



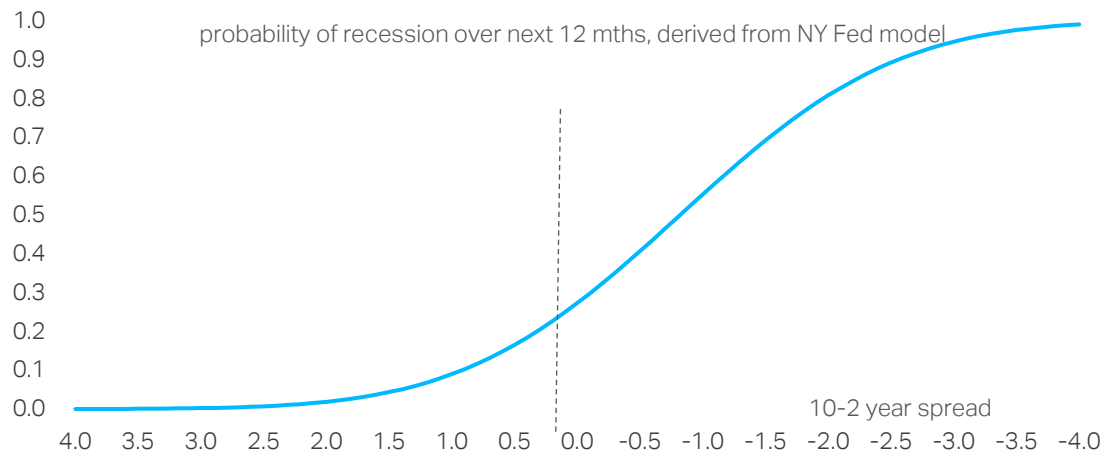
Macro Picture

THREE THEMES FOR 2019

Dario Perkins

Consensus forecasts for 2019 are remarkably dull, with most of the sellside expecting a repeat of 2018: lower growth, slightly higher inflation and volatile (low return) financial markets. But with sentiment increasingly shaky, we discuss three themes that could shift this consensus – the Fed’s rate pause, global trade wars and Chinese policy stimulus.

Chart 1: US recession and the yield curve



Source: New York Fed, TS Lombard

PAUSE PATROL

Wobbly stock markets and a flat yield curve set up a dilemma for the Federal Reserve in 2019. Should it end its tightening cycle soon, confirming a pause in interest rates, or keep hiking in an effort to prevent possible over-heating? History suggests the Fed should try to avoid sustained inversion, while confirming a rate pause could have a powerful (short-term) impact on markets.

WAR OFF/ON

The threat of trade wars isn't gone. We suspect the Trump administration will try to avoid a major escalation in the conflict because the next round of tariffs will hurt US consumers. IMF analysis suggests a full-scale trade war would have a substantial impact on global GDP, including in the United States. But the conflict is 'structural' and policy mistakes are possible.

CRACKED CHINA

China's economy has deteriorated sharply, certainly more than the official data acknowledge. The authorities must now decide how to revive their economy. Another 2016-style credit splurge would undermine long-term financial stability and risk a repeat of Japan's deflationary slump. Currency devaluation provides an alternative policy tool – particularly in a trade war.

THREE THEMES FOR 2019

Sellside macro has struggled for creativity in recent years. According to the large number of 2019 publications we reviewed, the consensus expects the next 12 months to look exactly like the last 12 months, which – by the way – was exactly what they were also saying 12 months earlier. In other words, consensus forecasts are basically just a random walk. Most economists expect global growth to moderate (a little) further in 2019, with inflation (a little) higher and monetary policy (a little) tighter. They expect risk assets to rise, but with low single-digit returns. They expect bond yields to remain broadly flat and the dollar to depreciate slightly. While some sellside strategists are prepared to use the ‘R’ word (recession) and plenty talk about ‘volatility’, most think the serious macro trouble will be deferred to 2020 (a year later than they previously assumed). If you are a contrarian, you should love this dull consensus because it suggests 2019 will be a year for big surprises. But in which direction? We discuss three policy decisions that could swing the outlook either way, starting in the United States with the Federal Reserve.

Fed overtightening became the big theme of 2018, with most economists assuming officials would raise interest rates too far because ‘they always do’. Fed policy is now approaching a critical juncture, particularly with the yield curve famously on the brink of inversion. While US officials have a habit of downplaying the significance of the yield curve, history suggests they should proceed cautiously. When yields invert, recession usually follows, though with long and variable lags. Fortunately, the current FOMC seems reasonably pragmatic. With financial markets wobbly, breakeven rates falling and no real evidence of wages spiralling higher (the Phillips curve still isn’t working), we suspect the Federal Reserve will signal a pause in early 2019. The last two times the Fed did this – in 1998 and 2006 – their action sparked a major short-term rally in risk assets, with US equities bouncing strongly. But on both occasions, the economy was growing strongly and corporate earnings were buoyant. Fed policy alone might not be enough.

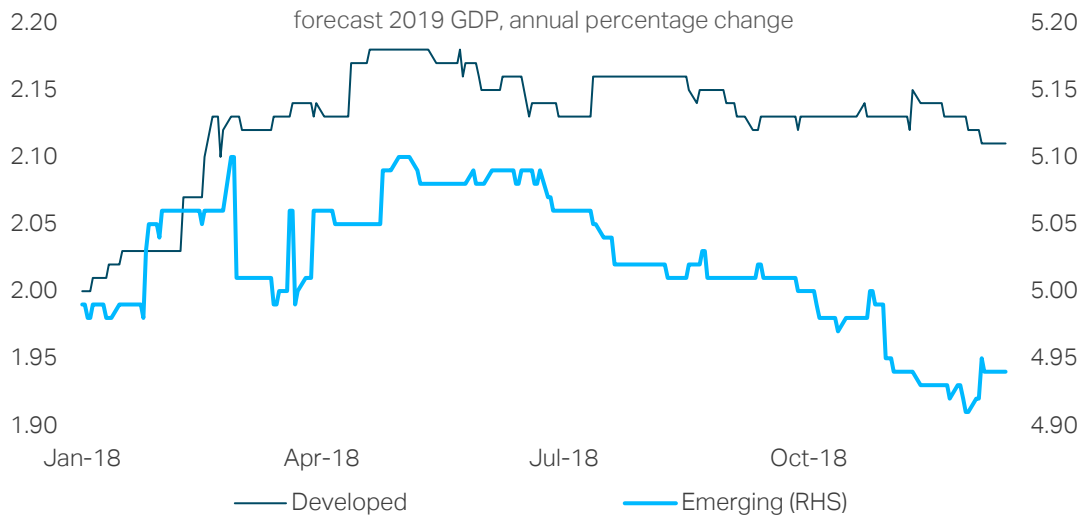
The Fed would clearly struggle to contain the fallout from a major international trade war. Most economists are assuming President Trump will ‘kick the can’ again in 2019, particularly if the stock market remains skittish. This is based on sound analysis. Trade uncertainty is already weighing on global capex and trade, even though the tariffs announced so far have only affected a tiny proportion of global trade. The next round of escalation in the conflict would be more dangerous, hitting US consumers particularly hard and – according to recent IMF simulations – having a substantial impact on the world economy. You can see why the US administration would want to avoid this scenario. But trade tensions between the US and China are ‘structural’ and will not be resolved quickly. And it is also likely Trump pivots the conflict towards Europe. Since the President has long pushed protectionist measures, nothing can be ruled out.

