Schroders

For professional investors and advisers only.

Economic and Strategy Viewpoint

Q2 2020

To all readers, we are moving to a quarterly publication schedule for the Economic and Strategy Viewpoint. Regular updates on our views and research pieces will be published in between and will be distributed directly. We hope this will enhance and increase the timeliness of our analysis in the digital marketplace.

Keith Wade
Chief Economist and Strategist
(44-20)7658 6296

Azad Zangana
Senior European Economist and Strategist
(44-20)7658 2671

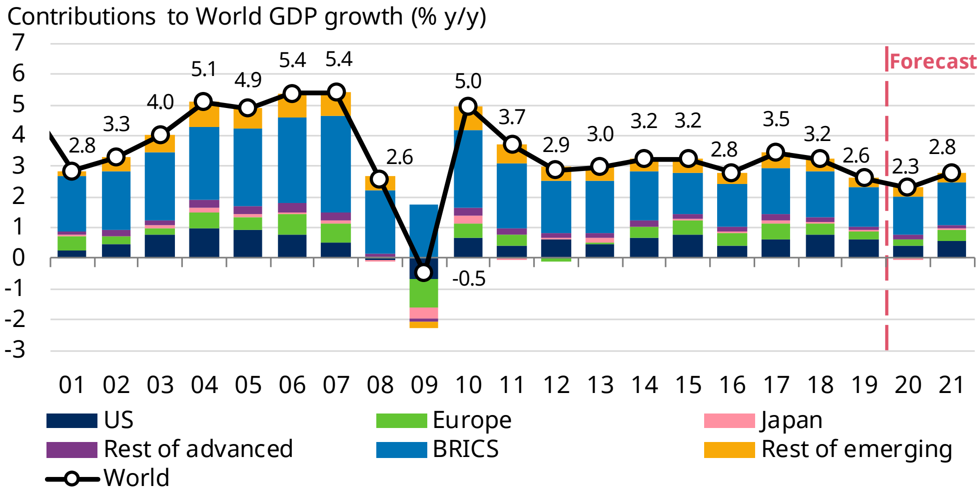
Craig Botham
Senior Emerging Markets Economist
(44-20)7658 2882

Piya Sachdeva
Japan Economist
(44-20)7658 6746

When China sneezes

- The coronavirus casts a dark shadow over the world economy by threatening to derail the revival in growth which began in the latter part of 2019. Economic indicators up to January continued to show a steady improvement in activity with business surveys signalling rising output and orders. However, confidence in the sustainability of the upswing has been undermined by the spread of the virus which has hit China hard and now threatens the rest of Asia and Europe.
- In response we are downgrading our global growth forecast for 2020 from 2.6% to 2.3%. The impact is concentrated in the first half of the year as the fall in demand and disruption to supply chains takes its toll on activity. Italy and Japan are likely to be in recession whilst output in the US, which is also affected by the problems at Boeing, is expected to have stalled in the first quarter.
- Thereafter, assuming the virus is brought under control, activity is expected to gradually improve in the second quarter and rebound more vigorously in H2 as firms start to catch up with the backlog of orders. The bounce back will be supported by easier policy as central banks in the US, China and the Eurozone cut rates and we see more use of fiscal policy in China.
- The considerable uncertainty around the virus means that we have introduced a new scenario – coronavirus pandemic – to capture a worst case where the virus spreads around the world causing a major dislocation in economic activity. The result would be a significantly weaker outcome for global activity compared to our base case.
- As a result the balance of risks around our baseline, where the upswing is delayed by the virus rather than being derailed, has swung back toward deflation.

Chart: World economy ails in 2020



Source: Schroders Economics Group, 26 February 2020.

When China sneezes

"It's not a question of if this (community spread) will happen, but rather more a question of exactly when this will happen".

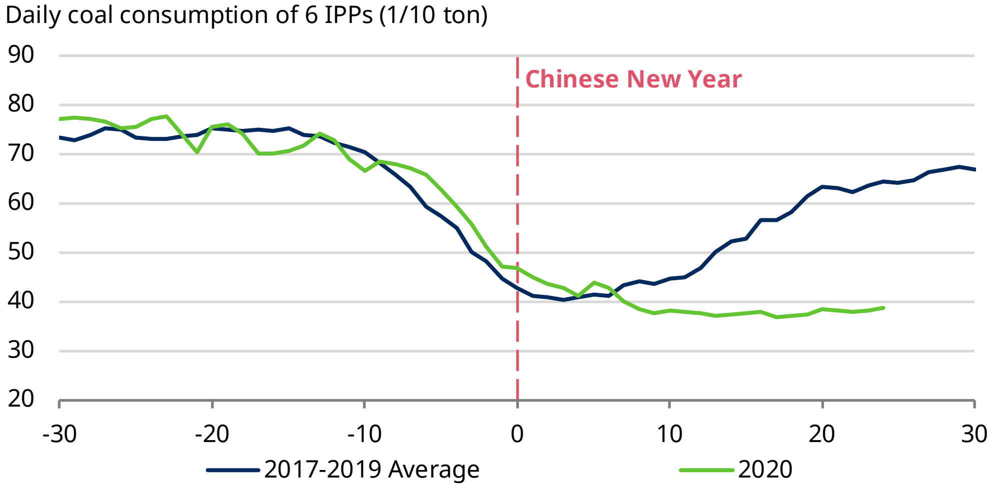
The US Centre for Disease Control and Prevention. US health officials warn of 'significant disruption' from coronavirus, 26 February 2020.

The coronavirus casts dark shadow over the recovery

The coronavirus casts a dark shadow over the world economy by threatening to derail the revival in growth which began in the latter part of 2019. Economic indicators up to January continued to show a steady improvement in activity with business surveys signalling rising output and orders. However, confidence in the sustainability of the upswing has been undermined by the virus, officially known as COVID-19, which has led to the quarantining and shutdown of large swathes of China's economy. Now the virus has emerged outside China with Korea, Japan and Italy particularly affected.

Like the virus itself, getting a grip on what is really happening is difficult. The Chinese authorities will publish GDP data for the first quarter on 16 April. No one expects this to be an accurate reflection of reality, but the scale of the downgrade will still be indicative, for demand as well as likely stimulus plans. Meanwhile, our activity indicator is suggesting a slowdown in activity to a 2.5% year-on-year rate in the Q1 compared with 6% at the end of last year. This would be consistent with the high frequency data such as daily coal consumption (see chart 1), property sales and traffic congestion which suggests a drop in current activity of more than 50%.

Chart 1: Tracking China's recovery



Source: Wind, AMAP, UBS, Schroders Economics Group. 26 February 2020.

Demand shock as China retrenches

Notwithstanding a further spread of the virus outside China, the impact on activity is being felt through the fall in demand from China and the disruption to supply chains. The former is deflationary and was reflected in the initial drop in commodity prices as China signalled a 30% cut in demand for oil, equivalent to a fall in global demand of 4%. For many industrial commodities, China accounts for more than half of global demand, whilst for cars and smartphones the figures are 34.5% and 29.2%, respectively.

