In brief
The global economy seems to be shifting from synchronized recovery to cyclical divergence as political risks threaten economic and financial fragmentation along geopolitical fault lines. After assessing the current state of the world economy, we analyze in greater detail the possibility and implications of a US dollar/interest rate shock as well as the risks of greater protectionism, in each case from a historical perspective. Risks clearly exist, but an extremely negative outcome is not our central scenario. Nevertheless, the era of extremely low volatility and synchronous growth seems to be over. Investors thus might want to engage in tactically defensive relative value strategies.

The dual risks of cyclical growth divergence and structural economic and financial fragmentation are driving up asset-price and FX volatility. This combination points to greater dispersion of risk premia and returns across countries, asset classes and, indeed, instruments - varying according to exposure to these cyclical and structural risks. We analyze the current state of the world economy and its consequences for investors, with a particular focus on the emerging markets (EM).

We believe tensions in major bond and currency markets owe more to growth divergence than the US Federal Reserve’s (Fed) paradigm shift from extraordinary back to “normal” monetary policy alone. Fed policy normalization proceeded smoothly during 2017 when the world seemed to be experiencing a synchronized Goldilocks recovery with solid and widespread growth and low inflation. In 2018, however, risks of a de-synchronization across major economies have risen, with downside surprises in the rest of the world and potential upside in US growth and inflation.

US growth and inflation had remained in line with expectations until Q1 2018, when the risks began tilting to the upside due to tax reforms and fiscal stimulus unprecedented in a mid-/late-cycle economy with little, if any, output gap left. The other major economies have decelerated, led by Europe and China, causing global growth to de-synchronize noticeably, undermining the Goldilocks narrative of
World economy: cyclical divergence and structural fragmentation are major risks, but not central scenarios

2017 and the risk-on portfolio allocations built up for the first time since the taper tantrum.

In Q2 2018, these challenges have increased. Evidence has accumulated that the US will accelerate compared to other major economies, even as the eurozone recovers from its mid-cycle winter slowdown and with China still decelerating in response to tighter credit policy. The preliminary estimate of US Q2 GDP was 4.1%, in line with the consensus after major upward revisions. Invesco Fixed Income Nowcasts lie in the 3.6% range for Q2 (figure 1), but others - notably the Atlanta Fed - are in the high 4% range.

In any case, a US growth surge should support global growth and trade, offsetting deceleration in Europe and China, to the benefit of the emerging markets, as well as eurozone and Chinese exports. The caveats, however, are trade and technology tensions. US growth in the mid-3 to high-4% range with inflation near target would imply a 2018 US contribution to global nominal demand of some USD 1-1.4 trillion at an annual rate, up from a 2017 run rate of about USD 750 billion. By contrast: the 1% deceleration in real eurozone GDP, now being baked into consensus annual GDP forecasts, would subtract the equivalent of some USD 100-150 billion over the course of 2018 compared to 2017. Thus, accelerating US GDP adds more to global demand than the eurozone deceleration subtracts, but at the risk of greater cyclical global economic divergence, in turn raising the risk that the Fed will have to move further and faster than the European Central Bank (ECB), boosting the US dollar and tightening global and EM financial conditions.

Rising challenges
As long as the US doesn’t overheat, the global economy should tick over nicely. However, challenges have risen - not so much in global final demand as in global financial conditions, due to divergence and US dollar strength. This is caused by a combination of downside risks in the US and upside risks elsewhere. Mistimed US fiscal stimulus might boost inflation and prompt the Fed to be more hawkish, possibly bringing the next US recession forward even as global economic divergences widen along the way. Furthermore, monetary and fiscal policy responses may be constrained when the effects of the next downturn finally feed through. All of this is consistent with the flattening of the US yield curve despite surging growth, capacity constraints and increased bond supply from both increased US Treasury deficit funding and Fed balance sheet tapering.

