

Quarterly Macro Report

4th Quarter 2019

After a long hot summer, winter is on the way, a transition not entirely unsuitable as a metaphor for the economic outlook, which has also turned cloudier and cooler. But unlike in many previous cycles, this time the anchoring of inflation expectations, itself a remarkable achievement, has left central banks with room for manoeuvre.

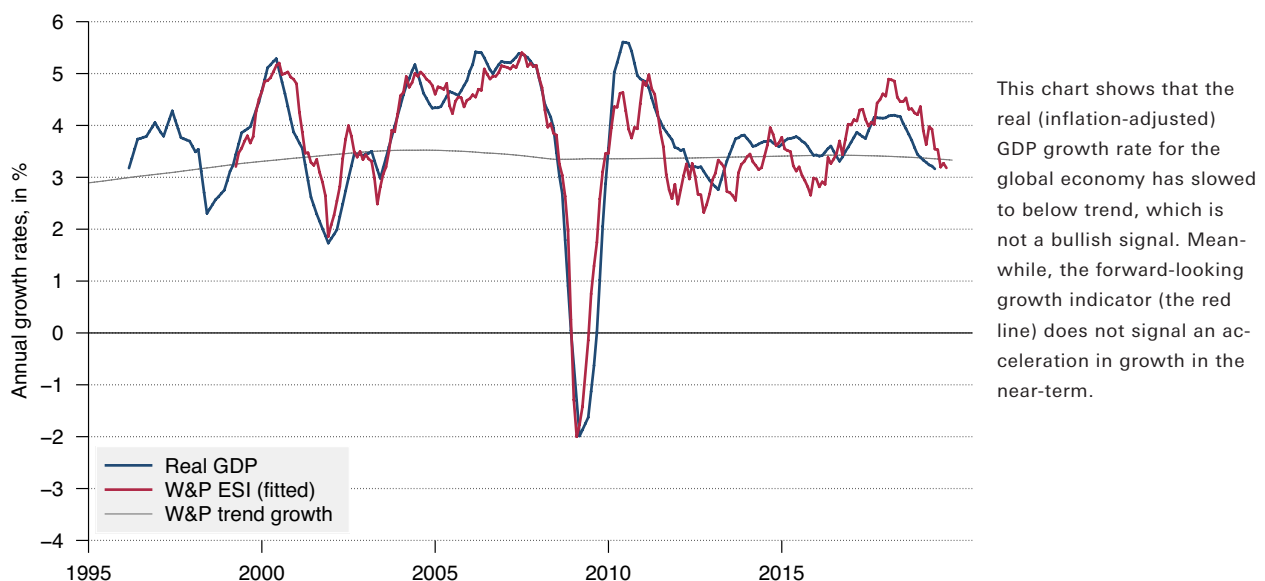
While the media has been proclaiming a looming recession, we would point out that based on the latest data it's still impossible to declare that a recession has indeed begun or is imminent. What is clear, though, is that the already marked slowdown in growth, shown in the chart below, could easily slacken further if helped along by events. Such a trigger event could be political in nature—say, the Middle East and oil prices—or the realisation of self-fulfilling prophesising, with mounting expectations of recession actually causing one.

The chart also shows that there have been phases of sub-trend growth over the past decade that did not foreshadow a recession. And while pundits are keen to point to the bearish signal of the inverted yield curve in the United States, where short-term rates have at times been

higher than long-term rates, we also know that there have been periods when the US yield curve has inverted, with no recession emerging for the next couple of years.

Be that as it may, central banks are trying to reverse the recent growth slowdown with dovish signals and policies. Several central banks have cut interest rates this year. What is unusual this time around is that interest rates are already very low. Thus, in such an environment, the modest rate cuts available today will be less powerful than larger cuts have been historically. Unsurprisingly, then, we are hearing more talk about ways central banks might use even stronger medicine. This stronger medicine essentially comes in the form of central banks deciding to expand their balance

Fig. 1: World growth and world growth expectations now below trend



Source: Thomson Reuters Datastream, Wellershoff & Partners

sheets by buying more assets – typically government bonds. Given the limited scope for big interest rate cuts today, the lower long-term bond yields in recent months may well reflect the market’s expectations that central banks will decide for the stronger medicine of increased asset purchases.

