Q3 2019

Global economic outlook

Bending, not breaking

Aberdeen Standard Investments Research Institute

Global Overview

Bending, not breaking

The global economy continues to falter as the trade war between the US and China intensifies. With few signs of an imminent easing in tensions we expect global growth to dip to its lowest rate in a decade, before flatlining at anaemic levels over the course of our forecast horizon. Even these gloomy expectations are contingent on proactive central bank policy support, and no further significant escalation on the trade front. If we are wrong on either count, the global economy could be staring down the barrel of a recession.

Trade tensions exploded over the summer. President Trump announced a plan to raise existing tariff rates, and add these levies to virtually all Chinese trade by the end of the year. These steps will nearly double the average tariff rate on Chinese imports. While a fresh round of talks are scheduled for October, we are sceptical that a deal can be reached to bridge the significant differences between both parties. Instead, we expect the measures announced to be delivered, with the risk tilted towards additional escalation.

The manufacturing sector has been the most obvious casualty in this dispute. Global trade volumes and manufacturing production have slumped, with forward-looking indicators suggesting further weakness to come. The more domestically-orientated services sector has thus far been more resilient, although we have started to see tentative signs that momentum is starting to falter a little. Overall, our macro momentum and nowcast indicators all point towards subdued near-term momentum in the global economy.

The combination of an escalating trade spat and weaker near-term activity has prompted further downward revisions to our forecasts. We now expect the global economy to slow to 2.8% this year – the weakest outcome since 2009. Thereafter, we see few prospects for a rebound in activity, with global GDP expected to hover around these levels in 2020 and 2021. In total this represents a 0.7 percentage point downgrade to our expectations last quarter, and puts us around 0.5 percentage points below consensus.

The downward adjustments have been broad-based, reflecting the wide reaching impact of trade tensions. The UK catches the eye, with a sharp recession next year the result of hard Brexit becoming our baseline assumption. Elsewhere, US growth rates are expected to halve from 2.2% this year to 1.1% in 2020 as tariff measures ratchet up alongside a fading fiscal impulse. In the open Eurozone and Japanese economies we expect growth to slip further below trend.

In emerging markets (EM), we have cut our expectations for growth in China as it feels the brunt of trade aggression and its more restrained policy easing cycle continues to deliver disappointing results. Elsewhere, we have become more cautious on the scale of the bounce back in some of the other major EM economies over the next 12 months against the backdrop of weak global growth.

Fewer changes have been made to the inflation outlook, with underlying inflation still undershooting target in most developed market economies. This familiar refrain reflects the muted passthrough from tighter labour markets to domestic price pressures. Indeed, in those economies which are seeing faster wage growth, the brunt of this is still being borne by increasingly stressed corporate margins. On balance, slower activity is likely to provide an additional weight on underlying inflationary pressures across economies.

The subdued inflation backdrop provides ample room for central banks to offer more support. We now expect the US Federal Reserve (Fed) to cut rates at every meeting this year, the European Central Bank and Bank of England to deliver a combination of rate cuts and asset purchases, and other major central banks to shift in a more supportive direction. Elsewhere, Chinese policy rates and the reserve requirement ratio will need to adjust further and the Renminbi will also depreciate further if the trade war escalates. In Brazil, India and Russia weak growth and below target inflation mean further cuts are likely over the coming quarters. Critically, these steps are only expected to cushion the slowdown in activity, rather than deliver a rebound in growth.

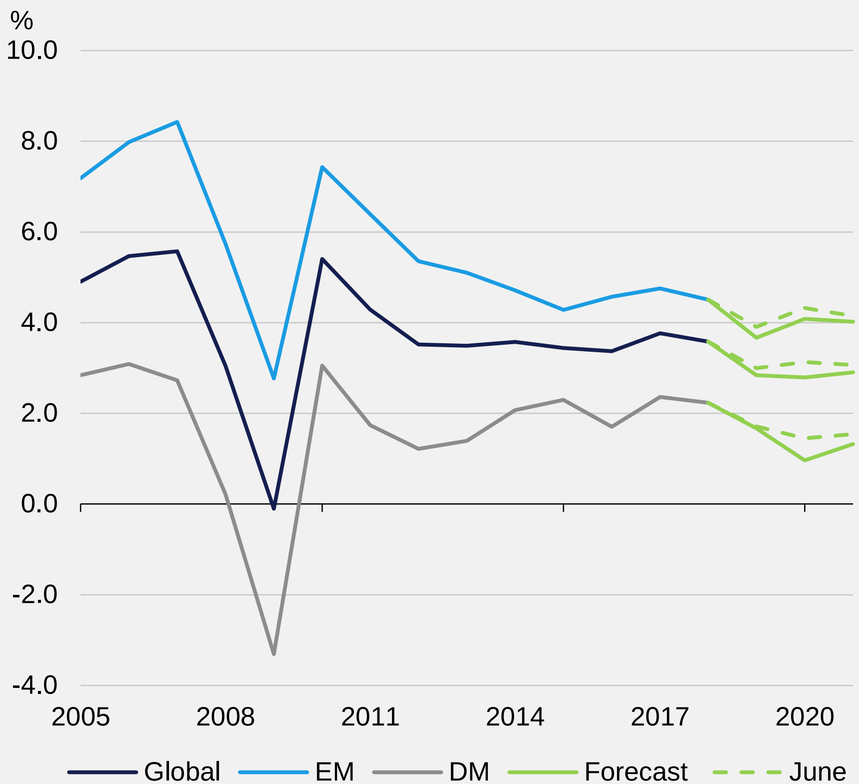
Despite the large downgrades we continue to believe that risks are tilted to the downside. This is perhaps most apparent on the trade front. We will need to watch closely that the escalation incorporated into our base case does not derail labour market conditions, which in turn would undermine the services sector. Moreover, our updated scenarios on trade policy highlight a sizeable risk of further escalation, which would deliver a blow to the global economy that central banks might not be able to combat.

Risks are not entirely to the downside. A trade deal between the US and China would lift some (but not all) of the uncertainty for firms. Moreover, it is possible that the magnitude of monetary stimulus, or its efficacy, surprises to the upside. Finally a broad based easing of fiscal policy would provide a significant impetus to global growth, but we would question the willingness of policymakers to deliver such a bold step.

House View forecasts

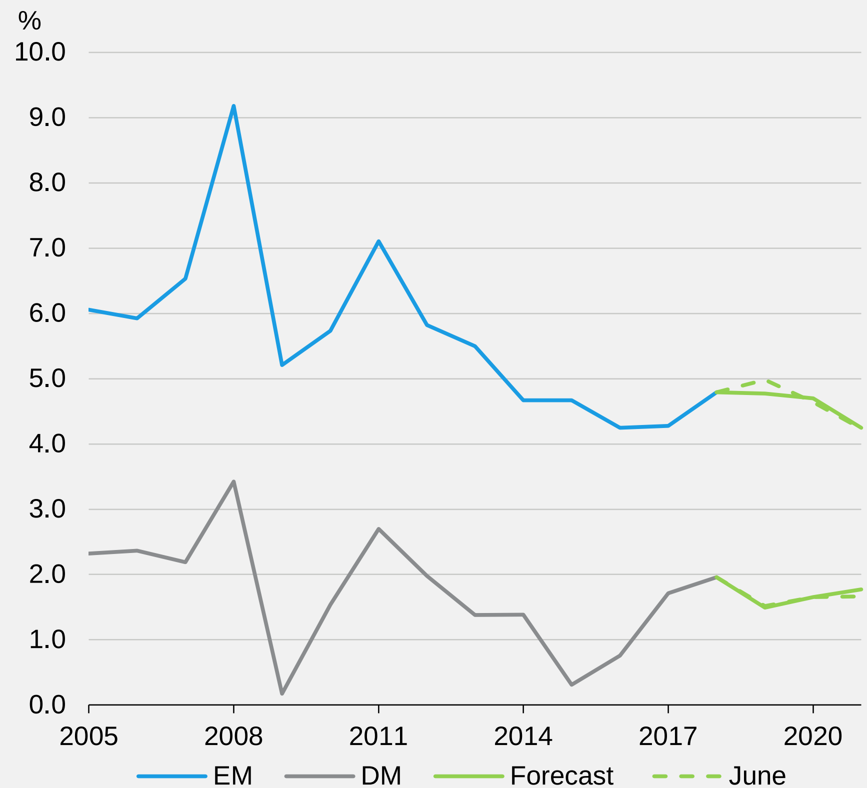
Looking from the top down

GDP Growth (%)



Source: Aberdeen Standard Investments, Haver, September 2019

CPI Inflation (%)



Source: Aberdeen Standard Investments, Haver, September 2019

* Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.

