CEEMEA
Business Group

Global Business Outlook 2015-2020

Are the emerging markets finished? Not yet.

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FOR CEE
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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 with a selected number of 350 key clients 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 The Economist Group, Vienna

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 350 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.

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One doesn't know whether to laugh or to cry.

We live in a crazy world.

The world bank estimates that $20 trillion (not billion, but trillion) of illegal, black, tax-evaded money is stashed in the global bank system; enough to pay off all of Greece's debt 60 times over.

Greece's lost EU funds and tax evaded money add up to about 450bn Euros, enough to pay off all of Greece's' debt with 100bn Euros left over to invest in the real economy.

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.

It was recently published that 85 individual people own the same assets and wealth as half of humanity (3.5 billion people).

Inequality is rising to disturbing levels and has been criticized by the Bank of England and the IMF. The point is proven by the fact that is 2013 in the USA the fastest growth category among consumer goods was the sale of "light personal aircraft".

More than 50% of all jobs created in the developed world (OECD) in the last 20 years have been so-called "non-standard jobs" part-time or self-employed. Some 60% 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.

US median household income has been stuck for 10 years at approximately $53,000.
UK median real wages in 2013 were the same as in 1979 (34 years).

There is a crisis in Russia by the way….because lipstick sales are rising! As in the great depression when the only growth category in the US economy was lipstick, in Russia today lipstick sales are doing well. The rationale in crises is that women apparently want to feel good during the downturn and perhaps want to cheer up their miserable men folk!

Speak English!!

In 2014 no major English-speaking developed/industrial market grew by less than 2.5% while no major developed/industrial non-English speaking economy grew by more than 1.5%.

The on-going denouement at FIFA is a shameful stain on global and especially European authorities: what were the Swiss doing? It is shameful and pitiful that the US FBI has to step in to clean up the global and European "stables". Sepp Blatter reminds one of Claude Rains, the Vichy French police chief in Casablanca, who says as the casino is being raided and he collects his winnings: "I am shocked that gambling takes place here!" But Blatter has none of the charm of Claude Rains.

Executive summary

Global economy

- The global economy and global business have never properly recovered from the 2009 financial crash.
- Two words sum up much of the global situation: chronic and malaise.
- The business crisis has turned into a chronic one.
- In 2014-15 there is an elevated sense of malaise. Opinion polls globally suggest that global optimism when asked about the future is at its worst since 1989.
- 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”.
- The Financial Times talks of the threat of secular stagnation in major economies.
- The 2009-2015 recession/sub-par growth period has been the longest and deepest since 1933.
- We estimate that 85% of companies are not satisfied with their sales, profits and market share both within developed and emerging markets.
- We are living through a period of great economic change: the “age of the oil price and dollar Chaos” and markets and companies are adjusting to this.
- Some sectors and some markets have rallied but the recovery is stop-start; scattered in some markets and not in others, and does not feel sustainable.
- In every year since 2010, the rate of GDP growth globally, in both developed and EM markets has been downgraded ensuring 6 years of disappointments.
- Some 60mn people are on the move as internal/external migrants hit the largest number in 200 years with the exception of 1945; this is causing trauma and rupture in the Mediterranean and the EU.

The big economies

- The USA economy is performing reasonably well. The USA stands out as a relative winner; but American cynics say sarcastically: “Yes we are better than Europe” and that achievement has needed trillions of dollars to be printed.
- More global and European executives are looking at the US again as a destination for foreign direct investment: re-onshoring is taking place.
- But 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!
- The emerging markets (EMs) slowed down last year and 2015 will be one of their softest years in the last 15 years. The famous BRIC has become IC as Russia and Brazil sink into recession in 2015.
- The Eurozone is doing much better this year thanks to low oil price, weaker Euro and QE but the question is how sustainable is this?
- The Eurozone will grow about 1,6% this year and that’s a bumper figure for the region…. which says a lot.
- The Eurozone was crippled for 5 years and politicians in the region have failed in their primary duty of care to their citizens when faced with a rampaging financial sector: they are guilty of dereliction of duty, not least of which is the way that taxpayers were put on the hook for Greek debt in May 2010 as investment bankers and hedge funds slithered away from their handiwork.
- The German growth model currently looks less secure and is hardly transferable to other European economies as it focuses most effectively on exports: the problem for Europe is weak domestic demand.
- Those commentators promoting austerity have lost the debate and even the IMF is having doubts.
- But Germany persists in its crazy determination to run a balanced budget in 2015: “Warum?”

Interest rates

- Interest rates will remain very low and close to zero for most major economies (UK rates have been for the last 5 years the lowest since 1689!)
- US rates will probably rise at the end of this year but only by a tiny amount from a very low (almost zero) base.
- As US rates rise and probably exert downward pressure on emerging market currencies, then EM central banks will have to match the US interest rate increases to protect their currency, but in so doing will probably curb GDP growth, which for many is already below-par.

The US dollar

- It is this presumption of rate increases (and stronger growth) which is driving the relative strength of the US dollar and we presume that the dollar-Euro rate will hover between 1.06 to 1.14 depending on various announcement about the US rate hike.
- A rising US dollar and eventually rising interest rates (very slowly) will lead to emerging market currency volatility/weakness through 2015-16.
- At the start of July 2015 the US dollar sat at a 8 year high to the Euro and the oil price continues to plummet.
- Inflation has not emerged as a global threat and will not become so; cheaper oil will also drive down prices.
- The rising dollar will help keep oil prices down as the value of oil and the dollar trend inversely.
- The dollar has risen sharply versus nearly all currencies and especially emerging market ones. In the past year the dollar has risen 25% against the Polish zloty and Poland represents one of the very best performing EMs.

The oil price

- The oil price will fluctuate between $57 to 68$ per barrel for most of 2015; shale energy is not going away
- Globally consumers seem not to be spending much of the $300bn windfall from the lower oil price: US retail was weak in Q1 and flat in April for example but did rally in May and June.
- One factor is that real wage growth after inflation has been poor around most of the world for many years or even decades.
- But with a lower oil price, this means inflation is coming down and therefore real wages are rising because of this (not because of the munificence of companies).
- 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.
- Cheaper oil ought to boost consumer spending in many parts of the world and this will be a buttress for global growth in 2015-16.

Emerging markets

- Emerging markets will therefore continue to “wobble” over the next 15 months and senior managers will have to explain softening sales growth combined with weaker FX returns.
- But long-termism in emerging markets has always been the key to success.
- Emerging Markets (EM’s) are not finished yet!
- In 2003-08 EM’s grew 3.5 times faster than developed markets and 3 times faster in 2010-13 but this differential will diminish to 2.5 times in 2014-18. But comparatively this is still pretty good.

<u>We are living through the period of the oil and dollar chaos.</u>

A quick word on Greece

At the time of writing (Monday 6 July) there is extreme uncertainty about the Greek outcome.

But rather than dwell on all the endless details, I outline the viable scenarios and get to some of the roots of the problem.

4 Scenarios:

1) Greece will stay in the Euro and accept the Troika's current austerity plans (15% chance);
2) Greek officials will negotiate a slightly modified deal which includes a token of debt write-off with the focus on "extend and pretend" i.e. push out payment deadlines and reduce interest rates (45% chance)
3) Greece will undertake a more formal default and stay within the Euro and some kind of ECB bank support (5%)
4) Greece will default and exit the euro (35%).

If Greece stays in the Eurozone under a revised austerity package it will still suffer 5-10 years more of deep and lingering social and economic pain. If it leaves the Euro, it will probably fare better over the medium-term but suffer extremely in the short-term due to a massive devaluation necessary for the introduction of the new drachma. There are no good options; Greece is going to suffer

Actually one good option would be to allow Greece to default on a large part of its debt and then to institute a series of reasonable growth programs. But the burden of default should be placed on the banks that recklessly lent the money originally. But European politicians removed this option in May 2010 when they let the banks and hedge funds off the hook to be replaced by Eurozone taxpayers.

