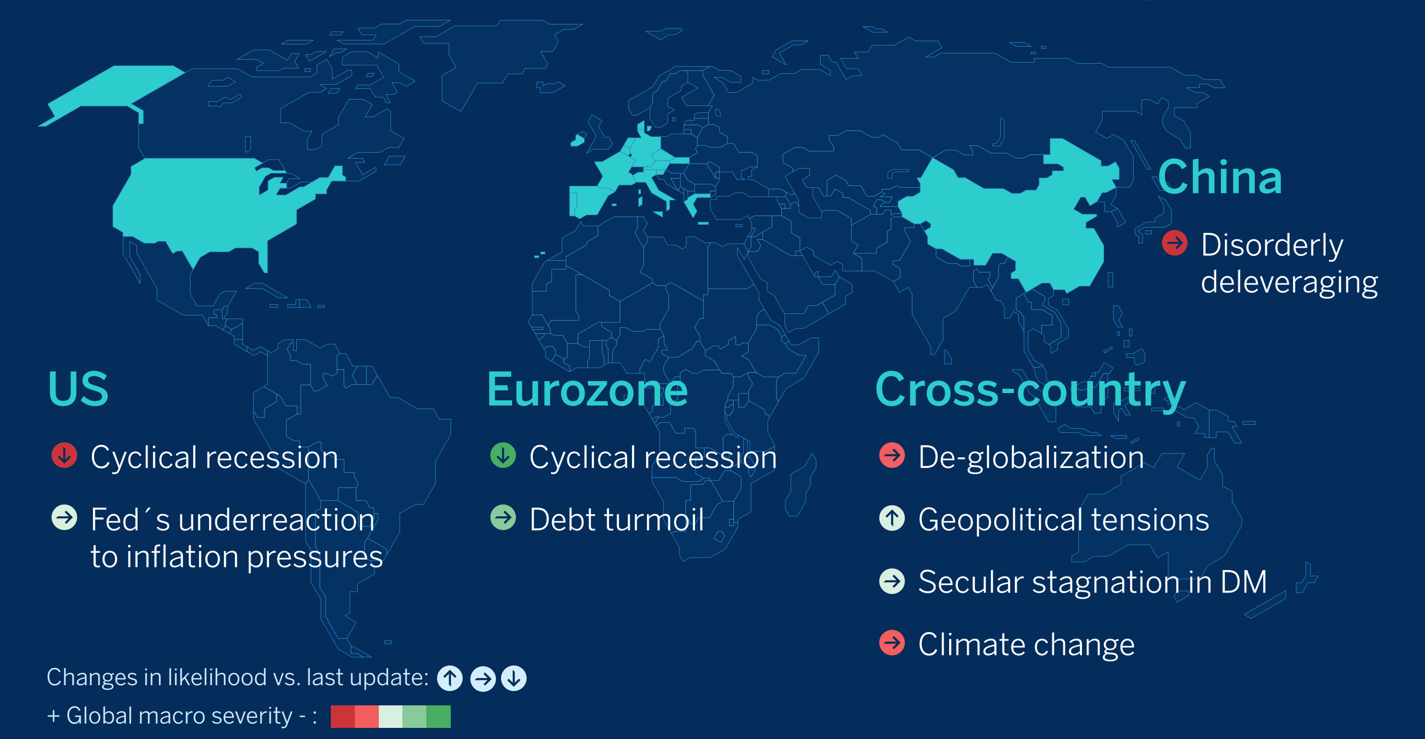
BBVA
Research

Global Economic Risk
Outlook 1Q20

Diminished risks in the short-term on the back of easing trade tensions and interest rate cuts across the board...

Main global macro-financial risks to the global economy
(severity in terms of global macroeconomic impact)

Source: BBVA Research



...but high concerns on structural issues. De-globalization and climate change risks on the radar

Consequences of 'irrational exuberance'.
Under a self-inflicted financial panic?

