TS Lombard

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Economics / Politics / Markets

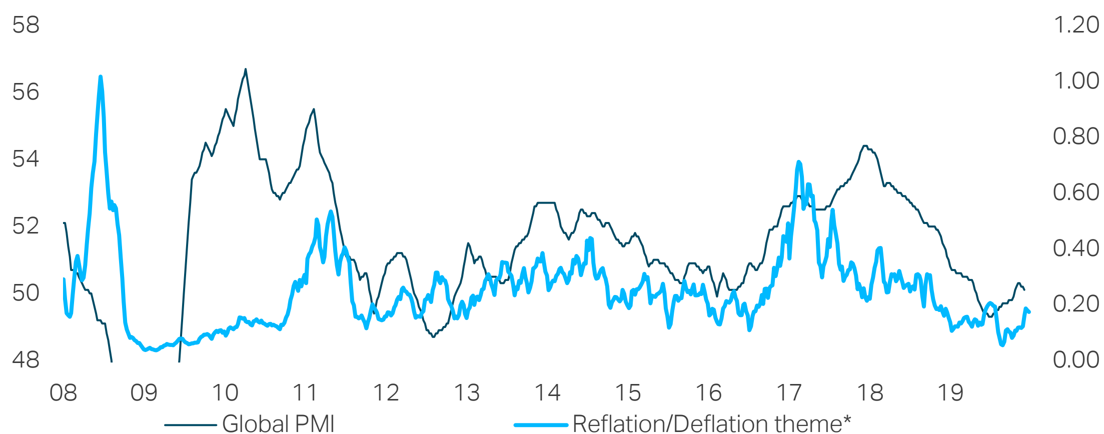
Macro Picture

THREE THEMES FOR 2020

Dario Perkins

The consensus expects a modest economic revival in 2020, enough to keep the global expansion going, but not sufficient to generate inflation or force policy tightening. We present three themes that could challenge this narrative: (i) a rebound in global capex/IP; (ii) faster wage growth, and (iii) dollar weakness/the end of US 'outperformance'.

Chart 1: Mini industrial cycles have driven market narrative



Source: Markit, Bloomberg, *ratio of Bberg news stories containing 'inflation' and 'reflation' to 'deflation' and 'recession'

INDUSTRIAL REVIVAL

Global growth has tracked a series of mini industrial/capex cycles since 2010, with financial pundits extrapolating these moves into a sequence of (temporary) 'reflation' and 'deflation' narratives. An important question for 2020 is whether the trade deal between the US and China will be sufficient to revive global demand and generate a new reflation theme for markets.

WAGE SQUEEZE

Labour markets are tight across the developed world, which means even a modest economic revival could intensity cost pressures. Financial markets are clearly not priced for such a scenario. Yet the more serious risk is that faster wages undermine corporate profits, a classic 'late-cycle' development. This is not just a US theme – euro margins are also under pressure.

DOLLAR CONVERGENCE

US macro 'outperformance' has dominated asset-price returns and ensured a persistently strong dollar exchange rate. This has created a bad equilibrium for the global economy. While a weaker US currency would alleviate these pressures in 2020, the rest of the world lacks genuine growth catalysts. China, Japan and the euro area are unlikely to launch large-scale stimulus.

THREE THEMES FOR 2020

The consensus macro view for 2020 is pretty unimaginative. Economists expect a small improvement in global demand, which will extend the long expansion but do little to 'reflate' the world economy or prompt a response from central banks. Most sell-side forecasters are obsessed with 'downside risks' to global growth and have (finally) given up on the idea that inflation will move higher. Yet, when we look at how the global economy has performed since 2010 we see a sequence of mini-cycles in global industrial activity and capital spending, which have always had a powerful impact on the prevailing market narrative. Financial pundits tended to over-extrapolate each phase of this cycle, flipping between 'reflation' and 'deflation' themes. The question now is whether the trade deal between the US and China will be sufficient to drive another upswing in global demand, which could push the market narrative back to 'reflation'. Capital spending provides the clearest route to stronger growth in 2020, especially as uncertainty has delayed spending and investment ratios are not high by historical standards.

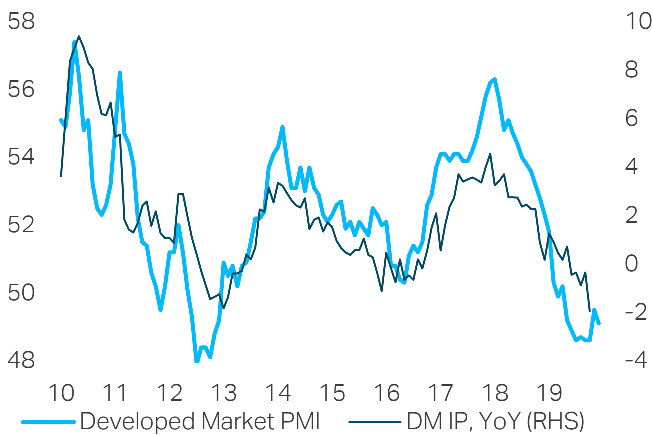
Financial markets look particularly vulnerable to inflation surprises. Over the past decade, most inflation shocks have been temporary in nature and usually linked to short-term moves in oil prices, which is another reason it is important to monitor the current geopolitical tensions between the United States and Iran. But, from a fundamental perspective, the more important question is whether the Phillips curve will finally re-emerge in 2020. Since most economies are operating with tight labour markets, it might not take much of a revival in global demand to generate cost pressures – especially as wages are already accelerating (gradually) in a number of major economies. Most investors are familiar with what is happening in the United States, but they might not be aware that similar developments are taking place in the euro area – especially Germany. Since low inflation and negative yields in Europe are an important anchor for bond yields in the rest of the world, the behaviour of European corporates could be decisive. Yet, given the way most advanced economies have performed since the 1990s, faster wage growth is more likely to undermine corporate profits than generate genuine cost-push inflation. In this sense, a sustained margin squeeze is the clearer threat to the global expansion in 2020.

Persistent dollar strength has also been a critical feature of the global economy in recent years. Since much of the world invoices its trade in dollars and a large amount of cross-border borrowing is denominated in USD, the strong exchange rate does little to 'rebalance' the global economy and instead spreads deflationary pressures throughout the world. Some investors are hoping this problem with ease in 2020, especially as the Federal Reserve has acted decisively to alleviate the 'dollar shortage'. Growth differentials between the United States and the rest of the world have also narrowed since mid-2019. There are even some investors who think this will prompt a powerful rotation into non-US equities, which look cheap on a relative basis. The main problem with this view is that most of the recent narrowing in growth differentials between the United States and the rest of the world reflects slower US activity, rather than genuine improvements elsewhere. Moreover, Europe, Japan and China still lack compelling growth catalysts. Policymakers in China are reluctant to re-stimulate their economy and, though some euro-area nations are planning to ease fiscal policy in 2020, the measures they have announced so far are actually pretty modest. Without these non-US growth catalysts, it is hard to envisage either a large depreciation in the US currency or a powerful rotation into non-US equities.

