

THE VIEW

Economic Research

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POLITICAL WORRIES, FLATLINING GROWTH AND AN ILLIBERAL CYCLE

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EXECUTIVE SUMMARY



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- In 2019-20, overactive policy makers, especially superdovish central bankers, and a new fiscal impulse (U.S., China and Europe, to a lesser extent) will help avoid a global recession, but flat-lining growth – with activity bottoming out in Q1 2020 – will be the norm, reminding us of 2015-16 muddle-through. Over the summer, escalating political risks (US-China rivalry, Brexit, Italy's new government) exacerbated the pockets of recession visible in the first half of the year in trade, manufacturing and a dozen of economies. Looking ahead, a soft landing remains our baseline scenario (+2.4% in 2020, down from +2.5% in 2019 and +3.1% in 2018). In 2020, the U.S. should decelerate to +1.6%, the Eurozone to +1.0% and China to +6.1%. Global trade of goods and services will grow by +1.7%, the lowest rate since 2009. Consumers will be a source of resilience (low unemployment and high savings); domestic sectors, such as services and construction will help bridge a pivotal H1 2020, before easing monetary conditions and lower political risk help the manufacturing sector recover in H2 2020.
- This time around, expect more volatile markets and fickle capital flows, as our fragmented world has entered an “Illiberal Cycle”. Low-growth-low-inflation may hide more direct pass-through from political risks to financial markets, and the need to manage negative externalities of very interventionist policy-makers. Though we expect pragmatism on the U.S.-China trade tensions as the U.S. economy decelerates, a last minute extension of Article 50 in the UK, and few(er) mistakes by neo-authoritarian leaders in emerging markets, fiscal and monetary policy – as well as tax, tech, and competition policies – will continue to be instrumentalized to offset trade uncertainty or win elections. However, these policies will exhibit diminishing returns, given increasing vulnerabilities of the private sector and capital markets. A more fragmented world also means volatile commodity prices (~70\$/bbl for oil), currencies (3-5% depreciation on average) and capital flows for emerging markets.
- To exit these limbos, there are two upside possibilities, and two downside risks. Potential positive developments include: an electoral bifurcation in the U.S. in 2020 and a moratorium on protectionism (40% v. 60% for more of the same), and a sizeable fiscal response from Europe, taking the baton from the U.S. (20%). These would call for rapid normalization by central banks to avoid exuberance. On the negative side: a credit event from a zombie corporate in the U.S., for instance (20%), a major policy and a full-fledged U.S.-China trade and currency war (10%) will trigger a recession.
- What does this mean for markets? Along with rising volatility, the directionality of global markets will be hard to get. Historically, fixed income assets have been the outperformers in late cycle periods. A severe economic downturn would lead equity markets to a double digit downward correction. The superdovish central banks will keep bond yields at very low levels. We expect the 10 year Bund at -0.4% at end-2020 and the 10 year U.S. yield at 1.7%. The ongoing uncertainty would push gold prices to higher levels even though at the moment there is not enough confidence to take outright long positions. Higher volatility from the U.S.-China trade conflict will keep the dollar strong (1.10 at end-2019 and 1.12 at end-2020 for the EUR/USD). The renminbi should depreciate further to 7.23 for the CNY/USD in one year term).
- What does this mean for companies? Our Global Insolvency Index is forecasted to increase by +8%, both in 2019 and 2020, with a still noticeable increase in Asia (+15% in 2019 and +16% in 2020), a rebound in Western Europe (+3%) and a trend reversal in North America (respectively +2% and +4%).



+2.4%

**Expected global GDP growth
in 2020.**

ESCALATING POLITICAL RISKS EXACERBATING ALREADY VISIBLE POCKETS OF RECESSION

There are three key takeaways from the first half of the year:

First, the dispute between China and the U.S. has escalated, bringing us into a merchandise trade recession.

Global trade of goods dropped by -0.9% compared to H2 2018, as both Q1 and Q2 posted contractions for the first time since 2009. The new wave of protectionism announced by President Trump over the summer will push the U.S.'s average tariff up by +1.5pp to 9% by 15 December (it averaged 3.5% in January 2018), and caused new volatility on capital markets, and wait-and-see mode among consumers and companies. We are stuck in a world of higher tariffs by default and higher trade policy volatility. Trump's decision to delay some tariffs that could affect consumer prices (to after the peak retail shopping season), could mean he is aware of their negative impact on the American consumer. This strategy could signal a shift to a regime of higher tariffs for longer. Hence, in the current configuration, while further tariff escalation is less likely and not our baseline scenario - as it

would damage the U.S. domestic economy - we expect the average U.S. tariff to remain around present levels (~9%) well into 2020. But we also expect continued volatility over policy announcements on both the U.S. and China's sides, as shown by the recent indications of a temporary Trade Détente after this summer's escalation.

