



Economic and Strategy Viewpoint

December 2019

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Global growth upgraded as the cycle extends



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- We upgrade global growth forecasts in response to a fall in trade tensions between the US and China. Our 2020 forecast is increased from 2.4% to 2.6%, the first upgrade this year. The world economy looks set to avoid a recession as the cycle extends. Imbalances which would spark a downturn are absent and activity is gaining support from easing trade tensions and monetary policy.
- Compared to our previous forecast the balance of risks has become more evenly weighted. In September, the skew was toward weaker growth and higher inflation; in this update, upside and downside risks are balancing each other. This reflects the addition of reflationary scenarios and removal of some stagflationary outcomes.

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Europe forecast update: a brighter external outlook



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- The eurozone growth forecast has been revised for 2020 as signs of a trade deal between the US and China, albeit a partial one, begin to emerge. Net trade is now forecast to rebound in 2020, although could suffer again in 2021 should tensions return after the US presidential election. Meanwhile, domestic demand looks robust in 2020, but as the eurozone approaches the end of its cycle, domestic growth is expected to moderate in 2021.
- The UK outlook has also been upgraded, but largely due to reduced Brexit risk. While the results of the general election will be key, opinion polls suggest a smooth Brexit is in sight. This should reduce noise from stockpiling and destocking. In addition, more fiscal giveaways are likely than previously expected. However, low inflation in the near-term has delayed the next rate rise to 2021.

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2020: a better year in store for most emerging economies



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- A better trade outcome helps lift EM growth expectations, and overall we think 2020 will see faster growth for the region than 2019.
- China though will continue to slow, and is likely to abandon binding growth targets altogether from 2021.

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Japan: end of Abenomics on the horizon

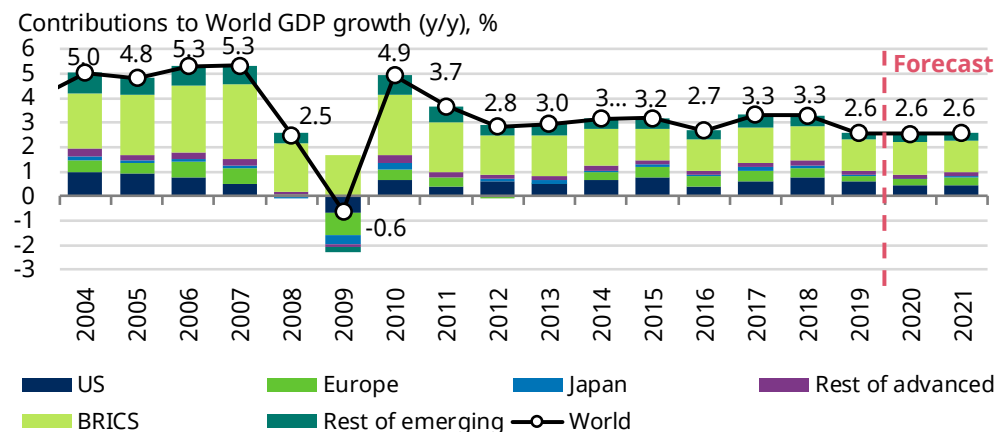


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- We upgrade 2020 growth due to a US-China trade war truce. Meanwhile, fiscal stimulus should help support growth in 2021 as trade tensions return and Prime Minister Abe's term comes to an end. In the near term, the lack of inflation in October may surprise investors given the hike in VAT.

Chart: Forecast outlook



Source: Schroders Economics Group. 20 November 2019. Please note the forecast warning at the back of the document.

Global growth upgraded as the cycle extends

“We're in the final throes of a very important deal... it's going very well.”

President Trump on the US-China trade talks, 26 November, Bloomberg.

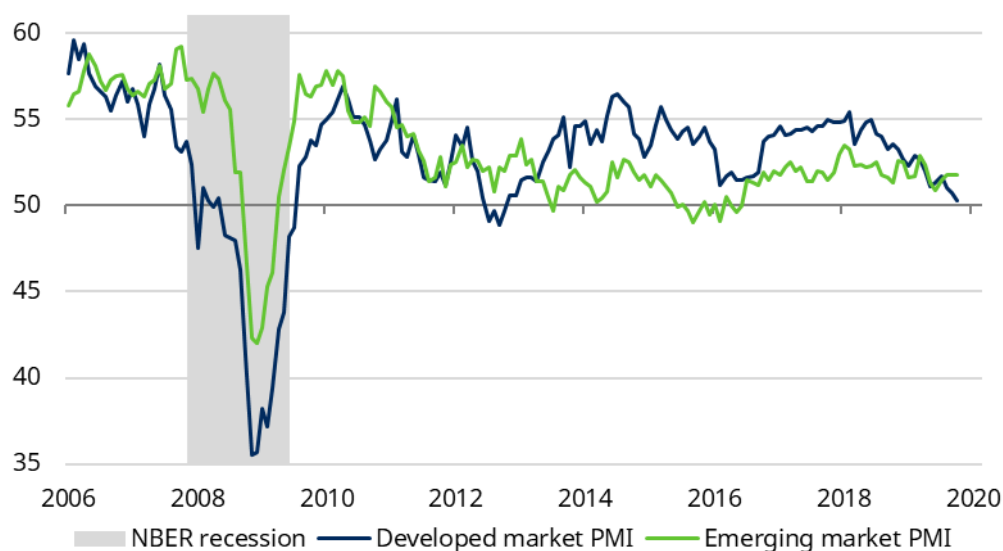
Global growth upgraded for the first time this year

We are upgrading our global growth forecasts in response to the easing in trade tensions between the US and China. Our forecast for next year increases from 2.4% to 2.6%, the first upgrade this year (see chart on front page). The world economy looks set to avoid a recession as the cycle extends. The imbalances which would trigger a downturn are absent whilst activity is gaining support from an easing in trade tensions and monetary policy.

Underpinning the increase in the growth forecast is a more optimistic view on trade relations between the US and China, such that we now expect a truce in the form of a "phase one" deal rather than an increase in tariffs to 25% as previously assumed. Global trade and capital investment strengthen as a result with activity improving in Europe¹ and Japan as well as the US.

For China the official GDP growth forecast is unchanged at 6%; however, we have upgraded our "unofficial" growth forecast, as measured by our Schrodgers China Activity Indicator (SCAI), by 0.4 percentage points. Our overall emerging market (EM) forecast is slightly downgraded as a result of specific issues in Hong Kong SAR and Argentina. It is still the case though that the EM are expected to pick up pace next year while developed economies decelerate compared to 2019, an outcome consistent with the recent purchasing managers' indices (chart 1).

Chart 1. Emerging markets outpacing developed



Source: Refinitiv Datastream, Schrodgers Economics Group, 21 November 2019.

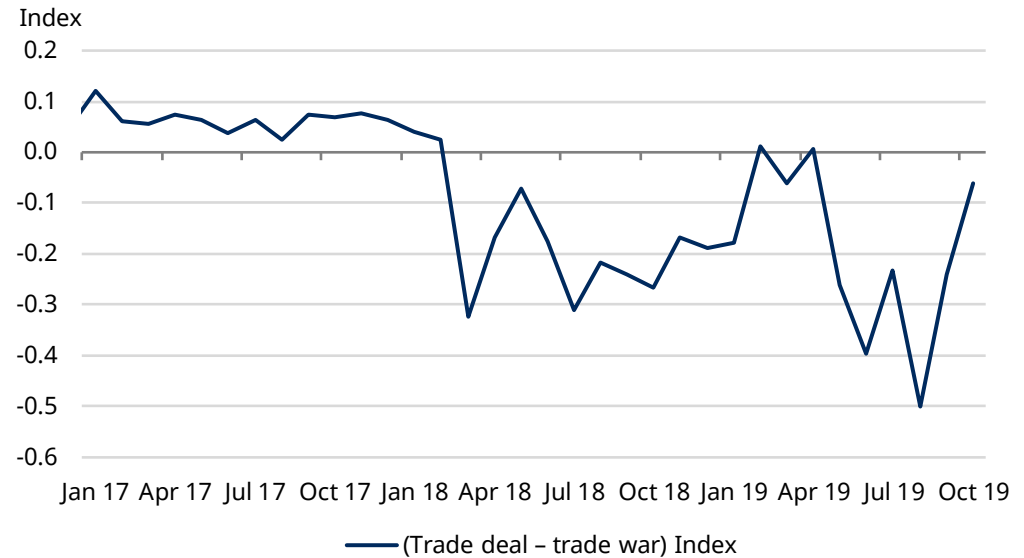
Trade tensions to ebb next year, but return in 2021

We have extended our forecast out to 2021 and expect global growth to remain at 2.6%. However, 2021 is likely to be marked by a return of the trade tensions between the US and China. Whoever wins the US presidency will want to follow up on "phase one" and deliver a more wide ranging deal which will cover the thorny areas of intellectual property and state subsidy of export industries. Negotiations are likely to be fraught and we would expect tariffs to rise again in the second half of 2021.

¹Note that the UK growth forecast actually falls to 0.8% for calendar 2020 although this is largely a result of the inventory cycle whilst underlying final demand strengthens.

Coming back to the present, our barometer of the state of the trade talks indicates an increasing prospect of a deal (chart 2). Trump needs some additional stimulus for the economy in 2020 and China is not having to make major concessions on intellectual property. It is still possible that the deal fails: China has been pushing back against the tariffs imposed by the US and the deal is overdue. In addition 2020 will bring a new source of uncertainty in the form of the US presidential election. These factors are likely to temper the rebound in capital spending.

