LPL FINANCIAL RESEARCH

Weekly Economic Commentary

July 14, 2014

Gauging Global Growth in 2014 & 2015

Update: Developed Markets Grow, While Emerging Markets Slow

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Highlights

Global GDP growth in 2014 remains on track to accelerate versus 2013's pace, excluding the impact of the weather.

The pace of growth in the global economy is a key driver of global earnings growth, and ultimately, the performance of global equity markets.

In our view, markets may already be looking ahead to the second half of 2014, and especially the third quarter, to gauge the true underlying pace of global growth.

The outlook for global growth is important to investors, since it defines the ultimate pace of activity that creates value for countries, companies, and consumers. This week, as investors begin to digest the S&P 500 earnings reports for the second quarter of 2014, we provide an update on how estimates for economic growth for 2014 and 2015 in the United States and across the globe have evolved over the past few years.

Last week, Christine Lagarde, Managing Director of The International Monetary Fund (IMF), signaled that the IMF would cut its global growth forecasts for both 2014 and 2015, when it releases its mid-year forecast update later this month. Although the release garnered plenty of headlines in the media, the majority of financial market participants took little notice of the report. Why? Because consensus forecasts for global gross domestic product (GDP) growth are available monthly from sources like Bloomberg News, and because markets react to changes in projected paths of economic growth every day amid the daily, weekly, and monthly drumbeat of economic data and events from around the globe.

Why Global GDP Growth Matters

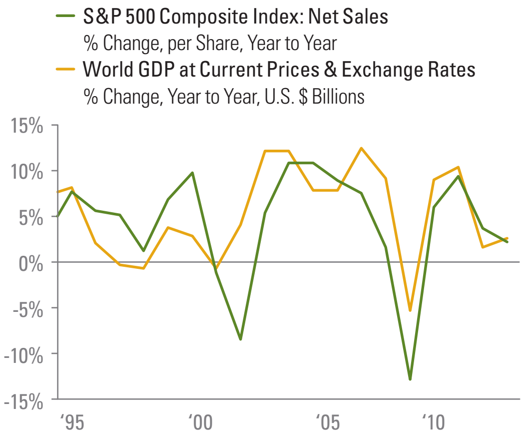
A good proxy for global revenue growth is global GDP growth plus inflation.

Although prospects for U.S. economic growth have generated the most headlines, in recent years markets have focused more on the prospects for global GDP growth. Why does global GDP growth matter? As we have noted in prior *Weekly Economic Commentaries*, financial markets—especially equity markets—focus intently on earnings. Broadly speaking, earnings growth is driven by "top-line" growth, or revenue growth, less the costs incurred earning that revenue, with labor accounting for more than two-thirds of total costs. A good proxy for global revenue growth is global GDP growth plus inflation. Thus, the pace of growth in the global economy is a key driver of global earnings growth, and ultimately, the performance of global equity markets [Figure 1]. The consensus is expecting revenue growth for S&P 500 companies to post a 3% year-over-year gain in the second quarter of 2014.

U.S. Growth Estimates Marked Down the Most

Figure 2 details the progression of the consensus GDP forecasts for 2014 and 2015 for the world, the United States, China, the Eurozone, and Japan over the past several years. The latest (mid-July, 2014) Bloomberg-tracked economists' consensus forecast for 2014 global GDP growth stands at 2.5%, down 0.3%