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A sharp rise in the US fiscal deficit, already expected to reach 5-6% of GDP, in an economy operating at or above potential, could reduce headroom for countercyclical fiscal easing in the next recession. Moreover, the Fed will probably not be able to cut rates by the 500-600 bps that it makes during a typical recession before hitting the zero lower bound and could thus find itself forced to resume quantitative easing (QE). And recession may come forward despite the fiscal stimulus if trade/technology tensions sufficiently tighten financial conditions or dampen confidence and global corporate investment intentions.

Downside surprises outside the US have contributed to cyclical divergence in Q1 2018 and remain a risk in the face of trade/technology tensions and the after-effects of credit policy tightening in China, which are not being fully offset by the easing of monetary policy. The eurozone had been growing above trend through 2017, but in Q1 seemed to be decelerating (figure 2). The ECB has already responded with plans to delay rate hikes until well into 2019, rather than alter plans to bring its QE programme to closure by year-end. This should help mitigate eurozone growth and inflation downside risks, but delayed rate hikes are another euro-negative on top of US dollar-positive upside US risks. US dollar strength due to these macro divergences is, in our view, tightening financial conditions, especially in the emerging markets that rely heavily on dollar funding.
Eurozone deceleration could become more severe and recession risks rise in a full-blown trade war, a disruptive hard Brexit or a major political confrontation between populist governments and the EU – and the ECB’s room for manoeuvre could be called into question. Policy and short rates remain negative, a factor that continues to pose problems for eurozone banks, also because their lending capacity has suffered as their equities have been hit by eurozone economic deceleration and trade tensions. The room for additional ECB QE already faced bond supply constraints under the ECB’s capital key, which effectively limits bond buying across member states according to their eurozone GDP weights.

Nevertheless, we expect Europe to return to trend rather than continue slowing towards a recession, as some of the transitory effects of a severe winter, anti-reform strikes in France and the political season in Germany and Italy pass out of the data. European political risks remain high, but the challenges of dealing with populism around migration, refugees, fiscal and structural reforms today pale in comparison to the urgent, existential risks of the euro disintegration during the height of the eurozone crisis in 2010-12.

And China?
China’s policy-led credit tightening, economic slowdown and rebalancing could also be affected. Efforts to rebalance from net trade and investment to a consumption and services-led economy – all while maintaining strong growth to reduce debt ratios – would be complicated by a trade war. Rising US trade barriers, short of outright restrictions on trade or widespread curbs on foreign investment inflows required to finance the trade deficit, would imply a stronger US dollar and a weaker renminbi. Indeed, the People’s Bank of China may be accommodating pressure on the renminbi and other financial assets as trade tensions have risen.

Renminbi depreciation could be a natural market response to rising trade barriers, and implicit threats of devaluation could be a strategic response to trade/investment friction as part of bilateral US-China bargaining given the prominence of currency valuations in US assessment of unfair trade practices. A large devaluation would be negative for China, the US and the rest of the world – including the eurozone and the emerging markets: it would retard China’s rebalancing towards domestic demand, which would benefit from the greater consumer purchasing power arising from a stronger real exchange rate. And devaluation would import inflation into China, which might prove useful for the debt ratios in the short term; but it would also export deflation and probably weaken global trade growth to the detriment of the eurozone and emerging markets, including China.

The economic cost of populism and protectionism
The already challenging combination of cyclical divergences and macro policy risks is compounded by geopolitical tail risks that could conceivably complicate both the cyclical and structural global growth outlook, especially for the emerging markets. The rise of populism, in the US and Europe in particular, threatens to disrupt the globalization of international trade, investment and migration that has spanned decades of Western economic liberalization, the opening up of China, India, the former Soviet bloc, Latin America and Africa. As if that were not enough, geopolitical tensions between the US and China stand in stark contrast to the peace dividend that began with the Soviet collapse. In a worst case scenario, the investment thesis for the emerging markets could be called into question.

