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Timely insights from Barings' Macroeconomic & Geopolitical Research Team

November 2018

IS THE GLOBAL ECONOMY REALLY AT A TIPPING POINT?

IT'S IMPORTANT TO KEEP TODAY'S MARKET RISKS IN PERSPECTIVE AMID ECONOMIC ACTIVITY THAT IS SLOWING, BUT STILL VERY STRONG.

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You can hear the bearishness in everyone's voice. They don't trust a cycle this old. They won't fight the Fed. They fear a market swoon amid a world of crazy politics.

But are those really the right assumptions? The risks are clearly mounting, as we saw in recent data signaling slight economic contractions in Germany and Japan. But **for now anyway, monetary, fiscal and political headwinds hardly seem strong enough to tip us into a global recession.**

THE FED FACTOR

If the biggest market worry centers on the Fed, that should begin to dissipate early next year. Rates are surely rising and debt service is growing more expensive, but how likely is it that U.S. monetary policy is really "behind the curve"? Wages and tariffs may be nudging some prices higher, but energy and technology prices are falling.

Most forecasts have core inflation hovering just above 2%, which suggests that the end of the current tightening cycle is in sight. The Federal Open Markets Committee seems headed slowly and tentatively toward a 3% Fed Funds rate at the end of next year if the "dot plots" hold, but futures markets are pricing in lower rates.

Meanwhile, monetary accommodation reigns in Europe, Japan, China and beyond. And long-term demographic trends and new technologies seem likely to keep any inflationary spikes in check.

FISCAL POLICY DOES NO HARM

The second major cyclical worry comes from the U.S. federal budget, which now seems less predictable than ever. As the new Congress takes shape, there is a lot of talk about the budget deficit that is set to reach US$1 trillion next year, but there is also very little determination from either political party to raise taxes or cut spending as they gear up for the next presidential election.

This means that U.S. firms should not expect fresh tax cuts to boost their earnings, but they probably didn't pass the full 2017 cuts through to earnings this year anyway and may therefore enjoy reserves to support next year's results. More important, they should expect steady domestic demand supported by continued low unemployment and strong household balance sheets.

One key trend to watch will be the prospect for rising productivity that should come from higher business investment. The latest U.S. investment numbers have been weak, and further weakness could undermine earnings beyond next year. But that, too, is probably a longer-term concern.

Meanwhile, fiscal policy globally has been generally supportive in large economies like China, Japan and even Germany. It may not be enough to accelerate global growth, but it's hardly contractionary.

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POLITICAL DRAMAS

Even if you are comfortable with the growth and inflation outlook, a long list of political risks looms next year. The trick in these polarized times is to disaggregate political preferences from economic analysis. Democrats tend to magnify the risks to the economy that might undermine President Trump's reelection campaign. Republicans tend to pin outsized hopes on tax cuts and deregulation.

For the current cycle, the most important political theater to watch in Washington may come in the likely standoffs over the debt limit and government funding. These may trigger market gyrations, but the disruptions shouldn't be enough to tip the U.S. economy into recession.

In Europe, Britain's new relationship with the European Union will become much clearer well before the official 'Brexit' date of March 29 next year. Italy is Europe's biggest challenge, and there is not enough money to bail out an economy that size if its government loses the confidence of bond markets. But the country's debts are long-term and mainly held domestically. The budget standoff is real, but likely to subside as politicians turn their attention to European parliamentary elections that carry few direct market consequences.

The largest political risk for the global economy could be the deepening trade frictions with China. We may be surprised by a temporary truce at the G-20 Summit in Buenos Aires at the end of November, with Presidents Trump and Xi perhaps opting to delay escalation for now. Still, the nagging issues around China's economic subsidies and protection of intellectual property will not be resolved quickly.

But the greatest damage from tariffs will likely come over the very long term, as companies reassess their investment priorities in a world of rising trade barriers. The near-term impact of tariffs on global growth should remain limited, as both the Chinese and U.S. economies depend overwhelmingly on internal demand.

THE BOTTOM LINE

The clouds on the horizon are real and there is plenty of room for unpleasant surprises, especially from higher debt servicing costs and continuing pressures on some emerging markets. Still, **it's important to keep these risks in proper perspective against a very global economy that is slowing, but still very strong, and political tensions that are distracting, but unlikely to trigger recession.**

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**As of September 30, 2018*