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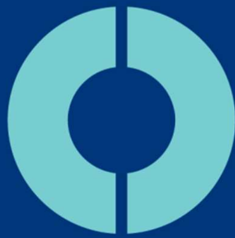

# Economic and Strategy Viewpoint

September 2018

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## Global forecast update

- We have trimmed our activity forecast for the second time this year and now expect global growth of 3.3% this year and 3% next (previously 3.4% and 3.2% respectively).
- The change is driven by significant cuts to Europe and Japan and lesser reductions in the US and emerging markets for 2018. For next year, the reduction reflects a more pessimistic view of the trade wars with the dispute between the US and China expected to escalate as both sides defend their red lines.

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## European forecast update: trade wars weigh on growth

- Eurozone growth failed to rebound in the second quarter as trade wars weighed on world trade, hurting the monetary union's external performance. Reform minded member states like Germany and Spain recorded a pick-up in growth, but France and Italy were a drag on the overall growth rate.
- As we believe trade wars are likely to intensify, we have downgraded the growth forecast for this year and next. Inflation has been revised higher due to energy prices and a weaker euro. The ECB is still expected to end QE in December and raise interest rates twice in 2019.
- UK growth has also been revised down, largely for the same reasons. Brexit uncertainty remains high, but negotiations are about to reach a crescendo. We explore the prospects for sterling in a no-deal or cliff-edge Brexit scenario versus entering a transition period.

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## EM forecast update: the turbulence continues

- It is difficult for emerging markets to outperform when global growth takes a turn for the worse, and even more so when trade is under threat.
- The EM growth outlook receives a downgrade, even as inflation pressures start to build.

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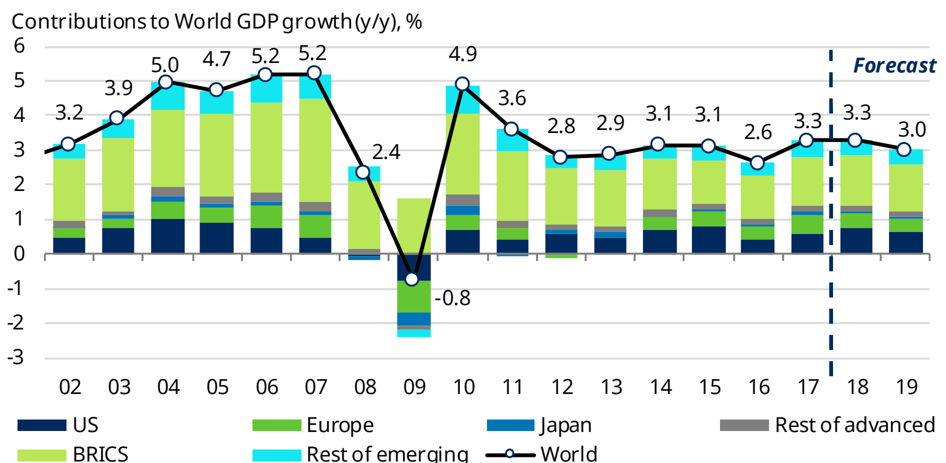
## Views at a glance

- A short summary of our main macro views and where we see the risks to the world economy.

### Chart: Global growth




Source: Thomson Reuters Datastream, Schroders Economics Group. 15 August 2018.
Please note the forecast warning at the back of the document.

# Global forecast update

**"We're talking to China... they just are not able to give us an agreement that is acceptable, so we're not going to do any deal until we get one that's fair to our country."**

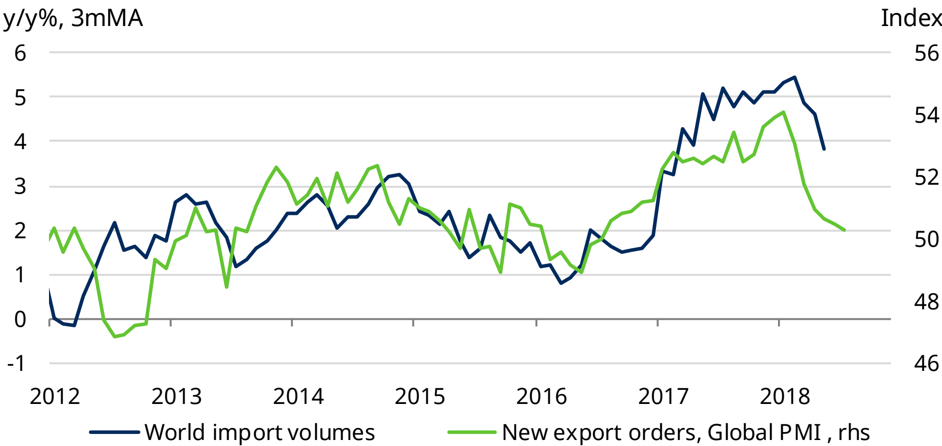
President Trump
cited on Bloomberg 16 August 2018.

### Global growth downgraded for the second time this year

We are revising down our forecast for global growth for the second quarter running. For 2018 the forecast goes to 3.3% from 3.4% and in 2019 to 3% from 3.2%. The most significant changes are in Europe and Japan where growth has disappointed in the first half of 2018, but we have also nudged down our forecast for the US (by 0.1% to 2.8%). The emerging market forecasts are also slightly weaker this year and next led by a downgrade to our forecast for China in 2019 to 6.2% (from 6.4%).

The downgrade is consistent with our view of a soft patch in the world economy in coming months (see last month's Viewpoint, Summer lull?) and indicated by the weakness of industrial metals prices, our global activity indicator and the Purchasing Managers' export orders survey (chart 1).

**Chart 1: Slowdown in export orders signals weaker trade**




Source: Thomson Reuters Datastream, Schroders Economics Group (G0018), 16 August 2018.

Looking further out the downgrade for 2019 has been driven by our revised expectation of a deeper and more prolonged trade war between the US and China. This is expected to persist beyond the US mid-term elections and result in tariffs on all goods traded between the two nations, with China also applying non-tariff barriers to US companies. Recent comments from both sides suggest this will be a drawn out affair (see above) and both global trade and capital investment spending will suffer from the uncertainty created.

### Our forecast moves in a more stagflationary direction as tariffs hit costs

Our inflation forecast remains at 2.7% for 2018, where we continue to be above consensus on US inflation, and we have revised up our inflation forecast for 2019 to 2.7% (from 2.4%). The latter reflects increased tariffs as well as a higher profile for oil prices next year (as projected by the futures curve). Gauging the effects of tariffs on inflation requires a view on currency moves and the degree of pass-through to final prices.

In this respect, the dollar is expected to remain firm in the near term offsetting some of the effect of US tariffs. We assume that tariffs add around 0.3% to US core inflation next year which builds in a degree of pass-through and some impact on profit margins. The risk of full pass-through and higher inflation is significant given the pressures on finding new supply at this late stage of the cycle. When combined with

the downgrade to our growth forecast, the outlook has moved in a more stagflationary direction.

## US rates to peak before ECB and BoJ start to hike

On the policy front, we still expect two more rate hikes in the US this year and two next year with the fed funds rate reaching 3% by the middle of 2019. We see this as the peak as the lagged effect of tighter monetary policy will combine with a fade in fiscal stimulus to slow the economy. The Federal Reserve (Fed) is already indicating that it is thinking about how much further interest rates need to rise. Once the peak is in sight markets could shift significantly as the period of dollar strength will draw to a close.

**Turn in dollar awaits peak in US rates**

In this respect it is possible that the Fed will have finished raising rates before the European Central Bank (ECB) and Bank of Japan (BoJ) have even started. The ECB is expected to end QE by the end of Q4 this year and raise rates twice in 2019, ending the era of negative policy rates in the eurozone. However, after tweaking policy in the summer, the Bank of Japan (BoJ) is not expected to move again over the forecast period. Additional forward guidance has allowed the BoJ to lift the cap on yield curve control to 20bps, while providing a dovish narrative of 'strengthening' the framework. In our view, the willingness to accommodate higher bond yields suggests the BoJ's strong reluctance to ease further, despite the lack of progress in reaching the inflation target. Although we expect the next move to be tightening, we see this outside the forecast horizon due to subdued inflation and a too narrow window to move ahead of the consumption tax hike in Q4 next year.

Meanwhile, UK rates are also on hold this year, although we expect further rises in 2019 as the path of Brexit becomes clearer. In contrast, lower inflation, and liquidity concerns see China policy head the other way with the People's Bank of China (PBoC) easing the reserve requirement ratio (RRR) and policy rates lower. Russia is expected to ease next year, but the interest rate cycle is expected to turn upwards this year in India and next year in Brazil.

