Schroders

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Economic and Strategy Viewpoint

November 2018

Keith Wade
Chief Economist and Strategist
(44-20)7658 6296

Azad Zangana
Senior European Economist and Strategist
(44-20)7658 2671

Craig Botham
Emerging Markets Economist
(44-20)7658 2882

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Turning to fiscal policy?

- The recent sell off in risk assets primarily reflects fears of weaker growth and a slowdown in corporate earnings in 2019. Our global growth indicator remains robust, but has become much more dependent on the US as others have faltered particularly in Europe.
- As central banks look to normalise monetary policy, fiscal policy is returning to vogue as governments take a leaf from the Trump play book. We may even see extra fiscal support in the US where there is potential for a surprise Republican performance in the forthcoming mid-term elections.

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Eurozone: Keep calm and carry on

- Forget Italy; Eurozone activity indicators are down again as concerns about growth re-emerge. The manufacturing sector is struggling with new orders declining, possibly caused by the escalation in the US-China trade war.
- Much of the weakness seems to be in Germany, particularly in the auto sector. New emission standards are to blame for the temporary drop in production and demand.
- Despite the reports of slowing growth, the economy is still expected to perform in line with its trend rate of growth, meaning that unemployment keeps falling, and wages continue to recover. The European Central Bank is happy to hold its course against this backdrop.

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Brazil backs Bolsonaro

- Bolsonaro has outperformed expectations and shifted to an economic stance that pleases investors, but the real test is yet to come.
- Without unforced errors, there is reason to expect Brazil's outperformance to continue until confronted by reality in mid-2019.

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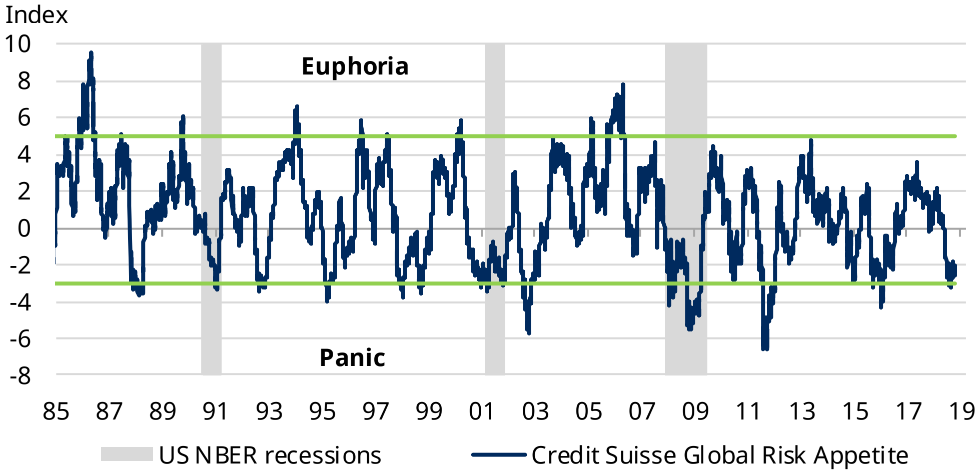
Views at a glance

- A short summary of our main macro views and where we see the risks to the world economy.

Chart: Market turmoil – investors panic



Source: Thomson Reuters Datastream, Schroders Economics Group, 24 September 2018.

Turning to fiscal policy?

Risk assets sell off on fears of weaker growth

Markets hit an air pocket in October with risk assets selling off on a range of fears from US-China trade wars to Brexit to the Italian budget proposal. At the time of writing the S&P500 index has given up its gains for the year whilst the Eurostoxx 50 is down by 10% and emerging market equities by 14% year to date. Bond markets have not had a particularly good year, but relative to equities the gap in performance means that the Credit Suisse risk appetite index is close to panic (see chart on front page).

Trying to pin down the cause of the correction is absorbing much media attention but we would point out that concerns over trade wars and who is or isn't leaving the EU or the euro have been around for some time. For us the most plausible trigger of the recent volatility is the rather downbeat comments from US companies about next year. Caterpillar, often seen as a global bellwether, expressed caution on the outlook citing tariffs, while another industrial firm, 3M, cut its full year earnings forecasts, blaming the strong dollar. When combined with comments and somewhat disappointing quarterly results from Amazon and Alphabet – Google's parent company – there is a sense that we have passed the peak in terms of earnings growth.

In addition we would remind readers that an expected increase in volatility has been one of our themes for this year, a consequence of the tightening of monetary policy and the challenge for markets of beating elevated expectations. After the positive growth surprises of 2017, investors raised their forecasts and we have seen more downside surprises this year.

On the liquidity side, the US Federal Reserve (Fed) has indicated that policy rates are now at neutral, but is showing little sign that the rate hiking cycle is over. Meanwhile, quantitative tightening continues apace with the Fed stepping up its balance sheet reduction programme to $50 billion per month in October. The European Central Bank (ECB) has started to taper and confirmed that it will end its asset purchase programme in December. Meanwhile, there are increasing signs of the Bank of Japan (BoJ) scaling back purchases of government bonds.

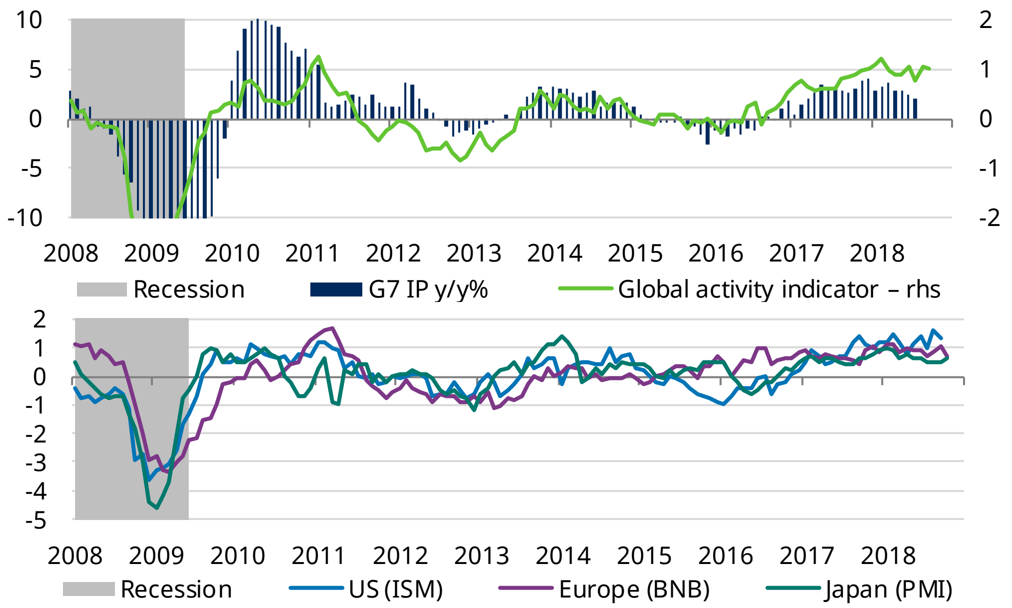
Clearly, tightening liquidity is set to remain a feature going forward and our focus this month is on the growth outlook and whether we might see a repeat of the conditions that led to the synchronised recovery of 2017. Stronger growth would allay earnings concerns for next year and if broadly supported could prompt a market rotation away from the US dollar, towards non-US equity markets.

Prospects for re-convergence?

