The global economy is at the crossroads. While the US remains a bastion of macro stability, the latest data in Europe, China, and across emerging markets have all showed clear signs of slowing. Ultimately we are optimistic about the US, but believe that the downside risks have risen sharply in Europe. The trade war between the US and China is approaching the key March 1st deadline, a hard or soft Brexit will happen on March 29 without an extension, and the US will decide on the Section 232 national security report into autos by February 17 with implications for European autos and growth. Europe could be tipped into recession with negative developments on these binary issues.

We expect US growth to maintain its strong pace despite some recent softening in financial conditions and incoming data. We forecast real GDP growth of 2.5% in 2019 and 2.1% in 2020. The labour market continues to strengthen and signal further gains in consumer spending. Tax cuts and fiscal spending acts as tailwinds and are expected to remain supportive through 2020. Some recent data releases have softened and financial conditions have tightened, but concerns are overblown. The latest ISM reading is consistent with GDP growth around 4% annualized. The notable downside risks include: (i) escalation of trade war; (ii) sharp tightening in financial conditions and (iii) slowing China/Euro area growth dragging US growth lower too.

Eurozone growth momentum is slowing rapidly. We cut our 2019 euro area growth forecast further to 0.9% from 1.2%, the 3rd downward revision in the last two months. Weak external demand is a key drag, compounded by concerns of cracks appearing in domestic resilience – weakening job and capex indicators.

In January, German manufacturing PMI fell below 50 and we now expect Germany to contract again in Q1-19. Eurozone composite PMI for January fell for the fifth month in a row. Our SIREN Momentum index also continued to slide in January, falling to its lowest level since late 2014. Finally, our Eurozone trade cycle indicator also suggests drift towards recession.

Risks are mainly on the downside – “No deal” Brexit, trade war escalation (auto tariffs by US) could tip euro area economy into recession.

China’s Q4-18 real GDP growth slowed moderately to 6.4% while the slowdown was more pronounced in nominal GDP –to 8.1% from 9.6% in Q3. Industrial production and retail sales rebounded slightly in Dec-18, but overall trend is downwards. January manufacturing PMI came below 50 for 2nd consecutive month. Overall, we expect real GDP growth to slow further in Q1 and reach 5.9% in Q2. We see three factors putting downward pressure on the economy; (i) the cooling property and land cycles; (ii) the weak confidence in the private sector; and (iii) and the US-China trade war.

The Chinese government is now emphasizing a tightening bias on fiscal spending. This was evident in its recent move whereby the government deferred providing subsidies to local governments for boosting consumption of cars, home appliances etc. Contrary to the market expectations for a fiscal stimulus, we see a negative fiscal shock to be rather likely in 2019.

We think the burden of policy easing will fall on the monetary side; and if the economy slows further, the government may have to loosen controls on the property market.

EM is naturally taking cues from the developments at the core, but these ripple effects have been outweighed by the benefits of a more gradual Fed normalization. This will hold as long as growth holds. We maintain a constructive view for the year and expect EM to growth at 4.6% in 2019.

Asia growth momentum has slowed the most and focus will be on China and export oriented economies (Singapore, Taiwan etc.). In LatAm, outlook for Brazil and Mexico looks marginally positive while Argentina is expected to continue to contract. In CEEMEA, focus will be on Turkey (CBT action), South Africa (fiscal issues and possible rating d/g) and Russia (sanctions risk). Also, election in several EM economies (India, Turkey, South Africa, Argentina, Indonesia etc.) could be a source of economic boost.

Fed: 2 hikes in 2019, down from our previous expectation of 3 hikes
ECB: First depo rate hike delayed to December-2020, from March-2020
BoJ: Discussion in next 2-3 years on changing policy goal from inflation to growth or price level
Boe: One hike in Aug-2019, though our conviction has weakened due to a dovish tone from the MPC
PBoC: Two more RRR cuts in 2019. Likelihood of more monetary policy easing is rising
The House View: Snapshot (Continued)
8 February 2019

Key downside risks

- **Crash Brexit**: With clock running down to March 29th deadline and ongoing deadlock amongst UK MPs over the Brexit Withdrawal Agreement continues, the risks of a ‘no-deal’ Brexit have risen (an indicative probability of 15%). Hard Brexit would be painful for UK and Europe in particular, causing cumulative GDP loss of ~4% and 1% respectively over 2019-2020
- **Recession**: Sharp slowdown in Chinese and European growth (as indicative from latest data) & associated recession/correction in financial markets could subtract 1-1.5% point from global growth
- **Italy, France, & EP election**: Concerns over Italian debt sustainability, escalation of “Yellow Vest” movement in France, or uncertainties around upcoming European Parliamentary elections, all present risks this year. The grand coalition in Germany may also become strained later this year posing additional risks
- **Trade conflict**: Failure to secure trade deal between US-China, imposition of tariffs on EU autos or higher tariffs on China imports, or escalation of conflicts beyond trade could all hit global growth fairly hardly

Key themes

- **Brexit**: Brexit talks still no close to resolution despite time running out. PM May’s strategy is simply running the clock down and hoping to get Labour support for the deal. Our baseline view is that UK MPs will approve PM May’s deal to avoid a crash (‘no-deal’) Brexit. We turn neutral on Sterling
- **Trade war**: Recent US-China trade talks signalled some optimism. Although, no draft framework was agreed upon. The 90 day truce is going to end on 1st March, post which, absent a deal, US is set to impose higher tariffs on $200bn of Chinese goods. The US will also decide on the Section 232 national security report into autos by February 17 with implications for European autos and growth.
- **EU/German Politics**: Anti-establishment parties are likely to gain seats in upcoming elections, potentially undermining effective economic policymaking

Market views

**Market sentiment**

- **Higher risks**: Episodes of higher volatility will become more common moving forward

**Equities**

- **Bullish US equities**: While earnings are slowing, the market is pricing for an overly steep slowdown into Q2-19F, and neutral US equities. The recent rebound has taken them back to fair value

**Rates**

- **Strategically bearish**: The market is still underpricing the magnitude of likely Fed rate hikes, especially given our forecasts for inflation to gradually rise throughout the year
- **In Europe, the biggest policy change will likely be new credit easing from the ECB**

**FX**

- **We expect the dollar to depreciate this year due to an unfavourable flow backdrop**: An exception is that we expect the dollar to rally further versus the Chinese yuan.
- **Bullish euro**: We still expect flows to stabilize, the current account surplus to stay high, and the ECB to move forward with gradual, albeit delayed monetary tightening
- **Lean Bullish yen**: The balance of risks for the yen are skewed toward strength versus the dollar

**Credit**

- **Structurally wider, but expect near term relief rally**: Anticipate positive excess returns this year

**EM**

- More gradual Fed normalization is beneficial for EM assets, if growth holds,
- EM FX valuations are particularly attractive. We also maintain our core constructive view on EM credit

**Oil**

- By the end of Q1, we expect to see risks balanced around the Brent at $63/bbl level, underpinned by coordinated OPEC supply cuts, demand growth, and US sanctions on Venezuela and Iran

Key macro and markets forecasts

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Recent publications

- The House View – At the crossroads, 7 February 2019
- The House View – 2019 Outlook: Growth to plateau, but not collapse, 19-December-2018
- The House View – US keeping solid global growth alive, 15-November 2018
- The House View – Markets after the recent sell-off, 16-October 2018