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Global Macro Environment: Outlook for 2020

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5 December 2019

CIO outlook 2020

The benign market environment should continue for the time being. However, an economic slowdown or rising inflation could throw a spanner in the works.

Economic outlook

The global financial market environment is currently in an equilibrium state of moderate growth, expansionary central bank policy and low inflation (the so-called “Goldilocks scenario”). However, we are seeing a trend towards a slowdown in global economic growth mostly due to trade war uncertainties.

Interest rates continue to trend downwards globally. However, markets have lately started to anticipate a somewhat less loose monetary policy from the Fed, which in turn has prompted our macro model to signal a possible turnaround in interest rates in the US, in particular. Other regions, such as Europe and Japan, could follow in the medium term if economic growth stabilises again and trade war uncertainties ease.

A number of meaningful, early economic indicators remain positive and are surprisingly robust (copper prices, consumer credit banks and credit card companies in the US). In particular, the global transport sector remains stable (e.g. container shipping). And the trend in European transport indices also continues to point upwards.

The Chinese currency (yuan) remains stable. This is a positive development of global relevance as it is essential that the significant monetary easing on the part of the Chinese central bank has an undisturbed and positive effect on the economy, without agitating currency markets. Thus, the potential for future interest rate cuts by the Chinese central bank remains intact.

Favourable environment for financial markets

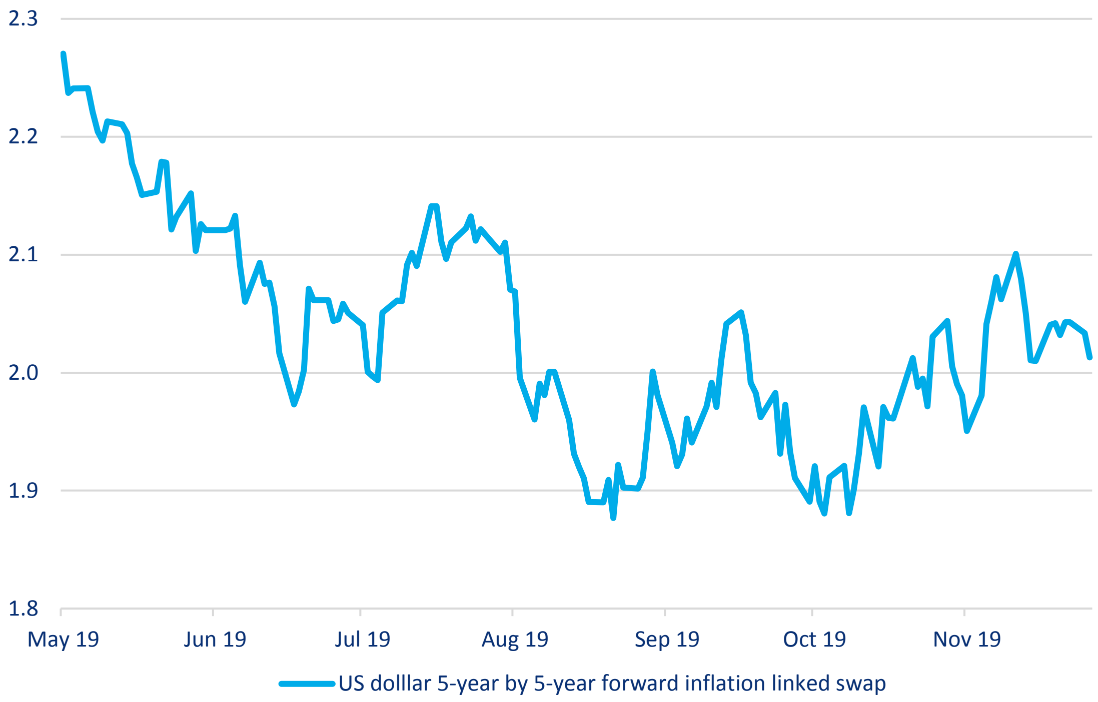
Looking at the big picture on financial markets, we have been observing the two phenomena “Goldilocks” (mentioned above) and “Wall of Worry” for some time.

The “Wall of Worry” refers to widespread doubts on the part of investors and analysts about the systemic health of the financial system from multiple perspectives. As long as the Wall of Worry is in place, however, there are usually no market bubbles or major exaggerations. Valuations on financial markets appear fair rather than excessive and speculation is restrained.

Together, these two phenomena have historically contrived to form a favourable environment for financial markets, as they combine positive fundamental, monetary and psychological factors. A combination that, however, is often ignored and appears rather unspectacular.

Historically, inflation has typically sounded the death knell for Goldilocks. As soon as inflation rises too high, loose monetary policy becomes very difficult to maintain, and at the same time the economy overheats. Excessive confidence in the longer-term stock market outlook and complacency on the part of investors lead to an overly positive sentiment, which is a contrarian indicator.

Chart: Inflation expectations remain low, but first signs of trouble need to be watched closely



Source: Thomson Reuters Eikon, November 2019

Market-based inflation expectations, as measured by the five-year forward inflation-linked swap five years ahead, are still low. But there are initial signs of a trend reversal and a level above 2.6% would constitute a warning signal.

Summary

What would need to happen for the "Goldilocks scenario" to end? We are seeing two main dangers here:

1) an economic slowdown
2) a more restrictive monetary policy by the central banks (higher interest rates or/and an end to quantitative easing (QE)).

A more restrictive monetary policy would likely occur if the economy accelerates or inflation expectations rise. Neither strong inflationary pressures nor robust economic growth currently exist. Therefore, we expect a continuation of the favourable Goldilocks environment for the time being. However, the tide can turn quickly on inflation, as there is a great deal of liquidity in the system. This excess liquidity can lead to unexpected inflationary effects via multiplier effects or simply lead to higher inflation expectations. Developments must therefore be closely monitored.

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