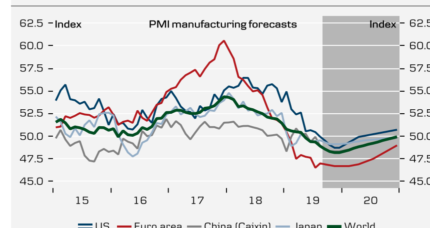
22 August 2019

Global Economic Update

Stuck in the mud but no hard landing yet

- The global macroeconomic backdrop has weakened significantly since we published *The Big Picture – Renewed trade dispute casts shadow over global economy* on 11 June, following the escalation of the trade war between China and the US. In this document, we present our updated economic outlook for the US, China, the eurozone, Germany, Japan and several emerging markets.
- We see further downside for the global economy in coming months, followed by a stabilisation and modest rebound on the back of monetary and fiscal stimulus.
- Our new base case of no solution to the trade war between China and the US ahead of the 2020 US presidential election has led us to downgrade our growth trajectory for both advanced and emerging markets.
- The risk of a more pronounced downturn has increased (we assume 30% probability of a recession in the next two years). However, in our view, there is also possible upside from a sudden breakthrough in US-China trade negotiations, more aggressive central bank easing and still strong consumer confidence.

Further headwinds for the global manufacturing sector in coming months



Source: Markit, Macrobond Financial, Danske Bank

GDP forecast—global overview

	2018	2019		2020		2021	
% y/y	Danske Bank	Danske Bank	Consensus	Danske Bank	Consensus	Danske Bank	Consensus
Global	3.6	3.0	3.2	3.2	3.2	3.3	3.0
Developed markets of which	2.2	1.6	-	1.2	-	1.4	-
USA	2.9	2.3	2.3	1.7	1.8	1.8	1.8
Euro area	1.9	1.1	1.1	0.9	1.1	1.3	1.2
Japan	0.8	1.4	1.0	0.5	0.4	0.3	0.9
UK	1.4	1.2	1.3	1.3	1.2	1.4	1.7
Emerging Markets of which	4.5	3.9	-	4.5		4.6	
China	6.6	6.2	6.2	6.0	6.0	6.0	5.8
India	7.3	6.5	6.7	7.0	6.9	7.0	7.2
Russia	2.3	1.2	1.2	1.7	1.7	2.4	1.8
Brazil	1.1	0.9	0.9	2.0	2.1	2.3	2.5
Turkey	3.2	-2.0	-1.6	1.7	2.3	2.6	3.2
South Africa	0.8	0.7	0.6	1.5	1.5	1.7	1.8

Source: Consensus, Danske Bank

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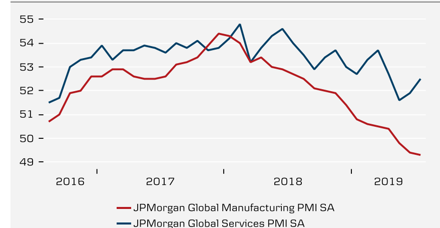
Overview

This document updates our global economic outlook and discusses the downside and upside scenarios from our baseline. **The global macroeconomic and political backdrop has weakened significantly since we published *The Big Picture – Renewed trade dispute casts shadow over global economy* on 11 June.** Some of the downside risks that we flagged have materialised, most notably the decision by Donald Trump's administration in late July to escalate the trade war with China, further after signalling an intention to hit the remaining USD300bn of imports from China with 10% tariffs. On the back of the announcement in late July, global risk sentiment dived further and global bond yields fell to new lows.

In light of the escalation of the trade war and the severe negative impact it has had on the relations between the two countries, **we no longer expect a deal between the two sides ahead of the 2020 US presidential elections in our baseline** (we assume 60% probability of no deal). However, we do not preclude the two sides from delivering a sudden breakthrough, seeing a 40% probability of a trade deal (for more discussion on the scenarios, see *US-China Trade – Three trade war scenarios – 'no-deal' now our baseline*, 8 August).

