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Marketing Material

Early signs of stabilization

Downside risks to global growth have shrunk in recent months. But we do not see much potential for an upside surprise either.

_ In recent months, leading economic indicators stabilized.
_ We remain somewhat hopeful that a truce in the trade war between China and the U.S. can be reached.
_ Like the trade war, Brexit has mainly meant one thing frequently underestimated by economists: rolling uncertainty.

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So far, so good. In recent months, leading economic indicators have stabilized. That was a necessary condition in order to avoid a recession. In itself, we do not believe it will be enough to reverse the temporary slowdown we have been warning about for quite a while. Indeed, we have been forced to take many of our growth forecasts for both this year and the next down by another notch. For the Eurozone we see a growth in gross domestic product (GDP) of 1.1% in 2019 and 0.9% in 2020 which reflects a change of -0.1% and -0.2%, respectively. The cuts are even larger in the U.S., where we expect growth to slow to 1.6% in 2020, from our reduced forecast of 2.2% this year.

Nevertheless, we are cautiously optimistic. We think that the world economy should start to accelerate again in 2021, mainly thanks to several of the larger emerging markets recovering. That list includes India, Brazil and Russia, though not China. All these countries are frequently seen as stand-alone stories. Similarly, it has become fashionable to think about Brexit or Donald Trump's trade policies as reflecting unusual periods of turmoil in British or American politics. And of course, there is always much to be learned by carefully analyzing individual countries, whether the goal is to understand political or economic dynamics.

In the case of China, we think GDP growth will slow to 5.8% in 2020 and 5.6% in 2021. Lingering trade tensions are only one of the reasons. The bigger underlying cause is demographics. In 2021, 25 million Chinese will reach their retirement age. By contrast, only 15 million young people will enter China's workforce, reinforcing labor shortages that are already starting to loom in certain areas.[1] Nor is demographics China's only vulnerability. Household debt has risen quite dramatically and much faster than GDP. Adding China's transition to a more service-oriented economy we believe the country is unlikely to see a return to the double-digit growth rates of previous decades.

None of this is exactly new. China watchers have been fretting for well over a decade about whether the country could be challenged by demographics before per-capita income could reach rich-country levels. Nor is slower economic growth necessarily a bad sign, if lower rates prove sustainable. Looked at from Beijing's perspective, however, these remain the main economic-policy challenges that had already been lurking in the background when the trade conflict with the U.S. started. Alongside the unrest in Hong Kong, they also offer a reason why China might wish to defuse trade tensions. Plainly, it would allow China to focus on other policy challenges closer to home.

1 DWS Investment GmbH, Macro Group, based on data from the State Statistics Bureau of China, November 2019

We remain somewhat hopeful that a truce in the trade war between China and the U.S. can be reached in the coming weeks. Partly, this is because we would expect both parties to have an interest in doing so. President Trump, after all, faces re-election in 2020. A trade truce would help sentiment. But, even if it materialized as we expected, such a truce looks unlikely to actually reverse the damage. This is partly because of Chinese history: during the 19th century, a weakened country was forced to sign unequal treaties with various colonial powers. Its leadership will likely be wary signing off on anything reminiscent of those 19th century trade concessions in the face of foreign pressure. Meanwhile, a weakened U.S. President facing impeachment might use further trade escalation to try to project strength in an election year. Thus, there remain risks that mutual misunderstandings, paired with brinkmanship, could cause further escalations. To see how such factors can override economic self-interest even in mature democracies, Brexit is a case in point.

Like the trade war, Brexit has mainly meant one thing frequently underestimated by economists: rolling uncertainty. As long as there appeared to be a firm date for the UK to leave the European Union (EU), companies could at least try to plan accordingly, if necessary by postponing investments. With every extension requested by the UK and granted by the EU, however, this has become increasingly hard. It also left businesses more and more unnerved. British politics, it would seem, has become so unpredictable that companies are unable to adjust in a timely fashion.

Economists trying to capture such factors tend to rely on sentiment indicators, while talking about "upside" and "downside" risks to their base case. And yet, as the economist Frank Knight pointed out almost 100 years ago, there is a big difference between risks of the sort that you can measure, quantify and prepare for, and uncertainty, reflecting the essential unpredictability of future events.[2] We think Brexit firmly belongs to the second category, as companies in the UK and elsewhere are increasingly realizing. After years of globalization and integrating supply chains, a country's disintegration from an area it has close economic ties with is novel and marks a structural break. Except that Brexit still has not happened! Tariffs, regulations, travel arrangements and all the rest of the rules governing relations between the UK and the EU remain the same in 2019 as they were before the 2016 referendum. So far, it has been the mere – if at times very credible – threat of further political chaos ahead that caused all the damage, including the sharp fluctuations in the value of the pound.