1. INDUSTRIAL REVIVAL

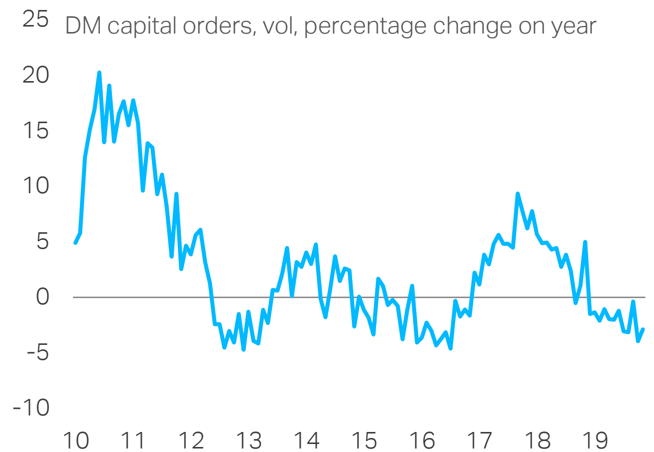
Global macro performance has actually been pretty dull over the past decade. Growth has been persistently sluggish (but rather stable), while inflation has hovered around (but been consistently below) central banks' targets. In past publications, we called this the New Mediocre, but 'secular stagnation' is also a popular characterization. Despite the general lack of macro volatility, a series of mini industrial cycles have kept financial analysts busy, usually to the point of over-extrapolating every short-term data swing into create a new 'breakout' narrative. Since 2010, macro pundits have flipped several times from worrying about recession and deflation, to speculating about 'reflation' and a major bear market in bonds. Looking at the 2020 consensus, it appears sell-side economists have finally adjusted to the New Mediocre, which is why most forecasters are struggling to identify any big new themes for the global economy. The consensus thinks growth, inflation, bond yields and currencies will sit close to current levels.

Chart 2: Mini industrial cycles



Source: Markit, CBP

Chart 3: Global capital cycles



Source: National accounts measures, deflated using capital PPIs

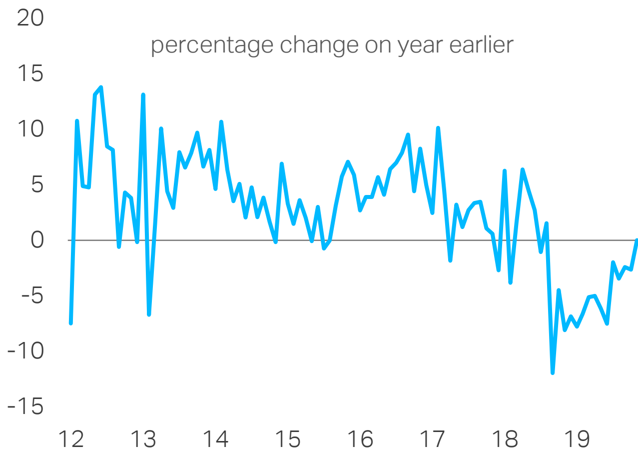
Another mini-revival?

Given the market tendency to over-react to short-term industrial trends, it wouldn't take much of an improvement in the global economy to swing the consensus in a more bullish direction – especially as most investors are fixated on 'downside risks'. Certainly, there was a series of temporary factors that weighed on global industrial activity in 2019, which are now beginning to fade. Auto production, for example, has been a particularly important drag. According to the IMF, tax incentives in China have been heavily distorting Chinese demand, bringing forward around 20% of 2018-19 demand into 2016-17. When these incentives expired, demand plunged. New EU regulations haven't helped the situation, causing a surge in European inventories and a tumble in output. But there are now signs of a modest recovery in the global auto sector.

Two other areas of macro weakness have also eased, namely previous overcapacity in the semiconductor industry – which hit tech output hard in 2018-19 – and generally high levels of manufacturing inventories. Admittedly, it can be tricky to understand large swings in the inventory cycle. Manufacturers in a number of countries built up their stock levels considerably in 2018 but it is not clear whether this was because they had become overly bullish about future activity, or because demand suddenly plummeted (probably both). In any case, these high levels of stocks weighed on global growth in 2019, as companies were able to meet existing orders without increasing their production. So the unwinding of this inventory position could remove

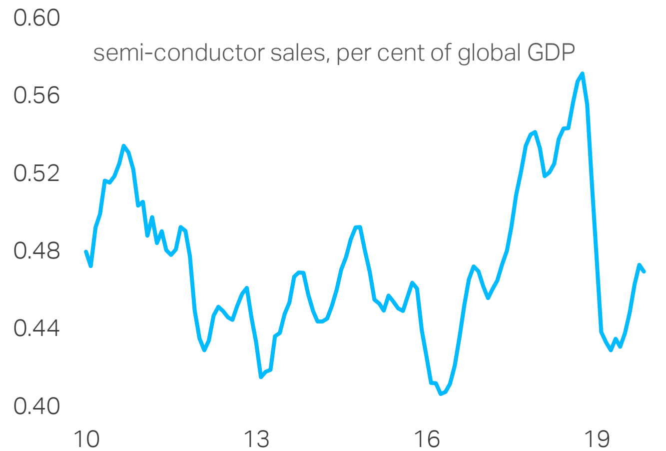
another drag on the manufacturing sector in 2020. The latest PMI data show orders are already recovering relative to existing stock levels, which suggests output will improve. And if manufacturers become more optimistic about the future, they might even decide to actively rebuild their inventories, which would provide an additional boost to global GDP.

Chart 4: Global auto sales recover



Source: TS Lombard based on national data

Chart 5: Tech cycle bounces back

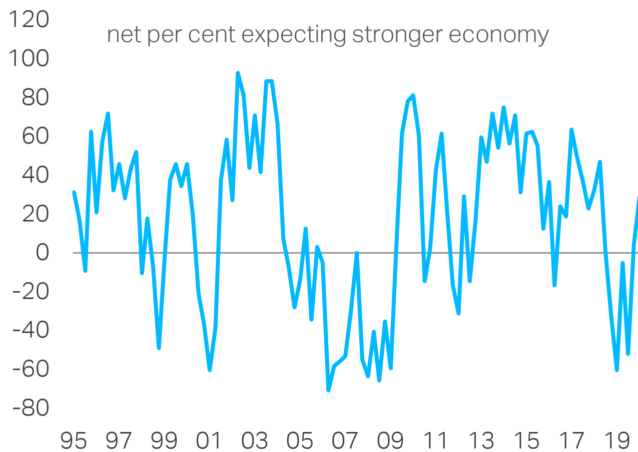


Source: Datastream, TS Lombard

Trade resolution a game-changer?

