BBVA Research

Creating Opportunities

Global Economic Risk Outlook

3Q19

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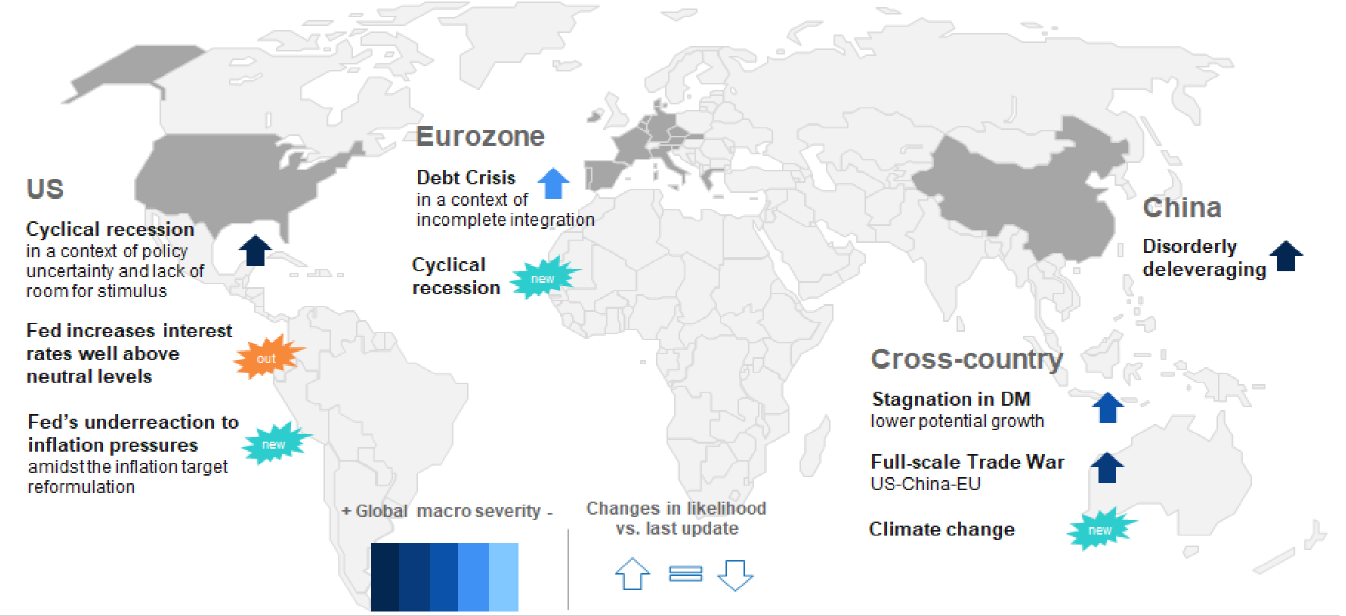
Trade war escalation and US recession, main threats

This report presents an analysis of those **global shocks, most of low probability, which may have severe effects on the global economy**. In general, the **balance of risks continues to be tilted to the downside** against a backdrop of trade tensions and increasing probability of recession in the US in the short-to-medium term. The current context of growth deceleration, low inflation and high policy uncertainty, as well as the dovish stance adopted by the main central banks, reflects this worsening of the global outlook. We update our set of global risk events accordingly:

- **a full-scale trade war remains in the center of the stage despite the recent truce in China-US disputes.** The probability of a "no deal" is not negligible given the unpredictability of these negotiations and the huge distance between the two sides on issues like technology, subsidies, charged tariffs or enforcement methods. Threats on auto industry and the position of the US against Mexico are also potential sources of risk
- **we highlight the relevance of a cyclical recession in the US and a disorderly deleveraging in China as risk scenarios**. In the case of the US, economic indicators continue to surprise on the downside, edging up the probability of recession one year ahead amidst mounting sources of concern (trade, elections, corporate leverage). In China, policy easing to face trade woes threatens to increase existing financial vulnerabilities in the medium-to-long term (debt overhang, housing market, distortions in credit allocation)
- **the risk of a broad resurface of debt sustainability concerns in the Eurozone continues on the table,** with Italy in the spotlight, in a context of lack of substantial advances in terms of fiscal integration, banking union and structural reforms to promote the economic growth in the medium term. The resolution of Brexit conflict is also an issue given its implications for the single market and the UK economy
- **a protracted stagnation of Developed Economies** continues to be a **structural risk event**, **even with a certain upside bias** according to the recent economic dynamics (in both growth and inflation)
- finally, we incorporate as **new risk scenarios**: (i) a **cyclical recession in the Eurozone** (current dynamics), (ii) a **Fed's underreaction to inflation pressures** (reformulation of inflation target) and (iii) **climate change**

