Global market perspective

Economic and asset allocation views

July 2019

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Editors:

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Introduction

Both equities and bonds rallied strongly in the second quarter as markets moved to price in a more dovish path for central bank monetary policy. The trigger came from the US where expectations for interest rates moved down significantly, from assuming no move in policy this year to assuming rate cuts. The European Central Bank also signalled easier policy, whilst rates have eased across Asia which has been particularly affected by the trade wars.

Soft economic activity and ongoing trade tensions were the catalyst for these moves, against a backdrop of subdued inflation. Although a more difficult economic backdrop does not bode well for corporate earnings, equity markets have benefited from a re-rating on the back of lower risk free interest rates. Toward the end of the quarter, optimism increased as the US stepped back from raising tariffs on Mexico and then, at the G20 meeting, agreed to resume trade talks with China.

We see only a modest improvement in the economic environment with global growth expected to remain subdued over the next 12 months. Fading fiscal stimulus and the effect of past tightening of monetary policy weighs on the US, whilst Europe and Asia do not have sufficient domestic demand to drive growth at an above trend rate. The strategy note takes a closer look at the outlook for US monetary policy whilst our research notes report on our cyclical models and the impact of heightened geopolitical risk.

From an asset allocation perspective, our economic outlook leads us to be cautious on equity markets and we have focused our risk budget on credit and carry assets which can benefit from low rates whilst being less vulnerable to the economic cycle.

Keith Wade

Chief Economist and Strategist, 9 July 2019

Asset allocation views: Multi-Asset Group

Global overview

Economic overview

Renewed trade tensions have pushed our forecast in a more stagflationary direction as downside risks to growth persist. We have kept our 2019 global GDP forecast unchanged at 2.8%, while downgrading the 2020 figure to 2.6% (from 2.7%). Rising geopolitical risks are set to hurt business confidence and reduce capital expenditure, thereby weighing on global activity. As such, the 2020 growth profile has seen downward revisions across the board, leaving our forecasts for next year below consensus.

Regarding inflation, we have increased our CPI projections for 2019 and 2020 in all regions, which is largely driven by the oil price. US inflation is also revised up following the breakdown in US-China trade negotiations and the subsequent increase in tariffs from 10% to 25% on $200bn of imports.

The balance of risks to our baseline view are skewed toward stagflation, which is where we allocate the most scenarios, such as the new entry "Oil jumps to $100". However, the individual scenario with the greatest probability is still "US 2020 recession", which poses a deflationary risk to the baseline.

Central bank policy

While inflation remains low and global activity is softening, central banks will look to support growth through looser monetary policy. The US Federal Reserve (Fed) is projected to start cutting rates in the second half of this year, with the first move in July. Meanwhile, we have pushed out our projected rate hikes in the UK again, where we expect the Bank of England (BoE) to leave the interest rate at 0.75% for the rest of the year before tightening once in 2020. For the European Central Bank (ECB) and the Bank of Japan (BoJ), we have taken out all of our rate hikes from the forecast as we project both regions to leave policy on hold through 2020. In China, we expect further stimulus through a lower reserve requirement ratio (RRR).

Implications for markets

We retain our neutral view on global equities. While we still believe that earnings growth will remain supportive of equities in the near term, we foresee limited improvement further out. Our models indicate that equities have become more fully valued after the recent strength. Additionally, cyclical risks remain elevated and unabated trade tensions could weigh in coming months. Rising volatility is a risk factor with ongoing political and policy uncertainty.

Within equities, we have a preference for the US and emerging markets (EM). US equities will benefit following noticeable recoveries in momentum signals for both price and earnings revisions and a more accommodative Fed. Valuations remain attractive for EM equities following the large sell-off in 2018, although trade wars remain a threat. EM markets with a more domestic focus present better opportunities. In addition, a more stable (or potentially weaker) dollar could be a catalyst for a stronger EM earnings story in coming months.

With the Fed's dovish stance, we have become less worried about the risk of recession in the near term. However, we would like to see a further stabilisation in the earnings outlook before upgrading from our neutral view. Momentum continues to be one of the strongest among major equity markets and should continue to be supportive by ample liquidity.

On Japanese equities, we remain neutral in our stance. We feel that exports will struggle due to the weaker outlook for global growth and the strengthening yen and there are few signs of an improvement on the domestic front. Unless

there is a noticeable pick-up in domestic demand, particularly capex, we will stay neutral. Within the Pacific ex Japan region, we remain neutral as export weakness in Singapore continues to be a drag.

In comparison, we expect the UK to face headwinds, with the increasing probability of a "no-deal Brexit". Fading investor sentiment could also weigh on equities and as a result we remain negative. We are more positive on Europe and have upgraded to neutral. Although the earnings environment has improved, we remain cautious over the risk for a stronger euro on the back of Fed-induced US dollar weakness.

Turning to the duration view, we remain positive on government bonds, due to their hedge potential in periods of market stress and a backdrop of a weaker global cyclical picture. In bond markets, we have upgraded US Treasuries and Japanese government bonds (JGBs) to positive, due to the potential positive impact from rising trade war rhetoric on growth. A positive upgrade for UK gilts is underpinned by the risk of a "no-deal Brexit". We remain positive on German Bunds due to the ECB retaining its dovish stance due to the lack of inflation pressure, and from a carry perspective due to the slope of the curve. We remain neutral on both USD and local currency emerging market debt (EMD).

Turning to the credit markets, we have turned positive on the asset class, as valuations are more attractive from a short-term perspective. This presents an opportunity against a backdrop of easing global liquidity. We have upgraded US investment grade (IG) as we believe more attractive valuations and a new mini-liquidity cycle are likely to offset our long-standing structural and fundamental worries. We keep our positive view on European IG bonds due to the supportive policy environment aiding market liquidity and the attractive fundamentals. On high yield (HY) credit, we have downgraded the US to neutral and have again upgraded our view on European HY, to positive. We remain cautious on US HY due to fears about fundamental credit quality. In Europe, attractive valuations and solid fundamentals support the upgrading of HY credit to positive.

Our outlook on the broad commodity complex remains neutral due to the negative carry and price momentum behind the market. We are positive on gold as a hedge, gaining further support from mild US dollar weakness. We have downgraded agriculture to negative because of excessive inventory levels. We remain neutral on the energy market, despite the mid-Q2 sell-off. Lastly, we stay neutral on industrial metals after the sell-off, amid global growth concerns.

Table 1: Asset allocation grid – summary

Equity	0 (+)	Bonds	0			Alternatives	0	Cash	+
Region		Region		Sector		Sector			
US	+ (0)	US Treasury	+ (0)	Government	+ (0)	UK property EU property	– +		
Europe ex. UK	0 (–)	UK gilts	+ (–)	Index-linked	+	Commodities	0		
UK	–	Eurozone Bunds	+	US IG EU IG	0 (–) +	Gold	+ (0)		
Pacific ex. Japan	0	Emerging market debt (USD)	0	US HY EU HY	0 (+) + (0)				
Japan	0	Emerging market debt (local currency)	0						
Emerging markets	+								

Key: +/- market expected to outperform/underperform (maximum ++ to minimum – -) 0 indicates a neutral position.
Note: The above asset allocation is for illustrative purposes only. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability and riskiness of individual asset classes in different regions. For alternatives, due to the illiquid nature of the asset class, there will be limitations in implementing these views in client portfolios. The views for equities, government bonds and commodities are based on return relative to cash in local currency. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged).
Source: Schroders, June 2019.

Regional equity views

Key points

0	Equities	
+ (0)	US	We upgrade our position to positive for US equities following noticeable recoveries in momentum signals for both price and earnings revisions. Looser monetary policy is also set to support medium term performance for US stocks. However, continued trade tensions between the US and China could be a significant headwind for the market and our positive outlook. Higher tariffs will trigger a de-rating of price multiples but unlike October 2018, earnings expectations have already been cut and positioning is still fairly cautious.
–	UK	We stay negative on UK equities due to the increasing probability of a "no–deal" Brexit. Political uncertainty has hit business confidence and weakened investor sentiment, which presents a strong headwind to domestic equities. We are also concerned that the weakened GBP is not enough to support the market because confidence levels are so poor.
0 (-)	Europe ex. UK	We upgrade to neutral for European equities as the region has held up well alongside other global markets, performing strongly year to date. Overall, earnings and sales results have improved since the last quarter and macro data appears to have bottomed. A further improvement will see equities rally but political uncertainties persist with the Italian budget and the departure of the UK from the EU. The weakness of the euro has benefitted the sectors with more international exposure while the largest European sector, banking, has underperformed due to the flatter yield curve.
0	Japan	Japanese equities have underperformed the global market despite their attractive valuations and stable economic growth. As a more cyclical market, the effect of trade tensions has been profound. The relative weakness has been particularly noticeable in earnings revisions which have lagged significantly behind most markets. However, we stay neutral as a lack of confidence continues to undermine improving fundamentals.
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	We expect Pacific ex Japan equities to perform in line with global equities. Within the region, we are neutral on Australian equities as the latest data is very mixed. Despite the cut in interest rates, we are hesitant to act confidently in one direction before we receive further information on the health of the domestic economy. We stay neutral on Singapore, where fundamental data has been weak. Green shoots in China improve the outlook but we are yet to see evidence that recent stimulus has fed through into the Singaporean economy. For Hong Kong, we remain overweight on the market given the now positive earnings revisions and stronger business activity.
+	Emerging markets	For EM, valuations appear attractive with good upside potential and a stronger growth potential facilitates our positive view for the region. However, trade tensions will drag on performance, therefore the markets with a more domestic bias present a more interesting opportunity. China is currently benefitting from fiscal and monetary stimulus as earnings revisions have troughed. Stronger growth here should support other areas in EM, such as Korea and Taiwan. However, poor tech earnings and disrupted supply chain issues will likely steer investors away from these areas.

Note: The scores for equities this quarter have been adjusted upwards to reflect the revised scoring framework which uses returns relative to cash, making scoring consistent across different markets. These do not reflect upgrades in our outlook.
Key: +/- market expected to outperform/underperform (maximum ++ minimum – -) 0 indicates a neutral position.

