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THE BIG PICTURE: GROWTH, SENTIMENT AND MARKETS

Berenberg Macro Flash

What a difference a year makes. In the first half of 2016, markets worried excessively about perceived risks of a hard landing in China, deflation in the Eurozone and a potential recession in the US. Grave political risks seemed to loom front, right and centre. On my most recent roadshows in Europe and the US, I was struck by how much sentiment has turned: unlike before, few investors disagreed with the assessment that the world is coping fairly well with the risks and that the Eurozone will continue to muddle through quite successfully.

Are markets now swinging too much into rosy optimism to make up for the excessive pessimism of early 2016? In my view, that is not yet the case. None of the major developed economies is displaying the kind of credit, wage or investment excesses that would require a cleansing correction soon. Fundamentals underpin a positive outlook for the global economy with room for the Eurozone to catch up somewhat with the US. We expect Macron to deliver serious reforms in France. That will have a positive effect on the Eurozone as a whole. At least for the Eurozone, risks to our-above consensus growth forecasts are still tilted to the upside.

Start with a few key facts: in the last two quarters, Q4 2016 and Q1 2017, GDP expanded at an average annualised rate of 1.6% in the US, 1.7% in the UK and 2.0% in the Eurozone. For the US, the most recent result probably understates the underlying momentum slightly after average annualised growth of 1.9% in 2015 and 2016. For the UK, recent data are broadly in line with the average annualised pace of growth in the last two years of 1.8% whereas the Eurozone seems to have gained a little extra momentum beyond the 1.7% average pace of the last two years.

WHAT IS DIFFERENT THIS YEAR?

On balance, recent hard data for the key economies on both sides of the Atlantic are not (yet) far away from the 2015-2016 averages. So what has changed since early 2016?

1. The outlook for **global trade** has improved. Despite renewed concerns about Brazilian politics and Chinese debt, many emerging markets are in better shape than they were some 15 months ago. The adjustment crisis that many of them went through in late 2015 and early 2016 is largely over. In addition, China has once again shown that it has not yet exhausted its ability to fuel continuing growth through a further build-up of debt.

2. **Sentiment** has brightened significantly, especially with regards to the Eurozone. Hard data cannot fully explain that shift. With an average annualised pace of real GDP growth of 2.0% in Q4 2015 and Q1 2016 and core inflation of 0.9% yoy, the key backward-looking data for the Eurozone a year ago were virtually identical to what they are now. Instead, the shift in sentiment mostly shows that some of the past concerns had been overdone, including those about deflation risks in the wake of the oil price collapse.

3. Markets are taking **political risks** much more in their stride after key risks discussed in 2016 failed to take a major immediate toll on economic performance. Brexit will likely reduce UK trend growth from 2.2% to 1.8% over time as fewer skilled people move to the UK and businesses expand their capacities at a slower pace. However, the Brexit vote has not derailed the UK business cycle. In the US, the rather unusual president Donald Trump has neither started a trade war with China nor struck a deal with Russia's Putin at the expense of Europe. Although he generates serious noise and

seems to undermine the global soft power of the US, the worst fears that he had raised with his campaign rhetoric have not materialized, at least not yet.

4. **Brexit** and **Trump**, **Putin** and **Erdogan** have discredited right-wing populists across much of core Europe. Instead, pro-EU sentiment has strengthened in many countries. The tail risk of a euro breakup has receded further. Although it is still early days, recent votes in the Netherlands, France and some German regions suggest that support for right-wing populists may have peaked.

These factors have supported the broad-based gains in Eurozone economic sentiment over the last six months. Despite a small correction in May, the European Commission's gauge of economic sentiment remains close to its highest level since September 2007. In line with a buoyant assessment by purchasing managers as captured in the PMI indices, these surveys indicate some upside risk to our calls for Eurozone GDP growth of 1.8% in 2017 and 1.7% in 2018. With no sign of a major rise in inflation for the foreseeable future, it is "not too hot, not too cold" time for the Eurozone..

GLOBAL CONCERNS: US AND CHINA

Some of the rise in markets since last November has been based on hopes for a major **US fiscal stimulus** to come. To some extent, export-oriented Europe is a leveraged play on the US and global economy. Genuine fiscal and regulatory **reforms** to strengthen supply and hence long-term trend growth in the US would turn the US into an even more attractive market for exports. However, a mere US **fiscal stimulus**, that is a debt-financed boost to US demand, would not necessarily be good for Europe. By pushing the US above its trend growth rate, such a boost could compress the US business cycle. Although it would add some vigour short-term, it would raise the risk that the Fed would have to end the party earlier than otherwise to combat an excessive rise in wage inflation. In such a scenario, Europe could expect to benefit slightly first while US growth accelerates beyond trend but to be hit hard once the Fed takes the punch bowl away.

The **Eurozone** recovery from the post-Lehman crisis had been interrupted for two years by the euro confidence crisis of 2011-2012. As a result, the Eurozone is further away from any domestic overheating risk and any excesses that would need to be cleaned by a subsequent recession than, say, the US or the UK. Moderate growth in line with the underlying trend in the US and other key trading partners would give the Eurozone recovery more time to mature. But even if US demand growth gets a boost from a fiscal stimulus in 2018, as we expect, a subsequent US correction that could have a material impact on the Eurozone would probably not be due before 2020 at the earliest.

As the global economy No. 3 after the US and the Eurozone, **China** matters. A major crisis in debt-ridden China would hit global and European financial markets as well as business confidence and investment much more than, say, a hard Brexit would. Seen from afar, China's accumulation of debt seems unsustainable. Although China is again trying to rein in shadow banking activities somewhat, it remains unclear whether China can defuse its debt problems before they become more dangerous. Fortunately, a corrective crisis does not seem to be imminent. Much of the debt is within the state-controlled sector, between state-owned enterprises and state-owned banks. That makes it easier to settle debt issues. Also, low inflation would allow the central bank to underwrite bad debt and expand its balance sheet if necessary to prevent a major financial crisis.

MORE OPPORTUNITIES THAN RISKS

On balance, we see more opportunities from reform progress in France under Macron than we see risks from potential upsets such as a strong showing of euro-sceptic parties at early elections in Austria and potentially Italy this autumn.

Of course, we need to watch the key risks closely. Does the US economy overheat prematurely? Is China heading for a grave financial crisis? Could populists win elections in Italy and really dare to bankrupt the country and its wealth-owning citizens by taking Italy out of the euro? By and large, the risks seem to be well contained for the time being. In addition, markets that had been excessively nervous and excitable in the immediate wake of the Lehman and euro crisis seem to have learned to cope with the inevitable degree of uncertainty. Across Europe, leading economic indicators have moved up in the last six months. Even if they now move sideways with occasional corrections from their current elevated levels, they would remain in line with growth at or slightly above trend.

Yes, the observation that a positive outlook in general and cautious euro-optimism in particular have gone mainstream does make me a little nervous. Still, economic fundamentals and the balance of risks warrant a positive outlook for the time being, both for major economies and for financial markets.

For a more **thorough discussion of key fundamentals,** see Mickey Levy's report on global growth and profit gains.

For our **complete set of forecasts**, see forecasts at a glance

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