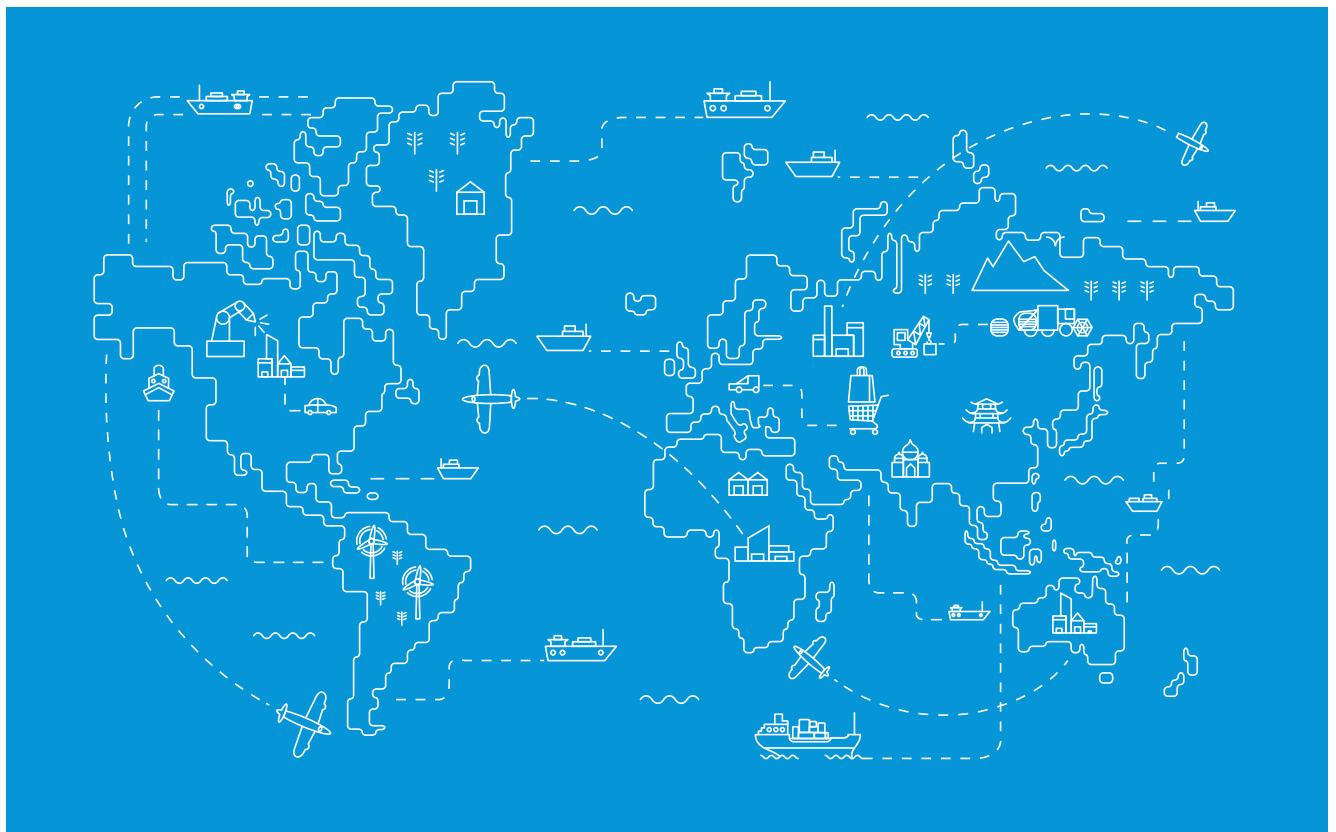


# THE REAL ECONOMY

NOVEMBER 2015

GLOBAL EDITION





## THOUGHT **LEADERS**

Our thought leaders are experienced professionals, with years of experience in their fields, and strive to help you and your business succeed. Thought leaders who have contributed content to this issue include:

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# DEVELOPED ECONOMIES: THE EFFECTS OF US POLICY NORMALISATION ON GLOBAL CENTRAL BANKS

## A middle market perspective

by **Joe Brusuelas**, Chief Economist, RSM US LLP

The US Federal Reserve (Fed) is set to embrace modestly higher interest rates during the next three years, in a slow and orderly fashion, which takes into account the global economy, dollar appreciation and disinflation. The September Fed decision to postpone the first step in policy normalisation shows that the central bank is taking into account global financial and economic conditions. However, improvement in the US labour market and economy during the past two years means the probability of a rate increase this year remains high, even with the recent volatility in global asset markets.

### MIDDLE MARKET INSIGHT:

The recent decision by the Fed to postpone the first rate increase, possibly even until 2016, means that middle market firms concerned about tightening financial conditions and the higher cost of capital have more time to prepare for a shift in the global financial landscape.