The Chinese government is also facing a dilemma in 2019. Growth has dropped sharply over the past 18 months, as the authorities have tried to wind down the massive credit splurge that has kept their economy growing despite persistently weak global demand. Having overdone the policy tightening, the consensus is hoping Chinese officials will announce another aggressive stimulus programme in 2019, reflating the economy and lifting global growth. But this would compound the economy’s underlying imbalances, further inflating one of the biggest credit bubbles in history. China doesn’t want to follow Japan’s example and suffer a deflationary slump, which would be extremely dangerous politically. With fundamentals shifting, FX devaluation now offers an alternative way to revive their economy (particularly in a trade war). But RMB devaluation and only modest China stimulus would be bad news for global markets.

1. PAUSE PATROL

Even with 'synchronized boom' unexpectedly becoming 'synchronized slowdown' in 2018 and global growth deteriorating faster than most people imagined, nobody on the sellside is talking about a recession in 2019. Consensus forecasts for the world economy suggest only a modest dip in GDP growth, from 3.75% to 3.6%. EMs, which have suffered a substantial tightening in financial conditions and remain seriously exposed to global trade uncertainty, account for much of this downgrade. Meanwhile, the inflation backdrop doesn't seem particularly scary either, with the sellside expecting only a small price acceleration in 2019 – certainly nothing to worry policymakers. Central banks are widely expected to tighten only modestly, with a couple of rate hikes from the Federal Reserve and perhaps token moves from the ECB and the BoJ. This uninspiring outlook doesn't sound particularly dangerous for financial markets. Strategists are assuming low (single-digit) returns in equities, flat bond yields and modest dollar depreciation. Though, given the price action in recent days, investors are becoming increasingly nervous.

Chart 2: Modest global GDP downgrades



Source: Bloomberg

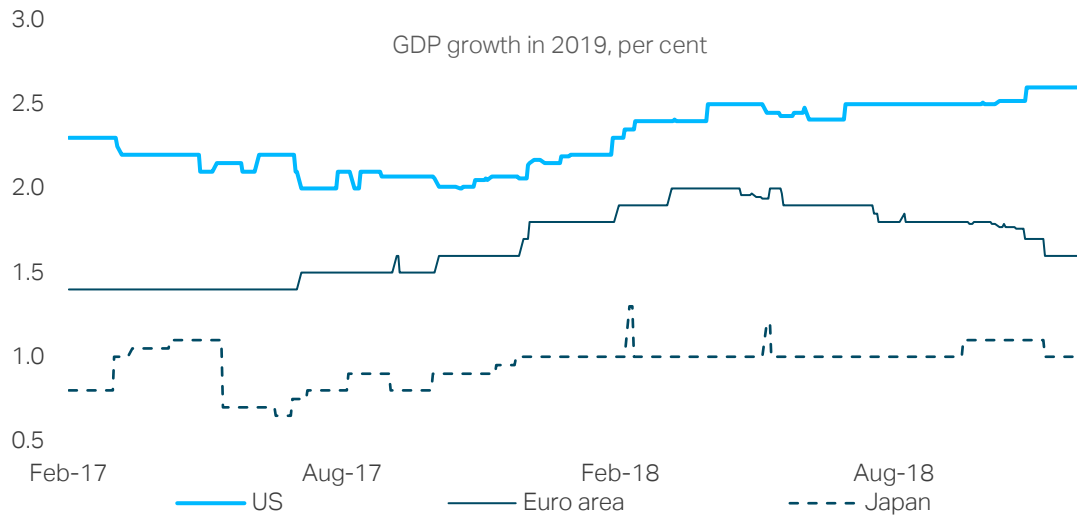
With everyone basically expecting a continuation of the trends we saw in 2018, there is plenty of scope for surprises – in both directions. While identifying risks is always tricky – economists tend to focus on the 'known unknowns', rather than the really dangerous 'unknown unknowns' – we can at least identify the big policy decisions that could have a powerful bearing on global financial markets in 2019. These include: (i) Will the Fed end its policy tightening early in the year or push on regardless of yield inversion? (ii) Will President Trump ratchet up his trade war, leading to a major escalation in the conflict? And (iii) Can the Chinese re-stimulate their economy, or will they accept weaker growth and/or try to devalue their currency? If these three decisions go the 'right' way in 2019, risk assets could regain their poise and even stage a classic rally. But if even one of these decision goes the wrong way, the next 12 months could be difficult.

The case for a Fed pause

Let's start with the Federal Reserve, which – if you believe the popular sellside narrative – has long been the likeliest cause of the next recession. Wall Street analysts like to point out that the Federal Reserve "always overtightens", ignoring the lags in monetary transmission and pushing on with interest rate hikes until the economy suddenly sinks into recession. Through much of

