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Insight Perspectives

Economic and political update

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The Insightperspectives newsletter is produced by Insightview.eu Ltd (Private Limited Company), Denmark, and is published on a monthly basis.

The editor-in-chief is Carsten B. Pedersen. If you are interested in subscribing to the newsletter, send your contact details to info@insightview.eu

The Insightperspectives newsletter provides a summary of what happened in the month under review, plus articles about "special issues" in the global economy.

The newsletter attaches importance to identifying and analyzing current and future trends in the global economy, financial market and politics.

All articles will be linked to external sources and Insightview.eu, which includes more charts, maps, data and elaborating comments.

What readers say about Insightperspectives

Nina Smith, Professor, **Aarhus University**, School of Business and Social Sciences Departm. of Econ. and Business. Former chairman of the Danish Economic Councils.

"This is actually a very good newsletter if you want to get quickly informed about major economic issues all over the world"

Flemming A. Jørgensen, Vice President, **Danfoss** Group Treasury & Insurance

"Insightperspectives is a valuable supplement to the daily stream of information, received from banks and the various other providers of news and market analysis. It puts the issues discussed into context and provides a view on the long term implications, which can easily get lost in the daily flow of information"

Ole Damgaard-Nielsen, Managing Director, **Inter IKEA** Treasury

"Insightperspectives provides an easily understandable summary of the financially most important events, news and developments around the world."

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"Insightperspectives brings an independent viewpoint on important economic, political and financial events. Thoughtful insights - I read regularly"

Peter Bundgaard, CEO, PM and founding partner of **BLS Capital Management**

The editor of Insightperspectives is simply the best macroeconomist I have ever experienced. For more than a decade I have been a reader of his thoughtful analysis that comes with an edge. This is the only macroeconomic analysis you will need to be able to follow global trends that can make a difference in your own day-to-day decision-making, whether in business or investments.

Global economic and political update

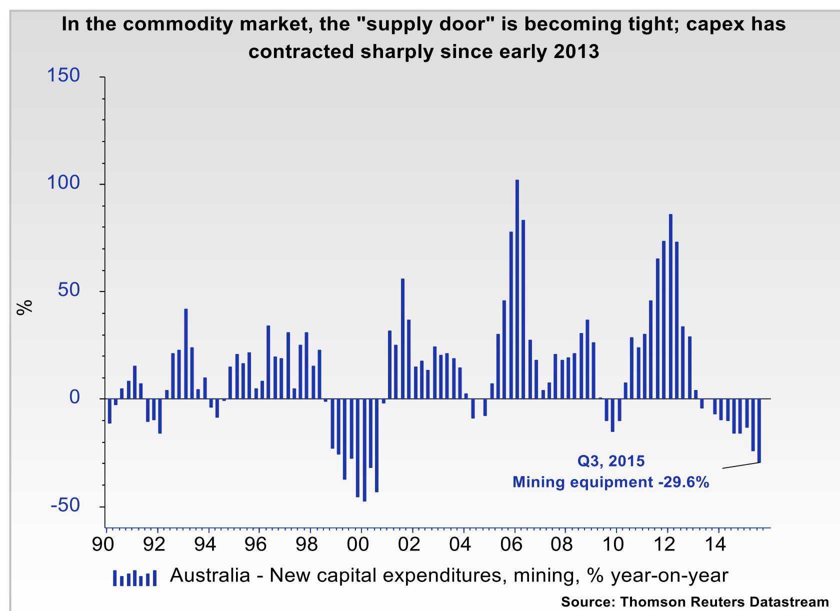
In 2016, the world economy is headed towards significant uncertainty due to an overwhelming number of destabilising factors. In the Middle East, Western and Russian interference has yet again ended up with creating new and more dangerous security vacuums. In this region, the Iran nuclear deal in particular reinforced existing conflicts (Syria, Yemen, Libya i.e.) – read the Insightperspectives article, Iranian nuclear deal risks creating security vacuum beyond the Middle East (April 2015). Unfortunately, this may soon end up with a direct military confrontation between sunni-led Saudi Arabia and Shia-led Iran – read the BBC-article, Iran: Saudis face 'divine revenge' for executing al-Nimr or click here to see the distribution of Muslims in the Middle East.

The world is also exposed to uncertainty after the majority of central banks have spent all monetary ammo since late 2008 to avoid a repetition of the Great Depression – read more in the article, The 2016 Global Economic and Financial Market Outlook, on page 17. On the positive side, the monetary strategy appears to have been a success in the United States, which was also why the Federal Reserve decided to raise policy rates in December – read more in the USA section.

In China, policymakers still have room for more monetary easing even though Beijing is now a believer of supply-side economics. The next monetary leg, however, could have serious global implications, as more monetary easing needs to be combined with steeper yuan depreciation (read the Insightview article, The Chinese dilemma - something needs to give in). This risks creating more jitters in emerging market countries and may refuel the ongoing global currency war – read more in the China section.

In the Euro-zone, policy rates are already negative. In December, this did not prevent the European Central Bank from cutting policy rates deeper into negative territory, even though the European economy shows visible evidence of gaining momentum – read more in the Euro-zone section. Indeed, the Euro-zone is

exposed to cyclical tailwind. Ironically, this is not least due to the fact that ECB president Draghi failed to create inflation, which has refueled households' real purchasing power. In the first half of 2016, low inflation will probably prevail in the global economy due to weak demand; but this could end abruptly when demand finally recovers, as plunging capital exenditure in the mining sector has made the "supply door" rather tight.



In Europe, the political situation could create significant headwind in 2016 from several directions. Granted, the biggest short-term "threat" failed to show up in December as Front National, a far-right party, did not gain a landslide victory in regional elections in France, as the political establishment united its forces against the party in the second round.

On the other hand, the outcome of Spain's national elections in December made the country yet another fragile factor in the European Union. The balance of power was radically changed; the political establishment, the Popular Party and the Socialist Party, are forced to either form a grand coalition or work together with the two newcomers, Podemos (far-left) or Ciudadanos (ultra market-liberal). The only positive factor, at least from a financial market point of view, is that the Socialists and Podemos are not able to establish a majority.

Whereas the outcome of Spain's national elections is part of the aftermath of the financial crisis in 2008-2009, the ongoing refugee crisis could prove far more dangerous to Europe's financial market in 2016. This is because Chancellor Merkel's autocratic decision-making in connection with the refugee crisis has endangered cohesion in the European Union. This has made many small EU member countries reconsider their position when it comes to deeper European integration, which was probably also part of the explanation behind the Danish "No" on December 3 to

adopting EU rules in the field of justice and home affairs – read more in the Denmark section.

When Mrs. Merkel granted visa to all Syrian refugees in August, she may have read sentiments correctly in Germany; but the Chancellor underestimated the reaction in the majority of other EU-countries. Indeed, Berlin's single-handed response to the refugee crisis has reignited nationalist sentiment in a number of European countries. In Eastern Europe, not least in Poland, Chancellor Mrs. Merkel's "wir schaffen dass" has been answered with ".....aber nicht mit uns!"

Indeed, Europe has plunged into the worst crisis since WWII. The situation is worsened by the fact that Berlin is now threatening countries not willing to take their "fair share" of an increasing number of refugees with economic and legal consequences – read the Spiegel Online article, Streit über Flüchtlingsverteilung: Steinmeier droht EU-Partnern.

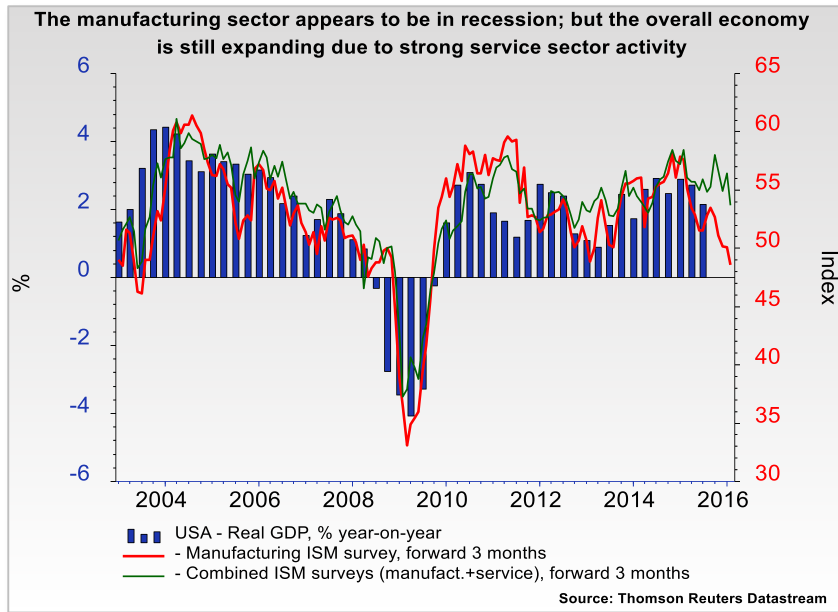
Ironically, at the same time as more European countries see Mrs. Merkel as a destabilising factor, the Financial Times and Time named Mrs. Merkel "person of the year". In Russia, the president, however, could not care less; what matters to Mr. Putin is that Mrs. Merkel's spontaneous decision-making has provided a highly unusual political comeback to a cornered Moscow – read also the article, Seehofer und Stoiber besuchen Putin; CSU stellt Russland-Sanktionen infrage.

USA – First interest rate hike since 2006; more tightening in the pipeline

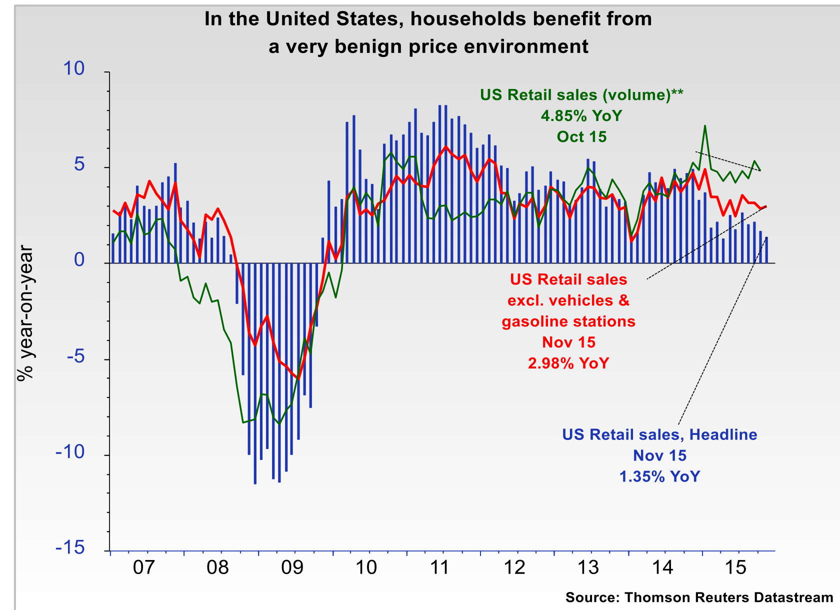
On December 16, the US Federal Reserve decided to raise policy rates by 25 basis points. This was a widely expected and long overdue move. Policy rates are expected to be raised again in March 2016. A valid question is of course why the Federal Reserve should raise policy rates? Inflation is absent and the manufacturing sector appears to be in recession. Furthermore, the leading national manufacturing sentiment index (ISM) fell in November to 48.6 from 50.1 in October, which was the lowest level since June 2009 (below 50 means contraction).

The answer is simple. First of all, monetary policy remains excessively loose, which is predominantly to the benefit of "useless" asset price inflation. In addition, the manufacturing sector accounts for less than 15% of GDP. The far more important non-manufacturing sector (service sector) is still relatively strong although the headline index in the leading service sentiment survey (ISM) has shown some

weakness in the last few months. In November, retail sales in volume terms rose close to 5% year-on-year and consumer sentiment remains upbeat – read the Insightview article, US December consumer sentiment stays upbeat as fear of terrorism fails to dent sentiment.



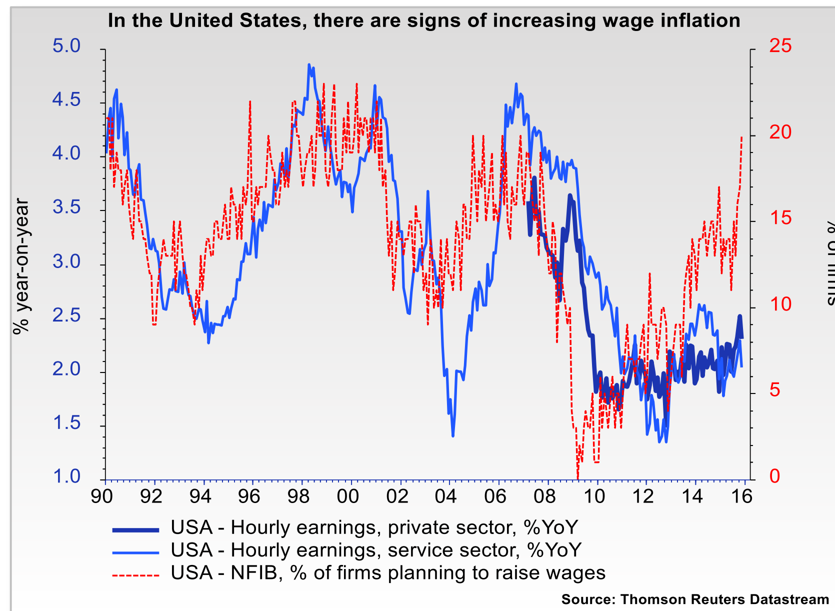
At present, US households are exposed to multiple tailwinds: inflation is low, the labour market is strong and there are tentative signs of stronger wage increases in the pipeline. The latter was also reflected in the firms'-compensation-plans-index in the leading small business sentiment survey (NFIB); the index jumped in November to the highest level since 2006.



These factors will make it difficult for Federal Reserve Chairman Yellen not to hike policy rates yet again in March. Granted, higher policy rates will make the yield curve flatten more aggressively in the first quarter of the new year, which is a harbinger of slower growth later in 2016. The latter is the case as this time the economy will prove far more sensitive to changes in monetary policy than in the past.

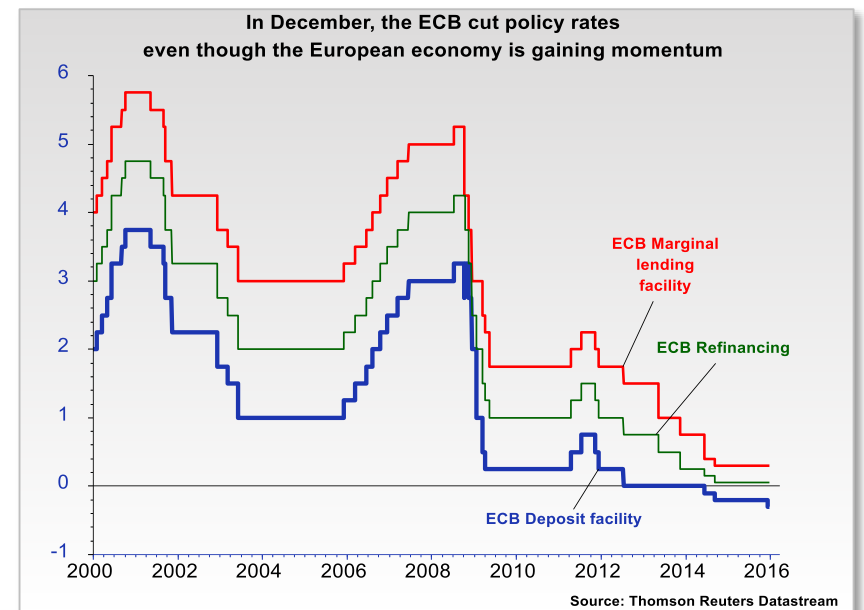
In December, the yield curve prediction was also supported by the fact that the six-month-outlook index in the regional Philadelphia Federal Reserve survey fell

sharply (the six-month-index is highly correlated with the yield curve). A flattening yield curve is an important factor in Insightperspectives' 2016 Outlook on page 17, which assesses the US economy to be "late-cycle" - see Insightperspectives' "real time" economic cycle.



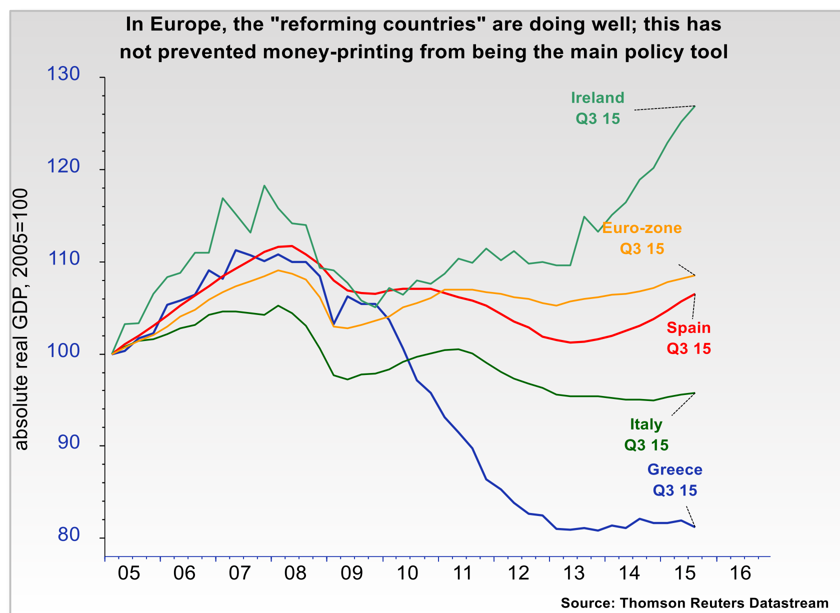
Euro-zone – ECB cuts policy rates; strong cyclical tailwind is confronted by political headwind

On December 3, the European Central Bank decided to cut the deposit rate to minus 0.3% from minus 0.2%. In addition, the central bank said it intends to extend its €60 billion per month bond buying program by another six months until March 2017 "or beyond" (a promise to provide liquidity for longer). The latter, however, is a "free promise"; in early 2015, the US Federal Reserve also promised to keep ultra-low interest rates in the "foreseeable future" although this was replaced with a rate hike in December – read more in the USA section.



The financial market, however, expected a far more aggressive monetary move as the ECB was seen to put its money where its mouth is by raising its bond buying program. Instead, ECB president Draghi suffered a crushing defeat in the Governing Council after over-promising in the media.

At this stage, the European economy does not need more monetary stimulus. The European economy is assessed by this newsletter to be mid-cycle - see Insightperspectives' "real time" economic cycle. The economy benefits from an ultra-loose monetary policy and, ironically, the ECB's failure to create inflation in spite of a weak euro. At present, the best leading indicators in Europe are still harbingers of strong demand in the manufacturing and service sectors, at least in the very near future.



The problem is that the improvement is predominantly based on front-loading of "future growth" and a beggar-thy-neighbour-policy caused by the ECB's very aggressive monetary policy. Indeed, only few countries in the Euro-zone (Spain, Portugal and Ireland) have seen an economic recovery based on real improvement in macroeconomic fundamentals. This is also why Europe's corporate sector may prove hesitant when it comes to boosting investment.

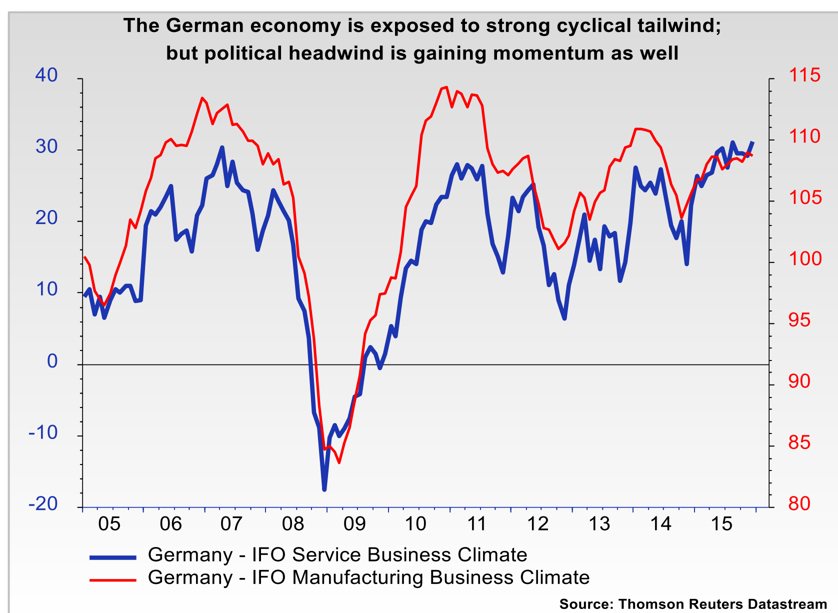
The latter is the case not least if the refugee crisis creates significant headwind, which may dent the current strong cyclical tailwind. The political impact of the refugee crisis has only just started and will become even more visible if Brussels (or more precisely Berlin) decides to force member countries to take more refugees as part of the latest deal with Ankara - read the Bloomberg article, Hungary's Orban Says Germany Struck `Secret' Turkey Refugee Deal.

Germany – Solid short-term growth; but "wir schaffen dass nicht" gains momentum

Germany is at the center of the European refugee crisis. So far, however, this has not been negative for growth, at least not until recently. Manufacturing sentiment remains relatively upbeat. This is the case even though the leading IFO manufacturing headline index fell marginally to 108.7 in December from 109.0 in November. The IFO service index, however, rose to

an all-time high of 31.2 in December from 29.2 in November.

Germany is exposed to strong cyclical tailwind; the economy will continue to see strong growth in the first half of 2016 as Berlin is forced to boost public sector spending to accommodate hundreds of thousands refugees. The question, however, is how a left-leaning Chancellor Merkel will finance soaring refugee-related spending?



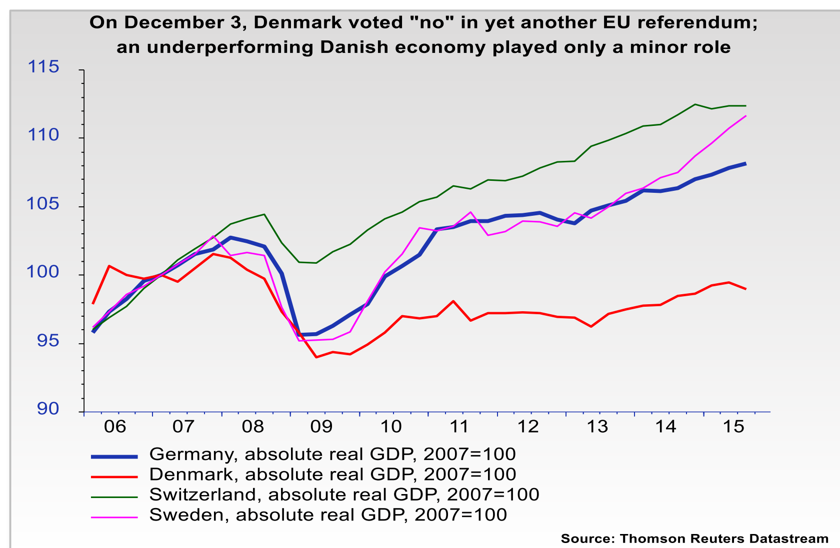
Another question is integration. So far, Mrs Merkel has failed to tell the German voters that successful integration of more than one million refugees means sweeping economic reforms and cuts in welfare benefits. This is in sharp contrast to the fact that Germany recently launched a minimum wage.