The absence of a trade agreement between the two sides in the near future and **a cautious easing policy by the central banks are set to weaken the momentum in the global economy near term**. The biggest impact of the trade war is the uncertainty about global value chains and the future state of the global economy, which is hurting investment demand, global trade and manufacturing activity. As a result, we see further downside for the global manufacturing sector in coming quarters; in other words, we believe the global economy is *stuck in the mud* for the time being. However, the service sector has held up well.

While the manufacturing sector has slumped, the service sector has held up well



Source: Markit,, JP Morgen, Macrobond Financial, Danske Bank

In response to the weakened outlook for the global economy and sharp falls in inflation expectations, we expect the Fed, in particular, and other central banks to ease monetary policy quite vigilantly. The Fed already cut its policy rate in July and the ECB has opened the door to easing at the next meeting in September.

We now expect the Fed to cut its policy rate a total of five additional times (see *FOMC Research – New Fed call: five more from Fed*, 15 August), while *we think the ECB* will cut rates by 20bp (see *ECB Research - New ECB call - rate cut and restart of QE,* 18 June), restart QE and *introduce a tiering system* (see *ECB – Mitigating side effects – gauging the tiering premium*, 16 August). Many emerging markets' central banks, including the Brazilian, Russian, Indian and Indonesian central banks, have already followed suit with monetary easing. We believe the monetary policy easing in both advanced and emerging markets will support domestic demand in their economies.

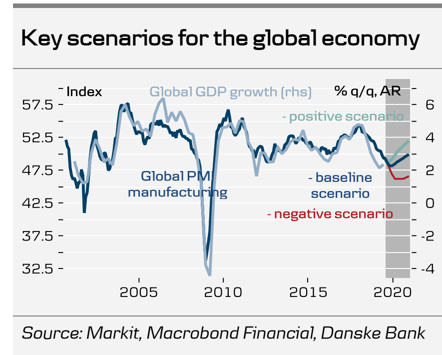
On aggregate, we downgrade the outlook for the global economy in coming years. We lower our growth outlook, expecting global growth to be 3% in 2019, followed by a slight pickup to 3.2% in 2020 and 3.3% in 2021 (versus 3.2% in 2019 and 3.4% in both 2020 and 2021 in *The Big Picture – Renewed trade dispute casts shadow over global economy* on 11 June). Following weakness in coming months, we expect the global economy to stabilise early in 2020 and witness a modest recovery onwards, as the stimulus measures from the global central bank and fiscal easing in China start to kick in.

While our baseline assumes modest growth in the global economy, the risk of a more pronounced downturn is increasing. Among the key downside risks are further escalation of the trade war between US and China, possible US car tariffs versus Europe, a hard Brexit this autumn or too slow and small stimulus by the global central banks. Furthermore, another key risk is a negative spiral in confidence and actual spending in the global economy set forth by the current negative headlines. In our view, the risk of the downturn resulting in a global recession is around 30% over the next 18 months.

While there are currently many negative headlines, there are also upside risks (see positive scenario). The US and China could find an agreement in the trade dispute, which would underpin market sentiment by removing uncertainty and supporting a pickup in investment and global trade. Consumer sentiment remains strong. There are few noticeable imbalances in the biggest economies, which normally precedes a recession. Inflation pressures are still modest allowing central banks to extend stimulus rather than stepping on the brakes, keeping easy financial conditions with the potential to support global demand.

In our view, three factors are critical to the economic outlook for the global economy over the next three to six months: (1) monetary and fiscal stimulus in advanced and emerging markets, (2) trade discussions between China and the US and (3) Brexit negotiations. In the table below, we outline some of the key dates for each risk factor for which to watch out.

