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2020 Global Risk Analysis

Examining the pitfalls of the “Goldilocks” economic scenario

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Summary

- Outlooks expecting a rise in the financial markets since the end of last year can most easily be described as the expectation for a Goldilocks economy. Outlooks were based on the following developments: (1) the global economy hit bottom, (2) monetary easing policies were continued, and (3) there were fewer uncertainties. An environment became manifest in which the growth trend in prices of a broad range of financial assets could be supported. It was not impossible to envision a scenario in which the global economy would be getting back on the road to full-fledged economic expansion accompanying the asset effect associated with growth in prices of financial assets. However, there are a number of cautionary notes which should accompany this scenario.
- First of all, it will likely take time for the global economy to hit bottom. Chiefly, it should be noted that declines in capital goods and durables centering on the advanced nations are becoming more serious. Secondly, maintaining low inflation is contingent on the continuation of monetary easing policies, and in this context, it is necessary to keep an eye on movements in the price of natural resources. Meanwhile, it has also become unclear whether or not the FRB will be able to continue its current asset purchasing program. The third factor is that if the Democratic Party wins a majority in the US presidential and congressional election, it will become highly likely that the corporate tax will be raised. Furthermore, we cannot ignore the risk that current President Donald Trump could move toward adopting a weak dollar policy in hopes that this would give him an advantage in the election campaign. While not all of these factors are necessarily high risk realistically speaking at this time, they are issues which we must remain aware of.

Fundamental reasons the international financial markets were shaken by tensions in Iran

From early on at the beginning of this year tensions have been running high in the global financial markets. To start there was the tension in Iran. The sudden appearance of this unexpected diplomatic problem took most market participants by surprise, and poured cold water on the optimistic mood which had prevailed since the autumn of 2019. As of this point it appears that escalation of the US-Iran conflict has been avoided, and market turmoil has subsided. That said, it would be unwise to brush this phenomenon aside with a stale expression such as “temporary stock market volatility following the appearance and then receding of geopolitical risk.” Why do problems in the Middle East lead to turmoil in the market? Understanding the true nature of the problem will help us to avoid the trap of this widely circulated rosy scenario.

In this report we provide a concise overview of the optimistic outlooks which supported the growth in stock prices since last autumn, and a comprehensive examination of risk factors in 2020.

Three factors required for a “Goldilocks economy” to appear

Outlooks expecting a rise in the financial markets since autumn of 2019 can most easily be described as the expectation for a Goldilocks economy. A Goldilocks economy is an economic environment consisting of three factors. Concretely speaking, (1) the economy shifts into a recovery (the growth rate of the global economy accelerates), but not so much as to cause the inflation rate to rise, (2) monetary easing policies continue, and (3) economic uncertainties, such as political risk, are limited. These three factors have to be present, and growth in the prices of financial assets has to be maintained.

A Goldilocks economy is the stage prior to the economy getting back on the road to full-fledged economic expansion accompanying the asset effect associated with growth in prices of financial assets.

Looking back into the past, we see that the process of moving from an economic downturn to a Goldilocks economy, and then onto a shift into a full-fledged economic expansion phase, was not always smooth. An example from recent memory is the economic slowdown of 2015 and the appearance of expectations of a Goldilocks economy at the end of that year. Over the next year, 2016, and on into 2017 the global economy met with an acceleration phase. However, the hopes for the 2016 economy which appeared at the end of 2015 were betrayed.

The scenario that was hoped for at the time went something like this: the Greek fiscal crisis, which rocked the global economy in 2015, as well as the Chinese economic slowdown associated with the devaluation of the yuan, would both be overcome, and the global economy would turn toward recovery in 2016. One of the assumptions was that the FRB would encourage economic recovery by holding down the pace of its interest rate hikes. As for political risk, the American presidential election and the UK Brexit vote were yet to come, but the assumption of this scenario was that Hillary Clinton would win the presidential election and the UK would be able to avoid Brexit.

In reality, however, early on in 2016, the hawkish stance of the FRB caused turmoil in the financial markets. At the same time the yuan and the Chinese economy again became unstable, while UK voters gave their support to Brexit, and the winner of the American presidential election was Trump. After each of these developments, market participants had to correct their outlooks.

So what about this time around? Below we examine the risks involved with each of the factors necessary for a Goldilocks economy. Our conclusion is that each one of these factors requires a cautionary note. And of these three factors, the second requires the greatest caution.

