2019
The power of the business cycle

Five themes to keep in mind in the coming year

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US monetary policy

<u>US monetary policy is once again the leading factor driving the global economy (lower)</u>

Federal Reserve's stance: restrictive in our view; it is neutral, in the Fed's view

- *Borrowing costs have been rising and consumer confidence may have peaked in December, so the effects should show in December already, in the form of weaker spending. 3Q18 was probably the peak in real GDP growth*
- *Employment growth was very strong in 2018 – labour is cheap, but this is the problem! The low unemployment rate is not reflective of genuinely strong inflationary pressures, and the wage rigidity index is high in historical terms across education levels*
- *According to the Fed's dot plot guidance, the majority of the FOMC expects another 25bps and up to 75bps cumulative rate increases in 2019E, and it is guiding overall for flat rates from 2020E*
- *We believe that one more rate hike is likely; two more are plausible; and an aggressive rate cut phase by 2020E is highly likely*
- *The market is discounting some likelihood of one more rate increase and the beginning of some easing from 2020E*
- *We see 0.5ppts of downside to the consensus real GDP growth projections for 2019E and close to 2ppts of downside for 2020E*

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Trade wars

This dispute cannot be resolved in a matter of months – it is likely to last several years: we assume nothing less than five years, and it may take up to 10

Expect trade talks to proceed in phases: calm; escalation; unreasonable; small deal… & repeat from the start

The US has an equally strong interest in reducing the trade deficit vis-à-vis the EU, as it has with China

The trade war is likely to develop into a currency war over time

Where we stand:

- *There was an improvement in the US trade balance in 2Q, which was undone in 3Q*
- *The upcoming talks with China are unlikely to yield the final breakthrough, but eventual minor concessions are likely. The US is unlikely to stop there, however*
- *The trade negotiations are not the key reason behind the downturn in the business cycle*

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EU politics

There is only one big theme that matters, but two key events to watch, in practice

Themes: voters falling out of love with the EU and wanting big changes

Events: the Brexit negotiations and the EU parliamentary elections in May

Where we stand:

- *The deal offered by the EU to the UK is, de facto, unacceptable for the UK*
- *PM May is thinking tentatively about another attempt at a vote in mid-January, which is likely to fail, at best; at worst, it will be delayed again*
- *There is no real way to change the deal into something that the UK parliament will accept*
- *There is also no genuine desire to have the UK crash out of the EU. The only real option to break the deadlock is for the UK to call another election. A second referendum is a popular option, but not one that will yield a solution*
- *The most likely scenario is an extension of the talks. There is only one binding date: 29 March 2019*
- *The EU parliamentary elections are due in May. EPP stands some chance of winning again, but there is a high risk that the "Eurosceptic" front, led by the Italian vice PM, will win*
- *A victory of the established party would provide a superficial sense of stability; a victory by the anti-establishment would be likely to be better for the EU's future*

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EU economic downturn

Eurozone data show a clear downturn of activity, led by Germany and followed by Italy

Inflation is close to the peak, ECB rate hike is irrelevant

The ECB is likely to end up implementing quantitative easing (QE) again in 2020E. The Federal Reserve may do something similar by then too

Where we stand:

- *Unemployment rates to rise by summer 2019E*
- *Central Europe to experience a tiny and shallow downturn in 2019E. However, wages should continue to rise*
- *The Eurozone needs a different fiscal framework, but it should agree to some fiscal easing in 2020E, at best*
- *It does not matter who leads the ECB after Draghi; the ECB is being pushed into more QE because there is no agreement on anything else*

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Nobody escapes the business cycle

Business cycles have become longer, but will never disappear completely as long as credit exists

We have passed the peak – this is what is driving the stock market sell-off

2019E is likely to see further financial market weakness as unemployment rates and defaults are likely to appear

The market will force central banks to re-start the stimulus

Watch out for:

