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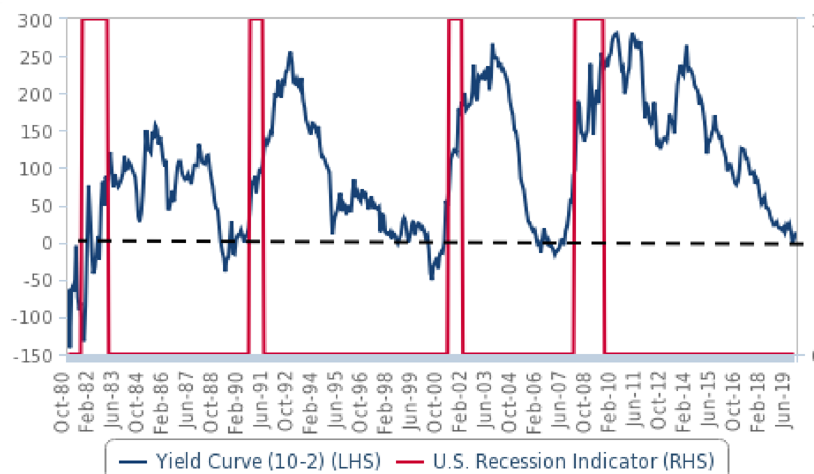
Recession Risks: Webinar Q&A

On September 13 we hosted a webinar titled 'Recession Risks: What To Watch?', which is part of our Recession Risk series of articles that we started in April to help our clients better understand the rising risk, and the potential impact, of another global recession. Below we provide answers to some of the questions that we received from our clients during the webinar. Many clients seem concerned about the prospects of a recession as well as which regions – and countries within those regions – remain most vulnerable.

Are Financial Markets Pricing In A Recession?

Certain financial market assets are pointing to a recession in the near term, but others are not. For example, bond yields are pricing in much slower growth and inflation swaps are pointing towards low inflationary pressures consistent with recessionary conditions. Additionally, a large portion of the yield curve in the US (and other countries) is inverted, which typically signals that a recession is forthcoming. At the same time, we have stated to see some safe haven assets such as gold, the Japanese yen and the Swiss franc start to outperform, perhaps as investors position themselves for greater risks ahead. That said, other financial instruments are not flashing red just yet. US equity markets as measured by the S&P 500 remain reasonably close to their all-time high, and credit spreads both for investment grade and high-yield debt remain reasonably tight, despite selling off in recent days. However, spreads between German and Italian bonds, which typically widen during risk-off conditions, they also remain quite tight, showing little stress there too. While financial markets are not all pointing in the same direction, the yield curve has a strong historical track record of forecasting a recession, which could hit in the next 16 months or so – based on the average time it took from curve inversion to recession during the last four recessions.

Yield Curve Flashing Red?
US - Yield Curve & Recession Index



Source: Bloomberg, Fitch Solutions

Can The US & China Decouple?

The word decouple is probably a bit too strong in our view as the US and China are not only the two largest economies in the world, but significant trade ties remain between both countries, with China accounting for 22% of total goods imports and the US accounting for about 20% of all goods exports from China. That said, China has slowly been diversifying its economy in two ways. First, the re-balancing of the Chinese economy now means that exports account for approximately 18% of GDP in 2019, a sharp decline from the 30% registered

