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Global Outlook: Coping with the politics of anger

Political risks: tide of populist anger across the Western world

- **US:** fiscal boost versus rising protectionist pressure; can Congress tame Trump?
- **UK:** go-slow Brexit; Theresa May's Brexit illusions; Labour in disarray
- **Eurozone:** referendum risk in Italy; reform hope in France; Germany stable

Economic outlook: trend growth in developed world

- **US:** consumer spending to remain firm, modest fiscal boost to come
- **UK:** Brexit hurts with a lag – less investment now, slower trend growth thereafter
- **Eurozone:** fiscal and monetary policy support demand as oil tailwind fades
- **China:** trend slowdown; risks still contained but rising long-term

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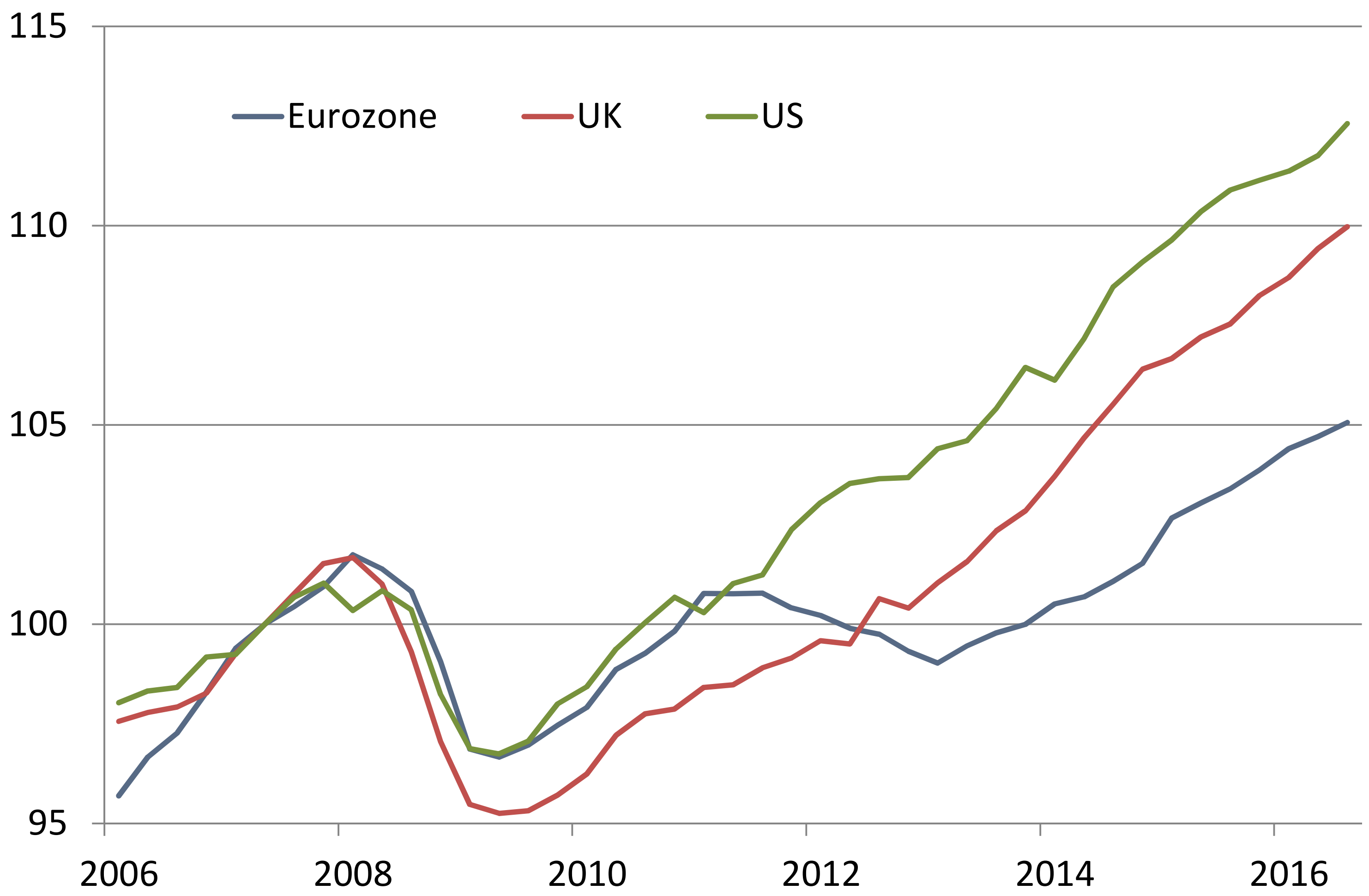
Economics

The big picture: US, Eurozone, UK - mind the gap

GDP: US and UK far ahead of the Eurozone since 2011

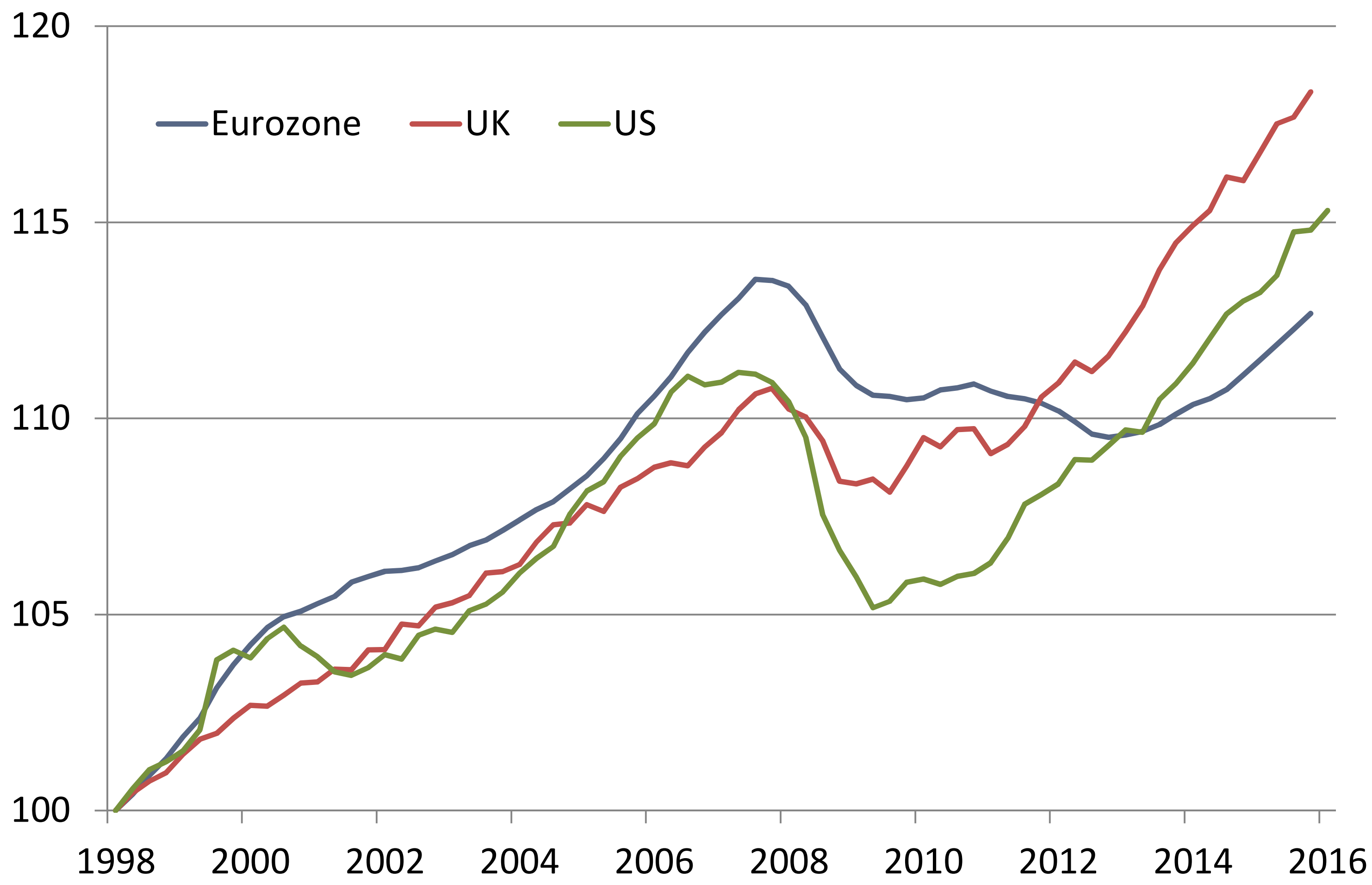


Index, 2007=100. The bounce in Eurozone real GDP in early 2015 reflects the statistical impact of asset shifts of major multinational corporations in Ireland and not a change in underlying growth dynamics. Source: Eurostat, ONS, BEA.

- Aggressive monetary policy has supported a moderate upswing in the US and the UK since spring 2009.
- The Eurozone fell back when the ECB allowed contagion to spread from Greece to the Eurozone as a whole in mid-2011.
- The Eurozone turned up shortly after Draghi‘s ‚whatever it takes‘ speech in July 2012.
- The region has enjoyed roughly trend growth of 1.5% since mid-2014.

Labour market: Eurozone versus US and UK

Increase in employment since the start of the euro



Level of employment, 1Q 1999=100; labour force survey data.
Source: Eurostat, ONS, BLS.

- Until 2008, the Eurozone created more jobs than the US and the UK.
- After a sharp post-Lehman correction, the US labour market has recovered.
- The Eurozone adjusts more slowly. Under the pressure of the euro crisis, employment fell until spring 2013 before a modest rebound set in.
- Why is US unemployment at 4.9% so far below the 10.1% Eurozone rate?
- The participation rate has fallen in the US from 76.3% in 2000 to 73.7% in 2014 while rising from 65.9% to 71.7% in the Eurozone and from 74.6% to 78.4% in UK.
- In the UK, wages rather than employment took the post-Lehman hit. The UK also reduced incentives for early retirement.

Fiscal policy: Eurozone prudence

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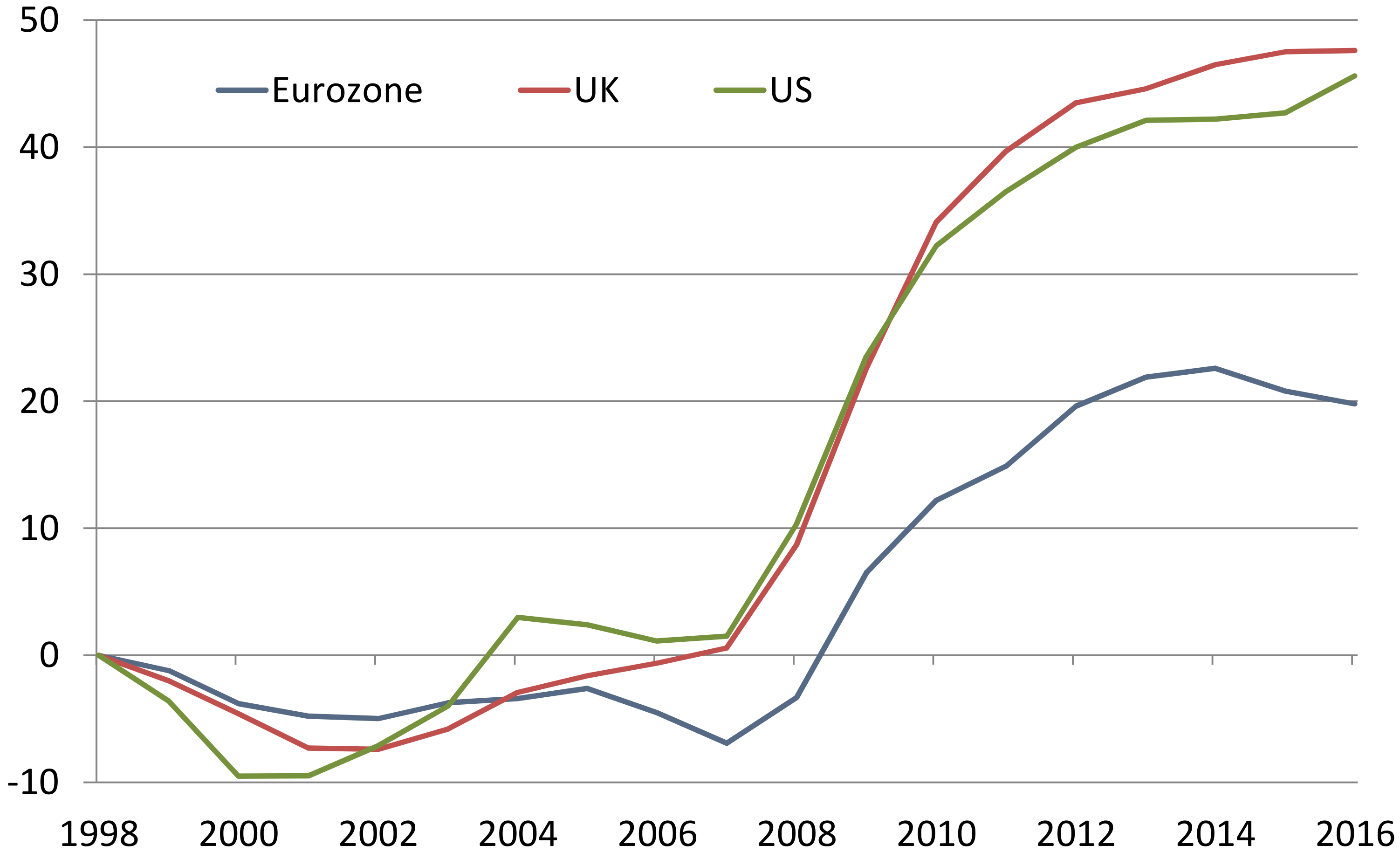
Change in public debt ratio since start of euro, in % of GDP



Increase in the ratio of gross government debt to GDP since the start of the euro, in percentage points of GDP. End-2016 ratios: Eurozone 91.6%, UK 89.2%, US 108.1%, Japan 250.7%. Source: Eurostat, EU Commission projections for 2016.

- After Lehman, the debt ratio surged much less in the Eurozone than in the US and the UK. Japan would be off the charts.
- Until 1998, the UK had been more prudent than the future Eurozone. Since then, it's the other way round.
- Less aggressive monetary policy and faster fiscal repair explain why Eurozone demand growth has lagged behind the US and UK since 2011.
- But policy is now different. In early 2015, the Eurozone returned to its 1.6% trend rate of growth.
- Brexit adds to the UK's fiscal problems – the impact is not in the chart yet.

Economic outlook: more of the same – or back to boom-bust?

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Not too hot, not too cold – learning to love mediocre

The legacy of post-Lehman mega-recession: caution reigns. Less investment, less credit and less wage growth than usual. No exuberance = long upswing in the Western world, Eurozone some two years behind US and UK.

US economy: fiscal boost ahead – expect three Fed rate hikes in 2017 and two in 2018

- Households, companies and banks have repaired their balance sheets. Cheap oil and ongoing employment gains have turned US households into global consumers of last resort. Trump stimulus will add to that.
- Trumpenomics: significant fiscal boost in late 2017 and in 2018; Fed to raise rates less cautiously.

Eurozone: return to trend growth of 1.5% in 2017 after minor setback in mid-2016

- **Easing up.** Austerity is over, ECB has turned more aggressive. Eurozone can stay close to 1.5% growth.
- **Strong tailwind** from cheap oil euro is fading: But the headwinds from export drop to emerging market and subsequent inventory correction are also over fading. Balanced growth
- Reform countries in the lead, France lagging, Italy held back by political risks, Germany enjoys golden decade.

UK: Brexit slows recovery, BoE and weak GBP cushion short-term blow, trend growth down from 2.1% to 1.8%

China: bumpy rebalancing. Trend growth slowing but demand stays close to trend. No inflation, 40% savings rate, $3.2 trn fx reserves = China can use still prevent hard landing. But debt and long-term risks are rising.

Emerging markets: The worst is over; oil is stable, emerging markets are adjusting. Most markets are better prepared for Fed hikes now than they were a year ago. But mind the risks in Russia and Turkey.

US labour market: creating jobs at a sufficient pace

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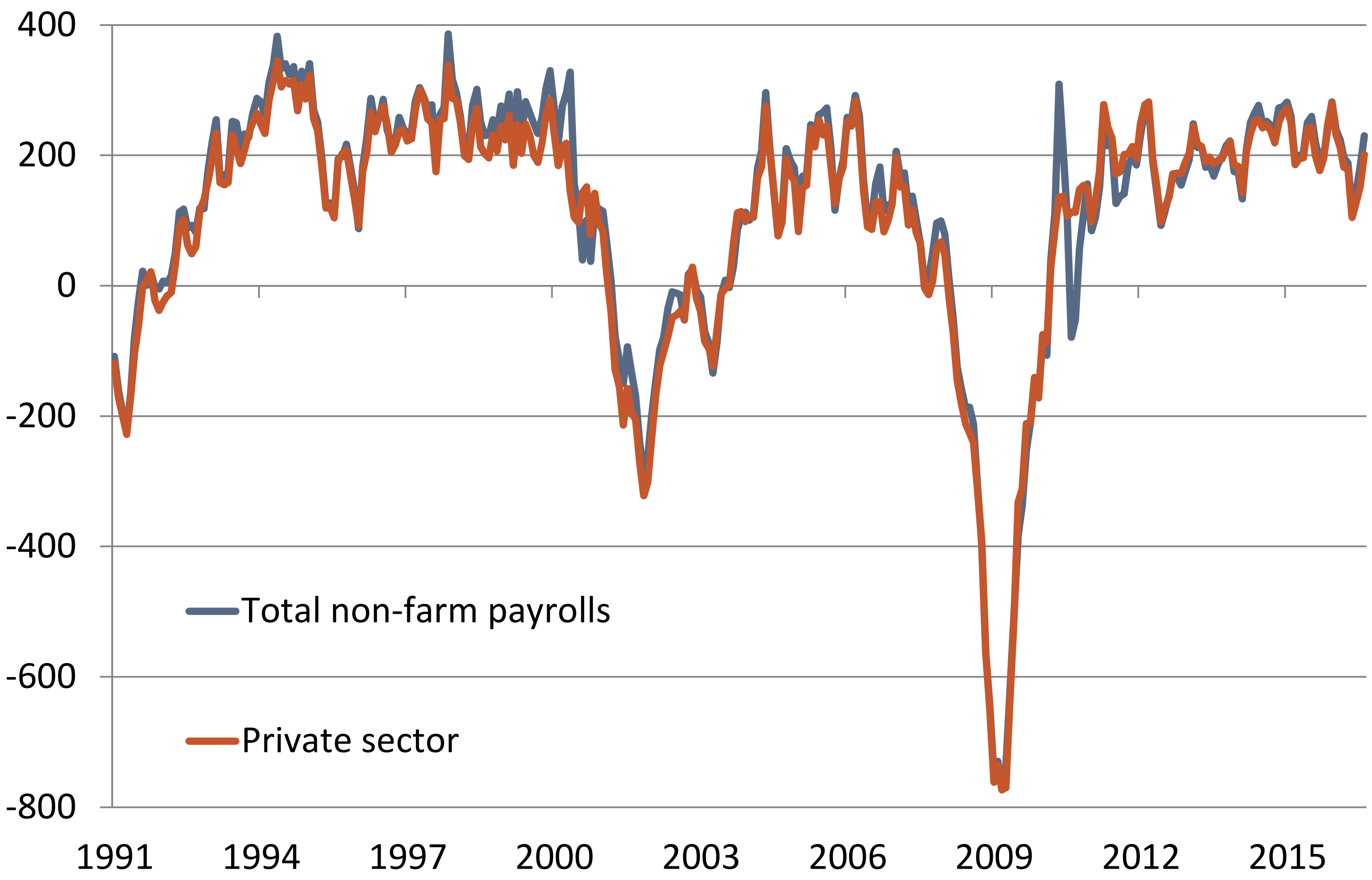
Monthly change in payrolls



Monthly change in payrolls, in 1000s, 3-month rolling average.
Source: BLS.

- Steady progress since 2011 with short-term fluctuations.
- Employment gains eased from 282k in Q4 2015 to 192k in Q3 2016) as the labour market reacted with a lag to softer GDP in late 2015 and early 2016.
- Low inflation enables the Fed to use its monetary policy to keep the economy on track.
- We look for a Fed hike in December 2016 in response to sustained if modest gains in domestic demand.
- Fed will react to Trumpenomics fiscal boost; up to three rate hikes in 2017.