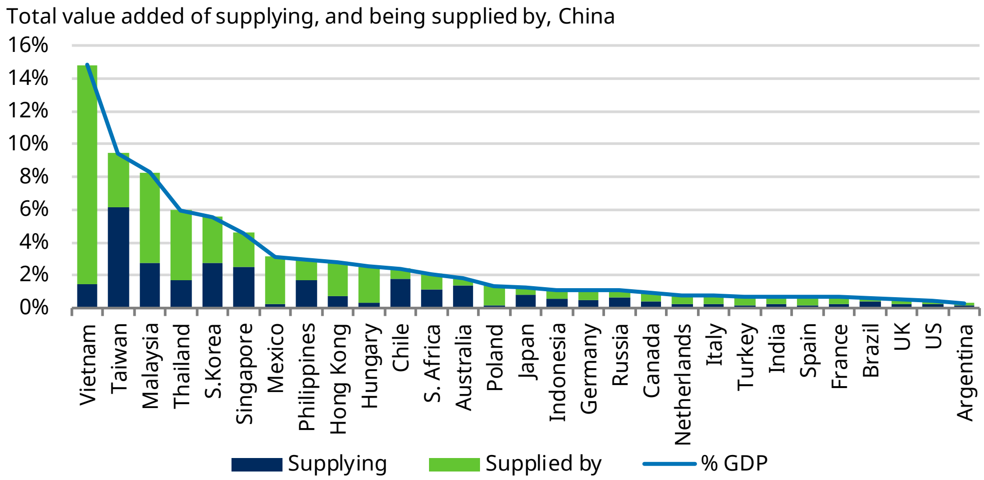
Supply side effects are gradually being felt with an increasing number of companies across Europe, Asia and the America's reporting shortages of parts. Fiat Chrysler has warned of closing a car plant. In the UK, construction equipment maker JCB has put its staff on short-time working. Budget clothing retailers such as Primark are concerned about supplies while hotels have noted the fall off in tourism. We can expect more stoppages and lay-offs as firms start to face cash flow problems.

Supply chains are also being disrupted, posing a threat to banking systems and activity

In China, service sector businesses such as restaurants, cinemas, hotels and transport have been severely hit by the restriction of movement. Banks have been directed to keep lending rather than foreclose on loans during this period, an advantage of the state controlled system which will no doubt mop up the bad debts at a later date. Elsewhere though, banks and credit markets are expected to become more stressed and the longer shortages persist and production is disrupted the higher the risk of default. This would pose a significant challenge for policy makers.

From a regional perspective, South East Asia is most vulnerable given its close ties with the China supply chain. For Vietnam, its contribution (in value added terms) to China's exports plus its dependence on imports from China makes it the most exposed – with just over 14% of GDP involved in either supplying, or receiving supplies from China. On this metric, the next five countries are all Asian and nine of the top 10 are from the emerging markets. By contrast, many European countries run at less than 1% of GDP. Although this suggests the developed economies are less exposed it should be remembered that it can only take the loss of one part that cannot be substituted to bring output to a halt.

Chart 2: Supply chain exposure to China



Source: OECD TiVA, Refinitiv Datastream, Schroders Economics Group. 21 February 2020.

CNY holds firm despite the crisis for now

One transmission mechanism from the crisis to the rest of the world which has not come into play, so far, is a sharp fall in the Chinese yuan (CNY). Economic crises are often accompanied by capital flight leading to a collapse in a country's currency. In theory, China should be no different. However, the currency volatility of 2015 led to a significant tightening of capital controls. When combined with likely intervention in the foreign exchange market by the authorities and state banks, the CNY has held firm and prevented a significant deflationary shock to the rest of the world.

Global growth recovery: delayed not derailed

Our baseline forecast assumes that the COVID-19 outbreak is contained and that activity in China can recover to its pre-virus level by the end of the second quarter. Global activity should then recover relatively rapidly as companies return production to normal. Our assumption is more cautious than some who see production levels being restored by the end of the current quarter. Some output will be permanently lost, particularly in the service sector, while natural caution on the part of individuals and the authorities will mean that it will take time for spending patterns to normalise.

On this basis the recovery is delayed not derailed, as the factors which supported the recovery remain supportive. Monetary policy is easy and the full benefit of last year's loosening in monetary conditions has still to fully flow through to activity. Similarly the reduction in trade tension as a result of the phase one trade deal between the US and China should lift growth as uncertainty ebbs. For the UK, there is the added benefit of an agreement to leave the European Union (EU), although we await a free trade agreement to replace existing arrangements.

Downgrade means 2020 growth forecast to be weakest since 2009

However, the near term impact from COVID-19 is significant and largely as a result of the virus we are downgrading our global GDP forecast from 2.6% to 2.3% for 2020 (see chart front page). Such an outcome would make this year the weakest since 2009, the height of the global financial crisis. Against this backdrop inflation remains relatively benign and we continue to look for a further easing in monetary policy in the US, Eurozone and China (see below).

US growth to stagnate in Q1

In the US, first quarter activity is being depressed by the decision by Boeing to halt production of its 737 MAX jet. With inventory of planes high due to safety concerns, delivery is dependent on regulatory clearance. Production of these new jets has been halted, but a gradual recovery in this area of industrial production should help lift growth in the second half of this year and into 2021. When combined with COVID-19 effects, first quarter growth is now expected to be flat and overall GDP growth for 2020 is downgraded from 1.8% to 1.6%.

Phase one trade deal to boost US growth

However, as mentioned above we still see a recovery with activity being lifted by last year's monetary easing and the phase one trade deal with China. The latter boosts growth directly for the US through the $200 billion increase in purchases from China. If realised this would be a significant leap in US exports to China equivalent to a rise of 56% in year one and 47% in year two, worth 0.4% and 0.5% of US GDP.

