THIS MONTH'S TOPIC

There is no synchronised global economic cycle

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The essential

A key theme at the start of 2019 is a synchronised global economic slowdown. This is the clear message given by the recent PMI surveys. Global growth seems to be on the wane, while global risks continue to add to the climate of uncertainty. In the developed economies, all eyes are on the US cycle and the fall in its ISM indexes. Meanwhile, in the emerging world, the focus is naturally on China, whose economy continues to show signs of losing steam at the start of this year.

However, appearances can be deceptive. In particular, this is because the signs of a slowdown chiefly relate to manufacturing (which is inherently more exposed to global trade), a sector that will tend to shrink over time. Also, we should remember that 2018 started with an apparently synchronised global expansion – but that did not last long! It now seems that the global cycle peaked at the end of 2017, so we should not rush to judgement on 2019 just yet. Different economies have slowed or are slowing for a variety of reasons. And some of factors that have weighed on the last few months have disappeared (oil has slumped by some 30% since early October). The US and China have struck a trade truce that is in the interests of both parties to uphold, given the worsening outlook. **In this environment, the apparent synchronisation of the global cycle may prove short lived.** While the United States and China are gradually slowing down, the rest of the world may still experience "autonomous cycles". This is made more likely as monetary policies are set to become more dovish: either more accommodative (China), or less restrictive (United States).

Let's take a look at the main trends affecting the key regions.

In the United States, the 5-point fall on the manufacturing ISM (at its lowest level in December since November 2016) suggests that the slowdown will be more severe than expected – especially as credit spreads have tightened considerably over the past weeks. The government shutdown and the stock market correction have further fuelled uncertainty. Meanwhile, the stimulus effect of the tax cuts and spending increases will begin to fade soon. As such, business investment is likely to show a more marked slowdown than expected (slowdown in global demand, downward revision in earnings projections, less visibility).

However, none of these factors should push the US economy into recession. The strength of the labour market should continue to support household consumption. Furthermore, US economic growth looks set to return to potential (around 1.7-1.8%) before long. The overall picture is of a significant economic slowdown that will naturally be accompanied by a marked fall in earnings, albeit after an exceptionally good year boosted by tax cuts. It is this latter point that is concerning the equity markets, which have probably begun to take higher levels of growth (GDP and corporate earnings) for granted.

As a result, the Fed is likely to make a pause sooner than expected, as the risks are becoming asymmetric. There will still be time to get monetary normalisation back on track later if the signs of a slowdown do not materialise, while at the same time inflation begins to accelerate.

In Europe, despite the recovery starting later than in the United States, the economies began to slow down in 2018, and there were still signs of a downturn at the turn of the year. The output gap has closed in most countries. **Several factors contributed to the decline in growth in 2018:** the rise in oil prices (until October), the slowdown in global trade and lower growth in the emerging economies. **Moreover, political uncertainty on a number of fronts has made the European outlook more gloomy** (Brexit, Italian budget, "yellow vest" protests).

- The Italian government – under pressure from the markets – revised down its deficit target for 2019 to stave off the EU's excessive deficit procedure (to 2.0%), illustrating the governing coalition's pragmatism.

- In France, the "yellow vest" crisis is still impacting the country's economy (Q1 growth figures are expected to take a hit) and political situation (the reforms will probably be postponed). That said, the measures announced by the government will increase consumers' purchasing power, which should boost consumption a little later in the year.
- In Germany, Angela Merkel's decision not to stand for re-election of the CDU following the results of the regional elections has effectively shut down discussions on further eurozone integration. However, it is worth noting that Annegret Kramp-Karrenbauer, who will succeed her as CDU leader, takes the same line on many issues as Mrs Merkel.

We will nonetheless have to wait for the European elections in May, and then a new parliament, a new German Chancellor and the new heads of key European institutions (Commission, ECB) for any significant progress to be made in strengthening the Eurozone – so nothing will happen before the autumn. In the meantime, political tensions are inevitable between now and the elections in May.

The United Kingdom's fate continues to be tied to the outcome of Brexit. In our central scenario, we assume that Theresa May's withdrawal plan is approved by the UK Parliament. This would enable the UK to benefit from a long transition period (from March 2019 to December 2020) with its trade rules unchanged while it continues its negotiations with the EU. However, we cannot rule out an "accident" of history that would lead to a hard Brexit (see section on risks and the investment talk released on this issue on 9 January).

