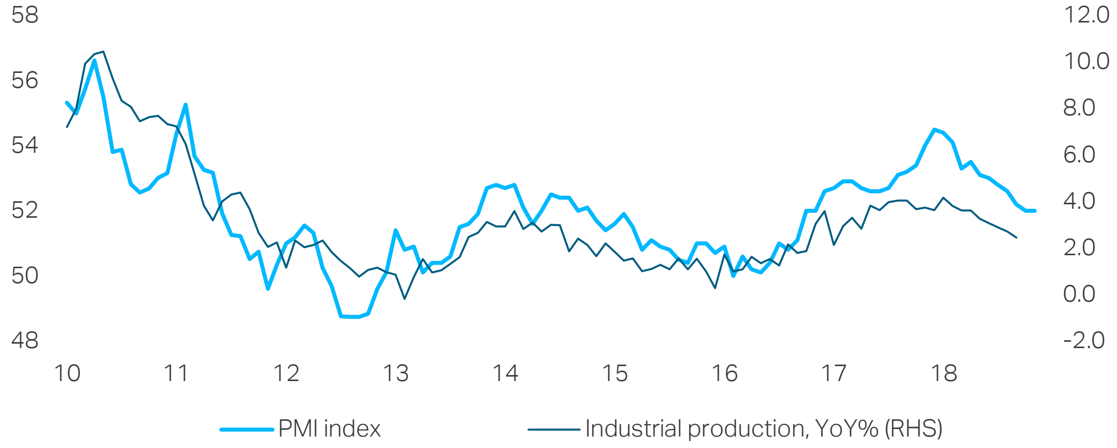
Macro Picture

GROWTH SCARE

Dario Perkins

Global growth has slowed materially in 2018, contrary to consensus forecasts 12 months earlier. Three forces are to blame: (i) deteriorating financial conditions; (ii) Chinese policy tightening, and (iii) trade-war uncertainty. EMs have suffered most. While a global recession is unlikely, weak growth provides a choppy environment for markets in 2019.

Chart 1: Global slowdown



Source: Markit, CPB, TS Lombard

FORCE THREE

2018 was supposed to see strong, synchronized growth. Instead, we have had a sizeable EM-led downturn. The main forces that have damaged global demand – tighter financial conditions, China's aggressive policy squeeze and uncertainty about trade policy – have hit the emerging economies hardest. Given their size, EM weakness is globally more significant than in the past.

CHINA PUZZLE

The pattern of the last few years has been repeated, with Chinese policy shifts again leading global economic activity by 6-12 months. This is a puzzle for economists, because the apparent magnitude of these spillovers is much larger than direct trade and financial linkages warrant. Either the relationship is spurious, or China now has an outsized impact on global markets.

POLICY TRILEMMA

Global growth is likely to remain subdued in 2019, providing a difficult environment for risk assets. Three major policy decisions could be decisive for market performance. For a bullish environment, the Fed pauses, the Chinese re-stimulate and President Trump cancels his trade war. But if any of these decisions go the other way, 2019 could be even tougher than 2018.

GROWTH SCARE

12 month ago, most sellside economists were predicting strong synchronized growth and a remarkably benign environment for risk assets. 2017 ended with the United States, the euro area and China enjoying their strongest combined performance since the global financial crisis. Bond yields were rising but this was 'good news', proof that secular stagnation was ending. Yet, contrary to what most investors expected, the economic outlook has steadily deteriorated through 2018. China has slumped, parts of Europe are flirting with recession and even the United States is past its cyclical best. With stock markets down and the yield curve 'close to inversion' – there are now just 13bps in the 10-2 spread – we appear to be facing the most serious growth scare since 2015/16. Fitting economic narratives is easy in retrospect and looking back at 2018 it is clear why the global economy has struggled. The combined impact of tighter financial conditions, substantial Chinese policy tightening and major trade-war uncertainty has seriously undermined global demand. EMs have suffered most (they were most exposed to these deflationary forces) but given their size, this produced a global macro shock.

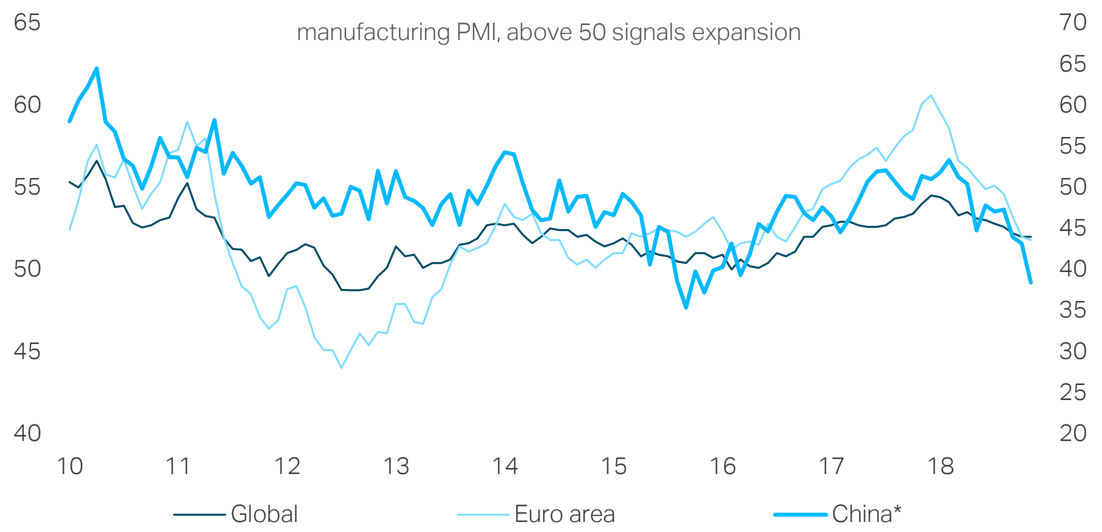
There is a question about the role China is playing in the current downturn. China has been stuck in a stop-go policy cycle since 2008, with each wave of easing (or tightening) leading a wider expansion (or slowdown) in global activity, typically by 6-12 months. In this sense, investors could have predicted the 2018 global economic slowdown entirely on the basis of aggressive Chinese monetary tightening in 2017. And with Chinese M1 slumping to its lowest readings on record, presumably more global economic weakness is still to come. But while China is now the second largest economy in the world, this apparent leadership of the global macro cycle creates something of a puzzle for economists. Beyond the other EMs (which have large exposure), trade and financial linkages with China are modest. Macroeconomic models suggest it would take very large swings in China's economy to influence global trade and investment in the way simple correlations since 2008 seem to suggest. This must mean either China's apparent cyclical leadership is spurious, or it reflects wider spillovers – such as through business sentiment, capex and asset prices – that conventional analysis of the global economy tends to ignore.

While it is difficult to disentangle precisely the three main forces that have undermined growth in 2018, it is hard to imagine these problems suddenly disappearing in 2019. We do not think the recent deterioration in activity marks the start of a global recession, but it is also hard to imagine a powerful economic revival. US fiscal stimulus will fade and some of the more interest-rate sensitive parts of the economy are also now under pressure. The likeliest scenario is that global growth remains lacklustre, providing an unhelpful – but not disastrous – environment for risk assets. Yet several important policy decisions will also have a critical bearing on how financial markets perform in 2019. These include: (i) the Chinese response to their slowdown, (ii) whether and when the Federal Reserve stops raising interest rates; and (iii) the extent to which the US and China can reach a settlement that postpones their trade war. The most bullish outcome – modest Chinese stimulus, a Fed pause and a ceasefire in the trade conflict – could yet deliver a material late-cycle rally in global equities. Conversely, if any of these decisions go the wrong way, financial markets could face another difficult year, possibly even a 'proper' bear market.

