

# Is the Global Recovery Faltering?

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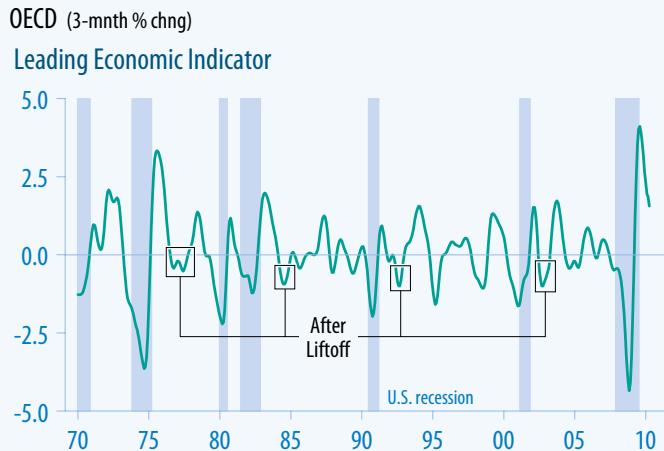
Financial markets are speaking with one voice this spring, and the message is mounting concern over the global growth outlook. From the correction in equities, to the 15% drop in commodities since the start of the year, to the deep dive in long-term government bond yields, markets are bracing for markedly slower growth ahead. Beyond the prospect of weak activity in Europe, markets have also been rattled by China's tough measures to cool property prices, and now by signs that the U.S. recovery is losing momentum. Leading indicators are chiming in as well, with the OECD's main measure clearly past its peak, even before equities began to slide (*Chart 1*).

But just how serious a hit have global growth prospects taken recently, and is this just a normal deceleration after the initial lift-off stages of a recovery? After all, it's almost a textbook pattern for leading indicators to fade rapidly after first blasting out of recession (and this cycle's blast was especially impressive), so a moderation on this front is hardly cause for deep concern on the recovery's health.

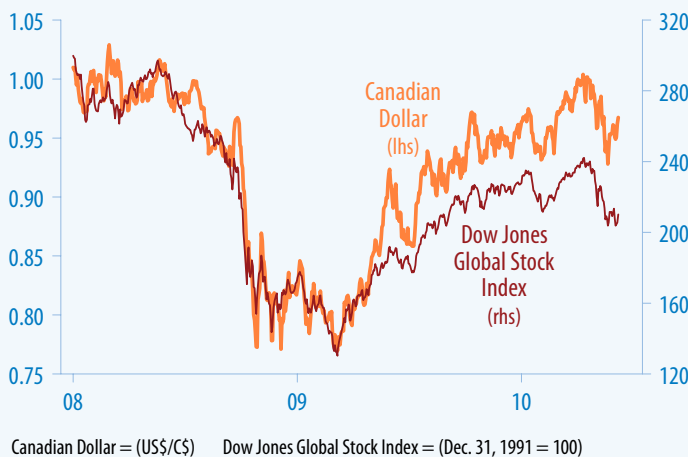
While the retreat in equities may have garnered the most attention recently (*Chart 2*), the deepening slide in a broad array of commodities may be the more telling symptom of growing caution on the global growth outlook. Both copper and oil prices have recently broken decisively below their 200-day moving average for the first time since late 2008 (*Chart 3*), and both are close to taking the 50-day average below the 200-day measure (the so-called death cross). Note that the CRB is now below levels prevailing a year ago, when the North American recovery had not yet even begun and the U.S. economy was still losing around 500,000 jobs per month. This steep pullback points to a much deeper malaise among investors, even on the previously impregnable growth outlook for Asia.