A softening in China's stance is unlikely. China would rather play the long game, as it is not bound by elections. It could retaliate further by letting its currency depreciate, taking economic patriotism measures, taxing additional U.S. imports and easing monetary policy. Europe or Mexico aren't safe and sound: On the European front, we continue to believe 10% tariffs on European car imports could be implemented in November 2019, which would take the average U.S. tariff to around 10%. In our trade monitoring framework, the trigger to enter a full-fledged "Trade War" scenario would be the U.S. average tariff reaching 12%. Such a scenario would sink the world economy into recession, subtracting -2pp from global GDP growth over two years (vs. -0.5pp for our

current "Trade Feud" scenario). With higher tariffs and trade policy volatility, we expect a prolonged low-growth regime for global trade of goods and services. Indeed, for 2019, we forecast the lowest growth in global trade of goods and services since 2009 in volume terms (+1.5% after +3.6% in 2018), a result of the ongoing recession in merchandise trade, despite the relative resilience of trade in services. The outlook for 2020 (+1.8%) shows no significant improvement. In value terms, a stronger dollar and uncertainty have led to deflationary pressures on commodity prices, prefiguring the collapse of trade in value this year and a modest rebound next year. Despite the 50% reduction in Saudi crude oil output (6% of the global supply) following the September drone attack, we expect a modest impact on oil prices as a return to normal should be possible within 60 days, with Saudi exports largely covered through stocks. Overall, Brent prices should reach USD 66/bbl on average in 2019.

Figure 1: Impact of trade tensions on 2020 forecasts

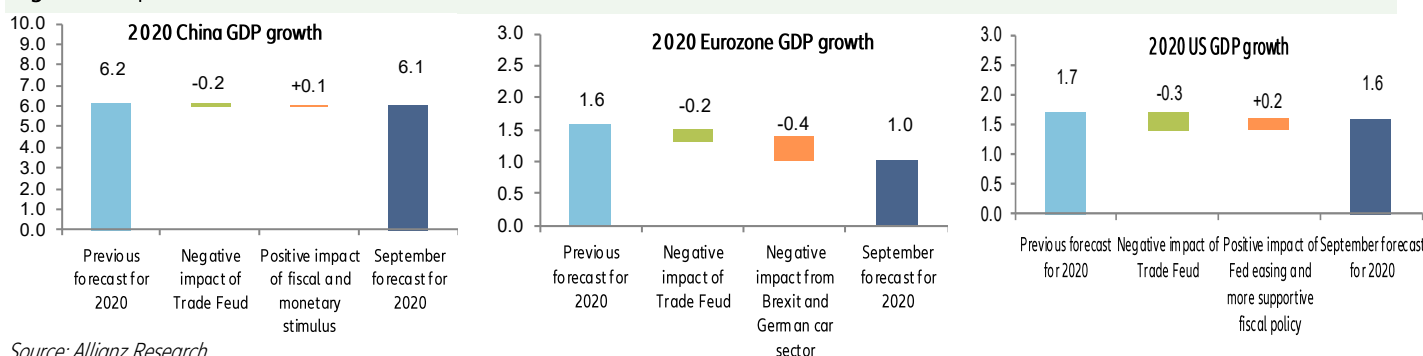
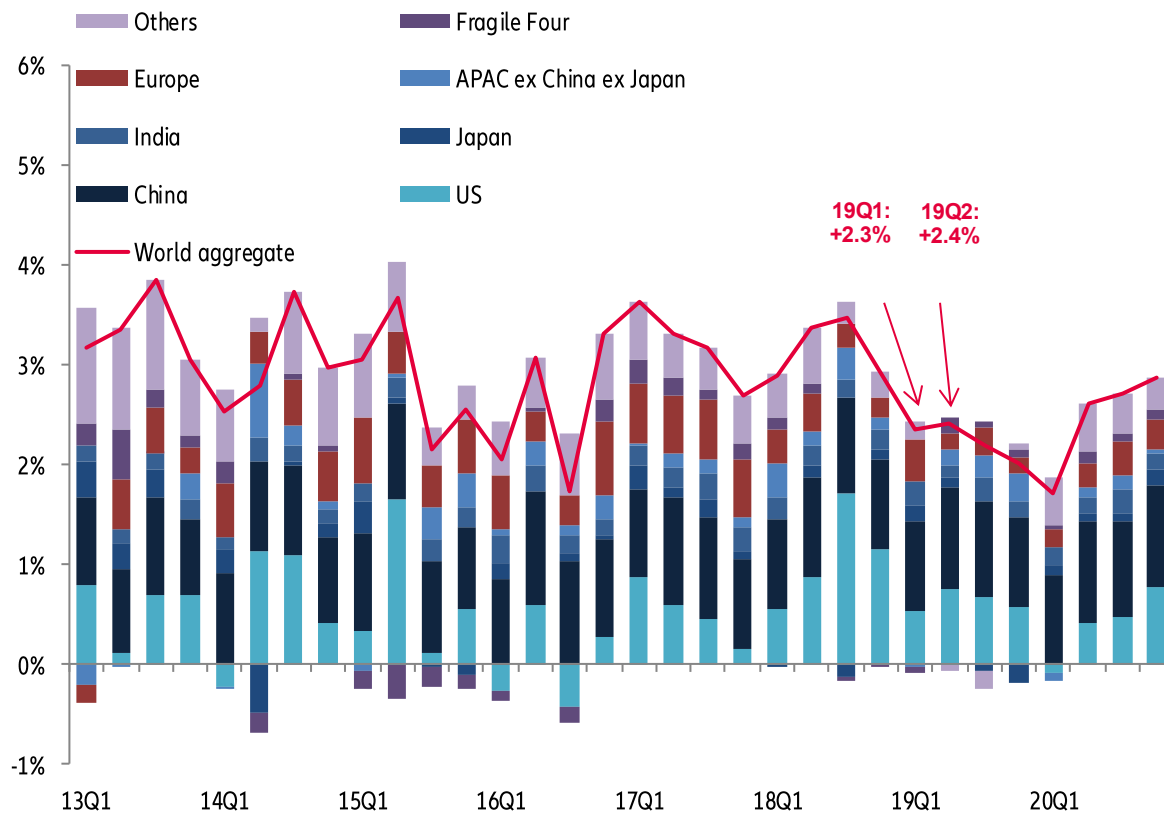


Figure 2: World growth, q/q annualized



Sources: Bloomberg, Allianz Research

Second, global manufacturing entered negative territory (-0.2% y/y expected in September), notably in advanced economies such as the U.S., Germany, Japan and the UK.

