



## Global Economic and Financial Outlook

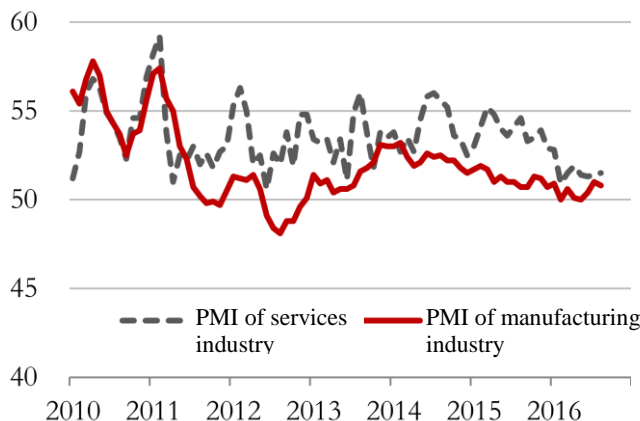
2016Q4 (Issue 28)

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### Highlights

- In 2016Q3, global economy recovered, the Brexit did not show severe aftermath yet, and capital reflux promoted economic stabilization of emerging economies. We maintained our expectation of global economy growing at 2.5% throughout 2016.
- Global financial markets saw strengthened stability, but the risk types have changed. Capital markets were improved in general, vulnerabilities of emerging markets nudged down and commodities markets started to seek re-balancing.
- According to our expectation, in 2016Q4, global economy will continue to grow sluggishly, sufficient attention should be paid to potential risks of financial markets, uncertainties over political and economic events and the possible interest rate hike by the Fed will cause market turbulences.

### Global PMI Hints Stabilization of Global Economy



Sources: Wind, BOC Institute of International Finance

### BOC Institute of International Finance Global Economic and Financial Research Team

Team leader: Chen Weidong

Deputy leader: Zhong Hong

Team members: Wang Jiaqiang

Liao Shuping

Chen Jing

Wang Youxin

Zhao Xueqing

Ma Man

E Zhihuan (Hong Kong)

Huang Xiaojun (New York)

Lu Xiaoming (New York)

Qu Kang (London)

Lin Lihong (Singapore)

Zhang Mingjie (Frankfurt)

Contact: Wang Jiaqiang

Telephone: 010-66592331

Email: wangjiaqiang@bankofchina.com

## Globalization or De-globalization: Where is the World Economy Heading?

### —— Global Economic and Financial Outlook (2016Q4)

In 2016Q3, the impact of Brexit has not crossed the borders yet, global financial markets became more stable, and the capital reflux of emerging markets benefited the real economy. However, the risk types have been changing. Looking into the last quarter of 2016, global economy will continue to grow sluggishly, sufficient attention should be paid to potential financial risks, political and economic events and the interest rate hike by the Fed will possibly cause a new round of market turbulences.

#### Part I Global Economic Review and Outlook

##### I. To Globalize or not to Globalize, That's a Question

In 2016Q3, the UK referendum on leaving the EU just dealt shocks to own country mainly, without any obvious rise of financial risks. According to PMI and sentiment survey, global economy has recovered (Figure 1). Based on preliminary estimates, the annualized growth rate of GDP was about 2.8% in Q3, an increase of 0.5 percentage points over the previous quarter; year-on-year growth rate reached 2.4%, picking up 0.2 percentage points from the previous quarter (Figure 2). However, global economic recovery remained weak, and the market confidence was not steady due to the repeatedly changing expectations on when the Fed to raise interest rate.

Figure 1: Global PMI Figures

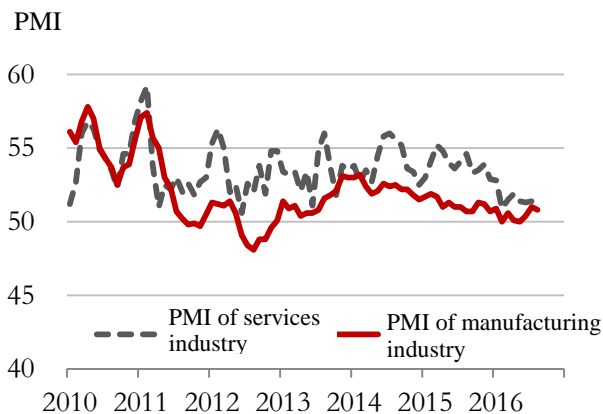


Figure 2: Development Tendency of Global Economy



Sources: Wind, BOC Institute of International Finance

In Q4, mild growth of global economy will continue, and the quarter-on-quarter annualized growth of GDP is expected at about 2.8%, still lower than potential growth level. Considering that new growth engines are not pooled together yet and risk factors remain steady, we maintain our 2.5% expectation for global economic growth in 2016. Among developed economies, the U.S. economic growth is dragged down below expectation due to the dollar appreciation and fragile investment, among others, and the Fed has to postpone its rate hike schedule again and again under different constraints; backed by the easing policy, Europe has managed to keep its domestic demands sound and resuscitation scaling-up, but the British economy dips into stagnation; the Japanese economy

still fails to shrug off such negative factors as yen appreciation and deflation pressure. Turning to emerging economies, thanks to strengthening of economic incentives, stabilization of commodity prices out of bottom, control of geopolitical risk and easing of domestic political unrests, some of those countries have succeeded in picking up the speed of recovery. However, the economy of emerging countries continues to be weary overall, and the policy outcomes should be further consolidated.