The onset of much stronger growth in the US economy, which will help offset falling demand for exports from emerging markets and developing economies, as well as aggressive monetary policy put in place by the European Central Bank (ECB) and the Bank of Japan, should combine to provide a global economic and liquidity buffer, as the Fed embarks on its rate hike campaign.

While investor fears of a repeat of the rapid 140 basis-point increase in the US 10-year Treasury yield between May and December 2013 (the so-called "Taper Tantrum", according to US media), or of a repeat of the 1994 to 1995 rate hikes that some associate with the series of banking and financial crises that followed, are understandable, in our view, the probabilities of a similar development are overstated.

### MIDDLE MARKET INSIGHT:

Global middle market firms should experience rising demand, as advanced economies expand, even as policy normalisation in the United States and UK occurs. However, firms should still prepare to face tighter financial conditions inevitably, once this phase of the US business cycle ends.

Instead, if long-term US Treasury yields rise by 100 points during the first six months after the first rate increase (an outlier in our opinion), developing economies that run large, current account deficits, or whose exports of oil and commodities account for outsized proportions of growth, would likely see an increase in capital outflows of between 0.5 percent and 0.8 percent of gross domestic product. That is less than one standard deviation from the norm, which is inconsistent with a global economic crisis. In other words, the upcoming rate hike campaign will not resemble that unleashed by the Fed when former chairman Alan Greenspan increased the policy rate by 300 basis points over a 13-month period, between 1994 and 1995.

It's important to note that the Fed ended its asset purchase programme in October 2014, and since that time, the US 10-year Treasury yield has averaged 2.13 percent, only two basis points below its current level, and well below the 2.44 percent averaged between 2013, and the end of the Fed asset purchase programme. Thus, the probability of a global adverse monetary shock emanating from the United States has diminished. Moreover, while emerging market yields remain higher than before the so-called "Taper Tantrum", there are no signs of credit risk, funding stress or general counterparty risk that implies global systemic risk. (See Global Financial Conditions Watch in this issue).

The Fed's lift-off may be delayed by global financial turmoil, but it will not be denied. The economic slowdown in China and the knock-on effects to emerging markets, in addition to falling oil and commodity prices, will take a period of a year or more to unwind. Fed policy is now tied to improvement in those markets. The US central bank is clearly signalling to global investors and forward-looking firm managers that it will take into account global financial conditions when setting policy.

We anticipate the Fed will lift the policy rate by 25 basis points this year, followed by another 50 to 75 basis points early next year, before the central bank holds until after the 2016 US presidential election.

Then, in 2017 and 2018, the central bank will likely get more aggressive and move rates higher in the wake of what will have been a multiyear period of above-trend (2 percent) US growth. The Fed's own forecast implies that the policy rate should increase by about 250 basis points by the end of 2017; although, given the demographic and technological headwinds facing the US economy, a move to 200 basis points in the policy rate is probably more likely.

For global central banks, this poses a challenge. For developed, emerging markets and developing countries that run current account surpluses and have flexible exchange rates, a gradual and orderly rate increase campaign should be relatively easily absorbed. For these economies, as conditions improve and monetary accommodation eases, demand for exports should increase. Once the floor in oil and commodity prices is found, their period of adjustment should be short. Economies such as Mexico, for example, which is engaged in a period of economic reform, and India, which has taken steps to liberalise domestic markets and narrow current account deficits, are in far better shape to adjust to US policy normalisation than others.

Economies that have large current account deficits, and which are therefore holding significant quantities of dollar-denominated debt, or which maintain pegged exchange rates, the near- and medium-term transitions will be challenging. Under conditions of a sharp increase in rates in the United States, Eurozone, UK and Japan, this would result in falling equity prices, slowing or shrinking industrial production, and currency depreciation and would put the central bank in the unenviable position of being forced to raise interest rates at the worst possible time.

This may be particularly challenging for economies that are overly dependent on oil and commodity exports that would create possible monetary and tax shocks associated with dollar appreciation, causing the cost of oil to fall further and commodities with it. Many of these economies have deteriorated over the past year and experienced large currency depreciations independent of Federal Reserve policy. Under such conditions, capital outflows would increase and currencies depreciate sharply, causing central banks to hike rates and fiscal authorities to pull back on outlays. Economies such as Brazil, Malaysia, Russia, South Africa, Turkey and Venezuela could come under significant pressure.

Fortunately, only the United States is contemplating a rate increase this year. The Bank of England will likely wait until mid-2016, and the European Central Bank (ECB) and Bank of Japan will not be raising rates for a number of years. In fact, our estimation of the ECB's reaction function, which explains how the central bank alters policy in response to changing economic conditions, implies that the central bank will remain accommodative for far longer than it currently has signalled to investors. We anticipate its balance sheet will grow to about €4.2 trillion euros, far higher than the official policy goal of €3 trillion.