Much of the on-going debate is smoke and mirrors and ignores the fundamentals that got us here: greed, corruption and incompetence. Western banks and armament suppliers recklessly financed deals with shady Greek counterparties that eventually led to Greece's effective bankruptcy. First the finances were abused and wasted and then the Troika's debt repayment program destroyed what was left of the real economy. The Troika policies have sliced 25% off Greek GDP while bumping debt upwards (not downwards) to 177% of GDP in 2014 from 130% in 2009. .

- The Greek debt in question amounts to around 340bn Euros.
- It is estimated that tax evaded Greek money sitting in western European, US and Swiss banks amounts to 150bn euros.
- Greece has apparently "lost" 80bn Euros of EU funds.
- For 20 years during the 1980s and 1990s, Greece was the third largest importer of conventional weapons in the world to the tune of 220bn euros. Where is that money now? What happened to the weapons sold? Essentially corrupt western European arms suppliers financed by dodgy western European bank financed deals via corrupt Greek procurement agencies in conjunction with corrupt Greek officials and military personnel, ensuring that the vast amount of this money was raked off.

The total of the sums above could pay off all of Greece's debt immediately with about 100bn Euros left over to finance some social and productive investment.

Business quotations

A few weeks ago at 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

Just last week in Vienna, one regional manager commented in a similar vein:

> Even now, the crisis is not over but just of a different nature. Everything in business for us and others now takes so long; deals are longer to conclude as negotiations drag on; receivables take just a few more extra days/weeks; marketing campaigns are more complex and frustrating. As I say, everything just takes longer and nothing is straightforward anymore.

The EMEA President of one global beverages company said last year:

> The CEO and Board constantly talk of the new normal and are aware of the changes taking place in markets. But when it comes to setting budgets, they behave "old normal": they think we can make organic growth targets in the developed world of 4-6% that is now totally impossible. And in the emerging markets they still dream that we can achieve high single digits or even double digits like in the good old days. But legislation and access to market has changed all that. In developed markets very low single digits is the best achievable and if we fight aggressively for market share and grow organically in emerging markets we should be satisfied with mid or even low-single digit growth. The top leadership thinks they understand the new normal but they are really in denial.

One US CEO recently mentioned to me that:

> Danny, we and other global players can "always" make the bottom line and like nearly all companies on Wall Street we are beating earnings expectations. But our top-line growth is another story. It's not bad, don't get me wrong, but my challenge for 10 years has been to drive that top line and not just the bottom one.

Emerging markets still have a lot going for them

What's happening in some of the major emerging markets?

- Many emerging markets are performing at lower levels than in 2010-13.
- Russia and Brazil will be in recession this year as BRIC becomes IC.
- China will continue its managed slowdown and perhaps dip below 7% GDP.
- India will grow faster this year than China for the first time in about 3 or 4 decades.
- Turkey is "not bad" but slower than in 2010-012 with heightened political and financial risk but we still see the market as a key priority one for the next 10 years.
- Africa was growing strongly and once again becoming sexy as a destination of western foreign direct investment but the lower oil price of 2015 and in future years may take some of the shine off the continent's prospects.
- South Africa is posting weak growth numbers which are insufficient to compensate for high unemployment and much of Latin America is performing below par.
- Core Central Europe has clocked up two years of good economic performance and looks sustainable.
- This apples to the core CEE markets of Hungary, Poland Czech Republic, Slovakia and Romania.
- Core Central Europe is performing so well at the moment that this region's GDP growth this year will be 8 times faster than that of Latin America! (see below for further regional comparisons).

2013 saw the first tapering crisis for the emerging markets (EMs) (the idea that QE would decrease/taper in the US and US interest rates would rise) and 2014 saw this trend continue coupled with both regional and country specific crises combined with weaker commodity and energy prices.

Most EM markets will under-perform in 2015 and through into 2016. A major driver of all this is the slowdown in China and the restructuring of its growth components.

Pre the 2009 crisis, EM's GDP grew at an average of 7% but this will decline to 5.0% in the period 2014-2018 on the back of weaker commodity prices, slowing investment from the mega-corporates in emerging markets especially in the energy and mining sectors and also on the back of soft global trade. Put another way, 70% of all EMs will record lower growth in 2014-18 than in the pre-crisis period.

In 2018-138 EMs grew 3.5 times faster than developed markets and 3 times faster in 2010-13 but this differential will diminish to 2.2 times in 2014-15 and then average 2.5 times in 2016-18. But comparatively this is still pretty good.

GDP growth rates selected periods

Emerging markets versus developed ones

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

Put another way, between 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 forecasts have typically been downgraded 2-3 times each year for the last 5 years and these downward revisions have applied to emerging markets as much as to developed ones. The EMs continue to out-perform developed countries in terms of GDP growth, consumer spending and investment growth but they too have tended to disappoint rather than exceed expectations in recent years.

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, sucjing out too much time and resources. Let's ratchet down investments and pull back and invest and focus on our growing market: the good ol' USA (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 2015 and perhaps into 2016, senior managers have to be more specific and precise in finding growth in the various key emerging markets.

For example in China, many big multinationals (MNCs) now see their organic sales growth down to 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.

> 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 is beginning a managed slowdown of its economy with focus shifting to domestic demand, household consumption with more spending directed at health and education to help Chinese consumers feel more confident so that they will spend more and lower the country's saving ratio. The authorities are aiming for less focus on exports and fixed investment. To some extent this is working but there is still reliance on economic stimulus through the investment model.
2. The slowdown in China is affecting global supply chains and reducing growth levels across much of south-eat Asia.
3. 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.
4. For example, Brazil will be in recession this year largely due to softer exports of commodities and food products to China and other EMs.
5. US interest rate policy has had a massive impact on EM currency and economic stability since the "taper tantrum" of spring 2013.
6. Uncertainty lingers as most commentators anticipate the next interest rate hike in the US will take place at the end of his year.
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 a deterioration in sentiment towards eastern Europe (while core CEE markets are flourishing—see below).

So those are the factors which 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. The markets offer openings for affordable innovation; companies cannot rely solely on the premium brand "game" any more and have to be diversified.
4. 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).
5. Demographics is a no brainer.
6. Brand penetration is still low in many EM's.
7. New options for e-commerce are present.
8. There are still new geographies to develop with much of Africa still relatively "untouched".
9. Sub-nationals 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 opportunites (and challenges).
10. 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 sale 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

	2014	2015	2016	2017	2018
GDP					
Global	3.4	3.1	3.8	3.9	4
Developed markets	1.7	1.9	2.3	2.1	2.2
Emerging markets	4.3	3.6	4.7	5	5
Differential	x2.4	x1.7	x2.1	x2.5	x2.5
Household consumption					
Global	2.3	2.5	3	3.1	3.2
Developed markets	1.6	2.2	2.6	2.6	2.7
Emerging markets	3.8	3.1	4	4.2	4.3
Differential	x1.5	x1.4	x1.6	x1.7	x1.6
Fixed investment					
Global	3.8	3	4.3	4.5	4.6
Developed markets	3.4	2.1	3.4	3.5	3.6
Emerging markets	4.1	3.9	5.1	5.3	5.4
Differential	x1.3	x1.8	x1.5	x1.5	x1.5

Between 2002-08 and 2009-11, the emerging markets (EM's) typically out-performed the developed/ industrial ones by factor of 3.0 to 3.5 times. This 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 annual GDP average over the same period.

