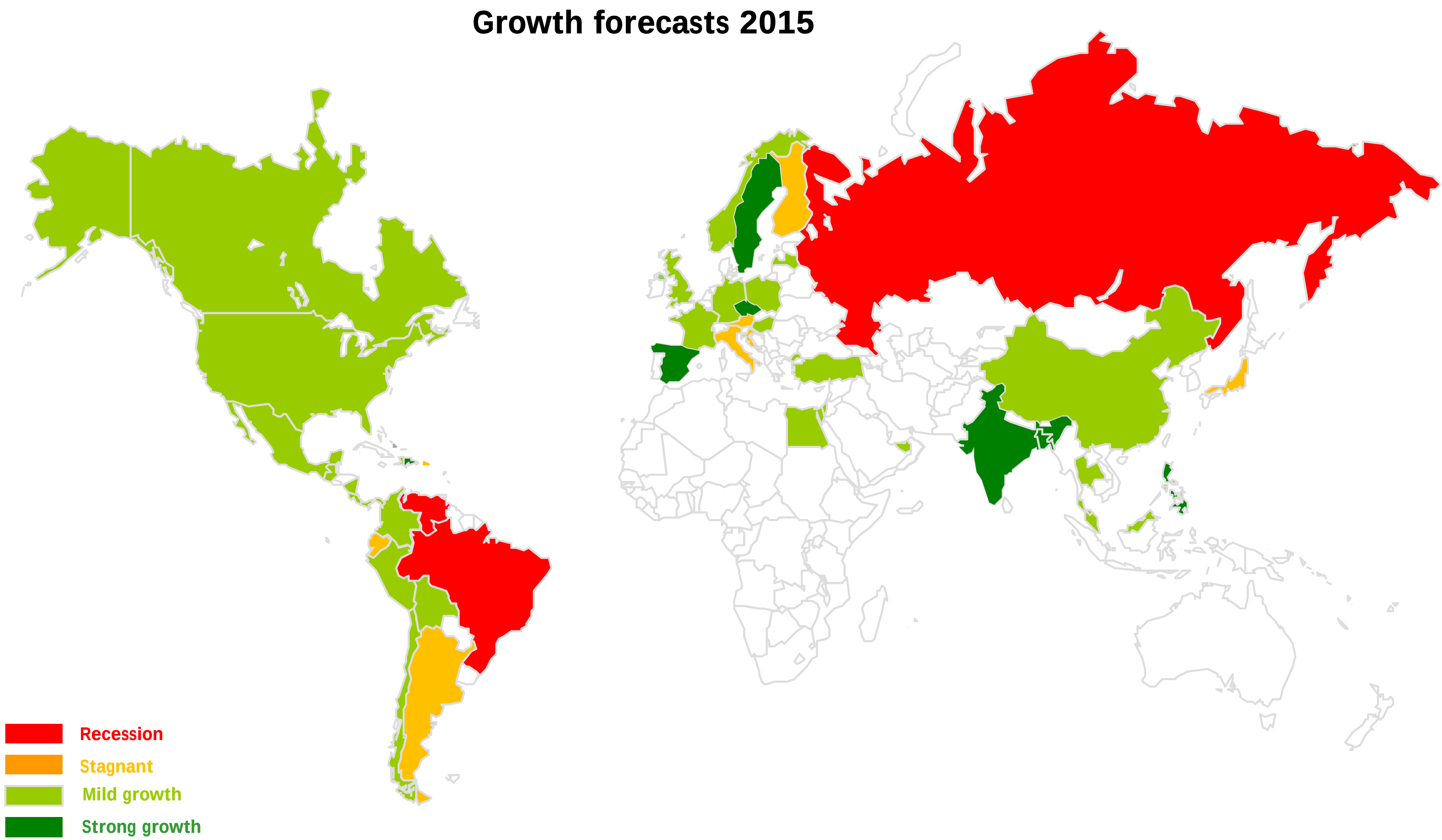
Déjà Vu, Again:
China, Oil, the Fed and ...

Manuel Balmaseda
CX Economics

May 26, 2016

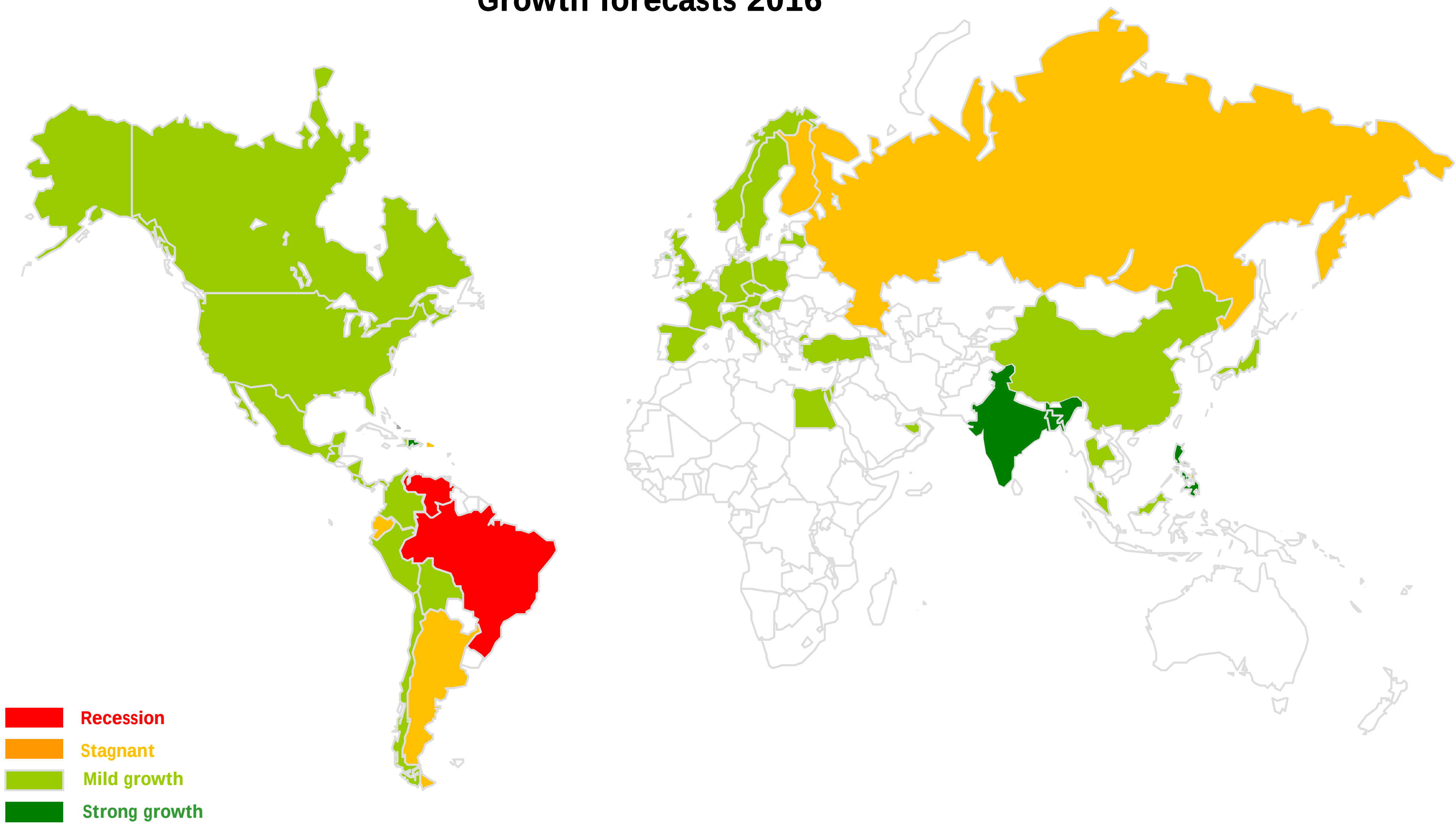
Stability in the developed world, though no reasons to party. Challenging for EMs



Fuente: CX- Economics and Consensus Forecast

Stability in the developed world, though no reasons to party. Challenging for EMs

Growth forecasts 2016



Fuente: CX- Economics and Consensus Forecast

Global activity in the cross-fire of shocks

China's slowdown

Drop in oil prices

Buffers

Buffers

2016

Buffers

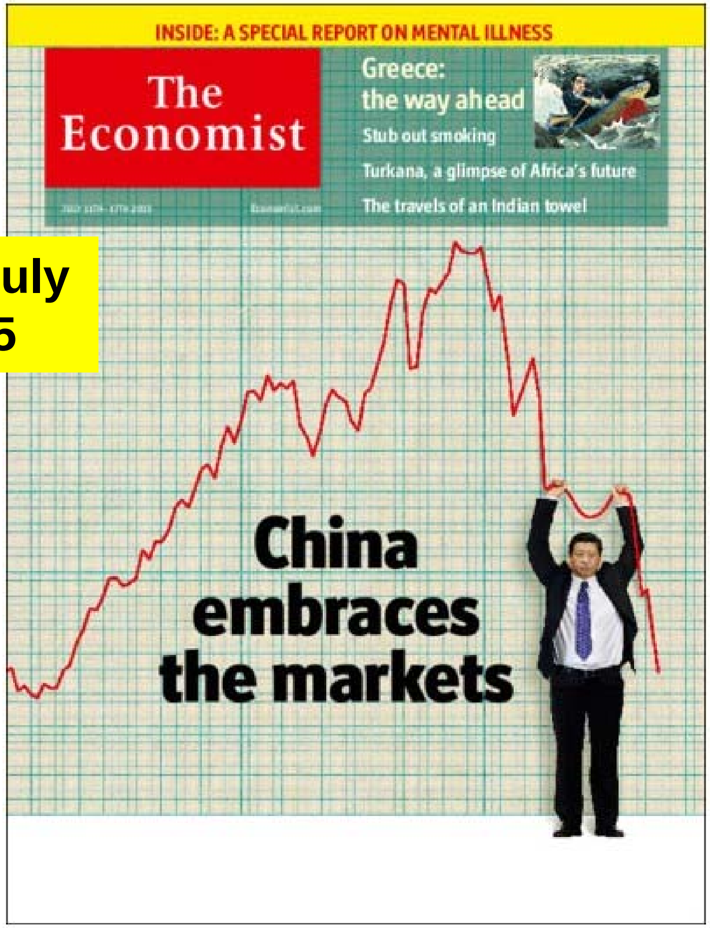
Buffers

Geopolitics

Fed and "other" central banks

China generates volatility in markets

11 July 2015



27 Aug 2015

Global financial markets have become more sensitive to changes in China's economic and financial conditions and policies

Will China manage a soft landing?

Sharp correction of Chinese stock market

Will China manage a soft landing?

