

THE VIEW

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LANDING SOFTLY IN 2019: A DRAMA IN FIVE ACTS

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EXECUTIVE SUMMARY



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- 2018 saw strong growth while leading to a maximum of uncertainty. World growth in 2018 reached again a high level of +3.1%. Yet it nurtured uncertainties on the possibility of a trade war, non-viable US and European fiscal policies, the Fed's too high assertiveness, emerging markets' resilience, the multiplication of political risks and a potential burst of the global credit bubble. 2019 will be a de-nouement year on all these thorny issues. It should lead to a soft landing of the world economy.
- Pragmatism to prevail in solving trade disputes. Disappointing growth in Q3 and Q4 2018 confirmed that surplus countries could suffer a lot from further deterioration of trade relations with the US. The market's correction reminded President Trump that US companies won't be immune in case of a global trade collapse. We see 2019 as a year of risk de-escalation in trade relations.
- Fiscal policies will play the role of a safety valve. President Trump's turbo charged tax cut program bore fruit in terms of growth but jeopardized sustainability of public debt. On the opposite side fiscal conservatism was not sustainable for societal reasons in Europe and for preserving growth in China. 2019 will be a year of fiscal re-balancing to the detriment of growth in the US (+2.5% in 2019 vs +2.9% in 2018) and in favor of demand in Europe (+1.6% of growth in 2019 vs +1.9% in 2018) and China (+6.3% in 2019 vs +6.6% in 2018).
- The Fed will be less assertive and alleviate pressures on global liquidity. A disorderly adjustment of the US fiscal policy will be a source of instability requiring the Fed to envisage a maximum of two hikes in 2019 in order to support impaired animal spirits. Risky assets (emerging and credit assets) will find some relief in this.
- Sector risk analysis suggests that the credit bubble is likely to start dis-inflating in an orderly manner. Over the last three quarters leading to Q4 18, sectors downgrades have outpaced upgrades allowing us to pinpoint the peak of the cycle in an early manner. Our growing concern on transportation, construction and car manufacturers re-emphasizes the cyclical nature of these new difficulties. This should adversely impact the global investment cycle in the short-term albeit alleviating pressure in the global credit market over the medium-term.
- Country risk analysis mirrors heterogeneity; in a broadly resilient picture, policy mistakes will remain the separating factor among emerging markets. The change of stance in the US monetary policy will play in favor of emerging economies. In this context, markets will continue to show their capacity to discriminate between sustainable and unsustainable models of growth.
- Alternative scenarios. In case the ongoing US – China negotiations fail, global trade could rapidly head towards a regime of lower growth. The equity market could experience a severe selloff, global credit conditions could significantly tighten. Confronted with mounting risks of recessions, major economies could be exposed to higher deficits hampering their capacity to tame social tensions and political risk. This is a scenario of a forced landing during which the multiple risks coalesce in a very adverse scenario to which we attribute a 25% probability (against 55% in our central case and 15% for a scenario where the global economy overheats in 2019 and consequently experiences a hard landing as a behind the curve Fed briskly tightens its policy). We have also identified 5 different tail risks in which things could turn out even more badly: a generalized trade war, the burst of US credit bubble with a systemic dimension, a default of the Italian debt, a freezing of China's capital market and a stranded asset shock.



Photo by Sarah Cervantes on Unsplash

LANDING SOFTLY IN 2019

A DRAMA IN FIVE ACTS

A. Looking backward on 2018: there is no free lunch

The MSCI world equity index has lost -18.4% of its value between its peak in September 2018 and its most recent trough of January 2019. This significant correction has been the occasion for traditional doomsayers to deliver particularly pessimistic views about the state of the world economy. In our view, this volatility in financial conditions was easily foreseeable and does not really announce a disorderly adjustment of world growth.

It is just symptomatic of a transition between the peak of activity after a rare phase of synchronized acceleration in growth in 2016 and 2017 on the back of both public and private debt, and a phase of desynchronized deceleration starting in H2 18 resulting from the uncertainty regarding trade issues and a tighten-

ing of US monetary policy.

As usual, the Fed is shaping and will continue shaping markets and the global cycle. There is no free lunch: accumulating debt is a source of instability and the trigger of this instability is often the tightening of the Fed's monetary policy.

