CEEMEA Business Group

Global Business Outlook 2016-2020

It doesn't feel so good, does it?

by Dr. Daniel Thorniley

President, DT-Global Business Consulting

danielthorniley@dt-gbc.com

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About the author

Dr Daniel Thorniley
President, DT Global Business Consulting
Co-Founder, CEEMEA Business Group

DanielThorniley@dt-gbc.com

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

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

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

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

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

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

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

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

Content

DT-Global Business Consulting GmbH, Address: Keinergasse 8/33, 1030 Vienna, Austria,
Company registration: FN 331137t
and GSA Global Success Advisors GmbH, Hoffeldstraße 5, 2522 Oberwaltersdorf, Austria
Company registration: FN 331082k

Contact: Dr Daniel Thorniley, President, DT Global Business Consulting GmbH
E: danielthorniley@dt-gbc.com / www.ceemeabusinessgroup.com

Introduction

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

- The start of 2016 has been the worst financial one for 20 or 55 year depending on definition.
- There is a small but growing chance that this year will entail a deep global crisis: the sense of fragility is elevated.
- If this is the start of 2016, then roll on 2017!
- When China sneezes, the world catches a cold.
- The stock market and economic turmoil in China is the catalyst to the current mayhem in the markets
- Last year China became the largest economy in the world on a PPP basis but no one in the world, including the Chinese government, knows the real size of the economy.
- And everyone is shadow-boxing with the Chinese the growth rate: officially and in IMF statistics it is down from 9-10% in recent years and in 2015 was running at 6.9%.
- But the private western consensus view is that the economy is growing in arrange of 4.2% to 5.5% based on electricity consumption and cargo transportation indicators etc.
- Some commentators put Chinese growth currently at 2.5% but this looks extreme.

But it's not just about China.

- The economic and business crisis has turned CHRONIC and embedded and our executive quotations below substantiate this.
- There is a deep global malaise and this is reflected in global surveys.
- The Global Happiness Indicator (not exactly the same as consumer confidence) is at its lowest level since 1989 when people expected the world to improve with the end of the Cold War. It was the "End of History", liberal democracy had won.
- A bell-weather company like Caterpillar has reported 4 years of falling sales for the first time in the company's 90-year history.
- The global economy and business sector have never fully recovered from the 2008-09 financial collapse
- 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.
- Institutions and governments responded poorly to the crisis and its after-effects: mismanagement and flawed policies (intense austerity) hurt the global economy and consumers more than necessary.
- Governments globally and especially in the western world were too frightened or incompetent or corrupt to reshape the financial sector and to eliminate the deep structural flaw in that sector: "too-big-to fail", "too-big- to-jail".
- Tens of millions of people have lost full-employment and been dumped into self-employment and the so-called gig economy" where they act as out-sourced independent contractors.
- This trend explains the underlying insecurity of the many younger (and older) generations in western developed societies: a new "precariat" has been created which undermines consumer confidence.
- Little wonder that consumers globally and especially in developed markets are reluctant to splash out on expensive, branded consumer goods.
- The fact that the global consumer has never recovered properly from the 2009 crash also explains why most FMCG and retailers have been disappointed by the relatively muted reaction in 2015 to the supposed $400bn consumer windfall to consumers stemming from lower oil prices.

Executive summary

Global economy

- The global economy and global business have never properly recovered from the 2009 financial crash.
- The current miserable financial start to 2016 underlines this: markets feel insecure and will panic at the slightest cause.
- The superficial news coming out of China: stocks falling and a depreciating renminbi are not exceptional but the underlying structure of the Chinese economy and the lack of transparency about growth levels are the bigger concerns.
- At the start of each the last 5 years, the consensus view has always been that the global economy would accelerate in any given year, but this has been followed every year by 3-4 growth downgrades. Every one of the last 5 years started with elevated hopes and expectations only to end in disappointment and frustration.
- In our own analysis for this year, we intend to learn from experience and do not forecast any global growth acceleration in 2016 (against the trend consensus). Indeed, there is a growing risk of a growth deceleration in 2016 which is underlined by the frenetic start to this year.
- Like all international organisations, we will play the game of quoting official GDP growth numbers for China at around 6.5% but we will provide editorial qualifications.
- Two words sum up much of the global situation: chronic and malaise.
- The business crisis has turned into a chronic one and does not look like changing for another 3-5 years.
- 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 2009-2015 recession/sub-par growth period has been the longest and deepest since 1933.
- 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 and scattered and does not feel sustainable.
- 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 required 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 a low oil price, a 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.

Interest rates and inflation

- Interest rates will remain very low and close to zero for most major economies (Eurozone, Japan and the UK and UK rates have been for the last 5 years the lowest since 1689!).
- US rates rose, as we predicted, in December 2015 but only by a tiny amount from a very low (almost zero) base. We expect US rates ranging about 0.7% towards the end of 2016 and at about 1.25% in 2017.
- 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 currencies, but in so doing will probably curb GDP growth, which for many is already below-par.
- Eurozone rates will remain effectively at zero for the next 3 years as quantitative easing is maintained and increased; Japanese rates will be barely higher at 0.1% for the next few years reaching 1% only in 2020. This should clearly entail a strong US dollar especially as the oil price falls.
- Global inflation has been remarkably low in the last 3-4 years as we predicted. The consensus is for an inflation pick-up in the next 2-3 years and while we concur with the direction, we doubt that inflation in the developed markets will rise as quickly as from 0.3% last year to 1.5% in 2016. We see a more subdued inflation pick-up mostly due to prices creeping upwards in the US and one or two emerging markets. But the two big drivers for low global inflation will not disappear soon: weak oil/commodity prices and low wage demand. We see inflation in industrialised economies rising at most by 1.9% only in 2020.

The US Dollar

- It is the presumption of US 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 around an average of 1.04 for the next 2-3 years and could even reach parity for some time.
- As the Eurozone stabilises and Euro rates slowly climb up, then the Euro ought to rally to about 1.10 to the dollar by 2020.
- A rising US dollar and eventually rising interest rates (very slowly) has led to emerging market currency volatility/weakness through 2015-16.
- At the start of 2016 the US dollar stood at an 8-year high to the Euro and the oil price continues to plummet. It also stands at multiple record strong levels versus most other currencies in the world.
- CFOs are already adapting to a strong dollar period at least into 2020.
- The rising dollar will help keep oil prices down as the value of oil and the dollar trend inversely.

