Prospects

Quarterly – No. 19/120 – July 3, 2019

WORLD – Macroeconomic Scenario for 2019-2020

A new wisdom for a new age

J.M. Keynes (1925)

Trade tensions and, beyond these, geopolitical tensions look set to last. The prospect of weaker growth, accompanied by substantial uncertainty, is adversely affecting expectations. Signs of a slowdown, which are now more marked, are firming up. Nevertheless, the guidance and actions of the preventively accommodative central banks should reduce the risk of a painful landing.

Zoom vidéo

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Even after it was felt (with shamefully naive optimism) that sweet reason would prevail, and people believed that the US and China would be able to set off down the road to a compromise as a prelude to a happy resolution of their differences, a trade war is still looming – despite the truce concluded between Presidents Trump and Xi at the G20 summit.

But this is only one component – a highly visible one, it is true – of the manifold China-US tensions. This dispute – a confrontation between one great power that senses its hegemony under threat and another, competing and winning, great power – looks like it is here to stay. It is likely to spread over time, as long as the benefits in connection with maintaining the attributes of a 'superpower' exceed the short-term cost of destroying the rival power (see *Focus*). While some of the US's demands (improved access to the Chinese market and protection of its intellectual property) can still be considered by the Chinese, its demands as regards the subsidies granted to state-owned enterprises cut to the heart of China's development model and are, quite simply, unacceptable. Some phony respite phases are obviously possible but in no way do they portend any lasting easing of China-US relations.

Therefore, trade tensions and, beyond these, geopolitical tensions look set to last and are hampering growth.

In **the US**, in addition to the natural run-down of the growth rate, uncertainty and shrinking corporate margins will result in a contraction in productive investment in 2020. We factor a slight recession in 2020 into our central scenario. However, our assumed preventive monetary easing on the part of the Federal Reserve (especially justified as there is no threat from inflation) would stop growth and the equity markets from going into free-fall. **The US cycle, with its impressive longevity, would thus finish at end-2019 on below-potential year-on-year growth** (at 1.6%, vs 2.2% in 2018). We expect annual US growth should come out at 2.4% in 2019 and close to 1% in 2020.

In the **Eurozone**, the end of the cycle is proving 'abnormal'. The most recent, mostly favourable, numbers suggest that growth had dropped excessively as a result of temporary factors. Once that correction had been absorbed, growth might have been likely to pick up once more, although at a more subdued rate. However, the mismatch between the hard data that is still testifying to the strength of domestic demand and the less encouraging signals from the surveys suggests caution. The surveys seem to have captured greater uncertainty than the straightforward caution that usually accompanies a cyclical slowdown. The uncertainty – the materialisation of risk linked to international developments – is thus having a depressing effect on forecasts, especially forecasts for investment, even though the deterioration in the earnings outlook is still limited. **Nevertheless, domestic demand seems unlikely to suffer from a sudden correction and the preventive action of the ECB, by removing financial constraints on a lasting basis, should keep growth near its potential level** (an annual average close to 1.2% in 2019 and 2020).

In **China**, the wide-ranging and lasting trade dispute with the US will have a direct negative impact on trade flows and an indirect impact on consumption and investment, which added together could slice close to 1.0ppt and 1.8ppt from GDP growth in 2019 and 2020, respectively. The consequences of the slowdown are already visible in the labour market, whose resilience is a decisive component of social stability. The Chinese authorities are thus gearing up to adopt a response on a par with the problem, in order to offset the fall-off in aggregate demand. They will go into action on every front – easing monetary policy, tolerating currency depreciation, providing stimulus for bank lending and infrastructure projects – **to boost growth, so that it does not move far from the 6% target, a baseline compatible with an acceptably resilient labour market.**

Thanks to the **preventive easing that the leading central banks** will undertake (a policy entirely justified by the deteriorating inflation-free economic outlook and the multiplication of sources of concern and financial turbulence), we can outline a substantial slowdown but not a collapse in growth. Above and beyond the messages signalling the coming easing from the Federal Reserve and the ECB, the central banks are thinking about their medium-term monetary strategy and seem on the point of inventing "a new wisdom for a new age" (Keynes, 1925). **What with accommodative central banks thinking about their mandate and the appropriate tools for fulfilling it, risk-aversion, an inflation-free economic slowdown – what we have is an environment where long-term interest rates seem set to stay low for a very long time.**

Focus – Geopolitics, long-term trends versus the tweet factor

The trade war is only one component of the geopolitical tension between the United States and China. It will span a number of years and be a source of multiple shocks and volatile expectations.

Factoring geopolitics into an economic scenario involves three difficulties. The first is that we are in an area that does not easily lend itself to quantification. We must therefore get used to working not with indicators but with signals (key events that sometimes have scant economic impact in the short term but a powerful political impact). The second is the high probability of error in geopolitical scenarios, no doubt greater than that of macroeconomic scenarios, because human imponderables play a significant role (think the 'tweet factor', etc). The third is that the idea is to connect long-term trends with the short term. Yet, those trends must be clearly set out today because only they will allow us to understand the true nature of the US–China trade 'war'.

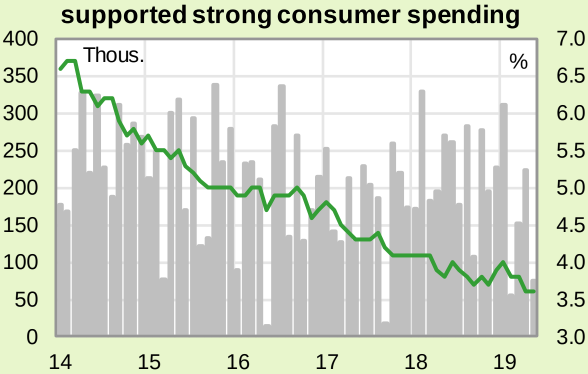
1. What is playing out between the US and China is the outcome of a power confrontation that began long before Donald Trump came on the scene, and which no doubt will continue in different forms even if he is no longer in power, because it corresponds to a profound historical shift: a reaction by a dominant power (the US) to the catching-up of a competing power (China). Political analysts use the expression "hegemonic transition" to characterise these historic shifts. It suggests that the declining power, feeling itself under threat, goes on the offensive not only against the rising power but also against the entire system of international governance, which it considers no longer defends its interests.
2. A hegemonic confrontation always plays out in several areas (nowadays including cyberspace, or even outer space) but also in certain fields of power, ranging from military or economic 'hard power' to educational or cultural 'soft power', and 'smart power', which reflects a state's ability to impose its own governance standards. Power rivalries between the US and China should therefore result in disruptive events deriving alternately from all these areas, but always shifting from one to the next. Even if the markets are more responsive to trade or technology issues, we should not underestimate the battle of cultural models and issues, because if – at the end of the day – there is a winner, it will be the one that also won the soft-power war, as social networks will have boosted the winner's importance.
3. The confrontation will continue as long as the medium-term interests (economic, but also political or ideological) of the declining power (the US) are greater than the short-term cost to it of destroying the system. For the time being, Trump's political interests seem fairly obvious, as this enables him to give shape to that electioneering slogan 'Make America Great Again'. As for naming a foreign enemy, it is a fairly classic move in the history of populist powers – and powers more generally – of consolidating legitimacy at home.
4. US threats against Huawei made the long-term visible, ie, America's desire to block China's technological rise. This risks accelerating thinking about value chains, but let us keep sight of the fact that changes in strategy will be costly and take a long time to implement.
5. The risks of hegemonic transitions always result in very aggressive behaviour against the competitor on the part of the dominant power, and this implies that the usual rules of negotiation can be circumvented and redefined. At a deeper level, we have entered an international environment where many things that once seemed impossible are now possible, including in the realm of technological and financial interdependence.

Ultimately we obviously do not know whether the world will organise itself on a bilateral or multilateral basis, but during the transition period the economic scenario and corporate strategies will be impacted by both direct and second-tier effects: in the short term with trade, financial or regulatory shocks; in the medium term when it modifies economic policies or expectations; but also in the long term, whether because of changes in global governance standards or the economic strategies of countries and businesses.

Developed countries – More than a natural winding-down

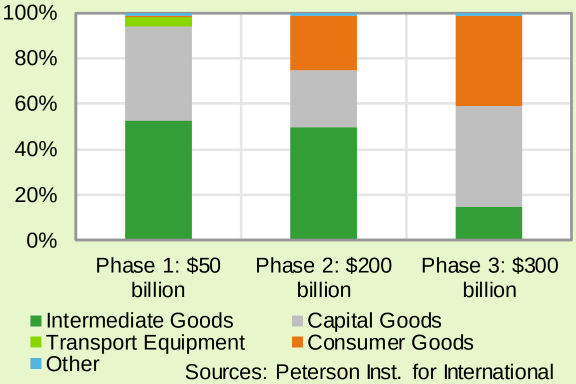
Tensions around trade and – knocking on from these – geopolitical tensions seem likely to persist and are hampering growth. The prospect of weaker expansion surrounded by uncertainty is adversely affecting expectations. The downturn, which is now more pronounced, is taking shape.

US: tight labor markets have supported strong consumer spending



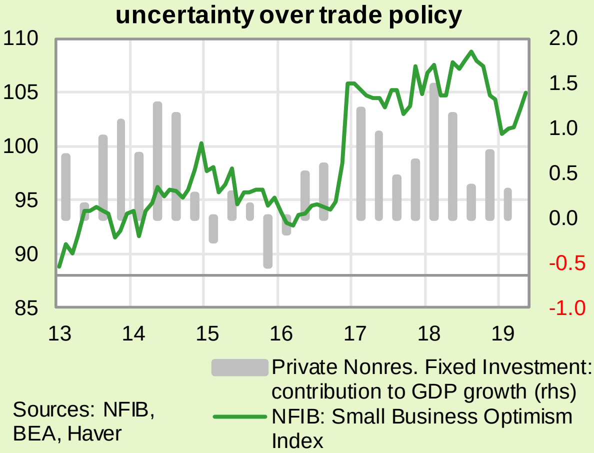
Sources: BLS,

US: future China tariffs will fall on consumer goods to a larger degree



Sources: Peterson Inst. for International

US: Business capex likely to slow on uncertainty over trade policy



Sources: NFIB, BEA, Haver

USA: trade tensions weigh on growth

Uncertainty and thinner profit margins lead firms to pull back on investment spending. The US will enter into its longest expansion on record in July. However, our updated base-case economic outlook anticipates a mild recession in 2020. The main reason for the recent downgrade to our forecast is the assumption of no happy resolution of trade tensions between the US and China and potentially stormy trade relations with other key trading partners. We believe that the impact on households and businesses from tariff hikes and business uncertainty could easily trim GDP growth by 0.5 percentage points or more over our forecast horizon.

We expect Q219 GDP to slow to around 1.9% from 3.1% in Q1. **Real GDP growth this year is forecast around 2.0%, measured Q4 on Q4 – near its long-term sustainable pace – down from 3% growth in 2018**, which was temporarily boosted by deficit-financed tax cuts. Solid consumer spending over the past year has reflected healthy job-market conditions, with low unemployment and gradually rising earnings. Meanwhile, tax cuts for businesses and strong global growth have lifted business sentiment and investment.

If tariffs rise on most US imports of Chinese goods, as we think likely, the tariff (tax) increase will be borne by US consumers through higher prices on imported goods and their US-produced substitutes. This reduction in purchasing power leads to slower real household spending growth. The impact of higher tariffs could essentially erase any fiscal stimulus from past tax cuts for middle-income households.

