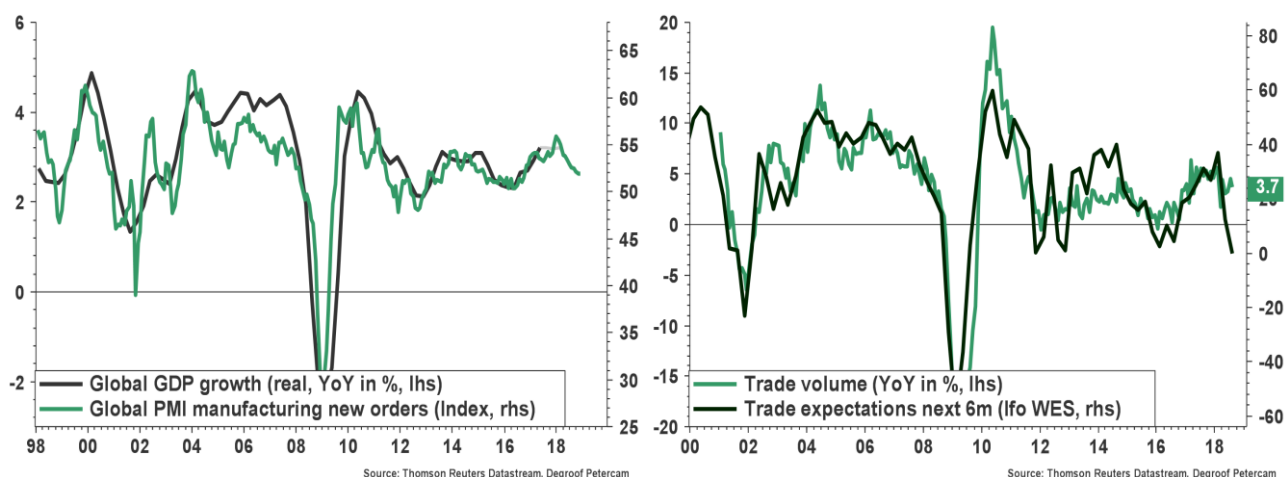


Global economy set to reveal more evidence of cooling in 2019

Recent developments in financial markets suggest investors are coming to terms with our long-held scenario that economic growth would slow down in the second half of this year. Although talk of an imminent recession seems overdone, the world economy looks set to reveal more evidence of cooling next year. While current tariffs are still modest and the tone of debate between the US and China has softened a touch, the risk of escalation remains significant. Indeed, tensions go beyond the issue of the bilateral trade balance. China’s economic, cultural and technological rise over the last three decades have also undermined the US superpower status. But even apart from that, expectations for global trade already point to further deceleration in the months to come. This is consistent with reduced prospects for global growth. Since the US economy is still growing firmly and core inflation hovers around the 2% target, this will not deter the Fed from raising interest rates next week. That said, the strong dollar, global trade tensions and fading effects of US stimulus look set to translate into slower growth in 2019. At some point, this is likely to convince US monetary policymakers to move to the side lines. Meanwhile, despite policy easing, Chinese credit growth continues to decelerate. Therefore, risks to economic activity are still skewed downwards. On the inflation front, despite the strong cyclical global recovery over the last two years, wages and prices have reacted only modestly. True, headline inflation accelerated significantly over the last two years. But this was mostly due to the sharp increase in energy prices. Base effects and the recent fall in oil prices will now cause headline inflation to fall pretty sharply in 2019. There has been a lot of talk about the death of the Phillips curve but it might be premature to confirm that message. All in all, underlying inflationary pressures have been gaining strength. At the same time, other factors including globalization, technological change and digitization, the ageing of the population, insufficient labour union power, lower anchored inflation expectations and sluggish productivity growth suggest that inflation is unlikely to break out any time soon. Indeed, in recent years wage growth has become less sensitive to changes in labour market conditions.



