



Global Economic and Financial Outlook

2017 (Issue 29)

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Highlights

- The global economy is estimated to grow at only 2.5% in 2016, extending the weakness for years. The low growth in advanced economies and the slowdown in developing countries remain unchanged. International investment and trade was subdued and globalization was faced with headwinds.
- Global financial markets fluctuated upward with key financial assets reaping handsome return. A number of events such as Brexit and U.S. election pushed up volatility. New progress was made in international governance reform, easing uncertainty.
- The global economy is expected to improve moderately in 2017, but the outlook is not optimistic. In particular, uncertainties over political and economic events and accelerated rate hike by the Fed will cause market turbulences. The downside risk can not be ignored.

Global Economy and Trade Have Maintained Weak Growth for Five Consecutive Years



Sources: IMF, BOC Institute of International Finance

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Growth Breakthrough in the New Landscape of Global Governance

—Global Economic and Financial Outlook (2017)

In 2016, the global growth was sluggish for the fifth consecutive year while the volatility of the global financial markets increased. The recovery in the advanced economies lacked momentum with frequent occurrence of “black swan” events; the capital outflow in the emerging markets slowed down and the real economy was on a stronger footing. Looking into 2017, the global growth is expected to improve slightly, however, the financial risk is accumulating and the shock brought by the setback of globalization and reversal of global liquidity is unneglectable. In particular, the political and economic events in the U.S. and Europe and the accelerated rate hike by the Fed are likely to cause new turbulences.

Part I Global Economic Review and Outlook

I. The Lackluster Real Economy Calls for Change of the Global Governance Landscape to Promote Growth

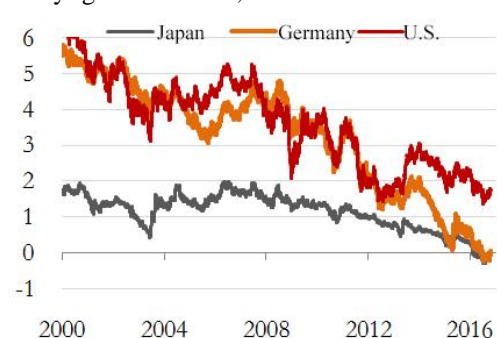
I.1 The global economy remained weak in 2016 and extended divergence in growth over the years

According to initial estimate, the global economy would only grow at 2.5% in 2016, hitting record low in five years (Figure 1); the international trade would grow at less than 2.0%, also hitting the slowest pace since 2010, some economies even declined; international direct investment fell sharply by 12.5% with significant difference across regions. The growth of the direct investment was mainly driven by merges and acquisitions, which is insignificant for the growth of the real economy. The central banks in advanced economies kept their policy rates at relatively lower levels, especially the European Central Bank and Bank of Japan which continued to implement the negative interest rate policy to ramp up the quantitative easing. While the world was still in an unprecedented low interest rate environment (Figure 2), the investment and consumption demand was subdued because of the liquidity trap; the global prices were generally at lower levels despite the slightly rebound in the commodity prices. In addition, the occurrence of a range of de-globalization “black swan” events, such as the renewed trade protectionism, Brexit referendum and the U.S. general election, disrupted investor confidence. Among emerging markets, the Asia Pacific continued to grow moderately at a slower pace, the Eastern Europe and Latin America narrowed their contraction, while other regions were subdued.

Figure 1: Global Economic and Trade Growth Trend



Figure 2: Development of Global Interest Rates
10-yr govt bond rate, %



Sources: IMF, Wind, BOC Institute of International Finance

I.2 The global economy is expected to maintain moderate growth in 2017

The global growth is likely to rise to 2.8% in 2017, but still below its potential level; the inflation may arrive at a turning point, increasing to about 3.3% from 2.9% in 2016. On the supply side, the aging population, the lower labor productivity, the stronger financial constraint and the shortage of technological breakthroughs will continue to limit the global growth in the mid-to-long term. On the demand side, the intertwined positive and negative forces will prevent the global economy from growing faster. Firstly, the U.S. economy is likely to grow faster on the new measures to be taken by the Trump administration to build infrastructure, revitalize the manufacturing sector and reduce tax; but the uncertainties over its tendency for trade protectionism and anti-immigration will likely restrict its contribution to the world's economic growth. Secondly, major economies are generally still under monetary easing (for instance, the policy of negative interest rate and quantitative easing adopted by major advanced economies such as Europe and Japan is hard to be changed), and the fiscal policy is also likely to play a role in promoting growth; but the accelerated normalization of the monetary policy by the Fed will change the global liquidity situation and possibly exacerbate the financial market turmoil, hence hitting the recovery of the real economy. Thirdly, emerging economies in Asia Pacific such as China, India and Indonesia are expected to maintain relatively higher growth and continue to be the key forces in promoting the steady growth of the global economy. In particular, the continued acceleration of investment and construction in the Belt and Road region will become the highlight of the global demand growth. Fourthly, those emerging economies that rely on commodity export are likely to benefit from the market price recovery (particularly Russia and Brazil are expected to weather through the economic recession); but the imbalance between supply and demand is unlikely to improve in the short term, which will restrict the extent of the market rebound.

I.3 The predicament of continued global weakness needs a way out and enhanced global policy coordination and governance collaboration is especially important

Better global governance can increase the support of macro policy to the real economy and deepen the structural reform to drive technical innovation and contribute to a more stable international financial market, hence promoting the recovery of the real economy. While maintaining a peaceful and stable geopolitical situation and keeping a fair and open multilateral trade system could provide a healthy external environment for the development of each country. On the one hand, the global governance was faced with unprecedented challenges in 2016, in particular, the UK referendum to leave the EU and the result of the U.S. general election brought about huge uncertainty; on the other hand, the reform of the global economic governance has made significant progress and the G20 Hangzhou Summit clearly raised the notion of innovative growth pattern, pointing out the direction for the world economy. In addition, there's new development in other aspects, such as the cooperation between BRICS countries, the establishment of free trade zone in Asia Pacific, the Belt and Road regional cooperation and the signing of FTA between EU and Canada. Enhancing global public governance will help reverse the de-globalization headwind and provide positive source of energy for the sustainable development of the world economy over the long haul.