- *The peak in inflation – likely before summer 2019E*
- *Persistent equity market sell-off to lead the FED and the ECB to capitulate eventually, but it may take six more months*
- *Housing markets overvalued in the core Eurozone and potentially in the US*
- *Any country with fiscal space is likely to use it in 2020E. The US is running out of fiscal space; the Eurozone needs big policy changes, or something big will break eventually*

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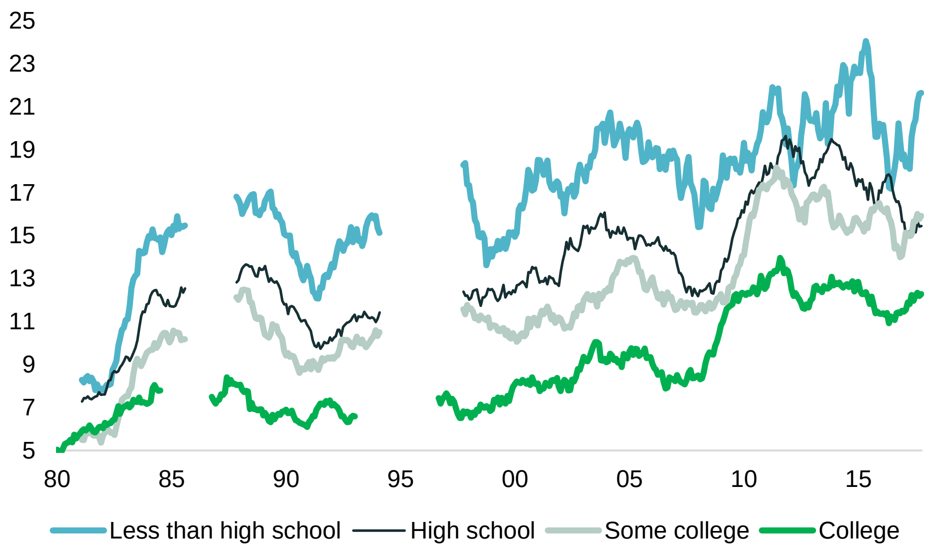
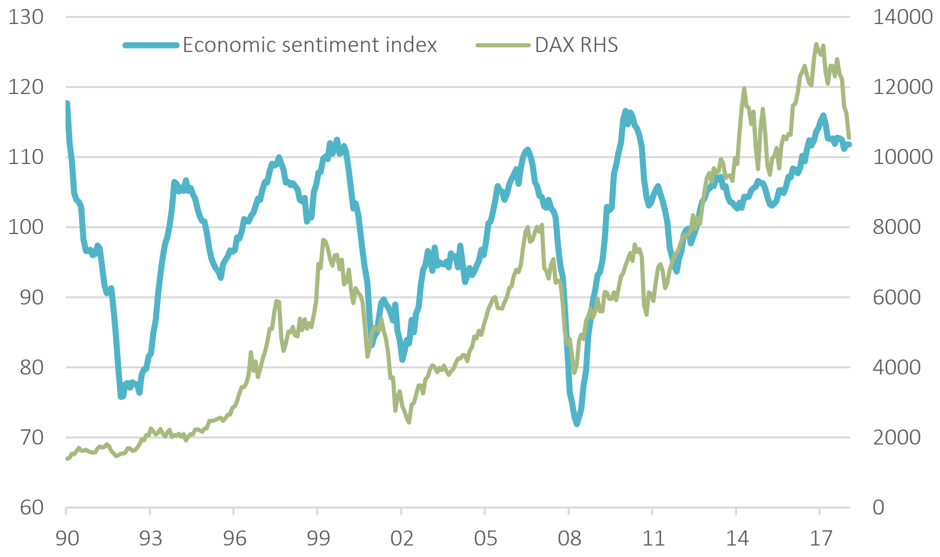
Two key charts to keep in mind

US wage rigidity indices



Germany: sentiment & stock market performance



Sources: www.frbsf.org for the wage rigidity index; Bloomberg, ADA Economics

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