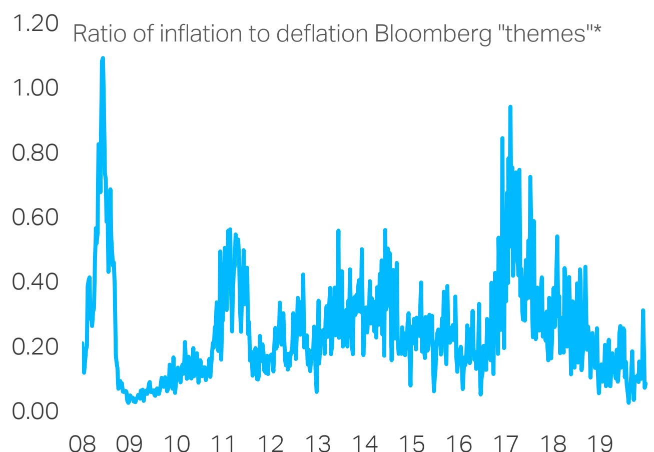
While the unwinding of these temporary forces is helpful, the recent cease-fire in the trade war between the United States and China could be the real swing factor for the global industrial cycle. The difficulty, however, is knowing exactly how much the conflict has discouraged capital spending and whether the 'Phase One' agreement will be sufficient to bring this investment back on line – after all, many of the fundamental issues remain unresolved and could return after the US election (regardless of who wins). Most of the evidence we have on the macro impact of the trade war is anecdotal or based on surveys. Corporate earnings reports are full of references to the conflict, but this is also a convenient scapegoat when companies are missing their profits guidance. Survey data are more reliable, but they tell us nothing about the magnitude of these

Chart 6: Mini-cycles in investor sentiment



Source: BoAML survey via Twitter

Chart 7: Shifting market narratives

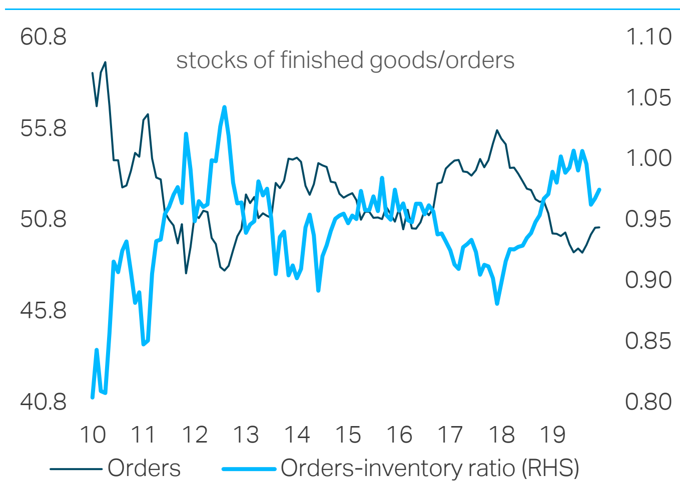


Source: Bloomberg, TS Lombard *see Chart 1 for explanation

effects. All we know is that companies say the conflict is constraining their activity, with "uncertainty" taking over from "labour shortages" as the main macro concern.

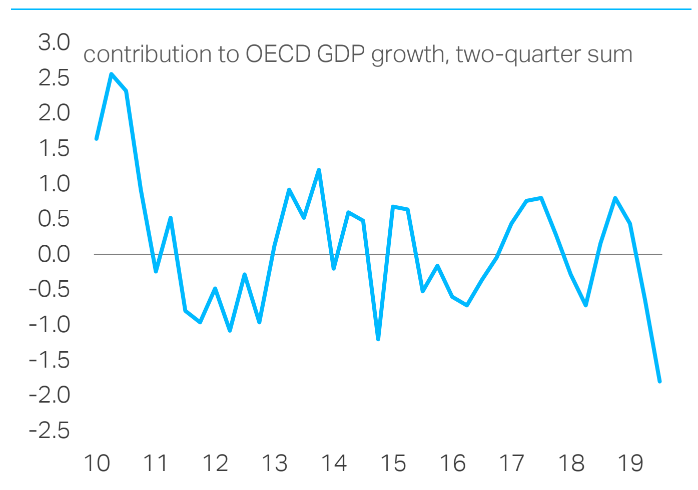
Even with limited 'hard data' to assess the impact of the tariffs, economists have used sophisticated econometrics to calculate the effects of trade uncertainty on business spending. The Federal Reserve's estimates, the most influential in terms of their impact on monetary policy, suggest the effects have been large. Fed staff report that uncertainty about US tariffs shaved at least one percentage point from global GDP since the middle of 2018, with the pain increasing with each ratcheting up of the conflict. These findings are in line with estimates from the OECD and the IMF, which are based on structural models of the global economy and make assumptions about financial conditions and 'confidence effects'. In its latest *Economic Outlook*, the OECD claimed the trade war would reduce G4 business investment by around 1.5-2.0% pts.

Chart 8: Global inventory cycles



Source: Markit, TS Lombard

Chart 9: Stock-piling dragged on OECD GDP

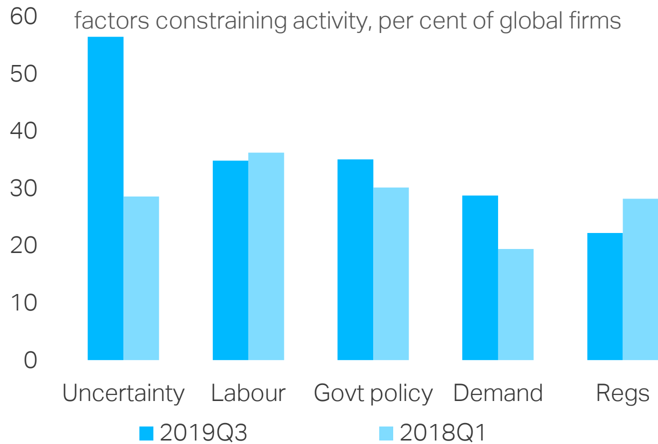


Source: OECD, TS Lombard

Pent-up capex?

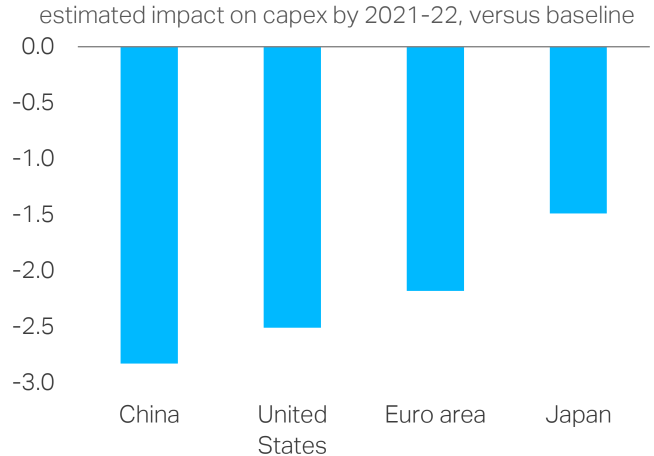
While it is difficult to judge the exact size of the boost, it is likely the easing in US-China tensions will lift global industry in 2020. With 'pent-up' demand for capex, this improvement could easily beat economists' modest expectations. An investment recovery would not only deliver another mini-cycle in manufacturing, it might even rekindle the 2017-18 'reflation' narrative. We can assess the amount of pent-up demand for capital spending by analysing investment ratios across the major economies (Charts 12 and 13). While the results of this exercise depend heavily on the decision about whether to use nominal or inflation-adjusted data (since the price of capital goods has fallen sharply relative to consumer goods and the GDP deflator), there is certainly nothing in this analysis to suggest the major economies are 'over-invested', especially for an economic expansion that is more than a decade long in some jurisdictions. Of course, China is an important exception – the Chinese capital ratio remains close to record highs.