In sum, a decade after the global financial crisis, central banks are still finding it difficult to reduce their balance sheets.

An unhelpful political backdrop

Politics used to matter less for economic growth trends in the advanced economies because, apart from war, their political systems were designed to prevent a single person or party from exerting too much influence over the levers of power. But today politics is back in ways that are challenging that old orthodoxy.

The list of political risks that could have an impact on the global economy is becoming longer – and this at a time when global growth is anyway slowing. Most prominent on the radar screen is the fluctuating temperature of the trade dispute between the United States and China. There has been a growing sense that this conflict suggests a disruption far more profound and structural than soybean quotas and tariffs on washing

machines. It may signal at least a partial reversal of globalisation, forcing many companies to rethink their supply chains. Some of these big logistical changes should show up in unexpected inventory growth that would temporarily impact GDP calculations.

This is already what the GDP data from the UK has shown: A build-up of stocks of all kinds in the run-up to Brexit is evident from the quarterly GDP numbers. The slowdown in the growth of trade globally can also be attributed in part to politics. The US-China trade spat and the Brexit-related reconfiguring of supply chains are just two of the most prominent political rocks in the road. There is also the escalating dispute between two other large, economically important trading nations, Japan and South Korea. Tensions between Iran and the US are also ongoing and could flare up at any moment, rippling out to oil prices, airline stocks and consumer and business sentiment generally. Argentina’s latest dance with sovereign debt default and its imposition of capital controls are blows to the region and to trade with its bigger neighbour, Brazil.

This partial list of active political hotspots would be remiss if it failed to mention North Korea, which remains an unresolved, multipronged source of tension involving China, the United States, Japan and, of

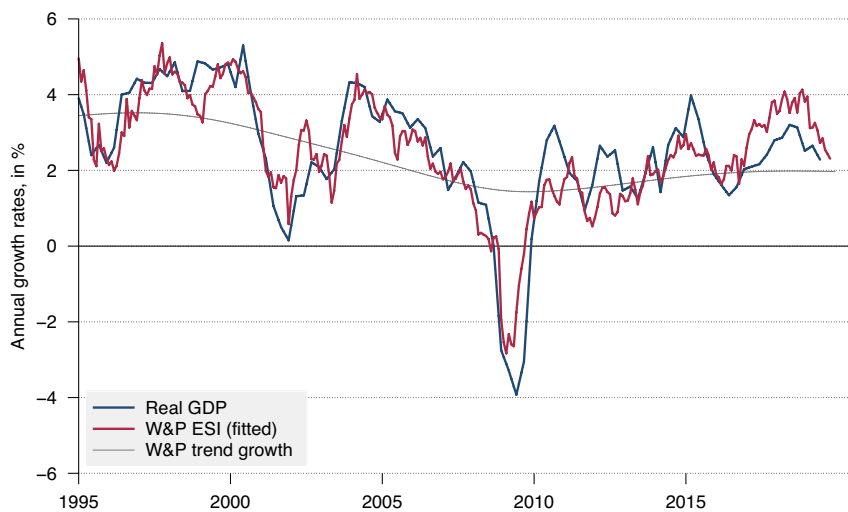
Table 1: Macroeconomic estimates

	Real GDP growth in %						Inflation in %					
	2017	2018	2019P	2020P	2019Δ	2020Δ	2017	2018	2019P	2020P	2019Δ	2020Δ
USA	2.4	2.9	2.2	1.6	-0.1	-0.3	2.1	2.4	1.9	2.3	0.1	0.2
Euro area	2.6	1.9	1.2	1.1	0.1	-0.1	1.5	1.8	1.4	1.5	0.1	0.1
Germany	2.8	1.5	0.6	0.6	0.0	-0.6	1.5	1.7	1.7	1.9	0.2	0.3
France	2.4	1.7	1.3	1.2	0.0	0.0	1.0	1.9	1.3	1.7	0.1	0.3
Italy	1.8	0.7	0.1	0.4	0.1	0.0	1.2	1.1	0.8	1.2	0.0	0.1
Spain	3.0	2.6	3.1	1.7	0.8	-0.1	2.0	1.7	1.0	1.4	0.1	0.2
United Kingdom	1.8	1.4	1.1	0.8	-0.1	-0.4	2.7	2.5	1.8	2.0	-0.1	0.0
Switzerland	1.7	2.5	0.8	0.8	-0.5	-0.6	0.5	0.9	0.5	0.5	-0.1	-0.3
Japan	1.9	0.8	0.8	0.4	-0.1	0.1	0.5	1.0	0.6	0.8	-0.1	0.0
Brazil	1.1	1.1	0.9	1.6	0.1	-0.8	3.4	3.7	3.4	3.8	-0.2	-0.3
China	6.9	6.6	6.2	5.7	0.0	-0.3	-0.5	0.6	2.7	2.6	0.4	0.1
India	7.2	7.0	6.0	6.3	-1.0	-0.9	3.3	3.9	3.9	4.1	0.0	-0.1
Russia	1.6	2.3	1.1	1.7	-0.1	-0.2	3.7	2.9	4.3	4.3	-0.7	-0.2
World (PPP)	3.8	3.6	3.0	3.2	-0.2	-0.3	3.2	3.6	3.4	3.5	-0.2	-0.2

