CEEMEA
Business Group

The Global Economic and Business Outlook

Why your company is struggling globally
Why there is no future for your children

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Content

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About the author

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Danny Thorniley is President of DT-Global Business Consulting GmbH (an LLC company). DT-Global Business Consulting is Danny's own consultancy company based in Vienna through which he works closely with over 400 corporate clients advising on business strategy in CEEMEA, global and emerging markets.

These companies are part of the CEEMEA Business Group, which is an advisory and consultancy service, which Danny runs with a small team of long-standing senior colleagues. The services of the Group include written position papers, presentation slides and private client meetings as well as in-house presentations. He is also invited to make some 60 speeches/presentations by clients across the world on global business trends, business operations, emerging markets, corporate best practice.

His speaking ability covers global corporate business trends, corporate Best Practice and specialisations in BRIC (Brazil, Russia, India and China), USA, Europe, East-Central Europe, Russia, Mid-East & Africa and emerging markets. Danny writes a monthly business report for his clients doing business in Russia and he visits Moscow every 2-3 weeks.

For 23 years (until the closure of the Vienna office) Danny was Senior Vice President of the CEE/Russia region at The Economist Group.

Danny has exceptional skill sets in global business strategy, business in emerging markets and CEEMEA and hands-operational knowledge of business operations, distribution, partnerships, investments and human resource issues.

He has worked on a personal basis with hundreds of companies operating in emerging markets for 23 years and has personal contacts with most senior western MNCs operating in the CEEMEA region and beyond. He makes frequent presentations at CEO and Board level (over 100). He has personal friendships with leading executives in many of the leading companies of the world.

He holds and has held a number of non-executive and advisory board memberships with companies in the services, IT and executive search sectors. He is currently a member of the Global Advisory Board of the US company Aecom chaired by former UK Prime Minister Sir John Major.

Dr Thorniley was educated at Oxford University. He holds a Bachelor of Arts degree, a diploma and a doctorate degree in Soviet political economy.

Food for thought

"There are only two things which are infinite: first, the universe and second, human stupidity…but I'm not sure about the universe", Albert Einstein

"A depression is a chronic condition of subnormal activity for a considerable period without any marked tendency either towards recovery or collapse", John Maynard Keynes

"Multiculturalism has failed totally. The idea that people from different ethnic groups working successfully side by side is wrong". Who said this in October 2010? Angela Merkel.

Executive summary

- There is a global sense of malaise and the feeling that human progress is being reversed.
- The global economy and global business have never properly recovered from the 2009 financial crash.
- After the economic heart-attack of 2009, the illness turned chronic.
- There seems to be no big reasons why global GDP should rally much in the next 2-4 years.
- The 2009-15 recession has cost the global economy about $9 trillion whereas in today's dollars the Second World War cost a mere $1.7 trillion.
- The banks were never fixed and once again the financial sector in Europe is in turmoil; Italian banks are the current Achilles Heel.
- And Europe will eventually face another Greek bail-out; Greece is bankrupt and there will either be Grexit or debt write-offs in the next 2-3 years.
- The perception of uncontrolled migration has the potential to rip apart politics and societies in the developed world; the process has started.
- Angela Merkel—the gravedigger of Europe?
- Young people are having less sex in Europe (see page 13).
- Some 27% of people aged between 27 and 33 in the EU live with their parents!
- 63% of youths in Europe are either unemployed or have temporary jobs!
- Brexit will trim a little off already fragile GDP growth and a bit more from Eurozone estimates in 2017 with most of the hit in that year.
- The most popular name in the UK last year for new born boys was Mohammed.
- Global GDP estimates have been downgraded every year for the last 6 years.
- The next big economic time-bomb: student loans in the US and globally. In the US youths, who are getting older, are burdened with $1.3 trillion of student loans which now affects 35mn "students".
- The next US and global banking crisis could stem from non-performing student loans.
- Education costs in the US have risen 1,120% between 1978 and 2010 and have risen way above inflation since 2010.
- House ownership in the UK is at its lowest level in 33 years and more people do not have the financial resources to catch up with ever-rising house prices.
- In the UK renting tenants spend 47% of their disposable income on rent and in London this leaps to 72%!
- Between 2005-2014 some 66% of households in 25 advanced markets representing some 560mn people saw their real incomes (wages and capital) stagnate or fall. This compares with just 2% who experienced the same in 1993 to 2005.
- If the banks fail to lend to the real economy, then "helicopter money" will have to be employed: coupons of 500 Euros to every citizen to spend within 6 months!
- The consensus for oil over the next 18 months is $53 to $58 per barrel.
- Interest rates will remain very low globally and are now in many cases negative with consequences for banks and savers.
- Interest rates will stay close to zero or negative in the UK, Eurozone and Japan for the next 2-3-5 years; US rate increases are on hold and will only start to creep up at end of 2016 if then.

- The US dollar will probably stay relatively strong given a better growth outlook than rest of the world and thanks to those slowly rising rates.
- We see the Euro-dollar averaging 1.10 in the near –term and then trending to 1.05 as US rates rise.
- Global trade continues to shrink alarmingly and is a key determinant behind chronically weak global growth.
- Similarly, global fixed investment is going through a rough ride and 2016-17 will be weak years.
- In 2015 US public capital investment, which includes infrastructure, was just 3.4% of GDP at $610bn which is the lowest figure in 60 years. The estimated shortfall in necessary infrastructure spending from 2016-2025 is estimated at $1.5 trillion.
- Emerging markets are much slower than in the past but they are still growing faster than developed markets.
- The scare over China at the start of 2016 has abated but this is because the government resorted to standard stimulus policies in the spring rather than further reforms.
- Some emerging markets are struggling badly and these include Brazil and South Africa.
- Expectations for business in the Middle East have had to be cut radically and Saudi Arabia is no longer the boom market it was 18 months ago.
- Sub-Sahara Africa has suffered the same fate and is going through one of its regular down cycles
- Russia is not as bad as some media portray but much depends on your sector; the medium-term outlook could be "ok or not bad" but the glory days will not return and average GDP over the next 5-8 years will be about 2.5%+ (see my Russia reports).
- The CEE region is a safe haven and a relative global star (see my CEE reports).
- Austerity is being buried? 7 years too late. Japan turns to fiscal loosening: more proof that austerity is dead. In the UK former chancellor's mono-mania for a balanced budget has been dumped. When will the Germans follow suit?

Introduction

This report argues forcefully that many citizens have been left behind economically and alienated politically. There is great need for economic and social change if worsening political scenarios are to be avoided. It's a political, social and corporate issue.

> The fundamental theme of this report is that if very large segments of society and indeed voting majorities are not satisfied with their livelihoods, incomes, jobs or lack of, then they will not be "happy consumers". I argue that the current global economic system is failing in creating FINAL DEMAND and this is an albatross around the necks of most companies doing global business.

It is becoming clear that many large parts of the electorate across the developed world (USA, EU, UK) have an intense loathing and antipathy of established elites and the political establishment: the centre-right and centre-left parties have lost their legitimacy and prerogative to rule.

> People on the street perceive that their governments did not protect them from the bankers in 2008-09 and since then they have not protected them from what they see as uncontrolled migration in recent years.

PART 1: THEMES AND ISSUES

Global political risk

Austerity + migration = Brexit
Austerity + migration + terrorism = implosion of the European Union in 2019 or 2023
Austerity + migration could mean President Trump

Unless migration is "fixed" or more precisely the perception of uncontrolled migration is "fixed", then it will intensify as the social and political cancer of the early 21st century and metastasize in the next 3-7 years to such a level that it will destabilise and eventually destroy the EU/European political structure. Political elites in Europe, the developed world and the USA have "lost the plot" on this issue.

We think this current Populist-Wave No 1 will not succeed in all countries and scenarios listed below. BUT if the centre political establishment does not respond effectively to the democratic concerns of the people --- austerity, jobs, social welfare, equity and migration --- then Populist-Wave No 2 in the period 2020-2023 will be much more destructive and have deeper wide-ranging impacts on the political landscape.

My own personal and perhaps cynical view is that the European (US?) leadership will squander this "last chance" through blindness, ineptitude and corruption.

The US scenario of a President Trump is real but our estimate (and only that) is that US austerity was less deep than in Europe and migration is not as uncontrolled. On this basis Trump would fail to become president (but that is not a guarantee). However, his toxic influence on US politics will remain long after he has departed the scene.

White House Washington D.C. January 2017: "Ladies and gentleman, please all rise for President Donald Trump".

What are the consequences of that statement which would start to kick in after the November 2016 election IF Trump were to win?

First of all, will he win? Probably not. But even after the Democrat Convention, the bounce in the polls for Hillary Clinton is only about +5% nationally and everything will depend on turnout and the results in a few key swing states such as Ohio, Pennsylvania and Florida and some of the rust-belt mid/northern states. Most commentators rate his chance at about 33% (but these commentators were also wrong about Brexit) and I would put his chances at 40%.

And the consequences of a Trump victory? Much/all depends on just how far Trump converts his populist electioneering slogans into actual government policies and to what extent he brings in genuine administrative expertise to run the administration. Some/many of the plans (the wall with Mexico for example) are presumably un-implementable.

- The global financial markets would shudder and most stock markets would lose 10-20% by end of 2016
- The turn of year would be bleak indeed
- More protectionism would come about and shatter global trade which is already extremely fragile
- As trade links between the US and China shrank, suppliers into the two largest markets in the world would diminish and the recession would immediately turn global—Asian and European sub-suppliers would get whacked.
- China could decide to retaliate with capital controls, restricting US corporate access to the Chinese market and eventually pulling some of its FX reserves out of US funds
- Global trade which is barely positive now would turn sharply negative by -5% to -15% or worse which would devastate investment and industrial output
- Unemployment would spike in China, the US and globally, and consumer spending would start to contract sharply

- Global GDP in 2017, instead of the current consensus of around 2.6% (PPP basis) would be flat or negative -2.0%
- The duration of the recession would depend on the factors above: who are his advisors and which policies are implemented in full?
- In terms of trade alone, markets such as China, Mexico and Israel would be hit outright but would drag all markets with them and first in line would be Thailand and Korea given the level of trade dependency with the US
- Global FDI would also diminish but this would take longer to respond than bond and FX markets and only start to shrink from spring 2017
- Global investment projects would be postponed and many investors into the US would pause for thought
- We presume (!) that Trump's comments on the US role globally and about not necessarily supporting NATO allies will be forgotten in large part once in office
- But there is a clear possibility that global security relationships are subverted and the role of the US questioned for years to come
- NATO countries, South Korea and Taiwan would be stressed
- It is argued that North Korea would take the opportunity to engage in more adventurism
- Some commentators argue that a Trump presidency would benefit Russia. The gossip suggests this but actually such an eventuality should prove disastrous for Russia economically: the resulting global recession would hammer the oil price which could slump to $10-20 per barrel putting enormous strain on the rouble and the Russian economy. Indeed all commodity producers, which include many emerging markets, would be severely hurt.

Trump Summary

Global recession of unknown duration; weaker commodity markets; weaker equity markets; interest rates held down further and more deeply negative as a response; introduction of "helicopter money" and further QE to provide liquidity; presumably and ironically a stronger dollar as investors look for security; or could there be a run on the dollar as funds turn to the renminbi and the Euro and yen and as China pulls out in part from the dollar? Outlook for US treasuries also uncertain but global investors would be screaming for safety and rush to German and Japanese bonds (and US ones) making the yields on these deeply negative.

The missing link: final demand

Why is your company struggling globally?

Most of the 400 companies I work with have been unable to achieve sustainable top-line sales growth in global markets and they have generally struggled with their business and this is across sectors (see comments above).

Middle and senior managers can scratch their heads about what's not working right and can allude to errors or mismanagement in the following features of business and say "We are not getting this right":

- ✓ Marketing
- ✓ Advertising campaigns are misdirected
- ✓ We make poor use of e-commerce and digitisation
- ✓ We don't have right consumer segmentation
- ✓ Our route to market needs to be better
- ✓ We have to improve our distribution channels and partners
- ✓ We need different brands/new brands/modified brands
- ✓ We don't understand discounts and promos
- ✓ Our financing and receivables structure isn't right
- ✓ Our corporate focus is not right: too tight or too broad
- ✓ We are in the wrong product/geographical markets
- ✓ We have the wrong corporate structure: markets/products/matrix
- ✓ Our HR policy is wrong
- ✓ We have too little/too much upward innovation
- ✓ Same for downward innovation

- ✓ Our price points are too high/too low
- ✓ We don't understand innovation properly
- ✓ We need more/ less M&A

And on and on. And executives are perfectly right and professional in looking at all these aspects of business and many more. BUT all this ignores one massive, major aspect that is beyond the control of executives and their companies:

> **At the end of the day and for the last 6-8 years there simply has not been enough FINAL DEMAND. The global consumer is too stressed and strained. Companies have failed to understand that the majority of global consumers are under pressure.**

This is critical to all companies in all sectors and not just to FMCG ones and retailers.

> Because at the end of almost every business chain (if you sell equipment or concrete or steel), there sits the global end-user/consumer and she/he is not a happy puppy. This discontent is reflected both in spending patterns affecting corporate sales trends and in shifts in politics and rising populism.

These comments apply to consumers and business in developed markets but the trends are then mirrored in emerging markets.

The global consumer is strained because of:

1) Poor wages (see below)
2) Off-shoring --- unemployment
3) M&A activity.

Downsizing, government "reforms", corporate "restructurings", outsourcing and M&As have carved out full-time jobs from many developed economies.

Too many global CEOs and corporate boards don't appreciate or understand enough that their own companies bear some of the responsibility:

> Corporate cost optimisations and job cuts stemming from M&As have caused more job losses in the US and Europe than jobs lost to China and off-shoring.

Since 2008 mergers in the USA sought to reduce recurring annual costs by some $150bn and very little of that was passed on to consumers but it did entail the loss of hundreds of thousands of jobs; so the consumer got a double-whammy of fewer jobs without cheaper products.

When we combine an insecure present existence with an uncertain future, we create the so-called Precariat (those who live a precarious existence in rich, developed countries).

Why do people hate their governments and politicians?

The collapse of the centre left and the centre right
Populism 1.0 and 2.0

The political risks of 2015-17 include:

1) Brexit.
2) The perception of uncontrolled migration is a constant political time bomb.
3) October 2016 Italian constitutional referendum.
4) October 2016 Austrian presidential election.
5) October 2016 Hungarian referendum on migration policy.
6) November 2016 US presidential election.
7) End of 2016 – trigger of Article 50 for Brexit.

