



## Global Economic and Financial Outlook

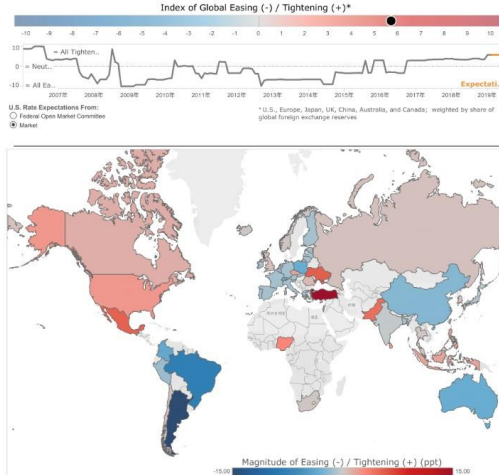
2019Q2 (Issue 38)

March 28, 2019

### Highlights

- The first quarter of 2019 witnessed sluggish global trade and investment activities, weakening manufacturing growth, decelerating growth rate of major economies, and prominent downward pressure.
- Looking ahead, the global economy faces such risks as the downturn of US economy, protectionism, asset bubbles, and geopolitical conflicts.
- Under the weak global economic recovery, major economies have slowed down the normalization of monetary policy, and some economies may stop raising interest rate or start lowering interest rate.
- With the global liquidity picking up, the positive factors in the global stock markets are stronger than the negative factors, and the stock markets of major economies may gain support in the second quarter.
- Europe will see many key events such as the European Parliament elections and the new ECB President in 2019. Whether Europe can work together for political breakthroughs and economic reforms is crucial to its long-term stable development.

### Global Monetary Policy Tracker



Source: www.cfr.org, BOC Institute of International Finance

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## **Global Monetary Policies Face a Turning Point**

### **-- Global Economic and Financial Outlook (2019Q2)**

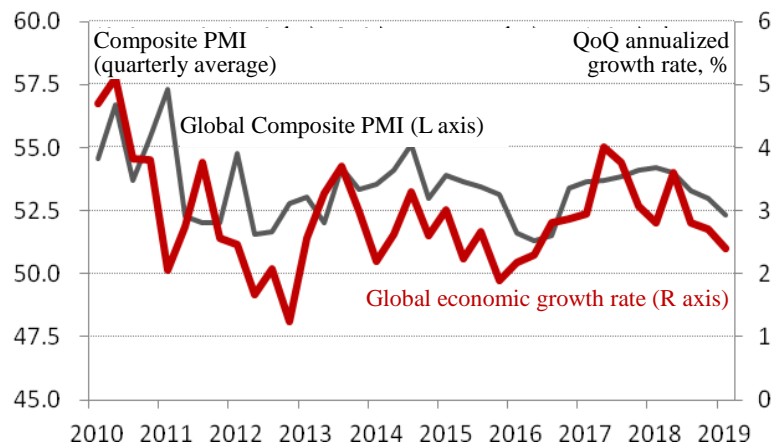
The first quarter of 2019 witnessed sluggish global trade and investment activities, weakening manufacturing growth and prominent downward pressure. Major economies experienced decelerated growth, with the start of cooling off in the US, continued downturn in Europe, and relatively moderate performance of Japan. Meanwhile, the emerging economies showed diverging performance, with slightly eased financial pressures.

#### **I. Quarterly Review and Outlook for the Global Economy**

##### **I.1 Downward pressure on the global economy is emerging**

Since 2019, the downward trend of global recovery has further continued. Growth in major economies has been sluggish, and international trade and investment activities have continued to shrink. According to the World Trade Organization (WTO) and the United Nations Conference on Trade and Development (UNCTAD), global trade in goods is estimated to grow by 3.0% in 2018, down 1.7 percentage point from the previous year; the global direct investment fell by 19%, marking a decline for the third consecutive year. In terms of leading indicators, the World Trade Outlook Indicator (WTOI) dropped to 96.3 in the first quarter of 2019, down 2.3 percentage points from the previous quarter, the lowest since March 2010. Specifically, the export orders, automobile production and sales, international air freight and electronic components all recorded a sharp decline. The Baltic Dry Index (BDI), a bellwether for global trade, has kept on falling since 2019, and fell about 50% by mid-March. Meanwhile, the Global Manufacturing PMI released by JP Morgan Chase in February was merely 50.6, down 0.2 percentage point from the previous month, the lowest in the past two and a half years, indicating that the downward pressure on the global economic recovery was emerging. Since 2019, international organizations have lowered their economic growth forecasts for the year successively. Based on preliminary estimates, the QoQ annualized growth rate of global economy in the first quarter of 2019 is 2.3%, down 0.4 percentage point from the previous quarter.

**Figure 1: Global GDP vs. Composite PMI**



Source: Wind, BOC Institute of International Finance

## **I.2 Recovery status and policy orientation of major economies**

**The US economy is cooling.** Since 2019, the US economic growth has slowed down, failing to continue the satisfactory performance of the previous year. Based on the falling inventories, slackening consumer spending, declining residential investment and government shutdown, we expect that the US economic growth in the first quarter will decrease remarkably to around 1.5%, down 1.1 percentage points from the previous quarter. The Fed’s monetary policy will shift from “hawkish” to “dovish”, the pace of interest rate hike will slow down, and the balance sheet reduction is expected to be concluded at the end of September 2019.

**The European economy remains weak.** The downward pressure on the European economy intensifies in 2019. Due to the combined impact of rising internal political risks, sluggish private consumption and external trade frictions, the manufacturing and service sector PMIs of the Euro area are both at historic lows. The economic growth rate in the Euro area is expected to stand at 0.7% in the first quarter, with monetary policy remaining accommodative in 2019. Plagued by the uncertainty of Brexit, British consumption and investment are sluggish, and the pound sterling fluctuates sharply, which has caused a big impact on the economy. The economic growth rate of the UK is expected to be 1.2% in the first quarter.

