MONTHLY MACRO OUTLOOK

ThirdRock

KEY MACROECONOMIC DEVELOPMENTS

- Production-side metrics now indicate a synchronized slowdown, in contrast to the synchronized expansion of early 2018
- The recent election of Bolsonaro in Brazil could be another Lula moment, sparking a solid economic run in the near term
- Our euro retrospective at 20 years suggests a continued steady performance of the currency, with breakup a tail risk

The mood in markets at the turn of the year appear to have shifted, staging a decisive recover from the lows around Christmas of last year. Unsurprisingly, markets appear to have gotten ahead of themselves again, after overshooting on the pessimistic side in December. As we discuss in this month's outlook, global macroeconomic indicators paint a very different picture from that which prevailed at the start of 2018, and with fragile fundamentals, we continue to advise appropriate caution on risk assets. That said, markets that were disfavored through much of 2018, such as Brazil, now appear to be attractive again, both from an asset front as well as—perhaps surprisingly—from an economic perspective (at least in the short run). We close with a review of the euro's performance as it enters its third decade, and argue that extreme pessimism over the currency's prospects are not warranted, so long as political will for continued integration remains solid.

FROM SYNCHRONIZED GROWTH TO SIMULTANEOUS SLOWDOWN

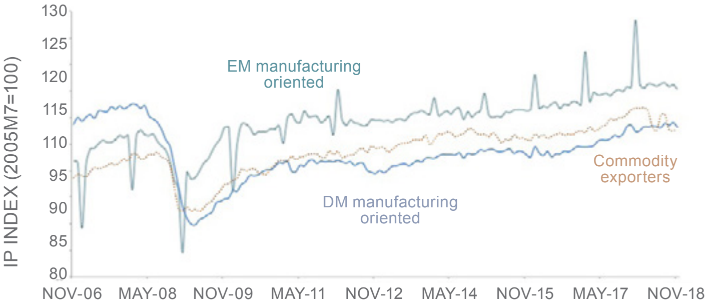
At the start of 2018, optimism abounded. The prevailing narrative at the time—which we subscribed to, briefly—was that the world was in the throes of synchronized global growth. It was the first time that the global economy had experienced this pleasant state of affairs since the global crisis of 2007/08. Yet even as that belief spread and became incorporated into government policymaking and financial market asset prices, a number of cracks in the storyline began to appear.

We warned of the first of these shocks around beginning of the second quarter. Based on real-time estimates of global economic activity, we pointed to a slight cooling in economic activity, premised on a slowing of above-potential developed markets (DM) growth, with little contribution from emerging market (EM) economies beyond their respective growth trends that would offset the DM slowdown. It was a theme that we returned to repeatedly over the course of 2018, as various major DMs—such as Japan and Germany—flirted with quarter-to-quarter contractions in output, while growth in China tottered in the face of a deteriorating trading environment and a belated effort to expand credit by the central bank. We even suggested, near the end of the year, that the hitherto mighty U.S. economy was not immune from the deleterious effects of a slowdown elsewhere, especially since its late-cycle stimulus was built off the back of deficit-financed tax cuts in the face of an already high public debt burden.

As the world pulls into 2019, what had been an almost steady rise in worldwide industrial production (IP)—even taking into account the stumble that DM manufacturing-oriented economies faced as a result of the European crisis, along with the blip faced by commodity exporters at the beginning of 2016 as a result of slowing Chinese commodity demand—appears to have reached a plateau at the end of last year. This stalling of industrial activity is evident for all three major groups and— in the case of EM manufacturers and global commodity exporters—the level of production has even begun to fall (see Fig. A).

“ What had been an almost steady rise in worldwide industrial production appears to have reached a plateau at the end of last year. ”

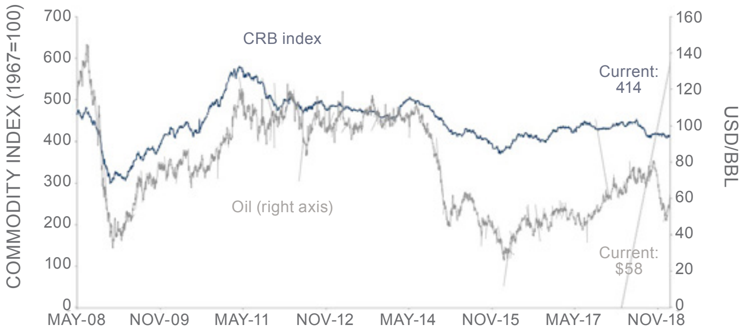
FIG. A: THE ALMOST-STEADY RISE IN WORLD INDUSTRIAL OUTPUT SINCE THE GLOBAL CRISIS IS BEGINNING TO LOOK INCREASINGLY SHAKY



Source: Thirdrock calculations, from Datastream.
Notes: DM-MO defined as the G4 (including the full Euro Area); EM-MO defined as China, India, Korea, Mexico, Poland, South Africa, Thailand & Turkey. CE defined as Australia, Canada, Norway, Argentina, Brazil, Colombia, Indonesia & Russia.