Chart 2. Sentiment toward a trade deal has improved sharply

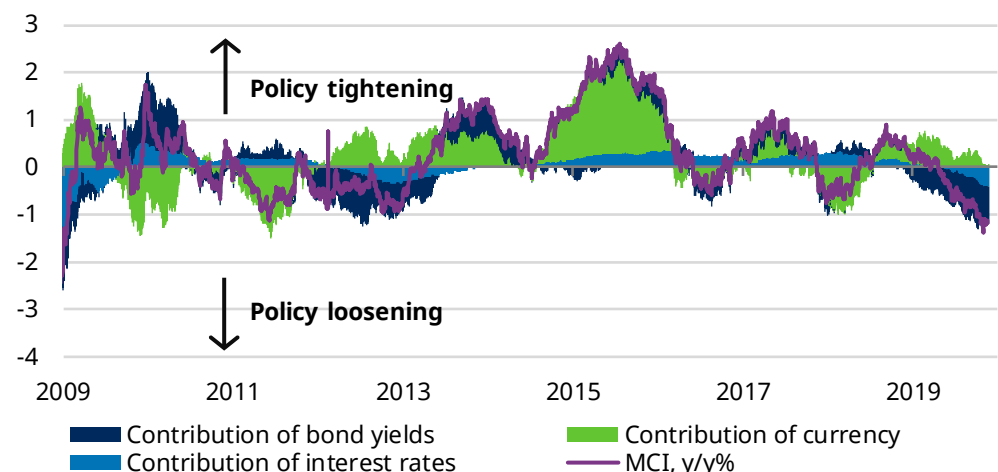


Based on key word count from Reuters articles.
Source: Schroders Economics Group, 18 November 2019.

Liquidity is feeding through

In addition to support from a reduction in trade tensions, the benefits of lower interest rates will also be felt. Our US monetary conditions indicator – which combines moves in policy rates, bond yields and the dollar – is at its loosest for nearly a decade, largely a result of the fall in long rates (chart 3). Signs of the effect this is having on activity can be seen in the US housing market where mortgage applications and housing starts have picked up sharply.

Chart 3. US monetary conditions at loosest for nearly a decade



Source: Schroders Economics Group, 20 November 2019.

Meanwhile, global inflation remains relatively stable at 2.6% and unchanged from our previous forecast. In our model for the US consumer price index (CPI), core inflation (ex. food and energy) picks up from 2.3% in Q3 to 2.5% in the current quarter whereby it stabilises before declining in the second half of 2020 and through 2021. The profile

reflects the long lags between growth and inflation with this year's slowdown not impacting prices until late in 2020.

Above target inflation is not expected to cause a concern to the US Federal Reserve (Fed) for two reasons. First, the Fed has indicated that it will be prepared to tolerate an overshoot at the end of the cycle, given concerns of deflation as the economy slows². Second, headline inflation is held down in the forecast by stable-to-lower oil prices, which would help keep inflation expectations under control. On this basis, and with growth below trend, we expect the Fed to ease once more with a 25 basis point cut in April 2020. The Fed is then expected to lay low as the presidential election gets underway before easing again in 2021.

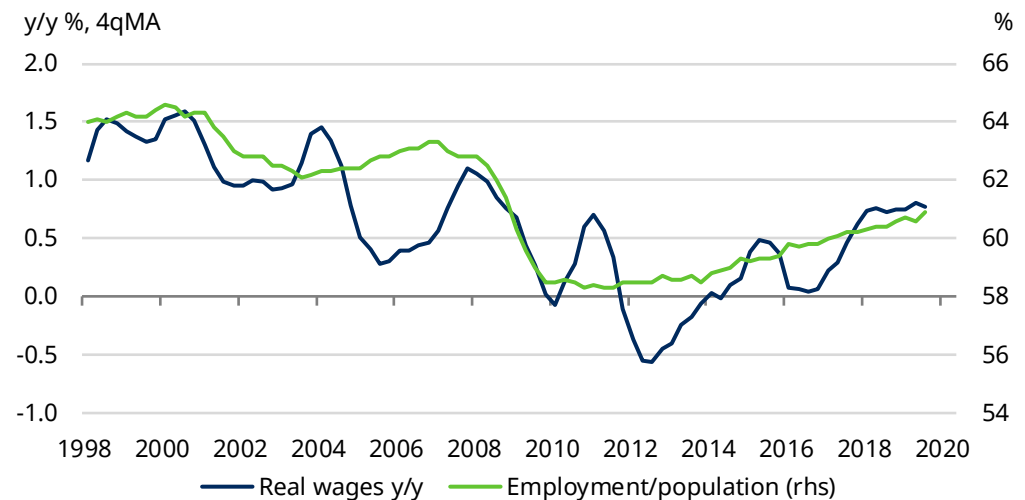
Scenarios: growth-inflation risks becoming more balanced

2020 could see the US swing to the left

We have updated our scenarios to reflect the shifting balance of risks to the world economy. On the presidential election we introduce a "US swings left" scenario to capture the possibility of a radical Democrat taking power, rather than our central assumption of a Trump win. Changes in regulation and taxes would then affect growth in 2021, whilst an increase in the minimum wage would raise inflation in the US. At the global level, inflation would be lower as a consequence of a weaker dollar, making this scenario deflationary. The impact would be felt before 2021 through a weaker equity market and lower business confidence in 2020.

Our second new scenario is "wages accelerate". We have had this scenario in the past and had dropped it as the Phillips curve flattened. However, whilst the relationship between unemployment and wages has weakened there is still a correlation with wages and the employment-population ratio, a broader measure of labour market slack (see chart 4).

Chart 4. US economy keeps finding new workers



Source: Refinitiv Datastream, Schroders Economics Group, 20 November 2019.

Wages accelerate scenario – a reminder we are late cycle

The increase in employment to population has been a favourable supply side development and allowed the US economy to keep finding workers and grow. We factor in some rise in wages alongside a further rise in the employment to population ratio in the baseline forecast; however it is possible that wages accelerate by more than expected.

This scenario is seen as reflationary as higher real wages initially drive up consumer spending and growth. International trade accelerates, boosting growth in the rest of the world. However, as the economy hits capacity limits, inflation picks up and the

²Note that on their preferred measure, the core personal consumption deflator, the rise above 2% is likely to be less than on the CPI.

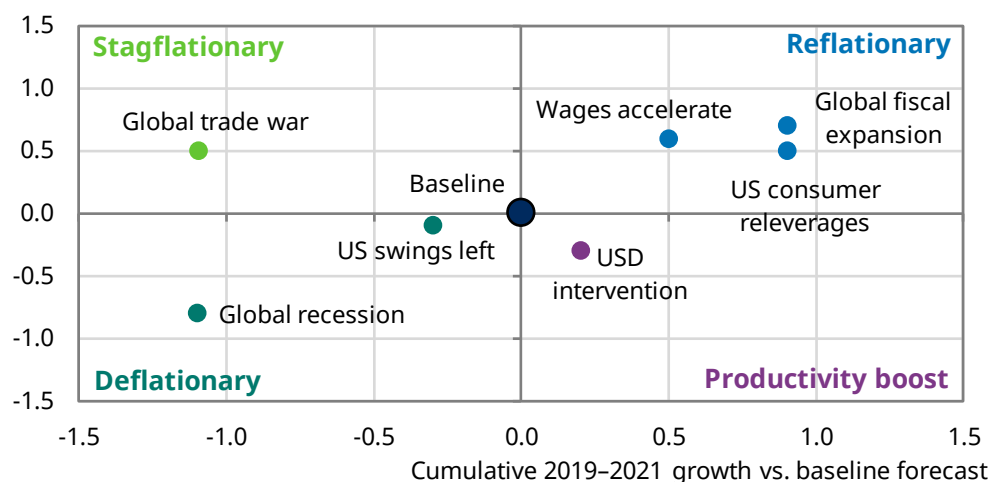
"US consumer re-leverages" scenario is reflationary

mix of growth turns more adverse. The Fed ends its easing cycle and tightens monetary policy with the fed funds rate rising to 3% by the end of 2021. Since markets seem to have priced out the risk of inflation ever returning, this scenario is a good reminder that we are near the end of the cycle.

In our October Viewpoint we highlighted the extended period of de-leveraging by the household sector in the US. Our central scenario assumes that the ratio of debt to income remains stable; however it could rise as households respond to lower interest rates. This would bring a return to the period where the US consumer becomes a driver of global growth. As in the "wages accelerate" scenario, the outcome is more reflationary than the baseline. The trade off between growth and inflation is slightly more favourable, but the response of the Fed is similar with rates rising to 3%. Stronger growth also brings higher rates elsewhere, but the degree of tightening is less, reflecting the greater amount of slack outside the US economy.

Chart 5. Scenario grid

Cumulative 2019–2021 inflation vs. baseline forecast



Source: Schroders Economics Group, 20 November 2019.

