BBVA Research

Global Economic Risk Outlook

1Q19

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Creating Opportunities

Sharp activity corrections in the US and China as main global risk events

- The **balance of global risks has deteriorated during the last quarter** on the back of mounting factors affecting, simultaneously, the main economic blocks (see Box. *Higher uncertainty: are we poised for a bumpy road ahead?*). Although we **keep unchanged the set of potential global risk events**, our assessment about their **likelihood** in the short-medium term **has experienced some tweaks**.

- In particular, **the risk of a cyclical recession in the US has gained relevance**. The probability that a full-employment economy enters a slowdown phase increases in the absence of effective expansionary supply-side measures. Traditional predictors of recession show a higher likelihood in the short term in a context of significant political and economic policy uncertainty, as well as concerns on corporate leverage.

- **The risk of a disorderly deleveraging in China remains high, even with a certain upside bias.** A flagging growth and increasing doubts about the size of the current slowdown coexist with a growing debt overhang -amidst further “targeted” monetary and fiscal stimulus- and intense financial pressures on the corporate sector.

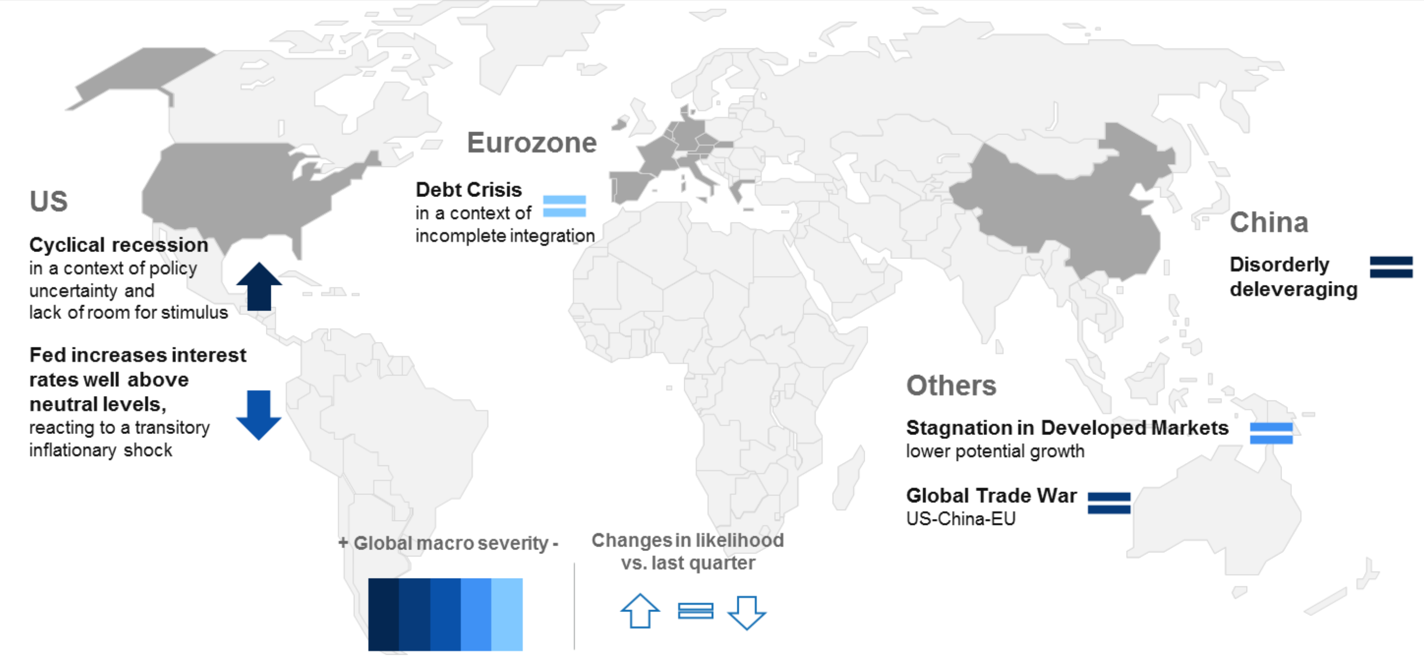
- With regards to the **global trade war**, it **continues to be a risk event** with a similar probability than one quarter ago, **despite the relatively more favourable climate in the trade talks** between the US and China. Crucial issues related to intellectual property (technology), foreign investment and Chinese policy subsidies to strategic sectors remain unresolved and could hinder the signing of a final trade agreement. The potential imposition of tariffs on the European automotive sector by the US is still a source of concern.

