

MACROECONOMIC CONTEXT

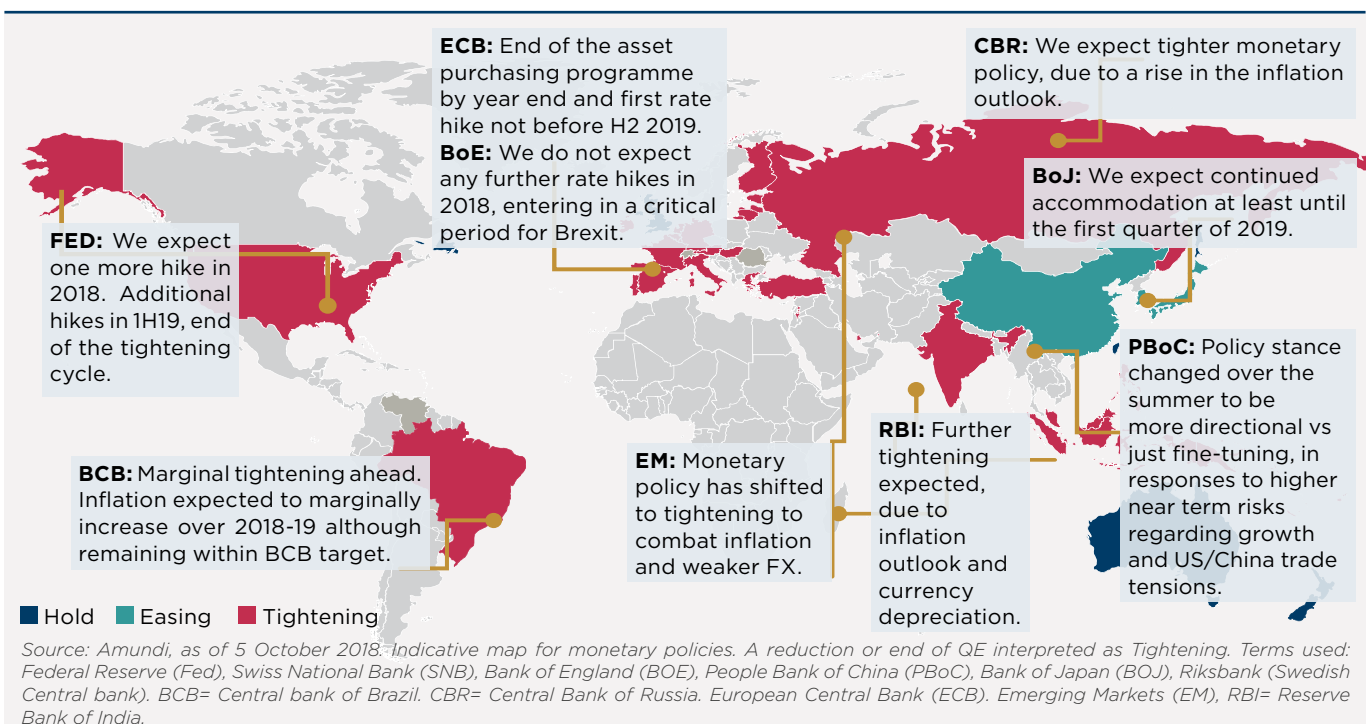
Our convictions and scenarios

Central scenario (70% probability): “multi-speed” slowdown that risks becoming a synchronised slowdown, due to the multiplication of risks