Fixed income views

Key points

+	Bonds	
+	Government	Valuations in the government space still remain expensive after yields dropped further to historically low levels. Cyclical risks around the globe are still very much present and recession risks stay elevated. Consequently, central banks policy has remained accommodative, supporting government bond markets. Overall, the efficacy of bonds as a defensive asset during periods of stress continues to provide a tailwind and with the risks of a stagflationary environment still relatively low, we maintain a positive view. We have upgraded our view on US Treasuries because of the weak cyclical outlook, paired with continuous rhetoric on trade wars between the US and China. The US Fed has moved in a more dovish direction and the market is expecting at least two rate cuts in 2019 and two more in 2020. US flash PMIs for June have weakened, pointing towards lower near-term growth prospects. We remain positive on German Bunds, especially as the European Central Bank is keeping a dovish stance in trying to increase growth and raise inflation back to its target. Furthermore, recent economic data has shown signs of stabilisation. Meanwhile, from a carry and hedging perspective, rate differentials remain attractive for foreign investors, particularly from the US. We have also upgraded gilts to positive, which could benefit from uncertainty in the UK due to increasing probability of a "no-deal Brexit". Economic activity is slowing, as signalled by the fall in business confidence, house prices and PMI manufacturing which is below 50, signalling a contraction. We have also become positive on Japanese Government Bonds given the current threats to export demand due to trade wars.
	Investment grade (IG) corporate	We have become more positive on US credit as we believe more attractive valuations and a new liquidity minicycle are likely to offset our long-standing structural and fundamental concerns.
0 (–) +	US EU	We maintain a positive view as fundamentals are strong in Europe and low interest rates provide additional support. Interest coverage ratios look stable and corporate spending is not elevated.
	High yield (HY)	We retain a neutral view on US HY as valuations are still attractive. However, we remain conscious that fundamental credit quality might deteriote in coming months.
0 +	US EU	We continue to hold a positive view as fundamentals are strong and valuations are appealing. Default rates remain low.
0 0	EMD USD-denominated EMD local currency-denominated	One of the key headwinds for emerging market debt in 2018 and early 2019 was the increasingly hawkish US Fed. Now that US policymakers have switched to a more accommodative policy stance, this headwind has abated. We remain neutral after the strong rally in long term yields over recent months continues. Valuations remain at unattractive levels. Despite a stable outlook, we expect future return is largely driven by the short end only.
+	Index-linked	We remain positive on US-breakevens as the recent economic weakness has already priced much of the poor outlook. We acknowledge that wages look to be tracking sideways, but the YoY oil price move in H1 is likely to keep upward support on breakevens at these levels.

Note: The views for government bonds are based on return relative to cash in local currency. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged). Key: +/- market expected to outperform/underperform (maximum ++ minimum – -) 0 indicates a neutral position.

Alternatives views

Key points

+	Alternatives	
0	Commodities	Overall we remain neutral on commodities given negative momentum and carry but we are positive on gold as a key macro hedge for portfolios. Since last quarter, we have upgraded our position on gold to positive amid rising growth risks to the global economy and intensifying geopolitical tensions. The dovish shift in central banks and weaker USD has improved the medium-term outlook for bullion. In the energy market, we maintain our neutral stance despite the negative momentum from the May sell off. Dulled global demand and tapered US output look to offset the supply risks stemming from Iranian sanctions and OPEC+ cuts. The market is also buoyed by the Saudi commitment to fill the gap created by the Iran sanctions. Global growth concerns have also weighed on industrial metals as the market corrected sharply in Q2. However, we see limited scope for a further decline at this stage. Prices will be supported by Chinese stimulus measures but the upside potential is capped without larger scale fiscal spending; as such, we stay neutral. We downgrade agriculture to negative on the back of strong harvests in South America and worsening prospects for a US-China trade deal. At the margin, global stock levels are set to remain elevated, putting downward pressure on prices.
–	UK property	We forecast property total returns to be negative in 2019, for the MSCI/ IPD Annual UK index, but we expect a huge variation across different types of real estate. For example, secondary shopping centre values could fall by 20% or more this year, whereas industrial and regional office capital values should remain relatively stable, assuming the economy avoids a recession. Our main focus for diversified portfolios is on industrial/logistics serving large population centres and offices in winning cities such as Bristol, Leeds and Manchester. We are also investing in certain niche types (e.g. hotels with management agreements, retirement villages, social supported housing) and real estate debt that should offer more attractive and less correlated returns. The investment market has lost momentum this year as investors hesitated ahead of Brexit and as structural headwinds facing the retail sector intensified. Furthermore, banks are reluctant to lend against retail real estate and serviced offices, restricting the ability of debt-backed investors to make purchases. The total value of transactions in the first half of 2019 was approximately one-third lower than in the first half of last year. Consequently, yields in the retail sector rose by 0.2% in the first five months of 2019 and yields on secondary assets in more favoured sectors such as industrial and regional offices have also edged up.
+	European property	Although the value of investment transactions in continental Europe has fallen by 10-15% from its peak in 2017 (source Real Capital Analytics), there are no signs except in the retail sector that investor sentiment is cooling. On one hand, the slowdown in the economy means that prospects for office and industrial rental growth have dimmed slightly. On the other hand, the gap between real estate and bond yields has widened since the start of 2019, as bond yields have fallen. As a result, we expect that the office and industrial yields will be stable over the next 18 months, before rising by 0.25-0.40% through 2021, or 2020. Conversely, shopping centre yields will probably increase by 0.5-1.0% in 2019-2020, as investors price in lower rents. The last three years have seen a widespread increase in European office rents. Prime rents have risen on average by 5% p.a. since 2015 and in Berlin and Stockholm rental growth has exceeded 10% p.a. While office rental growth is likely to slow through 2019-2020 in line with the economy, we expect it to remain positive. In the industrial market we favour multi-let estates and smaller distribution warehouses where it is still possible to buy good assets on yields of 5%, or higher. We also see value in hotels with management agreements. We are cautious about most retail assets, because we do not believe that current yields reflect the risks of higher vacancy and falling rents.

Note: Property views based on comments from the Schroders Real Estate Research team. The views for commodities are based on return relative to cash in local currency. The views for corporate bonds and high yield are based on credit spreads (i.e. duration-hedged).
Key: +/- market expected to outperform/underperform (maximum ++ minimum – -) 0 indicates a neutral position.

Economic views

Central view

Trade wars and Brexit cast shadow over our forecasts

Our headline growth forecasts have not changed significantly from our previous update with global GDP still set to expand at a rate of 2.8% in 2019. Although unchanged, the global figure incorporates upward revisions in the US and Japan and equal downgrades to the eurozone and emerging markets. Our estimates for this year were supported by robust Q1 GDP prints, where most regions beat their market estimates. However, much of this growth can be attributed to inventory building, which we expect to be temporary.

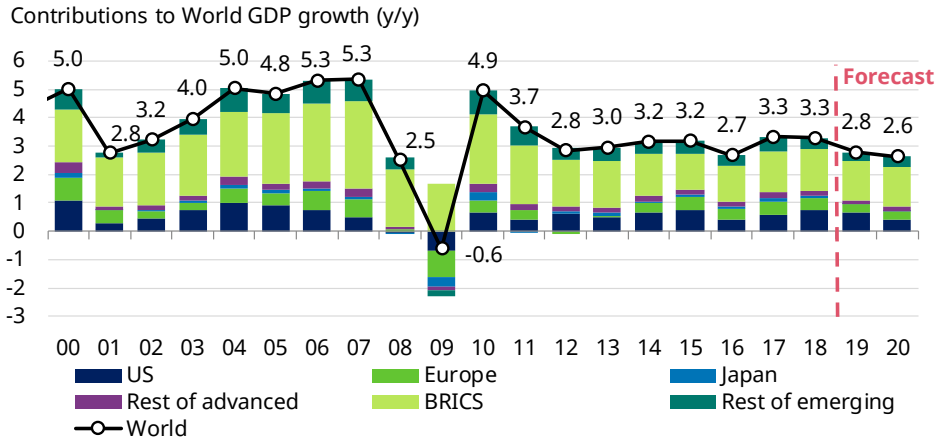
Growth prospects will also be hit by the setback in US-China relations and ongoing Brexit uncertainty, which is damaging business confidence and forcing firms to delay capital expenditure. As such, we have trimmed our projection for 2020 GDP to 2.6% from 2.7%. There are small downward revisions across the board with US growth cut to 1.5% and China to 6% (both 0.1% weaker). Our growth forecasts for 2020 are generally below consensus.

Meanwhile, our inflation forecasts have been raised for this year and next with increases in all regions largely driven by the rise in oil prices year-to-date. US inflation is also higher as a result of the breakdown in the US-China trade negotiations and the subsequent increase in tariffs from 10% to 25% on $200bn imports from China.

Regarding monetary policy, increasingly dovish tones from the Fed has seen an additional 50bps worth of cuts added to our 2019 forecast. The first move is expected to be in July before a second cut in September. In the UK, we have reduced the tightening profile of the BoE with the bank rate assumed to stay at 0.75% through 2019 before hiking once at the start of next year. The ECB and the BoJ are set to remain on hold through 2020 and neither are scheduled to use alternative monetary policy tools, such as QE and yield curve control. Meanwhile, China is projected to ease further through a RRR cut which is now expected to reach 10% by end 2020 (previously 11%).

The US dollar is expected to remain firm in the near term, but to weaken later in the year as policy begins to loosen compared to the eurozone and the UK. Sterling (GBP) is also boosted by our assumption that the economy enters a transition period in October rather than crashing out of the EU. However, there is considerable uncertainty surrounding Brexit given the forthcoming change in the prime minister.

Chart 1: Global growth and forecast for 2019 and 2020



Source: Thomson Reuters Datastream, Schroders Economics Group. 18 June 2019.

Risks are skewed toward stagflation and deflation

Full details of the scenarios can be found on page 12.

Scenario analysis

For this quarter, we are only changing one of our scenarios by bringing back a former entry, **Oil jumps to $100**. This scenario replaces "Global Inflation Surge", which was based on higher wage growth driving prices. The new scenario has a similar stagflationary impact versus the baseline but it reflects an outcome where the loss of Iranian oil supply and the threat of conflict in the region causes oil prices to surge.

The **Italian debt crisis** continues to feature in the stagflationary section. The scenario assumes tensions between Italy and the EU commission are renewed during the construction of the 2020 budget in the autumn of this year.

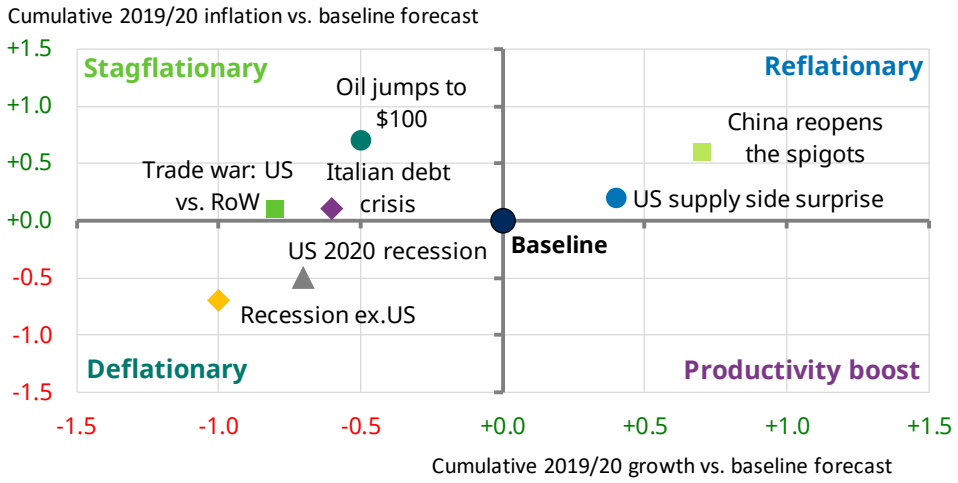
The final stagflationary risk to the baseline is a **Trade war: US vs. RoW** outcome. Although we expect an agreement to be reached between the US and China, we acknowledge the possibility that no deal is struck between the two superpowers. President Trump then proceeds to raise auto tariffs on the rest of world.

