

ECOWEEK

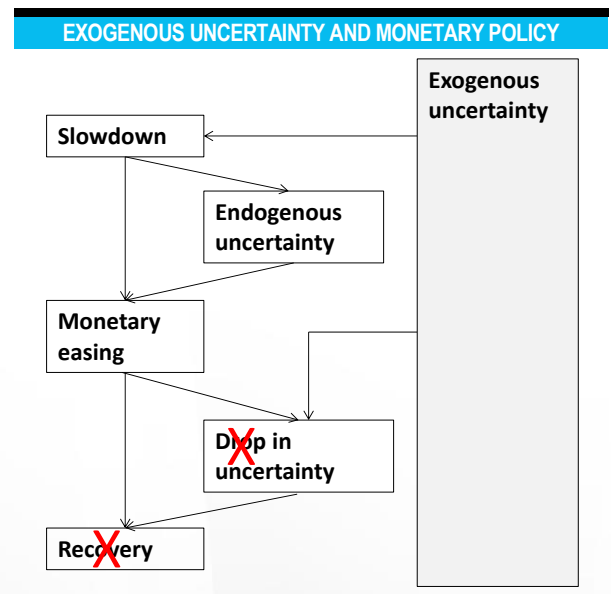
No. 19-27, 05 July 2019

Exogenous versus endogenous uncertainty and monetary policy

■ A high level of uncertainty can act as a drag on growth ■ Whether monetary easing will succeed in boosting growth will depend on the nature of uncertainty. Endogenous uncertainty follows from the normal development of the business cycle and rate cuts should succeed in reducing this uncertainty by boosting confidence of economic agents ■ Exogenous uncertainty is not driven by the business cycle but is triggered by other factors, such as, in the current environment, ongoing trade disputes. In this case, monetary policy effectiveness suffers and, despite rate cuts, the growth slowdown should continue until its root cause (exogenous uncertainty) is addressed.

Both on theoretical and empirical grounds, it can be argued that a persistently high level of uncertainty can act as a drag on economic growth. In such a case, monetary policy can be called upon to stop the slowdown so as to avoid that it would develop into a recession. However, the effectiveness of monetary accommodation will depend on the nature of the uncertainty. A first type of uncertainty is endogenous. It results from the normal development of the business cycle: slower growth raises concern about what is causing it, how long it will last, what will be the amplitude of the drop in growth, how it will influence household income and corporate profits, etc. A credible central bank can, by means of sufficient policy easing, reduce the level of uncertainty because economic agents expect that in due course, the monetary transmission channels will work. It is this expectation which boosts confidence, encourages cash-rich households to increase their spending, entices companies to invest more, raises the demand for bank credit, etc. As a consequence, endogenous uncertainty drops, stimulating spending even more.

A second type of uncertainty is exogenous. It doesn't follow from the normal course of the business cycle but is triggered by other factors such as geopolitics or economic policy. An example of the latter are trade disputes, such as those we have experienced since last year between the US and China. Exogenous uncertainty has its own drivers (e.g. negotiation tactics in matters of international trade) which are hardly influenced by cyclical developments. This has important implications for monetary policy. The effects of rate cuts, which are supposed to support confidence and trigger an increase in spending, are neutralised by ongoing high levels of uncertainty. After all, what difference does a 25bp cut in the policy rate make when companies and households have no idea whether, going forward, import tariffs will be hiked further or will be lowered, because an agreement has been reached? The same line of thinking can be extended to other instances of exogenous uncertainty, such as Brexit. Given the debilitating effect of exogenous uncertainty on monetary policy effectiveness, policy decisions are required to address it in order to stop the growth slowdown.



