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GLOBAL ECONOMIC & MARKET OUTLOOK

Eurobank

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- Global economic growth is expected to accelerate to 3.8% in 2015 from 3.3% in 2014, driven by stronger domestic demand, loose monetary policies and low energy prices.

- The euro area economy is expected to remain anemic and fragile. A recession should be avoided on the back of accommodative monetary policy, easier financial conditions, weak currency and solid global demand.

- The strengthening US recovery towards H2 2014 and 2015 is reinforced by the waning negative effect of fiscal consolidation, improving financial conditions, accelerating labor market and a continuing recovery in the housing sector.

- Risks to our economic outlook originate from multiple sources:

    - An unexpected rise in US long-term yields due to a sudden increase in core prices could depress global economic activity.

    - Poor structural reform implementation amidst stagnation in France and Italy poses risks of financial turmoil in the euro area.

    - Inflation expectations in the euro area could de-anchor amidst anemic growth rates.

    - Intensification of geopolitical tensions in Eastern Europe and the Middle East.

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I. Global Outlook

Olga Kosma, Vasilis Zarkos

Global growth decelerated significantly to an annualized rate of 2.7%in H1 2014, from 3.9% in H2 2013, due to a slowdown in both advanced and emerging economies. The temporary plunge in the US, the fragile recovery in the euro area and the weaker demand in Japan owing to the consumption tax increase led to weaker-than-expected rate of growth in advanced economies. On the other hand, although economic activity accelerated in the second quarter of the year in emerging Asia (including in China, on new measures to boost activity), geopolitical tensions concerning the Russian-Ukraine crisis and the Middle East have weighed on real economic activity in those regions. Looking ahead, we expect acceleration in real economic activity in the second half of the year, driven by stronger domestic and external demand in both advanced and emerging economies. Global growth is expected to accelerate to about 3.8% in 2015, with main downside risks concentrating on a lengthened weak recovery in advanced economies, a sharp increase in US long interest rates, as well as re-intensifying geopolitical tensions.

Country/regional economic outlook

After a temporary plunge in the first quarter of the year due to adverse weather conditions and a sharp inventory correction, the **US economy** accelerated in the following two quarters. Meanwhile, the labor market has continued to improve, with the unemployment rate having fallen 1.4 pp over the past year. Although the economy is in a recovery phase, price pressures remain well contained, with core consumer price inflation standing at 1.7% over the past couple of months and TIPS-based measure of longer-dated inflation expectations being on a downward trend. Looking ahead, we believe that a rebound in real personal consumption will probably support GDP growth, reinforced by better household balance sheets and lower gasoline prices. Moreover, the recent stabilization of housing demand and the pace of home price appreciation after the slowdown earlier in the year are indicative of an improving outlook for residential investment. On the contrary, the contribution from net trade to overall GDP growth is expected to be less positive, given weaker global growth and the normalization in net exports reported in Q3. Overall, we expect real GDP to grow by about 2.2% y-o-y in 2014, the same growth rate achieved in 2013. An acceleration of real economic activity towards a growth rate of about 3.0% is expected for 2015, above the potential rate of growth which is estimated at merely 2.0% due to lower productivity growth and population aging. The strengthening recovery towards 2015 is reinforced by the waning negative effect of fiscal consolidation, improving financial conditions, an accelerating labor market and a continuing recovery in the housing sector.

Euro area economic growth is expected to ratchet up in the course of 2015 on the back of robust external demand, weak currency, accommodative monetary policy and easier financial conditions. However, it will remain anemic and fragile due to subdued confidence and persistent headwinds that contain growth dynamics. Sluggish economic performance and structural reform implementation risk in France and Italy pose risks of financial turmoil in the euro area. Inflation is expected to remain low for a protracted period of time. Outright deflation should be averted by a moderate rise in demand and the ECB's readiness to defend price stability. We expect the ECB to broaden its asset purchase program due to anemic economic outlook amidst prevailing downside risks, failure to increase its balance sheet materially by existing measures and persistently low inflation.

In **Japan**, a rebound in private demand post the consumption tax hike, accommodative monetary policy and solid external demand are expected to bolster economic activity. However, economic growth is expected to be tepid as households' consumption is constrained by diminishing real wages and net exports are expected to contribute marginally to GDP expansion. Achieving a sustainable 2% price stability remains challenging. The BoJ is expected to continue its asset purchase program until at least 2016, when inflation is forecasted to hit the 2% target. Additional monetary easing is expected if inflation dynamics falter. The country's growth, inflation and debt dynamics rely on successful implementation of structural reforms. In the external environment, risks to our economic outlook stem mainly from lower than expected global demand, a new bout of financial tensions and an escalation of geopolitical turmoil

Risks to our global growth outlook

(a) Higher US long-term yields

The Fed concluded its third quantitative easing program (QE3) at the end of October 2014, starting the clock for the first interest rate hike. Although the FOMC did highlight the data-dependence of the monetary policy turning point, ensuring that interest rates will be kept at the current-zero level for a considerable time, a quicker acceleration of core prices could cause a more hawkish monetary policy stance. An earlier-than-expected tightening of US monetary policy could lead to a sharp repricing of risk and increased market volatility. This market turmoil could result in a significant rise in foreign bond long-term yields and falling equity prices, depressing global economic activity.

(b) Poor structural reform implementation amidst stagnation in France and Italy pose risks of financial turmoil in the euro area.

Failure of policymakers in France and Italy to provide reform momentum could fuel concerns over the debt sustainability of these countries and trigger a new bout of financial strains, most likely propagating to other weak euro area members. France and Italy will defer achievement of a balanced budget until 2017 in exchange for bold structural reform commitments. Reform fatigue poses implementation risk, while low borrowing costs increase complacency with respect to tackling deep-seated growth impediments. Furthermore, the rapid rise of euro-skeptic political parties in view of the 2015 electoral cycle in Greece, Portugal and Spain increases reticence of weak government coalitions to abide by fiscal discipline and carry out unpopular reforms. Yet, maintaining the momentum of adjustment reforms is crucial to enhance debt sustainability, bolster economic confidence and avoid sliding into entrenched stagnation.

(c) Lingering risk of deflation in the euro area

The risk of deflation in the euro area lingers, fueled by loss of growth momentum, anemic economic prospects and persistently low inflation printings. Nonetheless, in our baseline scenario, outright deflation should be averted on the back of a pickup in economic activity. Moreover, confidence on the readiness of the ECB to take additional course of action, if needed, is expected to keep long-term inflation expectations in check. Finally, the depreciation of the euro is exerting upward pressure on import prices, counterbalancing falling energy prices.

(d) Intensification of geopolitical tensions in Eastern Europe and the Middle East

Geopolitical tensions in the Ukraine front pose downside risks to European growth prospects. The faltering of the Russian economy due to sanctions has spill-over effects to business sentiment among European exporters. An escalation of the crisis would provoke harsher sanctions and retaliating measures, taking a bigger toll on euro area production. In the Middle East region, intensification of the strife could cause energy disruptions, leading to a higher energy burden on households and companies.

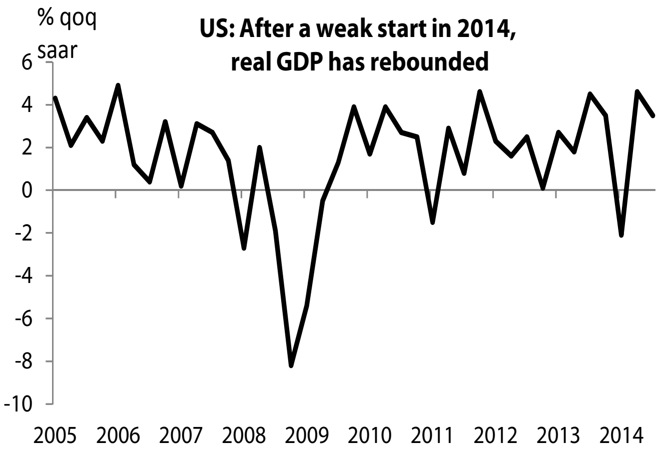
II. Global Economic Outlook

1. The US economy

Olga Kosma

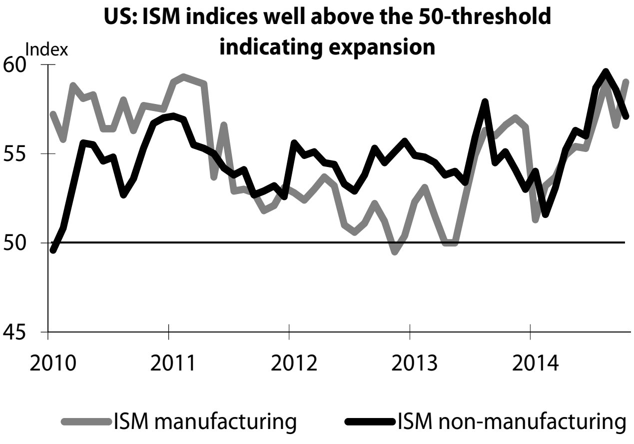
- After a temporary plunge in Q1 2014 due to adverse weather conditions and a sharp inventory correction, the US economy accelerated significantly in the following two quarters of the year.
- Leading indicators point to an acceleration of real personal consumption growth, boosted by the recent decline in gasoline prices, the improvement in the labor market and the easing of credit standards, unless there is a further increase in the personal savings rate.
- The recent stabilization of housing demand and the pace of home price appreciation after the slowdown earlier in the year are indicative of an improving outlook for residential investment.
- We expect real GDP to grow by about 2.2% y-o-y in 2014. An acceleration of real economic activity towards a growth rate of about 3.0% is expected for 2015, above the potential rate of growth of merely 2.0% due to lower productivity growth and population aging.
- The Fed's forward guidance continues to ensure that interest rates are expected to be kept at the current near-zero level for a considerable time following the end of the asset purchase program at the end of October. The October FOMC policy statement does not change our view that the FOMC will proceed with the first rate hike in mid-2015, responding to the improving labor market and economic conditions.

Figure 1.1



Source: US Bureau of Economic Analysis (BEA)

Figure 1.2



Source: Institute for Supply Management, Federal Reserve

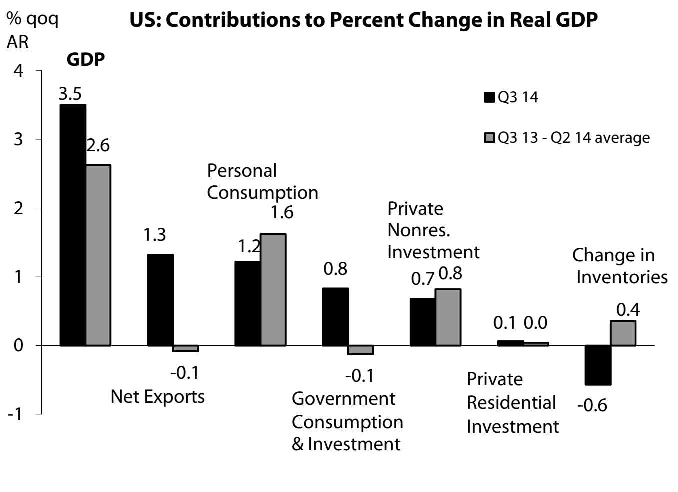
Overview

After a temporary plunge in the first quarter of the year due to adverse weather conditions and a sharp inventory correction, the US economy accelerated significantly in the second quarter of 2014. Real GDP growth rebounded sharply to 4.6% q-o-q saar in Q2, underpinned by stronger consumer spending as well as residential and business investment. The positive US growth performance has continued well into Q3 (+3.5% q-o-q saar), boosted by a surge in federal defense spending and net exports (Figure 1.1). The labor market has continued to improve, with the unemployment rate having fallen 1.4 pp over the past year. Although the economy is in a recovery phase, price pressures remain well contained, with core consumer price inflation standing at 1.7% over the past couple of months and TIPS-based measure of longer-dated inflation expectations being on a downward trend.