US households: reducing the debt overhang

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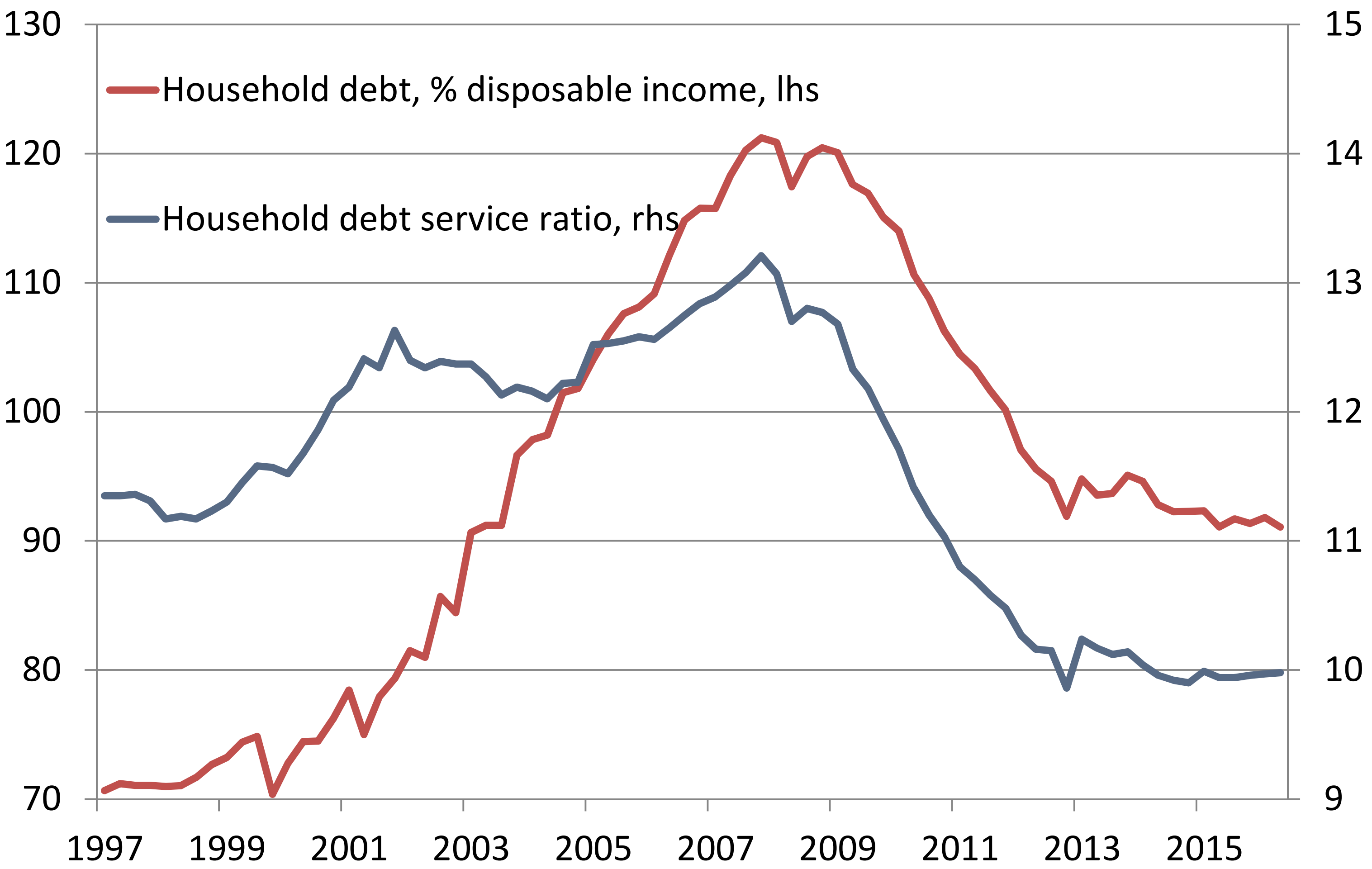
US household debt: nice progress



In % of disposable income; debt ratio on left-hand scale, debt service ratio on right-hand scale.
Source: Fed.

- Households borrowed heavily when house prices were rising rapidly.
- After the real estate bust, households reduced their debt.
- Rock-bottom rates have brought debt service costs down sharply.
- Households are content with their financial position. They are no longer afraid of losing their jobs and their home.
- The deleveraging is over.
- Households started to spend more freely again in 2013.
- Low oil prices have boosted the purchasing power of households. But that effect will soon be over.

US housing market: a long recovery

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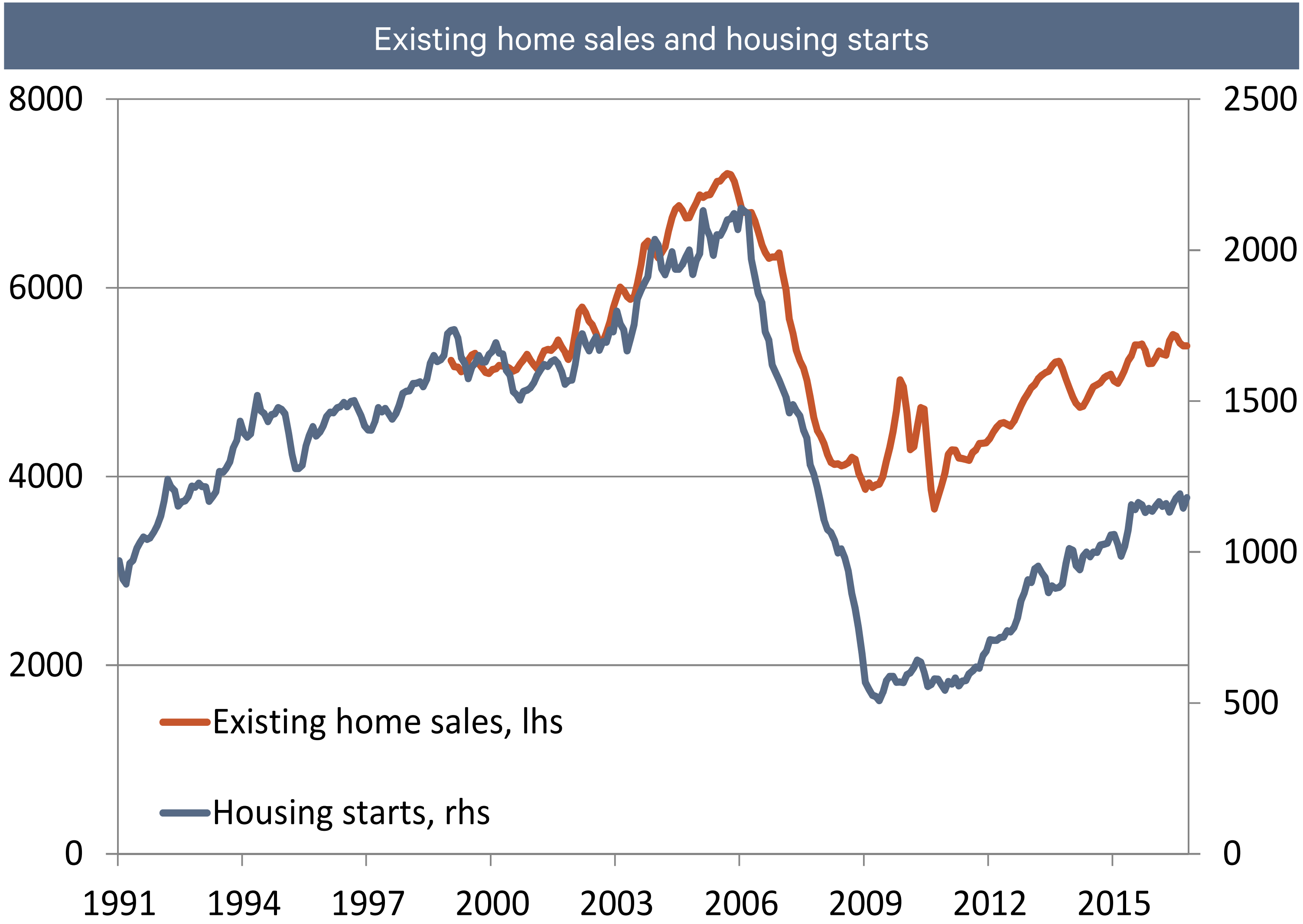

Existing home sales and housing starts, in 1000s, 3-month rolling average.
Source: BLS.

- Boom, bust, recovery.
- Helped by on-going gains in employment, rising real incomes and very low financing costs, US consumers are building and buying houses again.
- The trend looks solid. The rebound can continue for some years without getting into the bubble danger zone.
- Residential construction contributes 3.5% to US GDP, well below a normal 5%.
- Fed will not derail the upturn. Expect a Fed hike in December, followed by up to three hikes in 2017 and two in 2018

China: using public investment as the key buffer

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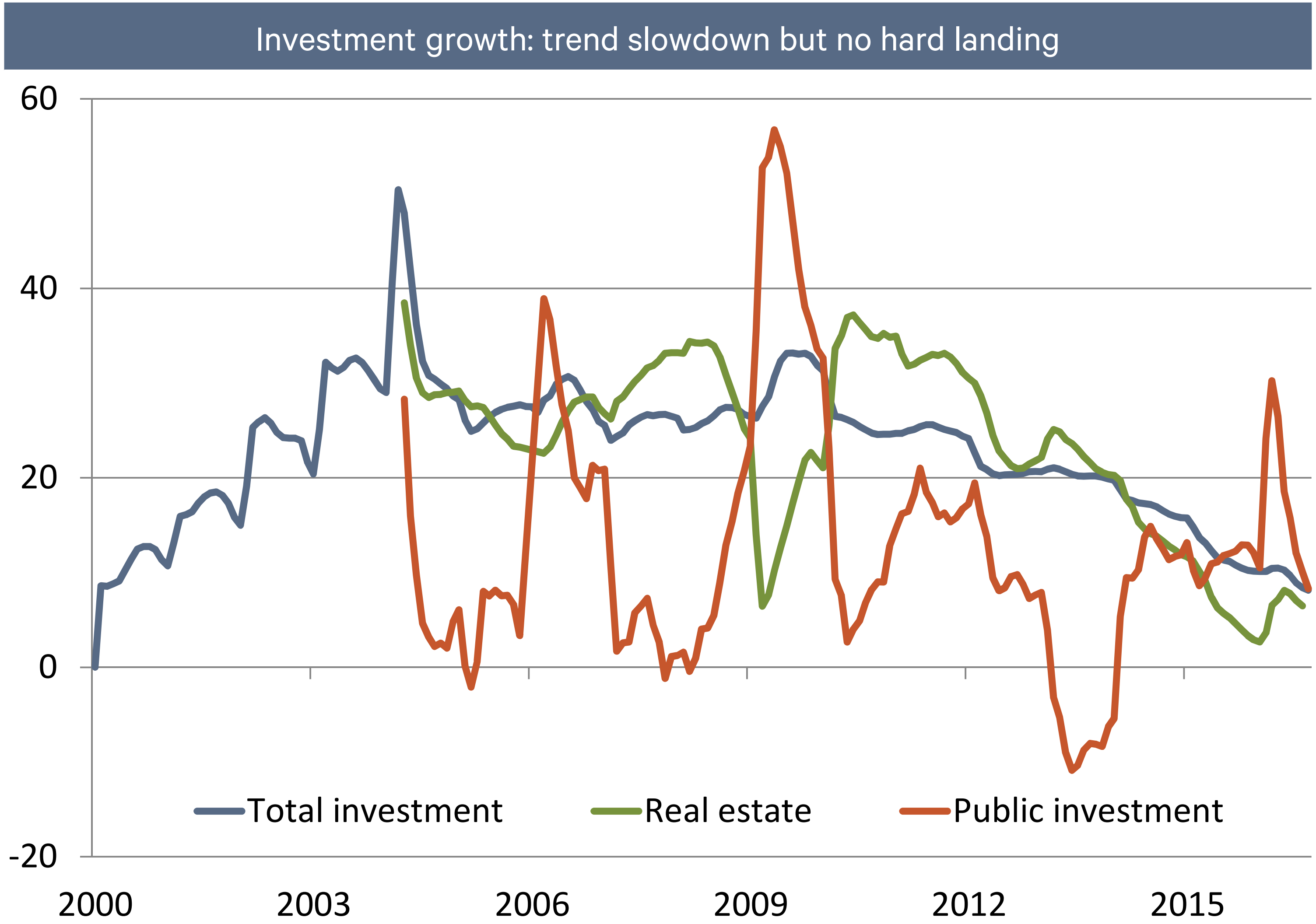

Yoy change in %, 3-month average.
Source: China National Bureau of Statistics.

- As the economy matures, trend growth slows down.
- Investment growth is far less spectacular than it was 5 years ago.
- The authorities use public investment as a buffer, turning the taps on and off as needed to stabilise overall demand growth.
- This has worked so far – and will continue to work for a while.
- No inflation = room for stimulus. China can use all policy levers to keep demand close to trend.
- 40% savings rate and $3.2 trn fx reserves are still comfortable cushions.
- But China is storing up debt trouble for the future.

Europe: the rebound at home

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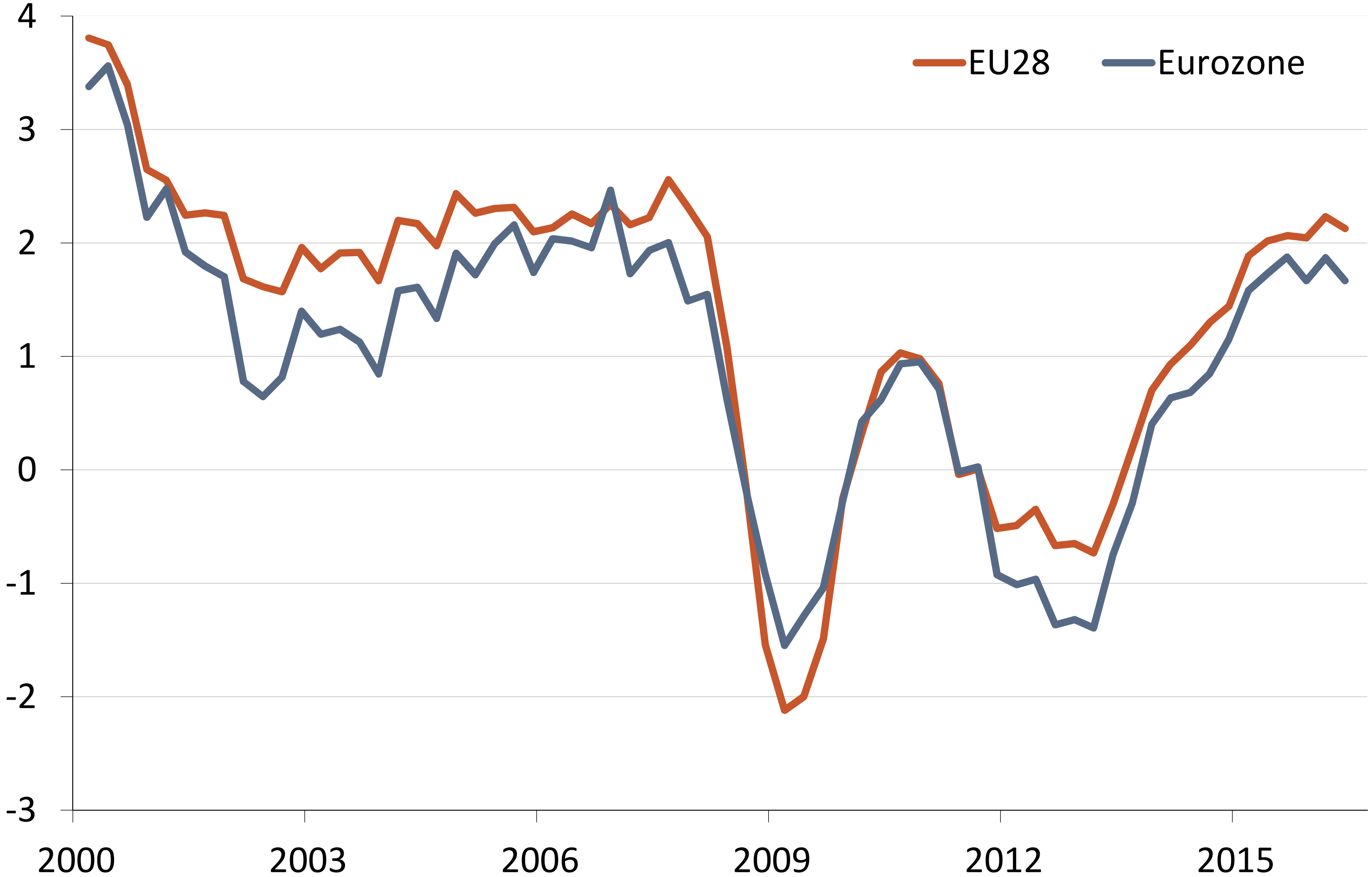
Private consumption has rebounded – that provides a cushion against external shocks



Household final consumption expenditure, yoy change in %.
Source: Eurostat.

- Most European companies sell most of their wares in Europe.
- Private consumption accounts for 57% of GDP in the EU and 55% in the Eurozone.
- After two serious recessions in the wake of the Lehman and the euro crises, consumer spending has rebounded.
- This provides some cushion against external shocks.
- Low oil prices had lifted consumption growth above trend in late 2015 and early 2016. Expect a return to the 1.4% trend from late 2016 onwards.

Monetary policy: ECB catching up and set to surpass Fed soon

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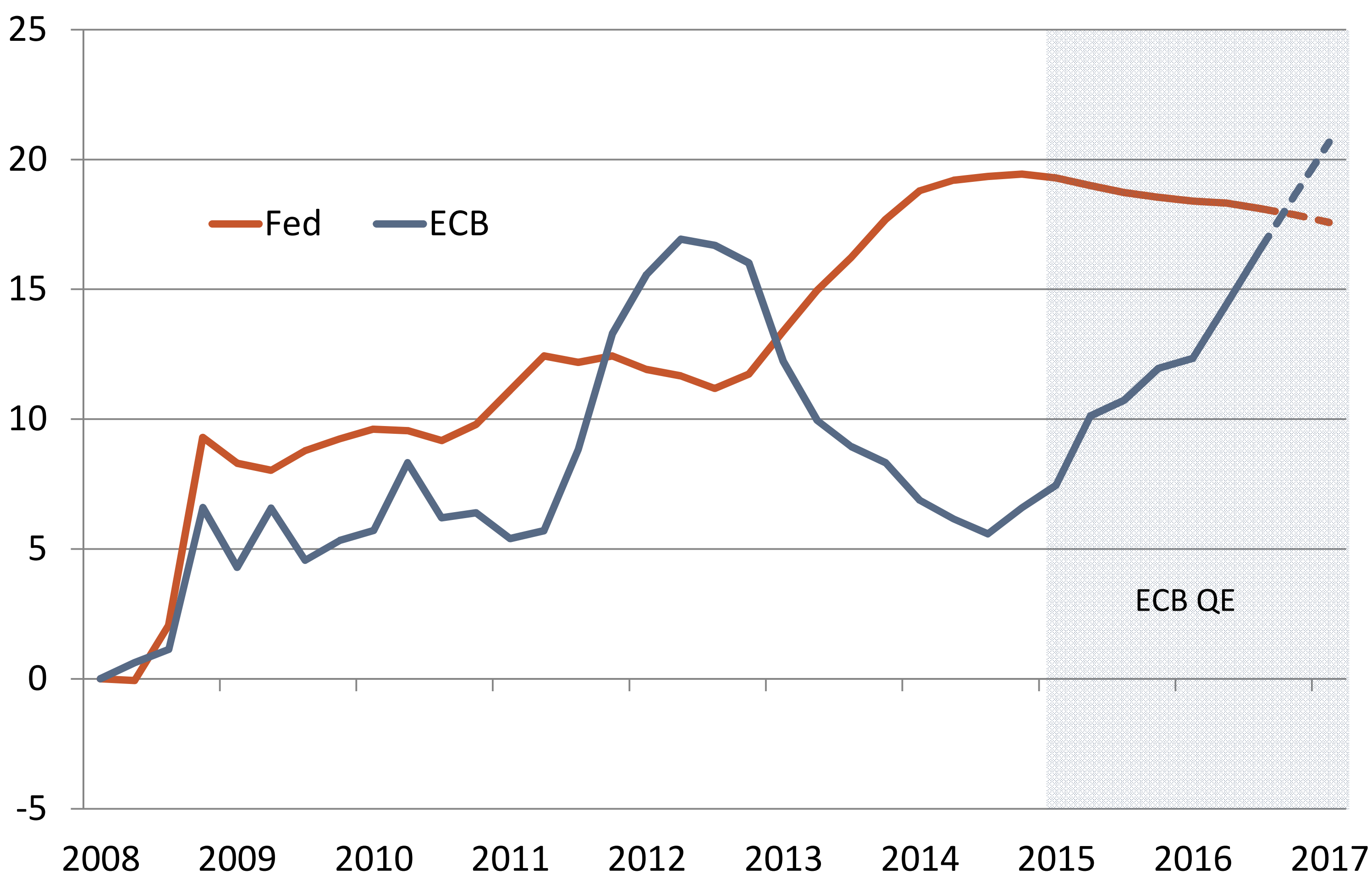
Increase in central bank balance sheets since 1Q 2008, in % of GDP



Increase in ratio of central bank balance sheet to GDP, in percentage points of GDP since Q1 2008. Dotted lines: projecting a stable nominal balance sheet for the Fed and an increase in the ECB balance sheet by €80bn of asset purchases per month from April 2016 onwards.
Source: ECB, Bloomberg, Berenberg calculations.

- The Fed reacted more aggressively to the Lehman-crisis than the ECB.
- While the LTROs briefly boosted the ECB balance sheet…
- … they did not stop the euro confidence crisis. Only the OMT promise did that trick.
- Since late 2014, the ECB has become more aggressive.
- By the end of 2016, the increase in the ECB balance sheet will likely be similar to that of the Fed.
- ECB likely to extend its bond purchases beyond March 2017 before starting to taper in H2 2017.

