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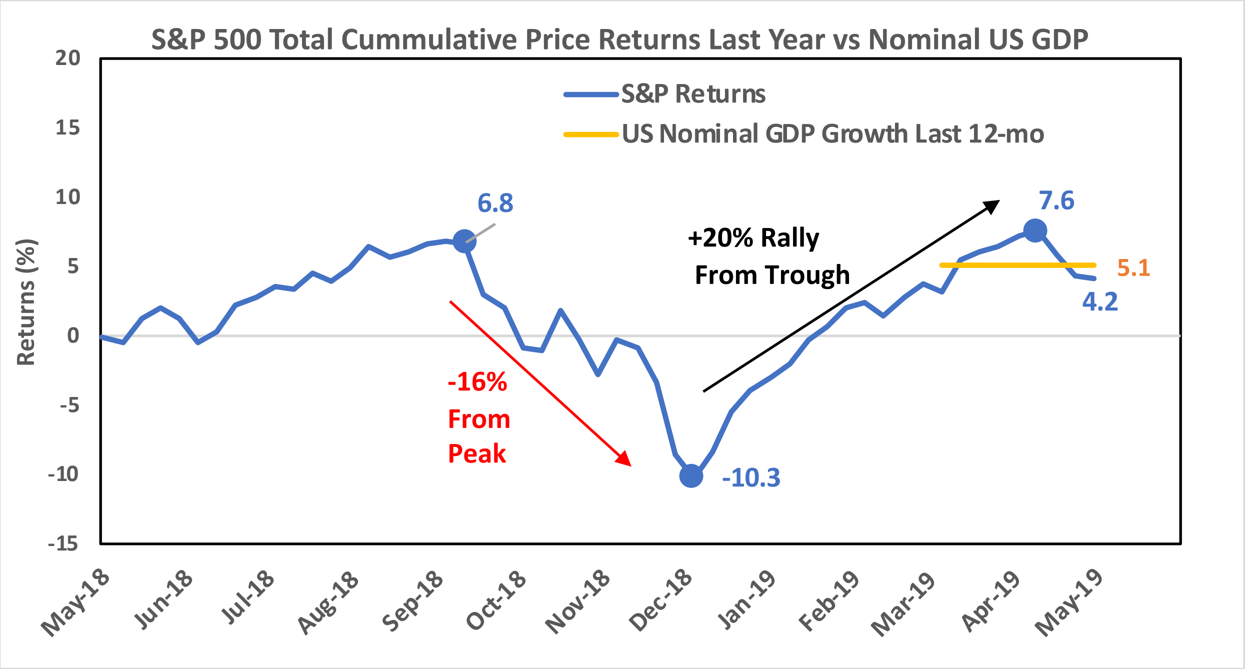
State Of the Markets: Macro Commentary

Here We Go Again: The Reemergence of the Risk of a Global Slowdown

A Rally That Wasn't

Here we go again as the risk of global slowdown once again reasserts its hold on markets. Risk assets had rallied from the global slowdown driven sell-off trough of late 2018 even with the negative news about Brexit, the Muller report, and Iran saber rattling. However, this rally is hardly a confirmation that world economic growth is robust. As shown in the graph below, the equity rally from the trough pretty much brought markets back to the levels prior to the sell-off, and consistent with nominal GDP growth.

Figure 1: Despite 20% Rally, Equities Are About Where They Were in 2018 Prior to The December Sell-off



