ECONOMIC OUTLOOK

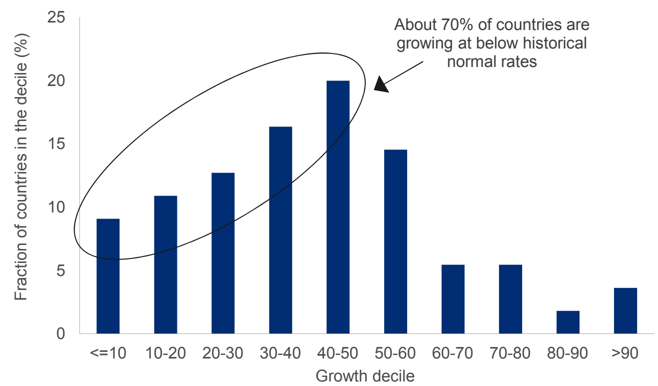
Treading carefully

We continue to tread carefully in a world of slower growth, substantial downside risks and not particularly compelling asset valuations.

Despite higher equities and rising oil prices, global economic growth remains anemic and has slowed somewhat among developed nations. The earnings of U.S. publicly traded companies continue to fall, though there are tentative signs they are about to bottom. Chinese growth – which revived nicely earlier in the spring thanks to the artificial injection of government stimulus – is beginning to fade again.

A few downside risks have ebbed, but the list of threats remains extensive. Particular dangers emanate from a handful of overcooked debt markets. An assortment of Chinese risks and evidence of an aging business cycle also remain significant.

Exhibit 1: Unusually slow growth in most countries



Note: Q4 2015 year-over-year real GDP growth of a country relative to its historical growth from 2001 to Q4 2015. A sample of 55 countries used.
Source: Haver Analytics, RBC GAM

Soft global signals

Global macroeconomic signals remain fairly weak. Most regions of the world have been recording below-average economic growth for many years (Exhibit 1), and what growth there is may be ebbing. Evidence for this downtrend can be found in global purchasing manager indices (indicators of manufacturing sector growth), which have been shifting lower for several years. The developed world signal has deteriorated with particular conviction since the middle of 2015. In contrast, emerging-market nations – having suffered the worst of the decline in prior years – may now be stabilizing at a low base.

Corroborating this indication of slower growth, global trade is now in outright retreat. This is arguably the result of quite a number of different factors, some of them structural in nature (rising competitive parity among nations; trade saturation; China's slowdown), but some of them clearly indicative of weakness in the current economic cycle.

In short, there is the usual mix of conflicting signals, but an overall trend toward soft economic growth.

Rebounding oil

Commodity prices have staged an impressive if only partial recovery in recent months, with oil prices leading the way. Having tumbled as low as US$26, crude is now hovering near US$50 per barrel. There are two main reasons why.

First, the recent period of ultra-low oil prices has triggered a reflex response in both demand and supply. Demand is rising robustly in response to the allure of cheap prices. Meanwhile, supply is reacting to the same incentive by moving downward.

The second reason is a rash of temporary supply outages around the world, including those due to the fires around Fort McMurray. Of course, temporary supply outages are just that: temporary. Oil prices may have to give back a portion of their recent gains in the short run.

Firming inflation

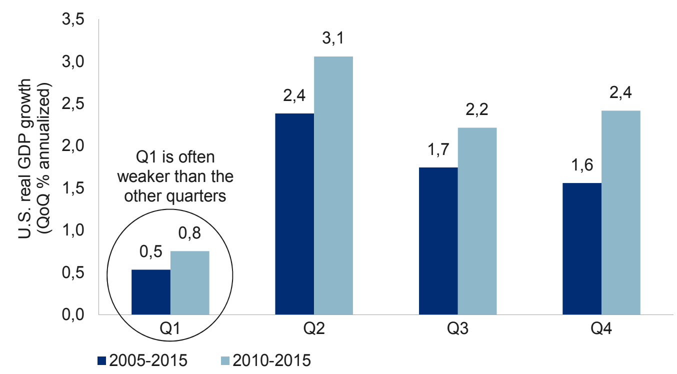
After successfully anticipating below-consensus inflation readings for some time, we are edging our inflation forecasts higher. There are several reasons for this. First and most obviously, commodity prices have rebounded. This bleeds directly into higher inflation.

