



Global Economy Watch

What do changes to the global economy mean for sovereign investors?



Dear readers,

The global economy has seen some twists and turns in recent weeks.

In the US the good data keeps on rolling in: the labour market has created more than 2.5 million jobs in the past year which raises the likelihood of the Fed hiking its policy rate. In contrast, China is facing a simultaneous downturn in both its business and financial cycles.

The origins of the Chinese crisis date back to the days of the global financial crisis which was when policymakers embarked on large-scale fiscal and monetary stimuli to maintain GDP growth in line with targets. Businesses responded to the demand stimulus and funded their growth using the cheap debt that was on offer. Six years into the stimulus programme, domestic private sector debt had grown from 100% to 140% of GDP.

With most of the new funding channelled into infrastructure and property projects, the authorities are now grappling with the bursting of a real-estate bubble. China's nominal GDP growth—a key determinant of how easy it is to pay down debt—has also flagged as its real effective exchange rate has appreciated by more almost 50% since last quarter of 2007.

Chinese policymakers have taken action to stimulate the real economy. The People's Bank of China cut interest rates and the yuan allowed to

moderately fall against the dollar. But academic research shows that credit-intensive expansions tend to be followed by slower recoveries. The risks to the Chinese outlook are clearly weighted to the downside and we have downgraded our outlook to 6.5% GDP growth in 2016.

But our attention is turning towards sovereign wealth funds (SWFs) which, at the end of September will be having their annual get together at the International Forum of Sovereign Wealth Funds. In anticipation of this, we have been thinking about the links between SWFs and more broadly sovereign investors (SIs), and the global economy. More specifically, we think there are three changes that have occurred to the global economy that could have implications for SIs: economies moving on from the crisis, the US preparing to raise rates and oil prices expected to be lower for longer.

We believe that these changes mean that now is the time for sovereign investors to review their macroeconomic objectives. Therefore, we have suggested a set of questions related to future sovereign finances and changes in the global economic environment that policymakers will need to take a view on to help them assess whether their sovereign investment fund's current objective(s) is still the best one(s) for their economy.

Click [here](#) and [here](#) to read our recent blog posts on China.

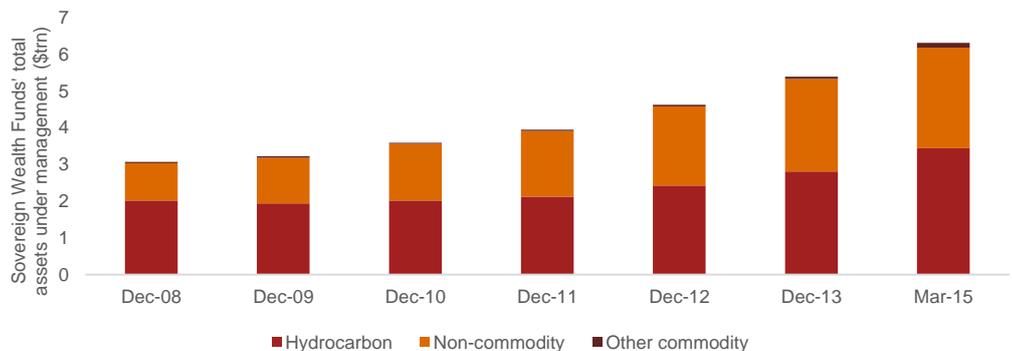


Kind regards

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Fig 1: Sovereign Wealth Fund's assets under management have approximately doubled since the financial crisis



Source: 2015 Preqin Sovereign Wealth Fund Review

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Economic update: strong Q2 growth in the Eurozone periphery and turbulence in China

Eurozone periphery growth continues in Q2

The Eurozone periphery grew by 0.5% quarter-on-quarter in the second quarter of the year. This was more than twice the rate recorded in the core economies (see Figure 2) bringing overall Eurozone growth to 0.3% on a quarterly basis.