Risks to growth and inflation: becoming more balanced

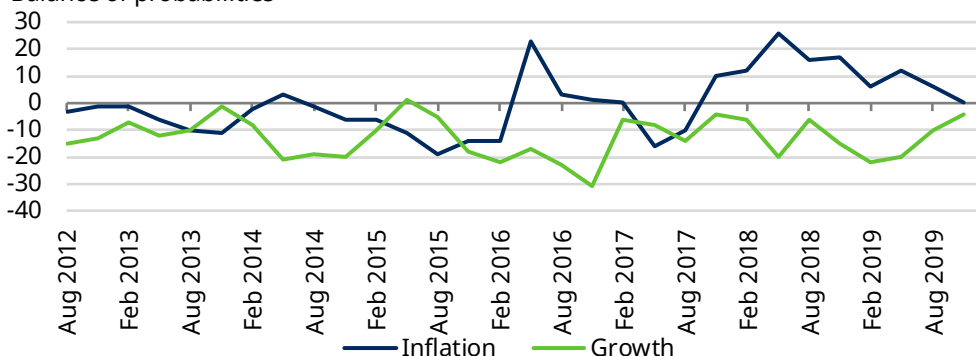
New scenarios mean tail risks are less skewed to the downside, more balanced

Our other scenarios are unchanged and the three new scenarios replace the "Italian debt crisis", "food prices surge" and "US-China trade deal" variations. The latter has been incorporated to some degree into the baseline.

Compared to our previous forecast, the balance of risks has become more evenly weighted. In September, the skew was toward weaker growth and higher inflation; in this update, upside and downside risks are balancing each other. This reflects the addition of reflationary scenarios and removal of some stagflationary outcomes (chart 6).

Chart 6. Growth and inflation vs. baseline (probability weighted)

Balance of probabilities¹



¹Probabilities based on Economics team estimates.

Source: Schroders Economics Group, 20 November 2019.

Europe forecast update: a brighter external outlook

“If you can make it through the night, there's a brighter day.”

Tupac Shakur.

Better news on the US-China trade war has raised the prospects for at least a partial trade deal in the near future. This has prompted an upgrade to our eurozone growth forecast as we expect the large exporting member states to benefit from the potential improvement in world trade.

For the UK, we are approaching the end of the beginning for Brexit. If the election follows the readings from opinion polls which currently point to a Conservative majority, then Brexit should be complete by the end of January 2020, and the UK will move into the transition period. This should pave the way for a recovery in both business investment and household spending. Meanwhile, a fiscal expansion is on the way as both of the large parties are locked in a game of one-upmanship to outspend the other.

Germany escapes recession

Germany has avoided recession as most member states beat expectations in Q3

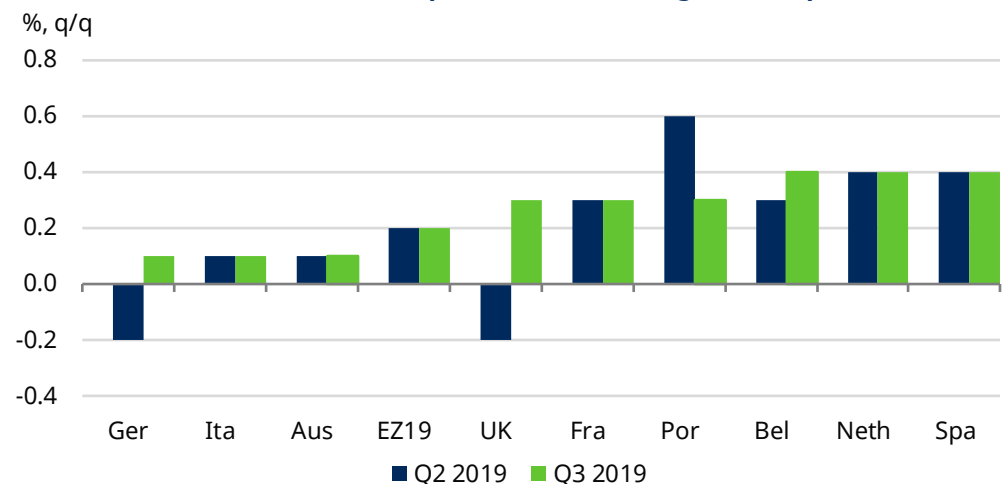
Eurozone real GDP growth was unchanged at 0.2% q/q for the third quarter, and while this was a sluggish sub-trend performance, it was nevertheless better than consensus expectations. Indeed, all eyes were on Germany, which had been predicted to enter a technical recession after it contracted in the second quarter. However, markets were surprised to learn that Germany had in fact eked out 0.1% growth.

Detailed data have yet to be released, but Destatis, the German Federal statistics office, reports that growth mainly came from household and government consumption. Net trade improved, but was probably negative again. Meanwhile, corporates continued to grow investment in construction, but investment in machinery and equipment was down.

Elsewhere, Spain, the Netherlands and Belgium all achieved 0.4% growth. France also beat expectations by maintaining a growth rate of 0.3%, reporting a similar trend to Germany, where a positive contribution from domestic demand helped offset a negative contribution from net trade. Finally, despite the political uncertainty over the summer, Italy also managed to beat expectations with 0.1% growth (chart 7).

Weak external demand has persisted, while domestic demand remains robust

Chart 7: Most member states outperform consensus growth expectations in Q3



Source: Eurostat, ONS, Schroders Economics Group. 18 November 2019.

Overall, despite the better than expected outturn, growth remains subdued across Europe. Domestic demand is probably running above trend in most countries, helped by falling unemployment rates, low inflation, and steady wage growth. The big question for the eurozone outlook is whether weakness in the external sector will spread to hit domestic demand, or could a US-China trade deal lead to a recovery in eurozone net exports.

The eurozone growth forecast has been revised up on the prospects of a partial trade deal between the US and China

Eurozone forecast update – trade related rebound

Looking ahead, the forecast for eurozone GDP growth nudged back up to 1.2% for 2019, undoing the downgrade last quarter. This is on the back of third quarter GDP coming in in-line with our forecast, and a slight improvement in leading indicators heading into the fourth quarter.

For 2020, the GDP growth forecast has been raised from 0.9% to 1.2%. This is motivated by a change of view on the trade war. We had previously predicted a further tariff increase, with the US applying 25% tariffs on all imports from China. This now looks less likely, and so with our assumption of a temporary truce, we have revised up our forecast for eurozone net trade, boosting the overall GDP growth figures.

We assume that once the US presidential election is out of the way, trade tensions with China will return. Therefore, we have growth slowing again in the second half of 2021 as shown in chart 8. Domestic demand is also forecast to slow by the end of 2021 as the eurozone enters late cycle territory. Further falls in unemployment will be more difficult to achieve, though wage growth will continue, at the cost of squeezing profit margins. GDP growth for 2021 is forecast at 1.4%.

Chart 8: Eurozone GDP forecast

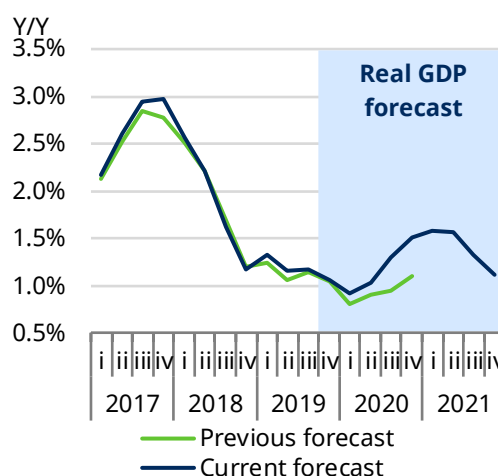
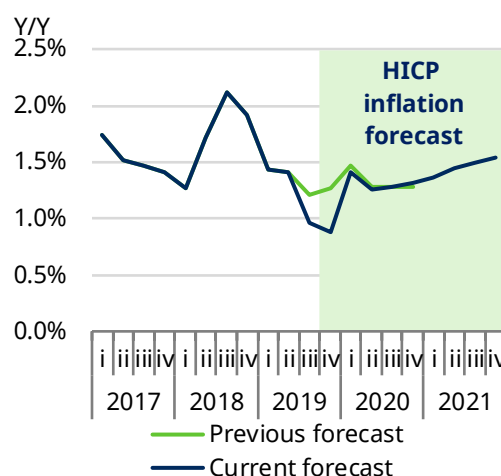


Chart 9: Eurozone inflation forecast



Source: Schroders Economics Group. 18 November 2019. Previous forecast from August 2019. Please note the forecast warning at the back of the document.

As for inflation, we have nudged the estimate a little lower for 2019 to 1.2%, although it should be noted that the latest monthly y/y measure stands at just 0.7% in October. The main downward contributor at present is energy price inflation, which has declined from +10.8% y/y in October 2018 to -3.1% y/y in the latest release. Core inflation (excluding energy, food, alcohol and tobacco) has been more stable at 1.2% y/y.

Looking ahead, we forecast core inflation to continue its recovery over 2020 and 2021, as unemployment continues to fall, helping to support household spending. However, the recent fall in global energy prices is likely to lower the annual headline rate of inflation in the near-term, before it begins to recover in 2020. Overall, we

forecast headline inflation to average 1.3% in 2020 (unchanged from previous forecast), rising to 1.5% in 2021.

Room for more easing?

The ECB has restarted QE, and cut its deposit rate

The European Central Bank (ECB) restarted quantitative easing in November, purchasing €20 billion worth of assets per month. It also cut its deposit rate from minus 40% to minus 0.50% in September, but left its refinancing rate at zero. Outgoing ECB president Mario Draghi left on a gloomy note, citing external weakness and low inflation as reasons for the monetary policy easing. He also called for more fiscal easing, acknowledging the limits of monetary policy. We have no doubt that his successor, Christine Lagarde, will stay the course, and we expect one more cut to the deposit rate in the first quarter of next year (to -0.60%). We expect Lagarde to use her experience as the former head of the IMF to press for fiscal stimulus, although we remain sceptical that she will succeed.