II. The North American Economic Growth Is Likely to Pick up Speed Moderately and the Fed Hike is Expected to Accelerate

II.1 Due to the new policies of the Trump administration, the U.S. economic growth is likely to accelerate

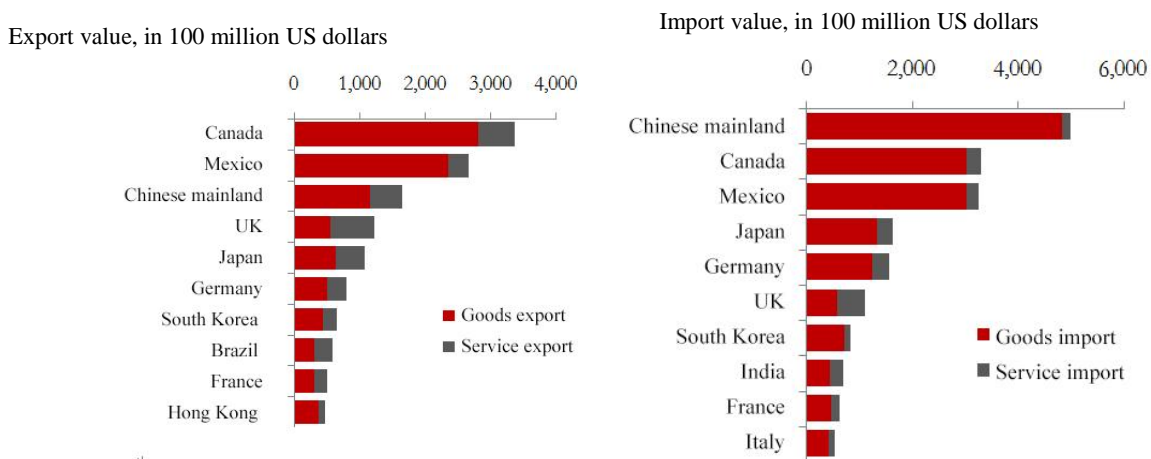
In 2016H1, the U.S. economy recorded weak growth due to decline in investment, and the growth picked up speed moderately in H2. Consumer spending continued to grow, driven by the lower unemployment rate, increasing personal disposable income and rising revolving credit of banks.

Government spending and investment recovered and net export continued to rise mildly. However, because of sluggish growth of corporate profits and limited investment desire, fixed investment growth remained slow. The U.S.GDP growth rate is estimated at about 1.5% for 2016. Looking into 2017, the U.S. economic growth is expected to accelerate. In particular, once implemented, the policies of the Trump administration to enhance infrastructure, reduce taxes for both corporate and individuals and raise trade tariff will give short-term boost to the U.S. economy. The recent leading indicators for the real economy and the financial markets such as the stocks and currencies made expected reactions. We expect the U.S. GDP growth to rise to 2.0% in 2017. The persistent growth will bring the U.S. close to full employment and cause obvious inflationary pressure. The Fed is expected to raise interest rate twice in 2017 in addition to the 25-basis point hike in December 2016.

II.2 Canada and Mexico are likely to grow faster in parallel, but risk the shock from new policies of the U.S.

As the key trade partners of the U.S. (Figure 3 and 4), Canada and Mexico are both export-oriented and energy-reliant and are closely related to the U.S. economy. For instance, as Trump advocates restricting Mexican immigrants and strengthening trade protectionism, the Mexican Peso has tumbled recently due to the result of the U.S. election.

Figure 3: Top 10 Export Destinations of the US, 2015 Figure 4: Top 10 Import Source Countries of the US, 2015



Sources: Wind, BOC Institute of International Finance

In 2016H1, the Canadian economy fluctuated wildly mainly due to the fire in an oil-producing province which seriously affected the oil production and export. In H2, the real GDP grew strongly, attributable to reconstruction of the fire-stricken province, oil production back to normal, rebound of the international oil price, depreciation of Canadian dollar, increase of the U.S. import demand, recovery of consumer spending and export as well as the growth of the energy and mining and quarrying sectors. The Canadian economy is expected to grow faster moderately in 2017, but given the lack of growth potential, especially the slowing down of the housing market, the growth is still likely to be limited.

The Mexican economy also recorded strong growth in early 2016, but real GDP contracted in Q2 as investment and industrial output decreased sharply especially in the oil and mining sector. In H2, as oil price stabilized and peso was kept at low level, Mexico witnessed improvement in export, employment, industrial output and retail, resulting in strong recovery of the real GDP. In 2017, the growth of the Mexican economy is expected to rise slightly. In order to guard against the inflation risk in the context of the sharply depreciating peso, the central bank of Mexico is likely to keep the interest rate at relatively higher level.

