ECONOMIC UPDATE
INVESTMENT CLOCK

Dark clouds, but no storm

Issue #16, February 2019

ROYAL LONDON
ASSET MANAGEMENT

Multi asset views from RLAM

Royal London Asset Management manages £113.9 billion in life insurance, pensions and third party funds*.

We have six Global Multi Asset Portfolios (GMAPs) across the risk return spectrum with a full tactical asset allocation overlay.

*As at 31/12/2018

This month's contributor:
Melanie Baker
Senior Economist

US: The combination of slower global growth, tighter financial conditions in December and the government shutdown means that the economy will likely perform worse than previously expected in Q1. Slower growth still seems likely, but with more of that coming through in early 2019 than previously assumed.

China: Policymakers are stimulating the economy. We'd expect to see more impact from that in coming months. US-China trade relations are also less of a worry now than they were late last year.

Eurozone: Upside potential remains limited by exposure to external risks and political worries, but the second half of 2019 should see some improvement.

UK: The path ahead remains very Brexit dependent. Uncertainty will linger. With the global economy having slowed, we expect fewer and later Bank of England (BoE) rate rises.

Global growth has been losing momentum, with the turn of the year weaker than previously expected. Damage to the UK economy from prolonged Brexit uncertainty is starting to stack up. Recession risk has risen. However, we remain cautious rather than pessimistic. Some downside risks have eased: financial conditions have loosened; China continues to stimulate its economy and the US has stopped raising interest rates (for a while at least). That bodes better for the second half of 2019. Investors now face a waiting game for data improvements.

Summary

2018 global economic indigestion: The global economy had a lot to digest in 2018 including higher oil prices, rate rises, the threat of all out trade war, a de-risking drive in China, political issues in Europe (Brexit, Italy) and US government shutdown topping things off in December. Arguably, weak data so far this year are a symptom of continued indigestion from these factors. Medicine has been administered (e.g. lower oil prices and policy stimulus), but will take time to work.

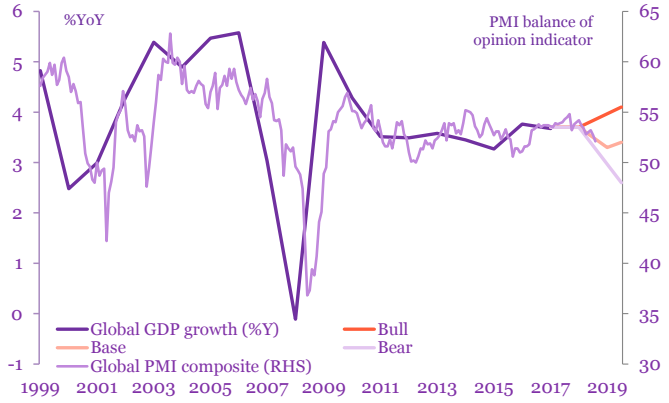
2019 brings dark clouds, but no storm: Global growth likely cools a bit further and we revise down our expectations for 2019 GDP growth: 1) Recent data has been weaker than expected; 2) the impact on growth of earlier US fiscal stimulus will fade; and 3) 2018 monetary tightening acts with a lag. However, we no longer expect another round of US-China tariff hikes, the threat from tighter financial conditions has faded, China continues to stimulate and the more cautious central bank stance all help growth prospects for later this year.

Policymaker 'put' has limits, but interest rates paused: Expectations of more underlying domestic inflationary pressure means we don't expect rate cuts to pick up, but we expect rates to rise less and later than we had previously anticipated.

Risk watch list: Surveys indicate that Japan, the UK and the Euro area are already close to stagnating. A US recession within the next 12 months looks plausible (not central case). Trade tensions could easily revive; there is a risk of higher than expected inflation (and therefore interest rates); volatile markets may yet cause problems and we still can't rule out a disruptive 'no deal' Brexit.

Cautious stance: After buying in the sell-off and after the recovery, our multiasset team have taken profits, moving to a more neutral equities position, partly reflecting the uncertain economic environment. See www.investmentclock.co.uk

Chart 1: Global growth – clouds gathered, but not expecting a storm



Source: IMF, IHS Markit, RLAM forecasts

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Economic forecast summary

March 2019 Base Case

Region	2018 GDP growth	2018 CPI end Q4	2018 Policy Rate Q4	2019 GDP growth	2019 CPI end Q4	2019 Policy Rate Q4	2020 GDP growth	2020 CPI end Q4	2020 Policy Rate Q4
US	2.9	2.2	2.5	2.4	1.9	2.75	2.0	2.3	2.75
	(2.9)	(2.3)	(2.5)	(2.5)	(2.0)	(3.00)	(1.9)	(2.1)	(3.00)
China	6.6	2.2	–	6.2	2.3	–	6.2	2.5	–
	(6.6)	(2.0)	–	(6.2)	(2.3)	–	(6.1)	(2.5)	–
UK	1.4	2.3	0.75	1.1	2.0	1.0	1.6	2.2	1.25
	(1.3)	(2.4)	(0.75)	(1.6)	(2.0)	(1.0)	(1.8)	(2.2)	(1.5)
Eurozone	1.8	1.9	0	1	1.4	0.0	1.7	1.9	0.25
	(1.9)	(2.1)	(0.0)	(1.4)	(1.7)	(0.25)	(1.8)	(1.9)	(0.5)
Japan	0.7	0.8	-0.1	0.7	1.6	-0.1	1.1	0.9	-0.1
	(0.9)	(0.9)	(-0.1)	(1.1)	(1.8)	(-0.1)	(1.1)	(0.9)	(-0.1)
Global	3.7	–	–	3.3	–	–	3.5	–	–
	(3.8)	–	–	(3.5)			(3.3)		

Nov 2018 estimates in brackets.

Source: National Statistics offices, RLAM forecasts

Key central bank forecasts

- Fed stays gradual and, after a pause, raises rates another 25bp later this year
- No rate rises until early 2020. European Central Bank (ECB) rate rises proceed very gradually
- BoE raise rates again in H2 2019, assuming a withdrawal deal is agreed, disruption limited and greater visibility in post-Brexit trading arrangements. They then raise rates once every three to four quarters
- People's Bank of China ease further in coming months

Global economic scenarios 2019/20

Upside scenario (20% probability): Productivity powers ahead

- Global growth recovers to 4%+, helped by significant improvements in productivity and the impact of stimulus in 2018/19, especially from China, is more powerful than expected
- Underlying inflation remains subdued as productivity growth dampens domestic inflationary pressure
- Brexit transition is smooth and progress towards a comprehensive trade deal proceeds rapidly, minimising disruption to the UK (and euro area) economy
- Central banks tighten policy gradually, though to higher levels than currently expected

Base case (60%): Global growth (mostly) in post-crisis range

- Global economic growth stabilises a touch below the 3.5% -4% post-crisis range, but is within range by 2020
- UK growth remains below average amid continued uncertainty around the final Brexit outcome and domestic politics, despite a withdrawal deal being ratified
- Inflation pressures build, but not strongly
- Cautious central banks. Fed and BoE hike; ECB, Bank of Japan (BoJ) maintain easy policy. Fed ends balance sheet run-off

Downside scenario (20%): Trade tensions and a disruptive Brexit

- Trade tensions re-escalate, damaging supply chains across the world and hitting business confidence. Brexit is highly disruptive to the UK economy
- Inflationary pressures are higher than expected given tight labour markets, constraining central banks' willingness to ease policy despite slower growth
- Global growth moves beneath the bottom of the post-crisis range (<3%)

Probabilities are subjective and indicative such that we'd broadly see a 20% chance that the economy performs in line with/better than the upside case and a 20% probability that the economy performs in line with/worse than the downside scenario.

Economic outlook

Global economy: lost momentum

Global growth has continued to slow. We don't expect a US recession in 2019, but several major economies look close to stagnation. Global GDP growth looks set to be slower in 2019, but with more of the weakness in the first half of 2019 than we'd expected and we lower our forecasts. Still, policy-makers are responding and financial conditions have improved, leaving the outlook for the second half of 2019 a touch brighter – trade relations and Brexit permitting.

Global growth has continued to slow and more than expected. The Global composite PMI indicator remains above 50.0, but has fallen to levels seen during the last major recession scare in 2016. The slowdown looks broad, though with continued US outperformance (Chart 2). Trade indicators suggest that global export growth has slowed further too (Chart 3). Global GDP growth so far looks set to slow further in Q1, rather than stabilise looking at these indicators.

Global economy suffers from 2018 indigestion: 2017 saw a big pick up in trade, likely partly a reflection of earlier Chinese stimulus, so slowing trade growth is perhaps not surprising. The strong dollar, high oil prices (for most of 2018) and rising interest rates have proved a challenging backdrop for some economies. Worries related to Brexit, Italy and the overhanging threat of all out trade war have kept firms more cautious than they would otherwise be. Some countries have also faced one-off issues that have dampened activity e.g. weather, natural disasters and disruptions in the European autos industry. Then, to top things off in December, we had the US government shutdown. Particularly worrying was the way these factors appeared to lead to a sudden loss of confidence in markets and a sharp tightening in financial conditions. That greatly increased risks to the global outlook by the end of 2018, with the risk of negative feedback loops from tighter financial conditions into the real economy.

This indigestion has further to run, but some recent developments have improved the outlook for H2 2019:

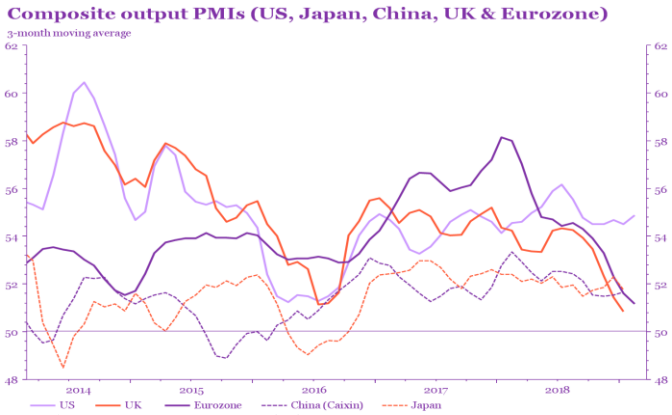
1. Oil prices at lower levels. Though oil prices have risen from their lows, they remain substantially below levels reached by October 2018. This is dragging down headline inflation (Chart 4) – good news for consumer finances.

