ECONOMIC UPDATE
INVESTMENT CLOCK

Trade versus Stimulus

Issue #17, June 2019

ROYAL LONDON
ASSET MANAGEMENT

Multi asset views from RLAM

Royal London Asset Management manages £123.4 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 31/03/2019

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Summary views by economy

US: The US economy shows signs of losing momentum. The H2 outlook has deteriorated with the latest ramp up in trade tensions between the US and China, but consumer fundamentals remain supportive. A rate cut is likely this year.

China: The China slowdown shows some patchy signs of stabilisation, but China is at the centre of the escalation in trade tensions. We expect more stimulus to help offset some of the negative impact.

Eurozone: Supports to growth (from accommodative monetary policy, lower oil prices, higher pay growth) will likely be partly offset by exposure to external risks.

UK: The path ahead for the UK remains Brexit dependent. Uncertainty will drag on investment, but consumer spending and a somewhat looser fiscal stance will provide support. We don't expect a Bank of England (BoE) rate rise over the next 12 months.

The global economy has been slowing since the start of 2018. There are patches of stabilisation and strength in the recent data, but the outlook has taken a turn for the worse given the state of trade tensions. Brexit remains unresolved and levels of UK political uncertainty are high too. However, prospects of central bank easing and more China stimulus calm the nerves. Global growth is unlikely to be spectacular, but there are sufficient supports in place to avoid a significant further downturn if trade relations stabilise.

Summary views

Patchy green shoots..: Q1 GDPs were stronger than expected in a number of economies. Since Q1, looking at recent monthly data, there are signs of stabilisation in some of the China and euro area business survey data. US housing activity is no longer trending lower and US consumer indicators have held up well. China stimulus and more dovish central banks left things looking on track for reasonable global growth in the second half of this year.

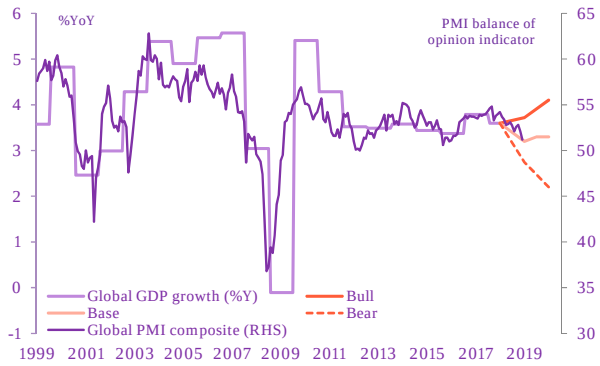
...under threat: However, the outlook worsened following the escalation of trade tensions between the US and China. Unsettling things further was the US threat of tariffs on Mexico. That threat has receded, but it may leave businesses less certain about where policy is heading. Business optimism fell in May.

Policymaker 'put' has limits, but easier policy likely: Policy stimulus and reasonable consumer fundamentals (low unemployment and higher pay growth) should help keep the global economy out of recession. Tight labour markets and low levels of policy ammunition help restrain what we can expect from central banks. But the turnaround in rate outlook is likely already helping the economy.

Risk watch list: 1) A further escalation in trade tensions between the US and China and recurring threats of tariffs elsewhere are a high probability. Investment and, crucially, hiring would likely suffer. 2) Markets have priced in more central bank easing than – at least for now – seems likely. Central bank communication missteps could lead to tightening financial conditions. 3) No deal, no transition Brexit remains a risk.

Moderately overweight stocks: With inflation muted, policymakers are signalling easier policy and a global recession is not imminent. Our multi-asset team remains overweight equities and short-duration high yield credit, but underweight commodities given slower global growth. See www.investmentclock.co.uk

Chart 1: Global growth – Still slowing



Source: IMF, IHS Markit, RLAM forecasts

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Economic forecast summary

June 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 (2.4)	2.1 (1.9)	2.25 (2.75)	1.7 (2.0)	2.4 (2.3)	2.25 (2.75)
China	6.6	2.2	–	6.2 (6.2)	2.4 (2.3)	– –	6.0 (6.2)	2.5 (2.5)	– –
UK	1.4	2.3	0.75	1.3 (1.1)	1.8 (2.0)	0.75 (1.0)	1.4 (1.6)	2.0 (2.2)	1.00 (1.25)
Eurozone	1.8	1.9	0	1.2 (1)	1.4 (1.4)	0.0 (0.0)	1.4 (1.7)	1.5 (1.9)	0.0 (0.25)
Japan	0.8	0.8	-0.1	0.9 (0.7)	1.5 (1.6)	-0.1 (-0.1)	1 (1.1)	0.8 (0.9)	-0.1 (-0.1)
Global	3.7	–	–	3.2 (3.3)	–	–	3.3 (3.5)	–	–

Source: National Statistics offices, RLAM forecasts. March forecasts in parentheses

Key central bank forecasts

- Fed cuts rates 25bp in H2 2019 and signals that more rate cuts could follow.
- No rate rises within the forecast horizon. European Central Bank (ECB) push back rate guidance further and add some degree of state contingency.
- BoE raise rates in H2 2020, assuming greater certainty around Brexit and no 'no deal Brexit'. They then raise rates once every three to four quarters.
- People's Bank of China ease in coming months.

Global economic scenarios 2019/20

Upside scenario (20% probability): Productivity powers ahead

- Trade tensions subside. Gl0bal growth recovers to 4%+ by the end of the period, helped by improvements in productivity and the impact of stimulus in 2018/19, especially from China which is more powerful than expected. The UK remains in the EU through this period.
- Underlying inflation remains contained as productivity growth dampens domestic inflationary pressure.
- Central banks tighten policy gradually, but to higher levels than in the base case.

Base case (60%): Global growth subdued, but avoids downturn

- Global economic growth stabilises below the 3.5% -4% post-crisis range as pressures to rebalance global trade and de-globalise prove persistent.
- UK growth remains below average amid continued uncertainty around the final Brexit outcome and domestic politics, even though actual Brexit transition is relatively smooth.
- Inflation pressures rise, but modestly.
- Central banks switch to temporarily easier stances, helping to stabilise growth. Very limited hiking resumes or starts in several economies towards the end of the forecast period.

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 in the short term given tariff increases. After some hesitation, central banks ease policy more markedly.
- Global growth moves significantly below 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.

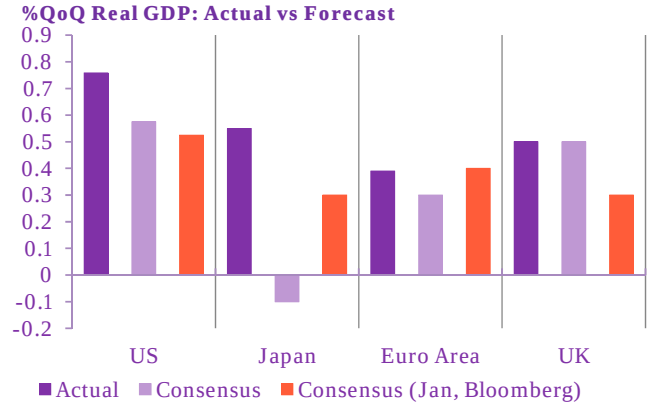
Economic views and forecast outlook

Global economy: 'Trumpling' on green shoots

Before the latest batch of higher tariffs, global growth was showing tentative and patchy signs of green shoots. After the escalation in trade tensions, GDP growth looks likely to be (only) slightly weaker than previously forecast, once further Chinese stimulus and a modestly easier Fed are assumed. Another layer of tariff escalation, however, could present a serious risk of recession.

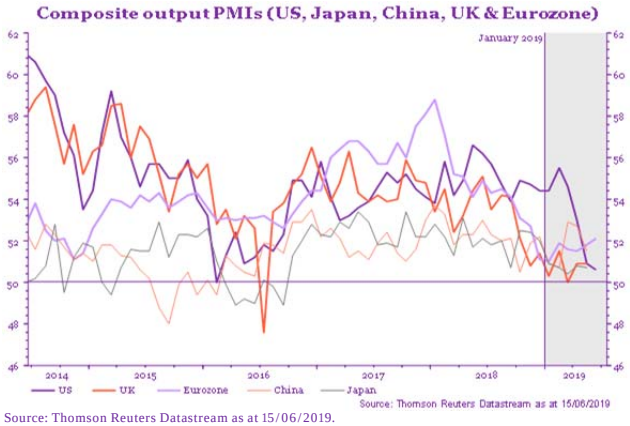
Some green shoots. On the surface, the year started off well: Q1 GDP outcomes generally surprised on the upside (Chart 2), although the details of some of those GDP releases have been less positive than the headline. Purchasing Managers' Index (PMI) surveys have continued to suggest that global growth is slowing (see front page chart), but indicators in several major economies have been showing signs of stabilisation, including some of the PMIs (e.g. Chart 3). Data in most major economies has been far from uniformly downbeat. The data is patchy for sure, but there have been a few observations in recent weeks that would have been consistent with expecting better global growth in H2.

Chart 2: Better than expected start to the year…for GDP at least



Source: Bloomberg as at 15/05/2019. 'Consensus' refers to Bloomberg consensus at time of data release

Chart 3: 2019: Some PMIs have been stabilising



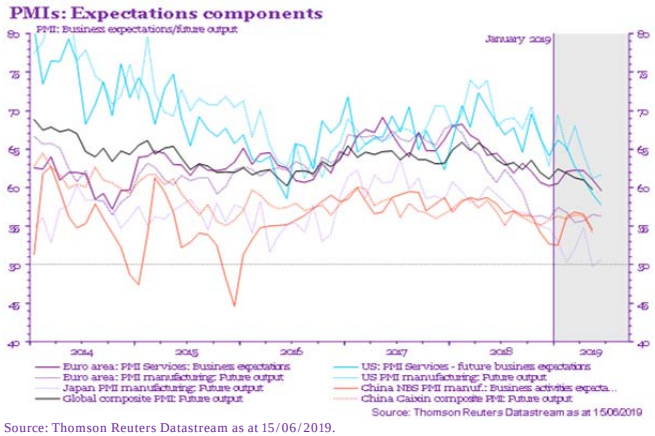
Source: Thomson Reuters Datastream as at 15/06/2019.