Tariffs and trade tensions significantly increase uncertainty for many large businesses as they need to assess how to re-optimise their supply chains. This takes time and is costly. Business investment outlays are likely to be curbed while firms figure things out.

In addition, **a squeeze on profits is expected to trim business capex**. The cost structure facing firms is rising for both labour (rising wages) and non-labour non-energy inputs (higher tariffs). As firms' pricing power is limited, profit margins will be squeezed, in our view leading to a pullback in investment spending on equipment. Lastly, low oil prices suggest reduced business investment outlays for structures related to US oil & gas exploration and development.

The impact on net exports will depend on the magnitude of the global slowdown and the trade-weighted value of the USD. We think that the direct trade impact will be relatively modest, directly trimming two-tenths from real GDP growth next year.

We see little potential for renewed fiscal stimulus to offset the supply shock from trade disruptions. Politicians have talked about sizable infrastructure initiatives. However, for President Trump, infrastructure spending means funds for a wall along the US/Mexico border, which is a non-starter for the Democrats. Republican congressional support for USD2trn in

US: recession probability predicted by Treasury spread

Source: New York Fed

infrastructure funding is very weak. Such spending would exacerbate the large and growing budget deficit or it would require politically unacceptable tax increases, such as a higher Federal gasoline tax, which would be extremely unpopular in the run-up to the general election in November 2020.

We look for the FOMC to cut its Fed funds target range by 50bp in the second half of 2019. **These 'insurance' rate cuts, however, will probably be insufficient to stop the US economy from experiencing a mild recession in 2020** in our view, as we expect lower rates to elicit a smaller response from sectors of demand traditionally sensitive to interest rates (housing and motor vehicles), and we look for two additional rate cuts in the first half of 2020 as the unemployment rate rises.

A negative supply shock from trade combined with squeezed corporate profit margins is likely to be accompanied by a pullback in equity-market valuations that generate negative wealth effects (see Focus below). Furthermore, while the recession signal from an inverted Treasury yield curve may have been attenuated by QE policies that lowered long rates, we think it unwise to ignore it.

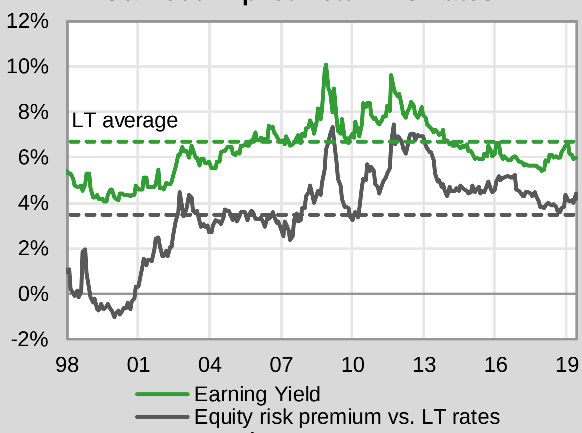
Focus – Our scenario is negative for equity prices, but not catastrophic

Our central scenario – an escalation of US-China tensions on multiple fronts, mild recession in the US in 2020… – is clearly not upbeat for equity markets. Indeed, our macro scenario is more pessimistic than the consensus, although expectations have been revised down over the past year. That said, we expect central banks to ease their monetary policy anew and to react quickly and strongly to any significant tightening of financial-market conditions. In our view, equity indices will likely decline progressively in the coming quarters, but we do not expect a real bear market.

Corporate earnings are likely to stagnate globally at best and to contract in the US, coming in well below consensus expectations, which are still suggesting 10% earnings growth in 2020. A US recession and lower global growth will weigh on corporates' top-line growth. In addition, corporate earnings will suffer from a compression of margins, which are at a historically high level in the US. Indeed, wages are accelerating even if only progressively, tariffs are increasing input costs and the political uncertainty may force expensive adjustments to corporate supply chains.

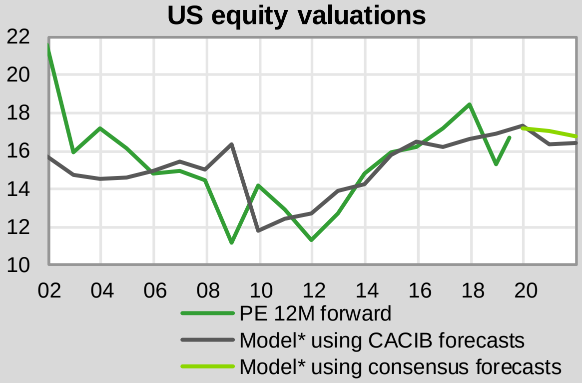
In term of valuations, equity markets are expensive by historical standards, but mostly because risk-free rates are low. Equity index price-to-earnings ratios are 10-15% above their long-time average in the US and 5-10% higher in the Eurozone. But the risk premium that investors are requesting for holding equities rather than risk-free bonds is above its long-term average level, by more than 75bp in the US.

S&P 500 implied return vs. rates



Sources: Datastream, Crédit Agricole CIB

Limited derating of US equity valuations

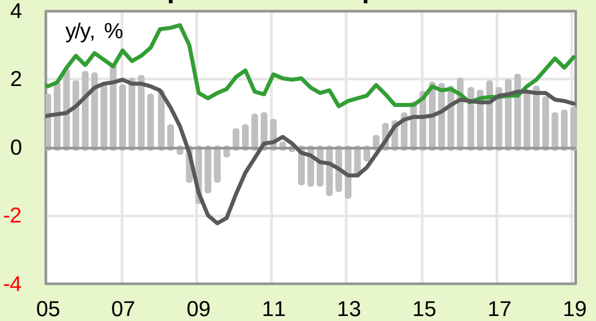


* based on the unemployment rate, CPI inflation & LT rates

Sources: Datastream, Crédit Agricole CIB

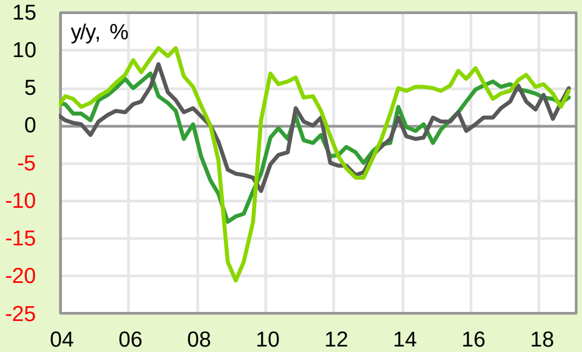
We expect the Fed to cut its policy rates by 100bp during the coming year and the other major central banks to at least keep their monetary stance as accommodative as it is, which will support equity valuations. Facing higher economic risk and political uncertainty, we think investors will require a higher equity risk premium. That said, we expect the increase in the ERP to remain limited for two reasons: (1) we are forecasting only a mild US recession and not a global recession, a scenario more like 2015-16 than 2008; (2) we expect central banks to react quickly and strongly to any significant decline in risky asset prices. Indeed, inflation pressures are muted and central banks have limited room to cut rates, so they should be focused on limiting any downside economic risks implied by a tightening of financial conditions.

EMU: strong fundamentals for private consumption



Sources: Datastream, Crédit Agricole S.A.

EMU: investment



Sources: Datastream, CA S.A.

Eurozone: a genuinely materialised risk in an "abnormal" end-of-cycle

GDP growth in the first quarter of 2019 ultimately turned out to be more dynamic than expected, at 0.4% compared with our March forecast of 0.3%, and **represented an acceleration from the growth in the last quarter of 2018 (0.2%)**. In addition, growth is being driven by continued positive domestic fundamentals: a strengthening of private consumption and further strong investment. The contribution from foreign trade was slightly positive but was based on export and import flows, which were also weak.

One might, therefore, have expected – in the wake of an 'exaggerated' downward adjustment following the exceptional cycle in 2017 – to see a return to 'normal'. But no-one believes that any more. We could also reassure ourselves by supposing that the temporary factors that have affected some manufacturing sectors, such as cars, chemicals and pharmaceuticals, have finally faded. Growth would return to a more moderate pace but would still have a bright future. This view could also be backed up by industrial production data, which – like the national accounts – rebounded in Q119. However, a few factors, including the disconnect between this 'hard' data and signals from the surveys, prevent us from endorsing this positive scenario.

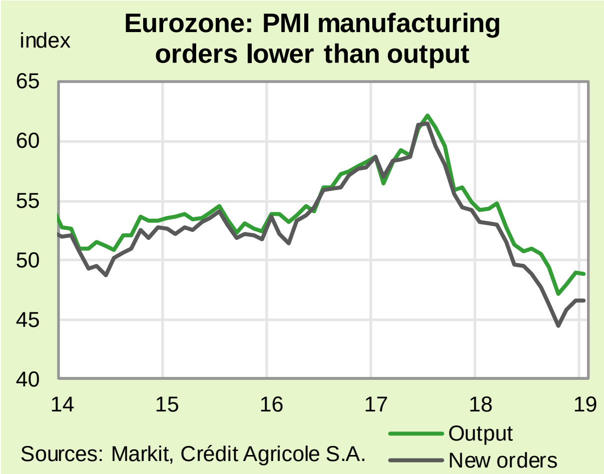
First is the fact that **growth was low in June in the Eurozone's private sector; and, while activity has picked up in the service sector, a further drop in manufacturing sector production is underway**. Second come the indices. Businesses' optimism as to their activity outlook 12 months out continued to decline. Negative signals are coming from market expectations, especially those concerning inflation.

The surveys seem, therefore, to have captured a more lasting shock than simply factoring in the direct impact of the trade dispute between the US and China. Economic agents are gradually integrating a more structural breakdown involving the dislocation of the multilateral order and attacks against the institutions tasked with organising international relations – and the potential corollary of currency instability and the necessary reorganisation of value chains. This is generating a lot of uncertainty, and that uncertainty is a risk in itself. The risk has already materialised by leaving a lasting mark on confidence.

In this very abnormal end-of-cycle, it is therefore necessary to integrate this change in paradigm and expectations into the Eurozone's domestic-demand fundamentals, which remain strong. This is because private consumption is sustained by robust job creation (1.3% YoY in Q119) and sharply accelerating wages (+2.7% YoY in Q119). Low inflation continues to further boost purchasing power, underpinned in some countries by tax measures and increases in the minimum wage. The only thing that has held back a greater increase in household spending is the rise in the personal savings ratio: for precautionary reasons, or with a view to rebuilding real wealth, or else to nurture a housing-related wealth objective.

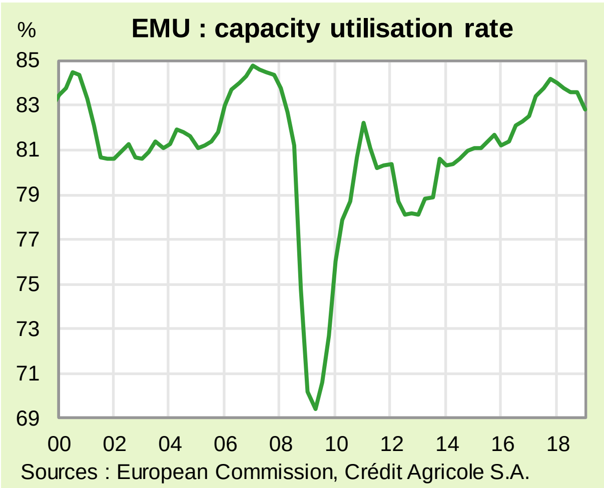
Investment, for its part, has been very dynamic in both its productive and housing construction components. For the productive component, the growing availability of vehicles that have passed the WLTP tests should feed into the build-up of transport assets over the coming months. With the housing construction component, the gradual recovery in the housing and construction cycle in peripheral countries is supplementing the already dynamic cycle in the core countries.

