ECOWEEK

No. 20-01, 10 January 2020

Markets and geopolitical uncertainty: (ir)rational complacency?

■ **There is a considerable gap between what are considered to be the geopolitical ramifications of the escalating tensions between the US and Iran since the start of the year and the subdued reaction of markets** ■ **The market reaction probably reflects the investors' view that the probability-weighted impact on growth should be very limited because the risk of a major escalation is considered to be small and/or because of an expectation that the impact of higher oil prices on the economy is limited** ■ **What also may play a role in the market reaction thus far is that, leaving the geopolitical uncertainty aside, the economic environment is considered to be conducive to taking risk: stabilisation of survey data, reduction in trade-related uncertainty and accommodative monetary policy.**

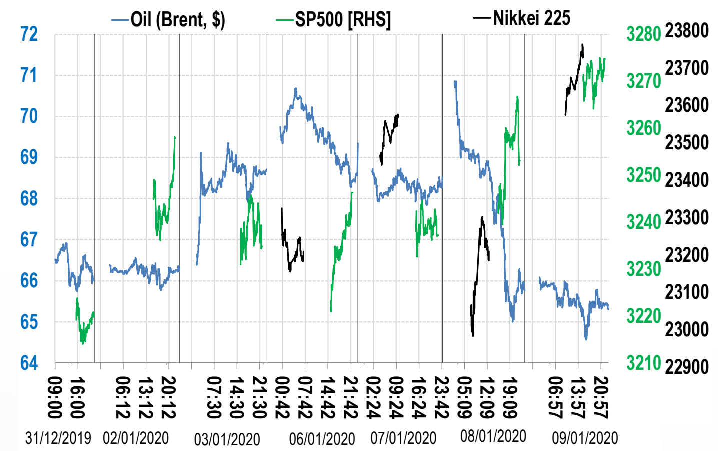
Compared to the analyses from political commentators of the escalation of tensions between the US and Iran since the start of the year, the market reaction has been very subdued. It is tempting to call it an example of irrational complacency, based on a view that risks are being underestimated, although the opposite interpretation can also be defended: what, at first glance, looks like complacency, could be a reflection of rational pricing of uncertainty.

The economic consequences of geopolitical uncertainty[1] are complex and varied. The transition to a regime of higher uncertainty can end up weighing on growth, notably via slower growth of corporate investment. This effect takes time to materialise because it depends on how quickly companies become convinced that the higher uncertainty is there to stay and that it influences their business. Uncertainty spikes, which are short-lived, can trigger knee-jerk market reactions whilst having limited or no lasting consequences, neither on markets nor on the economy. A key question is how exactly uncertainty influences the economy: which variables are impacted in the first place and how do they, in turn, influence production, inflation, spending, interest rates, etc.?

In gauging the consequences of the confrontation between Iran and the US, oil prices play a key role as a channel of transmission considering that an escalation could end up causing supply disruptions. It is worth recalling the developments in August 1990 when the invasion of Kuwait by Iraq caused a doubling of oil prices within three months. After having peaked in October that year, prices stayed at a high level for several months and only approached their pre-invasion level in the spring of 1991.

.../...

MARKET REACTION FROM 19/31/12 TO 20/09/01



Source: Bloomberg, BNP Paribas

[1] In Macrowaves, the podcast of BNP Paribas Economic Research, the topic of geopolitical risk has been addressed in 2019 in three episodes: definition, impact on business and impact on business strategy.

ECONOMIC RESEARCH DEPARTMENT

Hence, it makes a big difference whether an oil price increase is short-lived (because disrupted supply can be restored very quickly) or more lasting.

