Perseverance or Denial? We stick to our forecasts

Global macro monthly

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Key points

- While macro data have been scant and mixed, the US Federal Reserve surprised with a very dovish tone
- Eurozone GDP ended 2018 in line with our expectations, with Italy in recession but France and Spain showing upside resilience. We see further slowdown ahead for the region
- The Brexit saga's latest episode provided little clarity, although the clock keeps ticking
- Beyond the year-end technical rebound, Japanese growth should remain low
- China closed 2018 at 6.4% growth, the weakest in almost a decade but bank loans are accelerating encouragingly
- Similarly, indicators in other emerging markets pointed to a potential further economic slowdown ahead

Our January Investment Strategy[1] published last week generated multiple comments in a welcome wave of interest for the current macroeconomic backdrop. As we wrote back then, the past two months have seen the consensus forecast move closer to the one we published in November with our 2019 Outlook[2], with then (and still now) sub-consensus GDP growth forecasts for the US, the Eurozone and China.

Unsurprisingly, this generalised downgrade of macroeconomic forecasts has been accompanied with a shift in worries, from whether we were exaggerating the slowdown to the possibility that recession is already upon us.

In this Global Macro Monthly, we review our macroeconomic analyses for each region and update our growth forecasts incorporating the latest data, from GDP figures for the final quarter of 2018 to business surveys and monthly activity indicators. Altogether, we end up rather comfortable with our previous numbers: the US slowing to 2.2% this year (still above potential growth) and not hitting recession over the next twelve months, Eurozone growth further down to 1.2% (after 1.8% in 2018) and China slowing to 6.1% (after 6.5%).

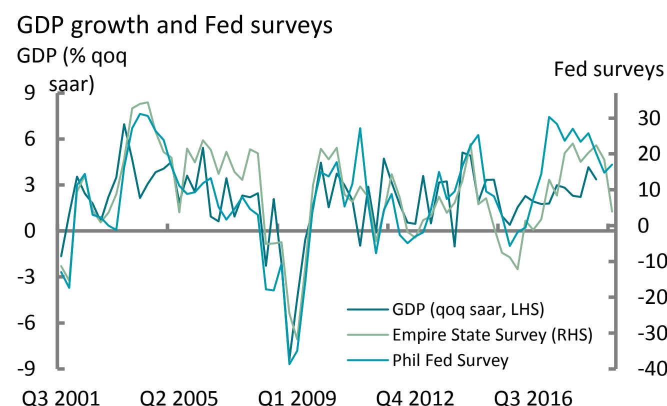
US data doubts send Fed on dovish path

Rarely has a month delivered so little economic news about the US. Yet this reflected the closure of many of the departments that provide the economic news in a record partial government shutdown. In total, the government was shut down for 35 days. However, with only 25% of government spending affected, the Congressional Budget Office estimated this would reduce growth in the fourth quarter of 2018 by 0.1ppt (annualised) and 0.2ppt in the first three months of 2019, which would largely be made up in subsequent quarters – in line with our forecasts. The shutdown occupied most of US President Donald Trump's time and hence we have seen little progress on trade talks,

[1] "US slowdown to dodge recession", AXA IM Research, 25 Jan 2019
[2] "Macroeconomic Outlook 2019: As QE ends, will the global cycle turn?", AXA IM Research, 27 Nov 2018

which resumed this week with Chinese Vice Premier Liu He in Washington for negotiations.

Exhibit 1: Scant US data has been mixed



Source: Federal Reserve Bank of Philadelphia and New York and AXA IM R&IS calculations

The data that has been issued has been mixed. Labour market data remain strong, payrolls rose by 312,000 in December, January's ADP report was a firm 213,000 and jobless claims hit a level last seen in the 1960s. Business surveys have, in the main, been weak. Several, including the ISM[3], Empire State survey and Chicago PMI[4], fell to two -year lows, however, the Philly Fed survey bounced off recent lows (Exhibit 1), the NFIB[5] small business survey remains around the same level it has been at since 2017 and the ISM non-manufacturing index has softened, but remains elevated. Housing has been more troubling, with existing homes sales falling below five million for the first time since 2015 and pending home sales suggesting more weakness ahead. However, new home sales rose by 17% on the month in November, to take the level back to the 2017/18 highs. Meanwhile consumer confidence measures have eased – but look likely associated with the government shutdown.

