Sunday Wrap

Happy Sunday,

It's a beautiful autumn day here in Berlin, and apart from a couple of other early birds, I'm alone here at my favorite café.

I'll like to share my thoughts on two topics this morning, namely:

- **Christine Lagarde's maiden policy speech as ECB president on Friday. I thought it was excellent, containing more insight into her thinking than what I read in the media afterwards.**
- **The outlook for the global economy and markets in 2020 and 2021, benefitting from the collective input from my entire economics and strategy teams. I'll summarize our just published annual piece, which we titled "Late-cycle blues" – you get the message…**

1. Lagarde's first policy speech as ECB president: A thoughtful depiction of the landscape – and a few markers on her thinking about policies.

On Friday, Christine Lagarde delivered her first major policy speech as ECB president. The occasion was the 29th Frankfurt European Banking Congress. She was introduced first by Frankfurt mayor, Uwe Becker, who tried to charm her with a few gracious remarks in French, but only to end with a warning that trust in the ECB and its policies is ebbing out with implications for medium term growth.

Lagarde delivered her speech masterfully, of course, but I wonder why she left Becker's remarks on trust unanswered. Wouldn't it have been obvious for Lagarde to open her talk with a reference to opinion polls which show that the trust in the euro has actually now reached an all-time high? Maybe the difference between Germany's financial center and the general public? – I'll get back to that.

But, first, let me discuss the substance of Lagarde's prepared speech. It was excellent, drawing up the economic landscape and the policy options, in the process revealing for the first time where she comes down on some of the big issues facing the ECB. I recommend it in its entirety (it's here: The future of the euro area economy).

Erik F. Nielsen
Global Head of CIB Research
Group Chief Economis
(UniCredit Bank, London)
+44 207 826-1765
erik.nielsen@unicredit.eu

Bloomberg: UCGR, UCFR
Internet: www.unicreditresearch.eu

For me, the highlights were:

As expected, she made a strong case for a boost to domestic demand, but framed it as a need for more public (and private) investment to boost both short term and long term growth (rather than the usual counter-cyclical "fast money" disbursements). She pointed out that "over the past ten years, domestic demand growth has been almost 2 percentage points lower on average than it was in the decade before the crisis, and it has been slower than that of our main trading partners." She also noted that "stronger domestic demand puts economies in better position to withstand swings in the global business cycle and disruptions in world trade … [and it strengthens] the domestic economy, which is that it facilitates rebalancing. More dynamic internal growth offers a way to improve the functioning of the euro area and to accelerate crisis recovery."

In contrast to her relatively well rehearsed fiscal views, Lagarde went further on structural policies – and refreshingly so. Instead of picking on the usual national issues of market rigidities (important as they are), she took a European approach and called for elected policymakers to "empower" the internal market, including by completing the banking union (by striking the right balance between risk reduction and risk sharing), capital markets union, the digital single market and the single market in services." Bravo!

Still better (for me, at least), Lagarde sent some pretty clear messages on the way she is leaning on the key monetary policy issues, including the present stance of policy and how she may think of the forthcoming review. While I'm sure that nothing will change until the new members of the Executive Board have settled in and the portfolios have been allocated, we'll surely also need to wait for the policy review. Yet, I noted three important signals in her speech on Friday:

First, she reminded us that the "long-term deceleration in growth rates [is] … reflected in the long-term decline of global interest rates", adding (note this): "As growth rates are a fundamental driver of interest rates, even countries that have tried to raise interest rates have gradually lowered them again." The message was clear: We can't raise interest rates until growth is back – and growth has to be generated primarily by fiscal and structural policies.