Such a slowdown is perhaps most stark when one considers the set comprising commodity exporters. In some ways this group can be considered a bellwether, since their macro prospects are heavily influenced by the terms of trade that they face, which in turn is easily buffeted by the winds of global demand and supply. Yet even when we set aside the usual machinations over supply in the global oil market (a topic we touched on in last month’s Macro Outlook), the dip in energy—and commodity prices more generally—over the past half-year (see Fig. B) can be attributed in large part to slowing global demand conditions. Consequently, we regard the massive drop in the growth rate of industrial activity in commodity-exporting economies as essentially symptomatic of the more broad-based weakness elsewhere.

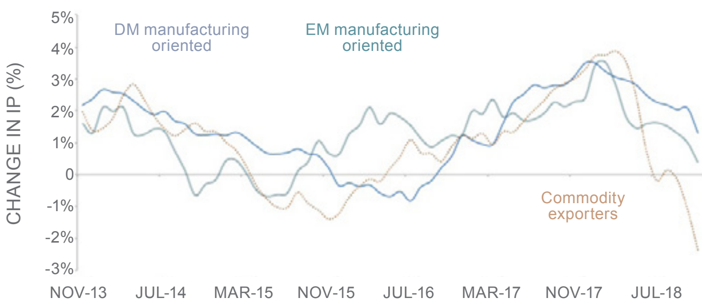
FIG. B: ENERGY PRICES HAVE FALLEN MOST ACROSS ALL COMMODITY CLASSES, BUT THERE IS WEAKNESS ACROSS THE BOARD



Source: Thirdrock calculations, from Thomson Reuters Eikon.
Notes: Oil prices are simple average of Brent and WTI prices per barrel. CRB index is normalized to 100 in 1967.

And this elsewhere is in the global manufacturing sector for both DMs and EMs. Year-on-year growth in IP for both groups decelerated over the course of 2018, after peaking in January last year. Among EMs, IP growth eked out only 0.4 percent in November, the lowest for about three years. And for DMs, IP growth clocked in at 1.3 percent; a relatively stronger print, no doubt, but still a marked halving from just a year ago. Perhaps most concerning is the fact that the trend in all three groups is unmistakably downward (see Fig. C). Of course, modern economies comprise much more than just their manufacturing sectors—especially among DMs—which is why such slowdowns have not immediately translated into outright recessions. But this cries out “synchronized global slowdown” more than just about anywhere that we’ve seen in the data.

FIG. C: THE GROWTH OF INDUSTRIAL PRODUCTION HAS UNDENIABLY SLOWED WORLDWIDE, ESPECIALLY COMPARED TO A YEAR AGO



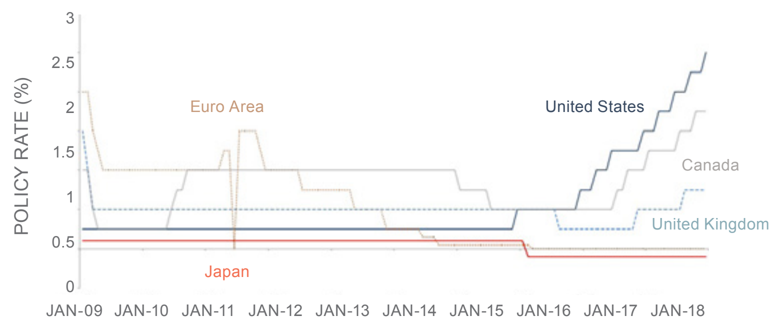
Source: Thirdrock calculations, from Datastream.
Notes: Series are MA(3) of monthly data. DM-MO defined as the G4 (including the full Euro Area); EM-MO defined as China, India, Korea, Mexico, Poland, South Africa, Thailand & Turkey.
CE defined as Australia, Canada, Norway, Argentina, Brazil, Colombia, Indonesia & Russia.