Why will oil stay at $33 per barrel or why it will rise to $50?

(for our full oil price analysis, see appendix below)

We see oil fluctuating at an average of $40-47 per barrel this year but below we outline why the price could stay at $33 or even less or why it could rise to $50.

The $33 scenario

1) News out of China continues to disappoint.
2) Weak Chinese numbers and disappointing ones globally mean less demand for energy.
3) As sanctions are eased, Iranian oil starts flowing into the market during 2016-2017.
4) Saudi Arabia continues with its persistence to damage other suppliers (particularly Iran) and US shale producers and to capture more markets share by keeping the price low via maintained production. News coming out of Saudi Arabia suggests this is the case as the authorities prepare for more cutbacks and austerity measures.
5) OPEC remains a busted organization.
6) US shale producers do not disappear and prove more resilient, productive and sustainable than the Saudis imagined.
7) The markets are panicked and speculative: 20-25% of the total drop in price is due to short-selling and pure speculation.

Based on these factors the consensus for the oil prices declines from $40-50 to $30-35 per barrel.

Why $50 scenario?

1) Any good new coming out of China.
2) While the markets are spooked at the moment, they will grab hold of any tiny good news to spike the price back up.
3) Increasing tensions in the Middle East; worsening relations between Iran and Saudi Arabia. So political risk could pop the price upwards.
4) But one factor lying behind the upbeat perception on oil is that soon we will arrive at equilibrium: this view argues that energy companies have cut back so much on investment that sometime soon weaker supply will balance fallen demand. Some argue that if this happens and coincides with any political risk or supply-chain blockage (fires at refineries etc.), then the market could panic upwards very quickly.

Emerging markets

- As China wobbles and companies struggle to meet ambitious plans, more headquarters will ask; "Why don't we take a whole fresh look at our global emerging markets". This does not and should not mean massive downsizing or any abandonment of the EMs but rather companies may want to re-assess their priorities. China will remain a key global business market for the next 50 years and rank No1 and 2 with the USA for that period. But an increasing number of companies will ask whether they have too many eggs in the China basket and may choose to swap around resources: the CEE region merits closer attention 9see below) as they markets are currently providing strong GDP growth, sophisticated distribution and supply chains, proximity to European markets and a good skilled labour force. Indeed, more companies are investing again in the region and looking to establish out-sourcing facilities.
- Companies may also want to plan for more market share in Russia. While the market looks very strained at the moment, this large volume, large population European market will not go away. Companies still report decent profitability levels. Companies will also want to fix in market share for the long-term.
- But emerging markets will 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 (EMs) are not finished yet!
- In 2003-08 EMs 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 this is still pretty good comparatively.

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

17 Black Swans in 2016-2020

1) China

Economic developments in China are deteriorating. In fact the catalyst for recent, global financial turmoil has been quite minor: the collapse of an unrepresentative stock market from bubble heights and effectively a small devaluation of the renminbi (the renminbi is at a 5-year low but is down only 6% on last August). But more fundamentally commentators in the West and in China are unable to pin down GDP growth trends in the world's largest economy: officially GDP grew in 2015 at 6.9% and the consensus for 2016 is 6.5 % but most commentators in the West put GDP growth in 2015-16 in a range of 4.5% to 5.5% with some pessimists suggesting lower figures. If we don't know the size and growth rate of the world's largest economy, no wonder things are a bit tense! We do not anticipate any economic implosion in China: the Chinese authorities (who have not covered themselves in glory in the last 9 months) have the financial firepower of $3.3 trillion to bolster the economy and they have the political will to prevent an implosion which could increase political risk. But growth is going to trend at lower levels: officially 5.5% to 6.5% in 2016-2020 and unofficially at about an annual average of 4.5% to 5.0%.

2) The oil price (at a 12-year low) and the commodity cycle

If oil continues to plunge to $25 or $15 per barrel, this certainly will help global consumers eventually, although they have failed to sparkle in 2015 and spent relatively little of the $400bn oil bonanza. But extreme low commodity prices would destablise global economies creating winners and losers and among the latter would be some emerging markets, energy companies, and those operating in fixed investment and infrastructure. The effects of weak commodity prices are mixed but resultant uncertainties could lead to more financial turmoil.

3) Emerging markets (EMs)

EMs have come under downward pressure to their currencies as US interest rates rise and the dollar powers ahead. More attention has been paid to rising corporate debt in emerging markets and they have certainly gone off the boil. But as we argue below, over the medium-term emerging markets ought and will have to play an important role in all corporate strategies.

4) International migration

This is especially disruptive at many levels in Europe (see box below). We are experiencing the greatest mass global migration since 1945. Human movements into Europe are manifestly out of control and the ineptitude of European governments is again brought into focus. The consequences will be economic, social-cultural and political. This is just the start of the story. Will Europe face a "New Paradigm": entailing the implosion of Schengen, preventative detention to confine suspected terrorists before the blow up city centres?

5) Schengen agreement

As a consequence of this migration, the European Schengen open borders system is dead or will require major surgery. This is already de facto but European governments and the EU are months behind the curve.

6) Greece is not over

The fat lady has not finished singing. Economic, financial and political trends still look unsustainable fort the country. Another EU multi-billion Euro bail-out is 80% certain (presuming all Eurozone creditors will agree) and Grexit is 50% probable over the next 2-4 years.

7) Brexit

Speaking of Exits, what about Brexit? We think this is only 35% likelihood as voters are still likely to vote for the devil they know sometime in 2016, but the Scottish referendum showed how things can materialise and get scary. Even if Brexit occurs, after months or more than a year of turmoil, we do not think the commercial impacts will be massive: some modus operandi will be discovered. Investors will still want to invest in the UK for its domestic market and the easier tax environment will still attract and retain the financial sector. Supply chains and administrative, duty costs would rise but perhaps only marginally. Brexit would be far from optimal for the UK and Europe but it seems survivable.

8) European and especially Italian banks still represent risk in the next 1-3 years.

