

Rebalancing

Economic Themes and Emerging Risks for the Balance of 2016



Themes

■ Oil's Not Well

- ▶ A world of cheap petroleum

■ Eastern Anxiety

- ▶ China attempts a difficult transition

■ Growing Prospects

- ▶ Central banks tackle a complicated mandate

■ Age Isn't Just a Number

- ▶ Demographics and economic performance

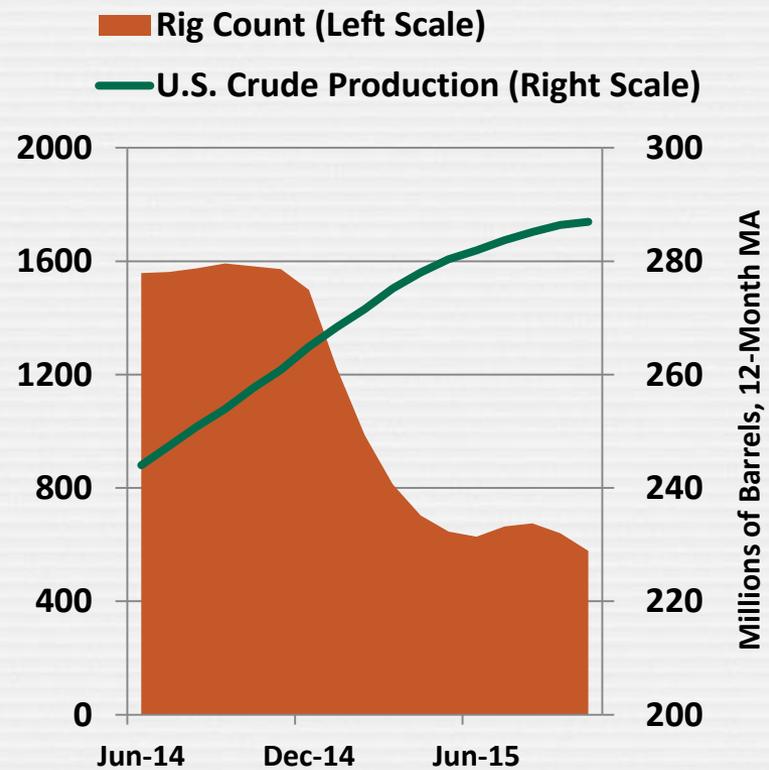
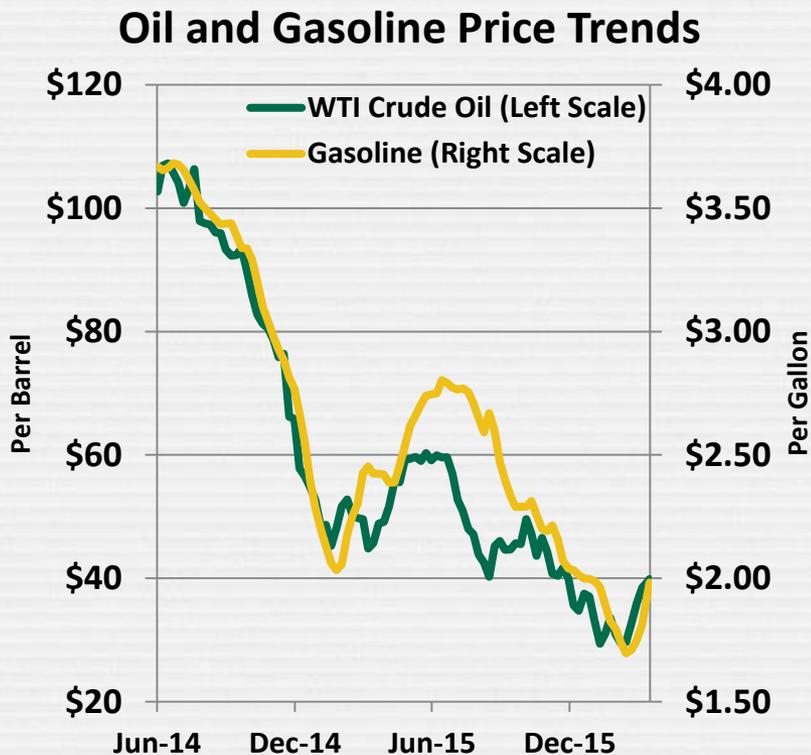


Sapping Energy



Depths of Decline

- Crude prices have fallen by two-thirds in 18 months
- Production continues to expand