At present, there is a headwind of "de-globalization" across the world, e.g. national protectionism in political and economic sectors, rising isolationism and populism and increasing tension of the geopolitical state. Judging by the direct investment and trade flow indicators, the Index of Globalization stalls and even declines. "De-globalization" is just one of the negative factors leading to continued weakening of global economy. Of course, the drivers of globalization never stop struggling against that headwind. At the G20 summits, all parties have actively made efforts to seek coordination of national policies in order to avoid protectionism; major global organizations of economic and financial governance, e.g. the World Trade Organization and the International Monetary Fund, are the very leading force of globalization. At the G20 Summit held in Hangzhou this September, G20 Leaders reaffirmed their standstill pledge with respect to trade and investment protectionism in all forms and committed to rolling back any new trade protectionist measures. They mandated WTO, OECD and UNCTAD to monitor their adherence to these commitments. G20 leaders also stressed, the public should be well informed of the benefits of trade and market opening and appropriate domestic policies should be devised to ensure that all parties are benefited. Anti-globalization is wrestling with pro-globalization, the result will decide which way to go: forward or backward. The UK, once a pioneer riding the wave of globalization, has now set a bad example in the referendum. The U.S. advocated to establish an open trading system after WWII, but now it chooses to embrace isolationism and protectionism. In the future, developing countries may rise as a new power to push globalization by actively taking part in the making of global economic and trade rules.

## **II. The North American Economy Continues to Grow Moderately and the Fed Is still likely to Raise Interest Rate in the Rest of 2016**

**The U.S. economy is expected to grow moderately at a faster speed.** In 2016H1, the U.S. economy recorded weak growth, troubled mainly by the reduction of fixed investment, inventory investment and government expenditures, but relatively robust consumer spending and feeble net export bolstered the continual growth of its economy. When it came to Q3, the economic growth accelerated mildly at an expected rate of about 2.9%. Decrease of unemployment rate and increase of personal disposable income, etc., support further growth of consumer spending. Fixed investment, industrial output and inventory investment may rebound after continued negative growth, in parallel with possibly further moderate growth of export. However, because of sluggish growth of corporate profits and still limited investment desire, fixed investment growth will remain slow, in particular the investment in residential houses, once presenting strong growth, tending to slow down. Viewing from primary leading indicators, the U.S. economy is unlikely to decline as there is a foundation for continued moderate growth in Q4. Consumer spending will keep increasing in the context of increasing personal income, dropping liabilities and rising revolving credits of banks. The Fed still did not take any action in September, increasing the probability of raising interest rate in December.

**Canadian economy restored growth.** The economy of Canada is export-oriented and energy-dependent. In 2016Q2, a fire broke out in a major oil-producing province of Canada, seriously affecting oil production and export, leading to a 1.6% drop in the annualized growth rate of real GDP. In Q3, real GDP rose powerfully, estimated at an annualized rate of 3% approximately, attributable to oil production back to normal, reconstruction of the fire-stricken province,

depreciation of Canadian dollar, increase of the U.S.' import demands and recovery of consumer spending and export. Q4 may sustain this growth trend, but the growth rate will possibly ease. As expected, the central bank of Canada still set the benchmark interest rate at 0.50% at the policy meeting in September, which will possibly remain unchanged in the next quarter.

**Mexican economy resumed growth.** Mexico also features an export-oriented economy. In 2016Q2, the country's real GDP grew by -1.6%(SAAR) due to substantial decrease of investment and industrial output. In Q3, Mexico improved its export, employment, industrial output and retail sectors as the crude oil price was stable and the exchange rate of peso was kept low, but its industrial output remained weak, economic growth was still lower than the potential level, real GDP was estimated at about 3.0%. In Q4, continuous improvement is predictable for Mexican economy, with expected real GDP at about 2.2%. In order to prevent the escalation of inflation expectation in the context of depreciation of the peso, the central bank of Mexico will continue to adopt a relatively high interest rate.

### **III. The Impact of UK Referendum Subsided and the European Economy was Back to Steady Recovery**

**British economy recovered steadily and the impact of Brexit gradually waned.** In 2016H1, the British economy was on the rise, only being exposed to short-term fluctuations in the aftermath of the referendum on leaving the EU. Against the downward pressure, the Bank of England unveiled a package of measures: a cut in Bank Rate to 0.25%, a new Term Funding Scheme, and more purchase of UK government and corporate bonds. The economic data in August far exceeded the market expectation, and the country is shrugging off the short-term impact of the vote to leave the EU. Affected by such factors as higher international oil price and weakened pound lately, CPI is on the rise, yet still at a historic low level. In Q4, the British economy is still faced with a lot of uncertainties, and the risk of mild recession hovers. Britain is ready to further adopt a series of easing policies including interest rate cut, QE and tax reduction to fight economic decline.

