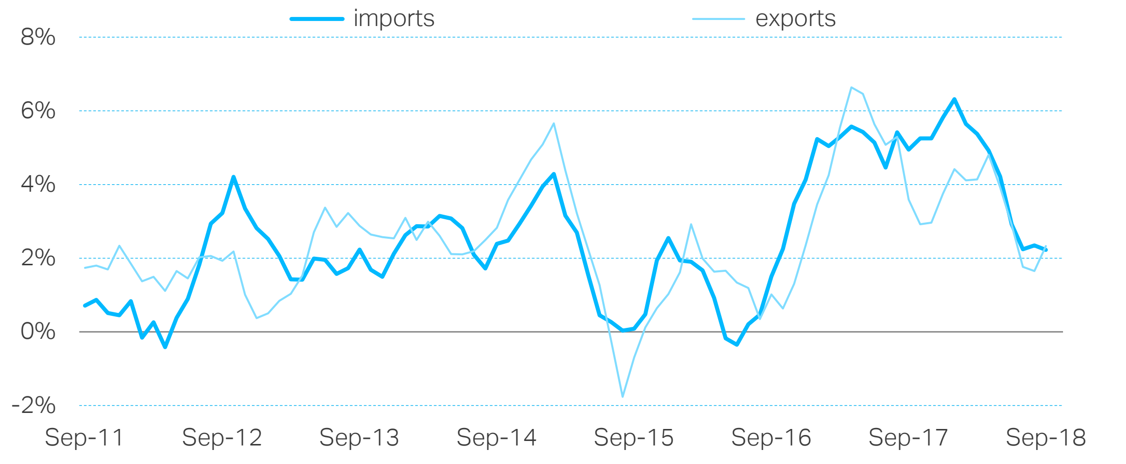
LSR View

CHICKENS HOME TO ROOST IN 2019

Global Team

- Global slowdown already started – Q3 down in EMs, Japan, Germany
- Oil price slump to ease DM slowdown, but producers may cut spending
- EMs bore the brunt of dollar-up/yuan-down, but now bottoming out
- US Q3 less good than it appeared – down to 2% YoY growth by 2019 Q4
- China to revive through cheaper yuan as well as policy stimulus
- EA hurt by slower world trade – below-trend growth possible in 2019
- Japan like EA losing exports, but more hurt by Chinese proximity
- Risks include trade war worsening, US bear market, Italy, Japan, Brexit

World trade volumes, 6-mths/6-mths % change, saar



Source: Dutch CPB, Datastream, TS Lombard

Contents

Summary

The global slowdown now seems to have started in mid-2018, and shows the now decisive importance of emerging markets to the world economy. China and other emerging markets account for 40% of world GDP measured at current FX rates (15% and 25%, respectively) and their slowdown led to a sharp mid-year reduction in world trade growth.

China was slowing anyway, but the trade-war moves by the US in mid-2018 turned a mild rise in the dollar to a rapid advance, with the real yuan falling likewise: in both cases by 7-8% in real, trade-weighted terms from their spring levels. The trade-war damage was thus exported to the rest of the world as the rising dollar (and until September, oil price) inflated other countries' import costs while the sliding yuan made their exports less competitive. As well as damaging severely the non-oil EMs, this double-whammy also hurt Japan, the Asian Tigers and Europe, though all of them got some relief this autumn from the sudden slump in oil prices.

We have become modestly bullish on EM prospects – they could be bottoming out, following the severity of their downswing and the oil price slump. But their current-account deficits have been huge for a dozen years now, so debts are large as well as deficits, meaning some normalisation of dollar interest rates is also a problem. While their FX rates may have adjusted, the associated cutbacks of domestic demand will continue to affect world trade into 2019. This is also the case in China. There too, recent relief has been provided by some de-escalation of the trade war, but only modest policy stimulus is expected, and together with the benefit of a much cheaper yuan this should revive growth in the second half of 2019 after a slow first half.

The US economy could fall back on the consumer as its source of growth as gasoline gets cheaper, but the high dollar is hurting exports while that and trade-war uncertainty are inhibiting business capex growth. The big adjustment under way is to positive real short-term interest rates – for the first time for ten years – with slower housing, as well as a risk to stock prices.

In Europe, export dependence led to negative Q3 GDP change in Germany and Italy, though greater service-sector orientation meant France, Spain and the UK continued to grow. The German exposure to Chinese and EM growth, together with Italy's uncompetitive costs, mean EA growth could be below-trend this year for the first time since recovery started in 2013. The UK continues to be politically convulsed by Brexit, but our view of the likely outcome should leave growth relatively unaffected once the uncertainty is reduced in a few months' time.

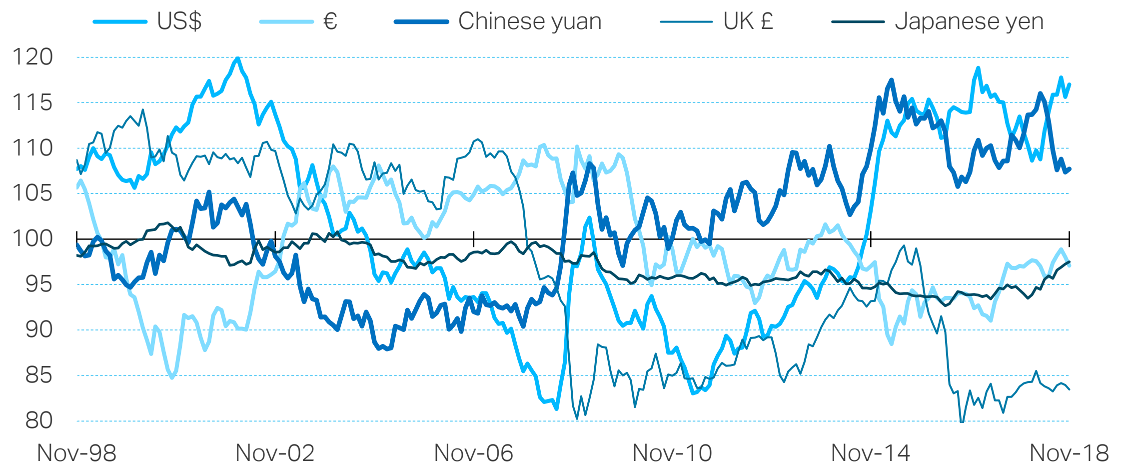
Japan (and Korea and Taiwan) are doubly vulnerable to current problems, both dependent on China's growth in their export-led economies, and weakened in worldwide competitiveness by the yuan's depreciation. Japan's 0.6% drop in real Q3 GDP may not be followed by a further Q4 fall, but underlying growth is now likely to remain weak, despite the bonus of the oil price slump.

The risks in this outlook are biased to the downside, though trade war resolution would be a big plus. On the other hand, the trade war could easily move from luke-warm to hot, and this would hurt stock prices and aggravate the negative aspects of the world economy described above. Other sources of stock market risk include earnings falling short of current rosy expectations and possible medium-term trade-war effects as globalisation gives way to regionalisation into blocs: North America, China-centred east Asia, and Europe. Other risks examined below include Italy and the euro, and Japanese debt and deficit escalation.

Global slowdown already started

It is unusual for EMs to move collectively in one direction, but that has happened since last spring. A small springtime rise in the dollar was transformed into a large jump in the summer, as the yuan fell under the threat of trade war. The rising dollar and falling yuan combined with a slowing Chinese economy to cause trouble for most EMs, sharply slowing world trade.

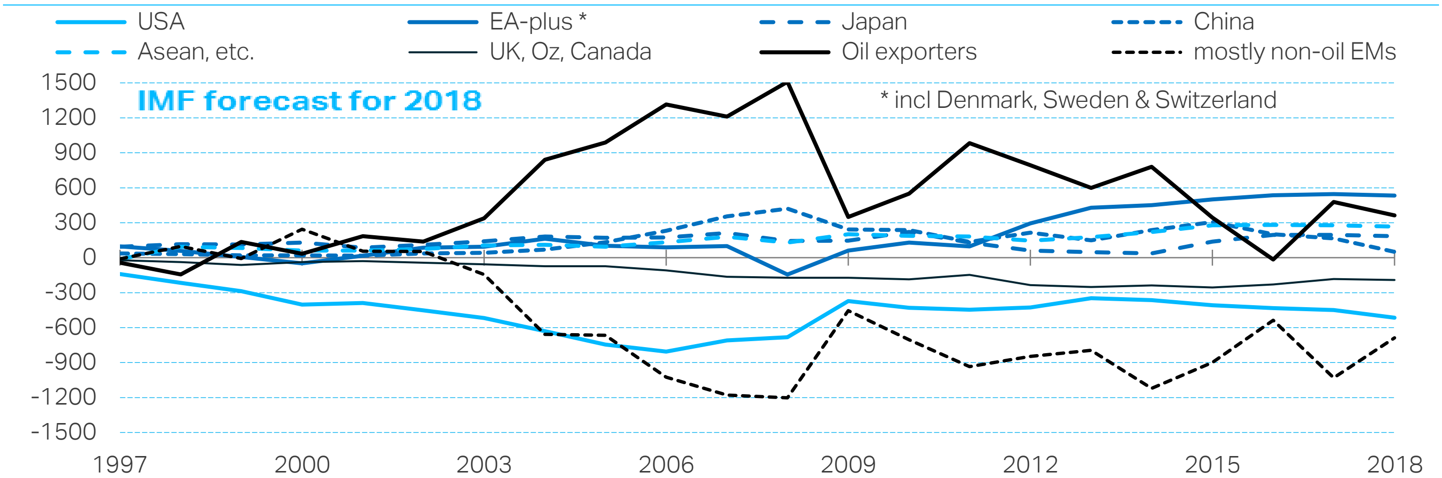
Chart: Real FX rates, PPI-based, long-run average = 100



Source: Datastream, TS Lombard

A variety of factors are combining to reduce growth – and an end-2018 recession is possible in Japan, and even Germany. The combination of a rising dollar and falling yuan – each move by some 7-8% in trade-weighted, real terms – has already created severe difficulties. As well as the EMs, vulnerable economies include Europe and Japan. China is also weakening. Countries not in the trade dispute face costlier imports – partly relieved by the recent oil price slump – and China's more competitive cost challenge in exports in a slowing world-trade environment.

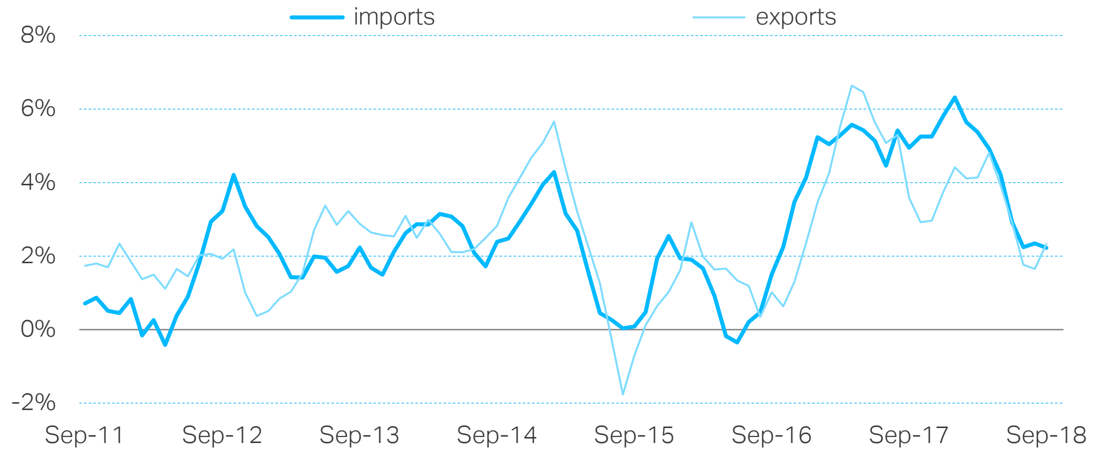
Chart: Global current account balances, $ billion



Source: IMF, TS Lombard

The savings-glut Pacific region economies – Japan, Korea and the Asian Tigers – could suffer in the usual way from weaker world trade and the depreciation of China's yuan, though some of them may gain business from diversion of US imports to alternative routes into the US. The US could also be slowed by a combination of global weakness, trade-war-driven uncertainty, an increasingly overvalued dollar and delayed effects of monetary and financial-market tightening. Chart 2 above highlights the vulnerability of non-oil EMs other than China. EMs now account for 40% of world GDP at current prices, and 37% of imports. (At comparable prices, 'purchasing power parity', their world-GDP share is 60%.) Their fortunes are an increasingly important force in the world's economy and growth.

Chart: World trade volumes, 6-mths/6-mths % change, saar



Source: Dutch CPB, Datastream, TS Lombard

China has slowed for domestic reasons (policy has focused on curbing debt escalation). It is now subject to US tariffs on some of its exports. Together with EM stress the result is a sharp slowdown in world trade. As in 2015, these are the first times that EM issues have dominated the world economy since this wave of globalisation began after 1991's end to the Cold War.

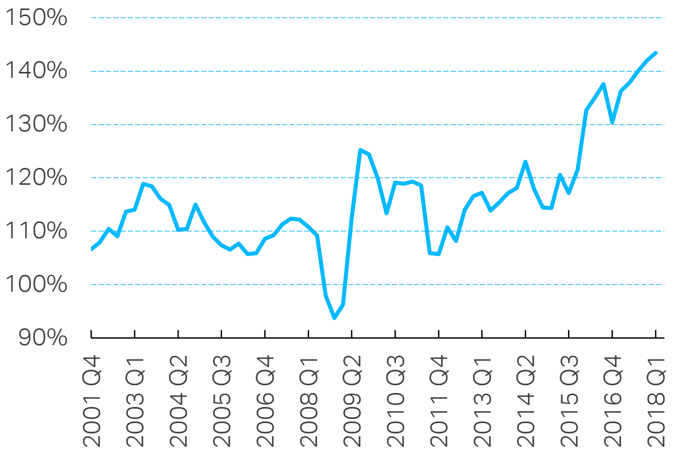
While the US-China trade war is subject to a 90-day 'truce', few expect negotiations in that period to cause the US to abandon entirely its new tariffs on imports from China. Some of China's retaliation against US exports may be unwound. But there is little sign in the US of awareness of major downsides for the US in pursuing its trade-war goals, concerning intellectual property and technology transfer as much as hoped-for 're-shoring' of jobs to the Mid-West.

This leaves China with little option but to accept (perhaps provoke) further yuan depreciation. Partly, that is the obvious way to compensate for foreign trade losses. But also, alternative forms of stimulus to offset the currently weakening economy would either involve fiscal deficits or monetary easing: in both cases tending to ramp up debt ratios that it is the current goal of policy to curb. So we expect further yuan depreciation, though at a more modest pace than in the middle months of 2018. This would, however, add to the competitive cost pressures both on other EMs, mostly in deficit, and on far eastern DMs like Japan and Korea, as well as Europe.