Looking ahead, the manufacturing sector remains firm headed into Q4, with the ISM manufacturing index surging to a three-year high of 59.0 in October. Nevertheless, the ISM services index posted a modest decline to 57.1 in October, after its post-recession high of 59.6 in August, but it is still well above the 50 threshold that indicates expansion (Figure 1.2). Although industrial output fell by 0.1% m-o-m in October, US manufacturing regional surveys (Empire State and Philadelphia Fed indices) surged in November, suggesting upside momentum for the manufacturing sector. Meanwhile, the Conference Board's index of leading economic indicators was stronger than expected in October (rising 0.9% versus consensus expectations of 0.6%), reinforced by accommodative financial conditions, improving labor market conditions and enhanced manufacturing activity. According to our estimates, real GDP growth will decelerate to about 2.5% q-o-q saar in the final quarter of the year from 3.5% in Q3 2014. The composition of growth will probably change compared to Q3, as the surge in defense spending is unlikely to be repeated. We believe that a rebound in real personal consumption will probably support GDP growth, reinforced by better household balance sheets and lower gasoline prices. The recent surge of consumer sentiment to new post-recession highs confirms our view for higher overall consumption growth ahead. As far as investment is concerned, the September decline in core capital goods orders and shipments –the main input for equipment and software- sets a hurdle for business investment acceleration in Q4. Moreover, the recent stabilization of housing demand and the pace of home price appreciation after the slowdown earlier in the year are indicative of an improving outlook for residential investment. In addition, the contribution from net trade to overall GDP growth is expected to be less positive, given weaker global growth and the normalization in net exports reported in Q3.

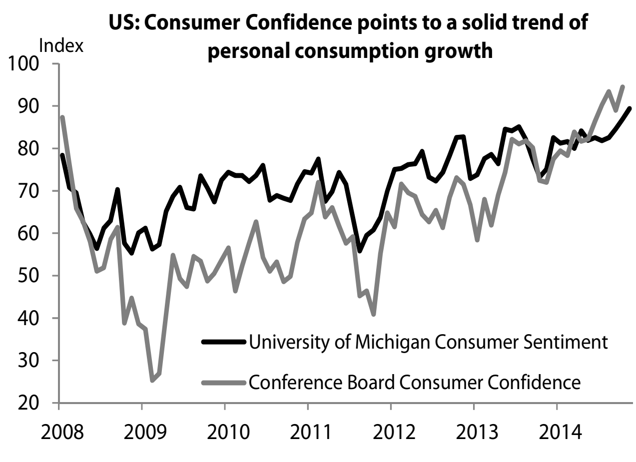
Overall, we expect real GDP to grow by about 2.2% y-o-y in 2014, the same growth rate achieved in 2013. An acceleration of real economic activity towards a growth rate of about 3.0% is expected for 2015, above the potential rate of growth which is estimated at merely 2.0% due to lower productivity growth and population aging. The strengthening recovery towards 2015 is reinforced by the waning negative effect of fiscal consolidation, improving financial conditions, an accelerating labor market and a continuing recovery in the housing sector. Risks to our US outlook could arise from renewed political controversy concerning federal fiscal policy issues, or a sudden increase in price inflation that could lead to an unexpected rise in interest rates. As far as risks from the external environment are concerned, a severe deterioration in global growth or a sharp rise in oil prices due to geopolitical tensions could have a substantial negative effect on US growth.

Figure 1.3



Source: US Bureau of Economic Analysis, Eurobank Research estimates

Figure 1.4



Source: The Conference Board, ThomsonReuters/University of Michigan

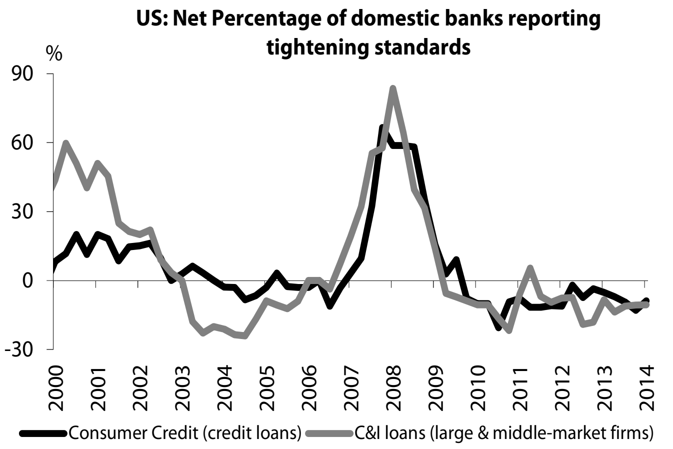
Upside surprise in Q3 GDP growth due to defense spending and net trade

According to the advance estimate of the Bureau of Economic Analysis (BEA), real GDP increased by 3.5% q-o-q saar in Q3 2014 -beating market expectations- after an annualized increase of 4.6% in the second quarter of the year (Figure 1.3). The upward surprise to our expectations came from government spending, which increased by a robust 4.6% q-o-q saar, contributing 0.83 pp to real GDP growth. This strong contribution by the government sector was largely driven by federal defense spending, which reported its largest quarterly increase (+10.0% q-o-q saar) in more than five years, suggesting that the drag from government spending has eased significantly. In addition, net trade made a significant positive contribution, adding 1.3 pp to real economic activity after two consecutive quarters of negative contribution. Domestic private sector was relatively weaker, as business investment growth decelerated to 5.5% q-o-q saar in Q3 from 9.7% in Q2 and residential investment slowed significantly to 1.8% q-o-q saar from 8.8% previously. Moreover, personal consumption growth was on the softer side, decelerating to 1.8% q-o-q saar from 2.5% in Q2 and, therefore, contributing 1.2 pp to real output growth. Inventory investment was a substantial drag, subtracting 0.6 pp from real GDP growth, as the change in private inventories came back to more normal levels compared to the previous quarter. All in all, final sales increased by 4.2% q-o-q saar, reporting their best performance since Q4 2010. Nevertheless, excluding the strong government sector, final sales to private domestic purchasers rose at a more modest rate of 2.3% q-o-q saar.

Personal consumption and residential investment should accelerate in the following months

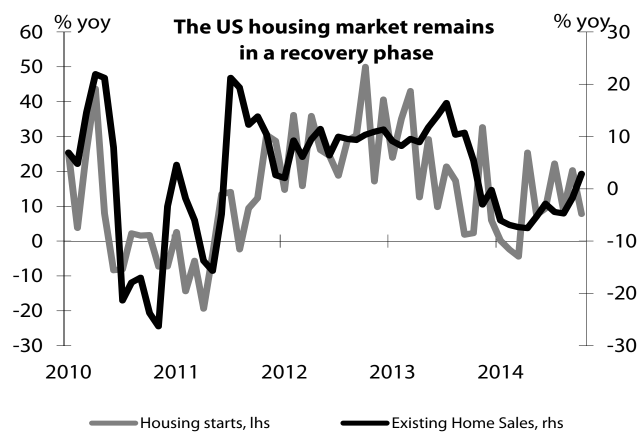
Although residential investment and personal consumption expenditures were relatively weak in Q3, the underlying pace of private domestic demand points to solid momentum in the final quarter of the year. Looking ahead, the Conference Board's index of US consumer confidence rose at its highest level since October 2007, to 94.5 in October from an upwardly revised level of 89.0 in September, with broad based advances in the present situation and consumer expectations components. Furthermore, consumer sentiment of the University of Michigan surged to 89.4 in the preliminary November reading from 86.9 in October, boosted by further gains in economic conditions and consumer expectations as well (Figure 1.4). Meanwhile, October core retail sales that feed into GDP rose 0.5% m-o-m, following an upwardly revised 0.0% monthly change in September (-0.2% m-o-m previously), putting consumer spending growth on a fairly solid trend. According to our estimates, real personal consumption growth should accelerate to 2.5% q-o-q saar in the final quarter of the year from 1.8% in Q3, boosted by the recent decline in gasoline prices, the improvement in the labor market and the easing of credit standards (Figure 1.5), unless there is a further increase in the personal savings rate. We believe that the negative effects from global demand deceleration and a stronger dollar on US economic activity will be offset by stronger private domestic demand, including stronger US consumer demand.

Figure 1.5



Source: US Federal Reserve

Figure 1.6



Source: US National Association of Realtors, US Census Bureau

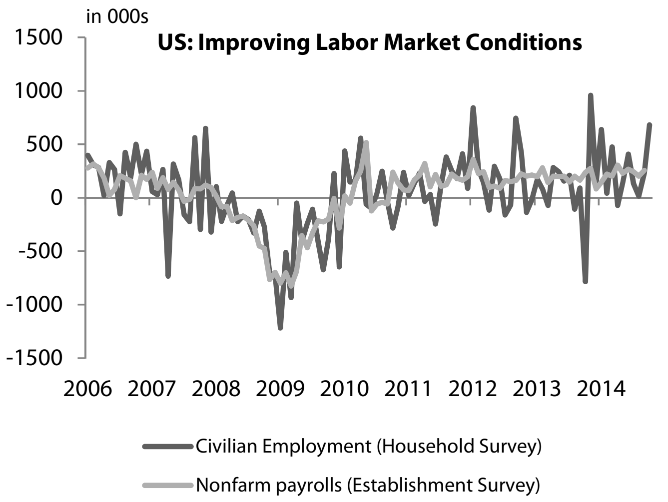
Furthermore, as the negative effects of the mortgage rates increase and the unusually bad winter weather on the housing recovery evaporate, we expect upside momentum for the housing sector. US existing home sales have been on upward trend in recent months, while the significant increase in building permits over the last couple of months suggests that the housing starts decline reported in

October should be reversed in November (Figure 1.6). In addition, the NAHB housing market index of homebuilder sentiment reversed most of the October decline and rose to 58 in November from 54 in the previous month, pointing to a continuing recovery in homebuilding activity in the following months. The October 2014 Senior Loan Officer Opinion Survey on bank lending practices revealed easier lending standards for residential mortgages, although demand for nontraditional residential mortgages was moderately weaker. We expect the housing sector to remain in a recovery phase, with residential investment growth accelerating to roughly 8.0% q-o-q saar in Q4 from 1.8% in Q3 2014.