**Japan’s economy is performing modestly.** Presently, Japan’s economic performance is modest, but inflation remains low. The core CPI stays around 1%, which is still below the target of the central bank. Japan plans to raise the consumption tax from 8% to 10% in October, which may release some consumer demand in advance and in turn boost economic growth in the first half of the year. If the government introduces corresponding fiscal support policies, the economic shock generated by tax increase may be partially offset. Economic growth of Japan is expected to reach 0.3% in the first quarter of 2019, and Bank of Japan will maintain the easy monetary policy for a relative long period of time.

**The financial pressure of emerging economies eases up slightly.** As the Fed slows down interest rate hike and central banks of Europe and Japan maintain easy monetary policies, the financial pressure faced by emerging economies was alleviated to certain extent in the first quarter of 2019. The repatriation of capital is conducive to

stabilizing home currencies and warming up of the capital markets. However, a slowing global economy, deteriorating external demand and depressed commodities prices will create downward pressure on emerging economies. In 2019, affected by weak economy in the Eurozone, the economic growth rate of Central and Eastern Europe is expected to decline remarkably, the Asia-Pacific region will witness modest decrease, and the Middle East and Africa is expected to remain sluggish. Meanwhile, the Latin American region is expected to experience slow recovery from the recession of the past two years. It's expected that the overall economic growth rate of emerging economies in the first quarter will be around 2.8%, down 1.1 percentage points from the previous quarter.

### **I.3 Notable risk factors**

So far this year, the financial market rally has eased the investor nervous sentiment to a degree, but the following risks may become important factors triggering market volatility.

**The first is the downside risk of the US economy.** At the meeting of Federal Reserve Open Market Committee (FOMC) in March, attendees expressed their concerns on prospects of the US economy. Right now, the effects of Trump's tax cut policy are dwindling, and due to the constraints of the Democratic Party, a further fiscal stimulus in the US becomes less likely in 2019 and 2020. As the 2020 presidential election approaches, the US policy uncertainty increases, and another government shutdown may be caused by the national debt ceiling issue. Trade frictions have made the US trade deficit expand further, and net exports have become a bigger drag on the US economy. The above factors indicate that the economic downturn is looming in the US, and once the economy deteriorates more than expected, it will trigger market panic and global economic shocks.

**The second is the risk of protectionism.** Albeit a higher probability of a trade agreement between China and the US, we must be fully prepared for the possible extension and increased complexities of trade frictions between the two countries because Trump may change his China policy and rely on this hype to shift domestic focus, especially in the face of the US economic slowdown and reelection pressure. In the meantime, the US and Europe, the US and Japan, and other economies remain in conflict over industries such as automobiles, agricultural products and high-tech. What's more, the developed economies have tightened their foreign investment scrutiny, imposing constraints on global trade, industrial chain development and international direct investment.

**The third is the risk of asset bubbles.** Debts have piled up worldwide in the low-rate environment of the past decade. According to the Washington-based Institute of International Finance (IIF), global debt-to-GDP hit 318% in Q32018, up 33 percentage points from a decade ago, to which the increase of non-financial companies' debt contributed about one third, and non-financial companies' debt-to-GDP reached an all-time high of 92%. Unlike the pre-crisis story, the current rise in global debt is not primarily driven by bank credit but more by the massive bond issuances, particularly the issuances of high-yield bonds and corporate bonds in emerging economies. Organizations such as IIF and the Bank for International Settlements (BIS) have taken note of this structural change and warned of possible asset bubble risk. In the case of a sluggish economy and a lower investment return, there may be an unexpected fall in asset prices and herding behaviour in the market,

thus draining off the liquidity.

**The fourth is the risk of emergencies or geopolitical events.** In 2019, significant political events will take place in many countries or regions around the world. For example, Thailand, India and Argentina will hold general elections, and the European Parliament will launch elections. The situation in the Middle East and South America has made the two regions a battlefield of the US, Russia and Europe, and the geopolitical conflict there is still serious. At special time points, geopolitical emergencies may trigger risk aversion among international investors, leading to fluctuations in financial markets or commodity prices.

**Table 1: Forecasts for Key Economic Indicators of Major Economies in 2019 (%)**

Region	Year /Quarter Country	GDP growth, %			CPI growth, %			Unemployment rate, %		
		2017	2018	2019 <sup>f</sup>	2017	2018	2019 <sup>f</sup>	2017	2018	2019 <sup>f</sup>
America	USA	2.2	2.9	2.2	2.1	2.5	1.9	4.4	3.9	3.7
	Canada	3.0	1.8	1.5	1.6	2.3	1.7	6.3	5.8	5.8
	Mexico	2.0	2.0	1.7	6.0	4.9	4.1	3.4	3.3	3.5
	Brazil	1.1	1.1	2.4	3.5	3.7	3.8	12.8	12.3	11.6
	Chile	1.5	4.0	3.3	2.2	2.4	2.8	6.6	6.9	6.6
	Argentina	2.9	-2.4	-1.0	23.6	34.9	39.2	8.4	9.2	10.0
Asia Pacific	Japan	1.9	0.8	0.8	0.5	1.0	0.9	2.8	2.4	2.4
	Australia	2.4	2.8	2.6	1.9	1.9	2.0	5.6	5.3	5.0
	China	6.8	6.6	6.4	1.6	2.1	2.5	3.9	3.8	4.0
	India	7.1	7.3	7.4	3.3	4.0	3.5	—	—	—
	South Korea	3.1	2.7	2.5	1.9	1.3	1.5	3.7	3.8	3.9
	Indonesia	5.1	5.2	5.1	3.8	3.2	3.5	5.4	5.4	5.3
Europe and Africa	Euro Area	2.4	1.8	1.1	1.5	1.8	1.4	9.1	8.2	7.8
	UK	1.8	1.4	1.4	2.7	2.5	2.0	4.4	4.1	4.1
	Russia	1.6	2.3	1.5	3.7	2.9	5.0	5.2	4.8	4.8
	Turkey	7.4	3.0	0.2	11.1	16.2	17.2	10.9	11.0	12.9
	Nigeria	0.8	1.9	2.4	16.6	12.1	11.9	20.4	23.1	-
	South Africa	1.4	0.8	1.5	5.3	4.6	5.0	27.5	27.1	27.6
Global		3.3	3.2	2.8	3.2	3.8	3.1	—	—	—

Source: BOC Institute of International Finance

Note: “f” stands for forecast.