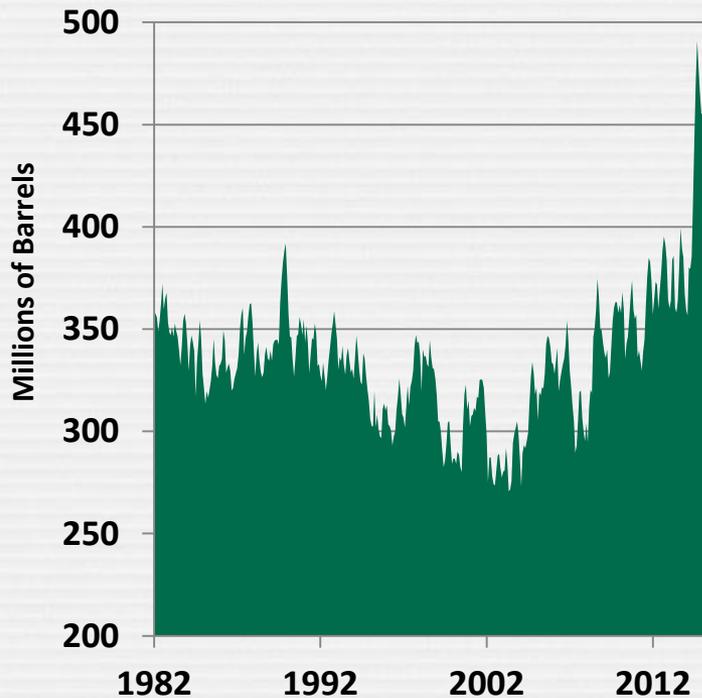
Sources: Bloomberg, EIA



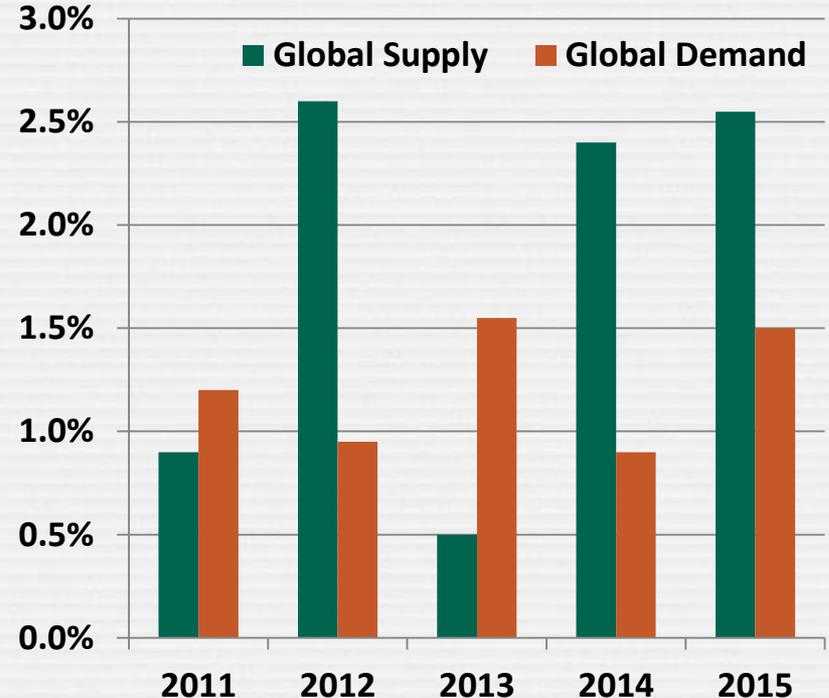
No Relief in Sight

- Running out of storage capacity
- This is a supply story

U.S. Crude Oil Inventories



Oil Supply and Demand Growth

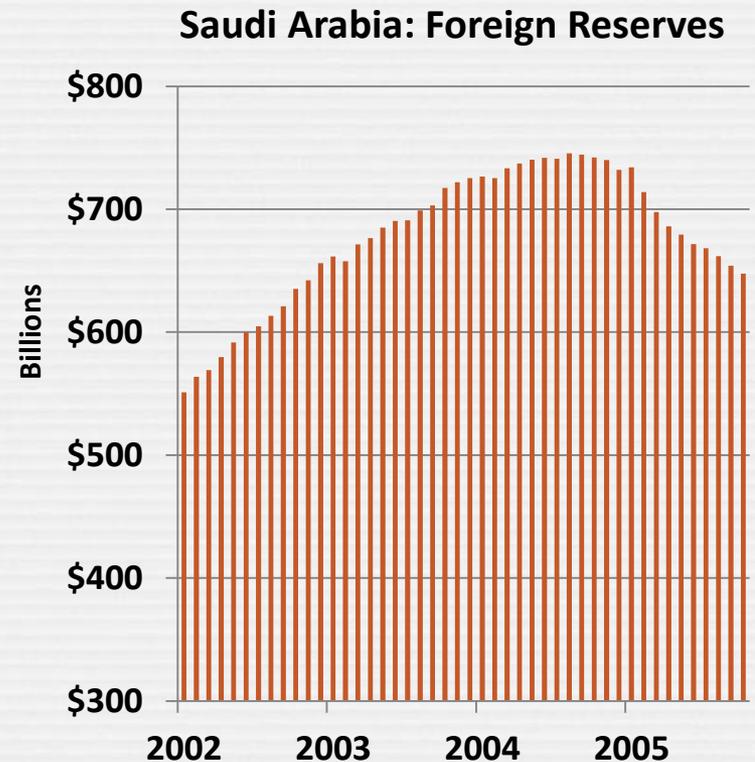
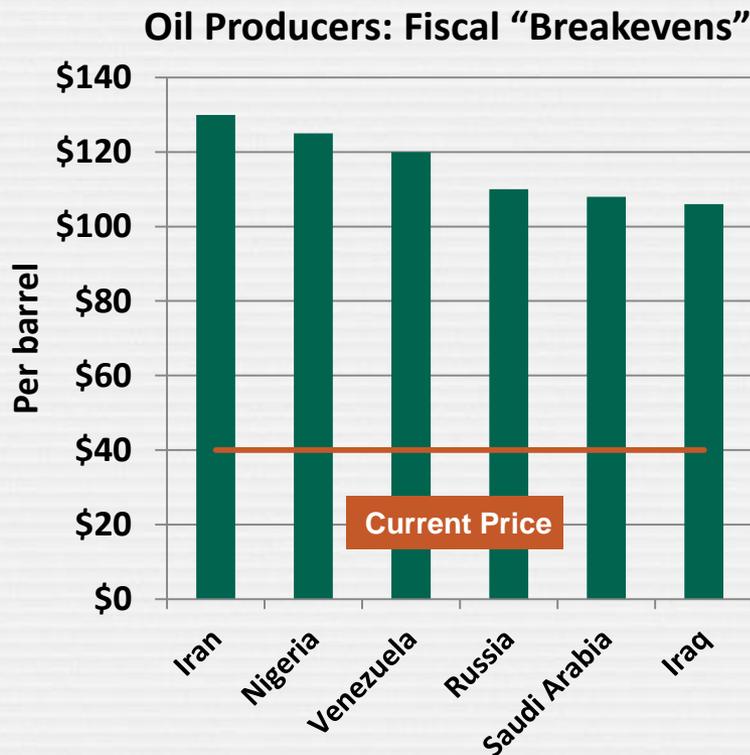


Sources: Department of Energy, BP, Northern Trust



Pain Points

- Social benefits and interest payments must be sustained
- How long can the “game” go on?



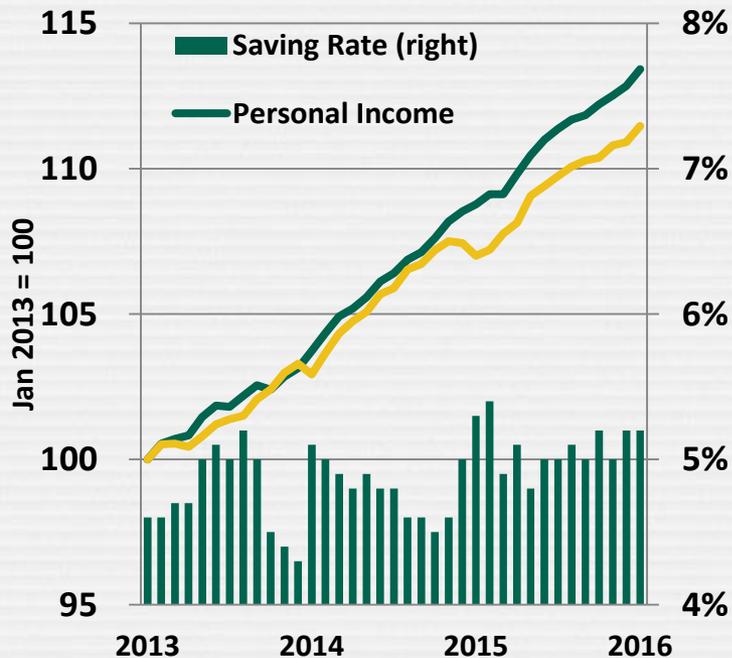
Sources: IMF, Haver Analytics



The Benefits of Cheap Fuel

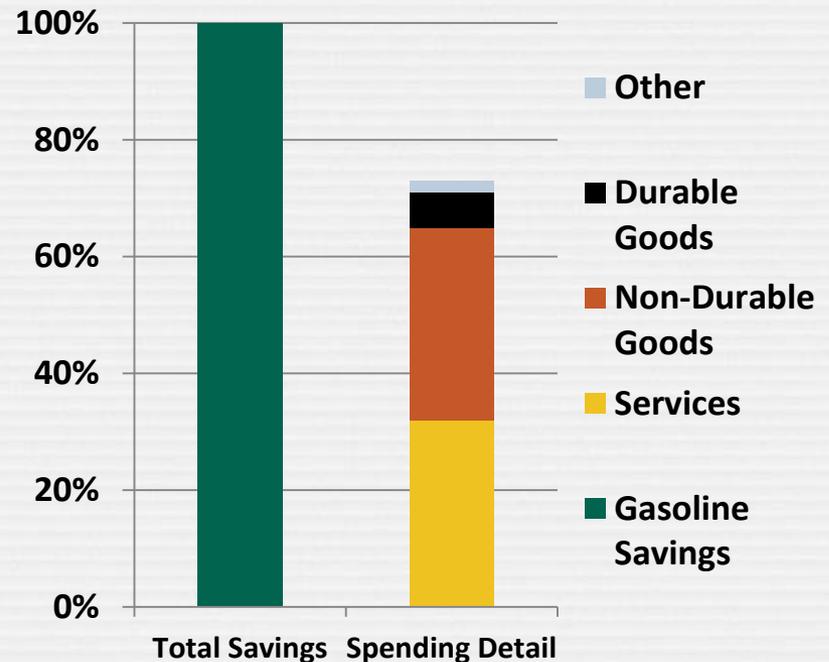
- The proceeds have not been used to enhance savings
- Spending outside of retail on rent and health care

U.S. Household Trends



Sources: Haver Analytics, JP Morgan Institute

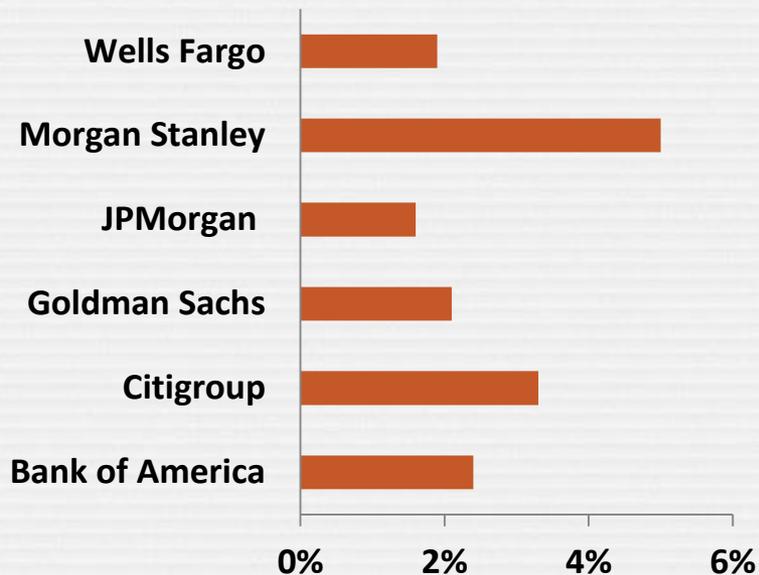
How Have Consumers Spent Gasoline Savings?



