Market Outlook Q2 2019

Anticipating a recession

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"We introduce our proprietary recession model for the US and the Eurozone and show that both regions are heading for a recession in 2020. This report analyses the likelihood of these recessions and the best way investors can prepare their bond and equity market portfolios for this scenario."

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Recession, what recession?

The race is on for the next economist to become a media superstar by correctly predicting the next recession in the US. The winner will become a celebrity on CNBC and Bloomberg TV, and though it will not propel her to superstardom like the "predictions" before the Global Financial Crisis by Nouriel Roubini or Meredith Whitney, she will nevertheless be able to command a premium on future salaries and bonuses and boost her career. Essentially, correctly predicting a recession allows you to milk the achievement until the next recession starts, so roughly seven to ten years.

> Most economists who predict an imminent recession have successfully predicted nine of the last two recessions.

No wonder then that more and more economists try to make more and more precise predictions as to when the US will enter recession and how bad it will be. Unfortunately, most of the people who enter this race have successfully predicted nine of the last two recessions, so their judgement often has more entertainment value than investment value.

In my ten rules for forecasting[1] I emphasise the need to rely on data and avoid extreme forecasts. Unfortunately, that won't make us famous, but hopefully it will make this report more useful for real life investors.

In this report we will introduce our proprietary recession probability models for the US, the UK and the Eurozone and look at the current likelihoods for a recession over the next one to two years. Based on these models, we can then address the likely impact a recession in the US and other regions might have on investments over the next one to two years. We will first address fixed income investments, with a special focus on high yield bonds, senior loans and CLOs, since these investments have been touted as being at extreme risk if business conditions worsen. In the second part, we will focus on equity markets and how they might be affected by rising recessionary risks.

Finally, we will address how central banks are likely to react should recessionary risks increase. Given the low interest rates in most Western regions, many central banks have little to no ammunition to fight a recession with monetary policy measures. The example of the Bank of Japan might be instructive as to whether unconventional policy measures could help.

[1] https://blogs.cfainstitute.org/investor/2019/03/04/10-rules-for-forecasting/

Building a recession model

We all know that some macroeconomic variables can "predict" a recession in advance. Monetary policy rates typically rise towards the end of an economic cycle and if the central bank tightens too much, then this can trigger a recession. We also know that bond yields anticipate a recession and the famous yield curve inversion is one of the most reliable indicators of future recessions. Other indicators, such as labour market data and credit conditions, have predictive power as well.

But none of these indicators is failsafe and the lead times vary from recession to recession. Thus, the best we can do as economists is to combine different indicators and get an overall picture of the economy. And even then, we can only make assessments, as to how likely a recession is, not when it is going to start or how bad it is going to be. Our recession model reflects these uncertainties.

In our recession model we create a probit model based on the development of the following indicators:

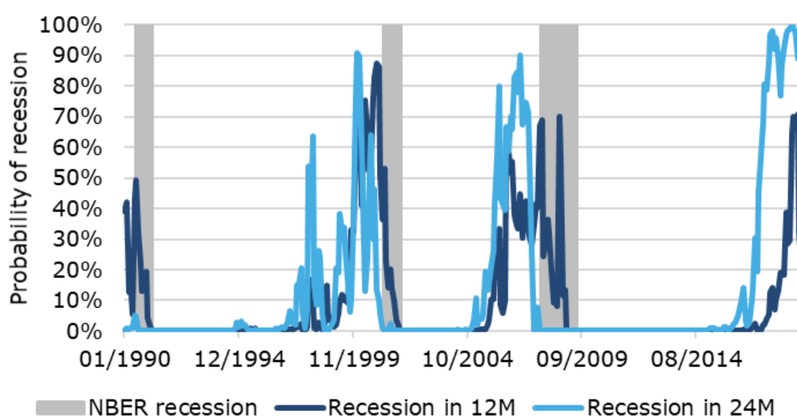
- the annual inflation rate,
- the monetary policy rate,
- the Bloomberg Financial Conditions Index,
- the steepness of the yield curve,
- the unemployment rate,
- the local manufacturing PMI, and
- the growth in fixed investments from the national accounts.

We define a recession as two subsequent quarters of negative growth except in the US, where we use the official recession dates as defined by the National Bureau of Economic Research (NBER). Based on past experiences, the probit model calculates the best combination of these variables to calculate the likelihood of a recession starting in the next twelve months and the next 24 months.

This model has the advantage that it tends to be rather reliable as a predictor of recession probabilities because it is restricted to what can reasonably be forecast without trying to do the impossible, like forecasting the exact onset of a recession or the depth of the contraction. However, there are clear limitations to the model as well. Because recessions are rare and we rely on indicators like the Bloomberg Financial Conditions Index that have a limited history, we can only fit the model for the last twenty to thirty years. This means that we have only two to three recessions to fit the model to.

As a result, the output of the model needs to be interpreted with caution. Even if the likelihood of a recession in the next twelve months is 100% according to the model, it could be that there will be no recession. Similarly, a recession could materialise even though the model predicts a likelihood of recession of 50% or so.