- We **continue to monitor a potential debt crisis in the Eurozone as a risk scenario** due to the persistence of high uncertainty on *Brexit* and the fragmented political and policy spectrum in some countries. The elections to the European Parliament in May constitute also an instability factor.

- Finally, **the recent change in the Fed’s tone** -towards a more dovish and data-dependent stance- points out a pause in the path of hikes, which **lowers the probability of overshooting** (rates above neutral levels).

- **No changes** in our assessment about a structural risk event of a future **stagnation of Developed Economies**.

Main global macro-financial risks (*) to the global economy (severity in terms of global macroeconomic impact)
Click here for a complete definition of each risk event



(*) Currently perceived as feasible by market participants and economic observers that could generate a sizable deviation from our baseline scenario. Though these are usually events of low-mid probability, their feasibility and adverse effects are large enough to require monitoring. Source: BBVA Research

US cyclical recession amid policy uncertainty and lack of room for stimulus

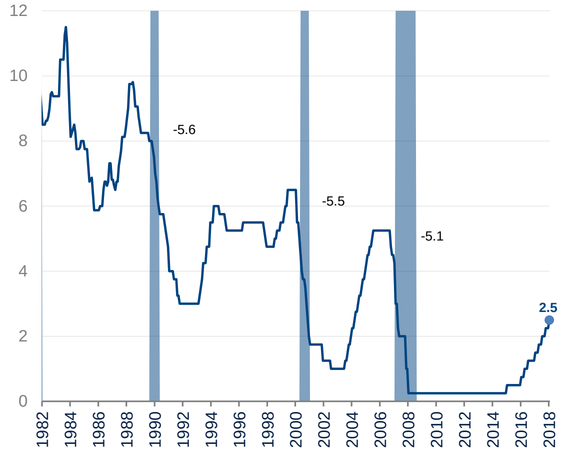
Fears of a recession in the US flooded the markets during the last quarter of 2018 **with no signs of disappearing in the short-term**, especially once the effects of fiscal stimuli wear off. The likelihood that a full-employment economy enters a slowdown phase increases in the absence of effective expansionary supply-side measures aimed at promoting productivity. Hints of an inverted yield curve are usually interpreted as the onset of a recession, which can create a negative feedback loop on the cycle health, limiting private spending and precipitating the adjustment.

In this particular episode, moreover, **there are several aggravating factors: political and policy uncertainty** (trade disputes and the deterioration of the US relations with its main allies intertwine with domestic political controversy) **and high corporate leverage** (focus on high yield credit). **The lower margin of manoeuvre from monetary policy** (average Fed funds rate cuts during a downturn is close to 5pp, twice than the current level), **along with fiscal constraints**, **would exacerbate the negative effect** of an economic slowdown on private sector expectations, taking its toll on domestic demand. Besides, some recent studies[1] suggest that **the duration of the current expansion** (2nd since 1947) **could bring around greater job destruction to those activity sectors that have accumulated most mismatches** (in terms of skills), aggravating the severity of the slowdown.

Some widely known **recession probability models based on the slope of the yield curve** (New York Fed) **place this probability close to 20% in the next 12 months**, which is higher than the threshold at which the model signals the onset of a crisis. **These figures**, though, **should be nuanced** given the downside pressure exerted by the high preference for 'safe-haven' assets on the long-term rates (negative term premium). In this spirit, we have carried out **a counterfactual analysis through a modified curve slope**[2], only taking into account the ACM risk-neutral component (yield slope excluding term premium component), which **confirms that this probability has been increasing during the last year, but it is far from its own threshold** (Figure 2).

