Extending the Long and Winding Road of the Business Cycle

2019
GLOBAL ECONOMIC OUTLOOK

- We expect the key macro theme next year will be re-convergence of global growth rates, but there are several "ifs."
- The US Federal Reserve needs to resist the temptation to push real policy rates back toward past levels of neutral.
- China needs to diversify the range of tools used to lean against the negative impact of US tariffs on Chinese goods and stimulate private sector growth.
- The European Union needs to mitigate the potential negative economic effects of Brexit, the Italian budget standoff, and the 2019 election.

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One of the defining characteristics of the current business cycle – other than its close-to-record length – is the volatility of global macroeconomic conditions.

A pickup in business investment in 2017 sent a strong stimulus along global supply chains, which led to a more synchronized growth environment. That especially benefited the export-oriented economies of Europe and Asia and pushed global growth rates above their longer term potential. In 2018, growth diverged again, with most developed world economies losing much of the previous year's momentum as the investment cycle faded. Increased uncertainty over an escalating global trade conflict weighed on corporate sentiment and ultimately economic growth in Europe and Asia, while the US economy benefited from an unusually late-cycle fiscal stimulus.

Global financial market volatility has picked up in 2018, pointing to an anticipation among investors that a more serious deterioration in global macro conditions is in the air. That suggests the outlook analysis for 2019 should be more about assessing whether underlying economic conditions allow for an extension of the global business cycle or whether we are indeed looking at a more pronounced downturn in the next few years.

We see two debates as most critical in the assessment of global recession risks. The first is the question of whether the Federal Reserve can successfully normalize monetary policy and engineer a soft landing for the US economy. The second is whether the authorities in China can calibrate their economic policy tool successfully to prevent a hard landing of a rapidly slowing economy without reigniting concerns of a credit crisis.

Can the Fed pull off a soft landing for the US?

The Fed's policy trajectory is critical for the extension of the current business cycle; out of the 12 US rate hike cycles since 1955, eight resulted in a recession. Achieving a soft landing is actually against the odds.

We started 2018 arguing that conditions were as good as they would get and warned that the acceleration in global growth that had pushed up markets to new highs would not continue. US economic growth has held up better compared with other major developed world economies thanks to more bullish business and consumer confidence. At the start of the last quarter of 2018, both still hovered near multi-decade highs.

Partially responsible for the bullish sentiment is the fiscal stimulus enacted in 2017. Yet, at a cost of an estimated $1.5 trillion increase in US debt over the next 10 years, it looks to have delivered a mere 50-basis-point pickup in US GDP growth this year – and the effect is expected to fade quickly over the next few years. One hand of the government, the Department of the Treasury, is spending the taxes from future generations to add stimulus to the economy now, while the government's other hand, the Fed, is raising rates to withdraw stimulus. Those two forces counteract each other, leaving a fairly small net positive impact on the US growth outlook.

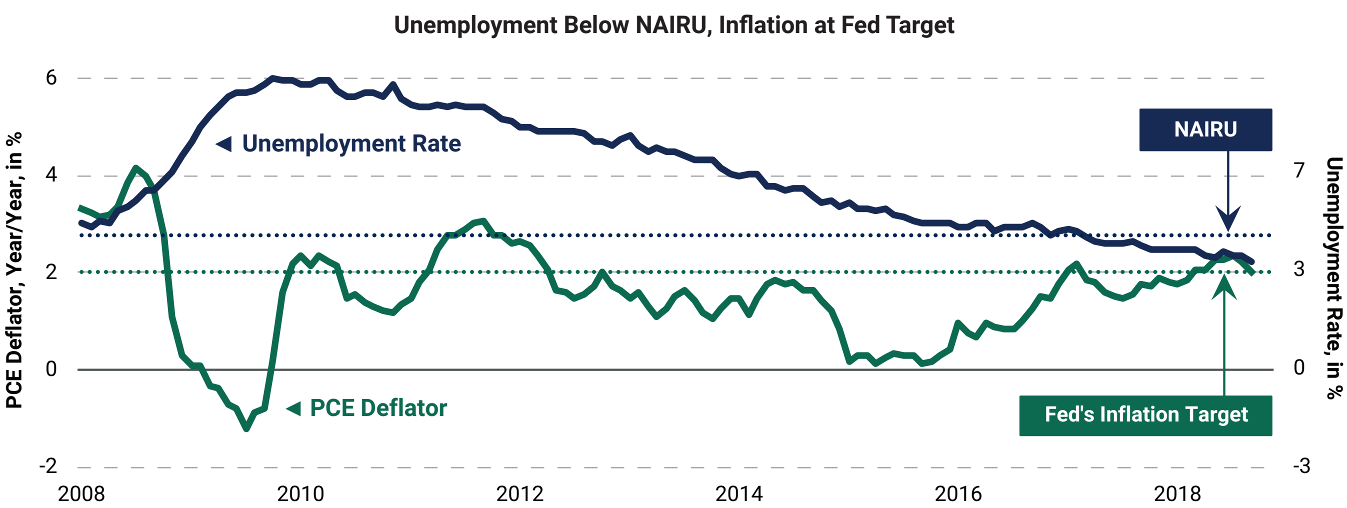
US economic conditions point to more rate hikes in 2019. The long cycle has pushed the US unemployment rate to its lowest level since the late 1960s and the number of people officially counted as unemployed has fallen well below the number of open job positions. Yet that also highlights the increasing problem of labor supply shortages, which will constrain how fast the economy can grow. Somewhat puzzlingly, there is still no sign that the excess demand for workers is significantly pushing up wage growth. Companies continue to protect profit margins even at the expense of further business growth. The good news is that this particular type of corporate behavior also supports an expectation of continued modest US inflation.