But the clear conclusion is that even in this soft patch, the emerging markets will be growing 2.0 to 2.5 times faster than developed ones and that household consumption and investment will be increasing at rate of 1.5 times or more of 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.

How does the CEE region compare with others? Very well actually.

- Core CEE region is booming!
- Core CEE is growing at 8 times the GDP of Latin America!
- Poland is one of the best performing transitional markets in the world.
- Consumer confidence in Hungary and the Czech Republic over the last 20 months has seen some of the best improvements in the world and in Europe.
- When the Eurozone grows by an extra 1%, then the CEE region grows by an extra 1.3%.

CEE and other regions comparative GDP growth

	2014	2015	2016
Core CEE region	3	3.4	3.3
South East Europe	1.6	2.2	2.6
West Europe (including UK)	1.3	1.7	1.8
USA	2.2	2.6	2.7
Latin America	1.2	0.4	1.9
Asia pacific	4.6	4.7	4.9

Sources: Consensus Economics, Ceemea Business Group, IMF

The comparative numbers speak for themselves with the core CEE region growing faster than any region in the world with the exception of Asia Pacific.

Core CEE went through a very tough 5 year period economically and commercially from 2009 to May 2013. The core CEE region and south-eastern Europe were badly hit and business confidence was poor for most of 2009 to spring 2013 with occasional exceptions. Business executives were certainly disappointed with the region. Hungary and Czech Republic were immersed in recession or at best sub-par growth just 2-3 years ago. The exception in the CEE region was Poland which along with Russia and Turkey was a key regional market. The timing of the core CEE revival is rather good as critically Russia and Ukraine obviously are going through recessions while Turkey is experiencing a softer patch. More companies are putting their focus on core CEE region.

Poland remains one of the best markets and didn't go through any 5 year slowdown as with the other CEE markets: instead it stuttered briefly from autumn 2012 to summer 2013 . Poland is actually storming along at the moment with excepted GDP growth of 3.5% this year and next with perhaps some upside potential. Poland is of course a developed and highly competitive market but still, a good and large volume market to have in ones' portfolio.

The other markets which have turned the corner are Czech Republic, Slovakia, Hungary and Romania.

> When you combine these markets with Poland, one has a decent sized cluster that helps in part compensate for the deceleration in Russia, Ukraine and Turkey.

Unfortunately the same is not the case for for other SEE markets and Slovenia and Croatia and the smaller ones are still struggling; they are about 10-18 months behind developments in core CEE.

The key point to make is that the economic numbers are improving but this does not automatically translate into booming results. These core CEE markets are mature, transitioned markets (although they do retain regions that are still emerging). The core CEE region will remain a mature single digit sales market for most companies and we are seeing this trend in 2015 and this is the outlook for the coming years. But we can confirm that more companies than ever are reporting a mild/steady uptick in business. One US major conglomerate reports organic top-line sales growing at 8-10% and as the regional managing director notes: "for such markets, this is very sizeable and helps buttress other slower markets in the EMEA region".

And there is more good news: unless there is a serious downturn in the Eurozone or eastern Ukraine turns into something much more deadly then the consensus is for these markets to grow steadily and sustainably for the next 5 years. So far, events in eastern Ukraine and sanctions on Russia have had only a marginal impact on CEE GDP figures trimming off 0.1% or 0.2% off growth of 2.5% to 3.5% for these markets this year and next.

The only major cloud on your horizon is probably your own corporate headquarters (!): they are seeing many markets globally soften and with the CEE region posting good economic numbers and a reasonable business rally, headquarters are likely to be saying: "Well done, congratulations and now give us even more top line and bottom line". We are witnessing a similar trend in parts of the MEA region where the actual business recovery is not as strong a sin the CEE region

There are several key reasons for the turnaround

As we noted above; one axiom is that when the Eurozone grows by an extra 1%, then the CEE region grows by an extra 1.3% and in 2014 the Eurozone added an extra 1.5% and this year may well add another 0.7% growth to the 2014 figure. The rally in the Eurozone is the key driver for CEE exports, investment and industrial output. But from mid-2014 we also started seeing a positive contamination from exports and investment into consumer spending which has usually been the weak link in these markets. Unfortunately unemployment has been slower to recover but even these stubbornly negative figures have started to improve across the region since late 2014 (in Hungary, thanks to government programs unemployment tumbled more quickly and earlier).

1. Improvement in Eurozone: low oil price is helping disposable consumer spending on non-energy items , low inflation is helping real wages, a weak Euro is helping exports and quantitative easing will help stock markets and the property sector.
2. New credit emission is rising 2-4% which is quite decent and in Poland such new credits are rising at 4-6%, close to record levels.
3. Several CEE governments are imposing softer austerity programs on their economies.
4. Inflation (or deflation) is extremely low in all the CEE markets.
5. This is allowing the central banks in the region to keep interest rates at record low levels which in turn is stimulating the investment and production outlook.
6. But low inflation (or deflation) is very important in stimulating real wages (i.e. salary after inflation): some nominal wages are rising well given the demand for labour as economies expand. But even in economies where nominal wages are for example just +1%, then if inflation is negative at say -1%, then real wages are positive by 2%. The combination of some increase in nominal wages against a back-drop of very low inflation is boosting consumer confidence and household spending.

A few samples of economic indicators which are typical for these core CEE markets testify to the recent improvement:

- Consumer confidence in Hungary in the last 12 months has improved at the fastest rate of any country in Europe.
- At the start of 2013 Czech industry was down -4.2% and at the start of 2015 was up 4.5%.
- At the start of 2013 business confidence in Slovakia was -9 and at the start of 2015 was +4.
- Retail sales in Poland are now +3% compared with flat trends in the summer of 2014.
- Industrial production in Poland was up 6% at the start of 2015 while negative for much of 2013.
- Hungarian retail sales were -3.2% last year and + 4.2 now.
- Hungarian industrial production was down -2.7% last year and up 6.3% now.

What you should know about the oil price

Some interesting figures

- The USA has become the largest global energy producer.
- US oil output is 80% up on its 2008 figure.
- China has taken over from the USA as the largest global energy consumer.
- Currently US energy imports are the lowest since 1960.
- In August 2014 the US imported not one barrel of oil from Nigeria which is normally one of its biggest suppliers
- 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.
- Russia is a big loser. A $1 decline in the oil prices entails losses to the Russian budget of about $2bn and so with oil at $60, the Russian treasury forfeits in 2015 $80bn on 2014 revenues. A 10% reduction in the oil price also means Russian GDP declines by 0.7%.

Why has the oil price collapsed?

- Shale/energy production is accelerating quicker than anticipated against a weak demand back-drop
- Global demand is stagnating as China slowdown and the US buys from itself.
- We are entering “the age of the dollar”; several trends dictate that the US dollar ought to be relatively stronger in the coming years. The oil price and dollar value move in inverse proportion to each other so this ought to impart downward pressure on oil.

- The US is also supplying more to the world and buying less energy from it.
- Libya and Iraq production helped plug any gaps in 2014.
- Speculation and shorting account for at least 25% of the price movements.
- Saudi Arabia decided in November last year not to support the oil price and thereby broke the OPEC oil cartel.
- Global stock markets started getting spooked at the low oil price fearing it was more an indicator of weak demand and not just low supply.
- Saudi Arabia was fed up with acting as the oil supporter of last resort.
    - The Saudis felt that other suppliers would not stick to agreed limitations and thus they would lose market share.
    - 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.
    - But Us shale producers are proving efficient and productive: the numbers of wells has dropped markedly this year but overall production has not fallen much
    - 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.

