MARCH MACRO UPDATE

All updates to the Q1 Macro Outlook have been outlined below in grey.

US Economic Outlook

- Two rate cuts are on the cards by mid-year, as growth and inflation projections are lowered.
- The Fed will also take note of a material and rapid change in financial conditions.
- Growth is set to be closer to 1.5% in 2020.

Reviewing our Watch list for 2020:

(1) Can the consumer (accounting for almost 70% of GDP) continue to prop up the economy?

Current readings remain supportive. In January, real spending was tepid but positive after a weak ending to 2019. The savings rate has risen to close to 8% suggesting a more cautious attitude. Labour data remains positive as the participation rate has risen in recent months. Consumers remain critical to the growth outlook, with signs of modest expansion in place. Discretionary spending will need to be closely watched in the event of the virus outbreak taking hold in the US.

(2) Will business investment manage to benefit from some of the uncertainties being resolved? Namely the trade conflict with China, less disruptive global supply chains and a potential resolution to Brexit.

The trade resolution has been overwhelmed by the virus impact on trade, supply chains and sales. A prolonged shut-down in China and the potential disruption across other regions is a negative. Overseas sales will inevitably be compromised, as will supply of essential items. There are indications that the return to normality will take longer in China. However, the authorities are expected to respond aggressively with both fiscal and monetary levers. In the longer-term, a reorientation of the supply chain is likely.

(3) Will corporate earnings match the optimism within the broader risk markets? Apart from the importance of earnings for the stock market, clearly it is also necessary to maintain job growth and the ability to increase capital expenditure.

US corporate earnings growth has been cut significantly by analysts. Further reductions will follow unless the backdrop stabilises.

(4) Will the persistent undershooting of core inflation finally end? Wage growth will be crucial, and our base case is for the labour market to tighten further with skill shortages emerging in key sectors.

Inflation will undoubtedly be lower in the coming months reflecting lower energy prices, weaker demand, a stronger US dollar and the potential risk of margins being lowered in the face of tougher overseas conditions.

Other areas to watch:

The Fed will pay attention to the tightening in financial conditions due to the fall in the stock market and wider credit spreads. The episode at the end of 2018 provides a good barometer for how the Fed is likely to respond to current market conditions.

China and Emerging Markets (EM) Outlook

- EM news, particularly in Asia, has worsened.
- Policy easing to continue
- The impact of coronavirus is most profound across Asia: Trade and travel restrictions.

The scene is also set for further monetary and fiscal loosening in the EM block.

Reviewing our Watch list for 2020:

(1) China Phase 1 trade deal – can it translate into a decisive trade deal in 2020? The Phase 1 deal has included a roll back in tariffs from 15% to 7.5% for $120 bn of goods, whilst the new tariff threat has been removed. The thrusts and counterthrusts matter as the two largest economies have managed to undermine global industrial confidence and trade flows. Chinese domestic growth has inevitably slowed as confidence has waned and real activity has followed suit.

The first phase of the trade agreement was signed, and it has led to lower Chinese tariff rates and sets the scene for the second phase in 2021. The positive impetus should seep through once the virus hit abates.

(2) Away from trade tensions confidence levels have begun to stabilise. Looking for a further rebound in tandem with the developed block setting the scene for a potential growth upgrade.

Major manufacturing confidence slump to a record low in February provides a clear indication of a tough Q1. The slump is bigger than expected.

Consensus is for a potential contraction of 8-10% Saar in Q1 GDP.

Consensus is for a rapid V-shaped recovery from Q2 onwards based on a rapid return to normality in terms of supply chains, easing of travel restrictions, impact of monetary easing and further fiscal support.

2020 growth has been trimmed to 4.5%-4.75% from 6%. This is contingent on a Q2 bounce.

(3) Fiscal policy was loosened in China in 2019 and further measures may yet be taken irrespective of the trade deal in an effort to prop up growth close to 6%. India is also likely to embark on fiscal support as growth has slowed to below 5%.

The authorities have indicated that they will provide fiscal support to local governments and provinces. Companies will receive a period of grace which will require banks to be supportive and the PBoC to provide sufficient funding. The Medium-term Lending Facility (MLF) has been reduced and will be cut further.

(4) USD weakening will be welcome, providing relief across the whole EM block. It is unlikely that the Fed or the US Treasury will deliberately pursue a weak dollar policy but a shift in growth differentials and an easing in trade tensions may well provide the backdrop for EM currency appreciation.

EM currencies have weakened considerably as there has been a flight to quality.

European Economic Outlook

- The Monetary policy review will have to take a backseat but the ECB is always slow to respond.
- A rate cut less likely but an expansion of QE more likely by mid-year.
- Pressure for fiscal loosening intensifies – Germany has taken the first step.
- 2020 another year of persistent inflation undershoot with sluggish growth.

Growth has been weak in 2019 and is expected to remain below potential in 2020 in line with the ECB's projections.

Reviewing our Watch list for 2020:

(1) The steep decline in manufacturing sentiment across the region was stark, led by Germany, as it was buffeted by the hit on autos and the slow-down in global growth. There are finally welcome signs of a tentative stabilisation. Clearly it is vital for Europe that the auto industry in Germany retains a firmer footing even though the tariff threat remains in the background.