III. The European Economy Recovered Steadily amid Multiple Challenges

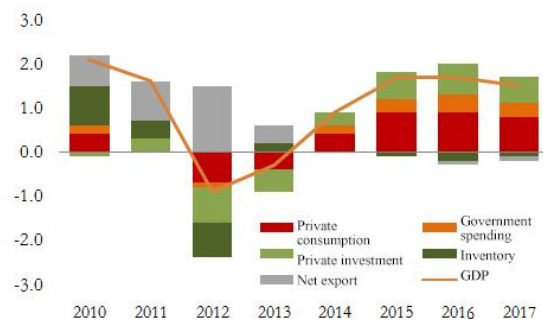
III.1 Eurozone economy grew moderately but appears vulnerable with downside risk

As the positive effect of the weakening Euro and lower oil prices gradually waned, the moderate recovery of the Eurozone economy slowed down compared with the previous year. Major member states had mixed performance. France was volatile while Italy was lackluster (Table 1). Private consumption was still the primary growth engine, pushing the Eurozone to keep moderate growth (Figure 5); monetary easing gradually improved the financing condition, accelerating the corporate and household lending. However, in the context of the negative interest rate, the profitability of the financial sector in the Eurozone generally declined. Some major banks saw ballooning bad debt or strained capital, causing pressure to build up and risks to rise. The Eurozone is expected to record moderate growth in 2017. The recovery of the labor market, the effect of the monetary easing and persistent structural reform of the member states will become key drivers of the moderate recovery. The inflation picked up on the rise of the energy prices and is expected to stand above 1% in 2017 which is still some way from the preset target. Therefore, the possibility of the ECB to further extend monetary easing cannot be ruled out.

Table 1: Economic Growth of the Eurozone and Selected Countries
GDP growth rate, %

	2015	2016	2017	2018
19 member countries of Eurozone	1.7	1.7	1.5	1.7
Germany	1.7	1.9	1.5	1.7
France	1.2	1.3	1.4	1.7
Italy	0.8	0.7	0.9	1.0
Spain	3.2	3.2	2.3	2.1
Greece	-0.2	-0.3	2.7	3.1

Figure 5: Eurozone Economic Growth and Contributors
GDP growth rate, contribution, %



Sources: European Commission, BOC Institute of International Finance

III.2 UK economy faced high uncertainty

The UK economic growth will slow down to about 2% in 2016. The services industry fared well, offsetting the decline of the other two industries and stabilizing the overall economic condition in the wake of the referendum to leave the EU. From the international perspective, the U.S. president election brought mild instability to the global economy. The debt and deficit in the UK was still enormous and depreciation of the British pound further increased the inflationary pressure, causing the market uncertainty to continue to grow. The UK economic growth is expected to further slow down to about 1.5% in 2017. The long-term prospect is not optimistic. The tough negotiation between the UK and EU regarding Brexit will continue. Given rising uncertainties in the short-to-mid term, the Bank of England is expected to keep the easing monetary policy and the UK government is likely to support the economic fundamentals in terms of fiscal policy.

III.3 Emerging markets in East Europe saw solid growth while Russian economy is likely to recover

In 2016, economy of some countries in East Europe slowed down from the previous year but the overall growth was still above that of the Eurozone. Driven by the loose fiscal condition and income growth, Romania performed strongly. Going forward, countries will continue to benefit from the steady recovery of the labor market, which, along with the boost of the EU fund to the

investment, will push the overall growth higher. Russia suffered heavily from the oil price slump and international sanctions, but the country took timely measures to deal with recession. With the transition of the growth model starting to show positive results, Russia is estimated to resume positive growth in 2017. However, in order to return to the growth track above 4%, the country must expedite the search and adjustment of the economic policy to find new growth engines. Amid military coup, conflicts and turmoil, the security situation of Turkey took a U turn in 2016, in particular, the tourism industry suffered from heavy losses, slowing down the economic growth from the year earlier. While private consumption and public spending will continue to drive economic growth in 2017, the deteriorated business environment adds uncertainties to the economic outlook of Turkey.

IV. Asia Pacific Economy Achieved Moderate Growth

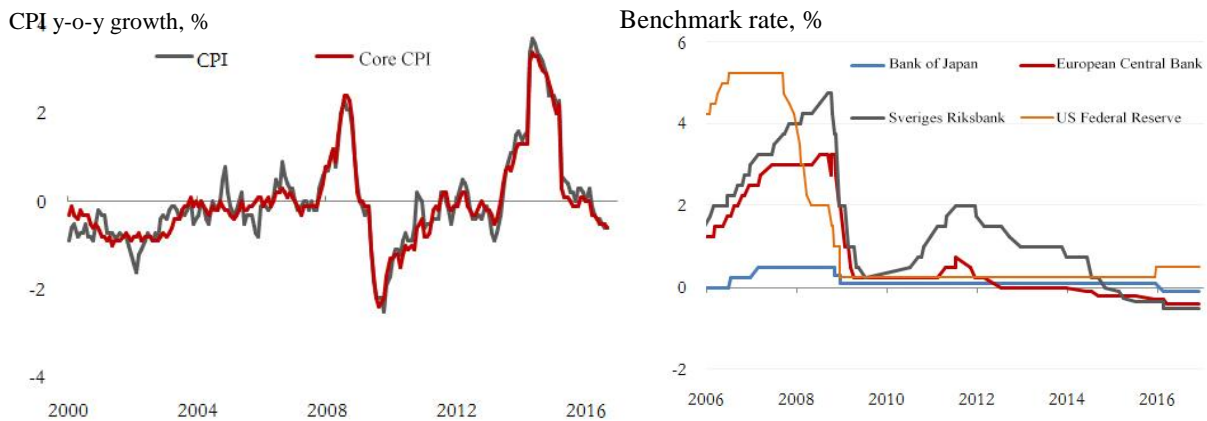
IV.1 Emerging economies in the Asia Pacific maintained stable and relatively fast growth

In 2016, the internal demand increased in the Asian emerging markets as a result of the monetary easing, offsetting the weak external demand. Meanwhile, the rally of the global commodity prices also helped the export-oriented Asian emerging markets to recover. The Indonesian economy has been stable with the year-on-year growth of GDP standing at 5.0% for the first three quarters; thanks to the increased bank lending, government infrastructure spending and foreign investment, Vietnam recorded a GDP growth of 5.9% in aggregate for the first nine months; in order to cope with weak external demand, declining export and sluggish internal consumption, the Thailand government implemented stimulus measures to boost investment, prompting the economic growth to hit new high for more than four years in H1; the Philippine economy grew at a rate of 6.9%, also the highest rate in three years, in particular, investment recorded a year-on-year growth of 27.6%. Should the economy of China and India stays stable in 2017, the Asian emerging markets will be able to continue steady growth. The overall GDP growth is expected to stay at around 5.7%. The prospect of the U.S. rate hike is likely to affect the capital flow in the Asian emerging markets, posing challenges to the economic growth.

