MONTHLY MACRO OUTLOOK

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ThirdRock

KEY MACROECONOMIC DEVELOPMENTS

- An extended trade dispute between China and the U.S. may become a drag on an already-weakening world economy
- The effects of Brexit on the UK economy are beginning to show, and is likely to get worse even with a modest deal
- The longer-run outlook for India is fairly bright, if one steps back from the immediate challenges to the economy

This month, developments on the global trade front force us to return to the theme. Rather than focus on either economic implications or political-economy considerations in the bilateral China-U.S. relationship—as we have in the past—we instead consider the global trade picture, and suggest some linkages between trade turmoil and the recent turbulence in emerging markets (EMs). We also peer more into the challenges the United Kingdom will face as it prepares to exit the European Union, and make the case that India's growth trajectory is solid, so long as it resolves a number of shorter-run challenges, especially with regard to banking system fragility.

TRADE IN THE DOGHOUSE

On September 24, the United States imposed a new round of tariffs of 10 percent on an additional $200 billion worth of Chinese goods. This escalation upped the ante on $50 billion worth of goods that are already subject to a 25 percent tariff rate (introduced in July and August). With another $267 billion worth of goods identified and slated to roll out on short notice, virtually all of China's exports to the U.S. either now face, or are under threat of facing, taxes upon crossing the American border. China, for its part, has retaliated to each round of fresh tariffs. Most recently, it threw up a proportionate (albeit absolutely smaller) set of extra duties on $60 billion of U.S. exports to the Middle Kingdom.

An escalating trade war—an outcome we had previously regarded as a minor possibility—is now an undeniable reality. What is worse, it is nigh impossible to divorce recent turmoil in EMs from this essentially bilateral spat, given how exposed most EMs are to trading relations, and how interconnected many East Asian EMs are to China via the East Asian production chain.

We had previously argued, largely on the basis of economic theory, that the direct effects of a tariff war would be limited. Even in a scenario where significant tariff barriers are enacted—which isn't the case quite yet—global GDP losses would clock in between 2 to 3 percent in total, and over the course of many years. Now, while this isn't small potatoes, such a decrease does not, in and of itself, constitute much of a long-term worry. What is more worrisome is if the bilateral tariff spat becomes the basis for an even more severe retraction in global trade flows, which have already been struggling in the post-crisis era. So with a few months now under our belt since the commencement of trade policy actions, it seems like an appropriate time to examine the extent to which trade tensions have spilled over into global trade patterns.

FIG. A: : THE VALUE OF TRADE BEGAN TO STALL AT THE END OF THE FIRST QUARTER, BUT DECLINES IN VOLUME HAVE BEEN VERY MODEST

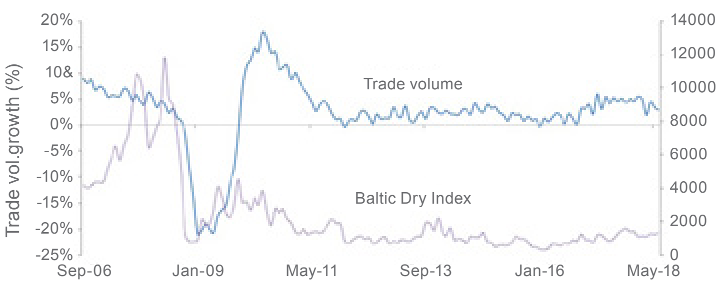
Source: Thirdrock calculations, from CPB/Datastream.
Notes: Trade defined as simple average of import and exports.
Global trade value and volume indexes renormalized from 2005 to 2014.

Even to the untrained eye, the recent stagnation of the dollar values of trade flows does not appear to be egregious (Fig. A). Indeed, the massive dive in the value of trade that occurred due to the rapid appreciation of the dollar in 2014 was far greater in magnitude, not to mention the great trade collapse that followed in the aftermath of the 2008 global crisis. Furthermore, trade volumes also appear to have hardly budged; this has been due to the fact that import volume contractions have been largely offset by the continued rise in exports. Set against the much sharper declines experienced in recent memory, then, it is difficult to make the case that trade wars have made much of a dent to international economic exchange.

