Q-Review 2/2014

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Growth with a shadow of a doubt

- According to our forecasts, the world economy is turning to a path of more robust growth during this year.
- We forecast that this year the real GDP will grow 0.9 percent in the Eurozone and 1.6 percent in the U.S.
- The growth is impended by the risk misallocations caused by central bank interventions.
- The growing risk of war may trigger a global financial turmoil.

World economy has entered a strange new phase. Interventions by central banks have effectively underpriced the risk of several assets classes while at the same time economic fundaments have improved marginally and some have even deteriorated. The values of common risk measures, like the Chicago Board Options Exchange Market Volatility Index (VIX), have reached levels not seen after the first half of 2007. Demand for different collateralized products, like collateralized loan obligations (CLO's), has increased, implying that the investors accept more risk to get reasonable profit. At the same time, more leverage was used. What makes these tendencies worrisome is that periods of low volatility and high risk have frequently preceded financial crashes. News of "deaths" of some sovereign bond markets has been troubling as the volume of trade has collapsed due to massive central bank interventions.

Increasing leverage in high risk products is not an imminent threat, unless there is *trigger* for safety. As always, the timing or the nature of these triggers are nearly impossible to forecast exactly. Currently we can see few plausible triggers. One such trigger is war. Economic hardship usually paves road for political extremes and nationalistic ideas. Sovereign nations looking way out may even resort to use of military power. Potential hotspots are:

- Iraq – ISIS
- Arab spring
- Some nations left in turmoil / Syria
- Sunnis vs. Shias
- China/Vietnam - territorial waters/oil
- China/Japan - territorial waters
- Rise of Nationalistic / anti-EU parties in EU
- Thailand
- China - Russia –cooperation

Every hotspot, if escalated, has potential to deliver a big blow to the world economy. To become a trigger for safety, escalation of conflict needs to be in a level where it either has disrupting effect on the world economy (e.g., oil price shock) or it causes a belief that it will become a major event for the global economy. While the former maybe somewhat controllable through global politics (up to point at least), the latter is beyond any political control, because central banks cannot stop wars. If there would be a scare among investors about the fallout of the escalation of some conflicts, central banks would have little chances of stemming the panic, especially as their policy tools are almost exhausted at the moment.

Globally, there are several troubling trends in the markets. The yields of the "former" crisis countries of Europe have reached the level not seen since 2007 while their debts keep rising. Some sovereign bond markets have also "died" or paralyzed. This is one of the unintended consequences of central bank's interventions. If the price of an asset does not correspond to the market fundaments and risks, there will be no trade among normal market participants (participants without endless liquidity, like central banks). Yields of CCC-ranked companies have also been decreasing while the global economy has been improving only marginally. The yields of the peripheral countries in Europe have been falling due to the extremely low interest rates currently gripping the money markets. This has led investors to seek profit from ever more risky, low rated corporate bonds which, combined with the lackluster global economic growth, has created an unhealthy investment environment. As interest rates are extremely low, investors looking for a decent profit may only resort to leverage and high risk products. Generally, weak global growth is bad for risky assets, but due to massive government interventions the risk has been mispriced. This creates a cycle of high leverage among high risk products, which feeds to more leverage that was last seen during the period of 2000-2007. One can find evidence of 'carry-trade' where investors borrow long and buy short. If there is a trigger for safety, this setup will lead to a *fire-sale* of assets and a financial panic, once again. According to our estimate, the likelihood of such a triggering event, leading to new global economic crisis, is 20 % during this and next year.

Despite the worrying build-up of instability, there are also reasons for cheer. The U.S. job market looks better, despite the rather sharp (revised) drop in GDP in the first quarter. Chicago purchasing managers index (PMI) is high, consumer spending has steadily increased, and industrial production is growing. In Eurozone, it seems that after a grueling period of austerity several crisis countries are returning to growth. Spain and Portugal have posted a positive GDP change figures for a first time since 2011 and 2010, respectively. The GDP of Greece is still declining but with a diminishing rate and is expected to return to growth next year. The European central bank (ECB) is also considering further stimulus. One of the plans of the ECB is to start buying Asset-Backed Commercial Paper (ABCP) in an effort to try to push banks to lend more. It could help the revival of GDP growth, but with a cost of distorting the markets further.