1. FORCE THREE

Back in 2017 it looked like the global economy was finally breaking out of its post-2008 funk. Manufacturing was booming, with a surge in capital orders and a powerful pickup in world trade. For the first time in a decade, the world seemed to be facing a strong, synchronized revival, with the United States, China and the euro area all growing faster than their underlying trends. This would have been a remarkable turnaround given that 12 months earlier most investors had been fretting about global recession, negative bond yields, and central banks running out of policy ammo. Unfortunately, the macroeconomic outlook has steadily deteriorated through 2018 and recession worries have resurfaced. The extremely flat US yield curve is compounding this fear. With only 13bps separating 10-year and 2-year Treasury yields, it wouldn't take much of a deflationary shock to invert the curve, after which global recession might become consensus.

Chart 2: Industrial downturn

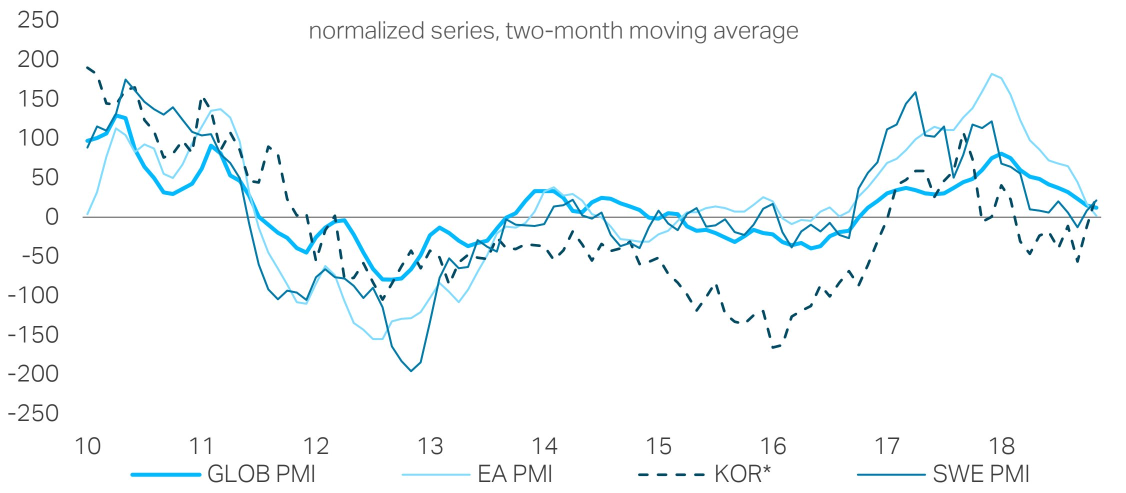


Source: Markit, *Hong Kong PMI's new business from China index

Synchronized dimming

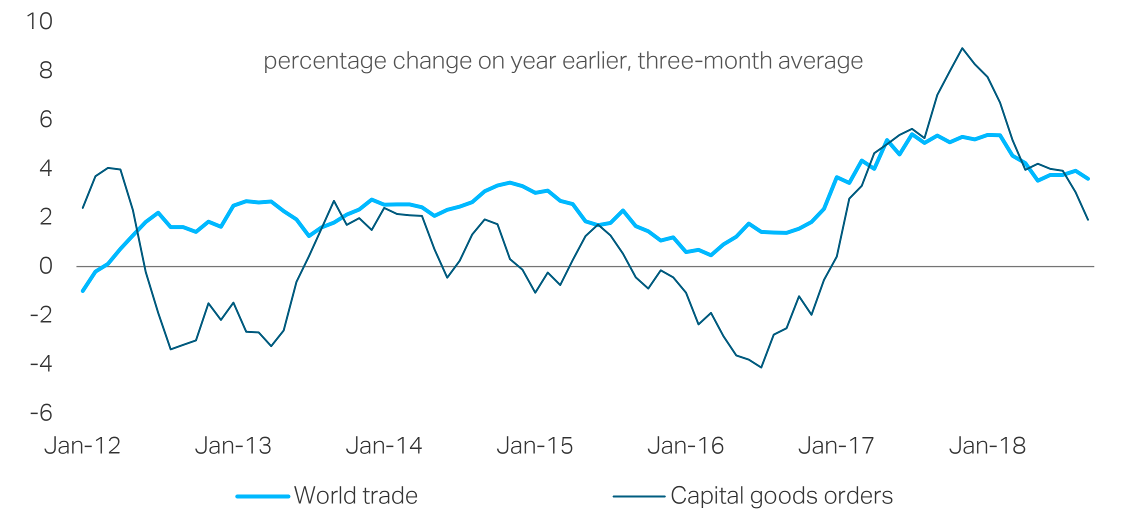
By the middle of 2018 it was already clear that both China and Europe were deteriorating. While most economists blamed euro-area weakness on a series of one-off factors, such as supply bottlenecks, the timing of the Easter holidays and temporary swings in auto production, it soon became obvious that something more profound was taking place. Europe's largest economy – Germany – actually contracted in the third quarter and most euro-area data have remained decidedly soggy since then. Data outside the euro area have also disappointed expectations. The sellside has a variety of favourite 'leading indicators' to track global demand, most of which have turned lower. Whether it is South Korean exports, German factory orders or the Swedish PMI (which actually leads the wider euro aggregate by around four months), the message is remarkably consistent – the synchronized boom has turned into a synchronized downturn.

Chart 3: Popular sell-side leading indicators



Source: National sources, Markit, TS Lombard estimates

Chart 4: Capex-led global downturn

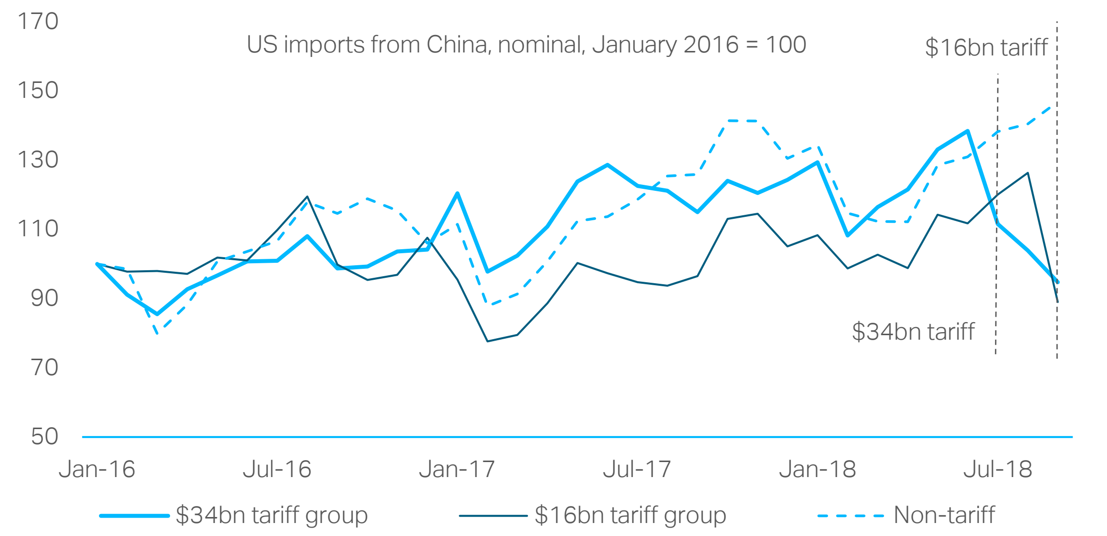


Source: TS Lombard, capital orders is a weighted average of US and EA core industrial capex orders