So what are monetary and fiscal authorities to do in developing markets over the medium term, where risk of a monetary shock lies? First, reductions in dollar-denominated and short-term debt is of the essence. Second, creating more stable monetary conditions by hitting inflation targets would buttress policy credibility. This is critical, because policy credibility tends to reduce the necessity or pace of interest rate hikes to avoid overdepreciation of national currencies. Third, undertaking structural reform, putting primary budgets on a path to balance and putting in place policy incentives to diversify economies away from an overreliance on oil or a narrow range of commodities would bolster policy credibility. India and Mexico are two economies that have profited from the imposition of structural changes over the past few years. Fourth, maintaining exchange rate flexibility, but being willing to take reasonable and targeted support measures can shore up currency or slow depreciation. In periods of global economic change, adjustment via the currency channel remains one of the effect mechanisms to cushion transitions and provide outlets for growth.

# AT A GLANCE

## EMERGING MARKETS

### CENTRAL BANK OUTLOOK

by **Joe Brusuelas**, Chief Economist, RSM US LLP

#### Asia

##### People's Bank of China

The People's Bank of China (PBOC) has adopted an accommodative monetary stance in light of the two standard deviation shock to regional financial conditions and growth deceleration in the domestic economy. We anticipate further cuts in the policy rate (the one-year lending rate is currently 4.6 percent) and reserve requirement ratio (currently 18 percent), given the threat that volatility in financial markets spills over into the real economy. The non-deliverable forward market implies that the PBOC will further devalue the yuan by about 3.5 percent during the next 12 months.

##### Reserve Bank of India

The Reserve Bank of India (RBI) is in a much stronger position to respond in a gradual and orderly fashion to global monetary conditions. With inflation at 3.7 percent, near the bottom of the bank's 2-to-6 percent target range, the monetary authority surprised investors by cutting the RBI repurchase rate to 6.75 percent from 7.25 percent. RBI Governor Raghuram Rajan is focused on establishing the independence of the institution alongside the aggressive policy liberalisation programme of the fiscal authority, so it is probable that the monetary authority will proceed slowly in its easing programme and may wait until the second quarter of 2016 to reduce the policy rate again.

##### Bank Indonesia

The Indonesian central bank finds itself in a challenging situation. With the regional economy slowing and inflation standing at 7.2 percent, well above the bank's 3-5 percent target range, and the rupiah depreciating, conditions aren't ideal for the monetary authority to adopt an easing stance. With the rupiah down 20 percent against the US dollar during the past year, Bank Indonesia is currently focused on stabilising the currency.

##### Bank of Korea

The Bank of Korea (BOK) is caught between a rock and hard place, as it seeks to navigate the difficult path between a decelerating Chinese economy and the beginning of the US central bank's rate hike campaign later this year. With inflation on a year-ago basis at 2.1 percent, below the 2.5-3.5 percent target range, the BOK is well-positioned to respond to external developments. We anticipate the BOK will remain on hold, keeping its policy rate steady until the Fed moves.

##### Philippine Central Bank

The monetary authority held the key policy rates firm at the recent 25 Sept. policy meeting. The overnight borrowing and lending rates are at 4 percent and 6 percent, respectively. This was the eighth consecutive meeting that the central bank chose to preserve the monetary status quo. With oil and commodity prices continuing to trend near the lower end of their recent ranges, the central bank should continue to see inflation, which is currently at 1.7 percent, trend below the 2-to-4 percent target range.

##### Singapore Central Bank

Economic rebalancing in China, structural shifts in global trade and a slowing economy imply a modest adjustment to the trading band of the Singaporean dollar. With mild deflationary pressures taking hold amid slower growth, the Monetary Authority of Singapore will likely adopt a mild easing policy going forward.

##### Thailand Central Bank

The monetary authority recently reduced its economic outlook to 2.7 percent from 3 percent, with the acknowledgement of downside risks from slower China growth, low oil prices and weaker demand for exports. While the central bank's economic outlook has grown

more dour, it's waiting to see the impact of the recent implementation of \$5.6 billion in fiscal stimulus before embarking on a more aggressive monetary policy path.

## EMEA

### South African Reserve Bank

The South African Reserve Bank (SARB) is in a very difficult position. In light of slowing global demand for exports, and domestic unemployment remaining elevated at 25 percent, it may find it difficult to continue its tightening policy. Given the SARB reduced its growth forecast for the next three years, and the risk of capital outflows, if the central bank ends its rate hike campaign when the US Federal Reserve starts its rate hike campaign, it may find it necessary to reverse that decision soon or undertake other forms of currency intervention to maintain the value of the rand.

### Israel Central Bank

Slow growth, domestic deflation and weak demand for exports all imply that the monetary authority may choose to implement further unorthodox policy to boost growth prospects going forward. With the benchmark interest rate at 0.10 percent, near the zero bound, tax accommodation is likely to provide a greater boost to the economy than a 10 basis point cut in the policy rate. In the interim, a weaker shekel will provide a boost for growth via improved competitiveness.