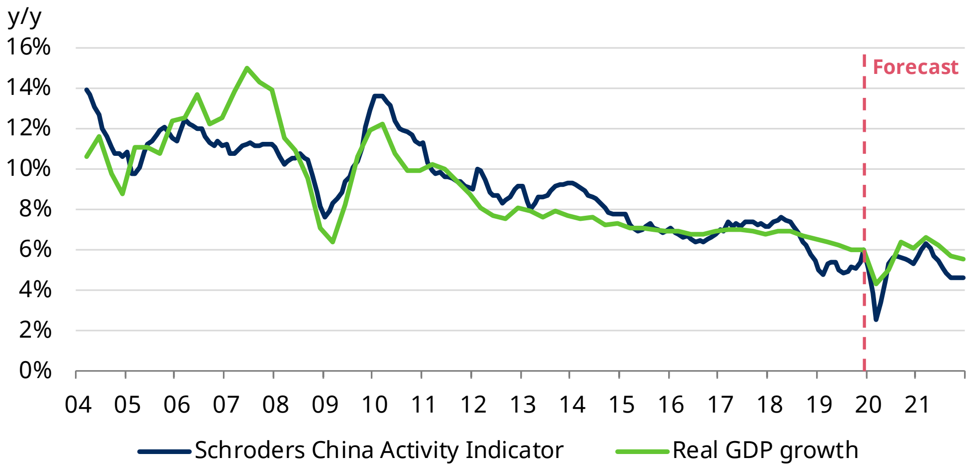
In practice, the impact on real export volumes will be reduced by higher prices and imports. Moreover, China will struggle to meet its obligations and we are only factoring in an increase of $150 billion in US exports over the next two years. This is still significant though and could have meaningful impacts in markets where increased orders for US firms displace those from other countries. Nonetheless, failure to meet the $200 billion target is likely to re-ignite the tariff wars between the US and China. Meanwhile, monetary easing is boosting the US housing market and, with the recovery later this year, 2021 is expected to see growth of 2.2% (previously 1.7%).

Impact of coronavirus on China and the wider emerging markets

With China at the epicentre of the coronavirus crisis, it should be no surprise that we downgrade emerging market (EM) growth from 4.5% to 4.1%. China itself accounts for the largest part of our downgrade (down 0.5 percentage points to 5.5%), even assuming a relatively swift resolution to the outbreak. More than 10% of the first quarter's working days have been lost, and the return to work will be gradual given the need for quarantine measures and a dispersed workforce after the new year holidays.

As with the US, the silver lining is that we do look for a V-shaped recovery (see chart 3). We assume the Chinese authorities have, after delaying initially, taken strong enough action to contain the virus and that we have passed the peak in cases. The country should begin to return to work in March, and pent up demand should then drive stronger growth. Growth should be materially stronger in the second half of the year and we would expect 2021 to record stronger growth than 2020. Policy measures will also be introduced to support the upturn with the authorities aware that China needs growth of at least 5.5% this year to meet its target of doubling income per head over the past decade.

Chart 3: China GDP growth and Schroders activity indicator



Source: Refinitiv Datastream, Schroders Economics Group, 26 February 2020.

Elsewhere in the emerging economies, the hit to growth is less severe. Brazil and India are relatively closed economies with low direct exposure to China, though India has its own problems, and the longer depressed Chinese demand weighs on commodity prices the greater the issue becomes for Brazil, which already suffers from torpid growth. In past years, the hit to oil demand and prices would have been more consequential for Russia, but policy measures aimed at insulating the economy from fluctuations in international oil markets should help minimise the spill-over.

Japan and Italy probably in recession

Coronavirus to tip Japan into recession

Meanwhile, we slash the Japanese growth outlook for 2020 from 0.2% y/y to -0.7% y/y. The severe contraction in Q4 (-1.6% q/q) following the rise in VAT was almost double the magnitude economists had expected and this large disappointment drives most of the downgrade. We now know that the lack of a surge in demand in Q3 reflected poor domestic demand rather than successful measures to smooth spending ahead of the tax change. A weaker than previously expected Japanese economy along with Japan's vulnerability to the impact of the coronavirus (through tourism, exports and its supply chains) leads us to downgrade the growth outlook for the first half of 2020. We now call for a Japanese recession in the first quarter. Early indications from the PMI and export data are that activity continues fall.

Looking further out, we still expect a recovery in growth in 2021, but nudge down our expectation to 0.9% y/y (from 1% y/y) as Japan regrettably loses out from China's commitment to buy more from the US resulting in China diverting demand away from Japanese manufactured goods.

Like Japan, the Eurozone saw a disappointing end to 2019 as GDP grew by just 0.1% q/q or 0.9% y/y in the fourth quarter. The continuation of weak external demand acted as a drag on growth, while domestic disturbances in the form of protests in France and Italy appear to have contributed to the downside surprise.

Italy also forecast to experience a dip in GDP

Domestic demand is expected to remain robust over the forecast horizon, although the coronavirus disruption is likely to have a significant, but short-term impact. For the major exporters, supply chains are likely to be disrupted, reducing both the supply of imported intermediary goods, and demand for finished final and capital goods, especially from Asia. Other member states, such as France and Italy, are also likely to suffer from reduced tourism activity. When combined with the coronavirus outbreak this could be enough to push Italy into a technical recession in the first quarter. Beyond the near-term disruption, the forecasts assumes a recovery in external demand which should lift growth from the second half of the year. Eurozone

GDP is forecast to fall from 1.2% in 2019 to 0.9% for 2020 (revised down from 1.2%), before recovering to 1.4% in 2021.

Table 1: Eurozone growth and inflation forecast by country

	GDP growth (%)			HICP inflation (%)		
	2019	2020	2021	2019	2020	2021
Germany	0.6	0.9↓ (1.0)	1.3↓ (1.4)	1.4	1.3↓ (1.5)	1.6↓ (1.7)
France	1.2	0.8↓ (1.2)	1.1↓ (1.3)	1.1	1.2↓ (1.5)	1.4↓ (1.6)
Italy	0.2	-0.3↓ (0.2)	0.5↑ (0.4)	0.6	0.8↓ (1.0)	1.2 (1.2)
Spain	2.0	2.0↑ (1.9)	2.1↑ (1.8)	0.7	1.1↓ (1.2)	1.5↓ (1.6)
Eurozone	**1.2**	**0.9↓** (1.2)	**1.4** (1.4)	**1.2**	**1.1↓** (1.3)	**1.3↓** (1.5)

Source: Schroders Economics Group, 26 February 2020. Previous forecast from November 2019 in parenthesis.

The UK bucks the trend

Meanwhile, the UK bucks the trend in the forecast update by receiving an upgrade to GDP growth for 2020 to 1.1% (previously 0.8%) before rising to 2.2% in 2021 (revised up from 2.1%). More aggressive destocking than had been anticipated at the end of 2019 removes a potential drag for this year. We therefore expect growth to gradually gather momentum as business investment begins to recover, followed by consumer spending. The government also appears ready to loosen fiscal policy by around 0.5% of GDP in the forthcoming budget, though the impact will be limited at first.