The world economy became less synchronised in 2018

Our global growth indicator remains robust and has been a better predictor of turning points in the world economy than the panic index. However, having synchronised in 2017 the major economies have moved out of step in 2018. The US has continued to power ahead, but growth elsewhere has been more lacklustre. For the third quarter US real GDP expanded by a robust 3.5% annualised whilst China and Europe cooled. We have yet to receive the comparable figures for Japan, but the breakdown shows they have also failed to keep pace with the US (see chart 1).

Chart 1: Global activity indicator robust, but less synchronised



Source: Thomson Reuters Datastream, Schroders Economics Group, G0005, 23 October 2018. The global activity indicator is an average of the US ISM, Belgian National Bank survey, and Japanese PMI. PMIs in the lower panel have been standardised

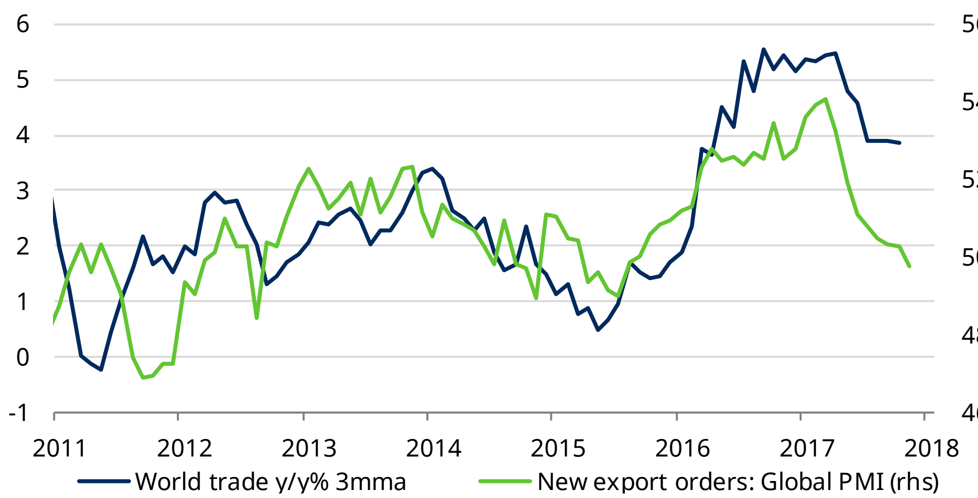
The key factor has been the slowdown in global trade growth such that economies which rely heavily on external demand have seen activity slow. In 2017 a revival in trade growth lifted all boats creating a synchronised recovery. However, as the tide ebbed, growth fell back such that only those with robust domestic demand were able to maintain strength.

Fiscal policy has kept the US growth engine running as trade slowed

For example, the US experienced weaker growth in net exports in Q3, but successfully offset this with stronger domestic demand. Expansionary fiscal policy has played a significant part in boosting consumption and government spending. In this respect President Trump's fiscal largesse could be seen as coming at just the right time: switching on the boosters just as the economy was beginning to fade.

From this perspective, it could be argued that the prospects for a resynchronisation of global growth depend on whether global trade will pick up. At this stage though this looks unlikely as leading indicators such as the global purchasing managers index (PMI) of export orders point to a further deceleration in coming months (see chart 2).

Chart 2: Global trade to slow further



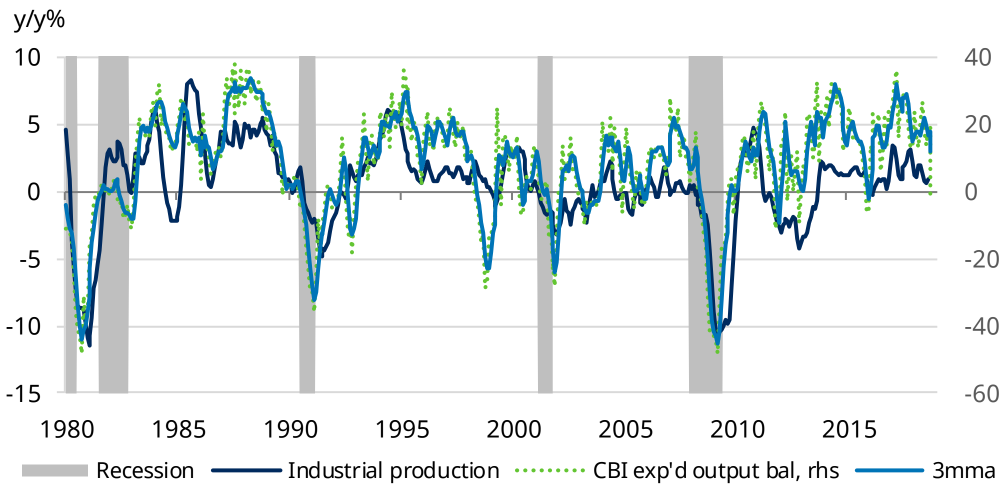
Source: Thomson Reuters Datastream, Schroders Economics Group, G0018, 23 October 2018.

Recent data suggests that the Eurozone and China remain in the doldrums with the PMIs slowing further in October (see next section for more on the Eurozone slowdown). However, Japan has recently shown some signs of strength with a pick-up in the flash PMI in October and capex intentions in the Tankan and Business Outlook survey have been notably strong this year. The economy is set to receive a fiscal boost this quarter as rebuilding gets underway following recent natural disasters.

UK, Eurozone and China remain in the doldrums

Meanwhile, the UK may face a further deterioration with indicators such as the CBI survey pointing to a weak spell for the economy. The UK growth rate has been below the G7 average since the vote to leave the EU in 2016, having previously been above. The uncertainty created has hit business investment and with the government now preparing the country for a hard exit in March many will put off major purchases. This applies to both business and households and creates the real risk of a temporary albeit damaging dip in activity around the turn of the year.

Chart 3: CBI output expectations point to dip in UK output

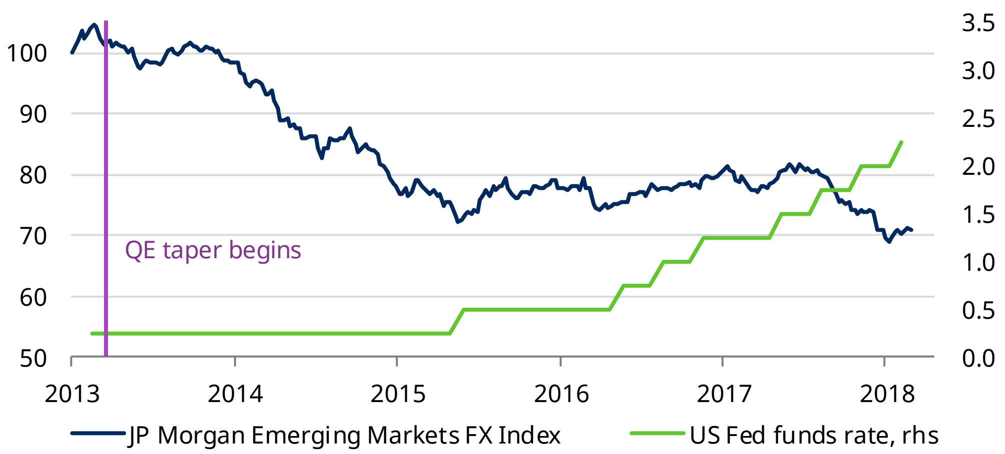


Source: Thomson Reuters Datastream, Schroders Economics Group, G0035, 23 October 2018.

