Economy

Economic outlook - 20 questions about 2020

Friday 10 January 2020

Bruno Cavalier - Chief Economist
bruno.cavalier@oddo-bhf.com
+33 (0)1 44 51 81 35

Fabien Bossy - Economist
fabien.bossy@oddo-bhf.com
+33 (0)1 44 51 85 38

https://www.oddosecurities.com

Since 2018, world economic growth has been dragged down by the downturn in the manufacturing sector against the backdrop of a "trade war". For a large part of 2019, the question that most preoccupied investors and economists was whether the US and, with it, the rest of the world, would fall back into recession. Over the summer, these concerns almost entered irrational territory. As we enter 2020, general sentiment is calmer and more in tune today with the real economy, whose situation is far from catastrophic. In this note, we will examine in the form of a Q&A the key questions likely to shape the economic outlook.

- To sum up all the events that marked 2019, it could be said that this was the year when the much-feared recession did not take place. This concern spread like a virus over the summer. Everything was used as a pretext to forecast a recession; but two factors particularly fed these fears.
- The first is the state of manufacturing. Manufacturing activity is contracting in a large number of countries, and in some, such as Germany, the crisis is very severe. It would be simple – but incorrect – to believe that manufacturing is an infallible guide to fluctuations in the whole economy. In reality, the main characteristic of the current business cycle is that problems in manufacturing have barely contaminated other sectors. A decoupling has taken place, illustrating the very different situation between world trade and domestic demand, with downside risks on the one hand and neutral risks or upside on the other. At present, some industries, such as the automotive sector in Germany or the aerospace sector in the US, continue to face structural problems, but the general picture is that global manufacturing confidence is past its trough. The easing of trade strains between the US and China probably has something to do with this.
- The second source of anxiety lies in the interest-rate environment. Nominal interest rates are low everywhere, or even negative, leaving little space for monetary loosening to rescue the economy if necessary. The yield curve is also flat in many places and has even inverted at times. This signal is supposed to presage a deterioration in the growth and inflation outlooks. Without going so far as to claim that long-term bond yields have become "false prices" as a result of central banks' increasing grip on the government debt market, the signal conveyed by yield curves is undoubtedly harder to analyse than in the past. The interest-rate environment is widely seen as abnormal, causing obvious pain to the financial sector, banks and asset managers. There is nothing like the financial sector for spreading and magnifying real economic shocks. Last year, central banks, led by the Fed, took the bull by the horns with loosening measures. While it is fashionable to say that monetary policies have lost all their effectiveness, this is not what we have observed in the wake of these decisions. Financial conditions have indeed eased, providing more oxygen to the world economy. In the absence of a true overheating, central banks are not taking much risk in maintaining such accommodative policies. Even if inflation picks up in 2020, as is likely, there is no prospect of any monetary tightening.
- All in all, despite a struggling industrial sector, stagnant global trade in goods, and a bleak rate structure, the expansion phase that began more than ten years ago has not ended. In truth, most of the growth slowdown took place in 2018, not in 2019. Over the past four quarters, world real GDP has grown at a fairly stable annualised pace of around 3% q/q. In our opinion, this looks more like a floor than a ceiling for the year ahead.

Disclaimer:

Disclaimers for Distribution by ODDO BHF SCA to Non-United States Investors:

This publication is produced by ODDO BHF Corporates & Markets, a division of ODDO BHF SCA ("ODDO"), which is licensed by the Autorité de Contrôle Prudentiel et de Résolution (ACPR) and regulated by the Autorité des Marchés Financiers ("AMF").

This document, when distributed outside of the U.S., is intended exclusively for non-U.S. customers of ODDO and cannot be divulged to a third-party without prior written consent of ODDO. This document is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment. This document has been developed by our economists. It does not constitute a financial analysis and has not been developed in accordance with legal requirements designed to promote the independence of investment research. Accordingly, there are no prohibitions on personal dealing ahead of its dissemination. "Chinese walls" (information barriers) have been implemented to avert the unauthorized dissemination of confidential information and to prevent and manage situations of conflict of interest.

At the time of publication of this document, ODDO and/or one of its subsidiaries may have a conflict of interest with the issuer(s) mentioned. While all reasonable effort has been made to ensure that the information contained is not untrue or misleading at the time of publication, no representation is made as to its accuracy or completeness and it should not be relied upon as such. Past performances offer no guarantee as to future performances. All opinions expressed in the present document reflect the current context which is subject to change without notice. The statements, assumptions and forecasts contained in this document reflect the judgment of its author(s), unless otherwise specified, and do not reflect the judgment of any other person or of ODDO. This document does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this document is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice.

This document is for institutional investors only. It may not contain information necessary for others to make investment decisions. Consult your financial adviser or an investment professional if you are not an institutional investor.

Disclaimers for Distribution by ODDO BHF New York Corporation to United States Investors:

Please refer to the most recent research reports on the subject companies for complete information and relevant disclosures.

This document is produced by ODDO BHF Corporates & Markets, a division of ODDO BHF SCA ("ODDO"). It is distributed to U.S. investors exclusively by ODDO BHF New York Corporation ("ONY"), MEMBER: FINRA/SIPC, and is intended exclusively for U.S. institutional customers of ONY and cannot be divulged to a third-party without prior written consent of ONY. This document is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment. This document is being furnished to you for informational purposes only and should not be relied upon as sufficient to form a basis for any investment decision.

At the time of publication of this document, ODDO, and/or one of its subsidiaries may have investment banking and other business relationships with any of the companies in this report. While all reasonable effort has been made to ensure that the information contained is not untrue or misleading at the time of publication, no representation is made as to its accuracy or completeness and it should not be relied upon as such. However, ODDO has no obligation to update or amend any information contained in this publication. Past performance offers no guarantee as to future performance. All opinions expressed in the present document reflect the current context which is subject to change without notice. This document does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of particular clients. Clients should consider whether any advice or recommendation in this document is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice.

This document is not a research report as defined in FINRA Rule 2241(a)(11) because the material in it is limited to one or more of the exclusions of the definition of research report in Rule 2241(a)(11)(A). This document is for institutional investors only. Consult your financial adviser or an investment professional if you are not sure you are an institutional investor.

Disclosures Required by United States Laws and Regulations:

Rule 15a-6 Disclosure: Under Rule 15a-6(a), any transactions conducted by ODDO, and/or one of its subsidiaries with U.S. persons in the securities described in this document must be effected through ONY.

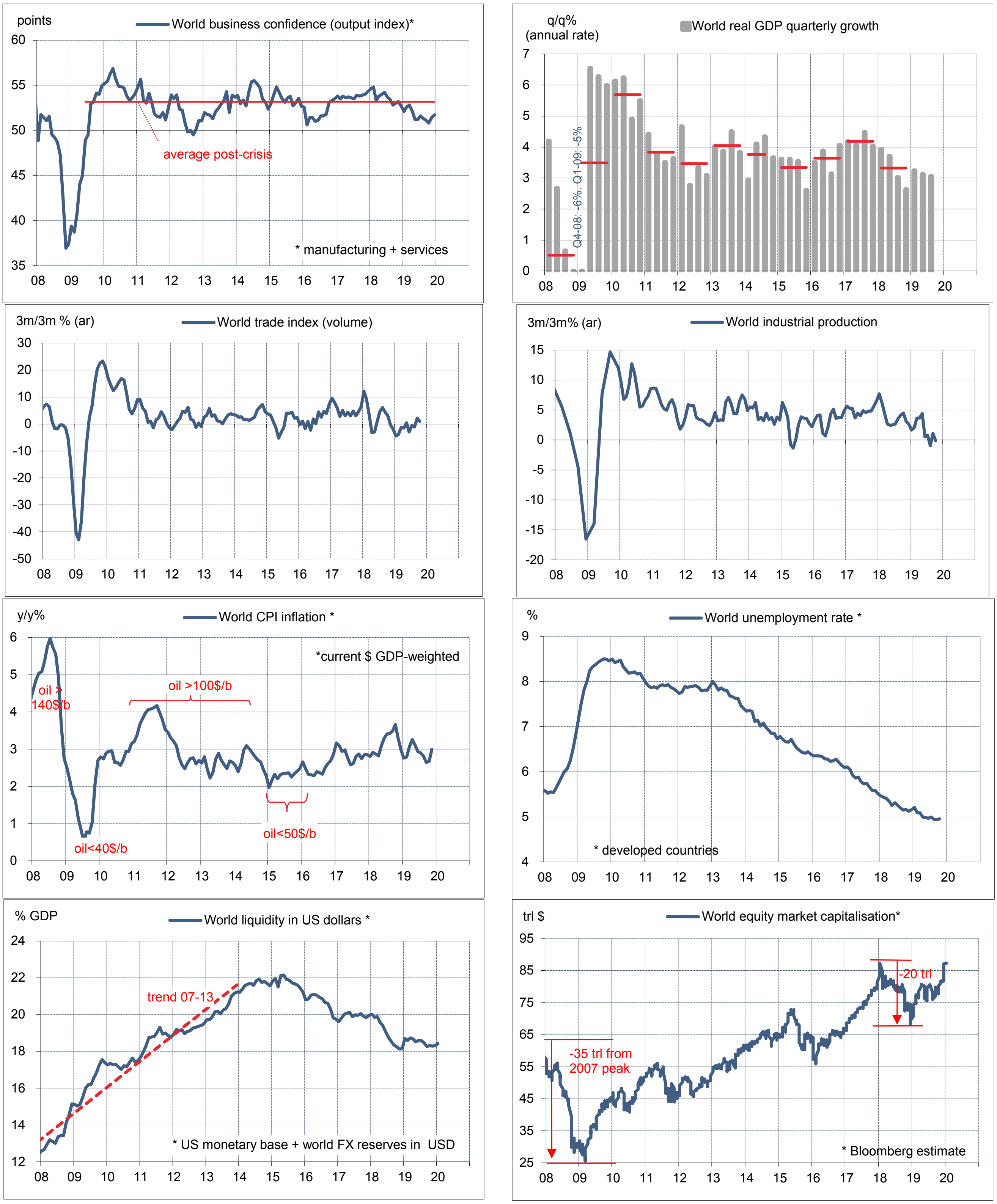
Contact Information of firm distributing investment recommendations to U.S. investors: ODDO BHF New York Corporation, MEMBER: FINRA/SIPC, is a wholly owned subsidiary of ODDO BHF SCA; Philippe Bouclainville, President (pbouclainville@oddony.com) 150 East 52nd Street New York, NY 10022 212-481-4002.

Statement of conflict of interests of all companies mentioned in this document may be consulted on Oddo & Cie's research site .