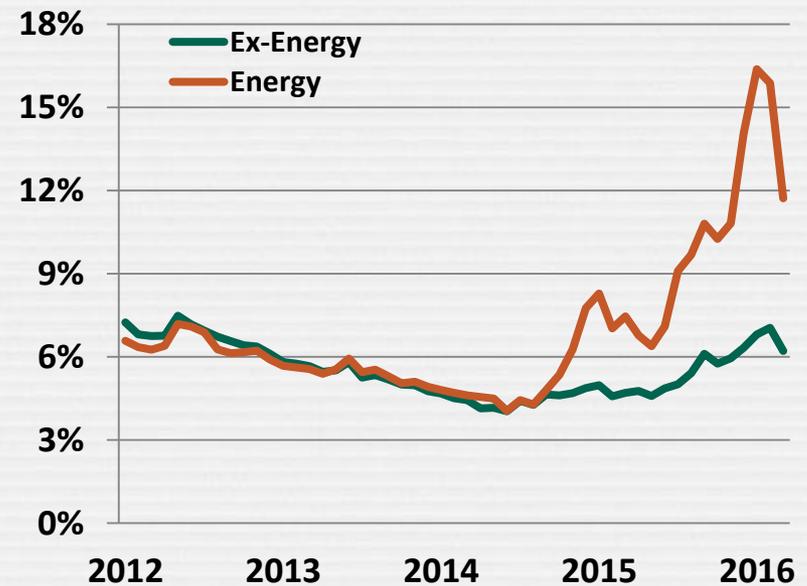
Exposure to Energy

- Energy lending is only 3% of total lending at U.S. banks
- Most credit has been sourced from the markets

Energy Loans as a Percent of Total Bank Loans



High Yield Bond Spreads



Sources: Reuters, Bloomberg, Haver Analytics

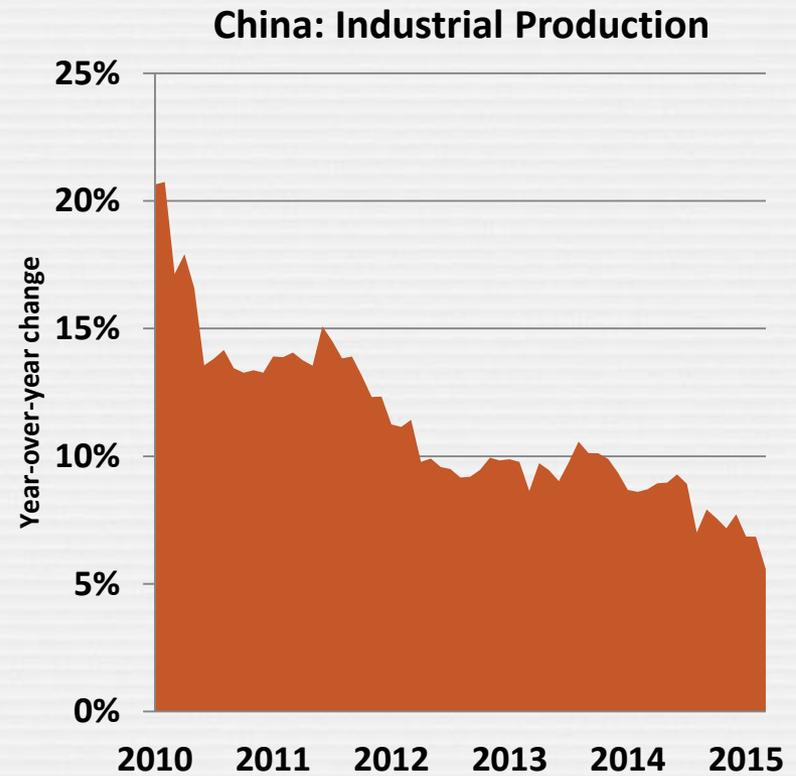
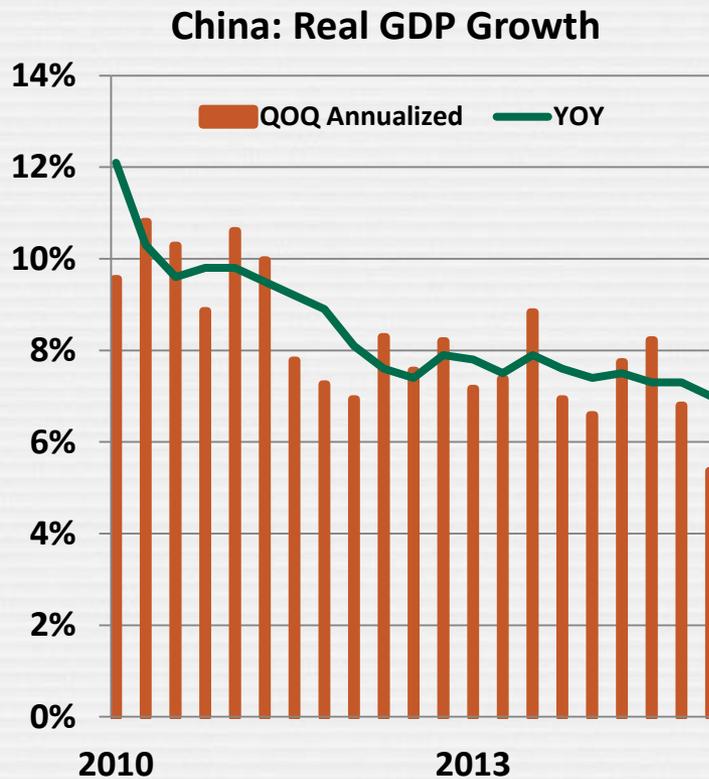