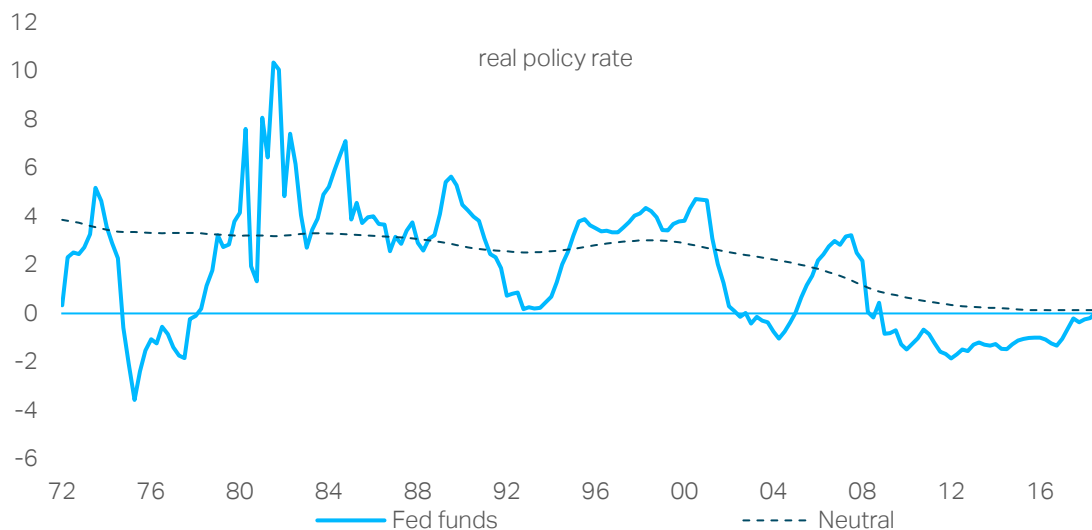
2018, risk assets also seemed to believe this narrative, with each of the three market sell-offs preceded by sudden spikes in long term interest rates. At least as far a market action is concerned, the global economy seems highly sensitive to rising yields. Yet there was always a glaring problem with blaming the next recession on the Fed before it had even happened – it assumed sellside strategists are a lot smarter than Fed officials. And Jerome Powell’s pragmatism has raised doubts about this view in recent months. With markets under pressure and the US economy slowing, the Fed seems less determined to raise interest rates.

Chart 3: Consensus forecasts holding up



Source: Bloomberg

Chart 4: US rates hit “neutral”

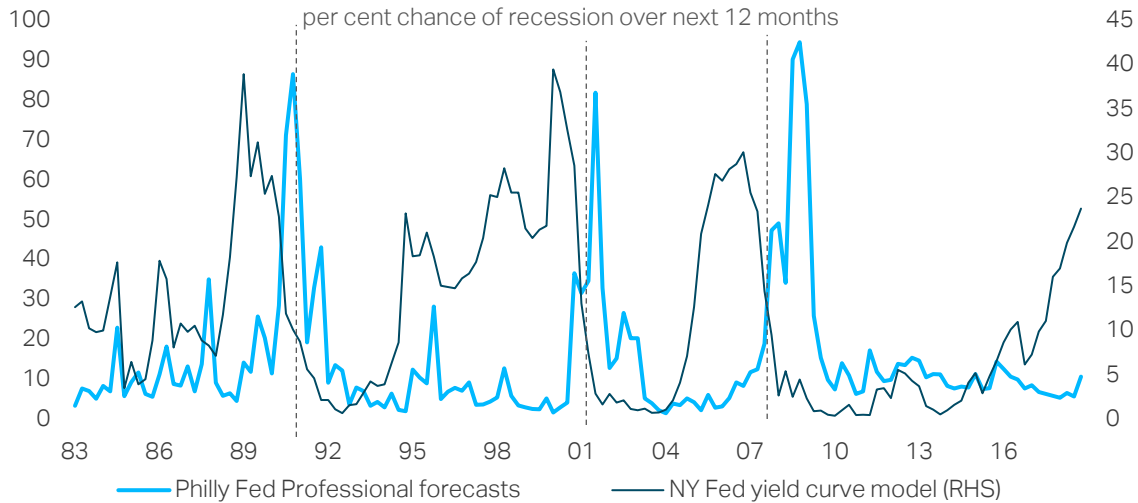


Source: Laubach and Williams, TS Lombard

There are good reasons to think the Federal Reserve will take a pause in early 2019. For a start, policymakers have concluded that interest rates are already close to neutral. How do they know this? They have model-based estimates, such as those in Chart 4, but realistically these models

are not very helpful. The confidence intervals on the Laubach-Williams model, for example, are wide. The authorities can only be 66% confident that neutral is between -0.3% and +5.7%. So the Fed is also watching inflation and bond yields. Rising inflation and/or yields would be a sign that the central bank is falling behind the curve. But there is no evidence of this. With the Phillips curve still misfiring, there is no obvious acceleration in consumer prices. After a decade of over-forecasting inflation and missing their target, it would take a brave Fed to ignore these trends.

Chart 5: US recession probabilities



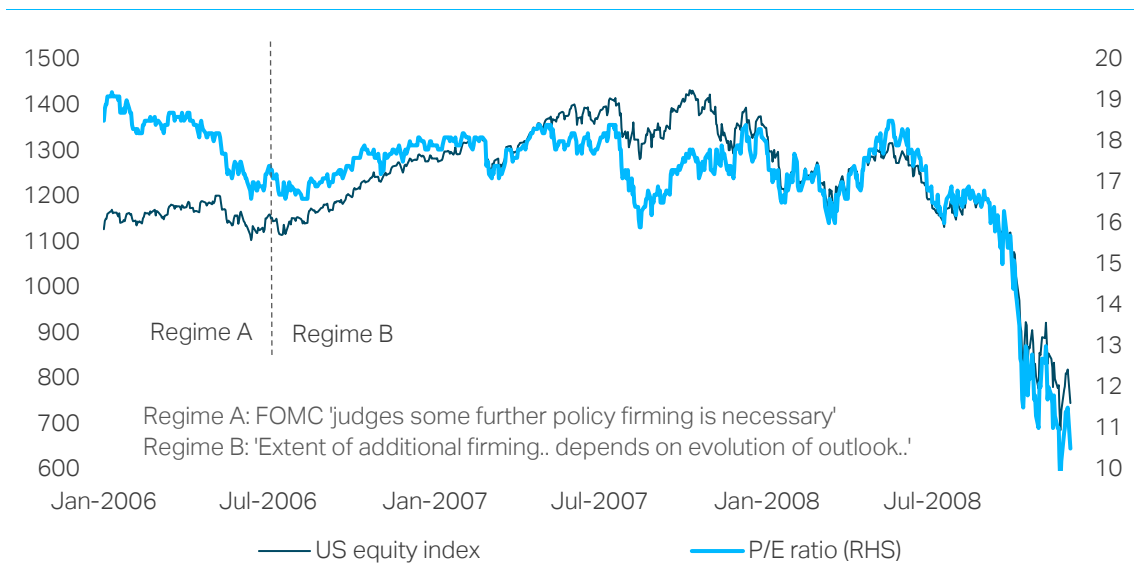
Source: Philadelphia Fed, New York Fed, TS Lombard

Avoiding inversion

Low yields and a flat forward curve offer even more compelling evidence that interest rates are close to neutral. In fact, with the spread between 10-year and 2-year yields heading to zero, further Fed tightening risks inverting the curve. We have always felt that US officials would not be prepared to do this. After all, yield inversion is historically the most reliable recession indicator they have. Models such as those produced by the [New York Fed](#) suggest the risk of recession is already non-negligible at the current spread and this risk increases sharply with any further flattening of the curve. Of course, there are good reasons to think things are different this time because global QE is 'artificially' compressing the US term premium, but the current group of officials know their predecessors always used similar arguments to explain away inversions. Historically, bond markets are usually right and Fed officials usually wrong (see Annex).

