US slowdown to dodge recession

Monthly Investment Strategy

Keep Calm: the US should dodge a recession in the next 12 months

Mindful of the sharp tightening of financial conditions since the publication of our 2019 Outlook[1], we have updated our probabilistic model of US recessions. Clearly, our outlook for the US economy, which was below consensus back in November, was a herald of subsequent market fears. Since the relationship between the recession risk and the market sell-off goes both ways (with our assessment of a causal, rather than casual, link between the UST yield curve inversion and economic recessions[2]), the question was whether market events had overtaken the economic outlook and threatened an even sharper slowdown in activity[3].

Good news: while we estimate that the probability of recession has been rising, it remains below critical thresholds, confirming our assessment that we are moving closer to the end of the cycle. However, our models are not signalling a sharp downturn in the next twelve months. That said, we do expect banks to tighten their lending conditions for households, small and large firms, which we see as the key driver of the US economic slowdown this year and next. As a result, we have revised our outlook for US GDP growth slightly lower to 2.2% for 2019 (from 2.3%). This is even further below the 2.5% consensus, but still, we argue, above the US potential growth rate.

Key points

- We downgrade modestly our US growth forecast to 2.2% in 2019 and still do not see a recession over the next 12 months
- We also reduce our Eurozone growth forecast to 1.2% in 2019, with a challenging external backdrop (read China slowdown) risking to spill over to domestic demand
- The impact of the Chinese fiscal and monetary stimulus therefore becomes of paramount importance
- We maintain our limited risk appetite, upgrade Euro IG credit to neutral and emerging debt to overweight

Interestingly, the transmission of this deterioration, from financial conditions to the real economy through the banking system and broader credit conditions, will take a substantial period (several quarters and up to a full year) before it is reflected in the most surveyed economic and market variables. Even a forward-looking indicator like the ISM business survey has historically lagged our recession model by around six months.

Our analyses and forecasts indicate that this reassuring message from the US economy can be extended globally. First, the Eurozone has been slowing dramatically since early 2018 and we expect Italy to fall back into technical recession, while Germany looks set to only narrowly avoid one. But the magnitude of the recent macroeconomic disappointment has been exacerbated by a collection of one-offs: changes to German auto emission standards, Italian budget concerns, the French *gilet jaunes* disruption… We do expect a modest, upward normalisation in sequential growth ahead. Second, the monthly dataflow from China has been worryingly soft, with trade, for example, free-falling. Here again, we expect data to get worse before they

[1] AXA IM Research, "Macroeconomic Outlook 2019: as QE ends, will the global cycle turn?", November 2018
[2] Page D., Venizelos G. and Savage J., "Is the yield curve pointing to a recession?", October 2018
[3] Page D., "US to avoid recession, for now", January 2019

turn better… but the Chinese authorities have already begun to deploy the available arsenal of stimulatory measures, including some monetary easing and a greater boost from fiscal policy, which already appears to have arrested the sharp deceleration in infrastructure spending, but will likely take longer (we estimate until at least the second quarter) to show more obvious signs of traction in the broader economy. "Stability" was a clear key word at the Central Economic Work Conference held at the end of December and we expect Chinese authorities to monitor activity closely to achieve this end. Altogether, we have edged our growth forecasts only slightly lower for the US (2.2%), Eurozone (1.2%) and China (6.1%) for this year. However, we note other forecasters, including the latest International Monetary Fund global forecasts, are moving more quickly towards our view.

But please don't Carry On with political procrastination

And still, the combination of a challenging market and macro environment (the ebbing of the tide of global liquidity as the cyclical expansion likely nears its end) with a high level of political procrastination leaves us with an unsettling feeling of *déja vu*.

For example, signs of progress and encouraging high-level meetings have created hopes of an appeasement in the US-China trade war. Still, if no proactive decision is made, the 10% tariffs on 250bnUS$-worth of US imports from China will almost automatically turn into a more harmful 25% on 1 March. The extreme polarisation of US politics has also lead to the longest, and still ongoing, partial government shutdown in US history. True, the economic impact remains muted (we estimate it will have an annualised impact of about 0.2pp in the first quarter to date) as 75% of government is still funded. But this only serves to allow the shutdown to continue for longer!