### Russian Central Bank

Inflation has accelerated to 15.8 percent on a year-ago basis and the ruble has depreciated against the dollar by 66 percent during that time frame, as the Russian economy has fallen into recession. Until the price of oil bottoms out and inflation dynamics improve, the central bank will keep its policy rate at 11 percent in the near term, which likely means that policy will remain very tight relative to domestic economic prospects well into next year.

### Turkey Central Bank

The monetary policy committee (MPC) has left its policy rate unchanged for seven consecutive months. The one-week repurchase rate is at 7.5 percent. The central bank

has signalled it will take steps in response to the coming global monetary tightening cycle, as the Fed raises rates later this year. The MPC has indicated it will raise rates to protect the lira, which has depreciated 33.6 percent against the US dollar during the past year.

## Latin America

### Brazilian Central Bank

Economic conditions remain challenging in Brazil, as the central bank paused at its September meeting to keep the SELIC rate at 14.25 percent. Given the rapid depreciation of the real, and a recession linked to slower demand for commodities from China, it's likely that the central bank will have little choice but to raise the rate above 15 percent either later this year or in early 2016. With the probability of any tax stimulus quite low due to political polarisation in the country, the central bank is the only institution capable of acting to support the currency and economy in the near term.

### Chilean Central Bank

Like many emerging market central banks, the Chilean monetary authority will remain on hold until it assesses the reaction of global financial markets to the US Fed's looming rate hike. For now, with inflation at 5 percent, well above the 2-to-4 percent target rate, and economic growth weak, the shift in the central bank's policy at its most recent meeting to a tightening bias is a sure sign that currency stability will be the policy priority in the coming year.

### Banco de Mexico

The Banco de Mexico has warned of pass-through risk due to a weak peso, which has depreciated by approximately 25.71 percent against the US dollar. This implies that the monetary authority has made a de facto decision to time the next rate hike to that of the US central bank's policy. The implementation of recent policy liberalisation and the opening up of Mexico's oil complex to foreign investment both suggest that Mexico will remain among the leading emerging market economies during the next two to three years.



# DETERMINING WHEN INTERNATIONAL EXPANSION IS RIGHT FOR YOUR BUSINESS

by **Anand Selvarajan**, RSM Regional Leader, Europe

There comes a point in every company's life span when it may need to consider expanding to international markets. In fact, international expansion, while challenging, remains an essential component of a company's overall growth strategy, both from a cost reduction perspective, as well as opening up new revenue streams.

When the bank is asking where you're planning to be in three-to-five years, the knee-jerk answer is usually "China". However, international growth may not mean crossing oceans immediately, but instead growing your footprint within your geographical region.

Whether you decide to expand into emerging markets or developed markets, there are some key factors to consider before taking this important step.

## **Understand the market**

It sounds obvious, but it is essential to research the market and to assess whether there is a genuine demand for your product or service and whether your product is relevant to the local culture. If so, your product may need to be adapted to meet local tastes and regulations.

Surprisingly, many of the world's most respected brands have not adopted this approach.

McDonald's faced protests from militant anti-beef campaigners in India, and only added vegetarian items to their menus after several years of difficulties. Starbucks lost the Australian market to coffee drinkers who felt they were going to hurt the local coffeehouses they had grown up with.

On the other hand, there have been tremendous success stories. One of the most instructive comes from KFC, which arrived in China back in 1987. The parent company, Yum Brands, staffed the chain with local managers, and shaped the menu to Chinese tastes. In addition to a traditional KFC menu, customers could also order local dishes, such as congee. KFC now enjoys a 40 percent market share.

It is essential not to underestimate local cultural nuances and to adopt a flexible mindset to navigating cultural differences.

Once you have decided where to expand, consider all the options in financing this growth, including bank debt, private equity or your own profits. The next step is likely to be the "how?" – options will range from simply exporting to that international market to establishing a fully-fledged local presence.





## Manage the risks

Moving into new markets is a big step and however exciting, you need to move at the right pace and assess how best to manage the risks. Some companies tend to underestimate the costs of doing business, the complexity of repatriating profits, and grasping the intricacies of local regulations and tax regimes. Complying with the varying requirements of multiple tax jurisdictions is complicated, time-consuming and can be fraught with risk. Transfer pricing strategies have, therefore, become one of the most important tax issues facing international companies—whatever their size.

In addition to managing your currency risks, there is also intellectual property protection and brand protection to consider.

You will need to research all likely costs, including shipping costs, banking costs and changes in exchange rates. It is therefore essential to develop a strategic business growth plan and know where to look for the right local partners. The key to success will be having trusted advisors on the ground, who know the local market dynamics, can help you protect your business and assist you in complying with local rules and regulations.

## Conclusion

International business can be complex, and it may be tempting to simply follow your peers or a large client. But a "me too" approach can lead to challenges and overlook potential opportunities in other markets.