The strong dollar is a major reason why we expect 2019 to see a US slowdown, alongside some hesitation of business capex because of the uncertainties of the trade war. It is entirely possible that this will engender a change of emphasis in US policy, away from tariffs on China. The actual US deficit, as Chart 2 (above) shows, is largely the counterpart of surpluses in continental Europe and Japan, not China: China's current account surplus is now well under 1% of GDP, down from more than 10% ten years ago. It may well be that as 2019 draws on, and the threat of economic slowdown in a US election year (2020) increases, US policy will switch to attempting to penalise Europe, especially in the car industry. But this prospect, with some relief for China, is only likely to emerge as a result of the 2019 slowdown we forecast here.

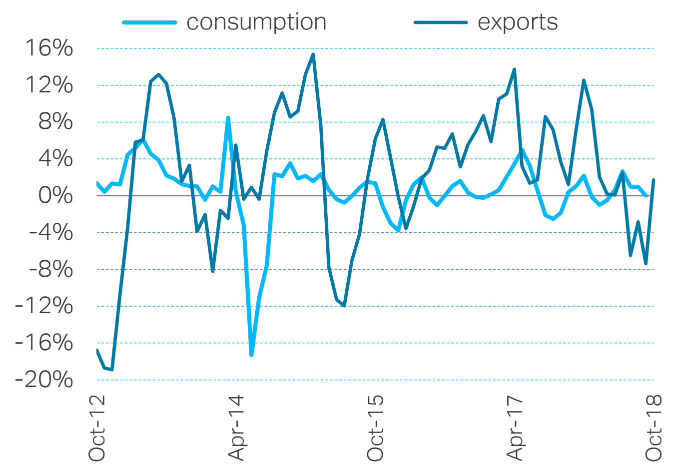
High oil prices have been particularly burdensome for non-oil economies, notably Japan, Korea, the EA and most EMs, but the recent oil price slump is a favourable reversal of this factor. This does not mean that these countries will be leading a strong recovery, as prospects are driven by a complex mix of factors. These include cutbacks in oil exporters' spending, and the scale of shale fracking activity in America. The dollar's strength against the yuan may start to be matched by weakening against the euro and yen, hurting their exports. And the knock-on effect of the slowdown already felt in major export-led economies (and in major sectors of demand in the US) may cut into capex activity and monetary policy and conditions.

Chart: EM non-fin'c'l debt, ex. China, %/GDP



Source: BIS, TS Lombard

Chart: Japan, real demand, 3-mo/3-mo %, saar



Source: Datastream, TS Lombard

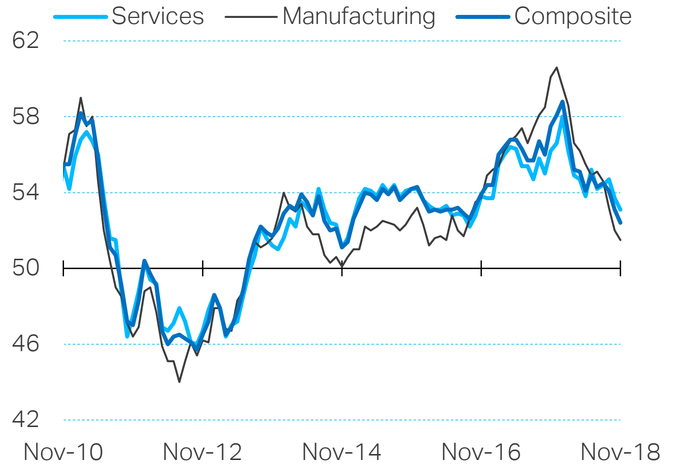
Non-Chinese EMs may have hit bottom in terms of the intense market sell-off that started in the spring, but its effects are still reverberating in the world at large. The scale of their deficits, averaging $800 billion a year outside of China for a dozen years, has led to a debt build-up, much of it in dollars, that is suddenly both more costly and less easy to roll over, with conventional US paper now yielding more than inflation even at short maturities. Both because of the resulting higher interest rates, and reflecting recent FX depreciations, their domestic demand is now weak, accounting in part for the slowdown in world imports.

The great exporters, Japan and Germany, have had serious difficulties already. Japan had a remarkably bad Q3, with real GDP down 0.6% and September very weak. Inventory management was conservative and October saw a bounce in exports. So a second negative quarter for real GDP will probably be avoided in Q4. But with Chinese competition if anything intensifying and the US slowing along with the rest of the world, the recent topping out of business capex could give way to a decline. Japan's consumers will gain from cheaper oil. And the steady appreciation of the real, trade-weighted yen may also help real consumer incomes – but will, of course, make the outlook for the chief growth drivers, exports and capex, that much more difficult.

The EA has a similar mix of factors to Japan, but without the proximity of China to intensify the pressure arising from the yuan's decline. Germany is the most export orientated of the big four EA economies, and saw GDP fall 0.2% in Q3. Italy, also more industrial than most and heavily dependent on supplying to Germany, also saw real GDP fall, by 0.1%. While they both stand to benefit from distance from China, export growth since the financial crisis has been largely to China and the EMs, so the global slowdown is affecting them badly. They will also be helped by the recent oil price slump, but Germany particularly suffered in Q3 from a sharp build-up of inventories that could unwind in Q4 and 2019 Q1, conceivably causing a second negative quarter for GDP, even though much of the inventory variation if offset by imports.

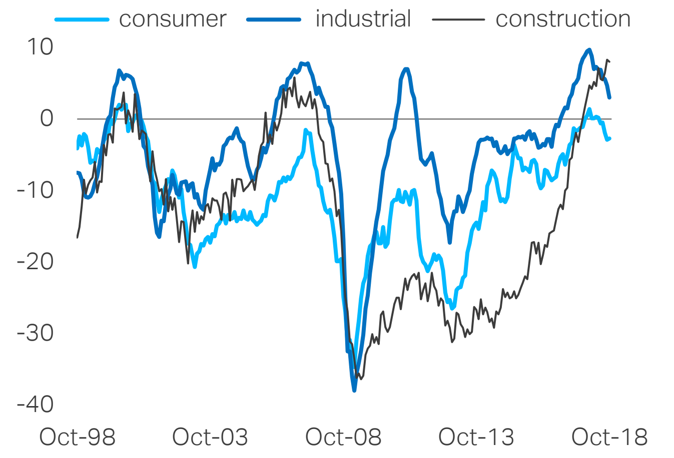
Italy is the European country most directly in competition with China. Its chief industrial sectors are 'commodity industries' that could now stagnate after the relatively feeble growth of the past five years, when most of the EA has been growing robustly. France, more of a service economy than Germany and Italy, saw Q3 GDP rose by 0.4%, although industry is similarly troubled. Spain has out-performed the rest of the big four EA countries for five years now; Q3 growth was 0.6%.

Chart: EA PMIs (50 = recession threshold)



Source: Datastream, TS Lombard

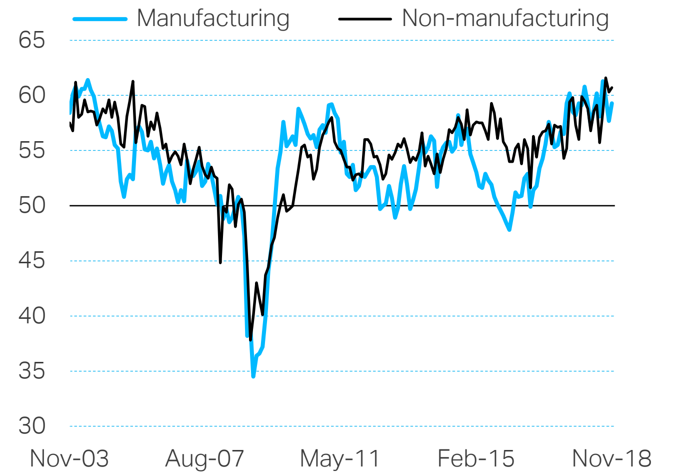
Chart: EA sentiment indicators



Source: Datastream, TS Lombard

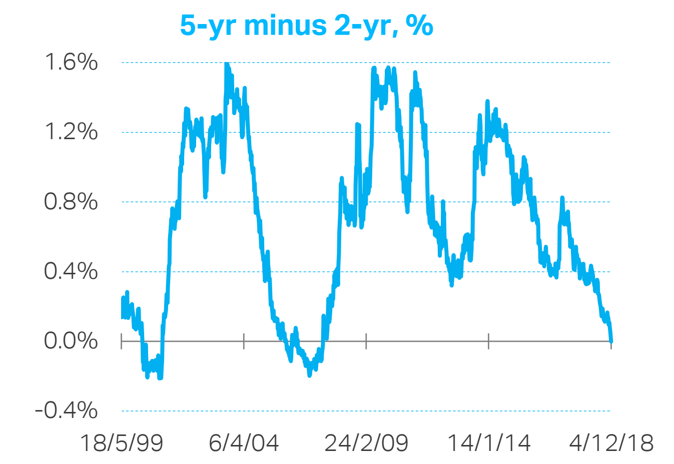
Prospectively, the EA economies will be growing during 2019 at less than their potential rate of about 1¼%, and well below recent rates. Projections for growth over the four quarters of 2019 might be for 1-1¼% each in Germany and France, 2% in Spain and nil in Italy. The biggest problem arising from this would be continued widening of the gap by which Italy is falling behind the rest, and the political and economic policy problems that arise from that (see p.31 below).

Chart: US ISMs still buoyant ...



Source: Datastream, TS Lombard

Chart: ... but short maturities curve now flat



Source: Datastream, TS Lombard

The US economy has been the strongest of the developed markets and the real-economy indicators remain favourable. But financial indicators are less rosy, and some of the strength in Q3 was unlikely to be repeated, even if US consumers have 'looked through' the mid-year upswing of oil prices, and are now justified by the recent oil price slump: they used up savings to sustain spending in Q3. The Q3 growth rate of 3.5% (annualised) was boosted by more than a full percentage point by the combination of falling personal savings and rising inventories.

The key indication of incipient weakness was Q3 export volume being down, housing too, and business capex only rising by a minimal amount. The basic point is that the sharp mid-year rise in the dollar has brought it to a level that in the past has led to economic weakness, as it hurts exports – especially when world trade growth is softening, as now – and squeezes profitability of US firms, but particularly stock market earnings. The relative restraint of business capex in Q3, however, is hardly explained by dollar strength, given the time-lags in scheduling of business capital spending. Probably it is chiefly accounted for by trade-war uncertainties.

A conspicuous aspect of current financial conditions is that short-term interest rates have been at or close to zero for most of the past ten years, and well below inflation … but no longer. Habits of behaviour that have arisen as a result now have to be unwound, including assumptions that investors have grown accustomed to making. Meanwhile, the short end of the Treasury yield curve – the 5-year yield minus the 2-year – has gone flat, normally a sign of impending economic slowdown. However, this signal has typically been registered six to 12 months ahead of the actual slowdown in the past. Our 2019 forecast is that US growth over the four quarters of 2019 will be slower than in the recent past, perhaps at a 2% rate, but not a recession.

One result of this potential slowdown is that the Federal Reserve may halt its interest rate hikes soon, particularly as the slowdown seems to be caused by trade-war uncertainties and the overvalued dollar as well as by normal cyclical factors – rising interest rates and bond yields. Given the apparently spontaneous slowing of business capex and the deflationary effect of the strong dollar, further tightening could merely reinforce the downswing un-necessarily; it would be highly likely to turn the 5-year minus 2-year yield curve negative in the chart above.

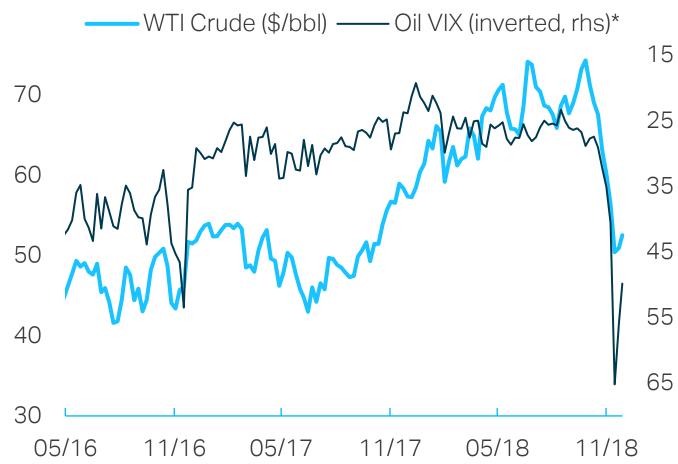
Oil – OPEC almost back to square 1

2018 has been a rollercoaster for the oil market. Brent spent most of the year ranging between $70 and $80, extending the uptrend in place since June 2017. Receding fears of a rapid escalation in Trump's trade war with China lifted global risk sentiment around the end of the summer, benefiting oil along with the rest of the commodity complex. Crude prices spiked in September amid evidence that OPEC's progress in scaling back over-compliance with the cuts – the result of involuntary reductions in Venezuelan production and declining supply from Iran – had stalled. To make matters worse, intense uncertainty surrounding the enforcement of Trump's Iranian sanctions kept the market on its toes. Investors saw risks as largely one-way, stoking worries about the thinning margin of safety in OPEC's spare capacity and fuelling speculation of a quick move to $100/bbl.

Things changed dramatically in October. The US administration's decision to offer waivers on imports of Iranian crude deflated the 'Trump premium' on prices. It also led investors to shift their focus away from geopolitics to the broader fundamental outlook. Consumption had already started to slow at the same time as crude production was rising, with Saudi Arabia, Russia and the US all pumping at record rates. As global inventories crept higher in H2, the softer restrictions on Iran raised the possibility of a supply glut developing in 2019.