Quantitative indicators

Growth momentum slows while recession risks are rising

Near term growth momentum has slowed and our models show a rising risk of recession over the next two years. This, alongside less accommodative financial conditions, helps explain why we have revised down our near term outlook and added to expectations for policy easing.

Near-term activity indicators – across our **macro momentum indicators** the improvements in the global model were insufficient to offset declines seen in European-centric editions, leaving overall momentum softer. **Nowcast estimates** suggest a stabilisation in the US, Eurozone and EM in Q3 at modest levels, whilst Japan is expected to deteriorate further. The UK nowcast, hit by swings in the inventory cycle, currently suggests a pick up following last quarters contraction.

Our **EM activity indicators** suggest a further slowdown in activity in Brazil, Russia and India. Our **China Activity Indicator** meanwhile deteriorated in July. The weakness was broad-based across partial indicators, suggesting that the bounce back in Q2 could have been temporary.

Recession indicators – our models, now calibrated to give the probability of recession within 12 and 24 months, suggest a low risk of a US recession in the near term, but rising risks (40%) with the next 24 months. In Germany recession risks are much higher according to our model, with the probability of recession over the next 12 and 24 months sitting at 45% and 53% respectively.

Financial conditions indicators – our **US financial stress index** continues to show below average levels of stress, but we have seen this increase in recent weeks due to volatility around the trade war.

Our **China financial conditions index** moved towards tighter financial conditions on account of a negative contribution from Money & Credit factors. Despite efforts by policymakers to ease conditions the index has shifted back towards 'neutral', suggesting limited support through this channel. More policy action will be required to deliver a pronounced easing in financial conditions.

Indicator	US	Eurozone	UK	Japan	China	Brazil	Russia	India	EM	DM	Global
Nowcast	🟠	🟠	🟢	🔴					🟠		
Activity Indicator					🔴	🔴	🔴	🔴			
Macro Momentum											🔴
Financial conditions	🟠 stress low				🔴 conditions tighter						
Business Cycle Indicator	🟢 expansionary	🟠 downturn	🔴 contractionary	🟠 downturn							
Recession Probability	🟠 12m – 15%	🔴 12m – 45%									
	🟠 24m – 37%	🔴 24m – 53%									

Key:

🟢 **improving** Recession probability stated is the probability within the next 12m and within the next 24m. Eurozone recession models are for German economy.

🟠 **stable** Business cycle refers to stylised phase of the cycle region is currently in.

🔴 **deteriorating** US financial stress index and Chinese financial conditions index.

Source: Aberdeen Standard Investments, Haver, Thomson Reuters Datastream, Bloomberg, August 2019

United States

Under pressure

The US economy is clearly slowing as trade tensions weigh on business sentiment and the effects of last year's fiscal stimulus fade. However, this downshift is not expected to turn into a rout. Policy easing and solid domestic demand is expected to provide some much needed ballast.

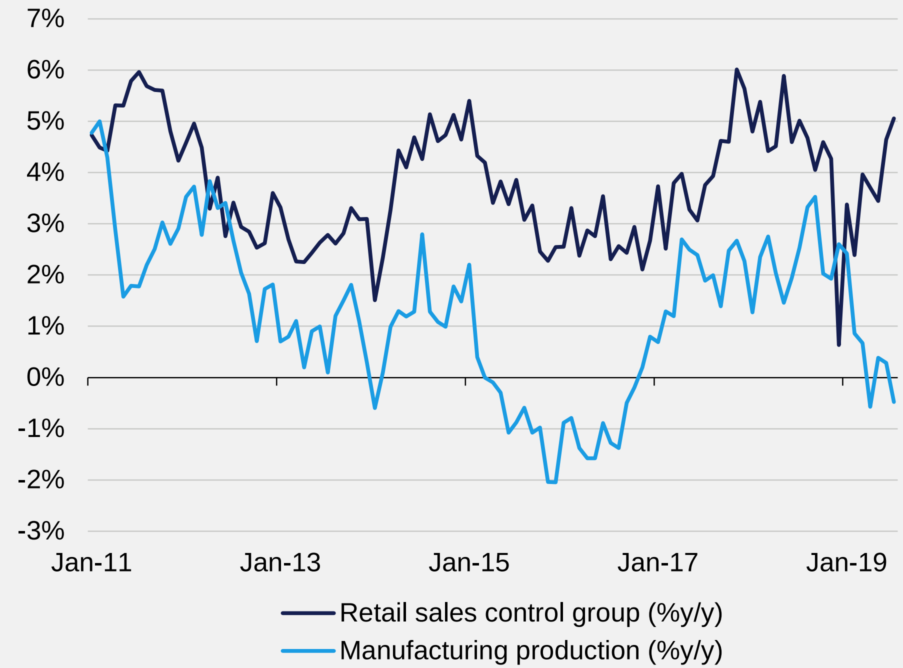
The more external facing parts of the US economy are clearly having a tough time of it. The manufacturing sector looks to be heading into a recession, with output down 0.5% year-on-year (y/y) and survey data for the sector pointing to further declines ahead. This slump has pushed capacity utilisation lower and weighed on new investment. Core capital goods orders and shipments have slowed notably. Firms are clearly feeling the chills from weaker global growth and trade uncertainty.

This weakness stands in clear contrast to better performance in the retail sector. US households continue to spend, with core retail sales up a very impressive 5.1% y/y (in nominal terms), supported by strong income growth and upbeat consumer sentiment. With aggregate consumer spending accounting for more than two thirds of overall growth, this impulse is clearly providing critical support.

There are reasons to believe that households will have a tougher time of it going forward. First, we are seeing signs of slowing labour demand, which is expected to lead to a deterioration in earnings growth. Second, upcoming tariff measures are set to fall more heavily on final consumer goods, increasing the impact on households. Third, there are signs of wobbling consumer confidence, which if sustained could push household precautionary savings rates a little higher.

However, we do not think that these factors will be powerful enough to trigger a large scale retrenchment in spending. Moreover, the Fed is now expected to cut rates another three times before the end of the year. This should help provide a stabilising influence on the US economy, which is expected to slow notably over coming quarters, but not stall.

Contrasting fortunes



	2016	2017	2018	2019	2020	2021
GDP (%)	1.5	2.3	2.9	2.2	1.1	1.6
CPI (%)	1.3	2.1	2.4	1.9	2.0	2.2
Fed Funds (%)	0.6	1.4	2.4	1.4	1.4	1.4

Source: Haver, Aberdeen Standard Investments, September 2019

China

Feeling the squeeze

Underlying Chinese activity growth has decelerated in recent months as financial conditions have tightened once more and the trade war reaccelerated. Though we anticipate additional policy easing over the next few quarters we do not think this will sufficient to counteract the effects of the trade war and the diminishing efficacy of policy.

China watchers are in somewhat unchartered waters at present. The typical post-crisis cycle has seen policy ease substantially to support growth, before tightening only when there has been a decisive transmission to credit growth and the real economy.

On this occasion however, easing financial conditions have failed to translate into stronger growth. According to our proprietary index at least, financial conditions have already started to tighten. So what is going on?

