Q1 2019

Global Economic Outlook

Spring is coming

Aberdeen Standard Investments Research Institute

Global Overview

Spring is coming

The current global economic growth environment remains subdued. Our suite of short term activity indicators has deteriorated since our last outlook, and global business sentiment surveys have yet to find a bottom.

In response, we are seeing policy stabilisers kick in. Central banks in developed market (DM) economies have put policy tightening on hold, while policymakers in China are adding to stimulus efforts. Finally, some of the political risks that plagued markets in 2018 have become less acute in the short term.

Central bankers have found this policy easier to justify on account of still subdued inflation. Headline price growth has been depressed by lower global energy prices, but underlying measures of inflation have also been soft. Indeed, even the US economy, which has enjoyed an unusual late-cycle fiscal stimulus, is still delivering muted underlying price dynamics. This makes it easier for central bankers to delay tightening in a more uncertain economic environment.

The speed and extent of the shift in Federal Reserve (Fed) communication has been most remarkable. Chair Powell has shifted from signaling multiple further hikes, to a warning that the next change in policy is as likely to be up as down. In the Eurozone, the European Central Bank (ECB) has pushed back its guidance on rate hikes until at least 2020; the Bank of Canada (BoC) has shifted in a dovish direction; the Bank of England (BoE) is on hold amidst Brexit uncertainty; the Bank of Japan's (BoJ) yield curve control framework is on lock down; and, in most other DMs, policy tightening is on ice.

Meanwhile, signs also point towards Chinese policymakers taking further steps to loosen domestic policy settings. Reserve requirement ratios have been cut, and are likely to be lowered further while other credit easing measures have been implemented, although the authorities are still signaling a desire to constrain shadow banking growth. Taxes have also been lowered again, adding to last year's fiscal easing through personal and corporate tax cuts.

Before November's G-20 meeting, we were fearful that the US would impose a 25% tariff on all imports from China by mid-2019. At the same time, intransigence in both Rome and Brussels over Italy's 2019 budget left open the potential for a more serious debt crisis. However, in both instances, brinkmanship has softened, as leaders faced the economic, political and financial consequences of their aggressive stances.

Because the underlying drivers remain in place, these political risks have most definitely not gone away. But as long as the uneasy truces now in place hold, the drag on growth and returns from uncertainty should moderate as the year progresses. This is also true of Brexit, where although a catastrophic no-deal scenario cannot be ruled out, our assessment is that a softer outcome remains much more likely.

The combination of easing short-term political risk and a more accommodative stance of policy is loosening financial conditions. Government bond yields have fallen sharply, the trade-weighted dollar has depreciated, portfolio capital flows to emerging markets have picked up, corporate credit spreads have narrowed and equity prices have rallied. It is our judgement that this loosening will have at least some efficacy. Indeed, in aggregate we expect global GDP growth to slow from 3.6% in 2018, to 3.2% in 2019, before picking up to 3.5% in 2020. In sequential terms, the maximum growth impulse will be felt in H2 2019 and H1 2020 before growth moderates again.

This impulse should be most powerful in emerging market (EM) economies. Last year, they were caught in the crosshairs of US and Chinese policy tightening, slowing global trade growth, and building risks around protectionism. Relief on all these fronts, alongside cyclical base effects, will help those EM economies hit hardest in 2018. The upshot is that while aggregate EM growth is expected to drop to 4.2% in 2019 from 4.6% in 2018, we now expect growth jump back to 4.7% in 2020.

The DM story is a little more nuanced. The open Eurozone economy will benefit most from the expected acceleration in the global production and trade cycles. Japan will similarly enjoy a better global growth backdrop, albeit with domestic headwinds from a consumption tax hike in the autumn. The US meanwhile is expected to continue to slow, with the fading of its 2018 fiscal stimulus still dominating its growth profile.

It is important to emphasise that the expected pick-up in growth over coming months is unlikely to be as powerful as in 2016/17, because policy stimulus will be more muted and there is less spare capacity to be absorbed. Moreover, the risks to this turnaround are tilted to the downside, with leverage in key countries and sectors potentially a constraint on the growth impulse from easier financial conditions and the deeper political backdrop still unfavorable. As such, it is plausible that a more aggressive easing from major central banks will be necessary before growth finds a bottom.

Quantitative indicators

Moderation in growth continues

Our nowcasting framework and Chinese activity indicator both point to a sustained slowing in near-term economic momentum. Meanwhile, our macro momentum indicator remains well below 50, but has begun to rise again. In the medium term, our business cycle indicators are shifting to downturn, and US recession risks are peaking at the 12 month horizon.

US – Despite weaker-than-anticipated retail sales in December, the US continued to grow above trend in Q4, as predicted by our nowcast. However, the pace of growth slowed and is expected to continue to slow into Q1. In spite of mixed Purchasing Managers' Index (PMI) readings, activity at the start of the year is set to remain above trend according to our nowcast, although our judgemental forecast is for a sharper slowdown. Recession risks have risen on a 12m horizon, driven by the financial variables in our models.

UK – Our UK nowcast showed a sharper slowdown than reported in the official print of 0.3% quarter-on-quarter (q/q) in Q4, and current data in Q1 suggest a bounce back to above trend growth. This is at odds with signals from our business cycle indicators which firmly place the UK in the downturn phase.

Eurozone – Similar to the UK, our Eurozone nowcast suggested weaker growth than was delivered over Q4. This signal of soft underlying growth continued into the first quarter, with partial indicators for the region, in particular manufacturing PMI surveys, deteriorating further.

Japan – The Japanese economy grew in line with our nowcast in Q4, with the pace of growth rebounding from the large contraction seen in Q3. Current expectations are for a slowdown in the pace of growth over the first quarter of the year, with January's 3.7% contraction in industrial production weighing on the nowcast for Q1.

EM – In our aggregate EM nowcast the picture is relatively stable, with growth expected to be maintained around trend over the first quarter of the year. However, the signal from our China Activity Indicator is less optimistic, with the index currently sitting around two standard deviations below trend. We await the release of February's industrial production data and other partial indicators to get a better sense of how the quarter will shape up.

	Shorter term						Medium term	Longer term		
	Nowcasts				China Activity Indicator	Macro Momentum	Business Cycle Indicators	Recession probability		
	Q4 18		Q1 19					12m	18m	24m
US	Above trend	Slowing	Above trend	Slowing			Expansionary	46%	11%	11%
Eurozone	Below trend	Slowing	Below trend	Steady			Downturn			
UK	Below trend	Slowing	Above trend	Increasing			Downturn			
Japan	Above trend	Increasing	Below trend	Slowing			Expansionary			
China					Below trend, Slowing					
EM	At trend	Increasing	At trend	Steady		Low (37.5%) and Rising				
DM							Expansionary			

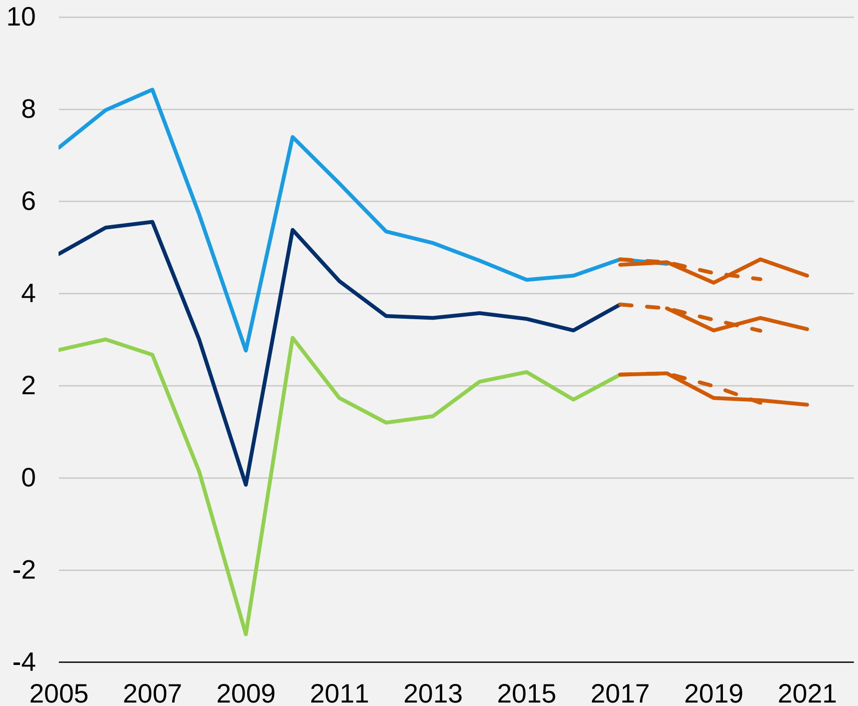
Note: Macro momentum is measured as diffusion index between 0 and 100, Note: we are measuring the deviation of the current nowcast value from potential growth in each region as well as whether the pace of growth is increasing, decreasing or being maintained in the current quarter.