Mixed data and a lack of official figures have left markets nervous. However, financial conditions have eased markedly in recent weeks, unwinding half of the tightening seen in the fourth quarter. Recession models based on financial conditions suggest that the US has been close to thresholds that have historically tended to signal a downturn in the coming 12-months – but importantly fell short of these levels. We continue to warn of a more material slowdown in economic activity, driven by a fading fiscal stimulus and tighter financial conditions. We maintain our outlook for GDP growth to slow to 2.2% in 2019 and 1.4% in 2020, from an expected 2.9% in 2018. Consensus forecasts currently pencil in growth of 2.5% and 1.9%.

The Federal Reserve (Fed) has switched tack in 2019. Fed Chair Jerome Powell started the month describing a more "patient" outlook. The Fed left policy unchanged in January, but included "patient" language in the statement. At the ensuing press conference, he presented a dovish outlook suggesting that the Fed now had "no prior" with regards to future rate hikes, removing guidance for "some further gradual increases" in the months ahead. Many have accordingly reduced their outlook for rate hikes to just one or none this year. However, we cautiously still consider two hikes likely. We consider a further easing in financial conditions likely – now led by the Fed – and expect growth to continue above trend. With wage growth firmer and productivity growth likely to soften, we see underlying inflation trending higher, beneath the oil-driven softer headline. For now, we continue to suggest that the Fed will need to tighten policy further from here, but we recognise the risk that our forecast of a June hike may need to be deferred.

The Fed also announced that it would maintain an "abundant reserve" system for its monetary operations. We have long argued this was likely, as it is the only system consistent with future quantitative easing (QE). Having made this decision, Powell stated that the Fed was deliberating the next steps for balance sheet policy. He gave no details and suggested more would be available over the coming meetings. However, with markets fretting over the scale of unwind, some pressures in the short-end of the market and our own assessment that the unwind was having some impact on tightening monetary policy, we believe the Fed could soon announce an earlier-than-expected slowing of this process.

Eurozone: a weak end to 2018, a soft start into 2019

As expected the euro area ended 2018 on a weak note, growing by 0.2% quarter on quarter (qoq), a similar pace to that seen in the third quarter of 2018 but a deceleration from the 0.4%qoq growth recorded in the first half of 2018. This is consistent with an annual growth rate of 1.8% in 2018, down from 2.5% in 2017. Eurostat does not provide GDP expenditure details at this stage (they will be available on 7 March), but we estimate domestic demand contributed to growth, although less so than in the third quarter of the year (+0.3pp after +0.4pp in the third quarter 2018), while net trade was no longer a drag.

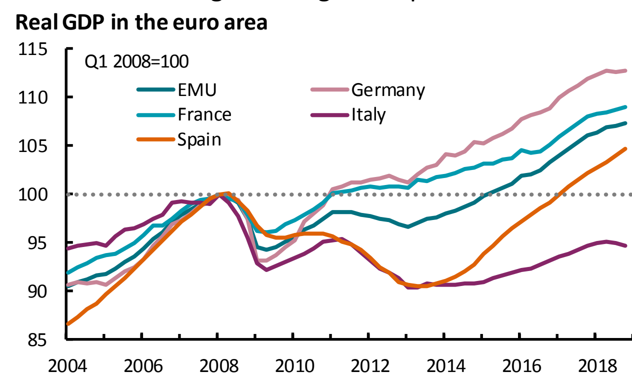
This profile is underpinned by details from the French, Italian and Spanish statistical offices, which all pointed to some positive contribution from trade, on the back of a rebound in exports and some moderation in import growth- the latter being consistent with slightly lower domestic demand. German trade data (The fourth quarter GDP estimate will only be released on 14 February) suggest this also holds true for Germany. On the domestic demand front, we believe France and Italy are to blame for the slight euro area slowdown, yet for likely different causes. In France, GDP

[3] Institute of Supply Management
[4] Purchasing Manager Index
[5] National Federation for Independent Business

surprised to the upside at 0.3%qoq, a similar pace to the one seen in the third quarter of the year. Domestic demand weakness was primarily driven by lower private consumption in particular of goods related to the disruption caused by the Yellow Vests movement. Investment slowed as well, but INSEE signalled it was mainly a correction from elevated levels seen in a third quarter boosted by businesses' purchases of cars ahead of the implementation of the new emission certification system (WLTP) in September. The picture is different in Italy, which entered into recession in final three months of 2018. GDP surprised to the downside, shrinking by 0.2%qoq, and we believe that, as in the third quarter of 2018, investment was responsible for the brunt of the downward adjustment. Deteriorating business surveys, weakening credit demand and tighter credit standards for investments as shown in the fourth quarter European Central Bank (ECB) Bank Lending survey point to limited appetite for investment in a context of still elevated political uncertainty. In parallel one euro area country seems to remain immune to decelerating global growth: the Spanish economy grew more than expected by 0.7%qoq. Dynamic labour market, rising wages and supportive fiscal measures are key factors behind this resilience. We expect Spanish growth to continue to outperform its euro area peers in 2019, although slowing to 2.2% year on year.