China's Challenges



China: Seeking Sustainability

- Slowing pace of growth
- Heavy industry hindered by slow global demand



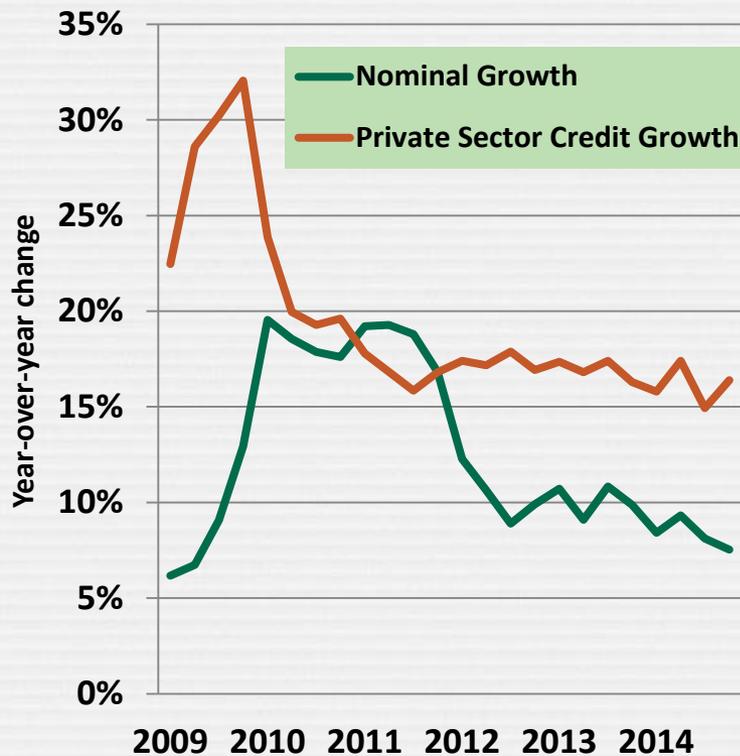
Source: Haver Analytics



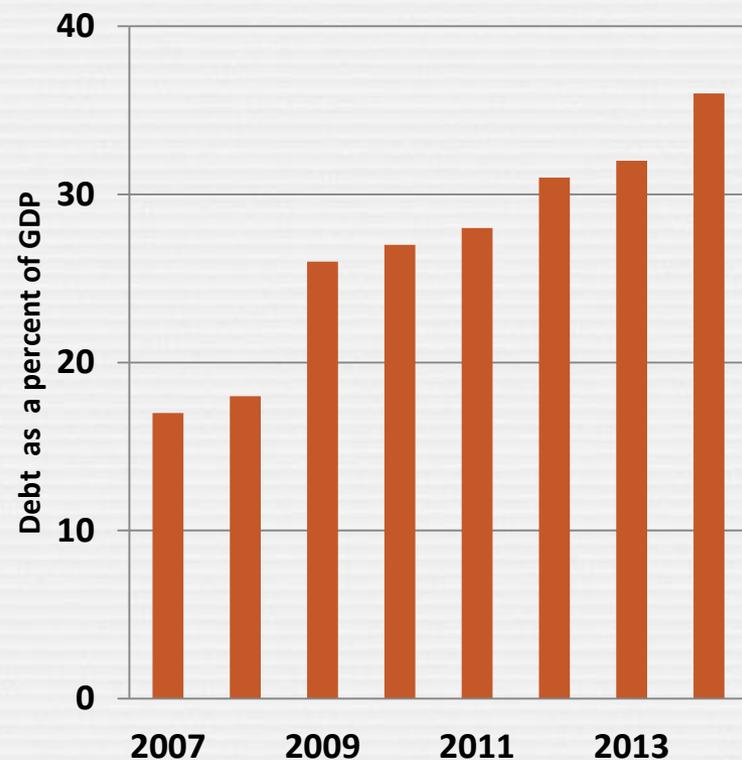
China: The Challenge of Managing Leverage

- Credit at all levels has been growing very rapidly

China: Credit vs. GDP Growth



China: Local Government Debt

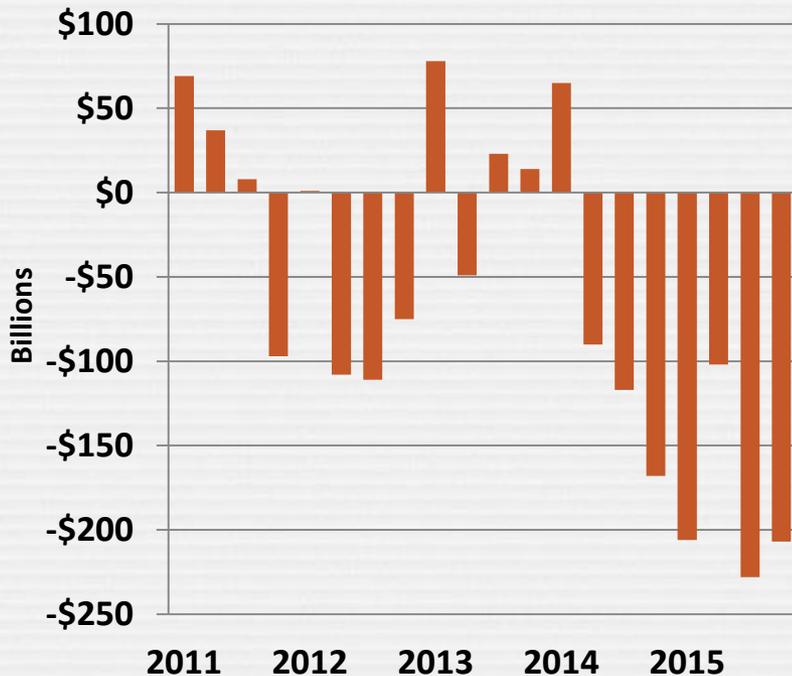


Sources: Wall Street Journal, Haver Analytics

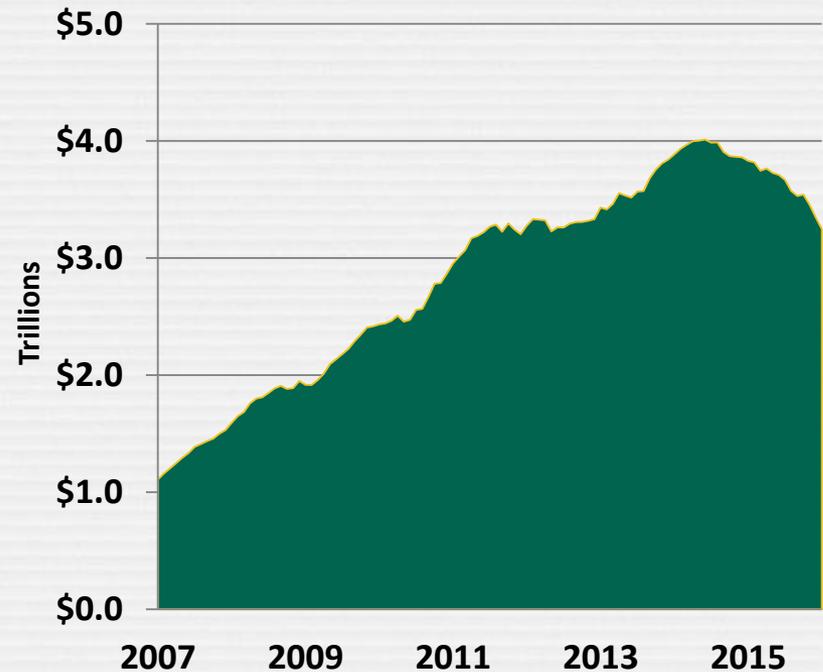
Controlling Capital

- Money has been leaving China
- Pressure on asset and currency values

China: Capital Outflows



China: Foreign Exchange Reserves

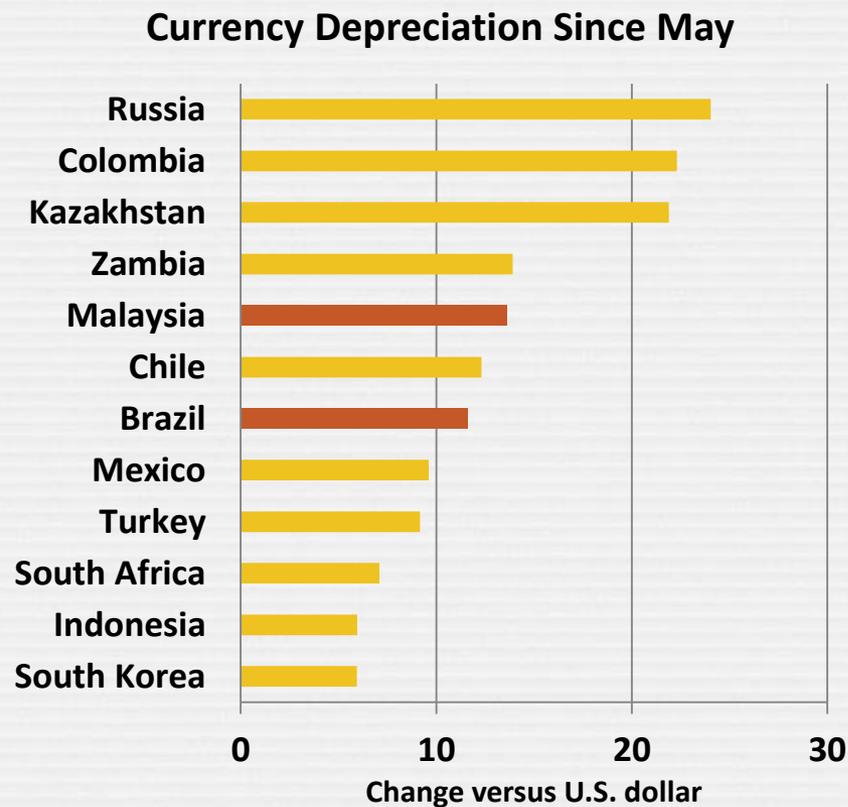
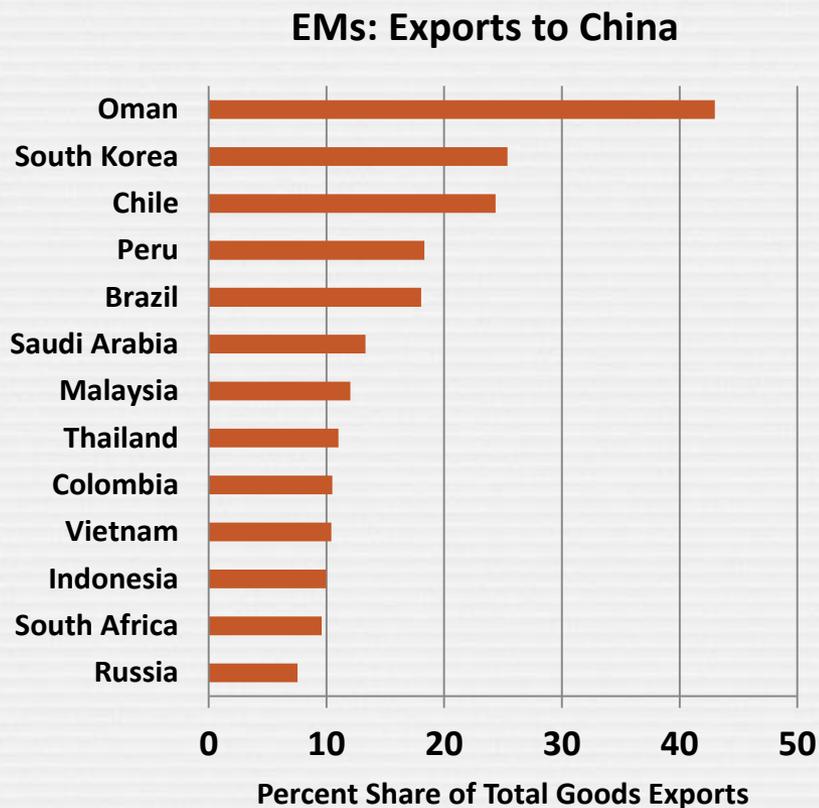


