Outlook for the Global Economy, Oil Prices, Macro Policies and Markets: Investors Severely Underpricing The Risks of a US-Iran Escalation and Conflict

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Scenarios for the Global Economy for 2020

1. Return to expansion (3.4% growth globally)
2. Continuation of current slowdown (3.0%)
3. Further slowdown and near stall, ie growth recession (2.7%)
4. Global Recession (growth < 2.5%)

Continued slowdown was most likely scenario even before the build-up of US-Iran tensions

- Macro data are still soft for US, EU, Japan, China and many EM
- US-China Cold War and decoupling continuing even with the Phase One deal
- Brexit can be bumpy even after the UK elections. Risk of cliff at end of 2020
- Problems of Europe and Eurozone go well beyond Brexit
- US politics will be highly dis-functional in 2020 (impeachment, Democrats's possible nomination of a progressive, risk of a "rigged election", dirty electoral campaign)
- Excesses of the late cycle in the US (high corporate debt and loose lending standards; slowdown of growth; rise in wages above inflation squeezing profit margins)
- US equities frothy if not bubbly (Shiller CAPE, slowdown in EPS growth, P/E expansion rather that EPS leading to higher valuations; thus strong risk of a correction)
- Many EM are quite fragile and/or politically unstable

Scenarios for the US-Iran Conflict

1. Return to status quo after short term tensions (5% prob)
2. Escalation of tensions short of direct military exchange (45% prob)
3. Direct military exchange short of a full scale war (30% prob)
4. Full scale war (20% prob)

From escalation to direct conflict & full war

- Markets expect that a full-scale war (scenario #4) is unlikely as both Iran and US want to avoid it
- But they they assume – by current asset pricing - that scenario #1 of a status quo is most likely
- But between #1 and #4 other scenarios – escalation (#2) or a direct conflict short of a full-scale war (#3) - are highly likely. And those scenarios lead to serious economic and financial damage.
- And it is a slippery slope as what starts as #2 can easily escalate into #3 and once you are in #3, scenario #4 becomes more likely
- Also Iran cares about avoiding regime change (driven by an internal revolution). So anything that leads to escalation (#2 or #3 or even #4) makes the regime stronger as the populus/mobs will rally to the side of the regime once there is an escalation.
- Even in #4 the Iranian regime survives (as in #4 there will not be an invasion of Iran via boots in the ground by US forces and mass destruction of military and civilian infrastructures would lead Iranian masses to support in mass the regime). While in #4 Trump loses the election (US regime change) as oil prices spice to $150 a barrel and a recession and market crash takes place

Implication for oil prices

1. Oil below \$70
2. Oil between \$70 and \$80
3. Oil between \$80 and \$100
4. Oil well above \$100 and possibly as high as \$150

Flawed market view: oil shocks are unlikely as world is very different from 1970s

The flawed view that oil shock are less likely and severe today vs the 1970s is based on the following arguments:

- Energy input in consumption and production has sharply fallen since 1970s
- US is now energy self-sufficient given shale gas and oil revolution
- Inflation and inflation expectations are much lower and central banks will thus not hike following a stagflationary oil shock
- Marginal propensity to spend of oil exporters is today not much lower than the one of oil importers

Why oil shocks likely and matter even today

- Even with lower energy use large oil shocks reduce aggregate demand and are negative supply shocks
- Distributional effects within US btw energy producers and energy users (households and energy using sectors)
- A spike in oil prices in Middle East (Brent) affects US prices too (WTI)
- Key economies are net oil importers (Europe, Japan and major EM such as China, India, Korea, Turkey, South Africa)
- Central banks will not hike rates but their space to cut or ease more is now limited
- Energy exporters will initially save most of a windfall

Impact of oil shocks in a basic demand/supply model is still large

- JPM estimates that shutting down the Strait of Hormuz for 6 months spikes oil prices by 126% (to $150 a barrel). Even a one month shutting down of the Strait leads to a rise in oil prices of $15
- That model doesn’t include likely precautionary stockpiling and the rise in the fear premium
- Model doesn’t include other impacts: risk-off and equity market correction; option value of waiting and fall in capex plus fall in biz confidence; fall in consumer confidence and precautionary households savings

Implications for macro policies of various scenarios

1. Fed, ECB, BoJ and other major CBS on hold; current set of fiscal policies
2. Fed cuts rates 25-50bps to 1%; ECB goes to -0.60% and BoJ to -0.20%; slightly higher fiscal stimulus in EZ and Japan but none in US given gridlock in election year
3. Fed cuts rates below 1%; ECB goes to -0.70% and does enhanced forward guidances and greater QE on private and public assets; BoJ goes to -0.30% and buys more ETFs and other public and private assets. Greater fiscal stimulus in EZ, UK, Japan and minor G10; some fiscal stimulus in US
4. Fed goes to 0%, forward guidance and QE; other G10 go to variants of monetization of fiscal deficits. Large fiscal stimulus in all G10, more so in countries with greater fiscal space

Implications for asset markets

1. Modest risk-on and reflation. US and global equities have single digit returns. Long rates in US, Germany and Japan go modestly higher (by 20 bps or so). Credit spreads remain low for HY and HG. Dollar and safe haven currencies weaken modestly
2. Modest risk-off with 10% US and global equities correction. Long rates retest the lows of 2019. Credit spreads modestly widen. Safe haven currency modestly appreciate. Gold 5% higher.
3. Correction turns into a bear market (20% down on global equities). Long rates go below 2019 lows. Credit spreads widen sharply for HY. Safe haven currencies appreciate by more than 5%. Gold 10% higher.
4. 30-40% plus fall in US and global equities. US long rates below 1%. Bund yield and Japanese bond yields more negative than 2019 lows but spread widening for Italy and other risky DM bond markets. Sharp widening in HY and HG and EM spreads. Gold prices increase by more than 10%. Safe Haven currencies sharply higher, especially US $, Yen and Swiss Franc.