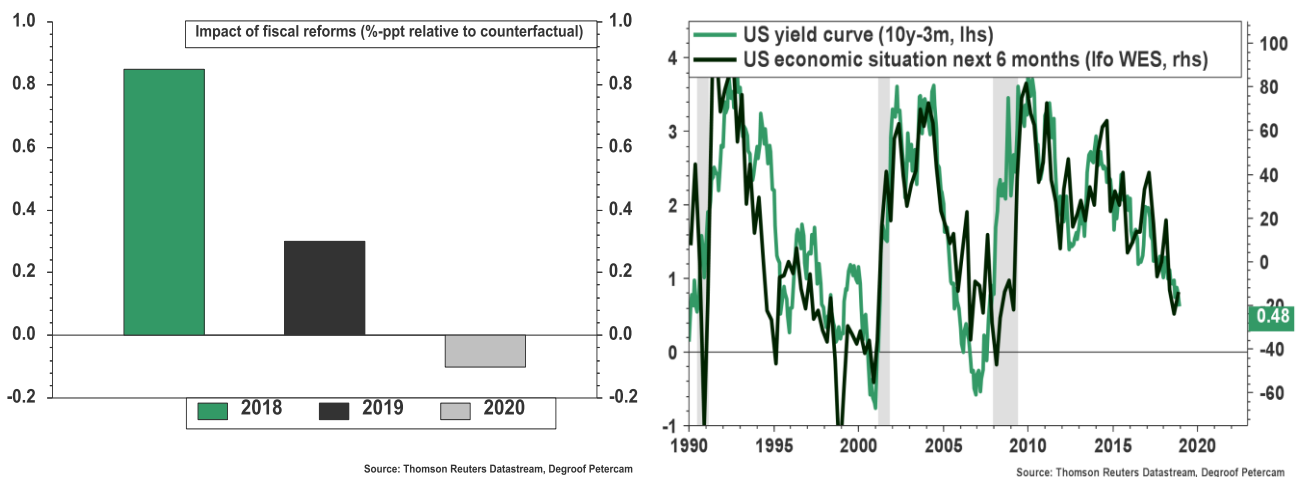
Fed to adopt a more cautious wait-and-see approach

The US economy has fired on all cylinders over the past two years. The combination of tax stimulus and increased government spending provided significant tailwinds to growth in 2018. In the second and third quarter economic

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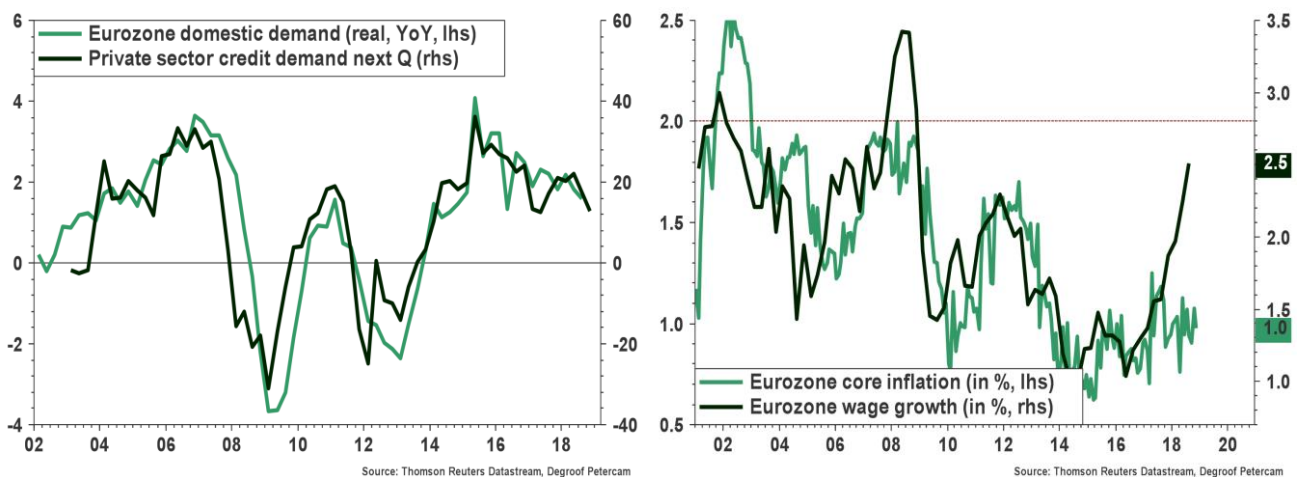
growth came in at respectively 4% and 3.5% (annualized). Estimates suggest that a great deal of these spectacular growth figures can be explained by the budgetary initiatives taken by the new Trump Administration. This year's growth was lifted by around eight tenths of a percentage point. Looking forward, however, that positive effect ebbs away. The United States are currently seeing the second-longest economic expansion in history. Expansions don't die of old age and the overall picture remains robust but at the same time it is difficult to see how the current pace of activity can be sustained for much longer. Third quarter GDP growth (3.5% QoQa) was boosted by inventories while investment stalled and net trade contributed negatively. Indeed, the strong dollar is weighing on exports. In addition, apart from the temporary fiscal boost, there are already some signs of hesitation in areas of the economy sensitive to higher interest rates such as housing and car sales. Meanwhile, the yield curve has continued its flattening trajectory. This is something to monitor closely as it tends to go hand in hand with slower economic growth further down the road as the graph below suggests. Trade poses an additional risk. The conflict between the US and China remains unresolved even though we are seeing some softer talk on trade more recently. Data on the inflation front are sending mixed signals. Sharply lower energy prices mean that headline inflation will fall substantially in the first half of 2019. Core inflation, on the other hand, has firmed materially to just below 2% on the back of higher wage growth as the labour market is nearing full employment. But with unit labour cost growth still subdued, it should remain well in check. All in all, the Fed is still on course to hike rates in December and March. But we expect US policymakers to adopt a more cautious stance afterwards when more evidence of cooling economic activity shows up in the data.



