

Schroders



# Economic and Strategy Viewpoint

November 2019

# 3

## Profits outlook poses a challenge for US equities



**Irene Lauro**

Economist

- The supportive tailwind from lower interest rates is likely to fade, and earnings will have a crucial role in determining equity returns with stock prices to be driven by the real state of the economy and its corporate sector.
- Last year, the Trump administration's tax cut provided a substantial boost to post-tax profits and was enough to buoy the US stock market to new record highs, masking the deterioration of pre-tax profitability of the US corporate sector.
- However, the fiscal stimulus has started to fade and we are forecasting US profits to continue to stagnate throughout next year, as rising labor costs and weaker capacity utilisation will put margins under further pressure.

# 8

## The next crisis?



**Craig Botham**

Senior Emerging Markets Economist

- The IMF is worried that parts of the last crisis are repeating themselves, as dollar financing rises.
- Emerging Markets are particularly exposed, but we find that this exposure is not uniform and even if dollar funding is disrupted there are parts of the sector where the impact should be limited.

# 12

## Fiscal policy: lessons from Japan

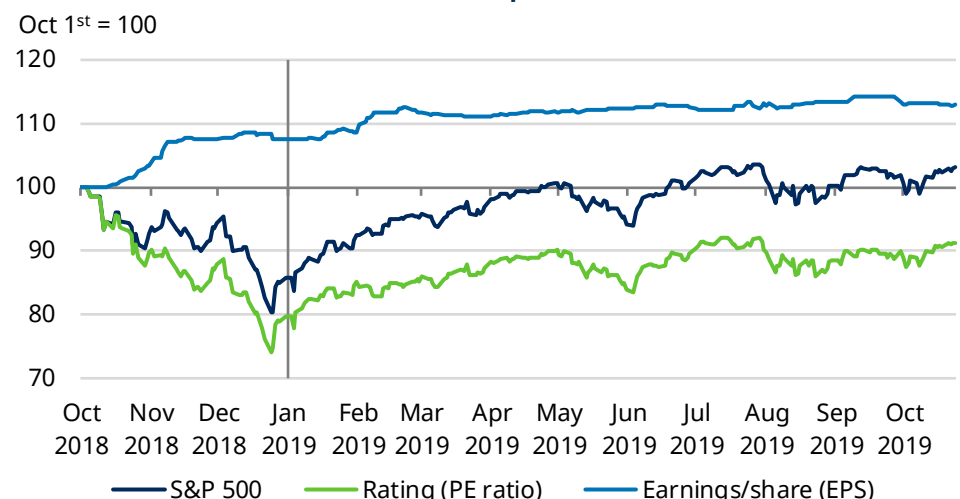


**Piya Sachdeva**

Japan Economist

- While things would have been worse without public spending, a lack of a durable recovery in growth or sustained inflation suggest that Japan's experience with fiscal policy in the 1990s was ultimately unsuccessful.
- For the rest of world, Japan's failure has shown that to be most effective, fiscal spending should come in large doses, be productive and sustained. Japan's case highlights the difficulty that fiscal policy faces if attempting to offset much larger headwinds in the private sector, or lift the potential growth rate.

### Chart: What's driven the S&P 500 in the past 12 months?



Source: Refinitiv Datastream, Schroders Economics Group. October 23, 2019.

# Profits outlook poses a challenge for US equities

## The supportive tailwind from lower rates and tax cuts is likely to fade

Earnings will matter from here

Equity market returns year-to-date have been strong, with the S&P 500 rallying 20%, despite a weakening global economy and intensifying trade tensions. Yet since the beginning of the year, earnings per share have barely moved. The rise in share prices has almost entirely been driven by easier monetary policy from the US Federal Reserve (Fed), supporting a substantial rise in the price-to-earnings (P/E) ratio. Moreover, as shown in the chart on the front page, if we look at the past 12 months the S&P 500 has risen only slightly, as markets experienced a sharp de-rating in the last quarter of 2018 followed by a near equivalent re-rating in early 2019. We believe that this leaves the market vulnerable to a correction as unless the Fed exceeds expectations in loosening monetary policy, the tailwind of multiple expansion is not likely to be sustained. Earnings will have a crucial role in determining equity returns as stock prices will be driven by the real state of the economy and its corporate sector.

All our cyclical indicators are still signalling that we are at a late stage in the economic cycle. While easier monetary policy has supported consumer credit conditions and the housing market, the corporate sector appears to be under greater pressure. In particular, US corporate profitability has deteriorated this year with profits shrinking in the first two quarters.

Recent revisions highlight a deterioration in US profits

Data revisions from the Bureau of Economic Analysis showed that US corporations were far less profitable in recent years than previously thought, with corporate profits peaking five years earlier than previously estimated. As shown in chart 1 below, the pre-tax profits share of GDP fell from 8.7% in 2014 to 6.2% in the second quarter of 2019. While we are not forecasting a US economic recession in the near term, our concerns have risen as the profit share tends to be a reliable recession indicator. Since the early 1960s, every recession was preceded by a prolonged period of margin contraction. The dip recorded in 1985–86 was the only exception, when the drop in profits was mainly concentrated in the energy sector due to collapsing oil prices.

The profits share is a reliable recession indicator

Chart 1: US profits before tax as % of GDP



Source: Refinitiv Datastream, Schroders Economics Group. October 22, 2019.

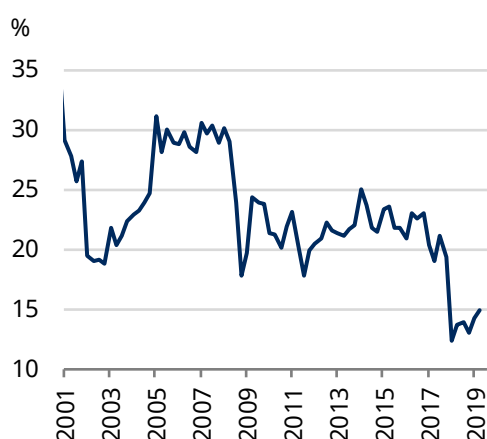
## Trump's tax cut masked an underlying deterioration

From an investor perspective, corporate profits matter because they are a key driver of equity returns. Here we focus our analysis on the profit margins in the national income and product accounts (NIPA) data, as they tend to be a good predictor of the earnings per share (EPS) for the S&P 500 large cap US equity index. NIPA measures profits across the whole economy, including private and publicly listed companies.

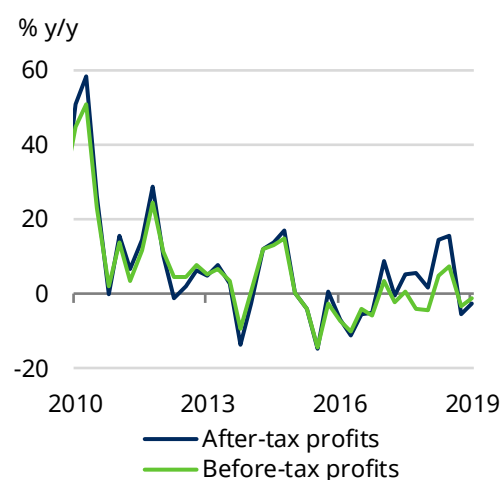
More specifically, when updating our profits model, we find that post-tax profits are a better predictor of EPS than pre-tax profits. Last year, for example, pre-tax profits in the non-financial sector grew a mere 0.9% year-on-year (y/y), while earnings per share of the S&P 500 recorded a stellar performance, rising 21.8% y/y. This divergence can be largely explained by the reduction in the federal corporate tax rate from 35% to 21%, introduced by the 2017 Tax Cuts and Job Act, that masked the underlying deterioration in US profits.