The major downside risk falls on European sovereign debt worries and its residual impact. Forecasters raced to downgrade European growth prospects as the crisis unfolded. While the Euro Area accounts for a still-substantial 15% of the global economy, it has added almost trivially to

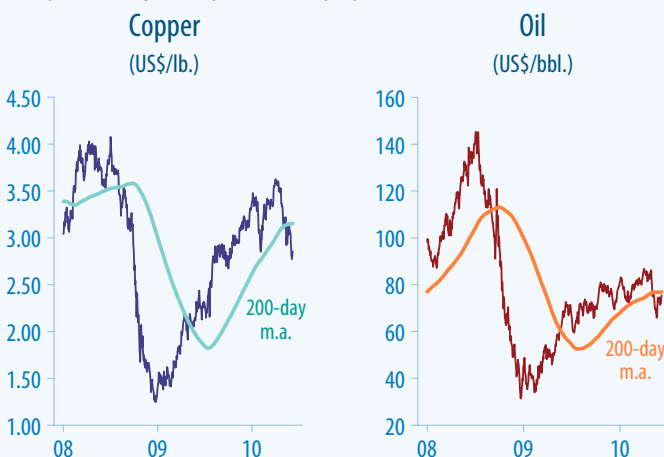
**CHART 1**  
**GLOBAL GROWTH: BACK TO EARTH**



**CHART 2**  
**AS THE WORLD TURNS**



**CHART 3**  
**ANOTHER TURN FOR THE WORSE**



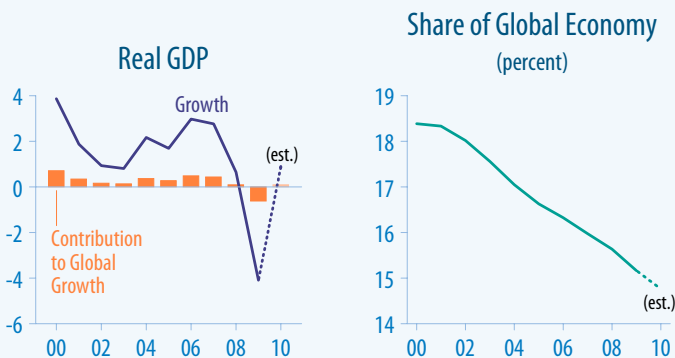
global growth over the past decade (*Chart 4*). From 2000 to 2008, the region accounted for just 8% of worldwide growth (punching at half its weight), so it's not exactly earth-shaking news that Europe won't be a big contributor to the expansion.

Growth worries from Europe are probably overdone, but concerns on the credit front are well-founded. A collapse in global credit markets was the key factor leading to the Great Recession and the global financial sector is still in the recovery room. Another negative credit shock would sharply curtail lending activity. However, we don't expect to see any sovereign defaults over the next year or two, and as that becomes apparent over the coming months, financial pressures should ease, especially on European banks. Greece is still the most likely default candidate, but there should be more certainty around global sovereigns before that potentially unfolds in about two years. Moreover, even in the event of a default in Europe, these assets are not opaque, toxic junk, worth pennies on the dollar, a la U.S. sub-prime mortgages.

So, has the growth picture beyond Europe been truly damaged by recent events? China has been another major focal point of concern. After white-hot 11.9% y/y real GDP growth in Q1, government officials have moved to cool the economy and particularly the real estate sector. Worries about a home price bubble prompted tighter mortgage lending rules in addition to higher bank reserve and down-payment requirements. Recent data have shown signs of slowing, but not drastically. And if China slows abruptly, those tightening measures can be reversed, and lending quotas loosened. Simply put, domestic policy drives China's economy much more than foreign developments (i.e. Europe)—witness last year's 9% growth rate in the face of the most intense global downturn of the past 60 years. GDP growth has consistently been led by domestic demand in recent years (*Chart 5*). In any event, note that exports soared almost 50% y/y last month, hardly a ringing endorsement for the "sky-is-falling" view.