We expect that, next year, the Fed will be looking at an economy that is gradually losing momentum, in part due to its own actions and in part due to typical late-cycle labor supply constraints. The International Monetary Fund (IMF) estimates the US output gap, the difference between the economy's steady potential growth rate and the actual realized rate of GDP growth, has not only closed the chasm that opened up during the last recession, but turned positive and is not far off the peaks we saw in the two previous cycles. That's the motivation driving the Fed to normalize US monetary policy. However, as long as wage growth remains moderate and inflation trends close to the bank's 2% target, there is no reason to push rates beyond neutral.

The problem? The so-called neutral level of interest rates – at which monetary policy is neither stimulating nor restraining growth – is only a theoretical concept. The Fed's own estimates indicate we are likely to get there in March 2019, when policy rates are expected to hit 2.75%. Any additional rate increase beyond that will likely seriously weigh on US economic growth.

As a result, we expect the Fed will pause or even more permanently suspend the current rate hike cycle by the summer of 2019. That expectation contrasts with the Federal Open Market Committee's forward guidance, which signals the rate hike cycle to continue into 2020. In our risk management role, we are focusing on any changes in the committee's forward guidance well before an actual pause occurs. If the Fed stops the rate hike cycle at neutral, we expect the US economy will soft-land in 2020 with GDP growth back close to 2%, thus extending the US business cycle beyond our forecast horizon.

The Fed's Motivation to Normalize US Monetary Policy



Source: Congressional Budget Office, Thomson Reuters Datastream, Bloomberg, PineBridge Investments as of 11 October 2018.

Can China avoid a hard landing?

Even though growth has been on a gradual downward slope over the past couple of years, China is still a big consumer. It buys about half the world's coal and steel, highlighting its ongoing importance for commodity producers. China also accounts for more than a third of total sales for Germany's luxury automobile brands; that's about 50% more than the US.

Obviously, a more severe slowdown in China would have negative implications far beyond its borders. That's why it's important to understand whether the administration's efforts to lean against the current slowdown will be successful or not. This is especially difficult to assess.

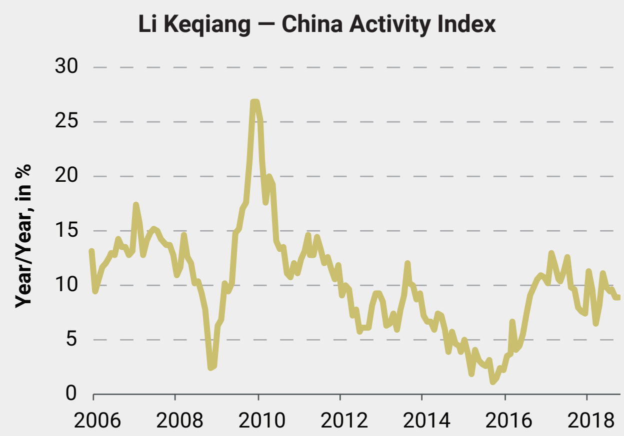
One complication is that we don't know how much China's growth momentum has deteriorated. GDP growth held up fairly well in the third quarter of 2018 with an annual rate of 6.5% – only marginally below the first-half average. However, a lot of anecdotal evidence is pointing to a more serious slowdown in the underlying momentum of economic activity. The average of China's two manufacturing purchasing managers' indexes has fallen close to the expansion/contraction threshold of 50. A number of our contacts on the ground have pointed to deteriorating housing market conditions, and German automakers have issued warnings about sagging Chinese consumer demand.