In addition to the logistical challenges of trading in unfamiliar markets, companies need to be aware of the risks involved and how to mitigate them. Developing local relationships and thinking long term will be key building blocks in maximising the exciting opportunities that lie beyond your borders. While some companies are beginning this journey, those already trading internationally can use these tips to become increasingly efficient and streamlined in their processes and structures.

It is impossible to predict the future, but you can navigate confidently, with a strong growth strategy. With more than 50 years' experience advising companies in international markets, RSM has a local presence in 110 countries and continues to assist companies in maximising international opportunities.

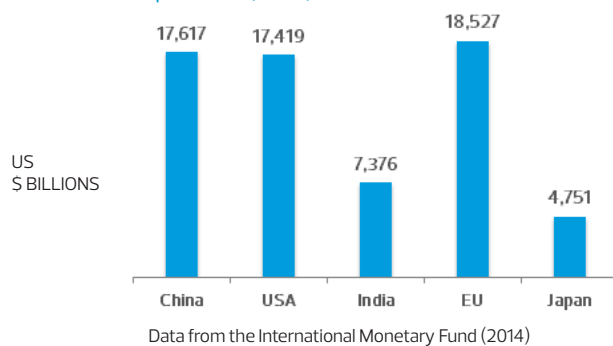
# INDIA WATCH

## WILL INDIA BE THE NEXT HOTSPOT FOR ECONOMIC GROWTH?

by **Dr. Suresh Surana**, Managing Partner, RSM India

India is presently the world's third-largest economy, with gross domestic product (GDP) of US \$7.4 trillion, in terms of purchasing power parity (PPP). The World Bank and International Monetary Fund (IMF) have projected India's annual growth rate at 7.25 percent for 2015. In the midst of a global economic slowdown across geographies, this raises an interesting question—Will India be the next hotspot for economic growth?

### Gross domestic product (GDP)

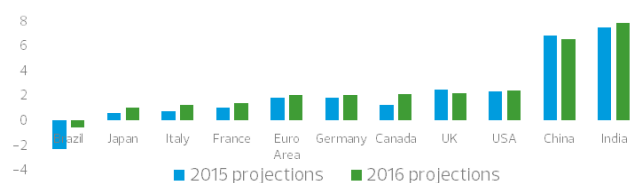


Apart from the size and sustained growth of the economy, India has the world's largest democracy, which has a history of smooth shifts of power during the past six decades, and an independent judiciary. The new visionary political leadership, favourable demographics with more than 65 percent of the population below the age of 35 years, and a large, educated workforce, are what may be fuelling the high growth expectations. The two distinguishing features of the Indian economy are its domestic-oriented economy (constituting about 75 percent), with limited reliance on exports, and a high savings ratio (30 percent). These factors certainly make India an interesting proposition for most businesses with an international perspective. Interestingly, the outlook for short-term growth is also good. According to the IMF, the Indian economy is the "bright spot" in the global landscape.

- Gross domestic product (GDP) during 2015**  
US \$7.9 trillion measured in terms of PPP
- GDP growth rate**  
Projected at 7.25% for 2015
- Currency and exchange rate per one US dollar as of 18 September, 2015**  
\$1 US = INR 65.93
- Market capitalisation as of September 2015**  
\$1.46 trillion US
- Global ranking**  
Third-largest economy in the world, in terms of PPP
- Young demography**  
1.271 billion (2015), with more than 65 percent below the age of 35 years
- Forex reserves (as of 4 Sept. 2015)**  
\$349 billion US
- Political system**  
Federal republic, with largest parliamentary democracy

India's economic growth will predominantly be driven by the information technology (IT) and business process outsourcing (BPO) industries, as well as infrastructure and banking, financial services and insurance sectors. The other major growth driver can be the Make in India initiative aimed at boosting India's manufacturing competitiveness.

### Global economy evolving at different speeds across regions Real GDP growth, % change from previous year



Source: OECD Interim Economic Outlook (September 2015)

## Information technology and business process outsourcing hub

India is known as the information technology hub for leading software companies of the world. Most of the IT giants, such as Microsoft, Oracle, SAP and Accenture, are using India as their principal development centre, employing hundreds of thousands of engineers and other IT professionals.

The exports of information technology services, business process outsourcing services and software services exceeded US \$100 billion in tax year 2014–15.

With the Digital Revolution sweeping the world due to advancement in social, mobile, analytics and cloud technologies, India's growth is expected to accelerate in the coming years. Currently, India has a remarkable 55 percent share in the global outsourcing market due to a tech-savvy workforce and a cost arbitrage two to three times that compared with the large advanced economies.

According to A.T. Kearney's Global Services Location Index 2014, a ranking of top 50 most attractive offshoring destinations, India has retained its position as the best outsourcing destination in the world.

## India remains the leading destination for global sourcing

As per India Brand Equity Foundation, lower development cost, rising technology intensity and growing local demand for top-of-the-line, unique technology products have attracted research and development (R&D) investments from foreign companies in India. More than one-third of the top 1,000 global R&D spenders have centres in India.