Improving labor market conditions should gradually translate into price increases

Solid job creation since the beginning of 2014 has resulted in a decline in the unemployment rate below 6.0%. The participation rate has been unchanged since October 2013, as the re-entrance of previously discouraged workers into the labor force has been offset by further retirements among the baby boomers. After an impressive 250k average monthly gain in the past six months, total nonfarm payrolls grew by 214k in October with upward revision in September's reported payroll gain. As far as the household employment survey is concerned, civilian employment rose by a firm 683k in October (Figure 1.7), leading the unemployment rate down by one-tenth to 5.8%, below the FOMC's central tendency of 5.9-6.0% in Q4 2014 (September projections). Meanwhile, the Fed's update to the Labor Market Conditions Index (LMCI), which incorporates data through the end of October, revealed greater improvement in labor market conditions over the past six months than previously estimated[1]. Furthermore, the Job Openings and Labor Turnover (JOLTs) report has shown that unemployed job seekers for each job opening has fallen to 2.0 over the last couple of months, which is down significantly from the level reported at the beginning of the year, suggesting that labor market slack is on a downward trend, albeit not at its pre-crisis level (1.4 in March 2007, see Figure 1.8). As the US economic recovery strengthens, monthly job gains are expected to remain buoyant, bringing the unemployment rate down to 5.2% by the end of 2015, around the natural rate of unemployment.

Figure 1.7



Source: US Bureau of Labor Statistics

Figure 1.8

Source: US Bureau of Labor Statistics

Despite the accelerating recovery in labor market conditions, price inflation is still below the 2.0% Fed's target and wage growth has remained subdued over the last two years. After its recent peak of 2.1% y-o-y in June 2014, the headline CPI inflation came in at 1.7% y-o-y over the last three months due to falling energy prices, reporting a 0.1% m-o-m cumulative decline through August-October. Following flat readings in recent months due to lower commodity prices and the dollar appreciation, core prices came in stronger than

[1] The LMCI is a newly introduced tool used by the Fed to assess changes in labor market conditions. The LMCI is derived from a dynamic factor model of 19 labor market indicators to extract a single index variable. The LMCI is derived from the Kalman smoother, meaning that the estimate of the index in any particular month is the model's best assessment given all past and future observations. Thus, when a new month of data is added to the sample, the model will revise its estimate of history in response to the new information. In practice, these revisions tend to be modest and concentrated in the most-recent six months of the sample.

expected in October, increasing by 0.2% m-o-m mainly due to core services inflation. Core prices are expected to pick up only gradually towards 2.0% in 2015, as there will be upward pressures from reduced slack in the US economy (primarily to the prices of services) and rising shelter inflation (rents and owners' equivalent rent).

Following the end of QE3, the first rate hike is data dependent

As expected[1], the FOMC announced the end of its third in a row quantitative easing program (QE3) at the end of October 2014, as the Committee recognizes "gradually diminishing" rather than "significant" underutilization of labor resources. Job gains were described as "solid", while the assessment of household spending was kept unchanged, reporting that it is increasing at a moderate pace. It should be noted that the Fed did not reiterate the phrase that fiscal policy is restraining growth, but it did mention risks emanating from the dollar appreciation or weak global growth, but with limited effects on US growth.

Although the Fed expects that inflation will be held down by "lower energy prices and other factors" in the short-term, it acknowledges a diminished likelihood of inflation running persistently below the 2% target compared to the beginning of the year. Nevertheless, the Committee does note that market inflation expectations have declined somewhat, while survey based measures of longer-term inflation expectations have remained broadly unchanged. That said, it seems that the Fed is not actually worried about the plunge in market-based inflation compensation measures, provided that the plunge is not accompanied by a decline in household or professional forecaster surveys.

The Fed's forward guidance continues to ensure that interest rates are expected to be kept at the current near-zero level for a considerable time following the end of the asset purchase program at the end of October. Underlying the data-dependence of the timing of the first rate hike, the FOMC pointed out two risks relative to this view by saying that interest rate hikes could come later if progress towards the Committee's employment and inflation targets proves slower than projected, or sooner if progress towards Fed's dual mandate is faster than currently expected. This guidance was actually similar to the one used by Chair Yellen at the September post-meeting press conference.

Overall, the October FOMC policy statement does not change our view that the FOMC will proceed with the first rate hike in mid-2015, responding to the improving labor market and economic conditions. The only dissenter for Fed's October decisions was Minneapolis Fed President Kocherlakota, who favored a continuation of the asset purchase program and stronger commitment to keep fed fund rates unchanged until the one-to-two year ahead inflation outlook has returned to 2.0%.

[1] See Kosma O. (2014), "US Fed: Faster convergence toward the Fed's mandate could prompt earlier tightening", Eurobank Research, Global Economic and Market Outlook Focus Notes, August 28.

2. The euro area economy

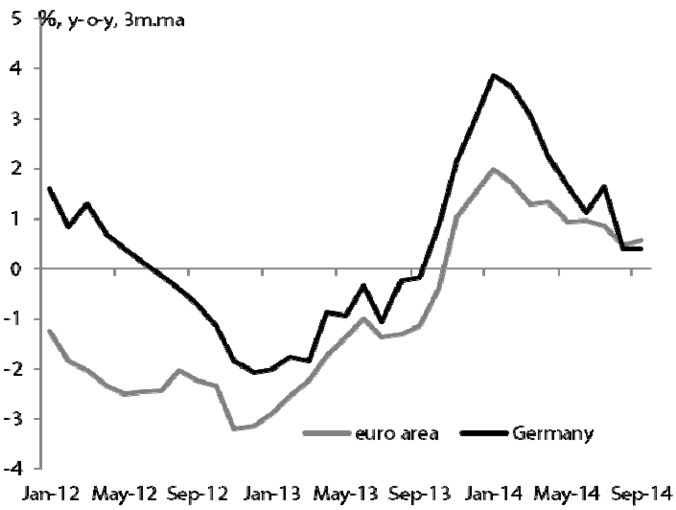
Vasilis Zarkos

- Euro area economic growth is expected to ratchet up in the course of 2015, on the back of robust external demand, weak currency, accommodative monetary policy and easier financial conditions.
- It is encouraging for the euro area economy that focus has shifted to a more growth-friendly policy mix, with the proposal of measures to prop up investment and create jobs. Action should be bold and timely on this front. However, political discord may lead to a tenuous outcome.
- Sluggish economic performance and poor structural reform implementation in France and Italy pose risks of financial turmoil in the euro area.
- Inflation is expected to remain low for a protracted period of time. Outright deflation should be averted by a weaker currency, the ECB's readiness to defend price stability and a moderate rise in demand.
- We expect the ECB to broaden its asset purchase program due to anemic economic outlook amidst prevailing downside risks, failure to increase its balance sheet materially by existing measures and persistently low inflation.

The euro area economy should gain some momentum in 2015, albeit remain fragile

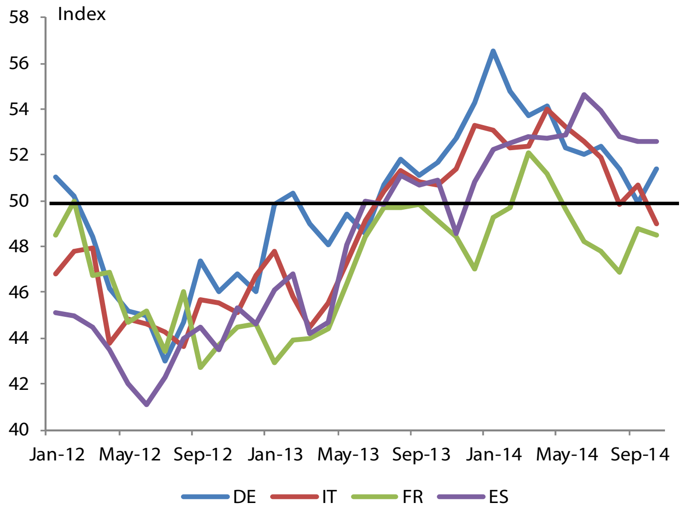
The euro area GDP grew slightly faster (0.2% q-o-q) than expected (0.1% q-o-q) in the third quarter, due to higher French GDP growth (0.3% q-o-q). Despite the upside surprise, economic activity remains lackluster (Figure 2.1), as lingering headwinds thwart growth. Weakness has been observed in all major economies, including Germany, where data indicate a wobbling economy. Leading indicators reveal that economic sentiment proved disappointing (Figure 2.2), pointing to protracted weakness in the final quarter of the year. Given that the economy has failed to gain momentum as envisaged earlier in the year, we have lowered our forecast of annual real GDP growth in 2014 to 0.8%, down from 1% in July.

Figure 2.1
euro area: industrial production ex construction



Source: Eurostat

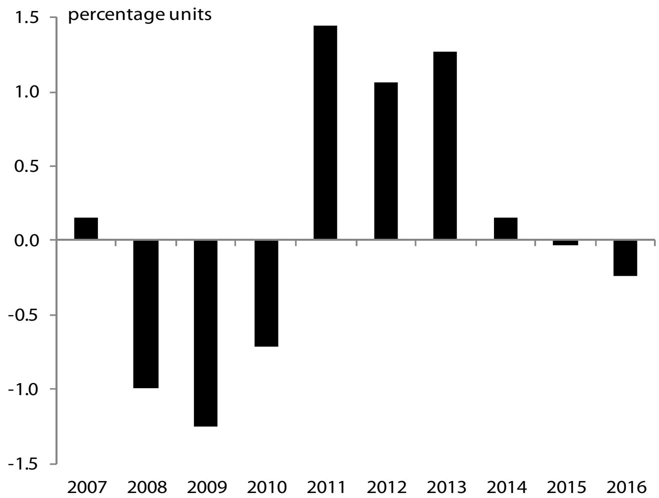
Figure 2.2
euro area: PMI manufacturing



Source: Bloomberg

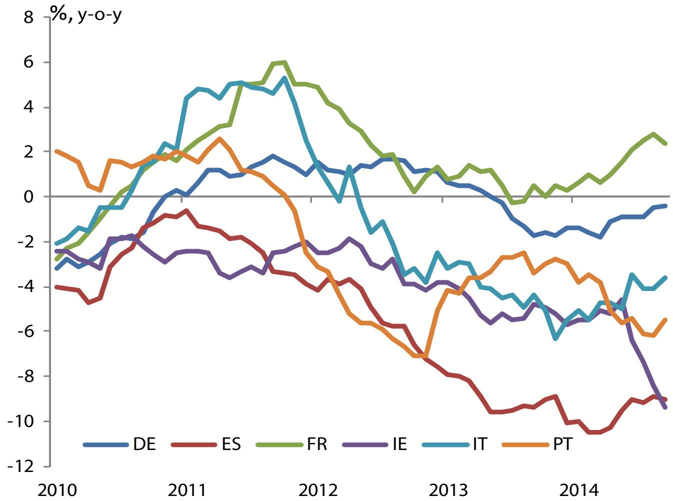
Looking ahead, we expect the euro area GDP growth rate to ratchet up in the course of 2015, on the backdrop of moderate fiscal consolidation, accommodative monetary policy, improved government borrowing conditions, slowly improving employment, enhanced confidence in banks' balance sheet as result of asset quality review, support from stronger global growth and some pay off from structural reforms in program countries. In particular, euro area exports are expected to benefit from robust growth in the US and the UK, where about 24.5% of total exports of goods are oriented. Moreover, the depreciated euro is expected to promote competitiveness of euro area exports. Monetary policy divergence between the ECB, the Fed and the BoE suggests that the euro depreciation will be sustained. Moreover, the drag from the fiscal effort is projected to be modest, relative to the retrenchment observed in the aftermath of the financial crisis (Figure 2.3). Finally, German domestic demand should be bolstered by strong fundamentals.