Eurozone economic activity falling back towards potential

Weakness in industrial activity, partially reflecting temporary factors such as the implementation of new emission testing procedures in the car industry, and weaker confidence indicators suggest that the pace of economic activity is softening. The latest eurozone PMI data are back at levels last seen in 2016. The European economic cycle has seen solid improvement since the second half of 2016 on the back of ample spare capacity and economic activity is now falling back to growth rates more in line with potential. The eurozone unemployment rate has dropped back to just over 8% and wage growth is finally picking up, implying that underlying price pressures should move somewhat higher from here. That said, headline inflation (now at 2%) will be negatively impacted by base effects related to the evolution of energy prices. All in all, the ECB is still on course to end its asset purchases by the end of this year. But it is still too soon for an actual rate hike. The ECB systematically got its inflation forecasts wrong and the 2% target is still way out of reach. As things stand, the first rate hike will probably not come before September 2019. Italy's new populist Eurosceptic coalition government will remain a source of uncertainty for both Italy and the Eurozone. Confidence in Italy has dropped significantly following the elections earlier this year and the budget dispute with the European Commission. Some kind of budget deal looks

likely but the more important issue is that economic growth remains hugely disappointing. As such, without further institutional progress in the Eurozone, the country remains vulnerable to periods of self-fulfilling panic reactions in markets. The so-called ‘yellow vest’ protests have forced French President Macron to ease budgetary policy and the budget deficit for 2019 is expected to move beyond 3% of GDP. This is not a huge issue in itself but countries like Germany and the Netherlands are likely to interpret it as more evidence of fiscal profligacy, hindering institutional progress towards more solidarity. Meanwhile, Brexit uncertainty is still huge. But at least, Prime Minister May survived the Conservative Party’s confidence vote. As long as she doesn’t resign, and the Conservatives remain in government, the risk that the party could be led by a hardline Brexiteer for the last few months of the Article 50 withdrawal process is now much lower. While the EU will probably offer guarantees and promises that it will not use the backstop as a tool to permanently trap the UK in the EU customs union, there is very little chance that it will be removed. The question is whether this will satisfy the hard Brexiteers and the Northern Irish DUP. At this point, the current deal is unlikely to pass parliament. Therefore, even though the soft Brexit scenario is still the most plausible one, chances of a hard Brexit remain significant.