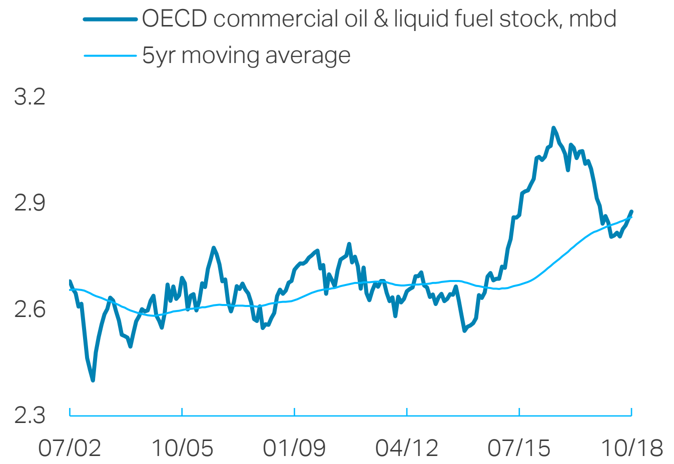
With the demand outlook deteriorating, investors' conviction that output tweaks from OPEC+ (i.e. the alliance between OPEC and cooperating non-OPEC members led by Russia) would, on their own, be enough to 'fix' things was shaken. The sentiment pendulum swung violently from one extreme to the other in a short period of time. Even so, lack of an OPEC+ supply response was not really an option as the group convened in Vienna earlier this month. While the market had already gone through a meaningful reset, there was little doubt that news of 'no agreement' would send prices into a tailspin. The announced cuts for (1.2mbd over H1 2019) are a middle-of-the-road decision, taking production back to roughly where it was in May – when supply started rising in response to mounting market anxiety – and still leaving output above OPEC's estimate for the call on its crude in 2019.

Oil resets lower as volatility spikes



Source: Bloomberg, TS Lombard *CBOE Crude Oil ETF Volatility Index*

Inventory build-up resumed in H2



Source: Bloomberg, TS Lombard

Reduced OPEC+ supply should help put a floor under prices. But this is also an uphill road for the cartel, which is almost back to square one in terms of gaining investors' trust – like in early 2017. Building credibility then took sustained over-compliance with the cuts in order to drive inventories lower. The stars were aligned for oil prices, with the global synchronised expansion taking root and demand surprising positively. In contrast, now the world economy is slowing. With US shale output surprising to the upside and financial market sentiment on shaky ground, the bar for a sustained oil price rally in 2019 has shifted higher.

EMs – from 2018 slump to 2019 volatility

Some major elements in the outlook:

- **Risk**: We raise our call on overall risk to moderate positive.
- **Brazil**: We cut our call on equities from strong to moderate positive.
- **China**: We raise our call to moderate positive following Trump's de-escalation of the US-China trade war.
- **Turkey**: We raise our call to moderate positive as we expect further recovery from oversold levels.

Asset allocation view

	Equities ($)	Currencies	Local rates	Credit ($)
Risk	+1 (-1)			
Asset class	+1 (-1)	-1	+1 (0)	-1 (+1)
Relative country views				
China	+1 (-1)	-1	-1	n/a
Brazil	+1 (+2)	+1	+1	+1
India	-1	-1 (0)	-1	n/a
Russia	-1 (+1)	-1 (+1)	-1 (+1)	-1 (+1)
Mexico	-1	+1 (-1)	+1	+1 (0)
Indonesia	+1	+1	+1	-1
Philippines	+1	+1 (0)	+1 (-1)	-1
Thailand	-1 (0)	-1	-1	n/a
South Africa	-1	-1	-1	0 (-1)
Turkey	+1 (-1)	+1	+1	+1

Scale
+2
+1
0
-1
-2

Last month in brackets

The scores for our relative country views sum to zero in each column.

For further explanation, see our methodology.

This publication was originally part of our EM service. Click here for more details.

Notes on Portfolio Strategy

Below we explore in more detail the assumptions and judgments behind our current portfolio strategy recommendations.

Shorter, more volatile swings will characterize markets next year

The EM "perfect storm" that we had warned about in early September did happen but passed sooner than we expected. By October, we had raised our overall EM risk outlook from strong to moderate negative and this month we hike it again to moderate positive. Although we are positive on EMs in the short term, we think markets will be increasingly volatile next year; we therefore expect more frequent changes in our calls during the course of 2019 in response to fast-moving market developments.

There are both technical and fundamental factors behind the recent upgrades to our outlook. The technical factor reflects a change in market structure and dynamics that we think signals "the death of the cycle". Over the past 10 years, central banks worldwide pursuing QE policies have pumped vast quantities of liquidity into markets. This has created a situation in which the gradual adjustment of markets to underlying changes in fundamentals, such as the current move to QE exit, has given way to sharp, increasingly volatile market moves. The dominance of market technical factors was on display during the so-called "volmageddon" market selloff in February and more recently in the steep ups and downs in global oil prices.

Because these new market dynamics affect both EM economic variables and key policies, they will move markets. The sharp rebounds of equity markets and currencies in both India and Indonesia as oil prices plummeted during November illustrate this new reality. At the same time, there is no guarantee that such positive external influences will continue in future. Indeed, oil prices are showing signs of reversing recent weakness in response to likely Russian and OPEC production cutbacks. That is why short but volatile swings up and down will likely characterize markets next year.

The traditional bull and bear market cycles have given way to a new market structure that is inherently more volatile. These new market dynamics put a premium on tactical rather than strategic investment strategies. That is why we think current bullish and bearish EM recommendations for next year are not very helpful for EM investors; markets are simply too volatile to maintain a given direction for more than two to three months. In a tactical investment environment, investors must be prepared to be both bullish and bearish at the same time; decisions hinge on individual markets because an overall EM cycle is no longer dominant.

Meanwhile, fundamental factors have changed significantly, making a renewed "perfect storm" for EM markets less likely. Below we review these positive developments, which we rank by relative importance.

- **The trade war is already past "peak Trump".** The 90-day trade war truce that came out of this weekend's G20 meeting between Xi Jinping and Donald Trump represents a significant de-escalation of US threats to China and is therefore a major positive for EM markets. Trump backed down from his earlier aggressive tariff threats for two main reasons: first, his tariffs have not had the expected impact on Chinese growth because economic stimulus and a weaker yuan are being used effectively by Chinese policymakers to sustain domestic growth; and second, the further escalation of tariffs would tilt their costs more towards the US economy than China. Furthermore, mounting evidence of the failure of Trump's protectionist policies (e.g., massive losses for soy farmers and GM plant closures) are feeding the increasing pushback from US industry and agriculture. As US economic growth slows next year, Trump will be hard pressed to find evidence that the US is winning his tariff wars.

  Trump's concession of a 90-day truce met with nothing specific from Xi Jinping. Xi reaffirmed China's readiness to negotiate and he cited a list of trade actions to which China may be prepared to commit. For its part, the US is insisting on tangible evidence of compliance with so-called structural issues related to high-end technology and China's state-directed economic development policies.

  Having seen the success of its strategy of waiting out Trump and not overreacting, China is in a strong negotiating position: Beijing can easily find limited concessions to offer on items included on the US wish list. These can be used to bolster arguments about why new tariffs should be postponed in order to allow talks to continue. Given the complexity of the issues under discussion, such negotiations cannot be tied up in 90 days and could easily drag on until 2020 when the US election cycle will catch up with Trump.

- **The Fed is likely to pause rate hikes by March at the latest.** The speech by Fed Chair Jerome Powell last Wednesday indicated that US short rates were close to neutral and that the Fed was about to end the current run of rate hikes. We expect the Fed to pause its hiking cycle for a period of months, but Fed rate hikes could resume in H2/19. This is another short-term positive for EM markets.

- **The precipitous decline in oil prices will be positive for many EMs.** The nearly US$30/bbl decline in oil prices since early October has buoyed the currencies of many EMs and eased pressure to tighten domestic monetary policies in order to support those currencies. Russia's oil revenues have been affected, too; but as fiscal accounts were already in strong surplus, the overall effect on domestic Russian economic policy has been small. We view the decline as a short-term positive because further declines are unlikely once OPEC and Russia cut production, which is likely to happen soon.

- **Brazil's election has turned out much better than expected with President-elect Jair Bolsonaro surprising with the selection of a liberal, pro-reform cabinet.** Doubts remain about whether Bolsonaro can escape the fate of Argentina's Mauricio Macri, who similarly entered office with high hopes for fiscal reform but saw his plans go up in flames once markets began to worry how the country would finance its fiscal deficits. Fortunately for Bolsonaro, Brazil is in a much stronger position than Argentina as its still-large deficit is financed mostly domestically. Nonetheless, markets will follow progress – or the lack of it – in moving pension reform forward in the early months of the new administration. The outlook gives rise to hope but could disappoint if Brazil's politicians revert to past behaviour and block needed reforms.

- **Turkey has managed so far to avert a wider financial crisis, although a hard economic landing is still in its early days.** The decision by the Turkish Central Bank to hike the policy rate 625bps in early September stabilized financial markets and fuelled a rally in extremely oversold sovereign bonds and the lira. The banks are still facing severe pressure from NPLs and some will undoubtedly require public resources to clean up their balance sheets and resume normal lending. Although details are still unavailable, the government is reportedly working on plans to relieve banks of weak loans and thus stabilize their capital positions. We think the economic outlook for later this year is still troubling, but a wider crisis has been averted for now.

An important characteristic of all these positive factors is that they are short term and at risk of being reversed in the next three to six months. This underlies our recommendation of a tactical investment strategy. EMs are likely to be hit again before midyear by unexpected developments. The reason is simply because markets are moving into unknown territory as QE exit is rolled out in 2019 by both the Fed and the ECB. How such a debt deleveraging processes will impact EMs in the months ahead remains a major unknown. The surprises that have already shown up – for example, pressures on spreads in the US corporate bond market – suggest that the way ahead is strewn with an unusually large number of pitfalls.

In terms of EM growth and inflation we do not expect much change next year in most of countries we follow. Overall growth will ease slightly with limited changes mainly in Turkey, which we think is already in recession and will experience only weak recovery during H2/19. We project that Chinese growth will fall, albeit marginally. We also think policymakers will be successful in targeting stimulus to contain the fallout from the trade war and excessive fiscal restraint earlier this year. Elsewhere, we project a sizeable recovery in Brazilian economic growth thanks to a strong rise in economic sentiment, which will likely buoy both consumption and investment.

EM 2019 forecasts

	Real GDP yoy 2018	2019	Inflation Dec/Dec % 2018	2019
EMs	4.8	4.7	3.5	3.2
EM Asia				
China	6.5	6.3	2.5	2.6
India	7.6	7.5	4.5	5.0
Indonesia	5.1	5.0	3.2	3.3
Philippines	6.4	6.5	6.0	3.5
Thailand	4.2	4.0	1.3	2.0
EMEA				
Russia	1.8	1.5	4.0	4.7
South Africa	0.5	1.2	4.7	5.3
Turkey	3.0	0.0	22.5	15.0
LATAM				
Brazil	1.0	2.8	3.9	4.5
Mexico	2.1	1.9	4.5	4.2

Source: TS Lombard.

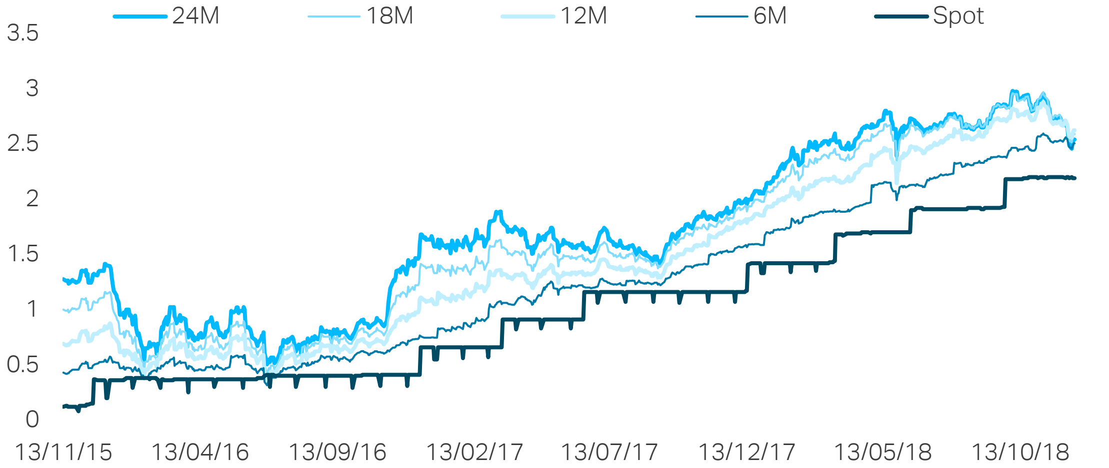
With regard to inflation, we think EM central banks have been largely successful in containing the inflationary pressures that resulted from weaker currencies and higher oil prices up to October. Our forecasts show the largest declines in two countries, Philippines and Turkey, that have performed less well than other EMs. The central banks in both of these countries were slow to rein in inflationary pressures but have now brought down inflation rates significantly. Excluding these two countries, we expect inflation trends to move gradually higher next year, from an average of 3.6% to 4%.

US – tricky adjustment to positive real rates

The outlook for 2019 is slower growth with markets remaining volatile. Recession will be avoided mainly because household balance sheets remain in good stead, though overly invested in equities, while the drop in oil prices will deliver a needed boost to real income. As for markets, they remain volatile because the rising political cacophony, in the US and globally, will leave few openings for investors to separate signal from noise.

The Fed goes into the year softly, hoping to offset market volatility that may very well be signalling more than a repricing of risk. There is already evidence that the interest rate sensitive sectors of the economy have begun to slow, notably housing. Other data have begun to suggest a waning of sentiment and a slowdown in hiring. Inventory, moreover, is likely to give the economy a boost in Q4 (and a drag from high imports) owing to fears over tariff hikes but reverses course in Q1. And then there are the headwinds from more debt to be financed with the Fed buying less of it. The needed pull of foreign capital will keep the dollar on the strong side and raise real term yields. As a result, White House efforts have the opposite of their intended effect, namely to onshore economic activity.

Chart: Fed funds rate - spot & futures



Source: Datastream, Bloomberg, TS Lombard

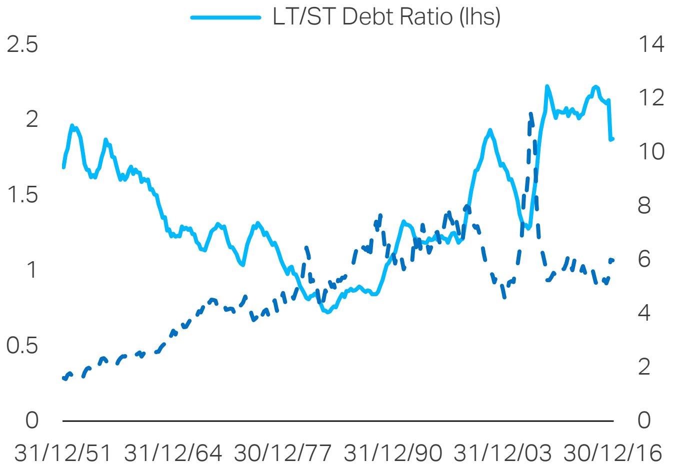
Still, the recovery at this point in time just won't fit into the box of standard cyclical metrics. The reason, we believe, is that the economy is transitioning from a decade of zero interest rates to levels where money is again a viable asset class and a cost for short-term capital. Ten years is a long time, and a lot of investments and economic activity have been built on a zero rate. The return of viable money markets consequently demands a period of transition among the impacted parties. There is also the transition of banking to a liquidity rich system short on capital for traditional lending. None of these adjustments were ever going to be straightforward or painless. This alone will incentivize the Fed, Powell really, to stop with the real funds rate around 50 to 75 basis points and let the financial system and real economic activity sort things out, before pressing policy rates higher – as long as the immediate threat of inflation is fading.