Chart 10: Surveys highlight uncertainty problem



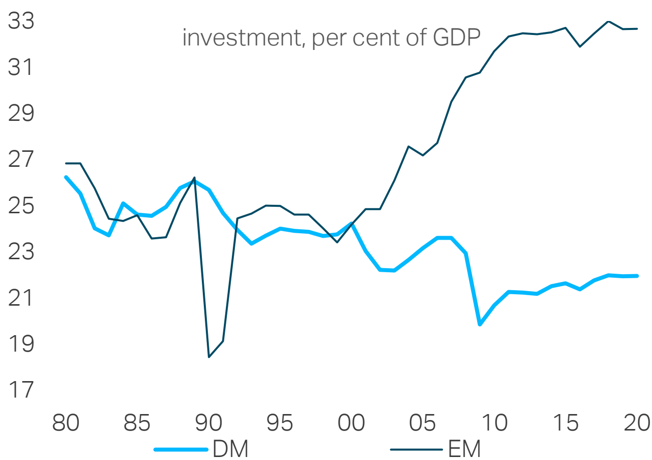
Source: OECD based on Duke Global Business Outlook

Chart 11: OECD estimates sizeable capex hit



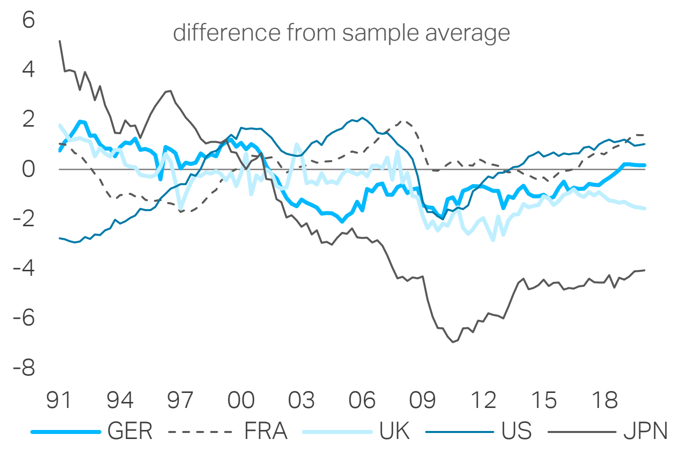
Source: OECD Economic Outlook, Dec 2019

Chart 12: Nominal investment shares



Source: IMF World Economic Outlook database

Chart 13: Real investment ratios

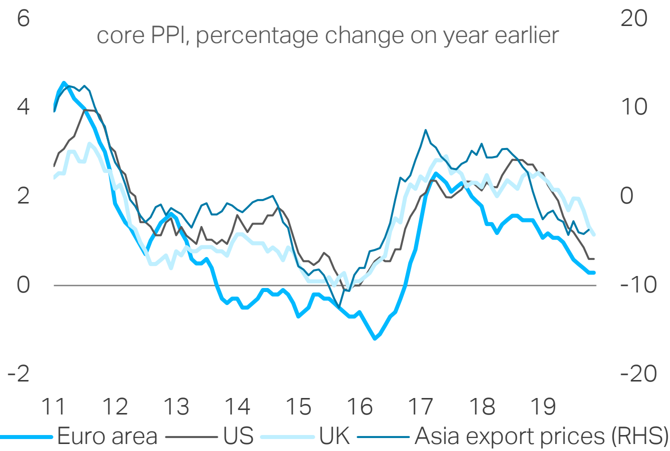


Source: OECD, TS Lombard

2. WAGE SQUEEZE

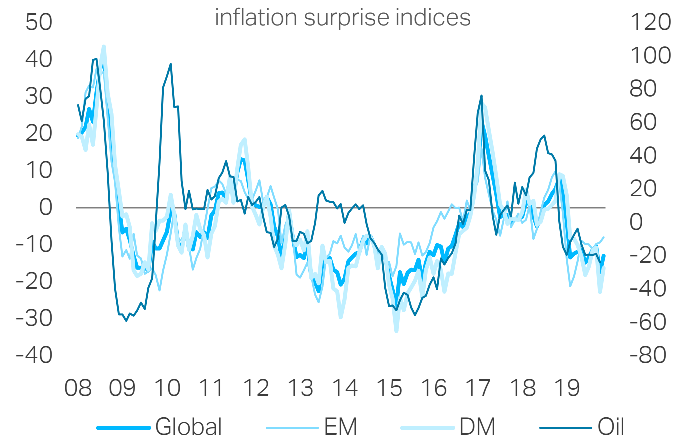
If a cyclical revival in global industry/capex has the potential to create a new 'reflation' narrative for financial markets, it is worth asking what it would take to see a more serious inflation scare in 2020. After all, though consumer prices have been subdued for more than a decade, there have been plenty of episodes where investors have become (unduly) worried about the prospect of inflation suddenly breaking higher. Remember also that the current deflationary skew in yields leaves bond markets particularly vulnerable to any sustained acceleration in consumer prices. Minneapolis Fed estimates suggest US yields are pricing a zero chance of US inflation rising above 3%, which is an extremely unusual starting point, even for the New Mediocre.

Chart 14: Producer prices track industrial cycle



Source: National sources, CPB, TS lombard

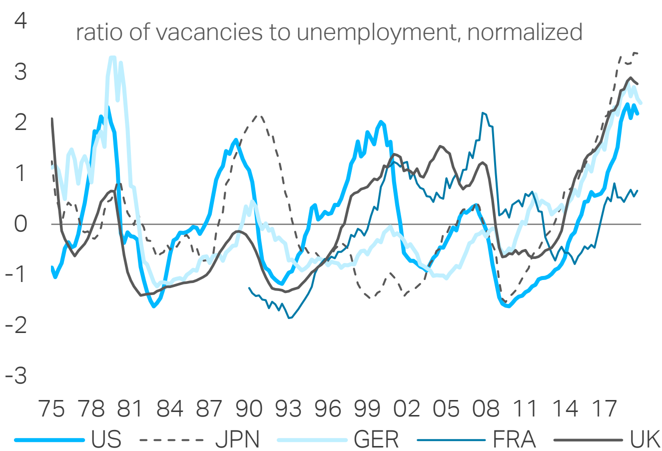
Chart 15: Oil main cause of inflation surprises



Source: Bloomberg, TS Lombard, YoY change in oil (RHS)

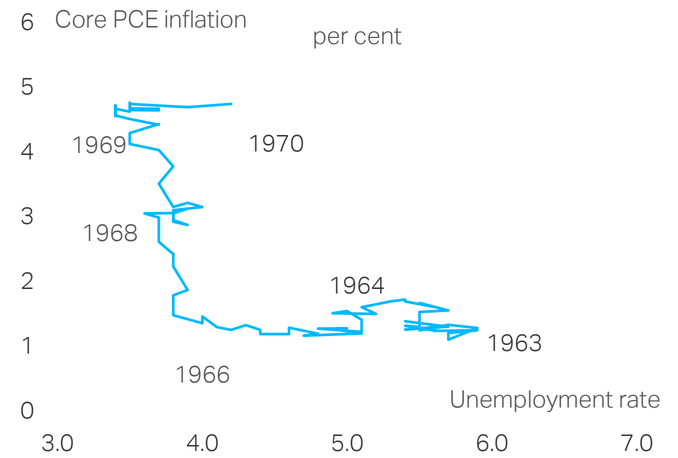
While stronger industrial activity would boost producer prices and lift traded good prices, oil-prices have had a disproportionately large impact on inflation expectations since 2008. Chart 14 shows global 'inflation surprise' indices, which compare short-term price pressures to economists' forecasts, have been strongly correlated with changes in energy prices. This means any spike in oil prices in 2020, even if it is supply-induced (watch the tensions between the United States and Iran), could have a powerful impact on bond yields and the market's perception of inflation. Yet energy-price developments are sure to be temporary and might even be deflationary for global demand, so this is not the sort of move that would prompt policy tightening. Central banks are hoping to see more sustained rises in consumer prices.