Sources: Goldman Sachs, Haver Analytics



Potential Contagion

- Dependence on China and commodities drives weakness
- Direct U.S. exposure is modest, indirect exposure is large



Source: IMF, Haver Analytics



Central Strategies



Challenges for Central Bankers

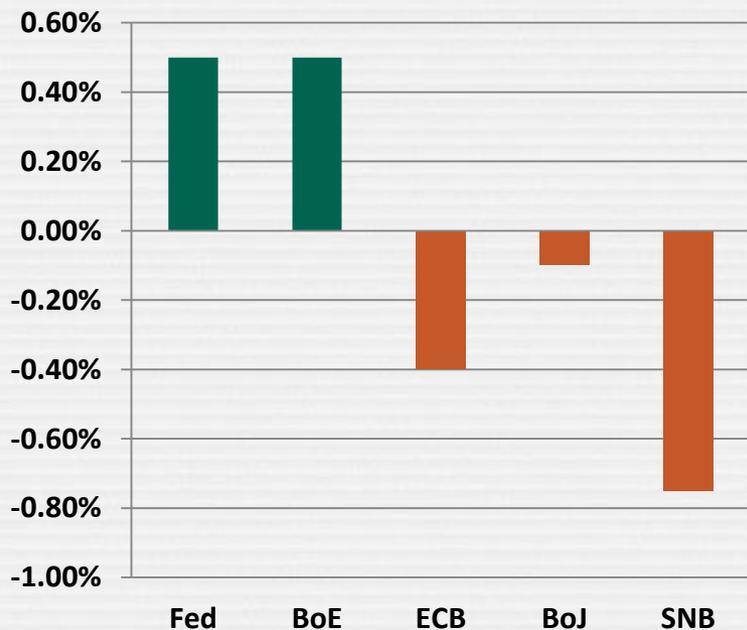
- **Global forces challenge local policy**
 - ◆ Can central banks control inflation as effectively as they used to?
- **Risking addiction to extraordinary measures**
 - ◆ At some point, economies need to demonstrate self-sufficiency
- **Balancing mandates**
 - ◆ Currency control, financial stability, inflation, etc.
- **Maintaining independence**
 - ◆ The extremes of policy have attracted more attention from politicians
- **Communicating effectively**
 - ◆ The most honest outlook is also the least helpful to markets



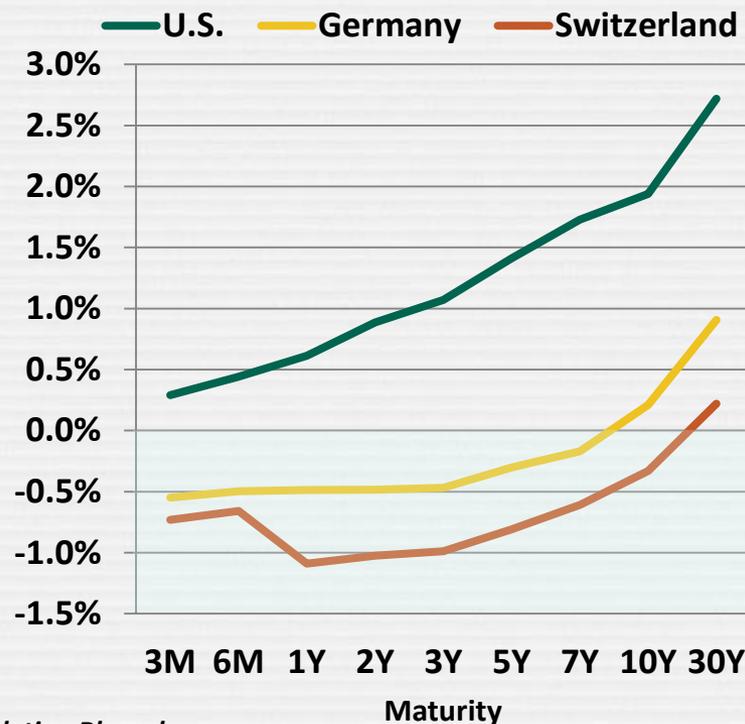
Current Interest Rates

- Monetary policy is very easy in developed markets
- Safe assets are popular...at any price

Central Bank Deposit Rates



Sovereign Yield Curves

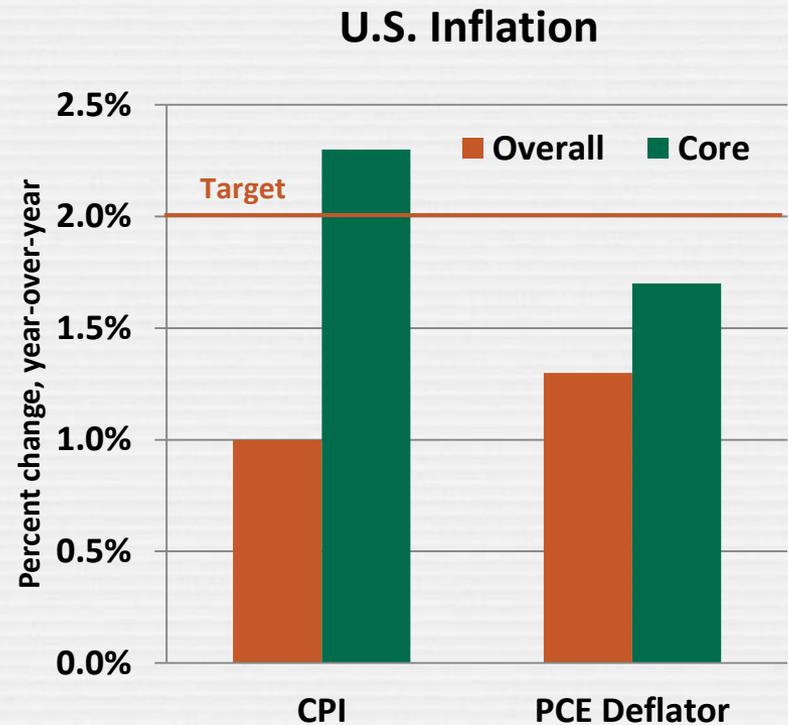
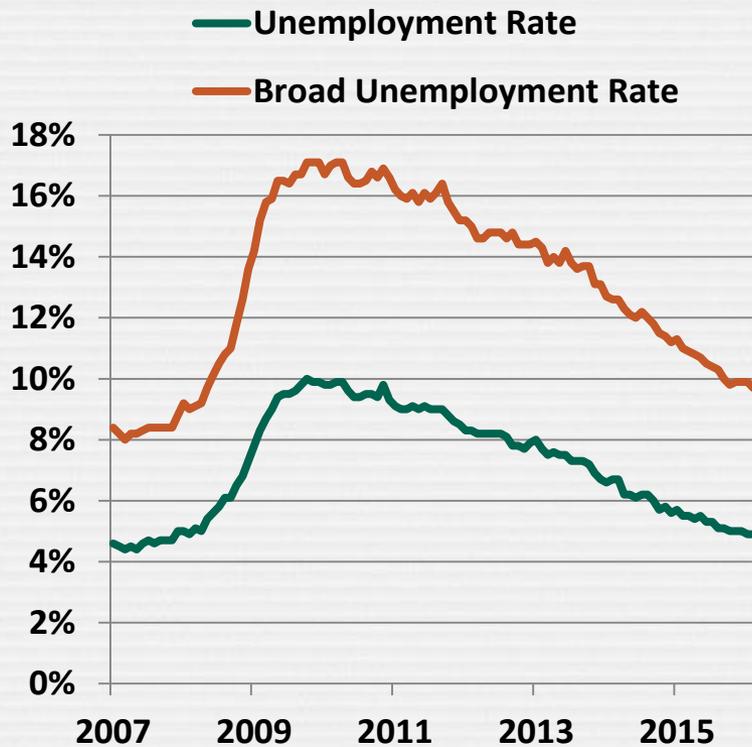


