

Flash Economics

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Good news ahead will buoy financial markets

We think that financial markets are going to recover thanks to several good pieces of news:

- The euro zone is not going to slip into recession at all, contrary to investors' current expectations;
- In the United States, the Trump administration is going to seek compromises on trade with China, Japan, Europe and Mexico, as it has done with Canada;
- There is no serious cause for US growth to fall significantly lower than potential growth, which has increased thanks to the upturn in productivity gains.

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Investors are pessimistic in the spring of 2019

Equity valuation (Chart 1) and the recent trend in credit spreads (Charts 2A and B) show that investors have been pessimistic in the spring of 2019.

Chart 1
Forward PER

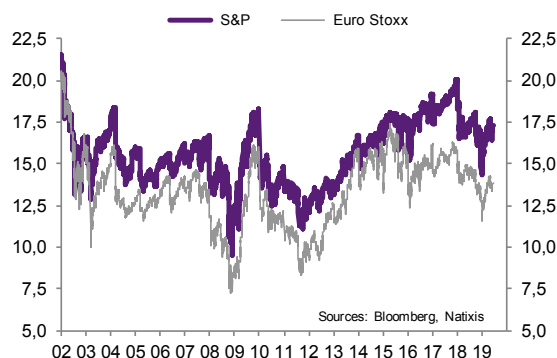


Chart 2A
Investment Grade credits spread*
(asset swaps, in bp)

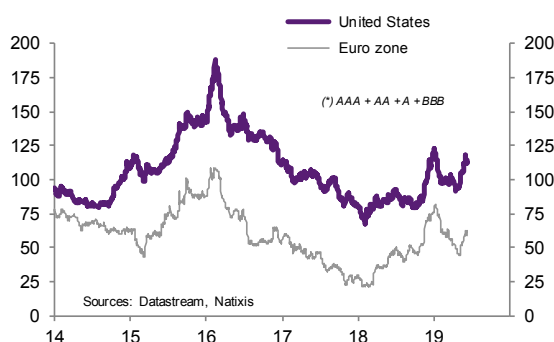
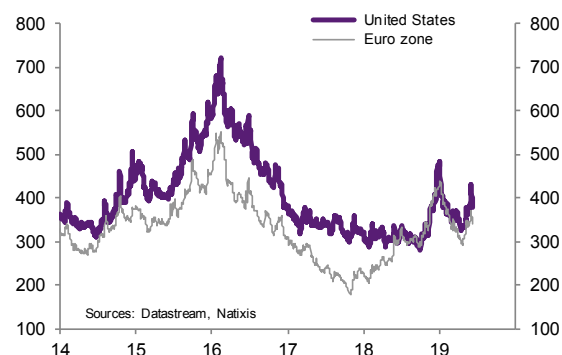


Chart 2B
High Yield credit spread (asset swaps, in bp)



But we believe that this pessimism is going to subside thanks to the arrival of three good pieces of news.

Three good pieces of news to come

1. The euro zone is not going to slip into recession

Investors currently believe that the euro zone is going to slip into recession: they are selling euro-zone equities (Chart 3A) and have taken a short position in the euro (Chart 3B).

Chart 3A
Euro zone: Purchases of equities by non-residents (USD bn)

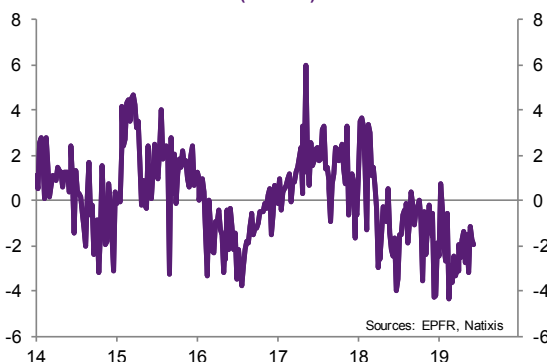
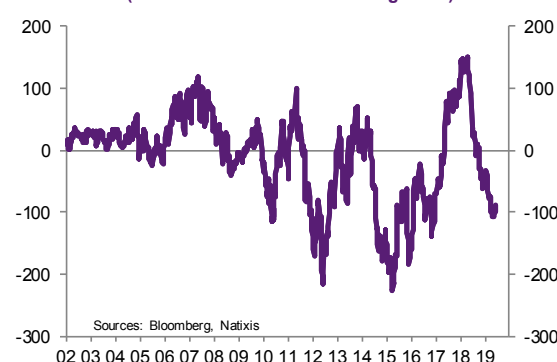


Chart 3B
Net open position in the euro (in thousands of contracts: long-short)



But the euro zone is not going to slip into recession.

Growth (0.4% in the first quarter of 2019) is being boosted by expansionary fiscal policies in France and Italy (**Chart 4A**), very low interest rates (**Chart 4B**) and real wage growth (**Chart 4C**).