IV.2 Japan witnessed slow growth and implemented aggressive monetary policy

In 2016, Japan economy grew slowly for two reasons. First, the deflationary pressure increased, hitting household consumption and investment willingness. The core CPI saw year-on-year decrease for seven consecutive months since March (Figure 6) due to weak private consumption and corporate capital goods spending. Second, the Yen appreciation took a toll on the export, causing corporate profit to fall. In order to respond to the weak economy, the Bank of Japan took bold steps to reform the monetary policy framework. It was the first central bank to implement the negative rate policy in Asia in January (Figure 7); subsequently in September, it launched quantitative and qualitative monetary easing with yield curve control, the “counter operation twist”. On the one hand, it demonstrated the determination of the Bank of Japan to stimulate growth, on the other hand, it indicated that the effect of monetary policy was abating. Looking into 2017, as international oil price stabilizes and Fed hike pushes the Yen to depreciate, the inflation rate in Japan is expected to edge up, thus driving up household consumption and investment willingness. The monetary policy will focus more on interest rate tools and the possibility remains that the QE scale of JPY80 trillion per year could be changed. The negative interest rate policy has shown strong effect in pushing down the short-term interest rate, therefore further cut by Bank of Japan is still in the cards.

Figure 6: Still Strong Deflationary Pressure in Japan Figure 7: Benchmark Rate Changes of Four Central Banks



Sources: Wind, BOC Institute of International Finance

IV.3 Australia pursued transformation of economic growth

The Australian economy slowed down in 2016 as the mining boom cooled substantially due to weak global demand. The real GDP grew 3.3% year-on-year in Q2, higher than the revised rate of 3.0% in the previous quarter. The growth was mainly driven by the expansion of government spending before the election and the mild increase of household spending and housing construction which offset the gloomy investment in the mining sector. In recent years, Australia has been actively pursuing other economic growth pillars. Public and consumer spending, export and housing investment has become the new pillar industries and managed to challenge the dominance of the mining sector in the economic growth. The central bank of Australia has cut rate twice to the historic low of 1.5%, which partly boosted demand. It still has room to cut rate in the future. The economic outlook of Australia depends heavily on the global performance, especially the economic conditions of China, its largest trade partner. We expect its GDP to grow 2.5%-3.5% in 2017 and inflation is estimated at 1.5%.

V. South America is Hard to Improve While Africa and Middle East will Grow Moderately

V.1 The recession of Latin America continued and is unlikely to improve in 2017

Latin America was in recession in 2016 for two consecutive years due to: global growth was subdued and international trade lagged behind; the Fed hike is pending and the international financial market is volatile; the commodity price was depressed, the risk exposure of foreign trade expanded and external vulnerability increased. Meanwhile, the rising fiscal deficit constrained the policy space, making it hard to stimulate economic growth through loose fiscal policy. In terms of monetary policy, some countries have raised the benchmark interest rate above the comfortable level specified in the Taylor Rule to curb inflation and capital outflow and left little leeway in promoting economic growth. Looking into 2017, the economic growth is still unlikely to improve. This is because: the sluggish global growth leads to weak demand for commodities, thus the prices will remain at a low level; the new policies of the Trump administration will disrupt the political and economic relations between US and Latin America, causing trade and diplomatic conflicts; the space of the monetary and fiscal policy is limited as Latin America countries are in the interest rate rise cycle to combat capital outflow and inflation amid Fed hike and strong dollar, which will have negative impact on the economy in the long run.

V.2 Middle East and North Africa will grow moderately

The economy of the Middle East improved in 2016. Countries in the region adopted austerity measures successively and adjusted industry structure to focus on the development of the non-oil

industry and reduce dependence on oil. Given relief of sanctions and increase of oil output, Iran is expected to be the frontrunner among Mid-east economies with GDP growth of 4.6% in 2016. But risks also remain: the gross government debt of a majority of countries was on the rise, and the debt of oil importers such as Egypt, Jordan and Lebanon continued to rise with their debt to GDP ratio far exceeding that of oil exporters, in particular, the government debt in Egypt increased to 94.6% of GDP in 2016 from 69.6% in 2010. In 2017, commodities will show mild recovery. This, along with continued economic reform and external demand derived from Eurozone growth, will help improve the economy in the Middle East; but the continued conflict in Iraq, Libya and Yemen will weight on the regional economic growth. We expect the GDP growth in Middle East and North Africa to reach 3.3% in 2017.

V.3 Economy of Southern Africa is likely to improve

Thanks to the rise of the commodity prices, the economy of Southern Africa has been growing at above 5% in the last decade. Since 2016, the changing global financial conditions as a result of the weak commodity prices, Fed hike and Brexit has inflicted the economic growth of the Southern Africa. In 2016, the overall growth of Southern Africa was sluggish. The growth was also mixed, the resource-dependent countries such as Nigeria and Angola saw continued weakness in the short term, while countries such as Ivory Coast, Rwanda, Ethiopia, Senegal and Tanzania continued to improve due to low oil price and abundant infrastructure investment. Going forward, as commodity prices pick up, the economy of Southern Africa is expected to bottom out in 2017 with GDP growth of 3.1%. But this is premised on countries taking fiscal reform, reducing government debt and fiscal deficit, otherwise the economy will become more fragile and troublesome.

