Macro

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Steady as she goes

The world economy retains a more solid footing than you might think. There are plenty of risks, however.

Let's start with the good news. Are we facing a severe U.S. economic downturn or even a recession as financial markets appeared to be signaling in recent weeks? Clearly, the answer is no. Conventional leading indicators, which have proven reliable in the past, remain reassuring. U.S. economic momentum continues to look solid indeed. In fact, we have slightly increased our forecast for 2018 to 2.9%. We continue to expect only a slight deceleration, to 2.7% in 2019. This partly reflects the fading effects of debt-financed tax cuts and spending increases of the past year under the Trump administration.

Leaving aside some relatively isolated areas of weakness, such as housing in parts of the United States, a slight deceleration is perfectly consistent with the cycle lasting well beyond our 12-month forecasting horizon. The U.S. economy has lately been growing above potential, and the labor market is already very tight. A pickup in productivity, perhaps reflecting a combination of tax cuts, deregulation and slight rises in corporate investment, would help. Still, the pace of growth probably needs to slow, if the U.S. economy is to avoid recession risks in the longer-term. That is exactly what we are forecasting.

For the rest of the world, the outlook is admittedly somewhat less benign but far from dismal. Outside the United States, we have taken down our forecasts another shade. For the world as a whole, we now expect 3.7% growth in 2018 and a still perfectly respectable 3.6% in 2019. For China, we stick to our 6% forecast in 2019. Not so long ago, this was well below consensus. Lately, incoming data forced some of our more optimistic peers to trim their forecasts, as the trade conflict between China and the United States has started to take its toll. It remains to be seen whether the recent truce on trade will prove sustainable. Other reasons for caution include China's high levels of private-sector debt and structural trends, such as an aging population and the shift towards services. Set against all this, China's leaders appear determined to soften the slowdown through various stimulus measures and still have plenty of monetary and fiscal tools at their disposal.

Other emerging markets (EM) present a sharply contrasting picture. The likes of Turkey and Argentina are facing some well-known, country-specific challenges. Still, domestic-demand growth continues to look solid in much of Asia, with Indian economic growth on track to accelerate to 8%. On average, we expect emerging-market growth to be roughly the same in 2019 as in 2018. Provided, of course, that matters on the trade front are at least not getting worse. Another potential source of volatility is the oil price, which we expect to recover to 60 dollars a barrel by the end of 2019.

In a nutshell

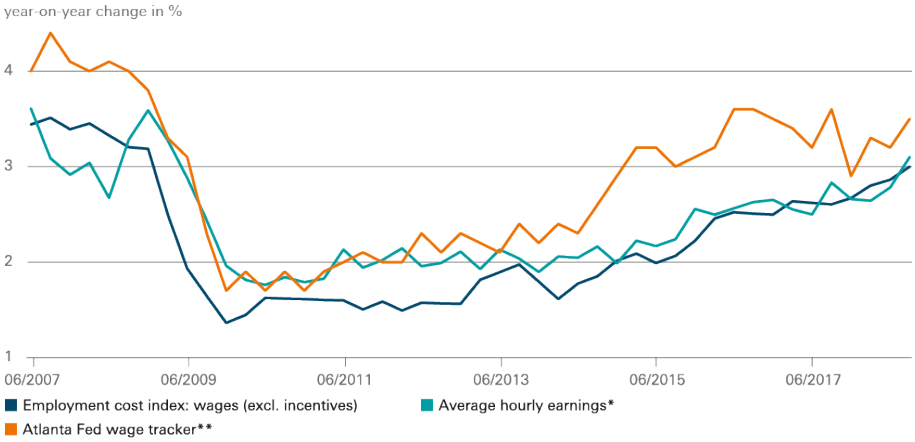
- U.S. economic momentum continues to look solid indeed.
- For the rest of the world, the outlook is admittedly somewhat less benign but far from dismal.
- The biggest risks continue to surround European politics and they are skewed to the downside.