Chart 4A
Fiscal deficit (as % of nominal GDP)

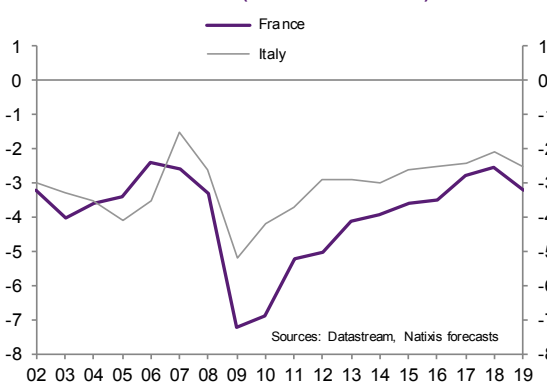


Chart 4B
Euro zone: Interest rate on fixed-rate loans to households and companies (as %)

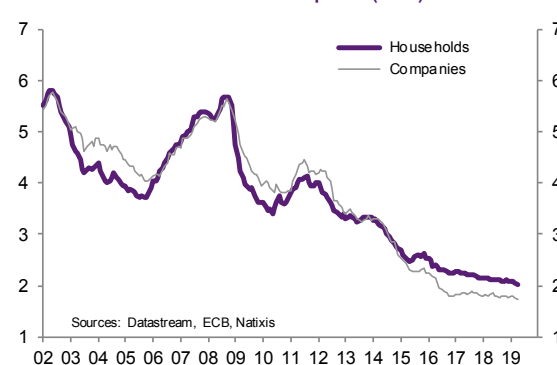
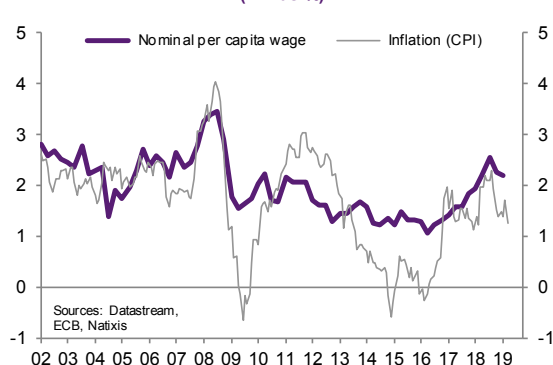


Chart 4C
Euro zone: Inflation and nominal per capita wage (Y/Y as %)



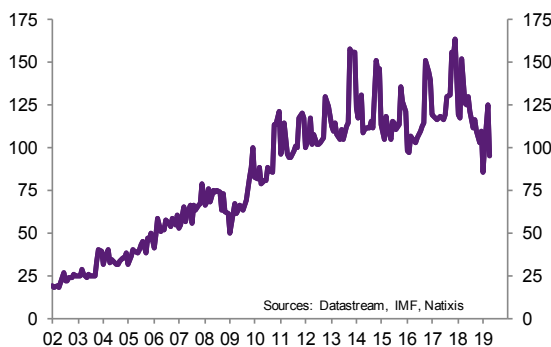
Investors are therefore going to become less pessimistic about the euro zone.

2. The Trump administration is going to seek compromises on trade with China, Japan, Europe and Mexico

It will do so because a lasting trade war would weaken the US economy:

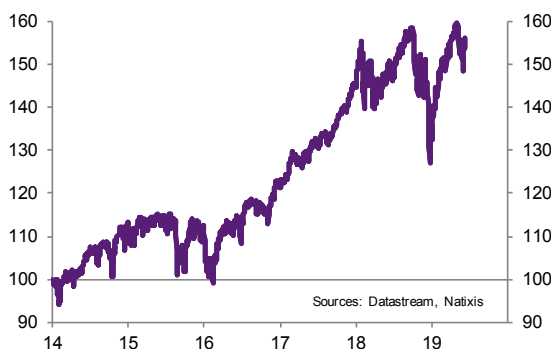
- Due to retaliatory measures by the other countries (US exports to China have fallen, **Chart 5A**);

Chart 5A
United States: Exports to China
in value terms (USD bn per year)



- Due to the fall in the equity market every time protectionist measures are announced (September 2018, May 2019, **Chart 5B**) and the extent of the equity wealth effect in the United States.

Chart 5B
S&P stock market index (2014:1 = 100)



Investors should therefore stop worrying about a lasting trade war.

3. There is no factor that would send US growth below potential growth, which is high

The upturn in productivity gains in the United States (**Chart 6A**) has **driven up potential growth** (**Chart 6B**), which is already good news.