## II. Review and Outlook for International Financial Markets

### II.1 International financial markets see reduction of overall risk, but debt risk to beware

After the turbulent final quarter of 2018, global financial markets embraced reduction

of overall risk, rebound of investor confidence and risk appetite, and decline of risk premium in Q1 2019. The volatility of the major economies' stock, bond, FX and energy markets dropped significantly. In particular, the Fed's dovish remarks and the progress of Sino-US trade talks have pulled the US stock market back to robust growth, with volatility falling below the historical level. While central banks of the developed world signaled to shift to the relatively loose monetary policy, the earnings-driven investors returned to the emerging markets, causing an obvious trend of funds flowing back to emerging economies. According to the IIF, emerging market inflows (including stocks, bonds, bank credits and foreign direct investments) began to increase substantially in January 2019, ending a net outflow for five consecutive months. Net inflows to South Africa and India soared to USD16.4 billion and USD13.3 billion, respectively. Besides, in emerging economies, currencies were stabilized, and bank credit conditions tended to improve. The IIF's composite index of EM Bank Lending Conditions Survey is expected to be back to above 50, showing lending is expanding.

Among the risk factors affecting the stability of global financial markets, the following aspects are worthy of attention:

First, revenue and sales growth has begun to slow down at US companies, but their debt ratio is on a rise, especially the scale and proportion of high-leverage and high-yield liabilities increase too fast, making it the most vulnerable part of the financial market. Big banks worldwide are under pressure to increase their profits, while the flattening or inverted yield curves will directly affect the profit and asset expansion of banks and long-term institutional investors. Although the IIF's indices of bank lending conditions in the US, Euro Area and Japan remain in the expansion range of above 50, many indices, especially the US index, have begun to decline. In a survey, the Fed found that some US banks had begun to tighten credit standards, and US dollar assets registered a net outflow in the first quarter. These may weaken future financial stability in the US and the world again.

Second, SKEW (Black Swan Index), the skewness index of S&P 500 option price created by the Chicago Board Options Exchange (CBOE), fell from a high level in Q4 2018 but tended to rebound in Q1 2019. This reflects a higher expectation of investors for shocks in the market. The maturity structure of VIX shows that investors remain cautious about future prospects and expect the index to nudge up from the current reading of about 13. However, the Fed is now dovish, which will increase investors' risk appetite, possibly continuing to gather market risks and causing asset bubbles.

Third, investor sentiment in emerging economies remains fragile. Given a sudden deterioration in the market risk appetite, financial pressure will reappear, and the possible triggers include external pressures such as crisis in individual emerging economies or protectionism. Currently, bonds and syndicated loans of about USD3.9 trillion are due at the end of 2020 in emerging economies, typically in Egypt, Nigeria, Colombia, Lebanon, Chile and Argentina. Among such bonds and syndicated loans, foreign-currency debts account for about 33%. While corporate debt is growing rapidly, household debt in emerging economies continues to grow as well, reporting a 30% increase since 2016 and exceeding USD12 trillion. Household debt in the Czech Republic, India, Mexico, South Korea, Malaysia and Chile has increased by more than 20%. Non-bank financing in emerging economies is also growing fast, and the proportion of unsecured debt in the non-financial private sectors granted by non-banking institutions has risen from 17% in 2008 to nearly 25% today, with Chile

and South Korea scoring the fastest growth. The above-mentioned factors have heightened the external vulnerability of emerging economies.

## **II.2 US financial risks increase modestly**

In Q1 2019, decreasing risks across the US financial markets were accompanied by the improvement of risk indicators in lots of areas, and the monthly average of the US Risk of Financial Crisis Index (ROFCI) declined from 36.66 in the previous quarter to 32, remaining in the safe zone. The risk status improvement was mainly attributable to the restoration of market confidence since the Fed continued to signal the slowing of monetary policy tightening and the Sino-US trade talks made progress. However, against the slowdown of the US economic growth, the T-bond yield curves are almost inverted, and the downside risks will increase in the next two years; global economy, in particular the economy of emerging markets, slows down; and there is still uncertainty around Sino-US trade frictions. All these factors are threatening the stability of financial markets, making ROFCI edge up in each month of the first quarter. Looking into the second quarter, there are both positive and negative factors influencing the index, and it may increase modestly within the safe zone. If China and the US reach a trade agreement, or the Fed remains neutral in its monetary policy, the market stability will be strengthened; if the US T-bond yield curves narrow further or become inverted, the market volatility will intensify.

## **III. Specific Analysis**

### **III.1 Adjustment and evolution of global monetary policies**

The monetary policy cycle is normally counter-cyclical to the economic cycle. In 2017-2018, with the upturn of global economic situation and reduction of deflation risk, countries began to normalize their monetary policies. However, the normalization process has started to slow down as the driving forces of economic recovery are gradually weakening worldwide with a loss of synchronism, the growth of international trade is decelerating, and foreign direct investment has dropped for three years in a row.

