

# Macroeconomic Outlook **2019:** As QE ends, will the global cycle turn?



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# Macroeconomic Outlook 2019: As QE ends, will the global cycle turn?

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By Laurent Clavel and Maxime Alimi



- We expect the US will enter a cyclical slowdown in 2019 while the Fed will end its hiking cycle at 3%-3.25%
- The Eurozone is already slowing down and we see European politics skewing risks to the downside. The European Central Bank will likely be prudent and leave interest rates on hold until at least September
- We have a less positive view on risk assets and are looking to move equities back to a neutral position over the course of 2019
- We expect that bund yields will remain range-bound between 0.2% and 0.7% in 2019 and see value in US treasuries above 3.25%

## The last lap of the cycle

The US looks set to post growth of 2.9% for 2018 – its best since 2006. Some of this momentum, underpinned by a spectacular, pro-cyclical fiscal expansion, should continue for some time yet. However headwinds, including fiscal fade, restrictive trade policies and most importantly in our view, tighter financial conditions, are gathering. This should lead to a classic cyclical slowdown to 2.3% in 2019.

For 2020, the current consensus forecast and the FOMC's suggest a soft landing but in our view sharp slowdowns are historically more common. Indeed, economies faced with deceleration, typically develop a vicious circle of falling confidence, reduced spending and investment, as well as a sharp unwind in inventories. While we acknowledge that anticipating the exact timing of recessions is very difficult, our 2020 forecast sees US growth below potential, at 1.4%.

We therefore expect the US Fed to end its hiking cycle by the close of 2019 at 3%-3.25%, after a well-anticipated hike in December and three more next year. In late 2020, we would expect the Fed to reverse gears and enter a phase of easing.

## European lacklustre resilience and political stand-offs

Lagging by about two years in this cyclical expansion – largely because of policy mistakes – the Eurozone is unfortunately already slowing down. A year ago, business surveys were suggesting there would be an acceleration in activity but after an incredibly disappointing 2018, Eurozone growth now looks likely to settle at 1.9%, vs. 2.5% in 2017. Looking further ahead, we anticipate that the bloc's growth will drop further to 1.4% in 2019, and then to 1.2% in 2020. While consumption and construction should hold relatively steady, corporate investment should ease in the wake of falling business confidence (with company credit demand at its lowest since early 2014) and declining profitability. Most importantly, net trade should weigh on growth with slowing external demand, chiefly from the US and China, as well as lower competitiveness and fairly robust imports.

This lacklustre resilience should prove enough for the ECB to bring the deposit rate to 0% by spring 2020. Even with inflation at a non-negligible distance from the objective, we expect this

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**Despite an already greyish outlook, politics skewing risks to the downside**  
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move to be presented as a normalisation rather than a tightening, arguing that the side effects of negative interest rate policy are progressively offsetting its benefits. We also expect T-LTRO in H1 2019.

If anything, and despite an already greyish outlook, we see European politics skewing risks to the downside. First, the Italian budget saga is still unfolding and there is the potential risk of financial contagion taking hold. As we expected, the EC has suggested the opening of an Excessive Deficit Procedure. And if our macroeconomic assessment is correct, the softening of growth will see public debt return to a rising trend. Second, while UK Prime Minister Theresa May finalised a Withdrawal Agreement with the EC on 14 November, Brexiters, the Northern-Irish Democratic Unionist Party and Labour have expressed their opposition and there is a high risk of the UK Parliament rejecting the deal in December. UK political uncertainty remains visibly high and we are mindful that a “no deal” Brexit in March is very possible. Finally, while the US administration has narrowed its protectionist attacks towards China, tariffs being imposed on the EU's car sector remain a 2019 possibility.

## China walking a tightrope, diverging regional and intra-regional trends in emerging markets

2018 has also witnessed the shifting effect of the US-China trade conflict from a market shock to a growth shock. Our base case is for the tariff rate to rise from 10% to 25% next year, covering \$250bn of Chinese goods. This protectionist escalation is the key driver of the economic slowdown we expect for China in 2019 (6.1% from 6.6% this year). The trade impact will be partially offset by a “cautious” policy easing by Beijing, focusing on fiscal supports for households and private-sector businesses.

Given the structural shifts in the external environment, we expect Chinese policymakers to “walk the talk” with structural reforms, strengthening intellectual property protection, liberalising financial markets, opening up the capital account and reforming the corporate sector. These transformations (which we forecast will see the first annual current account deficit in China since 1993) will be beneficial in the long run and may also help in 2019 to appease the tension with the US.

Meanwhile, emerging markets have been suffering from the tightening of global financing conditions (dollar appreciation and rising UST yields), exacerbated by heavy capital outflows. Still, economic growth proved rather resilient. And whilst the US trade war rhetoric, currency shocks, and further tightening should all limit EM expansion in 2019, we expect domestic demand to remain relatively resilient, alleviating some of the pressures coming from weaker trade volumes. In particular, pent-up demand in large EMs such as Brazil and India should see EM GDP growth at 4.6%. This overall resilience would however mask diverging regional and intra-regional trends, with Argentina and Turkey in recession vs. Brazil substantially accelerating.

## Asset Allocation: Shifting down a gear

2018 has been a frustrating year for investors. Despite a fair economic backdrop and strong earnings' growth in most parts of the world, global markets delivered poor performance. At the time of writing, all major liquid asset classes had posted negative year-to-date total returns. An explanation we had put forward for such performance in our 2018 Outlook was that the tide of QE had begun to reverse, which would put downward pressure on asset prices and upward pressure on correlations. And, since H2 2018, the stock of assets owned by central banks globally has fallen, and this has initiated an unwind which could take several years.

If this view is correct, 2019 could prove just as challenging as 2018, which is why we are shifting the risk in our asset allocation down a gear. We have a less positive view on risk assets and are looking to move equities back to a neutral position over the course of 2019. Presently, we are also maintaining an underweight position in credit, while keeping cash and government bonds at neutral.

As a result of the ECB's cautious stance, inflation continuing to disappoint (stable breakeven) and the heightened political risk in Italy, bund yields should remain range-bound between 0.2% and 0.7%. The Italian situation has deteriorated and we expect Italian 10-year bond yields to grind higher and settle above 4%. In the US, we see value in treasuries above 3.25%, especially as a diversifier in the case of a more pronounced macroeconomic slowdown. Credit spreads are likely to remain under pressure in 2019 due to a host of macro headwinds and a less advantageous technical backdrop. In particular, we are concerned about the record share of BBB-rated credits, within the IG sector, which raises the spectre of downgrade risk into HY.

Turning to equities, our base case of decelerating economic activity is expected to dampen top line growth and profit margins are enduring growing pressures. We expect earnings per share growth to deliver close to 7% for global equities. Nevertheless, reduced excess liquidity, rising US short-term rates and possibly higher equity-risk premiums, driven by heightened volatility and weaker investor sentiment, all suggest limited scope for a multiple expansion.



# QE: The great unwind kicks into gear

By Research & Investment Strategy and Multi-Asset Investments

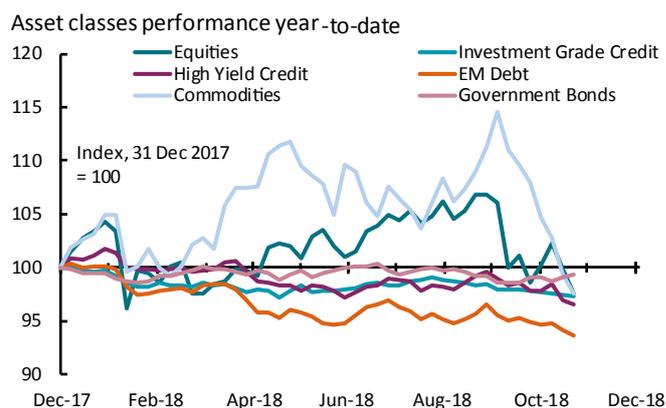


- The QE tide is reversing, putting downward pressure on asset prices and upward pressure on correlations
- We take a less positive view of risk assets and look to downgrade equities to neutral over the course of 2019
- We do not expect bund yields to break above the 0.2-0.7% range in 2019 and see value in treasuries above 3.25%

## A year of no return

2018 has been a frustrating year for investors. Despite a fair economic backdrop and strong earnings growth in most parts of the world, the performance of global markets was poor. At the time of writing, all major liquid asset classes have posted negative total returns year-to-date (Exhibit 1). While these are expressed in local currency terms, the picture is slightly better for a globally diversified euro investor who has enjoyed the depreciation of the euro against the dollar since the spring. By far the biggest swings have been experienced in commodity markets where oil prices enjoyed a bull run that ended abruptly in October.

Exhibit 1: nowhere to hide



Source: JPMorgan, BAML, Barclays, GSCI and AXA IM R&IS calculations  
Note: global indices in local currency terms

The paradox is that this poor market performance has come at the same time as strong improvements in fundamentals. For calendar year 2018, corporate earnings are set to have gained 24% in the US, 5% in the Eurozone and 19% in EMs. A lesson for this year may be that market gains in 2017 had possibly already priced and discounted 2018 growth while looking forward to less rosy news in 2019.

## The quantitative easing tide

An alternative explanation – and a theme we had highlighted in our 2018 Outlook – is the end of QE as the reversal of a tide that would put downward pressure on all asset prices. A number of factors are pointing in this direction.

First, valuations have deteriorated across all the main asset classes in 2018, be it government bonds, credit or equities. As a result, diversification has started to work less well between bonds and equities, suggesting that something more than just a simple switch between risk-on/risk-off assets has started to drive markets. Second, the sleeping volcano, volatility, has awoken. The market moves in February provided a striking illustration of volatility breakouts while a more gradual but persistent increase in the CBOE volatility index (VIX) has been evident since early October.

Developments over the course of 2018 support the idea that QE should be seen as the stock of assets currently owned by central banks globally. As such, it is only this year that QE started to be unwound and 2019 will be the second year of that process.

## Embracing low returns

If this is correct, 2019 could prove just as challenging as 2018. The Quantitative Tightening steamroller may translate into both lower expected returns and higher correlations than usual. It may be wise to embrace low returns and refrain from increasing risk as a way to capture higher performance. This view underpins our decision to shift our asset allocation down a gear. We have a less positive view on risk assets and are looking to downgrade equities to neutral over the course of 2019. We also maintain an underweight position in credit while keeping cash and government bonds at neutral.

## Interest rates – monetary policy divergence set to continue

The divergence between the US Fed and the ECB has been a major driver of rates markets over the past three years. We expect this tendency to continue in 2019, with the Fed hiking rates another three times to 2.75-3.0%, above market expectations. On the other hand, the ECB will likely take stock of the current growth deceleration and there is a risk that the liftoff might be postponed into 2020. The Euro overnight index average (Eonia) curve is currently pricing in the first 15bp hike around February 2020.

## Treasuries reaching equilibrium levels

Looking along the yield curve, 95% of this year's 70bp increase in nominal treasury yields is almost entirely due to the move in real yields. Inflation expectations have contributed very little to

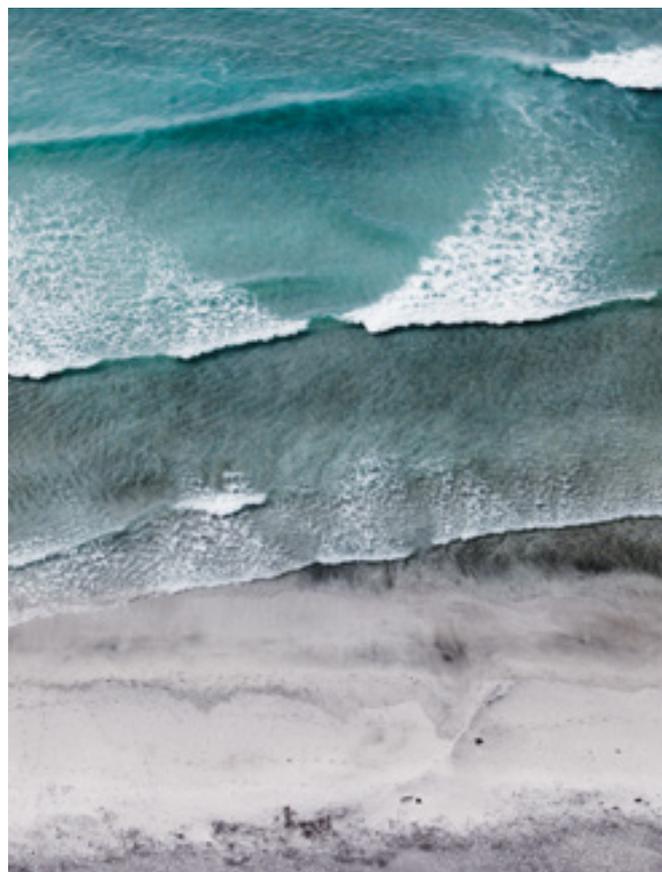
rates markets (only about 5% in the US) and we expect this theme to also continue in 2019. An inflation surprise is still in the cards given the economy is currently operating at full employment, but we think the probability of such a surprise remains a minor one at this stage. We see value in Treasuries above 3.25%.

## Bunds trapped in a range

European rates are still an entirely different story, with widespread heterogeneity across the area and some signs of contagion appearing in peripheral fixed income markets as well as the banking sector. The ECB's strategy will remain tilted toward prudence, patience and persistence, as long as the political jitters in Italy continue.

As a result of the ECB's cautious stance (very limited normalisation of monetary policy and term premium), inflation disappointing (stable breakeven) and Italy (political risk premium), bund yields should remain capped and range-bound, keeping French OATs anchored. Also, we see little room for inflation expectations to move higher in a context of core inflation flatlining in 2019 and after the recent correction in oil prices.

This implies a neutral position on Eurozone core and semi-core bonds and breakevens. We do not expect bund yields to break above the 0.2-0.7% range in 2019.



## Implications for yield curves

The US curve is likely to continue trading close to “inversion” levels, as suggested by the forwards (Exhibit 2). We think that only a more aggressive rate path could tilt the curve deep into negative territory, sending a distinct slowdown signal to the US economy. Risks (that include the US’s trade war with China, European politics, potential concerns over China’s economic growth) and the limited upside on bund yields should help cap the long end of the US curve. However, the heavy pace of treasury issuance should also limit the downside on yields. All in all, we maintain a long position on 10Y US treasuries, partly as a diversifier in case of a more pronounced macroeconomic slowdown.