These unanswered questions are beginning to impact household sentiment, which was reflected in a survey published in December. The survey showed that 83% of all German households expect the economic situation to get worse in the coming years - read the article, Deutlicher Stimmungsumschwung bei den Deutschen. In 2016, consumer sentiment could worsen even more when households realise that Chancellor Merkel's "wir schaffen dass" is rejected by other EU member-countries – read the Die Welt article, In der Flüchtlingsfrage gibt es fast keine Solidarität.

Denmark – "No" is a message to Brussels and Berlin

On December 3, Denmark voted no to adopting EU rules in the field of justice and home affairs; Denmark's centre-right government had wanted to abandon some of the existing Danish opt-outs within this field. There are of course different interpretations of the outcome. Nonetheless, this newsletter sees the outcome as yet another clumsy attempt of the political establishment

in Denmark to pass more sovereignty to the European Union.



The vote was first of all a no-confidence vote to the Danish parliament and Prime Minister Lars Loekke Rasmussen in particular. Interestingly, the majority of the Danes are positive when it comes to the European Union (the Danes want membership of Europol); but it annoys many Danes that a self-appointed elite believes they know what is best for Denmark without asking them directly.

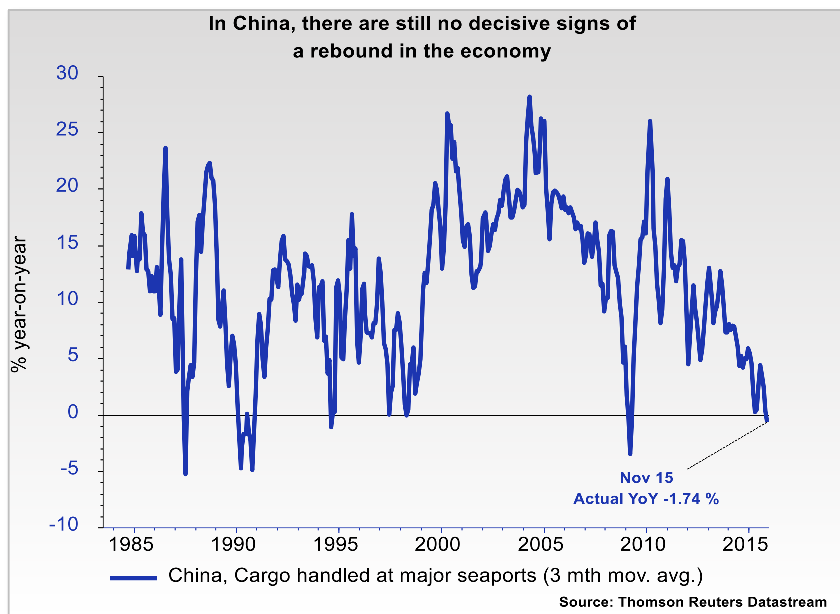
The outcome of the Danish referendum may not have any direct significance for the European Union (it is neither an issue in Brussels nor in Strasbourg). On the other hand, this is a message to Berlin and other European capitals that the "European idea" is still not deeply rooted, at least not when it comes to deeper integration. In many small member states, an increasing number of voters are worried about giving up sovereignity.

This may also have something to do with Chancellor Merkel. In 2015, Mrs. Merkel may finally have shown a capacity to act; but her style has often been highly autocratic. Today, Mrs. Merkel ignores that she is Chancellor in a country where the constitution was based on West Germany (Mrs. Merkel is from East Germany). Even though Mrs Merkel may have all the "politically correct" answers, she cannot commit the entire European Union alone. Such commitment has to be based on democratic rules. If Mrs Merkel does not recognise this important difference, she risks alienating many member states. The failure of the political elite to listen to the voters risks creating tensions in Europe in 2016, which is also an important part of the 2016 Outlook on page 17.

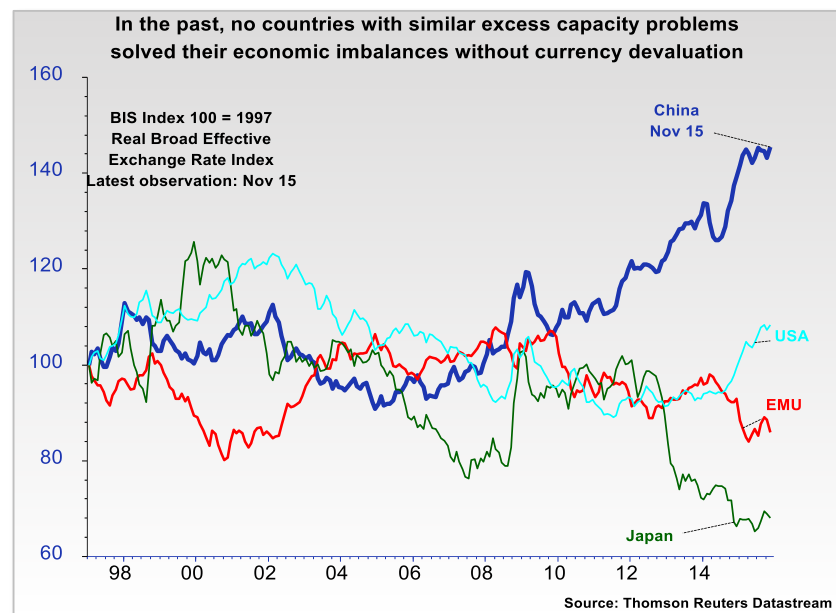
China – Devaluation is now an official part of the strategy; supply-side economics is on the rise

Until August 2015, Chinese policymakers abstained from using the yuan to create growth. Beijing is very

well aware that the mainland needs to move up the value ladder, which requires a "moderately overvalued" currency. The current downturn in the manufacturing sector, however, has proved more severe than expected. There are no signs yet of an upcoming rebound in manufacturing activity, surely not as long as excess capacity remains a problem in many industries - read the Xinhua article, China to tackle industrial overcapacity. In December, a report showed that cargo handled at major seaports contracted at the fastest pace since March 2009; cargo handled by rail (November 2015) declined at the fastest rate ever seen.



Weakness in the manufacturing sector is now so severe that Beijing seems inclined to act more aggressively. The domestic economy needs more monetary easing, which is only possible if the Chinese central bank, PboC, allows an overvalued yuan to depreciate more significantly (read the Insightview article, The Chinese dilemma - something needs to give in). This was also why Chinese policymakers allowed the yuan to continue depreciating against the US dollar in December even though the euro appreciated.



In 2016, Beijing will stay on a path of further devaluation, which could pull the yuan down to 7.0 against the US dollar – see the 2016 Outlook on page

17. In December, this prediction was supported by the PBoC saying that the foreign exchange market needs to follow the trade-weighted real exchange rate index (CEFTS) rather than only the yuan exchange rate against the US dollar. In this context, the yuan could depreciate more sharply against the US dollar if Insightperspectives proves right that the euro will hit parity against the US dollar.

In 2016, Beijing will be walking a tightrope. Adding more liquidity to the domestic economy requires that Beijing eases capital control more aggressively as the central bank no longer will need to intervene to support the currency, at least not to the same extent as in the past. On the other hand, easing capital control may animate more Chinese capital to move abroad, which could endanger price stability in the housing market.

At present, however, the housing market is not yet at risk as capital control remains relatively tight. Last month, this was also reflected in a house price report from the National Bureau of Statistics (NBS). In November, the leading newly-built house price index (70-cities) continued to increase 0.3% month-on-month, according to Insightview's population-weighted calculation (click here to see an updated price chart). House prices rose 1.2% compared to the same month in 2014. In China, house prices see support from the fact that new supply entering the market has declined sharply since late-2014, at least this is the case in tier-1 and to some extent tier-2 cities. This has not only closed the gap between demand and supply, but new supply has declined below new demand.

Since until recently, the general view in Beijing was that supply needs to adjust to solve China's economic imbalances. In this context, it is interesting that President Xi Jinping has now become a devotee of "supply-side economics", which is also something Beijing has done nothing to disguise in the media. In December, state-sponsored newspapers told their readers that China needs policy measures similar to what Ronald Reagan and Margaret Thatcher launched in the 1980s – read the China Daily article, Xi leads shift from Keynesianism to 'supply-side' economics.

If supply-side economics is the new game plan, this should be supportive to the Chinese stock market as this will allow market forces to play a bigger role – read more in the Insightview article, China manufacturing PMI heralds more contraction as Beijing becomes devotee of supply-side economics. The final 13th Five Year Plan will show whether this comes true!

Japan – Weak yen is no longer seen as panacea to solve economic imbalances

In Japan, Abenomics was supposed to weaken the yen and boost exports. The problem, however, is that global demand is slowing and Japanese exporters have no intention of reducing export prices denominated in foreign currency. Instead, they used a weaker yen to book a windfall profit. In November, Japanese exports fell 3.3% year-on-year in yen terms, which was the biggest decline since Prime Minister Abe took office in December 2012.

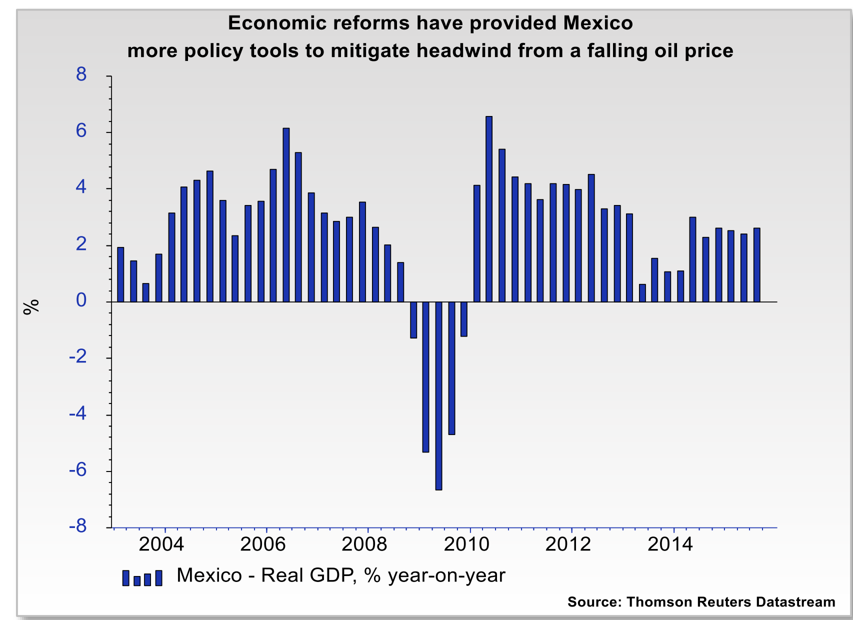
Japan is in a highly difficult situation. It is pretty obvious that a weaker yen will do no good to the economy, at least this seems also to be the conclusion according to an increasing number of voting members at the Bank of Japan – read the Japan Times article, BOJ adjustments signal limits to monetary easing. The decision by the US Federal Reserve to raise policy rates also reduces the need to raise the current level of money-printing in Japan as this may help keep the yen heavily undervalued for a little longer.

The yen, however, may be headed for abrupt appreciation. This will be the case if the Bank of Japan abstains from introducing additional monetary stimulus measures; this is simply a necessity to keep the currency significantly undervalued. In 2016, the yen,however, may be exposed to more appreciation factors. This is not least the case if the financial market moves into a risk-off environment in the first quarter, which is part of this newsletter's 2016 Outlook; this could reinforce yen repatriation. Ironically, the biggest appreciation factor is if the Japanese economy is responding to Abenomics. This would leave the Bank of Japan empty-handed when it comes to arguing for more monetary easing; good news simply risks becoming bad news.

Mexico - Reform process provided more tools to mitigate global headwind; but this may no longer be enough

In 2015, the Mexican central bank has been preoccupied with adding liquidity as the economy has seen headwind from a falling oil price. So far, the strategy has been relatively successful simply because Banxico has to a large extent ignored a declining peso, at least until recently. This has only been possible because inflation has been relatively well-behaved, which has to be credited to a reform-minded government. In the last few years, Mexico implemented bold structural reforms, which made the Mexican economy far more flexible compared to the Brazilian economy.

Mexico's improved economic credibility has provided policymakers with more tools to mitigate the impact of external shocks. Lately, the fiscal deficit has increased partly because one-third of fiscal revenues are oil-related. This, however, has not been punished by the financial market, at least not to the same extent as in the past. In 2015, Mexico has been able to show steady growth. On the other hand, the current account deficit is on the rise and Mexico's international reserves are declining. This has also gained the attention of the foreign exchange market. Many investors are now speculating against the peso, not least because policy rates are relatively low. The currency is at its weakest level since the late 1990s, measured in real terms.

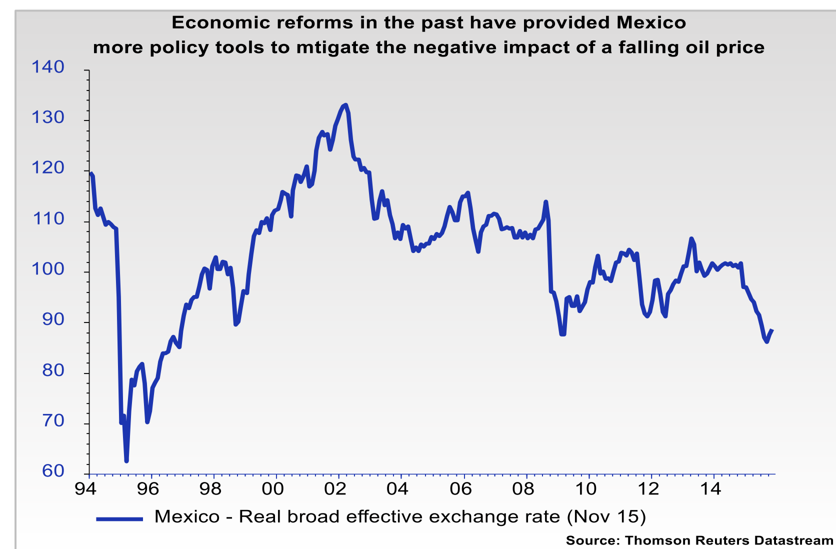


So far, the Mexican economy has benefited from its proximity to the US economy. This should continue if the US economy is mid-cycle. In December, however, Mexico's policy strategy was put to a significant test as the US Federal Reserve decided to raise policy rates by 25 basis points. Further down the road, this will slowly make the US economy late-cycle (the United States

accounts for 80% of Mexican exports). The Mexican central bank was therefore forced to act immediately by raising its policy rates by 25 basis points as well to 3.25%.

In the near future, China, could also create headwind to Mexico. This is the case as Beijing appears to be on a path of more yuan depreciation. China cannot sit tight, having seen the yuan appreciate strongly against all other currencies in the last five years at the same time as overcapacity and overleverage have become more pronounced on the mainland – read more in the China section.

Even though the Mexican government has pursued a prudent strategy in the last few years and this has made policy-making more flexible, there is no doubt that global headwind is gaining momentum. Recently, the Mexican central bank has tried to stem the decline of the peso by intervening in the foreign exchange market.



These efforts, however, will not be efficient at the same time, since until recently the central bank added liquidity to the domestic market. Indeed, Mexico may soon acknowledge that it may not even be enough just to mirror US monetary policy; a sharper rate hike may be required. On the other hand, this will make the Mexican peso even more attractive; the currency is already undervalued!

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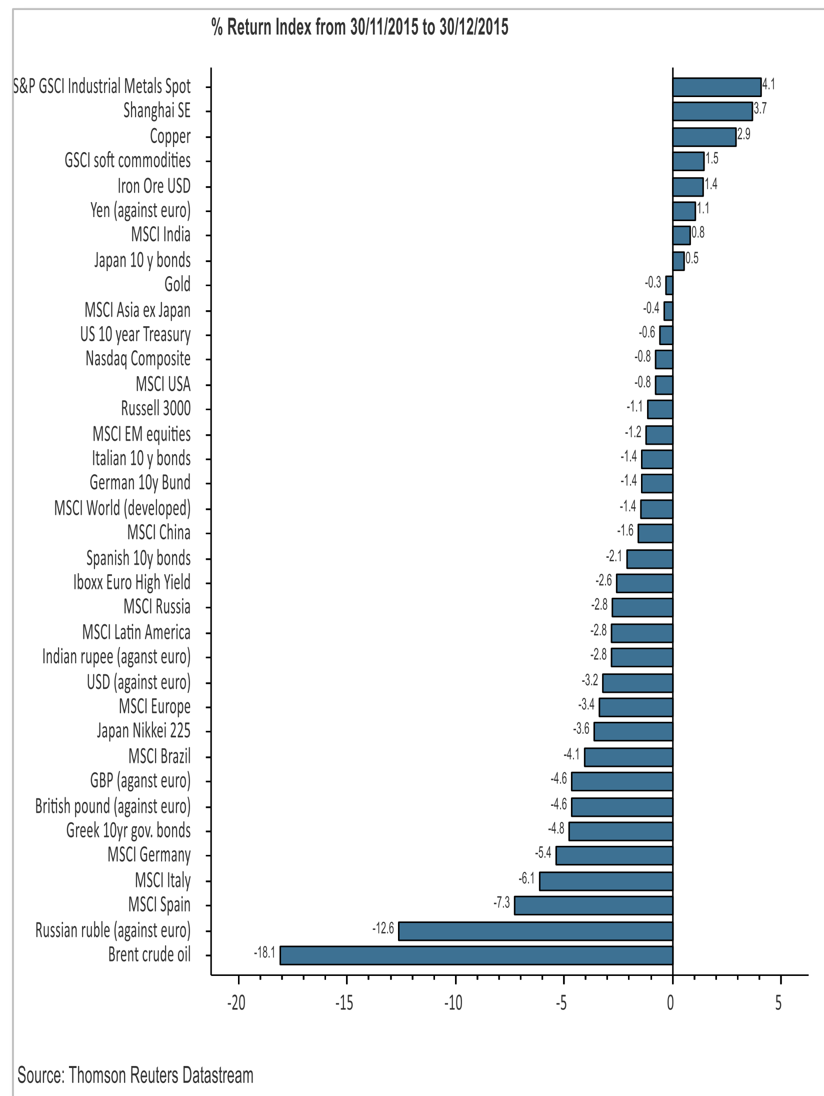
Financial Market Update

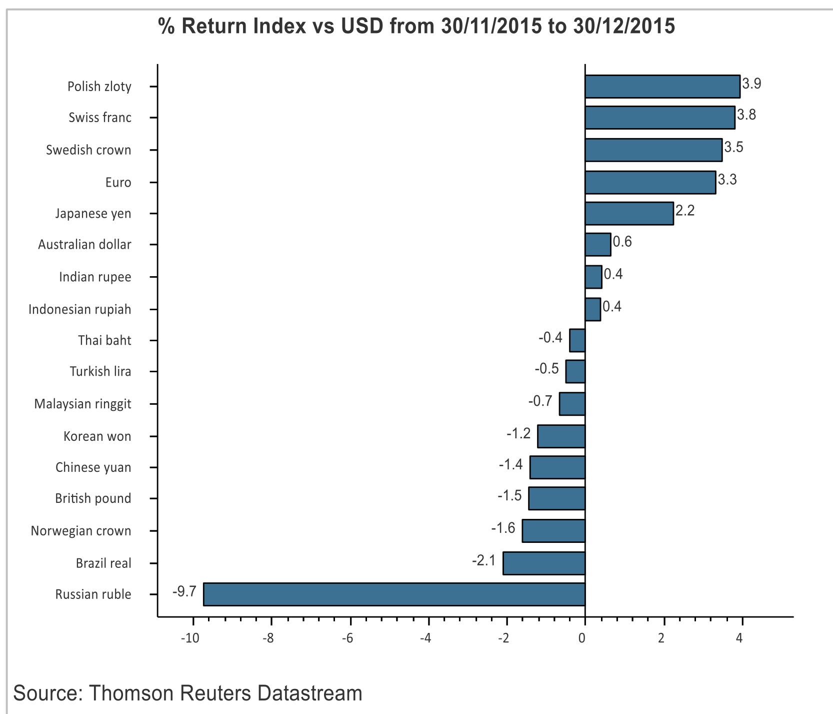
The year of 2015 closed with significant weakness in the oil market. The Brent oil price plunged 18% in December, which was 35% lower than one year ago. In December, a weak oil price also negatively impacted the Russian ruble (minus 12.6%). Conversely, industrial metal prices rose 4.1% in December and iron ore prices rose 1%.

In the last month of 2015, weakness also prevailed in the global stock market. The MSCI Developed World index fell 1.4% (December 30), which was dragged down by a 3.4% decline the MSCI Europe index. The European financial market partly suffered from ECB President Draghi's failure to fulfil "promises" delivered to investors in the previous months, which made the euro bounce back sharply against the US dollar (+3.2%). The MSCI Spain index in particular was hit hard plunging 7.3% in December. Nonetheless, MSCI Europe is still up 5.9% compared to one year ago, while the MSCI USA index is up 2.2% (all in local currency).

In contrast to the developed stock market, the Shanghai Stock Exchange Index rose 2.7% in December as Beijing continued to launch more easing measure; the index was up 10.3% in 2015.



In the foreign exchange market, the British pound was the biggest loser falling nearly 4.8% against the euro. In return, the Japanese yen rose 2.2% against the US dollar; this trend may continue in the first half of 2016 as the Bank of Japan appears to have second thoughts about more monetary easing – read more in the Japan section. In December, the decline in the Brazilian real continued after the country's sovereign credit rating was downgraded by Fitch.



In December, the Chinese yuan fell 1.4% against the US dollar in spite of a recovering euro. In Beijing, it appears as if policymakers are making leeway for more yuan depreciation in 2016; this is the case after the Chinese central bank said that it focuses predominantly on the trade-weighted exchange rate index. This is of special interest, as this index has increased sharply in the last five years – read more in the China section.

