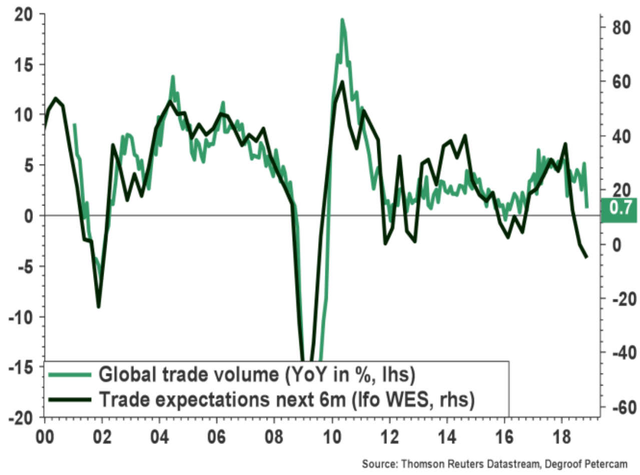
MACRO ECONOMIC UPDATE

February 2019

Global cooling, lowflation and market volatility pushing central banks in more cautious stance

- ✓ The world economy reveals more evidence of cooling with leading indicators mostly pointing to slower activity ahead. Growth in world trade volume has decelerated significantly and risks are still skewed to the downside.
- ✓ At the same time, some arguments caution against too much pessimism. These include more positive signals surrounding the trade talks between the US and China, central banks' willingness to remain flexible, lower energy prices and the implementation of Chinese stimulus measures.
- ✓ Headline inflation will continue to fall as a result of base effects linked to the evolution of energy prices. Core inflationary pressures, meanwhile, remain tame in general despite recent acceleration in wage growth.
- ✓ The upshot is that central banks are absolutely in no hurry to tighten monetary conditions. If anything, their tone of voice has turned even more cautious.



US economy holds up well but slower growth on the horizon, Fed goes into 'patient' mode

- ✓ The US economy has fired on all cylinders over the past two years. Incoming economic and survey data remain pretty solid. Moreover, the labour market continues to post an impressive job gains.
- ✓ That said, the fading of the fiscal stimulus, the lagged effects of earlier rate hikes and a weaker external environment in combination with the strong USD suggest that growth will weaken from here.
- ✓ Headline inflation will decrease substantially in the first half of 2019 while core inflationary pressures continue to hover around the Fed's 2% target.
- ✓ The combination of lower anticipated future activity, modest inflation and volatility in financial markets has caused the Fed to become more cautious. In fact, over the last few months the Fed has taken a remarkable U-turn towards more 'patience'.
- ✓ Mr. Powell pointed to several factors including the recent volatility in financial markets, the uncertain impact of the government shutdown, trade negotiations and the continued weakening of global economic activity.
- ✓ The Fed also provided more guidance on its balance sheet. While the Fed has reiterated that it doesn't see the

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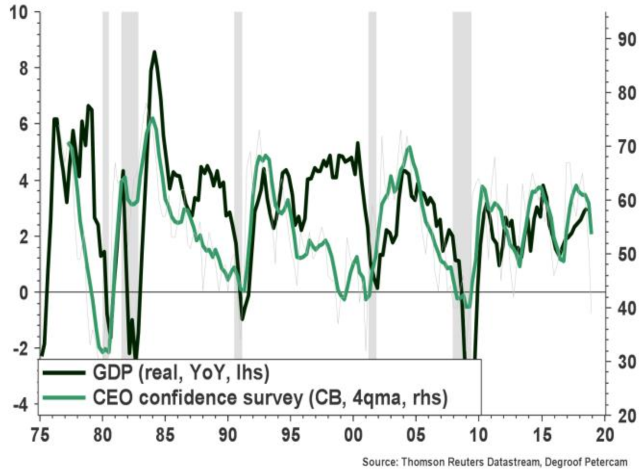
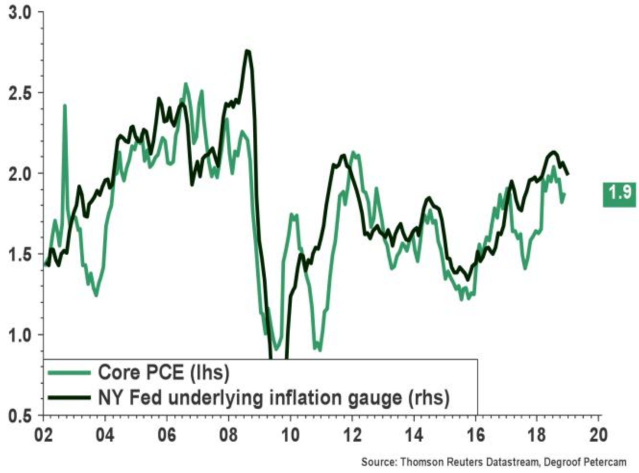
balance sheet as ‘an active policy tool’, Mr. Powell stressed that the Fed wouldn’t hesitate to adjust the run-down process if needed. In any case, its balance sheet looks set to remain very large in historical perspective.

