DWS

June 7, 2019

Increasingly fragile

The outlook for the world economy is getting cloudier. Escalating trade tensions could trigger further downgrades.

- With the latest policy proposals, the U.S. is challenging the very technology clusters behind much of the country's recent economic prowess
- As yet, we have not given up hope that economic rationality and self-interest will eventually prevail.
- For now we have only downgraded our growth forecasts very modestly, but caution that growth is not the only concern markets are likely to worry about.

Johannes Müller
Head of Macro Research

Ever since protectionist measures were initially introduced by the Trump administration, we warned of the potential for initial trade tensions to escalate to a full-blown trade war. Trade wars of various sorts are clearly now upon us. However, it remains too early to say whether decision-makers have already reached the point of no return towards further escalation. This is reflected in the very modest downgrades of our growth forecasts so far. For the U.S., we now expect gross-domestic-product (GDP) increases of 2.5% in 2019 and 2% in 2020. For both years, we have penciled in 1.2% for the Eurozone, and 6% for China.

In all these instances, our forecasts reflect a bit of a balancing act. The rebound in the first quarter of 2019 was much stronger than expected. In China and Germany in particular, there were plenty of hopeful signs early in the year. Not all of this momentum will fade immediately. In China, some of the fiscal countermeasures are only starting to kick in and for 2019 at least, the risks to our 6% growth forecast look pretty evenly balanced.

In the U.S., robust labor-market data continues to underpin our assessment that we are dealing with a well-behaved moderation. The U.S. Federal Reserve appears to take a similar view and looks set to continue its "wait-and-see" approach. For the next twelve months, we expect the Fed neither to raise nor cut interest rates. Beyond that, we now see a better than even chance that we are at the peak of the U.S. rate cycle.

In the current environment, though, 12 months appears like an awfully long time. The U.S. trade stance towards Mexico, for example, has been constantly changing. Which brings us back to trade tensions and the reasons why we thought them so worrying, even a year ago. When it comes to tariffs, the impact on inflation, central-bank responses and even GDP growth tends to be, in pretty substantive ways, the least of the many concerns they habitually trigger in financial markets.

Trade in finished goods and services allows countries to specialize. According to about two centuries of economic theorizing and economic history, this process of specializing tends to be beneficial to all countries involved. This is true even if some country is "better" at producing all finished goods and services. Trade allows all countries involved to use available resources, including land, labor and capital, more efficiently.

Assume, for example, that Austria, is a better place to grow both potatoes and corn than Czechia. Trading can still increase

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overall food production, if Czechia's disadvantage is comparatively smaller in one of those vegetables. The same logic holds not just for vegetables, but often with a bit of a twist. For most goods and services, the quality of land or climate matters less than benefitting from having an educated workforce nearby. That will attract more businesses and, in turn, more workers, giving rise to economies of learning. In our example, highly efficient manufacturing clusters might emerge in Czechia, precisely because it was initially less attractive for farming.

The snag is that this process of specialization leaves economies highly vulnerable to the shifting winds of history and geopolitics. The results can be dramatic and lasting, as was the case in real-world Austria and Czechia, almost exactly 100 years ago as the century-old Habsburg Empire disintegrated. New trade barriers meant that from one day to the next, those highly efficient Czech manufacturers lost many of the markets for their products. That was obviously bad for growth and inflation. More importantly, plenty of investments in both newly independent countries turned out to be misguided, because they relied on being able to trade freely.

Fast forward a century, and today's interdependent world economy looks, if anything, even more vulnerable than such historic examples might suggest. The reason is that nowadays, countries have increasingly specialized less in finished goods and services and more in particular intermediate steps in the supply chain. A "Chinese" smartphone might indeed be assembled and designed in China – but rely on a U.S.-owned operating system along with components sourced from around the world. A competing "U.S." handset might merely be designed in the Silicon Valley, assembled in China and marketed by a London-based advertising firm.

This complex web of interconnections would seem to deter policymakers from upsetting global supply chains. Most obviously, the U.S. is challenging the very technology clusters behind much of the country's recent economic prowess. So you would expect businesses to lean on their respective governments. As yet, we have not completely given up hope that rationality and economic self-interest will eventually prevail.