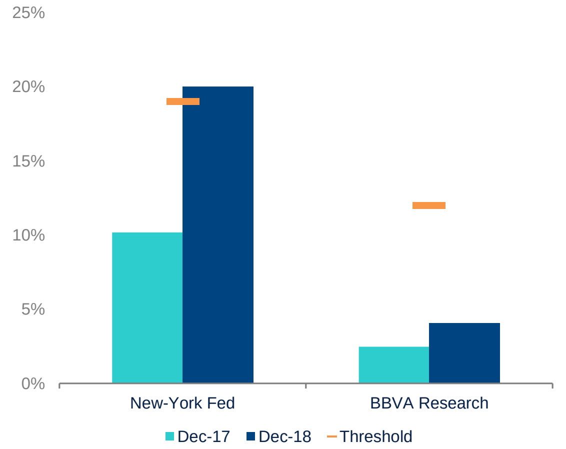
The lower global demand caused by the US slowdown would translate into a fall in world trade and a sharp correction in commodity prices, increasing financial volatility. The preference for safe-haven assets would coexist with bulky capital outflows from Emerging Markets (EM), higher sovereign risk premia and currency depreciations. The macroeconomic impact would be more severe in those economies with higher trade openness (specifically, greater exposure to the US) and dependence on exports of raw materials. Against this backdrop (deflationary pressures), monetary stimuli by Developed Markets (DM) central banks would partially contain the tightening of funding conditions, providing EM central banks some leeway for gradual interest rate cuts in the mid-term.

Figure 1 Fed funds reduction after a US downturn and current levels (shaded areas indicate recessions), %



Source: Federal Reserve Bank of New York and BBVA Research

Figure 2 One-year-ahead recession probability for the US Based on New York Fed data for Treasury curve decomposition



Source: Federal Reserve Bank of New York and BBVA Research

1 "A Forest Fire Theory of Recessions and Unemployment" (2014)
2 The predictive power of the modified curve slope remains unchanged when only accounting for the risk-neutral component albeit with a lower threshold.

A disorderly deleveraging process in China

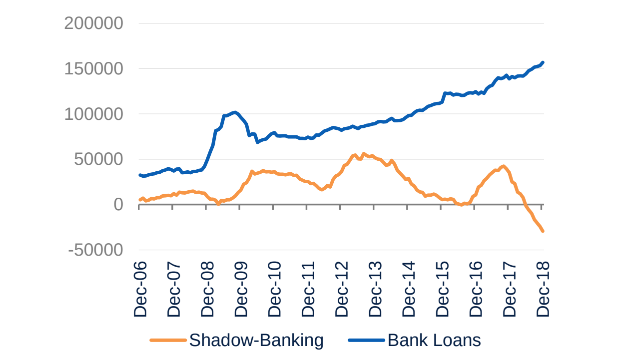
Increasing doubts on the intensity of the economic slowdown kept the downward pressure across Chinese financial assets in 2018. Equity prices registered the highest correction among the main world indices and the renminbi extended its depreciation, **despite the size of stimulus adopted** to tackle the activity adjustment (mainly, 'targeted' liquidity injections to SME, cuts in reserve requirement ratio and fiscal support via infrastructure investment and tax cuts). The effective liquidity injected by the PBOC for lending accounts for ca. 3% of GDP since the start of 2018, while the estimated size of tax cuts rises to 1.2% GDP.

A flagging growth –visible also in household expenditure indicators–, amidst protectionist tensions and high levels of private debt seem to be the inception point of this financial instability episode. On the latter, the authorities have been implementing a series of policies aimed at curbing the rise of corporate debt, among which the **shutdown of shadow banking activities in favor of traditional banking** stands out (Figure 3). According to the latest data from the BIS, the private sector debt receded slightly in 2Q18 (205.5% of GDP, -0.3 points with respect to the previous quarter), driven by the corporate sector (-2 points); however, this subtle improvement has not offset the spike experienced in 1Q. In fact, other credit **measures such as the total social financing do not show relevant signs of deleveraging at the end of the year** despite the moderation in the pace of credit growth (Figure 4).