ECB monetary policy at work: the power of money

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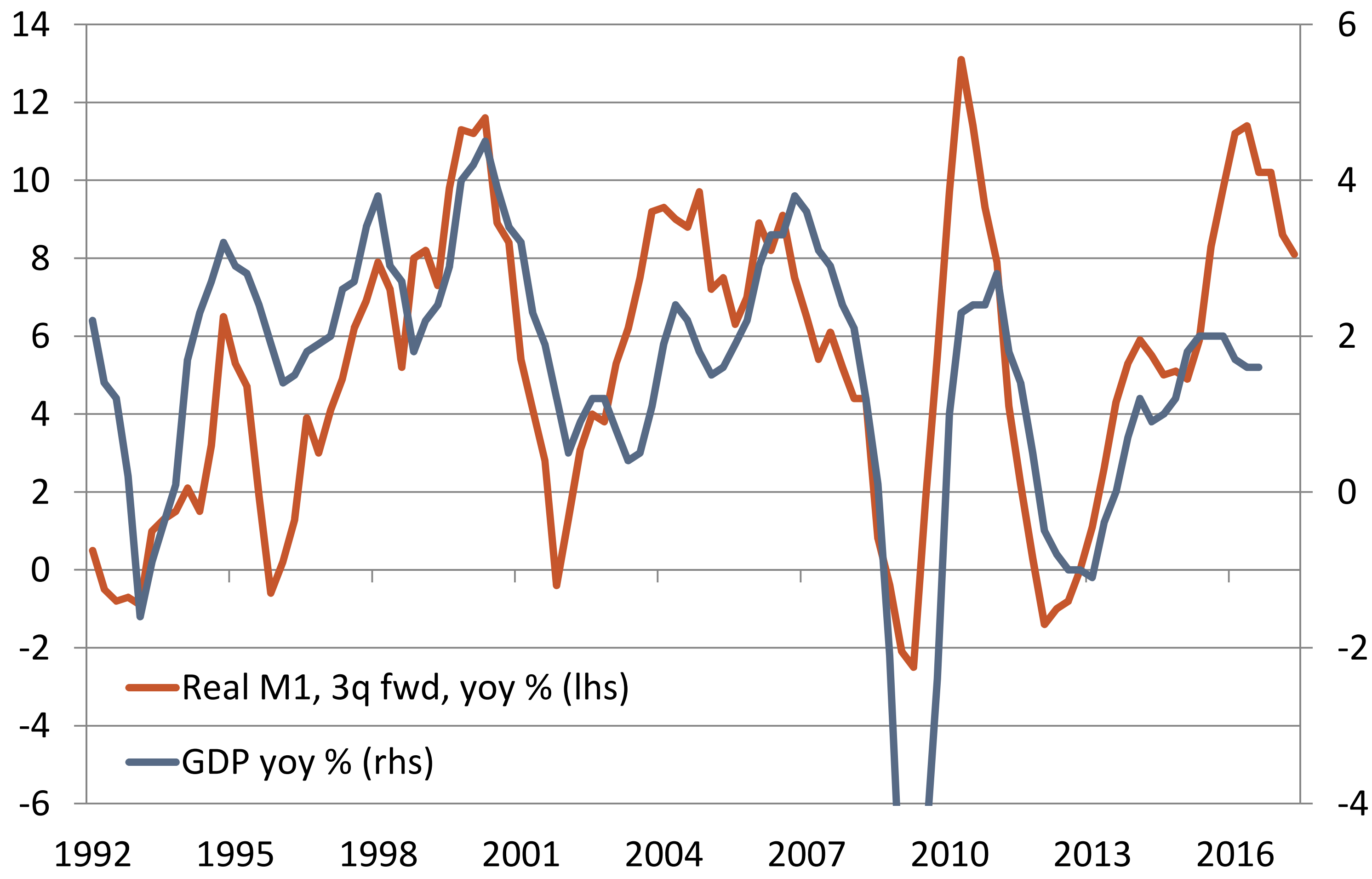
Real M1: Our best leading indicator for the Eurozone



Yoy changes in %, real M1 advanced by 3 quarters.
Source: ECB, Eurostat, Berenberg.

- Have money, will spend: major changes in real M1 money supply dynamics herald changes in GDP growth some three quarters in advance.
- Monetary policy is working. The ECB took two major policy initiatives in the last four years. It announced the OMT safety net in the summer of 2012 and prepared serious asset purchases from June 2014 onwards.
- In both cases, real M1 growth accelerated strongly.
- Real M1 points to firm domestic demand, although people now want to hold more precautionary cash than before.
- However, domestic demand may not strengthen further in late 2016 as M1 growth has started to slip a little.

ECB monetary policy at work: tight spreads

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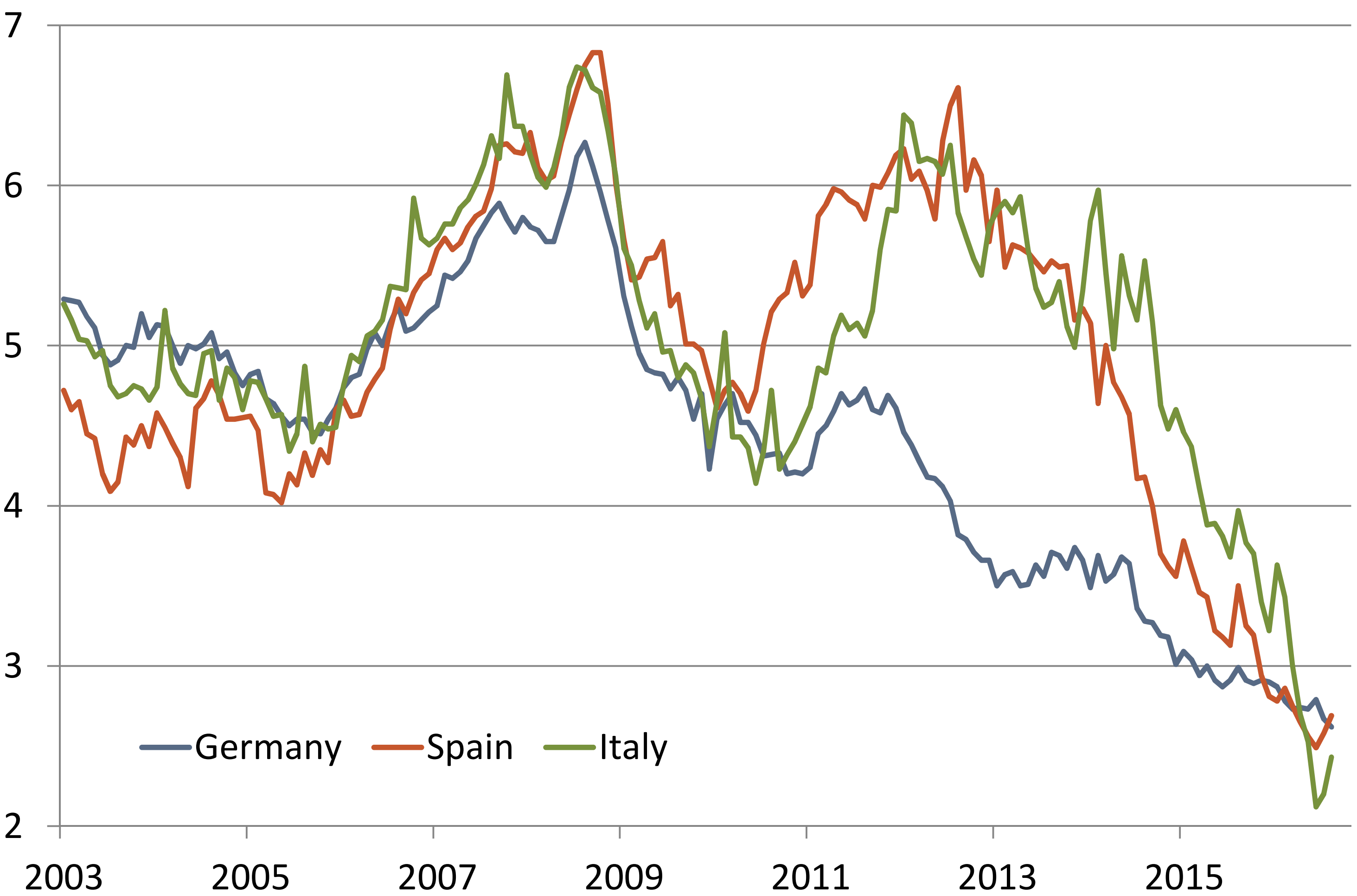
Eurozone SME borrowing costs fall faster since the ECB stepped up easing



Effective interest rate on new loans to non-financial corporations up to €1m, 1 to 5 years maturity. In %.
Source: ECB.

- Since June 2014, the ECB has announced a series of easing measures, including rate cuts and full-scale bond purchases.
- The stimulus is working. Nominal borrowing costs for small and medium-sized enterprises have dropped significantly since May 2014.
- Inflation expectations have also declined, but borrowing costs have fallen by more. This provides a real boost for businesses.
- The much tighter spreads over Germany suggest upside for Spain and Italy…
- …. although renewed concerns about Italian banks and its politics could cause a near-term dent to growth there.

ECB monetary policy at work: the credit cycle has turned up

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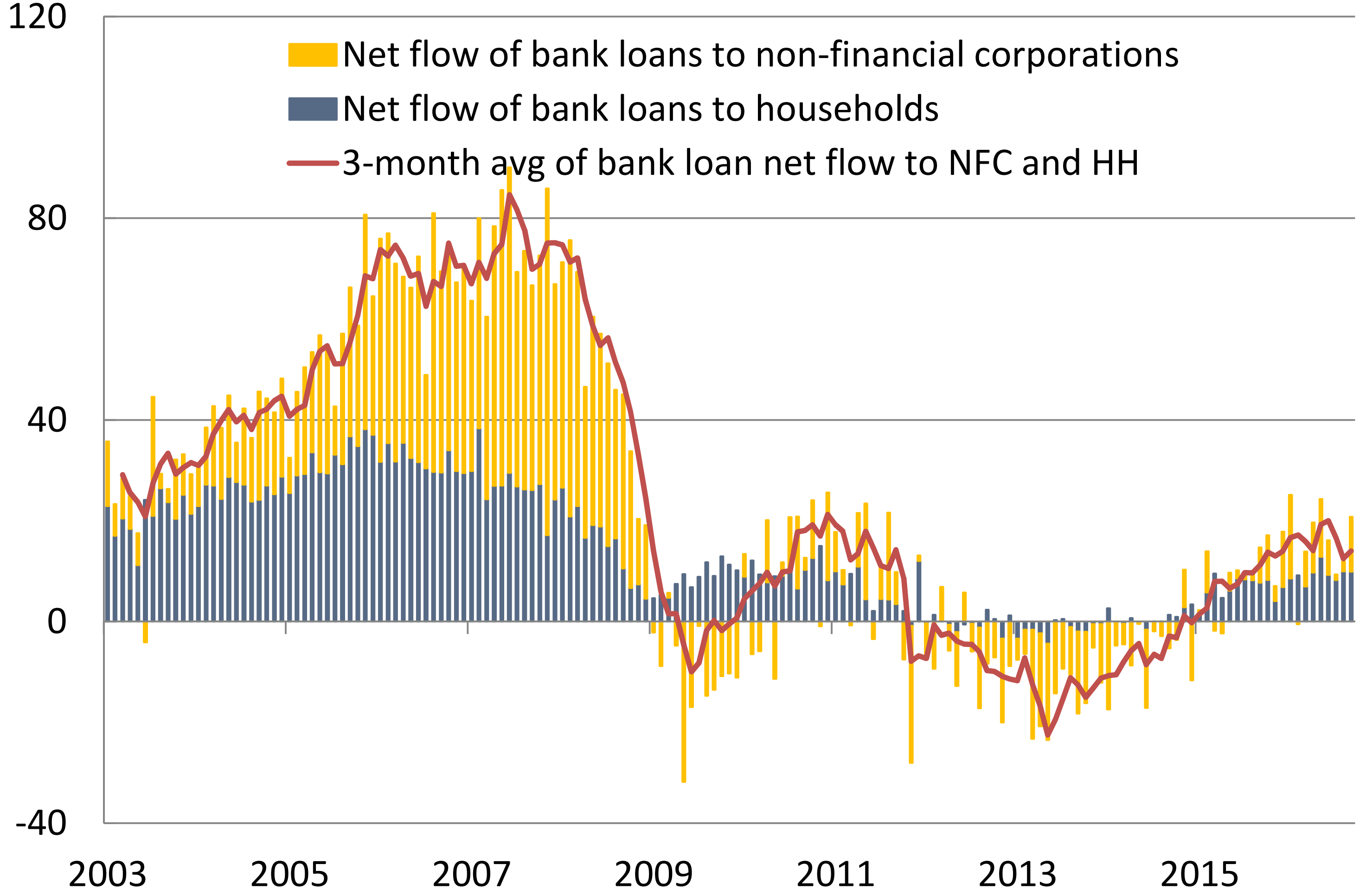
Eurozone: Net flow of bank loans to non-financial sector

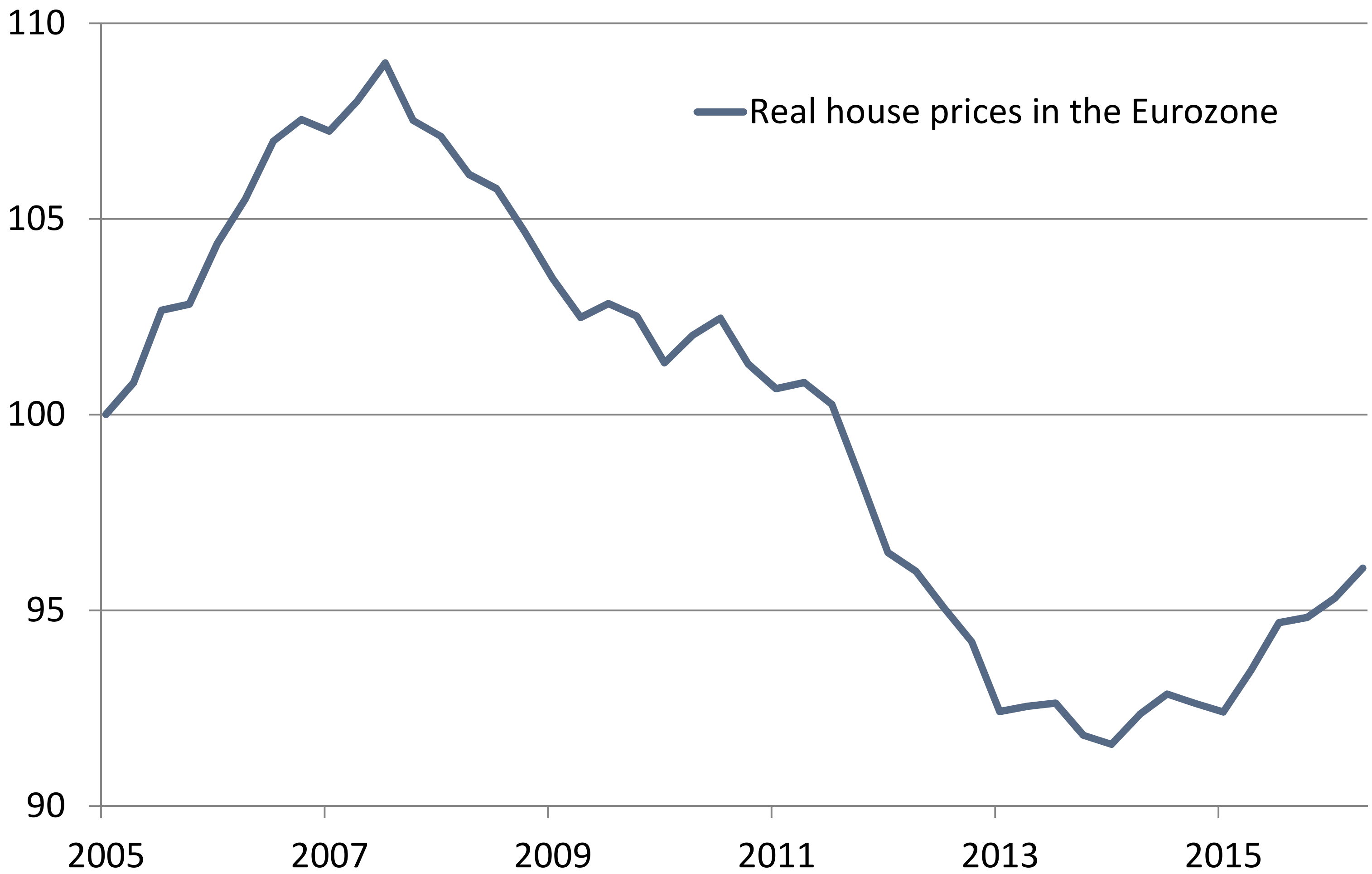


Net flow of bank loans, in € bn; from February 2009 onwards adjusted for loan sales, securitisations and notional cash pooling. Net flows to non-financial sector are 3/month moving average.
Source: ECB.

- After a long period of credit compression, bank lending has picked up.
- Banks are easing their lending standards.
- Credit demand has firmed.
- However, credit demand is still weaker than in previous cyclical upswings. Households and companies have ample cash reserves and are more reluctant to borrow than they were pre-Lehman.
- As usual, the flow of loans to households leads the cycle whereas loans to companies lag the cycle.
- Concerns about Italian banks contributed to a deceleration in the summer of 2016.

Where is the bubble? Eurozone house prices

Real house prices are still very subdued



Index of house prices deflated by Consumer prices, Q1 2005 = 100.
Source: ECB, Eurostat.

- Boom – bust – recovery.
- Eurozone house prices are recovering from a low base.
- Despite record-low financing costs, the Eurozone is far away from a new bubble.
- Mortgage credit is expanding a just 2% yoy.
- Claims that the ECB may be inflating real estate prices in a dangerous way are not supported by facts.
- Even German house prices are not yet overvalued. Mortgage credit growth of 4% in Germany is not yet dangerous. But it needs to be monitored.
- Regional problems within the Eurozone would have to be dealt with by macro-prudential tools.

Where is the bubble? Eurozone equity prices

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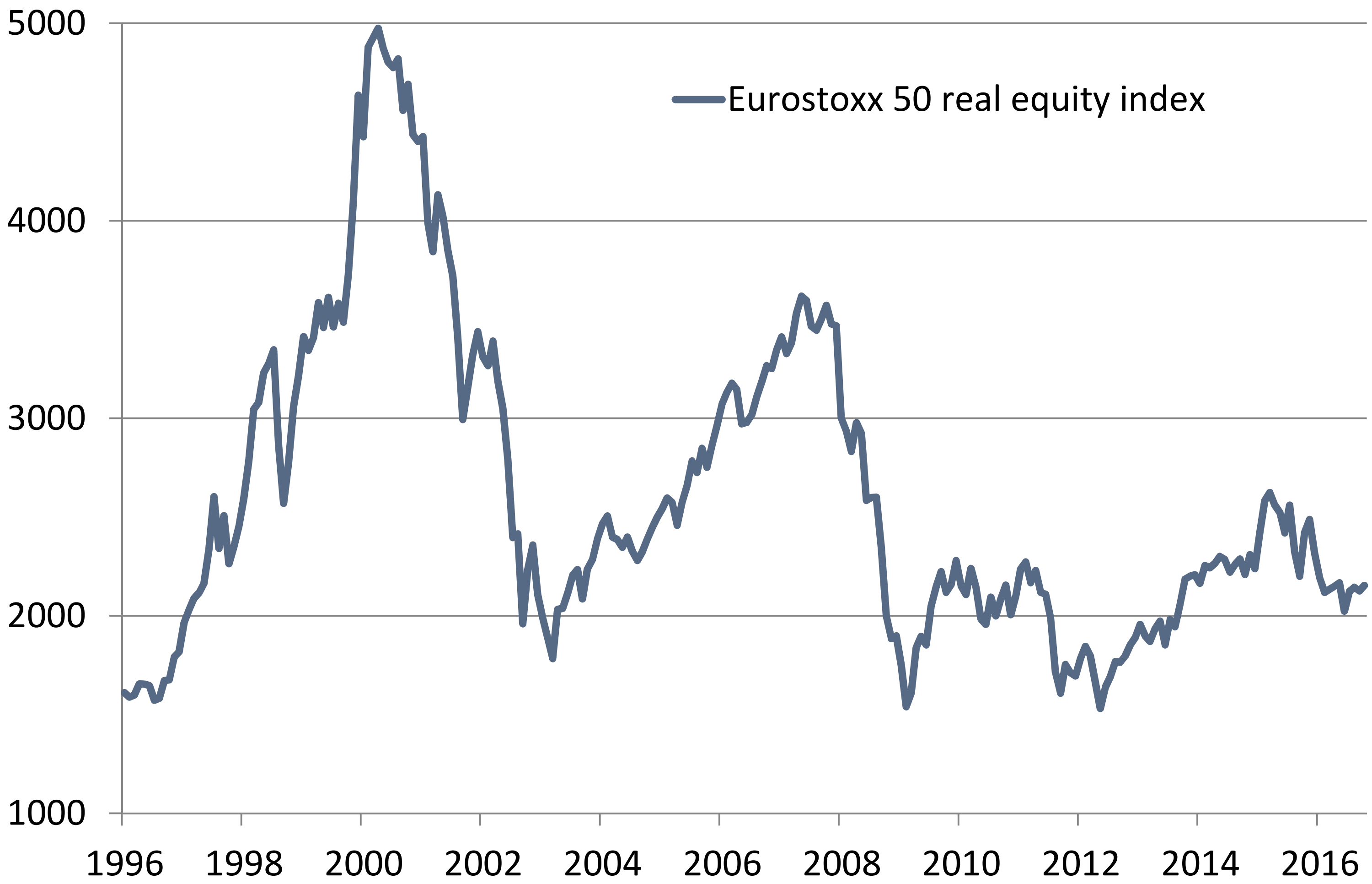
Real equity prices are still very subdued



Eurostoxx equity index deflated by CPI.
Source: Bloomberg.

- Where is the bubble?
- In real terms, Eurozone equity prices remain far below their 20-year average.
- Risk aversion is distorting the ratio of dividend yields to „safe haven" sovereign bond yields.
- If risk aversion recedes, equity prices and bond yields could both move up.
- However, the long list of political risks in the US and Europe could keep risk aversion elevated until the populist threat has receded.