The two visions

Optimistic	Pessimistic
The slowdown is the byproduct of the shift towards a more sustainable growth model (increasing the weight of consumption and services)	Disequilibria built up during recent years will finally take its toll

Optimistic

The slowdown is the byproduct of the shift towards a more sustainable growth model (increasing the weight of consumption and services)

Availability of policy space and many tools to manage the transition

- Relatively healthy public sector balance sheet,
- Large domestic savings,
- Still important role of the state

Pessimistic

Disequilibria built up during recent years will finally take its toll

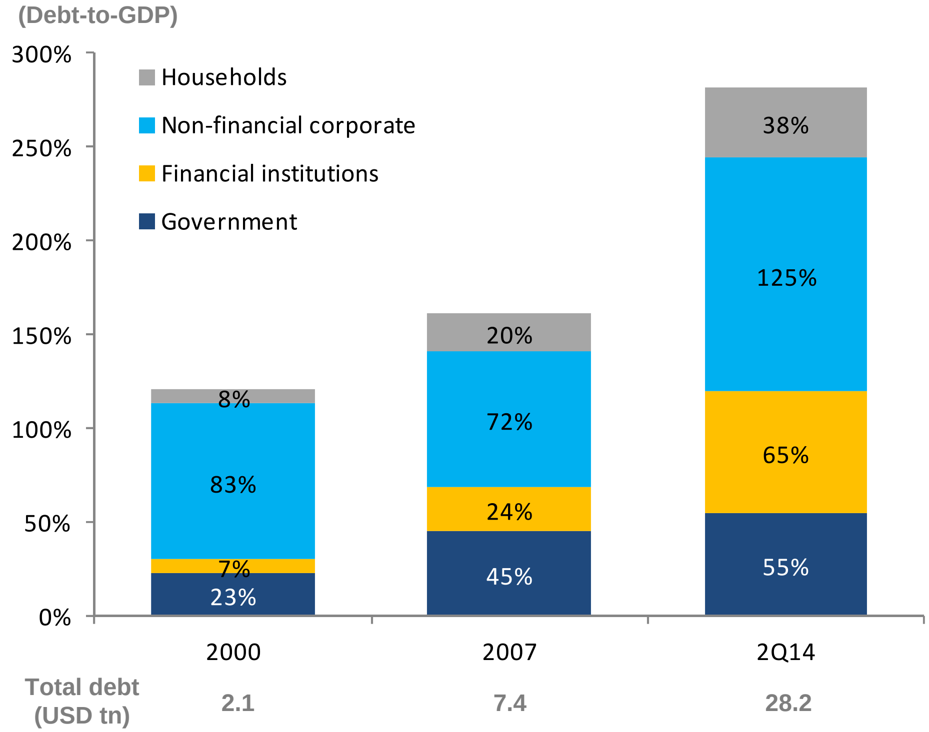
- Excess capacity in some sectors
- Excessive leverage in the private sector,
- Episodes of irrational exuberance in asset markets (stock market, real estate)

Authorities will not be able to manage or "soften" the bursting of the bubbles

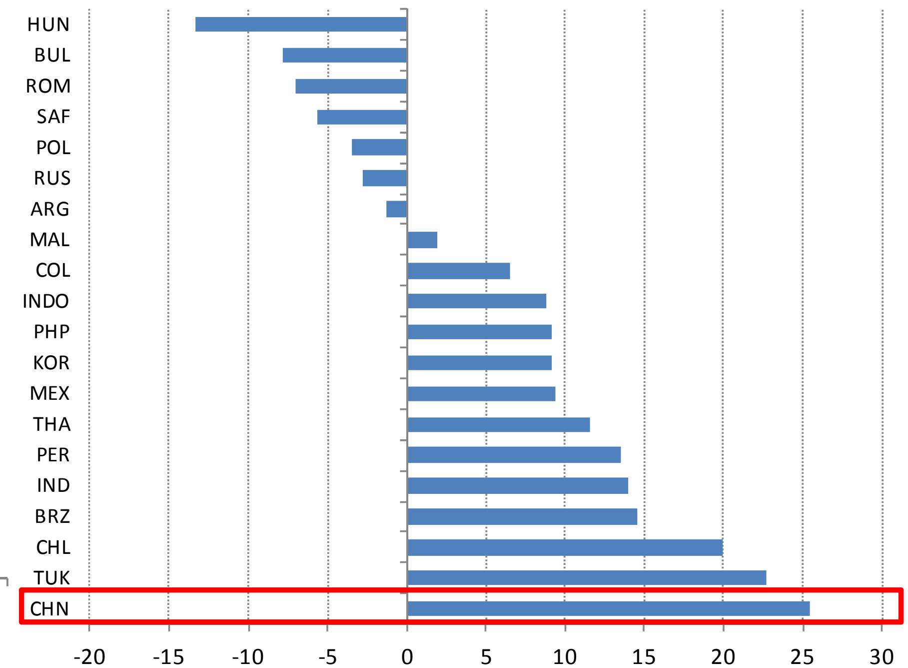
Achieving a 'soft landing' of the economy while addressing vulnerabilities and advancing structural reforms will be challenging

Will China manage a soft landing?

Corporate debt increase in emerging markets may be a source of risk (particularly in China, but not only)



Total China debt. In USD amd % of GDP



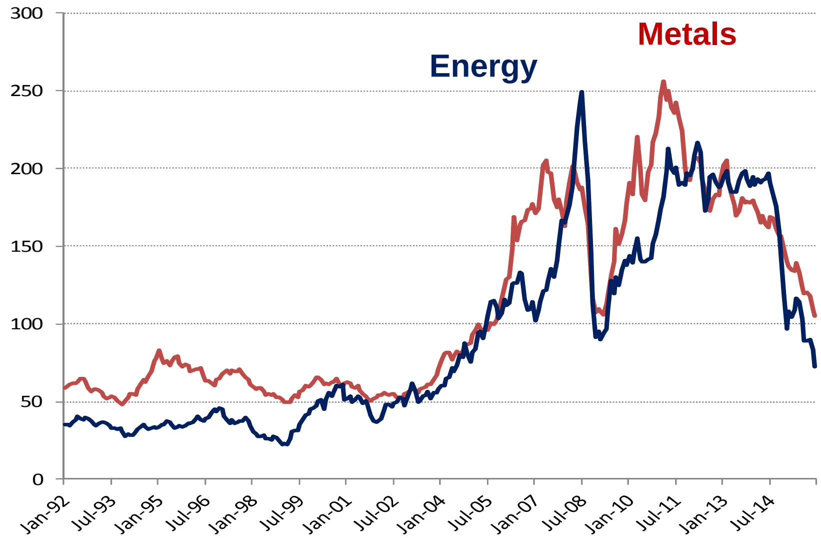
Change in corporate debt: 2007-2014 (in % of GDP)

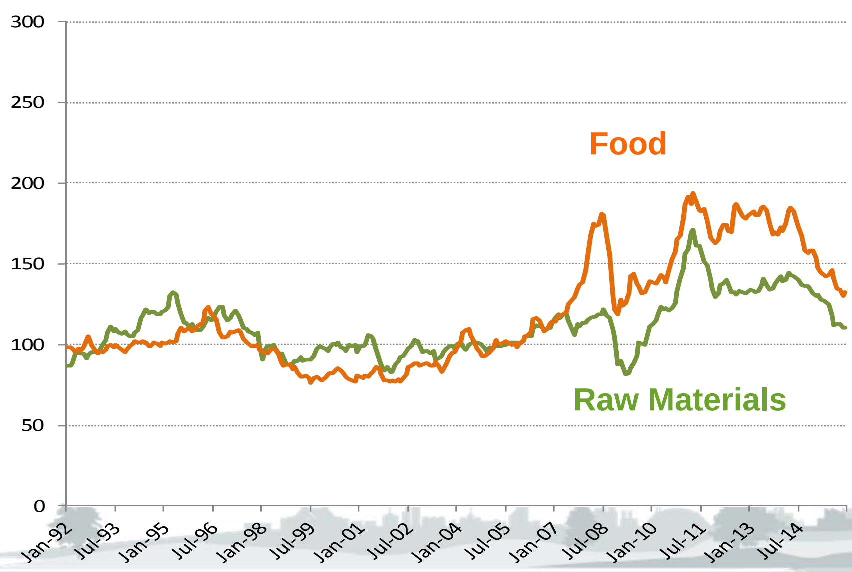
Higher leverage has also been associated with, on average, rising foreign currency exposures

Source: IMF (Global Financial Stability Report) and Mackinsey Global Institute Analysis

Collateral effects of the Chinese landing: commodity price drop

Commodity prices have fallen sharply, particularly energy and metals





Strong EM commodity demand → ***Upswing in commodity prices***

↓

Incentives for capacity build out and technology innovation

↓

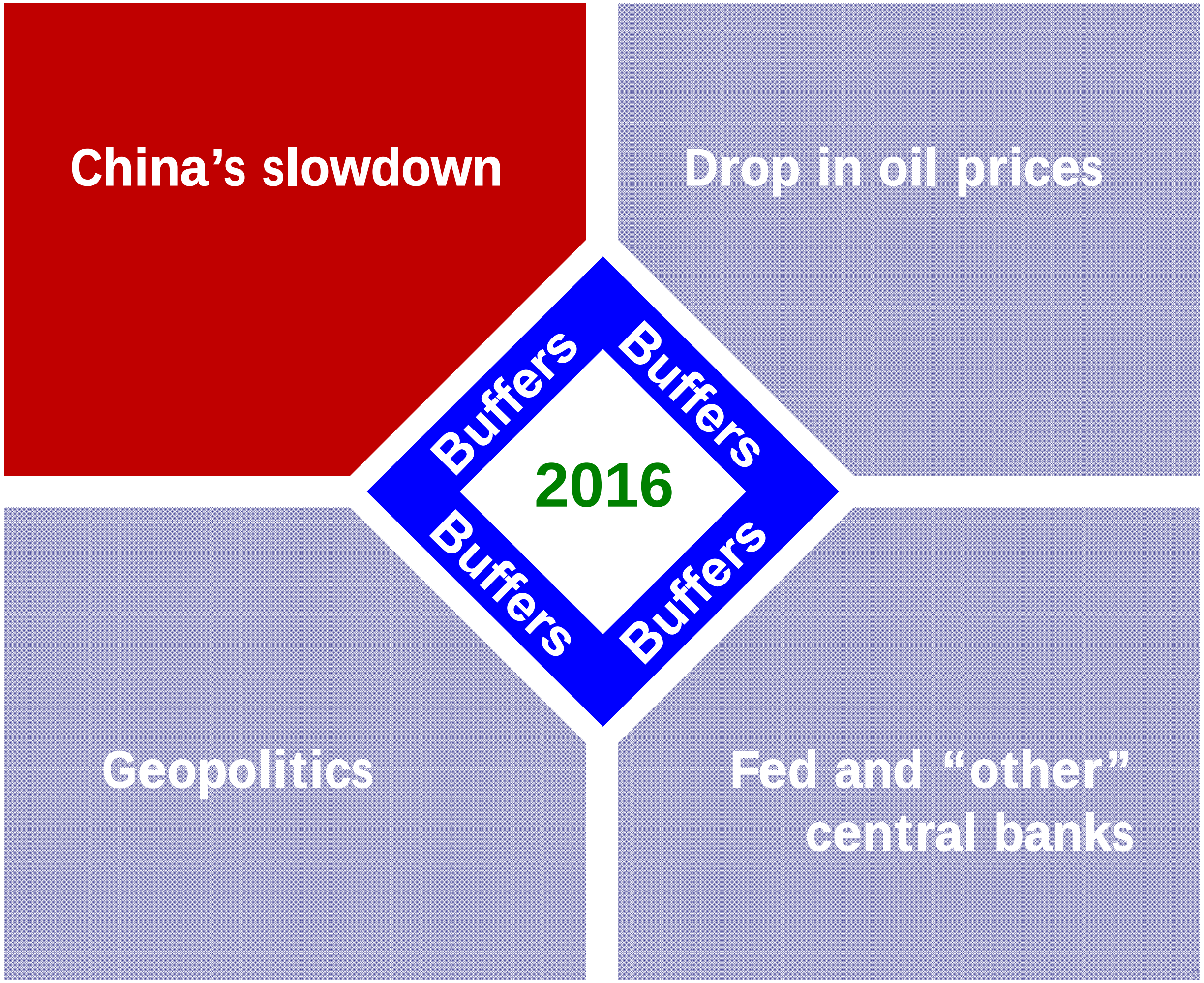
Oversupply + **Softening of EM commodity demand**

↓

Commodity prices downswing

Will China manage a soft landing?