2. Policymakers have responded. Central banks sound less keen to tighten interest rates, most notably the Fed. These changes in stance have been helped by core inflation which still looks relatively stable (rather than rising in line with higher pay growth). Chinese policymakers have announced more stimulus measures. The Euro area has moved to a more stimulative fiscal stance.

3. Financial conditions have loosened again. Having tightened dramatically in December, markets have been reassured by the Fed's change in tone (and arguably the lack of recessionary data in the US). Financial conditions on some measures are back to being looser than average (Chart 5).

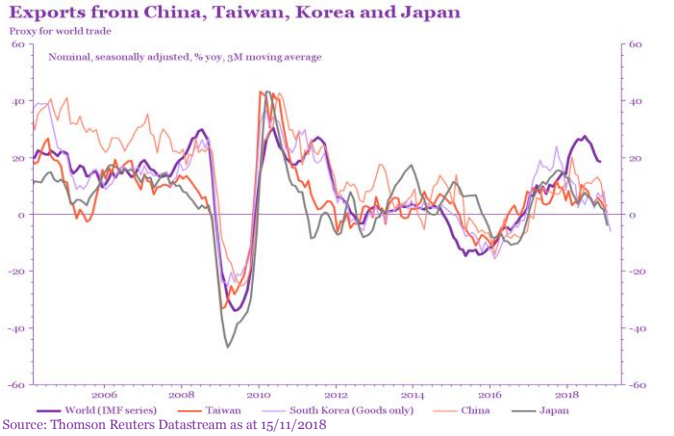
4. Trade truce holding. I remain sceptical on the prospects of a lasting truce and certainly on prospects of a tariff rollback, but the trade truce between the US and China and the EU/Japan and the US has held better than I would have expected while talks continue and a further rise in China-US tariffs is no longer my central case.

Chart 2: Slowdown looks broad



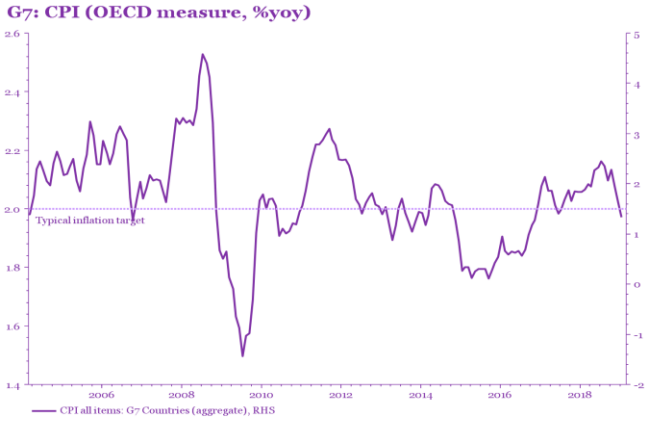
Source: Thomson Reuters Datastream as at 15/02/2019

Chart 3: Slower export growth



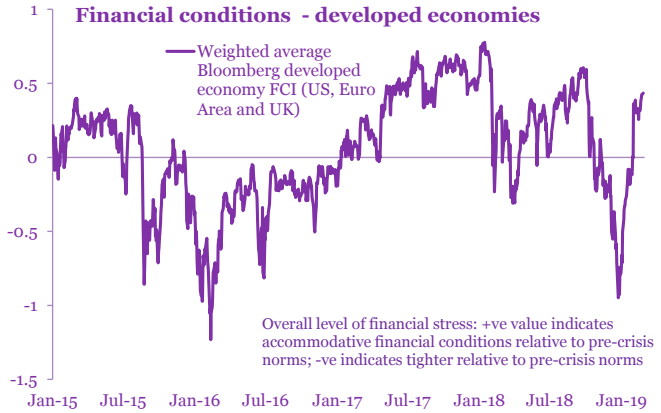
Source: Thomson Reuters Datastream as at 15/11/2018

Chart 4: Marked decline in G7 headline inflation



Source: Thomson Reuters Datastream as at 15/01/2019

Chart 5: Financial conditions have loosened



Source: Bloomberg, RLAM. Series uses Bloomberg FCI indices, with weights based on PPP share of world GDP.

But global growth still likely to be slower in 2019

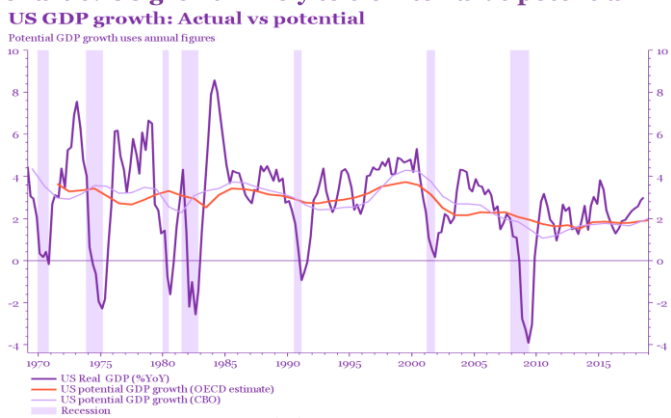
1. Bumping up against 'speed limits': Many economies are low on spare capacity, with labour markets tight. That suggests it will be difficult to maintain above potential rates of growth (without generating significant inflation). The Organisation for Economic Co-operation and Development (OECD), International Monetary Fund (IMF) and Congressional Budget Office (CBO) all put US potential growth at close to 2% (Chart 6). As of Q4 the US economy was still growing above this rate.

2. Lagged effects from earlier tightening: The US may be on hold for now, but monetary policy affects the economy with a lag. The Fed was still hiking in December (chart 7) and the ECB has only just ended Quantitative Easing (QE).

3. The best of the US stimulus impact will soon be behind us and current policies imply a fiscal *tightening* starting in 2020.

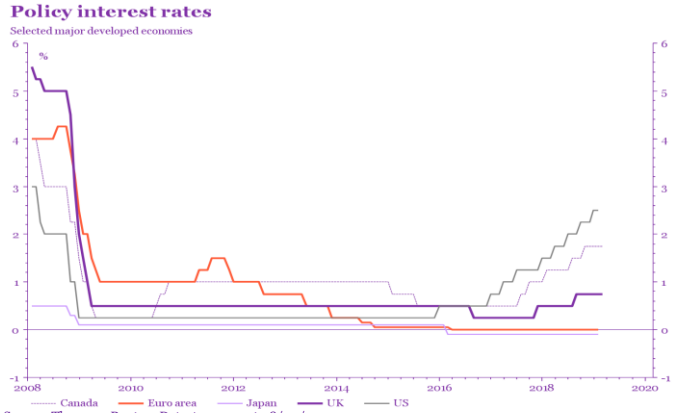
4. Financial conditions prone to tightening: The markets are probably overestimating policymakers' willingness and ability to 'ride to the rescue'. That means scope for disappointment – and periodic returns to tighter financial conditions – remains high. Economic slack is limited and pay growth has risen. For inflation targeting central banks, that implies a higher hurdle for policy reversal (all else equal). Appetite for major fiscal stimulus or to stimulate lending is likely to remain somewhat constrained by already high debt levels (public sector in Europe/Japan, corporate in China).

Chart 6: US growth likely to slow towards potential



Source: Thomson Reuters Datastream as at 15/08/2018.

Chart 7: Effects of recent monetary policy tightening yet to fully play out



Source: Thomson Reuters Datastream as at 28/02/2019.

...And a number of risks loom large

Trade tensions can easily revive: Since our last quarterly update, the trade truce between the US and, respectively, China, the EU and Japan has held while talks are ongoing.

Although the US has agreed to hold back on higher tariffs for now while talks continue, given US demands, we are not convinced that the US will be assuaged long-term by the kind of concessions that China will feel willing or able to make.

The US continues to investigate autos and auto parts to decide whether to impose the threatened 25% tariff rate. The US Department of Commerce will have presented President Trump with recommendations. The President has until mid-May to decide whether to impose tariffs. The obstacles in the way of any US-EU trade deal remain formidable.

We don't expect recession, but the risks have risen: Arguably, this expansion has been going on for so long that a recession looks 'overdue'. With surveys signalling multiple major economies barely growing at all at the turn of the year, the global economy looks vulnerable. Although, most US data aren't yet following the script of previous recessions, signs of tighter credit conditions and the housing slowdown make us nervous around risks of a US recession too, especially looking ahead to 2020.

Brexit: By now we would have expected a withdrawal deal to have been passed and for parliament to be passing the necessary legislation ahead of Brexit. Time is now getting very tight ahead of the scheduled 'Brexit Day' on 29 March and the economic damage caused by this prolonged uncertainty is now more visible in UK data (and, arguably, beyond).

Bottom line: lowering our growth forecasts again
We lower our forecasts again and now expect 2019 global GDP growth to be 3.3%, compared to 3.5% previously. That largely reflects a weaker than expected end to 2018 and weaker than expected start to 2019. Our forecasts for 2020 are little changed and higher in some cases, partly reflecting that we no longer assume US-China tariffs rise from current levels and now assume that monetary policy will be tightened by less than previously expected.

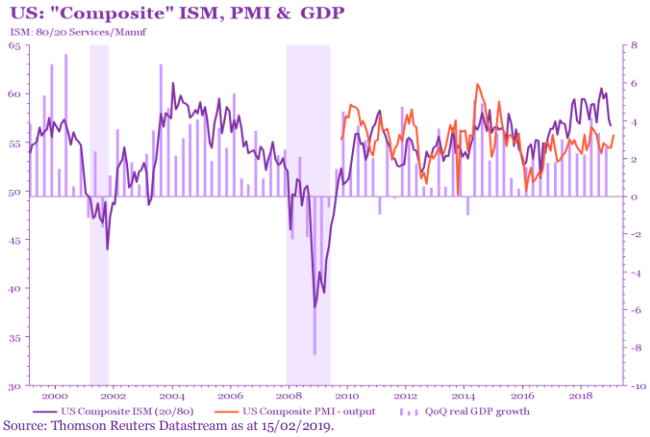
US: 2019 slowdown

US data continues to outperform, but that outperformance is getting patchy in places and the economy is showing areas of weakness. The combination of slower global growth, tighter financial conditions in December and the government shutdown means that the economy will likely perform worse than previously expected in Q1. By the end of 2019 the best of the fiscal stimulus effects will be behind us and the economy will still be absorbing the effects of past Fed tightening. However, the bounce-back in financial conditions, if sustained, will help and we assume less Fed tightening than we did a few months ago. Slower growth therefore still seems likely, but with more of that coming through in early 2019 than previously assumed. The probability of a 2020 recession has risen.