#### **1. Manifestations of slowing normalization of global monetary policy**

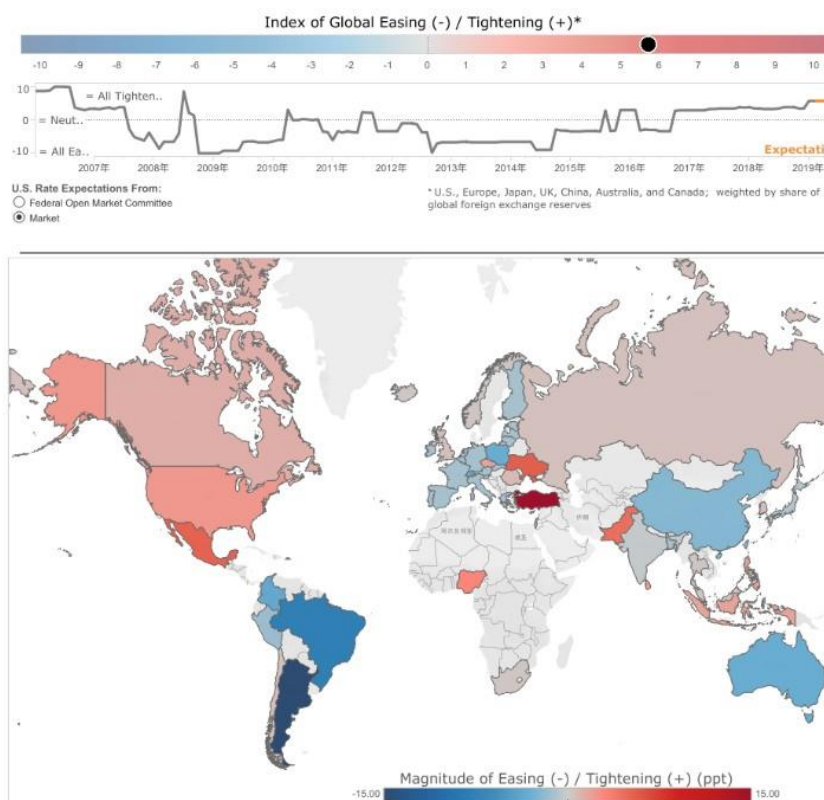
**The US:** After the country's capital market fluctuated sharply in Q42018, the Fed's attitude towards the process of tightening the monetary policy changed significantly. "Be patient" became a word most frequently mentioned by the FOMC members with voting right, and many hawkish officials turned dovish. In December 2018, the FOMC lowered the number of interest rate hike in 2019 from three to two. The FOMC statement in January 2019 deleted the expression of "gradually increase interest rate further", and emphasized that future interest rate adjustments would rely on economic data before making further changes to the stance of policy. The FOMC meeting in March released a stronger dovish signal than before, not only defining that the end of September 2019 will be the deadline of trimming the balance sheet but also indicating most Fed officials expect there will be no interest rate hike throughout 2019 and only one hike in 2020.

**The Euro Area:** The European Central Bank (ECB) just took the first step in the normalization of monetary policy in December 2018 by ending four years of bond purchases. However, in March 2019, ECB decided to keep the three key interest rates at their present levels, revise the forward-looking guidance, further loosen the monetary policy stance and postpone the earliest rate hike at least until the end of

2019. At the same time, a new series of quarterly targeted longer-term refinancing operations (TLTRO-III) will be launched after an interval for three years, featuring built-in incentives for credit conditions to remain favorable. This means that the euro area will launch a new round of monetary easing in 2019 instead of fully starting monetary tightening.

**Emerging economies:** In the year to date, some emerging economies have adjusted their monetary policies following the slowdown in global economic growth, weak external demand and suspension of monetary policy normalization in major developed economies. To stimulate the economy, the Bank of India has unexpectedly cut interest rate by 25 basis points in February, the first time to do so in the past 17 months.

**Fig. 2: Global Monetary Policy Tracker**



Source: [www.cfr.org](http://www.cfr.org), BOC Institute of International Finance

## 2. Reasons of slowing normalization

**First, global trade is slowing, economic growth is falling, and debt burden is rising.** With regard to trade, the reorganization of trade relations by the US in 2018 affected the global trading system considerably. Consequently, global cross-border trade in goods increased by only 3.0%, a sharp slowdown from 4.7% in 2017. In terms of economic growth, the IMF forecasts that global economic growth will decline to around 3.3% (by Purchasing Power Parity or PPP) in 2019 from 3.6% last year. Speaking of debt burden, the leverage level of the non-financial sector in the developed world has climbed from 200% in 2008 to around 250%, and most of debts (nearly USD2 trillion in bonds and loans) in the emerging economies will expire in 2019. If monetary policies continue to tighten, it will bring shocks to global economic growth and exacerbate the debt burden of both developed and emerging economies.

**Second, the US economic growth may be at its peak.** Being in expansion for as long as nine years, the US economy has now entered the final stage of economic recovery. Assessing from the economic indicators, most of the US confidence indices at the end of 2018 and early 2019 fell from high levels, and most manufacturing indicators slowed down in January and February 2019, of which the manufacturing PMI dropped to 54.2 in February, a new low since Trump took office. The labor market showed signs of cooling. In February, the US nonfarm payrolls increased by merely 20,000 after seasonal adjustment, a sharp decline from a year/month ago, hitting a 17-month low. The number of initial claims for unemployment benefits shot up to a high level. The market generally believes that the US economy will possibly enter the downtrend cycle, with a growth expected at 2.2%, 2.0% and 1.8% in 2019, 2020 and 2021, respectively. The US economic slowdown will cause the Fed to adjust the pace of monetary policy normalization.

### **3. Evolution direction and route of global monetary policies**

**The Fed is slowing its rate hike pace. More-than-expected deterioration in the economic conditions will possibly lead to another easing cycle.** There will be no rate hike in 2019 and one hike at most in 2020, after which this round of rate hike cycle will end. According to the latest FOMC meeting, the Committee intends to reduce the cap on monthly redemptions of Treasury securities from the current level of USD30 billion to USD15 billion starting in May 2019, and to conclude the reduction of its aggregate securities holdings in the System Open Market Account (SOMA) at the end of September 2019, thus finally keeping the balance sheet at USD3.8 trillion around. If the economic slowdown beats the expectation or the stock market plunges, it is possible that the Fed will bring rate hikes to an end before the end of 2019 and start another monetary easing cycle. After the FOMC meeting in March, the Fed Funds Futures Market projected that the probability for the Fed to reduce rate at least once was 35% by December 2019, in contrast with the prior day's probability projection at 24%. Rate cut is more likely to occur within the year.

