Markets grapple with government dysfunction

Weekly Market Compass: Geopolitics threaten to drag down economic growth

Jan 22, 2019 | Kristina Hooper, Chief Global Market Strategist

Last week saw government dysfunction on full display in several different countries. While politicians in the UK and US continued to make headlines, expectations for lower economic growth emerged in a report from the International Monetary Fund.

Will the UK crash out or stay in?

In the United Kingdom last week, Parliament rejected Prime Minister Theresa May's Brexit Withdrawal Bill with resounding force, and the next day narrowly defeated a "no confidence" vote called by opposition leader Jeremy Corbyn. The question is, "Where do we go from here?" Last week's votes make for "fatter tails" – on one end of the spectrum, there is an increased chance that the UK may "crash out" of the European Union with no deal. But on the other hand, there's also an increased chance that the UK will remain in the European Union (EU).

Last week, the British pound rallied on the news, suggesting that, of the two fat tails, remaining in the EU – or having a very soft exit – is far more likely. The EU has certainly made clear that it is not open to making concessions that would enable greater UK support for May's Brexit deal. In my view, it seems more likely that the March 29 separation date mandated by Article 50 will be postponed, and we could even see a second Brexit referendum. More than 170 business leaders wrote an op-ed piece in The Times last week, urging a second Brexit referendum: "The priority now is to stop us crashing out of the EU with no deal at all. The only feasible way to do this is by asking the people whether they still want to leave the EU … politicians must not waste any more time on fantasies. We urge the political leadership of both the main parties to support a People's Vote."

Annegret Kramp-Karrenbauer, the successor to German Chancellor Angela Merkel as leader of the Christian Democratic party, joined other German leaders in a heartfelt plea to Britons in The Times, reassuring them that Europe would love to have them stay in the EU: "Without your great nation, this continent would not be what it is today … After the horrors of the Second World War, Britain did not give up on us. It has welcomed Germany back as a sovereign nation and a European power." It went on to list some of the things it would miss about the UK, finishing with, "But more than anything else, we would miss the British people – our friends across the Channel."

Momentum clearly seems to be building for a soft Brexit and/or a second people's referendum. In fact, some of the debate has already turned to what could be on a second referendum ballot – whether it would pose a binary question (such as "leave or remain" – similar to the first referendum) or offer a variety of options for the type of relationship it would like to have with the European Union (possible options would be remain, soft Brexit, hard Brexit, etc.)

Yesterday, however, Prime Minister May unveiled her Plan B for Brexit withdrawal, which seemed an awful lot like Plan A. (If Plan A and Plan B were newborn babies, you'd have to paint nail polish on one baby's toenail in order to tell the difference.) May roundly dismissed the option of a second referendum and also dismissed the idea of pushing back Article 50. In response to this less-than-flexible stance, Labour leader Corbyn announced he was planning several votes in Parliament on options for how the UK can avoid a "no-deal Brexit," including holding another Brexit referendum.

With this, the potential for a crash out has certainly increased. We will need to follow developments closely.

Will the US shutdown affect stocks?

The UK isn't the only nation developing an expertise in government dysfunction; the US is also an apt student. The partial government shutdown has hit the one-month mark and still shows no signs of abating; interestingly, the stock market has yet to show signs it cares about the shutdown. The big question I've been getting is if and when that will change.

I believe stocks have been buoyed by optimism about a possible resolution to – or at least improvement in – the US-China trade war. And there's certainly good cause for that optimism, as I touch on below. However, I believe at some point the government shutdown could impact the stock market.

In my view, the greatest threat to stocks would come from a downgrading of US credit. Fitch Ratings has warned that a downgrade could be possible this year if the current shutdown were to continue and dysfunction were to spread, impacting future fiscal policy decisions such as the debt ceiling. Recall how stocks plummeted in the summer of 2011 when US sovereign debt received a downgrade from Standard & Poor's.

Conventional wisdom has been that the economic impact of a government shutdown would be largely transitory because government workers would eventually receive their back pay, as they have in past shutdowns. But that view is predicated on a relatively fast resolution to the shutdown. The longer it drags on, the more it is likely to impact economic growth. And stocks could certainly fall in expectation of a drop in economic growth.

Another complication is that, because this is a partial government shutdown, investors aren't fully aware of which government agencies are impacted, which are relying on temporary funding sources, and what the implications will be the longer this lasts. For example, I am hearing anecdotally that air travel has fallen as people choose to forego flying for fear that security lines will be very long. If this is borne out in real data, airline stocks could suffer. And while many furloughed government workers continue to work without pay, that number may decrease as time goes on, adding to the problems created by the shutdown.

Beyond that, we have to worry about what the longest US government shutdown in history will do to business and consumer confidence. The most recent consumer confidence reading, released last week, showed a significant drop in sentiment. And economic policy uncertainty typically dampens business investment and hiring.

