GLOBAL MARKETS OUTLOOK

Road ahead still looks bumpy for equities

We have revised up our end-2019 forecasts for equities, which previously pointed to a large correction. But even without this big pothole, we continue to think that the road ahead for them will be bumpy. Admittedly, we had underestimated the extent to which looser monetary policy would shore up stock markets. But the further easing that we anticipate in some cases is already discounted. Meanwhile, with the global economy likely to remain in the doldrums, and the US-China trade war not going away, we suspect that corporate earnings will struggle to live up to investors’ expectations of a rebound.

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- Emerging Market Currencies
# Key Macroeconomics Forecasts

## Table 1: Forecasts

<table>
<thead>
<tr>
<th>% change on a year earlier</th>
<th>World Share²</th>
<th>2017</th>
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<th>Forecasts</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
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### Latest

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### Selected Policy Rates (%)

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<td>India</td>
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<td>2.55</td>
<td>2.30</td>
<td>1.80</td>
<td>2.25</td>
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Sources: Refinitiv, IMF, CE

1) Annual change at PPP exchange rates for aggregates. 2) % of world GDP in 2018 PPP terms. 3) Estimates based on our China Activity Proxy. 4) We use CAP-derived GDP estimates for China in aggregates for emerging Asia, emerging economies, and the world. 5) Excludes Venezuela. 6) PBOC 7-day reverse repo rate. 7) Based on our “repeated-delays” scenario for Brexit.
# Key Market Forecasts

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<td>UK¹ – FTSE 100</td>
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<td>Emerging Asia – MSCI</td>
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<td>Latin America – MSCI</td>
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## 10-Year Government Bond Yields (%)

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<th>End 2021</th>
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<td>Italy</td>
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<tr>
<td>UK¹</td>
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<td>0.75</td>
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<tr>
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## $-Denominated Government Bond Yields (%)

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<th>End 2020</th>
<th>End 2021</th>
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<tr>
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<td>5.20</td>
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<td>Latin America – JPM Morgan EMBI Global</td>
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## Selected Exchange Rates

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<td>US Dollars per UK Pound¹</td>
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Sources: Refinitiv, Bloomberg, CE

¹) Based on our “repeated-delays” scenario for Brexit.
The Economic Outlook

Worse to come for advanced economies and China

- Having already slowed from 4% to 3%, world GDP growth is likely to take another leg down in the next quarter or two, as growth in advanced economies slows to its weakest pace since 2012. The recovery into 2021 looks set to be modest, with global growth ending up at around its current subdued rate of 3%.

- Some disappointing data released at the start of October led to renewed headlines of an impending “global recession”. While there are clearly weak patches here and there, the world economy in aggregate continues to defy fears of an imminent collapse. Monthly activity and survey data suggest that global growth in the third quarter remained where it has been since the start of the year, at around 3% annualised.

- Most of the weakness in the world economy this year has been in industry, while the services sector has held up quite well. (See Chart 1.) The latest monthly hard data tentatively suggest that global industry has passed the worst. But we aren’t convinced. Timely business surveys still bode ill for German manufacturing, while in China, the prop to industrial demand from the construction sector is set to fade.

- Another key theme in 2019 has been the underperformance of advanced economies compared to emerging economies. (See Chart 2.) In Q3, advanced economies look to have grown by little more than 1% annualised, and we think that worse is yet to come.

- Weak profitability, growing spare capacity and uncertainty regarding both the trade war (which we expect to escalate) and Brexit make an unfavourable backdrop for investment. This year’s loosening of financial conditions will probably only support a recovery in business investment growth from the middle of 2020.

- Meanwhile, consumer spending growth is likely to slow. Stable average earnings growth and lower inflation have so far offset the drag on real incomes from weaker employment growth. (See Chart 3.) But softening hiring intentions suggest that jobs growth will weaken further, which means that wage growth is likely to ease.

- Moreover, consumers are unlikely to receive a further boost from lower inflation. Admittedly, the continued fall in backlogs of work supports our view that core inflation is set to fall. (See Chart 4.) But we also expect oil prices to rise to $70pb in 2020. If so, higher energy prices should offset the drag on headline inflation from lower core inflation. (See Chart 5.)

- The outlook is better for some emerging economies. Policymakers have more ammunition and are already offering stimulus in several cases, perhaps most notably in India. But Chinese stimulus is proving less effective than in the past. What’s more, consumers there will continue to suffer from high inflation related to African Swine Fever.