**Eurozone economy continued to see weak recovery.** Alongside the abatement of positive effects from weakening euro and lowering oil price, the recovery of Eurozone economy slowed down, with growth rate in Q2 decelerating to 0.3%. Among large economies, Spain and Germany continue to develop their economy, while France and Italy are trapped in stagnation due to fragile consumer spending. The pickup in foreign demands pushes the contribution ratio of exports higher. Thanks to the easing monetary policy, Eurozone has managed to ameliorate overall financing conditions, the lending to corporate and household sectors is increasing quickly and low-cost funds are being channeled to the real economy slowly to expand the investment scale. As for the external environment, the shadow of refugee crisis and terrorism still hang over this region, while the uncertainties arising from the Brexit will impair confidence in the trade of Eurozone. We think that the growth of Eurozone will continue to slow in the next several months. How long the European economy will recover mildly will depend on sustained resuscitation of labor market, subsequent effects of monetary policy and substantive progress of countries' structural reforms. However, the inflation rate still leaves far away from the preset target, and the ECB is still pressured to take further easing measures.

**Emerging markets in East Europe were mixed.** Emerging markets in the EU have benefited from the improvement of employment market and the rise of wages, etc. In these EU countries, private consumption grows robustly, far exceeding the average level of Eurozone. Russia's economy is still dragged down by the adverse factors including sanctions by the western countries and low oil prices. However, Russia may slow the speed of recession since its anti-crisis plan has shown preliminary effects in non-energy and raw material exports and the like. To regain growth, the Russian government should accelerate the research in how to adjust its economic policies and

search for new points of economic growth. Following the military coup attempt and terrorist attacks one after another, Turkey's security situation worsened. However, Turkey, an export-oriented economy, is now beset with internal and external troubles, which will cause the investment environment to deteriorate, the policy reform steps to stall and the economic uncertainties to add.

#### **IV. Asia-Pacific Economy Features Moderate Growth under Loose Policy**

**Bank of Japan introduced a new monetary policy framework to stimulate the country's depressed economy.** Year to date, private consumption, accounting for 60% of GDP, has been relatively weak, with a mere 0.2% growth quarter on quarter in Q2; equipment investment of private enterprises has been sluggish, registering -0.6% and -0.1% growth quarter on quarter in Q1 and Q2 respectively. As there are more uncertainties in economic prospect, enterprises are not willing to increase investment but wish the government could premiere new economic stimulus package. But private housing investment was eye-catching in Q2, trade was improved, and current account surplus in H1, at JPY10.6 trillion, made a record high since the Lehman crisis. Due to uncertain rate hike by the Fed and continuous changing U.S. Dollar Index, the yen continues to strengthen against other currencies while being rocky, exerting great pressure on the monetary policy formation of Japanese central bank. Both G7 Summit and G20 Summit have pledged to avoid competitive devaluation, making it impossible for Japan to lower the exchange rate of yen through exchange interventions. In September, Bank of Japan updated the monetary policy framework to "quantitative and qualitative monetary easing with yield curve control". However, the update may only play a limited role in boosting the economy.

**Emerging economies in the Asia-Pacific grew moderately due to weak external demands.** In 2016Q2, GDP of Indonesia, the Philippines, Vietnam, Thailand and Malaysia grew by 5.2%, 7.0%, 5.6%, 3.5% and 4.0% year on year respectively, and their price index was relatively stable. International capital continued to flow back to emerging markets due to the postponement of rate hike by the Fed, while the exchange rate of currencies of Asia-Pacific emerging economies also steadied. Emerging economies in the Asia-Pacific are export-oriented, so the economy is vulnerable to low-speed growth of global economy and trade and has slowed down significantly. How to stimulate domestic demands, reduce reliance on peripheral environments and re-balance the economic growth pattern will determine the long-run performance of Asia-Pacific economies. The Asia Development Bank cut its outlook for economic growth in developing Asia by 0.1 percentage points from 5.7% in March to 5.6% in 2016, but maintained its growth forecast for 2017 at 5.7%. Obviously, it is quite hard for global trade to reverse the weakness trend, the emerging economies in Asia-Pacific still depend on domestic demands, of which consumption expenditure will underpin the economic growth. Emerging economies in Asia are picking up the speed of releasing economic stimulus packages and reforms. The central bank of Malaysia cut the benchmark interest rate by 25 basis points to 3% in Q3, the first cut after five hikes since 2009. In Vietnam, the H1 growth rate of GDP was less than that a year earlier, making it difficult to realize the full-year target of 6.7% for GDP growth. Indonesia grew faster in H1, and there is still room for the country to further relax the monetary policy.