Caught in the cross-fire between positive and negative factors



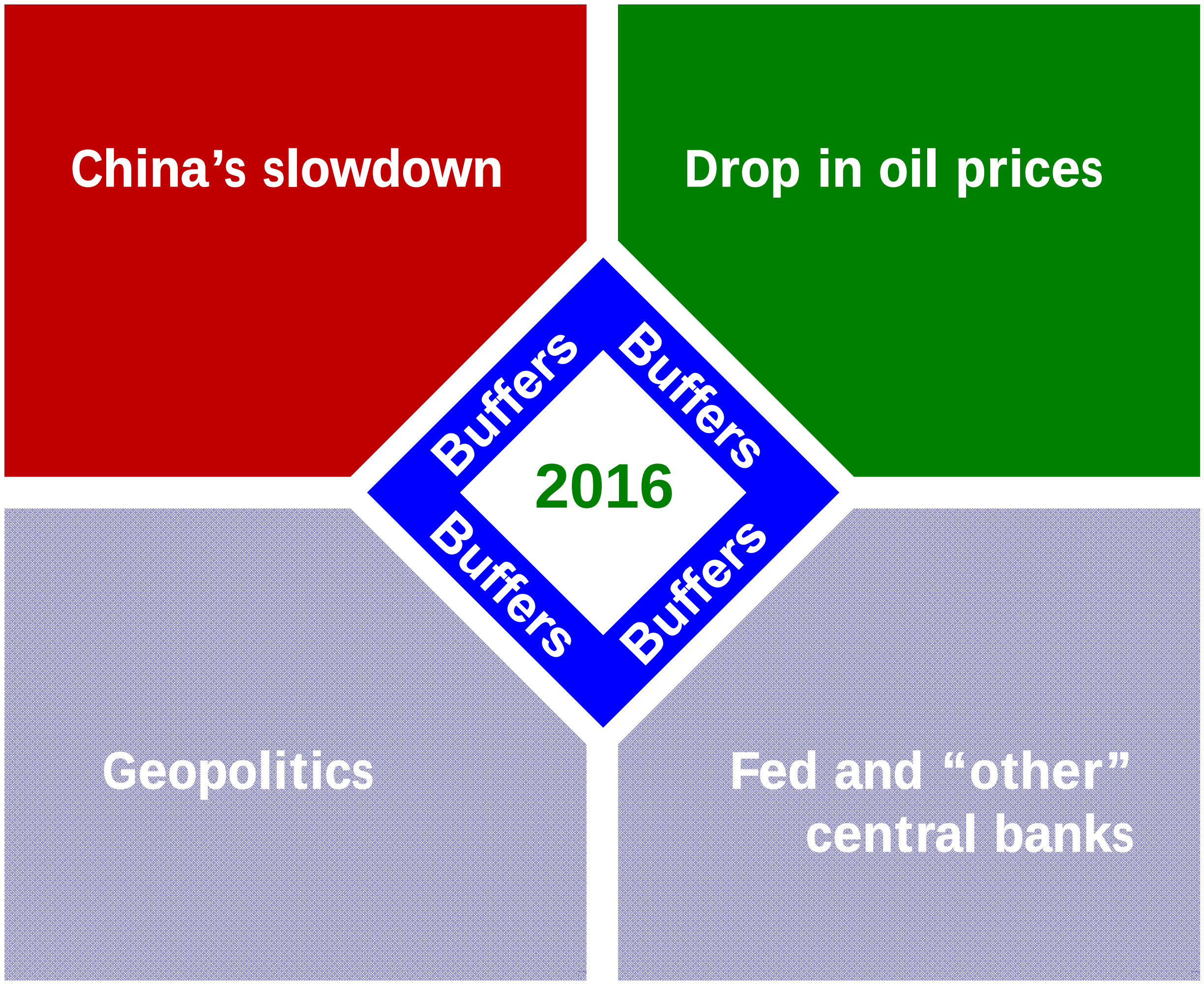
Oil is unambiguosly a positive supply shock for Europe

Although the market volatility generated may have negative repercussions

Has oil finally bottomed out?

Brent oil price. $/b. Source: DS

Caught in the cross-fire between positive and negative factors



Tapering: costless strategy?

Discussion continues to be center around the Fed

Oct. 13

ary policy normalization will have costs regardless the way it is implemented

1) Disorderly exit

Long term inflation expectations disanchoring

2) Too late/too soon exit

Permanent vs. transitory effect of financial crisis on potential growth

3) Right in time exit

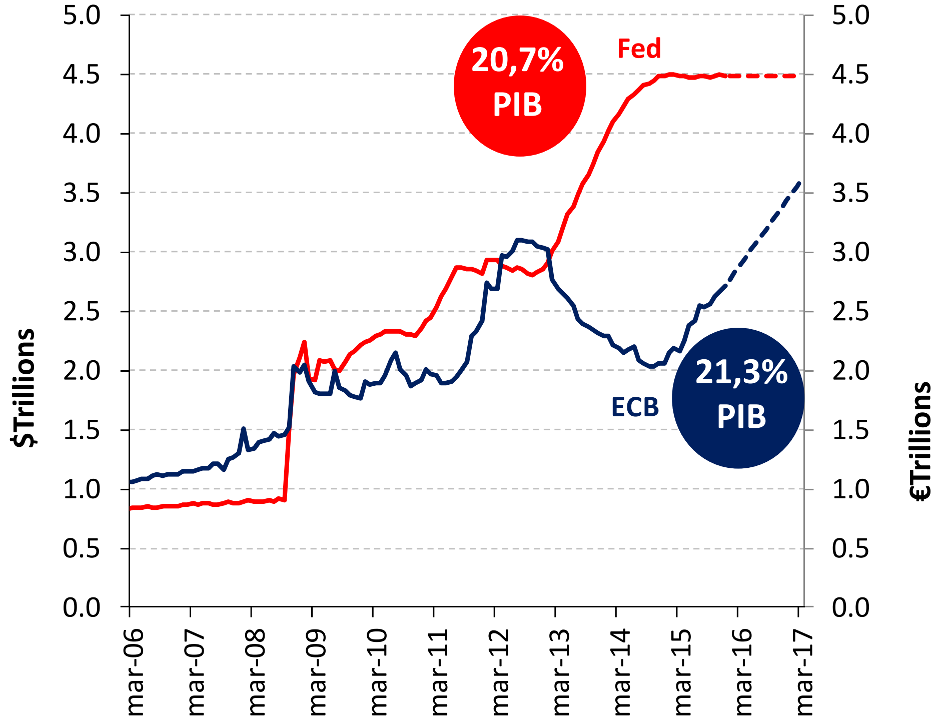
- Sunk costs: Fixed income bubble Any other bubbles?
- Coordinated or uncoordinated (first mover disadvantage)
- Inefficient allocation of resources
- Impact on EMs

“Ain’t no free lunch”

Fed: End of QE. Time for normalizing the abnormal?

CEMEX

First mover advantage?



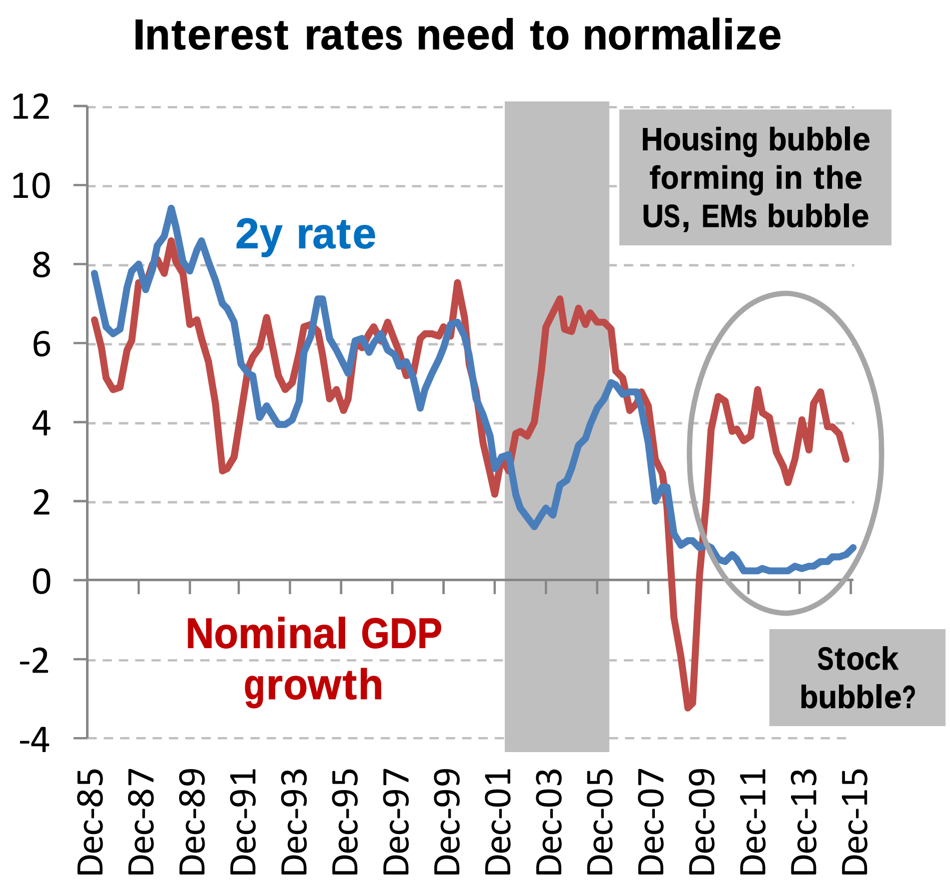
Source: DS. Fed (in US$) and ECB (in €) Balance Sheet. Trillions

Interest rate rises are unlikely to go as smoothly

"Long-term interest rates are at very low levels, and [...] when the Fed decides it's time to begin raising rates [...] term premiums could move up, and we could see a sharp jump in long-term rates."
Janet Yellen May 7th 2015

"Low market liquidity may act as a powerful amplifier of financial stability risks"
IMF May 2015

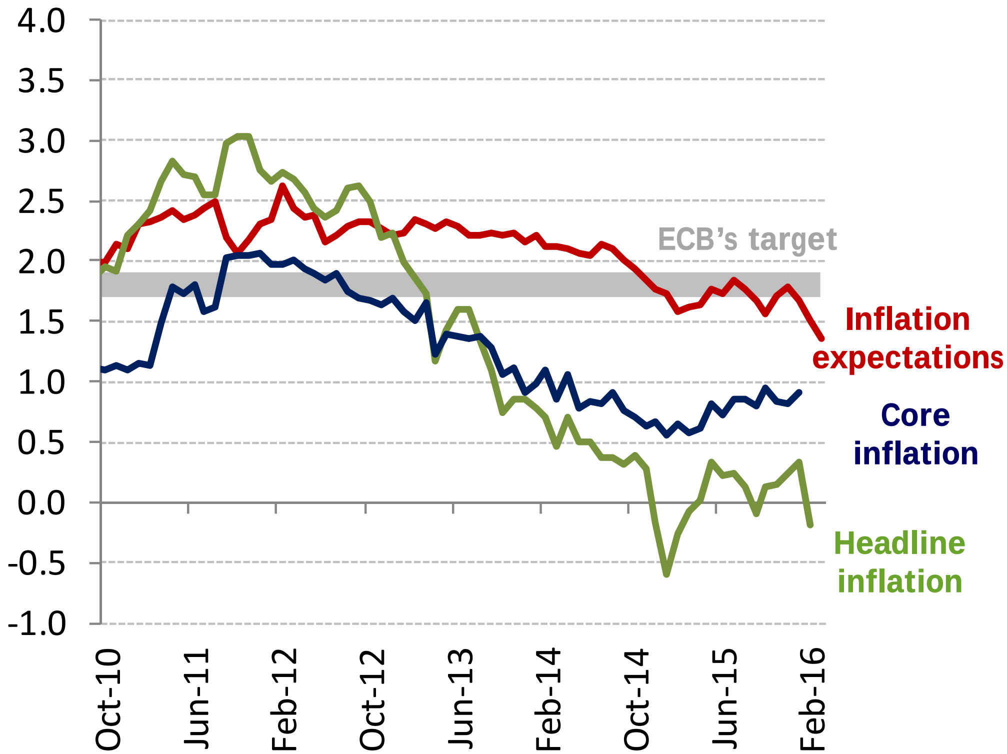
Normalization needed sooner or later …



Where will the next bubble show up?

ECB policy: "do whatever it takes". Will it be enough?