## Scenario analysis

We have updated our scenarios to reflect the revised baseline and current tail risks in the world economy. Trade wars continue to be a focus although more is incorporated into the baseline than before. On the negative side we see a risk that the EU weighs in alongside the US to impose tariffs on China (Trade wars: China vs. RoW). This would significantly increase the proportion of China's exports affected by tariffs from 19% to 38% and as a result we would expect China to devalue the yuan (CNY) by 20% at the start of 2019. Such a move helps to offset part of the effect of tariffs on Chinese goods, but is also likely to create considerable volatility in financial markets as the dollar strengthens. The overall effect is for a stagflationary outcome with global trade slowing but prices rising as a result of higher import duties (see chart 2).

On a more optimistic note, we have a global trade liberalisation scenario where the US and EU strike a deal to remove tariffs thus prompting China to follow suit. The resulting opening up of markets leads to a boost to trade, productivity and growth. Inflation is expected to be lower in this scenario as input costs fall and competition intensifies.

**European political risk returns courtesy of Italy**

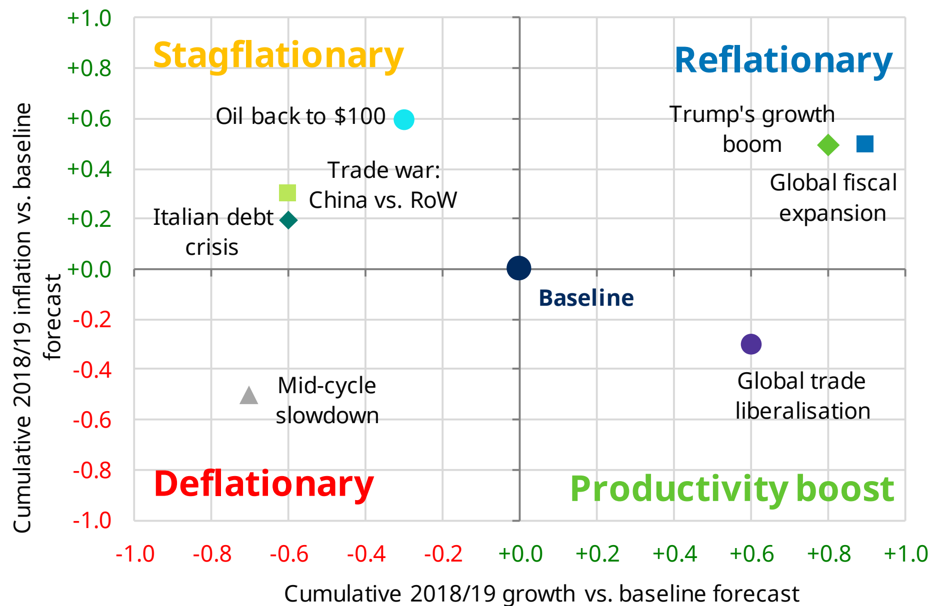
To reflect the increase in political risk in Europe we have a crisis scenario where the new Italian government clashes with the EU over budget plans (Italian debt crisis). This results in a widening of spreads and a sharp fall in the euro. The situation is only stabilised after the ECB restarts QE and a technocrat prime minister is installed. However, there is a significant loss of output in Europe and the political situation is expected to remain volatile.

Our third new scenario is designed to capture the strength of confidence in the US economy (Trump growth boom). Rather than slowing from the heady 4% pace of the second quarter, the economy maintains momentum as rising business confidence leads to stronger investment and employment. Global growth is stronger, but the Fed has to raise rates more rapidly (to 4% by the end of 2019) and the dollar strengthens.

Otherwise we continue with our scenarios for a mid-cycle slowdown where we see a greater near-term impact on business and consumer confidence from the tariffs which impacts spending on capital investment and consumer durables. Global fiscal expansion sees a loosening of fiscal policy across the G7 and emerging markets as governments try to boost growth and quell populist unrest. Finally, the risk of a rise in energy costs as a result of US sanctions on Iran is captured by 'Oil back to $100'.

**Balance of risks skewed toward stagflation**

**Chart 2: Stagflationary outcomes dominate scenarios**




Source: Schroders Economics Group. 16 August 2018. Please note the forecast warning at the back of the document.

In terms of probabilities we would see the risks as being skewed toward stagflation with three scenarios falling into this quadrant. The second highest outcome would be reflation with two scenarios. Higher inflation remains a concern, but that this is more likely to be combined with weaker rather than stronger growth.

# European forecast update: Trade wars weigh on growth

**“A trade war where you have rounds of retaliation and rounds of responses would create an entirely different climate. We would have to assess both the direct effects, which may be significant as the numbers significantly go up, and the indirect effects of confidence – especially on business investment.”**

**ECB President Mario Draghi, 26 July 2018.**

Our new assumption that trade wars will escalate between the US and China (see the previous section) puts the Eurozone in a difficult position. The European economy is more geared towards external trade than most advanced zones, which means it is likely to suffer should global trade weakens further. Therefore, in updating the forecast this month, we are forced to downgrade Eurozone growth for this year and next.

Meanwhile, as we approach the crescendo in Brexit negotiations, risks are coming into focus. We have updated our UK forecast, but also looked at the prospects for sterling in the event of a cliff-edge Brexit, or a deal being reached on the Withdrawal Agreement.

## Reform laggards drag down Eurozone growth

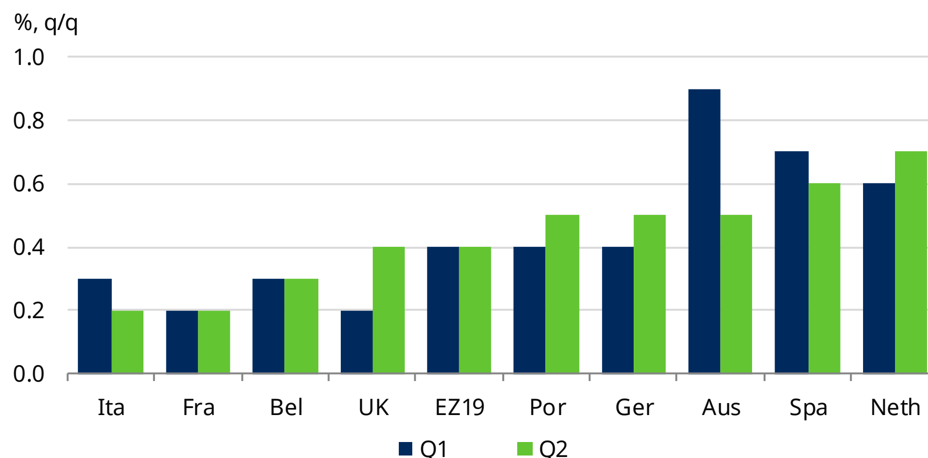
Following the poor start to the year, expectations were high that growth would rebound, especially as temporary factors such as heavy snowfall and an outbreak of influenza were likely to have weighed on activity in the first quarter. However, as data came in from private business surveys, it became clear that there was a wider slowdown occurring.

**Eurozone growth rebounded in the second quarter**

Second quarter GDP data has now been published, and it shows a rebound in activity for most of the large member states. Austria and Spain recorded slowdowns, though compared to history, growth has remained robust. Meanwhile, Italy saw quarterly growth slump to just 0.2%, while France matched Italy's weak growth, and its own from the previous quarter (chart 3).

The Netherlands, Portugal and Germany all recorded accelerations, and decent rates of growth. Even the UK saw an improvement despite ongoing concerns over Brexit. The Eurozone aggregate overall was 0.4% in the second quarter – unchanged from the upwardly revised figure for the first quarter.