MAIN GLOBAL MACRO-FINANCIAL RISKS TO THE GLOBAL ECONOMY (SEVERITY IN TERMS OF GLOBAL MACROECONOMIC IMPACT). Click here for a complete definition of each risk event



Source: BBVA Research

Full-scale trade war involving the US and its main trade partners

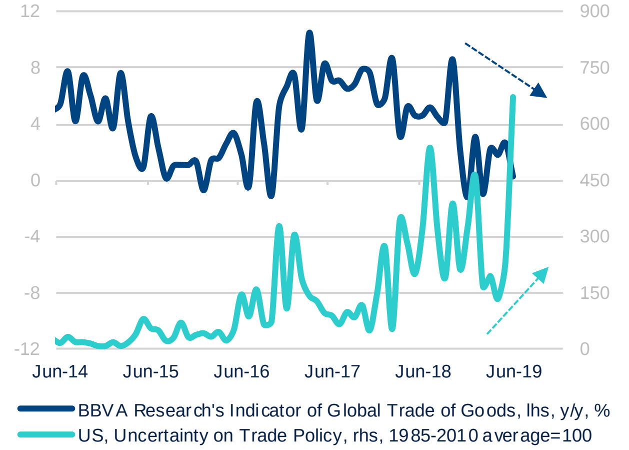
Early this year, we were in a period of trade truce and negotiations between the U.S. and China after the handshake at the G20 in Buenos Aires; now, we are in a relatively similar situation after the G20 meeting in Osaka. The **uncertainty on** the outcome of **this new period of *impasse*** is high, given the deterioration in the relationship between the two countries caused by the escalation of trade and technological reprisals in May and June.

Trade barriers have increased during last months, with the focus of the disputes moving from trade to technology, a field where the long-term economic global leadership is at stake. ‘Ups and downs’ in negotiations have eroded the trust between the two parties: for China, the US demands are harsh and even unreasonable to some extent, while for the US, China is not showing sufficient predisposition to tackle the structural issues that keeping its competitive advantages. Additionally, the US position on China in next months will be influenced by the political debate on the eve of Presidential elections (end-2020), as well as the pace of domestic slowdown. Thus, a new cycle of truce, negotiation, rupture and so on is not out of the question, increasing the probability of a trade war risk.

The most updated data point to a **sharp slowdown of global trade of goods** in the first half of 2019, that intensifies the trend of deceleration observed since mid-2017, when both the uncertainty on trade policy and trade barriers started to increase. The current level of the average tariff imposed by the US on China’s imports is 18%, surpassing by six times the 2017 level. If the US decided to raise tariffs on the rest of imports from China, the average tariff would increase to 28% (x9). Under this hypothetical scenario, and given the low room of China to retaliate through higher tariffs, bilateral trade costs between the US and China could return to levels of 70’s.