Of course, looking at historical trade flows tell us only how trade has performed of late, with less indication of how it will evolve. To get a better sense of this, we look to a useful leading measure of trade costs, the Baltic Dry Index (BDI). The BDI is not a crystal ball, but its component sub-indices capture the costs associated with trading activity net of policy barriers. Analysts often rely on this measure as a handy gauge of global appetite for trade. As it turns out, the BDI has been in the doldrums since 2009, and its very slow recovery since 2016 parallels the very tentative pickup in trade that began at that time (Fig. B). For our purposes, it also offers a much more real-time signal of trading action, and possibly a glimpse into whether trade-related uncertainty is eating away at volumes.

Thankfully, the BDI has held up thus far. Even as trading volume growth has slumped in recent months, the index has not fallen much further from its current (admittedly anemic) levels. Of course, further falls are entirely possible, but for now we are comfortable with the view that the effects of the tariff war have not yet led to trade falling off a cliff.

FIG. B: GROWTH IN GLOBAL TRADE VOLUME AND CROSS-BORDER TRADE COSTS, 2006M9--2016M6



Source: Thirdrock calculations, from CPB/Datastream.
Notes: YoY growth rate of global net trade volume index (2005=100), with period averages for 1993M1-2010M12 and 2011M1-2016M1.

Why have we concentrated so much on this issue? Mainly because we believe that the largely bilateral trade spat and recent EM weakness are intimately intertwined. Don't get us wrong; recent EM troubles go well beyond trade concerns, and are as much (of not more) an external debt dependency issue, especially for the weakest economies such as Argentina, South Africa, and Turkey. But the iron logic of balance of payments means that changes in the import and export of real goods and services must ultimately net out against cross-border financial flows. So if trade faces a hit, capital flows will not be exempted, and this will eventually translate into even more unbearable debt burdens.

This double whammy to trade and finance could in turn be the sort of unnecessary yet undeniably detrimental shock that the global economy clearly does not need right now. Global growth has already lost most of its momentum relative to the start of the year, and without the support of easy monetary and liquidity conditions, a prolonged trade war could be the proverbial straw that breaks the camel's back. In a worst-case scenario, the uncertainty-cum-trade shock tips the world into outright recession, led by China and other EMs, but with Europe then other DMs trailing not long after. While this outcome will by no means be the sort of sharp contraction similar to the crisis-induced recession a decade ago, it will still be an unfortunate, self-induced own goal.

In the meantime, we retain an uneasy caution vis-à-vis EM assets. This uneasiness is in part due to the fact that many EMs are simply collateral damage in this trade war. Whatever the case may be, fundamentals alone do not appear sufficient to shelter EMs from the negative sentiment currently pervasive in the space.

“ For now we are comfortable with the view that the effects of the tariff war have not yet led to trade falling off a cliff. ”

UNITED KINGDOM: BREXIT BREXIT EVERYWHERE

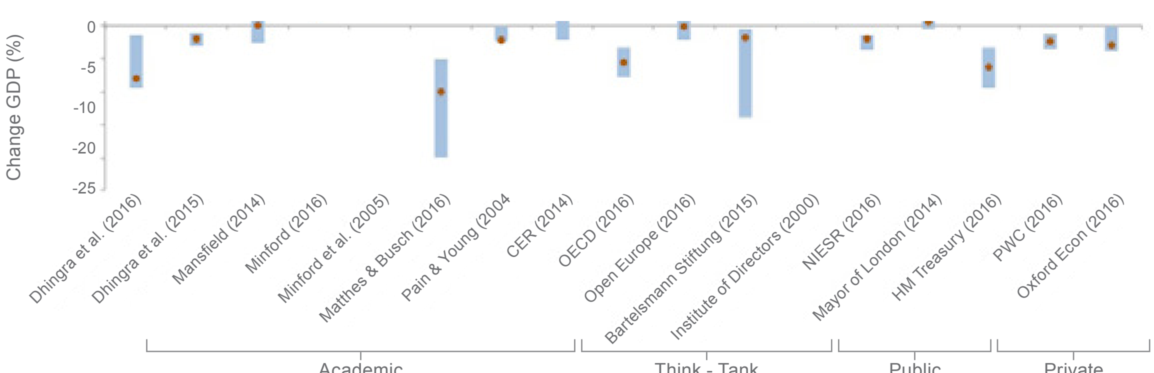
Pick up any random copy of the Financial Times over the past two years, and one is left with the distinct impression that Brexit is one of the major news stories that simply will never die (at least, as judged by the regular lifespan of most news stories). Indeed, it seems like an eternity since June 2016, when the citizens of the United Kingdom—or, perhaps more accurately, the aged, overwhelmingly working-class voters of rural England and Wales—chose to separate the country from its half-century- old economic union with the rest of Europe. Yet as interesting (and important) Brexit will be for UK citizens, the entire episode should be carefully understood in wider perspective.