So why has the economic outlook worsened? We see several forces at work:

(i) Tighter financial conditions: Global financial markets had become eerily calm in 2017, with bullish growth prospects, historically low volatility and widespread evidence of a search for yield. Low interest rates and massive central-bank asset purchases, particularly by the ECB and Bank of Japan, had pushed investors into riskier securities in an effort to generate higher return. By early 2018 the policy outlook had become more challenging. Not only was the Federal Reserve raising interest rates faster than expected, but the ECB and BoJ seemed determined to wind down their QE programmes. Rising bond yields became a reflection of monetary tightening rather than improving growth prospects, producing a more difficult environment for risk assets. Risk premia suddenly widened and volatility returned, with three significant S&P 500 corrections since the start of the year.

Chart 5: Impact of US tariffs by product group



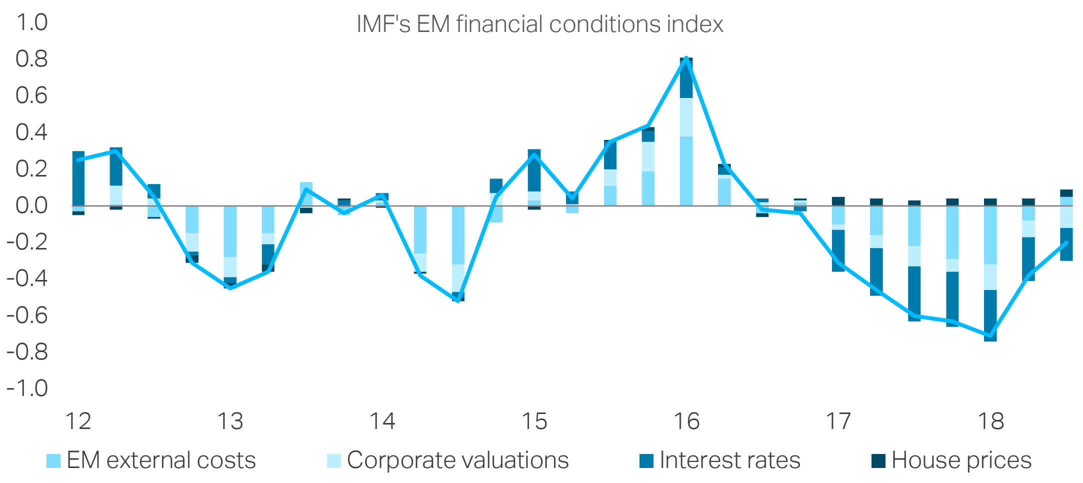
Source: TS Lombard estimates based on official data and Treasury tariff lists

(ii) Trade war uncertainty: President Trump became much more aggressive during the spring, first by imposing US import charges on steel and aluminium, then adding tariffs on $50bn Chinese imports, while also threatening a full-scale trade war with China and Europe. Negotiations at the recent G20 meeting have postponed the next round of the conflict by 90 days, but the situation remains an important source of uncertainty for the global economy. So far, Trump's tariffs have had only a limited direct impact on global trade. Aggregate US imports from China have actually accelerated in recent months, as importers tried to front-run the charges, buying in anticipation of each tariff hike. We see this by looking at those goods that have already been included in Trump's trade war. Demand surged ahead of the tariffs and then dropped sharply once the tariff was actually imposed (Chart 5). Yet the indirect impact of the trade war has arguably been more important. Facing serious uncertainty, large exporters around the world have delayed their investment decisions, leading to a sharp slowdown in capital spending and world trade.

(iii) China policy tightening: The Chinese authorities have engineered a sizeable slowdown in their economy since 2016, through their efforts to curb excessive credit growth and 'de-risk' their banking system. As the second largest economy in the world, these policies are bound to have had a significant impact on demand elsewhere, particularly those countries with large China exposure. But the magnitude of these global spillovers remains a subject of intense debate. Statistically, there appears to be a remarkably powerful relationship between China's stop-go policy cycle and broader ups and downs in the global economy. This relationship is hard to square with traditional macroeconomic models and what we know about other countries' direct exposure to Chinese demand – which we analyse in the second part of this macro picture.

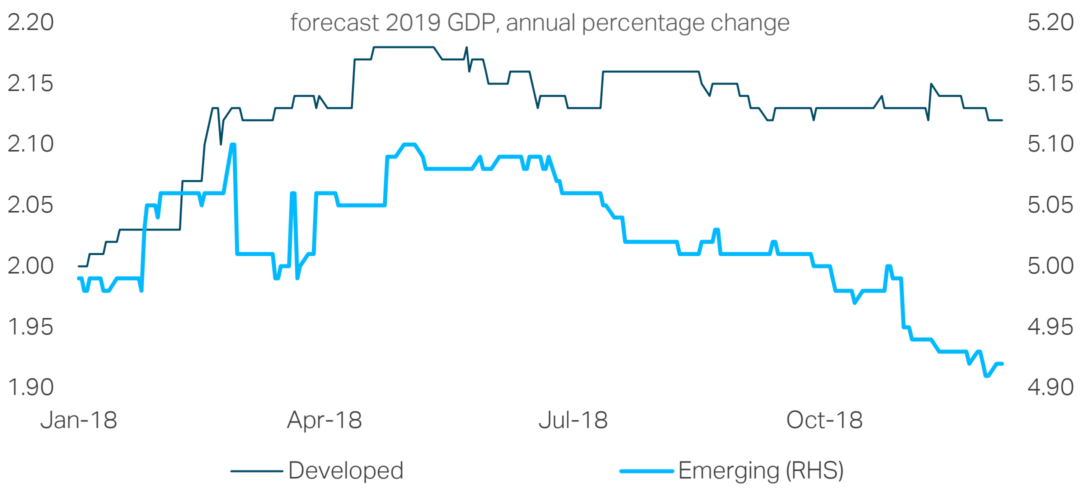
(iv) Tech reassessment: It is debatable whether this should be included as a fourth factor because the recent problems in the tech sector are arguably a response to wider market and macroeconomic weakness. That said, booming tech demand clearly added to the post-2016 global reflation theme and to the extent exuberance in this sector went too far, it could now be an additional source of weakness. In previous notes we showed how some parts of the world have become heavily integrated into a new global tech cycle and if demand for certain products such as smartphones is becoming saturated, this will cause serious problems.