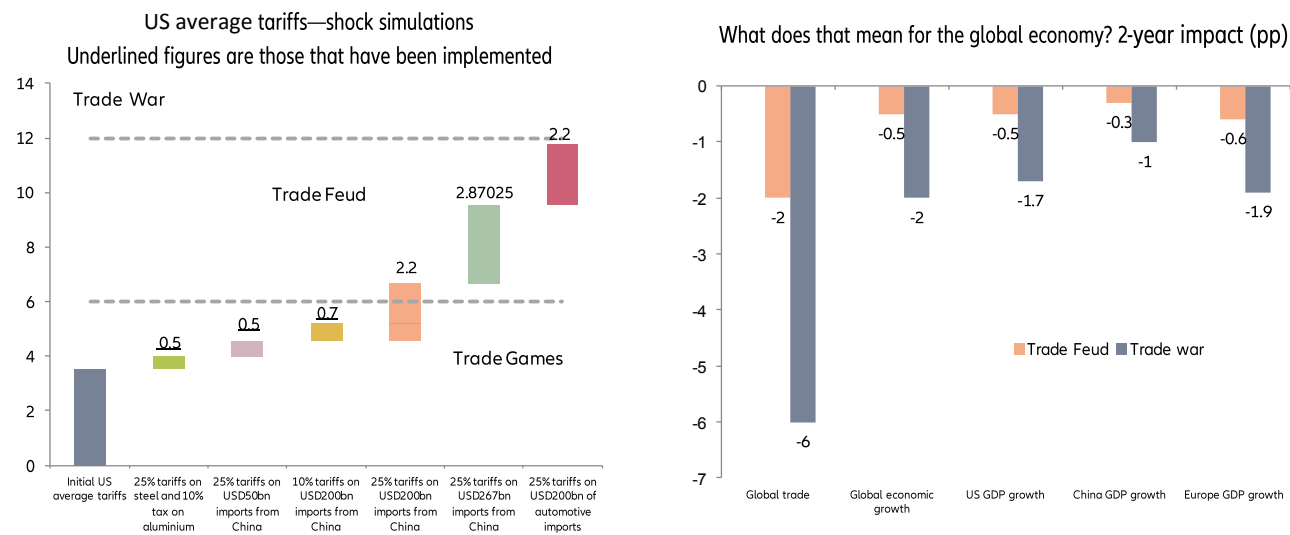
B. Looking in on 2019: please don't panic, this is just the cycle

1. Pragmatism to prevail in solving trade disputes

The trade dispute between China and the US has escalated until Q4 18 and is now on pause until March 2 2019, a deadline after which President Trump will decide on whether to implement a rise from 10% to 25% in US tariffs weighing on USD 200 bn of imported Chinese products. In 2018, the average US tariff increased from 3.7% to 5.2%, resulting in a series of retaliations by major

trade partners and an overall deceleration of global trade. In our framework, we identify regimes of trade growth based on some thresholds in US average tariffs. Below 6%, we remain in territories where global trade grows at a healthy level (we expect global trade in value to grow by +6.3% in 2019 compared to +7.2% in 2018). Having analyzed the situation in a game theory framework, we expect Chinese partners to offer concessions to the US in order to buy insurance against the most extreme aspects of the US President's trade policy - in a similar manner as between Canada and Mexico during the NAFTA/USMCA negotiations. Given the poor performances of the market at the end of 2018 and beginning of 2019, President Trump is likely to accept them to show his capacity to negotiate better deals.

Figure 1 Trade scenarios and impacts on growth



Sources: Euler Hermes, Allianz Research



Photo by Ivandrei Pretorius from Pexels

2. Fiscal policies to play the role of a safety valve

In 2019, fiscal policies will generate asymmetries between the US and the rest of the world and contribute to normalize or reduce the artificially high level of outperformances of US assets compared to others.

