

Macroeconomic
and Country Risk Outlook

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The 7 dwarfs of global growth



Economic Research

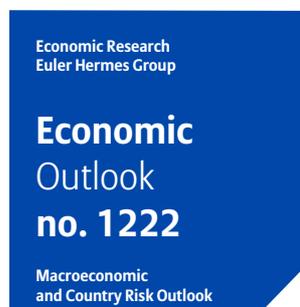


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A bear in the China shop

LUDOVIC SUBRAN

2016 obviously got off to a flying start with another round of fear factors coming all the way from China.

One bad leading indicator coupled with stumbling circuit-breakers sufficed to trigger a stock market and currency carnage and get the planet to worry about China and the world. At Euler Hermes, we have been writing (and talking) about increasing past-dues, non-payments and insolvencies by Chinese companies for the past couple of years. The disconnect between headline macroeconomic figures (and stock markets) and the real economy was obvious and now the question is whether we should all be worried about China.

Yes and No.

Yes because the industrialization phase seems to have come to an end. Traditional manufacturing sectors are plagued with debt (leverage ratios tripled in the past 15 years) and will not start investing again for a long time as profitability has eroded massively and state support will not be automatic anymore.

Yes also because the world needs to find another favorite consumer as Chinese imports continue to decelerate, causing commodity prices, from oil to iron ore, to stay low and neighboring trade hubs to suffer. As a result, countries think about firewalls against contagion, companies about shortening supply chains and people worry about their savings.

(Un)fortunately, exposure to the Chinese risk is quite low in real life. In addition, there are reasons to believe that China can get its acts together, eventually. China can still rely on its

untapped consumers from the rural ones to the urban ones with Western tastes (and savings rates); demand is on the rise for services and high-end products.

More importantly, China has an immense strength; its leadership. As the world finally starts scrutinizing China's every move and that country experiments iterative policy-making, China can turn the tables if it solves its own trilemmas.

First, the currency one; China cannot have a semi-fixed exchange rate, free capital flows and an independent monetary policy.

Second, growth; growth targeting is good but does not work with either quality (deleveraged) growth or with supply-side reforms.

Third and last, the funding one; China has to choose between protecting its balance sheet, continuing its expansionary fiscal policy and playing the trade card once again, with initiatives such as the One Belt, One Road.

These crossroads are important for China; they could restore trust and attractiveness or create more frenzy. In the meantime, China, as well as other hotspots from the future of Europe, to the politics of the U.S., to the Middle East and the Emerging World, it will be yet another VUCA (Vulnerability, Uncertainty, Complexity and Ambiguity) year. This military acronym introduced in the 1990s usually calls for preparedness, anticipation, evolution and intervention. This is where the world does not seem to be in marching order.

So, Happy VUCA Year everyone!

OVERVIEW

The 7 dwarfs of global growth

The global economy will grow at a modest pace in 2016, but there is room for cautious optimism

THE MACROECONOMIC RESEARCH TEAM

+2.8%

real global GDP growth
in 2016

Real GDP growth, annual change, %

	Weight*	2014	2015	2016f	2017f
GLOBAL GDP	100	2.7	2.6	2.8	3.0
Advanced economies	62	1.7	1.9	2.1	2.1
Emerging economies	38	4.6	3.7	4.0	4.5
North America	25	2.4	2.4	2.5	2.4
United States	22	2.4	2.5	2.5	2.4
Canada	2	2.5	1.1	2.0	2.7
Latin America	8	1.2	-0.5	-0.4	1.7
Brazil	3	0.2	-3.7	-2.4	1.2
Western Europe	24	1.3	1.6	1.7	1.8
United Kingdom	4	2.9	2.4	2.1	1.9
Eurozone	18	0.9	1.5	1.7	1.8
Germany	5	1.6	1.5	1.8	1.8
France	4	0.2	1.1	1.4	1.6
Italy	3	-0.4	0.7	1.1	1.2
Spain	2	1.4	3.1	2.6	2.1
The Netherlands	1	1.0	1.9	2.0	2.1
Portugal	0	0.9	1.5	1.7	0.4
Central and Eastern Europe	6	1.4	-0.1	1.5	2.2
Russia	3	0.6	-3.7	-0.3	1.0
Turkey	1	2.9	3.6	3.3	3.5
Poland	1	3.4	3.4	3.5	3.5
Asia	29	4.8	4.8	4.8	4.7
China	13	7.3	6.8	6.5	6.4
Japan	7	-0.1	0.8	1.3	0.8
India	2	7.3	7.4	7.6	7.8
Oceania	2	2.8	2.3	2.3	2.6
Australia	2	2.7	2.3	2.4	2.6
Middle East	4	2.6	2.8	3.4	4.0
Saudi Arabia	1	3.5	3.0	3.0	3.5
United Arab Emirates	1	4.6	3.0	3.5	4.0
Africa	3	3.3	3.4	4.0	4.6
South Africa	0	1.5	1.5	2.0	2.0

*Weights in global GDP at market prices, 2014

Sources: National sources, IMF, IHS, Euler Hermes forecasts



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- In our economic outlook, we explore the 7 dwarfs of the global economy. By these we refer to miniscule drivers of economic growth, including, for example, Sleepy trade and the Happy consumer.
- Beware the Evil Queen of business insolvencies. She may be making an unwelcome guest appearance in 2016. Companies' insolvencies are forecast to rise by +1% in 2016 because of sluggish growth and volatility.
- Fortunately, the Snow White of business investment is finally here.
- In our worldwide analysis we estimate that global growth will remain limited, with no genuine acceleration compared to 2015: +2.8% in 2016 and +3% in 2017.
- Divergence between emerging markets and advanced economies will persist. Emerging markets will experience below-trend growth but are less crisis-prone than in the past.
- The US and the UK are reaching the end of their recovery cycle whereas the Eurozone has clawed its way back into growth.



Waiting for Snow White

The holiday season may be over; but still, don't we all like believing in fairy tales?

Imagine a world economy that lives happily ever after. A world without concerns about a Chinese hard landing or the pace of forthcoming Fed interest rates hikes. A world where geopolitical risk is not pervasive and global trade would resume its role as an accelerator of growth. Imagine financial markets that display a modicum of common sense and stability. Think of a reality where companies and businesses do not fear delayed payments or insolvencies.

Unfortunately, the world we live in is a tad more complicated. Euler Hermes expects global GDP growth to only edge up to +2.8% in 2016 (and +3% in 2017). This would mark the 6th consecutive year of sub-3% global GDP growth.

For the most part, the limited improvement in global growth stems from stabilization in the hardest-hit emerging economies. Brazil and Russia are still in recession but it will be a little less severe.

In any case, we see a continuing divergence between emerging markets and advanced economies. Emerging markets growth probably bottomed out this year and is expected to reach +3.7% in 2015 and +4% in 2016. But most emerging markets will continue to experience below-trend growth, above all those that have not curbed external and internal imbalances. Still, the situation does not portend a repeat of the crises of

the 1990s because emerging markets are more resilient and have more buffers than in the past. All in all, we do not foresee a genuine acceleration next year, and global growth will remain limited. Or as some pundits might describe it - tiny. While overall leverage remains high, growth drivers are - well - too small. Inspired by that fairy tale many of us watched with wide eyes many years ago, in what follows we analyze the real world situation. Introducing the 7 dwarfs of global growth, an investment Snow White and even the Evil Queen of insolvencies.

Dwarf #1: Sleepy trade to open one eye in 2016

In 2015, the volume of global trade in goods and services continued to grow below-trend (+2.7% in 2015, +6% per year over 2000-10). There are few signs of a significant upturn in the medium term.

Negative cyclical shocks have been numerous since the global financial crisis. Austerity measures had a dire impact on demand and intra-regional trade in the Eurozone. Difficult external conditions such as low commodity prices, higher US interest rates and tightening of monetary policy, as well as significant internal macroeconomic imbalances all acted as a drag on emerging markets demand. Brazil and Russia, for example, have been hit hard.

+3.7%

growth in global trade volume, but +0.9% growth in value

More importantly, trade is undergoing significant structural adjustments. First, the integration in global value chains is abating.