The slowdown in global growth is already a given and has been factored into firms' expectations: for the time being, it has not had any visible impact on accumulation behaviour. Due to the sluggishness of production capacity it should first be the industrial capacity-utilisation rate that should vary almost instantaneously with demand. However, although effectively falling, that rate is still at the high level of mid-2017. Partly in view of the very late start to the accumulation process during this cycle, and partly due to the absence of any slowdown in domestic demand over the past year, the capacity-utilisation rate will need to fall further before investment pays the price of a painful adjustment.



Our scenario factors in a gradual adaptation of spending behaviour to the expected slowdown in the US economy, itself affected by the rise in the cost of intermediate production due to higher tariffs. **So far, the Eurozone is less vulnerable to that kind of cost increase,** except in the event (not included in our central scenario) of higher tariffs on the European automotive sector and European retaliation on US products. It is also less vulnerable to a rise in wage costs, which are more sluggish than in the US. As a result, there is less prospect of a deterioration in profits in the Eurozone. This supports less of a deterioration in investment, although its productive component has nevertheless been revised down.

Our scenario rules out a sudden correction in demand (investment and consumption) due to a more marked drop in earnings expectations. The immediate action of the central banks aims to prevent that sudden correction by easing monetary and financial conditions. These need to better align with a downward revision to earnings, especially in the US, and thus help avoid a financial shock. Thanks to this 'preventive' action, which should limit the deterioration in financing conditions for large corporates, in their wealth situation (leading to downward revisions to the value of their equity and assets) and in lending conditions overall, it is possible to forecast a gradual adjustment in investment towards its new long-term equilibrium. The lack of negative wealth effects resulting from the fall in stock-market valuations should also help to avoid any sharp fall in household consumption.

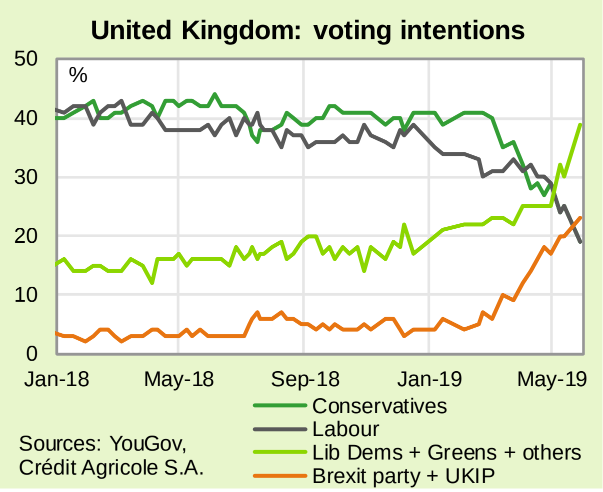


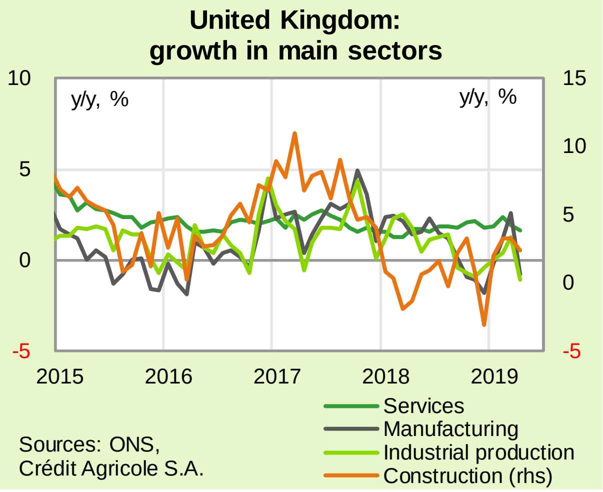
In conclusion, **we outline a growth scenario (1.2% in 2019 and 1.2% in 2020) that is below the potential level – a scenario where financial constraint is removed for the foreseeable future by the central banks**. The ECB is no longer waiting for a risk to materialise before acting. It reckons that the risk is already there, taking the shape of prolonged uncertainty, and that, failing any improvement, an additional dose of monetary easing will be necessary. Additional budgetary support is also being provided by a number of national fiscal authorities, but not in any concerted or coordinated manner. The Eurozone's growth profile is the outcome of increasingly divergent trends: they are differentiated according to the degree to which they are exposed to trade pressures, fiscal room for manoeuvre and the level of national political risk.

UK: an unstable political climate in a more uncertain global environment

Brexit: higher risk of no-deal Brexit on 31 October

Theresa May's inability to get her withdrawal agreement through Parliament has polarised British voters, forcing both Conservatives and





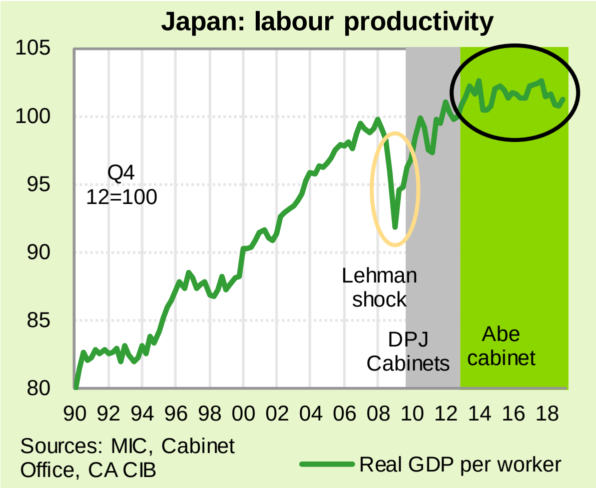
Labour to take radical Brexit stances: exiting the EU on 31 October at the latest, with or without a deal for the Conservatives, or in Labour's case arguing for a soft Brexit. The European Union has ruled out any reopening of negotiations on the withdrawal agreement, which automatically increases the probability of a no-deal Brexit on 31 October 2019. However, Parliament is largely opposed to a no-deal Brexit, and the government's already thin majority has fallen even further during Theresa May's leadership (effective majority of only three MPs). The government is therefore more vulnerable to a vote of 'no-confidence' than before. We therefore believe that a snap election following a vote of no-confidence is very likely as a means for Parliament to stop a no-deal Brexit. This snap election could take place before year-end provided that at least seven weeks are needed between a vote of no-confidence and the staging of a general election. A further postponement of Brexit would be needed, making the assumption that Parliament would be able to oblige the government to ask for an extension of Article 50 and that the EU would agree to it. At this stage it is difficult to predict the outcome of a general election, but opinion polls are suggesting that a left-wing coalition has marginally more chance of obtaining a majority in Parliament than a new Conservative government.

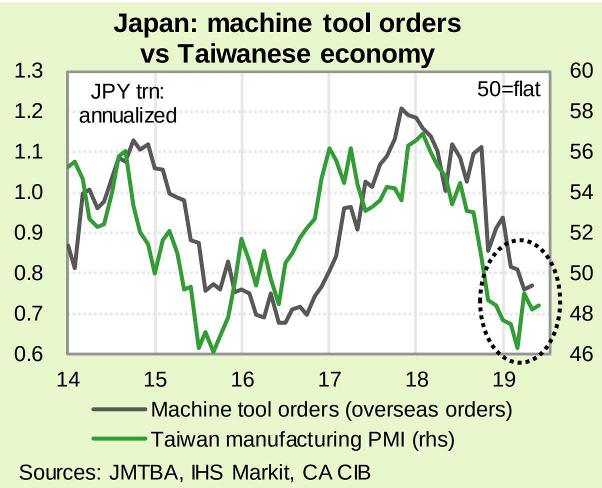
Increased growth volatility in the short term, probable contraction in GDP in Q219

Fears of a no-deal Brexit taking place on 29 March 2019 bolstered manufacturing growth in the first quarter, at 2.1% QoQ, as firms built up record inventories. This behaviour was reversed at the start of the second quarter, leading to a near 4% drop in manufacturing production in April. May's manufacturing PMI has dipped into contraction territory for the first time since July 2016. The service sector, which is more dependent on domestic demand, continued to show modest but steady growth in the first quarter (0.4%). However, monthly data at end-April shows that activity has stalled for three months. We are forecasting stable GDP in the second quarter (and growth of 1.4% in 2019, the same as in 2018); nevertheless, with a -0.2% carryover in April, the risks around our forecast are on the downside.

More imbalanced, more fragile growth

Uncertainties regarding Brexit will continue to adversely impact private investment, which is likely to continue declining in the coming quarters. Foreign trade could continue to benefit from weak sterling, but we are forecasting a negative contribution to growth from net exports in the medium term, given the expected slowdown in the Eurozone and the US, and moderate growth in UK domestic demand. Household consumption is still the main driver of growth, despite the uncertainties around Brexit, thanks to still-favourable fundamentals and in particular a labour market seeing full employment, with an unemployment rate of just 3.8%, and where wages growth (3.4% in the private sector) is close to its cyclical peaks. Purchasing power (measured by gross disposable income deflated by the consumer expenditure deflator) rose 2.1% in 2018 after two years of near stagnation. It should continue to pick up over the coming months against a backdrop of falling inflation. That said, households' financial situation is fragile, as suggested by their low personal savings ratio (4.8% in Q418) and a debt ratio, which – at 148% of disposable income – is one of the highest among the advanced economies. The policy mix will remain supportive. Growth in public sector consumption is likely to remain sustained as the government has eased its budgetary policy. The economy should continue to benefit from favourable monetary and financial conditions, with a monetary





tightening process that has likely ended despite the BoE's relative hawkish stance.

Japan: economy to bottom out towards year-end

Japan's Q1 GDP produced a surprise, with real growth of 2.2% QoQ saar. However, this strength is due mainly to a sharp decline in imports, and naturally suggests Q2 real GDP growth will slow. We expect Q2 growth to slow to 0.4% QoQ saar, with net exports being the major drag.

Going forward, we need to be watchful for any volatility in the economy that could accompany the VAT hike scheduled for October. On the past two occasions of a VAT hike (in 1997 and 2014), consumer spending was heavily front-loaded, followed by a reactionary decline in consumer spending and a decline in households' purchasing power due to a discrete rise in the CPI, hence resulting in great volatility in the economy. This time around, however, the Abe Cabinet plans to implement an expansionary fiscal policy as well as the introduction of free infant education, which will, at least partially, offset the negative impact of the VAT hike.

More fundamentally, we continue to focus on wage development and the timing of a pick-up in machine tool orders – a leading indicator of private capex:

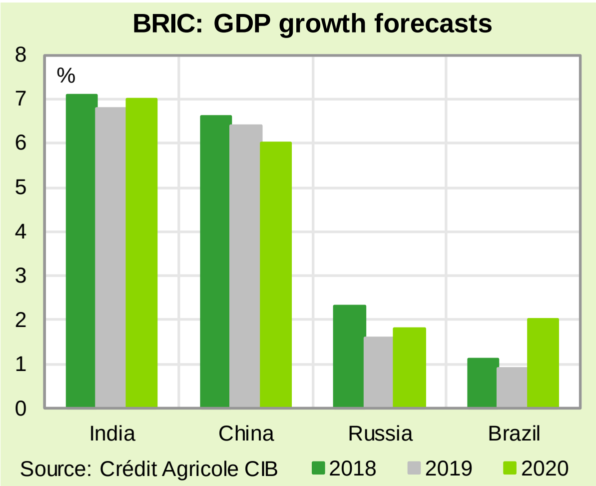
- ✓ **Growth in nominal per-capita wages has been as slow as ever at around 1% YoY.** We believe this lack of acceleration in wage growth arises from a lack of growth in GDP per employee, ie, labour productivity. We need to change the employment system and increase the mobility of labour.
- ✓ To gauge the timing of a pick-up in machine tool orders, we can focus on the Taiwanese manufacturing PMI as a leading indicator, with about a six-month lag. Taiwan's manufacturing PMI bottomed most recently in February. Of course, it is still too soon to see whether this is a real bottom or if there is another trough waiting ahead. However, given this lead–lag relationship, we expect **Japan's capex to bottom towards year-end**.

