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ECONOMIC UPDATE: ITALIAN RISKS LOOM LARGE DESPITE SOME GOOD NEWS ELSEWHERE

Berenberg Macro Flash

FIRST THE GOOD NEWS:

- The **US economy** continues to power ahead. As strong increases in demand and employment go along with only a modest rise in wage inflation, the US Fed will continue to raise rates gradually at a pace and to an extent which poses no serious threat to growth. Gains in US demand are likely to remain at or above the 2%+ trend well into 2020. That bond yields have edged up makes sense. They are a symptom of, but not a risk to, US growth.

- Amid all the noise, **Brexit** is on track towards our base case of an agreement in the coming months for a semi-soft deal. UK Prime Minister Theresa May has survived the Conservative Party conference. Helped by a further softening of the UK position, the EU27 and the UK could settle for a fudge (a general declaration of principles for future trade after a "no change" transition period until the end of 2020) and a "backstop" guarantee to permanently rule out border controls for goods at the Irish land border. See our Brexit update and Brexit: entering the hot phase.

- The crisis in **some vulnerable emerging markets** such as Turkey and Argentina continues to simmer but has not spread to such an extent that it would pose a major risk to global growth.

NOW FOR THE BAD NEWS:

- The **US-China trade war** shows few signs of easing soon. The more the trade issues get enmeshed with the geostrategic rivalry between the US and China, the more difficult it may become to resolve the more technical trade problems. Like other conflicts, this trade war will end eventually. But while tensions are high, uncertainty about the consequences for the global trading system and the impact on global supply chains weighs on confidence in outward-looking industries in major parts of the world.

- **Higher oil prices** are a modest drag on real incomes and growth in key oil-importing regions such as the EU and China. As a rule of thumb, an increase in the price for Brent crude by €10 per barrel reduces real disposable incomes in the Eurozone by 0.3% because it raises the consumer price level by such a magnitude. Brent crude is now trading €9.3 per barrel above its April-August average.

- Most importantly, the **Italian risk** now looms much larger than before. Having presented a fiscal plan that is testing the limits of market patience, Italy's radical leaders have turned into their own worst enemies. Instead of trying to re-assure nervous investors, the top leaders of 5Stars and Lega have inflamed passions by telling markets that they would not care even if the BTP-Bund spread were to surge to 400bp from just below 300bp now. That they blame the spread widening on the EU's response to Italy's envisaged breach of fiscal rules does not inspire confidence either.

Our base case for Italy remains a noisy muddling through (see Italy's budget: the trouble in Rome). However, the careless rhetoric suggests that the noise could go well beyond the brief spike in tensions that had rocked markets in May. Also, the tail risk that Italy's radical government may spark a genuine debt crisis soon has risen in the last few days. Like Greece's newly elected radical leaders in mid-2015, Italy's government would ultimately have to back down in a genuine crisis. If the radicals cannot find willing lenders any more, they cannot finance their expensive plans. Italy's economy is almost ten times as large as that of Greece. Whereas Greece's confrontation with creditors in 1H 2015 had hardly any impact on the wider Eurozone economy at the time, a crisis in Italy would affect the entire region for a while. Fortunately, the Eurozone would have the required instruments to contain the contagion risks after a while if need be. For a timeline of next steps in the Italian fiscal saga, see page 2 of the report quoted above.

OUTLOOK: TRANSATLANTIC GAP STAYS WIDE

Supported by deregulation, tax reform and tax cuts, the US economy is unlikely to be affected very much by trade tensions and Italian risks. However, for outward-looking sectors in the Eurozone, the prospect of rising sales to the US is overshadowed by trade war concerns and the correction in some emerging markets. As confidence is wobbly anyway, the Italian risk can cause a further dent to confidence and growth. One week ago, we reduced our economic forecasts for the Eurozone. Largely due to Italy, the risks to our calls are clearly tilted to the downside for the next few months. For now, the transatlantic growth gap looks set to stay wide.

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