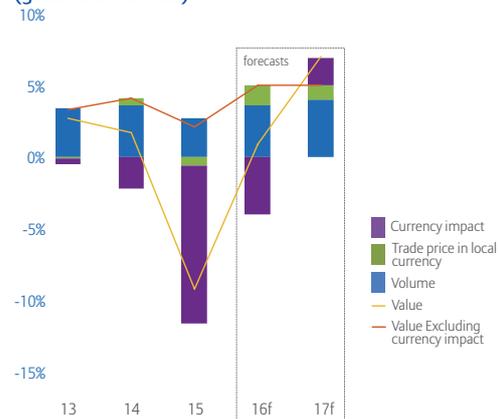
For instance, the comparative advantages of former low-cost countries in South East Asia, and Eastern Europe are disappearing as they mature (e.g., higher wages) or as the cost of automated production decreases.

Second, changes in global demand drivers such as the rise of the emerging markets consumer induce a revamp in global trade flows. China is the overarching protagonist in many of these trends. Its internal rebalancing from industry (investment) to services (consumption) translates into lower sales for primary and intermediate goods suppliers. This has rendered trade growth less responsive to demand growth.

Going forward, we expect a modest acceleration in the volume of global trade in 2016 (+3.7%) and 2017 (+4.0%) (see Chart 1). Growing demand from high-income economies and above all business investment, which is more trade-intensive than consumption, will combine with a progressive pick-up in demand from China. This should allow for a gradual acceleration in global trade.

In value terms, a small upturn is likely in 2016 (+0.9% from -9% in 2015) before a larger increase in 2017 (+7%) as downward pressures on key currencies resume. Price in USD terms will likely continue to contribute negatively in 2016. Key major currencies (EUR, JPY, RMB, e.g.) will depreciate anew against the USD, reflecting diverging monetary policies.

Chart 1 Global trade growth (goods and services)



Sources: IHS, Euler Hermes

Dwarf #2: Will emerging markets remain Grumpy in 2016?

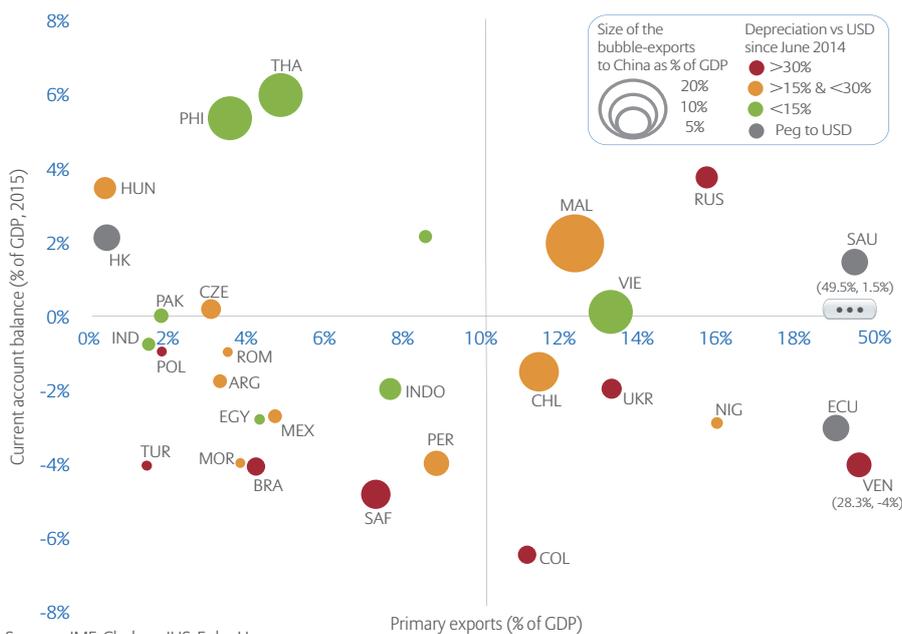
2015 was (again) a very tough year for emerging markets. The double whammy of a slowdown in China and expectations of a Fed rate hike (and thus a stronger USD) translated into plummeting commodity prices and currencies. This was too much to bear for most countries. Although these risk factors may bottom-out in 2016, some countries remain highly vulnerable. As is usual with regard to emerging economies, differentiation will be the name of the game. In Chart 2, we assess the sensitivity of emerging countries to the three risk factors via three key metrics: (i) Current-account balance, which measures a country's vulnerability to capital flows associated with the Fed rate hike; (ii) Exports to China as a share of GDP; (iii) Primary exports as a share of GDP.

Additionally, we use the depreciation of the currency since mid-2014 as a proxy for all other factors not captured by these three metrics. For instance, despite its current-account surplus, Russia has experienced a -65% fall in the Rouble, owing to a sharp increase in political risk. In September, we already identified the BRUNTS (Brazil, Russia, Nigeria, Turkey and South Africa) as the most vulnerable countries. These countries have seen a significant deterioration in their economic prospects and have little room to support growth in the short run. Both external trade and domestic demand are weak; policy support is constrained by strong macroeconomic imbalances (either twin deficits or strong pressures on the currency). In this regard, they will remain under the volatility spotlight in 2016. Likewise, Colombia, and to a lesser extent, Malaysia, Indonesia, Chile and Peru could also face difficult times.

Dwarf #3: Timid (oil) prices

Oil prices have nearly halved in 2015 compared to 2014 (on average). Still, Russia, the US and Saudi Arabia, the three main oil producers, show no sign of cutting back their production. As such, 2016 is likely to see oil prices drop again. The quick end to the current price war expected by many did not happen as US oil producers are more resilient than ever. American energy companies have shelved their least productive and most speculative drilling projects while keeping their best wells running to repay their sizeable debts. They have also learned to extend

Chart 2 Emerging Markets exposure to China, Commodities and Fed Yearly



Sources: IMF, Chelem, IHS, Euler Hermes

the life of their wells to be less dependent on breaking ground on new ones. At 9.17mn/bd, US production is currently higher than it was at the beginning of the year. As a result, we expect the Brent oil price to go down by -15% to USD46 per barrel on a yearly average in 2016 before starting to recover in 2017. Oil prices will thus remain low for an extended period of time. This is a strong tailwind for net oil importing countries and explains our benign forecast for the Eurozone. On the contrary, low oil prices hurt net oil exporters. Their economies suffer from weaker terms of trade, which translates into a stark deterioration of trade balance. This, in turn, eats

at their fiscal revenues. This is all the truer when a currency is pegged to the USD, making it impossible to absorb shocks to fiscal balances by foreign exchange movements. More generally, stabilizing (at a low level) commodity prices should stop spiraling lowflation effects. Also, as demand is improving, deflationary pressures will fade away. This trend will be most notable in the Eurozone, where firms' turnovers will pick up for good. However, a strong rebound in prices is not expected. The ongoing deleveraging process in both advanced and emerging countries precludes such a possibility.



-15%

forecasted fall in oil prices compared to 2015

Dwarf #4: Sneazy financial markets

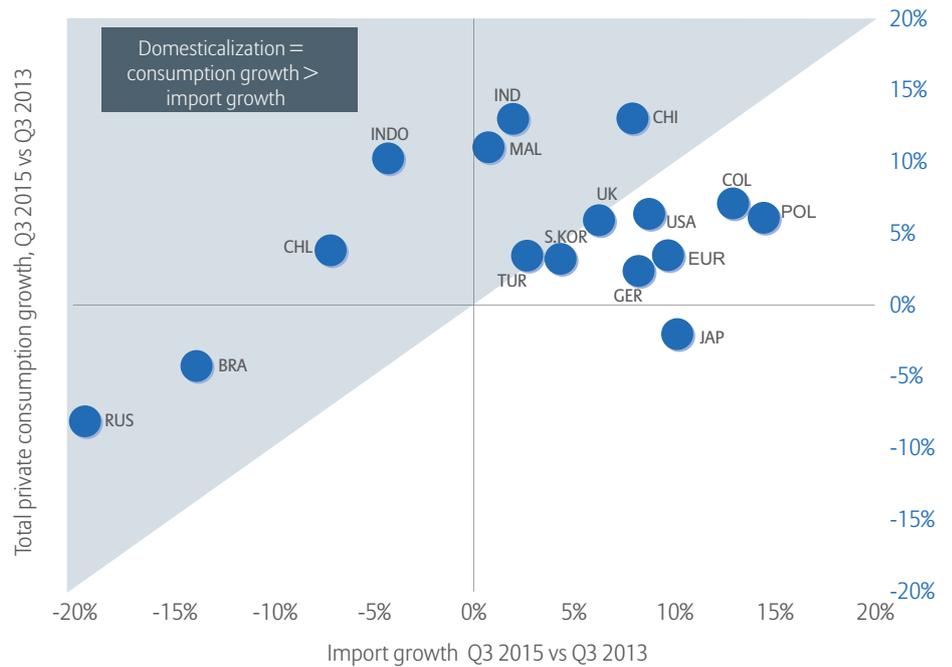
Financial markets got a cold in 2015. Indeed, oil is not the only commodity to have taken a plunge. Other commodities such as iron ore (-54%), Nickel (-53%) or Steel (-50%) have also tumbled. We expect commodity prices to remain low for some time but most should reach a trough in 2016.

