WELLS FARGO

International Commentary — January 28, 2022

Hawks, Doves...But, Who's Talking About The Swans?

Summary

Terms such as hawks and doves have been mentioned in just about every macroeconomic conversation over the last few years. Rightfully so, as doves have turned to hawks and as monetary policy has been such an important driver of the global economy as well as financial markets. In this report, however, we will spend time talking about the swans. Meaning, the unpredictable or yet to be fully appreciated events that can still have a significant impact on the global economy, global financial markets or even more specific asset prices. While none of the events we highlight in this report represent our base case assumptions, we believe they are worth outlining as situations to still keep an eye on. As we have seen over the last two years, conditions can change rapidly, and thinking about the swan events before they unfold allows us to be nimble in adjusting our forecasts should circumstances evolve quickly.

We've identified events at the global level, within the developed world as well as in the emerging markets. From a global perspective, a significant selloff in global equity markets could cause sharp downward revisions to our global GDP forecast, and significant changes to our currency forecasts. There are also under-recognized risks around potential trade wars. Tensions between the U.S. and China have certainly not receded; however, we feel markets are not prepared for the Biden administration to raise Trump-era tariff rates and resume the U.S.-China trade war. On the other hand, we feel markets may also be discounting President Biden's ability to secure a Phase II trade deal and lift all tariffs imposed under the Trump administration. Brexit-related tensions could also rise to a point where the EU and the U.K. embark on a trade war of their own. Trade dislocations on the border of Northern Ireland resulted in U.K. threatening to invoke emergency clauses, which could give the EU legal grounds for imposing tariffs. And finally, the possibility of regime change in Turkey has yet to be seriously considered. Should President Erdogan be restricted from running for office or outright lose the election, the Turkish lira could see an unprecedented rally and become one of the biggest success stories in recent emerging markets history.

Economist(s)

Brendan McKenna
International Economist | Wells Fargo Economics
Brendan.Mckenna@wellsfargo.com | 212-214-5637

Nick Bennenbroek
International Economist | Wells Fargo Economics
Nicholas.Bennenbroek@wellsfargo.com | 212-214-5636

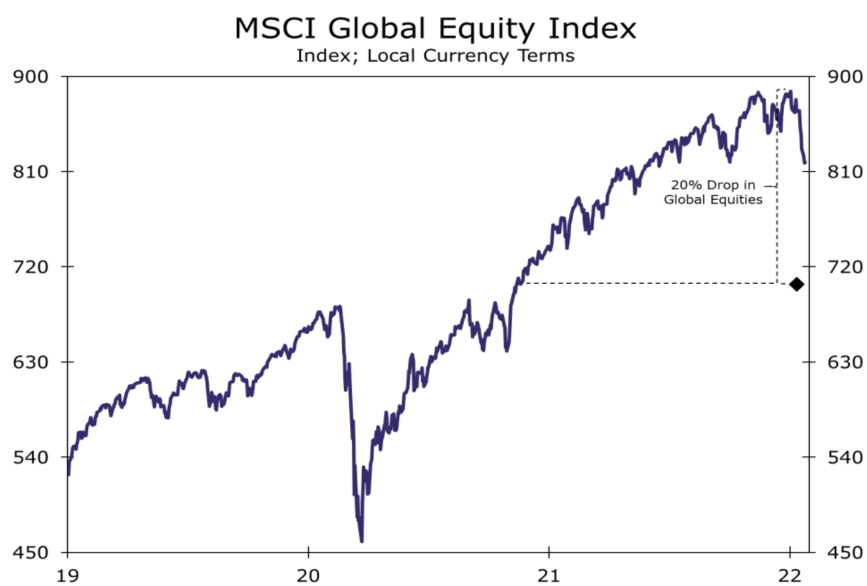
Jessica Guo
Economic Analyst | Wells Fargo Economics
Chuyue.Guo@wellsfargo.com | 704-410-4405

