Europe are weighing on consumer and business confidence
  - The ECB has eased, and will likely to do more, but private sector credit continues to contract
  - Fiscal policy remains hampered by deficit rules
- Growth has resumed, but:
  - The labor market is chronically weak
  - Inflation is dangerously low
  - Growth is sluggish and expected to remain that way, with GDP only rising by a little more than 1.0% in 2015

Eurozone

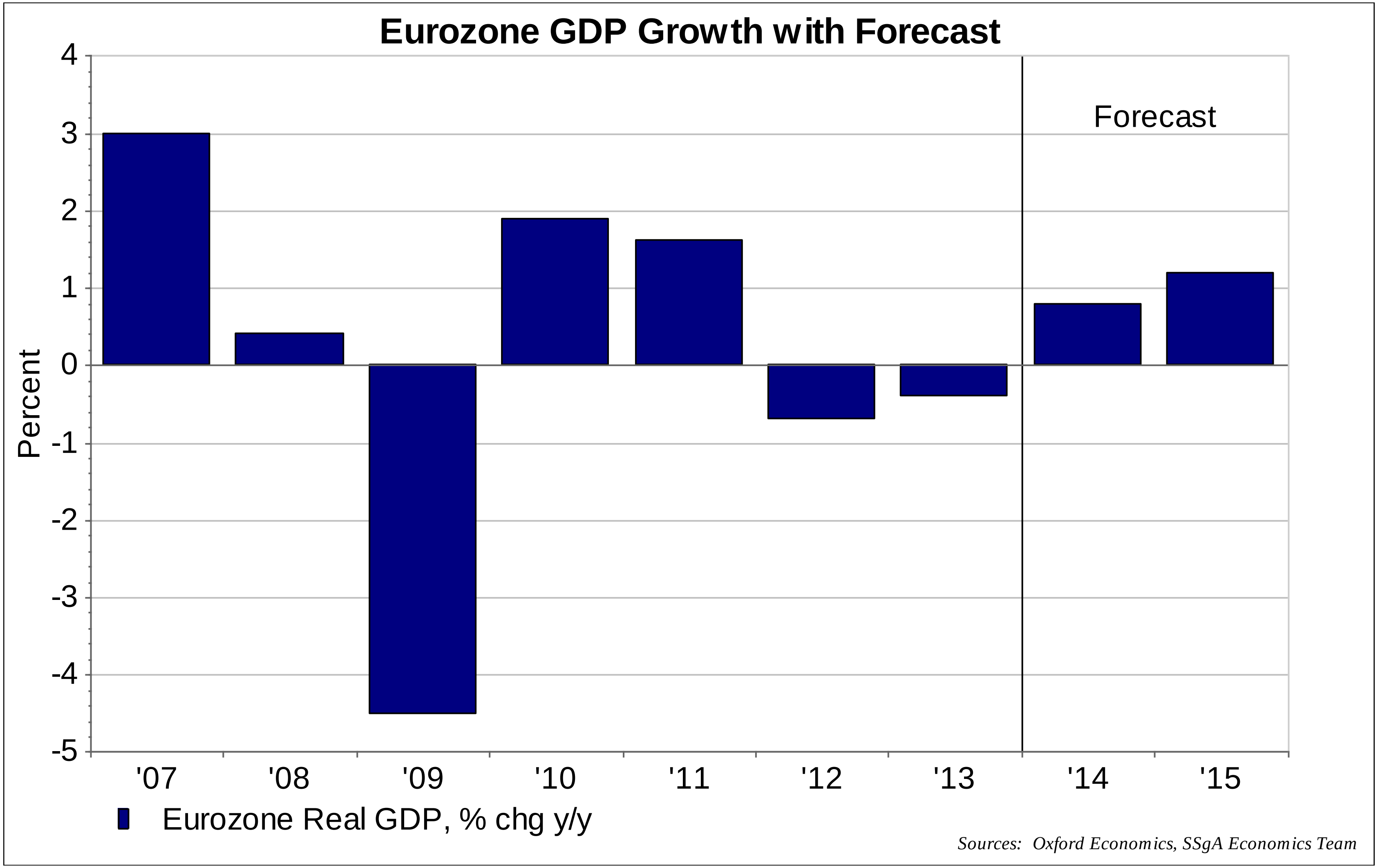

Eurozone Unemployment Rate
13
12
11
10
9
8
7
Percent
'07
'08
'09
'10
'11
'12
'13
'14
Eurozone Unemployment Rate
Sources: Oxford Economics, SSgA Economics Team