Emerging countries – Buffers to handle the global deterioration

Emerging markets are facing growing challenges (the escalation of the economic war and the US slowdown), but they also enjoy domestic and external buffers. Thus, EM economic performance should not be that bad in coming quarters, after all.

A growing challenge: trade, protectionism and other geopolitical tensions

A few months ago, the markets were contemplating the possibility of an agreement between the US and China that could put an end to the bilateral tensions. However, the tone has deteriorated since then. Right now, even if the G20 summit has provided some relief (at least temporarily), it seems realistic to believe that the US-China relationship is engaged in a long-lasting period when tension will remain high. This could lead to further pressure on the issue of bilateral trade and tariffs. True, there could also be periods of improvement on that issue, depending on the international agenda and President Trump's mood. However, the dispute covers not only trade but also more difficult issues such as intellectual property and China's development strategy, particularly when it comes to its technological upgrade. It also relates to the core of its economic system, where the relationship between the Communist Party and state-owned enterprises plays a key role. This makes it very difficult for China to back down.

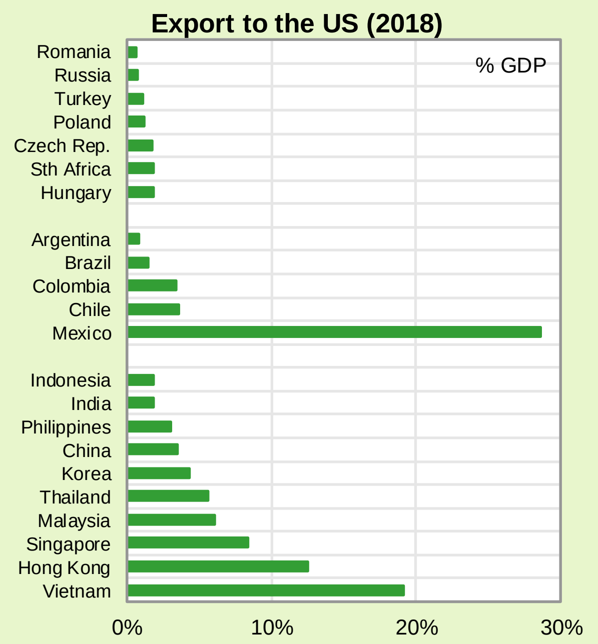


On the US side, we assume that, beyond Trump himself, a bipartisan consensus seems to have emerged in favour of engaging China and trying to slow its ascent not only as an economic giant but also as a global geopolitical leader that could compete with the US. Against such a backdrop, we expect the global geopolitical landscape to remain clouded by trade, economic and geopolitical tensions between China and the US. Furthermore, recent events have shown that these tensions could have ramifications at the corporate level. Bottom line: the EM outlook is facing these growing challenges that could weigh on trade prospects, but also on firms' and investors' confidence.

A bolder relief: global central banks becoming increasingly dovish

However, the EM outlook also benefits from the increasingly dovish tone of the world's main central banks. The shift in US rate expectations has been rather dramatic over the past few months. The market is currently pricing a significant amount of dovishness, with one rate cut expected in the next three months and two or more rate cuts in the next six months. The ECB has followed the Fed and has shifted to a much more dovish stance, with President Draghi widely opening the door to a 'QE2' programme and possibly some rate cuts or other easing measures. In China, aggregate financing has increased rather strongly since the beginning of the year, and we expect the PBOC will likely implement further easing measures too.

Overall, those central banks that have a global impact have become increasingly dovish, and the expected improvement in global liquidity conditions should help EMs to buffer the negative impact of increased uncertainty on economic momentum and global confidence.



Source: Crédit Agricole CIB

Source: Crédit Agricole CIB

Tepid outlook for EM exports and investment

This outlook is all the more welcome since EM exports have been weaker than expected over the past few months. EM exports have continued contracting (measured in USD terms, compared with one year ago). This is a reflection of weaker demand from developed markets but also likely the consequence of increased uncertainty about global trade.

The US deceleration will make it more difficult for EM exports to recover. Our US economist expects a mild recession to take place in the US next year. Investment should also be negatively impacted by this gloomy trade outlook, particularly in those emerging countries that are strongly export-oriented.

Enjoying buffers

The good news is that many emergi ng countries have enough leeway to cut rates or at least keep them stable for now. In addition, as the largest countries are also the least open to trade, they are in a better position to weather the lacklustre external trade outlook. Our outlook is also coloured by the fact Europe's GDP growth will accelerate slightly next year, whereas China's growth will slow slightly, as Chinese policymakers follow up with stimulus measures in order to put a floor under GDP growth and job creation.

Interestingly, the EU matters significantly more than the US as a destination for EM exports (22% of EM exports headed towards the EU in 2018 vs 15% to the US). In total, exports to the US represent only 4% of cumulated EM GDP (roughly the same for China and for EMs ex-China).

Some will be more equal than others

The way EMs will be impacted by the US slowdown and the prolonged US-China tensions depends mostly on a handful of criteria. Trade-openness matters, particularly trade integration with the US. Also, the countries that export consumer goods could be more impacted than those that export commodities. Indeed, we expect China's stimulus to benefit investment (including infrastructure) more than private consumption – hence the countries exporting energy and commodities to China should benefit more from the Chinese support measures. Countries involved in the tech sector may also suffer more, should the US-China tensions continue to build up around tech firms.

Whether or not external financial vulnerability is an accurate factor of vulnerability is more ambiguous. On the one hand, should risk-aversion rise due to the economic war between the US and China, or to other geopolitical factors, then the likes of Turkey or Argentina could suffer from FX depreciation pressure and possibly higher interest rates. However, on the other hand, lower US yields on the back of the US monetary easing should also provide buffers to those countries relying on external financing.

Overall, the negative impact of the US slowdown and prolonged period of US-China tensions may be somewhat muted for EMs on average. We still expect EM growth to reach 4.1% in 2020, compared with 3.9% in 2019.

Region by region, we expect Asia to slow, but only to a limited extent. India, which is less open to trade than its peers, is expected to accelerate slightly. We see Asia as a whole decelerating from 6.0% last year to 5.8% in 2019 and 5.6% in 2010.

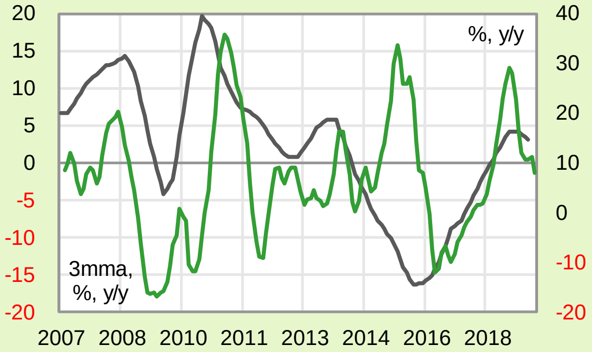
In Latin America, Argentina may gradually exit recession. Brazil should slowly recover. Given the heavy weight of this country in the region, Latin American growth should re-accelerate. However most other countries in the region should actually decelerate.

Emerging Europe may also accelerate slightly in 2020, as Turkey will likely exit recession, whereas Russia's growth may be roughly stable, and Central Europe is much more integrated with Western Europe than to the slowing US economy.

Brazil: time to show results

The first six months of Bolsonaro's administration were marked by elevated political noise and a rollercoaster of market sentiment. The president and his party initially exposed their lack of ability to articulate with Congress, although there has been a significant improvement more recently. Beyond the political noise, a top economic team and firm commitment with a liberal agenda has held strong. Finance Minister Paulo Guedes has been the lead promoter and supporter of the importance of a pension system overhaul. Congress and the population's awareness of the need to make large-scale changes to the current system is maturing to the point that polls show the majority of the population and more than 70% of Congress are in favour of the reform. Since April, the government has been working more closely with Congress to agree on the several topics concerning the pension bill. Improved articulation between the government and coalition parties has guaranteed that the bill does not get too dehydrated by the opposition's demands. As we get into July, Congress gets ready for a two-week break, and markets wonder whether the bill could already be voted on the floor of the Lower House before their break – it will be a close call but it goes to show that market participants like the dynamism with which the bill is progressing in parliament.

Brazil: commodity prices remain an important driver of investment



Sources: IBGE, BCB, CA-CIB

The initial proposal aimed at saving BRL1.1trn in ten years. Guedes and his team has been working hard to bullet-proof the bill and avoid any major dent to the original text. As we head closer to the first vote in the Lower House, we estimate a bill that will generate savings of BRL900bn – almost twice the size of the bill that was about to be passed in the previous administration.

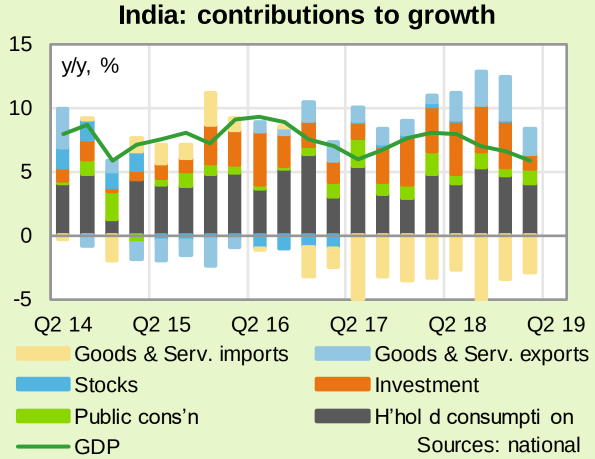
Outside of Brasilia, the state of affairs remains a concern to Brazil-watchers. The economy lost momentum in Q119 and the most recent data in Q219 shows no sign of a rebound. We revised our growth projection for 2019 to 0.9%, a level even weaker than 2018 and the third consecutive year of disappointment – the feeling on the ground is that Brazil never came out of the 2015-17 recession. Investors were initially hopeful that a liberal agenda would have a quick impact on sentiment – crucial for demand to rebound and investment to start to come back. With the pension reform closer to approval, the BCB should be more comfortable in cutting interest rates. Lower interest rates and a firmer grip on the reform agenda may be the missing link to a recovery.

Nonetheless, **one cannot ignore the likely headwinds coming from a likely escalation of the US-China trade war and the impact that a more uncertain global trade environment has on global growth**. Brazil remains sensitive to commodity prices and global trade. The more dovish stance by central banks all around the world should help mitigate those effects but the backdrop remains challenging. We remain

Russia: FX reserves

Source: Crédit Agricole CIB

India: contributions to growth



Sources: national

confident that the liberal agenda is likely to continue beyond the pension reform with a tax reform, privatisation and increased openness all contributing to a healthier business environment for the country.

Russia: a safe place to be?

Against a global backdrop marked by mounting uncertainty, Russia looks like a more stable place. True, economic growth has slowed at the beginning of the year, but we expect it to somewhat regain momentum in coming quarters. The government intends to gradually deploy investment spending that could benefit the country's short-term growth as well as its potential growth. Politically, the issue of Putin's succession will have to be addressed, but there is still time to do that as Putin's mandate ends only in 2024.