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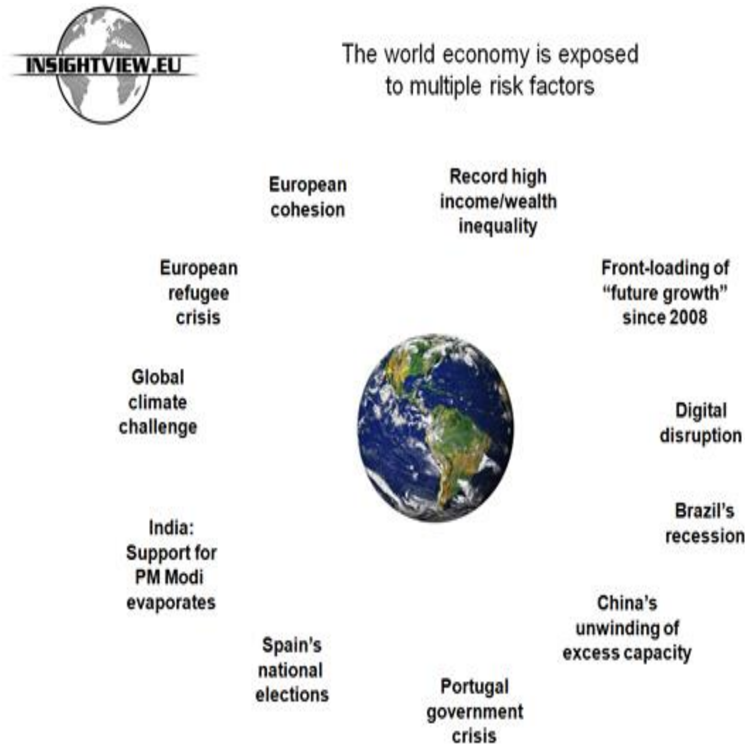
The 2016 Global Economic and Financial Market Outlook

The 2016 Outlook is based on the outlook of Insightview.eu, the publisher of Insightperspectives. It is highly recommended to click here or on the image on the left to see a more comprehensive and detailed slides presentation of the forecasts for economic growth, currencies, stock markets, commodity markets. Not all forecast charts will be included in this article – only in the slides presentation.

The world is headed for a volatile 2016 as politics have become a decisive factor, not least in Europe. This occurs at the same time as aggressive monetary stimulus measures since 2008 have made the macroeconomic cycle go out of sync. In many developed and developing countries, this has created even more indebtedness, which causes more deflationary pressure - read also the article, The third deflation wave - the consequence of having escaped deflation in 2009.

One year ago, Insightperspectives warned in the 2015 Outlook about an increasing divide between the voters and the political establishment, not least in Europe. This divide is no longer only a risk. In a few European countries, it has already propelled the far right into power. Indeed, this could be the early stage of a significant change in Europe's political landscape.

Unfortunately, the factors pose a risk to global growth, which is also reflected in the 2016 Global Growth Forecast - see the next page. Granted, the political factor is often ignored by many investors and corporate leaders; the timing and size of its impact is simply too difficult to measure, they argue. This may be true; on the other hand, it is not difficult to map a political storyboard in Europe, which will give rise to more serious political tensions in the coming years.



This would be bad news as many developed countries cannot afford the economy coming to a standstill, since they have used all monetary ammunition to create the latest recovery. Indeed, since 2008, the developed countries have front-loaded "future growth", which will be missing in the coming years. Furthermore, fiscal policymakers in the same countries have seen their fiscal debt situation continue to deteriorate, which makes them even more vulnerable.

THE ECONOMY

In the short run, the **US economy** is still exposed to significant tailwind from very low interest rates and benign inflation. This, however, may soon come to an end as the US Federal Reserve appears now to have begun a long overdue monetary tightening process. This will make the yield curve flatten, which is a harbinger of slower growth from mid-2016.

Indeed, higher policy rates will turn the US economy into a late-cycle economy. On the other hand, there are no visible signs yet of an upcoming recession in the United States. Granted, the manufacturing sector is probably in recession, but this sector accounts for less than 15% of GDP.

GDP growth	USA	China	EMU	Japan	S. Korea	Germany	Brazil	France	UK	Italy	Spain	Portugal	India
2014	2,4%	7,3%	0,9%	-0,1%	3,3%	1,6%	0,1%	0,2%	2,9%	-0,4%	1,4%	0,9%	7,0%
2015	**2,5%**	**6,7%**	**1,5%**	**0,8%**	**2,6%**	**1,5%**	**-3,6%**	**1,2%**	**2,4%**	**0,7%**	**3,1%**	**1,5%**	**6,9%**
2016	2,1%	6,0%	1,6%	1,3%	2,4%	1,6%	-3,0%	1,2%	1,8%	1,5%	2,8%	1,2%	6,7%
2017	1,5%	5,4%	1,5%	1,3%	2,0%	1,7%	-0,5%	1,3%	1,5%	1,2%	2,1%	1,2%	6,8%

Far more important is the still upbeat sentiment in the service sector, which accounts for close to 80% of GDP. This sector is still exposed to plenty of tailwind, not least due to the fact that US households remain in an excellent position; wages are increasing, the wealth effect is still positive and the labour market will continue to show strength in the first half of 2016 - read more in the article, Underlying details show strong US retail sales report as households see strong tailwind.

In **Europe**, where the economy is seen to be mid-cycle, the biggest threat to the current cyclical tailwind is increasing political tensions brought about by the refugee crisis. Ironically, this is the case even though the influx of refugees is supposed to boost growth. The latter is still expected to be the case, at least in the very short run. A true “Willkommen policy” requires more than just politically correct statements; successful integration of refugees requires further reforms of the European welfare system and lower minimum wages, which is barely part of discussions in, for instance, Germany.

The problem, however, is that the failure to find a common policy approach to the refugee crisis is threatening the survival of the entire European Union. Many European countries blame Berlin for a sharp increase in the number of refugees. This is the case as Chancellor Mrs. Merkel autocratically made more important decisions on behalf of the entire union without consulting the other EU-members. Most notable was Mrs. Merkel’s decisions to grant visa to all Syrian refugees in August and her “embracement” of Turkey’s maverick president, Mr. Erdogan.

The political divide in the European Union is already felt in Poland and France, where the far right has seen soaring support from voters in national and regional elections. This is not only a threat to further EU integration; soaring support to the political parties on the far right is also a boost to anti-market forces to the

disadvantage of the corporate sector and the stock market. In the short run, the biggest threat to a market liberal European Union is Brexit, which can no longer be ruled out if Prime Minister calls a referendum in 2016 – read The Telegraph article, EU referendum will be in 2016, David Cameron signals as he prepares to campaign for Britain to stay.

On the other hand, if Insightperspectives proves right that the refugee crisis becomes a liability to growth later in 2016, this may provide the president of the European Central Bank with new arguments in favour of expanding its ongoing money-printing program. The latter and a deepening political mess in Europe should create another downward leg in the euro.

China, however, has more room to ease monetary policy, which is highly needed due not least to weakness in the manufacturing sector, overcapacity and high corporate and local government indebtedness. This time, however, stimulus measures may do little to help the rest of the world, at least in the short run. This is the case as Beijing joins the global currency war, although reluctantly.

In China, more monetary easing needs to be accompanied by more yuan devaluation (read more about this issue in the Insightview article, Manufacturing weakness will force Beijing to act more forcefully; cargo-handled-at-major-seaports contracts at fastest pace since March 2009). This will have serious ramifications in the global financial market; and could give rise to even more downward pressure on other emerging market currencies and ultimately more turmoil in the global stock market.

In **Japan**, policymakers have no ammunition left, having printed money since early 2013. Indeed, Prime Minister Abe fired a number of "arrows" that nearly all hit him in the back. The coming quarters will therefore be crucial for Japan. If Abenomics proves a success (the jury is still out), the Bank of Japan is left empty-handed when it comes to arguing for more monetary easing. Ironically, this could turn good news into bad news, as the current undervalued level of the yen is highly dependent on more monetary easing. If the foreign exchange market believes the Bank of Japan's ultra-loose monetary policy is coming to an end (or money-printing is not expanded), this could trigger yen appreciation, which poses a significant risk to the stock market. This process could be reinforced in an environment of global risk-off.

In 2016, **emerging market** economies will continue to see increasing volatility, not least if Insightperspectives

proves right that China will allow its currency to depreciate more significantly in the first quarter of 2016.

THE COMMODITY MARKET

In the commodity market, the “supply door” is narrowing as the mining sector has seen a steep decline in capital expenditure in the last few years. At least, this is the case in the non-energy sector and may soon be the case in the oil market, although here international politics play a far bigger role.

Further down the road, this could create the right conditions for a sharp rebound in commodity prices, when demand regains momentum. The latter, however, requires that China launches more aggressive stimulus measures, which is also part of Insightperspectives’ storyboard for 2016. The situation in the oil sector, however, is far more complicated as Saudi Arabia still shows no signs of intending to end the ongoing price war - read also the article, The game plan of president Putin matters to the global financial market - not least when it comes to the oil price.

THE STOCK MARKET

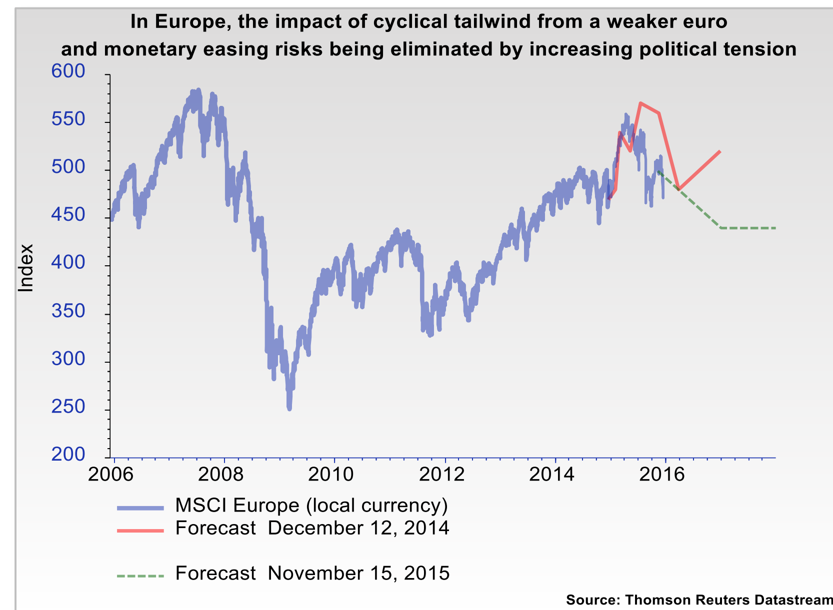
In the 2016 Outlook, the US economy is perceived to be late-cycle although this is based on the forecast that the US Federal Reserve will continue to raise policy rates and the dollar stays strong. Such an outcome will be a drag on the US stock market.

The perception that the European economy is seen to be mid-cycle is not expected to benefit the European stock market that much due to rising political tension caused by the refugee crisis. This risks turning the European stock market into a “value trap”. Granted, this is a call not without risk, as the European economy

is exposed to significant tailwind from ultra-loose monetary policy.

Conversely, the factors needed to raise political tensions in Europe exist as well. In the not too distant future, the European Union may have to distribute many more hundred thousands of Syrian refugees, which will require a tougher stance by Brussels.

In Berlin, some politicians are even talking about imposing "economic sanctions" on countries such as Poland if they fail to comply - read the Bloomberg article, Hungary's Orban Says Germany Struck `Secret' Turkey Refugee Deal. Indeed, this is a perfect environment for policy mistakes and fatal misunderstandings – read also The Guardian article, Polish PM rounds on European parliament head over 'coup' remark. Indeed, the European stock market stands in front of a very bumpy road in 2016!

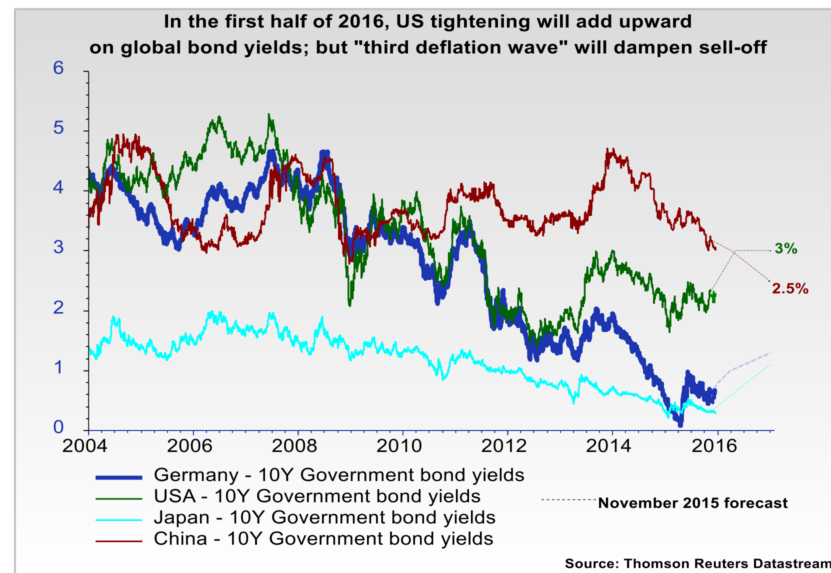


In the developed countries, the Japanese stock market in particular may be exposed to the biggest downside risk. First of all, foreign investors are heavily exposed to this market. In addition, increasing global market jitters in 2016 may trigger yen repatriation, which could strengthen the yen dramatically to the disadvantage of the stock market.

THE INTEREST RATE MARKET

At present, Insightperspectives does not expect any dramatic changes in interest rates with the exception of China. In the developed countries, government bond yields are expected to increase slowly, not least in the United States as the Federal Reserve is finally anticipated to raise policy rates. The biggest impact from the latter is probably felt in other asset classes than bonds and particularly outside the United States.

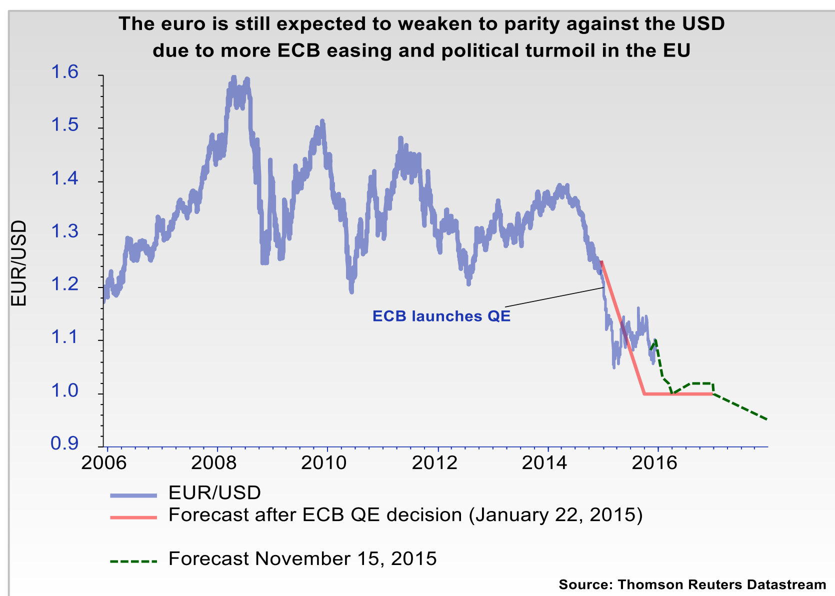
In China, however, interest rates could decline sharply as Beijing may already be on a path of money-printing (quantitative easing), which will put downward pressure on the Chinese yuan. The latter risks releasing more deflationary pressure in the global economy, which will put a cap on bond yields in the developed world.



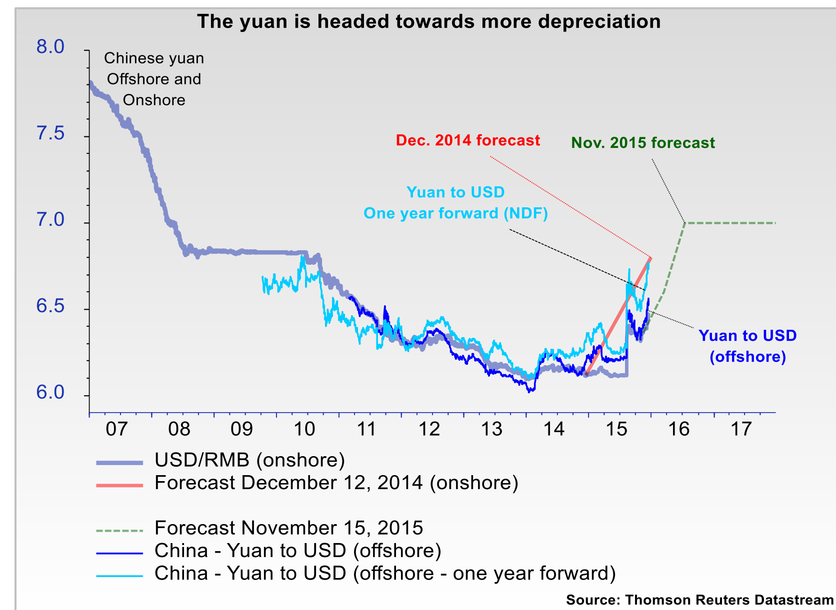
THE FOREIGN EXCHANGE MARKET

In 2016, volatility in the currency market is expected to increase sharply as an increasing number of investors will try to find shelter in “safe currencies”. This will not be easy as the global currency war is expected to gain momentum when it becomes clear that Beijing can no longer afford having the world's economic problems rest on its shoulders.

In this context, however, the euro may still see downward pressure in 2016 as the European Central Bank appears to be biased towards printing money more aggressively. The British pound is also at risk, as it becomes clear to investors how fragile the current recovery is. In contrast to Britain, the Swedish crown is expected to see support from strong macroeconomic fundamentals - read also the article, BoE has plenty of excuses not to follow the Federal Reserve; buy Swedish crown against the British pound.



On the other hand, the Japanese yen is exposed to the biggest appreciation pressure as the Bank of Japan is having second-thoughts about the efficiency of money-printing. This acknowledgment, however, could prove fatal in a foreign exchange market where the Japanese yen is only significantly undervalued due to the fact that the Japanese central bank is expected to keep printing money.



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China

Go West! Why Chinese students go abroad – and why only some of them return

By Invitation

Insightperspectives regularly invites experts to write on "special" issues. In this context, **Stig Thøgersen**, dr. phil., professor of China Studies, School of Culture and Society, Aarhus University, has been invited to write about why millions of young Chinese study abroad.

Stig Thøgersen, dr. phil., is professor of China Studies, School of Culture and Society, Aarhus University. He went to China for the first time as a language student in 1974-1975 and has followed the transformation of Chinese society ever since. He has done fieldwork in several Chinese provinces and has published extensively on Chinese education and on political, social and cultural change in rural China. Presently, Stig Thøgersen is particularly interested in the changing worldview of young Chinese professionals and is heading a research project on Chinese students abroad.

In 2014, a record number of 459,800 students left China to study abroad, an increase of 11.1 per cent over 2013. More than three and a half million Chinese have studied abroad since the country opened up in 1978 and China is now, by a wide margin, the world's largest source of international students.

Studying abroad is primarily a family investment. Close to 92 per cent of the students who left in 2014 went out on their own expense. The Chinese government

generally encourages young people to study abroad, but it supports less than five per cent of them financially.

Chinese students' preferred destinations are the US, Japan, Australia, and the UK, in that order. Anglophone countries are, for obvious reasons, most students' first choice, but according to UNESCO, France, which received more than 25,000 students in 2012, and Germany with close to 20,000 students managed to squeeze in as number 8 and 9 on the top-ten list.

To the host countries, and particularly to universities hit by cuts in public spending, Chinese students are a most welcome source of income. In the academic year 2014-2015 they contributed $9.8 billion to the U.S. economy, according to the U.S. Department of Commerce, and many universities around the world would be in dire straits without the tuition fees paid by Chinese and other international students.

Opting out of the Chinese education system?

An interesting recent trend in the outgoing flow of Chinese students is that their age profile is changing. For many years, the majority went abroad for their graduate studies, but the balance is now shifting. More are now leaving China as undergraduates and high school students, and when Australia recently opened its junior high schools (years 7 to 9) to foreign students, a Chinese expert predicted that large numbers of young Chinese teenager would make use of this option. In 2014, almost 30% of all Chinese students abroad were enrolled in secondary schools.

Image: Shutterstock, Tom Wang

While the exodus of graduate students to a large extent simply reflects a desire for higher academic quality, the dramatic growth in the number of young students can be seen as a sign of deep dissatisfaction with the existing Chinese education system. We should, of course, remember that almost 98 per cent of all

university students never study abroad, but particularly among higher middle class parents, who have the economic ability to offer their child a foreign education, there is a growing feeling that something is fundamentally wrong in Chinese schools, even though students perform brilliantly in PISA tests.

A Hurun Report from 2014 found that rich Chinese investors quoted the quality of education as their top reason for emigrating (21 per cent), closely followed by environmental pollution (20%), and food safety (19%). According to the report, "[t]he average age at which China's millionaires send their children abroad to study is 18. Among the children of the super-rich, the average is lower, at just 16 years of age."

The discontent of the super-rich is only the tip of the iceberg. For decades experts, teachers, and parents have criticized the highly competitive Chinese school system for putting too much pressure on the students, for relying on rote learning, for killing children's creativity, and even for "stealing their childhood", as it is often expressed. Students who are sent abroad at a younger age will be under less pressure from the Chinese national university entrance exam, the notorious gaokao that is the driver behind practically all teaching activities in the Chinese education system. This gives parents more freedom to place their children in those alternative schools and kindergartens that are now popping up all over the country.

Middle class parents' enthusiasm for Western, liberal education – either in China or abroad – does not only grow out of their concern for the children's well-being. They also believe that creativity, curiosity, and an independent and explorative mindset will be crucial in the future job market as China is moving toward the high end of the value-added chain. So paying the high tuition fees of foreign universities is primarily seen as an investment in the family's future. Partly for this reason, several foreign actors have discovered the economic and academic potential in being present in the field of higher education inside China itself. Prominent examples of different models are the University of Nottingham's campus in Ningbo, the China Europe International Business School in Shanghai, and the Sino-Danish Centre for Education and Research in Beijing.

Will they come back?

Right from the first students were sent out in 1978, the Chinese government has been concerned about whether they would ever return after graduation.

During the 1980s and 1990s, many decided to remain abroad, particularly after the suppression of the student movement in 1989. Why should they go back to an authoritarian state with low living standards and few career options? The government's appeals to students' patriotism were generally ignored at this time, so China was soon facing a classic brain drain problem. However, a new policy introduced in 1992 promised that the government would “support studies abroad, encourage [graduates] to come back to China, and grant them freedom to come and go”. This policy, which is still in place, signaled a focus on the positive effects of "brain circulation" rather than on brain drain.

The government has evidently realized that Chinese scholars, experts and entrepreneurs with key positions in foreign companies and institutions can be just as useful to China as those who come back, at least as long as they are willing to integrate mainland Chinese colleagues in their social and commercial networks. Still, it is important for China that some of their best brains return, and particularly since the financial crisis in 2008 the government has had some success in attracting Chinese graduates from abroad. More than 360,000 students came back in 2014, up 3.2 per cent from 2013, and 1.81 million students in total have returned to China from overseas since 1978.

In order to attract more people, a so-called 1000 Talents Plan was introduced in 2008, which promised better working conditions and a range of special privileges to particularly competent overseas graduates who agreed to return to China. Some provinces and cities later announced similar local plans. Such policies have made it more attractive for some experts to go back to China part of the year, without giving up their position in the West. However, recent research indicates that "...the return of the large numbers of the very best and very brightest is still not happening."