Beyond production, however, other metrics often used to determine the state of the business cycle have been somewhat more resilient. Retail sales across the G4 have not been markedly weaker, although they have dipped much more dramatically in certain EMs, such as China and India (and to a lesser extent, South Korea). Disposable incomes have also held up globally. But echoing the slowdown in production, employment measures—in particular the unemployment rate—have also begun to trend sideways (albeit at or close to record lows). For instance, the recent bottoming of the unemployment rate at 3.7 percent, followed by a pickup to 3.9 percent—even if spun positively as a result of increased labor force participation—is a classic end-cycle signal. Our takeaway here is that the production side of the economy has been the first to show weakness, and should this spread into the consumption side, slowdown dynamics could become much more entrenched. The steady souring of consumer sentiment in Europe and Japan (the case since the first quarter of 2018) is, therefore, a continued blot in this regard.

So here we are: within the short span of a year, what was a happy medium of worldwide economic expansion has now become a downshift that, with each passing month, looks more baked into the global economic pie than ever. And as this reality dawned, markets began to react; the brutal October selloff was followed by a very bloody December, and market participants began to price the prospect of weak macro fundamentals ever more seriously (see Fig. D). On our part, we do think the rapid moves in those two months probably overstated the near-term risks, and markets this year appear to be belatedly coming to terms with the fact that the pre-Christmas selling may have been excessive.

We are not out of the woods yet, of course, and the severe weakness of manufacturing across the world underscores how delicate the task that lies ahead for policymakers actually is. Foremost on their minds would be how to achieve the delicate balance of pausing the global rate hike cycle. This process has been in place for several years now, with different central banks at different stages of monetary tightening. The United States is furthest along its rate hike process, but if one takes into account the tapering of unconventional asset purchases by the Bank of Japan (since mid-2017) and European Central Bank (since late last year, as discussed in our previous Outlook), along with other monetary authorities in Canada and the UK (see Fig. E), it is clear that money is tighter now than it has ever been in this particular business cycle.

FIG. D: THE U.S. IS FURTHER ALONG ITS RATE HIKING, BUT MONEY IS TIGHTER ACROSS ALL DMS THAN AT ANY OTHER POINT THIS CYCLE

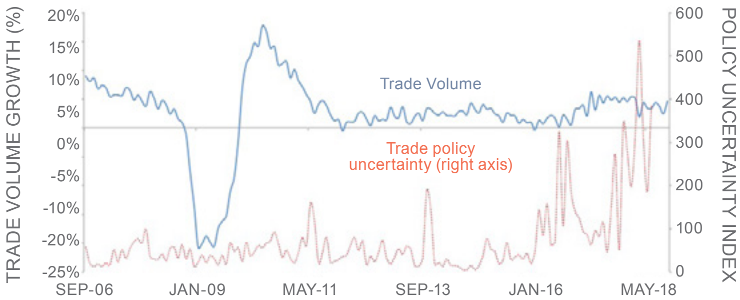


Source: Thirdrock compulation, from Central Banks/Datastream.
Notes: Official central bank policy interest rates. Declared central bank inflation targets differ (CAN: 2 +/- 1%; EUR: < 2%; GBR, JPN, USA: 2%).

Ensuring that this unwinding is orderly and gradual is especially critical for EMs, which have been forced to raise rates (to prevent excessive capital flight or, in some instances, as an outright defense for shoring up their battered currencies) in the face of domestic macro weakness. Their accommodation in the face of the Federal Reserve's unabated rate rises over the course of the year probably prevented a worse carnage than that which played out in the first half of 2018; still, central bankers in these economies will appreciate any relief they obtain from pauses by the Fed in the first half of this year.

The other major issue likely to keep policymakers up at night concerns trade. Since the Great Trade Collapse in the immediate aftermath of the global crisis, globalization has largely been on the retreat: the expansion of trade flows collapsed to just 2.9 percent between 2010 and 2016, from a 5.6 percent rate in the two decades prior. 2017 raised expectations as a nascent pickup began, but 2018—with all the talk of trade wars and the associated uncertainty over policy—saw a dip in trade once again (see Fig. E). The likelihood of a full-on trade recovery in the year ahead is not high. Absent the tailwind from solid international trading relationships, it is difficult to envision a healthy global economy.

