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Marketing Material

Rising risks

We expect a further gradual weakening in growth, caused by trade tensions and related uncertainties.

_ The signs of lasting damage from ongoing trade conflicts continue to grow.

_ For now, much of the data merely points to a temporary slowdown in global growth, rather than a full blown recession in either the United States or the Eurozone.

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Three months ago, we warned that: "The outlook for the world economy is getting cloudier. Escalating trade tensions could trigger further downgrades." Sadly, this has now come to pass. In several export-oriented economies, notably Germany and Japan, we had to cut our growth forecasts for both 2019 and 2020. For the U.S., we have left our 2020 forecast unchanged at 2%, but now expect just 2.3% for 2019, 0.2% less than three months ago. The U.S cut is not actually related to 2019 economic performance. Instead, it is due to a revision of past data, dating back to 2018. To be sure, U.S. economic momentum is weaker this year, with the stimulus from tax cuts continuing to fade. However, that has always been reflected in our gross-domestic-product (GDP) forecast.

Indeed, if you look at the U.S. in isolation, forward-looking economic signals remain decidedly mixed, rather than unambiguously negative. For example, the ratio between leading and coincident economic indicators remains near its recent peak. Leading indicators, such as new orders in manufacturing, help to predict future trends. Coincident indicators, such as personal income, are measured in real time. So, if personal income was to shrink at the same time as orders began to deteriorate, you would, all else equal, notice a decline in the ratio. In past cycles, there have usually been substantial declines in the ratio, well before U.S. recessions started. The current pattern more closely resembles past temporary slowdowns. Another indication is, companies' continuous hiring of temporary workers. And, financial conditions broadly remain in line with economic growth of just above 2%.

Of course, you can always find reasons to worry. One particular bugbear is the yield curve. Recently, it has inverted in the U.S. and elsewhere, meaning that, for example, yields on 10-year U.S. Treasuries fell below those of 2-year U.S. Treasuries. In economic terms, the best way to think of inverted yield curves is as measuring the willingness of fixed-income investors to pay for "recession insurance." The more inverted yield curves are, the higher the implied recession risk premium investors are willing to settle for. That merely suggests, though, that plenty of investors are already quite gloomy – not that they are necessarily right to be gloomy. Also worth noting is that inverted yield curves of this sort are, if anything, self-denying rather than self-fulfilling prophecies: by driving down long-term yields, bond markets make a recession less likely, even in the absence of central-bank action.

Instead, the U.S. Federal Reserve (the Fed) looks set to continue its policy of 1998-style pre-emptive cuts, even as it remains reluctant to embark on a full-blown cutting cycle. We expect two more interest-rate cuts in the next 12 months. For the European Central Bank (ECB), we expect a small cut of 20 basis points to -0.60%, the introduction of a tiering system for central bank deposits, and a resumption of asset purchases as part of a broad package. We also expect these steps to be enough to stabilize the situation.

Both the Fed and ECB have been put in an unenviable position. Signs of financial-market nervousness and real economic damage in key countries such as Germany can mostly be traced back to global trade tensions. Yet, as central bankers rightly lamented at their recent conference in Jackson Hole, there is little monetary policy can do to alleviate the longer-term damage caused by protectionist policies. As we explained in our trade special (see CIO Special – Free trade under attack as of 5/17/18) last year, temporary protectionist measures are akin to taxing a highly efficient production technology. And permanent protectionist measures are akin to destroying existing production facilities at home and abroad. So, at least in an economy at full employment before a trade shock, all you eventually get from printing money (in one way or the other) in reaction to a trade shock is an economy just as much poorer, but with inflation added to the list of economic woes. The correct policy prescription, in our view, would be to simply stop the trade hostilities.