- We forecast global GDP growth to fall just below 2.5% annualised in Q4 and then to rise gradually over the course of next year. (See Chart 6.) We expect both the slowdown and subsequent pick-up to be driven by advanced economies, and the US in particular. Growth in emerging economies should be fairly steady, but this masks a structural slowdown in China and cyclical recoveries elsewhere. In year-on-year terms, our global growth forecast remains below consensus expectations. (See Chart 7.)

- Finally, world trade growth should remain subdued for a while yet. Leading indicators point to near-zero growth in late 2019 (see Chart 8) and a modest economic recovery in 2020 should limit the scale of the rebound.
The Economic Outlook Charts

Chart 1: Markit Global Manufacturing & Services PMIs

Chart 2: GDP (% q/q Annualised)

Chart 3: Real Compensation Of Employees & Private Consumption In Advanced Economies (% y/y)

Chart 4: Backlogs Of Work Component Of the DM Composite PMI & Advanced Economy Core Inflation

Chart 5: Oil Price & Energy Contribution To OECD Headline CPI Inflation

Chart 6: World GDP

Chart 7: World GDP Forecasts (% y/y)

Chart 8: World Trade Volumes & Leading Indicators

Sources: Refinitiv, Bloomberg, Markit, OECD, CEIC, IATA, CE
Developed Market Money Markets

Fed to end easing cycle in December, ECB to ease further in 2020

• Since the last edition of the Global Markets Outlook on 1st August, we have revised our forecast for US monetary policy. Back then, we anticipated that the federal funds rate would reach a trough in December at 1.5-1.75%. We now, think, however, that it will do so then at 1.25-1.5%, despite Jerome Powell’s comments after the rate was cut in October. The upshot is that we are now a bit more dovish about the prospects for US monetary policy during the rest of this year than investors, whereas previously we were significantly less dovish.

• Investors’ expectations for the federal funds rate further out in time have swung around a lot since 1st August, but changed little on balance despite the rate cuts in the meantime. (See Charts 9 & 10.) Overall, there is no longer a big difference between our view and that of investors of where the rate will bottom out. (See Chart 11.) This has prompted us to make significant changes to our market forecasts.

• In September, repo rates spiked due to a shortage of reserves in the US interbank market. In response, the Fed injected short-term liquidity and announced that it would resume purchases of Treasuries, initially at a pace of $60bn per month, in order to increase the level of reserves in the banking system. While the Fed was at pains to emphasise that its new purchases should not be seen as a resumption of QE, and it will only purchase very short-term bonds, its balance sheet will now start to grow again. Together with the ECB’s resumption of QE (see below) and the BoJ’s continued asset purchases, this means that the combined balance sheet of the major central banks is set to expand again. (See Chart 12.)

• The ECB announced a new stimulus package in September, including a cut in the deposit rate to -0.5% and the resumption of asset purchases from November at a rate of €20bn per month. It also introduced a tiering system for banks reserves and eased the terms of its TLTRO scheme, which will reduce the costs of negative rates for commercial banks.

• This move was widely anticipated, and investors have pared back their expectations of further easing slightly since then. (See Chart 13.) In part, that may be due to objections from several influential Governing Council members, which suggests that there could be significant resistance to easing policy further. Nonetheless, we still expect the ECB to cut interest rates by a further 30bp and increase its monthly asset purchases to €30bn per month next year as the euro-zone economy continues to slow and inflation remains below target.

• In the UK, the outlook depends in large part on how Brexit and the recently-announced general election play out. Expectations for interest rates have risen as the likelihood of a no-deal Brexit has fallen over the past couple of months, but investors still expect a cut by the BoE next year. (See Chart 14.) Our view is that the Bank will cut by 25bp unless a deal with the EU is agreed early next year, and that there would be significant monetary easing in the case of a no-deal exit. But if a deal is agreed, we think that the Bank’s next move will be to raise interest rates. (See Chart 15.)