This will be all the truer for "OpEx" commodities such as nickel, zinc, soybean, which are used as inputs in the basic business of companies, and as such could see a timid rebound in 2016. In contrast, the outlook of "CapEx" commodities, such as iron ore, steel, copper or coal, is more challenging and their prices could fall again by 10%.

More generally, the metals complex is much more exposed to China and its rebalancing. On the off-chance that Chinese growth would remain the same in 2016 but driven more by consumption than investment, it would still be more supportive for, say, oil demand, than metals demand.

Challenging commodity markets undoubtedly put pressure on the currencies of commodity exporters. Countries such as Indonesia, South Africa, Brazil, Chile or Peru, will once more experience downward pressures on their currencies.

Chart 3 Imports growth vs. Consumption since 2013 (real terms)



Sources: IMF, World Bank, IHS, Euler Hermes

Dwarf #5: The Happy consumer will not save the world

Consumer spending has been a bright spot for the global economy for about a year.

In advanced economies, it has shown resilience to the 'global mess' thanks to low oil prices, improving employment and easing credit conditions. For instance, retail sales growth in the Eurozone has shot up from +0% y/y in June 2014 to +1.7% in September 2015. Even more im-

portantly, consumers have been more willing to make long-term purchases, as evidenced by the rise in car sales, i.e., +8.3% y/y in the Eurozone and +6% y/y in the US. This signals that households are facing the future with more confidence.

Still, there are at least 2 reasons why the happy consumer will not be a huge tailwind for the world economy.

First, as inflation will edge up a bit in 2016 whereas wages will not (Europe) or barely (US), real disposable income growth will be moderate. In other words, the boost coming from low oil prices will abate gradually, thus putting a lid on consumption growth. Moreover, households' indebtedness remains high, especially in the developed world, so that some of the windfall will be saved.

Second, and more crucially, we see increasing evidence of the emergence of a "domestication" trend, whereby countries are becoming more and more inward-looking. Protectionist measures and the closing of capital accounts are two manifestations of this trend. A higher pace of consumption growth than import growth since 2013 is another (given that, for instance, services consumption increases) (see Chart 3). This is particularly striking in emerging countries such as India, where consumption has grown by 13.2% since 2013 whereas imports have grown a paltry 2%.



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Dwarf #6: The policy-mix Doc is back

Despite falling international reserves in emerging markets, global liquidity will remain abundant. Thanks to the Bank of Japan, the ECB and the PBoC, liquidity should grow by at least +6% in 2016 (see Chart 4).

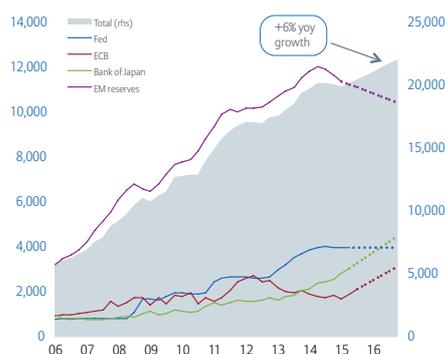
The BoJ recently fine-tuned its easing stance, notably by increasing its purchases of stocks issued by companies that are “proactively making investment in physical and human capital”. In China, continued low inflation and slower growth in investment suggest further easing in the short run. The ECB has refrained from stepping up its monthly asset purchases but we still expect it to do so in 2016. In any case, its QE will extend at least into 2017. Despite its first rate hike in 9 years, the Fed will continue to reinvest the proceeds coming from maturing assets on its balance-sheet, thus preventing a “liquidity squeeze”.

Meanwhile, fiscal policy is turning from a significant headwind into a moderate tailwind in some major economies. The heavy burden is turning into a humble boost.

In China, a strong increase in public expenditures is helping to keep growth on track. This stance will be maintained next year as the economy continues to show signs of weakness.

In Japan, the government continues to step up its efforts to enhance growth with an additional stimulus package worth 0.6 pp of GDP. New pro-growth measures were announced including a 3% rise in minimum wages and lower corporate taxes for companies.

Chart 4 Emerging markets reserves vs. advanced economies monetary base (USD bn)



Sources: IHS, Euler Hermes

+6%
growth in global liquidity in 2016

In the Eurozone, providing shelter and accommodations to refugees and an enhanced focus on fighting terrorism entail loosening the purse strings.

Dwarf #7: Dopey, loose cannons and short-termism

Political and institutional uncertainties could continue to pose a problem.

First, some legacies from the past will last throughout 2016. The EU announced the extension of economic sanctions against Russia until July 2016. Risk of conflicts remains elevated in the Middle East with the collapse of Yemen's government and political instability in Syria.

Second, rising social tensions in some major economies is a cause of concern. In Brazil and South Africa, social discontent is increasing as a result of deteriorating economic prospects and increasing unemployment.

Third, elections will bring a slew of uncertainties. The US presidential election is obviously critical and can be a game changer for the longer term. Presidential elections in countries such as the Philippines can bring significant changes regarding the economic outlook. The current president has put the economy on better footing and the next leadership will have to maintain the pace of reforms to enhance long-term growth.

In Taiwan, the upcoming presidential election could be a watershed event with regard to the relationship with mainland China.

Fourth, possible institutional changes can be sources of disruptions. There are never-ending discussions surrounding Greece. Add to that the risk of a “Brexit”. If the UK votes in a referendum to exit the European Union, at least some EU institutions would have to be reorganized and revamped.

Snow White is waking up, just like the investment cycle

The start of an investment cycle is the key to reignite the global economy's main engines. Up to now, investment has been the main laggard in the recovery, especially in developed countries.

This explains why real domestic demand in the Eurozone, for instance, is still more than 3% lower than pre-crisis. Crucially, the concern is not only that investment is a source of demand (and economic growth) in the short term, but it is also a key determinant of long-term growth potential.

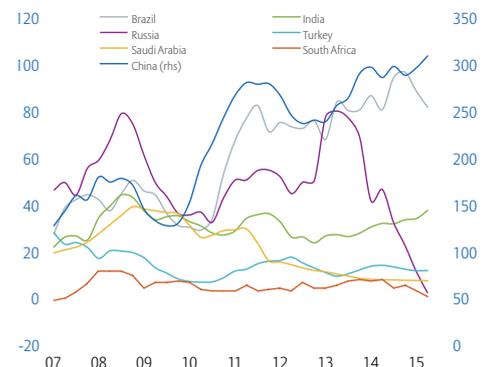
Looking back, and contrary to popular wisdom, the main areas of weakness in developed countries' investment spending have been residential and government investment. The latter is cur-



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Chart 5 FDI inflows in selected emerging markets (USD bn, annual)



Sources: IHS, IMF-IFS, Euler Hermes

forecast insolvencies to rise by +20% and +14% respectively; (ii) the end of the recovery cycle in the US and the UK. After having hit record low levels, corporate bankruptcies are expected to increase by +3% and +5% respectively in 2016.

The outlook appears more favorable in the Eurozone where we expect a steady -6% decline next year. However, these bright prospects mask very heterogeneous conditions.

Spain and Ireland will lead the pack with declines of -10% (but from very elevated levels), whereas insolvencies in Germany are expected to register their slowest decrease since 2009 with -2%. France and Italy will enjoy a second year of decline with -3% and -8%, respectively. ■

rently falling at a -10% y/y pace in Europe. Although the decline should moderate in 2016, we do not expect a quick recovery.