On the deflationary side, we retain our two recession scenarios. The first, **US 2020 recession**, incorporates fears that the US economy is more fragile than expected and output begins to contract at the start of 2020 bringing an end to the cycle. The other scenario, **Recession ex. US**, sees the downturn in Europe, China and Japan deepen as weak export demand undermines business confidence.

For the reflationary section, we include **US supply side surprise** where the labour supply picks up through a higher participation rate and a more flexbile jobs market. This extends the cycle by keeping wages and inflation muted while facilitating stronger growth. This feeds through to the global economy as increased US demand fuels world growth.

Finally, we continue with **China reopens the spigots** as a reflationary risk to the baseline. This scenario stipulates that Chinese policymakers revert to their old playbook and adopt large scale monetary and fiscal stimulus to avoid a deepening economic slowdown.

Chart 2: Scenario analysis – global growth and inflation impact

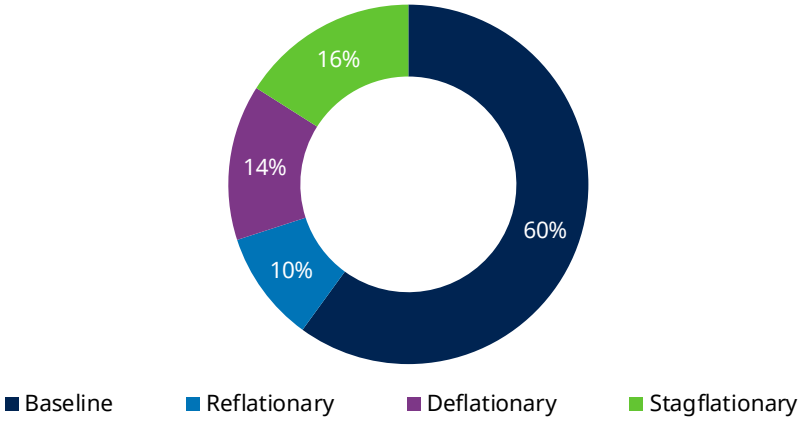


Source: Schroders Economics Group, 18 June 2019.

Chart 2 summarises the impact each scenario has on global growth and inflation relative to the baseline. The balance of probabilities has shifted back towards the stagflationary scenarios, overtaking the deflationary outcomes this

quarter. The reflationary risk has increased to a 10% probability compared to 9% in the previous period. Downside surprises to growth still pose the greatest risk to our baseline as the combined probability of negative growth scenarios is 30%. Indeed, the individual scenario with the highest probability is "US 2020 recession".

Chart 3: Scenario probabilities



Source: Schroders Economics Group, 18 June 2019.

Table 2: Scenario summary

	Summary	Macro impact
1 **Italy debt crisis**	Although Italy has reached an agreement with the European Commission on its budget for this year, we would expect renewed tension between Rome and Brussels in the autumn as the next budget is formulated. Markets fear another more serious dispute, pushing the 10yr BTP yield up to 6%. After a couple of failed auctions, the government is forced to seek help from the rest of the E U in the form of a bail-out. There is some knock-on effect to other peripheral bond markets. A technocrat is installed as Italian PM, and the ECB's OMT programme is activated. QE is also restarted in 2019 as the eurozone faces a deep recession.	**Stagflationary:** The principal impact is weaker global growth with all regions affected as Italy drags Eurozone growth lower and the increase in uncertainty weighs on confidence and spending. On inflation the picture is more mixed: for the eurozone, this is a stagflationary scenario due to EUR falling to 0.99. The US and Japan see their currencies appreciate, and combined with lower oil prices and a shock to financial markets, both see lower growth and inflation compared to the base. The impact on EM is more mixed. China intervenes to prop up the CNY, but Brazil, India and Russia all see FX depreciation as global risk aversion rises.
2. **China reopens the spigots**	China reverts to its old playbook to avert a deepening economic slowdown. Casting aside the relative timidity of current stimulus measures, policymakers embark on large scale fiscal and monetary stimulus, embodied in massive infrastructure spending and a resurgent property sector. Global commodity demand skyrockets, to the benefit of a number of emerging markets, and Chinese demand for manufactured goods also jumps.	**Reflationary:** Stronger demand from China boosts world trade and increases commodity prices with the result that both global growth and inflation are higher than in the baseline. The trade sensitive eurozone sees a significant boost to growth in 2020 with EM also benefitting. Interest rates are higher across the DM and in EM (ex. China).
3. **Trade war: US vs. RoW**	The US administration decides to impose tariffs on auto imports from the rest of the world thus extending the trade war into new territory. Meanwhile the dispute with China worsens as trade talks fail and the US imposes further tariffs on the remainder of imports from China.	**Stagflationary:** Higher import prices push inflation higher whilst weaker trade weighs on growth. Capex is also hit by the increase in uncertainty and the need for firms to review their supply chains. Central banks are expected to focus on the weakness of activity and ease policy by more than in the baseline.
4. **Oil jumps to $100**	President Trump's withdrawal from the Iran nuclear deal and imposition of sanctions results in 1 million barrels per day being removed from global oil supply, as the agreement collapses. Risk premium on oil rises as threat of conflict in the region between Iran, Saudi Arabia and Israel spreads beyond Syria. Given the tightness of the oil markets, oil prices surge to $100 p/b where they remain over the forecast period.	**Stagflationary:** Higher oil prices feed through rapidly into inflation putting a squeeze on oil consumers world wide. Oil producers benefit but do not increase spending rapidly enough to offset cut backs elsewhere. In the US, stronger shale gas capex and output initially offset the shock, but once this fades, the effect on household budgets and global trade drag on growth. Policy easing by the Fed is more limited as the central bank weighs higher inflation against weaker growth.
5. **US supply side surprise**	The US labour market proves to be more flexible than expected with labour supply continuing to rise through a higher participation rate as more people return to the workforce. This extends the cycle by containing wages and inflation in the US for longer than in the baseline allowing stronger growth. There is a knock-on to growth in the rest of the world though stronger US demand although slightly higher commodity prices raise inflation.	**Reflationary:** Stronger real growth means the Fed will cut real rates less in 2019 and as the economy expands further in 2020, the central bank keeps policy on hold. Interest rates are slightly higher elsewhere in line with stronger activity.
6. **US 2020 recession**	The US economy proves to be more fragile than expected, as tighter monetary policy combined with the end of fiscal stimulus slow demand and cause business and households to retrench. Output begins to contract at the start of 2020 thus bringing an end to the cycle whilst commodity prices and inflation fall. The Fed eases, but markets slump on fears of a wider global recession.	**Deflationary:** Weaker US growth drags global trade lower, hitting the eurozone, emerging markets and Japan particularly hard. Increased market volatility also hits demand through tighter financial conditions and weaker confidence and consequently global growth slows sharply. Monetary policy is eased significantly across both the DM and EM economies in 2020.
7. **Recession ex. US**	The slowdown in Europe, China and Japan gathers momentum as contracting export growth undermines business confidence causing capital spending to contract. Firms retrench and unemployment rises, hitting consumer spending. Commodity prices weaken and inflation falls.	**Reflationary:** Weaker growth drags global trade lower, hitting the US which is also affected by increased market volatility and tighter financial conditions. The USD is expected to strengthen putting added pressure on EM. Monetary policy is eased around the world.

Source: Schroders Economics Group, 19 June 2019

A gentle touch on the tiller from the Fed?

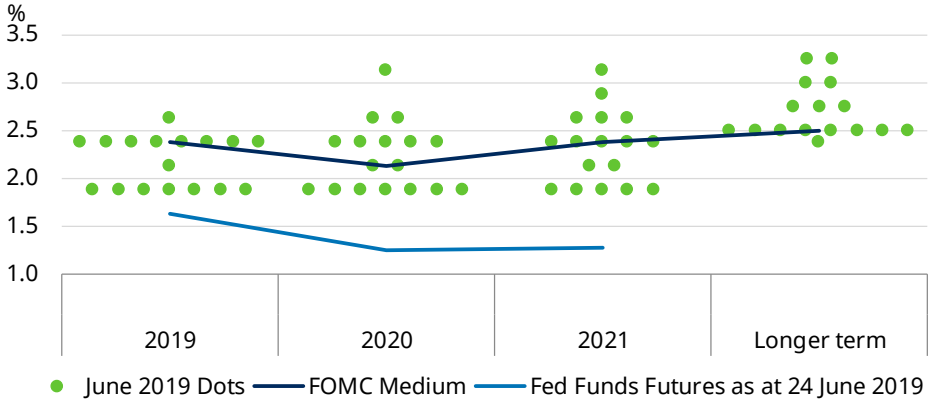
"The crosscurrents have re-emerged, with apparent progress on trade turning to greater uncertainty and with incoming data raising renewed concerns about the strength of the global economy."

Jerome H. Powell, Chair US Federal Reserve, speech 25 June 2019

Interest rate expectations have moved significantly as central banks turn dovish

The past month has seen a significant shift in interest expectations. Markets are now pricing in 75 basis points of rate cuts in the US by the end of 2019, compared with almost no move expected at the beginning of May (see chart front page). The change in expectations has been driven by concerns over global growth and trade tensions between the US and China. At the US Federal Reserve's (Fed) June rate setting meeting seven of the committee indicated that they saw a rate cut by the end of 2020. The median dot plot has a cut in rates in 2020, but the dots remain well above market expectations (chart 4).

Chart 4: The Fed dot plot and market expectations

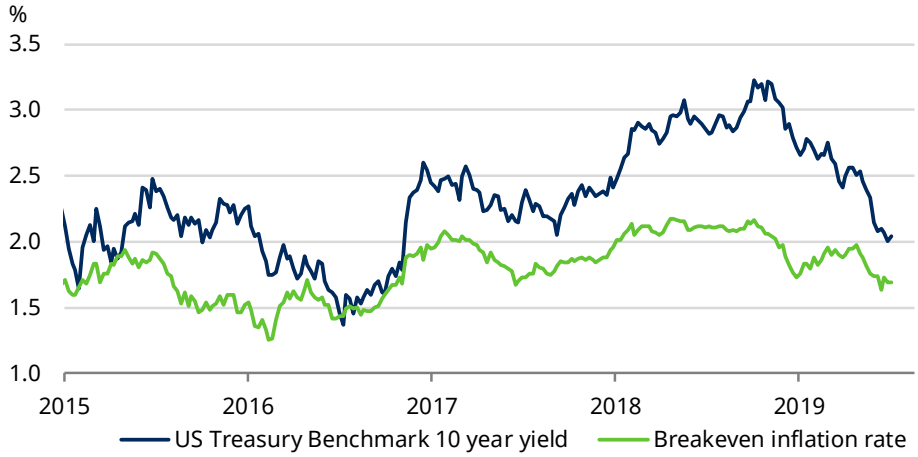


Source: Thomson Reuters Datastream, Schroders Economics Group, 25 June 2019 (g0080).