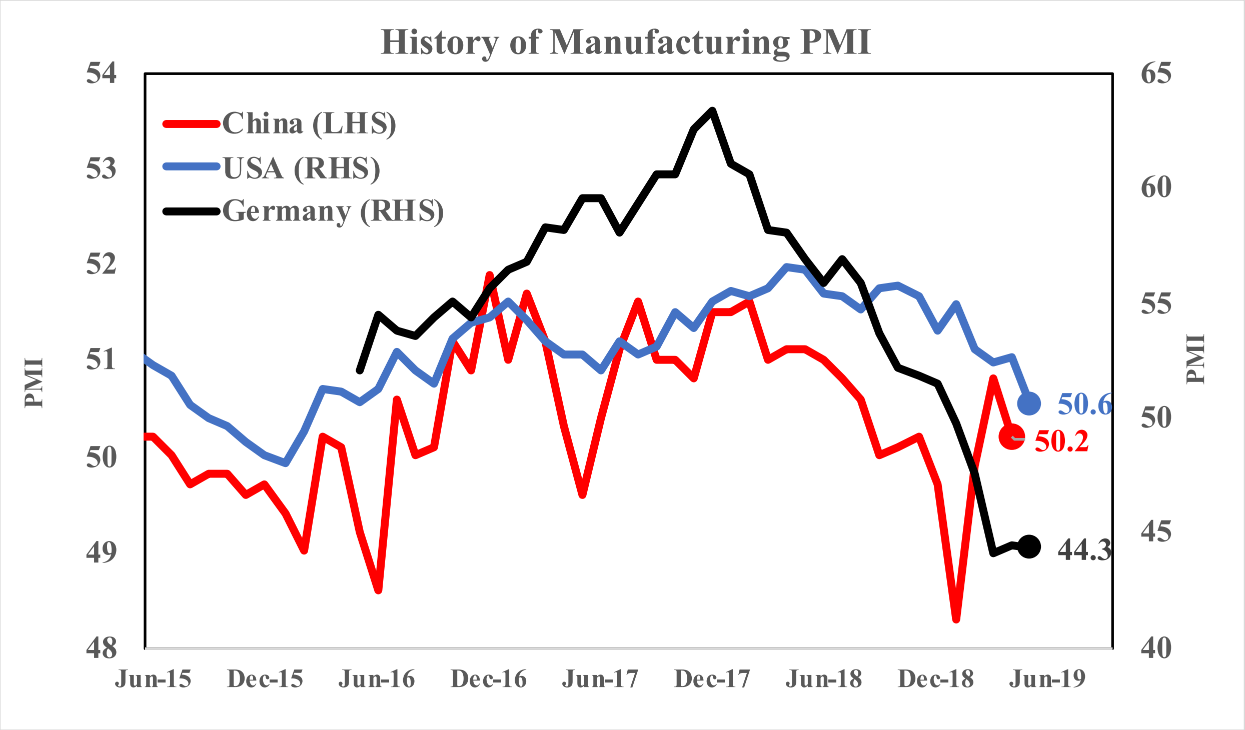
The 2019 rally probably reflects the view that a near term slowdown that was being priced in during December was not in the cards, particularly given the potential downside risk seemed to be abating: China/US economic war. The market discounted the potential of these negotiations turning south. The argument I heard most often was that Trump would agree to pretty much anything to set the stage for the 2020 elections. He would just declare victory even if the original goals of changing the Chinese economic model failed to materialize. This rally, such as it is, was brought to a stop because the thesis of a quick end to the China/US economic war was proved wrong as the US increase tariffs to 25% on $200 billion of imports from China, and Trump threatening tariffs on the remaining $300 billion or so of imports. Not surprisingly, China has threatened retaliation as well. More importantly, the escalation is starting to have an impact on economic growth not just in the US and China but in the rest of the world, where economic growth was already slowing. Hence, the reemergence of the macro theme of global slowdown. In my view, the repricing is not finished both because global growth will continue to slow until governments push through another round of stimulus and because it is unlikely that the China/US economic war resolution will happen any time soon. First, in my view, the economic war will not be easily resolved by a simple agreement with