Of course, Lagarde could have gone even further, because not only is potential growth important for rates, there is good empirical evidence that the so-called "consumption risk" is an even more important determinant for equilibrium interest rates. And with all the policy uncertainty around now, this may indeed be an additional issue. Certainly, as you probably know, we are now witnessing an increase in precautionary savings across much of the OECD area, including in the eurozone. In case of interest, Bank of England MPC member Gertjan Vlieghe gave an excellent speech on this back in October; it's here: Monetary Policy: Adapting to a Changed World

Second, she noted that "The ECB's accommodative policy stance … remains in place. As laid out in the ECB's forward guidance, monetary policy will continue to support the economy and respond to future risks in line with our price stability mandate. And we will continuously monitor the side effects of our policies." The reference to the existing forward guidance can only be interpreted as "no change" in policies for the time being, and that – I'm pretty sure – means until the review is done, which I guess will be in late 2020.

Third, Lagarde explained the need for higher inflation very neatly in this way: "Since countries in a monetary union do not have their own exchange rates, they have to adjust to crises through prices. This is easier to achieve when growth is strong at the euro area level and inflation is in line with the ECB's objective. Adjusting countries can quickly improve their relative prices and export more to other members of the union. But if internal demand is too weak and inflation too low, such rebalancing across countries obviously becomes harder."

Again, the message seems clear: We won't settle for a lower inflation target when we do the review! If you are a frequent reader of these Sunday musings, you'll know that I have talked a lot about the issue of relative price changes, and therefore the need for higher inflation, so I was particularly pleased to see this important argument highlighted by Lagarde.

Also, as I have discussed in recent weeks, there seems to be an implicitly (maybe explicitly?) agreed ceasefire between the Governing Council members when it comes to communication of the policy direction. That said, Executive Board member designate, Professor Isabel Schnabel, has not been shy about her call for her colleagues in the German economics community, and the German media, to debate ECB policies in a more serious manner than the simplistic attacks (with few real arguments) we have seen in recent years. As I have tweeted on a number of occasions, this is refreshing, and highly welcome – and I rather suspect Lagarde may feel the same way…

Hence, I also listened carefully to Bundesbank president Jens Weidmann's speech later on Friday. It was a good speech in which he discussed the limitations (and pitfalls) of forward guidance. Again, if you are a frequent reader of this note, you'll know that I too am skeptical about forward guidance if it moves beyond describing the reaction function. That said, I think we all agree with this part of Weidmann's speech: "forward guidance could be a preferred policy tool near the lower bound of interest rates. Indeed, the reformulation of forward guidance introduced in September maintained the focus on policy rates."

But Weidmann went further when he drew conclusions which were clearly aimed at the review. Specifically, he noted that if the ECB were to commit "to hold interest rates lower for longer than implied by the monetary policy rule, the central bank [would] pledge to let inflation overshoot its target in the future. In this way, it could provide an additional stimulus to the economy via inflation expectations". He conceded – yet an option he immediately shot down because of the inherent problem with time inconsistency (I agree) and because "intentionally [aiming for] higher inflation rates would not be consistent with [the mandate of below, but close to 2% over the medium term] … and may pose a communication challenge and a credibility risk". Here I don't think he respects the "medium term" aspect of the mandate sufficiently, and he seems to suggest the target is asymmetric, which I would disagree with. (I also disagree when he characterizes the resulting higher inflation as "a cost" because there is no conceivable scenario that would send inflation so far above 2% that it would entail a risk of a cost to growth.) His speech is here: What the future holds – Benefits and limitations of forward guidance

In other words, the dance at the ECB around the upcoming review is already in full swing. All in all, a fun day in Frankfurt.

2. My team's collective thoughts on the outlook for the global economy and markets in 2020 and 2021.

This past Thursday, we at UniCredit Research published our big annual outlook, covering 2020-21. It's the product of a massive undertaking during many weeks involving all the members of my macro and strategy teams. I hope you'll take a good look at it (it's here: The UniCredit Macro & Markets 2020-21 Outlook: Late-cycle blues)

To whet your appetite, here's a brief summary:

We expect the present global economic slowdown to continue for another year as the weakness in manufacturing spreads to services and consumers, broadly following the normal pattern for this late stage of the business cycle. We forecast a trough in global growth in the second half of 2020, followed by a gradual recovery in 2021 – although back towards a lower trend-growth rate than in the past, primarily because of the rolling back of globalization.