Bond yields have declined around the world

Meanwhile, bond yields have tumbled with the 10 year US Treasury heading back to 2%, with much of the recent movement being driven by lower inflation expectations (chart 5).

Chart 5: US bond yields have fallen significantly



Source: Thomson Reuters Datastream, Schroders Economics Group, 9 July 2019 (GR9A).

These moves have not been confined to the US, with yields falling sharply across developed sovereign bond markets. Comments from European Central Bank president Mario Draghi, that the central bank would be considering easing

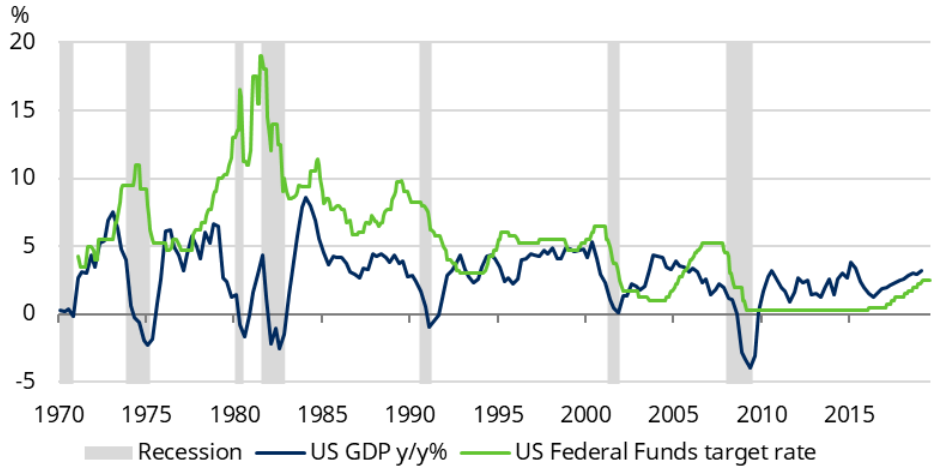
measures at its next meeting, proved to be particularly powerful. Subsequently, the market value of bonds trading at negative yields reached $12.5 trillion on 19 June according to Bloomberg, beating the last peak in 2016.

An insurance rate cut?

Fed looks to repeat the success of 1995

The question is whether the Fed can get away with just one or two rate cuts, similar to 1995 or 1998, or if this is the start of a major easing cycle, as in previous recessions (chart 6).

Chart 6: Fed rates and GDP growth



Source: Thomson Reuters Datastream, Schroders Economics Group, 25 June 2019.

Looking at the latest "dot plot", the Fed is clearly leaning toward the former: a gentle touch on the tiller that sets the economy back on course. The 1995 move which led to a soft landing in the economy has been seen as one of Alan Greenspan's greatest achievements as Fed chair.

Growth is slowing as fiscal stimulus fades and the budget deficit grows

The answer will in large part depend on the sort of slowdown we get in the US, and in the way the Fed chooses to react to growth and inflation.

In terms of the slowdown, we have argued for some time that US growth is likely to disappoint next year, largely as a consequence of the fading of fiscal stimulus and the disruption caused by trade tariffs. The benefit from tax cuts has now been largely felt and it would seem unlikely that Congress will approve further fiscal stimulus given that the budget deficit is running at $975bn (4.5% GDP).

Meanwhile, tariffs are disrupting supply chains and increasing company costs. The evidence suggests that China is not "paying the tariffs" as President Trump claims and instead the cost is being borne by US firms and consumers. The trade picture did improve following the meeting between Xi and Trump at the recent G20 summit (after we publish). However, business surveys show little improvement in trade or export orders as yet, which suggests another three months of sluggish activity at best. While we are optimistic on an eventual agreement, the gap between the US and China on intellectual property and technology would seem too wide to lead to an immediate deal.

Trade alone is not sufficient to derail the US economy, which is 85% driven by domestic activity. In this respect the main drag from tariffs is through uncertainty about the business environment which is felt in the real economy as companies delay their spending plans. Capital spending (capex) and employment are the two most vulnerable areas.

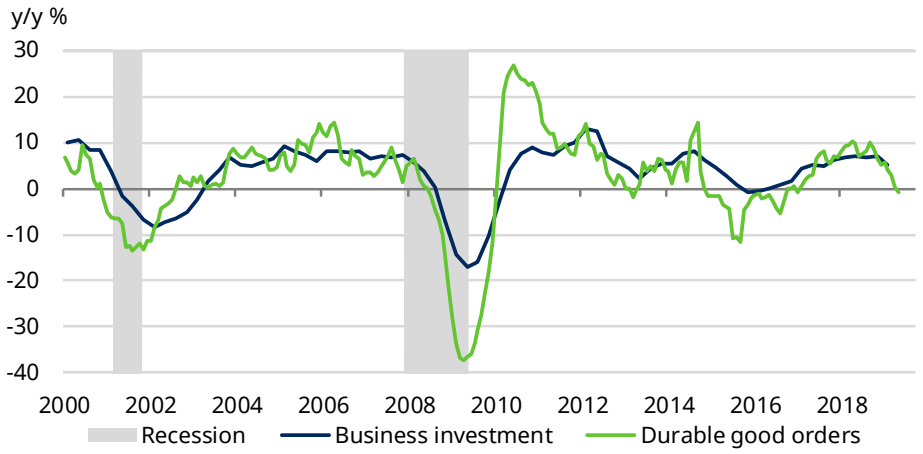
Job cuts in the US have risen significantly this year with the Challenger survey reporting an increase of 39% in the first five months of 2019. Overall

employment has held up relatively well so far, but non-farm payrolls grew only 75k in May and with downward revisions to past readings, the level of employment was well below expectations.

Uncertainty is weighing on capex..

On the capex side the signs of weakness have been clear for some time. From adding 1.1 percentage points (pp) to quarterly growth in the second quarter of last year, fixed investment contributed only 0.4 pp in the first quarter this year. With residential investment flat, much of this was driven by business spending. The latest durable goods orders figures suggest there is more weakness to come (chart 7).

Chart 7: US durable goods orders signal weaker business capex ahead



Source: Thomson Reuters Datastream, Schroders Economics Group, 26 June 2019 (GQJO).

...one of the swing factors in a recession

The focus on capex is important as it is one of the swing factors in determining the depth of any downturn and whether an economy will experience a recession. Recessions can and have been caused by weaker consumer spending, but in the current environment where households have de-levered and the interest burden remains low the shock is more likely to come through a corporate sector retrenchment. This would eventually hit the consumer through weaker employment and income growth, but the cause would originate elsewhere.

The focus on capex and business spending highlights the importance of the political environment. Business needs clarity on the outlook to be able to commit to increased spending. In the UK, Brexit uncertainty has taken a significant toll on the economy by depressing investment and taking GDP growth down from 2% to 1%. As discussed above, the trade wars are having the same effect on the US, causing companies to rethink their investments due to uncertainty about the trade regime and who they can deal with.

More generally, geopolitical risk as measured by the GPR index[1] remains elevated. Analysis shows that high levels of the index are associated with weaker economic activity and in the current environment this will weigh on capex (see why geopolitical risk is on the rise in the next section).

Whilst this argues for a greater slowdown we would note that we would need to see more pressure on corporate profitability and cash flow to produce a major retrenchment. This will gradually come through, but will be primarily felt in 2020 when we expect US profits to decline by 4%. It is less of a problem today.

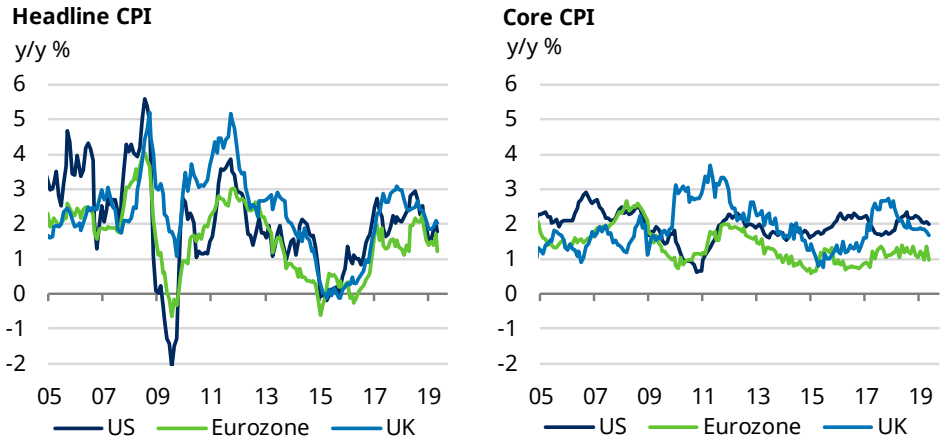
[1]Source: "Measuring Geopolitical Risk" by Dario Caldara and Matteo Iacoviello at https://www2.bc.edu/matteo-iacoviello/gpr.htm.

Inflation is no obstacle to easier policy

Any discussion on interest rates needs to take account of inflation which remains surprisingly quiescent and has allowed the fed to pivot toward a more dovish stance. Given the late stage of the US cycle, this has been a surprise and suggests that structural factors may be weighing on prices and preventing the normal cyclical pick-up. One such factor would be the intense competition in the retail sector as a result of the rise of internet shopping. On a more cyclical note, prices will be under downward pressure as firms run down inventory in coming months.

Low inflation is not just a US phenomenon, inflation has been weak in developed economies for the past six months, allowing other central banks to be more dovish without jeopardising their mandate (chart 8). Core inflation in the UK and eurozone is below 2%, and at just 1% in the latter is uncomfortably low.

Chart 8: Inflation remains subdued



Source: Thomson Reuters Datastream, Schroders Economics Group, 25 June 2019 (g0071).

It is quite possible that inflation will begin to move up again in the US given the effect of tariffs, higher oil prices and the tight labour market. But even if the core rate did move above 2%, it is questionable whether the Fed would react by tightening. Although the mandate remains to keep inflation at 2% the central bank is very aware that an overshoot at the end of the economic cycle could soon turn into an undershoot as growth slows. In this respect a modest overshoot is likely to be tolerated and would not prevent the Fed from easing further in 2020.

Pushing on a string?

Monetary policy likely to be less effective than in earlier cycles

This leads us to expect the Fed to cut rates at its next meeting at the end of July and to follow up with another move in September. These will probably be presented as insurance cuts to keep the expansion on track. However, the circumstances today are very different from 1995 when Alan Greenspan was at the helm. Back then the global economy and trade were more buoyant and the US consumer stronger. In our view, rate cuts at that time were more effective at stabilising growth as household borrowing responded to lower credit costs.

Today, in the wake of the financial crisis and the greater regulation of the banking system it is doubtful that the monetary transmission mechanism will be as effective. Rate cuts always take time to work and are often accompanied by claims that the central bank is "pushing on a string". This time though there will be genuine doubts, with the result that the Fed will still be cutting rates in 2020 in our view. Look out for calls for the Fed to restart quantitative easing and for a more active fiscal policy.