Following the trade uncertainty shock, manufacturing activities rapidly decelerated, prompting a global industrial recession. But there are three additional factors behind the difficulties in the corporate sector, particularly for companies that are globally integrated:

- The difficulties of the car industry, which are multi-sided and concentrated in Germany. The car industry has to manage a levelling-off of demand in the U.S., the first contraction of demand in a decade in China, a rapid contraction of the market in India, the consequences of Brexit and the implementation of new

emissions norms in Europe. For the two last aspects, political movements or factors are clearly at work.

- The fatigue of the Electronic sector. The car industry's challenges have translated into fatigue in the electronics sector (they are highly interdependent), whose cycle has also been impaired because of the Huawei case and the diplomatic spat between Japan and South Korea. Consumer fatigue can also explain the state of this saturated market. Once again, political factors play an important role.
- Intermediate goods as the main victim of multi-sided de-globalization. Developing at a more rapid pace, compared with other sectors, the stalling of trade in intermediate goods is one of the best illustrations

of the fact that globally integrated business models are the most impacted by the current shocks on cars and electronics.

In such a context, export-driven economies, largely relying on the dynamism of foreign demand, are suffering to a larger extent.

Third, GDP growth flatlined in almost 10 countries (Germany, UK, Italy, Singapore, Hong Kong, South Korea, Russia, Brazil and Argentina), increasing fears of recession for the remainder of the year. In Europe, resilient France and Spain contrast with weaker Germany, which is battling the trifecta of car regulation, Brexit and trade uncertainty (in that order). In the UK, a higher probability for a no-deal Brexit (40%) has contributed to an unprecedented level of uncer-

OVERACTIVE POLICY MAKERS WILL HELP AVOID A RECESSION, BUT EXPECT FLATLINING GROWTH

The global economy should avoid a full-fledged recession in 2019-20, thanks to economic policy initiatives, including: (i) a positive, even if moderate, fiscal impulse from the U.S., Eurozone and China; (ii) global monetary stimulus visible in H2 2019 as the number of central banks easing their policy stances is at its highest since 2009 and (iii) the trade dispute not intensifying much further, with the possibility of a “temporary relaxation” in the U.S.-China dispute. U.S. attention could switch to European cars in November, the deadline for the decision about auto import tariffs. However, the implementation could be delayed to 2020 and only be gradual (a 10% tariff first, vs. the 25% announced) as a way of pressuring the EU in trade negotiations, similar to current developments with China.

A soft landing of the global economy remains our baseline scenario, as superdovish central banks, and a new fiscal impulse (in the U.S. and China, and Europe to a lesser extent) help safeguard global growth, which could stand at +2.4% in 2020, albeit the lowest since 2009, down from +2.5% in 2019 and +3.1% in 2018. We expect quarter-

on-quarter growth to bottom out in Q1 2020 before moderately recovering in H2 2020. Such bottoming out should be caused by a correction in very high levels of inventories, the negative impact from the trade feud, an insufficient fiscal stimulus and consumer fatigue causing zero-growth in the U.S. while elsewhere, (nominal) growth will be flatlining (Eurozone, China, emerging markets as a whole). In 2020, the U.S. should decelerate to +1.6% in 2020, the Eurozone to +1.0% and China to +6.1%. Global trade of goods and services will grow by +1.7%, again the lowest rate since 2009.