Economic activity is not the only driver of profits. Our calculations of the effective tax rate from the national income and product accounts show that the corporate tax rate declined significantly in 2018. The effective average tax rate for corporations was 20% in 2017, and fell to 13.2% in 2018 (chart 2), enough to buoy the US stock market to record highs. The tax savings drove profits to new highs, as after-tax corporate profits grew 9.5% y/y, the strongest gain since 2012 (chart 3). Our analysis suggests that this stimulus is beginning to fade, as the effective corporate tax rate has started to rise this year.

**Chart 2: Effective tax rate for US corporates**



**Chart 3: Pre-tax and after-tax profits**



Source: Refinitiv Datastream, Schroders Economics Group. October 22, 2019.

### Rising labor costs to put pressure on margins

When an economy is in late cycle, unemployment usually falls further, making wage costs grow faster, and thereby putting greater pressure on margins. If companies are not able to pass rising costs on to consumers then margins will have to take the strain. In our view, rising inflation is not likely to be sufficient to offset rising labor costs and weaker capacity use. As a result, earnings, and in turn profits, are likely to suffer. As fading fiscal stimulus exacerbates the effect of a slowing domestic economy, the downward trajectory of profits could give equity investors some cause for concern.

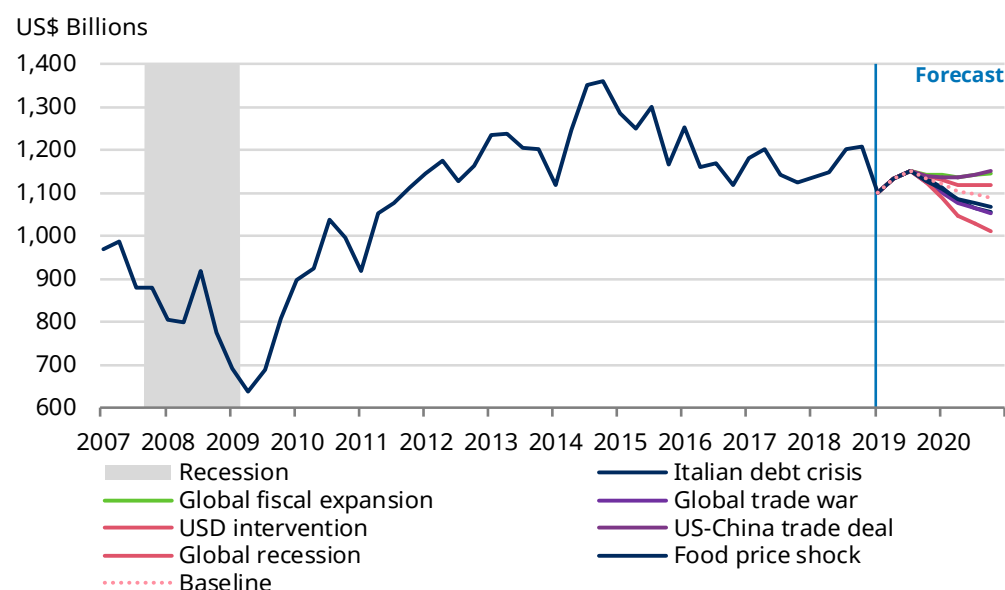
## Capacity use to drop as growth falls below trend

### Caution on earnings is warranted

Our top down approach allows us to forecast the share of profits in GDP via margins and capacity utilisation. While the forecast for capacity utilisation is being driven only by real GDP growth, the margins forecast is affected by growth in labor costs, prices and productivity. Our forecasting model suggests that caution on US earnings in the coming quarters would be appropriate, as we expect economic profits to continue deteriorating throughout next year.

US economic growth is expected to fall below trend and, when this happens, capacity utilisation drops, putting downward pressure on economic profits. Moreover, margins will be squeezed as labor costs increase, while inflation and productivity decline on the back of weaker growth. Our model suggests that before-tax profits are expected to decline 3.7% y/y this year and 2.4% in 2020, while post-tax profits will decline 4.8% this year and 2.4% next year.

**Chart 4. US profits outlook: baseline and scenarios**



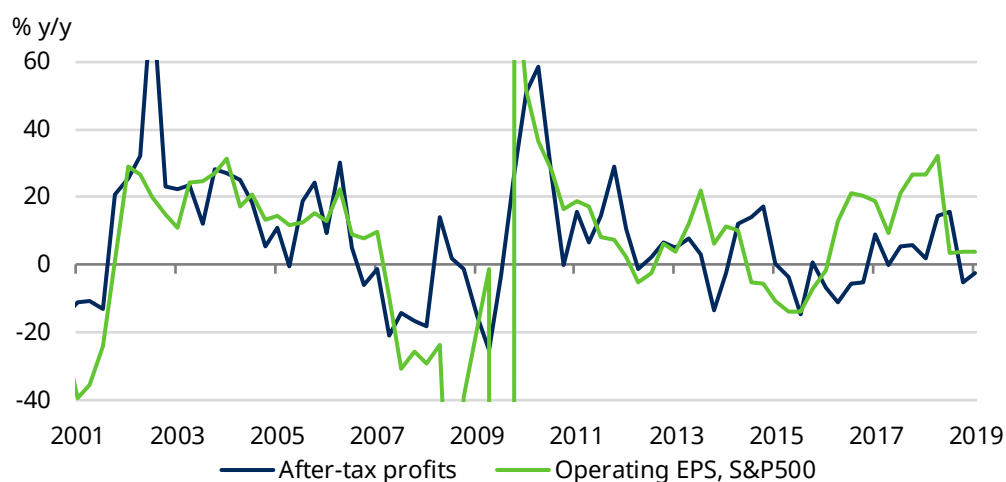
Source: Refinitiv Datastream, Schrodgers Economics Group. October 22, 2019.

## NIPA profits are a good predictor of EPS growth

Unsurprisingly, corporate profits will suffer the most should the global economy experience a recession, causing economic profits to fall by 7.4% next year. The scenarios in which we see positive profits growth in 2020 are where the US and China agree a trade deal that includes the removal of all tariffs, lifting business confidence and boosting global trade, or where the G7 and BRIC economies loosen fiscal policy significantly in order to support economic demand (chart 4).

As we explained earlier, corporate profits data from the national accounts differs from the S&P500 data because NIPA measures profits across the whole economy, including private and publicly listed companies, thereby giving a more comprehensive picture of corporate financial health. Earnings per share (EPS) for the S&P 500 large cap US equity index are more volatile than the top-down profits due to the effects of leverage and write-offs. However, as they are directionally similar (chart 5), we exploit this relationship to get an estimate of market earnings per share.

