Global Economic **Outlook 2019**

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G10 outlook for 2019

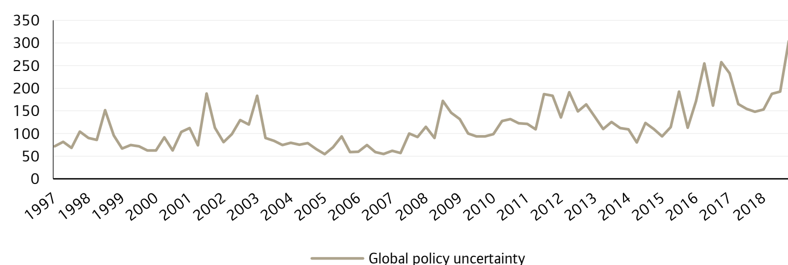
A wall of worry

Global growth is slowing, recession concerns are rising, and policymakers in major developed nations are less able to fight off a downturn given that policy rates are still very low and balance sheets bloated. Asset prices, such as stocks and corporate credit, have therefore had a difficult time. 2019 will not be much easier for either asset prices or the global economy.

Rising uncertainty

2018 proved that aggressive trade policy – from the US – can not only damage business confidence abroad but blow back to hit the US as well. **Protectionism is not a zero-sum-game, as the US seems to be finding out.** The countries and regions most heavily hit by protectionist fears have been those with large trade surpluses that stand directly in the US line of fire. Here, we mean the likes of China, the euro zone, and Japan. But elsewhere as well, policy uncertainty has risen significantly due not only to US protectionism but also other aspects of US behaviour, such as the policy-by-tweet preference of the president.

Figure 1: Policy uncertainty soars



Source: Baker, Bloom, Davis

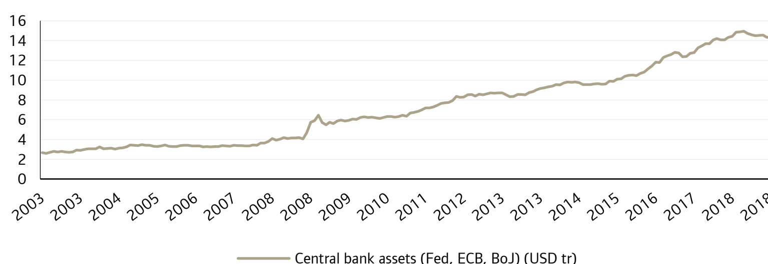
The cost of protectionism has been a waning of global growth. Last year's global GDP is likely to have been slightly below the 3.7% seen in 2017, and 2019 should be weaker still, with growth likely to be in the 3.0%-3.5% range. An added problem is that China's talismanic role in propping up global growth is also waning as it fights its own demons of excessive debt. Talk of recessions among advanced economies has increased due to many factors. One is the sheer longevity of the expansion. The US for example has enjoyed one of its longest ever expansions. But, as former Fed Chair Yellen said, expansions don't die of old age; to which another former Fed Chair Bernanke quipped that they tend to be killed off instead. For many, the murderer is the Fed which is perhaps why it has been put under so much pressure to cease rate hikes by President Trump.

However, we believe that the murderer is more likely to be found in the financial markets which may, or may not, slump because of overly zealous Fed tightening. Asset prices have fallen sharply already, with a 10%-plus decline in global stocks last year. We doubt that the fall will end here, and that could endanger business and consumer confidence still further. Policymakers should try to come to the rescue with the Fed, for instance, pausing, if not ending, rate hikes. The US administration could try to dial down the protectionist rhetoric, possibly even agreeing new trade deals with China, the EU and Japan to prevent further tariffs. But, in our view, much of the damage to global growth has been done and, while some trade and Fed optimism might aid asset prices for a while, **it probably won't cause 2019 global growth to outperform 2018 or mitigate recession risks materially**.