Sources: Haver Analytics, Bloomberg



The Fed's Dual Mandate

- Joblessness has fallen sharply in the last two years
- Inflation has been creeping up



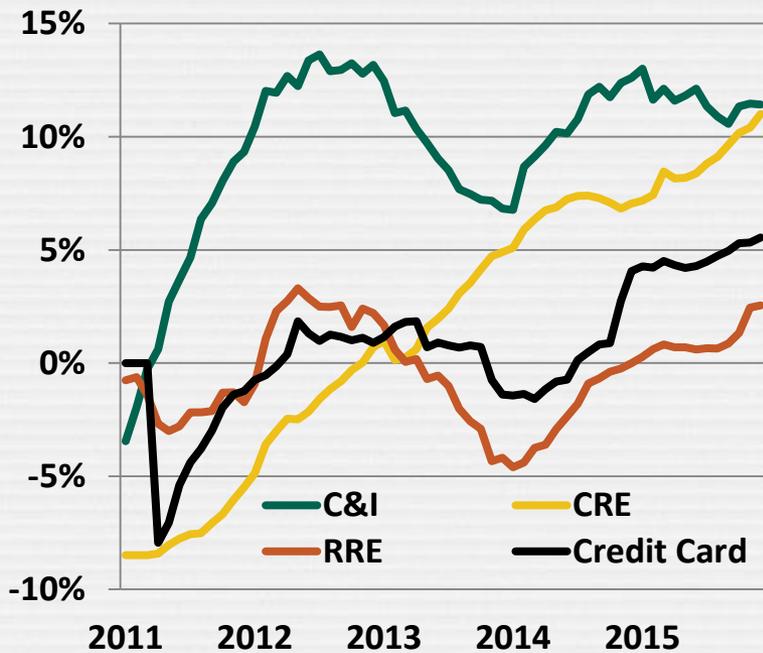
Sources: Bureau of Labor Statistics, Bloomberg



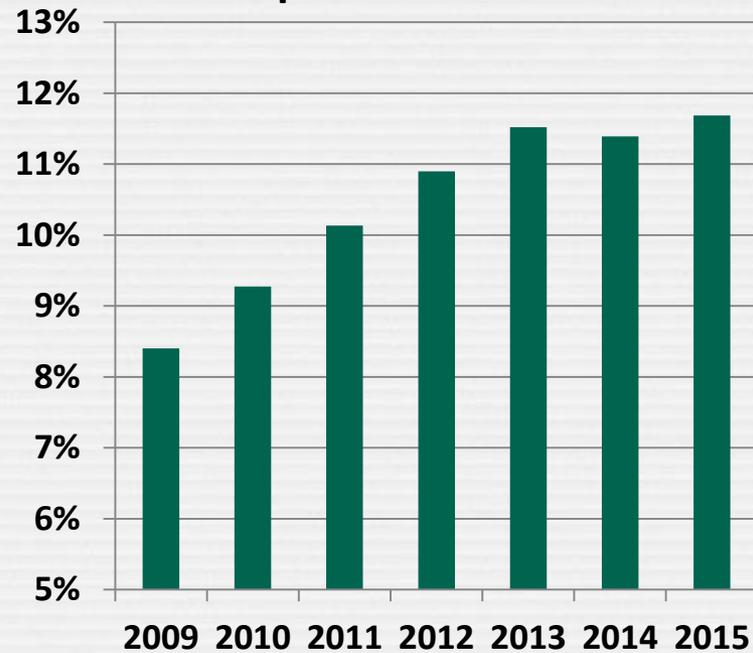
U.S. Credit Creation and Capital

- The banking channel is open
- The basis for taking risk has been reinforced

U.S. Lending Growth



Tier 1 Capital Ratio Top 10 U.S. Banks



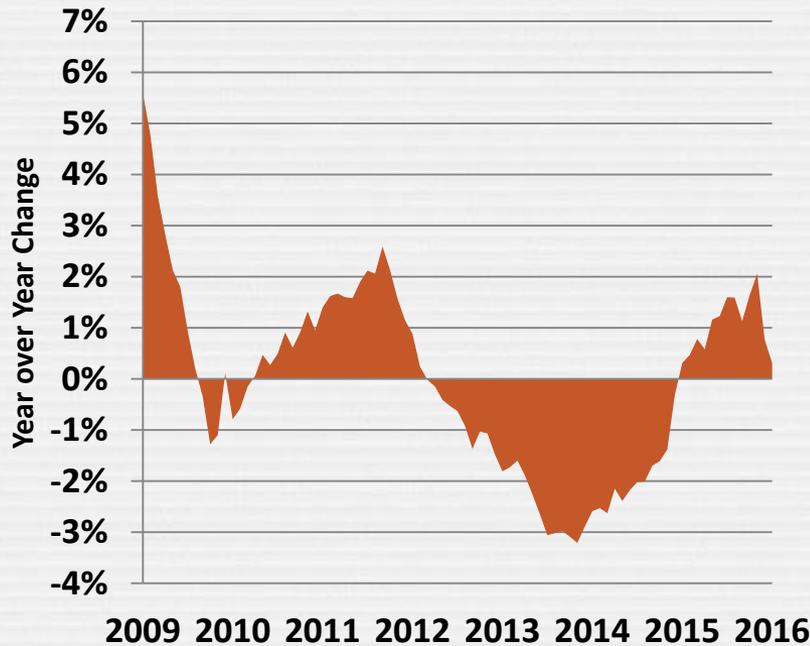
Sources: Federal Reserve, SNL, Haver Analytics



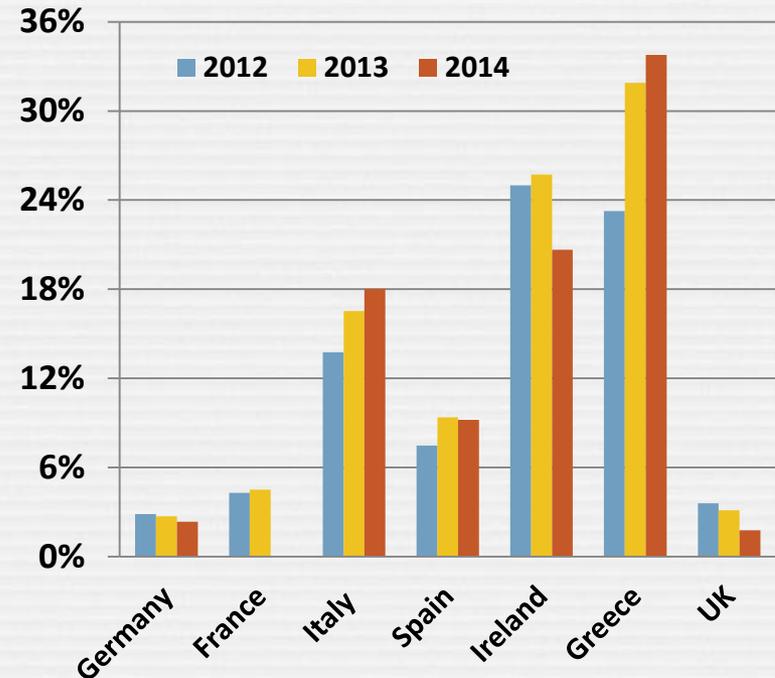
Draghi's Dilemma

- Clean balance sheets facilitate credit creation
- Monetary policy cannot compensate for poor capital