Bringing this all together, investors and company managers need to answer several questions in deciding on how to react to the recent increase in tensions: a) will they continue to escalate? b) will it end up creating oil supply disruptions? c) if so, what would be the impact on oil prices? d) would this impact be very temporary or last for several months? e) how would economic activity react? f) could the reaction be of such a nature that a recession would follow? In such a scenario analysis, the growth impact at the end of the decision tree is equal to the product of the values in decision nodes a) to f). Market reaction thus far suggests that investors consider that the probability-weighted growth impact is likely to be very small. This could reflect a view that risk of a major escalation, all in all, is not that high and/or that the impact of higher oil prices on the economy is limited. Factors in favour of the latter argument are the fact that the oil intensity of production and consumption has declined compared to the 70s, that there is an excess supply of oil on the market (hence the OPEC production ceilings) and that inflation is sufficiently low. This last point means that, even if oil prices were to rise, central banks would not be forced to react hastily to the ensuing higher energy inflation[2]. On the other hand, one should keep in mind that the slower growth environment could actually increase the sensitivity to oil shocks.[3]

Quite likely, what also plays a role in the market reaction thus far is that, leaving the geopolitical uncertainty aside, the economic environment is conducive to taking risk: business surveys have stabilised in recent months, the prospect of a phase 1 deal between the US and China has eased concerns about further trade clashes and monetary policy is highly accommodative.

William De Vijlder

[2] Interestingly, already in 2006, the point about a reduced sensitivity to oil price increases was made by David Walton, member of the monetary policy committee of the Bank of England, in a speech on "Has oil lost the capacity to shock?".

[3] This is considered to have played a role in 1990 where a global slowdown was already underway. Moreover, in several countries, business and consumer confidence was already low before the crisis in the Gulf started. For an analysis of these events, see Michael M. Hutchison, Aggregate demand, uncertainty and oil prices: The 1990 oil shock in comparative perspective, BIS Economic papers No. 31, August 1991.

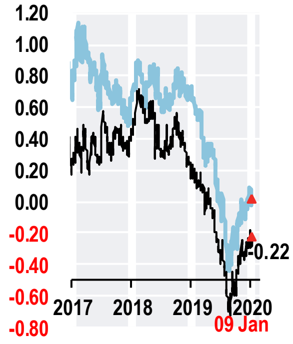
Markets overview

The essentials

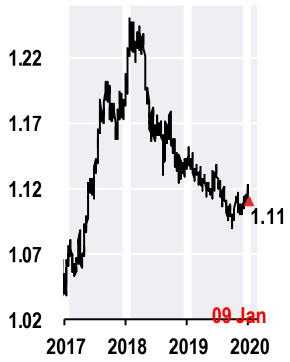
Week 3-1 20 > 9-1-20

↘	**CAC 40**	6 044	▸	**6 043**	**-0.0**	%
↗	**S&P 500**	3 235	▸	**3 275**	**+1.2**	%
↘	Volatility (VIX)	14.0	▸	12.5	-1.5	pb
↘	**Euribor 3M (%)**	-0.38	▸	**-0.39**	**-0.9**	bp
↘	Libor $ 3M (%)	1.87	▸	1.83	-4.0	bp
↗	OAT 10y (%)	-0.02	▸	0.02	+3.9	bp
↗	Bund 10y (%)	-0.29	▸	-0.22	+6.8	bp
↗	US Tr. 10y (%)	1.79	▸	1.86	+7.0	bp
↘	**Euro vs dollar**	1.12	▸	**1.11**	**-0.6**	%
↘	Gold (ounce, $)	1 548	▸	1 548	-0.0	%
↘	**Oil (Brent, $)**	68.1	▸	**65.6**	**-3.7**	%

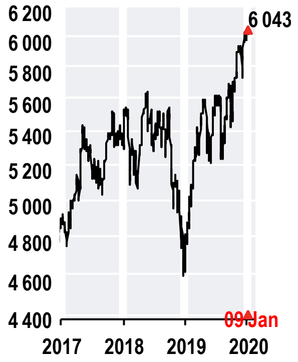
10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

