NOVO BANCO

Global Economic Outlook and Risks

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The global economy is in a late stage of the cycle. Activity should continue to expand, but at a slower pace. Downside risks have increased.

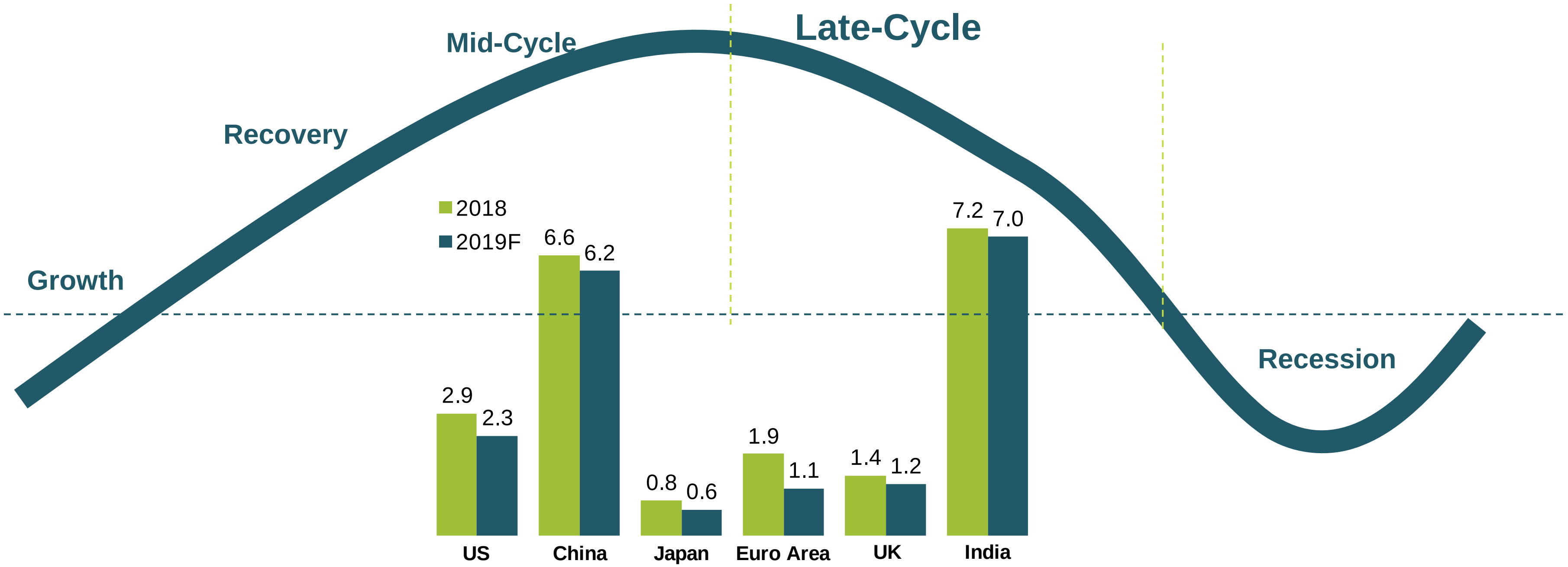
Late cycle constraints:

- Limited spare capacity
- Scarcer resources
- Higher wages and costs
- Less expansionary policies

Lower Growth

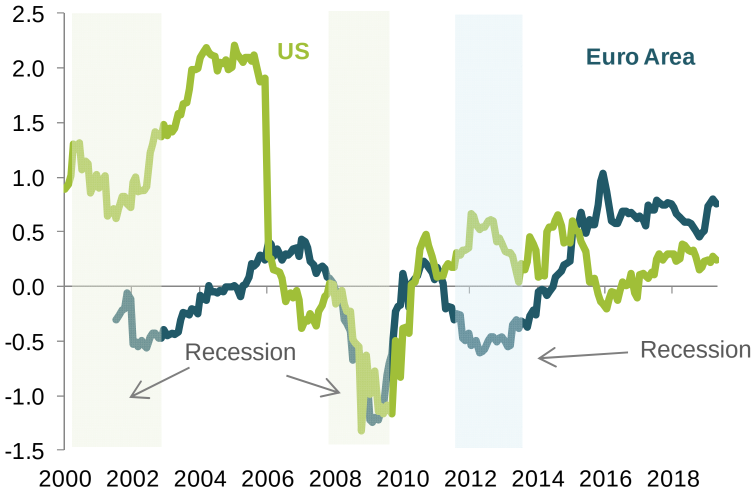
US (Fed Beige Book): *"Labor markets remained tight, including notable worker shortages for positions relating to information technology, manufacturing, trucking, restaurants, and construction. (…) Wages continued to increase for both low- and high-skilled positions."*

Portugal (BoP Economic Bulletin): *"The number of firms reporting difficulties in hiring skilled workers is above the historical average. Among the factors limiting production, hiring difficulties are reported as the second most important factor."*

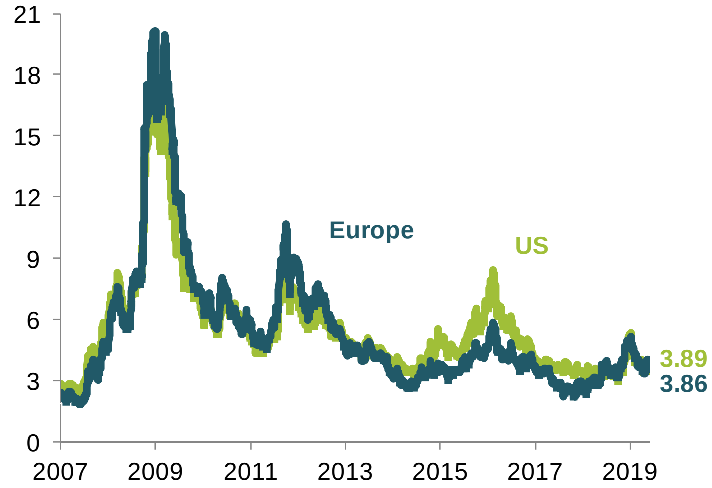


Slower activity has been mainly reflecting a convergence towards trend growth. Fundamentals are still supportive of growth.