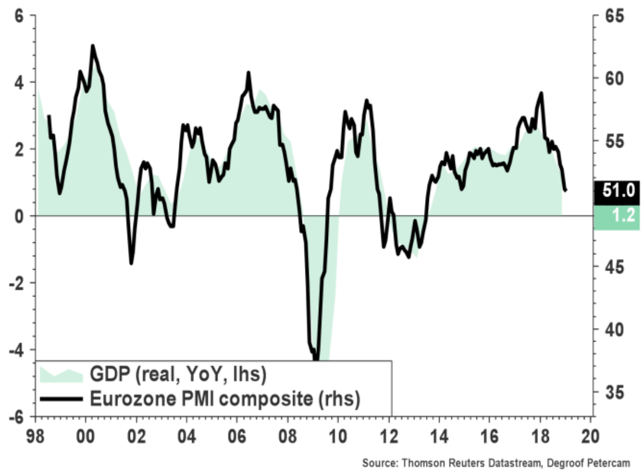
- ✓ Meanwhile, a couple of issues remain unresolved. Trade negotiations start up again after the Chinese New Year Holiday and attention has shifted back to the possibility of a renewed government shutdown. From March on, the debt ceiling looks set to become the next political hurdle.

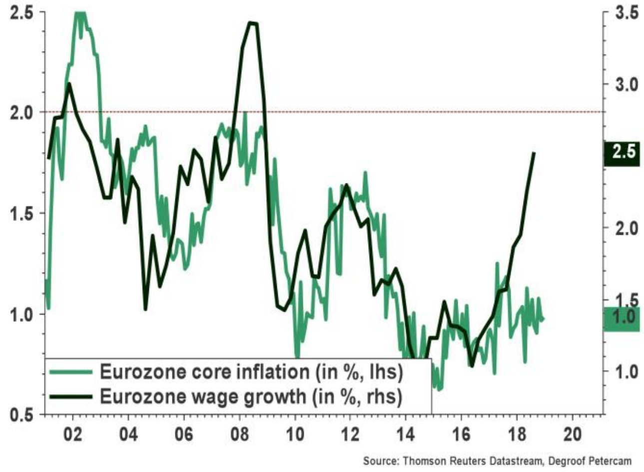




Eurozone economy quickly losing momentum, ECB sounding increasingly dovish

- ✓ The Eurozone economy has seen solid improvement in recent years. But activity has weakened and prospects look rather bleak. Economic activity finished on a weak note in 2018 and most business surveys suggest that things continued to worsen at the start of the year prompting many observers to revise their forecasts lower.
- ✓ Both external and domestic factors lie behind the Eurozone slowdown. Industrial production growth has dropped into negative territory on the back of a slump in car manufacturing (linked to new emission standards) and weaker demand from China. And despite fairly solid growth for the quarter as whole, retail sales actually decreased in December. Consumer confidence has come down too, albeit from elevated levels.