We think the US will experience a mild recession during the second half of next year (timing is always tricky, of course, but direction seems pretty clear to us), while European growth will bottom out during the same period at low but positive growth rates, with the weakness concentrated in some countries, including Germany, Italy and Russia. By the end of 2021, we expect US GDP growth to be back towards 2%, eurozone growth towards 1.5% and the CEE region at close to double that of Western Europe (all annualized rates).

This is not a particularly controversial outlook. On Friday, for example, the OECD also concluded (in their Economic Outlook) that the global economy is fragile. They forecast global GDP to grow by 2.9% this year and then "barely more in the next two years". Like us, the OECD highlights the prospect of the weakness in manufacturing spilling over to services and consumption, and the "downward pressure on hiring intentions, household incomes and spending", partly due to the increasing savings, as I noted above.

We expect monetary policy across most of the world to ease as the downturn proceeds during 2020 (we expect the Fed to cut rates by a total of 100bp), although not the ECB, which will be on hold until after the review is done late next year. Partly as a result, we expect EUR-USD to move towards 1.16 by the end of 2020.

The risks seem higher than usual, and they are all man-made, unfortunately. Global trade policies – starting and ending with Trump – is the single biggest source of uncertainty, and this will continue to have a negative impact on sentiment and, hence, on investment. We include in the report an important section on our four key judgements, which underpin the central scenario (and alternative scenario analyses) namely that (i) trade tensions are here to stay, (ii) the US will enter a mild recession late next year, (iii) there'll be only moderate impulses from monetary policy easing, and (iv) there'll be very little help from fiscal policy.

Given this outlook, our Strategy team recommends a shift towards safer assets. As they write in the Outlook, we think the 2020 asset performance will be a tug of war between monetary stimulus and deteriorating growth prospects (the former cannot prevent the latter!), at a time when most assets look rich compared TO fundamentals. We therefore expect potentially sharp drawdowns for risky assets as a US recession approaches.

Timing the market reaction is difficult, of course – to say the least. However, given the high level of valuations and the build-up of imbalances, we think the global equities correction could be in the order of 20%. The trigger might come from negative news on the consumer side, denting growth prospects, or might be related to sentiment potentially accompanying political developments or policy decisions. In this case, tightening financial conditions would themselves be a driver of the growth slowdown. A recovery in global growth in 2021 would lay the foundation for a recovery in appetite for risky-assets following the bearish turn we foresee.

We see 10Y UST yields dropping as low as 1.50% by year-end, with long duration adding up to over 5% total return over 2020. In the case of prior recession periods (from the 1950's onward), USTs have delivered returns of over 10% on average with peaks at over three times such level, outperforming both cash, credit and equity exposure. However, the starting government bond yield level is much lower this time, but we expect a solid performance, especially in the current market environment.

Credit will benefit somewhat, but as one moves towards lower rated paper, the sensitivity to the slowdown will increase while the support of the Fed will fade out. The US credit cycle poses further risks, given the rising leverage, falling profits and rising default rates. Therefore when it comes to USD denominated assets, we prefer the risk reward offered by duration over credit exposure.

Correlation will work its way into European assets, also exposing European equities to losses. Domestic developments are not supportive of an equity bull story either. Slightly cheaper valuations compared with US equities, relative earnings growth (European companies have stabilized since Q2, although at low levels, while US companies have just started to decline) as well as a higher equity premium (consequence of lower yields across Europe) remain supportive factors for European equities, at least in relative terms.

ECB's flows will continue to support the assets targeted by the asset purchase program. However, we believe that Bunds are close to their fair value and long duration in EUR and will deliver muted returns. Thanks to ECB's flows and featuring the scarce attribute of a yield pick-up, government bonds across periphery will offer better potential, in our view.