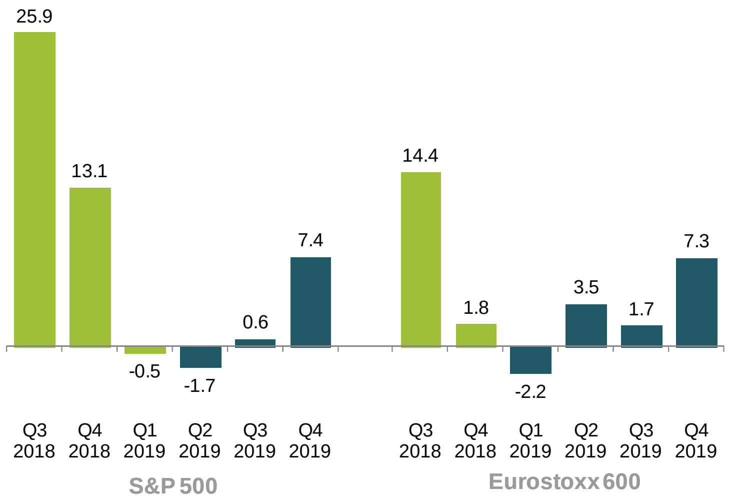
Monetary and financial conditions indicator



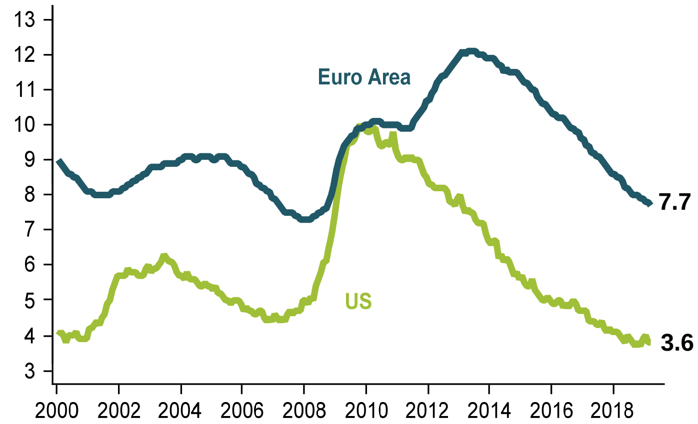
Bloomberg Barclays Corporate High Yield Index (Average Yield, %)



Corporate earnings growth (% YoY)



Unemployment rate (% labour force)



Sources: Bloomberg, Macrobond, Factset, Reuters, NB Economic Research.

So far, expectations of a benign economic scenario in 2019 have mostly been confirmed. But exogenous risks, arising from trade and political tensions, are becoming more serious.

"BENIGN" 2019 SCENARIO

- Current activity indicators reflect a convergence of growth towards its trend, i.e. towards more moderate but more sustainable levels. The main economies should continue to expand.
- Wages increase, but at moderate rates. Inflation remains contained.
- The US Fed moderates its bullish outlook and slows down or interrupts its policy rate increases in 2019.
- Financing conditions remain favourable. Corporate credit spreads remain contained. Corporate earnings continue to increase, even if at more moderate rates.
- Beyond oil, industrial commodities exhibit a more stable behaviour.
- The main political risks (e.g. trade wars, Brexit, Italy) develop into benign outcomes.

Resilient GDP and domestic demand growth in Q1. US and Euro Area continue to create jobs. Downturn in industrial activity associated with specific sectors (autos) and with China deceleration.

~3.5% YoY growth in US wages; ~2%-2.5% growth in Euro Area wages. Inflation close to average. The Fed and the ECB have adopted a more cautious stance and have signalled no further increases in policy rates in 2019.

Positive returns in the main equity indices. Credit spreads remain contained. YoY decline in Q1 2019 earnings, but a recovery to single digit growth is expected ahead).

>30% YTD increase in oil prices (Brent).

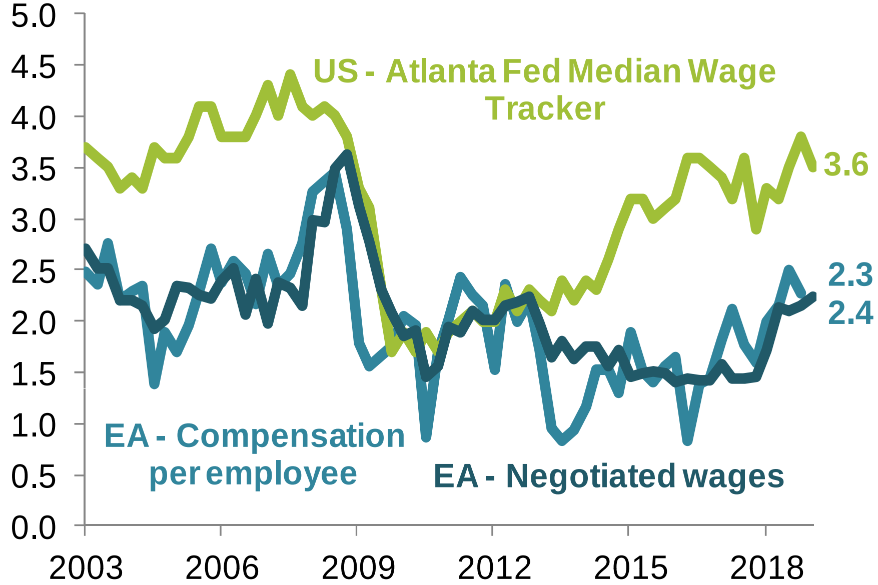
~5%-7% YTD in the CRB metal and food indices.