**Chart 5: After-tax profits and operating EPS for the S&P 500**

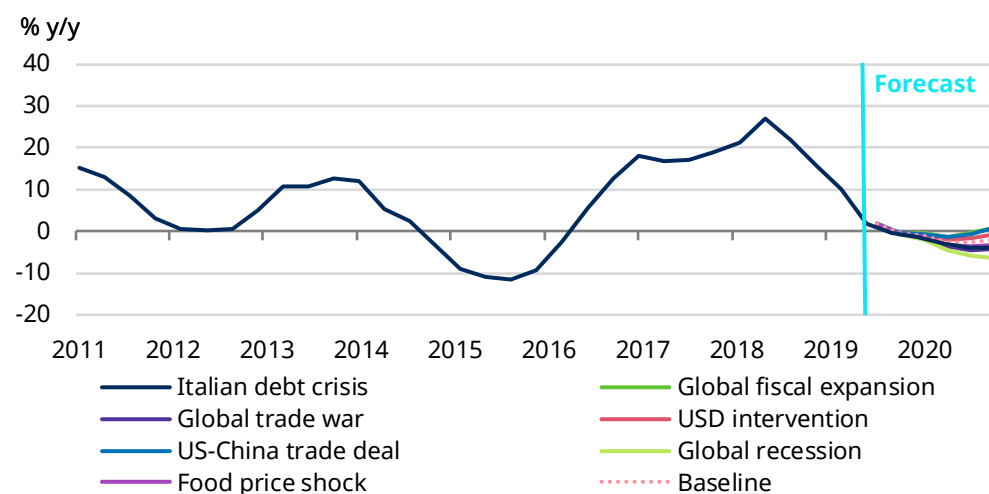


% y/y	2018	2019	2020
<b>Before-tax profits</b>	0.9	-3.7	-2.4
<b>After-tax profits</b>	9.3	-4.8	-2.4
<b>Operating EPS</b>	21.8	-0.6	-2.0

Source: Refinitiv Datastream, Schroders Economics Group. 22 October 2019.

Our model suggests that S&P 500 operating earnings are likely to fall by 0.6% in 2019 and to drop by 2% next year. This compares with 2018 earnings growth of 21.8% and forward expectations of 12% in 2019.

**Chart 6: Outlook for EPS for the S&P 500: baseline and scenarios**



Source: Refinitiv Datastream, Schroders Economics Group. October 22, 2019.

## Conclusions

The new profit picture reaffirms the cyclical nature of profit margins, in line with the fact that the US economy is in the late stage of the economic cycle. As the economic expansion has matured, a tighter labor market has put upward pressure on wage growth, leading to a late-cycle drop in profit margins. Last year, the Trump administration's tax cut provided a substantial boost to post-tax profits, masking the anaemic growth of pre-tax profitability of the US corporate sector. The tax cut also drove investor confidence to high levels, helping support the S&P 500.

However, the fiscal stimulus is now behind us and the real state of the US corporate sector will start to matter for equity returns. We are forecasting the US profits

recession to continue throughout next year, as rising labor costs and weaker capacity utilisation will put margins under further pressure. The earnings per share of the S&P 500 have hardly grown so far this year, while stock prices significantly benefitted from easier monetary policy. In this environment the market is vulnerable to a correction as earnings deteriorate further.. An economic recession is not in our forecast, but we will closely watch business investment and firms' hiring intentions, as firms could react to deteriorating profitability by cutting costs. Lower business capital expenditure (capex), or a rise in the unemployment rate could end the current economic expansion.

A boost in productivity growth could potentially help firms keep labor costs under control. However, given that labor shortages are likely to intensify, any productivity gains are likely to be muted. Alternatively, a scenario in which demand gets stronger, as in our global fiscal expansion scenario, could help US corporates limit the pressure on margins through higher price inflation. Finally, monetary stimulus could start coming through more strongly, helping to boost growth and prevent a profits recession from turning into a full economic recession.

# The next crisis?

“Serial default on external debt... is the norm throughout every region in the world.”

Reinhart & Rogoff 'This time is different: a panoramic view of eight centuries of financial crises' (2008)

## The IMF has raised concerns over dollar funding vulnerabilities

Looking beyond the US, imbalances have been building in other parts of the world. Even if the US is able to dodge a recession, there is a chance that one emerges elsewhere, with vulnerabilities in emerging markets a possible catalyst.

In its latest Global Financial Stability Report, the IMF raises the alarm over two interrelated emerging market (EM) issues. The first is the debt picture; after a tough 2018 risk appetite seems to have returned, and at the same time US Treasury yields have fallen sharply. The combined effect of this has been to drive funds into EM debt markets, resulting in a reduced creditworthiness amongst EM corporates as assorted measures of leverage have risen<sup>1</sup> and growing vulnerabilities for some EM economies. Much of this debt is dollar denominated, linking to the IMF's second concern around the rise of dollar denominated lending by non-US banks. In many economies, and in most EM economies considered, they point out that the share of dollar denominated activity has increased since the global financial crisis (GFC).

This matters because during the GFC it was these non-US banks lending in dollars who proved crucial transmission mechanisms for financial stress. As their ability to obtain dollars to continue lending dried up, they placed strain on their own countries' financial systems, and on the systems and economies of other countries to whom they had made loans. Emerging markets, with the least recourse to alternative funding sources, in dollars or other currencies, were hardest hit.

While dollar funding seems ample today, a look at the recent US repo market stresses should alert us to how easily calm waters can become choppy. With that in mind, in the rest of this note we will take a look at where vulnerabilities may lie within emerging markets.

## Assessing exposure

## Exposure across EM is not uniform

Emerging markets have been here before. Dollar funding has been a vulnerability not only during the GFC, but in EM crises prior to 2008 and again in 2013 during the so called Taper Tantrum. The spotlight focused in on economies with particularly high short term hard currency borrowings; longer term debt is not a problem if the disruption in dollar financing lasts only a few months.

For short term exposures, we focus on the gross external financing requirement (GEFR) which combines all hard currency liabilities maturing within twelve months. To measure economic exposure, we show this relative to GDP (chart 7). We also show each country's position at the time of the Taper Tantrum; the last time EM experienced this stress<sup>2</sup>.

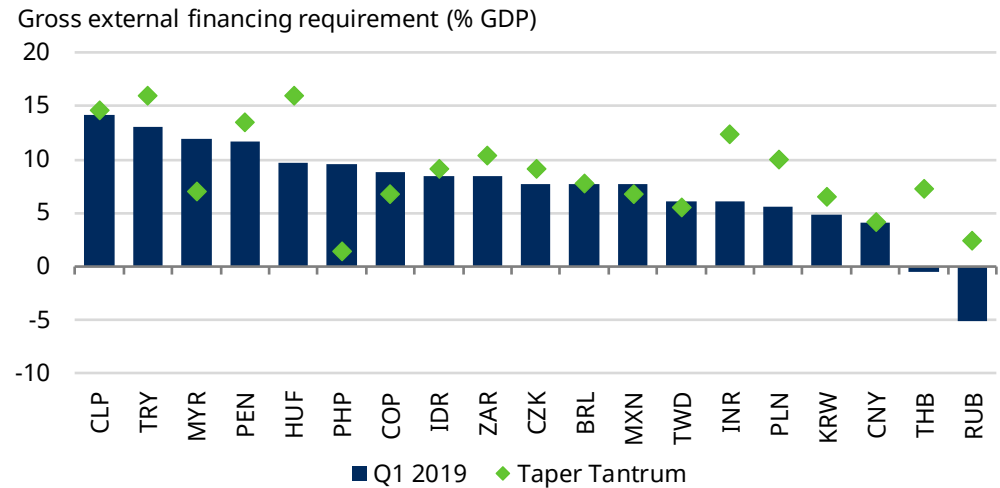
The encouraging thing to note is that most of EM has improved its position relative to 2013. Two economies actually now have surpluses rather than deficits of funding. Overall, the region looks more resilient to dollar funding shocks notwithstanding the IMF's analysis.

<sup>1</sup>The IMF note that the average rating of SOEs in particular has deteriorated meaningfully since the financial crisis.

<sup>2</sup>A negative GEFR typically means that an economy is running a current account surplus and has very low external debts or cross country bank liabilities.