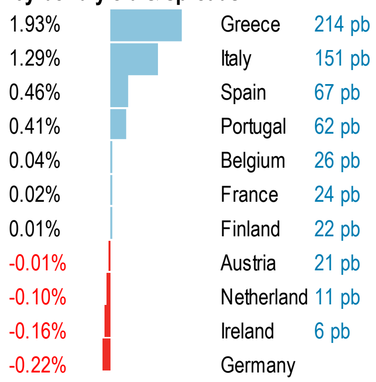
Interest Rates		highest' 20		lowest' 20	
€ ECB	**0.00**	0.00	at 01/01	0.00	at 01/01
Eonia	**-0.45**	-0.45	at 01/01	-0.46	at 07/01
Euribor 3M	**-0.39**	-0.38	at 02/01	-0.39	at 09/01
Euribor 12M	**-0.26**	-0.24	at 03/01	-0.26	at 09/01
$ FED	**1.75**	1.75	at 01/01	1.75	at 01/01
Libor 3M	**1.83**	1.91	at 01/01	1.83	at 08/01
Libor 12M	**1.95**	2.00	at 01/01	1.95	at 08/01
£ BoE	**0.75**	0.75	at 01/01	0.75	at 01/01
Libor 3M	**0.80**	0.80	at 08/01	0.79	at 01/01
Libor 12M	**0.97**	0.98	at 01/01	0.96	at 03/01

At 9-1-20

Yield (%)			highest' 20		lowest' 20	
€	AVG 5-7y	**0.06**	0.10	at 02/01	0.01	at 06/01
	Bund 2y	**-0.59**	-0.59	at 09/01	-0.62	at 07/01
	Bund 10y	**-0.22**	-0.19	at 01/01	-0.29	at 03/01
	OAT 10y	**0.02**	0.08	at 01/01	-0.03	at 07/01
	Corp. BBB	**0.90**	0.91	at 01/01	0.84	at 06/01
$	Treas. 2y	**1.58**	1.59	at 08/01	1.53	at 03/01
	Treas. 10y	**1.86**	1.91	at 01/01	1.79	at 03/01
	Corp. BBB	**3.16**	3.18	at 08/01	3.11	at 03/01
£	Treas. 2y	**0.57**	0.61	at 08/01	0.53	at 01/01
	Treas. 10y	**0.82**	0.83	at 01/01	0.74	at 03/01

At 9-1-20

10y bond yield & spreads



Commodities

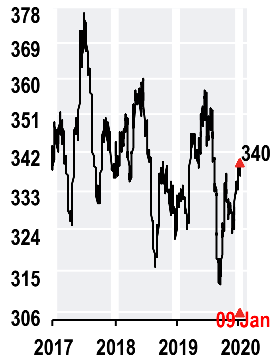
Spot price in dollars		lowest' 20			2020(€)
Oil, Brent	**65.6**	65.6	at	09/01	**-0.0%**
Gold (ounce)	**1 548**	1 521	at	01/01	**+2.9%**
Metals, LMEX	**2 858**	2 831	at	03/01	**+1.6%**
Copper (ton)	**6 153**	6 104	at	03/01	**+1.2%**
CRB Foods	**340**	336	at	08/01	**+1.4%**
wheat (ton)	**232**	227	at	06/01	**+2.2%**
Corn (ton)	**149**	149	at	09/01	**+0.8%**

At 9-1-20 *Variations*

Oil (Brent, $)

Gold (Ounce, $)

CRB Foods



Exchange Rates

1€ =		highest' 20			lowest' 20			2020
USD	**1.11**	1.12	at	01/01	1.11	at	09/01	**-1.1%**
GBP	**0.85**	0.85	at	03/01	0.85	at	01/01	+0.4%
CHF	**1.08**	1.09	at	01/01	1.08	at	08/01	-0.6%
JPY	**121.62**	121.99	at	01/01	120.61	at	03/01	-0.3%
AUD	**1.62**	1.62	at	07/01	1.60	at	01/01	+1.4%
CNY	**7.70**	7.82	at	01/01	7.70	at	09/01	-1.6%
BRL	**4.53**	4.55	at	07/01	4.51	at	02/01	+0.2%
RUB	**68.06**	69.72	at	01/01	68.06	at	09/01	-2.4%
INR	**79.06**	80.49	at	06/01	79.06	at	09/01	-1.3%

