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3Q 2019 Economic and Market Outlook

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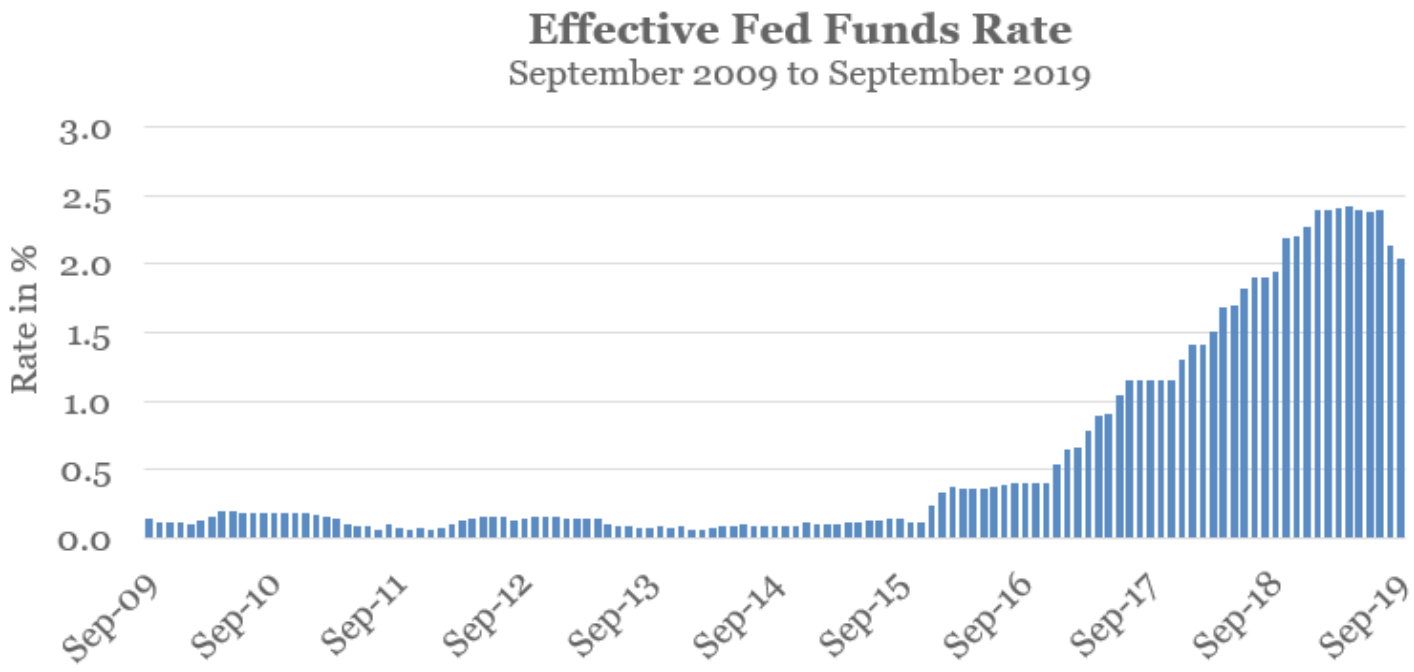
Uncertainty regarding the impact of the ongoing trade war is the primary factor driving global growth expectations lower. While the manufacturing sector is taking the brunt of the slowdown, the latest surveys suggest that the service sector is starting to feel the pressure as well. European economies, particularly Germany which relies heavily on global trade, are trending toward a modest 1.4% annual growth rate given the impact of higher tariffs on their auto sector and reduced new order volume.

This trend will likely continue as long as there remains a lack of specifics on trade. Until then, the Federal Reserve Bank and the European Central Bank are likely to continue to support the markets with low borrowing rates and other measures designed to boost the economy. While all of that sounds ominous, the fact is that outside of global trade, the U.S. economy remains on solid footing and is now likely to get a boost from lower borrowing rates given the Fed's recent decision to reverse course and ease monetary policy.