Premature expectations for economic recovery to be corrected

Regarding the question of economic recovery, there are definitely some bright spots. First of all, global inventory adjustment pressure, which has continued since the end of 2017, is gradually easing. Secondly, the beginnings of a recovery in demand for semiconductors has been observed centering on Asia, due to the shift to 5G on communications systems in the near future. For this reason, installation of 5G on various devices and sales of new devices are expected. And thirdly, a provisional agreement has been reached in the US-China trade issue, which has been a factor in encouraging the global manufacturing downturn.

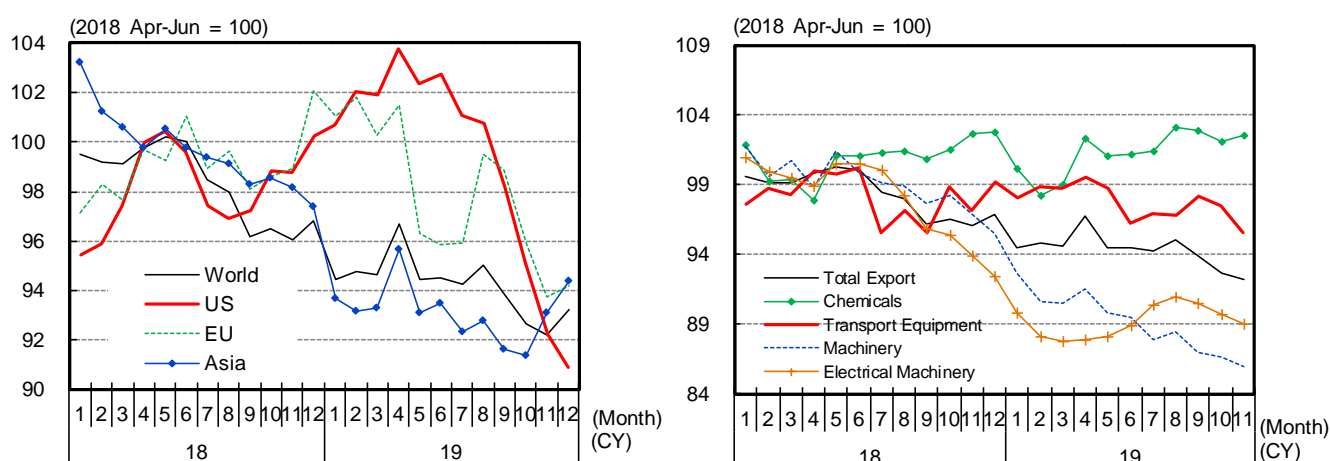
Even so, we expect that it will still take some time before production in the manufacturing industry shifts into a full-fledged recovery and a return to expansion. While a recovery in demand for semiconductors has been detected centering on Asia, the decline in demand for capital goods and durables centering on the advanced nations is becoming more serious (Chart 1). There are two major factors behind this situation. First, the effects of tax cuts in 2018 means that the cyclical economic slowdown is coming late to certain other countries, including the US where adjustment has just begun. Additionally, it is impossible to ignore the decline in demand for capital goods due to the downturn in global factory operating rates in the manufacturing industry which began in 2018¹.

However, this may be merely a trivial matter. Sooner or later, assuming that an economic recovery phase eventually arrives, the market correction phase arising due to unreasonable market expectations will also come to an end. In that sense, our argument here also may simply be the question of a time lag.

Conditions necessary for the continuation of an accommodative financial environment

The issue which must be given serious consideration here is the sustainability of an accommodative financial environment. The possibility that central banks might begin monetary tightening is no doubt unlikely for some time to come. Even the US economy shows no signs of overheating at this time. Needless to say, the same is true in the case of the EU and Japan. It is not difficult to imagine that current FRB Chairman Powell, who stepped on a tiger's tail and invited market turmoil through intensive rate hikes in 2018, has incentive to hold back on taking any noticeable action until the US presidential election has taken place.

Export Volume by Source of Demand and by Product **Chart 1**



Source: Cabinet Office, Ministry of Finance; compiled by DIR.

Notes: Seasonally adjusted figures, 3-month moving average. Seasonal adjustment in chart on right by DIR, except for totals.