However, we do expect a slight pick-up in housing activity in the Eurozone and in the US. It should be supported by improving employment and income prospects, credit conditions and a lack of attractive alternative investment. The rebound in the US will be quicker though because the deleveraging of the household sector is far more advanced than in Europe.

Meanwhile, we see the beginning of an investment cycle for European companies. At +5.4% y/y, real business investment growth in Europe is finally outpacing the US, where it is driven down by investment in structures (-1.2% y/y) in the exploration & production sector.

The rationale behind this rebound is fourfold: a rise in turnovers; an improvement in profitability; the real cost of capital would become even lower; and massive war chests on the balance sheets of companies.

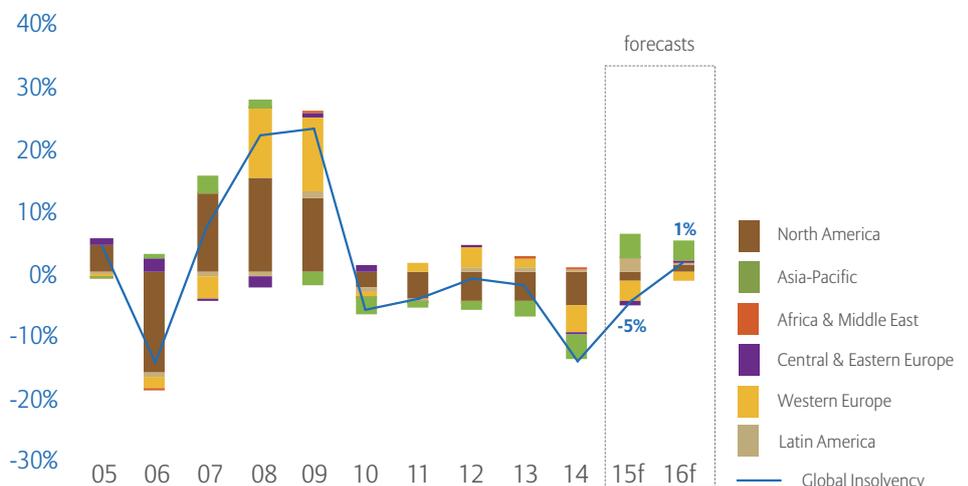
Cash might also pursue different assets altogether. Indeed, given the cheapness of emerging markets' assets and undeniable long-run potential, foreign direct investments (FDI) in selected countries are set to increase. As of Q2-2015, and despite experiencing its worse recession of the past 30 years, yearly FDI flows in Brazil are still higher than in 2012-2013 (see Chart 5).

Beware of the Evil Queen's rotten insolvency apples

After six consecutive years of decline, we expect business insolvencies to rise by +1% in 2016 (see Chart 6).

Sluggish growth and volatility will weigh on corporates' revenues and margins. This increase will be driven by two main dynamics: (i) the economic slowdown in emerging markets, especially in China and Latin America, where we

Chart 6 Euler Hermes Global Insolvency Index and regional indices (Yearly level basis 100=2000)



Sources: National Statistics, Euler Hermes forecasts

**REGIONAL
OUTLOOK**

US: More slow growth as the Fed hikes and the expansion ages

An optimist's view of the US economy would be that it is perhaps the most solid in the developed world. A more cautious view would be that in 2016 the economy is likely to grow by the same disappointing +2.5% rate as in 2015, but with higher business risk.

Much of the risk stems from the fact that the Federal Reserve has started to tighten monetary policy. Moreover, the expansion may be nearing the end of the business cycle.

While most of the world's major central banks (representing more than 50% of global GDP) are loosening monetary policy, the Fed is tightening. It has signaled that it might continue to raise rates from 0.375% to 1.375% by the end of 2016. Historically, when the Fed raises rates, banks tighten lending conditions, making loans harder to get and charging higher interest rates (widening spreads, see Chart 7).

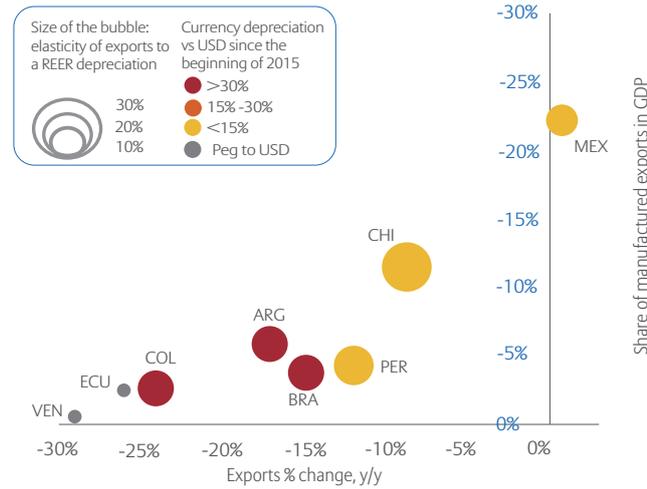
This combination pressures businesses. It can contribute to slower payment as seen in Euler Hermes' proprietary Payment Behavior Index, and to higher insolvencies. Euler Hermes forecasts these to rise by +3% in 2016.

Fed tightening also supports a strong dollar which in 2016 will have several deleterious effects. These include a headwind for exports and lower commodity prices which hurt producers. A weakness in manufacturing can occur due to the slowdown in investment from producers.

Chart 7 Federal Reserve target interest rate vs. net % of banks widening spreads (%)



Chart 9 Sensitivity of exports to currency depreciation (%)

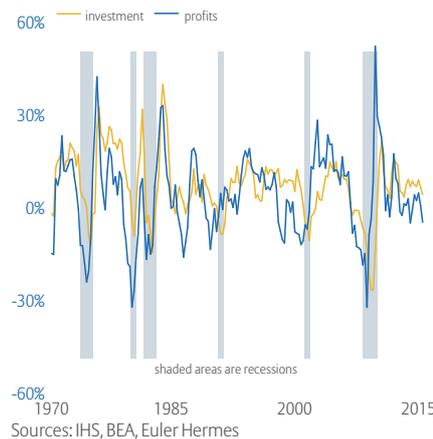


Investment often slows towards the end of an expansion, as does profit growth (see Chart 8), which has now turned negative on a y/y basis. Further suggesting that the expansion could be past its prime, is the fact that it is now 78 months old. This is a far longer period than the post-WW-II average of 58 months. Of the 12 cycles during that period, the current one is the fourth longest.

Latin America in a perfect storm

Public and external accounts have deteriorated in almost every country of the region. Main currencies have depreciated strongly against the USD amid falling commodity prices, Chinese economic slowdown and monetary tightening in the US. External conditions are not expected to improve significantly in 2016, and will constrain public spending. Monetary policy might have to be even more restrictive to combat inflation and further (although less severe) depreciation.

Chart 8 Real Corporate Profits and Investment (y/y % growth)



-2.4%

GDP in Brazil, making 2016 the 2nd consecutive year of recession

Currency depreciation does not have a visible positive impact on the competitiveness of exports, which will underperform in real terms again in 2016.

With the exception of Mexico, regional exports are strongly concentrated in primary goods. Thus export performance relies more on demand growth than on price-competitiveness (see Chart 9).

We expect regional GDP growth to remain flat in 2016, following a -0.4% contraction in 2015. Activity in Mexico (+2.8% in 2016) will continue to be driven by the US economic cycle. But Chile (+2%), Colombia (+2.7%) and Peru (+2.8%) will experience another year of below-trend growth. Economic recession is expected in Ecuador (-1.1%) and Venezuela (-6.6%) as activity is extremely dependent on oil revenues and fiscal spending. With very restricted access to capital markets, both countries are struggling to find external financing.

Positive signals are at last coming from Argentina. The newly-elected President Mauricio Macri vowed to lift trade and capital controls, consolidate public finances, and build a better framework for inflation management. These adjustments will be painful in the short-term, leading to a recession in 2016 (-1.5%). However, they will help attract foreign investment back to the country.



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Brazil: Deep recession will continue

After stagnating in 2014, the economy is set to contract by -3.7% in 2015 and by -2.4% in 2016. Corporate insolvencies will surge by +25% in 2015 and by +18% in 2016. Despite easing, inflation is likely to remain above the target until the end of 2016, suggesting further monetary tightening and a credit slowdown.