**Chart 7: Short term external vulnerabilities are generally lower across EM**



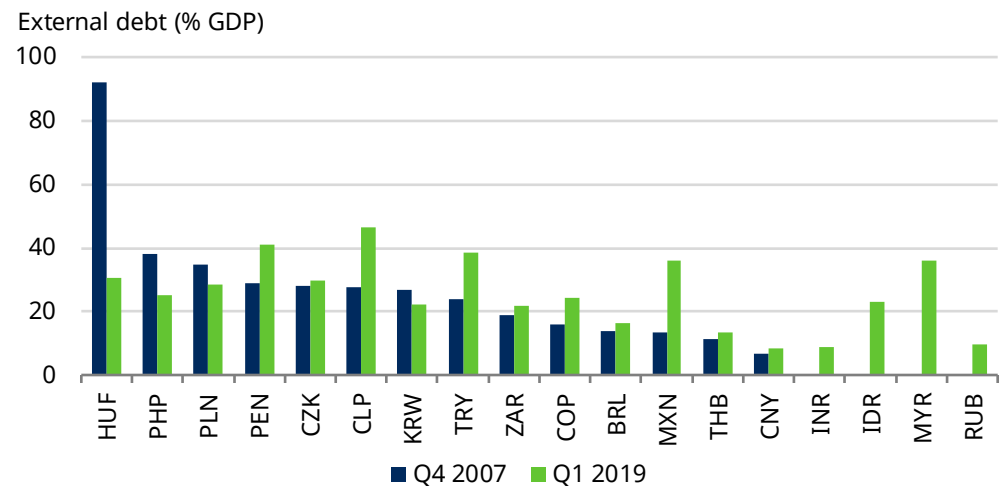
Source: BIS, Refinitiv Datastream, Schroders Economics Group. October 24, 2019.

**A large and permanent increase in dollar funding costs would be painful**

Beyond short term disruptions, we could also find ourselves in a world in which dollar funding costs become structurally higher. This could be through monetary policy, regulation, or geopolitical disruption. Then it is not only the twelve month view we need to worry about, but the total external debt picture (chart 8). For comparison this time we have opted for the pre-crisis levels, as the GFC was the last time all of EM suffered longer term disruption to dollar funding.

Here the picture is less positive for EM. Hungary clearly has made huge improvements (though this came via legislative fiat and was very painful to European banks) but for the countries where we have data there are more economies seeing an increase in external debt than a decrease. Chile, Turkey, Peru and Mexico stand out for the relative increase but also the absolute level, compared to their peers.

**Chart 8: Vulnerabilities rise if we look beyond the next 12 months**



Source: Refinitiv Datastream, Schroders Economics Group. October 24, 2019. 2007 data not available for India, Indonesia, Malaysia and Russia.

**There are other sources of dollars, but they are not always enough**

Emerging markets then have perhaps learnt some lessons from past crises, and have reduced their exposure to shorter term hard currency funding. In theory, at least, short lived disruptions to dollar funding markets should be less painful than in the past. If those disruptions persist, however, the total stocks of debt give more cause for concern. Nonetheless, there can be mitigating factors even when exposures are high, as the IMF acknowledge.

## Assessing resilience

Buffers against strains from the dollar markets largely consist of alternative sources of dollar funding: sizeable exports, swap lines, and currency reserves. A healthy banking system can also offer some resilience by providing alternative sources of credit to support activity.

One way to measure the adequacy of these buffers is to compare them to the vulnerabilities. In chart 9 we show external debt relative to exports, and the GEFR relative to reserves. This should provide some guidance on how well individual EM economies would be able to handle any loss of dollar funding on a short (GEFR) or longer term (total external debt) horizon.

The general picture is not hugely positive for Latin America, with economies from the region generally overexposed to both short and long term dollar funding risk. Turkey undeniably stands out but otherwise the Emerging Europe, Middle East and Africa (EMEA) region looks less at risk, with perhaps an elevated short term vulnerability in South Africa. EM Asia, with the exception of Indonesia, looks well insulated against disruptions in global dollar credit.

**Chart 9: Alternative sources of hard currency often outstripped by debt needs**



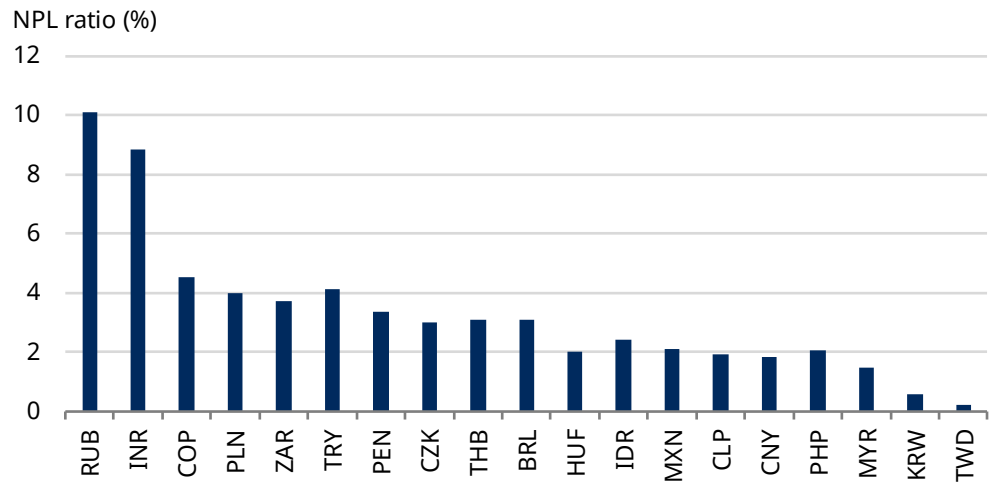
Source: Refinitiv Datastream, Schroders Economics Group. October 24, 2019.

**In some cases, local banking systems could cushion the loss of dollar financing**

When it comes to banking systems, we lack a full picture of capital adequacy across EM but we can look at asset quality. IMF data on non-performing loans (chart 10) again shows a non-uniform picture. Encouragingly, in a way, asset quality is poorest in a couple of the less exposed economies. Russia and India have low external debt burdens and, in the case of Russia, very low short term financing needs as well. The situation of banks in Turkey and South Africa is unfortunate given both countries rank more highly in vulnerability. EM Asia again looks pretty robust, though we have reason to doubt the Chinese figures.

As a final note, we should mention that throughout this piece we have implicitly assumed that external or hard currency debt is dollar debt. This is not always the case. While for EM Asia and Latin America, 80% or more of external debt is denominated in dollars, data from the BIS show that for EM Europe the figure is closer to 50%. Perhaps unsurprisingly, the region makes greater use of euro financing, and this should provide a shield against disruptions in dollar credit.

**Chart 10: A healthy banking system can withstand more external stress**



Source: Refinitiv Datastream, Schrodgers Economics Group. October 24, 2019.

Overall, the risks highlighted by the IMF from dollar funding and foreign borrowing would appear to have most immediate relevance for Latin America. The region's economies find themselves more exposed, on average than other emerging markets but also with less resilience against possible shocks. Turkey, despite recent improvement, also remains vulnerable. In aggregate though it is heartening to note that exposure to shorter term stresses is reduced across EM on average, and more risk averse investors should find that EM Asia, in particular, is well insulated in the event of prolonged stress in global dollar financing. As mentioned, EM Europe, particularly countries within the EU, also enjoy a buffer in the form of greater use of, and easier access to, euro funding.

# Fiscal policy: lessons from Japan

“Merely creating demand by expanding government spending as the government has done in the past will not solve the problem.”

Japanese Cabinet Office, December 2001

The ongoing long-run issue for the world economy is a deficiency in demand with no obvious engine of growth. As investors increasingly hope that fiscal stimulus will come to the rescue to support global growth, we look at the Japanese experience of fiscal stimulus in the 1990s and ask why it was unable to get Japan out of secular stagnation.