This shift in monetary policy will support the all-important housing market in the U.S. by lowering mortgage rates further. Growth in housing starts and increasing existing home sales bode well for future residential and consumer spending, which will likely drive economic growth higher going forward.

Figure 1: Lower Policy Rates Help to Support Continued Economic Growth



Source: FRED Economic Data, Board of Governors of the Federal Reserve System

A View to 2020: Political and Geopolitical Risks

If slowing global growth wasn't enough, the headlines over the next year will be dominated by the upcoming 2020 U.S. Presidential Election. Under normal circumstances, election cycles bring uncertainty and volatility, but with the newly announced impeachment proceedings to start in the House, it is probable that markets will react to every piece of breaking news in an effort to handicap the eventual election winner.

A slowing U.S. economy would hinder President Trump's re-election prospects and bolster the chances of a Democratic win in 2020. This gives the current administration incentive to de-escalate the trade war with China so that global growth can recover, particularly within the manufacturing sector, which has approached stall speed according to recent global and U.S. based purchasing managers' surveys. A reading above 50 indicates expansion while a reading below 50 suggests a contraction. The global manufacturing sector began to contract over the summer and has pulled U.S. manufacturing lower as a result.

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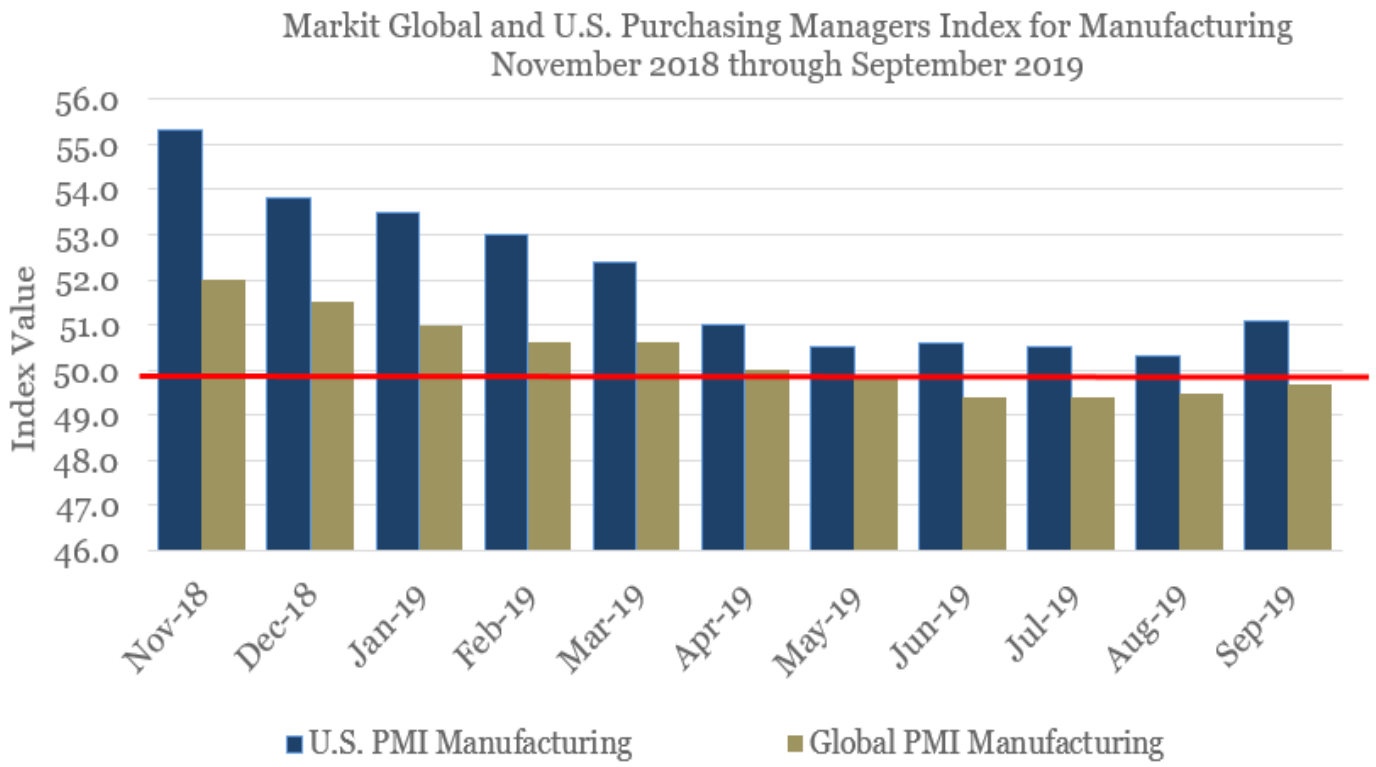
Figure 2: Trade Uncertainty had a Negative Impact on Manufacturing Outlook