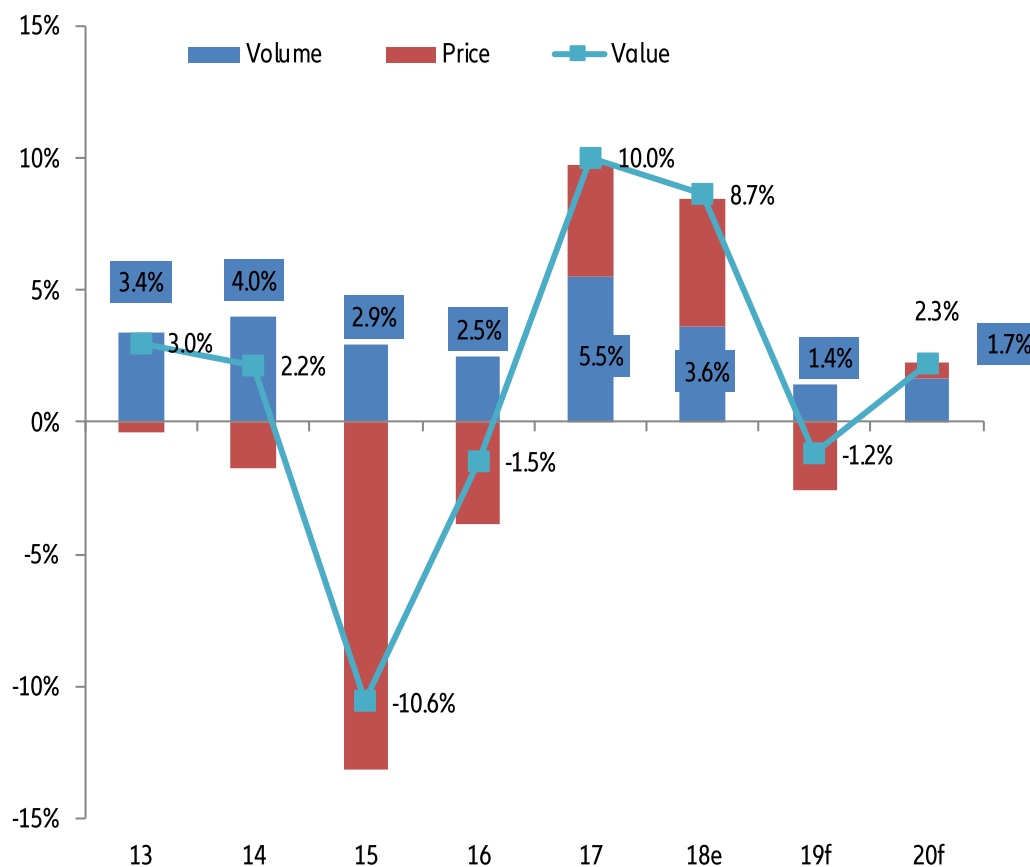
The consumer will still be a source of resilience amid a prolonged low-growth regime and persisting deflationary pressures for trade. A decoupling between service activities and manufacturing activities has been clearly visible over the last few months. Global economic growth will continue to be supported by the consumer, who will in turn support the services and construction sectors.

Indeed, the global easing will help keep interest rates at extremely low levels, while developments in the labor markets will only modestly deteriorate, which will help keep consumer confidence at comfortable levels. However, the negative impact from a continuation of the trade feud - which we estimate at -0.5pp of global GDP growth and more than 2pp on global trade over two years - will keep manufacturing production, notably for intermediate goods, at very depressed levels. In value terms, a strong dollar will maintain deflationary pressures on commodity prices (+2.2% after -1.2% in 2019).



Photo by Josh Appel on Unsplash

Figure 3: Global Trade of goods and services (% y/y)



Sources: Euler Hermes, Allianz

Indeed, we see deflationary forces persisting. Prices will be negatively impacted by three different factors, i.e. a progressive deceleration of global demand, the persistent strength of the USD (which will play its role of safe haven in a context of high uncertainty) and declining commodity prices because of the impairment of the global industrial cycle.

Export-driven economies see their growth forecast significantly revised on

the downside. Consumer fatigue in developed economies and tighter trade conditions are likely to severely weigh on the growth performances of export-driven economies. We have significantly revised on the downside the expected growth performance of Germany, Japan, South Korea, Taiwan and China. If uncertainty persists, commodity-driven economies could be next on the list of potential victims.

Emerging economies could suffer. A

strong USD is equivalent to a global tightening of monetary and financial conditions. Moreover, the deceleration of global demand has a relatively bigger impact on their growth. Finally, the most fragile economies, namely those that have the least domestic potential to absorb the external shock (fiscal buffers), are likely to be targeted by the market again.

OUR FRAGMENTED WORLD ENTERS AN “ILLIBERAL CYCLE”, CREATING VOLATILITY AS POLICIES YIELD DIMINISHING RETURNS

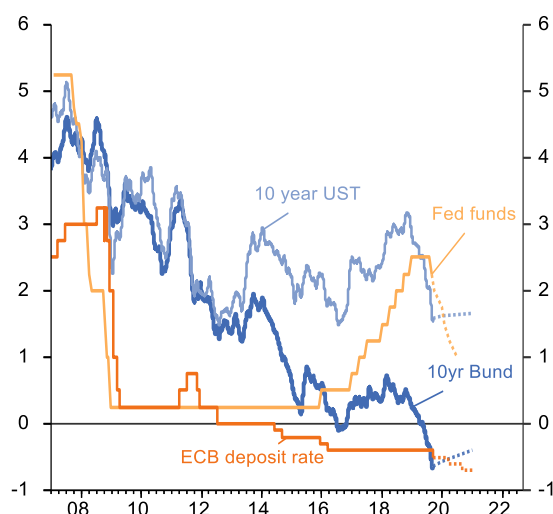
The leitmotif of this summer, with long-lasting and unforeseeable consequences, is interventionism: trade, monetary and fiscal policies have all contributed to significantly altering the free functioning of markets, a sign that the world economy is gradually entering what we call an “illiberal global cycle”.

Low-growth-low-inflation may hide more direct pass-through from political risks to financial markets, and the need to manage negative externalities of very interventionist policy-makers. Political risk prevails and could intensify, but big-ticket items should be resolved. Though we expect eventual pragmatism on the U.S.-China trade tensions, a last minute extension of Article 50 in the UK, and few(er) mistakes by neo-authoritarian in emerging markets, fiscal and monetary policy – as well as tax, tech, and competition policies – will continue to be used to offset trade uncertainty or win an election.