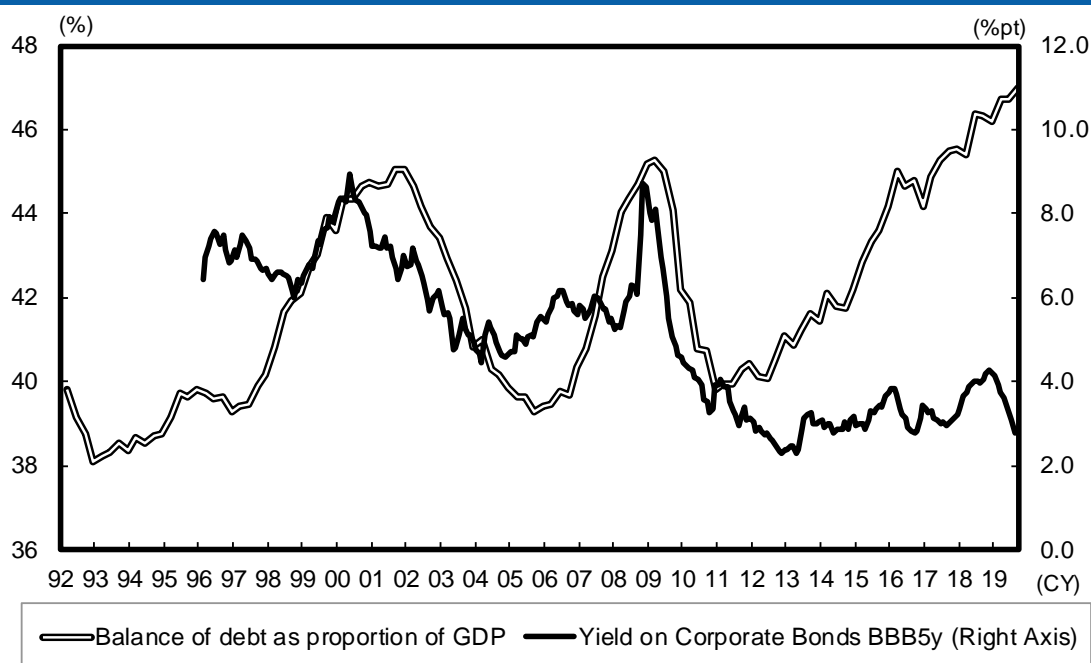
¹ For details see the DIR Report dated 27 December 2019, *Outlook for Japan's Economy in 2020: The key to regaining accelerated growth: recovery scenario for the global manufacturing industry*, by Shunsuke Kobayashi and Yutaro Suzuki.

However, the situation would be quite different if the inflation rate were to rise rapidly due to an external factor, such as the oil crisis of the 1970s. Fears of another oil crisis was of course the major factor which upset the financial markets when the recent problem with Iran occurred. If an unstable Middle East situation were to limit the supply of energy, it is highly likely that stagflation (an economic slowdown accompanied by high inflation) would be generated. Recent history proves that a recession can easily be caused by monetary tightening under conditions of slow economic growth. Looking back at historic recessions in the US after WWII, we see that in most cases recessions were foreshadowed by inflation and monetary tightening.

The impact of an external shock originating in unwanted monetary tightening could be especially serious in comparison to past examples if it were to occur at this time. One of the consequences of the ultra-low interest rate policies which have continued since the global economic crisis of 2008 has been the increasing tendency for corporations to carry out debt leveraging. Debt currently carried by US corporations expressed as a proportion of GDP substantially exceeds the levels seen just before the Lehman Brothers collapse which triggered the global economic crisis of 2008, and the level immediately before the IT bubble burst (Chart 2). At the same time, we should not ignore that this is also the result of share buybacks financed by the issuance of corporate bonds, the other side of the story being that the asset effect occurs here as a result of growth in stock prices, and helps push up the real economy. At the same time, however, care must be taken regarding the risk that this precarious balance could be lost².

Let us pause here for a quick exercise in logic. The traditional index used to evaluate a stock's performance is the price earnings ratio, or PER (market value per share divided by earnings per share). PER is theoretically defined as the reciprocal of the expected rate of return. If the PER is 20x, the expected rate of return is 5%. The expected rate of return can be broken down into three factors: (1) the risk-free rate (interest on safe assets) + (2) risk premium (preparedness for corporate bankruptcy risk and performance fluctuation risk) – (3) expected growth rate (corporate profit growth rate).

Outstanding Debt of US Corporations as a Proportion of GDP, and Interest on Corporate Bonds³
Chart 2



Source: FRB, BEA, S&P, Haver Analytics; compiled by DIR.