The tricky process of policy normalisation

The Fed might be criticised by the president for lifting policy rates but at least it now has rates at the bottom end of the Fed's 'neutral' range of 2.5%-3.5%, and presumably has some room to ease policy should the current downturn become far more material. But for other advanced-economy policymakers, rates are still far below neutral and, for some, like the ECB and BoJ, the rate hike process has not yet started, let alone moved on to the balance sheet reduction that we are seeing in the US. This clearly raises concerns that their policy response might be lacking should economic growth slide significantly. The Fed's balance sheet normalisation, which is currently worth some USD50bn per month in terms of asset reduction, has turned the tide when it comes to balance sheet reduction among the major central banks.

Figure 2: Balance sheets starting to fall



Source: Federal Reserve, ECB, BoJ

The Fed could continue to wind down the balance sheet at its present pace and allow this to tighten monetary conditions as a substitute for further rate hikes. **A pause in the rate-hike cycle certainly seems to be in place.** It could prove temporary, but our view that global (and US) growth will wane and financial conditions will tighten, suggests longevity. We doubt that the Fed will hike rates again this year.

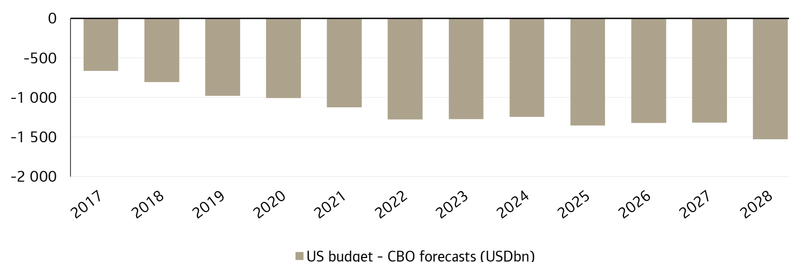
For most other advanced-country central banks the path back towards a more 'normal' monetary policy setting is proving a tortuous one, and we don't see this changing in 2019. The ECB has ended net asset purchases this year but its hints that the first rate hike could occur before the end of 2019 seem far-fetched. Instead, it seems likely that the Bank will deploy more tools to keep monetary conditions loose, such as extra long-term repos for banks. The Bank of Japan had helped to engineer slightly higher government bond yields last year by widening the target range for 10-year JGBs. But as we see dollar/yen falling to below 100 this year, the BoJ will have its work cut out to 'tighten' any more as the stronger yen should push the Bank of Japan even further away from its 2% inflation target. Other central banks that have started to lift rates, such as the Bank of Canada, Riksbank and Norges Bank, should all find that their best laid plans for **further rate hikes are stymied by soft growth and elevated global risk aversion**.

Headwinds for treasuries

The outlook for sovereign bonds in 2019 will have, as usual, the US treasury market at its heart. On the surface at least, it might look as if yields can fall given a likely Fed pause, softer growth and ongoing anxiety about risker assets, such as stocks. All these things could lower yields and redeem treasuries safe-asset appeal. But while all these factors could have a role to play, we suspect that treasuries won't rally significantly, and yields will end the year higher than where they started; probably around 3.0% for 10-year notes, for instance. This is partly because of our reading of the economy and the Fed's likely actions and partly due to some other factors that we feel are a bit disconcerting when it comes to the attraction of treasuries. Indeed, the Fed's pause could persist through this year but that probably won't stop the president from complaining that high rates are "killing" the economy. This political meddling in Fed policy counts as one of the 'other' factors we mentioned earlier. Others include

inconsistencies in the administration's fiscal and trade policies. At the heart of the administration's policies to date are tax cuts and spending increases that have inflated the budget deficit, aggressive trade policy designed to lower the trade deficit, and a quest for strong economic growth unencumbered by Fed policy. But, these three aims are inconsistent. The huge increase in the budget deficit from around two-thirds of a trillion dollars in 2017 to a projected one trillion in 2020 implies that the federal government will have to attract more savings from the domestic private sector and/or the foreign sector to fund the bigger deficit.