Emerging markets have suffered from a stronger US dollar

For the emerging markets (EM) beyond China the strength of US demand should have been a support for export growth. Instead they have suffered from the effects of higher US interest rates and a stronger US dollar which has tightened financial conditions. Higher US rates have slowed the search for yield and drawn capital back to the US putting pressure on EM exchange rates (chart 4). In the worst case this has led to a financial crisis (Turkey and Argentina), but more generally has tightened local liquidity and pushed up borrowing costs.

Chart 4: EM FX and the Fed



Source: Thomson Reuters Datastream, Schroders Economics Group, 23 October 2018.

Taking a leaf from the Trump play book

Easier fiscal policy in China, Europe and Japan

Faced with this backdrop, governments are beginning to look at the Trump play book on fiscal policy. China announced tax cuts in October where income tax brackets would be lifted and tax allowances increased providing a benefit to households of RMB500–600 billion (0.5% GDP). There is talk of more to follow in terms of auto sales, VAT and corporation tax reductions.

In Europe, German fiscal policy should be modestly expansionary next year and, of course, Italy has announced a more growth orientated fiscal policy, contrary to the rules set by the EU commission in Brussels. The UK has also just announced a more relaxed budget and fiscal giveaways which will increase the level of annual borrowing as a share of GDP for the first time since 2009/10. Meanwhile, as already mentioned, Japan has announced a supplementary budget in the wake of the natural disasters faced by the country and there are discussions on how to offset the impact of the higher consumption tax in 2019 such as spending more on pre-school education and other measures.

Scope for a surprise in the US mid terms?

It is also possible that we see more fiscal support in the US. It is widely expected that the Democrats will regain control of the House of Representatives in the upcoming mid-terms. The subsequent grid-lock with the Republicans retaining control of the Senate would mean that there is little prospect of the president passing any more tax cuts. However, the Democrats might be persuaded to support fresh infrastructure spending which they have favoured in the past.

Alternatively, the mid-terms could deliver a surprise which sees the Republicans retain control of the House. A low popularity rating for a president, as is currently the case, traditionally spells trouble for their party. When accompanied by a strong economy and high levels of consumer confidence, however, the incumbent party can still perform well. On our analysis the current high levels of consumer confidence suggest that the Republicans could lose fewer seats than expected and retain control of both the House and Senate. If so then we can expect to see more tax cuts as the president moves to boost the economy ahead of his bid to be re-elected in 2020.

The new 'put'

Going forward we would expect increasing pressure on governments to deploy fiscal policy to support faltering growth. With the central banks now focused on normalising monetary policy, governments will be increasingly stepping in as the supporters of growth. For investors this would mark a profound shift from the traditional central bank 'put' to something less flexible and more dependent on the complexities of politics.

Eurozone: Keep calm and carry on

"We're talking about a weaker momentum, not a downturn. This is clearly certified by most survey indicators... [which] remain above – and in some cases well above – historical averages."

Mario Draghi, President of the European Central Bank, 25 October 2018.

Investors have been fixated on the political budgetary showdown between the Italian government and the European Commission since the summer. As we wrote last month, we continue to believe that so-called Italy crisis is a red herring. Instead, our attention has turned to Eurozone activity data, which has weakened further heading in to the fourth quarter.

In August, we downgraded the Eurozone growth forecast by some margin to factor in our view that the trade war between the US and China would likely escalate and have negative consequences for Europe (at least initially before trade divergence occurs). The latest downturn may be due to the trade war but warrants further investigation.

Eurozone manufacturing slumps

Leading activity indicators fell sharply in October, pointing to a further slowdown in growth

Leading indicators suggest the Eurozone economy slowed markedly in October. The preliminary macro composite purchasing managers index (PMIs) fell from 54.2 to 52.7, which is consistent with real GDP falling from 1.7% year-on-year growth in the third quarter, to just 1.3% y/y[1]. On a quarterly basis, this translates to the monetary union stalling in the final quarter of the year. Of course, this is only a reading for October, but it is worrying nonetheless.

Within the details of the latest PMI report, new orders led the aggregate index lower. One piece of good news was that the backlog of work remained above 50, suggesting that demand continues to outstrip supply (chart 5). Therefore, even if orders fall further and below 50, output may continue to grow to meet the backlog of orders.

Chart 5: EZ macro composite PMIs

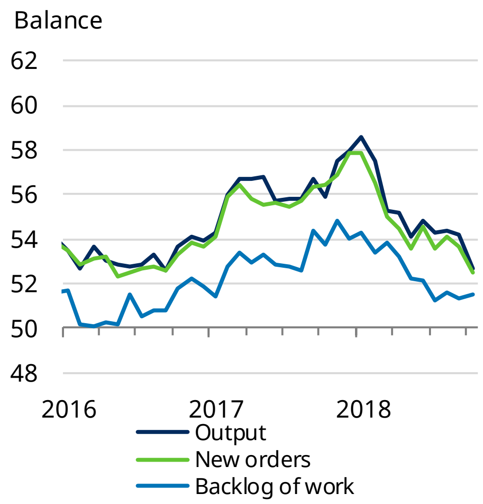
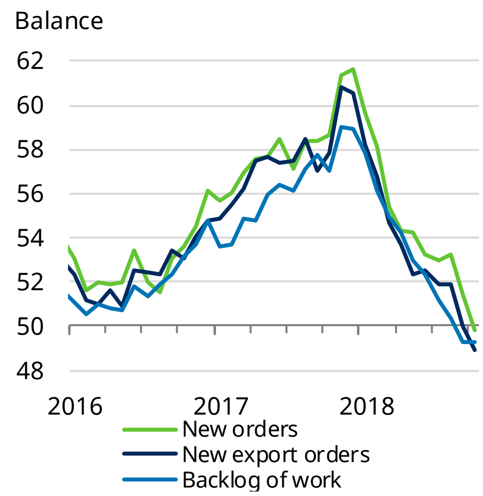


Chart 6: EZ manufacturing PMIs



Source: Thomson Reuters Datastream, Markit PMIs, Schroders Economics Group. 29 October 2018.

[1]The PMI surveys are presented as a net balance of positive and negative responses with regards to the question asked. 50 is the neutral point, and so if the Output index is above 50, then on balance, output has increased over the month, while below 50 marks a contraction.

Manufacturers appear to be the weakest link, with falls in orders, and especially export orders

A further exploration of the data shows that the services PMI slowed, but remained in expansionary territory. However, the real weakness in the economy can be found in the manufacturing sector, where the PMI report showed new orders below the neutral 50 mark for the second consecutive month – the first time orders have been contracting since June 2013.