E Estimates Wellershoff & Partners Δ Deviation from consensus economic forecasts

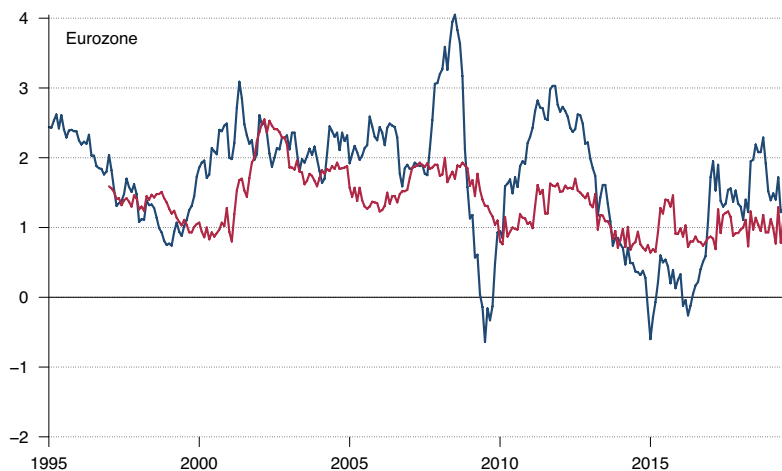
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: W&P US growth indicators have correctly predicted the slowdown



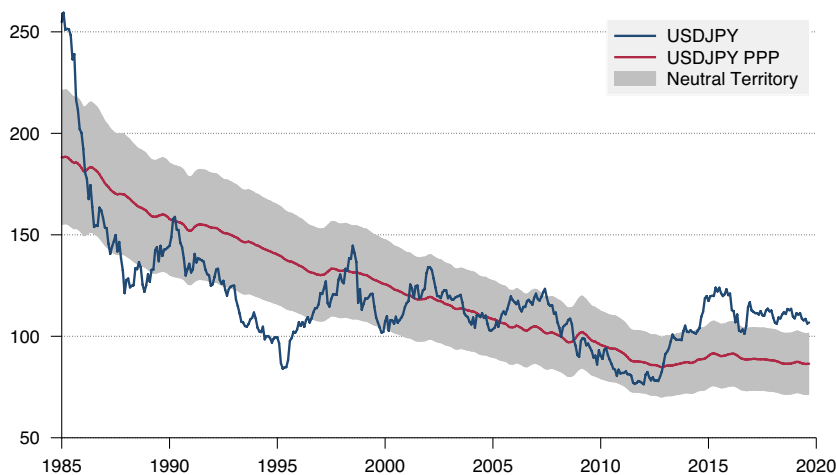
This chart shows that our economic growth indicators for the US have correctly anticipated the recent slowdown. Unlike in much of the rest of the world, however, US growth continues to be above trend.

Fig. 3: Different this time: The inflation story in Europe



In 2007, in the run-up to the global financial crisis, the ECB had to hike interest rates because headline inflation had risen to 4%. Today, inflation is “too low”. This means that the ECB has to look for new ways to pump money into the economy.

Fig. 4: The Japanese yen’s safe-haven appeal seen again recently



We have expressed the view in these reports that the Japanese yen had untapped appreciation potential because it was substantially undervalued against a range of major currencies, including against the US dollar. During the summer we began to see the yen start to close some of this undervaluation gap.