First, some recent history might help provide context. The referendum was introduced by then-prime minister David Cameron (of the Conservative Party), in what was regarded as the fulfillment of a re-election promise. But it was likely also a calculated political gambit to allow Cameron to offset the power of anti-Europeanists within his party, and hence allow him to focus on his own domestic political agenda (had the referendum result been that Britain would stay). During the run-up to the vote, both sides campaigned vociferously, but most neutral observers would claim that the so-called "Leavers" played relatively more fast-and-loose with the truth, whether in terms of the costs of remaining in the EU, or with promises of what would occur should Britain leave. After a fairly thin majority voted to leave, Cameron resigned from his post; and following a period of political wrangling, Theresa May—the then-Home Secretary and someone who had initially opposed Brexit—emerged as Prime Minister. In March 2017, May triggered Article 50, which set the stage for the UK to leave the union within two years.

Recognising the political nature that underlaid the Brexit vote is important, because in many ways, political considerations will be what determines the eventual deal that Britain will end up with, come 2019. The so-called "red lines" underscored by the negotiating parties are all political. For example, the UK's desire to retain full control over labour flows is premised on immigration politics. Similarly, the EU's red lines—such as the avoidance of a hard border between the Republic of Ireland and Northern Ireland—are also politically driven (in this case, preserving the hard-won political stability on the Emerald Isle). Since political positions routinely trump economic concerns, the right way to think about the post-Brexit arrangement is to acknowledge that it is first and foremost a political one.

This is not least because few economists believe that exiting the EU will be a net positive for the UK, even way back during the pre-Brexit run-up. Estimates of the net economic impact to GDP as a result of Brexit range from a loss of as much as almost 8 percent of output, to a gain of around 3.5 percent (Fig. C). Moreover, the vast majority of the studies suggest a drag to growth, not just in the immediate term, but also in the future. This is mainly attributable to the loss of trading efficiencies, as well as reduced capital flows to finance investment. Thus, it is not unfair to characterise the view held by the profession as leaning toward pessimism with regard to Britain's economic prospects over the medium to longer term.

FIG. C: THE RANGE OF ESTIMATES FOR THE ECONOMIC EFFECTS OF BREXIT POINT TO A NET NEGATIVE EFFECT ON GDP

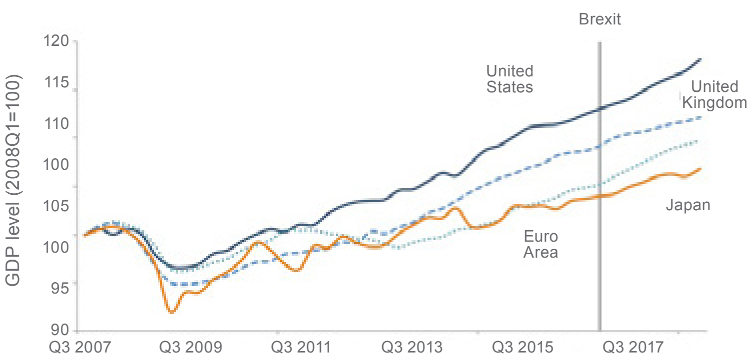


Source: Thirdrock compilation

Notes: Bars indicate upper and lower bounds of net change in real GDP, and dots indicate the central scenario. Estimates were constructed using a range of methodologies, over various horizons, and are not strictly comparable.

Over the short run, it is evident that the impending Brexit is already exerting its toll. Since the referendum, the pound depreciated by around 13 percent against both the dollar and euro. Foreign exchange markets are often excellent gauges of the temperature of asset prices—at the very least, they determine returns in one's currency of interest—and this precipitous decline is a sure-fire signal of market concerns over what Brexit means for the UK. Perhaps more telling, the growth performance of the economy—which closely tracked that of the U.S. immediately following the crisis—has now begun to diverge, even as Japan and the Euro Area have started to reverse their comparative underperformance (Fig. D).

FIG. D: WHILE UK POST-CRISIS GROWTH KEPT PACE WITH THE U.S. PRIOR TO THE BREXIT VOTE, THEIR PROSPECTS HAVE DIVERGED RECENTLY



Source: Thirdrock calculations, from Thomson Reuters Eikon and Datastream.
Notes: Series are quarterly real GDP levels, normalized to 2007Q3=100.