**The economic growth in the Eurozone is trending down, and the normalization of monetary policy will be postponed.** The economic growth in the Eurozone is expected to decline further. With no significant improvement in constraints upon the economic growth of the Eurozone, it is expected that its economic growth will fall from 1.8% in 2018 to 1.1%. In this context, the Eurozone monetary policy will emphasize stability, without expected rate hike in 2019, while the "reinvestment program" (quantitative easing) will continue for a long time after the first rate hike.

**The Brexit is pending, and the Bank of England will advance its rate hike process slowly.** According to the Office for National Statistics, the UK's GDP growth was 1.4% in 2018, the slowest since 2013. Due to the uncertainty caused by Brexit, consumption, financial and real estate industries have been hit hard and the economic performance has been sluggish in the UK. For the time being, no matter how the Brexit process will evolve in the future, the economic growth resilience and potential of the UK is bound to weaken as a result. Therefore, facing the potential outcome of stagflation, the Bank of England is very cautious about continuous interest rate hikes. It is expected to raise interest rates by at most once in 2019.

**Japan, with a weak inflation, will not withdraw from the quantitative and qualitative easing policy at the moment.** In 2018, Japanese GDP grew by 0.8% YoY, a sharp decrease of 1.1 percentage points from the previous year. Moreover, Japan's

inflation has been below expectation, and the core CPI growth is far below the 2% target. Therefore, the Bank of Japan will not withdraw from the quantitative and qualitative easing policy for the time being and maintain the negative interest rate policy. The Bank of Japan will hold fast to the tone of the large-scale stimulus package.

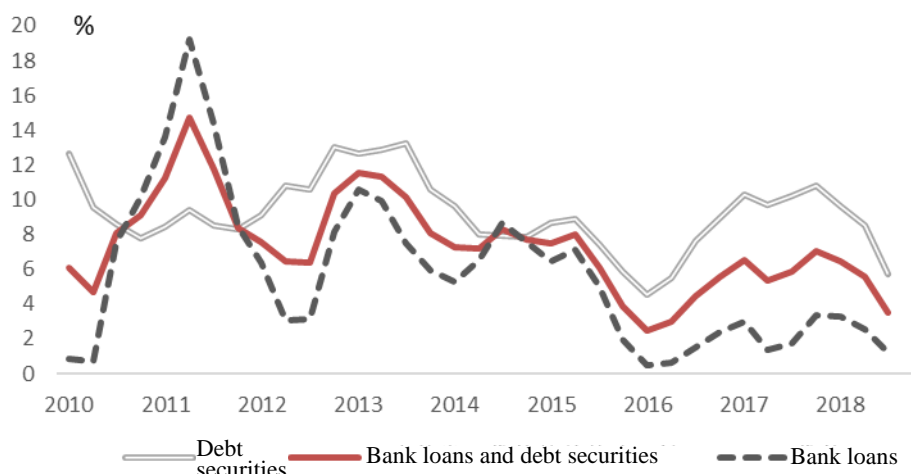
**Emerging economies may enter a rate cut cycle again.** It is expected that the overall economic growth of emerging economies will decline slightly from 4.8% in 2018 to 4.5% in 2019. Major emerging economies, including China and India, are facing downward pressure. The People's Bank of China is gradually easing its monetary policy, and the Reserve Bank of India has also exercised interest rate cuts during the year. In addition, emerging economies in the Asia Pacific such as the Philippines are recently under increasing pressure to cut interest rates as the pressure for economic growth is mounting. Major Latin American countries such as Brazil, Argentina and Mexico responded to capital outflow and currency depreciation with large rate hikes in 2018. This year, as the Fed's rate hike slows down and financial risks are mitigated, they may once again enter the rate cut cycle to cope with economic downward pressure.

### **III.2 Outlook of global capital markets**

#### **1. Global liquidity change amid adjustment of monetary policies**

Liquidity exerts a significant influence on the capital markets. In 2018, total assets of the central banks of the US, Europe and Japan peaked and then went down for the first time since the global financial crisis in 2008, continuing to tighten the global liquidity. According to the BIS global liquidity indicators which gauge the status of worldwide USD liquidity using the US dollar credit to non-bank borrowers outside the US and the issuance of US dollar debt securities to non-residents, US dollar credit (including debt securities and bank loans) to non-bank borrowers outside the US grew by 3.5% at end-Q3 2018 from a year ago. Specifically, the growth of US dollar-denominated loans slowed to 1.2% while that of debt securities issued stood at 5.7%. This marked the third quarterly slowdown of the indicators in a row since Q4 2017. However, with the normalization of the monetary policy of major economies slowing down in 2019, the downward trend of aggregate liquidity in the US, Europe and Japan may be reversed, which will drive the change of risk appetite in the international financial markets.