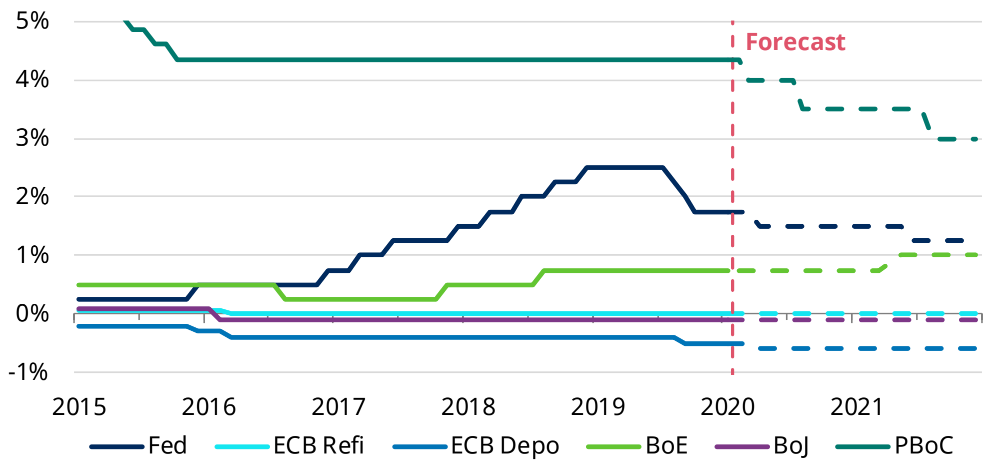
Policy response: further easing ahead

Benign inflation creates space for monetary policy to ease further

Global inflation remains relatively benign in the forecast, ticking up to 2.6% this year before declining to 2.3% in 2021. Lower oil and commodity prices combined with the lagged effects of last year's slowdown are expected to keep prices in check. Wages are likely to pick up further as labour markets remain tight, but not accelerate markedly. We do see some inflationary pressure in EM where we expect the supply disruptions, combined with existing inflationary pressures (largely from food prices), to overwhelm the lower demand effects for prices, and drive inflation higher particularly in China. This effect, however, is contained to 2020, and frontloaded. Inflation in the second half of the year, and more so in 2021, is expected to decelerate even as activity recovers. Against this backdrop, policymakers have considerable space to keep policy loose or ease further.

Recent developments have increased our conviction that the US Federal Reserve (Fed) will ease further in April this year. While we expect growth to recover in the second half of the year it would be a brave central bank that could look through a flat economy threatened by coronavirus and leave rates unchanged. Consequently, another 25 basis point cut taking the Fed funds target range to 1.25% to 1.5% is expected in April. Although we see the Fed as being on hold thereafter until the end of the year, we would also expect a continuation of the policy of buying Treasury bills to maintain liquidity at the short end of the money market, a move seen by many (not the Fed) as equivalent to QE.

Chart 4: Policy interest rates – actual and forecast



Source: Schroders Economics Group, 26 February 2020.

Expecting easier policy in the US, China and Eurozone

For China, the policy response will likely be a melange of different rate cuts. We forecast a 50 basis points (bps) reduction in the benchmark rate, and 200 bps reduction in the RRR this year. Alongside that, we think further cuts to the medium term lending facility and loan prime rates are almost certain, as are further injections of liquidity for the interbank market. This will complement a fiscal splurge focusing on infrastructure investment.

With both growth and inflation revised down in the forecast, we have kept the European Central Bank's cut in its deposit rate (-0.50% to -0.60%). However, we have pushed this out to the second quarter. Policy is otherwise expected to remain unchanged, with QE being maintained throughout the forecast.

The Bank of England failed to lower its main policy interest rate at the start of this year despite heavy hints. Instead, it is focused on the improvement in leading indicators following the abatement of Brexit risks. Our growth and inflation forecast is consistent with a hike in rates in 2021, although the Bank will be keen to proceed at a glacial pace.

Brexit is likely to return to become a concern for investors at the end of 2020 and bring volatility in GBP, but the forecast assumes a partial trade deal to be achieved, thus removing the risk of the UK exiting the transition period without a trade deal, and defaulting to WTO terms of trade.

For the Bank of Japan (BoJ), low inflation is nothing new, but a high chance of a recession and the ongoing fall in exports clearly raises the chances of a rate cut this year. However, given this would have limited impact and hurt the financial sector, the central bank is more likely to keep rates unchanged.

Importantly, the Japanese yen – a key barometer for the BoJ – has been fairy stable. Meanwhile, fiscal policy is the main lever to support growth and we already have a fiscal stimulus package (worth 1.8% of GDP to 2021) baked into the forecasts, albeit with a low multiplier. However, the Japanese government could easily draw up another package.

We also expect policy rate cuts in each of the BRIC economies, with the largest in Russia where policy space is highest. This sees rates fall from 6% currently to as low as 4.5% by the middle of 2021. India is also expected to cut by around 100 bps in 2020, while Brazil, given its recent pause, is expected to reduce rates just one additional time over the next two years.

Scenario analysis

Introducing a pandemic scenario adds a deflationary tail risk

Clearly there is a risk of a worse outcome on the coronavirus. Although there are signs of stabilisation in China the threat to the rest of the world is rising. Health authorities continue to warn of the virus hitting more widely with the recent warning from the CDC in the US ("when, not if") causing widespread alarm. However the WHO has warned for sometime on the risk of a pandemic given the virulence of the virus and the fact that people are infectious without showing symptoms.

Consequently we have introduced a coronavirus pandemic scenario where Europe, the Americas and the rest of Asia see a significant rise in cases. The result is a fall in global demand and activity although disruption to supply chains will also produce pockets of higher price pressure. Overall the outcome will be deflationary with policy rates lower than in the baseline across all the economies we forecast.

Alongside the new pandemic scenario we maintain our global recession scenario. This is primarily driven by a retrenchment in the corporate sector in response to the decline in profits. Our forecasting model highlights the weak outlook for US corporate profits in the baseline. After falling more than 4% y/y last year, we expect pre-tax non-financial profits to continue shrinking 1.7% this year and 0.3% in 2021 (see table 2).

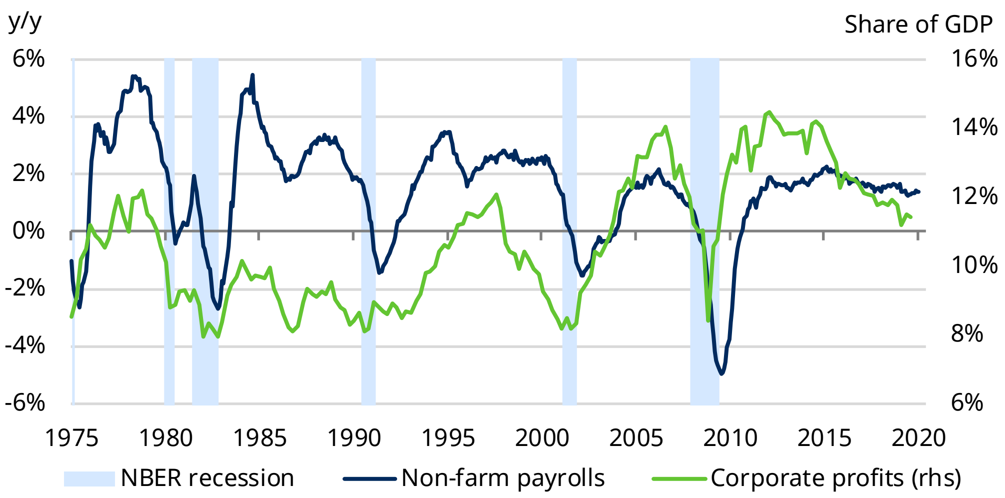
Table 2: US Profits growth forecast

% y/y	Pre-tax economic profits	After-tax economic profits	S&P 500 EPS (operating)
2020	-1.7	-1.6	-1.4
2021	-0.3	-0.3	-0.2

Source: Schroders Economics Group, 26 February 2020.