Why geopolitical risk is on the rise

Keith Wade
Chief Economist
and Strategist

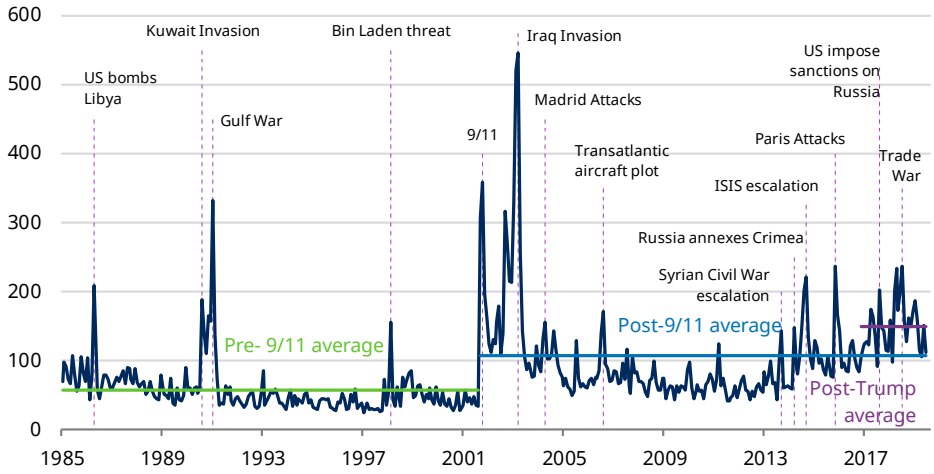
In our recent Inescapable Truths report we highlighted geopolitical risk as one of the potential disruptions investors will have to grapple with in the coming years. We argued that a heightened level of geopolitical risk alongside other disruptive factors would mean greater volatility in financial markets. Investor concern is apparent in surveys with geopolitical risk being regularly cited as the greatest tail risk for markets[1]. In this piece we discuss the nature of geopolitical risk, its impact on the economy and markets and why we believe it is increasing.

Geopolitical risk – impact and outlook

The term geopolitical risk is used to describe a wide range of issues, from military conflict to climate change and Brexit. It relates to, but is not the same as, the risk posed by populism. For our purposes we are looking at the relationships between nations at a political, economic or military level. Geopolitical risk occurs when there is a threat to the normal relationships between countries or regions. From an investor perspective we are focused on how shifts in these relationships can impact the economy and create volatility in financial markets.

The Geopolitical Risk index ("GPR") is probably the most widely quoted measure and reflects automated text-search results of the electronic archives of 11 national and international newspapers. The index captures the number of mentions of key words such as military tensions, wars, terrorist threats or events[1]. Chart 9 shows the GPR back to 1985 with the clear impact of 9/11, after which the average level of geopolitical risk doubled. There has been a notable increase in the GPR index during the Trump presidency.

Chart 9: Geopolitical Risk: step change after 9/11



Source: "Measuring Geopolitical Risk" by Dario Caldara and Matteo Iacoviello at https://www2.bc.edu/matteo-iacoviello/gpr.htm. Schroders calculations and annotations, 10 June 2019.

[1]For more detail see "Measuring Geopolitical Risk" 9 November 2017 by Daniel Caldera and Matteo Iacoviello

A trinity of uncertainty risks

Geopolitical risks can be seen alongside other sources of uncertainty. Mark Carney, Governor of the Bank of England, has described an "uncertainty trinity" of geopolitical, economic and policy uncertainty[1]. Economic uncertainty refers to the risk created by the business cycle and structural factors such as the impact of new technology on growth. Policy uncertainty is concerned with the direction of interest rates, taxes and regulation as well as threats to the governance of monetary and fiscal policy such as the independence of central banks.

Here we are focused on geopolitical risk, but recognise that many events contain elements of each. For example, the current trade dispute between the US and China is a geopolitical risk as the issue threatens normal relations between the two superpowers, but it also adds to economic uncertainty and has aspects of policy risk as the two nations reappraise their trade regulations and tariff structures. The same can be said of Brexit where the UK's proposed break from the European Union represents a geopolitical event, which then creates economic and policy uncertainty.

Impact on economies and markets

Disentangling the impact of each is difficult, but essentially uncertainty weighs on the economy and financial markets as decision makers hold off from making major commitments. The principal economic casualty is capital spending as without clarity on the economic environment firms delay making key investment decisions. Employment may also be hit for the same reason. Demand weakens as households delay spending on big-ticket items such as motor vehicles and housing. Meanwhile, financial investors hold off as they try to assess the impact on the economy and policy and when the cloud of uncertainty is likely to lift.

Empirical analysis by Caldera and Iacoviello[2] finds that significant increases in the GPR result in weaker economic activity and lower equity market returns. Industrial production, employment and trade are all adversely affected with the effects persisting for a year after the initial shock. The advanced economies tend to be notably more affected than the emerging markets, although this may reflect the fact that the GPR index is limited to text searches in US and UK newspapers.

On the financial side, geopolitical risks have a negative impact on equity market returns in all advanced economies, whilst short-term (two-year) US Treasury yields decline. The same study also found significant effects on capital flows with higher geopolitical risk resulting in lower capital flows to emerging markets, but higher flows to advanced economies as investors become more risk averse.

More surprisingly, the oil price was found to weaken in response to increased geopolitical risk. This is contrary to conventional wisdom, which probably reflects memories of the oil embargo of the 1970s. However, although the Middle East continues to generate headlines it has less impact today as a greater proportion of global oil supply is controlled by non-OPEC countries such as the United States and Russia. Consequently, the response of the oil price to geopolitical shocks is consistent with the downturn in economic activity.

Buy the rumour, sell the fact

The Caldera and Iacoviello analysis finds that economic activity and financial markets were more affected by geopolitical threats than by actual events such as the start of a war or imposition of sanctions. For the US economy, actual events produced a small, but short-lived decline in economic activity with the stock market rising one month after the shock. Meanwhile, geopolitical threats

[1]Uncertainty, the economy and policy, Mark Carney 30 June 2016.
[2]See Caldera and Iacoviello.

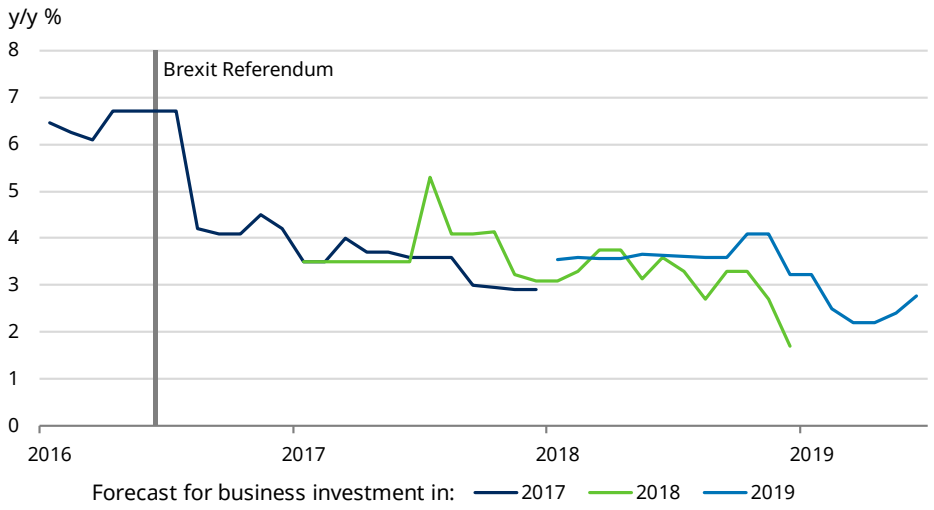
produced large and protracted recessionary effects as well as a decline in stock prices.

This finding reinforces the stock market adage to "buy the rumour, sell the fact" and probably reflects the fact that threats tend to increase risk premia as they increase uncertainty and downside tail risks. By contrast, actual geopolitical events tend to resolve uncertainty and prompt a policy response which provides protection to economies and markets.

Recent events

Looking at the world economy today, at both the macro and market level there is evidence of these effects as a result of the uncertainty created by the US-China trade dispute and by the UK's decision to leave the EU (Brexit). Ascribing outcomes to particular events is always fraught with danger given the many factors driving economic behaviour at any moment. Nonetheless, we would note that UK business capital spending growth has stalled since the EU referendum in June 2016 and has been below the expectations of forecasters prior to the referendum (chart 10a). Consequently, growth has moved from being above to below the G7 average (chart 10b).

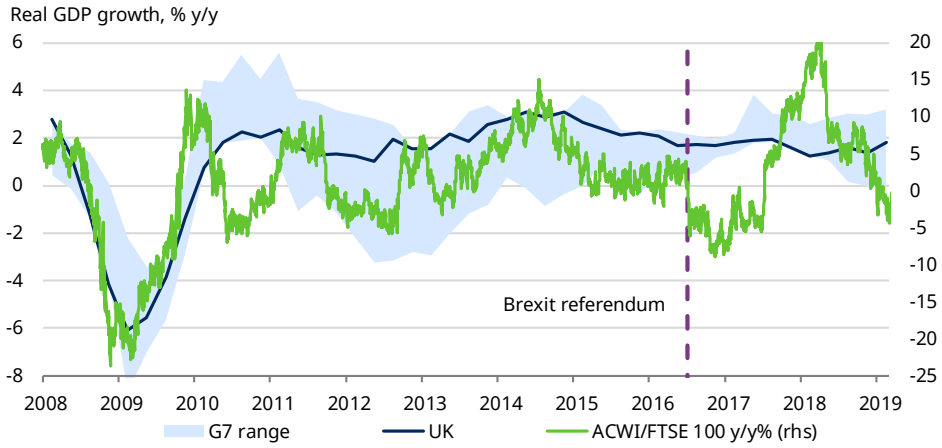
Chart 10a: The Brexit drag on UK capex – falling expectations



Source: Thomson Reuters Datastream, Schroders, 10 July 2019.

UK equity market performance is complicated by the behaviour of sterling, but the FTSE-100 underperformed world equity markets after the result of the referendum and, after a sterling related recovery, has underperformed since late 2017 (see chart 10b). The latest (April) BoAML survey found that the UK was the most unloved of any global equity market or sector with investors significantly underweight, suggesting that they are unwilling to commit capital as a result of Brexit uncertainty.

Chart 10b: The relative performance of the UK economy and market.



Source: Thomson Reuters Datastream, Schroders, 10 July 2019.

Finding similar effects in the US is more difficult as the economy has performed well during the Trump presidency in both economic and market terms, helped in large part by tax cuts and fiscal expansion. The trade wars have, however, created concern amongst US firms many of whom have placed capital expenditure (capex) on hold. Nonetheless, the equity market has outperformed and surveys show fund managers are overweight. Meanwhile, the dollar has been firm and there is evidence that capital has flowed into the US and away from the emerging markets as tensions with China increased, as seen in previous periods of increased geopolitical risk. This has been amplified across the emerging markets on concerns over economies with supply chains which feed into US-China trade.