Eurozone Inflation far below ECB's target



Risk of not acting further

- **Disanchoring inflation expectations**
- **Debt deflation spiral**

Risk of acting further

- **Negative interest rates scenario distorting financial markets**
- **Uncertain consequences for the banking sector**

Rather do too much than too little

Source: DS

Deflation, collateral damage in Europe

- **Higher increase in** ***spreads***
- **"*Sudden stop*" risk**
- **Credit crunch**
- ***Economic*** **contraction and necessity of restoring public finance**

Deflation

Break-up risk

- **More difficult to repay debt**
- **Fiscal adjustment more severe**
- **Contraction of activity (shy consumption and investment)**

Risk of default

- **Increase in spreads**
- **More necessity of real adjustment (fall in demand)**
- **Social unrest reignites (austerity fatigue in periphery - rescue fatigue in the core)**

Déjà vu, "old" shocks keep acting up

Chinese landing

- Lower Chinese demand (imports)
- Lower commodity prices

Negative for countries with strong trade ties with China and commodity exporters

Oil supply shock

Positive for oil importers

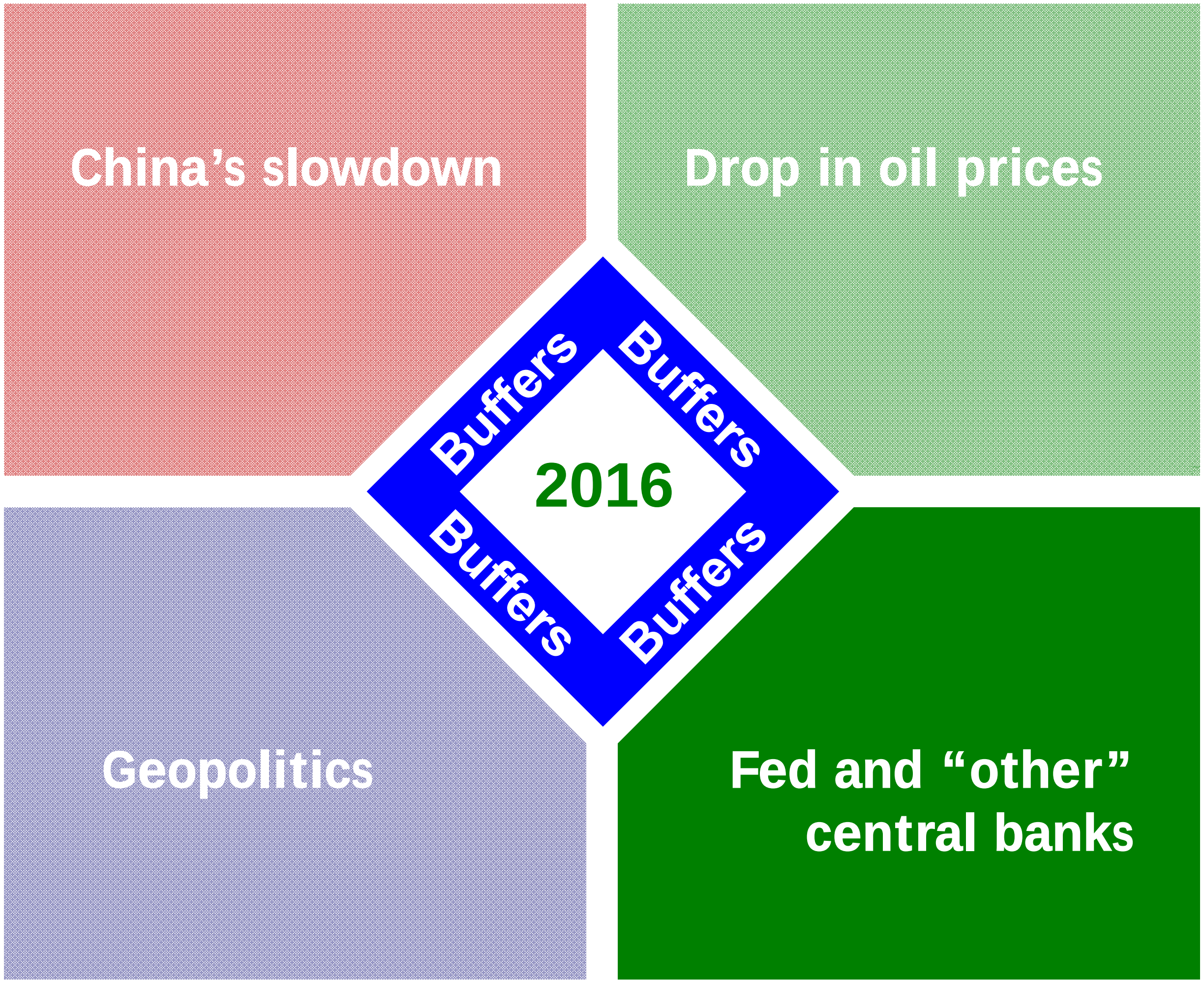
Increased risk aversion

Fed's tightening

- US Dollar appreciation
- Capital outflows from EMs

Negative for countries with high external financing needs and high USD debt

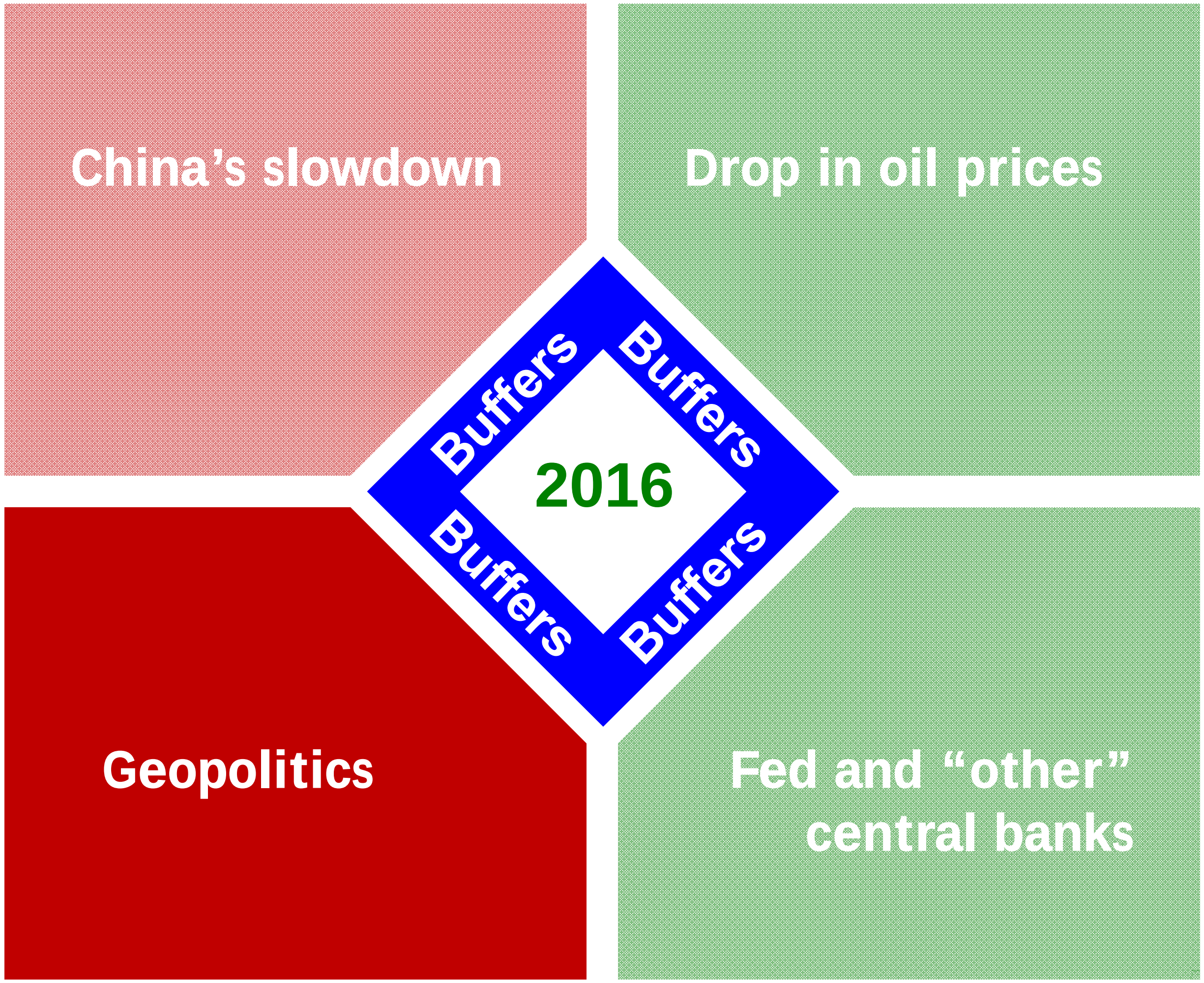
Caught in the cross-fire between positive and negative factors



Can we predict the unpredictable? Geopolitical risk

Geopolitical risk with economic roots, but not anticipated by economists

Caught in the cross-fire between positive and negative factors



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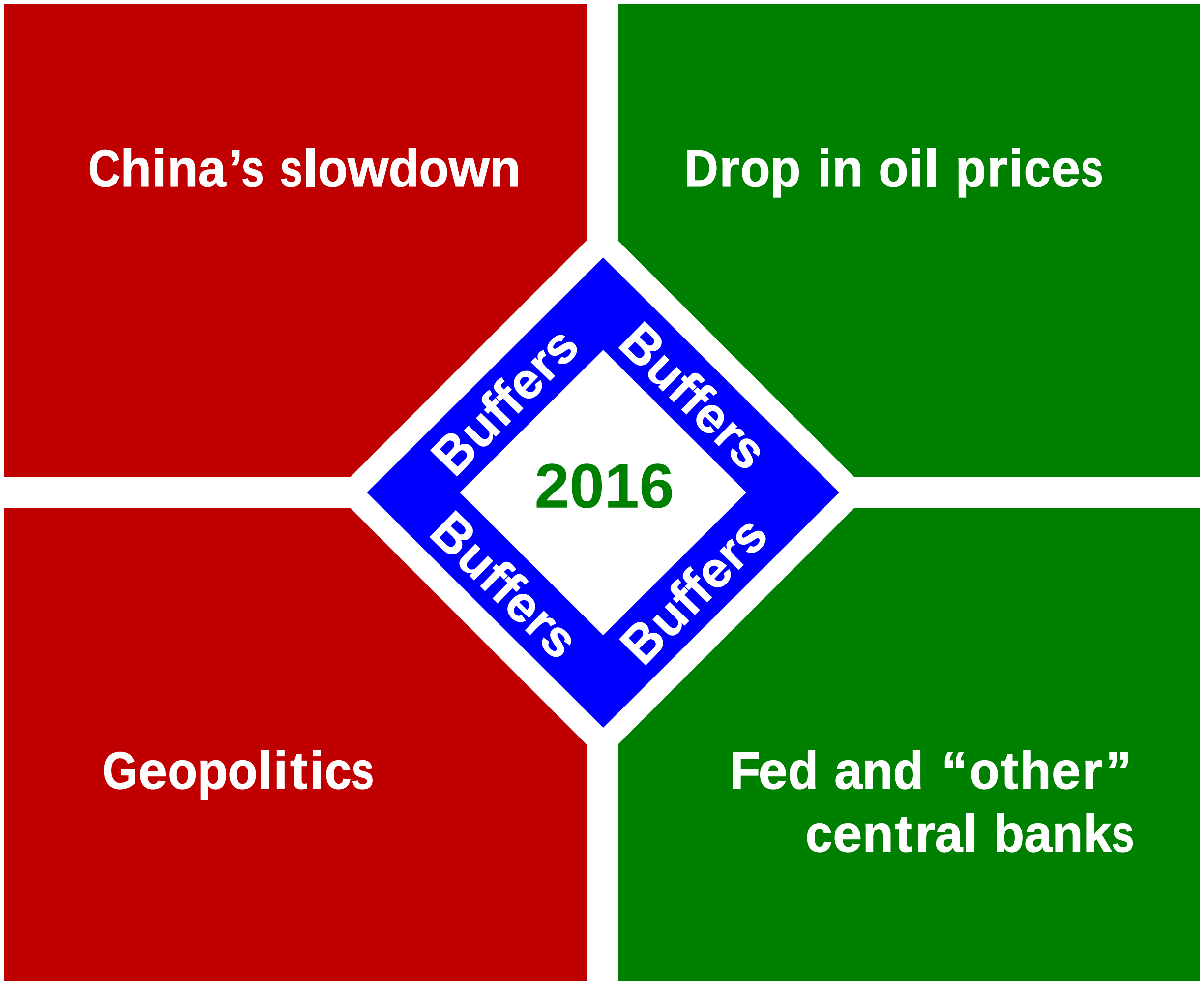