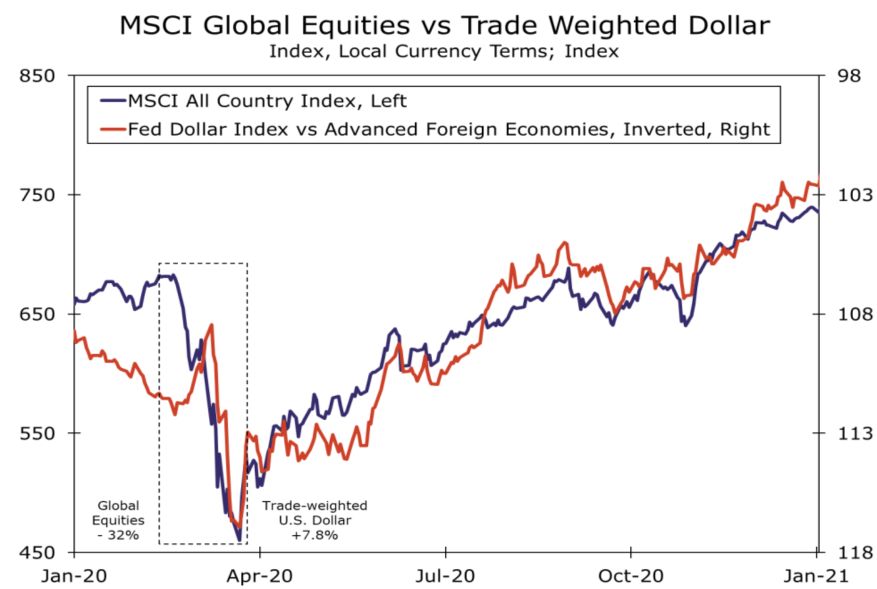
All estimates/forecasts are as of 1/28/2022 unless otherwise stated. 1/28/2022 9:57:58 EST.

Global equity markets see an extended decline

Black Swan Scenario: Global equities have come under some pressure in early 2022, though current weakness is expected to only be corrective as Wells Fargo's equity strategy team does not forecast an extended decline in equity markets. However, an global equity decline of 20% or more is a plausible scenario, stemming from two potential risk factors. The first is persistent and elevated inflation in the U.S. as well as internationally that sees most central banks tighten monetary policy more aggressively than markets expect. Second, the emergence of a new virulent COVID strain that prompts either renewed wide-spread restrictions or voluntary caution by consumers.

Economic and Financial Market Impact: A combination of aggressive tightening and sharply higher global bond yields, or renewed COVID concerns, would likely lead to significantly more weakness in global equity markets. Higher yields along with other drags on activity can ***cut 0.75% from our 2022 global GDP forecast*** (currently 4.2%). With respect to currency markets, in an extended equity market decline scenario, ***the trade-weighted dollar could strengthen 10%. G10 currencies would likely drop 7% and emerging currencies selloff 15%.***