## India—the next manufacturing powerhouse?

Historically, Indian manufacturing was not considered globally competitive due to the inflexible labour market, infrastructural constraints, high input costs and the economies of scale.

The new political leadership has embarked upon a mega-initiative, called "Make in India", for overhauling the entire manufacturing landscape by encouraging multinational and domestic companies to manufacture their products in India. The main objective of the Make in India campaign is to facilitate investments into India by reducing barriers to doing business in India, fostering innovation, enhancing skill development, protecting intellectual property and building a best-in-class manufacturing infrastructure.



With the Make in India initiative picking up pace and the opening up of the defence sector in India for manufacturing, several large companies have picked up the gauntlet and have made firm commitments for investment in India. Some of the significant investment announcements include contract manufacturing giant Foxconn deciding to invest US\$5 billion in factories and research development for the manufacturing of iPhones and iPads and General Motors' investment of additional US\$1 billion to the manufacture of cars for domestic consumption and export.

While most global manufacturing giants remain sceptical about India's ability to implement the manufacturing reforms, the Make in India initiative, if implemented effectively, has the promise to transform India due to the large domestic markets, availability of resources and lower labour cost.

## Concluding remarks

Apart from the IT and manufacturing sectors, the other sectors that are likely to attract huge investments are infrastructure and banking, financial services and insurance. Based on these initiatives, it is expected that the Indian economy can achieve growth rate of 8–9 percent per year in the next three to four years. However, India has the history of underperforming to its true potential. It remains to be seen whether infrastructure constraints, high interest rates, indifferent bureaucracy and widespread corruption will play a detrimental role in India's growth story or whether the focused reform measures shall overcome such challenges.

India's proposition as the next economic growth epicentre is critical in view of the global slowdown and continued uncertainty. If successful, India can be the shining star among its global peers and shift the global economic picture for decades to come.

# GLOBAL FINANCIAL CONDITIONS

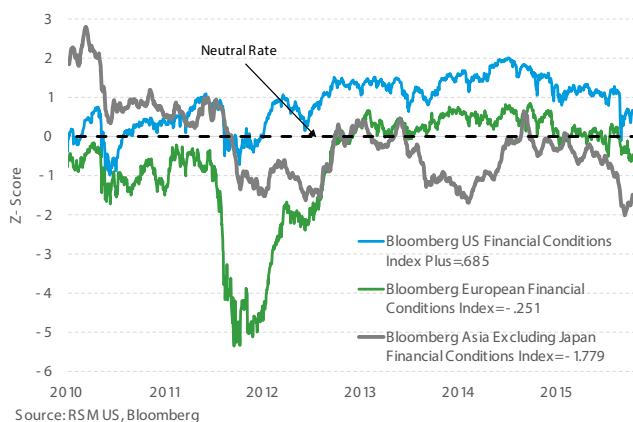
by **Joe Brusuelas**, Chief Economist, RSM US LLP

Volatility has riled global financial markets during the past two months. However, a look at key global measures of credit risk, funding stress and counterparty risk shows financial conditions remain remarkably stable. While volatility may continue as global investors rebalance portfolios away from China, oil, energy and commodities, there is no indication of a general systemic crisis in the near term.

## Global financial conditions

After China devalued its currency on 11 Aug., a tidal wave of volatility swept across global asset markets, resulting in a general tightening of financial conditions. In Asia, excluding Japan, financial conditions stand about 1.93 standard deviations below neutral, and in Europe, they are four-tenths of a standard deviation below neutral, all of which suggests a net drag on global growth. The Bloomberg Financial Conditions Index Plus stands six-tenths of one standard deviation above neutral and has improved recently, along with stronger US economic data releases.

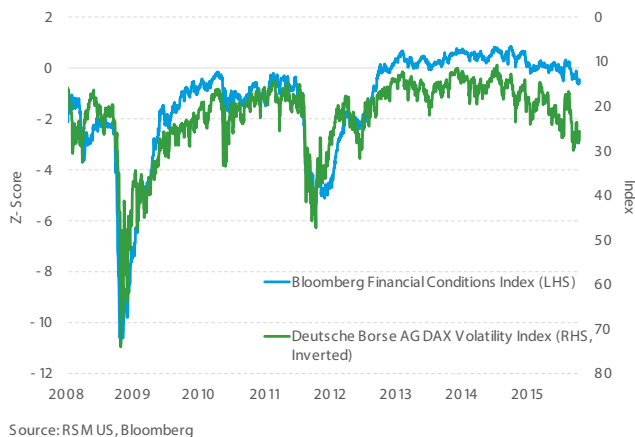
### Global financial conditions show only modest tightening



## European financial conditions

Financial conditions in Europe have tightened modestly during the past two months, while the Deutsche Borse AG DAX Volatility Index implies further fallout from the slowdown in global growth. Although the European Central Bank's asset purchase programme has succeeded in reducing borrowing costs, the gap between regional borrowing costs and overall economic slack implies that the monetary authority will likely increase its quantitative easing programme in 2016 and lift the current target of purchases well above the current three trillion euros.