Chart 16: Tight developed labour markets



Source: National sources, TS Lombard

Chart 17: When the Phillips curve steepened



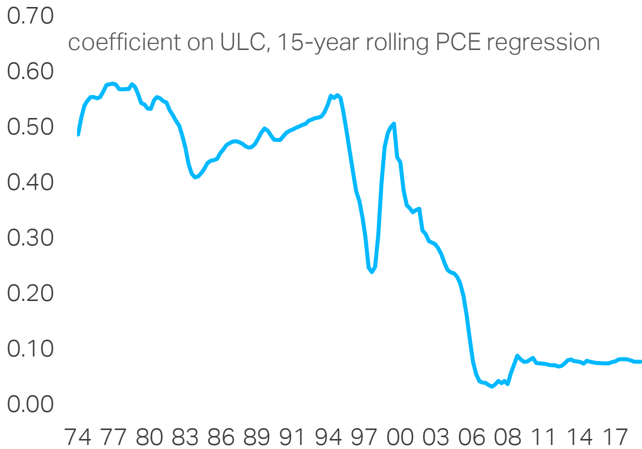
Source: BLS, TS Lombard

What about tight labour markets?

The more compelling story for higher inflation depends on the Phillips curve, the traditional relationship between unemployment (or, more broadly the amount of slack in an economy) and wages/prices. For years, economists have argued that persistent declines in unemployment would eventually generate an acceleration in wages and, as businesses sought to pass on these cost increases to their customers, inflation pressures would build. The problem, of course, is

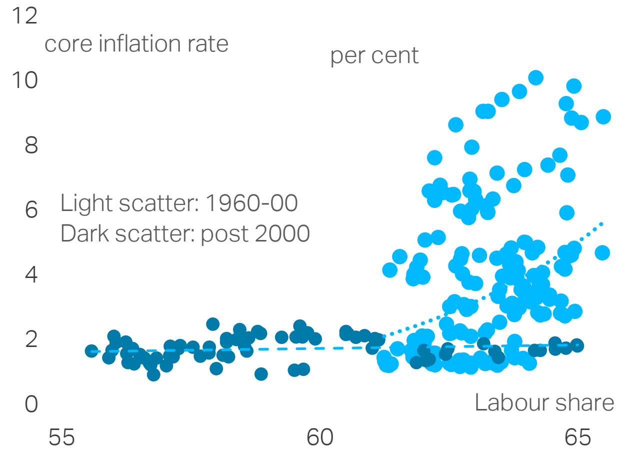
that this model of the economy no longer seems to work. Labour demand has continually increased (see V/U ratios, Chart 16), unemployment has hit multi-decade lows across the developed world, yet the underlying rate of inflation hasn't budged. The Phillips curve has performed so poorly in recent years, most economists have given up on its predictions.

Chart 18: The death of wage-price spirals



Source: TS Lombard estimates, ULC: Unit labour costs, PCE: core prices

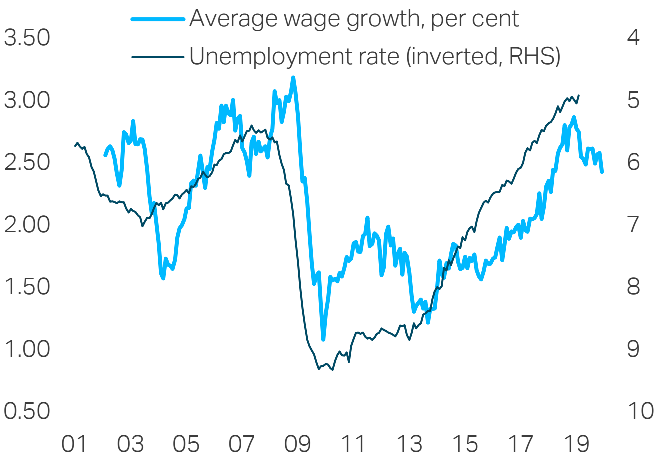
Chart 19: CPI doesn't respond to wage share



Source: BLS, BEA, TS Lombard

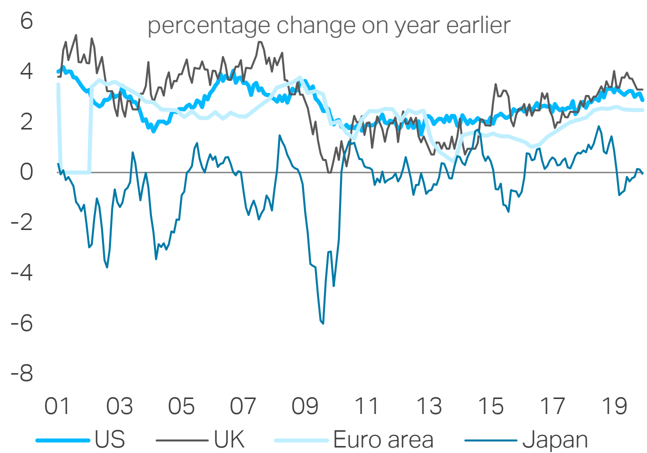
So the obvious inflation surprise would involve a revival in the Phillips curve, just at the point where the economics profession (and in particular central bankers) have abandoned the idea. There are two reasons why this possibility is not totally unreasonable. First, this is exactly what happened in the late 1960s, which was also a long economic expansion in which inflation seemed to disappear, only to make a dramatic reappearance. Chart 17 shows the Phillips curve steepened dramatically in the late 1960s, after a long period of flatness. The second reason we can't totally dismiss a revival in the Phillips curve is that low unemployment rates do seem to be adding – albeit gradually – to wage pressures. Wages rates in a number of major economies are experiencing a gradual acceleration (Charts 20-21). Even if the Phillips curve for consumer prices has disappeared, the Phillips curve for wages still seems to be functioning.

Chart 20: Phillips curve in DM wages



Source: National sources, TS Lombard

Chart 21: Gradual wage boost



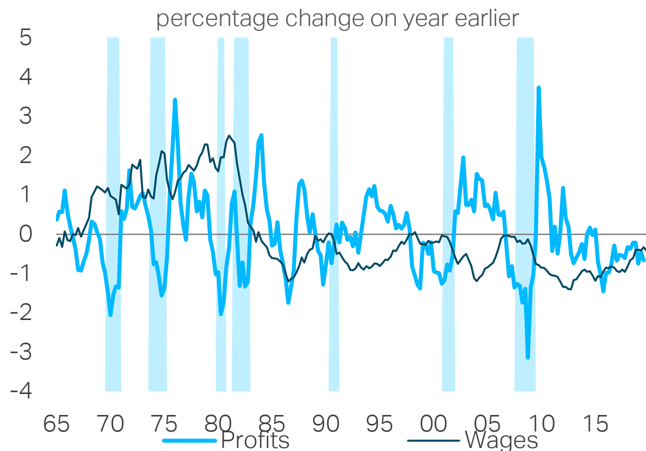
Source: National sources, TS Lombard

The short-term outlook for US wages looks less robust than it did a few months ago, thanks to a recent slowdown in headline hourly earnings, but other wage indicators are mixed and we expect to see a modest re-acceleration through 2020. Perhaps Europe is the more remarkable story, particularly Germany. German workers secured hefty pay rises in 2019, even as the economic outlook deteriorated. This is an important development for the global economy because disinflation and negative yields in Europe have been a nominal anchor for interest rates in other parts of the world. The US situation of chronically depressed term premia in bond markets and a persistently strong exchange rate makes more sense with sub-zero yields in Japan/Europe.