At 9-1-20 *Variations*

Equity indices

	Index	highest' 20			lowest' 20			2020	2020(€)
CAC 40	**6 043**	6 044	at	03/01	5 978	at	01/01	+1.1%	**+1.1%**
S&P500	**3 275**	3 275	at	09/01	3 231	at	01/01	+1.4%	**+2.5%**
DAX	**13 495**	13 495	at	09/01	13 127	at	06/01	+1.9%	**+1.9%**
Nikkei	**23 740**	23 740	at	09/01	23 205	at	08/01	+0.4%	**+0.7%**
China*	**88**	88	at	09/01	85	at	01/01	+3.0%	**+4.4%**
India*	**597**	597	at	09/01	580	at	06/01	+0.7%	**+2.0%**
Brazil*	**2 345**	2 429	at	02/01	2 345	at	09/01	+0.1%	**-0.1%**
Russia*	**839**	839	at	09/01	807	at	01/01	+2.7%	**+5.1%**

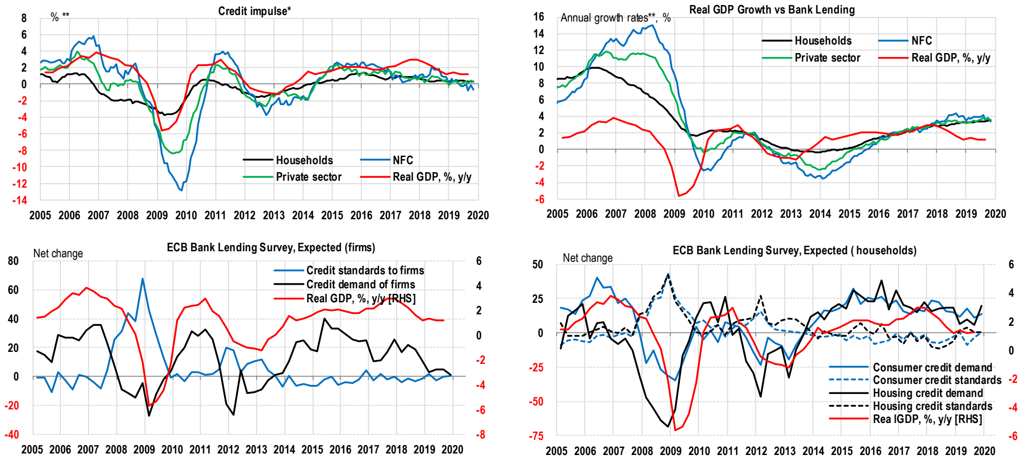
At 9-1-20 *Variations*

* MSCI index

Pulse

Credit pulse in the eurozone: positive for households, negative for companies

After picking up in October, the credit pulse of non-financial corporates (NFC) in the eurozone dipped again in November. Yet the decline in the private sector's credit pulse was still very mild, bolstered by the remarkable stability of the credit pulse for households. Recent trends should extend into first-quarter 2020: the banks surveyed expect loan demand from NFC to continue to ease. Inversely, exceptionally low interest rates should continue to boost loan demand from households, mainly for home loans.



*Credit impulse is measured as the annual change of the annual growth rate of MFI loans ** Adjusted for securitizations

Source: ECB, ECB survey on the distribution of credit, BLS, BNP Paribas calculations

Indicators preview

As usual around the middle of the month, we will see the release of several important data in China: retail sales, industrial production, property investment, fixed asset investment. In addition we will have the estimate for GDP in Q4 2019. In the US several statistics will be published on the housing market: mortgage applications, housing market index, building permits and housing starts. In addition we have regional business surveys in the US, the Fed Beige Book as well as University of Michigan sentiment. The schedule is light with respect to the eurozone: inflation, trade balance, industrial production.