Trade and political tensions are building. Trade wars (US-China, US-EU), Brexit, EU-Italy Budget tensions, US-Iran military/political tensions, etc. are major downside risks

With higher wage growth (and higher oil prices), why is inflation still low...?

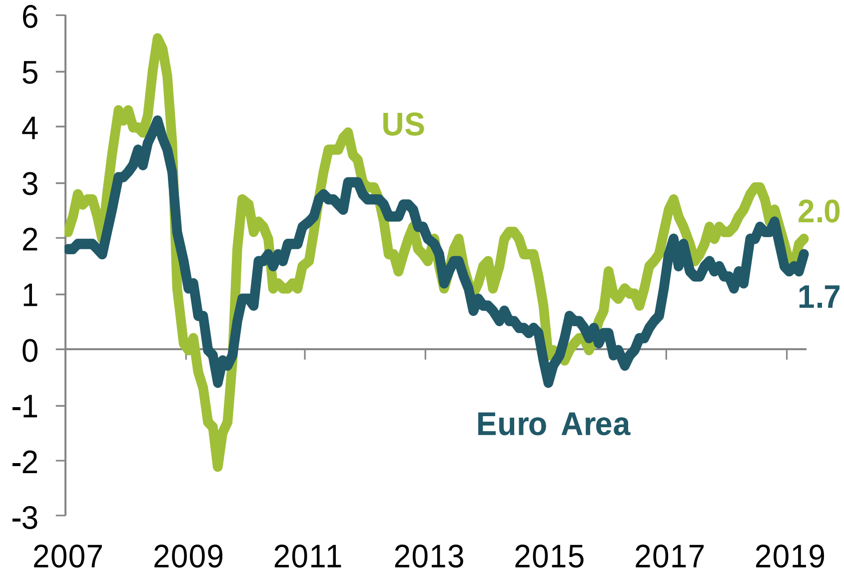
Wage growth

(% YoY)



Inflation rate

(% YoY)



Sources: Bloomberg, NB Economic Research.

(i) Globalisation and automation have hurt workers' bargaining power;

(ii) Dominant global firms tend to prevent competition, faster productivity growth and higher wage growth;

(iii) Firms have low pricing power; this may reflect lack of confidence in demand growth, as well as the rise of digital commerce, which has increased the ability of consumers to find the lowest prices;

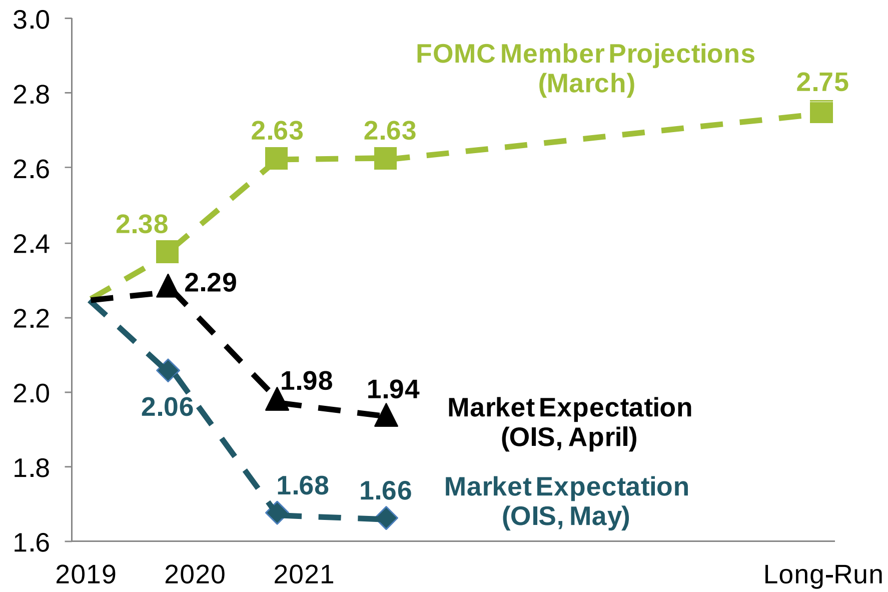
(iv) Firms have been accommodating higher wages and costs through lower profit margins.

(v) Central Banks have gained more credibility in fighting inflation.

Dovish stance from the main central banks has led to downward revisions in interest rate expectations.

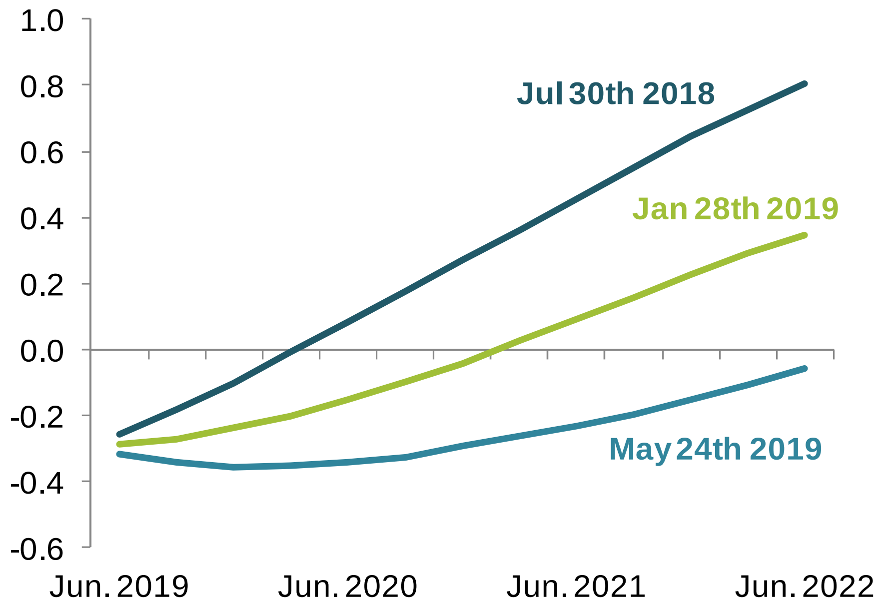
Expectations for the US Fed Funds rate

(%)