The real risk from wage growth

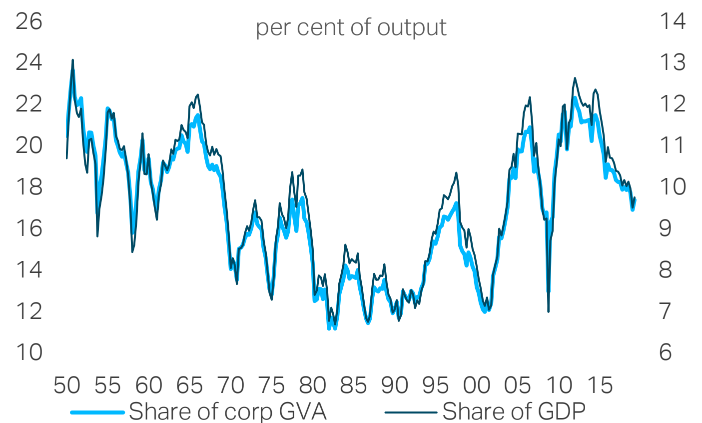
The reason there is still a faint Phillips curve relationship between wages and unemployment but not between consumer prices and unemployment is that profit margins have become more responsive to unit labour costs. While in the 1970-80s, companies tried to pass on cost increases to consumers by hiking their prices, these days they are more inclined to absorb them in their margins. Tight labour markets continue to generate faster wages (though less so than in the past) but there is a decline in margins late in the cycle (rather an acceleration in prices). We can observe this shift in several ways: (i) a simple regression of core inflation on unit labour costs shows a collapse on the ULC coefficient after the 1990s; (ii) there has been a flattening in the scatter plot between inflation and the wage share; (iii) margins decline ahead of recessions, with this squeeze becoming the clearest sign of an expansion running out of potential runway.

Chart 22: Link between profits and wages



Source: BEA, TS Lombard

Chart 23: Late-cycle margin squeeze?



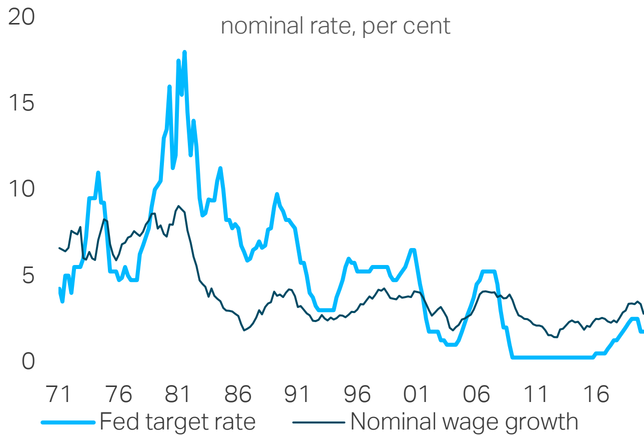
Source: BEA, TS Lombard

With wages picking up modestly in 2018-19, profit margins in several major economies are already under pressure. This means, if global demand rebounds in 2020 and tight labour markets cause a further acceleration in wages, the pressure on corporate profits will probably intensify. This is a potential problem not only in the United States, but perhaps more surprisingly in Germany and parts of Europe. If German companies are unable to raise their prices, they could face a serious squeeze on their earnings, which could compound existing recessionary forces – especially if consumers do not step up their spending (a long-term problem in Germany).

It seems odd to worry about a gentle wage acceleration when we know persistently low income growth has contributed to prevailing economic imbalances, not to mention its potential role in polarization and political 'populism'. From a medium-term perspective, faster wage growth is probably desirable, not least because it provides a possible route out of secular stagnation and persistently low interest rates. As we explained in a previous Macro Picture, an acceleration in

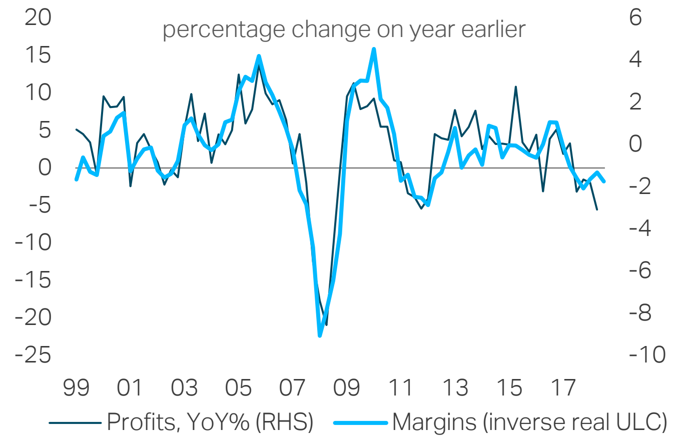
wages was one of the forces that eventually brought an end to previous episodes of secular stagnation, especially the Long Depression of the late-1800s. But in a short-term "cyclical" sense, wages are a threat because they could undermine increasingly stretched margins, perhaps even bringing an end to the expansion.

Chart 24: Fed responds to wage trends



Source: Federal Reserve, BLS

Chart 25: German margin squeeze



Source: Bundesbank, TS Lombard

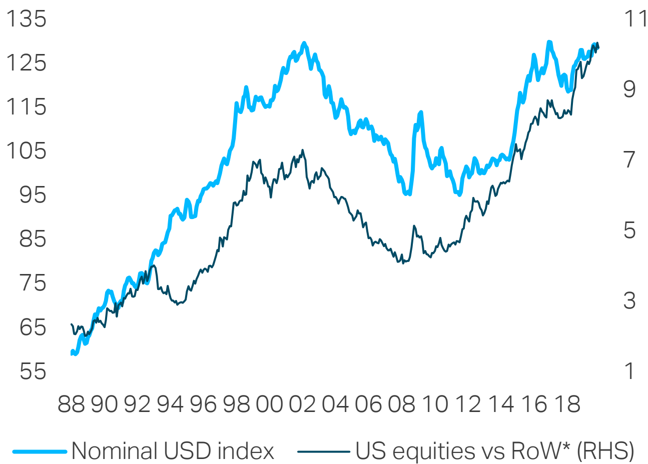
3. DOLLAR CONVERGENCE

With the global economy only capable of 'mini' cycles and low unemployment failing to revive inflation, we have identified two of the main symptoms of the New Mediocre. Yet there is also a third symptom, which actually compounds these deflationary trends – the resolute strength of the US currency. Since the dollar continues dominate both the invoicing of international trade and the denomination of cross-border lending, US exchange-rate buoyancy tends to weaken global trade activity and tighten financial conditions, spreading deflation across the world. This is different from 'textbook' view of exchange-rates, which assumes that any currency move will help to 'rebalance' global demand and erode prevailing growth discrepancies. The strong US dollar is bad news for everyone and a major propagation channel for secular stagnation.

