## Economic Background – December 2019

### Winner Takes It All[1]

In our last Economic Background of the decade global growth has weakened to 3%, its slowest pace since the global financial crisis and a material slowdown from 3.8% in 2017. Rising trade and geopolitical conflicts are contributing to the background of uncertainty alongside muted productivity growth and a distinct slowdown in global manufacturing sectors.

The global slowdown is occurring at a time when monetary policy has eased significantly across developed and emerging markets. This is now the most synchronised global easing period since the financial crisis, with 60% of central banks in a cutting rate cycle and central bank balance sheets set to increase to new highs.

*Source: JP Morgan, Refinitiv*

Monetary policy has been used extensively to try to steer economies through the effects of various crises and prolong the economic expansion. More recently central banks have tried to mitigate the worst effects of the US-China trade dispute, through rate cuts and increases to liquidity in their respective financial systems. However with interest rates low and signalled to remain so, global inflationary expectations remain subdued. The extraordinary stimulus since 2009 has led to some inflation but this has been almost entirely in the inflation of asset prices. Increasingly central bankers are openly willing to accept higher inflation, highlighting the limitations of monetary policy and encouraging governments to release the fiscal purse strings. This is manna from heaven for those politicians keen to utilise the low interest rate environment to enact their policies.

### Let's get physical (fiscal)

*Source: Economist*

There is no doubt that fiscal policy will play a bigger role in the coming months and years ahead. This is likely to introduce more interest rate volatility than we have had in recent times which in turn will lead to more asset price volatility. The fiscal purse has already started to expand in the US. Following the corporate tax cuts in 2018 President Trump, with the Democratic run Congress, agreed to increase the government's spending limits. The result so far is spending of $4.45 trillion in the 2019 financial year, an increase to the deficit of nearly $1 trillion. This is not the balanced budget Trump promised Republicans he would enable.

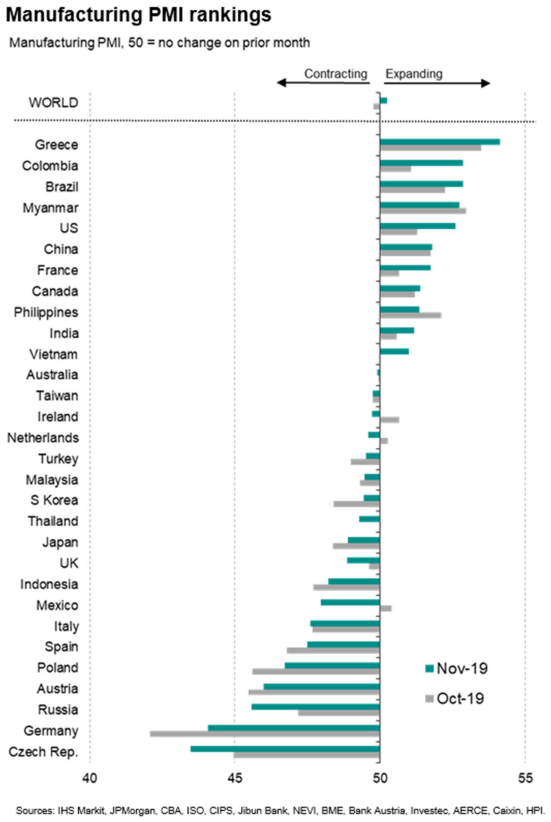
Chinese stimulus, by its own central bank's admission has been more "targeted" than previous splurges in lending programmes. Following limited tax reforms and cuts to bank reserve requirements, it is expected that forthcoming stimulus will focus on infrastructure spending. The size and depth of any forthcoming package is dependent upon the Chinese government's willingness to embrace a slower growth rate and its ability to overcome its debt problem. It is worth remembering that China experienced its first default on a domestic bond in 2014. By 2018 it had $16.5bn of default and 2019 looks set to equal that number. As the trade dispute with the US rumbles on concern surrounds the scale and breadth of defaults and the impact it may have on the Chinese system.

Ahead of the 2020 summer Tokyo Olympics, Japan has just announced a $121bn stimulus package which will focus on the repair of typhoon damage, infrastructure spend and investing in technology. It remains debateable whether they can execute on the spending

[1] The Winner takes It All, ABBA, 1980.

plans, given their current workforce and immigration policy and how much of a hindrance the recent rise in consumption tax will be.

The European Central Bank (ECB) has bemoaned the lack of a consistent and joined-up fiscal and monetary policy, with Germany's penchant for a 'black zero' balanced budget in its sights. Chancellor Merkel and finance minister Olaf Scholz have been unmoved by the calls, despite the German economy narrowly avoiding being in recession in the third quarter and the manufacturing sector continuing to contract. With pressure increasing inside and out of Germany to expand the current investment plan, Ms Merkel explains that it is not the lack of money which is the issue but bureaucracy and planning at a local level. As the global slowdown continues, hurting demand for Germany's exports, it may take a shift in social demand to shake existing political ideologies. Global manufacturing has been hardest hit in the trade slowdown and in particular vehicle production. December brought some respite as manufacturing activity fractionally increased in November. Production, new orders and employment data all pointed towards an improvement in conditions. However goods exports fell, suggesting that the overall growth of manufacturing is being held back by trade flows. As can been seen in the PMI rankings Germany and the Czech Rep. are still heavily in contraction, with Poland, Spain and Italy joining them at the bottom of the list.