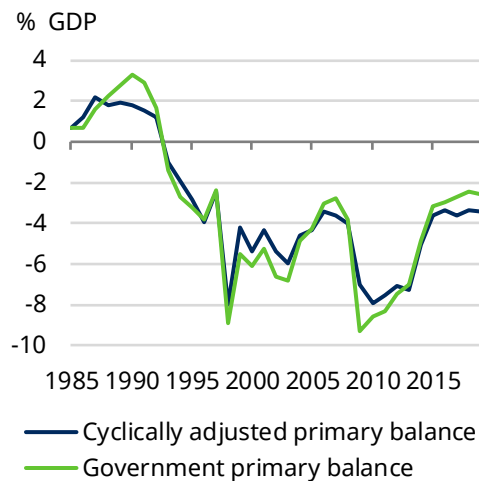
## Embarking on fiscal policy

**Fiscal spending amounted to 35% GDP over 10 years**

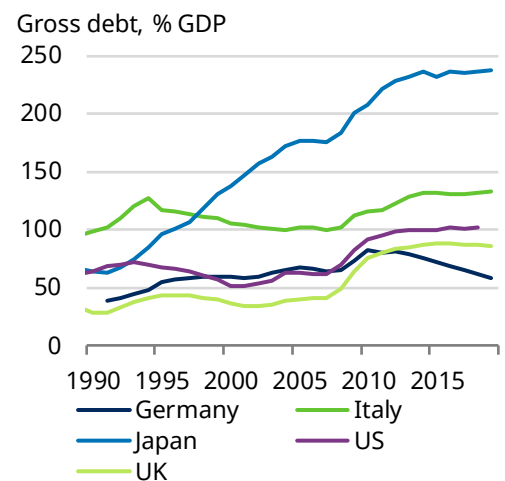
Following the crash in the asset price bubble in 1991, the Japanese government embarked on a series of fiscal measures through the 1990s to boost demand. The first major fiscal package was announced in 1992, which was followed by nine more fiscal packages and seventeen supplementary budgets. While exact estimates of the annual budgets vary, total spending amounted to JPY182 trillion. In inflation adjusted terms, this represents 35% of GDP spent over a decade or roughly 3.5% of GDP per year.

Spending efforts, along with a decline in revenue as the economy weakened, resulted in a deterioration in the budget balance. The Japanese government went from recording a healthy budget surplus of 3% of GDP in 1990 to running significant and consistent budget deficits since 1993 (Chart 11). This subsequently propelled public debt to the highest in the world (Chart 12).

**Chart 11: Persistent deficits**



**Chart 12: Government debt**



Source: Refinitiv, OECD, Schroders Economics Group, October 29, 2019 (LHS), Source: Refinitiv, IMF, Federal Reserve, Schroders Economics Group, October 29, 2019 (RHS).

**A pure accounting approach shows public demand propped up growth**

As always, it is difficult to determine how much fiscal policy helped Japanese growth, all else being equal. However, a pure accounting approach using national accounts data suggests that fiscal policy did help support growth through public demand.

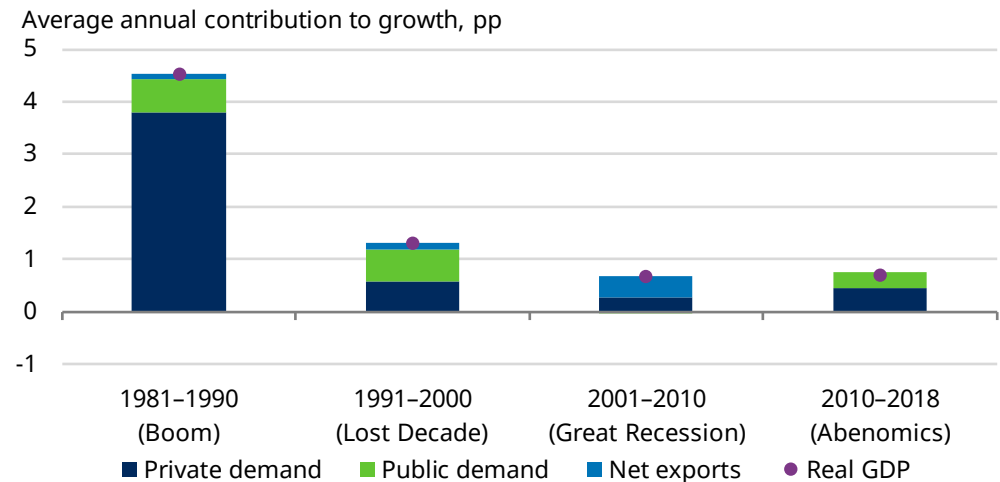
Primarily driven by private demand, Japanese growth fell from an annual average of 4.5% in the 1980s to 1.3% in the 1990s. Public demand – made up of public investment, government consumption and public inventory – contributed an annual average of 0.6 percentage points (pp) to growth in the 1990s (chart 13). In 1992 and 1993 as fiscal stimulus started, public demand actually more than offset the contraction in private demand. So public demand clearly helped prop up growth,

**The small boost in growth implies a low fiscal multiplier**

suggesting that things would have potentially been worse in its absence. However, given the sheer amount of spending, this should be fairly unsurprising.

Somewhat worryingly, the contribution to growth from public demand, on average, was unchanged from the 1980s to the 1990s. Moreover, an average contribution to growth from the public sector of 0.6pp, given the amount spent, implies a very low fiscal multiplier. This suggests that fiscal policy in fact was not particularly effective at all. (The fiscal multiplier is the ratio of change in national income to the change in government spending that causes it).

**Chart 13: Contribution to Japanese growth through the decades**



Source: Refinitiv, Schroders Economics Group, Cabinet Office, October 29, 2019.

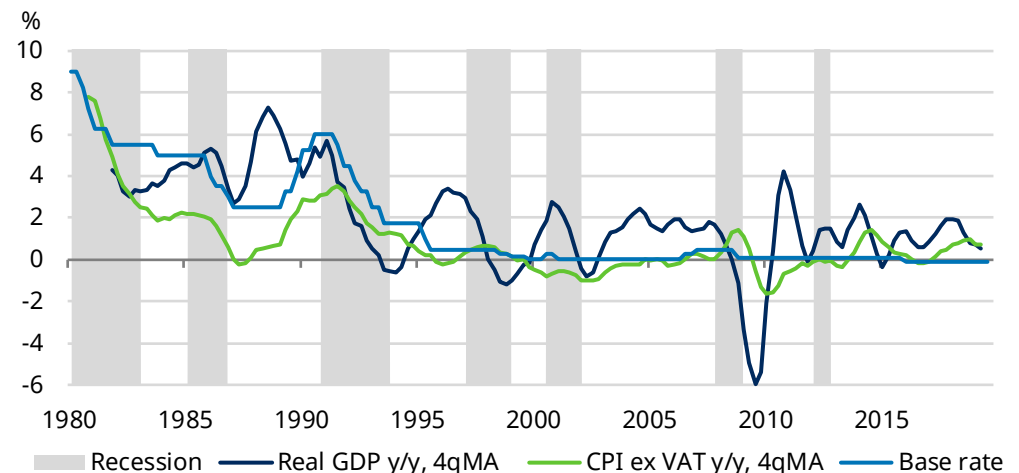
**As the second arrow, fiscal policy was used again in Abenomics**

Despite some acknowledgement from authorities that fiscal policy did not work (see quote above), expansionary fiscal policy was used again following Prime Minister Abe's re-election in 2012. In another attempt to revive the Japanese economy, fiscal stimulus was framed as the second arrow of "Abenomics", along with the other arrows of monetary easing and structural reform. Interestingly, public demand did help support growth in the 2010-2018 period.

