MACRO UPDATE: GLOBAL RISKS, EU SUMMIT, GERMAN POLITICS

Berenberg Macro Flash

GLOBAL MARKETS: NO NEED TO WORRY TOO MUCH YET
Financial markets often lead the real economy by one or two quarters. Could last week's equity sell-off herald an economic downturn in 2019? Probably not. Of course, for three reasons, the risk is not quite as negligible as it was when markets last corrected in February and March. First, the big US fiscal stimulus has partly run its course by now. As the impact fades, the US will likely lose some momentum in the second half of next year. Second, the trade tensions between the US and China have escalated into a genuine trade war that both sides are finding difficult to resolve soon because trade issues have become enmeshed with their geostrategic rivalry. Third, constrained oil supply (Iran, Venezuela) has pushed up oil prices, current concerns about Saudi Arabia keep oil issues in the news. Oil prices now serve as a noticeable drag on real income growth in major oil-importing regions. In the Eurozone, oil currently adds 0.75 ppt to the yoy rate of inflation.

However, none of these factors seems potent enough to derail the global upswing for good and trigger a self-reinforcing downturn:
• In the absence of a new artificial fiscal stimulus, US growth will likely slow to a pace of around 2.5% over the course of next year from 3% now. This would ultimately be positive rather than negative. It would reduce overheating risks and make the upswing more sustainable.
• The US-Chinese trade war sows uncertainty among companies as to how they should adjust their cross-border supply chains. That retards investment growth and demand for investment goods. But the risk of a much wider disruption of global trade has receded due to the armistice struck between the US and the EU in July and the new NAFTA deal now. The overall impact of trade tensions on global growth next year should thus be modest.
• Consumers and companies are digesting the higher oil prices now. Unless oil prices were to rise much further again, they will be less of a drag on growth next year.

After some weakness in 2H 2018, Eurozone data may firm again in 2019, partly offsetting the modest US slowdown. Nine years into the post-Lehman recovery, the Western world has not yet built up the credit, wage or investment excesses that would require a cleansing recession in the near future. A recession will come eventually, but more likely in 2021 when inflationary pressures may have advanced sufficiently in the US to warrant a sharper Fed reaction than in 2019 or 2020. We see the recent rise in US yields, which helped to trigger the equity market correction, more as a symptom of rather than a risk to US economic performance. It may affect valuations but should not restrain demand growth by much for long (see putting the rise in bond yields into perspective). If higher yields and/or lower equity prices were to hurt US economic momentum significantly, the Fed could simply correct that by signaling a softer policy outlook. In the absence of serious inflation pressure, the Fed has no reason to let US growth fall below its trend rate.

Of course, the causality between markets and the real economy can run both ways. Even if economic fundamentals provide no convincing reason for a massive and prolonged bear market now, we still have to ask whether the equity market correction could, on its own, cloud the eco-
nomic outlook significantly. Unless equity prices were to drop much further, that also seems highly unlikely. After large gains in US household worth (up 8.2% yoy in Q2 2018), even a sizeable correction in equity prices would still leave household wealth in good shape. In the Eurozone, negative wealth effects play little role for household demand anyway. In addition, US economic fundamentals are unusually strong thanks to some pro-supply policy changes and a buoyant labour market. It would thus take much more serious financial turbulence to hit US business or consumer confidence sufficiently to cause a major slowdown.

On balance, we need to brace ourselves for some further volatility in global markets and somewhat weaker economic data in Europe near-term. Trade tensions, Brexit, Italy or even German politics could provide some fodder for that (see below). But unless the political risks were to get out of hand, we do not see this as the prelude to a major global downturn or even recession.

EU SUMMIT: BREXIT AND ITALY
Italy and Brexit may dominate the headlines at the EU summit on 17-18 October. With Italy due to submit its budget plans for 2019 to the EU today, EU leaders may give a first rough assessment at the summit, probably asking Italy to rein in the deficit and base its fiscal plans on more realistic assumptions for economic growth. Shortly afterwards, by 22 October, the EU Commission will probably ask Italy to adjust its plans as the first formal step in a process that will likely end in the EU rejecting the Italian budget.