Fig 1: US recession model predictions



Source: Bloomberg, Fidante Partners.

> Our recession model should be taken seriously, but not literally.

Because models are subject to estimation errors the output of our recession model should be taken seriously, but not literally. As a rule of thumb, we should take values above 50% as a serious warning sign that a recession may start within the projected time window and values above 70% or so as a flashing red light that a recession is likely, but not certain.

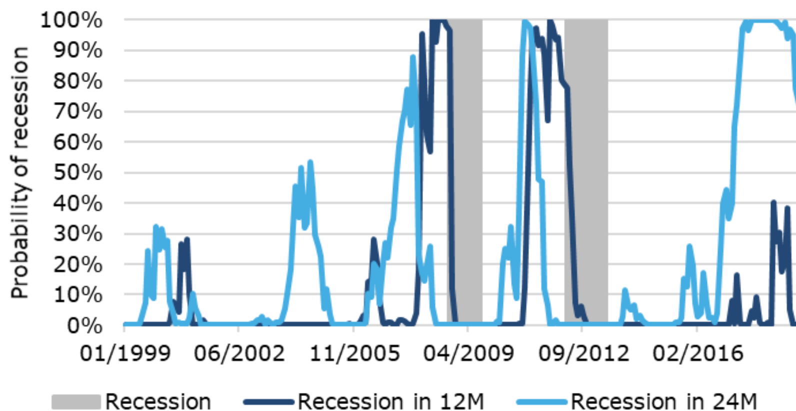
Keeping these limitations of our recession model in mind, we can look at the current model predictions for the US in Fig. 1. As the chart shows, the likelihood of a recession in the US in the next two years is extremely high and the warning lights are clearly flashing red there. However, for a long time it seemed as if this recession was still a long way away, with the likelihood of a recession in the next twelve months hovering between 10% and 20%. In September 2018, the likelihood started to rise above 50%, indicating that the slowdown we saw materialising in late 2018 might accelerate and put the US into recession in late 2019.

Until the end of the year this likelihood increased, but recent better than expected macroeconomic data has led to a decline once more. Today, the likelihood of a recession in the next twelve months hovers around 20%. To us, this indicates that the US is on track to entering a recession at some point in 2020. At this stage, a recession can still be delayed or avoided if monetary policy becomes more accommodating or fiscal policy creates renewed stimulus, but the track we are on clearly has a high likelihood of ending in a recession.

We did calculate a recession model for the UK, but given the political uncertainty around Brexit, the current predictions are meaningless since the economic environment can literally change overnight. Furthermore, the current predictions are boring, stating that there is almost no chance of a recession in the UK if the country stays on its current path (which it clearly won't since the current path includes membership in the EU).

Much more interesting are the predictions of our recession model for the Eurozone shown in Fig. 2. Similar to the US, the model forecast for the likelihood of a recession in the next 24 months is very high, but while the likelihood of a recession in the next twelve months has been hovering between 30% and 40% for most of the second half of 2018, it now has declined to almost zero as Germany and Italy seem to have left their recent downturns behind, for now.

Fig 2: Eurozone recession model predictions



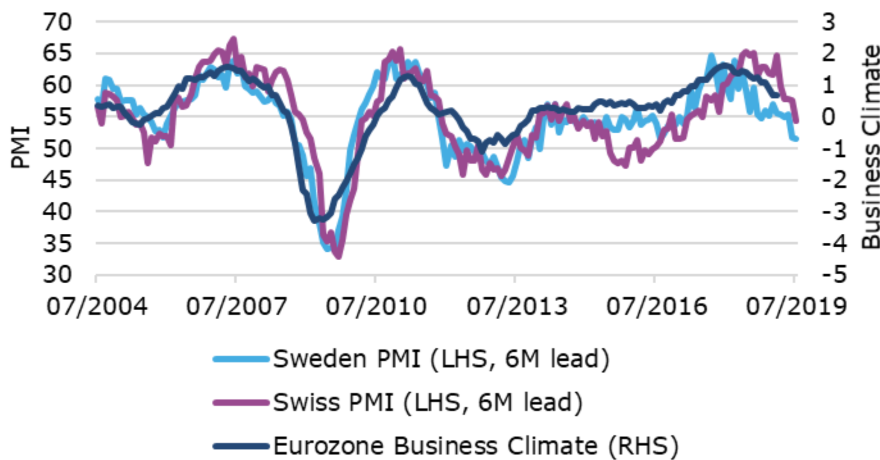
Source: Bloomberg, Fidante Partners.

Closer inspection of our recession model for the Eurozone reveals that the model forecast for the next twelve months is more dependent on the development of the PMI and inflation in the Eurozone, while the 24-month forecast is more dependent on the steepness of the yield curve and the unemployment rate. This means that if the PMI for the Eurozone declines, the likelihood of a recession in the next twelve months in our model rises. And this creates the possibility that the current projected likelihood for a recession in the Eurozone is too low.