Unfortunately, there is little sign of global trade peace breaking out any time soon. Aside from the erratic policy pronouncements by the U.S. President, there are worrying signs of protectionist trends catching on. This includes not only the conflict between South Korea and Japan, but also between the European Union (EU) and several developing countries. The new European Parliament will probably be more willing to flex its muscles, notably on trade issues related to environmental concerns. We continue to hope that economic self-interest will prevail – eventually. In the meantime, trade conflicts in general and the one between the U.S. and China in particular remain a drag on the global economy. By contrast, we are reasonably confident about two other frequent political worries. On Brexit, we think that by constantly beating the "No-Deal" drum, the new Prime Minister Boris Johnson is likely to prevent the UK and the remaining EU 27[1] from sleepwalking into a "No Deal." In Italy, snap elections seem to have been avoided for the time being.

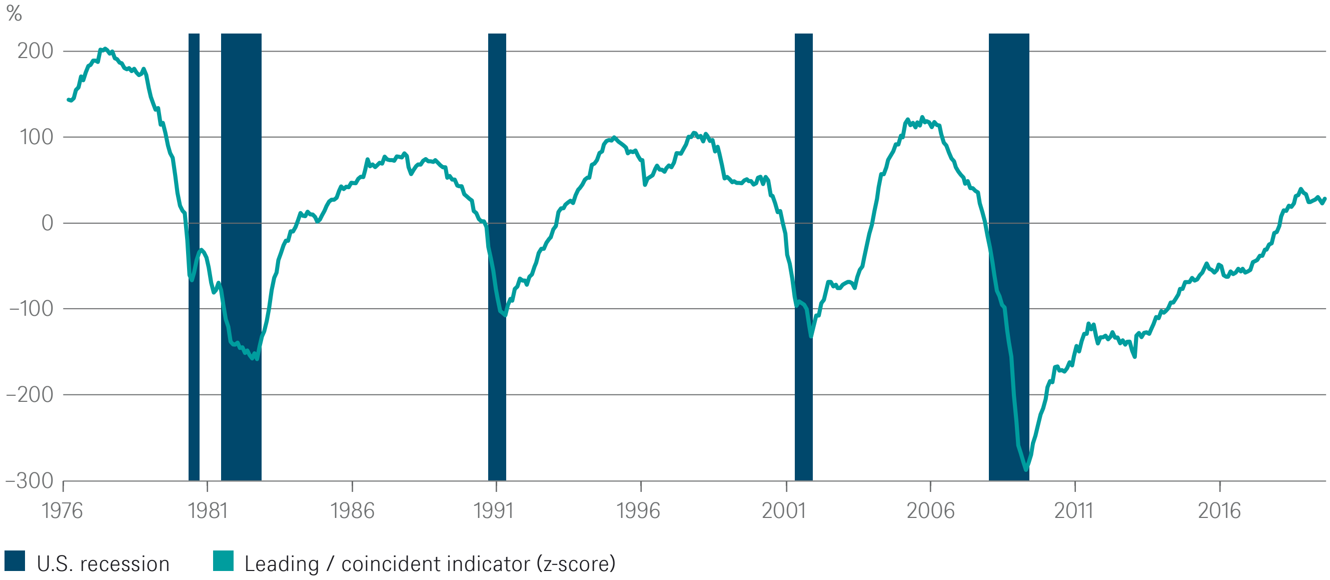
So, to sum it all up, the world is facing decelerating growth. However, we do not expect a recession in the U.S., nor in China, nor in the Eurozone as a whole. We believe that monetary policy is set to remain expansionary, providing support to the economy and financial markets. In Europe, there are signs fiscal policies might ease, though probably not enough to have much of an economic effect in the next 12 months. Inflation should remain low, at least for now. Could we, and central banks, be wrong in this comparatively benign assessment? Of course, and in more ways than one!