We expect diminishing returns of economic policies. Along with higher debt levels, negative-yielding debt and less directionality on capital markets, this will continue to undermine credibility of institutions, with no normalization in sight. The announced policy-mix in the U.S., Eurozone and China will not be

enough. Worldwide, about USD 16 trillion of government bonds – or 25% of the market - trade at negative rates, nearly triple the amount in October 2018. This indicates very depressed investor expectations in terms of economic outlook. Hence, central bank reactions have to be strong: We expect three rate cuts in the U.S. next year and two rate cuts by the ECB, as well as a higher pace of QE as soon as April 2020. The PBOC has announced RRR cuts in September to be followed by other cuts in October and November for those banks directly supplying loans to private and small companies.

Figure 4: Key interest rates, %



Sources: Markit, Allianz Research

Figure 5 :World GDP growth, %

	2016	2017	2018	2019	2020
World GDP growth	2.6	3.3	3.1	2.5	2.4
United States	1.6	2.4	2.9	2.4	1.6
Latin America	-1.2	0.9	0.9	0.4	1.1
Brazil	-3.3	1.1	1.1	1.0	1.8
United Kingdom	1.8	1.8	1.4	1.2	0.8
Eurozone members	1.7	2.6	1.9	1.1	1.0
Germany	2.1	2.8	1.5	0.6	0.6
France	1.0	2.4	1.7	1.2	1.2
Italy	1.2	1.8	0.7	0.2	0.4
Spain	3.2	3.0	2.6	2.1	1.7
Russia	0.3	1.6	2.3	0.7	1.1
Turkey	3.2	7.5	2.8	-0.2	2.3
Asia	5.0	5.3	4.9	4.5	4.3
China	6.7	6.9	6.6	6.2	6.1
Japan	0.6	1.9	0.8	0.9	0.4
India	8.1	7.1	6.8	5.3	5.8
Middle East	4.7	1.3	1.6	0.8	2.1
Saudi Arabia	1.7	-0.7	2.4	1.2	1.2
Africa	1.2	3.2	2.7	1.9	1.9
South Africa	0.6	1.4	0.8	0.5	0.0

* Weights in global GDP at market price, 2018

NB: The revisions refer to the changes in our forecasts since the last quarter
Fiscal year for India

Source :Allianz Research

While monetary stimulus has worked well in the past, we believe it will be increasingly ineffective at current rates while it will feed into higher vulnerabilities. The credibility of central banks, notably the Fed, has been severely affected over the past few months. In addition, vulnerabilities and negative externalities from central banks are expected to be visible in 2020. Debt accumulation, from already high levels, could start to be a cause of worry in the U.S. and China, notably as regards to the private sector and in the case of a too-fast-and-badly-managed exit from such accommodative monetary policies. Thus, the potential for systemically large fiscal stimuli are rather limited in a context of approaching elections in the U.S. (even if Democrats and Republicans have showed some capacity to reach a bipartisan agreement on the debt ceiling issue) and fiscal modera-

tion in China (for structural policy purposes) and Europe (for sustainability purposes). In Europe, private sector debt, although rising sharply in recent years, remains lower compared to China and the U.S. (100% of GDP compared to more than 200% in China and more than 150% in the U.S.). In addition, total savings also remain high in Europe. The ratio of private sector debt to total savings is thus relatively lower in Europe: 3.8 compared to 4.3 in China and 8.3 in the U.S. Overall, we believe the monetary impulse will be delayed to H2 2019 and will help stabilize at low levels the economic activity in big economies.

A more fragmented world also means volatile commodity prices (~70\$/bbl for oil), currencies (3-5% depreciation on average) and capital flows for emerging markets.

To exit these limbos, there are two upside possibilities, and two downside risks. Potential positive developments include: an electoral bifurcation in the U.S. in 2020 and a moratorium on protectionism (40% v. 60% for more of the same) but less business-friendliness; and a sizeable fiscal response, from Europe, taking the baton from the U.S. (20%). These would call for rapid normalization by central banks to avoid exuberance. On the negative side: a credit event from a zombie corporate in the U.S. for instance (20%); a major policy and a full-fledged U.S.-China trade and currency war (10%) will trigger a recession.

WHAT DOES THIS MEAN FOR MARKETS AND COMPANIES?

Relative to bonds, equities have been in a bear market for almost a year. For example, the S&P 500 has lost respectively 9, 15 and 18% against 10-, 20- and 30-year UST. The underperformance of broader equity market indices, like the Russell 2000 index, relative to risk-free bonds is even more pronounced: respectively -19, -23 and -25% against 10-, 20- and 30-year UST. If the past is any guide, such a pattern of relative performance typically heralds a recession. Market expectations about monetary policy tell very much the same story. This U-turn in short-term policy rates expectations is one of the most pronounced on record. It explains almost entirely the 170 bps fall in the yield on 10-year UST from 3.20 to 1.50% over the same period.

