CLOSING THE LOOP IN 2019

Economic Research Department
Global Economic Outlook
Q4 2018
Global growth to remain on a healthy trajectory despite the multiplication of risks:

1. **Self-correcting mechanisms**: US fiscal and monetary fuses to preserve the economic circuit from systemic unsustainability

2. **Fine-tuning policy tools**: Fueling demand in the short-term and repairing supply in the medium-term will be the leitmotiv of China and Europe

3. **Technical inspection**: The market will continue to differentiate defective emerging economies from sound ones

**Macro assumptions**: Brent oil prices at 69 USD/bbl in 2019; 65 USD/bbl in 2020. EUR/USD at 1.17 at the end of 2019, 1.24 end 2020; emerging currencies to stabilize in H1 2019

**Inflation and interest rates**: The peak of inflation is behind us in advanced economies but there are rising price pressures in the emerging markets post currency depreciation. We expect US 10Y interest rate to be at 3.0% at the end of 2019 and 2.8% at the end of 2020

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**Real GDP growth, %**

<table>
<thead>
<tr>
<th>Region</th>
<th>2017 Latest forecast</th>
<th>2017 Revision (pps)</th>
<th>2019 Latest forecast</th>
<th>2019 Revision (pps)</th>
<th>2020 Latest forecast</th>
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<tr>
<td>World GDP growth</td>
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<tr>
<td>United States</td>
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<td>2.5</td>
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<td>1.7</td>
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<tr>
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<td>1.0</td>
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<td>1.0</td>
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*Weights in global GDP at market price, 2017

NB: The revisions refer to the changes in our forecasts since the last quarter

Fiscal year for India

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The political and economic risk landscape remains crowded with potential recession triggers. Uncertainty is unlikely to escalate further, but expect it to linger. Visible impact could still increase as the negative effect kicks in with a lag.

The multiplication of uncertainty sources has contributed, beside the normalization of monetary policies in developed markets, to a significant tightening of world credit conditions, pointing toward a deceleration of growth.
US average tariff rose to 5.2% in 2017, it could cross the 6% trade feud threshold in 2018 if the US implements 25% tariffs on USD200bn imports from China.

Further escalation to a trade feud scenario could cost half a percentage point of GDP growth; a trade war would cost two percentage points of GDP and a global recession.
Global trade growth to slow in line with global demand

The US, the Eurozone and increasingly also China will act as a key driver for trade growth in the short-run

Trade diversion has already started and could disrupt supply chains. Asian pivot stands to benefit the most
We expect our Global Insolvency Index to keep on increasing in 2019 (+6% after +10% in 2018). We expect 2 out of 3 countries to post an increase in insolvencies, and 1 out of 2 countries to register in 2019 more insolvencies than over the 2003-2007 period.
FISCAL AND MONETARY FUSES TO PRESERVE THE US FROM DEBT UNSUSTAINABILITY
Solid employment growth provides a strong boost to household confidence and stronger consumption.

The fed funds rate looks set to rise above the US nation’s saving rate from Q4 2019 onwards. In these territories, the probability of a recession becomes non negligible.

Investment is showing signs of weakening amid higher interest rates, less supportive external conditions and deteriorating corporate credit quality.
Looking at total US debt aggregated across all sectors, the deleveraging mode is still on, suggesting that the systemic risk is not implicated for now.

Deviations from the long-term growth trend of debt is traditionally a good indicator for the nature of an upcoming crisis. Today, public debt and corporate debt are at risk.

The share of high yield bonds has been flat since 2015 at around one third (below the 2009 peak of 45%). But the share of the lowest invest grade level (BBB) has reached a record high of 35% in Q2 2018.
Circuit breaker #1: The Fed will hike interest rates twice in 2019 as inflation remains stuck above 2%

Circuit breaker #2: A government shutdown is possible in Q4 2019. It will trigger a significant tightening of monetary and financial conditions

History of US government shutdowns

2013 (President Barack Obama): Oct. 1 to Oct. 17 - 16 days
1995-1996 (President Bill Clinton): December 5, 1995, to January 6, 1996, - 21 days
1995 (President Bill Clinton): Nov, 13 to 19 - 5 days
1990 (President George H.W. Bush): October 5 to 9 - 3 days
1989 (President Ronald Reagan): December 18 to December 20 - 1 day
1986 (President Ronald Reagan): October 16 to October 18 - 1 day
1984 (President Ronald Reagan): October 3 to October 5 - 1 day
1984 (President Ronald Reagan): September 30 to October 3 - 2 days
1983 (President Ronald Reagan): November 10 to November 14 - 3 days
1982 (President Ronald Reagan): December 17 to December 21 - 3 days
1982 (President Ronald Reagan): September 30 to October 2 - 1 day
1981 (President Ronald Reagan): November 20 to November 23 - 2 days
1979 (President Jimmy Carter): September 30 to October 12 - 11 days
1978 (President Jimmy Carter): September 30 to October 18 18 days
1977 (President Jimmy Carter): November 30 to December 9 - 8 days
1977 (President Jimmy Carter): October 31 to November 9 - 8 days
1977 (President Jimmy Carter): September 30 to October 13 - 12 days
1976 (President Gerald Ford): September 30 to October 11 - 10 days

Sources: Wikipedia, Allianz Research

Nonfinancial companies’ debt issuance in the US

Record high refinancing needs will make tightening credit conditions painful for US non-financial companies

Sources: IHS, Allianz Research

Sources: IHS Global Insight, Allianz Research

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A rush to redeem shares of mutual funds could exacerbate losses of relatively illiquid types of assets. Negative wealth effects will hurt consumption prospects.