Fiscal consolidation seems essential to limit growth in public debt and to regain investor confidence. However, enacting ambitious (but necessary) reforms will prove challenging amid strong political tensions. An impeachment procedure against President Rousseff is ongoing and her popularity plunged to record lows.

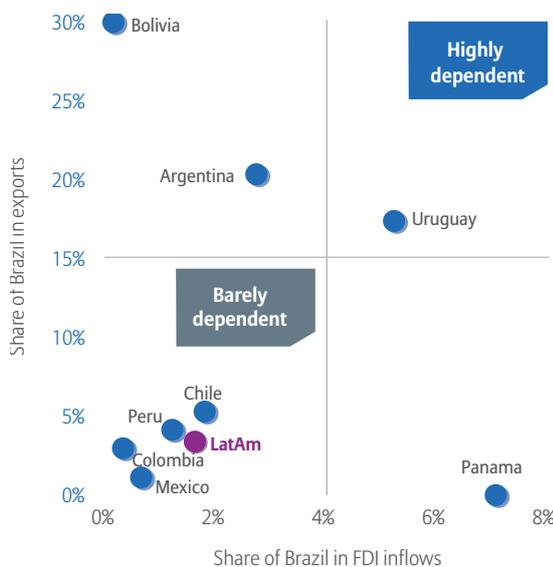
Argentina, Uruguay, Panama and Bolivia will be particularly impacted by the current situation in Brazil because of their strong trade or investment links with it. Yet, negative spillovers to the rest of the region should be broadly limited (see Chart 10).

Chart 11 Profitability of non-financial corporations (%)



Sources: IHS, ONS, Euler Hermes

Chart 10 Sensitivity to Brazil (%)



Sources: National source, UNCTAD, Banco Central do Brasil, Chelem, IMF-IFS, IHS, Euler Hermes calculations

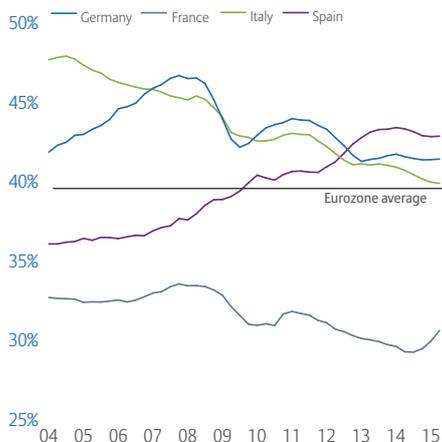
United Kingdom: The end of the cycle

Contrary to the Eurozone, the UK's real GDP has exceeded its 2008 level since 2013. However, the pace of increase has moderated recently. It is expected to remain at around +0.5% q/q on average by the end of 2017. Growth continues to be mainly driven by services while the manufacturing and construction sectors are slowing down. Private consumption will continue to be the main driver of GDP growth, but momentum is deteriorating: (i) weak productivity growth suggests slower job creation and lower wage growth; (ii) most of the fall in unemployment rate is due to part-time workers and self-em-

ployment; (iii) households' savings reached record low levels. On the corporate side, capacity utilization rates signal a slowdown in firms' investment. The UK already suffers from chronically low investment, i.e., 17% of GDP on average since 2005 vs. 20% in Germany and 23% in France. Foreign investment started to slow down and fears of a Brexit should exacerbate this trend in 2016. Weak price competitiveness due to the GBP appreciation will continue to limit export opportunities (the BoE is expected to increase rates in H2 2016). Pressures on companies' selling prices are a drag on turnover and profitability (see Chart 11).

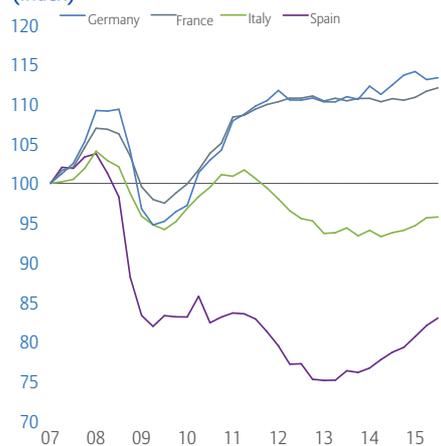
Overall, GDP growth should weaken to +2.1% in 2016 (after +2.4% in 2015) and to +1.9% in 2017. ▶

Chart 12 Eurozone gross profit share of non-financial corporations (4Q, % of GVA)



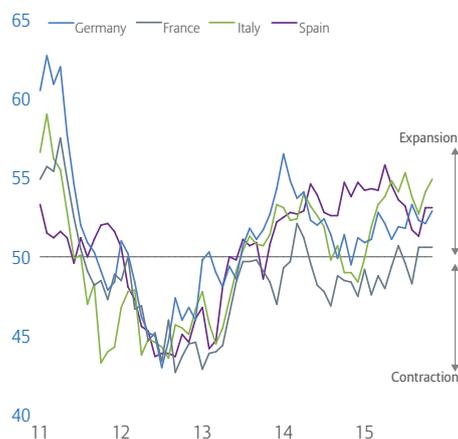
Sources: IHS, Eurostat, Euler Hermes

Chart 13 Eurozone turnover of non-financial corporations (Index)



Sources: IHS, Eurostat, Euler Hermes

Chart 14 Eurozone PMI



Sources: Bloomberg, Euler Hermes

Eurozone: business investment is back

The Eurozone remains in a steady but moderate recovery phase since mid-2014.

GDP is expected to grow by +1.7% in 2016 (after +1.5% in 2015) and by +1.8% in 2016. More than half of this growth came from Germany and Spain in 2015. But the picture should be more balanced in the next two years with France and Italy coming back in the game.

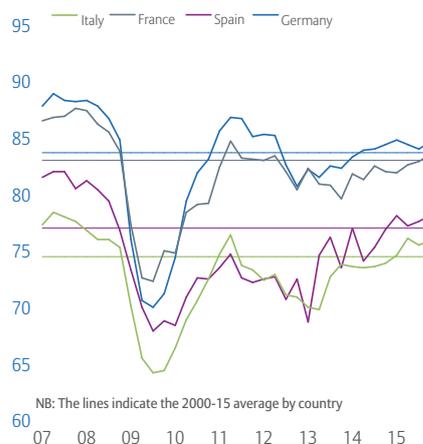
In 2015, the recovery has been mainly driven by households' consumption, and to a lower extent, by exports. Firms' investment has started to catch-up, but the recovery remained quite heterogeneous. Spain has benefited first from a strong export recovery starting in 2013 and then, more recently, from a pick-up in internal demand. Yet it has remained timid in Italy given the absence of an accelerator effect.

The good news is that the pick-up in demand we saw in 2015 can translate into higher business investment in 2016. Encouragingly, business confidence indicators (PMIs and national surveys) and capacity utilization rates seem to confirm that a positive trend is emerging.

In addition, the quantitative easing (QE) program implemented by the ECB in March and extended in December (albeit below expectations) improved financing conditions. Bank loans' interest rates in Southern European countries converged toward the low French and German levels. Moreover, companies are able to self-finance part of their future investments. Nominal GDP growth picked up in 2015. A further moderate boost should come in 2016 from increasing consumer prices. This will help companies to better price their products and therefore support the recovery in turnover. Industrial firms' turnover, which had suffered the most since 2009, have been more upbeat in Q2 2015: +5.5% (compared to Q2 2014) in Spain, +2% in Italy, +1% in France. Furthermore, lower com-

The Eurozone is clawing its way back into growth

Chart 15 Eurozone capacity utilization rate (%)



NB: The lines indicate the 2000-15 average by country
Sources: IHS, European Commission, Euler Hermes

modity prices and improving financing conditions supported companies' profitability. However, downside risks remain. We do not expect much lower Brent prices or a weaker EUR in 2016, which could imply a more moderate growth in domestic and external demand. The good news is that interest rates will remain low, household savings rates are relatively high across the region, and the labor market recovery should continue, even if at a slow pace. Should negative surprises arise in 2016, we believe the ECB will react by increasing its QE program. Domestic demand should be supported by new public investments.



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Chart 16 Eurozone loan rate to SMEs (%)



Sources: Bloomberg, Euler Hermes

Germany: Continued robust growth

Real GDP grew by an average +1.5% y/y in the first three quarters of 2015, driven by domestic demand.