² For details see the DIR Report dated 25 April 2019, *Last resort for the FRB as it faces imminent reverse yield: Only choice remaining is a stealth Reverse Operation Twist*, by Shunsuke Kobayashi and Yota Hirono.

³ This report uses credit ratings assigned by Standard & Poor's, which is not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act.

If the price of natural resources continues to rise, monetary tightening would cause (1) to increase. Meanwhile, (3) will decline due to rising energy costs and rising interest rates. Then (2) will increase. Even with figures for this exercise that are as realistic as possible, if we raise the first figure by 0.5%, then reduce the second figure by 0.5% and raise the third figure by 1.0%, the expected rate of return would grow to 7%, while PER would decline to around 14x. In other words, the stock price will have dropped by around 30%. The asset effect which had until now had the effect of pushing up the economy would shift into a negative trend all at once. If this were to occur it would be difficult to ignore the effect on the real economy.

Here in Japan, it would not be possible to brush this off as someone else's problem. According to estimates using the DIR model, an increase of 10 dlrs/bbl in the WTI crude oil price would bring downward pressure of 0.11% on Japan's real GDP and 0.48% on nominal GDP (Chart 3). Meanwhile, an estimate of corporate business performance shows a reduction in operating surplus of 0.3 tril yen in the manufacturing industry, and 0.6 tril yen in the non-manufacturing industry, or a total of 0.9 tril yen (Chart 5). In addition, there would be impact via the international financial markets as described earlier in this report.

Effect of \$10/bbl Increase in Price of Crude Oil on Japan's Economy **Chart 3**

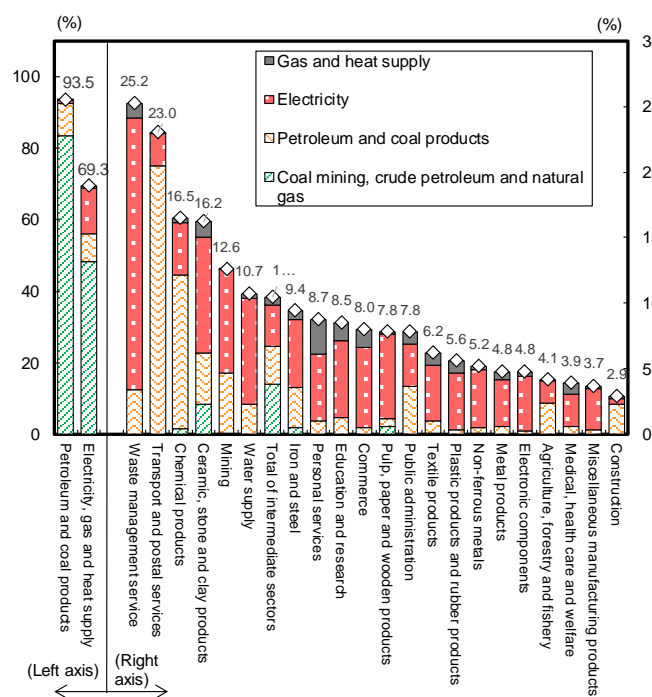
		Real GDP	Real Personal Consumption	Real Housing Investment	Real Capital Expenditure	Real Exports	Real Imports	Nominal GDP	GDP Deflator
		%	%	%	%	%	%	%	%
\$10/bbl Increase in Price of Crude Oil	1st year	-0.11	-0.18	-0.34	-0.43	-0.09	-0.55	-0.48	-0.37
	2nd year	-0.13	-0.22	-0.51	-0.48	-0.09	-0.66	-0.45	-0.32
	3rd year	-0.12	-0.20	-0.41	-0.52	-0.09	-0.62	-0.49	-0.37

		Current Account Balance / Nominal GDP	Import Prices	Export Prices	CGPI	Core CPI	Industrial Production	Indices of Tertiary Industry Activity	Indices of All Industry Activity
		%pt	%	%	%	%	%	%	%
\$10/bbl Increase in Price of Crude Oil	1st year	-0.45	3.76	0.45	0.60	0.21	-0.21	-0.11	-0.12
	2nd year	-0.43	3.79	0.45	0.61	0.31	-0.25	-0.13	-0.15
	3rd year	-0.48	3.80	0.45	0.62	0.29	-0.24	-0.13	-0.14

Source: compiled by DIR.