Market expectations for the 3m Euribor

(%)



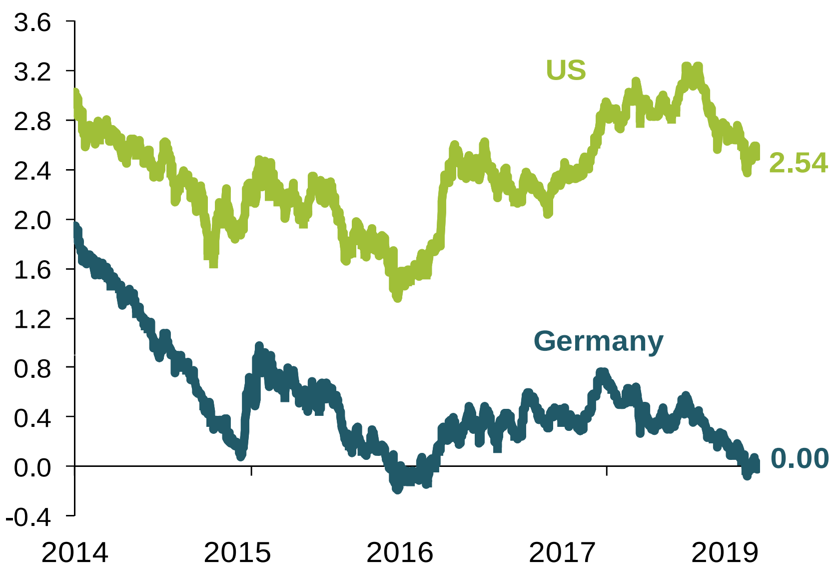
Sources: Bloomberg, NB Economic Research.

Low inflation expectations and a rise in global risks have led the main central banks to adopt a dovish stance in monetary policy. The US Fed and the ECB have lowered their growth and inflation forecasts and have signalled that there will be no policy rate increases in 2019. The market has reacted by lowering further its expectations for market interest rates.

An environment of low interest rates should remain in place.

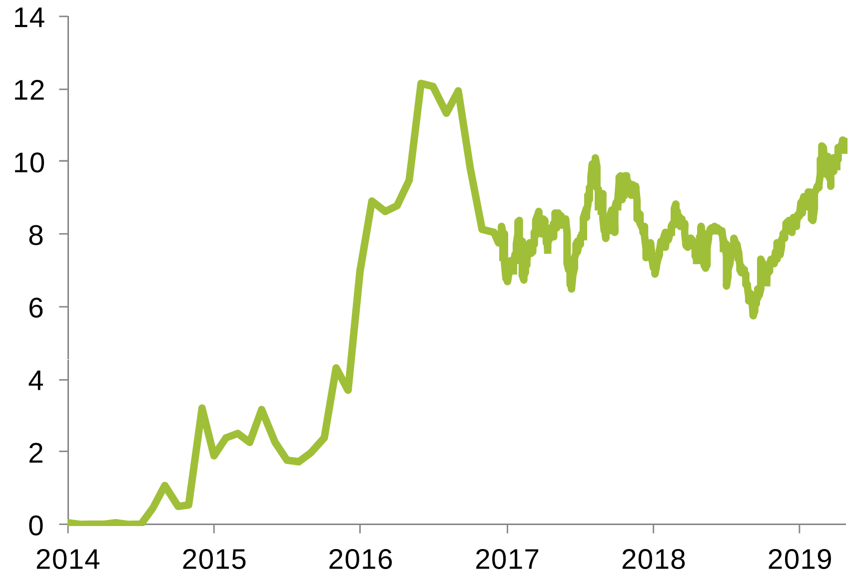
10Y Treasury and Bund yields

(%)



Public debt with negative yields

(USD trillion)



Sources: Bloomberg, NB Economic Research.

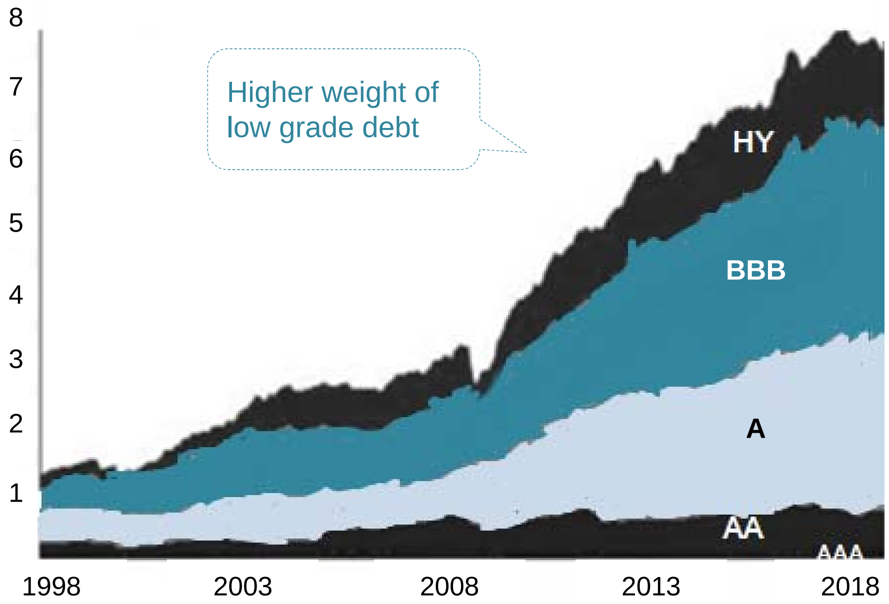
Significant liquidity injections by the main central banks have failed to lift inflation and GDP growth significantly. This has sparked fears of an economic and financial "ice age" (successive lower highs and lower lows for inflation and nominal GDP growth). This scenario may be exaggerated. But central banks' dovish stance suggests we should expect low rates for longer.