Chart 6: Tighter EM financial conditions



Source: IMF Global Financial Stability Report October 2018

Chart 7: 2019 forecast revisions



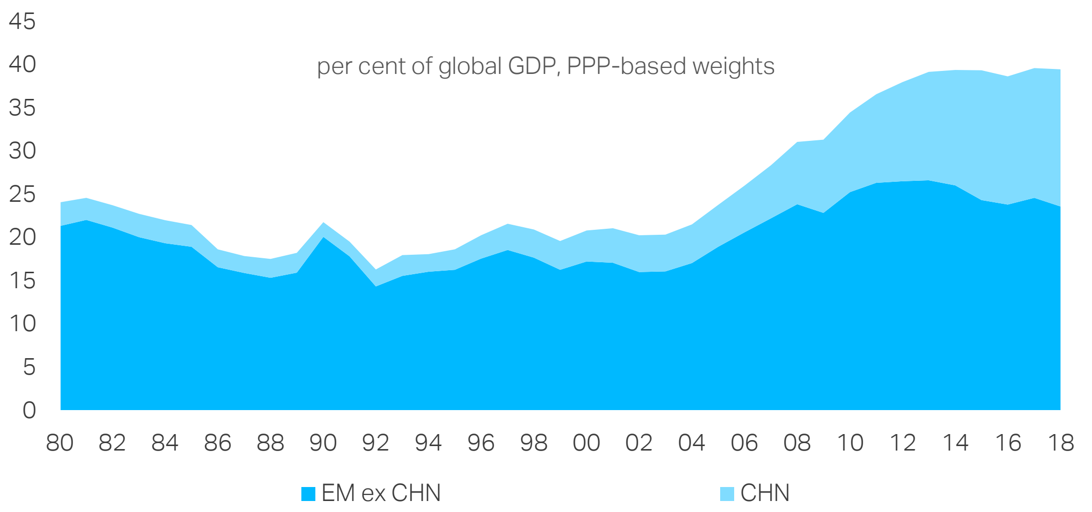
Source: Bloomberg average GDP forecasts

EM-led downturn

While it is easy to identify the broad reasons for the 2018 slowdown, it is harder to disentangle their relative importance. We know investment spending has been particularly weak, driving world trade lower, but is this due to the uncertainty caused by Trump's trade war, tighter financial conditions in global markets, or reduced demand from China? Most likely, all of these forces have been at work at the same time. We also know that the Emerging Economies are particularly exposed to these problems and have suffered most in 2018. EMs tend to be heavily trade dependent, have large exposure to China and are especially vulnerable to shifts in global risk appetite, particularly where those shifts involve the Federal Reserve and USD liquidity.

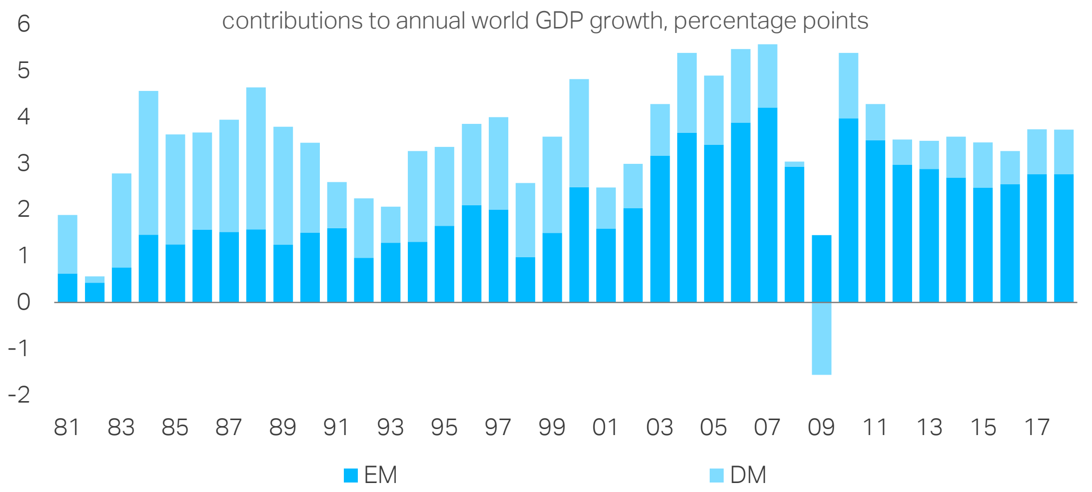
EM assets have suffered substantial capital outflows, which has caused a significant tightening in financial conditions and a sharp deterioration in macroeconomic performance. The IMF's recent Financial Stability Report looked at these portfolio flows in detail, offering clues to what has been driving global risk appetite in 2018. Their analysis suggests while rising US yields and the rally in the dollar were an important drag on EM securities through the first part of the year, particularly those countries with large USD debts sure as Turkey and Argentina, trade wars and general risk aversion took over during the summer (spreading the pain to large EM exporters).