FIG. E: TRADE GROWTH HAS BEEN ANEMIC SINCE THE CRISIS, BUT ITS NASCENT RECOVERY TOOK A BEATING AS POLICY UNCERTAINTY ROSE



Source: Thirdrock calculations, from CPB/Datastream and Baker, Bloom & Davis (2016).
Notes: YoY growth rate of global net trade volume index (2005=100). Trade policy uncertainty based on U.S. categorical policy uncertainty index measured using textual analysis by Baker, Bloom & Davis (2016), updated to December 2018.

Where does that leave the world economy? Not in a very secure position, unfortunately. We don't like buying into the prevailing gloom that has so rapidly shifted analyst sentiment from parroting synchronized growth to simultaneous slowdown, but it is hard to shake off the reality that significant headwinds have emerged from both the real and nominal sides. These shocks go beyond jittery financial markets; as discussed here, the trade shock has led to appreciable reductions in cross- border commerce, and interest rate rises have begat capital flow reversals and undermined the availability of credit.

The bottom line is that caution is warranted. There is still sufficient room for policy action to preempt a more persistent slowing of economic activity, the window for such interventions is closing, and the margin of error correspondingly tighter. This is especially the case for the two largest global economies, China and the United States. Consequently, continued trade frictions and political distractions (such as the U.S. government shutdown) can only prod that much more before what's left of economic strength wears down as well. So while we wouldn't go as far as some analysts as to call for outright recession by the end of 2019—or price in, as financial markets did in December, greater-than-even odds of a recession—we believe that the economic outlook worldwide is in a particular fragile phase for the remainder of the year. Investors should position themselves accordingly.

BRAZIL: BACK TO THE PAST OR BACK TO THE FUTURE?

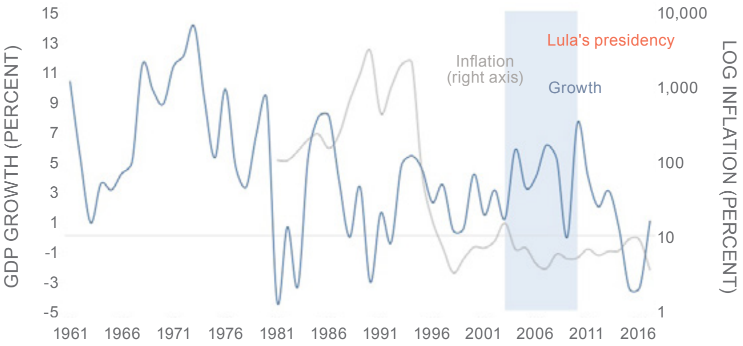
Emblazoned across the Southern night sky embedded in Brazil's flag is the national motto, Ordem e Progresso (Order and Progress). For many observers over the past decade, Latin America's largest economy has always seemed to embody the very opposite, with everything from its energetic samba dancing to its free-flowing ginga football to its Afro-Latin cuisine seeming to defy order in favor of passion. Unfortunately, Brazilian politics has not been exempt from such free-swinging style, and the ongoing Lava Jato (literally, "Car Wash") political-criminal investigation is characteristic of how economic progress in the economy may potentially be better served by more, rather than less, order.

It is against this backdrop that Jair Messias Bolsonaro (the middle name translating, literally, to “Messiah”), an inveterate populist and anti-establishmentarian (setting aside his very long political history, which dates back to the late 1980s), was elected. Both the media and political analysts in the West have repeatedly framed him as Brazil’s version of Donald Trump, which—to be entirely fair—is not a poor characterization of Bolsonaro’s personality. But from the perch of economic policy, however, Bolsonaro’s assumption into the presidency actually harks back an even earlier moment in the country’s history: that of the election of Lula, which held the office between 2003 and 2010 (and who, incidentally, has recently been sentenced to a dozen years in prison for corruption charges related to the Car Wash scandal).

Those of us paying attention to Brazilian politics at the time will undoubtedly recall the hue and cry—liberally sprinkled with premonitions of doom—immediately following the Lula’s election. An unapologetic far Left former union organizer, his ascent to power seemed, to his detractors at least, to be a rude throwback to many periods in Brazil’s history where socialist power was accompanied by economic dislocation.

Yet the subsequent period of his tenure was characterized but moderate to impressive growth rates and—more dramatically—a decisive end to the plague of high inflation in the economy (see Fig. F). One could quibble, of course, that the heightened growth that prevailed toward the end of his term was the result of a fortuitous combination of policy goosing and supercharged terms of trade during the late stages of the commodity supercycle. And that breaking the back of inflation probably owed more to the application of the modern tools of central banking—expertly wielded and engineered by then-governor of the Banco Central do Brasil, Henrique Meirelles—alongside an overall benign global price environment. But whatever one’s reservations, it is undeniable that Lula upended earlier expectations and was far more favorable for Brazil’s economic landscape and performance than even his most ardent supporters would have expected in late 2002.