On a national basis, the second quarter of 2015 marked a few milestones. Spain grew at 1.0% which was the fastest rate recorded since the first quarter of 2007. Italy recorded three consecutive quarters of growth for the first time since 2011.

And, despite all the odds, Greece managed to grow at 0.9% on a quarterly basis (albeit from a low base). A closer look at the figures though showed that this was probably fuelled by a large number of new car registrations. In our main scenario we expect the Greek economy to shrink by 1.1% this year and 2.5% in 2016.

How immune is the Eurozone to the turbulence in China?

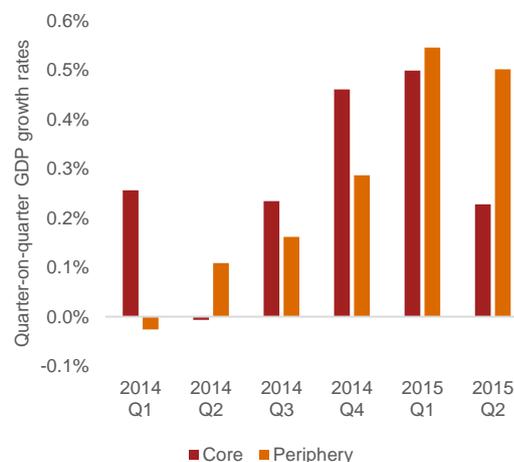
Looking at merchandise trade figures, Germany is the most exposed Eurozone economy to China. Specifically, German merchandise exports to China make up around 2% of GDP which is the highest in the Eurozone. However, the latest reading of the German IFO Business Climate index shows that sentiment remains largely unaffected.

Part of this trend can be explained by robust domestic demand growth, which provides an additional cushion to businesses that would otherwise sell their goods offshore. In the aftermath of lower oil prices, consumer growth has averaged around 0.6% quarter-on-quarter which is stronger than overall GDP growth.

We will discuss the wider implications of recent events in China in more detail in the next edition of Global Economy Watch.¹

¹We have also written a blog related to events in China which can be read [here](#).

Fig 2: Q2 GDP growth in all three core economies was slower than the UK and the US



Sources: PwC analysis, Eurostat

The quarterly figures are weighted using 2014 GDP numbers. The regions have been defined as follows: Core: Germany, France and the Netherlands, Periphery: Italy, Spain, Portugal and Cyprus.

Interview on sovereign investors with Michel Meert, Investment Consulting, PwC



Michel has more than 20 years of experience in asset management. His role is to advise a wide range of institutional clients globally, including sovereign wealth funds, foundations

and private wealth organisations, with a focus on asset allocation and investment governance.

What has been the impact of recent developments in the global and domestic macroeconomy and financial markets on a sovereign investor's (SI) investment strategy?

Much of sovereign investor wealth is a result of excess revenues from natural resources. The severe drop in oil prices, which started in mid-2014 and has resumed recently, impacted fundamentals significantly. Countries that benefited from substantial fiscal surpluses in the past are now facing budget deficits and, therefore, certain SIs are facing diminished inflows, and in some cases even outflows. Managing a fund with decreasing assets is very different from a growing portfolio, and more challenging for investment teams.

Another significant development

impacting all asset owners, including SIs, is the change in fixed income markets. Following a prolonged period of falling yields, we are now experiencing a potential inflection point or at least an end to decades of strong bond performances. This is having an impact on how funds are constructing portfolios. Alongside other institutional investors, SIs are seeking alternative sources of return and increasing allocations to less liquid or less traditional asset classes.

What other factors do sovereign investors take into account when deciding on an investment strategy?

The asset allocation and investment strategy of SIs should be driven by their mission, investment beliefs and investment objectives. A significant differentiator is whether the focus is on diversification – investing internationally and across asset classes – or whether to encourage the development, stability and/or diversity of the domestic economy and infrastructure. Countries with large reserves often have specialised funds or sub-funds addressing different missions. SIs that are tasked with preserving wealth for future generations have a long-term investment horizon and differ substantially from pension funds or insurance companies which are driven by their liabilities. This allows them to have large allocations in asset classes that are

not appropriate for more medium to short-term or liability-driven investors. This can be a significant advantage for SIs and allows them to invest more in illiquid assets and longer-term strategies.