Date	Country	Event	Period	Survey	Prior
01/14/2020	United States	CPI Ex Food and Energy YoY	Dec	--	2.3%
01/14/2020	China	Trade Balance CNY	Dec	3.1275e+11	2.7421e+11
01/15/2020	France	CPI EU Harmonized YoY	Dec	--	1.6%
01/15/2020	Germany	GDP NSA YoY	2019	--	1.5%
01/15/2020	United Kingdom	CPI YoY	Dec	--	1.5%
01/15/2020	Eurozone	Industrial Production SA MoM	Nov	--	-0.5%
01/15/2020	Eurozone	Trade Balance SA	Nov	--	2.45e+10
01/15/2020	United States	MBA Mortgage Applications	Jan	--	--
01/15/2020	United States	PPI Ex Food and Energy YoY	Dec	--	1.3%
01/15/2020	United States	Empire Manufacturing	Jan	4.0	3.5
01/15/2020	United States	U.S. Federal Reserve Releases Beige Book			
01/16/2020	Japan	Core Machine Orders YoY	Nov	--	-6.1%
01/16/2020	Germany	CPI EU Harmonized YoY	Dec	--	1.5%
01/16/2020	United States	Retail Sales Advance MoM	Dec	0.5%	0.2%
01/16/2020	United States	Philadelphia Fed Business Outlook	Jan	3.4	0.3
01/16/2020	United States	NAHB Housing Market Index	Jan	--	76
01/17/2020	China	Retail Sales YTD YoY	Dec	8.0%	8.0%
01/17/2020	China	Property Investment YTD YoY	Dec	--	10.2%
01/17/2020	China	Industrial Production YTD YoY	Dec	5.6%	5.6%
01/17/2020	China	Fixed Assets Ex Rural YTD YoY	Dec	5.2%	5.2%
01/17/2020	China	GDP YoY	4Q	6.0%	6.0%
01/17/2020	United Kingdom	Retail Sales Ex Auto Fuel YoY	Dec	--	0.8%
01/17/2020	Eurozone	CPI YoY	Dec	--	1.0%
01/17/2020	United States	Building Permits MoM	Dec	-0.8%	1.4%
01/17/2020	United States	Housing Starts MoM	Dec	0.8%	3.2%
01/17/2020	United States	Industrial Production MoM	Dec	0.0%	1.1%
01/17/2020	United States	University of Michigan Sentiment	Jan	99.0	99.3

Source : Bloomberg, BNP Paribas

Economic scenario

UNITED STATES

- Despite the support coming from the Fed rate cuts in 2019, we expect growth to slow in the near term under the influence of corporate investment (slower profits growth, trade uncertainty) and housing (declining trend of affordability, despite a recent rebound). Consumer spending should be more resilient but could slow on the back of a less dynamic labour market.
- As a consequence, we expect two Fed funds target rate cuts in the first half of 2020.

CHINA

- Economic growth continues to slow. Industrial activity and exports have been hard hit by US tariff hikes. Domestic demand has also decelerated.
- The central bank is easing liquidity and credit conditions, but the reduction in financial-instability risks should remain a priority and banks are prudent. Fiscal policy is expansionary through increased investment in infrastructure projects and household/corporate tax cuts. Tax measures are expected to have some success in supporting consumer spending.
- Consumer price inflation has accelerated due to rising food prices (soaring pork prices), but core inflation remains subdued.

EUROZONE

- The economic slowdown is continuing in the eurozone, especially in Germany, due to the international environment and difficulties in the manufacturing sector. The recent stabilization of business surveys, albeit at a low level, provides some hope but needs to be confirmed.
- Inflation is now expected to decrease while core CPI is hardly moving. The activity slowdown also implies that the pick-up in core inflation could be slower than expected until recently.
- The very accommodative monetary policy should be maintained as long as inflation hasn't converged sufficiently, in a convincing and lasting way, towards the ECB's objective.