The most immediate risks continue to surround Europe, and they are skewed to the downside. One area to watch is obviously trade – and the question whether and how hard the Trump administration might target European carmakers. Two other perennial topics are Brexit and the ongoing haggling over Italy's fiscal outlook. Our base case continues to assume that awful outcomes, such as a cliff-edge Brexit or a rating downgrade of Italian government debt towards junk, can be avoided. Achieving that, however, might require some market discipline, which, in turn, could reinforce rather than diminish political brinkmanship.

Note that none of the risks we have outlined above are all that new. Indeed, Chinese debt, trade, Italy and Brexit are all topics we have been carefully monitoring for a while and incorporating into our forecasts. The same is true of the shift in monetary policies towards quantitative tightening. What then explains the severity of some of the moves we have recently seen in financial markets, notably in U.S. equities? One intriguing explanation concerns wages. With the U.S. economy operating at full capacity, you might expect wage growth to start putting a dampener on companies' earnings by squeezing corporate margins. It is too early to say whether this may have already started to happen. If and when it does, that might, however, prove painful for Wall Street but not necessarily for U.S. households, let alone the global economy as a whole. Instead, it is exactly what a benign macro-economic scenario of a successful exit from quantitative easing might look like.

U.S. labor costs are slowly trending upwards

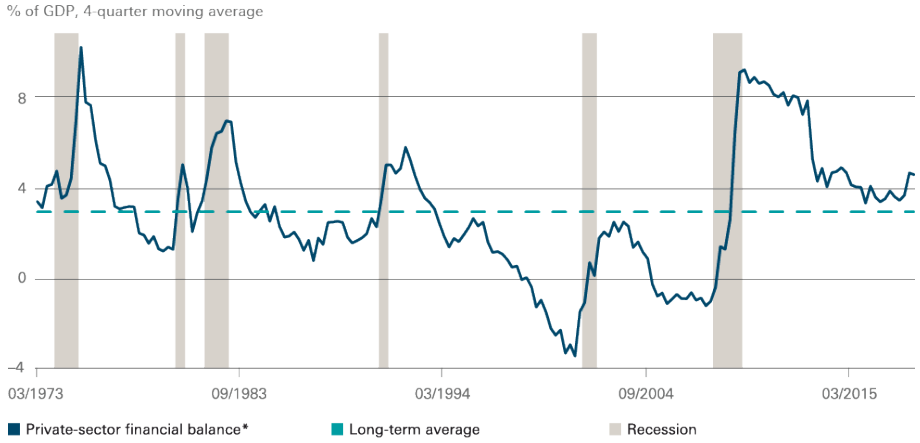
So far, wage growth has remained fairly moderate, but according to most estimates, U.S. labor-market slack appears to be largely gone.



Sources: Bureau of Labor Statistics (BLS) of the U.S. Department of Labor, DWS Investment GmbH as of 11/2018
*Last observation: 10/2018
**unweighted, 3-month moving average

Healthy U.S. private-sector financial balances

As yet, there are few obvious signs of the sorts of excesses such as deteriorating private-sector finances that preceded previous recessions.



Sources: U.S. Bureau of Economic Analysis (BEA), U.S. Federal Reserve Board, DWS Investment GmbH as of 11/2018
*Total income minus total spending

Glossary

Barrel (bbl)

A **barrel (bbl)** is the commonly used unit to measure crude oil. One barrel is about 159 liters.

Emerging markets (EM)

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

Fiscal policy

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.

Junk bonds

Junk bond is a colloquial term for a high-yield or non-investment-grade bond.

Margin

Margin describes borrowed money that is used to purchase securities.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Quantitative easing (QE)

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

Quantitative Tightening (QT)

Quantitative Tightening (QT), as opposed to Quantitative Easening, describes the process of a Central Bank reducing its monetary stimulus by shrinking its balance sheet.

Recession

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

Volatility

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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