What are the main measures that sovereign investors use to assess the performance of their funds?

The success of a SI should be assessed against clearly defined objectives. Often too much focus is placed on short-term investment returns rather than risk and longer-term outcomes. The risk appetite of SIs can be much higher than other investors due to their longer investment horizon and therefore their ability to capture a premium for illiquid investments.

SIs also have the tendency to assess and monitor their performance versus their peers, despite sometimes very different objectives.

Other non-financial measures are increasingly being focussed on, such as sustainability of the portfolio and reputational risk linked to investments. SIs are growing in importance and are realising their role, and responsibility, as major asset owners, and are likely to have a substantial impact on financial markets and society globally going forward.

Sovereign investors and macroeconomic objectives – time for a rethink?

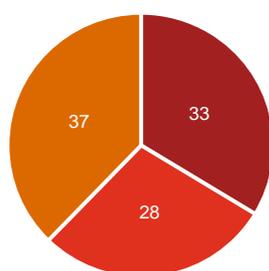
Fig 3: Sovereign investors can target three main macroeconomic objectives

Main objective	Specific objective
Capital maximisation <i>Building a capital base for the growth and preservation of national wealth</i>	Balancing intergenerational wealth
	Funding future liabilities
	Investing reserves
Stabilisation <i>Macroeconomic management and economic smoothing</i>	Facilitating fiscal stability
	Stabilising the exchange rate
Economic development <i>Investment to boost a country's long-run productivity</i>	Investing in hard infrastructure
	Investing in social infrastructure
	Pursuing industrial policy

Source: PwC analysis

Fig 4: Capital maximisation and economic development are the most common objectives for SIs

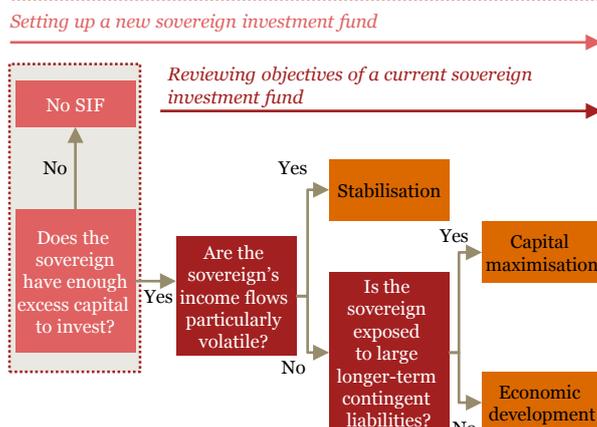
Number of SIs with the stated objective in 2014



■ Capital maximisation ■ Stabilisation ■ Economic development

Note: Total exceeds 74 as some SIs have multiple objectives
Sources: PwC analysis, Individual SIs, SWFI, Sovereign Wealth Center

Fig 5: Stylised questions for policymakers to review fund objectives



Source: PwC analysis

Sovereign investors are important economic agents

Since the financial crisis, sovereign investors (SIs¹) have become an increasingly important feature of the global economy. SIs typically take the form of a Sovereign Wealth Fund (SWF) or a public pension reserve fund. The total global assets that SWFs manage increased from around \$3 trillion at the end of 2008 to just over \$6 trillion in March 2015 (see Figure 1).