Fig. 3 shows the Eurozone business climate together with the PMIs for Sweden and Switzerland. The PMIs for Sweden and Switzerland have a six-month lead on the developments in the Eurozone because both Sweden and Switzerland are small open economies that depend heavily on exports to the Eurozone. If demand in the Eurozone weakens, both Sweden and Switzerland are likely to be more affected by this than larger economies in the Eurozone, which tend to have more diversified economies. Fig. 3 clearly shows that the business climate in the Eurozone has been deteriorating for some time, but the trend should continue to point to lower readings in the next six months. This, in turn, would bring the Eurozone closer to recession later in 2019.

Overall, our assessment of the Eurozone is similar to the US. Economic growth is slowing down at a pace that could lead to a recession at some point in 2020. But while the level of growth in the Eurozone is lower than in the US, the growth slowdown in the US appears to be happening at a faster pace, so that in this race to the bottom, the US seems to be catching up with the Eurozone, for now.

Fig 3: Eurozone business climate trending down



Source: Bloomberg, Fidante Partners.

If a recession comes, what should I fear? – part 1

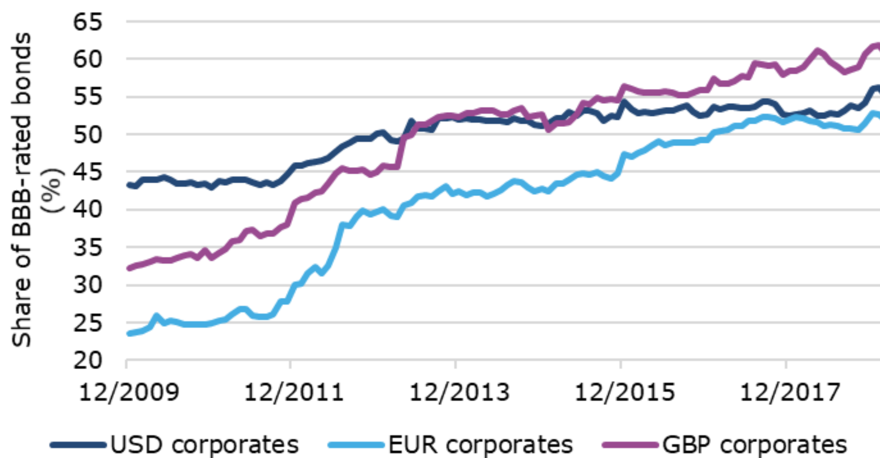
In the fixed income space there are currently two major threats that are mentioned time and again – the proliferation of BBB-rated investment grade bonds and the proliferation of cov-lite senior loans. Both of these developments have at times been identified as the potential trigger for the next financial crisis or potential weapons of mass financial destruction. As for the reliability of these claims, we would like to refer to our opening statements about economists trying to predict the next recession.

But as Fig. 4 shows, there is a point to be made about the increase in BBB-rated bonds within the investment grade universe. For all three major currencies, more than half the bonds in the investment grade universe have a rating of BBB, meaning that if business conditions worsen, these bonds could quickly be downgraded to junk bond status. What makes this situation so dangerous is that many institutional investors will be forced to sell these fallen angels as soon as they are downgraded from investment grade to high yield because of their limitations on what bonds they can invest in.

This typically creates dislocations that can be exploited by other investors. For example, it is beneficial for investors to sell BBB-rated bonds as soon as one of the major rating agencies downgrades the issuer to BB. This is, because most institutional investors require a majority of several rating agencies to downgrade a bond before they have to sell it. While these rules are well-intentioned to protect against individual downgrades by a single rating agency it typically creates a threshold effect whereby credit spreads for a bond widen only mildly after the first downgrade and then explode once a second rating agency follows suit. To avoid this sudden spread widening it pays to "front-run" other bond investors and sell bonds after the first downgrade out of the investment grade universe.

On the other hand, it pays to invest in fallen angels that have been downgraded from investment grade to junk bond status shortly after their downgrade. The technical selling pressure in fallen angels immediately after their downgrade leads to excessive spread widening and it often takes several weeks for spreads to normalise. Providing liquidity to forced sellers and buying fallen angels right after a downgrade can lead to excess profits.

Fig 4: Share of BBB-rated bonds



Source: Bloomberg, Fidante Partners.