8) 2016-2017 rising authoritarianism in Turkey/break up of migrants deal?
9) Open-ended terrorist attacks: assaults on schools, gas attacks.
10) Open-ended rivalry in South-China Sea.
11) Continued implosion of Syria and Iraq.
12) March 2017 Dutch general election.
13) Spring 2017 French presidential election.
14) Autumn 2017 German federal elections.
15) During 2017-19 Scotland secedes from the UK?
16) Greece is bankrupt and will never pay back its debt; further bailouts; northern European discontent. The "fat lady has not finished singing" on this one.
17) The Middle Eastern cauldron: ISIS and an imploding Middle East/global terrorism; Syria and the Arab winter; Sunni-Shiite tensions turn hot; Israel-Palestine.
18) And on continental Europe eastern Ukraine remains a frozen conflict.

Austerity programs have destroyed jobs, growth and investment across Europe and in other developed markets since 2010. It was a totally mis-guided political idea and we argue this further in the report below. But we make the points regarding austerity that 1) growth could never rise quickly enough to pay off rising debt levels and 2) the idea that the private sector would step in confidently to fill the gap left by government as the latter paid off debts was utter garbage; instead austerity and spending cuts destroyed corporate and consumer confidence and ensured that economies stayed in recession or sub-par growth for much longer than necessary. We are still living with the consequences today and disturbingly the German government is one of the few holdouts that believe further austerity would do good.

Most other commentators now concur that austerity failed the Eurozone and could have done more damage to the US. The US economy is in better shape than Europe and Japan because it did not engage in such deep austerity and manged its banking system a bit better. The US may also avoid the consequence of populism in the form of a Trump presidency because austerity did not bite deeper and because migration is not so out of control as in Europe and integration works better.

We presume that Hillary Clinton will squeak in for the presidency and that perhaps in Austria, France, the Netherlands and Germany that centre-left and centre-right parties will gang up in grand coalitions to prevent populist parties and leaders taking power despite the fact that they may turn out to be the largest party or biggest vote catcher in first rounds. But we perceive the greatest risk as arising in the next 3-5 years because we presume that such coalitions of the centre will fail abysmally in bringing about fundamental economic and political changes, which a growing number (and majorities) of people want. We fear that coalitions of the centre, once they have kept out the populists will revert to the norm, avoid real change in economic and migration polices, keep "jobs for the boys" and divide the political and financial spoils for themselves.

Increasingly people see established political elites as lackadaisical, inept, detached, aloof, arrogant, ignorant placemen with an enormous sense of self-entitlement, nepotistic and frequently corrupt who believe themselves to represent some sort of elite but who are in fact mediocrities and nobodies who happened to be in the right place at the right time or worked themselves up the greasy pole over many decades within their detached and alienated political parties. In Austria to name the country where I live, a prosperous country ranking No 12 in the global happiness indicator, the two centre parties have been blatant in dividing up the spoils of power between themselves, legally or otherwise. Elderly politicians line up for senior and massively remunerated posts because it is "Muggin's turn" (an English idiom meaning something like "He is the oldest, so the gets the job"). The loathing by the people for the supposed elites is vitriolic.

> But populism will fail this time round (presumably?), but established elites and coalitions of the centre will then fumble their opportunity to make sensible changes and the greater risk of populism in a second tsunami will rebound in 2-5 years. Worse is to come.

The austerity policies of the UK and EU have destroyed job security and undermined real wages over the last 5 and 20 years (also in the USA –see above). People feel they have been mistreated economically and financially. They feel that that their elected representatives have abandoned them and are more concerned about the welfare of a minority running the banking sector or with a minority of foreign migrants; they see that no one was punished for the financial crash of 2008-09; they witness growing social global and regional inequality and

manifest corruption and tax avoidance ("Taxes are for poor people") as exemplified most recently in the Panama Papers, and they see the financial security of their children eroded.

> **This is the gunpowder; the spark is migration.**
> **The UK left the EU because of migration.**

Of course there were many factors but the perception of uncontrolled migration was the decisive factor for Brexit.

The following remarks are not pleasant and represent analysis and do not necessarily reflect my personal opinions. I state this to avoid any possible criminal prosecution under EU or Austrian laws or UK laws for "hate crimes" or "hate speak".

> Large sections of British citizens (white working class and lower middle class) especially in the north, north-east, eastern UK and the midlands and combined with middle class and lower middle class voters in the south, south-east and central England do not want any fresh immigration of Black, African, Middle eastern, Arab, Muslim migrants into the UK nor do they welcome migrants from south-eastern Europe.

Mass migration into the UK started to climb significantly from 2004 and this was something the "left- behind segments" of British society never voted for and never accepted.

> They got their revenge in June.

Accusing people who think like this of being stupid, ignorant, fat racist fools is not constructive and often does not attract their vote, as we have seen. But unless European governments understand this, the political and social outlook for the EU is bitterly bleak.

> Global migration, at its highest levels since 1945 and which we all know is part of globalisation and the political implosion of the Middle East, is the ticking time bomb of the 21st century. UK and European politicians have failed miserably in addressing it both in terms of communicating with people and addressing their fears and at the practical level of setting sensible policies and ensuring competent control of the borders. It is not racist to ask to discuss the issue of migration and to ask to debate whether multiculturalism is good or bad and to ask what the fiscal cost is.

Why people hate their governments and politicians: economics
Incomes, wages, stagnation, death

US median family income in 2007 was $53,000 and had been stuck at that level for 10 years since 1997. But in the three years to 2010 it sank to $49,000 and then fell further to $46,700 in 2013. Real wages in the US infamously have barely budged upwards in the last 25 years and this is actually just starting to improve.

US average weekly earnings, adjusted for inflation, failed to reach their 1972 peak of $342 for the next 39 years in a row; in 2011 the figure at $295 was still 14% lower! Put another way US median household income has been stuck for 10 years at approximately $53,000.
From 1989 to 2014 the shared of wealth in the top 3% of US households rose from 44.8% to 54.4% BUT the share of the bottom 90% fell from 33.2% to 24.7%.

UK real wages were negative by -10% in 2008-2013 – the worst numbers for 500 years with the possible exception of the Depression of 1867; real wages in the UK paid to skilled labourers have fallen by -10% in the last 6 years.

Put another way, UK median real wages in 2013 were the same as in 1979 (34 years). Real wages stayed flat in Germany for 15 years and only picked up into small positive territory in late 2014. The outlook though is for further stagnation in nearly all these markets as inflation climbs upwards slowly.

In Germany real wages were flat or negative for most of the years 2000 to 2015. These wages crept up in 2015-16 thanks to low inflation and some better pay deals. But unskilled migrants arriving through 2015-16 will ensure downward pressure on wages especially in the low skilled sectors. After waiting for so many years for better pay, German workers will see migration derail this positive trend.

Footnote: real wages have been improving in the US, UK and Eurozone recently (last 18 months) and have even turned slightly positive. This is due not to re-found munificence from companies and government but from the fact that inflation has collapsed in most markets and is close to deflation. This means that even if someone only has a pay rise of 0.5%, if inflation is zero, then that entails 0.5% rise in real wages. Real wages will be a bit better this year but low-skilled migration and price sticking upwards a little in the next 18 months will halt this temporary upbeat trend.

A 2016 report by McKinsey substantiates the arguments we have been making for several years:

> **Between 2005-2014 some 66% of households in 25 advanced markets representing some 560mn people saw their real incomes (wages and capital) stagnate or fall. This compares with just 2% who experienced the same in 1993 to 2005.**
>
> **No wonder people are sick and tired politically, and have become even more difficult consumers.**
>
> **If slow growth persists, which it seems it will, then as much as 80% of people will experience flat or negative incomes from now to 2025.**

In this survey Sweden comes off relatively best while trends in Italy (with almost 100% of people seeing flat or negative incomes in the last 10 years) was much worse than the norm and other poorly performing countries include the UK, the USA, France and the Netherlands.

In the US the life expectancy of non-college educated white American males has been falling steadily in the last 12-14 years from about 73.5 years to 68 years due to poor diet, rising suicides and addiction to prescription drugs. If this current trend continues this category of US males (not all US males) will have a lower life expectancy than the average Russian male in 8-10 years.

On the theme of rising inequality, one sentence can suffice:

> **The fastest growing category of consumer spending in the USA in 2013 was "personal pleasure aircraft".**

So what? Rich families save up to buy aeroplanes and that's great for private jet builders. But if the money were spread more widely, then more companies would benefit from broader consumer spending. All the above numbers and arguments help to explain why (in addition to other sobering macroeconomic news) the majority of companies globally are stressed and strained and find the consumer in developed markets (and globally) to be so difficult to adapt to and understand.

Why people hate their governments and politicians: politics

> **I am surprised there has not been a social revolution in the UK.**

Who said this in 2011? Some disappointed radical revolutionary? No, it was Sir Mervyn King, the then Governor of the Bank of England. Well there was no social revolution in the UK in 2011 but there was in June 2016 with the Brexit vote. Mervyn King, who also condemned the excesses of the financial sector and damned prevalent "casino banking", was surprised because the damage caused by the financial crisis, which was then followed by excessive and obsessive austerity programs in the UK and Eurozone, ought to have caused more of a social and political reaction.

For several years now the manifesto of main-stream centre-left and centre-right parties in the developed world has been the following (slightly exaggerated but not much):

1) We are going to slash and burn the economy
2) We will raise your taxes and especially consumption taxes
3) We will raise the costs of social insurance
4) We will not support pay rises
5) We will reduce health and educational spending
6) We will permit years of entrenched unemployment and youth unemployment
7) We will not protect your children's future
8) We will protect the banks and transfer trillions of dollars and Euros to them
9) We will protect banks and hedge funds from risk to Greek debt and transfer this to taxpayers
10) We will reduce our own corruption by only having 5 bank accounts in Panama instead of 10
11) We will permit large, uncontrolled migration which you detest
12) We will then accuse you of being fat, nasty, aggressive, stupid, ignorant racist fascists who don't understand complex issues.

Finally: VOTE FOR US!

On that last point about "fat voters", I certainly do detect a contempt and alienation among main-stream politicians who see the "lower orders" as obese slobs who have bad diets and choose not to buy wonderful organic foods and who are people who wear cheap plastic clothes. The contempt, loathing and alienation are reciprocated in turn by these "lower orders" and there has not been such alienation between large segments/majorities of the population and the centre political establishment: we see this with Trump and Sanders in the US and across Europe in populist parties. The political centre is imploding.

> This is now personal and voters want to send a message of rebuke and revenge to politicians who fail to hear them.

Mainstream parties are out of touch. As the Financial Times noted:

> The tragedy of today's Eurozone is the sense of resignation, which the establishment parties of the centre-left and centre-right are allowing Europe to drift into the economic equivalent of a nuclear winter.

All of the above undermines consumer confidence and changes consumer perceptions and behaviour, invariably to the detriment of western companies.

What Europe and developed markets need and what they will probably get

1) EU incompetence

Germany and the Eurozone needs to respond with a stimulus package of massive investment in infrastructure (Germany is one of the worst investing countries in the OECD) and creation of real jobs, with massive training programs that lead to real, full-time and long-term jobs sponsored, if need be, by state subsidies, with massive investment into IT and R&D. This can easily be funding by debt while money is so incredibly cheap. Such development could go hand in hand with well-structured PPP projects (and not projects where the state is ripped off).

It is doubtful that the EU establishment has the sense or competence to do this. It is more likely that a bunch of tired looking, grey-haired old men will utter the same delusional platitudes that have caused sub-par growth for 8 years and youth unemployment of 21-23% across the continent with youth unemployment in the peripheral countries at 48%. The economic and political mismanagement of the EU and Eurozone is chronic and tragic. The appalling Jean-Claude Juncker, president of the unelected and fumbling European Commission is surely the worst and most detached politician on the planet today.

On the political side, the European external borders need to be controlled by the EU's Frontex, which laughably 10 months after the migration crisis of summer 2015, remains a Mickey Mouse, underfunded and organisationally crippled institution.

What we need	What we will get
GDP growth model	Half-hearted austerity
Youth employment scheme	Germany blathers about balanced budget
Massive R&D investment	Weak investment
Massive IT development	Misguided mega-schemes with wasteful procurement
New lending programs to SMEs	Channelling money through banks which do not lend

And on migration: we need an effective migration policy that is clear, transparent and pays heed to the concerns of tens of millions of voters.

Instead in recent days Merkel has defended her open-borders policy and the head of human rights for the UN insists that all migrants including purely economic ones have an inalienable right to come to Europe.

The latter kind of statements are those which will rip the heart out of the European project.

2) US gridlock

We also fear that even if Clinton wins the election, then the US political system will undergo another 4 years of gridlock: the House of Representatives will certainly remain Republican and the Senate most probably. The Republicans will refuse any bipartisanship with Clinton given their political loathing of her: just as they blocked Obama's legislative programs so they will do the same with Clinton.

The tragic generation gap

The young are getting poorer; the old are getting richer

The current middle-age adult generation of 2000-2020 in the developed world will be "the worst one" since 1945 in the sense of not passing on a better future to their children.

This is a generation that has failed its children.

Generation Y (20-35 year olds today and their younger cohorts) in the developed world have never been in such a relatively weak economic situation in the last 60-70 years.

The prosperity of the young generation across the developed world has plummeted:

- Youth unemployment is close to 50-year record levels across the developed world and especially so in Europe (see below)
- 63% of the youth in Europe are either unemployed or have temporary jobs!
- In the US for the first time since 1776 under 30s are now poorer than retired people
- Last year in the US the income of pensioners rose faster than the income of people younger than 25 for the first time in 200 years
- This trend was replicated in France for the first time since 1789
- For the first time ever in France recent pensioners generate more disposable income than families headed by a person under 50 years of age
- Real incomes of young people today in the US and Italy are less than 30 years ago
- In the UK in recent years the disposable income of pensioners has risen 3 times faster than the income of young people
- In the developed world generation Y earn 20% less than the average citizen

The big time-bomb: student loans in the US and globally

- In the US youths, who are getting older, are burdened with $1.3 trillion of student loans which now affect 35mn "students"

- Education costs in the US have risen 1,120% between 1978 and 2010 and have risen way above inflation since 2010.

> Astonishingly 27% of youths in the EU aged between 25-32 (which is not that young) live with their parents!!

This number is shocking and reflects that young people do not have proper jobs and decent incomes, do not have financial security and are unable to put down deposits for property mortgages. They are so fragile economically that they are not even able to find affordable rental accommodation in the public or private sector.