## Chart 3: Eurozone GDP growth slows for most



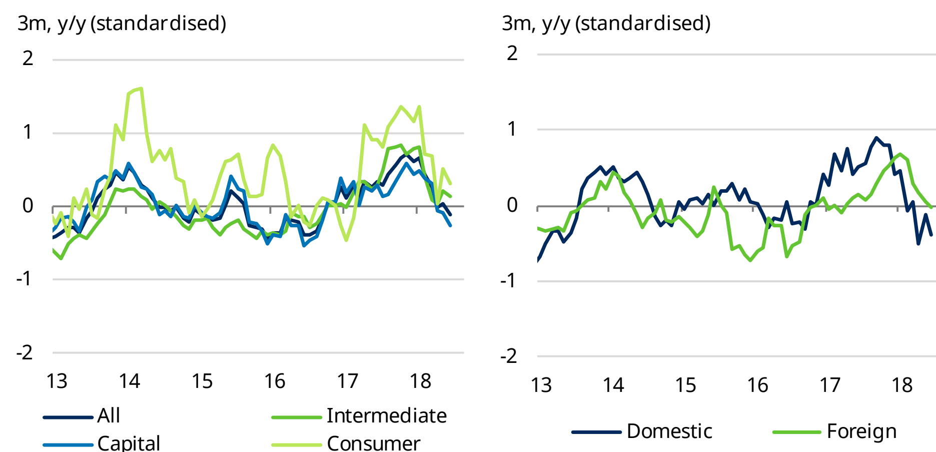

Source: Eurostat, ONS, Schroders Economics Group. 17 August 2018.

As these are early estimates, the expenditure breakdown for most countries is not yet available. However, from the information made public so far, it appears that the drag from net weaker exports has intensified from the first quarter. Domestic demand is said to have held up well, but it seems that Europe has been buffeted by protectionist headwinds once again.

One of the more striking data releases this quarter was for German goods orders, which showed broad-based declines in every category of trade (capital, intermediate and consumer goods trade), along with falls in both new orders from domestic and foreign markets (charts 4 and 5).

**Net exports was again a drag on growth, and with new orders weakening, there are few signs of a turnaround**

## Chart 4 and 5: German new industrial orders




Source: Thomson Reuters Datastream, Schroders Economics Group. 20 August 2018.

Foreign new orders reached their fastest growth rate since 2011 last year, but have since fallen back. They are now back to their long-run average growth rate, although if trade wars intensify, growth in new orders could easily fall further.

As foreign new orders data has a slight lead over exports data, the prospects of a rebound in net trade appear grim. This calls for a downgrade to the contribution from net trade to GDP growth.

## Eurozone forecast update: growth downgraded

Turning to the forecast, we have downgraded Eurozone GDP growth for 2018 from 2.4% to 2.0% (chart 6). This is our second consecutive downgrade to the year-ahead forecast. Second quarter data was slightly below our forecast, but our re-assessment of trade wars, and the subsequent impact on the Eurozone's external performance as discussed above is the main reason for the downgrade. Domestic demand has largely been in line with the forecast.

2019 is forecast to follow a similar pattern. Ongoing trade tensions to hold back external demand, but domestic demand is likely to remain firm. Growth has been downgraded from 2.1% to 1.7%. Although expected to be lower than the previous two years, growth remains above trend, which should result in further falls in unemployment rates, and erosion of spare capacity.

**The Eurozone forecast is heading in a stagflationary direction**

**Chart 6: Eurozone GDP forecast**

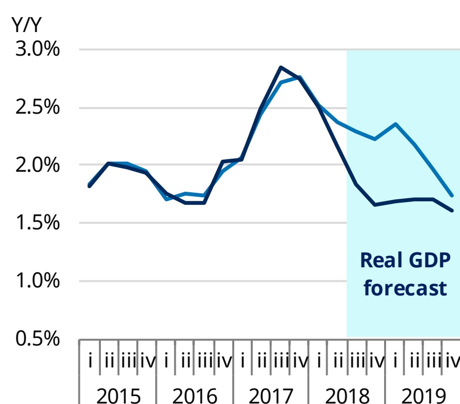
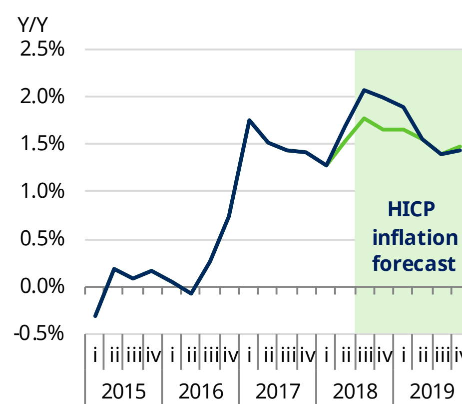



**Chart 7: Eurozone inflation forecast**




Source: Schroders Economics Group. 15 August 2018. Previous forecast from May 2018. Please note the forecast warning at the back of the document.

As for inflation, the euro's ongoing depreciation against the US dollar has led us to revise up Eurozone inflation from 1.6% to 1.8% for 2018 (chart 7). 2019 has also been revised up, but this is largely caused by a more neutral oil prices profile derived from the futures market. Our last forecast incorporated a downward sloping curve, and so the impact of the update is to remove the disinflationary impulse from wholesale energy markets. The inflation forecast for 2019 has been revised up from 1.5% to 1.6%.

**The ECB is expected to stick to its forward guidance**

Turning to monetary policy, the European Central Bank (ECB) is back in wait and see mode since it updated its forward guidance in June (see the July Economics and Strategy Viewpoint). Recent growth will have undershot the ECB's forecast, while inflation has slightly overshot. Meanwhile, the ECB is monitoring two key risks. The first is the worsening external environment will impact the Eurozone economy, and the second is the political situation in Italy. The Italian government is expected to put forward its budget proposals in the coming months, with expectations of a small fiscal stimulus package looking likely. However, there is a risk that the populist government goes further and picks a fight with the European Commission. This is captured by our 'Italian debt crisis' scenario, which as the name suggests, models a sharp rise in Italian government bond yields. Eurozone growth is severely hit in this scenario while the euro falls sharply. In this scenario, the ECB has no choice but to extend QE.

Focusing again on the baseline forecast, as the ECB's forward guidance of ending quantitative easing only at the end of this year and keeping interest rates on hold through the summer of 2019 has a fairly long shelf life, we highly doubt it will be

altering course before the end of this year. If growth slows down to between 1–1.5%, then it may look to extending QE further. However, as the ECB is running out of asset to buy, it could instead increase the time between the end of QE and the first rate rise in its guidance. Such as slowdown only appears in our risk scenarios, and so we do expect the ECB to end QE in December, and then raise interest rates twice in 2019.

## UK forecast update: waiting for Brexit

A big improvement in the weather in the second quarter helped boost retail spending and activity across the UK economy. Real GDP growth picked up from 0.2% quarter-on-quarter in the first quarter (previously estimated at 0.1%) to 0.4% in the second quarter. This was slightly below our forecast, but significant historic revisions complicate matters. For example, annual growth for both 2016 and 2017 was lowered by 0.1 percentage points respectively. GDP grew by 1.3% in the second quarter compared to the same quarter a year earlier, which is also below our previous forecast.

Household consumption and investment improved in the second quarter, and in a similar fashion to the Eurozone, net trade was the big area of weakness. In fact, if we only focus on final sales, which exclude the impact of inventories including the alignment adjustment, then aggregate demand contracted by 0.1% for the second consecutive quarter – effectively in technical recession.

**UK growth picked-up in the second quarter, though final sales are in recession**

Therefore, in updating the UK forecast, we have been forced to downgrade growth for 2018 to 1.2%, compared to 1.4% previously. Growth for 2019 has also been lowered (from 1.6% to 1.3%) as the economy is expected to continue to struggle even post Brexit (chart 8).

**Chart 8: UK GDP forecast**

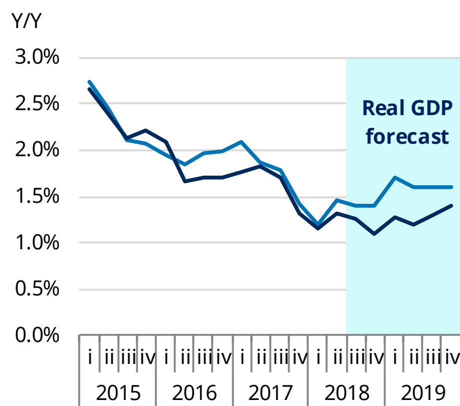
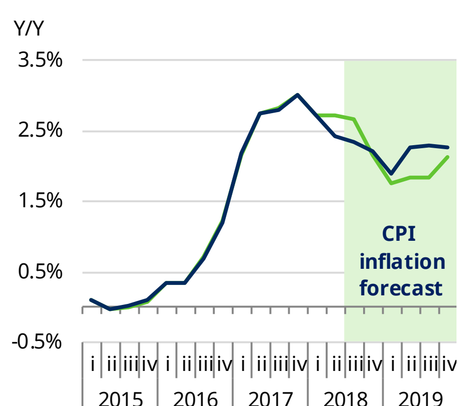



**Chart 9: UK inflation forecast**




Source: Schroders Economics Group. 15 August 2018. Previous forecast from May 2018. Please note the forecast warning at the back of the document.