Still, all is not well in the real global economy. The growth in the U.S. is not yet totally convincing. Money supply has diminished with the accordance of the tapering of the bond purchases by the central bank of the U.S. (Fed). Retail sales have also continued to slump. Most worryingly, the purchasing power (real income) of the middle class has been shrinking for the last five years. The middle class of the U.S. is the most powerful consumer group in the world and thus a decline in their income hurts the recovery of the world economy. Growth in Eurozone is very weak, at best. Unemployment is still almost 12 percent and youth employment is almost 24 percent. The share of non-performing loans in Italy and in many other peripheral countries keeps rising. In addition, the former core countries, Finland and The Netherlands, face problems in achieving economic growth.

In Finland, the problem is more severe than in The Netherlands. In Finland, the GDP has not grown for two years and it still lingers around the same levels as in 2007. Net level of investments (gross investments minus depreciation) has decreased to levels not seen since the depression at the beginning of the 1990's. The government has raised a variety of taxes to combat the budget deficit, which has diminished private consumption and investment activity even further. Due to the increase in the share of the government expenditures of GDP, financed by borrowing, unemployment is still "at bay" with the unemployment rate hovering around 8.5 percent and the youth employment rate being above 20 percent. Although Finland tops many of the studies of competitiveness, she has lost her price competitiveness. Finland is also in the middle of a major structural change due to the outsourcing of the ICT and forestry sectors, which were the back-bone of the economy of Finland in the 1990's and 2000's. Finland has influential labor unions, which makes it very difficult to regain competitiveness through salary decreases. Thus, as internal devaluation is not possible, euro is becoming more and more of a problem for Finland. Finland desperately needs an (internal or external) devaluation to regain her competitiveness in the global markets. Because the exit of Finland from Eurozone is highly unlikely, Finland is at risk of becoming one of the troubled economies in Eurozone within the next five years.

In Table 1, we present the *nowcasts* and the growth forecasts for the real GDP of Finland, the United States and the Eurozone.

Table 1. Nowcasts (nc) and forecasts for the growth rate of real GDP in the US, Eurozone and Finland. Source: OECD, Bureau of Statistics and GnS Economics.

Quarter	Finland	Eurozone	USA
2014:1	-0.36	0.18	-0.25
2014:2 (nc)	0.13	0.19	0.71
2014:3	0.40	0.28	0.50
2014:4	0.24	0.21	0.61
2014	0.2	0.9	1.6
2015	1.4	1.3	2.6

According to our forecasts, real GDP of the U.S. will grow around 1.6 percent this year. Growth in Eurozone will rise a bit from last year (0.5 %), but the economy of Eurozone will still grow at a very modest pace. The GDP of Finland is forecasted to grow by only a tiny pace, so that Finland may well continue in a recession through this year.

Process descriptions

The forecasts reported in this Q-review are based on the statistical modeling methods from the most recent academic research on predicting business cycle fluctuations. Nowcasts refer to the forecasts of the growth rates of the real Gross Domestic Product (GDP) for the current quarter. Nowcasts are needed because the standard measures for the GDP are published after a considerable lag and are typically subject to subsequent revisions, indicating that the coincident state of the economy is always uncertain. Our nowcasts for the current quarter are based on statistical models where all relevant information available at the time of nowcasting is utilized.

The GDP forecasts for longer horizons (over the current quarter) are based on the dynamic forecasting models where forecasts are constructed iteratively. This means, for example, that the three-quarter forecast is essentially based on the two-quarter forecasts and so on. Forecasts are constructed for all three economic areas (eurozone, Finland and the US) indicating that they depend on each other. Finally, note that the forecast scenarios considered in this Q-review are based on the expert view of GnS Economics.

The next Q-review will be published in December 2014.

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