One prurient, silly, sexual comment:

> Living with your parents actually has a noticeable impact on demographic trends. Why? Think about it! If you are living with mum and dad and you can hear them snoring at night through the thin walls, you are less likely to engage in recreational sex 9 times per day. In fact you may confine yourselves to 4 times per day or much more likely stick at zero…just like mum and dad! ☺

There is actually one commercial positive here. While these young people have strained incomes, by living with mum and dad they do save on rental costs and laundry etc. and will have more disposable income to spend on consumer items (iPhones etc.?)

But other figures undermine this possible positive consequence. It appears that the outlook for a property-owning democracy in the West is becoming more elusive. House ownership in the UK is at its lowest level in 33 years and more people do not have the financial resources to catch up with ever-rising house prices.

> In the UK renting tenants spend 47% of their disposable income on rent and in London this leaps to 72%!

Not much left to spend on anything else.

And what does this all mean for the generations? Well, if I may make a very bad joke☺, it goes like this and is similar to the plots of Balzac, Dickens and Galdos novels.

> The older generations have everything: property, houses that have made them millionaires, decent savings and good pensions from the good old days, jobs in the past were real and based on contracts and with social, health and holiday benefits. The younger generation has none of this. From a cynical and purely financial point of view (and apologies again for the upcoming brutal remark) most children would like to see their parents dead!!
>
> Now of course, they love you and you are wonderful parents but strictly speaking in financial terms it would be very convenient if parents could….well….move on!
>
> More seriously on this point, many parents are transferring their wealth and property to their children while they are alive and seek to provide as much support as they can.

The gig economy

Over 100 years ago Henry Ford understood that you needed to have happy, well-paid workers because they become happy and high-spending consumers who will buy products that you produce at affordable prices. It's not brain surgery. But too many bureaucrats and global CEOs have failed to understand and maintain this link.

In their endeavours to cuts costs and to downsize to meet the bottom line, far too many global CEOs and Boards have forgotten one obvious axiom:

> **Employees are consumers; if you bash one, you bash the other.**

This means that sustained employment is becoming more rare and at the same time nominal wages and real wages have been crushed. Little wonder consumers did not rush into the stores around the world to spend their supposed $400bn oil price bonanza in 2014-15.

The trend in employment in developed markets is as follows:

> Top-level senior management and some key posts in finance, IT are OK and in fact benefit from disproportionately high incomes
> Middle-management and back office jobs are being devastated thanks to IT innovation, M&As, outsourcing and extensive cost cuts
> Low-end jobs in cleaning, retail, services, minding of elderly people on the lowest salaries and zero hour contracts are expanding.

Summary: the small top is doing well; the big middle is being slashed; the cheap bottom is booming.

We have long harped on about the economic and especially the jobs model not working well in developed economies in recent years. While top-line unemployment numbers are falling in both the US and UK, much of the good news does not stem from people walking into steady, well paid, regular jobs.

> More than 50% of all jobs created in the developed world (OECD) in the last 20 years have been so-called "non-standard jobs" i.e. part-time or self-employed. Some 70% of all jobs created in the UK in the last 10 years are non-standard and some report that all net job creation in the UK has been non-standard.

The employment numbers for youths in Europe are highly disturbing:

- 25% of 16-24 year olds in the Eurozone are unemployed with some countries recording 40-60%
- Of those in jobs 52% of them are in temporary ones

> **These numbers mean that about 63% of youths in the Eurozone today do not have proper, contracted employment. Little wonder that consumer spending patterns are warped.**

- The track record for temporary jobs is not good: In France, Italy and Spain fewer than 30% of those in temp. jobs had permanent ones three years later

Looked at in another way the numbers remain concerning:

Those in temporary employment as a % of total employment

	All workers	15-24 year olds
OECD	11	24
Europe	14	41
UK	7	15
Germany	13	53
France	16	57
Spain	24	69

So one quarter of all Spaniards who have a job have no job security and across Europe young people are being used as a surplus labour pool.

Additionally, in Spain, 80% of new jobs are temporary ones and in France the number is 86%.

The "gig" economy in the UK

- A shocking 83% of new employment created in the UK since 2007 stems from people turning to self-employment.

- There are 4.55mn self-employed people in the UK, which is the highest figure since records began.
- The number of self-employed grew in the last year by 375,000, which is the largest one-year jump.
- 17% of the current total workforce is self-employed, the highest number in 40 years and this will rise to 30% in the next 20 years on current trends
- Some 33.7% of total UK employees are part-timers or self-employed, the highest number on record and these people do not have full benefits and are precarious and part of the "precariat"
- The wages of the self-employed have fallen by -25% since 2008
- 40% of the self-employed work part-time because they cannot find enough hours of work.
- More than 50% of these people earn less than 35% of the median average wage.
- Some 78% of the self-employed are over the age of 50.
- Anecdotally most one-man/woman companies fail.
- Zero hours contracts in the UK rose by 15% last year to encompass over 850,000 workers and some major food retailers have 85% of their staff on such contracts and Buckingham Palace engages in this method!

We cannot build a secure, sustainable economic recovery based on zero-hours contracts and temporary jobs. Based on the above we take to heart the following statement:

"The biggest danger to capitalism is the operation of capitalism itself".

This would appear to be a quotation from Karl Marx but is actually from Paul Polman, the CEO of Unilever!

It does seem from the above that the economic model is not working and that the global economic model is flawed.

The economic recovery in the US and UK appears finally to be diversifying across several sectors but initially and even now, much is reliant on the rising value of the property market (and second/third homes for rental income) and unsecured debt is creeping up again. The recovery in both countries (until 2016 and Brexit) was not based on creating real jobs in manufacturing to build and create products and services. Its seems that both markets (and the Eurozone) are incapable of providing an economic model which can finance innovation, public-private initiatives, infrastructure development that in turn creates jobs so that reasonably well-paid workers can then purchase goods and services with money from their pockets and/or savings; instead we do seem to be recreating some of the features prior to the 2008-09 crash.

QE in the US and UK has tended to channel funds inefficiently through the commercial banks and then usually the money ended up in speculative housing markets and/or boosting stock markets. Relatively little has ended up in the real manufacturing economy and infrastructure.

Conclusion: QE has been and is a necessary stimulus to combat deeper recessions but is not a sufficient factor to restore sustainable growth: it prevents deeper recession rather than creating solid long-term growth. More fiscal stimulus is required, more direct investment, more job creation which puts money and wages in people's' pockets rather than just consumption via credit. There is a long way to go.

Business conclusion

And this all has a direct impact on business and corporate results. If so many consumers belong to the "precariat" (in a precarious situation), then FINAL DEMAND will prove inevitably weak; companies will face consumers constantly demanding promos and discounts; retailers will forever be stuck in brutal price wars; and there are limits to creating affordable innovation in products and services.

Uncontrolled immigration into Europe: a ticking time bomb

Some 60mn people are on the move globally as internal/external migrants hit the largest number in 200 years with the exception of 1945; this is causing trauma and rupture across Europe.

This is a very emotive topic. What concerns me deeply is that there is no sensible discussion communicated to citizens about the costs of immigration and the challenges from assimilation and integration. Anyone questioning the practicalities of the "refugees' march for freedom as they continue their pilgrimage for sanctuary" (quoting one international TV source) is quickly labeled not politically correct or worse. Instead we should debate, discuss and legislate.

But who said the following: "Multiculturalism has totally failed. People from different cultures living happily side by side does not work". It was German Chancellor Angela Merkel speaking on 16 October 2010 quoted by the BBC. Curious.

Two recent comments cause deep concern:

1) EU Commissioner Tusk noted last autumn that: "The EU cannot control its external borders". This is surely one of the most disturbing statements in recent years.

This was a frightening and shocking confession. What is perhaps even worse is that the same applies today. Aside from seeking to "bribe" and buy-off an increasingly authoritarian Turkish regime, little has been done effectively. Of course countries have taken unilateral actions and closed borders and including Austria and Sweden: ifSweden, a rich, affluent, liberal, tolerant society cannot make migration work and employs its army to close the border, what hope is there for other societies?

2) When the German political opposition asked the government in autumn 2015: "How many migrants have arrived in Germany this year? (2015), the response was "We don't know". This must be painful for technocratic, efficient German bureaucrats.

However many migrants arrived in 2015in Germany (about 1.15mn), the authorities do know that they have "lost" 120,000. The authorities were planning to process these and declare some of them economic migrants but now they have gone.

In January 2016 EU commissioner Timmermans announced that 60% of migrants were economic ones "with no reason to be in Europe". No one believes that many will be deported and processing deportations will take 2-3 years and hundreds of millions of Euros. In Sweden, where also 60% of migrants are suspected to be economic ones, some 75% of those likely for deportation have now disappeared.

In March 2016 Commissioner Tusk (the one who can't protect borders) shouted: "Do not come to Europe!" but this was 9-12 months too late and seemingly still contradicts Chancellor Merkel's statements of July 2016.

But compared with the emotional commentary on the topic, the debate on actual fiscal cost is derisory. Officials and commentators seem reluctant to mention this topic.

Numbers are hard to pin down but several estimates suggest that the cost of 100,000 migrants is one billion Euros in the first year plus about 10-15%. This seems about right as Germany is set to allocate some 12-15bn Euros to migrant-related costs in 2016 and Austria, having taken some 100,000 migrants, will spend some 1.3bn Euros on related costs. This is a startling development for Germany, an economic system which was almost brutally fixated on achieving a balanced budget in 2015-16 and engaged in deep, antagonistic debates with its European partners. Overnight this is blown out of the water.

Also immigration will without doubt bring wages down in recipient countries: this is fairly obvious. Real wages in Germany (UK, USA) have been negative for years or decades and only in the last 9-18 months or so have they ticked up into positive territory simply because inflation has fallen virtually to deflationary levels: if your pay rise is 1.0% and inflation is zero, you just got a 1% pay increase in real terms! But the strong consensus is that migration will bring wages down especially in lower-paid sectors. Eventually German and European workers will find this out and presumably with political consequences.

Certainly the timing of an extra 1.5mn migrant with low skill sets and poor language skills is not good. In the 1960s unemployment was negligible in Germany and Europe when millions of Turks were employed in a booming manufacturing industry. Today Europe is still fundamentally weak despite a current economic flurry based on short-term positives (see below). Overall unemployment has been stuck at over 11% until recent

months when it improved to 10.5%; youth unemployment averages 20-25% across the continent with levels of 45-60% in some peripheral countries such as Spain, Italy, Greece, and Portugal. It seems logically and economically improbable that the Eurozone can absorb such numbers of migrants.

Getting precise numbers with accurate definitions is impossible but rounded numbers suggest one million migrants arrived in Europe by sea in 2015 and that another 300,000-450,000 came from or via the Balkans; most of the latter are not eligible for refugee/asylum status but processing their repatriation will take time and prove costly and many tens of thousands will stick or disappear into communities; it's estimated that Germany is only repatriating about 30% of the economic migrants.

Some 100,000 migrants have arrived in Austria and a similar figure in Sweden: the countries have respectively populations of 8.5mn and 9.6mn and are absorbing the highest numbers of migrants on a population proportionate basis. And the numbers are not slowing: in the first week of 2016 some 3,000 per day were arriving in Greece in mid- winter (this works out at 80,000 per month in mid-winter).

Hopes of good assimilation and integration raise myriad questions. Sweden has effectively reversed policy and closed its borders and is using the army to control immigration; a political tussle has developed with Denmark over transport across the Oresund Bridge; in turn Denmark refuses to accept migrants coming north from Germany. If Sweden, a liberal, cultured, sophisticated, affluent, fiscally strong country, closes its borders, then something is seriously wrong. Few would deny that assimilation has failed in that country (with the exception of footballers and 1-2 politicians) with effective ghettos of tens of thousands established in the suburbs of Malmo and Stockholm. The social Democratic-Green coalition government confessed the game was up. If Sweden can't cope, how will others manage?

On assimilation generally the sexual attacks in Cologne at the start of 2016 have been well documented and the sad political correctness which keeps this out of the news also infuriates many average citizens. France for example does not document crimes by ethnic grouping which hinders terror investigations.

Germany's leading feminist Alice Schwarzer has stated: "Germany is naively importing male violence, sexism and anti-Semitism". It is also well documented that most migrants in Sweden and Germany are single males. In Sweden today the gender ratio of teenagers aged 14 to 17 is 106 males to 100 females. If most migrants are accepted, which will be the case, then the ratio rises to 116 to 100. Sexual violence is rising and expected to intensify and the Economist magazine, no illiberal journal, states: "Skewed sex ratios mean lots of sexually frustrated young men".

Terrorism related to immigration is a fear across Europe and the USA. Of the 1.15mn who walked into Europe last year, how many were experienced terrorists? 165,000! Actually that number is just made up by me because the sad answer of course is that no one knows. However, the UK and Lebanese secret services estimate (and they should know) that "only" about 3,500 confirmed terrorists entered European territory last year.

Schengen is dead in practical terms or will require on-going surgery. The system can only survive if an effective, large and well-costed EU Border Control is established with supra-national authority. This would need to be up and running in spring 2016 (8-12 weeks away) prior to the next tide of 100,00s of migrants. Such effectiveness seems beyond the EU's limited organisational capabilities. This is already 6 months or 6 years behind schedule.

The EU is splitting along a North-South axis and also an East-West one. Central Europe appears from opinion polls very averse to immigration. This stems from their history in that most countries did not experience any non-European immigration as the UK and France in the 1950s from the Caribbean and from Algeria and North Africa; in the 1950s and 19560s Germany absorbed many Turkish workers as they were needed to man the assembly lines of the automotive companies and other manufacturers. Conversely today Poland is 98% ethically white and apparently 97% Catholic.

Across the world but especially in Europe political tensions are rising as citizens become more cynical and alienated as they realise that their governments did not protect them from the ravages of the bankers, appear unable to organise and control mass immigration and cannot protect them from rampant terrorists .

This all adds to a sense of European and US malaise. There will be a social, political and fiscal cost to bear and the public European debate is inadequate as are to date any practical measures taken transnationally.

The first consequence of recent migration? Brexit, and more to follow.

But I am genuinely sorry to say that much of the blame lies at the door of German Chancellor Angela Merkel (a competent and decent person). Her administration though was the one fixated on obsessive austerity which undermined the economic and social relations of the EU and then in the autumn 2015 she made the most catastrophic decision of the 21st century (to date) by announcing German open borders (if only for one week before back-tracking). The rest of the continent is now paying for that totally ad hoc, unconsidered emotional decision and announcement. The EU institutions have failed to function and proven incapable of ensuring a viable migration policy with efficient border controls. The laws for migration set up in a different age after the Second World War need rescinding and modification; instead we have had delusional wishful thinking and anyone who raises any questions is accused of racism or of being a member of the Klu Klux Klan!