Trump. This economic conflict was brought to confrontation with China through a broad base of support from Democrats and Republicans in the US, and by Europe, particularly Germany. So, Trump could not just unilaterally declare victory without a substantial push back, not just from Democrats but from his own party and from Europe. Second, the goal of these negotiations was all about technology not trade. The focus was on trying to stop the systematic acquisition of cutting-edge US technology by China both directly and through theft as driven by the push of their "built in China 2025" plan. Accordingly, the goal of US tariffs is not trying to close the trade gap with China but in forcing the Chinese to change their behavior. Third, China was unlikely to agree to any fundamental changes in their "2025 plan" and their drive towards acquiring high tech manufacturing because they needed it to offset the headwinds of demographics and inefficient investments that is dragging down their GDP. The fourth reason, and in some sense the most important one, is that China has not followed through on any agreement that have made with the world or the US to change in the last 20 years. So, how can any agreement reverse that behavior… the answer it can't, unless China wants to change and as I point out in point 3, they don't.

Slowing World Growth And The Emergence Of The Economic Growth/Policy Cycle

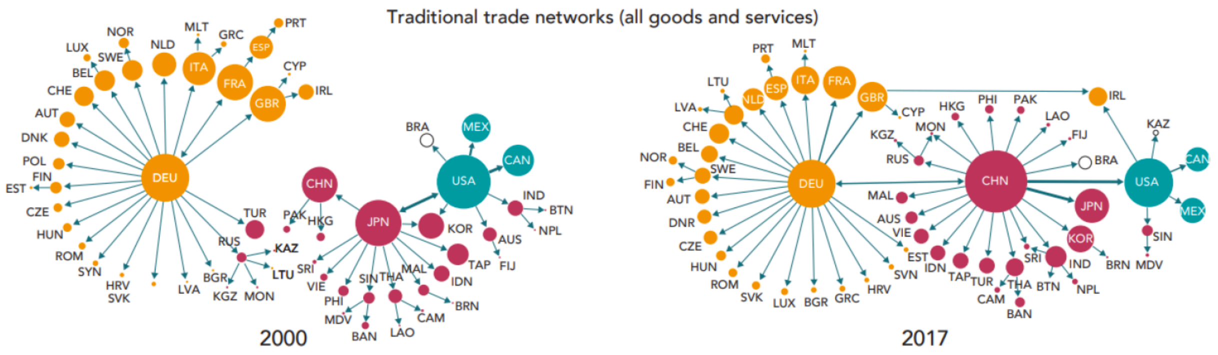
So, the slowing growth of the world's economy will be hit by yet another headwinds driven by the negative impact of a deteriorating economic war of China/US, as show in Figure 2. The key question is will this slowdown along with the turn south of the trade war push governments to turn to stimulus, much as they have in the last three times of slowing growth as shown in figure 3.

Figure 2. Even Before the Trade War Escalation, Economies Were Slowing



As I have argued in the other pieces is that world growth is slowing because the underlying the growth levels of 2001-7 were artificially driven by the powerful tailwind from the intro of China into the world economic infrastructure through WTO That growth fed growth in the world through trade and the global value chain (GVC) as shown in Figure 3, supported by the mortgage credit growth of the US.   World growth has fundamentally slowed because there have not been other factors to replace these tailwinds of growth, as shown in Figure 4. In addition, the growth in China could slow as the current QVC in China moves to other parts of the world.

Figure 3. China Has Replace Japan As the Center Of The Global Value Chain (GVC)