Pressure is building for fiscal policy to take over, but we remain sceptical

Fiscal policy has always been set by individual member states, with only occasional coordination to meet fiscal targets, or to bail out other member states. As a result, while member states have in theory been bound by Maastricht Treaty budgetary rules, they have been free to choose how they met deficit targets. Those limits can be relaxed during a cyclical downturn, but immediate correction is then required to put public finances back on a sustainable footing.

Investors have been calling for fiscal stimulus from Europe for some time, especially in the large surplus economies like Germany and the Netherlands. However, ministries of finance in most member states plan for multiple decades ahead, especially those that are more fiscally responsible. With the looming demographics challenge gathering pace over the next decade, the strategy in Europe has always been to minimise government debt levels, to make room for additional borrowing to pay for the care and retirement of the baby-boomer generation³.

Easing, if any, will be done at the country level

Moreover, Europe has more generous automatic stabilisers than most other regions. These are policies such as social insurance or unemployment benefits. They are referred to as automatic as they do not require political activation, which is not the case in the US. Therefore, a cyclical downturn in Europe would trigger such spending, helping to ease concerns over demand.

What about EU-wide projects? There is certainly scope for the European Commission or European Investment Bank to lead such efforts, but with Eurosceptic parties on the rise, this could provide more fuel to the fire. Many in the northern member states are wondering why their fiscal prudence should be rewarded by austerity, in order to bail out Greece and other less responsible member states.

Some fiscal stimulus will probably be announced in 2020, but it is unlikely to be worth more than 1% of GDP, and especially unlikely to be co-ordinated from Brussels. It will be down to individual member states to take action.

UK forecast update: approaching the end of the beginning of Brexit

The UK also managed to avoid recession, although, business investment remains weak

Like Germany, the UK also avoided entering a technical recession in the third quarter having contracted in the previous quarter. Real GDP growth was 0.3% q/q, although this did disappoint consensus expectations of 0.4% growth.

Within the details of the report, households are still spending at a steady pace. However, business confidence remains in the doldrums as business investment failed to pick up, and has only had a single positive quarter of growth since the start of 2018. It is worth mentioning that the government has not helped matters. General

³Generally considered as those born between 1941–1961 – a period after the Great Depression and World War II where birth rates spiked considerably.

UK growth has been revised up, partly due to reduced Brexit risk, but also due to more fiscal stimulus

government investment contracted 1.8% in real terms in the latest release, having contracted by 3.6% in the second quarter.

The rest of the data remains heavily distorted by Brexit stockpiling and destocking. In the latest release, companies were destocking following the large build-up of inventories that occurred at the start of the year. Given the Brexit deadline was shifted to 31 October, we will probably see some further stockpiling in fourth quarter data.

Overall, the data suggests that the economy is coping with the uncertainty from Brexit. Households continue to spend, though businesses remain cautious. Leading indicators suggest the economy will slow further in coming months as external headwinds start to hit the economy.

Looking ahead, the result of the general election on 12 December will be key. It appears that the incumbent Conservative Party is enjoying a comfortable lead in opinion polls ahead of the election. If this translates into votes, the party should return as the next government with a majority. This will allow the Withdrawal Agreement to be pushed through parliament, and for the UK to leave the European Union by the end of January, entering a transition period where trade negotiations will begin.

For the economy, more Brexit certainty should help lift corporate confidence and business investment. Consumer spending could also rise as precautionary savings unwind. These have always been features of the UK forecast. Changes made to our forecast are twofold.

Firstly, before parliament broke up for the election, more progress was made on the Withdrawal Agreement that anticipated. This has led to a significant fall in the risk of a no-deal Brexit, helping sterling to rise against most major currencies. With the reduction in risk, there is less of a need for stockpiling as we approach the January Brexit deadline. We have therefore downgraded growth in the first quarter of 2020 (less stockpiling), but then revised up growth in the second quarter. On a year-on-year basis, the impact appears dramatic due to base effects (chart 10). However, it has been smoothed on a quarterly basis.

Chart 10: UK GDP forecast

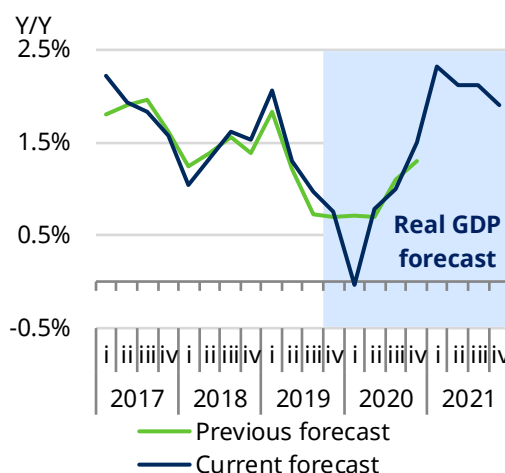
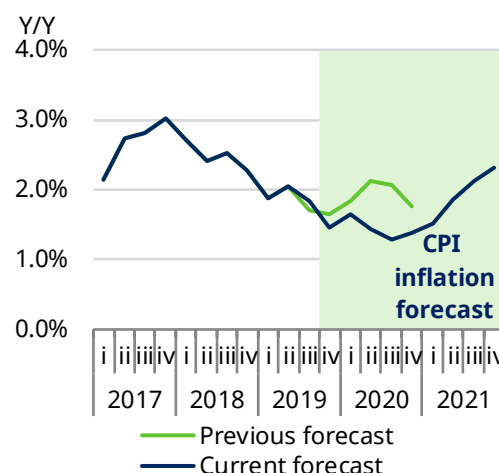


Chart 11: UK inflation forecast



Source: Schroders Economics Group. 18 November 2019. Previous forecast from August 2019. Please note the forecast warning at the back of the document.

Secondly, growth has been revised up in the back end of 2020, with an even stronger profile for 2021. This is due to the larger fiscal spending promises being made in the run-up to and during the election campaign. The Conservative and Labour parties are locked in a battle of one-upmanship, although the latter is also threatening to

nationalise many companies in the process. In any case, our previous assumption of about 1% of GDP worth of fiscal stimulus now seems too cautious. 1.5-2% appears to be more likely, but we will learn more once the parties have released their election manifestos. We will follow-up with more detailed analysis before the election.

Turning to UK inflation, the forecast remains unchanged for 2019 at 1.8%, but has been revised down to 1.4% for 2020. This is partly due to lower energy prices, but also due to the appreciation of sterling appearing to have a larger impact on input prices than previously anticipated. Core goods prices are likely to decline sharply in coming months, while inflation of services is likely to remain stable.

Labour market conditions appear to be waning. Wage growth has eased in recent readings, as evidence that weak growth has started to impact hiring. The latest release shows that 58,000 jobs were lost in the three months to August. As GDP is not expected to meaningfully pick up until the second half of 2020, companies can expect a little respite from building labour related cost pressures. However, as the economy does start to recover from Brexit, headline inflation is forecast to rise to average 2% in 2021 (chart 11).

Bank of England turns dovish

Given the new inflation forecast, it seems unlikely that the Bank of England (BoE) will be able to raise interest rates just after Brexit. In its presentation of its new quarterly Monetary Policy Report (previously known as the Inflation Report), the BoE's governor Mark Carney stated that interest rates rising were contingent on a smooth Brexit, a recovery in domestic growth, and a recovery in the external economy. Indeed, two members of the monetary policy committee voted to lower interest rates immediately.

As a result of recent developments, we have pushed out the next rate rise in the forecast from next year to May 2021, with interest rates ending 2021 at 1%.

The BoE has turned dovish, suggesting that a rise in rates may not follow until 2021

2020: a better year in store for most emerging economies

A trade deal, even if only a truce, is a better backdrop for emerging markets (EM) than a full-blown trade war between the US and China. This prompts some growth upgrades, though in India domestic troubles continue to conspire to overwhelm the more favourable external backdrop. We suspect actual growth in China will still be below the official number, so although the trade truce prompts an upgrade to our in house indicator (see the section on China) we do not upgrade the official number. There may, however, be some upside risk, as we discuss later. Overall, the story of 2020 should be one of acceleration for most EM, with inflation still contained.

We expect most emerging markets to improve next year

Moving into 2021, we mainly expect a continuation of the 2020 growth story given the negative output gaps in the region. The one exception is China, now likely set on a course of secular slowdown with only some minor cyclical perturbations. Inflation is likely to begin to climb as those output gaps are filled, while pulling back in China as the impact of swine flu fades.

Table 1: BRIC growth and inflation forecast summary

% per annum	GDP			Inflation		
	2019(f)	2020(f)	2021(f)	2019(f)	2020(f)	2021(f)
China	6.2 (6.2)	6.0 (6.0)	5.5	2.8 (2.7) ↑	3.2 (2.8) ↑	2.5
Brazil	0.9 (0.7) ↑	2.4 (2.0) ↑	2.5	3.6 (4.0) ↓	3.0 (3.9) ↓	3.4
India	5.7 (6.5) ↓	7.3 (7.4) ↓	7.2	3.3 (3.0) ↑	4.0 (4.0)	4.0
Russia	1.1 (1.2) ↓	1.8 (1.6) ↑	1.5	4.6 (5.0) ↓	4.1 (4.6) ↓	4.7

Source: Thomson Datastream, Schroders Economics Group. 18 November 2019. Numbers in parentheses refer to previous forecast.

EM central banks have mostly surprised to the dovish side in 2019, prompting downward revisions for rates as we continue to test the waters for the new neutral interest rate. China is an exception, with the People's Bank of China (PBoC) turning more cautious and also looking to other monetary policy instruments.