Interestingly, almost 70% of this decline in nominal bond yield is attributable to a fall in real yield, the remaining 30% to diminished long-term inflation expectations. Allianz Research estimated the UST to reach 1.6% and 1.7% at the end of 2019 and 2020. The Bund is expected to stay in the negative territory with -0.6% and -0.4% accordingly. The U.S. corporate sector has been doing reasonably well and continues to do so. Reasonably only, because - first - share buybacks boost EPS growth, and - second - aggregate dividends and share buybacks account for almost 90%

of aggregate operating earnings, a level which is probably not sustainable. That said, the S&P 500 aggregate earnings account for only 18% of the after-tax profits of the whole U.S. corporate sector. Especially from 2014 onwards, this broader aggregate has been growing at a much slower rate than the S&P 500 aggregate earnings. The profits of the non-financial corporate sector that are generated domestically have actually been in a recession, owing to net interest payments (despite the low level of interest rate), employees' compensation (despite the lack of wage inflation) and the amortization of fixed capital. Without the support of overseas profits and tax cuts, the profit recession would have been deeper.

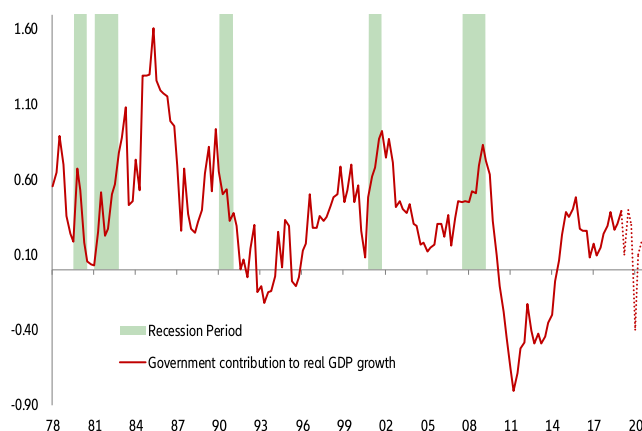
As in Q2, gold has had a good run in Q3 in all major currencies, bringing its year-to-date performance anywhere between 15 and 29%. Interestingly, the gold-implied volatility has risen whenever the gold price has increased. This is a quite unusual pattern: implied volatility typically rises when the price of the underlying asset falls and people are willing to hedge the downside risk. This unusual pattern indicates that gold is seen as a safe haven but with not enough confidence to take outright long positions.

Higher volatility from the U.S.-China trade conflict will keep the dollar strong (1.10 at end-2019 and 1.12 at end-2020 for the EUR/USD). The renminbi should depreciate further to 7.23 for the CNY/USD in a one-year term).

With regard to non-payment risk, we expect two out of three countries to register an increase in corporate insolvencies in 2019 and almost three out of five countries to end 2019 with more insolvencies than posted annually before the 2008-2009 global crisis. The upside trend would remain broad based in 2020. our Global Insolvency Index is forecasted to increase by +8%, both in 2019 and 2020, with a still noticeable increase in Asia (+15% in 2019 and +16% in 2020), a rebound in Western Europe (+3%) and a trend reversal in North America (respectively +2% and +4%).

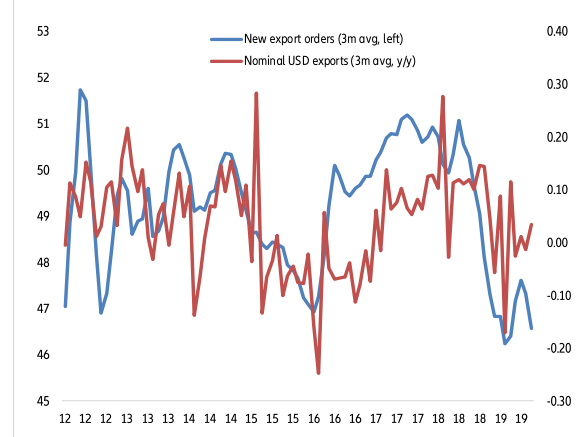
REGIONAL SCENARIOS

Figure 6 :Public expenditures' contribution to growth (pp)



Sources: National Sources, Allianz Research

Figure 7: Nominal exports and export orders in China



Sources: IHS, Allianz Research

No escape from the trade shock in the US, as a trough of activity is still expected in H2 2020. In Q2 2019, the U.S. economy grew by +2% q/q annualized compared with +3.2% q/q annualized in Q1 2019. As we expected, this deceleration reflected an impairment of the investment cycle alongside much lower performances on the exports side. We expect this trend to continue in the coming month as the manufacturers' confidence level has significantly declined. In particular, the accumulation of inventories in previous quarters calls for a lower contribution of investment over the next coming months, with a trough of activity expected in H2 2020. Thereafter, the easing of monetary policy should produce its first tangible and positive impact on growth. All in all, we expect U.S. GDP growth to reach +1.6% in 2020 compared with +2.4% in 2019 and +2.9% in 2018.

The bipartisan agreement reached on the debt ceiling issue has reduced the probability of a disorderly adjust-

ment of U.S. debt. But the probability of a U.S. recession is still non-negligible, albeit lower than before, because of two other fundamental changes: (i) the expected continuation of the Fed's accommodative monetary policy and (ii) the tightening of trade policy, with the latest protectionist initiatives likely to lead to higher prices of imported consumer goods. In 2020, we expect a significant increase in core inflation, which should remain well above +2% y/y. This in turn will induce an erosion of real disposable incomes and a progressive deceleration of consumption.

