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

EUROPEAN UPDATE: TRADE WAR, BREXIT, ITALY

Berenberg Macro Flash

TRADE WAR IMPACT

Sell the rumour, buy the fact? Having lost ground on trade war and emerging market concerns in the last six weeks, European equity markets have taken Tuesday's escalation of tit-for-tat tariffs between the US and China in their stride. While Eurozone fundamentals remain positive, the trade war accentuates the risk that growth may stay mediocre a little longer instead of re-accelerating to an above-trend pace in Q4 2018 already.

As ECB president Mario Draghi explained at his 13 September press conference, the immediate economic effects of new trade barriers fall into three categories:

First, the direct impact on prices and production. In our view, this impact will remain modest. It is also widely distributed among consumers and producers in the countries concerned and along international supply and distribution chains. To put the potential direct costs into perspective: at 2017 import values, the extra tariffs the US has so far imposed on China would yield $33bn per year, equivalent to 0.2% of US GDP. China's countermeasures add up to less than half that amount.

Second, the damage to confidence. The effect was very visible in March and April in the Eurozone, followed by only a small further erosion of confidence thereafter. As long as the US-EU armistice on trade holds, the additional hit to confidence from the US-Chinese trade war should also remain limited.

Third, the impact on complex cross-border supply chains. With new trade barriers between the economies No. 1 and No. 3 in the world and threats of more to come despite hopes that it may all end well, companies do not know how to rejig their supply chains. As a result, they may delay decisions. That could show up in reduced business investment and hence less global demand for European investment goods for a while.

Both the US and China have good economic and political reasons to settle the dispute soon. But Trump's rhetoric and the US inclination to see trade through the prism of a future geopolitical rivalry does not make it easy for China to yield ground. Memories of the unequal treaties which colonial powers forced on Beijing in the 19th century still run deep in China. The chances that China and the US could strike a deal to before the 6 November midterm elections seem low. President Trump and President Xi are likely to meet at the Asia-Pacific Economic Cooperation forum (17-18 November) and possibly at the G-20 summit (30 November - 1 December). These meetings may be occasions to defuse tensions.

European companies are strongly engaged in both China and the US. The escalation of the US-Chinese trade war, the resulting if limited drag on Chinese growth and a „wait and see" attitude towards investment decisions until the outlook has become clearer can keep growth in the export-oriented Eurozone a little longer below the solid gains which underlying domestic fundamentals would suggest.

EU SUMMIT: TOO EARLY FOR A BREXIT DEAL

Aware that the UK prime minister faces an uphill battle at the Conservative party congress starting on 30 September, EU leaders are trying to be polite to Theresa May during the EU summit discussions that continue today in Salzburg. After May's dinner presentation yesterday, EU leaders may ask her to amend rather than ditch her „Chequers“ plan and grant her a little extra time by scheduling a special Brexit EU summit for mid-November instead of insisting to wrap up the talks at the EU's regular October summit already.

On substance, however, the EU has reportedly little to offer beyond the position which EU chief negotiator Michel Barnier had presented with full EU27 backing before: The UK has to make up its mind whether it wants a mere Canadian-style free trade agreement or a customs union with the EU (or perhaps a Norway-style single market deal) after the post-Brexit transition period ends in late 2020. The Irish border remains the big sticking point.

The hot phase of negotiating the envisaged umbrella agreement for future EU-UK relations will start after the Conservative party congress. From an EU perspective, the talks could potentially be heading towards a fudge combined with a backstop:
First, to make it easier for May to get the envisaged umbrella agreement on future EU-UK economic relations through the UK parliament, the deal could be less detailed than the EU would have liked, leaving more issues to be settled in future negotiations during the post-Brexit transition period. A lack of details could allow May to claim that the final result could still be close to her Chequers plan while allowing other Conservatives to hope that it would be rather different.
Second, the more details are left open in the umbrella Brexit agreement now, the more will the EU insist on an ironclad „backstop“ guarantee that there will be no hard border on the Irish isle whatever the outcome of the detailed negotiations during the transition period later on: If the UK mainland leaves the customs union with the EU after the transition period, Northern Ireland would have to stay inside the customs union.

This „backstop“ would be very difficult to swallow for the UK government which relies on the Northern Irish DUP for its majority in parliament. Upon hopefully concluding the pre-Brexit agreement in November, both the EU and May could thus emphasise that neither side expects the backstop to be activated as future talks on details of a post-Brexit trade arrangement would most likely find a better solution.

We continue to see a 60% chance for a semi-soft Brexit under which the UK de facto stays in the EU customs union for goods (or very closely aligned with it), thus avoiding the need for a hard border in Ireland. Faced with the choice between such a deal and the chaos of a no-deal hard Brexit (or even new elections that could sweep Labour's Jeremy Corbyn to power and/or result in a new Brexit referendum), many reluctant Conservatives would probably vote for the deal. While some Conservatives will almost certainly defect, a few opposition MPs may help the deal over the line. That is our base case with a 60% probability - which leaves a significant 40% risk for potentially more unsettling outcomes including a 20% risk of a hard Brexit (see Brexit: back to the drawing board).

ITALY: BUDGET DISCUSSIONS HEATING UP

Shortly before Italy needs to present its fiscal plans on 27 September, 5Stars leader Luigi Di Maio has increased the pressure on Finance Minister Giovanni Tria to allow for a 2019 budget deficit closer to 3% than 2% of GDP. Whereas Tria reportedly wants to allocate only €1bn for the 5Stars flagship „citizen's income" in the 2019 budget, Di Maio demands €10bn for that measure. He also wants €7bn for the flat tax, €8bn for the partial reversal of the pension reform and €3bn for further election promises according to Italian media reports. Di Maio's total demands of €28bn would increase the 2019 fiscal deficit by around 1.6 percentage points.

Di Maio's stubbornness can be explained by the poor performance of 5Stars in opinion polls. The average of the last 6 polls puts the other coalition party, Matteo Salvini's Lega, 2.5 percentage points ahead of 5Stars. At the general election in March, 5Stars had still won 15 points more than the Lega. Rising tensions between Lega and 5Stars may even raise the risk of early elections. Salvini wants to increase tax revenues by up to EUR 20bn via a one-off tax amnesty, which is not supported by 5Stars, while Di Maio demands to axe tax exemptions, which would hurt Lega voters more than 5Star supporters. They also have opposite views about two large infrastructure projects (a Franco-Italian rail link and a gas pipeline). So far, Tria does not seem to be giving in to Di Maio's demands. He reportedly threatened to resign if Di Maio does not agree with his budget proposal. We still expect all involved parties to find a compromise in the end. Di Maio would have little to gain from new elections.

We look for a budget deficit target of c2.6% of GDP in 2019 – see Heading for an even hotter September. Despite the current noise, chances are that the deficit target could be slightly lower than that. In the unlikely event that Di Maio does not moderate his demands and that Tria would resign, Italian risk spreads could increase significantly.

This message has been produced for information purposes for institutional investors or market professionals, it is not a financial analysis within the meaning of § 34b or § 31 of the German Securities Trading Act (Wertpapierhandelsgesetz), no investment advice or recommendation to buy financial instruments. The message does not claim completeness regarding the information on the developments referred to in it. On no account should it be regarded as a substitute for the recipient's procuring information for himself or exercising his own judgements. The message may include certain descriptions, statements, estimates, and conclusions underlining potential development based on assumptions, which may turn out to be incorrect. Berenberg and/or its employees accept no liability whatsoever for any direct or consequential loss or damages of any kind arising out of the use of this message or any part of its content.
-- For full economics reports please visit our website or contact capitalmarkets@berenberg.de.

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