Economics

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Global outlook 2019: coping with serious risks

- **Serious risks:** After a rocky finish to 2018, the outlook for 2019 is marred by a number of serious risks, ranging from trade tensions and Brexit to the ongoing downturn in China and a potential drop in US confidence. The risk of recession in the developed world is more acute than it has been since the end of the euro crisis. Still, it remains a tail risk that is unlikely to materialise in 2019.
- **Too early for a recession:** Ten years after the post-Lehman mega-recession, we do not yet find major credit, inflation or investment excesses in the developed world that would require a cleansing recession within the next two years. Isolated issues, such as those in the US corporate bond market, are unlikely to cause a recession against a backdrop of mostly healthy fundamentals.
- **US economic momentum** will slow in 2019, reflecting a fading fiscal boost and a decline in confidence related to financial market and trade-related uncertainties, as well as softer global economic growth. However, sustained job gains, further increases in wages and lower energy prices will support consumer spending.
- **China** suffers from the inevitable deceleration in trend growth and an excess debt burden accumulated in previous credit binges. Trade tensions and a cyclical downturn exacerbate the problems. In early 2019, weaker Chinese demand will show up in softer global trade growth. However, China will likely strike a trade deal with the US. It will also support demand with a more aggressive monetary and fiscal stimulus – at the price of kicking some of its problems down the road again.
- **Eurozone rebound after a grey winter:** After a series of external shocks and political risks pushed growth well below trend in late 2018, the Eurozone could recover if and when these risks fade. If trade tensions ease, China avoids a hard landing and the UK does not fall into the hard-Brexit trap, Eurozone growth could recover from spring 2019 onwards. Lower oil prices strengthen the case for a narrower growth gap between oil-importing Europe and the oil-producing US.
- **Releasing the Brexit brake:** We forecast an 80% chance that the UK will avoid a damaging no-deal hard Brexit. If so, the fading of Brexit uncertainty would present considerable upside potential for the UK economy over the medium-term.
- **Bad news can turn into good news:** Weaker GDP growth in the US, China and Europe in early 2019 can strengthen the political case to ease costly trade tensions instead of escalating them further. In turn, trade deals could bolster sentiment.
- **A monetary buffer:** As core inflation remains subdued across the developed world, central banks can adjust their projected policy course to cushion an unexpectedly pronounced deceleration of demand growth. Expect China to deliver a stimulus.
- **It may get worse before it gets better:** Our growth forecasts for 2019 are mostly below consensus (see Table 1). However, as we expect some of the key risks to fade, we are more optimistic about 2020. Forward-looking markets could start to play the theme of a return to risk-on mode at some time during 2019.

Table 1: Berenberg forecasts versus consensus

	GDP 2019	GDP 2020	Inflation 2019	Inflation 2020
US	-0.1	0.4	0.0	0.2
China	-0.1	-0.1	-0.1	-0.2
Japan	0.0	0.5	0.2	0.0
UK	0.3	0.2	0.1	0.2
Eurozone	-0.4	0.2	-0.4	0.0
Germany	-0.4	0.2	-0.3	0.1
France	-0.4	0.3	-0.2	0.4
Italy	-0.4	0.2	-0.3	0.1
Spain	-0.2	0.3	-0.3	0.2
Portugal	-0.2	0.4	-0.3	0.2

Yoy changes in %. Source: Bloomberg consensus taken on 2 January 2019; Berenberg projections

Key macro reports

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Overview: coping with a cocktail of risks

The outlook for 2019 is marred by a number of serious risks...

After a rocky finish to 2018, the outlook for 2019 is marred by a number of substantial risks, ranging from trade wars and Brexit to the ongoing downturn in China and concerns about a potential drop in US confidence. Worsening political gridlock in the US and the UK, and the challenges that the rise of populist parties poses to the cohesion of the Eurozone add to the risks. Unlike this political backdrop, key economic fundamentals remain encouraging, though.

...but the economic upswing in the western world has not run its full course yet

Ten years after the post-Lehman mega-recession, the economic upswing in the western world has not run its full course yet. Apart from isolated problems, such as those in the US corporate bond market, we do not yet find serious credit, inflation or investment excesses that would require a cleansing recession within the next two years. Despite some up-drift in wage inflation on both sides of the Atlantic, core inflation, ie inflation excluding energy and food, remains even lower than we – and central banks – had expected a year ago. As a result, central banks can continue to normalise their policy stance in a way that does not jeopardise the economic upswing. If need be, central banks can adjust their projected policy course to cushion an unexpectedly pronounced loss of demand momentum.