Prospects

It is unlikely that the growth in the number of Chinese students abroad will stop. The youth cohort will shrink over the next years, but more families will join the middle classes and frustrations with China's education system will probably continue unabated in the absence of fundamental reforms. At the same time, we see a growing trend towards young Chinese studying abroad for a shorter period of time, maybe a semester or two, without aiming for a foreign degree but rather as part of their personal development, much like European

backpackers who take a year off between high school and university. Having spent some time abroad is rapidly becoming a symbol of culture, a marker of knowing the good life.

The growing number of alternative primary schools and even kindergartens in China can be expected to create their own audience for foreign education as it will prove difficult for children who have attended such schools to return to the regular Chinese state system.

Whether students will go back to China after graduation or stay abroad will depend on the job markets in both China and the West, on immigration rules, and on a host of other factors. However, there is a clear trend towards more flexible arrangements, where those Chinese whose qualifications are in particular high demand will travel between and combine positions in China and the West. Their families will probably live abroad. Away from the smog and the hardships of the Chinese school system.

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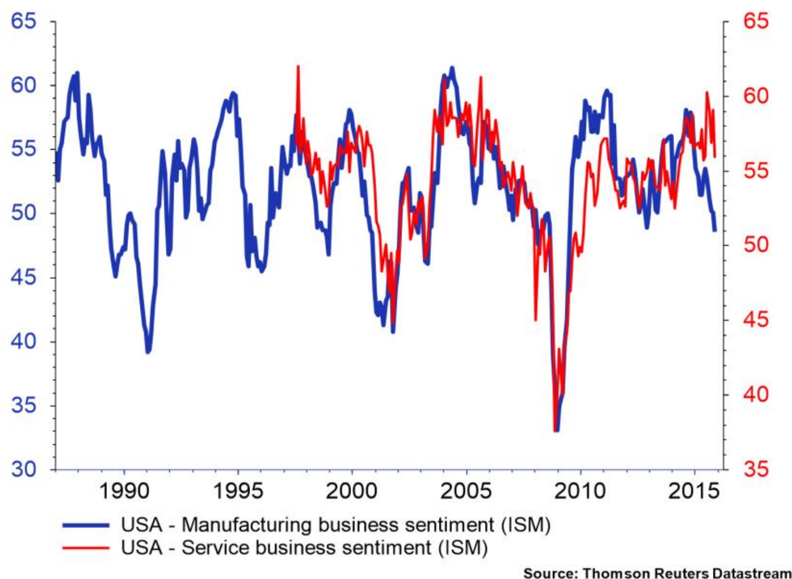
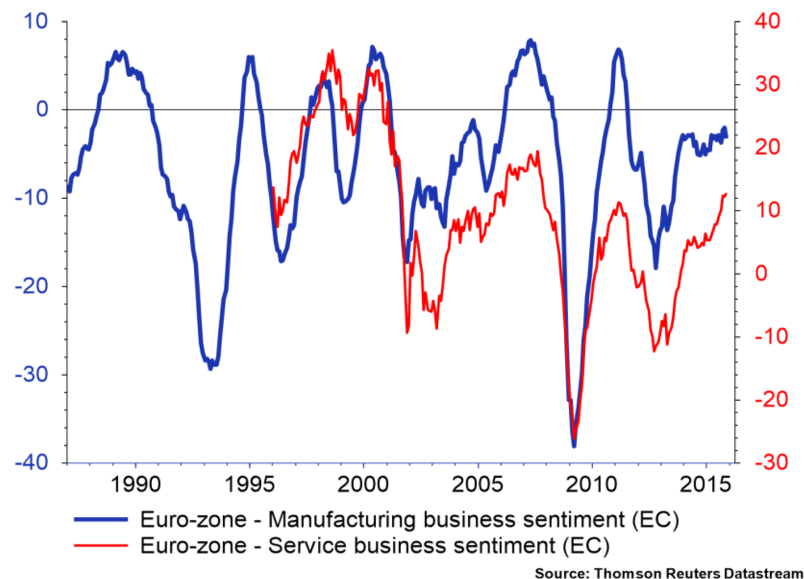
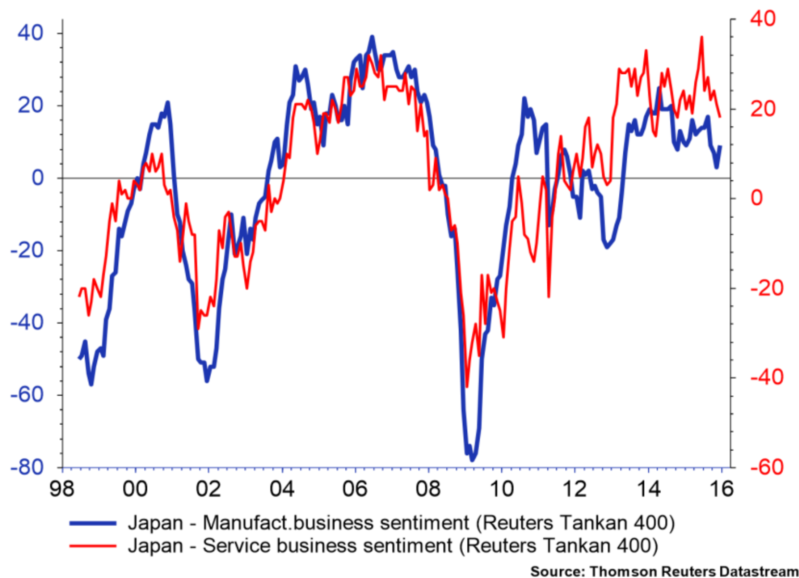
Charts

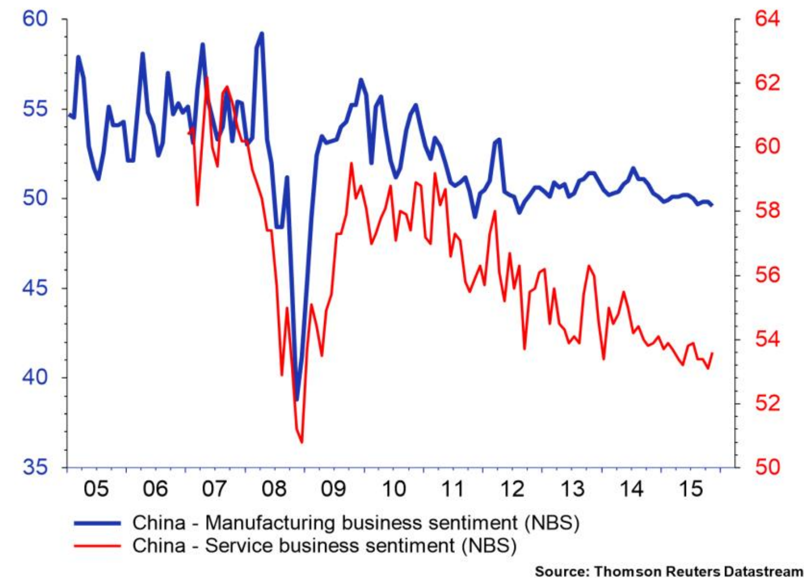
All charts are updated on December 30, 2015

Business Sentiment

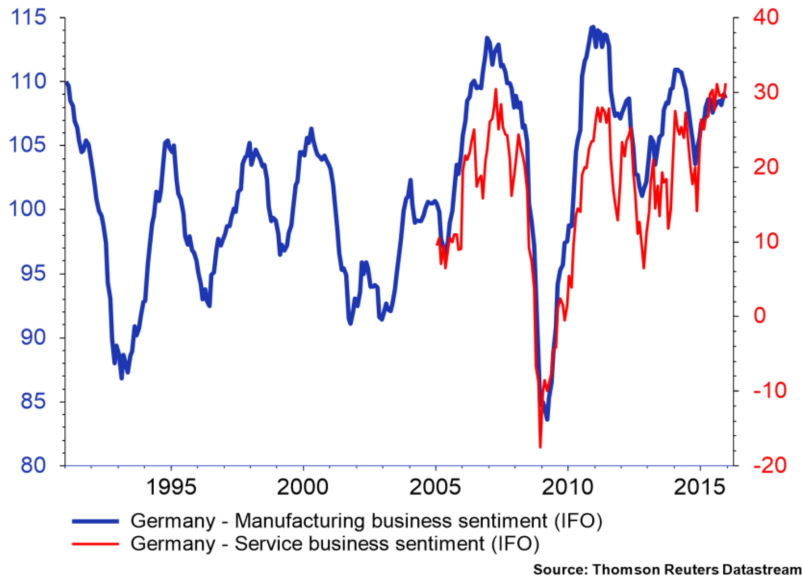


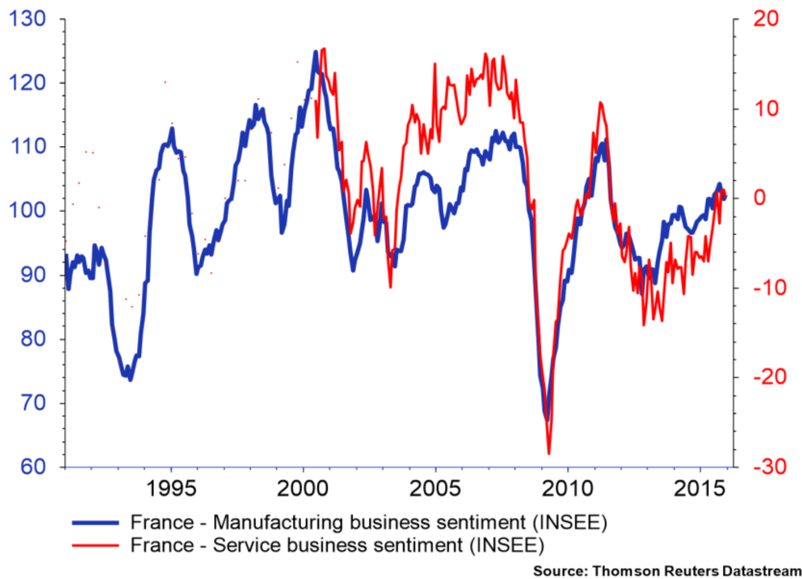


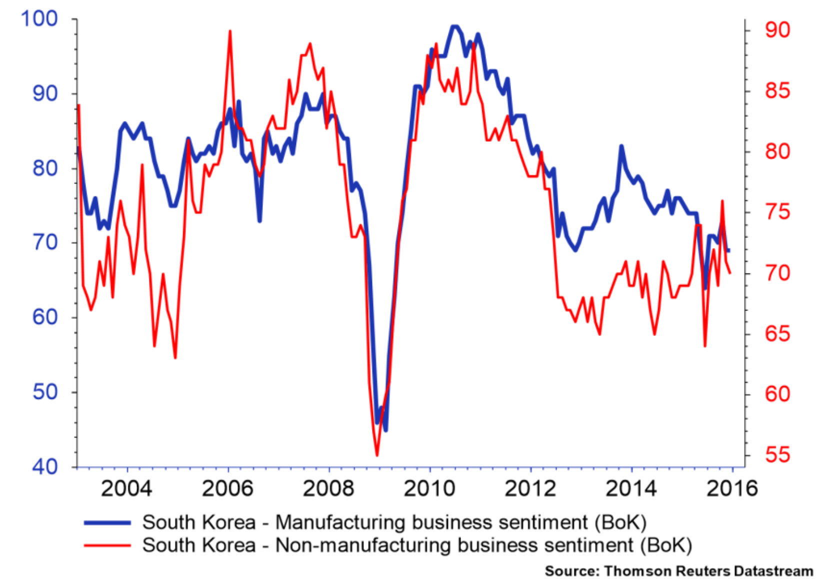




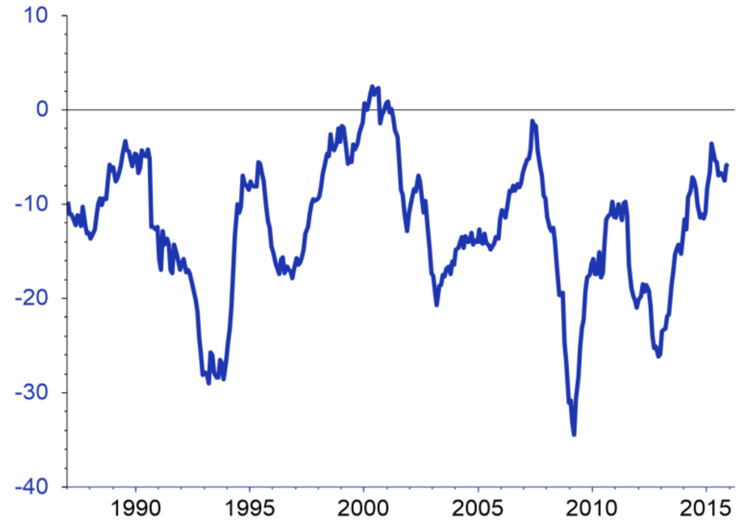
Business Sentiment (continued)

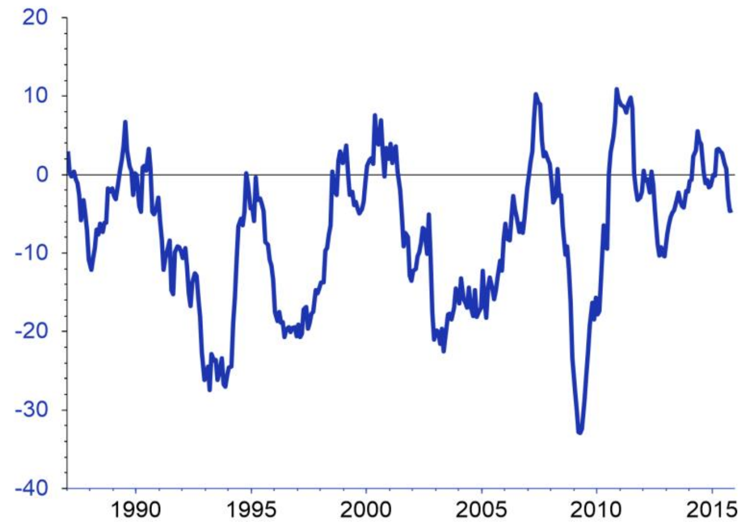




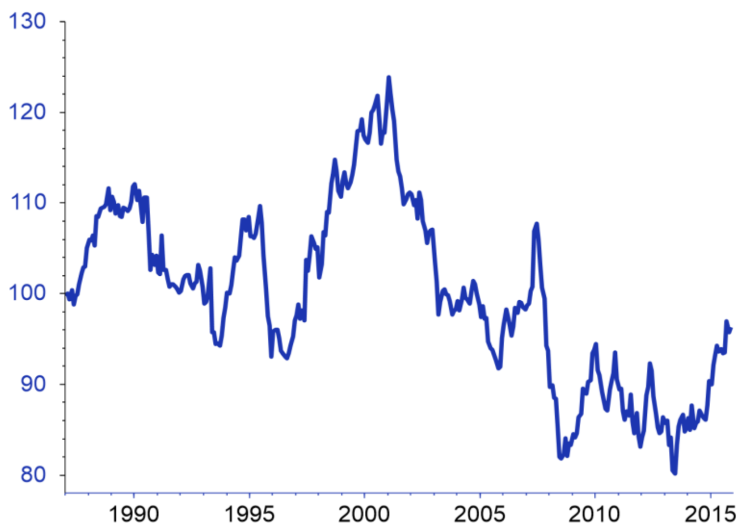


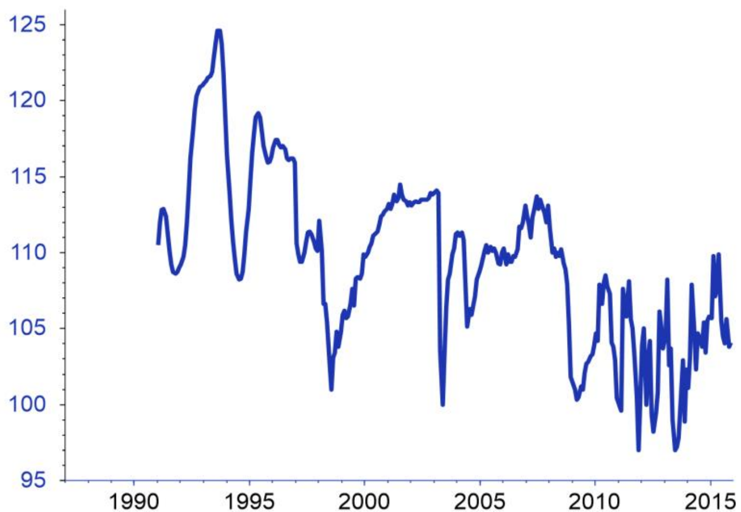
Consumer Confidence

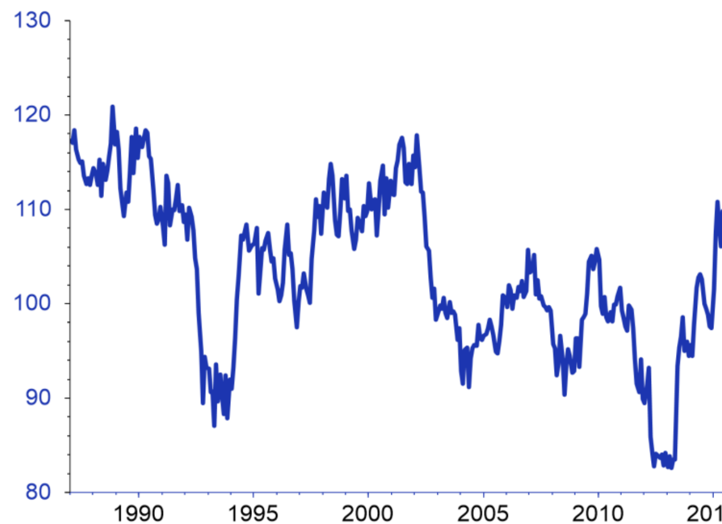




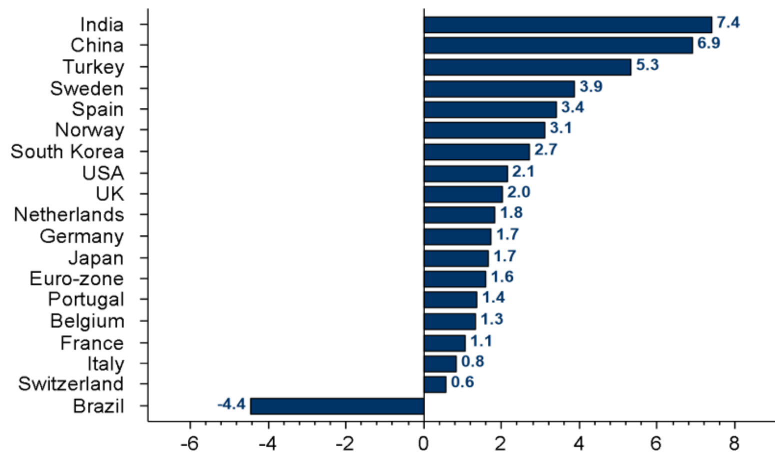
Consumer Confidence (continued)