Expansion of 'risk taking' strategies in financial markets: while the **nominal GDP** of the US, Eurozone and Japan has increased by **$5.3 trillion** from 2008, their **central banks' balance** sheet has expanded by **$10 trillion**

A new wave of debt buildup: the ratio of total **global debt on GDP** has already reached levels of **230% in 2018** according to World Bank, with Emerging Markets at the forefront

The sensitivity of global GDP growth to a non-financial uncertainty shock has declined significantly after Lehman crisis. However, **the response of global growth to a financial shock (VIX increase) continues to be relevant and similar than in the past in a short-term horizon**

De-globalization risk
steaming from broader rivalry among big economies

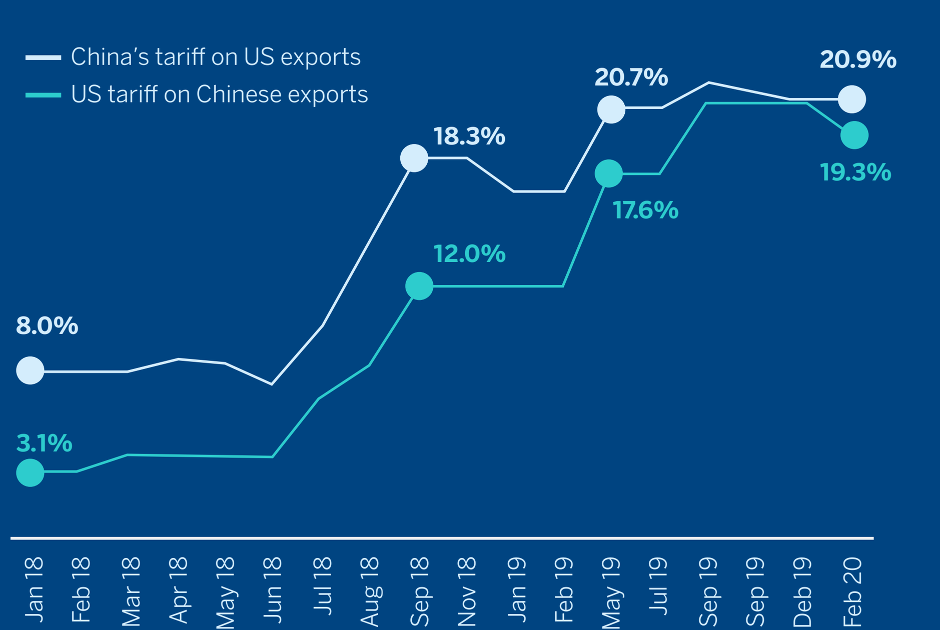
One of the most relevant global risk events in the medium term: the rise of a secular de-globalization trend, characterized by a prolonged and deep breakdown in cross-border economic and financial relations

From the trade side, the 'phase one' deal reached between China and US neither envisages a significant roll-back of tariffs, which will remain high, nor reduces the probability of renewed tensions

The technological sector is in the center of the stage

Average tariff imposed by the US ans China after "phase one" deal (%)

Source: BBVA Research Based on PIIE data



US recession amid private sector vulnerabilities and high policy uncertainty

'Recession risk' has fallen to its lowest level since December 2018 thanks to Fed's 'mild easing' cycle, but downside risks on the US economy remain. Main sources of concern:

- **High corporate indebtedness** (worsening of credit standards and expansion of leverage funding)
- High degree of **economic policy uncertainty** (from the domestic and the external side)
- **Signals of stretched valuations** (equity, corporate bonds and commercial real estate)
- **Re-surge of liquidity tensions in funding markets** (repo segment)
- **Limited margin of maneuver to adopt countercyclical policies**

A disorderly deleveraging process
in China

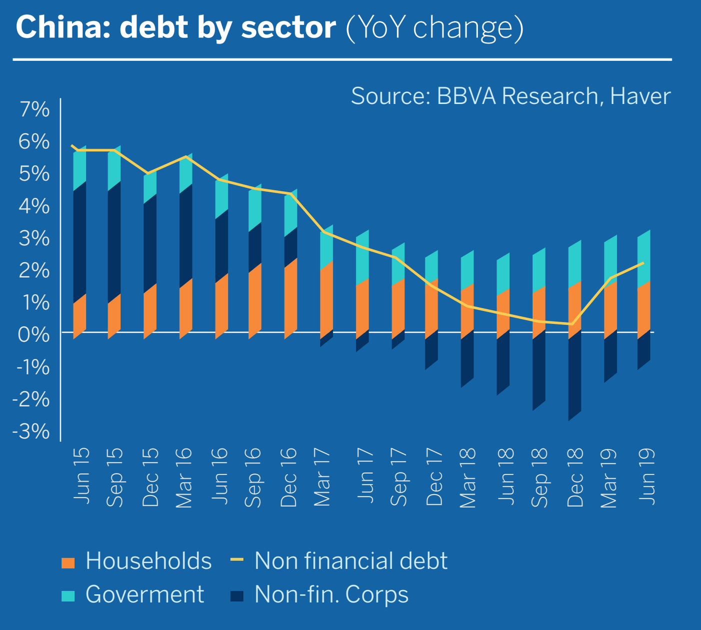
The **ongoing build-up of financial vulnerabilities**, in a context of heavy reliance on short-term stimulus, **keeps this source of instability well alive in the medium term**