Eurozone sentiment: convergence and stability

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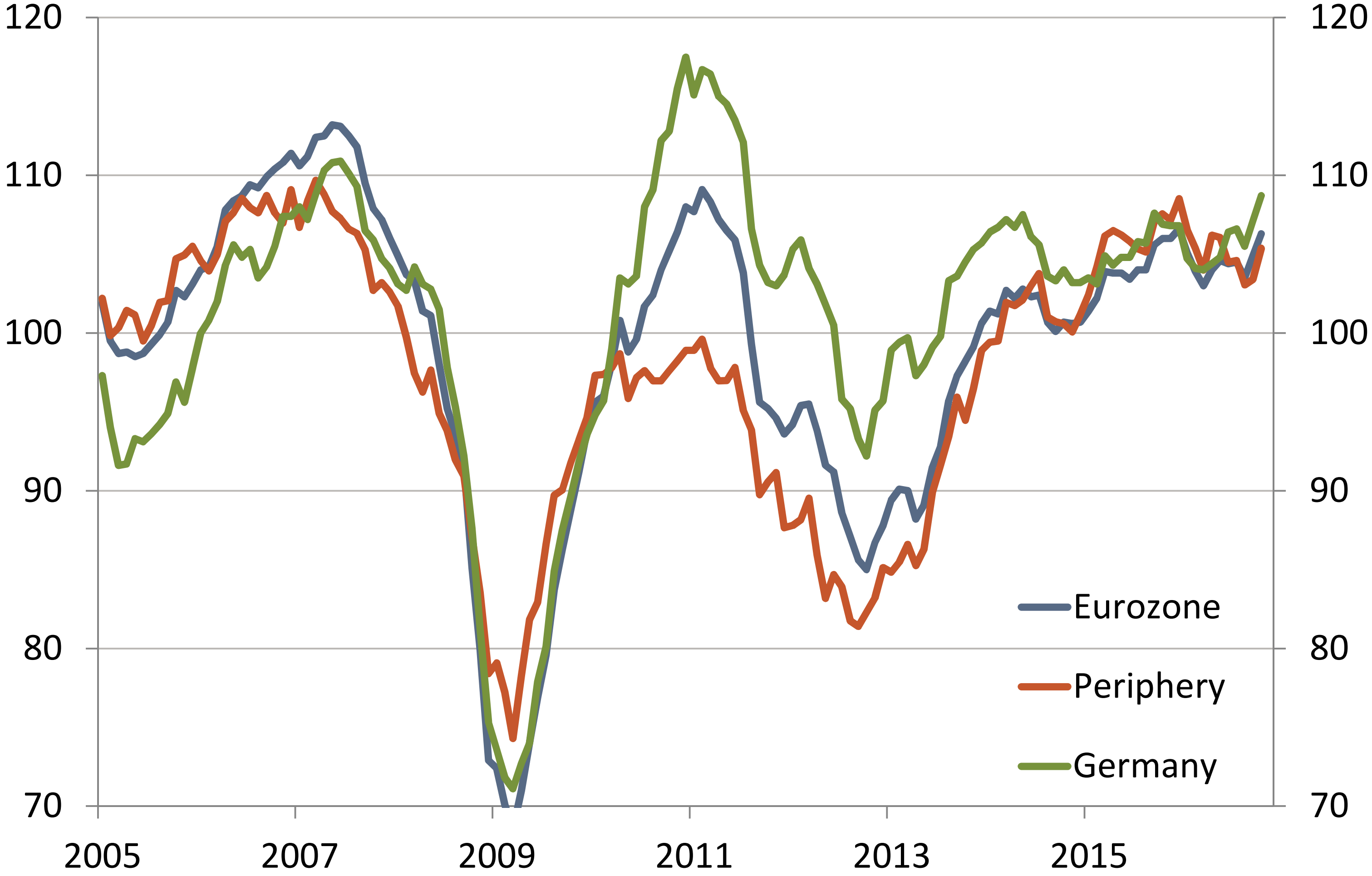
Economic sentiment: reform countries almost on par with Germany and Euro average



Economic sentiment, Eurozone, Germany and weighted average for Spain, Portugal, Greece and Cyprus; no data for Ireland. 100= long-term average.
Source: European Commission.

- During the euro crisis, sentiment in the periphery was far below that of the core.
- Since autumn 2012, the erstwhile crisis countries have moved up nicely.
- Sentiment in the periphery is now similar to that in the core.
- For the Eurozone, modest fluctuations in sentiment at a level above the long-term average of 100 point to growth in line with the 1.5% trend rate.
- The Brexit vote caused hardly any dip over the summer.
- Better export prospects after the end of the emerging market crisis are helping a little.

The blueprint for European reforms: the German turnaround

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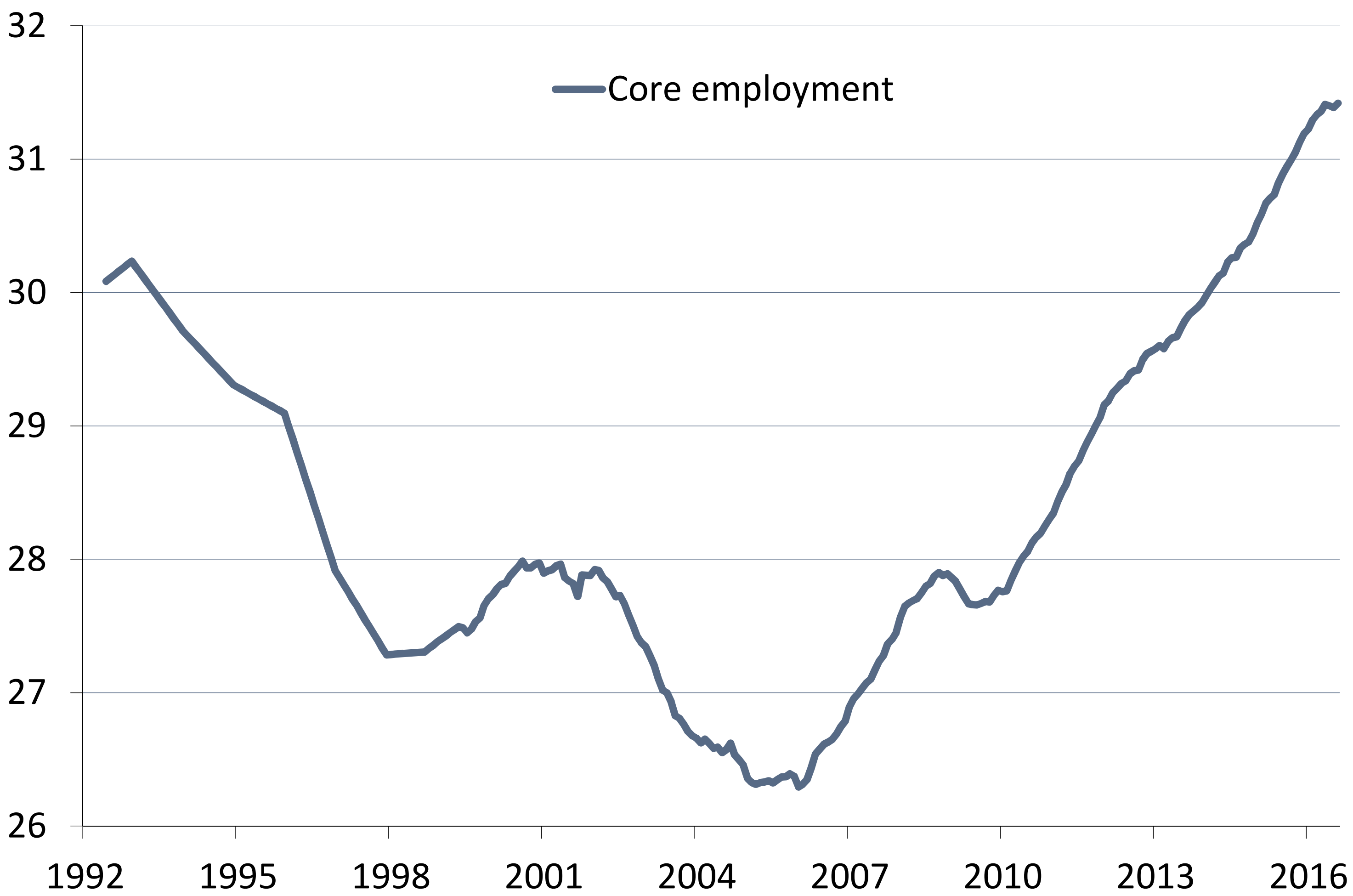
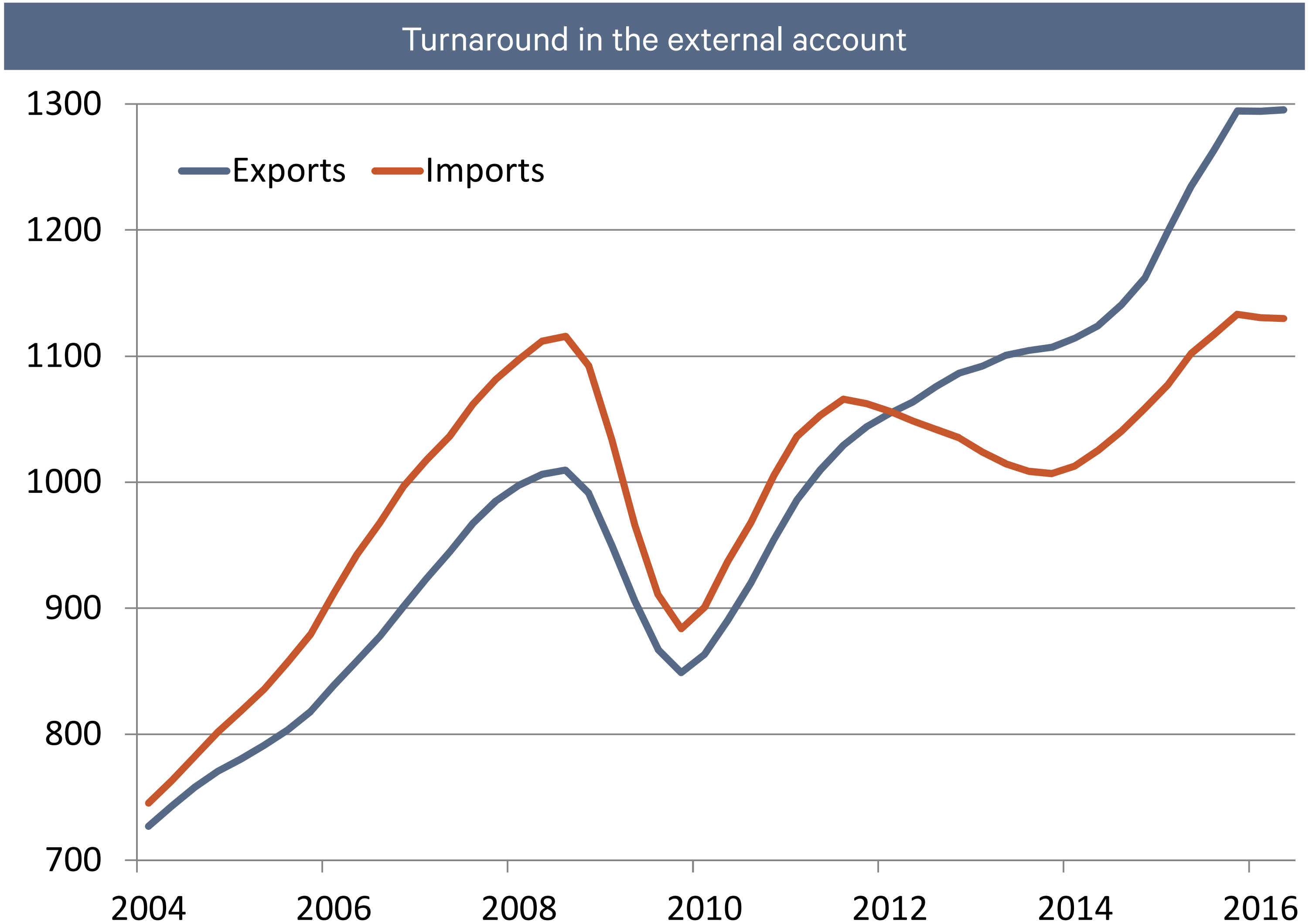
Core employment: strong increase since 2006



Core employment: subject to social security contributions, in million.
Source: Bundesagentur für Arbeit, Bundesbank.

- It's the labour market, stupid.
- After four decades of rising joblessness, Germany turned its labour market around with the reforms of 2004.
- Since early 2006, core employment has risen by 5 million (+19%) to a new record of 31.4mn.
- More employment
  = more taxpayers
  = balanced budget
- The German experience shows: labour market reforms work after a lag. More than 30% of recent new hires are immigrants.
- Strong employment gains bode well for German consumption.
- The rewards of prudence: Germany can afford the extra spending on refugees and infrastructure.

Euro periphery adjustment progress (I): external adjustment



Nominal exports and imports of goods and services, 4-quarter rolling sum in billion of euro. Reform-5: Italy, Spain, Greece, Portugal and Ireland.
Source: Eurostat, Berenberg calculations.

- The five euro crisis countries (Italy, Spain, Greece, Portugal and Ireland) have turned their external accounts around convincingly.
- They balanced their joint current account in late 2012 and have now achieved a surplus above 1% of GDP.
- The erstwhile crisis countries no longer need to import capital.
- Imports have picked up again since 2014. Except for Greece, which has been held back by an incompetent populist government, the countries can afford to import more.
- This is the sweet taste of success.

Euro periphery adjustment progress (II): Labour costs

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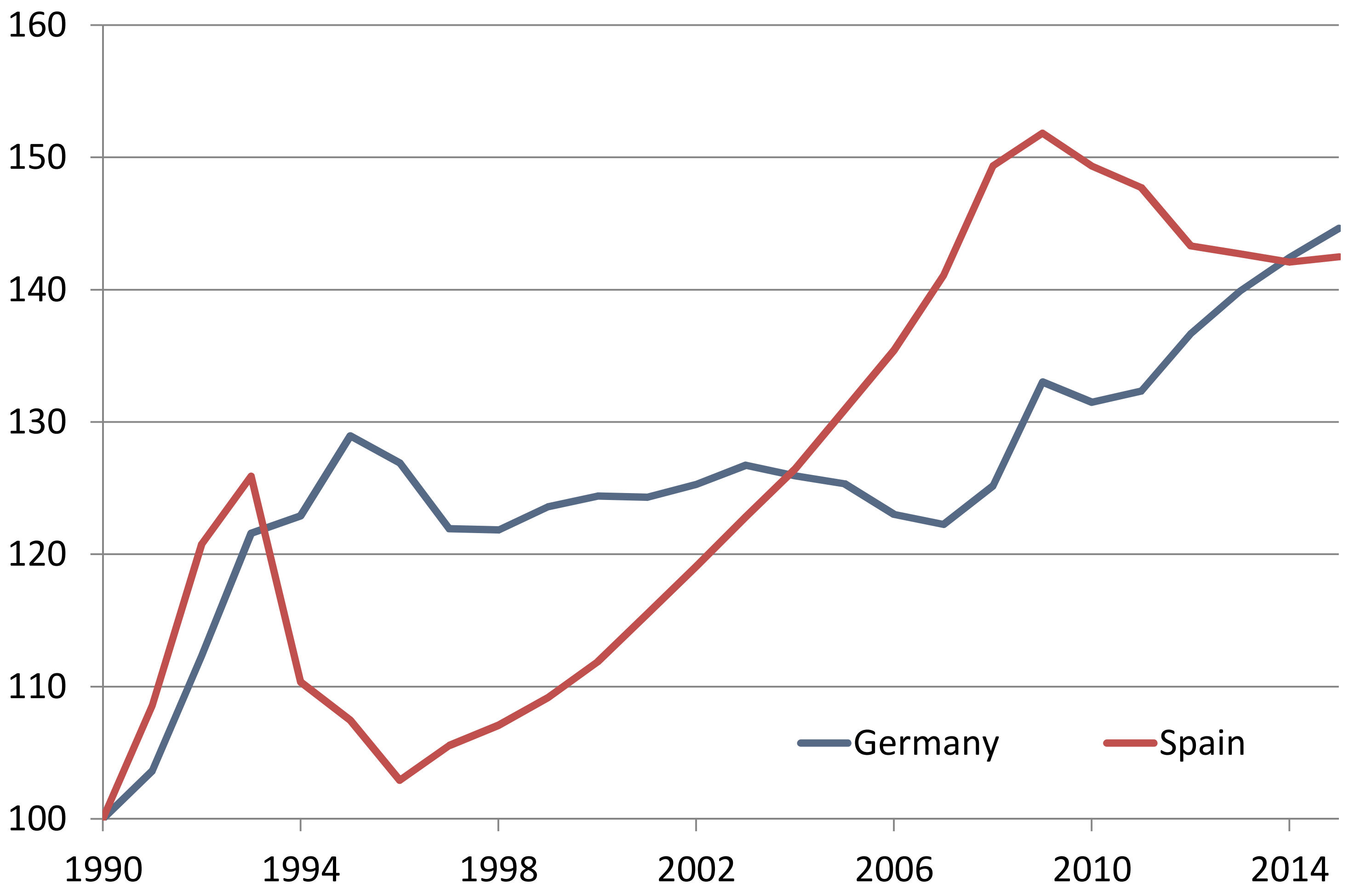
Unit labour costs: Germany versus Spain



Real unit labour costs, 1990=100.
Source: European Commission.

- Turnaround at the euro periphery…
- …where real unit labour costs have fallen sharply.
- Turnaround in Germany as well…
- …where labour costs are rising at an above-average pace.
- In the 1990s, Germany refused to deal with the costs of unification. It turned into the "sick man of Europe".
- After a long period of wage restraint and the reforms of 2004, Germany became competitive again…
- …while Spain let its labour costs surge until 2009.
- Spain has now corrected its excesses.
- In relative terms, Spain and Germany are back to 1990.

Euro periphery adjustment progress (III): Structural reforms

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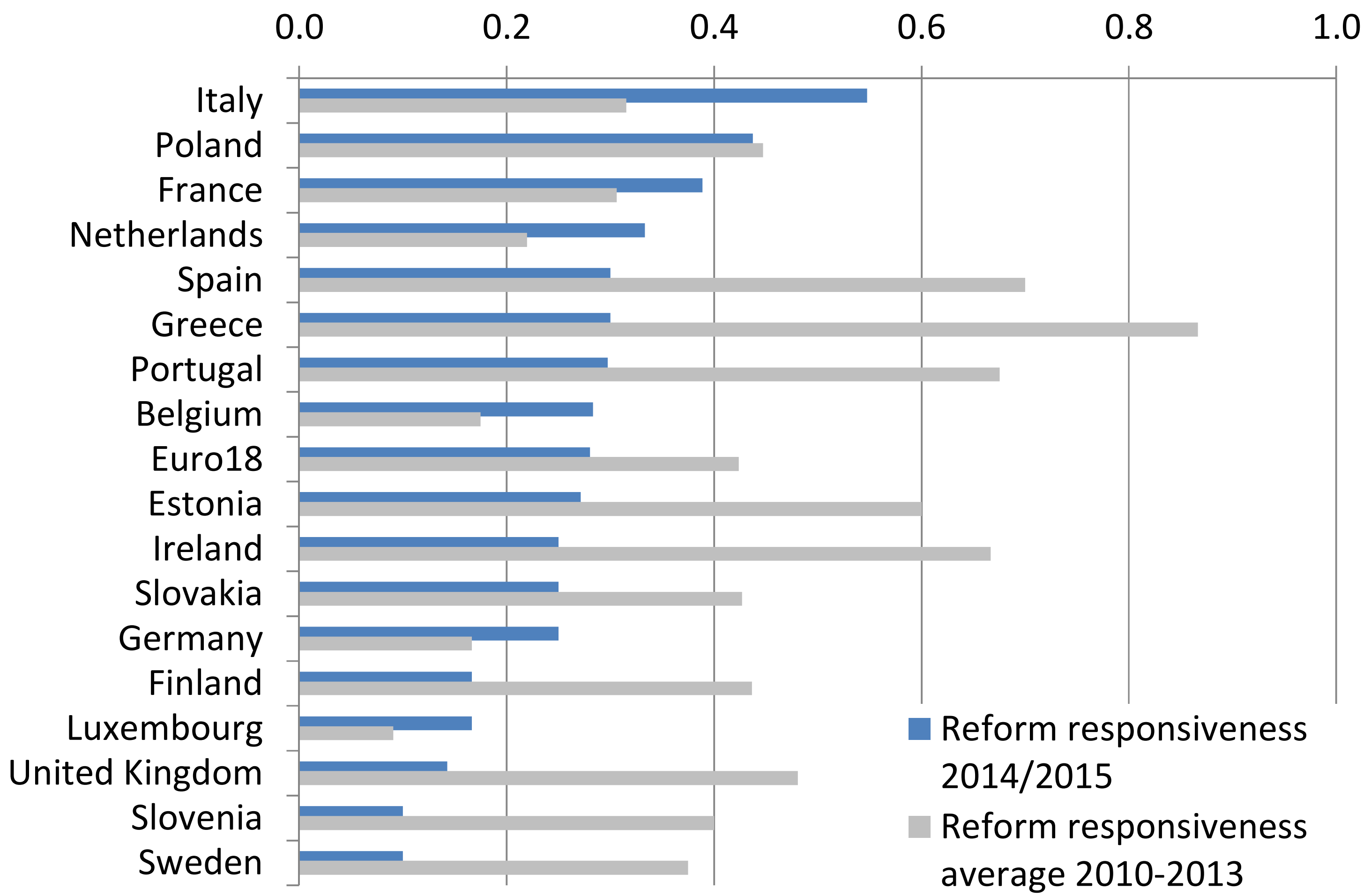
Crisis countries more responsive to OECD reform proposals

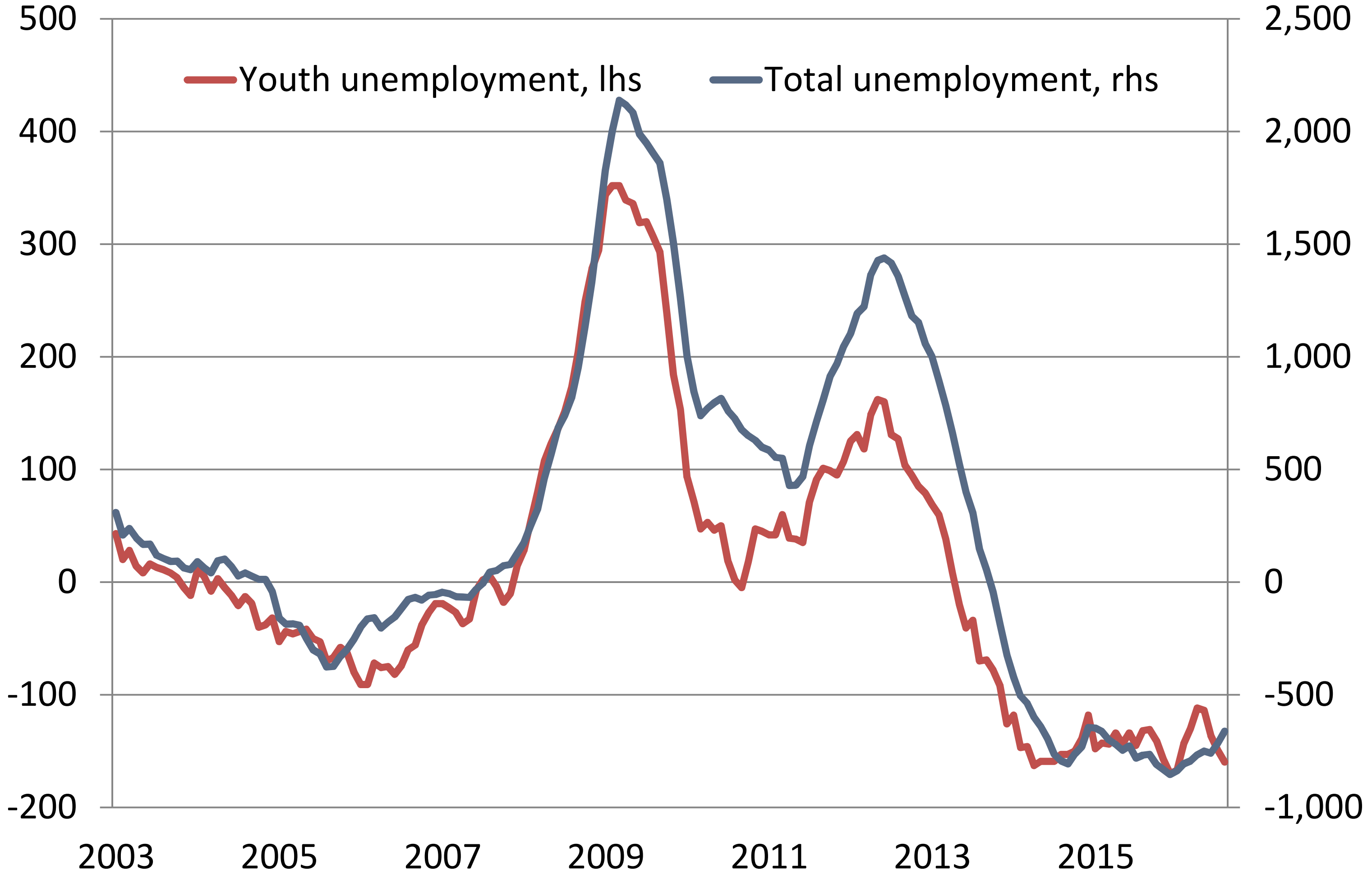


Responsiveness to Going for Growth recommendations across OECD countries, reform responsiveness 2014/15 compared to average of 2010/11 and 2012/13. Score from 0 (no reforms) to 1 (serious reforms in all policy areas identified by the OECD).
Source: OECD Going for Growth database.