#### **V. South America is Beset with Troubles Internally and Externally, Africa and the Middle East Witness Continued Depression**

**Major economies in South America are beset with troubles both at home and abroad.** Lackluster growth of global markets, sluggish trade, turbulent international financial markets and low, vibrating commodity prices have discouraged the market confidence. Foreign capital is gradually changing the direction of its flows, thus weakening its support to Latin American economy. Political instability has increased the economic uncertainties. After Brazil's former

president Dilma Rousseff was stripped of her duties in impeachment, the political turmoil spread over to the other parts of Latin America. Future economic development still bristles with difficulties. Mixed commodity prices, in violent swings, are incapable of pulling the economy. In Q4, bigger potential of rate hike by the Fed will channel international capital back to the U.S., elevating the borrowing cost of South American countries. Caught in a dilemma of having to raise interest rate to curb inflation and capital flight and maintaining loose policy to promote growth, countries like Brazil and Venezuela will continue to show a picture of "negative growth, high inflation, high unemployment".

**Economy of Southern Africa is in deep trouble.** The price decline of mineral products worldwide dealt a big blow to Zambia and South Africa, etc. in a direct way. Countries in eastern and southern Africa such as Ethiopia, Malawi and Zimbabwe were stricken by a drought, Liberia, Guinea and Sierra Leone were still exposed to the follow-up impact of the Ebola epidemic, Chad and Cameroon were haunted by terrorist attacks. In southern Africa, more families found it very hard to increase income, consumption expenditure grew in a limited range and unemployment rate stayed high, damaging the prospect for economy in Q4. Nigeria recorded economic shrinkage for two consecutive quarters, the first time in the past over 20 years. Debts of Kenya, Angola, Mozambique and Ghana continued to rise. Certainly, there are a few bright spots in the region. For example, economic growth of such oil importers as Cote d'Ivoire, Kenya and Senegal is expected to reach 6% this year, underpinned by continuous infrastructure investment and strong private consumption.

**The Middle East and Northern Africa suffered from a weakening economy.** Because global oil prices swung at a low level, regional conflicts escalated and budgets were slashed, economy of the Middle East and Northern Africa will slow to 1.3% in 2016. Under the New Normal of low oil prices, countries in this region are committed to promoting economic diversities and relevant reforms. Iran managed to realize the biggest surplus of non-oil trade in recent years and its inflation rate was reduced to a one-digit figure for the first time since 1991. The central bank of Iran will change the dual-exchange regime of riyal to adopt consistent exchange rate policy before March 2017. The government of Egypt proposed an economic reform package, including introducing VAT, reducing energy subsidies and adopting floating exchange rates. The Cabinet of Saudi Arabia unveiled the National Transformation Plan 2020 in June 2016, with diversification of economic development, development of private economy and increase of investment at the core.

## Part II Global Financial Review and Outlook

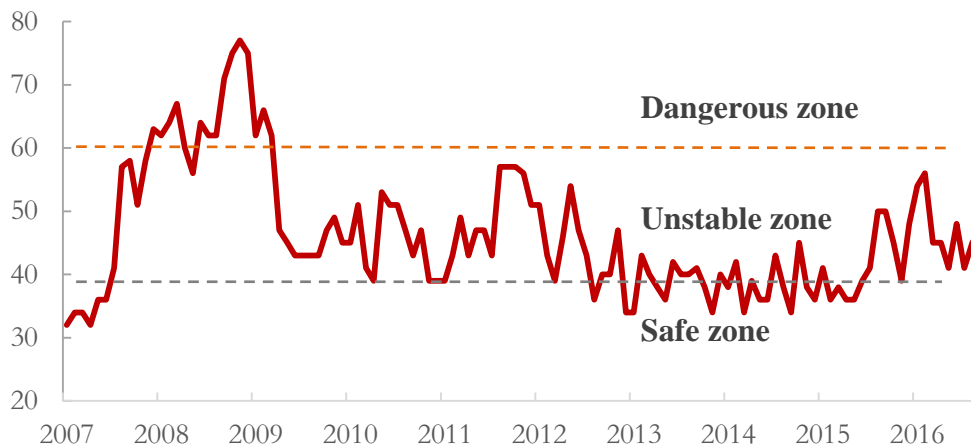
### I. Stability of Global Financial Markets was Improved, yet Exposing to Changing Types of Risks