Eurozone



Source: FactSet Research Systems

Eurozone

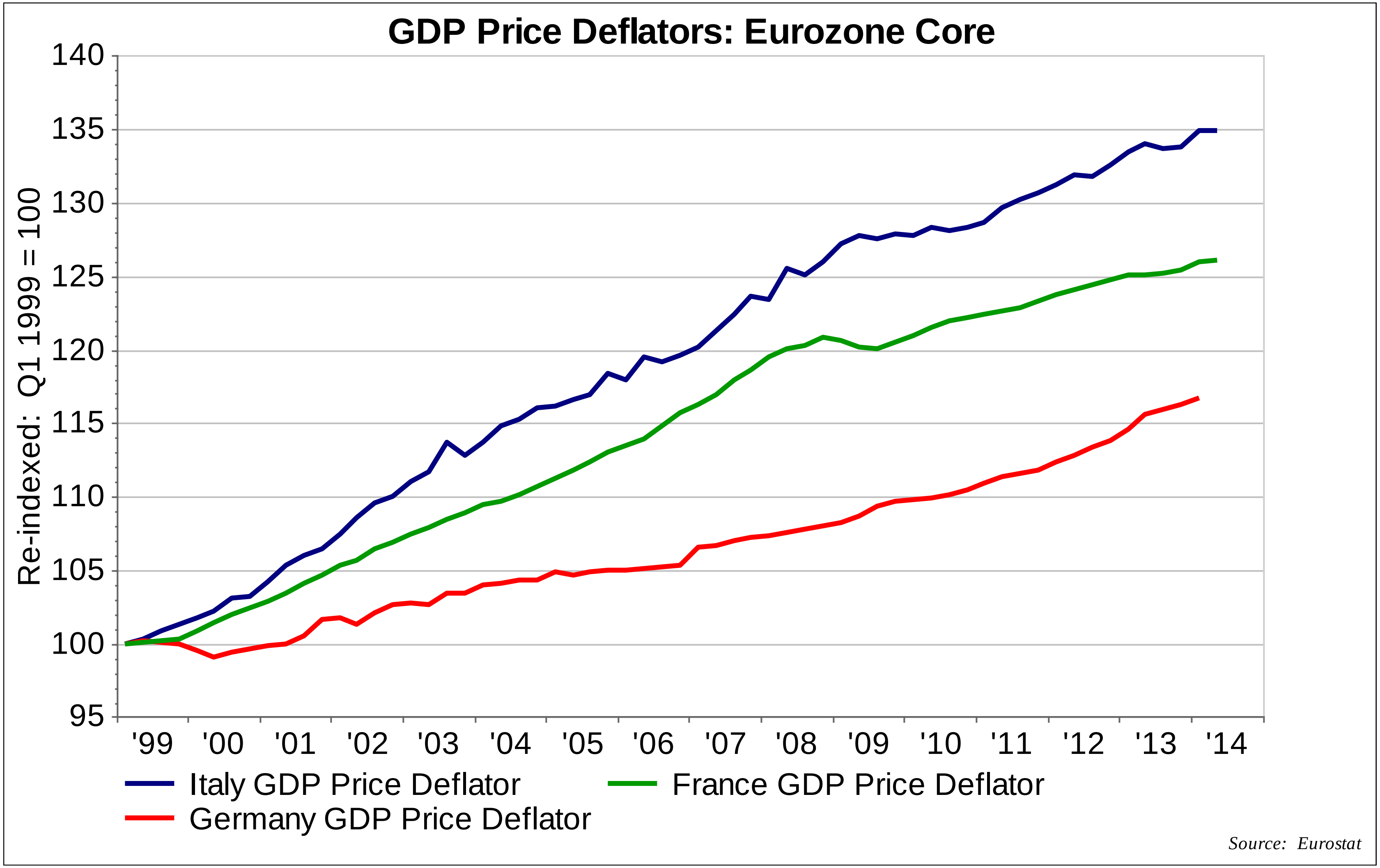


Eurozone GDP Growth with Forecast
4
3
2
1
0
-1
-2
-3
-4
-5
Percent
Forecast
'07
'08
'09
'10
'11
'12
'13
'14
'15
Eurozone Real GDP, % chg y/y
Sources: Oxford Economics, SSgA Economics Team