Contents

SNAPSHOT OF THE WORLD ECONOMY

World economic and financial indicators



Charts 1 - Sources: Thomson Reuters, Markit, CPB, ODDO BHF

20 QUESTIONS ABOUT 2020

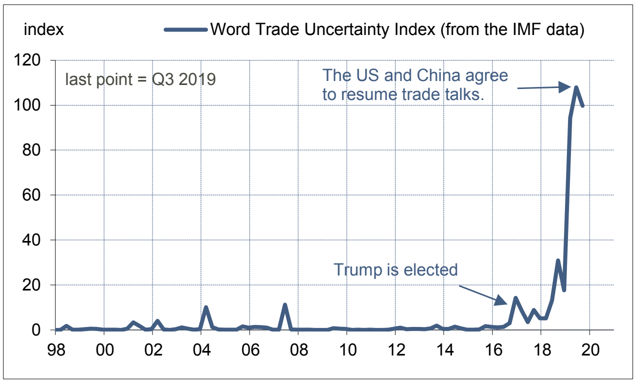
In what follows, we will examine in the form of Q&A the principal drivers and uncertainties of the economic outlook in 2020.

Q1 – Trade war – a pause, before new upsets?

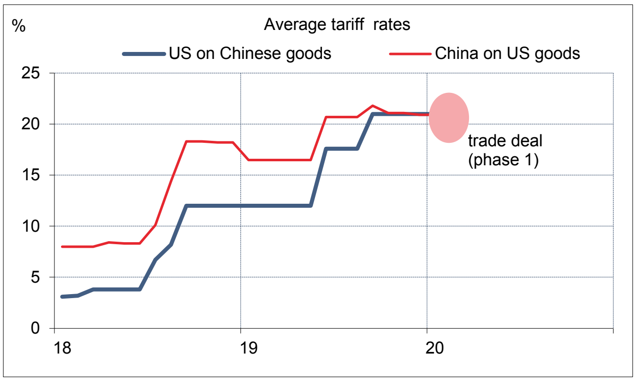
What has become known as a "trade war" pitting the US against more or less the rest of the planet has been raging since spring 2018. Almost all countries in the world have trade surpluses with the US. This situation is considered intolerable by Donald Trump, who sees it as evidence that trade relations are biased against his country. His objective is to restore the balance by imposing tariffs on one country after another.

In reality, the US trade deficit reflects a domestic savings shortfall and does not result from the alleged unfairness of free trade agreements or the WTO. It is determined by macroeconomic factors, not by the level of tariffs. As a result, tariff hikes have had no impact on the US trade deficit[1]. What's more, any protectionist measures taken by the US have in most cases been followed by retaliatory measures of similar intensity. The result of this "tariff war" is a reduction in the fluidity of trade. The macro direct effect of the slowdown in trade has been fairly modest to date, but this new environment has also brought to the surface concerns about a radically new subject: world trade uncertainty (**Chart 2a**). It is natural for economic agents to take decisions in an uncertain universe, but in the present case there is no obvious point of comparison for this uncertainty. The negative effect on manufacturers' confidence and their incentive to invest appears to be significant.

World: trade uncertainty index



US-China: tariffs



Charts 2 – Sources: IMF, PIIE, ODDO BHF

The attack on free trade, at least in a multilateral framework, is a constant feature of the Trump administration's policy. This policy has been implemented somewhat erratically, alternating between periods of strain and respite. Each strain is marked by tariff hikes, and each respite by a stabilisation. To date, there have been no notable U-turns (**Chart 2b**). Even if President Trump cannot admit this, his "trade war" has failed. There is some pain for China, but not to the point of accepting all concessions. The increase in the cost of goods made in China is ultimately being borne by US importers or households. The rise in tariff revenues collected in the US (+$30bn in one year) is a redistribution between US agents, not a transfer from China.

[1] In March 2018, when the US administration launched the first round of tariffs, the visible trade deficit with the rest of the world was $829bn. Over the past year, it has more or less stabilised at $850bn. The bilateral deficit with China has decreased slightly, but this has been matched by an increase with the rest of the world (trade diversion phenomenon).

At the time of writing, the respite is prevailing. The US and China concluded the “phase 1” of a trade deal at the tail end of 2019. A “phase 2” is being studied. Chopping up the negotiations in this way is a recognition that the two countries are too distant from each other to sign a complete and final agreement, but also too interdependent to engage in an all-out war. There are no swift gains for President Trump. As we enter an electoral year (**Q18**), President Trump probably has more to gain from seeking a stabilisation or de-escalation of trade strains that in maintaining pressure, whose repercussions are felt by US companies. But trade uncertainty will not disappear as if by magic. This is therefore a risk factor for business confidence.

Q2 – Geopolitics – what could affect US-China relations and oil?

There are few areas in which relations between the US and China are not likely to have global repercussions in case of strains. There is no shortage of analyses describing these relations under the prism of a new cold war, or even as a repeat of the Peloponnesian war[2]. Trade frictions are only the tip of the problem. At the start of this year, each party seems determined to ease strains and pursue dialogue (**Q1**). Is there anything that could unravel these good intentions? The question of Hong Kong is worth considering here.

Hong Kong represents far more than its economic weight alone (0.4% of world GDP). It is one of the principal financial markets and a key link in Asian trade. Since March 2019, the territory has been the stage of protests against an extradition law allowing China to interfere in the legal system, something that is viewed as a threat to the principle of “one country, two systems”. At times, Hong Kong authorities have appeared overwhelmed by the scale of protests, raising fears of an open intervention by Chinese forces. The US Congress adopted in November a text authorising sanctions in case of human rights breaches, whereas President Trump has been more vague about his intentions. The Chinese authorities view this as interference in its domestic affairs. In short, if the Hong Kong region were to experience an even more severe social and political crisis, this could modify Sino-US relations, and indirectly the world economy.

The second geopolitical risk to take into account is an old classic: the Middle East and its influence on the oil market. It has become a cliché to describe this region as a flashpoint. Last year, several tankers were attacked in the Strait of Hormuz. In September, production sites in Saudi Arabia were targeted in an attack blamed on Iran. The start of this year has seen a sharp ratcheting-up of strains between Iran and the US, with each making dire threats against each other. As result, the oil price (on 10 January) is more or less on its 2019 average. This is not exactly the sign of a panic.

It is of course impossible to secure all oil production and distribution in this region, and the geopolitical premium is likely to spike at times. Global oil balances are not what they were during the oil shocks of 1973, 1979 or 1990. One of many illustrations of this is that US oil production totalled around 13 mb/d in 2019, according to the IEA, up from less than 6 mb/d ten years ago. During the same period, the combined production of Iran and Venezuela, to name two countries at risk, has fallen from 6 mb/d to 3 mb/d. If the oil price truly spirals, with a lasting rise of say 25% compared with 2019, the increase in the net oil bill (supply – demand) would represent 0.1% of GDP in the US, 0.4% in Europe, Japan and China, 0.7% in India and 0.9% in South Korea. This type of shock clearly has a twofold negative impact – price rises and declining activity – but it would need to be of a far greater intensity to trigger a recession.

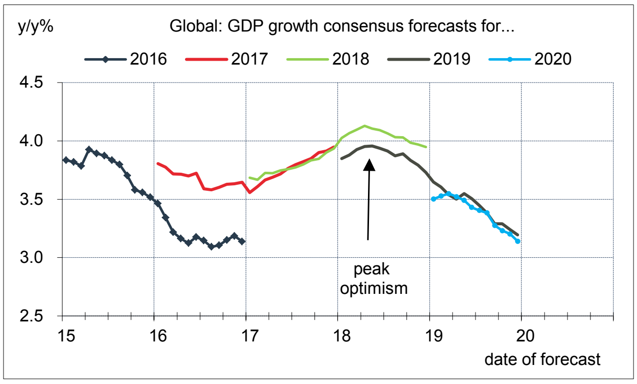
[2] *Allison (2017), The Thucydides Trap, Foreign Policy*

Q3 – World growth at 3%– a floor or a ceiling?

A comparison can be made between the current situation and the slowdown observed in 2015 and early 2016. In both cases, world economic growth fell to a level dangerously close to its stall speed, estimated at around 2.5%. Consensus forecast stands today at approximately 3% (**Chart 3a**). In both cases, there was also a sharp decline in confidence and industrial production. The closely-watched ISM-manufacturing index fell below the alert threshold of 50 points (47.2 today vs 48.0 at its January 2016 trough). The Fed was forced to adjust its plans by postponing policy rate hikes in 2016 and by lowering rates in 2019. There are, of course, some differences. In spring 2016, when pessimism predominated, a recovery began to take shape. With hindsight, this stemmed from the stabilisation of oil prices (this was the major shock at the time, as the trade shock has been in recent quarters), the Fed's more accommodative stance and, above all, a stimulus plan in China. On this last point, nothing of this sort appears to be on the cards in 2020. The priority of Chinese authorities is no longer, as in 2016, or previously in 2008, to stimulate growth in the short term at the cost of higher indebtedness, but instead to ensure balanced growth (**Q5**). If China does not stimulate its economy, can world growth still re-accelerate? It is necessary to examine the outlook in each major region.

In the US, the output gap has been plugged since last year. There are no obvious signs of overheating (**Q8**), but the sharp rise in company indebtedness is raising concerns. What would happen if interest rates were to rise? Companies are cutting their capital expenditure (**Q7**). This is more than cancelled out by the firmness of consumer spending. In the short term, there is a downside risk to activity because of the repercussions of the Boeing shock. However, with the (modest) easing of trade uncertainty and a policy mix that is set to remain stimulating thanks to elections, the economy should grow at least at its potential rate, in the region of 2%.

World: 12-month forward growth forecasts



World: new orders index

Charts 3 – Sources: Consensus Inc, Thomson Reuters, ODDO BHF

It is in Europe that the cold snap has been felt most severely. In Germany and Italy, two countries representing half the Eurozone, growth has fallen to around zero. Political risk remains high, even if it is often only a distraction (**Q19**). There are good reasons to express some optimism about the region's outlook. Firstly, setting the industrial shock aside, the rest of the economy has barely weakened (**Q9**). Retail sales, employment, bank lending and construction are all growing strongly. Secondly, there are mounting signs of a stabilisation of confidence in the manufacturing sector, suggesting that the adjustment of inventories and order books has made good progress. Lastly, economic policy is expansionary. The ECB is doing its utmost, and successfully, to loosen financial conditions. Fiscal policy is modestly stimulating. With growth that has dipped below its potential trade to less than 1% annually in recent quarters, there is scope for an acceleration. In our view, this is the principal source of upside surprises in 2020.