- Who is implementing pro-growth structural reforms?
- The OECD regularly checks whether countries are heeding its detailed reform recommendations.
- The bailout countries have enacted sweeping reforms…
- …while Germany does very little.
- With the easing of the crisis, reform momentum slowed down significantly in the reform countries in 2014/15.
- For some countries such as Spain, this is a sign of success. For Greece, it spells trouble.
- Good news: Italy is now ahead. Even France is doing more.

Eurozone progress: labour market has turned up

Change in unemployment in the reform countries



Change in total unemployment in Spain, Portugal, Ireland and Greece, in 1000s, 12-month sum, based on monthly nsa data.
Source: Eurostat.

- The worst is over for the labour market of the reform countries.
- Since the peak in April 2013, the number of unemployed in Spain, Greece, Portugal and Ireland has fallen by 2.3mn to a still-high 6.3 mn.
- Youth unemployment remains very high, with a total of 900k. But the number of unemployed aged 16-24 has declined by more than 500k since the peak (February 2013).
- The labour market reforms support sustainable jobs growth.
- The challenge now: preventing reform reversals.

Greece: The Varoufakis effect

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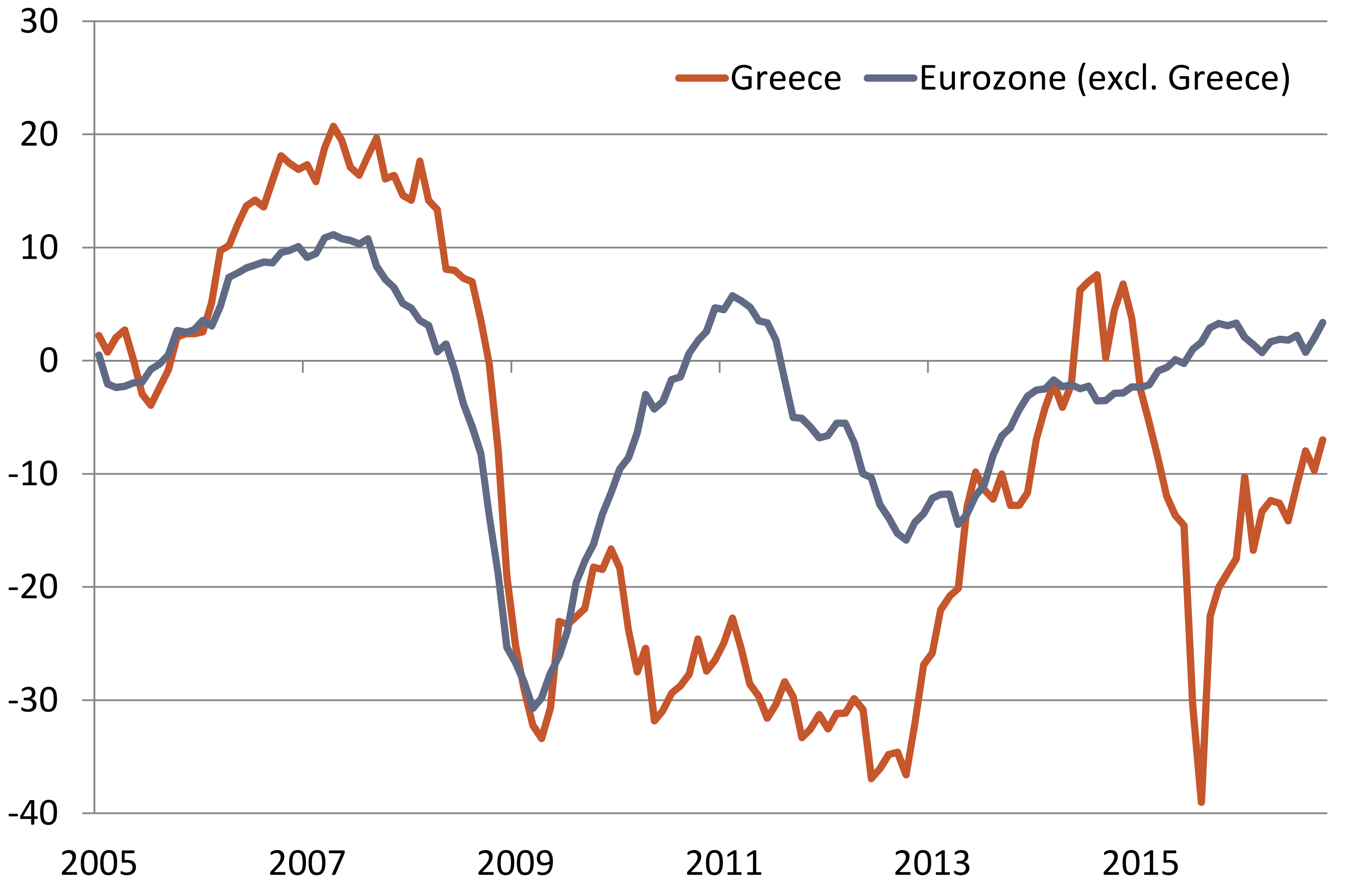
Greek recovery choked off by politics in early 2015, mediocre rebound since autumn 2015

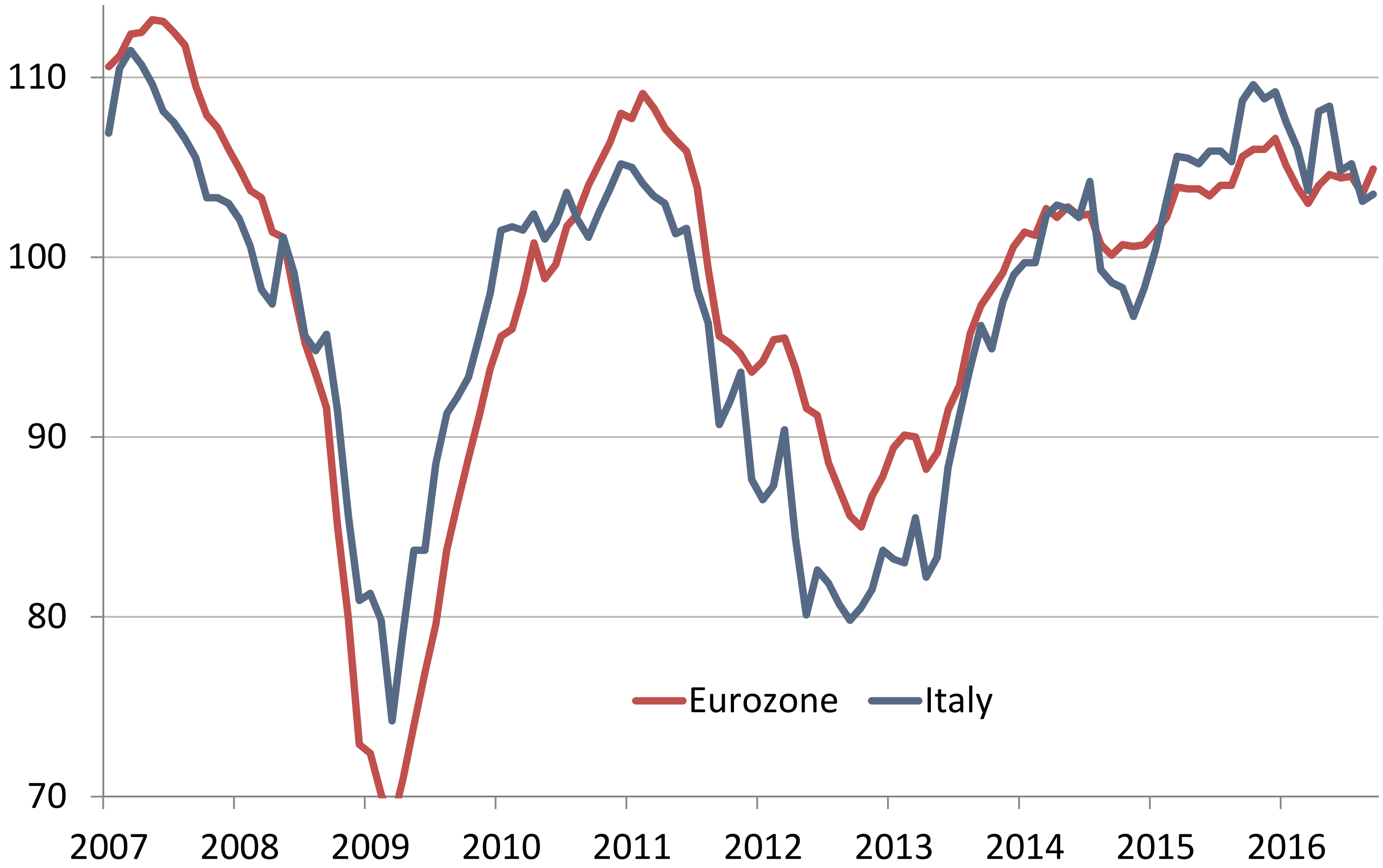


Corporate confidence: average of industrial, services, retail and construction confidence.
Source: European Commission, Berenberg calculations.

- Sentiment turned up after the ECB stopped the rot in August 2012.
- **Samaras recovery:** on the back of a major surge in confidence, Greek GDP expanded at a 2% pace in Q1-Q3 of 2014.
- But when the Syriza threat came to the fore in late 2014, Greek confidence collapsed.
- **Tsipras recession:** While Spain and Cyprus roar ahead, Greece has fallen back into a deep crisis.
- Populism doesn't work.
- After Tsipras fired Varoufakis and signed a new deal with creditors, confidence recovered.
- But the reluctance to pursue reforms still holds back the recovery.

Italy: Renzi effect at risk

Italian economic sentiment has now fallen below the Eurozone average



Index levels, rebased to 2005 = 100.
Source: European Commission.

- Renzi finally delivered his big labour market reform in January 2015.
- Thereafter, Italian sentiment surged well above the Eurozone average.
- But the rebound is fragile.
- Renewed concerns about the banking system and the risk that Renzi may lose the constitutional reform referendum on 4 December are now weighing on confidence.
- Political risks make it difficult to attract the capital needed to shore up the banks.

Political risks

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Coping with the politics of anger

The politics of anger: populist backlash against globalisation and immigration threatens open societies.

Three reasons to hope that populism will peak soon

- **Employment is rising:** wage growth will strengthen gradually
- **Austerity is over: more opportunities to compensate the losers of change**
- **Populists can't deliver**: they either get real (Syriza) or founder

President Trump

- **Fiscal boost and some deregulation at home – but protectionism and isolationism abroad?**
- **Checks and balances** are strong in US domestic policy, but not in foreign and trade policy.
- **Key risks**: trade war with China, weaker NATO, the wrong deal with Putin? Probably not – but risks remain.
- **Eclectic interventionism** rather than respect for rules and institutions?

Brexit: Containing the damage

- Small short-term hit to investment demand, serious long-term damage to supply.
- Theresa May: slow approach to Brexit has helped to contain short-term damage, but risk of "hard" Brexit.
- UK in weak bargaining position. The UK needs access to EU27 market much more than vice versa.

Eurozone: Italian risk, French opportunity

- No contagion: Brexit problems strengthen cohesion of EU27; Trump is too unpopular here to set an example
- But populism is rampant in parts of EU27 as well. Key risk: Italy's 4 December 2016 referendum.
- A European opportunity: pro-reform Fillon (or Juppe) for president?

Political events to watch out for in 2017

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Jan	• 22, French primaries, Socialists (possible runoff on Jan 29)
Feb	• 12, German presidential election (by electoral college)
Mar	• 15, Dutch general election • 26, German regional election (Saarland)
Apr	• 23, French general election (2nd round on May 7)
May	• 7/14, German regional elections (Schleswig-Holstein, North Rhine-Westphalia)
Sep	• TBD, German general election (most likely date: Sep 17 or 24)

Brexit: the impact on the UK

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Dent to demand now, less trend growth thereafter – and serious political risks

Only small dent to demand

- Theresa May's slow approach to Brexit and the BoE stimulus helped to contain the short-term risks to aggregate demand.
- Rising risk of "hard Brexit" as lack of serious short-term crisis encourages the Brexit hardliners.

In the long run, Brexit hurts trend growth – 1.8% versus 2.1% pre-Brexit

- Weaker investment, slower population growth and limited access to the EU market for services will reduce the UK's potential growth rate. A hard Brexit could exacerbate the damage substantially.

Political impact – Brexit risks UK breakup

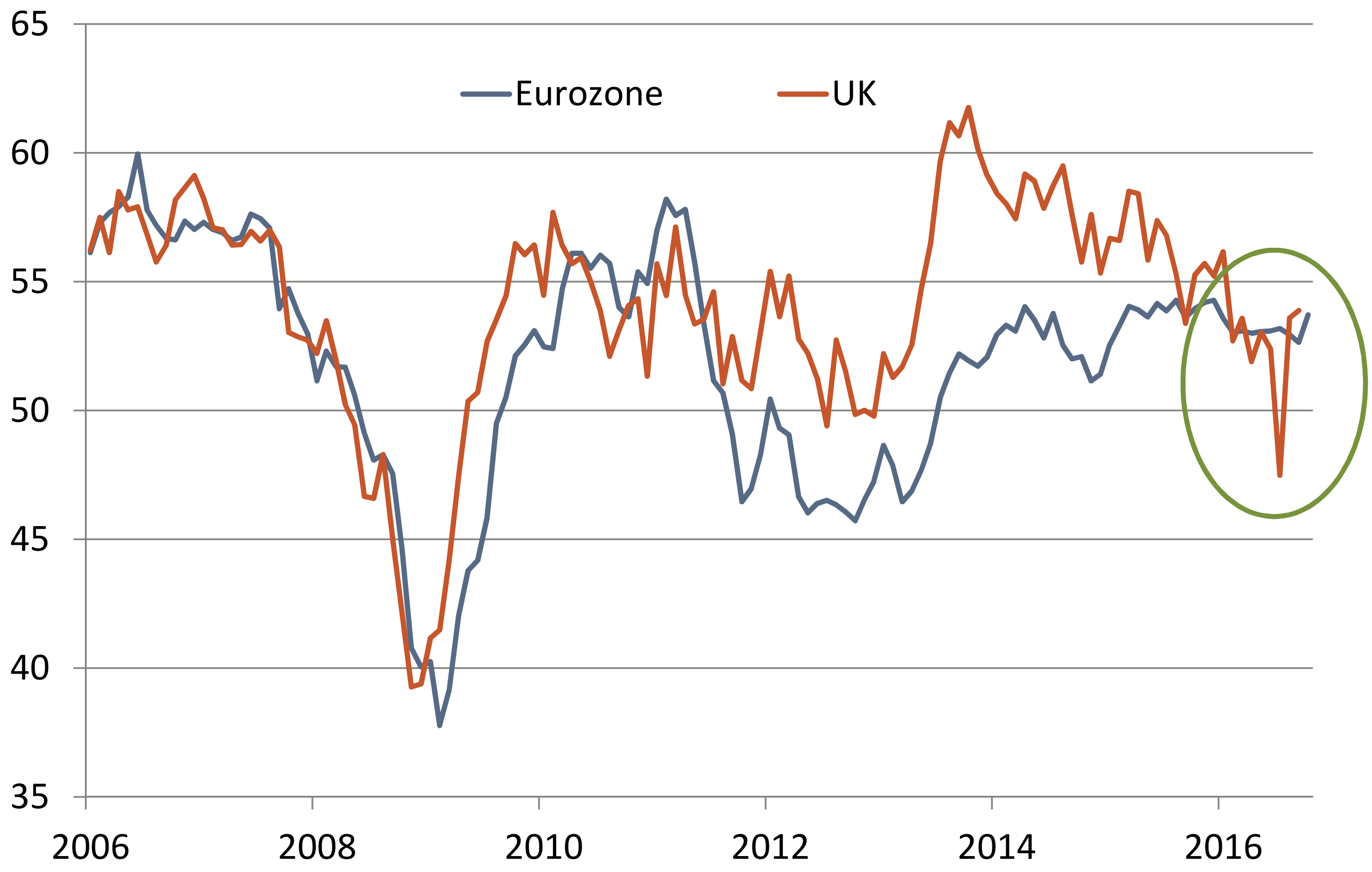
- Second Scottish independence referendum? But low oil prices make independence difficult.
- Could Northern Ireland break away? Long-term demographics favour the pro-EU Catholics. A hard border between Northern Ireland and the Republic of Ireland could trigger a referendum on UK membership.

A chance to relent? Probably not

EU will not offer better terms to the UK. What if the UK does not like the result of exit negotiations,? If Brexit has not happened by the May 2020 election, a new government may theoretically relent. But such an outcome is highly unlikely as long as Labour is unelectable. Theresa May wants Brexit by spring 2019.

Up and down – UK versus Eurozone PMIs

UK gets beyond the knee-jerk dip, impact on Eurozone limited so far



PMI composite indices aggregate the sub indices for manufacturing and services. PMIs are seasonally adjusted, 50 = no change.
Source: Markit, Haver analytics.

- In a knee-jerk reaction to the Brexit vote, soft data plunged for the UK in July, only to rebound strongly in August as Theresa May steadied the ship.
- The Eurozone is affected by the damage which one of its major trading partners, the UK, is inflicting on itself.
- So far, the impact on Eurozone is limited.
- Prime minister May has prevented an immediate crisis of confidence, but risk of "hard Brexit" has risen with Brexiteers emboldened by lack of serious short-term crisis.