Overall though the contrasting experience of the US and UK bears out one of the truths about geopolitical risk: domestically-driven economies tend to be more resilient than their internationally-exposed counterparts. Even if the former are the protagonists of geopolitical risk, it is those most closely tied to the global economy who are at greatest risk.

The point is borne out when we look at the sensitivity of a range of economies to the global trade cycle. Countries like the US, India and Brazil where GDP was primarily driven by domestic factors were amongst the relative winners, whilst China, Germany, Japan, Singapore and South Korea were those who were most dependent on international trade and were more vulnerable to the disruption created by heightened GPR. There is some evidence that this is reflected in equity market performance with Germany and Japan significantly underperforming the US in many episodes of heightened geopolitical risk.

It is partly in recognition of the economic and market effects of geopolitical risk that China has embarked on the Belt and Road Initiative (BRI) as an alternative source of growth which is largely independent of the US and existing global trade. In this way the economy may become more resilient to increases in geopolitical risk in the future.

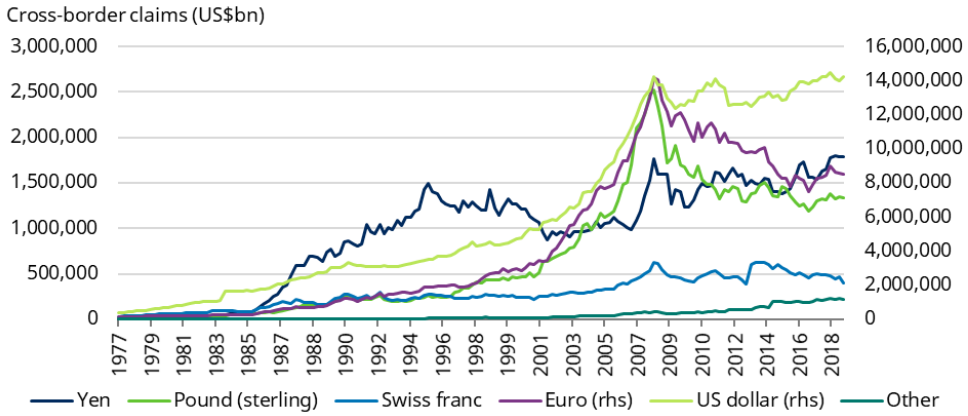
Dollar dominance

Arguably, the US should be more vulnerable as it runs a large current account deficit and so relies on the "kindness of strangers" (i.e. capital inflows from overseas) to maintain its spending. In the current environment, stronger growth and higher interest rates relative to the rest of the world have reinforced support for the dollar. However, even in the absence of monetary tightening by virtue of its reserve currency status the US has not struggled for funding during periods of heightened GPR. Indeed, in some ways the US could even be seen as

a "beneficiary" of increased geopolitical risk through the increase in safe haven flows to the economy.

Furthermore, the importance of the dollar in the financial system has increased since the global financial crisis as European banks have pulled back from international lending and cross border claims in dollars have risen relative to those in euros (chart 11). This has strengthened the US in the geopolitical arena on issues such as the Iran nuclear deal where the threat of sanctions on banks which break US rules has made it difficult for the other players in the negotiations (the UK, France, Germany and China) to go against the US. The renminbi RMB is someway from becoming a reserve currency.

Chart 11. Cross-border financial flows



Source: Bank for International Settlements, 30 May 2019 (data to q4 2018)

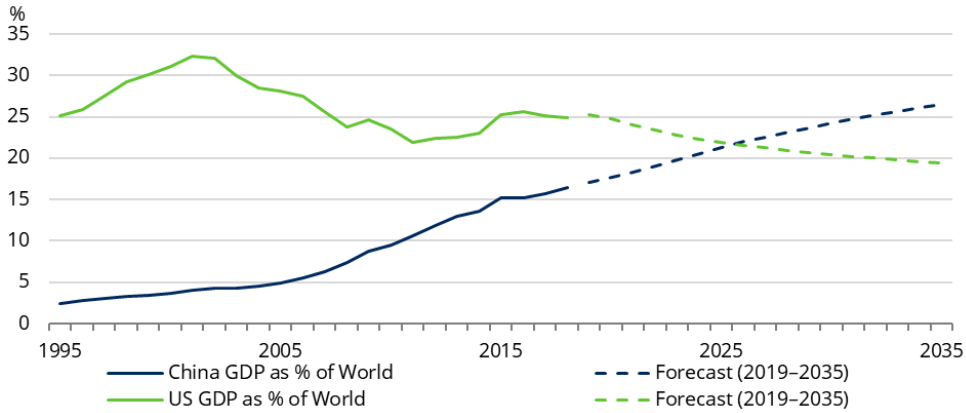
The outlook: factors driving geopolitical risk

Although it is easy to attribute the increase in GPR to personalities such as Donald Trump, we would see the rise as part of a more general trend which is being driven by two key economic developments.

The rise of China

The first is the rise in China where national income is expected to match that of the US by the end of the next decade. From less than 5% of global GDP as recently as 1995, China is expected to account for just over 20% by 2025 (chart 12). Meanwhile, the US share has declined from a peak of 30% to 25%. The US will still be the richer country in terms of income per head, but China will have an equivalent weight in global GDP. In this respect China will rival the US for influence and power in international politics and trade. This has significant implications for the relationship between the two countries and particularly the attitude of the US toward multi-lateral agreements and institutions.

Chart 12: China to match US national income by 2030



Source: Thomson Reuters Datastream, Schroders (G0039).

For most of the post-war era the gains from increased trade and co-operation primarily accrued to the US as the world's largest trading economy. However, now the gains from globalisation are shared more evenly the incentive for the US to develop broader agreements is reduced. Meanwhile, the costs of leading globalisation and policing its rules through international institutions remains high. This is leading to a world where the US is no longer prepared to back those institutions; is taking a more aggressive line in its relationships with other countries; and is showing a preference for bi-lateral rather than multi-lateral agreements. As a result patterns of trade are expected to become more regionalised in coming years with hubs around the US, China and the European Union.

The rivalry between the US and China extends beyond trade and encompasses technology with both nations looking to gain an advantage in areas which will lead the next wave of growth. In the military sphere China has increased its defence spending ten-fold since 1994 and is now the second largest spender in the world. The gap remains significant with the US spending $649bn on defence in 2018 compared to $250bn in China[1], but the two nations now account for half of global military spending and are the principal drivers of its growth.

The so-called 4th industrial revolution is expected to be driven by robotics and Artificial Intelligence (AI) and the winners will be those who can acquire and combine the two most successfully. The current dispute between the Us and China is as much a "tech war" as a "trade war" with an agreement on the respect and protection of intellectual property likely to be at the heart of any eventual deal. The consequence is likely to be a regional rather than global solution and the development of twin technologies as we are now seeing in smartphones with the recent US sanctions on Huawei.

These changes suggest more scope for geopolitical risk as the US has less of a vested interest in the global system and is more willing to risk division and break relations with other states. Strong trade links provide the incentive to maintain friendly political and military relationships so as these unravel we can expect more geopolitical conflict. This is a conclusion that will outlast President Trump.

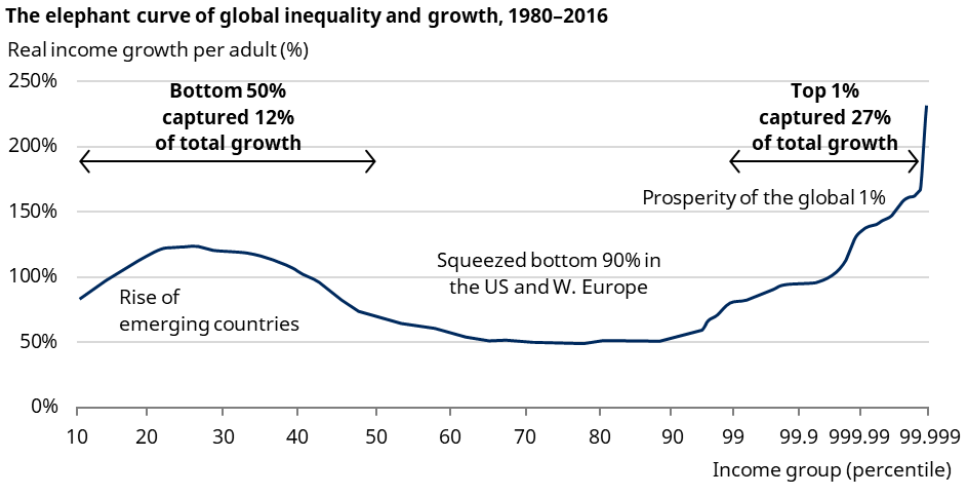
The rise of populism

The second force is the rise of populism. Brexit, the election of Trump as president of the US and the coalition government in Italy are all examples of the increase in populism driven by a sense amongst voters that the economy is no longer working for them. Underlying this is the stagnation of median earnings and the increase in inequality in the major economies. On a global scale this is

[1]Source: Stockholm International Peace Research Institute.

probably best represented by the so-called "elephant" chart which shows the change in real income since 1980 for workers across a range of emerging and developed economies. The clear "winners" have been those in the former group reflecting the rise of China and India, whilst the "losers" have been concentrated in the middle to upper income groups found in North America and Europe.

Chart 13: The middle has been squeezed as real income gains have been captured by the tails



Source: World inequality report 2018.

Populists have tapped into public discontent through economic nationalism

Consequently there is a strong desire for change, or to turn the clock back, amongst the electorate. Whilst it is difficult to generalise, populists have tapped into this dissatisfaction through the theme of economic nationalism where the blame for economic malaise is pinned on globalisation particularly increased imports, outsourcing and immigration. Hence slogans such as "America First" and "Take back control", etc.

From an economic perspective, this supports policies such as protectionism, the withdrawal from trade agreements and restrictions on immigration and cross border investment in the pursuit of economic self interest. Clearly, these policies will increase geopolitical risk as countries renegotiate their alliances and trading relationships and become less connected and dependent on each other.

It seems unlikely that the rise in populism will reverse in the near term. Although Emmanuel Macron's victory in the 2017 presidential election in France was a boost for liberal policies, he has struggled to turn the economy around and has recently succumbed to populist pressure from the *Gilets Jaunes* to reverse course. Meanwhile, populist parties made further gains in the European elections in May, albeit less than expected, whilst the odds on President Trump being re-elected in 2020 are rising. These developments tend to move in long waves and it will take some time for politicians to persuade voters that they have a stake in the system.

Clearly there are significant overlaps between the two forces driving geopolitical risk. The rise of China has gone hand-in-hand with the increase in globalisation which has created winners and losers and helped feed populism. Whilst it is possible to identify other factors such as new technologies which have been equally responsible for the rise in income inequality through their effects on employment and wages, the populist narrative has become well established.

The causes of geopolitical risk today may be different from in the past but we could see a series of rolling disputes keeping geopolitical risk at elevated levels, for example as the Trump administration pursues its America First policy through trade and technology.