Traditional trade networks (all goods and services)
2000
DEU
ITA
FRA
GBR
ESP
PRT
CYP
IRL
MLT
GRC
NLD
NOR
SWE
LUX
BEL
CHE
AUT
DNK
POL
FIN
EST
CZE
HUN
ROM
SYN
HRV
SVK
LVA
BGR
KGZ
MON
LTU
KAZ
RUS
TUR
PAK
HKG
CHN
JPN
USA
MEX
CAN
BRA
IND
BTN
NPL
KOR
AUS
TAP
FIJ
IDN
BRN
CAM
LAO
BAN
MDV
PHI
VIE
SRI
SIN
THA
MAL
2017
DEU
CHN
USA
JPN
KOR
MEX
CAN
KAZ
IRL
BRA
FIJ
LAO
PAK
PHI
HKG
CYP
MON
KGZ
RUS
MAL
AUS
VIE
EST
SVN
IDN
TAP
TUR
THA
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CAM
BAN
SRI
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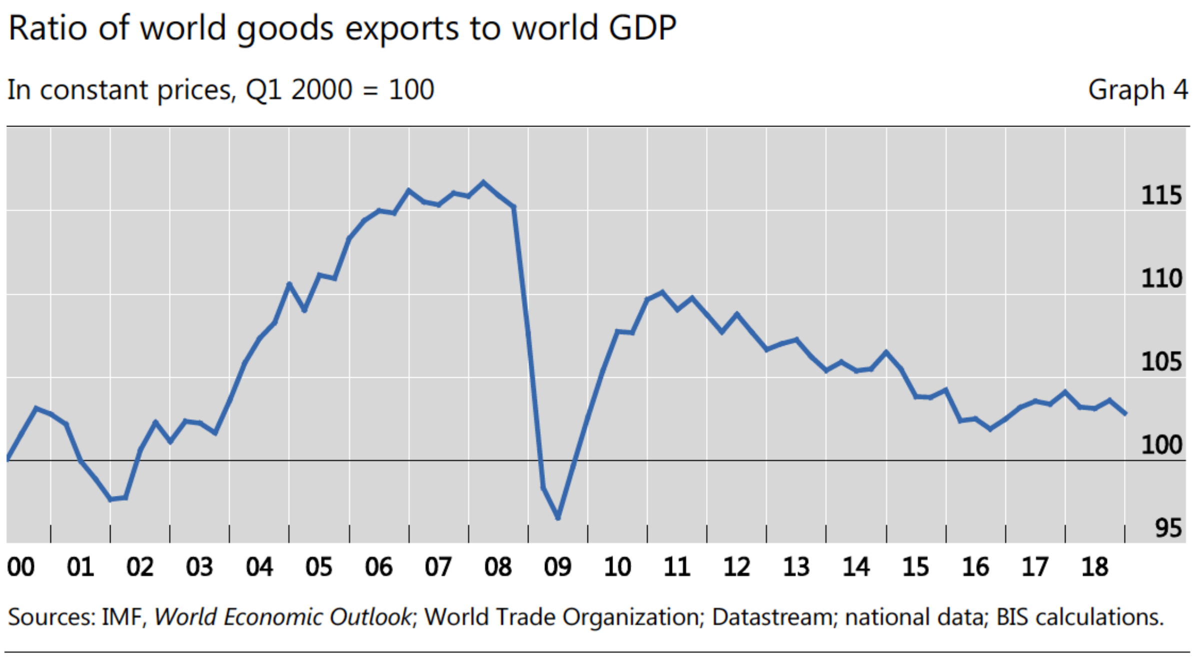
NPL
BRN
MDV
SIN
PRT
MLT
ESP
ITA
FRA
GBR
NLD
LTU
LVA
CHE
BEL
NOR
SWE
FIN
AUT
DNR
CZE
HUN
ROM
SVK
LUX
BGR
GRC
HRV

Source: X Li, B Meng and Z Wang, "Recent patterns of global production and GVC participation", in D Dollar (ed), *Global Value Chain Development Report 2019*, World Trade Organization et al (see footnote 3 for full reference).