FIG. F: LULA'S PRESIDENCY COINCIDED WITH A PERIOD OF STRONG ECONOMIC PERFORMANCE, DESPITE EARLIER EXPECTATIONS

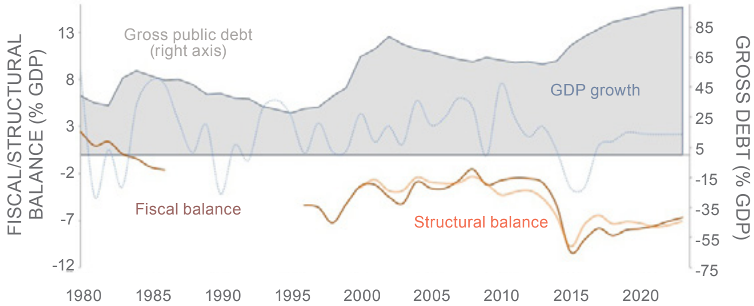


Source: Thirdrock calculations, from World Bank WDI
Notes: Annual real GDP growth and natural logarithm of the CPI inflation rate. Shaded area represents period of Lula's presidency.

Not to overwork an analogy, but there are certainly reasons to draw unlikely parallels between the Lula and Bolsonaro. Both were perceived as relative outsiders (albeit from different ends of the political spectrum), and cast themselves as champions of the disaffected (although again, to fairly distinct constituencies). Perhaps more relevant for our interests, both appointed market-oriented economists to helm important positions within their administration (Lula placed Meirelles as head of the central bank and, subsequently, as minister of the economy, while Bolsonaro tapped Paulo Guedes, a Chicago-trained investment banker, for the minister position and Roberto Campos Neto, another pro-market banker, to lead the monetary authority). The stage is thus set, so far at least, for a move away from Dilma Rouseff’s dirigisme, as well as Michel Temer’s ill-conceived hardline austerity policies.

This shift toward growth-focused policy, if well executed, may well elevate the economy out of its recent funk. The economy had endured two years of contraction, averaging negative three-and-a-half percent; it only just scraped into positive growth territory in 2017 and 2018, expanding at an anemic 1.0 and 1.4 percent annually (see Fig. G). While a tight-fisted consolidation in fiscal expenses could well have helped rein in runaway fiscal deficits in 2015 (peaking at almost 10 percent of GDP), the experiences of Europe have demonstrated that overzealous consolidations can delay macro recoveries, and an alternative strategy that focuses on countercyclical spending can provide important short-run relief—by limiting an excess contraction in output, which after all is the denominator in the debt/GDP ratio—leaving the more disruptive structural reforms for when the economy is healthier.

FIG. G: BRAZIL'S FISCAL POSITION DETERIORATED DUE TO THE RECESSION, BUT TOUGH CONSOLIDATION MAY HAVE SLOWED RECOVERY



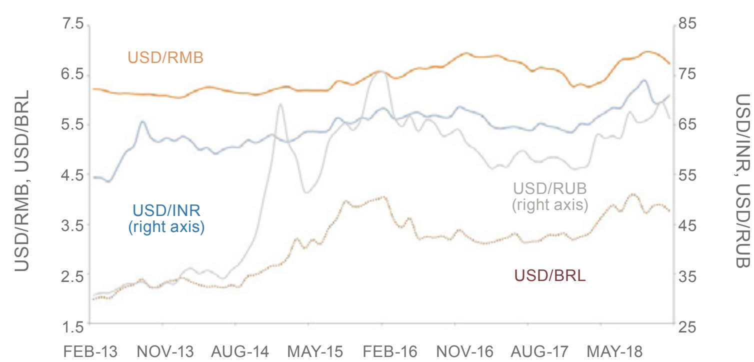
Source: Thirdrock calculations, from Mauro et al. (2013) and IMF WEO (2016)
Notes: The structural balance is the cyclically-adjusted fiscal balance further corrected for one-off expenditures/receipts. Values for 2017 are estimates, and after 2017 are projectios. Fiscal (structural) balance data between 1987-1995 (before 2000) not available.