9) Volkswagen

VW should weather the storm but the US Justice Department will be out for massive compensation of up to 25-35bn Euros. An eventual settlement should prove smaller but this will hand over VW for years to come.

10) Isis and an imploding Middle East/global terrorism

The terror group Isis has ruptured much of the Middle East and raised tensions across the globe with its ad hoc terror campaigns. While it may be losing battles on the ground now, it appears likely to linger for several years as a threat to societies within the Middle East and the West. Perhaps the worst black swan is if some disreputable arms dealer sells to Isis any nuclear capability or dirty bomb options.

11) Syria and the Arab winter

Tragic events in Syria bear some resemblance to the European 30-Year War (1618-1648) encompassing religious and sectarian conflict with outside intervention. Sadly the time frame looks about right. This is all part of the "Arab Spring" morphing into a bleak "Arab Winter". Libya, Syria, Iraq and Yemen are failed states and the first three will probably never function again within their current international borders. The Sykes-Picot border lines drawn in the sand in 1916 are gone.

12) Sunni-Shiite tensions turn hot

Syria coalesces with the 1,000 year conflict between the religious strands within Islam of the Sunni and Shiite. Tensions are elevated between Sunni Saudi Arabia and Shite Iran and the last 5-6 years have seen them fight proxy wars in Iraq, Syria and Yemen.

13) Israel-Palestine

It hardly seems appropriate to mention the Israel-Palestinian conflict, which is in the 68th year (started in 1948) of a probable 100-year war or even 1,000 year conflict, because sadly it seems so much part of normal global background noise.

14) Ukraine and Russia

The hot-military conflict in eastern Ukraine appears to have abated but could always turn nastier to the detriment of the Ukrainian and Russian economies. The middle case scenario is for the region to remain a dysfunctional economic and political cancer damaging everyone in the region.

15) Fundamental flaws in the global economic model

Most western developed markets were ruptured by the 2008-09 financial crash; governments did little to mend the underlying flaws in the financial system: another such bubble-bank crisis can easily happen again in the next 2-5 years—almost nothing has been learned; workers/employees are losing out to capital which means that consumption is always strained while stocks and property have flourished. The figures on temporary youth unemployment are disturbing (see below).

16) Political tensions/extremism/populism

Citizens feel betrayed by their inept governments who do little to protect them from banking rampages, uncontrolled immigration and rising city-centre terrorism and abuse (Paris and Cologne).

17) US President Donald Trump

And if you really want to get worried, conjure in January 2017 with the words: "Please all rise for US President Donald Trump!" ☺

Uncontrolled immigration into Europe: a ticking time bomb

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

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

Two recent comments cause deep concern:

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

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

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

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

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

Certainly the timing of an extra 1.5mn migrant with low skill sets and poor language skills is not good. In the 1960s unemployment was negligible in Germany and Europe when millions of Turks were employed in a booming manufacturing industry. Today Europe is still fundamentally weak despite a current economic flurry based on short-term positives (see below). Overall unemployment has been stuck at over 11% until recent months when it improved to 10.5%; youth unemployment averages 20-25% across the continent with levels of 45-60% in some peripheral countries such as Spain, Italy, Greece, and Portugal. It seems logically and economically improbable that the Eurozone can absorb such numbers of migrants.

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

Some 100,000 migrants have arrived in Austria and a similar figure in Sweden: the countries have respectively populations of 8.5mn and 9.6mn and are absorbing the highest numbers of migrants on a population proportionate basis. And the numbers are not slowing: in the first week of 2016 some 3,000 per day were arriving in Greece in mid- winter (this works out at 80,000 per month in mid-winter). It seems probable that the daily average will spike back to 10,000+ in the spring and summer 2016.

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

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

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

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

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

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

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

As long as the European, US and global consumer remains fearful, discouraged, and frustrated then most western companies will struggle to achieve business traction and a sustainable business recovery. The global economy has undergone so may "new normals" in the last 7 years that nearly all executives appreciate that the "good old days" are now gone for ever

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

Everything is bad, everywhere!

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

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

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.

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

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

The 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.

But it's not all economic/business bad news: the USA is holding up but growing "only" at a trend of 2.5%; the Eurozone is in a sweet spot at the moment for several reason but can only scrape together GDP growth of 1.5%+. But some companies are reporting reasonable results in this these two regions but far from all firms. India is picking up economically but many companies only have a small foot-print in the market. The core CEE region is performing very well economically and this is filtering through into better corporate results. The Cee outlook also looks reasonably sustainable.

Emerging markets still have a lot going for them

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	4.5%	2.1%
2018-2025	5.0%	2.0%

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

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

> "To hell with the emerging markets. They're under-performing, not meeting expectations, sucking out too much time and resources. Let's ratchet down investments and pull back and invest and focus on our growing market: the good old' 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 need to be more targeted and precise in finding growth in key emerging markets.

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

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

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

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

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

Why are the emerging markets (EMs) slowing?

1. China continues to struggle with a transition to a more market driven economy less dependent on export and investment and with more focus on driving consumer spending by boosting investment into educational and health sectors. But transforming the largest global economy when the global economic environment is still extremely stressed is proving harder than originally anticipated 1-2 years ago. The Chinese authorities have not been shown in their best light in recent months and have both mishandled the deflating of a stock market bubble and a liberalisation/devaluation of the renminbi. The actual devaluation to date over the last 6 months has only been 6% even though this was sufficient to cause the current turmoil and market angst. But as noted above, global markets are becoming increasingly frustrated with the opaque nature of Chinese statistics: how can you invest in Chinese assets when you don’t know the size of the economy or its real growth rate? China looks set to report official growth of 6.0% on average over the next 3-4 years but the western consensus for “real” GDP growth is significantly lower i.e. a range of 4.5% to 5.5%.
2. The slowdown in China is affecting global supply chains and reducing growth levels across much of south-eat Asia.
3. But despite this, Asia-Pacific overall should see GDP growth of 4.6% in 2016; similar to that of 2015 and only slightly down on the 4.8% reported in 2014.
4. The Chinese slowdown is part of the reason that energy and commodity prices have slumped and this has dampened growth rates in nearly all commodity-producing countries.
5. For example, Brazil will be in recession this year mainly because of softer exports of commodities and food products to China and other EMs but also due to slumping domestic demand, high inflation and undermined confidence in the wake of a string of corruption scandals. The Brazilian recession will continue into 2016 and ensure that Latin American economies will decline overall in both 2015 and 2016 as Venezuela and Argentina exacerbate the situation.
6. US interest rate policy has had a massive impact on EM currency and economic stability since the “taper tantrum” of spring 2013. Hopefully some of this impact will diminish as rates ticking up in 2016 become more normalised.
7. The US economic recovery is making it look like a good location for foreign direct investment and capital flows are being diverted back to the US or the UK or even parts of the EU.
8. Specific factors have also taken the shine off some of the markets with of course the military conflict in Ukraine which has devastated the Ukrainian economy and damaged that of Russia and prompted western sanctions and caused deterioration in sentiment towards Eastern Europe (although core CEE markets are flourishing—see below).

