



بنك الإمارات دبي الوطني
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US Visit Note: Surprisingly upbeat

We recently visited the US where we met with a number of market participants and a surprising degree of unanimity about the outlook for the US economy. The article below summarizes our main findings about the key issues facing the US and the rest of the world in 2019.

US growth to slow to trend in 2019-2020

The overall impression we took away was a fairly positive one whereby the US economy was expected to continue growing next year and in 2020, albeit at a slower pace than in 2018, but with little to no risk of a recession over that period, and with interest rate risks skewed to the upside of the Fed's forecasts of three hikes in 2019.

This was a little surprising, as much of the conjecture regionally and internationally appears to be anticipating when a recession will occur given the longevity of this economic cycle, and there was only one opinion on our trip that warned that this could indeed happen in 2020.

However, for the most part US growth was anticipated by most participants to be closer to the trend growth rate of 1.5-2.0%, but with the employment rate at risk of falling further towards 3.0% (from 3.7% currently) the chances are rising of inflation moving up slowly and steadily forcing the Fed to continue tightening. The US fiscal stimulus has been huge, worth approximately USD1.5 trillion over 10 years, and the peak impact is likely to be felt in H1 2019.

Market may be too dovish on rates

There was broad unanimity of the view that that the Fed will accordingly tighten 3-4 times in 2019, after raising once more this year in December, and with the possibility of a further hike(s) in 2020. Our own forecast has been that interest rates will be raised only twice in 2019, as we see the impact of higher rates starting to be felt in H2 2019 and we expect the economy to be feeling the cumulative pain from evolving trade tensions. This view appears to be held by the markets too which are still not pricing in the full three rate hikes implied by the Fed's dot plot in 2019. However, there are now much clearer upside risks to this view with the lagged effects of fiscal stimulus still being felt deep into 2019, albeit being offset by gradual monetary tightening and the impact of trade tensions.

In terms of the impact of recent Trump criticism of the Fed, this was thought likely to be minimal overall, although there was an observation that it might actually produce the opposite result to the one intended by causing the Fed to bring forward its hikes in 2019, ahead of the election in 2020. In any case it was highlighted in a number of meetings that the Fed Chair cannot be fired by the President and that Chairman Powell would likely be oblivious to Trump criticism, as would most of the FOMC.

There were a number of interesting observations about useful gauges of recession risks to monitor. Some of these were about the how the Fed reacts to equities and the yield curve, while others were more about economic data. The view about equities was that a bear market amounting to a 20% correction would have to be sustained over at least 3 months for it to meaningfully impact Fed decision-making. As far as the yield curve is concerned it was felt that only a vocal minority at the Fed is bothered by a flattening in the yield curve, as its shape reflects so many different variables, while most members are more relaxed about its' shape. In fact more important than the yield curve itself was thought to be the New York Fed survey of market participants in terms of what it says about expectations about the economy and Fed policy, and to some extent the economic data itself, in particular the non-farm payrolls data, which over time give a more reliable lead on recession risks.

Tim Fox
Head of Research & Chief Economist
+971 4 230 7800
TimothyF@emiratesnbd.com

Khatija Haque
Head of MENA Research
+971 4 230 7803
KhatijaH@emiratesnbd.com

End of balance sheet normalization.

It was thought likely that the Fed will signal an early end to balance sheet normalization next year, with the Fed likely to announce this at its March 2019 meeting, gradually lowering the reinvestment caps over the 6 months ending in September 2019. This fits with the picture of a Fed looking to tighten monetary fairly quickly, and reinforces the positive sentiment towards the dollar.

The impact of this on bond yields was viewed differently by various institutions. **For the most part the sense was that 10-year bond yields would be steady at around 3.0-3.30%**, which should result in the USD staying strong even as the yield curve flattens a little. However, there were some institutions that saw yields moving higher still as a result of increased supply of treasury bills and bonds, as the US government is expected to run the largest budget deficit of the major advanced economies at around 6.0% of GDP, and as foreign central bank demand for USTs diminishes.

Other than above factors, the main observation was that 2019 will have a very busy risk calendar. Trade wars, Iran sanctions, Brexit and 'Quitaly' were all mentioned as key issues, along with the end of ECB QE, North Korea's continued weapons program, the Mueller investigation, Turkey and other EM risks. The impact of the US mid-terms that were held last week will also be important on the prospective legislative agenda, as well as on the political volatility that might be expected to be experienced both within the US and internationally.

Trade wars to remain an issue in some form

On trade, it was pointed out that this is an issue that President Trump has firm beliefs about: namely that trade deficits are bad and trade surpluses are good. As such, the situation is likely to get worse before it gets better, and it could be the second half of 2019 before trade tensions come to an end. However, most analysts expected a deal to be reached earlier next year. Even then, tensions will not go away completely due to the different world views that the US and China have.

In terms of US-China there will be repeated rounds of testing each other's resolve, until continued pain forces an eventual compromise. The US tariff rate on USD200bn of Chinese goods will likely rise from 10% to 25% on the 1st of January and the back and forth will continue until weakening economies cause weak markets and a public pushback. China will retaliate and the US has promised tariffs on all remaining Chinese products. The possibility was also mentioned of Trump imposing quotas on Chinese imports if tariffs alone do not reduce the trade deficit. Only when both sides are out of ammunition will the basis for a negotiation be found.