Table 2: BRIC monetary policy expectations

% (year end)	2019(f)	2020(f)	2021(f)
China RRR	13.00 (12.00)	10.00 (9.00)	9.00
China lending rate	4.00 (4.00)	3.50 (3.50)	3.00
Brazil	4.50 (5.75)	4.00 (5.25)	4.00
India	5.00 (5.15)	4.50 (5.00)	5.25
Russia	6.50 (7.25)	6.00 (7.00)	6.75

Source: Thomson Datastream, Schroders Economics Group. 18 November 2019. Numbers in parentheses refer to previous forecast.

We see room for limited further easing in the BRIC economies in 2020. However, we expect central banks to largely keep rates on hold or even look to hike towards the end of 2021 as inflationary pressures pick up.

Inflation is still soft, allowing ever greater easing from central banks

China: taking a new tack in 2021

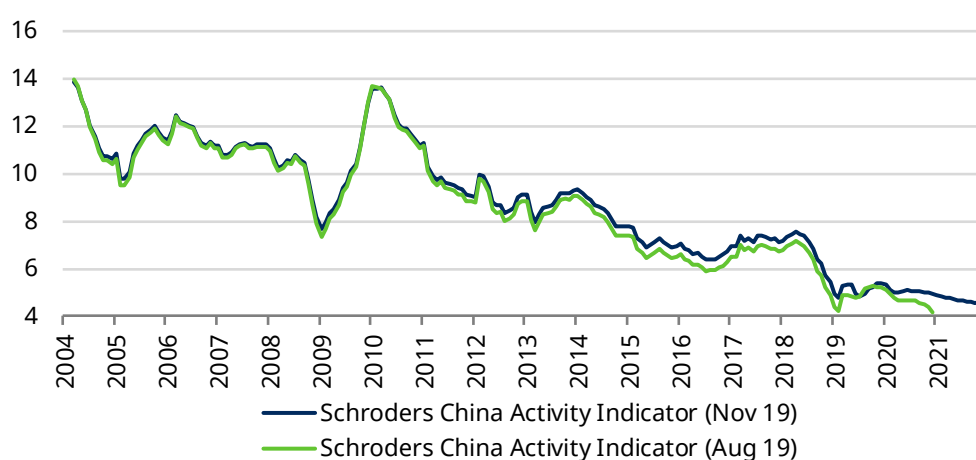
A truce in the trade war provides some breathing room for China, and should allow for a better performance from trade and industrial production than we had previously forecast. This results in an upgrade to our Schrodgers China Activity Indicator (SCAI) for 2020 (chart 12) of around 40 basis points, though we still see a deceleration versus 2019.

In terms of the official growth rate, we have not altered our 2020 number, having also left it unchanged at 6% at our last update despite the re-escalation, at that time, of trade tensions. Simply put, we see 2020 as too important a year, symbolically speaking, for the government to allow growth to slip below 6%.

The income target for 2020 actually requires 6.2% growth this year and next year, so if anything we may have upside risk to the GDP number. However, a review of historic GDP data is due soon and will likely revise higher existing GDP, reducing the growth needed for 2020.

Chart 12: Upgrading Chinese economic momentum for 2020

A better outlook for trade boosts Chinese investment and production



Source: Refinitiv Datastream, Schrodgers Economics Group. 21 November 2019. Previous forecast from August 2019. Please note the forecast warning at the back of the document.

In some ways, more interesting at this point than the trade war or the 2020 outlook and its mix of stimulus, is what happens to Chinese growth and policy in 2021. Having achieved its goal of doubling per capita incomes from 2010, we think the Chinese government will next seek to move away from binding growth targets.

The costs of these growth targets have been clear to see; growth in output has been impressive, but growth in debt has been astonishing. Speculative financial market bubbles, excessive leverage, and wasteful investment have all built up in China's financial plumbing, like the fatbergs in London's sewers. Business as usual would have some unpleasant future consequences.

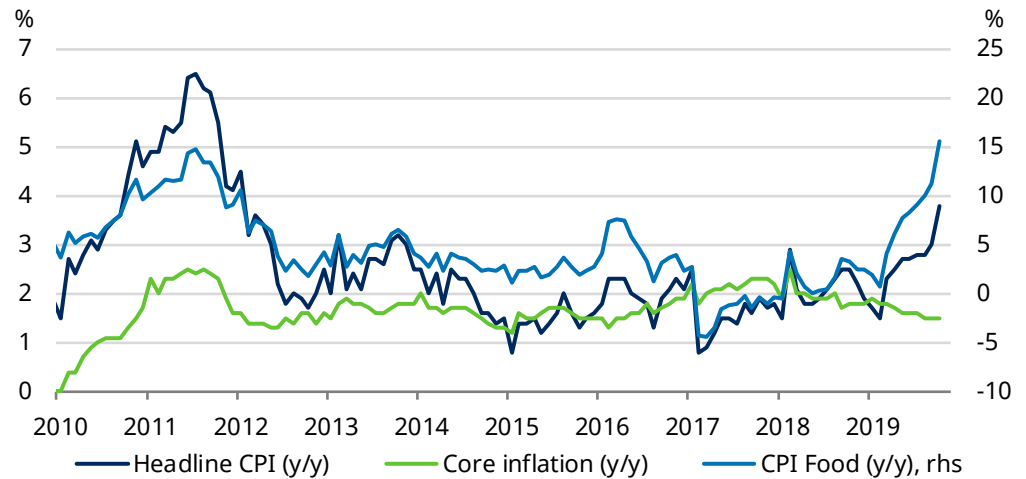
2020 is likely to be the last year with a binding growth target

We do not mean to suggest the government will cease to care about growth. However, it is more likely to focus on the parts of economic growth that the populace cares about; employment. There is also likely to be more attention paid to quality of life, not only pollution but the provision of better quality social services, particularly in rural areas.

This shift away from growth targets will allow GDP data to more closely reflect reality as the political cost of doing so diminishes. It is this that drives our 2021 deceleration to 5.5% growth, more or less in line with a slowdown in our SCAI.

Swine flu induced food inflation unlikely to abate until the second quarter

Chart 13: Food prices drive inflation higher in China



Source: Refinitiv Datastream, Schroders Economics Group. 21 November 2019.

Inflationary pressures continue to rise, prompting an upward revision for this year and next. This is driven almost entirely by the ongoing shortage of pork, linked to African Swine Flu. Pork prices are currently growing at over 100% year-on-year (y/y), and this seems unlikely to peak before the Chinese New Year holiday at the end of January.

The good news for the PBoC, however, is that core inflation pressures are very weak (chart 13) and so there is little real need to hike. We would expect the central bank to look through high headline inflation and focus on activity and core inflation measures when deciding monetary policy; both of these warrant further easing over the next 24 months.

Brazil: pensions reformed, what next?

The reform progress has spurred the central bank to ease more aggressively

Next year should be a much better one for Brazil's economy. Not only should the passage of pension reforms boost confidence and investment, but one off shocks to growth like the Brumadinho dam disaster seem very unlikely to repeat. In addition, the central bank has been able to cut interest rates even more aggressively than expected, which should feed through to activity over the next twelve to eighteen months.

The pension reform bill ultimately delivered savings in line with the more optimistic estimates, and in passing the reform the country took a sizeable step toward fiscal sustainability. The journey is not complete but investors and households should now have greater confidence that a more violent fiscal dislocation will not occur, and this confidence should encourage credit growth, investment and consumption.

Given that the economy remains easily below potential, with plenty of spare capacity, we would expect something of a virtuous cycle to occur as growth picks up. This should support another year of modest growth in 2021 in the absence of supply side constraints on the economy.

Policymakers of course will still wish to assist growth, but at this point that assistance is likely to be relatively marginal. The central bank has already cut rates sharply and probably only has limited room to run; we anticipate easing coming to an end at 4%.

Fiscal space, meanwhile, is still tight, despite the success of pension reform. This is because the reforms essentially mean that future spending will not have to be cut, rather than immediately delivering budgetary stimulus options. For the most part, efforts from the government will need to be legislative. We would expect an array of micro-reforms, each incrementally improving the ease of doing business, alongside an attempt to overhaul the tax structure.

In a parallel with India, Brazil is seeking to cut down the number of taxes imposed on business by combining different state and federal taxes into a single goods and services tax. Theoretically, this would be helpful for corporates; even if the tax burden is little changed, a simpler set of paperwork reduces the effective cost faced.

As the Indian experience showed, however, attempts at such reform are seldom simple and do not always deliver the savings hoped for. The need to balance competing state and federal government interests means this is unlikely to pass in the next six months. That said, we do assume some simplification is managed towards the end of 2020.