In the US, the start of the year (characterized by a particularly lengthy government shutdown) confirmed our 2018 call that the US budget will be a particularly thorny issue and a game changer in the US cycle in 2019. In a context of highly polarized positions in the US Congress and approaching Presidential elections in 2020, we expect the climax of a US budget paralysis to be reached in Q4 19, leading to a particularly painful adjustment of the market and the real economy at the beginning of 2020. Representing a source of growth in 2018, the US fiscal policy will be a source of instability and uncertainty in 2019, thereby reducing the size of the ongoing fiscal stimulus' multiplier.

Even if this adjustment will be painful in the short-term, we consider that it will contribute to alleviate the size of the US corporate bubble over the medium-term as the tightening of fiscal conditions will significantly impact the US credit market.

In Europe, the stance of the fiscal policy will on average become more expansionary as governments try to tackle the negative shock on global trade (external demand), respond to social demands amid rising populism, and tame political risk.

In China, a demand-supportive policy will also try to absorb the US protectionist shock without unduly increasing over-capacities. Contrary to the conditions in the US, European and Chinese fiscal policies will have a stabilizing function in 2019.

3. The Fed will be less assertive and alleviate pressures on global liquidities

As we expect the US GDP growth to decelerate to +2.5% in 2019 and +1.7% in 2020 compared with +2.9% in 2018, the Fed, in a forward-looking manner, is likely to change its monetary policy stance by adopting a significantly more dovish approach. Despite a high level of uncertainty, we persist to think that the Fed will approve two rate hikes in 2019, as the US economy will show some resilience until Q3 19.

However, patience will be key for the Fed as recently reiterated by James Powell, meaning that we will see a denouement in 2018's assertiveness of the US Central Bank. It will have large implications for the rest of the world. We are convinced that the recent episodes of volatility in markets and instability in growth (European soft patch of Q3 18 and Q4 18) mainly represent a delayed response to the tightening of monetary and credit conditions originating from the US.

As a consequence of a progressive denouement in the Fed's assertiveness, the USD is likely to depreciate in 2019 and offer some respite to emerging economies and smooth an expected weakening of global animal spirits.

4. Sector risk analysis suggests an orderly disinflation of credit bubble

At a global level, our December 2018 update of sector risk ratings pointed out a limited number of upgrades (3) and a larger number of downgrades (24).

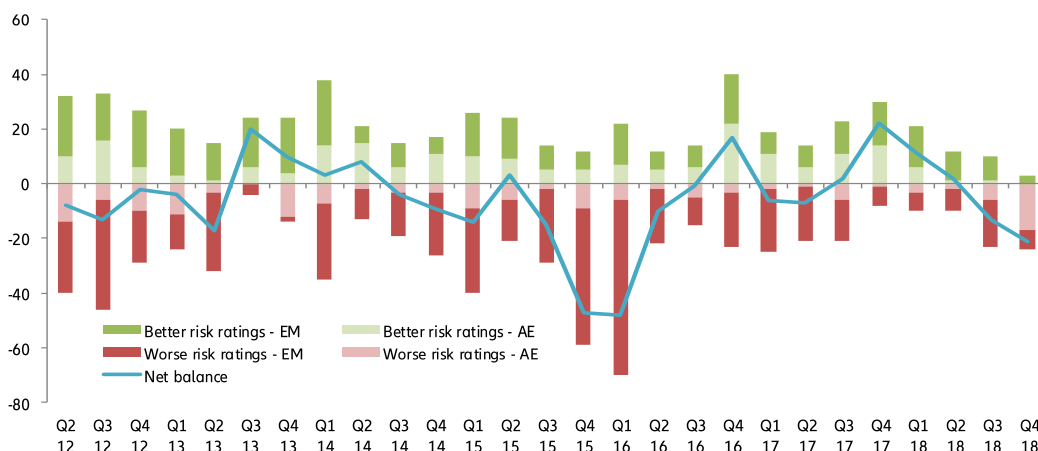
This reflects the continuity of the trend reversal initiated at the end of 2017 and the evidence that the ongoing soft landing of the global economy has already started to impact sectors and companies not only in terms of volume of activity but also in terms of profitability and liquidity – key pillars of our sector risk assessment.

Indeed, the last five quarters have been marked by a gradual decrease in the number of upgrades (from 30 in Q4 17 to 3 in Q4 18) and, at the same time, a continuing rebound in the number of downgrades (from 8 to 24).