Time for policymakers to consider SIs' objectives

Over this time, the global economy has changed with knock on effects on SIs:

- **Moving on from the crisis:** The economic downturn had a significant impact on some SIs which had to provide funding to their governments or prop up domestic financial sectors. For example, Ireland's National Pensions Reserve Fund was initially set up to fund future pension payments, but during the crisis, a large chunk of its assets were used to bailout the banks. Now, the recovery is well underway in most peripheral economies. In Ireland, the sovereign fund has become the Ireland Strategic Investment Fund with the aim of supporting "economic activity and employment in the State."
- **US monetary policy and a strong dollar:** The crisis saw a prolonged period of expansionary monetary policy in the US and other advanced economies. But this is about to change. Interest rate rises are expected to occur soon (although the developments in China may delay this even further) and the dollar has been strong for some time in anticipation of this.
- **Oil prices - lower for longer:** Over 50% of SWFs' assets under management are financed by hydrocarbons. However oil and gas prices are expected to remain relatively low out to 2020. The IMF projected in July that oil prices would rise slowly to around \$70/bbl. by 2020, but this was before recent falls and events in China led to a renewed sharp decline in oil prices.

In light of these changes, the current objective(s) of SIs may no longer be appropriate. We think now is the time for policymakers to review their sovereign investment funds and ask whether different objectives could be beneficial for their economy.

What objectives can SIs target?

Based on a review of the stated objectives of 74 SIs², we have established a framework of macroeconomic objectives (see Figure 3). The three main ones are: capital maximisation, stabilisation and economic development. Figure 4 shows capital maximisation and economic development are more common objectives than stabilisation.

When reviewing SIs' objectives, policymakers need to consider what their fund has been doing recently and what they want the fund to do over the next decade, which may involve a change in strategy. To help with this we have come up with some questions that policymakers can use to consider what the most appropriate objective(s) might be.

What macroeconomic questions do policymakers need to answer?

Policymakers need to form a view on expected sovereign income and expenditure as well as how changes that have occurred to the global economy could affect their economy.

Policymakers can use the stylised question tree in Figure 5 to consider how the future path of sovereign finances might align to a particular objective. This is a relatively simple structure but it could provide a quick and early indication of what a fund might try to achieve before a more detailed analysis is conducted.

To complement this, we think there are three questions that policymakers need to answer linked to the changes to the global economy that we have outlined above:

1. Moving on from the crisis, what structure does the domestic economy need to take so that there are several sustainable and diversified drivers of growth?
2. Will a tightening monetary policy cycle in the United States mean that the US dollar remains strong for a prolonged period of time?
3. Will changes to demand and supply factors in the oil market keep prices low over the medium-term?

After policymakers have taken a view on all of these questions, they will be better positioned to begin assessing whether a change is needed to their SIs' objective(s). The chosen objective(s) should be at the heart of measuring the fund's performance. Strong investment returns, while important, are not necessarily a sign of success. The fund has to meet its macroeconomic objective(s) to be deemed truly successful – that is the benchmark against which SIs' performance should ultimately be assessed.

¹ SIs are broadly defined as any organisation which consists of "a pool of assets owned and managed directly or indirectly by government to achieve national objectives."

² SWFs and sovereign pension reserve funds (excluding other types of public pension reserve funds).