By not wanting to raise rates further than the bond market 'allows', officials are effectively outsourcing monetary policy. Even then, with yields currently so flat, it might only take a small deflationary shock to invert the curve. A further deterioration in global demand and a large drop in oil prices could do the trick, producing full inversion and fevered recession talk. After all, [US yields respond to international influences](#), not just domestic factors. We saw something similar in 1998, when a series of EM crises caused a global growth scare that produced the one 'fake' yield inversion in modern US monetary history. 2019 could produce a repeat performance. Still, investors should remember that the lags between yield inversion and US recessions tend to be long and variable and a pragmatic Fed – one that is not prepared to deliberately invert the curve – could make this leading indicator less reliable than it was in the past.

Chart 6: Stocks rallied after the 2006 Fed pause

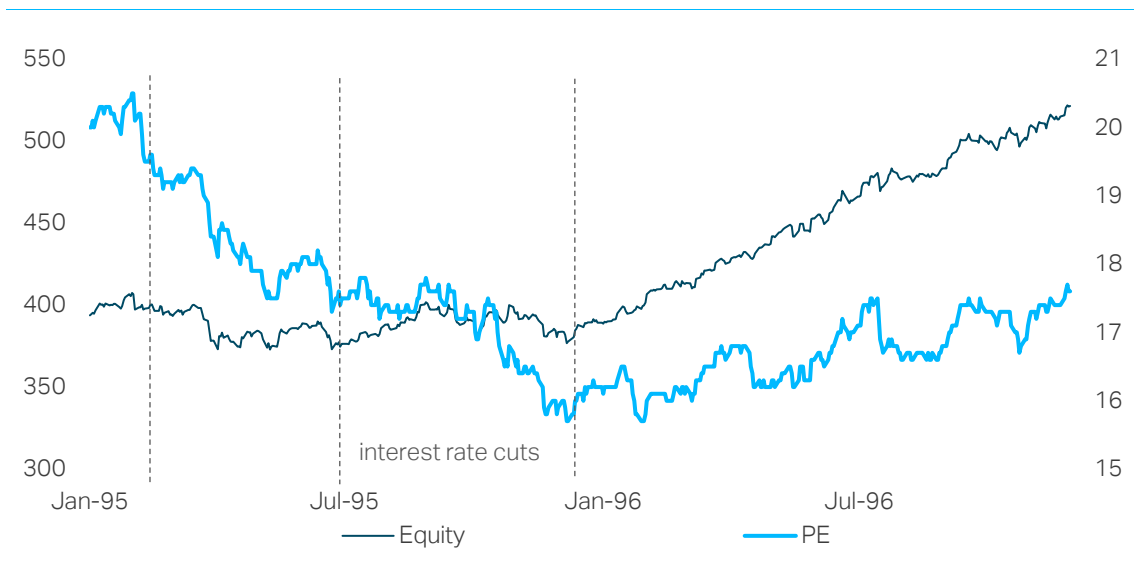


Source: Datastream, Federal Reserve

Market response to Fed pause?

Market pricing moved decisively in December to just one rate hike in 2019. But past experience suggests that the Fed announcing the end of its tightening cycle could still have a powerful impact on risk assets, even if officials try to dress up the move as a mere 'pause'. The most bullish scenario would be a repeat of what happened in 2006. Even though the Fed threatened to resume policy tightening when necessary, the move sparked a powerful rally in US stock markets (Chart 6). We saw something similar in 1998, though the Fed went beyond a simple pause and cut interest rates (Table 1). But these bullish episodes also coincided with positive US growth surprises and resilient corporate earnings. Three years earlier, in 1995, the Fed had to work much harder to restore confidence after a period of aggressive monetary tightening. US stock markets continued to de-rate for a full 12 months despite three successive Fed rate cuts.

Chart 7: 1995 mid-cycle Fed easing



Source: Datastream

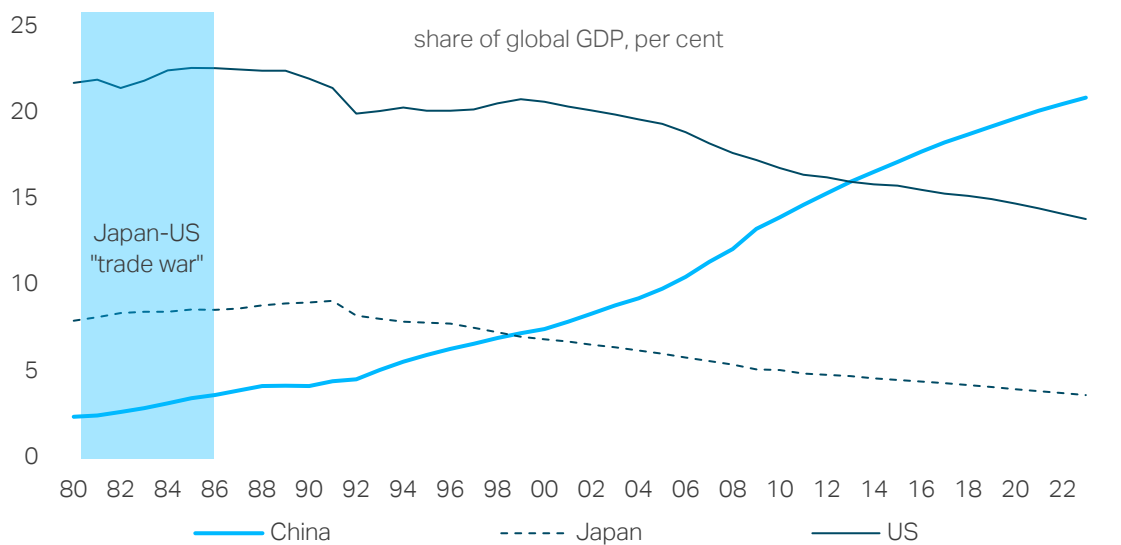
Table 1: The drugs (usually) work

	Hiking cycle	Dovish shift	Market reaction
2006	Fed hiked from 1% to 5.25% over two years (July 2004 to June 2006) Problem: mortgage rate shock	Rates on hold for 15 months before recession and banking crisis force Fed to cut rates in Sep 2007	US stocks rally 20% in six mths PE rises from 16.6 to 18.3
1995	Fed hiked from 3% to 6% over 12 months (February 1994 to February 1995) Problem: Major bond-market selloff	Fed cuts three times, to 5.25% (July 1995 to January 1996) Resumes hiking in March 1997	US stocks broadly flat for 12 mths Market rebounds with economy PE de-rates from 20.5 to 16
1998	Fed hiked from 5.25 to 5.5% (March 1997) But signals desire to burst stock bubble Problem: EM crises and LTCM crash	Cuts rates from 5.5% to 4.75% (September 1998 to Nov 1998) Resumed hiking in June 1999	US stocks rise 30% in 12 mths PE rises from 22.1 to 26.6 Dotcom bubble