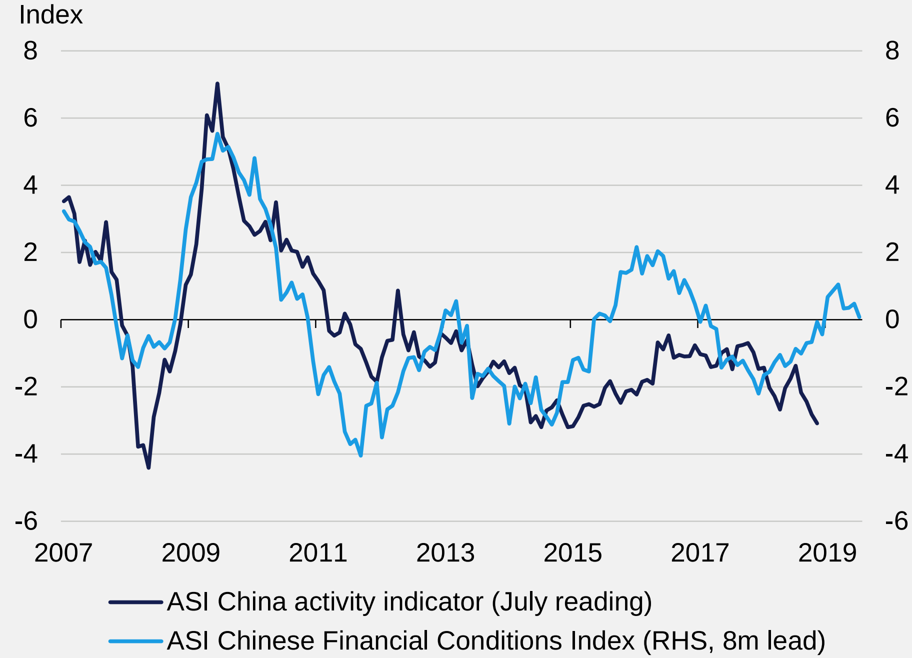
We think the weak transmission of policy easing can be explained by four factors: (1) the easing is taking place against the backdrop of the escalating trade war with the US; (2) the authorities have so far acted to prevent easing from boosting the shadow banking sector; (3) the efficacy of policy is diminishing against the backdrop of excess leverage; and (4) the fiscal measures taken to prop up growth have been poorly designed.

The upshot is that with the trade war escalating beyond our already pessimistic expectations in the first half of the year, and little evidence that a more aggressive policy stimulus is in prospect, we have further downgraded our already below consensus expectations for growth over the next two years. Indeed, by 2020 we now expect underlying growth to fall to only a little above 5%, which would be a new post-GFC low.

In this environment we should not be surprised to see further declines in market interest rates, as well as further currency depreciation.

Source: Haver, Bloomberg, Aberdeen Standard Investments, September 2019

Worrying trends



	2016	2017	2018	2019	2020	2021
ASI GDP (%)	5.8	6.6	6.4	6.0	5.4	5.2
Official GDP (%)	6.7	6.8	6.6	6.2	6.1	5.8
CPI (%)	2.0	1.6	2.1	2.5	2.5	1.9

Eurozone

Manufacturing recession – contained or contagious?

The Eurozone is in a manufacturing recession. Key to the outlook is whether this downturn will broaden to drag overall GDP growth negative. We are forecasting very low, but still positive, growth – but clearly the Eurozone remains extremely vulnerable. Therefore, significant monetary easing is on its way.

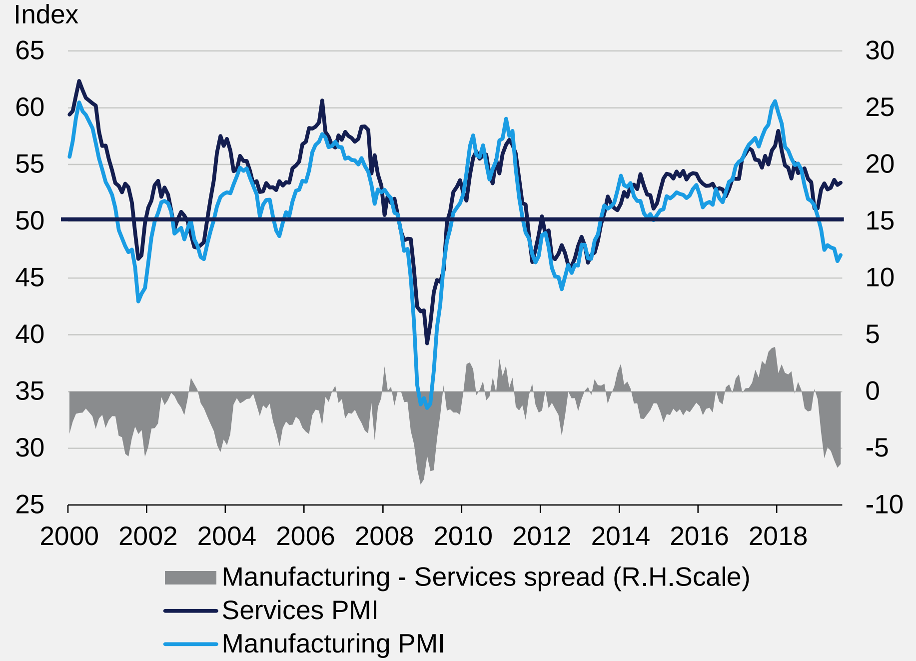
Eurozone industrial production has declined in 12 of the past 18 months, and is some 4% below its late-2017 peak. Meanwhile, the manufacturing Purchasing Managers' Index has been below 50 for seven consecutive months. In Germany, the industrial downturn has been more severe still, such that overall GDP contracted 0.1% in Q2 and is likely to fall again in Q3. The Eurozone services sector is still expanding (see chart), but cracks are starting to form. Leading indicators of employment growth are dropping, and consumer savings rate are rising. We have therefore marked our growth forecasts lower, although we don't think the headwinds are severe enough to be forecasting annual GDP contractions.

The further downward revisions to our growth forecasts mean that we have also lowered our inflation projections. Indeed, with GDP sub-trend, we now expect next-to-no rise in underlying core inflation over our forecast horizon. As such, 2019, '20, and '21 are set to be the seventh, eighth and ninth years respectively that Eurozone inflation has been below 2%.

Against this backdrop, our call for renewed ECB easing has become consensus. We expect a significant package of measures to be announced in September, including a 20 basis point rate cut and a relaunched QE programme. We forecast an additional 20 basis point rate cut in December, as other major central banks also ease monetary policy. In addition, the ECB is likely to engage in a broader review of its policy tools and inflation target before too long. Hopes for a fiscal stimulus are widespread, but political-economy considerations still constrain the support that is likely to come from additional government spending.

Source: IHS Markit, Haver, Aberdeen Standard Investments, September 2019

Historically large manufacturing-services divergence



	2016	2017	2018	2019	2020	2021
GDP (%)	1.9	2.5	1.8	1.1	0.7	0.7
CPI (%)	0.2	1.5	1.8	1.2	1.2	1.3
Depo rate (%)	-0.40	-0.40	-0.40	-0.80	-0.80	-0.80

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Japan

No room for error

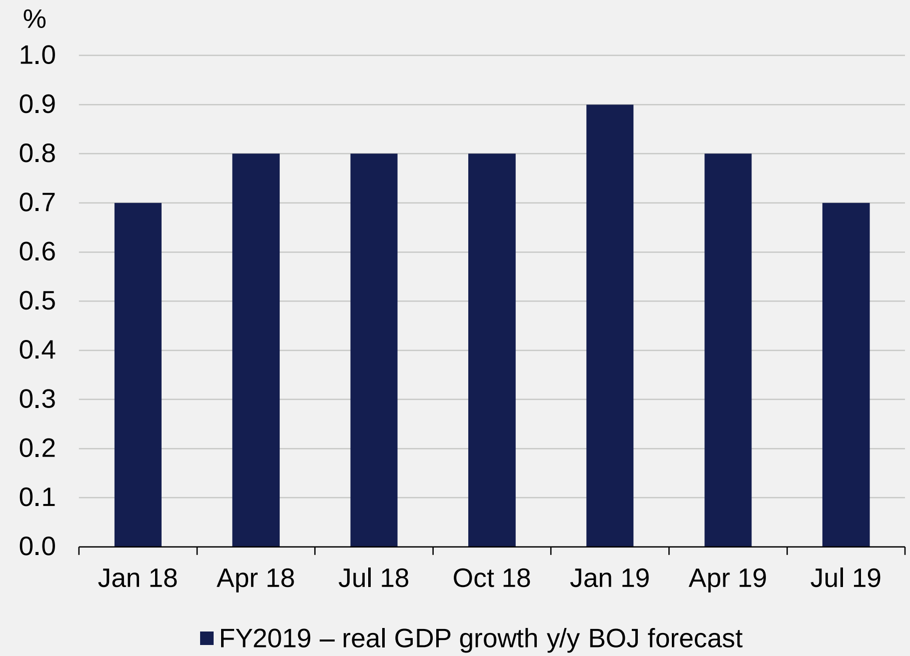
Our central scenario is for a mid-cycle slowdown, with further downside risks from the VAT hike.