The Chancellor's' behaviour last autumn is all the more off-hand given that in October 2010 Angela Merkel stated the following:

> Multiculturalism has failed totally. The idea that people from different ethnic groups working successfully side by side is wrong.

The Brexit decision and the close result in the Austrian presidential election and the rise of Donald Trump and new populist parties in Sweden, the Netherlands, Denmark, Greece, Spain, Italy and even Germany, stem in largest part from metropolitan, liberal, middle class and detached established elites ignoring the wishes and aspirations of millions of grass-root voters.

> The political system is ruptured.

In the UK Brexit referendum the Remain side focussed on the economic risk and reeled out dozens of global officials and leaders who warned the British people of economic collapse if Brexit won. But as one UK politician commented: "They are not listening, they don't care. This is not about money, it's about race". Net migration into the UK in 2015 at some 320,000 was the highest number on record; the second highest number was in 2014; the numbers have risen steadily for the last decade. The most popular name for new born boys in the UK last year was Mohammed.
Yes and it's something more as well: in a globalised economy where hundreds of millions have been left behind and are faced with patronising and frequently corrupt and venal leadership, the electorate wanted to "send a message" to this detached establishment. This was pay-back time.

> The key issue in the UK revolved around viscerally-held, atavistic, nativist, nationalist, patriotic values which were entirely related to questions of culture and national identity.

A mini example of this now being recognised is that immediately after the Brexit vote members of parliament from the British Labour Party rebelled against their left-wing party leader Jeremy Corbyn. This internal political revolt was instigated by his remarks last weekend that he "accepts open migration with all its benefits". But his parliamentary party colleagues now realise that if this is their party's policy, then, after being eliminated last year in Scotland, they would be wiped out in their northern and central heartlands of white, working class voters. Without Scotland it is very unlikely that Labour will ever form a UK government again; without their working class headlands they lose their raison d'etre. Related to our comments, one very senior Labour adviser notes: "Labour movement activists have to stop dodging working-class objections to low-wage inward migration or assuming it can all be resolved by an appeal to anti-racism".
The populist, nationalist party UKIP, led by Nigel Farage, gained 4 million votes in the general election last year and looks set to increase that number substantially next time. Labour politicians are also rebelling now because the possibility of an early general election in the next 18 months is a growing possibility.

It is clear from the above and recent elections in Austria, Germany Italy, Spain and upcoming ones in France that the traditional parties of the centre-left and centre-right have lost their legitimacy with large swathes of the UK and European electorate. The rise of Donald Trump to become the Republican presidential nominee is another example of the collapse of the traditional political elites.

If the Eurocrats and bureaucrats and political, metropolitan elites of the EU do not recognise the visceral, atavistic nature of the migration question, then the EU will splinter in the next 3-5 years. This disturbing conclusion has been supported recently by an internal report of the German Finance Ministry which accepts the growing possibility of "Austria, the Netherlands, Denmark, Sweden, Hungary and even France voting to leave the EU in the coming years". The sad reflection is that ruling European governments now have to keep their people away from the voting booths.

Emerging markets still have a lot going for them

GDP growth rates selected periods

Emerging markets versus developed ones

	Emerging markets	Developed markets
1993-2003	5.0%	2.0%
2003-2008	7.5%	2.1%
2010-2013	5.0%	1.6%
2014-2018	4.5%	2.1%
2018-2025	5.0%	2.0%

Put another way, during 2007-13 developed markets grew by a cumulative total of 4% over this period compared with emerging market growth of 37% in those 6 years. The EM's survived the global crisis in much better shape.

But what do you do when the global CEO says at the corporate strategy meeting:

> "To hell with the emerging markets. They're under-performing, not meeting expectations, sucking out too much time and resources. Let's ratchet down investments and pull back and invest and focus on our growing market: the good old' U.S. of A (and parts of Europe) where we feel comfortable"!

So clearly the challenge for senior managers in emerging markets is to continue to manage corporate expectations…. downwards. This has been the name of the game through all the business cycles in the last 10-20 years so not much change here!

For much of the last 15 years the state of play has been:

> Developed markets = big volume and low growth while…
> Emerging markets = low volume and big growth

But with the emerging markets (EMs) wobble continuing through 2016 and perhaps into 2017, senior managers need to be more targeted and precise in finding growth in key emerging markets.

For example in China, many big multinationals (MNCs) now see organic sales growth down at levels of 3-5% compared with 8-15% some 18-24 months ago. China, and many other emerging markets are no longer trans-nationally big organic growth markets for sales. The trouble in China is that many western companies have still set themselves organic growth targets of 10%+.

> Senior managers now have to spend more time digging out growth from the corners of emerging markets and at the same time they have to spend more time defending the EM strategy to global headquarters and argue forcefully about operating profit targets against a background of slowing growth and depreciating currencies.

The BRICs and many of the top 10-15 emerging markets are wobbling but this is not the time to pull out and hand over these markets to the competition and thankfully most companies appreciate this. The key to success in emerging markets has always been long-termism.

Business success in the emerging markets over a 5-10 year time-span is a no brainer.

The EMs will grow at a faster rate than the developed world this year and for the next year but they will become more challenging as consumers change their behaviour and investment/spending patterns change.

Why are the emerging markets (EMs) slowing?

1. China continues to struggle with a transition to a more market driven economy less dependent on export and investment and with more focus on driving consumer spending by boosting investment into educational and health sectors.
2. The slowdown in China is affecting global supply chains and reducing growth levels across much of Southeast Asia.
3. But despite this, Asia-Pacific overall should see GDP growth of 4.6% in 2016; similar to that of 2015 and only slightly down on the 4.8% reported in 2014.
4. The Chinese slowdown is part of the reason that energy and commodity prices have slumped and this has dampened growth rates in nearly all commodity-producing countries.
5. For example, Brazil will be in recession this year mainly because of softer exports of commodities and food products to China and other EMs but also due to slumping domestic demand, high inflation and undermined confidence in the wake of a string of corruption scandals. The Brazilian recession will continue into 2016 and ensure that Latin American economies will decline overall in both 2015 and 2016 as Venezuela and Argentina exacerbate the situation.
6. US interest rate policy has had a massive impact on EM currency and economic stability since the “taper tantrum” of spring 2013. Hopefully some of this impact will diminish as rates ticking up in 2016 become more normalised. Indeed we have seen this as US rates seem to be put on temporary hold.
7. The US economic recovery is making it look like a good location for foreign direct investment and capital flows are being diverted back to the US or the UK or even parts of the EU.
8. Specific factors have also taken the shine off some of the markets with of course the military conflict in Ukraine which has devastated the Ukrainian economy and damaged that of Russia and prompted western sanctions and caused deterioration in sentiment towards Eastern Europe (although core CEE markets are flourishing—see below).
9. The Middle East region’s political outlook darkens with each year and now that Saudi Arabia has engaged in a series of sweeping spending cuts and new borrowing/fiscal policies, the big Saudi market is much less appealing than 12-18 months ago.
10. MEA Problems have been exacerbated with Sub-Sahara Africa continuing to cool in the wake of falling commodity prices and with South Africa and Nigerian growth weakening sharply.

So those are the factors that got us here.

But why will emerging markets re-establish their priority status in the future?

1. The numbers below show that economic catch-up is still happening albeit at a lower rate.
2. The middle class and lower middle class will continue to rise as a proportion of EM and global population, again at a slower rate than between 2002-08 and 2010-13 but the trend will persist.
3. Even on current lower growth rates, it’s expected that 220mn people will join the Chinese middle class by 2026.
4. The markets offer openings for affordable innovation; companies cannot rely solely on the premium brand “game” any more and have to be diversified.
5. Having said that, many EM markets are hot spots for luxury goods and premium brands (yet again at much lower rates of expansion than recently; for example the Chinese anti-corruption drive has shrunk the Chinese luxury goods market).
6. Demographics are a no brainer.
7. Brand penetration is still low in many EM’s.
8. New options for e-commerce are present.
9. There are still new geographies to develop with much of Africa still relatively “untouched”.

10. Sub-national regions are increasingly important: third-tier cities in China, the Russia regions, parts of Anatolia in Turkey, the north-west regions of Brazil etc. If companies can create the right route-to-market options, then these territories offer significant opportunities (and challenges).
11. New companies are cropping up in the EM's and local champions are emerging or returning. Yes, such companies can prove tough competitors but they also need inputs and suppliers. Some developed market conglomerates have reported solid sales increases to these "new companies" who are looking to upgrade their own production.

Despite the recent slowdown, EM's now account for 52% of global GDP on a PPP basis and 35% on an exchange rate basis.

GDP and sectoral growth in developed and emerging markets and differentials 2014-2018

Between 2002-08 and 2009-11 the emerging markets typically out-performed the developed/industrial ones by a factor of 3.0 to 3.5. This divergence has clearly decelerated sharply in recent years and this trend will take some time to stabilise and recover; especially as the developed markets have got their "second wind" with US growth likely to average 2.5%+ between 2014-18 and with the Eurozone likely to see an average GDP growth of 1.6% over the same period.

But the clear conclusion is that even in this soft patch, emerging markets will grow twice as fast as developed ones and EM household consumption and investment will increase 1.5 times more than in their developed counterparts in the coming years.

> If companies are looking for growth, then it's still to be found in the emerging world. It's just that senior management will have to get accustomed to the EM new normal.

What are CEOs and business managers saying? How do they see the business outlook?

I would estimate that 85% of the 430 companies I work with are not satisfied with their business in emerging markets or indeed with their global business overall.

The global economy has undergone so may "new normals" in the last 7 years that nearly all executives appreciate that the "good old days" are now gone forever.

Some months ago in London, I bumped by chance into a good friend who is responsible for all international business at one of the largest conglomerates in the USA. He has been working with the company for almost 30 years and is in charge of all business outside the US. We chatted informally about friends and families and then spent just a few minutes on business. He said for effect:

> **Everything is bad, everywhere!**

He did then elaborate that they were doing well in some areas: with affordable innovation, that sales into the agricultural sector were good and that sales to some large emerging market corporations were also solid.

Last year at a business presentation in Prague, over coffee I mentioned to several executives that the global cries had morphed into a chronic one. All the executives present agreed and one summed up the consensus thus:

> Yes, yes, yes. The crisis is now chronic. We have been walking through mud for 2-3 years now. We are surviving but its' extremely difficult to get any business traction.

This mood was echoed by the CEEMEA President of a major US consumer goods company who said:

> "We've not had an easy year since 2008. And to be honest I don't see any easy ones in the next 5 years either".

The CEE President of one European consumer products company (see below) commented that selling brands is critical to success but is now 2-5 times harder than in the past. This theme was taken up recently by the insightful CEO of Unilever Paul Polman when he commented this summer (after a decent first half with 2016 sales up globally by 4.7% and by 8% in emerging markets) that:

> "Unilever has to work twice as hard as 5-10 years ago to achieve these results".

But it's not all economic/business bad news: the USA is holding up but growing "only" at a trend of 2.0%; the Eurozone was in a sweet spot at the moment for several reason but can only scrape together GDP growth of 1.5%+ and Brexit will dip that down to 1.1% in 2017. But some companies are reporting reasonable results in this these two regions but far from all firms. India is picking up economically but many companies only have a small footprint in the market. The core CEE region is performing very well economically and this is filtering through into better corporate results. The CEE outlook also looks reasonably sustainable.

Conversations with EMEA presidents

Last month in Lausanne and Geneva I met with some 25 EMEA presidents and the conclusions of those conversations were:

- Yes, business globally is very tough and most talked of global sales growth in the 1-3% range
- Consumers in all categories are getting more demanding and harder to read
- Russia is not as good as it was but better than western commentators think
- CEE is very good and within that region Romania is one of the best performing markets
- India is fine or good but not matching the media hype and remains a very challenging market operationally
- Brazil "is a disaster" as the one executive from an industrial conglomerate noted
- Sub-Sahara Africa and Saudi Arabia are not the exciting boom markets they were 18 months ago and just the reverse: sales in Nigeria and South Africa are slumping and Saudi Arabia is proving very hard with corporate budgets constantly reforecasted downwards and with many companies facing issues with receivables. But there were some mixed views on Saudi: one industrial company reported negative trends while one US IT firm talked up their own sales.

Perhaps one of the most interesting and perhaps sad conclusions to come out of these meetings was that these senior executives with an average of 25 years business experience all referred to the "old chestnut" problem of short-termism versus long-termism. I had actually had similar conversations with 1-2 of these same executives 20 years ago when we all complained that far too many companies lose sight of the long-term business objective in the mad race to make quarterly profits. As we did 20 years ago, we decided that there was no solution to this problem and operational managers would have to continue playing the budget game and face the comment from headquarters:

> We won't invest in your markets until you can show us excellent sales and profits! (Chickens and eggs).

5 major factors which drive the global economy and business

1) The banks

The situation at the start of 2016 improved marginally as bank lending rose in Europe but banks still represent one of the future black swans and this has become all the more evident in Summer 2016 as stress tests raise more questions.

Several senior corporate executives have confided in me with their deep-felt concerns about the global and especially European banking set up.

The chairman of one private equity company and a former senior banker told me recently:

> "Danny, we have about 300mn Euros of liquid profits from the last financial year and of course I will not be keeping that in banks (I think he may be stashing this money in treasuries). The European banking system is flawed: the Greek and Spanish banks cannot be trusted and when they collapse soon they will take the French and German banks with them. The German banks are not much better either".

While the managing partner of a global law firm told me:

> "Danny, I am pretty wealthy and I am putting all my private money outside the banks. They are not viable and in the next 2-3 years something awful will happen".

Given the seniority of these executives, these are disturbing comments indeed.

The banking sector has under-preformed in recent years in terms of supporting the real economy. Over the next 5 years, it will only be a slow and tentative recovery in proper financing for the real economy. The banking sector has hung like an albatross around the neck of the global economy.

The banks have also contributed to the global malaise due to their public indictments for malpractice. Normal people are confused that bankers do not go to jail for behaviour that would put most normal people behind bars for 30 years. Major banks are fined almost every week or month for malpractice it seems, and this leaves a nasty taste in the mouth and contributes to the above global malaise.

In order to stimulate consumer spending, finally it is just possible that some governments will now turn to "helicopter money" which means that methods will be found to circumvent the banks which do not lend the money to the real economy. This can involve cash hand-outs to citizens and I personally favour the idea of coupons or postal orders:

> The idea is that everyone or every family receives a coupon to a value of X Euros/dollars/yen (say about 200-300 Euros per person) and this is time limited to 3-6 months and then becomes invalid and can be spent on anything except property, stocks & shares, alcohol, cigarettes or sex….so all the good things in life are exempt ! ☺

Seriously though, some means have to be found to stimulate final demand. If the banks fail to do it, then other steps have to be employed. Governments and central banks are about 5-7 years too late in any such initiatives.