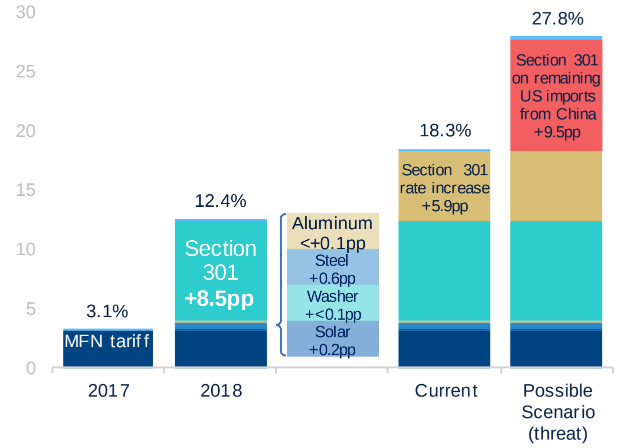
Although the degree of uncertainty around the estimated impacts of such kind of events is significant (lack of recent evidence -increasing China’s global role- and multiple channels of impact, both direct -trade- and indirect -confidence, cost of funding-), different modelling approaches share that **China would suffer the most** due to its higher trade openness and dependence on the US demand. **Higher import prices would also hurt the US consumers** but to a lesser extent if a certain trade diversion (import’s substitution by national production and/or reallocation towards other foreign partners) takes place. **Europe would suffer mainly if tariffs on autos are increased**. **The impact on Emerging Markets (EM) would be relevant** (global demand relapse, appreciatory pressure on the USD and EMBI spread rebound). Last but not least, the importance of a trade war risk lies not only in the fact that the gradual deterioration of the real situation brings it closer to the baseline scenario, but also because both players, the US and China, show their own economic vulnerabilities, which might heighten potential effects of a worsened trade environment.

GLOBAL TRADE AND UNCERTAINTY ON TRADE POLICY



Source: BBVA Research and “Measuring Economic Policy Uncertainty” by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com

AVERAGE TARIFF IMPOSED BY THE US ON IMPORTS FROM CHINA (%)



Source: BBVA Research based on data from Chad P. Bown, 2019, “The 2018 US-China Trade Conflict After 40 Years of Special Protection” PIIE Working Paper 19-7

US recession amid policy uncertainty and lack of room for stimulus

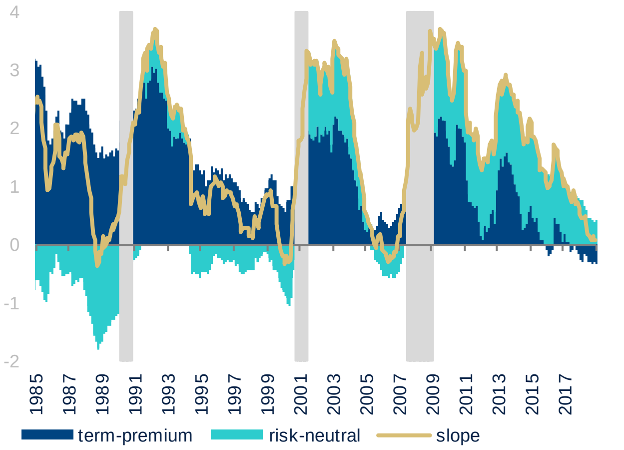
'Late-cycle' (end-of-expansion) **fears have intensified during last months.** Survey indicators have declined amidst the deterioration of investment perspectives, with a clear underperformance of manufacturing (potential impact of trade tensions) and construction data. Although the labour market still remains solid, the pace of job creation has started to slow down. The negative balance of economic surprises has coexisted with the relapse of expected inflation and the shift in the Fed's monetary policy stance. The dovish turn of the central bank, opening the door to interest rate cuts as an "insurance" against recession (financial markets are already discounting at least two cuts for this year), is probably the strongest signal of the recent worsening in the US economic outlook.

Recessions used to be preceded by excessive imbalances (housing bubbles, banking crisis, financial markets overvaluation, etc.) but **the accumulation of small vulnerabilities could also trigger a sharp activity correction**. The environment of global uncertainty, defined by the protectionist threat and geopolitical tensions, along with some domestic sources of risk (political uncertainty on the eve of elections, fiscal cliff in absence of further measures and, mainly, high corporate leverage and credit risk-taking strategies), has the potential to trigger an economic downturn. The fall in long-term sovereign yields responds partially to growing concerns on a potential demand shock coming from a systemic economy as the US. Thus, recession probability models based on the yield curve slope (New York Fed model) place this probability above 30%, and even excluding the component of term premia, the signal offered by the bond market reflects increasing fears of recession one year ahead. The lack of margin for countercyclical policies (short real rates likely close to natural level) constitutes undoubtedly a source of concern for investors.