Source: BNP Paribas

William De Vijlder

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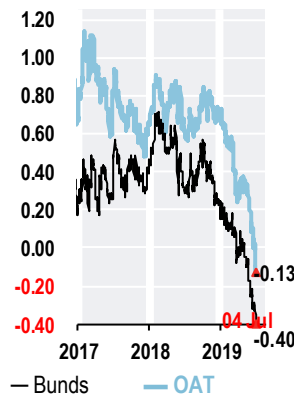
Markets overview

The essentials

Week 28-6 19 > 4-7-19

↗ CAC 40	5 539	▶ 5 621	+1.5 %
↗ S&P 500	2 942	▶ 2 996	+1.8 %
↘ Volatility (VIX)	15.1	▶ 12.6	-2.5 pb
↘ Euribor 3M (%)	-0.35	▶ -0.35	-0.9 bp
↘ Libor \$ 3M (%)	2.32	▶ 2.29	-3.1 bp
↘ OAT 10y (%)	-0.01	▶ -0.13	-12.1 bp
↘ Bund 10y (%)	-0.32	▶ -0.40	-7.5 bp
↘ US Tr. 10y (%)	2.00	▶ 1.95	-4.5 bp
↘ Euro vs dollar	1.14	▶ 1.13	-0.9 %
↗ Gold (ounce, \$)	1 412	▶ 1 416	+0.2 %
↘ Oil (Brent, \$)	66.9	▶ 63.6	-5.0 %

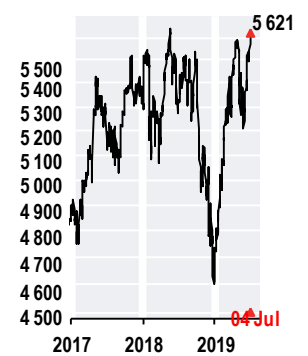
10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

Interest Rates	highest' 19	lowest' 19
€ ECB	0.00 at 01/01	0.00 at 01/01
Eonia	-0.37 at 07/06	-0.38 at 19/06
Euribor 3M	-0.35 at 24/01	-0.35 at 04/07
Euribor 12M	-0.26 at 06/02	-0.26 at 04/07
\$ FED	2.50 at 01/01	2.50 at 01/01
Libor 3M	2.29 at 01/01	2.29 at 03/07
Libor 12M	2.18 at 21/01	2.15 at 25/06
£ BoE	0.75 at 01/01	0.75 at 01/01
Libor 3M	0.76 at 29/01	0.76 at 03/07
Libor 12M	0.88 at 11/01	0.88 at 03/07

At 4-7-19

Yield (%)	highest' 19	lowest' 19
€ AVG 5-7y	-0.05 at 09/01	-0.05 at 03/07
Bund 2y	-0.76 at 05/03	-0.76 at 18/06
Bund 10y	-0.40 at 01/01	-0.40 at 04/07
OAT 10y	-0.13 at 08/01	-0.13 at 04/07
Corp. BBB	0.92 at 08/01	0.92 at 04/07
\$ Treas. 2y	1.77 at 18/01	1.73 at 20/06
Treas. 10y	1.95 at 18/01	1.95 at 03/07
Corp. BBB	3.48 at 01/01	3.48 at 03/07
£ Treas. 2y	0.49 at 27/02	0.49 at 03/07
Treas. 10y	0.67 at 18/01	0.67 at 04/07

At 4-7-19

10y bond yield & spreads

2.82%	Greece	321 pb
1.68%	Italy	207 pb
0.34%	Portugal	74 pb
0.25%	Spain	64 pb
-0.06%	Belgium	33 pb
-0.13%	France	27 pb
-0.15%	Austria	25 pb
-0.23%	Finland	17 pb
-0.25%	Ireland	15 pb
-0.25%	Netherland	15 pb
-0.40%	Germany	

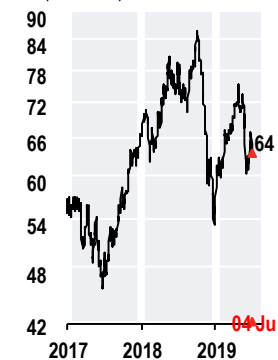
Commodities

Spot price in dollars	lowest' 19	2019(€)
Oil, Brent	63.6 at 01/01	+21.2%
Gold (ounce)	1 268 at 02/05	+11.9%
Metals, LMEX	2 776 at 03/01	+0.4%
Copper (ton)	5 909 at 03/01	+0.6%
CRB Foods	346 at 07/03	+8.1%
wheat (ton)	189 at 10/05	-3.0%
Corn (ton)	170 at 24/04	+26.8%