The rest of the world economy can only benefit from an easing of US-China trade strains and a recovery in the industrial cycle (**Chart 3b**). Even a stabilisation on these two points would constitute progress. Some large emerging countries have experienced soft patches in the past two years (Turkey and India), but the worst seems to be over. Other emerging countries are in huge difficulty (Argentina and South Africa). By and large, the emerging world suffers when the Fed raises its interest rates, when the oil price surges and when the dollar appreciates. The Fed has made a complete monetary U-turn. Oil risk is not nil but appears contained. As for the dollar, its appreciation – strong in 2018, more modest in 2019 – is showing a few signs of losing momentum (**Q18**).

Q4 – Manufacturing crisis – global factors or specific factors?

In the space of ten years, the world economy has experienced three industrial cycles (recovery followed by a slowdown/contraction). According to the CPB's estimates, global industrial production fell by 0.5% year-on-year in October, a slowdown of 3.7pts in one year. The current cold snap therefore appears more severe than the two previous ones in 2012-13 and 2015-16. That said, regional differences exist (**Table 4**). In the US, the industrial recession was far more pronounced in 2016; in the Eurozone, the situation was far worse in 2012 than today; and there is obviously nothing comparable anywhere to the Great Recession of 2009.

Industrial cycles from the Great Recession to today

Industrial production excl.construction	2009		2012-13		2015-16		2019	
	Trough	one year before	Trough	one year before	Trough	one year before	Trough	one year before
World	-12.3 %	4.5 %pt	0.7 %	3.5 %pt	0.6 %	3.1 %pt	-0.5 %	3.2 %pt
Advanced countries	-18.4 %	1.9 %pt	-1.8 %	1.0 %pt	-1.1 %	1.8 %pt	-1.9 %	2.3 %pt
- o/w US	-14.8 %	-0.8 %pt	1.4 %	3.6 %pt	-4.1 %	3.3 %pt	-1.3 %	4.1 %pt
- o/w EMU	-21.7 %	4.8 %pt	-4.0 %	0.2 %pt	0.0 %	2.3 %pt	-2.7 %	0.8 %pt
Emerging countries	-6.8 %	9.6 %pt	2.9 %	6.3 %pt	2.3 %	4.4 %pt	0.7 %	3.9 %pt

Table 4 – Sources: CPB, ODDO BHF

Since all regions are affected concomitantly, albeit to varying degrees, global forces must be at play. Trade uncertainty appears to be to blame (**Q1**). Besides the slowdown in trade, manufacturers have frozen their capital expenditure while they await more clarity on production chains (US-China relations for the electronics sector, and US-Mexico relations for the automotive sector). Production has been cut to avoid an excessive inventory build-up in the face of moderating global demand.

Locally, some industries have been (or are being) hit by specific shocks. The most significant case is the German automotive production chain and both its geographical repercussions (on subcontractors in Eastern Europe) and sectoral repercussions (on chemicals and electronics). A combination of negative factors has taken a toll over the past two years – new CO2 emission standards, tariff threats by the Trump administration and plunging demand in a number of important external markets (the UK because of Brexit and Turkey because of a financial crisis) – and all this at a time when no-one can judge the strength of future demand for new electric and hybrid vehicles. This crisis has shed light on the oversizing of this sector in the German economy and largely explains the country's stagnation (**Q10**). In the medium-to-long-term, the electrification of the industry necessitates massive investment, but in the short term there are still no tangible signs of a recovery in business confidence surveys. Manufacturing confidence is no longer falling but remains depressed, as does production.

The other specific shock is in the US aerospace industry because of the flight ban on the Boeing 737 Max in March 2019 after two fatal crashes. The production rate of these aircraft was cut to 42 per month in 2019 (-15%) before a complete shutdown in January 2020. Today, no-one knows if and when the aircraft will be declared flightworthy again. This will have a negative impact on Q1 GDP growth of up to 0.5pts on an annualised basis. The knock-on effects on other sectors (suppliers and subcontractors) are uncertain, but this Boeing shock is likely to weigh in any case on the confidence and production of US manufacturers for several months. This main explain part of the weakness of the ISM-manufacturing index (47.2 in December, its lowest level since 2009).

What, then, is the outlook for manufacturing in 2020? After six months below the critical 50-point threshold, the global PMI index crept back above it at the end of 2019. Order books have also bottomed out. Trade uncertainty is no longer increasing (but remains high), the oil sector will benefit from the geopolitical risk, the automotive crisis in Germany is no longer worsening (fingers crossed) and, more encouragingly, the semiconductors cycle that took such a toll on Asian industrial production in 2019 has rebounded. Aside from the ongoing Boeing shock, all this suggests that global manufacturing production will return to a modestly positive trend.

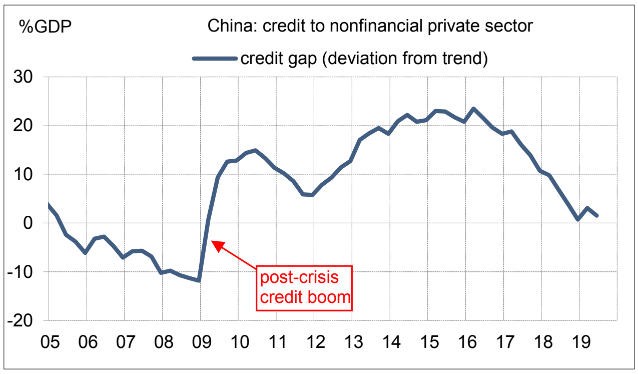
Q5 – China – stabilising the economy without a stimulus plan?

China once again experienced no hard landing in 2019. This prediction, rolled out by some year after year, appears as credible as the existence of unicorns – or, in this case, dragons. After all, the past year witnessed a series of events that could have derailed the Chinese economy. In the end, economic growth averaged 6.2%, in line with the target, compared with 6.5% in 2018 (**Chart 5a**). This is not too bad for an economy that has been hit by:

- an intense trade crisis with the US[3];
- a spike in inflation, hitting an annualised 4.5% today (+2.6pts vs end-2018), caused by a vast swine fever epidemic;
- continued efforts to clean up the financial sector, one of the government's priorities;
- a loss of markets as a result of the downturn in the global manufacturing and electronic cycles;
- a severe correction in the automotive sector (new emissions standards and tax incentives);
- a major political crisis in Hong Kong.

China: GDP and proxy of GDP

China: private sector debt



Charts 5 – Sources: Thomson Reuters, ODDO BHF

The response has not been a large credit-fuelled stimulus plan, since this type of action has no longer been one of the government's priorities since 2017, with the focus placed instead on financial stabilisation. According to the BIS, the credit bubble in the private sector has been sharply curtailed since the extreme levels attained in 2015-2016 (**Chart 5b**). The objective is to avoid an overheating in the residential market, which would imply a slump in the near future. In the past, home prices have followed mini-cycles of around 2-3 years, with large fluctuations both upwards and then downwards. It is striking that in 2019 these prices have moderated gradually. Indeed, to mitigate the effects of the trade war, the authorities have mainly undertaken selective loosening, with a few fiscal measures (tax cut) or monetary measures (reduction in the required reserves ratio) and, depending on the state of strains with the US, by allowing the exchange rate to fall more easily.

[3] According to the PIIE's estimates, 65% of Chinese products sold in the US are subject to tariff measures decided on by the Trump administration, compared with 45% one year ago and zero two years ago.

At the start of 2020, the difficulties outlined above have not all been resolved, in particular the situation in Hong Kong (**Q2**). For the remainder, it appears that inflation has peaked, that industrial production and the automotive sector have bottomed out, and that relations with the Trump administration have become less strained. In these conditions, Chinese authorities are likely to continue pursuing precisely the same selective economic stimulus policies without abandoning the financial clean-out. Depending on the circumstances, this delicate calibration may change, but the option of a vast stimulus plan is no longer on the table.

Q6 – US – is the business cycle near its end?

For the first time in the official history of the US business cycles, dating back to the mid-19th Century, a decade has ended without a recession. The current expansion period is the longest ever recorded, having already reached 127 months, compared with the previous record of 120 months between 1991 and 2001. There is a widespread belief that at such an advanced age of the cycle the probability of entering recession is bound to grow. But this analogy with human life has no solid statistical basis[4].

The apparent disconnection between the length of the expansion and the probability of recession is a characteristic of cycles following the Second World War and seems to be becoming stronger over time under a twofold influence. *First*, the reduction in the weight of manufacturing in the economy. In the past decade, there have been three industrial cycles (**Q4**), each lasting around 3-4 years, in line with the frequency of recessions prior to 1945. But the weight of manufacturing is no longer sufficient today to tip the whole economy into recession. *Secondly*, the strengthening of macroeconomic stabilisation policies. All recessions lead to job destructions, something that economic policymakers want to avoid more than anything. Maximum employment is one of the Fed's objectives (**Q14**).

US: recession probability

US recession probability

	2001 recession (average)	2008 recession (average)	mid-2015	mid-2016	mid-2017	mid-2018	mid-2019	mid-2020
Coincident models								
- unemployment rate	65	80	0	0	0	0	0	-
- jobless claims	44	58	1	3	3	2	2	-
- stock market	39	51	7	3	4	15	2	-
- building permits	0	83	0	0	0	0	1	-
Average	**37**	**68**	**2**	**2**	**2**	**4**	**1**	**-**
Forward models								
- yield curve	42	28	0	1	2	3	6	26
- diffusion index	15	53	7	7	16	5	4	36
- bond premium	62	28	8	19	25	12	11	8
- oil price	38	34	18	4	3	3	20	18
- corporate profits	68	34	9	14	27	20	17	15
Average	**45**	**35**	**9**	**9**	**15**	**9**	**11**	**21**
Benchmark								
- business cycle duration	36	27	16	20	26	30	37	43

Table 6 – Sources: Thomson Reuters, ODDO BHF (we explained in more detail the various models estimated her in our note of June 2019: "On your marks, get set, cut").

A recession is triggered by the combination of a shock (oil, monetary or financial) and a certain configuration of the economy, characterised in particular by mounting price strains, a downturn in residential housing expenditure and a disconnect between capital spending by companies and their profits (with the former rising and the latter falling). In other words, the typical pre-recessionary profile is a slowdown in consumer demand that is not detected by companies. The recession occurs when companies realise their mistake and cut their spending. This is absolutely not the profile painted by current data. On the contrary, business investment has stagnated today (**Q7**), whereas consumer spending remains robust and the housing sector has begun accelerating again.