UK inflation has been coming in lower than expected in recent months as weak domestic demand has limited the ability of firms to pass on cost increases. Headline CPI inflation peaked at the end of 2017, and has been falling slowly ever since, as the impact from the depreciation in sterling has been dropping out of the annual comparison of prices.

Looking ahead, the pound has fallen by 5.6% against the US dollar and 1.8% against the euro since our last forecast update, which raises the level where inflation troughs in our forecast at the start of 2019. Similarly, the higher oil price profile for 2019 removes the previously assumed disinflationary drag from energy prices.

The forecast for CPI inflation has been lowered from 2.6% to 2.4% for 2018, but raised from 1.5% to 1.6% in 2019 (chart 9).

Meanwhile, Brexit continues to dominate the public debate. As the time remaining to reach a deal ebbs, businesses are being advised to consider the worst possible case scenario of a 'no-deal' or 'cliff-edge' Brexit. At the time of writing, working level talks have resumed, although key politicians are still on their summer holidays. With no new information since the publication of the government's white paper, we have not changed our assumptions on Brexit. We continue to assume the UK will reach a deal on the Withdrawal Agreement, which would allow for the transition period to begin after Brexit in late March 2019, running through to the end of 2020.

## Prospects for the pound

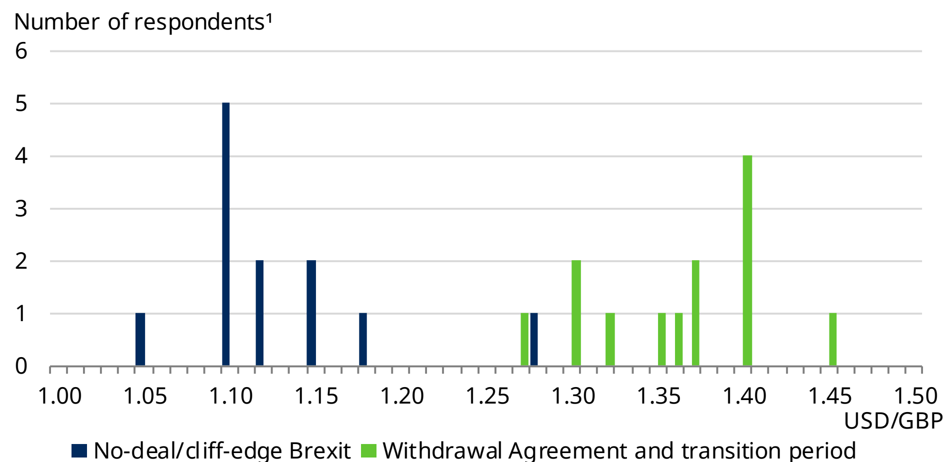
What would happen in a cliff-edge Brexit scenario? Deadlines for talks are flexible, but most believe a deal would need to be in place by the end of the year at the latest. This would allow enough time for member states' individual parliaments to ratify the agreement. Therefore, if the UK is heading for a cliff-edge Brexit, then we are likely to know by the end of the year, leaving just under four months to prepare for the new reality.

The immediate economic impact is likely to be determined by the move in sterling, and so to gauge sentiment in the market, we polled a mix of investment banks and economic consultancies and asked where they thought USD/GBP would trade when it became apparent which scenario the UK was heading for: cliff-edge Brexit or completing the Withdrawal Agreement and a transition period. Note, we did not specify whether the UK would pursue a 'hard' or 'soft' Brexit, only that talks would continue during the transition phase. 13 institutions responded (including ourselves) in the week to 20 August, when USD/GBP averaged 1.28.

The result of the informal poll is very interesting. The majority of respondents saw significant downside risk to GBP in a no-deal Brexit scenario; with the average estimate for USD/GBP at 1.129 (chart 10). In addition, most expect a significant appreciation should the Withdrawal Agreement be completed, with an average consensus estimate of 1.361.

**A survey of forecasters shows significant downside risk to GBP in a 'no-deal' Brexit scenario**

### Chart 10: Where could GBP end up?




Source: Schroders Economics Group. 20 August 2018.
[1]Forecast respondents include: Bank of America Merrill Lynch, Experian Economics, EY ITEM Club, Economic Perspectives, HSBC, Société Générale, Commerzbank, Jefferies, IHS Markit, Pantheon Macro, Redburn, Goldman Sachs and Schroders.

Estimates of GBP in both scenarios are skewed towards the centre, for obvious reasons. However, the poll suggests that most forecasts think there is more downside risk than upside from here: about -11.5% vs. +6.6%.

Before we conducted the poll, our prior was for GBP to fall to 1.15 in a no-deal scenario, but rise to 1.35 in a transition period scenario. This suggests those polled see greater downside risk. Moreover, as we have previously written, we see a 35–40% chance of a no-deal scenario, and 60–65% chance of an agreement. Applying the mid-points of those probabilities to the average consensus estimates from our poll, we reach a fair value for USD/GBP of 1.274, which is broadly in line with where the currency cross is trading today[1].

The above analysis highlights the degree of uncertainty around the outlook for sterling, but is also suggests that the current level against the US dollar is unsustainable. The pound appears to be trading based on the probability of two significantly different scenarios, only one of which is likely. While it is true that other scenarios are possible: a delay in Brexit, a second referendum, or even Parliament abandoning Brexit altogether, at this late stage, the seem to be highly unrealistic for political reasons.

## Bank of England on hold until after Brexit

**Having just raised interest rates, the BoE is likely to remain on hold until after Brexit**

The Bank of England (BoE) raised its main policy interest rate from 0.50% to 0.75% – its highest level since March 2009 and the first hike above the post-financial crisis level. The Bank backed away from raising rates in February owing to a significant slowdown in growth. However, the improvement in data mentioned earlier allowed the Bank to proceed with a hike in August.

The Bank has kept its forward guidance of slow and limited interest rate rises, with three rate hikes in three years broadly expected. We forecast two rate rises in the second half of 2019 but this is dependent on a smooth Brexit.

[1] 1.278 on 20 August 2018.

# EM forecast update: the turbulence continues

"The dollar has lost its credibility."

Turkish Finance Minister, Berat Albayrak,
14 August 2018.

**As the trade outlook darkens, EM prospects dim**

It is difficult for emerging markets (EM) to outperform when global growth takes a turn for the worse, and even more so when trade is under threat. Consequently, with downgrades to developed market growth and a much more pessimistic outlook for global trade, it is little surprise that our EM growth outlook also receives a downgrade. Further tariffs are likely in the final quarter of this year, so come too late to make much difference to this year's growth. But 2019 sees a significant (by the standards of Chinese GDP) revision to the outlook for China. The outlook also weighs on Brazil and is enough to cancel out tailwinds for India and Russia.

**Table 1: BRIC GDP growth forecast summary**

| % per annum | GDP | | Inflation | |
|---|---|---|---|---|
| | 2018f | 2019f | 2018f | 2019f |
| China | 6.6 (6.6) | 6.2 ↓ (6.4) | 2.1 ↓ (2.4) | 2.4 ↑ (2.0) |
| Brazil | 1.8 ↓ (2.7) | 2.0 ↓ (2.2) | 3.5 (3.5) | 4.6 ↑ (4.5) |
| India | 7.5 ↑ (7.3) | 7.5 (7.5) | 4.8 ↓ (4.9) | 5.3 ↑ (4.4) |
| Russia | 1.9 ↓ (2.1) | 1.9 (1.9) | 3.0 ↓ (3.5) | 4.6 ↑ (4.4) |

Source: Thomson Reuters Datastream, Schroders Economics Group, 10 August 2018. Numbers in parentheses refer to previous forecast.

**Unenviable task for central banks in a more stagflationary outlook**

Despite the more challenging growth outlook we do not see most central banks turning more dovish, with inflation concerns coming to the fore for Brazil and India. Russia will likely have to moderate its own easing cycle this year, delivering one fewer cuts than expected, but then going further than we had originally anticipated in 2019 based on central bank statements about the perceived neutral rate. Our expectations for Chinese policy are unchanged; some more monetary easing, but no additional measures from the central bank despite the deterioration in the growth outlook. Instead, the onus will lie upon fiscal policy, as signalled by recent, unusually public, policy debates.