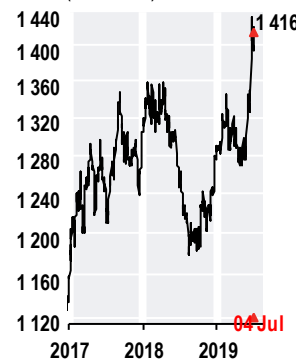
At 4-7-19

Variations

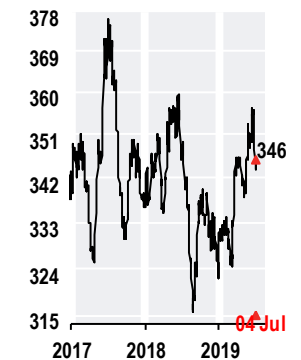
Oil (Brent, \$)



Gold (Ounce, \$)



CRB Foods



Exchange Rates

€ =	highest' 19	lowest' 19	2019
USD	1.15 at 10/01	1.11 at 30/05	-1.3%
GBP	0.90 at 03/01	0.85 at 14/03	-0.0%
CHF	1.11 at 23/04	1.11 at 24/06	-1.3%
JPY	127.43 at 01/03	120.99 at 31/05	-3.0%
AUD	1.61 at 17/06	1.57 at 18/04	-1.0%
CNY	7.75 at 09/01	7.51 at 25/04	-1.2%
BRL	4.28 at 20/05	4.18 at 31/01	-3.4%
RUB	71.59 at 01/01	71.16 at 20/06	-9.7%
INR	77.29 at 04/02	76.84 at 03/04	-3.2%

At 4-7-19

Variations

Equity indices

Index	highest' 19	lowest' 19	2019	2019(€)
CAC 40	5 621 at 04/07	4 611 at 03/01	+18.8%	+18.8%
S&P500	2 996 at 03/07	2 448 at 03/01	+19.5%	+21.1%
DAX	12 630 at 04/07	10 417 at 03/01	+19.6%	+19.6%
Nikkei	21 702 at 25/04	19 562 at 04/01	+8.4%	+11.8%
China*	86 at 09/04	68 at 03/01	+12.8%	+14.7%
India*	609 at 03/06	530 at 19/02	+7.2%	+10.7%
Brazil*	2 297 at 04/02	1 862 at 17/05	+15.7%	+19.7%
Russia*	747 at 04/07	572 at 01/01	+20.9%	+32.3%