We now turn to key risk scenarios and historical parallels to analyze the current situation in more depth – not because history repeats itself per se, but because it does often rhyme with patterns that can provide useful guideposts.

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**Risks and consequences of a US dollar shock, an interest rate shock or a joint US dollar/rate shock**

We break down the combination of cyclical economic and structural geopolitical risks into a US dollar shock, an interest rate shock and a joint US dollar/rate shock in order to help assess how the world economy and emerging economies and asset classes are likely to fare in various scenarios.

- We would define a US dollar shock for these purposes as a scenario in which the US dollar rises largely because of downside risks and surprises in other major economies, without a US interest rate shock. Such a scenario would occur if the US economy were on track while the other countries surprised on the downside. US policy rates and yields would not rise, but global rates would fall, causing other currencies to depreciate relative to the US dollar. Global financial conditions would tighten meaningfully, but not severely. This scenario was arguably unfolding in Q1 2018.
An interest rate shock would be one in which US policy rates and yields rise without significant US dollar strength because of domestic overheating and excessive US imbalances - notably inflation, but also the so-called “twin deficits” in the fiscal and external current accounts at a time when other economies were growing robustly without significant imbalances. Rising global rates amid rising US refinancing needs and expected currency depreciation would keep the US dollar from rallying significantly even as US policy rates and bond yields rise. This scenario is reminiscent of the 2004-06/07 US business cycle.

A joint US dollar/rate shock would be a scenario in which US overheating requires a strong Fed response beyond expected tightening, likely in the context of relative weakness elsewhere. The result would probably be a significant, even severe tightening in global financial conditions, one which could severely dent emerging market and global growth. Features of this scenario could include downside geopolitical risks - including trade/technology tensions which could drive down global investment and growth, combined with a cyclical upswing in the US driven by short-term fiscal stimulus. This risk has risen in Q2 2018 and may well remain elevated in coming months.

We expect US dollar strength to pose idiosyncratic adjustment pressures on emerging market countries with excessive imbalances, especially current account deficits and high short-term financing needs. We do not expect a systematic market shock as occurred during the 2013-14 Taper Tantrum because the external financing needs and macro imbalances - inflation and current account deficits of most countries across the market have been substantially reduced since then.

Furthermore, relatively buoyant commodity prices on the back of a strong US dollar suggest that the world economy is in reasonable shape - even granting that the oil price rally probably owes partly to geopolitical risks such as Iran or Venezuela sanctions. These shifts in the commodity terms of trade also point to divergences across different categories of emerging market countries and currencies - commodity importers, metals/minerals versus hydrocarbon exporters.

A sustained US interest rate shock resulting from a significant inflation surprise could be reminiscent of the Reagan era; high real interest rates and a yield curve steepening which might require the Fed to respond with a significant monetary tightening that could in turn generate a US dollar shock. Such a risk scenario is more likely to pose a systemic risk to the emerging market asset class by raising global risk premia significantly. The yield curve would not flatten but rise and steepen, eventually inverting in anticipation of a US - and a significant global - slowdown. Emerging countries would face significantly higher refinancing costs, and sequential corporate, financial or serial defaults might well occur.

We believe the emerging market asset class is far more exposed to a significant interest rate or joint US dollar-rate shock than a US dollar shock. A US dollar shock, driven by downside in other major economies, would be less of a challenge for the overall market because the emerging market asset class as a whole has experienced a significant current account adjustment already (figure 3) in response to the withdrawal of

Figure 3
Emerging market external deficits have narrowed, but debt service/refinancing needs remain high

Figure 4
Emerging market public debt is high and rising, though increasingly domestic

A sustained US interest rate shock resulting from a significant inflation surprise could be reminiscent of the Reagan era.
US dollar financing precipitated by the eurozone financial crisis and the taper tantrum.