Industrial production stopped falling in the second quarter (+0.6% quarter-on-quarter) but forecasts in July point to a further deterioration in Q3. The news has been better in the electronic parts and device sector, where global semiconductor sales are bottoming out, and leading indicators such as the South Korea electronic parts shipment/inventory ratio have improved. However, despite leaner inventories a production rebound in Japan remains conspicuous by its absence, with overall production in this sector expected to fall 0.2% q-q in Jul-Sep based on firm forecasts.

Our view is increasingly diverging from policymakers who continue to cling to a mid-cycle rebound scenario. If this fails to materialise, we think there are three options: 1) cut the short and long policy target; 2) buy more exchange-traded futures (ETF); 3) increase fiscal response. We are sceptical about the efficacy of such measures and in all three regards believe a 'stealth easing' is already underway. At -30bp yields on 10-year Japanese government bonds are outside the +/- 20bp target band, with the BOJ recognising greater flexibility here in line with our call for a widening of the band to 30bps. The Bank of Japan has also ramped up ETF purchases, while a supplementary budget is also being prepared – likely to be passed in January/February Diet session.

In terms of fiscal support, the government JPY5.5trn in spending offsets is largely a one-for-one given an estimated additional tax burden from the VAT hike of JPY5.2 trillion. Work is underway on a supplementary budget. JPY5trn is a key threshold between business as usual and emergency-style packages – with initial indications of JPY4trn underwhelming. Importantly, a worse than expected impact from the VAT hike are unlikely to affect initial budget planning decisions as only one-month of post-hike data is likely to available before the budget is submitted for cabinet approval in December.

Under-estimating the impact of trade war?



	2016	2017	2018	2019	2020	2021
GDP (%)	0.6	1.9	0.8	1.0	0.2	0.9
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

Source: Haver, Bank of Japan, Aberdeen Standard Investments, September 2019

United Kingdom

No deal, no growth

We are now incorporating a no deal Brexit hitting the economy by the first quarter in our forecasts. As such, we now expect the UK to fall into a sharp recession next year and significant monetary easing in response.

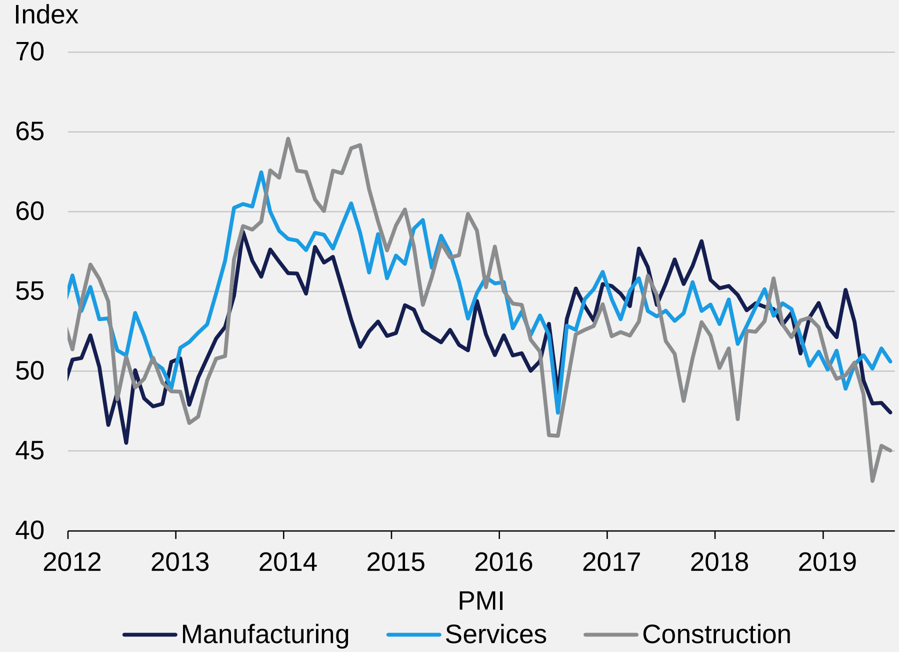
UK economic activity has already largely ground to a halt. The economy contracted by -0.2% in the second quarter of 2019. Granted, some of this weakness reflected temporary factors related to inventory management and the bringing forward of the normal summer shut down of car factories. However, beyond these temporary factors, it is clear that Brexit uncertainty in general, and no-deal risk in particular, is weighing heavily on the economy, and the economy is perilously close to a recession.

The economic shock following no deal would be severe. Increased barriers to trade (through higher tariffs and non-tariff barriers) with both the EU and the rest of the world would raise the cost of trade and impair cross-border supply chains. Investment – which has been weak for several years already – is likely to contract extremely sharply.

Sterling will depreciate sharply and inflation will pick up. This increase in inflation will see the UK return to a period of falling real wages. In the aftermath of the referendum, households smoothed their consumption in response to falling real wages by sharply reducing their saving rate. Given that the saving rate is already extremely low, there is much less scope for households to respond in this way now, and so consumption is also likely to decline.

We expect the Bank of England to cut interest rates back to the effective lower bound, which we estimate to be 0.1%, and restart QE, in part because the government is likely to try to appoint a new governor willing to prioritise growth. Fiscal policy is also likely to be eased significantly, perhaps with a cut to VAT to try to combat the inflationary pressure of weaker sterling. However, this will not be enough to fully offset the negative shock to the economy from no deal.

Already teetering on the brink of recession



	2016	2017	2018	2019	2020	2021
GDP (%)	1.8	1.8	1.4	0.9	-1.5	0.4
CPI (%)	0.7	2.7	2.1	1.9	3.7	2.6
Bank rate (%)	0.25	0.5	0.75	0.75	0.1	0.1

Source: CIPS, IHS Markit, Haver, Aberdeen Standard Investments, September 2019

Emerging Markets Ex-China

Overestimating the trend

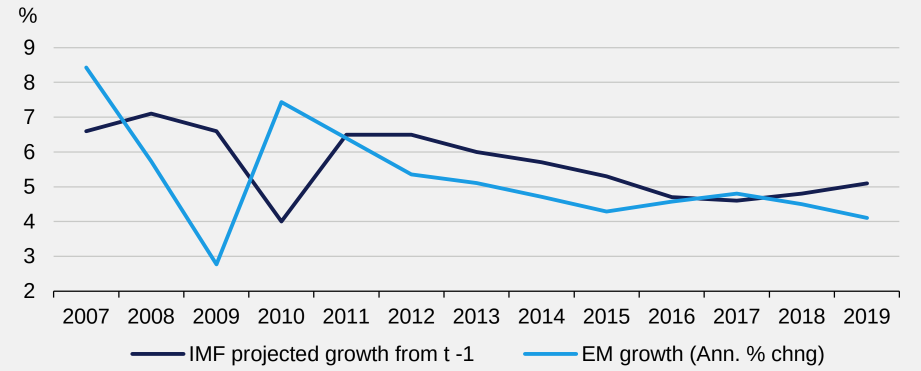
The EM forecasts of both the consensus and the major international organisations have been biased upwards since the financial crisis. This has important implications for how investors should think about the growth outlook for 2020 and beyond.

What do 2012, 2013, 2014, 2015, 2018 and 2019 all have in common? They are all years in which the International Monetary Fund (IMF) and the broader economic consensus overestimated how quickly emerging markets would grow when they compiled their forecasts in the previous year. In fact one has to go back to 2009 to find a year where the IMF significantly underestimated the growth that would occur in the following year. That forecasting record is even worse when one considers that official Chinese and Indian growth has almost certainly been overstated by the authorities over that period.