At 4-7-19

Variations

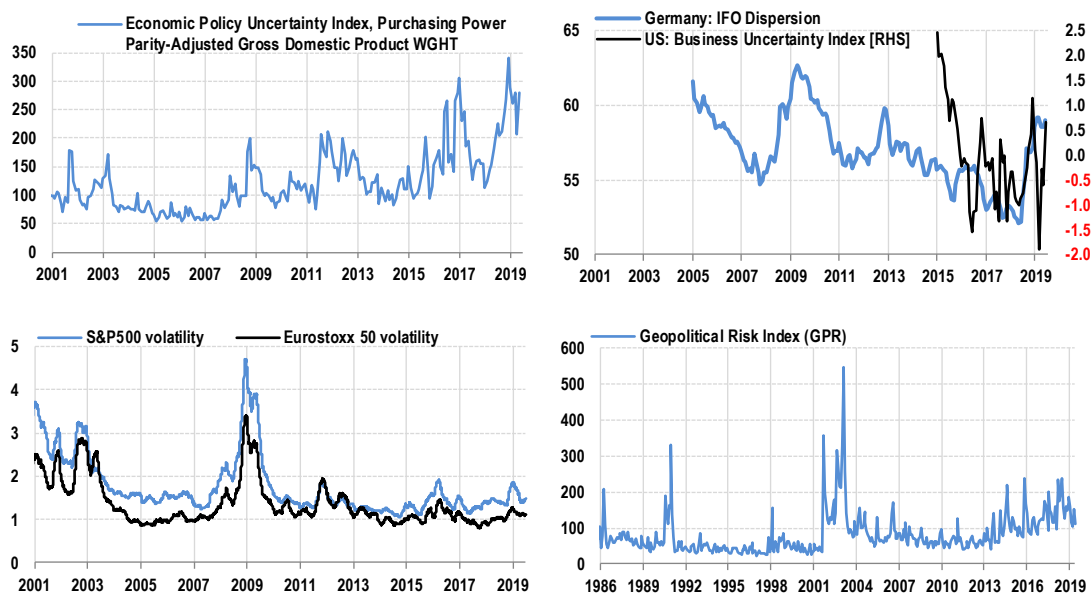
* MSCI index



Pulse

Uncertainty: persistently high

High levels of uncertainty can have a profound impact on economic activity and financial markets. Our Pulse presents different metrics. Starting top left and moving clockwise, the economic policy uncertainty index, which is based on media coverage, remains very high. This doesn't come as a surprise considering ongoing trade tensions. Companies in Germany still feel very uncertain and, after a brief dip, the uncertainty level of US companies has rebounded. The geopolitical risk index, again based on media coverage, has eased a bit in recent months, although the longer-term trend is still up. Uncertainty based on individual share price performance is still rather low: the prospect of monetary policy easing clearly helps.



volatility = 60-day moving average of the cross-sectional standard deviation of daily returns of the index constituents

Source: Economic Policy Uncertainty, Bloomberg, IFO, Atlanta Fed, BC, BNP Paribas

Source: Bloomberg, Markit, BNP Paribas

Indicators preview

A rather light week ahead of us in terms of data with industrial production for the month of May in Germany, France, the eurozone and Japan. In the UK, the monthly GDP estimate will show how the economy is doing faced with ongoing Brexit uncertainty. China will publish trade balance data (important given the trade confrontation with the US and the economic slowdown) as well as information on aggregate financing. In France and Germany we will have inflation numbers. The Banque de France will publish its industrial sentiment index for June. In the US, inflation numbers will be released as well as mortgage applications. The FOMC meeting minutes will be eagerly awaited considering the shift in tone towards easing.

Date Time	Region	Event	Period	Survey	Prior
07/08/2019	Greece	Industrial Production SA MoM	May	0.5%	-1.9%
07/08/2019	France	Bank of France Ind. Sentiment	June	--	99
07/09/2019	United States	NFIB Small Business Optimism	June	--	105.0
07/09/2019	China	Aggregate Financing CNY	June	1.8955e+12	1.4e+12
07/10/2019	France	Industrial Production MoM	May	--	0.4%
07/10/2019	United Kingdom	Monthly GDP 3M/3M Change	May	0.0%	0.3%
07/10/2019	United States	MBA Mortgage Applications	July-05	--	-0.1%
07/10/2019	United States	FOMC Meeting Minutes	June-19	--	--
07/11/2019	Germany	CPI EU Harmonized MoM	June	--	0.1%
07/11/2019	France	CPI EU Harmonized MoM	June	--	0.3%
07/11/2019	United States	CPI MoM	June	0.0%	0.1%
07/12/2019	Japan	Industrial Production MoM	May	--	2.3%
07/12/2019	Eurozone	Industrial Production SA MoM	May	0.2%	-0.5%
07/12/2019	United States	PPI Final Demand MoM	June	0.1%	0.1%
07/12/2019	China	Trade Balance	June	4.5e+10	4.165e+10

Source: Bloomberg, BNP Paribas



Economic scenario

UNITED STATES

- Growth picked-up by early 19 but this was partly due to one-off factors (inventories). The trend in private domestic demand is more subdued. The housing market is softening, corporate investment should slow, as well as exports. Core inflation remains well under control and has eased a bit.
- Regarding the more cautious message delivered by the Fed's president. J. Powell (about trade tensions), we believe the Fed Funds target rate will be cut by 2 quarter points in Q3, coming back to 1.75-2%

CHINA

- Economic growth continues to slow. Activity rebounded in March 2019 but weakened again afterwards. The recent flare-up in trade tensions with the US has again darkened export prospects.
- The central bank is easing liquidity and credit conditions, though the reduction in financial-instability risks via regulatory tightening should remain a priority. Fiscal policy has also turned expansionary through increased infrastructure spending and a rising number of household/corporate tax cuts.
- In the short term, exports and private domestic investment should continue to decelerate. Tax measures should support consumer spending.

EUROZONE

- Despite a stronger than expected growth in the 1st quarter of 2019, the economic slowdown is continuing in the eurozone, especially in Germany, due to international environment uncertainties and a slowdown of exports to China. Capacity constraints also play a role and activity in the manufacturing sector continues to decline.
- Inflation is now expected to decrease while core CPI is hardly moving. The activity slowdown also implies that the pick-up in core inflation should be slower than expected until recently.
- Monetary policy remains cautious and proactive, the ECB announcing the launch of another round of longer-term refinancing operations (TLTRO) for eurozone banks.