This has been led by very anemic levels of investment since 2016, which have averaged around one percent (as opposed to twice as much in earlier years, albeit with much greater volatility). This sluggish rate of capital expenditure (especially residential investment) is troubling, since it is symbolic of heightened Brexit-related uncertainty—uncertainty being especially corrosive of investment, whether foreign or domestic. Furthermore, one could make the plausible case that it was the British household that has kept the economy buoyed for longer than otherwise in the vote's aftermath, with elevated consumption spending. Yet was only a matter of time before softness in consumer confidence—which plunged after the referendum and has remained depressed since—eventually translates into curtailments in actual spending, as consumption brought forward in anticipation of actual Brexit becomes exhausted. When both investment and consumption turn down, the UK economy will find it hard to escape recession.

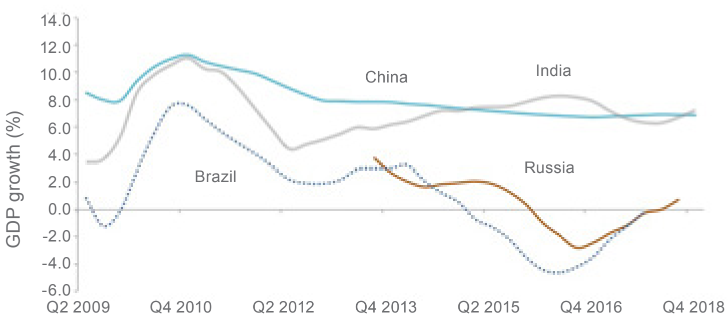
If confronted with a choice of alternative scenarios outside of the union, most economists would recommend integration arrangements with either very close economic ties (such as that currently practised by Norway) or substantially free flows of goods, services, capital, and labour (such as the partial single-market access employed by Switzerland). Yet these are not really options currently on the table. Instead, the UK will most likely exit the union with concessions somewhat favouring the EU, along with a lukewarm commitment by both parties to work toward some future agreement that would further strengthen economic cooperation, without spelling out in too much detail what such cooperation might entail. And the reason why any final agreement will ultimately be weighted against Britain is that it simply holds a much weaker bargaining position, which was further eroded by the decision to activate Article 50 before the groundwork for negotiations had been well-laid. The outcome will simply be a variation of the canonical "chicken" setting—beloved amongst game theorists—with the key difference being that payoffs accruing to the two players are actually asymmetric, with generally poorer ones for the UK in almost every state of the world.

All that said, markets are likely to view this as a "soft" Brexit—soft because the "hard" alternative to reverting full-bore to WTO rules would have been avoided—and because more concessions by the UK will likely result in a deal more akin to the current status quo. But like in so many EU "solutions", this strategy will simply involve kicking the proverbial can down the road once more, with the need to revisit the issue in the months and years ahead. We remain very cautious on UK assets, especially those priced in the pound.

INDIA: FINALLY ESCAPING THE "HINDU" GROWTH RATE AND FULFILLING ITS ENORMOUS POTENTIAL

A couple of Outlooks ago, we suggested that leading PMI figures hinted at another solid second quarter for Indian growth, following an impressive 7.7 percent YoY in the first quarter. And voila! The latest numbers exceeded all but one economist in the Bloomberg consensus, clocking in at 8.2 percent, and is the strongest among the large emerging market (EM) economies (Fig. E). This surprise among forecasters is, in part, attributable to industrial production figures; these had fallen from 6.5 percent to 5.2 percent in Q2, prompting many to adopt a more cautious view. But in an economy that has relied much more on services as a growth driver—although we'll return to this as a possible point of concern below—data from manufacturing tend to be less indicative of economywide activity. So it is fair to place a lighter weight on data emanating from secondary industries, and take these latest figures in our stride.

FIG. E: INDIA IS NOW THE FASTEST-GROWING AMONG THE MAJOR EMERGING ECONOMIES



Source: Thirdrock calculations, from Thomson Reuters Eikon and Datastream.
Notes: Series are MA(4) of non-seasonally-adjusted YoY GDP growth computed from quarterly constant-price GDP data.