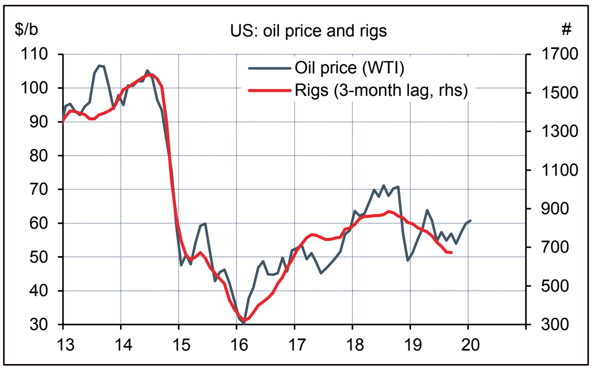
[4] *Rudebush (2016), Will the Economic Recovery Die of Old Age?, FRBSF Economic Letter.*

In short, a recession is a relatively rare event, each with its own specific characteristics, that represents a discontinuity in the economic cycle. The probability of recession risk can be calculated on the basis of historical data, keeping in mind the limits of this exercise (**Table 6**). No model can claim to be perfect. In the table above, we have drawn a distinction between coincident models, which estimate the probability of recession at instant T (a less trivial question than it appears), and forward models, which give the probability of recession within 12 months. At the last reading, the absolute risk was fairly low and decreased over the course of H2 2019. In particular, the inversion of the yield curve has been reversed thanks to Fed rate cuts. Note that these models do not factor in the unprecedented risk posed by the sudden spike in trade uncertainty over the past two years (**Q1**).

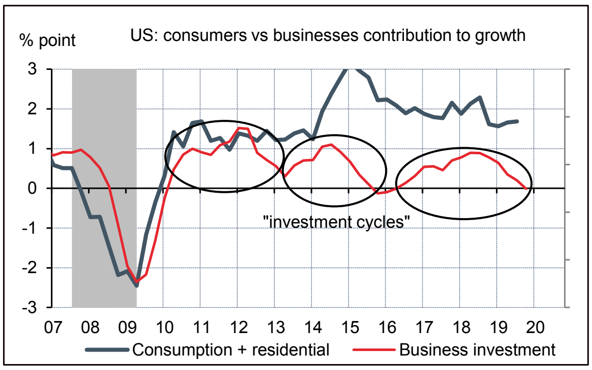
Q7 – US – will business investment pick up?

After accelerating strongly for two years, spending by non-financial companies has slowed sharply since the end of 2018 in the "equipment" part and, even more so, in the "structures" part. Thanks to the carry-over effect, they will have grown by around 2% on average in 2019, but momentum has turned negative over the past three quarters. Business investment contracted in Q2 and Q3, and preliminary data suggests it did the same in Q4. It was towards the middle of 2018, just when the trade war began to gain in importance, that the confidence of CEO weakened. Spending intentions have since staged a correction. This shows how any hope of a recovery in the investment cycle requires a lasting respite on the trade war front.

US: new rigs and oil price



US: consumer cycle vs business cycle



Charts 7 – Sources: Thomson Reuters, ODDO BHF

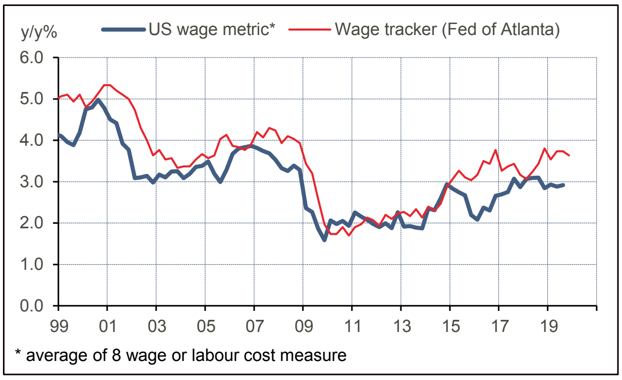
While general uncertainty may have deterred companies exposed to global trade or with production chains scattered across several countries, this explanation alone is not sufficient. Looking more closely at the specific characteristics of the present cycle, it can be seen that the investment downturn is largely influenced by the oil sector, like in 2014-16 but to a lesser degree. New shale oil rigs closely track fluctuations in the oil price (**Chart 7a**). The drop in prices between 2018 and 2019 was rapidly translated into a decline in investment. Even if the Middle East is not expected to go up in flames following recent strains between the US and Iran (**Q2**), geopolitical risk will not disappear overnight. This provides some support for the oil price and, by extension, to spending in the oil sector. A second specific factors that has weighed on investment is the halt to deliveries of Boeing's 737-Max, which has faced a flight ban since March 2019. After this date, reduced production of this aircraft contributed to an approximately 1% decrease in business investment. Starting in January, production will grind to a halt, doubling the negative impact in the short term (deeply negative contribution by inventories). The duration and amplitude of the shock are unclear today, but it certainly does not bode well in the short term for the aerospace industry, and hence for industrial production and investment.

Industrial cycles are shorter and more regular than cycles in the broader economy (**Q4**). Capital expenditure, which is highly linked to manufacturing, has the same pattern. This is why there are several investment cycles within the expansion phase (**Chart 7b**). Barring an exceptional shock, as was the case in 2008, the investment correction tends to end once the inventory adjustment has been completed. In contrast with the 2001 recession, which was preceded by a spurt in capital expenditure (internet bubble), the same cannot be said of the upward phase of 2016-2018. In short, the investment outlook remains cloudy at the start of the year but may brighten up within a few months. This will only happen if the oil sector continues to stabilise. The unknown factor lies, as we said above, in the repercussions of the Boeing shock.

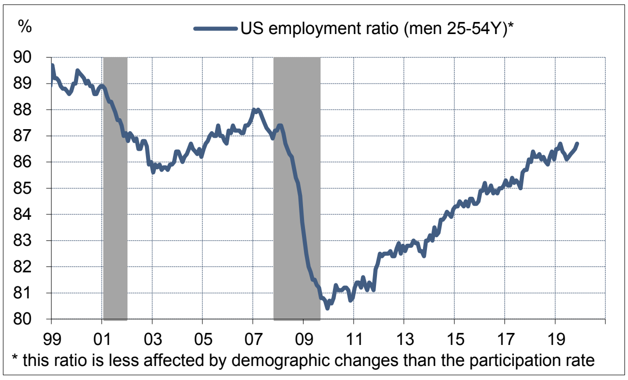
Q8 – US – is there a risk of wages overheating?

The unemployment rate is at a 50-year low, standing at 3.5% of the labour force. The pace of job creations, though still solid, has moderated since 2018, a sign that labour supply is more restricted. The CBO calculates that the output gap is positive at +0.7% of GDP in 2019, compared with +0.2% in 2018 and -0.8% in 2017. In these conditions, if wages were to accelerate more quickly than productivity gains[5], the result would be a situation typical of ends of cycles (**Q6**), with inflationary strains and a squeeze on company margins.

US: wage indicators



US: male employment rates



Charts 8 – Sources: Thomson Reuters, ODDO BHF

For the time being, wage strains are contained. The wide range of wage or cost indicators can paint slightly different pictures, but, by and large, wages have been growing at a relatively stable annualised rate of around 3% over the past two years (**Chart 8a**). The combination of ultralow unemployment and contained wage gains may appear somewhat surprising, or at least atypical by historical standards. This is partly due to the return to employment of people who had dropped out of the job market or were hard to employ. Transition rates from unemployment or inactivity to employment have sharply increased since the end of the crisis and have not weakened in the recent past.

In short, the equilibrium unemployment rate is lower than in the past, and this should prolong the expansion phase[6]. Unused capacity exists, preventing excessive strains from emerging in the labour market in the very short term. This is illustrated, for example, by the employment ratio for men aged 25-54, which has risen steeply in recent years, though without entirely reversing its decline during the Great Recession (**Chart 8b**). If its recent growth rate continues, it will take another three years to return to its pre-crisis peak.

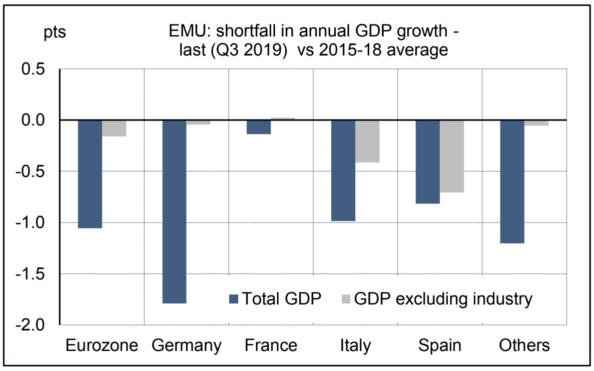
[5] This is not the case today. Unit labour costs are currently growing at just under 2%, in line with their past five-year average (1.7%).
[6] Petrosky-Nadeau & Valletta (2019), "Unemployment: Lower for Longer?", FRBSF Economic Letter

Q9 – Europe – is the manufacturing/non-manufacturing decoupling sustainable?

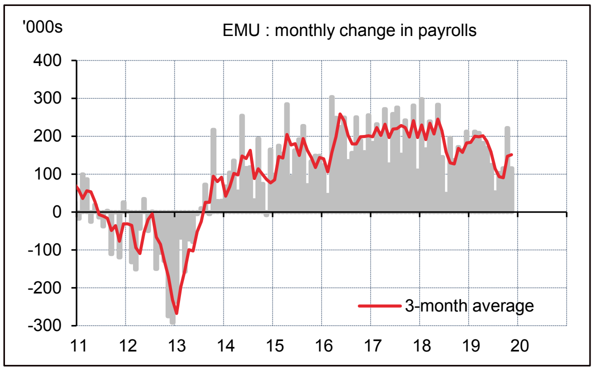
The disparity between manufacturing and the rest of the economy is a global phenomenon, but it is most pronounced in the Eurozone, and especially in Germany (**Q10**). The figures speak for themselves. Industrial value-added (20% of the total) has lost six points of growth since peaking in 2017, falling from +4.5% to -1.5%. whereas other sectors only lost one point, slowing from +2.8% to +1.8%. In Italy and Spain, the cold snap had a broad sectoral reach, but everywhere else it was restricted to manufacturing (**Chart 9a**). This completely distinguishes the present situation from the previous cyclical downturn of 2012. At that time, a period marked by spikes in sovereign and bank stress, the adverse shock was mainly of domestic origin and spread to the whole economy because of tightening financial conditions. This time, although the shock has a domestic dimension (the crisis in the automotive sector), it primarily results from external demand. Perhaps more importantly, it is not coupled with a credit contraction, nor any restriction of the policy mix.