India: the only way is up (hopefully)

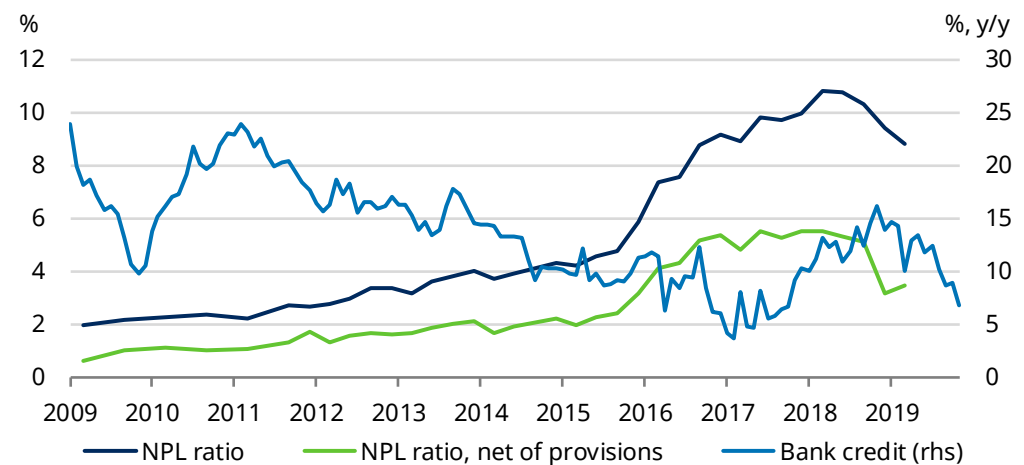
Growth continues to disappoint as financial sector woes mount

Economic data has continued to disappoint in India, suggesting no immediate end to the slowdown afflicting the economy. This prompts a significant downgrade for this year, and while we do not massively alter our 2020 expectation at this stage, if we do not see the beginnings of an inflection and revival in the fourth quarter we will have to apply a large downgrade to 2020 as well. More broadly, we are beginning to question whether trend growth may be materially lower than the ~7% we have typically assumed.

Low inflation has enabled additional easing from the Reserve Bank of India (RBI) which should feed through to growth in 2020. We also expect more easing to come, with higher food inflation likely to subside and core inflation remaining subdued.

One caveat here is that RBI easing seems to be having only a limited impact on effective interest rates. The stresses affecting the Indian financial system appear to be impairing the transmission of monetary policy, though non-performing loans (NPL) in the banking system are at last coming down.

Chart 14: Credit growth has struggled, weighing on activity



Source: Refinitiv Datastream, Schroders Economics Group. 21 November 2019

The government continues to roll out measures to alleviate some of these financial system stresses, including a bailout fund recently for the real estate sector. This can help address asset quality issues for banks, as well as begin to revive one of the hardest hit sectors and sources of employment. Government spending has also begun to pick up after the election induced hiatus.

Overall it is hard to see things getting much worse for India. We would expect a recovery in credit, supported by government largesse, to support better growth in 2020, flattered by a low base effect. We are conscious, however, that we are now very much on the high side of consensus. Risks are definitely to the downside and if we do not see additional decisive government action and a turnaround in the credit story, we would look to revise down our 2020 projection.

A reduction in expected fiscal stimulus but greater room for monetary easing

Russia: steady as she goes

The government has scaled down its fiscal ambitions, announcing in September that fiscal funds of around 400 billion rubles would be made available for investment in 2020. Compared to prior estimates of 1500 billion previously, this is a clear downgrade.

Luckily for the Russian economy, global growth (in our forecast at least) is set to improve, and with fewer inflationary pressures to worry about from fiscal spending, the central bank has signalled a willingness to take a more dovish tack. This is reflected in our expectations for further easing this year and next. Inflation itself remains weak (a common theme for much of EM), and will likely fall further as the base effect from the VAT increase fades.

So far, so boring. Russia has rather successfully insulated itself from swings in the global economic cycle through fiscal prudence and foreign exchange intervention, and seems content with a very modest pace of growth.

The main threat to this tranquillity, as ever, is geopolitical. The US-China relationship garners far more headlines now but tensions between the US and Russia never entirely died down. The Mueller report was ultimately less explosive than anticipated and helped tamp down sanctions risk for much of 2019. However, a number of new bills have been working their way through the US legislature, suggesting sanctions risk can not be discounted entirely. Still, economically significant measures are not on the immediate horizon. Stable serenity looks to be Russia's lot for the near future.

Japan: End of Abenomics on the horizon

“With the weight of that responsibility on my shoulders, I hope to continue pushing to resolve all of the policy issues we currently face, always maintaining the caution of my earlier days as Prime Minister.”

Shinzo Abe, as he becomes Japan’s longest serving Prime Minister, 20 November 2019.

The main change to the outlook is an upgrade to growth for next year to 0.2% year-on-year (y/y) due to a US-China trade truce. Meanwhile, fiscal stimulus should help support growth in 2021 as Prime Minister Abe’s term comes to an end and trade tensions return. Near term, the lack of inflation in October may surprise investors given the hike in VAT.

Domestic demand holds up in Q3

The Japanese growth story is one of stable domestic demand but weak external demand

Japanese growth slowed to 0.1% quarter-on-quarter (q/q) in the third quarter, not far from expectations of 0.2% q/q. Domestic demand slowed slightly but remained at healthy levels by Japanese standards. However inventory drag almost offset the primary drivers of domestic demand, consumption and capital expenditure. Net exports were, again, a drag to growth. Taking a step back from quarterly volatility, the Japanese growth story remains one of fairly stable domestic demand but weak external demand.

Chart 15: Domestic demand holds up

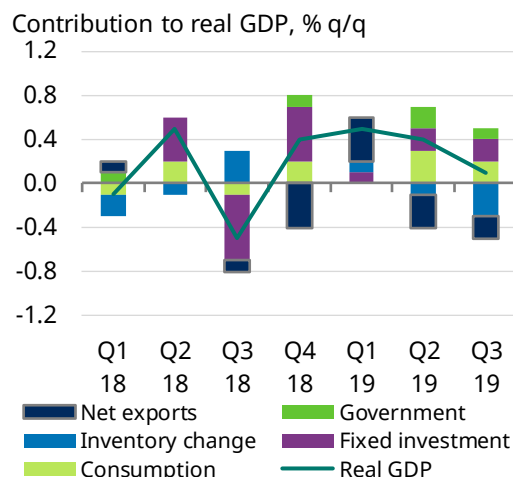


Chart 16: Jump in retail sales



Source: Refinitiv, Schroders Economics Group, 22 November 2019.

The jump in retail sales suggests that some consumption was indeed brought forward

We had, admittedly, anticipated growth to rise in the third quarter, consistent with households bringing forward spending ahead of the October tax change. This primarily explains our downgrade to 2019 growth to 0.8% y/y (along with data revisions).

On reflection, lack of stronger consumption could be successful policy making by the Japanese authorities, who have gone to large efforts to smooth consumption. On the other hand, it could be that “frontloading” did happen, thereby boosting growth, but simply offset weak underlying consumption. If we consider the jump in retail sales, as shown in chart 16, and a backdrop of low wage growth and weak consumer sentiment, we suspect the latter was more likely the case.

The magnitude of the fall in domestic demand in the fourth quarter will create a clearer picture of the underlying Japanese economy.

We also highlight to investors that Typhoon Hagibis likely provided supply side constraints to activity. On the other hand, a lack of inflation spike – perhaps surprising to some investors – suggests little detrimental impact to household real income, a promising factor for activity.

VAT led inflation offset by education measures

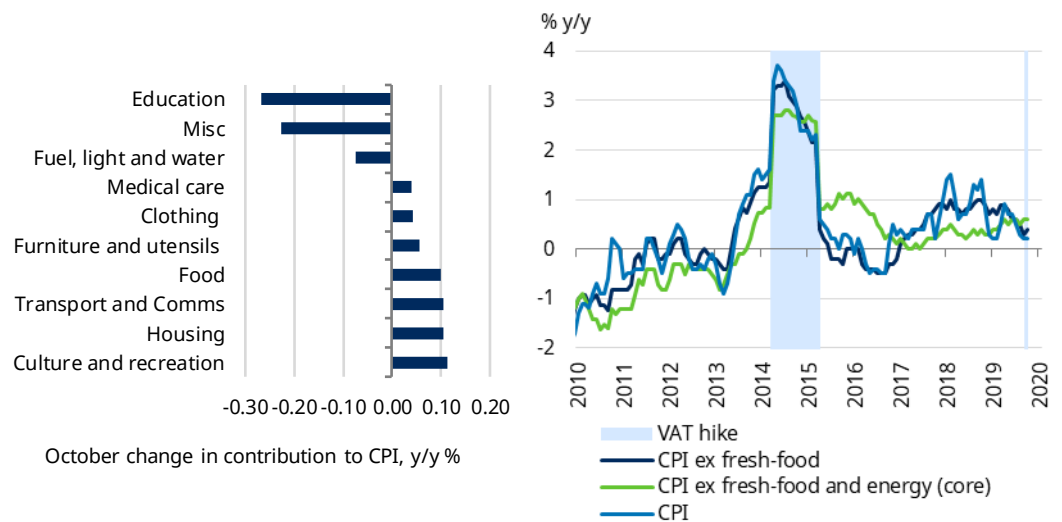
While we have previously highlighted that the inflationary impact of the October VAT hike would be lower than 2014, October inflation data shows that free pre-school education policy measures almost offset the inflation impact from the consumption tax hike. The “headline” measure of Consumer Price Inflation (CPI) was unchanged at 0.2% y/y and excluding fresh-food (the measure targeted by the Bank of Japan) edged up by only 0.1% y/y to 0.4% y/y (chart 17 and 18).

Special reference data published by the Ministry of Internal Affairs and Communication, shows that the VAT hike added 0.77 percentage points (pp) to inflation. But with free pre-school education taking 0.57pp off the headline number, there was little change to overall inflation in October. In utilities and communication, implementation of the tax change was delayed by one month so this data does not capture the full impact of the VAT hike.