The cost of Brexit: UK public debt dynamics

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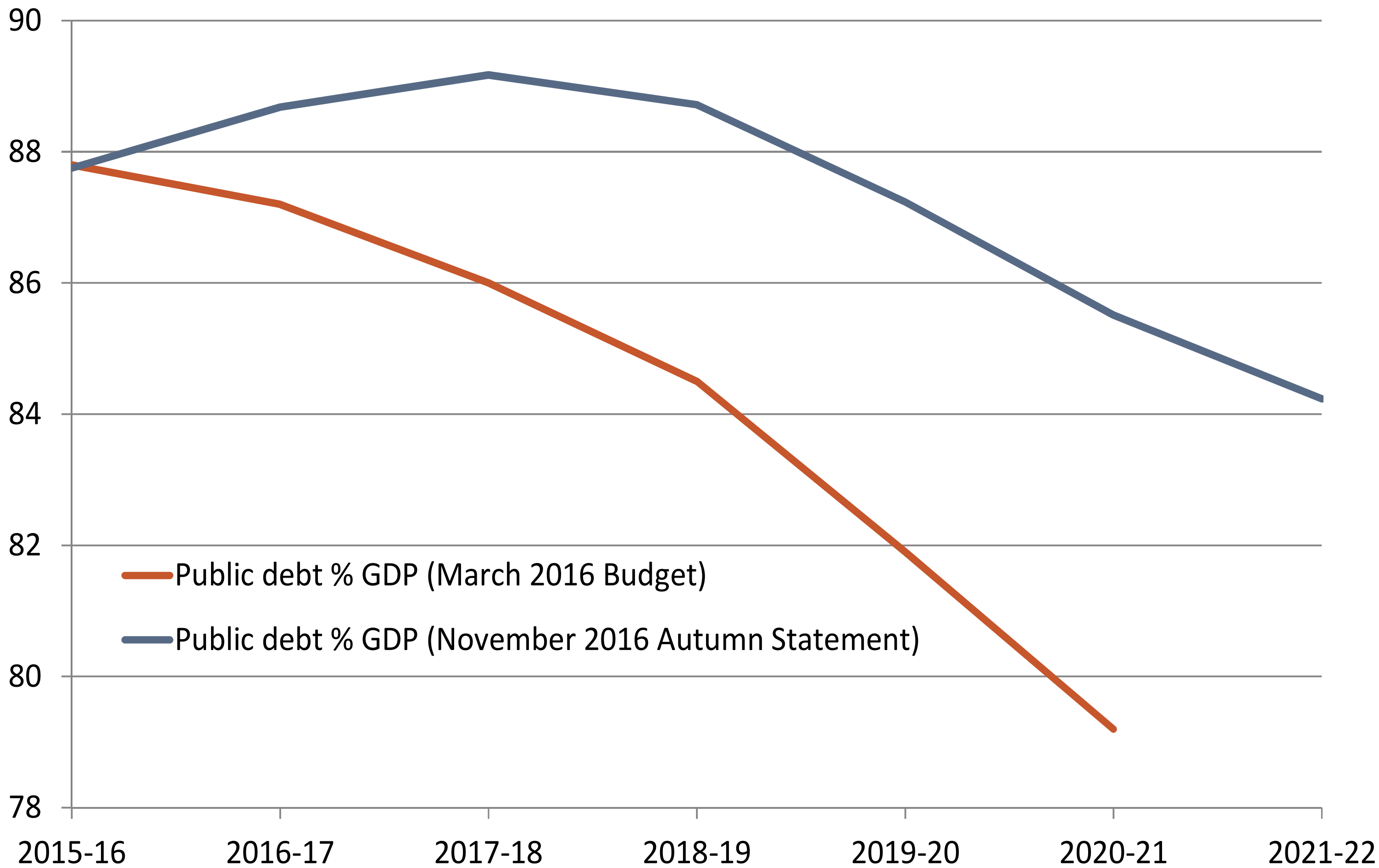
UK public debt-to-GDP ratio: official projections before and after Brexit vote



Official projections of the UK's debt-to-GDP ratio, Maastricht definition; March 2016 projection adjusted for the revised 2015/16 outcome.
Source: Office for Budget Responsibility

- Brexit is expensive.
- It raises the UK debt ratio in two ways, by reducing GDP growth and by raising the fiscal deficit.
- Before the Brexit vote, the UK's official fiscal watchdog had expected the debt ratio to fall by 8.6 percentage points of GDP from fiscal year 2015/16 to 2020/21.
- The OBR now expects merely a drop by 2.2 points. Brexit could thus add around £140bn to government borrowing over the next five years.

UK's export exposure to EU27 – industry versus services

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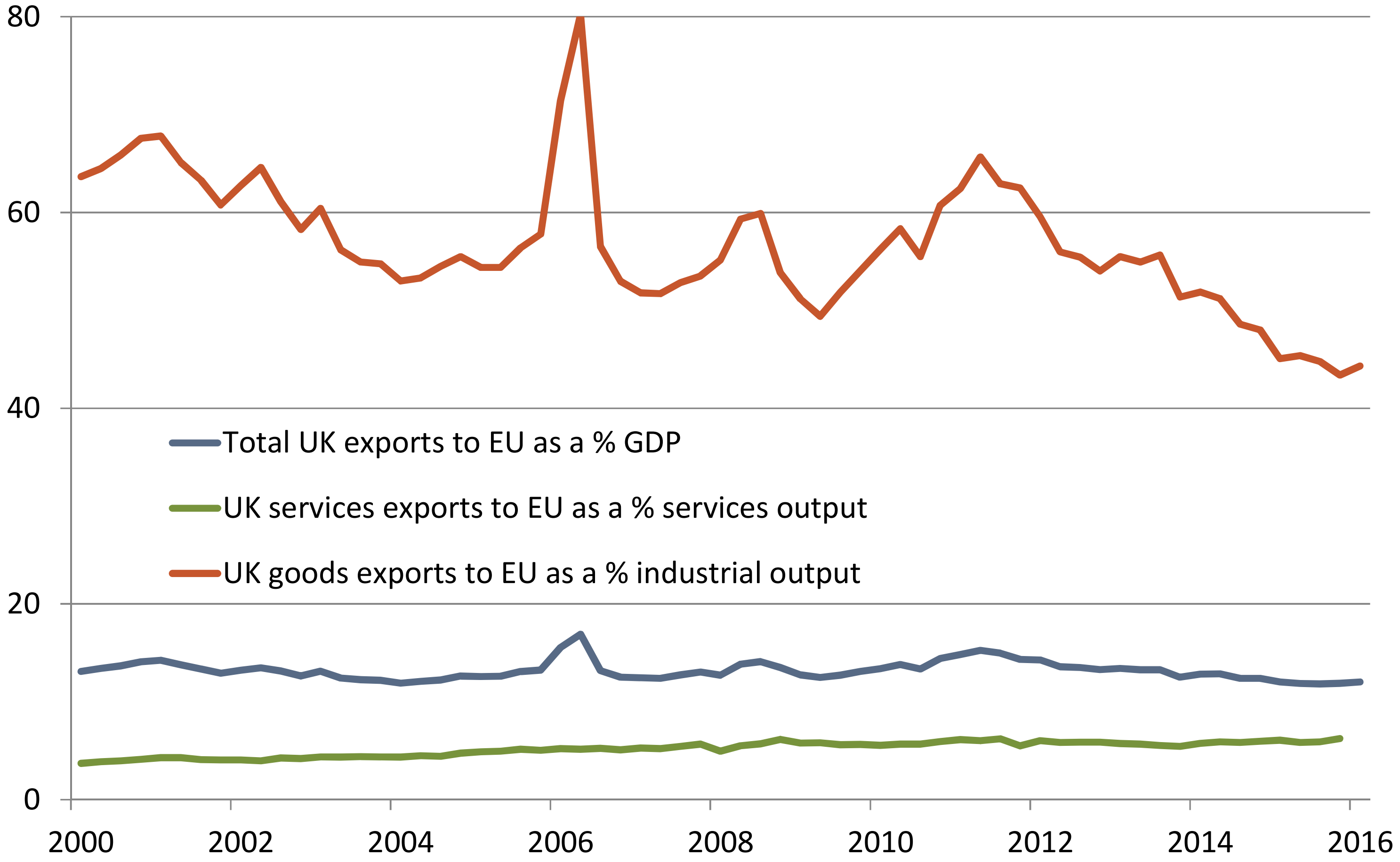
UK exposure via exports to EU27



Source: ONS, Berenberg calculations. Quarterly data.

- The UK earns around 12% its GDP by exporting goods and services to the EU27.
- While the share has fallen over time, goods exports to the EU27 account for around 45% of industrial output. It is far less for services – around 6% as many services are not tradable.
- In terms of GDP contribution, the difference is much smaller. Services exports to the EU make up 5% of UK GDP versus 7% for goods exports to the EU.

Potential Brexit model with the EU for post-EU UK

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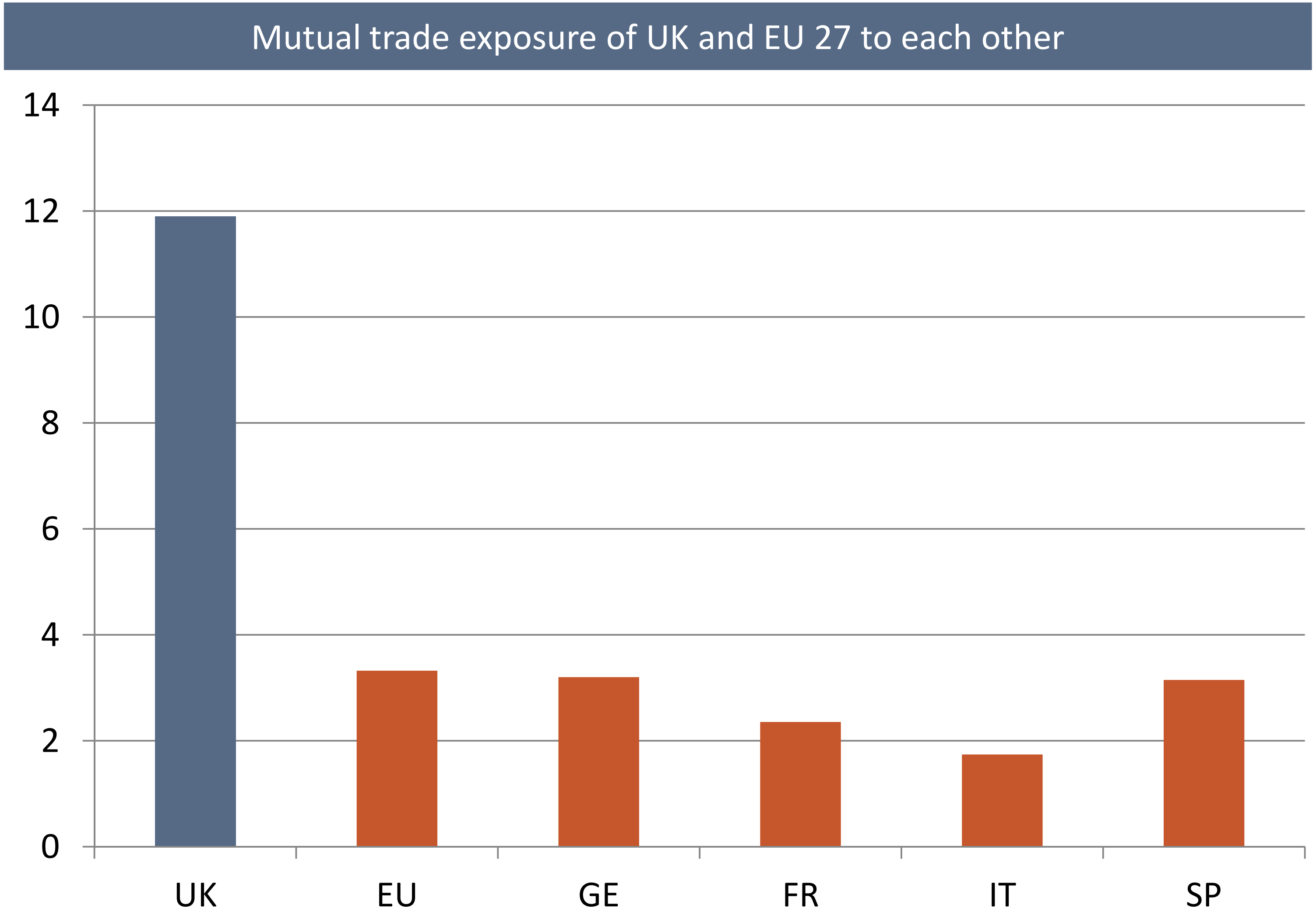
Possible trade options with the EU after Brexit

	World Trade Organisation (basic model)	Bilateral Agreements (Swiss model)	European Economic Area (Norway model)
Zero tariff trade within the area	No	Mostly goods – partial services	Yes but farming and fishing excluded
Free to set external trade policy	Yes	Yes	Yes
Votes on EU law	No	No	No
Free movement of people	No	Yes	Yes
Customs union	No	No	No
Fiscal contribution to EU budget	No	Yes	Yes
Shared business regulations and block on soft barriers such as state aid	No	Partial	Partial
Open service markets and passporting	No	Partial	Yes
Covered by external trade agreements	No	No	No
EFTA membership	No	Yes	Yes

Source: HM Government "Alternatives to membership: possible models for the UK outside the EU"

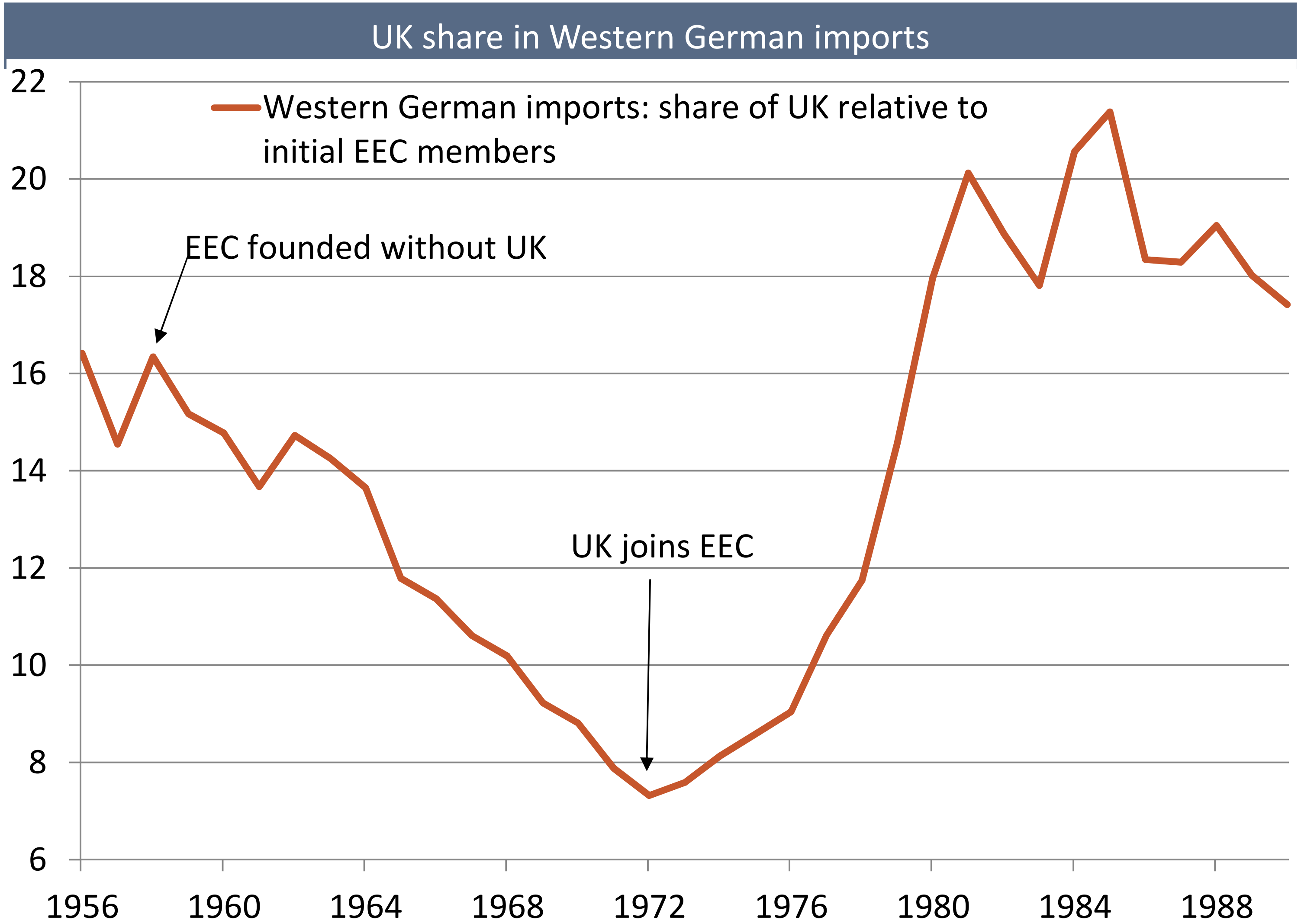
UK and EU27: who depends on whom?



UK data shows exports to EU 27 as % UK GDP. All other country data shows exports to UK as a % of GDP.
Source: ONS, Bank of England, Eurostat, Berenberg.

- Whereas the UK earns around 12% of its GDP through exports of goods and services to the EU, the EU 27 earns 3% of its GDP through its exports to the UK.
- In post-Brexit negotiations, the bargaining position of the EU will be much stronger than that of the UK.
- The individual exposure of the four largest EU economies to the UK is relatively small compared to the UK's exposure to the EU 27.

Britain beware: the power of trade diversion



UK share in Western German imports of goods, in % of Western German imports from original EEC members France, Italy, Benelux.
Source: Bundesbank.

- How would Britain fare outside the EU? Nobody knows for sure. But history holds a clear lesson.
- From 1958 to 1972, Britain stayed outside the European Economic Community (EEC). As EEC members traded more with each other, Britain lost market share so badly that it soon asked to be admitted to the club.
- After Europe finally allowed the UK to join in 1973, its market share rebounded sharply.
- Outside the EU, Britain would be at serious risk of losing out again.

Political risks in Europe

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The politics of populism

Populist protest parties are a nuisance across the Western world, from the US (Tea Party) to the UK (UKIP), from Sweden to Spain (Podemos), from France (Front National) to Greece (Syriza, Golden Dawn). They rail against the centre (Washington, Brussels), immigration and other indignities of modern life.

But key institutions in Europe (EU, euro) are more fragile than those in most nation states (US federal government, US dollar). As a result, populists could do more damage in the EU than in the US.

A right-wing populist backlash against immigration is the biggest risk to the cohesion of Europe as the issue of immigration often takes on an anti-EU edge ("need national control of our borders" = leave EU)

Key elections and political risks to watch:

- **Brexit fallout:** any domino effect? So far, the British vote has strengthened pro-EU sentiment elsewhere.
- **Greece:** Tsipras struggles to implement the deal he signed in August 2015. Once again, he prefers tax hikes over pro-growth reforms. That's bad for Greece. The silver lining: Greece now has a responsible opposition.
- **Spain:** Rajoy heads minority government, tail risk of new elections from May 2017 onwards.
- **Portugal:** Fragile left-wing alliance, reform reversals, fiscal challenges.
- **Italy:** Renzi at risk in 4 December 2016 constitutional referendum. "Five Stars" less radical? Berlusconi weak.
- **France:** Le Pen unlikely to win in 2017. Fillon could herald a major reform drive.
- **Germany:** Merkel under pressure in migrant crisis, but Germany remains solidly pro-EU and pro-Euro.
- **Austria:** Far-right candidate for ceremonial post of president ahead in some polls for 4 December repeat vote.
- **Turkey:** Will Erdogan stick to the deal and control Turkey's sea border again to contain the flow of refugees?

Migration: The big surge is over

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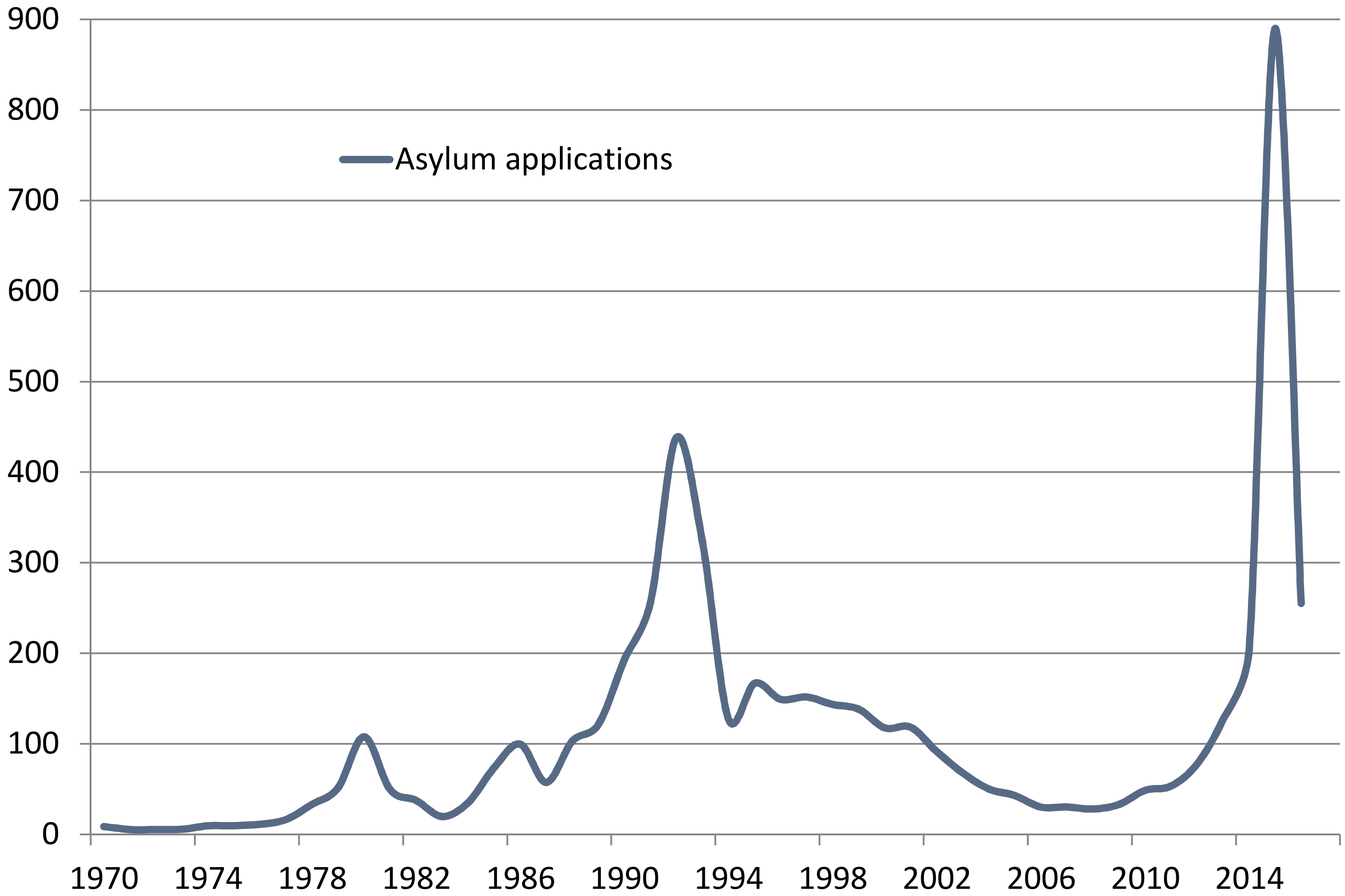
Number of new asylum seekers in Germany, in 1000