9. The Middle East region's political outlook darkens with each year and now that Saudi Arabia has engaged in a series of sweeping spending cuts and new borrowing/fiscal policies, the big Saudi market is much less appealing than 12-18 months ago. Many companies have thus invested heavily anticipating continued strong demand; increasingly Dubai/UAE appears the hottest market in the MEA region.
10. MEA Problems have been exacerbated with Sub-Sahara Africa continuing to cool in the wake of falling commodity prices and with South Africa and Nigerian growth weakening or staying well below-par.

So those are the factors that got us here.

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

1. The numbers below show that economic catch-up is still happening albeit at a lower rate.
2. The middle class and lower middle class will continue to rise as a proportion of EM and global population, again at a slower rate than between 2002-08 and 2010-13 but the trend will persist.
3. Even on current lower growth rates, it's excepted that 220mn people will join the Chines middle class by 2026.
4. The markets offer openings for affordable innovation; companies cannot rely solely on the premium brand "game" any more and have to be diversified.
5. Having said that, many EM markets are hot spots for luxury goods and premium brands (yet again at much lower rates of expansion than recently; for example the Chinese anti-corruption drive has shrunk the Chinese luxury goods market).
6. Demographics are a no brainer.
7. Brand penetration is still low in many EM's.
8. New options for e-commerce are present.
9. There are still new geographies to develop with much of Africa still relatively "untouched".
10. Sub-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 opportunities (and challenges).
11. New companies are cropping up in the EM's and local champions are emerging or returning. Yes, such companies can prove tough competitors but they also need inputs and suppliers. Some developed market conglomerates have reported solid 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 a factor of 3.0 to 3.5. This divergence has clearly decelerated sharply in recent years and this trend will take some time to stabilise and recover; especially as the developed markets have got their "second wind" with US growth likely to average 2.5%+ between 2014-18 and with the Eurozone likely to see an average GDP growth of 1.6% over the same period.

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

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

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

- Core CEE region is booming!
- Core CEE is growing at 8-10 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. CEE will grew 8-10 times faster than Latin America in 2015 and will maintain a similar ratio in 2016.

Core CEE is a safe haven for investors and companies.

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% in both 2015 and 2016. Poland is of course a developed and highly competitive market but still, a good and large volume market to have in ones' portfolio. Populist politics are in the news at the turn of the year but we think that would still need some deterioration before it starts to damage the underlying economy; politics and EU reaction and business confidence dropping could take off

0.2% from our above figures, which still means that Poland will be performing well economically and commercially.

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 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. But there is even good news here and Serbia, Croatia and Slovenia all came into positive growth in 2015 and the sub-region of South-east Europe will grow by 2.8% this year after just 1.5% in 2015.

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: the 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 prop up stock markets and the property sector.
2. New credit emission is rising 2-4% which is quite a decent pace and in Poland growth is 4-6%, close to record levels.
3. Several CEE governments are softening austerity programs in 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 that 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 backdrop of very low inflation is boosting consumer confidence and household spending.

Summary of factors at play in the CEE region

- Re-onshoring is taking place.
- This is being led by outsourcing as companies better appreciate CEE's attractiveness and proximity to European markets.
- There are still some opportunities to buy small local champions and engage in smaller scale M&A.
- There are still some opportunities to localise in these markets.
- CEE looks good for a combination of 1) GDP growth 2) business pick-up and 3) relative political stability
- There is still some GDP convergence to happen: GDP per capita across the whole region is only 35-65% of the EU average (although in cities like Prague it exceeds 100%).
- EU funds are a major benefit.
- The consensus is for a steady rise of the middle class: more consumer segments will be buying brands as well as affordable products.
- More brand penetration is taking place.
- But not everyone is "rich" in CEE with many opportunities for "rural sales" and affordable innovation.
- CEE feels more dynamic that sluggish Western Europe and volatile Eastern Europe: a nice middle!
- Political risk still looks comparatively muted compared with Russia, India, China, Turkey, the Middle East.
- Corruption levels are…well…ok: Romania and Bulgaria score badly but Romania is making sterling efforts which could be replicated in the Czech Republic and Belgium among others!

Why is there this global malaise?

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

There are an increasing number of 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 mainstream parties because they feel they have been abandoned to rampaging bankers, uncontrolled migration and unequal social systems.
- Inequality is rising across the globe, both 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 up to 2015 grew at their slowest level since 1867.
- Real wages have only climbed into positive territory recently because inflation has collapsed or deflation has set in: it has not been due to the munificence of government or corporate organisations.
- Real unemployment is stuck at elevated levels in most economies but unemployment numbers have improved in the US and is close to 5% and has also come down from almost 12% to 10.5% in the Eurozone: but of course this is still elevated. Below are some underlying issues behind these numbers.
- Youth unemployment in Europe at 40-70% 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 Palace 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 people are 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 is 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:

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

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

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!

There are at least two big issues here:

1) The economic structure is flawed

The economic recovery in the US and UK appears finally to be diversifying across several sectors but initially and even now, much is reliant on the rising value of the property market (and second/third homes for rental income) and unsecured debt is creeping up again. The recovery in both countries 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 that in turn creates jobs so that reasonably well-paid workers can then purchase goods and services with money from their pockets and/or savings; instead we do seem to be 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 has ended up in the real manufacturing economy and infrastructure.