Dollar weakness in 2020?

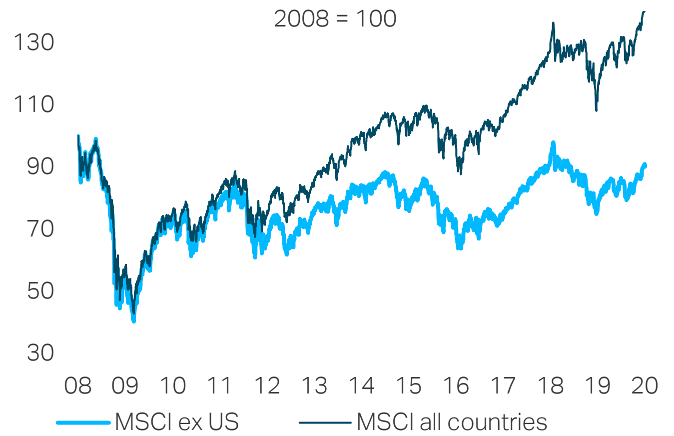
It is not hard to understand why the US exchange rate has been so robust in recent years. US economic performance has comfortably outperformed other developed nations, especially Europe and Japan. This has led to significant divergences in bond yields, particularly as the ECB, the BoJ and the BoE have been struggling against the lower bound, unable to cut interest rates further (or exit from QE). The recent gap between US rates and other major economies is quite extreme by historical standards. US outperformance has also shown up in relative asset-price performance, where US equities have comfortably outperformed most other stock markets. The strong dollar actually boosts relative US returns and harms non-US balance sheets, creating a 'sticky' new equilibrium for global markets. And when people are nervous about global economic prospects, they tend to seek safety in US securities, which only compounds these trends.

Chart 26: US equities and USD



Source: Bloomberg

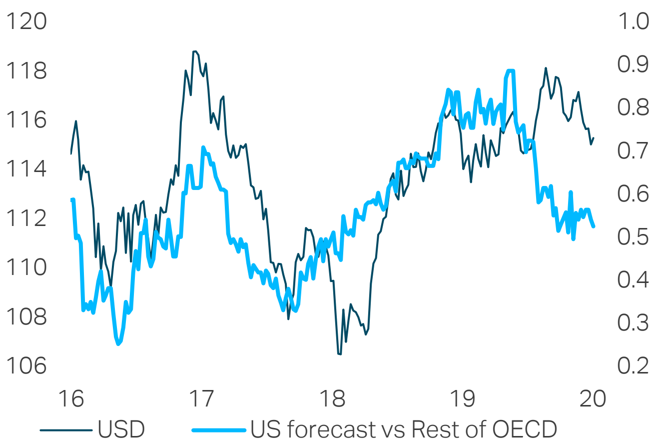
Chart 27: US outperformance



Source: Bloomberg

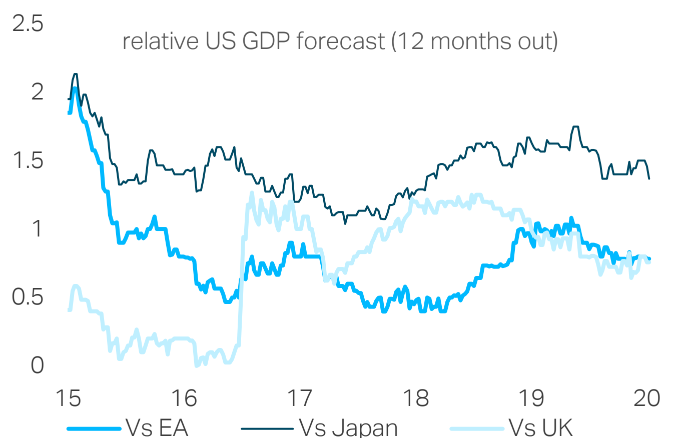
Since the strong dollar has caused problems for the global economy since 2015, intensifying the forces of secular stagnation, it makes sense to think a weaker exchange rate (if it happens) could alleviate these pressures – further reinforcing any global reflation narrative. Given the underlying reasons for USD strength, this would probably require a narrowing in growth and interest rate differentials between the United States and Europe/Japan. As far consensus GDP forecasts go, we have already had a reduction in US outperformance. Charts 28-29 show the average US GDP forecast for 2020 has fallen relative to those for the euro area and Japan since the autumn. This is because the US economy slowed in the final months of 2019 and is likely stay subdued during the first half of 2020, 'catching down' with other developed nations. Short-term interest-rate divergences have also narrowed, as the Federal Reserve cut interest rates in an 'insurance' move designed to keep the US expansion going.