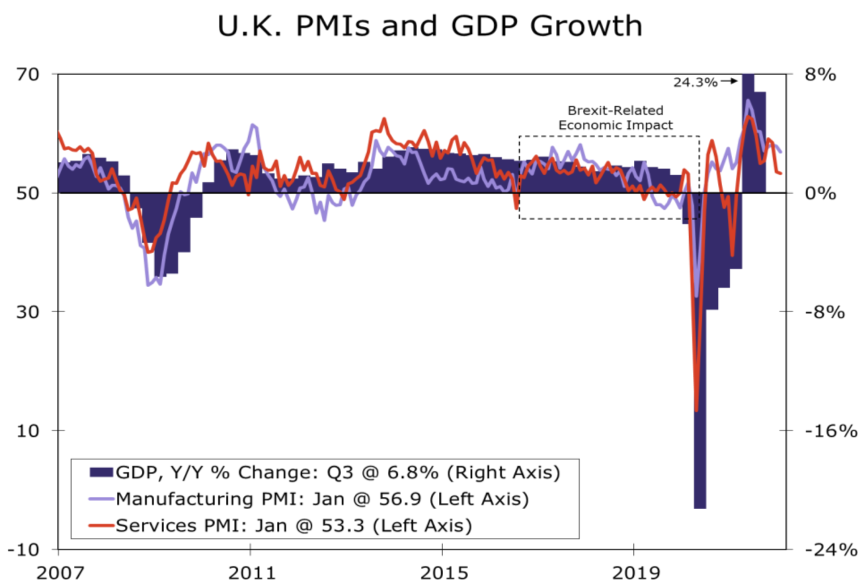


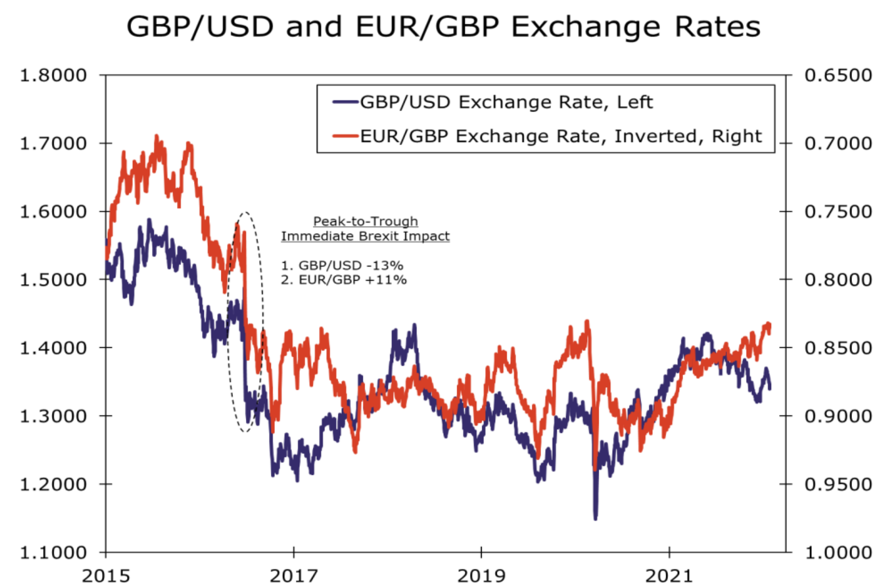
Source: Bloomberg Finance L.P. and Wells Fargo Economics

EU-U.K. Brexit tensions lead to a European trade war

Black Swan Scenario: Once thought to be over, Brexit-related tensions built toward the end of 2021. Renewed stress in the EU-U.K. relationship stems from the Northern Ireland (U.K.) border and customs checks on products from mainland U.K. before goods can be moved into Ireland (EU). U.K. officials claim customs checks create a border within the United Kingdom and trade has suffered as a result. In response to trade disruptions, the U.K. has threatened to invoke an emergency clause known as Article 16, which could end Northern Ireland customs checks. Under the Brexit agreement, if Article 16 is triggered and customs checks end, the EU would be entitled to retaliatory measures, which could include tariffs or terminating the post-Brexit trade deal, essentially starting an intra-Europe trade war.

Economic and Financial Market Impact: Should an EU-U.K. trade war unfold, the U.K. is likely most at risk, from an economic as well as markets perspective. An ***EU trade war scenario could trim up to 1% off our 2022 GDP forecast*** (currently 4.2%). The pound could also come under pressure, and while the currency may not experience the same selloff as in the aftermath of the 2016 referendum, we would expect the pound to weaken against the dollar as well as the euro. In this scenario, ***the GBP/USD exchange rate could fall to $1.20 within weeks and the EUR/GBP exchange rate could move to GBP0.8750***. Medium-to-longer term pressure could also persist on the pound.