Conclusion: QE and tampering with the system has not worked and underlying destabilisers are still embedded within the global economy.

2) We have the wrong type of capitalism

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

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

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

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

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

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

The employment numbers for youths in Europe are disturbing:

- 25% of 16-24 year olds in the Eurozone are unemployed with some countries recording 40-60%
- Of those in jobs 52% of them are in temporary ones
- The track record from temporary jobs is not good: In France, Italy and Spain fewer than 30% of those in temp. jobs had permanent ones three years later

Looked at in another way the numbers remain concerning:

Those in temporary employment as a % of total employment

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

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

Additionally, in Spain, 80% of new jobs are temporary ones and in France the number is 86%.
When we combine an insecure present existence with an insure future, we create the so-called Precariat (those who live a precarious existence in rich, developed countries). And then this is combined with a back-drop of weak nominal and real wages. The numbers never cease to shock.

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

US average weekly earnings, adjusted for inflation, failed to reach their 1972 peak of $342 for the next 39 years in a row; in 2011 the figure at $295 was still 14% lower! Put another way US median household income has been stuck for 10 years at approximately $53,000.

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

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

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

So what? All the above numbers and arguments help to explain why (in addition to other sobering macroeconomic news) the majority of companies globally are stressed and strained and find the consumer in developed markets (and globally) to be so difficult to adapt to and understand.

6 major factors which drive the global economy and business

1) The banks

The situation in 2016 is marginally better as bank lending takes off in Europe but banks still represent one of the future black swans.

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: new loans across the Eurozone were negative for 5-6 years and only in recent months, thanks to extended QE, have turned slightly positive, but still inadequate to drive a sustainable European recovery. New loans in the US have been consistently stronger for the last 5 years and this explains in part superior performance in the US.

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 (at 75), rose slightly in 2013 (to 78) and climbed though 2014 (to 85) and reached 95 in 2015 by when it had risen close to a 20-year high level. In China confidence has been surprisingly stable and not so volatile: in 2012 the level was 101 followed by 99 in 2013 (Note: the US and Chinese indicator is not directly comparable) followed by a steady recovery through to January 2015 when it tipped 110 before falling to 104 in December 2015. Moreover, 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 used to be among the best in the CEEMEA region in recent years but Russian consumer confidence slumped in 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	Dec 2015
Eurozone	-26	-15	-12	-6
Czech Republic	-24	-12	+0.3	+4
Germany	-10	-2	-2	-4
Greece	-72	-66	-50	-61
France	-27	-26	-22	-15
Hungary	-47	-22	-19	-19
Poland	-31	-23	-15	-12
Romania	-32	-35	-20	-20
Sweden	0	+17	+13	+7
UK	-17	-2	+2	+1

3) Austerity programs

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

The situation going into 2016 is fractionally better as more governments come to realise that obsessive austerity was part of the problem and not the solution.

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

> Austerity has failed Greece and most other markets.

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

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

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

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

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.

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.

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, 23% youth unemployment and youth unemployment in the peripheral markets at 40-60%.

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. Even M&A activity, when you take out distressed mergers and tax dodging, are not looking sustainable and valid for underlying growth. US and European companies are well known for sitting on cash piles of some $4.5 trillion, money that is not being constructively utilised.

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

Our figures in the differential table above shows that the pace of investment slowed sharply in developed and emerging markets in 2015 and we anticipate only a mild recovery in 2016. Business confidence will be lacking and even with interest rates at super-low levels, banks and companies will continue to be reluctant to take on projects together. Companies will probably still sit on the majority of their cash or indulge in share buybacks to boost the CEO’s position and the contentment of shareholders.

Estimates for global corporate investment in 2014 suggest that globally investment was flat or more likely fell after a -1% drop in 2013. Global fixed investment decelerated in 2015 and was down on 2014 as energy and commodity and emerging market firms slashed spending. Estimates suggest that investment in manufacturing and energy will be cut by as much as by $800bn in 2015 and with some overlap into 2016. The financial turmoil at the start of 2016 will not encourage project financing further this year. Undoubtedly shale producers will be financing fewer (but more productive) wells this year. 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 3.5% in 2015 and by 2% in the Eurozone after several years of negative trends. Fixed investment in the Eurozone is still -15% on its pre-crisis level. This applies to the rest of the world: investment has never recovered from the 2009 bloodbath.

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

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	+3-4%

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".

The key point is that pre-crisis and even in 2010-11, global trade used to grow 2-3 times global GDP but by 2015 trade growth was only matching GDP or even dipping below it. The outlook for global trade in 2016 is to increase by about 3%, so once again very close to the GDP number. Trade is no longer a support to the global economy.

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. We predict stabilisation or mild dollar appreciation from here at least for 18 months and then some small rally from the Euro and some emerging market currencies. But for now the dollar is King.

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	Jan 2016
Indian rupee	55.0	61.8	63.4	66.8
Russian rouble	30.2	32.9	62.7	82.0
Turkish lira	1.76	2.23	2.32	3.0
Brazilian real	2.0	2.4	2.7	4.0
South African rand	8.6	10.8	11.7	16.6
Mexican peso	12.8	13.1	14.9	17.8
Indonesian rupiah	9.6	12.1	12.65	13.9

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	2020
Global (PPP)	2,9	3,4	3,2	3,5	3,8	3,9	4,0	3,8
USA	2,0	2,4	2,5	2,8	2,7	2,8	2,9	2,7
China	7,7	7,4	6,8	6,8	6,7	6,5	6,1	5,8
Eurozone	-0,4	0,9	1,6	1,7	1,6	1,8	1,9	2,0
Germany	0,5	1,6	1,7	1,9	1,8	1,9	2,0	2,0
France	0,2	0,4	1,4	1,6	1,6	1,7	1,8	1,9
Italy	-1,7	-0,4	0,8	1,4	1,5	1,4	1,6	1,8
Spain	-1,2	1,3	2,8	2,7	2,9	3,0	2,7	2,6
Greece	-4,2	0,7	-2,0	0,0	1,8	2,3	2,5	2,7
Russia	1,3	0,4	-3,5	0,8	1,8	2,6	2,9	2,7
CEE (core)	0,9	3,0	3,4	3,3	3,0	3,2	3,0	2,9
India	4,7	5,6	7,0	7,7	7,8	7,8	7,9	7,9
Brazil	2,5	0,1	-1,4	0,5	2,3	2,6	2,9	3,0
Mexico	1,1	2,3	2,5	3,5	4,2	4,4	4,3	4,2
Turkey	4,0	2,9	2,8	3,3	3,6	3,7	3,9	3,8
South Africa	1,9	1,5	1,4	1,9	2,2	2,8	3,1	3,2

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.
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. Oil imports are at the lowest since 1945 while oil exports are at their highest since then.