Early indicators for Q4 signal a somewhat mixed but overall positive outlook. Retail trade grew by a solid +2.9% y/y in October while manufacturing output increased by just +0.4% y/y. New orders in manufacturing declined by -1.2% y/y.

Meanwhile, trends in survey indicators are generally favorable. The quarterly averages of both the manufacturing PMI and the Ifo Business Climate Index have steadily improved from Q4 2014 to Q4 2015. The GfK Consumer Climate Indicator, after surging to a 13-year high in June,

eased slightly by -0.9 points until December. Still, it remained well above its long-term average and is forecast to improve again in January. Overall these high frequency indicators continue to signal robust, domestic demand-driven growth. Euler Hermes expects full-year GDP growth of +1.5% in 2015 and acceleration to +1.8% in 2016. It may be supported by additional public sector spending related to the ongoing refugee influx. However investment growth remains weak, despite low corporate loan rates and capacity utilization remaining above its long-term average. Improvement is not expected before H2 2016.

France: Fluctuat nec mergitur

In 2015, France has finally awakened from its state of hibernation.

After 3 years of circa 0.4% real GDP growth, GDP will grow by 1.1% in 2015, +1.4% in 2016 and +1.6% in 2017. In the short-term, Euler Hermes does not expect the recent terrorist attacks to have a long-lasting impact on the economy. Indeed, latest confidence surveys, although understandably showing a sharp fall in the retail and services sector, remain strong and point toward further growth in months to come. If history is any guide, only repeated terror attacks really put a dent on growth, primarily via a fall in foreign direct investment (FDI). As such, after a soft patch in Q4, consumption

will resume its positive trend. It will grow by 0.4% q/q on average in 2016. However, consumption will not be alone this time. Investment will contribute for the first time since 2012 (+1.7% y/y), primarily on the back of stronger corporate investment.

In addition, the combination of a (very) slowly falling unemployment rate in 2016 and a still-rising purchasing power will bolster households' investment. This is especially true for home maintenance and improvement purchases. After 9 consecutive quarterly falls, it will strengthen gradually in 2016 (+0.3% q/q on average).

Italy: Momentum is improving

Italian GDP started to recover in 2015, following three consecutive years of recession.

The reform implementation process did not lose momentum and Jobs Act already has a visible positive impact on employment (+145K jobs in 2015).

Private consumption benefited from the positive mix of low inflation, lower oil prices, high savings and low indebtedness. 'Made in Italy' has enjoyed increased external demand, thanks to the temporary effects of the Expo Milano and the lower euro.

Total good and services exports has increased by +4% in real terms since Q3 2014. The pace is high, but is still the weakest across the four biggest Eurozone countries.

After seven years of contraction, investment has picked up. Investment in machinery and equipment increased by +2% in real terms since mid-2014 and was supported by the rise in goods exports. However, the construction sector is expected to remain depressed. Investment is still 30% below 2007 levels, production remains on a downward trend and housing prices are at a record low. The recently unveiled EUR160bn 5-year investment plan (i.e. 10% of GDP), with EUR24bn for infrastructure, is good news.

All in all we expect GDP growth to pick-up to +1.1% in 2016 (after +0.7% in 2015) and +1.2% in 2017.

Spain leads the Eurozone in terms of growth

Along with Ireland, Spain is the leading growth engine in the Eurozone. Real GDP growth is expected to reach +3.1% in 2015, +2.6% in 2016 and +2.1% in 2017. Private consumption will remain robust amid low inflation and the improving labor market (still, the unemployment rate is close to 20%). However, growth will somewhat slow as the positive effect of the fall

Economic recovery in Spain is beating expectations

Despite this positive outlook, fragilities remain. Notably, private sector credit continues to contract. In this sense, further support from the ECB will be welcomed.

The political landscape also appears uncertain. The General elections held in December resulted in a divided Congress. The emergence of a coalition strong enough to govern seems unlikely given the political rifts between parties. Early elections cannot be ruled out.

in oil prices will diminish and fiscal support will be lower.

Public investment (notably in construction) is expected to slow significantly. This should give more space to private business investment, whose momentum is strong.

Exports will remain solid thanks to the euro's continuing weakness and the competitiveness gains achieved over past years. But net exports will contribute negatively to growth since the recovery in domestic demand will drive up imports. Accordingly, the current account surplus should diminish slightly in 2016, but will remain positive.

+2.6%

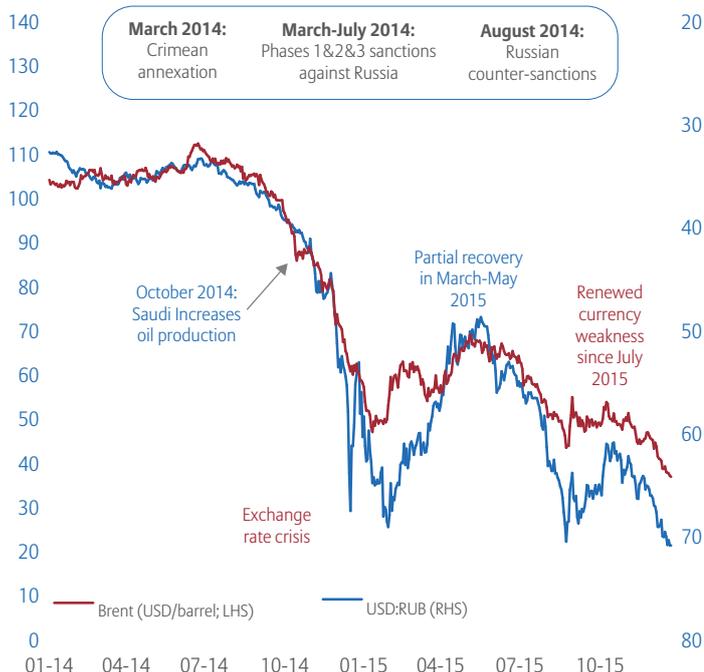
GDP growth in Spain in 2016.

The country's economy is slowing down but remains among the fastest-growing in the Eurozone



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Chart 17 USD/RUB and Brent oil price (USD)



Sources: Bloomberg, Euler Hermes

Robust outlook in Central Europe

Real GDP growth in the 11 EU members in Central and Eastern Europe (CEE) picked up to +3.2% in 2015. It should continue at that pace in 2016.

These countries have been largely resilient to the Russian crisis thanks to (i) a rebound in domestic demand; (ii) the Eurozone recovery; and (iii) overall modest export exposure to Russia.

The exceptions are the Baltic States which are more vulnerable to disruptions to export flows to Russia (see Chart 18).

Turkey on the brink

GDP growth in Turkey accelerated to about +3.6% in 2015 thanks to improving domestic demand, especially surging pre-election public spending.

However, Euler Hermes forecasts a slowdown to +3.3% in 2016 as downside risks have increased. Especially, sharply deteriorated relations with Russia will likely have adverse effects on Turkish exports. This could lead to renewed currency instability which could trigger inflationary pressures and rising interest rates.



Central and Eastern Europe: Diverging

Russia's crisis will ease only gradually

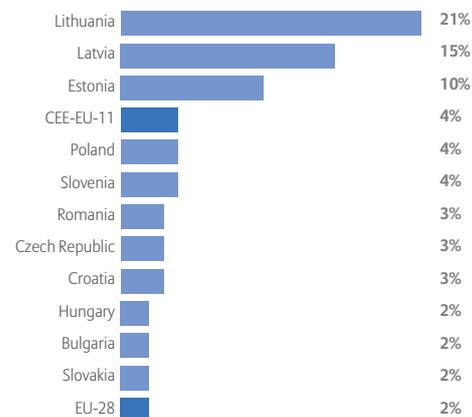
The recession may have bottomed out. Economic contraction in Russia moderated to -4.1% y/y in Q3, after -4.6% in Q2.

But early Q4 data suggest that any recovery will be very modest. In October-November, industrial production dropped by -3.6% y/y and retail sales by a hefty -12.4%. Such figures indicate that consumer spending is still weakening. It is taking place against the backdrop of high inflation and the renewed slump of the RUB, currently down -45% from a temporary peak in May. Depreciation is closely trailing plunging global oil prices (see Chart 17).

Ongoing low oil prices combined with recently extended Western economic sanctions will weigh on the recovery. Euler Hermes forecasts real GDP to contract by -0.3% in 2016, after -3.7% in 2015.