2. WAR OFF/ON

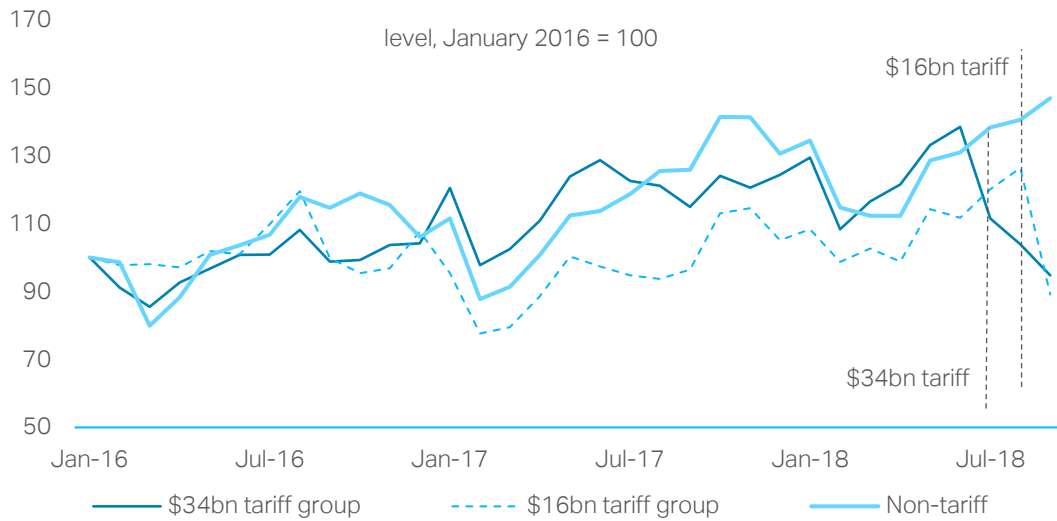
The Federal Reserve would certainly struggle to contain the fallout from a major escalation in the trade war between the United States and China. After the G20 meeting last month, that conflict has been postponed – officially until the spring – but it has definitely not gone away. We have long argued that the trade war between the US and China is ‘structural’ and deep-rooted in the question about which of these superpowers will lead the global economy in the future. Their long-term policy ambitions are fundamentally at odds, which means the situation is not comparable to previous (relatively minor) skirmishes, such as between the United States and Japan in the 1980s. In the 80s there was no question about which country was the dominant partner and the solution was fairly easy – Japanese car companies relocated to the States, curbing the US bilateral trade deficit with Japan and creating American jobs. There is no simple solution to the conflict we see today and the pressure for US protectionism will not disappear.

Chart 8: Economic rivals



Source: IMF, TS Lombard

Chart 9: The direct impact of US tariffs

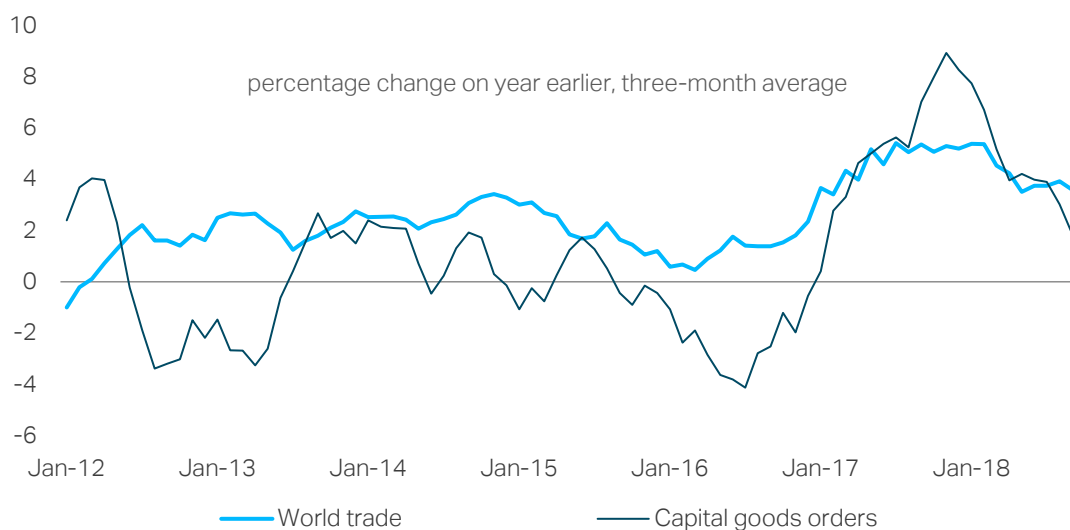


Source: US import data, TS Lombard

Impact of the trade war so far

The direct impact of the trade war was fairly modest in 2018. Chart 9 shows that US imports of tariffed products actually surged ahead of each US charge and then dropped sharply on implementation. We see this by looking at the first two waves of protectionism, which hit \$34bn and \$16bn of US imports respectively. Overall, with President Trump continuously threatening to ramp up the number of goods including in the conflict, US imports continued to rise and America’s bilateral trade deficit with China actually widened. This frontloading of import demand was less apparent in China, presumably because the authorities demanded a more ‘patriotic’ response. But in aggregate, US/China tariffs only affected a small fraction of world trade.