Profits have been weak for some time, but surprisingly have not led to much in the way of retrenchment by firms (chart 5). The global recession scenario assumes that this changes and companies start to defend their profit margins by cutting labour. The rise in unemployment then hits consumption resulting in a significant downturn in activity. The pattern is repeated around the world as profits remain weak globally.

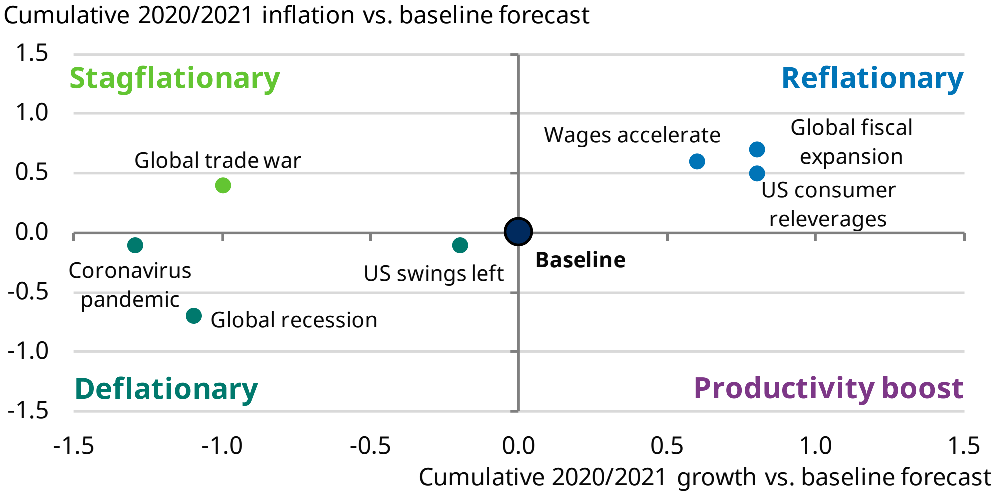
Chart 5: Profits slowdown signals greater weakness in jobs



Source: Refinitiv Datastream, Schroders, G0046 27 February 2020.

We have also retained our US swings left scenario where Bernie Sanders wins the presidency. Sanders has made a strong start in the race to become the Democrat nominee by winning the first three states and whilst markets seem to give him (or any Democrat) little chance of beating Trump the opinion polls remain very close. For example, the latest CBS News/YouGov polls carried out on 23 February show Sanders, Biden and Warren narrowly ahead of Trump in a general election. Trump was narrowly ahead of Bloomberg and Klobuchar and would have tied with Buttigieg who has now left the race. There is a long way to go, but these results suggest that the Presidential election race will be closer than markets are currently anticipating, meaning that the prospect of the US swinging left could impact markets ahead of the election in November.

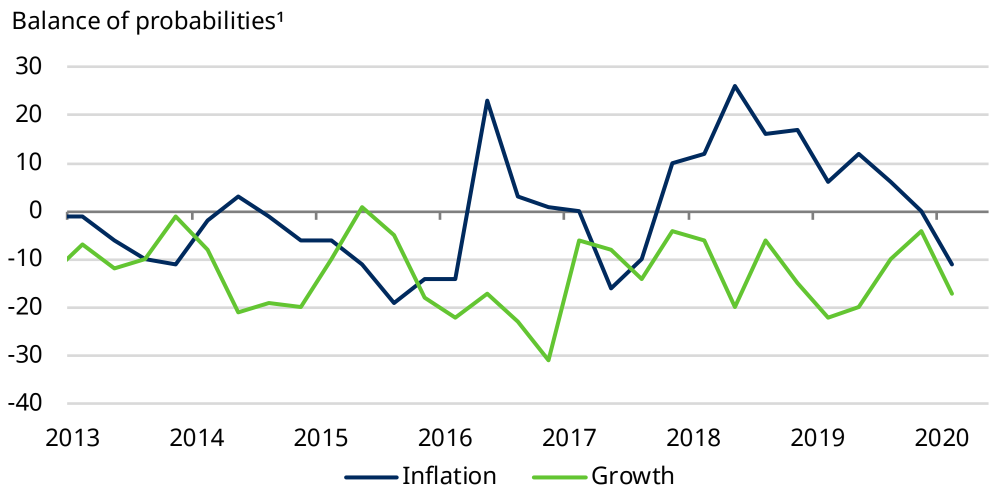
Chart 6: Scenarios growth and inflation vs. baseline forecast



Source: Schroders Economics Group, 26 February 2020.

In terms of upside risks, we retain our reflationary scenarios: global fiscal expansion, wages accelerate and US consumer releverages. On the latter, despite the health of consumer balance sheets, incomes and employment there is little sign that consumers are accelerating their spending. Recent retail sales numbers indicate that retail spending got off to a slow start in January with no increase in core sales and downward revisions to earlier figures. Taking account of our global trade war scenario, the overall balance of probabilities moves in a more deflationary direction largely as a result of the introduction of the pandemic scenario (chart 7).

Chart 7: Balance of probabilities vs. baseline forecast



Source: Schroders Economics Group, 26 February 2020.
¹Scenario probabilities are based on mutually exclusive scenarios.