Chart 8: EMs dominate global GDP



Source: IMF World Economic Outlook database

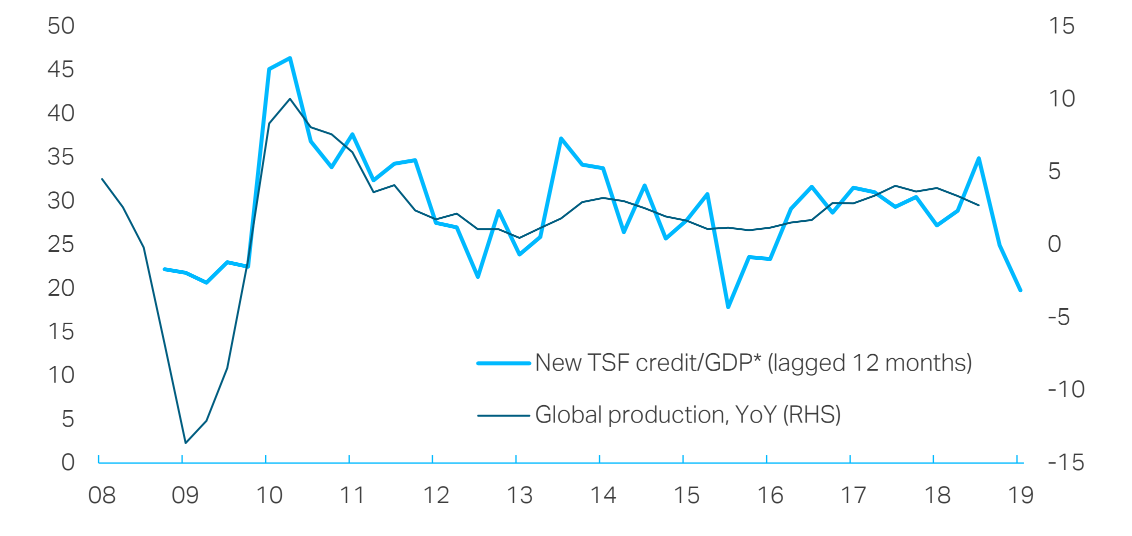
Chart 9: EM dominance



Source: IMF, TS Lombard estimates

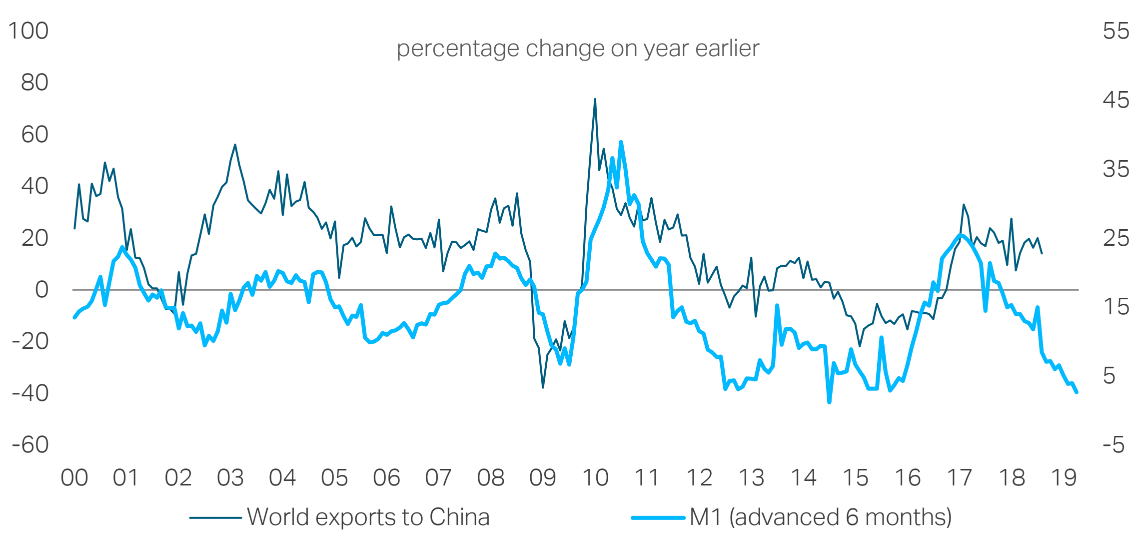
The EM slowdown is important because these countries are now a big part of the global economy. On a PPP basis, the IMF's preferred way to calculate global GDP, the emerging economies account for more than 60% of total output. (The fraction is lower in simple dollar terms.) Worse, because these economies have been expanding rapidly, their contribution to global growth has been even more significant. In the past, the developed world has usually been able to shrug off EM-specific problems but this is naturally more difficult today. The obvious comparison is with the late nineties, when a series of severe EM financial crises damaged global market sentiment but did not turn out to be systemic for aggregate world demand. While most EMs look more resilient than they did in 1998, adopting better macroeconomic policies, the stakes for the global economy are undoubtedly much higher today. What happens in China could be particularly important given China's outsized contribution to the global economy.

Chart 10: China stimulus drives the world?



Source: TS Lombard estimates

Chart 11: Chinese monetary policy and imports



Source: Official Chinese data, IMF trade database, TS Lombard estimates, Exports on RHS axis

2. CHINA PUZZLE

There is an interesting debate about whether China's slowdown has actually been the dominant force driving global growth lower in 2018. After all, not only are we talking about the second largest economy in the world – close to the United States on a PPP basis – but there is also a compelling correlation between Chinese policy swings and the broader global economic cycle. There have been three rounds of Chinese policy stimulus since the subprime crisis (2008, 2013, 2016), each followed by aggressive tightening. And these stop-go swings in Chinese policy map developments in the global economy with impressive regularity. When the China stimulates, the rest of the world accelerates, usually with a lag of around 6-12 months. When the Chinese tighten, the rest of the world slows. We see this in Chart 10, which plots Chinese credit against global manufacturing. It also shows up in the OECD's leading indicators, where China's economy always seems to move first (Chart 12). If this simple correlation is to be believed, the 2018 global slowdown could have been predicted purely on the basis of Chinese policy tightening in 2017.

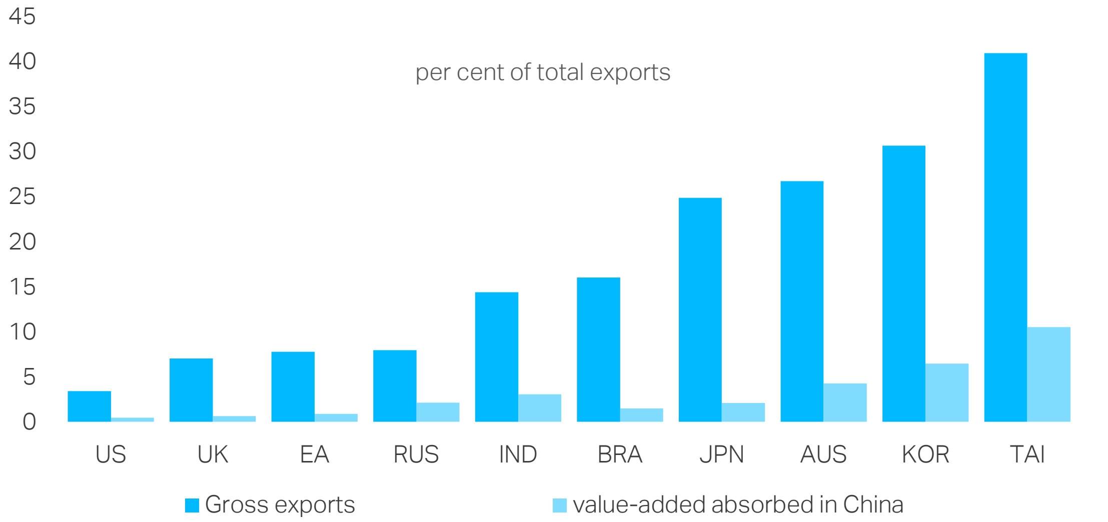
Chart 12: China's leading indicator leads OECD

Source: OECD, TS Lombard

Model says 'no'

China's statistical leadership of the world creates a puzzle for economists because it doesn't match what we see in terms of other countries' trade and financial exposures. While exports to China have increased since the country joined the WTO, they remain relatively low – particularly for the United States and most European countries. Even for Germany, which has celebrated its growing exposure to China since the early 2000s, we are still only talking about <10% of total exports. We should also bear in mind that a significant portion of this demand from China is actually derived from other parts of the world. China sucks in huge quantities of intermediate goods and components which it then re-exports to meet demand elsewhere, including the United States. When we exclude these effects and focus on the 'value added' absorbed in China, export exposures to China become rather negligible. Chart 13 shows the ECB's estimates, which radically reduce the direct impact of Chinese demand on the rest of the world.