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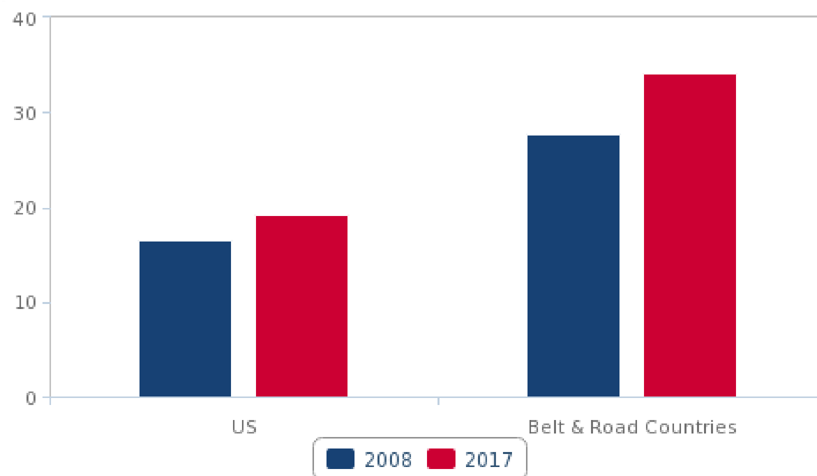
before the global financial crisis. Moreover, exports to Belt & Road (B&R) markets – a key focus of China – account for about 35% of all Chinese exports, much more significant than the 20% that go to the US. As such, China's reliance on exports and the US economy has somewhat diminished over the past few years relative to B&R markets. However, this does not mean that they can decouple altogether, as they remain interlocked.

China Looking To Export More To B&R Countries
China - Exports, % Of Total



Source: National sources, Fitch Solutions

Will A US-China Deal Save The Day?

China-US trade talks are set to resume on October 10, and while we do not think a deal is likely before the US 2020 presidential election, we have been flagging the outside chance for some form of 'mini deal', or at least a period of de-escalation should the US or Chinese economy weaken substantially. The manufacturing sector in China remains in contraction, and the latest manufacturing PMIs in the US follow on the heels of tepid US consumer sentiment in recent months, as measured by the University of Michigan, which showed that consumers are increasingly worried about the impact of tariffs. While we are not holding our breath in terms of the outcome of the negotiations, it does suggest that there may be more room than before for policymakers to de-escalate tensions slightly during the next round of meetings, particularly as President Donald Trump looks ahead to the 2020 election.

That said, we do not believe that a 'mini deal' or a de-escalation would lead to a meaningful boost to growth either in China, the US or even in Europe. The US and China are far into their decade-long economic expansion, and structural factors will also cap upside potential over the coming quarters in the event of a deal. And while a 'mini deal' would allow investors to breathe a sigh of relief over the short term, it would unlikely solve all outstanding issues given the large gulf in demands between the two countries, which would likely result in an escalation in trade tensions thereafter. Furthermore, ongoing protests in Hong Kong continue to escalate and could see a greater crackdown by Beijing over the coming months. This may give the US a pretext to harden its stance on China, which may in turn complicate upcoming trade negotiations. Lastly, with the outlook for Brexit still uncertain, global investors will also remain cautious, which could act to prevent a sharp pick-up in capex and spending.

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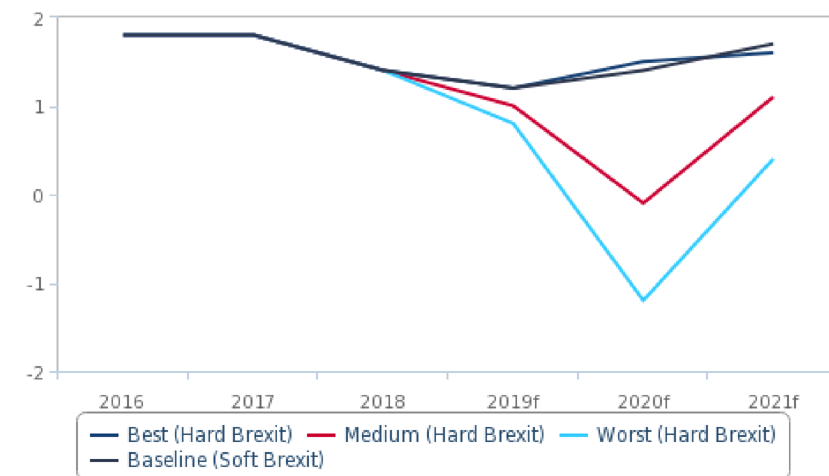
Brexit Scenario Impact On GDP Growth

UK - Scenario Analysis



f = forecast. Source: Fitch Solutions

What Would The Impact of A Hard Brexit Be?