**Table 2: BRIC monetary policy**

| % (year end) | 2018(f) | | 2019(f) | |
|---|---|---|---|---|
| China RRR | 15.00 | (15.00) | 14.00 | (14.00) |
| China lending rate | 4.35 | (4.35) | 4.00 | (4.00) |
| Brazil | 6.50 | (6.50) | 7.00 | (7.00) |
| India | 6.75 | (6.50) | 7.00 | (7.00) |
| Russia | 7.25 | (7.00) | 6.50 | (7.00) |

Source: Thomson Reuters Datastream, Schroders Economics Group, 10 August 2018. Numbers in parentheses refer to previous forecast.

## China: measuring weaker growth

After a remarkably stable three quarters, in which the economy grew steadfastly at 6.8% year on year (y/y), activity seemed finally to slip in the second quarter of 2018. But if we look at the higher frequency data, it seems odd that the change in GDP growth was so muted. Industrial production was perhaps relatively stable, with an average growth rate of 6.4% compared to 6.6% in the prior quarter, but retail sales growth slowed to 9% from 9.9%, investment to 4.8% from 7.5%, and exports to 11.4% from 17% y/y.

**We create a new proxy for Chinese growth**

This stability of GDP can make the life of a China economist both easy and hard. On the one hand, it is not too hard to forecast a GDP number that only moves by 10 to 20bps from year to year, let alone quarter to quarter. One can simply forecast the official target and be done. On the other hand, this is not representative of our views on the direction of the economy, or what it means for global trade growth and risk appetite. Volatile high frequency data in China will often upset markets even as GDP continues serenely on.

### Chart 11: Schroders China Activity Indicator shows more cyclicality

Source: Thomson Reuters Datastream, Schroders Economics Group, 14 August 2018.

To illustrate this, we have constructed an alternative activity indicator for China, based on a principal component analysis (PCA)[2] of some of the most watched monthly data. We include retail sales, fixed asset investment, industrial production, exports and imports, all in inflation adjusted terms. Between them, these data series should cover most aspects of the Chinese economy and in general act as analogues to the expenditure components of GDP. PCA derives the common movement of these series and distils it into a single measure, which we then standardise to officially reported real GDP. For ease of reference, we will call the resulting data series the SCAI, or Schroders China Activity Index, plotted against GDP on chart 11.

**Tighter policy has seen momentum roll over, trade wars will make it worse**

The SCAI shows the slowdown that anecdotal evidence heavily implied was underway in 2015 and 2016, and the subsequent rebound in activity. Momentum now looks to have rolled over, and we expect that the SCAI will continue to trend lower through the third quarter and potentially bottom out by the end of the year. Presently, stronger trade data is supporting the SCAI but we expect this to fade with the imposition of tariffs; a frontloading ahead of tariffs on agricultural products was apparent earlier in the year (chart 12), and we expect something similar is occurring

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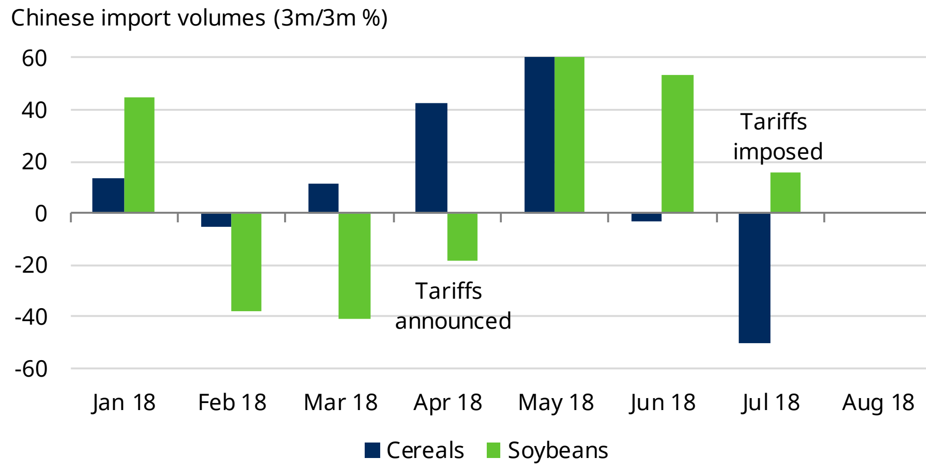
[2] PCA is a statistical method which extracts the common variance of a set of variables. Applied to Chinese economic data, the hope is that the greatest common variance is the underlying growth momentum of the economy.

now. Our GDP forecast follows a similar profile, but in increments of 10bps, while the SCAI is likely to move around 100bps lower, from 7.2% currently to a little over 6%.

### Chart 12: Tariffs generate frontloading of trade and then weakness




Source: Thomson Reuters Datastream, Schroders Economics Group, 15 August 2018.

**More accommodative policy likely, but effective only with a lag**

We expect this slower growth to bring a measure of policy accommodation. Policymakers have already begun shifting to a more dovish stance, with a change of language from the central bank suggesting easier monetary policy lies ahead. There have also now been press reports of a more accommodative state approach to investment by indebted local governments, in the now familiar pattern of timid economic reform. Consequently, infrastructure investment, which has been a key driver of overall investment weakness, will likely recover in the coming months. We also expect easing from the central bank, probably in the form of a headline reserve ratio requirement (RRR) cut as well as additional liquidity support via market operations.

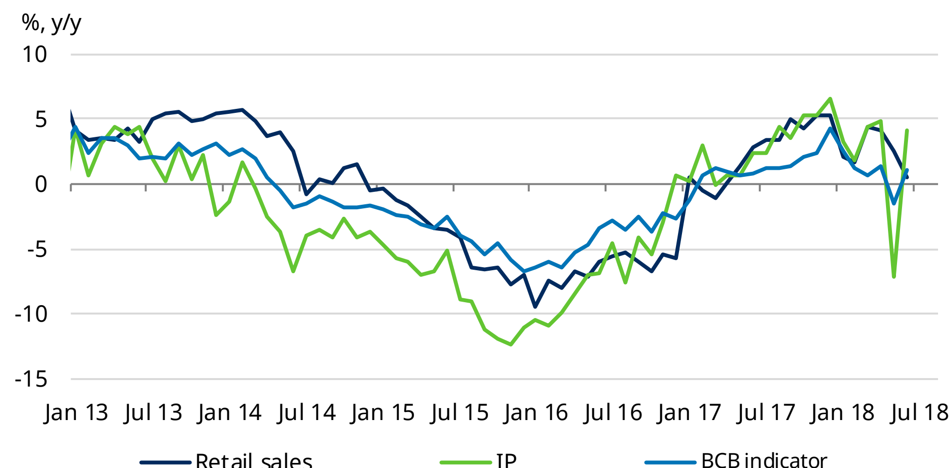
It will take time, however, for a shift in policy to translate to growth, and we do not think enough will be done this year to deliver more than a stabilisation. Further support will be needed next year as the escalation of the trade war really begins to bite. We downgrade 2019 growth to 6.2% to reflect the expected impact of tariffs and trade tensions on exports and investment.

## Brazil: political battle lines drawn

**A bad start to the year for Brazil made worse by strike action**

At the time of writing we are still waiting for Brazil's second quarter GDP release, but a disappointing data print seems guaranteed thanks to a highly disruptive truck drivers' strike in May. With essentially no road freight for 10 days, retail sales and industrial production contracted sharply, and the central bank's GDP proxy for the month fell by 1.5% y/y. While this has been followed by a rebound in the affected series (chart 13), some loss of output seems inevitable, and the slowdown from 2017, which started in the first quarter, is unlikely to be reversed. This weakness, and the disappointing start to the year, led us to materially downward growth for 2018 to 1.8%, from 2.7% previously.

Chart 13: Brazilian growth dented by strike action in May




Source: Thomson Reuters Datastream, Schroders Economics Group, 14 August 2018.

This downward revision of growth should support the case for central bank rates to be kept on hold this year, despite the weakness in the Brazilian real. We do expect hikes to be needed next year as inflation continues to climb off the lows, but an underwhelming growth picture should constrain the central bank to a gentle hiking pace of just 50bps in 2019.

**Electoral uncertainty still very high**

At present the political outlook remains inchoate, and so our base case assumes no material change in policy; more of a muddling through. However, things should begin to take shape over the next month as the campaigning season begins in earnest. Alliances have been drawn up and the more extreme candidates look relatively isolated, with little allocated air time for political broadcasting. This hands an advantage to the more market-friendly Alckmin, though he continues to lag behind in opinion polls. The odds of a positive outcome have perhaps risen slightly, but there are still plenty of risks, as evidenced by the history of Brazilian elections.