Note: Simulation using the DIR macro model. Figures denote rate of deviation and divergence from the standard solution.

Percentage of Intermediate Inputs Accounted for by Energy Inputs in All Industries Chart 4



Source: Ministry of Internal Affairs and Communications; compiled by DIR.

Note: Figures for 2015 are estimates based on the input-output structure.

Effect of 10% Increase in Price of Crude Oil on Corporate Earnings (Operating Surplus) Chart 5

	Amount Y bil	Rate of Change %
All industries	-934	-0.9
Manufacturing	-342	-2.3
Beverages and Foods	-11	-0.3
Textile products	-2	1.8
Pulp, paper and wooden products	-10	-1.1
Chemical products	-96	-5.7
Petroleum and coal products	23	3.2
Plastic products and rubber products	-6	-15.6
Ceramic, stone and clay products	-34	-5.7
Iron and steel	-101	-3.1
Non-ferrous metals	-68	-12.1
Metal products	-5	-1.3
General-purpose machinery	-2	-0.2
Production machinery	-3	-0.2
Business oriented machinery	-1	-0.5
Electronic components	-5	-
Electrical machinery	-3	-
Information and communication electronics equipment	0	-
Transportation equipment	-13	-1.7
Miscellaneous manufacturing products	-3	-0.5
Non-manufacturing	-592	-0.7
Agriculture, forestry and fishery	-8	-0.3
Mining	33	30.1
Construction	-59	-3.6
Electricity, gas and heat supply	-174	-32.9
Water supply	-4	-0.7
Waste management service	-7	-2.5
Commerce	-31	-0.2
Finance and insurance	-3	0.0
Real estate	-5	0.0
Transport and postal services	-245	-8.3
Information and communications	-5	-0.1
Education and research	-17	-2.3
Medical, health care and welfare	-18	-0.7
Membership-based associations, n.e.c.	-1	3.2
Business services	-12	-0.2
Personal services	-36	-0.7

Source: Ministry of Internal Affairs and Communications, Bank of Japan; compiled by DIR.

Note: Figures for 2015 are estimates based on the input-output structure.

Of course, at this time it appears that both the US and Iran have a stronger incentive to avoid open conflict, which perhaps makes our considerations up to this point overly pessimistic. However, the question is not limited to the Iran issue alone. If supply constraints of some kind were to cause the inflation rate to rise, thereby causing interest rates to rise even a small amount, the effect could then be amplified via the financial markets, and cause major effects on the global economy.

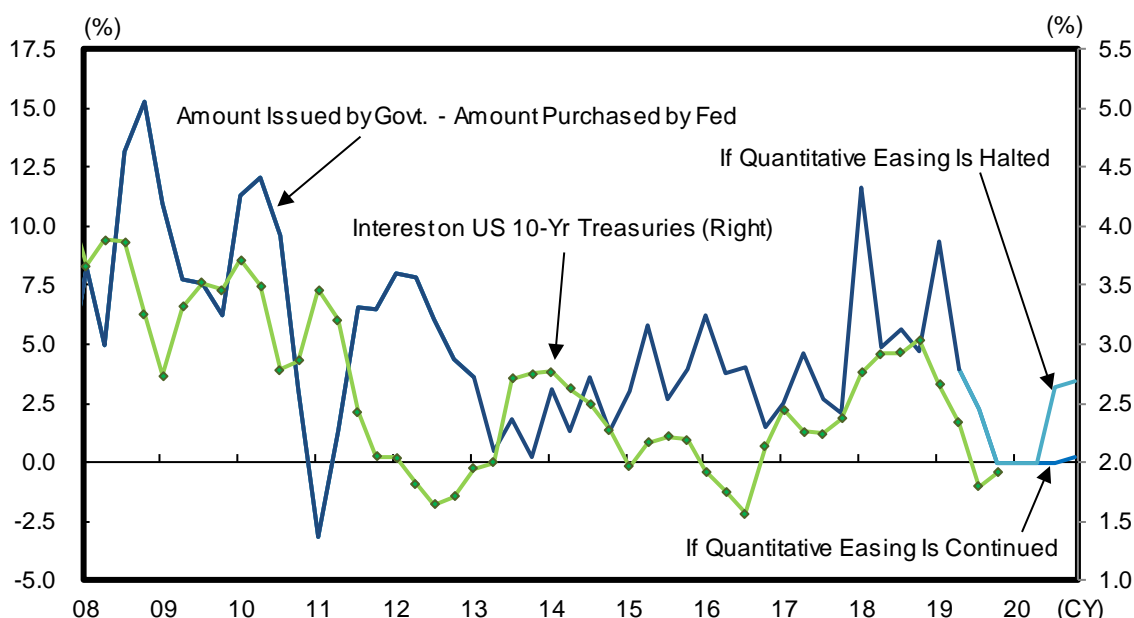
As for monetary policy, there is one more point which should be mentioned. There is some concern regarding the sustainability of the FRB's quasi-quantitative easing. Ever since the latter half of October 2019, the FRB has again been increasing the amount of its asset holdings as shown in Chart 6. The goal of this policy is to supply the short-term financial market with liquidity. FRB insists that what they are doing is not quantitative easing, but the result is that supply and demand of US treasury bills has become tight, and it is highly likely that this is a factor in holding down interest rates (Chart 7).

