Global Data Watch

- Fed closer to tapering as low inflation anchors G-4 rate expectations
- China stands nearly alone in unveiling ambitious reform program
- EM lift from external demand is enough to offset domestic drags
- Next week: Looking for stability in November flash PMIs

The delinking

While Janet Yellen’s confirmation hearing provided no policy signals, the Fed appears close to tapering its asset purchase program. In delaying action in September, the FOMC cited political uncertainty and concerns about rising interest rates amid a downward shift in growth momentum. Since that decision, political risk has abated and the US economy has displayed surprising resilience. Conditional on our forecast that employment gains remain close to this year’s 186,000 average monthly increase, we expect the Fed to announce tapering in January.

Midyear tapering talk roiled global fixed income markets as tapering should push US long-term interest rates higher and weigh on EM assets (see “De-risking EM into year-end and awaiting better entry levels,” J. Chang, MorganMarkets, November 14). However, the disruptive midyear shift in the expected path of policy rates is unlikely to be repeated. Indeed, G-4 forward rate expectations have moved lower in recent weeks even as the news on growth has been positive. And in the week since a strong October US employment report shifted sentiment toward earlier tapering, end-2016 Fed rates expectations have remained stable. This delinking of tapering and G-4 rate expectations reflects changes in the macroeconomic landscape (particularly low inflation) and its interaction with an evolving forward guidance framework.

- Low inflation separates tapering from rate normalization. Although the decision to taper will be based on the Fed’s assessment of labor markets and growth momentum, rate normalization will be determined by how rapidly inflation and perceived output gaps move back toward their norms. With DM core inflation holding stable at close to 1%, and significant imported disinflation in the pipeline, a perceived slower path toward inflation normalization is anchoring forward rates even as tapering looms.

- Looser rules, more discretionary forward guidance. Faced with a lower interest rate bound, G-4 central banks have moved down the path of

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A fall in inflation provides him some breathing room—core inflation fell to 1.7% this week. But we expect pressure to continue to build as we project the unemployment rate to drop below 7% in 3Q14.

China’s leaders unveil ambitious road map

One factor promoting aggressive efforts on the part of central banks is the lack of action by governments on structural reform. China is a notable exception as its 3rd Plenary Session delivered an ambitious reform plan for the next 5-10 years. In a comprehensive report released on Friday, the government spelled out a multitude of reform tasks covering economic, financial, legal, cultural, ecological, and social governance issues. Among these are proposed changes to the “hukou” (household registration) system, financial market liberalization, plans to allow more private investment in state-owned enterprises, and expanded farmers’ rights. Depending on their implementation, the proposed changes would help China achieve more balanced and sustainable growth in the long term. The plan is sure to face opposition from vested interests. A special leadership committee is supposed to oversee the reforms, though it remains unclear how it will operate.

This week’s October activity data reinforced the message from the business surveys that the economy’s momentum remains solid and may be tracking above our forecast for 7.8% q/q saar growth this quarter. Next week’s flash manufacturing PMI will give further guidance. With the housing market booming and CPI inflation surpassing the 3%oya mark for the second consecutive month, we look for the government to intensify its effort to contain perceived imbalances. One clue is whether the slowdown in October credit growth is sustained to intensify its effort to contain perceived imbalances. One clue is whether the slowdown in October credit growth is sustained.

Japan reaccelerating after 3Q cooling

Japanese GDP growth cooled to 1.9% q/q saar in 3Q, consistent with the midyear deceleration in most activity data. The advance was focused in public works, housing, and inventory investment, whereas consumption and equipment capex barely rose and net exports declined. The signs point to a quick reacceleration to a 4% pace of GDP growth this quarter. Incoming data already signal an uptick in consumer spending, while next week’s international trade report should confirm a revival in export gains. The bigger question mark is business behavior. Business sentiment has rallied (see this week’s Reuters Tankan), but this has yet to translate into a vigorous recovery in spending. It is possible that 3Q capex will get revised up following the MoF survey, while the recent gains in domestic orders hint at stronger expenditures this quarter. An expansionary business sector is needed to anchor...
the recovery, especially with the consumption tax increase coming in April.