The EUR curve is likely to be driven by a complex combination of rates expectations, political noise and market positioning. In the environment of low interest rate volatility, the EUR-forward space is likely to attract carry-hungry investors in 2019, thus preventing the curve from realising the flattening implied by forwards. However, positioning is a double-edged sword and could lead to substantial volatility in the event of a sudden repositioning.

Exhibit 2: USD and EUR yield curves & forwards



Source: Bloomberg and AXA IM R&IS calculations

The Italian situation has deteriorated as tighter financial conditions and weak business confidence have continued to weigh on growth, offsetting the fiscal stimulus. The public debt ratio may move higher if the budget deficit hovers above the 3% threshold, leading to more confrontation between the Italian government and the European Commission. In this context, we expect Italian 10 year bond yields to grind higher and settle above 4%.

## Credit - dancing with bears

The current market correction is giving credit investors pause for thought. The key question is to determine whether the credit cycle is finally turning or whether markets are simply experiencing yet another air pocket.

US dollar HY spreads, for example, broke out of their unsustainably tight spread range in October and have continued to widen in November. But they remain within the historic norms of credit



spread behaviour within hiking cycle by the US Fed. By the same historic norms, a true turn in the credit cycle could be over a year away, which chimes with our macro view of a slowdown in US growth in 2020 with risk of recession in 2021.

Timing the cycle notwithstanding, credit spreads are likely to remain under pressure in 2019 due to a host of macro headwinds and a less advantageous technical backdrop. But, the more we widen into year-end, the weaker the bearish argument for 2019 given that credit valuations inevitably improve with spread widening. We take note of the fact that credit spreads are already wider than the levels we saw at the end of 2016, which were followed by a spread rally in 2017 (Exhibit 3).

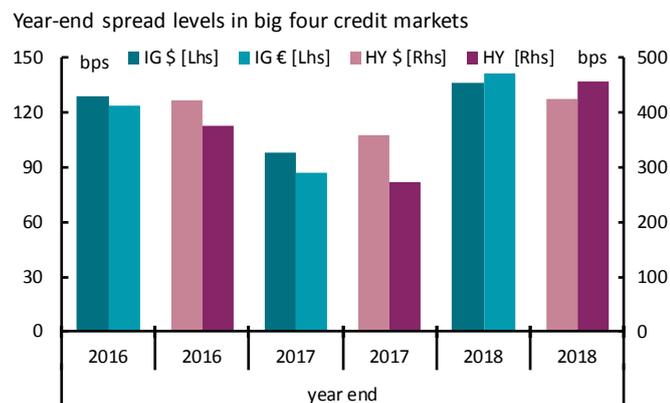
The Achilles heel of credit markets in the current cycle is the record share of BBB-rated credits, which raises the spectre of downgrade risk into HY. The problem is more significant in the US, where jumbo acquisitions have left certain IG corporates at

levels of leverage that exceed IG norms. This means that they are very dependent on strong profits in order to reduce leverage and avoid dropping into a HY rating over the next 2-3 years.

Euro credit on the other hand faces higher economic and political uncertainty. Not only does it have superior credit fundamentals, its underperformance in 2018 due to contagion from the Italian budget saga could lead to spread outperformance in 2019, especially in a scenario where the ECB extends monetary policy support.

Across the rating spectrum, HY should continue to outperform IG amid rising interest rates, due to its higher spread carry and shorter duration. The risk to this call is a protracted risk-off episode that drives government debt yields lower, boosting IG returns.

Exhibit 3: Spreads set to end 2018 at wider levels than at the end of 2016



Source: Intercontinental Exchange (ICE), Bloomberg and AXA IM R&IS calculations

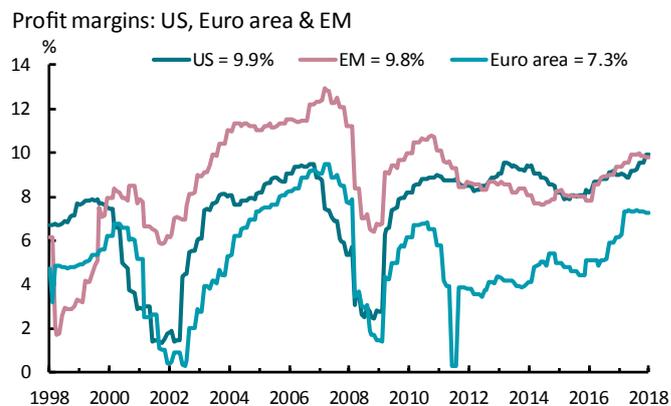
## Looking to downgrade equities to neutral over the course of 2019

In 2019, our base case of decelerating economic activity is expected to dampen top line growth relative to recent movements. Pressures on profit margins are a key concern, induced by the rise in unit labour costs and the fading effect of the tax stimulus in the US, they limit the upside for earnings (Exhibit 4).

Consensus earnings forecasts appear slightly optimistic and are likely to be revised downward going forward. Management guidance has also begun to turn cautious citing concerns mainly on the policy front.

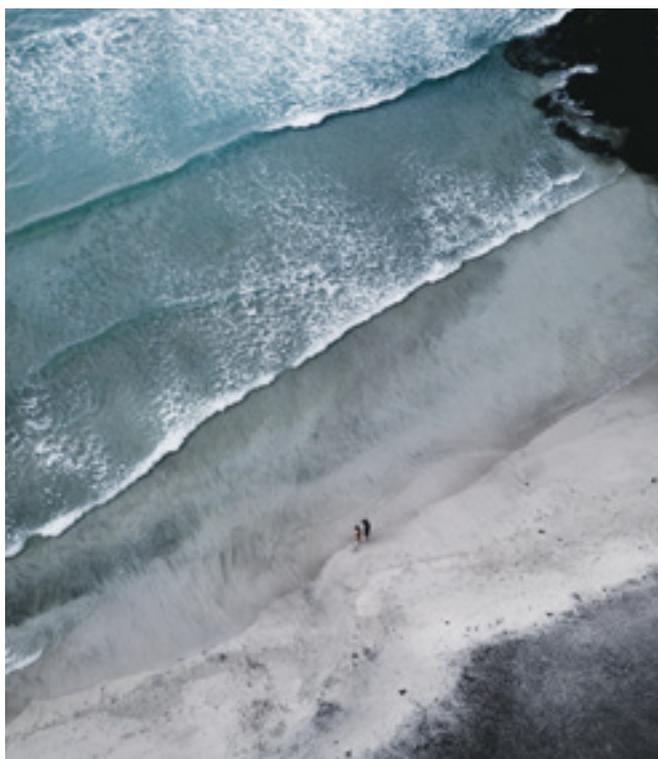
Overall, we expect earnings per share growth to deliver close to 7% for global equities, stabilising after the solid run in 2018. On aggregate, for the asset class, we believe valuations are not a major headwind at this juncture and are close to our fair value estimates. However, we also see limited scope for re-rating with reduced excess liquidity and rising US short-term rates due to the ongoing monetary tightening internationally, and possibly higher equity risk premiums driven by higher volatility and weaker investor sentiment.

Exhibit 4: Peak margins are a key concern for 2019



Source: Bloomberg and AXA IM R&IS calculations

We expect returns to be primarily driven by earnings growth considering the limited scope for a re-rating of valuations. In our cross asset allocation, we look to neutralise our positioning in global equities over the course of 2019, while continuing to prefer the United States over the Eurozone in our regional allocation. Political risks in Europe continue to weigh on the region's equity markets while the banking sector remains under pressure as the yield curve fails to steepen along with muted economic momentum. We continue to track the corporate leverage situation in the US, which has meaningfully shifted over recent years, especially in the small cap universe. On the equity style front, the key question remains whether we see a mean reversion in structural divergence in value versus growth stocks in 2019.



# US outlook: Slow to catch on

By David Page

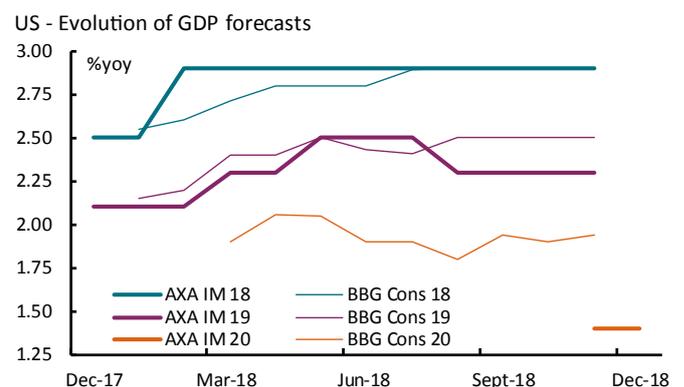


- Leaving behind the fastest rate of growth since 2006, we expect growth to come in below consensus at 2.3% next year, before materially decelerating in 2020 at just 1.4% (consensus 1.9%).
- On balance, we expect the US to avoid recession in both 2019 and 2020, but the risks are rising in 2020. Soft landings are indeed historically rare.
- The Fed should tighten policy to 3.00-3.25% by the end of 2019. We change our call to expect a rate cut in H2 2020.

## Leaving behind the fastest growth since 2006

2018 looks set to deliver growth of 2.9% – our forecast since February this year – and the market consensus since mid-year (Exhibit 1). This would see US expansion at its fastest rate since 2006 and before the financial crisis. Some of this momentum looks likely to continue into 2019, and the large fiscal expansion that has underpinned growth in 2018 should continue to boost activity in 2019.

Exhibit 1: Leading consensus forecasts in 2018



Source: Bloomberg and AXA IM R&IS calculations

But 2018 is likely to prove a peak for US economic growth. From next year, a number of factors are likely to weigh on activity, including a fading fiscal effect, restrictive trade policies, tighter financial conditions and modest economic overheating. We expect this to reduce growth in 2019 to 2.3% (consensus 2.5%). This process is likely to continue into 2020, when we expect to see a material deceleration, forecasting growth of just 1.4% – markedly lower than the current consensus of 1.9%.

## Opposing growth trends rise

A 'fiscal fade' is likely to contribute to slower growth over the coming years. Part of 2018's robust expansion was driven by fiscal expansion following the Tax reform and Bipartisan Budget Act in 2018. Our estimates suggest that fiscal stimulus added around 0.6pp to GDP growth in 2018, but that this contribution will fade to 0.25pp in 2019 and to a mild contraction in 2020 (although a replacement two-year spending deal will be possible at that time).

Trade policy is also likely to weigh. The increase in protectionism has been one of the defining features of 2018 and its economic impacts are likely to be felt across the globe over the coming years. The outlook for trade policy is highly uncertain. However, our baseline assumption is that with the immediate political pressure removed, US President Donald Trump may be willing to accept concessions from China to consolidate gains in the trade war to date. We are pencilling in a deal struck between the US and China over the coming months, which would halt the escalation of the tariff war before it covers all Chinese imports, but not before the US raises tariffs to 25% on \$250bn of Chinese exports at the start of the year. We also envisage the imposition of tariffs on US imports of autos and parts. While this accounted for \$360bn in 2017, we would expect tariffs to exclude Canada and Mexico (50% of imports) because of the deal made in parallel to the US-Mexico-Canada Agreement trade pact. We would also expect this to exclude imports from Japan (15%) and the EU (16%) while these economies are independently negotiating trade deals with the US. It could also exclude China if a deal is struck here. This would mean tariffs applied to only 9% of US auto imports, some \$50bn, with Korea the largest affected.

We estimate a relatively modest impact on US economic activity based on this outlook, reducing GDP growth by 0.1pp in both 2019 and 2020. However, we acknowledge that trade policy could escalate beyond our baseline scenario, leading to larger macroeconomic effects.

We also consider modest signs of overheating in the economy. Unemployment currently stands at 3.7%, much lower than the US Fed's 4.3-4.6% central estimate of the longer-term rate. We expect the unemployment rate to fall further, below 3.5%, by end-2019. This 'tight' labour market is generating increasing evidence of skill and labour shortages and wage pressure. These are in turn likely to result in lower employment growth over the coming years – which would dampen household nominal income growth, despite firmer wage growth. An expectation of fading productivity growth, alongside accelerating wages, would push unit labour cost growth higher. This is likely to reduce corporate profitability, weigh on investment spending and lift inflation, further reducing household real disposable incomes. Modest overheating looks set to reduce activity.

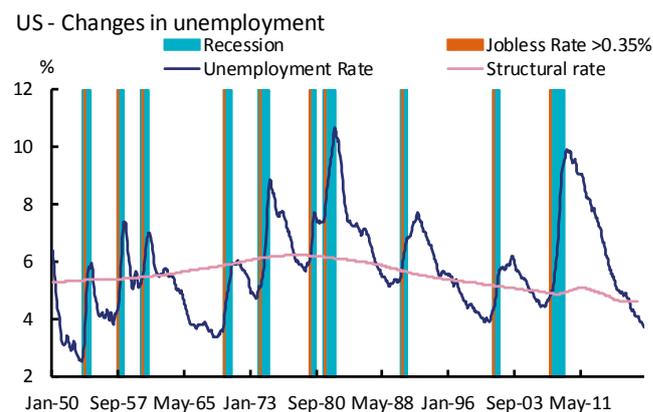
Tighter financial conditions represent another headwind to growth. The Fed's policy tightening is translating into tighter financial conditions, which in early 2018 remained as loose as they had been since 2000. Financial conditions are materially tighter at the time of writing, partly following a sharp correction in October 2018. Even factoring in a rebound, we expect part of the tightening to be permanent. Moreover, considering the trend toward mean

reversion in IG credit markets<sup>1</sup>, we expect credit spreads to rise by around 30bps in 2019 and 2020. Altogether, the tightening in financial conditions should reduce GDP growth by around 0.7pp in each of the coming two years.

## Sharp slowdowns are historically more common than soft landings

Identification of these separate headwinds is not strictly additive but does suggest a material resistance to US growth over the coming years. The Fed and consensus forecasts envisage this resulting in a modest deceleration back towards trend for 2020. Such a deceleration would likely prove beneficial, resulting in a stabilisation of the labour market at high levels of employment and reducing the risks of significant over-heating.

