# Global Economic Outlook - January 2019

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In the old days (and by old, we mean twenty years ago), markets would start to quiet down in early December. Traders and portfolio managers would curtail their activity weeks before year-end, allowing them to get their minds out of the markets and into holiday parties. And yes, there were still a number of corporate holiday celebrations back then…

Policy makers were also reluctant to spoil the spirit of the season by making big news as the new year approached. All of this allowed business economists to enjoy a welcome respite and to prepare their annual outlooks in quiet repose.

2018, however, closed with a bang. (And it was not a celebratory bang from a fireworks show.) Markets were unsteady throughout December, amid signs of economic moderation, ongoing trade frictions, concern over monetary policy and renewed dysfunction in Washington. Declining and volatile asset prices reflected heightened uncertainty over the outlook.

Yet as we separate noise from signal, we arrive at the conclusion that 2019 should be a successful year for the global economy. Growth may not match the levels seen last year, but that is to be expected; the effects of U.S. tax reform are fading and the impact of trade restrictions is rising.

To achieve a favorable outcome, tension surrounding four situations will have to de-escalate.

- **East-West Trade Relations.** Our expectation is that both China and the United States will retreat from their harsh rhetoric and find ways forward. China is anxious to avoid further economic deterioration and credit stress; the U.S. administration is seeking to avoid further market upset.
- **Brexit.** A disorderly "no-deal" separation has been rising in likelihood, but our most-likely case is an extension of current deadlines. An agreement leaving current patterns of commerce and finance largely in place should follow.
- **Political Dissonance.** An opposition House has been seated in Washington, and European parliamentary elections may find extreme parties making gains. Markets have handled populism in stride up to this point, but may soon find their patience challenged.
- **Monetary Policy Misgivings.** The world's central banks are, rightfully, becoming less accommodative. Some see a disconnect between the market's expectations and those of the U.S. Federal Reserve, the European Central Bank, and the Bank of England. Furthermore, stress between governments monetary authorities is rising. Care must be taken to reach sound decisions on policy, and to communicate them effectively.

### United States

- In the year ahead, the U.S. economy will likely grow at a steady but slower rate than the high levels seen in 2018, as the short-term stimulus provided by tax reform tapers. But slower growth is still growth: employment will remain strong, and inflation will continue to firm. These are the conditions under which we would expect further tightening by the Federal Reserve.
- There is upside potential, if the increased business investment envisioned by the authors of tax reform comes to fruition. And productive trade negotiations would support growth, make its benefits more wide-spread, and reduce the international tensions that characterized 2018.
- Though it remains a low probability, we cannot rule out a recession. Risks are legion: The federal government is starting the year shut down; if prolonged, a fiscal cliff scenario would have severe effects. Unsteady markets could destroy consumer and business confidence, while a rising dollar could stall exports. The current expansion has proven durable and resilient, but rising uncertainty is reflected in rising volatility.

**Eurozone**

- After a disappointing third quarter, soft incoming data has dampened hopes of a strong rebound in the last quarter of 2018. In 2019, the common currency region is expected to continue to grow, albeit at a slower pace. Modest wage growth, coupled with subdued inflationary pressures, will likely underpin private consumption. Exports should recover this year, under the assumption that various global trade uncertainties move closer to resolution.
- Though not in our baseline, a reversal in protectionist and regional populist sentiment could lead to upside surprises. Italy has made enough concessions to end the budget fight with Brussels, and our base case for Brexit imagines commercial and financial channels remaining as open as they are today. Monetary policy is likely to remain very supportive, the European Central Bank (ECB), is unlikely to raise rates this year and fiscal policy is heading in a less austere direction.
- Though we expect the economy to slow modestly, a recession triggered by domestic or external factors cannot entirely be ruled out. The European parliamentary elections in May and senior EU leadership changes later in the year (including the presidency of the ECB) could challenge confidence and create policy uncertainty. Public and private debt levels in the eurozone are high, creating a channel of contagion in a worst-case scenario.

**United Kingdom**

- Lost in the constant hand-wringing over Brexit is the fact that the U.K. economy has soldiered on. We expect it to continue doing so. Prime Minister Theresa May's Brexit deal comes up for parliamentary approval in the week starting January 14; it may get serious consideration, as none of the other options seem overly attractive. Even if the deal is defeated, the EU may grant the U.K. additional time. Both sides have a lot of trade at stake, and have a history of reaching solutions at the 11th hour.
- Considering recent events, there is only limited upside to the British economy. The chancellor has promoted a looser fiscal stance, which should help. And the weakness of the pound (the product of Brexit uncertainty) makes British exports more competitive in world markets. It might also be observed that an orderly Brexit has the potential to deliver some upside surprise through improved sentiment and a rebound in business investment.
- Having said that, the likelihood of a "disorderly no-deal" is still significant and presents downside risk to the U.K. economy. A no-deal would result in a severe recession, a sharp fall in the pound's value, high inflation and sharp interest rate hikes. If combined with a shift in power to the Labour Party (which has vowed to increase government involvement in the economy), things could become difficult.