Things still look good…: Despite the recent growth scare, on the whole the US economy continues to outperform, most indicators do not signal an economy about to go into recession but instead look consistent with continued above trend growth rates for now (Chart 8). Fiscal policy is still providing a boost, the US consumer looks reasonably robust (despite the December retail sales fall); the labour market is still generating jobs at a robust pace (Chart 9), inflation looks contained and pay growth has been rising on average – a good combination for household finances.

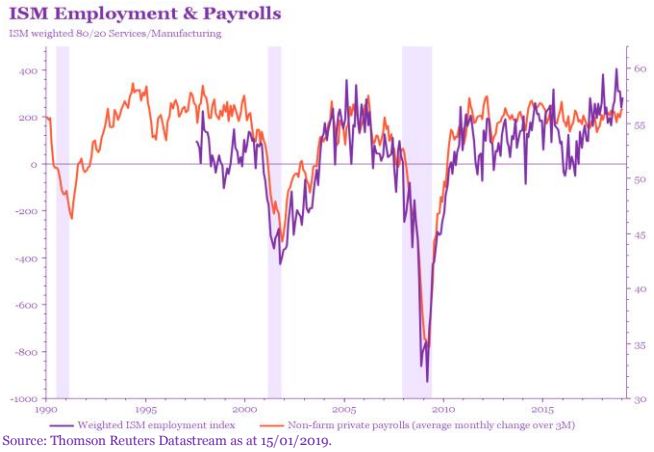
…but not as good as they used to: Some slowing in growth momentum is visible across several areas of the US economy and in business surveys. In general, the turn of the year has been weaker than expected in the US. Some disruption from the government shutdown has been apparent and consumer confidence is off its highs (Chart 10). Uncertainty around trade tariffs and the global outlook, as well as latterly the government shutdown, appears to have weighed on business sentiment. The December tightening in financial conditions, though temporary, may weigh on the US economy in 1H (Chart 11) and the housing market has slowed.

Chart 8: Data still consistent with decent US growth



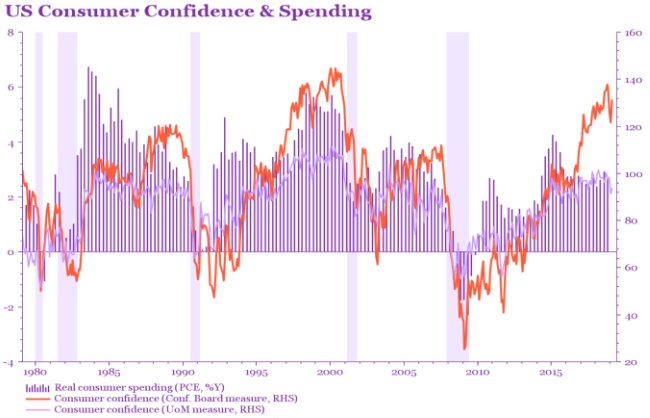
Source: Thomson Reuters Datastream as at 15/02/2019.

Chart 9: US economy still generating jobs



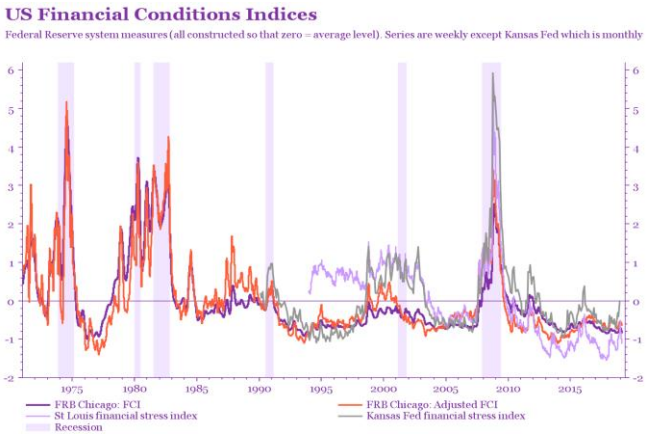
Source: Thomson Reuters Datastream as at 15/01/2019.

Chart 10: Consumer confidence off its highs



Source: Thomson Reuters Datastream as at 15/11/2018.

Chart 11: US Financial conditions: Sharply tighter in December; better since



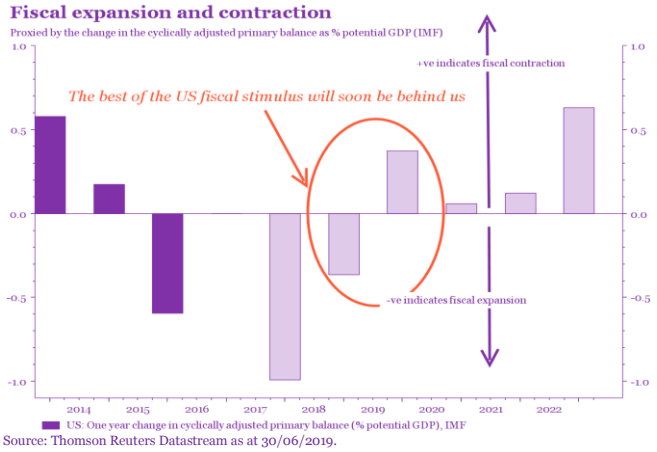
Source: Thomson Reuters Datastream as at 15/02/2019.

More slowdown to come, but 2H prospects better than before: Some of these factors will continue to drag on incoming data for another few months. We still expect the lagged effects from past Fed tightening and a weakening boost from fiscal stimulus to lower US growth rates on average into 2020.

However, we now expect less Fed tightening in 2019 which helps growth prospects a touch by late 2019 compared to our previous forecasts.

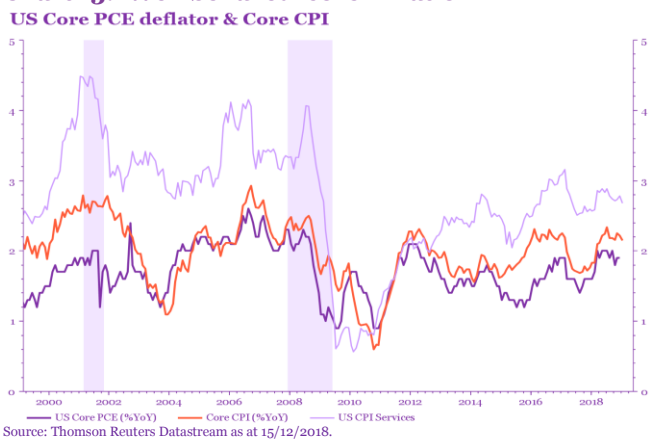
- **Constrained prospects for faster growth:** The labour market still looks tight. In isolation, this constrains the scope for faster growth without generating upward inflationary pressure. Although inflation measures have been well behaved, pay growth, on average has been rising.
- **Best of the fiscal policy boost soon behind us**: Looser fiscal policy under the Trump administration boosted corporate profits in 2018, but earnings growth is slowing. By late 2019, the best of the fiscal boost should be over (chart 12).
- **Fed pause:** The global economy is slowing, the US economy has lost a bit of momentum and recession risks have risen. There are still no clear signs of higher pay growth feeding into higher inflation (chart 13). The Fed have understandably been emphasising patience. With a weaker turn of the year than expected in the economy, we now expect them to pause until at least the middle of the year and expect only one more hike from them this year. Alongside that, we expect the Fed to end Quantitative Tightening (QT) as the size of the balance sheet/excess reserves approach the perceived optimal range.

Chart 12: The best of the fiscal expansion soon over



Source: Thomson Reuters Datastream as at 30/06/2019.

Chart 13: 'Well behaved' core inflation



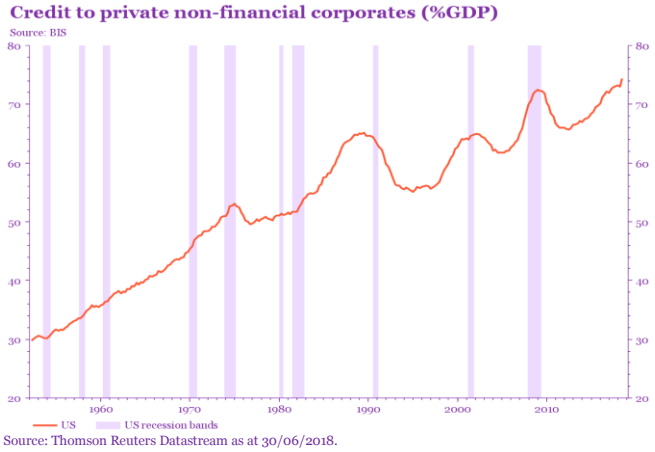
Source: Thomson Reuters Datastream as at 15/12/2018.

Corporate debt remains important to keep an eye on. The stock of corporate debt, while not a likely cause of a downturn, is sizeable enough to act as an amplifier in a downturn.

The **stock** of corporate debt has risen significantly in recent years (chart 14); the **quality** has deteriorated (e.g. growth in 'covenant-lite' lending); the **purpose** of much of the debt raised doesn't appear to have been funding an upsurge in growth-enhancing investment, for example.

Market movements in December illustrated the risk of market re-pricing. Any rise in recession worries could prompt wider credit spreads again and reduce demand for debt from some issuers who may then find it difficult to rollover their debt.