**Fig. 3: Continuous Tightening of Global USD Liquidity in 2018**

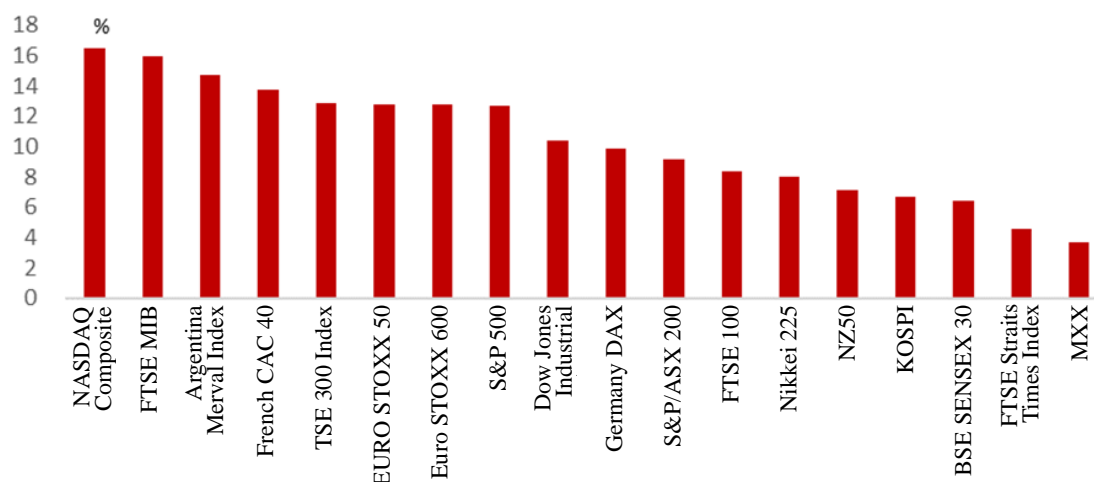


Source: BIS, BOC Institute of International Finance

## 2. Global capital markets review and outlook

In 2018, global stock markets fluctuated significantly, and all the major stock indices fell. The hardest hit went to European stock markets, with German DAX declining by 18.3% across the whole year. US stocks fell first and then rose, and the year-end decline narrowed compared with the mid-year, with S&P 500 sliding by only 6.2% from the beginning of 2018. Since 2019, the downward trend of global liquidity has been curbed, and together with the easing of trade disputes between China and the US, global stock markets have rebounded sharply. On the whole, the growth rate and rhythm of the stock indices in developed countries and emerging markets are quite consistent, showing a trend of synchronism. European and the US stock markets led the gains, with S&P 500 and FTSE MIB rising by 12.7% and 15.9% from the beginning of the year, respectively. After this round of gains, the global stock markets restored certain value from the overshooting in 2018.

**Fig. 4: YTD (March 20) Ups and Downs of Major Foreign Stock Markets**



Source: Wind, BOC Institute of International Finance

Looking into the second quarter, global stock markets are poised to face more positive factors than negative factors, and major stock indices may get certain support. First,

global central banks are ready to ease their monetary policies, thus boosting the risk appetite. Second, global trade tensions may be reduced to some extent. International investment banks estimated that global trade disputes had suppressed about 10% of the gains in global stock markets. So, if the trade situation is relieved, there will be room for further growth. Third, the profits of high-tech companies are increasing, which is good for the stock markets. According to the Q1 financial reports, large technology giants saw faster profit growth. For example, Facebook turned the highest quarterly profit in its history. The S&P Dow Jones Indices show that in the first two months of 2019, stocks of the four high-tech companies - Microsoft, Facebook, Apple and Amazon contributed about 12% to total gains of the S&P 500 index.

Looking at global bond markets, in the context of accommodative monetary policies, there is limited room for price rise of safe-haven assets such as bonds. By region, the US bond yield will vibrate downwards and the yield curves will continue to flatten. On March 22, 2019, the US Treasury 10-year bond yields sank below three-month Treasury bill yields for the first time since 2007, and the spread between the 2-year and 10-year Treasury bond yields was also close to inversion. Eurozone bond yields may remain low and volatile, but given the fiscal problems of member states, their Treasury bond yields will be divergent, and may fluctuate sharply in some countries. The UK bond market is highly uncertain. If it chooses the hard Brexit, the country's bond yields will fluctuate significantly. Emerging market bonds look promising, thanks to easing monetary policy of the developed world, capital inflows and high yields on domestic bonds, among other favorable factors.

### **3. Potential risks**

In 2019, global capital markets will possibly become more sensitive, especially to the following major risks:

**First, the US stocks are still at a high level.** The Shiller PE ratio, which measures the price level of US stocks, is still at a high level which has been ever seen since the global financial crisis in 2008. Though the capital markets are booming, downward pressure on the real economy is mounting. The slowdown of the US economy will inflict upon corporate earnings, which may be reflected in asset prices. In January 2019, the World Economic Forum (WEF) released a survey report listing the asset bubbles of some major countries as one of the top 10 global risks in 2019.

**Second, the negative impact of Brexit lingers.** On March 14, 2019, the British Parliament voted to seek a delay in Britain's exit from the EU. The veto of the two Brexit agreements further increased the difficulty of talks between the UK and the EU, and affected the credibility of the British government. In the future, the capital markets of the UK and other EU members will continue to face uncertainty. Due to the delay of Brexit, major capital markets in Europe will remain under great uncertainty.

**Third, there is uncertainty in Sino-US trade frictions.** The American and European economic data go weak, and Sino-US trade frictions are eased at this stage. Substantial progress was made in the seventh round of high-level trade talks between China and the US. Delaying the increase of tariffs has buoyed the market sentiment in a short term. But Trump recently announced on Twitter to delay the deadline for reaching an agreement. The US-China game may continue for a long time, adding uncertainty to the global capital markets.

**Fourth, emerging economies slow down.** Latin American countries, e.g. Brazil, Argentina and Venezuela, are suffering political and economic turmoil and exposed to high inflation and high debt risks. Since the manufacturing of India and Vietnam is highly dependent on the primary product market, they are witnessing restricted development, slower economic growth, limited space for increase of earnings in the capital market and lingering investment risks under the existing industrial structure.