Source: Markit, JP Morgan Asset Management Guide to the Markets, November 2018 – September 2019

While pessimism over trade policy can certainly have an impact on overall growth expectations in the short term, a shift momentum in trade negotiations, or a change to key economic variables like the level of interest rates, could make the current slowdown short lived. In fact, in 2015, the U.S. experienced a similar mid-cycle slowdown, but growth began to accelerate again as the cycle progressed.

BREXIT or BUST

In addition to the uncertainty surrounding the Presidential race in the U.S., Boris Johnson, Britain's Prime Minister, is trying to negotiate an exit from the European Union. Johnson's threat to leave without a deal seems unlikely to materialize given the recent U.K. Supreme Court ruling. As a result, the October 31 deadline for Brexit would be delayed again, this time to January 31, 2020.

The common theme in both the U.S. and the U.K. is that political uncertainty and unresolved trade deals can have an impact on the real economy. Global manufacturing is currently weak because of these factors, but normally tends to go through three year cycles, with slower growth over 18 months followed by accelerating growth over the next 18 months.

Research from *Bank Credit Analyst*, an independent macro-economic research firm, suggests that we are about half way through the current cycle and global growth should pick up over the coming year. However, the added uncertainty surrounding trade and political outcomes in the U.S. and elsewhere may prolong the current slowdown.

Global Growth Recovery Depends Largely on China

Partly as a result of the trade war and partly due to internal government policies, Chinese economic growth continues to slow. Actions taken thus far to help stimulate their economy such as cutting reserve requirements for banks and letting their currency value decline relative to the U.S. dollar have not been enough to offset the impact of higher tariffs and general trade related weakness at this point. However, renewed efforts by China to stimulate its own economy and also resolve the outstanding issues related to U.S. trade would help to spur growth again.

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Figure 3: Chinese Currency has Weakened, Offsetting Impact of Higher Tariffs

Source: FRED Economic Data, Chinese Yuan to One U.S. Dollar

The market reacted poorly when China allowed their currency to depreciate in 2016. The concern at the time was that China was losing control of its economy and that government officials were acting to keep capital in China by making it more expensive to move it offshore. The initial market shock was significant, but as illustrated in Figure 7, the currency strengthened again. Interestingly, the value of the Yuan versus the U.S. dollar has again depreciated and crossed the psychologically important 7.0 per U.S. Dollar for the first time, although the market reaction has not been as severe.

Policy makers in China will most likely continue to find ways to stimulate their economy to boost growth. If successful, this should have a positive impact on their own market as well as provide welcome relief to global exporters that depend on Chinese demand.

Summary

The global economy has experienced a manufacturing slowdown, but we believe we will avoid a recession thanks to recent Federal Reserve actions and the likelihood that there will be some resolution of the ongoing trade war with China.

While tariffs in the short term can be inflationary, they also tend to be transitory in nature. The lack of significant inflationary pressure in the U.S. economy gives some breathing room to the Federal Reserve and will allow them to cut rates further, if required.

In that scenario, global equities should break out of the trading range they have been in since early 2018 and bond yields should rise. More economically sensitive sectors, such as energy and financials that have been suffering of late, may recover. European markets tend to be more cyclically exposed and would perform well in that environment. However, the U.S. is approaching an election year that seems more partisan than ever, which will keep investors on high alert.

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