Chart 14: Keep an eye on corporate debt



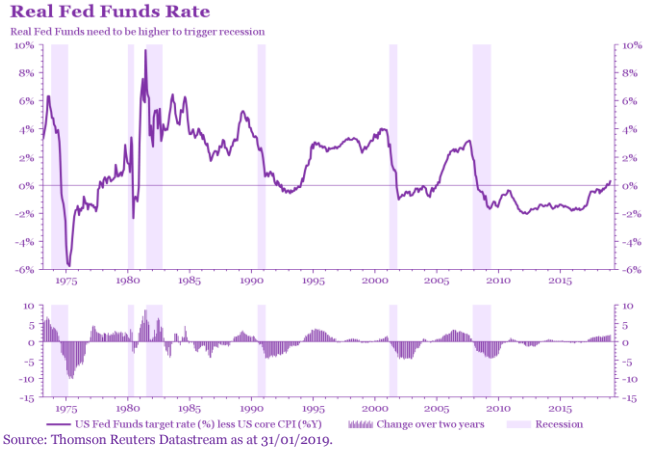
Source: Thomson Reuters Datastream as at 30/06/2018.

US recession watch: Still more of a risk for 2020 than 2019: We expect a slowdown, not a recession, but recession risks continue to warrant monitoring especially after several major downside data surprises (e.g. December retail sales) and surveys or hard data signalling that some developed countries are in technical recession or in danger of it. Most US activity indicators (e.g. payrolls, PMIs, ISMs) remain well above levels we've seen immediately before previous recessions, but the following warning lights are '**flashing amber**':

- The real **Fed Funds Rate** is not at levels that have previously been associated with recession. However, the change in real rates over the last two years is (chart 15).
- The NY Fed's recession indicator (chart 16) based on the **shape of the yield curve**, suggests recession risk has risen. However, the yield curve can remain flat for some time and recession follows inversion with a lag (see here).
- Real M1 **money supply** growth is weak (chart 17), contractions have tended to occur before recessions.
- Banks report that **credit conditions** for US firms have tightened (chart 18) and credit spreads remain higher than they were just a few months ago. However, the level of both are below either 2001 or 2008.
- **Residential investment** and the NAHB housing survey often fall ahead of recessions. They have weakened, but not to levels previously seen before recession (chart 19).
- **Stockmarkets**: US recessions are often preceded by or accompanied by falls in equity markets, although these do send false signals too (chart 20). The S&P 500 fell sharply in December 2018.

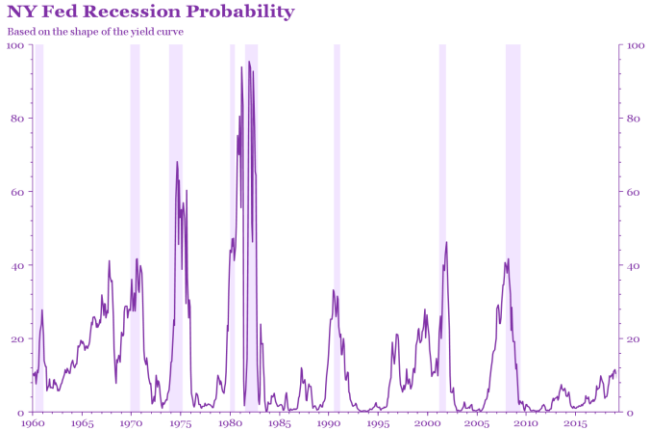
US recession 'amber warning lights'

Chart 15: Real Fed Funds rate low...but rising



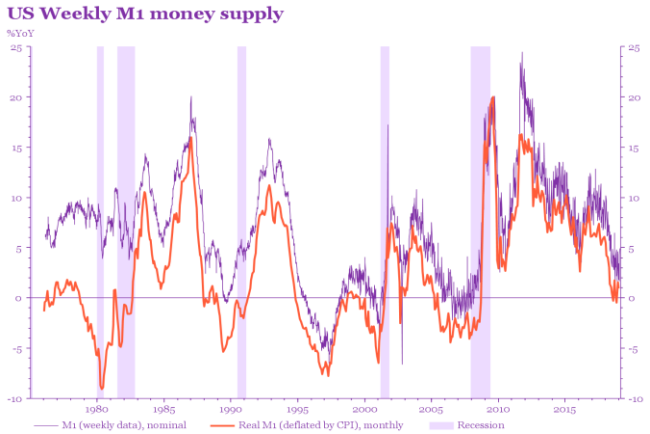
Source: Thomson Reuters Datastream as at 31/01/2019.

Chart 16: Yield curve model suggests recession risks have risen



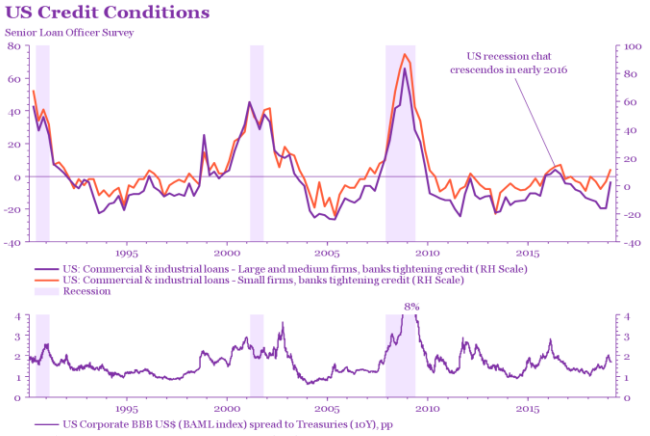
Source: Thomson Reuters Datastream as at 15/02/2019.

Chart 17: Real M1 growth weak. Contraction in real money growth has been a recession signal.



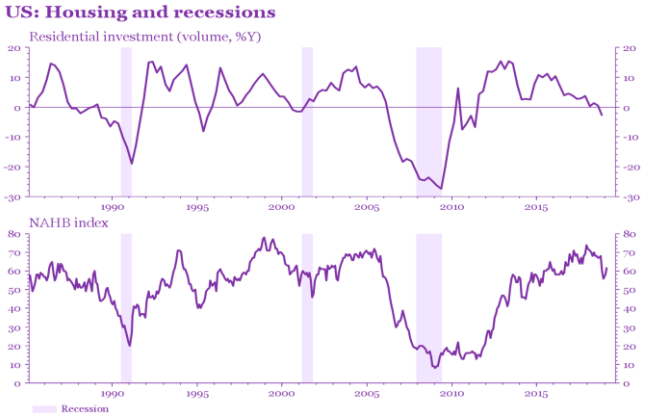
Source: Thomson Reuters Datastream as at 11/02/2019.

Chart 18: Credit conditions (bank lending to firms) worsening and credit spreads widened last year



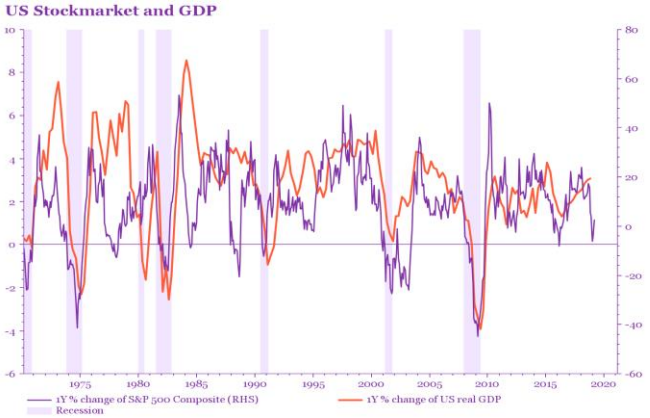
Source: Thomson Reuters Datastream as at 15/02/2019.

Chart 19: Residential investment is contracting; NAHB housing measure is still off its highs



Source: Thomson Reuters Datastream as at 15/11/2018.

Chart 20: Equity corrections can be a recession signal



Source: Thomson Reuters Datastream as at 28/02/2019.

China: waiting for a better second half

The Chinese economy has slowed, dramatically so, on some measures. The slowdown in China helps explain the slowing in overall global growth seen in 2018. Policy has firmly reversed course though, and policymakers are stimulating the economy. We'd expect to see more impact from that in coming months. US-China trade relations are also less of a worry now than they were late last year.

GDP growth has slowed (chart 21). Indicators are consistent with a sharp slowing in growth in the manufacturing sector. Other data, particularly surveys covering the services sector, have held up much better (chart 22). Retail sales have been weak although the phasing out of tax cuts on car sales has been having an impact on auto sales, as has slower credit growth (with a dampening impact on autos production in other countries), see chart 23. Trade data has held up well, but will have included an element of front-loading ahead of tariff increases and now Lunar New Year effects too.

Some of the slowing in the Chinese economy is the result of the impact of previous stimulus (2015/16) fading (Chart 24). China has also been trying to de-risk the financial system. This has helped to shrink the shadow banking sector, but also reduced credit growth.

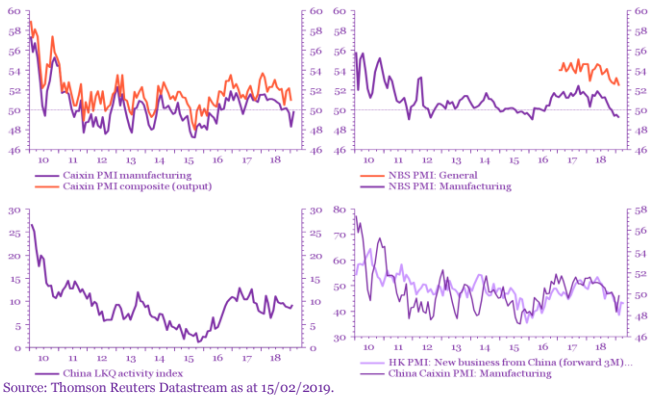
Charts 21 & 22: Growth has slowed

China: IP, Investment, Retail sales, Industrial profits & GDP

% YoY, mix of real and nominal, series made to be continuous where there are gaps

Source: Thomson Reuters Datastream as at 15/12/2018.