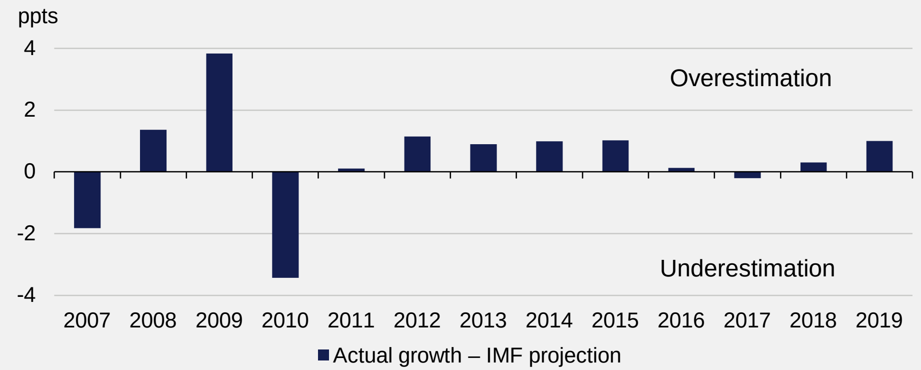
What explain this upward bias to emerging market forecasts? Part of the reason is likely due to the nature of the shocks that have arisen over the past decade. For example, even if one thought that oil and commodity prices were too high in 2013 it would have been difficult to forecast both the timing and magnitude of the hit that was to come. A similar argument applies to the more recent trade war that has been an important driver of global industrial and trade weakness over the past year.

But that is not the whole story. What also seems to be contributing to the errors is the tendency of the IMF and others to overestimate potential growth across many emerging markets. Whether because economists have not fully absorbed how much of the softening in EM growth over the past decade is structural, or for other reasons, that tendency leads to excess optimism about how much and how quickly growth can rebound after a bout of weakness. Forecasting can never be perfect but this pattern is one reason we are comfortable with our own forecasts being well below consensus for 2020 and 2021.

Familiar disappointments



Driven by weaker potential growth



Source: IMF World Economic Outlook, Haver, Aberdeen Standard Investments, Q2 2019

Russia, India, Brazil

Signs of life?

We are in the unusual position of expecting growth in Russia, India and Brazil to improve in 2020 while growth moderates in much of the rest of the world. However, this is more of a marker of just how weak growth was in the first half of the year.

Russia avoided falling back into recession in Q2 as growth rebounded strongly after the first quarter contraction. This confirmed our expectation that most of the Q1 weakness was attributable to temporary factors like the VAT hike. Looking forward the outlook remains subdued against a backdrop of low oil prices, weak global growth and a tighter US sanctions regime.

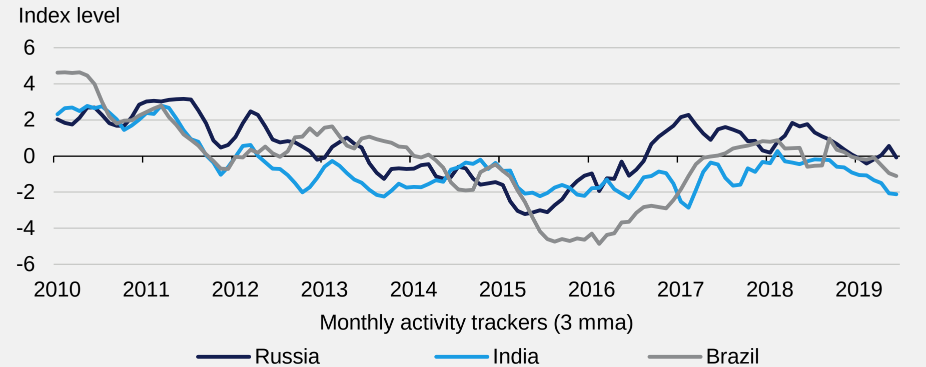
Brazilian growth has followed a similar pattern to that of Russia, with Q2's growth rebound more than offsetting Q1's contraction. Forward looking indicators suggest that modest growth will continue. This, alongside subdued inflation and fiscal consolidation, opens up the path to a significant monetary easing cycle.

India's economy may be expanding more rapidly than either Russia or Brazil but the trend is very poor. H1 2019 was the weakest half for growth in seven years as consumers continue to rein in their spending. Look for further policy easing to revive the moribund economy.

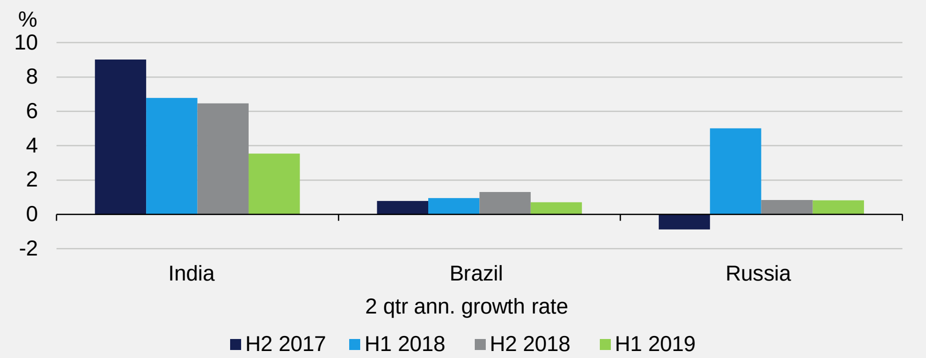
	2016	2017	2018	2019	2020	2021
Russia						
GDP (%)	0.2	1.6	2.3	0.9	1.8	1.3
India						
GDP (%)	8.2	7.1	7.2	5.2	6.4	6.6
Brazil						
GDP (%)	-3.5	1.1	1.1	0.9	1.5	1.4

Source: Haver, Aberdeen Standard Investments, Q3 2019

Troubling trends in activity



Call for further policy easing



Australia, Canada, Sweden

Feeling the chills from external headwinds

The darkening external outlook is reinforcing the lower for longer policy outlook in all three economies, though Australia and Canada have more space to ease policy than Sweden.

Following cuts to the cash rate in June and July, and a government committed to maintaining the tax favourability of housing, real estate prices are rising again. But with forward-looking indicators pointing to weaker labour demand, inflation still well below target, and the global economic picture dimming, policy will need to ease further. QE will come eventually, but we think it is more likely to be delivered once the current economic expansion comes to an end.

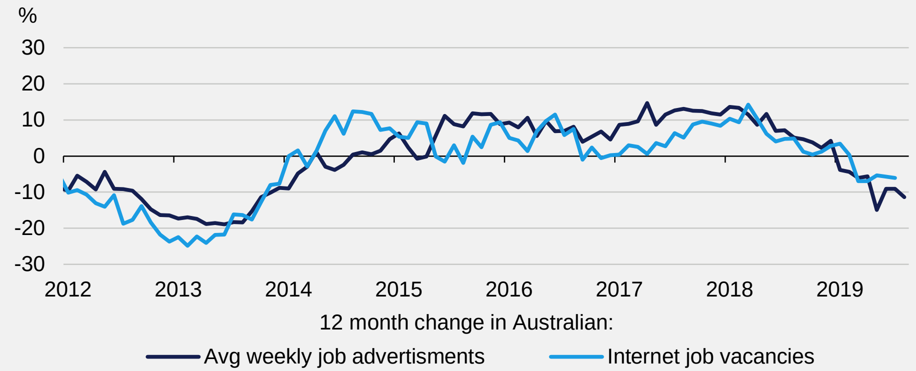
The Bank of Canada continues to highlight that policy is appropriate with growth close to potential and inflation at target. However, it has flagged concerns over the global backdrop and a willingness to step in should conditions deteriorate.

Swedish GDP contracted in Q2, as the external sector slowed and domestic demand weakened. Leading indicators are downbeat and we have marked down our forecasts, and no longer expect rate rises from the Riksbank. Chalk that up to another central bank overestimating its ability to achieve self-sustaining growth.