Projections: September 2015

	Share of 2014 world GDP		Real GDP growth				Inflation			
	PPP	MER	2014	2015p	2016p	2017-2021p	2014	2015p	2016p	2017-2021p
Global (Market Exchange Rates)		100%	2.8	2.8	3.1	3.1	2.3	1.8	2.5	2.5
Global (PPP rates)	100%		3.4	3.3	3.6	3.6				
United States	16.1%	22.5%	2.4	2.6	2.8	2.5	1.6	0.3	1.8	1.9
China	16.3%	13.4%	7.4	6.9	6.5	5.7	2.1	1.7	1.8	3.0
Japan	4.4%	6.0%	-0.1	0.9	1.7	1.3	2.7	0.9	1.0	1.9
United Kingdom	2.4%	3.8%	3.0	2.6	2.4	2.3	1.5	0.2	1.6	2.0
Eurozone	12.2%	17.4%	0.8	1.5	1.6	1.7	0.5	0.2	1.2	1.4
France	2.4%	3.7%	0.2	1.1	1.3	1.9	0.6	0.2	1.1	1.2
Germany	3.4%	5.0%	1.6	1.5	1.7	1.6	0.8	0.4	1.6	1.7
Greece	0.3%	0.3%	0.7	-1.1	-2.5	2.5	-1.4	-1.2	-0.2	1.4
Ireland	0.2%	0.3%	5.2	3.9	3.9	2.5	0.3	0.2	1.1	1.5
Italy	2.0%	2.8%	-0.4	0.7	1.2	1.3	0.2	0.1	0.9	1.4
Netherlands	0.7%	1.1%	1.0	2.0	1.5	1.9	1.0	0.8	1.3	1.3
Portugal	0.3%	0.3%	0.9	1.6	1.8	1.8	-0.2	0.6	1.1	1.5
Spain	1.5%	1.8%	0.7	3.1	2.6	2.0	-0.2	-0.3	1.0	1.2
Poland	0.9%	0.7%	3.5	3.5	3.4	3.2	0.2	-0.7	1.3	2.5
Russia	3.3%	2.4%	0.6	-5.0	-0.5	1.9	7.8	15.0	8.0	4.3
Turkey	1.4%	1.0%	2.9	2.7	3.2	3.7	8.9	7.9	6.8	6.2
Australia	1.0%	1.9%	0.7	2.6	2.0	2.9	2.6	2.5	2.6	2.5
India	6.8%	2.7%	7.0	7.5	7.9	6.1	3.8	-1.5	4.3	6.0
Indonesia	2.5%	1.1%	1.2	4.9	5.0	5.4	6.4	6.8	5.8	5.1
South Korea	1.6%	1.8%	3.3	2.8	3.3	3.5	1.3	0.9	1.9	2.9
Argentina	0.9%	0.7%	0.5	0.8	1.8	2.1	-	20.0	25.0	-
Brazil	3.0%	3.0%	0.1	-0.9	0.7	3.1	6.3	8.0	6.0	4.8
Canada	1.5%	2.3%	2.4	1.1	2.1	2.2	1.9	1.2	2.0	2.1
Mexico	2.0%	1.7%	2.1	2.3	3.0	3.9	4.0	2.9	3.2	3.1
South Africa	0.7%	0.5%	1.5	1.8	2.0	3.2	6.1	4.8	5.8	5.3
Nigeria	1.0%	0.7%	6.3	4.0	4.5	6.0	8.1	10.0	10.0	7.3
Saudi Arabia	1.5%	1.0%	3.5	2.6	2.8	4.4	2.7	2.3	2.6	3.4

Sources: PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI), with the exception of the Indian indicator which refers to the Wholesale Price Index (WPI). Argentina's inflation projections use the IPCNu Index. We will provide a 2017-2021 inflation projection once a longer time series of data is available. There is not a complete series of year-on-year price growth data available for 2014 so we have not provided an estimate for annual inflation in this year. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0-0.25% (December 2008)	Rate to start to rise later in 2015 or early 2016	16-17 September
European Central Bank	0.05% (September 2014)	Rate on hold until at least late 2016	22 October
Bank of England	0.5% (March 2009)	First rise expected in early 2016	10 September



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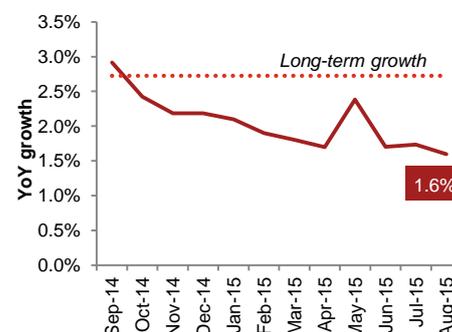


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PwC's Global Consumer Index

Growth in consumer spending fell in August, continuing on a trend below its long-term growth rate. Global equity markets faltered in July after suffering from a sharp market sell-off in China as growth loses steam. Despite a small improvement in confidence, industrial production slowed as activity in the Eurozone (Germany in particular) and Russia weakened. These trends point to a continued weakening in consumer spending in the short-term.



The GCI is a monthly updated index providing an early steer on consumer spending and growth prospects in the world's 20 largest economies. For more information, please visit www.pwc.co.uk/globalconsumerindex

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