However, index investors or investors who hold a broadly diversified portfolio of investment grade bonds should not fear too much since it is unlikely that a large amount of BBB-rated bonds will be downgraded at the same time. Thus, while the downgrades create a significant drag on the performance of the overall portfolio, the drawdowns are unlikely to be large on a portfolio level. Obviously, the situation is different for

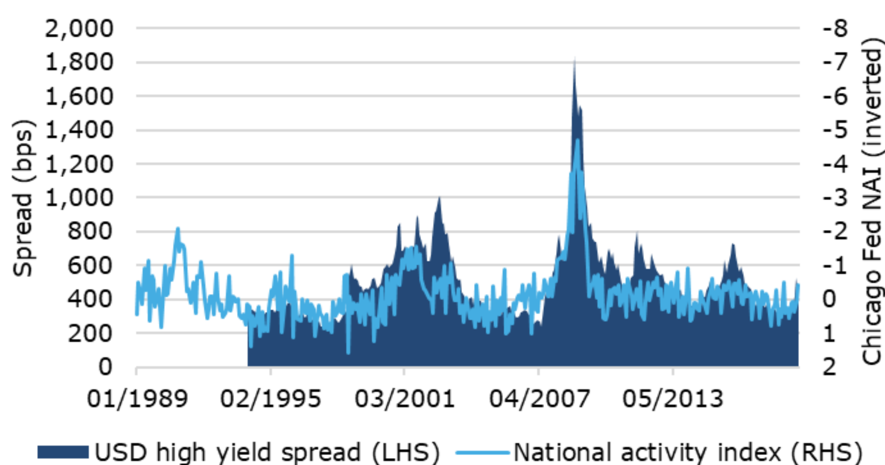
investors with a more concentrated portfolio of bonds where a single downgrade can cause significant losses on the overall portfolio. The key to success in dealing with this risk is both portfolio diversification and position sizing. Investments should be spread across many different issuers but also limited per issuer and per sector, in order not to bet the house on a specific sector or issuer.

While it is possible, in our view, to limit losses in investment grade bonds once the next recession in the US or the Eurozone strikes, it will be much more difficult to avoid significant losses in the high yield bond and the senior loans spaces. As business conditions deteriorate, highly leveraged companies will be the first to feel the squeeze on their ability to repay existing loans and bonds and their refinancing costs will rise quickly and significantly. Fig. 5 shows the spread on USD high yield bonds over Treasuries since 1989 together with the Chicago Fed National Activity Index (NAI). The NAI provides a convenient way to estimate spread developments in USD high yield bonds as economic conditions change. As Fig. 5 shows, high yield spreads and the NAI move almost perfectly in opposite direction.

As we can see from Fig. 5, during a recession, high yield spreads should widen from the current level of 400bps to the range of 600bps to 800bps, creating substantial losses. However, as we have mentioned above, many investors are increasingly concerned about the proliferation of cov-lite loans in the leverage loan sector. As we have stated before, cov-lite loans clearly have lower credit protection than traditional bank loans and thus the loss given default of these loans may be significantly higher than experienced in the past. But as we have also stated before, cov-lite loans converged towards the covenant structure of traditional high yield bonds. So, it pays to investigate historical episodes of high yield bond crashes to assess how big the fallout from the next recession might be.

Luckily, we have seen something like this happen before, though it was 30 years ago, and few investors today have first-hand experience with this episode. I am speaking, of course, of the 1990 junk bond crisis. The runup to the crisis was somewhat similar to the last decade insofar as investors were searching for yield in bond markets as Treasury yields declined below levels that were considered "adequate" for investor portfolios. In the 1980s, this search for yield was triggered by Treasury yields declining below the psychologically important level of 10% after Fed chair Paul Volcker successfully tamed inflation. Investors, who were relying on yields above 10% in their bond portfolios, took on increasing credit risk to compensate for the decline in government bond yields.

Fig 5: High yield spreads and Chicago Fed National Activity Index

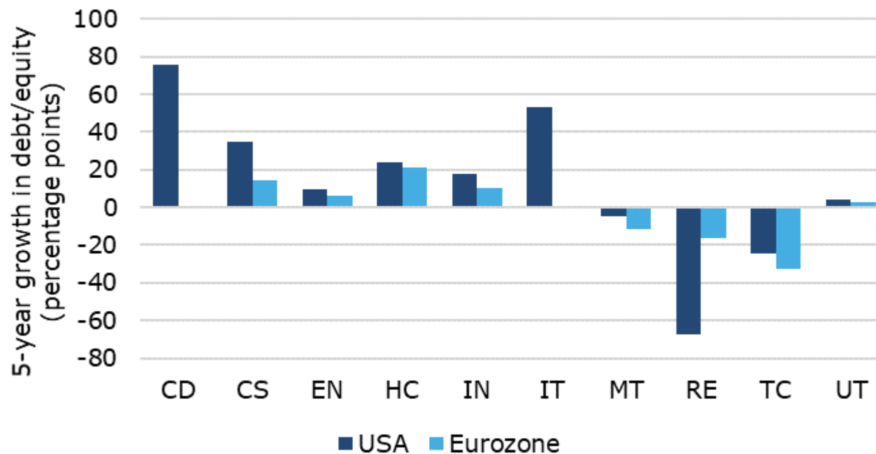


Source: Bloomberg, Fidante Partners.