Figure 4. World Growth Has Slowed Because World Trade Has Slowed

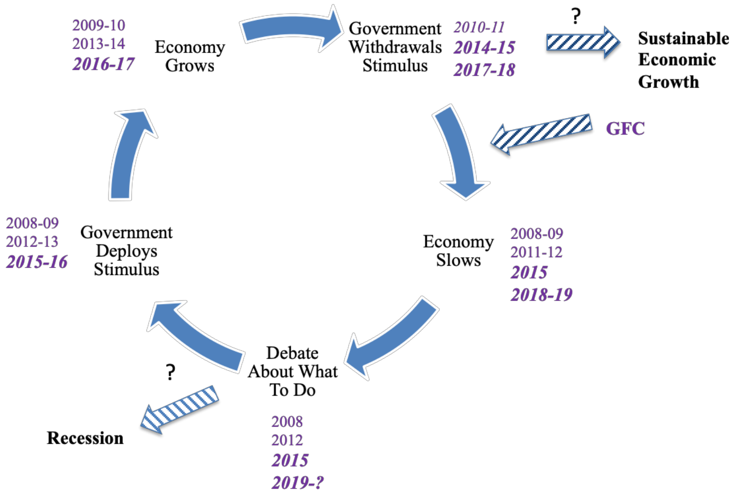


Sources: IMF, *World Economic Outlook*; World Trade Organization; Datastream; national data; BIS calculations.

However, governments around the world are unwilling to concede that the growth in 2001-7 was an aberration but rather the target level for growth that was temporarily pushed down by the GFC. Accordingly, governments have created the policy/economic cycle shown in Figure 5. And it is this cycle that has created strategies since 2008 and continues to provide opportunities in the current economic slowdown.

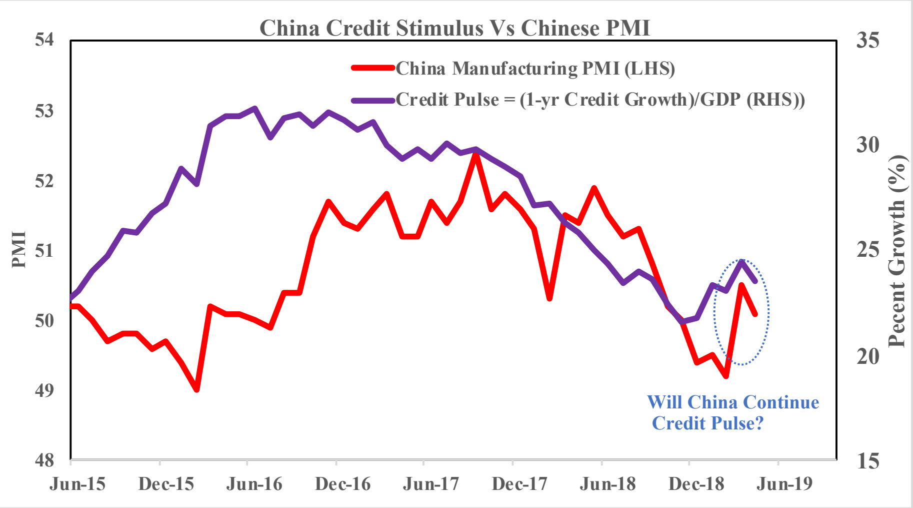
Figure 5. The Direction of Growth Will Determined By The Next Turn of The Policy Cycle

The Next Turn Of The Stimulus Cycle


2009-10
2013-14
2016-17
Economy Grows
Government Withdrawals Stimulus
2010-11
2014-15
2017-18
?
Sustainable Economic Growth
GFC
Economy Slows
2008-09
2011-12
2015
2018-19
Debate About What To Do
2008
2012
2015
2019-?
?
Recession
2008-09
2012-13
2015-16
Government Deploys Stimulus

The ultimate degree of slowdown could be determined by the decision by government's about stimulus, most importantly, China and the US. However, the decision by the US and China governments about stimulus is not entirely clear without risk. As shown in figure 4, the recent china credit stimulus ebbs and flow are a perfect example. China slowdown in the 4th quarter 2018 pushed them to pick up credit stimulus with the resulting pickup in growth in the 1st quarter of 2019. However, their reluctance to continue down the credit stimulus path resulted in their slowing the pulse with the resulting slowdown. As I have argued elsewhere, they are more likely to use other channels for stimulating their economy other than credit. More likely that they wait to see the extent of the slowdown in China before they push credit stimulus.