A 'hard' or 'no-deal' Brexit would have a significantly negative impact on UK and European growth, which could spread elsewhere. The UK economy could contract by as much as 1.2% in 2020 in the most adverse hard Brexit scenario. The contraction could be particularly severe in the second half of 2020, with real GDP forecast to shrink by 1.8% y-o-y and by 1.4% y-o-y in Q320 and Q420 respectively. The most adverse scenario envisages a 10.0% depreciation of the pound against the US dollar, a 20 basis point (bps) drop in business sentiment, a 15.0% fall in the stock market, and a 24bps decrease in household consumptions' contribution to growth relative to the baseline case. European countries would also be at significant risk given that Germany and Italy, which together account for approximately 45% of the eurozone's GDP, are very close to a technical recession. Indeed, GDP in Germany contracted by 0.1% q-o-q in Q219, while Italian growth flatlined over the same period. As such, a hard Brexit would lead to a significant shock to sentiment and exports for the eurozone, areas that are already quite weak.

What Is The Outlook For Latin America? Which Countries Would Be At Risk Of Another Recession?

The outlook for Latin America has weakened as the crisis in Argentina, a slowdown in growth with the region's largest trading partners and idiosyncratic domestic challenges weigh on the region's growth outlook. Indeed, we forecast the region to slow from 1.6% in 2018 to 1.4% in 2019, before picking up in 2020 to 2.1%. While not our core view, a global recession would impact Latin America via a combination of falling exports, a loss of consumer purchasing power, weaker asset prices and slower business investment. In such a scenario, we at Fitch Solutions believe Latin America would be relatively ill prepared to address a growth shock, given weak domestic demand and limited room for fiscal and monetary stimulus. While all economies in the region would be impacted, we highlight Argentina, Bolivia, Ecuador and Mexico as particularly vulnerable relative to their regional peers. In Argentina, we would expect continued declines in consumption, investment and exports. That could, in turn, prompt increasingly populist policymaking under a government that we expect will be led by Alberto Fernández.

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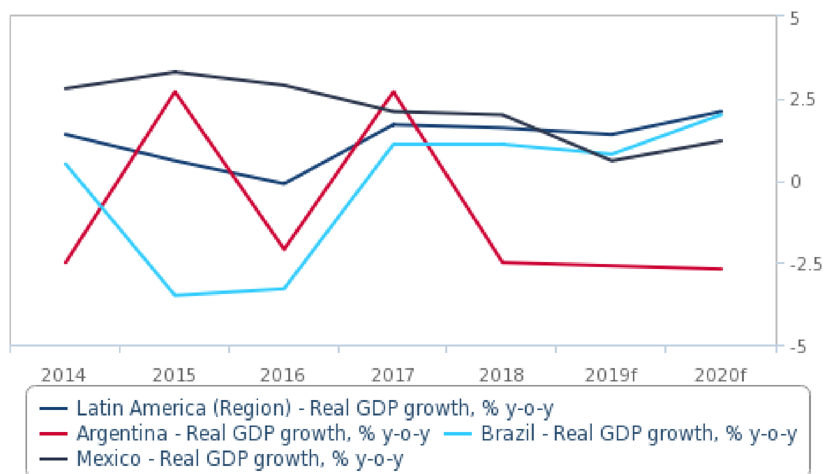
Latin American Growth Faces Risks
Latin America - Real GDP Growth, % y-o-y



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In Mexico, there is some opportunity over the short term for limited trade substitution from China – Mexican exports to the US remain strong – but in the event of a recession, Mexico would suffer heavily. While it has slightly more policy flexibility than other countries in the region, growth is already stagnating as it narrowly avoided a technical recession in H119, and it has the highest level of exposure to trade among Latin America's major economies, mostly to the US. This would leave Mexico exposed to an increase in protectionism in the US, particularly if President Donald Trump remains in office past 2020. While Brazil has some advantages that might reduce the impact of a global recession, including relatively low levels of trade exposure and foreign ownership of local debt compared with regional peers, it is exposed to commodity prices, is a twin-deficit economy, and the real is among the most volatile emerging market (EM) currencies. In addition, a large fiscal deficit (forecast at 6.6% of GDP in 2019) and high levels of public debt (80.3% of GDP) constrain the government's ability to stimulate the economy in the event of a shock, and growth is consistently low.