Several **risk factors** could pose a threat to an orderly deleveraging process assumed in our baseline scenario. The **banking system has not fully absorbed the bulk of debt from shadow-banking**, given higher regulatory pressures. This could generate a negative loop on the economy through constraints to roll over debt, increasing the risk of **corporate defaults** (30% of listed private enterprises do not generate enough profits to cover their interest expense), and lower fixed investment decisions. Besides, the pronounced **downturn in stock prices** may exert some pressure on equity-backed loans (15% of private enterprises use these instruments as funding collateral). Lastly, the ongoing **upward trend in household and local public debt** puts further hurdles in the way. Metrics frequently used to measure buffering capacity in the face of a financial shock (reserves to M2 or fiscal space) have continued to deteriorate. Thus, **early-warning banking crisis models keep China in a high risk zone**[3].

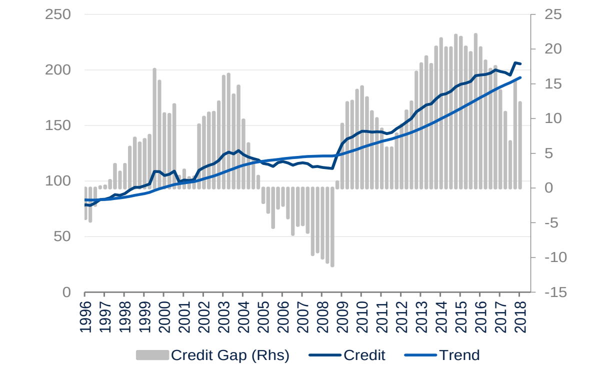
To sum up, **the risk of a disorderly deleveraging event remains on the center stage, even with an upside bias.** The contraction of Chinese demand would drag down global trade and commodity prices, conjuring up recent episodes of financial stress in China (summer 2015, Jan-2016), while a global risk re-pricing would increase EM risk premia. The macroeconomic impact would be more severe for economies more open to world trade, particularly those highly dependent on commodity exports. For net commodity-importers, the fall in prices could cushion the recessionary effect and create certain deflationary pressures. The impacts on DM would be greater than expected due to the lower room for maneuver to adopt counter cyclical policies. DM would resort to accommodative monetary policies whereas EM would raise rates, in the short term, to contain capital outflows.

Figure 3 China: 1-year accumulated flow of financing operations. 100 Mil Yuan



Source: Haver Analytics and BBVA Research

Figure 4 Non-financial private sector debt in China (% GDP and deviation points), 2Q18



Source: BIS, Haver Analytics and BBVA Research

3 https://www.bbvaresearch.com/en/publicaciones/country-risk-quarterly-report-fourth-quarter-2018/

Global trade war involving US, China and EU

The **temporary trade truce between the US and China**, reached in December of 2018, **brought a temporary relief** to the protectionist turn. The decision of holding off on imposing additional tariffs on goods for 90 days was taken in a context of increasing signs of slowdown in China and concerns on the US cycle. However, the dissent among the parties involved in ongoing negotiations, mainly from the US side, keep the level of uncertainty at high levels, jeopardizing the possibility of a definitive agreement that would avoid further escalations.

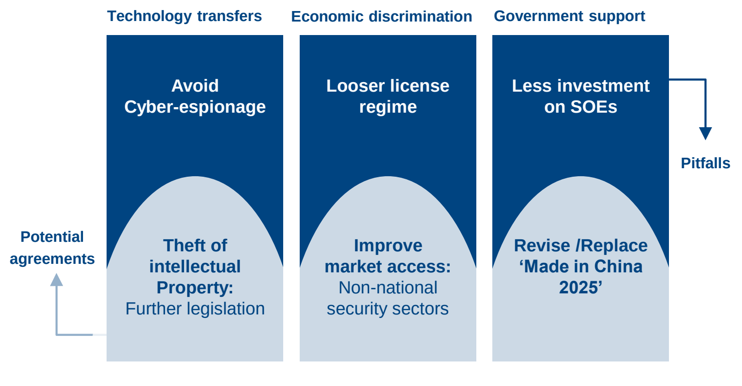
Even if both countries managed to reach a trade deal, other structural issues, crucial for the US-China relationship in the medium term, continue to be unresolved (Figure 5). The US is focusing its demands on deepening economic reforms, addressing key themes such as the **protection of industrial property**, the interference by the Government in the operations of **foreign direct investment** or the **policy of subsidies to strategic industrial sectors** (energy, transport, metals, etc.). Although China has taken some steps in this direction in order to smooth the trade talks (for example, with the intention to approve a new foreign investment law in March), the level of uncertainty remains high (Figure 6), which may, in turn, hamper the resolution of trade negotiations. **With regards to the EU, the discussion about the imposition of tariffs on automotive sector**, in the event that Europe rejects further opening of its markets to US companies, **is still open**. Hence, protectionist measures affecting this sector (relevant for Germany or France) should not be ruled out.