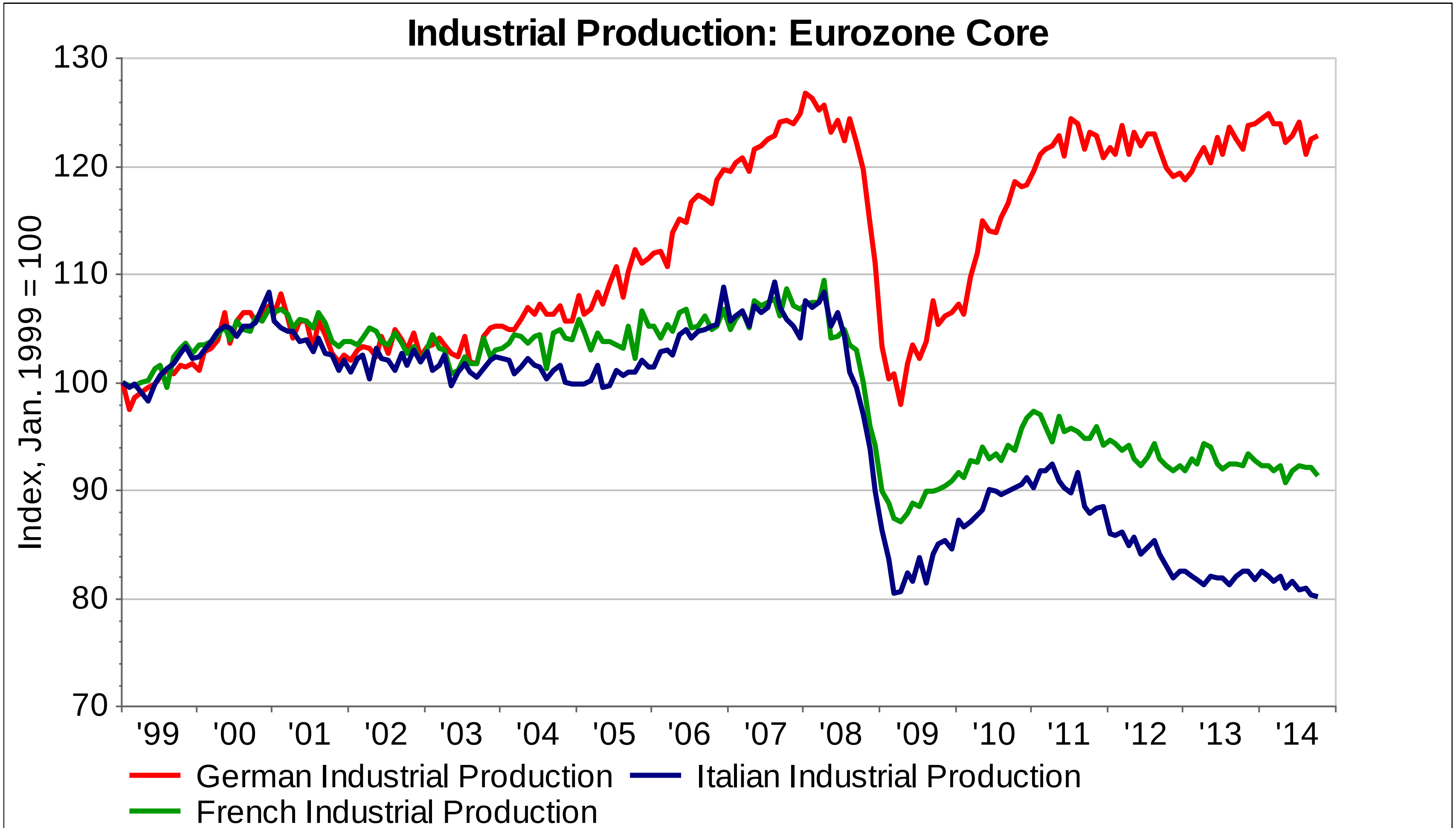
Eurozone

- There are some upside risks
  - Lower oil prices
  - Lower euro
- But there are few grounds for optimism in the longer term
- The Eurozone has serious structural flaws, which while not <u>yet</u> threatening its survival are preventing it from thriving
  - Competitiveness within the zone has diverged
  - Exchange rates should adjust, but they no longer exist
  - So economic performance is diverging

Eurozone


GDP Price Deflators: Eurozone Core
Re-indexed: Q1 1999 = 100
140
135
130
125
120
115
110
105
100
95
'99
'00
'01
'02
'03
'04
'05
'06
'07
'08
'09
'10
'11
'12
'13
'14
Italy GDP Price Deflator
France GDP Price Deflator
Germany GDP Price Deflator
Source: Eurostat