Exhibit 2: 0.35pp rise in unemployment is a tipping point for the labour market



Source: BLS and AXA IM R&S calculations

Yet economies faced with deceleration often develop a negative momentum that exacerbates the initial impulse. A tipping point then sees a vicious circle of falling confidence, rising precautionary savings, reduced spending and investment, a sharp unwind in inventories, rising unemployment – an exacerbated drop in demand confirming the initial shortfall in confidence in a self-fulfilling, self-reinforcing expectation. This particularly swift deteriorating momentum makes predicting the timing of recessions particularly difficult. For example, each of the last eight US recessions since the 1960s has been preceded by a relatively modest 0.35pp increase in the unemployment rate from its nadir (Exhibit 2). After this point, economic downturns have quickly gathered momentum.

Moreover, history is not replete with evidence of economic soft-landings. From the 1950s, only two periods could fit that definition.

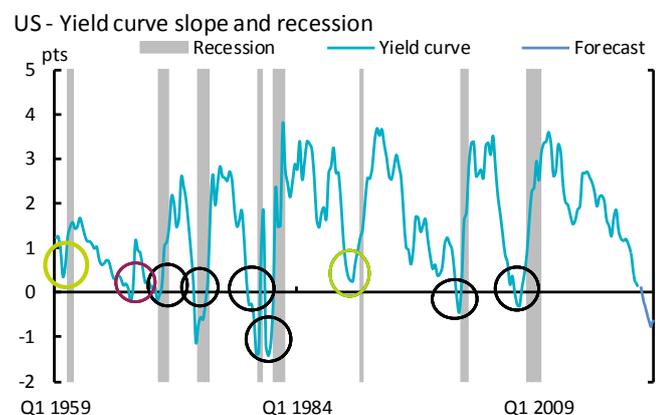
<sup>1</sup> Page, D., Savage, J., Venizelos, G., "Is the yield curve pointing to recession?", AXA IM Research, 25 October 2018.

**1966** – growth dropped from 8.5%yoy at the end of 1965 to below 3% across 1967, with unemployment stabilising just under 4%. This followed a tightening in policy in 1966, but limited Fed action over the subsequent years<sup>2</sup>.

**1995** – activity slowed down from over 4% growth in 1994 to around 2.5% in 1995 following a 300bp Fed tightening with unemployment stabilising around the CBO’s estimate of the natural rate of unemployment (5.4%). However, the Fed immediately began to ease policy, reducing rates by 75bps over the next year and again in late 1998 as the Asian crisis emerged. This period also saw faster productivity. Although unrecognised at the time, this muted inflation pressures, allowing the Fed to persist with looser monetary policy.

Given the difficulty of building forecasts on essentially endogenous fundamentals, we use alternative signals to help us time any potential downturn. On our forecasts, unemployment only rises in excess of 0.35pp from its low at the start of 2021, suggesting a downturn thereafter. The yield curve has also provided a 12-month warning of recession after inversion<sup>1</sup> (Exhibit 3). On our forecasts, inversion looks likely at the end of 2019, signalling a downturn in early 2021. Both tools are only indicators of recession. However, both suggest that the US should decelerate across the course of 2019 and 2020, but only risk recession in the following year.

Exhibit 3: Watch for the UST yield curve inversion as another recession signal



Source: BLS and AXA IM R&IS calculations

## The Fed unlikely to pre-empt the slowdown but hiking cycle over by end-2019

As described, the Fed has played a key role in previous soft landings. In the 1960s, it ‘failed’ to tighten policy sufficiently to manage inflation, while in the mid-1990s by pre-emptively easing policy in 1995 and 1998 to extend the cycle (albeit aided by productivity improvement muting inflation).

<sup>2</sup> In 1967, Fed Chair William McChesney Martin supported a fiscal tightening with US Treasury Secretary Henry Fowler. While this was eventually delivered in June 1968, Martin was said to have considered this an error in policy and resumed tightening monetary policy in 1969, by which time inflation had risen materially. Source: Federal Reserve History.

We believe it will be more difficult for the Fed to ease policy this time. First, the Fed does not currently expect a meaningful deceleration in 2020 or 2021. Second, broader economic developments argue for more restrictive monetary policy, including low levels of unemployment, wage acceleration and expectations of rising inflation. Third, the Fed is also likely to be mindful of the financial stability implications of looser policy.

Hence the Fed could extend the cycle, but likely only at the cost of more obvious economic overheating over the coming years. This, in turn, could result in a more material downturn eventually reminiscent of the 1960s. Moreover, President Trump’s recent interjections have made the Fed’s job more difficult. Any easing in Fed policy could now be interpreted as bowing to political pressure, which could lift presently stable longer-term inflation expectations.

With the Fed Fund Rate (FFR) still estimated to be below neutral, further modest tightening appears on the cards and we forecast FFR rising to 3.00-3.25% by the end of 2019, which would mean three hikes after December 2018. However, as signs of economic deceleration gather momentum, we now expect the Fed’s third hike in 2019 to 3.00-3.25% to be its last in this cycle. We change our outlook from a final hike in 2020 to can now envisage the Fed beginning to cut rates in H2 2020 (to 2.75-3.00%), with the prospect of a more material reduction envisaged for 2021 if the slowdown continues.

## Other known unknowns which could change this outlook

External events could change the timing and shape of the slowdown. Previous recessions were exacerbated by external shocks such as the first Iraq War and 9/11. Apart from such unpredictable geopolitical events we review below the main risk factors we would monitor throughout 2019.

**A substantial acceleration in productivity.** We forecast subdued productivity growth at 1% annualised as seen since 2012. Hence we assume the recent pick-up is a short-run boost associated with fiscal stimulus. Faster productivity, whether recognised in the official data or not, would allow similar economic resilience, but would witness more subdued inflation. This would also allow the Fed to adopt a slower pace of tightening (reminiscent of the 1990s).

**Trade war escalation.** The evolution of trade policy is uncertain. In the short-term we optimistically expect no further material escalation, but such hopes may prove misplaced if US incentives are more focused on strategic containment of China than Trump’s “Art of the Deal”. Short-term trade escalation would create more material headwinds for activity and inflation in 2020 and beyond. Conversely, our medium-term pessimism may prove misplaced if the White House is really striving to promote free trade, which could see anticipated headwinds become tailwinds.

**The puzzle of US households’ savings.** US saving estimates were revised materially higher in mid-2018, but we are sceptical that these can cushion expected income declines. Persistently higher saving, despite ebullient consumer confidence and rising

wealth, suggests that desired saving levels are also now higher (potentially reflecting demographic factors). Moreover, saving may also be affected by changes in distribution: estimates suggest 80% of savings are held by the top 10% of household income (50% by the top 2%)<sup>3</sup>. In either case (demographics or inequalities), savings are unlikely to supplement any income deceleration. Yet, if this assessment proves false, households spending could persist despite slower income growth.

## Moving through the late-cycle

In broader terms, the US appears to be travelling a familiar late-cycle path. Peak growth this year is likely to see the current expansion mark its second longest since the 1940s. The economy is in a position of excess demand and, with above-trend growth expected next year, should increasingly lead to signs of overheating. The Fed is gradually tightening policy to rein in growth and manage prospects of excess inflationary pressure. This reflects a Fed focused on its inflation mandate. Historically, however, such late cycle paths have ended in downturn. We suggest a similar outcome is likely this time, but for now our estimates suggest that growth for next year should still be solid, with deceleration only gaining momentum in 2020 and not facing outright contraction until the following year.

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<sup>3</sup> Wolff, E.N., "Household wealth trends in the US, 1962-2016: Has Middle Class Wealth Recovered?", NBER, Nov 2017



# It's getting cloudy: The ECB won't take back the umbrella

By Apolline Menut and Alessandro Tentori



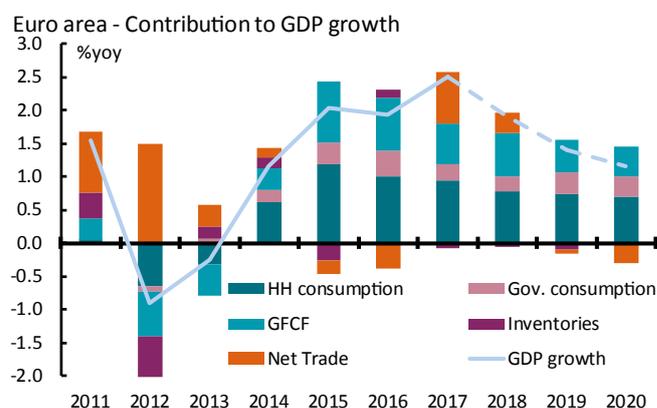
- Following a disappointing 2018, we expect Eurozone economic growth to drop further in 2019 and 2020, respectively to 1.4% and 1.2%, mainly as a result of the weaker external backdrop
- Headline inflation should hover around current levels in H1 2019 before moderating on energy base effect. Meanwhile we expect core inflation to gradually and modestly pick up, to 1.2% in 2019 and 1.5% in 2020
- This should prove enough for the ECB to bring the deposit rate to 0% by spring 2020 – arguing that the negative effects of negative interest rate policy are progressively offsetting its benefits. Although we remain sceptical about an “operation twist”, we expect T-LTRO in H1 2019
- A heavy political agenda lies ahead, with the European Parliamentary elections in May likely to show further gains for populist parties, and a round of musical chair at top EU posts

## A disappointing 2018...

Eurozone economic activity has been disappointing for most of 2018 as some temporary factors distorted growth. These included bad weather conditions and high levels of sick leave

in Germany in the context of seasonal flu (Q1 18), strikes in France and accelerating inflation (Q2 18) and disruption in the German car sector due to the introduction of the new EU emission certification system (Q3 18). But more importantly, the moderation in 2018 euro area growth to 1.9% has been driven by a less supportive global environment. After a remarkable boost to growth in 2017 of +0.8pp (Exhibit 1), net trade moderated in 2018, as the pass-through of past euro appreciation, decelerating global trade and rising trade tensions dampened exports growth. Meanwhile, domestic demand proved resilient, helped by a dynamic labour market and very easy credit conditions.

Exhibit 1: Domestic demand still the main growth engine

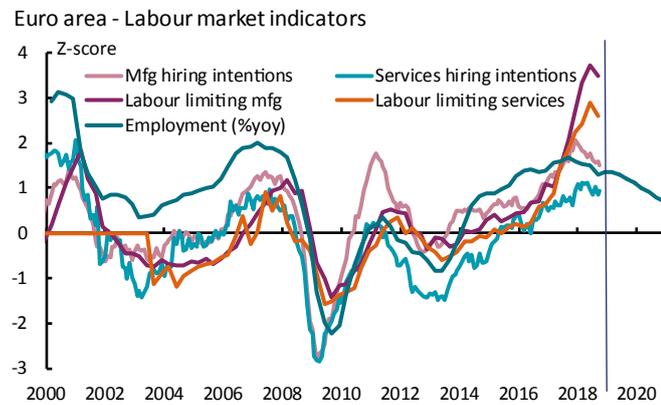


Source: Datastream and AXA IM R&IS calculations

## ... And a further slowdown beckons

Looking ahead, several factors should push euro area growth further down from its 2017 peak of 2.5%, to 1.4% in 2019 and 1.2% in 2020. First, although private consumption will remain the main growth driver, it should slightly decelerate in the coming years on the back of lower job creation. Both consumer and business surveys are indeed pointing to lower hiring intentions and a large, close-to-historical high proportion of firms is actually mentioning labour as a factor limiting production (Exhibit 2). This should lead to slightly less buoyant consumer spending, despite solid wage growth, still easy credit conditions and some fiscal boost (especially in Germany).

Exhibit 2: Job creation slowing



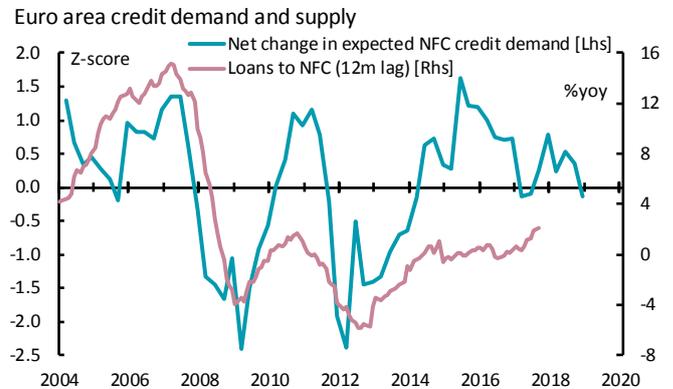
Source: Datastream and AXA IM R&IS calculations

**Second, investment should moderate in the wake of high uncertainty and the lack of global traction.** We see investment slowing down to 2.4% in 2019 and 2.1% in 2020, from 3.1% in 2018. Most of the deceleration should be driven by corporate investment, while construction should hold steadier, as suggested by historically high confidence indicators, the expected continued strength in housing prices and favourable credit conditions. Conversely, several factors should weigh on business investment in the coming years.

Elevated uncertainty, which has already severely affected euro area business confidence, is an obvious one. We believe it has already started to impact firms' credit demand, which stands at its lowest since Q1 2014, according to the ECB Q3 Bank Lending Survey (Exhibit 3).

The weaker external environment, embodied in our forecasts of lower growth in the US and China, is another factor. In the context of a less favourable demand outlook, rising input costs with healthy wage growth but no significant gain in productivity mean that corporate profitability is likely to decline – again, not a great incentive for investment spending. Altogether we expect investment contribution to growth to drop from an average of 0.8pp of GDP in the 2015-2017 period, to 0.5pp on average in 2019-2020.