In the mid-term over the next 2-5 years shale developments ought to exert a softening impact on energy prices and the trend for a weaker US dollar also to ensure over the medium-term that energy prices are not rallying. At the moment with soft-ish global growth, the case for any strong energy price rally seems very distant and the Russian economy and government will probably have to work with this massive energy "new normal" for several years. This will have consequences for the GDP outlook and business and also for Russian government policy and the prospects of economic reform and diversification.

The oil price spending bonanza: where is it?

In the 4th quarter of 2014 global retail sales rose by about 6% but with the full impact of lower oil prices settling in, retail sales in the first quarter of 2015 surprised sharply on the downside staying basically flat while total discretionary consumer spending increased by a mere 1.1%. The US disappointed in particular and the federal reserve stated in April that:

> The expected boost to household spending from lower energy prices has apparently so far failed to materialise.

Globally it was expected that some $520bn of increased consumer disposable income would hit the global retail and household spending markets with at least $250bn of that ear-marked for the USA.

In the first months of the year, the Eurozone consumer sentiment picked up a bit quicker than others and consumer spending rose in Q1 this year by 0.6% compared with a zero figure for the final quarter of 2014. The good news is that latest figures form the US have spiked with core retail sales increasing by a sharp 5.4% in May. Until May it seems that most US and global consumers were reluctant to spend any windfall and were content to sit on the money.

A few points summarise the situation:

- Lower oil prices kicked in from October 2014.
- This should mean more money in peoples' pockets and also lower inflation.
- But perhaps the end consumer is not getting all of the supposed bonanza of $520bn especially when governments are reducing oil and energy subsidies as for example in Indonesia.
- Until May-June US and global consumer spending had not rallied but took a turn for the better in early summer.

- Another added benefit is that lower energy prices mean lower inflation which in turn means that real wages are rising globally: if your pay rise is zero this year and inflation is +2%, you are miserable; if your pay rise is zero and inflation is -2%, then you are a cheerful puppy! And may spend more.
- Lower inflation may be the real driver of improving confidence and eventually greater consumer spending.
- But this mini spending boom may turn out even more temporary if: the oil price continues to creep up and once inflation globally starts to climb slowly to levels of 1-2% instead of -0.5% to zero.
- Also inflationary benefits could prove temporary because after one year, the lower oil price does flow out of the figures and a new base is created i.e. lower oil price and lower inflation are only beneficial for one year unless they continue to fall further.

Why this malaise?

Opinion polls globally and especially in developed/industrial societies suggest that people are more despondent about the future outlook than at any time since 1989. Why is this?

There does seem to be growing malaise among voters and consumers globally and especially in Europe but also the US and Japan to lesser extends. There are many social, political and economic factors explaining this:

- Mis-guided austerity programs have damaged the social fabric and alienated people.
- Voters are increasingly turning away from main-stream parties.
- Inequality is rising across the globe in developed markets and emerging markets: people increasingly feel that there is no fairness and equity in their workplace or society generally.
- Blatant corporate tax avoidance (Amazon and so many others) underscore there is no level playing field: as one US aristocrat once famously said: “Taxes are for poor people”.
- Real wages have remained stagnant or negative in most major economies for 3-30 years. Real wages in the UK in the 4 years until 2015 grew at their slowest level since 1867.
- Real unemployment is stuck at elevated levels in most economies and youth unemployment in Europe at 50-75% is pornographic: the lost generation or even the betrayed generation.
- Middle income and middle management jobs are being stripped out of economies: only highly skilled people or poorly paid ones can find work.
- New service sector jobs are usually insecure and poorly paid; “zero hours contracts” (people beckoned for work when a few hours are available and with no social security provisions) are becoming the norm: in the UK even Buckingham Place uses such work contracts!
- Affordable housing in some capital cities is close to non-existent: can a normal human live in central London?
- Again young people are hit the hardest: their parents having bought homes in the 1960s and 1970s and the young generation is waiting for their parents to die!
- Indirect taxes are rising.
- The outlook for state and corporate pensions of the future is extremely bleak.
- High level corruption among elites and politicians is a weekly news item across the world. Shamefully the European and Swiss authorities cannot even clean up the world football association Fifa. The US FBI are obliged to come in and clean up our mess.

So much of the above stems from a dereliction of duty and care by politicians and elites especially in Europe in response to the financial crisis of 2008-09. Our elected officials did not protect us from the assault and exacerbated the after-effects through wilfully damaging austerity programs.

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

> 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.

A few years ago in the UK someone asked rhetorically: “I wonder why the British people have not risen in revolution at the consequences of the financial crash?” That person was not some left-wing radical yearning for Red October, but the former Governor of the Bank of England Mervyn King.

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

Global political turmoil is exacerbating strains in global migration. More people are on the move today than at any time in the last 200 year with the exception of 1945: last month it was reported that 60mn internal or external refugees (60mn) are on the move, predominantly in North Africa and the Middle East. Organised human trafficking is at a record high: the traffickers now put 400 people in a ship without a crew and aim it in the general direction of Europe. It is questionable, given the economic weakness of the Eurozone, whether the European region can cope with the influx of unskilled and financially destitute people flowing into the continent. European politics are starting to be de-stabilised as a result. Someone said in 2010 about immigration into Germany that: “Multiculturism has failed, utterly failed” and that person was German Chancellor Angela Merkel who also elaborated that the idea of people from different cultural backgrounds living happily "side by side" did not work. This development is a deep long-term threat which will fester. Once again main-stream politicians are blind-sided.

The model isn’t working?

“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!

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 property market (and second/third homes for rental income) and unsecured debt is creeping up again. The recovery in both countries has not until very recently been 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 which in turn creates jobs so that reasonably well-paid workers can then purchases goods and services with money from their pockets and/or savings; instead we do seem to be re-creating 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 ends up in the real manufacturing economy and infrastructure.

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 60% of all jobs created in the UK in the last 10 years are non-standard and some report that all <u>net</u> job creation in the UK has been non-standard.

We cannot build a secure, sustainable economic recovery based on zero-hours contracts.

US Median family income in 2007 was $53,000 and had been stuck at that level for 10 years. 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. But trends in average wages never fail to shock:

<u>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!</u>

Real wages in the UK in 2013 were at the same level as in 1979.

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”.

7 major factors which drive the global economy and business

1. The banks

The banks (financial sector) got us into this mess and have proven incapable of getting us out of it; 7 years on after the start of the recession, the ECB and UK government are promoting schemes to stimulate lending to SMEs and we were rightly sceptical of the chances of success. New bank credits have been inadequate to support a sustainable business recovery with new loans proving either negative or sluggish at 2-3% per annum i.e. not enough to boost growth, which has also been under downward pressure from weak government investment due to austerity programs. Among developed markets the exception has tended to be the USA where overall credits have been rising at 2-5% when they were flat or negative in Europe.

Thanks to the QE taking pace in the Eurozone now, we are indeed starting to see bank lending to SMEs beginning to rise. This is good news but like much else in the Eurozone, it's arriving 6-7 years too late.

Global corporate investment is negative or flat (see below) and some of this stems from poor availability of financing at acceptable rates.

New bank credits have assisted EMs and are still surging in China (+12%) and in Turkey (+20%) to name just two. But new bank credit fell in Russia from 30%+ in 2013 to 10% in 2014 on a sharply downward trend and will presumably turn negative in 2015. We think interest rates will rise in several emerging markets making lending tougher.

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. <u>The banking sector has hung like an albatross around the neck of the global economy.</u>

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 have been fined or criticised (!) for the following range of activities:

- Illegal fixing of Libor interest rates (a market of about one zillion dollars!!)
- Manipulation of Euribor rates
- Miss-selling of mortgages to Fannie Mae and Freddie Mac
- Rigging of forex markets (another zillion dollar market!)
- Abetting money laundering by Mexican drug cartels (and fined for doing so)
- Illicit behaviour with credit default swaps
- Raising prices for precious metals
- Mis-selling insurance polices

This leaves a nasty taste in the mouth and contributes to the above global malaise.