What Is The Outlook For Sub-Saharan Africa? Which Countries Would Be At Risk In Another Recession?

We forecast that growth in Sub-Saharan Africa (SSA) will accelerate slightly from 2.7% in 2018 to 3.3% in 2019 and 3.5% in 2020, with growth being driven by public infrastructure projects in East and parts of West Africa. A global recession and a sharp rise in capital flight would create policy trade-offs, ultimately limiting the flexibility and effectiveness of monetary and fiscal policy in the region. A large number of economies in the region would likely be impacted; however, South Africa would be most vulnerable. It is a twin-deficit country, and the rand is both widely traded and viewed as a proxy for EMs, making it particularly vulnerable to risk-off sentiment. Moreover, growth in South Africa is already anaemic - we project real GDP growth of 0.6% in 2019 and 1.4% in 2020 - and there is limited room for fiscal stimulus given already-high spending commitments arising from ambitious social programmes, including the roll-out of a National Health Insurance scheme, and increased contingent liabilities in the form of further government guarantees to state-owned enterprises.

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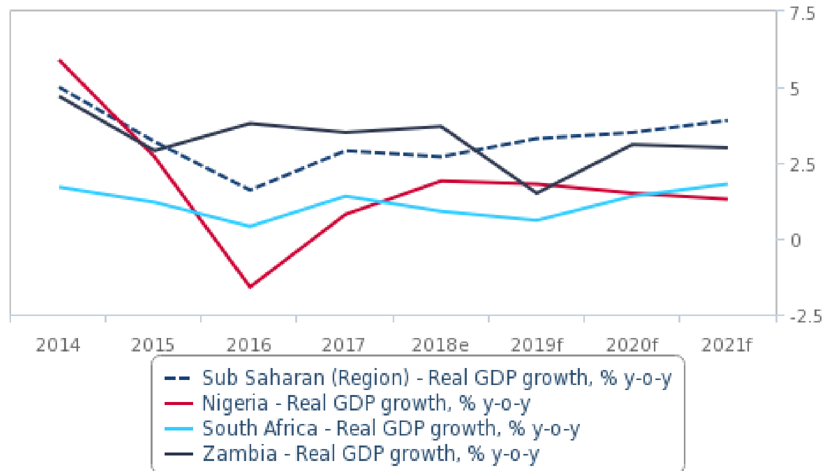
Sub-Saharan Africa Remains Vulnerable
Regional Growth, % y-o-y

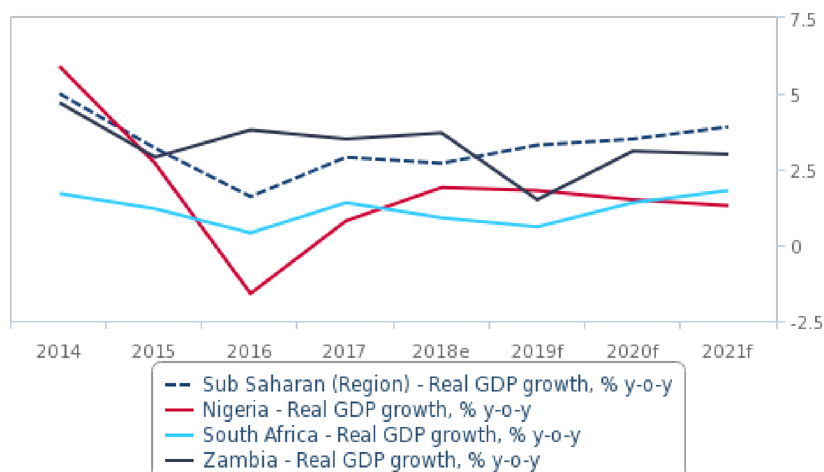


e/f = Fitch Solutions estimate/forecast. Source: National sources, Fitch Solutions