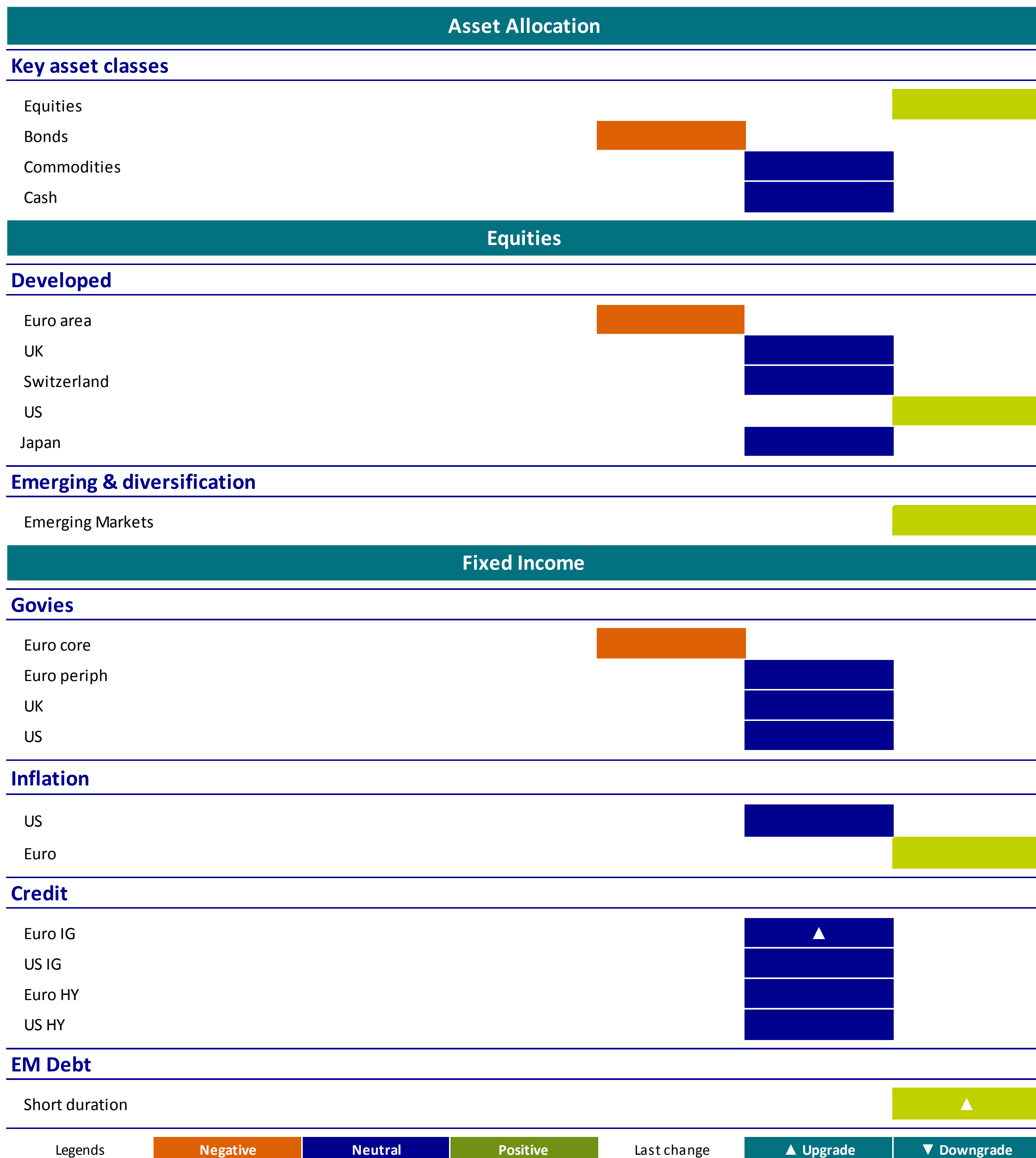
But the most emblematic example comes from the UK where the Brexit process seems trapped in version of the film Groundhog Day starring an intransigent UK Prime Minister Theresa May instead of (a young) Bill Murray. Worried that a December Parliamentary vote on the 558-page Withdrawal Agreement (also known as "the deal") would see a heavy defeat, May postponed the vote to January in the hope of rallying extra support for it. Despite the additional time, she lost by an unprecedented margin of 230 votes. With a Parliamentary amendment forcing the government to suggest a plan B only three days later and with Labour leader Jeremy Corbyn refusing to engage in cross-party discussions, the UK Parliament could end up voting on what is effectively the same deal - as if the previous vote and subsequent vote of no-confidence had not taken place! Interestingly, most political analysts and economists we met to hopefully challenge our view (including the impressive Lord William Hague) agreed with our judgement that the probability of the most adverse outcome occurring (*id est* exit without any deal on 29 March) was somewhere between 10 and 20%, with our estimate towards the higher end of this interval. Yet here again, if no proactive decision is made, a no deal Brexit is the default option, the highly disruptive consequences of which cannot be robustly estimated as no prior event even vaguely resembles such an outcome.

Asset allocation: positive but limited risk appetite, back to neutral on Euro IG credit

In this context, we maintain our reduced risk appetite but still remain overweight equities in the US and emerging markets. Valuations are no longer a headwind in the former and even a potential (medium-term) tailwind for the latter. More importantly, our carefully constructive macro outlook is consistent with modestly positive returns backed by earnings and despite our expectations of further de-rating in the price/earnings ratio. The main change this month comes from bringing our exposure to Euro IG credit back to neutral with the past spread widening offering more reasonable valuations. We also upgrade emerging debt to overweight on the back of a more dovish Fed, less pressure from the US dollar and, here also, cheap valuations.