**Financial markets have become more stable, but new risks are emerging.** Global financial markets have been stabilized step by step after violent swings at the year beginning. In Q3, investors' risk appetite was raised because of the following factors: higher expectation of the market on the U.S.' slower progress towards normalization of monetary policy, better prospect of emerging markets, especially stabilization of China's economy and RMB exchange rates, and the quicker-than-expected subsiding of the Brexit's impact. As a result, in the developed world, stock markets rallied, fluctuations eased and the spread between corporate and government bonds dropped. Capital flowed from developed markets into the stock and bond markets of emerging countries, supporting that the stock markets of the latter could grow ahead of their developed counterparts, corporate and government bonds posted larger issuance and higher price. However, bank stocks all over the world still performed unsatisfactorily. MSCI World Index continued to rise

in Q3, while VIX, an index reflecting the volatility of stock market, plunged to an all-time low. In addition, Correlation and Volatility Indexes of S&P 500 were also at a historic low. As the time for the Fed to raise interest rate approaches, the U.S. Dollar Index nudged up violently. Sufficient attention should be paid to the potential risks that may affect the stability of financial markets, including the Fed's rate hike, and market divergence as a result of the negative interest rate policy taken by Europe and Japan, as well as soaring leverages of enterprises in the emerging markets and the forthcoming debt repayment period.

**ROFCI improved following a sharp decline.** In 2016Q3, the U.S.' Risk of Financial Crisis Index (ROFCI) picked up after decline at the beginning of this quarter, and the monthly average decreased to 44.33 from 44.66 in the preceding quarter, still within the unstable territory (Figure 3). Stability improved mainly in the fields of stock market, corporate credit market, bank stock market and exchange market, but worsened mainly in non-financial money market and interbank money market. ROFCI shows that credit risk, market risk and foreign exchange risk steadied or fell but liquidity risk rose. Given the numerous uncertainties in global financial markets in Q4, particularly the uncertainties of the Fed's interest rate policy and the possibly changing direction of global funds, it is unlikely for the financial markets to improve stability significantly, and ROFCI will possibly fluctuate further within the unstable zone.

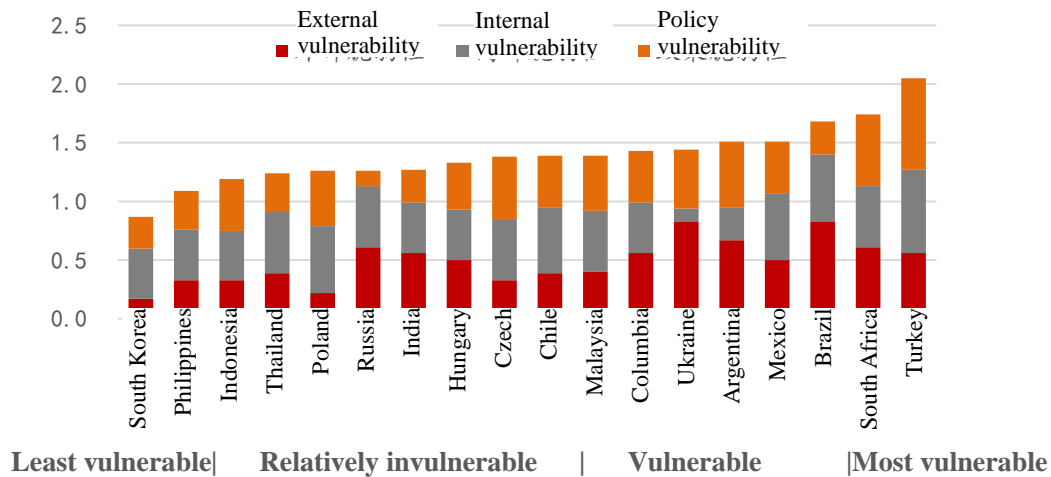
**Figure 3: Movement of the ROFCI**



Source: BOC Institute of International Finance

**Overall financial vulnerability of emerging economies edged down.** We have analyzed and ranked the financial vulnerability of 18 emerging economies according to the Emerging Economy Vulnerability Index issued by the Institute of International Finance (IIF). One country's financial vulnerability index consists of three parts: external financial vulnerability, domestic financial vulnerability and economic policy vulnerability. In 2016Q3, Ukraine, Brazil and Argentina were the most externally vulnerable; Turkey was the most internally vulnerable; Turkey, South Africa and Argentina were the most vulnerable in the policy sphere. Overall, Turkey remained the most vulnerable; vulnerable countries mainly include South Africa, Brazil, Mexico, Argentina, Ukraine and Columbia; the Philippines, Indonesia and Thailand were relatively invulnerable; South Korea was the least vulnerable (Figure 4). In Q3, the number of relatively invulnerable countries increased while that of vulnerable countries decreased; overall financial vulnerability of emerging markets decreased slightly.