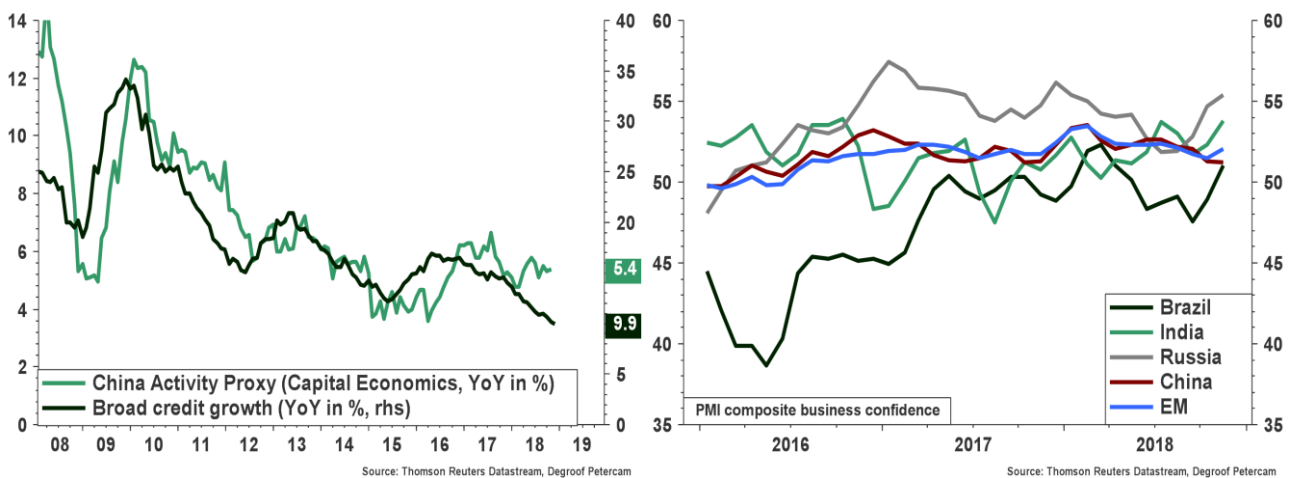
Boj remains put and looks at financial vulnerabilities

Economic activity in Japan has clearly softened since the start of the year. And the outlook for economic activity remains downbeat as the government has pledged to press ahead with the sales tax hike scheduled for October. Meanwhile, incoming inflation prints remain modest. Headline inflation will decrease significantly on the back of base effects linked to energy prices while underlying price pressures may strengthen a bit further on the back labour market tightening and accelerating wage growth. An increase in the regular earnings number encouraging in this regard. Survey evidence still points to a lack of skilled labour and a high ratio of job-openings to applicants. But so far core inflation has increased only a bit. The BoJ remains firmly in easing mode, allowing only technical adjustments to its policy of yield curve control for now until more evidence of price pressures appear. In addition, the BoJ issued a stronger warning for side-effects of its policies on financial intermediaries over the long run.

Chinese credit slowdown takes its toll on growth

Budgetary and monetary policymakers in China are stepping up efforts to arrest the ongoing slowdown spurred by a decline in credit growth and international trade tensions. Renminbi depreciation, lower interbank interest rates, tax cuts and extra investment spending should at some point produce stabilizing results. But for now at least the risks are still tilted to the downside. More broadly, the situation in the emerging world is very different from region to region and from country to country. Recent upheaval in EM financial markets has sparked comparisons to the debt crises of the 1980s and 1990s. True, tightening financial conditions usually herald a more

difficult environment for emerging markets. That said, the analogy looks of the mark. Apart from Turkey and Argentina the risks facing most EMs today are significantly smaller. Indeed, the vulnerability of EM in general is lower compared to past decades. Many EM have improved their macroeconomic frameworks, including the use of flexible exchange rates, ample reserve buffers and multiple financial safety nets. For more info, please see [this blogpost](#). In Brazil, the extreme-right Jair Bolsonaro emerged as the winner from the elections. He will be confronted with a challenge. The sustainability of Brazil's public finances will depend on the continuation of the ongoing public spending reforms. In India, the spat between the Modi government and the central bank has raised questions on the independence of the central bank in the wake of a default of a major infrastructure funding company (~shadow bank).



Forecasts for 2018-2019

	<u>GDP</u>				<u>Inflation</u>			
	2017	2018	2019	2020	2017	2018	2019	2020
US	2.3	2.9	2.2	1.4	2.1	2.5	2.1	2.1
		2.9	2.6	1.7		2.5	2.2	2.0
Eurozone	2.5	1.9	1.4	1.2	1.7	1.7	1.7	1.7
		2.1	1.8	1.6		1.7	1.6	1.7
Japan	1.7	0.8	0.9	0.8	1.1	1.1	1.2	1.2
		1.1	1.2	0.2		0.9	1.1	1.7
China	6.7	6.2	5.7	5.3	2.2	2.2	2.4	2.3
		6.6	6.3	6.0		2.1	2.3	2.7

Update December 2018, Consensus forecasts

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