Demand issues have been a key factor explaining the downgrades in each quarter. Yet, profitability and liquidity issues have gradually taken more importance in H2, triggering respectively 7 out of 10 and 5 out of 10 of the downgrades posted in Q4 18. At the same time, we continued to register a significant number of industries with weaker perspectives (99 in Q4 after 130 in Q3) but not (yet) a change in risk ratings.

In Q4, most of the downgrades occurred in the same set of cyclical sectors already affected by downgrades in the previous quarters of 2018, namely Construction (4 downgrades), Transportation (6) and Automotive (7).

Figure 2 Changes in sector risk ratings in AE and EM by quarter (absolute numbers)



Sources: Euler Hermes, Allianz Research

The cyclical nature of sectors being concerned by downgrades provides proof for us that we are currently dealing with a normal cycle, which has originated in a global tightening of monetary and financial conditions, with the Fed being the main actor.

With respect to this, we can consider the recent adjustment as an orderly disinflation of the current cycle. This is painful in the short-term as it will impair the investment cycle, but at the same time it will thwart the global credit bubble from further inflating and therefore representing a systemic risk in the long run.

The worse ratings in the Construction sector are mainly driven by the deterioration of demand, while the sector has seen little improvement of the risk profile in the past years. In the US, the latest permits data continued to disappoint and weighted on the level of risk, downgraded from Low to Medium.

In Q4, the Transportation sector faced one downgrade from Low to Medium risk (in the US) and five downgrades from Medium to Sensitive. Downgrades in France, Austria and the UK are related mainly to road transport, due to slowing demand and higher costs. We also downgraded the Automotive sectors in four Western European countries: Germany (suppliers), France

(suppliers) and Austria (manufacturers and suppliers) from Low to Medium, as well as the UK (manufacturers and suppliers) from Medium to Sensitive.

Less favorable expectations come from the tightening in regulation (with the new certification regime in place since September 2018 and so called "WLTP"), the accelerating decline in diesel, the weakening outlook for extra-EU exports and Brexit-related issues affecting both consumption and production sides and weigh on suppliers which are the most exposed to German carmakers as well as operators involved in the UK market. Downgrades posted in 2018 impacted 5% of all the industries monitored. Yet, most of them were from Low to Medium or from Medium to Sensitive.

In other words, the industries classified in High risk, meaning in imminent or recognized crisis represent less than 4% of cases as of December 2018, i.e. 45 sectors around the world concentrated in Latin America (17), Middle-East/Africa (13) and Central/Eastern Europe (12).

In terms of sectors, Construction, Metals and Textile industries are particularly affected. This means that almost 1 out of 5 industries still hold a Low level of risk as of December 2018 – with Pharmaceuticals, Chemicals and Agrifood as top per-

formers – and more than 1 out of 2 industries remain at a Medium level of risk, thus still keeping noticeable room for maneuver when looking at the average situation of companies in each sector.

5. Country risk analysis to mirror market's capacity to discriminate

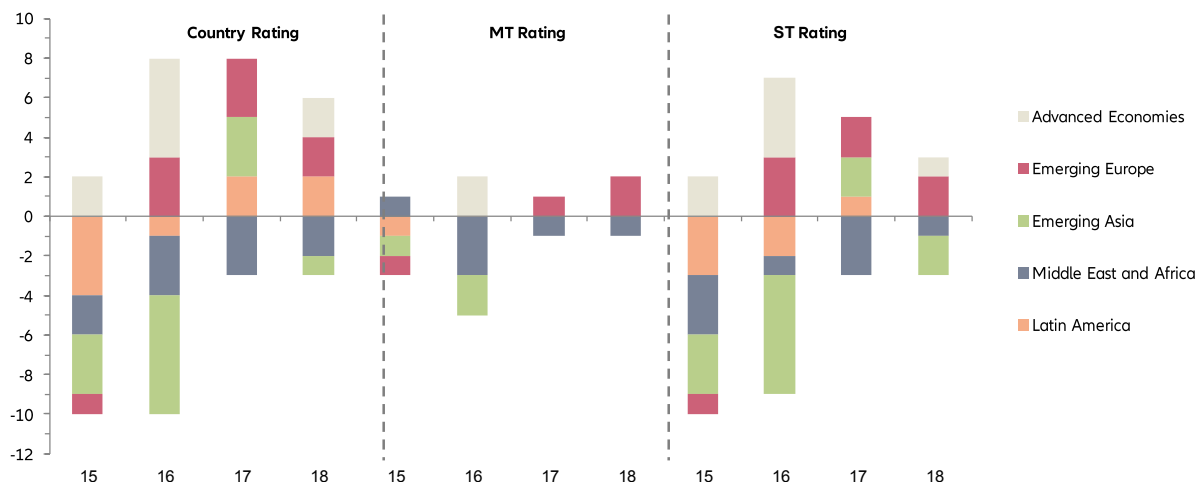
Country risk has developed in line with the global business cycle. The slight easing in world GDP growth from +3.2% in 2017 to +3.1% in 2018 was mirrored by a decline in the net change in the Euler Hermes overall Country Ratings from net upgrades of +5 in 2017 to +3 in 2018 (see Figure 3).