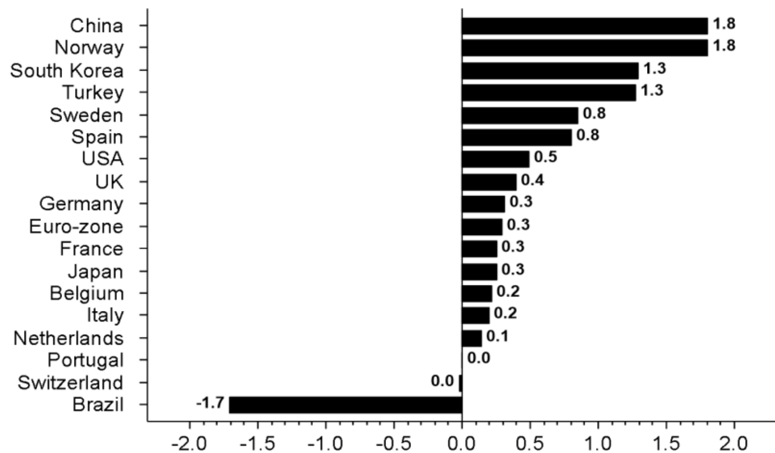


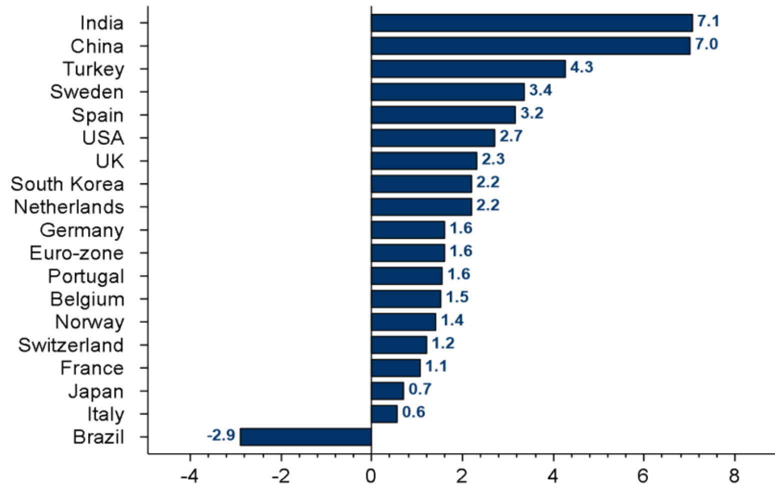


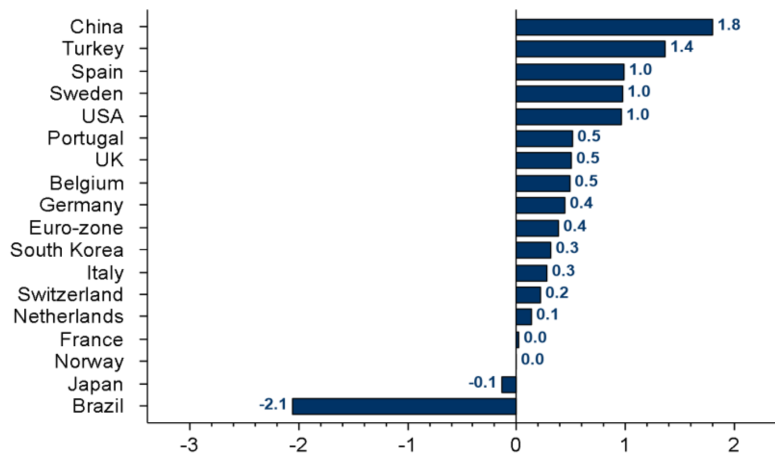


Real GDP growth

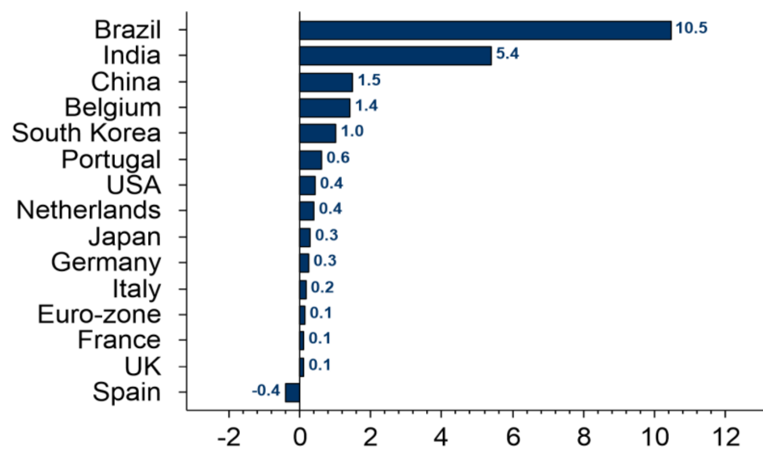




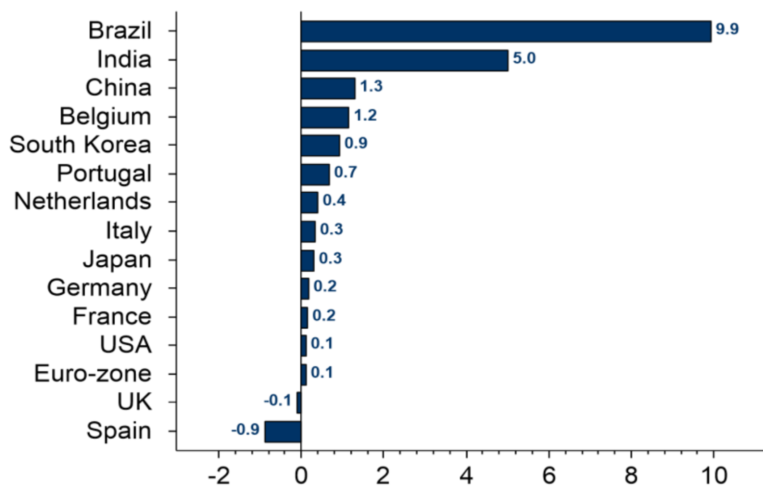




Consumer price inflation

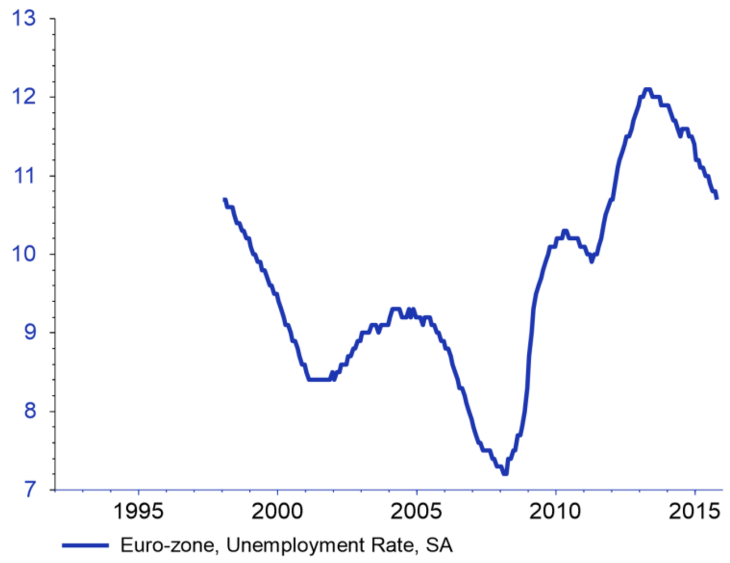


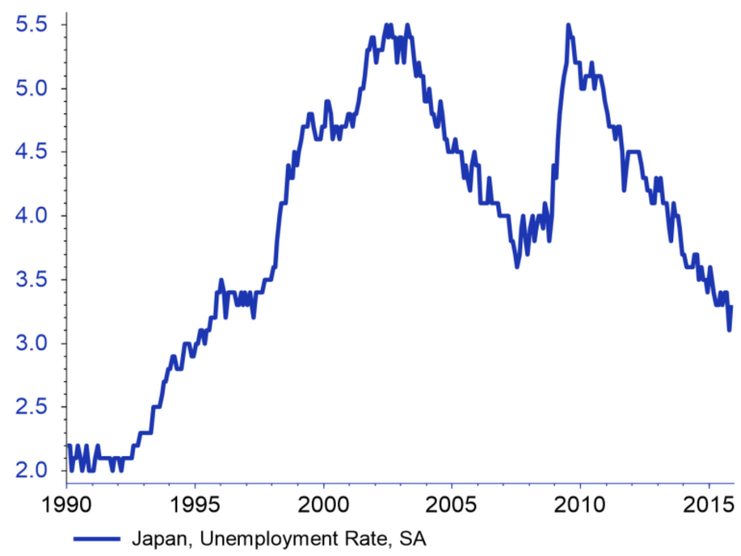
Source: Thomson Reuters Datastream

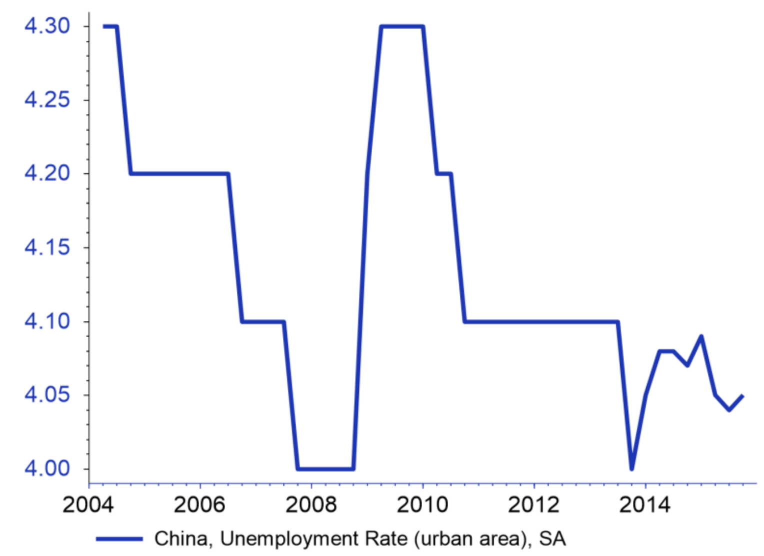


Source: Thomson Reuters Datastream

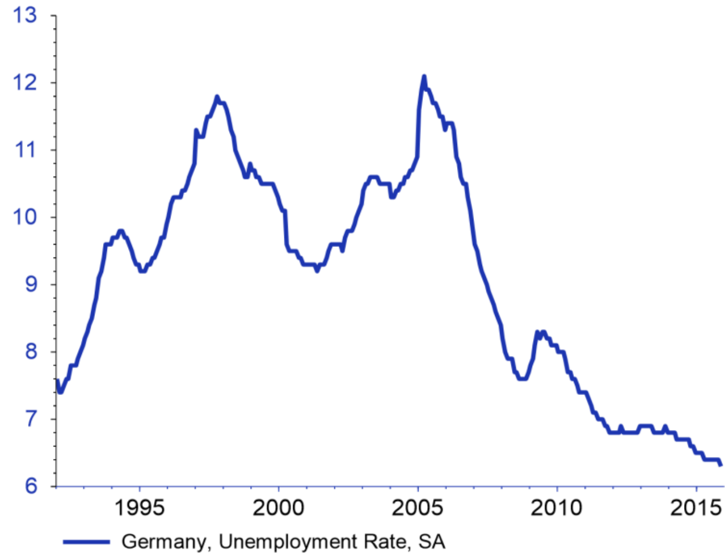
Unemployment

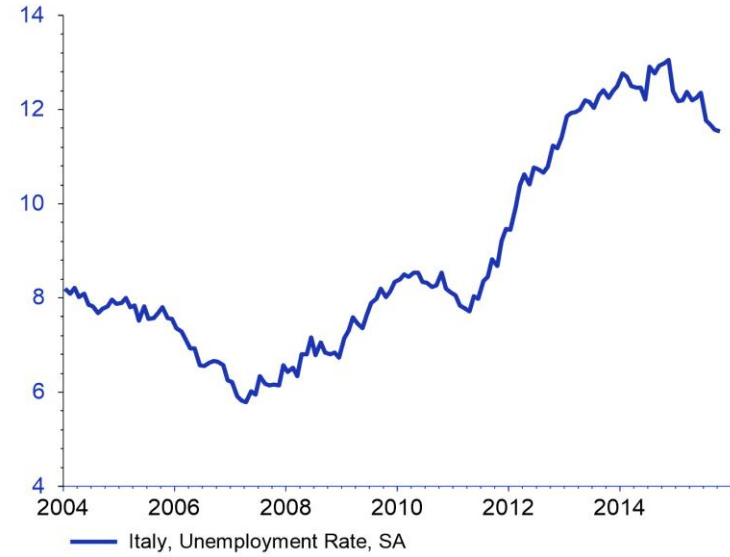




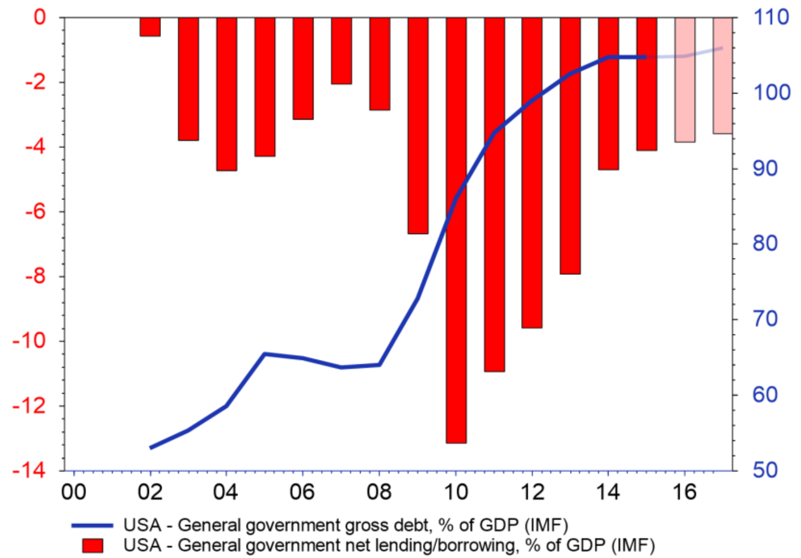


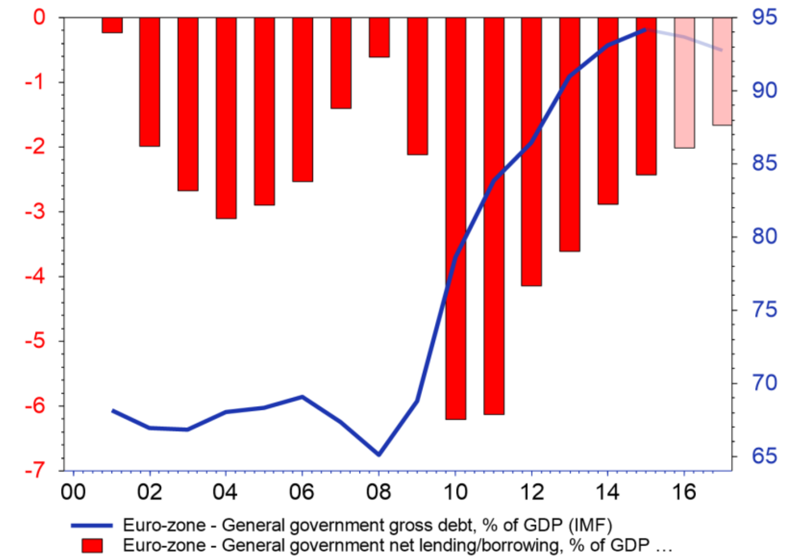
Unemployment (continued)

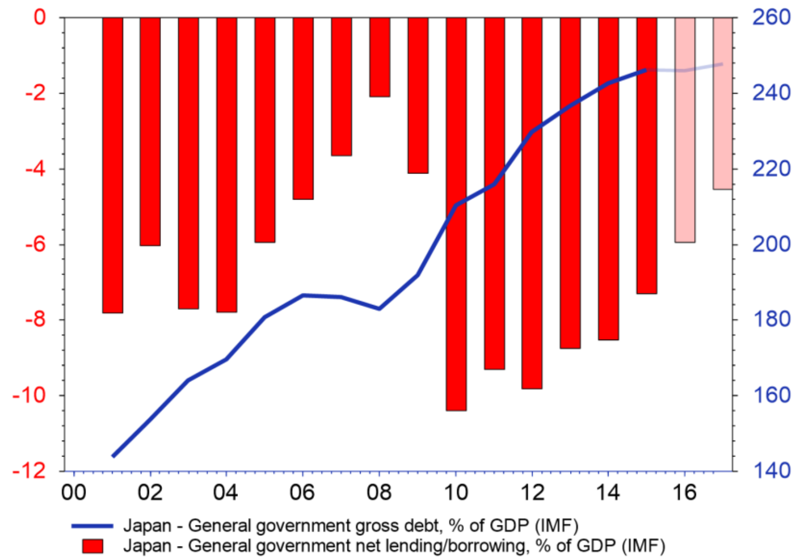


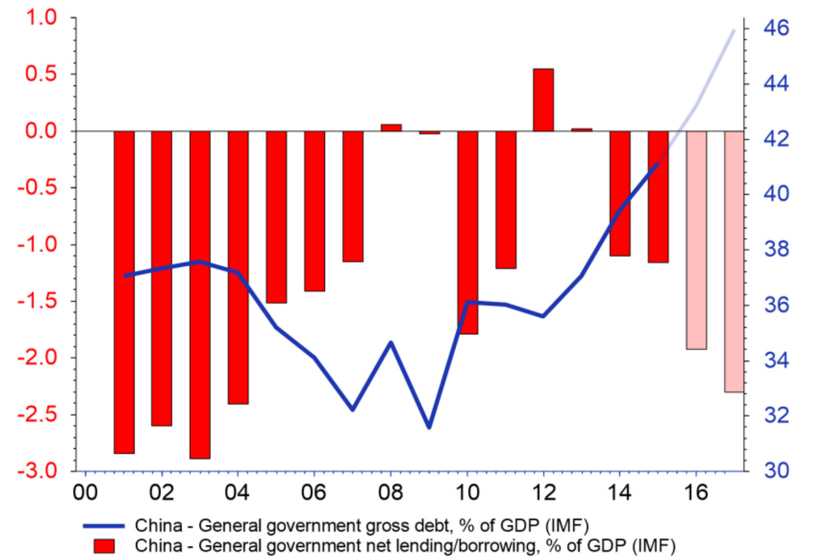


Public Sector Balances

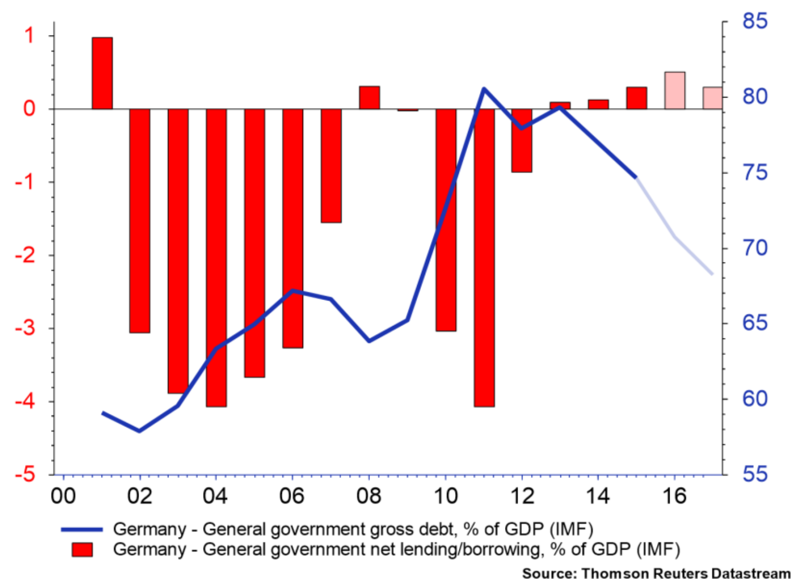


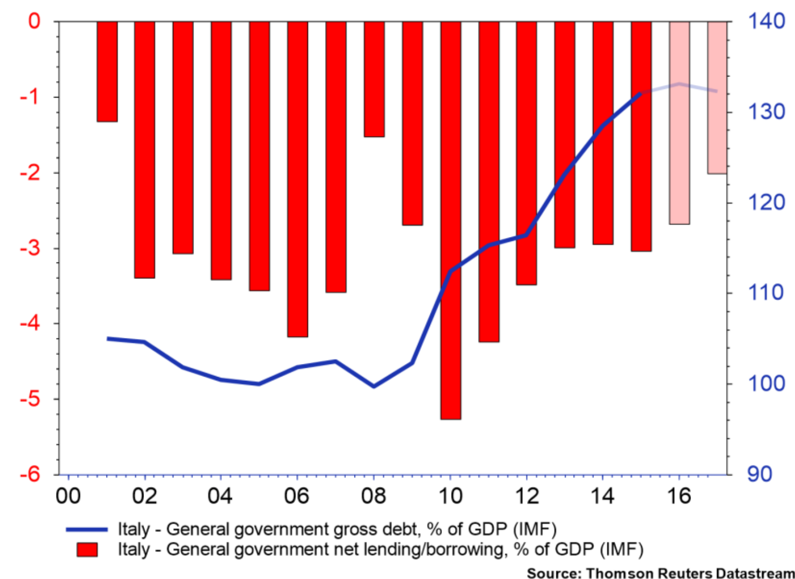


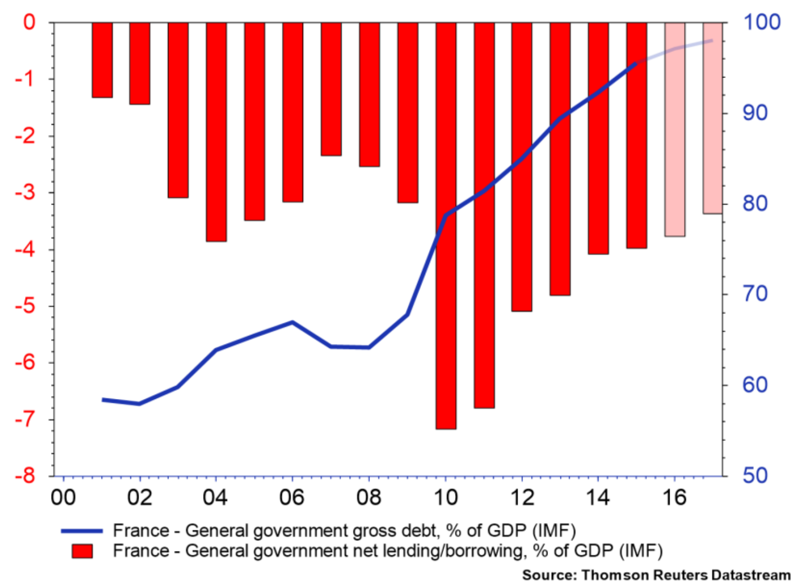


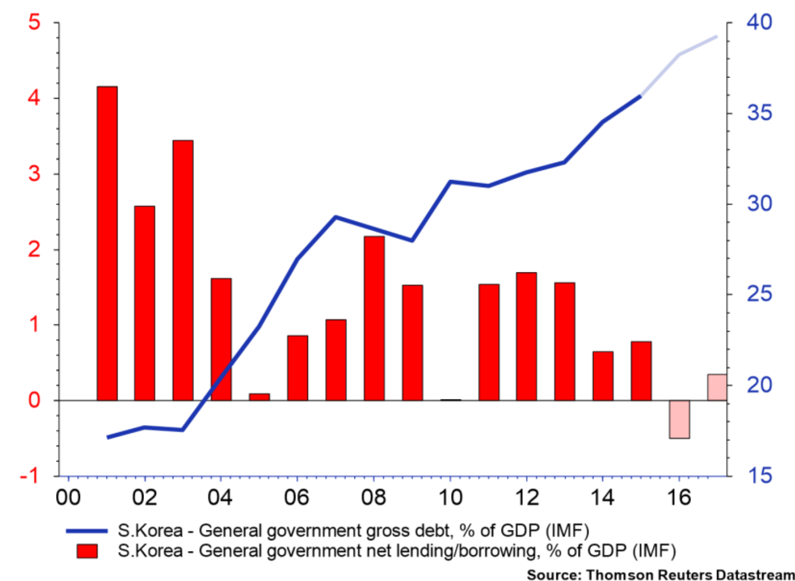


Public Sector Balances (continued)