**Weak recovery keeps pressure on ECB**

The Euro area posted a second straight gain in GDP in 3Q13, further evidence that a weak recovery has taken hold. Our judgment is that underlying momentum is gradually improving, and this message should be reinforced by a rise in next week’s flash PMI for November. The breadth of advance within the Euro area is encouraging. Spain returned to growth in 3Q13, tracking the upturns that previously had taken hold in Portugal and Greece. However, with growth expected to struggle to reach trend next year, the backdrop will remain highly disinflationary. Inflation could fall further in the near term and is forecast to stay below 1% for at least the next six months, threatening deflation in the periphery. Having just cut rates, the ECB’s likely next step is to reinforce its low-for-long message at the December meeting, when the staff’s 2015 forecast will be unveiled. We think inflation may be projected as low as 1.2%oya.

Although the Euro area continues to make progress in building a more robust institutional structure, some minor setbacks occurred this week. Ireland decided to exit its program without putting in place the backstop of a precautionary credit line. There are negatives in the suggestion of Irish distrust at the strings that may have been attached to a credit line and in the failure to establish a precedent that might have been helpful later for Portugal and Greece. In addition, the European Commission raised tensions with its surprisingly tough criticism of Spain, Italy, and others to toughen their 2014 budgets. We expect pushback from these governments as the Euro group meets to discuss the Commission recommendations next week and maintain our call that the pace of fiscal drag across the region will further ease by around 0.5%-pt of GDP in 2014.

**An uneven firming in EM growth ex. China**

Our research has highlighted the conflicting forces affecting EM growth. We think the export impulse from rising DM demand is beginning to dominate, delivering a gradual but uneven lift in EM GDP growth. Korean exports are posting solid gains, and this is feeding through to stronger manufacturing, even as the economy is held back by the relatively high level of household debt and the soft housing market. In this week’s policy statement, the BoK projected a gradual narrowing in the output gap as the recovery broadens. Against this backdrop, we think policy rates will remain on hold at 2.5% during the coming year, while the government will provide targeted support to the housing market, low-income households, and small companies. India’s economy is strengthening as well but with no spare capacity as stronger demand is feeding inflation pressures. This week we learned that consumer inflation moved back above 10%oya in October while WPI galloped to 7%. If the current inflation momentum is sustained or the rupee weakens further, the RBI is likely to hike rates again next month rather than wait for January.

In emerging Europe, this week’s 3Q GDP reports confirmed a further pickup in growth, notwithstanding an unexpected setback in the Czech Republic. The region is benefiting from the recovery in Western Europe and policy support afforded by low inflation. The main exception is Turkey, where the combination of a large current account deficit (about 7% of GDP) and high inflation has prompted a significant tightening of monetary policy. This week we slashed our 2014 forecast for Turkey to 3.0% from 3.8% mainly due to tighter credit conditions. The central bank has pledged that policy will remain tight until inflation falls to the official target of 5.0%. To this end, bank lending rates have already increased by around 300bp since midyear. We expect the CBRT to shift its interest rate corridor up by 100-150bp further to support the lira against tapering-related pressures in 1Q14.

Next week’s reports should confirm that Mexico’s economy returned to growth last quarter (J.P. Morgan: 3.1%/q/q saar) following an unexpected contraction in 2Q. Temporary drags are fading, though the latest data suggest growth may fall short of our forecast for near 5% growth this quarter. In Brazil, widespread public demonstrations likely led to a drop in 3Q GDP. The continued stagnation in Brazil’s GDP proxy in September underscored our forecast for a partial recovery in growth this quarter amid continued monetary tightening.

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**Graph:**

**Monthly real GDP proxy**

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*Source: INEGI, BCB*

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