**Figure 4: Financial Vulnerability Index of Major Emerging Economies (September 2016)**

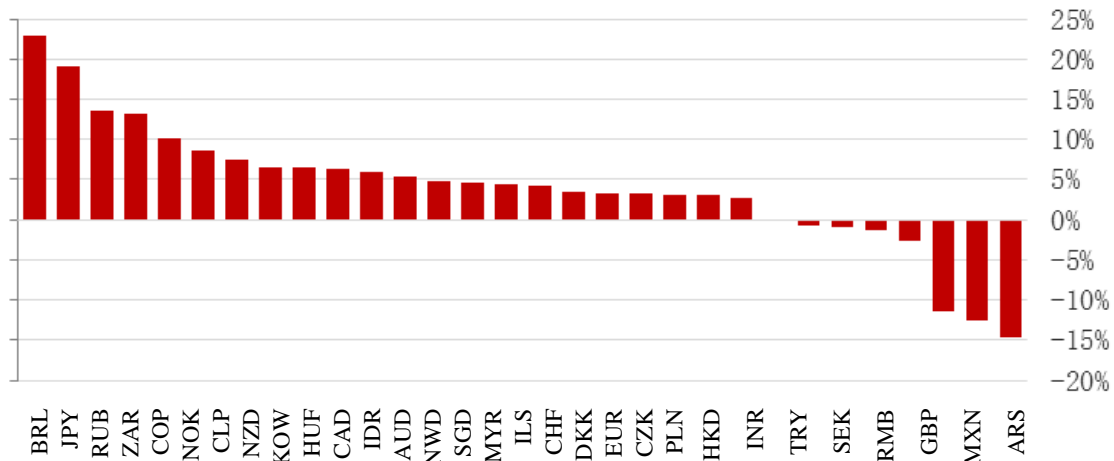


Sources: IIF, BOC Institute of International Finance

## II. Tension of Global Foreign Exchange Markets was Relieved

In 2016Q3, global foreign exchange markets were stable overall, safe-haven currencies continued to rise, and currencies of emerging markets rebounded (Figure 5). In Q4, there is a higher possibility of rate hike by the Fed, leading the trend of global markets.

**Figure 5: Changes in the Exchange Rates of Major Currencies against the US Dollar as Compared with the Year Beginning (by September 22, 2016)**



Source: Bloomberg, BOC Institute of International Finance

**The interest rate increase expectation drove US Dollar Index to rebound slightly.** In 2016Q3, U.S. economic landscape showed a trend of modest expansion, and the household expenditure posted sound growth. In particular, the employment market continued to improve, reinforcing the market expectation on rate hike by the Fed, so the US Dollar Index once broke the 97-mark in July. However, as the economic prospect of the U.S. still hid uncertainties, the Fed was prudent about the course of rate hike and chose not to take any action in September. Subsequently, the US Dollar Index adjusted for fluctuations and was kept at the level of 95. **Yen continued to strengthen, Euro perked up slightly and GBP remained low.** In 2016Q3 when risk aversion was heightened, yen

was still on the rise. The easy monetary policy adopted by the Japanese central bank was incapable of addressing the exchange appreciating dilemma, and the USD/JPY has surpassed 101 for many times. Following plummet at the end of June due to the UK referendum on leaving the EU, euro was supported by the moderate growth of Eurozone economy, the retaining of interest rate by the ECB and the unchanging asset purchases and QE programme in Q3. Since August, the UK has eased the monetary policy, steadying and improving its economic indicators, and the financial market became smooth gradually, with the GBP/USD hovering at the low level of 1.32. **Currencies of emerging markets and commodity exporting countries rose steadily.** In 2016Q3, emerging markets posted stable growth, of which Asian countries saw improvement of their economy, with many indicators reviving. Financial sector of emerging economies was less undulated, MSCI Emerging Market Currency Index rose by 2.23% compared with the end of June. Crude oil, gold and industrial metals reported different decreases over their high levels in June, which, to a degree, constrained the increment of commodity-related currencies such as ruble, Canadian dollar and Australian dollar.

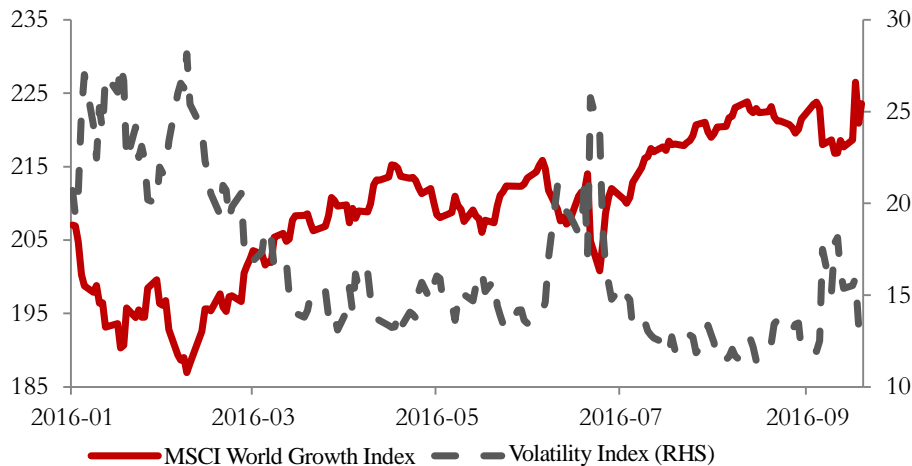
**Looking into 2016Q4, the Fed's potential rate hike will be mostly crucial to the fluctuations of exchange markets.** The U.S. economy is progressing towards the employment and inflation targets, and there is great possibility for its interest rates to increase. We expect that the U.S. dollar will strengthen again as the decisive factor of global exchange market fluctuations in 2016Q4. As the globe is prone to risk aversion, the yen will remain at a high level, and it is hard to relieve the appreciation pressure. However, for the Eurozone, its development is uncertain due to the impact of the Brexit, banking pressure, the Italy referendum on leaving the EU and many social problems, and it is difficult to realize the inflation target, so we expect the exchange rates of euro will edge down. The progress towards leaving the EU will affect the subsequent trend of British pound, and together with the lingering of related negative factors, we expect the British pound will remain relatively low in the coming period of time. Currencies of emerging markets and commodity exporting countries will be put under depreciation pressure alongside the rally of U.S. dollar. In particular, threatened by economic recession, Russia, Brazil, Argentina and Mexico, etc. will be still exposed to the exchange rate decline risk.