Schroders Economics Group: Views at a glance

Macro summary – March 2020

Key points

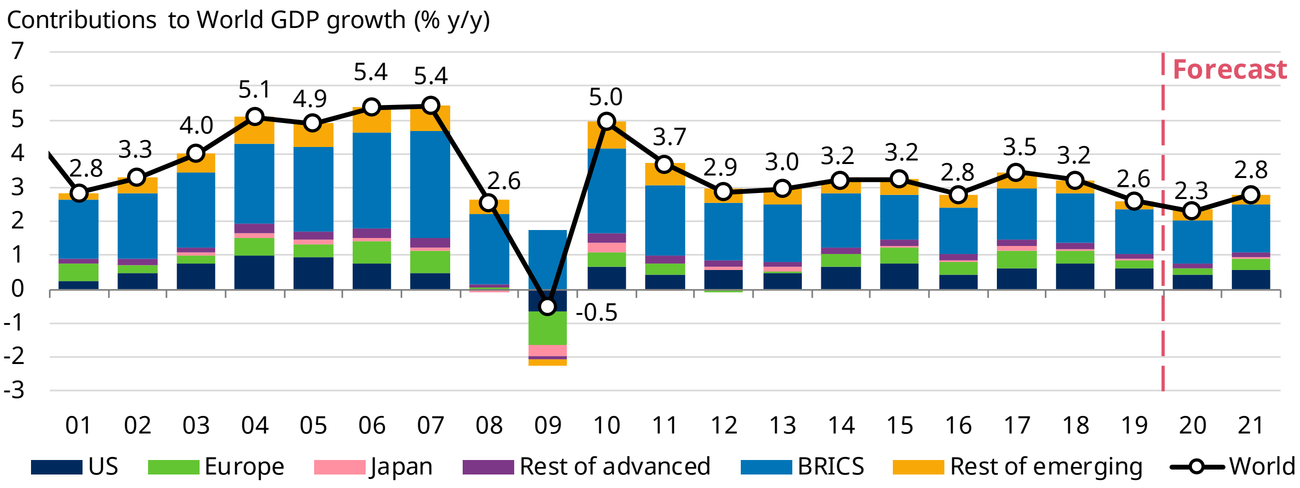
Baseline

- After expanding by 2.6% in 2019, global growth is expected to moderate to 2.3% in 2020, driven by the near term impact from COVID-19 which hits demand and disrupts supply chains. However, we expect the recovery to be delayed rather than derailed as we assume that the virus is contained and that activity in China and other affected countries can recover to its pre-virus level by the end of the second quarter. Nonetheless, such an outcome would make this year the weakest since 2009 - the height of the global financial crisis. Meanwhile, global inflation is also forecast to remain reasonably stable at 2.6% in 2020.
- The signing of the "phase one US-China trade deal", means that trade tensions should remain low this year. However, following the presidential election, 2021 is likely to see a return of trade tensions as China struggles to meet its obligations to buy an extra $200bn of US exports (we factor in $150bn). Moreover, negotiations around a wider ranging "phase 2" deal covering the thorny areas of intellectual property and state subsidy of exports are likely to be fraught and we expect tariffs to rise again in the second half of 2021.
- US growth is expected to slow from 2.3% to 1.6% in 2020. Activity will be depressed by Boeing's decision to halt production of its 737 MAX jet and when combined with COVID-19 effects, Q1 growth is now expected to be flat. US core inflation remains stable at 2.3% this year but lower energy inflation keeps headline inflation at 2% y/y throughout the forecast period. Lack of growth in the first quarter as well as virus concerns should allow the Fed to cut rates by 25bps in April, before laying low as the presidential election gets underway before easing again in 2021.
- Eurozone growth is expected to slow to 0.9% in 2020 as a recession in Italy and slowdown in France offset an improvement in Germany and stability in Spain. Growth should then recover to 1.4% in 2021. Inflation should edge down to 1.1% in 2020. With weak growth and inflation, the ECB should continue QE through 2021 after another depo rate cut to -0.6% in Q2 2020.
- UK growth is likely to fall to 1.1% in 2020 from 1.4% in 2019. The UK is expected to negotiate a sector-by-sector free trade agreement with the EU that will come into force from 2021. As Brexit uncertainty abates, the economy is forecast to rebound, with GDP growth rising to 2.2% in 2021. Inflation is expected to fall to 1.6% in 2020 due to lower energy prices, weaker growth and a recovery in sterling. As inflation picks up in 2021, the BoE is forecast to hike rates to 1%.
- Still recovering from the rise in VAT and now hit by the coronavirus, Japan is expected to fall into recession in Q1. Even though activity recovers in the second half of the year, the economy should contract by 0.7% in 2020. Meanwhile, the BoJ are expected to remain on hold.
- We expect a deceleration in EM economies in 2020 to 4.1%. We expect growth in China to fall to 4.3% in Q1 and remain under 5% in Q2 before picking up to over 6% in H2. China itself should slow to 5.5% in 2020 even assuming a V-shaped recovery. Growth should recover further to 6% in 2021. Supply side disruption combined with existing price pressures should drive inflation higher in the first half of the year. These factors should then subside in the second half of the year, resulting in EM inflation of 4.3% in 2020. On the policy side, we expect a melange of different rate cuts in China (benchmark rate, RRR, medium term lending facility and loan prime rate) as well as fiscal spending on infrastructure.

Risks

- The overall balance of probabilities are skewed in a deflationary direction, largely as a result of the introduction of a coronavirus pandemic scenario.

Chart: World GDP forecast



Source: Schroders Economics Group, February 2020. Please note the forecast warning at the back of the document.