Will the pause have the intended effect? Since the unwinding of the great zero interest rate policy era began in December 2015, there have been two prior episodes of curve compression: in the first half of 2016 and again in late summer 2017 (see chart). On both occasions the Fed chose to stop raising rates and manipulated term yields by lowering forward policy projection. Capital markets responded and the economy continued to expand.

What makes the current episode different is the modest inversion in the 3 to 5 year part of the Treasury curve. Whenever the Fed has chosen to ignore inversions and plow forward hiking rates, recession ensues. What makes the current episode the same is markets recognizing that the transition to "normal" money market rates changes the return calculus of risk assets and effectively reveals underlying fragilities (eg corporate leverage and EMs), all at a time when known headwinds to growth in 2019 are gaining in force. By stopping now we are certain the Fed will not make things worse and, more important, give markets and the economy time to absorb and adjust to what's been done.

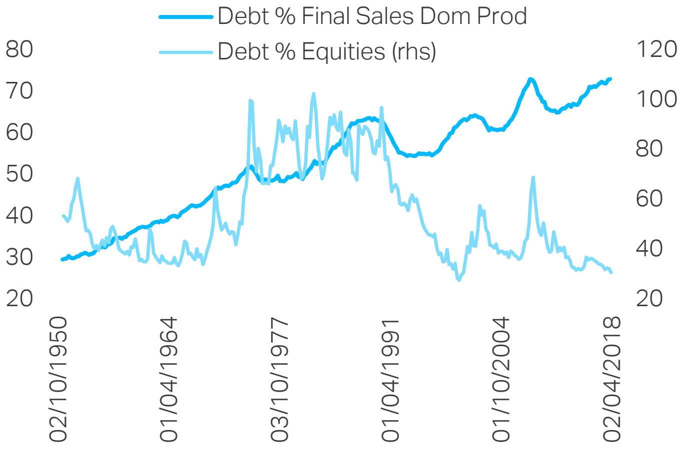
One of Powell's concerns going into 2019, and the concern of many others, is the potential impact of higher funding costs on corporate balance sheets with term yields expected to rise. The refinancing story is not, however, particularly problematic. Of the $5.4 trillion in net new bonds issued since 2009 began, $212 billion was issued in 2009, or 9% of the total. In contrast, during the four quarters ending third quarter 2015, net issuance was $462 billion (19% of the total), the largest four quarter total since the recovery began.

Chart: Non-fin co. debt ratios mostly up



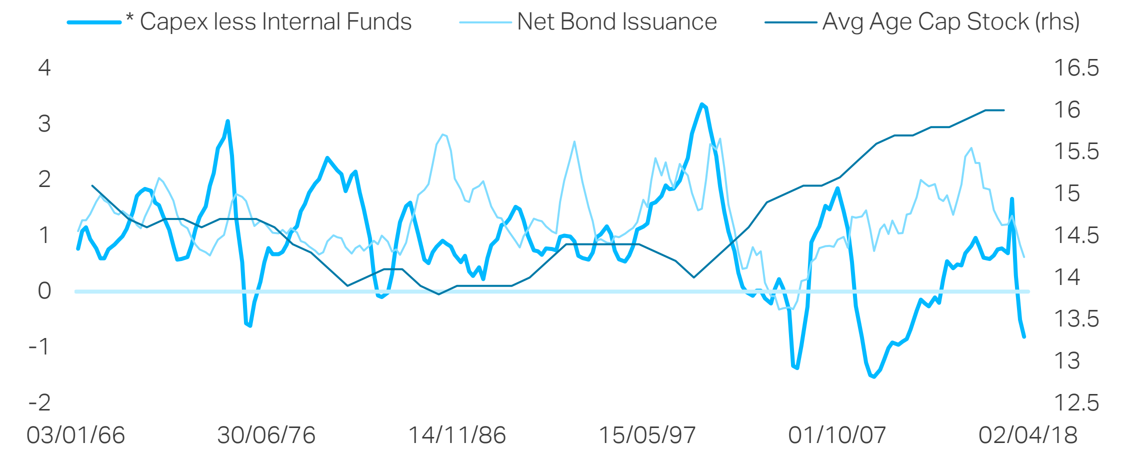
Source: Datastream, Bloomberg, TS Lombard

Chart: ... except v. stock values



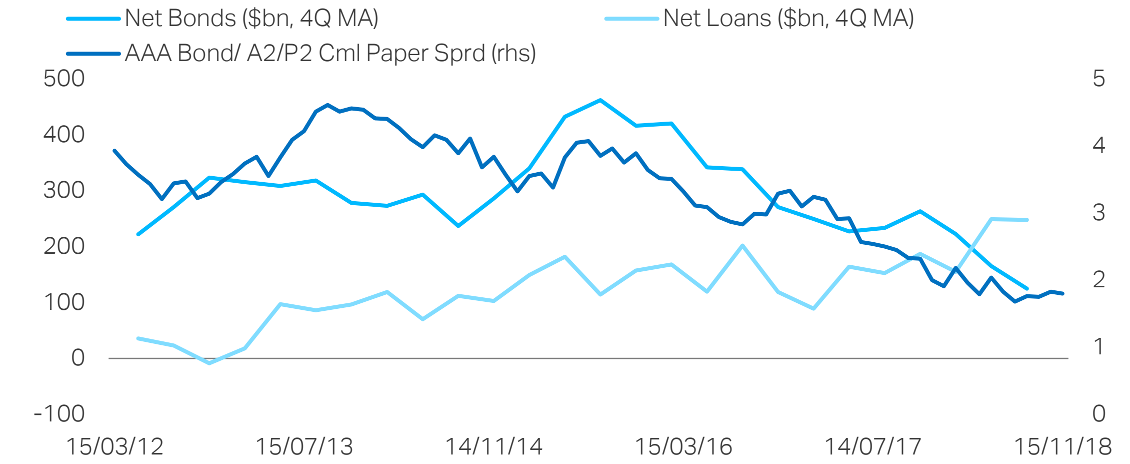
Source: Datastream, Bloomberg, TS Lombard

Chart: Capex ratios down => assets get older



Source: Datastream, Bloomberg, TS Lombard

Chart: Issuance decisions are opportunistic

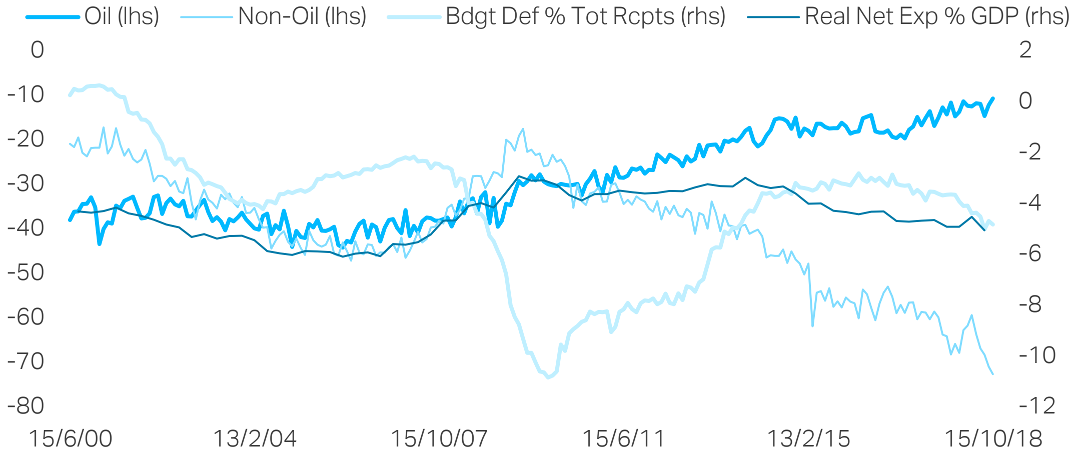


Source: Datastream, Bloomberg, TS Lombard

The record low yields of this recovery and the steeply positive corporate yield curve allowed firms to engage in a massive maturity transformation of their debt. The ratio of long-term to short-term debt has not been this high since the mid-1950s (see chart). where current leverage takes on importance is in relation to corporate income and the consequent importance of equity valuation in the willingness of lenders to underwrite debt (see chart) We add to this the fact that the net increase in indebtedness was not to finance capital spending for future revenue generation, as it has been in the past. This, in turn, has allowed the capital stock to get very old (see chart). From a macro perspective, the vulnerability of nonfinancial firm solvency to their debt load comes from revenue generation first, equity valuation second, and interest rates third.

The US trade deficit also looks to be become a more contentious issue in 2019, as the US becomes a larger net importer of foreign capital as a percent of GDP because of the larger budget deficit. The burden of adjustment in the real goods sector will fall most heavily on the capital goods industries Trump is trying to save (see chart). And the nation with whom he has picked his political fight, China, is set to be an even bigger direct source of capital to fund the domestic US saving shortfall – as least in the first order.

Chart: US goods trade balance & budget deficit



Source: Datastream, Bloomberg, TS Lombard

In the coming year we expect firms to rely more heavily on short-term financing. Firms are opportunistic in terms of where along the yield curve they finance and this cycle has been no different. When financing curves flatten, CFOs believe long rates will soon fall and so choose to borrow at the short-end, willing to roll higher-cost debt until term yields drop. Of late, as the corporate curve has flattened, loan growth is now greater than net bond issuance (see chart). This raises the possibility of a choke point for corporate finance. CLOs have been an important source of non-bank financing for firms. The rise of money market yields and apprehension about the future together should force a repricing of these vehicles to ensure a sufficient supply of investment capital. Firms dependent on this financing will face a meaningfully positive cost of capital for the first time in 10 years.

Then there is the ongoing issue of bank finances. With the adoption of QE and Basel III, the Fed funds rate went from cost to benefit for large banks and the reverse for small ones. Back when the banking system ran on a scarcity of reserve funds, raising the Federal funds rate raised the marginal cost of bank funding. Once the Fed began paying interest on excess reserves, a higher funds rate meant a higher return on capital. (The level of reserves banks have on deposit at the Fed is part of the liquidity and capital requirements set out by the BIS.) The regulatory impact has been that money-centre banks have the surplus of deposits and are therefore lenders of capital. But small banks need to borrow deposits to fund their loan book, a reversal from prior years. Higher rates and a flatter curve will consequently squeeze small bank earnings. Since QT began, the top-eight banks' stocks are down 4.5%, but the S&P regional-banks 1500 is down 8.6%.

What all of this means is that the shrinking Fed balance sheet is not reducing liquidity but being transferred back to the banks -- money center banks, more exactly. Price discovery for debt is therefore being transferred back to the market. Treasury will no longer be able to issue at what was a subsidised yield. Add to this the end of QE in Europe and there is no other conclusion than a rise in real yields, unless private capital demands shrink back markedly. Either way, it spells slower growth.

China – domestic slowdown AND trade tensions

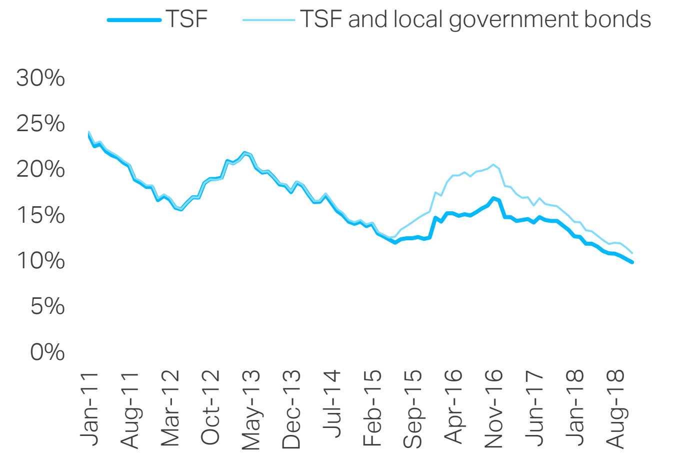
Beijing will tolerate slower growth in 2019. Next year's GDP target is likely to be lowered to the 6-6.5% range from "around 6.5%" in 2018. Recent macro data confirms our view that market expectation of China relying on old-style credit easing and tried-and-tested fiscal measures to prop up the economy is misplaced. We expect economic activity to weaken through Q1/19 until the impact of stepped-up policy easing materializes in H2/19.

Credit growth to rebound

Faced with growing financial stress and downside risk to growth, policymakers have eased liquidity and softened their tone by giving priority to "stabilizing leverage" over "deleveraging". However, we believe it is too early for Beijing to claim victory and end the deleveraging campaign, which has been eased, not reversed. In 2019 the overall focus is likely to switch from curbing shadow banking to redirecting credit flows from LGFVs, SOEs and households to private firms. As a result, SME capex could remain relatively strong, but large-scale fiscal stimulus and national property easing may not be an option for policymakers.

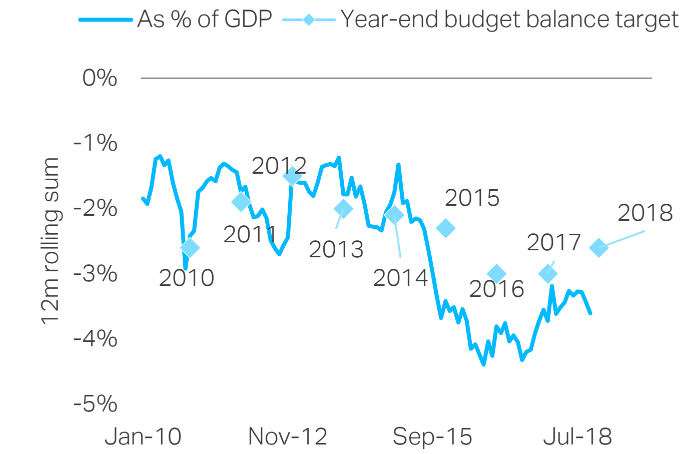
Monetary policy will remain broadly neutral, but limited easing is likely in Q2/19 when the Fed puts hikes on hold in March. Last month, total social financing (TSF) rose just 9.9%, the lowest increase since the PBoC started the series in 2003. Adjusted for local government bond issuance, total credit growth hit a record low, too: 10.9% in November, down from 15% in December 2017. Within TSF, the pace of bank loan growth remained strong at 13.1% in November, higher than 12.7% in December 2017. However, shadow credit continued to shrink across the board, which reflects continued regulatory pressure on the shadow-banking sector.