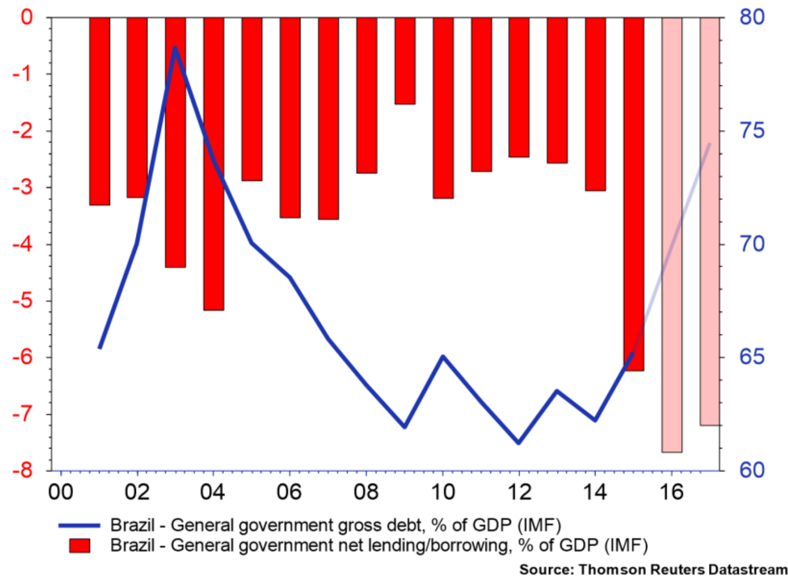


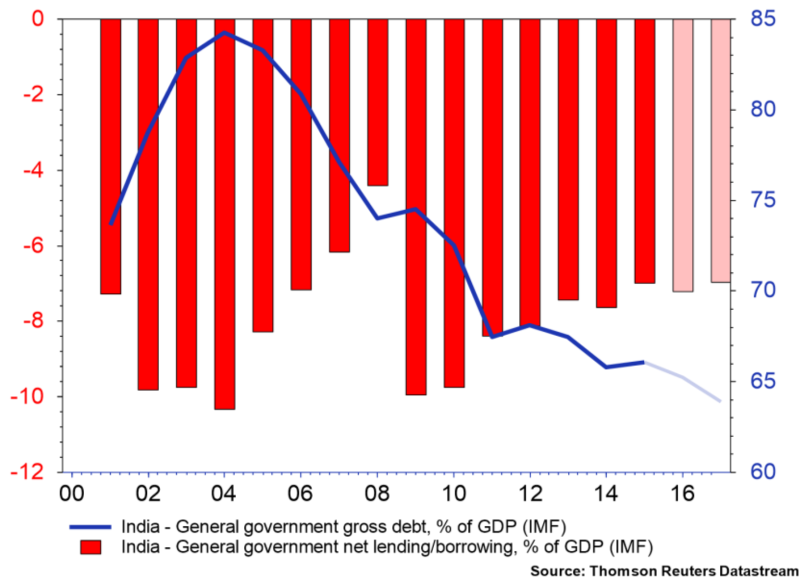




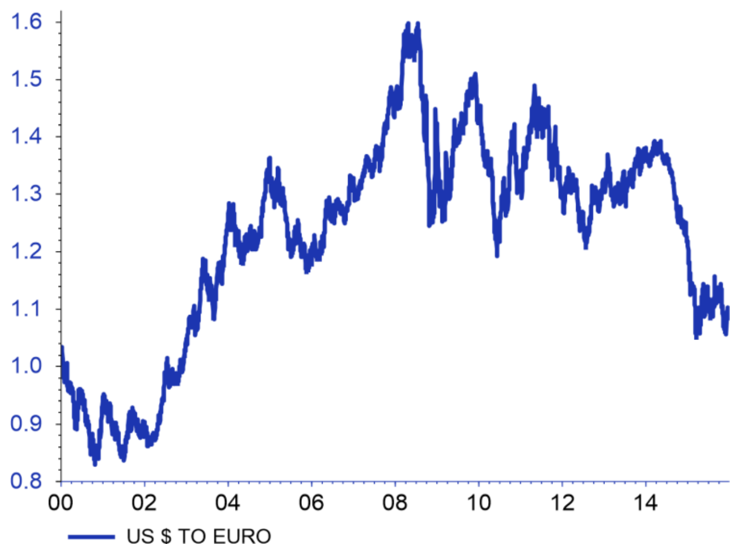


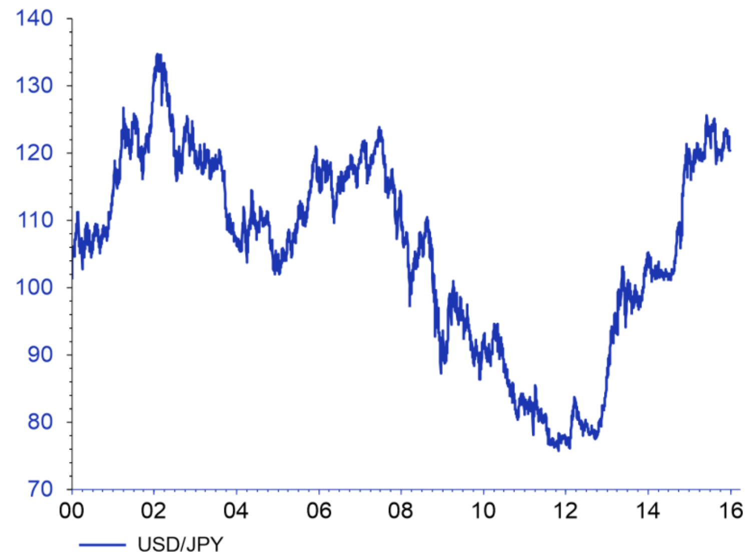
Public Sector Balances (continued)

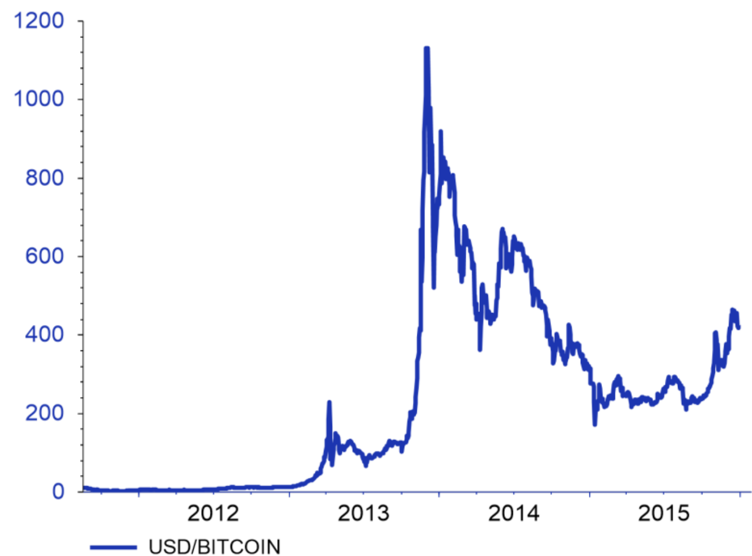




Foreign Exchange Market







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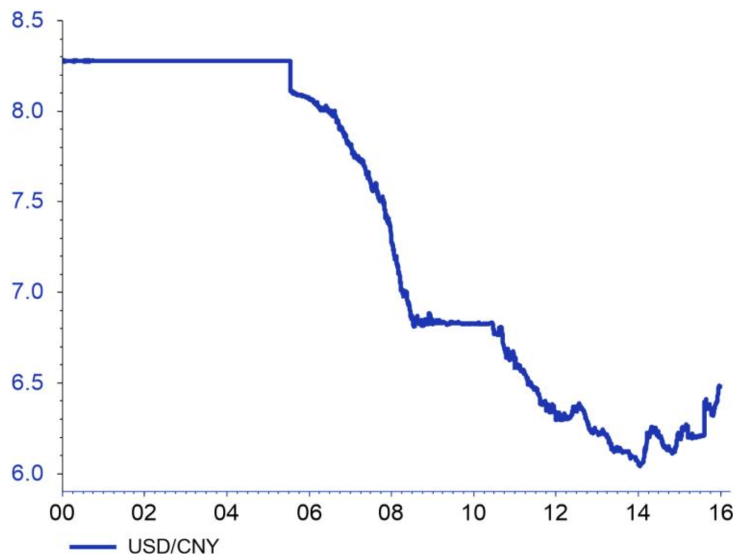
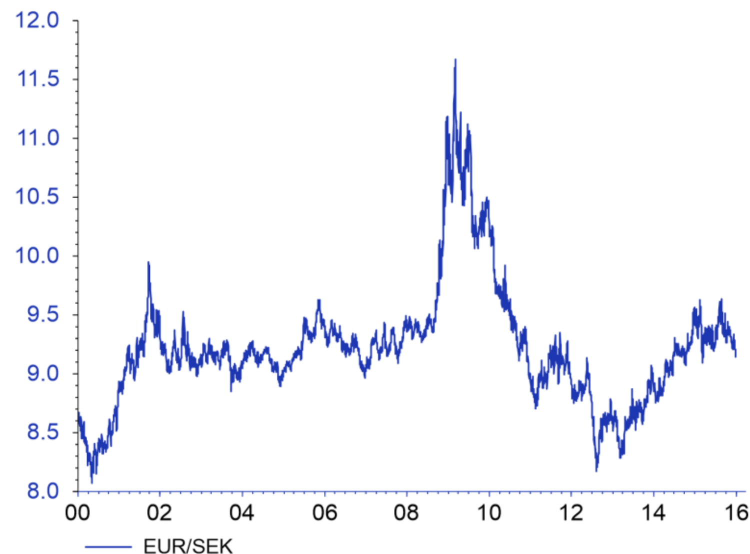
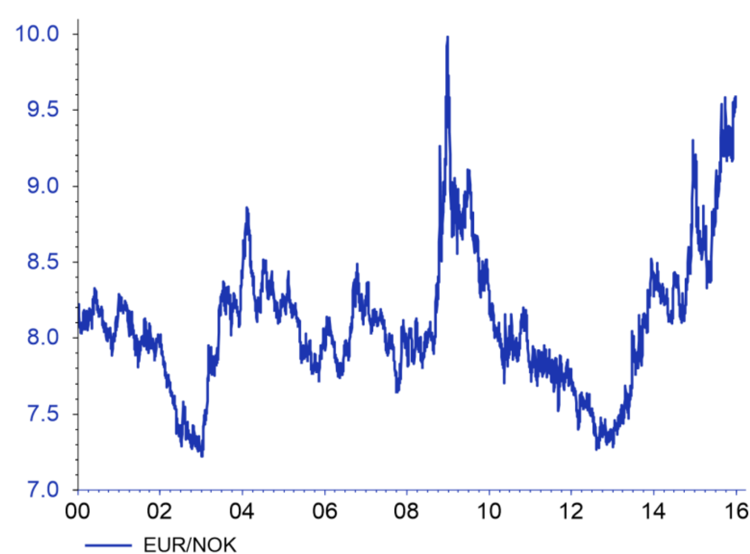
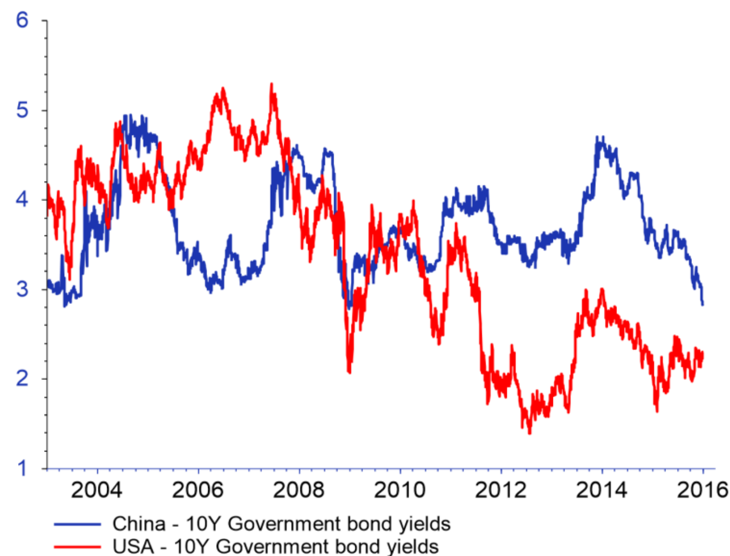
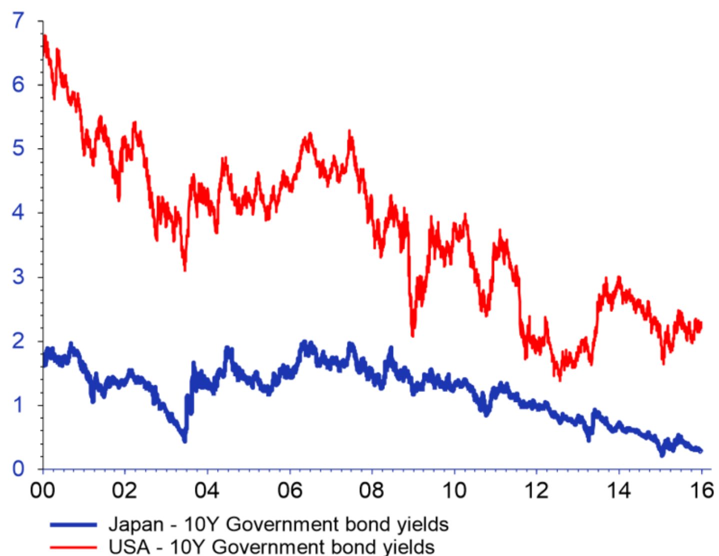




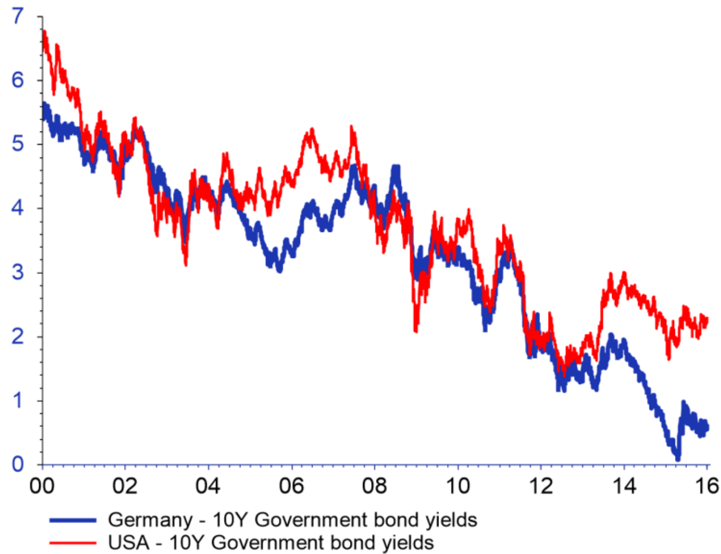


Government Bond Yields

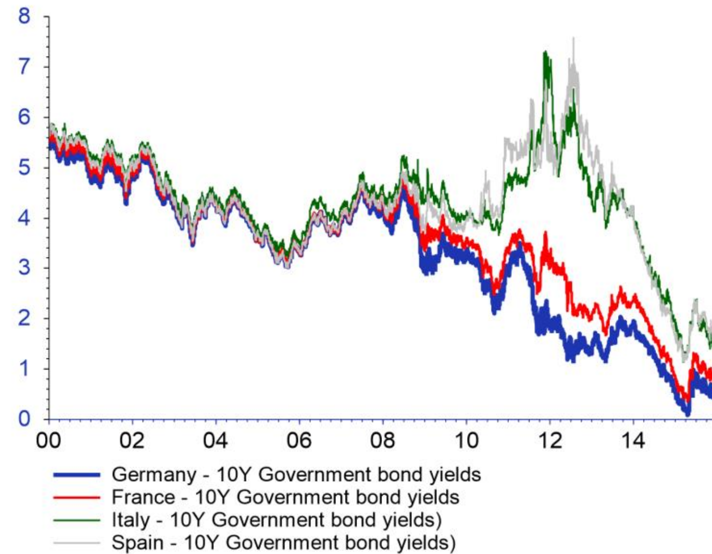




Government Bond Yields (continued)



Source: Thomson Reuters Datastream



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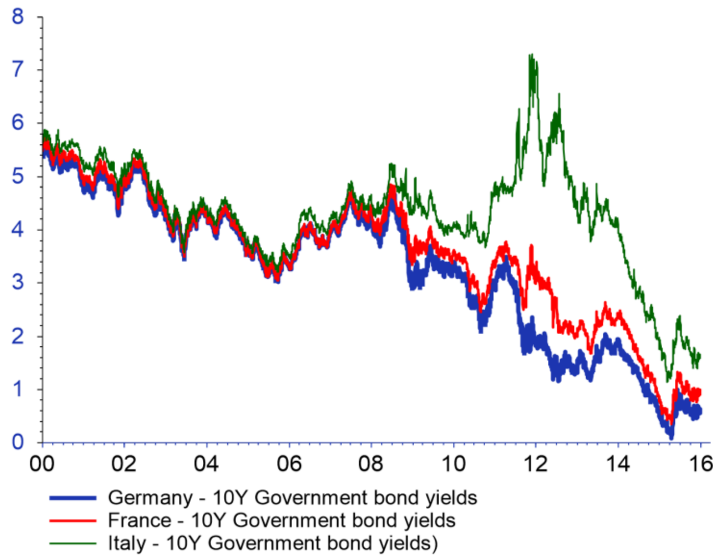

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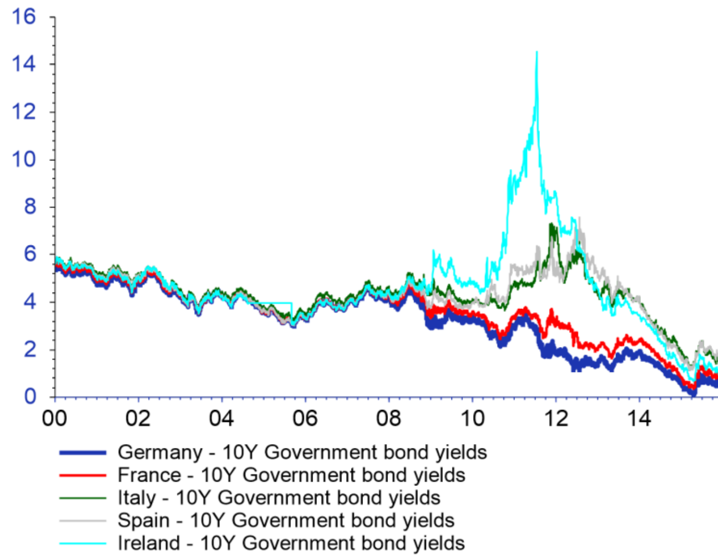

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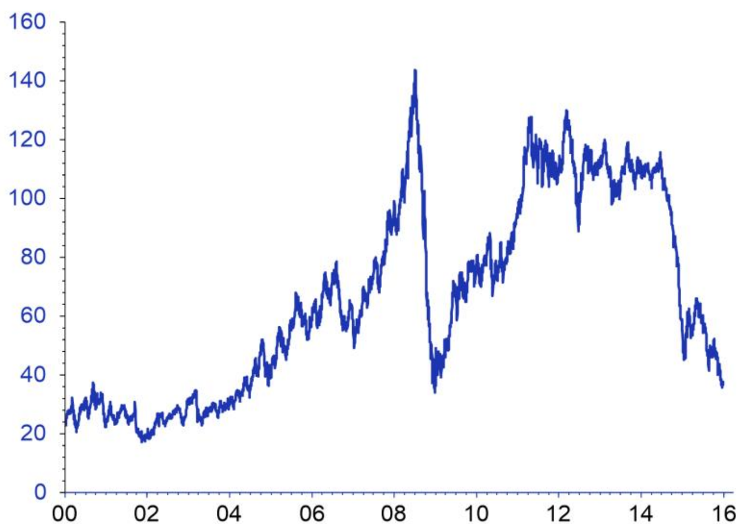
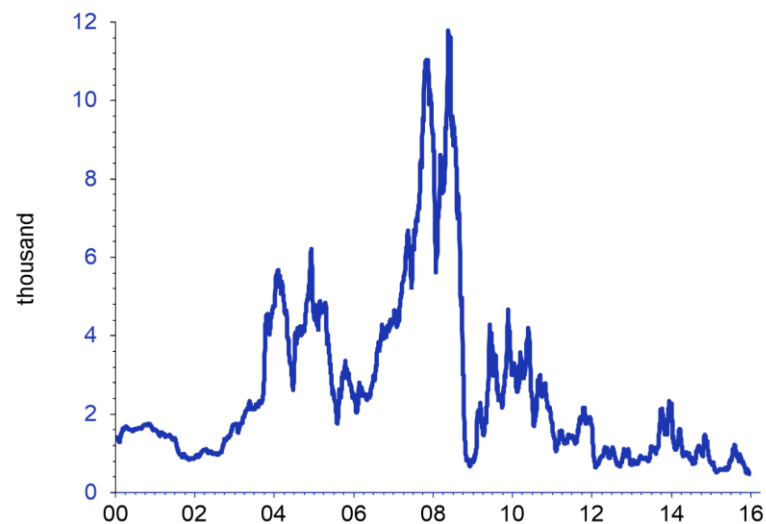
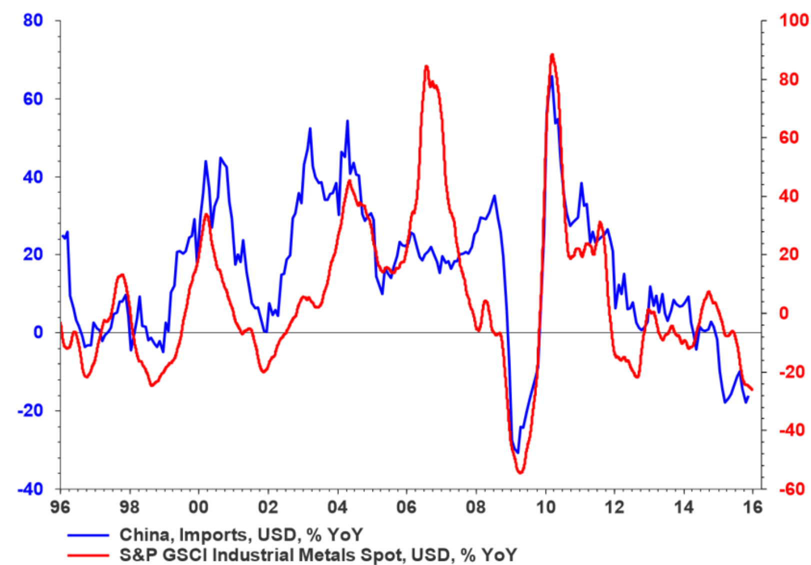
Commodity Markets