On the monetary side, inflation is moderating and should continue to do so, we believe. As a consequence, the CBR will likely continue to lower interest rates, at a pace that will depend on the budget policy. On that front, the government intends to use part of the sovereign funds to back public investment – but we do not expect policymakers to stray very far from the orthodox budgetary guidelines they have been following over the past few years. Against such a backdrop, we look for low, but rather stable economic growth, twin surpluses and a roughly stable currency, together with still-attractive carry.

There are two main risks to this scenario. First, **possible new US sanctions would hurt the FX and rates markets**. However, such shock may be temporary, as both the Russian authorities and investors have had time to prepare themselves for such a risk, and as budget and current-account surpluses would act as buffers.

The oil price would represent a more crucial risk, should the global slowdown be bolder than expected and lead to a strong fall in the oil price. In that case both economic growth and the external and budget balances could deteriorate meaningfully.

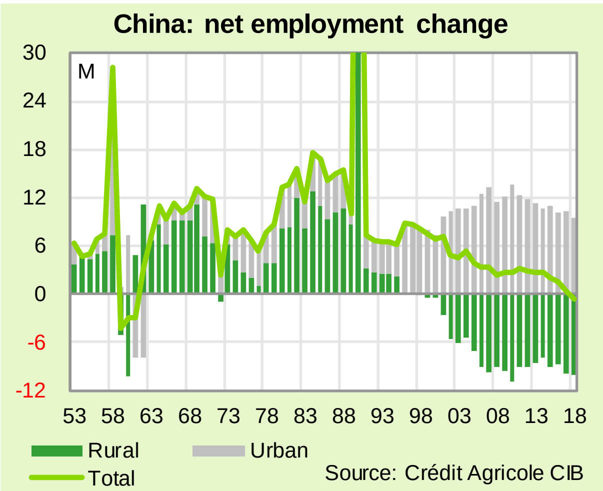
India: heading for a gradual recovery

Growth came out at 5.8% YoY in Q119 (the last quarter of India's 2018/19 fiscal year). This should be compared with the 6.6% recorded in the previous quarter and 8.1% in the first three months of 2018. **Behind that counter-performance are smaller contributions (to growth) from household consumption, external demand and, above all, investment. Conversely, the contribution from public consumption has doubled.** Over the full 2018/19 fiscal year, GDP growth has thus stalled at 6.8% (GDP growth stood at 7.1% in the previous fiscal year).

This slowdown in Q119 was expected, for several reasons: an unfavourable base effect, the electoral context and all the related uncertainty likely to have an adverse impact, in particular on business investment, and the liquidity problems encountered by non-bank financial institutions, but not so markedly. The consensus forecast was for growth of 6.3%; we think the negative fallout from the electoral period was probably somewhat underestimated. However, **it seems to have been the difficulties faced by not only non-bank financial institutions but also banks themselves** (especially the state-owned banks, still hampered by large-scale non-performing loans) **that weighed on activity**. We believe this is one of the first issues that the new Modi government will have to tackle if it wants to inject new life into the Indian economy.

In the meantime, in view of all this, **in early June the central bank once again cut its key rate by 25bp to 5.75%, the third cut since the start of the year** – and the easing cycle may not be over yet. This should inject some liquidity into the economy. The tax measures announced by the government in February should also continue to have a positive impact, and others could be added. And of course, the election is over and its outcome is deemed to be rather fortunate by the business community – however, let us remain cautious here, recalling the lacklustre economic record of Modi's first term, an upper House still unvested in the government's cause and a new victory for the 'strongman of India', whose platform is partly built on questions of security, identity, Hindu nationalism and economic promises that will be difficult to keep or to finance. That said, an improvement could be on the cards from H219, especially as the base effect should then invert from unfavourable to favourable. **At present, growth is forecast at 6.9% for the 2019/20 fiscal year.**

China: stepping on the accelerator



Mounting growth pressures to trigger increase in stimulus. We expect the economic war with the US to escalate in Q419 after another attempt to negotiate a deal in Q319 following a better-than-expected outcome from the meeting between Presidents Trump and XI at the G20 summit in Osaka. The resulting direct drag – through a weaker trade in goods balance – on Chinese GDP growth will materialise mostly in 2020, and in fact late 2019 may see an improvement in exports as businesses rush to ship goods to the US ahead of the new tariffs. However, the indirect negative impact – through weaker investment and consumption – will deepen already this year. We estimate that the economic conflict with the US will generate a hit to Chinese growth of 1.1 percentage point in 2019 and 1.8 percentage point in 2020 (0.3 points and 0.6 points, respectively, directly through a lower trade balance, and the remainder indirectly).

The most painful implication of such developments will be the weakening of the labour market. Already in 2018, before the bulk of the trade war impact, China reported a 540k loss in payrolls, the first negative reading since 1961. The situation has continued to deteriorate in 2019, with 12M rolling gross new job creation in urban areas falling to a 15-month low in May. It is bound to get worse amid an increasing number of businesses, foreign and Chinese, moving manufacturing out of the Mainland to bypass the US tariffs. The pressure on payrolls is coinciding with weakening incomes, whose growth in real disposable terms slowed in Q119 to the second-weakest pace in history. This poses a challenge to social stability, which is based, among other things, on a strong labour market.

We believe that, **in order to achieve its GDP growth target and stabilise the deteriorating labour market, Beijing will respond with a multi-pronged effort to make up for aggregate demand lost due to the economic conflict with Washington**:

- ✓ Window guidance for banks will be used to substantially boost the supply of credit, with deleveraging postponed till after economic growth stabilises.
- ✓ In order to encourage demand for loans, interest rates will be reduced. We envisage a rate-cutting cycle between Q319 and Q120, largely coinciding in timing and magnitude with the Fed's monetary easing, which should bring the PBoC benchmark 1Y lending rate down by 75bp to 0.75% and the PBoC 7D reverse repo rate by 80bp to 1.75%; the central bank's lending rate is likely to be

abolished in another step in the reform of the interest rate system. The increased volume of credit will largely be used to fund infrastructure projects, allowing for a rapid transmission of stimulus to the real economy.

- ✓ The RMB should be allowed to depreciate in line with China's deteriorating external position.

We believe that the direct and indirect impact of the trade war as well as of stimulus will be a weakening of the current account by 0.7% of GDP in 2019 and 1.2% of GDP in 2020, to a surplus of 0.6% of GDP and a deficit of 0.2% of GDP, respectively. The balance of payments will be hit to the tune of 1.6% of GDP this year and 2.4% of GDP next year, swinging to a shortfall of 1.4% of GDP or ~USD200bn already in 2019 and of 1.9% of GDP or ~USD300bn in 2020. Given the long-term outlook for rising shortfalls, the PBoC will not be in a position to defend the 7.00 exchange rate vs the USD any longer, and will let it be exceeded in a gradual and controlled manner, resulting in the CNY depreciating to 7.05 at the end of 2019 and 7.30 at the end of 2020. In consequence, export competitiveness lost through higher US tariffs will be partially recouped. We note that in the very near term the currency should appreciate to 6.75, after the truce reached in Osaka.

Finally, **the government deficit will be widened**, both on-balance-sheet – in its local government segment, funded by issuance of special bonds – and off-balance-sheet. The former should reach 5.1% of GDP this year vs the currently planned 4.1% of GDP, and 5.5% of GDP in 2020, while the latter will likely amount to about 6.0% of GDP and 6.5% of GDP, respectively.

As a result of such strong stimulus, GDP growth will remain in line with targets, and we keep our existing forecasts of 6.4% in 2019, with Q219 likely to see a cyclical bottom, and 6.0% in 2020. In addition, CPI inflation should rise to 2.6% this year due to a porcine disease, and to 2.4% next year on account of a weaker RMB – both below the government's 3.0% target.

Focus – China – US economic war to escalate

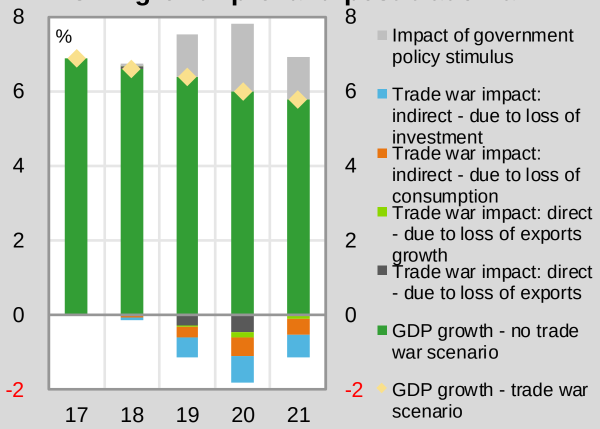
Our central scenario for the US–China trade war and a broader economic conflict is that a short-term de-escalation will take place following the meeting between Presidents Xi and Trump at the G20 summit in Osaka, including another attempt to negotiate a deal in an effort to appear responsible on the global stage and to try and extract concessions from the other side. However, we believe the efforts are likely to ultimately fail, and in the medium term (starting in Q419) the conflict will probably re-escalate, including through the US imposing a 25% tariff on most of the remainder of Chinese exports, with China retaliating via tariff and non-tariff barriers; we see a ~60% probability of such development.

The reason for our negative outlook is two-fold. First, historically, challenges to and changes in the position of a global hegemonic power have often been associated with a prolonged, multi-dimensional conflict, and the US–China relationship has in recent years followed the same pattern. Secondly, a total trade war appears to be less costly to both sides than accepting the demands of the opposition.

For China, while US demands regarding market access and intellectual property protection could largely be entertained, the demanded change in its development model based around subsidies for state-owned enterprises is unacceptable economically and politically. In the economic dimension, the resulting loss of GDP growth would be greater than what is likely as a result of all Chinese exports coming under a 25% US tariff. In terms of politics, the consequence would be a loss of much of the power base that the enterprises form for the Communist Party, which lies at the core of political stability.

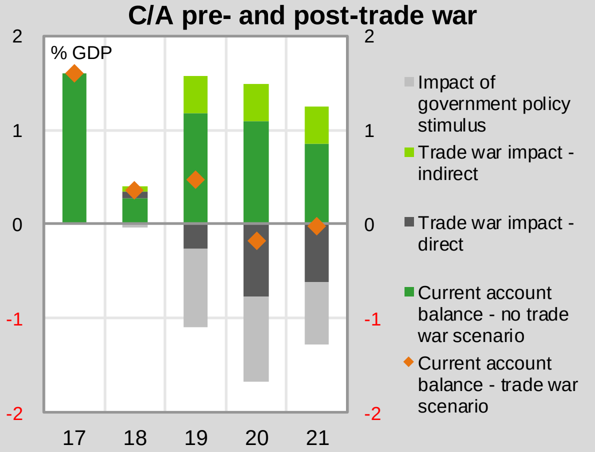
For the US, the unbalanced – to its disadvantage – relationship with China is resulting in continued losses in terms of exports, output, employment, fiscal revenues, investment and productive international assets, which outweigh the gains such as cheaper imports and Chinese demand for US Treasuries. Now that Washington has finally reached for tools that could rebalance the relationship – and given the bipartisan and broad-based nature of domestic support in favour of a tough stance vis-a-vis China – the Trump administration is unlikely to yield. It could do so only in the unlikely scenario of extreme political pain, such as through a loss of voter support due to a potential collapse of the equity market, which should be averted with Fed rate cuts.