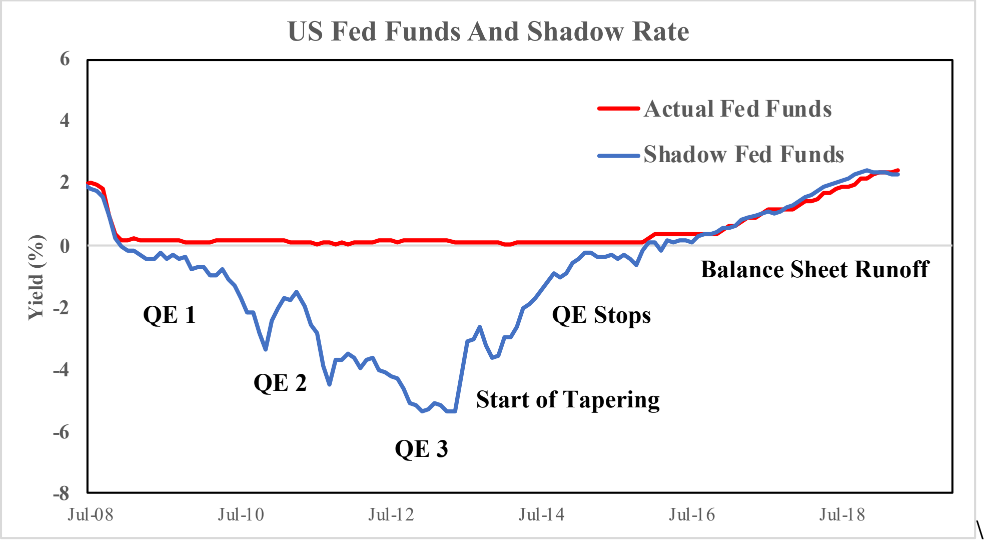
Figure 6. China Economy Follows The Path of Credit Stimulus



That brings us back to the Fed. The real issue is the Fed: will they or won't they? They are clearly torn. One part of their mandate is full employment, which looks rosy. However, the US economy even with the strong Q1 numbers is actually slowing. The headwinds from China/US trade war and the ebbing of the impacting on GDP from fiscal stimulus will weigh on US economic growth. Accordingly, I believe they cut rates and start up QE4. They have already stated they will stop rolling off their balance sheet. The next step will be outright easing, more likely cutting rates not just forward guidance.

A major rate cut will have to wait for a substantial softening of the labor market or in inflation expectations. But, given the rising uncertainty about growth, those events are likely in the next six months. In addition, they are starting to come to grips the impact of their policy actions on the World and hence on the US economy of the last few years that goes beyond rate hikes. In the graph below, I show both the actual path of Fed Funds as well as a measure of Fed Funds that incorporates QE, the shadow Fed Funds rate. This measure adjusts for the zero bound. On this measure, the Fed has effectively tightened rates almost 700 bps. As I have written about, it is QE rather than rate hikes that have had the biggest impact on EM.

Figure 7. The Extent of The Fed's Tightening Is Substantially Understated By Their Rate Hikes



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What to Do?

I am positioning for all the governments to blink and turn to stimulus in one form or another but in a non-systemic fashion. I believe that the ECB will need to act very soon given the deteriation in government finances of Italy—read the news today--and the lack of pickup in Germany growth without a pickup in exports to China. Next will be the Fed. Again, as I have argued previously core growth in the US is slowing even with the current strength of the labor markets. The tail wind from fiscal stimulus is ebbing, and 2nd quarter growth will slow substantially as the transitory positive factors in 1st quarter—trade and inventory--become drags on growth in the 2nd quarter. Ultimately, the impact of the tighter monetary policy, in combination with the impact from the trade war will ultimately erode even the labor market. More importantly, looking the Fed looks out of place given the policy stance both fiscal and monetary of the rest of the world. So, here is what I am recommending, as I have detailed more extensively in other pieces.

- Buy receivers in the US or curve caps
- Buy Euro puts/USD calls
- Buy receivers on Euro rates
- Sell CNH and buy US

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