2. Consumer confidence

This is the big positive in the global economy: the table below refers to EU member states but trends globally are not bad or better: in the USA consumer confidence stabilised in 2012, dipped at the end of 2013 but then rallied through 2014 and through to summer 2015 by when it had risen close to a 20-year high level. In China confidence has been volatile (often at good levels) for the last 2-3 years while 2013 saw a deterioration followed by a steady recovery through to summer 2015: 85% of Chinese believe their children will have a better future than themselves, whereas this number in the Eurozone lingers at barely 15%; consumer confidence in Russia and Turkey were among the best in the CEEMEA region in recent years but Russian consumer confidence slumped in the first quarter of 2015 to the second worse level since 1998 and Turkish confidence also slipped during 2015 but not steeply.

Consumer confidence indicators

(A high negative number means low confidence)

	Dec 2012	Dec 2013	Dec 2014	June 2015
Eurozone	-26	-15	-12	-6
Czech Republic	-24	-12	+0.3	+3
Germany	-10	-2	-2	+3
Greece	-72	-66	-50	-47
France	-27	-26	-22	-18
Hungary	-47	-22	-19	-25
Poland	-31	-23	-15	-12
Romania	-32	-35	-20	-16
Sweden	0	+17	+13	+11
UK	-17	-2	+2	+5

3. Austerity programs

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

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 177% last year (2014) 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 many others.

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

China and Turkey have grown because they ignored austerity; the US has survived reasonably well because it created a reasonable stimulus and only flirted suicidal with the "fiscal cliff" for a short period. The US economy is the world's biggest example of how you grow your way out of recession with a little bit if stimulus, ignoring austerity and making your banks do their job. In recent years the UK performed best when the British Chancellor eased off on austerity (and didn't tell anyone). One reason why the CEE region is doing better now is because several new governments also eased off on austerity.

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

We have argued for several years that a mono-fixation on austerity programs would never work and have been proven correct. These programs have failed in terms of growth but also by their own criteria of reducing debt. Austerity across Europe cut growth and raised debt levels. 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.

Drahgi seeking a QE program while Germany this year aims for a balanced budget at 0.0% depicts the schizophrenia of the poor Eurozone. What a mess!

Eurozone austerity has left most of the continent with tepid growth over the last 5-6 years (now rising more to outside factors) and with 11% unemployment, 25% youth unemployment and youth unemployment in the peripheral markets at 50-70%.

No growth, no jobs and higher debt.

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 and also been reflected broadly in M&A activity. 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 at dinner in Vienna:

> Danny, regarding 2015 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.

Estimates for global corporate investment in 2014 suggest that globally investment was flat or more likely fell after a -1% drop in 2013. Capex by emerging market (EM) companies fell -4% in 2013 and was set to repeat that performance in 2014 with a worsening trend in the final months of 2014 as oil and commodity prices collapsed. Much of the global slowdown in corporate investment is taking place in the energy and mining sectors and among some of the big spenders in Russia, China, India and Brazil. Such BRIC and EM commodity firms account for at least 20% of total global corporate spending, so when they are down, so too are global figures.

However, outside these BRIC markets and the energy and mining sector, trends are marginally more upbeat with business investment rising in the US this year by 3.0% and set to form part of the sustained recovery in 2016 at 3.6%. Fixed investment in the Eurozone was -3% in 2013, close to flat last year and will reach about +1.5% in 2015 and then trend at about 2% in the next 2-3 years. Fixed investment in the Eurozone is still -15% on its pre-crisis level.

It is now well publicised though that with the oil price collapse energy companies including the big majors but also hundreds of fracking firms in the USA and Canada will curtail or postpone capex spending in 2015. Amounts of reduced spending up to $1 trillion have been mentioned and of course if this does transpire, then global capex will be in for a very tough year and the above figures could prove best case.

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.

Economists were hoping that a bounce-back in global trade in 2014-15 would signal that the global recovery was finally escaping the effects of the 2008-09 recessions but as with other indicators, this is now called into question.

	Global trade trends (growth/decline)
Pre-crisis 2005-08	+5-9%
2009	-12%
2010-2011	+10%
2011-2013	+2% to -1%
2014-2016	+4-6%

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”.

6. Emerging market exchange rates

The US dollar is king and has risen sharply over the last 18 months versus nearly all currencies globally. Some steady dollar appreciation is still taking place. But the world is waiting to see what happens when US interest rates are finally raised at the turn of 2015-16 (or just perhaps earlier).

The EMEA President of a major drinks company told me in London last year that:

> On one level you can forget business and consumer trends: my results have been so distorted and hurt by FX fluctuations that we have really been rocked and budgets wiped out. Of course we do look at the underlying business and sales in local currencies but if the FX is against you for extended periods, it starts to sound like excuses to the Board, even though it is certainly not.

Selected currencies versus the US dollar

	Jan 2013	Jan 2014	Jan 2015	June 2015
Indian rupee	55.0	61.8	63.4	63.1
Russian rouble	30.2	32.9	62.7	55.9
Turkish lira	1.76	2.23	2.32	2.69
Brazilian real	2.0	2.4	2.7	3.13
South African rand	8.6	10.8	11.7	12.3
Mexican peso	12.8	13.1	14.9	15.7
Indonesian rupiah	9.6	12.1	12.65	13.33

EM currencies collapsed from spring 2013 and then stabilised temporarily in spring 2014 before drifting downgrades against the dollar again through 2014 and this year. But EM currencies still look wobbly as oil price volatility and future rising US interest rates will probably be destabilisers. One would presume that the financial markets had factored in upcoming US interest rate increases but some degree of at least mild turmoil can be expected when the rates eventually tick upwards probably at the end of the year.

7. Rising geopolitical uncertainty

For Europeans especially, the debacle over Greece, the war conducted in eastern Ukraine are sharp reminders of the fragility of the European model which served generations well from 1945 to about 1975 (“The Glorious 30 Years” according to the French phrase).

Meanwhile in Middle East blood bath only becomes more horrific and bloody with the evil perpetrated by fanatics belonging to ISIS, all of which stems from the destabilisation in Syria which has its root cause in the rupture of Iraq. The Arab Spring has turned into the Arab Winter. The fanatics of ISIS are trying to take the world back to 700 AD with its theatrical butchery and denial of the Renaissance and Enlightenment. The Shia/Sunni 1,000 years’ war continues at full pace with religious slaughter at full throttle. The alienation between Sunni Saudi Arabia and Shiite Iran is the fundamental bedrock of conflict in the Middle East today.

Israel and the Palestinians continue their 100 years' war, which started in 1948 (we are entering year 67) as the conflict and misery shows no sign of abating. Iraq, Libya and Syria will presumably never function again as unitary states within their former borders.

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.

Global economic outlook

Real GDP growth (%)

	2013	2014	2015	2016	2017	2018	2019
Global (PPP)	2.9	3.4	3.2	3.5	3.8	3.9	4.0
USA	2.0	2.4	2.5	2.8	2.7	2.8	2.9
China	7.7	7.4	6.8	6.8	6.7	6.5	6.4
Eurozone	-0.4	0.9	1.6	1.7	1.6	1.8	1.9
Germany	0.5	1.6	1.7	1.9	1.8	1.9	2.0
France	0.2	0.4	1.4	1.6	1.6	1.7	1.8
Italy	-1.7	-0.4	0.8	1.4	1.5	1.4	1.6
Spain	-1.2	1.3	2.8	2.7	2.9	3.0	2.7
Greece	-4.2	0.7	-2.0	0.0	1.8	2.3	2.5
Russia	1.3	0.4	-3.5	0.8	1.8	2.6	2.9
CEE (core)	0.9	3.0	3.4	3.3	3.0	3.2	3.0
India	4.7	5.6	7.0	7.7	7.8	7.8	7.9
Brazil	2.5	0.1	-1.4	0.5	2.3	2.6	2.9
Mexico	1.1	2.3	2.5	3.5	4.2	4.4	4.3
Turkey	4.0	2.9	2.8	3.3	3.6	3.7	3.9
South Africa	1.9	1.5	1.4	1.9	2.2	2.8	3.1

Source: CEEMEA Business Group

The US 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.