2) Consumer confidence

This is a reasonably big positive in global economy as consumer confidence has rallied in the last 2-3 years in both Europe and the US has stabilised at levels close to good levels of 2006-08 after crashing in 2009 and dipping a bit more in 2012-13. Overall consumer spending has been a big positive in the US and the UK and has picked up a bit in the Eurozone. In China confidence has been surprisingly stable and not so volatile: in 2012 the level was 101 followed by 99 in 2013 owed by a steady recovery through to January 2015 when it tipped 110 before falling to 104 in December 2015 and rallied again to 112 in July after a sluggish spring. Moreover, 85% of Chinese believe their children will have a better future than themselves, whereas this number in the Eurozone lingers at barely 15%.

3) Austerity programs

Austerity: the cure that made everything worse and condemned a generation.

The situation going into 2016 is fractionally better as more governments come to realise that obsessive austerity was part of the problem and not the solution. Japan's fiscal policy in August 2016 is just another example of a policy shift away from destructive austerity.

Greece's national debt as a proportion of GDP was 129% in 2009. After 5 years of blood, sweat and tears and an austerity program that slashed 25% from GDP, public debt stood at 182% last year (2015) and it is estimated that if the current Troika austerity debt package were to continue Greek debt would be 189% in 2019.

> Austerity has failed Greece and most other markets.

The IMF conducted a report some two years ago reviewing about 50+ austerity programs spread over 20 years or more and the Fund concluded that not one of the austerity programs had succeeded based on its own terms of success. The October 2014 IMF report bears quoting at length and reflects concerns about missing growth and its consequences.

> Large negative growth surprises in the Eurozone should not trigger additional consolidation efforts, which would be self-defeating. Infrastructure investment, even if debt-financed, may well be justified and can help demand in the short run and supply in the medium run.

More recently in its May 2015 report the IMF was even more radical (admittedly these remarks refer to industrialised countries with stable fiscal positions and the IMF commentators may have been taking a punch at Germany!):

> It does not follow that once debt is accumulated, it should be paid down to restore growth.
>
> On the contrary the cure would seem to be worse than the disease – the taxation needed to pay down the debt will be more harmful to growth than living with the debt.

Increasingly influential global economic commentators and former economic Nobel Prize winners argue forcefully that austerity failed its purpose.

Austerity across Europe meant no/sub-par growth, no jobs and higher debt. The rationale of austerity programs is that by reducing public debt and bringing down deficits, this will increase business confidence and the private sector will fill the vacuum left by reduced government spending. This did not happen. And the current mini recovery in the Eurozone has nothing to do with austerity programs and more to do with exogenous factors.

The killer argument against the austerity programs is:

> **The level of debt grows faster than the rate of GDP growth to repay it.**

End of story.

4) Business corporate investment

Companies and CEOs do not perceive the recovery to be sustainable enough to warrant strong corporate investment and this has disappointed. Even M&A activity, when you take out distressed mergers and tax dodging, are not looking sustainable and valid for underlying growth. US and European companies are well known for sitting on cash piles of some $4.5 trillion, money that is not being constructively utilised.

Consumer uncertainty fed through into corporate uncertainty creating an environment where companies delayed and postponed investments or downsized projects. As one CEO of a major US Company told me in January in Vienna:

> "Danny, regarding 2016 I am still totally uncertain about the level of uncertainty".

This is a funny remark but full of implications: when CEOs are uncertain, they wait and see.

In 2015 US public capital investment which includes infrastructure was just 3.4% of GDP at $610bn which is the lowest figure in 60 years. The estimated short-fall in necessary infrastructure spending for 2016-2025 is estimated at $1.5 trillion.

Between 2005-13 global energy and metals firms spent almost $6 trillion drilling and digging in Australia, Brazil and in North Dakota. But the commodity slump has changed all that and energy, chemical and mining companies are in the process of slashing their investment budgets by 25-50%. Global investment and especially in developed markets will dip further this year and remain sluggish in 2017. The big drivers are: major global energy companies slashing investment spending and the reduction could amount to $500bn to $700bn over a 18 month period; big companies in the emerging markets are also cutting back or postponing and this is often related to the commodity cycle; and Brexit will also temper investment in the UK and the Eurozone.

In Asia the slowdown in trade means that private investment in the region, which is the bigger chunk, remains stagnant or slightly negative. Government investment which represents about 35% of total investment has performed quite well in recent quarters but we expect this to soften through 2016 and 2017 on weak trade flows. Some Asian markets are able to plug the gap with more consumer spending: India, Indonesia and Philippines.

Looking forward there will be a growing divergence between slowing investment in “old” industries and booming investment in modern technologies: while overall investment in Europe and the USA will be under downward pressure in the next 18-24 months as cut backs take place in energy equipment, property, oil and gas, metals and mining and chemicals, there will be a contrary surge in investment in the internet and software and overall tech hardware. Estimates suggest that investment globally in the internet (most of this investment made in the USA and parts in Asia) will grow about 55% over the period 2014-2017 with the higher levels recorded in the coming years; investment in software could rise 35% over the same period. The biggest investors in the coming years will be pharma and IT companies.

5) Global trade

Weak global trade has been a major reason holding back the global business recovery: when exports are weak, companies retrench on the domestic market and reduce investment and cut back on hirings which in turn harms consumer spending: it’s a vicious circle. The recent weak trade figures in turn explain the disappointing numbers for industrial output and fixed investment, which have plagued many markets and undermined B2B sales globally.

	Global trade trends (growth/decline)
Pre-crisis 2005-08	+5-9%
2009	-12%
2010-2011	+10%
2011-2013	+2% to -1%
2014-2016	+2.5%

The slowdown in China is exacerbating weak trade in Asia and globally while disrupting global supply chains: China is also producing more for itself internally within China as supply chains “come home”. In the 1990s as much as 60% of the value of China’s exports came from imported goods and materials; this is now down to 35%.

The key point is that pre-crisis and even in 2010-11, global trade used to grow 2-3 times global GDP but by 2015 trade growth was only matching GDP or even dipping below it. The outlook for global trade in 2016 is to increase by 2.5% as in 2015. Merchandise trade in dollar terms last year was down -13% thanks to the stronger dollar and weaker oil prices. Trade is no longer a support to the global economy.

PART 2: CORPORATE BEST PRACTICE

10 key factors to succeed in the current business climate

1. Analyse consumers in a more differentiated fashion: if in the past you had 3-10 categories of consumers, break them down into 10-20 categories. Companies need to analyse and fine-tune their approach. Many of the big FMCGs state that they now have more consumer categories and segments than ever before. The consumer is more complicated.

2. Build the brands; brands have supported western sales across the globe in the recent year. The regional director of one European consumer goods company stated recently:

   > "The brands are keeping our business going across Europe in these difficult recent years. BUT it is much more difficult to sell the brands today. We can do it but it takes 3-5 times more time, effort and energy and money to achieve the same results as 2-3 years ago or 7-9 years".

   This means that marketing and sales staff have to work harder and more effectively as well as executives in research and strategy.

3. <u>While brands are critical, never forget affordable innovation: the future of business is the emerging markets and their future is the rising middle class and the lower-lower middle class and the aspiring working class. This is where sales growth will come from in the next 10 years.</u>

4. Look at the mid-brand and mid-price products. Many companies have downgraded the importance of this sector but given strains in overall business, more executives are now willing to take a second look at the mid-tier products and prices. The regional director of one European consumer goods company noted:

   > "Yes, getting the middle market right is a real challenge for everyone and like other companies we also struggle at times, but we see one of our products as a huge "branded middle" and this product does consistently well. Thanks to this "melange", we get it right".

5. All the above relates to the fact that a growing number of consumers in emerging markets and developed ones are more fixed on VALUE; your sales and marketing teams have to work harder to convince the consumer to buy your products and services. Related to the points above, your customers and clients are asking more often:

   > "I love your brands and the quality of what you do and how your staff treats me, but why are you so bloody expensive?"

   It's then the challenge of your sales and marketing team to explain just why you are "so bloody "expensive", perhaps by first of all denying the fact!

6. As you develop these new categories and regions, make sure that your distribution and route to market is fit for purpose: some consumer goods companies are looking to do more for themselves or to reduce the number of distributors in order to improve the quality of the relationship.

7. Consider M&A activity: but this is a huge challenge and their remains a mis-match in price between sellers and purchasers. But clever bolt-on acquisitions were and remain a good strategy while avoiding the fanfare and hubris of the mega-mergers.

8. Remember that competition is only getting fiercer from regular western competitors, newcomers in the market from the Middle East, Asia, peripheral European companies who can't find business at home and also from China: increased Chinese competition is mentioned at nearly all the meetings I attend.

9. Also watch out for "mosquito attacks" (Please see my January global paper for details) which refers to how major global players are finding themselves stung by small players who attack them in a special product

niche or with a small innovation or R&D. Big companies can smack one or two of these "mosquitoes" to death or buy them! But when they start to proliferate in number, they become more than a nuisance.

10. Be very aware of "good enough to have competition": this has been around for a long time but has become more common as newcomers enter the market trying to seize a piece of the action: good enough to have competition is when a (new) competitor looks to steal your existing clientele by offering a product with an inferior brand and lower quality but of a standard which functions and does the job. It's good enough to have. And frequently it is 5-10-30% cheaper than your product. How do you reply to your customer when he/she asks: "What are you going to do about his? Can you match it?"

Best practice

And you must resort at all times to Best Practice. When the cake is growing slowly or not at all, then companies have to get clever but there is more to real Best Practice than being "Wall Street clever": short-termism and the demands of shareholder activists do not help long-term stable business growth and executives need to find as many ways as possible to ensure decent, mutually supportive relationships with customers, suppliers and employees. Many/most companies fail to do this.

Companies used to spend a lot of time on 5-year business plans but whenever something went wrong and not according to plan, they would simply alter the Plan or forget about it! If you have a 5-year Plan, which presumably aims for solid growth in the EMs, then the best advice is to stick with it but to accept that grandiose growth plans will have to be tweaked and made more realistic.

> Annual and 5-year plans are always talked about internally in companies as "being a stretch". The trouble is this usually means stretching senior and regional managers like on a medieval rack! ☺

Given that the next 15-18 months will not be easy, some of the lessons that are being learned currently in Russia can be transferred in part to other emerging (and developed) markets. The managing director of one major international consumer goods company said last month in Moscow:

We have to share the current pain and share it reasonably. This means that:

- Customers have to take some pain through higher prices;
- Suppliers have to take some pain through cheaper input prices;
- And we have to take some pain with lower operating profits.

These are wise and sensible words but, as most readers know, the last goal will be a hard story to sell to global headquarters.

Companies are engaging in cost cuts across many markets or introducing efficiencies; companies are either cutting staff in some markets and/or postponing new hires as they tweak growth plans downwards. But as part of our advice for Best Practice globally and within emerging markets, we always advocate the following:

> Never cut cost so deeply that you damage relations with your customers;
> Never cut costs so deeply that you alienate suppliers and distributors;
> Never cut costs so deeply that you lose the loyalty and trust of your staff and top talent.

Wise words and simple common sense, but sadly pressure from global headquarters often prevents implementation. As we all know, it's a question of degree and emphasis and many regional managers across the world are seeking to introduce sensible efficiencies without taking an axe to their business.

The CEO of a major consumer products company summed up his strategy recently as:

1. Push brands in western/developed markets (and in emerging markets) and aim for upward innovation and premium products at good margins.

2. Press for more launches and affordable innovation in emerging markets and use positive results from emerging markets in developed ones where applicable.
3. Manage the supply chain for efficiencies.

What can you do? We highlight here the best responses

- Engage in Best Practice all the time.
- Manage expectations – too often companies deny reality because of unreasonable markets and shareholder demands. Accept there is a new normal.
- Think long-term: how do you survive the crisis, what do you do after it?
- The business cake is not going to grow much in many markets and therefore…
- Go for sustainable market share in developed markets and emerging ones: market share will be more important than short-term top/bottom line growth.
- Make sure your customers like what you do for them. Explain that you understand they are going through tough times and you are doing something for them.
- Stay close to customers/clients – communicate more.
- Go for possible growth in emerging markets.
- Look for growth in sub-regions of national markets.
- Find new consumer segments: sub-premium, above-discount, etc.
- Innovate your products and services upwards and downwards.
- Affordable innovation is the key to success but it's tough to get it right.
- Offer the client solutions and integrated systems and the after-sale servicing that goes with it. If you are selling ball bearings, then offer all the engineering kit that goes with it and the process systems that surround the ball bearings. And related to this offer the after-sale servicing and future upgrades. This deepens and lengthens the relationship with the client rather than limiting the process to a one-off sale of ball bearings.
- Move quickly and try to streamline systems.
- But never compromise on compliance.
- Consider your route to market and you will probably need to constantly review this
- Hire the right people and keep them.
- Give autonomy to your local staff.
- Scenario planning is also the name of the game.
- Don't get fixated with a single set of budget numbers – rather ensure that your strategy, structure and people are the best possible.

We are seeing many (standard) features in the on-going crisis

- Companies are postponing projects.
- They are engaging in cash management: "If I can't make the top-line, then I'll make sure I make the bottom line.
- Delays in receivables, especially from governments, are on the rise.
- Companies are selectively postponing marketing and sales campaigns. This is understandable but must be carefully calibrated. Best Practice shows that companies that cut the least here survive better in the long-term.

Finally regarding best practice, a few words from the former CEEMEA president, with 40 years' experience, of one of the world's largest FMCGs:

- Delegate downwards; try to avoid going through HQ
- Always innovate downwards -- reach out to your consumers
- Control your working capital and protect you distribution network
- Maximise the local content
- If you have excess HR capacity, train them to do something else, something new. Don't abandon them.

This executive also summed up corporate structures with the remark "Geography is king". Most companies operate with some sort of matrix structures either simple or often complex. The point of his remark is that whenever there is a choice to be made on where emphasis should be given -- product line, function or country, then in his wise opinion the country/market takes precedence. By the way, this approach is designed almost exclusively for emerging markets. Other criteria come into play in developed ones.

PART 3: THE GLOBAL ECONOMIC OUTLOOK

The Global Economic Outlook: executive summary

Even prior to Brexit, at the start of each of the last 7 years, the consensus view has always been that the global economy would accelerate in any given year, but this has been followed every year by 3-4 growth downgrades. Every one of the last 5 years started with elevated hopes and expectations only to end in disappointment and frustration.

There seems to be no big reasons why global GDP should rally much in the next 2-4 years.