Chart 10: Capex-led trade slowdown



Source: TS Lombard, capital orders are weighted average of US and euro area

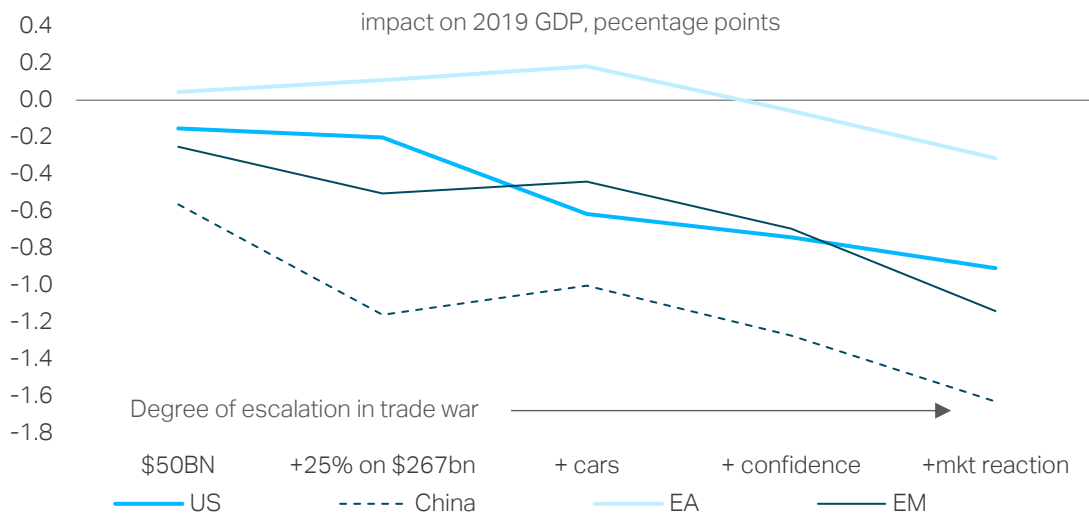
While the direct impact of the trade war was modest, the indirect effect could still have been substantial. Facing serious uncertainty about future trade relations, large exporters cut

investment sharply in 2018, triggering a capex-led slowdown in global trade (Chart 10). Admittedly, trade wars were not the only source of uncertainty in 2018 and it is hard to disentangle the impact of protectionist rhetoric from the combined effects of monetary tightening, China's economic slowdown and general worries about the state of the global economy. But unless there is a major breakthrough in the talks between the US and China, which seems unlikely given their objectives are fundamentally at odds, protectionist uncertainty will continue to restrain global capital spending and industrial demand in 2019.

Dangers of escalation

As long as there is no quick resolution to the trade crisis, there is always the risk of a more serious escalation, particularly if talks between the two governments break down and/or President Trump adopts a more aggressive negotiating strategy. The next round of tariffs would have a more material impact on the global economy, including domestically in the United States. So far, US officials have mainly targeted industrial goods from China, which are easily substitutable and only affect US prices indirectly. But once the administration levies tariffs on more than \$200bn worth of imports, it will be difficult to avoid taxing consumer products directly, which will have a more tangible impact on US prices and real incomes. While this should make further escalation less likely, President Trump sometimes follows his own economic logic.

Chart 11: Trade war impact in 2019



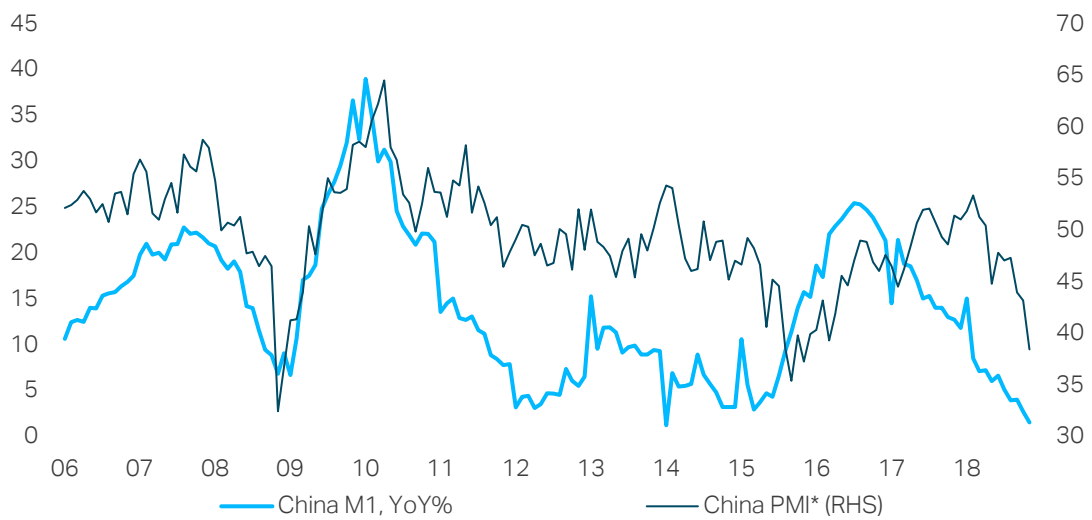
Source: IMF World Economic Outlook

The IMF recently published a handy set of simulations showing what further rounds of protectionism might do to the global economy in 2019-23. Chart 11 provides their estimates for 2019, including both direct effects on trade plus potential spillovers to investor confidence and global asset prices. Their worst case scenario halves US growth in 2019, cutting around 1%pts from GDP. The impact on China and the emerging economies is even larger, shaving around 1.5-2 percentage points from GDP. And despite (implausibly) small effects in the euro area, they estimate that global demand would be around 0.75% lower. Whole not strictly a recession, this would still be a sizeable macro shock – particularly with markets already under pressure.

3. CRACKED CHINA

An escalation in the trade war would also have major repercussions for China's economic policies in 2019. China's slowdown has surely been one of the most important macro themes of the last 12 months, with the latest data suggesting the country is facing its trickiest environment since at least 2015/16. Of course, worries about a 'hard landing' in China are not new. Federal Reserve transcripts, for example, show US officials were first worried about a China crash in 2005, while some sellside analysts have spent their entire careers saying China's economy is doomed. Yet the authorities have always managed to keep the economy growing, postponing structural problems with a series of aggressive credit-fuelled investment splurges. And with the country no longer able to rely on buoyant export demand, Chinese officials have introduced three large rounds of stimulus since the global financial crisis – in 2008, 2013 and 2016. These policies have had huge implications, both domestically and for the wider global economy.