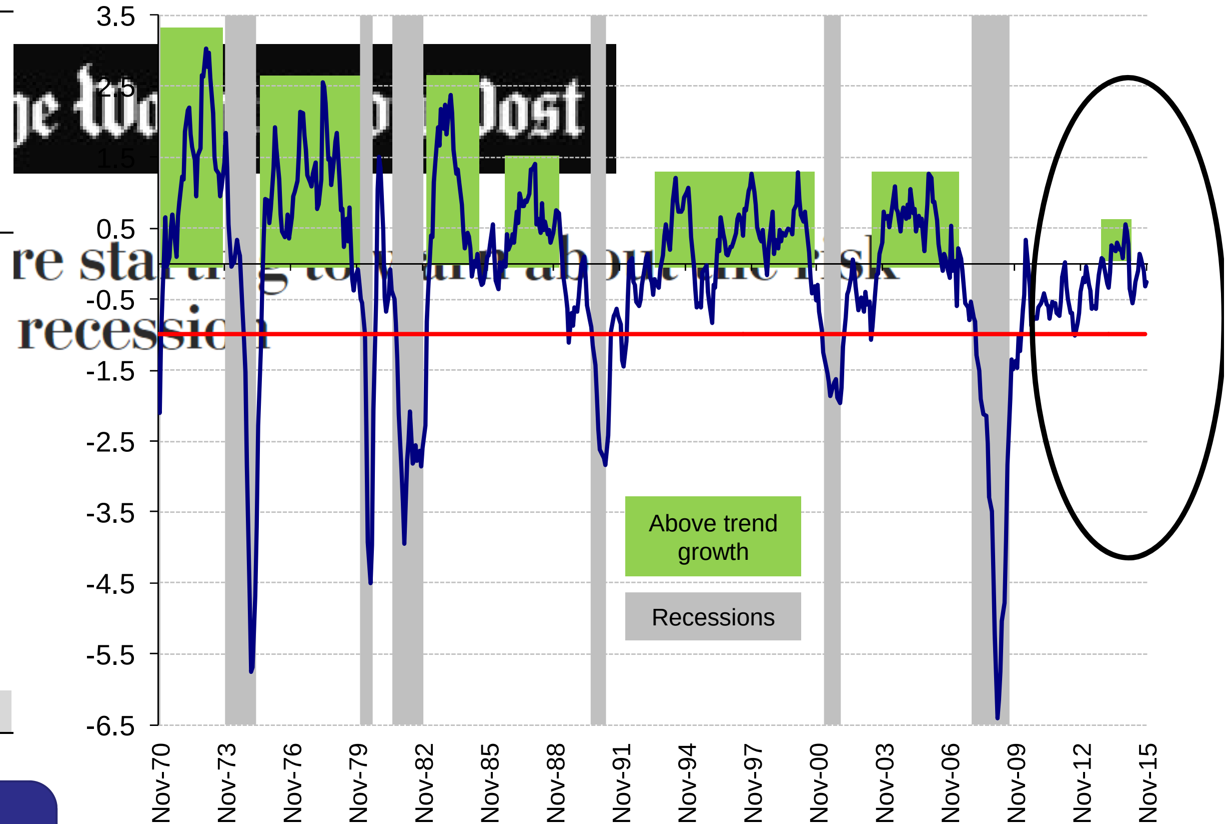
Is the US expansion coming to an end?

No such thing as a “normal” cycle

Recessions		*Duration of expansions in months*
Peak month	*Trough month*	
November 1948	October 1949	37
July 1953	May 1954	45
August 1957	April 1958	39
April 1960	February 1961	24
December 1969	November 1970	106
November 1973	March 1975	36
January 1980	July 1980	58
July 1981	November 1982	12
July 1990	March 1991	92
March 2001	November 2001	120
December 2007	June 2009	73
Assumming December 15 as peak		79

No recession but 2% economy

This expansion has been very weak, almost no quarters of growth above trend

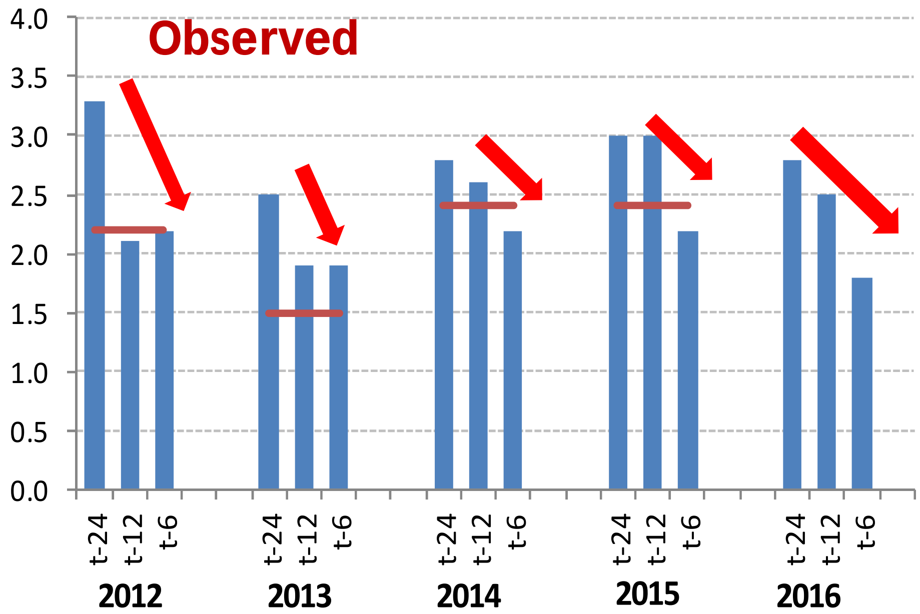


CX US Activity Indicator. 40% available information in November.
Source: CX and NBER

US: *Déjà vu*, again

GDP observed growth and Consensus Forecast expectations

US



Example: for 2015 growth

t-24: CF as of Jan. 14

t-18: CF as of June 14

t-6: CF as of June 15

US continues to disappoint expectations

Source: CF and CEMEX

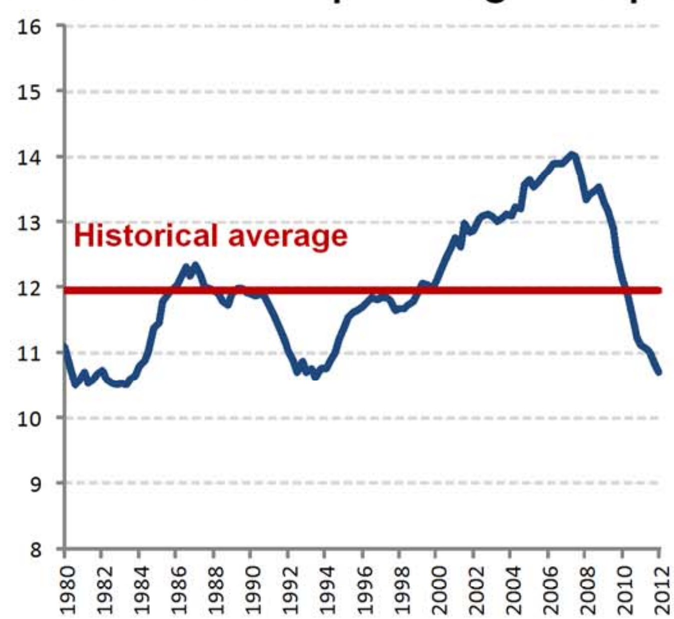
Light beyond the (fiscal) cliff

Oct. 12

Supporting drivers:

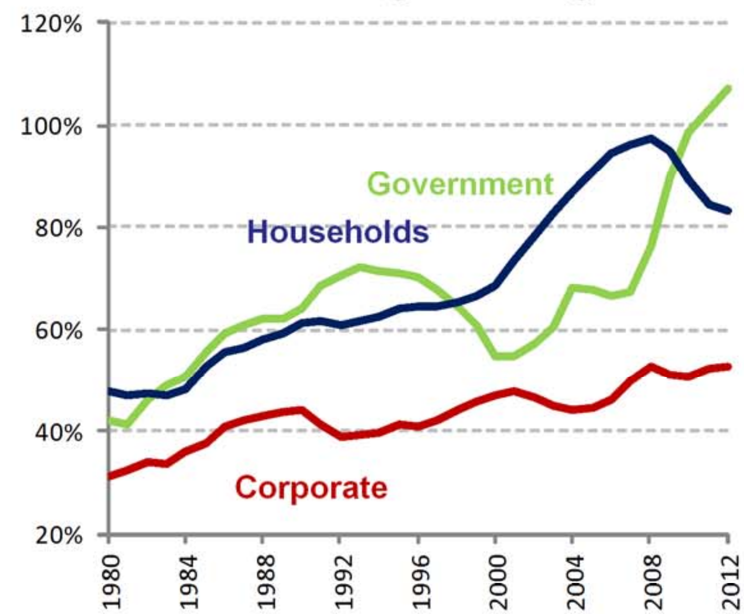
- Improving household finances
- Corporations in strong position to invest
- Ample liquidity on the back of very expansive monetary policy
- Fiscal tightening only modestly
- Banks in sound position (ample cash coverage)
- Residential investment contributing positively to growth

Households with ample margin to spend …



Households debt service % of disposable income

… but leverage still high.

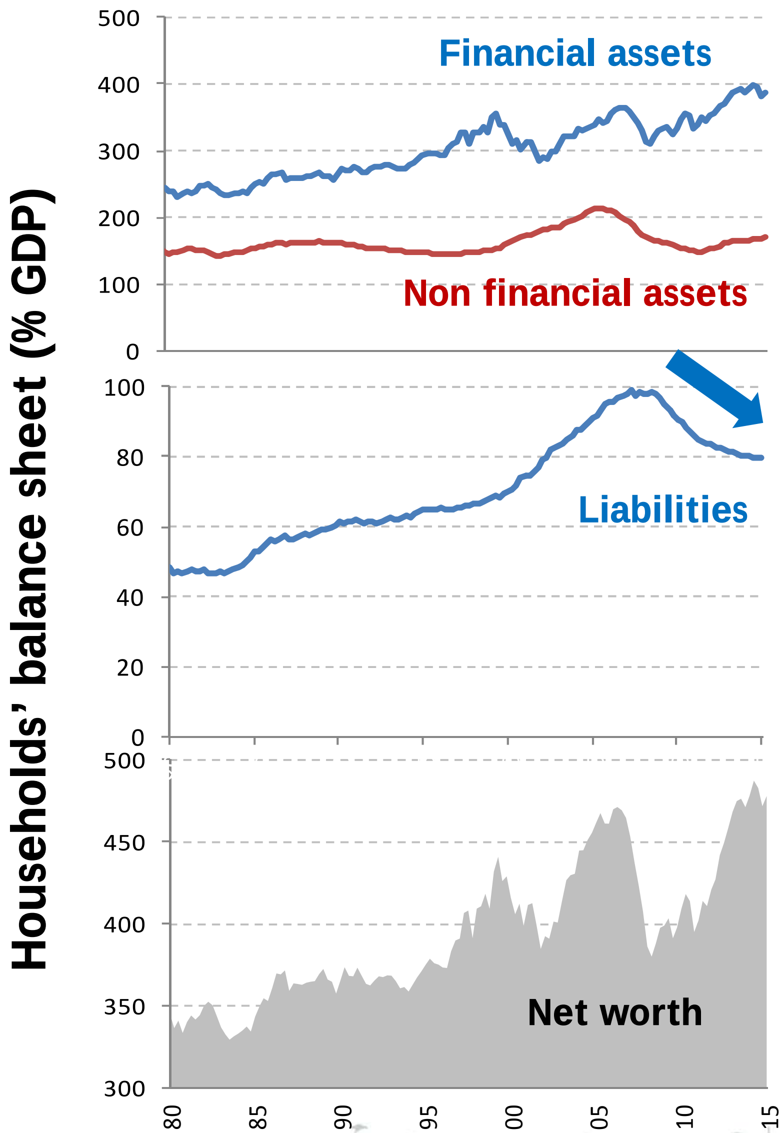


Debt outstanding (% GDP)

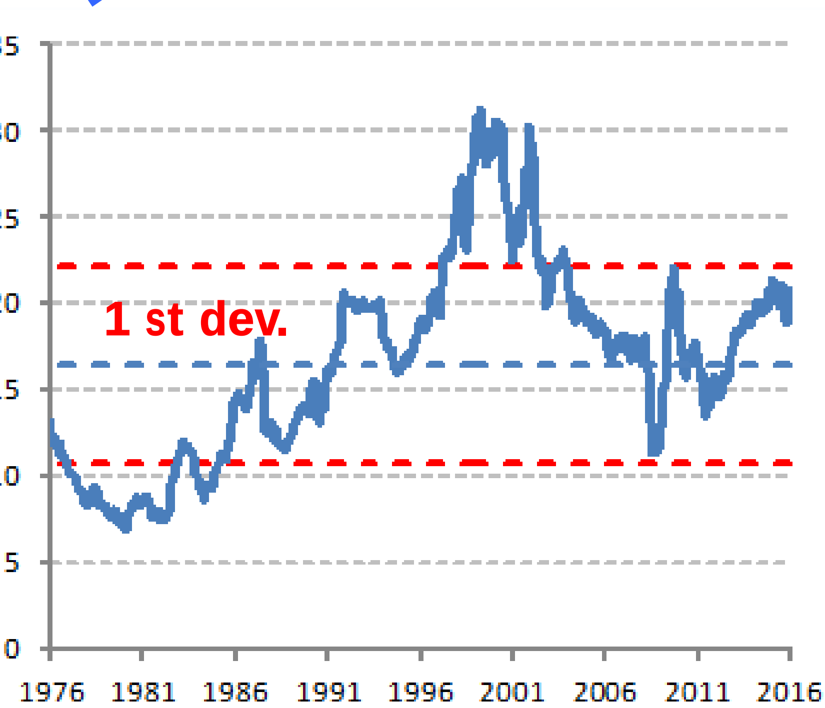
Source: BEA and Federal Reserve

… but it only guarantees mild growth (deleveraging still ongoing)