This upside surprise is also notable because the Indian economy had disappointed over the past few years. Much of this was policy-induced. Prime Minister Narendra Modi had rolled out a demonetisation plan at the end of 2016—which replaced high-circulation 500 and 1,000 rupee notes in a bid to (ostensibly) crack down on tax evasion and promote digital banking—which led to a severe liquidity shortage that derailed activity for at least several quarters (growth in the first half of 2017 averaged 6 percent, versus 7.5 percent in the third quarter of 2016 before the program). Recent evaluation by the Reserve Bank has suggested that the policy was of limited success; currency in circulation has returned to almost pre-intervention levels, and household saving has actually crept down, rather than being spurred by the initiative.

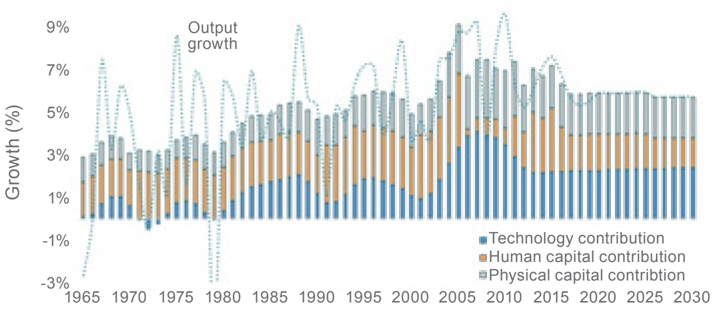
Just as the effects of demonetisation had begun to fade by the middle of the following year, the government rolled out a nationwide goods and services tax (GST) in July 2017. A few of the longer-run goals for the tax were laudable: it sought to simplify indirect taxation by harmonising state-level, value-added taxes via a common GST, and hence reduce barriers to interstate trade, along with petty corruption by state tax officials. But the short-run effects were palpable: growth in the second half of 2017 failed to bounce back and averaged a below-trend 6.6 percent.

Thankfully, these effects appear not to have been persistent. The Indian economy has since recovered, and most expect the short-run prospects of the economy—current rupee woes notwithstanding—to improve substantially. At the very least, its recent outperformance relative to the other major EMs is likely to continue, especially with China's managed slowdown expected to hold, and both Brazil and Russia having a long way to go before fully recovering from their deep recessions that began in 2014 (and even so, few analysts expect these economies' longer-run trend growth to come anywhere close to that of India's).

" Even casual observers of the Indian economy have, in recent years, become more attuned to its tremendous potential. "

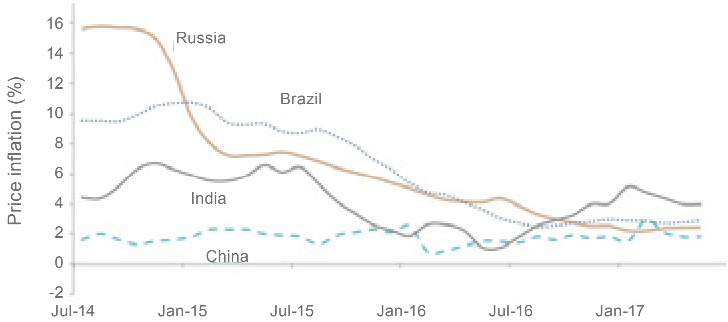
Indeed, even casual observers of the Indian economy have, in recent years, become more attuned to its tremendous potential. The substantial liberalisation following its balance-of-payments crisis in 1991 saw a steady improvement in savings rates—from an average of around 15 percent of gross national income in the 1970s and 80s to highs in the mid-30s this decade, before falling to 32 percent last year—which went toward financing much-needed domestic investment. Physical capital expenditures have been complemented by human capital accumulation: the average years of schooling has risen from just 3.5 years in 1990 to more than double that in 2017, and is expected to augment the so-called "demographic dividend" of a growing labour force through the coming decade. Even productivity, which has been a bane for so many advanced economies since the advent of the global crisis, has been trending upward in India, as inefficiencies in resource allocation (owing to the socialist years) continue to be corrected. Reasonable projections of these contributors to India's long-run trend growth suggest that, even by conservative estimates, India should easily clock growth rates in the order of between 6 and 7 percent, if not higher (Fig. F).