Eurozone Lending



Non-Performing Bank Loans



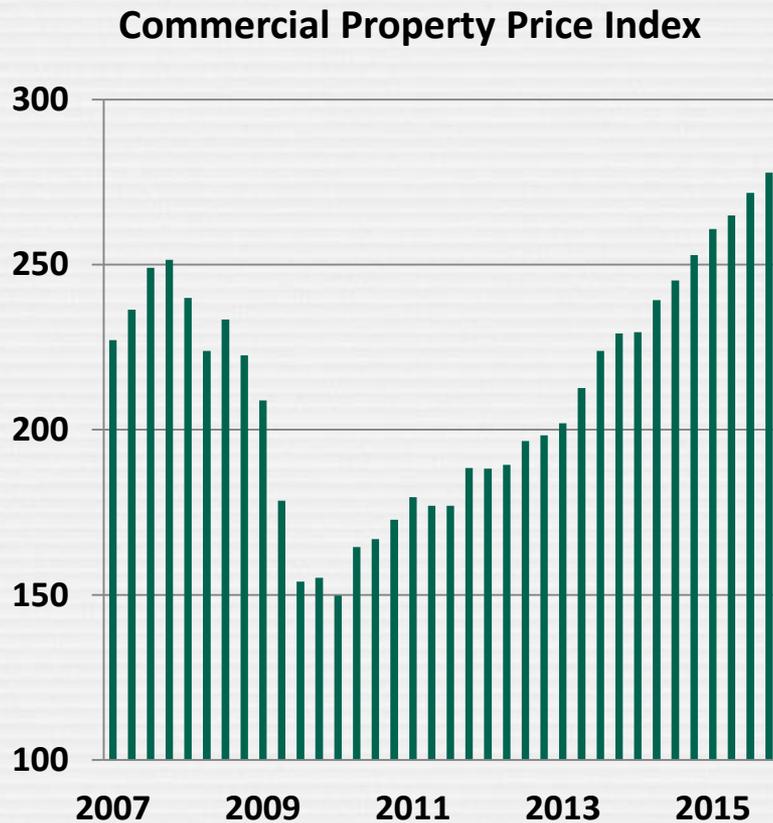
Source: Haver Analytics. IMF Financial Sector Indicators

A Few Words on Negative Interest Rates

- **Less Stigma than 2008**
 - ▶ Little, if any hoarding of currency
 - ▶ Institutional markets have adjusted comfortably
- **Quantitative Easing may have lost its luster**
 - ▶ Successive rounds have been less effective
 - ▶ Central banks are unnatural asset managers
- **Some complications to respect**
 - ▶ Retail depositors may not react well
 - ▶ Money market mutual fund dislocations
 - ▶ System constraints
- **For the U.S., a remote possibility for now**



Systemic Issues?



Source: Federal Reserve

■ CRE Lending (left)

- Standards recently tightened

■ Cyber Security

- Trends in payments and information flow

■ Asset Managers

- The new shadow banking system?

■ A Prolonged Search for Yield

- Investors gravitate towards asset classes they are not naturally comfortable with



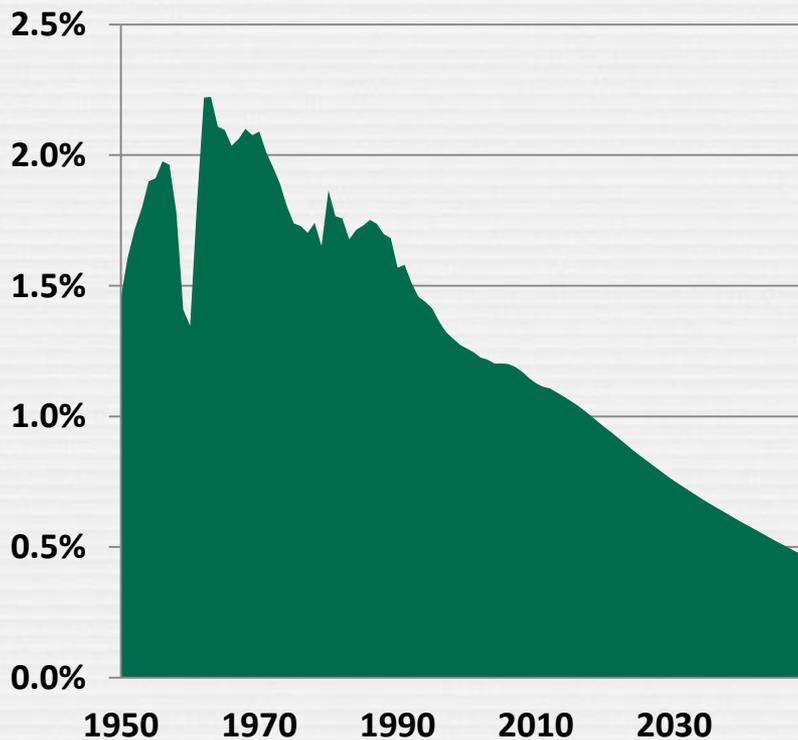
Aging Gracefully



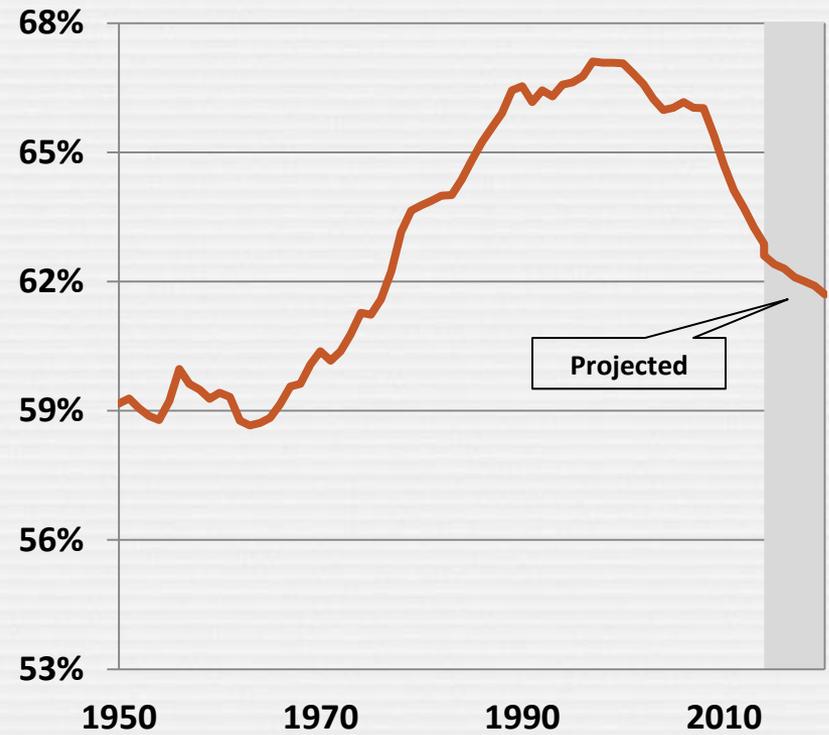
Slow Population Growth

- Modest growth and shifting composition across markets
- Potential for a shrinking labor force