Chart 6A
United States: Per capita productivity (Y/Y as %)

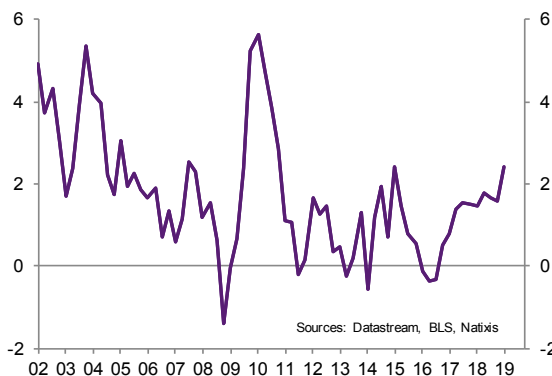
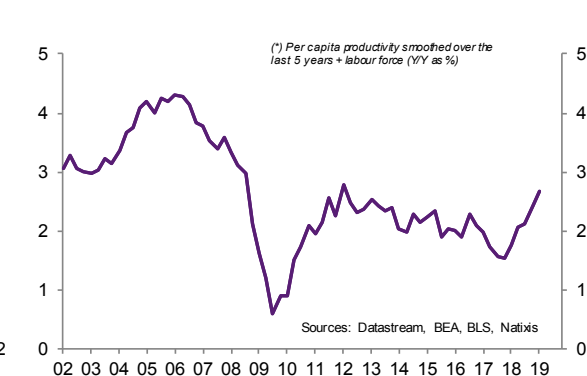
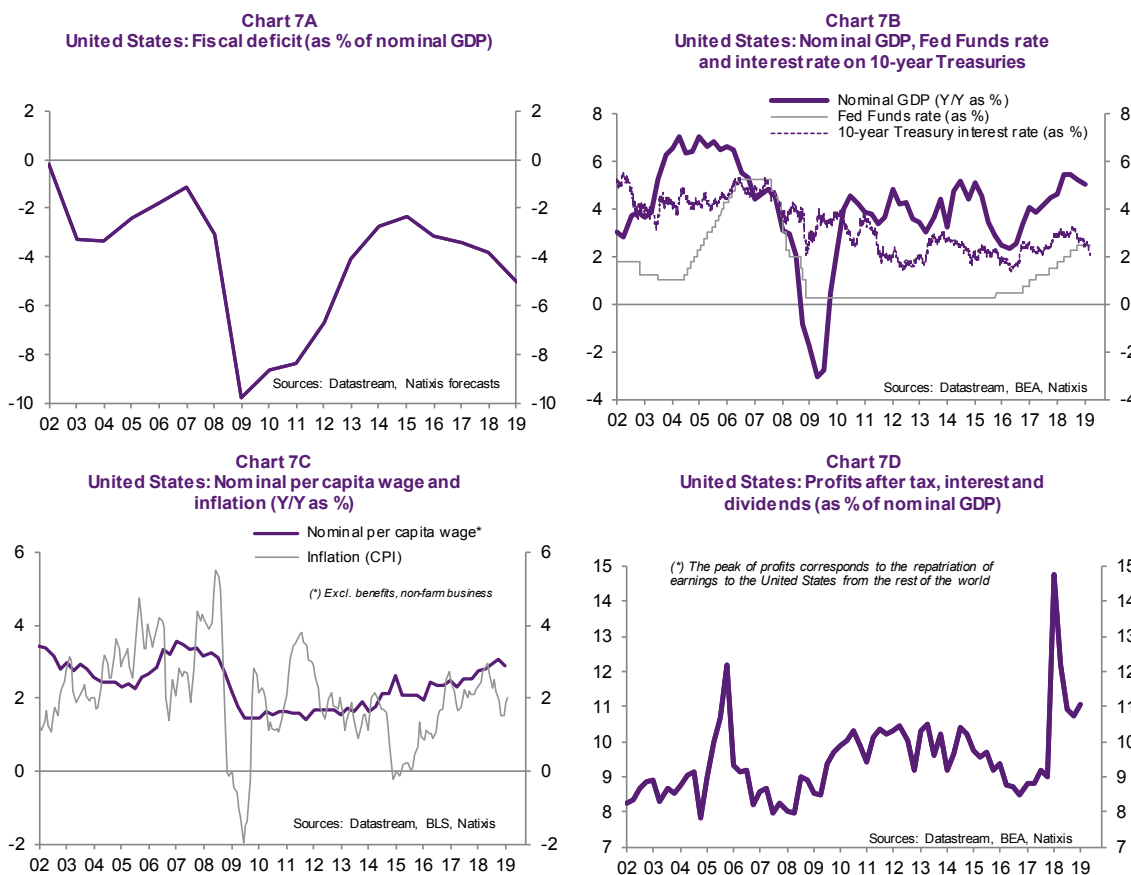


Chart 6B
United States: Real potential growth*



Moreover, both fiscal policy (**Chart 7A**) and monetary policy (**Chart 7B**) are expansionary in the United States, while the fall in inflation is boosting household purchasing power (**Chart 7C**) and corporate profitability is high (**Chart 7D**): it is hard to see growth being much lower than potential growth in the United States.



Conclusion: Investors should become more optimistic again

Given:

- The observation that the euro zone is not in recession;
- The convergence towards compromises on trade between the United States and the other countries;
- A US growth rate not far from potential growth, which has risen,

investors are likely to gradually become more optimistic again.

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