Sunday Wrap

Happy Sunday from New York,

Following the IMF annual meetings in Washington, which I reported on last Sunday, I spent this past week in Boston and New York meeting a good number of our clients to discuss their impressions of the outlook. In a nutshell, almost everyone shared the gist of my impressions from Washington, namely no real recovery in sight for global growth and little hope of a constructive policy response. Yet, with no clear evidence that the crisis in manufacturing is spilling into services or households, nobody seems prepared to call the end of the cycle, let alone adjust their portfolio allocation towards less risky assets.

In today's note, I'll summarize my replies to the four most frequently asked questions from clients this past week:

- **Question 1: Why do you think the US will slow significantly next year, and what will trigger it?**
- **Question 2: How bad is European – and German – growth, and will there be a fiscal response?**
- **Question 3: What will the ECB do under Lagarde?**
- **Question 4: Brexit: Will we soon get a degree of certainty?**

Question 1: Why do you think the US will slow significantly next year, and what will trigger it?

In our view, the US will likely slow to a mild cyclical recession next year (although I'm starting to think it might be only late next year, or even in early 2021) as the longest expansion naturally peters out because the tight labor market pushes wages higher and hence profits lower. Corporations are already heavily indebted, but credits were taken primarily to buy back stocks and for M&A, rather than for investment – and without those investment, spare capacity has now basically closed.

Sure, the unprecedentedly early turn by the Fed (they'll likely make it three cuts in a row on Wednesday) will help cushion the blow, but we are almost certainly very close to the point where the big fiscal stimulus is coming to an end, and maybe even turning into a drag. In other words, I can believe the overall US policy stance may delay, or cushion, the downturn, but it won't prevent it. There is a reason why most recession probability models, including the Fed's own models (whether based on labor markets, profit margins or yield spreads), signal a high probability of a recession within the next year or so.

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Many investors have challenged this view because it's so difficult to pinpoint a trigger for the downturn (as it always is), but my point is that the beginning of the next US recession is unlikely to be a "cliff-edge event", but much more likely to resemble the fable of the "boiling frog".

And while there probably still is some time left for the frog to jump out of the pot, the water is definitely beginning to heat up. US unemployment is at a record low, and wage growth is on an upward trend, even if the monthly numbers are a bit volatile. The 3-months moving average of the Atlanta Fed's Wage Growth Tracker, for example, is now pushing 4%. So, not surprisingly, the impact on profits is beginning to show: While US corporate earnings were still growing in Q2 (although by a modest 1.2% year-on-year), the roughly 40% of US companies which have reported Q3 results so far have posted a decline of 0.5% year-on-year in Q3 earnings. As my colleague, Christian Stocker, has pointed out to me, the occasional positive earnings surprises we have seen is simply a reflection of companies having provided rather muted guidance in recent weeks, thereby lowering analysts' expectations.

So, for me, there is very little doubt that we are heading into a US slowdown, and it's most likely starting just around now. Historically, it takes about four quarters for the US economy to descend from present growth levels to about zero, but maybe it'll be a bit slower – or faster – this time. That's not my point, but to think that we are not heading into a measurable US slowdown seems overly optimistic to me.

The (small majority of) investors I met with this past week, who hold a more optimistic view of the US outlook, expect Trump to agree next year to a ceasefire in the trade war with China and to refrain from starting one with Europe, either because he – facing election - sees the light when growth slows, or when/if the US stock market takes a hit. (Of course, if the stock market takes a hit of, say by 10%-15%, the damage may already have been done because of the tightening in financial conditions). Investors who are closer to my view of the outlook for US growth fear (as I do) that Trump will double-down on tariffs next year, as the election campaign gets seriously under way in an environment of slower growth - to identify "the foreigners who treat America so unfairly".

We shall see, but Trump may very well stay between a half-way decent 2020 US economy of modest easing, and a more severe downturn. The bad news is that, so far, he's got his understanding of what creates growth all wrong.

Question 2: How bad is European – and German – growth, and what will it take to get fiscal stimulus?

European growth as a whole is not in good shape (and corporate earnings for Q3 are down so far by more than 2%), but it is predominantly a German story. Apart from Germany and Italy, virtually all of the eurozone has continued to expand at close to trend growth all the way through Q3, although some easing now seems under way in some countries. As Thursday's PMIs for October showed, the main weakness remains the manufacturing sector, which continues to be constrained by external headwinds, whereas the services sector recorded ongoing (slow) expansion. But the PMIs also showed an impressive acceleration in France, while Germany has now turned into being a drag on European growth.

