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Ten theses for 2019

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At the beginning of 2019, the investor sentiment is down. The market prices already reflect the transition from the current phase in the economic cycle, “downturn”, to a recession. Is the fear of a recession exaggerated? Here are our ten theses for the development of the financial markets in 2019.

• Weakening, but no recession

Real global economic growth has been weakening for numerous quarters on a global scale. The negative output gap has disappeared. The unemployment rates are already low. This alone implies a downturn from above-average growth to growth rates in line with the trend (more precisely: from above potential towards potential). In addition to the market-based leading indicators, the survey-based ones (purchasing managers’ indices) and the “real” indicators (industrial production) also suggest a continued slow-down of growth.

The decline in growth in the USA constitutes a normalisation after very strong quarters last year, caused by fiscal stimulus (massive expansion of the deficit). Also, the rate hikes by the US Fed have affected the interest-sensitive sectors. In China, the curtailing of the shadow banking system led to a liquidity shortage and to weaker growth. The latter is the most important reason for the weak development of the goods sector on a global scale (exports, production, investments). A technical recession, defined as real GDP shrinking for two consecutive quarters cannot be ruled out in some countries (e.g. in Germany in the second half of 2018). Globally speaking, we “only” expect a continued downturn. The most important premises: China experiences a sufficiently strong positive stimulus to stabilise growth.

• Low consumer price inflation

Inflation remains low in the developed economies. The economic boom phase has not lasted long enough for it to exert sustainable upward pressure on consumer price inflation. The positive aspect: central banks have an easier time taking supportive action. Most recently, that has happened in the USA, where the central bank suspended the rate hike cycle.

• Wage inflation

Unemployment rates have fallen to low levels across many countries. We can see accelerated growth in wage costs. At the same time, economic growth is losing momentum. The currently high company earnings growth is coming under pressure.

• Low key-lending rates

In several countries, the key-lending rates adjusted for inflation are negative. Even in the USA, where we have seen numerous rate hikes, the Fed funds rate is only slightly positive net of inflation. Real key-lending rates will remain low this year. However, if the assumption is correct that the worries of recession in the USA are exaggerated, the US Fed will raise the Fed funds rate in the second half of the year. Money supply (M0) will continue to decline in the USA. Only the central bank in China (PBoC) will continue to implement expansive steps.

• Supportive fiscal policies

The fiscal policies have a mildly expansive effect on global economic growth. The stimulus is (still) coming from the USA and (increasingly) from China. Italy and France are expanding their deficits, too.

• Restrictive credit environment

The credit environment has exerted a dampening effect on economic growth. Generally, banks in the emerging economies are tightening their lending terms. This means that credit growth will decline. The negative credit impulse in China (falling credit growth) is particularly relevant. This is due to the political focus on the reduction of the shadow banking system. The Chinese economic policy is trying to dampen the weakening by providing the banks with more and cheaper liquidity. In the Eurozone and the USA, the credit impulse is slightly negative as well.

• Populism

The populist movement remains globally relevant. This year, the EU parliamentary election will be one litmus test among others. The most plausible reason for the anti-establishment attitude is the ongoing stagnation of real income in many countries.

This has at least three implications:

- Deteriorating quality of political governance. Decision-making is tedious and difficult to predict (government shut-down in the USA, chaos in the British parliament about Brexit).
- Stagnation or reversal of globalisation. Global trade and international organisations (WTO, EU) are under pressure.
- Politics are geared towards a higher share of wages as part of GDP (Italy).
- Structural reforms are not being executed properly or at all (Italy, France, Eurozone). The likelihood of a higher level of integration in the Eurozone and an increase in productivity in Italy is low. In Brazil, the new president, Jair Bolsonaro, has fuelled hopes for free-market reforms. Whether they will actually be passed in the fragmented parliament remains to be seen.

• Rivalry USA - China

Geopolitically, the ongoing rivalry between the USA and China will be the dominant factor. Even in the event of a (temporary) agreement in the trade conflict between the two countries, the structural trend from a unipolar to a multipolar world will continue. This will provide fertile soil for conflicts across a wide variety of fields (technology sector, export and investment limits).

• Little room to manoeuvre

Many structural problems will come with an immediate effect on the markets. The room to manoeuvre is limited for economic policies. This means that an average recession would have more dire effects than it would have had previously.

- The current key-lending rate in some important countries is not far off the effective lower bound and the neutral interest rate. The ECB cannot lower the key-lending rates anymore in the event of a recession. Even in case of growth stabilising on low levels, the ECB will be having a hard time raising interest rates. At a Fed funds rate band of 2.25-2.50%, the US Fed is already hitting the level where the interest rates are neither supportive nor restrictive for the economy.
- The government debt ratio (Italy) and new debt taken out (USA) are already very advanced.
- In China, the high level of debt in the private sector impedes further positive credit stimulus.

• Search for the fair value

The investment regime tries to establish the fundamentally justified asset price based on the fair value (value strategy), in contrast to carry, trend, or speculation strategies.

Summary: if the most important (hypo)thesis, "weakening, but no recession" were to materialise, risky asset classes (equities) would have to be considered more attractive than risk-free government bonds. The markets have already priced in the transition to a recession. The more cautious signals from the US Fed (i.e. no further rate hikes for the time being) support the markets; as do the cut of the minimum reserve guidelines for banks in China (i.e. more liquidity), the decrease in the oil price, the agreement between Italy and the European Commission about the planned new debt, and the (possible) agreement between the USA and China in their trade conflict. Negative factors are the decline of the survey-based leading indicators for economic growth, in line with the trend, and the political uncertainty (US government shutdown, Brexit).

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