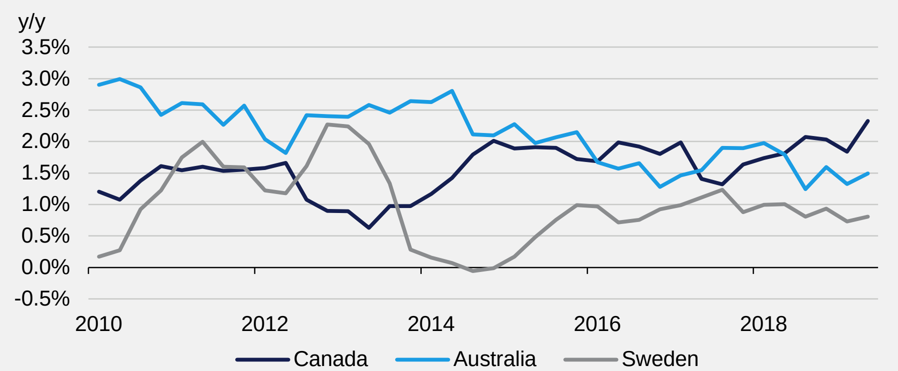
	2016	2017	2018	2019	2020	2021
Australia						
GDP (%)	2.8	2.4	2.8	1.7	2.3	2.2
Canada						
GDP (%)	1.1	3.0	1.9	1.5	1.8	1.9
Sweden						
GDP (%)	2.5	2.4	2.5	1.5	1.1	1.2

Source: Haver, Aberdeen Standard Investments, September 2019

A roll over in the labour market



Core CPI inflation



Monetary policy

More easing coming

The current levels of financial conditions across the developed world are broadly supportive of growth. However, this is largely a result of the market pricing in significant further easing by the major central banks. We tend to agree with the market that further monetary easing is forthcoming. This should be enough to stabilise financial conditions at current levels.

We expect the Fed to cut rates by another 75 basis points this year, with a 25bp cut at each of the remaining three meeting this year. This would mean a cumulative 100bp of cuts in 2019, which we would characterise as a mid-cycle easing rather than the commencement of a full-blown easing cycle.

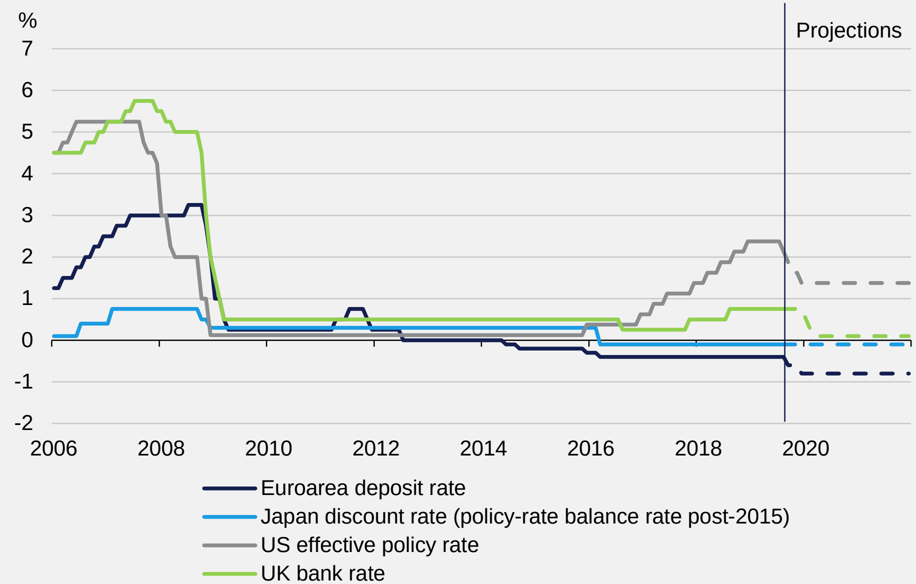
In Europe, we expect a 20bp cut from the ECB in September, tiering of interest rates to try to mitigate some of the negative side effects of negative rates on banks, and the resumption of QE at a rate of Eur40 billion a month (though this could be delayed until later in the year). We then expect a further 20bp cut in December, taking the depo rate to -0.8%. We are agnostic as to whether this represents the effective lower bound on rates, so would not rule out further cuts were conditions to deteriorate further, possibly in the event of a no deal Brexit.

Having incorporated a no deal Brexit into our baseline for the UK, we now expect the Bank of England to embark on significant monetary easing early next year. This is partly because we expect the government will ensure that the next governor of the Bank of England, who will be in office by January next year, is committed to supporting growth in the event of no deal. Therefore, we expect rates to be cut to 0.1%, which seems to be the Bank's estimate of the effective lower bound, and QE to restart.

We now expect both the Reserve Bank of Australia and Reserve Bank of New Zealand to cut policy rates two more times, with QE now being actively debated in Australia, though we think a more substantial economic shock would be necessary to trigger a shift to unconventional easing for the first time.

Source: Haver, Aberdeen Standard Investments, September 2019

Help is on the way



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

Policy rates	2019	2020	2021
US (%)	1.38	1.38	1.38
UK (%)	0.75	0.10	0.10
Japan (%)	-0.10	-0.10	-0.10
Eurozone (depo rate) (%)	-0.80	-0.80	-0.80

* Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.

Many paths to no deal

Brexit analysis

Following Johnson's election to Leader of the Conservative party, we flagged that the risks were rising on Brexit. We have now updated our scenarios for the near term (pre-October 31) and end state. A clear message comes through: the cumulative no-deal Brexit risk is the single most likely end state at 50%. This reflects the political bifurcation that has taken place on Brexit, the new more hard line Brexit government and the dwindling time remaining to secure a deal.

There are three key questions will determine the outcome in the short term: What does Johnson want? Can opposition parties mobilise effectively? Will EU leaders compromise on the backstop? In the short term, we think an election before October 31 or an extension that facilitates a general election is the most likely path for the UK (see Table). However, investors should remember that an election delays but does not solve the Brexit challenge.

While Johnson's internal machinations are unknowable, we do know that the rise of the Brexit party was a key change for the Conservative party. Having bled support to the Brexit party under May, Johnson's hard line approach has won back some of that support. That dynamic means that Johnson is extremely hemmed in by the ERG/Brexit party.

Our multi-step scenario analysis highlights that the probability that there is a no-deal Brexit at some point is 50% given. This reflects the political bifurcation that has taken place on Brexit, the new more hard-line Brexit government and the dwindling time remaining to secure a deal.

There has been optimism in recent weeks that key leaders are signalling some willingness to consider reopening the withdrawal agreement if a viable alternative to the Irish backstop consistent with EU law is found. There is reason for caution here: the path to a compromise here remains very thin and parliament's willingness to trust the administration to deliver a compromise is at an all-time low.

Next Step Scenarios	Waymarks	Market Impact	Indicative Likelihood
Extension beyond October 31	Opposition MPs produce clear, joined up communication pre-parliament return Opposition coalition mobilise in parliament through commons votes rather than confidence vote	Gilt Yields: Rise 5-10bps Sterling Trade Weighted: up 5-10% IG Credit Spread: 10bps lower Equities: FTSE 350 broadly flat, modest rotation to domestics.	45%
No Deal Brexit October 31	Remain MPs do not coalesce around single solution Conservative Remainers signal stronger party loyalty than Brexit focus Normalisation of No Deal Brexit in media Withdrawal agreement negotiations break down Johnson prorogues parliament	Gilt Yields: Fall 20-30bps Sterling Trade Weighted: Fall 5-10% IG Credit Spread: 30-40bps higher, led by banks and insurers unless BOE policy is unexpectedly accommodative Equities: FTSE 350 down c.7%; FTSE 100 outperforms 250 with major rotation out of domestics, financials	25%
General Election before October 31	Conservative Remainers leave the party amid fears of No Deal risk Anti-No Deal MPs fail to organise legislation Media/public backlash against proroguing parliament Dominic Cummings importance recedes	Range for Gilt Yields: Unchanged Sterling Trade Weighted Move: 0-5% lower Range for IG Credit Spread: 30-35bps higher Equities: UK domestic de-rate 5%	25%
New Withdrawal Agreement Passes by October 31	EU messaging on alternatives continues to become more positive Negotiations increase between both sides Pressure increases as prorogued parliament fails to act Legal experts coalesce around alternative solution	Range for Gilt Yields: Rise 10-20bps Sterling Trade Weighted Move: 10-15% higher IG Credit Spread: 10-15bps lower Equities: FTSE 350 broadly flat; significant rotation to domestics	5%

Source: Aberdeen Standard Investments, September 2019

Harder to turn back

US-China trade tensions expected to continue

The recent escalation in tariff threats, the depth of change demanded by the US by China and a marked hardening in China's red lines provides further downside risk for markets. Recent events have confirmed our fears that the negotiation process is likely to be volatile, with periods of escalation and relative quiet.