REGIONAL VIEWS

- **In the world economy**, 2018 began based on the theme of a synchronised global recovery. But, this did not last. Since the spring, the protectionist measures taken by Donald Trump have changed the game. Emerging economies, some of which are heavily indebted in dollars, have been weakened due to the broad-based appreciation of the US currency. The depreciation of their currencies has generated local inflation and led their central banks to tighten monetary policies, which has weighed on economies already negatively affected by massive capital outflows. Advanced economies have begun to slow down. In our view, the year will end with a global economy that is evolving in a disjointed fashion, with increased downside risks.
- **In the United States**, the economy has been driven by very accommodative fiscal policy that is likely to continue to produce effects for some time; but, the fiscal multipliers should progressively erode next year. We expect growth to decelerate to its potential, but not before late 2019/ 2020, meaning that the US economy should lose 1pp of growth by 2020. This situation will have a negative impact on corporate profits, especially if inflationary pressures intensify by then, which is possible, given the fact that the economy is operating at close to full employment.
- **In Europe**, despite a recovery that started well after that in the US, national economies have begun to slow in 2018. The output gap has closed in most countries, and Italy is the only one in the Eurozone (excluding Greece) where GDP has not recovered to pre-crisis levels. Several factors have contributed to the slowdown in growth in 2018: the rise in oil prices, the slowdown in world trade, and the slowdown in emerging economies. In addition, political uncertainties have muddied the waters (Brexit, Italian budget). The possibility of a coalition change in Germany following the defeat of the two major government coalition parties (CDU and SPD) in local elections marks the end of the Merkel era. The loss of the chancellor’s leadership may hinder initiatives to strengthen the integration of the Eurozone that were under consideration. It will probably be necessary to wait for European elections in May 2019 and a new parliament, a new European Commission, a

1/ Monetary policy: more asynchrony in Central Banks actions in 2019



new Chancellor in Germany, and clarification regarding leadership of the institutions of the EU (Commission, ECB) to make significant progress in strengthening the financial architecture of the Eurozone. The Italian government, sensitive to market pressure, seems ready to postpone some costly measures. The UK continues to see an uncertain future due to Brexit. It seems very likely that the British government and the EU will reach an agreement on the Irish border that will allow the UK to benefit from a transition period (from March 2019 to December 2020) during which negotiations would continue.

- **In Japan**, the outlook remains favourable. The weakness seen since mid-2018 should be short-lived. We think that Japan is relatively immune to US-China trade disputes. Exports to the US and China account for around 3% of GDP. This means that a decelerating Chinese economy on the heels of sanctions should be roughly covered by the strength of the US economy (in the short run). In addition, it is somewhat surprising that companies plan to increase investment spend at rates not seen since 2007, despite the threats to global trade. The labour market has not been this tight since 1974 and wages are growing at the highest rate in more than 20 years (+1.8% yoy in IH18). The increase in VAT scheduled for October 2019 (from 8% to 10%) should boost consumption before weighing on household spending, once the measure is in place. However, we anticipate a 30% lower impact than that caused by the last VAT increase in 2014. Despite these factors, GDP growth should mechanically fall in late 2019 and early 2020, to well below its potential. But, we do not expect this slowdown to last.
- **In China**, the rise of protectionist threats has weakened the economy and the risk of a sharp slowdown has increased during the year. The Chinese authorities changed their policy mix during the summer, opting for a counter-cyclical stabilisation policy. China will use all the levers that are available to avoid a hard landing. Keep in mind that the local authorities have more room for manoeuvre than the American authorities. Under these conditions, we still expect a gradual and controlled slowdown in China. All eyes are, naturally, on the G20 meeting that will take place in Argentina in late November 2018, during which Presidents Trump and Xi have planned to meet. This meeting may result in an easing of the pressure on trade, at least temporarily.
- **In other emerging economies**, the deterioration of domestic conditions – particularly related to the risks posed by US protectionist measures – may continue to weigh on the business climate and investment (particularly in North Asia and Mexico). Other countries, on the other hand, are likely to continue to be able to meet their infrastructure needs (Indonesia and the Philippines, for example). Consumption should remain strong in economies with close to full employment. Although many emerging economies are fragile (Argentina, Turkey, South Africa) and/or heavily indebted, we would point out that nominal potential growth remains very much in favour of emerging economies relative to advanced economies.

GLOBAL THEMES

On a global scale, the macrofinancial situation remains very unbalanced. Even if the economic outlook is generally satisfactory (growth close to or even higher than potential over the next two years), the rise in the number of risk factors – especially those of a political nature – are tending to increase global uncertainty, with this potentially higher uncertainty affecting investment decisions.