The fact that 2018 still posted net upgrades reflects continued systemic resilience. That said, country risk became more heterogeneous in 2018 as the number of both total upgrades (to 18 from 12 in 2017) and total downgrades (to 15 from 7 in 2017) increased.

In our view, the market will continue to show its capacity to discriminate between sustainable and unsustainable models of growth.

Our downgrades have rightfully identified the weakest economies in the loop. In the context of rising US interest rates and global liquidity tightening, policy mistakes in key emerging markets were particularly penalized in 2018.

Figure 3 Net changes in Country Ratings by region, from 2015 to 2018



Sources: Euler Hermes, Allianz Research

Policy mistakes will continue to play a key role, especially when they come along with existing or rising macroeconomic imbalances or with structural vulnerabilities.

Among key emerging markets we have identified Brazil (weak public finances, policy uncertainty), South Africa (low growth and rising debt) and Russia (sanctions on financing flows, oil price) as tightrope walkers that could see a downgrade in 2019 in the event of renewed policy mistakes.

More resilient but also on our watch list are India, Indonesia and the Philippines (rising current account deficits), Mexico (policy uncertainty) as well as Hungary and Romania (lack of policy response to counter overheating concerns).

However, the majority of key emerging markets – especially those in Europe and Asia with current account surpluses – is well-positioned and should remain stable as long as the global trade environment stays relatively benign.

That said, the net change in the Euler Hermes overall Country Ratings could move from net upgrades in 2018 (+3) to balance or a small number of net downgrades in 2019.

As country risk ratings are forward-looking, this would reflect the continuation of the soft landing in 2020.



REGIONAL OUTLOOK IN 2019

A. The US to steadily decelerate as fiscal policy switches from a tailwind to a headwind

The US economy will progressively decelerate in 2019 as the impact of the 2017 stimulus fades away, whilst uncertainties regarding public debt sustainability are increasingly likely to hamper the investment cycle. Q4 19 will represent for us a turning point, during which another gridlock due to a government shutdown is likely to occur, damaging once more the general level of confidence. The growing perception by the market that public debt is not on a sustainable path will generate volatility and entrench the belief that austerity policy will emerge in 2020.

This anticipation of a budgetary U-turn in 2020 is likely to negatively impact growth via a much lower contribution to growth of both residential and non-residential invest-

