Nick Kounis, tel +31 20 343 5616

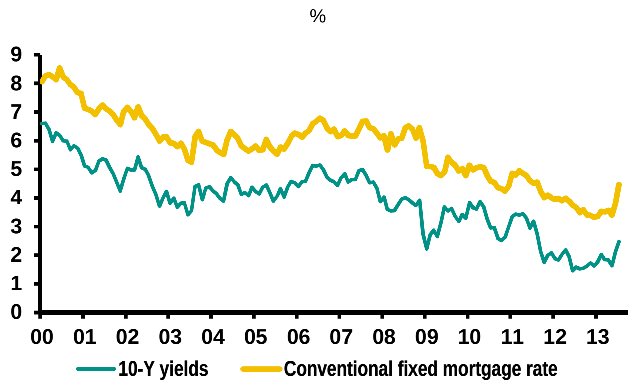
Global Economy: Will the Fed's exit spoil the party?

Financial markets have been dominated by worries about a fall-out from an easing of monetary stimulus. We do not think that the resulting tightening of financial conditions is sufficient to throw the recovery off course. The pace of fiscal consolidation is easing in the advanced economies, while private sector balance sheets are strengthening, especially in the US. Stronger demand in the west should give the emerging markets a lift as well. We continue to think that we are most likely on track for stronger growth in the coming months, with an above trend pace of global expansion likely to take hold next year. This means that a stronger economy should eventually underpin investor sentiment, rather than an increase in financial stress undermining economic activity.

Reduction in liquidity is worrying markets

William McChesney Martin, the Federal Reserve's ninth and longest serving Chairman, famously said that the central bank's job is 'to take away the punchbowl just as the party gets going'. Even though neither the removal of the punchbowl nor the party are an immediate prospect, financial markets have been dominated by worries about a fall-out from an easing of monetary stimulus, ever since Chairman Ben Bernanke's signal that the central bank could start to reduce the pace of asset purchases later in the year. This has unsettled risky assets and pushed up government bond yields. We assess the impact on the outlook for the global economy and financial markets going forward.

US Treasury yields and mortgage rates

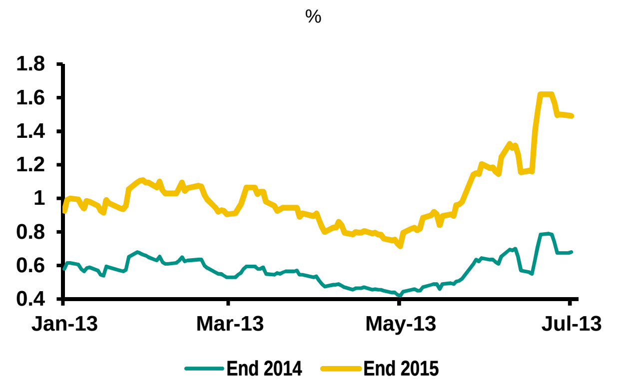


Source: Thomson Reuters Datastream

Tightening of financial conditions not severe

One reason not be too worried about the impact of Fed exit on the economy is that the tightening of financial conditions has been manageable so far. US Treasury yields have risen by around a percentage point from their lows at the start of last month, while this is set to push up mortgage rates by a similar amount. As a result, there has been a sharp pull-back in mortgage refinancings, which had been reducing interest payments and therefore were a support for disposable income. However, a strengthening labour market should more than compensate for this effect. Furthermore, we still think that the housing market upswing has a long way to go. Mortgage rates remain historically low and home affordability remains relatively high. At the same time the level of home building is modest, while there is pent-up demand for housing. Similarly, the decline in equity prices has not been dramatic. For instance, the S&P 500 has fallen by around 5% from its peak, but that followed a 16% rally from the start of the year.