In this context the USD will not be challenged as a reserve currency as reserve status results from a 'disorganized collective choice' and to change it would require a degree of coordination that is unlikely to be achieved in the coming years at least.

The inflationary impact of trade wars were thought likely to be limited as the strong dollar will help to offset it in the US. Also the fiscal stimulus will cushion any growth and confidence shocks. Agreements with South Korea, the EU, Japan, Mexico/Canada are a template as to how things will develop, and will not be settled until China agrees to buy a lot of US imports.

If all tariffs are imposed the impact will be to knock 0.5% off Chinese growth, taking it below 6.0% while the US could see 0.7% off its growth. The knock-on effect will be felt on China's supply chain, and the EU will be the next tension point with the US, although Merkel's exit could however make the US/EU

relationship easier. To some it was felt that the US's trade spat with everyone else could lead to more liberal trade policies in the rest of the world, including between the EU and China.

US political risk to remain elevated

The split Congress will result in gridlock until the 2020 Presidential election. Although there will be some areas where the Republicans and Democrats can find compromises (infrastructure, drug prices), overall there will be limited policy action, and Trump may see some value in forcing a government shutdown relatively quickly to demonstrate the dysfunctionality of Congress. It all suggests that the fiscal stimulus will fade and with it growth, but that the Fed will continue to tighten gradually.

The speed with which Trump changed his Attorney General suggests that he is gearing up for the findings of the Mueller probe, and there were hints that some big indictments could be around the corner. Democrats may ultimately have to choose between promoting legislation and doing deals on the one hand, and supporting investigations into Trump on the other, with the Presidential election in two years' time already in many people's minds.

Global risks and themes

- Italy was portrayed as an accident waiting to happen, with fiscal policy becoming unsustainable and structural reforms being reversed. All in all it could end up with a sovereign debt default and with Italy crashing out of the EU in a crisis that was described as 'Quitaly'.
- When it comes to Brexit it is harder to conceive of a no-deal Brexit, than to expect a deal that does not command a Commons majority. Even after divorce deal and a 3 year transition there was a view expressed that the UK could seek to re-enter the EU in a number of years' time, a view we find a little far-fetched. More likely it seems that the UK is heading towards a deal that commands no majority in Parliament, a situation that may end up with another referendum.
- The ECB was broadly believed to be running out of bullets and will not hike until September 2019, with the risk skewed towards a delay, especially if the Italy debt problems become worse which seems likely.
- China will adopt an aggressive easing to offset the slowdown affected by trade wars. It is widely recognized that China requires growth of at least 6% in order to keep unemployment from rising, even with an aging population and declining workforce. This highlights the inefficient allocation of resources/ savings in that economy.
- Finally, Japan has the best chance in 20 years to get out of deflation. The BOJ will be steady on monetary policy all the way to 2020, while concerns about debt seem premature, with most analysts of the view that the upcoming consumption tax increase next year was premature and inappropriate and would weigh on growth.

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Emirates NBD Research & Treasury Contact List

Emirates NBD Head Office
12th Floor
Baniyas Road, Deira
P.O.Box 777
Dubai

Jonathan Morris
General Manager Wholesale Banking
JonathanM@emiratesnbd.com

Aazar Ali Khwaja
Senior Executive Vice President
Global Markets & Treasury
+971 4 609 3000
aazark@emiratesnbd.com

Tim Fox
Head of Research &
Chief Economist
+9714 230 7800
timothyf@emiratesnbd.com

Research

Khatija Haque
Head of MENA Research
+9714 230 7803
khatijah@emiratesnbd.com

Anita Yadav
Head of Fixed Income Research
+9714 230 7630
anitay@emiratesnbd.com

Aditya Pugalia
Director - Financial Markets Research
+9714 230 7802
adityap@emiratesnbd.com

Daniel Richards
MENA Economist
+9714 609 3032
danielricha@emiratesnbd.com

Edward Bell
Commodity Analyst
+9714 230 7701
edwardpb@emiratesnbd.com

Mohammed Al Tajir
FX Analytics and Product Development
+9714 609 3005
mohammedtaj@emiratesnbd.com

Hessa Al Khawaja
Research Associate
+9714 609 3015
hessaalkh@emiratesnbd.com

Sales & Structuring

Group Head – Treasury Sales
Tariq Chaudhary
+971 4 230 7777
tariqmc@emiratesnbd.com

Saudi Arabia Sales
Numair Attiyah
+966 11 282 5656
numaira@emiratesnbd.com

Singapore Sales
Supriyakumar Sakhalkar
+65 65785 627
supriyakumars@emiratesnbd.com

London Sales
+44 (0) 20 7838 2241

Egypt
Gary Boon
+20 22 726 5040
garyboon@emiratesnbd.com

Emirates NBD Capital

Hitesh Asarpota
Head of Debt Capital Markets.
+971 50 4529515
asarpotah@EmiratesNBD.com

Investor Relations

Patrick Clerkin
+9714 230 7805
patricke@emiratesnbd.com

Group Corporate Affairs

Ibrahim Sowaidan
+9714 609 4113
ibrahims@emiratesnbd.com

Claire Andrea
+9714 609 4143
clairea@emiratesnbd.com