Economic scenarios 2018

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Q3 is drawing to its end. Traditionally, this heralds the development of a strategy for the next year, an important part of which is the creation of scenarios. On the basis of the status quo, we have drawn up three further different scenarios in this blog entry.

Scenario 1 – "Goldilocks"

The current environment is favourable for numerous asset classes. Real economic growth is strong and has a solid basis. The global economy grew by 3.8% from Q1 to Q2 (annualised) (source: Erste AM). This value is more than one percentage point above the long-term expected value, i.e. potential growth, and it is at the upper end of the bandwidth of quarterly growth recorded since 2010. The leading indicators for Q3 suggest a moderate slowdown to about 3% (source: Erste AM).

At the same time, inflation is low. In many areas of the world, consumer price inflation is below the respective target of the central bank. In line with this situation, the central bank policy is very supportive. The key-lending rates are very low, the liquidity of the large central banks will have grown by more than USD 1,000bn by the end of the year, and the signals sent by the central bank members with regard to the future monetary policy suggest a cautious stance.

There is one fly in the ointment: this favourable environment is already priced into the various asset classes. Valuations are elevated. By definition, "Goldilocks" is the best of all conceivable scenarios. We assign a likelihood of 30% to this scenario.

Below we would like to illustrate a few scenarios that could put this very favourable environment for the financial market at risk, in decreasing order of likelihood.

Scenario 2 – normalisation

The low interest rate level shows that the recovery from the Great Recession of 2008/09 has not been completed across all areas. In the normalisation scenario, the important economic indicators, economic growth, inflation, and interest rates are heading for their target values in the medium to long term (several years):

- Potential growth (world: 2.7%)
- Inflation target of the central bank (about 2% in many industrialised countries)
- Neutral interest rate (about 2% in the USA and about 1.5% in the Eurozone)

Additionally, the bond purchase programmes of the central banks are about to expire or be reduced, both in a very cautious manner. The values do not change significantly in comparison with the Goldilocks scenario. The probability of this scenario occurring is 40%. It is beneficial to equities and disadvantageous for bonds.

Scenario 3 – stagflation

In contrast to the normalisation scenario, the important economic indicators change in a more significant fashion in this scenario. Economic growth falls clearly below potential growth. Sometimes, the term “growth recession” is used. The tricky issue about the relation of growth and inflation is the non-linear, inert character. For a long time, there does not appear to be any relation. Inflation remains low, although the economy is booming. Only once growth is starting to weaken, does inflation rise – and above the central bank target as well. This forces central banks to hit the brakes, i.e. the key-lending rates are raised to above neutral. This scenario will occur at a probability of 20%. It is of course disadvantageous for most asset classes with the exception of cash.

Scenario 4 – shock

The name already suggests that the scenario entails a negative event at a low probability (10%) but with drastic repercussions. More specifically, it affects all the events that constitute a so-called deflationary shock (a shock to sustainably falling prices and wages). Inflation is low in many parts of the world. The gap to the zero line, which represents the border between inflation and deflation, is therefore small. Also, there are signs that suggest that the long-term inflation expectations by consumers, market participants, and economists are already on the falling side. The key-lending rates are very low as well. The gap to the level from which they cannot be cut any longer is narrow. This means that the central banks cannot do much more in order to absorb any negative event. Experience shows that the various governments will only take steps with a time lag, and they expand the budget deficits so as to support the economy. The central banks help by installing new asset purchase programmes. This environment is positive for credit-safe government bonds and disadvantageous for equities. What events could trigger such a negative environment? Globally speaking, China stands out on the back of the vastly increased level of credit, which could collapse under its own weight, much like we have seen in other countries in the past (USA, Spain, Ireland ten years ago).

Inflation is key

The environment will remain favourable for the financial markets with a probability of 70% (Goldilocks 30% + normalisation 40%). The realistic, unfavourable scenario of stagflation will occur with a probability of 20%. The clearly negative scenario of a deflationary shock is associated with a low probability of 10%. Noticeably, the development of the economic indicator inflation can be used to describe the majority of the four scenarios:

1. Goldilocks: low inflation
2. Normalisation: increase in Inflation towards central bank target
3. Stagflation: increase in Inflation above central bank target
4. Shock: negative inflation

The first finding that will feed into the formulation of the 2018 strategy: the assessment of inflation is crucial.

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