US 3M interest rate expectations (Eurodollar futures)



Source: Thomson Reuters Datastream

Federal Reserve will manage expectations

The worry has to be that the market correction will gain its own momentum, with the subsequent tightening of financial conditions and loss of confidence leading to a more substantial break on the recovery. The ghost of the Fed-inspired 1994 bond market massacre is never far from the discussion of the central bank's exit this time around. At the same time, it is rightly pointed out that the extent of monetary easing – through a combination of enormous asset purchases and zero rates – has been historically unprecedented. However, the facts on the ground suggest that this could well be a 'good tightening cycle' as in 1983 and 1998. Crucially, inflation remains very well-contained. James Bullard, President of the St Louis Fed has recently made a convincing case that inflation is trending too low, while the central bank should 'defend its inflation target'. The subdued inflation background gives the Fed time to exit gradually. Indeed, the central bank has laid out its timetable and has made it clear that asset purchases will not be fully ended until mid-2014, while the first interest rate increase will not become before 2015. The combination of transparent, early signalling and low inflation should prevent 1994-style nasty surprises. Indeed, in 1994 the market was taken by surprise, while the degree of tightening was aggressive, with 250bp of rate hikes in that year. We think that the tapering of asset purchases is now largely priced into financial markets. History shows that market reactions to changes in QE tend to be front-loaded. Meanwhile, rate hike expectations are broadly in line with the Fed's guidance, with officials having already started to intervene verbally to calm market markets down. Overall, then the Fed should be able to manage expectations, despite the bumpy start. The one exception is if the acceleration in growth and/or rise in inflation is unexpectedly sharp, sparking worries that the central bank is behind the curve.

US economy on track for acceleration

Fundamentals for the US economy continue to improve, and it looks likely that growth will accelerate noticeably in the coming months and in 2014. Private sector balance sheets look healthy, helped by rising asset prices and falling debt levels. This means that households are more ready to spend, while companies are in a position to hire and invest. Meanwhile, the revival in the housing market is already underpinning residential investment. Finally, the fiscal consolidation – totalling 1.8% GDP – that has been restraining overall demand this year, should ease significantly. The tax hikes kicked in at the start of the year, while more modest spending cuts will play-out in Q2-Q3 of this year. All this suggests that the economy will move to above-trend growth rates from the fourth quarter of this year onwards. Indeed, we have recently revised our US growth forecast for next year upwards, given the impressive momentum in the private sector.

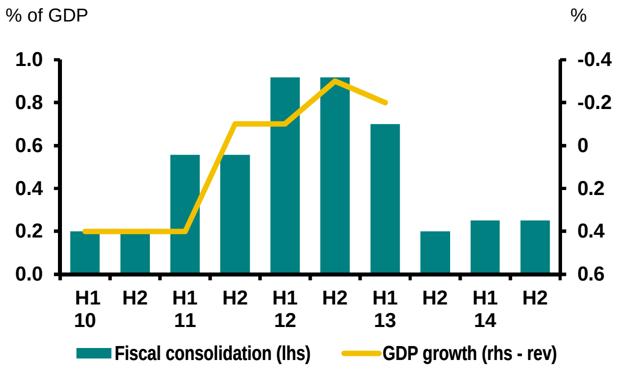
Fed exit expectations do not easily translate to ECB

Eurozone financial conditions have also seen some impact from the Fed's communication. Long-term interest rates have risen, reflecting a deterioration in investor sentiment, which has hit peripheral bonds, and rising short-term interest rate expectations. However, we think given the subdued outlook for inflation the ECB is unlikely to tighten monetary policy this year or next. Economic conditions are really rather different on either side of the Atlantic. Although recent evidence suggests that the eurozone economy is starting to stabilise, this follows six successive quarters of contraction, while the US economy has just clocked up its fifteenth successive of quarter of expansion.

Eurozone moving from austerity to growth

We think that a slow economic recovery is now on the cards. For a start, the austerity that has been weighing down domestic demand, is likely to ease. The European Commission has signalled a shift in Europe's stance on austerity. Budget consolidation will be reduced in France, Spain, and Italy, though the Netherlands will likely put in place extra cuts. Before the recent steps, we estimated that budget cuts for the eurozone as a whole amounted to 1.4% GDP this year and 0.7% next year, following 1.8% GDP in 2012. On the basis of the changes, we assess that total fiscal austerity measures will decline to around 0.9% GDP this year and 0.5% GDP next year. Assuming that around half of the previously targeted budget cuts were already carried out in the first half of this year, this implies that the pace of austerity will fall off sharply in the coming months. The change in the degree of austerity also led us to upgrade our eurozone forecast for next year. Another positive is that financial stress has eased compared to 2011/2012 and uncertainty about the future of the single-currency area has ebbed noticeably following the announcement of the ECB's conditional sovereign safety net last year. Finally, a US-led improvement in global demand should support exports. Still, there are a number of negatives that limit the speed of Europe's recovery. Unemployment is likely to continue to rise well into next year, which will keep wage growth subdued. These forces will likely restrain consumer demand. In addition, banks remain in a moderate deleveraging process, which means that credit conditions will remain tight.