Eurozone



Sources: Bundesbank, INSEE, ISTAT

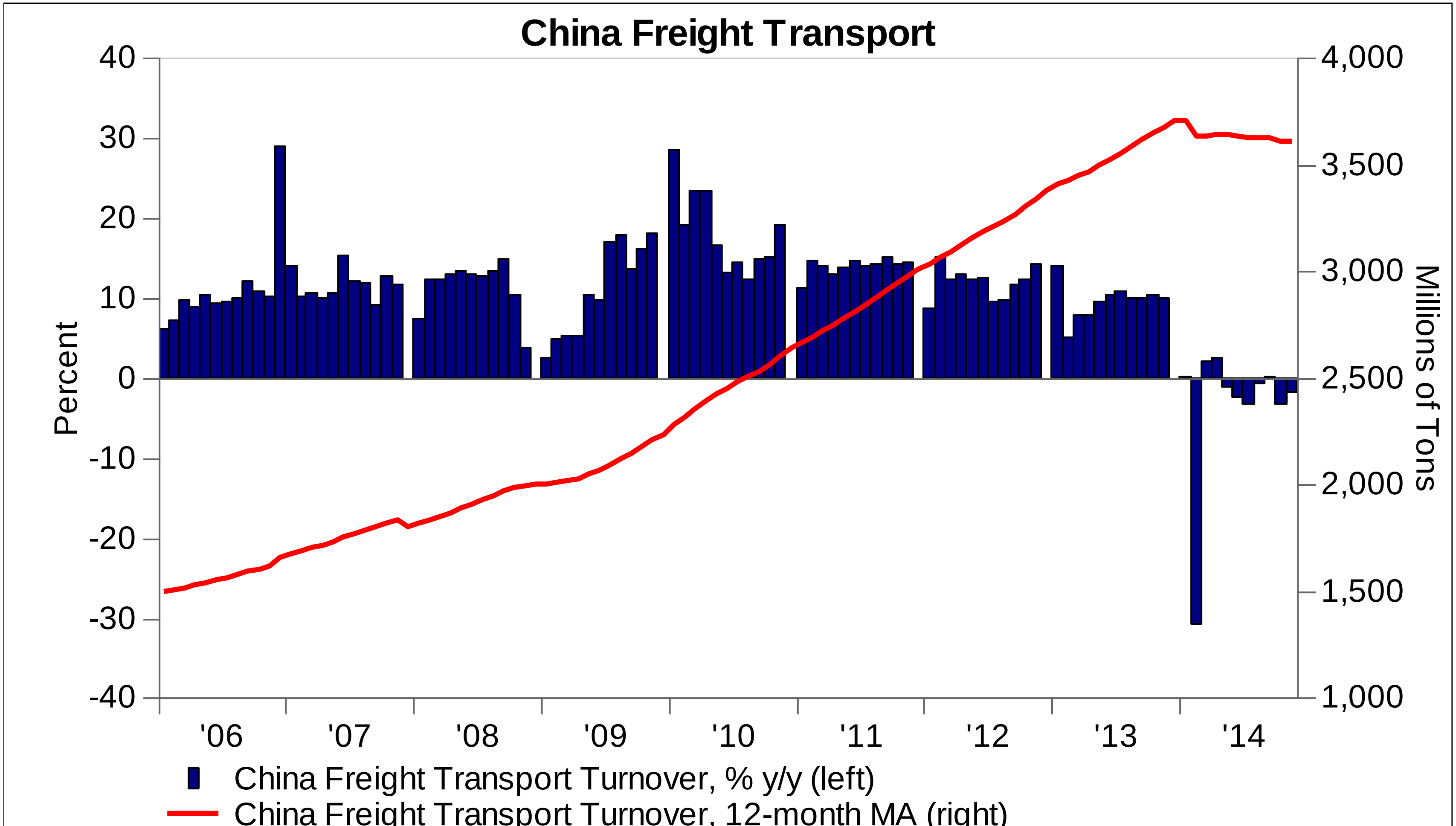
China

- There are clear signs of slowdown:
  - Short-term bank lending has slowed sharply
  - Freight transport is falling
  - Electricity output is essentially unchanged over the last year
- And there are other concerns
  - The pace of restructuring of the economy
  - Weakness in the property market
  - Fragilities in the shadow banking sector
- Leading global investors to fear a hard-landing, cascading defaults and financial instability