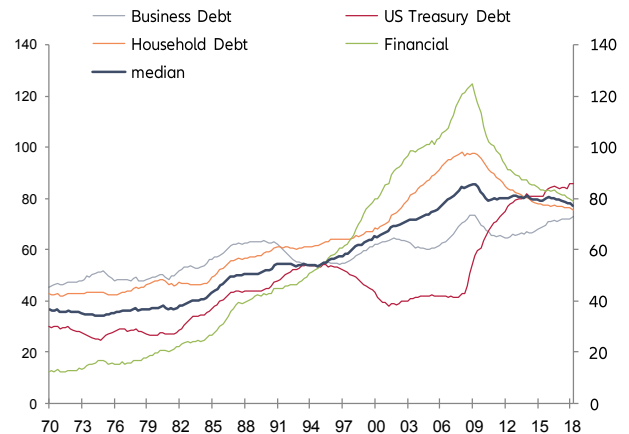
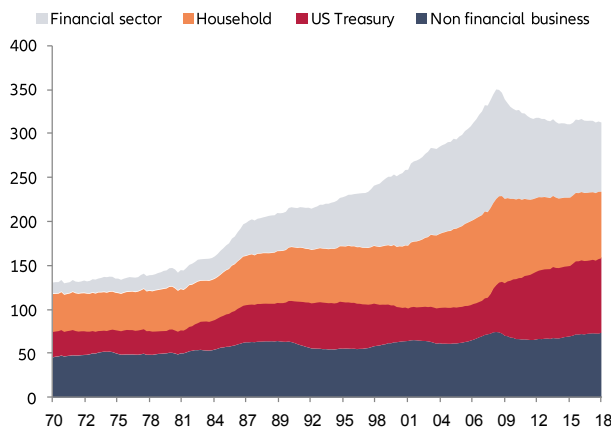
ment. The investment cycle is also likely to be impacted by a deterioration of fundamentals in the US credit market as we have evidence that an excess of debt in the US economy has triggered a kind of anesthesia of price mechanisms. Credit spreads should rise in 2019 representing another blow to the investment cycle. All in all, we expect the US economy to grow by +2.5% in 2019 compared with +3% in 2018.

B. The Euro zone and the UK to be up to the challenge of political risk

The soft landing of the Eurozone economy after four years of above potential growth would be supported by (i) slightly more expansionary fiscal policy led by Germany; (ii) a moderate acceleration in private consumption; (iii) better external conditions, in particular concerning a positive impact from the fiscal and monetary stimulus in China in H2

2019 and resilient growth in emerging markets. Moreover, positive confidence effects from the resolution of major setbacks for confidence such as Brexit, the alleviation of the danger of additional tariffs on the EU auto sector by the US, the resolution of the US-China trade dispute, and in-check stress in Italy would also support growth. We estimate that this uncertainty "put" has cut as much as -0.3pp of GDP growth in Italy and the UK for example. However, the expected high polarization in the European political landscape post-EU elections where 39% of seats are likely to go to anti-establishment parties (with 16% for hard populists) could make EU voting procedures longer and create noise. In addition, the formation of the EU Commission for an appointment on Nov. 1st could take more time and pose additional difficulties.

Figure 4 US debt by economic actors (% GDP)



Sources: Euler Hermes, Allianz Research

Overall, the Eurozone slowdown is likely to continue with GDP growth at +1.6% at best in 2019 and +1.4% in 2020. However, risks are tilted on the downside given the negative base effects from the fall in production in Germany and sluggish consumer spending in France at end-2018. Inflation is expected to remain stable at around +1.7% in 2019-20 but should temporarily moderate in H1 given the recent fall in oil prices.

Consequently, lower nominal growth should impact corporates' turnover which had already lost -1pp of annual growth at mid-2018 compared to the year before.

In addition, positive impact from lower oil prices could get compensated by higher wage growth and gradually less accommodative financial and monetary conditions which will have an impact on margins.

However, given the challenging macroeconomic conditions the unwinding of monetary stimulus will proceed at a gradual pace at best in 2019. Assuming that the economic upswing in the Eurozone remains intact in 2019 we expect the ECB to raise rates for the first time since 2011 starting off with a +15bp hike in the deposit rate in September followed by a +25bp hike in all key rates in December.

However, should economic growth disappoint we would not exclude a slower pace of the rate normalization. To counter any liquidity shocks the ECB will likely announce a new round of TLTRO funding in Q1 19 to support lending conditions.

Germany. Looking at country details, the overall economic situation in Germany can still be described as good despite the recent setback.

The domestic economic conditions for a continuation of the upswing, albeit at a more moderate pace, are still in place. This applies in particular to private consumption. The disposable incomes of private households will continue to grow quite strongly in nominal terms in 2019.

Real GDP growth is expected at +1.7% (from +1.5%), much lower compared to 2016-17 levels of +2.2%.