Nonetheless, the lack of inflation surge is clearly different to previous hikes and in turn, the impact to consumption from an “income” effect is lower. A hit to consumption is still likely given spending that was brought forward and those benefitting from the education policy may opt to save the windfall rather than spend. However taking these factors together, the lack of inflation provides an upside risk to fourth quarter activity.

Chart 17 and 18: Inflation unchanged despite VAT hike

Free pre-school education did a good job in offsetting the VAT hike



Source: Thomson Reuters Refinitiv, Schroders Economics Group, 21 November 2019.

The lack of VAT hike “spike” also provides downside risks to our inflation outlook, which we had already revised lower to 0.9% y/y in 2020, due to oil prices and lower cyclical pressures. Nonetheless, our inflation outlook continues to remain below 1% – a situation very familiar to the Bank of Japan (BoJ).

The market has priced out expectations of a rate cut

A close call for Boj rate cut

At the October policy meeting, the BoJ tweaked its forward guidance to say rates would be kept “at present or lower levels” hinting at a future rate cut from the current -0.1%. We continue to keep a close eye on the outlook for global trade and prospect of yen appreciation – the two most important concerns of the BoJ. These concerns have faded somewhat; the yen has been fairly stable against the US dollar and looking ahead, an end to or at least fewer rate cuts from the Fed, plus signs of global growth stabilisation point to a weaker yen than we previously expected. Moreover, a US-China trade agreement should halt the slowdown in global trade somewhat. Perhaps in reaction to this, the market has priced out expectations of a rate cut, driving government bonds yields higher (chart 19 and 20). We retain our call for the BoJ to cut rates in December in an attempt to soften the blow from the consumption tax hike amid a backdrop of weak growth and inflation. This goes somewhat against the market consensus and we admit it is a close call.

Chart 19: December rate expectation

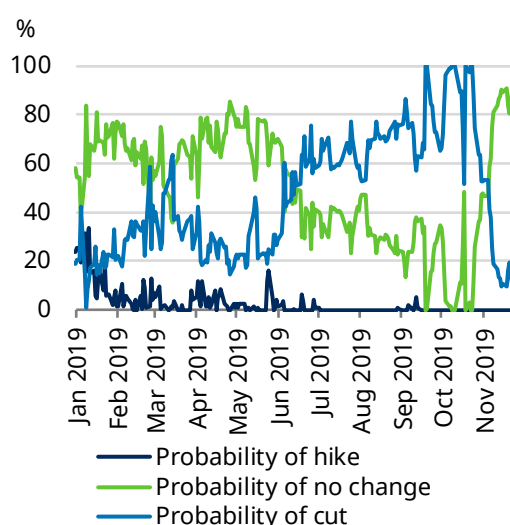


Chart 20: JGB yields rise



Source: ¹Implied using OIS rate, Bloomberg (LHS), Refinitiv (RHS), Schroders Economics Group, 22 November 2019.

Japan will benefit from a trade deal

Trade deal supportive for 2020, fiscal supports 2021

We still see an underlying moderation in domestic demand in 2020. This is due to slowing employment growth leading to lower consumption growth. Labour shortages and accommodative financial conditions will likely remain supportive for firms, low growth in 2020 should result in a moderation in capex, while demand related to the Olympics will have peaked.

Our revised view that a truce in the US-China trade war will occur, leads us to upgrade Japan’s growth forecast as it will indirectly benefit from better exports and capex, clarity around the trade deal being important for the latter. But we see trade tensions returning in the second half of 2021 to weigh on the Japanese economy once more.

Meanwhile, public spending will be a supporting factor for growth and a more supportive fiscal stance in 2021 along with favourable base effects leads us to pencil in 1% growth in 2021. We factor in additional spending equivalent to 1% of GDP on top of what has been previously announced (see March Economic and Strategy Viewpoint).

Investors will start to question what is next in terms of political leadership

The end of Abenomics slowly approaching

Finally, as extend our economic outlook into 2021, we must also consider political events and changes in our forecast horizon.

Undoubtedly, the main one for the Japanese economy will be the end of Prime Minister Abe's third term as the Liberal Democrat Party (LDP) leader in September 2021. Having ruled out a fourth term, this gives Abe – now Japan's longest serving Prime Minister – under two years left to continue his quest of reviving the Japanese economy (see quote). With this end-point for "Abenomics" – characterised by the PM's three policy "arrows" of monetary easing, fiscal stimulus and structural reform – now in sight, investors will start to question what is next in terms of political leadership for the Japanese economy. Governor Kuroda's term is set to continue through the forecast horizon, expiring in April 2023.

Schroders Economics Group: Views at a glance

Macro summary – December 2019

Key points

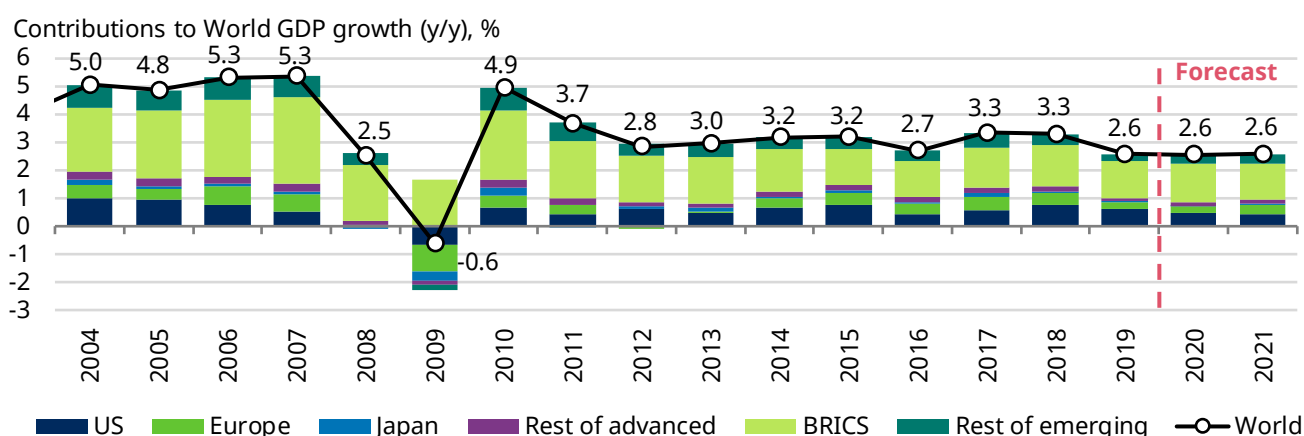
Baseline

- After expanding by 2.6% in 2019, global growth is expected to remain stable in 2020 as a slowing in advanced economies is offset by an acceleration in emerging markets. The world economy looks set to avoid a recession as the cycle extends into 2021, where we expect global growth to continue at 2.6%. Meanwhile, global Inflation is also forecast to remain stable at 2.6% in 2020.
- We assume a "phase one" US-China trade deal. However 2021 is likely to be marked by a return of trade tensions. Negotiations around a wider ranging deal covering the thorny areas of intellectual property and state subsidy of exports are likely to be fraught and we expect tariffs to rise again in the second half of 2021.
- US growth is expected to slow from 2.3% to 1.8% in 2020. US core inflation continues to rise, peaking next year before declining through 2021, however the drag from energy means that headline inflation should remain just above target at 2.1% in 2020. With growth below trend, we expect the Fed to cut rates by 25bps in April, before laying low as the presidential election gets underway and then easing again in 2021.
- Our expectation is for growth and inflation in the Eurozone growth to remain fairly stable at 1.2% and 1.3%, respectively. Both should pick up slightly in 2021 but with inflation still only at 1.5%, the ECB should continue QE through 2021 after another rate cut to -0.60% in Q1 next year.
- UK growth is likely to fall to 0.8% next year from 1.4% in 2019. We assume that polls are correct in pointing to a Conservative win in the upcoming general election allowing the Withdrawal Agreement to be pushed through parliament and for the UK to leave the EU by the end of January. The UK then enters a transition period that preserves the status quo of single market and customs union membership. Inflation is expected to fall to 0.8% in 2020 due to lower energy prices, weaker growth and a recovery in sterling. As inflation picks up in 2021, the BoE is forecast to hike rates to 1%.
- Growth in Japan should fall to 0.2% in 2020 from 0.8% as the economy is hit from the VAT hike. We expect a December rate cut from the BoJ to help support activity and weak inflation.
- We expect most of the BRIC economies to enjoy accelerated growth in 2020, taking the EM growth rate to 4.4% from 4% in 2019, a pace which will slow marginally in 2021. China alone is expected to slow further, though not to breach the 6% barrier until 2021 when it slows more abruptly to 5.5%. Inflation remains under control, with the exception of the impact of swine flu in China, and allows for additional easing across EM in 2020, with a more mixed picture the following year as economic recovery starts to generate modest inflationary pressure.

Risks

- Risks to inflation are balanced and we still see a slight downside risk to growth. However the downside risks to growth are lower than earlier on in the year reflecting the addition of reflationary scenarios and removal of some stagflationary outcomes. The highest individual risk scenarios are both deflationary – US swings left and the global recession scenario.