Corporate financing will remain difficult in this environment. Insolvencies (up +10% in 2015) and DSO (53 days in 2015, up from 33 in 2007) should continue to rise.

Chart 18 Share of exports to Russia in total exports (2014) (%)



Sources: IMF, Euler Hermes

Africa & the Middle East: Commodity prices limit potential in both regions

In Africa, growth will remain below the long-term annual average (+4.6%) in 2016 (+4%) but may creep back to that marker in 2017.

Risks are on the downside. The region is a mixture of oil exporters and oil importers but most economies remain dependent on currently weak internationally-determined commodity prices, with little prospect of significant rebound in the short term.

The Africa Rising story is linked to that of China; the latter is the region's largest bilateral trade partner. So far, Chinese imports of African-sourced goods appear to be holding up in volume terms, although not in value.

Not all resource-rich African countries are severely affected. Oil and base metal exporters including Angola, Nigeria, Sierra Leone, South Africa and Zambia face challenging times. But some economies are forecast to continue to grow at +5% or above each year in 2015-17 (including Côte d'Ivoire, Ethiopia, Mozambique and Tanzania).

In the Middle East, GDP growth will remain below the long-term annual average (+4.6%) throughout the forecast period, perhaps rising to +4% in 2017.

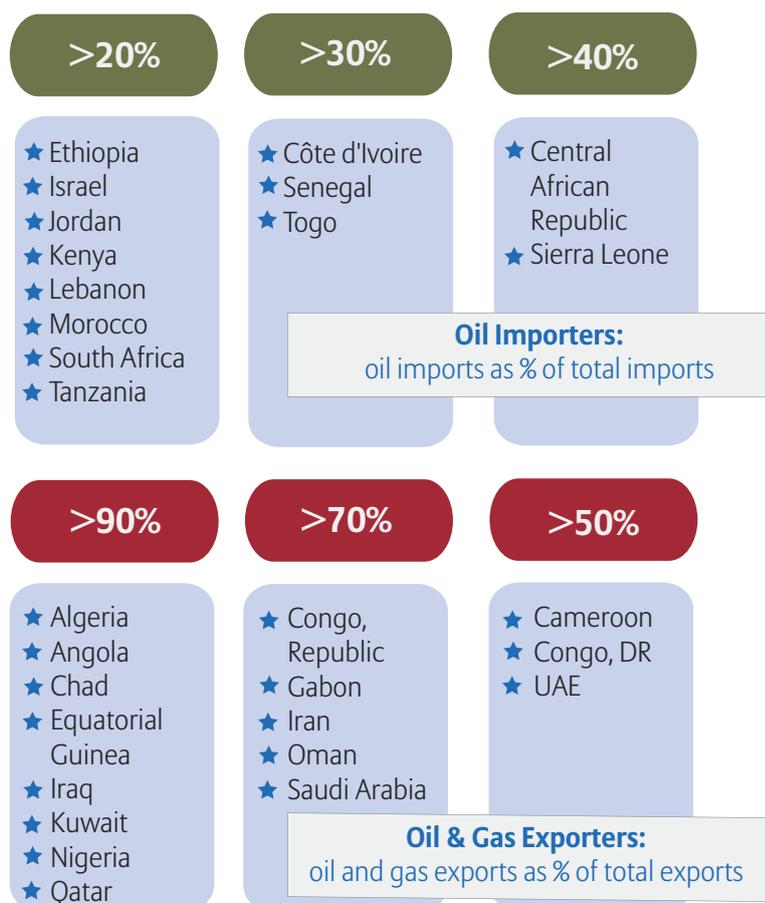
The oil price remains critical. It directly affects exporters and has an indirect effect on energy importers (including Jordan and Lebanon) that rely on the economic welfare of larger neighbors (see Chart 19). Our assumptions include positive contributions from Iran (a general spurt to growth as sanctions are lifted) and Israel (a natural gas boost).

But expansion in the GCC countries will be lackluster and dependent on state spending. With oil and gas prices unlikely to stage a significant rebound in the short term, risks are on the downside. Moreover, existing conflicts (including Iraq, Syria and Yemen) have the potential for further negative contagion. Religious, tribal and sectarian divides will remain powerful influences across the region and further afield.

Asia: Solid domestic demand keeps growth in a firm range

GDP growth will remain solid but below the long-term average of +5% (+4.8% in 2016, and +4.7% in 2017; see Chart 20).

Chart 19 Mirror, mirror on the wall. Who is the most dependent of all?

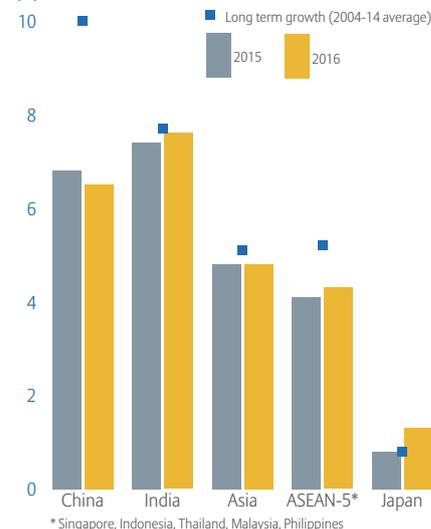


Sources: UNCTAD, Euler Hermes

While growth is set to decelerate in China, a modest upturn is expected in Japan, India and ASEAN. A supportive policy mix, increasing wages and solid labor market will allow for acceleration in domestic consumption. Nominal exports will see only a gradual improvement reflecting fewer downward price pressures and limited improvement in global demand. Investment is set to gain traction but at a slow pace. This is due to moderate increases in market opportunities, higher costs of financing in USD terms (i.e., higher interest rates in the US) and fragile business sentiment. Regionally, growth momentum will depend on China's economic rebalancing and the strength of Japan's recovery.

Asian GDP growth should prove resilient

Chart 20 GDP Growth vs Long term average (%)



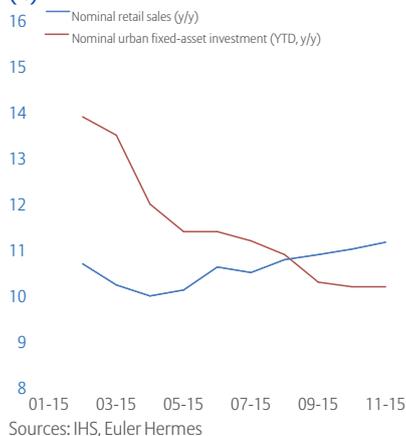
* Singapore, Indonesia, Thailand, Malaysia, Philippines
Sources: IHS, Euler Hermes



+4.8%
Asia's GDP growth will remain below long-term average in 2016

© Image Fotolia_19365853

Chart 21 Investment and retail sales (China)
(%)



China: GDP growth is set to slow in 2016 (+6.5%) and 2017 (+6.4%)

Our scenario assumes a gradual acceleration in domestic consumption. It will be mainly supported by public expenditure in 2016 and by private consumption thereafter.

Investment will prove resilient. Yet it will grow below trend, reflecting ongoing overcapacity reduction and high corporate debt issues. Higher domestic demand will allow for a rebound in imports, progressively reducing the trade balance surplus.

This outlook is based on the continued efforts to rebalance the economy and clear guidance on policies. China's authorities will probably have to set clearer priorities for the next two years to avoid following "conflicting objectives".

Firstly, keeping the RMB stable could be a difficult task. It may prove especially challenging if authorities aim to both preserve monetary policy independence and further liberalize the capital account.

Secondly, maintaining a solid financial base, namely high foreign exchange reserves and sound public finances, will require more selectivity in terms of expenditures. Thus, increasing both investment abroad and domestic fiscal stimulus will probably not be sustainable in the longer term.

Thirdly, "the move to quality growth" and the associated reforms (SOEs, corporate deleveraging and freer capital markets) entail less control on the growth target.