Exhibit 3: Elevated uncertainty weighing on credit demand



Source: Datastream and AXA IM R&IS calculations

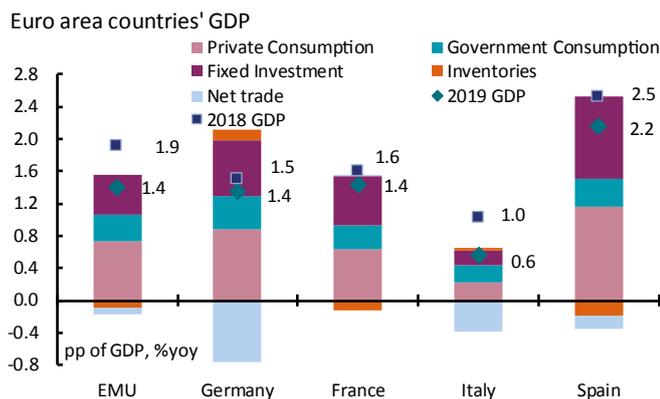
**Last but not least, we expect net trade contribution to growth to turn negative in the next two years, as we foresee a significant deceleration in key trade partners.** In addition to the direct trade impact of lower external demand, elevated uncertainty amid recurrent tariffs threats may also take a toll on exports. Furthermore, despite the EUR/USD depreciation in the past few months, the euro's REER (the trade-weighted measure adjusted for export prices) has only stabilised after rising substantially in late 2017, which is not helping competitiveness. Meanwhile imports should slow but still remain robust, in line with firm domestic demand, leading to an overall negative trade contribution.

Embodied in our forecast, are expansionary fiscal policies - a tailwind worth highlighting. After a neutral stance in 2018, fiscal policies should boost euro area growth to the tune of 0.3pp of GDP. The main support will come from Germany, with the 2019 Budget planning a fiscal easing of approximately 0.75% of GDP (higher spending on pensions, tax relief for low and middle-income earners and 0.5pp of income cut in unemployment insurance contributions). Of course, Italy plans a very loose fiscal stance for 2019-20, but our estimates see tighter financing conditions

“  
Euro area growth further down from its 2017 peak  
”

offsetting most of the fiscal stimulus effect on economic activity. Altogether, Italy should remain the laggard and we expect growth to ease down to 0.6% in 2019, while Spain will lead the pack, despite growth normalising to 2.2% in 2019. Germany and France should move in sync with 2019's growth pattern falling down to 1.4%, but as a result of different drivers (Exhibit 4).

Exhibit 4: Cross-country differences (contrib. to GDP)



Source: Datastream and AXA IM R&IS calculations

## Risks skewed to the downside

Our baseline scenario assumes that no tariffs will be imposed on the EU's car sector. In addition, we assume Brexit ratification by March 2019, with status-quo maintained at least until the end of the transition phase by end-2020. However should these assumptions prove wrong, trade disruption would severely undermine growth, while related uncertainties would have a negative effect on aggregate demand.

But Italy casts the darkest cloud to our outlook, given the potential risk for financial contagion. In our baseline case, we see Italian growth almost halving next year, its public debt ratio on a slightly rising trend and its deficit hovering around the 3% threshold. The government has recently softened its tone suggesting it could postpone the implementation of some measures, so we acknowledge that we might see some better deficit number, around 2.5% of GDP for 2019. Yet, we believe it will not be enough to avoid the opening of an Excessive Deficit Procedure (EDP), which would rather require a structural reform agenda. Snap elections could lead to significantly less expansionary fiscal policies but are not in sight, as the latest polls are quite inconclusive with Lega and Five Star neck-on-neck. But political dynamics could move, as the economy decelerates further. We think credit rating agencies will closely watch the evolution of financial conditions and their negative effects on growth. In our baseline, we account for spillovers into the economic sector (via the trade impact) but not for financial contagion. Financial spillovers to other peripheries, with a revival of the sovereign-bank loop could damage growth via tighter financial conditions – higher interest rates and reduced credit supply – as well as via a confidence shock. In such a situation, the ECB would likely be forced to deviate from its gradual normalisation of monetary policy.

## Inflation: Slowly waking up Phillips

Headline inflation has been on a rising trend in 2018, hitting the ECB's target of 2% several times since the summer, as a result of higher energy prices. We expect positive energy base effect to support headline inflation in Q1 2019, before fading in H2. On average, we project inflation to reach 1.8% in 2018 and 1.5% in 2019, with a deceleration in 2020 to 1.4%, also reflecting the moderation in economic activity.

Meanwhile, core inflation has hovered around 1.0% on an annual basis through most of 2018, despite the Eurozone's unemployment rate falling to 8.1% – its lowest level since late 2008. The still elevated labour market slack, reflected in broader metrics such as the underemployment rate which stood at 16% in Q2 2018 (still 2pp higher than 10 years ago) should continue to weigh on core inflation in the near term. We expect that wage growth should nevertheless remain solid, in line with labour market developments and in particular the fact that the job vacancy rate was at its highest in Q2 2018, since 2004. As unit labour costs keep rising, firms profit margin should be squeezed further (unit profit growth slowed to 0.7% on a quarterly basis in Q2 2018 from 2.7% in Q3 2017), leading to some price pressures. We therefore expect the Phillips curve to slowly wake up in H2 2019, pushing the core inflation average to 1.2% in 2019 and 1.5% in 2020.

## The ECB won't remove the umbrella

Although we see the economy slowing and core inflation still substantially away from the ECB's target, we believe the ECB will go for a 15bp deposit rate normalisation (likely not calling this move “a hike”) in September 2019. And bar a negative surprise, the ECB could then end its negative interest rate policy and lift the refinancing rate to 0.25% in March 2020. The ECB may argue that growth is still above potential, at circa 1.2%, and that such changes are modest and legitimate as the negative effects of negative interest rate policy would be starting to offset the positive ones. In addition to the interest rate trajectory, we think the policy package the ECB will deliver in 2019 might contain some interesting technical details, showing that its “monetary umbrella” remains very much in place. As recently noted by the ECB's Chief Economist, Peter Praet<sup>1</sup>, the Governing Council might decide to operate along two key dimensions, namely liquidity dynamics and duration extraction.

**On liquidity, the existing T-LTRO programme amounts to €740bn and is a key policy tool both in terms of its regulation-driven liquidity needs as well as the heterogeneous distribution of this term liquidity. Announcing an extension or a new programme altogether in H1 2019 might be needed, to avoid a large jump in financing costs for the banking sector**

<sup>1</sup> Praet (November 2018), Preserving Monetary Accommodation in Times of Normalisation, speech.

– keeping in mind the rate applied to T-LTROs is between main refinancing operations and the deposit rate. Indeed, €399bn of T-LTRO will drop below a residual maturity of one year at the end of June 2019, thus becoming ineligible for Net Stable Funding under Basel III. Furthermore, we note that the regional distribution of T-LTRO-liquidity deviates significantly from the ECB’s capital keys, and hence from the philosophy underlying the public sector purchase programme. For example, Italian banks fetched 33% of T-LTRO liquidity, while at the same time holding a disproportionate amount of domestic government bonds (EUR 379bn). A new T-LTRO would thus alleviate funding difficulties for Italian banks.

**We are a bit more sceptical on duration extraction.** As QE ends, reinvestment of the principal payments of securities purchased under the asset purchase programme (APP) – estimated at €221bn between October 2018 and October 2019 – becomes a critical policy tool. But skewing the reinvestment toward longer bond maturities via an “operation twist” would face technical constraints, in particular given the high ownership share of the ECB’s holding in some countries (Germany, the Netherlands and Portugal) and the 33% issue/issuer limit. It would also infringe the market neutrality principle. Still, we would like to stress that the latter has been tolerating some flexibility, with the average maturity of ECB APP holdings having deviated quite persistently from the average maturity of outstanding bonds in the market.

## Back to a heavy political agenda

The timeline for the replacement of key EU-officials is very intense. The European Parliament elections take centre stage in May 2019, with the right-wing European People’s Party (EPP)’s Manfred Weber a potential (German) candidate for heading the European Commission. However, current polls indicate an increasingly fragmented Parliament, with the balance of relative power drifting away from the traditional centrist parties (EPP and the Socialists & Democrats) to the benefit of Eurosceptic and anti-establishment parties. Decision-making is likely to be subject to complex alliances and time-varying cross interest, most likely ending up in policy inertia.

Turning to the ECB, half of the Executive Committee will rotate, starting with Peter Praet by end-May. In addition to President Mario Draghi (31/10/2019), Executive Board member Benoît Cœuré’s term will expire at the end of December. These are two very “hot seats”, but we do not think that any outcome will significantly change the ECB’s reaction function. Unsurprisingly, the timing of the European Parliament elections complicates matters, as key stakeholders are trying to best position their representatives and therefore have to commit to political trade-offs. In any case, the “new” ECB will be confronted with a rather challenging macroeconomic environment. As such, a continuation of the current constructive dialogue with market participants will be essential for the successful conduct of monetary policy.



# Brexit looms: Stand by your plan

By David Page



- **The UK's economic outlook is materially dependent on how the country leaves the European Union**
- **A benign, transitional exit remains our central outlook and in this case, we would likely see an acceleration in UK activity in 2019 (1.8%)**
- **Conversely an abrupt exit would most likely deliver a sharp supply-side shock and a potential recession**
- **As the UK moves beyond the immediate post-Brexit reaction, the economy will re-synchronise, as the global economy decelerates (1.8% 2020)**

## Brexit dominates the outlook

The outlook for 2019 and beyond remains dominated by the UK's decision to leave the EU and the path it follows thereafter. We continue to believe the bleak implications that the UK would face, if it left without a deal – and particularly without a transition in March – will force a political acceptance of the arrangement that the government has brokered with the EU (or a mildly amended version).

Accordingly, we envisage that the UK will enter a transitional exit, to a softer end-state than has been suggested for much of the process. Yet such an outcome is far from guaranteed and while the UK and the EU would clearly not choose a more abrupt withdrawal, miscalculation may result in that outcome, meaning there would most likely be materially adverse consequences for the British economy.

Yet looking beyond the short-term uncertainty, the UK may find that whatever the outcome, the environment could become all the more difficult, as global economic activity materially wanes in 2020, as risks of a pernicious global downturn grow.

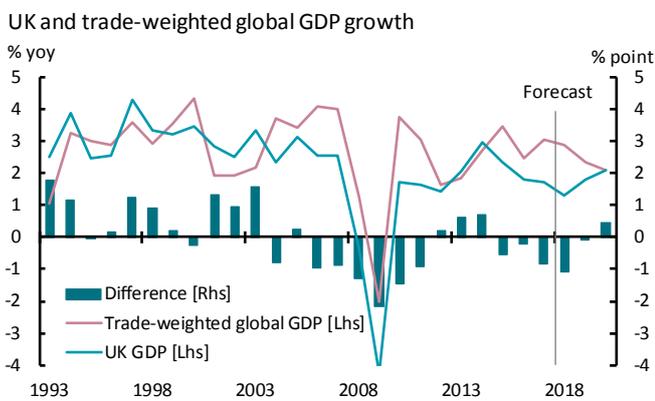
## Brexit debate well-rehearsed but no less significant

At the time of writing, the UK government had just finalised a Withdrawal Agreement, to be agreed at the EU Summit on 25 November. The agreement reflected the UK's acceptance of a 'backstop' Ireland border solution which would see the UK enter a customs union with the EU and agree to maintain a "level playing field", pledging alignment of goods regulations, as well as mirroring EU state aid and environmental rules.

This deal now needs to be ratified by UK and EU parliaments. However, as recent weeks have clearly illustrated, such a process is far from guaranteed in the UK.

Indeed, UK political uncertainty has been rife in recent weeks, with growing calls for a leadership challenge and a significant risk that the UK Parliament could reject the negotiated deal, at least at its first opportunity, which is expected in early December. Such a course would likely initiate a period of intense market and political volatility.

### Exhibit 1: Can Brexit underperformance reverse?



Source: National Statistics, IMF and AXA IM R&IS calculations

Agreement of this Withdrawal Deal – either in December or after a fraught period and a possible second vote in early-2019 – would importantly include a transition phase, (at least until end-2020, but likely to be extended further), significantly reducing the immediate uncertainty surrounding post-Brexit Britain. Moreover, while the UK will formally pursue an ambitious free trade agreement (FTA) with the EU during this transition, this should take several years and we do not expect any FTA to address requirements for the Irish border, which would likely leave the UK in a customs union with the EU for the medium to long term.

Following the significant uncertainty-induced underinvestment in recent years, such an outcome would underpin a rebound in business investment. Rising sterling would however not provide a symmetric benefit to the headwind of 2016's devaluation<sup>1</sup> but should deliver a slower inflation to boost household real incomes and spending. In addition, following the 2018 Budget, the Chancellor indicated a fiscal easing, which included a net 0.6% GDP shift in the fiscal stance for 2019, with the prospect of more to come in the event of a deal. In total, we forecast 1.8% GDP growth in 2019, if the UK accepts the Brexit deal.

1 In 2016, the 13% depreciation in trade-weighted sterling (20% from 2015 peak) lifted inflation, lowering household real income growth and spending. However, it did not have the traditional effect of raising business investment and net exports by more, as Brexit uncertainty constrained fresh activity. A rise in sterling over the coming months would provide a headwind to business investment and exports this time

## No deal outlook risks recession

Even now the chances of “no deal” are high. The government’s acceptance of a customs union resolution of the border issue reduces the impact of Brexit to migration control. This has made domestic ratification of the current deal difficult.

In the case of no deal without transition, business spending would weaken as firms increased overseas investment. Sterling would fall further, generating inflation and weighing on consumer spending. Exports would also struggle as trade was no longer covered by the EU’s FTAs.

These factors would slow demand and such an abrupt rupture would additionally deliver a supply-side shock. UK ports would be forced to check all goods entering the UK, which they have warned they are unprepared for and estimates suggest a 75% to 88% reduction in goods coming into the country, in the immediate aftermath. Quite apart from the implications for the UK’s 50% of imported food<sup>2</sup>, this would severely constrain UK manufacturing supply chains, limiting output. The extent of this impact is difficult to predict without historic precedent<sup>3</sup> but we suggest its effect would be significant, resulting in a recession.

The severity of such an outcome could see the UK attempt to forestall this by seeking to extend Article 50 – albeit not for further negotiation but to prepare for such an exit. This would mitigate some of the supply-side shock, reducing, but not eliminating the adverse impact on the economy. However, such a postponement would require the unanimity of the 27 EU remaining member states.