Figure 2.3
euro area: annual change of cyclically adjusted general government budget balance



Source: Ameco

Figure 2.4
euro area: credit growth to non-financial companies



Note: Data are adjusted for sales and securitization except for Italy.
Source: ECB

On the negative side, persistent drawbacks are expected to put a lid on euro area economic activity. Financial fragmentation, elevated unemployment, subdued business sentiment and ongoing deleveraging are expected to keep domestic demand constraint. Amidst persistent uncertainty, companies will opt for keeping capital expenditures subdued. In a similar tone, households are expected to keep consumption modest on the back of moderate wage growth, high unemployment and depletion of savings. Overall, we expect the annual economic growth rate to accelerate modestly in 2015 to 1.1%.

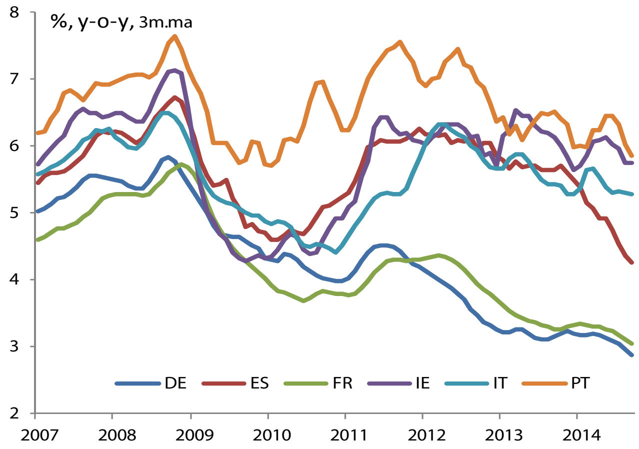
Lending conditions in the periphery remain tight

Tentative signs of a turnaround in credit growth in the euro area as a whole have arisen. However, aggregate data mask huge differences between core and periphery (Figure 2.4). Lending rates to companies remain divergent (Figure 2.5), though a strong downward trend in Spain should be noted. Good performance in the recent EBA/ECB stress tests and increased transparency in banks' balance sheets may reduce banks' reticence to expand their loan portfolio. However, economic risk perceptions and muted demand imply that loan shrinkage coming to an end is a more likely outcome than robust credit growth. In Q3 2014, European banks reported an easing of credit standards for loans to enterprises for the second quarter in a row. However, easing comes after a long period of tightening that started in Q3 2007, while it has been observed mainly in France, Italy and Germany.

Inflation is expected to rise very gradually; deflation should be avoided

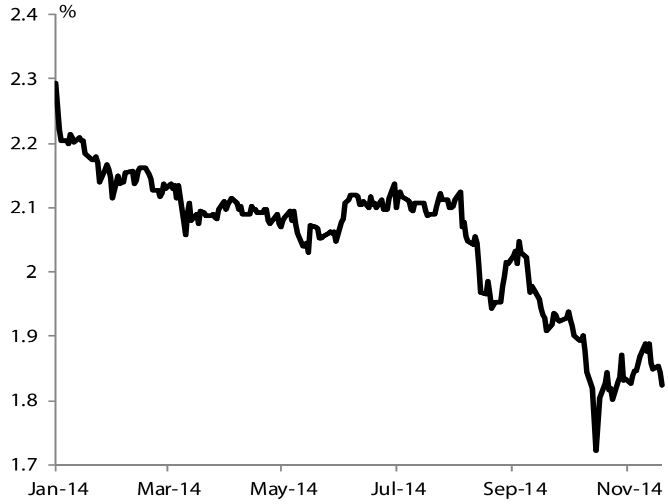
Headline inflation may have bottomed out in September (0.3% y-o-y). Looking forward, it is expected to remain low and rise only very gradually in the remainder of the year and in 2015. The economic slack is expected to keep price pressures muted, as both wage growth and firms' pricing power are constrained. Low commodity prices will also keep inflation subdued. Moreover, a likely pick up in structural reform momentum in Italy and France may pull down services inflation, putting a lid on inflation of the euro area as a whole.

Figure 2.5
euro area: lending rates to SMEs



Note: Rates refer to new business loans up to €1mn and with maturity over 1 year and up to 5 years, typical features of loans to SMEs
Source: ECB

Figure 2.6
euro area: 5Y5Y inflation swap breakeven



Source: Bloomberg

The risk of deflation lingers, fueled by loss of growth momentum, anemic economic prospects and persistently low inflation printings. Low inflation has its own detrimental effect on growth, as it results in higher real interest rates which hamper demand and investment. On the fiscal front, elevated real rates erode public debt sustainability. Nonetheless, in our baseline scenario, outright deflation should be averted on the back of a pickup in economic activity. Moreover, confidence on the readiness of the ECB to take additional course of action, if needed, is expected to keep long-term inflation expectations in check. Finally, the depreciation of the euro is exerting upward pressure on import prices, counterbalancing falling energy prices.

On a positive note, policymakers acknowledge the need to boost demand

In an environment of low growth and dire unemployment conditions, it is encouraging that the debate among policymakers has focused on measures to prop up domestic demand and create jobs. We fully endorse president's Draghi view that measures to strengthen demand should complement supply side measures and monetary policy initiatives. On the demand side, European Commission's president, Jean-Claude Juncker, will push through his proposal of a EUR300bn investment package, while governments agree on the improvement of investment conditions as a means to sustain demand. Discussions to stimulate investment should yield concrete and timely plans in order to support growth and employment and amplify the positive impact of structural reforms. On the supply side, policymakers should remain committed to structural reforms and cost cutting measures, necessary to unleash potential growth and buttress debt sustainability.

However, implementation risk on the supply side persists

In this context, a major source of domestic risk to our economic outlook stems from failure of policymakers to increase momentum in undertaking structural reforms. Reform fatigue poses implementation risk, while low borrowing costs increase complacency with respect to tackling deep-seated growth impediments. Furthermore, the rapid rise of euro-skeptic political parties in view of the 2015 electoral cycle in Greece (March), Portugal (September) and Spain (December) increases reticence of weak government coalitions to abide by fiscal discipline and carry out unpopular reforms. Yet, maintaining the momentum of adjustment reforms is crucial to enhance debt sustainability, bolster economic confidence and avoid sliding into entrenched stagnation. France and Italy in particular, will defer achievement of a balanced budget until 2017 in exchange for bold structural reform commitments. Weaker than expected macroeconomic conditions and/or failure to provide reform momentum could fuel concerns over the debt sustainability of these members and trigger a new bout of financial strains, most likely propagating to other weak countries.

In the external environment, geopolitical tensions pose downside risks to European growth prospects. In the Ukraine front, a final solution remains distant. The faltering of the Russian economy due to sanctions has spill-over effects to business sentiment among European exporters. An escalation of the crisis would provoke harsher sanctions and retaliating measures, taking a bigger toll on euro area production. In the Middle East region, intensification of the strife could cause energy disruptions, leading to a higher energy burden on households and companies.

The ECB is expected to broaden its asset purchase program in 2015

Faltering economic activity and de-anchoring of long-term inflation expectations led the ECB to embark on balance sheet management in order to boost inflation. In particular, the ECB intends to increase its balance sheet by about 1tn through a four-year lending program for euro zone banks (TLTROs) and purchases of private assets, currently involving covered bonds and ABS. However, size constraints and regulation impediments[1] in these asset classes cast doubts on the ability of the ECB to expand its balance sheet to the target of about €3tn. Additionally, the asset purchases may not work through the credit expansion channel, as intended. This is due to the fact that the asset purchases (as well as the TLTROs) may do little to appease banks' capital adequacy concerns. Moreover, the clout of the measures to alleviate borrowing conditions for SMEs, the category of firms most reliant on bank credit, is curtailed by the small size of the SME ABS and elevated risk pertaining to SMEs. Market-based metrics of inflation expectations (Figure 2.6) illustrate investors' concerns about the effectiveness of currently announced measures to ring-fence price stability.

With this in mind, and in view of our subdued economic and inflation outlook, we believe the ECB will eventually upscale its basket of the asset purchase program by expanding the set of asset classes and/or buying riskier assets within these classes. Auguring well for a broadened asset purchase program, in its November meeting, President Draghi underscored the Governing Council's unanimous agreement to alter the size and the composition of its unconventional interventions. President Draghi cited two contingencies for further action: failure to expand the balance sheet materially and failure to prop up inflation expectations. We expect both to be triggered.

The purchase of public debt seems to offer the best chances for a sizable increase of the ECB's balance sheet. In such a case, the observed euro depreciation would be most efficiently sustained. Public debt purchases would also convey the strongest deflation fighting signal, leading to a material shift in longer-term inflation expectations. However, political hurdles over full blown QE keep the bar for large-scale purchases of government bonds high, implying that a significant deterioration of the outlook is required to trigger sovereign QE. In any case, we do not expect additional asset purchase programs to be announced before year end, as the ECB will allow time to assess the effectiveness of the measures already in place.

[1] See Zarkos V. "ECB: TLTROs, covered bond and ABS purchases; intermediate steps towards full-blown QE", Eurobank Research, Global Economic and Market Outlook Focus Notes, September 30.

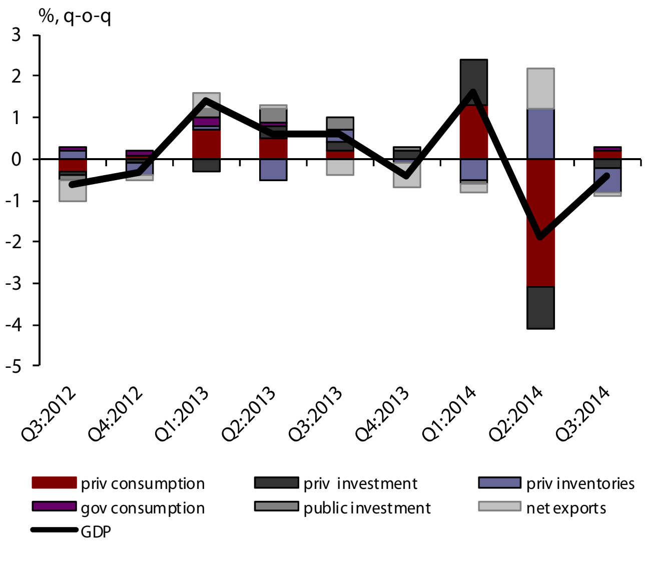
3. The Japanese economy

Vasilis Zarkos

- A rebound in private demand post the consumption tax hike, accommodative monetary policy and solid external demand are expected to bolster Japan's economic activity.
- However, economic growth is expected to be tepid, as households' consumption is constrained by diminishing real wages and net exports are expected to contribute marginally to GDP expansion.
- Achieving a sustainable 2% price stability remains challenging. The BoJ is expected to continue its asset purchase program until at least 2016, when inflation is forecasted to hit the 2% target. Additional monetary easing is expected, if inflation dynamics falter.
- The country's growth, inflation and debt dynamics rely on successful implementation of structural reforms. In the external environment, risks to our economic outlook stem mainly from lower than expected global demand, a new bout of financial tensions and an escalation of geopolitical turmoil.