It could be argued that central bank expansionary policies have contributed to asset price inflation, while perpetuating inefficient resource allocation.

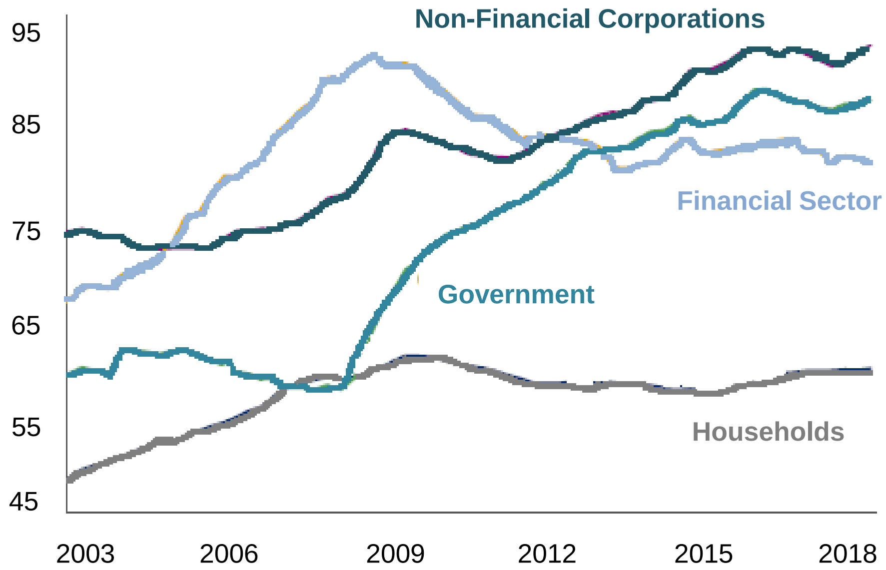
The environment of low interest rates has contributed to higher debt levels, and search for yield in financial markets has resulted in higher exposure to lower grade and higher risk debt.

US (investible) corporate bond market

(USD trillion)



Global debt by sector (% GDP)



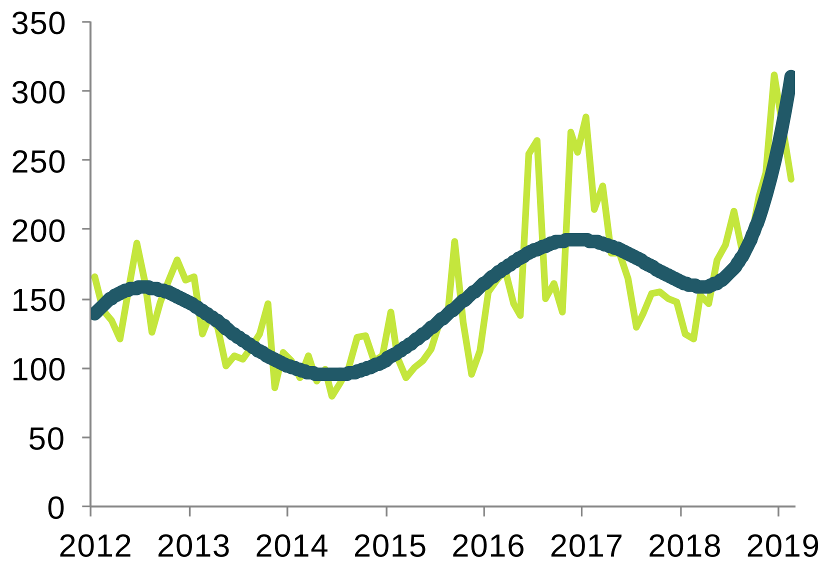
Sources: IIF, IMF, BIS, NB Economic Research.

The more cautious stance in monetary policy adopted by the Fed should prevent a sudden deterioration in credit markets caused by a more aggressive increase in interest rates. However, there is a risk that further downward revisions in earnings growth expectations could lead to corporate rating downgrades. Given the significant increase in BBB and HY debt in recent years, this could lead to a more visible deterioration in credit market conditions, supporting a more marked slowdown in economic activity.

Political and trade tensions are looming over the world economy. Higher uncertainty constrains spending decisions and hurts activity growth.

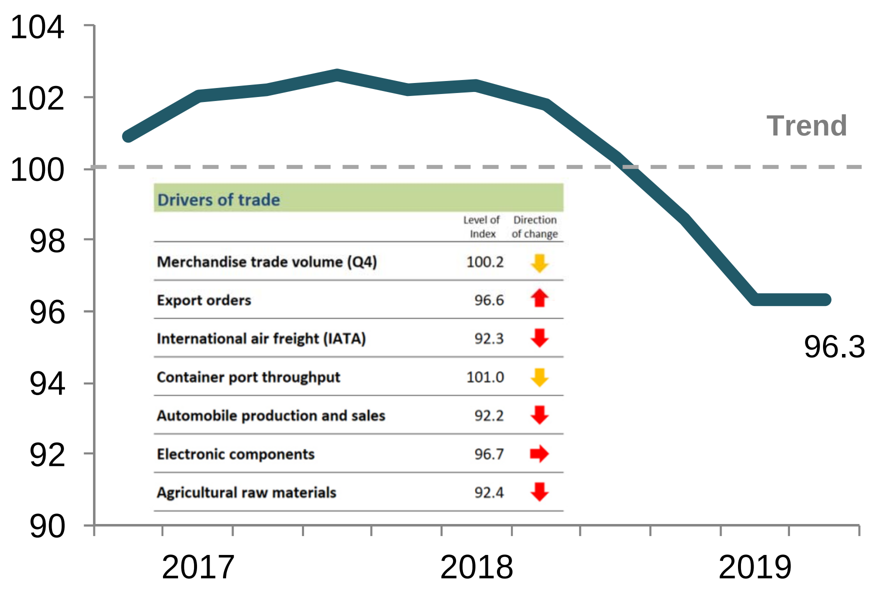
Global policy uncertainty indicator

Monthly data, actual and trend



WTO World Trade Outlook Indicator

(Trend=100, Quarterly)