Along came a group of financiers, like Michael Milken of Drexel Burnham Lambert, who popularised high yield bonds as an investment for yield-starved investors, arguing that as long as you hold a broadly diversified portfolio of these bonds, you'd be fine when individual bonds failed. Together with banking deregulation and the boom in leveraged buyouts, this created a ballooning market for high yield bonds. Of course, the boom times of the 1980s had to end at some point and when the recession of 1990 showed up, a great number of these high yield bonds defaulted. Overall, high yield spreads widened dramatically and while we do not have access to index data from that time, we can infer from Fig. 5 that high yield spreads may have increased to c. 800 bps in early 1990.

If all that sounds familiar to investors today, it's because it is essentially the same mechanism that has been operating since the GFC. As Treasury yields have declined to levels close to zero and in the Eurozone even to levels below zero, investors have been taking on more and more credit risk to generate sufficient income. The result has been a proliferation of high yield bonds and senior loans. Corporate borrowers have been all too willing to create supply. Taking advantage of the low interest rate environment, companies in the consumer discretionary and IT sectors in the US, and in the health care and industrials sector globally have increased their financial leverage substantially over the last five years (Fig. 6).

Fig 6: Change in financial leverage



Source: Bloomberg, Fidante Partners. CD= Consumer Discretionary, CS = Consumer Staples, EN = Energy, HC = Healthcare, IN = Industrials, IT = IT, MT = Materials, RE = Real Estate, TC = Communication Services, UT = Utilities.

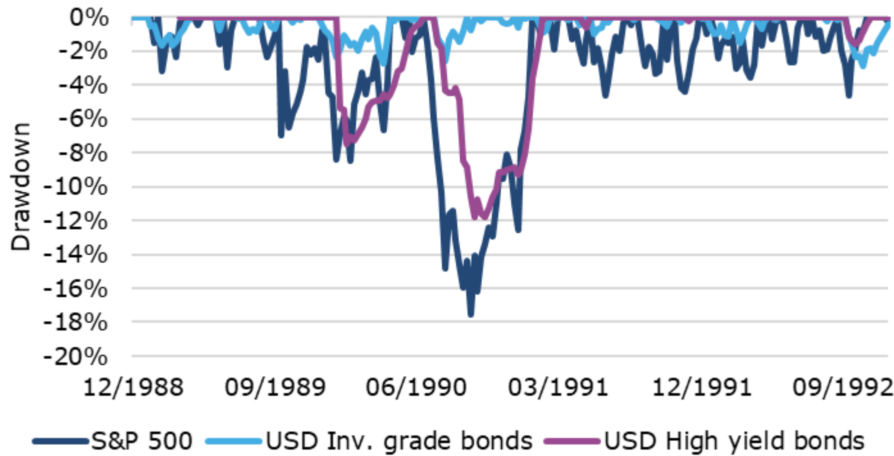
However, what often gets forgotten about the junk bond crisis is the comparison of junk bond performance to equities and other risky assets. This is what is done in Fig. 7, where we show the drawdown from the most recent market top at the time for US equities, US investment grade bonds and US high yield bonds around the time of the junk bond crisis and the subsequent recession of 1990. Several observations stand out in this chart:

- The initial shock of the junk bond crisis in February 1990 hit both high yield bonds and equities in equal measure, creating substantial but not devastating losses of up to 8%.
- Both stocks and high yield bonds managed to recover from these losses within four months, but when the recession of 1990 hit, bigger losses in the range of 10% to 18% followed.
- Equity markets lost more than high yield bonds because as bonds of highly leveraged companies got downgraded to junk status and junk bond yields rose, many leveraged companies were unable to refinance existing debt. As a result, they had to quickly shrink their balance sheets, creating a balance sheet recession that hit

earnings and created big losses for shareholders.

- Losses in investment grade bonds were limited even though many BBB-rated bonds got downgraded to junk bond status. These downgrades caused limited losses but a constant barrage of small drawdowns over an extended time period.

Fig 7: Drawdowns during the junk bond crisis



Source: Bloomberg, Fidante Partners. Past performance is not a reliable indicator of future outcomes.

The lessons we can draw from history can prepare us for the coming recession – whenever that may be. First, investors in high yield bonds, senior loans and CLO equity tranches should be prepared to experience losses that are similar in magnitude to equity markets. That is the normal risk of high yield investing and has been the case during every recession in history. Investors who think these risks are too high should ask themselves whether they would be willing to hold on to equities during the recession. If the answer is "yes" in the case of equities and "no" in the case of high yield bonds, senior loans and CLO equity tranches, then we would speculate that there is some element of irrationality involved.

Second, it is unlikely, that a crisis in high yield bonds or CLOs is going to create another financial crisis. The share of high yield bonds in global investment markets (all equities, bonds and alternative investments combined) is 1.7% at the moment according to our calculations. This is down from 2.5% in 1997, the earliest data we have available, and about the same as in the years before the GFC. The size of the senior loans market is about the same as the high yield bond market. If global financial markets have withstood a massive increase in defaults in highly leveraged borrowers then, why would they collapse this time around? During the next recession, losses in high yield bonds, senior loans and the equity tranches of CLOs are likely going to be substantial, but also manageable. Investors who are prepared for these kinds of drawdowns should be able to weather the coming storm relatively well in our view.