Note: Nowcasts are used as compliments to our judgemental forecasts, with these reflecting changing growth momentum, rather than our explicit forecast for quarterly growth in the region. We measure the deviation of the current nowcast value from our estimates of potential growth in each region. A deviation of +/-0.5ppts is required to define growth as above/below trend.
Source: Aberdeen Standard Investments, Haver, Thomson Reuters, March 2019

House View forecasts

Looking from the top down

GDP Growth (%)

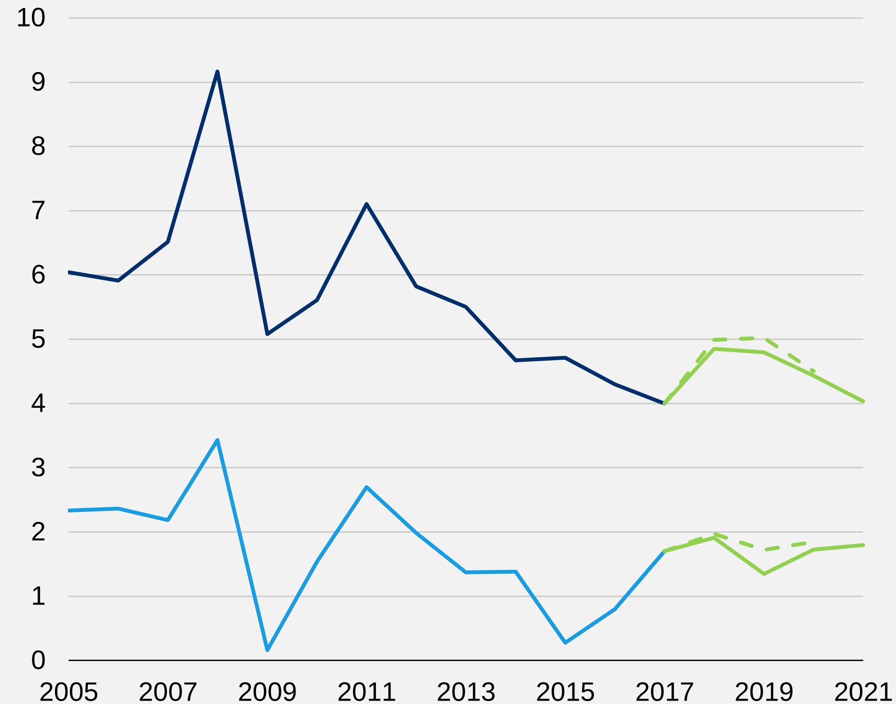


Growth forecast by region and forecast round:

Global — Emerging Markets — Developed Markets — Forecast — November

Source: Aberdeen Standard Investments, Haver, March 2019

CPI Inflation (%)



Inflation forecast by region and forecast round:

Emerging Markets — Developed Markets — Forecast — November

Source: Aberdeen Standard Investments, Haver, March 2019

United States

Growth slowing not stalling

The economy continues to head for a soft landing, as the effects of the fiscal stimulus sugar rush unleashed in early 2018 fades. With inflation well-behaved, the Fed has signalled a more cautious approach to policy tightening, reducing the risk of a policy error.

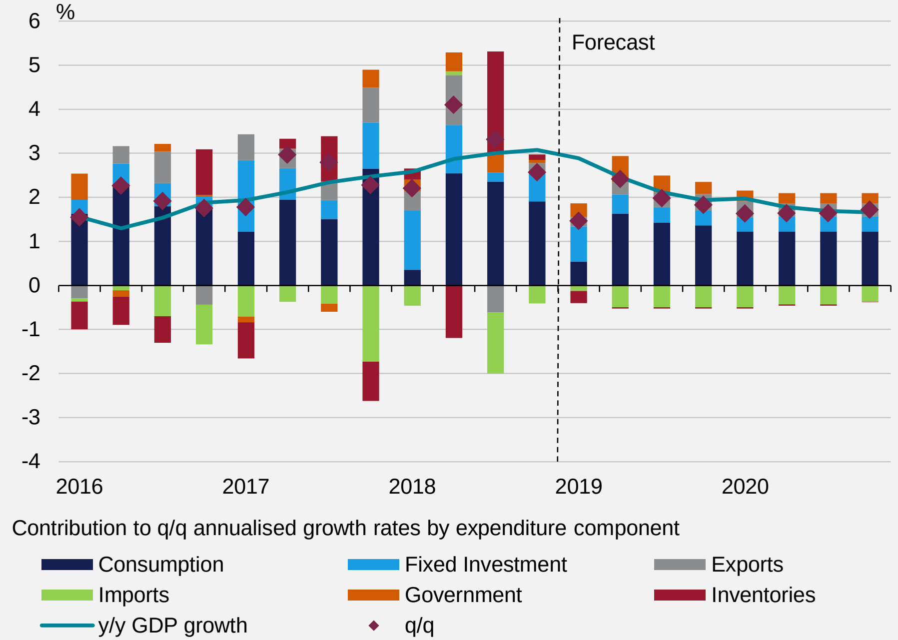
Growth slowed at the end of 2018, but still delivered a healthy 2.6%q/q in annualised terms. Activity was supported by robust growth in both household consumption and business investment. Residential investment meanwhile fell again, as the slowdown in the housing market continued. The drop in mortgage rates over recent months should provide some support here. Non-residential structures investment was also lower following the drop in energy prices last year.

Growth has started 2019 on a weaker footing. Personal spending fell in December amid market volatility and a government shutdown. This closure will have its own direct effect on activity, as will weather disruptions. However, while Q1 growth is likely to be soft, we think subsequent quarters will be firmer (see chart). Business sentiment remains solid outside the manufacturing sector, the labour market is robust, trade risks have lessened and there is still some fiscal stimulus in the pipelines – albeit less than in 2018. This should help the economy deliver growth of 2.4% this year and a trend-like 1.8% in 2020.

The Fed dropped its tightening bias in January in reaction to market stress, political risks, slower global growth and, crucially, still subdued inflation. In part, the weakness in price growth reflects better productivity last year, which is helping shield companies from rising wage pressures. Softer productivity growth this year should push inflation a little higher. This, alongside looser financial conditions, easing political uncertainty and still solid growth mean that our base case is for some modest further tightening, with one hike pencilled in for September and a final move in mid-2020. However, even this more muted tightening will be highly data dependent, reducing the risk of a policy mistake.

Source: Haver, Aberdeen Standard Investments (as of March 2019)

A soft landing in US growth



	2016	2017	2018	2019	2020	2021
GDP (%)	1.5	2.3	2.9	2.3	1.8	1.7
CPI (%)	1.3	2.1	2.4	1.9	2.2	2.3
Fed Funds (%)	0.6	1.4	2.4	2.7	2.9	2.9

China

Silver linings

Although business sentiment has yet to bottom, recent political and policy developments provide grounds for some optimism going forward. Not only are the authorities continuing to pump stimulus into the economy, but trade tensions are de-escalating. The upshot is that we expect growth to bottom by the summer and then turn up for a few quarters before resuming the downward trend by the end of the forecast horizon.