More generally, euro area activity indicators have started the year on a soft footing. January Flash PMIs fell to 50.7, the lowest level since mid-2013. The European Commission survey sent a similar message, down to a 26-month low. Consumer sentiment was a bit more positive, as it recovered some of the ground lost in December: this was primarily due to a rebound in French consumer confidence, after the Yellow vest movement pushed it sharply lower in December. Overall, soft indicators suggest that growth should at best stabilise in the first quarter of 2019, attaching slight downside risks to our 0.3%qoq euro area GDP forecast (Exhibit 2).

Exhibit 2: Heterogeneous growth profiles across EMU



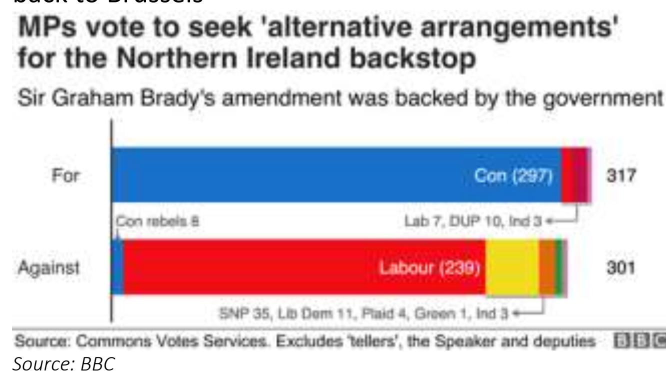
Source: Datastream and AXA IM R&IS calculations

ECB President Mario Draghi fully acknowledged the weakness of the data flow and moved the balance of risks to the downside at the January ECB meeting. He emphasized that the ECB Governing Council was still in an "assessment mode" trying to gauge the likelihood that the current slowdown persists. We continue to believe that a recession is a low probability event as domestic demand should remain resilient (rising purchasing power and fiscal stimulus). Yet we highlight that there are plenty of downside risks to our below consensus 2019 euro area GDP forecast of 1.2% (Brexit, trade war, spill-overs to investment). We expect Draghi to revise the ECB's growth and inflation projections lower at its March meeting, and to announce an extension of its targeted longer-term refinancing operations T-LTROs[6], although the latter could slip to the April meeting as the ECB needs time to calibrate.

UK struggles to deliver Brexit on time

The UK started 2019, where it had left off in 2018 – trying to deliver Brexit. The Parliamentary vote on the negotiated Brexit deal, shelved in December, was tabled in January. The result was a defeat of historic proportions for the government, which lost by 230 votes. The loss was immediately followed by a vote of no confidence in the May government, a vote that could have resulted in an early general election. However, May's government voted together, defeating the motion by 21 votes, broadly along party lines (Exhibit 3).

Exhibit 3: Arcane Parliamentary process sends May back to Brussels



Source: BBC

The Prime Minister was required to present an alternative Brexit plan within days of the vote. However, May doggedly stuck to the negotiated deal, until a further Parliamentary vote required her to return to the EU to renegotiate the Irish backstop in favour of "alternate arrangements". We see scant chance of success and European Commission Head Jean-Claude Juncker has warned of an increased chance of a "no deal" Brexit in light of these developments.

Yet Parliament also voted (in non-binding fashion) to avoid a "no deal" Brexit and narrowly avoided voting to delay Brexit. The next important date is 14 February. At that stage, we see the likelihood of Parliament setting a formal timetable to ask

[6] Targeted Longer Term Refinancing Operation

for an extension of Article 50 to avoid a "no deal" Brexit at the end of March. And expect it to follow with a process to allow for a cross-party motion to deliver a consensus Brexit. While political uncertainty is high, we think such an outcome could be delivered by the middle of the year. However, in the midst of arcane political process, the risks of the default "no deal" outcome on 29 March are beginning to edge higher again, while a longer delay and second referendum also remain possible.

Brexit is taking an increased toll on current economic activity. Business investment remains subdued, but consumer confidence has retreated to a seven-year low and the housing market is grinding slower. Fourth quarter GDP growth looks set to be subdued, not helped by a sharp drop in industrial activity in November, reflected across broader Europe. We forecast GDP growth for the fourth quarter of 2018 at 0.25%qoq, which would see annual growth up 1.3% for the year.