Unfortunately, the nature of trade wars is that they foster nationalist sentiment and jingoism. The same is, of course, true of actual wars. The first shots are fired in the hope of quick victories. And before decision makers know what they are up against, both sides are stuck in the trenches, with no obvious and politically feasible way out. In the conflict between the U.S. and China, we think that we are rapidly approaching the point at which both parties might not be able to find face-saving compromises any time soon. Events in that conflict and, to a lesser extent, the one between the U.S. and Mexico, may make it ever harder for the decision makers involved to contain them. Tariffs are bad enough, but at least economists have some ways to quantify their potential impact. Non-tariff barriers, such as blacklisting particular companies, are even worse.

So, who will suffer most? In the case of U.S. tariffs, the immediate answer is fairly obvious. A recent working paper by the National Bureau of Economic Research looked at the impact of the initial measures the Trump administration enacted in 2018. Unsurprisingly, it found that "the U.S. tariffs were almost completely passed through into U.S. domestic prices, so that the entire incidence of the tariffs fell on domestic consumers and importers up to now, with no impact so far on the prices received by foreign exporters."[1] Arguably even more worrying is the damage for the world's longer-term growth prospects, which could be felt for many years to come.

[1] Amiti, M.; Redding, S.; Weinstein, W. (2019) "The Impact of the 2018 Trade War on U.S. Prices and Welfare", NBER Working Paper No. 25672, available online: https://www.nber.org/papers/w25672; They also point to the relative scarcity of data and note that: "The Trump administration's trade war provides a natural experiment for evaluating the effects of trade policy." This is a helpful reminder that even with plain-vanilla tariffs, there is plenty of uncertainty over their longer-term impact – which is one of the reasons why among wiser policy makers, they have been going out of fashion in recent decades."

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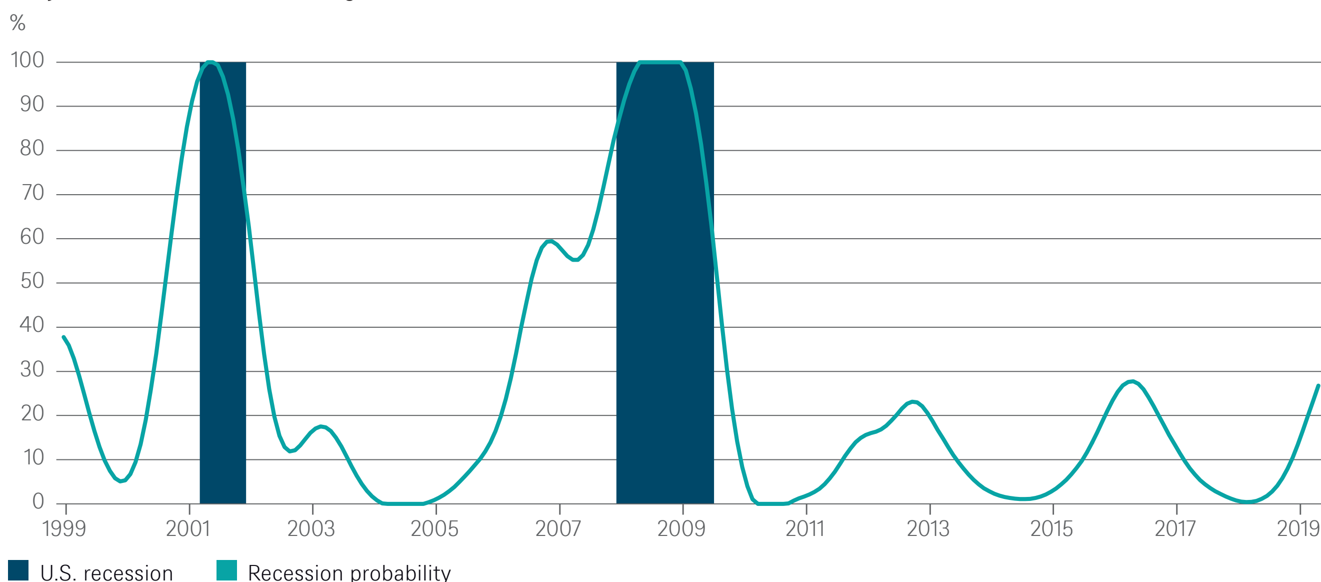
OUR U.S. RECESSION INDICATOR IS SENDING EARLY WARNING SIGNS

Our proprietary U.S. recession indicator has rebounded sharply since the start of the year. It currently suggests a recession probability of about 25% for the coming 12 months.



Source: DWS Investment GmbH as of 5/30/19

GLOSSARY

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The U.S. Federal Reserve, often referred to as "the Fed", is the central bank of the United States.

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