Though there is evidence to suggest that fiscal stimulus boosted growth in the short term, it is difficult to conclude that Japan's experience with fiscal policy in the 1990s was successful. The Japanese economy did not recover to its earlier pace of growth or achieve sustained inflation - the latter a key symptom of demand deficiency. Moreover, Japan's combination of low growth, low inflation and interest rates continues to characterise secular stagnation for many investors (chart 14).

**Chart 14: Japan's economy characterises secular stagnation**

**Japan's low growth, inflation and interest rates characterise secular stagnation**



Source: Refinitiv, Schroders Economics Group, October 29, 2019.

There are several reasons why Japanese fiscal policy was unsuccessful and we highlight a few below.

**“Realwater”  
spending is often  
much lower**

### **Announcements overestimated actual spending**

The Japanese government has long inflated the headline numbers of spending announcements due to double counting and loan programs offered by government affiliated institutions to the private sector. The real spending component, known as mamizu or realwater spending is often much lower. Posen (1998) found that, out of seven packages between 1992 and 1995, the mamizu proportion was at most 60%. Moreover, the Peterson Institute for International Economics (PIIE) found that between 1992 and 1996, Japanese local governments failed to spend one third of the announced public works spending.

### **Bridges to nowhere**

In terms of the mix of fiscal policy, Japan’s fiscal expansion was concentrated in public works, such as construction and infrastructure, with limited tax changes. The spending on public works became unproductive – giving rise to the familiar phrase to investors of Japan building “bridges to nowhere”. Ultimately, more productive spending may have resulted in a larger increase in the potential growth rate, through an improvement in productivity. On the taxation side, there was a minor tax cut in 1993 and large income tax cut in 1994 though households were aware that it was temporary. Hori et al (2006) found that although this boosted consumption, the effect was small and later was fully reversed, becoming insignificant over time.

### **Too conservative too quickly**

**Japanese  
authorities raised  
taxes too early**

After multiple years of big spending packages, the Japanese government became more conservative due to concerns surrounding mounting debt. There was no major spending package in 1996. In 1997, fiscal policy became contractionary; the 1994 income tax cut expired and the government hiked VAT and Japan was knocked into recession. This was particularly unfortunate timing as the tax change coincided with the Asian financial crisis. Nonetheless, critics highlight that the Japanese authorities raised taxes too early and prevented a full recovery as growth was on an upward trajectory before this.

### **Private sector headwinds were just too large**

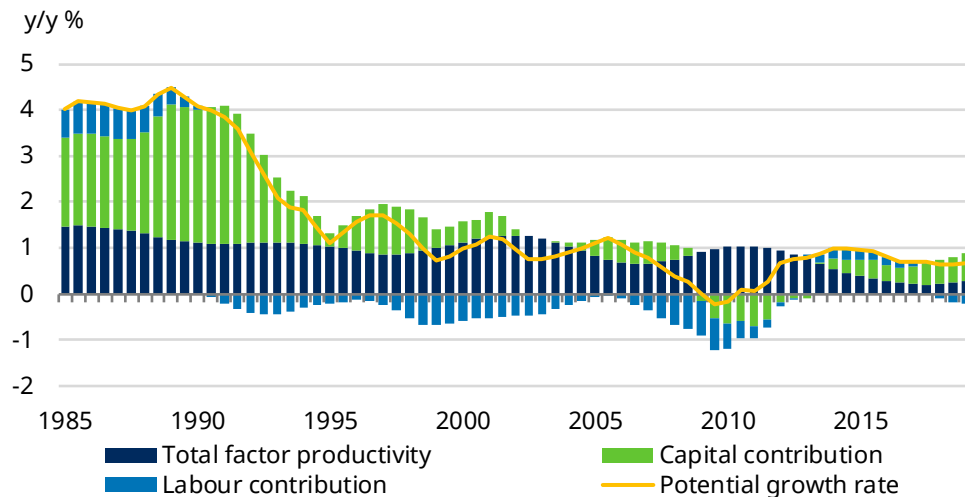
**Corporates  
deleveraged  
and investment  
fell sharply**

The collapse of the bubble severely impacted the Japanese economy and ultimately the private sector faced headwinds that fiscal policy alone was unable to overcome. Japan’s financial system became impaired and the balance sheets of banks and non-financial corporations deteriorated, the former suffering from a rise in non-performing loans. As corporates deleveraged and repaired their balance sheets, investment fell sharply from 34% of GDP in 1990 to 28% of GDP by the end of the decade. From the early 2000s, corporates in Japan began to run significant surpluses of savings over investment. Perhaps reflecting a “scarring effect” this still continues, with Japanese corporate cash holdings at 50% of GDP.

A substantial amount of wealth was lost. Between 1989 and 1992, the value of stocks and land prices fell by the equivalent of 130% and 110% of GDP, respectively. Households faced a sharp fall in wages, which later in 1998 became outright wage deflation alongside wider deflation.

In the bursting of the bubble, the value of stocks fell by the equivalent of 130% of GDP

Chart 15: Breakdown of Japanese potential growth



Source: Bank of Japan, Schroders Economics Group, October 29, 2019.

Fiscal policy was unable to lift the long run potential growth rate

Meanwhile on the supply side of the economy, the fall in investment along with a rapid ageing of the population resulted in the Japanese potential growth rate falling from 4% in 1990 to just 1% in 2000. Given these significant headwinds, fiscal policy was unable to lift the long run potential growth rate of the Japanese economy, although arguably this would have been worse without the public capital expenditure.

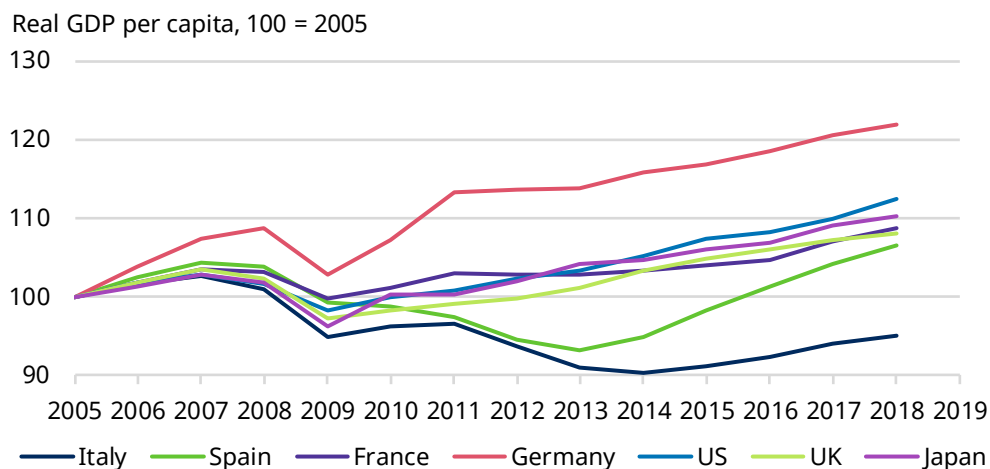
### Lessons for the rest of the world

With the usual caveat that we have no counterfactual, there is some evidence to show that fiscal stimulus did indeed boost Japanese growth. However, with the lack of a durable recovery in growth and inability to achieve sustained inflation, Japan's experience with fiscal policy in the 1990s was ultimately unsuccessful.

For the rest of the world, Japan's failure has shown that to be most effective, fiscal spending should come in large doses, be productive and sustained. However, more importantly Japan's case highlights the difficulty that fiscal policy faces if attempting to offset much larger headwinds in the private sector or lift the potential growth rate.