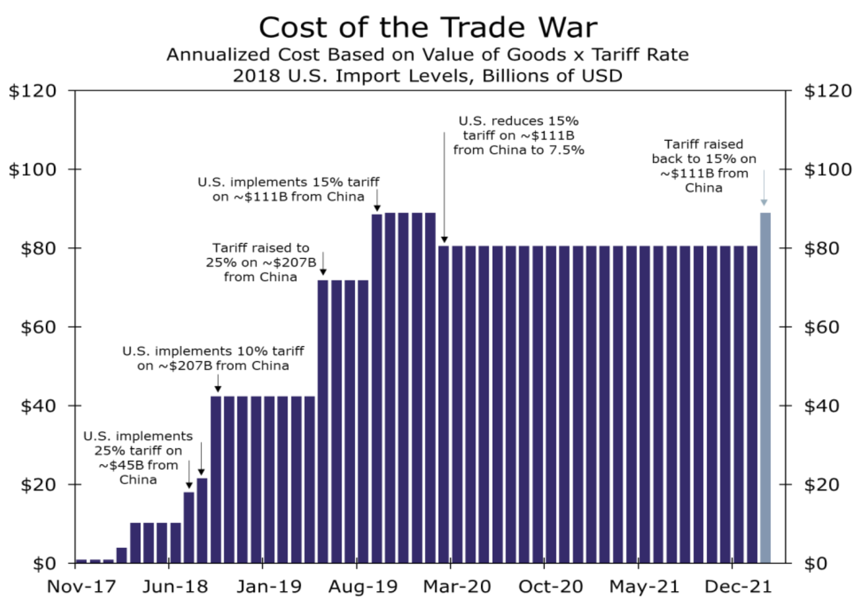


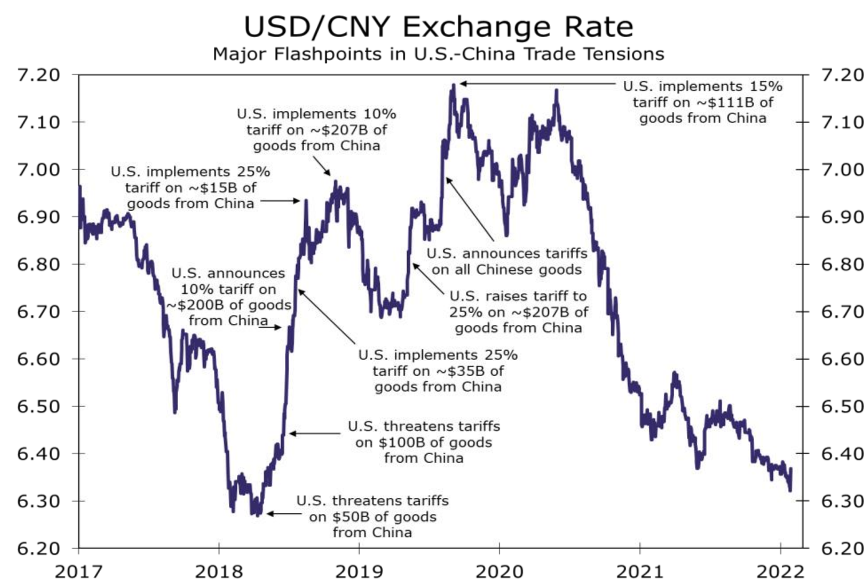
Source: Datastream, Bloomberg Finance L.P. and Wells Fargo Economics

U.S.-China trade war resumes. Biden raises tariff rates on China

Black Swan Scenario: Tensions between the United States and China rattled financial markets throughout 2018-2019, and while the U.S.-China relationship remains strained, trade-related issues have not been in focus the last two years. But, perhaps frustrated by a lack of progress on his coordinated attempt to induce behavioral changes from China, and possibly in an effort to rally support for the Democratic Party ahead of mid-term elections, President Biden raises tariff rates on exports from China. In this scenario, we would expect President Biden to raise the tariff rate - lowered to 7.5% under the Phase I trade deal - back to 15% on ~$111B of exports from China. Market participants would likely view this as the return of trade tensions and Biden effectively ending the Phase I trade deal with China.

Economic and Financial Market Impact: We would expect financial markets to come under pressure should President Biden raise tariff rates on China. Sentiment toward risk assets (i.e.: equities and risk-sensitive currencies) would likely deteriorate. In this scenario, and depending on the retaliation and rhetoric from the United States as well as China, ***the renminbi could weaken as much as 10%*** as renewed trade tensions unfold. From current levels, ***a 10% renminbi depreciation would take the USD/CNY exchange rate back above CNY7.00***.