Downside risks have risen: Since early May, there has been a deterioration in US - China relations. Earlier trade talks fell apart, the US raised tariffs on China, China retaliated in kind and hawkish rhetoric stepped up in China too. It has become hard to see where both leaders go from here and still declare a 'win', particularly as the US is entangling the trade and security agenda when it comes to China. It hasn't just been China either. In a surprise move, President Trump in late May announced that tariffs would be raised on imports with Mexico unless they took action against immigration. Those tariffs have been 'indefinitely suspended' after the two sides managed to make a deal on migration. The suspension is welcome news, but seems unlikely to have dampened President Trump's enthusiasm for tariff threats.

> "*Now, people haven't used tariffs, but tariffs are a beautiful thing when you're the piggy bank, when you have all the money…We have another $300 billion to go with China. I haven't done that to them because it's a very big thing for them, not for us. For us it's not going to matter because we'll be able to buy the product in other countries that don't have the tariffs. So it's not going to have an effect.*" (President Trump CNBC interview, 10 June).

Businesses worried: Importantly for the outlook for business investment and even hiring, surveys suggest that levels of business confidence and optimism fell in a number of countries in May in tandem with the increase in trade tensions (Chart 3). The temporary escalation in US tensions with Mexico and threatened tariffs was likely a particular surprise to businesses globally (given that the US had done a deal with Mexico and given the added dimension that tariffs related to immigration rather than specifically economic issues). Despite de-escalation of the Mexico-US tariff threat, businesses may now feel that they need to build a higher level of uncertainty into their decision making regarding the future trading environment.

Chart 4: Business optimism fell in May



Source: Thomson Reuters Datastream as at 15/06/2019.

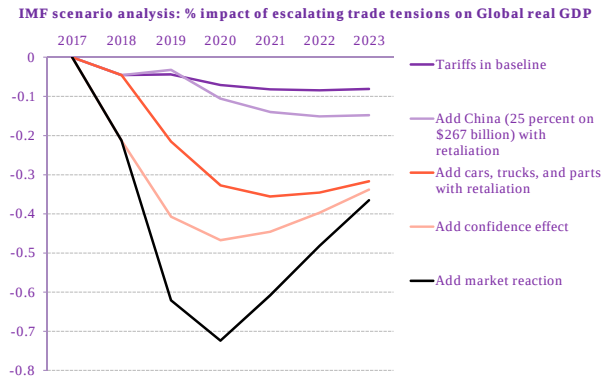
Impact of tariffs on global growth: Recent International Monetary Fund (IMF) analysis suggests an expected shorter-term impact on global GDP growth of ~0.3 percentage points from the May tariff increases. They expect more than half that impact to come through business confidence and financial conditions effects.

The effects aren't straightforward. Currency moves can offset some of the impacts. There is also an offsetting (US) fiscal revenue boost from the government raising tariffs. However, over the last couple of decades, the global trading system/network has reoriented itself with the role of China increasing massively. From here, US importers, for example, can re-orient their supply chains and redirect some of their demand away from China towards other production locations not subject to the higher tariff. However, that itself comes at a cost in terms of time and resources. Alternative production locations may be higher cost than China. Such trade re-direction also lowers the tariff revenue boost for the government. Evidence suggests that the US consumer has borne a cost in earlier tariff rounds (see US section). US exporters have also faced retaliatory tariffs.

Beyond the US and China, other countries have also felt the effects – not only through effects on business confidence and financial conditions – but reflecting that they feed into the supply chain for Chinese exports and also reflecting the broad (non-China specific) nature of some of the US tariff increases last year, e.g. washing machines. Some counties have benefitted from trade re-direction (e.g. Vietnam's exports to the US).

Were the US to escalate the trade war further and impose the additional 25% tariff on $300bn of Chinese imports and the threatened 25% tariff on autos imports, the impact on global growth would likely be more serious and more painful for US consumers too. More than 50% of the $300bn tariff list are consumer goods, increasing the chance of a significant impact on US inflation and an effective hit to US real household disposable incomes. Estimates of the potential impact on global GDP from the impact of implemented tariffs plus the additional two rounds of escalation (China and autos) peaks at about 0.7% of GDP on IMF analysis done last year (Chart 5). Again, however, much of the overall impact could be expected to come through financial conditions and business uncertainty.

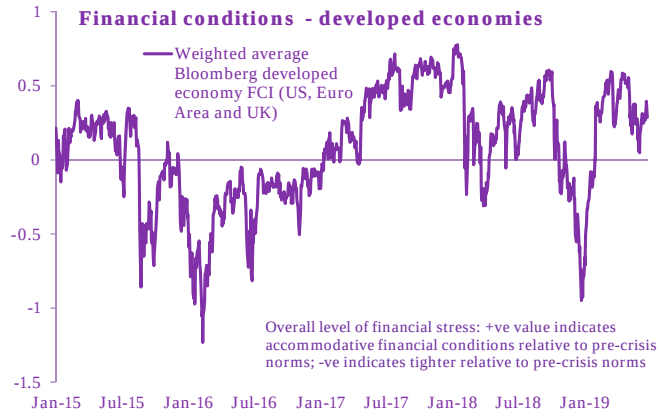
Chart 5: 2019: Some PMIs had been stabilising



Source: IMF Staff analysis. See October World economic Outlook for full explanatory notes

Central banks to the rescue: As businesses have become more uneasy, so have central banks. That has been apparent from recent central bank commentary, especially in the US and euro area where the ground is being prepared for a potential ease in monetary policy. Based on the tariff increases and escalation in trade tensions so far, the likely central bank reaction seems at least a 25bp rate cut in the US and pushing out forward guidance even further in the euro area. Expectations of central bank action have already helped keep financial conditions from tightening significantly (Chart 6).

Chart 6: Financial conditions kept relatively loose



Source: Bloomberg as at 24/06/2019

Risks remain high: Risks to keep an eye on include:

- **President Trump follows through** with his additional tariff threats. In that scenario, more aggressive rate action would look likely, e.g. three to four rate cuts in the US and a small cut in interest rates and renewed burst of asset purchases from the ECB.
- **Central banks disappoint**: However, not only is China stimulus still not in 'do whatever it takes mode' but there are still hurdles for many central banks to ease policy – not least, unemployment is still at its lows and central banks may still worry that the effect of tight labour markets on inflation has further to play out (see Chart 7). That may mean that central banks disappoint the market, resulting in a subsequent tightening in general financial conditions.

Chart 7: Low unemployment; inflation lagging?

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

US: Slowing

The US economy grew more than expected in Q1, but has since showed signs of losing momentum. Growth remains somewhat patchy with strength seen in some of the consumer data, for example, but weakness in some survey indicators. The H2 outlook has deteriorated somewhat (both for the US and global economy) with the latest escalation in trade tensions. There is still a significant probability of recession in the next 18 months. A rate cut looks likely this year.

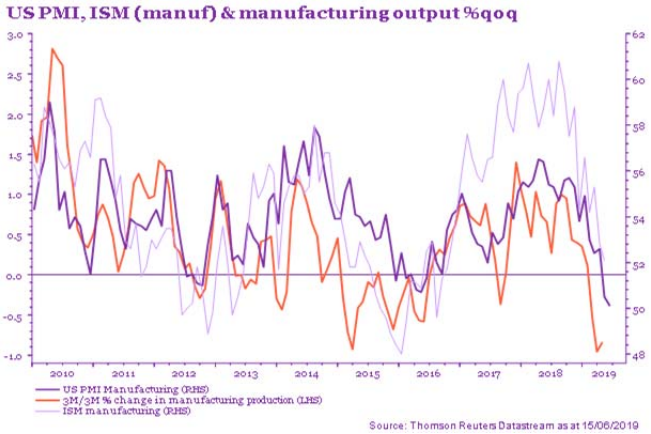
Q1 growth was strong *and* weak: Q1 GDP growth surprised expectations, growing a robust-sounding 3.1% (quarter-on-quarter annualised). However, the details were less reassuring, with weaker core domestic demand components like consumer spending and residential investment (likely partly related to the US shutdown) and sizeable positive contributions from volatile net trade and inventories.

Prospects for H2 were looking OK: Just a couple of months ago, there were already prospects for a moderation in growth in the second half of the year as the fiscal stance became less stimulative. However, there were also considerable supports likely to keep the US economy well clear of the recession threshold including rising pay, robust job gains, the Fed no longer signalling another rate rise this year and generally easier financial conditions compared to the start of the year.

But things have changed –

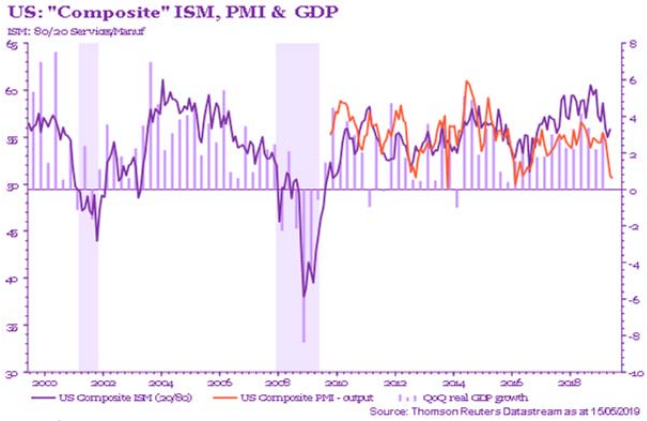
1) The data has cooled: Output growth in the manufacturing sector has slowed. Soft data, in particular, have been a disappointment. PMIs indicate that activity growth has waned, even if survey signals on consumer confidence and employment growth have held up (Charts 8, 9, 10 and 11).

Chart 8: US manufacturing indicators look weak



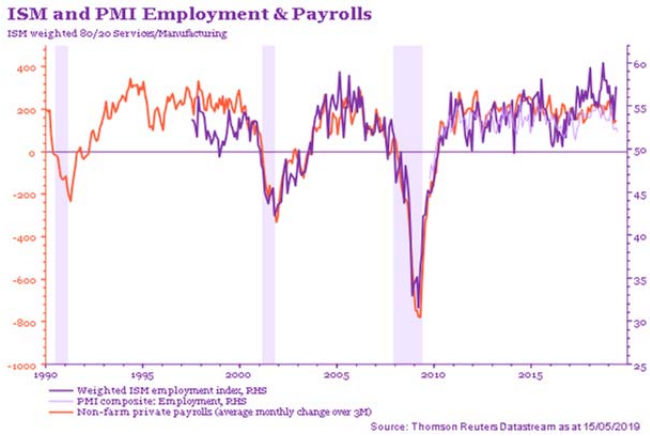
Source: Thomson Reuters Datastream as at 15/06/2019

Chart 9: Data consistent with waning US growth



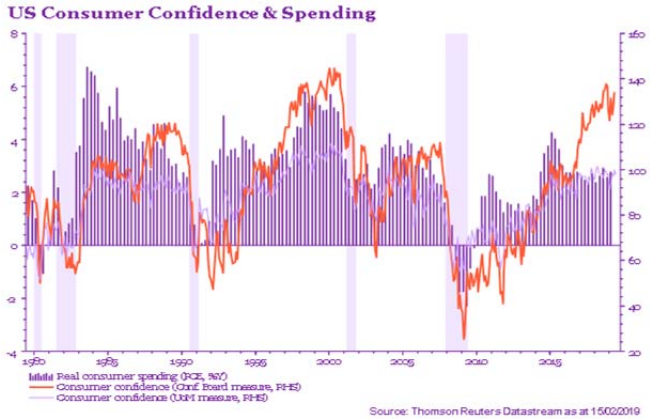
Source: Thomson Reuters Datastream as at 15/05/2019.