## Beyond Brexit, resynchronising with global cycle

Beyond 2019, the longer-term outlook for UK will also be governed by a re-synchronisation with the global cycle (Exhibit 1). Material deceleration in US economic activity and more modest slowdowns in China and Europe will leave UK trade-weighted demand growth for UK goods and services softer.

In a benign post-Brexit path, we believe the UK will have sufficient, idiosyncratic pent-up demand to buck the global trend in 2019 and 2020. We forecast the catch-up in investment spending, stronger consumer spending and easier fiscal policy to offset the worsening global headwinds that will tighten financial conditions and worsen net trade. Together, we forecast this seeing UK GDP growth rise by 1.8% in 2020, still in excess of trend, despite the global deceleration.

2 “Food Statistics Pocket Book 2017”, Department for Environment, Food & Rural Affairs.

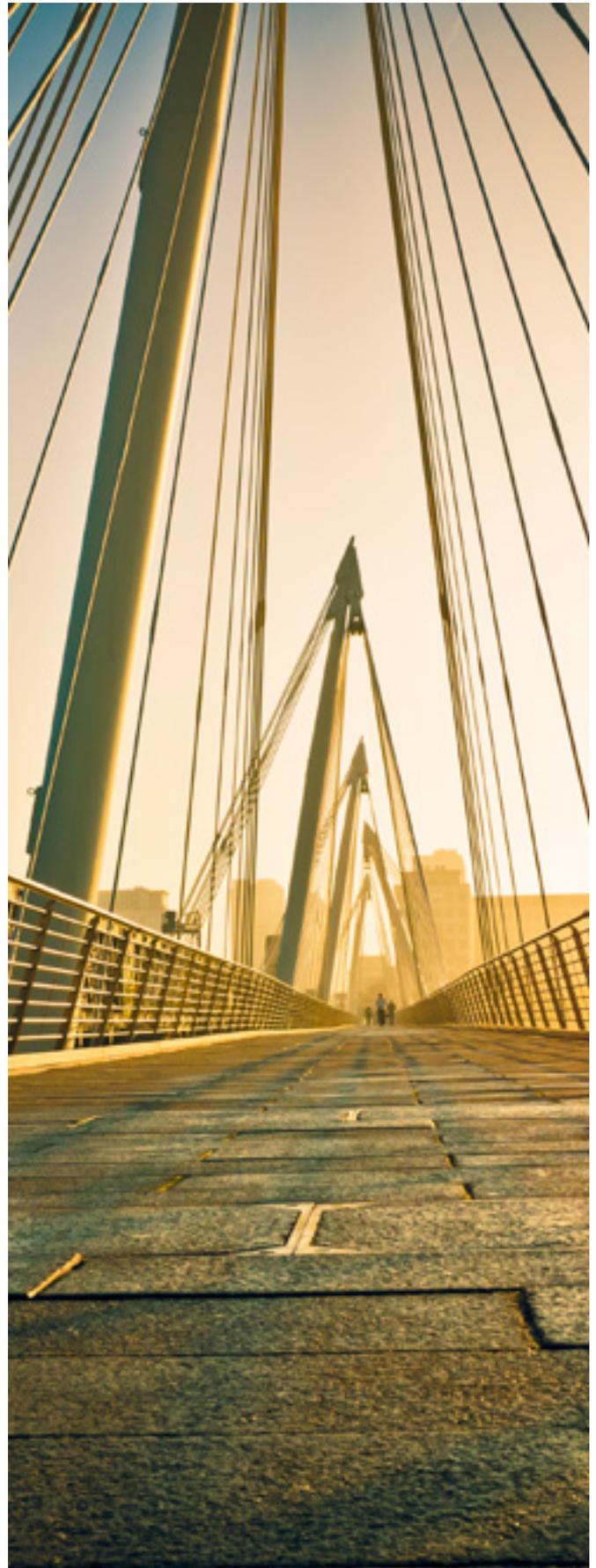
3 Previous episodes of adverse shocks have proved temporary (including the September 2000 truck-drivers’ strike, or oil-shocks of the 1970s), while positive shocks have evolved over time.

However, in the event of a malign Brexit, a material supply-side shock may only begin to ease in 2020, as ports increase capacity to cope with the necessary customs checks. While the UK economy might begin to post a tentative recovery in growth, it would do so from a more enfeebled position and it would not be as well placed to withstand the expect slackening of global growth.

## **Monetary policy to tighten unless the economy turns**

While the BoE has warned that it would assess changes in demand, supply and the exchange rate, before judging the correct course of monetary policy, we still consider an abrupt exit in March next year as likely to warrant modest easing in monetary policy. In such a case, we would envisage interest rates falling back to 0.25% and the prospect of QE before the end of 2019.

Equally, a Brexit deal that results in economic acceleration, further above trend in an economy the BoE already assesses has closed its output gap, points to a need for more policy tightening. In our central forecast, we therefore expect the Bank's Monetary Policy Committee (MPC) to resume tightening policy. The Brexit uncertainty, however, is highly likely to last for most of Q1 2019. We forecast that the Bank will tighten policy in May 2019, again in November and twice in 2020. The final hike to 1.75% is likely to prove contentious as signs of global deceleration gather. However, domestic inflation pressures appear likely to dominate.



# Japan: A little less consumption, a little more action

By Laurent Clavel and Ryutaro Kimura



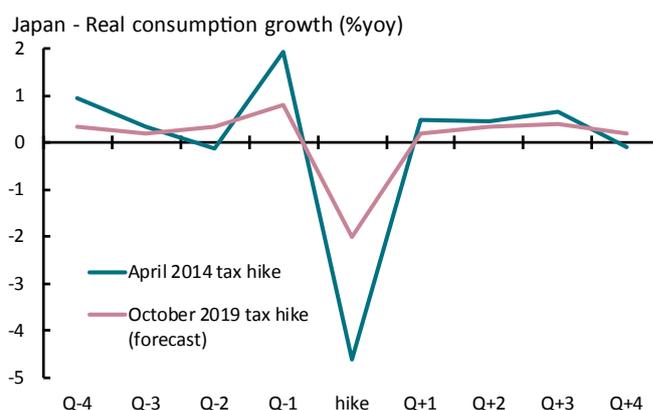
- Beyond extreme quarterly volatility (natural events in 2018, consumption tax hike in 2019), GDP should expand at a stable 0.9% in 2019
- We expect a significant slowdown in 2020 to 0.5% with the negative tax impact on real income but also a slowdown in corporate investment and public spending
- With low, entrenched expectations, core inflation should remain around 0.5% despite a record-tight labour market
- We expect the BoJ to stick to the Yield Curve Control framework made more permanent last July. The BoJ may also be tempted to exit negative interest rates

## As in 2018, GDP growth should remain volatile

The Japanese economy slowed down significantly in 2018, from 1.7% in 2017 to 0.9%, very close to our forecast a year ago (1%). Both household spending and net trade contributed to the softening. Household consumption slowed to 0.4% after 1.0%

in 2017, and residential investment contracted -6%, while on the trade front, exports slowed to 3% after growth of almost 7% in 2017. While the fading fiscal stimulus saw public investment contract 2% (and 2.5% in fiscal year (FY) 2018), corporate investment held up surprisingly well and accelerated from 3% in 2017 to 4.5% in 2018.

Exhibit 1: 2019 consumption tax hike similar but milder than 2014 precedent



Source: Datastream and AXA IM R&IS calculations

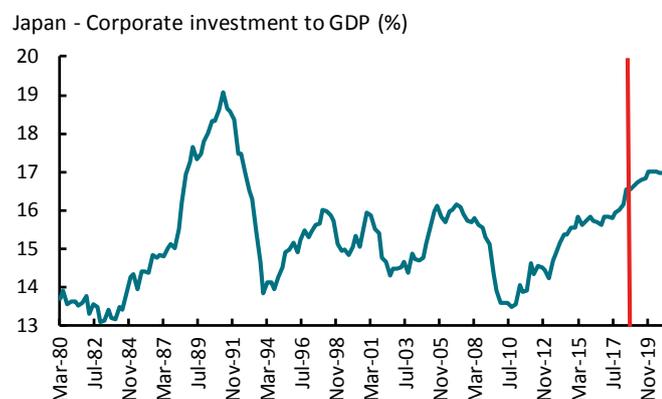
Japanese growth remained modestly above potential, which resulted in the tightest labour market on record – the unemployment rate fell to a 24-year low. While the level of growth was in line with our expectations, the large volatility in quarterly sequential growth was unexpected. On this front, after extreme natural events in 2018 (negatively affecting the first and third quarters), the consumption tax hike that comes into effect in October 2019 should keep growth volatile with front-loaded purchases expected as a result in the second and third quarters of the year and a sharp fall thereafter (Exhibit 1). Mindful of the 2014 precedent (when the April consumption tax hike sent the Japanese economy into a technical recession), the government has put in place several offsetting measures, for example exempting food from the tax hike. We therefore expect the impact to be more modest in October 2019, less than half of the 2014 effect.

Beyond this quarterly volatility, domestic-led growth should stabilise in 2019 at 0.9%, as in 2018, with households' real income still benefitting from sustained job creation, an acceleration in nominal wages and a modest pick-up in inflation. Residential investment may have reached a trough and should no longer weigh on growth. Conversely, net trade will likely remain a headwind, with further export softening (broadly in line with Asian trade) and robust import growth on the back of the domestic resilience.

## A little less consumption in 2020

In 2020, we expect lower growth, at 0.5%. First, beyond the tax-induced quarterly volatility, the pace of consumption should be lower as a result of the negative income effect from the consumption tax hike (which permanently reduces households' purchasing power). Second, corporate expenditures should fade as well as the investment to GDP ratio is soon expected reach its peak (Exhibit 2).

Exhibit 2: Peak investment cycle by 2020



Source: Datstream and AXA IM R&S calculations

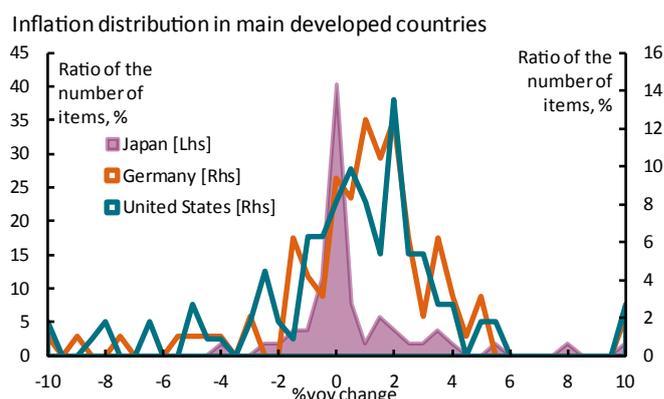
Exacerbating this feature, is the expectation that public spending should slow from the second quarter of 2020 onwards as the temporary boost ahead of the 2020 Olympic Games wears off.

## Core inflation barely rising on entrenched, low expectations

Despite the Bank of Japan's (BoJ) action, a record-tight labour market and surveys pointing to labour and capital shortages, "new" core inflation (which excludes fresh food and energy<sup>1</sup>, similar to the way it is defined in the US and the Eurozone) has failed to increase much (0.4% year on year (yoy) in October 2018).

With expectations of low inflation now entrenched (Exhibit 3) – a result of an ageing society and of the persistence of a low level of observed inflation over many years – we expect this feature to prevail and forecast "new" core inflation at 0.5% in 2019 and 2020. These figures are excluding the consumption tax hike impact which we expect, as in 2014, to be a one-year "bump" in "new" core inflation temporarily rising up to around 1.3%.

Exhibit 3: most of the CPI basket with stable prices



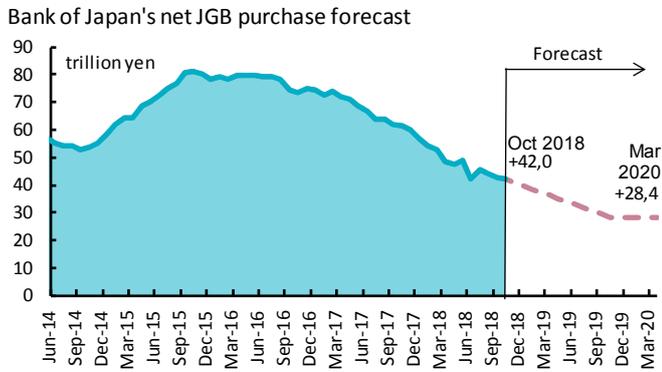
Source: Datstream and AXA IM R&S calculations – As of 21 November 2018

## A little more action from the BoJ

Meanwhile, the BoJ has been gradually reducing its net asset purchases, down to ¥28tn over the coming 12 months vs. ¥80tn in 2016 (Exhibit 4). While the net supply of JGB should increase, this should translate into a modest rise in JGB yields. This is in line with the BoJ decision in July to widen the interval around the 0% 10 year JGB yield target, from +/- 0.1% to +/-0.2%. The normalisation of key interest rates is however set to wait much longer and we expect the BoJ to keep rates unchanged until 2021. Recent comments from cabinet members nevertheless suggest that the inflation target has become much less interesting, allowing the BoJ to move towards an earlier exit, especially concerning short-term negative interest rate policy (which some BoJ board members have strong concerns about in terms of financial stability).

<sup>1</sup> As in the core inflation concept usually referred to for the US or the Eurozone, whereas the Japanese concept of (standard) core inflation only excludes fresh food, leaving most of the volatility linked to oil prices.

Exhibit 4: further QQE tapering in 2019



Source: BoJ and AXA IM R&S calculations

## Out of ammunition in the next downturn?

Unfortunately for the Japanese economy, the BoJ has few monetary policy options left to deal with the next recession. More than five years have already passed since BoJ governor, Haruhiko Kuroda, declared that a price target of 2% should be realized

within two years and started massive QQE. During the period, the BoJ tried new approaches, such as introducing negative interest rates and changing monetary policy to yield curve control, but both of these efforts failed to raise the inflation rate. Rather, due to negative interest rates and the flattening of the yield curve, the BoJ became concerned about the side effects of the policies, which included a decline in profitability of financial institutions and an increase in low quality loans.