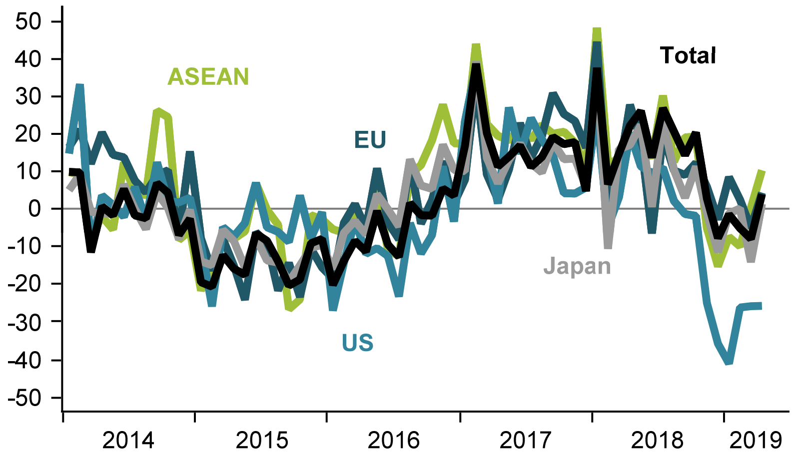
Drivers of trade	Level of Index	Direction of change
Merchandise trade volume (Q4)	100.2	
Export orders	96.6	
International air freight (IATA)	92.3	
Container port throughput	101.0	
Automobile production and sales	92.2	
Electronic components	96.7	
Agricultural raw materials	92.4	

Sources: Policy Uncertainty, WTO, NB Economic Research.

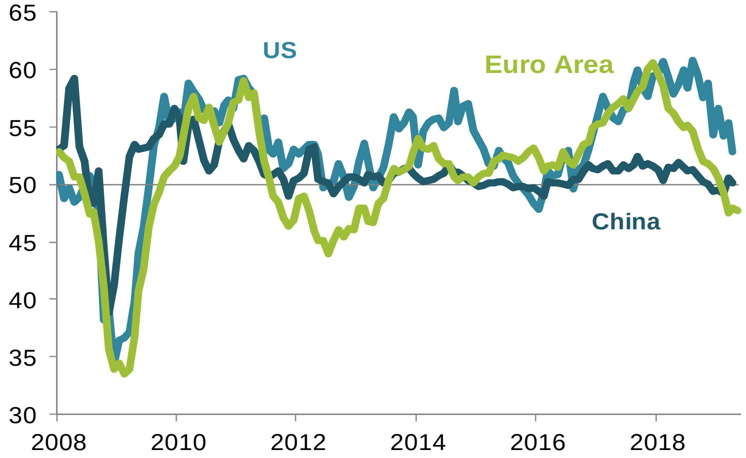
Political uncertainty related to trade wars, Brexit, rising populism in Europe, etc. is constraining confidence levels and investment spending. Structural adjustments and disruptions in production caused by trade wars have translated into slower growth in China's economy, with negative impacts on global demand.

The US-China trade war brings disruption to production and supply chains. It leads to lower growth and higher prices.

China – Imports from major trade partners
(% YoY)

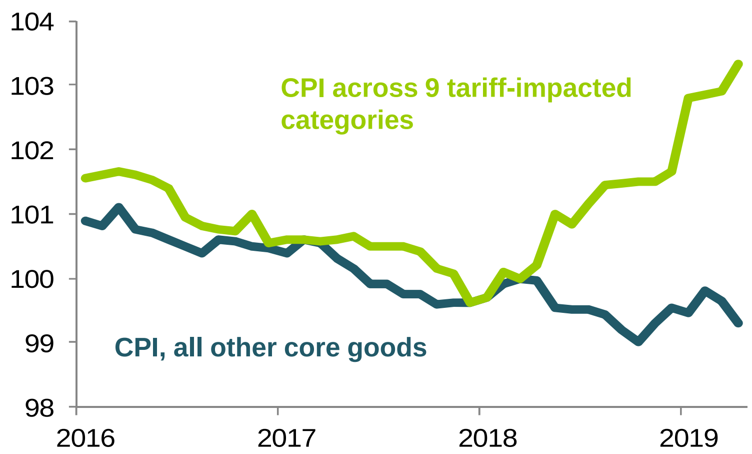


Manufacturing activity indicators
US ISM Manufacturing, Euro Area & China PMI Manufacturing



US imports from Vietnam (% YoY)