That being said, the deterioration on the production side on the back of less supportive external conditions pose downside risks to our forecast that could be revised by as much as -0.2pp should end-2018 data confirm this negative trend.

France. In France, growth will likely be impacted by low consumer confidence and social tensions.

These factors should trigger higher savings (15% of disposable income in Q4 18) and higher unemployment (9.2% in 2019, from 9.1% in 2018), with a possible -0.5pp impact on growth in a downside risk environment. Lowering inflation (+1% in 2019 down from +1.8% in 2018) will serve as a buffer, as it will support purchasing power and corporate margins, making the landing softer.

Italy. In Italy, despite the government embarking on a limited fiscal policy U-turn in December by promising to moderate its 2019 fiscal spending plan at least to some degree, economic momentum is unlikely to pick up markedly in the coming months. In fact GDP growth is expected to slow down from around 1.0% in 2018 to 0.6% this year. In our opinion, Italy will hardly reach the agreed deficit target of 2.04% of GDP given the weakening growth outlook, elevated borrowing costs, a higher structural primary budget deficit – due to the rollback of the pension reform – and no effort aimed at raising the economy's growth potential.

In addition, the expected strong results of Eurosceptic parties in the upcoming EU parliamentary elections are likely to strengthen the Italian government's confrontational stance against the EU over the course of 2019.

Spain. We see Spain outperforming its Eurozone peers again in 2019, while its gradual cyclical slowdown continues (+2.1%). Spain's resilience

can be partly explained by historically high profit shares (>43% of GVA) and subdued labor cost growth which allowed companies to invest. Reforms such as giving priority to company-level wage agreements (2012) controlled the wage increases despite employment gains.

However, the domestic slowdown will accelerate in 2019 and 2020 (below 2% growth) as the 2018 budget has been rolled over in 2019 given the lack of parliamentary majority, meaning the fiscal adjustment will be stricter than advocated by the current government (-0.5% of GDP additional correction in the fiscal deficit). The probability of snap elections remains high since the governing socialist party struggles to pass legislation while leading opinion polls.

UK and Brexit. Our Brexit central scenario continues to be a last minute blind deal between the UK and Europe (including an extension of Article 50 beyond March 29). This will give scope for the sterling to rebound to 1.15-1.20 against the EUR on average in 2019.

However, as high uncertainty remains, we continue to give a 25% probability to a no Brexit deal.

While general elections are less likely after Theresa May won the confidence vote from her party, we also include as an end scenario a second referendum on the Brexit deal which will ultimately require the extension of Article 50.

Economically, the longer uncertainty remains, the weaker the UK economy will become which is already visible in the depreciation of the pound sterling and general living standards of British households (with a current savings rate at 4.4%).

The prolonged uncertainty doesn't come without costs: we calculated that it costs at least -0.1pp of growth to the UK every quarter and GDP growth should reach +1.2% in 2019 and +1.0% in 2020.

C. China to intelligently fine-tune demand policy

Looking ahead, 2019 will not be a walk in the park.

Firstly, since the beginning of the year the news flows from corporates that are usually seen as bellwethers of the Chinese economy have not been encouraging with several profit warnings (Apple, Samsung).

Secondly, bad news from the car industry (first drop in 20 years) suggests that private consumption could be not as strong as expected.

We argue that there is still room to grow although the pace of expansion will likely be slower (+6.3% in 2019 after +6.6% in 2018) due to: weaker growth in exports as global demand softens; slower growth in domestic demand as policy stimulus remains prudent and industrial corporates struggle due to lower sales growth.

Household's consumption will likely be the main driver. Fundamentals are relatively solid. Unemployment rate is low (surveyed unemployment rate in urban areas at 4.8% in November) and income is growing at a solid pace (+8.7% estimated in 2018 for per capita disposable income). Credit to households is growing at a fast pace (above +15%) and fiscal policy is becoming increasingly supportive (authorities raised personal income tax threshold, and several tax deductions on expenditures such as rent and healthcare have been implemented this year). Inflation pressures will likely remain limited (+2.5% in 2019) helped by a continued opening (lower tariffs) of the economy and low oil prices.

On the corporate side, demand will likely be moderate hindered by lower sales (for exporters, commodity producers, e.g.) and a still elevated level of debt (155% GDP).