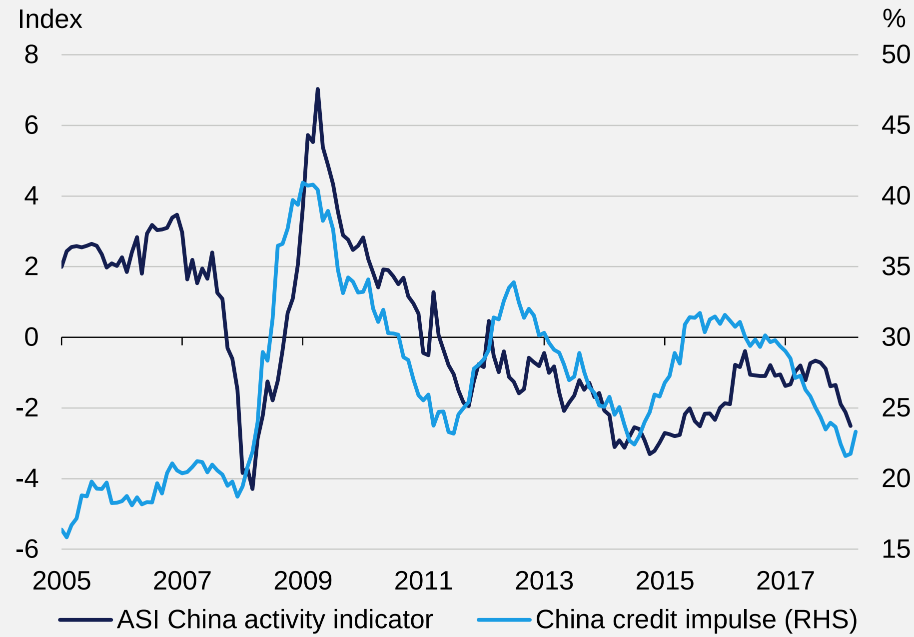
The post-GFC Chinese business cycle has had a very distinct pattern. In response to deteriorating economic conditions, the authorities aggressively loosen monetary and fiscal policy until growth accelerates. The economy then inevitably overheats forcing the authorities to tighten policy to rein in credit growth Then, when growth overshoots on the downside, the stimulus cycle kicks in again; wash, rinse repeat.

The past six months have followed this same playbook but with a few twists. Fiscal policy has eased but, instead of focusing on boosting fixed-asset investment, the emphasis has been on corporate, individual and indirect tax cuts. Monetary policy has also loosened, but the authorities have avoided relaxing regulatory constraints on the shadow banking sector, so as to avoid generating more severe financial imbalances.

This different flavour of stimulus has important implications for our forecasts. While we are confident that it will yield an improvement in the economy's underlying growth rate in the second half of the year and into 2020, its more restrained nature implies that the growth impulse is likely to be more modest than past stimulus efforts. Moreover, the composition of growth is likely to differ as well, with more of the benefits captured domestically, or by those external sectors servicing Chinese consumers rather than capital intensive producers. The trade truce should also support growth at the margin, as long as it lasts, although we are most interested in whether China uses it as an opportunity to open up its domestic product and financial markets to more competition.

Source: Haver, Bloomberg, Aberdeen Standard Investments (as of March 2019)

Nascent signs of a turn up in the credit impulse



	2016	2017	2018	2019	2020	2021
ASI GDP (%)	-	-	6.5	6.0	6.2	5.7
Official GDP (%)	6.7	6.8	6.7	6.3	6.2	6.1
CPI (%)	2.0	1.6	2.3	1.7	2.0	1.9

Eurozone

A sharp deceleration, but the trough is in sight

The Eurozone economy has been slowing sharply. GDP growth was just 0.7% annualised in the second half of 2018, compared to 2.7% annualised in the same six-month period at the end of 2017. Italy has fallen into recession, and Germany has only narrowly avoided one.

The slowdown has been driven by two factors: a big swing in the contribution to growth from net trade, reflecting the weaker global environment as well as earlier euro appreciation; and a series of temporary domestic disruptions, including new car emissions standards hitting German auto production, street protests in France and a sharp rise in political uncertainty in Italy.

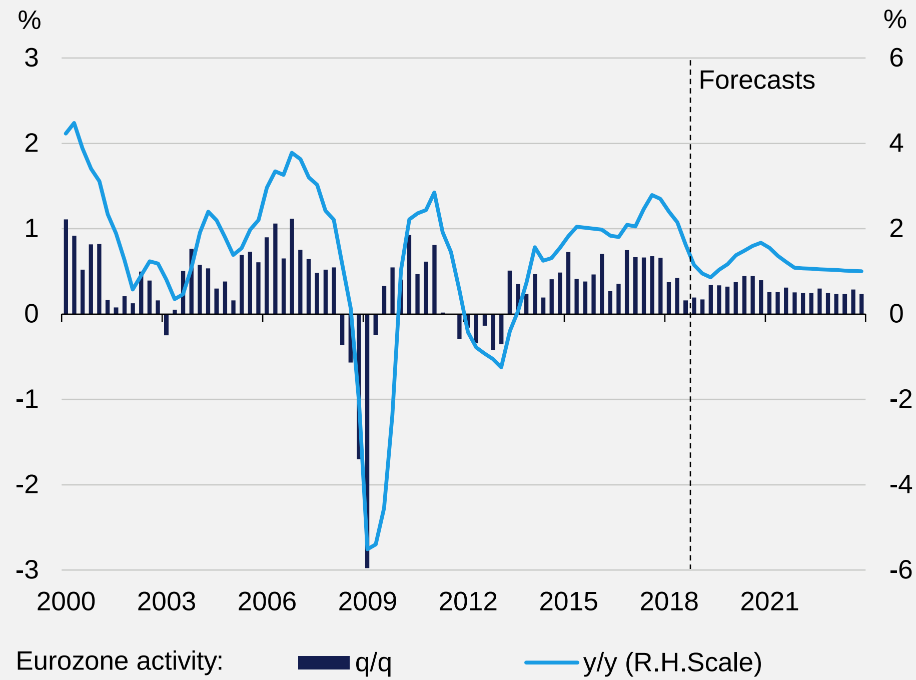
However, if we are right that the global economy is reaching a trough, and as temporary drags fade, the Eurozone should stabilise, and even modestly reaccelerate, from Q2 onwards. There may already be signs of this in the data – although the latest manufacturing PMI dipped below the 50 threshold, the services and composite PMI actually rose for the first time in six months. But note that, even with this reacceleration in our forecasts, we sit well-below consensus.

Headline inflation should decline further in 2019, reflecting negative oil base effects, before rebounding a little in 2020. Core inflation remains mired around 1% and, despite the recent improvement in wage growth, is set to rise only very slowly. In response the ECB has renewed its TLTRO programme to ensure ample bank liquidity, and altered its forward guidance to push back the date of the first rate hike into 2020. We don't expect a hike before mid-2020, and even then the hiking 'cycle' could consist of all of one or two rate hikes.

There are two main risks to our forecast. First, the US could impose tariffs on car imports, which would hurt Germany in particular. Second, the activity slowdown may simply not bottom out, and a region-wide recession could occur.

Source: Thomson Reuters Datastream, Aberdeen Standard Investments (as of March 2019)

We forecast modest & temporary improvement in growth



	2016	2017	2018	2019	2020	2021
GDP (%)	1.9	2.5	1.8	1.0	1.5	1.3
CPI (%)	0.2	1.5	1.8	1.1	1.4	1.3
Deposit rate (%)	-0.40	-0.40	-0.40	-0.40	-0.20	-0.20

Japan

Bumping around the bottom

Japan's close connection to the global production and trade cycles has seen it struggle over recent quarters. While an anticipated rebound in the external backdrop should provide some support, the domestic economy will have to contend with a consumption tax hike. Against these cross currents the BoJ's yield curve control framework looks like it is on lockdown.

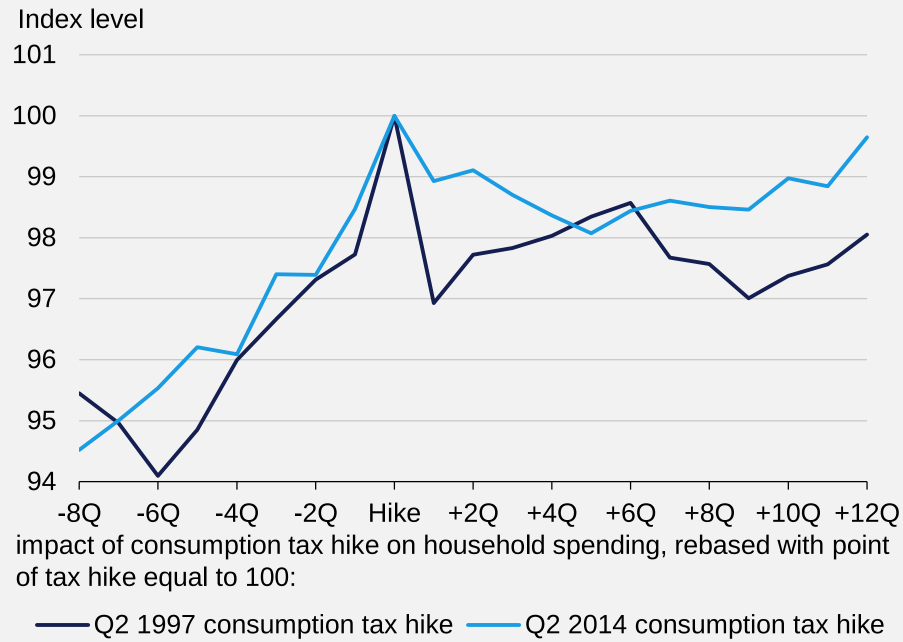
We have revised our expectations for 2019 GDP growth lower in this forecast round, reflecting continued weak trends in both industrial production and retail sales growth. On the former, there is likely help at hand. An expected rebound in the global industrial sector should support Japanese firms as we move through the year. However, on the latter, the outlook will be dominated by the planned hike in the consumption tax from the current 8% to 10% in October.