**Japan**

- Despite the third quarter contraction, the economy is expected to rebound in the last quarter of 2018 as Tankan surveys are pointing towards healthy business sentiment. A healthy labor market will provide impetus to consumption. Preparations for the 2020 Tokyo Olympics will boost investment, but softening external demand will likely result in lackluster export growth. The planned consumption tax hike in October will drive inflation up sharply and pull growth down in that quarter.
- Any trade openings achieved with China could benefit the Japanese and create upside for 2019. The effect of the proposed consumption tax hike could be milder this time than in the past, given the smaller scale of tax increase and government's intent to provide supplementary stimulus to offset the impact to the economy.
- Elevated protectionism is a key downside risk for the Japanese economy. Deteriorating economic conditions will raise concerns over the Bank of Japan's ability to combat another recession, as it remains in a highly accommodative mode. Japan's demographics also present a significant limitation for its economy.

**China**

- China's economy is feeling the heat from elevated trade tensions with the U.S. and subdued sentiment, reflected in recent weakness in exports and manufacturing. As a result, the government will continue to take measures to support the economy in 2019. Growth this year may not match recent levels, but should still outpace the progress seen in most of the other top ten economies.
- The recent 90-day truce indicates that the US-China trade negotiations could be headed in the right direction. There are reasons for both sides to be willing bargainers. A favorable outcome has the potential to deliver some upsides for the Chinese economy through better exports and a reduced level of credit pressure.

 

- China's ongoing financial reform, coupled with the confrontational attitude of advanced economies towards China's trade practices, will continue to weigh on growth in 2019. The risk of a breakdown in trade talks cannot be ruled out entirely, especially if China fails to offer adequate compromise. A renewed escalation of trade tensions amid internal rebalancing will take the steam out of China's economy and raise the risk of a hard landing.

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**Global Economic Forecast – January 2019**

| | 2016 | 2017 | 2018F | 2019F |
|---|---|---|---|---|
| **United States** | | | | |
| Real GDP (Q4-Q4 % change) | 1.8 | 2.6 | 3.1 | 2.1 |
| Unemployment Rate, EOP (%) | 4.7 | 4.1 | 3.7 | 3.6 |
| Inflation (CPI, Q4-Q4, %) | 1.8 | 2.1 | 2.2 | 2.5 |
| Policy Rate (Top), EOP (%) | 0.75 | 1.50 | 2.50 | 2.75 |
| **Eurozone** | | | | |
| Real GDP (Q4-Q4 % change) | 2.0 | 2.8 | 1.4 | 1.7 |
| Unemployment Rate EOP (%) | 9.6 | 8.7 | 8.0 | 7.8 |
| Inflation (CPI, Q4-Q4, %) | 0.7 | 1.4 | 2.0 | 1.4 |
| Policy Rate, EOP (%) | 0.00 | 0.00 | 0.00 | 0.00 |
| Deposit Rate, EOP (%) | -0.40 | -0.40 | -0.40 | -0.40 |
| **United Kingdom** | | | | |
| Real GDP (Q4-Q4 % change) | 1.7 | 1.3 | 1.4 | 1.6 |
| Unemployment Rate EOP (%) | 4.7 | 4.3 | 4.0 | 3.9 |
| Inflation (CPI, Q4-Q4, %) | 1.2 | 3.0 | 2.3 | 1.8 |
| Policy Rate, EOP (%) | 0.25 | 0.50 | 0.75 | 1.00 |
| **Japan** | | | | |
| Real GDP (Q4-Q4 % change) | 1.5 | 2.0 | 0.7 | 0.3 |
| Unemployment Rate EOP (%) | 3.1 | 2.7 | 2.4 | 2.5 |
| Inflation (CPI, Q4-Q4, %) | 0.3 | 0.6 | 1.0 | 1.6 |
| Policy Rate, EOP (%) | -0.10 | -0.10 | -0.10 | -0.10 |
| **China** | | | | |
| Real GDP (Q4-Q4 % change) | 6.8 | 6.8 | 6.4 | 5.9 |
| Unemployment Rate EOP (%) | 4.0 | 3.9 | 3.9 | 3.9 |
| Inflation (CPI, Q4-Q4, %) | 2.2 | 1.8 | 2.4 | 2.1 |
| Policy Rate, EOP (%) | 4.35 | 4.35 | 4.35 | 4.35 |
| **Exchange rates (EOP)** | **Dec-2018** | **Mar-2019F** | **Jun-2019F** | **Sep-2019F** |
| EUR/USD | 1.14 | 1.17 | 1.19 | 1.20 |
| GBP/USD | 1.27 | 1.28 | 1.30 | 1.33 |
| USD/JPY | 109.7 | 110.0 | 109.0 | 109.0 |
| USD/CNY | 6.87 | 6.92 | 6.90 | 6.88 |

*F: Forecast* *EOP: End of period*