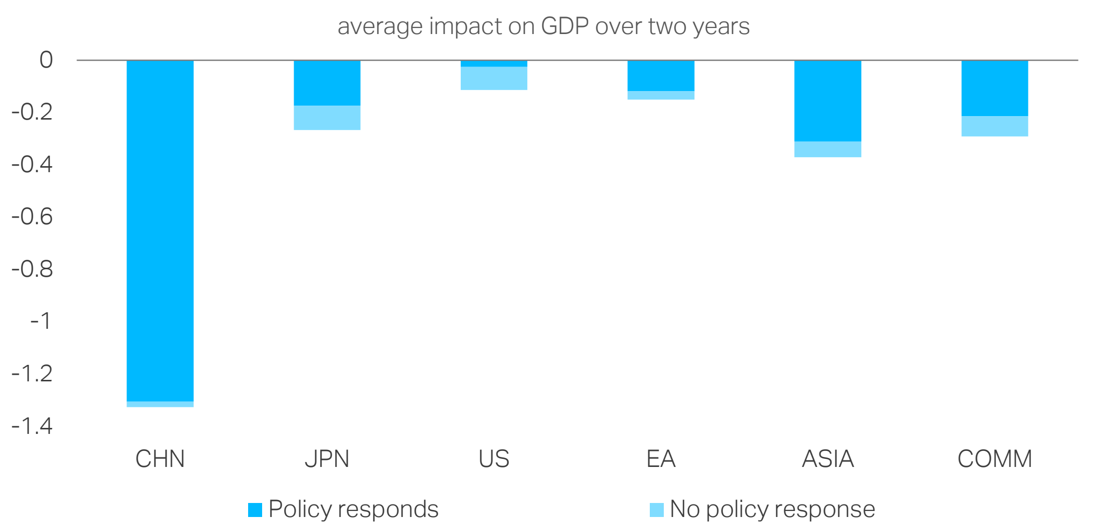
Chart 13: Trade exposure to China



Source: ECB estimates

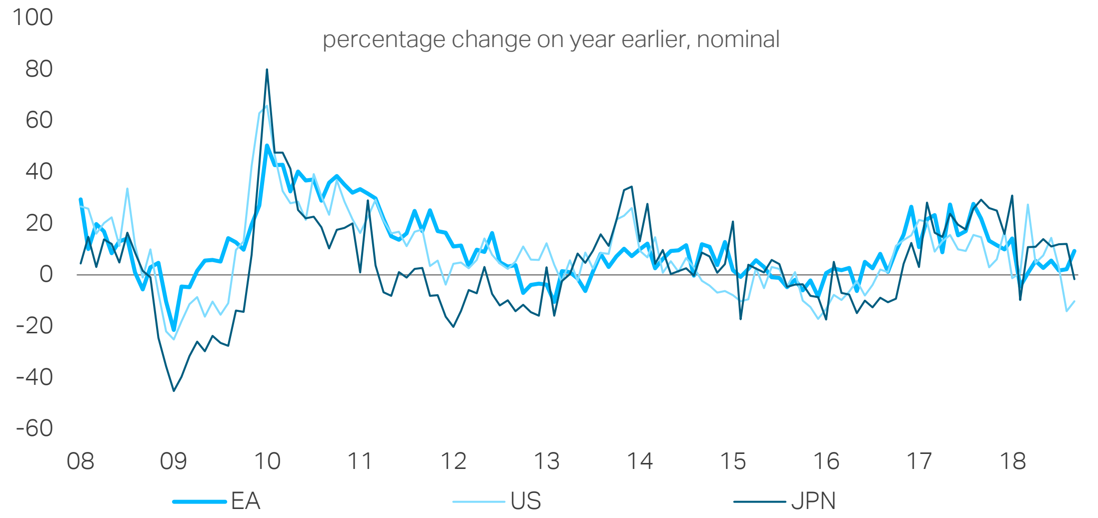
Large-scale macroeconomic models raise further doubts about the link between Chinese policy shifts and the wider global economy. A recent OECD simulation, for example, showed that every one percentage point reduction in Chinese demand would lower output in the United States and Europe by no more than 0.1-0.3% points. This finding is consistent with a recent ECB survey of external estimates, which found similar results across a range of macro models. To drive the global macro cycle in the way we seem to observe since 2008, either (i) the swings in China's economy must have been much larger –several multiples larger – than the official statistics acknowledge; (ii) the models are missing important spillovers not captured in direct trade linkages; or (iii) China's apparent leadership of the broader global economic cycle is spurious.

Chart 14: Impact of 1% China demand shock



Source: OECD Economic Outlook, November 2018, COMM – commodity exporters

Chart 15: China trade hit

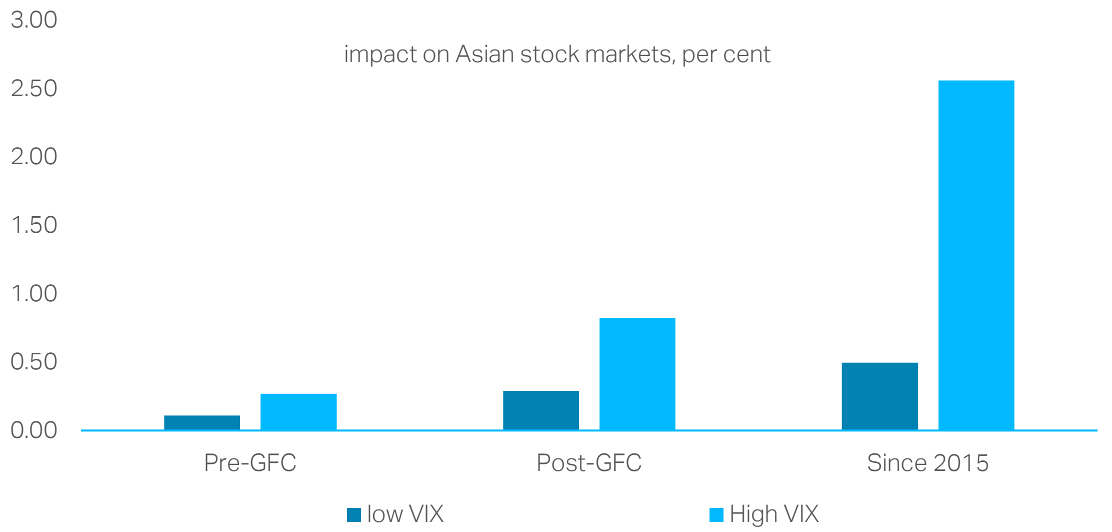


Source: National sources, TS Lombard

Correlations and causation

We suspect statistical spuriousness is part of the story – after all, we are talking about a small sample which includes only three major Chinese policy shifts. The first of these, the 2008 stimulus, coincided with aggressive action (both fiscal and monetary) across a broad range of other nations. The 2009 global recovery probably would have taken place without Chinese help. The second Chinese stimulus, which took place in 2012/13, coincided with the euro crisis. EMU breakup fears undermined market sentiment and damaged euro-area growth, only disappearing after the ECB promised to stand behind periphery debt. Once again, it is questionable whether Chinese stimulus played an important role in the post-2013 revival. If anything, the correlation between China and the rest of the world appears to run the other way. Problems in the US and Europe prompt a quick response in China but the global economy eventually recovers.

