26 May 2019

Harr's View

The global slowdown and what it means for markets

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Good evening all

Today, I discuss the imminent global slowdown, what it implies for the Eurozone and the consequences for markets. We are currently witnessing an historical economic battle between the world's two superpowers, the US and China, which our China economist, Allan von Mehren, describes *here*. The escalation of the trade war has turned into an all-out economic war after the US blacklisted Huawei. **In my view, this is a game changer for the global economy. The prospects of a modest, cyclical recovery in late Q2 and Q3, which I had expected until the escalation in trade tensions earlier this month, are dead in my view. Instead, I believe in a modest cyclical downturn in the coming months**, **but I do not believe the trade tensions will be enough to push the global economy into a recession.** Currently, US tariffs and other countries' retaliation affect around 12% of total US and 8% of total Chinese goods trade, while the share of Eurozone and world trade affected remains small (2%). Theoretically, tariffs transfer income from consumers and producers to governments. The macroeconomic influence of tariffs depends on the ability of producers and consumers to substitute imported intermediate inputs and final goods, whether from different countries or domestic sources. Moreover, the impact of trade tensions on confidence and financial conditions is crucial, together with the policy response by governments and central banks.

The IMF estimates that the impact of the trade war is most substantial in the short term, and it will in particular damage China as consumers, producers and policymakers take time to respond, while confidence and markets take a hit. The experience over the past year is that the trade war is hurting business confidence, manufacturing production and exports in China, with global spillover effects. **Over the coming months, we expect the trade war will dominate easing by the Chinese authorities and the Chinese cycle will turn lower.** I believe the trade war is starting to influence the US economy, as seen in Friday's manufacturing PMI, while US non-residential investments are also softening. **I expect a mild US downturn, as US financial conditions have just tightened marginally, while I believe there is a good chance that the Fed will begin cutting rates from late 2019.** However, if Donald Trump pushes ahead with 25% tariffs on the remaining USD300bn of US imports from China, it will be a significant hit to the global economy.

Where does this leave the Eurozone? I had argued earlier that China holds the key to the Eurozone recovery (see *here*). With China slowing again, I believe that the common currency area will slow modestly. Meanwhile, European politics may also influence economic sentiment in the coming months. The risk of a no-deal Brexit has increased slightly as a more pro-Brexit prime minister is likely to replace Theresa May. However, the Conservatives are very divided and the more moderate Conservatives may still go a long way to avoiding a no-deal outcome. (See *here* for our latest comment). UK-linked companies have stockpiled goods in recent months, which has boosted business confidence, manufacturing production and trade in the UK in 2019. At some point, UK-linked companies may begin to reduce inventories, which could weigh on the Eurozone cycle, even if a no-deal Brexit is averted.

Meanwhile, the European elections today will influence the selection of the next EU Commission and ECB presidents and thereby the direction for Europe in the coming years. This week, we hosted a large Nordic summit where I had the pleasure to moderate a panel with four distinguished speakers discussing the question: 'The future of the EU – more or less integration? The timing of this question is delicate as the Eurozone economy is way past the cyclical peak it reached in late 2017. Most panellists agreed that further economic and financial integration in the form of risk sharing between Eurozone member countries will be difficult before we reach a crisis stage. Instead, focus should be on national policies in terms of lifting productivity and overall growth. This also implies that the ECB will again have to play a central role in the next downturn, as it did during the crisis in 2010-12. The ECB naturally has less room to react this time given negative rates, a large balance sheet and political pressure. **However, I believe we should be careful not to underestimate the ECB's ability and willingness to react if a downturn occurs, as it has bent the rules before.**

What does the global slowdown mean for financial markets? For some time I have held the view that the USD will do well due to carry and US outperformance. **The trade war itself should be US dollar-positive, but if at some point it triggers a response from the Fed, I believe USD strength will be over, particularly versus cyclical, risk-sensitive currencies such as the NOK, AUD and NZD.** The markets are pricing central banks very dovishly and inflation expectations in the US and the Eurozone are at very depressed levels. I view the current dovish pricing of the central banks and inflation expectations as fair given the weakening global outlook and downside risks. **I expect US and core-euro interest rates to remain at current low levels for the time being, with the risk tilted to the downside for US rates. Finally, I expect global equity markets to head lower given the weakening global outlook.** That was all for today's comment. I wish you a great Sunday night and coming week, best regards, Thomas

Disclosures

Danske Bank A/S ('Danske Bank') has prepared this research report. The author of this research report is Thomas Harr, Global Head of FI&C Research.

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Expected updates

Weekly.

Date of first publication

See the front page of this research report for the date of first publication.

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Report completed: 26 May 2019, 17:55 CEST

Report first disseminated: 26 May 2019, 18:15 CEST