Similarly, we believe that European corporate credit will attract solid demand thanks to the hunt for yield and its positive technical picture. Some caution is warranted, however. European companies remain less vulnerable to credit concerns compared with their US peers but spread dispersion will continue across the rating spectrum, with the lowest rated segments more exposed to losses.

As always, I hope we have managed to explain our view of the most likely outlook for the next couple of years, as well as the key risks facing us – and, in the process, that we have managed to provoke you to think about something you hadn't thought about before. The entire UniCredit Research team stands ready to discuss any or all of it, if you have questions or comments.

And on that note, I have now consumed two cups of wonderful coffee, the sun is shining and Berlin is waiting for me….

Best

Erik

Legal Notices

Glossary

A comprehensive glossary for many of the terms used in the report is available on our website: link

Disclaimer

Our recommendations are based on information obtained from or are based upon public information sources that we consider to be reliable, but for the completeness and accuracy of which we assume no liability. All information, estimates, opinions, projections and forecasts included in this report represent the independent judgment of the analysts as of the date of the issue unless stated otherwise. We reserve the right to modify the views expressed herein at any time without notice. Moreover, we reserve the right not to update this information or to discontinue it altogether without notice. This report may contain links to websites of third parties, the content of which is not controlled by UniCredit Bank. No liability is assumed for the content of these third-party websites.

This report is for information purposes only and (i) does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for any financial, money market or investment instrument or any security, (ii) is neither intended as such an offer for sale or subscription of or solicitation of an offer to buy or subscribe for any financial, money market or investment instrument or any security nor (iii) as marketing material within the meaning of applicable prospectus law . The investment possibilities discussed in this report may not be suitable for certain investors depending on their specific investment objectives and time horizon or in the context of their overall financial situation. The investments discussed may fluctuate in price or value. Investors may get back less than they invested. Fluctuations in exchange rates may have an adverse effect on the value of investments. Furthermore, past performance is not necessarily indicative of future results. In particular, the risks associated with an investment in the financial, money market or investment instrument or security under discussion are not explained in their entirety.

This information is given without any warranty on an "as is" basis and should not be regarded as a substitute for obtaining individual advice. Investors must make their own determination of the appropriateness of an investment in any instruments referred to herein based on the merits and risks involved, their own investment strategy and their legal, fiscal and financial position. As this document does not qualify as an investment recommendation or as a direct investment recommendation, neither this document nor any part of it shall form the basis of, or be relied on in connection with or act as an inducement to enter into, any contract or commitment whatsoever. Investors are urged to contact their bank's investment advisor for individual explanations and advice.

Neither UniCredit Bank AG, UniCredit Bank AG London Branch, UniCredit Bank AG Milan Branch, UniCredit Bank AG Vienna Branch, UniCredit Bank Austria AG, UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia, UniCredit Bank Czech Republic and Slovakia Slovakia Branch, UniCredit Bank Romania, UniCredit Bank AG New York Branch nor any of their respective directors, officers or employees nor any other person accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith.

This report is being distributed by electronic and ordinary mail to professional investors, who are expected to make their own investment decisions without undue reliance on this publication, and may not be redistributed, reproduced or published in whole or in part for any purpose.

This report was completed and first published on 24 November 2019 at 14:44.

Responsibility for the content of this publication lies with:

UniCredit Group and its subsidiaries are subject to regulation by the European Central Bank

a) UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), Arabellastraße 12, 81925 Munich, Germany, (also responsible for the distribution pursuant to §34b WpHG). Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

b) UniCredit Bank AG London Branch (UniCredit Bank, London), Moor House, 120 London Wall, London EC2Y 5ET, United Kingdom. Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and subject to limited regulation by the Financial Conduct Authority, 12 Endeavour Square, London E20 1JN, United Kingdom and Prudential Regulation Authority 20 Moorgate, London, EC2R 6DA, United Kingdom. Further details regarding our regulatory status are available on request.

c) UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), Piazza Gae Aulenti, 4 - Torre C, 20154 Milan, Italy, duly authorized by the Bank of Italy to provide investment services.