To be most effective, fiscal spending should come in large doses, be productive and sustained

Chart 16: Real GDP per capita



Source: Refinitiv, Schroders Economics Group, October 29, 2019.

**Japan's huge debt burden shows that fiscal policy does not come without a cost**

Incredibly low interest rates facilitate cheap government borrowing but Japan's huge debt burden shows that fiscal policy does not come without a cost. The recent rise in Value-Added Tax (VAT) in a difficult global economic environment highlights Japan's fiscal challenge today, particularly against a backdrop of poor demographics.

Finally, for those investors concerned about "Japanification", Japan has shown that despite its secular stagnation, real GDP per capita can grow at a healthy rate – the decline in population means that the economy, on this measure, has matched US standards since 2005 (chart 16).



# Schroders Economics Group: Views at a glance

## Macro summary – November 2019

### Key points

#### Baseline

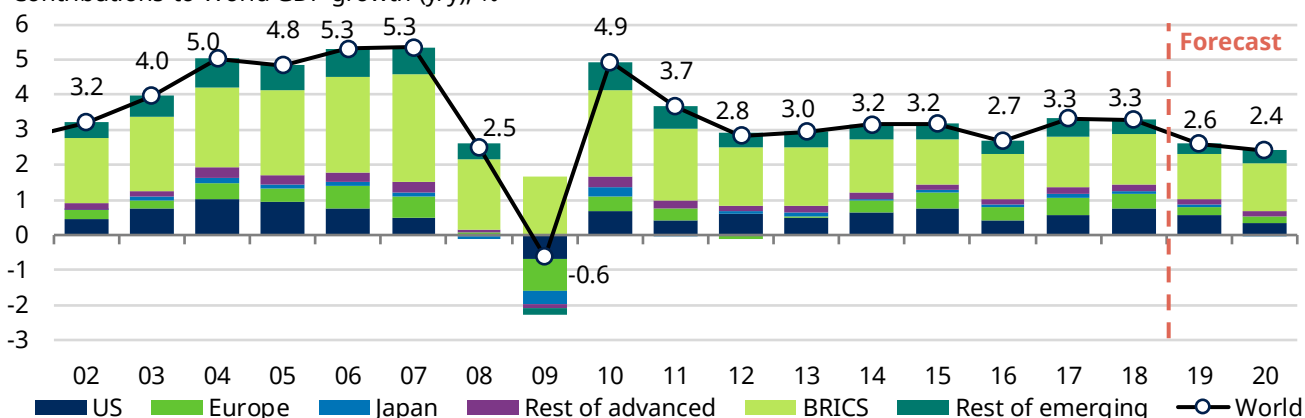
- After expanding by 3.3% in 2018, global growth is expected to moderate to 2.6% in 2019 and 2.4% in 2020 – the slowest rate of growth since the Global Financial Crisis. Inflation is forecast to decline to 2.6% this year after 2.7% in 2018 and then rise to 2.7% in 2020.
- Notwithstanding a “phase one” agreement, US-China trade tensions should continue to remain high into 2020.
- US growth is forecast to slow to 2.1% in 2019 and 1.3% in 2020. Following recent action from the Fed, we expect no more rate cuts this year. As the economy slows from fading fiscal stimulus and the impact of the trade war, the Fed is forecast to cut rates twice more in the first half of 2020.
- Eurozone growth is forecast to moderate from 2% in 2018 to 1.1% in 2019 as the full effects from the US-China trade war and Brexit hit European exporters. Inflation is expected to disappoint, remaining well below target as lower oil prices contribute to lower energy inflation, while core inflation fails to rise due to weaker GDP growth. The ECB is forecast to cut the deposit rate to -0.6% by the end of 2019, and continue QE for the foreseeable future.
- UK growth is likely to fall to 1.1% this year from 1.4% in 2018. Following a small delay, we assume that a Brexit deal with the EU passes Parliament in Q1 2020 ahead of a transition period that preserves the status quo of single market and customs union membership. Growth is then expected to slow to 1% in 2020. Inflation is expected to fall to 1.8% in 2019 due to lower energy prices, but weaker growth and a recovery in sterling after Brexit will keep inflation subdued at 1.9% in 2020. Meanwhile the BoE is forecast to hike rates to 1% in Q3 2020.
- Growth in Japan should rise to 1.2% in 2019 from 1.1% in 2018, however the path of activity should be volatile owing to the consumption tax hike in October this year. A slow recovery should follow resulting in -0.1% growth in 2020. Although inflation remains well under 2% in our forecast horizon, we expect the BoJ to cut rates by 30bps in December following an appreciation in the yen and escalation in trade war.
- Emerging market economies should slow to 4.2% in 2019 after 4.8% in 2018, led by China, but pick-up slightly to 4.5% in 2020 as other BRIC economies see a recovery. China suffers from continued trade tensions with the US and allows the currency to fall further alongside an easing from the PBoC, while dovish developed market central banks provide cover for more easing from their other emerging market counterparts.

#### Risks

- Risks are tilted toward deflation with the highest individual risk going on the global recession scenario where the economy proves more fragile than expected. We also see a risk of an escalation in the US-China dispute with the US extending the trade war to Europe.

#### Chart: World GDP forecast

Contributions to World GDP growth (y/y), %



Source: Schroders Economics Group, August 2019. Please note the forecast warning at the back of the document.

## Schroders Baseline Forecast

### Real GDP

y/y%	Wt (%)	2018	2019	Prev.	Consensus	2020	Prev.	Consensus
<b>World</b>	100	3.3	2.6	↓ (2.8)	2.6	2.4	↓ (2.6)	2.5
<b>Advanced*</b>	61.4	2.3	1.6	↓ (1.8)	1.7	1.1	↓ (1.4)	1.3
<b>US</b>	26.5	2.9	2.1	↓ (2.6)	2.3	1.3	↓ (1.5)	1.8
<b>Eurozone</b>	17.2	2.0	1.1	↓ (1.2)	1.1	0.9	↓ (1.4)	1.0
<b>Germany</b>	5.0	1.9	0.5	↓ (0.9)	0.5	0.8	↓ (1.2)	0.8
<b>UK</b>	3.6	1.4	1.1	↓ (1.4)	1.3	1.0	↓ (1.4)	1.0
<b>Japan</b>	6.7	1.1	1.2	↑ (0.9)	1.0	-0.1	↓ (0.2)	0.2
<b>Total Emerging**</b>	38.6	4.8	4.2	↓ (4.4)	4.0	4.5	↓ (4.6)	4.3
<b>BRICs</b>	25.3	5.7	5.2	↓ (5.5)	5.1	5.4	↓ (5.5)	5.2
<b>China</b>	16.7	6.6	6.2	↓ (6.3)	6.2	6.0	(6.0)	5.9

### Inflation CPI

y/y%	Wt (%)	2018	2019	Prev.	Consensus	2020	Prev.	Consensus
<b>World</b>	100	2.7	2.5	↓ (2.6)	2.5	2.6	↓ (2.7)	2.5
<b>Advanced*</b>	61.4	2.0	1.5	↓ (1.8)	1.5	1.7	↓ (2.0)	1.6
<b>US</b>	26.5	2.4	1.9	↓ (2.3)	1.8	2.2	↓ (2.4)	2.1
<b>Eurozone</b>	17.2	1.7	1.3	↓ (1.7)	1.2	1.3	↓ (1.6)	1.2
<b>Germany</b>	5.0	1.8	1.4	↓ (1.8)	1.4	1.5	↓ (1.7)	1.5
<b>UK</b>	3.6	2.5	1.8	↓ (2.0)	1.9	1.9	↓ (2.3)	2.1
<b>Japan</b>	6.7	1.2	0.7	↑ (0.3)	0.6	1.0	↓ (1.2)	0.7
<b>Total Emerging**</b>	38.6	3.8	4.1	↑ (3.9)	4.2	3.9	↑ (3.8)	3.9
<b>BRICs</b>	25.3	2.8	3.1	↑ (2.8)	2.9	3.3	↑ (3.1)	2.9
<b>China</b>	16.7	2.2	2.7	↑ (2.4)	2.5	2.8	↑ (2.7)	2.5