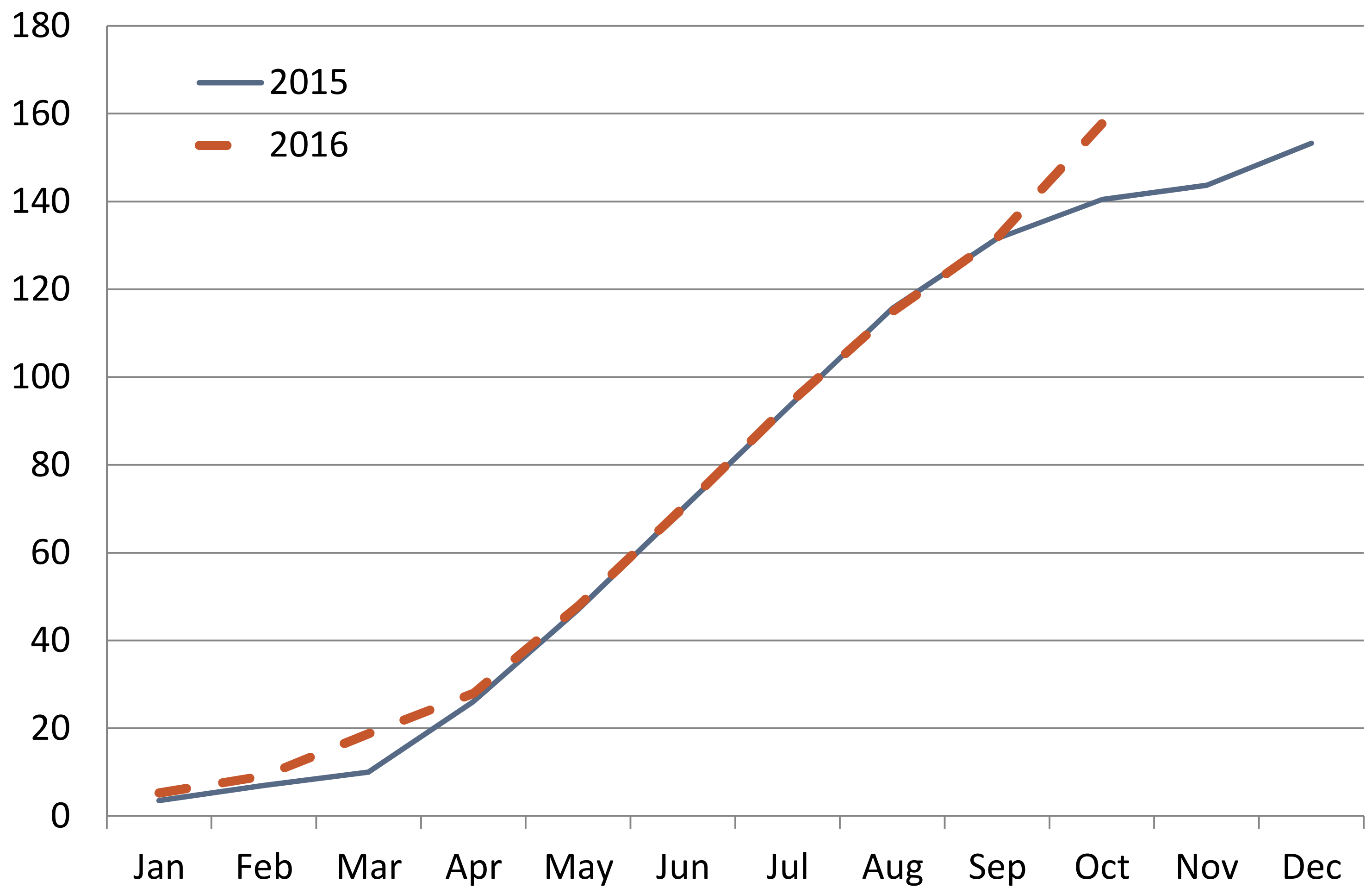


Number of asylum applications in 000s. 2015 and 2016 number of arrivals; 2016 estimate based on the January-September data.
Source: BAMF.

- Turkey's decision to allow refugees and migrants to cross into Greece freely started the 2015 migrant crisis.
- Macedonia closed the Balkan route in late February 2016.
- On 18 March 2016, the EU struck a deal with Turkey: money and an orderly resettlement of some refugees if Turkey takes some migrants back.
- Flow of migrants into Greece has slowed to a trickle.
- Europe will also have to maintain some internal border controls, keep more migrants in Greece and send more non-Syrians back.
- Germany has become less welcoming to would-be migrants. The number of new arrivals has fallen to a level that seems manageable.

The other migrant flow: from North Africa into Italy

Small uptick at the end: cumulative number of arrivals in Italy, year-to-date

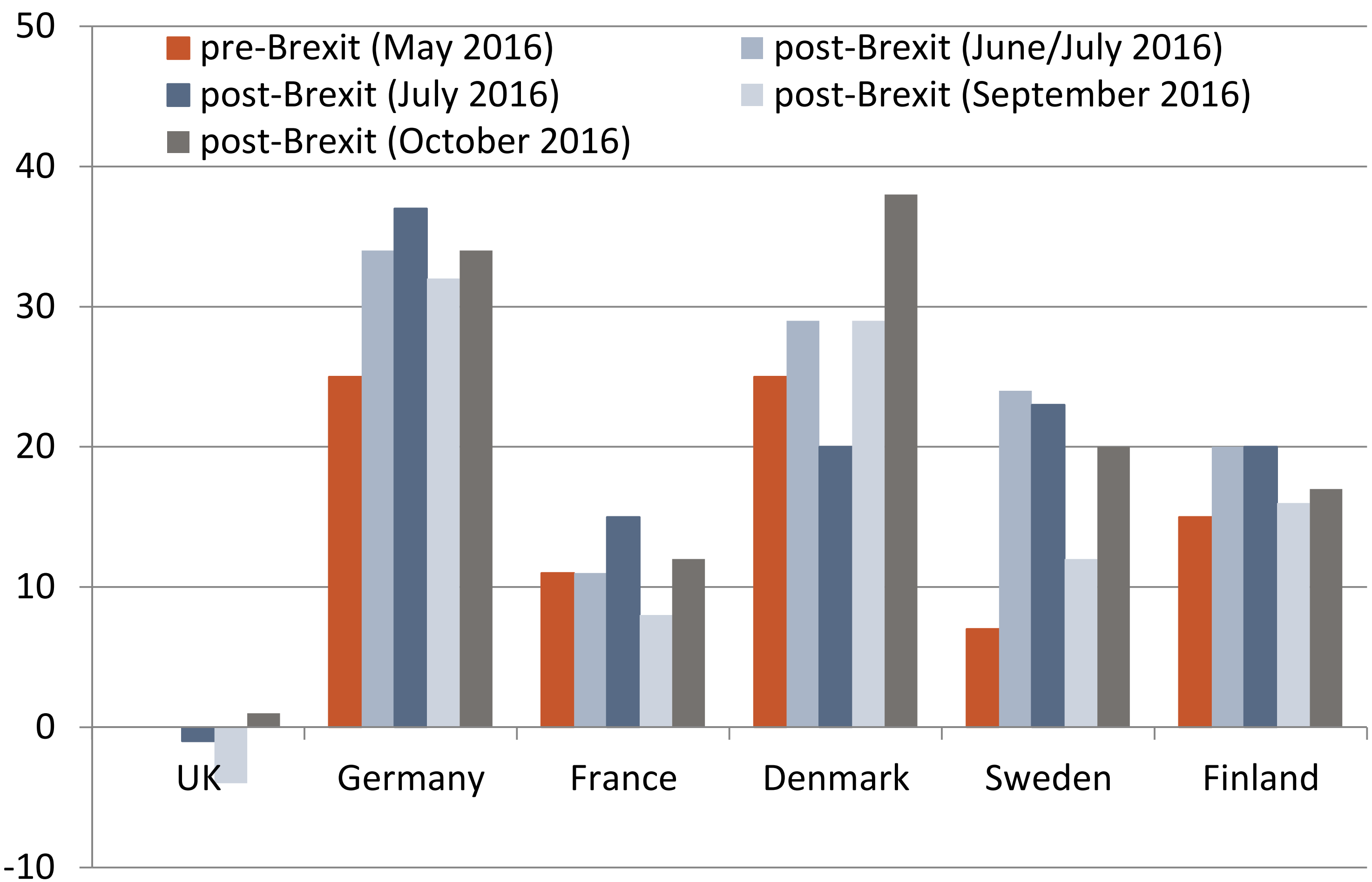


Mediterranean sea arrivals to Italy, In 1000s. Data for October2016 extrapolates the arrivals on 1-9 October for the full month.
Source: UNHCR.

- In 2015, 857k migrants and refugees arrived in Greece from Turkey. At the same time, 154k migrants crossed the Mediterranean from North Africa into Italy.
- Whereas the flow of people from Turkey into Greece has fallen sharply, the flow of mostly African migrants from Libya and Egypt into Italy stayed at 132k in the first nine months of 2016, in line with 2015.
- The number of arrivals did not drop in October, as it had done in 2015. This is a burden on Italy.
- Discouraging migrants who lack the required skills for the EU labour market while accepting genuine refugees will be a top priority for the EU.

Brexit contagion? EU approval rises instead

EU approval post- vs. pre-Brexit : Net balance of remain-leave in hypothetical referendum

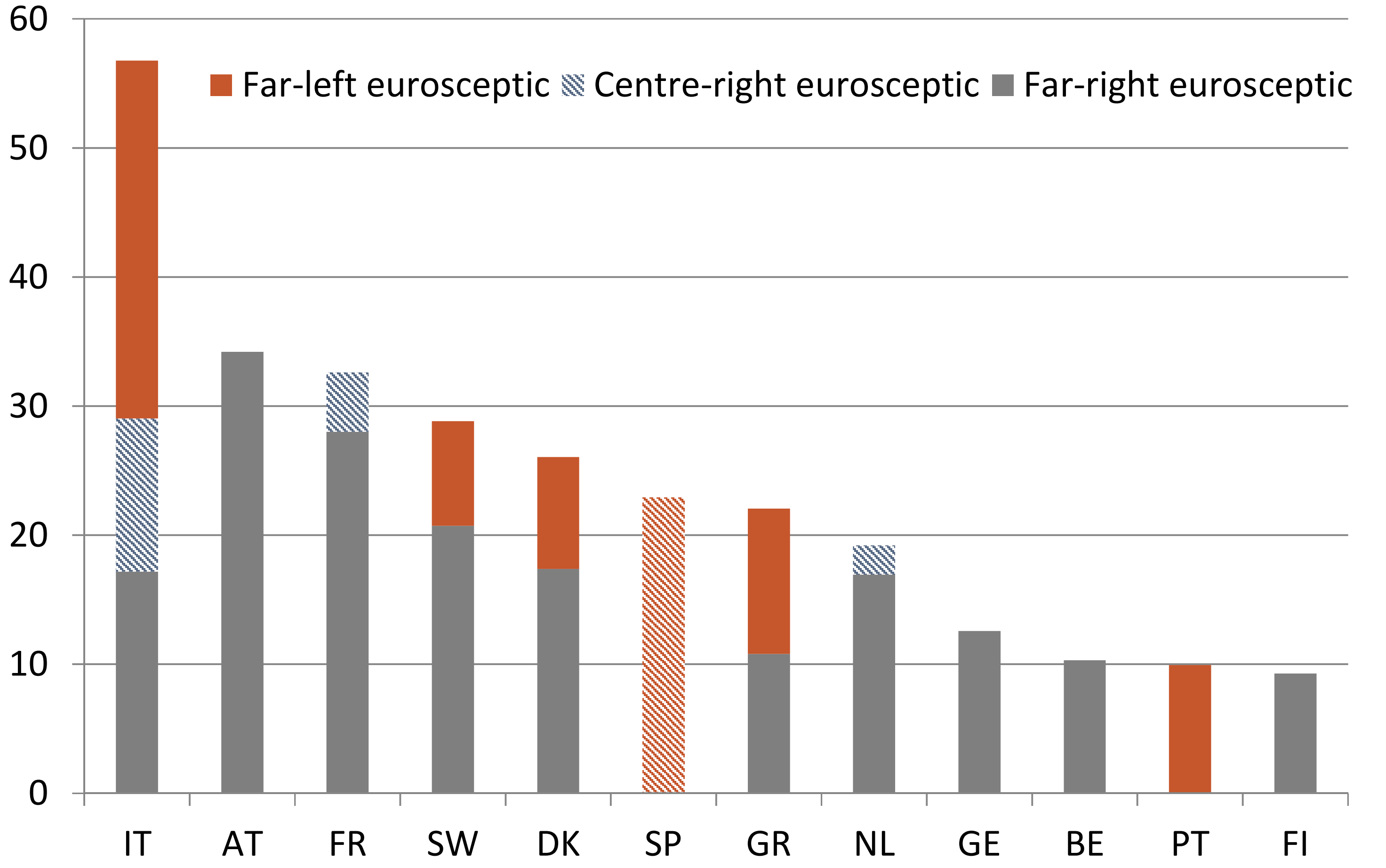


"If there was a referendum on EU membership, how would you vote?", net balance of "remain" and "leave" responses.
Source: YouGov Eurotrack 2016.

- After the Brexit vote, support for the EU has risen in many other countries.
- The „stay" lead ranges from 12 points in France to 34 points in Germany and 38 in Denmark.
- The uncertainty that has befallen the UK seems to act as deterrent against anti-EU populism in many other EU-27 countries.
- In Britain, the YouGov poll gives a small lead for „remain" in October, after leads for „leave" in July and September (and ties for May and June/July).

The politics of anger

Share of vote for EU- or euro-sceptic populists in national opinion polls



Italy: Lega Nord, FdI, Forza Italia (striped), Five Stars; Austria: FPÖ; France: Front National, DLF (striped); Denmark: DPP, Red-greens; Sweden: Sweden Democrats, Left Party; Netherlands: PVV, SGP (striped); Greece: Golden Dawn, LAEN, EE, KKE, PE; Spain: Unidos Podemos (striped); Germany: AfD; Belgium: Vlaams Belang; Portugal: BE; Finland: PS; relevant parties only; average of last five polls; striped means position somewhat unclear. Source: national opinion polls, Wikipedia, Berenberg calculations.

- The cohesion of Europe depends on the political will of its members to stay in the club and accept its rules.
- Populists from the left and the right have gained votes in the wake of the great financial crisis.
- The sorry fate of Greece has dampened the allure of left-wing populists somewhat.
- Extremes do meet. Classifying radical populist movements is not always easy. Italy's Five Stars are showing traits of hard left and hard right populism.

Italy: Renzi at risk in referendum to downgrade Senate

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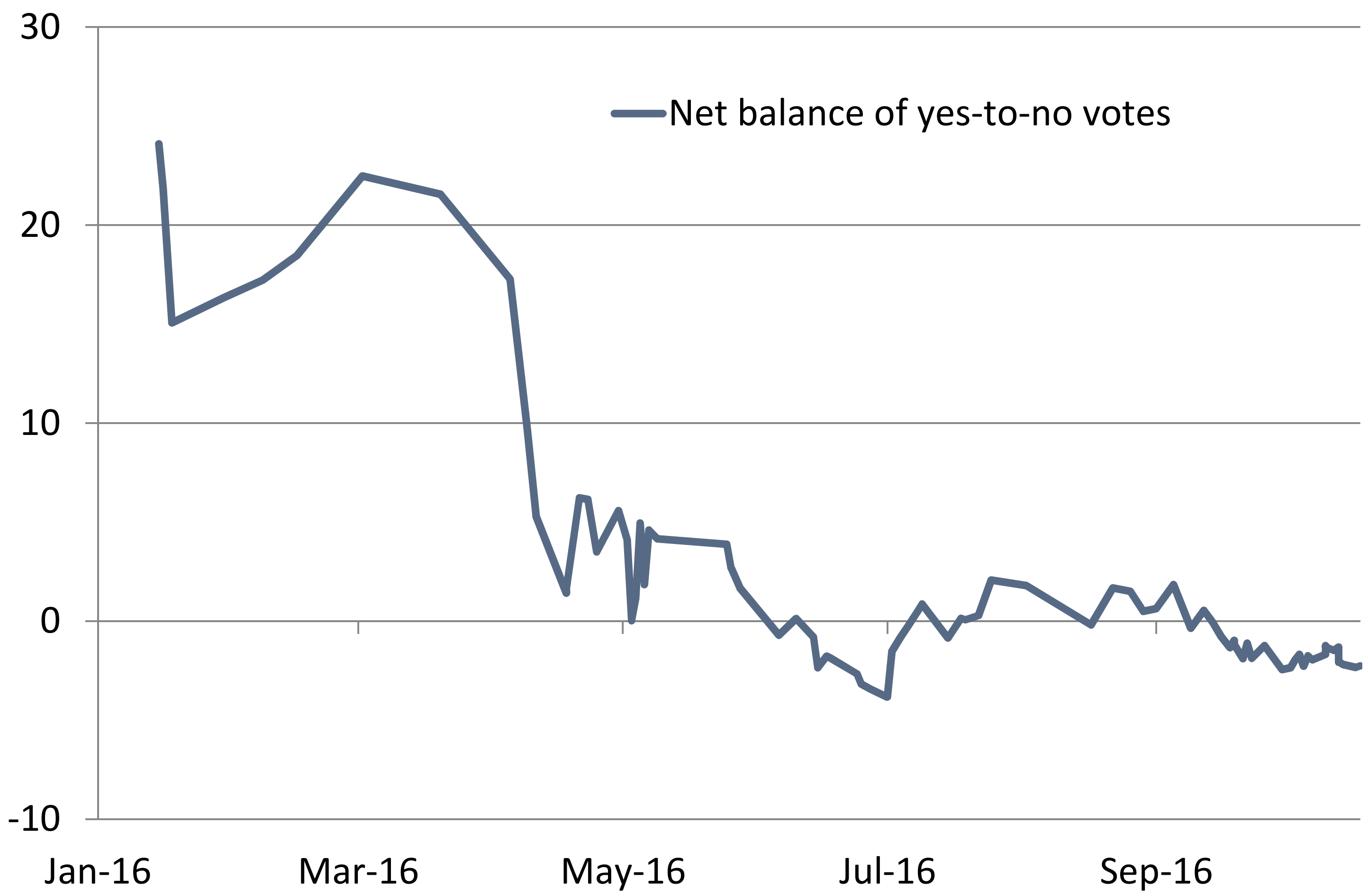
Italian opinion polls: Yes or no to constitutional reform?



Average of 5 latest available polls.
Source: National opinion polls, Berenberg calculation.

- Prime Minister Renzi needs to win a referendum on 4 December 2016 to ratify the de facto abolition of the Senate.
- That introduces a degree of uncertainty. Renzi has stated that he would resign if he does not win the vote.
- What if Renzi resigns? His government could try to soldier on without him. His centre-left coalition holds 340 of 630 seats in the lower house of parliament.
- But if the government fell apart and Italy needed early new elections, populists from the left and right would campaign with a call for a euro referendum.
- We see a 15% risk of early new elections in 2017.

Italy: Centre-left has lost its clear lead

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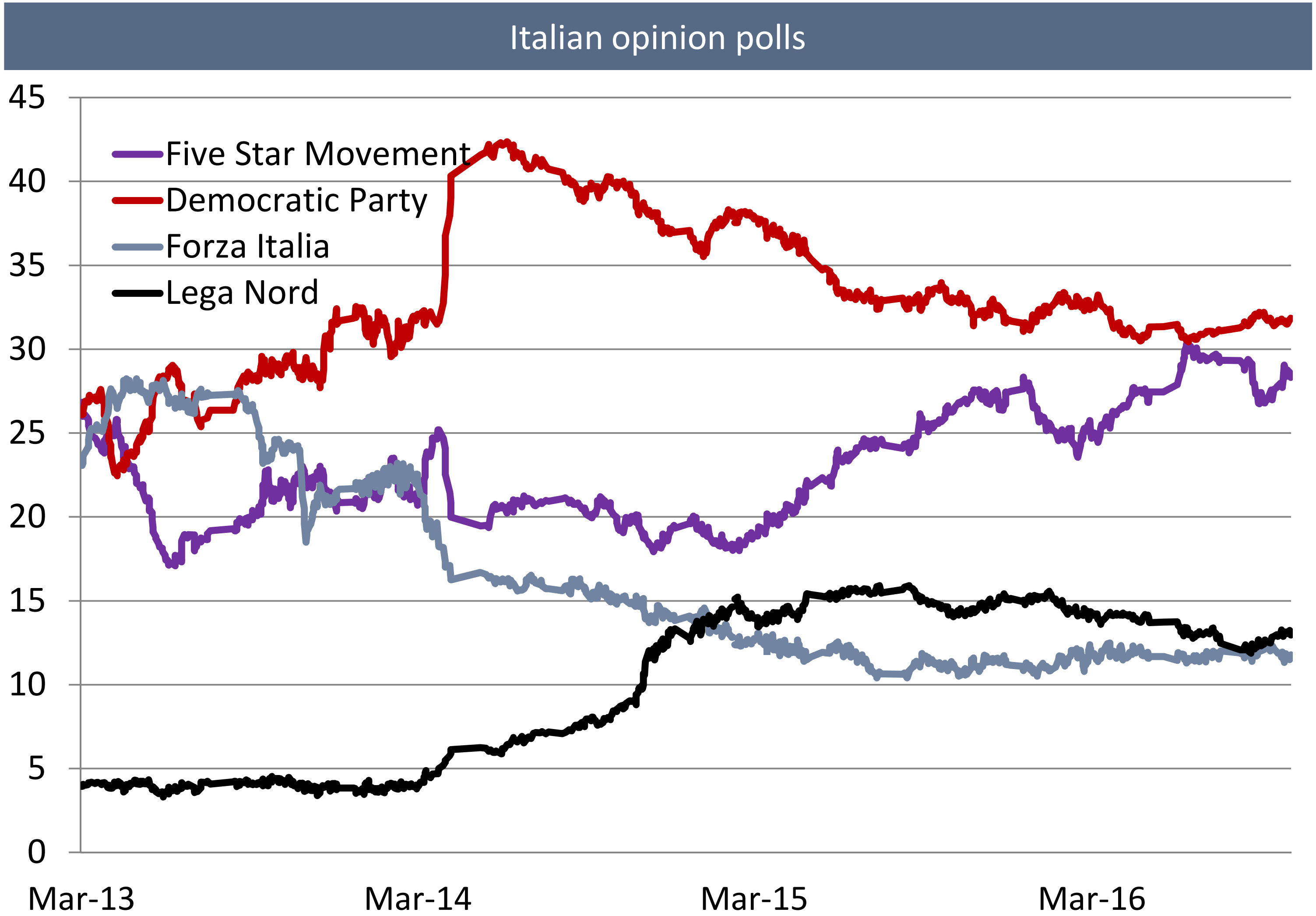

Centre-left Democratic Party, centre-right Forza Italia (Berlusconi), radical left Five Star Movement (Grillo), ultra-right Lega Nord, average of 5 latest available polls. Source: National opinion polls, Berenberg calculation.