United States/China trade war, US sanctions on Iran, tensions in the Middle East and political challenges in Europe are here to stay, not to mention the associated problems that persist. Indeed, growth continues to be driven largely by global debt. And, nominal potential growth is being weakened on a global scale by the aging of the population, the (observed) slowdown in productivity gains, and the structural weakening of inflation of goods and services. In other words, the current global “growth regime” seems unsustainable in the medium and long term. The world economy continues to expand, but this expansion is based on very fragile underpinnings, especially in the event of a sharp rise in interest rates (higher risk premia). This fragility is all the more worrisome since the room for manoeuvre of central banks and governments has decreased in many countries: those that still have the means to put in place stabilisation (counter-cyclical) policy mixes are becoming increasingly rare.

In particular, **in the United States, pro-cyclical fiscal policy leaves little room for manoeuvre** in the event of a turning point, especially since the Congress is now divided (with the Democrats controlling the House of Representatives and the Republicans having a majority in the Senate). In Europe, there is less room for manoeuvre in terms of both fiscal and monetary policy. The ECB has not started to normalise its policy but growth is already slowing. It will be difficult for it to raise interest rates later in 2019 if the Fed chooses to reverse its policy trajectory in the next 12 months (in anticipation of an economic slowdown).

The world economy operates in a scattered order. The disruptions in value chains brought about by the trade war are reshaping global trade to the benefit of China. Global trade will no longer be the engine that it has been in recent decades. That said, this is not a step backwards, in our view. Trade in services is growing, economies remain tightly intertwined, and Donald Trump is isolated internationally. Moreover, it is particularly important to note that the interests of populist/nationalist regimes do not automatically converge: there are indeed many countries where their economies are still dependent on relations with the rest of the world in order to develop (Eastern Europe, Turkey, Brazil, among others).

Against this backdrop, economies are more likely to experience more autonomous economic cycles in the future because they are more dependent on domestic demand. In a world that is increasingly unstable politically, a lasting desynchronisation of business cycles would be good news. That said, the US could well drag the world economy into recession if Donald Trump continues his trade offensive. A stronger confrontation with China on trade would only result in losers, starting with the protagonists in the conflict. However, the world economy should continue to grow in a “scattered manner” (ie, expansion at different speeds, with possibly some isolated downturns). But, to date, the risks are clearly skewed to the downside, including the possibility of a global synchronised slowdown.



Downside risk scenario (25% probability): a significant trade war-driven economic slowdown, a geopolitical crisis

The risk of further protectionist measures from the US, followed by retaliation from the rest of the world, remains high. China and the EU are particularly exposed to this risk.

- Aggravation of geopolitical tensions in the Middle East. Oil prices could rise above \$100/bbl.
- Uncertainty regarding rising trade tensions (primarily between the United States and China) against a backdrop of geopolitical risks (with Iran, for example), crises in several large emerging economies (eg, Turkey, Argentina), political risk in Brazil, a slowdown in China, and political tensions in Europe (a deterioration in the budget situation in Italy, Brexit) is encouraging companies to remain cautious.

Consequences:

- All things being equal, a trade war would drag down global trade and trigger a synchronised slowdown in growth and, in the short term, inflation. That said, a global trade war would quickly become deflationary by creating a shock to global demand.
- An abrupt repricing of risk on fixed income markets, with an across-the-board rise in spreads on govies and credit, for both developed and emerging markets, and a decline in market liquidity.
- Amid the resulting financial turbulence, the cycle-end story would resurface in the US.
- Central banks would cease recalibrating their monetary policies and, in the worst – albeit highly unlikely – case would once again resort to unconventional tools, such as expanding their balance sheets.



Upside risk scenario (5% probability): a pick-up in global growth in 2019

Donald Trump makes an about-turn after the US midterm election, reducing barriers to trade and engaging in bilateral negotiations with China. Domestically, the theme of increasing infrastructure spending could return to centre stage and extend the cycle in the United States.

- Acceleration driven by business investment and a rebound in global growth.
- Pro-cyclical US fiscal policy generating a greater-than-expected acceleration in domestic growth. Growth reaccelerates in the Eurozone after a dip. Growth picks up again in China on the back of a stimulative policy mix in the first half.
- Central banks would react late, initially maintaining accommodative monetary conditions.

Consequences:

- An acceleration in global growth would boost inflation expectations, forcing central banks to consider normalising their monetary policies more rapidly.
- An increase in real key rates, particularly in the US.
- Risk of boom/bust.

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