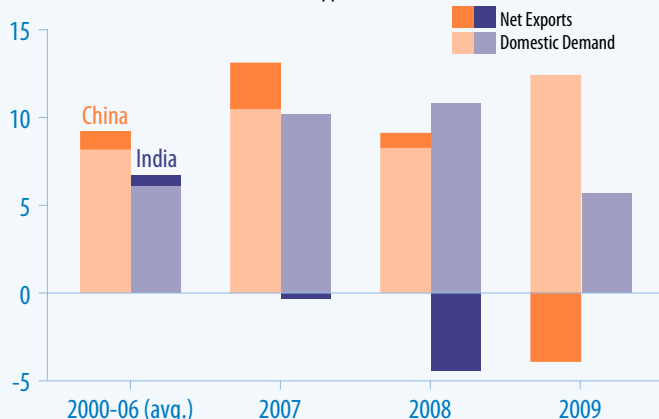
The strong domestic demand theme echoes through other emerging markets as well. Domestic demand drove both Brazil's Q1 GDP growth of 9% y/y (the best pace in 15 years), and India's 8.6% y/y surge. The increased reliance on domestically driven growth among emerging markets, along with their increasing share of the global economy, means that they should be relatively insulated from slower demand from Europe. And concerns about Europe's woes cutting off the supply of capital to Asia look off-base, given that Asia runs hefty current account surpluses and boasts massive foreign exchange reserves, and is thus a capital

**CHART 4**  
**EUROPE PUNCHING BELOW ITS WEIGHT**  
Euro Area



Source: IMF  
Growth = (y/y % chng)    Contribution = (ppts)    Share = Purchasing Power Parity Basis

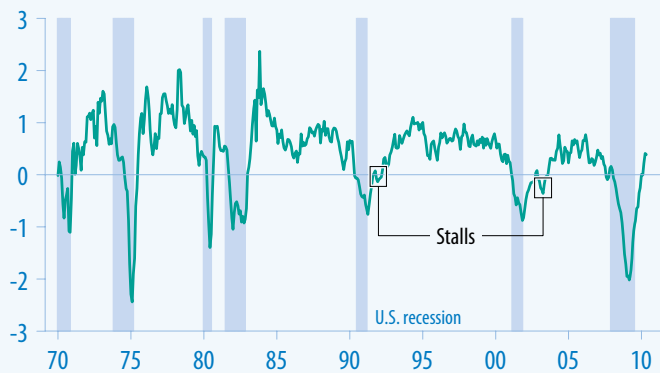
**CHART 5**  
**HOMEMADE GROWTH**  
Contribution to Real GDP Growth (ppts)



**CHART 6  
U.S. JOBS: THE BIGGER PICTURE**

United States (3-mnth % chng)

Private Sector Payrolls



supplier, not a drawer. While the downside risks from Europe can't be ignored, they likely aren't as significant as many fear for the developing world.

Arguably, it is the change in the U.S. outlook that has caused investor nerves to really fray. The May jobs report was the catalyst, revealing a meagre 41,000 net new private sector jobs last month. This followed a flattening in jobless claims, a moderation in consumer spending (retail sales dropped 1.2% in May), a retreat in leading indicators, and a surprisingly modest 3% rise in first-quarter GDP. However, one soggy payroll report does not a fall make, and recall that it followed a surprisingly upbeat result the prior month. Moreover, in the early stages of each of the past two recoveries, job growth has stuttered without a double-dip recession and, if anything, this cycle's private sector jobs revival has been more impressive than those

two episodes (*Chart 6*). And note that the economy managed to churn out 5.6% growth in the fourth quarter of last year, even as the economy was still shedding jobs. Essentially, the U.S. economy appears to be settling into the moderate recovery of around a 3% underlying GDP trend that many have been anticipating for the better part of the past year. The Blue Chip survey of forecasters has been consistently pegging a growth rate of just over 3% for 2011 since the start of the year, and that was unchanged in the survey conducted just last week. The biggest risk cited to this view was the spillover effects of Europe's debt debacle.

**Bottom Line:** Despite the very weak outlook for Europe and still-modest U.S. prospects, we believe that the broader global recovery remains on track, largely thanks to the powerful upswing still under way in the emerging markets. And while activity in the industrialized world does appear to be moderating, that is far from unusual at this stage of the cycle. While we cannot completely dismiss the risk of a double-dip, it would take something akin to a full-fledged credit freeze-up and a deeper equity downturn, or a major policy error to trigger it—and we believe that is where investor focus should be, not on the very typical monthly wiggles and wobbles in U.S. and Chinese economic indicators.

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