Regulatory authority: "Bank of Italy", Via Nazionale 91, 00184 Roma, Italy and Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany.

d) UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria and subject to limited regulation by the "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany. Details about the extent of our regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht are available from us on request.

e) UniCredit Bank Austria AG (Bank Austria), Rothschildplatz 1, 1020 Vienna, Austria. Regulatory authority: Finanzmarktaufsichtsbehörde (FMA), Otto-Wagner-Platz 5, 1090 Vienna, Austria

f) UniCredit Bulbank, Sveta Nedelya Sq. 7, BG-1000 Sofia, Bulgaria. Regulatory authority: Financial Supervision Commission (FSC), 16 Budapeshta str., 1000 Sofia, Bulgaria

g) Zagrebačka banka d.d., Trg bana Josipa Jelačića 10, HR-10000 Zagreb, Croatia. Regulatory authority: Croatian Agency for Supervision of Financial Services, Franje Račkoga 6, 10000 Zagreb, Croatia

h) UniCredit Bank Czech Republic and Slovakia, Želetavská 1525/1, 140 92 Praga 4, Czech Republic. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praga 1, Czech Republic

i) ZAO UniCredit Bank Russia (UniCredit Russia), Prechistenskaya nab. 9, RF-119034 Moscow, Russia. Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

j) UniCredit Bank Czech Republic and Slovakia, Slovakia Branch, Šancova 1/A, SK-813 33 Bratislava, Slovakia. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic and subject to limited regulation by the National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia. Regulatory authority: National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia

k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania. Regulatory authority: National Bank of Romania, 25 Lipscani Street, 030031, 3rd District, Bucharest, Romania

l) UniCredit Bank AG New York Branch (UniCredit Bank, New York), 150 East 42nd Street, New York, NY 10017. Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and New York State Department of Financial Services, One State Street, New York, NY 10004-1511

Further details regarding our regulatory status are available on request.

ANALYST DECLARATION

The analyst's remuneration has not been, and will not be, geared to the recommendations or views expressed in this report, neither directly nor indirectly.

All of the views expressed accurately reflect the analyst's views, which have not been influenced by considerations of UniCredit Bank's business or client relationships.

POTENTIAL CONFLICTS OF INTERESTS

You will find a list of keys for company specific regulatory disclosures on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

RECOMMENDATIONS, RATINGS AND EVALUATION METHODOLOGY

You will find the history of rating regarding recommendation changes as well as an overview of the breakdown in absolute and relative terms of our investment ratings, and a note on the evaluation basis for interest-bearing securities on our website https://www.unicreditresearch.eu/index.php?id=disclaimer and https://www.unicreditresearch.eu/index.php?id=legalnotices.

ADDITIONAL REQUIRED DISCLOSURES UNDER THE LAWS AND REGULATIONS OF JURISDICTIONS INDICATED

You will find a list of further additional required disclosures under the laws and regulations of the jurisdictions indicated on our website https://www.unicreditresearch.eu/index.php?id=disclaimer.

E 19/3

UniCredit Research* — Macro Research

Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research

Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research

Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu

Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at

Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu

Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

EEMEA Economics Research

Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu

Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de

Florin Andrei, Ph.D.
Senior Economist, Romania
+40 21 200-1377
florin.andrei@unicredit.ro

Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr

Dr. Ágnes Halász
Chief Economist, Head of Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu

Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg

Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

MR 19/3

*UniCredit Research is the joint research department of UniCredit Bank AG (UniCredit Bank, Munich or Frankfurt), UniCredit Bank AG London Branch (UniCredit Bank, London), UniCredit Bank AG Milan Branch (UniCredit Bank, Milan), UniCredit Bank AG Vienna Branch (UniCredit Bank, Vienna), UniCredit Bank Austria AG (Bank Austria), UniCredit Bulbank, Zagrebačka banka d.d., UniCredit Bank Czech Republic and Slovakia, ZAO UniCredit Bank Russia (UniCredit Russia), UniCredit Bank Romania.