The Economy in 2016: A Global Perspective from Dun & Bradstreet

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Abstract

According to Dun & Bradstreet's economists, the year 2016 will hold both numerous challenges for the post-recession global economy, as well as some positive indicators for the United States. Trends such as an emerging market growth slowdown, increased supply chain risk, monetary policy easing, the volatility of financial markets and the slow recovery process of the OECD all play into Dun & Bradstreet's risky forecast for the globe in 2016. In contrast, Dun & Bradstreet's proprietary US Economic Health Tracker and Small Business Health Index (BHI) both indicate that the US is poised for a strong year in 2016 compared to many regions of the world.

The Global View: Risks Abound

More than six years after the Great Recession (Dec 2007-Jun 2009) ended, a variety of risks plague the global economy as we head into 2016. In the advanced world, the US and the UK are leading growth, while the Euro zone and Japan struggle to achieve sustained expansion. More worryingly, emerging markets, which provided a backstop for global decline in the initial years of recovery following the recession, are now losing steam, led by a slowdown in China. Dun & Bradstreet's coverage of the 132 major economies of the world suggests that there are numerous and significant headwinds to global growth in the near term. For example, in the Q3 2015 Chartered Institute of Procurement & Supply (CIPS) Risk Index, powered by proprietary data and analysis from Dun & Bradstreet, our economists found that global supply chain risk remained stubbornly high last quarter as interconnected geopolitical developments threaten to redraw the supply chain map. The CIPS-D&B Global Risk Index stood at 79.1 in Q3 2015, only slightly down from the record high of 82.4 two years ago, and considerably higher than the pre-financial crisis level of just 40.4 in Q4 2003.

From a more general macroeconomic point of view, monetary policy easing worldwide is confirming fears for short-term economic growth. The ECB is creating expectations of a further easing in its policy stance in December. G7 equity prices remain dependent on reassuring policy signals from central banks and China. Services and consumption are tending to show resilience, versus manufacturing and investment. The headwinds from the emerging economies, in particular China, along with weaker than hoped for growth in the advanced economies, are in turn posing problems for the world's central banks. As of mid-November, 47 central banks had introduced more easing in 2015, while only 25 had tightened monetary policy. The actions of the US Federal Reserve, of course, remain of greatest interest in the monetary policy space; we expect the Fed to raise interest rates for the first time since 2006 in mid-December to start the process of interest rate normalization.

In contrast, in late October, the ECB unsettled markets by setting expectations that it would expand its EUR1.1trn quantitative easing program at its December meeting, with the possibility of cutting its interest rate should the downturn in emerging markets threaten the Euro zone's recovery. Meanwhile, with Japan having suffered a technical recession (two successive quarters of GDP contraction) and inflation falling well short of target, the Bank of Japan rejected pressure to expand its program of bond purchases in October, which, being worth close to 10% of GDP per year, is already far in excess of the ECB program in relative size.

Prominent global stock indices remain close to or above pre-crisis highs as of early Q4 2015. This is in spite of faltering corporate earnings in exposed sectors in the US, the downturn in swathes of Chinese upstream industry and the one-month dip of the Euro zone back to deflation in September. Central banks in the OECD are continuing to take extremely easy monetary stances. The volatility in financial markets in Q3 reflected the fears that this could end even as China threatened to unleash a negative demand shock and competitive currency devaluations globally. More confident performances from US and Chinese policy-makers since then reassured footloose fund-holders. Services sector resilience globally, compared to manufacturing, is another positive.

The Fed's rate liftoff in December will not end the long, slow post-crisis recovery the OECD has known to date. We still expect China's economy to decelerate to 6.0% real GDP growth and for Brazil's and Russia's economies to keep contracting in 2016. The slump in oil prices will spell dislocation for Russia, central Asia and other energy exporters with few resources, such as Angola and Nigeria. As for China, a key energy importer, its property market will continue its recovery in first-tier cities, but there will also be a growing realization that China's rich and poor provinces will see markedly diverging fortunes in the rest of the decade.

The US economy: leading the pack

D&B's US economic forecast is based on our unique micro-to-macro capabilities. In other words, we use D&B's proprietary micro data and analytics to inform our macro forecasts.

One of the most important and popular tools that Dun & Bradstreet employs to check the pulse of the economy, and advise our customers, is the US Economic Health Tracker (EHT), a monthly, multi-dimensional review of the health of the economy. The D&B tracker is unique in its construction and application; it combines our microeconomic insight distilled from the millions of company data and records in our databases, with our country insight and macroeconomic forecasts to generate a forward looking snapshot that provides our customers a peek into the near term future of the US economy, thereby helping them to plan their business strategies more effectively.