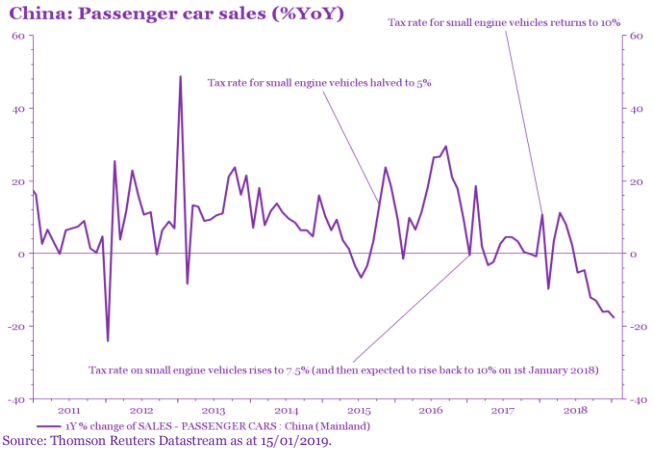
China surveys: Caixin PMI, NBS PMI, LKQ



Source: Thomson Reuters Datastream as at 15/02/2019.

Chart 23: Car sales have slowed significantly

China: Passenger car sales (%YoY)

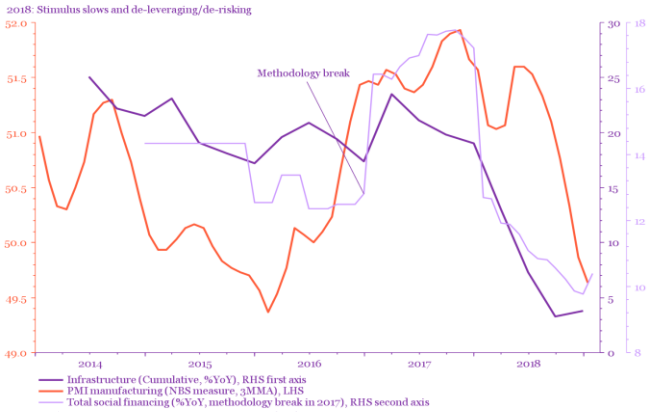


Source: Thomson Reuters Datastream as at 15/01/2019.

Charts 24: Growth slowed partly as the impact of past stimulus faded and as authorities moved to de-risk the financial sector

China: PMI, total social financing & infrastructure investment

2018: Stimulus slows and de-leveraging/de-risking



Source: Thomson Reuters Datastream as at 31/12/2018.

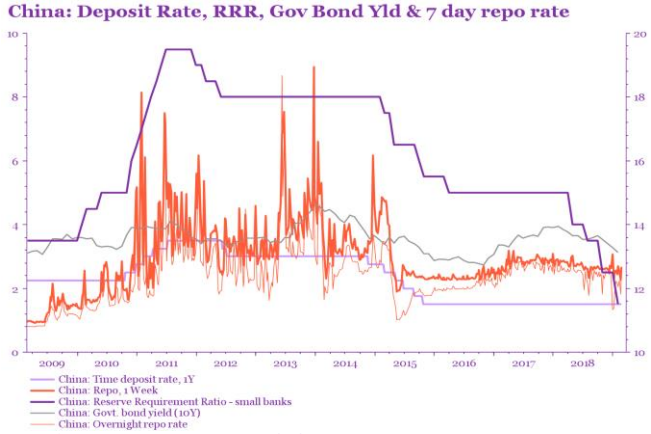
Meanwhile, relations with the US are (somewhat) less of a worry now for the outlook... China and the US continue to talk. The signs are promising that they will come to some sort of deal. However, we remain concerned about the likely sustainability of any deal. Any enforcement mechanism could become a flashpoint for a renewal of tension. We still find it hard to see what set of compromises would keep both China hawks in the US administration happy and not imply fundamental changes to China's longer-term strategic initiatives (e.g. the 'Belt and Road initiative').

...and China's policy easing will help: The impact of stimulus measures already implemented and those in the pipeline should be more visible in the data by the middle of the year, assuming no further rise in US tariffs:

- **Clearer stimulus intent**: December's Central Economic Working Conference (CEWC) ended with the government emphasising the need to stabilise aggregate demand through policy adjustments.
- Successive **RRR** cuts (Chart 25): The central bank cut the reserve-requirement ratio (this determines how much a bank needs to hold against its deposits, so a cut can stimulate lending) again in January (by 100bp).

- **New central bank facilities** have been announced, including the Targeted Medium-Term Lending Facility (late-Dec) and the Central Bank Bill Swaps programme.
- Increases in and front-loading of local government bond issuance quotas should boost **infrastructure** spending.
- **Tax** cuts: China analysts expect more tax cuts.
- **But no RMB devaluation**. A significant RMB devaluation would likely worsen relationships with China's neighbours, the US, and risk capital outflows. Our central case does not assume RMB devaluation.

Chart 25: Stimulus measures include RRR cuts



Source: Thomson Reuters Datastream as at 25/02/2019.

Enough? Too much? With such a stimulus effort on multiple fronts, there is a risk that the impact is much stronger than expected, especially if the threat of higher US-China tariffs is completely removed. For early signs of this being the case, we will be watching the money and credit data in particular (which should show an impact from both measures to improve supply of credit and measures boosting demand). We did get much stronger than expected total social financing figures in January (chart 26), potentially an early sign of stimulus having an impact. However, given strong seasonality and LNY effects, it is likely too early to draw firm conclusions.

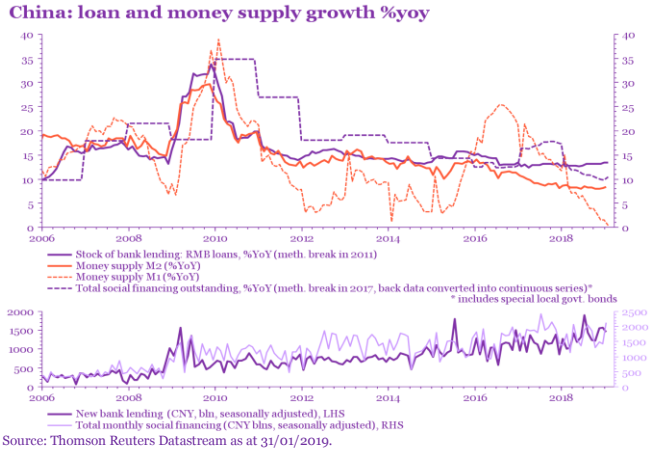
If this dose of stimulus is unsuccessful, we expect policymakers to do more, potentially in April after Q1 GDP and enough data points clear of LNY timing effects.

Longer-term risks remain, however, and Chinese growth still looks likely to slow on average:

Debt build-up: Rapid credit growth has raised concerns about financial stability over the medium-term and private debt is around 200% of GDP (chart 27). However, China has relatively low levels of dollar-denominated debt (at least as a % of GDP) for an emerging market economy. China also has large foreign exchange reserves and Chinese authorities have a broad range of targeted tools that they can use to stimulate activity given the role of the state in the economy. Still, high levels of debt are likely to leave Chinese policymakers reluctant to travel too far down the aggregate stimulus route.

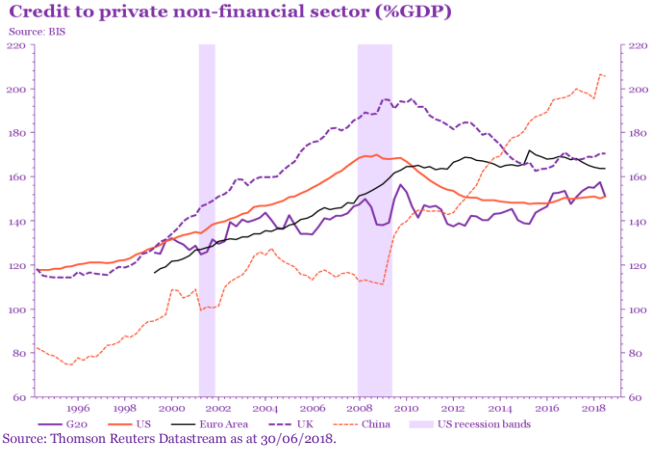
Longer-term growth challenge: China's potential rate of growth is set to decline, reflecting demographic factors (chart 28) - working age population growth has been negative now for several years - and a slowdown in productivity growth as the gains from rapid urbanisation fade. We expect China to lower its growth target from the current "around 6.5%".

Chart 26: Some signs of stimulus impacts in money and lending data



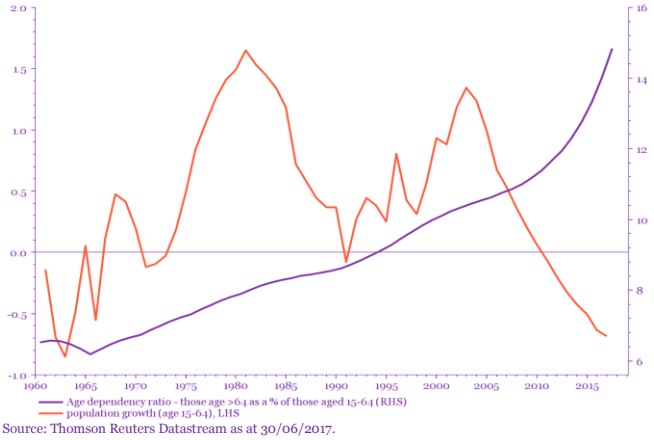
Source: Thomson Reuters Datastream as at 31/01/2019.

Chart 27: High levels of debt remain an underlying risk factor



Source: Thomson Reuters Datastream as at 30/06/2018.

Chart 28: China's demographics becoming more of a drag on growth as 'working age' population slows



Source: Thomson Reuters Datastream as at 30/06/2017.

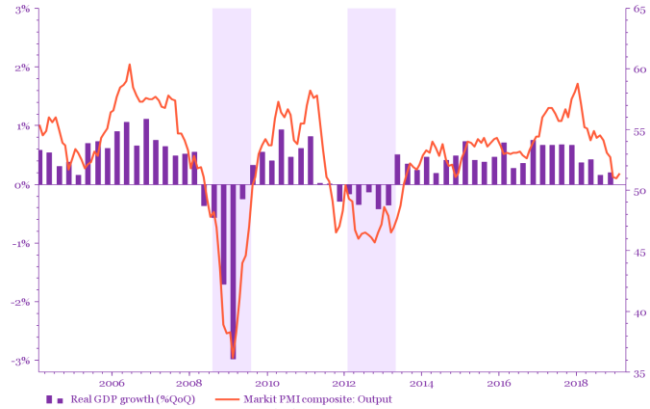
Eurozone: More disappointment

Growth in 2018 disappointed. After a worse than expected turn of the year we expect GDP growth of only around 1% in 2019. Upside potential (from accommodative monetary policy, lower oil prices, higher pay growth) remains limited by exposure to external risks and political worries, but the second half of 2019 should see some improvement.