Chart 10: Waning, but reasonable jobs growth



Source: Thomson Reuters Datastream as at 15/05/2019.

Chart 11: Consumers still confident



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

2) Worsening the outlook: There is now analysis from previous tariff rounds suggesting that US importers and consumers have borne an impact from higher tariffs (rather than Chinese exporters cutting their prices to offset the tariff increases). The IMF have estimated the hit from the latest round of tariffs on *global* GDP at 0.3%. For the US, analyst estimates of the impact of implemented tariffs is modest (~0.2% GDP). However, the impact of raising tariffs on a

further $300bn Chinese imports to 25%, let alone autos tariffs more broadly to 25%, would likely be larger (analyst estimates are wide and range from around a further 0.2% to more than a 1.0% hit to US GDP).

Central case forecast revised down; slower growth ahead: The US growth forecast (see page 2) has been revised down 0.3% in 2020:

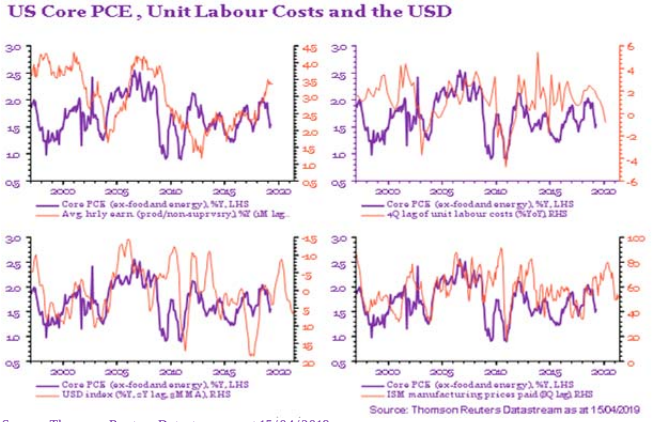
- **It isn't just about tariffs:** While the central case doesn't build in further tariff hikes, it does assume that the threat of further tariff escalation lingers. There are also other non-tariff dimensions to the current escalation in tensions, including changes to export controls and foreign investment approvals. Changes in non-tariff barriers are important for businesses too and can also have an impact on business investment.
- **Fiscal boost fades:** We had already expected fiscal policy to contribute less to growth as this year progressed, as the impact of stimulus waned (Chart 12). However, with relations between President Trump and Congressional Democrats tense, uncertainty is likely to linger for longer around, for example, whether or not spending limits will be raised (if they were not, fiscal policy becomes an outright drag on GDP from late 2019).

Chart 12: The best of the fiscal expansion soon over

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

- **Partly offset by a more dovish Fed...**: Earlier this year, a further rate *rise* by the Fed looked likely. In light of the trade tensions backdrop and weak core inflation (Chart 13), the Fed have prepared the ground for at least a 25bp rate cut. Further, markets are so firmly pricing in cuts that if the Fed fail to follow-through with a cut, a subsequent tightening of financial conditions would likely bump them into a rate cut anyway. In the event of a further lasting escalation in trade tensions, a 50bp rate cut could follow as early as July, followed by two or three further cuts as the impacts are felt in incoming data.
- **...and more accommodative financial conditions:** The market now prices in cuts for the Fed. Lower bond yields, in isolation, are a welcome support for the economy.

Chart 13: Weak core PCE and less than convincing signs it will be able to sustainably pick up above target

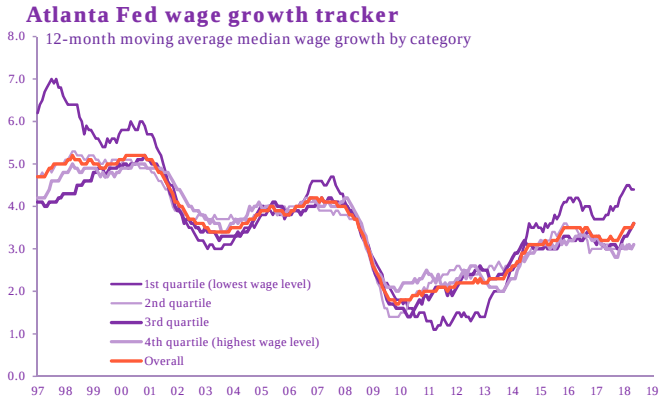


Source: Thomson Reuters Datastream as at 15/04/2019.

The US consumer can help keep the US out of recession: US wage growth has slowed recently, but remains strong. The fastest wage growth has been at the lower end of the pay distribution (where lower earners are in theory more likely to spend any additional earnings compared to high earners), see Chart 14. Lower bond yields and mortgage rates have additionally been providing some support for the housing market (Chart 15). Meanwhile, the US economy is still generating jobs, at least for now, at a pace exceeding trend average labour force growth (Chart 16). Altogether, the pace of real income growth looks consistent with a decent pace of retail sales growth (Chart 17).

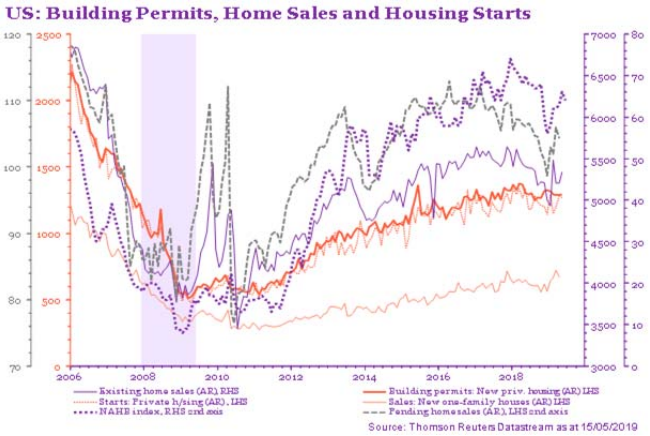
However, there isn't much room for payroll gains to slow before they would fail to keep up with growth in the labour force. Further, the higher tariffs we've seen so far will likely add modestly to inflation (~0.2 percentage points), dampening *real* income growth, but the mooted next round of tariff increases on China – mostly consumer goods – could do more serious damage (analysts estimate a half a percentage point or so boost to core PCE inflation). Recent analysis of earlier rounds of tariffs suggests that the costs were passed onto US importers and consumers (rather than absorbed by foreign exporters). With reduced competition, that analysis also found that US producers raised their prices too.

Chart 14: Highest pay growth for the lowest paid (more likely to spend from income)



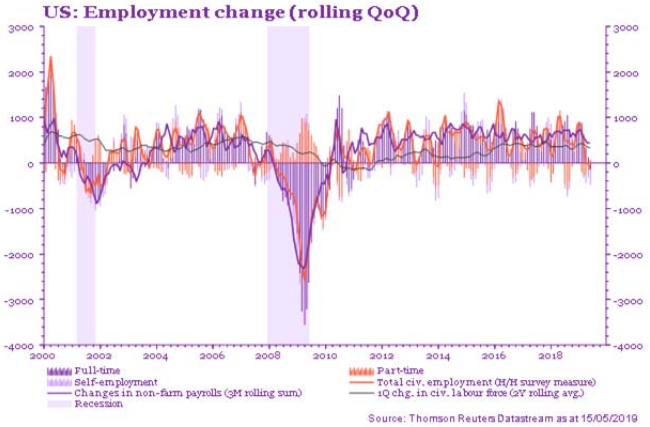
Source: Atlanta Fed as at April 2019.

Chart 15: Some recovery in housing market indicators



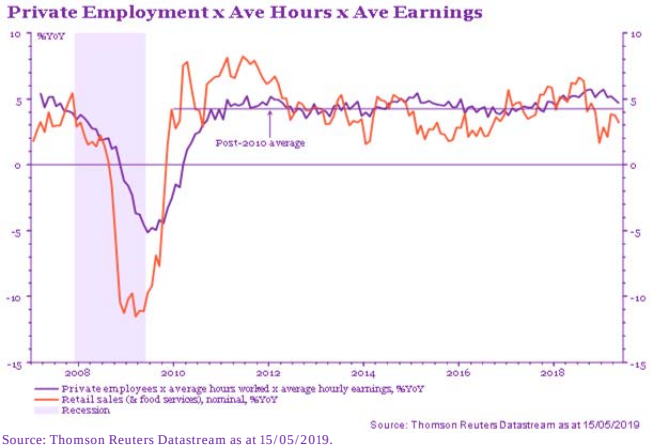
Source: Thomson Reuters Datastream as at 15/05/2019.

Chart 16: Payrolls running above 'breakeven' level



Source: Thomson Reuters Datastream as at 15/05/2019.

Chart 17: Labour market fundamentals still supportive of a decent pace of retail sales growth



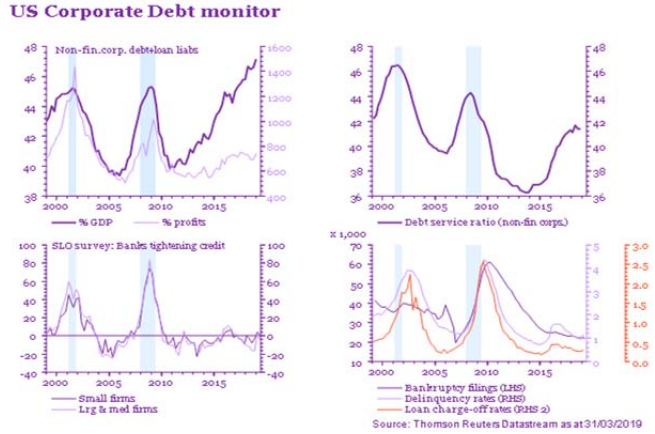
Source: Thomson Reuters Datastream as at 15/05/2019.