### **III. Global Stock Markets Continue to Improve, Political and Economic Events of the U.S. are Potential Risk Points**

**Global stock markets pulled back from earlier highs in 2016Q3.** Global stock markets improved gradually and the market nervousness was alleviated thanks to the easy monetary environment of the globe and the Fed's postponement of rate hike, among others. As at September 22, the MSCI World Growth Index stood at 223.57, rising by 6% in Q3 and by 19.6% from the lowest point at the year beginning. Global stock markets did not fluctuate much and the fluctuation reported at 7.8% in Q3. It is consistent with the changes in global risk aversion sentiment reflected by VIX (Volatility Index), indicating a risk decrease in global stock markets. Because of the nuclear test of North Korea and the Fed official's hint of rate hike, global stocks pulled back from their highs in this year at the start of September, meanwhile VIX soared. In late September, the Fed announced postpone of rate hike, stimulating global stock markets to rally (Figure 6).

**Stock indexes of major economies showed similar trends: overall reviving in Q3, damping first and then climbing in September.** As at September 22, Dow Jones Industrial Average, S&P 500 Index and NASDAQ Index climbed by 2.6%, 3.7% and 10.3% respectively in Q3; European FTSE-100 Index, French CAC40 and German DAX rose by 6.3%, 6.4% and 10.3% respectively; Nikkei 225 and Korea Composite Index gained 7.7% and 4.1% respectively. Stock market revivals are mainly attributable to the Fed's postponement of rate hike and the global financial markets' gradual digestion of the Brexit's impact.

Figure 6: MSCI World Growth Index and VIX



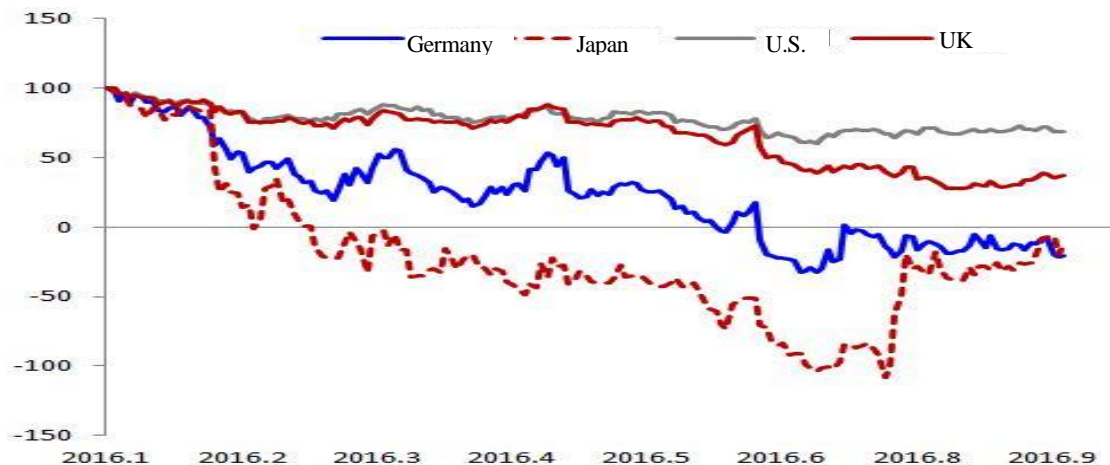
Source: Wind, BOC Institute of International Finance

**2016Q4 will see continued upturn of global stock markets but divergence of stock performance in different countries.** Although another hike by the Fed has greater probability, it will not fundamentally change the ample liquidity throughout the world. The markets will gradually digest the effect of potential rate hike and react to another hike relatively more calmly than that to the first hike in 2015. The negative interest environment will redirect capital into the stock markets for higher earnings. However, different countries will see divergence of performance: due to more hawkish stance of the Fed, the returning of a strong dollar and the political risk arising from the U.S. presidential election in November, among others, the U.S. stock market will possibly witness greater fluctuations; European stock markets will be challenged because local banks are still under heavy operating pressure and the uncertainties of the Brexit and the Italy referendum on leaving the EU may cause disturbances to stock markets; Asian stock markets will continue to improve because more capital will be channeled into the stock markets in the context of continuously appreciating yen and brilliant economic revivals of emerging markets in Asia.