Which is more than enough. Imagine, for example, that you are the CEO of a British manufacturing company currently exporting mostly to EU markets. As such, you would have much riding on the UK's snap general election on December 12. Not that knowing this latest looming decision date makes your life any easier! If the British polls are right for a change, and Tories win a majority in the House of Commons, you know that Tory leader Boris Johnson's Brexit withdrawal deal is likely to pass. You don't have much of an idea, however, of what a Johnson Brexit might mean for your business. Johnson has gone out of his way to rule out a customs union, regulatory alignment with EU standards, and even an extension to the transition period beyond 2020, in case a quick trade deal with the EU can not be negotiated as promised. The above-mentioned UK business would probably hope that a victorious Johnson might change his mind, especially on regulatory alignment.

Meanwhile, the main opposition Labour party is promising to reverse four decades of shrinking the role of the state. Labour is planning to raise taxes and spending by amounts unprecedented in peacetime. In the past, these measures were rather unwelcome by markets. In this regard, the markets' best hope is that Labour currently looks very unlikely to win a majority on its own and would probably have to rely on smaller, pro-EU parties. Yet, the result of this could well be another EU referendum, another one on Scottish independence, and, potentially, yet another snap general election before very long.

A similar dynamic, we think, has been at work when it comes to trade more broadly. The economic harm from U.S. tariffs goes well beyond the obvious impact on the global economy via the higher prices, resulting in lower consumption and imports. Global industrial production has been declining since the beginning of 2018. Increasingly, it has been tracking the Global Economic Policy Uncertainty (GEPU) Index, a risk index compiled by several U.S. academics.[3] It measures uncertainty in the 20 most important economies by reflecting the relative number of articles containing risk terms. The global index is then weighted with the national GDP. Thus measured, uncertainty is currently at a peak.

2 Knight, Frank H., (1921). Risk, uncertainty and profit (1964 reprint). New York, Augustus M. Kelley
3 For details, see: https://www.policyuncertainty.com/global_monthly.html

Paradoxically, the peak in uncertainty – as measured by mentions in global media outlets – is also one of the reasons why we are cautiously optimistic. In the UK and elsewhere one can already make out early signs of reversion to a more moderate political mean, admittedly with many hiccups along the way. The latest extension of the Brexit deadline to the end of January 2020 has already prevented the UK chaotically stumbling out of the EU on October 31, 2019. At the UK's snap general election on December 12, we think that the most likely scenario is probably another hung parliament. A newly elected House of Commons would probably be even less inclined to pass a Brexit of any sort, without a second, confirmatory referendum. In such a referendum, we would find it quite plausible for the initial Brexit decision to be reversed, while the alternative might well turn out to be a lot softer than what the Tories have been promising. So, the end-result, after all the upheaval of recent years, might well be trading arrangements between the EU and the UK not all dissimilar from the current status of full EU membership.

Since 2016, we have already seen plenty of echoes of the same political and socio-economic processes that caused Brexit in other countries. With the benefit of hindsight, it might well turn out that the British political systems actually coped better with the resulting challenges than other places. The same could well prove true at the U.S. 2020 elections. On the Democratic side, we expect that the eventual nominee will not veer too far to the left. And, a re-elected President Trump would probably still be constrained by Democrats holding on to the House of Representatives. Until the results are in, though, we expect plenty of nervousness among businesses and markets every time, for example, one of the more left-wing candidates for the Democratic nomination does well in a primary contest or surges in opinion polls.

All of which might sound like a recipe for yet more rolling political uncertainty and more damage to business sentiment. Another way of viewing this uncertainty, however, is to acknowledge that since the end of the Cold War, business may have been lulled into a sense of complacency. Plainly, plenty of political changes are possible and need to be considered before making an investment decision. And if businesses increasingly plan for changes that once seemed unthinkable, that should make economies more resilient if and when some of those risks materialize.