Chart 28: Narrowing growth differentials



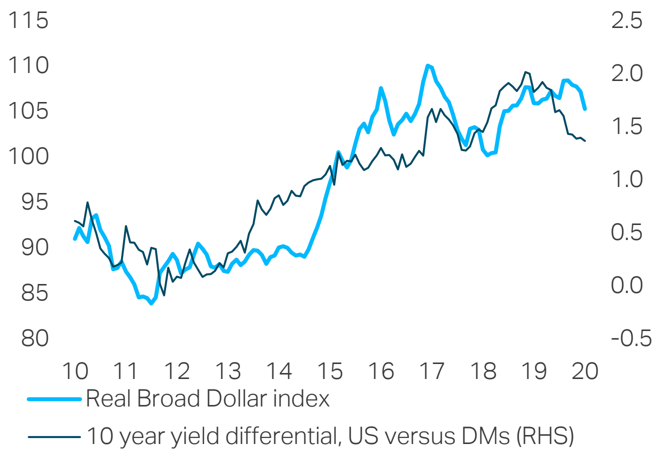
Source: Bloomberg, TS Lombard

Chart 29: US GDP versus other DMs



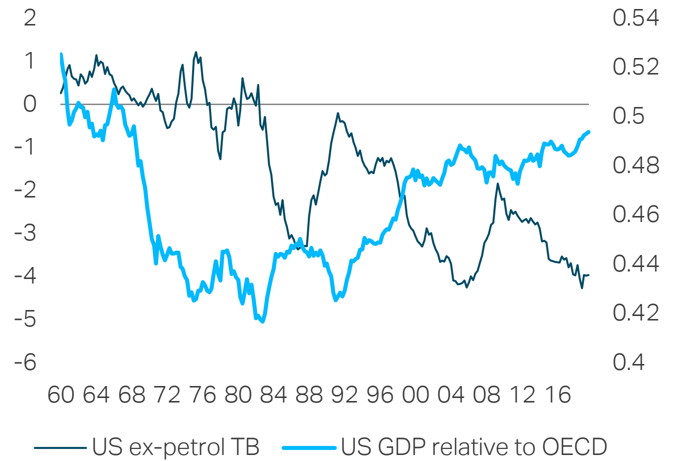
Source: Bloomberg, TS Lombard

Chart 30: USD versus yield differentials



Source: Bloomberg

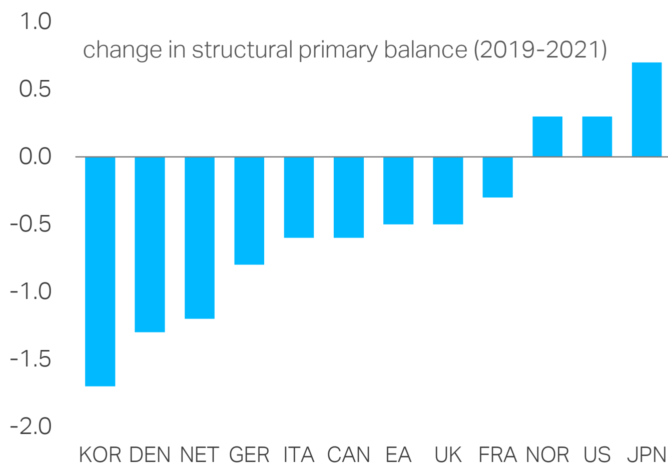
Chart 31: relative demand and the US CA



Source: TS Lombard estimates, OECD, TB is trade balance

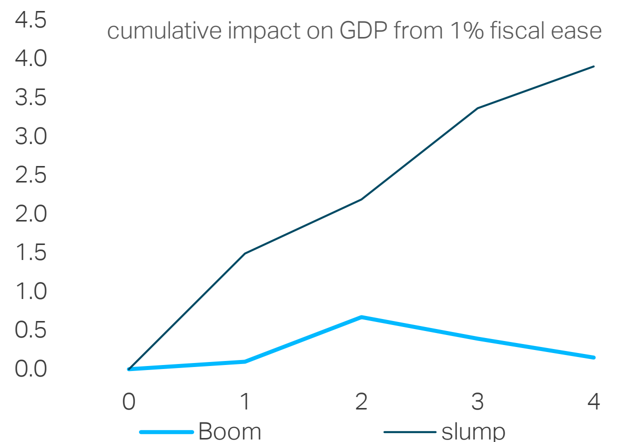
While the dollar has eased a little recently, it has not responded fully to the narrowing in GDP and rate differentials. There are two reasons for this (three, if we include tariffs). First, it is not just the relative price of the US currency that matters, but also its availability. The global 'dollar shortage' has been a reoccurring theme since the global financial crisis, particularly at times of the year when the largest banks try to shrink their balance sheets to meet new regulatory requirements. If dollars are in short supply on international markets, the bid for US currency would remain strong even when relative US macro performance dips. There were clear tensions in US money markets in late 2019, with funding conditions deteriorating and repo rates/overnight lending rates spiking higher. But with the Federal Reserve acting aggressively to restore dollar liquidity, including by re-expanding its balance sheets through new rounds of asset purchases, the availability of USD currency should be less of a problem in 2020 and beyond.

Chart 32: Modest fiscal easing



Source: OECD Economic Outlook

Chart 33: But fiscal multipliers are large



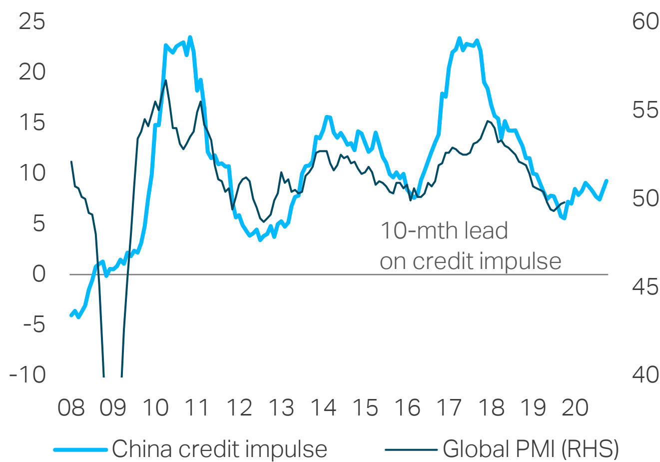
Source: Peterson Institute

World needs stronger non-US growth

While Fed liquidity should curb USD strength, a sharper depreciation would probably require stronger activity outside the United States. The same applies for any 'recoupling' between US and non-US stock markets, which has recently become a popular idea. Some investors see a lot of value in European equities, which are priced at attractive multiples versus the US. They are

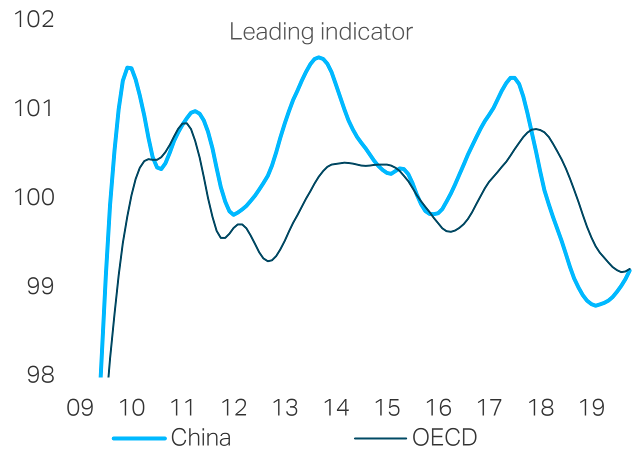
hoping 2020 will be the year for convergence in stock markets, delivering a powerful uplift to non-US equities. The problem with both these narratives – the big depreciation in the dollar and the potential for non-US equity outperformance – is that Europe, Japan and China lack genuine growth catalysts. Fiscal policy is perhaps the clearest route to growth but while policymakers in all regions have moved in the 'right' direction recently, the stimulus they are planning is actually rather modest – no more than around 0.5-1.0 per cent of GDP by 2021 (Chart 32).

Chart 34: Modest Chinese stimulus



Source: TS Lombard forecasts, Markit

Chart 35: China leads the world



Source: OECD, TS Lombard

US election risk?

US election uncertainty is another factor that could curb the dollar and even harm US equity market performance relative to the rest of the world. Historically, US stocks have performed well in election years – looking at the 23 election years since 1928, only four of these ended with losses for the S&P 500. These tended to mark the end of long secular bull markets, such as in 2000 and 2008. According to a US professor, the fourth year of the Presidential term is one of the most profitable for stock markets, though they don't usually perform as well as they do in year three (the year that has just passed). Yet some big hedge funds have warned that a victory for the 'radical left' (i.e. a Sanders or Warren administration) could trigger a nastier reaction in US stock markets. Given current betting odds, this implies US equities are currently benefiting from a sizeable 'Trump premium'. While such analysis is definitely too simplistic, uncertainty about the US election is something that could influence relative equities returns at FX markets in H2.

Bottom line

Our previous macro picture outlined the consensus view for 2020, basically another year of the New Mediocre, which would see modest global growth (no recession), subdued inflation, low interest rates and monetary policy on hold. In this macro picture we have identified three themes that could reshape the narrative in 2020: (i) the strength of industrial activity (particularly capex and its response to the US-China trade deal); (ii) the impact of tight labour markets on wages and what this means for profit margins; and (iii) US outperformance and the strength of the dollar. With investors obsessed with downside risks, the big non consensus combination for 2020 would involve a significant rebound in global manufacturing (especially outside the United States), a further acceleration in wages (perhaps with some pass-through into consumer prices) and a significant depreciation in the US dollar. This might even set markets up for a 'late-cycle meltup', the absence of which has been a source of much disappointment in recent years.

Authors

Dario Perkins
Managing Director,
Global Macro