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A Macro Smorgasbord: Top 10 Risks for 2020

With investor sentiment currently being challenged and buffeted by elevated geopolitical tensions, the outlook for global markets remains fragile at best in early 2020. The macro spotlight was firmly on the shifting sands of monetary policy last year as the Federal Reserve cut rates three times, thereby partially reversing its tightening efforts between 2015-2018, and as U.S./China trade tensions resulted in cuts to global growth forecasts for 2019 and 2020. We herewith now offer – again in no particular order – what we believe may be the Top 10 Macro Challenges for 2020.

This list is not exhaustive by any means, but is designed to be thought-provoking as investors finalise their investment strategies for the New Year. It is written in conjunction with our earlier publication in which we discussed what we see as the top 10 geopolitical risks in 2020. Please read on.

1. Hard Brexit

The geopolitical buffeting that has impacted global market sentiment in early 2020 may have helped distract investors from the Brexit process, but the U.K.'s path toward departure from the EU may still be littered with landmines. Boris Johnson's large parliamentary majority means that steering the EU Withdrawal Agreement through parliament will largely be a formality, ahead of the planned departure date of January 31. This is when the real hard work will start though.

The recent performance (strength) in cable indicates the degree of investor optimism that the Brexit saga is now at least entering the beginning of the end, although we remain cognisant that agreeing the necessary decree absolute with the EU in just 11 months (in order to avoid a 'no deal' exit at the end of the transition period in December) may not be impossible, but it will surely be challenging. Note that Canada needed nearly 7 years to agree its trade deal with the EU. As such, caveat emptor, we believe it would be dangerous to completely dismiss the risk of an accidental hard Brexit by this time next year.

2. Global trade / tariffs

A key driver of global market sentiment in 2019 was the changing winds of perception toward global trade and in particular the U.S. protectionist approach to its trade partners (China, Canada, Mexico, Europe). The spectre of an aggressive trade war between Washington and Beijing has been the source of macro uncertainty and has dampened global economic growth prospects for the coming year. At the same time, any suggestion of an increased probability of a trade deal being signed has been applauded by financial markets. This binary outlook for global trade will again be a key macro challenge for financial markets in 2020.

Moreover, as we approach the U.S. elections in November, any attempt by Trump to take a more belligerent approach to U.S. trade partners in order to strengthen his appeal among patriotic U.S. voters would be a tangible threat to global financial market sentiment. Conversely though, if Trump were to take his foot off the tariffs pedal a little in an effort to appear more 'statesman-like' this would likely buoy risk appetite and credit market performance. The macro outlook for global trade and the twofold implications for risk assets in 2020 therefore lies firmly with Trump.

3. U.S. economic slowdown / recession

Global risk asset pricing currently assumes a steady, non-inflationary level of U.S. economic growth over the coming year, with the Federal Reserve now expected to leave rates on hold for the foreseeable future. Indeed, we forecast that global growth prospects should improve this year and that any lingering recession fears should fade. We have long maintained that monetary easing 2019 should be interpreted as 'insurance cuts' not the beginning of an easing cycle. The three rate cuts implemented by the FOMC in July, September and October 2019 were all insurance cuts in our view.

The U.S. economic growth cycle is in its 11th year, but we see few traditional late-cycle characteristics, such as accelerating inflation or rising interest rates. Nonetheless, the slower GDP picture that we saw late last year is expected to recede further in early 2020. This said, while we look for U.S. economic growth to slow toward 2.0% this year, we maintain our view that the economy should avoid the spectre of recession. As such, we would interpret any shift toward a more pronounced macro slowdown as a shock to the market, which would likely result in a renewed defensive, dovish bid for treasuries and apply downward pressure to the dollar.

4. Chinese economic outlook (hard landing?)

Much has been written and said about the slowdown in the Chinese economy in recent quarters, but the overarching view to which we subscribe is that the country will avoid a 'hard landing'. Nonetheless, global markets will have to digest further slowing of the Chinese economy this year and likely get used to the beginning of a sub-6% GDP growth era. But given the steady downward trajectory that we have witnessed in China GDP from double-digit territory 10 years ago, this should not cause too much disruption for global markets. The real risk in 2020 would be of a more marked and surprise slowdown in Chinese economic activity, perhaps as a result of more penal U.S. tariffs. If China GDP growth were to fall into 5-handle territory we would anticipate a knee-jerk, defensive, risk off market reaction.

5. Inflation

Despite the U.S. Federal Reserve shifting to an easing bias and cutting the Fed funds rate by 75bps last year, and with other global central bank keeping the monetary policy sluice gates open, there has been a generic failure of loose monetary policy to achieve the broad target of a 2% inflation rate. The longer global monetary policy remains accommodative though, and with the European Central Bank likely among those institutions that will be eyeing further stimulus measures over the coming months to buoy macroeconomic growth potential, so inflation may be the unavoidable consequence. The longer rates remain low, the greater may be the eventual inflation cost that in turn could require a swift (hawkish) reversal in the direction of rates.