Eurozone: easing consolidation to support growth



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Emerging market assets have felt the brunt

The place where the building of Fed exit expectations has left the clearest footprint in emerging market assets. Emerging market bonds, equities and currencies have all plummeted. This reflects the unwinding of carry trades that had supported emerging market currencies and bonds, a deterioration in investor sentiment, disappointing economic data, the decline in commodity prices and the rise of political unrest in a number of countries. At the same time, weak currencies are limiting the room for monetary policy manoeuver in many countries. Meanwhile, the change in China's economic strategy, has also meant that the hurdle for the authorities to turn to monetary stimulus is relatively high. The authorities want to shift from an investment-led growth model to a more consumption-driven one, while avoiding imbalances in the property market and shadow banking system. A convincing recent example of the new found determination was the PBoC's early reluctance to ease a liquidity crunch in the banking system, given that it has one eye on restraining credit growth. This surprised some observers, and even raised the possibility that the authorities might be tolerant of even lower growth rates than previously indicated.

Revisions to the past, but recovery still seen
Given weak data over the last few months, we have made downward revisions to our GDP growth forecasts for all the big emerging markets. However, we still expect a recovery in economic growth in the coming quarters. Many emerging economies still depend heavily on the west for their exports, so stronger demand from the advanced economies will be an important positive for the outlook. In addition, infrastructure projects remain in the pipeline in China and these will also support a moderate recovery in growth. At the same time, we expect the weakness in commodity prices to persist, which will be favourable for net commodity importers, especially in Asia, but a negative to big commodity exporters, such as Brazil. Overall, the shift in China's growth model and the related end of the commodity super cycle means that emerging market growth rates will not reach pre-crisis levels, but growth will still be decent, and comfortably outstrip that seen in the advanced economies.

Above-trend growth, revival of investor sentiment
Bringing the picture together, we expect the global economy to gain some pace later in the year and to reach above-trend growth rates next year, driven by an acceleration in US demand. Sovereign bond markets should enter calmer waters in the near term, as short-term interest rates expectations have actually moved ahead of what central banks are signalling is likely. In addition, the inflation backdrop should remain favourable given that there is still slack in many economies. We see limited room for further rises in bond yields this year, though a strengthening recovery should see further significant rises in 2014. Meanwhile, we think that the improving cyclical picture and some cooling of central bank exit worries will sow the seeds for a revival of investor sentiment. This background of a gradual Fed exit, improving financial market conditions and a US-led growth acceleration should prove to be a favourable backdrop for the US dollar.

Table - GDP growth in key areas

%	2011	2012	2013	2014
US	1.8	2.2	1.8	3.2
Eurozone	1.5	-0.5	-0.5	1.3
Japan	-0.5	1.9	1.9	2.1
UK	1.1	0.2	0.8	1.8
China	9.3	7.8	7.5	8.0
India	6.4	3.4	5.5	6.0
Brazil	2.7	0.9	2.5	4.0
Russia	4.3	3.4	3.0	4.0
Developed	1.5	1.2	1.0	2.2
Emerging	6.1	4.4	4.6	5.4
Global	**3.9**	**2.9**	**2.9**	**3.9**
World trade	*6.1*	*1.8*	*3.5*	*6.5*

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Risks to the global economic outlook
The key downside risk to the world economy over recent quarters has been the possibility of a re-escalation of the sovereign debt crisis. This risk increasingly diminished since the introduction of the ECB's conditional sovereign safety net (named Outright Monetary Transactions) last year. This threat looks to be really rather low now, although it has not entirely evaporated. It could come to the fore if a government came into place in a vulnerable country that refused to follow the EU-IMF policy prescriptions. This would disable the OMT. Alternatively, if it came to light that the ECB was actually bluffing with regards to its – yet untested OMT commitments – this would also bring back stress in the eurozone in a hurry.

A more significant risk in the current environment is that the Federal Reserve's exit from its exception monetary policies more severely destabilises markets, and the resulting tightening in financial conditions and uncertainty leads to a renewed slowdown in growth. An alternative, but partly related, downside risk is that growth in a number of big emerging markets slows sharply.