All in all, **a trade war involving the main economic blocks** (sharp increases of tariffs and strong retaliation would shatter the reduction of bilateral trade costs registered since the 1990s) **needs to be monitored as a key global risk event despite the certain improvement in the US-China relations**.

China would be one of the most affected countries, not only due to the relapse of the external demand but also the deterioration in the confidence and financial channels (capital outflows, currency depreciation and higher risk of a disorderly deleveraging), driving the global economy into a slowdown. **Rising costs would also hurt the US and the EU, although to a lesser extent**, if a given import substitution effect takes place. **The negative impact on certain sectors or regions, however, could be remarkable**, especially on those more exposed to the high trade interconnection between the US and the EU (e.g. automotive).

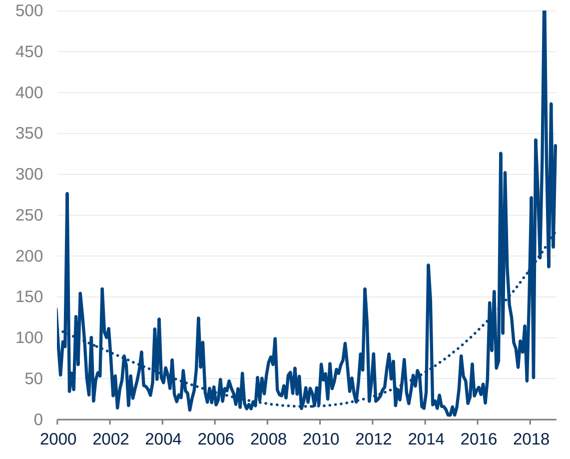
Therefore, global trade would see a major relapse, forcing countries to reassess their role on current global value chains and players would shy away from investment, whereas commodity prices would experience a sharp correction due to the demand effect. From a financial standpoint, such an environment of heightened uncertainty would transmit across the markets through higher volatility and a sell-off of risk assets. EM would suffer both from the real channel and from tighter funding conditions (appreciatory pressure on the USD and EMBI spread rebound). A delay in the monetary normalization in DM would be expected. It is worth highlighting that such a negative environment may be long lasting given the difficulty to rearrange production. **The costs of transition to a less cooperative environment would not be negligible either in the long term.**

Figure 5 Summary on US position regarding trade negotiations with China



Source: BBVA Research

Figure 6 US, Economic Policy Uncertainty on Trade Policy (1985-2010 average=100)



Source: http://www.policyuncertainty.com (Baker, Bloom and Davis)

Eurozone debt crisis in a context of incomplete integration

The 'ghost of debt' haunted once again European bond markets in the last quarter of 2018. This time, the trigger emerged from Italian Government's reticence to trim its budget deficit target for 2019 and the consequent European Commission reaction (risk of sanctions under the start of an Excessive Deficit Procedure). Peripheral risk premia, especially in **Italy**, rose sharply at the beginning of October, remaining at high levels until the end of the year. In January, Italy managed to reach an agreement to reduce its deficit target, relieving financial pressures. However, the elephant in the room is still there. Beyond the **uncertainty on the political front** (stability of the Government coalition) and economic policy decisions (margin to comply with deficit targets without compromising electoral measures of higher social expenditure), **concerns on the health of the banking sector** remain in the spotlight **in a context of sluggish growth** (technical recession) and lower support from ECB debt purchases.

