# AQUILA FLASH

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## "Winter is coming" – but not quite yet

**A long but steady expansion keeps recession fears at bay.**
"Winter is coming" is the motto of the Starks, one of the great ruling families on Westeros in the popular TV series, "Game of Thrones". On Westeros, seasons are of indeterminate length. Summer and winter can both last several years and a particularly long summer is generally thought likely to be followed by an abnormally harsh winter. There are parallels between the weather patterns on Westeros and the world economy's business cycle. While Westeros inhabitants fear a harsh winter investors fear a recession as 8 out of 10 bear markets were triggered by a recession. In the last 5 years world economic growth has averaged a mere 2.5% pa., well below the long-term average (3.5% pa.). 7 years have now passed since the great recession of 2008/9 and the world economy is still trudging upwards. Moderation and the depth of the previous recession may well be the keys to this cycle's longevity. With second quarter 2016 growth estimates for the major regions now having been published, it is a good time to make an assessment.

**The US economy has some weak spots.**
The current US economic upswing is now the longest of the 13 expansions since 1945. In terms of the growth rate it is also the weakest. A disappointing growth performance in Q1 (just 0.8% pa.) had led many to expect a significantly better performance in Q2. But the published figure – just 1.2% pa. – indicates some ongoing weakness in an economy which had hitherto been performing fairly well. On the positive side, consumer spending grew strongly at 4.2% pa. but declines in investment and government spending offset this. The recent decline of the ISM Manufacturing index – to 52.6 - does not particularly concern us as this figure is still near a 16-month high. And July data show that the labor market is healthy, the 255'000 figure for new jobs created (outside farming) being stronger than expected. We expect at best moderate US growth over the balance of the year, with some destocking from relatively high inventory levels and some recovery of investment. Given this, the Fed's caution in raising rates is justifiable. Some commentators also link this caution with the upcoming US elections in November. Despite this, the broadly positive flow of macro data, particularly for the labor market, and the recent gains in the price deflator for consumer spending, the Fed's preferred measure of inflation, suggest a September rate rise should not be ruled out. Indeed, we would view further hesitation on increasing rates based on the UK's recent Brexit vote as reliance on an unnecessary excuse and as a negative judgement on the US economy. All in all, the moderate growth path of the US economy suggests that this growth process can still continue but we reduce our growth estimate for 2016 from 2% to 1.8%.

**Growth in the Eurozone has stalled.**
Even before the UK's Brexit vote, the Eurozone economy was weakening. Thus the reported growth rate for Q2 (0.3% on the previous quarter) was half that for Q1 (0.6%), although the decline in growth for the broader EU grouping – from 0.5% to 0.4% – was less dramatic. The second estimates for GDP were somewhat higher, largely because Germany's

Economic Sentiment Index (ESI) has disappointed, falling to levels not seen since November 2012 when Germany was in recession. The ongoing weak data out of France and Italy are no surprise to us. Looking forward, the positive economic impact of euro weakness and low oil prices will tend to diminish toward the year-end. Since its major announcements in March the ECB has not delivered any big surprises and the July meeting fitted this pattern. The Eurozone central bank will wait to assess the impact of the UK's Brexit vote before deciding in coordination with other central banks on any necessary policy adjustments. The Eurozone economy remains weak, with unemployment stubbornly high and inflation well below the central bank's target. So the ECB will still try to stimulate the economy. We expect a decision at the September policy meeting to extend the ECB's QE program to end-2017 but think it unlikely that a further reduction in ECB's key refinancing rates will be announced. We have reduced our 2016 Eurozone growth forecast from 1.5% to 1%.

**The Bank of England has reacted boldly to the Brexit vote.**
The Bank of England has provided further stimulus, for the first time since 2009, in order to offset the economic impact of Brexit. While the cut – from 0.5% to 0.25% – in the Bank's key policy rate was as expected, the announcement of an extension to the Bank's QE program surprised markets. The Bank of England has increased its bond purchase target by £60bn. to £435bn. We expect a further cut in the Bank's policy rate – to 0% – in September. The UK will avoid a recession as the bold and rapid policy response to the Brexit vote will diminish its negative economic impact.

**The Japanese economy stagnates.**
After a surprisingly strong 0.5% growth rate in the first quarter the Japanese economy stumbled in the second quarter, registering a growth rate of just 0.2% on a year on year basis. In particular, Japan‘s export performance was hard hit by the continued strength of the yen. We note, however, that Japan's Manufacturing PMI has improved in July. As widely expected, the Bank of Japan announced further measures of monetary stimulus in July and officials point to synergies between fiscal and monetary policy. Even so, the generally weak economic trends suggest to us that the Bank of Japan's QE program will be significantly increased in September, although we don't expect another cut in interest rates. We forecast Japanese growth at between 0.5% and 0.8% in 2016.

**The Swiss economy seems resistant to crisis.**
In the first half-year Swiss exports reported a nominal growth rate of 5% despite the strength of the franc. The chemicals and pharma sector drove this expansion, offsetting the expected revenue declines in the watch and machinery sectors. The unemployment rate remains stuck at 3.1%, with the evidence suggesting that the Swiss labor market will not improve in the autumn. The KOF indicator for the Swiss private sector rose slightly in July while the Manufacturing Purchasing Managers' index, fell to 50.1 following 2 strong months. Still, it remains above the 50 mark which separates expansion from decline. We forecast Swiss GDP growth at 1% for 2016.

**One should not worry about China.**
Although the overall PMI data don't show improvement investors should not be alarmed. The non-manufacturing PMI index has risen, thanks to the tourism and finance sectors. The various government measures of stimulus are having an effect. Government spending is boosting the economy, offsetting the weakness of private sector investment. Overall, the macro data suggest relatively stable trends over the balance of this year, although officials continue to stress the importance of structural improvement and of rebalancing the Chinese economy. For 2016 we expect a growth rate of at least 6%.

**We forecast global growth of around 3% for this year.**
We forecast that the world economy will grow around 3% this year, an estimate which is slightly below that of the IMF (3.1%). Just as no one on Westeros knows when the first snows will fall, so no one can say when the next recession will start. But the motto of the Starks suggests that one must be prepared to meet the unexpected, whether by "strengthening the North Wall" or by prudently reducing financial risk in a portfolio. We stick with our neutral weighting in equities and would view any significant market setbacks as an opportunity to purchase quality stocks.

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