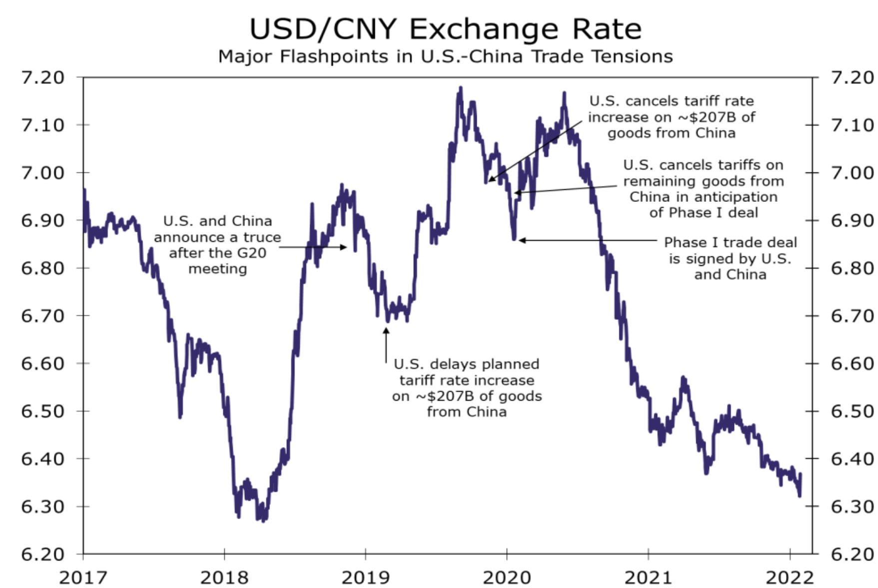


Source: Bloomberg Finance L.P. and Wells Fargo Economics

U.S.-China trade war ends. Biden lifts all tariffs on China

Black Swan Scenario: Relations between the U.S. and China are certainly strained; however, other economically influentially countries such as the United Kingdom, Canada and the entire Eurozone have expressed displeasure with China's behaviors, particularly toward trade. On the campaign trail, and maybe more so while in office, President Biden has stressed the importance of using a U.S.-allied coordinated approach to force China to change its perceived unfair economic and trade practices. Should Biden's strategy be effective at influencing China to commit to changes, a more comprehensive Phase II trade deal could be secured. Terms of the Phase II deal could include a complete removal of Trump-era tariffs and more frictionless trade between the United States and China.

Economic and Financial Market Impact: A Phase II trade deal and lifting Trump-era tariffs would likely result in a global financial market rally, and we would expect sentiment toward equities and risk-sensitive currencies to improve. In this scenario, the Chinese renminbi could experience relief-rally dynamics, and ***the renminbi could strengthen as much as 5%*** on the announcement of a Phase II deal and the effective end to the U.S.-China trade war. From current levels, ***a 5% renminbi appreciation would take the USD/CNY exchange rate to CNY6.00***, a level last seen in 2014 before the 2015 devaluation and before the United States took a more hawkish stance toward China.