Second, the underlying trend in core inflation is also visibly firming, and is stronger than many suppose. Core inflation readings are already around 2% in the U.S. and Canada, and trending higher elsewhere in the developed world.

Third, an aging population may well be inflationary rather than deflationary. Notwithstanding the Japanese experience (which was impacted by a range of other factors), a surge in retirees should translate into excessive demand, not excessive supply.

Despite all of this, we stop short of anticipating uncomfortably high inflation.

Exhibit 2: A soft Q1 is normal for U.S.



Source: BEA, Haver Analytics, RBC GAM

Negative rates underwhelm

Given the world's underwhelming rate of economic growth, it is not surprising that many central banks – with the U.S. a notable exception – continue to explore ways to boost growth rates. The remarkable consistency of this effort is reflected in the steady clip at which a relay squad of central banks have been printing money since the financial crisis.

The latest monetary-policy innovation has been to cut policy rates into negative territory. In a narrow sense, this has succeeded: borrowing costs over longer time horizons have fallen to the extent that the Japanese government can now borrow for a brain-bending 10 years and get paid for it.

Canada grapples with resource shock

The Canadian economy has been listless since early 2015, largely due to the negative repercussions of lower oil prices. The latest macroeconomic signals have improved slightly, as they should be given the tentative revival in commodity prices, but are still consistent with subpar economic growth. Economic growth should improve over the second half of 2016 and into 2017 as higher commodity prices and government infrastructure spending kick in. That said, oil prices are still too low to spur capital investment from moribund levels, so any recovery should be tepid.

The Fort McMurray wildfires will likely result in a second-quarter GDP contraction due to lower oil production, though the subsequent quarter should recoup the lost ground.

Canada's housing market remains white hot in the key markets of Vancouver and Toronto, though more tepid elsewhere. The rate at which home prices are appreciating in these two markets has become almost parabolic. Canada's overheated housing sector would certainly encounter turbulence if interest rates rise and/or when a serious economic downturn occurs.

A third and growing possibility is that home price gains become sufficiently parabolic that they eventually tumble under their own weight or with assistance from regulators. We still view Canada's housing and household-debt excesses as medium-term problems, but it is not outside the realm of possibility that the recent big price increases pull this forward.

Mixed U.S. growth

The U.S. economy continues to emit a barrage of mixed readings. On the positive side, bank lending remains robust and the job market has – until quite recently – exuded strength based on the pace of hiring, accelerating wages and a recovering labour-force participation rate. Second-quarter growth is tracking a significantly better figure than the scrawny 1.1% annualized gain in the first quarter (Exhibit 2) and the latest ISM (Institute of Supply Management) manufacturing and non-manufacturing indices have both rebounded nicely.

Conversely, other leading indicators are lacklustre and the historical relationship between credit spreads and GDP growth suggests that the economy is more likely to stumble than sprint over the next few quarters. It remains to be seen whether the recent pace of growth in bank lending can persist in the wake of a recent tightening of lending conditions. A further headwind is our expectation that the U.S. dollar will begin to strengthen again, imposing another drag on domestic growth and overseas profits.

Eurozone loses momentum

Prior to the U.K. referendum on leaving the European Union (Brexit), the Eurozone economy was clearly growing, with welcome contributions from both core and peripheral members. However, it was probably slowing slightly. This is for the usual set of global reasons, including more difficult financial conditions and greater policy uncertainty. Evidence of tighter financial conditions is apparent in the weakening of Eurozone credit growth after a long acceleration.

