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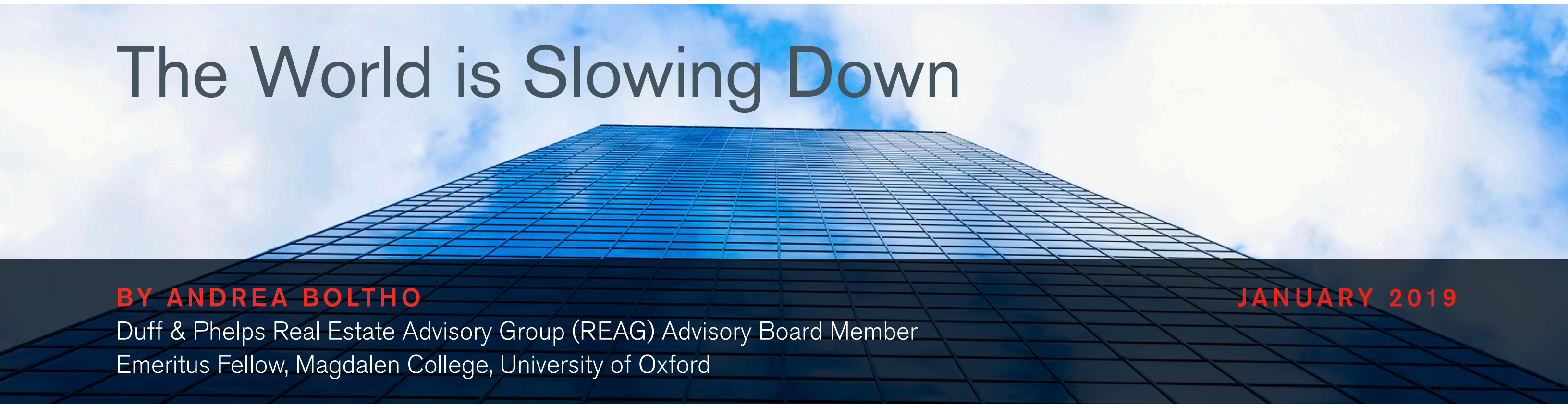

The World is Slowing Down

BY ANDREA BOLTHO

Duff & Phelps Real Estate Advisory Group (REAG) Advisory Board Member
Emeritus Fellow, Magdalen College, University of Oxford

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The end of last year saw a sudden rise in volatility on financial markets. Share prices, in particular, fell sharply almost everywhere suggesting that markets were gripped by feelings of greater uncertainty and by increasing worries about a coming recession in the world economy. These fears seem, however, overblown. Yes, there are signs of slowdown in the Eurozone, in the United States and in China (as well as in South- and East-Asia), but the underlying trends in real variables (as opposed to the froth of financial variables) point to a gradual and contained deceleration rather than to an impending crisis.

The U.S. continues to grow steadily and so does China. A U.S. slowdown in 2019-20 has been long predicted as fiscal policy stimuli fade away and higher interest rates begin to bite. If anything, the latter danger seems to have diminished since the Federal Reserve System appears to be opting for a much more gradual and moderate tightening of monetary policy than previously expected. Similarly, a modest Chinese slowdown over the next two years has also been forecast for some time, in line with a longer-run deceleration in the country's growth tempo. Here too, the slowdown may be less pronounced than had earlier been feared thanks to the recent adoption of some fiscal and monetary reflationary measures. The two countries are, of course, embroiled in a trade war and the present truce may be only temporary. Both economies will suffer from the mutual protectionism that has already been announced, let alone from any further escalation, but estimates of the likely negative effects remain contained.

In Europe, the outlook is most uncertain for the United Kingdom given that there is still no assurance that a compromise deal will be found once Brexit takes place at the end of March 2019. The forecasts shown below are based on the assumption that an agreement will be reached, but should a so-called "hard" Brexit (or absence of agreement) materialize, the outlook for the British economy could worsen significantly. Simulations by Oxford Economics suggest, for instance, that rather than growing by nearly 2 percent on average between 2018 and 2021, the UK's GDP would expand by only 1 percent per annum over the period, despite a further significant fall in the value of the pound and renewed cuts in interest rates by the Bank of England.

Elsewhere the news is less downbeat. Eastern Europe is still expanding rapidly. Growth rates of the order of 3 to 4 percent are expected this year and next not only in Poland, the leader of the pack, but also in Hungary, Slovakia and Bulgaria. Even Turkey, which is in the throes of recession at present, following sharp currency depreciation, virulent inflation and sky-high interest rates in 2018, is expected to return to positive growth by the beginning of 2020.

The Eurozone went through a rough patch during the Summer-Autumn of last year. The euro strengthened vis-à-vis the dollar, export growth to the rest of the world slowed down quite sharply, the German car sector suffered from a massive increase in unsold stocks, Italy seemed set on a clash with the European Commission because of its new government's electoral promises of fiscal expansion, France entered a period of turmoil and the European Central Bank (ECB) announced an exit from its quantitative easing programme, indicating, therefore, an impending tightening in monetary policy. The gloom was compounded by the GDP data for the third quarter of the year, which showed quarter on quarter declines in both Germany and Italy, for the first time since 2014.

Some of these fears have, however, dissipated. Italy and the EU have reached an (uneasy) compromise, helped in no small measure by the expansionary moves made by the French government in response to the “gilets jaunes” uprising. Turning to the much heralded tightening of monetary policy, this looks like being very mild, with the ECB’s short-term interest rate expected to remain negative through 2019, rising to barely ½ a percent by end-2021. As for the setbacks of late 2018, some of these may well have been temporary. Order inflows for German industry, for instance, have recovered somewhat in recent months, while French demand may benefit from Macron’s latest concessions. Should the surprising weakness in oil prices continue, European firms and households would also benefit from a further favourable effect on their purchasing power.

GDP growth expectations, at some 1½ percent per annum, remain modest, of course, if set against recent trends. They are in line, however, with the area’s potential output growth. Germany and Spain as well as Austria, Finland and the Netherlands look healthy. France, as mentioned above, should benefit from a small fiscal boost, but the outlook for Macron’s reform programme now looks more uncertain. Should the government make further concessions and retreat from its earlier intentions, the country’s medium-term outlook would undoubtedly suffer. Italy, as in the past, remains the weakest link. The new government’s policies have increased uncertainty; business confidence, in particular, has declined sharply. The public debt/GDP ratio may well increase further, given that growth prospects are put at less than 1 percent per annum over the next three years. And this, in turn, could weaken the position of the banking sector. The only redeeming feature has been the recent decline in the spread between Italian and German long-term interest rates.

Hopefully, this decline will prove long-lasting, but any turbulence on financial markets (even if due to non-Italian events) could well test it. The Eurozone has been in place for 20 years, but still remains fragile. And this fragility would sharply increase should Trump decide to penalize European car exports, something he has often threatened to do. Germany would be particularly vulnerable to such a move (and a “hard” Brexit would add to the country’s troubles given the importance of the UK market for its automotive sector). While a trade war with the United States would not necessarily result in recession, it would almost certainly dent growth significantly. And risks to the outlook would also increase should populist parties make large gains at the forthcoming European elections. Neither of these outcomes is a foregone conclusion, but they both point to negative downsides.

GDP GROWTH RATES (%)

	2017	2018	2019	2020	2021
Eurozone	2.5	1.9	1.6	1.6	1.4
United Kingdom	1.7	1.3	1.7	2.0	2.2
United States	2.2	2.9	2.5	1.9	1.7
China	6.9	6.6	6.1	5.8	5.4
China	3.0	3.0	2.8	2.7	2.7

Source: Oxford Economics.

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