A glance back at the past two consumption tax hikes gives a sense of what we should expect from this change in policy. In both instances we saw household consumption spike close to 3% in the six months leading up to the hike. However, this was immediately followed by sharp and prolonged drops in spending, with consumption still below its pre-tax hike peak three years later in both instances. As was the case in 2014, the government will try to offset the impact of higher consumption taxes by temporarily increasing government spending. However, the net effect is still likely to be negative, with the quarterly profile of activity growth distorted until well into next year.

Overall, a bumpy growth environment is not expected to provide a favorable backdrop for making meaningful progress on the BoJ's inflation target. Indeed, while core core inflation picked up slightly in January, at 0.3%y/y it remains stubbornly low. This will be temporarily boosted by the sales tax hike, but the BoJ should look through these effects. Indeed, there looks limited scope for the central bank to justify changes to its yield curve control framework over coming years. This will leave rates effectively on lockdown for the rest of our forecast.

Source: Cabinet Office of Japan, Haver, Aberdeen Standard Investments (as of March 2019)

Taxing times



impact of consumption tax hike on household spending, rebased with point of tax hike equal to 100:

	2016	2017	2018	2019	2020	2021
GDP (%)	0.6	1.9	0.8	0.7	0.8	0.6
CPI (%)	-0.1	0.5	1.0	0.7	0.8	0.9
Key rate (%)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1

United Kingdom
Brexit continues to drag

The UK economy slowed sharply in Q4 2018. Growth fell from 0.6% q/q in Q3, to just 0.2% in Q4, leaving full-year growth for 2018 at just 1.4%, the weakest reading for nine years. It is clear that Brexit-related uncertainty is now weighing very heavily on the economy, and is responsible for much of the slow down.

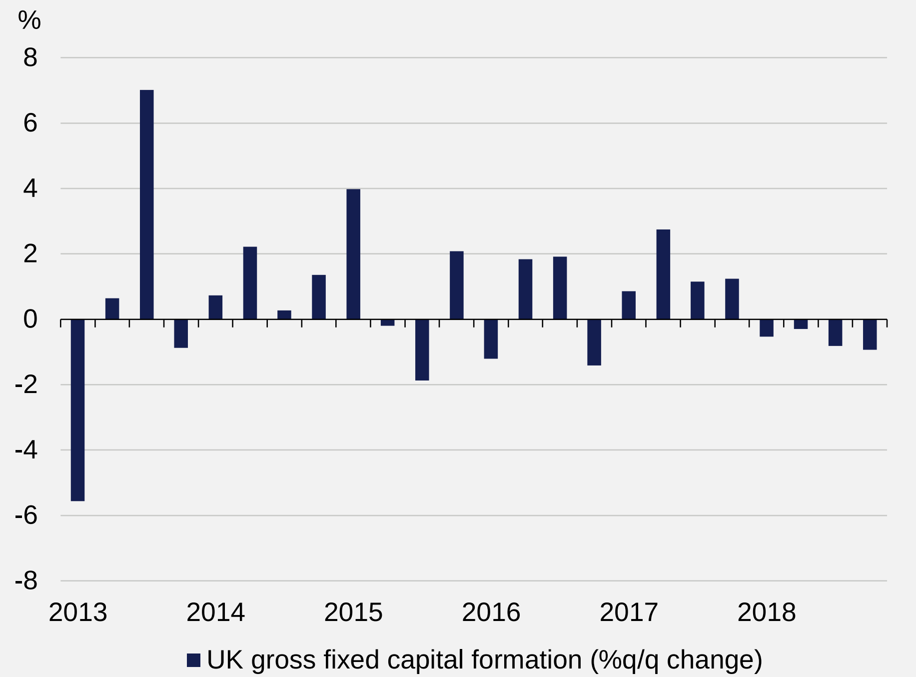
Business investment has now contracted for four successive quarters, leaving it down 3.7% over 2018 as a whole. This is despite a relatively tight labour market, accommodative monetary conditions and relatively high corporate profitability, all of which would normally be supportive of investment. It is hard to see any sustained pick-up in activity until there is some greater clarity on the UK's future relationship with the EU. Indeed we are forecasting growth of just 0.1%q/q in Q1, consistent with the recent weakness of business surveys.

However, assuming a 'no deal' Brexit is avoided and uncertainty around the terms of exit is not prolonged for too long, the economy is poised for a recovery in the second half of the year. Pent-up investment demand should be unleashed, while the ongoing recovery in real incomes should help support consumption. Fiscal policy is also set to be modestly supportive of growth.

At its February Quarterly Inflation Report, the BoE revised down its growth forecasts but maintained its tightening bias. This is because the Bank believes the output gap is largely closed and that potential growth is weak. Indeed, in its annual audit of the UK's supply capacity, it reduced its estimate of potential growth to "a little below 1.5%". As such, the economy will be in a position of excess demand, which should see inflationary pressure build.

We expect inflation to dip below 2% this year due to the fall in energy prices, before recovering back towards target over the next two years. In this context, we forecast one 25bp hike in interest rates from the Bank this year.

Brexit uncertainty weighing heavily on investment



	2016	2017	2018	2019	2020	2021
GDP (%)	1.8	1.7	1.4	1.0	1.7	1.5
CPI (%)	0.7	2.7	2.1	1.8	2.0	2.0
Bank rate (%)	0.25	0.5	0.75	1.0	1.25	1.5

Source: Haver, Aberdeen Standard Investments (as of March 2019)

Emerging Markets Ex-China

Better mood music

After a turbulent 2018, the mood music for EM economies has improved, as the three main destabilising forces – tight policy and weakening growth in China; negative spillovers from rapidly rising Fed policy rates; and escalating US-China trade tensions – have all abated, at least for now. This leaves us expecting aggregate EM growth to pick up significantly from the second half of this year.

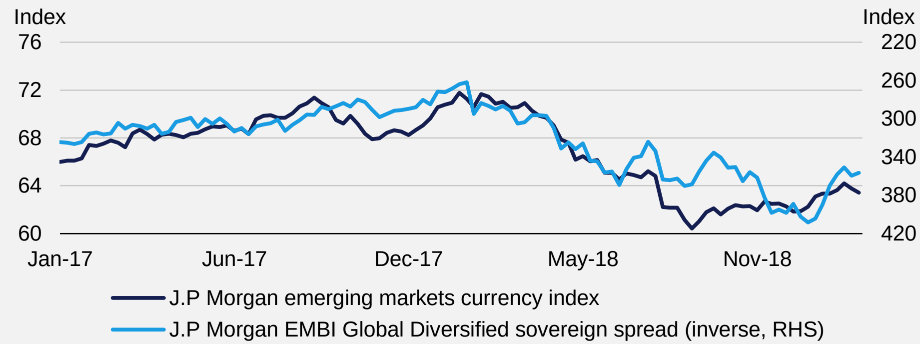
There is little doubt that EM financial conditions have loosened significantly over the past few months. The spread of EM hard-currency bonds over Treasuries has narrowed from 430 basis points (bps) to 350bps, leaving the average yield of the index at a 10-month low. EM currencies have on average been steadily appreciating against the dollar since last September. Portfolio capital flows to EMs rebounded to their highest level in a year, although net flows remain negative.