The change in Germany from being the European growth engine to being the drag on European growth has come surprisingly fast, leaving policymakers and many firms puzzled about what hit them.

The short answer is: Trump, Xi and Greta Thunberg: Trump ending free and predictable trade conditions has hurt the world's great manufacturing and trading nations, like Germany, hard. China (being the key casualty of Trump's madness so far) is now struggling with its demand management at a time when demographics weigh on Chinese growth as well. Re-starting the credit machine, along with fiscal expansion, may help some, but it hasn't done much – yet - for import growth, or car sales, in China. And then there is Greta and the rapidly changing attitude in European society and policymaking to climate change, and what it means for the auto industry.

But given the confusion I hear out of parts of Germany about the causes of the new weakness, let me also emphasize what is NOT the reason for the present German woes, namely the ECB and the monetary policy stance. In spite of the pain the ECB has imposed on the financial sector and on savers who don't want to assume risk, all reasonable estimates show that the net effect on the real economy of the monetary policy stance is substantially positive. According to the IMF, global growth has been boosted by about 0.5pp this year by the accommodative monetary policy stance, while trade infringements have dragged global growth down by about 0.8pp. There is no reason to think that these global numbers don't broadly apply to the eurozone as well.

So what's the right policy response for Berlin to this picture? Very few people (outside Berlin) seem to have any doubt here: Hit the fiscal accelerator! But to me, it's a bit less clear. If Germany is facing a simple cyclical downturn, some (well-designed) fiscal stimulus would be appropriate. But if it's a structural shift, which will lower potential growth, fiscal stimulus - in the traditional sense of - is hardly worth the effort. Then, rather, the effort should be on a (long-overdue) public investment program and spending on education to lift long term potential growth. (Public investment programs are also stimulative, of course, but since it takes much longer to identify, plan and execute such programs, they do often tend to be pro-cyclical – but so be it, they are still badly needed!)

But that all said, the message out of Berlin is still pretty clear: No need for fiscal expansion because we have full employment, and no additional public investment (beyond the climate package) because, depending on who you ask: (i) we don't need it, (ii) what's needed is the responsibility of states, not the federal level, (iii) a fiscal surplus and lower debt are better for the future generation than a higher public sector capital stock and more debt (even at negative rates), or (iv) we can't manage it, just look at the new Berlin airport….

So what would it take to change their mind? Like everywhere else, all politics is local, and nothing gets politicians going as a deteriorating labor market.

But while there have been a few high-profile announcements of layoffs in Germany and the survey data have begun to weaken, the German job market remains in very good shape. Following a 13 year-long upward trend in employment (only temporary interrupted in 2009), German unemployment has fallen to the lowest level since German reunification, while the number of vacancies – a bit off the peak – still hovers around 800,000, more than double its long-run average.

Hence, in my assessment, it'll be at least mid-2020 before the German labor market may start to catch the attention of Berlin, so the more likely route to European fiscal expansion will come only if the manufacturing malaise spreads to service and consumers across Europe, which would move the initiative to Paris and/or Brussels.

The sad bottom line of all this is that it's hard to think of eurozone growth outside a 0.5%-1.0% range next year.

Question 3: What will the ECB do under Lagarde?

Before I get to my best guess for an answer to that question, I want to make the following two points about Draghi's tenure – points which saw zero disagreement among the US investors I met:

First, Draghi's legacy will no doubt be his "within our mandate, we'll do whatever it takes", followed by his unwavering: "and believe me, it will be enough" – and the institutionalization via the OMT. With that, Draghi put the ECB on a comparable footing of other central banks as the lender of last resort, and hence the ultimate defender of the viability of the currency. Those opposing the wisdom of his statement, or the necessity of the OMT, owe it to society to lay out how they imagine the counterfactual would have been.

Second, Draghi's leadership style has come under attack in recent years, particularly his reliance on a very small court of advisors and his preference for setting out his desired direction in public speeches, thereby setting market expectations and – claimed by some – de facto forcing other Governing Council members to vote with him. Yet, in my opinion, Europe needs leaders who are willing to take strong and clear positions, and to lead from the front. How often have we not heard the complaint that Europe doesn't work because everything is decided by consensus? And, on all estimates I have seen, the net outcome of monetary policy under Draghi has been undisputedly positive for the economy. Again, the critics owe us a clear picture of what the counterfactual would have looked like.