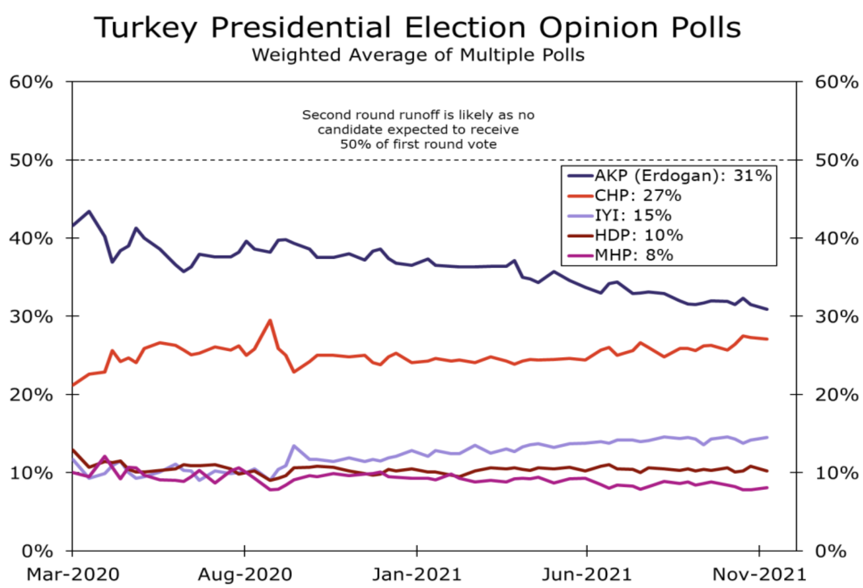


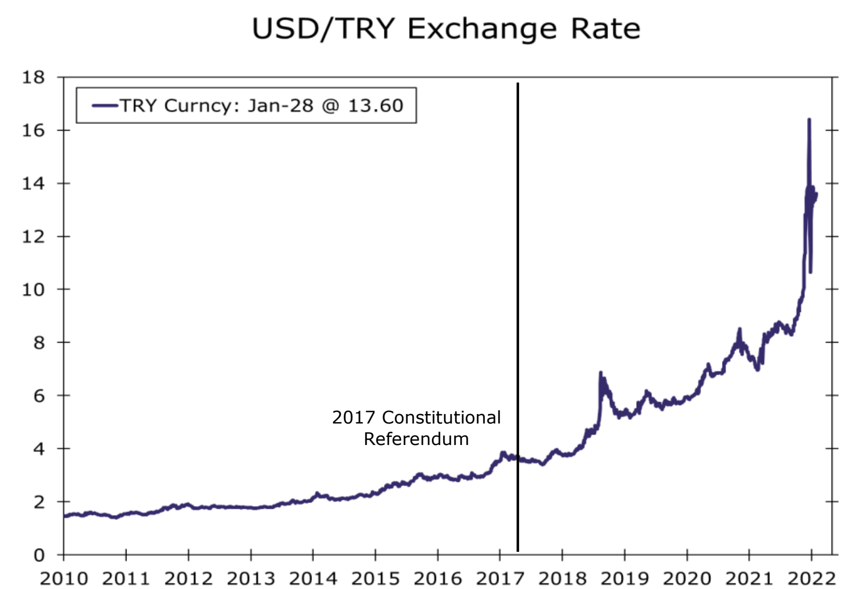
Source: Datastream, Bloomberg Finance L.P. and Wells Fargo Economics

Doomed to darling? Regime change sparks a huge Turkish lira rally

Black Swan Scenario: Presidential elections are set to take place in Turkey, possibly in 2022, but no later than mid-2023. Central bank decisions have been undermined by President Erdogan's influence and unorthodox views on monetary policy. The result has been elevated inflation, a collapse in the Turkish lira, and GDP per capita that is now below Global Financial Crisis levels. A scenario exists where President Erdogan may not be able to run for office due to term limit restrictions; however, assuming Erdogan is eligible, early opinion polls suggest support for his re-election bid may be losing momentum. Should a new administration take office monetary policy could head in a more orthodox direction, sparking a significant and long-lasting Turkish lira rally.

Economic and Financial Market Impact: and adjusts monetary policy settings to contain inflation and build credibility with the global investment community. ***Should Erdogan not retain office, the lira could experience an immediate 25% rally***. If the election ushers in a more orthodox direction for monetary policy, ***the lira rally could persist for an extended period of time and possibly bring the currency back to pre-constitutional referendum levels (TRY2.15) in the next five years***.





Source: PolitPro and Wells Fargo Economics

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

The 2022 Annual Economic Outlook: Restoring Balance in the Post-Pandemic Economy is available at wellsfargo.com/economicoutlook

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Mark Vitner	Senior Economist	704-410-3277	Mark.Vitner@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Charlie Dougherty	Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Sara Cotsakis	Economic Analyst	704-410-1437	Sara.Cotsakis@wellsfargo.com
Jessica Guo	Economic Analyst	704-410-4405	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

Required Disclosures