Japan: GDP growth recovered in 2015 and will likely remain solid in 2016 (+1.3%) and 2017 (+0.8%)

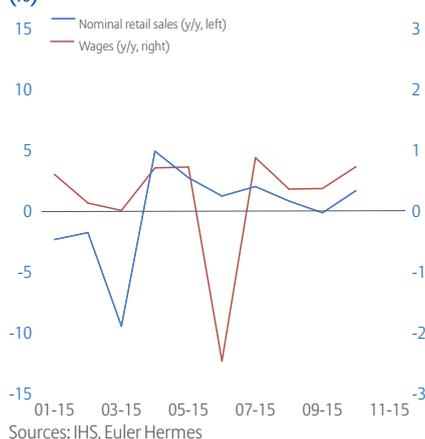
While exports still lack momentum, domestic demand is gaining traction.

Countercyclical fiscal policies (additional stimulus package of +0.6pp of GDP) and improved QE program will help foster growth recovery in H1 2016. Private consumption will probably pick up as consumer confidence recovers and structural reforms kick in (for example, an increase in minimum wages of +3%).

Investment will increase at a gradual pace. It will be supported by favorable credit conditions and a more conducive business environment (corporate tax reduced below 30% starting in April 2016). Exports are expected to accelerate in 2016 and to benefit from improved price competitiveness as a result of JPY depreciation. In 2017, domestic demand might weaken as the government will increase the sales tax to 10% in April 2017 (from 8%).

Stronger exports and selected supportive measures, such as the exemption of food items from the sales tax, will help sustain growth. ■

Chart 22 Wages and Retail sales (Japan)
(%)



Country Risk Outlook

Q4 2015 — UPDATE



IRELAND BB2 → A1

Real GDP growth is strong (at +6% in 2015 and +5.0% in 2016), allowing a high growth for real GDP per capita. The fiscal deficit has rapidly fallen and debt sustainability has improved thanks to high nominal GDP growth along with stronger competitiveness gains and better banking sector health.

CYPRUS B4 → B3

Cyprus should exit its international bailout programme by mid-2016. The country lifted off capital controls in April 2015 and successfully returned to the bond markets with low interest rates. The economy has returned to growth, with GDP expected to rise by +1.5% in 2015 and +2% in 2016.

CÔTE D'IVOIRE D3 → C3

In October 2015, the country held presidential elections deemed free and fair. This should engender a period of heightened stability and Côte d'Ivoire could regain its status as an economic power in West Africa. GDP growth is forecast to reach +7% or above in 2016 and 2017.

HONDURAS C3 → C2

Accompanied by the IMF and benefiting from low oil prices, the government is enhancing fiscal and external positions. Economic growth is set to remain solid in coming years, benefiting from low oil prices, the recovery in the US (remittances, exports) and increased FDI inflows. Business confidence is improving.

↓ 6

countries
downgraded
ratings

↑ 4

countries
upgraded
ratings

BRUNEI BB1 → BB2

Crude oil and natural gas production represent 70% of GDP and more than 90% of total exports. GDP growth decreased in 2015 (estimated -1.6%). General government net lending (-15% GDP) and current account balance (-3.1% GDP) deteriorated sharply in 2015. Risks are tilted to the downside with low commodity prices and low growth in external demand.

CHILE A1 → A2

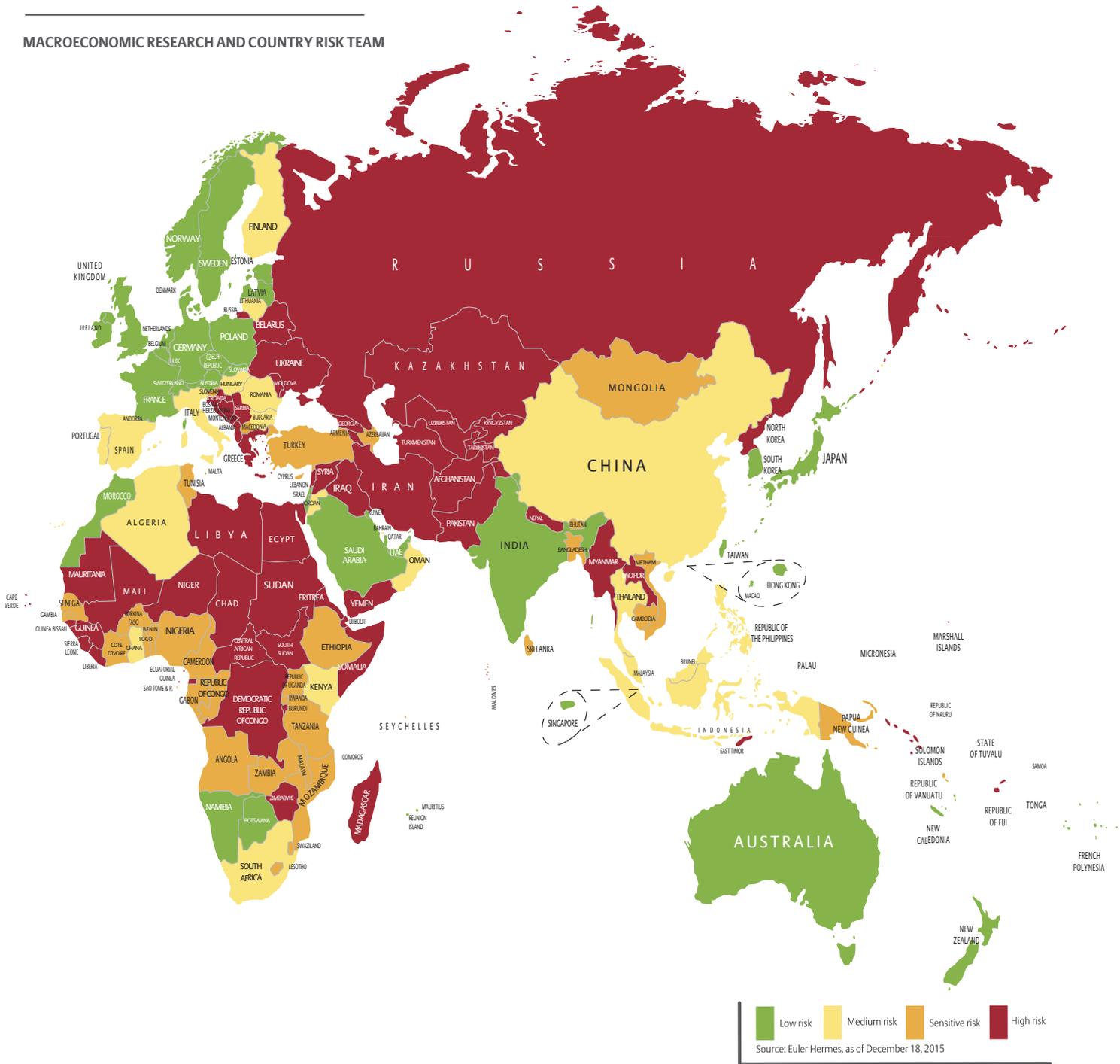
Export revenues have declined strongly due to low copper prices and China slowdown. The CLP has depreciated by -25% vs the USD since its last peak in July 2014. Tightening monetary policy is leading to a rise in interest rates and a credit slowdown. Economic growth will remain slow, around +2% in 2015-2016.

COLOMBIA BB1 → BB2

Export revenues have declined strongly due to the fall in oil prices and to weak developments in neighbouring Ecuador and Venezuela. The COP has depreciated by -50% against the USD since the last peak in July 2014. Economic growth will remain below 3% in 2015-2016.

10 changes in country risk ratings 4th Quarter 2015

MACROECONOMIC RESEARCH AND COUNTRY RISK TEAM



ECUADOR C3 → C4

Economic output has been hit by falling oil prices, which accounts for 50% of exports. The economy is forecast to enter recession, with GDP contracting by -1.1% in 2016. Due to dollarization, the Fed's rate hike will affect credit growth and export competitiveness.

OMAN BB1 → BB2

Oil accounts for around 50% of GDP and 80% of government receipts. Low energy prices will lead to large fiscal and current account deficits. High state spending will be managed by increasing public debt. GDP growth will be capped at +4% in 2015-17.

SOUTH AFRICA BB1 → BB2

Structural rigidities limit the economy's growth. These include, for example, the lack of skilled labour, limited job creation, infrastructure bottlenecks, and continuing balance of payments restraints. GDP is in a protracted period of low growth, and is expected to reach +2% in 2016 and 2017.

Medium term risk:
the scale comprises 6 levels: AA represents the lowest risk, D the highest.

Short term risk:
the scale comprises 4 levels: 1 represents the lowest risk, 4 the highest.



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