US recession risk: echoes of 1998 or 2001?

Martin Arnold
Economist

"Infinite growth of material consumption in a finite world is an impossibility."

E. F. Schumacher, British economist

US economic activity is fading and it appears that it has entered the late stages of its business cycle, with the risk of a recession looming. The alternative is that the US economy is merely in a mid-cycle slowdown. While historical comparisons are few, the 1998 and 2001 slowdowns for the US economy provide useful references. Although the 2001 slowdown resulted in a recession, there are some reasons to be optimistic about the current environment echoing a 1998 style slowdown, especially if policymakers can provide adequate support and stave off the threat of a potential recession.

What is the business cycle?

Economic activity has a tendency to fluctuate over time. These fluctuations, around a longer term trend, are referred to as the business cycle. The business cycle is a way to gauge the path of economic activity and determine whether a particular economy is operating above or below its full potential. The business cycle generally has four phases: recession, recovery, expansion and slowdown (See Chart 14). Analysis of economic variables, like unemployment and capacity use can be used to gauge what stage of the cycle an economy is in. In theory, an economy could grow at an 'equilibrium' rate for an indefinite period, but in practice, boom and bust cycles predominate. Accordingly, patterns of greed and fear can be seen in both economic activity and asset markets.

Chart 14: The business cycle

Source: Schroders.

Phases of the cycle

The expansion phase is characterised by activity being above potential and there is little or no spare capacity as the economy begins to grow above its potential. As a result inflationary pressure builds.

The slowdown phase sees growth growing above trend but decelerating, and inventory levels rising as aggregate demand begins to rollover.

In the recession phase economic growth is weak and falling, with rising unemployment as firms cut back production in response to depressed demand. There is spare capacity and inventory run-down as companies clear stock. It is also when the business cycle troughs.

In the recovery phase, spare capacity begins to be used and production recovers, as investment starts to improve, leading to an inventory build-up. The level of activity remains below trend, but economic policy is supportive.

According to Schroders' output gap (OG) model, the US economic cycle has moved into the slowdown phase. The phase change lower in recent months has been driven by falling capacity utilisation, but the robust jobs market in the US has been an offset.

Keynesian, Monetarists and Real Business Cyclists...

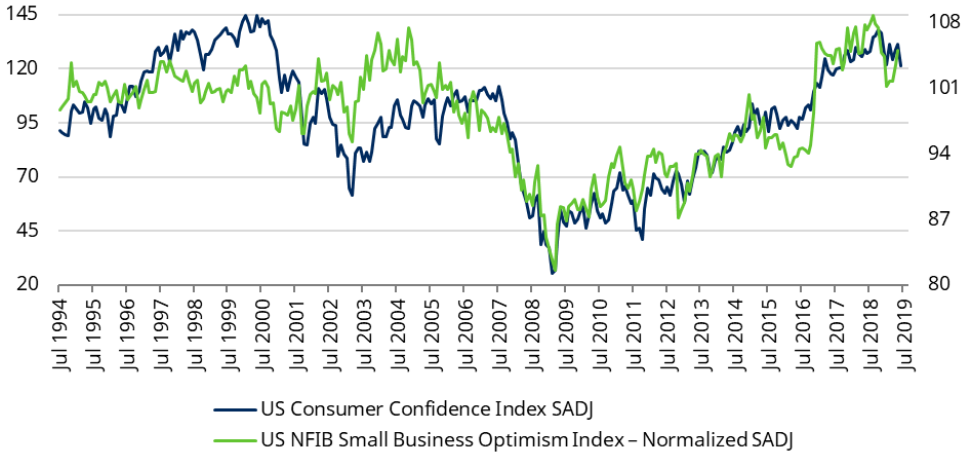
Economic theories abound as to the underlying drivers of the business cycle. The Keynesian theory emphasises the role of expectations of profitability impacting investment and in turn aggregate demand. This approach highlights how optimism or pessimism over the future can be self-reinforcing (multiplier mechanism). As an economy is expanding, sentiment is buoyant and rising sales/revenues generates greater investment, in turn boosting employment and incomes. At some point, rising aggregate demand leads to rising prices as capacity utilisation reaches an upper limit. Output and employment expands above the potential of the economy. Expectations of slower demand (and therefore profit) and higher costs ahead leads to cost cutting and lower rates of investment, as falling consumer sentiment depresses consumption. Keynesians advocate active monetary and fiscal policy to smooth out the volatility in the business cycle.

...and the real world

Interestingly, economic confidence remains robust in the US at the moment and is underpinning the solid jobs environment and the resilience of consumer spending (See Chart 15). Buoyant sentiment is also highlighted by the divergence of the soft survey data compared with the actual economic numbers in the US. Notwithstanding the current deceleration of profit growth of US corporates, Keynesian thinking could be somewhat optimistic about the potential for a rebound in growth and the current weak patch to be characterised as a mid-cycle slowdown if the household sector can remain buoyant.

Elevated sentiment will lift Keynesian confidence

Chart 15: Elevated sentiment

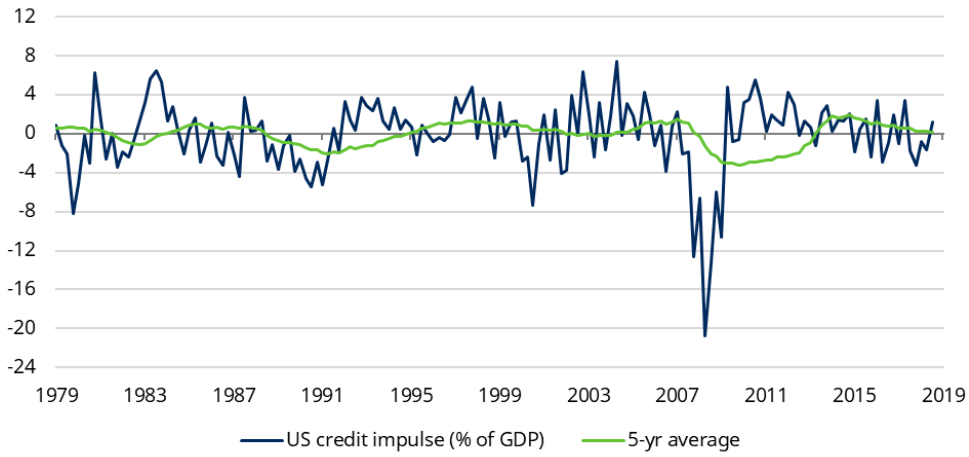


Source: Thomson Reuters Datastream, Schroders, 25 June 2019.

Monetarist theory of business cycles places the emphasis for movements in economic activity on the change in the amount of money in the system, or the money supply. The theory revolves around the credit cycle (See chart 16). Aggregate demand is buoyed by money supply growth, as corporates/individuals borrow to fund investment and consumption, as real

interest rates are reduced. Rising (excess) demand fuels inflation as larger and larger sums of money chase asset and goods prices higher. Rigidities in prices and wages can fuel inflationary pressures. As a result, monetary policy responds to rising prices by raising interest rates, essentially putting the monetary brakes on the economy. Margins are squeezed as rising costs, from wage growth and debt servicing constrict economic activity. As monetary policy is (over)tightened, investment contracts and if debt levels are high enough, servicing the debt becomes unsustainable. A contraction in output is exacerbated as jobs are lost due to corporate cost-cutting.

Chart 16: Credit stabilising

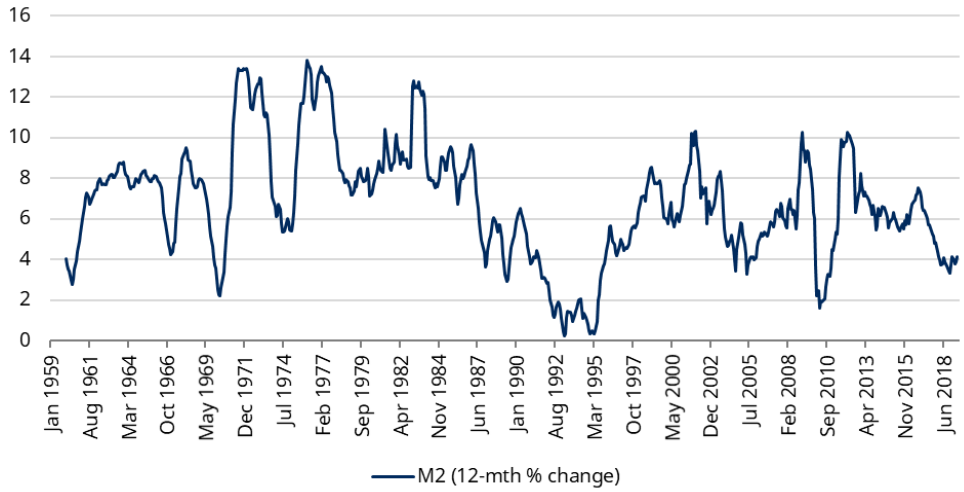


Source: Thomson Reuters Datastream, Schroders, 25 June 2019.

Further Fed stimulus will fuel Monetarist optimism

Currently, monetarist thinking would suggest that further stimulus from the US Federal Reserve (Fed) could avert the potential of a recession; there is some evidence of a stabilisation in US credit and lower rates should help increase the money supply via additional private sector lending (See chart 17).

Chart 17: Fed to boost money supply



Source: Thomson Reuters Datastream, Schroders, 25 June 2019.

The Real Business Cycle theory stresses the importance of exogenous (technological) shocks to the economy to drive the fluctuations in economic activity, rather than growth in aggregate demand being driven by factors within the economy like investment and consumption. Shocks can have a negative impact, like a surge in oil prices impairing demand by boosting prices or be a

positive influence on growth, like the development of new technology boosting efficiency in the production process.

Trade wars will concern Real Business Cycle adherents

It appears that the biggest shock to the US (and global) economies at the moment is likely to come from the escalation of the recent trade wars. Although sentiment remains robust, this uncertainty is impacting investment, and in turn growth expectations. Investment is rolling over under pressure from trade uncertainties, but the situation could be reversed with pragmatic policy changes (See chart 7).

In reality, the reason for business cycle dynamics is likely to combine elements from many different theoretical frameworks. Indeed, each business cycle is different, but the end of the business cycle develops from a build-up in excesses in the system that at some point becomes unsustainable, sending the economy into slowdown and then usually recession.

As implied above, both monetary and fiscal policy can influence the level of economic activity by stimulating or restricting behaviour, as deemed necessary by policymakers. For example, by raising or lowering taxes, the government can lower or support household consumption, respectively. Similarly, if the central bank raises (lowers) interest rates, this will discourage (encourage) investment and household spending. A policy mistake, that tightens policy too far, can inadvertently send an economy into a downturn.

The National Bureau of Economic Research (NBER) dates the US business cycle and defines recessionary periods. Notably, the NBER only defines two phases of the business cycle: expansion and recession. The NBER specifies a recession as a 'period of diminishing economic activity'. During an NBER recession the economy experiences a significant decline in economic activity. The NBER differs from the technical definition of recession – two quarters of negative growth – and uses a variety of economic variables, including GDP, the level of unemployment, and industrial production to determine the peak and trough of the economic cycle.