Part II Global Financial Review and Outlook

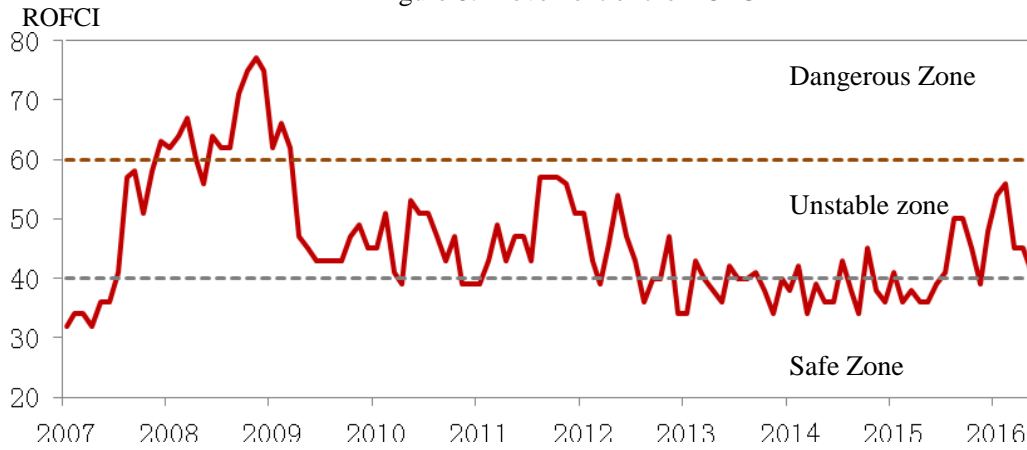
I. New Risks are Emerging in the Global Financial Market and Overall Risk is Likely to Accumulate

Global financial market suffered violent swings at the beginning of 2016; afterwards, it has been stabilized step by step thanks to the diminished recession risk in the U.S. and the world at large and the recovery of oil price. 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 quick subsiding of the Brexit's impact have combined to raise investors' risk appetite and drive recovery of capital market, thus easing market fluctuations.

I.1 ROFCI slightly picked up

At the beginning of 2016, the U.S. Risk of Financial Crisis Index (ROFCI) rose significantly; the index has decreased since then with gradual stabilization of financial market, but remained within the unstable zone (Figure 8). Compared with 2015, the overall financial risk in 2016 stayed at a higher level. Interbank market and non-banking money market worsened markedly; bank stock market fluctuated widely; yet risk in corporate credit market and the USD exchange market tended to decrease.

Figure 8: Movement of the ROFCI

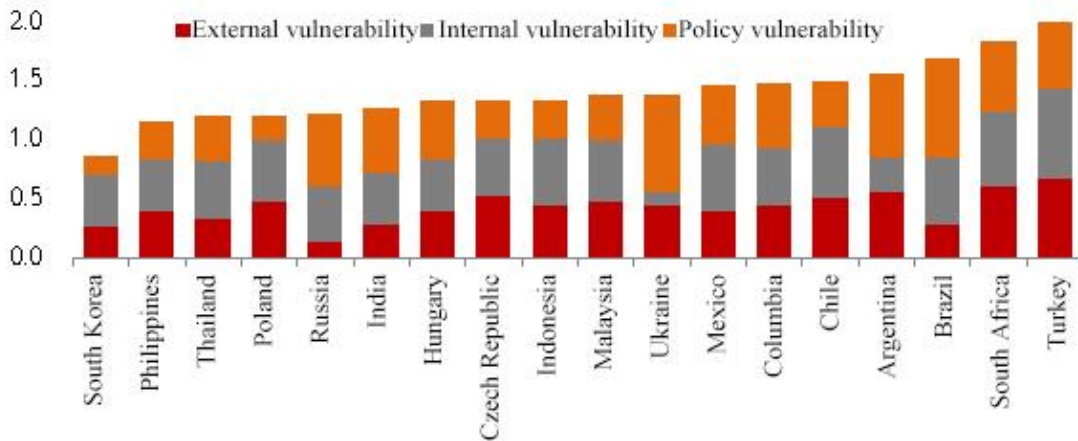


Sources: Wind, BOC Institute of International Finance

I.2 Overall financial vulnerability of emerging economies edged down

In 2016, overall financial vulnerability of emerging markets first increased and then decreased; in the first half year, emerging countries experienced slower capital influx and faster capital flight and the vulnerability increased along with slower economic growth and rising financial risks; in the second half year, emerging markets enjoyed capital reflux and less capital flight as a result of their accelerated economic growth, stabilization of global financial market and the loose monetary policies maintained by major central banks. In Q4, overall financial vulnerability of emerging markets edged down. Specifically, Turkey, South Africa and Argentina were the most externally vulnerable; Turkey, South Africa, Brazil and Indonesia were the most internally vulnerable; and Brazil, Ukraine, Argentina, South Africa and Russia were the most vulnerable in the policy sphere. Overall, Turkey is the most vulnerable and South Korea is the least vulnerable (Figure 9).

Figure 9: Financial Vulnerability Index of Major Emerging Economies in 2016Q4



Sources: Wind, BOC Institute of International Finance

I.3 New risks are expected to increase and overall risk likely to accumulate in 2017