In the UK it appears that no matter who forms the next government, fiscal spending will increase. As I write we are a week away from the UK General Election. The opinion polls and bookmakers currently suggest a Conservative majority is the likely outcome, but a hung parliament or minority led governments remain a possibility. We know that in politics much can change in a week, that the error margin of these polls is wide and sometimes bookmakers are wrong. After reviewing each party's manifesto the Institute for Fiscal Studies concluded that "rarely can a starker choice have been placed before the UK electorate". The choices made in this election will have a lasting impact on the shape and path of the UK economy.

**Political risks will remain heightened**

Whilst we are focussed on the UK General Election global attention is starting to turn to next year's US Presidential Election. As President Trump enters the final year of office, the possible election candidates for 2020 provide another distinct choice for voters.

If Donald Trump avoids impeachment, wins a second term and regains control of the US House of Representatives, he will again be able to return to his agenda of reshaping domestic and foreign policy emboldened. This is likely to lead to increased uncertainty over global trade. In the latest twist of the on-off trade dispute with China, the US president indicated that he was prepared to wait until after the US election to agree a deal. No deal is better than a bad deal it appears. This came a day after US trade representatives threatened to impose 100% tax on $2.4bn of French goods following the French proposal of a 3% digital sales tax.

In the Democratic race to challenge Donald Trump, Elizabeth Warren and Joe Biden are the front runners for nomination, albeit in still a wide field. If Ms Warren is successful in becoming US president, markets will have to absorb the prospect of wealth taxes, higher corporation tax and substantial changes to American technology and healthcare companies. There is a long way to go in this race, but as we get closer to the presidential election markets will focus in on the risks posed by both candidates.

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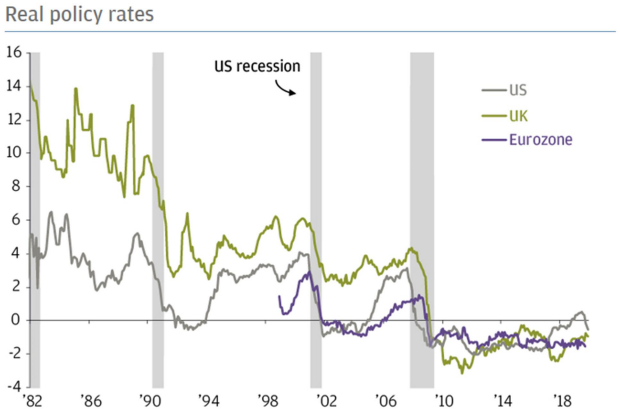
**Paying more for less (a greater fool)**

According to Goldman Sachs Investment Research over 80% of the gains in global stock markets this year can be attributed to valuation gains, or in other words investors are willing to pay more for the same asset. The declining interest rate environment, lack of recession and a small amount of earnings growth has provided an environment in which the S&P500 index has increased by more than 20% in the year to date. These positive factors have more than offset the risks from companies over global trade disputes and geopolitical strife. Valuations for the S&P 500 are now well above average. Expectations in the US are for more monetary stimulus in 2020 and so any deviation from this view is likely to take the shine off the lofty valuations, unless earnings growth increases. The reality is that 5 stocks have contributed to more than 25% of the US markets total return in the year to date.



Source: Bank of England, BEA, European Central Bank, Eurostat, ONS, Refinitiv Datastream, US Federal Reserve, J.P. Morgan Asset Management. Real policy rates are calcualted as the nominal policy rate minus the annual rate of core inflation. Periods of "recession" are defined using US National Bureau of Economic Research (NBER) business cycle dates. Data as of 31 October 2019.

Central banks, they tell us, are very aware of the geopolitical risks that exist in the world and are determined to keep the current expansion going. The clear message from the Federal Reserve and European Central Bank, at least is that should further stimulus be required they have the ammunition to deliver. The Bank of England (BoE) has been more circumspect and decided to hold until the Brexit quandary is resolved, but it too has indicated it will act should growth deteriorate. In real terms the US, UK and Eurozone are maintaining the negative policy rates strategy they have had over the past decade, providing support to asset markets.

There are some tentative signs of improvement. In the most recent data we have seen an increase in economic growth; however it remains clear that export activity remains subdued. A resolution or truce in the US-China trade conflict, a clear Brexit solution and an easing of tensions around the world could reignite business confidence and investment. Unfortunately the probability of a positive short term solution to these outcomes is low and investors should expect the heightened geopolitical risk to continue. If tensions escalate further, we should expect the global economy to slow further too.

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