Longer-term vulnerabilities and potential accelerants in a recession

High levels of lower quality US corporate debt remain a concern and could act as an 'accelerant' in a down-turn as wider credit spreads and a loss of liquidity in some markets meant some firms struggled to rollover funding.

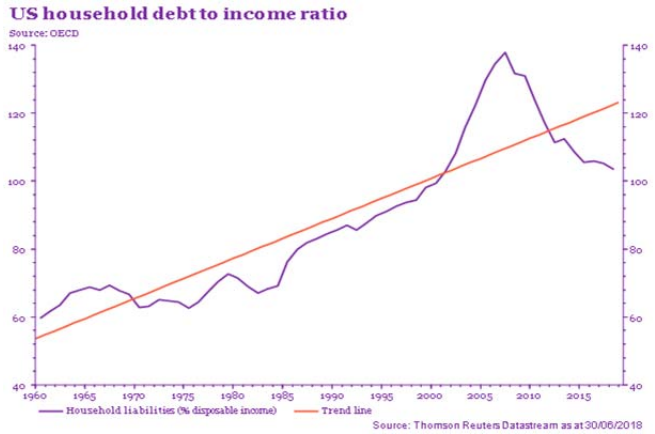
Households and the housing market look less likely to act as a recession accelerant though. Household debt levels remain lower as a percentage of income than they did pre-crisis (Chart 19) and residential investment is now a much lower percentage of GDP (therefore any correction in that sector less likely to tip the economy into recession), Chart 20.

Chart 18: Keep an eye on corporate debt



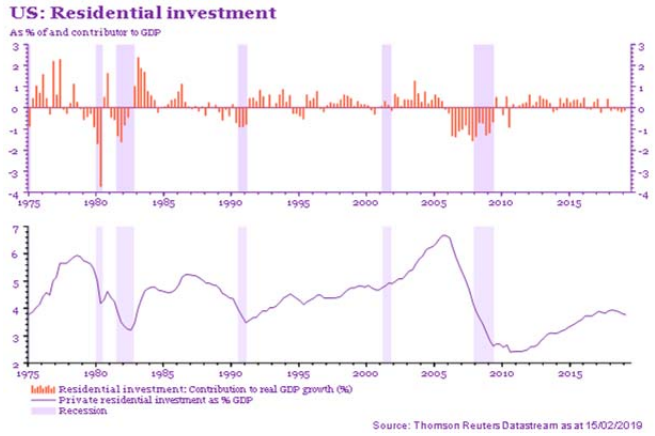
Source: Thomson Reuters Datastream as at 31/03/2019

Chart 19: Household debt not at worrying levels



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

Chart 20: Economy not over-exposed to a construction downturn

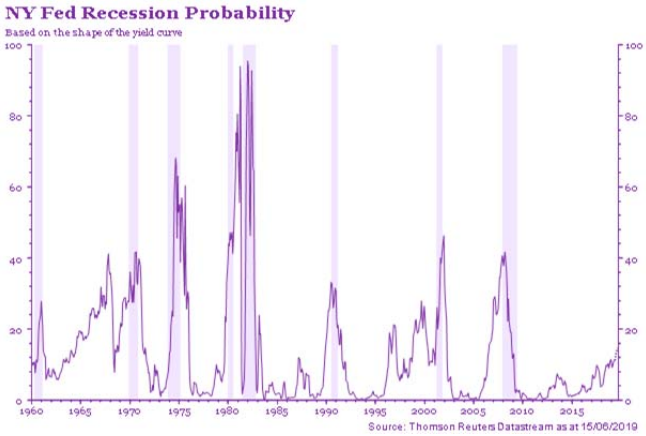


Source: Thomson Reuters Datastream as at 15/02/2019.

Recession still not central case, but some recession indicators continue to flash 'amber'. In order of concern:

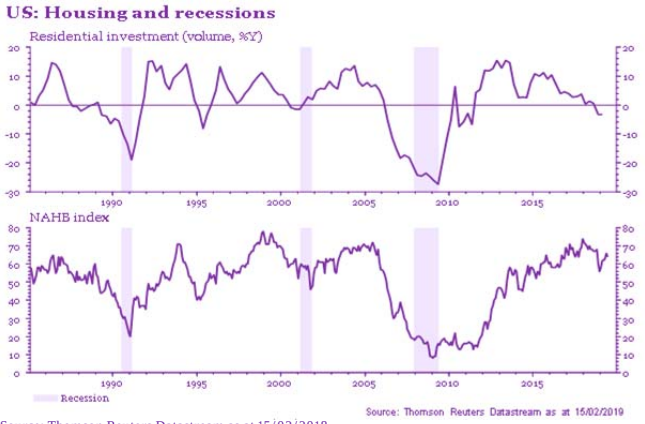
- The NY Fed's recession indicator (chart 21) - **yield curve based**, still implies a sizeable 12-month recession risk.
- **Residential investment** is falling, which has happened before the last few recessions (chart 22).
- Real M1 **money supply** growth (chart 23) is weak, but above the usual recession threshold.
- The real **Fed Funds Rate** remains at lower levels than previously associated with recessions (chart 24).
- **Credit conditions** point to *less* recession risk (chart 25).
- **Stockmarkets**: Equity markets are not sending recession signals at present (chart 26).

Chart 21: Yield curve model: recession risks higher



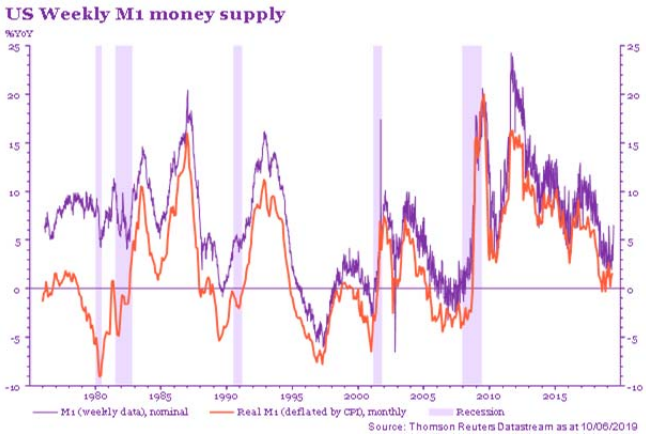
Source: Thomson Reuters Datastream as at 15/06/2019.

Chart 22: Residential investment is contracting; NAHB housing measure is still off its highs



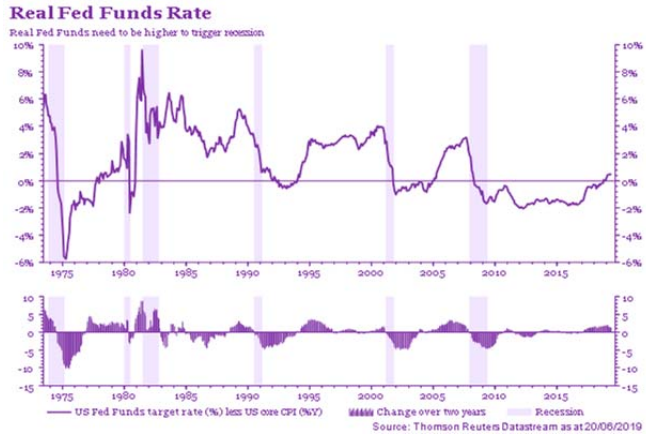
Source: Thomson Reuters Datastream as at 15/02/2018.

Chart 23: Real M1 growth weak. Contraction in real money growth has been a recession signal.



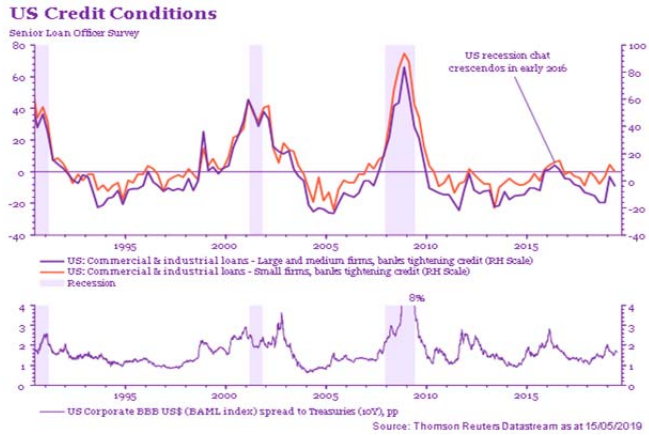
Source: Thomson Reuters Datastream as at 10/06/2019.

Chart 24: Real Fed Funds rate low, though has risen



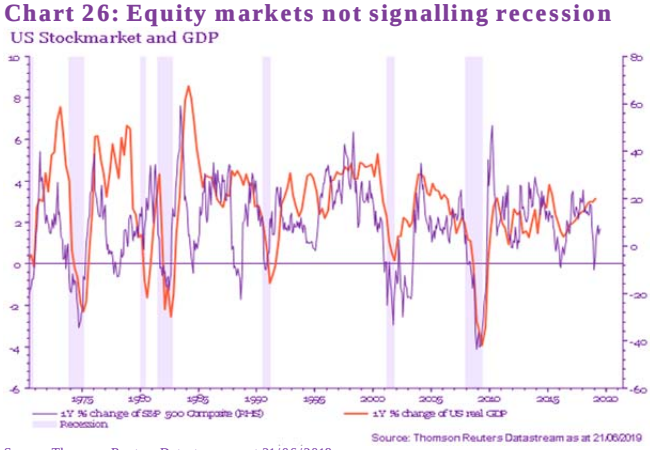
Source: Thomson Reuters Datastream as at 20/06/2019.

Chart 25: Credit conditions (bank lending to firms) and credit spreads imply modest recession risk



Source: Thomson Reuters Datastream as at 15/05/2019.

Chart 26: Equity markets not signalling recession



Source: Thomson Reuters Datastream as at 21/06/2019.

