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Three risks for 2018

Financial Markets Research Team
Nick.kounis@nl.abnamro.com
Tel: +31 20 343 5616
nick.kounis@nl.abnamro.com

In the second Global Daily Insight of this year, we set out three of the key downside risks to our positive view of the world economy and markets in 2018.

Sharper than expected slowdown in China - We expect only a gradual slowdown in China in response to targeted tightening measures by the authorities. China's import volume growth is seen slowing, but we think world trade and the global economy will be able to absorb this and keep expanding at above-trend rates. However, it is possible that the slowdown in China's economy is sharper than expected. Perhaps the authorities will not be able to get the policy stance 'just right' in managing the deleveraging process in the economy. The Chinese economy is a key driver of the global economy and world trade, so a sharper slowdown could very well lead to more moderate global economic growth than we are forecasting. The eurozone could be particularly adversely affected. A crucial part of the economy's strong performance in 2017 was a sharp acceleration in exports to the large emerging markets.

Inflationary pressures re-emerge - We expect inflation to remain well-behaved, as there is still plenty of slack in the eurozone labour market. In particular, broader measures of unemployment (for instance taking involuntary part-time unemployment into account) are still at elevated levels. Even in the US, accelerating productivity growth should offset the inflationary impact of higher wage growth. Still, headline inflation in the US and eurozone will rise on the back of higher oil prices, but this will be transitory. If we are wrong, and core inflation does rise more significantly than we think on the back of ongoing above-trend growth, central banks could remove policy accommodation more quickly, which would hurt investor risk appetite and lead to concerns about economic growth further down the road.

Italian political risk leads to broader worries - Italian elections in March are likely to see rising political risk premiums in sovereign bond markets. Investors will likely price in the uncertainty about the outcome. We expect similar trends – though less pronounced trends - as in the French elections last year, where spreads widened in the run-up to the elections before easing thereafter. We do not think that an Italian government will come into place that will put Italy on the path of euro exit after the elections. However, there are certainly euro sceptic tendencies in a number of the key political parties. In addition, forming any kind of government will not be easy and the prospect of continued policy stagnation against the background of weak economic fundamentals is very likely. So although we do not expect a lasting effect from the Italian elections, there could be a larger and/or longer-lasting impact than we assume that could lead to wider contagion. (Nick Kounis)