Nigeria is also potentially vulnerable. It maintains a multiple exchange-rate system, with both the interbank rate and 'investor and export' (also known as the Nigerian Autonomous Foreign Exchange Rate, or NAFEX) rate in effect managed. Weaker exports, and a sustained rise in the US dollar resulting from risk-off sentiment, would weigh on real GDP growth and investor demand for Nigerian assets including the naira, while putting increased pressure on the reserve stock needed to support the unit. Moreover, as with South Africa, growth in Nigeria is already muted - we project growth of 1.8% of 2019, slowing to 1.5% in 2020 - and the scope for fiscal activism is limited.

In Zambia, external liquidity is poor and economic policymaking increasingly unattractive to investors. A global recession would exacerbate such issues especially if the demand for, or the international price of, copper falls. A global recession could trigger further capital outflows, currency depreciation (with low levels of reserves to defend the currency) and slower growth in an environment in which the authorities have very limited capacity for monetary stimulus.

Growth In MENA Has Some Buffer, But Risks Remain
MENA - Real GDP Growth, %



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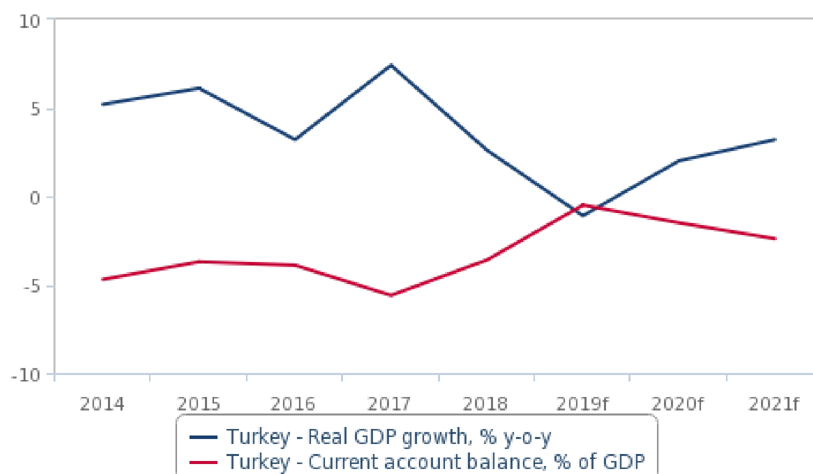
What Is The Outlook For The GCC? Which Countries Would Be Most At Risk?

We forecast the MENA region to slow to 0.7% in 2019, before picking up to 2.4% in 2020. However, another global recession would cause global oil prices to fall, likely prompting OPEC+ to further tighten restrictions on oil output and hence exports. Meanwhile, GCC fiscal revenues - of which a majority share is derived from hydrocarbons - would also moderate, likely encouraging governments across the bloc to pare back spending and implement new revenue-raising measures. This would then negatively impact private consumption and non-hydrocarbon activity, which remain heavily exposed to fiscal policy fluctuations. Declining foreign direct investment (FDI) inflows would exacerbate this trend, although we do note that GCC FDI levels have remained low for several years, suggesting the impact may not be very dramatic. From a macroeconomic vulnerability perspective, most GCC states have large financial buffers, low levels of debt and structural trade surpluses. States with comparatively weaker fundamentals (Bahrain, Oman) are usually able to draw on support from wealthier GCC peers in the event of rising fiscal or external pressure. This helps underpin investor confidence in the bloc as a whole, and implies any recession-related increases in debt-servicing costs would be manageable. Elsewhere in the region, Egypt, Jordan and Lebanon stand out as comparatively more vulnerable to shifts in global investor sentiment and capital flows from EMs to developed markets. All three countries have wide twin deficits and large public debt burdens, meaning their governments are at risk of sharp spikes in debt servicing costs, further constraining their already-limited fiscal flexibility. This is particularly an issue as social discontent remains elevated across all three countries, limiting their governments' perceived political space to fiscally consolidate.