FRANCE

- Growth is slowing although the economy shows resilience. Households' consumption should get a boost from the tax cuts and the jobs recovery. 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 its official rate twice in the first half of 2020 in reaction to a slowing economy, moderate inflation and high uncertainty. This should support the medium term growth outlook, which is why, after an initial decline, we expect Treasury yields to increase gradually.
- In the eurozone, the ECB's state-dependent forward guidance and the sluggishness of the inflation process imply that the very accommodative environment will remain in place for a long time. The movement of bond yields will be very much influenced by what happens to US yields, although we expect the increase in Bund yields to be smaller. Sovereign spreads in the eurozone should decline.
- We expect that the Bank of Japan will refrain from further monetary easing.
- We expect little change in EUR/USD even though euro's fair value is quite higher than current pricing.

	GDP Growth				Inflation			
%	2018	2019 e	2020 e	2021 e	2018	2019 e	2020 e	2021 e
Advanced	**2.2**	**1.7**	**1.1**	**1.6**	**2.0**	**1.5**	**1.6**	**1.4**
United-States	2.9	2.3	1.5	2.0	2.4	1.8	2.4	1.9
Japan	0.8	1.0	0.2	0.7	1.0	0.5	0.6	0.3
United-Kingdom	1.4	1.3	1.1	1.7	2.5	1.8	1.5	1.8
Euro Area	**1.9**	**1.1**	**0.8**	**1.3**	**1.8**	**1.2**	**1.0**	**1.0**
Germany	1.5	0.5	0.4	1.2	1.9	1.4	1.2	1.2
France	1.7	1.3	1.1	1.3	2.1	1.3	1.0	1.1
Italy	0.7	0.2	0.2	0.6	1.2	0.7	0.6	0.5
Spain	2.4	2.0	1.7	1.6	1.7	0.8	0.8	0.9
Emerging	**4.4**	**3.8**	**4.0**	**4.2**	**4.6**	**4.6**	**4.6**	**3.6**
China	6.6	6.1	5.7	5.8	2.1	2.8	3.5	1.5
India*	6.8	5.8	5.5	6.0	2.9	3.0	3.3	3.5
Brazil	1.1	1.0	2.0	3.0	3.7	3.7	3.4	3.7
Russia	2.3	0.9	1.5	1.5	2.9	4.7	3.8	4.0

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		2020						
End of period		Q3	Q4e	Q1e	Q2e	Q3e	Q4e	**2018**	**2019e**	**2020e**
US	Fed Funds	2.00	1.75	1.50	1.25	1.25	1.25	2.50	1.75	1.25
	T-Notes 10y	1.67	1.75	1.60	1.80	2.10	2.00	2.69	1.75	2.00
Ezone	Deposit rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
	Bund 10y	-0.57	-0.35	-0.50	-0.40	-0.30	-0.30	0.25	-0.35	-0.30
	OAT 10y	-0.28	-0.05	-0.20	-0.15	-0.10	-0.10	0.71	-0.05	-0.10
UK	Base rate	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
	Gilts 10y	0.40	0.71	1.00	1.10	1.20	1.20	1.27	0.71	1.20
Japan	BoJ Rate	-0.06	-0.10	-0.10	-0.10	-0.10	-0.10	-0.07	-0.10	-0.10
	JGB 10y	-0.22	-0.05	-0.10	0.00	0.05	0.10	0.00	-0.05	0.10

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates		2019		2020						
End of period		Q3	Q4e	Q1e	Q2e	Q3e	Q4e	**2018**	**2019e**	**2020e**
USD	EUR / USD	1.09	1.11	1.12	1.13	1.13	1.14	1.14	1.11	1.14
	USD / JPY	108	107	104	103	103	103	110	107	103
	GBP / USD	1.23	1.32	1.35	1.36	1.36	1.39	1.27	1.32	1.39
	USD / CHF	1.00	0.99	0.99	0.99	0.99	1.00	0.99	0.99	1.00
EUR	EUR / GBP	0.89	0.84	0.83	0.83	0.83	0.82	0.90	0.84	0.82
	EUR / CHF	1.09	1.10	1.11	1.12	1.12	1.14	1.13	1.10	1.14
	EUR / JPY	118	119	116	116	116	117	125	119	117

Source : BNP Paribas GlobalMarkets (e: Forecasts)