Chart 12: China's monetary tightening



Source: Markit, national sources, *Hong Kong new business from China index

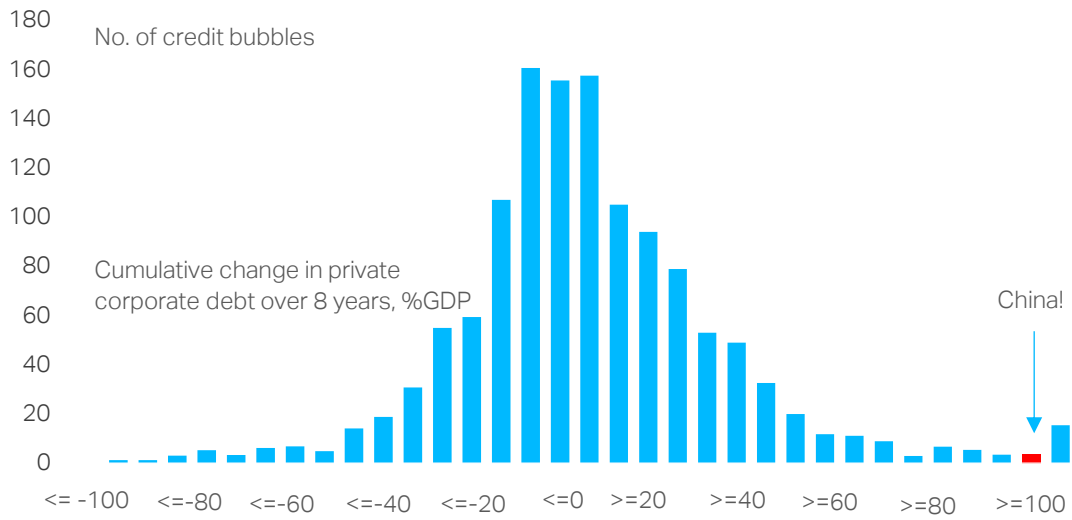
World's largest credit bubble?

On one level, China's stimulus programmes have been highly successful. China has enjoyed the longest period of uninterrupted growth since international records began, allowing the authorities to meet ambitious short-term GDP targets. But economic stimulus on this scale has also come at a serious cost, compounding the economy's underlying imbalances and creating dangerous longer-term vulnerabilities, particularly in the financial sector. China's private-sector credit/GDP ratio has risen rapidly, hitting levels that were associated with banking crises in other countries in the past. In fact, according to [a recent study by the ECB](#), China is now sitting on one of the largest credit bubbles in history (Chart 13). When bubbles of this magnitude burst, they usually cause huge economic damage, slashing long-term growth rates (Chart 14).

Yet China is not like many of the countries that blew themselves up with credit bubbles in the past. Since we are mostly talking about state-owned banks lending to state-owned enterprises, the concept of 'private-sector' credit is fuzzy and there is less chance of a 'margin call', the typical trigger for a financial crash. That said, the authorities clearly realize they cannot continue to throw debt at their economy in the way they have been doing over the past decade. They are keen not to repeat the errors made in Japan in the 80s, especially as the Communist system

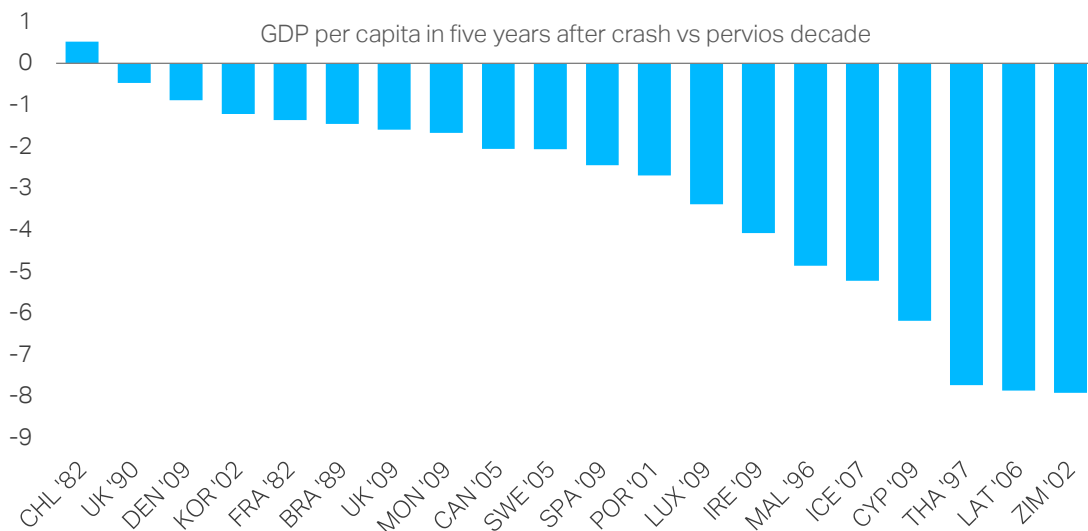
would struggle in an environment of persistent deflation and lasting economic stagnation. So the Chinese are reluctant to introduce stimulus on the scale of past programmes. Assuming the economic outlook doesn't deteriorate in a huge way and that Trump is willing to postpone a major escalation of the trade war, we suspect China's authorities would tolerate relatively low growth in 2019, which means they would opt for only a modest stimulus. This would probably be enough to stabilize activity over the next 12 months, rather than deliver a major revival.

Chart 13: History of credit bubbles



Source: ECB study

Chart 14: When credit bubbles burst



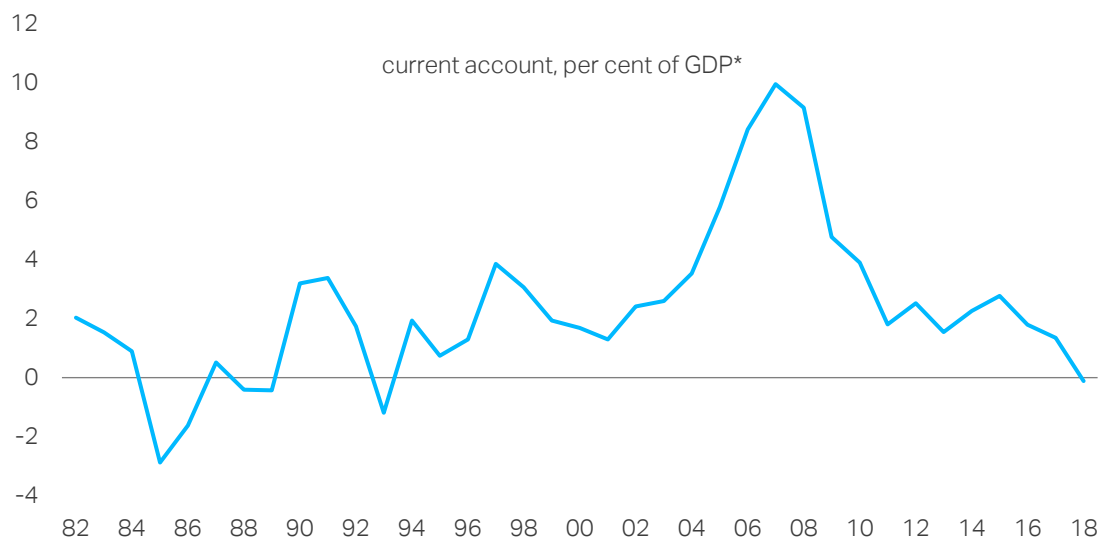
Source: ECB study

But in a trade war...