By the end of Trump's current presidential term, our base case is that current threatened tariff measures are ultimately delivered, although perhaps delayed beyond the current deadlines, with potential for further marginal hikes beyond this (see Table). There is a sizeable downside risk that we see a more severe escalation, which incorporates additional large tariff hikes across product groups.

The move by Trump to threaten and then partially postpone 10% tariffs on remaining Chinese goods is illustrative of our view that the mixed incentives load this relationship with downside risk. The Christmas timing and inventories led to a partial reversal but we cannot assume that after Christmas this tentative peace holds afterwards.

It warrants remembering how far we have come: with 25% tariffs on $250bn and plans to impose 10% on an additional $110bn in early September, and $160bn in mid-December. This will leave average tariffs on Chinese imports at ~21%, up from an average ~3% before the trade war began. Importantly, this planned escalation will affect consumers more directly than previous rounds of tariffs.

We think the 2020 Presidential election may bring new dynamics to the US-China relationship, which warrant careful watching for upside risks. There are three key waymarks: labour market weakness, severe market rout and voter support for the trade war. If there is substantial weakening in these, we would expect the likelihood of a deal to increase substantially from the current 20% to aid Trump's re-election prospects.

However, such a deal would require significant compromise on the US side to achieve: China's red lines are likely to remain malleable, particularly in the knowledge that the US election could change negotiating terms.

Source: Aberdeen Standard Investments, September 2019

US-China risks tilted to downside

Scenario	Description	Assumptions	Waymarks	Probability
Severe escalation	Negotiations between the US and China fall apart and tariffs rise sharply above existing threats (>10% additional) with formal non-tariff barriers introduced on both sides.	Economic data holds up in short term Taking China on seen as a win for Trump China opts to wait until the 2020 election Genuine deep divisions between both parties persist Both leaders refuse to compromise	No major movement signalled on either side Trump tweets about challenges Labour market data remains strong Republican polling signals voter support for taking on China	30%
Trump follows through on tariffs	US implements planned tariffs all Chinese imports and potentially delivers additional small hikes on certain tranches of goods. Pressure is applied to firms to avoid trade with China. Negotiations limp on	Economic data holds up in short term Taking China on seen as a win for Trump China opts to wait until the 2020 election Genuine deep divisions between both parties persist following implementation	Labour market data remains strong Republican polling signals voter support for taking on China Signalling is mixed from Trump and Xi Markets react negatively to new tariffs, providing some discipline beyond this threshold	40%
No escalation	US does not follow through on the next set of tariff threats and negotiations proceed in earnest but with no deal in sight	Economic data is weakening short term Trump's version of a win is uncertain China will negotiate to avoid tariffs but wants to wait Trump out Markets clearly price the risk of trade war	Labour market weakens severely Major market rout in fear of next tranche Republican polling signals voters unhappy about trade war Negotiating teams signal progress Trump twitter feed turns positive	10%
Tariffs removed	US and China agree a deal including a schedule to gradually withdraw tariffs based on certain conditions being met	Trump is following Art of the deal playbook US faces major economic & political pressure Market pressure becomes acute US settles for a poor deal that delivers few changes to Chinese industrial policy	Labour market weakens severely Major market rout over trade war Republican polling signals voters want a US-China trade deal Positive signaling emerges from negotiations Trump twitter feed turns sharply and consistently positive Leaks of agreement on renegotiated issues	20%

Global Themes

The future of globalisation

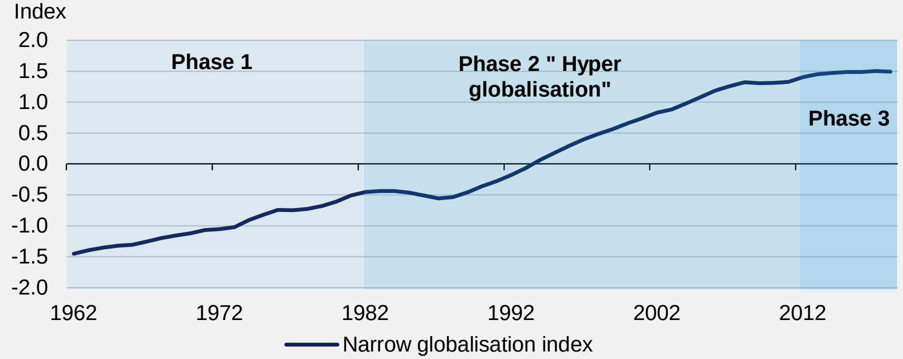
To provide a deeper understanding of the current state and probable evolution of globalisation, we have built a proprietary Globalisation Index. We identify three tectonic shifts in the nature of globalisation: 1) a profound shift in its composition – with trade & capital integration slowing while human and informational integration accelerates; 2) a shift in the balance of power in global trading relationships; 3) a strengthening headwind from policy and politics.

The continuation of the slow aggregate pace of globalisation will help keep potential economic and earnings growth lower than pre-crisis norms as it weighs on the commercialisation and diffusion of technological progress. That in turn should help sustain lower real interest rates and lower aggregate equity returns.

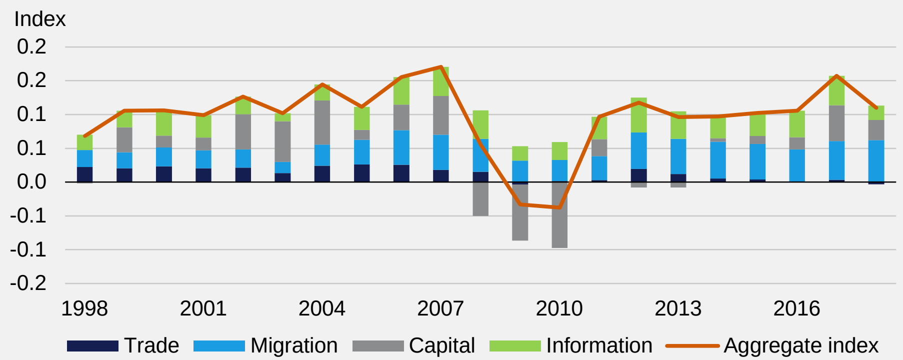
At a more granular level, slower goods trade and capital market integration relative to human and informational integration will tilt the relative winners from future globalisation away from 'super manufacturing trading' economies and multinationals reliant on global goods value chains, towards more domestically oriented, service based economies and firms. Importantly, the changing composition of globalisation implies greater dispersion in performance at the country and company level, creating greater opportunities for active investors.

Finally, a world in which strategic conflict between the US and China becomes more common, countries will increasingly be forced to choose to selectively align themselves to competing power blocs. This will increase the likelihood that the global trading and regulatory system fragments into competing regional blocs. As previous correlation and relationship structures break down investors will need to adapt and innovate both in terms of investment approaches and client outcomes.

ASI narrow globalisation index



Clash of 'old' and 'new' globalisation



Source: Haver, Aberdeen Standard Investments, September 2019

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Implications of looser Chinese financial conditions

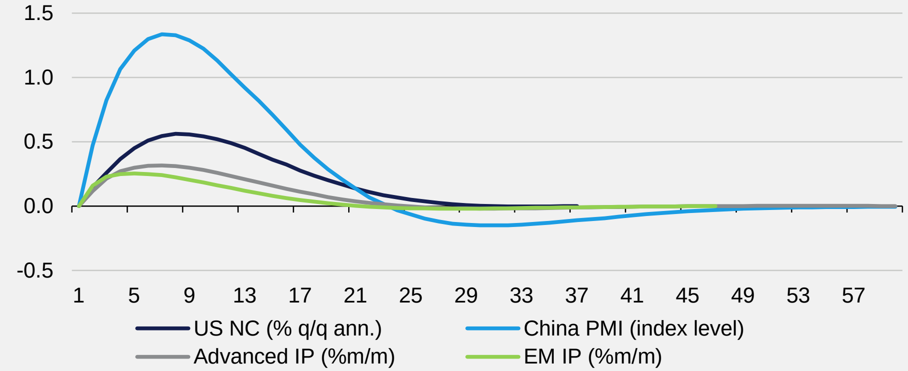
Recent empirical work assessing the implications of a shock to our Chinese financial conditions index has found significant impacts on not just Chinese domestic macro variables but also spillovers to other regions.