Key scenarios for the global economy



Source: Markit, Macrobond Financial, Danske Bank

Key factors to watch out for in the global economy over remainder of 2019

Key risk factor	Global policy stimulus			Trade war discussions	Brexit
	US/Fed	ECB/German fiscal	China		
August					24-26-Aug: G7 meeting
September				1-Sep: 10% tariff on certain Chinese goods	3-Sep: House of Commons returns to session (possible no confidence vote soon after?)
	9-Sep: US Congress returns to session				6-Sep: Legal challenge to PM's power to prorugue Parliament begins
		12-Sep: ECB stimulus package unveiled		New top-level talks planned for September	9-Sep: MPs may try to take control of Commons schedule (attempt to prevent no-deal Brexit)
	18-Sep: FOMC meeting	20-Sep: German climate package unveiled	*China does not have pre-set schedule for policy meetings*		29-Sep: Conservative Party Conference begins
October	1-Oct: Appropriations bill must pass to avoid government shutdown			1-Oct: People's Republic of China 70-year anniversary	2-Oct: Conservative Party Conference ends
	8-Oct: Fed Chair Jerome Powell speaks at NABE Conference in Denver				
	9-Oct: FOMC minutes	15-Oct: 2020 budget proposals sent to EU Commission			17-18-Oct: EU summit
	30-Oct: FOMC meeting				31-Oct: Brexit day
November		6-8-Dec: SPD party conference (decision on continuation of grand coalition)		13-Nov: Deadline for Trump decision on European car tariffs	
	20-Nov: FOMC minutes			19-Nov: US exemption on Huawei blacklist expires	
December	11-Dec: FOMC meeting	12-Dec: ECB meeting		15-Dec: 10% tariff on more Chinese goods	

Source: Danske Bank

Individual country updates

US: slower growth but no recession

In the US, we lower our GDP growth profile on the back of slower global growth and no solution to the trade war. We now expect US GDP growth of 2.3% in 2019, 1.7% in 2020 and 1.8% in 2021 (versus 2.5%, 2.0% and 2.0%, respectively, previously).

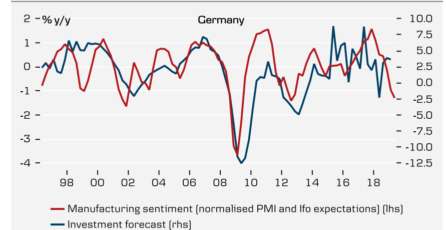
We expect non-residential investments in structures and equipment to decline, as businesses are still reluctant to invest to the same degree in the current environment, with high trade uncertainty despite financial conditions having eased. Without further Fed easing (we now expect five more cuts), the outlook would look worse for investments. In our view, there is no reason to expect a severe slowdown in investments in intellectual properties (one-third of non-residential investments), which would be similar to the 2014-16 experience. We have become more positive on residential investments, as lower mortgage rates are supporting the housing market, after a couple of difficult years. Private consumption fundamentals still look solid with increasing employment, solid real wage growth, high consumer confidence and now a stabilisation in the housing market. While fiscal policy in 2020 is no longer stimulating the economy, the bipartisan budget deal between the Republicans and Democrats on 1 August means that fiscal policy is not likely to be very contractionary.

Germany: caught in the maelstrom of trade war

In *Euro Area Research – Catching up with reality*, 28 June, we flagged that investors should brace for more negative surprises out of the euro area. Indeed, the latest data points to a continued clouding of the economic outlook, especially for the German economy, which remains caught in the crosswinds of the re-escalating trade war between China and the US. The prolongation of uncertainty on the global trade front leaves us to expect a more moderate pace of export growth ahead, as the German export performance remains highly correlated with global trade volumes. Ongoing declines in manufacturing sentiment also point to a correction in the so-far resilient investment growth. Employment expectations have fallen across sectors (though most pronounced in manufacturing) and now signal that manufacturing employment growth will start to go into reverse in H2 19 – a message that also holds for the euro area as a whole. Some light in the gloom continues to come from private consumption, as consumers still find themselves in a benign environment of rising real wage growth.

Overall, we expect the German economy to remain in stormy waters near term and a mild technical recession might be on the cards in Q3. In this light, we expect GDP growth in 2019 to arrive at a meagre 0.5% (0.7% previously) but, in our view, the downturn should be short-lived. The continued low interest rate environment should pave the way for a recovery in construction investment in Q4 and, as the downturn deepens, we would be surprised to see politicians sitting on their hands when important state elections loom in the autumn. Some initiatives are already being discussed in policy cycles, including schemes to avoid layoffs and invest in workers training as well as a climate investment package. Despite the tougher external environment, which we expect to persist into 2020, additional fiscal stimulus measures are set to be a key factor for the German economy to wean itself off its reliance on external demand and help it regain some ground in early 2020. Downside risks remain prominent, not least if US President Trump makes true on his threat to impose car tariffs, but a moderate recovery of German GDP growth to 0.7% (1.3% previously) in 2020 and 1.5% (1.6% previously) in 2021 should still be on the cards in our view.