This more benign backdrop, combined with subdued headline and core inflation pressures in most economies, is in turn allowing central banks to halt last year's tightening cycles and in some cases begin to loosen policy settings. Indeed, we now expect the Indian, Brazilian and Russian central banks to all cut their policy rates at least once through this year.

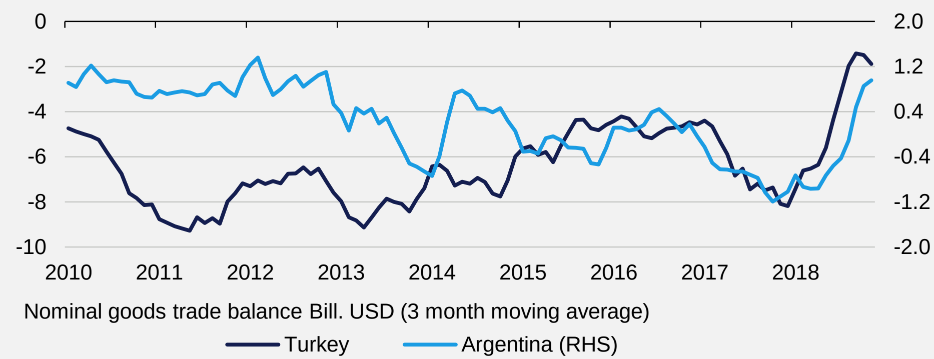
Historically there has been a close correspondence between the EM financial and growth cycles, and we expect this time to be little different. After falling to 4.2% in 2019 we now expect growth to pick up to 4.7% in 2020. This is in contrast with the DMs where in the aggregate we are expecting little change. Will this turn in the cycle sow the seeds of its own destruction? While investor sentiment towards EMs will ebb and flow, we think the more benign policy backdrop will persist at least through this year. Meanwhile, aggregate EM imbalances are low relative to history, and the most unbalanced economies are to adjust, providing at least some insulation against external shocks.

Source: Haver, Bloomberg, Aberdeen Standard Investments (as of March 2019)

Easing EM financial conditions



Rebalancing underway in Turkey and Argentina



Russia, India, Brazil

Getting back on track

As goes the aggregate EM growth and financial cycle, so too will Russia, India and Brazil. Most of the idiosyncratic risk come from internal and external political factors, which are weighing on growth in Russia, supporting growth in Brazil, and creating uncertainty in India.

After improving through the second half of 2018, Russian business sentiment has turned down in the first months of 2019. While the turn in the global cycle we are expecting should support activity as the year progresses, the prospect of tightening US sanctions will keep growth subdued.

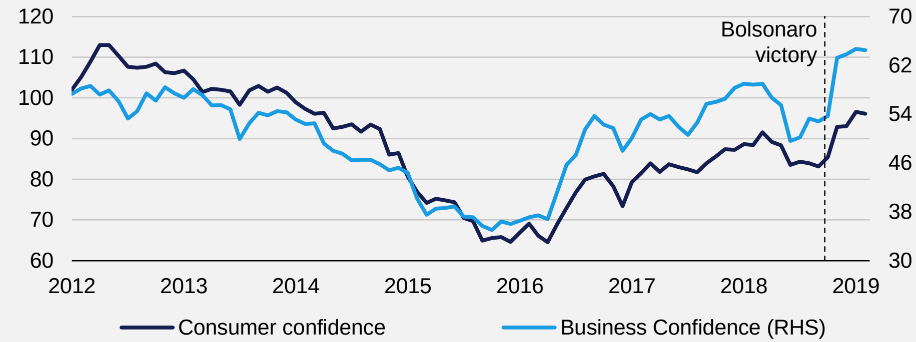
India remains one of the fastest-growing economies across the entire EM complex. In the near-term, looser fiscal and monetary policy settings will provide an additional fillip to growth. However, both are a double-edged sword, especially if they undermine hard-fought gains in policy credibility. The coming elections will be a referendum on Modi's term in office and are the largest risk to the outlook.

Bolsonaro's election has transformed the sentiment of Brazilian firms, who are excited about the prospect of fiscal and broader structural reforms. The government's success in shepherding proposals through Congress will determine the durability of the confidence lift.

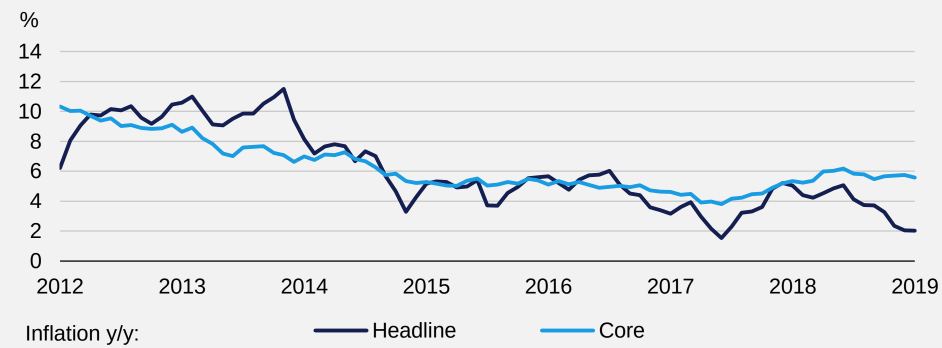
	2016	2017	2018	2019	2020	2021
Russia						
GDP (%)	0.2	1.5	1.6	1.4	1.8	1.4
India						
GDP (%)	8.2	7.1	7.5	6.5	7.2	6.7
Brazil						
GDP (%)	-3.5	1.0	1.1	1.8	2.2	1.8

Source: Haver, Aberdeen Standard Investments (as of March 2019)

Brazilian firms react positively to Bolsonaro's election



An unsustainable inflation wedge in India



Australia, Canada, Sweden

Debt hangovers constraining policy

The Canadian and Australian economies both softened in the second half of 2018, halting Canada's policy tightening, and effectively ending the prospect of a rate increase in Australia. While growth rebounded in Q4 in Sweden, further policy adjustment there will be limited. Large household debt imbalances leave all economies vulnerable to the end of the cycle.

The Australian economy slowed significantly in recent quarters as the housing downturn gathered pace and consumption growth was held back by weak income growth. With the economy set to grow at a below-trend pace, and inflation still below target, a rate cut is in the offing in the second half of the year.

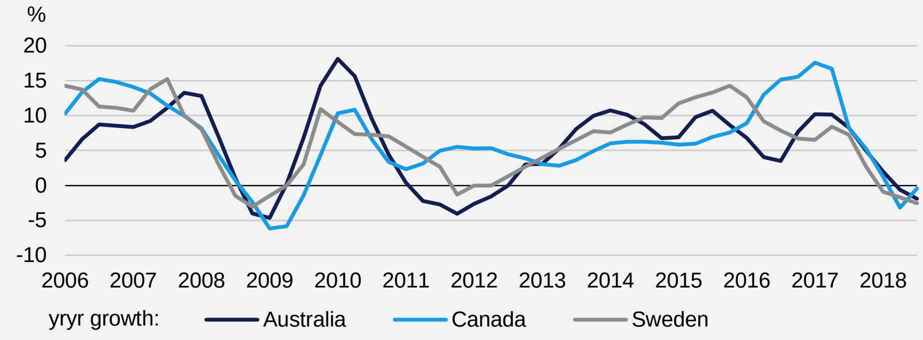
The Canadian economy slowed to almost a standstill at the end of 2018 as it felt the effect of weaker global activity and a terms-of-trade shock. In response, the BoC has dropped its tightening bias, with a improvement in activity clearly required to deliver further policy adjustment.

Sweden grew strongly in Q4, bouncing back from the Q3 contraction, and defying broader global weakness. Meanwhile, the Riksbank hiked rates at the end of last year. But with sentiment surveys downbeat and core inflation subdued, the next rate hike probably won't come until the end of the year.