Details and Trends in FRB Quantitative Easing Policy Chart 6

	Total	Treasury	T-bill	MBS
2017 Oct-Dec	▲ 10 bil\$	▲ 6 bil\$	-	▲ 4 bil\$
2018 Jan-Mar	▲ 20 bil\$	▲ 12 bil\$	-	▲ 8 bil\$
Apr-Jun	▲ 30 bil\$	▲ 18 bil\$	-	▲ 12 bil\$
Jul-Sep	▲ 40 bil\$	▲ 24 bil\$	-	▲ 16 bil\$
Oct-Dec	▲ 50 bil\$	▲ 30 bil\$	-	▲ 20 bil\$
2019 Jan-Apr	▲ 50 bil\$	▲ 30 bil\$	-	▲ 20 bil\$
May-Jul	▲ 35 bil\$	▲ 15 bil\$	-	▲ 20 bil\$
Aug-Oct 1H	0 bil\$	+ 20 bil\$	-	▲ 20 bil\$
Oct 2H-	+ 30 bil\$	+ 20 bil\$	+ 30 bil\$	▲ 20 bil\$
Nov-	+ 60 bil\$	+ 20 bil\$	+ 60 bil\$	▲ 20 bil\$

Source: FRB; compiled by DIR.
 Note: All figures are monthly maximums.

Net Issuance of US Treasuries (as a Portion of GDP), and Trends in Interest on 10-Yr Bond Chart 7



Source: FRB, CBO, Haver Analytics; compiled by DIR.
 Notes: Figures after July 2019 calculated by DIR based on FRB and CBO estimates.

The FRB plans on continuing this policy at least through the first half of 2020. To put it in another way, there will be plenty of room for a policy change during the second half of 2020 and beyond. Meanwhile, as the FRB has asserted, the purpose of the policy is simply to supply the short-term financial market with liquidity, and not to stimulate the economy by reducing interest rates. If we take this literally, it will not be at all strange if the FRB stops increasing its asset holdings or slows the pace in the near future as long as the short-term financial market does not malfunction as occurred sporadically between 2018 and 2019. But in that case, the risk of interest rates rising again will naturally be triggered. So the question is whether the FRB will be able to stick to its position. Or, on the other hand, will it adjust its thinking and continue quantitative easing? This point has been overlooked by many, and we believe that it is a question with a high rate of importance in predicting what will happen to the global economy in 2020 and beyond.

Uncertainty surrounding the US presidential election

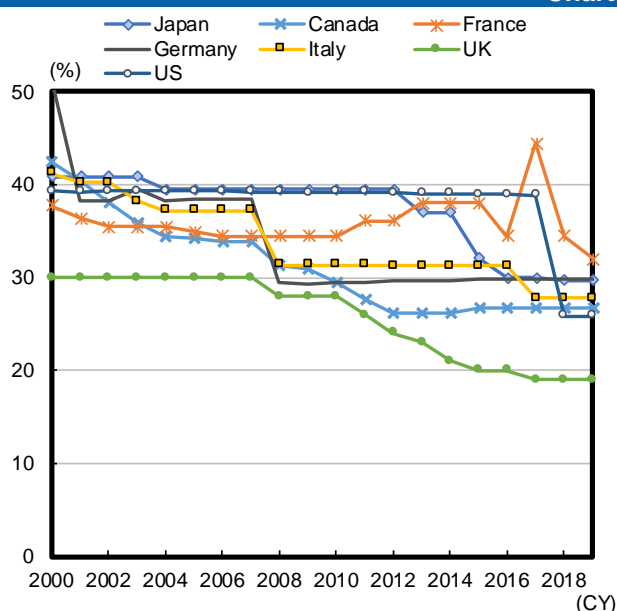
Now we provide a brief summary of the political risks. The assumptions supporting the expectations for a Goldilocks economy are as follows: The US-China problem will be laid to rest for the time being until the presidential election is over. China’s economy will return to a lull. The US presidential election will