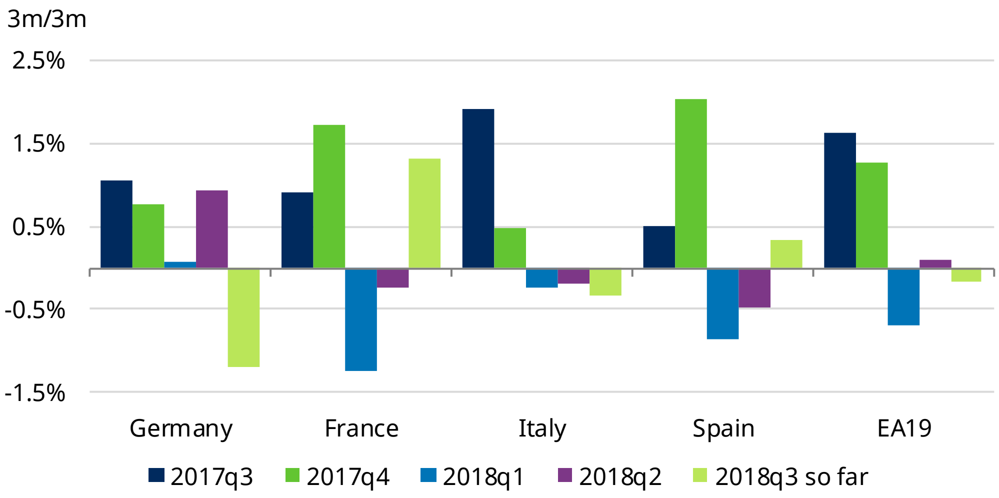
The fall in new orders has been led by the fall in new export orders, which is consistent with our forecast of waning external demand. Exacerbating worries is the fall in the backlog of work index within the manufacturing PMI report, which is now showing the backlog reducing. This suggests output growth should start to slow, and eventually fall if weak demand persists.

The PMIs are useful indicators of near-term future activity but are not accurate measures of output or orders. The responses by companies tend to be swayed by sentiment, such as for example, the euphoria of 2017 which did not materialise in the actual output figures measured by official statistical agencies.

The latest official industrial production data however also show signs of weakness. Estimates are only available for until August, but at the Eurozone aggregate, this would mean a contraction in output. Within the large member states, industrial production is weakest in Germany by far – contracting by 1.2% (chart 7). Italy is also seeing a contraction, but Spain and France have seen their best quarter since the end of 2017.

Germany seems to be leading the decline, with a poor performance so far in Q3

Chart 7: Industrial production led lower by German manufacturers



Source: Thomson Reuters Datastream, Schroders Economics Group. 29 October 2018.

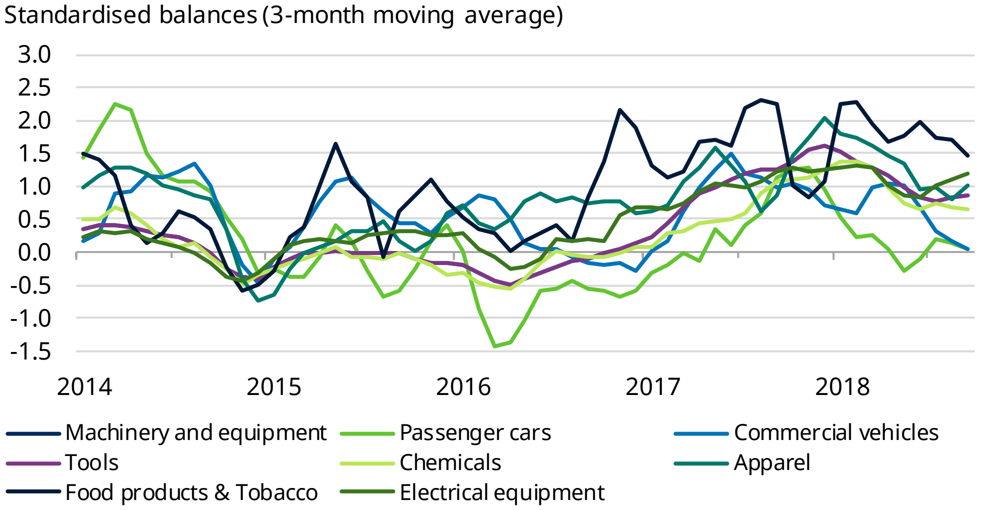
The experience in Italy could be blamed on the escalation of political uncertainty, but the recent weakness is nor particularly striking. Germany's poor performance on the other hand is more concerning, especially as Germany tends to outsource a significant proportion of its total exports to other countries across Europe. If Germany starts to stutter, then we should expect the ripples to be felt far and wide.

Kaputte Autos

How serious is the problem in Germany? A closer examination of recent production data shows that most of the weakness in recent months was in the production of commercial and passenger vehicles. The immensely detailed data available in the IFO survey shows that most manufacturing sub-sectors reported stable and above average growth rates, with the exception of car production (chart 8).

Most German manufacturing sub-sectors are performing well, but the autos sector has been weak

Chart 8: IFO survey shows recent autos to blame for weakness



Source: Thomson Reuters Datastream, IFO, Schroders Economics Group. 29 October 2018.

The fall in car production is corroborated by the 30.5% y/y fall in new car registrations reported in September by the German Motor Vehicle Authority, the Kraftfahrtbundesamt (KBA).

This is largely due to the new worldwide harmonised light-duty vehicles test procedure (WLRP). This was brought in after several manufactures were found to have been manipulating the behaviour of engines during emissions testing, leading to a more favourable outcome than in normal conditions. These new tougher standards were introduced for all new models from 1 September 2017, but also applied to all newly-registered vehicles from 1 September 2018. This prompted retailers to heavily discount non-compliant models before the deadline causing a surge in new registrations in August (+24.7% y/y according to KBA), but then the inevitable collapse in September mentioned above.

New emission standards prompted discounting in August, and a drop in demand and output in September

The WLRP has affected all of Europe, and so Germany is not alone. However, German car production is one of the largest subsectors in the German economy at 4.7% of total value added; the same size as education in Germany. The large size of the sector means the WLRP issue has had a disproportionately higher impact on German industrial production and GDP than in most other countries.

The slump in car registrations and output should prove to be temporary, and was mentioned as an isolated factor by European Central Bank president Mario Draghi at his latest press conference[2].

What about trade wars?

The weakness in export orders remains a concern, but there has been a rebound in Eurozone exports since we last examined the slump in the first half of the year[3]. Chart 9 shows the exports in the second quarter rebound compared to the fall in the first quarter, and exports in the three months to August rose even faster.

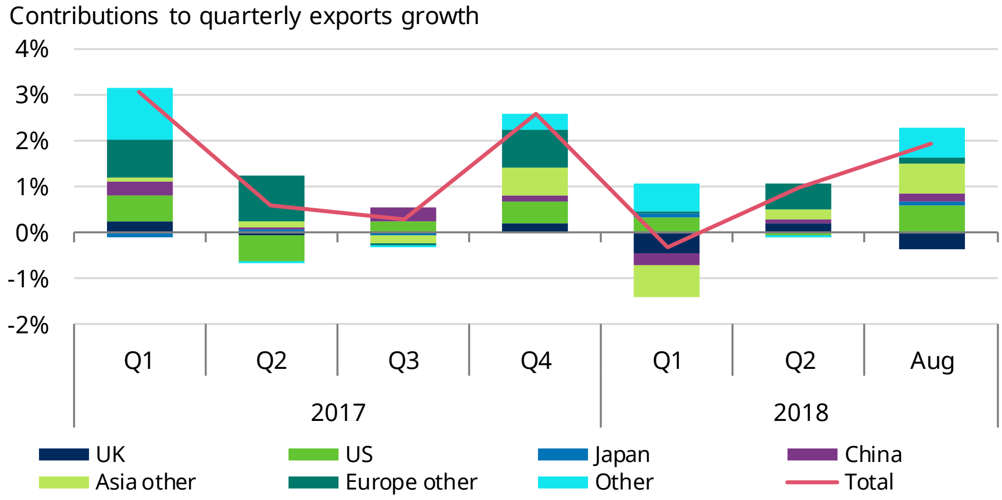
Good news is exports have rebound from the poor start to 2018

Our previous analysis had shown that three key export partners were the cause of the slump in the first quarter: Asia other, China and the UK. A breakdown of Asia other showed that OPEC Middle-East countries were at fault, possibly a lagged reaction to lower oil prices in 2017. Lower exports to the UK can easily be explained by the weakness in the economy and the fall in the pound following the Brexit referendum, while the slump in orders from China is assumed to be linked to concerns over global trade. Though US tariffs on Chinese exports have barely begun to have an impact, as

[2] 25 October 2018.
[3] See the July edition of the Economics and Strategy Viewpoint.