We model a three-unit shock, equivalent to the loosening which we have seen between 2017 and 2019, in our Chinese financial conditions index (CFCI). Using a Bayesian VAR we are able to model the implications of the shock for macroeconomic and market variables jointly and assess the impact over the 60 months following the initial shock.

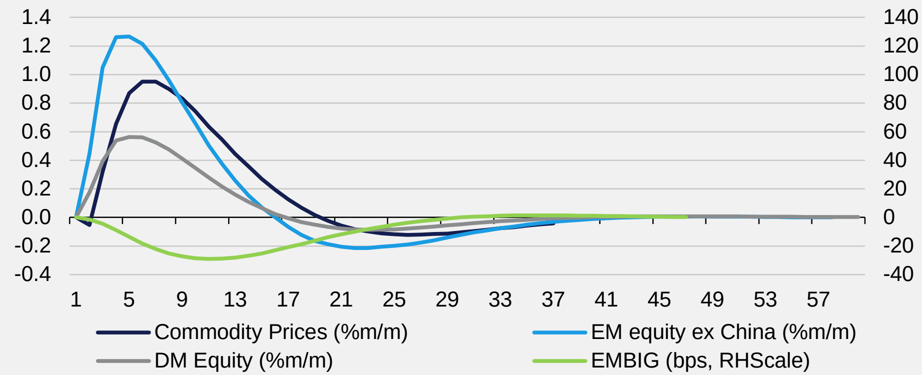
We find that the shock to Chinese financial conditions boosts the Chinese composite PMI, the pace of industrial production growth in both EM ex China and developed markets (DM) but also boosts our US nowcast. The length of time it takes for the peak effect to be felt in these variables differs with EM IP peaking first, followed by the Chinese PMI and DM IP then the US nowcast. The response of market variables also differs by region. We find that equity returns in EM ex China and DM react positively to the loosening in financial conditions with the peak in EM equities occurring earlier. Commodity prices are also positively impacted by the shock, albeit the peak effect occurring later, after six months. We also find that the shock causes a narrowing in the EMBIG spread of around 30bps after 11 months.

Despite the positive implications of loosening Chinese financial conditions and our expectations for further policy easing from Chinese authorities we do not expect a large spillover from this loosening. This is driven by factors external to this modelling framework, such as the composition of the policy loosening and the ongoing trade war between the US and China. Both of these are likely to lessen the efficacy of loosening and weigh on Chinese growth, thus weakening the anticipated spillovers.

Response of macroeconomic variables



Response of market variables



Source: Haver, Aberdeen Standard Investments, September 2019

The Fed's policy review – evolution or revolution?

The Fed is conducting a review of its monetary policy strategy as it seeks to repair the damage done to its inflation credibility over recent years, and bolster its policy firepower in a world of lower equilibrium interest rates.

While it is positive that the Fed is evaluating its policy framework, it should also be mindful that the current framework is not to blame for its own policy mistakes since the financial crisis. The Fed repeatedly underestimated spare capacity, overestimated the level of equilibrium interest rates, and, partly as a result of both of these, generated inflation forecasts that were too high. This meant that the central bank provided insufficient policy support after the crisis and sought to prematurely withdraw accommodation.

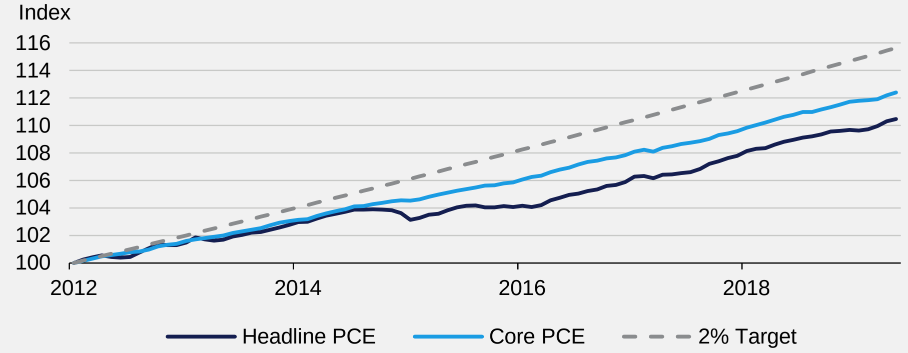
Instead, the ongoing review has centered on make-up strategies. Under this approach the Fed would not allow past deviations from its 2% target to be treated as bygones. Rather, it commits to partly, or fully, reversing these shortfalls or overshoots from the implied price level. If credible, this approach should boost long-term inflation expectations and provide an automatic stabiliser for the economy. For example, amidst a period of low current inflation, the new framework would require stronger offsetting actions. This would push inflation expectations higher in the medium-term and anchor long-term expectations at 2%. This would provide more real policy and labour market adjustment than in the current framework, particularly when rates hit the effective lower bound.

There are, however, downsides. Given past experience, credibility might be hard to win for the Fed, implying that longer-term inflation expectations may only increase following a sustained period of success. At the same time, the switch to a make-up framework will provide a communication challenge. Finally, the new framework could expose the Fed to more political pressures.

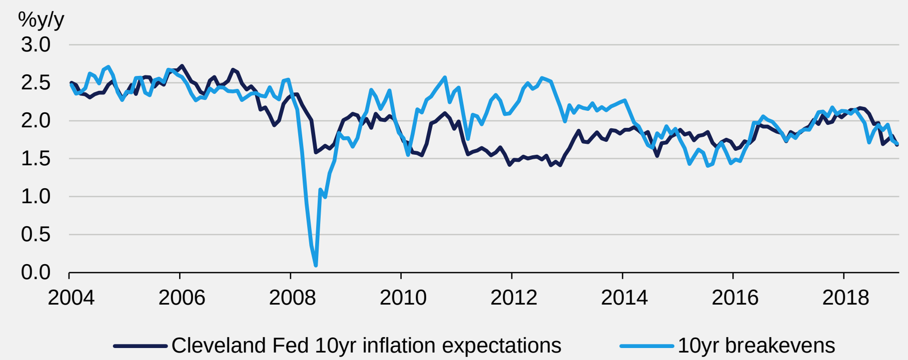
Overall, the Fed will need to deliver a framework that has strong make-up characteristics in order to reap the greatest benefit from this shift. Moreover, it will need to win credibility around this framework. More introspection around its recent policy missteps would help on this front. As would aggressive action in the early stages of implementation to build credibility.

Source: Haver, Aberdeen Standard Investments, August 2019

Consistent undershoots in the Fed's target



Have hurt inflation expectations



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Global forecast summary

	GDP growth			CPI inflation		
	2019	2020	2021	2019	2020	2021
Global	**2.8**	**2.8**	**2.9**	**3.4**	**3.4**	**3.2**
DM	1.7	1.0	1.3	1.5	1.7	1.8
US	2.2	1.1	1.6	1.9	2	2.2
UK	0.9	-1.5	0.4	1.9	3.7	2.6
Japan	1.0	0.2	0.9	0.7	0.8	0.9
Eurozone	1.1	0.7	0.7	1.2	1.2	1.3
EM	**3.7**	**4.1**	**4.0**	**4.8**	**4.7**	**4.2**
Brazil	0.9	1.5	1.4	3.7	3.4	3.6
Russia	0.9	1.8	1.3	4.6	3.8	3.8
India	5.2	6.4	6.6	3.1	3.9	4.2
China	6.0	5.4	5.2	2.5	2.5	1.9

Above consensus   Below consensus

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

* Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.

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