In Japan, the economy weakened towards the end of the year. However, the Japanese economy is largely insulated from the effects of the US-China trade war, as exports to the US and China only account for around 3% of Japan's GDP. On the plus side, it is encouraging to note that Japanese firms are planning to increase their investment spending at a level unseen since 2007, despite the threats currently weighing on global trade. The labour market is at its tightest since 1974 and pay is rising at its fastest rate for 20 years. The VAT rise scheduled for October 2019 (from 8% to 10%) should boost consumption before weighing on household spending, once the increase is in place.

In China, the increased threat of protectionism has weakened the economy and heightened the risk of a hard landing. The fall below 50 in December's manufacturing PMI and the slowdown in industrial output is fuelling concerns. Although the Chinese authorities radically changed the direction of their economic policy in the summer by implementing counter-cyclical measures to stabilise its currency, this has yet to have much effect. China will use all the levers at its disposal to avoid a hard landing. Also, it is worth remembering that it has more leeway in these matters than the United States. As such, we continue to expect a managed slowdown of the Chinese economy. Lastly, the agreement reached between presidents Trump and Xi at the G20 on 1 December should alleviate tensions between the two countries in the coming months.

In the other emerging economies, the deterioration in domestic conditions – mainly stemming from the risks posed by US protectionism – will continue to weigh on the business and investment climate (particularly in North Asia and Mexico). However, other countries will continue to cover their infrastructure needs (Indonesia and the Philippines, for example). Consumption should remain strong in the countries that are close to full employment. A number of emerging economies are still weak (Argentina, South Africa), while Turkey's recession deepened at the start of the year, in line with projections. **Nonetheless, we should mention that two of the factors that destabilised the emerging economies in 2018** (the rise in US long rates and dollar appreciation) **are no longer an issue**: long-term rates have come down and the dollar has stopped rising, which will ease the pressure on the countries with the most dollar-denominated debt. In addition, it should be borne in mind that the nominal growth potential for emerging economies is on average much higher than for the developed economies, which in theory ought to enable them to service their debt more easily.

At the global level, the presence of multiple – and, in particular, political – sources of risk tends to increase overall uncertainty, which could weigh more heavily on investment decisions. **Tensions over US-China trade, the Middle East and political upheavals in Europe are not going to be resolved any time soon**, and nor are the other major problems (high debt, weak growth, climate risk, inequalities impacting Western democracies). The foundations on which growth is currently based are therefore fragile, and would be particularly vulnerable to a sudden hike in interest rates (increase in risk premiums).

This fragility is especially worrying given that the central banks and governments of many countries now have scarcely any room for manoeuvre: there are not many countries that would be able to implement a counter-cyclical policy to respond to a shock, and they are becoming increasingly rare.

- In particular, **the US procyclical fiscal policy leaves little room for manoeuvre** in the event of a downturn, especially as Congress is now divided (the democrats have gained control of the House, while the republicans have increased their majority in the Senate).

- **In Europe, there is not much room for manoeuvre in either fiscal or monetary policy.** Although the ECB has not really started to normalise its monetary policy, growth is already slowing. We expect no rate hike from the ECB in 2019..

Trade tensions are high and global trade is sluggish, but this does not mean that global growth will plummet. The disruption of value chains caused by the trade war is changing the landscape of the international trade in goods, to China's benefit. Trade in services is expanding, economies remain closely intertwined and Donald Trump is isolated on the international stage. It is particularly important to note that the interests of populist/nationalist regimes are not necessarily converging: many of them are reliant on the rest of the world for their development (Eastern Europe, Turkey and Brazil, among others). Lastly, the share of consumption tends to increase in emerging countries as they develop.

As such, economies are more likely to experience more autonomous economic cycles in the future, as these will be more dependent on their domestic demand. And this is all the more likely if political risks are present on most continents, as there is indeed no reason for them to materialise simultaneously. In a world with an increasingly unstable political environment, we should expect economic cycles to decouple more often.

In short, given the uncertain outlook for both the United States and China, **risks remain tilted to the downside**. **Even though it is clear that we cannot rule out a long-lasting and synchronised global slowdown, we strongly believe that emerging and advanced economies are likely to decouple again by the end of the year.**

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