Europe tends to export machinery and capital goods to China, a worsening outlook is likely to have caused delays and cancellations of investment projects, which in turn hurt Eurozone exports.

Chart 9: Eurozone exports have rebound from the Q1 slump



Source: Thomson Reuters Datastream, Schroders Economics Group. 29 October 2018.

The latest data shows that exports to both the Middle-East and China have rebounded, but exports to the UK continue to fall. This presents some upside risk to our forecast for the end of the year. However, we doubt the latest pick-up will be sustained, especially as the exports orders data has continued to weaken in surveys as shown earlier. Moreover, our baseline view that the trade war will escalate further suggests more headwinds for exporters ahead.

Conclusions

Though Mario Draghi acknowledged the greater presence of downside risks for the Eurozone economy, especially from trade wars and political risk in Italy, he stated that the Governing Council's view was that risks to growth remained balanced. Quantitative easing has been tapered to €15 billion of purchases per month as previously announced, and is expected to end as scheduled at the end of the year.

While activity is slowing, GDP growth is still above trend, paving the way for the ECB to unwind its stimulus programme

There has clearly been a loss in momentum to the Eurozone economy this year. Some of the weakness has been caused by temporary factors, but some has been caused by exogenous external factors. The big picture, however, remains healthy. The economy continues to grow above trend, meaning that employment is growing at an accelerated pace, unemployment is falling, and wage growth is above average. All of which is supportive of an improvement in domestic demand, which has been the case over 2018.

The risk is that the weakness in the tradeable sectors starts to have a negative impact on other sectors and confidence. There are few signs of this so far, although retail sales growth has slowed this year, despite consumer confidence remaining high.

Finally, at the time of writing, draft 2019 budget proposals are being published. They appear to show that a number of member states, including Germany, are joining Italy by introducing some fiscal stimulus for next year. More to come on this next month when we will also be updating our forecast.

Brazil backs Bolsonaro

"There is no doubt. I would launch a coup on the same day. [Congress] doesn't work and I'm sure that at least 90% of the population would applaud. Congress nowadays does nothing; it votes only for what the president wants. If he is the person who rules, who decides and who gloats above the Congress, then let the coup be launched, let it be a dictatorship."

Jair Bolsonaro, on what he would do on his first day as president, speaking in 1999. Gazeta do Povo, 10 October 2017.

It is to be hoped that Jair Bolsonaro has moderated somewhat in the last twenty years, or the chaos of Brazilian politics will increase markedly under his presidency. Admittedly, his campaign rhetoric, nineteen years later, has remained unpleasantly controversial, in a mirror of his US counterpart. But for all his professed admiration for dictators, we do not think Bolsonaro poses an existential threat to Brazilian democracy; not least because we believe he will struggle to advance a controversial policy agenda as president.

The will and ability to reform

Bolsonaro has apparently embraced economic liberalism...

Financial markets, at least, have been rooting for a defeat of the left-wing candidate Fernando Haddad, successor to former president Lula, on the basis of the very different economic policies espoused by the two candidates. Superficially, this seems odd given that Bolsonaro has repeatedly voted against reform and spoken out against privatisation – he once said former president Fernando Henrique Cardoso should be shot for privatising iron ore miner Vale. However, in his presidential run this is one stance he did moderate, appointing pro-market Paulo Guedes as his economic advisor and now minister. Haddad, meanwhile, remained staunchly anti-reform, anti-privatisation and in favour of more spending.

However, we still have some concerns around Bolsonaro's Damascene conversion to the cause of free markets. Guedes is not the only advisor he has, and others on his team oppose the ultra-liberal stance Guedes takes, particularly on privatisation. Meanwhile, other key figures, including his likely chief of staff and one of his four senators, seem strongly opposed to pension reform. On top of these internal divisions, Bolsonaro must also contend with a fragmented legislature.

...and outperformed political expectations

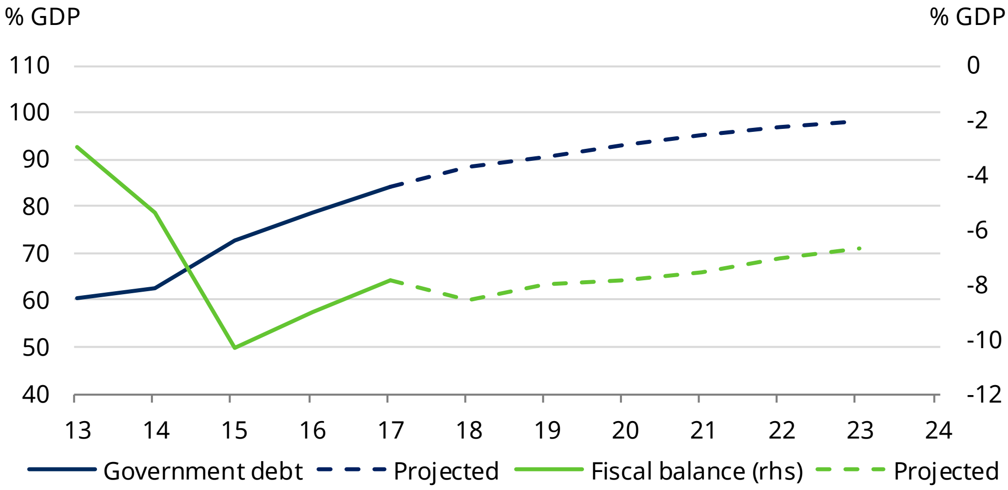
Bolsonaro's Social Liberal Party (PSL) performed much better than expected in congressional elections on 7 October, taking 52 seats in the lower house and four seats in the Senate. However, this still only gives it 10% and 5% respectively in the two houses, which now have 20–30 parties apiece. Pension reform, attempted and failed by the Temer administration, needs a supermajority of 308 votes to pass in the lower house. Can Bolsonaro cobble together a coalition and succeed where Temer failed? The elections have delivered a lower house which has shifted materially to the right, which should help. But early estimates of Bolsonaro's likely allied base are smaller than those of Dilma or Temer, in their early days in office, though still large enough to deliver the supermajority needed, in theory. Still, a cause for concern here is Bolsonaro's limited ability as a political operator; he will need to draw allies with skill in negotiating the legislative process.

The need to reform

Brazil's largest single economic problem at present is its fiscal position. Government debt-to-GDP is remarkably high by emerging markets (EM) standards at 84%, and is set to climb further thanks to sizeable deficits (7.8% of GDP in 2017, including interest payments) with the IMF projecting gross debt to hit 95.6% in 2023.