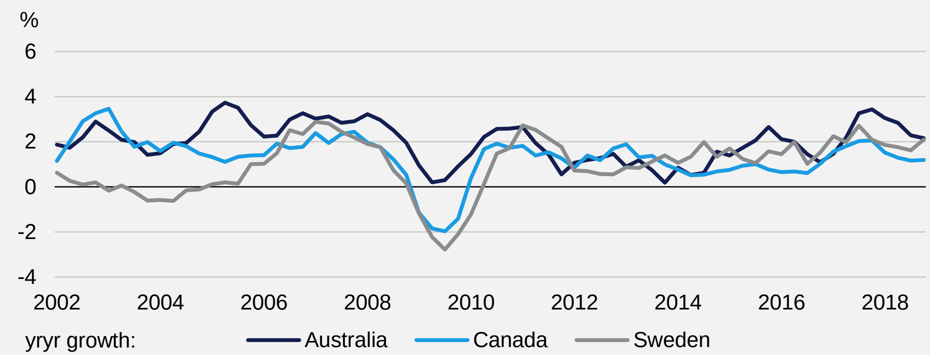
	2016	2017	2018	2019	2020	2021
Australia						
GDP (%)	2.8	2.4	2.8	1.9	2.3	2.2
Canada						
GDP (%)	1.4	3.0	1.8	1.5	2.2	2.1
Sweden						
GDP (%)	2.5	2.4	2.4	1.8	2.3	1.8

Source: Haver, Aberdeen Standard Investments (as of Q4 2018)

House price growth



Employment growth



Monetary policy

A flock of doves

Central bankers have shifted into support mode as the global economy stutters. This responsiveness to economic and market conditions has the potential to extend the cycle, with a return to any tightening bias set to be highly contingent on an improvement in the economic backdrop.

The more dovish rhetoric from the Fed over recent months signals a change in its reaction function, and reduces the chances of a policy error that would make the current cyclical downturn worse. The Fed is now expected to hike more slowly and to a lower terminal rate, with the next move put off until at least September, and one final move anticipated in mid-2020. This would imply a peak in the Fed Funds rate just shy of 3% – in line with our view of neutral.

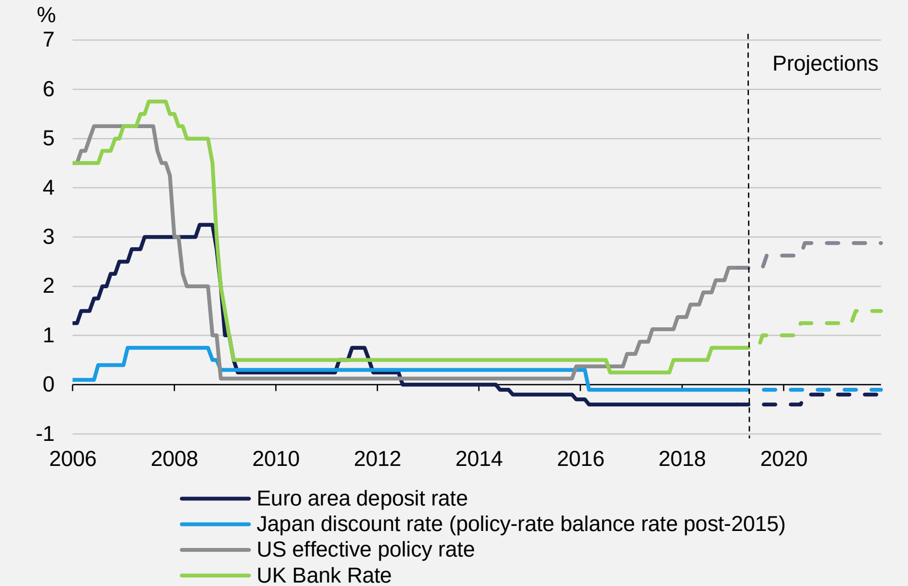
The Fed's shift is likely to be mirrored by a number of other central banks. This is particularly so in the Eurozone, where the ECB faces a sharper slowdown in growth and muted inflation. In this environment, we no longer expect the deposit rate to be lifted in 2019, and have pencilled in a move for 2020, predicated on cyclical conditions improving. However, should these expectations disappoint, the ECB may not deliver a hike over our forecast horizon.

The BoE continues to signal a need for slightly tighter policy, on the assumption that a smooth Brexit takes place. However, it will need to sit on its hands until it gets more clarity on this issue. The BoJ is unlikely to deviate from its current yield curve control framework, especially with another consumption tax hike on the way later this year.

The dovish policy shift from the Fed means that 2019 should be a year of domestic monetary policy easing across a wide range of Emerging Market countries, including Brazil, India and Russia. Of the three, the sustainability of policy easing in India is the most in question. The new Reserve Bank of India (RBI) governor has taken advantage of a fall in food price inflation to cut policy rates, but core inflation remains elevated at present. While it is too early to argue that RBI policy has become more politicised, we do think there is a risk that the commitment to inflation targeting has weakened.

Source: Haver, Aberdeen Standard Investments, March 2019

Gradual policy normalisation



Note: Dotted lines indicate our current policy rate forecasts by region.

Policy rates	2019	2020	2021
US	2.6	2.9	2.9
UK	1.0	1.25	1.5
Japan	-0.1	-0.1	-0.1
Eurozone (depo rate)	-0.4	-0.2	-0.2

Political analysis

Populists sensitive to market extremes

US-China and Italy-EU standoffs created a substantial rise in market stress in Q4. The crystallisation of these risks is precisely what has encouraged politicians to take a more constructive stance, at least in the near term.

For the US and China, this has meant an indefinite deferral of further tariff increases, which were due to increase the tariff on $200bn of Chinese imports from 10% to 25% on January 1st (then March 1st). Positive signalling from both Chinese and US negotiators has built optimism in markets that the trade war will not escalate further and that a reduction in tariffs may even be possible.

The US Trade Representative has made clear that any agreement will have to be predicated on "complete implementation subject to ongoing verification and effective enforcement". The practicalities and politics of such a monitoring and enforcement regime will be hard to navigate and sustain, creating potential for the deal to fall apart under pressure. We also still think that there are significant limits to the extent that China will be willing to upend its industrial and foreign policy strategy, and in particular the 'Made in China 2025' initiative, given its centrality to achieving Xi's long-term economic goals.

Nonetheless, market forces are incentivising constructive dialogue at least. And China is taking steps to liberalise its foreign direct investment flows while also cracking down on forced technology transfers. So, we have downgraded the risk of full trade war between the US and China from green to orange in our probability colour coding, below our limited trade war scenario. Visibility on the negotiation progress is extremely low, which is reflected in our wide scenario probability distribution.

Our risk framework continues to point to challenges in the US-China relationship that leave us still sceptical of the potential for the long-term stability in that relationship, even if a trade deal is agreed.

In Italy; the rollback of fiscal estimates to 2.04% from 2.4% following significant spread widening in Italian government bonds has reduced concerns for investors.

We remain skeptical about the ability of the government to hit such a specific deficit target given the ambitious revenue and growth targets embedded, particularly now that the economy has fallen into recession. Moreover, the European Commission's concerns are less with the headline budget deficit, and more with the structural deficit and debt-to-GDP dynamics, which are teetering close to unsustainability.

That said, the Commission appears to be capitalising on the progress with the Italian government and so immediate tensions have lessened. The French fiscal expansion in reaction to the 'yellow vest' movement, alongside challenging European Parliament elections in Spring, may also reduce – but not remove – the risk of outright conflict on the budget in the near term.

Scenario	Waymarks
China concedes and US declares victory	Chinese economic weakness becomes severe Domestic Chinese dissent over current policy path grows louder China signals willingness to concede on technology transfers and/or IP
Trump bows to domestic pressure	Opposition grows within the Republican party and Trump's support base Congress takes measures to restrict Executive's trade authorities Domestic lobbying from consumer groups & businesses threatens Trump's chances in 2020
Limited trade war ($51-$250bn)	Negotiations fail to garner resolution by March deadline but signals are positive for continued negotiations Chinese economic weakness continues Trump and Xi set firm date for summit
Full blown bilateral trade war (>$250bn)	Trump-Xi summit is taken off table completely Negotiations end without trade agreement Republican party and Trump voter base support against China Unofficial boycotts and administrative measures threaten US MNI revenues in China
Economic decoupling	Bilateral relations completely break down Economic disruption in China emboldens Trump The perception of China as a hostile, strategic threat grows in the US Business begin to move supply chains

Political analysis

Brexit creating political dislocation

The Conservative government failed to pass its Withdrawal Agreement through parliament for the second time, triggering widespread uncertainty about the outlook for UK-EU relations. However, parliament's vote to extend the Article 50 process rather than risk a no deal exit at end-March may take the immediate pressure off, but sets up the next few months up for potentially seismic political change.