The concern, of course, is that without aggressive efforts at addressing government expenditures, public debt will continue to spiral out of control. Indeed, the IMF projects that, at current projected growth rates, this debt load would top out at a little shy of 100 percent of GDP by 2023. This trajectory of debt accumulation will occur regardless of government balances or economic performance—indeed, the cyclically-adjusted fiscal balance is expected to improve markedly from the trough of 2015 to -7 percent by 2023—and were fiscal discipline or growth poorer, the debt stock would be even higher by then (recall, a nontrivial part of any debt repayment schedule comprises paying down the interest component). Still, the slowdown in debt buildup that would accompany a more responsible fiscal position—a major promise by the Bolsonaro administration— will go a long way toward building confidence in the future of the Brazilian economy.

“ Even with the amazing run the Bovespa has had thus far, valuations remain close to the lowest among EMs. ”

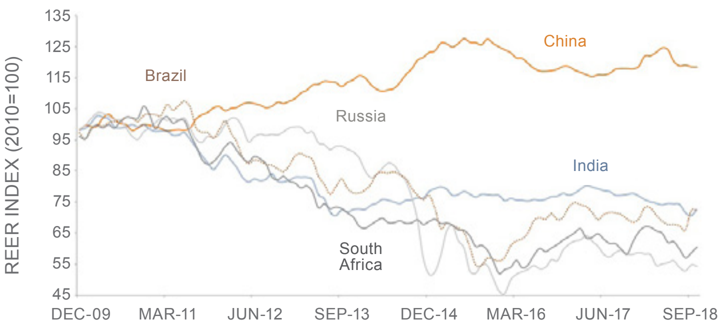
Some of this confidence returned after the worst of the 2014–17 crisis and recession. The real began its long recovery road in 2018, strengthening some 20 percent from January to December (it has since weakened a tad this year), bucking the trend prevalent among EM currencies through most of the year (see Fig. H). The currency has also held its own relative to its major trading partners, with the real effective exchange rate significantly off lows in mid-2016, and weakening the least among its BRICS compatriots (very recently overtaking India), with the exception of China (see Fig. I). What’s more, the laudable performance of the currency is but the tip of the iceberg insofar as risk assets are concerned.

FIG. H: THE *REAL* HAS STRENGTHENED OVER THE COURSE OF 2018, AFTER LANGUISHING THROUGH BRAZIL'S RECESSIONARY PERIOD



Source: Thirdrock calculations, from Thomson Reuters Eikon.
Notes: Currency pairs are monthly rates quoted in units of foreign currency to one USD, so that declines indicate depreciations of the USD (appreciation of the foreign currency).

FIG. I: WITH THE UNSURPRISING EXCEPTION OF CHINA, THE *REAL* HAS PERFORMED BETTER IN REAL TERMS THAN ITS BRICS COUNTERPARTS



Source: Thirdrock compilation, 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.

Brazilian equities have had an even more impressive run. The benchmark Bovespa essentially shrugged its shoulders in the face of the macro turmoil and, from 2016, posted an increase of 71 percent through the end of 2018 (it has continued to strengthen since this beginning of this year) (Fig. J). The record, while somewhat diminished in dollar terms, remains remarkable: 63 percent over the same period (although investors that plunged in only last year would have lost money, and only enjoyed a very credible 6.7 percent return if they held on through January this year.

FIG. J: THE BENCHMARK EQUITY INDEX HAS REMARKABLY BUCKED THE MACRO BACKDROP THROUGH THE CRISIS AND RECESSION

Source: Thirdrock compilation, from Datastream
Notes: The benchmark Bovespa index in local currency, whereas the MSCI index is given in USD. The overlap of the Bovespa and MSCI Brazil is substantial, and differences reflect mainly variations in currency returns.

If it isn't amply evident by now, Brazil reflects all the sorts of risks that one might expect an investment opportunity in an emerging market economy to exhibit: political, macroeconomic, and financial. Yet the recent past performance of the stock market demonstrates that political-economic analysis can only take you so far, and that the market pricing for Brazilian assets are either unbelievably prescient (a prescience still to be tested by time), or wildly overoptimistic. Of course, equity returns depend as much on the likely performance of profits and the macroeconomy, as it does on current valuations; so the natural question for anyone eyeing Brazil at the moment is: has it all been incorporated into the price, and all the returns to be had, taken?