Shock absorbers are at play in China, but not enough to avoid a stronger deceleration in growth. China's economy further decelerated in Q2 as its GDP came out at +6.2% y/y compared with +6.4% y/y in Q1 2019. Stagnant producer prices and industrial profits in July don't bode well for investment in Q3, and consumption's contribution to growth was smaller in Q2, showing no

sign of improvement in Q3.

We expect new fiscal initiatives in the coming months in China, ranging from higher targets of bond issuances to lower controls on local government leverage and more infrastructure spending (we expect supplementary spending of 2% of GDP, compared with the 5% of GDP stimulus already announced). We also anticipate further easing on the PBOC side. Two additional 50bp cuts are planned for 15 October and 15 November for banks directly distributing loans to small and private firms. The PBOC is also likely to implement other cuts in the RRR before the year's end, new cuts in the medium-term lending facility (TMLF) rate and, therefore, cuts in the Loan Prime Rate (LPR), as well as envisaging letting RMB depreciate further. Despite this, we expect the Chinese economy to grow by +6.2% in 2019 and +6.1% in 2020, mirroring a downward revision by -0.1pp due to rising tariffs and uncertainty, as well as the longer time needed to see a full transmission of the ongoing stimulus.

Europe should avoid recession as services and construction are saving the day amid a prolonged recession in the manufacturing sector.

The manufacturing sector entered a technical recession in Q2, mainly due to the strong contraction in Germany (-5.1% y/y in June). We expect this to continue in H2 given (i) the escalating trade dispute, (ii) a higher likelihood that the U.S. imposes 10% tariffs on its car imports in November and (iii) the rise in uncertainty in May, which triggered a rebound in the level of company inventories.

However, growth in disposable income and low interest rates will continue to support consumer spending. In addition, we have observed positive substitution effects from the U.S.-China trade dispute since the start of the year, which allows for a lower negative impact on Eurozone GDP growth despite its intensification: -0.2pp on average in 2019 and 2020, bringing our Eurozone forecasts down to +1.1% and +1.0% in 2019 and 2020, respectively.

Following September's comprehensive policy package, we expect the ECB to up the doses of monetary policy stimulus again in Spring 2020 (cut of the deposit rate by 20bp to -0.7% and increase of the QE pace to EUR30bn per month) in the context of subdued macro prospects in the Eurozone and

further policy loosening by the Fed. This, alongside more fiscal stimulus (notably in Germany) will help economic activity to an extent, but we believe monetary policy has reached its limit in the Eurozone.

Germany goes from Eurozone growth-motor to laggard. After +1.5% last year, the German economy will expand by only +0.6% per year in 2019 and 2020. Even if a recession is avoided for now, the subdued growth outlook suggests that the threat of it will remain acute in the coming quarters. At best, amid global uncertainty, mini-growth rates can be expected in the coming quarters, with private consumption and construction investment keeping the German economy afloat. The private sector's low indebtedness and high savings will help cushion the negative impact. However, a fiscal stimulus may not have much of a positive impact (+0.2pp of real GDP growth).

France is expected to outperform Eurozone peers. We expect GDP growth at +1.2% both in 2019 and 2020 as a result of a fiscal stimulus (~10 bn EUR in 2019, then 7bn EUR in 2020). Along with low rates, this stimulus is primarily beneficial to residential investment, which is again above 10% of household disposable income. Private

consumption is also benefitting but with two laggards: cars (as elsewhere in Europe) and food (as a result of food inflation, +3.2% y/y in August). Overall, corporates are still enjoying favorable turnover growth (+5.2% in the manufacturing sector), but their order books decreased (-1 month during the last year), mainly as a result of lower demand for the car value chain domestically and abroad, leading us to expect a sudden stop for French exports in H2 2019 after a favorable performance (+13bn EUR) in H1.

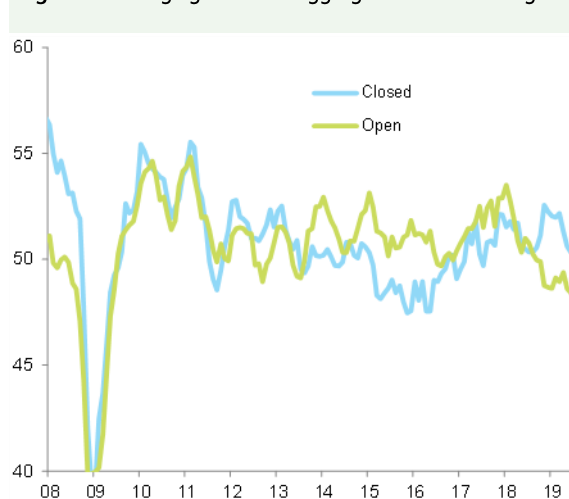
The Italian risk under control. The Italian economy has now treaded water for the past year, with external headwinds and elevated domestic political uncertainty weighing on economic momentum. Going forward, with the political outlook improving as the incoming PD & M5S coalition is likely to tone down Italy's fiscal spending plans and pursue a more conciliatory approach towards EU relations, domestic demand will start to show some signs of life again. Lower political uncertainty, coupled with the superdovish ECB, should keep bond spreads below 200bp. External headwinds will meanwhile continue to test the resilience of Italian exports until next year, so that overall we expect GDP growth to accelerate only slightly to +0.4% in 2020

Figure 8: Impact of 'no deal' Brexit, pp of real GDP growth per year



Sources: ITC, Allianz Research

Figure 9 :Emerging Markets: Aggregate Manufacturing PMI



Sources: Bloomberg, Allianz Research

While we see an extension of Article 50 as the most likely scenario for Brexit, the risk of a no-deal remains high (40%).