result in Trump's re-election and no risk of major change in policies is expected. Meanwhile, Brexit, which had been pending for some time, will continue to move forward, and hence will not cause a disturbance.

It is likely that these expectations will eventually be fulfilled. However, the outcome of the election is uncertain. The approval rating of current President Trump has not gone beyond the 40% level, and it is too early to as of this point to call the election. The problem here is that all of the major Democratic Party candidates (Biden, Sanders, and Warren) are in favor of increasing the corporate tax. The Trump administration lowered the federal tax rate on corporations from a maximum of 35% to 21%. Combined with state tax, this brought the effective tax rate for corporations down from around 40% to approximately 26% (Chart 8). Both Sanders and Warren have stated that they will return the corporate tax rate to its original level. Even Biden, who is considered to be a moderate, has said that he will change the tax reduction to half of what it was.

International Comparison of Effective Corporate Tax Rates

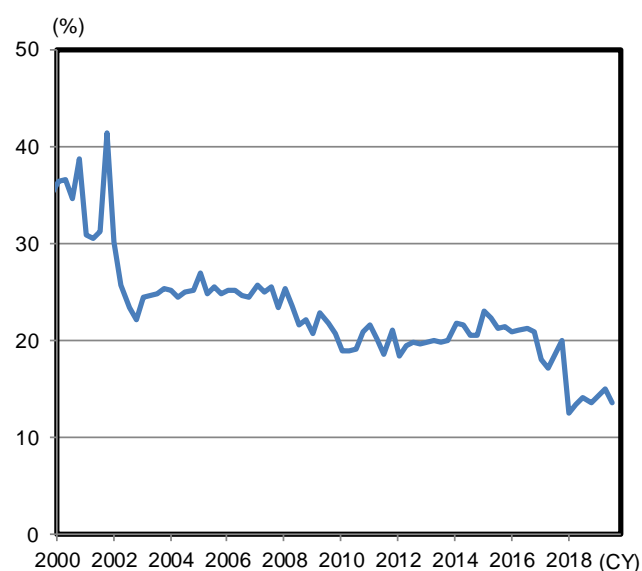
Chart 8



Source: OECD; compiled by DIR.

US Corporate Tax Rate (Actual Values, Non-Financial Enterprises)

Chart 9



Source: FRB; compiled by DIR.