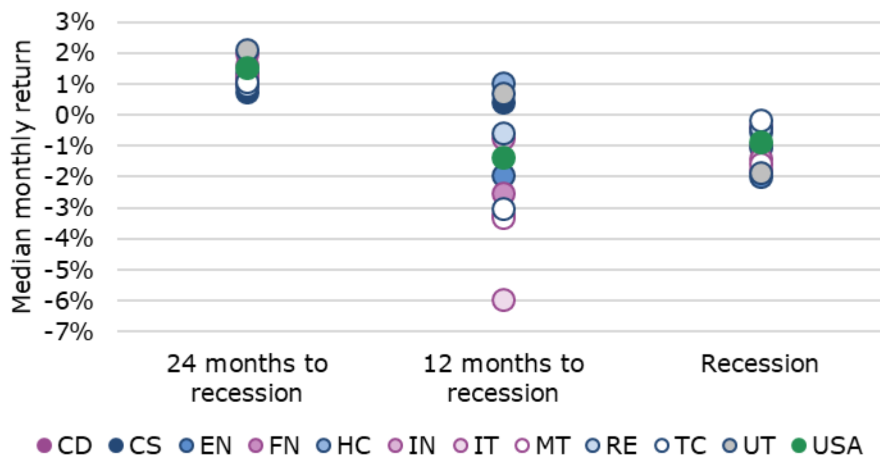
If a recession comes, what should I fear? – part 2

Fig. 7 gave us an indication of which asset class would likely be hit the hardest in the runup to the next recession: equities. As earnings growth expectations drop, valuations for equities decline and markets suffer steep losses in the six to twelve months before the onset of a recession. The companies that suffer the most tend to be cyclical companies that experience bigger swings in earnings and of course companies that have increased their financial leverage the most and have to shrink their balance sheet quickly. Fig. 8 shows the average performance of different sectors in the US stock market in the runup to a recession. We show here the results for US stocks, but the chart looks almost the same for Eurozone and UK equities with the exception that returns during the recession for UK and Eurozone stocks tend to be higher than in the last twelve months before a recession, while in the US returns during the recession are lower.

The time windows we look at in Fig. 8 are the period when the likelihood of a recession in 24 months is above 50% according to our recession model, the period when the likelihood of a recession in twelve months is above 50% and the actual recession period. If the recession is very far away, the dispersion between different equity sectors is very low and equities essentially move in lockstep with an average monthly return of 1.5% (18% annualised). During the recession, the dispersion is again low with all sectors showing negative returns ranging from -0.1% per month (-1.2% annualised) for communication services to -2.0% per month (-24.0% annualised) for energy.

However, in the runup to a recession, when the likelihood of a recession in the next twelve months is above 50% (i.e. the phase we are in at the moment), dispersion between equity sectors increases significantly and cyclical sectors significantly underperform defensive sectors. The performance for cyclical sectors ranges from -0.7% per month for industrials to -6.0% for IT. On the defensive side, however, returns range from +1.0% for health care to -3.0% for communication services and defensive sectors outperform cyclical sectors by 2.5% per month on average. Of course, past performance is not a reliable indicator of future results, but our preference for defensive stocks that we have outlined in our Outlook 2019 is warranted given the current increase in recession threats in both the US and the Eurozone.

Fig 8: US stock market dispersion in the runup to a recession



Source: Bloomberg, Fidante Partners. CD= Consumer Discretionary, CS = Consumer Staples, EN = Energy, FN = Financials, HC = Healthcare, IN = Industrials, IT = IT, MT = Materials, RE = Real Estate, TC = Communication Services, UT = Utilities, USA = US average. Cyclical sectors are marked in blue colours, defensive sectors in purple and the market overall in green. Past performance is not a reliable indicator of future outcomes.

Central banks to the rescue?

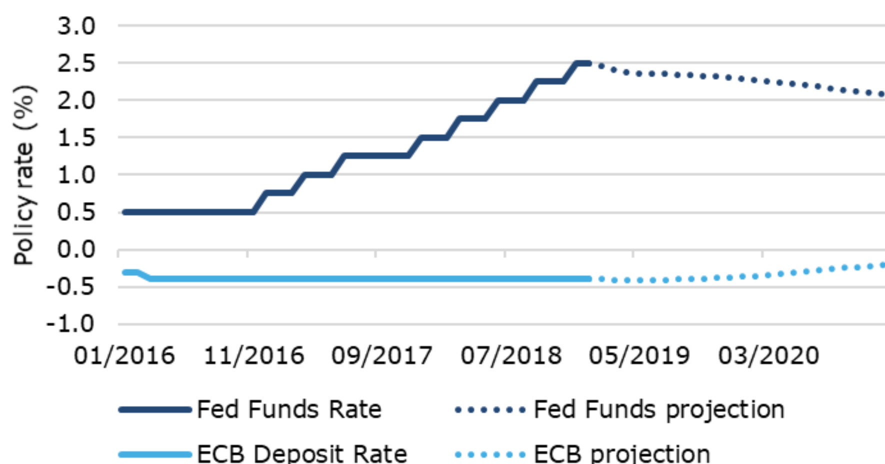
The big challenge the economy and investors will face when the next recession arrives is that central banks have little to no ammunition to stimulate the economy. While the Fed has weaned markets off its bond purchases and raised interest rates to some extent, the ECB has only now decided to stop buying additional bonds. A recession in the next twelve to 24 months could seriously undermine their mandate to keep inflation in check and avoid deflation. The Fed can at least lower interest rates to some extent and re-engage in quantitative easing to support the economy, but what is the ECB going to do?