Chart 16: Impact of China macro news stories

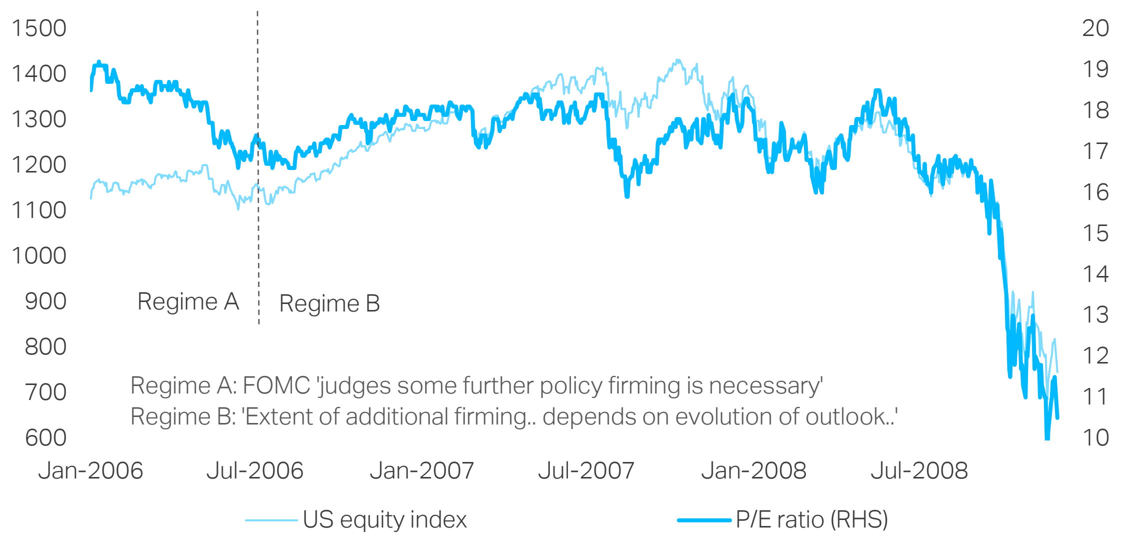


Source: IMF China spillovers report

Yet the impact of China on global growth in 2015/16 is much harder to ignore. Back then, China's slowdown and subsequent recovery did have a material impact on global growth prospects. A number of recent studies have looked at this episode in detail, showing that fears of a Chinese hard-landing and currency devaluation had a powerful bearing on global financial markets. This was partly due to important spillovers in commodity prices and global risk aversion, which are not fully captured by the economic models used by the OECD and ECB. The commodity channel was particularly important. Worries about Chinese growth triggered a collapse in energy prices, which hit oil producers hard. Though Western consumers eventually increased their spending, the short-term effect on global demand was powerfully negative.

Should China's economy continue to deteriorate, we cannot rule out another round of spillovers, both via commodity prices and broader financial contagion. There is certainly evidence that global stock markets have become more sensitive to China-related news in recent years. And investors are particularly worried about the Renminbi. With a third of the dollar's trade-weighted index tied directly or indirectly to China, you can see why this could be a big problem. The dollar is already high by historical standards and RMB devaluation – which would lead to further US appreciation – could cause another major tightening in global financial conditions. Indeed, what the Chinese decide to do with their currency could have a critical bearing on how global markets perform over the next 12 months. But it is not the only important policy decision in 2019.

Chart 17: Stocks rallied after the 2006 Fed pause



Source: Datastream, Federal Reserve

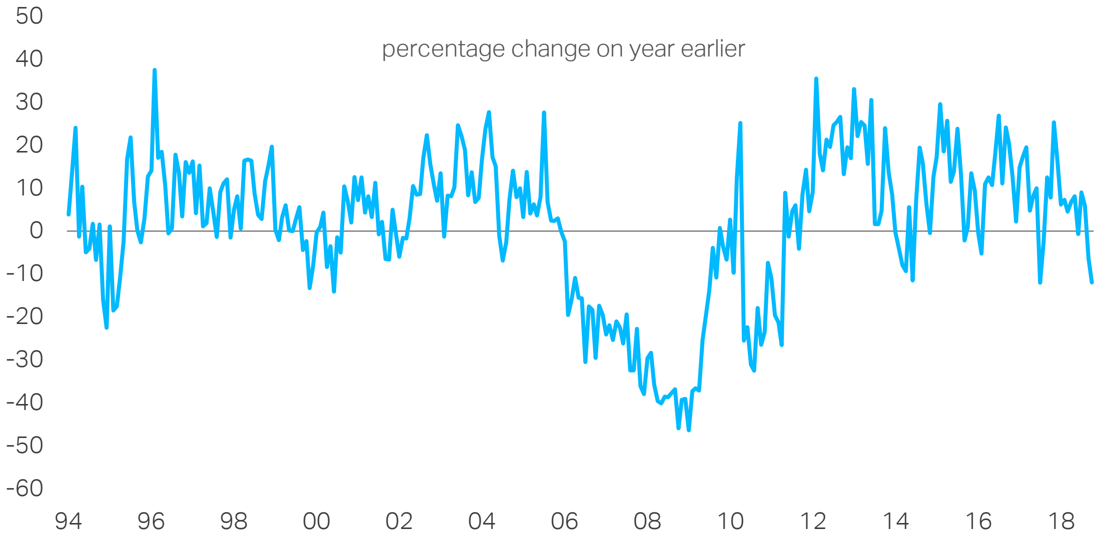
3. POLICY TRILEMMA

The global economy has slowed, responding to tighter financial conditions, trade uncertainty and Chinese policy tightening. The question now is what happens next. Will these forces reverse, prompting a rebound in global demand, or could the current situation deteriorate further, bringing a major bear market and/or global recession? We suspect the answer lies somewhere between these two extreme outcomes. We think global activity will stay weak in 2019, which will ensure another volatile and unrewarding year for risk assets, but we do not expect a major crash. That said, slower growth brings dangerous risks and several important policy decisions could tilt the macro environment either way. The most important policy questions are likely to be: (i) Will the Federal Reserve pause in early 2019, or push on with interest rate hikes? (ii) Will President Trump postpone his trade war? And (iii) will the Chinese re-stimulate their economy, or turn to currency devaluation instead.

Three choices, two scenarios

It is possible to envisage two very different scenarios for the global economy depending on what policymakers decide to do in 2019. In the bullish scenario, the Fed stops raising interest rates early in the year, Trump postpones his trade war (or even better, claims victory and ends the conflict altogether) and the Chinese introduce a modest stimulus programme, sufficient to put a floor under their economy. Investors would probably prefer a more aggressive Chinese response but this would aggravate medium-term stability risks. This benign set of policies would not only prevent a further deterioration in global demand but it could also have a powerful impact on financial markets, perhaps even reawakening the near-departed 2009-18 bull market.

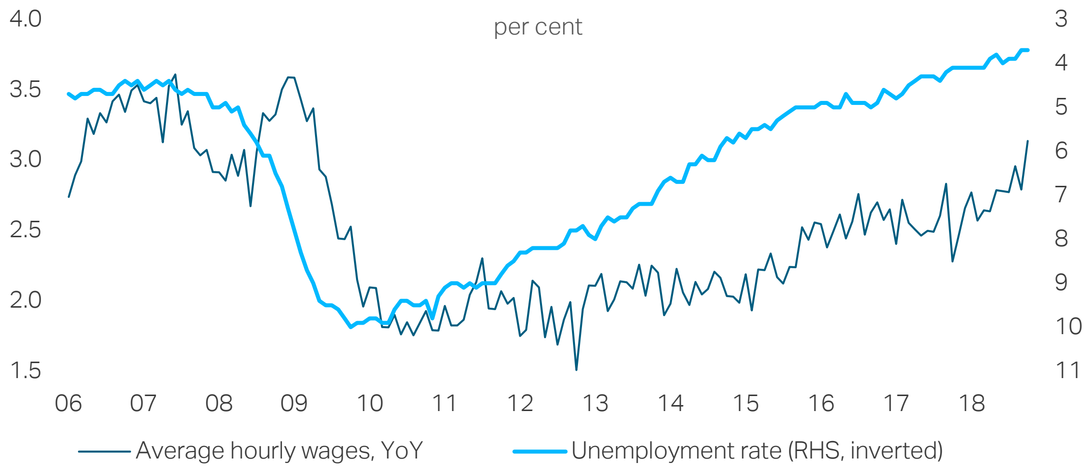
Chart 18: New US home sales



Source: FRED, TS Lombard

Consider the Fed pause. In the past, financial markets have greeted dovish tilts in US monetary policy with nothing short of euphoria. In 2006, for example, equity markets rallied 20% in six months on the news the Fed would no longer be raising interest rates, even though the housing market was struggling and officials maintained an explicit tightening bias, threatening to resume raising interest rates when the data warranted it (Chart 17). With interest-rate sensitive parts of the economy now slowing again (Chart 18), policy close to official estimates of 'neutral' and no real sign of the much feared Phillips curve kicking in – in fact, wage trends remain remarkably subdued (Chart 19) – there already a strong case for stopping the tightening cycle after the March hike, if not earlier. By showing pragmatism few sellside economists expected earlier in the year, when most thought the Fed would keep tightening until the economy sank into recession, a Fed pause would alleviate one of the main things investors have been worrying about in 2018.