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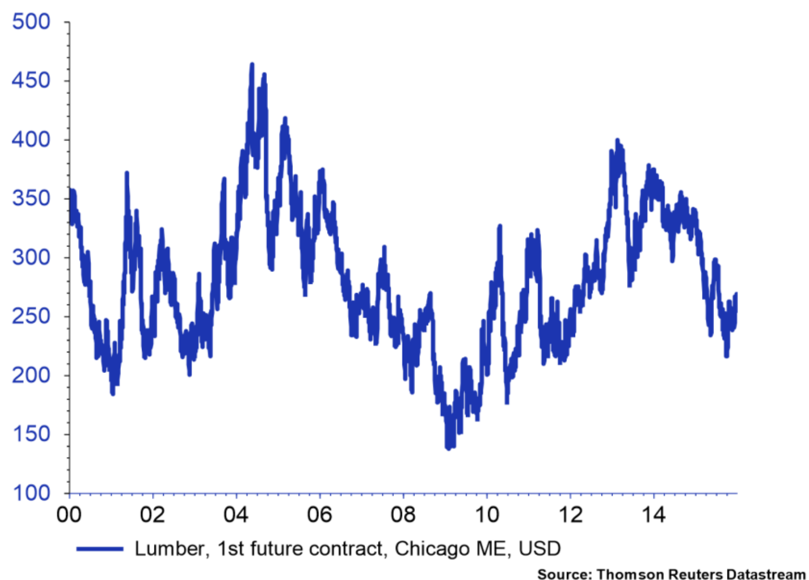
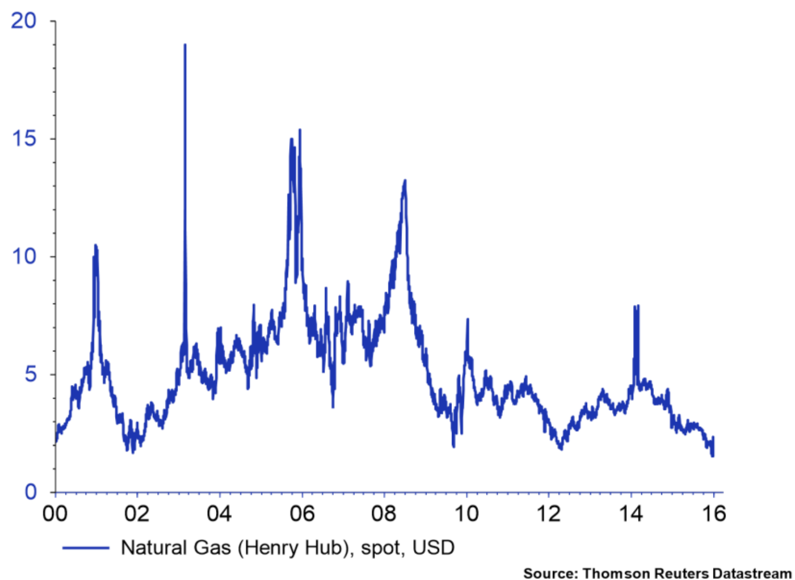
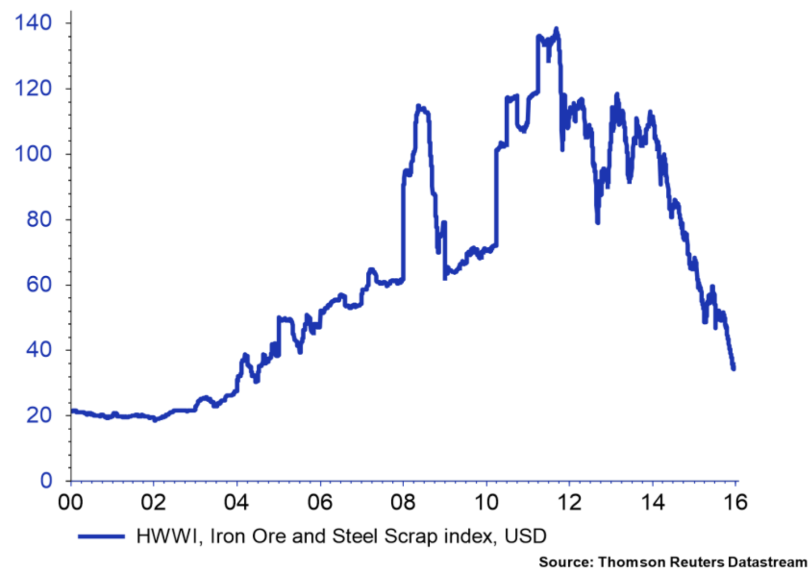
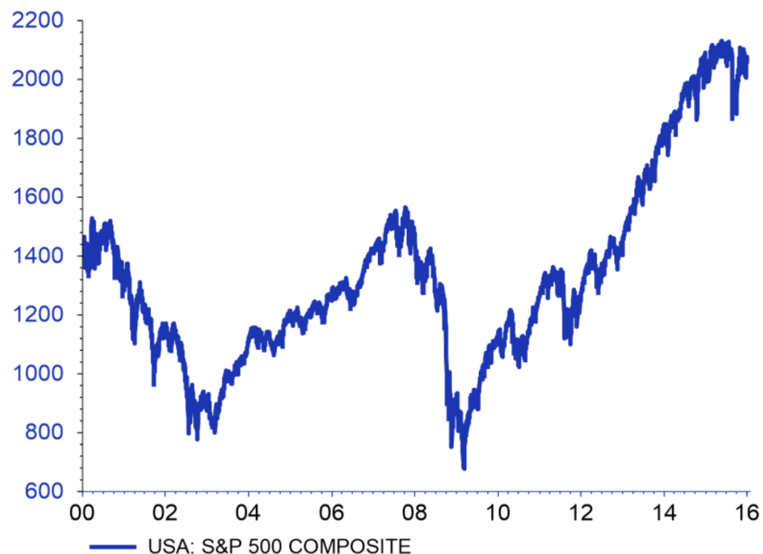


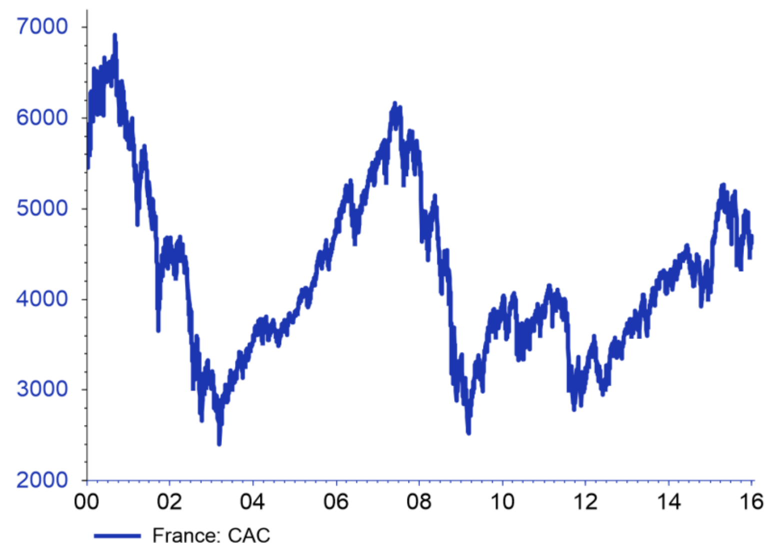


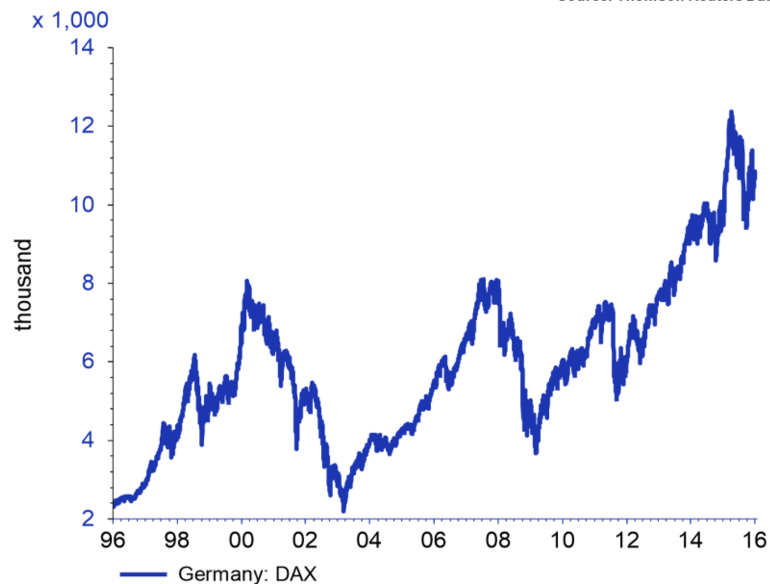


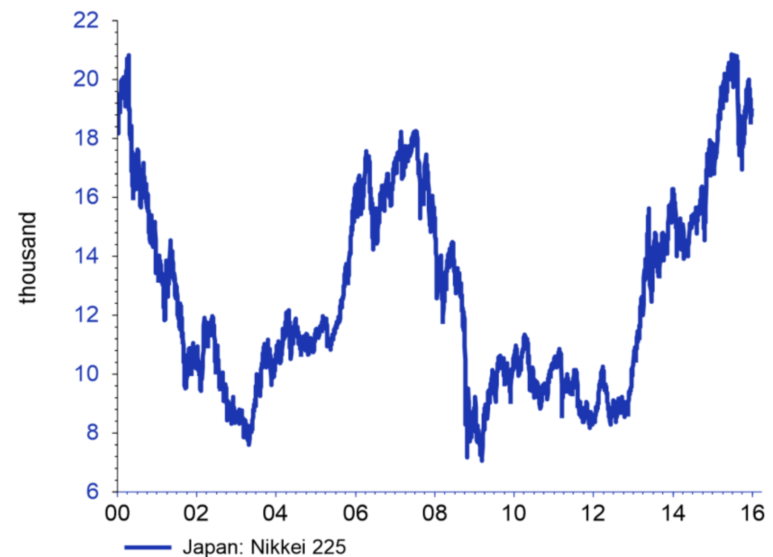
Commodity Markets (continued)

Equity Markets









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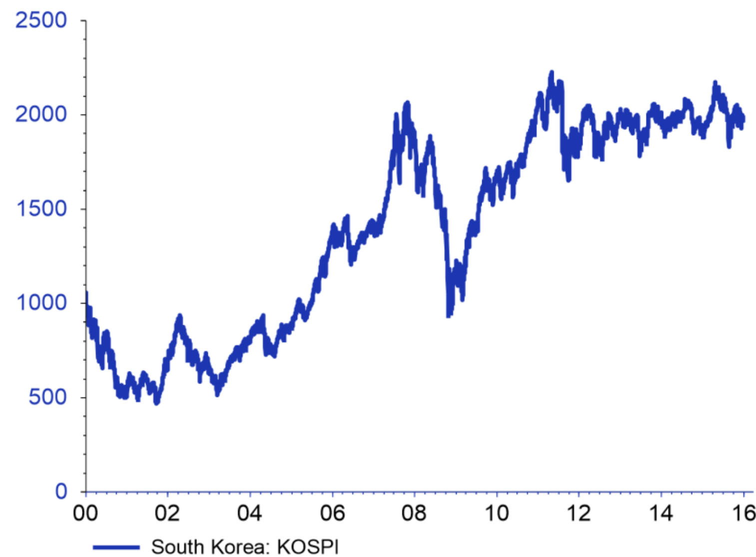

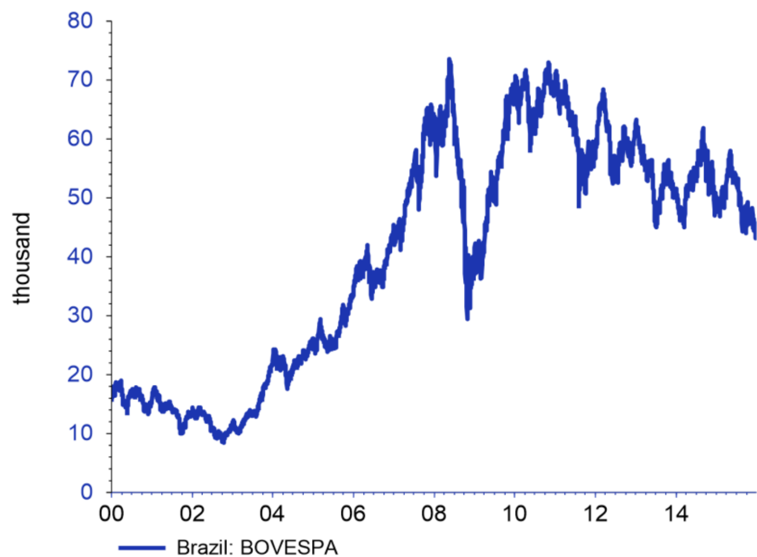

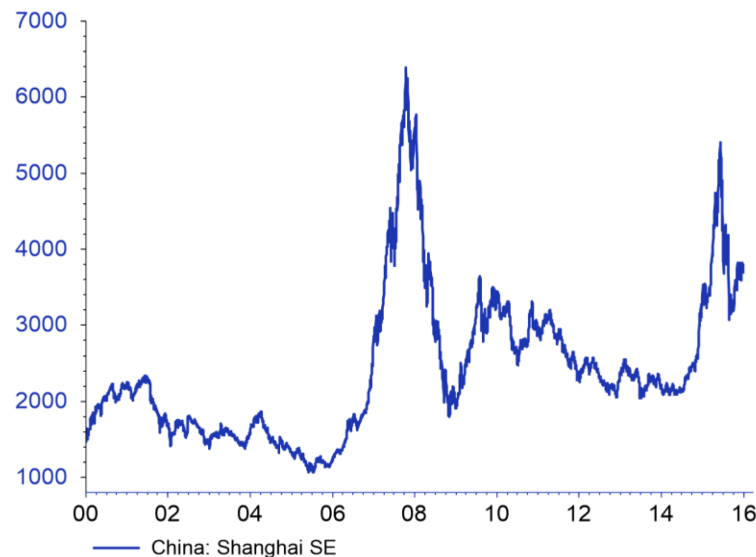

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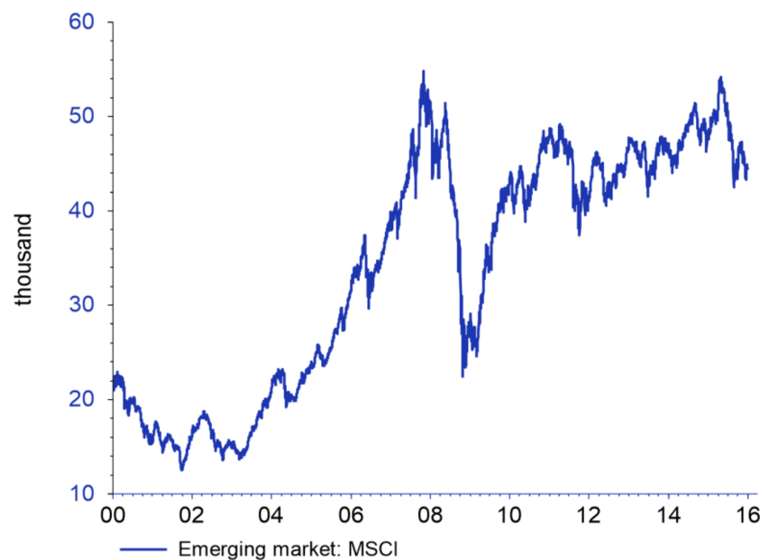
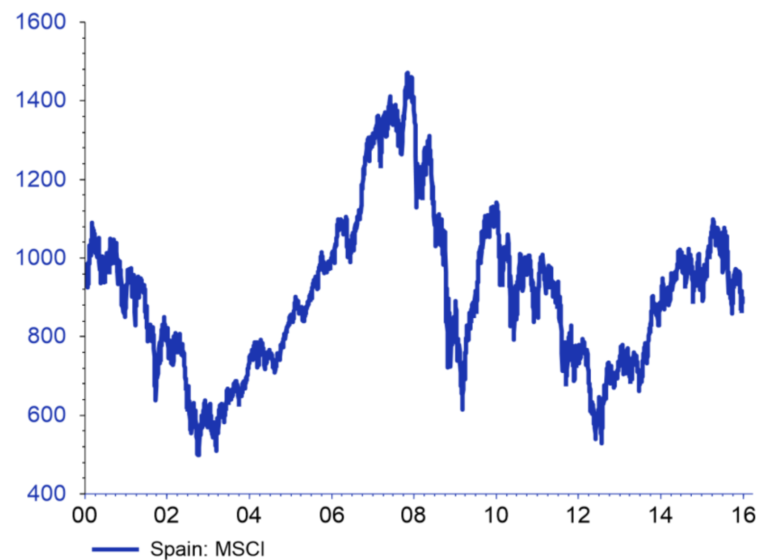
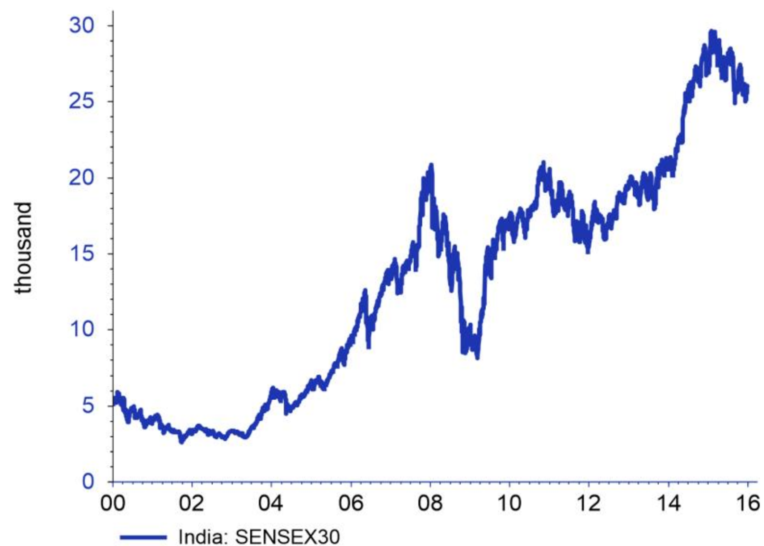
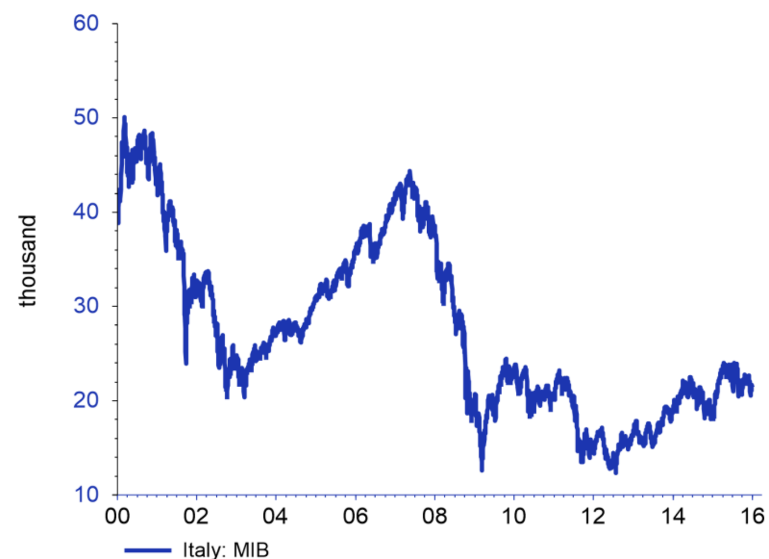
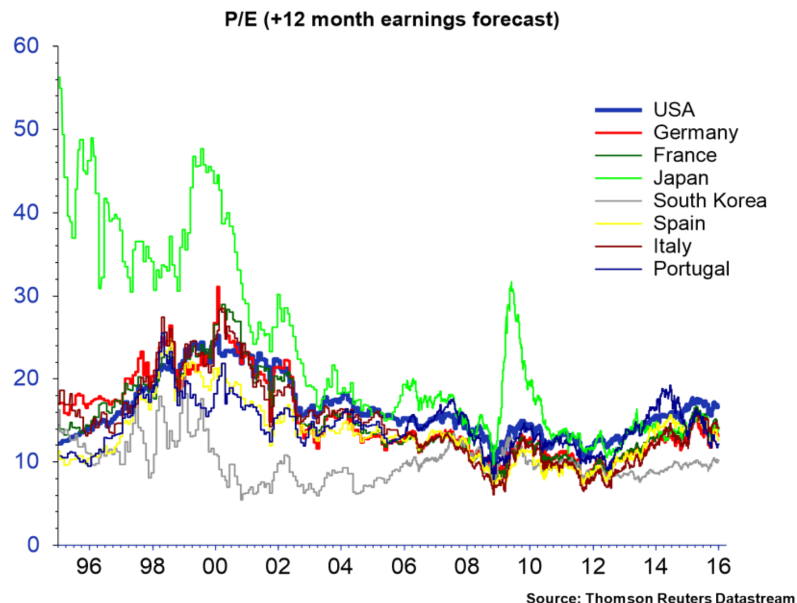


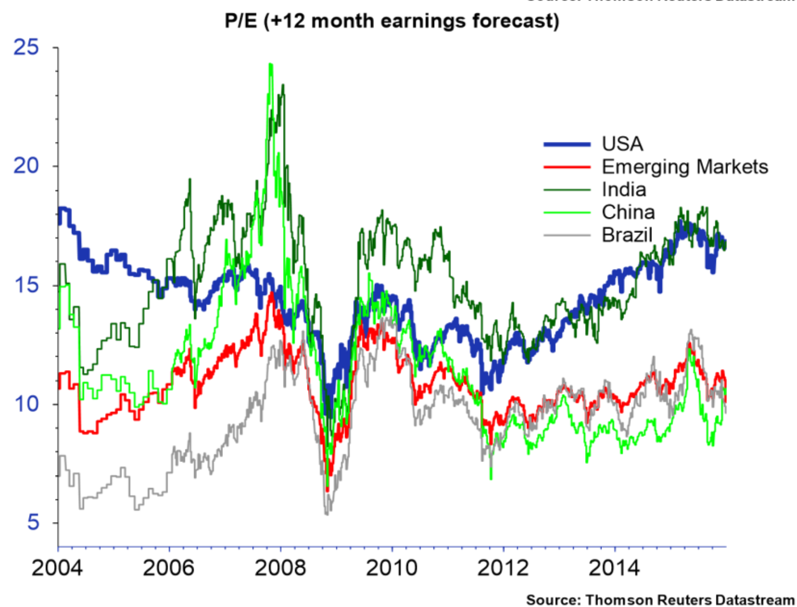




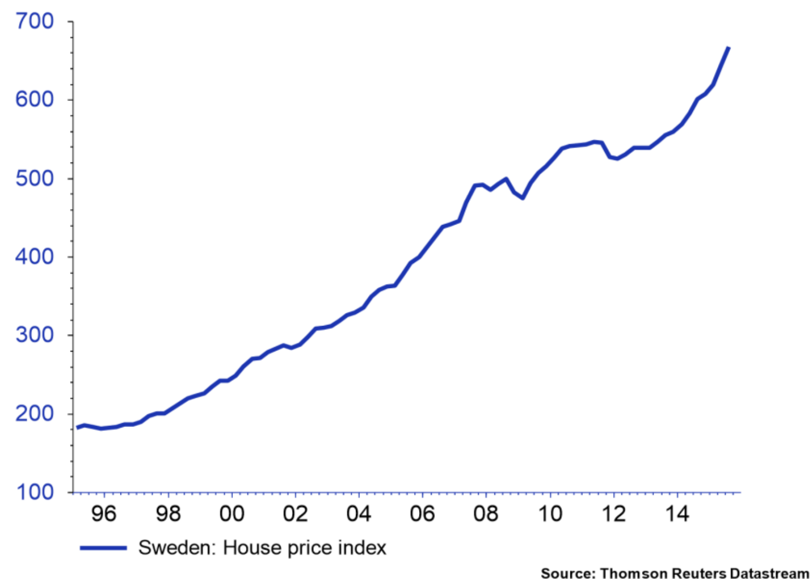


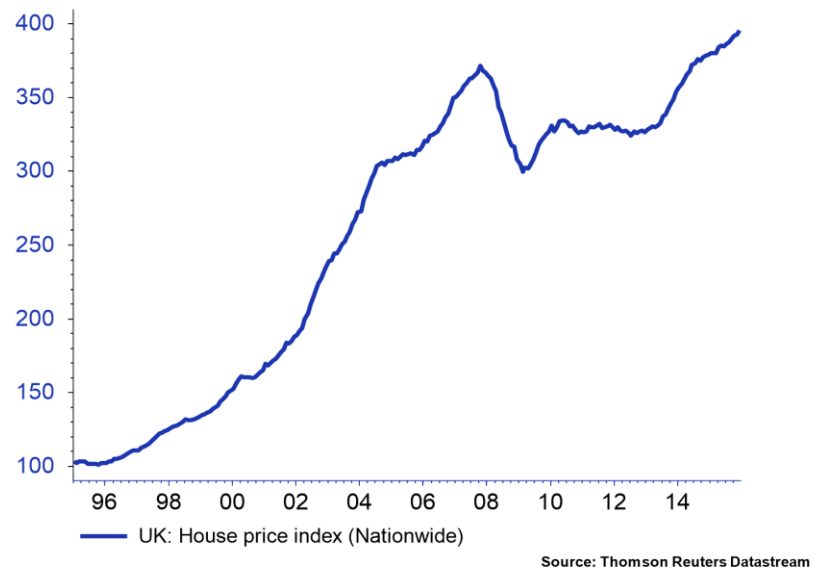
Equity Markets - Valuation

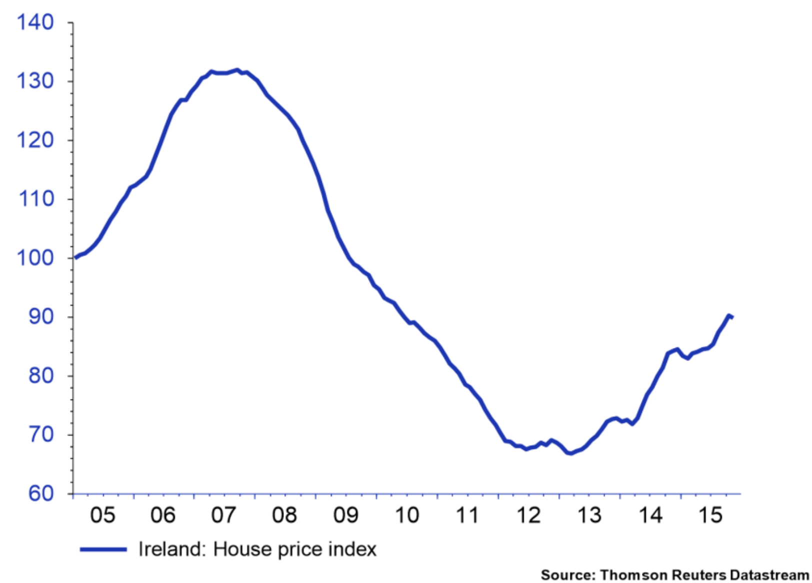




Home Prices







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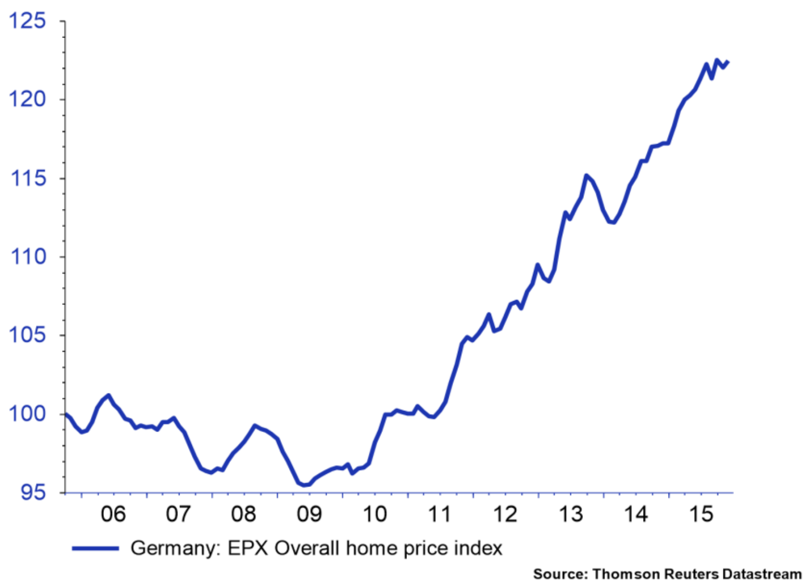