Source: Thomson Reuters Datastream, Wellershoff & Partners

course, South Korea. The strategic objectives of China and the United States differ with regard to the Korean Peninsula. Asia is home not only to superior economic growth, but also to deep political fault lines. At a moment when the United States and China are engaged in a tit-for-tat trade conflict, what happens in Hong Kong and North Korea, not to mention Taiwan, can suddenly take on great significance for markets.

Revived safe-haven appeal of the yen and the franc

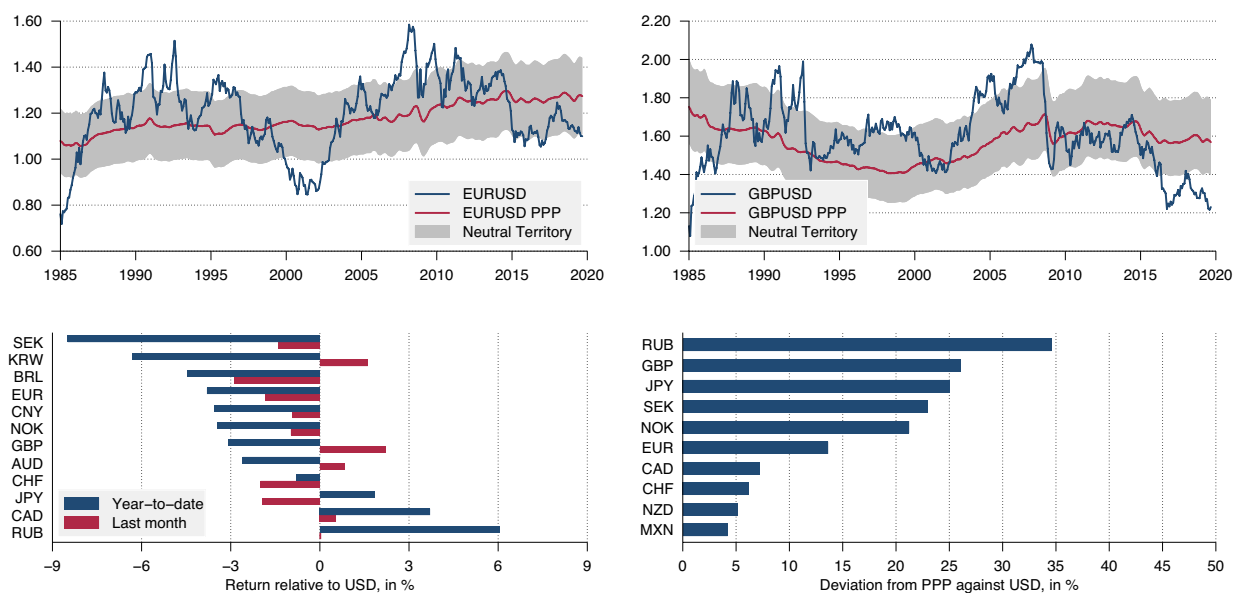
Market turbulence over the summer saw both the Swiss franc and the Japanese yen appreciate against the US dollar and the euro. The safe-haven nature of these two currencies is supported by their large current account surpluses, which continue to reinforce their economies' substantial net foreign asset positions. In other words, the residents of both of countries hold a considerable amount of assets abroad, some of which could be repatriated in times of crisis.

We see several good reasons for the yen to appreciate more than the franc. First, in our view, the yen continues to be substantially undervalued against many currencies, including the US dollar. Our purchasing power parity estimates put the yen at around JPY 86 per USD. While still undervalued, the franc is currently

less so against the dollar. We currently calculate the franc's purchasing power parity at around 0.93 against the dollar and 1.19 versus the euro.

The second reason we see greater appreciation potential for the yen than for the franc is because the Swiss National Bank has announced its readiness to intervene in currency markets to dampen the franc's appreciation. Indeed, this appears already to have happened during the summer. In contrast, Japan is a G7 member, a group that agrees not to intervene independently in the currency markets without the blessing of the other states. This raises the bar against outright FX intervention by the Bank of Japan.

Fig. 5: FX performance and valuations



PPP estimates based on producer price indices
Positive deviations from PPP indicate an undervaluation against the respective currency and vice versa.

Source: Thomson Reuters Datastream, Wellershoff & Partners

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