China: Still waiting on that bounce

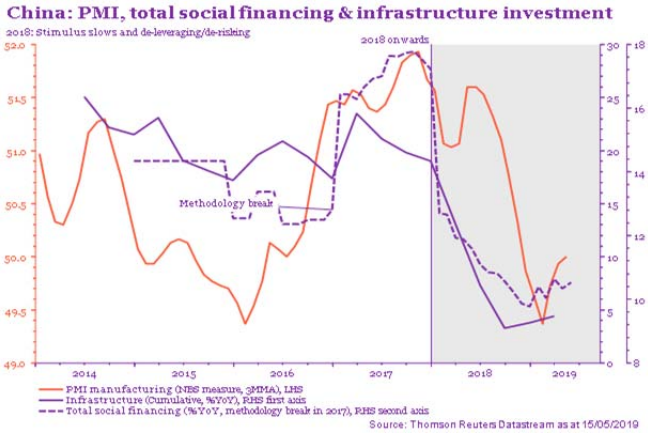
The Chinese domestic slowdown helped drive the 2018 global growth slowdown and shows some signs of stabilisation. However those signs are patchy and the data aren't yet showing a stimulus-fuelled upturn in the economy. Moreover, the escalation of trade tensions with the US has darkened the outlook. More stimulus is likely, which would help offset some of the negative impact on the Chinese economy of higher tariff and non-tariff barriers to trade. Growth looks set to be lower than expected, but further downgrades would be necessary if either trade tensions escalate significantly further or stimulus disappoints.

2018's trade tensions, the fading of earlier stimulus and China's efforts to de-risk the financial sector (e.g. clamp down on the shadow banking sector) help explain why growth slowed in China over 2018 (chart 27). Stimulus in the latter part of 2018 and into 2019 helps explain why prospects were for a better H2 2019 for the Chinese economy.

Chinese data have been volatile since the start of the year, partly reflecting Lunar New Year timing effects and tax changes. However, taking recent data points together, at best the indicators suggest some stabilisation in the economy rather than an upturn as of yet. Tracking the data over the past 18-months, signs of a slowdown have been followed by patchy signs of stabilisation in data including retail sales and PMI surveys (Chart 29 and 30).

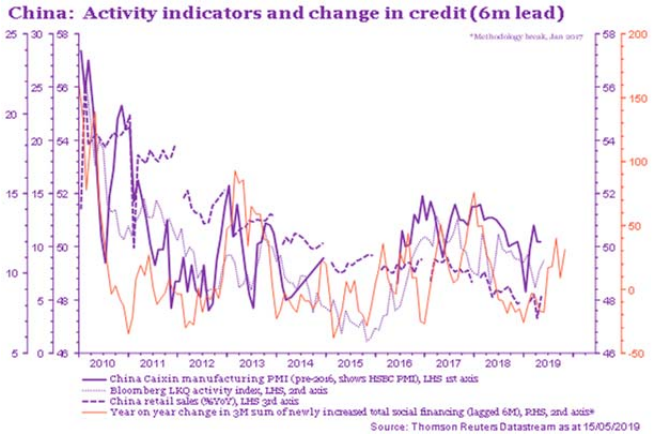
The stimulus since last summer can be seen in some of the money and credit data and, all else equal, should be expected to show through more visibly in activity data (Chart 28). However, the credit data has recently disappointed analyst expectations somewhat and data such as industrial production and fixed investment show some signs of slipping further rather than stabilising (Chart 29). With the escalation in trade tensions, the *expectations* components of the PMI surveys turned down in May (Chart 4).

Charts 27: Growth slowed partly as the impact of past stimulus faded and as authorities moved to de-risk the financial sector



Source: Thomson Reuters Datastream as at 15/05/2019.

Chart 28: Credit pick up supports outlook

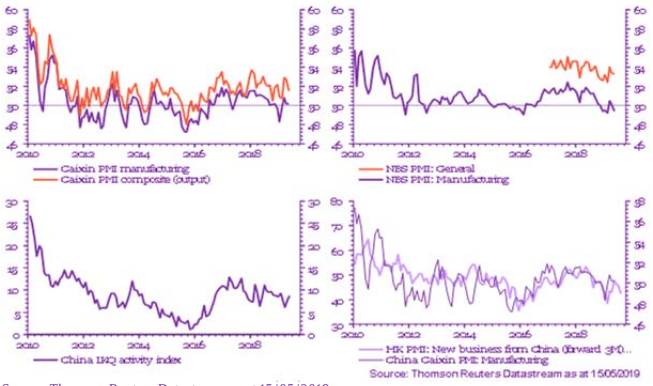


Source: Thomson Reuters Datastream as at 15/05/2019.

Charts 29 & 30: Growth has slowed

Source: Thomson Reuters Datastream as at 15/05/2019.

China surveys: Caixin PMI, NBS PMI, LKQ



Source: Thomson Reuters Datastream as at 15/05/2019.

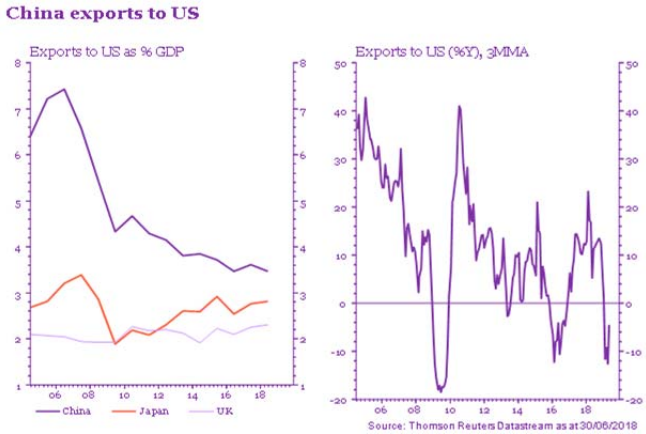
How vulnerable is China to the escalation in trade tensions? At the moment, it is not central case that the next tranche of tariffs (i.e. 25% on the further $300bn of US imports from China) goes ahead, but we assume for now that tariffs to date last the duration of our forecast horizon. Chinese economic growth looks vulnerable to the increase in trade tensions. Estimates of the impact on Chinese GDP of the recent increase in tariffs range from around 0.3% to around 0.5%. However, impact assessments around a further tariff escalation

suggest the impact would be much larger (estimates range between around 0.5% and 1.0%):

- China, over the last couple of decades has moved to the heart of the global trade system and trade flows between China and the US have been among the largest in the entire global trade system (measured by the scale of trade between the two countries compared with other country pairs).
- China's degree of external openness is not that large considering its often assumed export-led growth model. Exports plus imports as a percentage GDP (a crude measure of trade openness) is slightly below 40% for example, below euro area levels (though is more 'open' than the US or Japan). However, goods exports to the US amount to some 3.5%GDP (compared to 2.8% in Japan for example or 2.3% in the UK, though 20% in Canada).
- Evidence from previous tariff rounds suggests that Chinese exporters have taken a hit in terms of export volumes to the US for those products on earlier tariff lists.

China is not only facing higher tariffs, but importantly also an array of non-tariff barriers too. These are more likely to increase from here as the US increasingly merges its trade and security agenda on China. US export controls have extra-territorial reach too, thereby potentially impacting trade flows in third countries [1]

Chart 31: China's US exports continue to fall



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

Policy easing will help: The impact of stimulus measures already implemented should become more visible in the data and help provide some offset. Recent measures include:

- Further **RRR** cuts: The central bank announced further targeted RRR cuts in May (this determines how much a bank needs to hold against its deposits, so a cut can stimulate lending) amid renewed trade tensions.
- **Tax cuts:** The rate of VAT was cut on 1 April.
- **Local government bonds**: The government announced changes in the treatment of local government bond issuance which should increase investment spending.

Easing unlikely to fully offset the additional hit: Given the increased tariff level and ramping up of trade tensions, it is unlikely that the stimulus so far will prove sufficient to stabilise growth at Q1 levels. More will likely be needed, especially if the next level of tariff threats is implemented. The money and credit data may be an early place to watch both the stimulus effects and whether they are proving sufficient. So far, the strong boost earlier this year to the total social financing measure of broad credit in the Chinese economy has shown some signs of fading. However, as with most China data, recent volatility in the numbers thanks to a number of special factors has made the underlying trend harder to read.

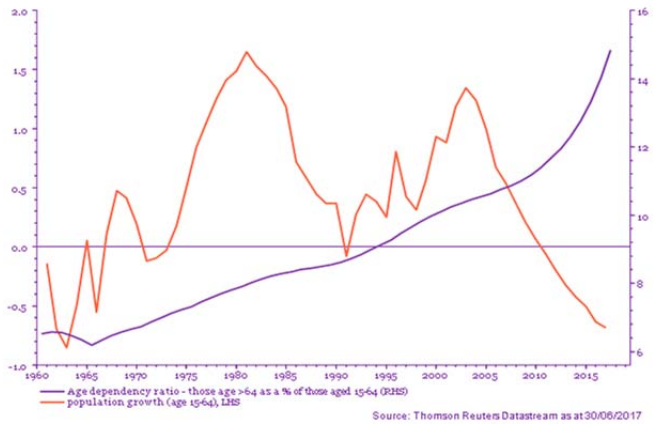
China's GDP growth is likely to be lower than previously forecast, reflecting the impact of the escalation in trade tensions offset partly by an assumption of further stimulus. If tariffs rise again, the forecasts will need to be cut further.

Longer-term risks remain, however, and Chinese growth still looks likely to slow on average over the next few years:

Debt build-up: Rapid credit growth has raised concerns about financial stability over the medium term and private debt is around 200% of GDP. High levels of debt are likely to continue to leave Chinese policymakers reluctant to stimulate too much. As recently as mid-May, the People's Bank of China (PBOC) reiterated its "prudent" stance, for example, including comments on not flooding the economy with excessive liquidity.

Longer-term growth challenge: China's potential rate of growth is likely to decline, partly reflecting demographic factors (chart 32) - working age population growth has been negative now for several years. China lowered its growth target in March from "around 6.5%" to 6.0-6.5%. That growth target seems likely to slip further in coming years.

Chart 32: China's demographics a drag on growth



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

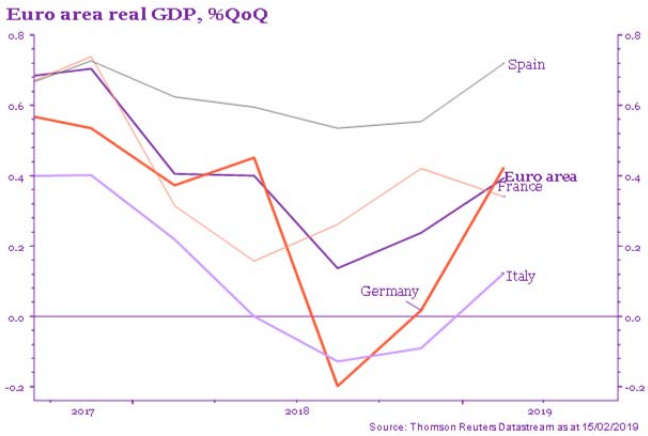
[1] The US Export Administration Regulations regime (where the US added the Chinese company Huawei as an entity in May) has extra-territorial reach and, generally, for products not made in the US, if 25% is of US origin, then that product is considered subject to US Export Administration Regulations. That means that tighter export controls can also impact third-party country exports. 'Exports' are also widely defined.