A global interest rate or a joint US dollar rate shock is more likely to be systematic because emerging countries as a whole have a high level of debt - public or private depending on the country. A large part of this debt, especially public debt, has been "domesticated" in the context of a general shift from fixed to floating exchange rates, but much of it is still owed to US dollar-based investors, even when issued in domestic currency in domestic jurisdictions (figure 4).

But we don’t want to invite trouble: we see the joint US dollar rate shock as a risk scenario rather than a central scenario, because we believe the current pressures originate in downside surprises and risks in the rest of the world rather than upside surprises to growth and inflation in the US itself. That said, such a risk scenario should be factored into the calculations of policymakers and investors alike because of the late cycle US fiscal stimulus.

The geopolitics of geo-economic fragmentation

Turning to geo- and domestic politics, we see parallels to the 19th century - a period of rapid innovation with competing economic and political models, considerable global and financial integration and significant Luddite-style resistance to change. The current so-called Fourth Industrial Revolution poses risks to employment and labor income in both skilled and unskilled segments of the workforce, across countries developed and emerging, suggesting that both widespread insecurity and resistance to progress will persist. Furthermore, the balance between private property rights, consumer preferences and insecurity in the labor market suggests continued competitive pressures for productivity growth and contained real wage/inflation pressures.

We do not expect a reassessment of a Cold War-type world economy fragmented by ideologically motivated barriers to trade and investment. Nor do we expect a breakdown of international political dialogue or economic and financial integration as occurred during the inter-war period. We expect that the Trump administration will continue to respond to resistance from businesses and specific states and other interest groups that are harmed by protectionist policies or retaliation. There is, after all, evidence of willingness to change course if policies should prove self-harming, as can be seen with the Rusal sanctions or the change of heart on ZTE following commitments to a recalibration of policies.

Even so, tensions in international trade and investment are likely to remain a persistent challenge. The structural tension in the global economy lies in the US-China geopolitical rivalry, given explicit identification of China as a threat by the US National Security Review. Trade tensions are clearly crucial, but are amenable to negotiation through lower tariff or non-tariff barriers. But lying at the heart of the issues between the US and China are two different political-economic models which are non-negotiable: the United States revolves around private property and market forces as the basis of technological and economic progress. In contrast, China’s mission statement centres on the collective national interest, which now includes industrial policies targeted at reaching and maintaining the global technological frontier and thus implies both economic and geopolitical rivalry, supported by the resources of the state.

Such sustained, elevated tensions are likely to cause periods of financial market stress that could tighten financial conditions and weigh on growth, especially in emerging market countries that are at the cutting edge of globalization, trade tension and investment restrictions. Resulting pressures on emerging market currencies could boost imported inflation, pushing central banks into a policy dilemma with the possibility of slower growth accompanied by higher inflation, or expectations thereof.
Even so, we do not expect a major crisis, given global experience in previous episodes of severe protectionism and geopolitical barriers to trade and investment. Severe protectionism is associated with deep recession and open conflict, most obviously following the Great Crash of 1929, arguably in parallel to today’s post-Global Financial Crisis protectionism: the 1930s US Smoot-Hawley tariffs exacerbated the Great Depression, and were overcome by World War II mobilization. Less famously but no less notoriously, President Jefferson’s 1807 imposition of tariffs was motivated by geopolitical tensions with Great Britain and France and is believed to have precipitated a 5% collapse in US GDP and led to the War of 1812 and burning of the White House.

However, it need not end so badly – and has not always done so. Threats of trade war precipitated the 1987 Black Monday, the largest one-day correction in US stock market history, but there was no actual trade war. The solution to the 1980s wave of Reagan-era US protectionism was a shift of auto investment into the United States - a result of negotiations and reconciliation among the major economic powers of the time - US, Europe and Japan.