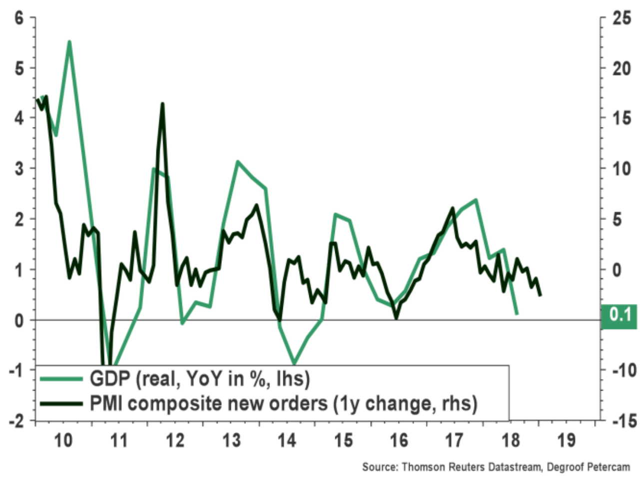


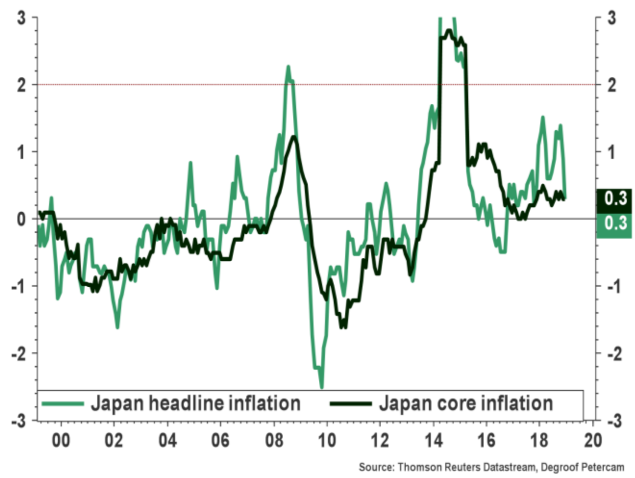
- ✓ Labour market conditions remain quite solid for now. The unemployment rate has dropped back to just below 8% and wage growth has finally picked up, implying that underlying price pressures should move somewhat higher from here (but not nearly enough to reach the 2% inflation target anytime soon). Meanwhile, headline inflation (now at 1.4%) is impacted negatively by base effects related to the evolution of energy prices.

- ✓ All this has led the ECB to admit that risks to the outlook have shifted to the downside while stressing that 'the market understands our reaction function'. This probably means that the first rate hike will not come in 2019. The ECB looks set to lower its economic forecasts in March and may be offering a new round of loans to secure funding in the banking sector.
- ✓ Italy remains a source of concern. Confidence in Italy has dropped significantly following the elections earlier this year and the budget dispute with the European Commission. Economic growth remains hugely disappointing. As such, without further structural and institutional progress both in Italy and the Eurozone, the country remains vulnerable to periods of self-fulfilling panic reactions in markets.
- ✓ Meanwhile, the Brexit saga drags on with no real solution in sight for now as discussions between the UK and the EU go in overtime. Nor the UK nor the EU will benefit from a 'no deal' but the risk that it still happens remains significant (cfr backstop issue).

Bank of Japan stands put as growth remains downbeat

- ✓ The outlook for economic activity remains pretty downbeat. Although policymakers intend to press ahead with the sales tax in October, they acknowledged that demand could be hurt and look set to offer some budgetary loosening in return.
- ✓ Despite tight labour market conditions, wage growth and inflation remain tepid. As a result, although the BoJ emphasises the risk of unwelcome side effects of its policy, monetary policy remains firmly in easing mode.

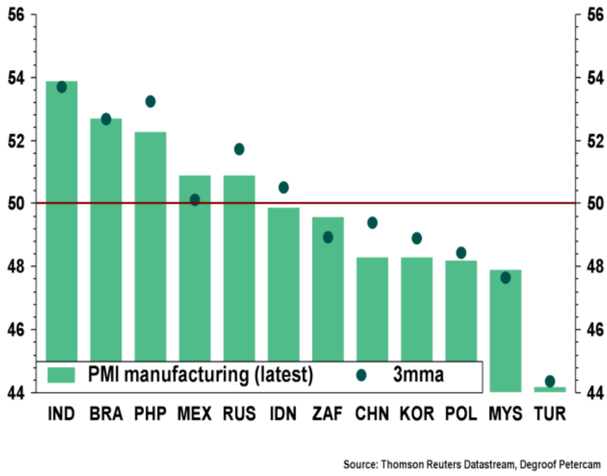




Chinese policymakers attempt to arrest the slowdown in growth, no significant upturn in sight

- ✓ 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. Official GDP growth, now at 6.5%, overestimates actual economic activity growth (a more realistic estimate hovers around 5%).
- ✓ Lower interbank interest rates, tax cuts (mostly directed towards families and SME's) and some extra investment spending should at some point produce stabilizing results. We expect this to happen about halfway through the year. But for now at least the risks are still tilted to the downside and the relatively modest stimulus measures taken so far (i.e. compared to the 2015/16 slowdown) are unlikely to lead to a significant demand boost. Meanwhile, trade tensions with the US remain fundamentally unresolved.
- ✓ More broadly, the situation in the emerging world is very different from region to region and from country to country. That said, the overall picture portrays economic softening. With regard to monetary policy, the fall in

headline inflation prices in combination with a downward shift in interest rate expectations in the US and Europe implies that most central banks are putting their tightening efforts on hold. The Indian central bank actually lowered interest rates in February. Indeed, from a EM wide perspective, the balance of risks with regard to monetary policy is now tilted towards more easing.



Forecasts for 2019-2020

	GDP			Inflation		
	2018	2019	2020	2018	2019	2020
US	*2.8*	**2.2**	**1.5**	*2.4*	**1.4**	**2.0**
		2.5	*1.8*		*1.9*	*2.2*
Eurozone	*1.8*	**0.9**	**1.1**	*1.7*	**1.1**	**1.6**
		1.5	*1.4*		*1.5*	*1.5*
Japan	*0.6*	**0.5**	**0.6**	*1.0*	**0.6**	**1.2**
		1.0	*0.4*		*0.9*	*1.3*
China	*6.6*	**5.0**	**5.0**	*2.1*	**2.0**	**2.4**
		6.2	*6.1*		*2.2*	*2.2*

Update February 2019, *Consensus forecasts*