Eurozone: Vulnerable signs of stabilisation

The euro area economy had a much better start to the year than expected, growing a respectable 0.4%Q in Q1. Supports (from accommodative monetary policy, lower oil prices, higher pay growth) will be offset by exposure to external risks and political worries, but at this point, the euro area economy looks likely to be only modestly weaker than previously expected.

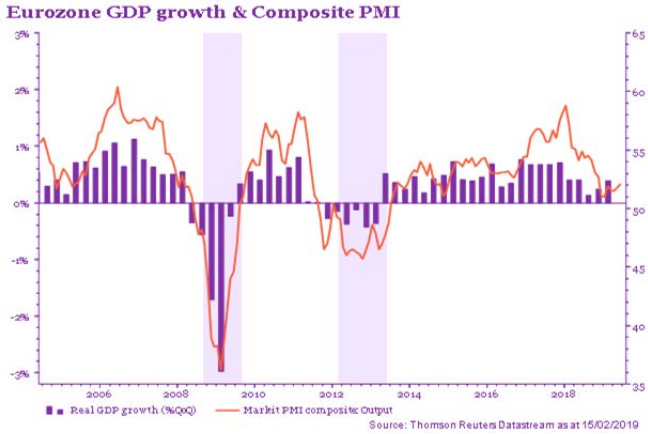
Signs of stabilisation: Q1 GDP growth was stronger than expected (Chart 33). Germany and Italy remain (significant) causes of concern, but surveys look consistent with some stabilisation in growth (chart 34). If trade tensions stabilise and, in particular, if the EU can avoid US tariff increases and a no-deal no–transition Brexit, growth stands a good chance of surprising on the upside.

Chart 33: Q1 bounce



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

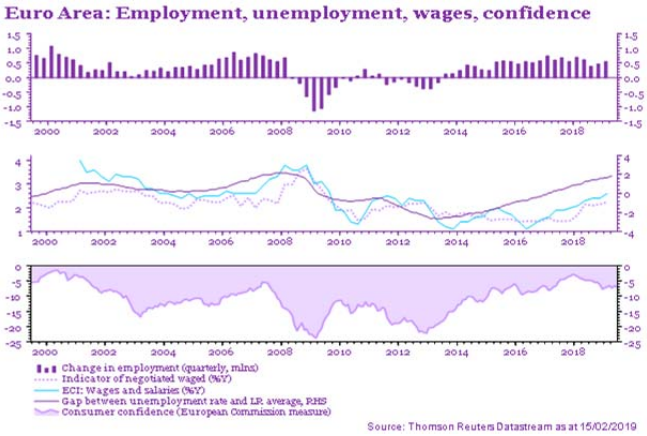
Chart 34: GDP growth and PMIs stabilise

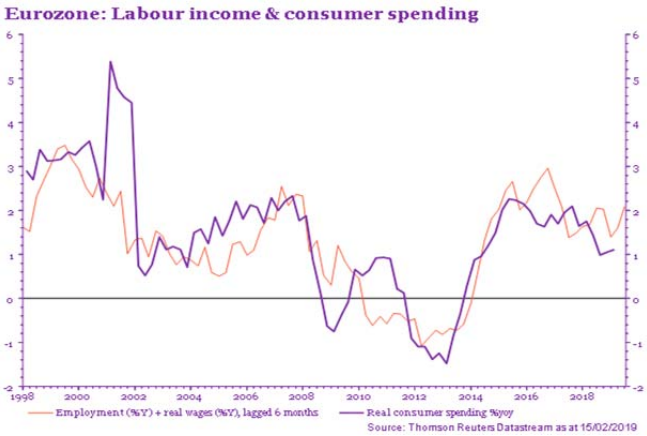


Source: Thomson Reuters Datastream as at 15/02/2019.

Support for the second half: Supports for growth include accommodative monetary policy; lower oil prices than seen over much of last year; and prospects for reasonable real income growth (employment growth holding up relatively well, wage growth stronger, but inflation has slowed (Charts 35 and 36). Fiscal policy should also be modestly supportive this year (Chart 37). The ECB now looks more likely to ease monetary policy over the next year too in light of risks to global growth and weak core inflation.

Charts 35 & 36: Labour market supporting spending





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

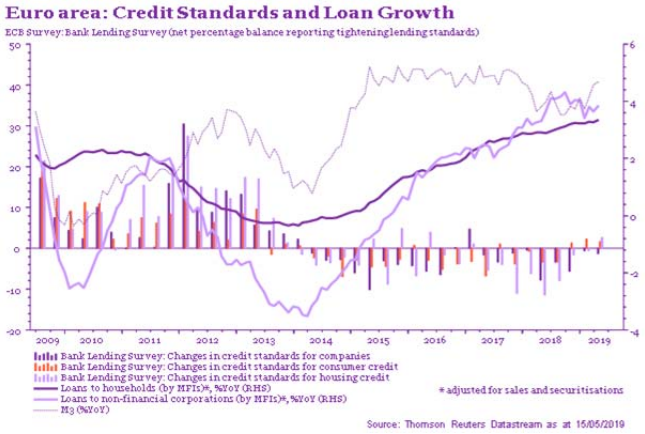
Chart 37: Fiscal policy a (small) boost for GDP growth

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

ECB dovish: ECB rate rises look even further away than they did three months ago. The ECB's forward guidance now states that they expect interest rates not to be raised at least through H1 2020 (end-2019 previously), since when the ECB's Draghi has hinted more forcibly that the ECB is readying more stimulus. The earlier than expected announcements on Targeted Longer-Term Refinancing Operations (TLTROs) also give us some comfort on the outlook, especially against a backdrop of already surprisingly healthy money supply and

loan growth. Loan growth to the non-financial private sector remains in the 3-4%Y range, despite some modest apparent tightening in credit conditions (Chart 38). Further quantitative easing (QE) looks more likely than a QE unwind over the forecast horizon.

Chart 38: Healthy loan growth



Source: Thomson Reuters Datastream as at 15/05/2019.

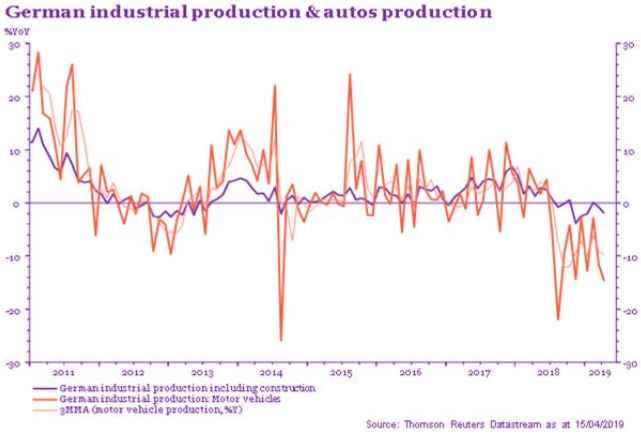
Not at the heart of the trade storm…yet: The US has directed its tariff threat firepower mostly at China (then Mexico), delaying a decision on autos tariffs until November (higher autos tariffs would be particularly impactful for the euro area, especially for Germany). However, the threat of auto tariffs remains and the extra-territorial reach of US export controls can mean that European companies are caught up in the measures being directed at China.

Signals on progress in US-EU trade talks have been mixed. It was only in April, that the European Council agreed to the negotiation mandate proposed by the Commission, though with France voting against. EU Trade Commissioner Malmstrom said in late May that the two sides had made some progress towards talks, but also recognised that the two sides had conflicting mandates on agricultural products. The issue of aviation subsidies remains contentious and may be used as the grounds for tariff increases in coming months. More generally, rhetoric from President Trump on the US' relationship with the EU continues to suggest that anti-EU tariff measures are a significant probability.

Beware a comeback for Cars, China, Brexit and politics: These four factors can be blamed for much of the underperformance of the euro area economy in 2018. They are all – to one degree or another – at risk of causing further damage to euro area growth prospects:

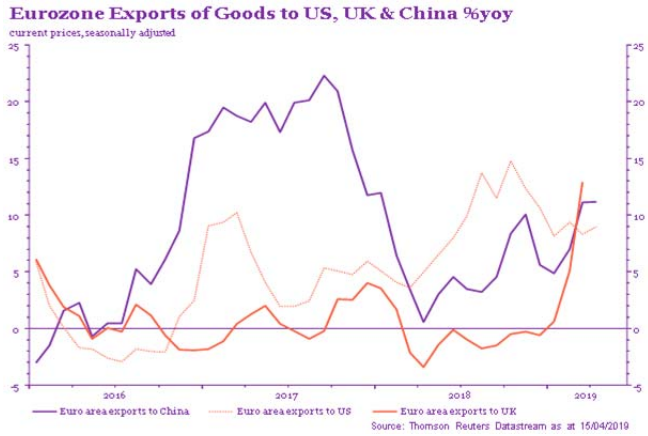
- **Car trouble**: German car production remains weak (Chart 39). If the US proceed with an increase in autos tariffs, things will get worse again. In 2018, the US was the main destination for *EU* car exports (29% of the total), with Germany the EU's largest car exporter (55% of total extra-EU car exports). Meanwhile, there are clearly some longer-run structural factors impacting the autos industry globally (e.g. transition to electric vehicles).
- **China:** China is the euro area's third largest *export destination* and export growth to China has been *picking up* (Exhibit 40). The euro area may benefit from import diversion as trade relations remain tense between the US and China. However, to the degree those trade tensions threaten end-demand in China this may not be sustainable. Chinese data suggest that domestic Chinese growth is, at best, stabilising rather than showing clear signs of picking up.
- **Brexit:** The UK is the euro area's second largest export destination. The threat of a no-deal, no-transition Brexit remains substantial (with Ireland particularly vulnerable) There was a pick up in exports from the euro area to the UK in Q1 (Chart 40), but likely related to Brexit preparations rather than signalling a major trend change.
- **Political uncertainty:** Elections for the EU parliament weren't quite the feared showcase for the rise of European populism. However, in Italy, as the popularity of the League has grown at the expense of coalition partner 5-Star, so the probability of an early election in Italy has grown. More generally, the incomplete nature of the euro area in terms of not being a fiscal union, for example, means that the euro area remains prone to revivals of worries about euro area break-up risks when parties with euro-sceptic tendencies do well.