Brazil needs to move quickly to head off a debt crisis

Chart 10: Brazil's debt problem is projected to deteriorate



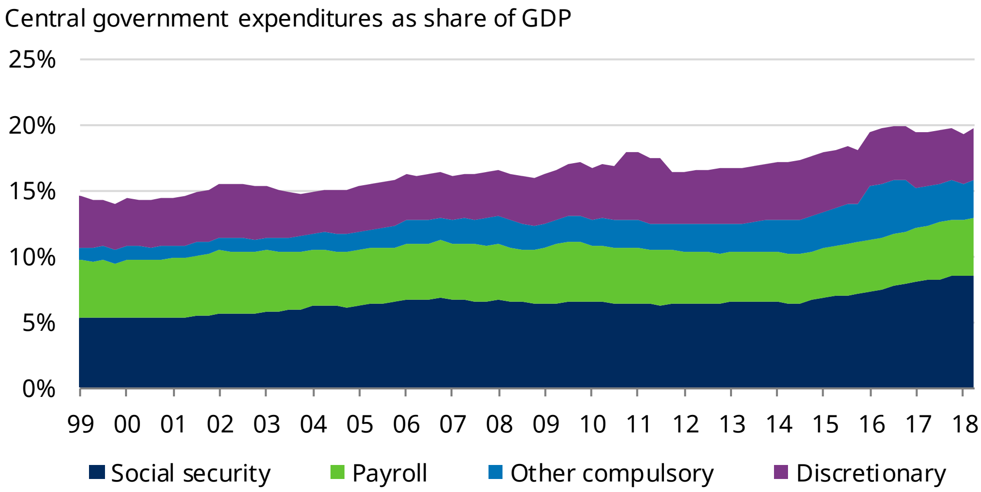
Source: IMF, Thomson Reuters Datastream, Schroders Economics Group. 24 October 2018.

Efforts have already been made, under the Temer administration, to tackle this. A spending cap limiting government expenditure to 2016 levels in real terms – which mandates a reduction in spending of 0.5% of GDP per year from 2019 – is helpful, but presents its own problems. Unfortunately for would-be fiscal hawks, some 80% of the budget consists of mandatory expenditures, leaving little fat to trim, particularly when investment spending and earmarked funding are taken into account. Deutsche Bank estimate this leaves about 7% of government expenditures subject to cuts. Without reforms to reduce mandatory spending, there will be strong pressure to lift the spending cap in 2019, which would be a terrible policy signal.

Pension reform is desperately needed

The lion's share of this budget expenditure is taken up by social security benefits, particularly pensions; a problem which grew notably under Dilma's government. As has been highlighted in the Economist and elsewhere, Brazilian expenditure on pensions is as high as that seen in Europe, despite wildly different incomes and demographics. Pension reform is therefore key to addressing Brazil's dire fiscal outlook. In their recent Article IV consultation, the IMF argued that to stabilise pension spending as a share of GDP, reform would need to increase retirement ages, de-link the minimum pension from the minimum wage, and reduce the generosity of public sector pensions in particular (80% of pension payments currently go to the public sector).

Chart 11: Government spending is large and hard to cut



Source: Thomson Reuters Datastream, Schroders Economics Group. 24 October 2018.

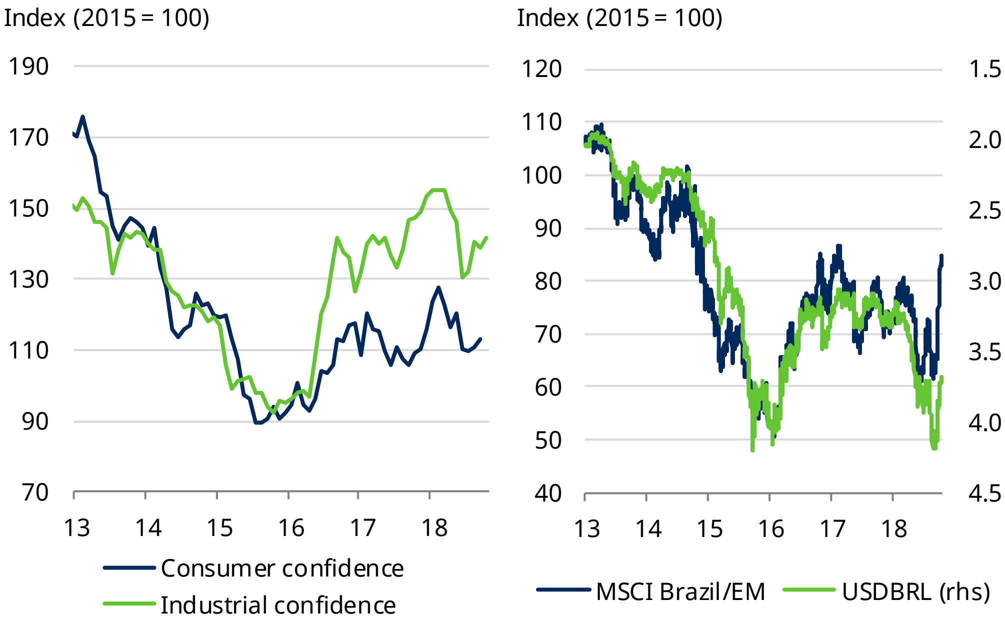
It would also be helpful to reduce payroll expenditure, simplify the tax code (particularly by reducing exemptions) and tackle the broader problem of mandatory expenditures. Pension reform though is key as being symbolic of intent, as well as the largest single ticket item of expenditure.

Market and macro implications

Confidence in Brazil's prospects is resurgent

At the beginning of the year, the strength of candidates on the political extremes, particularly Lula and Bolsonaro, was a major concern for investors, with hopes pinned on centrist candidates like Geraldo Alckmin, who performed abysmally in polls. This dragged on economic confidence and market performance throughout 2018. Over time, though, perceptions shifted, aided by Bolsonaro's apparent embrace of economic liberalism. Business confidence in particular has rebounded from its lows this year which should be positive for investment, while Brazilian assets have seen a resurgence of interest, in part because they offer a rare good news story in a torrid year for EM.

Chart 12: Bolsonaro bolsters Brazilian sentiment



Source: Thomson Reuters Datastream, Schroders Economics Group. 25 October 2018.

It seems likely that this initial optimism could extend to euphoria for a while. Assuming no unforced errors on the part of Bolsonaro, the first reality check for investors is likely to come in the second quarter of 2019, when a post-Carnival legislature comes to the practicalities of passing tough bills (legislative recess will begin on 22 December and end only on the 4 February, one month before Carnival). Until that point, markets should feed largely on the signals sent by the incoming president. Signs that Guedes is being side-lined (or that the corruption investigation could remove him) or that Bolsonaro is finding it harder than expected to build an allied legislative base, could knock the rally off course. On the other side, should Bolsonaro manage to attract experienced political names, this would further raise the perceived odds of passing tough reforms, given his own limited legislative experience (he has co-authored only two pieces of legislation in a near 30 year long career).

Ride the market euphoria, but be wary

On the macroeconomic side, the sheer relief at having avoided a leftist government should see a lot of deferred investments finally break ground. Currency strength after a period of weakness will also help calm nerves on inflation and the direction of interest rates. We would expect economic growth to begin accelerating, which should also have the effect of boosting Bolsonaro's political capital at a crucial moment.

For now though the Brazilian story seems a good one. We will keep an eye on Bolsonaro for signs of wavering policy intent, or even a preference for prioritising social legislation over fiscal issues. Should he fail to deliver, a sharp unwind seems likely, with particular pain in the fixed income space given the extremely challenging fiscal outlook.