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 start the economic recovery and to prevent 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 brought US interest rates down and told the business community that they would stay down for a very long time: eventually this spurred US corporate investment which has been relatively stronger than in other developed economies. Bernanke was rightly confident that underlying inflation threats were limited and even as the US grows at 2-3% now, inflation is still tame. He also understood that bond yields would not surge upwards (and in fact US and German yields have experienced close to record low levels).
4) And of course shale gas has changed the US and global economic picture. Investment and spending on shale gas and ancillary sectors have created at least one million jobs; some 20% of total US investment in recent years has been directed at the shale/fracking industry. The consequence of cheaper oil price means that US consumers will now benefit from more disposable income.

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 2.5% to 3.0%.

Part of the explanation is that sadly the US has tended to shoot itself in the foot over the last 5-7 years. Ben Bernanke succeeded in saving the US despite itself. Bernanke engaged in three sets of QE because fiscal policy and government spending were not pulling their weight.

Restrictive, austerity orientated programs subtracted one percentage point off US GDP growth in each year of 2011, 2012 and 2013.

And sadly, the USA does not have a functioning political system. The Republican Party was taken to the edge by the so-called Tea Party constituency. The republican majority in Congress (and now the Senate) was determined to prevent effective legislation. There is evidence: the last, out-going Congress was 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 Hilary Clinton wins the White House in 2018 and the republicans control the Congress (a possible scenario), then savage gridlock could continue for at least another 4 years to 2022 leaving the USA without a properly functioning system for at least 12 years. Again the lost opportunities and benefits that could have accrued to the economy are immense.

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.

The US has grown itself out of recession.

The USA grew at 2.4% last year and expectations at the start of 2015 were for about 3% GDP growth this year. But this year, as with 2014, started with a very weak first quarter, which means we have now downgraded this year to 2.5% growth with some possible upside. Much will depend on how the USA can expand with so many external headwinds from a weak Eurozone, a soft Japanese growth outlook and a slowing China. It will benefit massively from being more self-reliant on energy and lower domestic energy prices will benefit consumers gaining windfall extra consumption in 2015: but consumers did not take up spending for the first 4 months of the year but then did so in May when core retail sales increased by 5%. Inflation grew by 1.3% last year but will only rise by 0.5% this year ticking back up to 1.4% in 2016 and always below the Fed's official target of 2%.

There are at least 3 restraints on the outlook:

1. Fixed investment overall could waver as major energy, mining and other commodity companies cut back on investments. Best-case is for investment to rise by 2.5% to 3% this year depending on those sectors; worst case would be growth of about 1.25%.
2. Consumers are getting more confident but it was telling that they held back on consumption in the first quarter despite the oil windfall from lower energy prices, falling prices and rising incomes (hourly pay in the first quarter rose by a solid 3.3%). But this shows that while officially unemployment is down to a good figure of 5.4%, many new jobs are insecure, part-time, self-employed and/or poor paid
3. US corporate profits are being hit by the strong dollar. Such profits fell in Q1 this year by 6% or $125bn. Many major US MNCs gain 40% or more of sales and profits from abroad and/or in emerging markets and the strong dollar and softer emerging markets prove a double whammy.

After the very poor first quarter which once again was weather related in part, by May most indicators had turned to the better including retail sales, housing starts, capital goods production, shipments and business surveys.

Confidence is back also as companies issued $610bn of debt to June this year, which is $40bn up on the same period last year. Consumers have delivered and total household debt is 107% of disposable income with annual repayments taking up less than 10% of disposable income. So when consumers choose to, then can spend.

US Consumer confidence indicator

1985 to 1991	=	95	2009-2013	=	60-80
1991-1992	=	65-85	2013-1024	=	80-90
1992-1998	=	85-105	Nov 2014	=	97
2000-2008	=	80-100	June 2015	=	96

- Business confidence improved through 2013-14 at a level of 52 to 57 with any number of 50 being good. A slump was recorded in January 2014 due to bad weather but since then and in recent months the figure has hovered around 51-53.
- The manufacturing purchasing managers' index was steady averaging 52 in 2012-13 and then soared through 2013 and 2014 to 56-58 and has stabilised this year at 53-54: good numbers reflecting the upward trend in growth despite the pressure on corporate profits from the strong dollar.
- The housing price index at 177 in June is back to its January 2008 level but down on the January 2006 level of 202.

The Eurozone outlook

The Eurozone looks in better shape than it has done for more than 5 years. This is good news. But the recovery is very mild and could be based on transitory factors. The fundamentals may not be better; polices may still be bad for growth and social cohesion, and then there is Greece.

The Eurozone has climbed out of its 2013 recession of -0.4% to grow at a meagre 0.9% in 2014 and we think it could rally to 1.5 to 1.7% range in 2015. But the outlook is for another 3-5 years of sub-par growth below 2% ensuring a 12-15 year period of recession and sub-par growth in the region since the crisis began. Briefly in 2014 to about May of that year, things were looking marginally better but the CEO of Siemens was extremely accurate when he commented against the mood at that time that:

> Europe looks better than it is.

But after 5 failed years of retrenchment and weak growth, things look better for 4 main reasons:

1. The low oil price means that consumers have more disposable income and are slowly starting to spend it.
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.
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.
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 with 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 never.

The trouble is that many of these positive effects could flow out of the annual figures quite soon:

- The oil price has crept up from its low of $50 per barrel and unless it falls further in the coming months, then the base effect of low oil on inflation will drift out of the figures by the end of the year.
- As oil prices stabilise, then inflation could creep upwards slowly but that would have negative effect on real wages and therefore on consumer spending.
- Germany and the EU continue with their austerity packages with Germany aiming for fiscal zero balance this year.
- And then there is always Greece.

Fixed investment is still -15% on its 2008 level and Europe has never really got back into investment mode and Germany is a big culprit here (see below). Capacity utilisation in the region is still only 80% but likely to rise this year. M&A activity has picked up a bit globally this year but the numbers for the Eurozone show the mild nature of any recovery:

Eurozone M&A activity per annum during periods

2006-08	=	160bn Euros per annum
2009-13	=	74bn Euros per annum
2014-15	=	95bn Euros per annum

But the above positive factors are helping retail sales increase proving positive at the start of 2014 and recording their best growth figures of 2-3% this spring in 5-7 years.

- Business surveys are the strongest in 4 years.
- Business activity is increasing at the fastest rate since May 2011.
- Car registrations rose in recent months for the first time in two years and a rally in the automotive sector is benefiting many suppliers.
- 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 percentage of GDP from 24% in 2009 to 32% at end of 2014.

The Eurozone pulled out of deflation in early spring this year but prices are barely rising at 0.2% in June after deflationary numbers through the first quarter of the year. As ever though the ECB until Draghi introduced quantitative easing has been fighting a non-inflation dragon: inflation this year in the Eurozone will barely average 0.4%. Austerity programs have been too long and too deep. Even today when the Eurozone needs Germany to spend its way and the continent out of trouble, the German government is aiming for a zero budget balance: unnecessary and selfish to its European neighbours.