In the U.S., there are some worrying signs of profit margins getting squeezed. In the past, corporate America has typically reacted by laying off workers, sometimes quite suddenly. It remains too early to say, though, whether the trade-war-induced shock will play out exactly along those lines. Contrary to much of recent conventional wisdom, trade wars do not usually, or even necessarily, cause recessions. They tend to damage how much existing plants and businesses are worth in the long term, not necessarily how much of the remaining capacity might remain idle for a few quarters. And if trade tensions continue to escalate, there is an alternative scenario at least worth considering. That scenario is likely to be familiar to anyone still remembering the stagflationary[2] days of the 1970s: just as with oil shocks, adding loose monetary and fiscal policies to a trade shock is likely to be inflationary in the longer term. Let's hope today's policymakers do not repeat those mistakes.

1 The "EU 27" include all member states of the European Union except for the UK.
2 Combination of the words "stagnation" and "inflation," referring to a period where inflation is high while the economy is stagnating.

A LOW-NOISE INDICATOR

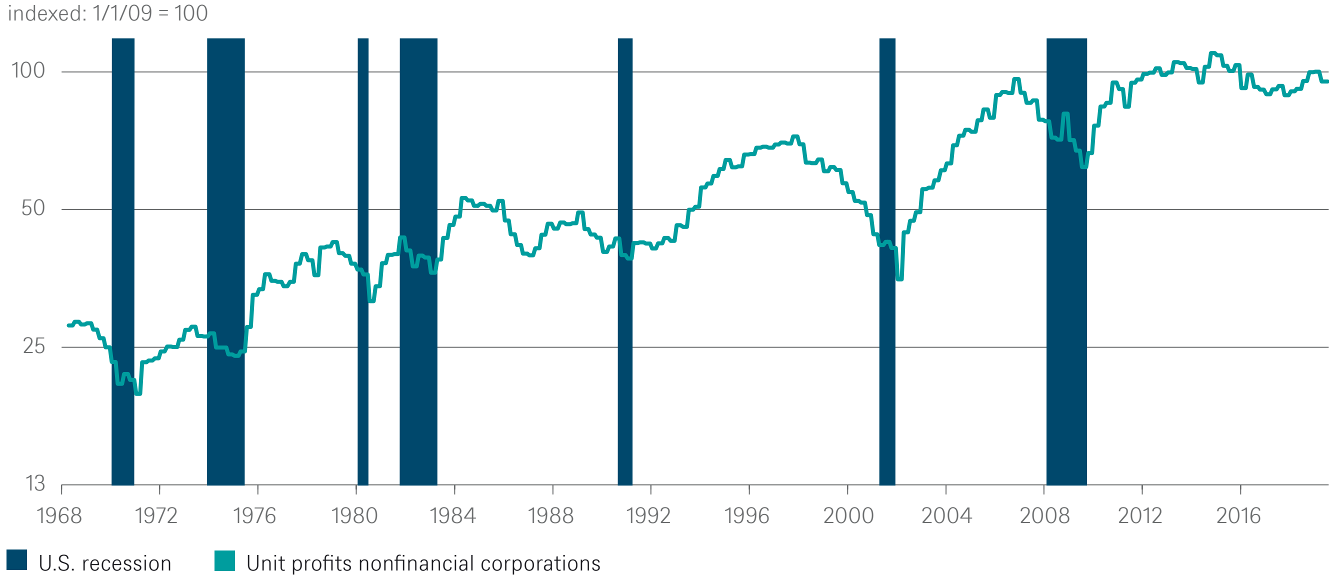
The ratio between leading and coincident U.S. economic indicators remains near its recent peak. That is suggestive of a temporary slowdown, not a recession.



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 8/30/19

U.S. UNIT PROFITS HAVE STARTED TO STALL

One of the more worrying signs for the U.S. economy concerns corporate profits. These are down 4.9% so far, which is not yet enough to serve as reliable recession signal. slowdown, not a recession.



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 8/30/19

GLOSSARY

One basis point equals 1/100 of a percentage point.

The European Central Bank (ECB) is the central bank for the Eurozone.

The European Union (EU) is a political and economic union of 28 member states located primarily in Europe.

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

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

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.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

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

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

Important Information – EMEA

Important Information – UK

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