GDP growth pre- and post-trade war



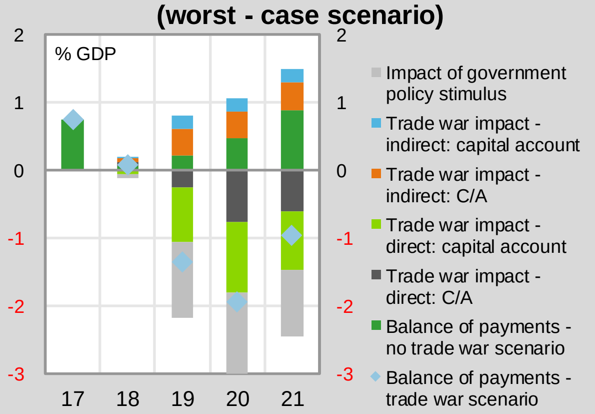
Source: Crédit Agricole CIB

C/A pre- and post-trade war



Source: CA CIB

BoP pre- and post-trade war (worst - case scenario)

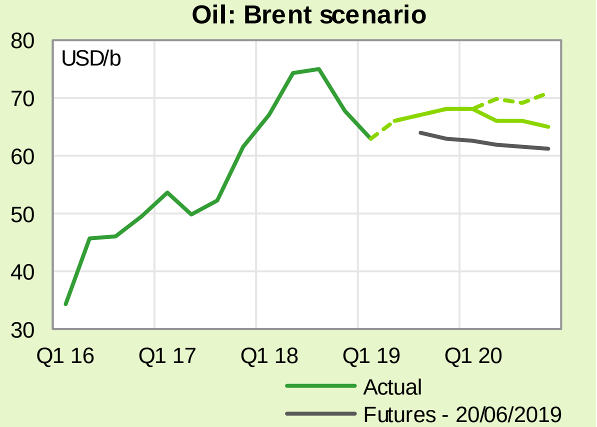


Source : CA CIB

Oil – Is there a captain aboard ship?

Faced with gale-force winds, the ship of oil is struggling to maintain its course. It will take a lot of skill on the part of duty officers such as Saudi Arabia to remain on course and steer the oil price between USD65/bl and USD70/bl – seen as a sort of "equilibrium price", and the price we have used in our scenario.

We may need to go back as far as the wars in Iraq to find an oil market subject to so much uncertainty. There is, of course, the geopolitical uncertainty embodied by the confrontation between Iran and Saudi Arabia, aided by the United States. At any time, the various sorcerers' apprentices (like Mickey Mouse in Disney's famous cartoon *Fantasia*) could lose control of events and trigger large-scale disruption to oil & gas supplies. The rate of growth in US oil production for 2019 and 2020 is difficult to estimate. Moreover, with the OPEC+ agreement on cutting production expiring in less than two weeks' time, OPEC and its allies are struggling to agree on a date for a meeting to extend the agreement signed last December. Then there is the hanging question as to how great US sanctions on Venezuelan oil production will be. Uncertainty around supply is also combined with that surrounding demand. It is extremely difficult to put a number on the impact of the US-China conflict, which we now assume to be a permanent feature, and which reverberates beyond the trade sphere alone. But the fall-off in growth (and the uncertainty around its extent) and demand will have a downside influence on oil prices. Conversely, although neutral in terms of global demand for oil, the new International Maritime Organization regulations on bunkering that come into force on 1 January 2020 should sustain oil prices in late 2019 and early 2020, in our view.



Sources: Thomson Reuters, ICE, CA S.A.

Our scenario is posited on an economic slowdown and hence lower demand in 2020. The impact of the drop in demand in 2020 will be partly offset by the new ship bunkering regulations. Governed or not by an agreement to cut production, we feel that Saudi Arabia will adjust its production so as to keep the oil price between USD65/bl and USD70/bl.

Monetary policy – Prevention at all costs

With the economic slowdown still in its infancy, it is first and foremost uncertainty that is prompting central banks to adopt a particularly accommodating tone. Action will come later. This preventive flexibility is easing the risk of a painful landing.

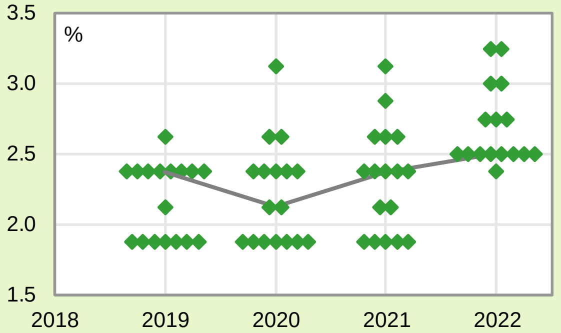
Fed: out of patience

We look for the FOMC to make two 25bp 'insurance' rate cuts in the second half of this year, most likely in July and September. The Fed, in our view, is ready to cut rates as trade tensions continue to lower growth prospects and inflation remains stubbornly low, suggesting a growth slowdown beyond the anticipated deceleration to 2% this year.

The June FOMC statement dropped references to Fed "patience" in determining future rate adjustments and noted increased uncertainty. **"In light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion..."**

We see this easing bias leading to rate cuts in Q3, as there was a substantial shift in the number of Fed officials in June looking to cut rates by year-end. While the Fed does not want to overreact, we believe that near-term economic and trade developments would have to be very upbeat to cause the Fed to delay supplying additional policy accommodation. Given the proximity of the lower bound, we see greater downside risk to the outlook from not cutting rates soon than from waiting.

FOMC June Fed funds projections



	2019	2020	2021	Longer run
Median	2,375%	2,125%	2,375%	2,500%
	+0bps	-25bps	+25bps	

Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run.

Source: Fed — Median projection

ECB: from Sintra with dove

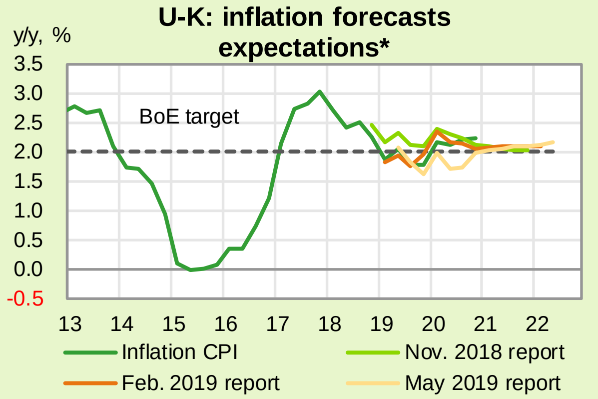
The accumulation of uncertainties and the materialisation of certain risks, as well as the flagging European economy – in an environment where European fiscal authorities continue to demonstrate their inability to deal with fragilities in a coordinated manner – **are once again forcing the ECB to intervene to safeguard the outlook for Eurozone inflation.** Whereas only a few months ago the ECB was moving towards a process of normalisation – for both its rates and its balance sheet – it is now ready to ease its monetary policy further. This was the meaning of Mario Draghi's speech in Sintra, confirmed by several members of the Governing Council.

Because of the deteriorating outlook and the ECB's commitment to addressing this, we are now expecting it to launch a new net asset purchase programme – both sovereign and corporate bonds – and to strengthen its forward guidance on rates and implement a tiered deposit-rate system. A rate cut does not seem to be on the cards at this stage but could be considered if the EUR were to appreciate too far. **Although the ECB does not seem to be considering doing so right now, we believe it will be necessary to ease the conditions for TLTRO III.**

Bank of England: against the flow, but not for long

Continued hawkish bias strains credibility. Despite the uncertainties surrounding Brexit, the increased volatility in UK growth and the moderate inflationary pressures, the BoE has maintained its relatively hawkish tone, repeating that CPI inflation should rise slightly above the 2% target in the medium term, assuming a key rate that moves in line with market expectations, ie, barely one rate increase over the next three years. Going against the flow of other leading central banks, the BoE is thus suggesting that it is still considering normalising its monetary policy, although at a very gradual pace and on a limited scale, despite the swelling downside risks to the outlook for growth, even though these were mentioned in the latest set of minutes (June).

Our Brexit scenario (no-deal avoided but prolonged uncertainty and a probable snap election towards year-end, requiring a further extension of Article 50) would have been compatible with a rate increase at the start of next year, if the global outlook were still favourable; but this is no longer the case. Expectations of a small-scale technical recession in the US in 2020 should prompt the BoE to revise its UK growth forecast down – at 1.6% in 2020 we felt that this was too high. **As a result, we are forecasting that rates will be kept unchanged this year and next, provided the UK does not crash out of the EU without a deal.**



* Based on market expectations of base rate and monetary policy measures announced
Sources: Quarterly inflation reports, Crédit Agricole S.A.

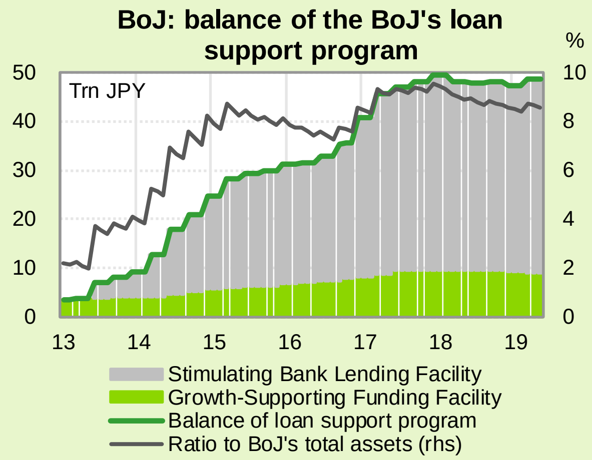
BoJ: to stay put unless USD/JPY approaches 100

We believe the BoJ will keep the current YCC (yield curve control) parameters intact, such as the targets for the IOER (-0.1%) and 10Y JGB yield (approximately 0%) as well as the allowed deviation of the 10Y JGB yield from the target (20bp upside and downside from the target).

However, it is obviously true that there is greater pressure on the BoJ now the Fed is getting ready for 'insurance' rate cuts. Even if the BoJ eases further, it has to tread a very narrow path between expected policy effects and the accompanying negative side-effects on the risk capacity of the financial system and the profitability of financial institutions.

While taking these negative side-effects into account, we can think of two tools for easing:

- ✓ To lower the rates applied to the Loan Support Program, under which the BoJ makes loans to banks at a low rate, currently 0%, based on the amount of increase in the balance of loans the banks have made. If the BoJ reduces this rate to a negative, it will not be as painful to banks as the negative IOER because such negative rates are applied to banks' liabilities, not assets. However, the problem is that the outstanding balance of this program has been flattish anyway, reducing any fundamental impact it could have.
- ✓ To increase the equity-linked ETF purchases by the BoJ. Indeed its impact on the appreciation of the JPY might be weaker than that of rate cuts, but it will come with fewer negative side-effects on the risk tolerance of the financial system and the profitability of financial institutions.



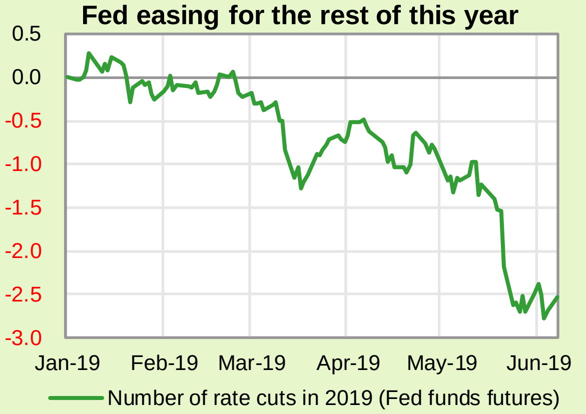
Sources: BoJ, CA CIB

Therefore, **in our baseline scenario we remain of the view that the BoJ will stay put but will increase its ETF purchases if the USD/JPY approaches 100 within the year**.