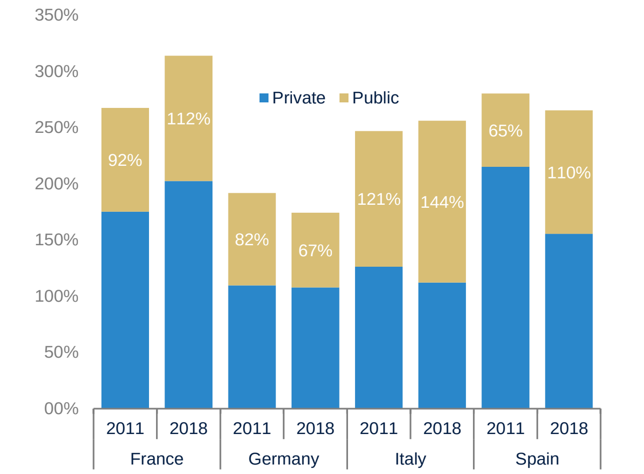
In **Spain**, the hurdles that the Government is facing to approve the Budget and tackle regional conflicts raise the likelihood of General elections, with the perspective of a more fragmented Parliament. The potential deviation from the deficit targets, as well as the reversal of certain structural reforms and the impact of measures already adopted on employment (minimum wages rise, for example), constitute another source of concern.

In this challenging environment, **hopes of further European integration have proven elusive** after the last European Council. The discretionary fiscal boost adopted by the French Government to quell the protests caused by the *gilets jaunes* has also contributed to put the credibility of the European agenda at risk. The **Brexit conflict** is another spot of instability for the Eurozone, both in the short term if the exit is not managed successfully, and in the mid-term given the uncertainty about its impact on the European Single Market.

All in all, **the risk of a broad resurface of debt sustainability concerns in peripherals remains relatively high** (Figure 7), coexisting with a less favorable economic environment, the withdrawal of government debt purchases by the ECB and a **potential upsurge of populist parties in the European parliamentary elections in May.**

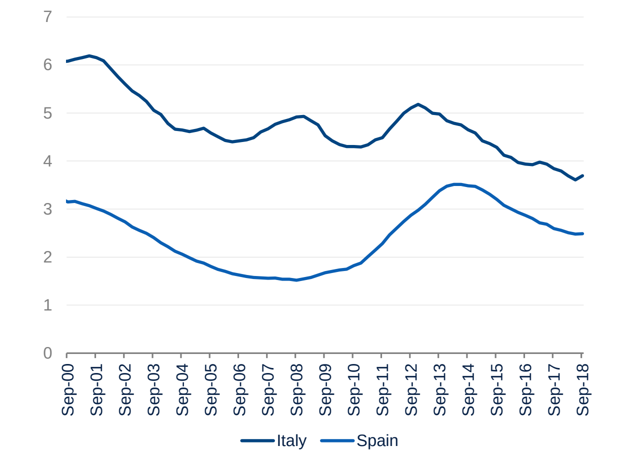
The main channel of contagion would arise from a sharp deterioration in funding conditions, exemplified by the rebound of peripheral sovereign long-term spreads and a negative feedback loop between banks and the real economy (liquidity tensions, credit crunch), all of it with spillovers on global financial volatility. Although the ECB would keep its current stimulus programs, their effectiveness would be lower than in the past (lower margin to surprise markets). Global trade and commodity prices would see a reduction due to subdued demand growth in the Eurozone. From the financial side, Germany would act as a 'safe-haven' (10y yield around 0%) and the euro would depreciate sharply. It is important to highlight that this risk scenario assumes that the mentioned concerns would be short-lived as long as Governments adopt a more prudent fiscal behavior and advance towards further integration (European budget, bonds with common guarantee, compensatory funds, etc.).

Figure 7 Total non-financial debt (% of GDP,2Q18)



Source: Haver and BBVA Research

Figure 8 Interest payments on General Government Debt (% of GDP)



Source: Haver and BBVA Research

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Fed increases interest rates well above neutral levels, reacting to a transitory inflationary shock