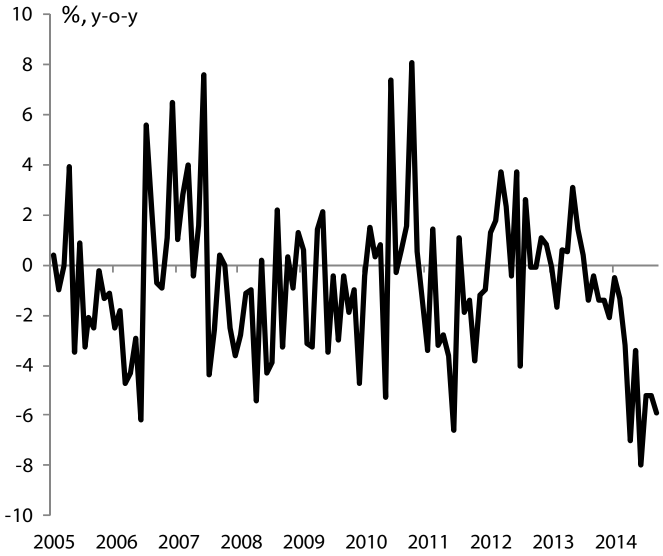
The Japanese economy slipped into a technical recession in Q3 (Figure 3.1), as GDP contracted by 0.4% q-o-q, contrary to a consensus view of expansion by 0.5% q-o-q. Depletion of private inventories and elevated imports were the sources of the negative surprise. Private demand rebounded softly in Q3 after a sharp contraction due to the VAT hike in April from 5% to 8%, which threw GDP growth into negative territory in the second quarter. In light of the economic malaise, PM Abe deferred the second VAT hike from 8% to 10% scheduled for October 2015 to April 2017, as the hike was contingent on continued economic strength. He also called for early elections in the Lower House in December and ordered fiscal stimulus worth ¥3tn to boost personal consumption.

Figure 3.1
Japan: Contributions to quarterly GDP growth



Source: Cabinet Office

Figure 3.2
Japan: Households' real disposable income



Source: Ministry of Internal Affairs and Communications

The Japanese economy is struggling to heal after the VAT hike, which took a heavier than expected toll on the economy. Looking forward, private spending is expected to support growth. A rebound in the Economy Watchers survey, a survey reflecting front-line workers' expectations, after suffering a drop in April, corroborates our view. Retail sales are on an upward trend, after the plunge triggered by the consumption tax hike.

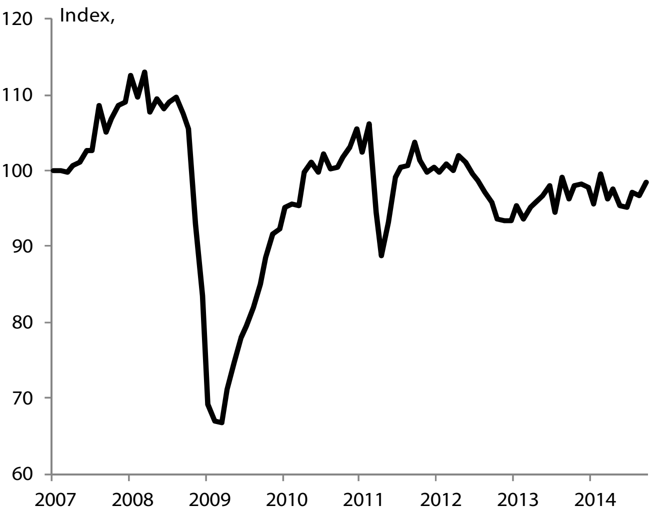
Furthermore, core machinery orders (i.e. orders excluding ships, electric power companies and mobile phones) as well as industrial production show signs that a recovery from the post-VAT hike payback has started to appear. A rebuilding of inventories is expected to propel GDP growth in the last quarter of the year. Real exports rose by 2.8% in September after two successive falls. Exports are expected to exhibit sustained growth due to solid external demand and yen depreciation.

Favourable global demand should support gross fixed capital formation. A glut of corporate profits and cheap borrowing bode well for a sustained contribution of capital expenditures to economic expansion. In line with this, the September BoJ Tankan survey revealed that large companies planned to increase their capex by 8.6% y/y in FY14, revised up from June's 7.4%.

On the negative side, growth momentum is expected to be contained due to unfavourable conditions with respect to real disposable income (Figure 3.2) and marginal contribution from net exports. Real disposable income is contracting as a result of rising headline inflation, increasing energy costs due to weaker yen and employers' reticence to increase nominal wages, eroding household's purchasing power. With respect to exports, JPY depreciation has failed to lead to a strong rebound in export volumes (Figure 3.3). Besides a moderation of growth in emerging economies, structural factors are also at play, concerning relocation of production overseas and contracts not being denominated in yen. Coupled with depreciated currency and elevated energy imports, net exports are expected to have a lacklustre contribution to GDP growth. Overall, the economy is expected to recede to a lower growth trajectory relative to the period 2012-2013, with GDP forecasted to grow by 0.5% in 2014 and 1.1% in 2015.

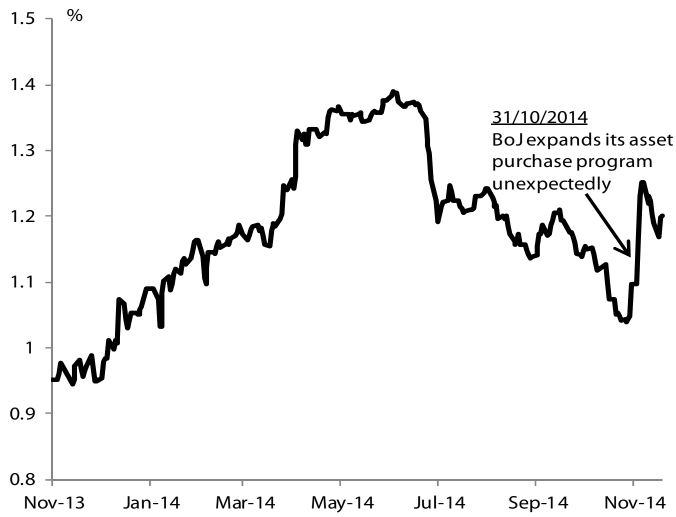
Achieving the 2% price stability target remains challenging. CPI ex food, the Bank of Japan's (BoJ) preferred metric, stood at 1% in September, after factoring out the BoJ's calculation of a +2.0 pp boost from the April VAT hike. Inflation expectations (as measured by the 10-year breakeven rates) have failed to embark on a clear upward dynamic, remaining well below 2% (Figure 3.4). Declined energy prices put downward pressure on inflation. Price pressures from consumption are expected to remain modest, as real wages have failed to rebound. Onerous dismissal conditions discourage firms from increasing wages, illustrating the importance of structural reforms in order to achieve sustainable 2% price stability.

Figure 3.3
Japan: Real exports



Source: Bank of Japan

Figure 3.4
Japan



Source: Bloomberg

As it became evident that the 2% inflation target would not be achieved by March 2015, as initially envisaged, the BoJ expanded its asset purchase program (QQE). In particular, the BoJ increased the annual pace of expansion of the monetary base to ¥80tn from ¥60tn, mainly by accelerating the purchases of JGBs, to around ¥80tbn from ¥50tn. It also extended the average remaining maturity of the JGB purchases by 3 years to about 7-10 years, in an attempt to influence interest rates over a wider spectrum. Moreover, the BoJ refrained from committing to a timing target for attaining the 2% inflation target, shifting to an open timeframe. The rational behind the ease was that somewhat weak developments in demand following the consumption tax hike and a substantial decline in crude oil prices have been exerting downward pressure on inflation dynamics. The BoJ is expected to continue its asset purchase program until at least 2016, when the Bank expects to hit its inflation target. Even then, the BoJ is likely to continue QQE in order to keep interest rates in check. President Kuroda has left the door open for additional action along the way, if inflation fails to rise as intended.

Domestic risks to our economic outlook stem mainly from a reticent approach in undertaking structural reforms essential to boost Japan's potential growth, ensure sustainable price stability and enhance the country's precarious debt dynamics. In June, the Japanese PM announced a series of reform proposals. Proposals have languished ever since. A modest economic outlook and likely reduction of the government coalition's political power after the Lower House elections in December bode ill for carrying out structural reforms in the period ahead. In the external environment, risks to the Japanese economy stem from lower than expected global growth, financial turmoil triggered by weakness in Europe and/or by the Fed exit strategy and higher energy prices due to an escalation of geopolitical tensions.

III. Macro Forecasts

Real GDP growth						
	2012	2013	2014f		2015f	
			Eurobank	Consensus	Eurobank	Consensus
US	2.3	2.2	2.2	2.2 (1.8 – 3.3)	3.0	3.0 (1.5 – 4.2)
EA	-0.7	-0.4	0.8	0.8 (0.5 – 1.0)	1.1	1.2 (0.7 – 1.6)
Japan	1.5	1.5	0.5	0.9 (0.4 – 1.3)	1.1	1.0 (0.5 – 2.0)
China	7.7	7.7		7.4 (7.0 – 7.5)		7.0 (6.5 – 7.7)
Russia	3.4	1.3		0.3 (-0.6 – 0.8)		0.6 (-2.5 – 1.7)
Brazil	1.0	2.5		0.3 (-0.1 – 1.5)		1.1 (-0.3 – 2.5)

Inflation						
	2012	2013	2014f		2015f	
			Eurobank	Consensus	Eurobank	Consensus
US	2.1	1.5	1.7	1.7 (1.5 – 2.5)	1.6	1.8 (0.9– 4.4)
EA	2.5	1.3	0.5	0.5 (0.4 – 0.7)	0.9	0.9 (0.5 – 1.5)
Japan	0.0	0.4	2.8	2.8 (2.7 – 3.0)	1.5	1.9 (1.1 – 2.5)
China	2.7	2.6		2.1 (2.0 – 3.0)		2.5 (1.4 – 3.4)
Russia	5.1	6.8		7.5 (7.0 – 8.9)		7.0 (6.0 – 9.3)
Brazil	5.4	6.2		6.3 (5.5 – 6.5)		6.3 (5.5 – 7.0)

Note: Range of forecasts by Bloomberg's survey in parentheses below point estimates.