### European financial conditions tightening



## TED spread

The TED spread, which is simply the difference between interest rates on interbank loans and short-term government debt, is a useful metric for measuring funding stress in global markets. Currently, this spread shows no meaningful increase in credit risk or counterparty risk in the global economy. During the financial crisis that followed the collapse of Lehman Brothers, both counterparty risk and credit risk increased significantly, causing lending to almost come to a standstill in the United States. The current spread is at 33, compared with 463 at the height of the financial crisis in October 2008.

### No sign of funding stress



Source: RSM US, Bloomberg

## Two-year swap spread

The spread between the rate on two-year interest rate swaps and US Treasury yields, a measure of credit risk in the global economy, has narrowed to 13.54 basis points from 24.78 on the day when the Chinese devalued the yuan. Swap spreads tend to be useful benchmarks for investors for debt purchases, including mortgage-backed securities and car loans. Narrowing swap spreads mean borrowing costs are falling, even as yields on US government securities remain essentially unchanged.

## Borrowing costs declining, even as government yields are unchanged

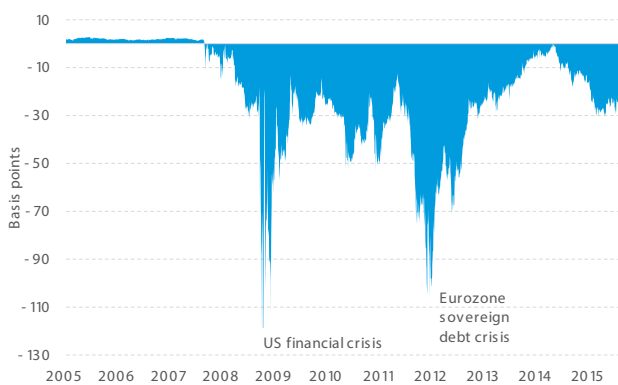


Source: RSM US, Bloomberg

## One-year USD cross currency basis swaps

Cross-currency basis swaps, which provide a glimpse into short-term credit risk and funding pressures (dollar shortages), have declined by 8 basis points during the past year, largely a function of the global economic deceleration and perceived risks associated with the possible exit of Greece from the Eurozone and slower pace of growth in China. However, there is simply nowhere near the funding pressures seen during the most intense portions of the US financial crisis in 2008 and even the European sovereign debt crisis in 2012.

### Funding pressures only modest compared to past crises

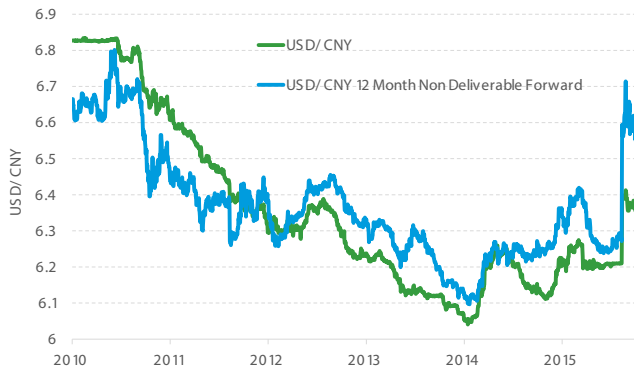


Source: RSM, Bloomberg

## US dollar, Chinese yuan and 12-month non-deliverable forward

Chinese fiscal and monetary authorities have spent more than \$400 billion to prop up equity markets and shore up their currency. The People's Bank of China has been purchasing yuan and selling US dollars to prevent a more rapid pace of devaluation. A look at the 12-month non-deliverable forward (NDF) implies a further 3 percent depreciation in the Chinese currency. The recent 25 basis point cut in the policy rate and the 50 basis point reduction in the reserve ratio imply that monetary authorities are increasingly worried about conditions in the real economy. Given these moves, and the strong probability of further tax stimulus later this year, it wouldn't be surprising if the NDF market is understating the coming depreciation of the yuan.

### NDF may be understating coming yuan depreciation

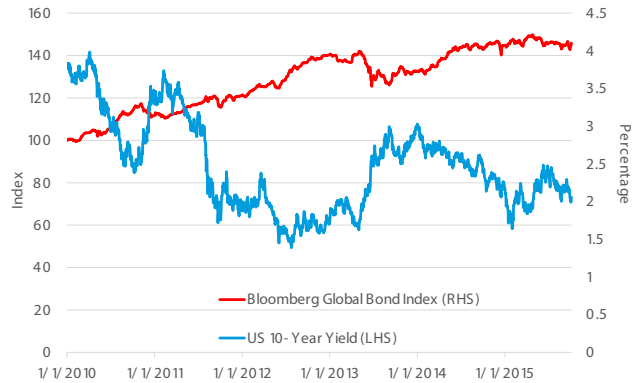


Source: RSM US, Bloomberg

## US 10-year Bloomberg Global Bond Market Index

Over the past several months, there has been a widening between the global 10-year benchmark and the Bloomberg Global Bond Market Index, which likely has more to do with the ongoing sovereign debt crisis in the Eurozone and the growth deceleration in China. That said, the spread has narrowed since late summer, as fears of an imminent Grexit have abated, even given the recent turmoil in global asset markets.

