

Global Outlook

Group Economics

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Changes to our base case...macro downgrades and global easing

- **We have downgraded our global economic growth forecasts...**
- **... and expect a global monetary easing cycle to take shape by the end of this year. This implies a longer period of sub-trend economic growth rather than recession for the global economy**
- **Economic growth could be roughly 0.5 pp lower on average in the major economies over the next twelve months compared to our current base scenario**
- **Within the eurozone we expect to see quarterly growth close to stagnation for the rest of this year, with technical recessions in Italy and Germany**
- **In the US overall economic growth will be sub-trend for the next three quarters before recovering back to trend in Q2 2020**
- **We expect central banks to embark on an easing cycle over the coming months, with the Fed cutting rates and the ECB launching QE**

Global Macro: A more negative view of trade conflicts

We have downgraded our forecasts for **global economic** growth and we now expect a global monetary easing cycle to take shape by the end of this year. The changes reflect that we now take a more negative view on the way the trade conflict will evolve over the coming months. President Trump appears less concerned about market reactions to his trade policies than previously thought. The clash with China last month and the tense relationship since already raised the risks. Meanwhile, the opening of a new front in the trade war with Mexico confirmed to us that the US administration would be more steadfast in the policy. We now therefore assume that there will be continued escalation of the trade conflict between the US and China/Mexico and possibly others going forward. Direct effects of tariffs are significant but not major, though indirect effects are likely to be large. In particular, we expect a sizeable impact through tighter financial conditions and lower business confidence. The global monetary easing cycle should set the scene for an improvement in economic growth in the second half of next year.

Economic growth could be roughly 0.5 pp lower on average in the major economies over the next twelve months compared to our current base scenario (with 0.3 coming in H2 and 0.2 in 2020H1 – with most of the effect on year average growth coming therefore in 2020). This implies a longer period of **sub-trend economic growth rather than recession** for the global economy. The region that gets closest to that is the eurozone, where we have quarterly growth close to stagnation for the rest of this year. Within the eurozone, we expect to see technical recessions in Italy and Germany. Still, any contraction is likely to be

relatively modest rather than a major downturn. We set out the details for individual economies and regions briefly below, and will follow up with more details going forward.

We have lowered our forecast for US economic growth for this year to 2.2% (2.3% previously) and 1.5% for next year (from 1.9%). The US is the major economy least sensitive to global economic developments, though tighter financial conditions and weaker confidence should leave their mark. Business investment is now expected to contract for the rest of 2019. Consumption is likely to hold up for the time being, but weaker business confidence will eventually hit jobs growth and in turn consumer confidence, leading to weaker consumer spending towards the end of the year. Overall economic growth will be sub-trend for the next three quarters before recovering back to trend in Q2 2020. Inflationary pressure will remain subdued, but the impact on inflation of slower growth will be offset by the pass through of tariff hikes.

We think that the combination of tariffs, weaker demand in the rest of the world, softer business confidence and tighter financial conditions will also leave its mark on **Emerging Asia**. Growth in the region is now seen at 5.7% this year (previously 5.9%) and 5.5% next (5.8%). **China's** economic growth is seen at 6.2% in 2019 (6.3%) and 5.8% (6%) in 2020. The revisions for China seem modest, but should be taken in the context of the relative stability of the official growth figures, and the new numbers imply more significant weakness in trade and manufacturing.

The eurozone is relatively sensitive to global economic developments and we expect the single currency area's growth to suffer from ongoing weakness in exports. In addition, given that the weakness in exports will persist for a longer period, domestic demand will increasingly feel the effects of spill-overs, with investment and the labour market weakening. We now see economic growth at 0.7% this year (from 0.9%) and 0.9% in 2020 (from 1.3%). This implies quarterly economic growth close to stagnation this year before a gradual improvement during the course of 2020. Overall, growth will remain sub-trend until around the middle of next year. Underlying inflationary pressures will remain weak throughout with core inflation at 1% in 2019 and 2020. Unemployment is likely to rise and wage growth will likely slow following the recovery seen in the last few quarters.

Global central banks and Rates & FX

Against the background of sub-par economic growth and weak inflationary pressures, we expect central banks to embark on an easing cycle over the coming months, which will lead to a further rally in high quality sovereign bonds. We now expect three Fed rate cuts between now and the first quarter of next year, while we previously expected the fed funds target range to remain unchanged. We are pencilling in one 25bp cut in Q3 (with July our base case but September a possibility) a second in Q4 and another step in 2020Q1.

We judge that **the ECB** will react to a more prolonged economic slowdown by relaunching QE. Concerns about low inflation and low inflation expectations were already building even under the ECB's more optimistic scenario, while ongoing sub-trend growth will make it more likely that inflation will significantly under-shoot the price stability goal over the central bank's policy-making horizon. An announcement of APP-II is likely by the end of the year, with actual purchases starting in January 2020 (though it could be launched early). We assume 9 months at EUR 70bn a month and a total size of EUR 630bn. We are still looking at the

details of the composition of the purchases, though we think once again there will be purchases of public sector, corporate and covered bonds. The issue(r) limit for sovereign bonds will need to be raised, while the proportion of corporate bonds in the total APP could be larger than in the past. A small rate cut (-10bp) is possible but for now we assume that interest rates will remain on hold at current levels during our forecasting horizon. We do not expect the euro to strengthen this year (which would be a trigger for a rate cut), while the ECB might be concerned that a rate cut could put pressure on bank margins over time.

We expect the **PBOC** to cut its main policy rate for the first time since economic growth weakened. We expect a 25bp cut this year and another next year, taking the 1y lending rate to 3.85%. Previously we expected no change given the targeted easing strategy. We also expect further reductions in the RRR, with the rate for large banks to be cut by 150bp this year (previously 100bp) and another 100bp in 2020 (previously 50bp), to take it to 11% by the end of that year. Over and above these steps, the Chinese authorities will also continue adding targeted fiscal and monetary support, with a specific focus on private firms and firms hit most by the US import tariffs.

Will the government bond rally continue?

Government bond markets have seen a spectacular rally over recent months, but our updated macro and central bank scenario suggests that it has some more room to run. Although our scenario for Fed rate cuts is priced in, history suggests that markets will overshoot and move further after the first rate cut, while downgrades to growth expectations could also put downward pressure on government bond yields. Meanwhile, the ECB's QE programme will put downward pressure on yields on both sides of the Atlantic. We see 10y Treasury yields falling to 1.9% by year end, while we see 10y Bund yields falling to -0.35% by year end. We see EUR/USD remaining flattish this year at around 1.12 (previously 1.16) within a range, as euro and dollar negative factors (in terms of easier monetary policy and slower growth) cancel each other out.

We will set out our central bank and market views in more detail in upcoming notes.

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