In this context, the **deterioration in credit cycle fundamentals** could exacerbate the impact of an economic slowdown on the corporate sector, through a sharper correction in profits, tighter funding conditions and a sell-off in equity markets. The segment of BBB-rated debt, which comprises about half of the high-grade market, is especially vulnerable. In this context, many potential sources of risk arise: (i) waves of rating downgrades (transition to high-yield), (ii) fire sales by institutional investors (high share in the base of investors), (iii) leverage loans and (iv) the link between nonbanks (retaining risky tranches of CLO) and banks as financial amplifier.

The lower global demand caused by a US recession would translate into a fall in world trade and commodity prices, increasing the financial volatility. The preference for safe-haven assets would coexist with bulky capital outflows from EM and currency depreciations. The impact would be more severe in those economies with higher trade openness and dependence on exports of raw materials. Monetary stimuli by Developed Markets (DM) would partially cushion the tightening of global funding conditions, providing EM central banks some room for gradual interest rate cuts in the mid-term.

US YIELD CURVE SLOPE (1y-10y, %)



Source: BBVA Research, New York Fed

CREDIT CYCLE: BBB SEGMENT

Credit Fundamentals	Level 2007	Level 2018	Percentile Signal 2007	Percentile Signal 2018
Size (as a percentage of IG outstanding)	34.6	49.3	●	●
Gross Leverage (times)	2.4	3.0	●	●
Net Leverage (times)	2.1	2.6	●	●
Share of Companies with > 4× Leverage (percent)	16	23	●	●
Interest Coverage (times)*	7.3	7.9	●	●
EBITDA Margin (percent)*	19	21	●	●
Gross Margin (percent)*	35	40	●	●
Spread (basis points)	198	121	●	●

* = Icons are reversed ● ● ● ● 0% 100%

Source: IMF (GFSR, April 2019)

A disorderly deleveraging process in China

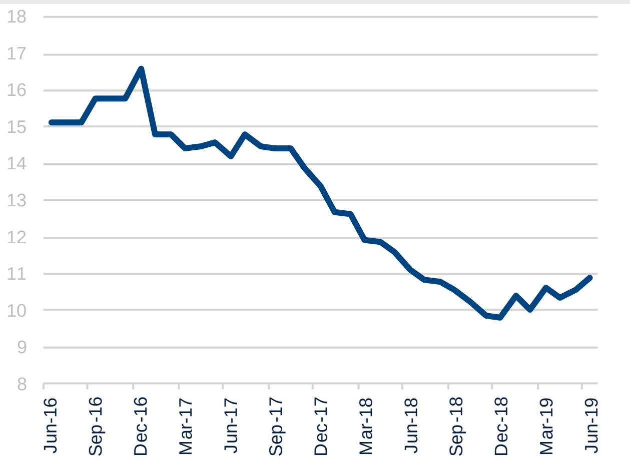
Stimulus measures adopted to face the impact of trade woes on the economic cycle have ended the pause in the deleveraging process observed through 2018. The decline in credit growth to non-financial businesses has halted during the first months of 2019, according to social financing data and leverage ratios for listed firms, while household and government debt has stuck with the recent dynamics of increases. As a result, the ratio of non-financial private debt to GDP rebounded in 1Q19, after three quarters of reduction, reaching maximum levels of 209%. Our model of banking crisis early-warning, based on private credit gaps, keeps China in the risk zone.

Beyond the aggregate debt overhang, **the ongoing readjustment in the structure of corporate funding** (shadow banking crackdown *versus* banking loan expansion) **also constitutes a source of concern** for two reasons: (i) the economic impact of credit tightening suffered by smaller firms, which largely relied on shadow banking funds intermediated by small and medium-sized banks with a relatively weak balance sheet position (many of these entities have brought back previously off-balance sheet shadow banking assets onto their balance sheets, which has further constrained their capacity to lend) and (ii) distortions in the credit allocation, in favor of riskier sectors as infrastructure or real estate (worsening of credit risk profiles and upward pressure on property prices).