- The economic and business crisis has turned CHRONIC and will not change for the next 5 years.
- The 2009-2015 recession/sub-par growth period has been the longest and deepest since 1933.
- A bell-weather company like Caterpillar has reported 4 years of falling sales for the first time in the company's 90-year history.
- The global economy and global business have never properly recovered from the 2009 financial crash.
- Global PMI at 51.2 in May 2016 was its second lowest figure since 2012.
- Despite two out of the three large economic systems (USA and Eurozone) performing reasonably well, global business does not "feel" quite so good; global business is still struggling and puffing along.
- The OECD states the global economy is "muddling through" at a "low level equilibrium".
- We are living through a period of great economic change: the "Age of the Oil Price and Dollar Chaos".
- Some sectors/markets have rallied but the recovery is stop-start and does not feel sustainable.
- Last year China became the largest economy in the world on a PPP basis but no one in the world, including the Chinese government, knows the real size of the economy.
- And everyone is shadowboxing with the Chinese growth rate: officially and in IMF statistics it is down from 9-10% in recent years and in 2015 was running at 6.9%.
- But the private western consensus view is that the economy is growing in arrange of 4.2% to 5.5% based on electricity consumption and cargo transportation indicators etc.

Interest rates and inflation

- Interest rates will remain very low and close to zero for most major economies of the Eurozone, Japan and the UK. And UK rates have been for the last 5 years the lowest since 1694 and went down further in mid-August!
- US rates rose, as we predicted, in December 2015 but only by a tiny amount from a very low (almost zero) base. We expect US rates ranging about 0.5% towards the turn of year 2016-17 and at about 1.0% to 1.25% in mid-late 2017.
- Eurozone and Japanese rates will remain effectively at zero (or negative) for the next 3 years as quantitative easing is maintained and increased; Japanese rates will be barely higher at 0.1% for the next few years reaching 0.8% only in 2020. This ought to entail a strong US dollar especially as the oil price falls.
- Global inflation has been remarkably low in the last 3-4 years as we predicted. The consensus is for an inflation pick-up in the next 2-3 years and while we concur with the direction, we doubt that inflation in the developed markets will rise as quickly as from 0.3% last year to 1.2% in 2016.

The US Dollar

- The US dollar rally, which started in 2013 and ran through 2015, has decelerated relatively in 2016 as the outlook for further US interest rate increases has softened. But with relatively stronger US GDP growth

than in Europe and Japan, we still think the dollar should be strong-ish and will hover around an average of 1.08 for the next 1-2 years and could strengthen further to 1.05 and even reach parity for some time.

- The rising US dollar led to emerging market currency volatility/weakness through 2014-16 and this has calmed for now.
- CFOs are already adapting to a strong dollar period at least into 2020.
- The rising dollar will help keep oil prices down as the value of oil and the dollar trend inversely.

Table: Real Global GDP growth (%) and by key markets

	2013	2014	2015	2016	2017	2018	2019	2020
Global (PPP)	2,9	3,4	3,1	2,7	2,7	3,0	3,0	3,2
USA	2,0	2,4	2,4	1,7	1.9	2,1	2,1	2,2
China	7,7	7,4	6,8	6,5	6.1	6,0	5,9	5,7
Eurozone	-0,4	0,9	1,6	1,5	1,1	1,5	1,8	1,9
Germany	0,5	1,6	1,5	1,4	0,9	1,5	1,7	1,6
France	0,2	0,4	1,2	1,6	1,2	1,7	1,8	1,9
Italy	-1,7	-0,4	0,6	0,7	0,3	0,6	1,1	1,2
Spain	-1,2	1,3	3,2	2,1	1,9	2,1	1,8	2,0
Greece	-4,2	0,7	-0,5	-1,0	-0,5	1,9	2,5	2,7
Russia	1,3	0,4	-0,3	0,8	1,8	2,2	2,7	2,7
CEE (core)	0,9	2,8	3,7	3,2	2,8	3,0	2,8	2,9
India	4,7	5,6	7,5	7,7	7,4	7,6	7,7	7,6
Brazil	2,5	0,1	-3,8	-3,3	0,8	1,6	2,0	2,5
Mexico	1,1	2,3	2,5	2,3	2,6	3,0	3,0	3,1
Turkey	4,0	2,9	3,9	3,0	2,9	3,0	3,2	3,3
South Africa	1,9	1,5	1,3	0,3	1,0	1,5	2,0	2,0

Source: DT-Global Business Consulting

What are the consequences of Brexit for the global economy and business?

Global growth was already fragile even prior to Brexit and in spring 2016 the World Bank downgraded its own estimate for 2016 for global growth from the consensus figure of 3.0% to a radically lower 2.4%. This seemed a bit extreme and I was looking at 2.7%. But Brexit certainly will entail weaker trade and investment globally and will undermine confidence. Global growth for 2016 could manage 2.7 on a central scenario and 2017 is now downgraded also to 2.7% (earlier estimate was 2.9%) before climbing back to 3.0% in 2018.

But if a domino effect starts in the EU or political risk heightens more than in our central scenario, then global growth in 2017 could stumble to 2.0% or less which would feel like a recession.

Much depends on the EU and Eurozone outlook. We have harboured doubts about Eurozone sustainable growth for years. Even in 2016 when the region was in a sweet spot with low oil, low inflation and a weaker Euro, the Eurozone could barely manage 1.6%.

We think Brexit will shave off 0.2% this year and take the region down to 1.5% in 2016 and the figure will fall to 1.1% in 2017. Again all risks are to the downside and if another country opts for a referendum or Exit or even if PM Renzi in Italy loses his October referendum on constitutional reform (sounds familiar?), then confidence and investment will collapse and the Eurozone could easily tumble to 0.5% growth or land in a formal recession at -1.0% or worse. This is not our central scenario. But last week the probability of Eurozone recession or sub-1% growth was just 10% and now it is 45%.

Brexit and the UK economy

- Migration and the perception of uncontrolled migration was the root cause of Brexit and is the biggest threat to the existence of the EU

- UK median real wages in 2013 were the same as in 1979 (a period of 34 years)
- Net migration into the UK in 2015 at some 320,000 was the highest number on record; the second highest number was in 2014; the numbers have risen steadily for the last decade.

Everyone knows that no one knows what's going to happen to the UK in the next two years and this of course applies to the next two weeks and two months. The markets are likely to prove extremely volatile in the short term. This may require global intervention from the main central banks. My own view is that in 12-18 months the UK will be bumbling along with GDP growth lower than prior to Brexit but still positive with the pound relatively stable at about -8% to 12% from its pre-Brexit average and investors are still buying UK gilts (bonds).

Much will depend on whether the UK is accepted into

a) Membership of the European Economic Area which would permit membership of the single market (such as Norway). This is the preferred option of the establishment and City. But it requires "free movement of labour" which is what Brexit was designed to prevent for most voters and also sizeable payments to the EU budget. Several senior UK politicians are now pushing for this.
b) The second alternative of a separate free trade area in goods such as Canada could take much longer and excludes financial services and includes non-tariff barriers
c) While the third option of ticking along using WTO legislation entails fewer benefits to the UK, tariffs and also excludes financials and services.

Without a free trade agreement or a special Association (and the latter looks unlikely and the former not probable at the moment), then the economic consequences will be noticeable.

UK GDP growth

GDP was relatively good for the UK in 2014-15 compared with weak growth in the EU and around the world: GDP was up 2.2% in 2013 and rose well in 2014 by 2.9% and then slowed to 2.2% in 2015. But GDP was decelerating already in late 2015 and the Brexit prelude saw growth slow down further in 2016 and trended at just 2.0% in Q1 of 2016.

The consensus for 2106 was also 2.0% but we anticipate weaker investment in the second half of this year and thus GDP will come in about 1.5% or even 1.3% this year.

All sorts of factors –falling confidence, weaker domestic investment, postponed foreign investment, higher inflation and a weaker pound -- will ensure that GDP growth in 2017 will decelerate from the expected 2.2% to a level ranging from 0.3% to 0.9% depending on how negotiations proceed with the EU and what the trends are after 6-9 months of volatility.

In 2018-2022 instead of trending at 2.1%, we anticipate mid-term growth of 1.4% to 1.6% or slightly higher.
We are presuming here a central scenario where negotiations with the EU do not unravel and that there will be fiscal stimulus from the government (and not sustained austerity) along with monetary stimulus from the Bank of England.

If the government maintains austerity, then the economy will sink to zero growth or recession of -1.0% (we also presume that Chancellor Osborne will be out of office in the coming months).

UK inflation

Inflation will rise but was going to anyway and from low levels. Inflation was close to flat/zero last year (2015) and was just 0.3% in the first 4 months of 2016. Inflation could spike but from low levels and as inflation was flat in 2015, we anticipate a rise to 1.3% this year and to 1.8% next year (2017). There is upside risk to 2.5% or even 2.8% in 2017 but we think the inflationary "threat" may be overdone.

We do not think there is any serious risk of hyper-inflation or even prices rising by more than 3-4% in the central scenario.

Which types of companies affected? (See our Brexit Report)

UK interest rates

The key Bank rate remains at its lowest level since 1869 at 0.5%. We expect Governor Carney to support growth and confidence by reducing the rate to 0.25% or even to zero over the next weeks and months dependent on the severity of the downturn in growth and global/European confidence. If the pound were to slump more than we expect, then he may be slightly reluctant to cut rates so much.

The pound sterling

The pound will be weaker but it has not really collapsed yet. The pound immediately after the referendum was -6% on its January 2016 figure versus the Euro BUT was above its multi-year averages against the Euro. Versus the dollar the pound is down just 5-8% on January 2016 and -12% on multi-year levels. We should remember that the pound spiked upwards in the weeks prior to the referendum on the presumption of a Remain vote (!) and that most currencies have slipped badly against the US dollar in the last 2-3 years.

The weaker pound will of course help UK exporters but they will be faced like all companies with a weaker mood in confidence and investment and perhaps by increased political turmoil and risk.

Finally, house prices will probably drop -5% to -10% outside London and by higher margins at the high end as some oligarchs and Arab investors turn elsewhere. But lower house prices and lower interest rates will help first-time buyers and younger purchasers.

The UK current-account and budget deficits are a couple of weak links though.

Investments: bonds and yields – two contradictory trends

The quest for yields

Many EMs (emerging markets) including Russia are seeing their currencies hold up against the dollar (and Euro) even while oil prices are falling in July-August. This is because global investors and funds are as desperate as ever for yield: with US rate hikes looking more likely to be limited and postponed, investors are looking further afield and now buying into ME bonds and currencies. This will continue as long as the outlook for higher US interest rates remains muted. The consensus is for one increase in US rates in 2016 towards the end of the year by 0.25% and then perhaps two more such hikes in 2017 to take US rates to about 1.0% to 1.25%

The quest for security

At the same time in mid-summer 2016 yields on developed market bonds and treasuries are at all-time lows of zero or actually negative. The fact the rates are so low and negative testifies to the overall weakness of the global economic outlook and the perception that risks are elevated. You buy German bonds at a loss because you are worried about the safety of everything else. Given the fragile current situation and the future risks, we presume that such yields will remain very low and negative for 1-2 years to come.

The oil outlook

The consensus for the oil price over the next 15 months ranges from $48 to $57 per barrel. We think that over the short term there will be significant volatility as supply and demand issues combat and contradict each other. Overt the short term we also sense that supply should on occasions not match demand and hence why the oil price could tick to $55. However, we believe that there are several medium-term factors which will ensure that the oil price is held down and probably will not rise sustainably over $65 in the coming 3-5 years.

- A key one factor lying behind any upbeat perception on oil is that soon we will arrive at equilibrium: this view argues that energy companies have cut back so much on investment that sometime soon weaker supply will balance fallen demand.
- The commodity super-cycle is definitely over for now due to over-supply and globally impaired demand.
- Saudi Arabian policy on oil prices appears to have destroyed OPEC as a functioning cartel and organization: it looks like we are in a price and market share fight to the bottom.
- Saudi Arabia was fed up with acting as the oil supporter of last resort.
- The Saudis wanted to retain market share to the relatively lucrative Asian market where GDP growth remains comparatively strong for now.
- It is assumed that the Saudis are also engaging in some economic warfare with Iran whose budget is only balanced at an oil price of $140.
- It is also thought that the Saudis are playing a sort of "game of chicken" with the US shale producers who are only profitable with an oil price in a range of $55-70.
- It is estimated that Saudi Arabia's own break-even point for a balanced budget is around $80 per barrel and thus current prices are also hurting Saudi Arabia.
- As sanctions are eased, Iranian oil starts flowing into the market during 2016-2017.
- The USA has become the largest global energy producer; US oil output is 70% up on its 2008 figure.
- The US is also supplying more to the world and buying less energy from it.
- Currently US energy imports are the lowest since 1960.
- China has taken over from the USA as the largest global energy consumer. But Chinese growth is slowing
- Shale/energy production ebbs and flows with the oil price. BUT we think that US shale supplies for the next 10-20 years will act as a natural cap on surges in the oil price. So whenever oil pops up over $55 or $60 shale producers will jump back in the market despite debts issues that they face.
- Global demand is stagnating as China slowdown and the US buys from itself.
- Speculation and shorting account for at least 25% of the price movements.
- A 10% drop in the oil price adds about 0.15% to global GDP so the current 45% decline could increase global GDP by about 0.7% in 2015
- A 20% drop in the oil price results in $70bn of extra disposable income for US consumers and they will now have more than $120bn extra spending power which will add yet another stimulant to the US GDP growth outlook. But the so-called oil windfall for consumers is taking longer to emerge
- Total oil exports in 2013 were worth about $1.1 trillion and a 40% drop in the oil prices entails losses of about $400bn for energy producers.

The US outlook

The US went through its usual bad start to the year (often to do with weather and the figures are often revised many months later) and the second quarter 2016 results were only slightly better: consumer spending, residential investment are the main engines of US growth and in the US the consumer tends to spend and save which is not bad. Superficially improving employment trends, higher real wages thanks to lower inflation and high household net worth are also supportive. But so far this year general investment has been weak (-9.7% in the second quarter) and corporate profits are stretched by the strong dollar and weakening global environment.

We expect GDP growth this year of 1.7% followed by a range of 1.8% to 2.2% over the next 3-5 years. After good private consumption in 2015 of 3.1%, this will moderate to 2.6% range this year and in 2017-18. Business investment will be weak this year and even flat or negative but recover to 3.5% in 2017. Housing investment remains good but one wonders if there is another bubble inflating there based yet again on credit?

Trade is weak and that reflects global trends. The budget balance is under control at -2.5% last year and will hover at -3% this year and in 2017.