• In Japan, the central bank made no changes to its policy stance after its comprehensive review in October. Nonetheless, investors are still discounting a small cut in short-term interest rates at some point over the next twelve months. (See Chart 16.) We don’t think that the BoJ will ease policy further, as it remains concerned about the adverse effects on the financial sector.
Developed Market Money Markets Charts

Chart 9: Short-Term Rates Implied In 2 Years’ Time By Overnight Indexed Swaps (Change Since 1st August, bp)

Chart 10: US Short-Term Rate Implied Over Time By Overnight Indexed Swaps (%)

Chart 11: US Short-Term Interest Rate (%)

Chart 12: Historical & Projected Net Asset Purchases* Of the Fed, BoE, BoJ & ECB ($bn)

Chart 13: Euro-Zone Short-Term Interest Rate (%)

Chart 14: UK Short-Term Rate Implied Over Time By Overnight Indexed Swaps (OIS) (%)

Chart 15: UK Short-Term Interest Rate (%)

Chart 16: Japan Short-Term Interest Rate (%)

Sources: Refinitiv, Bloomberg, Capital Economics
Emerging Market Money Markets

Broad-based easing cycle to continue, but lose pace

- We think that central banks across the emerging world will generally continue to loosen monetary policy until 2021, as economic growth and inflation remain fairly weak. The number of central banks cutting rates is likely to fall a bit, though, and a handful may even raise rates. (See Chart 17.)

- More central banks have resorted to interest rate cuts over the past three months. (See Chart 18.) In fact, since the last edition of the Global Markets Outlook, none of thirty key emerging market central banks we track has raised rates.

- In Russia, we don’t think that the monetary easing cycle is over yet. We expect a combination of below-target inflation and slow growth to prompt the central bank to lower its policy rate to 6.00% – which is the lower bound of its ‘neutral’ rate estimate – by early 2020. (See Chart 19.) And, if anything, the risks are now skewed towards interest rates being cut below 6.00%.

- Similarly, weak economic growth in our view will prompt further loosening in China. In August, the People’s Bank of China replaced its traditional benchmark lending rate and adopted – as well as slightly reducing – the loan prime rate (LPR) as the reference point against which banks price their loans. In the coming months, we think it will also cut its 7-day reverse repo rate – which usually sets a floor under banks’ funding costs. (See Chart 20.)

- In Brazil, the policy rate has been cut by a total of 100bp over the past few months, as inflation has remained below target and pension reform, which the central bank stated was a condition for further easing, passed its final vote in the Senate. But we doubt that the central bank will deliver as many additional rate cuts as investors anticipate, as the government will struggle to push through further reforms. We think that the policy rate will be lowered to 4.50% in December, and then remain at that level until at least 2021. (See Chart 21.)

- In India, the RBI has cut rates by a total of 135bp so far this year, and we forecast another 25bp rate cut in December. However, we think that this will be the last in this cycle. That is because we expect loose monetary policy to result in a gradual economic recovery over the coming quarters. That, compounded with concerns over the RBI’s independence, is likely to put upward pressure on inflation, preventing the central bank from easing monetary policy further. In fact, we think that it will change tack and raise rates before the end of 2020. (See Chart 22.)

- Turkey’s central bank has also delivered significant monetary policy easing over the past few months, lowering its 1-week repo rate by 10 percentage points, to 14%, as inflation fell and the US removed sanctions. While we think that the easing cycle will continue over the next few months, the central bank will also probably have to reverse course around the middle of next year, as inflation rebounds. Similarly, we think that rates will be raised in Romania and Hungary next year, given the persistence of inflation there, and in Colombia due to its weak external position.

- That said, most emerging central banks are likely to continue to ease policy over the next year or so (see Chart 23), as inflation falls and the global economic environment remains challenging. In particular, we are more dovish than investors about the prospects for interest rates in Emerging Asia in general over the next 12 months. (See Chart 24.)
Emerging Market Money Market Charts

Chart 17: Net Number Of EM Central Banks Tightening Monetary Policy

Chart 18: Selected Policy Rate Changes Since 1st August (bp)

Chart 19: Russia CPI Inflation & Policy Interest Rate (%)

Chart 20: China Market Repo Rate & PBOC Reverse Repo Rate (7-Day, %)

Chart 21: Brazil CPI Inflation & Policy Interest Rate (%)

Chart 22: India Policy Rates (%)

Chart 23: CE Forecasts Of Changes In Selected Policy Rates (bp)

Chart 24: CE Forecast For Policy Rate In 12 Months’ Time Less Rate Implied By Swap Markets (pp)

Sources: Bloomberg, Refinitiv, CEIC, Capital Economics
Developed Market Bonds

Bond yields likely to remain low across the board

- Government bond yields fell sharply across advanced economies after the US-China trade war escalated in early August and investors became more worried about the outlook for the global economy. By early September, the US 10-year Treasury yield was as low as 1.45%, barely 10bp above its all-time low from mid-2012. In many other advanced economies, yields did reach record lows. (See Chart 25.)