China


China Short-term Loans
Percent
25
20
15
10
5
0
'06
'07
'08
'09
'10
'11
'12
'13
'14
CN Short-term Loans, Monetary Financial Institutions, % y/y
Source: People's Bank of China

China



Source: National Bureau of Statistics

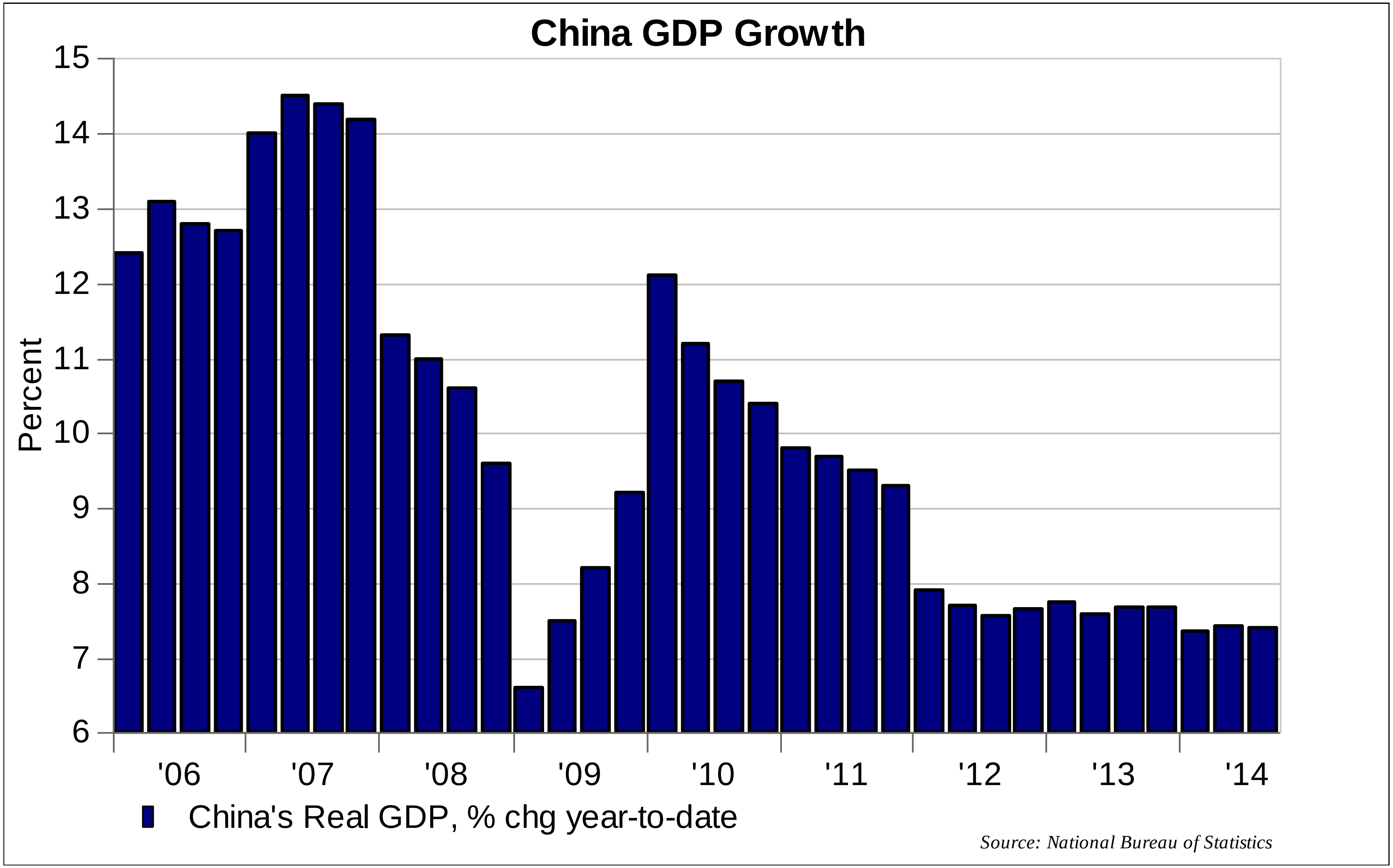
China


China Electricity Output
30
25
20
15
10
5
0
-5
-10
Percent
'06
'07
'08
'09
'10
'11
'12
'13
'14
China Electricity Production, % y/y
Source: National Bureau of Statistics