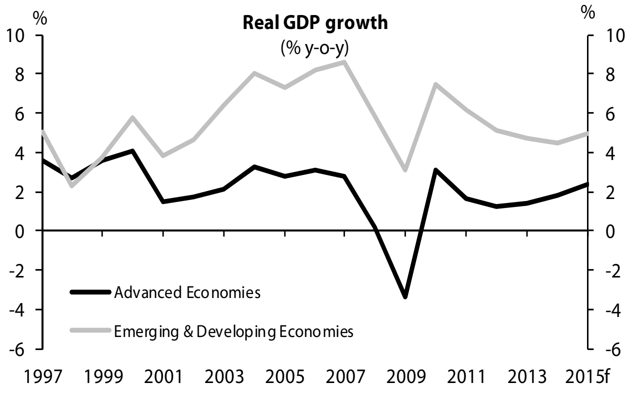
Policy Rates					
	Current	Q4 14f	Q1 15f	Q2 15f	Q3 15f
US	0.00 – 0.25	0.00 – 0.25	0.00 – 0.25	0.25 – 0.50	0.50 – 0.75
EA	0.05	0.05	0.05	0.05	0.05
Japan	0.10	0.10	0.10	0.10	0.10
China*	5.60	5.60	5.60	5.60	5.60
Russia*	9.50	9.00	9.00	8.50	8.50
Brazil*	11.25	11.50	12.00	12.00	12.00

*Bloomberg forecasts

IV. Graphs

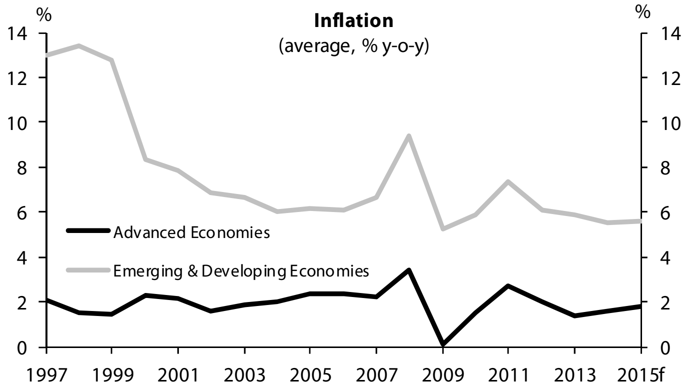
Global Economic Indicators – World Economy

World Economy

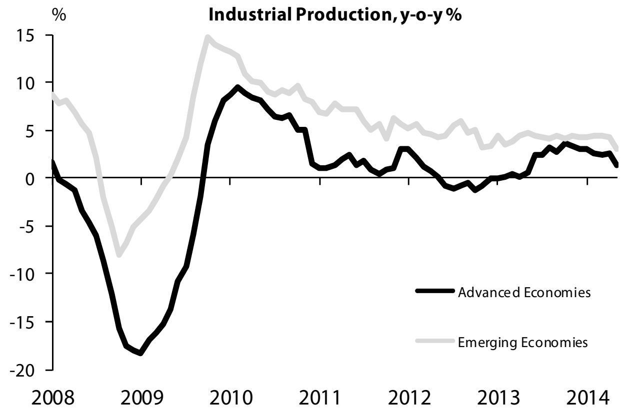


Source: IMF

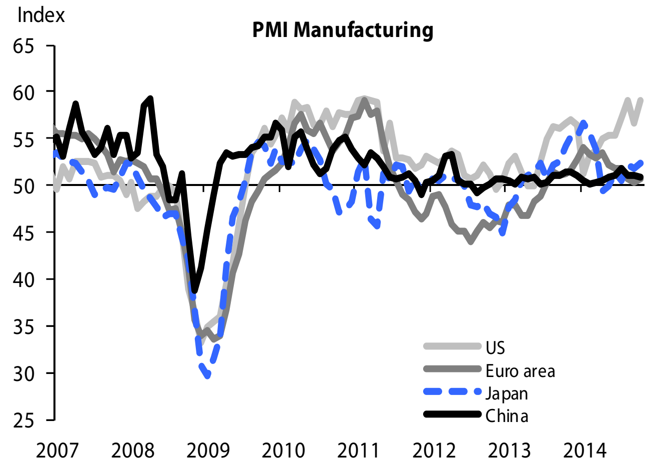
World Economy



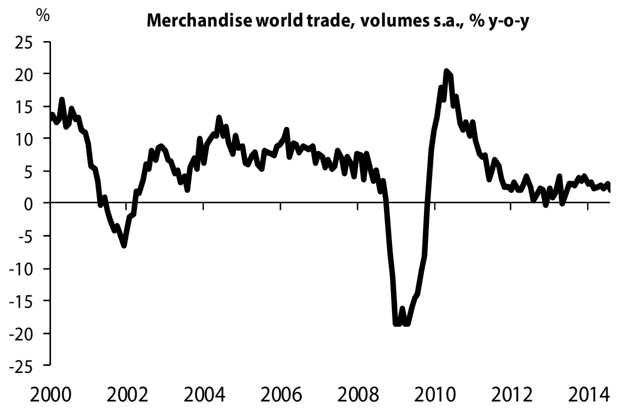
Source: IMF



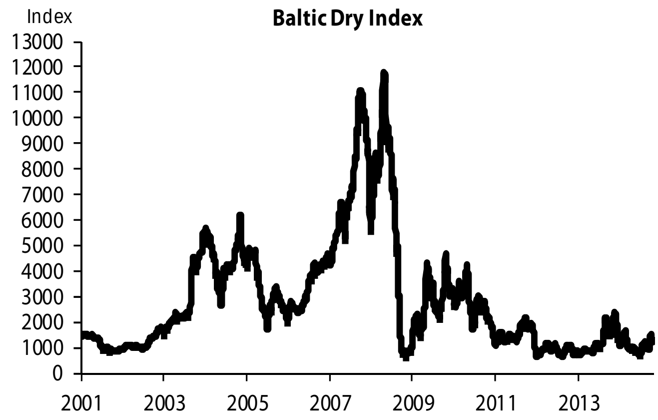
Source: CPB Netherlands Bureau for Economic Policy Analysis



Source: Bloomberg



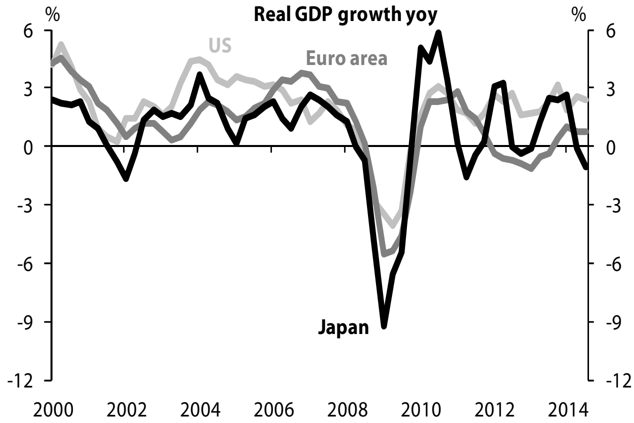
Source: CPB Netherlands Bureau for Economic Policy Analysis