#### IV. Bond Yield of Developed Countries Declined and Entered into the Era of "Negative Interest Rate"

**Since Q3, global sovereign bond markets saw fluctuations at large.** The Brexit has added more uncertainties to economy and politics of the world, causing the bond markets to swing and risk aversion sentiment of investors to heighten constantly. The 10-year U.S. T-bond leveled off, while weak economic figures further damaged the market's expectation on the Fed's rate hike, offsetting the boosting of some risk aversion requirements to the yield of U.S. bonds; affected by the U.S. data and the impact of Brexit, the ECB is more heavily pressured to implement the easy policy. The yield of Germany's 10-year T-bond tumbled, even to a historic low in July, and it is now nudging up; to alleviate the shock of exiting from the EU, UK has adopted interest cut and other easy measures, leading to the continuous decline of bond prices, which pulled the yield of 10-year T-bond to fall far below the pre-exit level; Bank of Japan did not increase bond purchases, disappointing the market, and the yield of its 10-year bond rose (Figure 7).

Figure7: Yields of 10-year T-bonds of Selected Countries (January 2016=100)



Source: Thomson Reuters, BOC Institute of International Finance

In Q4, having gone through the turbulences immediately after the Brexit, the market will recover its confidence and reduce the demands for purchasing T-bonds of the UK. Due to the uncertainties of the UK-EU relationship, the safe-haven flows will leave the UK and the country's T-bond yield is expected to rise. In Europe, the Brexit risk has been curtailed, but Eurozone's business sentiment and inflation indicators were less than expected in August. On September 8, the ECB announced to keep interest rate and easy policy unchanged, making the investors more disappointed. Short-term yield of government bonds in the Eurozone is expected to rise. In the future, the Eurozone will continue to implement the low interest rate policy and increase bond-buying scale, so yield of T-bonds in the region may remain low. Due to the potential rate hike by the Fed, short and long-term T-bonds of the U.S. will possibly score a decline of yield. Currently, the investors are very eager to seek positive return, and the emerging markets become attractive again. Global capital is gradually flowing into emerging bond markets, particularly at a faster speed year to date.

## V. Commodity Markets Started to Walk onto the Long Road towards Re-balance

**The development of commodity markets was weakened apparently in 2016Q3.** Due to lack of boost from incidental factors like supply disruption in Q2, commodities except zinc, nickel and cotton all posted price drop in Q3. In the **agricultural product market**, weather has played the foremost role in its performance. Wheat fared the worst (-19%), while white sugar once soared above 30%. In the **energy market**, the supply disruption factor (due to forest fire in Canada and less supply from Nigeria) that supported the oil price to skyrocket in Q2 has gradually waned to nil in Q3, and the energy market returned to the weakness fundamental lacking the strength to rally. Any factors which could push the price to increase sharply in a short period of time, e.g. talks about "oil production freeze", were forced back to the previous operating orbit soon against such fundamental. In the **industrial metal market**, all the base metals except copper and aluminum have recorded gains in Q3. In spite of mine closures, zinc continued to rise, cumulatively by more than 40% year to date. The economic picture of China, as the most important demander of industrial metals, will continue to produce significant influence on the price of industrial metals, in particular copper.

**Re-balancing and high volatility have become the two themes of commodity markets in 2016.** Currently, for commodity prices to seek re-balance, it will be a long process in view of soaring production capacity stimulated by previous high price and slowing global demands. It is necessary for commodity markets to maintain low price for a period of time, in order to eliminate high-cost

production capacity and restrict roll-out of new projects, thus riding of the supply causing market overloading and returning to the balance between supply and demand. Meanwhile, price is very sensitive to any positive or negative messages on supply and demand against such complicated background in an already-bruised market.

**The speed of re-balancing depends on the demand-supply changes.** From 2016Q4 to 2017, commodity markets will continue to seek re-balance. However, the speed will depend on the following factors: 1) The de-capacity progress of China. China has started the supply-side reform in industrial metal sector, typically iron & steel. The progress towards realizing capacity cut will exert an influence on the re-balancing process of commodity market. 2) The production elasticity of American shale oil & gas producers. American oil & gas producers have benefited from advancements in cost control and efficiency enhancement, etc. and slashed their cost of crude oil exploitation. Hence, in case of any rebound in oil price, these producers will resume production quickly and cut down oil price, extending the process of re-balancing. 3) Demands of China and India. As China's economy has slowed, the market begins to seek the next "booster of commodities". India stands out as the market focus because of its large population, rapid growth and economic growth phase, etc. In general, in the short run, India cannot replace China to lead another "commodity super cycle".

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