Download the full slide deck of our January Investment Strategy

Recommended asset allocation



Source: AXA IM Research – As of day month year

Macro forecast summary

Real GDP growth (%)	2018	2019*		2020*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**3.7**	**3.5**		**3.5**	
Advanced economies	**2.3**	**1.9**		**1.5**	
US	**2.9**	**2.2**	*2.6*	**1.4**	*1.9*
Euro area	**1.8**	**1.2**	*1.7*	**1.2**	*1.5*
Germany	**1.5**	**1.1**	*1.7*	**1.3**	*1.5*
France	**1.5**	**1.2**	*1.7*	**1.3**	*1.6*
Italy	**0.9**	**0.4**	*1.0*	**0.5**	*0.9*
Spain	**2.5**	**2.1**	*2.3*	**1.7**	*1.9*
Japan	**0.7**	**0.9**	*1.1*	**0.5**	*0.6*
UK	**1.3**	**1.5**	*1.5*	**1.6**	*1.6*
Switzerland	**3.0**	**1.7**	*1.7*	**1.5**	*1.7*
Emerging economies	**4.6**	**4.5**		**4.7**	
Asia	**6.3**	**6.1**		**6.1**	
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	**6.0**	**6.1**		**6.1**	
LatAm	**1.2**	**2.0**		**2.2**	
Brazil	**1.5**	**2.5**	*2.3*	**2.5**	*2.6*
Mexico	**2.2**	**2.2**	*2.1*	**2.0**	*2.4*
EM Europe	**3.2**	**1.6**		**2.4**	
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*
Other EMs	**2.8**	**2.9**		**3.4**	

Source: Consensus Economics, IMF and AXA IM R&IS calculations – As of 22 January 2019

CPI Inflation (%)	2018	2019*		2020*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**1.9**	**1.5**		**1.9**	
US	2.4	2.2	*2.3*	2.8	*2.2*
Euro area	1.7	1.2	*1.7*	1.4	*1.7*
Japan	1.0	0.7	*1.9*	0.5	*1.7*
UK	2.5	1.9	*1.7*	2.1	*1.5*
Switzerland	1.0	0.7	*1.4*	1.0	*1.3*
Other DMs	1.7	0.8		1.8	

Source: Bloomberg, IMF and AXA IM R&IS calculations – As of 22 January 2019

These projections are not necessarily a reliable indicators of future results

Forecast summary

		Current	Jan.-19	Feb.-19	Mar.-19	Apr. - 19	May -19	Jun. -19
United States - Fed	Date	1.75-2.00	30th	--	20th	--	1st	18th
	Rates (bp)		unch	--	+25bps	--	unch	?
Euro area - ECB	Date	-0.4 Depo and 0.0 Refinancing	24th	--	7th	10th	--	
	Rates (bp) / QE		unch	--	unch	unch	--	
Japan - BoJ	Date	-0.1 / 80tn (JGBs)	22nd	--	14th	25th	--	
	Rates (bp) / QE		unch	--	unch	unch	--	
UK - BoE	Date	0.50	--	7th	21st	--	2nd	
	Rates (bp)		--	unch	unch	--	+25bps	

Source: Datastream, AXA IM R&IS calculations - As of 22 January 2019

Asset classes	Reference	Current	Target		Total Returns	
			3 months	12 months	3M	12M
Rates (%)						
US 10Y Treasury		2.78	3.00	3.00	0.6%	0.6%
German 10Y Bund		0.26	0.35	0.40	-0.7%	-1.2%
British 10Y Gilt		1.32	1.50	1.70	-0.2%	-2.1%
Japanese 10Y JGB		0.01	0.05	0.05	-0.5%	-0.5%
Credit (bps)						
USD Investment Grade	BofA C0A0	146	135	160	1.7%	3.1%
EUR Investment Grade	BofA ER00	151	130	135	1.3%	2.0%
USD High Yield	BofA H0A0	427	400	480	2.7%	4.7%
EUR High Yield	BofA HE00	459	410	440	2.9%	5.0%
Equities						
US	MSCI US	2,543	2,600	2,650	1.6%	6.4%
Eurozone	MSCI Euro	202	203	205	1.4%	5.6%
Japan	MSCI Japan	940	940	950	0.9%	3.6%
Emerging markets	MSCI EM	1,018	1,030	1,075	2.2%	8.7%

Source: Bloomberg, AXA IM Research - As of 21 January 2019

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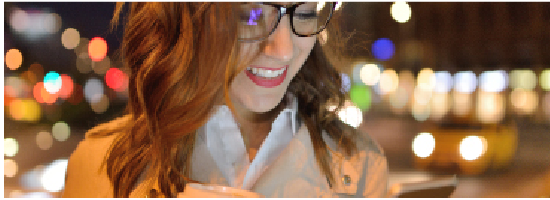
Our Research is available on line:



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