The stakes are high this time and extend to both basic economic relationships as well as geopolitics. Relations with Russia are very tense amid allegations of interference in the US political process as well as upending the post-World War II/Cold War perception that national borders are inviolate, at least in Europe, with the annexation of Crimea, destabilization of Donbass and frozen conflicts in Georgia and Moldova. Furthermore, President Trump’s domestic political strategy seems to play a major role in foreign security and economic practices, in a break with the past. He is focusing on the core issues of his core US rust-belt, swing-state constituency, which has been deeply affected by globalization and technological progress.

Yet there are reasons for hope because most other countries want to remain engaged in the international system, and the Trump Government is making some progress, as with Mexico for example. Although tensions are highest with China, the Trump administration is not singling out China. Meanwhile, Trump himself is undertaking major personal efforts to connect personally with President Putin, apparently to make Russia feel more confident that NATO and Europe do not represent a threat. And, he has responded to President Xi’s personal overtures, as in the case of the Chinese telecommunications equipment manufacturer ZTE. After paying a billion US dollar fine, the smartphone maker is now once again allowed to do business with US companies.

The desire to avoid economic closure is very likely as strong in the major EM countries as it is in the West. During the Cold War, the comparative economic isolation of the USSR, China, India, South Africa and even, to a lesser degree, many other countries throughout Latin America, Africa and Asia help to explain their relatively low levels and growth of income per capita, lower productivity and distance from the technological frontier.

Thus, there are reasons to believe that accommodations can be made and so-called “off-ramps” be found, even though the stakes are high and tensions are likely to persist. Ultimately, it is more likely that there will be engagement rather than isolation. After all, no major power is likely to change its economic model or goals, and history suggests that geopolitical isolation and economic autarky actually encourage rather than prevent tension, conflict or technological and military competition.

Conclusion: tactically defensive relative value rather than strategic hunkering down

The policy and investment implications, in our view, are the same for all other risky assets: the global economy is alive and kicking, but it's not in the best of health; amid major risks and challenges, a full-blown crisis seems unlikely. Despite justified concerns about antidotes to the next downturn or the cure for structural shifts in global integration if barriers should rise, we do not expect any sudden changes.

The global economy is alive and kicking, but it’s not in the best of health; amid major risks and challenges, a full-blown crisis seems unlikely.

But time is of the essence and is crucial if the real economy is to adapt based on the behaviour and national interests of all concerned governments.

For most emerging market governments, this means applying tighter macro policies to contain macro imbalances – whether above target inflation or excessive fiscal or external deficits; for those with already outsized imbalances, this means reducing them rapidly. For both, this means structural change to adapt to a global environment that may be structurally less forgiving of excessive imbalances because of the heightened risks of cyclical divergences and structurally higher barriers to further global economic integration.

We believe these are reasons for tactical defensiveness rather than strategic hunkering down for a nuclear winter in financial markets or the real economy. We expect the impact of political and policy risks to continue to be reflected in high volatility episodes, arguing for tighter monetary policy and slower growth in many emerging market countries, as well as a much greater variation in performance at the country level. Furthermore, the asset class as a whole does not need to go through a systemic shakeout, but some countries with excessive imbalances need to undergo major cyclical and structural adjustments – notably Turkey, Argentina and Venezuela. Others need significant structural reforms and fiscal adjustments to boost potential growth – notably South Africa and Brazil, among others.

All of these factors – top-down global and bottom-up country stories - could argue for relative value opportunities rather than a “sell-the-market” mentality. Although we are likely entering into a more variegated, volatile global environment, we believe it should
ultimately result in greater selectivity rather than a generalized outflow from the emerging market asset class. If Europe's and Japan's economies continue to surprise on the downside or US fiscal policy boosts inflation, causing the Fed to become more aggressive, we could see a sharp US dollar rally, with beta dominance most likely reasserting itself. Flare-ups in geopolitical risks or trade tensions would also likely resurrect beta dominance. In any such systematic, global downside scenario, emerging markets as an asset class would be very heavily exposed, as countries that have had the most growth and investment inflow benefit from globalization over time, and from cyclical global economic recovery, low global inflation and easy monetary policy.

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