Getting worse: The Euro area economy grew robustly in 2017, likely above the sustainable rate. It made sense for growth to slow in 2018, but momentum has worsened more than expected (chart 29) and growth in Germany and Italy have been particularly weak with the former only just avoiding a technical recession in Q4 and Italy entering one (chart 30).

Chart 29: GDP growth and PMIs slump

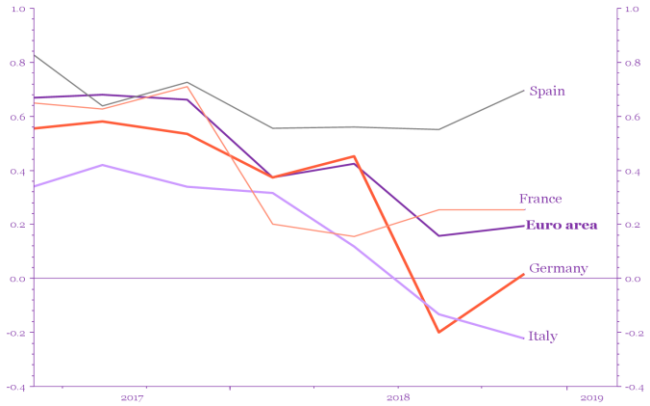
Eurozone GDP growth & Composite PMI



Source: Thomson Reuters Datastream as at 15/11/2018.

Chart 30: Germany and Italy particularly weak

Euro area real GDP, %QoQ



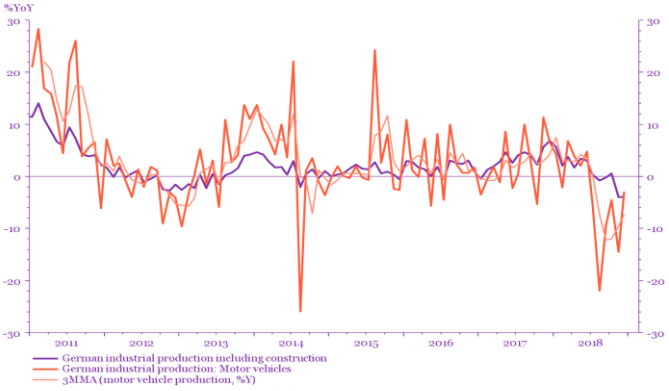
Source: Thomson Reuters Datastream as at 15/11/2018.

Blame Cars, China, Brexit and politics (and look to a better 2H): There are several obvious factors to try and pin the blame on for European underperformance. The second half of the year should be better on some counts:

- **Car trouble**: Trouble in adjusting to a new autos emission testing regime, weak China car sales, declining demand for diesel cars and the rise of electric vehicles have been making life difficult for many car manufacturers. In Germany, the Q3 fall in autos production was large enough to be a visible drag on GDP growth. The first of these auto sector factors is temporary and we have already seen a bounce-back in German auto industry data (chart 31), but other factors may prove a more sustained drag. If the US proceed with an increase in autos tariffs, things will likely get worse again.
- **China:** China is the euro area's third largest trading partner and third largest export destination and has been slowing. However, given Chinese stimulus, prospects for the second half look better.
- **Brexit:** The UK is the euro area's second largest trading partner and export destination. Export growth has slowed to China and the UK since 2017 (chart 32). The UK economy has been struggling, especially since the summer with the impact of Brexit uncertainty increasingly visible. Brexit has also been weighing on business sentiment in the Euro area.
- **Politics:** For much of the year, Italy was a major concern for investors with the looming threat of a confrontation over fiscal policy between its new government and the European Commission. At the start of 2019, Spain is set for a snap election in late April. Elections for the EU parliament may act as a showcase for the rise of European populism and damage sentiment.

Chart 31: Some autos recovery visible in Germany

German industrial production & autos production

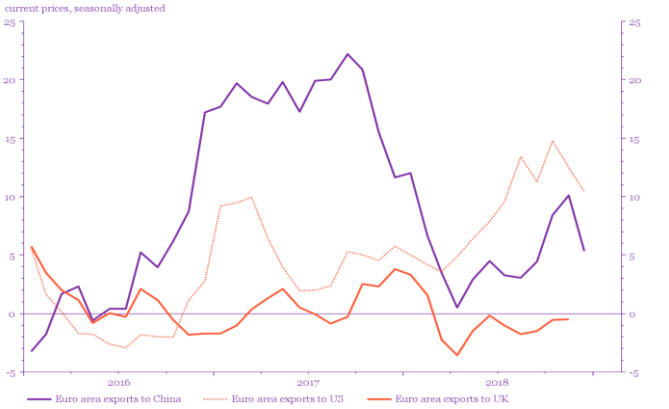


Source: Thomson Reuters Datastream as at 15/12/2018.

Chart 32: Slower export growth to China and the UK

Eurozone Exports of Goods to US, UK & China %yoy

current prices, seasonally adjusted

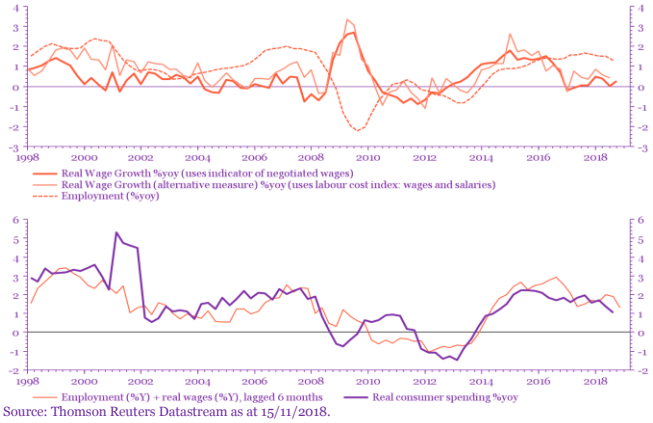


Source: Thomson Reuters Datastream as at 15/12/2018.

Support for the second half: Accommodative monetary policy, lower oil prices than seen over much of last year, prospects for reasonable real income growth (employment growth holding above 1% so far, wage growth picking up, but inflation slowing) (chart 33) and a somewhat weaker euro should be supportive for the second half of the year. We expect looser monetary policy in 2019 than previously, pushing back the timing of a first rate rise. Fiscal policy should also be modestly supportive this year (Chart 34).

Chart 33: Real pay growth has risen

Eurozone: Labour income & consumer spending

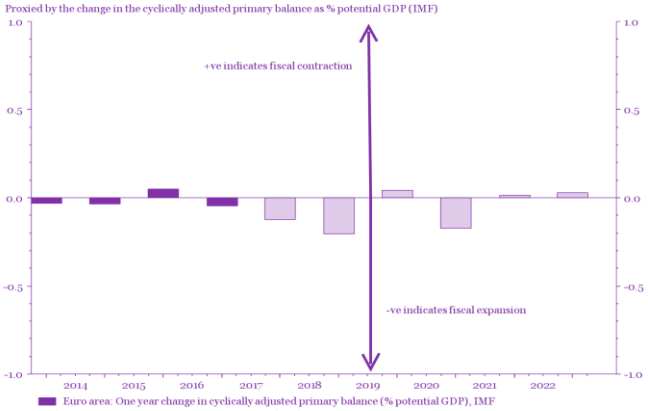


Source: Thomson Reuters Datastream as at 15/11/2018.

Chart 34: Fiscal policy a (small) boost for GDP growth

Fiscal expansion and contraction

Proxied by the change in the cyclically adjusted primary balance as % potential GDP (IMF)



Source: Thomson Reuters Datastream as at 30/06/2019.

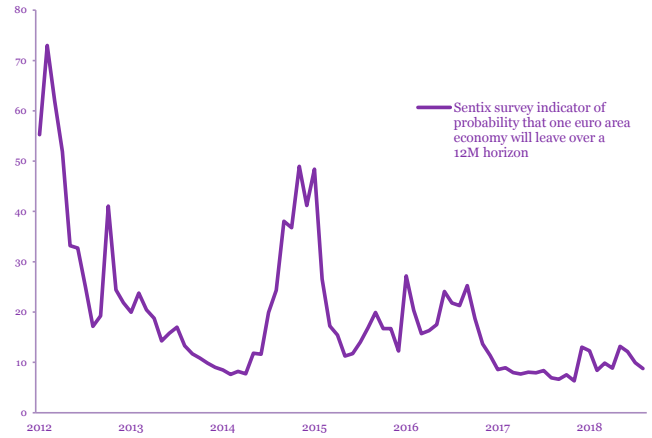
Delayed ECB hike: ECB rate hikes look even further away given recent data disappointments. We have pushed back our forecast for the first rate rise until Q4 2019 and wouldn't be surprised if this was delayed into 2020. To that end it seems likely that there will be some change in ECB forward guidance in coming months. We would also expect a successor to the Targeted Longer-Term Refinancing Operations (TLTROs) to be announced by the summer. We don't expect the ECB to start unwinding QE and engaging in asset sales for the two years of our forecast horizon.

Threats to the euro area outlook: US auto tariffs, global growth and politics remain threats to the outlook. The incomplete nature of the Euro area in terms of not being a fiscal union, for example, mean that the Euro Area is prone to revivals of worries about euro area break-up risks (chart 35) when parties with euro-sceptic tendencies make significant gains in elections.

Brexit is a key source of uncertainty for the outlook. Just as in the UK, many firms will be unprepared for a disorderly no deal Brexit outcome and it will take time (and be costly) to adjust to the changes that emerge.