- Yields have since rebounded as US-China trade negotiations have made some progress and worries about the economic outlook have eased a little. In the US, the 10-year Treasury yield remains a bit lower than in early August, but elsewhere 10-year government bond yields are a touch higher. That reflects how investors’ expectations for US rates have fallen, whereas elsewhere they have risen. (See Chart 26.) We expect government bond yields in the major economies to end 2019 near their levels now.

- In the US, we anticipate that the Fed will cut interest rates by another 25bp in December. But we think that this will prove to be the end of its easing cycle. If we are right, bond yields are unlikely to revisit their lows soon – in the past, the 10-year yield has typically bottomed out just before the Fed delivers its last rate cut. (See Chart 27.) We have revised down our forecast and now expect only a small increase in US Treasury yields over 2020 to 2% (from 2.5% previously), as we think that the Fed will cut rates again and then keep them on hold for a prolonged period. (See Chart 28.)

- In the euro-zone, our view is that anaemic growth and weak inflation will push the ECB to loosen policy further next year and that this will anchor bond yields around their current extremely-low levels. Continued QE and a new Italian government with a less confrontational approach to the EU should also help keep a lid on the spread between Italian yields and those in the core countries. (See Chart 29).

- UK Gilt yields have risen as the threat of a no deal Brexit in the near term has dissipated. But the outlook continues to depend on Brexit and the upcoming general election. If the prospects of a no-deal Brexit increased again, that would push bond yields lower. On the other hand, if a deal went through, yields would probably rise. (See Chart 30.) The recently-announced election adds another element of uncertainty, and the fiscal loosening planned by both major parties suggests upside risk to Gilt yields.

- In Japan, the 10-year JGB yield fell below the lower end of the BoJ’s target range of ±0.2% in September but has since rebounded to -0.1% or so. We think that it will remain around current levels this year, and rise towards 0%, the midpoint of the BoJ’s target range, in 2020 as the policy stance remains broadly unchanged.

- Meanwhile, investment-grade corporate bond yields have not altered much overall since the last edition of the Global Markets Outlook. Credit spreads rose in August as risky assets struggled, but have since fallen back. We wouldn’t be surprised if credit spreads edge up a bit as the global economy slows further. After all, they have tended to do so in the past when output growth has faltered. (See Chart 31).

- Euro-zone credit spreads have fallen relative to those in the US and the UK this year as investors priced in renewed ECB QE purchases of corporate bonds. (See Chart 32.) We think that euro-zone corporate bonds will continue to outperform their US and UK peers, given that we expect the ECB to ramp up its asset purchases next year and focus those on corporate bonds.
Developed Market Bonds Charts

Chart 25: 10-Year Government Bond Yields (%)

Chart 26: Changes In Expected Interest Rates & 10-Year Government Bond Yields Since 1st August (bp)

Chart 27: US Government Bond 10-Year Yield, Fed Funds Target Rate & Rate-Cutting Cycles (%)

Chart 28: US Expected Short-Term Rate At End-2020 & 10-Year Treasury Yield (%)

Chart 29: 10-Year Government Bond Spread To Germany (bp)

Chart 30: 10-Year Gilt Yield & Forecasts In Different Brexit Scenarios (%)

Chart 31: US GDP Growth & OAS Of IG Corporate Bonds

Chart 32: OAS Of ICE BofA ML IG Corporate Bond Indices (bp)

Sources: Refinitiv, Bloomberg, Capital Economics
Emerging Market Bonds

EM bond yields unlikely to drop much further

- The broad-based rally in EM bonds has paused since the last edition of the Global Markets Outlook, and we doubt that yields will start falling again anytime soon. Although central banks in many emerging economies will probably continue to ease monetary policy, this is already discounted in most cases. And given our view that the global economy will remain weak, we doubt that spreads will drop further.

- The yields of EM local-currency sovereign, dollar sovereign, and dollar corporate bonds have generally fallen so far this year, at least until September. (See Chart 33 & 34.) That has reflected two global factors. The first has been a broad-based loosening of monetary policy. The Fed has switched from raising to cutting rates, and this has been mirrored in a similar policy shift by EM central banks.

- The second factor has been strong demand for risky assets, which has pushed credit spreads down. Admittedly, changes in the risk premiums of local-currency bonds are not directly observable. But the spreads of dollar sovereign bonds, which should provide a fair approximation, have narrowed significantly. (See Chart 35.)