The resilience of the European economy is particularly striking when one looks at conditions in the labour market. Employment growth has moderated over the past two years but remains firmly anchored in positive territory. On our estimates, approximately 70,000 job creations per month are necessary to push unemployment lower. They totalled around 150,000 at the end of 2019 vs. an average of 187,000 in 2018 and 215,000 in 2017 (**Chart 9b**). The resilience of employment, in a non-inflationary environment, is boosting consumer spending. Retail sales volumes are growing by more than 2% annually, whereas they were decreasing at a similar rate in 2011. Overall, the financial situation of households is not unsustainable. There is no reason for consumer spending to slow overnight.

EMU: GDP growth, industry vs non-industry



EMU: employment growth



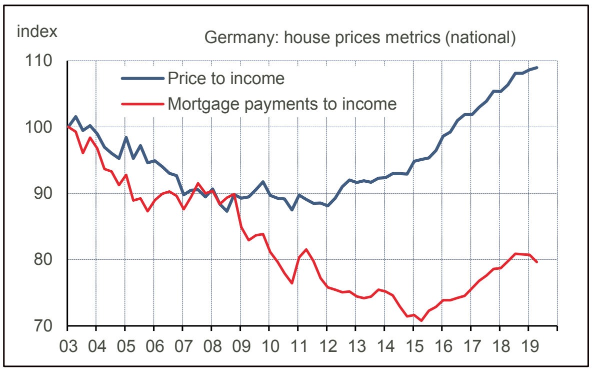
Charts 9 – Sources: Thomson Reuters, ODDO BHF

The final factor that differentiates the recent cold snap from the double dip of 2012 is construction, a highly cyclical sector that depends in large part on lending conditions (prices and volumes) and, for the non-residential part, public spending. Banks' profitability remains weak, but their balance-sheet health has made considerable progress in recent years. The loan standards survey does not point to any tightening. On the fiscal front, the orientation over the past two years has been a modest stimulus. On the monetary front, recent easing measures are moving forward without any risk of an abrupt interruption. The industrial slump was not contagious in 2018 or in 2019. It will not suddenly become viral. In fact, some recent data suggest that manufacturing confidence is past its trough. There are also signs that order backlogs are no longer emptying. The sectoral disparity is set to narrow through an industrial recovery, not through a weakening of the rest of the economy.

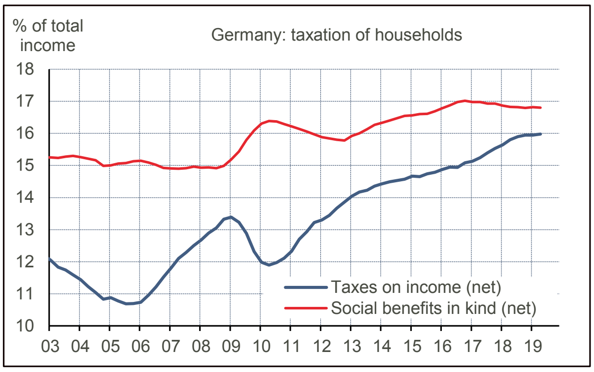
Q10 – Germany – will the economy overcome the automotive crisis?

The difficulties encountered by the German economy are easy to diagnose but hard to resolve. Since peaking at the end of 2017, real GDP growth has slowed by almost three points. The cause is self-evident: automotive production has been in freefall for the past two years[7] (**Q4**), and since this sector is the backbone of German industry, it has knock-on effects everywhere. The economy has narrowly averted a recession thanks to the cushioning effects of consumer spending – private and public – and construction. Looking ahead, since consumption is not expected to change direction, there are question marks about whether the construction sector is overheating. Home prices are rising fairly quickly. This may be a concern, since the previous phase of euphoria just after reunification was followed by a long period in the doldrums. The home price-to-income ratio has risen by around 20% since 2011 but remains lower than in the bubble years of the early 1990s. What's more, this ratio does not reflect the change in financing conditions (lower interest rates coupled with higher prices). To assess the sector's sustainability, it is better to compare a median buyer's monthly repayments and income. From this standpoint, the housing market does not appear to be overheating (**Chart 10a**), even if there are pronounced local strains. While prices are not disconnected from fundamentals, it is nonetheless worth noting that the weight of residential construction is fairly high (6.7% of GDP vs 6.1% on average). Public investment, which mainly relates to non-residential spending, is also growing at a brisk pace. There is little leeway for an acceleration in construction investment. A growth recovery will instead require a stabilisation of the manufacturing sector. Ideally, a fiscal stimulus would not do any harm.

Germany: housing market indicators



Germany: (net) taxation of households



Charts 10 – Sources: Thomson Reuters, ODDO BHF

This idea of a stimulus receives bad press, to say the least. It is simple to call for an investment plan (infrastructures and energy transition technologies), but coming up with one and then applying it is quite another thing. The country's decentralised structure does not help. What's more, the true fiscal problem may be less a lack of government spending than the excessive weight of taxation. As a percentage of total household income, net taxation (taxes minus social transfers) has risen by four points since 2010, an increase unprecedented elsewhere in Europe (**Chart 10b**). The coalition's government agreement, signed in early 2018, promises a search for balanced budgets ("*schwarze Null*"). The Chancellor's party even considers it to be its little "fetish", perhaps with some irony. There will be no major change in the fiscal stance before the next elections scheduled in 2021. Fiscal policy is only moderately expansionary and no more. There have been some strains recently on this question between the coalition partners, but at this stage, despite the SPD's leftist turn, there is no desire for snap elections. This leaves Germany, once Europe's driver, in a curious situation: weak economic growth but full employment, and record fiscal surpluses but political inaction.

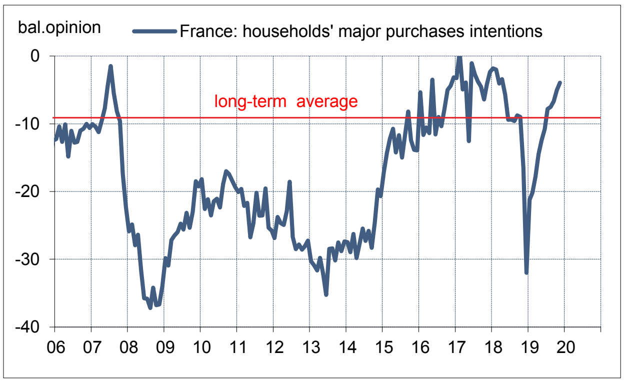
[7] The annual number of vehicles produced has fallen by 17% in two years, the same magnitude as during the Great Recession (the decline was concentrated then in one year).

Q11 – France – will consumers finally wake up?

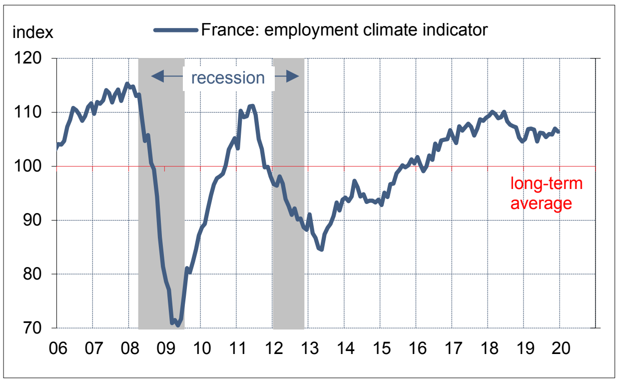
At the end of 2018, French consumers were gripped by panic as the “Yellow Vests” movement spread. In a couple of months, major purchases intentions plummeted to their lowest level since the depth of the Great Recession (**Chart 11a**). These concerns were clearly overdone. In recent weeks, the social climate has deteriorated again, but the problem this time is a more classic one: a few key bastions of union strength shut down or sharply curtailed public transport in protest against the government’s proposed pension reform. This type of disruption can affect a few sectors but does not leave a lasting mark on employment or growth. It will not be enough to knock the economy off course.

In these conditions, how are consumers faring? Their situation is mixed. In 2019, consumer spending was mediocre, growing by around one point below growth in spending power. Conversely, residential investment picked up strongly. According to statistics published by notaries, the number of transactions reached a new record, breaching the threshold of one million. Desire for home ownership is encouraged by sociological, demographic and financial factors (low interest rates), but such a recovery cannot be explained in the absence of a certain degree of optimism. In short, French consumers have saved to date what they have received as income support measures[8]. Unless the desired savings level has increased structurally, their spending should become firmer over time.

France: opportunity for making major purchases



France: employment climate indicator



Charts 11 – Sources: INSEE, ODDO BHF

The traditional drivers of consumer spending are all positive. Inflation is low, protecting the purchasing power of income. What’s more, after the “Yellow Vests” crisis, the government acknowledged that its initial government deficit reduction targets would be pushed back. It will not change direction and raise taxes just as Emmanuel Macron enters the second half of his term. Lastly, job market conditions remain robust (**Chart 11b**). Job creations are growing strongly, topping 250,000 annually since 2016. They will probably slow but remain sufficient to prolong the decline in unemployment. INSEE and the Bank of France agree on this point, despite their conservative forecasts. Consumer spending should accelerate in 2020.

Q12 – Brexit – the end of the beginning or the beginning of the end?

Politically, Boris Johnson has accomplished his objective to perfection. After fleeing his responsibilities as *Brexiteer* in chief in 2016 and then spending three years trying to trip up Theresa May, the Prime Minister from his own party, he has taken her place and enjoys a comfortable majority in Parliament following the December 2019 elections. There is nothing stopping him pushing through

[8] The principal measures were the housing tax, the cancellation of the increase in the CSG (health insurance tax) for pensioners, the cancellation of tax hikes on fuel and the exoneration of overtime from taxes and contributions.

the withdrawal agreement negotiated with the EU before 31 January. This will allow him deliver on his electoral promise – *Get Brexit Done* – at the cost of only a few months' delay.

The withdrawal agreement opens up a transition phase[9] until 31 December 2020 during which the two parties need to establish a new trade relations regime or, failing this, separate without an agreement. This second outcome is not a negligible risk, as was the risk of reaching no withdrawal deal, but in both cases it is hard to see how it would be in the UK's interest. Miscalculation is certainly possible in negotiations, but choosing the cliff-edge option at the end of 2020 makes no sense after spending three years avoiding it. Leaving this option open is not a credible strategy, in our view. It is more likely that concessions will be made, possibly by both sides, to avert this scenario. The working assumption is that both parties will seek to reach a free trade agreement based on the triple objective of *zero tariffs, zero quotas, zero dumping*. Based on historical experience, it appears impossible to finalise such an agreement in less than one year, to say nothing of the ratification phase (national parliaments and, in some cases, regional parliaments in all member states will have a say). All the ingredients are in place for uncertainty to surge as the new deadline approaches.