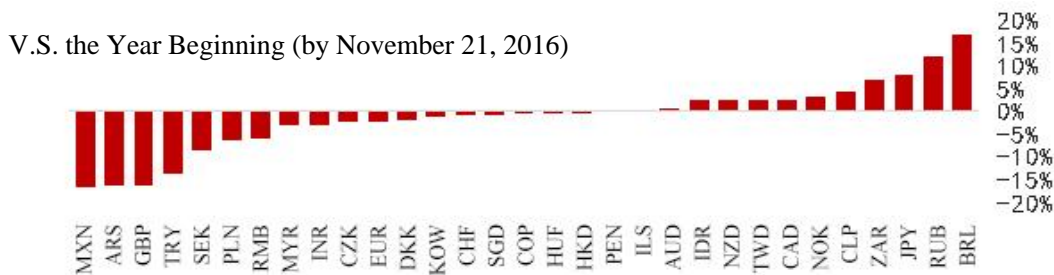
Major risk factors are as follows. The first lies in uncertainty of global policies. Fed rate hike is expected to pick up speed and policies of major central banks to be further divided. After the President-elect Trump assumes office, more policy uncertainties may emerge, including intensified trade protectionism and rising geopolitical risk; the process of Brexit also contains uncertainty; the intricate general elections of other European countries might cause the risk of more countries choose to leave the EU. Second, financial risks in developed countries. In 2017, inflation and

interest rate are likely to rise more rapidly, putting bond market under selling pressure. Underpinned by the loose monetary policy and the USD exchange rates, the rise of global asset price is likely to exceed economic and corporate profit growth and is vulnerable to the impact of monetary policy and the USD exchange rate changes. Central banks of multiple developed economies have adopted negative interest rate policy, making it harder to improve the profitability and asset quality of their banks. This in turn will continue to erode banks' capital buffer and put banking institutions under noticeable risks. Third, emerging markets face rising risks. Firstly, bank credit conditions of emerging markets tend to deteriorate, reflected by weaker credit demand, larger portion of non-performing loans and rising interest rates; secondly, enterprises of the emerging markets have issued large amount of bonds in the past few years which raised their leverage ratio and the repayment is about to be due; thirdly, about 46% of the global non-banking debts are denominated in the USD, one third of which are issued by emerging markets. If the USD appreciates, the debtors will be under greater pressure of repayment; fourthly, foreign reserves of emerging markets have decreased, increasing the debt risk.

II. FX Market: USD Maintained Its Strong Position, and Uncertainty and Risk Aversion Were Intensified

In 2016, amidst global economic weakness and rising financial vulnerability, the FX market experienced several rounds of fluctuations triggered by the expectation of Fed rate hike. In general, the USD held the dominating position, risk aversion drove up the JPY, European currencies hovered at a low level and currencies of emerging markets were under renewed pressure (Figure 10). Going forward, the progress of Fed rate hike and global economic and political landscape will continue to lead the FX market movement, presenting greater uncertainties.

Figure 10: Changes in the Exchange Rates of Major Currencies against the US Dollar in 2016



Sources: Bloomberg, BOC Institute of International Finance

II.1 USD Index rose with changing expectations on Fed rate hike and risk aversion drove up JPY exchange rate

In 2016, the U.S. economy rebounded following a sluggish period and expectations on Fed rate hike changed with it, making it the core factor affecting the direction of global FX market. Since Q3, the U.S. economy has recovered and employment market performed well, raising the expectation on rate hike by the Fed. Fed rate hike in December has become highly probable in spite of the increased policy uncertainty brought by election of Trump as the president. The USD has appreciated significantly, with the index exceeding 101 points, hitting the record high since 2004. Although Japan's economy faced severe downward pressure and extremely loose financial environment, JPY still strengthened substantially driven by global risk aversion sentiments and JPY hedging transactions. The exchange rate of yen against the U.S. dollar exceeded 100, the highest level since November 2013 (Figure 11).

II.2 GBP tumbled and EUR fluctuated at a low level

In 2016, British economy recovered mildly on the whole, but the unexpected referendum result to leave the EU added to the uncertainty, imposing considerable negative impact on UK and even the Europe at large. Consequently, GBP suffered a loss of nearly 9%. The risk brought about by Brexit rendered GBP to bear continuous pressure and fluctuate at a low level. Facing weak economic growth in the Eurozone, ECB kept strengthening loose monetary policies. Negative interest rates aggravated the banking sector's business risks, thus arousing political centrifugal force and populism. These factors, to some extent, curbed investment and employment, making it hard for EUR to resume its strong position (Figure 12)

Figure 11: USD Index and JPY Rate

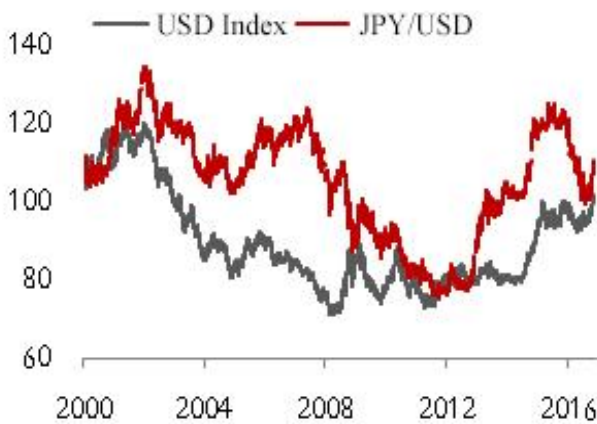


Figure 12: EUR and GBP Rate Movement



Sources: Wind, BOC Institute of International Finance

II.3 Currency depreciation pressure of commodity exporting countries in the emerging world was relieved

In 2016, Fed rate hike was postponed several times, which relieved the currency depreciation pressure and emotional tensions of emerging markets. MSCI Emerging Market Currency Index rose by 2.7% over beginning of the year. However, MXN, ARS and TRY still suffered from great loss, each tumbling above 10% over beginning of year, due to economic depression and political turbulence. Rising prices of commodities including crude oil and industrial metals supported the recovery of BRL, RUB and other currencies.

II.4 Looking into 2017, the progress of Fed rate hike and the change of global economic and political landscape will lead the FX market movement

In spite of the uncertainty in Trump's policies, rate hike by the Fed is highly likely in December 2016 and 2017 due to the U.S. economic recovery. The fiscal stimulus package might yield short-term fruits. The USD will maintain its strong position amidst short-term fluctuations and lead the changes of global exchange rates. Economy of the Eurozone will face downward pressure: the refugee crisis pending proper resolution, Italian referendum over constitutional reform and the upcoming general elections of Germany and France have added uncertainties. The economic and political risks might disable EUR from resuming its strong position. The negative impact of Brexit has lingered on, casting shadows over British economic and financial growth. UK is expected to maintain loose monetary policy and GBP to hover at a low level. Under the framework of stronger USD, currencies of emerging markets will continue to fluctuate along with the USD. As prices of commodities are unlikely to maintain strong growth momentum, currencies of commodity exporting countries have limited upside. In addition, geopolitical risks are increasing with the

comeback of protectionism and nationalism. We should guard against spillover effect of regional conflicts and turmoil over the FX market.