Of course, the biggest headache for China's policymakers is the more confrontational US trade policy. President Trump, with tacit support from the US Congress, has imposed tariffs on more than $250 billion of Chinese imports and currently threatens to extend the application of duties to the entire $500 billion of goods shipped from China to the US each year. Many US companies have already begun to redirect supply chains away from China. That's a major threat for an economy built around final assembly manufacturing for the rest of the world. We initially underestimated how far the Trump administration was willing to go in escalating the trade conflict. Once US business interests were sufficiently harmed, we believed pressure on elected officials would increase and eventually cap the administration's tariff push.

In fact, the signing of an updated agreement between the US, Canada, and Mexico was initially hailed as evidence that the Trump administration could indeed successfully broker new trade deals. Yet, while opening Canada's agricultural markets for some US dairy products is a positive, increased regulations for auto manufacturing in the three signatory countries will raise the cost of production and make the sector less competitive outside North America. It's hard not to argue the new US-Mexico-Canada Agreement (USMCA) is much less ambitious than NAFTA, the North American Free Trade Agreement, especially given the choice of its name.

Is China Growing or in Recession?

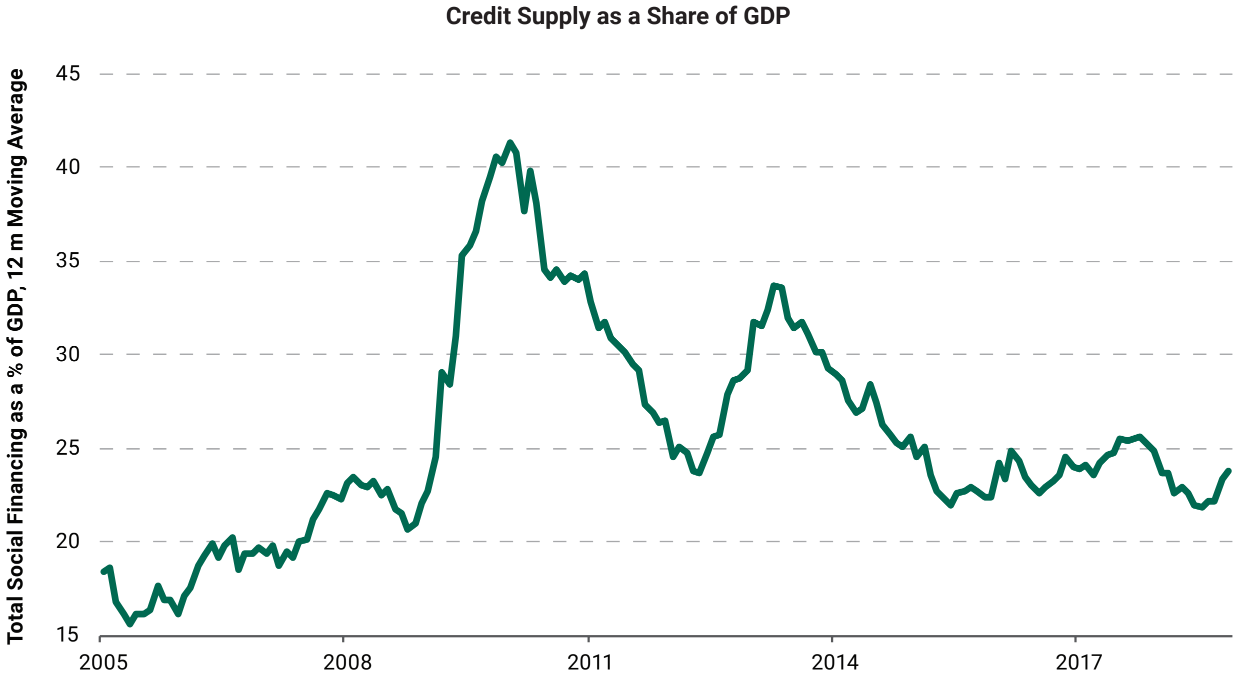
Official Chinese GDP numbers will continue to show robust growth, but private sector indicators of economic activity paint a much more bearish picture.