## India: a safe port in a trade storm

India is the one economy to receive a growth upgrade this year, and dodges a downgrade for 2019. India's limited exposure to global trade shields it in global downturns, particularly those driven by higher tariffs, and for now the domestic economy appears to be gaining strength. Part of this does come from what is known euphemistically as 'fiscal slippage', but we also think credit should become more supportive of activity given ongoing efforts to clean up the banking system.

**Indian growth is picking up but inflation is likely to follow**

Although inflation data this year has been a bit better than expected, resulting in a small downgrade to the 2018 outlook, 2019 faces more risks; the cyclical growth recovery, higher minimum support prices for crops, and elevated crude prices. There is also an upside risk to our inflation numbers for both years if the current currency weakness proves more than transitory. The central bank looks to be trying to pre-empt this, and we expect a frontloading of rate hikes to take the headline rate to 6.75% this year with another 25bps hike in 2019. However, subsiding inflationary pressures in the second half should limit the need for additional tightening. Currency weakness is again a risk to this view.

## Russia: sanctions strike again

Growth has been slightly softer than expected in Russia but not dramatically so, and so we edge down our forecast for 2018. 2019, for now, is unchanged, with higher oil prices (over $70 per barrel compared to closer to $50 previously) helping to offset the softer global picture. However, there is some uncertainty arising from growing

## Oil still supportive, but geopolitical risks are building again

geopolitical risk. The US is undoubtedly more interventionist, engaging in trade disputes with most of its trading partners, and applying sanctions to a number of countries. Though Turkey has occupied the most headline space in this regard, Russia has also found itself subjected to additional sanctions. The latest measures, effective from 22 August, focus on stopping US exports of 'national security sensitive goods' to Russia. While this will cover, according to the US State Department, hundreds of millions of dollars of trade, the bigger risk is the threat of escalation. If Russia does not comply with monitoring processes in the next three months, the US could prohibit bank lending and impose further trade restrictions. Separately, pressure is building in the US Congress for action against Russia in retaliation for electoral meddling, which could include sanctions on Russian sovereign debt. The more of these risks that are realised, the more growth would suffer.

This has already seen a reaction in the currency, adding to inflationary pressures which turned the Central Bank of Russia (CBR) more hawkish back in June. A planned VAT hike and higher inflation expectations saw a change in tone from the CBR. However, it has also set a neutral target as 6–7%. Reflecting these statements from the monetary authorities, we now project one less interest rate cut this year, but three next year to take the headline rate to 6.5%.

# Schroder Economics Group: Views at a glance

## Macro summary – August 2018

### Key points

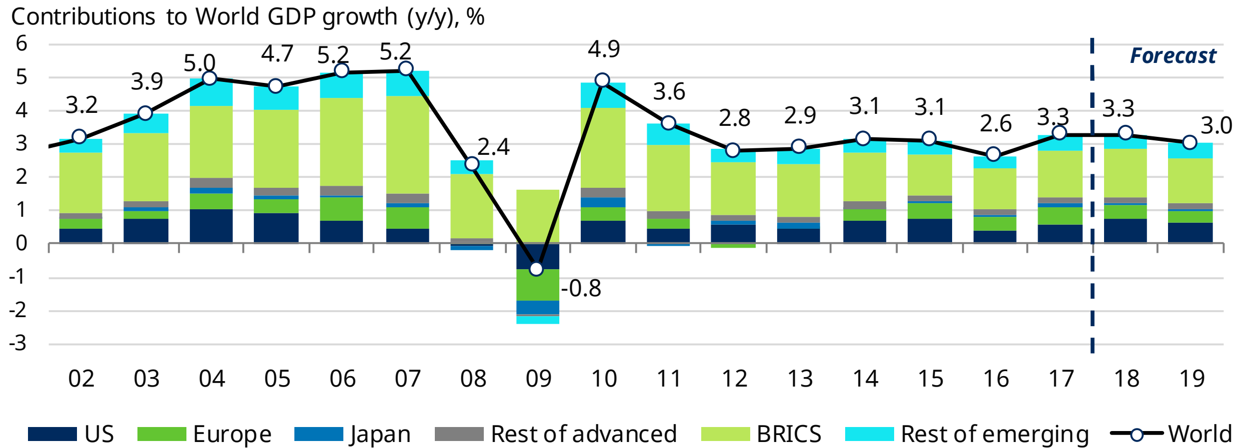
#### Baseline

- Global growth is expected to reach 3.3% in 2018 unchanged from 2017, before moderating to 3.0% in 2019. Inflation is forecast to rise from 2.3% in 2017 to 2.7% in 2018 and 2019. Core inflation in the US is expected to rise back above 2% in 2018 and the world economy moves firmly into the expansion phase of the economic cycle.
- US growth is forecast at 2.8% in 2018 and 2.4% next, incorporating President Trump's fiscal stimulus packages. The Fed has now started balance sheet reduction (quantitative tightening) and with core inflation rising, four hikes in total in 2018, and two more in 2019 final increase in 2019, ending the forecast at 3%.
- Eurozone growth is forecast to moderate to 2.0% in 2018, but remains robust overall. Italian political risk is back which will reintroduce volatility. Growth should moderate in 2019 to 1.7%, but this remains above trend. Inflation is expected to remain under 2%, with higher energy price inflation in 2018 replaced by higher core inflation in 2019. The ECB is likely to end QE in December 2018, before raising interest rates in 2019. The refinancing rate is forecast to reach 0.50%, and the deposit rate to reach zero, having been negative.
- UK growth is likely to slow to 1.2% in 2018 as Brexit uncertainty weighs on confidence. Inflation is forecast to fall back slightly to 2.4%, as sterling depreciation effects are replaced with energy and domestically generated inflation. 2019 is very uncertain given Brexit, but we assume a transition period will be agreed that preserves the states quo of single market and customs union membership. The BoE is expected to remain on hold for the rest of 2018 and hike twice in 2019 post-Brexit (to 1.25%).
- Japanese growth is forecast to slow from 1.7% in 2017 to 1.0% in 2018 and 2019, as inflation almost doubles to 0.9% owing to higher oil prices. After tweaking yield curve control policy in the summer, the BoJ is not expected to move again over the forecast period.
- Emerging economies are forecast to see growth largely unchanged at 5% over 2018 before slowing to 4.8% in 2019. China's GDP growth is forecast to continue its secular decline, exacerbated by trade wars.

#### Risks

- Risks to the baseline forecast skewed towards a more staglationary outcome. 'Trade war: China vs. RoW', 'Oil back to $100' and 'Italian debt crisis' are the main causes. 'Mid-cycle slowdown' is the only deflationary scenario, while 'Global trade liberalisation' provides a productivity boost scenario. There are two reflationary scenarios: 'Trump's growth boom' and 'Global fiscal expansion'.

**Chart: World GDP forecast**




Source: Schroders Economics Group, 15 August 2017. Please note the forecast warning at the back of the document.