Healthy consumers: PCE at 2.5%-3.0% growth. Financial stability remains a concern (precautionary saving)



PER ratio

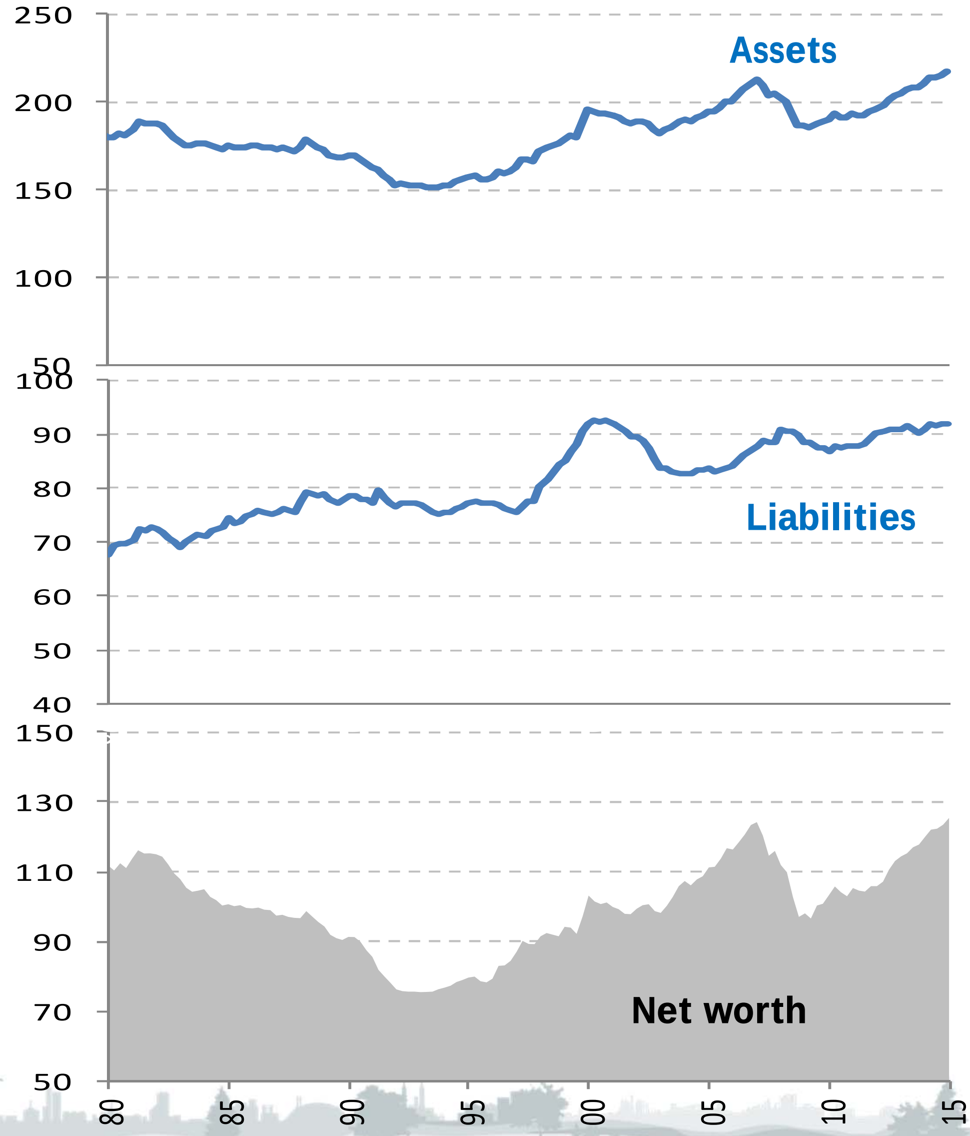


Justified by economic fundamentals or result of excess liquidity?

Source: Fed and CX

Investment: Healthy NFC' balance sheets also, despite debt accumulation

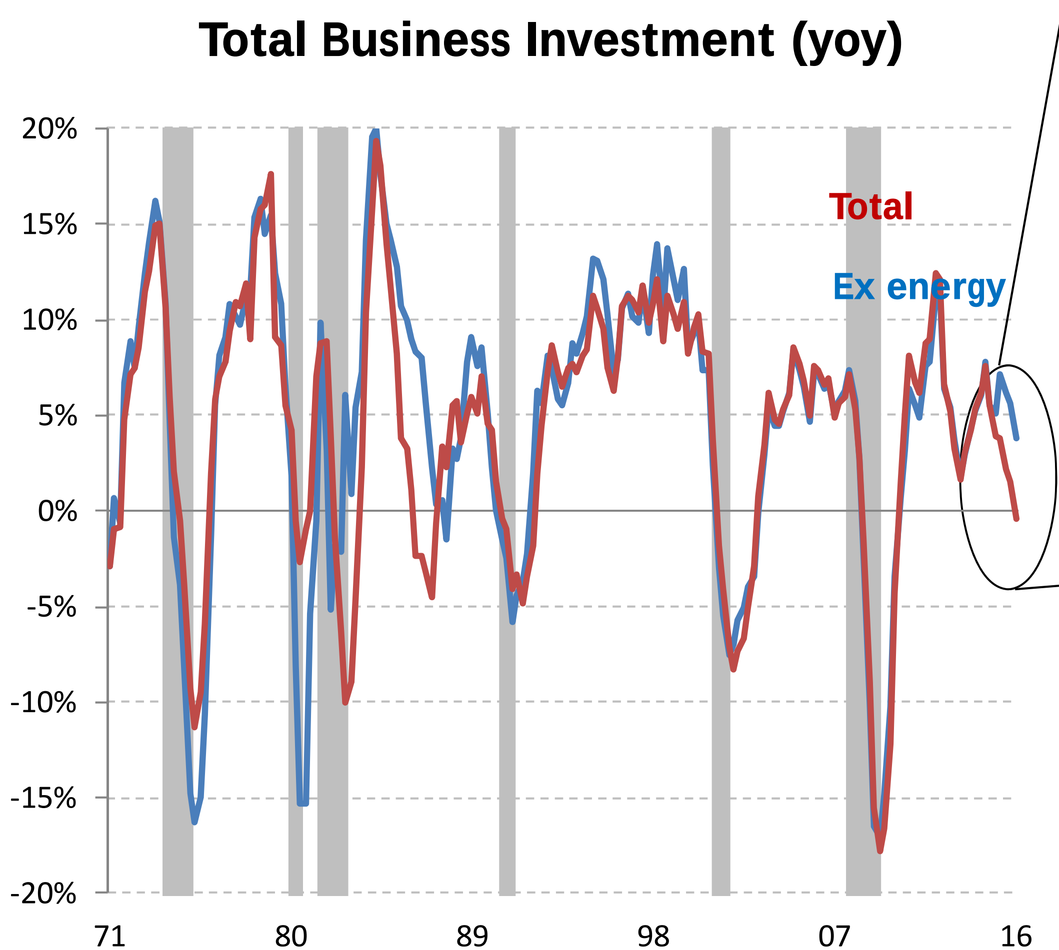
NFC' balance sheet (% GDP)



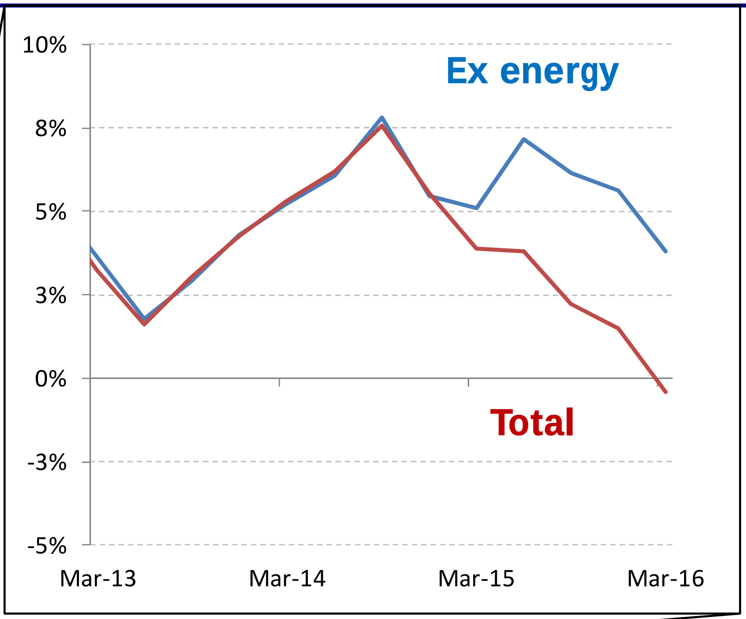
But growth weighed down by low CAPEX

Source: Fed and CX

Lack of CAPEX oil related. Ex-energy investment is doing OK but probably not strong enough



Energy weight (%)	15	33	10	5	6	3

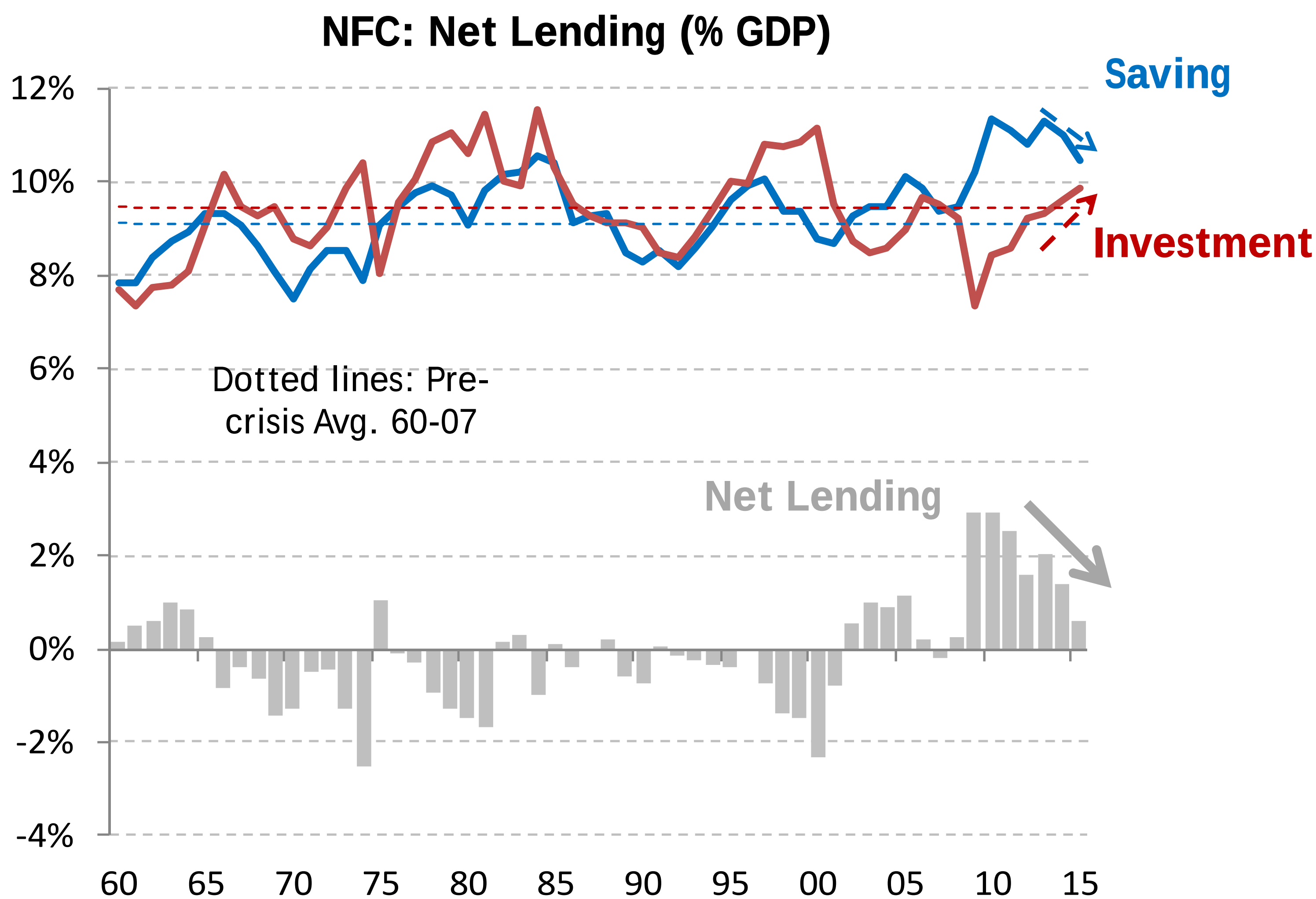


"Core investment" (ex energy) does not anticipate a recession in the short term

Source: BEA and CX

Ex Energy excludes mining exploration, shafts, and wells structures and mining and oilfield machinery.