Source: Thomson Reuters DataStream, Bloomberg, PineBridge Investments calculations as of 11 October 2018.

Fully aware now that the trade conflict with the US is not likely to end anytime soon, Chinese authorities are focused on re-stimulating the economy and offsetting the feared hit to domestic investment. The government has a range of tools at its disposal. This year, we have already seen two cuts in the bank reserve requirement rate that freed up more money that banks can lend to businesses. Total social financing, the Chinese government's measure of credit provided by the financial system to the private sector, is rising again, signaling increasingly looser financial conditions. Since March 2018, the Chinese yuan has fallen more than 10% against the US dollar, a move that has offset a significant portion of the adverse effects from the tariff increase on the directly affected sectors and has increased the profit margins of indirectly affected companies.

China Is Starting to Loosen Financial Conditions



Source: Thomson Reuters Datastream, Bloomberg, PineBridge Investments as of 11 October 2018.

The Chinese government is also using the fiscal tools under its control, whether that means cutting taxes for corporations and households or increasing the pace of local government bond issuance to finance infrastructure projects. We believe the government will be able to offset most of the trade headwinds, and real GDP growth in 2019 should be only marginally weaker than previously anticipated. The real problem for Chinese policymakers is that the tools under their disposal come with potentially serious side effects. Letting the currency depreciate could increase savings outflows and international criticism about currency manipulation. Accelerating the supply of credit to the private sector will further increase the already high level of debt there. Lowering reserve requirements for China's banks could erode the stability of the banking system.

There are no easy choices. President Xi will have to calibrate the three-pronged stimulus in such a way that it will produce maximum impact with minimal pain. If China can stabilize its growth trajectory and prevent a more abrupt slowdown in 2019, the global business cycle can extend beyond our forecast horizon.

Stumbling blocks are scattered in Europe

With US economic growth expected to slow and China's economy expected to benefit from more stimulative policy, we are looking for a broader global growth re-convergence. A change in Europe's monetary policy direction could contribute to that theme.

While we are looking for a pause or even suspension of the Fed's tightening cycle next year, the European Central Bank (ECB) seems set on finally removing its post-crisis policy stimulus. That may turn out to be easier said than done. President Draghi is in the twilight of his term at arguably the second-most important central bank in the world. His term ends in October 2019, but we assume his successor will be announced at the June European Union (EU) summit, which would render Mario Draghi somewhat of a "lame duck" exactly when the bank intends to start raising rates.

The ECB has tapered its asset purchase program and announced a December end to quantitative easing (QE). The bank's forward guidance on rates points to a first hike in September 2019. However, there are many potential pitfalls between now and then. First, there is no agreement between the EU and the UK over a transition period once Brexit becomes a reality at the end of March 2019. Most EU watchers believe a last-minute deal will avoid a more disruptive separation, but it surely ranks high on the list of risks to the ECB rate hike timetable. The standoff between the EU and Italy over the latter's intention to run a higher budget deficit next year in contravention to current EU rules poses a risk to eurozone financial stability and, thus, ECB policy. And the European Parliamentary elections in May could further destabilize governments in Germany and France and strengthen the populist forces within the EU.

It's not just politics; the eurozone economy has also slowed noticeably in 2018. The fading global investment mini-cycle, the increase in policy uncertainty, and the deteriorating global growth backdrop have weighed on business spending. The outlook for consumption, meanwhile, looks more optimistic. Unemployment rates in nearly all of the major eurozone economies continue to fall, with the notable exception of France. In fact, in some countries, such as Germany or the Netherlands, we can see serious cases of worker shortages. While that may cap the downside risk to eurozone growth in the coming years, the days of growing well above the estimated 1.25% potential growth rate seem over for now.

All these issues have the potential to delay the start of policy re-convergence, with significant consequences for currencies. A pause from the Fed would likely reverse the dollar strength we have seen in 2018. However, we expect a sustained euro rebound requires a successful lift-off in eurozone policy rates.

Political hotspots continue to emerge

Politics pose a risk in other parts of the world as well next year. In Japan, the Abe government is dead set on raising the country's consumption tax again. The last time Japan tried to address its massive public debt problem, in 2014, the economy fell into a recession that took a year to dig out from. Economic conditions are stronger today, but growth will surely slow in response to even a modest fiscal tightening.