Looking ahead, forecasts for growth will depend on the exact type and timing of Brexit. We exclude a "no deal", chaotic Brexit and are hence derive probability-weighted GDP forecasts of 1.6% for 2019 and 1.7% for 2020. A transition-based Brexit should deliver a meaningful boost to business investment as uncertainty recedes. This, coupled with firmer household and government spending, should lift growth despite softening global activity.

The Bank of England (BoE) looks set to deliver a relatively hawkish message at February's Inflation Report meeting, despite leaving policy unchanged amidst Brexit uncertainty. A tight labour market is driving wage growth faster and unit labour cost growth has been further lifted by slowing productivity growth. All point to rising domestically-generated inflation pressure. We have long forecast that the BoE will choose not to make any decisions in the first quarter's meetings due to Brexit uncertainty, but a delay in the process could see uncertainty spill into the second quarter. For now, we think the BoE will tighten policy in May despite the uncertainty and forecast another hike in November and one more next year (probably May). However, if the process remains as confused as it is now, the BoE may be forced to defer the hike for another quarter – it will likely be able to point to subdued growth and inflation dropping below target in the first three months of 2019 to justify any further pause.

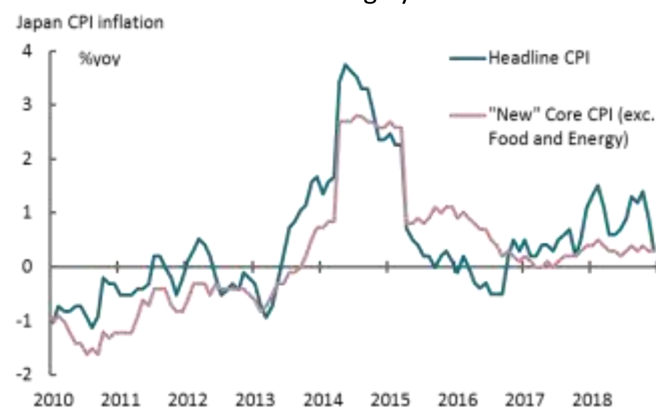
Japan: External environment weighing

In Japan, the first estimation of fourth quarter GDP will be released on 14 February and we expect a substantial rebound (up 2%qoq annualised), after the negative surprise in the third quarter, impacted by natural disasters. For 2019, the first releases have been quite disappointing. Flash PMI numbers have strongly declined, in line with trade uncertainties and slower demand from the major economies.

However, internal demand is still resilient, even if we should begin to worry about the continuing decline in consumer confidence. For the moment, retail sales growth is stable at 1.3%yoy after 1.4% in the previous month. We have some hopes that the acceleration in real wages – 0.9% year on year (yoy) in November – and the low unemployment rate (2.5%) stimulate consumption in the next months. We always believe growth will be challenged by the evolution of trade uncertainties but also household behaviour before the implementation of the tax hike in October 2019.

On the price front, headline inflation slipped to 0.3%yoy after 0.9% previously, impacted by the drop in oil and food prices (Exhibit 4). With the base effect of oil prices to come, we do not expect headline inflation to rebound in the first semester. "New" core inflation remains low at 0.3% and the only recovery could come from the transmission of wage acceleration into prices.

Exhibit 4: Headline CPI has largely declined



Source: Japanese Statistical Institute and AXA IM R&IS calculations

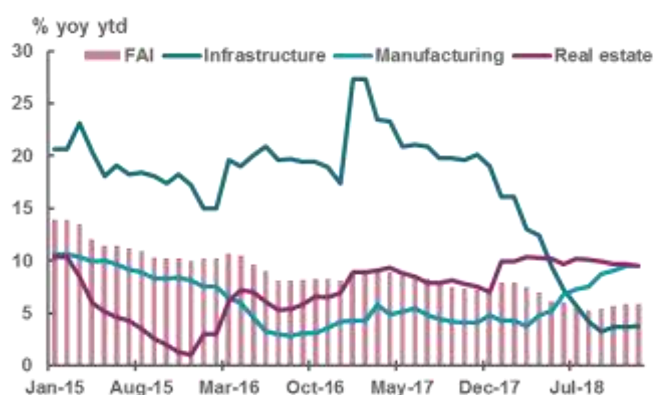
Concerning the last monetary policy meeting, the Bank of Japan (BoJ) has not delivered any changes. The BoJ will maintain its targets for short-and long-term interest rates and leave Exchange-Traded fund (ETF) and other risk asset programs unchanged (including the tolerable band for 10-year yields at plus or minus 20 basis points). The tone adopted by the BoJ since autumn 2018 suggests that further downsizing of its purchase policy is a possibility, even if it seems unlikely in 2019, especially because further policy adjustments should face tighter financial conditions (yen appreciation and equities selling off).