Turkey's Economy Still Struggling

Turkey - Key Economic Indicators



f = Fitch Solutions forecast. Source: National sources, Fitch Solutions

What Is The Outlook For Turkey?

The outlook for Turkey remains weak, although slightly less so than a few months ago. A less severe contraction in Q219 and a combination of loose fiscal policy, a public bank credit injection and central bank easing will see Turkey's economy perform better than we anticipated in 2019. We forecast growth to contract by 1.1% in 2019 and to grow by 2.0% in 2020 (revised from -1.9% and 3.5% previously). Our forecasts, however, imply that the economic recovery in 2020 will be significantly shallower, as the impact from stimulus measures this year fade and a deleveraging process resumes. However, we see increasing risks that the government favours a return to higher growth levels, as set out in its latest economic plan, and forgoes addressing some of the external vulnerabilities that the Turkish economy faces. As such, risks surrounding the Turkish economy have yet to abate and could, in fact, rise again if policymakers favour short-term growth drivers.

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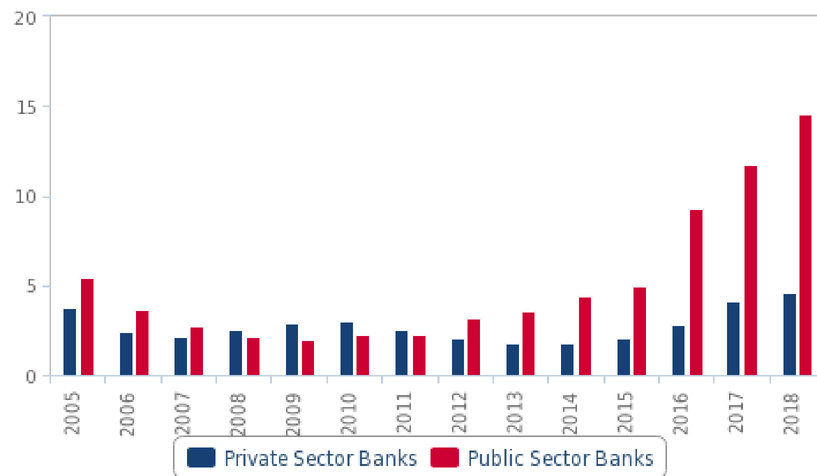
NPLs Mostly Driven By State Banks

India - Non Performing Loans, By Sector, %



Source: Bloomberg, RBI, Fitch Solutions

India Is Considered To Have A Low Level Of Private Debt, But Are There Risks?

Compared with many EMs, India has a low level of private sector debt, which includes both households and non-financial corporates. Data from the Bank for International Settlements (BIS) show that household debt accounted for 12.0% of GDP and non-financial corporate debt accounted for 46.0% of GDP in Q119, which is low compared with the EM aggregate of 37.0% and 92.0% of GDP respectively. That said, the quality of loans to these sectors has attracted scrutiny as non-performing loans (NPLs) have been rising in India, weighing on the banking sector. According to data from the reserve bank of India, the aggregate NPL stood at about 9.0% in March 2019, but there is a large divergence between private and public sector banks. Indeed, most NPLs have in large part been driven by weak asset quality help by public sector banks, which account for approximately two-thirds of all loans. NPLs at public sector banks stood at 14.6% in 2018, while private sector banks fared better at 4.6%. Despite challenges to the banking sector, we continue to expect structural drivers such as demographics, combined with a pro-reform government, to help deliver growth of about 6.5% over the coming years.

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