Other elections that have the potential to disrupt include polls in India, Indonesia, and Argentina, among the major emerging markets. Indian Prime Minister Modi is leading in the early polls and should get reelected. Indonesia's President Jokowi faces what is shaping up to be a challenging election given the softness in Indonesia's economy. Meanwhile, Argentina's President Macri is facing a more difficult battle following the sharp peso depreciation this year and yet another International Monetary Fund bailout. European divisions over fiscal stability commitments may be tested further in the run-up to elections in Poland and Greece.

Avoiding a recession

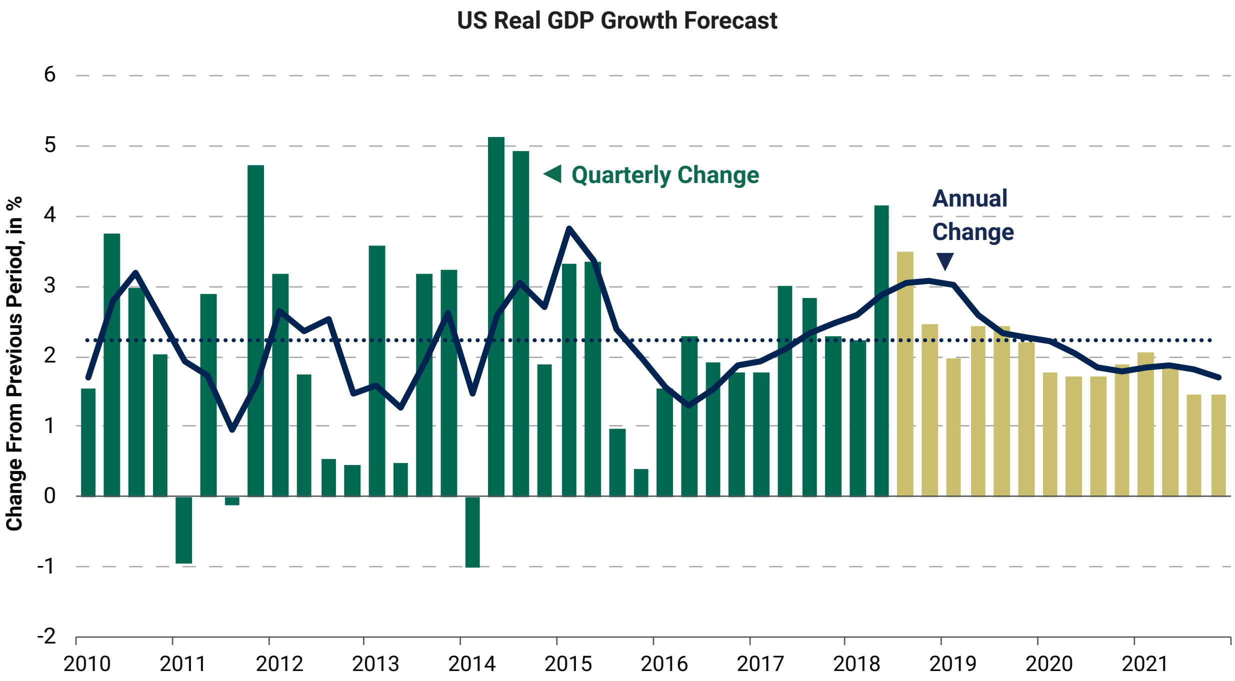
Turning points in global business cycles always generate substantial volatility, but even if we have reached peak growth in 2018, an imminent recession isn't inevitable. Instead, we expect the key macro theme next year will be re-convergence.

Overall, growth in the US will slow back toward the economy's potential growth rate in the next two years, catching up with the rest of the developed world, where the brief growth acceleration has already faded.

The risks to the 2019 global economic outlook, especially those in the economic policy arena, remain elevated. While the roadmap of challenges we need to overcome for an extension of the global business cycle is full of twists and turns, it's worth following.