- Over the past few weeks, however, the yields of EM bonds have stabilised. And we doubt that they will start falling again anytime soon.

- What’s more, we doubt that credit spreads will continue to fall. The current level of spreads does not reflect how much momentum the global economy has already lost (see Chart 36), and the spreads of EM sovereign and corporate bonds are still below their post-crisis averages. (See Chart 37.) Besides, we think that world GDP growth will slow further this year.

- With that in mind, dollar bond credit spreads are the lowest in Emerging Asia, both in absolute terms and relative to history. (See Chart 38.) We suspect that spreads there will rise a bit over the coming months, especially as China’s economy continues to slow.

- In Latin America, the average credit spread of Mexico’s dollar bonds appears high given the country’s credit rating (see Chart 39), and the fact that the López Obrador government has continued to pursue fiscal discipline. One reason is that the index contains the bonds of state-owned oil firm Pemex, which trade at a discount to those of the sovereign. Meanwhile, Brazil’s dollar bonds have been buoyed by progress on the new government’s pension reform, and its final approval in October. However, their credit spreads now look very low given the country’s non-investment grade credit rating, suggesting that the scope for a further fall is limited.

- Meanwhile, bond prices in Argentina have already fallen a lot after the finance ministry’s decision to reprofile some of the country’s debt. They now look consistent with typical recovery values after previous EM defaults. But history also suggests that there is plenty of room for them to fall even further, depending on how the new Fernández regime handles the debt restructuring. (See Chart 40.)
Emerging Market Bonds Charts

Chart 33: US & EM Average 10-Year Benchmark Government Local Currency Bond Yields (%)

Chart 34: EM Benchmark Dollar-Denominated Government & Corporate Bond Yields (%)

Chart 35: JP Morgan EMBI Global Regional Yield & Components (bp, Changes Since 31st December 2018)


Chart 37: EM Benchmark Dollar-Denominated Government & Corporate Credit Spreads (bp)

Chart 38: Stripped Spreads Of Major Regional Indices In JP Morgan EMBI Global (bp)

Chart 39: Spreads Of JP Morgan EMBI Country Indices & S&P LT FX Credit Ratings

Chart 40: Prices Of Argentina’s Dollar Bonds By Year Of Maturity & Approximate Historical Recovery Values

Sources: Refinitiv, Bloomberg, CEIC, CE
Developed Market Equities

Road ahead likely to be bumpy, even if another pothole in 2019 is avoided

- Although we expect the performance of developed market equities to continue to be held in check by sluggish economic growth and the ongoing trade war, we have removed from our forecast profile the temporary big correction in share prices that was implied by our previous end-2019 forecasts, for three key reasons.

- First, we now think that the Fed is more likely to exceed, than to disappoint, investors’ expectations for monetary easing during the rest of 2019. A key driver of the S&P 500’s rally this year has been a drop in the rate at which investors discount earnings, which has been fuelled by a fall in Treasury yields in the wake of the Fed’s change of tack. (See Chart 41.) While the fall in yields has been larger than we had originally envisaged, we no longer expect it to be reversed much this side of 2020.

- Second, we are now about half way through the Q3 earnings season and there is no sign of the results undermining the S&P 500. We have been right to anticipate a slowdown this year in the growth of earnings per share (EPS). (See Chart 42.) But the drag on the index has been more than offset by the reduction in the rate at which investors discount them. Even if, as we foresee, the economic data in the US undershoot expectations between now and end-2019, we suspect that the S&P 500 will hold up as investors fully discount a rate cut in December, which they are barely doing now.

- Third, when we last revised our end-2019 forecast for the S&P 500 in June, to 2,500, it was trading at around 2,900. So we were projecting a 14% drop over a period of more than six months. This seemed plausible to us, given our projection of slowing economic growth. After all, it was less than the 20%-old fall typically seen in a mild recession. (See Chart 43.) However, a combination of the market grinding higher and the passage of time means we would be shoehorning an unlikely near-20% drop into two months if we kept the forecast. Admittedly, the S&P 500 plunged in Q4 2018. But investors were worried then that the Fed would overdo monetary tightening. (See Chart 44.)

- The flipside is that we are no longer forecasting a post-correction rebound in the S&P 500 in 2020. And we still think that it will make no headway between now and the end of 2021, which would be a far worse performance than in recent decades. (See Chart 45.) This is partly because we don’t expect earnings to rebound in line with analysts’ expectations, given the bleak economic outlook. (See Chart 42 again.) It also reflects a view that the index won’t be boosted further by falling Treasury yields, like it was when the Fed also piloted the economy to a soft landing in the mid-1990s. (See Chart 46.)