Interest rates – Central-bank concerns spook the market

While the prospect of lower and more uncertain nominal growth has already been floating in the air for several months, a persistently tense geopolitical climate and the sudden shift in monetary policy on both sides of the Atlantic have profoundly altered the prospect of a 'normalisation' in developed markets.

The market is pricing in aggressive Fed easing for the rest of this year



Sources: Bloomberg, Haver Analytics, CA CIB

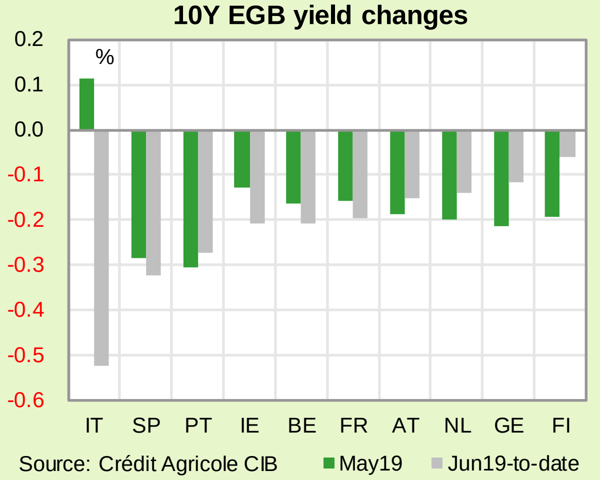
Change in vol surface over the past three months

3m Change, in basis points

	1Y	2Y	5Y	10Y	15Y	30Y
3M	+23.2	+19.7	+9.0	+5.2	+5.0	+1.2
6M	+22.4	+15.6	+7.8	+3.7	+3.7	-0.4
1Y	+15.6	+8.9	+3.4	+1.1	+1.1	-2.3
2Y	+3.2	+0.4	-0.1	-2.2	-3.6	-4.7
5Y	-2.6	-4.8	-4.7	-4.6	-5.4	-6.8
10Y	-3.9	-4.2	-3.9	-3.7	-3.0	-1.6
15Y	-1.3	-1.8	-0.8	-0.6	-1.0	+0.2

Sources: Bloomberg, Haver Analytics, CA CIB

10Y EGB yield changes



Source: Crédit Agricole CIB

US: low rates for longer

Based on the prolonged trade war and its negative impact on US consumer sentiment and business spending, we now project a mild recession next year. **The Fed is likely to respond with four rate cuts of 25bp each per quarter**, starting Q319, which would lower the upper bound of the fed funds rate from 2.50% to 1.50% by mid-2020.

Against this backdrop, we have revised down our 10Y Treasury yield forecast to 2.00% at end-2019. Under the forecast of a mild economic recession next year, we think the 10Y yield will probably decline further next year, towards 1.75%. With the pre-emptive Fed cuts, the recession will likely be shallow, as growth will probably resume by end-2020, in our view.

We are still leaning towards yield-curve steepeners, as the front end has room to outperform when the Fed starts cutting rates. However, given how much the curve has steepened, and the punitive carry in being long the front end, we took profits in a 5s30s yield curve steepener. Steepeners tend to perform best around the time of the first rate cut during an easing cycle.

In the past three months, volatility has jumped in the upper left side of the grid, as the Fed has shifted its rhetoric from being "patient" to closely monitoring the implications of the trade war for the economic outlook, and acting "as appropriate to sustain the expansion." This is a classic example of rising volatility during periods of heightened uncertainty. Vol has been directional with rates. When the market becomes volatile, lower rates tend to lead to higher vol, and vice versa.

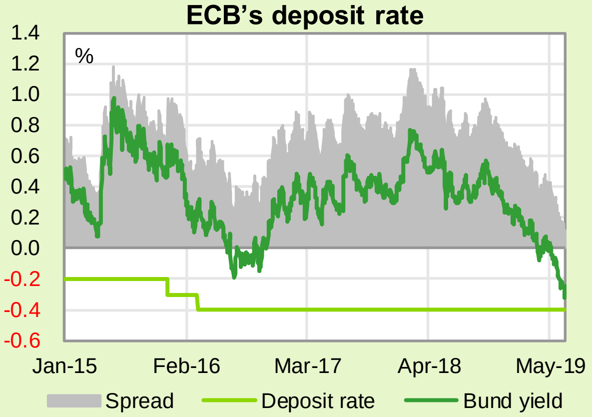
Eurozone: great expectations versus big threats

Making sense of rate moves

The market has been impacted by dovish central banks, which has pushed developed-market bond yields lower, many of which to record-lows – such as the Bund to within 10bp of the ECB's deposit rate. A sure sign of central banks' significant market impact is the outperformance of BTPs, as they would otherwise be weighed down by the likely commencement of the Excessive Deficit Procedure and the probable conflict between the government and the European Commission over next year's budget.

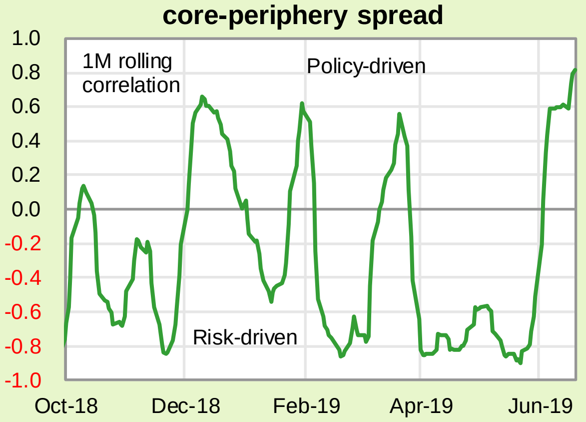
One way to illustrate to what extent the market has been driven by central banks' accommodative rhetoric in recent weeks is to observe the directionality of Eurozone government bond (EGB) spreads. Indeed, spreads and core yields tend to move in the same direction in a policy-driven regime, ie, 10Y Bund to all-time lows while the 10Y BTP-Bund spreads tightened to nine-month lows. However, if spreads and core yields were moving in opposite directions then it would likely reflect

10Y Bund yield versus ECB's deposit rate



Sources: ECB, Crédit Agricole CIB

10Y core yield vs core-periphery spread



Source: Crédit Agricole CIB

Spanish and Portuguese 2-30Y slopes

Source: CA CIB

a risk-driven environment; this was the case in April and May when political risk dominated the market's mind-set before attention switched to monetary-policy signalling by central banks.

What to expect in the coming months

In either policy- or risk-driven markets, core EGBs should continue to find support. That said, there is limited scope for Bund yields to fall further, although it is conceivable the 10Y can fall to within a handful of basis points of the deposit rate – as market pricing shows, expectations for this policy rate could be as low as -60bp within the next year.

We expect the low-for-longer ECB policy outlook, along with the possibility of additional stimulus measures later in the year, to continue encouraging investors to hunt for yield over the coming months –by increasing either their duration or credit risk exposures. Hence, flattening moves are likely for most EGB issuer curves, especially for non-core issuers like Spain and Portugal given their much improved fundamentals and reduced political risk. However, we are cautious on Italy due to likely fiscal-policy-related noise. We also think the environment is favourable for convergence among core EGBs, where, for instance, long-end Austrian and Finnish bonds have scope to tighten against neighbouring German and Dutch bonds.

Eurozone rates: lower for longer…tighter…and flatter

We have significantly revised our Eurozone rates forecasts, taking into account three key factors:

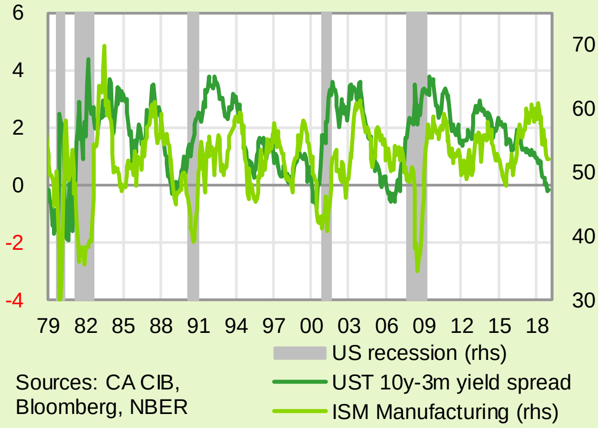
- ✓ **Economic risks are on the rise.** We do not expect any positive economic surprises in the coming quarter. The risk to global growth prospects is tilted to the downside. Eurozone inflation data will continue to indicate muted inflation pressures until at least end-2020.
- ✓ As hinted in the ECB's recent communication (in particular at the Sintra forum), **the central bank seems to be getting ready to act on the dovish side**. We expect the ECB to launch a 'QE2' in 2020, to strengthen its forward guidance on rates and to implement a tiered deposit-rate scheme, which would allow the ECB to cut rates (increasingly likely in our view).
- ✓ **Political uncertainty will persist after 2019.** Our central scenario for the US–China trade war and a broader economic conflict is a short-term de-escalation then a re-escalation in the medium term (starting in Q419). The likelihood of a no-deal Brexit has increased. The Italian fiscal outlook could be a source of noise in H219 (Excessive Deficit Procedure, credit reviews).

Concretely, we now see the 10Y Bund yield at -15bp by end-2020. This takes into account the likely **scarcity effect** due to the restart of an asset-purchase programme. We also believe that the search for yield will be further enhanced by this low-yield environment, resulting in flatter curves and tighter EGB spreads.

Exchange rates –Yield vs uncertainty

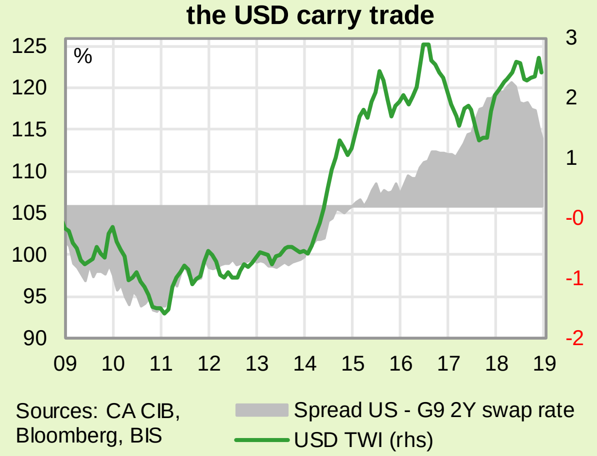
The erosion of its benefit in terms of yield seems likely to penalise the dollar. In the short term, however, European currencies, and first off the euro, are highly unlikely to benefit from this. We need to project ourselves into a more distant future before we can imagine a scenario where the euro will appreciate.

We expect a mild US recession in H2 2020…



Sources: CA CIB, Bloomberg, NBER

... To put an end to the USD carry trade



Sources: CA CIB, Bloomberg, BIS

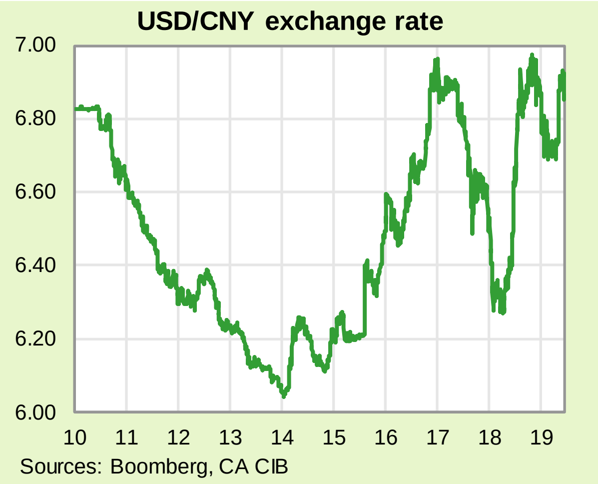
G10: policy convergence and the end of the USD carry trades

Since our last update in March, our economists have downgraded their projections for the global economy as it is battered by the intensifying headwinds of the global trade war, lingering geopolitical risk as well as the insufficient fiscal and monetary stimulus. In particular, our economists expect the European outlook to stabilise at a lower growth level, helped by the recently announced TLTRO III, further monetary stimulus from the ECB and the potential abatement of European political risks in coming months. Our ECB strategist expects that any new ECB accommodation would take the form of asset purchases rather than rate cuts. Monetary and fiscal stimulus should also help the Chinese economy cope with the headwinds from the trade conflict with the US.