In this kind of febrile political environment, with MPs breaking ranks from the traditional party lines, the risk of a general election is elevated. A general election campaign could pose a challenge for UK risk assets as investors are very nervous about the possibility of a Corbyn-led government, in spite of Labour's softer approach to Brexit.

The risk of further defections remains high for May's government as she attempts to balance the highly motivated pro-Brexit European Research Group (ERG) and the newly invigorated pro-remain/soft Brexit MPs. The likelihood that she remains in post is lower still, although as we repeatedly stress, another leader would face the same challenges trying to unite the party.

The departure of eleven Labour and Conservative Party MPs to the newly formed, pro-remain 'Independent Group' has also galvanised pressure from pro-remain MPs across the party divide. The upshot is that the risk of no deal has fallen from 20% to 10% in our scenario analysis while the risk of a second referendum is also elevated.

Overall, while the spread of probabilities remains wide and the path to resolution is not yet clear, the balance of risk for the UK economy and risk assets has tilted to the upside as Article 50 extension was favoured over no deal in the short term.

Institutional Framework	Waymarks	Economic impact
Modest-Moderate FTA (CETA-style) with Customs union on goods	EU signals continue as current with softening on language for long term relations Conservative government presents as staging post to longer term alternative Labour party softens stance on vote against Conservative deal as time ticks down Article 50 period extended Government change hands amid EU-dominated campaign	Range for Gilt Yields: 1.30–1.60 Sterling Trade Weighted Move: Increase 5-10% Range for IG Credit Spread: Rally to 1.35-1.40 Equities: FTSE 250 outperforms 100; UK domestics outperform on upside surprise, consumer staples underperform
Modest-Moderate FTA (CETA-style)	Conservative backlash intensifies while EU maintains customs union strictness DUP presents credible threat to government stability Irish border fudge solution is found	Range for Gilt Yields: Unchanged/ Slightly Higher Sterling Trade Weighted Move: Increase 5% Range for IG Credit Spread: Rally to 1.45 Equities: Slight relief rally in UK domestic market
EEA via EFTA or EU	Change in rhetoric from press, public and politicians in favour of EU/EEA Recession hits UK economy increasing the perceived risks of leaving EU EU insists Irish border requires single market membership	Range for Gilt Yields: 1.60 – 1.90 Sterling Trade Weighted Move: Increase 15-20% Range for IG Credit Spread: Tighten to 1.25 – 1.30 Equities: UK domestics and financials outperform on major upside surprise, consumer staples underperform
WTO	May remains in place but reverses course to avoid party breakdown Hardline Brexiteers elect a leader that supports their agenda and takes a harder line with EU Negotiations between UK and EU turn hostile Labour party refuses to support Conservative deal Article 50 period extension is not granted	Range for Gilt Yields: .75–1.00 Sterling Trade Weighted Move: Fall 10-15%initially but retraces some over 3-6 months following Range for IG Credit Spread: Sell off to 2.00, led by financials unless BOE policy loosens dramatically Equities: FTSE 350 down 7%; FTSE 100 outperforms 250 with major rotation out of exposed sectors (domestics, financials)

Quantitative Tightening

For the first time in over a decade we are seeing aggregate global central bank balance sheets decline. This has sparked speculation over the effects of Quantitative Tightening (QT), especially in the midst of slowing global growth.

Figure 1 shows the channels through which Quantitative Easing (QE) was expected to boost economies. The academic literature finds clear evidence that QE influenced asset prices and economic activity, particularly during bouts of market dislocation. However, there are reasons to believe the impact of QT will be smaller than QE.

First, QT is smaller than QE. The Fed is the only central bank unwinding asset holdings, and there have been clear signals that terminal central bank balance sheets will be larger than pre-crisis levels. This should dampen the tightening through this adjustment. Additionally, the signaling channel is likely to be less powerful. After the crisis, QE provided a compliment to rate cuts, reinforcing the easing in monetary conditions. During QT, these policies can act as substitutes. Should QT provide too severe a drag on economic activity, then rates can rise more slowly, or not at all.

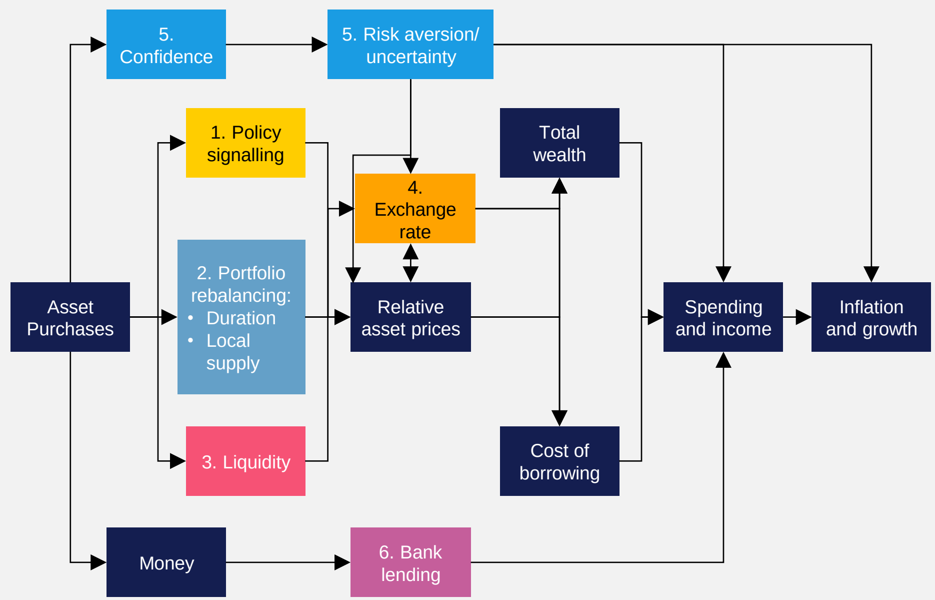
Second, there are few signs of stress as yet. Much has been made of the deceleration in narrow monetary aggregates as QT got going. However, the trend in broader monetary aggregates, particularly loan growth, has been resilient. Aggregate lending to households and corporate loans in the US continues to track 5% y/y and is at a decade high of 2.8% across the Eurozone. In response to asset sales we have yet to see a rise in term premium estimates for government bonds, However, there has been a more marked effect from sales of mortgage-backed-securities, with mortgage spreads up close to 50bps since the start of QT, weighing on housing.

QT has likely contributed to disruptions in money markets. The Fed has struggled to keep its effective rate in its target range, suggesting reserves are becoming scarcer. The potential to meet more acute reserve shortfalls going forward could cause issues for banks, with the OIS-Libor spread having widened notably over the second half of 2018, delivering tighter financial conditions in the US and abroad.

Moreover, the recent bout in market stress could have amplified the drag from QT. Indeed, there is a risk that the dynamic between QT and market stress is pro-cyclical, with one exacerbating the other. The Fed has provided more reassuring signals around its balance sheet policy in response, with this set to be larger over the long term.

Overall, QT is likely less powerful than QE. While it works through many of the same mechanisms, there are reasons to believe this policy will deliver a more modest change in overall monetary conditions. In particular, the size of the shift in balance sheets will be smaller, and central banks are being careful in their communication. The big risk is that rising market stress will amplify the effect of QT, creating a potentially dangerous feedback loop. However, the Fed has showed itself to be sensitive to these dynamics, which should provide some encouragement.

The transmission channels of QE



Source: Bank of England, 2018

Global Themes

Turning tides in financial conditions

Financial conditions have loosened in the first quarter of the year alongside a near-term pause in Fed tightening. Indeed, while financial conditions remain tight relative to the beginning of 2018, there has been a clear shift since the start of this year towards looser conditions. Markets have reacted cautiously, but positively to this, and financial stress is contained.