Under these circumstances, we anticipate that the options that the BoJ can take to combat the next recession will be limited to raising the pace and quantum of JGB purchases, mainly for an ‘announcement effect’. It could also consider shifting the target of yield curve control from 10 year to 20 year or 30 year JGBs in order to further lower super long-term interest rates, but considering the side effects mentioned above, the BoJ would struggle to justify this choice.

Regarding the possibility of foreign bond purchases, the BoJ repeatedly denies that foreign exchange policy is the jurisdiction of the Ministry of Finance. Also, since this is a substantial currency intervention, the Japanese government will face significant resistance from other countries, especially considering the US has been intensifying diplomatic pressure on trade with Japan. Instead, the stimulus would be mainly fiscal, with the fiscal target (already pushed back by Prime Minister Shinzo Abe to 2025) further delayed to 2030.



# China: Walking a tightrope

By Aidan Yao



- **The changing impact of the Sino-US trade war – from a market shock to a growth shock – is set to create strong headwinds for the Chinese economy in 2019**
- **Beijing is under pressure to steer policy towards growth preservation, but its desire not to reverse structural reforms will limit the vigour of stimulus**
- **Without a full policy offset, economic growth is expected to slow to 6.1% in 2019 and 2020, with waning inflation**
- **The changing macro environment will force Beijing to accelerate reforms on multiple fronts**

## A rocky path turns rockier in 2019

2018 has been a challenging year for the Chinese economy and financial markets. What got off to a positive start, following the strong momentum of 2017, quickly gave way to a rapid deterioration in economic fundamentals and investor sentiment. A sudden turn for the worse in Sino-US trade relations dealt a

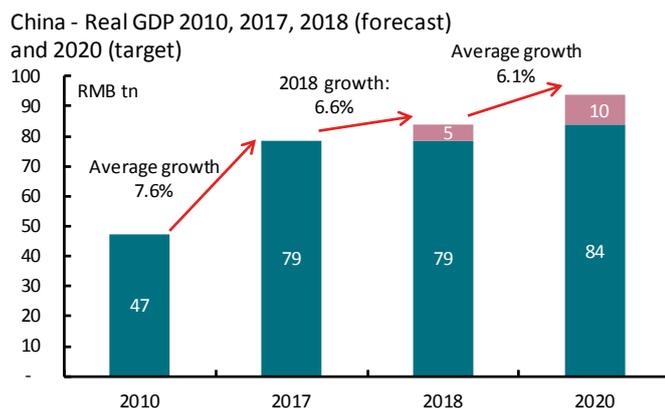
heavy blow to Chinese equities and currency. Domestic policies, particularly those centred on deleveraging and shadow-bank controls, also contributed to the negative sentiment by pulling down domestic demand. While macro policies have now been adjusted, we think these changes will be inadequate to reverse the negative growth trend. **We expect the economy to end 2018 at 6.6%, the lowest rate of growth since the global financial crisis.**

Turning to 2019, the Year of the Pig will unlikely get any easier. Externally, the Sino-US trade war has not yet impacted the real economy, as exports have been front-loaded ahead of the tariff implementations. However, these “pre-emptive” purchases will not last forever and **we expect the real shock of the trade conflict to hit home from early 2019.** Besides the growth impact, the trade war will also accelerate the turning of China’s current account balance, from surplus to deficit, with important implications for both China and the world.

China’s domestic conditions will, as usual, be buffeted by the ebb and flow of official policies. Beijing’s supply-side reforms (2015-2016) and deleveraging (2017-2018) have perpetuated profound changes in the macro landscape over the past few years. **The macro environment has now changed again and will require Beijing to steer its policy towards striking a better balance between growth stability and risk management.** However, the desire not to reverse reform progress will limit Beijing’s ability to stimulate the economy as quickly and aggressively as in previous

easing cycles. Without a full policy offset, we expect the economy to slow further to 6.1% in 2019 and 2020. By our calculations, this should be sufficient to achieve the official target of doubling 2010 GDP by 2020, making the slowdown less susceptible to political objections (Exhibit 1).

### Exhibit 1: Beijing under pressure to deliver GDP target



Source: CEIC and AXA IM R&IS calculations – As of 20 November 2018

## Real impact of trade war to hit home

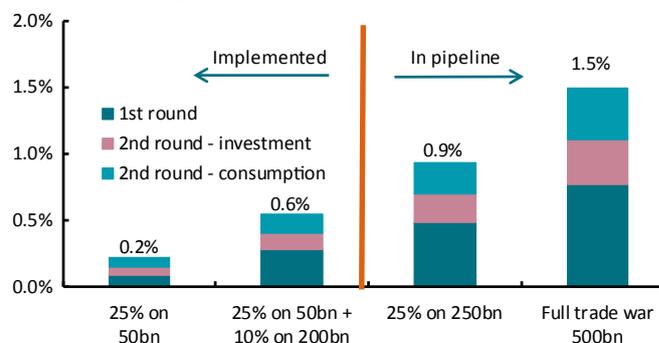
Delving into the details, 2018 has been an eventful year for China's external environment. The lack of follow-up actions in 2017 from Trump's anti-trade election promises had led to a popular belief that the "business-minded" President was more interested in doing deals than engaging in confrontations. However, such a sanguine view was proven wrong by the events of 2018, with trade sanctions, tariffs, and plenty of protectionist threats propagating major shocks across the global markets.

**Compared to other countries, China commands a unique position in Trump's protectionist plot.** Despite tentative deals with traditional allies, Trump has maintained pressure on China by repeatedly threatening to put all Chinese products under punitive tariffs. On the surface, the protectionist measures implemented so far are justified as necessary moves to punish China for its "unfair" trade practices and restore the bilateral trade balance. However, the on-going escalation of tensions – in trade, but also other areas – suggests that a deeper malaise has set in, one that has shaken the very foundation of US-China relations and which cannot be easily repaired under the current political setup. **This underscores our view that the trade conflict is likely to get worse before it gets better, and there are risks that the competitive landscape between the world's two largest powers could spread to other fields in the coming years.**

Given the likely protracted nature of the trade conflict, China needs to be prepared for its consequences. In our base case of a 25% tariff on \$250bn of goods, China's GDP growth will be lower by around 0.9ppt after accounting for the direct and indirect impacts (Exhibit 2). Combined with slower global demand, the ongoing trade tension will create a tough environment for Chinese exports, which we expect growth to grind to a halt in 2019 after a solid year in 2018.

### Exhibit 2: Trade war starts to bite in 2019

First and second round impact of trade war on Chinese GDP growth

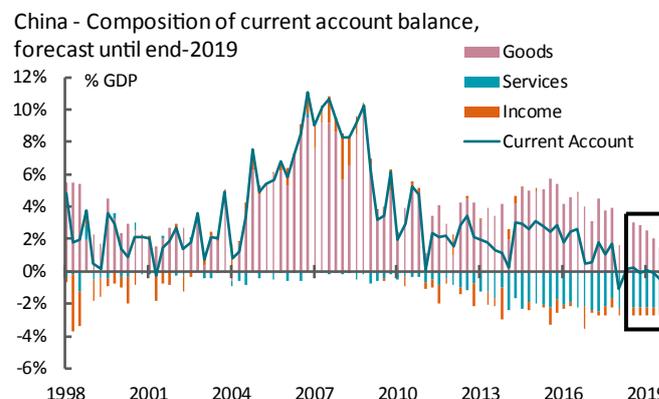


Source: AXA IM R&IS calculations – As of 20 November 2018

The adverse impact of the trade war will also be felt in China's current account (CA), which registered its first quarterly deficit in nearly twenty years in Q1-2018. Barring any surprises, **we expect the CA to record its first annual deficit since 1994 next year** (Exhibit 3). While the timing is clearly exacerbated by the trade war, the overall evolution of the CA is a result of China's own domestic factors, such as the rebalancing towards consumption-driven growth. We think this structural shift in China's current account will have important implications for the world:

- First, the erosion of CA surplus means that China will no longer export capital to the rest of the world, dampening its demand for global assets, such as US treasuries.
- Second, as the CA turns to deficit, China will have to borrow from offshore to finance its domestic investment and debt. This will put pressure on domestic interest rates and subject China to volatile global capital flows.
- Finally, the disappearance of the CA surplus will remove a structural support for the RMB, creating more volatility for the exchange rate.

### Exhibit 3: China's current account surplus is vanishing



Source: CEIC and AXA IM R&IS calculations – As of 20 November 2018

The above developments will in turn have policy implications for Beijing. The need to import foreign capital will require the authorities

to further liberalise and open up their domestic markets to attract global savings. In addition, China needs to manage its leverage problem carefully and expedite reforms to keep investors' faith in its assets. Finally, the RMB exchange rate needs to become more flexible if it is to act as an effective buffer for the economy by adjusting for export competitiveness. **In short, the turning of China's current account could represent an important catalyst for Beijing to accelerate reforms on multiple fronts over the coming years.**

## Domestic policy requires a delicate balance

These growth external challenges will spill over to the domestic economy, and in turn, affect overall GDP growth (Exhibit 2). **But the bigger impact, in our view, lies in the official policy adjustments needed to partially offset the effects of the Sino-US trade war.**

Seasoned China observers will know **the importance of official policies, not headline GDP, in driving the Chinese markets.** One only needs to go back to 2015-16 to see the drastic changes prompted by Beijing's supply-side reforms on the PPI and corporate profitability, which sowed the seeds of a massive equity rally in 2017. The recent policy shift towards deleveraging also generated profound changes in the financial system by forcing banks to cut their shadow-banking exposure and normalise off-balance-sheet activities. Together with a successful refutation in the economy, the deleveraging campaign helped to halt the rising trend in China's debt ratio last year, at 256% of GDP.

We expect a further shift in China's official policies in 2019. The worsening macro environment has closed the door on Beijing's singular approach to reform that takes little account of short-term

“  
**A more balanced policy mix that preserves both short-term growth and long-term structural progress is needed in the new environment**

”

impacts. **Instead, a more balanced policy mix that preserves both short-term growth and long-term structural progress is needed in the new environment.**

## Making stimulus more sustainable

**Recent developments suggest that such a policy shift is already underway.** To counteract rising growth pressure, Beijing has started to relax controls on local government debt, public-private-partnership (PPP) projects, and non-bank credit intermediation. In addition, the PBoC has cut the RRR three times to boost domestic liquidity and the government has lowered tax burdens for households and small businesses.

**Notwithstanding the pro-growth policy shift, there are important differences between the current stimulus and past ones.** To start with, China has less room to implement large-scale monetary stimulus, given the risk of exacerbating structural imbalances. The tepid liquidity injection and the lack of a significant easing of shadow-banking controls suggest that the authorities are wary of the pitfalls of such tools and are using them with caution.

**Instead, fiscal stimulus is implemented with more prominence.** Besides its lower risk of side-effects, fiscal policy can also be deployed more selectively, allowing Beijing to target specific sectors of the economy. The latter has enabled the authorities to direct policy supports to the household sector and private-owned enterprises (POEs) via tax cuts, subsidies and deregulation. For the former, the recent personal tax cuts could unleash up to RMB500bn worth of tax savings, or 0.6% of GDP, helping to support consumption growth and further the economic rebalancing in 2019.

The POEs have also received value-added tax reductions, along with other rebates and subsidies, with senior officials vowing more stimulus to come. By making the POEs the centre of policy supports, Beijing can achieve two objectives. **First, the POEs, on aggregate, are less indebted, but more productive and profitable than their state-owned counterparts (SOEs).** This will give the government more bang for the buck for its stimulus. But more importantly, by pledging “unwavering” support to the POEs, Beijing is reasserting the importance of private businesses in China's economic development. **Should these be followed by tangible actions that lead to a reallocation of resources to the private sector, away from the state sector, the net impact will be similar to a SOE reform.**

## But a “constrained” policy easing has costs

Compared to households and POEs, **we expect Beijing to be more cautious with policy easing for the housing market and infrastructure investment.** Even though some unwinding of the local government debt control should spur renewed growth in infrastructure investment, the scale of the recovery will be shallower than during past stimulus. We also do not expect a wholesale reversal

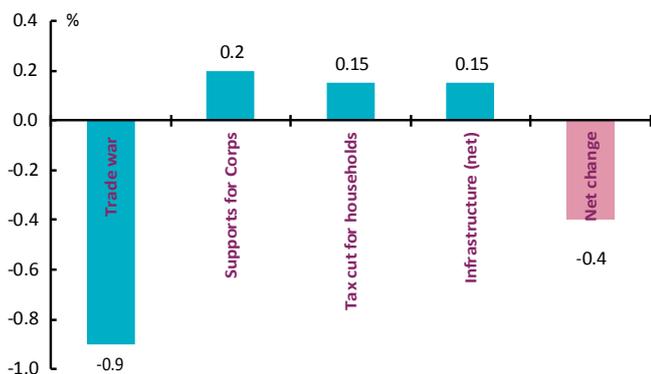
in housing market policy any time soon. Even though some scaling back of the recent tightening is possible beyond Q1, we still expect the property sector to be a drag on economic growth in 2019.

**In short, we think the mix of “proactive” fiscal policy and “prudent” monetary policy will remain intact.** The former will lead to a rise in the fiscal deficit to 3%, from 2.5% this year, with the expansion potentially amplified by local governments’ off-budget operations. The PBoC will also cut the RRR three to four times to supplement fiscal operations and maintain liquidity as other central-bank lending facilities, such as the Medium-Term Lending Facility (MLF), run off.

**Overall, Beijing’s attempt to strike a balance between short-term growth and long-term sustainability is laudable.** But this “cautious” policy easing will come at the cost of a less vigorous economic response. **We think the accumulative stimulus – even with more to come in 2019 – will not be enough to prevent a further growth slowdown to 6.1% in 2019 (Exhibit 4).** This growth backdrop will, in turn, put downward pressure on domestic inflation, which we expect to moderate to 2%, from 2.3% this year.