Historically, according to the NBER, the recession phase has tended to last around 11 months on average. It's worth noting that the majority of slowdown phases signalled by the Schroders' OG model over the past 40 years have coincided with periods of NBER recession.

Crystal ball gazing: echoes of 1998 or 2001?

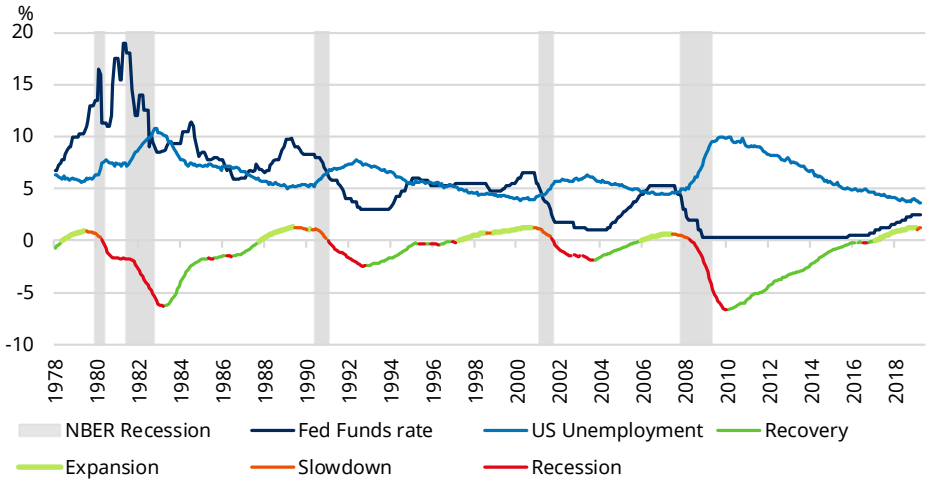
Various asset classes perform differently depending on which stage of the business cycle an economy is in. Typically, the slowdown and recession phases tend to be associated with lower returns to 'risk' assets and higher volatility than at other stages of the cycle. Conversely, the recovery and expansion phases are usually the phases in which 'risk' assets outperform more 'defensive' assets.

While historical comparisons are few, the 1998 and 2001 slowdowns for the US economy provide useful references. Both these periods, in comparison with 1995/96, were characterised by limited spare capacity, particularly on the jobs front, resulting in a positive output gap and decelerating activity. This is in contrast with 1995/96, when there was falling but spare capacity and industrial activity was broadly accelerating and the output gap was negative but rising.

The implications for monetary policy, however, are more nuanced. The Fed cut rates by 75 basis points in both 1995/96 and 1998. Historically, the Fed has consistently reacted by cutting interest rates promptly when the economy has been in a slowdown phase (See chart Chart). The Fed hiked rates in early 1997, just over a year after its last rate cut. The 1998 experience in the US saw the Fed cut rates three times before again hiking seven months later in mid-1999. In 2001, the Fed slashed rates by 400 basis points by the end of the recession

(NBER dated). It then continued to cut rates by another 150 basis points to a low of 1% in mid-2003. It preceded to raise rates a year later.

Chart 18: The Fed's reaction to business cycle dynamics



Source: Thomson Reuters Datastream, Schroders, 25 June 2019.
Note: Recovery, Expansion, Slowdown and Recession are phases of the Schroders Output Gap model.

Can US policymakers engineer a 'soft landing'?

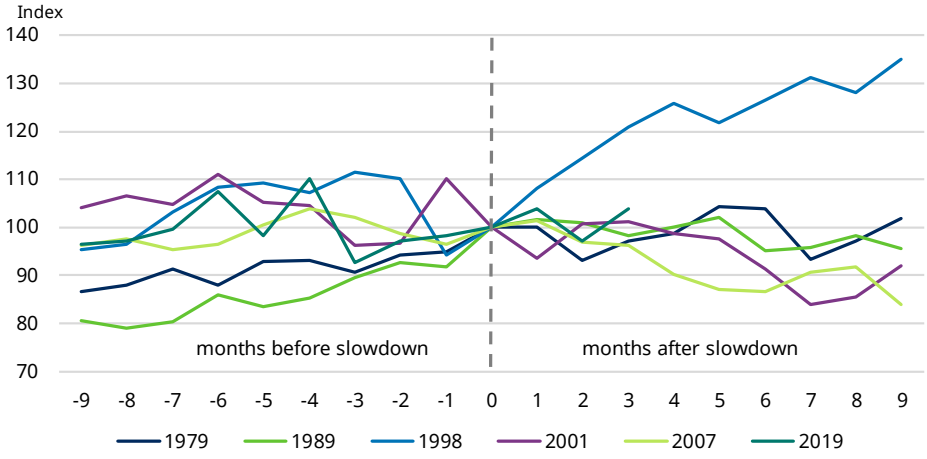
Fed officials have talked about the 'insurance' cuts in previous cycles to support the economy, and the dovish turn by the Fed in 2019 indicates again that they are reacting to what appears to be a significantly weaker economic outlook. Currently, interest rates are lower than at any other time in history for this stage of the cycle. Additionally, the amount of stimulus being injected into the system, from quantitative easing, is substantially larger, not just in the US but on a global scale. Such accommodative economic conditions are likely to remain supportive and are also part of the reason for our belief that the current slowdown period could be more prolonged than previous periods and potentially avert the recessionary phase that usually follows a slowdown. Nonetheless, the recession in 2020 is still a risk, particularly with the US political administration creating uncertainty and its attempts to co-opt monetary policy for political ends.

1998 is the standout for US equity market performance

In all of the previous examples of slowdown, US equities have performed poorly, with the exception of 1998 (See chart Chart). In 1998, the Schroders' OG model indicated a slowdown period that did not end in recession, a type I error, or a false alarm signal for a recession. The experience from 1998 is a clear standout in terms of equity market performance, with a 35% return delivered over the following nine months. At the time the Fed had begun to deliver rate cuts and the mid-1998 equity market slump reversed course and rebounded strongly. The monetary easing by the Fed in the late 1990's saw a boost in the money supply, and was another positive factor for growth.

There are some similarities between 1998 and the current environment: elevated consumer and business sentiment, against a backdrop of a central bank supporting economic activity. The Fed has room to move with inflation at similarly low levels to the 1998 experience. The Fed rate cuts, which began in September 1998, helped to increase the money supply, which importantly facilitated a rebound in the investment landscape.

Chart 1918: S&P500 performance



Source: Thomson Reuters Datastream, Schroders, 25 June 2019.

Although three rate cuts by the Fed in 2019 is almost fully priced in by the market, we expect this to be unlikely, with rates coming from a much lower base. Moreover, the jobs market was correspondingly as strong as today, lifting confidence and household sector activity. If the 'artificial' weight of US government policy uncertainty can be removed from corporate investment plans and drive a turnaround in a similar fashion to 1998, growth and risk asset performance could surprise to the upside in the near-term.

The longer the expansion, the shorter the recession

There is some evidence that the length of the cycle preceding a recession determines the length of the following recession[1]: the longer the expansion, the shorter the duration of the recession. Such evidence bodes well when comparing the current environment with the 2001 slowdown. The Fed was also raising rates in the year preceding the 2001 recession and responded too late in cutting rates in 2001. Industrial activity posted significant declines and there was a build-up of what was later found to be excess inventories which was followed by declining CAPEX – again echoes of the current environment. Additionally, oil prices were rising to historically elevated levels and the dot com boom turned to bust following the events of Y2K. Lasting only eight months, the length of the recession was shorter than average, assisted by expansionary fiscal policy by the incoming George W. Bush administration. In contrast, the Trump administration fiscal boost is currently fading.

Although it seems as if the US economy is in the late stages of its business cycle, there are some reasons for optimism, with indications that this time, the cycle could resemble 1998 rather than 2001. However, a recession in 2020 remains a risk and appropriate policy needs to be implemented to engineer a 'soft landing' for the US economy. And while the historical performance of US equity markets after a slowdown phase signal from the Schroders OG model is generally weak, there is potential for a grind higher if US policy provides a supportive tailwind, and at least meet market expectations. Failing that, crisis brings its own opportunities.

[1]Kleisen, K., The 2001 Recession: How Was It Different and What Developments May Have Caused It?, Federal Reserve Bank of St. Louis, September/October 2003.

Market returns

	Total returns	Currency	June	Q2	2019
Equity	US S&P 500	USD	7.0	4.3	18.5
	UK FTSE 100	GBP	4.0	3.3	13.1
	EURO STOXX 50	EUR	6.0	6.1	19.2
	German DAX	EUR	5.7	7.6	17.4
	Spain IBEX	EUR	2.9	1.3	10.3
	Italy FTSE MIB	EUR	7.6	2.7	19.9
	Japan TOPIX	JPY	2.8	-2.4	5.2
	Australia S&P/ ASX 200	AUD	3.7	8.0	19.7
	HK HANG SENG	HKD	6.7	-0.1	12.8
EM equity	MSCI EM	LOCAL	4.7	0.3	10.2
	MSCI China	CNY	7.8	-4.2	12.9
	MSCI Russia	RUB	6.0	13.2	21.3
	MSCI India	INR	-1.2	0.1	6.5
	MSCI Brazil	BRL	4.0	5.6	14.7
Governments (10-year)	US Treasuries	USD	1.5	4.4	7.6
	UK Gilts	GBP	0.5	1.7	4.4
	German Bunds	EUR	1.2	2.4	6.2
	Japan JGBs	JPY	0.6	0.8	1.8
	Australia bonds	AUD	1.5	4.4	10.0
	Canada bonds	CAD	0.3	2.0	5.5
Commodity	GSCI Commodity	USD	4.4	-1.4	13.3
	GSCI Precious metals	USD	7.7	8.3	8.9
	GSCI Industrial metals	USD	2.0	-7.0	1.0
	GSCI Agriculture	USD	0.3	6.3	1.6
	GSCI Energy	USD	6.6	-1.8	22.8
	Oil (Brent)	USD	3.0	-2.5	25.9
	Gold	USD	8.6	9.0	10.2
Credit	Bank of America/ Merrill Lynch US high yield master	USD	2.4	2.5	10.1
	Bank of America/ Merrill Lynch US corporate master	USD	2.3	4.3	9.6
EMD	JP Morgan Global EMBI	USD	3.0	3.8	10.6
	JP Morgan EMBI+	USD	4.1	4.4	10.8
	JP Morgan ELMI+	LOCAL	0.5	1.5	2.8
Currencies	EUR/USD		2.2	1.4	-0.4
	EUR/JPY		1.4	-1.3	-2.2
	USD/JPY		-0.8	-2.7	-1.8
	GBP/USD		1.0	-2.3	-0.1
	USD/AUD		-1.3	1.2	0.3
	USD/CAD		-3.3	-2.2	-4.3

Source: Thomson Reuters Datastream, Bloomberg, 02 July 2019.
Note: Blue to red shading represents highest to lowest performance in each time period.

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