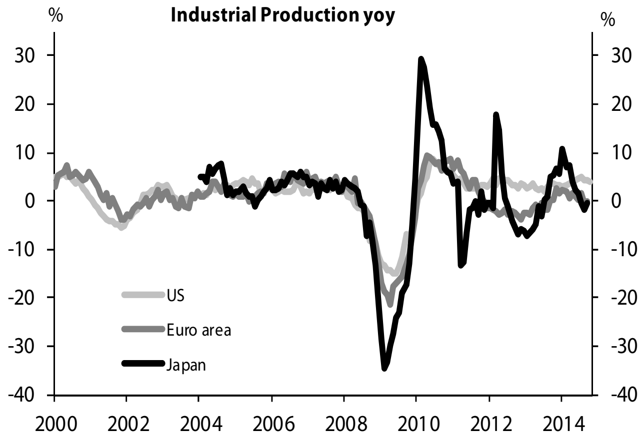
Source: Bloomberg

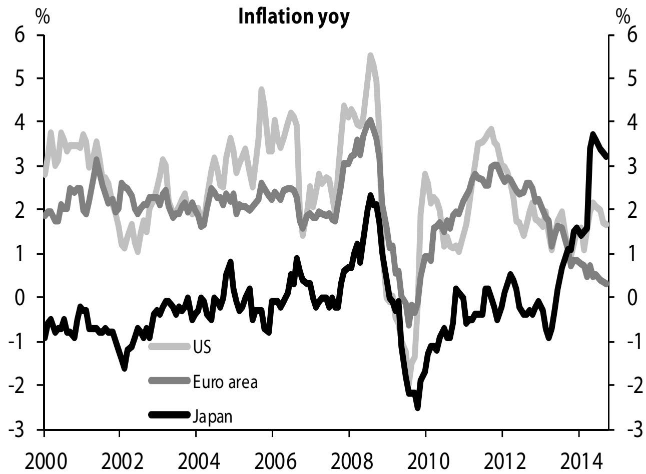
Global Economic Indicators

Advanced Economies



Emerging Economies

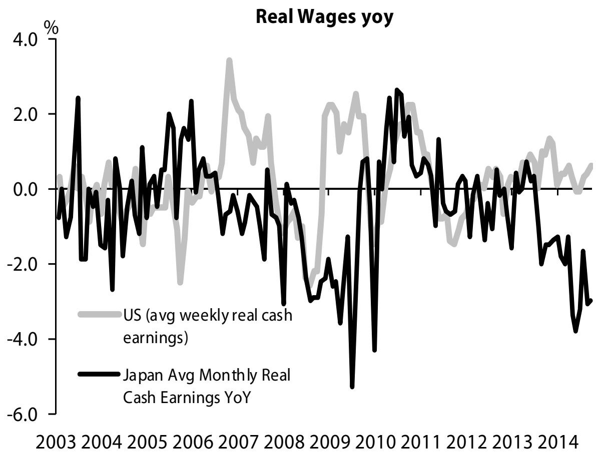




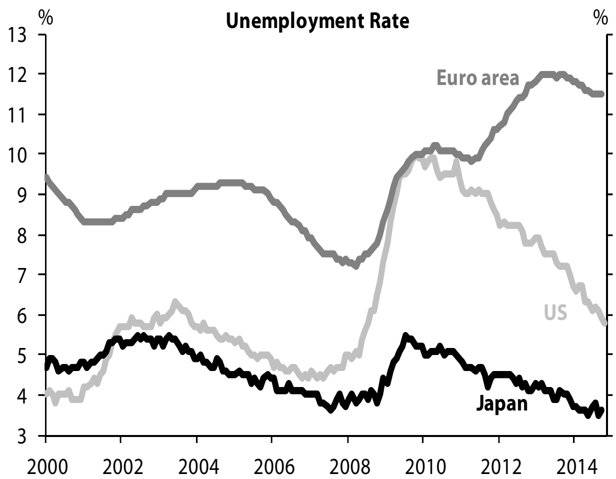
Source: Bloomberg, Ecowin

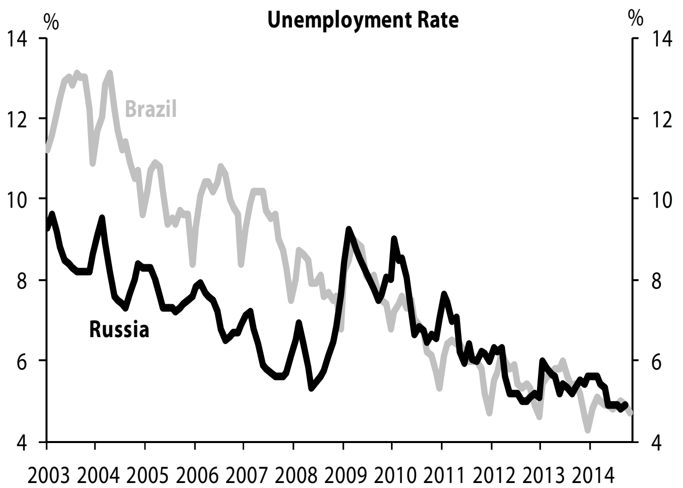
Global Economic Indicators

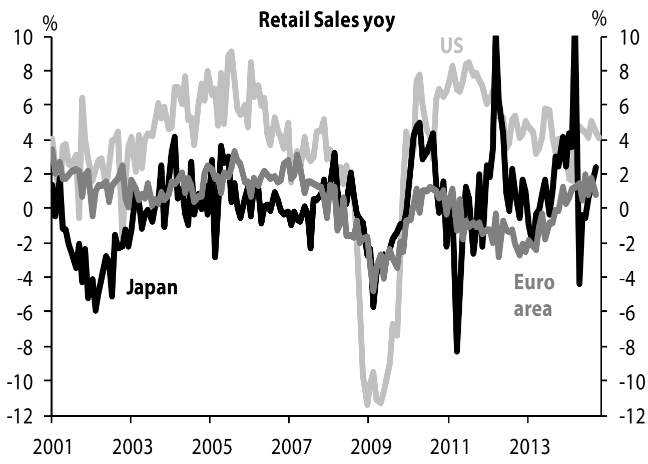
Advanced Economies

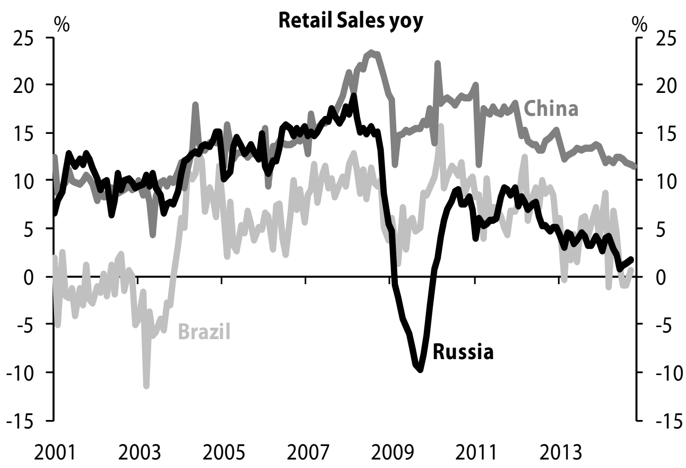


Emerging Economies





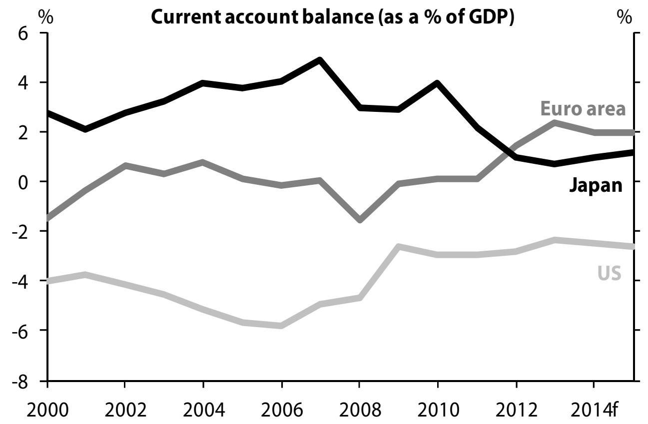




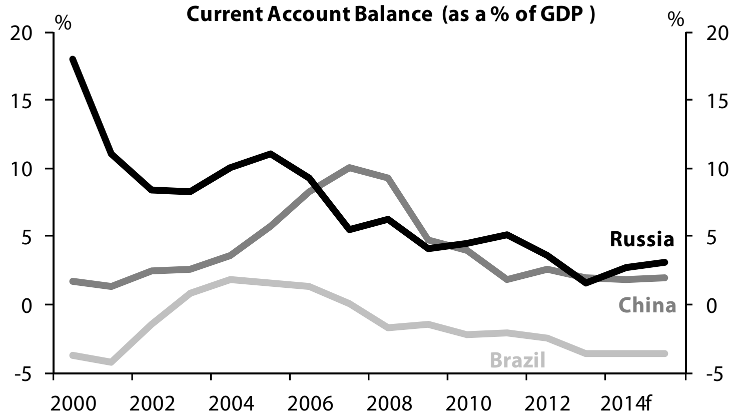
Source: Bloomberg, Ecowin

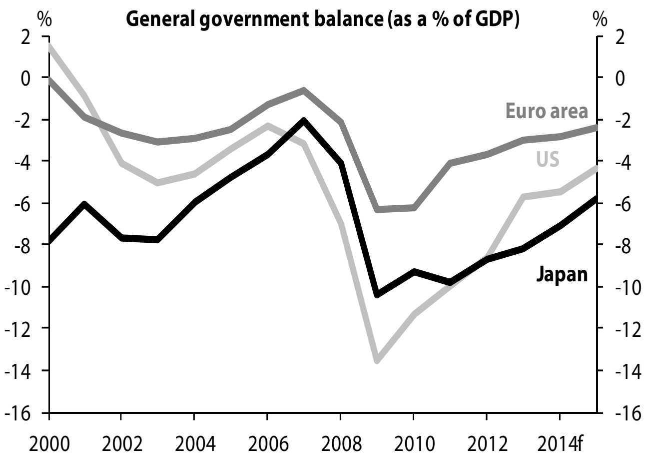
Global Economic Indicators

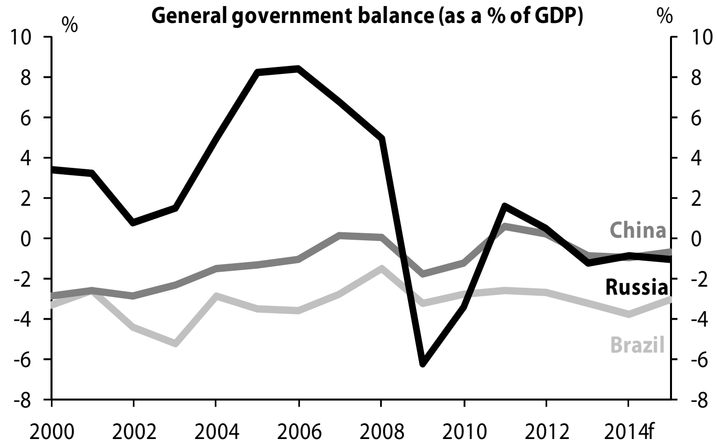
Advanced Economies

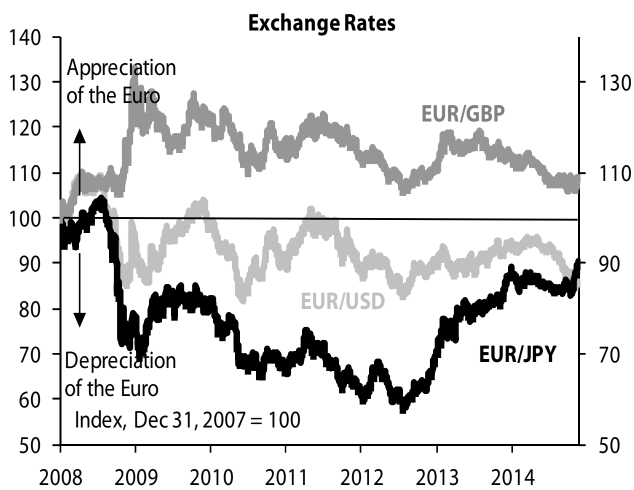


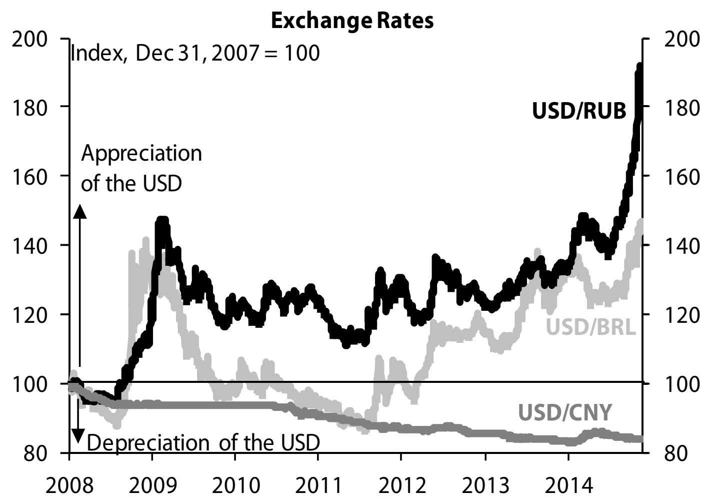
Emerging Economies











Source: Bloomberg, Ecowin, IMF, Eurobank Research

Global Equities & Sector Performance

Total Return (%) as of November 19, 2014

Global Equity Indices (in local currency)

Region	Index	Last Price	1w	1m	6m	12m	YTD
US	S&P 500	2048.7	0.5	7.6	9.4	15.0	10.8
EURO AREA	DJ Euro Stoxx 50	3123.1	2.2	6.7	-1.3	2.5	0.5
GERMANY	DAX	9472.8	2.4	8.7	-1.7	2.9	-0.8
FRANCE	CAC 40	4266.2	1.9	6.9	-4.2	-0.1	-0.7
UK	FTSE 100	6696.6	0.9	6.9	-1.5	0.2	-0.8
JAPAN	Nikkei	17288.8	-0.6	14.4	22.8	14.7	6.1
CHINA	CSI 300	2537.2	-1.6	3.4	19.9	4.6	8.9
INDIA	SENSEX	28032.9	0.3	6.1	15.0	35.9	32.4
RUSSIA	MICEX	1518.0	1.7	10.3	6.5	0.6	0.9
BRAZIL	IBOV	53402.8	0.8	-1.7	2.0	0.7	3.7

Source: Bloomberg

Sector performance as of November 19, 2014

Asia Sector Indices (in USD)

Asia – S&P 50 Index*	Last	1w	1m	6m	12m	YTD
1. Consumer Discretionary	11404.7	-2.3	1.2	-2.8	20.3	-2.4
2. Consumer Staples	14813.5	1.7	6.1	18.4	17.3	14.5
3. Energy	13688.5	-0.4	-0.9	15.2	14.3	8.8
4. Financials	4166.8	0.3	1.8	7.5	21.1	3.0
5. Industrials	3241.7	-1.9	-1.8	2.5	15.3	0.4
6. Information Technology	14112.5	-0.5	1.9	15.5	21.0	11.3
7. Materials	3798.1	-2.6	0.6	-0.7	3.5	-5.9
8. Telecommunication Services	2750.7	2.0	2.7	4.6	-1.9	1.0
9. Utilities	4102.3	0.0	0.7	11.3	1.5	8.1

Source: Bloomberg, Ecowin

Global Equities & Sector Performance

Sector performance as of November 19, 2014

European Sector Indices (in €)