Studies generally suggest that, as a percentage of GDP, the damage to the economy in a 'no deal' outcome would be much worse in the UK than for the euro area as a whole. Damage to the Euro area economy would be unevenly spread, however, with Ireland generally emerging as likely to face a particularly significant shock in the event of a 'no deal' outcome.

Chart 35: Periodic revivals of Euro area break-up worries



Source: Bloomberg

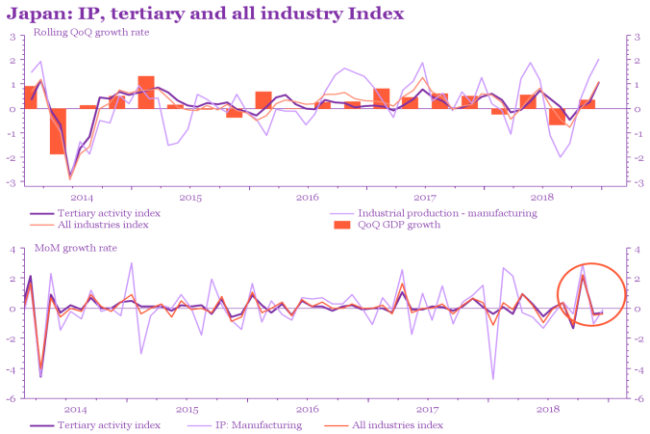
Japan: Waiting for an upturn…Q3?

The Japanese economy contracted in Q3 2018, largely reflecting the impact of several natural disasters. However, the economy failed to bounce convincingly in Q4 and data isn't pointing to a strong Q1 2019 either. We don't expect the scheduled consumption tax rise to knock the economy off course this year, but the weak start to the year means we nevertheless revise down our 2019 GDP forecast significantly.

The Japanese economy contracted in Q3 and failed to bounce strongly in Q4: Particularly visible in the monthly hard data, the Japanese economy bounced back in October after a natural disaster affected September, but then appears to have largely stagnated through November and December. That weak end to the year implies a weak ramp into 2019 and helps explain our forecast revisions (where we cut four tenths from our 2019 GDP growth forecast).

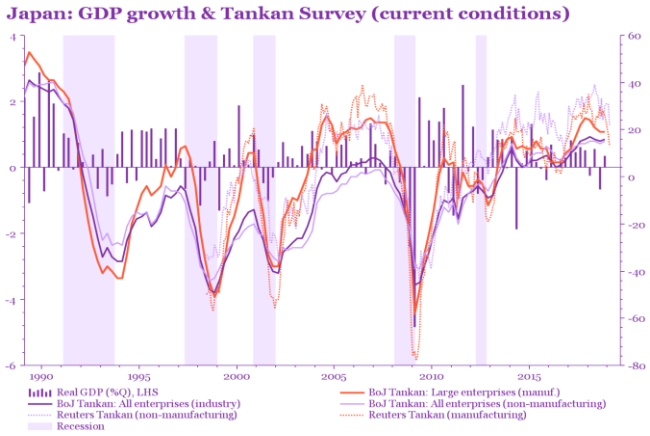
Surveys send a weakish signal for Q1 so far: The surveys are mixed, but the PMI composite suggests that the Japanese economy was close to stagnation in January. The quarterly BoJ Tankan has held up well, but the monthly Reuters Tankan has weakened significantly (chart 37).

Chart 36: Q3 GDP contracts, but surveys are more positive



Source: Thomson Reuters Datastream as at 15/12/2018.

Chart 37: Surveys mixed, but weaker



Source: Thomson Reuters Datastream as at 15/11/2018.

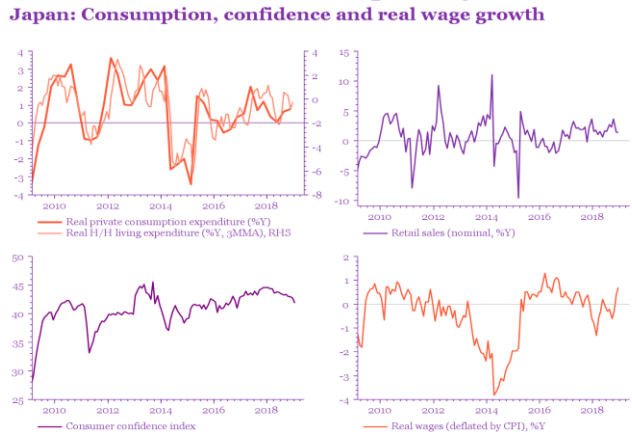
The labour market remains tight and higher real pay growth is good news for consumers: Employment growth remains strong (1.8%Y in December), and the labour market continues to look tight. The unemployment rate is bouncing around its lowest levels since the early 1990s. Pay growth continues to look relatively robust and real wage growth has picked up as headline inflation has declined. Although consumer confidence has deteriorated, consumer spending indicators look supportive for the economy (chart 38). We will likely also see some front-loading of spending as households prepare for the increase in the consumption tax.

We still don't expect the 2019 rise in consumption tax to knock the economy seriously off course: In October 2019, the government plans a sales tax rise from 8 to 10% (delayed from 2015 and then 2017). Some are nervous, given memories of the 2014 rise in the sales tax which was followed by a brief recession. This time around though, measures are being taken to help avoid a repeat (including various exemptions). However, front-loading may nevertheless result in further bumps for GDP growth as the year progresses.

A stronger mid year: Until early 2018, export growth to China was picking up strongly; the slowdown since has been particularly marked. A better tone to the Chinese economic data in the second half of 2019, should also be supportive of the Japanese economy, especially in Q3 when Japanese consumer spending will likely be particularly strong (ahead of Q4's consumption tax rise).

Meaningful monetary policy tightening still looks a distant prospect: Measures of underlying inflation remain weak, with a persistent deflationary mindset among businesses and consumers likely still partly to blame. Significant monetary policy tightening still looks a long way off for Japan (notwithstanding some possible further adjustments to bond targets, for example, to help offset financial stability risks).

Chart 38: Positive consumer spending indicators



Source: Thomson Reuters Datastream as at 15/11/2018.

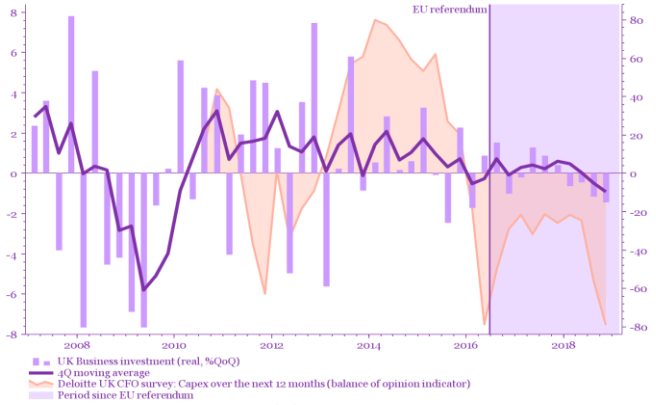
UK: Brexit damage stacking up

Brexit damage is more visible in the economy. The path ahead for the UK remains very Brexit dependent. Given continued domestic division over Europe, it is important to think about Brexit as a process rather than an event; uncertainty will linger whatever the next month or so brings for Brexit. Although MPs agreeing a version of the current UK-EU deal (still a tentative central case) would likely lead to some pick up in the economy, prospects for a significant boost have faded. With the global economy having slowed, we expect fewer and later BoE rate rises.

Uncertainty being felt more strongly in the data: With just under a month to go until the scheduled Brexit date, and with the outcome still uncertain, it is not surprising that we are seeing more Brexit impacts in some of the data. Businesses continue to flag Brexit as a major source of uncertainty. Business investment has now contracted for four consecutive quarters (chart 39). There is more evidence of firms stockpiling (chart 40). Consumer confidence looks fragile (chart 41), despite a strong labour market (chart 42). The UK economy has been slowing for some time, but contracted outright in December.

Chart 39: Business investment has slumped

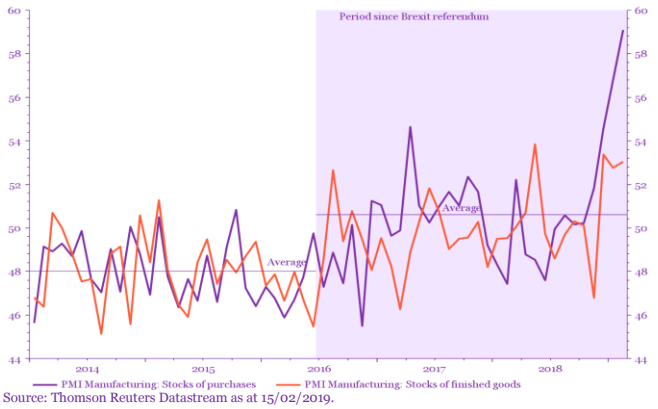
UK: Business Investment



Source: Thomson Reuters Datastream as at 15/11/2018.

Chart 40: More evidence of firms stockpiling

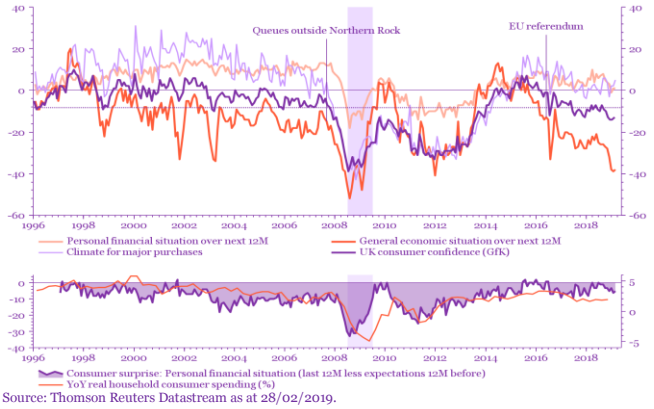
UK PMI Manufacturing: Inventories indicator



Source: Thomson Reuters Datastream as at 15/02/2019.

Chart 41: Fragile consumer confidence...