As far as China is concerned, currency devaluation would probably be a more desirable way to stimulate the economy than another domestic credit splurge. Macroeconomic fundamentals

have deteriorated and interest rate differentials have moved against the Renminbi in recent years. Meanwhile China also recorded a current-account deficit during the first half of 2018. Though erratic forces played a role, this was China’s first trade deficit since 1993. Also critical from a desirability point of view, the Chinese now feel they have a better handle on capital outflows, which would allow an orderly depreciation. This was not the case in 2015, when even a modest devaluation sparked a speculative attack on the currency. China’s exchange rate has already depreciated by 10% since the summer and right now it seems it is politics – not economics – that is discouraging a much larger move. Large-scale devaluation would further incite the trade war with the United States, guaranteeing another round of US tariffs.

Chart 15: China’s trade deterioration



Source: National sources, *2018 is first three quarters of the year

But if the trade war happens anyway, for reasons outside Chinese control, currency depreciation becomes an obvious policy tool – especially as the Chinese are running out of US imports on which to levy taxes. This would help China to offset the impact of the tariffs, boosting domestic industries, but it would be seriously bad news for the global economy. When China uses credit-fuelled investment programmes to stimulate growth, the rest of the world benefits through rising exports and improving sentiment. Currency devaluation would have the opposite effect, boosting China at the expense of the rest of the world. Remember, global markets did not respond well to the prospect of Chinese devaluation in 2015/16. Even a minor adjustment in the exchange rate sparked a severe wobble in risk assets and a major global growth scare. A repeat performance in 2019 would further undermine global risk appetite and non-China demand.

Bottom line

The consensus view for 2019 is remarkably dull. Most of the sellside expects slightly weaker global growth, slightly higher inflation, sticky bond yields and low single-digit gains in global equity markets. Despite big disappointments in 2018, few are prepared to predict a recession or the start of a major bear market. Instead, they warn of 'higher volatility' or speculate about potential problems in 2020. While we agree that the 2019 outlook is challenging – perhaps with global growth even weaker than the consensus expects – we see three highly uncertain policy decisions that could have a powerful bearing on risk sentiment over the next 12 months. In the

bullish scenario, a Fed rate pause, de-escalation of the trade war and mild Chinese stimulus could put a floor under global growth and perhaps even revive the (tired) bull market in equities. Conversely, if any of these decisions go the other way, 2019 could be a lot tougher than most people realize. The worst outcome would be a serious trade war combined with a Chinese administration that tries to pass on the cost of this war – and revive their troubled economy – using large-scale currency devaluation. This would likely produce a dangerous bear market.

[See Table of Fed's yield curve denial on next page](#)

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ANNEX: FED'S HISTORY OF INVERSION DENIAL

Inversion period	Fed views on yield curve inversion
1990 recession	
Feb-1989 FOMC	Greenspan: I take enormous comfort from the yield curve and what it says about Fed credibility. What does it tell us prospectively? What does it tell us about the future? I'm not sure of that. The yield curve in the United States and elsewhere has not been a reliable indicator of future inflation. And if it has not been a reliable indicator of inflation and most recessions are inflation induced, I am not prepared to bet the mortgage on the signals the yield curve are giving right now. So I'm not sure the yield curve is telling us a lot of important things.
2000 recession	
Feb-2000 Greenbook	Blamed inversion on 'expectations of changes in relative supply associated with Treasury buyback programme and other technical factors'. [Larry Summers, Treasury Secretary, had announced a \$30bn UST buyback just before inversion.] Staff noted two 'contending camps in the market. One saw inversion as a temporary phenomenon, expecting the curve to steepen again once the committee began to tighten in the first quarter. A different camp expected the inversion to continue, reflecting increasing agency supply plus slower economic activity as the fed tightened'
Mar-00 Greenbook	Continued to blame supply issues, noting CBO and OMB projections of cutbacks to Treasury debt issuance.
Mar-00 FOMC	Committee would have to tighten more aggressively to force yields higher and damp stock markets. The FOMC also discussed strong demand for duration assets from foreign and domestic private portfolios. Treasury issuance was too low relative to demand and set to decline further with government budget surpluses.
Oct-2000 FOMC	"It's a supply problem"
Nov-2000 FOMC	FOMC view shifts: 'Short end of yield curve had collapsed and clearly reflects the anticipation of easing, which has increasingly been priced into markets over the summer'
2007 recession	
Mar-06 Bernanke	Bernanke gave a speech titled 'Reflections on the yield curve'. He argued a substantial part of the decline can be attributed to a drop in the term premium. Partly reflects the Great Moderation and improved monetary policy. Partly due to increased intervention in currency markets by a number of Asian governments. Foreign central banks investing the bulk of their greatly expanded dollar holdings into US Treasury securities, putting downward pressure on yields. Also noted that the supply of Treasuries had not kept pace with demand from pension funds etc.
Mar-06 FOMC transcript	'The Chairman's speech notwithstanding, market participants are divided about the implications of the flat, or slightly inverted, yield curve
Sep-06 FOMC	'The inversion of the term structure in 2000 was a signal that, in retrospect, might have warranted a response'. Reinhart noted: 'This indicator may seem less compelling now for two reasons. First a flattening yield curve has send false signals as well over the years, including of recessions that didn't occur in the mid-1990s. Second, much of the downward tilting of the term structure seems to be a decline in term premiums, which might be a sign of reduced uncertainty rather than a sign of increased economic vulnerabilities'. Plosser: The predictive power of changes in the slope of the yield curve depends on why the slope changes. Half is due to the term premium, where predictive power of recession is less. Mishkin: 'I did some research on yield curves in recessions and I do not think that the yield curve is providing much information at this time. There are special reasons that the term premium is extremely low'
Recent flattening	
Dec-17 Yellen	There are good reasons to think the relationship between the yield curve and the business cycle may have changed
Jun-18 Powell	Range of views. Term premium has been very low, so there are arguments that flatter curve has less of a signal in it. What really matters is what the neutral rate of interest is and there may be a signal in the long-term yield about the neutral rate.

Source: TS Lombard based on Federal Reserve transcripts and other historical FOMC material