Finally, one can't help but wonder what would happen if the US were facing a serious external threat – a war or another financial crisis such as the one we experienced in 2008-2009. Would lawmakers ever be able to work together for the greater good? Fear about that possibility could really undermine confidence.

The IMF expects lower economic growth

But we don't just have to worry about government dysfunction; even more importantly, we need to worry about lower growth. Yesterday, the International Monetary Fund (IMF) released revisions to its World Economic Outlook. The global economy is now projected to grow at 3.5% in 2019 and 3.6% in 2020, which is 0.2 and 0.1 percentage point below last October's projections.[1]

The IMF provided more color on its outlook, explaining that risks to its projections leaned to the downside: "An escalation of trade tensions beyond those already incorporated in the forecast remains a key source of risk to the outlook. Financial conditions have already tightened since the fall. A range of triggers beyond escalating trade tensions could spark a further deterioration in risk sentiment with adverse growth implications, especially given the high levels of public and private debt. These potential triggers include a "no-deal" withdrawal of the United Kingdom from the European Union and a greater-than-envisaged slowdown in China."

As you can see, a number of those downside risks involve government dysfunction and other geopolitical issues.

China experiences its lowest growth since 1990

Just before the IMF released its downwardly revised economic growth outlook, China announced its gross domestic product (GDP) growth for 2018, which was 6.6%.[2] While the lowest level since 1990, it was in line with expectations. Looking ahead, there are concerns that economic growth will slow significantly as articulated by the IMF. However, I continue to believe that China will be able to sufficiently stimulate its economy through fiscal and monetary policy. For example, Chinese authorities announced last Friday that they are providing more stimulus on the fiscal, monetary and administrative fronts. Some of these measures include a value-added tax (VAT) exemption for small companies and a significant liquidity injection by the People's Bank of China.

China may also benefit from a quick resolution of US-China trade issues, which seems possible based on recent news flow. It was reported that US Treasury Secretary Steven Mnuchin had proposed the idea of lifting some or all tariffs on Chinese imports. Then last Friday, it was reported that China offered to reduce the US-China trade deficit by buying more US goods. By raising annual goods imports from the US by a combined value of more than $1 trillion, China would seek to reduce its trade surplus, which last year stood at $323 billion, to zero by 2024.[3]

This is the kind of minor concession that I expect the US to accept in order to declare the Sino-US trade war over, as it has proven too difficult to win major concessions in areas like intellectual property. But don't get too excited. Just as US-China trade wars may seem to be subsiding, we could see a US-EU trade war begin to ramp up.

Looking ahead

The big event of this week will be the World Economic Forum at Davos, whose theme this year involves globalization – which could be incredibly timely given the efforts around the world by various countries to de-globalize. Unfortunately, domestic disturbances are causing some world leaders to miss Davos. President Donald Trump and the US delegation are staying home because of the government shutdown, while French President Emmanuel Macron is staying home because of the yellow vest protesters. Not surprisingly, UK Prime Minister Theresa May has some significant problems to tend to on the homefront, keeping her away from Davos. And Indian Prime Minister Narendra Modi and Chinese President Xi Jinping are also staying home, focusing on domestic issues.

In light of the IMF's downward revisions to growth, especially for the euro area, we will also want to pay close attention to the bevy of European data being released this week, including consumer confidence and the manufacturing Purchasing Managers Index (PMI). We will want to do the same for China's Caixin Manufacturing PMI, as all eyes are likely to be on it given jitters about a potential Chinese deceleration this year.

I must reiterate that my expectation for 2019 is that global growth decelerates, but relatively modestly; and that is in keeping with the IMF's expectation for 2019. But I recognize that there are clear risks to the downside, particularly as country-specific issues (such as the US government shutdown, Brexit uncertainty, French yellow vest protests, tariffs on Chinese goods) could create a "perfect storm" that turns a modest slowdown into a more substantial slowdown. We will want to follow each of these situations closely.

Source

[1]*International Monetary Fund as of Jan. 21, 2019*

[2]*CNBC, "China's economy grew 6.6% in 2018, the lowest pace in 28 years," Jan. 20, 2019*

[3]*Bloomberg, L.P.*

Important information

In a "no-deal" Brexit, the UK would leave the EU in March 2019 with no formal agreement outlining the terms of their relationship.

The Eurozone Manufacturing PMI® (Purchasing Managers' Index®) is produced by IHS Markit based on original survey data collected from a representative panel of around 3,000 manufacturing firms. National data are included for Germany, France, Italy, Spain, the Netherlands, Austria, the Republic of Ireland and Greece.

The Caixin/Markit Purchasing Managers' Index (PMI) for China is considered an indicator of economic health for the Chinese manufacturing sector. It is based on survey responses from senior purchasing executives.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The value-added tax (VAT) is a type of consumption tax added to the price of goods and services.

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