- This year’s rally in the S&P 500 has been fuelled by an increase in its valuation, unlike for most of the period since the Global Financial Crisis (GFC). Nonetheless, we don’t think its valuation has risen to an unsustainably-high level. The 12m trailing earnings yield is ~5%, which is just 0.5pp below its post-GFC average. Admittedly, Shiller’s cyclically-adjusted earnings yield (CAEY) – the inverse of his CAPE – is only 3.4%, which is roughly half its average since 1881. But the CAEY is still high relative to the 10-year Treasury yield, unlike when the dot com bubble burst in 2000. (See Chart 47.)

- The revisions we are making to our forecast for the S&P 500 are mirrored in our revised forecasts for other major markets. (See Chart 48.) While we don’t expect exchange rates to have a big bearing on how they fare relative to one another, we do think that the relentless outperformance of US equities, a feature of the post-GFC landscape, is set to end. (See here.)
Developed Market Equities Charts

Chart 41: S&P 500 & 10-Year Treasury Yield (2019 YTD)

Chart 42: S&P 500/MSCI USA EPS (% y/y)

*Refers to MSCI USA Index, which closely tracks S&P 500, & fiscal, not calendar years.

Chart 43: S&P 500 Bear Markets In Past 50 Years

Chart 44: S&P 500 & Expected Change in Fed Funds Rate

Chart 45: S&P 500, Implied Paths & CE Forecasts

Chart 46: S&P 500 & 10-Year Treasury Yield In Mid-90s

Chart 47: S&P 500 & 10-Year Treasury Yields (%)

Chart 48: CE Forecasts For Major Equity Indices

Sources: Refinitiv, Bloomberg, S&P, NBER, Shiller, CE
Emerging Market Equities

We still think that the outlook is fairly poor

- We have revised up our year-end forecast for the MSCI EM Index. But we have not changed our view that the medium-term outlook is quite poor, given the prospects for the global economy and the US-China trade war. We expect the index to do little better than tread water between now and the end of 2021.

- The MSCI EM Index has bounced since the last edition of the Global Markets Outlook (see Chart 49) leaving it a long way above our previous forecast for the end of this year. And in the meantime, we have tweaked our projections for monetary policy – we are now anticipating a bit more easing than before from both the Fed and ECB. With that in mind, it makes sense to revise up our end-2019 forecast.

- Nonetheless, there are still several reasons to stick with our view that the outlook for 2020 and 2021 is not particularly bright. Some of the strength of the MSCI EM Index in the past couple of months has been down to one-offs, like the pension and corporate tax reforms in Brazil and India, respectively. Investors have also taken comfort from an apparent US-China “mini-deal”, which we doubt signals a real turning point in the trade war.

- More generally, we think that the outlook for EM corporate earnings over the next few years is poor, and worse than most analysts are anticipating. (See Chart 50.) That primarily reflects our below-consensus view of the global economy. The earnings of the MSCI EM Index tend to track the exports of the largest countries in the index, which suggests that they will struggle with the global economy stuck in the doldrums, even if the fortunes of a few large EMs improve a little. (See Chart 51.)

- Admittedly, looser monetary policy around the world, and the accompanying decline in bond yields, has supported valuations, helping to offset weaker earnings. But the bigger picture is that, even with this tailwind, EM equities have performed poorly since early-to-mid 2018 – around the time that actual and expected earnings started to decline – and remain well short of their peak then. (See Chart 52.)

- What’s more, we think that the big drop in bond yields is now behind us, even if most major central banks are likely to ease a little more. And the valuation of the MSCI EM Index as a whole is already some way above its average since the global financial crisis. (See Chart 53.)

- On a regional basis, we are more pessimistic about equities in EM Asia than those in Latin America or EMEA. That is largely because we think that China’s economy will slow further next year, and that US-China relations will deteriorate once again. The weightings of the industrial, IT and communications services sectors, which are arguably the most vulnerable to further rounds of the US-China trade and tech war, are particularly high in EM Asia. (See Chart 54.) And recent experience suggests that stock markets in Korea, Taiwan and China itself are especially vulnerable. (See Chart 55.)

