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MACRO UPDATE: MARKET TURMOIL, MERKEL, MACRON

Berenberg Macro Flash

MARKET TURMOIL: BAD NEWS CAN HAVE A SOBERING IMPACT

Every cloud has a silver lining. With luck, the dark clouds that have gathered over global markets and the global economy may even have two. This year, the surge in US growth driven partly by a fiscal stimulus has forced the Fed to lean against the artificial boost with a series of - probably - four rate hikes. Even more so, strong US growth has encouraged US President Donald Trump to wage his trade wars regardless of the costs. 2019 may be different on both counts.

The fears that are currently gripping markets are far overdone, in our view. Still, the market selloff now adds to other tentative signs that US GDP growth will return to a more normal pace in 2019. This has two consequences: (1) With inflation still under control, the Fed can start a long rate pause at some time in the first half of 2019. (2) As the impact of the fiscal boost fades, the economic costs of misguided trade policies and rampant protectionism will become more apparent in the US where they have so far been obscured by the tax stimulus. Gearing up for a re-election bid in 2020, Trump may soon see more upside for himself in striking "deals" than in intensifying his costly trade wars. If so, the fear factor that is currently weighing heavily on business and market confidence in Europe could fade over time. In this sense, less stellar news on US demand could turn into good news for the world eventually.

GERMAN POLITICS: LESS RISK, LESS OPPORTUNITY

That Annegret Kramp-Karrenbauer (aka "AKK") has narrowly won the vote to succeed Angela Merkel at the helm of Germany's centre-right CDU reduces the risk that Merkel's coalition with the SPD will fall apart and that Merkel may lose her job as chancellor in 2019. While the outlook for Merkel remains uncertain, we put the probability that she will still be chancellor at the end of 2019 at slightly above 50%. Bringing down Merkel, whose popularity has recovered recently, would carry risks for anybody attempting to do so. Nonetheless, Merkel still faces two big risks to her plan to stay in office until the regular end of her term in the autumn of 2021:

1. If the CDU gets trounced at the European election in May and at three East German state elections on 1 September and 27 October 2019, her party may still ask Merkel to step aside in favour of AKK (or somebody else?) so that her successor could establish her credibility as chancellor well before the next regular federal election in September 2021.
2. If the SPD does badly at these polls in 2019, which looks quite likely, the battered party may still choose to leave the coalition with the CDU/CSU in Berlin, bringing down Merkel in the process. That would usher in either new elections or, more likely, an AKK-led „Jamaica" coalition with the Greens and the liberal FDP.

As discussed before, the changes to actual German policies would be modest under any scenario. Even Friedrich Merz, who lost the CDU leadership contest to AKK on Friday by 18 out of 999 votes, would probably have been unable to turn his pro-business credentials into major policy shifts. The CDU's current coalition partner, the SPD, or the Greens as a potential new coalition partner, would have prevented major changes. For the European reform outlook, the vote for continuity with AKK instead of trying Merz may represent a lost opportunity. Precisely because Merz was seen as more conservative on economic matters, he could have found it easier than AKK to persuade the sceptics in the CDU/CSU (and the Dutch) to go along with a little more risk-sharing in a Europe that has still not adequately responded to Emmanuel Macron's reform proposals.

MACRON = RENZI? PROBABLY NOT

Could France's Emmanuel Macron end up like Italy's Matteo Renzi – a youthful reformer who erupted onto the national scene with a plan and mandate to transform his country, only to lose momentum prematurely? The renewed "yellow vest" protests against Macron on Saturday, marred once again by some street violence, raise uncomfortable questions. We have staked much on our call that Macron's structural reforms can usher in a golden decade for France. We look for Macron to finish the job of transforming his country, just like Margaret Thatcher had fundamentally changed the UK and the "Agenda 2010" reforms of 2004 had turned Germany around. We are thus watching with keen interest whether or not Macron may now backtrack.

Despite some superficial similarities, Macron has two advantages over Renzi:

1. He enjoys a solid majority in parliament, supported by a party that he has founded himself. Even if his LREM does badly at the European election in May, he can continue to govern at least until the end of his five-year term in 2022.
2. Within limits, Macron can afford to buy off protests with some fiscal concessions. France would face no financing problems if the fiscal deficit were to rise to just above 3% again in 2019.

Macron wants to meet representatives of the protesters this week. Beforehand, he will make a major announcement at 19h GMT today, probably offering some concessions while also upholding a firm line against the protesters' violent fringe. If his concessions involve mostly issues of style and some fiscal slippage, fine. However, if Macron were to rescind some of the pro-growth reforms he has already delivered and were to signal that he will not go for further such reforms, our big call on France as a potential future growth engine of Europe would be at risk. At this stage, we still attach a low probability to such an outcome.

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