Excess saving more than lack of investment. Although, latest data shows a slow return to "normality"



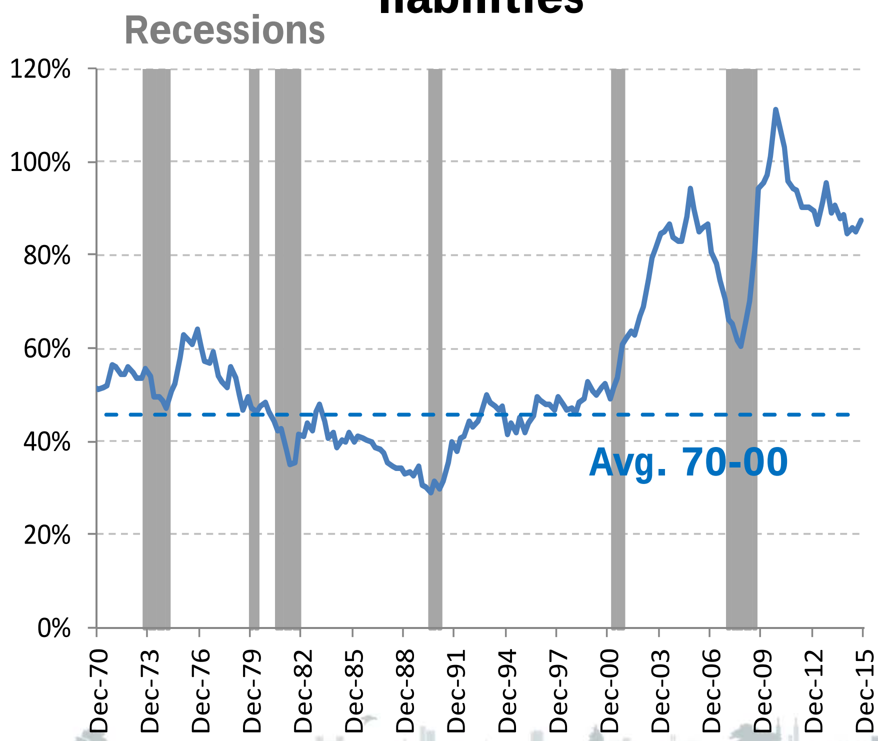
Europization (or Germanizing) of the US? It seems not

In sum: corporate savings are not being (fully) channeled to productive investment, as they were before the crisis

What are companies doing with the saving glut?

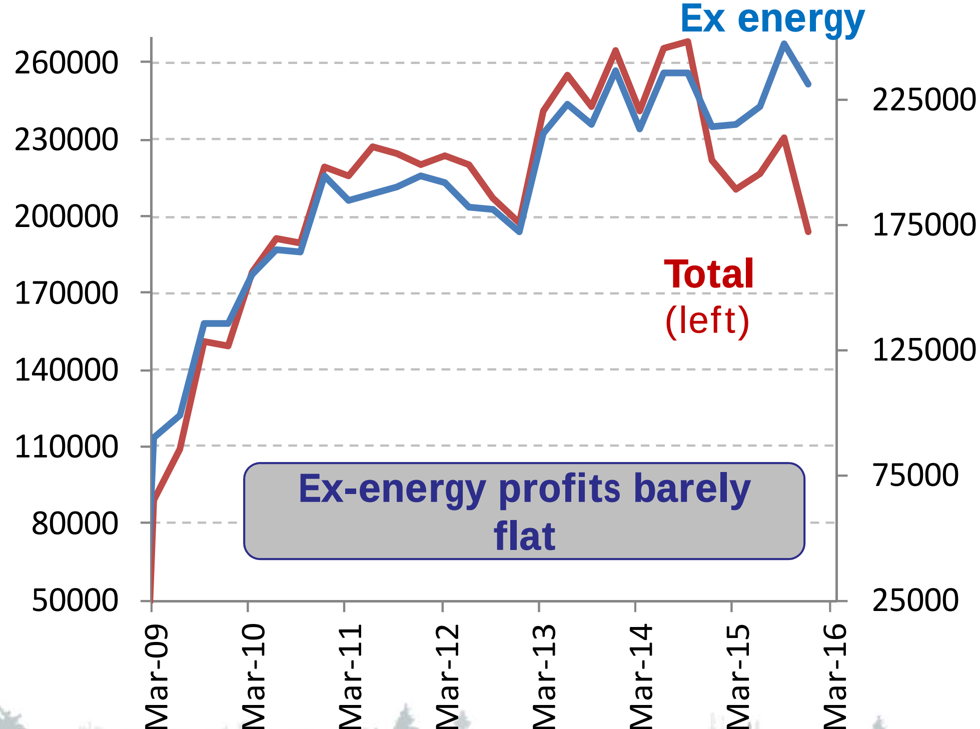
- Buyback stocks
- Pay dividends
- M&A
- Cash hoarding

NFC Liquid assets/short term liabilities



Source: Fed and CX

S&P 500: Operating profits (M$)



Source: S&P

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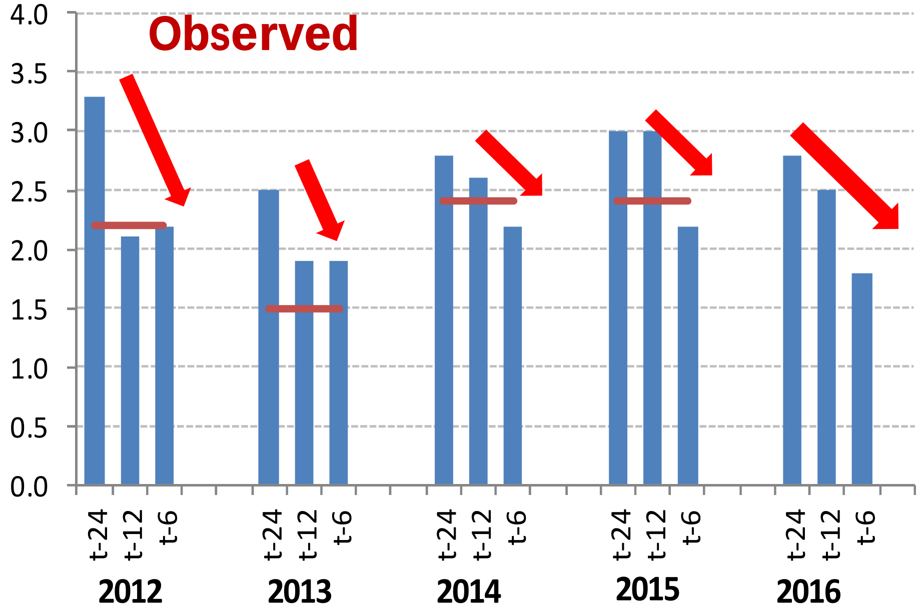
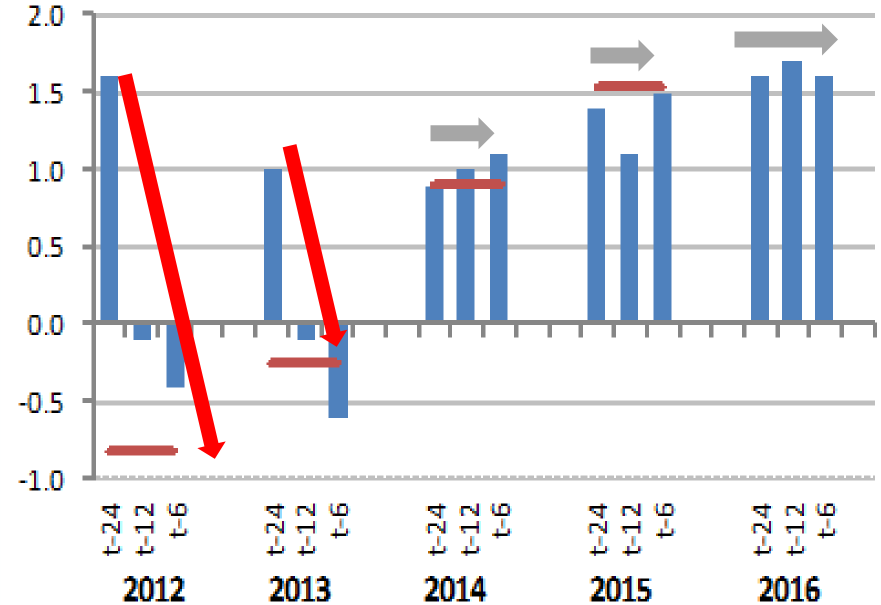


Eurozone



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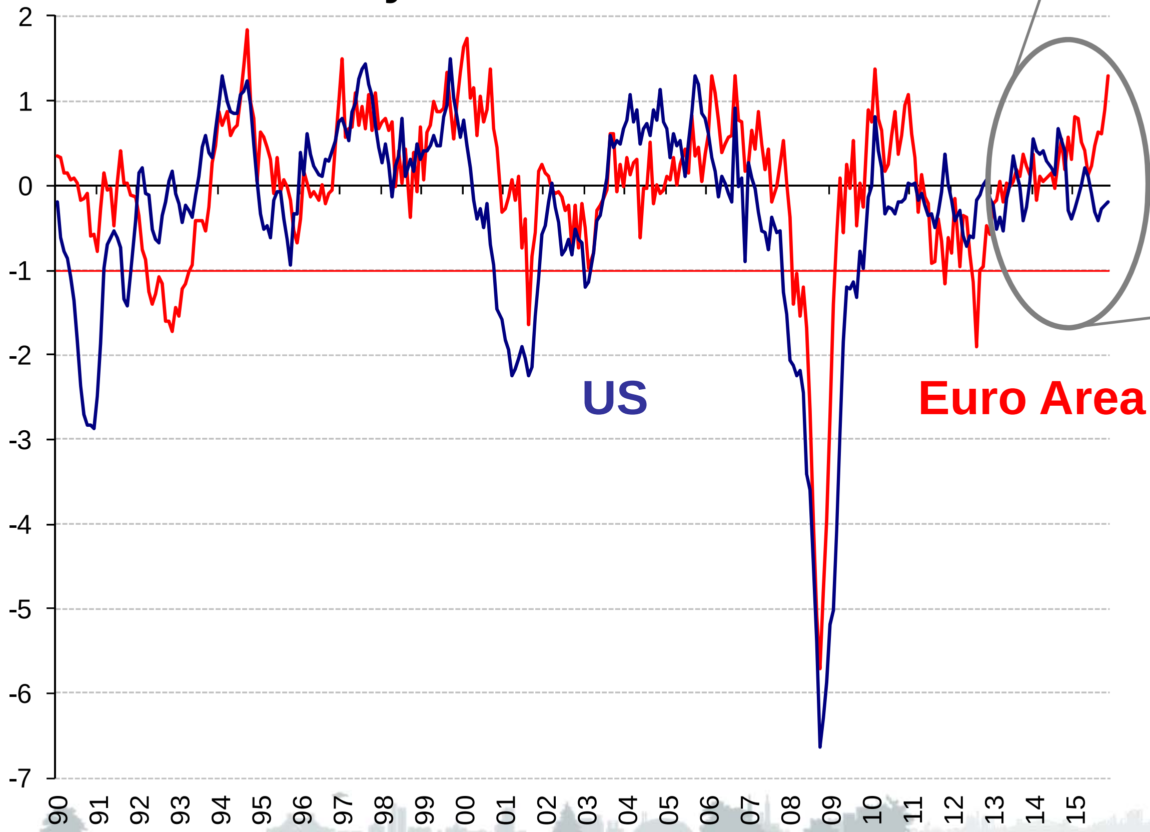
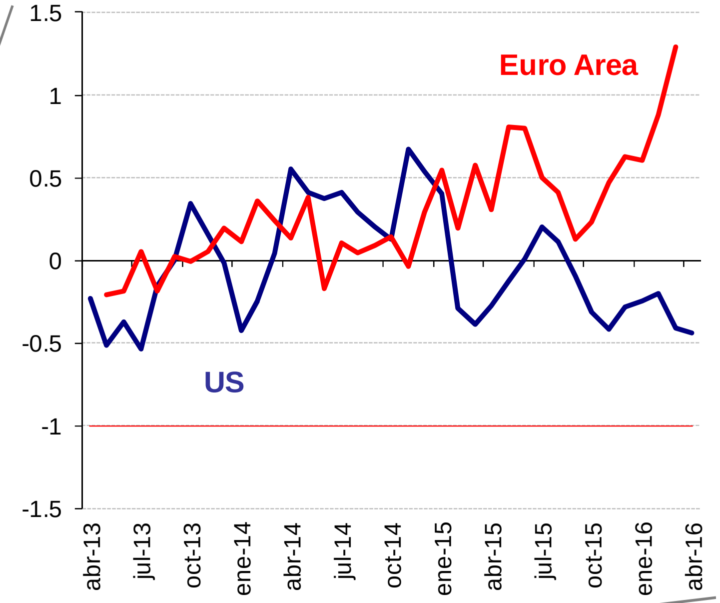
US: *Déjà vu*, again