Despite this sluggish year and moderate outlook, the US stands out clearly as the global winner economically and the rise of the dollar is a reflection and consequence of that. The US did several things right and also had

some luck. Global and European executives continue to look at the US as a destination for foreign direct investment: re-onshoring is taking place.

Why is the US doing better?

1) The US introduced economic stimulus in 2009, which was not as large or as long as that implemented by China and it was prematurely curtailed. But it lasted long enough to curb the worst effects of the great recession.
2) The US did a marginally better job of cleaning out its banks and US banks were extending new credits at a rate of 2-4% soon after the crash while European new credit was flat or -5%.
3) Ben Bernanke saved the US economy when he cut US interest rates and told the business community that they would stay down for a very long time: eventually this spurred US corporate investment.
4) And of course shale gas has changed the US economic picture for the better for the US!

The US is a big example of an economy escaping a downward debt spiral thanks to Keynesian expansionary (monetary) policy. Who now is bothered with all the nonsense about debt ceilings, fiscal cliffs, surging inflation and ballooning bond yields? On every single key point of economic policy, such commentators have been proven categorically wrong.

But we should never underestimate the impact of the recent recession, which was the longest and deepest for the US since the 1930s. We should also remember that it has taken trillions of dollars being thrown at the US economy to generate growth levels of 2.0%.

The manufacturing PMI is pretty decent and averaged 52-58 during 2012 to 2016 with a slight downward trend at the start of 2016 to a level of 51 but by June this year this was back to 52.9. Business confidence indicators are also not bad or better and followed the trend of PMI with good numbers until the turn of 2015-16 when this indicator dipped and has recently recovered to par levels or better.

But our point about corporate sales and profits is reflected in profit results in the US and Europe. In the US in the second quarter 2016 it looks like corporate earnings will be down by -2.8%, the fourth consecutive quarter of falling profits. As we have noted, this has much to do with the stronger dollar and the weak global outlook. As the stronger dollar trend eases out of the figures in the coming months, then US corporate earnings could get a push.

Growth is stronger in the new sectors of high-tech, R&D, genome pharmaceuticals, the Internet and software and mobile telephony-related sectors. But the ‘old industries” are struggling much more (heavy industry, manufacturing, energy and chemicals and transport).

Headline inflation has been and is low: an average of 2% in 2012-14 and 0% in 2015 and during 2016 the average is just 1.0% (well below the Fed’s official target of 2%). The Federal Reserve has been crystal clear in stating that the economic recovery is still fragile and that rates will be increased slowly and cautiously through 2016.

Consumer confidence is reasonably good and at a level of 90 for the last 6-12 months is getting closer to long-term averages after the deep slump in 2009 to 2013. Official unemployment has fallen to 4.9% in June this year from 8.0% at the start of 2013. But this is not due entirely to good new and well-paid jobs; many people are leaving the job rolls disillusioned; disability allowances have also shot up (as in Europe) as people turn to disability claims instead of unemployment benefits.

These relatively good numbers do not translate into storming retail sales, which averaged a very strong 5-6 % in 2010 to 2014 but then decelerated to 2.0% to 2.5% in 2015 and 2016 and the figure was 2.7% in June (still not bad). But, as in other markets, the American consumer is deleveraging, saving, spending less frequently, looking for value and splurging on treats. But this makes the jobs of the retailers and FMCGs more complex.

In summary: the US has performed consistently better than the Eurozone and Japan and other developed markets and deserves credit for this. Loose fiscal policy and Bernanke’s zero interest rates saved the US economy. But to get to here it is has cost a lot of treasure in the shape of trillion of dollars of quantitative easing.

And sadly in closing, the USA suffers from a dysfunctional political system. The system is gridlocked and there is evidence that recent sittings of Congress were the least productive in terms of legislation passed since 1805-07 when Jefferson was president. Obama seems to have finally given up on the system and will administer through executive decree. If Hillary Clinton wins the White House in 2018 and the republicans control the Congress (a probable scenario), then savage gridlock could continue for at least another 4 years to 2020 leaving the USA without a properly functioning system for at least 12 years (2008-2020). If Donald Trump becomes president (see above), then all bets are off!

The Eurozone outlook

(We have examined above the effects of Brexit and political issues in the region)

Prior to Brexit the Eurozone looked in better shape than it has done for more than 5 years. That was the good news but even with so many factors in its favour (see below), the region could only post GDP growth of 1.6% last year and this. And Brexit will take any minimal shine off the continent: GDP would have grown this year by 1.6% but that will be trimmed to 1.5% and in 2017 instead of 1.7%, this will decelerate to 1.1% or perhaps to below 1.0%.

The Eurozone climbed out of its 2013 recession of -0.4% but the outlook is for another 3-5 years of sub-par growth below 2% ensuring at least a 12-year period of recession and sub-par growth in the region (2008-2020). Whenever the Eurozone has a good quarter, it is unable to make it sustainable and Joe Kaeser, CEO of Siemens, summed up the trend extremely accurately:

> "The Eurozone always looks better than it is".

The tide has been in favour of the Eurozone recently until Brexit for 4 main reasons:

1. The low oil price means that consumers have more disposable income and are slowly starting to spend it. But only slowly: retail sales were negative from 2008 until 2014 and then rose by 1-2% in 2014-16 and were up by just 1.6% in June 2016.
2. Lower oil prices mean lower inflation, which in turn means higher real wages. Companies and governments are still far from generous in salary increases but when inflation is flat or negative then any nominal pay rise is good news and a positive boost to real wages. This is shown in the fact that nominal wages are sluggish at about 1.2% growth but thanks to inflation slumbering at just 0.2%, then real wages are up 1%. This figure is not very exciting but it's better than the negative figures of the recent past. Inflation has averaged 0% for 18 months and has been below 1% for 2.5 years.
3. The weaker Euro means that Eurozone exports are more competitive but 65% of Eurozone trade is within the region so the FX impact is limited but still a positive. We expect the Euro to linger around 1.08 – 1.10 to the dollar on average for the next 18 months but it could easily touch parity.
4. The ECB's quantitative easing will probably have the same effects as in the US and UK: direct positive effects on the real economy and employment will be limited; most of the gains will go to the property and stock markets. But this will trickle down and will also enhance business confidence. So while QE is 6 years too late, it's better late than nothing.

But fixed investment is still -13% on its 2008 level and Europe has never really got back into investment mode and Germany is a big culprit here. Capacity utilisation in the region is still only 80% but likely to rise this year.

- Retail sales in the Eurozone were negative from 2008 to 2014, which reflects how badly the consumer was hammered in this region. Since then we see retail sales climbing to 1.6% by Summer 2016 but this is hardly a strong trend.
- Business confidence is close to its recent 2-year average after a slump in 2012-13 but it is not back to its pre-2009 levels.
- Business activity at the start of 2016 was increasing at the fastest rate since May 2011.
- BUT in contrast Eurozone corporate profits are down in the second quarter of 2016 by shocking -11.3% compared with the same period in 2015.

- Car registrations at 856,000 per month in July are returning to their long-term average and a rally in the automotive sector is benefiting many suppliers. The July figure was the best in 6 years and reaching the recent top levels of 2010.
- Overseas earnings translated back into weaker Euros are having a positive effect on corporate profit results (the reverse of what is happening in the US).
- Peripheral markets have had to get more innovative and also find new markets as home ones slumped: Spain's exports rose as a percentage of GDP from 24% in 2009 to 33% at end of 2015.
- The good news is that unemployment has crept down to a 4-year low but still remains at 10.1% in July 2016. Youth unemployment has improved from 25% to 21% but as we note above, a lot of this is to do with "smoke and mirrors" with job-searchers put on training schemes or engaged in low-pay part-time work or moving into disability benefits.

The ECB resorted to QE last year, which was about 6 years too late, and under the program the Bank is buying 80bn Euros of public-sector bonds, covered bonds and asset-backed securities. In June this year the ECB extended this to buying corporate bonds and with its eye on quality corporate bonds, this could offer a maximum of 600bn euros worth of acceptable corporate bonds. The QE program has helped the Eurozone at the margins and hence why growth climbed to 1.6% in 2015-16 but it seems unable to push the growth level beyond 2.0% and this will be completely unobtainable now after Brexit. As with any QE program the trend is to boost the stock and property markets.

China outlook

The business background

As China wobbles and companies struggle to meet ambitious plans, more headquarters will ask; "Why don't we take a whole fresh look at our global emerging markets". This does not and should not mean massive downsizing or any abandonment of the EMs but rather companies may want to re-assess their priorities. China will remain a key global business market for the next 50 years and rank No1 and 2 with the USA for that period. But an increasing number of companies will ask whether they have too many eggs in the China basket and may choose to swap around resources: the CEE region merits closer attention (see below) as the markets are currently providing strong GDP growth, sophisticated distribution and supply chains, proximity to European markets and a good skilled labour force. Indeed, more companies are investing again in the region and looking to establish out-sourcing facilities.

For many companies operating in Asia, China will now rank as a tougher more challenging one and this has been the case for at least one year and 2-4 years for most companies. It will remain obviously the key, priority market for all companies working in Asia-Pacific but currently "hotter markets" (with much less volume) include Vietnam, India, Philippines, Indonesia and Myanmar.

Most western companies operating in China have been used to achieving steady double-digit organic growth in sales (see below). This was the case until 3-4 years ago when manufacturing companies started to note that their organic sales growth was ticking down from 15-25% to 8-15% and that trends simply continued each year. Organic sales for many industrial and manufacturing companies have decelerated to single-digit figures even to flat levels. But most such companies can still dig some top-line growth from the market.

But there is still support from important macro-economic indicators and wage figures.

China: business outlook

(I am indebted to my friends at IMA Asia for some of the statistics in this section).

China is by far the No 1 priority emerging market. Even though Chinese growth has decelerated in recent years (see below) and India is now the fastest growing major economy in the world, China retains the western corporate focus. Companies have built up their manufacturing and supply chains much more so than in India.

China experienced a tough start to 2016 but much of the economic turmoil (tumbling stock markets, dodgy devaluations) was defused by spring this year as the authorities embarked on a standard stimulus package.

> One stabilising factor in the global economy this summer is the relative calm in China. However, we wonder whether more problems are being stocked up for the future.

In current business terms though China has been the market that has caused regional Asian managers serious problems in meeting high expectations and budget targets in 2015 and in the first half of 2016. But the regional business mood has had to adjust to these changing times and after some months/years of adjustment, more regional and country managers are getting accustomed to the new normal.

Sales growth fell across Asia in 2015 to 5-9% top line in the major markets. But in 2016 executives are forecasting 12-15% top-line growth. These numbers regionally will be a stretch given the weak trade trends this year and sluggish investment but as we noted above, some markets are able to plug the gap with consumer spending. India remains the No 1 market in terms of expected organic sales growth at about 16% this year compared with 12% in China. BUT the volume of business for nearly all companies is massively larger in China than India. After recording 8-10% profit growth in the major markets of Asia last year, executives once again are aiming higher in 2016 at 10-14% and once again this will be a stretch.

This trend in industrial sectors (with sales trending down from +30% to 15% to 5% has also became increasingly visible in the last 18-24 months in consumer products, which again had a track record for high double digit growth ranging from 15-30% and with luxury goods also performing especially well. The economic slowdown and the campaign against corruption mean most consumer goods companies have seen recent steady or sharp reductions in sales growth. Some luxury goods firms have gone from 35% growth to zero or negative in 2-3 years. Domestic numbers for luxury goods and some other consumer products are adversely affected by the exodus of Chinese tourists who travel abroad and who buy abroad, often at cheaper prices, rather than at home (100mn tourists spent $30bn abroad last year). Several big FMCGs report that some quarterly sales results are now as low as 1-3% year-on-year.

> Despite China's economic slowdown, it seems that global and regional HQs are still trying to squeeze solid sales and profits from the Asian market. This is understandable given that the region's GDP growth sticks out positively compared with so many other sluggish markets. But the forecasts and budgets made tend to be very stretch ones indeed.

Features of business in China

China recently overtook Japan as the 2nd biggest consumer market in the word after the US and private consumption is around $3.25 trillion representing 8.5% of global consumption. Already by 2011-13 China had become the biggest contributor to growth in global consumer spending. As the government wants to move away from investment and export dependency, so the government will focus on health and education investment in order that consumers don't need to worry about self-financing for these services and can therefore spend even more on regular consumer products and services. This strategy is happening but so far is only partially successful and it will take 5-20 years to fully implement – like turning an oil tanker round at sea.

- Consumers are not brand loyal –surveys show that 75-85% of shoppers are keen to try new brands
- Retailers and FMCGs have responded to this: there are 2-3 times more brands on Chinese retail shelves than in other markets: shoppers are "spoilt for choice" and "spoilt for price"
- "First-mover brands" have now been around for a long time and are starting to look a bit jaded and tired
- The market for all products and services in already intensely competitive and local competition is rising in machinery and equipment, IT and most consumer products but especially toothpaste, some foods/ juices and cosmetics
- A young rural migrant worker will merrily spend a month's salary ($750) on an Apple iPhone.
- But they are aspirational, sophisticated and want value but also ostentation.
- They like to buy products that they can show-off to guests when they are visited at home.
- Word of mouth recommendations are very valuable and social media is important across the country not just in the major cities.

- Route to market is getting more complex as companies expand into third and fourth tier cities.
- E-commerce has already taken off and Chinese shoppers are on-line from the start
- China is the world's largest e-commerce market at $540bn in 2015
- Chinese consumers compare prices on the internet and look at price abroad and they will then either go abroad for cheaper products or employ "buying agents" who travel for a group of customers.
- Profits are tough to come by.

Two very BIG numbers: 1) urbanisation and 2) the middle class

For 6,000 years until 2011 the majority of the population living in China were rural inhabitants. This changed in 2011 when the number living in urban areas touched 51%. What is even more shocking is that by 2016 the percentage who are urbanised has already jumped to 53.5%, which suggests a massive acceleration in this trend.

Urbanisation has huge social and societal impacts on how people behave and of course it has enormous effects on the economy and on how consumers spend: investment needs to continue, concrete and steel still need to be produced and the demand for household durables (curtains, refrigerators, carpets etc.) remain buoyant.

Related of course to urbanisation is the famous Chinese middle class. Those in the middle class (defined as households over $20,000 will grow from 11% of the population in 2012 to 22% by 2022. This rise of the middle class and urbanisation are two massive shifts on going in China that will stabilise and buttress western sales. Some commentators suggest the transformation could be quicker with the middle class reaching 36% of households by 2025.

Another interpretation of this is that over the next 10 years to 2026, some 200mn Chinese will join the middle class. Once again this is a remarkably positive figure against the background of recent negative news from the country. Put yet another way, by 2025 China will have 550mn people living in middle class households (more than $20,000 per household) which dwarfs the number in Indian (131mn) and in the Asean-6 (excluding Singapore) at 144mn.