Chart: Total credit growth, YoY



Sources: CEIC and TS Lombard.

Chart: Budget deficit to increase in 2019



Source: CEIC.

As the impact of financial deleveraging and tighter local government financing wanes, total credit growth will start to bottom out in early 2019 amid more RRR cuts, higher loan quotas and faster local government bond issuance. We expect further RRR cuts totalling 200bp in 2019, while the PBoC is likely to be more flexible on bank loan quotas, along with other measures to support stable loan growth. In addition, there could be administrative window guidance for financial institutions to ensure that non-loan TSF activities become less of a drag. The central bank is likely to keep liquidity both stable and ample with seven-day repo rates at 2.5-2.8%.

Fiscal policy targets tax cuts and infrastructure

The government is likely to maintain its "proactive fiscal policy" statement in 2019. Indeed, we expect a more expansionary fiscal policy with a headline fiscal deficit exceeding 3% of GDP in 2019, up from 2.6% in 2018. Tax cuts will play a key role, with a reduction in personal income tax for households and cuts in value-added tax, corporate income tax and the social security contribution rate to support business, along with tariff cuts and higher tax rebates for exporters.

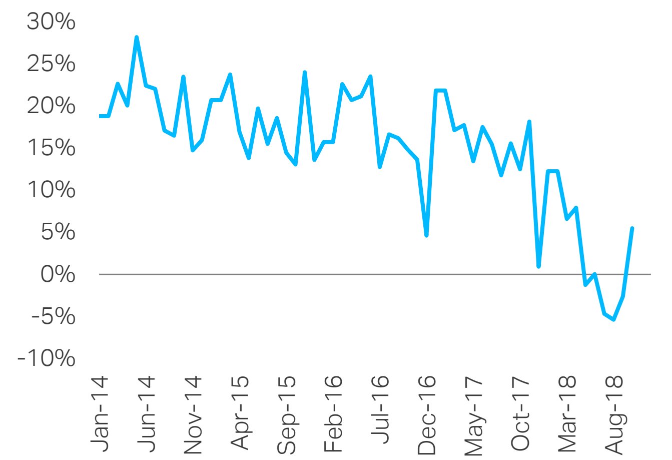
Beyond the general budget, we believe that the quota for local government special bond issuance is set to be increased to RMB1.9bn, compared with this year's RMB1.35bn. Moreover, the government is likely to expand its "quasi-fiscal spending" via policy banks and public-private partnerships to support infrastructure projects.

We expect infrastructure FAI growth to rebound to 8-10% in 2019, up from just 2% in 2018. The policy focus is likely to be on urban infrastructure that provides consumer services for urban households and infrastructure projects related to regional rebalancing, such as intercity transportation within major city clusters, the aim of which is to enhance economic integration between large and small cities and sustain productivity growth in the medium term.

Real estate and manufacturing investment to slow

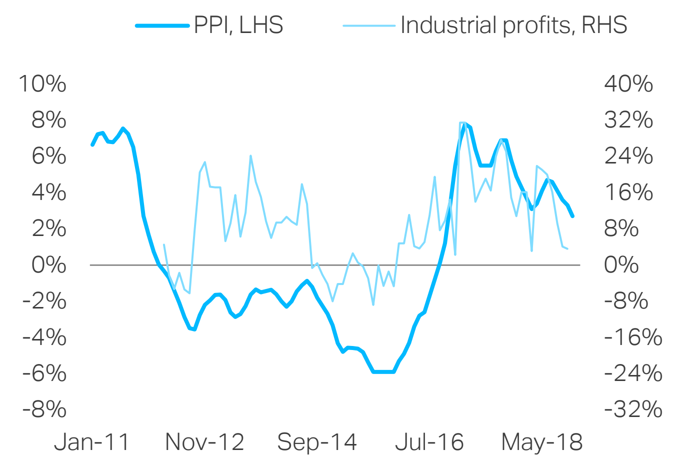
Overall, we expect residential housing sales volume to decline 5% in 2019 amid subdued household sentiment. Weaker sales would, in turn, put stronger pressure on real estate investment. The strength of nominal real estate investment this year reflects sustained double-digit growth in land purchases as developers replenish land banks; meanwhile, non-land investment has contracted. Since we expect housing sales to decline, we believe non-land real estate investment will continue to contract. Similarly, we think real estate investment (ex-land

Chart: FAI infrastructure, YoY



Sources: CEIC and TS Lombard.

Chart: PPI and industrial profits, YoY



Sources: CEIC, TS Lombard.

purchases) will witness a continued decline in 2019 and total real estate investment slow to 3% from 9.7% in the first 10 months of 2018.

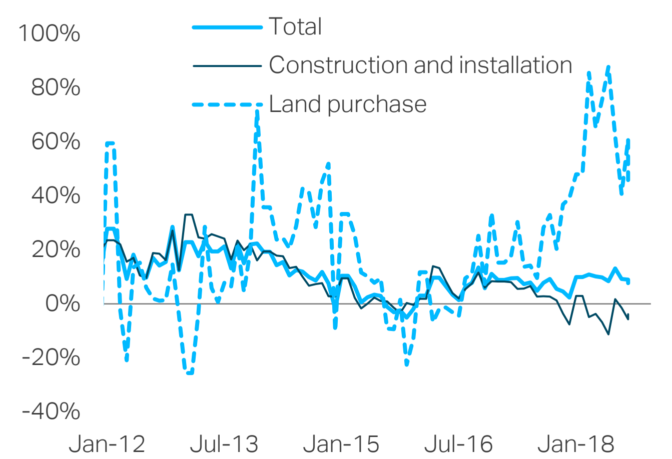
We expect strong macro headwinds to constrain manufacturing FAI growth. Over the past two years, PPI reflation, supply-side reforms and the improved capacity utilization rate have been the major factors behind the recovery in industrial profits, especially in the upstream industries. The carryover from two years of macro tailwinds has been double digit increases to manufacturing investment in 2018. Next year, capex will decelerate along with the slowdown in GDP and industrial activity. The sales revenue and profit growth of industrial enterprises is set to contract amid early signs of manufacturing companies shifting production out of China to avoid the direct impact of the trade war with the US.

Trade war risks remain

The outcome of the meeting between President Xi and President Trump at the G20 in Argentina was better than expected. Both sides agreed to work towards negotiating on structural issues in the next 90 days, during which period the US will keep tariffs on hold at 10%. Given the fundamental differences between the two sides on key issues, we expect tough negotiations ahead. If there is no agreement within 90 days, the US will raise the 10% tariff to 25%.

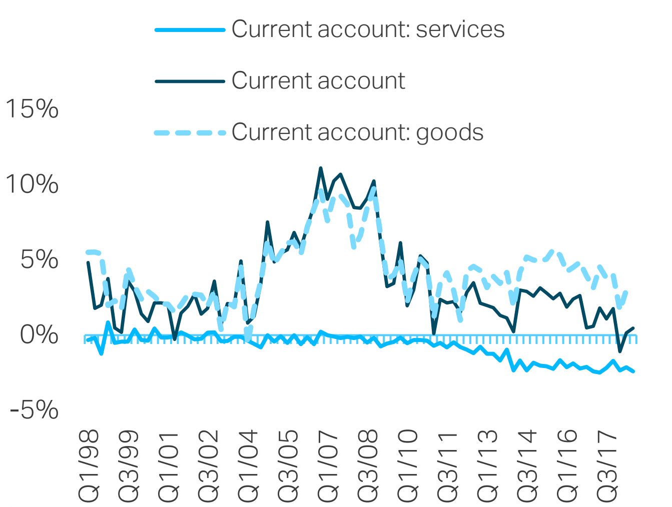
The 90-day truce nonetheless represents a de-escalation in US strategy. While we believe the differences between the two sides on structural issues are unlikely to be resolved within this timeframe, we do think that Beijing can offer limited concessions in order to gain multiple extensions of the talks, as it has already done with the tariff on autos and soybean purchases. Further moves by Beijing to deemphasize rhetoric surrounding the Made In China 2025 (MC2025) initiative are also positive. The MC2025 development plan is a central bone of contention for the US. Removal of the MC 2025 name if not the underlying goals will help the negotiation process. Indeed, this measure is likely to followed by others to which President Trump can point if he wants to extend the talks and further delay the move to the 25% tariff, not least because of growing pressure on US firms and farmers. While a temporary ceasefire will be positive for near-term growth and the yuan exchange rate, the impact of medium-term uncertainties will continue to dampen business sentiment and weigh on investment decisions. Any potential deal will involve a significant effort to reduce bilateral US-China trade imbalances. The bottom line is that China's current account will feel the impact whatever the outcome of the trade negotiations.

Chart: Real estate investment, YoY



Source: CEIC.

Chart: Current account balance, US$bn



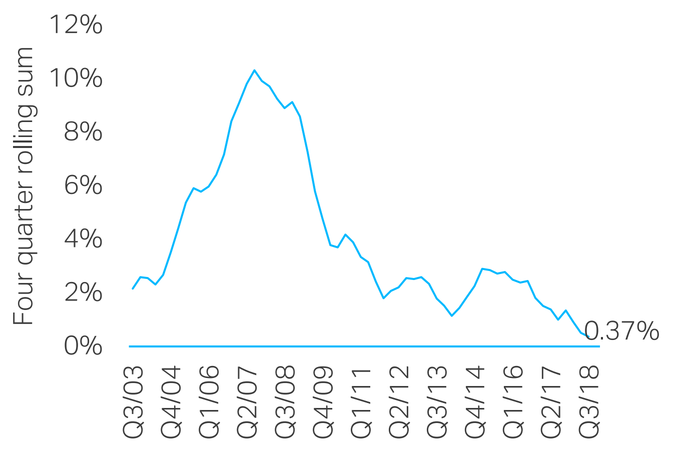
The current account registered a deficit of US$13bn in the first three quarters of 2018. We expect a larger deficit of US$20bn for the whole of 2019, turning negative in 2019 for the first time since 1986. We believe contractionary new export orders amid escalating tariffs, combined with the sizable service trade deficit, will be the key drivers behind the deficit next year. The market will force further depreciation of the yuan while the PBoC limits its interventions to dampen volatility but does not seek to defend any given level of the currency. We project a further 6.5% depreciation of the yuan during the course of 2019 before the currency recovers somewhat towards the end of the year.

Consumption growth driver under pressure

China's economy has been gradually shifting towards a consumer economy – the contribution of consumption rose from 45.3% in 2007 to 78% in 9M18. Household consumption has maintained relatively steady growth in recent years thanks to stable employment conditions, an expanding middle-income group and services accounting for a greater share of consumption. Looking ahead, household consumption may be constrained by the soaring debt burden and rising living costs in recent years.

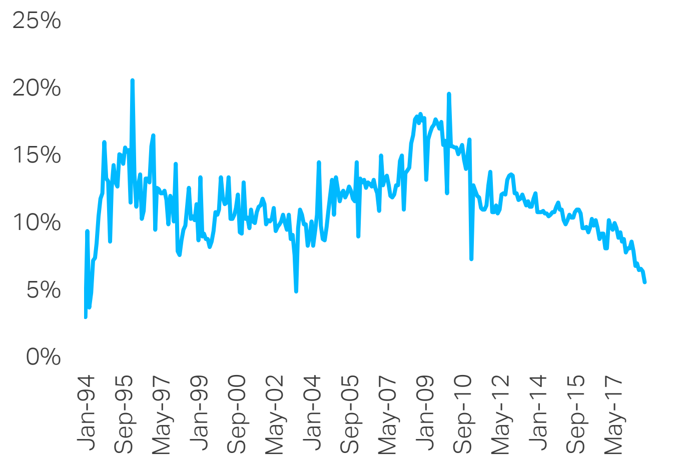
The household debt to GDP ratio rose from 36% in Q1/15 to 49% in Q1/18, which is much higher than in other emerging market economies. We believe that the rising debt burden has started to weigh on household consumption. The heavy concentration of household assets in property implies that consumption growth will be limited by constantly increasing debt repayment pressures. Quarterly real retail sales in Q3/18 were the lowest since Q1/94. We see the contribution of consumption to real GDP growth dropping from 4.9ppt in 2018 to 4.6ppt in 2019 and retail sales growth averaging 8.5% next year.

Chart: Current account, % of GDP



Source: CEIC.

Chart: Real retail sales, YoY



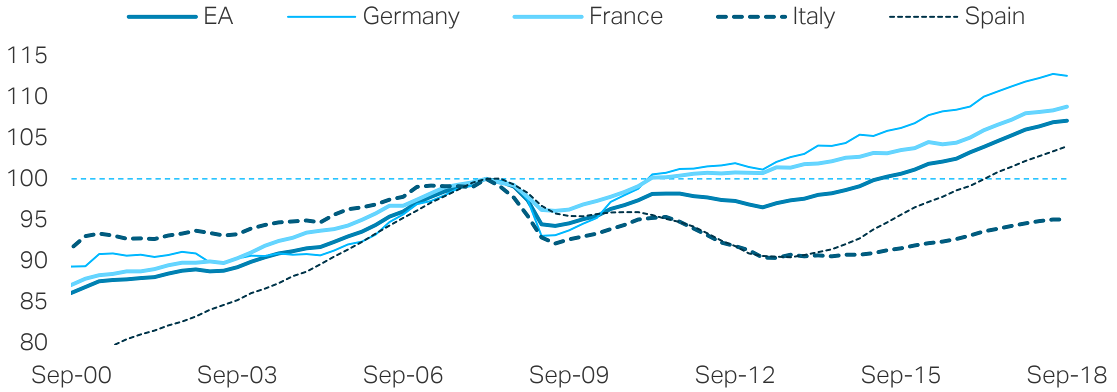
Source: CEIC.

EA slows – & ECB lacks ammo

Down but not out. The eurozone's buoyancy has ebbed following last year's super-charged growth. Annual gains in economic output has likely slowed to just below 2% this year from 2.5% in 2017. We expect real GDP growth to ease further to 1.5% in 2019. But with a trend growth rate of 1.2%, this is a healthy pace of expansion for the euro area which is in its sixth year of recovery. The EA growth cycle has room to run. The duration and size of the current expansion, which began in 2013, is still below the historical average. But there are increasing risks from slowing global growth, especially a pullback in emerging markets, and rising protectionism. Crucially, the divergence between Italy and the rest of the Eurozone, Germany in particular, will keep widening. In the absence of a meaningful fiscal boost, the ECB's options are increasingly limited as it tries to navigate an exit from its ultra-loose policy.