WARNING SPOTS TO BE MONITORED:

- **Debt dynamics:** the ratio of non-financial **debt on GDP has continued to rise** (261% in Q219 according to BIS data)

China: debt by sector (YoY change)

Source: BBVA Research, Haver



- **Financing pressure faced by small and midsize banks** (significant dependence on wholesale funding, weaker profitability, lower capital ratios...)
- Some firms having difficulties to repay its debts **(wave of defaults on corporate bonds)**
- **Surge of distortions to credit allocation,** in favor of small firms with a riskier credit profile
- **Rising household debt,** already close to 55% of GDP (+7.5pp in two last years), vs. the 40% EM average

Eurozone crisis amidst low growth
and high uncertainty on economic policy

Although the role played by the ECB as debt holder has significantly reduced the likelihood of a resurgence of tensions in sovereign debt markets (lower risk of debt unsustainability), debt crisis turmoil in the Eurozone cannot be ruled out on the back of:

- Social and political effects of insufficiently inclusive growth: **secular stagnation emerges as the main risk for the Eurozone**
- **Lack of enough monetary munition** to refloat the economic cycle (pending on the 'strategic review' of the ECB policy, including inflation target)
- **Constraints to adopt an ambitious program of fiscal stimulus**
- **Incomplete fiscal integration**

The new relationship that the EU gets to establish with the UK after 2020 also determinant to prevent economic disruptions on the Single Market.

Climate change:
transition costs in the road to mitigate physical risks

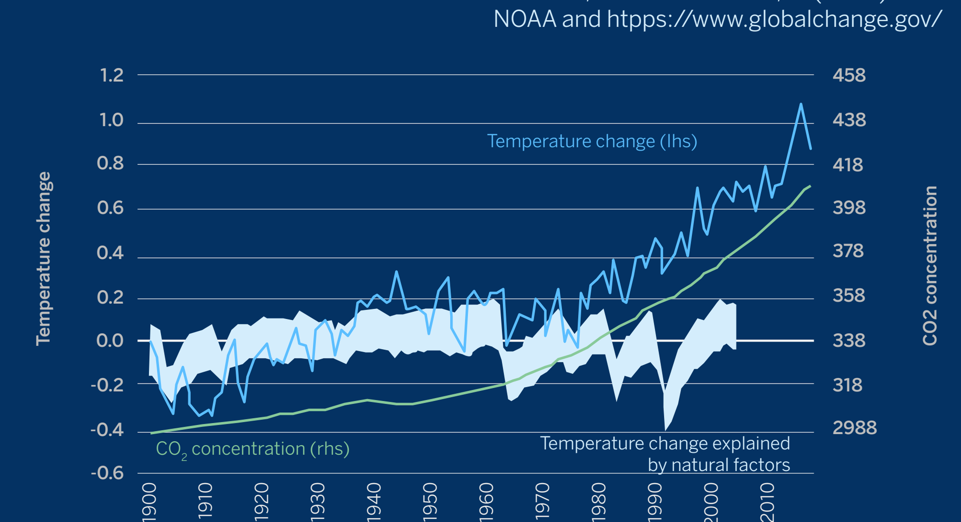
The persistent increase of temperatures may impact negatively GDP per capita (lower productivity and job creation)

The effect of the depletion of natural resources has not so far been completely internalized as a cost of economic activities
⇨ **private agents need to take ownership of the reduction of CO2 targets**

The range of potential economic measures to deal with the climate change is still open to discussion
⇨ **The European Green Deal is one of the most ambitious initiatives**

Global temperature and carbon concentration in atmosphere

Source: Andrés, J. and Doménech, R. (2020) from NOAA and htpps://www.globalchange.gov/



In a relatively short term horizon, the lack of clarity and/or coordination about economic policies could provoke **a sudden reassessment of asset valuations according to its climate risk exposure**