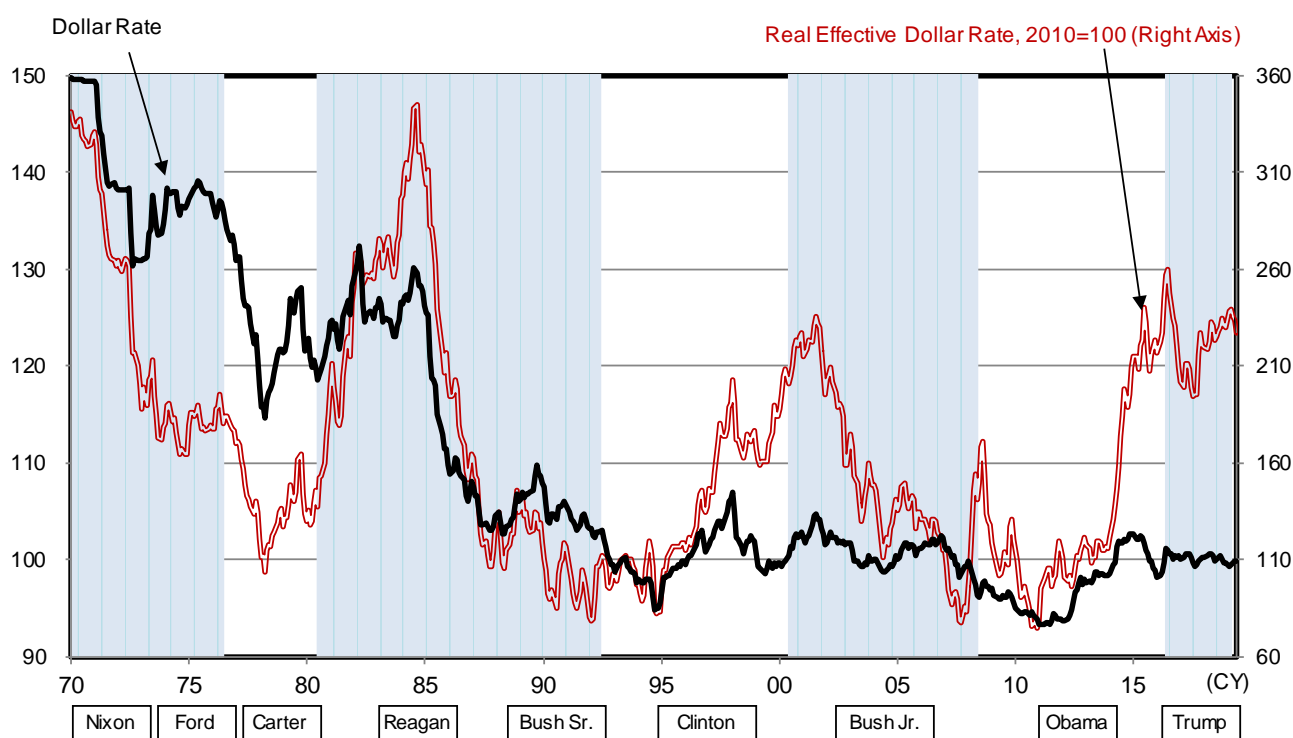
Now, what conclusions can we make about the impact of tax cuts? Previous to the tax cut, if a corporation with the maximum tax rate recorded a profit of 100 dlr, after tax profit would have been 60 dlr. Now, its profits would be 74 dlr on the same amount in profits, and increase of 23%. Of course, this argument focuses only on the maximum tax rate. The average tax rate in the US as calculated using statistics on the flow of funds in the US was around 21% in terms of actual values before the tax cut, while after the tax cut it was around 13.5% (Chart 9). In other words, after tax profits on profits of 100 dlr grew by approximately 9.5% from 79 dlr to 86.5 dlr. Due to the effects of the tax cut, the U.S. economy and financial markets have been booming since 2018. However, if the Democrats win in the presidential and congressional election later this year, there could very well be a reaction to the cuts in which, especially in the case of Sanders or Warren, the entire amount of the tax cut effect would disappear, while in the case of Biden, half of the effect would be removed⁴.

⁴ Of course, even if the Democratic candidate were to win the presidential election, this does not mean that the corporate tax rate would immediately be changed. The congressional election occurs at the same time as the presidential election, and the Democrats would have to win an absolute majority in both the upper and lower houses of congress in order for the possibility of a tax hike to come into view. Meanwhile, all of the Democratic candidates are saying that they will use the increase in tax revenue to increase social benefits and to invest in infrastructure, hence in the end, nothing may happen

Meanwhile, not only are there risks after the election, but also the question of what kind of approach President Trump might take in the election campaign. This remains a major uncertainty factor. The possibility that tensions in the Middle East could again arise is a major question in this context. There is not only the downside risk of foreign policy becoming more militant, but the upside risk of economic policy as well. With the Democratic Party holding the majority in the lower house, and the impeachment trial ongoing, it will be difficult to implement an effective fiscal policy until the day of the election. Assuming that this is the case, then we cannot ignore the possibility that Trump may quickly take this opportunity to adopt a weak dollar policy in order to stimulate the economy (Chart 10).

The Goldilocks economy, which can be described as the stage where the economy is in the process of moving from a slowdown to a period of acceleration, can be compared to an airplane preparing to land. It is not a condition that could be considered especially strong against external shock. And it is exactly here, in 2020, where multiple uncertainty factors have gathered. It is our hope that we can quickly identify where the turbulence lies, and successfully ride out the storm.

Long-Term Trends in the Dollar Exchange Rate, and the US Political Cycle **Chart 10**



Source: FRB, BIS, Haver Analytics; compiled by DIR.
 Note: Shaded parts represent periods in which a Republican administration was in office.

which would cause a stringent fiscal policy. Even so, caution is recommended regarding the possibility that political change could cause a shock to the system, felt in terms of corporate earnings, capex, employment, and the financial market.

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