In contrast, we now expect US growth to slow down significantly in H219 and the economy to slip into a mild recession in early 2020, on the back of the abating positive impact from fiscal stimulus, intensifying global economic headwinds, weaker domestic demand (business investment and consumer spending) and lingering political risk (a potential US government shutdown in Q419). In addition, our economists expect the Fed to cut policy rates twice this and next year, delivering a total of 100bp of monetary stimulus. This should trigger further convergence between US rates/yields and those abroad, especially as the likes of the ECB and the BoJ keep rates stable.

The cyclical and monetary policy convergence between the US and other G10 economies has been evident already in the considerable loss of rate advantage for USD across the G10. In our view, this will remain the key driver of the USD outlook in coming months and underpins our bearish outlook for the currency against JPY and gold. In addition, market risk sentiment should remain unstable due to geopolitical risk, the escalating global trade war and mounting evidence of a global growth slowdown. Against this backdrop, US and international investors will increasingly look to the Fed for support, given that the FOMC has the most firepower to respond to any spike in risk-aversion and thus any unwarranted tightening in global financial conditions. This should mute the appeal of the USD as a high-yielding safe-haven.

European G10 currencies like EUR and GBP may be less able to outperform the USD for the time being despite the widening EUR-USD and GBP-USD rate spreads. This is because further escalation of the political risks related to Brexit and, to a lesser degree, Italy could continue to weigh on the outlook for the currencies for most of H219. In particular, we think that the UK will come close to 'accidentally' tumbling out of the EU without a deal in October. We further expect that the tensions between Italy and the EU will linger well into Q419. In the case of the EUR, we think that the growing evidence of the 'Japanification' of the Eurozone could keep domestic investors invested abroad for longer, using EUR as a funding currency.



Further out, we see European G10 currencies as the relative outperformers over the next 6 to 12 months as Fed rate cuts and abating European political risks encourage the unwinding of USD carry trades funded in EUR and CHF. However, we continue to see CHF underperforming EUR. This is because CHF remains very overvalued, and the SNB should continue to follow the ECB if the latter introduces any further easing measures in the future.

NOK and SEK should outperform EUR on the back of central-bank policy normalisation (NOK) and overvaluation correction. Elsewhere, we remain less constructive on AUD and NZD as we expect the negative FX impact from the escalating conflict between the US and China to be compounded by further policy easing by the RBA and the RBNZ. Last but not least, we expect CAD, similar to NOK, to remain a relative outperformer among the G10 commodity-bloc currencies. This reflects our expectation of a renewed recovery in oil prices as well as the view that the BoC and in particular the Norges Bank will continue to buck the recent dovish trend among most other G10 central banks.

EM currencies: lower US rates vs difficult global economic times

We expect the **EM currency outlook to be shaped by one main positive factor and three negative ones**. On the positive side, **lower US rates & yields and the ECB's more dovish tone may keep some EMs in the spotlight, because of their carry-attractiveness**.

However, on the negative side, **the US slowdown beginning in Q419 and continuing into next year** (our US economist forecasts a light recession in 2020) should cap investors' appetite for EMs that are strongly focused on exports or on the tech sector. Also, in the context of escalating tensions between the US and China, **we have downgraded our CNY forecast** and now expect it to depreciate vs USD particularly in Q419 and into next year. This would make it difficult for other EM currencies (Asian currencies in particular) to appreciate.

In addition, **some currencies remain penalised by idiosyncratic challenges**. In this regard, in addition to ARS, the TRY continues to stand out. Even if the Turkish current account has narrowed significantly, the backdrop may become more difficult at the end of the year as domestic demand regains momentum, possibly at the expense of external imbalances.

Economic and financial forecasts

Interest rate

		2-Jul	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
USA	Fed funds	2.50	2.00	2.00	1.75	1.50	1.50	1.50
	10Y	1.99	2.05	2.00	1.85	1.75	1.80	1.90
Eurozone	Repo	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	10Y (Germany)	-0.36	-0.30	-0.25	-0.25	-0.20	-0.20	-0.15
10Y Spread vs. EUR	France	0.31	0.25	0.25	0.25	0.20	0.20	0.20
	Italy	2.23	2.80	2.80	2.60	2.40	2.30	2.25

Exchange Rate

USD Exchange rate Industrialised countries		2-Jul	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Euro	EUR/USD	1.13	1.12	1.14	1.16	1.18	1.20	1.21
Japan	USD/JPY	108.07	106.00	105.00	104.00	104.00	102.00	100.00
United Kingdom	GBP/USD	1.26	1.24	1.27	1.30	1.33	1.36	1.38
Switzerland	USD/CHF	0.99	1.02	1.01	1.00	0.98	0.98	0.97
Asia								
China	USD/CNY	6.87	6.95	7.05	7.15	7.20	7.25	7.30
Hong Kong	USD/HKD	7.80	7.81	7.80	7.80	7.80	7.80	7.80
India	USD/INR	68.89	71.00	71.75	72.50	73.25	74.00	74.75
South Korea	USD/KRW	1165	1195	1200	1210	1210	1220	1210
Latin America								
Brazil	USD/BRL	3.86	3.70	3.75	3.85	3.90	3.90	3.95
Mexico	USD/MXN	19.07	19.75	20.00	20.50	20.75	20.75	20.75
Emerging Europe								
Poland	USD/PLN	3.76	3.82	3.75	3.69	3.63	3.54	3.50
Russia	USD/RUB	63.31	63.50	63.00	63.00	63.50	64.00	64.50

Commodities

		2-Jul	2019		2019			
Precious metals			Q3	Q4	Q1	Q2	Q3	Q4
Gold	USD/oz	1,398	1,420	1,420	1,430	1,450	1,450	1,480

		2-Jul	2019		2020			
Av. quarter price			Q3	Q4	Q1	Q2	Q3	Q4
Brent	USD/BBL	63	67	68	68	68	66	65

Economic Forecasts

	GDP (yoy, %)			Consumer prices (yoy, %)			Current account (% of GDP)		
	2018	2019	2020	2018	2019	2020	2018	2019	2020
United States	**2.9**	**2.5**	**0.9**	**2.4**	**1.6**	**1.7**	**-2.4**	**-2.6**	**-2.6**
Japan	**0.8**	**0.9**	**0.7**	**0.8**	**0.8**	**1.0**	**3.5**	**2.9**	**3.3**
Eurozone	**1.9**	**1.2**	**1.2**	**1.8**	**1.1**	**1.1**	**3.3**	**3.2**	**3.1**
Germany	1.5	0.7	1.0	1.9	1.3	1.4	7.3	7.1	6.9
France	1.7	1.4	1.3	2.1	1.2	1.2	-0.3	-1.0	-1.0
Italy	0.7	0.2	0.4	1.2	0.6	0.6	2.5	1.8	1.8
Spain	2.6	2.3	1.9	1.7	0.7	0.8	0.9	1.8	1.7
Netherlands	2.6	1.5	1.4	1.6	2.5	1.5	9.8	9.8	9.9
Other advanced									
United Kingdom	1.4	1.4	1.2	2.5	1.9	2.0	-3.9	-5.3	-5.0
Canada	1.8	1.5	1.8	2.3	1.7	2.0	-2.8	-2.6	-2.5
Australia	3.2	2.8	2.7	2.2	2.3	2.5	-2.8	-3.1	-3.0
Switzerland	2.5	1.7	1.6	0.9	0.9	1.0	10.0	9.8	10.0
Asia	**6.0**	**5.7**	**5.6**	**2.4**	**2.6**	**2.7**	**0.9**	**0.9**	**0.5**
China	6.6	6.4	6.0	2.1	2.6	2.4	0.4	0.6	-0.2
India	7.1	6.8	6.9	3.6	3.4	4.0	-1.8	-2.0	-1.8
South Korea	2.6	2.1	2.2	1.6	1.0	1.3	4.5	4.3	4.0
Latin America	**1.2**	**0.9**	**1.7**	**9.4**	**8.3**	**6.9**	**-1.8**	**-1.6**	**-2.0**
Brazil	1.1	0.9	2.0	3.7	3.6	3.7	-0.8	-1.0	-1.8
Mexico	2.0	1.0	0.8	4.4	3.6	3.5	-1.5	-1.6	-2.0
Emerging Europe	**3.0**	**1.8**	**2.3**	**6.5**	**6.7**	**5.7**	**1.3**	**1.7**	**1.0**
Russia	2.3	1.6	1.8	4.3	4.9	4.0	5.0	4.5	3.5
Turkey	2.7	-1.3	2.0	16.5	16.5	14.5	-3.6	-0.3	-1.4
Poland	5.1	4.7	3.8	1.6	2.2	2.0	-0.7	-0.6	-1.0
Africa, Middle East	**1.1**	**0.6**	**1.7**	**9.5**	**10.0**	**7.2**	**2.7**	**1.9**	**2.0**
Saudi Arabia	2.2	1.6	1.9	2.5	0.0	2.0	9.1	7.9	7.3
United Arab Emirates	1.7	2.2	2.2	3.6	0.5	2.0	9.1	7.3	7.3
Egypt	5.3	5.3	5.4	15.0	13.0	10.0	-2.0	-1.9	-1.1
Morocco	2.8	2.8	3.1	1.8	1.0	2.0	-5.5	-4.5	-3.6
Total	**3.4**	**3.0**	**2.8**	**3.6**	**3.4**	**3.0**			
Advanced economies	**2.2**	**1.8**	**1.1**	**2.0**	**1.4**	**1.5**			
Emerging countries	**4.4**	**3.9**	**4.1**	**4.8**	**4.9**	**4.2**			

Public accounts

	Government balance (% of GDP)			Public debt (% of GDP)		
	2018	2019	2020	2018	2019	2020
United States	**-3.9**	**-4.7**	**-5.2**	**77.5**	**78.9**	**81.3**
Japan	**-4.5**	**-3.7**	**-2.7**	**238.8**	**237.6**	**235.4**
Eurozone	**-0.6**	**-0.9**	**-0.7**	**87.4**	**86.0**	**84.9**
Germany	1.7	1.2	1.0	60.9	58.3	56.3
France	-2.5	-3.1	-2.0	98.4	98.9	98.7
Italy	-2.1	-2.1	-2.6	132.2	132.5	133.4
Spain	-2.5	-2.3	-2.0	97.1	96.4	95.6
Netherlands	1.5	1.2	0.8	52.6	49.1	47.3
Belgium	-0.7	-1.2	-1.4	102.0	100.7	100.0
Greece	0.4	0.2	0.2	176.2	170.5	165.5
Ireland	0.3	-0.3	0.3	64.2	61.9	59.0
Portugal	-0.5	-0.4	-7.4	121.5	119.8	117.3
United Kingdom	**-1.9**	**-1.5**	**-1.3**	**86.5**	**84.7**	**83.2**

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