- Having said that, we think that India’s stock market will be a comparatively bright spot in the region, and among EMs more generally. Of course, the shot in the arm it received from September’s corporate tax shake-up is not likely to be repeated. But even allowing for that, India’s equities have fared better than most of their EM peers since mid-2018. (See Chart 56.) Since firms in India’s stock market typically earn quite a large share of their revenues at home, their exposure to weakness in the global economy and the US-China trade war is comparatively limited.
Emerging Market Equities Charts

Chart 49: MSCI EM & World Indices (1st Jan. = 100, LC)

Chart 50: MSCI EM Index Actual & Forecast EPS (USD)

Chart 51: MSCI EM Index Earnings & Exports Of 10 Largest Constituent Countries (% y/y)

Chart 52: MSCI EM Index Price & Trailing/Forward Local Earnings (Local Currency, Jan. 2015 = 100)

Chart 53: MSCI EM Index Price/Forward Earnings Ratio

Chart 54: Sector Weights In MSCI Regional Indices (%)

Chart 55: Ratio Of MSCI China, Korea & Taiwan Indices To EM Ex. Asia Index (13th June 2018 = 1)

Chart 56: MSCI India Index & MSCI EM Index (13th June 2018 = 100)

Sources: Bloomberg, Refinitiv, CE
Developed Market Currencies

Macroeconomic backdrop still likely to be positive for the dollar

- Given our revised forecasts for stock markets, we no longer expect big swings in appetite for risk to support the US dollar this year and undermine it in 2020. Given the prospects for the global economy and the fact that the current trade truce between the US and China will not last in our view, we suspect that the dollar will hold its ground over the next couple of years.

- Aside from sterling, which has continued to be driven by Brexit, the moves in developed market currencies since the last edition of the Global Markets Outlook have generally been small despite some big moves in expected interest rate differentials. (See Chart 57.)

- In general, we were right to downplay the influence of expected interest rate differentials on the dollar’s value against other “major” developed market currencies this year. (See Chart 58.) And we think that this will continue to be the case between now and the end of 2021, especially as there is no longer any significant difference between our forecasts for the federal funds rate over the next couple of years and the path implied in the markets.

- Admittedly, there is some scope for monetary policy in the euro-zone to weigh on the euro against the dollar next year. While we are broadly aligned with investors in our expectations for rates in the US, we are more dovish with regards to those in the euro-zone. However, that is not the main reason why we expect the euro to depreciate against the dollar over the next year or so. After all, the relationship between relative interest rate expectations and dollar/euro has broken down since 2017. (See Chart 59.)

- Our call on dollar/euro is mainly underpinned by relative growth prospects in the two regions, which we think will continue to favour of the US (see Chart 60), and our view that the trade war between the US and China is not over.

- There seems to be a lot of optimism in the markets that the US and China will agree a lasting trade deal. We, however, expect all US goods imports from China to be subject to a 25% tariff by early next year. China is likely to respond with largely symbolic tariff increases of its own. More substantively, we think that it will loosen monetary policy further and allow the renminbi to weaken by close to 7% between now and the end of 2020. With this in mind, we think that the currencies of the developed countries most exposed to the trade war and/or to the structural slowdown in China’s economy will also suffer. This includes the Australian (see Chart 61) and New Zealand dollars.

- In contrast, we expect the Canadian dollar to do better than the US dollar next year. This is because we forecast that the price of WTI will rise to $67 per barrel by end-2020, from $56 currently, as oil demand recovers and OPEC supply remains constrained. (See Chart 62.)

- On balance, we think that the backdrop of slower-for-longer global growth and escalating trade tensions will generally be dollar-positive. (See Chart 63.) Meanwhile, sterling’s fate will probably continue to depend on Brexit developments. (See Chart 64.) A general election on 12th December may seal the fate of Brexit but could also have some other important implications. Financial markets may either have to cope with a combination of a “hard” Brexit and otherwise business-friendly policies under the Conservatives or a “soft” Brexit and otherwise less business-friendly policies under Labour. In our view, this will limit the upside for sterling whatever the election result.
Developed Market Currencies Charts

**Chart 57: Relative Interest Rate Expectations & US Dollar (Changes Since 1st August)**

- Change in US dollar (% LHS)
- Change in 2-year OIS gap (bp, RHS)