Anyone who suggests that they know for certain is almost certainly yanking your chain, and so we won't pretend to know, either. What we will venture is that, even with the amazing run the Bovespa has had thus far, valuations remain close to the lowest among EMs; at 14.7 for the cyclically-adjusted Shiller price/earnings ratio, it is slightly lower than that of Mexico (at 18), and below most major EMs, with the exception of Russia (an eye-popping 6.4) and a few other Eastern European markets (in the low teens). And with the worst of the recession seemingly well into the rear-view mirror, and—as discussed above— the growth prospects holding promise (as long as Bolsonaro's team repeats a Lula), investments in Brazil are certainly intriguing (if not outright tantalizing) at the moment.

HAPPY 20TH EURO, YOU'RE NOW OUT OF THE TERRIBLE TEENS

The euro marks its 20th year as an operational currency this year, and as the currency stands on the brink of adulthood, the commentariat has happily obliged with both reviews of its past, as well as prognostications about its future. From our perspective, then, it is worth going through the same exercise, but we inform this exercise with the lens of the underlying economic motivations that the common currency was meant to provide.

One important caveat before we launch into it: like a number of others, we recognize that the euro is, ultimately, a political project, and so the viability and survivability of the currency rests on political foundations. And the overwhelming view of most Europeans is that economic unification stands as the bulwark of peace for a continent historically ravaged by war, and European integration culminates with (at the least) full economic union, which includes a common currency. Thus, so long as there is political will to keep the process of integration ongoing—and even with detractors, there still appears to be enough elite desire as well as popular support (save in Italy, which we discussed in a previous Outlook)—then the euro will continue to have a future. This dominance of politics over economics must condition any discussion that follows.

This does not mean, of course, that the future of the euro is either inevitable or secure. The euro was conceived for a region whose economies were relatively heterogeneous, and a number of economists—most famously City University of New York's Paul Krugman and Harvard's Marty Feldstein—pointed out that the zone did not exhibit characteristics consistent with an optimal currency area; these features, which would ensure the viability of a currency union, include relatively synchronized business cycles, mobility of factors of production such as labor and capital between economies, and countercyclical fiscal transfers. Counterarguments, mainly by European economists, were that many of these criteria were endogenous (a fifty- dollar word that simply means that the economies would gradually change over time to fulfill these conditions).

Over the past two decades, a number of these requisite conditions have indeed strengthened across the Eurozone. Capital, for instance, has readily flowed (some would argue, too readily) to the Southern periphery. The removal of migration barriers has also gone a long way toward facilitating cross-border labor flows (the proverbial Polish plumber was a political salient factor in the Brexit referendum), fears of language and cultural barriers notwithstanding. After all, the truth is that labor market flexibility would always only matter at the margin anyhow, even in a linguistically and largely culturally homogeneous country such as the United States; most motivated young Europeans were clearly willing to inject themselves into alternative cultures, and were sufficiently proficient in picking up English (which has become the lingua franca of Europe, perhaps ironically now that the UK is leaving), rendering concerns over labor market barriers essentially moot.

But a number of other conditions have failed to converge (or have not converged as much as the pro-European camp would like). Most notably, while there is evidence of an underlying common factor driving European business cycles, many economies continue to display sufficiently distinct cycles such that a common monetary policy has been more of an impediment than a blessing to macroeconomic performance. This was especially evident during the 2012/13 recession, where many economies in Northern and Central Europe required far less stimulus than those in the periphery. And while there has been some (very) limited movement toward fiscal unification—the European Stability Mechanism, which provides crisis-related countercyclical financial support, is capitalized by the respective ministries of finance—there has been overwhelming opposition to more decisive unionwide transfers, such as regional unemployment insurance system or dedicated centralized fiscal body, largely owing to fears of moral hazard: the Dutch are as unwilling to bankroll (perceived) lazy Greeks retiring at 61 as Italians are unwilling to subscribe to the (perceived) lifestyle of overworked Germans.

Such transfers are important, since the types of shocks faced by the economies of Europe continues to differ. Economic theory tells us that a fixed exchange rate, such as that which operates within the Eurozone, would give rise to higher variability of output when faced with a real-side shock, relative to a monetary shock. And although the Euro Area has experienced its fair share of monetary shocks—capital flow reversals during the global financial crisis are a prima pacie example—the greater overall openness of European economies means that shocks related to changes in global demand for their exports have been, and will continue to be, relevant in the future. This calls for an appropriate countercyclical stabilization mechanism, and the more automated this mechanism is, the better it will be insulated from the vagaries of European nationalist politics.