III. Global Stock Markets Pulled Back from Earlier Highs and Political and Economic Events are Potential Risk Points

III.1 In 2016, global stock market saw wider volatility

At the beginning of 2016, global stock market fluctuated broadly: global stock market fell amidst fluctuations due to the U.S.' economic slowdown, Japan's negative interest rate policy and European banking sector's huge financial loss. Later on, ECB proceeded with its easing monetary policy featuring negative interest rate and larger bond purchases and the Fed postponed its rate hike, which relieved market nerves and helped stocks of various countries bottom out. Since September, the U.S. economy has gradually improved, followed by higher expectation on Fed's rate hike, capital reflux to the U.S. and global liquidity crunch. As a result, global stock market pulled back from earlier highs to the level at the year beginning (Figure 13).

Figure 13: MSCI Global Capital Market Movement



Sources: Wind, BOC Institute of International Finance

III.2 Stock performance of major economies diverged

U.S. stock market gradually recovered from the plunge at the beginning of 2016 and saw strong gains especially after the presidential election, reflecting the market's confidence in the long-term growth of U.S. economy; UK stocks have perked up since July, after gradual digestion of Brexit impact; stock market of the Eurozone still underperformed as a result of European banks' worse earnings profile, weak European economic recovery and negative interest rates; stock market of Asia Pacific showed similar trends to Europe, mainly affected by economic fundamentals and U.S. presidential election results, etc.

III.3 Looking into 2017, global stock market will fluctuate downwards

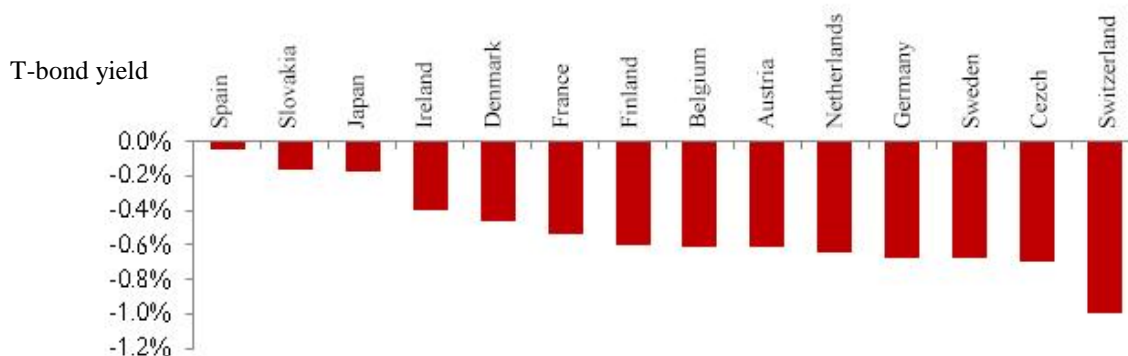
The Fed is expected to launch another rate hike, which will attract capital to flow back to the U.S. Fed rate hike will aggravate the capital drain of emerging countries and commodity exporters, while shortage of domestic liquidity and higher short-term interest rates will divert capital away from the stock market. Furthermore, USD appreciation will result in lower commodity prices. Therefore, countries with large external debts or high dependence on commodity exports, like Brazil and Argentina, are likely to suffer prolonged depression and falling stock markets. Trump's policy proposals include reducing dependence on loose monetary policy and stimulating economic growth by fiscal policy instead. This proposal will promote U.S. economic recovery, if carried out. However, Trump's repeated criticism over the Fed's slow pace of monetary policy normalization will also impact the global stock market: if the interest rate hike is accelerated, global hot money

will pour into the U.S., emerging economies, especially commodity exporters will be faced with severe capital flight and currency depreciation, and stock markets of all countries will be troubled. In addition, 2017 will witness the general elections of Germany, France, Italy and other countries. If more “black swan” events happen, the integration of Europe will be confronted with huge setbacks and the global stock market will suffer from new shocks.

IV. Bond Markets of Developed Countries Entered the Era of “Negative Interest Rate”

In 2016H1, government bonds of developed countries steadied higher driven by greater expectation on Fed rate hike, stable economic growth of Europe and U.S., etc.; in the second half year, central banks of Japan, UK and Eurozone strengthened their loose monetary policies, lowering government bond yield of developed countries. Yield of Japan’s 20Y T-bond fell below zero for the first time and yield of Switzerland T-bond ranging from one year to 30 years posted negative. As return on fixed-income assets in developed markets declined, lots of investors pursuing capital return have left for emerging markets. Size of sovereign bonds issued by emerging markets hit the record high, with Mexico, Argentina and Qatar issuing government bonds of USD107.5 billion in total. With the relief of geopolitical conflicts, government bond yield of Brazil, Russia and other major emerging economies declined, with negative yield spreading wider. By November 2016, 2Y government bonds of 15 countries and regions including Japan and Germany had recorded negative yield (Figure 14).