In my assessment, Draghi will enter the history books as one of the world's greatest central bankers, and as a defining personality in the European integration process.

So, what is Lagarde exactly inheriting? A policy stance so accommodative that the (presently politically accepted) toolbox is practically empty, and the financial sector on various forms of life support - and a somewhat split Governing Council, if less so than generally perceived in the media.

This has led many to conclude that Lagarde's greatest contribution to European growth will be her assumed ability to persuade the finance ministers to open the fiscal toolbox. I'm extremely skeptical that she'll be successful in this regard, and make more than a marginal impact on the political class. Finance ministers have different constituencies than the central bank chief, and personal friendships and respect are unlikely to sway their enthusiasm for a certain fiscal stance.

Rather, Lagarde will have to focus 100% on the monetary policy stance, and the communication of it to the politicians and the broader public. With a bit of luck (for her), policies won't need to be changed during the next 6-12 months, a honeymoon likely to be used to (and consolidated by) a comprehensive policy review. This time will also be needed to explain in greater detail to the public, particularly the German public, the reasons for the present policy stance. In this regard, the German government's nomination of Isabel Schnabel as the next German Executive Board member is very good news (but, as I discussed a few weeks ago, Schnabel's nomination and assumed appointment is also excellent news because of her outstanding qualifications.) It'll also be a time to bring the Governing Council closer together. I suspect Lagarde will have appealed to the GC members to avoid public statements that could be interpreted as "pre-announcements" of policy changes. How long this will last remains to be seen, and will surely depend on how growth and inflation develop.

And, in my assessment, the greatest risk to Lagarde's truce will be inflation and inflation expectations. As recently as this past Thursday, the ECB's survey of professional forecasters saw inflation expectations 5 years ahead drop to a new all-time low of 1.67%, from 1.74%, while 2 years ahead it dropped to 1.40%. Any further fall surely must trigger a message from the (soon) new ECB president to let us know whether this bothers her and the ECB. Will she take “the Issing line” that inflation of around 1% is of no concern, or will she keep the existing ECB line that inflation needs to get back to “below but close to 2%”? I sure hope it'll be the latter (for reasons I have explained before), but if lower inflation and inflation expectations bother her, she'll then also soon need to say what she intends to do about it.

Another rate cut will draw substantial criticism from the German public and the financial sector. Further QE via sovereign debt will draw ferocious opposition from the Bundesbank and other Northern central banks. Might it then be time to revisit purchases of private sector securities?

We all agree that as soon as the underlying economics, particularly inflation and inflation expectations, allows it, it'll be important to begin a normalization process to bring interest rates back to positive territory and to end their asset purchases. Unfortunately, on the present outlook, this will be, at best, a 2021 discussion, and maybe only a 2022 debate we'll be having – unless, we get that fiscal toolbox cracked open across Europe…

So yes, Mme Lagarde, do keep speaking about the need for fiscal policy to play its role, as Draghi did, but don't take your eyes off the details of the benefits and costs – and risks - of the present monetary policy stance. And, as soon as you can, do let us know how you think of the most appropriate reaction functions to positive vs negative shocks in the Eurozone economy.

Question 4: Brexit: Will we soon get a degree of certainty?

Short answer: No! – while the risk of a no-deal Brexit, and the extreme chaos that would bring, have now basically vanished, with the odds heavily favoring Boris' miserable Brexit deal, the uncertainty will continue for years to come.

This coming week we'll learn if we'll get early elections in December. If yes, the Conservatives stand to win an outright majority, in which case we'll get a Boris' deal by the end of January. However, British opinion polls are notoriously poor, so it's not inconceivable that the Conservatives will fail to get an absolute majority, in which case we almost certainly will get a second referendum – the outcome of which remains uncertain, but with the odds skewed towards revoking Art 50, and remaining in the EU – leaving the UK an incredibly divided and politically dysfunctional society for years to come. That spells uncertainty!

But a Brexit deal will leave so much unknown. As I have discussed before, remember, this is just the divorce bill, with all future relationship issues still to be negotiated, a process that'll easily last at least five years. Good luck, Boris!

Finally, in case you want our ongoing comments and analysis of Brexit, as it happens, my colleague, Daniel Vernazza, provides a steady stream of insightful notes, which you can find here: UniCredit Research Portal - Themes: Brexit

And on that note, I'll head out in rainy Manhattan for some coffee and a bit of messing around before getting on a flight back to London tonight.

Best

Erik

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