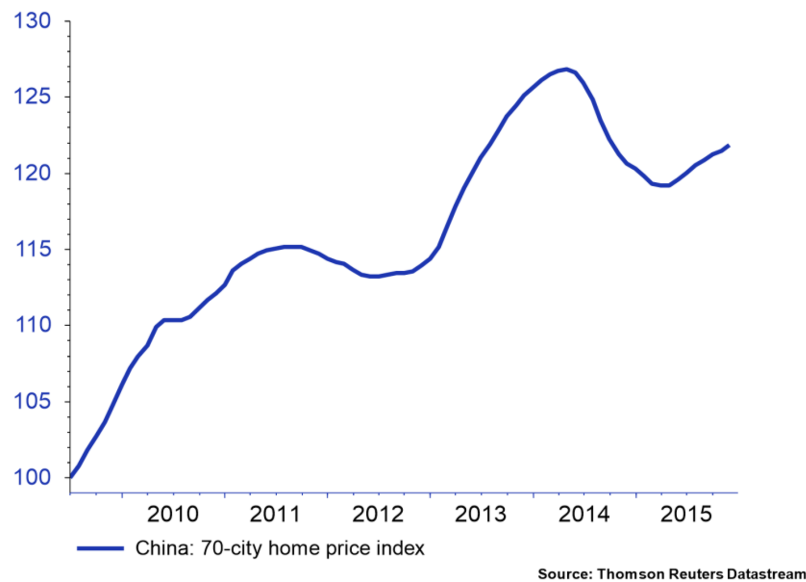

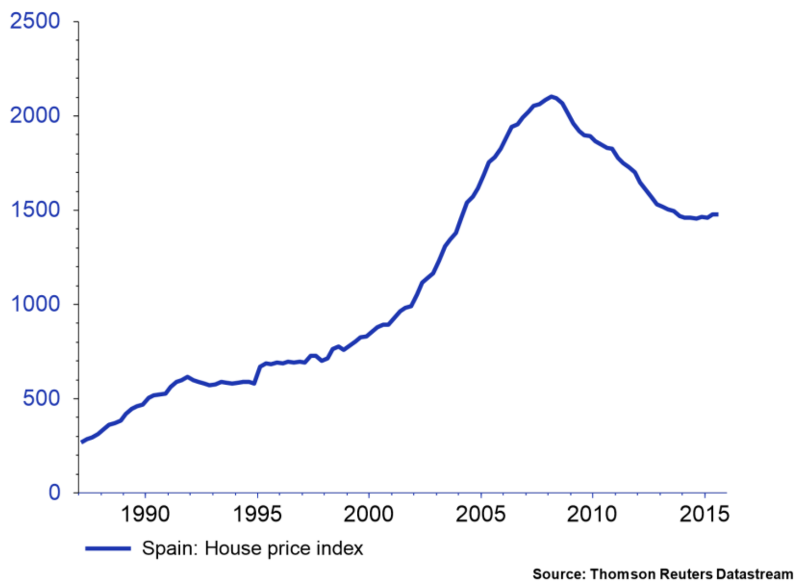

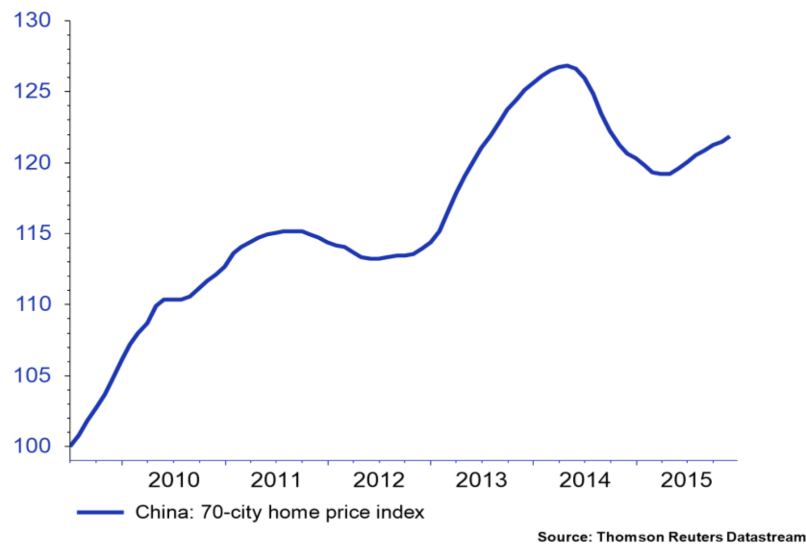

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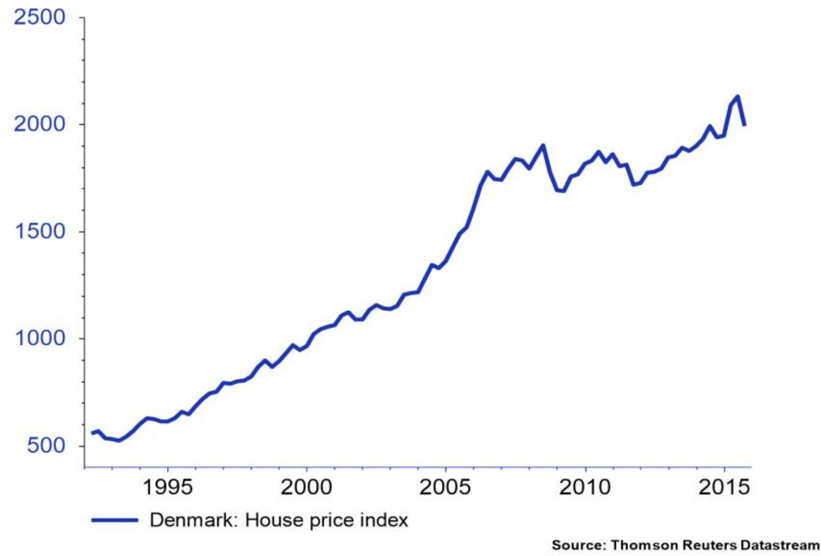
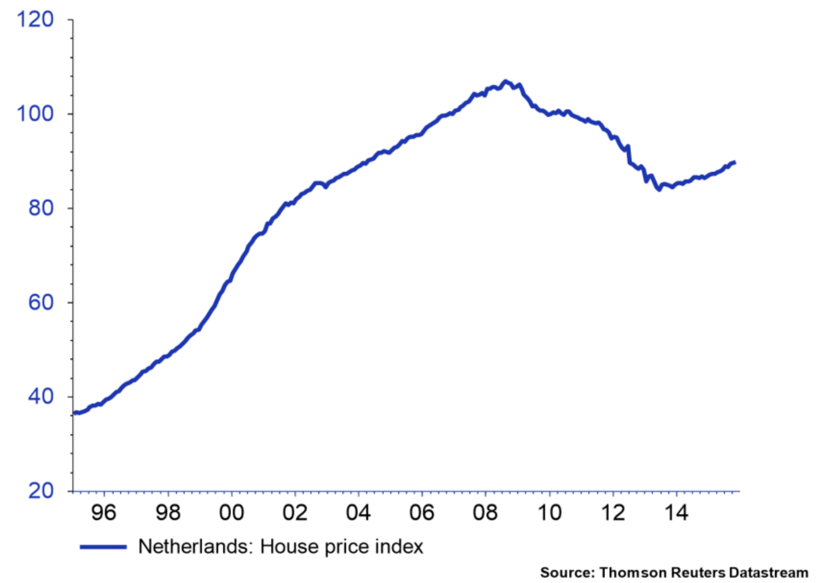
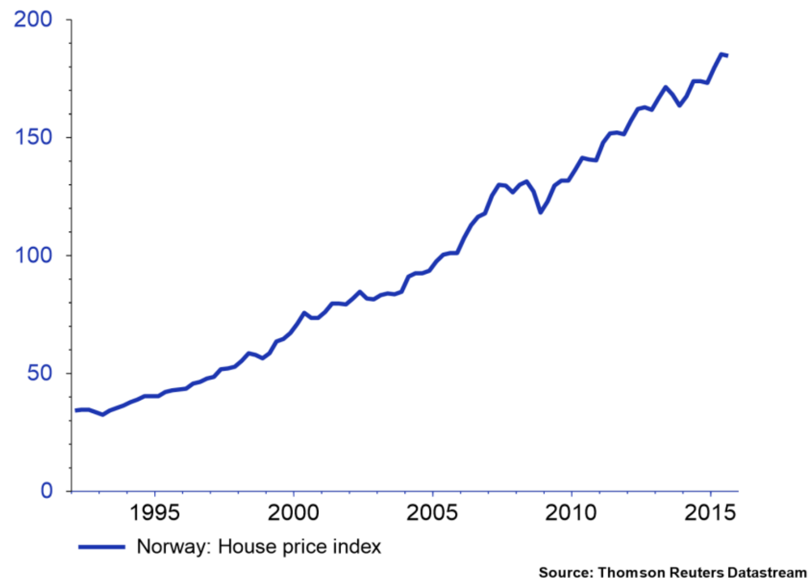
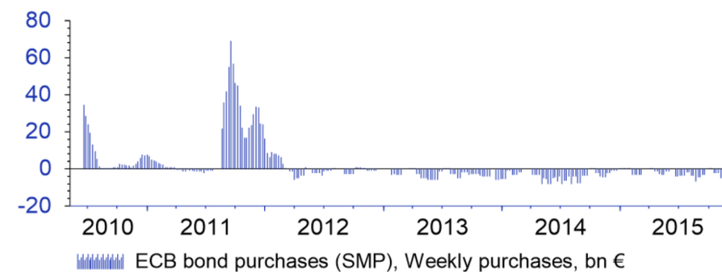
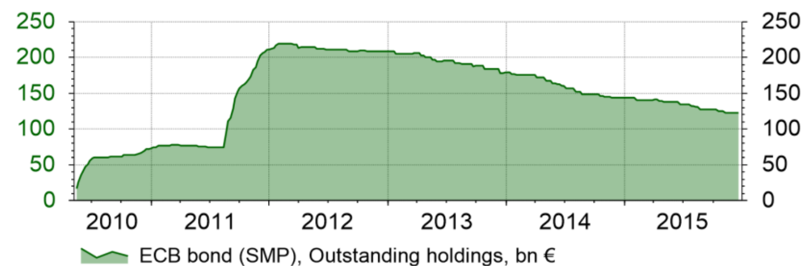


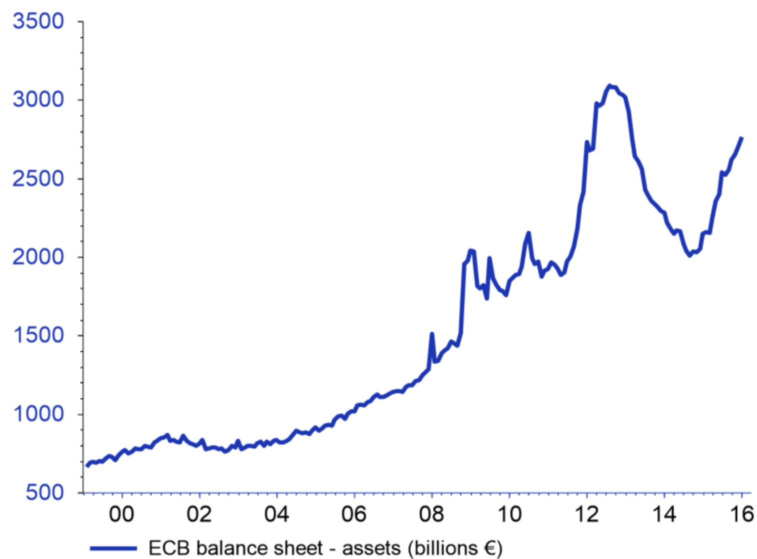


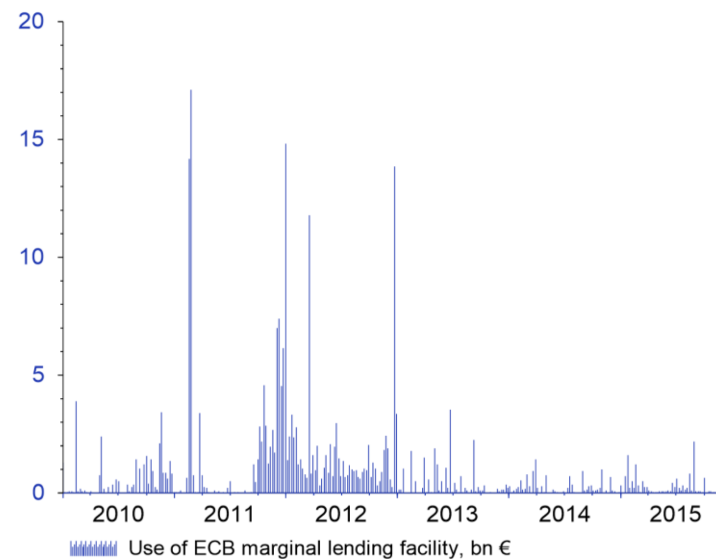


Euro-zone Crisis

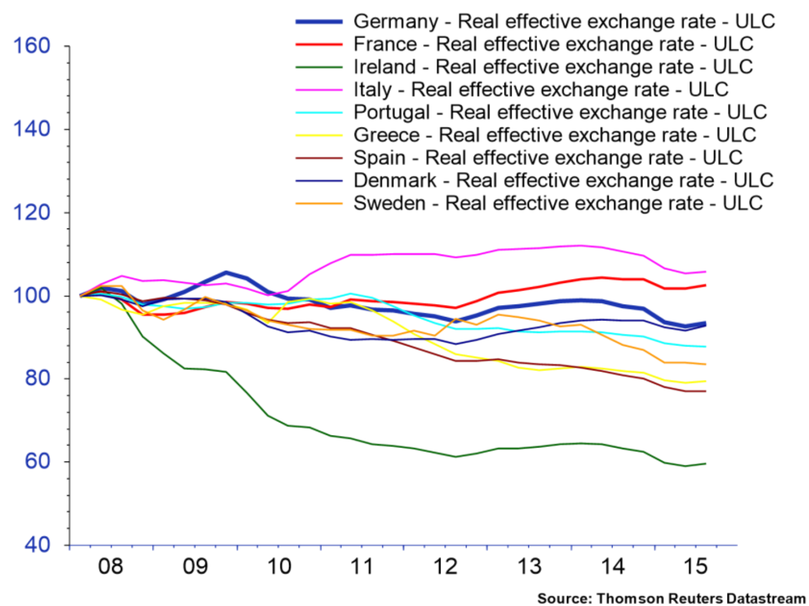




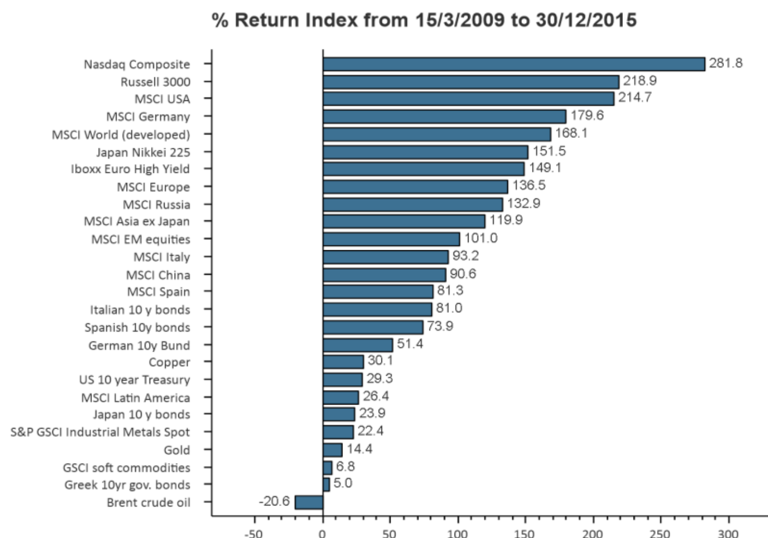




Labour costs



Performance of Asset types (local currency) – last update: December 30, 2015



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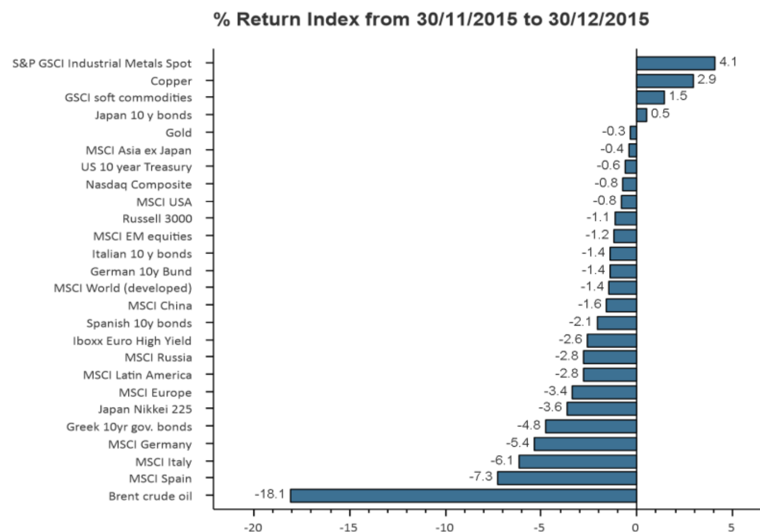

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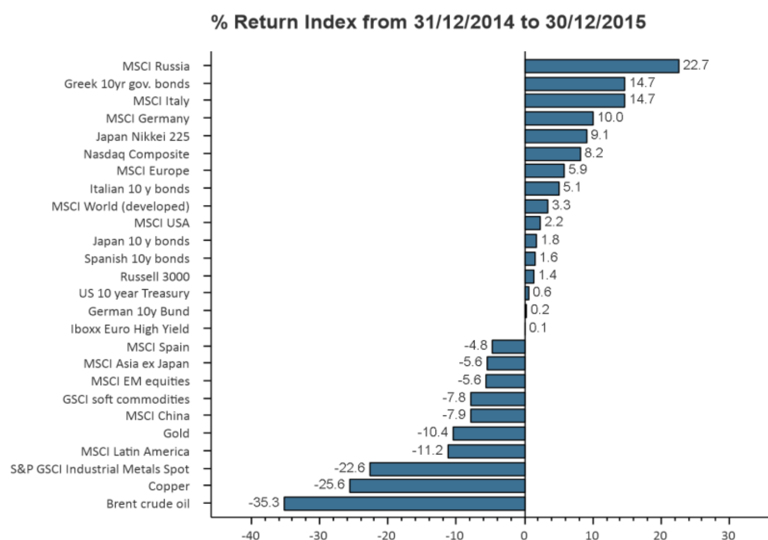

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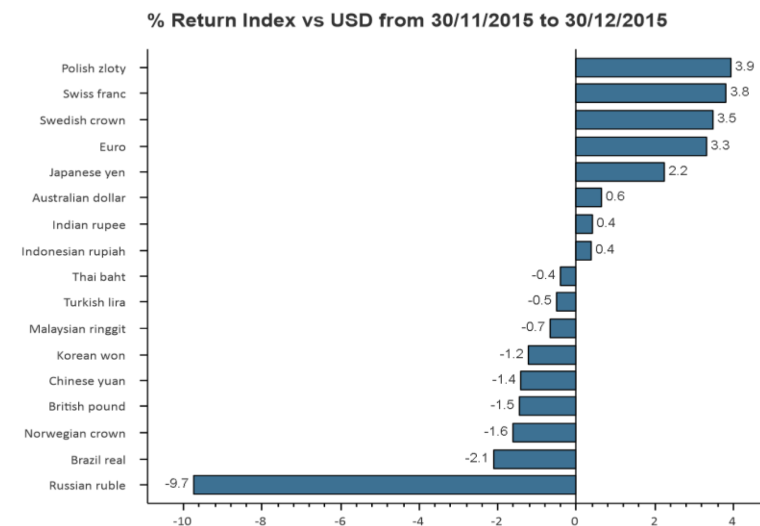

Source: Thomson Reuters Datastream

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