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THE RETURN OF RISK

Berenberg Macro Flash

Risk is back. After a stellar 2017 during which economic and political risks seemed to recede by the month, we have faced a barrage of concerns since February this year. The new US sanctions against Iran add a further dimension to a list of risks ranging from an overblown inflation scare to geopolitical concerns (North Korea, Middle East) and the serious trade tensions stoked by US president Donald Trump. Could this turn into a toxic mix that threatens the global economic upswing? While we cannot rule it out completely, that still looks rather unlikely, in our view.

WHAT HAS CHANGED?
Before we look at key risks, consider how the situation has changed:

1) After a year in which Trump refrained from rocking the boat in 2017, merely delivering some pro-business deregulation and a major tax reform with an even bigger tax cut to boot, he has taken a much more aggressive stance on trade and geopolitical issues in 2018, more in line with his scary 2016 campaign rhetoric.

2) The trade tensions are weighing on business expectations in export-oriented regions such as core Europe. The **fear factor** will likely restrain investment growth modestly across much of the world in Q2. In the US, the concurrent fiscal stimulus more than offsets the impact, though.

3) Investors are now more wary of risks again. When everything seemed to go swimmingly in 2017, global investors dared to sail more and more away from safe havens such as the US dollar (and German Bunds) towards far-flung shores. As a result, the US dollar fell despite Fed rate hikes last year. Now, with risk aversion creeping back, the dollar has rebounded without a major change in the Fed‘s approach.

4) A first negative feedback loop has kicked in. As investors shy away from some risks, the more vulnerable emerging markets are feeling the pinch from higher US interest rates and a stronger US dollar. In turn, problems in a few emerging markets add to a perception that the outlook for global trade and growth has worsened.

GEOPOLITICAL RISKS: IRAN, MIDDLE EAST, NORTH KOREA
Trump‘s confrontational approach carries serious risks. Abandoning the nuclear deal with **Iran** could further destabilise a volatile region, undermine trust in the US as a reliable partner and drive another wedge between Europe and the US. The long-term political consequences are unclear but potentially severe.

Still, the economic impact of a step that has not come as a major surprise should remain limited. Recovering only slowly from the pre-deal sanctions, **Iran** is currently not a top player in global oil markets (with crude oil exports of 2.1 million barrels per day in 2017, equivalent to 2.5% of global oil output). If the new US sanctions cause a noticeable drop in Iranian oil exports, a temporary spike in oil prices of, say, $5 per barrel could reduce annual real GDP growth in key oil-importing countries by a very modest 0.1-0.15 percentage points until additional supply from the traditional **swing producer Saudi Arabia**, **US fracking** or other sources closes the gap. That spike in oil prices seems to have happened ahead of Trump’s decision already.

For the economic outlook, the key question about the **Middle East** is not the intensity of regional conflicts but the potential threat to global oil supply. As an extreme case, a hypothetical open conflict between regional rivals Saudi Arabia and Iran, in which both countries bomb each other‘s oil installations and close the Strait of Hormuz, would be a very serious matter. The resulting shortage of oil would deal a severe shock to the world economy. But both countries should have a supreme interest in avoiding such a conflict, engaging merely in proxy wars in Yemen and Syria instead. It is hard to see how US sanctions on Iran could make such a bad-case scenario less unlikely than it was before. Iran needs to tread more cautiously, Saudi Arabia can lean back and watch its rival being weakened without having to do anything.

As to **North Korea**, it always seemed highly unlikely that North Korea’s abhorrent dictator would turn suicidal and start a genuine war. He now seems to be suing for peace instead.

STILL THE TOP RISK: A PROTRACTED TRADE WAR

On their own, the misguided trade restrictions which Trump has imposed or threatened to impose so far are too small to directly matter much for the economic outlook. Even after a few rounds of tit-for-tat, the direct costs in terms of impaired supply and higher prices for the countries concerned may shave 0.2-0.3ppt off GDP growth while adding a similar amount to the inflation rate. That would be unfortunate but easily bearable. The real risk stems from the uncertainty about the future trade regime, as shown by the serious damage Brexit has done to the UK already although the UK has not even left the EU Single Market yet.

We see three stylised scenarios:

1) **The deal.** China and the EU (and some smaller regions) are already talking to the US. China and - to a lesser extent the slow-moving EU - have indicated a readiness to compromise within limits. Our base case remains that Trump, using noise as a bargaining tool, will want to strike deals in the end that he will sell as major achievements to his base. After a tetchy period, the result could be somewhat enhanced mutual market access and some welcome restraints on the Chinese penchant for forced technology transfers. Once companies start to see and believe it, the near-term dent to economic growth will be over. Markets will return to risk-on mode. If the US can agree changes to NAFTA with Canada and Mexico soon, the probability of such a largely benign outcome would rise.

2) **Getting used to Trump**. Even if the US does not strike deals fast with its key trading partners, businesses and investors may simply get used to the noise. Unless the US were to impose a series of crippling trade restrictions in rapid succession, most European businesses will likely notice that their exports to the US keep rising despite some ongoing trade tensions courtesy of solid US domestic demand fueled by the 2018 fiscal stimulus. If so, **the fear factor could gradually fade**, paving the way for a economic rebound from a near-term dent to growth even if trade disputes continue to linger.

3) **Trade war**. In a worst-case scenario, Trump would not aim for any deals but get ever more aggressive over time, reacting perhaps to a US trade deficit that may well widen this year because of the US fiscal stimulus. A major and protracted trade war that confirms the worst fears of businesses and stokes such fears further could push demand growth in much of the developed world below trend and cause a number of emerging market crises. As the damage would be clearly visible almost everywhere, including in the US ahead of the November 2018 mid-term elections, we consider this a remote risk.

CONCLUSION

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Economic fundamentals across the Western world remain encouraging. Neither the US nor Europe or Japan have built up the kind of investment, credit or inflation excesses that would require a cleansing recession within the next two years. In the US and parts of the Eurozone (think France), pro-growth reforms strengthen the supply side.

Trade tensions and somewhat elevated oil prices can cause a near-term dent to growth. While this will be more than offset by a fiscal stimulus in the US, it will be clearly visible in Europe.

In response largely to the trade tensions, we have already reduced our 2018 growth forecast for the Eurozone from 2.5% to 2.3%, with near-term risks tilted to the downside. The recent rise in oil prices and the travails of some vulnerable emerging market accentuate the near-term risks.

Still, chances are that trade tensions will ease in coming months either because key trading partners such as China and the EU will strike new deals with the US (most likely) or because businesses and investors get used to the noise. Also, the economic impact of the new US sanctions against Iran should remain very limited. We look for economic growth to remain solid in the Western world, with Eurozone growth rebounding somewhat later this year after a dent now. In response, greater investor appetite for risk should help some emerging markets to attract more capital again and support equities relative to low-risk bonds.

We will send out a separate message on other less acute risks (inflation, Italian politics) in a few days.

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