China: Slowdown continues

The Chinese economy ended 2018 on a weak note, but not weak enough for people to worry that growth is falling off a cliff. Fourth quarter GDP growth clocked in at 6.4%, the weakest since the first three months of 2009, but in line with market expectations. The quarterly growth profile, which shows a persistent weakening trend – from 6.8% in the first

quarter to 6.7%, 6.5% and 6.4% in the fourth quarter – is indicative of an economy facing stiffening headwinds. Turning to the latest activity numbers, one may get the feeling that there is light at the end of tunnel. All three key indicators – industrial production, retail sales and fixed asset investment – showed improvement, with monthly growth either stabilising or ticking up from previous readings. But with external demand weakening and US tariffs starting to bite, this strength appears to be home-grown. One case in point is the turnaround in infrastructure investment, which grew by 5.7% in December (on a three-month moving average-basis), up from -4.4% three months ago (Exhibit 5). The early allocation of a RMB 1.39tn quota for local government bond issuance, ahead of the National People's Congress (NPC) approval, should help to keep this momentum going in the months ahead.

Exhibit 5: Recovery in infrastructure investment is well maintained



Source: CEIC and AXA IM R&IS calculations

Aiding this fiscal stimulus are signs that credit may be finally starting to flow to the real economy. The latest credit data shows that bank loans accelerated for the first time in six months. Corporate bond issuance also rebounded last month, along with a narrower decline in shadow banking components, which suggests the recent policy easing might have started to trickle through to the real economy. This is a good start towards unclogging the monetary transmission channel that should enable the abundant liquidity in the financial system to nurture growth in the real sectors.

Looking ahead, despite the tepid December data and the fact that 2018 GDP printed above Beijing's "around 6.5%" growth target, the job of engineering a soft-landing is far from over. Of the major economic headwinds, we anticipate for 2019, those on the external front have barely begun to gain force, and the worst of their economic impact is yet to come. We expect China's export growth to tumble further in the first quarter due to a combination of paybacks to previous export "frontloading", the US tariffs, and a genuine slowdown in global demand.

Overall, we think there are plenty of obstacles lying ahead, and there is no room for complacency. We see more VAT and fee reductions for small and medium-sized companies, along with further boosts to infrastructure and household spending. The People's Bank of China (PBoC) is also becoming more proactive on monetary policy, partly emboldened by the recent receding pressure on the yuan and capital outflows. We expect another two to three reserve requirement ratio (RRR) cuts throughout this year. If a trade deal with the US is struck (which would be good for RMB) and domestic weakness deepens (which calls for a greater policy response), cuts to benchmark interest rates (and other market rates) also cannot be ruled out.

Emerging markets: slowdown on its way

Trade war, currency shocks, tighter global financing conditions have sown the seeds of economic weakness as of early 2018. Industrial production and export momentum faded into H2 2018 and should continue to do so into the first half of 2019. Looking forward, the latest January PMI surveys point to a continued soggy outlook for emerging markets (EM) in Asia. In particular, Korea, Taiwan and Malaysia's indices remain below the waterline for at least two consecutive months. For the region's export barometers, Taiwan's PMI registered its lowest reading since the third quarter 2015, now at 47.5, Korea's PMIs are also in contraction territory. These reflect a particularly grim picture on the external side, with new export orders deteriorating across the board. Even in Indonesia, the PMI fell below the 50-threshold in January. The survey remained rather flattish in Thailand and India, attributing to stronger domestic demand. This confirms our view that the domestic engine could be a key offset to external weakness for EM Asia this year. EM Europe showed mixed survey results, Turkey unchanged from December levels (44.2), a bit better in Poland and slightly worse in Russia and the Czech Republic, both below the 50-watermark. Russia PMI continued to weaken for the third consecutive month, albeit at 50.9. In Latin America, there is a better general mood. Brazil survey shows resilience for three months now, with the index hovering at 52.7, in a post-electoral environment buoyed with hopes of structural reform being soon pushed through the Congress. Mexico manufacturing PMI picked up in January at 50.9 after pointing to contraction for two months; new orders index is also rebounding.

Pressure on inflation from past FX weakness and oil price strength already fade while growth moderation may require less monetary tightening this year. Inflation rate is already weaker across the board, in some cases even below the lower band of the central banks' target rates. Furthermore, in a context of less tight global financial conditions as of late, emerging markets and currencies fared better and pressure was off most central banks across EM which remained on hold for the last monetary policy meetings.

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