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

But we should never underestimate the impact of the recent recession, which was the longest and deepest for the US since the 1930s. We should also remember that it has taken trillions of dollars being thrown at the US economy to generate growth levels of 2.5% to 3.0%.

US GDP growth is very steady at around 2.5%, which in this global environment is reasonably good. In 2015 China overtook the US as the largest economy in the world on a PPP basis but in the same year global CEOs, for the first time in years, put the US as their No 1 priority global market above China, which has held top priority spot for more than 10 years. Also given the non-transparent nature of Chinese growth figures, the US may well indeed still be the largest economy in the world. Obviously China is catching up though.

Growth is stronger in the new sectors of high-tech, R&D, genome pharmaceuticals, the Internet and software and mobile telephony-related sectors. But the ‘old industries" are struggling much more (heavy industry, manufacturing, energy and chemicals and transport); this explains why the manufacturing PMI was down to 48.2 when the figure had been over 50 for most of 2015. The strong dollar is playing a part here and entails a drag on the economy and is certainly hurting US corporate earnings (many of the big US players sell 45-65% of their products abroad which a large chunk sold to the emerging markets). Corporate profits are tepid and lukewarm and following seasonal trends but are not growing by much (barely 1-3%); automotive production is sluggish and car registrations flat on seasonal trends. Business confidence is sluggish or falling outside the sexy sectors. The strong dollar in 2015 probably lopped off 0.35% of GDP growth and may subtract a similar amount in 2016.

Headline inflation grew by 1.2% in 2014 but slowed to just 0.3% in 2015. The consensus is for a figure of 1.5% in 2016 and 1.8% in 2017 (below the Fed's official target of 2%). Core inflation (excluding food and energy) was already at 1.8% in 2015. This moderate rise in inflation (which could be over-stated at the margins) is why US interest rates have started to rise from last month. The Federal Reserve has been crystal clear in stating that the economic recovery is still fragile and that rates will be increased slowly and cautiously though 2016. The central interest rate ought to be below 1% at year-end and only at 1.5% in 2017.

Consumer confidence is reasonably good and the official unemployment numbers have fallen to 5.3% and will dip below 5% in 2016 and 2017. But as we noted above, not all the new jobs are good and well paid and many people are leaving the job rolls disillusioned; disability allowances have also shot up (as in Europe) as people turn to disability claims instead of unemployment benefits. Curiously the pace of hiring relative to job openings is the lowest in the last 15 years.

US Consumer confidence indicator

1985 to 1991	=	95	2009-2013	=	60-80
1991-1992	=	65-85	2013	=	78
1992-1998	=	85-105	2014	=	85
2000-2008	=	80-100	2015	=	92

These relatively good numbers do not translate into storming retail sales, which only averaged 2% growth in 2015 compared with a very solid 4% in 2014 and 3.3% in 2013. As in other markets the American consumer is deleveraging, saving, spending less frequently, looking for value and splurging on treats. But this makes the jobs of the retailers and FMCGs more complex.

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

And sadly in closing, the USA suffers from a dysfunctional political system. The system is gridlocked and there is evidence that recent sittings of Congress were the least productive in terms of legislation passed since 1805-07 when Jefferson was president. Obama seems to have finally given up on the system and will administer through executive decree. If 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. If Donald Trump becomes president (surely not!) then all bets are off!

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. And then there is uncontrolled migration, disruptive politics and rising populism, a North-South and East-West political division while the fear of terrorism stalks the streets and could actually tick off 1.15% from GDP as well as diverting spending into policing and security measures. Rising migration costs (15bn Euros annually in Germany will bust fiscal controls and Germany's goal of balanced budget). These issues were discussed above.

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 1.6 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. But only slowly: retail sales were negative -2.5% in 2012 in the Eurozone and -1% in 2013 and then actually increased in 2014 by 0.5%; in 2015 though this figure climbed to an average of 2% but then started to fall in November to just 1.4% which could stem from the effects of the Paris terror attacks. Presumably the Christmas retail season turned out weak.
2. Lower oil prices mean lower inflation, which in turn means higher real wages. Companies and governments are still far from generous in salary increases but when inflation is flat or negative, then any nominal pay rise is good news and a positive boost to real wages. This is shown in the fact that nominal wages are sluggish at about 1.2% growth but thanks to inflation slumbering at just 0.2%, then real wages are up 1%. This figure is not very exciting but it's better than the negative figures of the recent past.
3. The weaker Euro means that Eurozone exports are more competitive but 65% of Eurozone trade is within the region so the FX impact is limited but still a positive. We expect the Euro to linger around 1.06 to the dollar on average for the next 18 months but could easily touch parity.
4. The ECB's quantitative easing will probably have the same effects as in the US and UK: direct positive effects on the real economy and employment will be limited; most of the gains will go to the property and stock markets. But this will trickle down and will also enhance business confidence. So while QE is 6 years too late, it's better late than never.

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

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 positive effects are tricking through into the unemployment numbers: overall unemployment in the Eurozone in 2013 was 11.8% but declined to 11.0% average in 2015 and dipped to 10.5% at the end of the year. We except unemployment to hover around 10% in 2016. Better, but clearly not good. These numbers also hide millions of people who have left the job roles, taken part-time posts, have become self-employed or moved to disability benefits. Youth unemployment overall has also fallen from 25% in 2013-2014 to “just” 22.5% in 2015. But again our figures above clearly show, most of the improvement stems from youngsters taking temporary jobs or being off-loaded into temporary training schemes.