Figure 3: Deficit expansion expected



Source: Congressional Budget Office

If the funding comes from domestic consumers and businesses, there will be less consumer and/or investment spending, and hence weaker growth. If the foreign sector is the supplier of extra savings, this will imply larger capital inflows; the flipside of which is a bigger current account deficit in the US. Already it seems as if this extra treasury supply from the rising budget deficit, which is compounded by the Fed's balance sheet normalisation of USD50bn per month, is weighing on the market. The bid-to-cover ratios at treasury auctions have slipped to levels not seen since before the financial crisis. Treasury yields are also very low in currency-hedged terms, which diminishes their attraction to overseas investors. For instance, 10-year yen hedged yields are below zero, and also below the yield available on 10-year JGBs to domestic Japanese investors. Finally, we've also seen reserve diversification away from the dollar by foreign central banks and not just those, such as Russia and Turkey that seem to have ditched treasuries in a fit of pique over their treatment by the US administration. When we put all these things together, **we think that yields may be hard pressed to fall significantly from current levels, and we look for 10-year yields to trade out much of the year in a 2.5%-3.0% range,** with the top end of this range most likely in play come the end of 2019.

A moderately weaker dollar

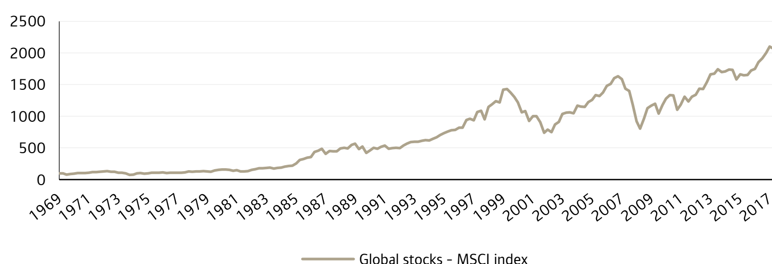
Our misgivings about US policy in areas such as trade and the budget lead us to a bias for dollar weakness. Still, if the combination of US policy and frail nerves in financial markets lead to a sharp decline in risk assets, such as equities, the dollar is likely to gain as its safe-asset qualities come to the fore. Don't forget, the global financial crisis was largely created in the US (with some help from the UK), and yet the dollar soared as risk assets plunged. Hence, **we think there could be a fine dividing line between dollar strength and weakness in 2019**: modest economic and financial market weakness, or indeed a recovery in both, should lead to general dollar weakness. But if economic and financial market vulnerability proves severe, the dollar is expected to rise, just as it did in 2018. Of the two, we lean towards the former scenario, and hence a modest fall in the dollar, probably of the order of 5-10% on a developed currency trade-weighted basket. The currencies with the most to gain from dollar weakness arguably fall into two camps. The first are even 'safer' currencies, like the yen and the Swiss franc, that should rally if the global economy and financial markets stay fragile. If things improve, then emerging market currencies that have been pushed down to very undervalued levels probably stand the best chance of strengthening against the greenback. The euro falls somewhere between the two. A rise to around 1.25 this year is anticipated as the dollar

softens but the euro is set to lose out to other currencies such as the yen, for reasons we've already mentioned, and the pound as the UK recovers from the Brexit fog that has shrouded the economy and the currency since the 2016 EU referendum. Indeed, with **the pound** sitting at very undervalued levels against the dollar and the euro, following its post-referendum slide, it **is one currency that could prove surprisingly strong in 2019**, should the thorny Brexit issue be solved in a way that's not too detrimental to the UK economy. Of course, sterling will slump should Brexit turn out to be hugely destructive for the economy, via a failure to secure both an exit deal and a transition period. The Bank of England's worst-case-scenario modelling suggests that sterling could fall as much as 25% under such a "disorderly" Brexit outcome but we think that the odds of such an outcome are very low – probably below 10%.