Schroders Forecast Scenarios

Scenario	Summary	Macro impact	Probability*	Cumulative 2020/21 global vs. baseline: Growth	Cumulative 2020/21 global vs. baseline: Inflation
Baseline	Our forecast for global GDP growth in 2020 has been downgraded from 2.6% to 2.3%, driven by slower activity in the US, China and Japan. Whilst we include the "Boeing effect" on Q1 US GDP growth, most of the global downgrade is due to the impact of the coronavirus with Q1 growth for China expected at 4.3% y/y. The virus weighs on global growth in H1, but delayed spending helps growth rebound in H2. In 2021, global growth should improve to 2.8%, but US-China tensions are expected to rise yet again following the Presidential election as China falls short of its commitment to increase imports from the US by USD200bn. The forecast assumes China buys USD50bn in 2020 and USD100bn in 2021 such that another round of US tariffs are enacted at the end of 2021. Following the transition period, the UK moves on to a new trade arrangement with the EU, with trade-offs between sectors. On the inflation side, the global inflation forecast for 2020 has edged up to 2.6%, as a downgrade to DM is offset by an upgrade in EM.	As the US does not grow in the first quarter of the year, the US Federal Reserve cuts its target rate by 25bps in April. The Presidential Election keeps the Fed on hold through the rest of 2020, but cuts again in the second half of 2021 as trade tensions bite. The ECB is now expected to lower its deposit rate 10 bps to -0.60% in Q2 and continue QE at a pace of €20bn per month. The BoJ is expected to keep yield curve control unchanged. In contrast to the cutters, the BoE is expected to remain on hold through 2020 and, as growth improves, they raise rates in 2021. China is still forecast to lower its rates to 3.5% by the end of 2020 and 3% by the end of 2021 and the RRR is expected to fall to 9% by the end of 2021. The USD is still expected to weaken in 2020, but by less than in our previous forecast against the EUR.	55%	-	-
1. US swings left	The S&P 500 drops by 10% in Q3 2020 as the opinion polls point to a change of President to a left wing administration, followed by another 10% fall in Q4 on the result. Policies include increased regulation, higher minimum wage and plans to reverse Trump's tax reforms.	Deflationary: For the US, a fall in business sentiment and negative wealth effects from the correction in the equity market hurt growth in the second half of 2020. There is further GDP weakness in 2021 on increased regulation, higher minimum wage and plans to reverse Trump's tax reforms. These factors also boost inflation. The Federal Reserve reacts by cutting interest rates to 1% by the end of 2021 and the dollar weakens. As US growth is lower and rest of the world currencies appreciate versus the dollar. This is deflationary for the rest of the world as export demand falls.	13%	-0.2%	-0.1%
2. Global fiscal expansion	Following the populist expansion in fiscal policy in the US, other countries decide to follow its lead either due to changes in governments, or in response to populist movements. The G7 and BRIC economies all loosen fiscal policy significantly through a combination of tax cuts and spending increases.	Reflationary: Fiscal loosening against a backdrop of above trend growth boosts confidence further, along with GDP growth. Some economies with low rates of unemployment see wage pressures rise, causing domestically generated inflation, while others with slack remaining, still see higher inflation through commodities and higher import prices. Central banks respond by tightening monetary policy more quickly, which eventually cools activity.	5%	+0.8%	+0.7%
3. Global trade war	The US administration decides to impose tariffs on auto imports from the rest of the world thus extending the trade war into new territory. Europe and japan retaliate by raising tariffs on US goods. Meanwhile, China falls well short of its commitment to buy an additonal $200bn worth of goods and services from the US as agreed in the "phase 1 deal". The US-China dispute with worsens and in the US increases tariffs on imports from China.	Stagflationary. Higher import prices push inflation higher whilst weaker trade weighs on growth. Capex is also hit by the increase in uncertainty and the need for firms to review their supply chains. Central banks are expected to focus on the weakness of activity and ease policy by more than in the baseline.	3%	-1.0%	+0.4%
4. Wages accelerate	After a considerable period where wages have been unresponsive to tightening labour markets, pay begins to accelerate in response to skill shortages. Wages accelerate around the world and economists revise their estimates of spare capacity considerably lower. Some economies such as Japan welcome the move as they seek to raise inflation expectations, while the US faces stagflation as it effectively runs out of capacity, forcing the central bank to tighten policy.	Reflationary: As US wage growth picks up, US core inflation rises to 2.6% by the end of 2021 and the Fed responds by tightening more aggressively taking its target rate to 3% by end 2021. As the philips curve's reasserts across the world, household real incomes rise supporting consumption although the rise in wages, squeezes corporate margins somewhat. Interest rates also rise more rapidly in Europe, Japan and emerging markets. On a two year horizon the overall impact is positive for growth and inflation although this woulld reverse as higher interest rates hit activity.	5%	+0.6%	+0.6%
5. Coronavirus pandemic	The coronavirus continues to spread and no longer remains contained within China as Europe, the Americas and the rest of Asia see a significant increase in cases. This not only impacts global demand by more than in the baseline, but also exacerbates supply shortages resulting in widescale disruption to global supply chains. Production is weaker and the downturn more prolonged than in the baseline.	Deflationary: For China, growth falls even further in Q2 to 3.8% and remains sub-4.5% for the rest of 2020. The disruption to supply chains result in a supply-side shock across the world. The US goes into recession as do many European economies. Meanwhile a fall in global demand reduces commodity prices and wider inflationary pressures. Interest rates fall more rapidly than in the base.	8%	-1.3%	-0.1%
6. US consumer releverages	After a sustained period of debt reduction, US households rediscover the joys of debt and the housing market is boosted by successful Fed easing. As the US consumer releverages, household debt as a share of GDP rises toward 80%.	Reflationary: Stronger US consumption boosts US growth and global trade. Inflation is also higher as demand increases and oil prices rise. As for interest rates, the Fed raises rates to 3%. Other economies benefit from the boost to global trade.	4%	+0.8%	+0.5%
7. Global recession	The slowdown in Europe, China and Japan gathers momentum as contracting export growth undermines business confidence causing capital spending to contract. Meanwhile, the downturn in profits catches up with the US economy causing business and households to retrench. Output begins to contract thus bringing an end to the cycle whilst commodity prices and inflation fall. The Fed eases, but markets slump on fears of a wider global recession.	Deflationary: Weaker growth drags global trade lower, hitting the US which is also affected by increased market volatility and tighter financial conditions. The USD is expected to strengthen putting added pressure on EM. Monetary policy is eased around the world.	7%	-1.1%	-0.7%
8. Other			0%	-	-

*Scenario probabilities are based on mutually exclusive scenarios. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2019	2020		Prev.	Consensus	2021		Prev.	Consensus
World	100	2.6	2.3	↓	(2.6)	2.4	2.8	↑	(2.6)	2.7
Advanced*	61.4	1.7	1.2	↓	(1.4)	1.4	1.8	↑	(1.6)	1.6
US	26.4	2.3	1.6	↓	(1.8)	1.9	2.2	↑	(1.7)	2.0
Eurozone	17.6	1.2	0.9	↓	(1.2)	1.0	1.4		(1.4)	1.2
Germany	5.1	0.6	0.9	↓	(1.0)	0.9	1.3	↓	(1.4)	1.5
UK	3.7	1.4	1.1	↑	(0.8)	1.1	2.2	↑	(2.1)	1.5
Japan	6.4	0.8	-0.7	↓	(0.2)	0.3	0.9	↓	(1.0)	0.8
Total Emerging**	38.6	4.1	4.1	↓	(4.5)	4.0	4.4	↑	(4.3)	4.5
BRICs	25.5	5.1	5.0	↓	(5.5)	4.9	5.4	↑	(5.1)	5.2
China	17.5	6.1	5.5	↓	(6.0)	5.6	6.0	↑	(5.5)	5.8

Inflation CPI

y/y%	Wt (%)	2019	2020		Prev.	Consensus	2021		Prev.	Consensus
World	100	2.5	2.6	↑	(2.5)	2.5	2.3	↓	(2.5)	2.4
Advanced*	61.4	1.4	1.5	↓	(1.6)	1.5	1.6		(1.6)	1.7
US	26.4	1.8	2.0	↓	(2.1)	2.0	2.1	↑	(2.0)	2.1
Eurozone	17.6	1.2	1.1	↓	(1.3)	1.2	1.3	↓	(1.5)	1.4
Germany	5.1	1.4	1.3	↓	(1.5)	1.4	1.6	↓	(1.7)	1.5
UK	3.7	1.8	1.6	↑	(1.4)	1.6	2.0		(2.0)	1.9
Japan	6.4	0.5	0.4	↓	(0.9)	0.6	0.2	↓	(0.6)	0.6
Total Emerging**	38.6	4.1	4.3	↑	(4.0)	4.0	3.5	↓	(3.7)	3.4
BRICs	25.5	3.2	3.9	↑	(3.4)	3.4	2.6	↓	(3.0)	2.8
China	17.5	2.9	3.7	↑	(3.2)	3.2	2.0	↓	(2.5)	2.2