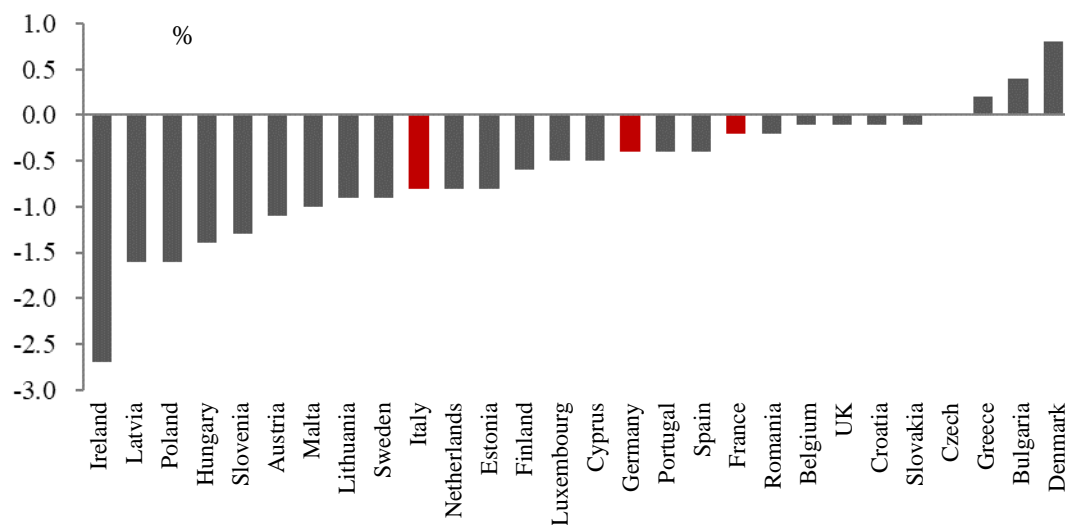
### III.3 Europe amid conflicts: where to go?

The current economy and politics of Europe are confronted with lots of challenges, e.g. rigid economic systems, gloomy prospects, rising anti-establishment sentiments and internal interest differentiation. In 2019, Europe will see many key elections, and it will go on a difficult journey amid lots of conflicts.

#### 1. European economy: rigid and gloomy

**The outlook for European economy is not optimistic.** Due to such factors as the global trade tensions and Brexit, the European Commission has significantly lowered its forecast for the Eurozone's economic growth in 2019, down from the previous 1.9% to 1.3%. The ECB and the Organization for Economic Co-operation and Development (OECD) are more pessimistic about the economic prospects of the Eurozone, projecting the growth at 1.1% and 1.0%, respectively. Internally, GDP growth rates of Germany and France as the core of Europe have dropped significantly, i.e. 0.4 and 0.2 percentage point lower than 2018, respectively; in Italy, the government budget has deteriorated, the reform process has stagnated, and economic growth is expected to decrease by 0.8 percentage point from the previous year; the expected growth of the UK will continue to decline by 0.1 percentage point under the current sluggish conditions; member states like Ireland, Latvia, Hungary, Poland and Slovenia which grew fast before are expected to lower their growth by one percentage point from 2018. The economic drivers of Europe have weakened from the periphery to the core, and then from the core to the periphery.

**Fig. 5: Expected Growth in 2019 vs Actual Growth in 2018 of EU Member States**



Source: European Commission, BOC Institute of International Finance

**Europe is responding to protectionism with protectionism.** In face of a higher

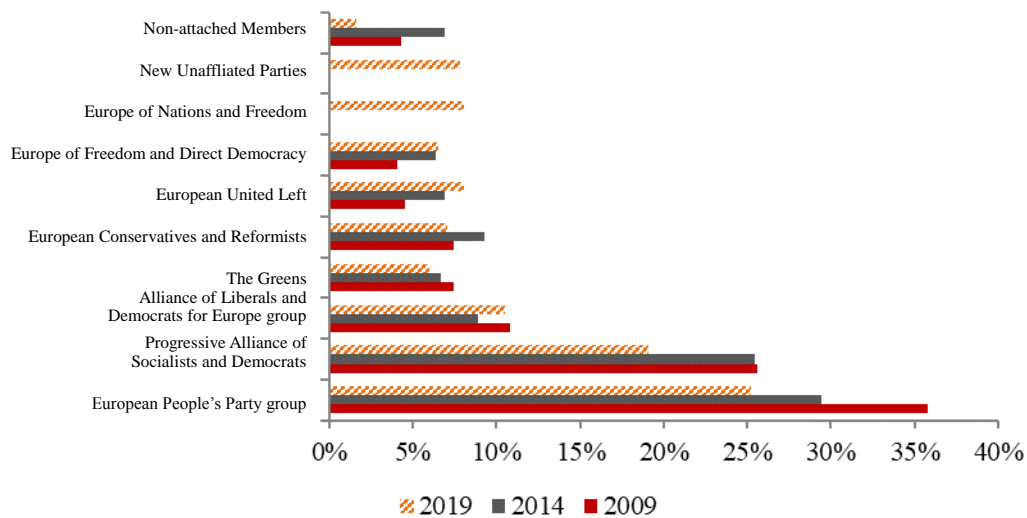
threat from unilateralism and protectionism, the relationship between world powers is characterized by greater competition than cooperation. In response to protectionism, Europe has resorted to the simplest and most direct way, i.e. protectionism. A draft EU framework for screening foreign direct investment was approved by the European Council on March 5 and will enter into force in April, with a transitional period of one year and a half. This was the first time for the EU to develop a foreign investment review framework comprehensively, which was aimed at better examining national security and public order and protecting the strategic interests of the EU. Member states such as Germany and France have launched plans or policies as a concrete action of implementing the “Europe First” ideology, in order to protect domestic enterprises and technologies and create regional united fronts. This deals a blow to the existing trade and economic order and further clouds the world with protectionism.

**A demanding and rigid regulatory system is constraining the economic development of Europe.** Europe values social justice and individual freedom, and thus has put a relatively demanding and rigid system in place, which restricts its economic development in many aspects such as the digital economy and competition rules. Firstly, the policies in force fail to adapt to the latest situation. In 2019, the European Commission killed off a highly anticipated Siemens-Alstom merger on railway business in the name of anti-monopoly. The rigid competition framework imposes constraints on enterprises within the EU to scale up. Secondly, the lengthy policy-making process cannot keep up with the pace of technological change. The *General Data Protection Regulation* (GDPR) which came into effect in May 2018 regulates how companies protect EU citizens’ personal data in an extremely strict manner. GDPR not only have difficulties in adapting to the varied digitization stages of member states, but also increases the overall development cost of digital economy and artificial intelligence in Europe, thus further jeopardizing the competitiveness of the new economy in Europe.