Risk aversion to remain elevated

On the surface, at least the rise in risk aversion that we saw in 2018 was down to issues such as US trade aggression, slowing growth and Fed policy tightening. These factors appeared to contribute to the 10%-plus fall in global stocks that we saw last year and weakness in many other 'risk' assets such as corporate debt. **In 2019** it is certainly possible, perhaps probable, that some of these **headwinds will ease**. The US seems minded to try to make trade progress with China, if only to shore up the slumping stock market, and the Fed is expected to pause its rate hikes for possibly the whole year. At face value these things could allow a recovery in risk assets in developed countries. However, this ignores the fundamental problem that the central bank monetary largesse that has been in place since the financial crisis has started to turn (Figure 2). It is turning slowly and gradually, but that's not important. What is important is that this monetary largesse has largely been 'spent' on acquiring financial assets rather than investing in productive resources. **One consequence of this is that developed-country asset prices have become over-extended to the upside, notwithstanding the slide we saw last year.** Another is that global productivity growth remains very weak partly because wages have remained low and investment poor. We feel that this is creating a conflict that's most likely to be resolved by more weakness in risk assets. This process started last year, and we doubt that the correction to date will prove sufficient.

Figure 4: Insufficient correction so far



Source: Bloomberg

There are other areas of financial markets that also bear watching if risk aversion continues to rise. For while global regulators appear to have done a good job of shoring up the banking system since the financial crisis, there are areas outside of banking that are concerning policymakers more and more. One such area is leveraged finance; lending to highly indebted companies and then packaging these loans into assets that are sold on to investors. It has echoes of the subprime crisis which engulfed the US housing market and the global financial system in 2007 and 2008. Few are predicting a repeat but, as is usually the case, crises tend to come as a shock, not as a predictable event.

Steven Barrow

China – another year of living dangerously

Policy stimulus significant enough to reverse China's economic slowdown seems most unlikely. Further support will undoubtedly be forthcoming, and the authorities have taken a pro-growth policy tilt in recent months, confirmed by key agencies post the Central Economic Work Conference. Rightly, Beijing anticipates that **2019 will be a difficult year**, and is, constructively, positioned accordingly. However, we believe that **policy aims to merely cushion the slowdown, not reverse it**.

Over the past two years the government has staved off panic, worked diligently to bolster private sector and consumer confidence, whilst remaining steadfast in de-risking the financial sector. Getting this balance right in 2019 will be critical.

Beijing's true north remains disincentivizing the allocation of resources towards non-productive investment to reduce this proportion as swiftly as possible without causing unemployment to rise, non-performing loans to balloon and destabilize the financial architecture, or batter confidence. However, currently, it is impossible to replace the non-productive investment with productive investment, thereby maintaining past rates of growth in fixed asset investment, which accounts for half of the economy. To wit, **investment growth slowed for the tenth consecutive year**, slipping from 7.2% in 2017 to the lowest rate on record of 5.9% in 2018.

It is hard to be optimistic in 2019. Last year, fixed asset investment in the tertiary sector, which accounts for 60% of total investment and includes large sub-components like real estate, infrastructure, water utilities and so on, expanded by just 5.4% y/y – the slowest pace in over two decades. Even with the increase in local bond financing anticipated, for example, which should support infrastructure investment, given the high base it would take time a tremendous fiscal impulse for a sustainable rebound in infrastructure spending. Consider this: railway investment accounts for just 2-3% of China's total domestic fixed asset investment and would need to increase by 100% in 2019 from 2018 levels, for total fixed asset investment to expand 1-2pps faster. Meanwhile, fixed asset investment in the secondary sector, which makes up almost another 40% of total investment, and is dominated by manufacturing, expanded by just 6%.

Private-led manufacturing investment held up well last year and we do expect supportive industrial policies to continue to channel funding for investment in technology. However, it is the firms in these external-orientated areas that are the most vulnerable to the trade war.

For stimulus large enough to move the dial, the government would need to reverse course on the housing market and slacken scrutiny over credit flows and the shadow banking sector. But, that would be foolhardy and short-sighted. Thus, **fixed asset investment is likely to remain soft in 2019**. Rather than tremendous additional fiscal outlays, policymakers will continue to lean on reductions and exemptions in taxes to ameliorate challenges facing the private sector and support consumption.