China economic outlook

China will remain a key growth engine of the global economy for the next 5 years and probably for at least the next 100 years. Growth is normalising and one should not be shocked by that. But the markets are shocked and the lack of transparency is a critical factor. Official Chinese figures that are then utilised by the IMF and World Bank suggest GDP growth now at 6.5% but the informal western consensus is ranging at 4.5% to 5.8%. This is a bizarre situation. Like other western commentators, our analysis is based on Chinese official and IMF figures.

In 2014 China's GDP (on a PPP basis) at $17.6 trillion surpassed that of the USA! This global mega-event didn't quite get the publicity it deserved. Ironically, in 2014 as China became the largest economy in the world (on a PPP basis) ahead of the USA, global executives downgraded China for the first time in 15 years to the No 2 spot as a market priority behind the USA!

China is the biggest economy in the world today on a PPP basis but it will take until 2020 at least before it achieves this at an exchange rate level. But Chinese people are of course not as well off as Americans: Chinese GDP per head in 1980 was 2% that of the US while today it is 25%, a huge increase but still a massive gap. Conversely in 2014 the level of investment in China was 40% above that of the USA, but of course the question is: how much of that was efficient? China's share of GDP will reach 18% of the global total by 2020.

One of the anticipated challenges for the Chinese economy kicked-in during 2013 when for the first time in history the working age population declined.

Currently Chinese GDP growth (by any definition) is at a 24-year low level.

	2005-15	2016	2017	2017-21
GDP	9.5	6.5	6.1	5.2
Consumer spending	8.8	7.1	6.3	5.5
Fixed investment	11.0	6.3	5.4	4.7
Manufacturing output	10.5	6.1	5.1	4.5
Construction	11.9	6.2	5.3	4.7

China is through a regular cycle: some bad economic news; the government reverts to the standard model of stimulus via more credits, looser bank controls and some regular state investment; this picks the economy up and as the government downscales its injections, the economy moderates.

The trouble is that the current stimulus is boosting growth in the short-term but is unlikely to generate any new kinds of supply.

The Chinese authorities, who have not covered themselves in glory in the last year with the mis-handling of the stock market fall and the announcements of currency devaluation, do have the financial firepower of $3.3 trillion to bolster the economy and they have the political will to prevent an implosion which could increase political risk. But their failings in the last 12 months have affected the managerial reputation of the Chinese authorities and growth is going to trend at lower levels: officially 5.5% to 6.5% in 2016-2020 and unofficially at about an annual average of 4.5% to 5.5%.

Consumer spending ought to be able to sustain growth levels of about 6-7% this year and next thanks to strong household balance sheets (unlike some/many developed markets), good employment growth and still solid wage increases. Government policies will also buttress consumers in social welfare and healthcare.

Private consumption remains robust especially in services. We also note that official retail spending data may not be capturing all of the spend via e-commerce. In other words, private consumption could be even more dynamic than we think.

Consumer confidence booked an average of 104 in the post-2009 years but then trended moderately downwards in 2015 and 2016 over the stock market devaluation and slowing growth. The figure was 103 in June this year after a further dip in Spring 2016. Retail sales were storming in 2011-12 at growth levels of 16-18% and then slowed to 12-14% in 2013-15 but through 2016 the steady fall has continued to 10.6% in June this year. Still, as we all know, retail sales increasing at 10% in the world's second largest economy is no bad thing.

A key driver maintaining consumer spending is the positive strong trend in real wages: with inflation down to 1.3% in 2015 and averaging about 1.8% this year and in 2017, nominal wages have bene and are rising at an average of 6.5% which means that real wages are increasing each year by about 4.5% which is a very decent and solid number. When this is combined with still decent new credit emissions also hovering at 10% this year, then consumers can choose to spend from their own pockets or to borrow money. It is such real wages that will keep consumption and retail sales at respectable levels and ought to ensure steady (if not spectacular growth for western FMCGs).

State banks now account for only 66% of lending and the rest takes place in the shadow banking sector. Most debts are held in China, which limits risk, and most debt is not held by households or central government but is in the hands of local government and a small number of large SOEs (state owned enterprises).

The credit/debt outlook is serious but on balance we still argue that it is manageable.

Investment and manufacturing will come under more pressure as especially bloated local government budgets are curbed but perhaps compensated to some extent by federal spending. But as we note, the authorities don't want just investment spending; they want efficient investment spending. The rebalancing of credit policies and inevitably tighter credit terms will hold back these sectors at levels of 5-6% in the coming years. Light industry will probably out-perform the older heavy sectors. But one challenge for the authorities is to get the private sector increasing productivity and investment; in the last 18 months, this has been a weak link as the private sector seems to lack faith in what the government can achieve.

The construction market in China is a phenomenon at the same size as the US one and accounts for 50% of the 14-country Asia-Pacific total construction market. Residential property takes up 50% of the market and this now faces huge over-capacity issues as we noted above; it's estimated that it will take 2-3 years to clean out. Positive trends in the service sector ought to stimulate demand for office space. This sector is typical of the problems with statistics: while official construction growth has been 5-7% recently, sales of cement in the country are actually falling.

The housing market has made a large rebound in recent months but there is still too much liquidity and excess capacity has ballooned in smaller cities to an estimated value of 6.5 years of total housing sales. But despite this, we are witnessing more stabilisation in recent months compared with Autumn 2015 to Spring 2016 and the stabilisation is visible in the property market, FX rates, FX reserves and very much in the successful roll-over of local government threat.

Chinese trade is plummeting and hitting global and Asian regional trade and GDP numbers. Exports were down -4.8% in June 2016 (year-on-year) and are following annual seasonal trends but on a noticeable sliding scale: exports were -2.7% in 2015 while imports slumped by -15% as the demand for western components shrank; in 2016 we forecast another -3% fall in exports in conjunction with -6% in imports before trade flows rise by about 4% in 2017. Trade is down in both dollars and volumes, as the energy price slumps, but also as the Chinese demand for intermediary products shrinks as the Chinese use more of their own domestic inputs to make exports.

At many levels, the anti-corruption campaign has had manifold effects: officials are much more cautious to sign off on deals and contracts and local officials are especially wary of land transactions; egregious spending is also cut back and many bureaucrats adopt the policy of wait and see which randomly delays projects and financing.

The government is also using fiscal policy as well as monetary measures to stimulate the economy: the target for the budget deficit in 2015 was -2.3% but came in at -2.7% and we predict that the deficit will widen to -3.0% or slightly more both in 2016 and 2017. As we argue, the authorities will use all measures to keep the economy afloat.

India outlook

	2005-15	2016	2017	2017-21
GDP	7.5	7.5	7.4	7.3
Consumer spending	7.1	4.9	5.8	6.8
Fixed investment	11	5.2	3.1	8.8
Manufacturing output	7.8	1.6	5.5	8.0
Construction	10	2.5	3.7	7.5

Getting a handle on Indian GDP figures are always a bit confusing as the government uses a financial year rather than calendar one. In addition India's new GDP series seems to overstate actual growth as much as 0.5% to 1.0%. But the trend is clearly upwards. As we have noted before, just as there is a north (poor) south (rich) divide, there is too within the economy: the rural and industrial sectors, restrained by weak investment, perform poorly or sluggishly while the services consumer/middle class sector shine relatively well. Overall we expect GDP to hover around 7.6% to 7.7% this year and for the coming 5 years; the Indian government expects closer to 8% but that would depend on global trends. Short-term trends are better than Indian ones in the past and better than many other developed or emerging markets.

> But converting decent GDP results into solid western sales has been a major challenge with the exception of a handful of companies who have been entrenched in the market for decades.

The government of Narendra Modi came in with elevated expectations and was not able to meet those but some success has been achieved and in August 2016 the GST the new goods and services tax passed through the upper house of parliament. This legislation has been in the air for around 10 years and the systemisation of tax will break down internal trade barriers and could add 0.5% to 1.0% to annual GDP growth. Details need to

be ironed out, not least of which regarding the rate of tax. It may take 10-18 months for the tax to be implemented but this remains a solid legislative achievement.

The economy has also been favoured by low energy prices which has had a double positive impact for India:

Lower energy prices means weaker inflation;
Reduced import costs have befitted the current account deficit;
Lower energy cost has entailed smaller government energy subsidies and a better budget deficit.

Inflation was as recently as 2014 close to double digits at 9.9% and high prices were a bane of India. But thanks to tighter monetary policy and falling energy prices, inflation sank to 5.0% in 2015 and will average 5.3% this year and in 2017. Real wages at least for the urban labour force will be decent as nominal wages have averaged 10% increases in the last 5 years and are probably set to repeat these in the next 5 years so we presume real wages running at a solid 5% rise annually. Rural incomes are more mixed: rural welfare schemes under Congress helped jack up rural earnings but Modi has tended to run down such programs.

Consumer spending growth rates have remained steady over the last few years despite the volatility in the economy and exchange rate, and we forecast steady and moderately rising consumer trends; more money has been directed at rural areas in recent years and that has eventually filtered through to spending at the lower end of the consumer scale as well. Household spending averaged 7% from 2009 to 2014 with 2011 being the strongest year and a dip-taking place in 2012-13; we see a similar average for the next 5 years with perhaps some very mild softening to 7.2% in 2020.

On the consumer side, entry-level consumers will provide a boost to the economy and western sales if the latter can achieve the right affordability offering. While some 1bn Indians will remain at or below the poverty line in 2022, 180mn will live in households earning $10-20,000 per annum, 127mn will be in households with $20-50,000 and 31mn will live in rich households earning more than $50,000.

In the last years of the Congress administration, domestic companies lost faith with the administration and private investment trended weaker down to increases of 4-5% when the economy needs much more than this for GDP growth and job creation. Indian companies preferred to sit on their cash or invest abroad. Fixed investment this year will be weak at 3-4% but we then reckon than the overall mood could improve on the back of some Modi reforms coming through and thanks to lower inflationary expectations. Fixed investment could rise to levels of 6-8% over the next 5 years and some commentators think a rally could get close to 10% annual expansion.

The overall mood is rising on the back of some key macro-economic improvements:

- We noted above that inflation is down close to 5%
- The lower energy price is helping the trade balance and the current account; the latter deficit already tumbled in 2013 from 4.8% to 1.1% in 2015 as gold imports were restrained.
- Despite the removal of Central Bank Governor Raghuram Rajan we do not expect major changes to interest rate policy: thanks to a low inflationary outlook and reasonable budget situation with the currency under control, we expect the key rate to remain close to its current low level of 6.5% or slightly higher to 7% over the next 15 months. This means that central interest rates will fluctuate above inflation by a moderate 1.5%
- New credit emission is steady at annul growth of 8-10%
- The budget deficit (IMF) definition is stable at a range of -6.5% to -7.0% (Indian government numbers have this closer to -3.5%)
- The monsoon still plays a key role in economic development as 17% of GDP stems from agriculture while it accounts for 50% of employment with food accounting for 45% of the inflation basket.
- Consumer confidence is close to a 7-year high but also not much better than in 2011.
- Business confidence slumped in 2012-14 on the back of ineffective Congress polices but this has rallied in the last year to a level of 54 and is now at its best level for 3-4 years but is still well below the boom years of 2006-12.
- The PMI indictor has also stayed above 50 for the last 3-4 years and is currently at 51
- But industrial output turned negative or flat from late autumn 2015 and has had a pretty miserable 2016 to date.

- We think domestic and international developments will keep the rupee close to the existing level of about 66-68 to the US dollar in 2016-18 with some moderate annual decline of -3% in 2019 to 2022.

We do not change our conclusions much from 6-9 months ago: after several years of relative slump and a deep malaise in Indian society at the end of Congress's last administration, things are looking up for the Indian economy and business outlook but the "jury is still out" on whether PM Modi can really implement engrained and sustainable reform. But some recent indicators have been good. Business for western investors remains interesting but challenges with regulation, poverty levels, ignorance of western brands and the north-south divide in the country are just some continuing features that companies have to cope with.

As ever, I hope you have found this long paper useful, interesting and positively provocative in parts. If you have any queries or comments, do please get in touch at your convenience danielthorniley@dt-gbc.com.

9 August 2016

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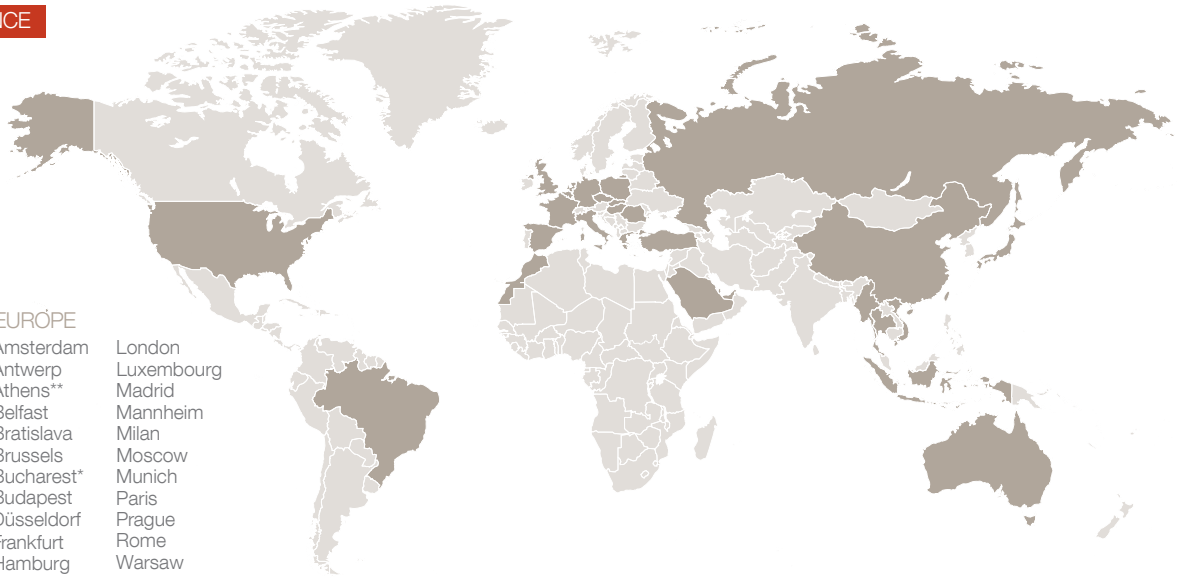

*Associated offices
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Fact Sheet

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Contact: corpmediarelations@hpe.com

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- **HPE is a leader in the majority of the market segments it serves - #1 in servers, #2 in networking, #2 in total storage, and #2 in IT services.**
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