### Imminent "Grexit" fears have abated

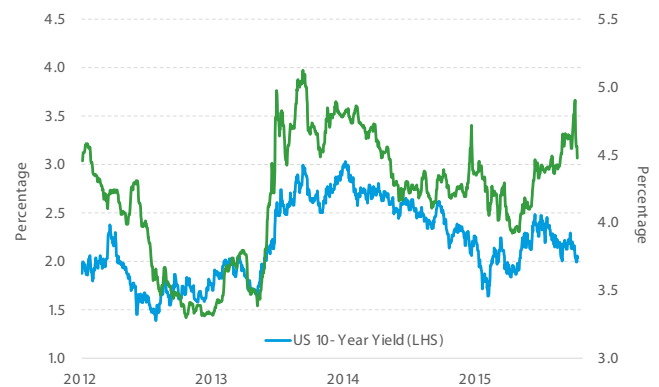


Source: RSM US, Bloomberg

## US 10-year JP Morgan EMBI investment grade yield

One sign of stress is the US 10-year versus the JP Morgan EMBI investment grade yield. There has been a divergence in the two metrics: although the JP Morgan investment grade yield remains about 50 basis points from where it was at the peak of the USA's so-called "Taper tantrum". The likely driver of the divergence has more to do with tightening financial conditions associated with the slowdown in Chinese demand for commodities and the knock-on effects in emerging market investment grade debt. This is likely an indication of a modest increase in capital outflows from developing economies.

### Increasing capital flows to USA from developing economies



Source: RSM, Bloomberg

# Q&A

## RSM ON THE GROUND

We asked Brendan Quirk, RSM's regional leader, Latin America, five questions about the economy in the region and key trends affecting the middle market.

**Q: Lately, more and more middle market companies are daring to export products and services around the world. What is different about this mindset and about middle market firms in Latin America, compared to 30 years ago? What is the main driver of this change?**

A: According to International Monetary Fund (IMF) 2014 data from 2003 to 2012, Latin America GDP growth rates are 5 percent or more than other emerging markets and the G-7.

This translates into 70 million people brought out of poverty and growth of the middle class by 50 percent, which builds the consumer base and translates into growth in the middle market. Many middle market firms in the region have also grown internationally and are in need of more sophisticated services to manage their business.

**Q: Many Latin American firms are beginning to look seriously at expansion into China and India's markets. Why?**

A: There are many strategic reasons to grow and expand into economies like China and India, but the most obvious is a presence in the largest future growth markets that are seeking quality products at competitive prices. We are adjusting to the demands in the new markets our clients are expanding into, and we are helping them get off the ground. For example, in Chile and Argentina, we see wine industry clients selling in China, and they either sell the high-end, most expensive wines or the larger-volume, cheap wine. This is an adjustment from wine exports sold in the United States and Europe, which has been traditionally the good-quality wine at a reasonable price.

**Q: How does the proposed Trans-Pacific Partnership (TPP), which includes some of the world's biggest economies on both sides of the Pacific, affect Latin America's economies and middle market firms, in particular?**

A: Higher tides lift all boats. The key Latin American economies involved in the TPP (Chile, Peru and Mexico) have implemented structures and policies that promote business and investment into the region, both directly into and from these countries. These countries are leading the growth in the region today and are proof that the policies in place are robust, as they are still growing, even with a general slowdown in the region.

**Q: Latin America is a much more economically diverse region than many believe. As a result, the economies in Latin America can grow at vastly different rates. Which areas of Latin America are leaders in growth right now and is that expected to continue?**

A: The real drivers of growth today are the countries that implemented the economic policies and institutions necessary to promote growth and development before or during the boom times (i.e. Chile, Colombia and Mexico).

It is also important to mention that countries like Mexico and Colombia, which were not overly reliant on the Chinese economy, are doing better. Finally, small sub-region countries in Central America and the Caribbean are the fastest growing, compared to larger economies.

**Q: What are some key themes middle market firms in Latin America should be aware of in the coming 12 to 18 months?**

A: The region continues to grow and be a critical part of global commerce. Among others, there will be more integration in global initiatives and organisations (e.g. World Bank, IMF, Organisation for Economic Co-operation and Development, global treaties, trade pacts), a peace accord in Colombia and the removal of the Cuban embargo – all of which will lead to growth and development within the region.

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