The **still-large stock of investment vehicle assets (WMP)** and the **signs of overvaluation in housing prices** ('housing wealth' effect is key for consumers) are another relevant pockets of vulnerability. In the first case, given the maturity and liquidity mismatches that entail these vehicles, which continue to operate with high leverage ratios to offer returns above market benchmarks, and in the second, as a consequence of potential spillovers of a sharp correction in housing prices on the banking sector (higher NPL) and the real economy. Against this backdrop, and in the context of economic slowdown, threats on higher trade tariffs and downward pressures on domestic financial assets, **further policy easing** (interest rate cuts, regulatory forbearance and/or fiscal stimulus) **may worsen existing vulnerabilities, in turn exacerbating risks to financial stability in the medium term**. The deterioration in the buffers available to tackle a financial shock (reserves/M2 or fiscal space) also needs to be closely monitored.

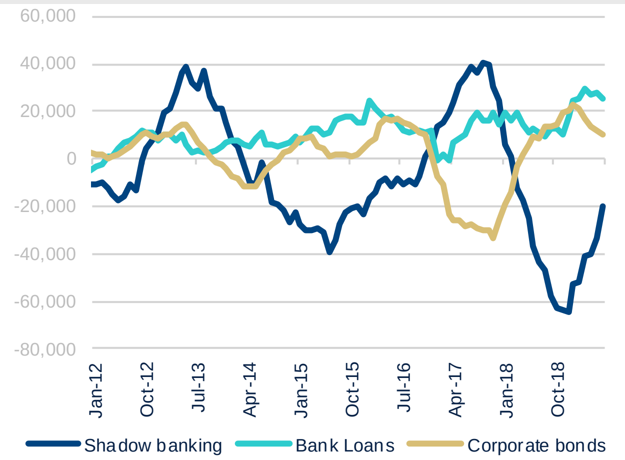
To sum up, **the relevance of a disorderly deleveraging event in China as a risk scenario remains high and has increased lately.** A contraction in Chinese demand would drag down global trade and commodity prices, conjuring up recent episodes of financial stress (summer 2015, Jan-2016), while a global risk re-pricing would have a differential effect on EM risk premia. The macroeconomic impact would be more severe for economies more open to world trade, particularly those highly dependent on commodity exports and/or trade flows from China. For net commodity-importers, the fall in prices could cushion the recessionary effect. DM would resort to accommodative monetary policies whereas EM would raise rates to contain capital outflows and FX depreciations.

TOTAL SOCIAL FINANCING (YoY, %), JUN19



Source: BBVA Research, Haver

FINANCING FLOWS
(1 YEAR ACCUMULATED, 100 MIL YUAN), JUN19



Source: BBVA Research, Haver

Eurozone debt crisis in a context of incomplete integration

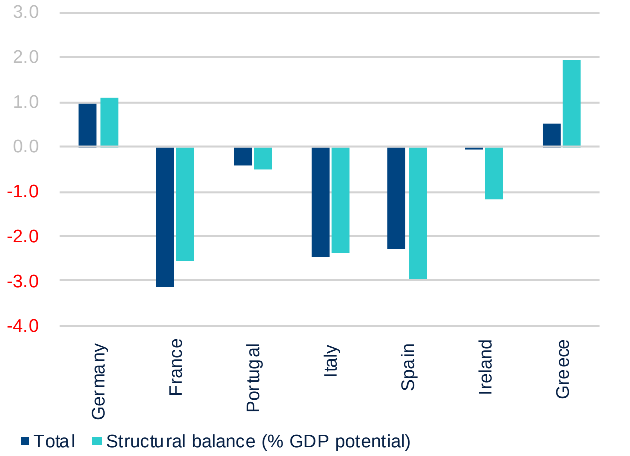
'Search for yield' strategies, in a context of very depressed *core* yields and growing expectations of further monetary easing by the ECB, **have spurred the demand of European peripheral bonds.** Sovereign risk premia have drifted lower, reaching 2010 minimum levels in the case of Spain, Portugal and Greece, and coming back to 2018 pre-budget crisis in Italy. **However, the sources of vulnerability that can resume financial tensions in peripheral bond markets remain alive.**