A technical recession is possible as early as 1H20. US growth slowdown will start in 2019 amid diluting impact of the fiscal stimulus and tightening credit conditions.
EUROZONE AND CHINA: FUELING DEMAND IN THE SHORT-TERM AND REPAIRING SUPPLY OVER THE MEDIUM-TERM
In 2019 GDP growth will be above potential for the 5th consecutive year but momentum continues to fade as external pressures rise and monetary and financial conditions become tighter.

We don’t expect downside risks to materialize (no Brexit deal, Italian crisis) but the high uncertainty "put" has weighed on economic growth in 2018.

A Grand Coalition of mainstream parties is likely; high risk of polarization in the EU political landscape. Higher hard populist support could create noise and make procedures longer.
France: Creative destruction in the making. Corporate creations increased by +11% in 2018 and should continue to the upward trend. At the same time, business insolvencies rose by +2.2% from the May trough to October.

Spain: Resilience partly explained by corporate dynamism. Historically high profit shares (>43% of GVA) and subdued ULC growth allows companies to invest. Reforms such as giving priority to company-level wage agreements (2012) controlled the wage increases despite employment gains.
The Eurozone investment cycle has been boosted by credit growth. Tighter financial conditions will make banks more risk adverse while market conditions could remain volatile as the ECB starts to normalize monetary policy.
The ultra-expansive monetary policy has served as a buffer in times of elevated political uncertainty, drowning out market concerns while supporting risk appetite.

As the ECB takes a first step towards normalizing its policy by ending monthly QE net purchases come Jan 2019, market discipline will start to return. But the reinvestment of maturing principal until at least early 2021 will act as a safety-net.

In times of past-the-peak economic growth and waning liquidity, we expect fiscal policy to step up its game to address lingering political discontent – at least in Eurozone countries where fiscal room for maneuver allows for it.
The trade dispute has shaved off around -0.2pp of annual German GDP growth...

...as well as a stabilizer for German exports

Intra-EU exports are acting as a buffer for lower extra-EU demand...

Sources: Eurostat, National sources, Allianz Research

Sources: National sources, Allianz Research

Sources: Chelem, National sources, Allianz Research

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**CHINA: BETTING (BOLDLY) ON HOUSEHOLDS**

### Household debt vs. credit to households
- **Households debt (% GDP, left)**
- **Credit to households (y/y, right)**

### Income growth
- **Nominal per capita disposable income**
- **Inflation**
- **Real Disposable income**

### Households Saving (% Disposable income)

**Driver #1: Strong credit growth**
**Driver #2: Positive income growth**
**Driver #3: Declining savings rate**

Sources: IMF, Allianz Research

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Overall credit growth is stable. By segments, the private sector is the one benefitting from current monetary easing.

Prudence is justified by the fact that the financial system is still under stress and room for maneuver is increasingly limited.

Sources: IHS, Allianz Research

N.B: loan to deposit and NPL ratios figures stop end Q3 2018, shadow banking flows take into account trust, entrusted loans and undiscounted bank acceptances over October 2017-September 2018. Non-financial corporations debt is based on BIS figures which end Q1 2018.

Sources: WIND, IHS, BIS, Allianz Research
How much RMB depreciation is required to make up for the US tariff shock?

A static approach (USD bn)

<table>
<thead>
<tr>
<th>10% tariff on USD imports from China</th>
<th>Cost</th>
<th>25% tariff on USD imports from China</th>
<th>Cost</th>
<th>RMB depreciation</th>
<th>Cost Absorption</th>
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<tbody>
<tr>
<td>50</td>
<td>5</td>
<td>50</td>
<td>12.5</td>
<td>-2%</td>
<td>-10</td>
</tr>
<tr>
<td>100</td>
<td>10</td>
<td>100</td>
<td>25.0</td>
<td>-4%</td>
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<td>150</td>
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<td>150</td>
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<td>62.5</td>
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<td>450</td>
<td>45</td>
<td>450</td>
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<td>500</td>
<td>50</td>
<td>500</td>
<td>125.0</td>
<td>-20%</td>
<td>-100</td>
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</table>

Bold figures indicate where we are end Q4. 10% on USD200bn imports and 25% on USD50bn imports from China have been enacted. RMB depreciated by -10% since March.