Unemployment will stay stuck above 11% this year but the breakdown is more devastating: youth unemployment in many economies is elevated at 20-25% and in the peripheral markets official youth unemployment is 50-60%. But when one strips out training schemes, mini-jobs and other sleight of hands, real youth unemployment is as high as 65-75%.

Counter to the above two positives is that the strictures of the Eurozone self-imposed fiscal rules will probably kick in further in 2016. Under these rules Germany's "stimulus package" will amount to 0.1% of GDP starting only in 2016 as it aims for a balanced budget this year. Eurozone deleveraging still has some way to go: private sector debt was 226% of GDP in 2009 and was still 220% in 2013.

Germany is often promoted as the model to follow but the German experience and occasional positive results have been driven by labour wage competitiveness thereby stimulating exports to other European partners and emerging markets. But the German model is a bad model when one wants to stimulate domestic demand and investment. Rather shockingly, Germany is a bad investor: there is an "investment gap" of some 80bn Euros; negative investment has occurred in 7 out of 8 manufacturing sectors since 2010 and most shockingly of all:

> Germany's investment rate in 2013 was the 4th lowest in the whole EU!

Germany is a good exporter but not everyone can be a surplus exporter; someone has to import. Private consumption has crept up to just over 1% growth in recent years but was stuck for many years at zero levels. Real wages are poor and mini-jobs dominate the labour market but official unemployment at 5.0% looks good and is half the Eurozone average. We do not argue against the fact that Germany has performed relatively well but we do stress it should not be the economic model for the region; it is rather an exception.

China outlook

China: historical, current and future

We knew that China was aiming for an economic slowdown and restructuring of its economy and here we are. China will enter the third year of a policy-driven deceleration in 2015. It's definitely part of the new normal.

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.

Currently Chinese GDP growth is at a 24-year low level. The stock market has collapsed 30% in the last month (after rising 130% in the year prior). But perhaps more worrying at the moment is that the Chinese government has "thrown everything" at the stock market collapse but for a couple of weeks was unable to prevent the collapse. It is very odd for the Chinese government to be unable to "fix anything".

Over the last 3-4 years the authorities and Central bank have been able to do just that and managed the planned deceleration of the economy away from excessive dependence on export and fixed investments as the plan to generate more domestic demand and consumer spending. One means to achieve this is to ensure that the population feels more confident about health and education provision and then they will feel free to spend on other consumer items. Until now China is a nation of savers and high investment combined with high savings rate of 40% means of course that China is a creditor nation.

The turnaround of the Chinese economy (like one of those immense cargo ships in the ocean) has started and the proportion of consumer spending has ticked up while the regular over-investment is decelerating and the savings ratio has stopped rising. But in the recent mini-crises regarding slowing growth, the authorities have also turned to the well-tried ways of boosting investment and promoting more in the housing sector. It is taking more investment to generate a unit of growth but if all else fails, the authorities find themselves forced to push that investment.

The authorities and Central bank have also resorted to standard tools for combatting any excessive downward dips in growth: in the first 5 months of 2015 the Ministry of Finance doubled the quota of local debt swaps with more liquidity injected into the system (260bn renminbi) and lending rates cut from 4.3% last autumn to 3.1% today.

Another major feature of the Chinese economy is that trade is falling sharply as China focuses less on exports, shifts its supply chains and decides to produce more at home. This is having a sharp impact on trade globally and especially in South-East Asia which is the main supplier base for China. The trade surplus has shot up by some 180% in the first 5 months of this year as the volume of imports slows and as the price of energy imports sinks on a lower oil price.

As we noted above, China is the biggest economy in the world today! This is at ppp calculations and 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 24%, 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 17% of the global total by 2020.

As a rule of thumb, 2-3 years ago most economic indicators were increasing 8-9% per annum whereas today most of these are climbing by "only" 7-8%.

- Retail sales are still buoyant at 10% in May-June compared with 12% rises in recent years
- Consumer confidence at 107 is above the 5-year average of 105 for this indictor (we will see if the stock market collapse weakens this upbeat mood)
- As we note below and in general, low inflation means that real wages are strong and keeping retail sales in double-digit growth
- While industrial output is much weaker than the trend at 6% this summer (compared with 10% in 2012-13 and 14% increases in 2010-12), manufacturing PMI is still above 50 and better than the Q1 figure which dipped below that number (the figure 50 is seen as the dividing line between good or poor growth outlook).

It also seems the economy is trying to innovate but how successfully with real value is unsure: in May this year year-on-year output of new energy vehicles, industrial robots and servers spiked by 280%, 125% and 100 respectively. In the first 5 months of the year on-line shopping jumped 38%.

All Chinese indicators, while dipping downwards, remain relatively, and in fact in absolute terms, still strong. But for western investors business results have been softening for several years and when the No 1 global growth market decelerates then companies feel the pain quickly. Unilever and other consumer product companies are seeing their organic sales decrease to levels of 2-3% compared with 8-15% in recent years. This is a sharp and rapid slowdown in such a priority market. The anti-corruption drive has severely impaired sales for luxury goods companies although we imagine that purchases abroad by Chinese tourists ($300bn per annum Chinese total consumer spending abroad in 2013) are probably still resilient.

	2002-13	2013	2014	2015-20
GDP	10.4	7.7	7.3	6.7
Consumer spending	8.9	8.2	7.5	6.8
Fixed investment	12.2	8.1	7.4	6.0
Manufacturing output	12.4	7.5	6.6	6.0
Construction	12.8	7.3	5.7	4.5

The authorities will also need to keep their eye very focused on the productivity slowdown and they have been able to push this indicator up by 11% since 2007 but greater automation will help. Property, construction and heavy industry and their suppliers will face the greatest strains in the next 5 years and the key question will be whether the Chinese consumer can keep the overall economy 'ticking along". The good news is that falling inflation means that real wages are still rising at 8-9%, which is probably the fastest level in the world today. On balance we remain convinced that the policy goals will be achieved without a crash but risks have risen over the last year.

GDP growth will average around 6.7% for the next 6-7 years on a declining trend and household consumption will tick along at about 6.8% with investment slower and construction and manufacturing in the same ballpark. All these numbers will still make the market one of the most appealing in the world. But competition is intense, companies have to adapt their innovation, the Chinese consumer is one of the most demanding and variable in the world:

- Consumers are not brand loyal.
- They 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.
- Profits are tough to come by.

The Central Bank authorities managed the currency in parts of this year to hurt speculators who were making a one-way bet on currency appreciation: the renminbi fell from 6.05 to the US dollar in January 2014 to 6.20 at the end of that year but was still stable at this level in May 2015. We think that a mild appreciation over the medium-term is the Central Bank's goal. But given the recent surge in the US dollar, stability with the greenback may be sufficient and so we see the currency hovering round 6.3 to the dollar for 2-3 years.

Over-investment generally and in the housing/construction sector remains a serious threat as does the credit expansion in the grey financing sector: this latter is probably the biggest current concern in our opinion. China already accounts for half of all capital-intensive production in the world. Corporate debt is a major challenge and in those sectors under pressure we anticipate further consolidations.

There are many features to consider about the Chinese economy

- The country is in the midst of the largest monetary expansion in history and the M2 supply has tripled in the last 6 years and of course this has aided and bolstered GDP in that period.
- 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.
- In 2012 the proportion of Chinese living in urban areas at 51% exceeded those living in rural areas for the first time in 6,000 years. Remarkably and almost shockingly, just 3-4 years later this proportion has risen to 54% of the population.
- In 2011 the rate of increase in rural wages exceeded the rate of urban wages for the first time since 1996.