Manufacturing sentiment points to further downside for investments



Source: Eurostat, Markit, Ifo, Macrobond Financial, Danske Bank

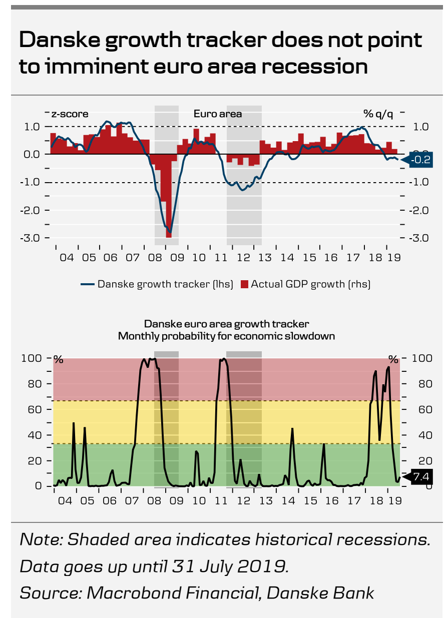
PMI signals manufacturing employment will start to fall in H2 19

Source: Eurostat, Markit, Macrobond Financial, Danske Bank

Euro area: low for longer

Benefiting from robust growth in Spain and France, the euro area economy has so far resisted falling off a cliff in the same way as Germany. Still, quarterly GDP growth moderated to 0.2% q/q in Q2 19 and with the risk of a no-deal Brexit, a replay of the Italian budget fight and rising obstacles for Europe's industrial sector, we expect the economy to remain stuck in low gear in coming quarters. Although financial markets are increasingly pricing in recession fears, economic variables do not tell a story of immediate calamity (see the Danske euro area growth tracker on the right). Nominal wage growth at 2.3% remains the highest rate in 10 years and accommodative monetary and fiscal policies should keep the economy afloat. That said, we remain sceptical about whether another ECB easing package would do much to kick-start the economy, as borrowing costs are already very low and, in our view, the key issue remains a lack of (external) demand, rather than too-tight financial conditions. Overall, we are somewhat more cautious about the investment and export outlook in light of the waning order situation and weaker growth outlook in key export markets, not least China and the US. We lower our euro area GDP forecasts to 1.1% (1.2% previously) for 2019 and to 0.9% (was 1.4%) for 2020.

Danske growth tracker does not point to imminent euro area recession



Note: Shaded area indicates historical recessions. Data goes up until 31 July 2019.
Source: Macrobond Financial, Danske Bank

Japan: strong fiscal boost set to keep growth on track

The Japanese economy has surprised on the upside recently. Private demand has been strong on both consumption and investments and, at the same time, fiscal spending is boosting demand. In 2020, we believe private demand is set to take a hit, as investments are likely to decline when Tokyo Olympics related projects wane and consumers face a VAT hike. Yet another record fiscal budget is in the pipeline for FY 2020, so despite a weaker outlook for exports, we believe demand will stay relatively strong.

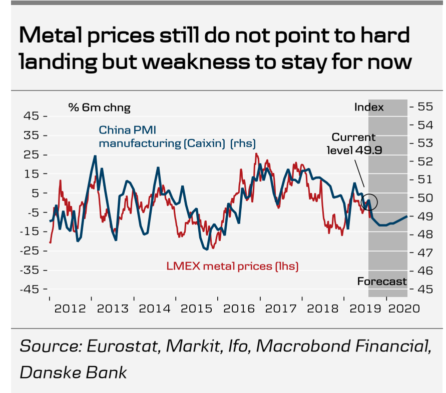
In our view, the probability that the Bank of Japan (BoJ) will ease further has risen but, as long as the economy stays on track, we expect it to be reluctant to do so. An extension of the forward guidance with a promise to keep short- and long-term rates at extremely low levels beyond spring 2020 is the first likely move. The BoJ is very close to running out of dry powder and the economy is increasingly dependent on fiscal policy. If Japan is to meet the, recently postponed, target of fiscal balance in FY 2027, we believe the fiscal stance will have to be less accommodative in FY 2021. Along with a weaker outlook for global demand and less tailwind for investments, we believe this will weigh on growth. We expect GDP growth of 1.4% this year, 0.5% in 2020 and 0.3% in 2021 (versus 1.0%, 0.5% and 0.5%, respectively, previously).