Chart: EA expansion to slow; divergences within EA to increase

Real GDP, indexed to Q1 2008=100

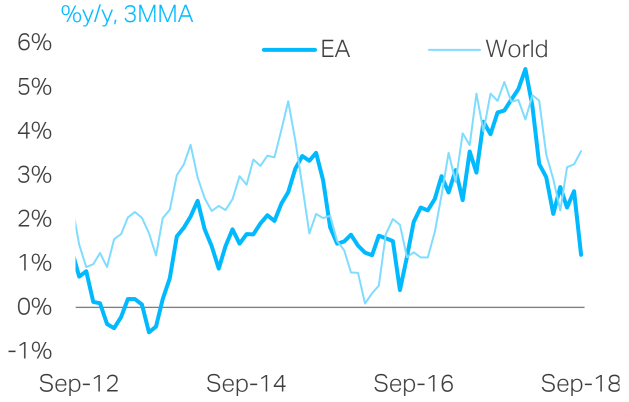


Source: Datastream, TS Lombard

The EA cycle is not over. The sharp loss of momentum in the eurozone this year has raised concerns that the EA cycle is fast-approaching an end. Having contracted in Q3, the risk of a technical recession is high in Germany and Italy. But we think the while the EA cycle is maturing, there is ample room to expand further.

Chart: EA undershoots global exports

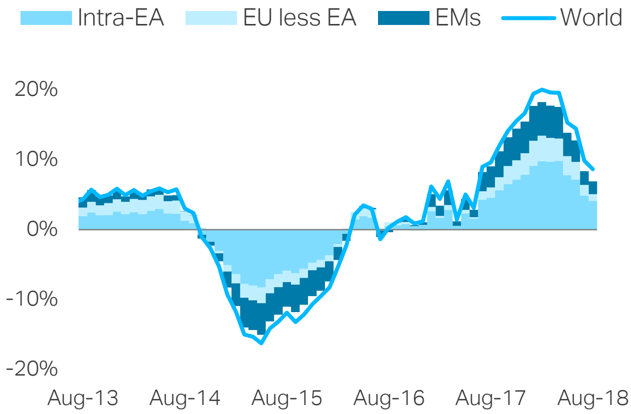
%y/y, 3MMA



Source: Datastream, TS Lombard

Chart: EA exports by destination

%-pt contribiution to annual X growth, 3MMA



Source: Datastream, TS Lombard

It is important to distinguish between the EA slowdown before and after May when an escalation in the trade war rhetoric triggered a decline in the yuan, which in turn drove EM FX sharply lower. During the first half of the year, EA growth deceleration was largely driven by temporary factors. A euphoric rate of gains in 2017, especially in H2 2017, led to a surge in capacity constraints. For instance, a historically large share of firms were citing the unavailability of raw material and labour as factors holding back their production plans. Besides, EA growth rate was returning closer to potential from what was a well above-trend rate of expansion. A policy-driven slowdown in Chinese credit growth also led to some slowdown in EA export demand.

Risks to EA expansion have increased. Some temporary factors (the new automobile emission testing standards and higher oil prices) have exacerbated the Q3 slowdown, especially in Germany. But even if we set these aside, there is genuine loss of momentum. The slowdown since mid-2018 has been largely driven by weakness in world trade and economic growth, especially in EMs. The 10% decline in RMB against the dollar has exacerbated competitiveness pressures on EMs already suffering from tighter liquidity due the Fed's normalisation. Declining EM FX has dampened EA's relative competitiveness while slower EM growth is weighing on EA exports, which has been one of the largest contributors to EA expansion in this cycle. The slowdown in external demand has hurt the exports-focussed sectors particularly hard.

Capex to slow

Chart: Firms' healthy balance sheets

Gross operating surplus, % of GDP, 4 qtrs avg

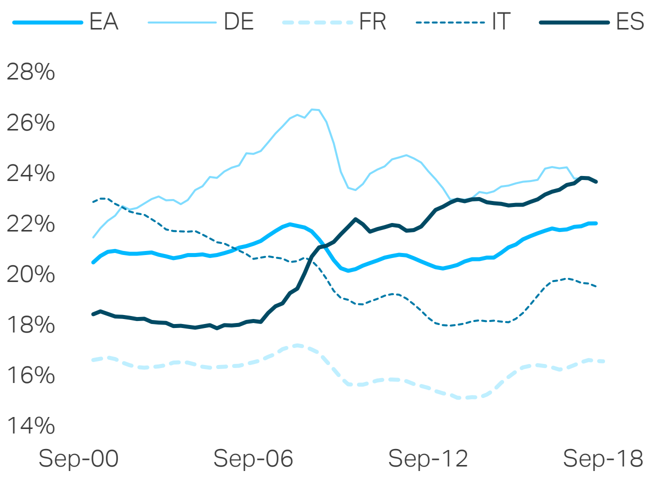
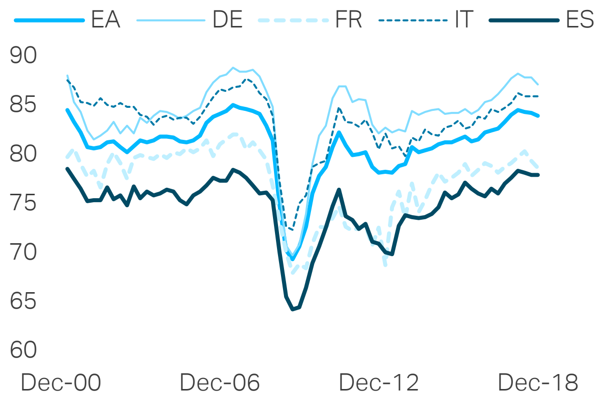


Chart: Capacity utilisation rates still close to cyclical highs

Capacity utilisation rates



Sources: Bloomberg, TS Lombard

It is becoming increasingly evident that the slowdown in EA exports is spreading to domestic demand, especially to capex. For instance, firms' have tempered their hiring and expansion plans. They have also revised lower their selling price expectations over the next few months. This is not surprising given the continued deterioration in exports orders and these pressures are unlikely to disappear anytime soon.

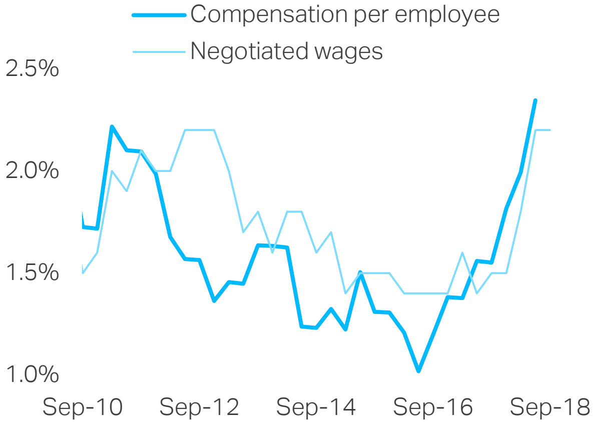
Still, we expect capex to respond contribute positively to EA growth next year. Capacity utilisation rates are close to cyclical highs, in spite of the recent modest pull back. Non-financial corporates' profit margins are healthy. Outside of Italy, financial conditions remain easy. Italy. Banks expect supply and demand for business loans to improve further, although at a slower pace than at the start of the year.

Households will be one of the key growth drivers. Nominal wage growth is accelerating at a rapid pace as the labour market continues to tighten. Annual gains in negotiated wages rose by 2.2% last quarter, the fastest since 2012. While firms have toned down their hiring plans recently, they still expect to add to their payroll at a brisk pace. The fall in the global oil price is a boost to EA consumers (charts on next page) who are some of the most vulnerable to a spike in energy prices. With their savings rates stretched, the capacity of households to dip into their savings to support consumption is limited, as was evident in Q3.

There will be some modest fiscal boost next year. According to the European Commission's latest projections (2018 autumn forecasts), the euro area's cyclically-adjusted budget deficit is likely to increase to 1.2% of potential GDP in 2019 from an estimated 0.8% this year. These projections are subject to multiple revisions. Besides, potential growth estimates are open to large measurement errors. Still, the drift towards a modestly stimulative policy is clear.

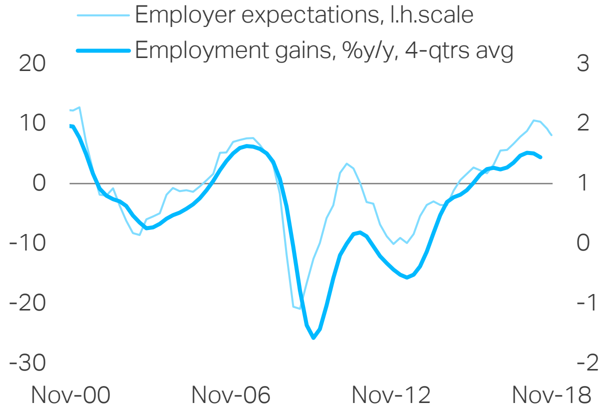
Chart: Wage growth accelerates

% annual change



Source: Datastream, TS Lombard

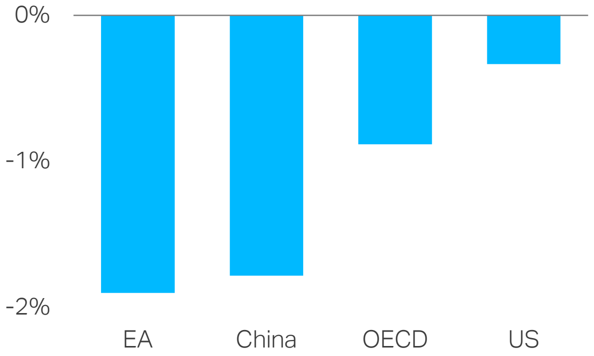
Chart: Less slack in the labour market



Source: Datastream, TS Lombard

Chart: Oil price fall who benefits most?

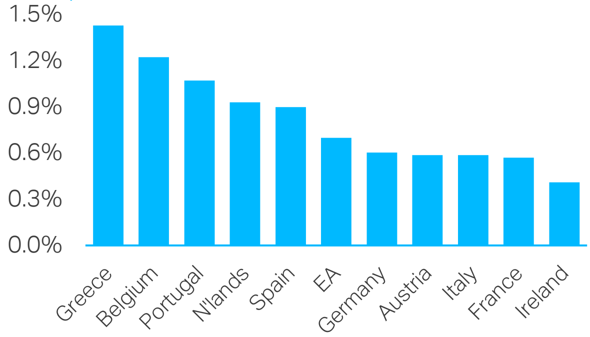
Trade balance, Fuel (SITC 3), % of GDP



Source: UNCTAD, Datastream, TS Lombard

Chart: An oil price boost to consumption

Benefit to consumption from a $25/bbl decrease in oil price, % GDP



Source: IEA, Datastream, TS Lombard

Nowhere is the drift to an expansionary fiscal stance more evident than in France where President Emmanuel Macron announced a stimulus package worth €10bn (0.6% of GDP) on December 10. These new set of measures will likely raise the net government borrowing to 3.5% of GDP next year – the largest in the euro area – and above the European Commission's 3% 'threshold'. Meanwhile, the populist budget proposals in Italy – the EA laggard and the most vulnerable economy to the ECB's QE exit (see below) – continue to be face uncertainty. The confrontational stance between Rome and Brussels has already driven up the cost of borrowing, watering down the stimulative impact of such measures.

Chart: Some fiscal stimulus to kick in

EC Autumn 2018 forecasts for 2018-20

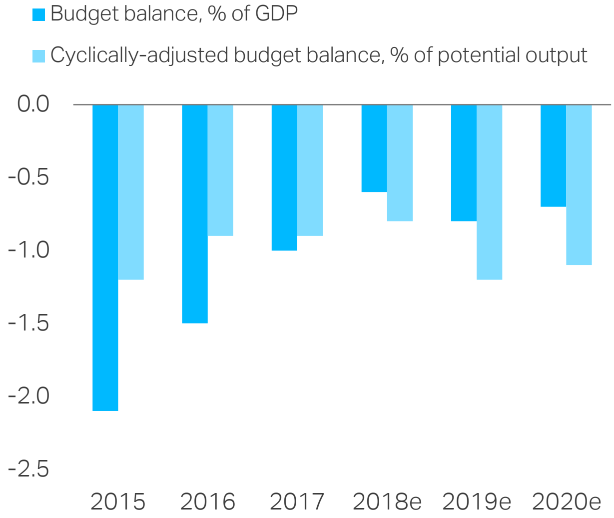
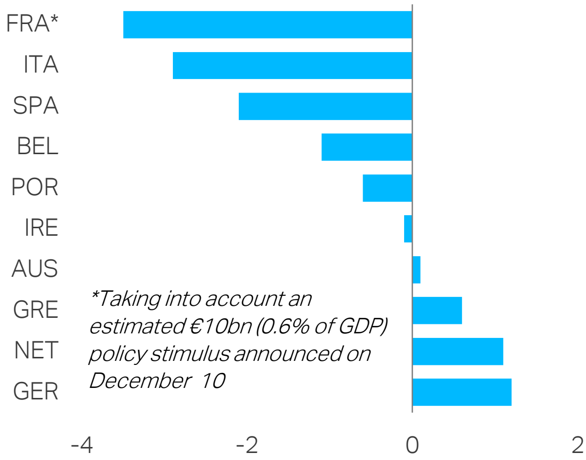


Chart: France stimulates; Italy less so

Budget balance, % of GDP, 2019 forecasts based on EC 2018 Autumn Report



End of the Draghi put. All ECB communications point towards the central bank terminating its €2.6trn asset purchase programme (APP) at the end of this month. But the ECB's exit from QE comes at a particularly difficult time. An end to the central bank's extremely accommodative policy will bring the EA's structural imbalances, in particular the sharp contrast between Italian and German productivity growth, to the fore. A slowdown in global growth and the competitiveness pressure from weaker EM FX could worsen the imbalances.

Italy failed to reform when the economy was growing at a relatively decent rate during 2014-17. The backdrop has turned more difficult since then. Monetary policy is turning less stimulative and external demand is deteriorating. Fiscal stimulus would give some temporary modest boost to growth. But the budget is lacking in measures to boost investment.

The ECB's options are increasingly limited. EA QE has been lopsided. The central bank purchases assets according to each EA country's capital key rather than, for example, the size of its sovereign debt. As a result, the Eurosystem buys a lot more bonds from Germany, which runs a budget surplus and has a small public debt, than from Italy, which runs a fiscal deficit and has a large debt burden. The ECB faces a scarcity of assets it can buy if it were to adhere its self-imposed capital key rules. Our strategy team estimates that only 4% of German bunds will be in private hands by the end of the year. But close to 40% on BTPs are still with private investors. As QE ends, the pressure on Bunds/BTP spreads will widen further. Some form of TLTROs is likely to be announced. This would buy Italian lenders some time, but it does not address the key problems facing the banks or the economy, which include lacklustre productivity and economic growth.

Limited monetary policy ammunition and a deteriorating external growth will increase the divergences within the euro area. A meaningful fiscal policy boost is needed, but it does not seem to be on the table, either for Italy or Germany.