GROUP ECONOMIC RESEARCH

William De Vijlder Chief Economist	+33 1 55 77 47 31	william.devijlder@bnpparibas.com
ADVANCED ECONOMIES AND STATISTICS		
Jean-Luc Proutat Head – United States, United Kingdom	+33 1 58 16 73 32	jeanluc.proutat@bnpparibas.com
Hélène Baudchon France – Labour markets	+33 1 58 16 03 63	helene.baudchon@bnpparibas.com
Louis Boisset European Central Bank watch, Euro area global view, Japan	+33 1 57 43 02 91	louis.boisset@bnpparibas.com
Frédérique Cerisier Euro area (European gouvernance and public finances), Spain, Portugal	+33 1 43 16 95 52	frederique.cerisier@bnpparibas.com
Raymond Van Der Putten Germany, Netherlands, Austria, Switzerland – Energy, climate – Long-term projections	+33 1 42 98 53 99	raymond.vanderputten@bnpparibas.com
Tarik Rharrab Statistics	+33 1 43 16 95 56	tarik.rharrab@bnpparibas.com
BANKING ECONOMICS		
Laurent Quignon Head	+33 1 42 98 56 54	laurent.quignon@bnpparibas.com
Laure Baquero	+ 33 1 43 16 95 50	laure.baquero@bnpparibas.com
Céline Choulet	+33 1 43 16 95 54	celine.choulet@bnpparibas.com
Thomas Humblot	+ 33 1 40 14 30 77	thomas.humblot@bnpparibas.com
EMERGING ECONOMIES AND COUNTRY RISK		
François Faure Head, Argentina, Turkey, Ukraine, Central European countries	+33 1 42 98 79 82	francois.faure@bnpparibas.com
Christine Peltier Deputy Head – Greater China, Vietnam, South Africa	+33 1 42 98 56 27	christine.peltier@bnpparibas.com
Stéphane Alby Africa (French-speaking countries)	+33 1 42 98 02 04	stephane.alby@bnpparibas.com
Sara Confalonieri Africa (Portuguese & English-speaking countries)	+33 1 42 98 43 86	sara.confalonieri@bnpparibas.com
Pascal Devaux Middle East, Balkan countries	+33 1 43 16 95 51	pascal.devaux@bnpparibas.com
Hélène Drouot Korea, Thailand, Philippines, Mexico, Andean countries	+33 1 42 98 33 00	helene.drouot@bnpparibas.com
Salim Hammad Latin America	+33 1 42 98 74 26	salim.hammad@bnpparibas.com
Johanna Melka India, South Asia, Russia, Kazakhstan, CIS	+33 1 58 16 05 84	johanna.melka@bnpparibas.com
CONTACT MEDIA		
Michel Bernardini	+33 1 42 98 05 71	michel.bernardini@bnpparibas.com

OUR PUBLICATIONS

CONJONCTURE

Structural or in news flow, two issues analysed in depth

EMERGING

Analyses and forecasts for a selection of emerging economies

PERSPECTIVES

Analyses and forecasts for the main countries, emerging or developed

ECOFLASH

Data releases, major economic events. Our detailed views...

ECOWEEK

Weekly economic news and much more...

ECOTV

In this monthly web TV, our economists make sense of economic news

ECOTV WEEK

What is the main event this week? The answer is in your two minutes of economy

POUR RECEVOIR NOS PUBLICATIONS

VOUS POUVEZ VOUS ABONNER SUR NOTRE SITE ONGLET ABONNEMENT
http://economic-research.bnpparibas.com

ET

NOUS SUIVRE SUR LINKEDIN
https://www.linkedin.com/showcase/bnp--paribas-economic-research/
OU TWITTER
https://twitter.com/EtudesEco_BNPP

Prepared by Economic Research – BNP PARIBAS
Registered Office: 16 boulevard des Italiens – 75009 PARIS
Tel: +33 (0) 1.42.98.12.34 – Internet :
www.group.bnpparibas.com
Publisher: Jean Lemierre. Editor: William De Vijlder

BNP PARIBAS

The bank
for a changing
world