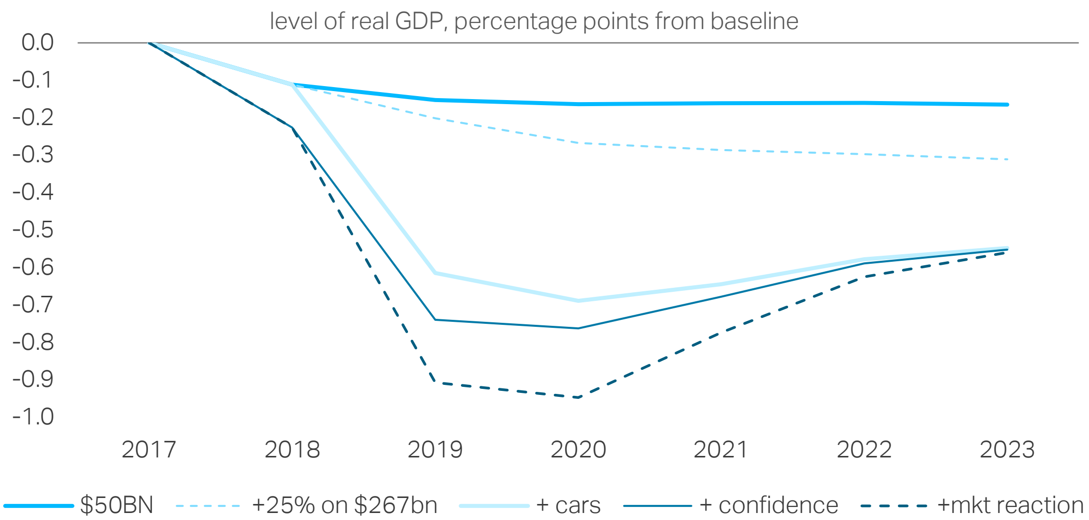
Chart 19: US Phillips curve still broken



Source: BLS, TS Lombard

Though markets should be able to rely on a pragmatic Fed in 2019, there is much more uncertainty about what President Trump and his counterparts in China will do. The US administration decided to delay the imposition of further (much larger) tariffs on China but only by 90 days. There are obvious questions about whether this latest round of talks will be able to achieve sufficient progress, particularly on such a tight timeframe. While we are assuming it is in US interests to delay any major escalation in the trade war because the next round of tariffs will hurt US consumers more directly, we have long argued that President Trump is serious about protectionism and we cannot rule out a more negative scenario in 2019. The IMF recently published some useful analysis of the trade war, showing what each round of escalation could mean for the global economy. Their most extreme scenario, which would include large-scale tariffs on China and Europe, plus a major deterioration in market sentiment, would hit all major economies hard, halving their forecast for US economic growth in 2019.

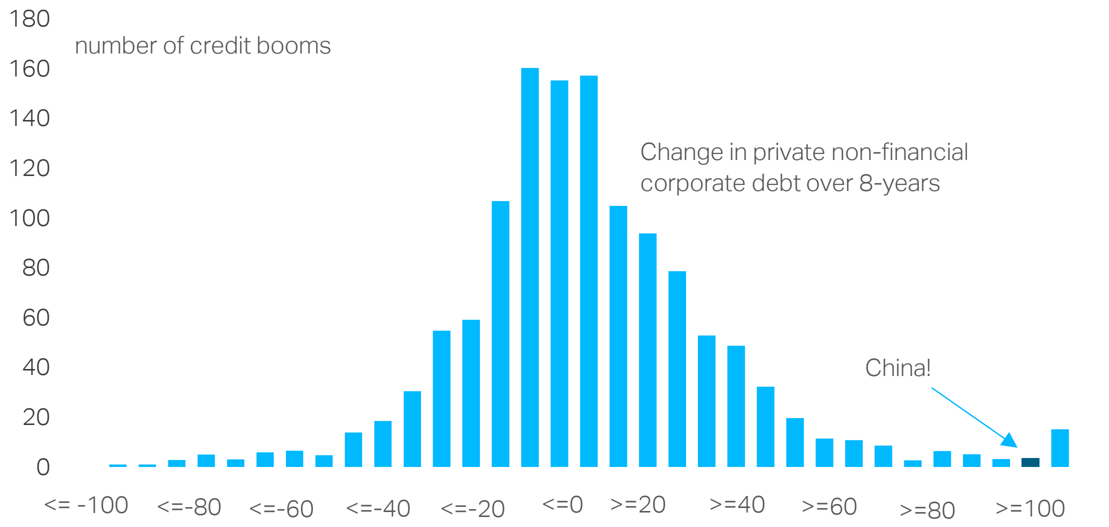
Chart 20: Trade war escalation – impact on US GDP



Source: IMF World Economic Outlook, October 2018

Meanwhile, China needs to find a new way to stimulate its economy without relying on another massive credit-fuelled investment splurge. The authorities are anxious not to allow their credit-GDP ratio to keep rising because they want to avoid a Japanese-style deflationary bust. Policymakers realise that even if they could avoid a banking crisis, it would be more difficult to prevent a serious economic slowdown, which could have dangerous political repercussions. Again, the likeliest outcome is relatively benign – modest and targeted stimulus. But a major escalation in the trade war changes Chinese policy arithmetic, providing the perfect excuse for the authorities to use their exchange rate as an alternative macro stabilization tool. The RMB is already overvalued, capital outflows appear to be under control, and China's trade position is steadily deteriorating. While not the likeliest outcome, the combination of global trade war and Chinese devaluation would be particularly devastating for risk assets in 2019

Chart 21: China's place in history



Source: ECB staff paper, 2018

Bottom line

Global growth has deteriorated through 2018, with fears of a synchronized slump replacing talk of synchronized boom. Three deflationary forces have been particularly important: (i) tighter financial conditions and a widening in risk premiums; (ii) major trade uncertainty, and; (iii) Chinese policy tightening. The Emerging Markets have suffered most, mainly because they were always most exposed to these forces. And since the global economy is more reliant on EM growth than ever before, the hit to aggregate world GDP and trade has been sizeable. China's role in this downturn has been particularly puzzling since shifts in Chinese macro policy seem to be having a much more powerful impact on global demand than might be expected based on direct trade and financial linkages. While we suspect this link is partly spurious, the 2016 episode shows global markets are more sensitive to Chinese economic news than ever before. While we think growth will stay weak and markets volatile, three crucial policy decisions could be decisive in 2019: the Fed pause, Trump's trade war and how the Chinese try to revive their economy.

Authors

Dario Perkins
Managing Director,
Global Macro