Chart: Still-major cost divergences within EA

EA ULC-based real FX rates (OECD source), long-run average = 100

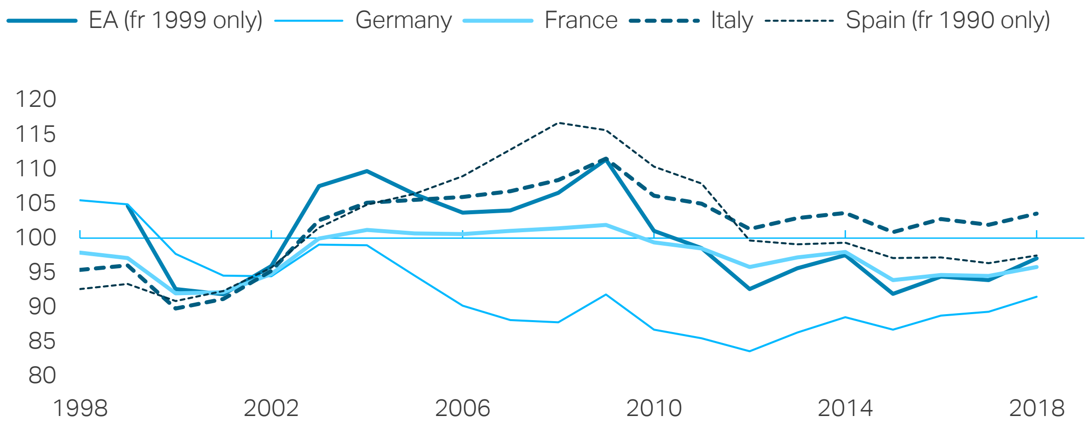
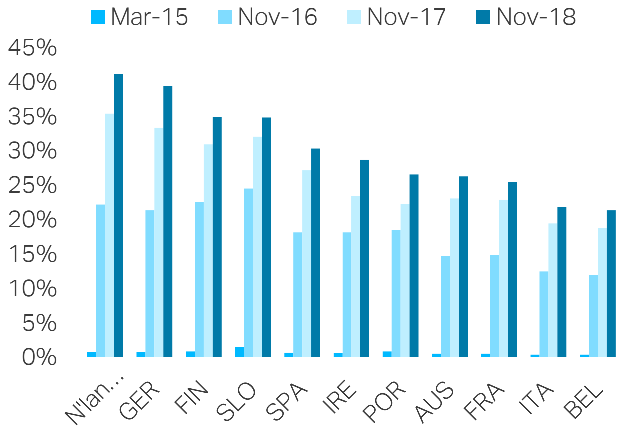


Chart: Eurosystem holdings of EA sovereign paper surges

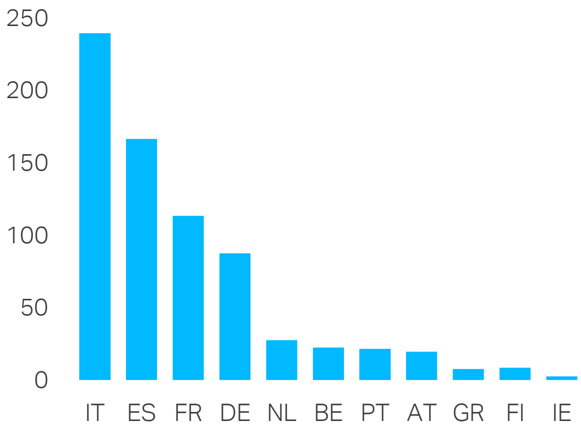
ECB holdings under PSPP as a share of central government bonds with maturity 1-30 years



Source: ECB, Datastream, TS Lombard

Chart: Italy's large reliance on TLTROs

Long-term refinancing operations, €bn, Oct-18



Source: ECB, Datastream, TS Lombard

Japan's Abenomics – arrows … or boomerangs

Cooling world trade translates to rising recession risk for Japan's export-dependent economy. To be sure, this may sound more alarming than it really is: with trend GDP growth of just about ½%, any period of subpar growth is likely to include negative quarters, i.e. the bar for a slide into recession is relatively low. But, to us, this now looks like a plausible scenario.

Significant downside risks suggest global conditions are likely to get worse before they get better in 2019. Chinese activity is slowing and, coupled with tight dollar liquidity, this has put the shackles on growth in the rest of EMs. While the US continues to outperform, buoyed by favourable fiscal measures, it looks like growth is set to dip next year, reverting closer to trend. Importantly, Beijing's reluctance to engage in major fiscal or monetary stimulus is a recipe for further yuan/dollar depreciation that will weigh on US growth, export deflation and spread the pain from the bilateral trade war. With EM demand on the back foot, growth prospects for the export-sensitive euro area look correspondingly dim.

Japan lies at the epicentre of these frictions, leaving the economy exposed. While the negative third-quarter GDP reading was to some extent the result of one-off factors (natural disasters), it may also be a harbinger of more challenging times ahead. With capacity utilisation down to 2016 levels, industrial activity is lacking impetus. Shipments to China, which comprise over a third of Japan's total exports, are slowing after an exceptionally solid 2017, so a sustainable recovery in external demand looks tenuous. Business confidence is soft, dragged by weakness in the manufacturing sector. The risk is that, as global trade suffers and the slowdown reaches US shores, profits come under pressure and sentiment deteriorates further, causing firms to rein in spending.

Strong private non-residential investment has been instrumental in Japan's recovery over the last couple of years. Capex and employment follow profits, and wages follow employment. In the early days of Abenomics, business earnings were lifted by a combination of yen depreciation and falling interest rates. The global synchronised expansion took the baton in 2016, boosting sales. Job creation gathered pace in 2017, tightening the labour market and paving the way for faster pay growth in 2018. Higher wages have propped up household incomes but expenditure continues to lag. Workers' propensity to consume has tumbled in 2018 due to a combination of structural and cyclical factors (see here for our take on this). Japanese households are opting to save more instead of spending the extra income, effectively acting like corporates – business saving remains at around a quarter of GDP, wholly excessive for an economy with such low potential growth.

Consumer confidence has soured in H2 2018, in tandem with slowing growth in employment and wages following a robust H1. If soft external demand causes businesses to retrench, then households could turn even more defensive and the virtuous cycle from income to spending – however imperfect it may be – will snap. In short, the path to rebalancing away from export-reliant growth to domestic demand is inherently unstable, as it continues to depend on a benign external environment.

A large and persistent private sector financial surplus can be offset only by deficits elsewhere, i.e. the government and/or foreigners (the current account). The problem is that, unlike in 2012/13, 'initial conditions' suggest limited scope for the external sector to shoulder the burden. Slowing global demand will keep the trade balance under pressure, though the recent drop in oil prices should offset some of the pain.

It is also hard to see how the exchange rate can act as a powerful release valve this time round. First, with the BoJ signalling it has reached the end of the road on monetary easing even as inflation disappoints, the room for Governor Kuroda to engineer large-scale yen depreciation is limited. Second, in real trade-weighted terms the yen is already around 20% weaker than it was in Q4 2012 (and 45% down against the dollar). With the yuan's 30% weight in the basket roughly double that of the dollar, the downside looks limited even if CNY depreciation were to also put JPY under pressure. Therefore, the current account surplus – which is hovering near multi-decade highs – is also unlikely to get a further boost from favourable moves in the primary income balance.

This leaves the government to pick up the slack. Shinzo Abe will have little choice other than to double down as the macro outlook sours in 2019. We expect fiscal policy to be loosened, perhaps considerably, relative to what is pencilled in by the Cabinet Office: in FY2019, the fiscal deficit could end up closer to 4.5% of GDP, where it has been for the last couple of years, than the latest official projection of 3.6%. Fiscal stimulus will help pull the economy along. But it could ultimately also expose the fatal flaw of Abenomics, i.e. deploying aggressive monetary easing to address domestic financial imbalances – ultimately a recipe for increasing Japan's external surplus instead of achieving a durable boost in private demand.

Finally, it is notable that dislocations in the FX forwards market (i.e. a wide cross-currency basis) – a corollary of strong hedging demand from Japanese investors in their reach for foreign yield – have led to a surge in overseas holdings of Japanese government paper despite depressed/negative yields (for more on this, see out latest *Global Financial Trends* publication). Non-resident investors own around 12% of total outstanding debt (and around 65% of short-term debt), not much less than the domestic banking sector's 15% share, facilitating the BoJ's passive taper. In a scenario where sustained fiscal deterioration takes Japan closer to the financial rocks, these flows could reverse, forcing the BoJ to ramp up QE just when it was starting taking baby steps towards normalisation.

Risks – trade war, big Bear, Italy, Japan, Brexit

The four risks examined here are not symmetrical: all four could be negative, while only one has the capacity to be positive. They are as follows:

- Trade war could be ratcheted up in intensity – negative risk – or could disappear or be much reduced – upside, positive risk
- A US bear market could develop, either from trade-war or other considerations
- Italian weaknesses could revive the 2010-13 euro crisis
- (least likely) Japan's huge and mounting government debt burden could finally lead to a crisis that some commentators have expected for 15 years or more

Trade war downsides and upsides

The section of this View on China describes our mainstream scenario for the trade war in which it intensifies gradually and the yuan declines against the dollar from 6.88/$ now to the 7.10-7.20 region, ie by about a further 3-4% (most of which would be 'real', as US and Chinese inflation are quite similar at the producer price level for finished goods). The downside risk would be return to the much more severe escalation widely expected before the Trump-Xi dinner in Buenos Aires. In this case, the worst immediate impact would be on the rest of the world, as the US is protected in the short-term from the impact of tariffs as the dollar rises, cutting other import prices. But a more severe escalation of trade war with China would significantly raise the chances of a 2020 recession in the US, driven by an overvalued dollar. As that is an election year, that risk is one reason for our mainstream scenario.

On the plus side, it is entirely possible that the trade-war issues will be settled, and markets revert to where they would have been anyhow. As this would involve a falling dollar, it could improve prospects in the US and the stock market, but also ratchet up the pressure on Italy and Japan, where currency appreciation could worsen the risks described below.

US bear market

For most investors the biggest risk in 2019 would be a US bear market. This could occur for a number of reasons:

1. Growth could fall short of our 2% forecast quarter-to-quarter annual rate, or investors might see the cut to 2% as a prelude to even slower growth or recession in 2020
2. Earnings forecasts for 2019 could be seriously over-optimistic
3. Regionalisation resulting from trade war, in place of full globalisation of supply, could both lower p/e ratios (reflecting greater risks) and earnings themselves, reflecting in the short run the overvaluation of the dollar and in the longer run suboptimal, 'regional' capex decisions
4. The competition for investors from a newly positive short-term real interest rate – for the first time for ten years – could cause erosion of interest in holding stocks for income, a relatively novel American habit

The first and second points above relate to one another. Clearly, the risk to the market from slower growth would most probably express itself through weak earnings. The trend of earnings excluding real-FX effects over the past few years (subsequent to the violent fluctuations around the financial crisis) has been for 7-8% annual growth in real terms, nearly 10% in nominal terms. Earnings growth fluctuates more than real GDP growth, so a shortfall from our real growth expectation would be magnified for earnings, whose current forecast for 2019 growth is 10%.

An equally serious risk would arise if the dollar stays strong, as this has a double-whammy impact on earnings: first, the value of foreign subsidiaries' earnings translated into dollars is cut; second, the profitability of domestic business is reduced where it is either generating exports or competitive with imports. More to the point, further strengthening of the dollar would itself be a reason why 2019 growth would be reduced, as it could slow exports even more – their volume fell in Q3 and prospects are poor anyhow – and also business capex, the two most crucial cyclical elements in the economy. The existing strength of the dollar, without any further appreciation, may already be enough to lead to some of these effects.

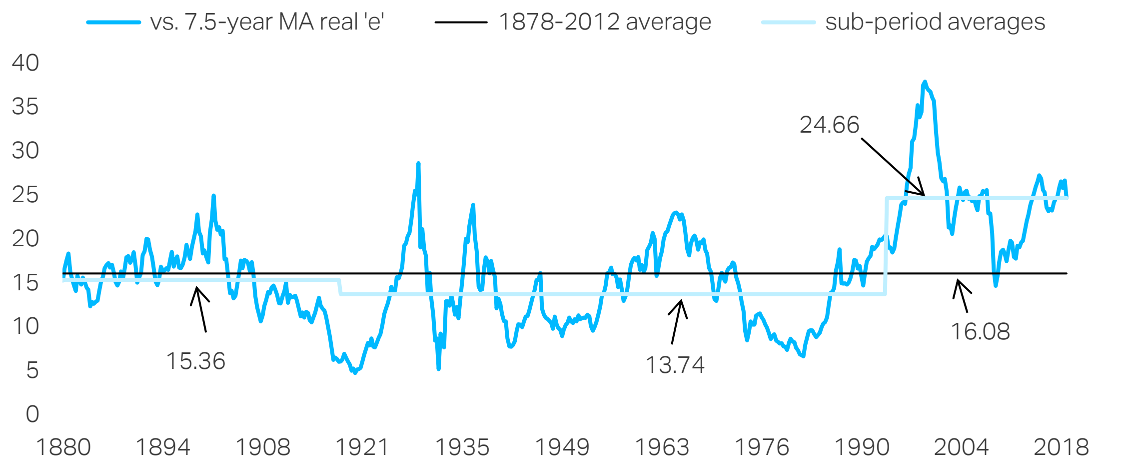
A deeper, longer-run threat to earnings arises from the reversal of interest rates to exceed inflation, after the prolonged 'ZIRP' (zero interest rate policy) since the financial crisis. The basic point here is that earnings grew more slowly than nominal GDP and incomes generally for 30 years between the 1950s and the 1980s, and have been rising relative to nominal GDP over the past 30 years. This looks suspiciously like a lagged response to the long-run interest rate cycle. From very low levels of interest rates after WW2, distorted for a while by the (often forgotten) Korean War, interest rates and bond yields rose steadily to peaks in the early to mid-1980s. From then on they fell steadily until 2016 (probably – it is not clear yet).

The section of this 2019 Outlook on the US economy, as well as the global introduction, started the analysis of consequences of the return to more normal interest rates – at least positive real rates at the short end of the maturity spectrum, by contrast with heavily negative real rates under ZIRP. One important feature of 2009-16's ZIRP and massive QE has been extreme buoyancy of stock prices. Less widely observed has been the obvious point that the exclusive post-2011 focus of policy on monetary rather than fiscal stimulus has seen much greater US inequality of incomes, including stock market earnings rising faster than nominal GDP.

