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

Growth forecasts 2015

Recession
Stagnant
Mild growth
Strong growth

Fuente: CX- Economics and Consensus Forecast
Stability in the developed world, though no reasons to party. Challenging for EMs

Growth forecasts 2016

- Recession
- Stagnant
- Mild growth
- Strong growth

Fuente: CX- Economics and Consensus Forecast
Global activity in the cross-fire of shocks

- China’s slowdown
- Drop in oil prices
- Geopolitics
- Fed and “other” central banks

2016
China generates volatility in markets

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**

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

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?

WOW! AND JUST IMAGINE IF THEY TOLD US THE REAL STORY!
Caught in the cross-fire between positive and negative factors

- China’s slowdown
- Drop in oil prices
- Geopolitics
- Fed and “other” central banks

2016
Oil is unambiguously 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

- China’s slowdown
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2016

Buffers

Buffers
Tapering: costs or strategy?

Oct. 13

Monetary 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?

First mover advantage?

"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

Source: DS. Fed (in US$) and ECB (in €) Balance Sheet. Trillions
Normalization needed sooner or later ...

Where will the next bubble show up?

Nominal GDP growth

Interest rates need to normalize

Housing bubble forming in the US, EMs bubble

Stock bubble?
ECB policy: “do whatever it takes”. Will it be enough?

Eurozone Inflation far below ECB’s target

- 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

- 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)

Break-up risk
Déjà vu, “old” shocks keep acting up

- **Chinese landing**
  - Lower Chinese demand (imports)
  - Lower commodity prices

- **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
  - for countries with strong trade ties with China and commodity exporters
  - Positive for oil importers
  - Increased risk aversion
  - Negative for countries with high external financing needs and high USD debt
Caught in the cross-fire between positive and negative factors

- China’s slowdown
- Drop in oil prices
- Geopolitics
- Fed and “other” central banks

2016
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

- China’s slowdown
- Drop in oil prices
- Geopolitics
- Fed and “other” central banks
Caught in the cross-fire between positive and negative factors

- China’s slowdown
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2016
Is the US expansion coming to an end?

No such thing as a “normal” cycle

<table>
<thead>
<tr>
<th>Peak month</th>
<th>Trough month</th>
<th>Duration of expansions in months</th>
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<tr>
<td>November 1948</td>
<td>October 1949</td>
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<tr>
<td>December 2007</td>
<td>June 2009</td>
<td>73</td>
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<tr>
<td>Assuming December 15 as peak</td>
<td></td>
<td>79</td>
</tr>
</tbody>
</table>

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

Source: CF and CEMEX
**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

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**Households with ample margin to spend …**

![Graph showing household debt service as a percentage of disposable income]

- **Historical average**

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**… but leverage still high.**

![Graph showing debt outstanding as a percentage of GDP]

- **Government**
- **Households**
- **Corporate**

Source: BEA and Federal Reserve

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**… 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)

Source: Fed and CX
Investment: Healthy NFC’ balance sheets also, despite debt accumulation

**NFC’ balance sheet (% GDP)**

- **Assets**
- **Liabilities**
- **Net worth**

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.

“Core investment” (ex energy) does not anticipate a recession in the short term.

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

Source: BEA and CX
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

Avg. 70-00

S&P 500: Operating profits (M$)

Ex-energy profits barely flat
US: *Déjà vu, again*

GDP observed growth and Consensus Forecast expectations

**US**

**Eurozone**

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

Source: CF and CEMEX
Activity in Europe seems to be more dynamic than in US

US: Déjà vu, again
Is Europe “really” growing?

**Reasons for optimism:**
- Low oil prices
- Credit finally expanding
- Weaker Euro
- ECB actions

European treasuries: the best financing conditions ever

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

2Y yields (%)
Source: Datastream
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