Exhibit 4: Policy easing does not offset the trade shock

China - Contribution to GDP growth change from 2018 to 2019



Source: AXA IM R&IS calculations – As of 20 November 2018

## Risks lie in policy uncertainties

**The biggest risks to our baseline outlook lie with the policy uncertainties from both Washington and Beijing.** The former, particularly with regard to trade policies, has proven extremely difficult to predict, and we do not expect the clarity in Trump’s decision-making to improve in 2019. In a situation of greater US-China conflicts, we expect a more aggressive policy response from Beijing to hold growth above 6%. In that environment, the PBoC will not be able to maintain a neutral policy stance, and may have to reverse deleveraging by relinquishing control of the shadow banking system. Beijing may also have to give up its curb on local government debt and the housing market to extract growth, even at the expense of economic sustainability. However, these aggressive moves to boost the economy may only extract a temporary positive response in the market, as investors quickly turn to long-run consequences of such stimulus.

On the flipside, a “cease fire” in the trade war would calm investor sentiment and alleviate pressure on the economy. The authorities, in that case, will not have to ease policy as aggressively, and may continue to deleverage the economy. This would be a positive scenario for the equity and currency markets, which appear to have already priced in significant disruptions of a protracted Sino-US trade conflict.



# Emerging markets' economic resilience: It's a kind of magic

By Irina Topa-Serry and Shirley Shen



- The roots of emerging markets' recent slowdown go back to early 2018, when global financing conditions started to tighten. Growth should nevertheless remain relatively resilient into 2019 albeit showing diverging regional and intra-regional trends
- Pent-up demand in Brazil and India should help growth to gain traction, while the global economic slowdown is likely going to affect most Asian and European developing markets. Recession in Turkey and Argentina, where elections will take place in 2019, should alleviate some of the imbalances but further policy action is needed to tackle structural issues and credibly anchor market expectations
- The economic outlook remains fragile, due to numerous 'unknowns' that could significantly affect emerging markets' trajectory, such as a stronger US dollar, higher US Treasuries rates, overshooting oil prices and the possibility of a full-blown trade war

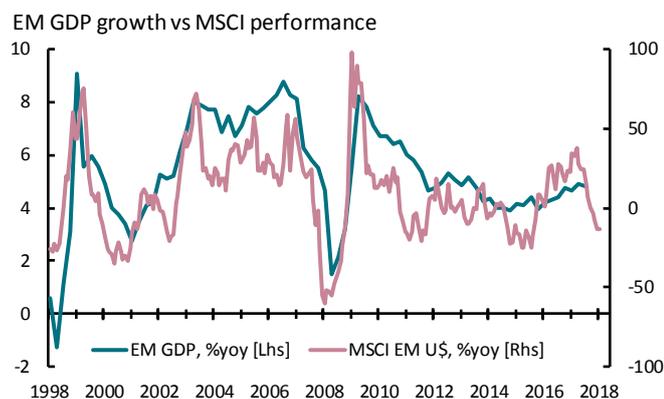
## 2018: The root of the slowdown

At the beginning of 2018, rhetoric of “synchronous economic growth” supported market enthusiasm. Almost a year on, and this optimism has vanished; instead, a sturdy US economy carried on with its overextended cycle, supported by corporate tax cuts. This situation contributed to a tightening of global financing conditions (dollar appreciation and an increase in US Treasury yields), which was exacerbated in EMs by capital outflows (Exhibit 1). Meanwhile, the US administration engaged in trade disputes going well beyond what most observers initially estimated. Frictions have emerged between the US and major EM economies such as China, Mexico and Russia, as a result of trade tariffs, which have been imposed, or due to targeted sanctions.

Still, economic growth proved rather resilient through H1 2018. Early estimates of GDP performances for Q3 look surprisingly strong in some countries and EMs are set to deliver GDP growth to the tune of 4.6% in 2018, just a touch below the 4.7% registered in 2017. Yet, the roots of the economic slowdown go back to mid-2018. Turkey and Argentina started to face major headwinds,

which we expect will lead them into recession. But these are not big enough economies to drive a sharp broad-based adjustment of the wider EM segment.

Exhibit 1: 2018 EM GDP more resilient than markets



Source: Datastream and AXA IM R&S calculations

## 2019: From trade engine to domestic demand buffers

A set of external factors including US trade war rhetoric, currency shocks, tighter global financing conditions (albeit still loose in a historical perspective) should all limit **EM expansion, keeping it below its trend growth in 2019**. Our expectations of an upcoming escalation of the tariffs Chinese exporters have to pay to the US, from the current 10% to 25% on goods worth \$200bn, will impact global trade next year. The effect of these tariffs could go beyond China and the US, as a significant portion of Chinese products is not manufactured entirely in China. Processed and assembled products make up 30% of Chinese total exports. This supply-chain connection means that the shock from the Sino-US trade war could be contagious for many countries that co-produce with China. As its exports to the US decline, China's imports of components and inputs from supply-chain partners will decrease too, spreading the negative shock across the global production process. Mexico and Canada may end up as net beneficiaries of China's loss of market share in the US, but most Asian countries will likely be casualties of the trade war. Temporary trade disruptions and diversions from one country to another will bear transition costs worldwide and we see EM as a whole no longer benefitting from the strong export growth engine in 2019.

Instead, we expect **domestic demand to remain relatively resilient overall**, alleviating some of the pressures coming from weaker trade volumes. Healthy household balance sheets, generally robust labour markets and **pent up demand in some big EMs, such as Brazil and India**, are likely to support household consumption into 2019. Additionally, fiscal stimulus is expected to support some Asian economies including India, Indonesia, the Philippines and Thailand (all these countries have elections likely taking place in the first half of 2019), as well as Korea and Malaysia (which have relatively expansionary budgets

pencilled in for 2019). Conversely, a more restrictive fiscal stance is expected in Argentina and Turkey, as well as in Brazil.

## 2019: Diverging regional and intra-regional trends

**EM growth is likely to stay at 4.6% in 2019**; it's a kind of magic hiding strong regional divergences between EM geographical blocks as well as diverging economic trends intra-regionally (Exhibit 2).

Exhibit 2: Resilience hides divergent regional trends

| Real GDP growth (%)       |            |            |            |            |
|---------------------------|------------|------------|------------|------------|
| Region/Country            | 2017       | 2018e      | 2019e      | 2020e      |
| <b>Emerging economies</b> | <b>4.7</b> | <b>4.7</b> | <b>4.6</b> | <b>4.7</b> |
| <b>China</b>              | <b>6.9</b> | <b>6.6</b> | <b>6.1</b> | <b>6.1</b> |
| <b>Asia ex-China</b>      | <b>5.8</b> | <b>6.1</b> | <b>6.1</b> | <b>6.1</b> |
| South Korea               | 3.1        | 2.8        | 2.6        | 2.5        |
| India                     | 6.7        | 7.3        | 7.4        | 7.5        |
| <b>Latin America</b>      | <b>1.3</b> | <b>1.2</b> | <b>2.1</b> | <b>2.2</b> |
| Brazil                    | 1.0        | 1.5        | 2.5        | 2.5        |
| Mexico                    | 2.0        | 2.2        | 2.2        | 2.0        |
| <b>Emerging Europe</b>    | <b>3.9</b> | <b>3.2</b> | <b>2.2</b> | <b>2.6</b> |
| Russia                    | 1.5        | 1.9        | 1.8        | 1.8        |
| Poland                    | 4.7        | 5.2        | 3.5        | 3.0        |
| Turkey                    | 7.4        | 3.5        | 0.5        | 2.5        |
| <b>Other EMs</b>          | <b>2.6</b> | <b>2.9</b> | <b>3.2</b> | <b>3.4</b> |

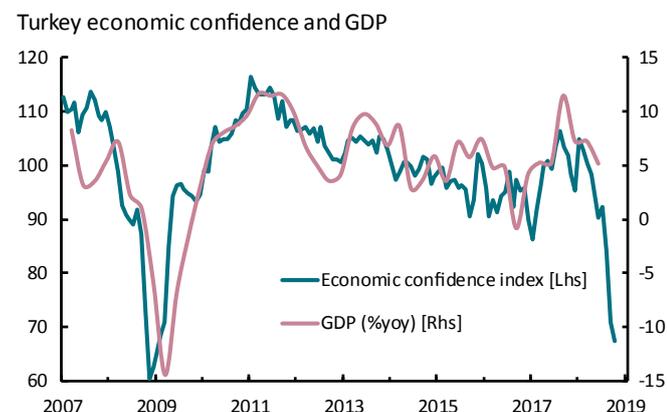
Source: AXA IM R&S calculations – As of 23 November 2018

**Economic slowdown is likely to continue in Asia**, driven by trade headwinds, which might affect China, Korea, Taiwan, Thailand and Singapore. Meanwhile, India and Indonesia are expected to continue to deliver relatively robust growth after having pushed through significant reforms in recent years. India's domestic demand rebounded in 2018 after a weak 2017 and this trend should continue into 2019, as it reaps the benefits of structural reforms and benefits from its favourable demographic dividend. Indonesia has been able to deliver a very resilient and consistent 5% growth per annum since 2014 and will likely continue to do so, benefitting from investment. It is also one of the least impacted countries by the trade war. Nevertheless both India and Indonesia remain highly vulnerable to oil price spikes, which could depress their respective trade balances, given their large dependence on oil imports. In addition, higher oil prices would weigh on public finances, given their large subsidies on oil-related products. In addition, currency weakness could add to these woes. As a result, central banks are inevitably under pressure to remain vigilant on the monetary policy front. Should the recent oil price weakness remain persistent in 2019, India and Indonesia may see these pressures waning, offering room for some positive surprises.

The less buoyant global economic backdrop and in particular the **weakness in the Eurozone should put some pressure on growth in EM Europe**. Central European countries have so far shown little deterioration, as depicted by some strong GDP estimates for Q3. Strong domestic dynamics and European Union funds may still provide support into 2019 but GDP growth is expected to moderate going forward, reflecting weakness in the Eurozone economy.

The overheated Turkish economy, buoyed by a large pre-election fiscal boost in 2017, came to a brutal standstill this year. Growing structural imbalances and political tensions with the US translated into a substantial depreciation of the currency, widening spreads and asset price losses. The Turkish central bank hiked interest rates by 1,600bps to 24% to restore some confidence, to anchor inflation expectations and stabilise the currency. Still, **Turkey will inevitably head into recession in the coming quarters** (Exhibit 3) and adjustments can be brutal. Any forecasting exercise bears a wide margin of error, given that monetary and fiscal policy reactions to any further financial markets pressure can be significant. We have pencilled in GDP growth at 0.5% for next year after 3.5% in 2018. Turkey is walking a tightrope and policy decisions will need to provide the right balance between credibly anchoring market expectations, while striving to limit the downward pressure on the economy. In this context, its upcoming municipal elections are likely to prove more difficult for President Recep Tayyip Erdogan than initially thought.

Exhibit 3: Turkey in recession



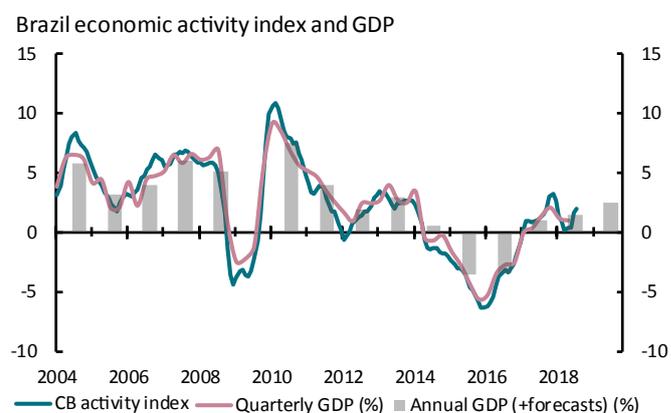
Source: Datastream and AXA IM R&IS calculations

In Russia, GDP growth is expected to reach 1.9% in 2018, supported by higher oil prices and recovering domestic demand. The economy has felt the pressure of the ongoing US sanctions, as well as a poor harvest. Still, Russia's macroeconomic framework remains strong given a credible fiscal rule. The 2019 implementation of VAT hikes is expected to keep a lid on the economic performance, as this will likely lead to a drop in consumption in Q1 of 2019, while the negative effect on real income will subside beyond that. Altogether, we forecast **Russian GDP growth at 1.8% in 2019 and 2020**, with consumption accelerating slightly but external trade slowing. Additional sanctions from the US remain a significant threat to our outlook.

In Latin America, the **Andean economies - Chile, Colombia and Peru - remain on a strong foothold**. The newly elected administrations are seeking to push through important reform agendas, which focus on fostering economic growth while tackling structural imbalances. This should boost growth in the long run. **Mexico's economy should grow at 2.2% in 2019 - the same pace as in 2018**. This relatively weak level is at least in part due to a slowdown in US demand. The newly elected President Andrés Manuel Lopez Obrador (commonly referred to as AMLO) will take office in December and his agenda aims to increase fiscal spending.

This could deteriorate Mexico's sovereign credit worthiness, put pressure on the currency and reinforce the tightening of financial conditions. Nevertheless, we remain confident in Mexico's institutional strength and the enactment of the fiscal responsibility law, which should limit the deterioration of public finances. **Argentina is already in recession, and growth should remain in negative territory in 2019** (but probably to a lesser degree than in 2018), given the tight financing conditions and fiscal consolidation, which was agreed upon in the IMF's Stand-By Arrangement. General elections will be held in the second half of 2019, in a difficult economic environment.

Exhibit 4: Brazil accelerating into 2019



Source: Datastream and AXA IM R&IS calculations

**Brazil** is expected to emerge from its lethargy following the strongest recession in its history, and we expect **growth to rise to about 2.5% in 2019 from 1.5% in 2018**, supported by a recovery in domestic demand from depressed levels (Exhibit 4). However, important hurdles remain; the newly elected President Jair Bolsonaro will need to convince a very fragmented Brazilian Congress to adopt the much needed structural reforms in order to navigate the country's debt trajectory onto a sustainable path. The success of these policy actions is of significant importance to the economic outlook.

**Economies in the Middle East** (with the exception of Iran, which is highly likely to endure negative economic growth, given the US's sanctions **should enjoy a favourable expansionary environment** on the back of strong oil price dynamics, in Saudi Arabia, and reform momentum in Egypt.