Chart 39: Autos trouble still visible in Germany



Source: Thomson Reuters Datastream as at 15/04/2019.

Chart 40: Export growth improvements look vulnerable



Source: Thomson Reuters Datastream as at 15/04/2019.

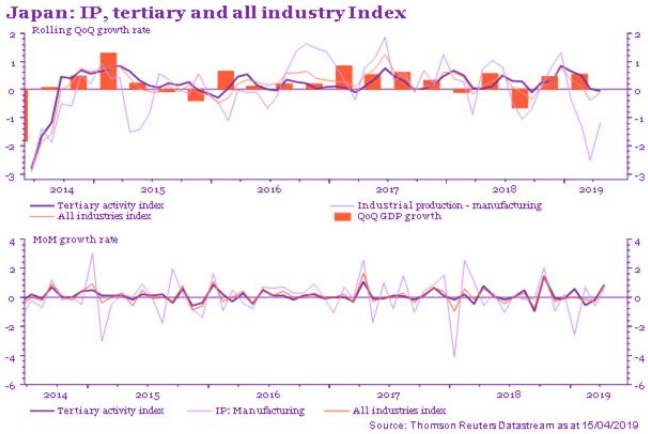
Japan: Still waiting for an upturn…

The Japanese economy surprised on the upside in Q1. We don't expect the scheduled consumption tax rise to knock the economy off course this year, neither do we expect President Trump to end up levying damaging tariffs on Japan. But survey data look soft and the global growth outlook has weakened. The 2020 GDP growth forecast is revised down modestly.

The Japanese economy is still struggling to gain traction: Hard data and surveys indicated that the economy has struggled to build sustained momentum. Although Q1 GDP growth was stronger than expected, indicators for Q2 are mixed and so far look consistent with weaker growth.

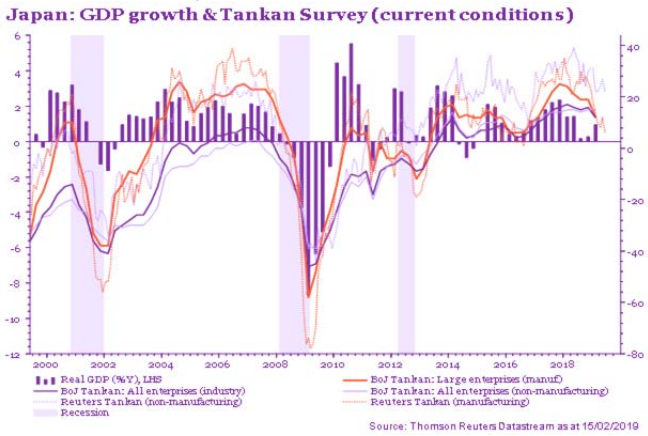
Although industrial production has started Q2 better than expected (Chart 41), retail sales disappointed in May and the PMIs indicate weak overall activity growth, with the manufacturing PMI still below the 50.0 'no growth' level. The monthly Reuters Tankan has weakened too (chart 42).

Chart 41: Hard data – struggling to sustain growth in Q2



Source: Thomson Reuters Datastream as at 15/04/2019.

Chart 42: Surveys mixed, but weaker



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

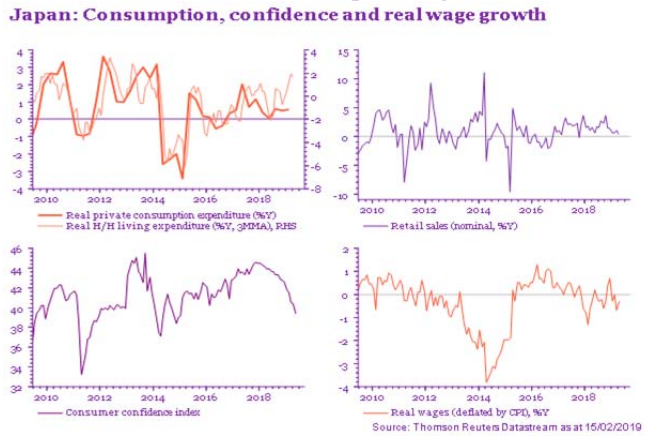
The labour market remains tight, but signs of higher pay growth have faded: Employment growth remains positive (0.6%Y in April), and the labour market continues to look tight. The unemployment rate is still bouncing around its lowest levels since the early 1990s. Pay growth however appears to have lost some momentum (albeit headline pay growth figures have been strongly affected by a change in statistical sampling). Consumer confidence has continued to fall too (Chart 43). We will likely see some front-loading of spending as households prepare for the increase in the consumption tax, but this has not been strongly evident yet in the household spending or retail sales data.

The government might yet pull the consumption tax hike, though not central case: In October 2019, the government plans a sales tax rise from 8 to 10% (delayed from 2015 and then 2017). Measures are being taken to help avoid damaging effects on consumer spending (including various exemptions, spending vouchers and childcare subsidies), but the broader global economic backdrop might yet be enough to persuade the government to pull the tax hike.

Trump shield? Japan remains exposed to trade tensions. However, the economy itself is relatively closed (exports + imports are only 34% GDP, compared to 61% in the UK for example). So far, Japan appears to have done a good job of containing tariff risks. The threat of higher autos tariffs has only be been postposed, not cancelled, but Trump's visit to Japan at the end of May appeared to go well and Japan appears well placed to be able to make concessions to the US (for example, by aligning the tariff treatment of the US with the tariff rates it would have seen under TPP).

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 partly to blame. Significant monetary policy tightening still looks a long way off for Japan.

Chart 43: Mixed consumer spending indicators



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

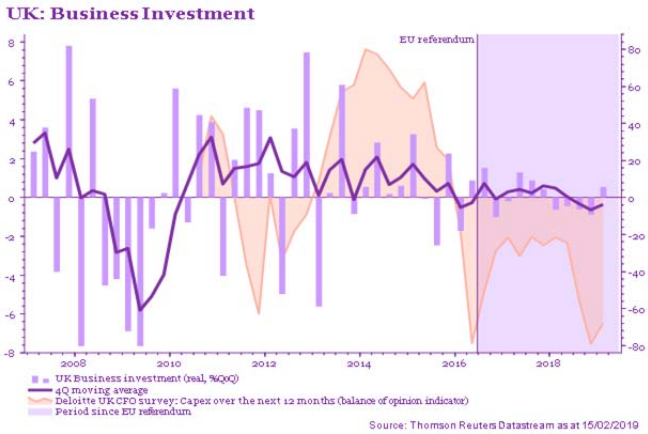
UK: Brexit bumps and patchy fundamentals

Given continued domestic division over Europe, Brexit remains likely to be a lingering source of political and economic uncertainty. That uncertainty will continue to drag on investment, although consumer spending and a somewhat looser fiscal stance should provide some support. The UK is not immune to the impact of global trade tensions either. As the global outlook has worsened and the timetable for Brexit drawn out, a BoE rate rise looks unlikely for a more extended period.

Brexit bumps in the data: The picture painted by surveys and hard data is one of an economy 'muddling through' with weak, but positive growth against a backdrop of significant uncertainty. UK data has been buffeted by Brexit in recent months as the original 29 March Brexit day approached, then was pushed back to October. Businesses continue to flag Brexit as a major source of uncertainty.

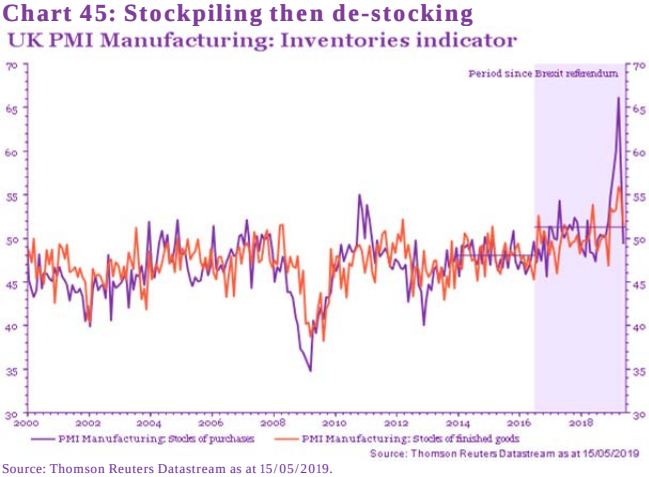
Business investment remains weak (Chart 44). There was evidence of stockpiling, and then unwind around the original Brexit date (Chart 45), as well as impacts on trade and production data. Consumer confidence has been picking up as the 'cliff edge risk' has retreated (chart 46), likely helped by low unemployment and higher real pay growth (chart 47).

Chart 44: Business investment weak



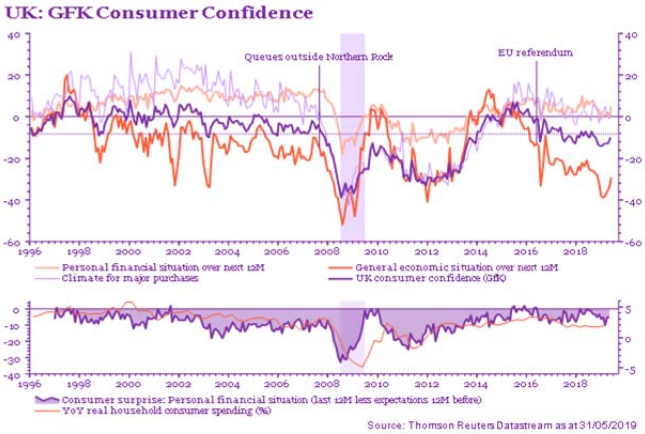
Source: Thomson Reuters Datastream as at 15/02/2019.

Chart 45: Stockpiling then de-stocking



Source: Thomson Reuters Datastream as at 15/05/2019.