**Chart 58: Relative Interest Rate Expectations & US Dollar Index**

- Expected interest rates lower in US, dollar weaker

**Chart 59: Euro-zone/US Implied Overnight Rate Spread & Dollar/Euro**

- Expected rates higher in E-Z relative to the US, euro stronger

**Chart 60: Euro-zone/US Growth Gap & Dollar/Euro (q/q)**

- Growth lower in the EZ than in the US, euro lower

**Chart 61: Renminbi & Australian Dollars Per US Dollar**

- Weaker Renminbi (vs US$), weaker Aussie (vs US$)

**Chart 62: Oil Price & US Dollar Per Canadian Dollar**

- CE Forecasts

**Chart 63: Change In US Dollar From Now to End-2020 Implied By CE Forecasts (%)**

- Dollar stronger

**Chart 64: CE Dollar/Sterling Scenario-Based Forecasts**

- "Deal" scenario
- "Repeated delays" scenario
- "No deal" scenario

Sources: Bloomberg, Refinitiv, CE
Emerging Market Currencies

EM underperformance likely to continue

• With global growth set to remain weak, and the trade war likely to rumble on, we think that most EM currencies will fall further against the US dollar over the coming quarters.

• Most EM currencies are only slightly lower now than they were when we published the last Global Markets Outlook. (See Chart 65.) They were initially buffeted by an escalation in the trade war, and the PBOC allowing the renminbi to weaken through 7.0 per dollar. However, they have benefitted recently from signs that the US and China have reached a “mini-deal” on trade. Overall, though, EM currencies have gradually weakened over the course of 2019 despite a sharp turnaround in expectations for monetary policy in the US. (See Chart 66.)

• That may partly reflect many EM central banks embarking on easing cycles of their own. But appetite for risky assets – which tends to move in tandem with sentiment about global growth – often has a greater bearing on EM currencies than expectations for relative interest rates. That explains why moves in EM currencies have a far stronger correlation with equity prices than with the two-year US Treasury yield. (See Chart 67.)

• Against a backdrop of a slowing global economy and an escalating US-China trade war, demand for EM currencies has remained tepid this year. Given that we expect the global economy to slow further over the rest of this year and remain soft in 2020, we think that further weakness in EM currencies is in store.

• We expect China’s economy in particular to slow much further from here. Since we also think that the US-China trade war will resume before long, we forecast that the PBOC will allow the renminbi to depreciate to 7.5 per dollar by end-2020. That would be a headwind for the currencies of Asian EMs with close trade ties to China. (See Chart 68.)

• While hefty current account surpluses should provide support to the Thai baht and Malaysian ringgit, we think that the Korean will come under pressure.

• We also expect the currencies of EMs with large external vulnerabilities to struggle more than most, as is often the case when weak global growth subdues appetite for risk. Volatile politics and persistently-high inflation mean the Argentina peso and Turkish lira will depreciate sharply in our view. Judging by the size of current account deficits and/or short-term external debts, the Romanian leu and Colombian peso also seem vulnerable, albeit to a lesser extent. (See Charts 69 & 70.) Given a dire outlook for growth in South Africa, the rand is also likely to be a poor performer.

• Among EMs with stronger balance sheets, a few currencies may fare better. Despite a grim outlook for China’s economy, we expect a rise in copper prices next year to lift the Chilean peso and Peruvian sol. Meanwhile, we see little reason why the Polish zloty and Czech koruna should not be more resilient, at least against the euro. However, we see little upside for the Russian ruble. The outlook for growth is poor. And a fiscal rule mandates the central bank to make purchases in the FX market if oil prices rise, as we expect. We also think that the Brazilian real will struggle, as President Bolsonaro’s reform drive runs out of steam.

• Overall, we expect most EM currencies to weaken by up to 5% against the US dollar by the end of 2020. (See Chart 71.) That may seem downbeat, given our view that the global economy will slow rather than collapse, and equity markets stagnate, rather than plunge. But EM currencies have rarely fared that much better over the past decade when there has not been a broad-based upswing in global growth. (See Chart 72.)
Emerging Market Currencies Charts

Chart 65: Changes in EM Currencies Vs. US Dollar (Since 1st August, %)

Chart 66: CE EM Currency Index & 2-Year US Treasury Yield (%)


Chart 68: Goods Exports To China

Chart 69: Current Account Balances (% of GDP, 2019 CE Forecast)

Chart 70: Short-Term External Debt (% of FX Reserves & % of Exports)

Chart 71: Change in EM Currencies Vs. US Dollar Implied By CE End-2020 Forecasts (%)

Chart 72: CE EM Currency Index

Sources: Refinitiv, Bloomberg, Capital Economics
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