Both chambers of the UK Parliament have approved a law seeking to block a 'no-deal' if PM Johnson doesn't reach an agreement with the EU by 19 October. In theory, this should block a hard Brexit. However, given that he lost his majority in a kind of 'no confidence' vote, the only way forward seems to be early elections. The UK economy will enter a technical recession in Q4 2019- Q1 2020 on the back of the absorption of contingency stockpiling. We expect GDP growth to slow down to +0.8% in 2020 from +1.2% in 2019.

Emerging Markets: Political risk prolongation

In Emerging Markets (EMs), the growth slowdown observable is quite strong (+3.8% in 2019, after +4.4% in 2018). Export hubs (Mexico, Emerging Europe, and Emerging Asia) are experiencing spillovers from growth downturns in their key trade partners (U.S., Germany and China), as well as the impact of the global trade recession in goods observed in H12019. Many of these economies experienced borderline recessions (e.g. Mexico, Singapore, and Korea) and avoided them as a result of the fiscal and monetary buffers they have. The leeway for rate cuts, along with the fiscal space many EMs have accumulated, should help growth to recover partially in 2020 (+4.1%). However, it should come with increasing divergence. First, some EMs are not benefiting from lowering yields, mainly since they have accumulated imbalances and do not benefit from the same fiscal space (Argentina, Brazil, South Africa). In these countries, the repetition of capital flow reversals has the potential to have stronger consequences on the non-payment risk, as evidenced by the Argentinean default in August, and credit events are more likely in this environment.

Annual GDP growth in the Emerging Europe region as a whole is forecast to decelerate from +3.1% in 2018 to +1.7% in 2019, before picking up to +2.3% in 2020, mirroring the perfor-

mances of the largest economies, Russia and Turkey. Emerging EU has benefited from substitution effects from the U.S.-China trade dispute. Looking ahead, these substitution effects are likely to fade as the U.S. economy is expected to slow. Moreover, the important automotive sector went into contraction across Central Europe in mid-2019, and it could be faced with U.S. tariffs by the end of the year. Monetary policy is already loose in the Emerging EU and there is little leeway in the near term as inflation has picked up in 2019 to date and is above respective targets. However, there is fiscal policy leeway in most of the region and several countries have already announced fiscal stimulus measures such as increases in public sector wages and social benefits. Yet, caution is warranted in Romania (high fiscal deficit), as well as Hungary and Croatia (high public debts).

Latin America might as well wait for Godot before going through a sizable growth recovery (+0.8% growth this year, +1.3% in 2020 - excluding Venezuela - after +1.4% in 2018), as it embraces key features of the illiberal cycle: further monetary easing, prioritization of household purchasing power and interventionism amid persistently high political risk. In H1 2019, the two largest economies (Brazil and Mexico) avoided recession by a hair's breadth as reality checks occurred. We expect central banks to prolong their accommodative cycle to weather the regional slowdown. The Brazilian economy should grow slowly this year (+1% after +1.1% in 2018). Yet the cycle could be moderately boosted in 2020 (+1.8%) by the final adoption of a watered-down pension reform and the first privatizations starting to bear fruit, somewhat propelling business and consumer confidence and helping investment recover. In Mexico, we still expect a low-growth regime (+0.4% in 2019, +1% in 2020) with policy uncertainty (both domestically and externally) driving off foreign investment flows. Argentina's default and predicted election result mean an additional year of deep economic contraction in 2020, and heightened political risk for companies. Colombia stays on our watch-

list as its vulnerabilities keep increasing, with a widening of its current account deficit (-4.2% of GDP).

In the **Middle East**, political risk is not abating, while oil output cuts and lower-than-expected oil prices will take a toll on growth in the GCC. The Hormuz strait tensions between Iran on the one side and the U.S. and partners on the other side are dragging on. In our baseline scenario we still do not expect an outright war between the two sides, but the risk of policy miscalculation leading to war, as well as new proxy wars e.g. in Lebanon, remains elevated. Economic growth in the region as a whole is projected to slow down to +0.4% in 2019, before moderately recovering to +1.3% in 2020 (reflecting downward corrections by -0.2pp and -0.6pp, respectively).

In Africa, growth is expected to slow down again to +1.9% both in 2019 and 2020 (+3.2% in 2018), not far from the low experienced in 2016 (+1.2%). The strongest disappointment is coming from the main export hubs of the region, such as Morocco (+2% in 2019 and 2020), Tunisia (+1.2% in 2019, +0.5% in 2020) and South Africa (+0.5% in 2019 and +0% in 2020). The imbalances still existing in key economies of the region and the poor ability to implement reforms are also a key bottleneck, particularly in Nigeria and South Africa, Algeria and Angola (all these economies exhibit negative growth per capita). Poor crops in the region and the low ability to generate enough power (as a result of water shortages) are also key bottlenecks, particularly in Southern economies (South Africa, Zambia, Zimbabwe). Debt sustainability is not a region-wide issue, but some pockets of vulnerability are rising. South Africa is a case in point, since shortages of cash in State-Owned Enterprises are putting an upside risk to public debt.

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