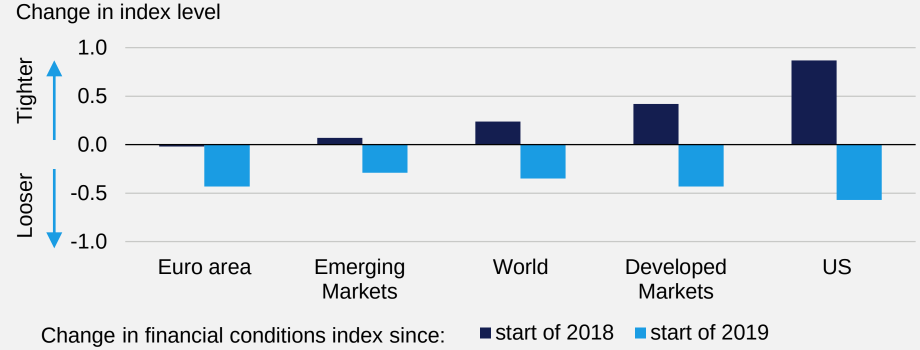
The shift in Fed communication led to a repricing of rate hikes in markets and in our own expectations. We now expect just a single hike in both 2019 and 2020. Similarly, we have removed our expectation of a hike in the deposit rate from the ECB in 2019, and pushed back rate expectations in other markets. Consistent with this support, we have seen a clear loosening in financial conditions relative to the beginning of 2019, despite conditions still being tighter than at the beginning of 2018. The biggest shift in financial conditions in the near term has been in the US, as one would expect, but the Euro area is a close second.

The pass-through to financial markets is clear. Ten-year Treasury yields and 30-year mortgage rates have declined more than 50bp from their 2018 peak. The trade-weighted dollar has depreciated year-to-date. Net portfolio capital flows to Ems have resumed. DM corporate credit spreads have narrowed. And equity prices have rallied significantly since the beginning of the year. It is our judgement that this loosening in financial conditions will have at least some efficacy, with macro momentum beginning to recover in Q2 and industrial growth picking up by the summer.

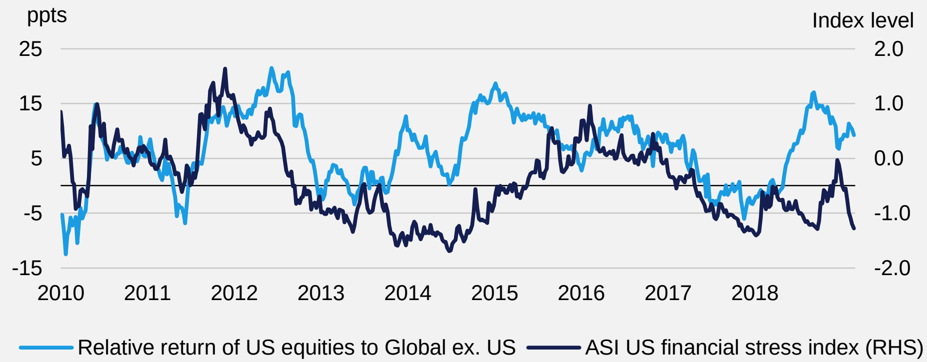
The rally in markets is mirrored in the declines seen in our financial stress index (FSI), which spiked to near positive levels in December. The FSI provides a broad signal of improving market sentiment, with the index covering many aspects of financial stress. The recent narrowing in corporate spreads, along with declines in market volatility measures for both equity and bond markets, have all contributed to the declines in our gauge of US financial stress.

Source: Bloomberg, MSCI, Goldman Sachs, Aberdeen Standard Investments (as of March 2019)

Financial conditions have already begun to loosen…



…and US financial stress has declined



Global Themes

Margin compression

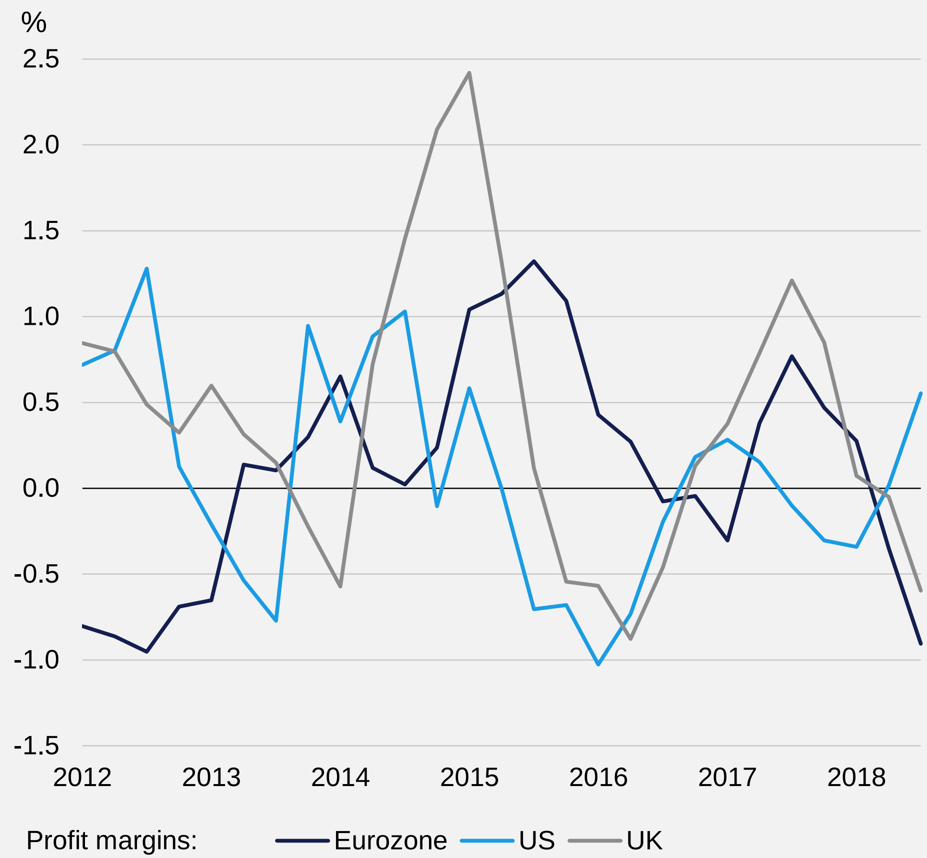
Despite rising labour cost growth, there is still no sign of a re-steepening of the Phillips Curve in the developed economies that would make us worried about meaningful upside risks to core inflation. Indeed, in the face of slowing nominal GDP growth and tightening labour markets, it is corporate profit margins that are giving way amidst weak pricing power.

The dominant driver of inflation in 2019 is likely to be negative oil base effects. This will mechanically drag headline inflation lower almost everywhere, before the effect fades towards the end of the year. Beyond the one-year point, the outlook for inflation is largely driven by underlying core inflation dynamics. In this respect, it is noteworthy that, despite the recent deceleration in many activity indicators, labour markets have remained resilient and there are signs of stronger wage growth and rising unit labour costs in most developed economies.

Rising unit labour costs put upward pressure on core inflation for an unchanged level of corporate profit margins. However, the sideways trend in Eurozone core inflation and the drop in UK core inflation imply a lack of pricing power among firms and downward pressure on profit margins. Our calculations suggest that a top-down macroeconomic definition of profit growth is now negative in both the Eurozone and UK. In the US, by contrast, profit growth remains positive, helped by a pick-up in productivity growth and a softening in compensation per hour.

Profit growth tends to be pro-cyclical, so the weak near-term outlook for growth points to continued downward pressure on profits, particularly in the Eurozone and UK. Put another way, tight labour markets and the continued upward drift of unit labour costs, combined with an environment of limited pricing power among firms, imply a flat to modestly upward sloping outlook for core inflation. That said, if we are right in our assessment that the global cycle is due to turn up from the second half of the year, especially outside of the US, corporate profit growth should also pick up modestly.

Profit margins under pressure amid rising labour costs



Source: Thomson Reuters Datastream, Aberdeen Standard Investments, March 2019

Global forecast summary

	GDP growth			CPI inflation		
	2019	**2020**	**2018**	**2019**	**2020**	**2021**
Global	**3.2**	**3.5**	**3.2**	**3.4**	**3.3**	**3.1**
DM	**1.7**	**1.7**	**1.6**	**1.3**	**1.7**	**1.8**
US	2.3	1.8	1.7	1.9	2.2	2.3
UK	1.0	1.7	1.5	1.8	2.0	2.0
Japan	0.7	0.8	0.6	0.7	0.8	0.9
Eurozone	1.0	1.5	1.3	1.1	1.4	1.3
EM	**4.2**	**4.7**	**4.4**	**4.8**	**4.4**	**4.0**
Brazil	1.8	2.2	1.8	3.7	3.7	3.6
Russia	1.4	1.8	1.4	5.1	4.2	3.6
India	6.5	7.2	6.7	3.7	4.6	4.2
China	6.0	6.2	5.7	1.7	2.0	1.9

Above consensus

Below consensus

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