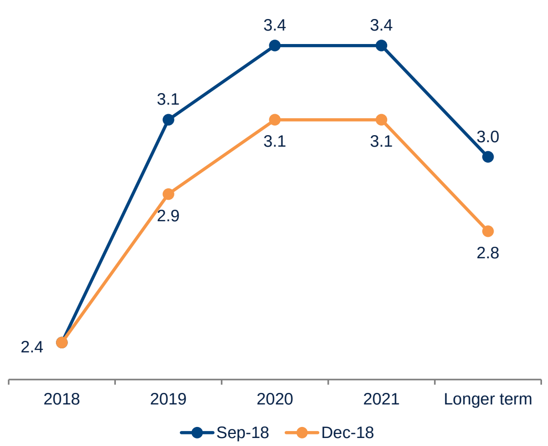
The tightening of funding conditions that brought along the financial markets sell-off at the end of the 2018 led **investors to rearrange their expectations for *fed funds* to the downside**, suggesting that the actual level of interest rates (2.5% after December hike) would be much closer to the neutral level (the rate at which real GDP is growing at its trend rate and inflation is stable) than previously anticipated. Indeed, ***fed funds* futures have discarded additional hikes this year, even pricing an interest rate cut with a significant probability**.

This market reaction was seconded by **the downward update of FOMC dots** (Figure 9) and the **recent cautious stance from the Fed's members**, in particular, from Powell. The **U-turn in the Fed's guidance** has coexisted with a more worrisome outlook for the US economy (political uncertainty is an issue) and the **emergence of "cross-currents" deteriorating the global outlook**, especially as a consequence of a lower demand from China and Europe amidst the trade conflict. Besides, the effect of accumulated rates hikes on the real economy may still be brewing and could filter to the domestic financial conditions with a certain delay. Lastly, **the Fed's shrinking balance sheet is prone to generate financial volatility** along the way, given the high uncertainty on the effects of the Quantitative Tightening: the inherent reduction of bank reserves could restrain short-term lending activity, mainly in repo and commercial paper segments. In this sense, the Fed has confirmed that it would be willing to take its balance sheet reduction policy off autopilot if conditions warranted.

In addition, **fears of an abrupt rise in inflation continue to be limited** due to both transitory forces (reduction in oil prices) and more structural ones, such as the absence of relevant wage pressures coming from the slack in labour market (a flattening Phillips curve). Hence, **the probability that the Fed decides to increase rates well above neutral levels is now lower than one quarter ago**. In any case, this source of risk should not be ruled out yet, pending to see how the first half of 2019 unfolds in terms of trade disputes and domestic cycle. Moreover, the Fed may be tempted to keep raising interest rates in order to have room for manoeuvre in the next recession or to increase real interest rates (slightly above 0%), hindering the generation of financial bubbles.

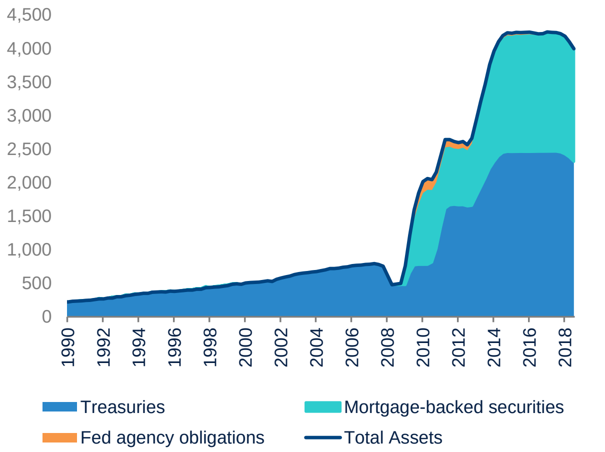
If this event were to materialize, the tightening in funding conditions, exacerbated by the stock markets correction, could catch many investors off guard, provoking a sharp financial shock which would impact on the US through higher costs of funding and financial wealth losses. The combination of lower GDP growth in the US and financial constraints would hurt global trade and commodity prices in the short-term. EM central banks would be forced to increase interest rates (following the Fed's tightening path) to contain capital outflows and anchor inflation pressures. Unlike in the aforementioned risk scenarios (more recessive), the pass-through effect would be higher in this case: the effect of currency depreciations would not be offset by the drop in demand. As regards the Eurozone, the ECB would keep its normalization path, but delaying the first interest rate hike due to the financial turmoil.