The ascendance of populist parties in last European elections paves the way for a potential surge in anti-euro rhetoric, **with Italy in the spotlight**. Apart from the stability of the Government coalition, the main concern lies on its position on the fiscal policy, prone to strong expansionary measures, and the negotiations with the European Commission around the compliance with deficit targets. So far, Europe has decided not to trigger the Excessive Deficit Procedure but tensions threat to return in absence of consolidation measures for 2020. The renewed noise around a parallel currency (Mini-BOTs) could also fuel 'Italexit' fears. In **Spain**, the **climate of political uncertainty remains** after the last cycle of elections. The outcome has been a fragmented parliament, which puts serious hurdles for the implementation of pending reforms.

Beyond the uncertainty on the political front, another spot of vulnerability is the **persistence of high concerns on the sovereign-financial sector nexus** (Italian banks holds more than 10% of its assets in domestic government bonds, and this percentage is close to 8% in Spain). If sovereign yields were to increase sharply, banks could register significant losses, exacerbating the impact of funding constrains on the credit and economic cycles. Finally, **progress towards further European integration continues to be timid**, mainly given the context of low growth and inflation and the limited margin of the monetary policy to counteract a potential relapse in nominal growth. It is pending to see the changes in the European strategy induced by the new members in charge of leading key institutions. **The Brexit conflict also needs to be resolved** (end-October) in order to reduce the uncertainty about the potential effects of a hard-Brexit on the single market and the evolution of the UK economy.

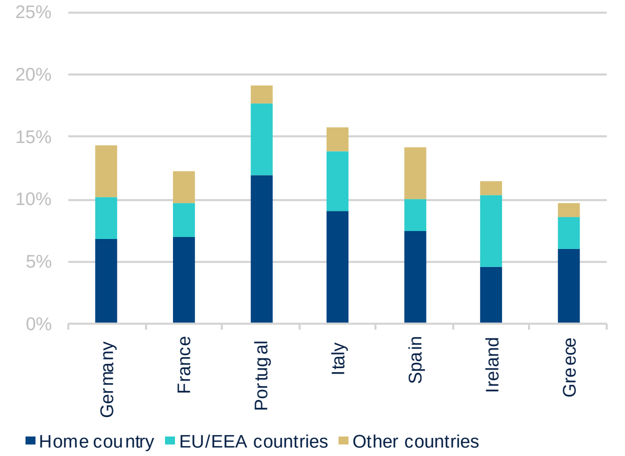
To sum up, **the risk of a broad resurface of debt sustainability concerns in the peripheral economies continues on the table**. Under an adverse scenario (short-lived event as long as integration advances are achieved), the main channel of global contagion would arise from an increase in financial volatility. Although the ECB would reinforce its stimuli, their effectiveness would be lower than in the past (lower margin to surprise markets). Global trade and commodity prices would see a reduction due to subdued demand growth in the Eurozone. German debt would act as a 'safe-haven' and the euro would depreciate sharply.

GENERAL GOVERNMENT BALANCE
(% GDP, 2019)



Source: BBVA Research, AMECO

BANKS' HOLDINGS OF PUBLIC DEBT
(% TOTAL ASSETS), 2018



Source: BBVA Research, EBA

Fed’s underreaction to inflation surge as a preamble to a new target

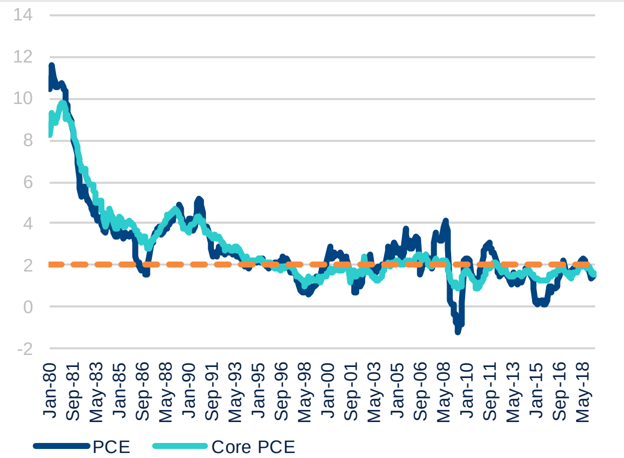
The level of nominal interest rates consistent with a neutral stance for monetary policy –that which ensures full employment and price stability– seems to be **much lower than in the past**. If this is in fact the case, the present context of nominal interest rates abnormally close to zero poses a significant limitation on the capacity of monetary policy for responding to an economic slowdown and/or a disinflationary period. As a potential way to address this issue, some economists and central banks propose the readjustment of the current policy framework (‘inflation targeting’). Although details differ among the alternative options, most of them embody the idea to **keep rates ‘lower for longer’ when the zero lower bound is hit**, in order to drive, firstly, a fall in bond yields, increase inflation expectations and, in the end, generate a higher optimism about the future growth.