Taken as a whole, it is difficult to argue that the economies of the Eurozone have not begun the process of structural transformation and adaptation that would be necessary for mutual stability into the future. The question, as always, is whether this convergence will occur quickly enough, before a massive crisis derails the project altogether. In our view, that crisis— were it to occur—would come in the form of an Italian exit.

As we have argued in previous Outlooks, Italy is simultaneously too big to fail, or to bail. In its essence, the economy suffers from a mutually-reinforcing double whammy: poor growth due to structural weaknesses induce a loss of confidence in future prospects, which inhibits private investment and constrains credibility necessary for successful policy reform, which in turn erodes current and future economic performance. A worse-case scenario would unfold in this manner: first, sustained bailouts of Italian banks would lead to substantial increases in the public debt burden; next, rating agencies would revise their assessments and issue downgrades; in the extreme case, a downgrade below investment grade would rule out Italian debt from consideration as collateral for the ECB; this downward spiral then precipitates a severe liquidity crunch, which worsens as the reality of financial fragility dawns on the public, who begin to withdraw their euros for deposit into other non-Italian banks (or to store under mattresses or floorboards, as the case may be).

Were things to play out in this fashion, it is difficult to see a path for its continued maintenance of the euro. As Italy crashes out of the Euro Area, a similar dynamic would likely play out across the periphery, with spikes in credit default swap pricing and corresponding rises in yield spreads. Italy—and any other peripheral economy that is forced to abandon the common currency—will see sharp depreciations of their new national currencies, and very rapid increases in inflation.

Of course, what is possibly most ironic about such a situation—were it to develop—is that poor credibility, especially in monetary policy, was precisely the reason behind many peripheral economies joining the Eurozone in the first place. The lira, for instance, had routinely experienced depreciations as a result of attempts by previous governments of Italy to offset some of the fiscal burden, and Italian inflation stood closer to 5 percent (compared to the 2 percent currently) from the mid-1980s through till the mid-1990s. Adopting the euro allowed the peripheral economies to effectively import the highly-credible low- inflation regime of the Deutsche Bundesbank, a privilege still enjoyed by these economies today (the flip side of this argument, of course, is that Germany has itself benefited from the relatively undervalued exchange rate of the euro and has used this to power the country’s impressive export machine).

Which brings us full circle to the underlying political premise underlying the EU and, by extension, the euro. While some have openly speculated about the survivability, our base case is that political will is sufficiently strong, and so the sort of extreme outcomes described above remains a tail risk. If anything, the sort of chaos that Brexit has engendered has turned out to swing sentiment heavily in favor of the common project, at least insofar as the rest of the EU are concerned. The euro, as it stands, remains poised for steady performance in the months and years ahead. Of course, a slowdown in economic growth for the Euro Area means that the currency is definitively sailing into headwinds; but at the same time, it should also benefit from a pause in the Fed rate hike cycle. Indeed, on balance, the euro currently trades at close to its very long-run average in both nominal and real terms (Fig. K), a reflection that much of this news has already been priced into the current rate.

FIG. K: THE EURO CURRENTLY STANDS AT A LEVEL BROADLY COMPARABLE TO ITS HISTORICAL AVERAGE AGAINST THE DOLLAR

Source: Thirdrock calculations, from Thomson Reuters Datastream. Notes: Nominal rate is monthly and quoted in units of USD to one EUR, so that declines indicate depreciations of the euro (appreciation of the USD). Data prior to 1999 are for the European Currency Unit (ECU). Real rate is the monthly trade-weighted real effective exchange rate (REER) index, rebased to 2010=100, for 61 economies as trading partners, using CPIs. Decreasesin the index indicate depreciations. Maroon horizontal line represents the 40-year nominal average.

ThirdRock

INVESTMENT TAKEAWAYS

Market volatility is likely to remain elevated, even as equity markets have been buoyed by recent Fed statements about pausing and positive earnings reports (curiously downplaying the underperformers). We continue to recommend underweighting U.S. equities, and rotating away from consumer discretionary into consumer staples and healthcare. And with a broadly neutral euro outlook coupled with a somewhat bearish view of European downside risks (as discussed in a previous Outlook), we remain unenthusiastic about European equities. Elsewhere in equity space, we have become keener with respect to a wider range of EM assets, including—as discussed in this Outlook—Brazilian equities, along with our long-standing advice to take on EM Asian exposure. Our Treasuries position is mostly short duration, with some inflation hedges via TIPS and recession hedges via the 30-year. As is the case for equities, we like the prospects associated with EM Asian fixed income, especially for relatively more creditworthy markets such as Korea.

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