## Schroders Forecast Scenarios

| Scenario | Summary | Macro impact | Probability* | Growth | Inflation |
|---|---|---|---|---|---|
| | | | Cumulative 2018/19 global vs. baseline | | |
| **Baseline** | For the second quarter running we have revised down our forecast for global growth. For 2018 the forecast goes to 3.3% from 3.4% and in 2019 to 3% from 3.2%. The most significant changes are in Europe and Japan where growth has disappointed in H12018, but we have also nudged down our forecast for the US. The emerging market forecasts are also slightly weaker. Though our 6.6% forecast for China is unchanged, our alternative activity measures suggest that growth momentum is fading. Looking further out the downgrade has been driven by our revised expectation of a deeper and more prolonged trade war between the US and China. The latter is expected to persist into 2019 and result in tariffs on all goods between the two nations with China also applying non-tariff barriers to US companies. Global trade and capex spending suffer in this environment. Meanwhile, we have revised up our inflation forecast for 2019 to 2.7% (from 2.4%) to reflect increased tariffs as well as higher oil prices. | We expect two more rate hikes in the US this year and two next with the fed funds rate reaching 3% by the middle of 2019. The ECB is expected to end QE in Q4 this year and raise rates twice times in 2019, ending the era of negative policy rates in the Eurozone. However, after tweaking policy in the summer, the BoJ is not expected to move again over the forecast period. UK rates are also on hold this year, although we expect further rises in 2019 as the path of Brexit becomes clearer. In contrast lower inflation, and liquidity concerns, see China head the other way with the PBoC easing the RRR and policy rates lower. Russia is expected to ease next year while Brazil is expected to belatedly join India in hiking. The USD is expected to strengthen further in the near term before weakening in 2019. | 65% | - | - |
| **1. Italian debt crisis** | The populist Italian government decides to pick a fight with Brussels and announces a 5% of GDP fiscal loosening. Markets baulk at the announcement, pushing the 10yr BTP yield up to 6%. After a couple of failed auctions, the government is forced to seek help from the rest of the EU in the form of a bail-out. A technocrat is installed as PM, and the ECB's OMT programme is activated. QE is also restarted in 2019 as the Eurozone faces a deep recession. The threat of restructuring/default on Italian debt remains, but yields return to more manageable levels thanks to the ECB and change in domestic policy. | For the eurozone, this is a stagflationary scenario due to EUR falling to 1.02. However, it becomes a deflationary scenario from the middle of 2019. The US and Japan see their currencies appreciate, and combined with lower oil prices and a shock to financial markets, both see lower growth and inflation compared to the base. The impact on EM is more mixed. China intervenes to prop up the CNY, but Brazil, India and Russia all see FX depreciation, while trade growth falters, making this a stagflationary scenario in EM. | 5% | -0.6% | +0.2% |
| **2. Global fiscal expansion** | Following the populist expansion in fiscal policy in the US, other countries decide to follow its lead either due to changes in governments, or in response to populist movements. The G7 and BRIC economies all loosen fiscal policy significantly through a combination of tax cuts and spending increases. | Reflationary: Fiscal loosening against a backdrop of above trend growth boosts confidence further, along with GDP growth. Some economies with low rates of unemployment see wage pressures rise, causing domestically generated inflation, while others with slack remaining, still see higher inflation through commodities and higher import prices. Central banks respond by tightening monetary policy more quickly, which eventually cools activity. | 4% | +0.9% | +0.5% |
| **3. Trade war: China vs. RoW** | The EU and US declare a trade ceasefire and ally against China, with the EU joining the US in imposing tariffs on Chinese goods in an attempt to force concessions on industrial policy and intellectual property protection. With 25% tariffs imposed on the bulk of its trade in Q4 2018, China retaliates with a 20% devaluation in Q1 2019, offsetting much of the impact of the tariff on its exports but at a cost to global activity and domestic price levels. | Stagflationary: Tariffs drive costs higher in Europe and US, leading to some inflationary pressure, partly offset by lower oil prices as activity slows. Safe haven currencies strengthen but the euro and EM currencies suffer, generating further inflation. Global activity takes a hit as trade weakens and the dollar strengthens. | 7% | -0.6% | +0.3% |
| **4. Oil back to $100** | President Trump's withdrawal from the Iran nuclear deal and imposition of sanctions results in1 mb/d being removed from oil supply as the agreement collapses. Risk premium on oil rises as threat of conflict in the region between Iran, Saudi Arabia and Israel spreads beyond Syria. Given the tightness of the oil markets, oil prices surge to $100 where they remain over the forecast period. | Stagflationary: Higher oil prices feed through rapidly into inflation putting a squeeze on oil consumers world wide. Oil producers benefit but do not increase spending rapidly enough to offset cut backs elsewhere. In the US, stronger shale gas capex and output initially offset the shock, but once this fades the effect on household budgets and global trade drag on growth. Policy tightening by the Fed is more limited as the central bank weighs higher inflation against weaker growth. | 3% | -0.3% | +0.6% |
| **5. Global trade liberalisation** | Talks between the US and EU heralds the beginning of an era of free world trade. The removal of all tariffs and non-tariff barriers encourages more countries to follow suit, including China. Global trade increases sharply as a share of GDP, with the most competitive benefiting the most. While those with the highest tariffs seeing increased demand for imports. | Productivity boost: More integrated global supply chains boost productivity and lowers costs in manufacturing. Savings are passed on thanks to new intense competition, helping to lower global inflation. Lower prices mean increased demand for goods, helping to boost GDP growth. | 4% | +0.6% | -0.3% |
| **6. Mid-cycle slowdown** | The moderation in global growth seen in H1 becomes extended as concerns over trade wars dent business and consumer confidence. Global trade slows, capital spending plans are put on hold and consumers save the bulk of their tax cuts. The world economy hits a soft patch which extends into early 2019. Thereafter, activity begins to pick up again as relations between the US and the rest of the world improve thus lifting confidence and spending. | Deflationary: Lower oil prices and slower growth reduce inflation. After raising rates in June, the Fed reverses tack and eases at the end of the year. Rates are cut once more in 2019 before a modest recovery allows the Fed to resume hiking toward the end of the year. Rates are also lower in the UK, Eurozone and China. | 5% | -0.7% | -0.5% |
| **7. Trump's growth boom** | After a strong Q2, growth momentum continues to build in the US on the back of rising business confidence which spurs capex and employment. The tax cuts also support stronger spending from households and firms. Growth is expected to remain robust and unemployment continues to fall over the next 12 months before capacity constraints cause higher inflation and a moderation in 2019H2. | Reflationary: The boom in growth is welcomed by the Trump administration but the build up of inflationary pressure forces the Federal Reserve to keep tightening policy. The fed funds rate hits 4% by the end of next year. Although growth elsewhere benefits from stronger US demand, the US dollar strengthens thus tightening financial conditions in emerging markets. | 6% | +0.8% | +0.5% |
| **8. Other** | | | 1% | - | - |

*Scenario probabilities are based on mutually exclusive scenarios. Please note the forecast warning at the back of the document.

## Schroders Baseline Forecast

### Real GDP

| y/y% | Wt (%) | 2017 | 2018 | | *Prev.* | Consensus | 2019 | | *Prev.* | Consensus |
|---|---|---|---|---|---|---|---|---|---|---|
| World | 100 | 3.3 | 3.3 | ↓ | *(3.4)* | 3.3 | 3.0 | ↓ | *(3.2)* | 3.2 |
| Advanced* | 62.8 | 2.3 | 2.3 | ↓ | *(2.4)* | 2.4 | 2.0 | ↓ | *(2.2)* | 2.1 |
| US | 27.1 | 2.2 | 2.8 | ↓ | *(2.9)* | 2.9 | 2.4 | ↓ | *(2.6)* | 2.6 |
| Eurozone | 17.4 | 2.5 | 2.0 | ↓ | *(2.4)* | 2.2 | 1.7 | ↓ | *(2.1)* | 1.8 |
| Germany | 5.1 | 2.4 | 1.9 | ↓ | *(2.3)* | 2.0 | 1.7 | ↓ | *(2.2)* | 1.7 |
| UK | 3.8 | 1.7 | 1.2 | ↓ | *(1.4)* | 1.3 | 1.3 | ↓ | *(1.6)* | 1.5 |
| Japan | 7.2 | 1.7 | 1.0 | ↓ | *(1.3)* | 1.1 | 1.0 | ↓ | *(1.1)* | 1.2 |
| Total Emerging** | 37.2 | 5.0 | 5.0 | ↓ | *(5.1)* | 5.0 | 4.8 | ↓ | *(5.0)* | 4.9 |
| BRICs | 24.2 | 5.7 | 5.9 | | *(5.9)* | 5.8 | 5.6 | ↓ | *(5.8)* | 5.8 |
| China | 16.4 | 6.8 | 6.6 | | *(6.6)* | 6.6 | 6.2 | ↓ | *(6.4)* | 6.4 |

### Inflation CPI

| y/y% | Wt (%) | 2017 | 2018 | | *Prev.* | Consensus | 2019 | | *Prev.* | Consensus |
|---|---|---|---|---|---|---|---|---|---|---|
| World | 100 | 2.3 | 2.7 | | *(2.7)* | 2.7 | 2.7 | ↑ | *(2.4)* | 2.5 |
| Advanced* | 62.8 | 1.7 | 2.2 | ↑ | *(2.1)* | 2.0 | 2.1 | ↑ | *(1.9)* | 1.9 |
| US | 27.1 | 2.1 | 2.8 | | *(2.8)* | 2.5 | 2.6 | ↑ | *(2.4)* | 2.2 |
| Eurozone | 17.4 | 1.5 | 1.8 | ↑ | *(1.6)* | 1.7 | 1.6 | ↑ | *(1.5)* | 1.6 |
| Germany | 5.1 | 1.7 | 1.9 | ↑ | *(1.8)* | 1.9 | 1.8 | | *(1.8)* | 1.9 |
| UK | 3.8 | 2.7 | 2.4 | ↓ | *(2.6)* | 2.5 | 2.2 | ↑ | *(1.9)* | 2.1 |
| Japan | 7.2 | 0.5 | 0.9 | ↓ | *(1.2)* | 1.0 | 1.3 | ↓ | *(1.4)* | 1.1 |
| Total Emerging** | 37.2 | 3.2 | 3.7 | ↑ | *(3.6)* | 3.8 | 3.7 | ↑ | *(3.3)* | 3.6 |
| BRICs | 24.2 | 2.2 | 2.7 | ↓ | *(3.0)* | 2.9 | 3.2 | ↑ | *(2.9)* | 3.0 |
| China | 16.4 | 1.5 | 2.1 | ↓ | *(2.4)* | 2.2 | 2.4 | ↑ | *(2.0)* | 2.3 |