The numbers are getting a bit better but not that good. When the superficial positive factors change, then GDP growth may slumber at 1.3% or even less but this is not our central forecast.

- Business surveys are the strongest in 4-5 years.
- Business activity is increasing at the fastest rate since May 2011.
- Car registrations at 820,000 per month are returning to their long-term average 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 a percentage of GDP from 24% in 2009 to 33% at end of 2015.

But again to provide some balance, despite the positive influencers on the economy and this could be as good as it gets, household spending was only up 1.8% in 2015 an fixed investment grew by only 1.6% after several years of very poor figures. Even with the much weaker Euro, exports were only rising by 4% last year, which is just above the global average.

The Eurozone pulled out of deflation in early spring 2015 but prices have only averaged 0.2% since then. The ECB though fought a non-existent inflation dragon until the ECB President Draghi introduced quantitative easing. QE will mean that interest rates remain close to zero for the next 3-5 years and it will require several years of QE to get inflation up towards 1-2%. Asset prices will benefit from the program as will property price across Europe and the property boom is no longer the only topic of conversation at dinner table in the UK: more Europeans want to use their flats as a bankomat!

Prior to the migration crisis, it seemed that fiscal stimulus would be very limited and hence why monetary policy would have to do the heavy lifting. The strictures of the Eurozone self-imposed fiscal rules were set to kick in further in 2016. Under these rules Germany’s “stimulus package” would amount to a laughable 0.1% of GDP starting only in 2016. But the extra 23-15bn Euros required for spending on migration needs will bust fiscal balance figures or plans for small fiscal deficits. Additionally, Eurozone deleveraging still has some way to go: private sector debt was 226% of GDP in 2009 and was still 218% in mid-2015. Only the UK, outside the Eurozone, has made much progress on bringing this down.

China outlook

We knew that China was aiming for an economic slowdown and restructuring of its economy and here we are. China will enter the 4th year of a policy-driven deceleration in 2016. It’s definitely part of the new normal and this is proving much more challenging than expected 12-18 months ago.

China will remain a key growth engine of the global economy for the next 5 years and probably for at least the next 100 years. Growth is normalising and one should not be shocked by that. But the markets are shocked and the lack of transparency is a critical factor. Official Chinese figures which are then utilised by the IMF and World Bank suggest GDP growth now at 6.9% but the informal western consensus is ranging at 4.5% to 5.5%. This is a bizarre situation.

Short-term factors have also caused sharp fluctuations in global markets both last August and at the turn of 2015-16. As we have noted, the actual underlying dynamics are not that shocking: the stock market is popping from an inflated bubble and even after months of double-digit collapse (when the market was fully open), the index has fallen since the summer last year by 40% but is actually back to its February 2015 level. Perhaps if the authorities hadn’t managed so hard to support the stock market, panic and reaction would not have set in so deeply. Of course the government did want the stock market to grow to absorb some of the loose cash sloshing around in the economy and to put it to some use.

But the authorities have also come in for reputational damage because mis-management of the stock market was combined since the summer with poor handling and communication regarding the exchange rate. Here again the numbers are no big deal and we have known for some time that the renminbi is no longer a one-way bet: in mid-August the currency sunk by just 3.2% and stayed stable until mid-December when the currency fell another 3.0%, so around 6% in 5 months. Once again the markets were spooked more by the apparent mis-management than the actual numbers or at least they should have been. The Chinese Central Bank did spend 108bn of its reserves in December supporting the currency but this does come out of $3.5 trillion dollars of reserves.

Western sales trends in China

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

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

This trend in industrial sectors also became increasingly visible in the last 18-24 months in consumer products, which again had a track record for high double digit growth ranging from 15-30% and with luxury goods performing especially well. The economic slowdown and the campaign against corruption means most consumer goods companies have seen recent steady or sharp reductions in sales growth. Some luxury goods firms have gone from 35% growth to zero or negative in 2-3 years. Numbers for luxury goods and other products area slow raped a bit by the exodus of Chinese tourists who travel abroad (300mn last year) who buy abroad, often at cheaper prices, rather than at home. Several big FMCGs report that some quarterly sales results are now as low as 0-2% year-on-year.

The challenge for most western companies operating in the Chinese market is that corporate headquarters are demanding still solid sales levels. Many companies set 2016 budgets some 3-4 months ago with targets of 7-13% sales growth. This looked like a stretch then and is all the more so now.

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

Consumer confidence at 110 is above the 5-year average of 105 for this indicator (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. Wages were rising nominally in manufacturing by an average of 12-16% in the last 5 years or so. With inflation ticking along at 2-4%, this meant that real wages were rising by 8-12%, one of the very highest levels in the world. We expect nominal wages to decelerate to still good levels of 7-8% against a backdrop of inflation in the next 4 years averaging 2-3% which means that real wages will average 4-5%, much lower than in recent years but still at a decent level. It is such real wages that will keep consumption and retail sales at respectable levels and ought to ensure steady (if not spectacular growth for western FMCGs)

Bank credit growth is steady at 11-12% and official retail sales are still solid at 11% range compared with 13-14% in recent years (official retail sales in China are a bit “funny” in normal times as they include some government purchases, but we are comparing like with like. And consumer spending growth overall is one of the fastest in the world at 7.0%.

GDP growth will average around 5.8% for the next 6-7 years on a declining trend and household consumption will tick along at about 6.7% 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.

And the famous middle class…

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. This rise of the middle class and urbanisation are two massive shifts on going in China that will stabilise and buttress western sales. Some commentators suggest the transformation could be quicker with the middle class reaching 36% of households by 2025.

Another interpretation of this is that over the next 10 years to 2026, some 250mn Chinese will join the middle class. Once again this is a remarkably positive figure against the background of recent negative news from the country. Given slowing trends, this number of 250mn could need to be tweaked down but the point remains that at least 200mn will rise in status by then.

Put another way, by 2015 China will have 550mn people living in middle class households (more than $20,000 per household) which dwarfs the number in Indian (131mn) and in the Asean-6 (excluding Singapore) at 144mn.