Schroders Economics Group: Views at a glance
Macro summary – November 2018

Key points

Baseline

– Global growth is expected to reach 3.3% in 2018 unchanged from 2017, before moderating to 3.0% in 2019. Inflation is forecast to rise from 2.9% in 2017 to 2.8% in 2018 and 2019. Core inflation in the US is expected to rise back above 2% in 2018 and the world economy moves firmly into the expansion phase of the economic cycle.

– US growth is forecast at 2.9% in 2018 and 2.8% next, incorporating President Trump's fiscal stimulus packages. The Fed has now started balance sheet reduction (quantitative tightening) and with core inflation rising, we expect another rate hike in December and two more in 2019, ending the forecast at 3%.

– Eurozone growth is forecast to moderate to 2.0% in 2018, but remains robust overall. Italian political risk is back and has reintroduced volatility. Growth should moderate in 2019 to 1.7%, but this remains above trend. Inflation is expected to remain under 2%, with higher energy price inflation in 2018 replaced by higher core inflation in 2019. The ECB is likely to end QE in December 2018, before raising interest rates in 2019. The refinancing rate is forecast to reach 0.50%, and the deposit rate to reach zero, having been negative.

– UK growth is likely to slow to 1.2% in 2018 as Brexit uncertainty weighs on confidence. Inflation is forecast to fall back slightly to 2.4%, as sterling depreciation effects are replaced with energy and domestically generated inflation. 2019 is very uncertain given Brexit, but we assume a transition period will be agreed that preserves the states quo of single market and customs union membership. The BoE is expected to remain on hold for the rest of 2018 and hike twice in 2019 post-Brexit (to 1.25%).

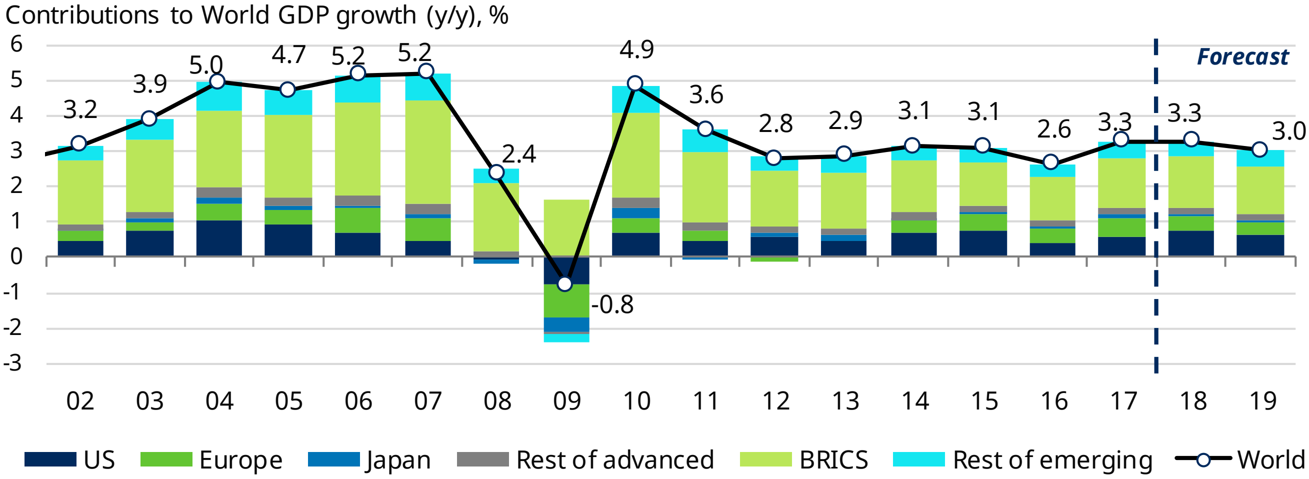
– Japanese growth is forecast to slow from 1.7% in 2017 to 1.0% in 2018 and 2019, as inflation almost doubles to 0.9% owing to higher oil prices. After tweaking yield curve control policy in the summer, the BoJ is not expected to move again over the forecast period.

– Emerging economies are forecast to see growth largely unchanged at 4.9% over 2018 before slowing to 4.6% in 2019. China's GDP growth is forecast to continue its secular decline, exacerbated by trade wars.

Risks

– Risks to the baseline forecast skewed towards a more stagflationary outcome. 'Trade war: China vs. RoW', 'Oil back to $100' and 'Italian debt crisis' are the main causes. 'Mid-cycle slowdown' is the only deflationary scenario, while 'Global trade liberalisation' provides a productivity boost scenario. There are two reflationary scenarios: 'Trump's growth boom' and 'Global fiscal expansion'.

Chart: World GDP forecast



Source: Schroders Economics Group, 15 August 2017. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2017	2018		*Prev.*	Consensus	2019		*Prev.*	Consensus
World	100	3.3	3.3	↓	*(3.4)*	3.3	3.0	↓	*(3.2)*	3.1
Advanced*	62.8	2.3	2.3	↓	*(2.4)*	2.3	2.0	↓	*(2.2)*	2.1
US	27.1	2.2	2.8	↓	*(2.9)*	2.9	2.4	↓	*(2.6)*	2.7
Eurozone	17.4	2.5	2.0	↓	*(2.4)*	2.0	1.7	↓	*(2.1)*	1.8
Germany	5.1	2.4	1.9	↓	*(2.3)*	1.9	1.7	↓	*(2.2)*	1.7
UK	3.8	1.7	1.2	↓	*(1.4)*	1.3	1.3	↓	*(1.6)*	1.5
Japan	7.2	1.7	1.0	↓	*(1.3)*	1.1	1.0	↓	*(1.1)*	1.2
Total Emerging**	37.2	5.0	4.9	↓	*(5.1)*	4.9	4.6	↓	*(5.0)*	4.7
BRICs	24.2	5.7	5.9		*(5.9)*	5.8	5.6	↓	*(5.8)*	5.7
China	16.4	6.8	6.6		*(6.6)*	6.6	6.2	↓	*(6.4)*	6.3

Inflation CPI

y/y%	Wt (%)	2017	2018		*Prev.*	Consensus	2019		*Prev.*	Consensus
World	100	2.3	2.9	↑	*(2.7)*	2.8	2.8	↑	*(2.4)*	2.7
Advanced*	62.8	1.7	2.2	↑	*(2.1)*	2.0	2.1	↑	*(1.9)*	1.9
US	27.1	2.1	2.8		*(2.8)*	2.5	2.6	↑	*(2.4)*	2.3
Eurozone	17.4	1.5	1.8	↑	*(1.6)*	1.8	1.6	↑	*(1.5)*	1.7
Germany	5.1	1.7	1.9	↑	*(1.8)*	1.9	1.8		*(1.8)*	1.9
UK	3.8	2.7	2.4	↓	*(2.6)*	2.5	2.2	↑	*(1.9)*	2.2
Japan	7.2	0.5	0.9	↓	*(1.2)*	0.9	1.3	↓	*(1.4)*	1.1
Total Emerging**	37.2	3.2	4.1	↑	*(3.6)*	4.2	4.2	↑	*(3.3)*	4.1
BRICs	24.2	2.2	2.7	↓	*(3.0)*	2.8	3.2	↑	*(2.9)*	3.1
China	16.4	1.5	2.1	↓	*(2.4)*	2.1	2.4	↑	*(2.0)*	2.3