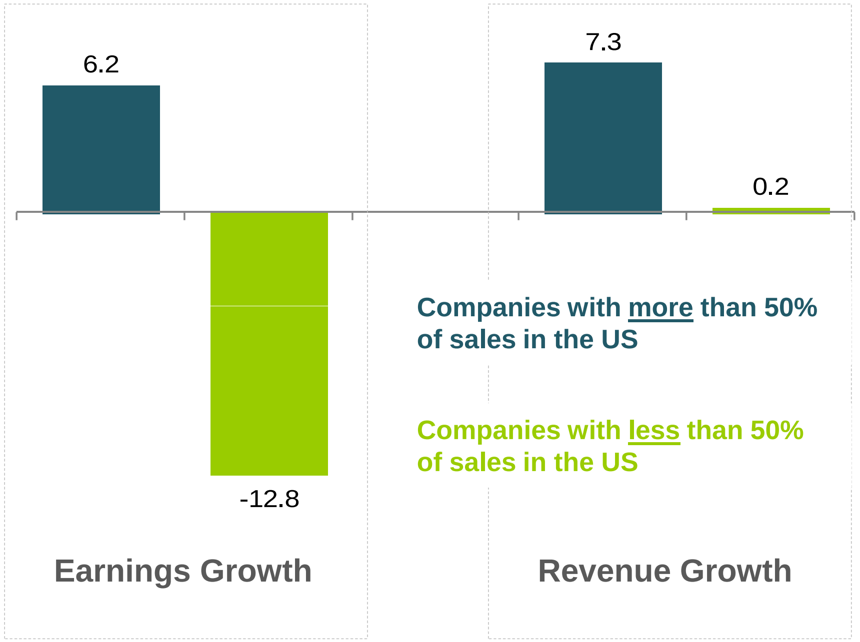
US Consumer price index (Feb 2018 = 100)



Sources: Bloomberg, Macrobond, Vietnam MPI, NB Economic Research.

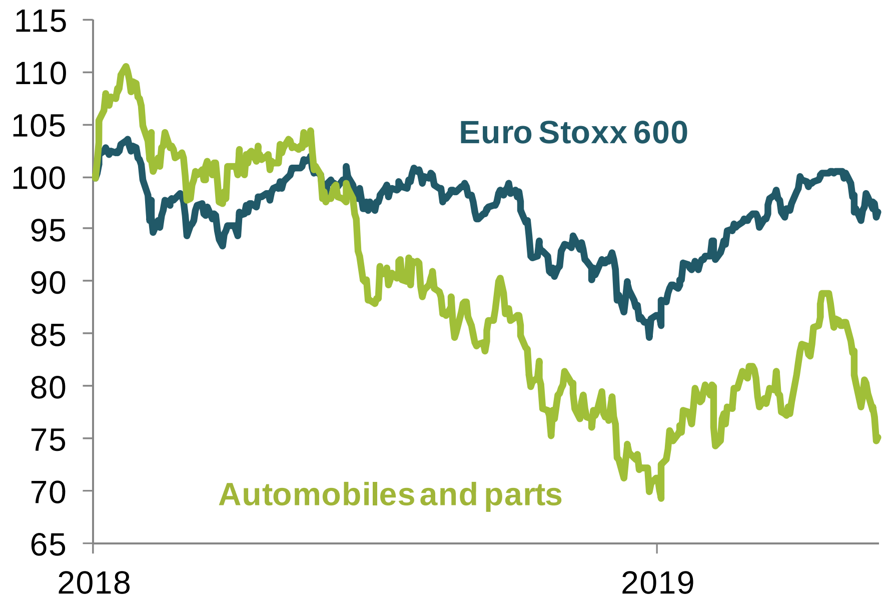
Tariffs are a tax on companies and consumers, and its impact will be increasingly felt as the trade war continues. Companies more exposed to trade flows are more impacted. US tariffs on Europe’s autos are a risk.

S&P 500 earnings and revenue growth, Q1 2019 (% YoY)



Euro Stoxx 600 stock index

General index vs. Autos (Jan 2018 = 100)



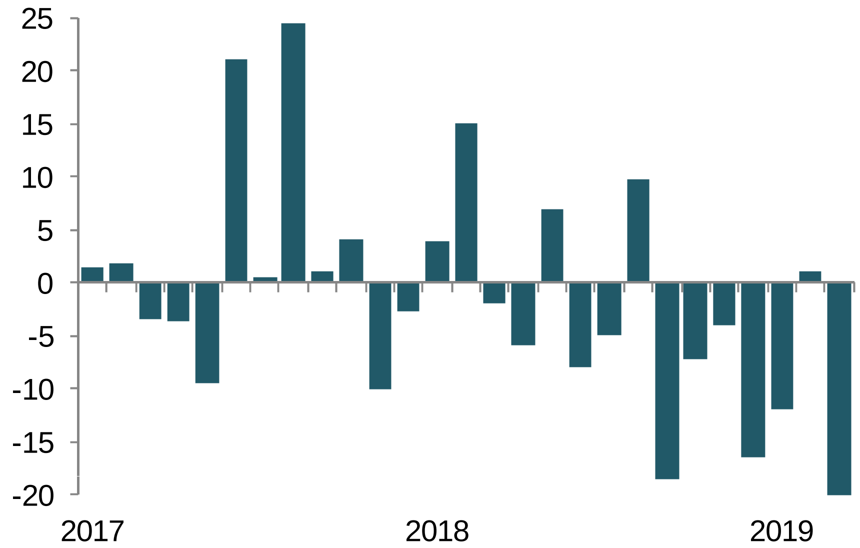
Sources: Bloomberg, FactSet, NB Economic Research.

The trade war has a disproportionate impact on manufacturing activity and on the stock market. Tariffs are a tax on companies and consumers, therefore hurting growth expectations. The uncertainty around trade tensions enhance these negative impacts. As the trade war continues and expands, it becomes more difficult to absorb or mitigate its costs. The threat of future US-EU trade tensions is a main downside risk to the outlook (this could involve US tariffs on imports of EU-made cars and parts).

A sharper than expected fall in China's growth and/or a sudden depreciation of the renminbi would hurt global growth. Emerging markets and Europe would be particularly hurt.