## **2. European politics: Eurosceptic and differentiated**

**Europe is seeing a rise in Eurosceptic sentiment and in anti-establishment political groups.** In Germany, the Far-Right Alternative for Germany (AfD) Party has developed into the third largest party in the Bundestag; in France, the National Rally has gained a considerable electorate base and become the country’s third largest political party; in Italy, two leading anti-establishment parties - The Northern League and the Five-Star Movement formed a coalition government in 2018; the anti-establishment forces are also strengthening in Austria, Hungary, Poland and the Czech Republic. In the past ten years, the Eurosceptic forces in the European Parliament have risen markedly, and most of the emerging parties are Eurosceptic. Three major Eurosceptic and anti-federalist political groups in the European Parliament, i.e. the European Conservatives and Reformists (ECR), the Confederal Group of the European United Left/Nordic Green Left (GUE/NGL) and the Europe of Freedom and Direct Democracy Group (EFDD), have taken more seats, increasing from 16% in 2009 to nearly one quarter in 2014. In the European Parliament elections to be held in May 2019, the proportion of anti-establishment party seats in 27 EU member states except the UK is expected to rise from the current one quarter to about one third.

**Fig. 6: Seats in the European Parliament by Party Group**



Source: European Parliament, Poll of Polls, Deutsche Bank

The rise of anti-establishment forces in Europe is attributable to the following three fundamental reasons:

**First, the European debt crisis has sowed the Eurosceptic seed.** The crisis has not only paralyzed the European economy but also cast lots of doubt on the institutional structure of “monetary union and fiscal autonomy” in the Eurozone. Countries with surpluses represented by Germany and countries with deficits represented by Greece and Portugal have many disputes over the issue of bailout. A unified monetary policy has made member states rely heavily on fiscal policy in dealing with external risks, increasing the debt burden of some member states. In the meantime, the responsible entities and policy objectives of fiscal and monetary policies are different, making it difficult to coordinate effectively, which has further enlarged the development gap among member states.

**Second, the disparity of powers and responsibilities has fostered the Eurosceptic forces.** In the EU, the contributions of some member states are not proportional to their powers. The Brexit is a typical example. The UK went out of the 2008 financial crisis earlier than its EU counterparts, and its due net contributions to the EU budget have increased rapidly since 2008, from GBP3.2 billion to GBP10 billion around. However, the UK’s voice in the EU has not been equally enhanced. Its seats in the Parliament still represent 10%, and it often has conflicts of interests with the Eurozone countries on such key issues as bailout of Greece. All these factors have solidified the will of the British people to leave the EU.

**Third, the immigration issue has ignited the Eurosceptic sentiment.** The influx of immigrants and refugees has caused European citizens to worry about their national identity and increased their dissatisfaction. Since 2004, with the continuous expansion of the EU to the east, a large number of EU immigrants have flooded into Central and Eastern European countries. The employment rate of EU immigrants is much higher than that of the natives and the immigrants from non-EU countries. As a result, people in EU member states believe that EU immigrants have grabbed their employment opportunities. At the same time, the refugee issue and the distribution mechanism

have further exacerbated the Eurosceptic sentiment. Central and Eastern European countries such as Poland, Hungary, the Czech Republic and Slovakia have made it clear that they will no longer accept refugees even if they are imposed EU sanctions. The internal contradictions in the EU have begun to intensify.

### **3. Europe amid conflicts: Hobble ahead**

In the future, Europe will draw a lesson from the past, seek political and economic reforms, and hobble ahead amid conflicts.

**In terms of the political structure, the political groups advocating establishment still dominate, but it becomes more difficult to advance reforms.** In the European Parliament, the pro-European European People's Party (EPP) and Progressive Alliance of Socialists and Democrats (S&D) are the two leading parties, with their combined seats representing 55% in the 2014 elections. According to the latest projection by the European polling organization -- Poll of Polls, in the forthcoming May 2019 elections, the seats of EPP and S&D may fall to 44%, but they will remain dominant in the European Parliament. At the same time, the Brexit process is facing numerous obstacles, which weakens the domino effect and dampens the Eurosceptic tendency to a certain extent. However, with the rise of anti-establishment forces, the interests of EU member states become more diversified, and Europe is trapped in more disagreements and costs in the course of reforms. In the future, Europe needs to reflect on existing systems and rules, bridge conflicts on important issues such as refugee policy and security crisis, balance domestic interests and collective interests of the EU, and advance European integration.

**In terms of the economic development, the Franco-German Axis heightens regional protectionism.** As the European Parliament elections draw near, Germany and France have both voiced their opinions and stances, reflected on the future of the EU and made strategic proposals. Germany unveiled a draft of the *National Industrial Strategy 2030*, supporting research and development in new technology innovations, protecting proprietary technologies of enterprises, encouraging strong cooperation within Europe and building larger European leading enterprises; France made several proposals in the "European Renaissance" plan, calling for reforms in three aspects -- freedom, protection and progress and emphasizing prioritizing the interests of European enterprises. Germany and France discussed changing the existing rigid framework, promoting the new joint plan for industrial policy in Europe, giving local enterprises more leeway in complementing respective advantages and forming industrial alliance, and enhancing the global competitiveness of Europe. In the future, Europe will seek a balance between a free and open internal market and the improvement of regional competitiveness, strengthen protectionism within the EU, and strive to become stronger again.

**In terms of the monetary policy, Europe will maintain the easing tone.** In the latest decision in March, the ECB has released a more than expected dovish signal and reversed its previous position. This was only three months after the end of the bond purchase program and the withdrawal of stimulus measures. The European Parliament elections and the subsequent distribution of powers among the members will in a way determine the nationality of the ECB President after Draghi, who will be elected in seven months. However, regardless of which country the new president will come from, France, Germany, Finland or whatever, and regardless of whether the president is dovish or hawkish previously, Europe will continue its easing monetary

policy in order to combat the downward pressure in light of the current weak economic data and suppressed core inflation.