Figure 14: Countries with Negative T-bond Yield in November 2016



Sources: Bloomberg, BOC Institute of International Finance

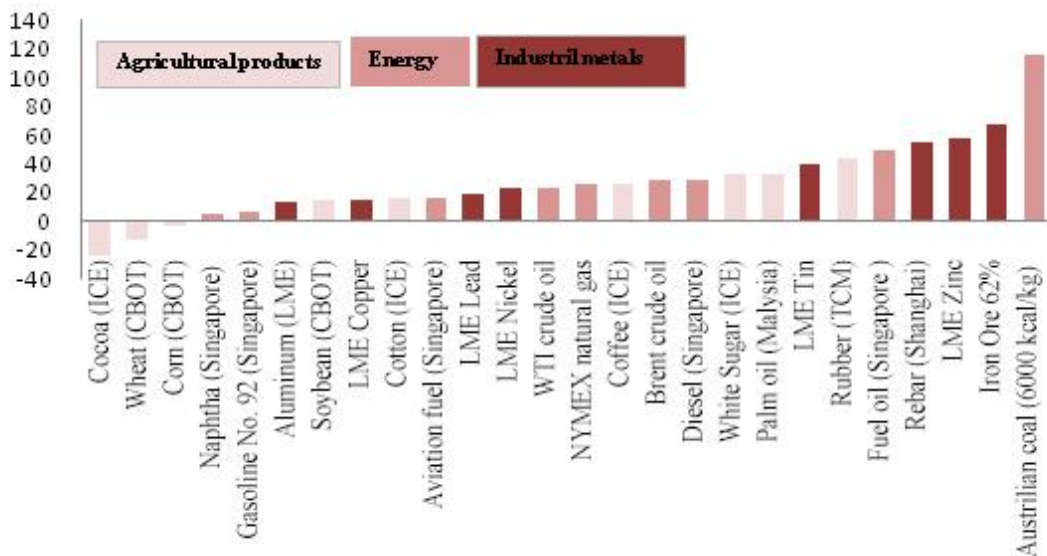
Brexit and Fed rate hike will exert after-market impacts. Relations between UK and EU were largely uncertain during the Brexit negotiations. In the long run, Brexit might impose more influence over European general elections due next year. For example, candidates representing “populism” may have greater chance of winning. Due to uncertainties in EU itself, safe-haven flows are likely to escape from Europe. Meanwhile, political factors led to lower risk appetite on global bond market, even the overall market risk appetite. After Trump was elected as U.S. president, global bond market has experienced a selloff period, as expectation on strong growth and high inflation will be accompanied by increased interest rates, thus leading to falling bond prices. Under this expectation, bond investors are bound to sell off bonds in advance and channel their money to markets with higher earnings. In 2017, economic growth and inflation of UK, Europe and Japan are likely to miss the target value, which gives their central banks little motive to adjust existing monetary policies. The Bank of England may continue to cut interest rate or maintain loose monetary policy. Yield of UK T-bond will be affected by uncertainties in the negotiations on leaving the EU. It takes a long time for all countries to normalize their government bond yield. Government bonds of developed countries can still be deemed as an effective hedging tool in the volatile market. Japan’s government bond will maintain its low yield rate amidst the

continual loose monetary policy. Development of emerging economies is imbalanced and diversified. Combined with more volatile oil prices and lower investor risk appetite, government bond markets of most emerging economies may fluctuate more broadly.

V. Commodity Markets Were Characterized by Stabilization and Re-balance

In 2016, commodity market was primarily characterized by re-balance. Yet, high volatility resulted from various events caused it to be off track from time to time. After the nearly full-range decline since 2014H2, commodity market began to stabilize in 2016, with most commodities embracing significant price increase over the year beginning (Figure 15). This, on one hand, was attributable to the market re-balance driven by low prices; on the other, the low base number at the year beginning also contributed to the growth.

Figure 15: Price Movement of Major Commodities 2016YTD (%)



Sources: Bloomberg, BOC Institute of International Finance

In the energy market, OPEC led by Saudi Arabia announced to shift from the former market share-oriented policy to restrictions on production at the end of September. Benefiting from the favorable news, oil price rose sharply. And coal price skyrocketed under the support of China's de-capacity practice. As for industrial metal market, due to the reversal of demand-supply relation caused by previous mine closures, zinc price increased substantially, making it outperform the other base metals with a growth rate of 58% year to date; surprisingly, iron ore price also jumped by 67% underpinned by China's strong demand, hitting investors with short position in succession. Agricultural product market was influenced by good or poor harvests. White sugar and palm oil reported price hike, wheat and corn became two of the few price-falling agricultural products this year due to large production and inventory.

In 2017, commodity market will seek further re-balance. Based on the low price levels in 2015 and 2016, prices of commodities represented by crude oil will recover by a narrow margin in 2017. Without doubt, any price rebound might attract producers previously squeezed out of the market to re-enter it, thus prolonging the re-balancing process. Seen from the current situation, commodity prices will diverge based on different fundamentals. In the energy market, as volume of supply excess is dwindling, crude oil price will rise in 2017 over this year. Yet, significant increase is not foreseeable unless supported by large-scale supply interruption or strong demand. In the industrial metal market, fundamentals of zinc and tin are solid, with potential upside; yet iron ore price is

unlikely to maintain its growth momentum of this year against the backdrop of large supply. Thanks to the conduction effect of rising energy prices and the function of market re-balance, prices of agricultural products on the whole will also nudge up, yet subject to the weather-related uncertainties.

Commodity market is closely related with international economic and financial environment. Currently, the following issues merit our attention: (1) Trump's election as U.S. president. Trump has his own propositions regarding monetary policy, fiscal policy, trade policy and energy policy. The extent to which these personal propositions are converted into national policies will exert direct impact upon the commodity market. (2) Speculation factors in China's futures market. Since the beginning of 2016, the ever-growing retail investors have shown their mighty force of disturbing the market, e.g. in the trading of iron ore, coal and copper, among others. Therefore, we need to keep an eye on the short-term liquidity often deviating from the fundamentals. (3) China's industrial policy, or its de-capacity progress. In 2016, China's de-capacity initiative has directly influenced the prices of coal and iron ore; the subsequent implementation and progress of this policy will continue to affect the market re-balance process of relevant commodity markets.

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