Public sector expenditures are expected to get traction in the form of higher infrastructure expenditures and more spending from State Owned Enterprises.

D. Emerging economies should exhibit resilience amid divergence

Growth is expected to stabilize in Emerging Markets. This outcome could result from two conflicting forces.

First, monetary policy tightening in the US was the main issue of 2018 and is expected to go progressively on hold in 2019. Inflation will likely be lower in 2019 in the G3 (US, Eurozone and China) as a result of lower oil prices.

Thus, the pressure on EM currencies as a whole will likely lower. However, as growth will decelerate in the G3, each EM area will be exposed to lower demand from its main partners.

Moreover, lower growth should also mean lower demand for commodity exporters. China is the case in point, as current low levels of manufacturing activity leads to lower import growth expectations, negatively impacting Latin American and African economies. Eastern Europe is also exposed to lower growth in the Eurozone, particularly in Germany.

Summarizing these external factors, EM should exhibit resilience amid divergence. Policy buffers are now wider in many areas compared to some years ago. Current accounts show surpluses in many Asian and Eastern European economies and were rebalanced in many others (e.g. in Brazil).

The divergence will be driven by the trade exposure as well as the degree of domestic policy heterodoxy, particularly triggered by renewed tensions on commodity exporters. E.g. in Brazil, higher risk spreads should impact corporate borrowing costs, despite a modest growth acceleration (+2.3% up from +1.3% in 2018).

Divergence may also expose some EM markets to bouts of exchange rate weakness. Lower demand in the G3 should add to that by triggering exchange rate undervaluation policies, particularly in Emerging Asia.

Africa will likely face the higher downside risk, since many countries will organize elections in 2019, amid a rise of armed conflicts in Central Africa and increasing social protests particularly in North Africa.

Against this background, we also see a potential for orderly tensions resolution, since many countries made progresses in terms of overall governance (e.g. Morocco, Kenya, Rwanda).



ALTERNATIVE SCENARIOS

A. A coalescence of risks to possibly trigger a forced landing

Our central scenario hinges on the assumption of favorable denouements in different perilous situations. There is for example a non-negligible possibility for trade negotiations between the US and China to turn out badly.

In such circumstances, global trade could rapidly head toward a regime of lower growth in which the probability of a recession could significantly increase in particular for export driven economies.

This probability would be nurtured by a severe correction of the equity market in conjunction with a severe deterioration of credit quality. In the meantime, the quality of coordination in economic policies, after two years of America first policy, would have significantly deteriorated.

In the absence of concerted answer to a rapid deterioration of global macroeconomic conditions, the world economy would experience a brisk deceleration bringing growth durably below its potential. We attach a 25% probability to this scenario.

B. Tail risk scenarios

We have identified 5 different tail risks: a generalized trade war, the burst of the US credit bubble with a systemic dimension, a default of the Italian debt, a freezing of China's capital market and a stranded asset shock.

- A generalized trade war. US average tariffs rise to 12%. Global trade is 6pp lower, and global growth 2pp lower compared to our central scenario.
- Burst of the US bubble with systemic impact. The burst of the US credit bubble requires a state intervention with further and unsustainable deepening of the US deficit. A run on the USD and Treasuries has a devastating impact at a global level.
- A default of the Italian debt. Italy's government sticks to a highly expansionary stance of fiscal policy. Credit downgrade follows to non-IG in 2019, banks lose access to ECB liquidity but the Italian government refuses to accept an ESM program. Spreads climb above +700bp, Italy falls into a deep recession. Due to significant contagion, particularly to the periphery, the Eurozone economy also contracts. ECB implements significant non-standard measures.
- A freeze of China's capital market. Defaults of large state-owned financial institutions trigger a freezing of monetary and capital markets. Large capital outflow occurs while the PBOC is unable to stabilize a steep fall in the CNY. Global equity also experiences a huge selloff.
- A stranded asset shock. Financial markets suddenly realize the loss of value related to stranded fossil fuel assets. The effects of a carbon bubble burst results in wealth losses estimated between USD 1 – 4 trillion, a correction similar in size to the sub-prime crisis.



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