Chart 46: Consumer confidence weak, but rising



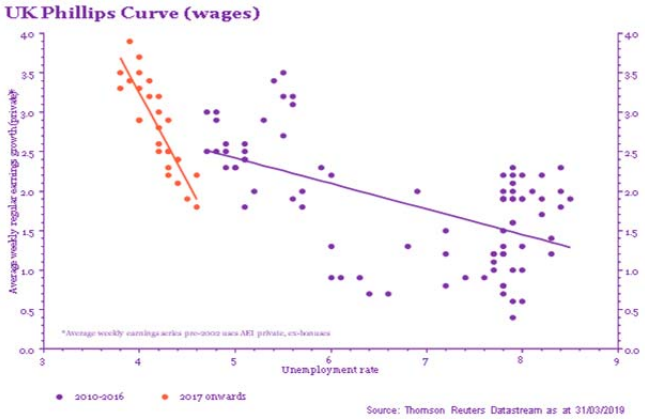
Source: Thomson Reuters Datastream as at 31/05/2019.

Chart 47: Real pay supporting consumer spending

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

Consumer resilient...: Consumer spending is likely to remain relatively resilient. Fundamentals still look supportive (Chart 47). If unemployment (3.8%) stays at such low levels, private sector pay growth can rise further (Charts 48 and 49). Pay growth (April 17-April 18) has also been strongest in the lowest paid occupations, where employees might be more likely to spend proportionally more of any additional income.

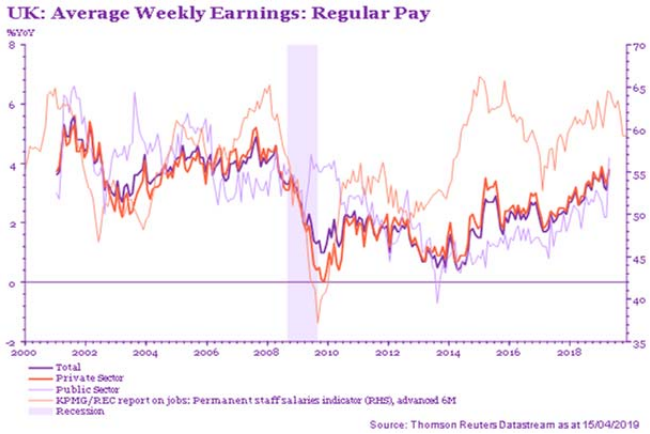
Chart 48: Lower unemployment = higher pay growth



Source: Thomson Reuters Datastream as at 31/03/2019.

...but spending growth may slow somewhat: The labour market has shown signs of cooling. In particular, full-time employment growth has slowed (Chart 50). UK households look vulnerable to a turn in the labour market: Savings rates, though having risen, are still at very low levels and consumer credit conditions have tightened. Take home pay will have been hit by the rise in pensions contributions in April under auto-enrolment and in-work social benefits have seen real terms cuts.

Chart 49: Pay growth has been picking up...



Source: Thomson Reuters Datastream as at 15/04/2019.

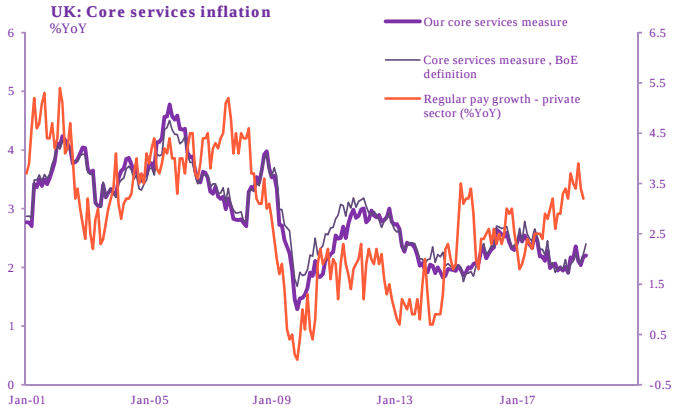
Chart 50: ...but full-time employment growth slowed

Source: Thomson Reuters Datastream as at 31/03/2019.

UK growth likely mediocre well into 2020: In our central case there is no clarity on whether the UK will be leaving the EU through 2019 and into 2020. In a 'deal' or 'no deal' outcome, uncertainty around the UK's ultimate relationship with the EU will linger over (likely years) of negotiations. The political fallout of Brexit has already increased economic policy uncertainty in the UK. Business investment is likely to remain relatively lacklustre over the rest of 2019. Support from consumer spending and government spending are likely to be offset by a weaker global backdrop.

BoE even more 'limited and gradual': With the global backdrop weaker, and limited evidence of a pick-up in domestically-driven inflation (Chart 51), despite persistently higher pay growth, the BoE now seems unlikely to raise rates this year, especially in the absence of more Brexit clarity.

Chart 51: limited domestic inflationary pressure

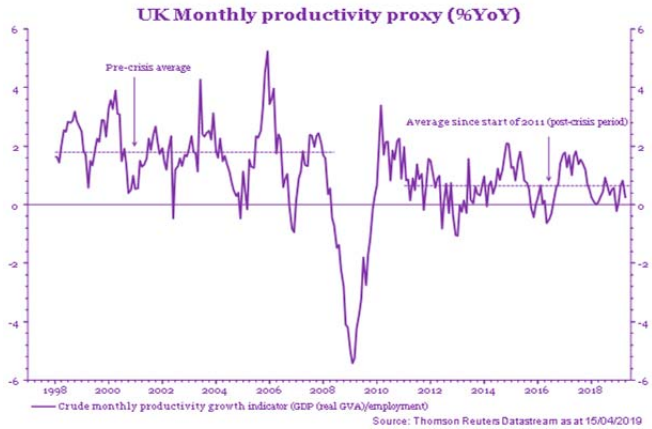


Source: ONS, RLAM, BoE, Thomson Reuters Datastream as at 15/05/2018.

Not expecting a bounce back in potential growth, even if we get a bit of Brexit clarity:

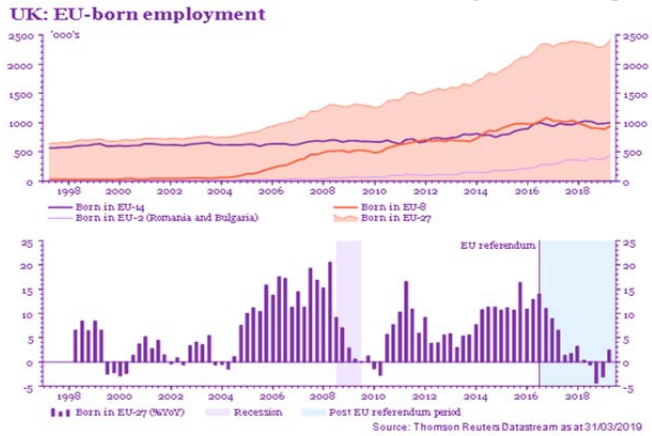
- Productivity growth has been persistently weak since the financial crisis, Chart 52;
- A jump in working age population growth isn't central case. Employment rich immigration from the EU may be slow to return post-Brexit (chart 53).
- Continued high levels of uncertainty are likely to dampen growth in the capital stock.

Chart 52: Persistently weak productivity



Source: Thomson Reuters Datastream as at 15/04/2019.

Chart 53: UK less attractive? EU immigration drops



Source: Thomson Reuters Datastream as at31/03/2019.

We assume that there is an endorsed and ratified withdrawal deal, but not this year and with a *similar probability to 'no deal' or 'remain' over a two year timeframe*. Those vying to succeed PM May have talked about re-negotiating the Withdrawal Agreement (which the EU have clearly said they won't re-open) and indicated a willingness for the UK to leave the EU on 31 October with no deal. It matters who leads the ruling Conservative party and country but, without a general election, the composition of MPs in parliament won't change and the majority of MPs still oppose a 'no deal Brexit' *and* the existing deal. Although in theory MPs have limited options to stop a government absolutely determined to leave with no deal, MPs always have the option to vote no confidence in the government where, if an alternative government cannot be formed in 14-days, a general election is called. In practice, it is arguably most likely that one of the following happens:

1. The new PM is more pragmatic than sticking to any promise (or not making one in the first place) of leaving the EU on 31 October no matter what. They voluntarily 'kick the can' into 2020;
2. MPs force a general election via a no confidence vote;
3. The new PM gets so fed up with parliament blocking them that they call a general election (which would then very likely get the required 2/3rd majority in the House of Commons to pass), or a referendum.

Although 2) and 3) are currently considered by many as unpalatable to most sitting Conservative MPs in light of recent polls, polls can change and are likely to change somewhat in the aftermath of the party electing a new leader.

Higher 'no deal' risk: There is still a significant risk that the UK exits the EU between 31 October and the end of 2020 with no deal at all. For example, either a referendum or general election could plausibly result in public endorsement for a 'no deal' outcome. Despite a majority of MPs having expressed opposition to 'no deal' Brexit, that remains the default option. 'No deal' risk has risen given the winner of the Conservative leadership contest will, it appears, have a 'harder' Brexit stance than PM May. For more on the economic effects of 'no deal' Brexit, see 'Dark Clouds but no Storm'.

Higher risk of 'remain': A 'Remain' outcome still has a significant probability too. Our central case is that the UK will still be in the EU at the end of 2019, given time simply looks too tight for re-negotiation and ratification and given that the EU was previously willing to extend the Brexit deadline. Beyond this year, the most likely Remain route is through a referendum or general election (where the majority of seats then went to pro-referendum parties). The probability of Remain has also increased as parliament repeatedly failed to approve the existing deal, increasing the potential need for a new process (election or referendum) to end the deadlock.

2019 Brexit scenarios

Upside scenario (~33% probability) – Remain

- There is still a subset of outcomes where the UK stays in the EU longer-term, especially via a referendum on the withdrawal deal, where 'Remain' is both an option and selected by a majority. Given the current make-up of parliament and sustained division, there is appeal in a political process to end the Brexit deadlock.
- Economic implications in 2020 vary, depending partly on how much political uncertainty or change precedes and follows the outcome. Sterling likely appreciates.

Base case (~33%) – Entering transition

- Uncertainty drags on until the/a deal is ratified, and after a further extension to the Article 50 deadline, with the UK activity indicators both bumpy and subdued on average in the meantime.
- Transition period avoids cliff edge, 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 gradual tightening path in H2 2020.

Downside scenario (~33%) – Disruptive 'no Deal'

- Process breaks down and there is no fully implemented transition period. This could happen through several routes (see above) and '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 on the economy, 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. The UK experiences a technical recession, with GDP ~4% lower than the base case after four years.
- The BoE cut rates and restart QE in response to the short-term demand shock and despite sterling weakness.

Scenarios are not exhaustive and probabilities are subjective