Figure 9 FOMC's dot plot: median of projections for fed funds (%)



Source: Bloomberg and BBVA Research

Figure 10 Fed's balance sheet: assets. USD billion



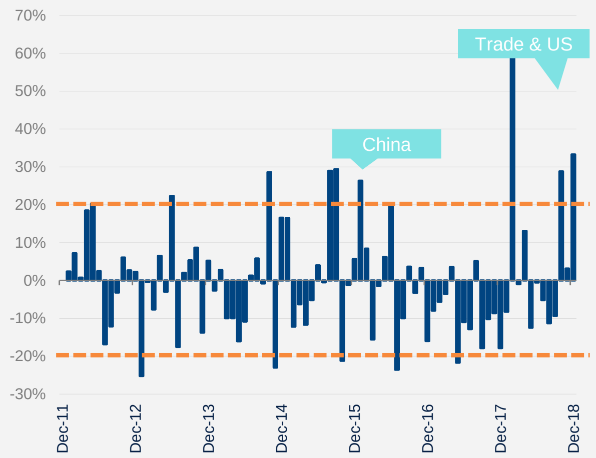
Source: Haver and BBVA Research

Box. Higher uncertainty: are we poised for a bumpy road ahead?

The accumulation of the aforementioned risk factors leaves behind a more uncertain economic outlook in the mid-term. The increase in financial volatility observed throughout 2018 is a reflection of this unstable environment. According to our analysis, much of this surge is not directly related to the observed slowdown in the global economy cycle, but rather to alternative uncertainty shocks that partially capture markets concerns.

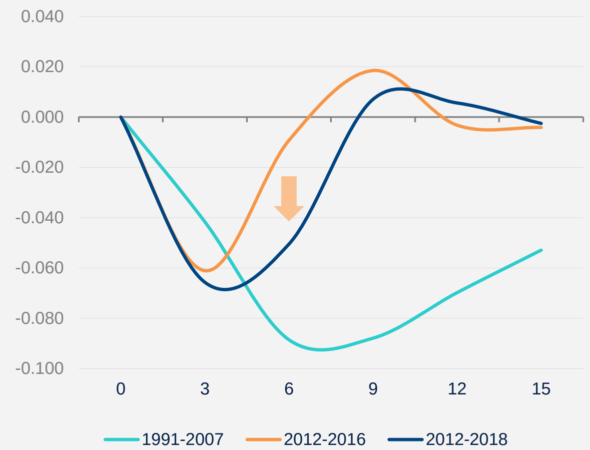
In fact, these kind of shocks (which are, by definition, uncorrelated with the observed global activity records) were the largest since the Global Financial Crisis (GFC), surpassing those seen in 2015-16 related to the episodes of financial stress in China (Figure 11). Although their impact on economic growth is less persistent than before the GFC (Figure 12), largely due to the role still played by central banks (provision of liquidity and slow normalization of rates), **the main risk lies in the high frequency that these shocks are acquiring, which increases the probability of attending an environment of higher financial volatility and lower growth throughout 2019**. Especially, if we bear in mind that the spots of risk that are generating greater uncertainty have no prospect of being resolved in the short term and are highly unpredictable: protectionism and political instability (in the US, China and Eurozone).

Figure 11 Uncertainty shocks unrelated to economic activity on VIX (% immediate change in VIX)



Source: Haver Analytics and BBVA Research

Figure 12 Effect on global GDP (pp, QoQ) of a transitory increase in VIX (average shock = +12%) due to alternative uncertainty shocks. Horizontal-axis: quarters



Source: BBVA Research

Methodology

We compare the results from three estimates of the same Vector Autoregressive Model (VAR) formed by the logarithm of the VIX and world growth. The first estimate uses the pre-crisis sample (1991-2007) and the other two the post-crisis sample (2012-16 and 2012-18). The residuals of the estimates are broken down into two types of shocks: uncertainty fluctuations caused by economic activity shocks and “other uncertainty shocks” (their orthogonality is guaranteed by the orthogonality of the residuals of the two estimated VARs). The exercise consists in comparing the impulse responses of these three VAR models.

- Lags: in accordance with AIC (Akaike Information Criterion)
- Frequency: monthly
- Endogenous variables: logarithm of the VIX, QoQ growth in world GDP (BBVA-GAIN)
- Source of data: VIX (CBOE) and world GDP (National Accounts, IMF and calculations of BBVA Research)

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