Fig. 9 shows the current market expectations for central bank policy rates in the US and the Eurozone. Markets now expect the Fed to cut interest rates to 2.25% by the end of 2019 and 2.0% by the end of 2020. We have always been more hawkish given the strong growth of the US economy so far, but should the slowdown in the US economy materialise fast enough for a recession to start maybe even in the first half of 2020, then the Fed would likely be forced to cut more aggressively than is currently priced in. However, the Fed remains in a difficult spot where wage inflation is rising, creating additional inflationary pressures, while economic growth seems to be cooling off.

In the immediate future, until summer, we think the Fed will likely focus more on current inflationary pressures and the potential for solid growth ahead (especially given the relatively strong growth in the fourth quarter 2018 that was released recently). Thus, a rate cut in the first half of 2019 seems unlikely at the moment. Instead, the risks may still be skewed to the upside as long as economic data remains solid. But once the economy cools off more as the year 2019 progresses, we think a more and more dovish stance, that may lead to a rate cut in the second half of 2019, is possible. However, this rate cut, in our view, requires growth in the US economy to slow down relatively quickly in the next six to nine months.

In the Eurozone, the ECB is literally out of ammunition to fight a recession. Policy rates can hardly go much lower because there comes a point when negative interest rates become so punitive to banks that they have to pass them on to depositors. And once these depositors are facing significant negative interest rates on their accounts, the risk of a run on banks to withdraw deposits and invest them in foreign currency deposits or other risky assets becomes substantial. And if depositors queue to withdraw their assets, we know how quickly banks start to run out of money and into default.

Fig 9: Monetary policy rate expectations



Source: Bloomberg, Fidante Partners.

In the case of a recession in the Eurozone the ECB may be tempted to emulate the Bank of Japan (BOJ), which had to stimulate the economy time and again despite interest rates close to or at zero. The BOJ has thus become the world's guinea pig in experimental monetary policy. The latest innovation was the decision by the BOJ to use central bank funds to purchase ETFs of Japanese equities. The idea was that by investing in Japanese stocks, companies would issue more equity and use the proceeds to increase capital investments.

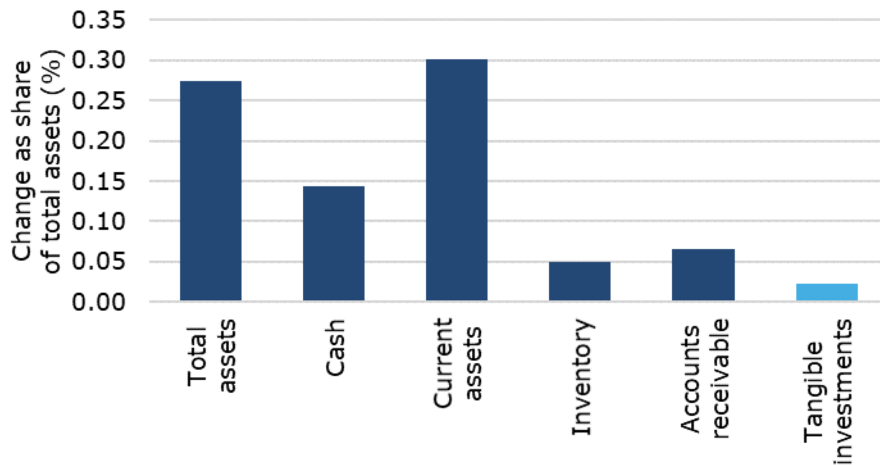
> "The Bank of Japan has become the world's guinea pig in experimental monetary policy."

By now we have sufficient experience with this new form of monetary stimulus to assess the efficacy of these equity purchases. The good news first. A study by Charoenwong and his colleagues showed that the purchases of the BOJ had a positive effect on the share price of the stocks they purchased.[2] On the day the purchases were made, the share price of the companies the BOJ bought rose. Share prices continued to rise significantly in the weeks after the initial purchase, possibly because the BOJ followed up with additional investments.

In reaction to these rising share prices, companies did indeed issue additional shares or stopped share buybacks and increased their cash holdings on their balance sheet.

