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EUROZONE UPDATE: SLUGGISH END TO 2018, BETTER NEWS AGAIN IN 2019

Berenberg Macro Flash

Trade wars, Italy, Brexit and elevated oil prices: an unusually potent cocktail of risks is restraining Eurozone growth. The chances that US-Chinese trade tensions may ease shortly have receded and the Italian noise is getting louder. As a result, we reduce our near-term forecasts for Eurozone growth. Instead of a qoq gain of 0.4%, we now project 0.25% qoq for Q4 2018 followed by 0.35% instead of 0.4% qoq for Q1 2019. After a period of below trend growth in 2H 2018, we expect Eurozone growth to re-accelerate to a pace just above the annualised 1.5% trend rate over the course of next year. The lower starting level for 2019 takes average annual growth for next year from 1.6% to 1.45%. Following an earlier revision, the overall change from our mid-2018 forecast that the Eurozone economy would expand by 2% in 2019 is substantial. However, the change reflects mostly a weaker performance in 2H 2018 and thus a lower starting level for 2019 rather than any major cut to the 2019 outlook itself. For forward-looking financial markets, the impact of the forecast revision should thus be small.

More growth over the course of 2019: We maintain our call that growth will pick up again during 2019 after a weak finish to 2018. The positive 2019 outlook reflects our view that underlying fundamentals in the Eurozone are largely healthy. Neither the Eurozone nor the US have developed serious credit, investment, or wage inflation excesses that would require a cleansing recession within the next two years. Instead, some of the factors currently weighing on Eurozone growth should be less prominent next year. For full details, see *Forecasts at a Glance*. Whereas the risks to our previous forecasts had been tilted to the downside, we see the risk to our new calls as balanced.

ECB impact: At its meeting on 13 December, the ECB will have to lower its projection of 1.8% real GDP growth for 2019 GDP growth visibly, in our view. However, as the ECB is keen to end its contentious asset purchase programme, this will not suffice to prolong asset purchases. Softer growth will likely trigger a debate at the ECB whether the guarantee to keep interest rates at their current record-low levels should be extended beyond the summer of 2019. The ECB need not take a decision on a potential tweak to its rate guidance in December already. It has plenty of time to watch the data. If growth rebounds from its 2H 2018 dip to an annualised rate at or above the 1.5% trend over the course of 2019, as we expect, the ECB will probably still start to raise rates very gradually next autumn.

KEY ASSUMPTIONS FOR 2019

Our forecasts for 2019 are based on a set of assumptions:

Trade wars: In early 2019, the US and China will start to negotiate seriously instead of continuing the 2018 spiral of hurling a series of punitive tariffs at each other. Despite occasional tensions, the US-EU armistice on trade issues will largely hold.

Italy: Under the pressure of markets, rating agencies and the EU, Italy will amend its fiscal plans modestly within the next three months to prevent a jarring debt crisis.

Brexit: The UK will avoid the no-deal hard Brexit (20% risk). Any other outcome would - despite the potential for serious noise in the meantime – be a modest positive relative to the heightened uncertainty now.

Oil prices will not rise much further next year. By adding 0.8 percentage points to Eurozone inflation, oil currently exerts a serious drag on real income growth. This drag will fade over the course of 2019.

China will scale up its monetary and fiscal stimulus if need be to prevent a further significant slowdown in aggregate demand growth beyond the loss in momentum that has already happened. As a result, the currently very subdued gains in Eurozone exports to China can firm again somewhat over the course of 2019.

Emerging markets will, on balance, fare less badly in 2019 than in 2018. The most vulnerable markets are already correcting and will reach a bottom in the first half of 2019. The Eurozone is feeling the pain now, for instance from a 27% yoy drop in German exports to Turkey in August 2018. While the export shock may still get a little worse in coming months, exports to Turkey and other vulnerable markets will stabilise in early 2019 and start to rebound later next year.

Taken together, a fading of some political risks, stronger gains in real disposable incomes at stable rather than rising oil prices and a lesser drag from net exports will allow Eurozone GDP growth to rebound to a pace of roughly 1.7% annualised over the course of 2019 after annualised gains around 1% in 2H 2018.

IMPACT OF THE MARKET SELL-OFF?

Financial markets can be a harbinger of major changes in economic momentum. But in line with comments from key central bankers on both sides of the Atlantic, we do not see the current selloff as a factor that, on its own, would restrain economic growth significantly. After large gains in US household worth (up 8.2% yoy in Q2 2018), even a sizeable correction in equity prices would still leave US household net 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 very pronounced 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 weaker economic data in the Eurozone near-term. Trade tensions, Brexit, Italy or even German politics look set to make further headlines. Our new forecasts reflect these concerns. But unless the political risks were to get out of hand, we do not see this as the prelude to a major global downturn. Instead, we look for better news next year.

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