Indeed, it may well be the latest chapter in a story that should be familiar to our readers. Since the end of the financial crisis a decade ago, a lot of economic indicators have been moving in slow motion, with the occasional periods of volatility in between. For many years, we have seen weak credit creation, weak company spending on capital expenditure, weak inflation, and so on, giving the current cycle unusual staying power. Increasingly, we are beginning to wonder whether something similar might be happening in politics. In the meantime, we expect monetary policy to remain on hold in both the Eurozone and the U.S., with no further interest-rate cuts by either the U.S. Federal Reserve (the Fed) or the European Central Bank (ECB). Of course, there remains plenty of uncertainty around that base case, too.

Remarkably, our thinking both on politics and on macroeconomics, has not changed all that much since August. Back then, our view that a No-Deal Brexit would be avoided and that no recession was looming seemed hopelessly optimistic to some of our colleagues. Since then, we have seen a few months of financial-market strength. Perhaps as a result, some have questioned whether we might now be too pessimistic. We would caution, however, that the risks have not vanished altogether.

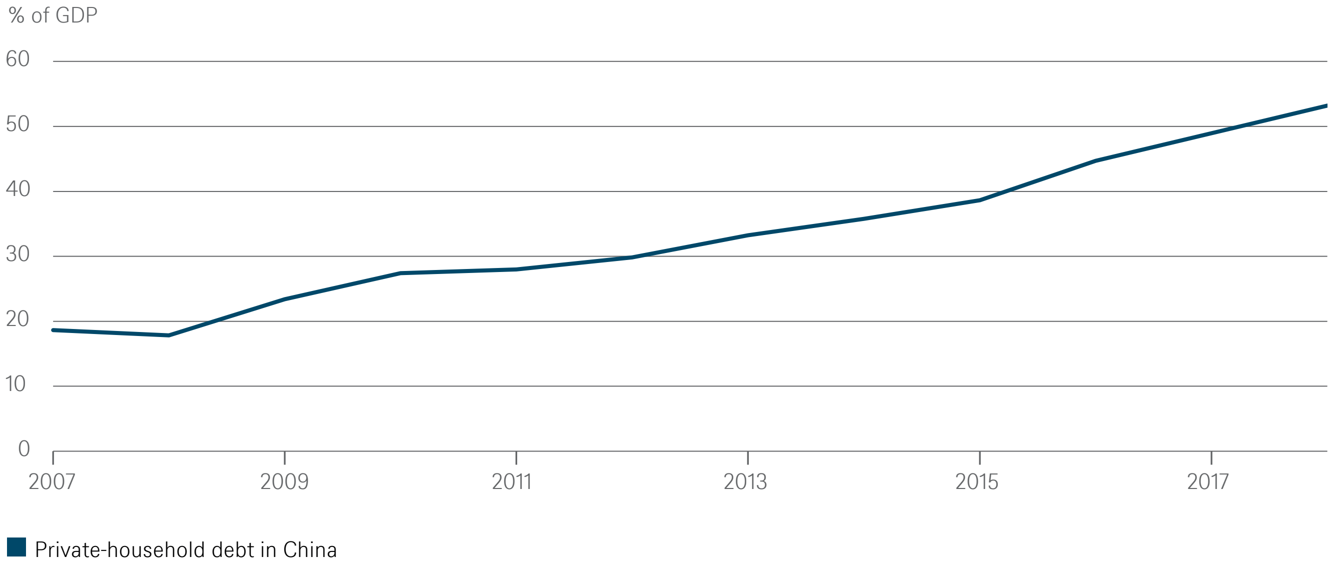
GLOBAL UNCERTAINTY

The uncertainty due to Brexit and the trade war drags down global industrial production.

Sources: Haver Analytics Inc., DWS Investment GmbH as of 10/30/19

CHINA'S PRIVATE- HOUSEHOLD DEBT

Debt of private households rose quite dramatically, almost tripling compared to 2008 numbers.



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 11/11/19

GLOSSARY

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

The Conservative Party, also referred to as "Tories", is a center-right political party in the United Kingdom.

The Democratic Party (Democrats) is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

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.

The Global Economic Policy Uncertainty (GEPU) Index measures uncertainty in the 20 most important economies by weighting the relative number of articles containing a range of risk terms.

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.

The House of Commons is the lower chamber of the United Kingdom's parliament.

The United States House of Representatives is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

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

The Labour Party is a center-left political party and one of the three biggest parties in the United Kingdom.

The pound sterling (GBP), or simply the pound, is the official currency of the United Kingdom and its territories.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

U.K.'s EU referendum held on June 23, 2016 in which the citizens of UK voted for an exit of the UK from the EU, with a majority of 52%.

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

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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