### Interest rates

| % (Month of Dec) | Current | 2017 | 2018 | | *Prev.* | Market | 2019 | | *Prev.* | Market |
|---|---|---|---|---|---|---|---|---|---|---|
| US | 2.00 | 1.50 | 2.50 | | *(2.50)* | 2.67 | 3.00 | | *(3.00)* | 3.03 |
| UK | 0.75 | 0.50 | 0.75 | | *(0.75)* | 0.89 | 1.25 | | *(1.25)* | 1.17 |
| Eurozone (Refi) | 0.00 | 0.00 | 0.00 | | *(0.00)* | -0.28 | 0.50 | ↓ | *(0.75)* | -0.10 |
| Eurozone (Depo) | -0.40 | -0.40 | -0.40 | | *(-0.40)* | | 0.00 | ↓ | *(0.25)* | |
| Japan | -0.10 | -0.10 | -0.10 | | *(-0.10)* | 0.11 | -0.10 | | *(-0.10)* | 0.14 |
| China | 4.35 | 4.35 | 4.35 | | *(4.35)* | - | 4.00 | | *(4.00)* | - |

### Other monetary policy

| (Over year or by Dec) | Current | 2017 | 2018 | | *Prev.* | Y/Y(%) | 2019 | | *Prev.* | Y/Y(%) |
|---|---|---|---|---|---|---|---|---|---|---|
| US QE ($Tn) | 4.3 | 4.4 | 4.0 | | *(4.0)* | -9.1% | 3.4 | | *(3.4)* | -15.0% |
| EZ QE (€Tn) | 2.3 | 2.2 | 2.4 | | *(2.4)* | 9.1% | 2.4 | | *(2.4)* | 0.0% |
| UK QE (£Bn) | 435 | 445 | 445 | | *(445)* | 0.0% | 445 | | *(445)* | 0.0% |
| JP QE (¥Tn) | 537 | 521 | 549 | ↓ | *(551)* | 5.3% | 563 | ↓ | *(567)* | 2.6% |
| China RRR (%) | 16.00 | 17.00 | 15.00 | | *15.00* | - | 14.00 | | *14.00* | - |

### Key variables

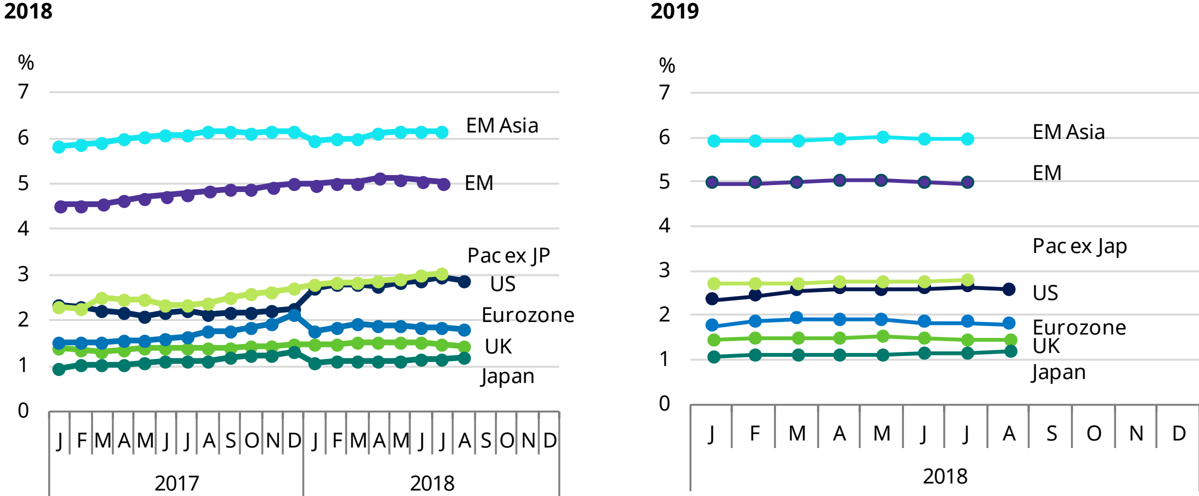
| FX (Month of Dec) | Current | 2017 | 2018 | | *Prev.* | Y/Y(%) | 2019 | | *Prev.* | Y/Y(%) |
|---|---|---|---|---|---|---|---|---|---|---|
| USD/GBP | 1.29 | 1.35 | 1.30 | ↓ | *(1.35)* | -3.9 | 1.35 | | *(1.35)* | 3.8 |
| USD/EUR | 1.16 | 1.20 | 1.14 | ↓ | *(1.18)* | -5.1 | 1.18 | ↓ | *(1.20)* | 3.5 |
| JPY/USD | 111.4 | 112.7 | 110 | | *(110)* | -2.4 | 108 | | *(108)* | -1.8 |
| GBP/EUR | 0.89 | 0.89 | 0.88 | ↑ | *(0.87)* | -1.2 | 0.87 | ↓ | *(0.89)* | -0.3 |
| RMB/USD | 6.84 | 6.51 | 6.90 | ↑ | *(6.35)* | 6.0 | 7.00 | ↑ | *(6.30)* | 1.4 |
| Commodities (over year) | | | | | | | | | | |
| Brent Crude | 74.1 | 55.6 | 73.6 | ↑ | *(71.6)* | 32.3 | 73.2 | ↑ | *(59.7)* | -0.4 |

Source: Schroders, Thomson Datastream, Consensus Economics, July 2018
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 06/08/2018
Previous forecast refers to May 2018
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

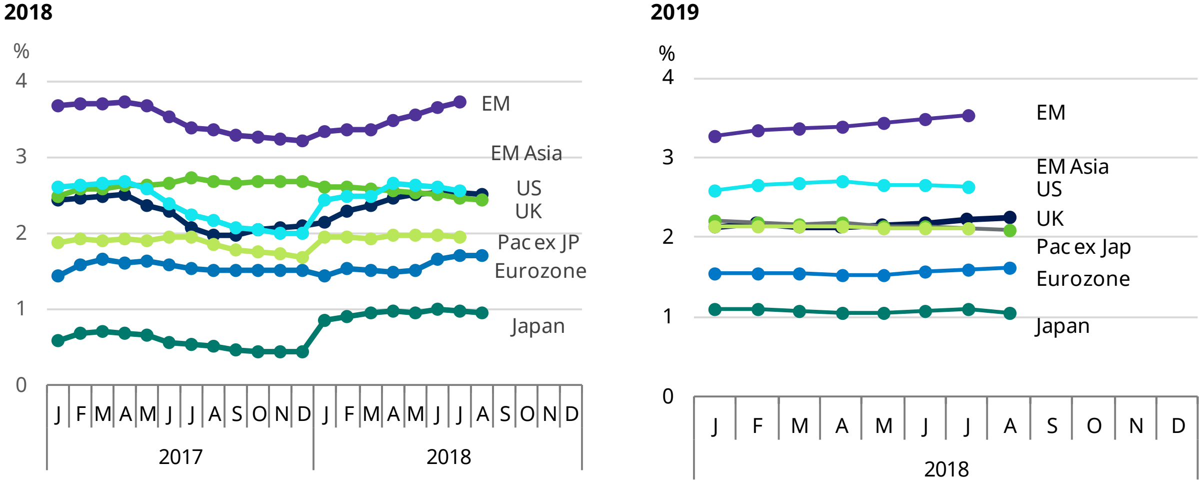
## Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

### Chart A: GDP consensus forecasts




### Chart B: Inflation consensus forecasts




Source: Consensus Economics (20 August 2018), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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