A free trade agreement is a better option than an abrupt separation (with a return to WTO rules), but it is far from a panacea. The scope of the agreement will prioritise goods, leaving services to one side, and will involve setting regulatory barriers. According to the UK Treasury's estimates, the level of UK GDP compared with staying in the EU would fall by 7.6pts in the long term in a no-deal scenario, by 4.9pts with a free trade agreement and by just 1.4pts in a scenario such as a European Economic Area with the UK staying in the single market[10]. In short, Brexit is not just a tough period to get through; it is also a process that, over time, will reduce mutual market opportunities between the UK and the EU. The respective weight of each of the two parties makes it clear which side has the most to lose in this story. Since the 2016 referendum, it is also worth noting that the UK's growth trend, which previously surpassed that of the rest of the continent, has fallen back in line with it. This is a strange way to break free and unleash growth potential supposedly shackled by the EU straightjacket!

Q13 – Lowflation – should central banks modify their inflation targets?

In 2018, for the first time in six years, inflation came close to its target in the Eurozone (HICP = +1.8%) and surpassed it in the US (PCE = +2.1%). It was possible to believe at the time that the economy was exiting the lowflation regime that had characterised the post-crisis recovery. This was a false alert. In 2019, inflation fell back to 1.2% and 1.4% respectively. In 2020, the ECB forecasts 1.1% and the Fed 1.9%.

Many explanations have been put forward for this missing inflation, including the influence of global factors (rather than local factors), the decline in potential growth, technology, demographics and others. The golden rule of central banks is to target an inflation rate of around 2% in the medium term, a level low enough to prevent inflation from becoming a concern in economic decisions but high enough to avoid deflationary risks during downward phases of the cycle.

When a target is missed recurrently, there are grounds for questioning the soundness of this strategy and the means used to implement it. This is what the Fed did last year and it is what the ECB is poised to do in 2020. The Fed's review is divided up into three questions[11]. First, the targets: would it be useful to adopt a new strategy seeking to offset periods of undershooting inflation. Second, the tools: this requires a precise analysis of the effectiveness of non-conventional measures that could be rolled out in case of recession. Thirdly,

---

[9] This transition phase can be extended for two years, a decision that has to be notified before 1 July. PM Johnson has said he wants to legislate to prevent such an extension.
[10] HM Treasury (2018), "EU Exit Long-term economic analysis". The estimates are given in the form of a range: we have used the central estimate here.
[11] Clarida (2019), The Fed's review of its monetary policy strategy, tools, and communication practices.

communication. At the ECB, the review has not officially been launched, but it is likely to follow similar outlines, with the probable addition of an analysis about the role the central bank can play in "greening" the economy (**Q20**).

The results of this work are uncertain. A revolution is unlikely. For sure, central banks will not revise down their inflation targets, as some recommend. Not only would this acknowledge their impotence but, more seriously, it would encourage agents to lower their inflation expectations. Raising inflation targets is an interesting idea in theory that economists have been debating for years, but it is a hard one to explain. What other measures are left? In the US, recent speeches by Fed officials have called for an average inflation target, implying that any deviation must be offset by a deviation in the opposite direction over the business cycle[12]. In Europe, it would be useful for the target's symmetry (which already exists in practice) to be stated more firmly, i.e. that 2% is not a ceiling. Some have raised the possibility of revising the price index calculation to include the cost of housing. This is a technical, though not trivial, question that does not fundamentally resolve anything.

It is patently clear that economic conditions have been structurally modified in the post-crisis decade. The risk of deflation, almost non-existent before 2008 (except in Japan), has resurfaced more frequently. In these conditions, central banks need to state more clearly what they can and cannot do. They know how to respond to inflation spikes, but not how to exit deflation. There is an asymmetry here. Two lessons can be drawn from it. The first is that monetary policy must be more accommodative and remain so for longer, even at the cost of taking some risks on the financial stability front. The second is that monetary policy cannot alone bear responsibility for macroeconomic stabilisation. More than a strategic review, true cooperation with other fields of economic policy is necessary. The low interest rates and asset purchases policy creates space for fiscal stimulus. But this still has to be used when necessary.

Q14 – Fed – a whole year in hibernation?

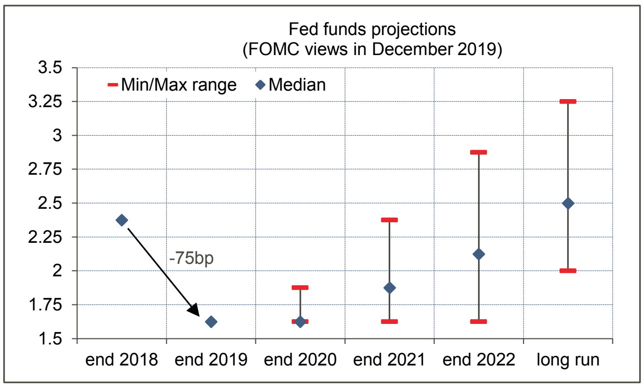
The Fed has rarely, if ever, modified its monetary policy so radically as it did in 2019 without the economic or financial situation having itself changed radically. When one compares the Fed's descriptions of the US economy today and one year ago, nothing appears to have changed. In December 2018, employment conditions were considered to be "*strong*", and in December 2019 "*solid*". Between these two dates, the US equity market has rallied by almost 30%. And yet, during this period, almost everything changed in the Fed's actions and risk assessment.

- Interest-rate policy – instead of the three rate hikes planned at the start of 2019, the Fed has cut its policy rates three times (-75bp). The central bank is no longer expressing any bias for the months ahead. A *status quo* is seen as the optimal option until more information emerges (**Chart 12a**). There are lingering downside risks to activity, but these are not of sufficient intensity to justify loosening monetary policy further. Thanks to the Fed's U-turn, the yield curve has returned to a more normal configuration (long-term rates > short-term rates) after five months of inversion. At its height, the 10-year/3-month spread was 50bp negative. Today, it is around 30bp positive.
- Balance-sheet policy – starting in 2017, the Fed allowed its balance sheet to shrink (at a maximum pace of $50bn per month) by reducing its reinvestments in maturing securities. This measure, presented as a technical one, did not gain much attention until the end of 2018 when the market got it into its head that it was one of the causes of the stockmarket rout. The Fed reacted initially by freezing the size of its balance sheet. The sudden strains that broke out in the repo market in September 2019 subsequently forced the Fed to increase its liquidity injections. In the space of three months, its securities portfolio grew by around $ 250bn, mainly in the form of short-term securities (**Chart 12b**). This balance-sheet expansion was supposed to continue until any risks of even temporary liquidity shortages were eliminated. At first sight, this is a very different motivation from that behind QE programmes between 2009 and 2014.

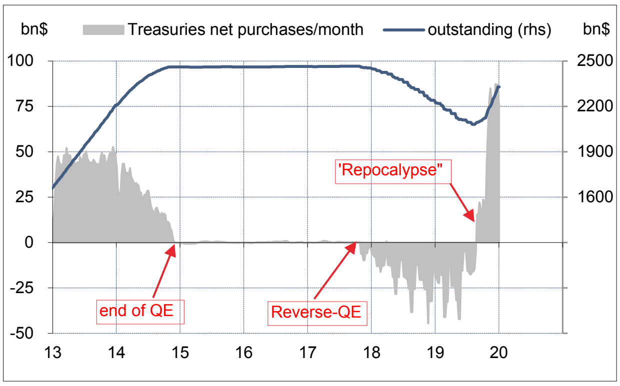
[12] *Technically, this amounts to targeting price levels rather than inflation rates. Here too, the obstacle is communication as monetary policy must remain easily understandable.*

- Strategic review – throughout the year, the Fed reviewed its strategy, policy and communication. The results will not be presented until mid-2020. A complete revolution is unlikely, but the idea of overrunning the 2% target is tolerable – and even desirable – after a very long period below this level, and it seems to be backed by many FOMC members (**Q13**). The Fed also believes that unemployment can stay very low without causing runaway wage inflation (**Q8**).

Fed: policy rate projections



Fed: outstanding Treasuries and net purchases



Charts 12 – Sources: Fed, ODDO BHF

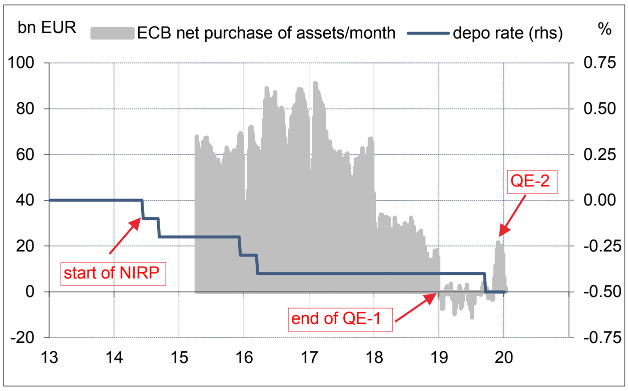
Monetary status quo in 2020, and perhaps even beyond then, is priced in today by the markets. No-one on the FOMC is actively calling for a deviation from this policy. What is the risk that this scenario does not materialise? If inflation picks up more sharply than the Fed anticipates (return to its target in 2020 and a little above it in 2021), it is prepared to take time to react. Monetary tightening therefore appears to be a very low probability scenario, especially in an election year. President-candidate Trump would not fail to step up his criticisms if the dollar ever did appreciate, with the risk, if he is re-elected, of truly endangering the central bank's independence. In contrast, a new wave of loosening cannot be completely ruled out. The lesson from 2019 is that the Fed has huge aversion to the risk of a recession (**Q6**), perhaps out of concerns that it lacks sufficient firepower to tackle one. Any unexpected risk factor, whether related to trade (**Q1**) or geopolitics (**Q2**), may prompt it to err on the side of caution.

Q15 – ECB – Christine Lagarde: politician or central banker?

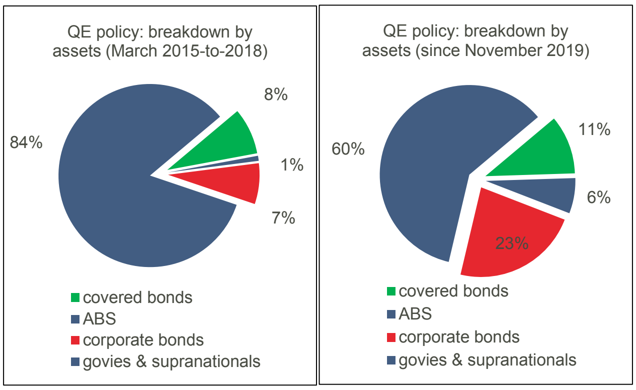
The Draghi era profoundly transformed the ECB, to say the least. Nobody contests – and some criticise – Draghi's decisive role in the design and adoption of exceptional monetary measures in response to the multiple crises that littered his term. Fundamentally, the principal change relates to the interpretation of the ECB's mandate. The Council pays greater attention than in the past to core inflation (rather than total inflation) and to credit aggregates (rather than to money aggregates) and recognises that support for the real economy through a durably accommodative policy is a precondition – thought not a sufficient one – for raising inflation towards its target. None of this is set to change immediately under the ECB's new president. As regards monetary policy choices, Christine Lagarde ensures perfect continuity. By forcing through the adoption of a "package" of easing measures before the end of his term, Draghi has gifted her one year of tranquillity (**Charts 13**).