China: weakness to continue but no hard landing

With a trade deal no longer part of our baseline scenario, we believe Chinese activity will be low for longer. In the short term, we look for PMI to fall further to reflect the recent escalation of the trade war. We expect PMI to stay at a low level in Q4.

However, we do not forecast a hard landing in China. So far, there is also still no sign of this. First, metal prices have moderated but have not fallen sharply as we would expect if growth decelerated into a hard landing. Second, China has eased policy since April 2018 through targeted credit easing to the private sector, lowering the Reserve Requirement Ratio, cutting taxes to households and businesses, increased infrastructure spending and announced subsidies for certain durable consumer goods. Over the past week, China revealed that it plans more stimulus for households in 2019 and 2020. The State Council has also stated that it wants to reduce financing costs for small businesses by one percentage point over the next year. We expect a recent reform of the monetary system to pave the way for rate cuts. Finally, we consider the housing market fairly robust due to low inventory levels. As the property sector drives around 25% of Chinese growth, this is an important pillar of support.

Metal prices still do not point to hard landing but weakness to stay for now



Source: Eurostat, Markit, Ifo, Macrobond Financial, Danske Bank

While China has not announced one single big stimulus package, we believe all the different measures taken add up to a decent support to cushion the trade war headwinds.

In terms of our growth forecast, we lower our forecast for 2020 from 6.2% to 6.0%. This would be the lowest rate since the 1990s. It is also the lower bound of the 6.0-6.5% growth range the Chinese leadership set for 2019 (we do not yet know the range for 2020 but we expect it to be unchanged). The risk to our forecast is on the downside, as we cannot rule out Trump escalating the trade war further.

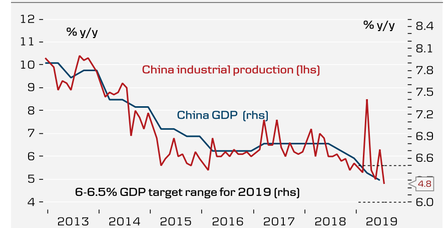
Emerging markets: victim of global slowdown and volatile risk sentiment but saved by monetary doves

Emerging markets have come under additional pressure, experiencing significant capital outflows since late July 2019, when the China-US trade war stand-off escalated and the markets interpreted the Fed's most recent 25bp rate cut as a too-cautious move. The risk sentiment and eagerness towards high-yielding emerging markets assets suffered further from the renewed concerns about Argentina after the incumbent president lost the primary election to the left-wing opposition candidate.

We expect the factors mentioned above combined with the ongoing global economic slowdown to keep creating headwinds for emerging markets. Importantly for the rest of the emerging markets segment, we cut slightly our China GDP growth forecast for 2020. The weaker Chinese growth outlook is set to weigh on neighbouring Asian economies, including the ASEAN 5. We cut slightly our GDP growth forecasts for Brazil and Turkey, which, apart from the global headwinds, are driven by idiosyncratic risks. We see Russia's GDP growth marginally lower than previously, as global demand for commodities is likely to moderate, while crude supply is set to stay abundant due to the US increasing production. We see lower growth in central and eastern European economies due to the elevated risk of recession in Germany, although domestic demand compensates for some of the external headwinds.

However, emerging markets have demonstrated increased flexibility to changing external conditions. Many emerging markets have been proactive in their monetary and fiscal policies, continuing to lower policy rates and providing plentiful FX liquidity to local banks and corporate sectors. Given the dovish change in our call for the US Fed's monetary policy (we expect five rate cuts) and the ECB's softening pace, we do not see broad long-term turmoil in emerging markets or unrepairable contagion from the Argentina crisis.

Chinese GDP heading for lower end of the governments' target of 6.0-6.5%



Source: Macrobond Financial, Danske Bank

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Date of first publication

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