There are three sub-components of the Tracker, each providing valuable business insight on their own. One key component of the Tracker is the D&B US Business Health Index (BHI), a broad measure of the balance sheet health of US corporations. The BHI is computed using an equally weighted average of D&B's Viability Score, Delinquency Predictor and Total Loss Predictor, and reports a normalized score of between 100% and 0%. A reading of 100% signals that the aggregate of all active and open companies in the US are recording very low levels of financial risks, while a reading of 0% indicates that they are recording very high levels of risk. A reading of 50% is the dividing line of the population between low and high levels of risk. The higher the BHI, the less likely it is that an exogenous event will negatively impact the population of US companies and send them into a tailwind, and vice versa. Further, the BHI is a leading indicator capable of predicting impending turning points in the financial health of companies.

The BHI saw significant improvement from a month ago and rose by a healthy 46 basis points to reach 54.9% in October. The index had peaked in May 2014 at a value of 54.1%, and since then fell in 9 out of the 12 months leading up to May 2015. This disappointing trend was broken in June, and has now been followed by five straight monthly increases bringing the index to its all-time high (history for the index begins in December 2010). In October, all three subcomponents of the BHI, namely Viability, Delinquency and the Total Loss Predictor rose, and all three reached their respective highest recorded values.

Throughout the ups and downs since May 2014, i.e. from one peak to another, note that the BHI has held above the 50% mark that separates overall balance sheet improvement from deterioration. In other words, in the event of an exogenous shock, balance sheets of US corporations are more likely to be able to withstand it rather than succumb to it.

By far the most important component of the Tracker is the Dun and Bradstreet Small Business Health Index (SBHI), which measures small business health (relative to 2004, the base year) as reflected in their payment patterns, failure rates, and utilization on credit. What makes the SBHI invaluable to us and our customers is that it is a leading indicator. During the Great Recession, the index had started its downturn approximately three quarters before any other macroeconomic indicator. It also signaled the recovery process significantly early, not only for the overall economy, but within granular segments as well.

Naturally, the SBHI's recent trajectory underlies our near term US forecast. Currently, we expect the US to close out 2015 with 2.5% expansion; growth will accelerate to 2.7% in 2016, and 2.9% in 2017. The SBHI rose decisively during the latest reporting period. Prior to this, the index had essentially stagnated for three straight months. Thanks to a solid 1.5 points jump in September, the SBHI came in at 97.8, the highest reading registered in 2015. This brought the Q3 average of the SBHI to 96.8, more than a point higher than the Q2 average of 95.5, but still somewhat short of the SBHI's December 2014 peak of 98.7. In other words, we expect a gradual improvement in the US operating environment in the near term, but small businesses will face modest headwinds.

One cautionary note here is that this is just one single month of improvement in the SBHI, and while it breaks a worrying stagnating trend that was starting to get entrenched, it still does not signal an upward trend, and we would need to see a few more months of sustained increases in the SBHI to upgrade our macro forecast. In fact, based on our investigation of the many, many sources of micro data that D&B owns, it is likely that the SBHI will continue to flip-flop through the end of the year. On the plus side, the latest reading puts the index 7.6 points ahead of its year-ago level of 90.2 in September 2014.

Note, the Card Utilization sub-index of the SBHI, which measures credit card utilization (a proxy for ease of credit availability), has remained lackluster in recent months. The Q3 average for the sub-index came in at 76.4, only slightly above the Q3 2014 average of 75.6. This indicates that while overall small business conditions are slowly improving, access to credit has plenty of room to improve. Our data indicate that the upcoming rise in interest rates is likely to have two different impacts on this. First, just the rise in the interest rates will force some zombie companies out of business since they will no longer be able to get credit at near zero rates.

Secondly, the elimination of these companies and the rise in the interest rate will eventually encourage lenders to offer and provide more credit, benefitting the rest of the businesses.

Delving deeper into the components of our GDP forecast, consumption, both private and public, will be the primary drivers of the economy in the near term. Consumers have led from the front since the recession ended, and thanks to aggressive deleveraging and low global energy prices, they remain well placed to remain the most significant driver of growth in 2016.

Job market strength is another factor underlying the strength of consumer spending. Stepping back from the month-to-month fluctuations in the number of jobs added, and looking at the broader trends instead, the US labor market remains strong. From its recessionary high of 10.0%, the topline unemployment rate has halved to 5.0% in October. Alternative measures also suggest that the extent of slack in the labor market has been diminishing steadily and we are moving closer to full-employment. The Federal Reserve's latest projections assume that the long run unemployment rate consistent with full-employment in the US is 4.9%. Even if we continue to see monthly job gains of around 150,000, this rate will be achieved in about four months.