FIG. F: INDIA'S POTENTIAL GROWTH THROUGH 2030 WILL BENEFIT FROM PRODUCTIVITY, SCHOOLING, AND INVESTMENT TAILWINDS



Source: Thirdrock calculations, from Barro & Lee (2015, 2016), IIASA (2010), ILO (2014), UN (2013, 2015), World Bank (2017)

FIG. G: ONE UNINTENDED CONSEQUENCE OF INDIA'S DEMONETISATION WAS A REINING IN OF INFLATIONARY PRESSURES



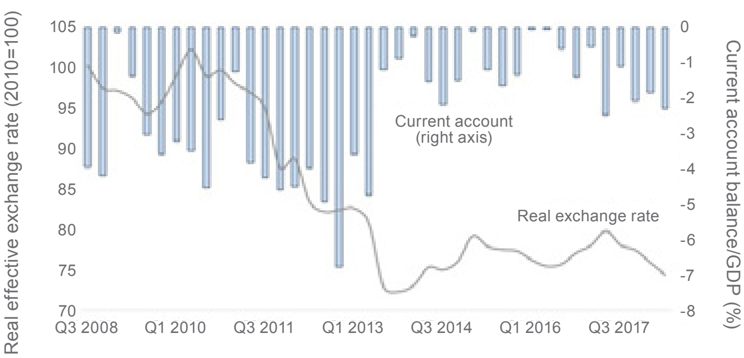
Source: Thirdrock calculations, from Thomson Reuters Datastream.
Notes: YoY inflation of the monthly headline and core (excluding food and energy) consumer price indexes.

In the shorter run, however, the Indian economy will certainly face a number of challenges. One (perhaps unintended) consequence of India's demonetisation and GST rollout was that tight money kept a lid on inflation through most of 2017; inflation went from a peak 5.1 percent at the start of 2017 to trough at around 4 percent currently (Fig. G). This softness mostly defied trends in other EMs, where price action either went sideways or picked up slightly, owing to commodity price pressure. Tack on how the contribution from the global component of inflation has been so quiescent over the same period, it is not too much to suggest that inflation—a perennial challenge for an economy that is both so dependent on favourable terms of trade from agricultural production, as well as large oil imports for transportation fuel—could well become a more salient issue in the months ahead. This will, of course, pose a dilemma for the Reserve Bank of India (RBI), which has an official inflation target of 4 percent. Even setting aside the RBI's chronic inability to meet its stated target, elevated prices will force the Bank to keep policy rates up, which in turn suggests a continuation of the poor run for Indian government bonds.

India has also not been spared from recent woes permeating through externally-dependent emerging markets. The rupee has fallen substantially since mid-2017, in both real and nominal terms. This, in turn, has meant an ever-greater burden from foreign-currency debt held on commercial balance sheets. This will, of course, compound the difficulties faced by the banking sector, already teetering due to the seemingly endless rise in the tide of nonperforming loans. It is for this reason that India is vulnerable to a financial crisis, rather than the traditional sources of vulnerability, such as excess fiscal or current account deficits (India has, to its credit, reduced these to just -3.5 and -1.9 of GDP, respectively, versus peaks of -5.9 and -4.8 percent just 5 years ago).

In mitigation, the rupee's depreciation may sow the seeds necessary for the economy's eventual recovery. Indeed, the weakness of the real exchange rate is clearly a factor behind the vast improvement in India's external account over the past four years (Fig. H), and continued weakness will play the role that flexible exchange rates are meant to play: allow the improved competitiveness to spur growth through exports. This textbook prediction will almost certainly hold, going forward, especially since India's service-dependent export composition is far less likely to be hit by the ongoing tariff wars currently wreaking havoc around the world.

FIG. H: THE FALL IN THE RUPEE HAS TRANSLATED INTO SUBSTANTIAL IMPROVEMENTS IN INDIA'S CURRENT ACCOUNT BALANCES



Source: Thirdrock compilation, from BIS/Datastream.
Notes: Trade-weighted real effective exchange rate (REER) indexes, rebased to 2010=100, for 61 economies as trading partners, using CPIs. Decreases in the index indicate depreciations.

INVESTMENT TAKEAWAYS

The overall environment for risky assets worldwide has continued to diverge. For the United States, equity markets have further strengthened, but valuations are still extremely elevated. We have remained invested in the U.S., but rebalanced toward more defensive markets and sectors, consistent with a more strategic allocation. Investors looking to take additional risk of the table can entertain traditional hedges, such as shorting the dollar yen, or picking up some longer-dated inflation- protected Treasuries. Quality is beginning to show up in the EM space, bolstered by attractive valuations; we reiterate our recommendation for patient investors to consider Asian EMs such as Indonesia and Malaysia, as well as India, as highlighted in this month's Outlook. Those diving in should be cognisant of the need to stomach near-term volatility.

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