USD/CNY

China's monthly net purchases of long term US Treasuries (USD billion)

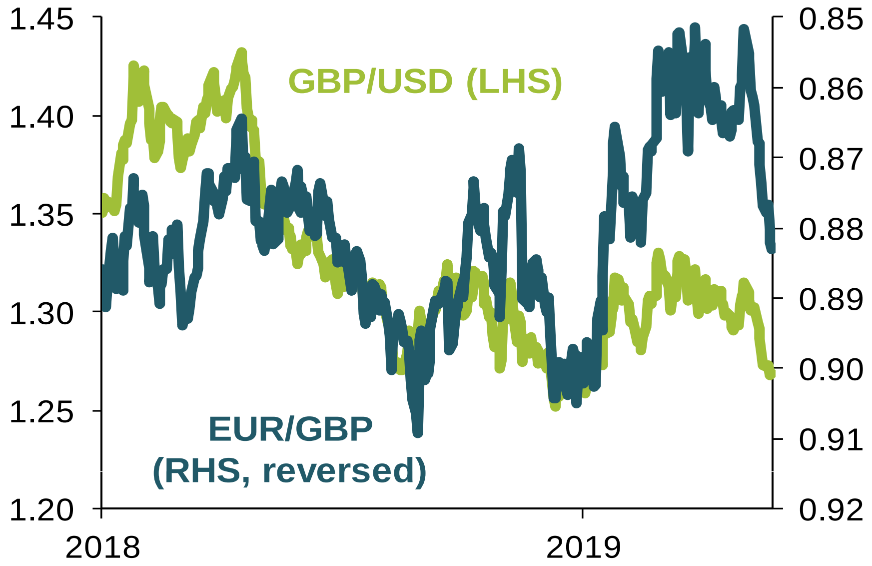


Sources: Bloomberg, US Treasury, FT, NB Economic Research.

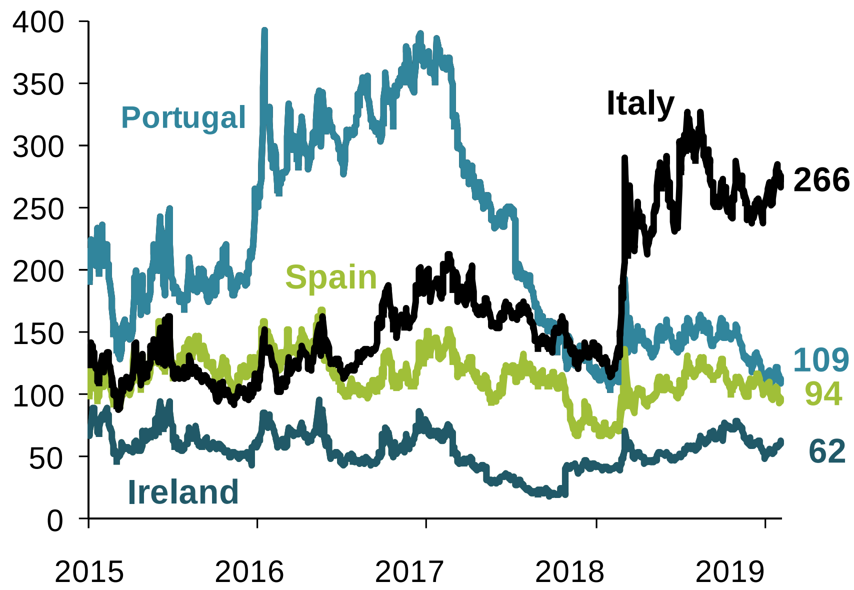
China's economic growth has been moderating as a result of intended structural adjustments (lower indebtedness, lower investment in excess capacity, smaller shadow banking, etc.). But the negative impacts of the trade war with the US could lead to a faster fall in activity growth, with negative impacts on the global economy. A sharper than expected depreciation of the CNY could lead to financial market instability (e.g. by worsening the outlook for emerging markets). And then, there's the fear of the "atomic bomb"... (i.e. China massively dumping US Treasuries – it holds USD 1.2 trillion, or around 7% of total Treasuries outstanding).

Recent political developments in the UK appear to favour a hard Brexit (or, to a lower extent, a new referendum) vs. a negotiated exit from the EU. The return of EU-Italy budget tensions is also a risk.

GBP/USD and EUR/GBP



10Y Government bond yield spread vs. Germany (bps)



Sources: Bloomberg, NB Economic Research.

The failure to approve the Withdrawal Treaty and the possibility of a new pro-Brexit PM in the UK appear to favour a scenario of a hard (non-negotiated) Brexit. The possibility of a new referendum could also have increased. A negotiated exit from the EU now seems a less probable (although not impossible) scenario. A hard Brexit would increase significantly the probability of a short term recession in the UK and the Euro Area.

A stronger support to nationalist/populist/anti-integration views in the Euro Area is a negative for the Euro Area outlook. It increases the chances of renewed EU-Italy budget tensions.

MAIN CONCLUSIONS

OUTLOOK

- Fundamentals are still supportive of economic activity: expansionary monetary policies, fiscal stimuli, job creation, wage growth. Normal/low inflation and low interest rates.
- But activity growth should moderate, as it moves towards more sustainable rates, i.e. towards trend...
- ...And rising political and trade tensions create significant exogenous risks to the outlook. The probability of a downturn/recession in the next 12-24 months has increased.

MAIN (KNOWN) RISKS

- Lower growth → Lower earnings → Corporate rating downgrades → **Credit market deterioration** → Tighter financial conditions; asset revaluation
- Higher **inflationary pressures** (tariffs, wages, etc.) & low activity growth → Lower earnings; constrained central banks; asset revaluation.
- Prolonged and **escalating trade wars** (US-China, US-EU, tariffs on autos) → High uncertainty → lower growth; **EM instability** (China, Turkey, Argentina, etc.); financial market instability
- **Hard Brexit** → short term recession in Europe
- Budget tensions in the Euro Area → **Italy rating downgrade** → financial market instability
- Other political/geopolitical developments: **US-Iran tensions**, **US debt limit** & Government shutdown
- **Trade agreements** (US-China, US-EU), Soft Brexit → higher confidence → sustained growth
- **Acceleration in productivity growth** → Cyclical expansion proceeds with low inflation

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