The government has, correctly, focused on ensuring that consumption growth holds up, but that too has proven difficult. Last year, nominal retail sales growth expanded by just 8.1%, the slowest rate since 2002 – and, in real terms, expanded at half the speed of the rate just 18 months prior. Alarmingly, consumption growth has become increasingly reliant on household debt – albeit from a low base – adding a **new risk to the outlook**. Consumer loans have more than doubled in the past three years, rising by 20% in just 2018, reaching near USD40trn in 2018. As a result, the household debt-to-GDP ratio has jumped by 10pps since the start of 2017. Of course, levered consumption works

counter to plans to halt the rapid growth in debt growth, with interest payments absorbing a greater share of income.

The headwinds facing consumption in 2019 are particularly important. Unlike previous episodes of softness in the economy, like 2008 and 2015, consumption seems more vulnerable. Much like in the past sluggishness is driven by capacity cuts, property restrictions and/or infrastructure investment slowing. However, unlike the past consumption may not remain relatively stable, suggesting that consumers ability to smooth consumption has been eroded. We know that if consumer spending falls it usually means there has been quite an unexpected shock to confidence: something that Beijing will work hard to avoid.

Another pressure valve has been the **increase in external debt**. For now, China's foreign debt doesn't look large relative to GDP, and over one-third of China's external debt is denominated in CNY, leaving around USD1.25 trillion in foreign-currency borrowing. The largest share of that dollar-denominated debt is held by Chinese banks, the PBoC and MoF. However, there are sectors, such as property developers that could run into headline-grabbing problems in 2019. Therefore, China’s potential for injecting volatility into the global financial system should not be ignored.

Added to the depressed growth in fixed asset investment and household consumption, external demand will be negatively affected by the trade war because the front-loading which occurred in H2:18 will become a headwind to export growth. That means that the economy is unlikely to find a bottom in the near term, even with a supportive policy mix. Instead, **GDP growth is forecast to slow from 6.6% y/y in 2018 to 6.1% y/y in 2019**. That would be the most sizable decline in GDP growth – in both absolute and relative terms – in over five years, undermining China’s L-shaped recovery.

The PBoC is clearly concerned about the economy, committing to intensifying counter-cyclical adjustments. However, a widespread acceleration in credit is unlikely due to the continued crackdown on non-bank financial institutions, the difficulties facing smaller banks, and the depressed economy. The RRR was cut four times last year, and both credit and money supply growth subdued. Last year, TSF increased by CNY19tr – down 15% y/y. For most of the year, commercial banks opted to hold extra reserves rather than lend money to the real economy. The is likely to persist in 2019 even though we anticipate another 200 bps cuts in the RRR in 2019, in tandem with additional injections through the targeted medium-term lending facility and other medium-term lending facilities, pledged supplementary lending, and open market operations. However, **monetary policy has lost traction**, with the subdued economic climate limiting the demand for loans that aren’t simply being used to roll over existing debt.

One thing we are sure of is that the PBOC is not in a position to follow any Fed hikes, so **we therefore expect the interest rate differential to narrow even further in 2019.** Against the USD, then, the CNY is likely to be pressured – the extent to which will depend on the trade war and rate trajectory in the US. Generally, as growth continues to come under pressure, **the government is likely to accept a weaker CNY**. The biggest risk is that China may misjudge the delicate balance it faces in the financial market and real estate sector, derailing the gradual nature of the slowdown, and sparking panic such as in late 2015.

In 2019, Chinese leaders will do more to support the economy: strengthening counter-cyclical adjustments, implementing an active fiscal policy, supported by a stable monetary policy. Nevertheless, **we foresee no large-scale stimulus**. The focus remains on improving the business environment and aiding consumption. Beijing’s measures will only slow the momentum loss, not reverse it, and will take longer to have an impact. Thus, **growth will continue to slow in 2019**.

Jeremy Stevens

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