The bad news coming from the study is that cash is largely where these additional funds stayed. Almost all the increase in total assets on the balance sheets in the quarter the BOJ made the investments in companies stayed in cash and other current assets. Inventories and tangible investments barely rose. The same was true in the year after the BOJ investments were made. Thus, the hoped-for stimulus for the real economy never materialised and the BOJ policy essentially managed to prop up stock markets without any effect on the real economy.

Fig 10: Impact of BOJ buying 1% of assets in a company on corporate fundamentals



Source: Charoenwong et al. (2019), Fidante Partners. Past performance is not a reliable indicator of future outcomes.

[2] Charoenwong, B., R. Morck, and Y. Wiwattanakantang (2019). "Asset Prices and Corporate Responses to Bank of Japan Purchases" NBER Working Paper 25525.

Conclusions

We have modelled the recession risks for the US and the Eurozone with our proprietary recession model based on macroeconomic factors. For both the US and the Eurozone a recession in the next 24 months seem likely. A recession in the next twelve months is somewhat more doubtful and the model indicates to us that a recession might start in 2020 in both regions.

Given this scenario, we assess the risks for stocks and bonds. We find that investor fears about the high ratio of BBB-rated bonds in the investment grade bond universe are likely to be overblown and can probably be managed well with a combination of good diversification, limits on position sizes and some active management techniques that exploit market dislocations around ratings downgrades.

In the high yield and senior loan space, we expect higher losses commensurate with the higher risk of these investments. However, the experience of the junk bond crisis of 1990 shows us that the losses will likely be limited and lower than in equity markets. Furthermore, fears about senior loans and CLO investments triggering the next financial crisis seem excessive to us.

The biggest risk remains in equity investments, in our view, where a combination of a deteriorating earnings outlook together with the need to quickly deleverage balance sheets can create substantial drawdowns. Fig. 11 summarises the risks and opportunities in different asset classes in the case of a recession in 2020.

Finally, we conclude that the reaction of central banks to a recession might be less effective than in the past. While the Federal Reserve in the US has room to cut interest rates and re-engage in quantitative easing, the ECB is literally out of ammunition should the next recession start in 2020. Unfortunately, measures that the Bank of Japan has taken to stimulate the economy through stock market purchases have proven ineffective so far and provide only limited benefits for the ECB.

Fig 11: Investment outlook for a recession in 2020

Asset class	Suitability	Opportunities	Threats
Cash	Medium	Safe haven in times of crisis and recession.	Still extremely low yields outside the US Dollar space.
Floating-rate notes	Medium	Higher returns than cash and money market investments and solid returns while credit spreads remain stable.	Risk of significant setbacks as credit spreads widen, but losses should be manageable and lower than equities.
Bonds	High	Government bonds are traditional safe haven assets that benefit from rate cuts.	Given little room for central banks to cut rates the upside in a recession might be limited.
Inflation-linked bonds	Medium	Benefit from falling real rates in a recession.	Declining inflation expectations in a recession limit upside compared to nominal government bonds.
Equity	Low	Defensive stocks can provide some protection from excessive losses.	Risks of significant losses in the runup to a recession.
Property	High	Compared to equities, losses should be smaller since rental income is more stable than corporate earnings.	Commercial property values inevitably drop in a recession and lead to declining NAVs.
Infrastructure	High	Compared to equities, losses should be smaller since cash flows are often guaranteed or more stable than corporate earnings.	Values inevitably drop in a recession and lead to declining NAVs.

Source: Fidante Partners.

What if? – Risks to our outlook

What if we do not get a recession in the US?

This is obviously the major risk of our recession model predictions and given the limited history we have on which to evaluate the model, this risk is non-negligible.

If the US manages to avoid a recession while the Eurozone does not, we should expect continued outperformance of US stocks vs. European stocks. In particular, we should expect cyclical stocks in the US to do well and outperform defensive stocks, as they have done in the first two months of 2019. In this case we would be very cautious about the prospects for European equities and would expect another major decline in share prices.

Meanwhile, US senior loans and high yield bonds should perform well in this scenario and the Fed may hike interest rates one more time in 2019. In this case, we would expect senior loans and high yield bonds to outperform government bonds and TIPS.

Can the Eurozone avoid a recession if the US drops into one?

If the US cannot avoid a recession, we think it is very unlikely that the Eurozone will be able to either. Eurozone growth is already low and the weakening economy in China is creating a lot of drag on European exports. If the US were to fall into recession, the foreign demand for European exports would likely fall so much that the German and Italian economies would fall into recession and with some delay, also the rest of the Eurozone.

What about China slowing down even more?

We have discussed the prospects for the Chinese economy in our recent Long View report.[3] There we show that a slowing economy in China is likely to trigger a recession in Europe but not in the US. However, a sharper slowdown or a crisis in China would most likely create a major global recession and potentially another financial crisis.

[3] The Long View: China is too big to fail. 7 February 2019, available here: https://www.fidante.com/resources/the-long-view-q1-2019

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