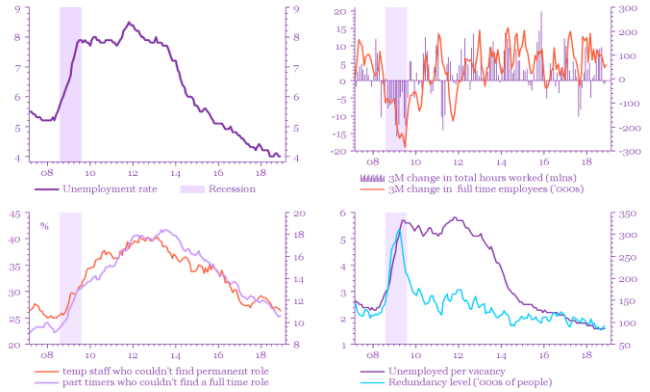
UK: GFK Consumer Confidence



Source: Thomson Reuters Datastream as at 28/02/2019.

Chart 42: ...despite a so far strong labour market

UK Labour Market summary indicators



Source: Thomson Reuters Datastream as at 30/11/2018.

We assume (somewhat tentatively) that there is an endorsed and ratified withdrawal deal. However, we now assume that this process, including passing relevant legislation, will not be completed before the 29 March withdrawal date. We assume that, a combination of Prime Minister (PM) May (and the EU) taking this 'to the wire' and the threats of both 'no deal' and 'lengthy extension' or a second referendum being dangled in front of different groups of MPs ultimately gets a deal pushed over the line after some (likely cosmetic) further compromise from the EU. However, even if a deal were approved before the 29 March, there would likely be insufficient time to pass and scrutinise necessary legislation - hence an Article 50 extension looks more likely than not.

'No deal' still a significant risk: At the time of writing, there is still a significant risk that the UK exits the EU in March with no deal at all. Growth would likely be significantly lower than our base case, with substantial economic disruption likely, and inflation higher – since we would assume GBP depreciation and some increase in average tariffs (see page 15). Despite a majority of MPs having expressed opposition to 'no deal' Brexit, that remains the default option.

Still a risk of 'remain': There remains some risk of a 'remain' outcome. The most likely route for that to come about now, we think, would be a failure by PM May to get her (even

amended) deal through parliament and a lengthy extension to the Article 50 process being requested, allowing time for a referendum.

However, it is somewhat unclear how such a request would come about in the first place. It will become more plausible if more support builds in parliament for amendments designed to give MPs more control over the Brexit process, equally if the PM moved more explicitly to make the choice before MPs as being 'no deal' or '*lengthy* extension'.

Ultimately, it is still far from clear that the majority of MPs would anyway support a referendum. The economic impact of a 'remain' outcome would depend on why and how it came about. At present, it seems more likely than before to get sufficient support from MPs only as a last resort after a significant amount of further political – and market – turmoil as a way of trying to alleviate a deadlock in the process.

It is also worth noting that a second referendum might raise the chance of 'remain', but also 'no deal', depending on the options on the ballot paper and public opinion at the time.

Modest relief boost: In our central case, with the transition in place, cross-border trading conditions don't change much in 2019. GDP should get a very modest boost as *some* investment previously held back is released. Why very modest?

- **Uncertainty lingers as a new round of negotiations starts**: The final shape of the UK-EU relationship (let alone the UK's trading relationship with partners beyond the EU) will be unclear for some time. However, any boost is likely to be modest, since negotiations on the future relationship with the EU will only start in earnest in 2019 and the outcome will remain uncertain for some time
- **The UK political fallout could be substantial**: No deal that PM May presents to parliament will please everybody. The next stage of negotiations will likely also be divisive. Several MPs have already split from both the Labour and Conservative Party, for some, partly as a consequence of the way each party has handled Brexit

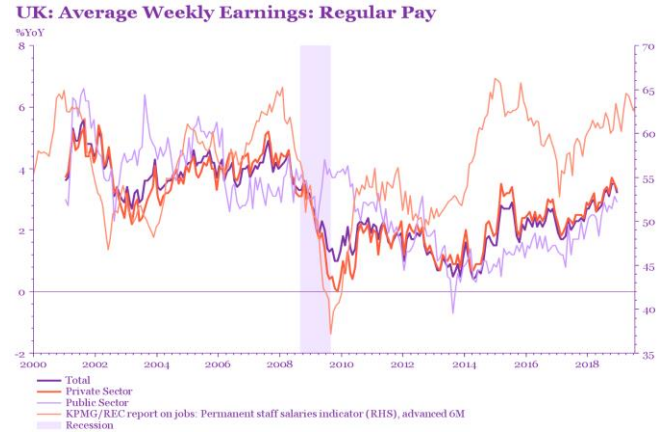
The consumer may help…: Full-time employment is still growing. Private sector pay growth has risen (chart 43) and is likely to rise somewhat further given tightness in the labour market (although we would expect the unemployment rate to stay close to 4% next year). Public sector pay rises have been promised. We'd expect whole economy average earnings growth a little above 3.5% by the end of 2019. Meanwhile, lower inflation is boosting real pay growth (chart 44). In our central Brexit scenario, sterling is likely to strengthen which should further lower CPI inflation (with a lag).

…somewhat: However, while Brexit uncertainty remains, consumer confidence may remain fragile. The more Brexit uncertainty lingers, the more firms may hold back on hiring. Take-home pay is also set to be dampened by upcoming increases in mandatory employee contributions to pension schemes (under auto-enrolment, the minimum employee contribution rises from 3% to 5% of pay from April 2019).

UK growth likely mediocre in 2019: Even in our central case, a degree of Brexit clarity and any modest relief boost to the economy comes too late to avoid the UK achieving only mediocre growth this year, given the weakish end to 2018 and surveys signalling stagnation at the start of the year.

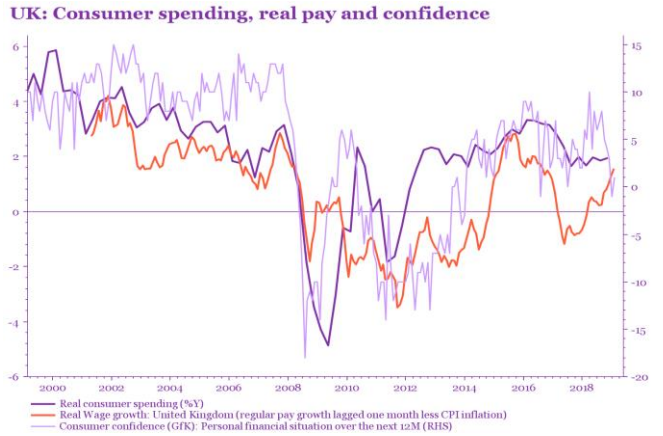
Not expecting a bounce back in potential growth either: We don't expect a bit of Brexit clarity to result in a sea-change to productivity growth (which has been relatively weak since the financial crisis); or a jump in working age population growth or the capital stock.

Chart 43: Gradual pick up in nominal pay growth



Source: Thomson Reuters Datastream as at 15/12/2018.

Chart 44: Real pay supporting consumer spending, but confidence likely to be dragging



Source: Thomson Reuters Datastream as at 15/11/2018.

Impact of a 'no deal' Brexit outcome

The impact of any 'no deal' Brexit outcome will depend on a number of factors including how prepared governments, businesses and consumers are. 'No deal' preparations are ongoing with resources being diverted into preparation for this potential outcome. The economic impact, especially in the short-term, will also depend on how far any elements of transition (even for relatively short periods) are agreed by the EU. The EU has, for example, already outlined limited contingency proposals.

However, surveys indicate that many firms are not ready. In the February BoE Agent's Summary, around half of companies surveyed felt that they were not ready for a 'no deal, no transition' Brexit.

It is also increasingly apparent that businesses cannot assume that the bulk of trade deals the EU has with third countries will be rolled over to apply to the UK. We continue to expect significant near-term disruption to the economy in the event of a 'no deal' Brexit. Sterling would also likely weaken significantly, raising prices and reducing real incomes.

Policy responses would likely include fiscal stimulus from the government and liquidity provision by the Bank of England. The monetary policy reaction is harder to gauge. Our guess is that interest rates would be cut very modestly, but the Bank of England remain at pains to stress that this won't necessarily be the case and that they may need to raise rates.

In a *pessimistic hard Brexit* scenario, by 2020, the level of GDP could be more than 3% lower than in our base case (and 4% lower than in a remain scenario), using some of the more downbeat analysts' estimates. In the Bank of England's worst case (no deal, no transition) scenario where what can go wrong, does go wrong, the level of GDP is damaged even further and the Bank raise rates.

2019 Brexit scenarios

Upside scenario (25% probability) - Remain

- There is a reasonable chance that 'Brexit Day' is pushed out beyond the end of the year ('temporary Remain') given how long the process has already taken and the apparent willingness of the EU to accept an extension request
- There is still a subset of outcomes where the UK stays in the EU longer-term, e.g. there is a referendum on the withdrawal deal, where 'Remain' is both an option and selected by a majority
- Economic implications in 2019 vary, depending partly on how much political uncertainty or change precedes the outcome and whether Article 50 is revoked entirely or just extended for a lengthy period. Sterling likely appreciates significantly if this outcome is seen as having some shelf-life

Base case (55%) – Entering transition

- Uncertainty drags on until the deal is ratified, sometime before the middle of the year, after the Article 50 deadline is extended for a short period, with the effects on the economy becoming more visible in the meantime
- Transition period avoids "cliff edge" in 2019, but negotiations around the future relationship start in earnest, maintaining an ongoing level of uncertainty including around the UK domestic political outlook.
- BoE resumes a (very) gradual tightening path

Downside scenario (20%) – Disruptive 'no Deal'

- Process breaks down and there is no fully implemented transition period. This could happen through several routes including repeated rejection by the UK parliament of the deal, and a second referendum which includes a 'no deal' option where that option gets a majority. 'No deal' is still the default if Article 50 is not revoked or a deal agreed
- On/off negotiations resume throughout the period, but direction of travel remains unclear
- Brexit impact more severe –Disruption to the economy is significant in 2019, although 'no deal' preparations and a degree of political will on both sides helps prevent some of the worst repercussions
- Sterling falls sharply and higher inflation squeezes real incomes. Growth slows and unemployment rises. It takes time to re-orientate the economy

Scenarios are not exhaustive and probabilities are subjective.