The Fed has just started the review of its strategic framework, **with a potential change in the inflation target on the table**. In fact, in the Monetary Policy Report submitted to the Congress in July, the Fed has included a price-level target (using 1998 as the base data) as a monetary policy rule to be analyzed, which concludes that interest rates now should be close to zero to offset last years of inflation rates below 2% on average.

Beyond **price-level target**, other options mentioned in the literature (Bernanke et al., 2019) are: **(i) raising the inflation target directly** (4% instead of 2%, for example; Ball, 2013) -a higher inflation rate reduces the lower bound on the real interest rate -; **(ii) turning the inflation target into an inflation rate range** to indicate more clearly the extent to which the central bank is aware to accept short-run deviations from that long-run goal; **(iii) defining an economic threshold in terms of inflation performance**, as a necessary condition for leaving the ZLB; **(iv) creating rules based on a shadow-rate** that may be negative and that reflect the necessary degree of monetary accommodation (under ZLB, interest rate should remain close to 0% until the forgone accommodation is compensated) and **(v) targeting nominal GDP**, which seems more appropriate to respond to supply shocks (as inflation rises and GDP falls, this rule weights both variations equally, avoiding a monetary tightening).

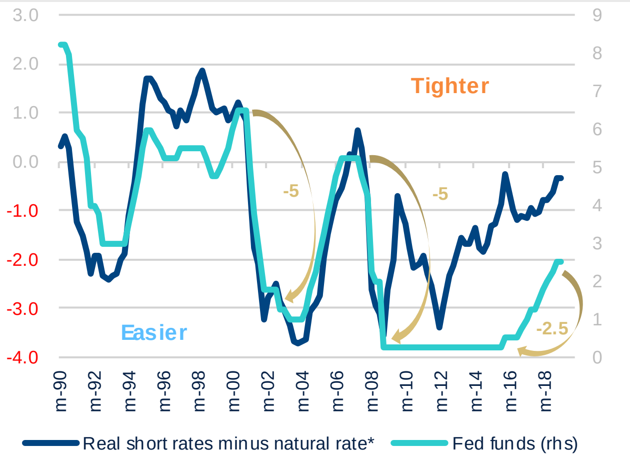
The success of such a change in the monetary policy framework rests on the trust of the agents about its effectiveness to reach the price stability goal. The uncertainty tends to be high during the transition to a new regime. If the central bank persists with low-rate policies as agents lose credibility in its strategy, **an inflation overshoot could lead to a costly un-anchoring of inflation expectations**. Therefore, the following adverse scenario arises naturally: under a potential reformulation of inflation targeting, the Fed shows a higher tolerance with inflation rates well above 2%, keeping interest rates unchanged during a prolonged period of time. The loss of credibility in the central bank spurs the risk of inflation, **triggering a sell-off in bond markets**. The sharp spike in long term yields would provoke a tightening of global funding conditions, with higher impact on those market segments more vulnerable to a deterioration in global financial volatility (credit markets, emerging assets).