There are differences of style and communication between the two presidents. As soon as she took up her position, the new president sought to reduce divisions within the Council, or at least to restore a normal form of expression. The strategic review (**Q13**) should make it possible to examine without needless controversy the arguments for and against past actions (QE, NIRP, TLTRO). By and large, existing studies conclude that, from 2014 onwards, these policies stimulated growth and employment, averted deflation at a time when it was most threatening and encouraged the lending recovery (**Q16**), but they also acknowledge that there were adverse consequences, such as on banks' profitability. It would be surprising if these conclusions were modified.

ECB: policy rate and asset purchases



ECB: breakdown of asset purchases



Charts 13 – Sources: ECB, ODDO BHF

Since she became president, Christine Lagarde has frequently spoken out on subjects that one would expect to be addressed by the managing director of the IMF (which she was) or by a finance minister (which she also was) and that do not relate directly to decisions taken by the ECB Council. Environmental problems, inequality and the role of fiscal policies are subjects widely recognised as important. A central bank cannot ignore them in its analysis of risks to the economy. But integrating them in its decision-making process runs the risk of making monetary policy more confusing, when clarity is recognised to be a strength. One example comes to mind: imagine that QE becomes one day a *Green*-QE; would it be possible to end it? In view of the criticisms that have poured down on the ECB because of negative interest rates **(Q16)** on the grounds that they led to a redistribution between agents, it is not hard to imagine new angles of attack of the ECB were it to extend its ambitions. Over time, this could be damaging to its independence.

Q16 – Negative rates – should we exit NIRP as quickly as possible?

The negative rates tool has been employed by a number of central banks for years in Japan, the Eurozone, Switzerland, Denmark and Sweden. The Swedish central bank was a pioneer in this area, and it was also the first to end this negative interest-rates policy (NIRP). Last October, it raised its policy rate from -0.50% to -0.25%, before setting it at zero in December. Its objective is not so much to embark on monetary tightening (which is not justified by Swedish economic conditions in any case) as to exit an “abnormal” situation that could pose monetary/financial stability problems (indebtedness, currency depreciation and taxation of deposits). In short, the Riksbank judged that the balance of the costs and benefits of the NIRP could turn negative if it were to be maintained indefinitely[13]. This debate is a central one for ECB (**Q15**).

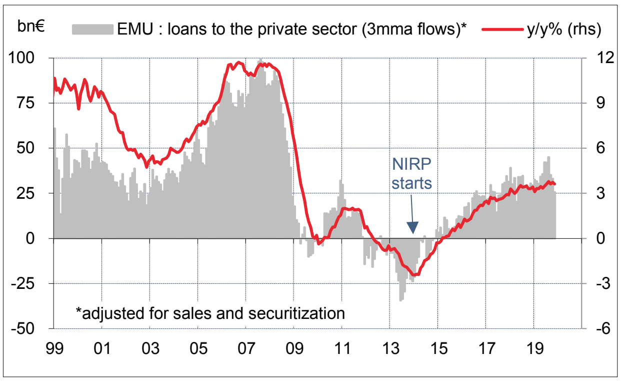
A monetary decision frequently has ambiguous effects. What ultimately matters is the net impact. In the case of the NIRP, the adverse effects of this policy are well known: a squeeze on banks’ profitability and risk of financial destabilisation. Researchers have suggested that a rate exists – known as the "*reversal rate*" – below which the negative effects exceed the beneficial effects, resulting in a contraction of bank loan origination and economic activity. There is no proof that this critical threshold is zero: it may be higher or lower. In a paper recapping 20 years of monetary policy in the Eurozone[14], ECB researches argue that if this "*reversal rate*" exists, it is below -1% (the deposit rate is currently -0.5%). Today, and after five years of the NIRP, there is not the slightest sign that European banks are restricting credit. Quite the contrary (**Chart 14a**). The transmission channel of monetary policy to the real economy is functioning properly, even if the yield curve is atypical.

---

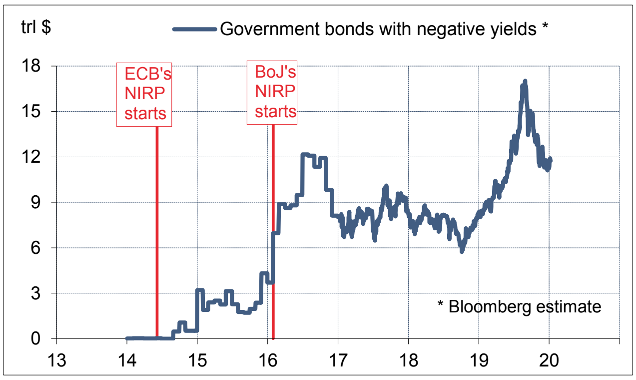
[13] There are local factors that should not be generalised. In Sweden, the housing market is under strain, but this is due to regulation at least as much as the interest-rate policy. What’s more, for a small, open economy, currency depreciation is a dangerous slope.
[14] Rostagno & al. (2019), “A tale of two decades: the ECB’s monetary policy at 20”, ECB WP.

Despite the lack of empirical foundations, criticisms of the NIRP are growing because of the political – and, for some, moral – dimension of the problem. By depressing asset yields, this policy leads to a redistribution of resources between agents. There are "winners" (borrowers and non-financial companies) and "losers" (savers and banks). The truth is that the first are not all in Italy or the second all in Germany.

EMU: bank loans to the private sector



World: government bonds with negative yields



Charts 14 – Sources: ECB, Bloomberg, ODDO BHF

Should the NIRP be ended as quickly as possible in the Eurozone and elsewhere? Such a decision would not be risk-free. If it is seen as a tightening of financial conditions at a time when growth is losing momentum, or if it leads to a reassessment of the sustainability of some forms of debt, it is hard to see what the real economy, and by extension the financial sector, could gain from it. Switching from negative interest rates (NIRP) to zero interest rates (ZIRP), as the Riksbank has done, is more of a symbolic than structural change. It is not obvious that this experience should be imitated. Pressure on long-term bond yields will not ease overnight, and a large portion of government securities (Germany and Japan) will continue to carry negative yields (**Chart 14b**).

Q17 – Dollar –Trump's ultimate wild card?

Dollar strength is one of the US President's frequent laments. He considers the dollar to be overvalued. In his Manichean vision of things, the cause of this is that other countries manipulate their currencies downwards and the Fed is too passive. Donald Trump is not wrong about the dollar's valuation. Studies estimating the dollar's "fair value" have concluded that it is overvalued. On the basis of purchasing power parities, the dollar is estimated to be 11% too expensive against a basket of major currencies, and almost 25% overvalued against the euro (PPA of $/€1.40). Regarding the causes of the dollar's strength, the competitive devaluations hypothesis is rather unconvincing, and Trump himself is partly to blame. With each new wave of tariffs over the past two years, a decision directly emanating from the White House, the Chinese currency has depreciated to cushion the shock on prices of traded goods. As for the Fed, in 2019 it eased its monetary policy by more than the average level in other countries.

What is the dollar's outlook? On the monetary front, a *status quo* is the preferred option almost everywhere. Barring a surprise, this is not the source of currency corrections. On the fiscal front, it is hard to imagine a tightening in the US and a strong expansion in Germany. On the trade front, the situation could change. A good way to depreciate the dollar would be to lower tariffs imposed since 2018. In any case, this would be a more effective way of rebalancing US trade with the rest of the world than raising tariffs. This would appear to be at odds with Trump's tariff obsession, but his real objective is to reduce the US trade deficit. In an election year, nothing can be ruled out.

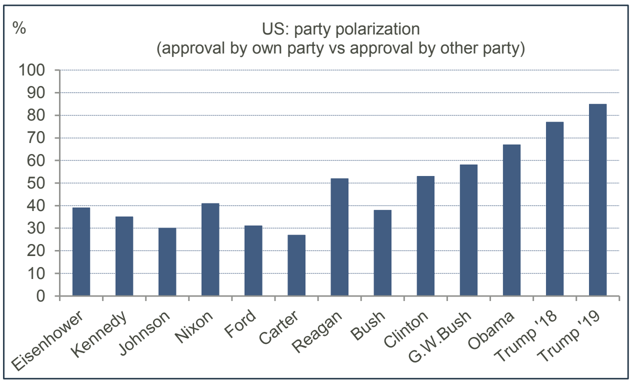
The dollar's strength partly reflects the US economy's outperformance. Or, to put it more correctly, the euro's weakness is a sign of wariness towards Europe (Brexit, disparities between countries and Germany's stagnation). The industrial correction has been more severe in the Eurozone than in the US. There is also more scope for a recovery there, in our view. In any case, the potential for an upward revision of the outlook appears higher on this side of the Atlantic. This could benefit the euro.

One last point worth considering in relation to the foreign-exchange outlook is the direction of oil prices. Since the mid-2000s, these two variables have had a deeply negative correlation (a strong dollar goes with a low oil price, and vice versa). In this perspective[15], a spike in the oil price (**Q2**) would put downward pressure on the dollar. But, in so doing, it would not necessarily be beneficial to candidate Trump, who also needs cheap gasoline to increase his re-election prospects (**Q18**).

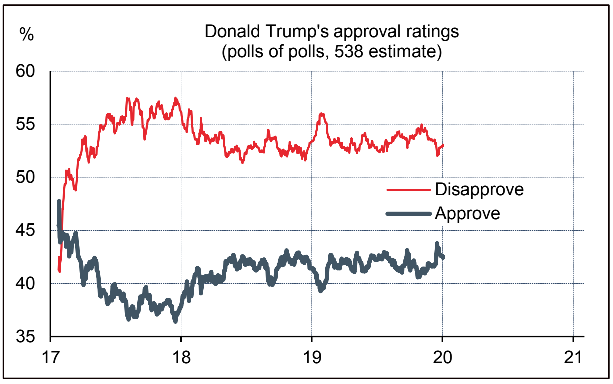
Q18 – US politics – is Donald Trump unbeatable?