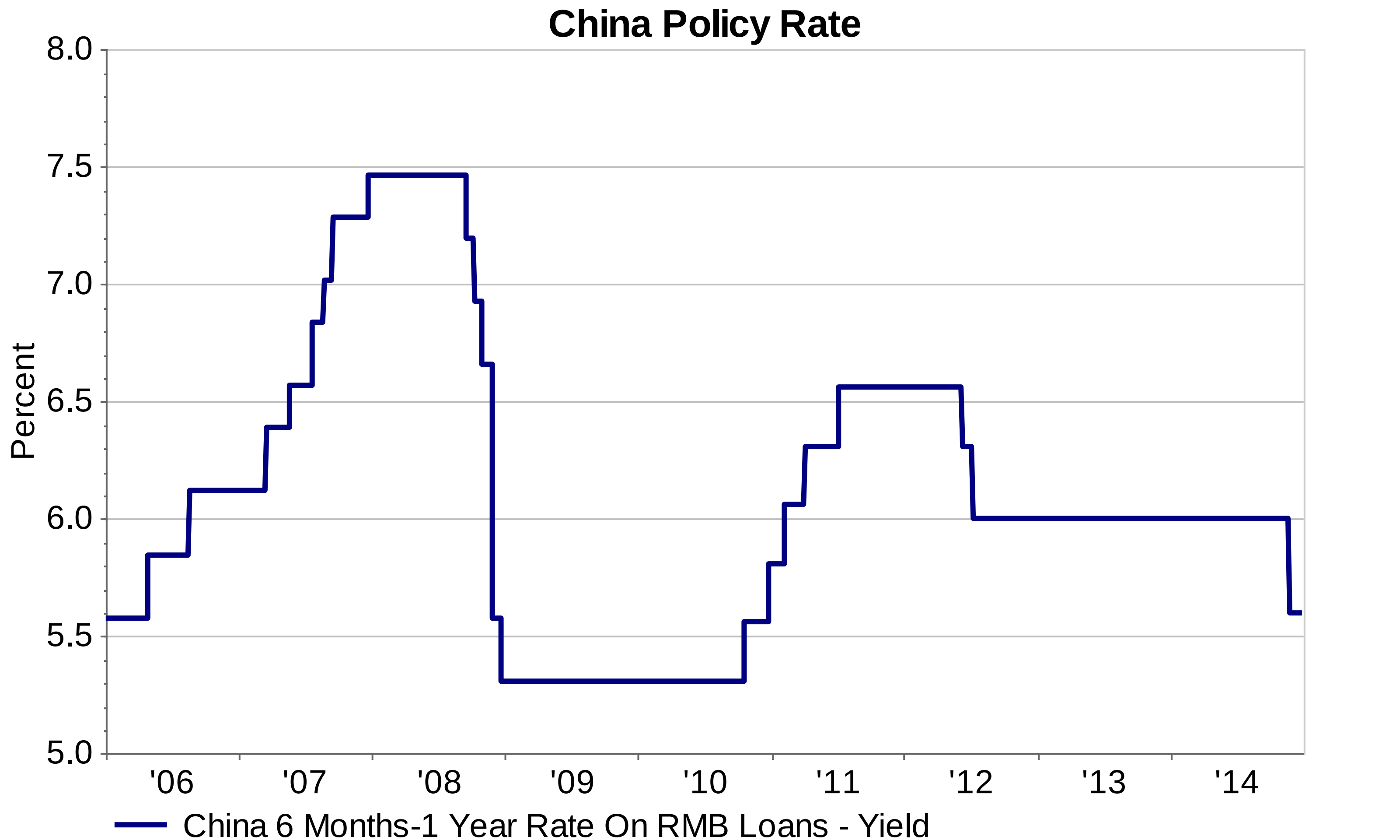
China

- But while the risks are skewed to the downside, we anticipate a soft-landing, with growth only slowing to 7.0%
  - Unlike most Western economies, China enjoys substantial monetary and fiscal policy flexibility
  - With approximately $4 trillion of foreign exchange reserves and a central government debt to GDP ratio of 40%, China has a large borrowing capacity in the event of an adverse shock
  - Moreover, the almost 50% drop in oil prices in the second half of 2014 provides a “cushion,” by boosting growth nearly 1.0% in 2015

China


China GDP Growth
15
14
13
12
11
10
9
8
7
6
Percent
'06
'07
'08
'09
'10
'11
'12
'13
'14
China's Real GDP, % chg year-to-date
Source: National Bureau of Statistics

China



Source: FactSet Research Systems

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