The one area where the labor market still remains a concern is wage growth. The steady, solid job growth has not translated into wage growth as expected. Average weekly earnings accelerated measurably in October, but again, we need this momentum to sustain. A faster pace of job growth would clearly help sustain the upward momentum in wages and would eventually push wage growth to a rate that is high enough to justify interest rate tightening by the Fed.

The outlook for public sector spending has also brightened recently; on October 30, a bipartisan compromise agreement was reached on the budget and debt-ceiling; among other things, the agreement eliminates the possibility of a government shutdown or US default through March 2017, thereby removing the drag on the economy from fiscal policy uncertainty. Additionally, it will lift the so-called sequester spending caps and increase discretionary spending by about $80 billion over two years, an amount that will be split equally between defense and domestic programs.

On the other hand, headwinds to the US economy are mostly external in nature, and affect the forecast for the other two components of GDP, net exports and business spending. The strength of the US dollar, in particular, will keep a lid on the contribution from both exports and capex. The latest phase of dollar appreciation began in the second half of 2014; between July 2014 and October 2015, the Broad Trade-Weighted Exchange Value of the USD has appreciated by nearly 17%. As the US economy continues to pull ahead of its peers in terms of growth, and the US Federal Reserve stays on course to raise interest rates by the end of the year, while central bankers in other parts of the world continue to drive down rates, global investors have sought safety in the US dollar, prompting its rise. We expect the dollar to keep gaining ground over its peers in the near term. Manufacturing exports have borne the brunt of the strong dollar, but other export oriented businesses have also suffered. The strong dollar will continue to impede export growth in 2016; an added concern is the slowdown of the broader global economy emanating in emerging markets, especially China, which will further weigh on demand for US exports.

Corporate profits of large multinational companies have also been eroded by the strong dollar, and this is a downside risk for near term business investment. New orders for durable goods fell by 1.2% from a month ago in September; orders have fallen in four of the last six months. More worrisome, orders for nondefense capital goods, excluding aircraft, also known as core capital goods, and a reliable leading indicator for business spending fell 0.6%. On a year ago basis, in fact, core capital goods orders have fallen for eight straight months. Compared with prior recessions, business spending has been much weaker during the latest recovery, and we expect it to be sluggish in the near term.

FX risk, a casualty of the strong dollar, will also play a central role in the Fed's monetary policy decision. The US dollar will remain strong, and as such, global commodity prices will remain weak into 2016. This has so far kept domestic inflation low, and well below the Fed's longer run target of 2%. Core CPI inflation, which strips out volatile food and energy prices, averaged 1.8% in Q3, while average core PCE inflation, the Fed's most preferred yardstick of price pressures, came in much lower at 1.3% in Q3.

That brings us to the question of monetary policy and D&B's outlook for interest rates heading into 2016. The first interest rate hike by the Federal Reserve continues to drive vigorous discussion and speculation in the policy space as the US economy gets closer to the end of the year. The business community and the general public remain unduly focused on whether the Fed will opt for the first hike in the Federal Funds Rate (FFR, the policy rate) at the FOMC meeting in December 2015, or at a later meeting in 2016. Dun & Bradstreet reiterates that the exact date of the rate liftoff is of little consequence to broader macroeconomic performance and businesses should prepare for rates to rise by the end of the year; instead the trajectory of the policy rate, and the pace of rates increases after the first one is far more important in defining the role of monetary policy in guiding the economy's expansion and hence for business planning; we expect subsequent increases in the FFR to follow a shallow path, reaching only 1.0% at the end of 2016.

An increase in financial markets volatility is likely to accompany the rate liftoff, both in domestic and global markets. The more immediate effect of the financial market fluctuations is likely to be upward pressure on the US dollar, thanks to its position as a safe haven currency. However, if history is a reliable guide, a rate hike might not necessarily lead to further unwelcome dollar appreciation. Since the 1980s there have been four occasions when the US Federal Open Market Committee began to raise the Federal Funds Rate in an attempt to steer the US from an accommodative environment toward a more restrictive one. On three out of four of those occasions, the dollar actually fell 3%-11% against all other major currencies immediately following the rate hike.

Conclusion

In summary, Dun & Bradstreet expects the US to keep expanding at a decent pace over the next year as the fundamentals of the economy remain healthy, in spite of a number of global headwinds. Both our proprietary micro data and our macro forecasts suggest that the US will continue to pull the global economy ahead in the next few months until a broader, truly global expansion gains traction. At the same time, it is important to be cognizant of the US as an open economy and the headwinds that originate mainly outside US borders.

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