Sentiment had begun to stabilise – the expected weakening will now provide a trigger for ECB action. The auto sector is in for another tough time with car sales in China grinding to a halt. Even in Europe, quarantine conditions are likely to hamper discretionary spending. Weakness elsewhere in Asia will undermine exports as well. There are indications that the return to normality will take longer in China. However, the authorities are expected to respond aggressively with both fiscal and monetary levers used.

(2) Can consumers stay resilient supported by a relatively strong job market, low inflation and better real wage growth? We will closely monitor consumer spending and confidence levels in the face of persistently low inflation expectations and weak economic sentiment.

Inflation is likely to be even lower due to lower energy prices and a weak business outlook should bolster real wage growth. The labour market has been relatively strong, leading higher nominal and real wage growth.

(3) Business investment was surprisingly strong in 2019 but with large variances across the region. Our base case is for modest gains in 2020 largely due to the base effect (i.e. 2019 was strong). There are still reasons to be positive with credit conditions supportive and consumers relatively buoyant. The threat of tariffs on autos and potentially other European goods remains ever present in the background.

The disruption across a wide swathe of industries will hamper investment short-term. Longer-term impact will be driven by just how prolonged the shut-down in China persists.

(4) Will fiscal policy be used actively with Germany at the forefront? There are some positive signs that there may be an effort to raise infrastructure spending, but policy moves are generally at a snail's pace in Europe and of course a number of countries do not have the room for manoeuvre.

Germany has given a firm signal for fiscal loosening but nothing concrete yet. Inevitably loosening across Europe is on the cards.

UK Economic Outlook

- Second stage of Brexit has begun with hard work ahead.
- The Bank of England (BoE) confused as ever giving conflicting signals.
- Fiscal policy loosening is expected but a major review now likely in the autumn.
- Consumer demand remains relatively strong but this is the only good news.

GDP growth in 2019 slowed to c.1.25% and should remain close to this level in 2020 as well. There is as much uncertainty as in Europe due to the obvious concerns over trade in the new post-Brexit world. Low inflation is also a continual issue into 2020.

Reviewing our Watch list for 2020:

(1) The EU/UK trade negotiations will need to make significant headway by mid-year. Experts are clear that a major re-writing of rules and engagement with the EU will require all 27 members of the EU having to ratify a new Treaty. Additionally, new trade arrangements must be put into place with other major trading partners. Markets and the BoE will certainly be on their toes.

Early days – public comments are a distraction and hopefully not reflecting underlying discussions.

(2) Businesses have held back from investment and surveys are rather pessimistic. An area that will need a close watch – will businesses respond positively to political stability and not worry about what they face from 2021 onwards? Companies are certainly poised to boost capital spending given the solid balance sheets and high cash balances.

No change domestically but overseas conditions are tougher due to Coronavirus.

(3) Will consumers continue to spend? Consumers have been resilient on the back of solid jobs growth, low inflation and higher nominal and real wage growth. There are headwinds ahead such as recent easing in job hiring, a slowing housing market and lower credit take-up.

The Labour market is still resilient, wage growth is holding up and real income is moving higher as inflation has eased significantly.

(4) How big will the fiscal boost be in 2020? The plans are ambitious with higher departmental spending on health, education and the police service. Additionally, £100 bn over five years in infrastructure. The fiscal impulse next year is likely to be around 0.5% and will rise in the years beyond as infrastructure spending begins to take effect.

Significant long-term fiscal easing is still likely but the debate on breaking debt commitments is proving to be a distraction. The Chancellor of the Exchequer may delay major overhaul until Autumn but will have to provide extra funding to help the health service short-term.

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Other G7 Economic Outlook

Canada:

– Canada remains a conundrum.

– Bank of Canada on hold at present but monetary policy should be looser.

Reviewing our Watch list for 2020:

(1) Inflation volatile and close to target. Can the Bank of Canada ignore the rise in all key measures of inflation in recent months in stark contrast to other major economies?

Lower energy prices, a weakening in global trade and uncertainty in demand will provide room for monetary easing.

(2) Watching for confidence levels to turn up. Growth has slowed from the rather freakish growth rate in Q2. The Bank of Canada has highlighted various concerns including business investment, trade and consumer demand.

Growth data is in line with expectations so far but awaiting impact of virus impact.

(3) Potential for further fiscal loosening given the considerable room for manoeuvre.

No plans for loosening at this stage.

Japan:

– Monetary policy to remain ultra-accommodative, with fiscal loosening implemented.

– Growth still tepid and inflation remains far too low.

Reviewing our Watch list for 2020:

(1) The persistent deflationary threat continues. Inflation is still below 1% across a broad range of measures. Should the Bank of Japan (BoJ) stop caring about a structural issue and instead focus on faster growth?

Deflationary trend persists. Sharp Q4 GDP contraction was a surprise due to the tax hike. Q1 looking weak as well.

(2) Worrying deterioration in the Tankan sentiment particularly with regard to business investment and export prospects.

Chinese supply chain disruption in addition to exports being hampered will depress growth in Japan in Q1. A number of key industrial sectors will be hit hard. Travel restrictions across large parts of Asia is not helpful either.

(3) Exports remain under pressure due to weak global trade growth and trade conflicts. Will the better tone finally help lift the gloom and provide support to exports?

As above.

(4) Can the BoJ afford to trim back on bond and ETF purchases? Important to note that both have been trimmed in recent months.

The BoJ and Ministry of Finance (MoF) will have to respond yet again but whether this fundamentally change the growth and inflation outlook is debatable.

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