## Another political year with policy implications

2019 marks a big election year for many countries including India, Indonesia, Thailand and the Philippines (mid-term). In general, we do not envisage surprise outcomes and expect policy continuity. In India, the political outcome is particularly important for the policy direction going forward. Here, the ultimate battle will likely be held between Narendra Modi's Bharatiya Janata Party and the main opposition the Indian National Congress. But even with a change of prime minister, policy continuity is anticipated. For Indonesia, with the current polls suggesting a 20pp lead for incumbent President Joko Widodo, the prospect of him winning is strong. Thailand's military junta has finally promised to hold the much-delayed election in February, which should allow the return to a civilian-ran government from a military-ran one, though further postponement cannot be ruled out. Finally, midterm elections in the Philippines will gauge the extent of the population's support for President Rodrigo Duterte's policies.

## Testing EM policy makers' astuteness

The extent of the current economic slowdown, which has been ignited by the tighter global financing conditions, will depend on the **quality of policy responses, particularly in vulnerable economies**. We see inflation pressures receding into 2019 as the effects of the past FX weakness and oil price strength fade. Growth moderation should require less monetary tightening in 2019, although some central banks may still need to act in order to stabilise their currencies or to keep inflation expectations credibly anchored – most notably in Turkey, Argentina, India, Indonesia and the Philippines. So far, **exchange rate flexibility has helped to absorb recent external shocks** but it will affect private and public balance sheets. Central banks' interventions in the currency markets remained rather limited in 2018, albeit focused on addressing market dysfunction in moments of stress, while still **keeping adequate reserve buffers**. This should continue to be the case next year. As mentioned previously, **EM fiscal policies appear rather counter-cyclical** with the exceptions being Argentina and Brazil.



# Forecast summary

| Real GDP growth (%)       | 2018*      | 2019*      |           | 2020*      |           |
|---------------------------|------------|------------|-----------|------------|-----------|
|                           |            | AXA IM     | Consensus | AXA IM     | Consensus |
| <b>World</b>              | <b>3.8</b> | <b>3.6</b> |           | <b>3.5</b> |           |
| <b>Advanced economies</b> | <b>2.4</b> | <b>2.0</b> |           | <b>1.5</b> |           |
| US                        | 2.9        | 2.3        | 2.6       | 1.4        | 1.9       |
| Euro area                 | 1.9        | 1.4        | 1.7       | 1.2        | 1.5       |
| Germany                   | 1.5        | 1.4        | 1.7       | 1.2        | 1.5       |
| France                    | 1.6        | 1.4        | 1.7       | 1.3        | 1.6       |
| Italy                     | 1.0        | 0.6        | 1.0       | 0.5        | 0.9       |
| Spain                     | 2.5        | 2.2        | 2.3       | 1.7        | 1.9       |
| Japan                     | 0.9        | 0.9        | 1.1       | 0.5        | 0.6       |
| UK                        | 1.3        | 1.8        | 1.5       | 2.0        | 1.6       |
| Switzerland               | 3.0        | 1.7        | 1.7       | 1.5        | 1.7       |
| <b>Emerging economies</b> | <b>4.7</b> | <b>4.6</b> |           | <b>4.7</b> |           |
| <b>Asia</b>               | <b>6.3</b> | <b>6.1</b> |           | <b>6.1</b> |           |
| China                     | 6.6        | 6.1        | 6.2       | 6.1        | 6.0       |
| South Korea               | 2.8        | 2.6        | 2.6       | 2.5        | 2.5       |
| Rest of EM Asia           | 6.1        | 6.1        |           | 6.1        |           |
| <b>LatAm</b>              | <b>1.2</b> | <b>2.1</b> |           | <b>2.2</b> |           |
| Brazil                    | 1.5        | 2.5        | 2.3       | 2.5        | 2.6       |
| Mexico                    | 2.2        | 2.2        | 2.1       | 2.0        | 2.4       |
| <b>EM Europe</b>          | <b>3.2</b> | <b>2.2</b> |           | <b>2.6</b> |           |
| Russia                    | 1.9        | 1.8        | 1.5       | 1.8        | 1.7       |
| Poland                    | 5,2        | 3,5        | 3,6       | 3,0        | 3,1       |
| Turkey                    | 3,5        | 0,5        | 0,8       | 2,5        | 3,0       |
| <b>Other EMs</b>          | <b>2,9</b> | <b>3,2</b> |           | <b>3,4</b> |           |

Source: Consensus Economics, IMF and AXA IM R&IS calculations – As of 5 December 2018

| CPI Inflation (%)         | 2018*      | 2019*      |           | 2020*      |           |
|---------------------------|------------|------------|-----------|------------|-----------|
|                           |            | AXA IM     | Consensus | AXA IM     | Consensus |
| <b>Advanced economies</b> | <b>2.0</b> | <b>1.9</b> |           | <b>2.1</b> |           |
| US                        | 2.0        | 1.9        | 2.3       | 2.1        | 2.2       |
| Euro area                 | 1.8        | 1.5        | 1.7       | 1.4        | 1.7       |
| Japan                     | 1.0        | 0.7        | 1.9       | 0.5        | 1.7       |
| UK                        | 2.5        | 2.0        | 1.7       | 2.3        | 1.5       |
| Switzerland               | 1.0        | 0.7        | 1.4       | 1.0        | 1.3       |
| Other DMs                 | 1.8        | 1.9        |           | 2.0        |           |

Source: Consensus Economics, IMF and AXA IM R&IS calculations – As of 5 December 2018

|                            |            | Central bank policy<br>Meeting dates and expected changes (Rates in bp / QE in bn) |                 |                        |                           |                         |                        |
|----------------------------|------------|--|-----------------|------------------------|---------------------------|-------------------------|------------------------|
|                            |            | Current  | End-18          | Q1 - 19                | Q2 - 19                   | Q3 - 19                 | Q4 - 19                |
| <b>United States - Fed</b> | Dates      |  | 18-19 Dec       | 29-30 Jan<br>19-20 Mar | 30-1 Apr/May<br>18-19 Jun | 30-31 July<br>17-18 Sep | 29-30 Oct<br>10-11 Dec |
|                            | Rates      | 2.00 - 2.25  | +0.25 (2.25-50) | +0.25 (2.5-75)         | +0.25 (2.75-3.00)         | unch (2.75-3.00)        | +0.25 (3.00-25)        |
| <b>Euro area - ECB</b>     | Dates      |  | 13 Dec          | 24 Jan<br>7 Mar        | 10 Apr<br>Jun             | 6<br>25 July<br>12 Sep  | 24 Oct<br>12 Dec       |
|                            | Rates      | -0.40  | unch (-0.40)    | unch (-0.40)           | unch (-0.40)              | +0.15 (-0.25)           | unch (-0.25)           |
| <b>Japan - BoJ</b>         | Dates      |  | 19-20 Dec       | 22-23 Jan<br>14-15 Mar | 24-25 Apr<br>19-20 Jun    | 29-30 Jul<br>18-19 Sep  | 30-31 Oct<br>18-19 Dec |
|                            | Rates / QE | -0.1/¥42tn   | unch/taper      | net QQE ¥40tn          | unch/taper                | unch/taper              | net QQE ¥30tn          |
| <b>UK - BoE</b>            | Dates      |  | 20 Dec          | 7 Feb<br>21 Mar        | 2 May<br>20 Jun           | 1 Aug<br>19 Sep         | 7 Nov<br>19 Dec        |
|                            | Rates      | 0.75   | unch (0.75%)    | unch (0.75%)           | +0.25% (1.00%)            | unch (1.00%)            | +0.25% (1.25%)         |

Source: Datastream, AXA IM R&IS calculations - As of 23 November 2018)

# Calendar of 2019 events

| 2019      | Date      | Event   |
|-----------|-----------|---|
| January   | 1 Jan     | US 25% Tariffs on \$200bn of Chinese imports  |
|           | 23 Jan    | BoJ Meeting                                   |
|           | 24 Jan    | ECB meeting                                   |
|           | 22-25 Jan | World Economic Forum                          |
|           | 30 Jan    | FOMC meeting                                  |
| February  | 7 Feb     | BoE meeting                                   |
|           | 17 Feb    | Section 232 investigation into Autos deadline |
|           | February  | Thailand General Election                     |
| March     | 1 Mar     | US Debt Ceiling Lifted                        |
|           | 7 Mar     | ECB Meeting                                   |
|           | 15 Mar    | BoJ Meeting                                   |
|           | 19 Mar    | FOMC meeting                                  |
|           | 21 Mar    | BoE Meeting                                   |
|           | 29 Mar    | Brexit Day                                    |
|           | 31 Mar    | Ukrainian Presidential Elections              |
|           | March     | China National Congress                       |
| April     | 10 Apr    | ECB Meeting                                   |
|           | 12-14 Apr | IMF/World Bank meetings                       |
|           | 17 Apr    | Indonesia General Election                    |
|           | 25 Apr    | BoJ Meeting                                   |
|           | April/May | Indian General Election                       |
| May       | 1 May     | FOMC Meeting                                  |
|           | 2 May     | BoE Meeting                                   |
|           | 26 May    | EU & Belgium Elections                        |
| June      | 6 Jun     | ECB Meeting                                   |
|           | 19 Jun    | FOMC Meeting                                  |
|           | 20 Jun    | BoJ & BoE Meeting                             |
| July      | 25 Jul    | ECB Meeting                                   |
|           | 30 Jul    | BoJ Meeting                                   |
|           | 31 Jul    | FOMC Meeting                                  |
| August    | 1 Aug     | BoE Meeting                                   |
|           | August    | US Debt Ceiling lift expected to bite         |
| September | 12 Sep    | ECB Meeting                                   |
|           | 13 Sep    | End of US Fiscal year                         |
|           | 18 Sep    | FOMC Meeting                                  |
|           | 19 Sep    | BoJ & BoE Meeting                             |
| October   | 20 Oct    | Swiss Federal Election                        |
|           | 21 Oct    | Canadian Federal Election                     |
|           | 24 Oct    | ECB Meeting                                   |
|           | 27 Oct    | Argentine General Election                    |
|           | 30 Oct    | FOMC Meeting                                  |
|           | 31 Oct    | BoJ Meeting                                   |
| November  | 7 Nov     | BoE Meeting                                   |
| December  | 11 Dec    | FOMC Meeting                                  |
|           | 12 Dec    | ECB Meeting                                   |
|           | 19 Dec    | BoJ & BoE Meeting                             |

# Abbreviation glossary

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|           |  |       |   |
|-----------|--|-------|---|
| 1Q18      | first quarter of 2018  | ISM   | Institute of Supply Management                        |
| 1H18      | first half of 2018   | JGB   | Japanese Government Bonds                             |
| [Lhs]     | left hand scale (graph)                                      | £     | Pound Sterling  |
| [Rhs]     | right hand scale (graph)                                     | LatAm | Latin America   |
| a.r.      | annualised rate  | LBO   | Leveraged buy-out                                     |
| BAML      | Bank of America Merrill Lynch                                | LTRO  | Long Term Refinancing Operation                       |
| BEA       | US Bureau of Economic Analysis                               | MBS   | Mortgage-backed security                              |
| BIS       | Bank for International Settlements                           | METI  | Japan's Ministry of Economic Trade and Industry       |
| BLS       | US Bureau of Labor Statistics                                | mom   | month on month  |
| bn        | billion  | MRO   | Main Refinancing Operation                            |
| BoE       | Bank of England  | n.s/a | non-seasonally adjusted                               |
| BoJ       | Bank of Japan  | NAFTA | North American Free Trade Agreement                   |
| bp(s)     | basis point(s)   | NBER  | National Bureau of Economic Research                  |
| CBO       | Congressional Budget Office                                  | NPL   | non-performing loans                                  |
| CEE       | Central and Eastern Europe                                   | NFIB  | National Federation of Independent Business           |
| CEEMEA    | Central and Eastern Europe/Middle East/Africa                | OECD  | Organisation for Economic Cooperation and Development |
| CPI       | Consumer price index   | OIS   | Overnight indexed swap                                |
| DM        | Developed market   | OMT   | Outright Monetary Transactions                        |
| EBA       | European Banking Authority                                   | P/B   | price-to-book ratio                                   |
| EC        | European Commission  | P/E   | price/earnings  |
| ECB       | European Central Bank  | PBoC  | People Bank of China                                  |
| EM(s)     | Emerging market(s)   | PCE   | personal consumption expenses                         |
| EMU       | European Monetary Union                                      | PEG   | price/earnings to growth                              |
| EPFR      | Emerging Portfolio Fund Research, Inc.                       | PMI   | Purchasing Manager Index                              |
| EPS       | Earnings per share   | pp    | percentage point                                      |
| ERP       | Equity risk premium  | PPI   | Producer price index                                  |
| ESM       | European Stability Mechanism                                 | PPP   | purchasing power parity                               |
| ETF       | Exchange-Traded fund   | QE    | Quantitative easing                                   |
| EU        | European Union   | QQE   | Quantitative and qualitative easing                   |
| €         | Euro   | qoq   | quarter on quarter                                    |
| Fed       | US Federal Reserve   | REER  | Real Effective Exchange Rate                          |
| FFR       | Fed fund rate  | RMB   | renminbi chinois (yuan)                               |
| FOMC      | Federal Open Market Committee                                | RRR   | Required rate of return                               |
| FTA       | Free Trade Agreement   | s/a   | seasonally adjusted                                   |
| FY        | Fiscal Year  | SMEs  | Small and medium size enterprises                     |
| GBP       | Pound Sterling   | SMP   | Securities Markets Programme                          |
| GDP       | Gross Domestic Product                                       | SWF   | Sovereign Wealth fund                                 |
| GFC       | Global Financial Crisis                                      | TFP   | total factor productivity                             |
| HKD       | Hong Kong dollar   | TLTRO | Targeted Longer Term Refinancing Operation            |
| HP filter | Hodrick-Prescott filter                                      | tn    | trillion  |
| HY        | High Yield   | UN    | United Nations  |
| ICT       | information and communications technology                    | USD   | US dollar   |
| IG        | Investment Grade   | US\$  | US dollar   |
| IIF       | Institute of International Finance                           | ¥     | Yen   |
| INSEE     | French National Institute of Statistics and Economic Studies | yoy   | year on year  |
| IMF       | International Monetary Fund                                  | ytd   | year to date  |

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