Sources: IHS, Allianz Research

A 10% RMB depreciation would help absorb a cost increase of USD 50 bn. More should be expected if the US raises tariffs further.

Fiscal stimulus is bearing fruit: Infrastructure and SOE investment are starting to pick up.

Sources: IHS, Allianz Research
Tariff cut: China’s tariff cuts help support import growth and absorb higher inputs cost due to oil prices and RMB depreciation

Partnerships: Accelerating partnerships helps diversify trade opportunities. The Belt and Road Initiative is the core strategy for now. Watch out for partnership in Asia (RCEP) and Europe

Reforms: Business-friendly reforms will be important to attract much-needed investment. Investor protection and insolvency resolution remain key problems
EMERGING ECONOMIES: TECHNICAL INSPECTION BY THE MARKET TO CONTINUE
In a scenario where US growth decelerates progressively, US monetary policy tightening would ease with Emerging Markets standing to benefit.

In case of adverse shocks, several Emerging Markets may face liquidity crises, adversely impacting the entire EM asset class.
**Advanced Economies: Adjusting to slower global demand**

- Economic growth is set to slow to in line with slower global trade especially for trade related economies (South Korea, Singapore, Hong Kong and Taiwan)
- Policymakers will use fiscal leeway's to support economic growth next year. Apart from Japan, public finances are generally sound in all markets
- High households debt (e.g. in Australia, South Korea, New Zealand), tighter global financing conditions and trade uncertainties (with a large potential impact on Singapore, Taiwan and Hong Kong) are the big ticket items that corporates and the private sector should keep in mind for 2019

**Emerging Economies: High tides for high flyers**

- Emerging Markets in the region will continue to grow above global growth on average benefitting from (i) resilient growth in China, (ii) trade diversion as corporates look for cheap alternative hubs of production (Vietnam, India, Indonesia and Philippines, e.g.) and (iii) supportive fiscal policy (Thailand). Yet tightening of monetary conditions and weaker global demand will lead to a growth deceleration
- Main risks stem from continued pressures on the currency of markets with twin deficits (India, Indonesia and Philippines), overheating risks (Vietnam and Philippines) and the outcome of elections in India, Indonesia and Thailand
EASTERN EUROPE: HEADING AWAY FROM OVERHEATING

CEE EU members
- Economic growth is forecast to moderate in line with the slowdown in the Eurozone. That said, robust domestic demand thanks to good absorption of EU investment funds and much improved labor markets provide some cushion against external shocks.
- Overheating concerns are fading as inflation has remained in check and strong wage growth is gradually retreating.
- Fed (and ECB) tightening and contagion risks are limited as surpluses or small deficits on the current and fiscal accounts as well as sufficient room for monetary tightening should help tame currency and inflationary risks.
- A key risk to growth is currently a potential sharp decline in global demand for automotive products.

Russia
- Growth will be limited to around +1.5% in the next years as new US sanctions affecting investment activity.
- The main risk is low oil prices for a sustained period, but fiscal buffers and credible monetary policy (prioritizing financial stability over growth) should help avoid a recession until 2020.

Turkey
- Sharp monetary tightening in September has calmed financial markets, for now.
- But the currency crisis is taking its toll on the economy: industrial output and retail sales are contracting sharply – supporting our forecast of a hard landing in 2019 – while...
- ...the tradable sector is re-balancing as sharp TRY depreciation has led to declining imports while supporting exports.

Sources: National statistics, IHS Markit, Allianz Research
Latin America’s activity decelerated (+1.5%, excluding Venezuela) in 2018 as Argentina sank into recession. Going forward we expect a gradual acceleration to +2% in 2019, +2.4% in 2020. Recovery still slow, and late cycle dynamics will exacerbate divergence. Two stories:

1. **Financial conditions will be less favorable for corporates** as monetary policy gradually shifts to tightening mode

2. **B.A.M’s future contingent on policy risk**: Brazil, instability of policy platform + pension reform outlook challenging; Mexico: policy choices contradicting pro-business stance; Argentina: severe austerity could fuel social discontent, mind elections in October 2019
Barriers to trade are inhibiting growth in the Southern part of the Africa. Reforms and openness are driving it in East Africa

As commodity started to decrease, Middle East and Africa are exposed to renewed exchange rate pressure (e.g. the Nigerian Naira on the black market exchange rate)

Sources: IHS Global Insight, Allianz Research

GCC
- Growth will pick up in 2019 due to higher oil output, fiscal stimulus and a robust non-oil sector. Slowdown in 2020 as oil prices fall
- Main risks are oil price shocks, oil output cuts, and deteriorating geopolitical tension

Israel
- Growth eases slightly in 2019 in line with global economy. The coming online of a new natural gas field will boost growth in 2020

Lebanon
- Growth will remain subdued as policy uncertainty (still no government after May elections) and political risk in general drag on