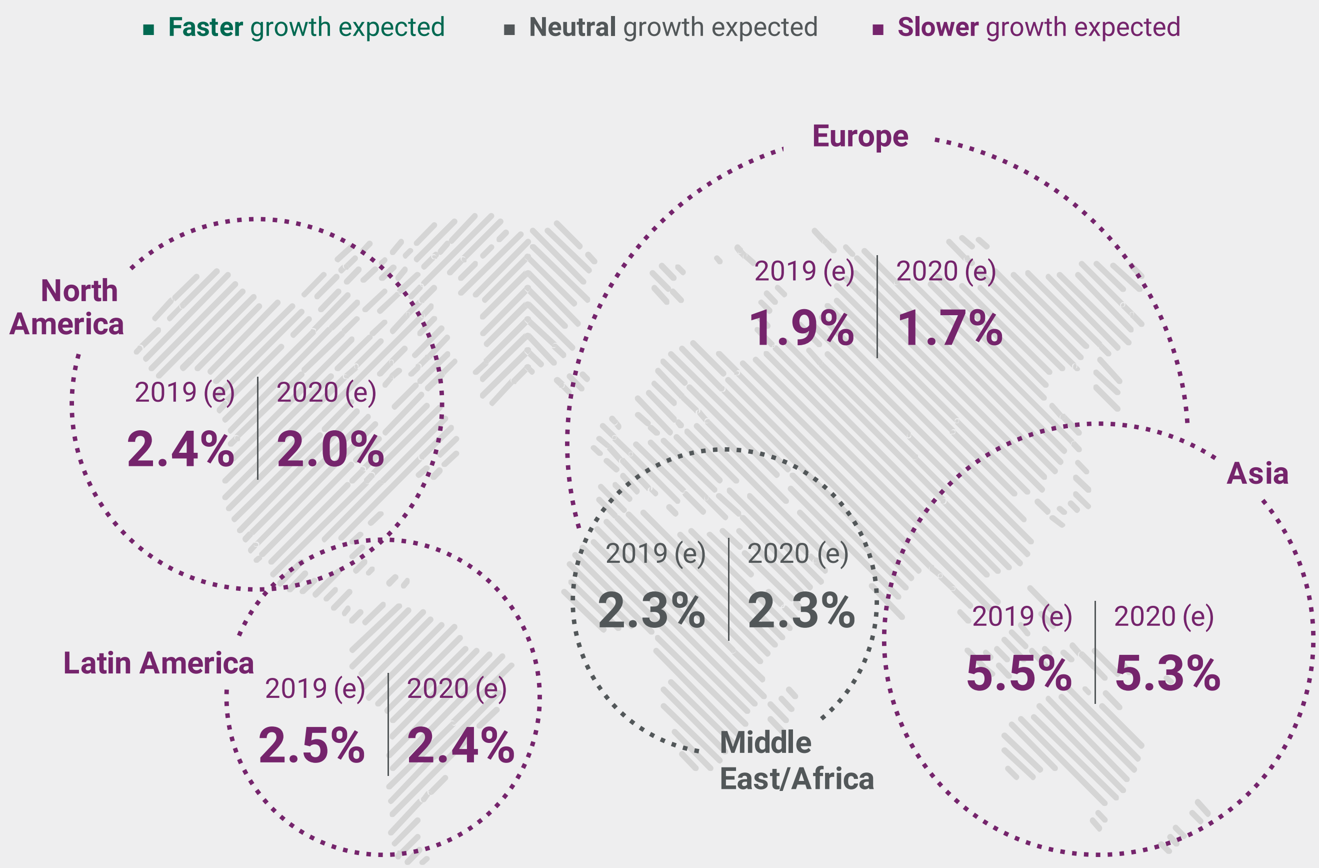
The Fed can successfully soft-land the US economy if policymakers resist the temptation to push real policy rates back toward past levels of neutral. China can successfully lean against the negative impact of US tariffs on Chinese goods and stimulate private sector growth, which will also benefit exporters around the world, if policymakers diversify the range of tools used in the effort. The ECB can set off a broader re-convergence in developed world central bank policy trends if the EU can mitigate the potential negative economic effects of Brexit, the Italian budget standoff, and the 2019 election.

US Economic Growth Will Settle Back to the 2.1% Recovery Average



Source: Thomson Reuters Datastream, Bloomberg, PineBridge Investments calculations as of 11 October 2018.

Global Growth Forecasts



Global GDP Growth: 2019 (e): **3.6%** | 2020 (e): **3.4%**

Source: IMF, Thomson Reuters Datastream, Bloomberg, PineBridge Investments calculations as of 6 November 2018.

About PineBridge Investments

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