Europe - DJ Stoxx 600	Last	1w	1m	6m	12m	YTD
1. Consumer Discretionary						
Automobiles & Components	745.5	2.3	7.9	-6.9	1.8	-1.1
Travel & Leisure	363.3	0.7	10.7	6.1	20.4	11.7
Media	458.5	1.6	9.8	7.8	8.3	4.7
Retail	555.9	1.5	10.1	-4.6	-5.7	-5.5
2. Consumer Staples						
Food & Beverage	951.6	0.1	7.5	4.6	10.9	12.3
Personal & Household Goods	1118.2	0.1	8.4	2.8	8.4	9.2
3. Energy						
Oil & Gas	677.3	1.4	4.5	-11.3	-3.2	-3.2
4. Financials						
Banks	401.7	1.8	2.9	-2.3	3.4	0.5
Financial Services	722.3	-0.1	10.3	4.2	14.1	6.6
Insurance	451.6	1.5	9.3	9.0	14.8	10.3
Real Estate	157.5	0.7	7.6	6.4	15.0	15.6
5. Health Care	1118.7	0.8	7.8	10.3	23.1	21.8
6. Industrials						
Industrial Goods & Services	669.4	0.2	7.9	-2.7	0.7	-2.4
7. Information Technology	292.5	1.4	9.6	7.0	3.5	0.7
8. Materials						
Basic Resources	741.0	-1.9	-0.1	-5.7	-2.9	-1.3
Chemicals	1424.5	1.9	9.0	0.3	7.0	3.9
Construction & Materials	589.0	1.4	7.8	-6.6	5.9	3.2
9. Telecommunication Services	696.6	1.7	14.3	6.9	12.6	9.6
10. Utilities	761.9	1.4	5.1	3.5	17.3	17.0

Source: Bloomberg

Sector performance as of November 19, 2014

US Sector Indices (in USD)

US – S&P 500	Last	1w	1m	6m	12m	YTD
1. Consumer Discretionary	551.6	1.5	7.3	9.7	9.0	4.1
2. Consumer Staples	498.7	1.3	6.9	10.5	13.1	12.7
3. Energy	630.9	-0.4	3.2	-7.4	-0.9	-3.2
4. Financials	324.0	-0.3	7.1	10.9	14.2	9.9
5. Health Care	789.2	0.6	10.2	17.4	25.7	22.9
6. Industrials	485.3	0.2	9.1	7.2	13.3	7.3
7. Information Technology	684.2	0.8	9.6	14.3	24.9	16.9
8. Materials	312.5	1.3	4.9	3.8	12.4	7.2
9. Telecommunication Services	162.3	-0.1	3.9	2.6	2.9	4.4
10 Utilities	231.0	0.3	4.2	10.1	18.4	19.5

Source: Ecowin

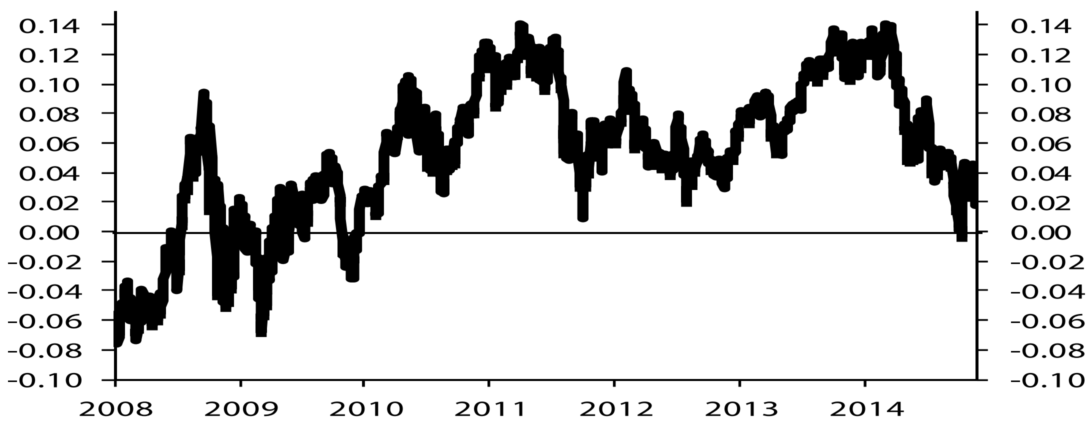
US Style Equity Indices

Total Return (%) as of November 19, 2014

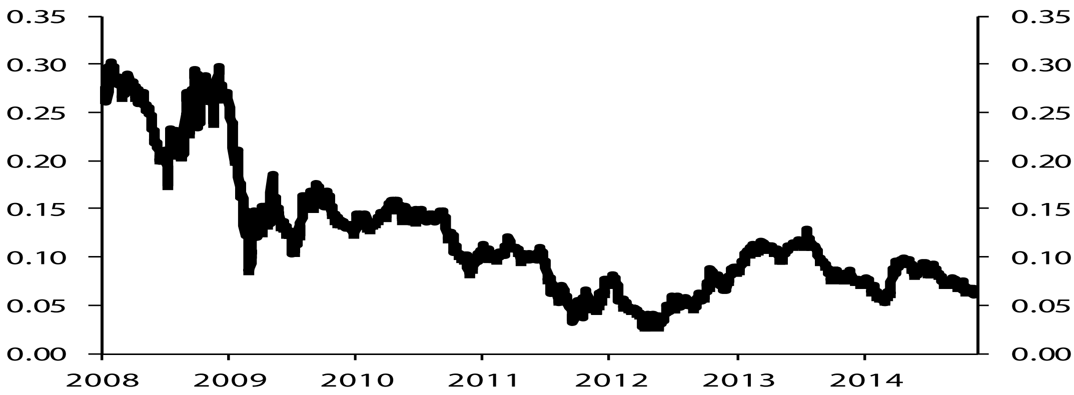
US Style Indices (in USD)

Index	Last Price	1w	1m	6m	12m	YTD
Russell 1000 (Large Cap)	1138.1	0.4	7.5	9.0	14.9	10.5
Russell 2000 (Small Cap)	1157.7	-2.4	5.7	5.4	5.3	-0.5
Relative performance (Small vs Large)		-2.9	-1.8	-3.6	-9.6	-11.0
Russell 1000 Value	1020.5	0.5	7.3	7.7	13.6	10.0
Russell 1000 Growth	958.0	0.4	7.7	10.4	16.1	10.9
Relative performance (Value vs Growth)		0.0	-0.4	-2.7	-2.5	-0.9

Relative Performance (small vs large)
(logarithmic scale)



Relative Performance (value vs growth)
(logarithmic scale)



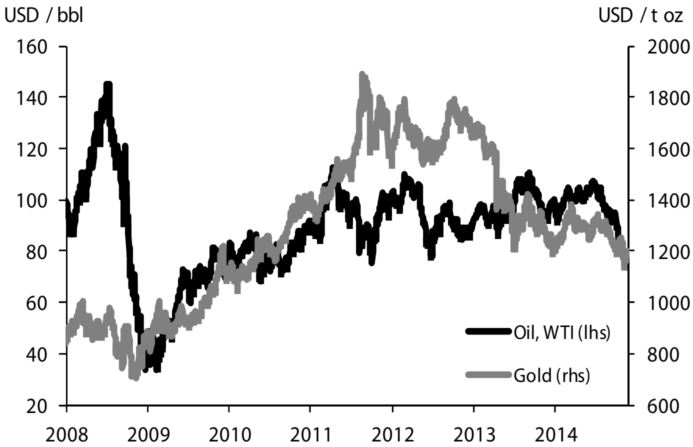
Source: Bloomberg

Commodities

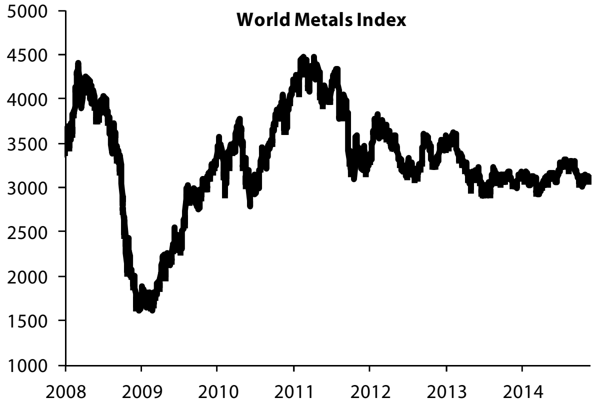
Commodity Performance (%) as of November 19, 2014

Commodities							
	Units	**Last Price**	**1w**	**1m**	**6m**	**12m**	**YTD**
Oil (WTI Crude Oil)	USD/bbl	74.6	0.5	-9.8	-27.2	-20.1	-24.2
Gold	USD/t oz	1193.9	2.8	-4.0	-7.8	-5.1	-0.7
Base Metals							
World Metals Index		3106.2	0.4	2.3	-0.9	2.4	-1.7
Aluminium	USD/lb	2020.0	-1.9	2.4	13.9	12.6	12.2
Copper	USD/mt	6685.0	0.1	0.7	-3.5	-4.1	-9.2
Lead	USD/mt	2031.0	-0.9	0.1	-5.7	-2.8	-8.5
Nickel	USD/mt	16145.0	3.4	2.8	-19.7	18.5	16.2
Zinc	USD/mt	2254.0	-1.2	0.2	7.8	18.9	9.7
Agriculture							
Corn	USD/bu	363.3	-6.0	4.3	-23.3	-12.9	-13.9
Soybeans	USD/bu	1004.8	-4.6	5.5	-18.8	-13.2	-11.9
Wheat	USD/bu	537.8	-2.9	4.7	-19.8	-16.9	-11.2

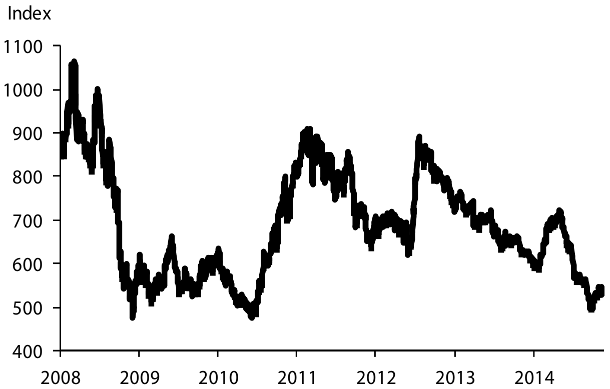
Oil & Gold



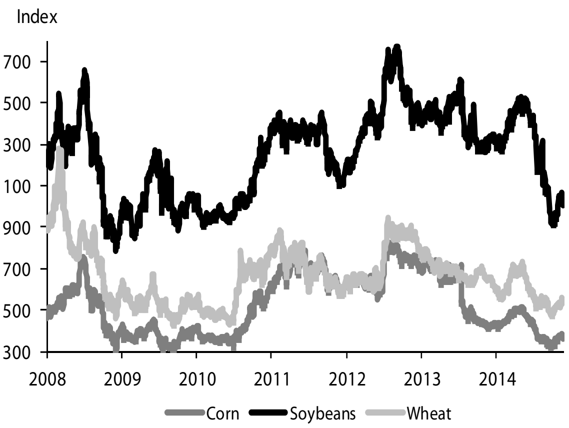
World Metals Index



Agricultural Index



Agricultural Indices



Source: Bloomberg, Ecowin

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