Chart: World GDP forecast



Source: Schroders Economics Group, November 2019. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2018	2019	Prev.	Consensus	2020	Prev.	Consensus	2021
World	100	3.3	2.6	(2.6)	2.6	2.6	↑ (2.4)	2.5	2.6
Advanced*	61.4	2.3	1.7	↑ (1.6)	1.7	1.4	↑ (1.1)	1.4	1.6
US	26.4	2.9	2.3	↑ (2.1)	2.3	1.8	↑ (1.3)	1.8	1.7
Eurozone	17.6	1.9	1.2	↑ (1.1)	1.1	1.2	↑ (0.9)	1.0	1.4
Germany	5.1	1.5	0.6	↑ (0.5)	0.5	1.0	↑ (0.8)	0.8	1.4
UK	3.6	1.4	1.3	↑ (1.1)	1.3	0.8	↓ (1.0)	1.1	2.1
Japan	6.4	0.8	0.8	↓ (1.2)	1.0	0.2	↑ (-0.1)	0.2	1.0
Total Emerging**	38.6	4.8	4.1	↓ (4.2)	4.1	4.5	(4.5)	4.3	4.3
BRICs	25.6	5.7	5.2	(5.2)	5.2	5.5	↑ (5.4)	5.3	5.1
China	17.5	6.6	6.2	(6.2)	6.1	6.0	(6.0)	5.8	5.5

Inflation CPI

y/y%	Wt (%)	2018	2019	Prev.	Consensus	2020	Prev.	Consensus	2021
World	100	2.6	2.5	(2.5)	2.4	2.5	↓ (2.6)	2.4	2.5
Advanced*	61.4	2.0	1.5	(1.5)	1.5	1.6	↓ (1.7)	1.6	1.6
US	26.4	2.4	1.8	↓ (1.9)	1.8	2.1	↓ (2.2)	2.1	2.0
Eurozone	17.6	1.8	1.2	↓ (1.3)	1.2	1.3	(1.3)	1.2	1.5
Germany	5.1	1.9	1.3	↓ (1.4)	1.4	1.5	(1.5)	1.5	1.7
UK	3.6	2.5	1.8	(1.8)	1.9	1.4	↓ (1.9)	1.9	2.0
Japan	6.4	1.0	0.6	↓ (0.7)	0.6	0.9	↓ (1.0)	0.7	0.6
Total Emerging**	38.6	3.5	4.1	(4.1)	3.9	4.0	↑ (3.9)	3.8	3.7
BRICs	25.6	2.5	3.1	(3.1)	2.9	3.4	↑ (3.3)	3.0	3.0
China	17.5	2.1	2.8	↑ (2.7)	2.7	3.2	↑ (2.8)	2.7	2.5

Interest rates

% (Month of Dec)	Current	2018	2019	Prev.	Market	2020	Prev.	Market	2021	Market
US	0.00	2.50	1.75	(1.75)	1.92	1.50	↑ (1.25)	1.52	1.25	1.46
UK	0.00	0.75	0.75	(0.75)	0.79	0.75	↓ (1.00)	0.66	1.00	0.69
Eurozone (Refi)	0.00	0.00	0.00	(0.00)		0.00	(0.00)		0.00	
Eurozone (Depo)	0.00	-0.40	-0.50	↑ (-0.60)	-0.40	-0.60	(-0.60)	-0.43	-0.60	-0.38
Japan	0.00	-0.10	-0.30	(-0.30)	0.01	-0.30	(-0.30)	0.00	-0.30	0.02
China	0.00	4.35	4.00	(4.00)	-	3.50	(3.50)	-	3.00	-

Other monetary policy

(Over year or by Dec)	Current	2018	2019	Prev.	2020	Prev.	2021
US QE (\$Tn)	4.0	4.1	4.0	↑ (3.8)	4.2	↑ (3.8)	4.3
EZ QE (€Tn)	2.4	2.4	2.4	(2.4)	2.6	(2.6)	2.9
UK QE (£Bn)	422	435	445	(445)	445	(445)	445
JP QE (¥Tn)	557.0	552	575	↓ (583)	609	↓ (623)	649
China RRR (%)	13.50	14.50	13.00	↑ 12.00	10.00	↑ 9.00	9.00

Key variables

FX (Month of Dec)	Current	2018	2019	Prev.	Y/Y(%)	2020	Prev.	Y/Y(%)	2021	Y/Y(%)
USD/GBP	1.29	1.27	1.30	↑ (1.24)	2.1	1.35	↑ (1.32)	3.8	1.35	0.0
USD/EUR	1.10	1.14	1.12	↑ (1.08)	-2.0	1.15	↑ (1.14)	2.7	1.12	-2.6
JPY/USD	108.9	109.7	110	↑ (103)	0.3	110	↑ (105)	0.0	107	-2.7
GBP/EUR	0.85	0.90	0.86	↓ (0.87)	-4.0	0.85	↓ (0.86)	-1.1	0.83	-2.6
RMB/USD	7.03	6.87	7.00	↓ (7.20)	2.0	7.20	↓ (7.30)	2.9	7.40	2.8
Commodities (over year)										
Brent Crude	63.5	71.6	63.9	↓ (64.2)	-10.8	58.1	↓ (59.5)	-9.0	56.3	-3.1

Source: Schroders, Thomson Datastream, Consensus Economics, November 2019

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.

Market data as at 25/11/2019

Previous forecast refers to September 2019

* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.

** **Emerging markets:** Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

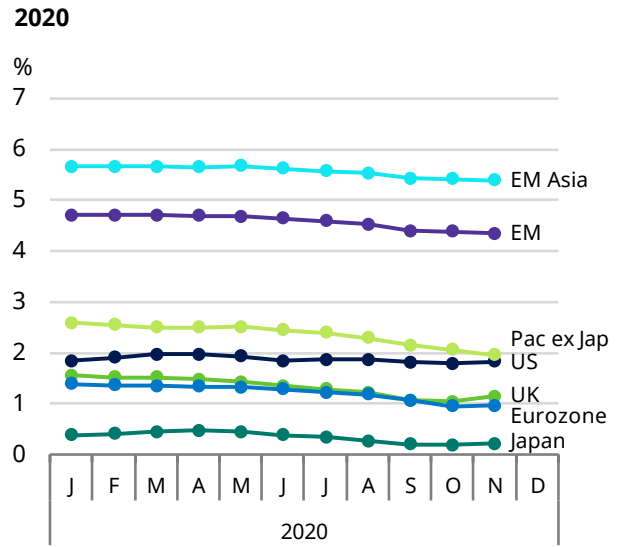
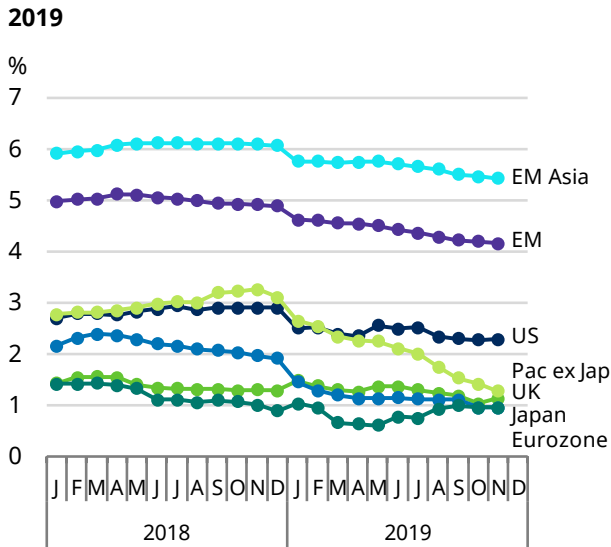
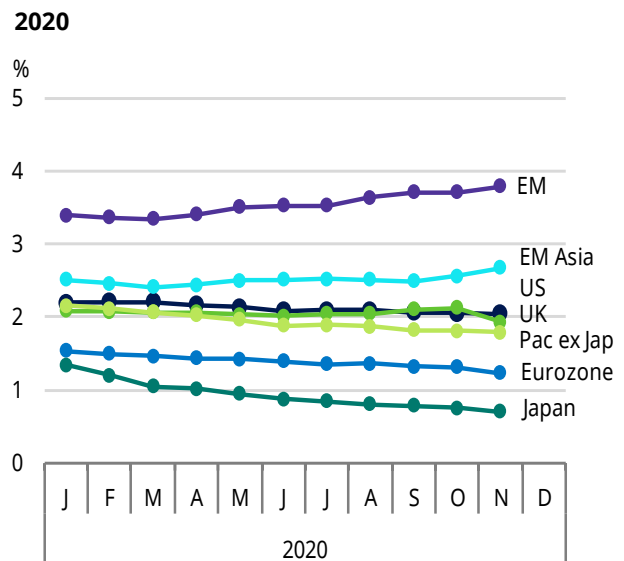
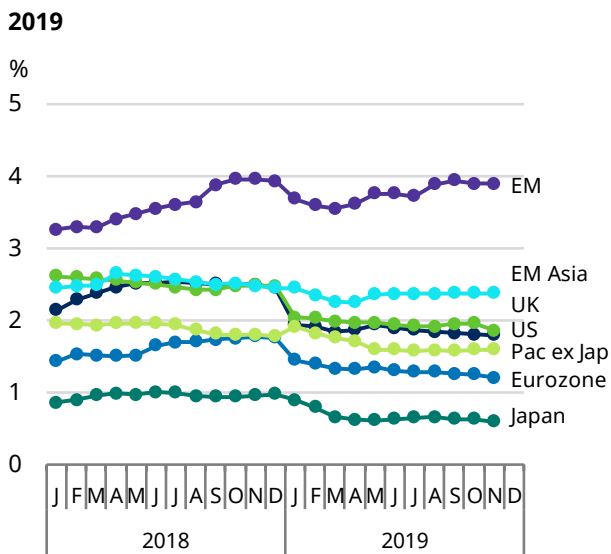


Chart B: Inflation consensus forecasts



Source: Consensus Economics (29 November 2019), Schroders.

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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