- Renzi remains popular, but much less so than he was when he started in early 2014.
- The next regular election is not due before May 2018.
- One big problem: Italy has no responsible centre-right as Berlusconi's Forza Italia is in disarray.
- The radical left Five Star movement may become less extreme over time as it gains some administrative experience. Having won the city of Rome, the Five Stars are now engulfed in a few scandals there.
- Early elections in Italy could unsettle markets. But that Italy could choose to leave the euro still looks very unlikely.

Spain: political stalemate resolved – for now

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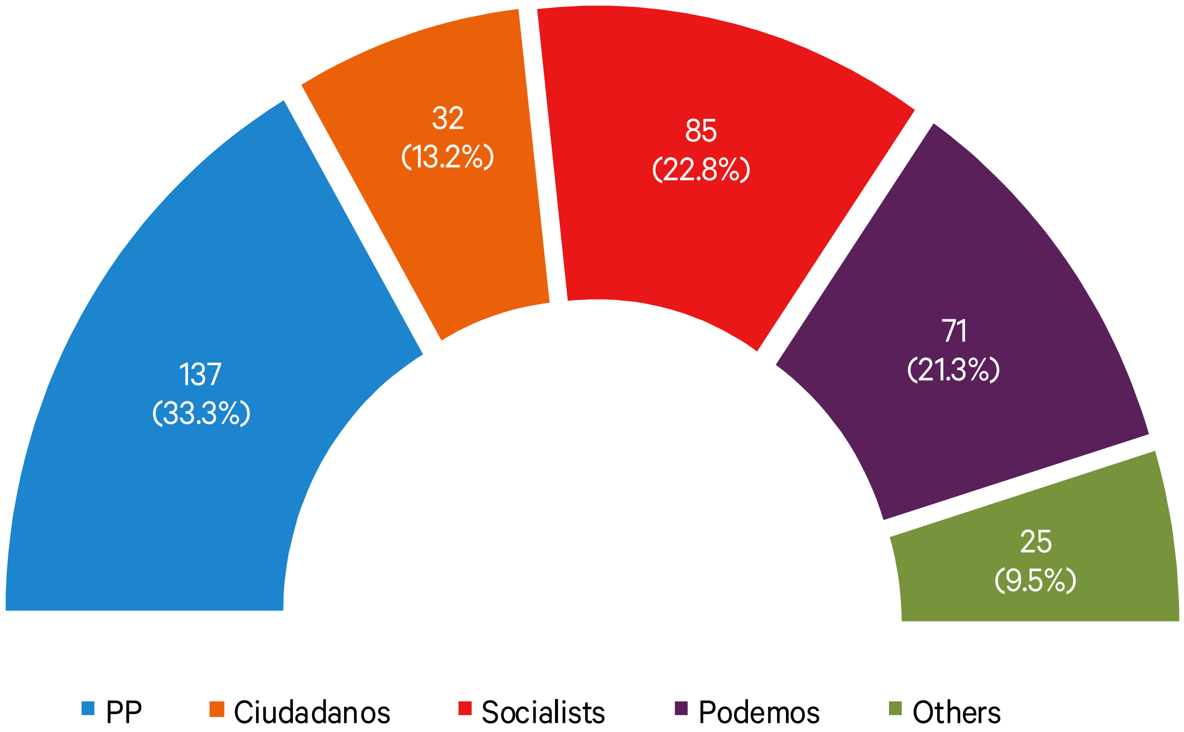
Seats in the Spanish parliament and voting shares June 2016



Seats in Spanish parliament after 26 June 2016 election, in brackets: share of national vote: others: regional and left-wing splinter parties.
Source: Spanish election commission.

- Rajoy stays on.
- After the centre-right Popular Party (PP) rebounded in repeat elections in June, the Socialists finally ousted their hardline leader and decided to tolerate a Rajoy minority government.
- Alternative of a Socialist government with ultra-left Podemos and Catalan nationalists foundered on the issue of an independence referendum for Catalonia.
- But even with the help of the Liberals and one friendly independent, Rajoy can count merely on 170 votes. That does not suffice to pass a budget unless the Socialists abstain again.
- A risk remains that Rajoy has to call new elections after six months.

Spain: Rajoy would have the upper hand in new elections

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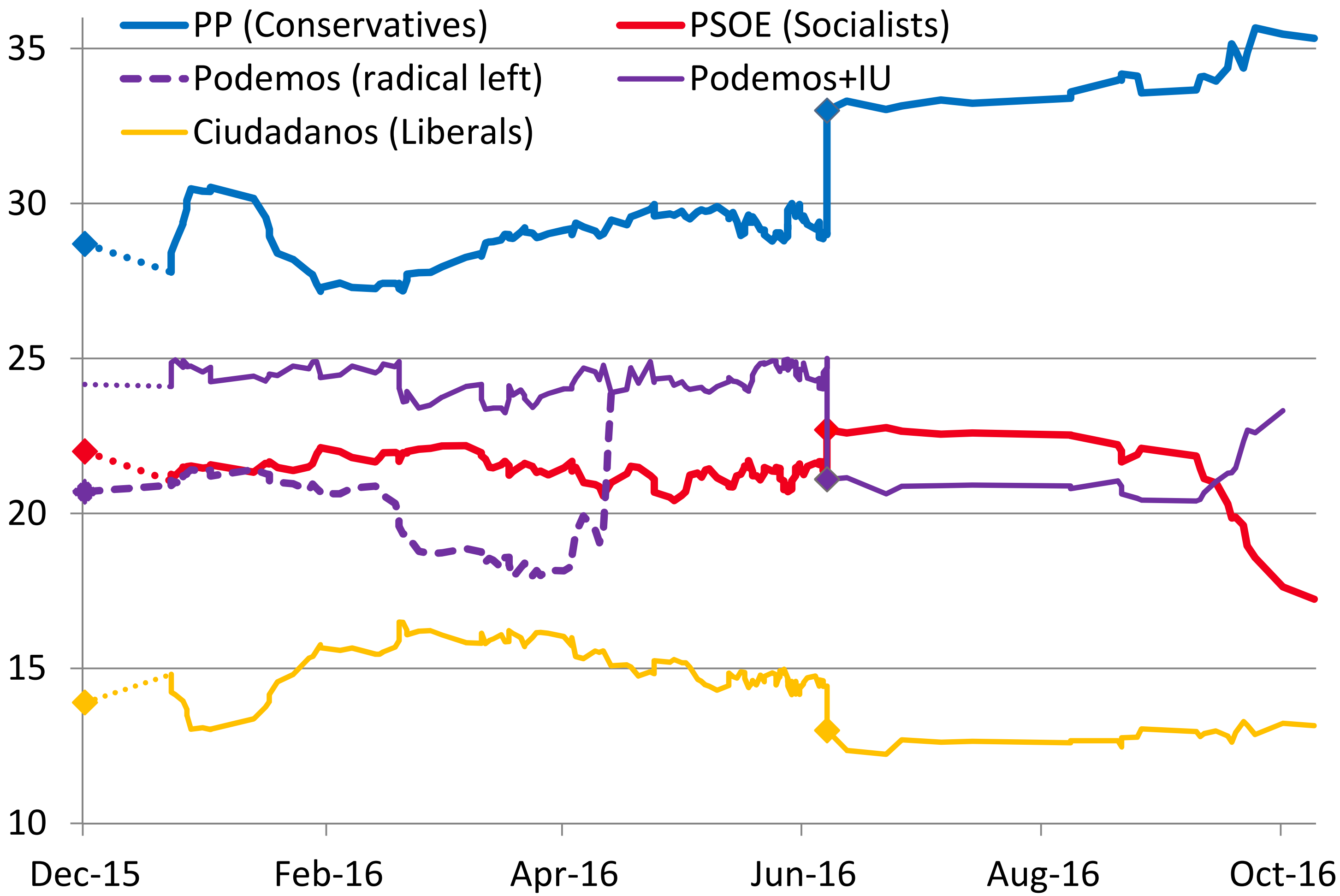
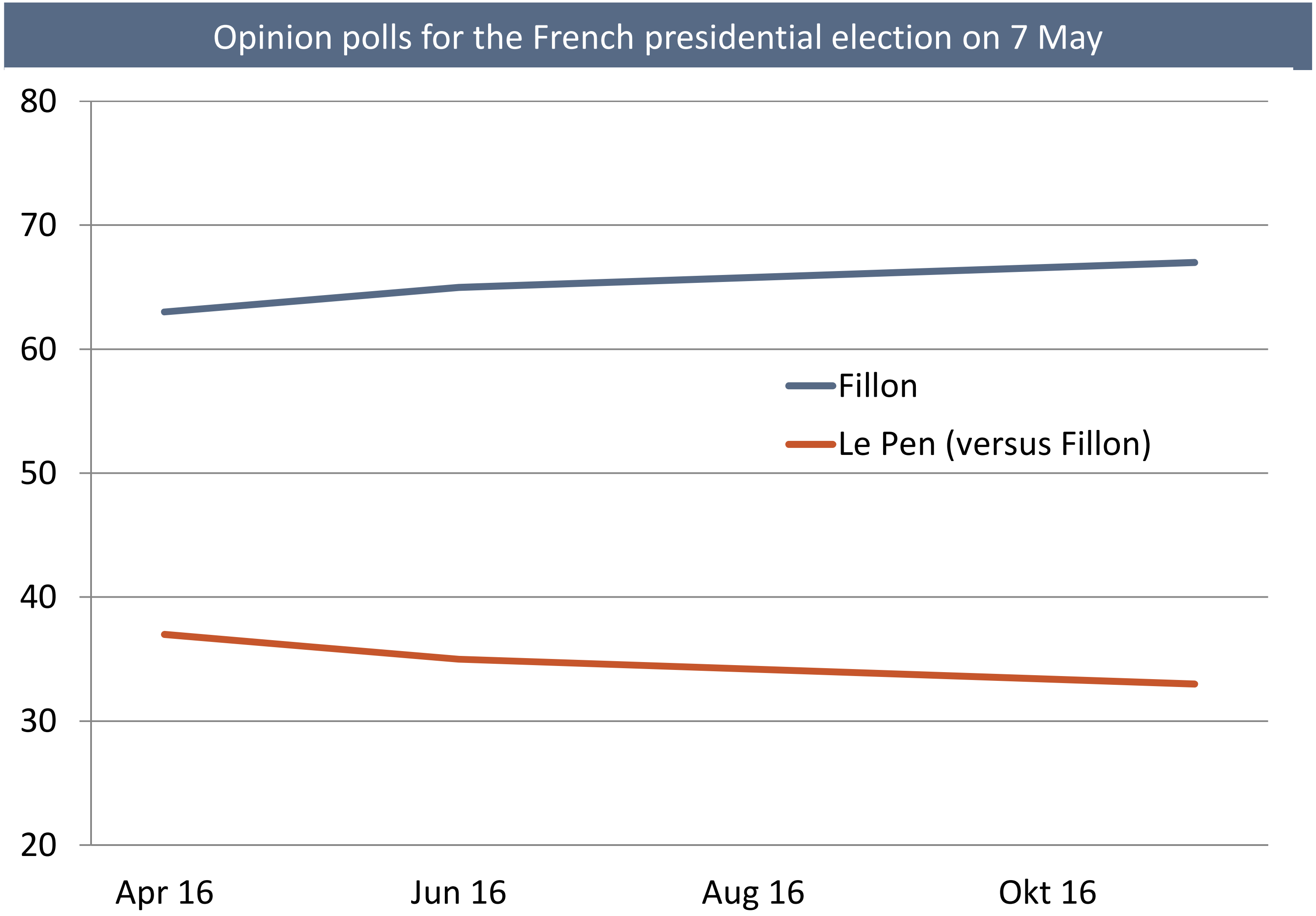
Opinion polls for the next national election



Opinion polls in Spain, first value: 20 December 2015 result. Sudden jump on 26 June 2016: result of repeat election.
Source: Spanish election commission, national opinion polls, Berenberg calculations.

- Prime minister Rajoy heads a minority government
- The initial refusal to tolerate a Rajoy minority government and the subsequent infighting has hurt the Socialists. Opinion polls show a further shift towards Rajoy's centre-right since the 26 June repeat election.
- The first test for Rajoy will be the budget
- Rajoy probably has the upper hand for now. Rajoy could call new elections from may 2017 onwards if need be.
- As long as the Socialists want to avoid early new elections, they will have to offer Rajoy minimum support for a budget.
- Expect few economic reforms – and few reform reversals. For Spain, that is good enough.

French opportunity: Fillon against Le Pen



Support for candidates in the second round of the presidential election if Fillon runs against Le Pen.
Source: Ifop, BVA and Harris.

- The centre-right candidate Francois Fillon looks set to make it into the run-off round for the presidential election on 7 May 2017.
- Fillon will likely win that vote, presumably against ultra-right Marine Le Pen.
- Could eurosceptic Le Pen win? Populist upsets are a big risk. But Le Pen would need to win the popular vote. Not even Trump did that in the US.
- Fillon wants serious reforms. He wants to liberalise the labour market, raise the pension age and trim the public sector.
- That is exactly what the French economy needs.
- A Schröder or Thatcher moment for France?

Germany: More votes for the small fry = Merkel at risk?

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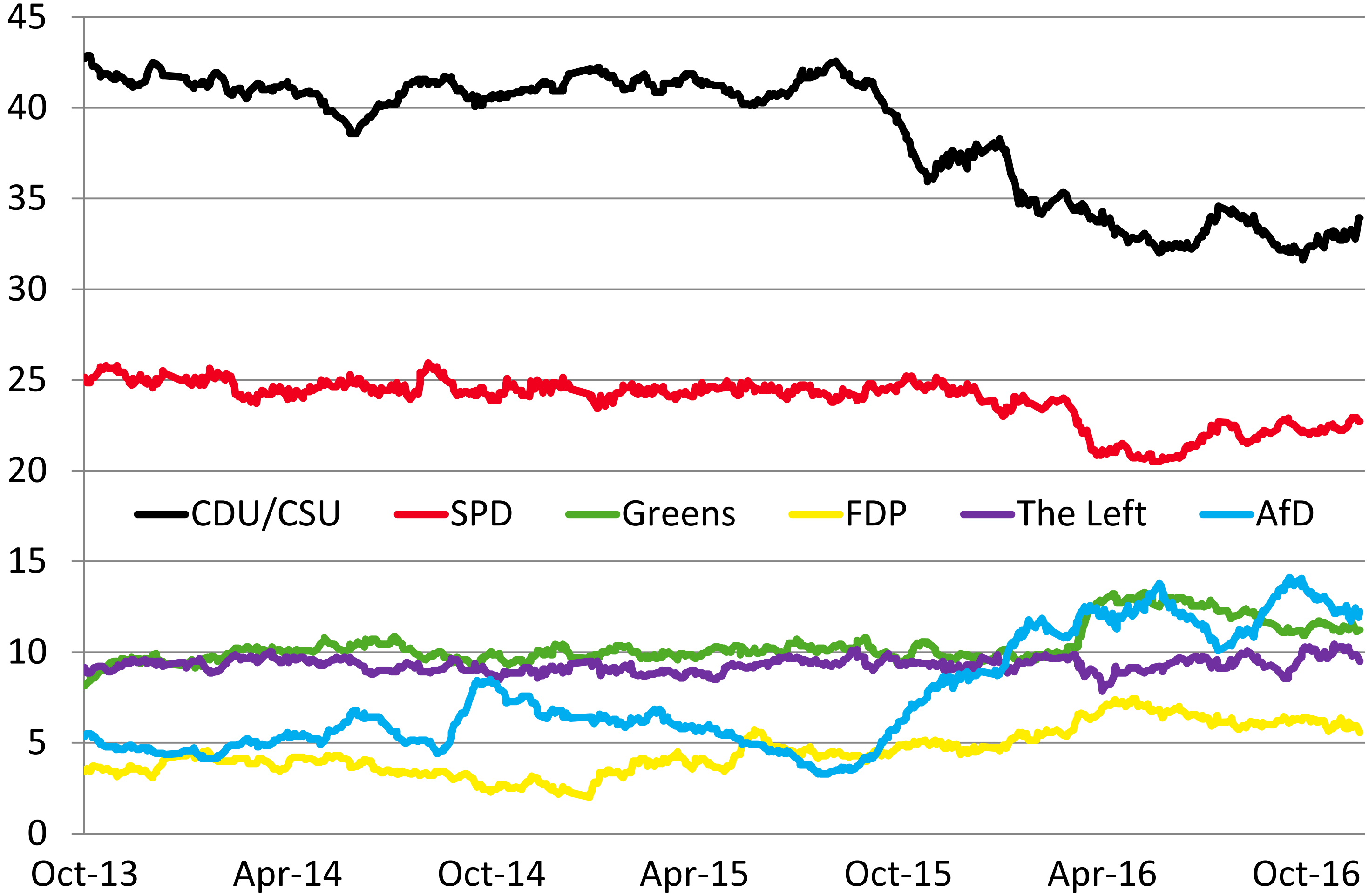
German opinion polls: centre-right loses some support to radical right



Centre-right CDU-CSU, centre-left SPD, centre-left Greens, liberal FDP, ultra-left The Left and radical right AfD. Source; average of 7 latest available polls.
Source: National opinion polls, Berenberg calculation.

- Refugees less welcome: support for chancellor Merkel's CDU/CSU has fallen from 41% to 34% in opinion polls.
- The refugee issue gave a big boost to the radical right AfD, especially in regional elections. In national polls the party scores currently 12%.
- Merkel at risk? Probably not. She has no obvious rival or successor. We expect her to win the September 2017 elections.
- But what if? Even without Merkel, any conceivable coalition in Berlin would be solidly pro-EU and pro-euro.
- Merkel has three potential coalition partners for next year: the reds, the Greens and the liberals.

Global economic forecasts

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	Weight	GDP				Inflation				Unemployment				Fiscal balance			
		2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018	2015	2016	2017	2018
World*	100.0	2.3	2.2	2.5	2.7												
US	22.5	2.6	1.6	2.4	2.9	0.1	1.3	2.2	2.4	5.3	4.9	4.7	4.5	-2.4	-3.0	-3.2	-3.6
China	13.4	6.9	6.7	6.4	5.9	1.4	2.0	2.2	2.3	4.0	4.1	4.3	4.3	-2.3	-3.0	-3.0	-3.0
Japan	6.0	0.6	0.7	1.0	1.1	0.8	-0.2	0.4	0.5	3.4	3.1	2.9	2.9	-6.5	-6.3	-5.0	-4.0
India	2.7	7.2	7.5	7.5	7.8	6.8	4.5	4.5	4.7					-6.9	-6.5	-4.0	-3.6
Latin America	7.5	-0.5	-1.3	1.9	2.7	14.9	28.3	20.8	9.3					-7.0	-6.9	-6.2	-5.5
Europe	29.8	1.3	1.4	1.5	1.7												
Eurozone	17.3	1.9	1.6	1.5	1.5	0.0	0.2	1.3	1.6	10.9	10.1	9.7	9.4	-2.1	-1.9	-1.7	-1.5
Germany	5.0	1.5	1.7	1.5	1.6	0.1	0.3	1.4	1.6	4.6	4.2	4.4	4.5	0.7	0.6	0.3	0.1
France	3.7	1.2	1.2	1.1	1.3	0.1	0.3	1.2	1.5	10.4	10.3	9.8	9.3	-3.5	-3.3	-3.1	-2.9
Italy	2.8	0.6	0.8	0.9	1.1	0.1	0.0	0.8	1.1	11.9	11.6	11.3	10.9	-2.6	-2.6	-2.5	-2.3
Spain	1.8	3.2	3.2	2.5	2.3	-0.6	-0.4	1.2	1.6	22.1	19.7	17.9	16.2	-5.1	-4.1	-3.4	-2.8
Portugal	0.3	1.6	1.2	1.2	1.3	0.5	0.7	1.4	1.5	12.7	11.2	10.3	9.7	-4.4	-2.9	-2.6	-2.4
Other Western Europe																	
UK	3.8	2.2	2.1	1.5	1.5	0.1	0.6	2.5	2.4	5.3	4.9	5.1	5.3	-4.4	-3.7	-3.2	-2.7
Switzerland	0.9	0.8	1.1	1.3	1.6	-1.1	-0.4	0.3	0.6	3.2	3.4	3.6	3.5	-0.2	-0.2	-0.1	0.4
Sweden	0.7	3.8	3.1	2.4	2.1	-0.1	1.0	1.6	1.8	7.4	6.9	6.7	6.5	-1.1	-0.5	-0.5	0.4
Eastern Europe																	
Russia	2.4	-3.7	-0.6	1.0	1.8	15.6	7.0	4.9	5.2	5.6	6.5	6.2	6.3	-2.8	-4.0	-2.9	-2.5
Turkey	1.0	4.0	2.9	2.8	3.3	7.7	8.0	8.3	8.3	10.6	11.0	11.3	11.2	-1.7	-2.1	-2.1	-2.1

Unemployment rate: Harmonised definition (ILO/Eurostat); fiscal balance: general government deficit in % of GDP excluding one-off bank support.

*At current exchange rates, not purchasing power parity. PPP estimates give more weight to fast-growing emerging markets and inflate global GDP.

Weights based on IMF World Global Outlook statistics 2014 GDP figures. Source: Berenberg

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