Interest rates

% (Month of Dec)	Current	2017	2018		*Prev.*	Market	2019		*Prev.*	Market
US	2.25	1.50	2.50		*(2.50)*	2.73	3.00		*(3.00)*	3.13
UK	0.75	0.50	0.75		*(0.75)*	0.84	1.25		*(1.25)*	1.06
Eurozone (Refi)	0.00	0.00	0.00		*(0.00)*	-0.30	0.50	↓	*(0.75)*	-0.15
Eurozone (Depo)	-0.40	-0.40	-0.40		*(-0.40)*		0.00	↓	*(0.25)*	
Japan	-0.10	-0.10	-0.10		*(-0.10)*	0.07	-0.10		*(-0.10)*	0.13
China	4.35	4.35	4.35		*(4.35)*	-	4.00		*(4.00)*	-

Other monetary policy

(Over year or by Dec)	Current	2017	2018		*Prev.*	Y/Y(%)	2019		*Prev.*	Y/Y(%)
US QE ($Tn)	4.3	4.4	4.0		*(4.0)*	-9.1%	3.4		*(3.4)*	-15.0%
EZ QE (€Tn)	2.3	2.2	2.4		*(2.4)*	9.1%	2.4		*(2.4)*	0.0%
UK QE (£Bn)	435	445	445		*(445)*	0.0%	445		*(445)*	0.0%
JP QE (¥Tn)	537	521	549	↓	*(551)*	5.3%	563	↓	*(567)*	2.6%
China RRR (%)	16.00	17.00	15.00		*15.00*	-	14.00		*14.00*	-

Key variables

FX (Month of Dec)	Current	2017	2018		*Prev.*	Y/Y(%)	2019		*Prev.*	Y/Y(%)
USD/GBP	1.28	1.35	1.30	↓	*(1.35)*	-3.9	1.35		*(1.35)*	3.8
USD/EUR	1.14	1.20	1.14	↓	*(1.18)*	-5.1	1.18	↓	*(1.20)*	3.5
JPY/USD	112.5	112.7	110		*(110)*	-2.4	108		*(108)*	-1.8
GBP/EUR	0.89	0.89	0.88	↑	*(0.87)*	-1.2	0.87	↓	*(0.89)*	-0.3
RMB/USD	6.96	6.51	6.90	↑	*(6.35)*	6.0	7.00	↑	*(6.30)*	1.4
Commodities (over year)										
Brent Crude	77.1	55.6	73.6	↑	*(71.6)*	32.3	73.2	↑	*(59.7)*	-0.4

Source: Schroders, Thomson Datastream, Consensus Economics, October 2018
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 29/10/2018
Previous forecast refers to July 2018
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

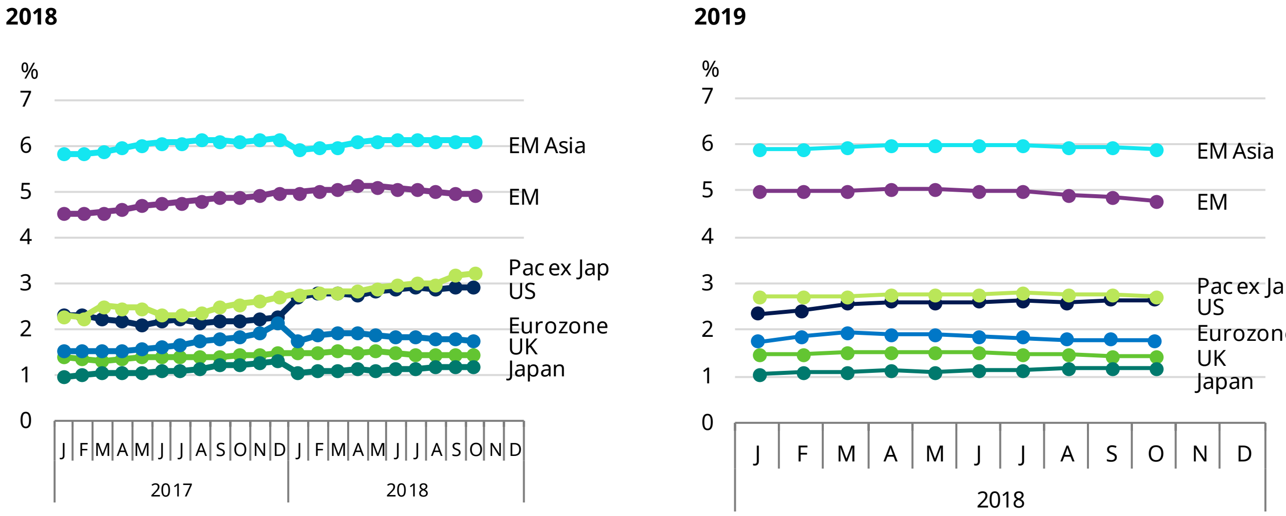
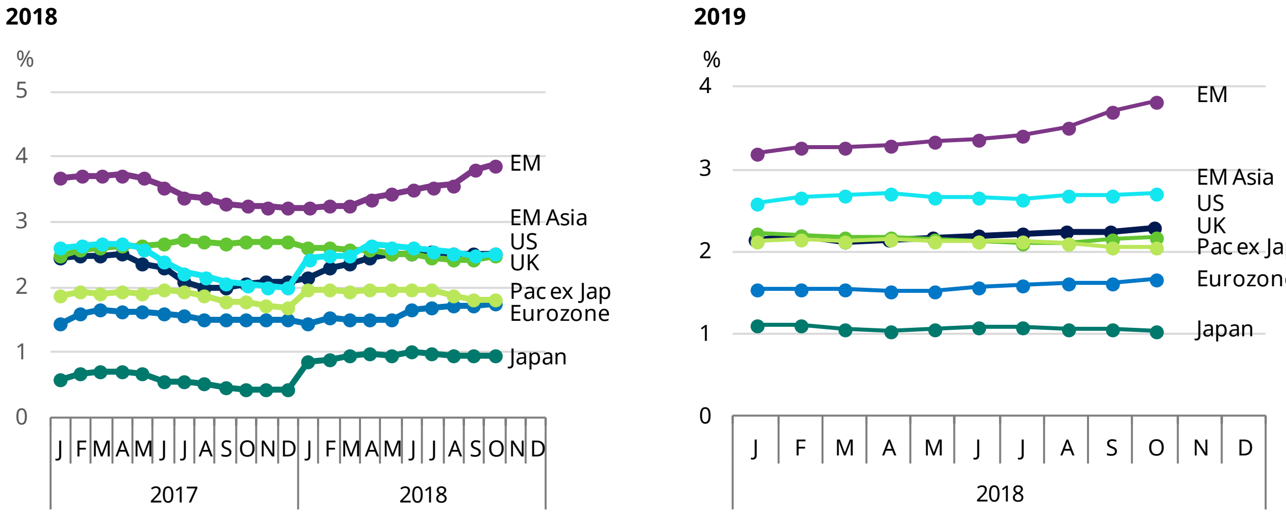


Chart B: Inflation consensus forecasts



Source: Consensus Economics (29 October 2018), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

Schroders

Schroder Investment Management Limited

1 London Wall Place, London, EC2Y 5AU
Tel: + 44(0) 20 7658 6000

schroders.com
@Schroders