Interest rates

% (Month of Dec)	Current	2019	2020		Prev.	Market	2021		Prev.	Market
US	1.75	1.75	1.50		(1.50)	1.45	1.25		(1.25)	1.33
UK	0.75	0.75	0.75		(0.75)	0.64	1.00		(1.00)	0.64
Eurozone (Refi)	0.00	0.00	0.00		(0.00)	-0.45	0.00		(0.00)	-0.42
Eurozone (Depo)	-0.50	-0.50	-0.60		(-0.60)		-0.60		(-0.60)	
Japan	-0.10	-0.10	-0.10	↑	(-0.30)	-0.01	-0.10	↑	(-0.30)	0.00
China	4.35	4.35	3.50		(3.50)	-	3.00		(3.00)	-

Other monetary policy

(Over year or by Dec)	Current	2019	2020		Prev.	Y/Y(%)	2021		Prev.	Y/Y(%)
US QE ($Tn)	4.0	4.2	4.4	↑	(4.2)	4.8%	4.5	↑	(4.3)	2.3%
EZ QE (€Tn)	2.4	2.4	2.6		(2.6)	8.3%	2.9		(2.9)	11.5%
UK QE (£Bn)	422	435	445		(445)	2.3%	445		(445)	0.0%
JP QE (¥Tn)	557	573	607	↓	(609)	5.9%	647	↓	(649)	6.6%
China RRR (%)	13.50	13.00	10.00		10.00	-	9.00		9.00	-

Key variables

FX (Month of Dec)	Current	2019	2020		Prev.	Y/Y(%)	2021		Prev.	Y/Y(%)
GBP/USD	1.31	1.32	1.33	↓	(1.35)	0.4	1.35		(1.35)	1.5
EUR/USD	1.08	1.12	1.10	↓	(1.15)	-2.0	1.06	↓	(1.12)	-3.6
USD/JPY	109.8	108.7	110		(110)	1.2	107		(107)	-2.7
EUR/GBP	0.83	0.85	0.83	↓	(0.85)	-2.4	0.79	↓	(0.83)	-5.1
USD/RMB	6.98	6.97	7.20		(7.20)	3.4	7.40		(7.40)	2.8
Commodities (over year)										
Brent Crude	56.2	64.2	57.0	↓	(58.1)	-11.3	55.9	↓	(56.3)	-1.8

Source: Schroders, Thomson Datastream, Consensus Economics, February 2020
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 13/02/2020
Previous forecast refers to November 2019
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan SAR, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

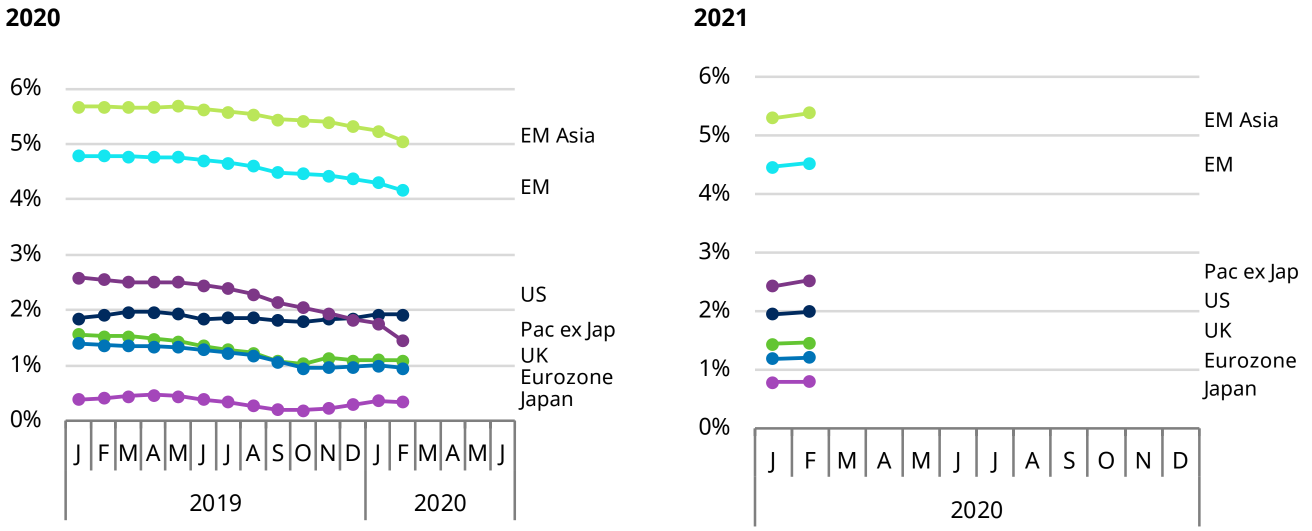
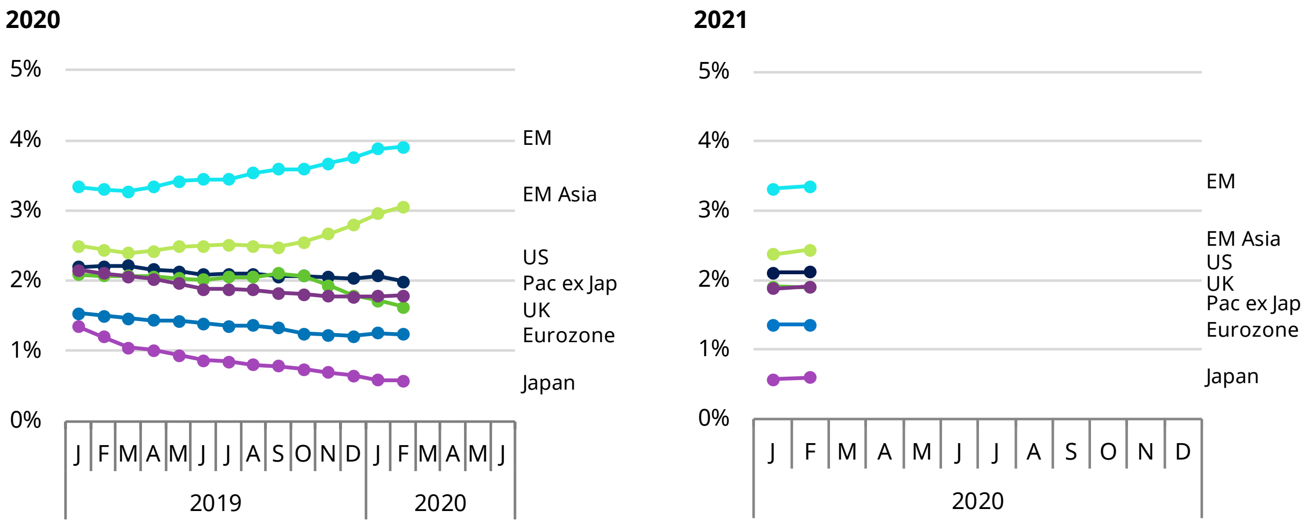


Chart B: Inflation consensus forecasts



Source: Consensus Economics (28 February 2020), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

Schroders

Schroder Investment Management Limited

1 London Wall Place, London, EC2Y 5AU
Tel: + 44(0) 20 7658 6000

schroders.com
@Schroders