We are also cognisant of the increasing correlation between the wider imposition of (Chinese) import tariffs and domestic (U.S.) inflation. We are optimistic that President Trump may scale back his trade rhetoric during 2020 as he eyes his re-election prospects for November, but if he were to harden his stance and encompass more imported consumer goods into his protectionist trade policies then a higher inflation rate would likely follow, with the consequent implications that could bring for the FOMC. Keep a close eye on wage inflation also. U.S. average hourly earnings have stabilised over the past 12 months in a 3.0%-3.4% YoY range for now, but any renewed growth acceleration could reignite hawkish concerns.

6. (German/Eurozone) Recession

With growth slowing, but still positive for now, we believe that macro downside risks and muted inflation pressures will continue to dominate the Eurozone's monetary and fiscal policy outlook in 2020, weighing on rates market sentiment and warranting an ultra-accommodative stance. Certainly, the fragile nature of the Eurozone economy is now experiencing 'slower growth momentum', with the former engine of growth – Germany – recently flirting with recession. As such, we believe that with the slowdown in economic activity in the Eurozone as a whole and with inflation structurally below the ECB's target rate that the spectre of 'Japanification' in the Eurozone is will be a key challenge for financial markets this year (2020).

So low and negative interest rates seem to be here to stay in Europe and as we move through 2020 their contractionary characteristics may do more harm than good; the negative yield curve raises challenges for both asset allocation and medium-term economic stability. Perhaps the key risk for this region in 2020 therefore would be more pronounced recessionary conditions in Europe, at least in part fuelled by the sharp decline in fixed investment growth in Q3 last year to +0.3% from +5.7% in Q2 and also the decline in government consumption growth to 0.4% in Q3 2019 from +0.5% in the prior quarter. Ms Lagarde and the ECB will have its work cut out seeking dovish solutions in the context of an already negative rates complex; the Bank's lack of monetary policy flexibility and fire-power could be a key theme over the next two years.

7. U.S. election uncertainty / volatility

The current assumption – in the absence of a more popular and electable Democratic candidate – seems to be that Donald Trump should win a second 4yr term at the November presidential election. However, while the fundamental strength of the U.S. economy, especially in terms of the labor market may only embolden his claim to have 'made America great again' and thereby strengthen Trump's re-election campaign, if the U.S. macro or geopolitical outlook should weaken, this could easily scuttle his election outlook. We do not subscribe to the U.S. recession scenario or to the demise of the dollar, but if we are wrong and the U.S. economy weakens sharply in 2020 then the consequent election doubts would be expected to dent equity and credit market performance. Overall, renewed political uncertainty could drive rates market volatility and undermine the backdrop for risk appetite.

8. Hong Kong

The social and economic unrest that brought the Hong Kong economy to a near stop late last year, will remain a not insignificant macro challenge to global markets in 2020. Political tension on the streets remains elevated. Bloomberg reports that according to the Hong Kong Retail Management Association, more than 5,600 (retail) jobs could be lost and thousands of shops could be shut over the coming six months as a result of the protests and violence, all of which will contribute to weaker economic dynamics across the region. Any renewed deterioration in the socio-political landscape in Hong Kong would tend to further dampen risk appetite and bolster the haven bid for treasuries. There may be light at the end of the Hong Kong tunnel though after Luo Huining, a Communist Party stalwart and loyal supporter of Xi Jinping was installed as the new director of the Hong Kong Liaison office. Luo will be measured (by financial markets) on his ability to restore peace and stability to the city.

9. Japan downturn

A weakening outlook for the Japan economy will be a key challenge for the global macro environment in 2020. Japanese data paints a bifurcated picture; consumption remains reasonably strong while business investment and exports have been disappointing of late. Japan's Service Sector PMI fell to 49.4 in December from 50.6 in the prior month; the index is now at its weakest in over 3 years (September 2016). Meanwhile, the latest data also showed new export business declining to a 6-month low. It is clear that the macro environment is being impacted by sluggish external demand as well as the negative pressures that are resulting from the country's 2019 sales tax hike. Modest fiscal easing could reduce downside risks, but the major risk for the economy going forward could be a deeper and more engrained, widespread downturn.

10. Spike or sharp decline in oil price

Any meaningful shift in the oil price over the coming year could have direct ramifications for GCC macroeconomic fundamentals and by extension the prospect for longer-term diversification strategies in the region. A sustained rise in the oil price as a result of production cuts or elevated geopolitical concerns would bolster government revenues among the oil producing nations and thereby tend to enhance the macro outlook for those economies. Conversely, if the global macroeconomic growth outlook were to deteriorate and/or global trade tensions were to intensify, perhaps for any of the reasons suggested above, thereby weakening the supply chain metrics and the oil price amid reduced aggregate demand, this would dent the macro outlook for oil producing countries, but would be a fillip for net oil importers.

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