Donald Trump is adulated by his supporters and scorned by everyone else. There is no middle ground. Partisan polarisation is not entirely new and has been a growing trend since the 1980s, but a new threshold has been crossed with Trump and the era of social networks (**Chart 15a**). Some observers refer to this as "tribalisation". Red (Republican) against Blue (Democrat). The recent vote in the House of Representatives to impeach the President followed partisan lines. The same will doubtless be true when the Senate votes on a potential conviction. Trump will be the first President to be impeached *and* acquitted during his bid to be re-elected. There is no evidence that this is harming him. It is already facilitating fundraising in the Republican camp. Because of this extreme polarisation, opinion polls have been very stable over the past two years (**Chart 15b**). Trump probably does not look unfavourably on an election that would be a sort of referendum on him.

US: degree of partisan polarisation



US: Donald Trump's popularity



Charts 15 – Sources: Thomson Reuters, ODDO BHF

It is tricky to predict the outcome of an election when we know only one of the two candidates, but a few common-sense rules that have emerged over time appear robust enough to shed light on the result. A model developed by political scientist Allan Lichtman[16] identifies 13 criteria. Experience shows that if the party in power meets at least eight of them, its victory is near certain. Candidate/President Trump already ticks seven boxes: 1. He is the sitting President. 2. He has no opponent in his party. 3. There is no serious candidate from a third party. 4. The economy is solid and will not be in recession during the campaign. 5. Growth under his term has exceeded (marginally) that under his predecessor. 6. He has made at least one major reform (tax reform). 7. There has been no major social unrest during his term. An eighth criteria is not met: his party lost its majority in the House during mid-term elections. The answers to the last five questions are more debatable. Have there been major scandals? Has Trump suffered a foreign policy failure? Has he landed a significant victory? Is the President charismatic? And will his opponent be so?

---

[15] There is no firmly established theory of the dollar-oil link. See Klitgaard & al (2019), The Perplexing Co-Movement of the Dollar and Oil Prices, NY Fed; and Coudert & Mignon (2015), Reassessing the empirical relationship between the oil price and the dollar, CEPII.
[16] Lichtman (1996), "The keys to the White House", Madison Books.

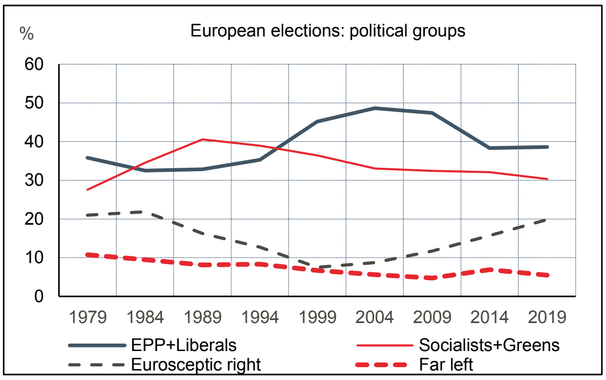
In the Democrat camp, before the start of the first primary elections, five candidates (Biden, Warren, Sanders, Buttigieg and Bloomberg) seem to score high enough in opinion polls or have sufficient financial resources to continue campaigning and hope to win the nomination. Besides differences between the candidates (age, wealth and political experience), there are notable differences between their programmes, especially on certain key subjects such as health insurance or tackling inequality. In European terminology, we would say that they span the spectrum from the pro-business centre to far-left positions. As in 2016, the outcome of the election may hinge on the results in a few swing states.

Q19 – European politics – is fragmentation a byword for inaction?

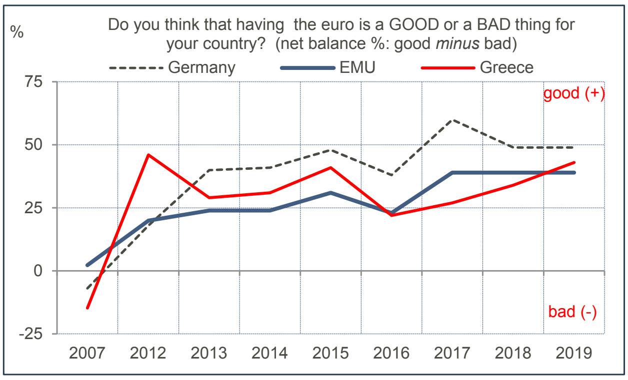
Podemos (2014), Syriza (2015), Brexit (2016), Le Pen (2017), Salvini and Di Maio (2018), Vox (2019): in recent years, each time that populism has scored points somewhere, it has always found a commentator ready to predict the end of the European Union or the Eurozone. These political forces, some from the right and some from the left, are opposed to varying degrees, and with some local particularities, to European institutions. In general, they do not have any truly realistic alternative plan.

In the handful of examples where Eurosceptic parties have gained power (Greece, Brexit and Italy), it has soon become apparent that there was a considerable gap between their promises and their actions. Reality quickly sets in, with its constraints of political (Italy), financial (Greece) or institutional (Brexit) nature. Populism is most firmly established in power in the UK, seemingly for several years. Boris Johnson's victory in December 2019 gave hard Brexiteers an opportunity to take complete control of the Conservative party. This does not fundamentally change the underlying issues concerning Brexit (**Q12**). In any case, Brexit has not inspired copycats elsewhere in Europe. It is even one of the few subjects on which other EU members, be they small or big, in the north or in the south, can agree on. There is no question of making big concessions to the UK..

EU: breakdown of seats in the European Parliament



EMU: support for the euro



Charts 16 – Sources: European Parliament, Eurobarometer, ODDO BHF

Elections to the European Parliament in 2019 also demonstrated that the populist wave was not a landslide. A majority of voters continue to turn elsewhere: to Conservatives, liberals, social-democrats or the greens. At the end of the day, pro-European parties continue to pull the strings of power (**Chart 16a**). The picture is mixed. On the upside, it is welcome that the risk of European disintegration is receding. Even leading politicians such as Le Pen and Salvini, once in favour of ditching the euro, have abandoned this position. But don't be deceived as they are merely following general opinion, which nowhere favours the return of national currencies (**Chart 16b**). On the downside: with the end of the bipartisan divided – in other words, with the fragmentation of political forces – it is necessary to form alliances, which can take time and prove fragile. The net outcome is not yet known, but Europe is not paralysed in any case by this new political landscape.

Q20 – Climate – what impact will greening have on growth and inflation?

Greta Thunberg has done more to popularise the climate emergency than all experts combined. In almost all areas, environmental issues are unavoidable, with the ultimate objective of greening economic activity. Everyone, at least in Europe, is expected to lower their carbon footprint. We will solely look here at policies to lower greenhouse gas emissions.

Europe's official target is to lower CO2 emissions by 40% by 2030 compared with their 1990 level (emissions were already down 23% in 2018). The new European Commission has proposed raising this target to a reduction of at least 50%[17]. To achieve this, the principal tool will be an increase in the price of carbon. This was recently around € 25-30 per tonne. Estimates made in France and Germany suggest that this price needs to reach around € 250 in 2030 for the reduction target to be attained[18]. Applying conservative growth assumptions, the weight of the carbon tax would rise from 0.3% of GDP today to just over 2% in 2030, an impulse of 0.2pts per year.

In an ideal world, this amount would be re-injected into the economy and the impact on activity would be neutral, simply shifting it to less polluting sectors. In practice, it would be prudent to expect that the introduction of such a tax will be negative in the form of higher prices. One example of the effects to be expected is provided by the German government's recent climate package. According to the Bundesbank's estimate, inflation would rise by an additional 0.3pts in 2021 and 2022, while growth would be broadly unchanged over the same period based on a carbon tax starting at €10 per tonne for all economic agents; at €25 per tonne, the impact on inflation could climb to 0.5pts. In short, greenhouse gas reduction policies are likely to raise inflation by 0.2-0.5pts annually over the next decade. Monetary policy could contribute to the greening of the economy by not reacting to this additional inflation[19] (**Q15**). In real terms, the policy rate would be lower than in a scenario without a carbon tax.

The expected impacts on growth are between neutrality (potential maintained) and a reduction of 0.1-0.2pts annually. But even if the total impact is fairly modest, there will be transfers between sectors of a greater order of magnitude, leading to the disappearance of some polluting companies. As such, there will be repercussions on employment, an area where policy makers become extremely nervous. To offset lost jobs or economic activity, new spending would be required to develop non-polluting industries. At this stage, the *Green Deal* is simply a slogan or a vague promise, little more. There is no getting away from the problem of the social acceptance of a carbon tax. The very principle behind a behavioural tax is that there is a complete redistribution of taxed resources to offset the cost of the energy transition. But if the government only sees this as a way to boost revenues, it is exposing itself to the risk of rejection. The "Yellow Vests" movement in France provided a clear illustration of this. It was partly born out of exasperation about the increase in the fuel tax, which was a carbon tax in name only.

[17] *European Commission (2019), The European Green Deal. This new target will not be validated until an impact study is completed in 2020.*
[18] *France Stratégie (2019), The Value for Climate Action ; German Council of Economic Experts (2019), Setting out for a New Climate PolicyCommission (2019)*
[19] *Brookings (2017), Climate Change and Monetary Policy: Dealing with Disruption*

OUR RECENT ECONOMIC RESEARCH

Economic Note

- About the German economic mythology (December 4, 2019)
- About the German non-recession (November 26, 2019)
- Will we have a Christmas Brexit? (November 19, 2019)
- European credit market tested by negative rates (November 7, 2019)
- Europe: no contagion, no recession (October 29, 2019)
- ECB: a critique of the critiques (October 10, 2019)
- European labour market health check (October 3, 2019)
- China: what are the adverse effects of the trade war? (October 1st, 2019)
- On trade uncertainty (September 24, 2019)

Focus France

- Will French consumers wake up in 2020? (December 19, 2020)
- France: the pension reform will not take place (November 13, 2019)
- The French are moving house (October 8, 2019)
- France: "real" jobs to underpin growth (September 2, 2019)

Focus US

- US: should we fear a return of inflation? (January 9, 2020)
- President Trump, impeached but re-elected? (December 20, 2019)
- Fed opts for status quo out to 2021 at least (December 12, 2019)

Economy & Rates (monthly)

- Lessons of 2019 (December 13, 2019)
- Europe: a second wind? (November 14, 2019)
- Europe without Draghi (October 18, 2019)

Economie Report

- Governance crisis and economic risk (September 11, 2019)
- Three men in a boat: Trump, Xi and Powell (May 22, 2019)
- No-deal Brexit – Economic and sectoral impacts (with the team of Financial analysts), 14 February 2019
- Scary monsters (season 2)… Trump, China & the Fed (January 9, 2019)