Up until the Brexit vote, the euro had been stronger than anticipated, despite a big new round of European Central Bank (ECB) stimulus that combined negative interest rates with a program of corporate bond buying and liquidity injections. The recent resurgence in raw-material prices constitutes a headwind for most of Europe.

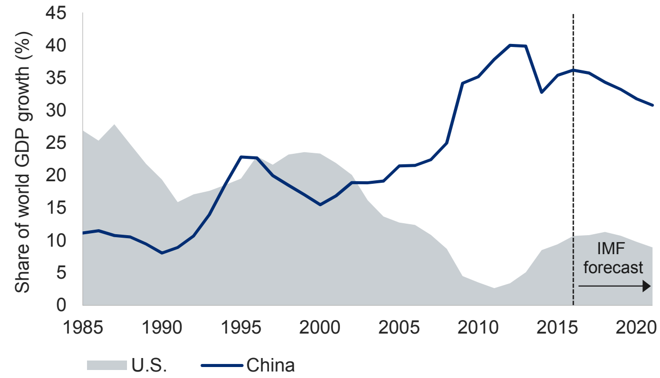
With the "leave" vote, the U.K. is now at greater risk of temporary recession, as financial market declines combined with increased risk aversion stall economic growth in the short run. Note that the U.K. will not actually leave the EU for several years, so this drag is not due to higher tariffs or diminished immigration but rather represents an anticipatory effect by businesses and households. While there are very real economic and financial market consequences that emerge from this decision – mainly, the extent to which financial conditions tighten – the most important developments and risks are political in nature, with Italy looking particularly vulnerable.

The long-term effect is only moderate, but not insignificant. Overall, the impact should be somewhat negative due to higher tariffs, less immigration and the slight diminishment of London as a financial hub. However, the precise effect depends enormously on what sort of subsequent relationship the U.K. negotiates with the EU.

Temporarily resurgent Chinese growth

China has become the world's most important economy to global investors for two reasons. First, it now generates a remarkable one-third of global economic growth, triple the next most important nation (Exhibit 3). Second, the economy looks to be quite fragile at present, relating both to debt excesses and to its wobbly efforts to transition to a consumer-oriented economy. As such, we look for Chinese economic growth to slow to 6.25% this year and to 5.75% in 2017.

Exhibit 3: China generates a dominant share of world growth



Note: 5-year average real GDP growth and 5-year average PPP-exchange-rate-based weights used in calculations. Source: IMF, Haver Analytics, RBC GAM

Historically, China has relied on a high level of competitiveness, the tailwinds of globalization and a high return on capital investment to spur itself forward. As these forces sputtered in recent years, it has papered over the resulting holes with ever-more credit.

The effectiveness of these forces now appears to be in retreat to varying degrees. China has lost a great deal of competitiveness as its wage growth has far outpaced productivity gains. Globalization itself is no longer advancing as quickly and Chinese trade is actually falling after decades of growth. Chinese capital investments are now achieving lower returns and there are clear signs of excess capacity in some sectors, including parts of the real estate market and much of heavy industry. Finally, the ability of Chinese borrowers to repay their debt is becoming more precarious.

Emerging markets bottoming?

Some leading indicators suggest that the multi-year deceleration in emerging-market growth is coming to an end. Given the prior precipitous tumbles of countries like Russia and Brazil, paired with the recent increase in resource prices, it seems plausible that they can mount some sort of recovery in 2017 and beyond. Brazil is also working to orient itself toward a more supportive public-policy environment.

However, faster emerging-market growth shouldn't be viewed as a certainty at the aggregate level: such leading indicators have only limited predictive power beyond the next few months, and we suspect there will be major exceptions to the story, such as in the case of China.

For more on our current view and outlook, please consult the full version of *The Global Investment Outlook* posted on our website at www.rbcgam.com/investment-insights/research-publications.

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