Over the weekend, ECB President Mario Draghi weighed into the debate, suggesting to Italy’s government that it should “calm down”. Draghi has a point. While the Italian budget draft breaches EU rules, the fiery rhetoric from Rome adds a lot to market concerns. Also, occasional voices from within the government that question the euro raise risk spreads. In turn, higher uncertainty Italy’s credit rating and elevated spreads raise financing costs for the Italian economy and retard economic growth. That, in turn, makes Italy’s current fiscal plans even more dangerous.

Crunch time for the UK. On Sunday, UK leaders apparently shied away from signing up to the outlines of a Brexit deal prepared by EU and UK negotiators in the days before. The very unsettled political situation in the UK with strong opposition from the Northern Irish DUP and from factions of the Conservatives against the “backstop” guarantee to permanently keep the Irish border open may have stayed Theresa May’s hand. Still, the EU is unlikely to change its offer materially. Facing the binary choice between a deal along the lines leaked last week and the upheaval of a no-deal hard Brexit, we still expect the UK to conclude such a Brexit deal shortly, perhaps after further discussions at the EU summit. But the stakes are high. A no-deal hard Brexit would cause serious damage to the UK and – to a lesser extent – also to the wider European economy. We will send out a more detailed Brexit comment shortly.
GERMAN POLITICS: IT COULD HAVE BEEN WORSE
The centre-right CSU and the centre-left SPD lost the state election in Bavaria. This spells some trouble for Angela Merkel’s CDU/CSU-SPD coalition in Berlin. Down by 10.5 points to 37.2%, support for the once dominant CSU has plunged to its lowest level since 1950. However, the losses for the CSU were less bad than the prior opinion polls which had projected a 33-35% result. If the state election in Hesse on 28 October, where Merkel's CDU is on the ballot, also yields a result for the centre-right that is not worse than current opinion polls, Merkel will likely not face a direct challenge from within her own CDU.

The real risk to watch stems from the SPD. Down 10.9 points to a mere 9.7% in Bavaria, the party seems to be in disarray. As discussed before, this adds to a risk that the SPD may leave the Berlin coalition. Such a move could potentially trigger the fall of Merkel and/or new elections. On balance, we still consider this as unlikely as the SPD would have too much to lose from new elections.

Roughly in line with opinion polls, the Greens (17.5%) were the key winners of the Bavarian vote, coming far ahead of the right-wing AfD (10.2%). Interestingly, the AfD’s tally fell short of the 12.4% of the votes they had garnered in Bavaria at the federal election last September. One reason for that is the strong showing of a regional centre-right group of “unaligned voters” (11.6%) who offer a more respectable alternative to the CSU on the Bavarian state level. Bavaria itself will probably be ruled by a coalition of the CSU and these “unaligned voters”, If so, policies in Bavaria would not shift in a way that would be relevant for markets or the federal level in Germany.

The trends seen in Bavaria, centre-right CDU/CSU and centre-left SPD down, centre-left and staunchly pro-European Greens up by more than the right-wing AfD, are roughly in line with pan-German opinion polls since the last federal election in September (see chart below). Whether the parties backing Merkel can arrest the erosion of their support will critically hinge on one issue: can they stop their noisy disputes that are putting off many voters? Nervous as they are, they may find that difficult. Unfortunately, German politics may remain noisy for a while. A significant change in policies is not on the cards, though, under any realistic scenario. Even a hypothetical change in coalition in Berlin, say from CDU/CSU-SPD to CDU/CSU-Greens-FDP or a change at the very top from Merkel to somebody else from the CDU would not cause a major policy shift. On key issues such as foreign policy and European affairs, all mainstream parties are fairly close.
German Opinion Polls

Support for political parties in %, starting point is the September 2017 election result. Source: ARD DeutschlandTrend

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