- Those in the middle class (defined as households over $20,000 will grow from 11% of the population in 2012 to 22% of by 2022. The rise of the middle class and urbanisation are two massive shifts on going in China that will stabilise and buttress western sales.

The Chinese economy and government policy are also cushioned by a number of positive factors:

1. Chinese FX reserves, after peaking above $4.0 trillion last year (sufficient to buy almost all the Fortune 500 companies in the USA) have dipped to a mere $3.7 trillion in March this year and capital inflows remain strong. This is due to shifts in the trade balance and current account as well as in currency management with the long-term renminbi appreciation coming to an end last year and with some capital flight actually being witnessed.
2. Importantly, inflation has fallen from 4.2% in late 2011 to 1.2% in June 2015 and we expect inflation to bobble around 2% to 2.3% in the next 2-3 years. Weaker inflation permits the government to engage in further stimulus when required.
3. The budget deficit is nicely under control at -2.5%: the government can still turn on the spending taps when it wants and did so this spring/summer.
4. The current account surplus is unsurprisingly positive at 2.0% to 2.5% as both exports and imports soften together.
5. Bank credit growth is steady at 11-12%.
6. Retail sales are solid at 10-11% range.
7. Consumer spending growth overall is one of the fastest in the world at 7.0%.

Summary: a hugely challenging market with many commercial pressures but the bedrock of Asian growth and with the USA one of two global economic pillars.

India outlook

India: historical, current and future

	2002-13	2013	2014	2015-20
GDP	7.6	4.7	5.6	7.5
Consumer spending	7.1	4.9	4.8	6.9
Fixed investment	11	1.0	1.2	7.2
Manufacturing output	7.8	0.3	1.0	8.5
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. Recent figures are also somewhat confusing and could be due to the authorities wanting to get bit of growth inflation: newly released figures for Q1 suggest growth jumped by 7.5% and that full year growth in 2014 was 7.1%. Both numbers feel inflated given that broad industrial numbers rose only 3.4% in Q1 this year after full growth of 1.8% in 2014.

Some commentators therefore think that growth this year will be closer to 6.8% rather than the consensus of 7.8% for 2015 and a similar number for 2016. Currently India is growing faster than China for the first time in decades. There were some concerns over this year's monsoon but rains in recent weeks improved and with better consumer spending, GDP ought to be able to rise at least in a range of 6.8% to 7.8% in 2015-16.

The current growth rally is based on some modest pickup in investment up 4.6% in Q1 with personal consumption not much changed at the turn of the year at about 6.4% (with room for much more). But the overall mood is rising on the back of some key macro-economic improvements:

- The lower energy price is helping the trade balance and the current account (the latter deficit narrowed from 1.7% in 2014 to a current 1.4%. The current account deficit already tumbled in 2013 from 4.7% to 1.7% as gold imports were restrained.

- Last year thanks to Reserve Bank policies and falling food and energy prices, inflation slumped from a recent peak of 11% to 4.4% last November and is ticking along at 5.1% in May. This compares with an average of 10-12% through 2010-14.
- We expect key interest rates to remain at relatively low levels of 6.75% to 7% over the next 15 months with some small positive risk.
- The budget deficit has also declined from 4.4% last year to a current 4.0%.
- The monsoon still plays a key role in economic development as 17% of GDP stems from this sector while it accounts for 50% of employment with food accounting for 45% of the inflation basket.
- Consumer confidence is close to a 5-year high but also not much better than in 2011.
- Business confidence slumped in 2012-14 on the back of ineffective Congress polices and as Indian companies declined to invest locally and preferred spending abroad. But the business confidence indicator is back up to a level of 56 which is lower than boom years of 2006-12 but better than the average of the last 2-3 years, so some improvement.
- This is supported a bit by the same trend in industrial output that is currently rising by 4% which is at the higher end of the last 4 year average.
- We think domestic and international developments will keep the rupee close to existing level of about 62-65 to the US dollar with some slight downside risk as US rates rise.

More focus will be directed at the investment side of the economy in the next few years and relatively less on consumption, which has survived better recently. Red tape and legislation needs to be cleared to free up frozen infrastructure projects currently worth $300bn. This would be a quick fix with mid-term positive impacts. Because of this focus we expect investment and construction figures to jump up substantially in the coming years to an almost 7-8% annual average. With maintained and steady growth levels in private consumption at above 6-7% in the coming years, GDP growth will rally close to at least 7% in the next 5 years with some upside risk. Growth in manufacturing in 2012-14 was very weak as firms ran short of capital and suffered problems with balance sheets. Lower interest rates and a pro-business policy ought to turn this around in the coming years. But growth will be held back by obstructionist states, lobbies and high levels of corruption and by soft global trends.

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.

Overall growth will be supported by weaker energy prices, which will help inflation continue its pre-existing decline. As inflation falls consumer confidence will rise and the Reserve Bank of India will also be able to continue its policy of reducing interest rates that in turn will buttress investment and construction, which in turn will help the job market. So quite a nice, positive cycle of factors inter-playing.

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. 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.**

6 July 2015

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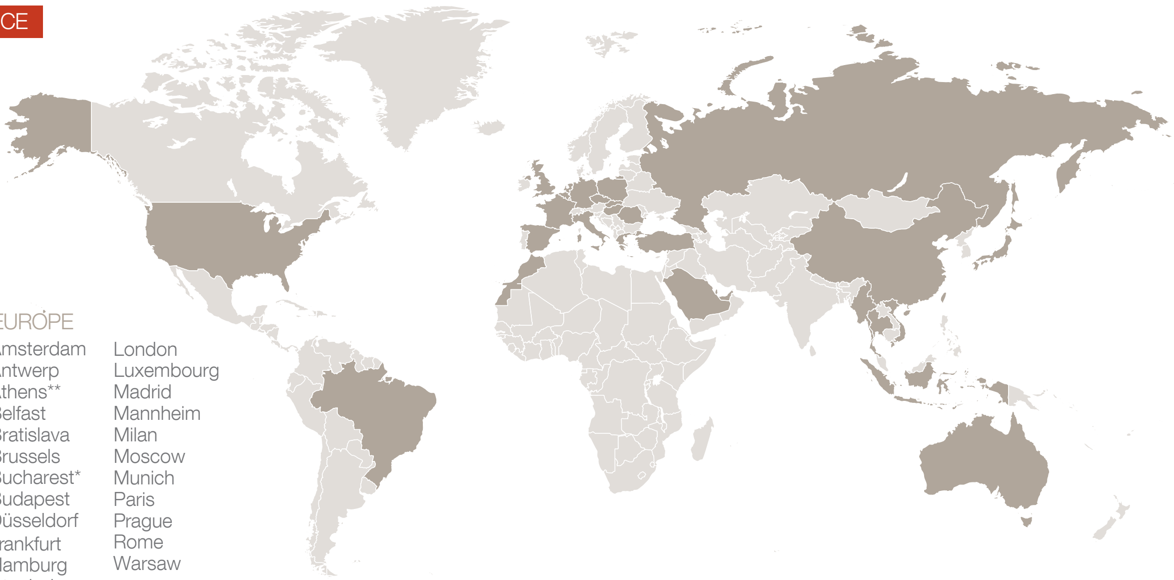

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EXCELLENCE IN EXECUTIVE SEARCH, TALENT RECRUITMENT AND HUMAN CAPITAL MATTERS

CROSS-BORDER MINDSET WITH A STRONG LOCAL PRESENCE IN D-A-CH, RUSSIA & CIS, CENTRAL EUROPE AND SOUTHEAST EUROPE

PASSION FOR PROFESSION AND RELATIONSHIPS

We thank you for your continuing partnership and support and we will be in touch soon!

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