US INFLATION (PCE, %)



Source: BBVA Research, Haver

MONETARY POLICY IN THE US (%)



Source: BBVA Research. *Natural rate based on Laubach-Williams (2003)

Increase in the frequency of climate-change-related natural disasters

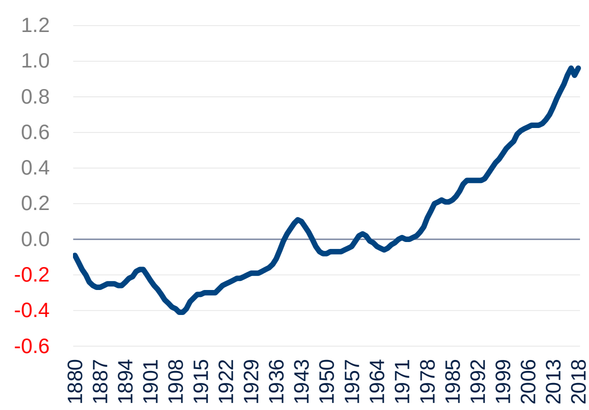
Figures below show the **evolution of the Earth's surface average temperature** since 1880 and a comparison of 2019 monthly temperatures, until June, with that of the 10 warmest years recorded. Its increasing trend **since mid-1960s** is beyond doubt, as the record levels reached in recent years, and, by the most elementary physical laws, scientists can confidently predict at least two serious adverse consequences: the melting of earth's ice bodies and the consequent rise of oceans and sea average levels. However, they show less certainty about the speed and smoothness of these effects, the likelihood (and imminence) of other impacts like the potential increase in temperature volatility, the probability of extreme fluctuations and/or the frequency and intensity of climate-change-related natural disasters (heat waves, wildfires, storms, extreme rainfall, floods, droughts, etc.).

Given these facts, there is scientific consensus on that the continuation of this trend will produce sooner or later, smoothly or abruptly, many **adverse and even disruptive effects on the global economy** (OCDE, 2015), the most apparent: coast land reduction and the consequent human, animal and vegetable displacement; agricultural production contraction (and volatility) caused by farming land scarcity, the higher frequency and intensity of storms and wildfires and the high temperature in itself (as there'll be changes in the type of viable crops); plus the indirect economic effects of the social conflicts spurred by this all and those associated to the transition to a greener economy (in line with the 2015 Paris Agreement).

On the other hand, as financial supervisors and central banks have been persistently warning in recent years, these **climate-change effects on the real economy pose serious threats on the stability of the global financial system** (via increase in credit risk, damage on collateral assets, etc.). It is for this reason that these authorities are currently working on regulatory policies for ameliorating such risk (NGFS, 2019) in addition to strengthen **green finance**, that is, the contribution of the financial institutions to facilitate the transition toward a net-zero-greenhouse-emissions global economy (one of the targets of the 2015 Paris Agreement).

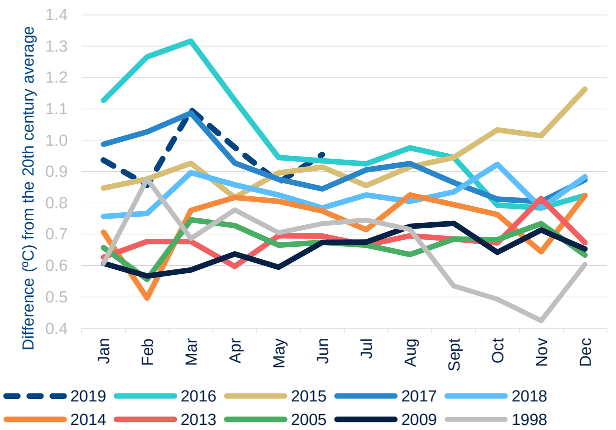
In this context, besides the almost certainty of the adverse long-run physical and transitional effects, there are **growing concerns among the scientific community that some severe short-run effects can materialize at any moment**, specifically, current scientific knowledge (NASA, 2005) and recent evidence (ECIU, 2018) do not allow to rule out the risk of a sudden and abrupt increase in the frequency of the aforementioned climate-related natural disasters, producing potentially catastrophic effects on the most vulnerable economies (islands, coastal regions, etc.).

GLOBAL LAND-OCEAN TEMPERATURE INDEX (CELSIUS DEGREES)



Source: BBVA Research, NASA

GLOBAL TEMPERATURES (WARMEST YEARS)



Source: BBVA Research, NOAA

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