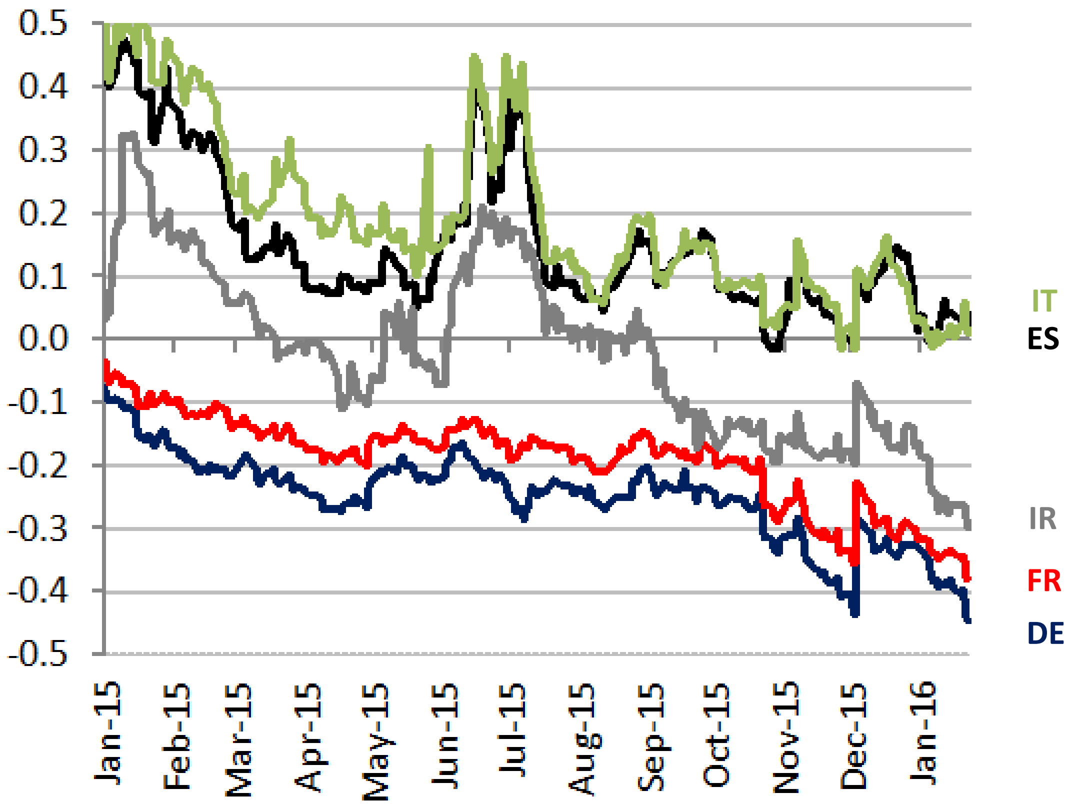
Activity in Europe seems to be more dynamic than in US





Is Europe "really" growing?

European treasuries: the best financing conditions ever



2Y yields (%)
Source: Datastream

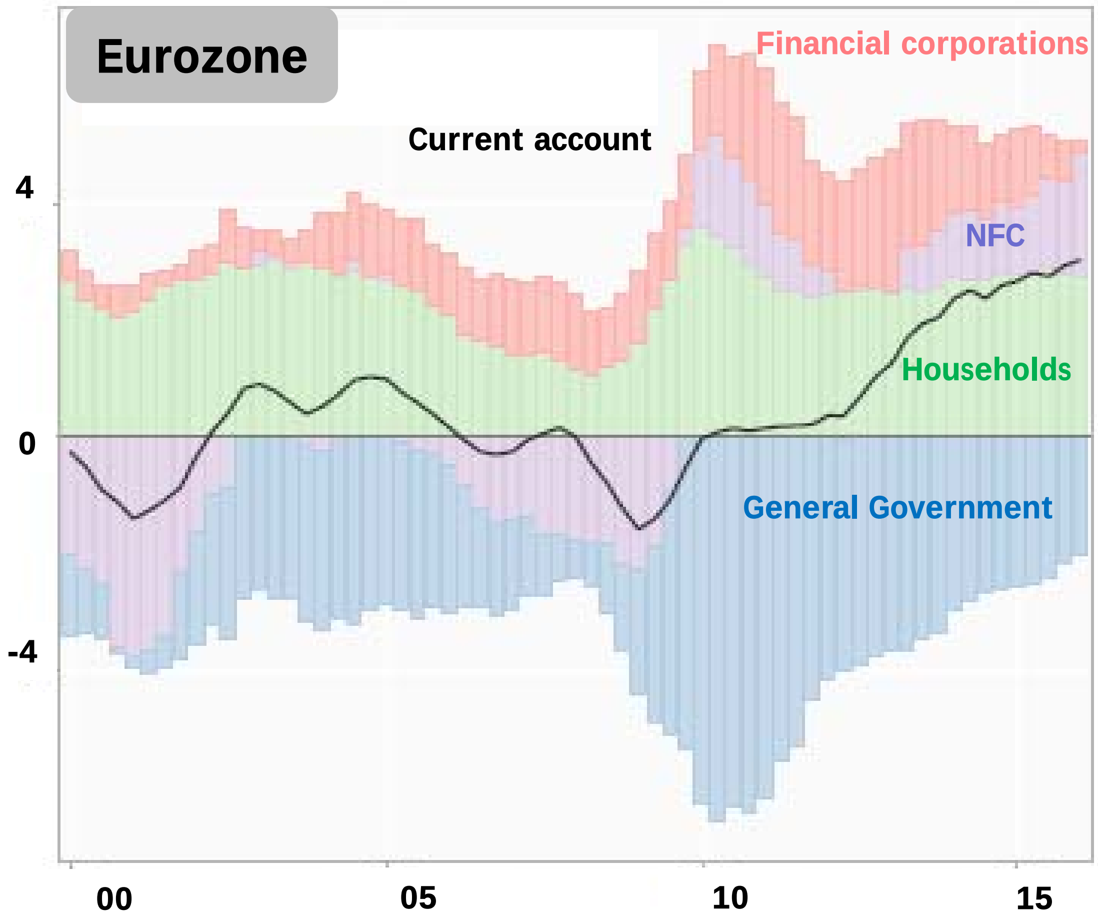
Reasons for optimism:

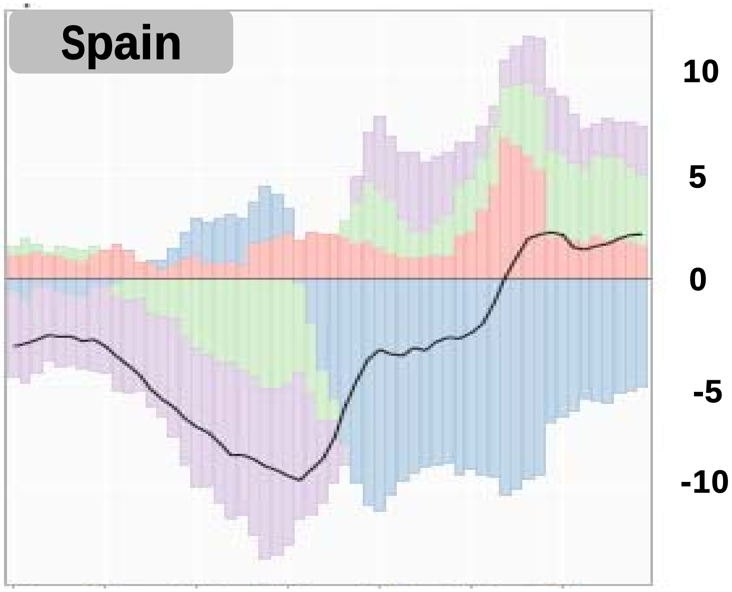
- **Low oil prices**
- **Credit finally expanding**
- **Weaker Euro**
- **ECB actions**

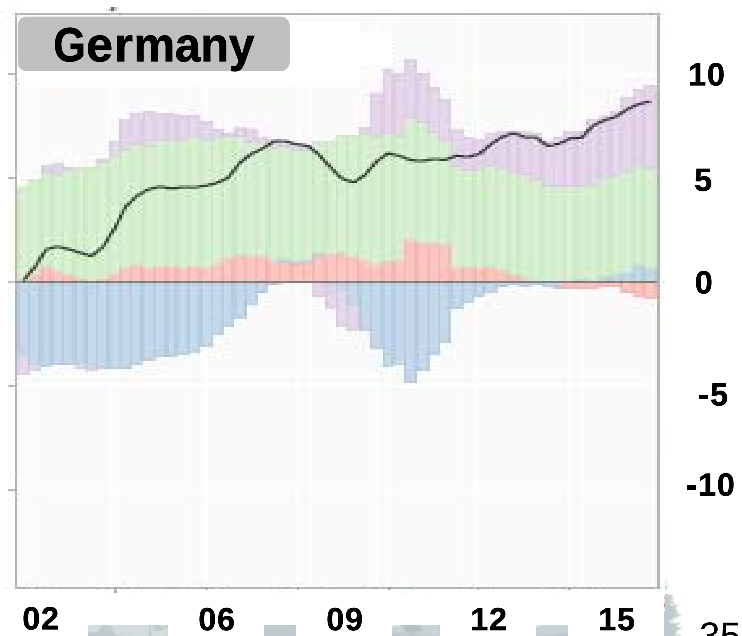
Financial stability (negative rates weigh down on the banking system) and political/institutional risks remain as the key threats

Large intra euro imbalances still remain

Net lending/borrowing (%GDP)







Source: ECB

Political Economy dominates over Economic Policy: Myopia

Eurozone remains an unfinished project.

- **Institutional reform/Fiscal reform**
  - **Lender of last resort (ECB)**
  - **Fiscal integration (European Treasury) and Eurobonds**
- **Incentive mechanisms (fiscal, regulatory, etc.)**
- **Banking Union**
  - **Pan-European banking resolution**
  - **European Deposit Insurance Institution**
  - **Regulation and supervision**
- **Structural reforms across Europe, predominantly in the periphery (competitiveness) but not only**

Dominance of domestic politics

Political Economy dominate over Economic Policy: Political risks

BREXIT

Refugees

Political polarization / Populism

Greece: Back to 2012?

But, all in all …

Notwithstanding,

"Sir, the following paradigm shifts occurred while you were out."

Thank you.

Manuel Balmaseda

CEMEX