With interest rates now arguably at the early stages of a return to normal, it is not a big stretch to suggest that we are beginning a new long-cycle upswing of rates. If that is the case the 30-year period of stock market earnings rising faster than nominal GDP may be ending – or perhaps soon drawing to an end. If so, with real GDP growth of around 2% and inflation about the same, the growth of earnings would be limited to 4%. If earnings are in future to be growing more slowly than GDP, even 4% would be high-side. In no way are US stock markets priced for this.

Turning to the trade-war issue, we have possible medium-term consequences that include a double whammy in the form of both lower p/e ratios as well as lesser development of earnings themselves. Starting with earnings, the central premise is that CEOs will think twice about low-cost investment in China. The risk of some political intervention such as tariff imposition that invalidates the economics of the capex means that globalisation could gradually give way to regionalisation. If the future holds the prospect of suboptimal location of new investment because of trade-war fears, then the return on capital will be reduced, and earnings growth will fall back vis-à-vis incomes generally, ie, versus nominal GDP growth.

Chart: US S&P CAPE w. long-run & sub-period averages



Source: Prof Shiller, Datastream, S&P, TS Lombard

When it comes to the second element in the double whammy, p/e ratios, we have to examine the long-run development of the cyclically adjusted p/e ratio (CAPE). The gloomier type of securities analyst has been pointing out for years that the CAPE is way above its long-run average, so that stock prices need to fall. Out chart above shows the real level of the S&P (ie, inflation adjusted) versus the average of real earnings over the previous 30 quarters (7½ years, the average length of the post-WW2 US economic cycle).

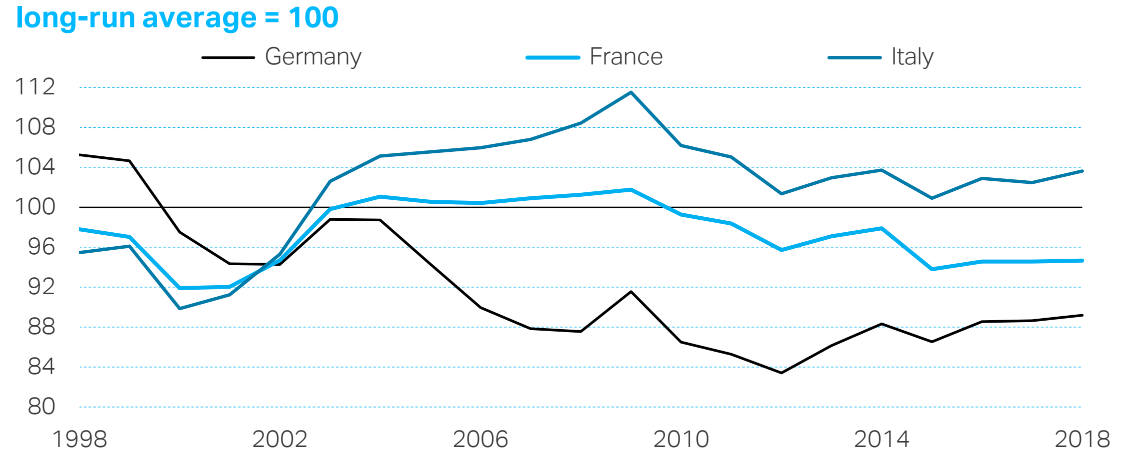
The fundamental point is that in the 'short 20th century' (1914-1991) not only were risks much larger than since the end of the Cold War, as WW1 was followed by the Great Depression, WW2, and then the Great Inflation and Cold War; but also the whole 77-year period saw a rival system on offer – Communism – under which private property would be expropriated. Since the end of the Cold War, with full globalisation, risks have been much smaller, and the CAPE therefore justifiably higher, averaging 24.66 versus 13.74 previously (see chart above).

Right now, the stock market's CAPE is precisely the same as the post-Cold-War average. But there is every chance that the shift from full globalisation to regional economic blocs could increase geopolitical risks. In the immediate, tangible sense this is even true as Japan, Korea and Taiwan are part of the US global alliance system, but will increasingly be part of the China-centred economic bloc. This can only be a source of tension and geopolitical risk. It implies that the future average CAPE will be significantly less than the post-Cold-War average, though it is highly unlikely to be as low as in the short 20th century.

Italy and the euro

The chief issue for the Italian economy in the next few years is that it is in 'fundamental disequilibrium', as it was called in the pre-1973 days of fixed exchange rates. As the euro is for its various countries an (ultra) fixed exchange rate system, the pre-1973 remedy for fundamental disequilibrium – devaluation – is not available within the EA. As the chart below shows, Italy and Germany have diverged strongly in their relative costs since well before the financial crisis.

Chart: Real effective FX rates, EA big 3, labour-cost based



Source: OECD, TS Lombard

The chart above shows for each country a fundamental measure of the real FX rate: the movement in its unit labour costs relative to those of the weighted average of its trading partners, including (but not limited to) the effects of exchange rate changes. Each country is shown relative to its own average position since 1973 (the end of fixed exchange rates, and the start of floating rates). But the average used for each country's '100 line' is that of the quarter-century 1973-98 that preceded the fresh fixing of rates in the euro – those 25 years being the period of largely free-floating rates, so that countries then found their own true level.

Germany engaged in fierce austerity in the 2002-05 period, because of its phobia about budget deficits. As a result its wages fell and relative labour costs declined by 15% compared with the 1973-98 reference period. Italy continued on its inflationary, pre-euro course, and thus by 2005-06 was 7-8% overvalued vis-à-vis the reference period – the euro's nominal exchange rate having been to a degree held down by German deflation, and thus rendering Italy overvalued.

As a result of these trends, the divergence between Italy and Germany relative to their pre-euro equilibrium position was 23 percentage points by 2006. This divergence rose to 27 %-points in the crisis (2007-09) and has shrunk a little since then, but not by much: in 2017 it was just over 20 %-points, and this year the OECD estimates it at exactly 20 %-points. Yet this shrinkage has been so very modest despite Italy having lost 5% of real GDP in the past ten years, whereas Germany has grown by 13%, a growth divergence of 18%, not far short of 2% a year.

The fact that Italy has a populist government can be largely attributed to this record of failure.

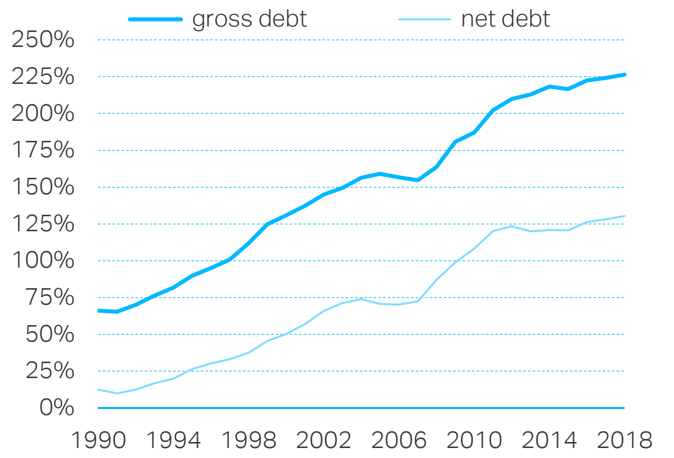
Is there a solution that does not involve Italy leaving the euro? The answer is that it would depend on two things: first the continued drainage of talent from Italy as its more enterprising citizens seek work elsewhere; second an effective fiscal union within the EA, or its equivalent under which Italian income shortfalls can be made up as its supply side adjusts costs down to be competitive.

The most immediate obstacle to fiscal union is energetic populist parties in Germany, The Netherlands, etc., and hidden support elsewhere in their populations for nationalist views, most obviously reluctance to subsidise Italy. But such North European populism is likely to be severely tested by the financial crisis that is likely to emanate from Italy in the next 2-3 years. Probably more likely than actions that force Italy out of the euro will be *ad hoc* subsidies or other relief measures – but on past form accompanied by insistence on Italian austerity programmes that will provoke strong reactions in Italy itself.

A period of major political turbulence may thus lie ahead for the euro area. In theory this is unconnected to the recent arguments within the EA over the Italian budget. But in political reality those arguments look like the various parties to the long-run dispute – European establishment versus the 'populists' (and some demagogues) – that will come out into the open if a new euro crisis occurs. Curiously, this could be accelerated by a benign outcome to the US-China trade-war issue. If that were to occur, much of the 'safe-haven' buoyancy could be taken out of the dollar, in which case the euro (and yen) could appreciate strongly, rapidly worsening Italy's competitive position.

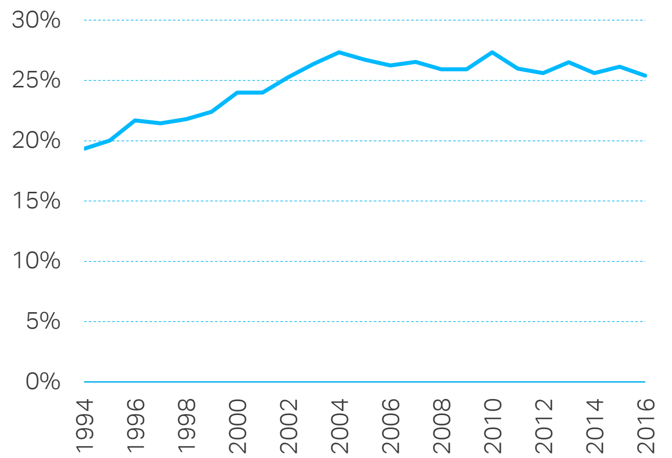
Japanese public debt ratio rising inexorably

Chart: Japan's gov't debt, %GDP



Source: OECD, TS Lombard

Chart: Japan's business saving, %GDP



Source: Japanese ESRI, TS Lombard

The recent combination of export-led growth and a smaller budget deficit has enabled Japan to slow the increase of its government debt ratio. But the worsening we expect in global conditions is likely to start it rising again soon. The reason is a structural excess of saving in the corporate sector. Despite the current account surplus amounting to over 4% of GDP in 2017, the budget deficit remained over 3½% of GDP, so the private sector financial surplus was between 7½% and 8%. And this was one of the lower totals for that surplus in recent years. As it returns to normal, higher levels in an economic downswing, and especially if the current-account surplus is reduced by weaker world trade, the budget deficit will mount again.

Unlike in the early days of Abenomics, 'initial conditions' suggest limited scope for the external sector to offset the private sector's financial surplus, leaving the government to pick up the slack. The recent drop in oil prices should ease some of the pressure on the trade balance, but it is hard to see how the exchange rate can act as a powerful release valve this time round. First, with the BoJ signalling it has reached the end of the road on monetary easing even as inflation disappoints, the room for Governor Kuroda to engineer large-scale yen depreciation is limited.

Second, in real trade-weighted terms the yen is already around 20% weaker than it was in Q4 2012 (and 45% down against the dollar). With the yuan's 30% weight in the basket roughly double that of the dollar, the downside looks limited even if the yuan were to drag the yen down with it. Therefore, the current account surplus is also unlikely to get a further boost from favourable moves in the primary income balance.

Japan's business saving is a consistently high 25-26% of GDP (latest full data: 2016) and even with relatively low returns on investment the private sector has typically invested less than this by 9% of GDP, ie, 16-17% of GDP. This is a higher number than in the US despite much slower real growth resulting from these investments. Over the past 20 years (or subdivided into 1998-2008 and 2008-18) the average current account surplus has been 2½-3% of GDP, and the average budget deficit about 6%. Just as slower export growth is liable to lower the current-account surplus from its current 4% of GDP back towards the average – say, to 3% – some weakening of capex is likely, raising the private surplus from its recent 7-8% of GDP towards the long-run 9%. This means the budget deficit will return to 6% of GDP (the 9% minus the 3%).

As a matter of arithmetic, to stabilise the net government debt ratio at its current 130% of GDP (ie, 1.3 times GDP) the nominal annual growth needs to be the deficit rate, 6%, divided by the net debt ratio, 1.3, in other words about 4½%. But with the real growth trend of only ½%, this would require 4% inflation. Which is not going to happen. In reality, even if real growth improves to a 1% trend, and inflation runs at 1% as well (more than seems likely) the 2% nominal growth of GDP will combine with a 6% deficit to drive up the 130% net debt ratio. In theory, with 6% deficits and 2% nominal growth, the net debt ratio will mount to 6%/2%, ie, 3 or 300%. In practice, Japan would have a financial crisis well before that point is reached.

It is impossible to forecast when the rising ratio of debt to GDP will create insurmountable problems for Japan, especially as its population seems remarkably calm about accepting these financial conditions and prospects. But it can be forecast with confidence that this debt problem will be getting worse for the foreseeable future.

UK's Brexit bomb threat

The fragility of the global outlook applies especially to Europe, as discussed earlier; and Europe's problems would be seriously aggravated by the economic and financial shock that would result from the UK "crashing out" of the EU next March. Put another way, the obvious hit to sterling and UK assets (with financials, consumer and homebuilding sectors in the front line) would not be the end of the story. The immediate shock – felt up front through the disruption to merchandise trade flows – would ripple through the north-west European seaboard. Put another way, Brexit should properly be regarded not only as a parochial UK crisis but also as a consequence of wider problems of Europe's political economy starting with the monetary union – and with the potential to cause vicious cycles.

That said, we rate the risk of a 'no deal' Brexit shock as negligible. This view might seem complacent given the present deadlock in the UK parliament that not only prevents the ratification of the Withdrawal Agreement (in turn, the condition for moving smoothly into a standstill transition) but also precludes steady majority support for any alternative course of action. The legal consequence of inaction would be a crash-out at the end of the when the two-year 'Article 50' process ends in March. The process of running down the clock amid parliamentary stalemate seems like removing the pin from a grenade.

While this grenade may be primed, it will not detonate. The reason for this is the political reality that a UK crash-out is the outcome least desired not only by the government but the whole of the UK political class excepting only an "enthusiastic" fringe. Always discernible beneath the surface, this reality was revealed in full public view on 4 December when the majority of the House of Commons shown in the graphic below passed an amendment to the European Withdrawal Act giving parliament the final say on what happens next if the Withdrawal Agreement is blocked.

Our sanguine forecast that a shock will be avoided does not mean that the crisis is over – far from it. The political temperature – hence also volatility in sterling and UK asset prices – will rise even further in the early weeks of 2019 as parliamentary battles focus on the project of setting up another referendum. This path could put an end to Brexit altogether; but the referendum project is fraught with difficulty and could well stall. In that case, however, a crash-out would still be avoided by the present Withdrawal Agreement being ratified by an exhausted political class. Even now this scenario seems the most plausible base case. It would mean protracted uncertainty about the UK's long-term relationship with EU for years to come – with the whole question becoming entangled again in the UK's political cycle even if the next election is not held before its scheduled date in 2022.

Anti-crash out majority of 22 for the "Grieve amendment"

Parliament will be able to propose a course of action to the Government