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# A change in global growth expectations ?

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Financial market fluctuations have intensified recently. This can be seen in both the equity markets and the bond markets, where the abrupt but temporary dip in the U.S. 10-year Treasury yield below 2% is a strong signal for a possible change in policy.

These financial market movements began the day after Janet Yellen's September 17 press conference. She remained vague on the timing of any increase in the Fed's rates, thus creating uncertainty and raising questions about the U.S. central bank's commitment to a swift change in its monetary strategy. According to the chairman of the Federal Reserve, it would not be advisable to act too quickly as long as imbalances remain in the economy. In general, the takeaway from her comments is that it is likely preferable to act a little too late than a little too soon, which explains why she has no interest in setting overly specific objectives for the actual direction of her monetary policy.

Two weeks ago, the meeting of the IMF lent credence to the idea that growth in the global economy would not be as strong as expected. For 2014, this estimate was revised from 3.7% in January to 3.3% in October. This rapid decline can be attributed to the lack of resilience in most major countries, with the exception of the English-speaking countries, and to emerging markets, which are growing at a slower pace than in the past.

These two issues have been a major source of the fluctuations in recent days and weeks.

If the Fed prefers not to act too quickly, despite robust growth, it is because it assigns a non-zero probability to the possibility of more moderate expansion of the global economy and because a more restrictive Fed policy would aggravate this situation.

It is this situation that gives investors pause. They were under the impression that the economy would more or less regain its pre-crisis momentum, with a robust growth rate, a limited inflation rate close to the central banks' targets and, lastly, business cycle management by the central banks. In this scenario, the Fed's interest-rate hike makes sense. It is the first step toward a normalization of the global economy.

However, if the global economy does not display the attributes expected and does not converge toward its pre-crisis profile, the situation becomes more complex. First, because growth will not keep pace with the past rate and, in particular, because it could be slower than expected in the long term.

Looking at the expected growth profile, there are numerous uncertainties in the near future. While English-speaking countries remain fairly robust, questions remain about momentum in other regions of the world.

## Chinese economy

Growth in China is slowing because this economy is looking to establish a growth model focused more on its domestic market, which is more dependent on services but also has to correct past imbalances, particularly in real estate. China will no longer be the stand alone leader it was before the crisis, and it will not have the ability to provide sustained impetus for global trade. This will hurt emerging countries but also Europe, including Germany, because much of the growth in its exports comes from its relationship with China.

## Japanese economy

Japan has been in recession since the severe negative shock resulting from the increase in the sales tax on April 1. Japan's structural issues have not been resolved and the aging of the population will not allow for a rapid change in direction.

## Eurozone economy

In the eurozone, the economy is looking to rally, driven mainly by the ECB, which is doing its utmost to implement a strategy that could generate more robust growth in the long term. But, before seeing any positive effects, some of the imbalances left over from the past need to be corrected. We also see the need for political consolidation accompanied by a more integrated political framework, but that will take time. In the short term, the situation remains murky and the eurozone is unlikely to make a strong, sustainable and robust contribution to global growth.

If the eurozone, China and Japan are not likely to converge toward a higher growth trajectory very quickly, then we may well wonder about the profile of U.S. monetary policy. Is it necessary and desirable for the Fed to raise interest rates fairly quickly? While that may ultimately be logical for the USA, does it not involve taking a risk on the rest of the global economy? An interest-rate hike by the Fed could result in significant capital outflows from emerging countries and could very quickly cause them to weaken.

In other words, is there any urgency to a tightening of U.S. policy?

Probably not, because the rest of the global economy is lagging behind U.S. momentum as each region remains mired in the slow momentum lingering from the past.

In that case, if the Fed postpones its interest-rate hike, valuations of all financial assets would change substantially.

It is conceivable that, in the coming weeks, investors' expectations will alternate between these two states of nature:

- the first is a return to a normalized situation that would be reflected in interest-rate hikes by the U.S. central bank, the idea being that the U.S. economy would have the ability to lift the profile of the global economy in the long term, as it has done in the past;

- the second state of nature is that of slower growth with lower inflation in the long term, including in the USA, and monetary policies that would remain accommodative, including in the USA.

Expectations will fluctuate between these two positions and this will create volatility on the financial markets. The second state of nature was underscored by expectations that were not met at Janet Yellen's mid-September press conference and by the worrying scenario painted by the IMF at its fall meeting. It cannot, however, be ruled out that this is the right scenario as significant imbalances remain and the convergence in China or in the eurozone toward a new growth model will be slow to take root.

*Written on 17/10/2014*

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**This document is published by Natixis Asset Management's Communications Department.**