### Interest rates

% (Month of Dec)	Current	2018	2019	Prev.	Market	2020	Prev.	Market
<b>US</b>	1.75	2.50	1.75	↓ (2.50)	1.92	1.25	↓ (2.00)	1.60
<b>UK</b>	0.75	0.75	0.75	↓ (1.00)	0.81	1.00	↓ (1.50)	0.72
<b>Eurozone (Refi)</b>	0.00	0.00	0.00	(0.00)	-0.41	0.00	↓ (0.50)	-0.44
<b>Eurozone (Depo)</b>	-0.50	-0.40	-0.60	↓ (-0.40)	-	-0.60	↓ (0.00)	-
<b>Japan</b>	-0.10	-0.10	-0.30	↓ (-0.10)	0.00	-0.30	↓ (-0.10)	-0.03
<b>China</b>	4.35	4.35	4.00	(4.00)	-	3.50	(3.50)	-

### Other monetary policy

(Over year or by Dec)	Current	2018	2019	Prev.	Y/Y(%)	2020	Prev.	Y/Y(%)
<b>US QE (\$Tn)</b>	4.0	4.1	3.8	↑ (3.7)	-7.3%	3.8	↑ (3.7)	0.0%
<b>EZ QE (€Tn)</b>	2.4	2.4	2.4	(2.4)	0.0%	2.6	↑ (2.4)	8.3%
<b>UK QE (£Bn)</b>	422	435	445	(445)	2.3%	445	(445)	0.0%
<b>JP QE (¥Tn)</b>	557	552	583	↑ (573)	5.6%	623	↑ (593)	6.9%
<b>China RRR (%)</b>	13.50	14.50	12.00	12.00	-	9.00	↓ 10.00	-

### Key variables

FX (Month of Dec)	Current	2018	2019	Prev.	Y/Y(%)	2020	Prev.	Y/Y(%)
<b>GBP/USD</b>	1.29	1.27	1.24	↓ (1.34)	-2.6	1.32	↓ (1.38)	6.5
<b>EUR/USD</b>	1.11	1.14	1.08	↓ (1.14)	-5.5	1.14	↓ (1.18)	5.6
<b>USD/JPY</b>	109.0	109.7	103	↓ (110)	-6.1	105	↓ (108)	1.9
<b>EUR/GBP</b>	0.86	0.90	0.87	↑ (0.85)	-3.0	0.86	↑ (0.86)	-0.8
<b>USD/RMB</b>	7.06	6.87	7.20	↑ (6.85)	4.9	7.30	↑ (7.00)	1.4
<b>Commodities (over year)</b>								
<b>Brent Crude</b>	61.3	71.6	64.2	↓ (70.2)	-10.3	59.5	↓ (69.1)	-7.3

Source: Schroders, Thomson Datastream, Consensus Economics, October 2019

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.

Market data as at 28/10/2019

Previous forecast refers to May 2019

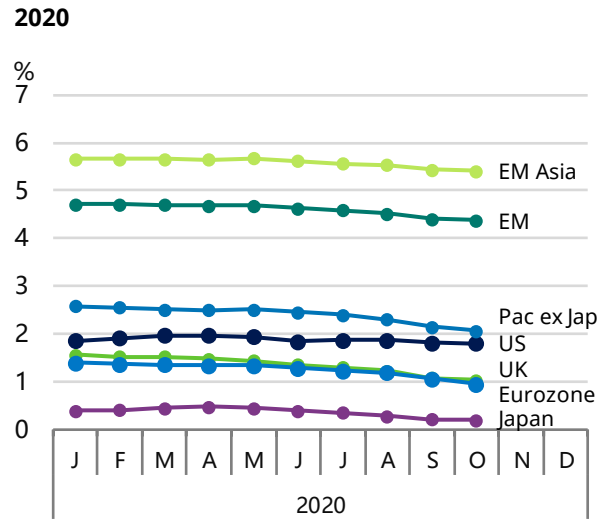
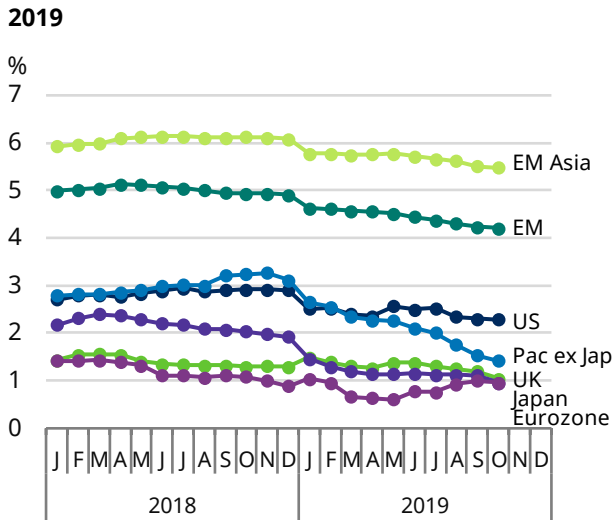
\* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.

\*\* **Emerging markets:** Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan SAR, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

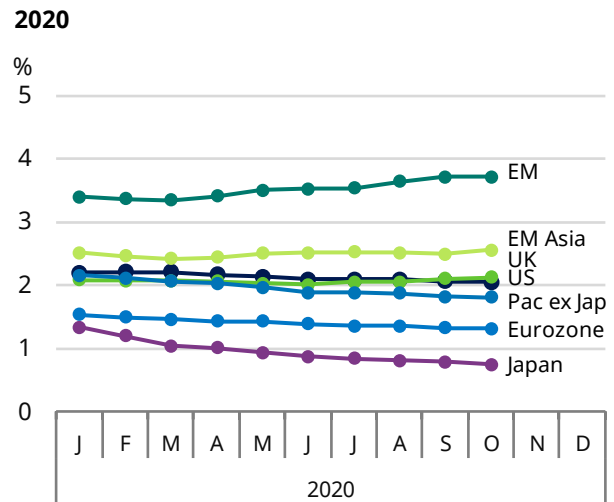
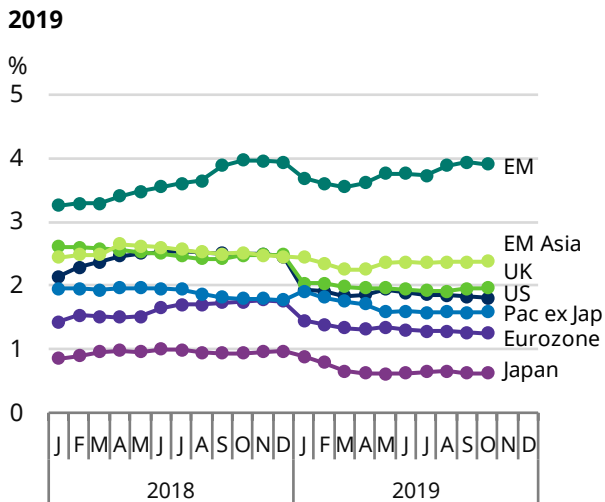
# Updated forecast charts – Consensus Economics

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 (October 29, 2019), 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.

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