1 Global GDP Has Been a Good Proxy for Corporate Revenue Growth



Source: LPL Financial Research, Haver Analytics, Standard and Poor's 07/11/14

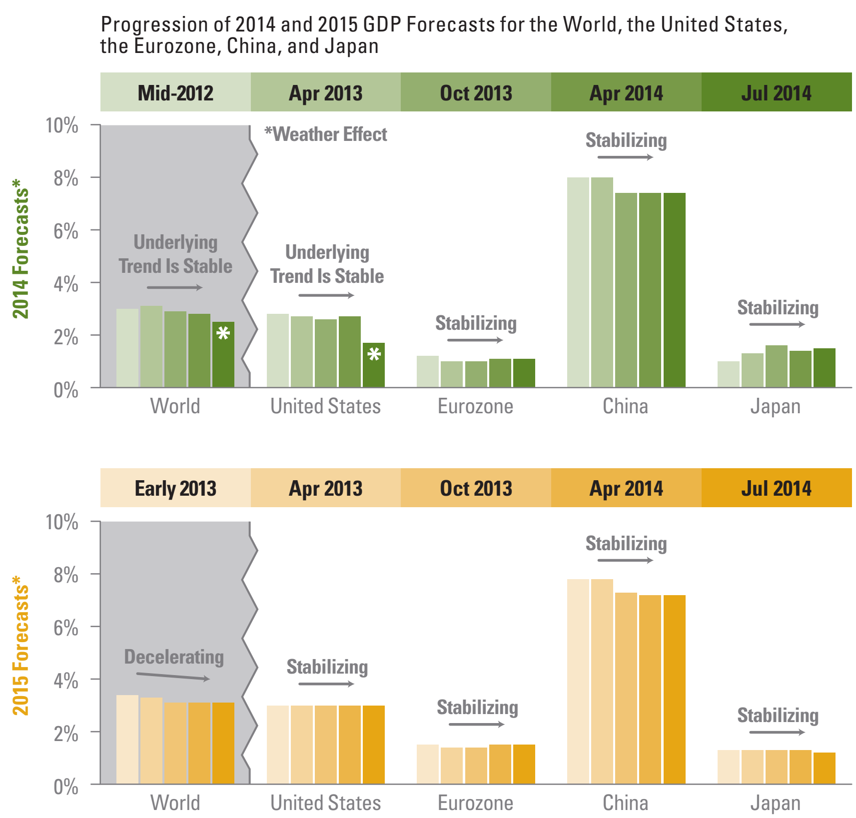
Past performance is no guarantee of future results.

The S&P 500 Composite Index is an unmanaged Index of 500 widely held common stocks that measures the general performance of the market. One cannot invest in an index.

from the 2.8% expected for 2014 back in April 2014. In mid-2012, when Bloomberg first began tracking consensus estimates for global GDP growth for 2014, the consensus was expecting 3.0% world GDP growth. The bulk of the markdown of global growth estimates for 2014 is due to unusually cold and snowy winter weather in the United States in the first quarter of 2014. Real GDP in the first quarter of 2014 fell at a 2.9% annualized pace in the United States, largely due to the impact of the weather, although inventory drawdowns and the impact of the Affordable Care Act also played a role.

While the Bloomberg-tracked economists' consensus expects U.S. GDP growth to snap back in the second quarter of 2014 to a pace that is above the economy's long-term potential growth rate, real GDP growth in Europe may slow (the U.S. will report second quarter 2014 GDP in late July 2014). Why? The weather takes the blame for this as well. As the United States was enduring one of the harshest winters on record, Europe "enjoyed" a mild winter, which helped to boost European GDP growth in the first quarter. The European data released thus far for the second quarter suggest that "payback" for the warm winter has dampened growth in that region. Despite the weather, the consensus forecast for Eurozone GDP growth in 2014 has not budged since April and remains at 1.1%. The Eurozone will report its second quarter GDP in mid-August 2014.

2 Weather Aside, Stability in Global Growth Forecasts for 2014 and 2015 Is a Positive Sign for Markets



Source: LPL Financial Research, Bloomberg 07/11/14

*Forecasts for 2014 and 2015 made in 2013 and 2014

Growth Estimates for China & Japan Maintained

Global GDP growth in 2014 remains on track to accelerate versus 2013's pace.

Growth estimates for both China and Japan for 2014 and 2015 haven't changed much since April 2014, or from the fall of 2013. China is set to release its second quarter GDP report later this week. In recent weeks, Chinese authorities have enacted a series of targeted fiscal, monetary, and administrative actions aimed at stabilizing China's economy. Japan's economy is benefitting from quantitative easing (QE), fiscal stimulus, and regulatory reform, together known as the Three Arrows. The Bank of Japan meets this week to discuss increasing the size of its QE program, but is likely to wait until the autumn of 2014 before reassessing the need for more monetary stimulus.

On balance — excluding the impact of the weather — global GDP growth in 2014 remains on track to accelerate versus 2013's pace, aided by stability in China, solid underlying momentum in the U.S. economy, and relative stability (albeit at low growth rates) in the Eurozone and Japan. In our view, markets may already be looking past the second quarter results and looking ahead to the second half of 2014, and especially the third quarter, in order to gauge the true underlying pace of global growth. ■

RES 4714 0714
Tracking #1-289912 (Exp. 07/15)