Chinese GDP and economic outlook

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

	2002-13	2013	2014	2015-20
GDP	10.4	7.7	7.3	5.8
Consumer spending	8.9	8.2	7.5	6.7
Fixed investment	12.2	8.1	7.4	5.7
Manufacturing output	12.4	7.5	6.6	4.8
Construction	12.8	7.3	5.7	4.7

Over the last 3-4 years the authorities and Central bank have been able to manage a planned deceleration of the economy away from excessive dependence on export and fixed investments as part of the plan to generate more domestic demand and consumer spending. This was proceeding reasonably smoothly until last August. The mild currency depreciation is of course part of that project and China does want to reshape its economy especially now when trade is so sluggish: trade used to grow by more than 20-30% until 2011 but this slowed to 5-7% during 2012-2014 and last year (2015) hit negative numbers with exports down by -3.5% and imports falling by a whopping 12%. We anticipate trade to pick up only marginally this year and next by 2-5% range.

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

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

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

Over-investment generally and in the housing/construction sector remains a serious threat, as does the credit expansion in the grey financing sector: the 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.

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

The government is also using fiscal policy as well as monetary measures to stimulate the economy: the target for the budget deficit in 2015 was -2.3% but probably came in about -2.7% and we predict that the deficit will widen to -3.0% or slightly more both in 2016 and 2017. As we argue, the authorities will use all measures to keep the economy afloat at a growth rate of at least 5.5%+ (official level)

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.

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.

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

	2002-13	2013	2014	2015-20
GDP	7.6	4.9	6.6	7.6
Consumer spending	7.1	4.9	5.8	6.8
Fixed investment	11	5.2	3.1	8.8
Manufacturing output	7.8	1.6	5.5	8.0
Construction	10	2.5	3.7	7.5

Getting a handle on Indian GDP figures are always a bit confusing as the government uses a financial year rather than calendar one. But the trend is clearly upwards. The new-ish government of Narendra Modi raised hyper expectations when he was sworn into office with the strongest government majority in 30 years. Things have improved but high expectations have been barley half met as the realities of Indian society, politics and the economy set in. But there is no doubt that improvements have taken place and some of these are due to a benign international economic environment in particular the low oil price which has helped bring down the government deficit (fewer subsidies) as well as curbing inflation.

Inflation was as recently as 2013 in double digits at 10.1% and high prices were a bane of India. But thanks to tighter monetary policy and falling energy prices, inflation sank to 6.7% in 2014 and dipped below 5% last year and we expect inflation to hover around 5.5% to 5.8% through this year as the economy ticks up. But high wage demand will not be a factor pushing up prices as we see only moderate wage push demand.

Consumer spending growth rates have remained steady over the last few years despite the volatility in the economy and exchange rate, and we forecast steady and moderately rising consumer trends; more money has been directed at rural areas in recent years and that has eventually filtered through to spending at the lower end of the consumer scale as well. Household spending averaged 7% from 2009 to 2014 with 2011 being the strongest year and a dip-taking place in 2012-13; we see a similar average for the next 5 years with some small upward risk to an average of 7.5%

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.

So the current growth rally does not emanate from any surge in consumer spending, rather it is based on some modest-good pickup in investment. Domestic companies and entrepreneurs had evidently had enough of the previous Congress administration and lacked confidence to invest in their home market and instead either sat on the money or dabbled in foreign investments. With the arrival of Modi and a number of incentives, domestic investment has recovered and still has some way to go. 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.

So, consumer spending steady to go on the back of strong rising investment trends coming back from a slump against the backdrop of better fiscal management and much lower inflation.

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

- We note that inflation is down close to 5%
- The lower energy price is helping the trade balance and the current account; the latter deficit already tumbled in 2013 from 4.8% to 1.4% in2015 as gold imports were restrained.
- With a stronger central Bank led by Raghuram Rajan 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. This means that central interest rates will fluctuate above inflation by a moderate 1.5%
- 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 7-year high but also not much better than in 2011.
- Business confidence slumped in 2012-14 on the back of ineffective Congress polices but this has rallied in the last year to a level of 54 and is now at its best level for 3-4 years but is still well below the boom years of 2006-12.
- This is supported a bit by the same trend in industrial output that is currently rising by almost 5% on average, which again is the best figure in the last 4 years.
- We think domestic and international developments will keep the rupee close to the existing level of about 64-66 to the US dollar with some slight downside risk as US rates continue to rise.

We do not change our conclusions much from 6 months ago: after several years of relative slump and a deep malaise in Indian society at the end of Congress's last administration, things are looking up for the Indian economy and business outlook but the "jury is still out" on whether PM Modi can really implement engrained and sustainable reform. 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.

10 January 2016

Appendix: The oil price: some things to know

- 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. The USA has become the largest global energy producer.
- US oil output is 80% up on its 2008 figure.
- The US is also supplying more to the world and buying less energy from it.
- China has taken over from the USA as the largest global energy consumer.
- Currently US energy imports are the lowest since 1960.
- 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.
- 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 2014 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.
- 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.

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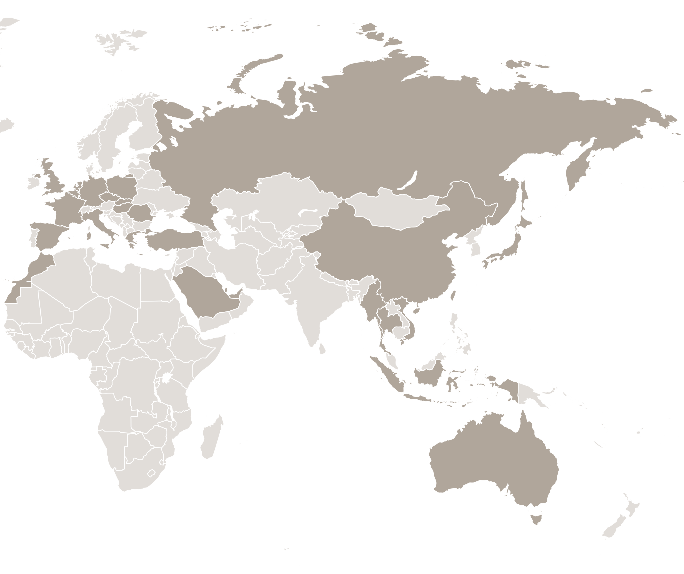

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