World Population Growth



U.S. Labor Force Participation Rate



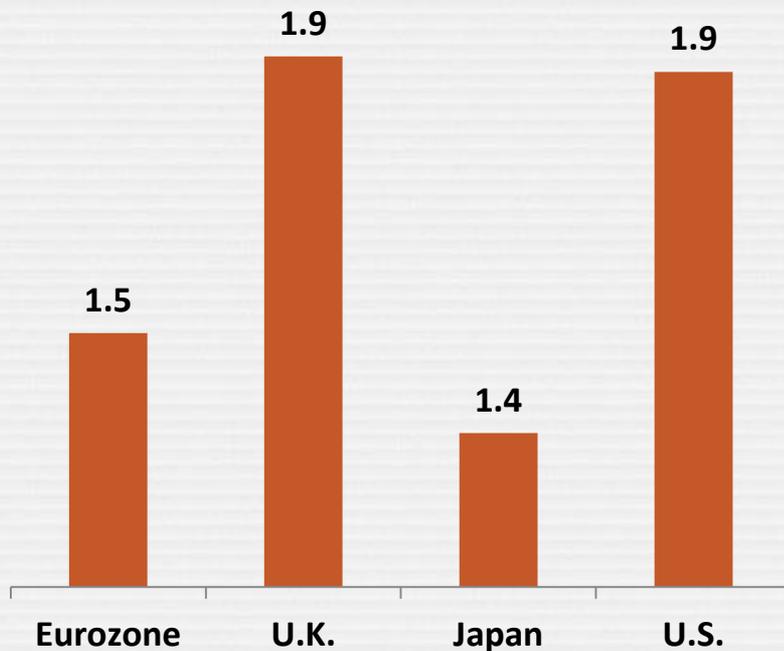
Sources: Bureau of the Census, CBO



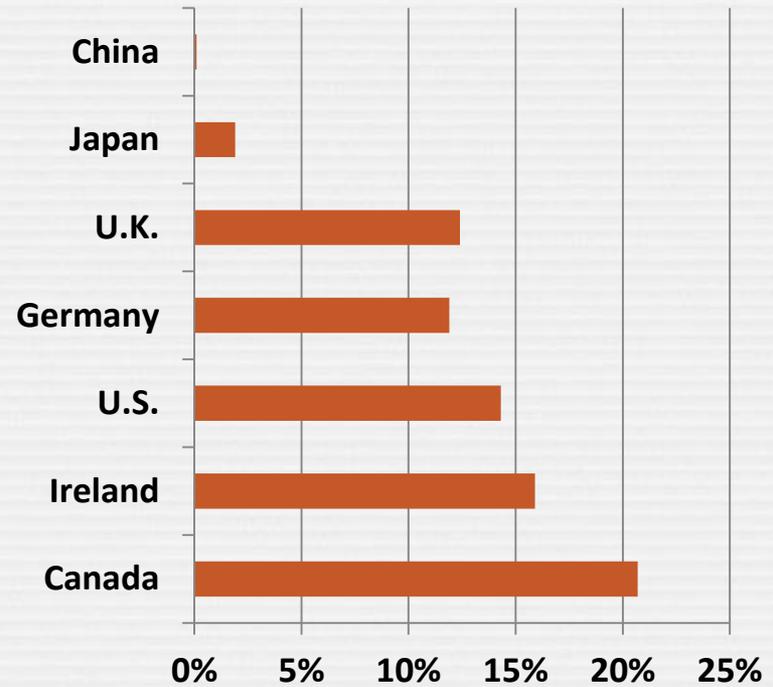
Sustaining Population

- Promoting fertility rarely works
- Accepting new entrants successfully is key

Fertility Rates Per Woman, 2013



Immigrant Population, 2013

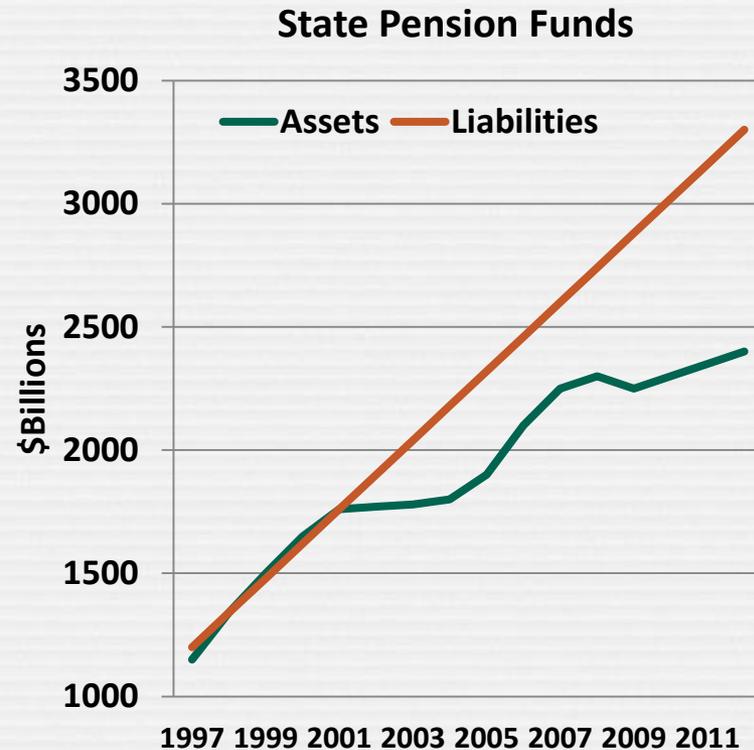
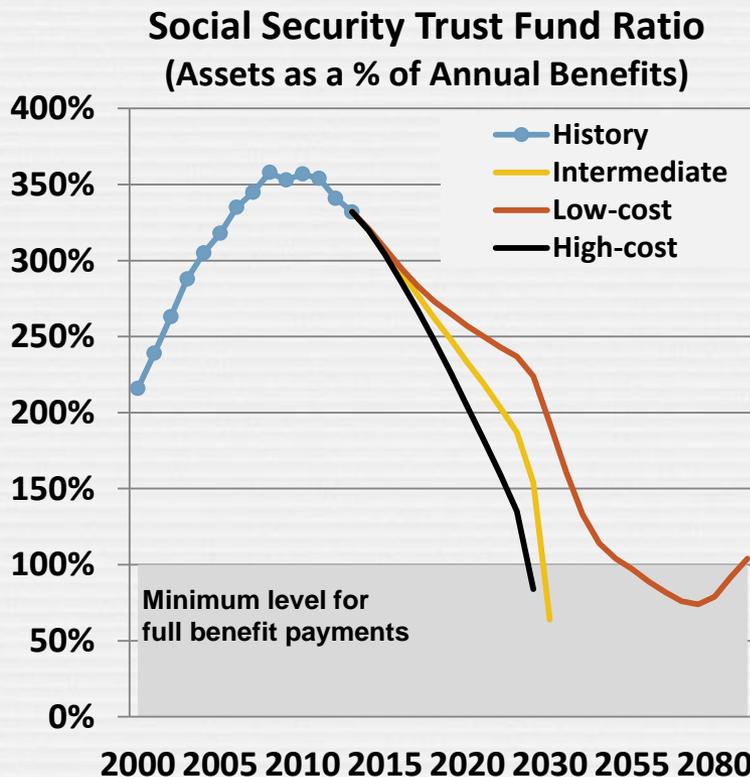


Sources: CIA, United Nations



The Long-Term is Here

- Aging populations can stress retirement systems
- Most Americans are woefully unprepared



Sources: Social Security Administration, Pew Center



Our Expectations

Global Economic Forecast – January 2016

	2013	2014	2015F	2016F
United States				
Real GDP (% change)	1.5	2.4	2.4	2.4
Unemployment Rate (%)	7.4	6.2	5.3	4.9
Inflation (%)	1.5	1.6	0.1	1.2
Policy Rate (Top), EOP (%)	0.25	0.25	0.50	1.00
Eurozone				
Real GDP (% change)	-0.3	0.9	1.5	1.7
Unemployment Rate (%)	12.0	11.6	11.0	10.5
Inflation (%)	1.4	0.4	0.1	1.0
Policy Rate, EOP (%)	0.75	0.25	0.05	0.05
Deposit Rate, EOP (%)	0.0	-0.20	-0.30	-0.30
United Kingdom				
Real GDP (% change)	2.2	2.9	2.4	2.6
Unemployment Rate (%)	7.6	6.2	5.4	5.5
Inflation (%)	2.6	1.5	0.1	1.0
Policy Rate, EOP (%)	0.50	0.50	0.50	1.00
Japan				
Real GDP (% change)	1.4	-0.1	0.5	0.9
Unemployment Rate (%)	4.0	3.6	3.4	3.3
Inflation (%)	0.4	2.8	0.1	0.4
Policy Rate, EOP (%)	0.10	0.10	0.10	0.10
China				
Real GDP (% change)	7.7	7.3	6.9	6.5
Unemployment Rate (%)	4.1	4.1	4.1	4.1
Inflation (%)	2.6	2.1	1.5	2.0
Policy Rate, EOP (%)	3.00	3.00	1.5	1.25



Parting Thoughts

- **The global outlook is cloudy**
 - ▶ **We expect China to avoid a hard landing**
- **Performance will continue to be somewhat uneven**
 - ▶ **Some regions and sectors are further along**
- **Risks to the outlook are varied**
 - ▶ **Potential for further instability**



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