BERENBERG
PARTNERSHIP SINCE 1590

MACRO NEWS 12/02/18

Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

MONDAY MACRO UPDATE: MARKET RISKS, GERMAN POLITICS, BREXIT

Berenberg Macro Flash

MARKET CORRECTION: ASSESSING THE RISKS

Ups and downs are part of life. For an economist, the key question is whether the severe correction in equity markets may herald the end of the post-Lehman economic upswing? That seems highly unlikely to us. As discussed a week ago upon analysing the economic implications of the stock market rout, we do not yet find the excesses in credit, investment, wage growth or inflation that would require a cleansing recession. While the equity market correction itself may have a temporary modest impact on some measures of confidence, we look for the current situation to turn into a minor version of 1987 when the economic cycle even gathered some momentum in the years after a much-discussed stock market sell-off. For an in-depth analysis of the US situation, see Mickey Levy's piece Rude financial correction not likely to sidetrack solid economic momentum.

The correction was sparked by a rise in one measure of US wage inflation. However, across the developed world, wage growth is still way off the danger zone. In addition, productivity growth can help to keep inflation at bay. On balance, we maintain our view that the economic recovery in the developed world will continue and that economic fundamentals will remain broadly supportive for financial markets. After years in which inflation has surprised to the downside, central banks will not overreact to a gradual return to more normal rates of wage gains and core inflation. Upon gradually normalising policy, they will take care to not thwart healthy rates of economic growth.

GERMAN POLITICS: CALMING THE CHOPPY WATERS

Despite a lot of noise, German chancellor Angela Merkel looks set to be formally re-elected for a fourth and final term ahead of the EU summit on 22-23 March. After a turbulent week, Merkel and her would-be coalition partner SPD are trying to calm the waters. Facing some backlash from her CDU rank-and-file against ceding the finance ministry to the SPD, Merkel explained in a rare TV interview on Sunday that the coalition talks would have failed otherwise. She vowed to stay on for a full four-year term and to make sure that the list of six CDU ministers to be revealed ahead of a party convention on 26 February would include a mix of older and younger people. Observers will scrutinise the list for any sign of early-stage succession plans. Merkel's authority has been weakened somewhat by the problems of building a coalition and the need to grant the SPD the finance ministry. Still, the CDU remains so focussed on Merkel that – after some grumbling – her party will likely endorse the coalition deal with a large majority.

After the demise of SPD leader Martin Schulz, the party's board wants to appoint the younger and energetic Andrea Nahles as acting chairwoman on Tuesday. After the headline-grabbing departure of Schulz under pressure, the SPD is probably now even more afraid of repeat elections than before. This makes it more likely that the 460k party members will vote in favour of the "grand coalition" with Merkel in their upcoming referendum (results to be published on 4 March). The very discussion within the CDU about ceding the finance ministry will also help the weakened SPD leadership to sell the deal to their party members. According to an Emnid poll, 84% of SPD supporters (a much broader group than party members) and 57% of all Germans want the SPD to say "yes". While the vote will likely be much closer than this poll suggests, the risk of an SPD "no" to the coalition deal seems to have receded a little. A tail risk remains, though.

On substance, we do not expect the transition to Olaf Scholz (SPD) as new German finance minister to make a major difference. The current mayor of Hamburg is seen as safe pair of hands on the more conservative side of his party. He has vowed to maintain the "black zero", that is a small budget surplus at the federal level. Also, the coalition deal circumscribes his room for extra spending. On European issues, he will play a significant role in negotiations. But as was the case with Wolfgang Schäuble, Merkel will ultimately call the shots. The German position will not soften by more than the conservative parts of the CDU/CSU can accept. For example, the coalition agreement makes it clear that the role of national parliaments (the power to veto serious financial commitments) will not change. See also German coalition: they have a deal, but not yet a government.

BREXIT: A LITTLE PRESSURE MAY HELP

The risk touted in some of the more excitable UK press that the recent tit-for-tat between the heads of the UK (David Davis) and EU (Michel Barnier) negotiation teams could lead to a breakdown in the Brexit talks is overdone, in our view. Once again, the EU is accusing the UK of not making its position clear in the negotiations. This is nothing new. It reminds us of the run up to the December 2017 summit. Just as some extra pressure from the EU encouraged the UK to agree on the terms of divorce in December, the EU seems to be re-opening this playbook ahead of the 22-23 March EU summit when the UK and the EU want to settle the terms of the transitional deal. Remember, time is short. Brexit negotiations need to be over before September 2018 so that any plan for a future relationship can be ratified by the UK and EU27 in time for Brexit in March 2019.

Our outlook for Brexit remains unchanged. After agreeing to transitional terms at the March EU summit that de facto keep the UK inside the single market and customs union until the end of 2020, we expect the UK and the EU to sketch out some broad aims for future trade during the summer. In the transition period, when the UK and the EU set out the future terms of trade, we look for the UK and the EU to agree on a semi-soft Brexit. In the end, we expect the UK to stay close enough to EU rules for many goods and some services to avoid a hard border in Ireland. As two-thirds of the members of the UK parliament are pro-EU, such a deal would probably get a majority backing in parliament. UK remainers could support a deal that keeps the UK partly aligned with the EU while the Brexiteers could back such an agreement as it would offer the UK some room to pursue its non-EU ambitions. For more detail on our Brexit outlook please see Brexit scenarios: now for the hard part.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
holger.schmieding@berenberg.com