FRANCE

- Growth is slowing although the economy should show some resilience. Households' consumption should get a boost from the tax cuts and the jobs recovery but inflation reduces purchasing power gains. Business investment dynamics remain favourable. The global backdrop is less supportive. A slight rise in core inflation is appearing but remains to be confirmed.

INTEREST RATES AND FX RATES

- In the US, we expect the Fed to cut rates twice in the second semester in reaction to a slowing economy, subdued inflation and heightened uncertainty. Bond markets are already pricing in rate cuts, which is why we expect that the decline of the 10 year treasury yield will only be moderate.
- The combination of slower growth and subdued core inflation leads us to expect that ECB official rates will remain unchanged this year and next. 10 year Bund yields are expected to rise only marginally to 0.00% by the end of this year. We forecast a yield of 0.15% by the end of 2020.
- No change expected in Japan.
- We expect the euro to strengthen versus the dollar considering that the latter is expensive on valuation grounds and that the Fed will ease its policy

%	GDP Growth			Inflation		
	2018	2019 e	2020 e	2018	2019 e	2020 e
Advanced	2.2	1.8	1.3	2.0	1.6	1.6
United-States	2.9	2.7	1.8	2.4	2.1	2.0
Japan	0.8	0.6	0.2	1.0	0.6	0.5
United-Kingdom	1.4	1.3	1.4	2.5	1.9	1.9
Euro Area	1.9	1.1	1.0	1.8	1.3	1.3
Germany	1.4	0.6	1.0	1.9	1.5	1.5
France	1.7	1.3	1.2	2.1	1.4	1.5
Italy	0.7	0.3	0.2	1.3	0.9	0.9
Spain	2.6	2.2	1.9	1.7	1.0	1.2
Emerging	4.5	4.2	4.7	4.7	4.8	4.3
China	6.6	6.2	6.0	2.1	2.2	2.6
India*	7.0	7.4	7.6	3.4	3.5	4.2
Brazil	1.1	0.8	2.5	3.7	3.9	3.9
Russia	2.3	1.5	1.7	2.9	5.1	4.1

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

* Fiscal year from April 1st of year n to March 31st of year n+1

Interest rates, %		2019				2018	2019e	2020e
End of period		Q1	Q2e	Q3e	Q4e			
US	Fed Funds	2.50	2.50	2.00	2.00	2.50	2.00	1.75
	Libor 3m \$	2.60	2.45	2.00	2.00	2.81	2.00	1.80
	T-Notes 10y	2.42	2.10	1.95	1.90	2.69	1.90	2.25
Ezone	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	Euribor 3m	-0.31	-0.30	-0.30	-0.30	-0.31	-0.30	-0.30
	Bund 10y	-0.07	-0.05	-0.05	0.00	0.25	0.00	0.15
	OAT 10y	0.26	0.30	0.30	0.30	0.71	0.30	0.45
UK	Base rate	0.75	1.00	1.00	1.25	0.75	1.25	1.25
	Gilts 10y	1.00	1.85	2.00	2.10	1.27	2.10	2.10
Japan	BoJ Rate	-0.06	-0.10	-0.10	-0.10	-0.07	-0.10	-0.10
	JGB 10y	-0.09	-0.03	-0.02	-0.02	0.00	-0.02	-0.05

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates		2019				2018	2019e	2020e
End of period		Q1	Q2e	Q3e	Q4e			
USD	EUR / USD	1.12	1.13	1.16	1.20	1.14	1.20	1.25
	USD / JPY	111.0	108.0	105.0	102.0	110.0	102.0	95.0
	GBP / USD	1.30	1.27	1.32	1.38	1.27	1.38	1.49
	USD / CHF	1.00	1.01	0.99	0.97	0.99	0.97	0.94
EUR	EUR / GBP	0.85	0.89	0.88	0.87	0.90	0.87	0.84
	EUR / CHF	1.12	1.14	1.15	1.16	1.13	1.16	1.18
	EUR / JPY	124.0	122.0	122.0	122.0	125.0	122.0	119.0

Source : BNP Paribas GlobalMarkets (e: Forecasts)

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