The worst of the drag from emerging markets is probably over

As usual, the situation in the diverse set of countries called "emerging markets" remains mixed. Higher costs of servicing dollar-denominated debt, the recent slowdown in China, Europe and Japan, and global trade tensions hurt many emerging economies in 2018. However, the adjustment crisis in some of the most vulnerable major emerging markets seems to have either ended (Brazil) or looks set to peter out shortly (Argentina, Turkey). Over the course of 2019, these countries will likely be less of a drag on global economic performance than in 2018.

Lower oil prices can help narrow the gap between Europe and the US

We expect China to delay a serious crisis with more aggressive monetary and fiscal stimulus. The Eurozone and Japan can also regain some momentum over the course of 2019 after a soggy start to the year. As long as the key political risks (escalating trade wars, hard Brexit, Italian debt crisis) do not materialise, the Eurozone can return to an annualised growth rate close to the 1.5% trend from Q2 2019 onwards after a grey winter. While the US should expand at a less vigorous pace as the impact of the 2018 fiscal stimulus starts to fade, we do not expect US growth to decelerate below a 2% annualised rate. Lower oil prices strengthen the case for a narrower growth gap between oil-importing Europe and the oil-producing US in 2019.

Cyclical dynamics can take on a life of their own

Beyond the mostly political risks, which we look at in more detail on page 12, we need to watch China and the risk that cyclical dynamics can take on a life of their own in the US and Europe.

China suffers from the inevitable deceleration in trend growth

- **China** suffers from the inevitable deceleration in trend growth of a catching-up economy, an excess debt burden accumulated in previous credit binges and the damage from trade tensions. Chinese growth may well be lower than official statistics suggest. Still, with a high savings rate, an external surplus and low inflation, China retains the capacity to open the credit taps again for a while if other stimulus measures fail.

A return to stronger Eurozone growth may be delayed beyond spring 2019

- In the **Eurozone**, the hit from a succession of external and political shocks started to seep into domestic demand in the final months of 2018. Even if the risks abate somewhat, as we expect, nervous businesses and households may continue to restrain spending growth for a while. If so, this could delay the return to stronger momentum to beyond spring 2019.

No longer immune to the risks, US growth could slow down more than expected

- The **US** faces the expiry of the 2018 fiscal stimulus, alongside the delayed impact of rate hikes and quantitative tightening. These factors may combine with the cost of trade tensions, the repercussions of the recent slowdown in China and other key trading partners and the impact of the equity market correction to cause a significant drop in consumer and business confidence. If so, US growth could slow by more than we expect.

With luck, the pessimism at start of the year will turn out to be overdone

At the start of 2019, these risks loom large. Confidence is fickle. However, healthy economic fundamentals such as ongoing gains in employment and real incomes in the US, Europe and Japan support our base case: 2019 could turn into a year in which the pessimism that has gripped markets in the last few months turns out to be overdone after what will probably be quite a rocky start. Despite serious wobbles, it is too early for a genuine recession as long as the world can dodge the top political risks. Political mistakes happen. But they are rarely bad enough to cause a recession just on their own.

US: economic momentum to slow in 2019

Growth to decelerate to 2.5% in 2019 due to lower confidence and softer global growth

US economic momentum will slow in 2019, reflecting the diminishing boost from the Tax Cuts and Jobs Act, a decline in confidence related to financial market and trade-related uncertainties, and softer global economic growth and trade volumes, stemming largely from weaker economic conditions in China. We expect US real GDP to grow by 2.5% in 2019 and 2.3% in 2020 after a strong 2.9% expansion in 2018. The probability of a recession unfolding in 2019 is low. We expect monthly employment growth to slow but remain healthy as the unemployment rate declines a little further. Inflationary pressures should remain contained, even as wage gains continue to improve moderately.

Consumption growth to moderate, but fundamentals remain solid

Consumption will remain the primary driver of demand growth in 2019. We expect real consumption to rise by 2.6%, an easing from the robust 4% annualised increase between Q2 and Q4 2018, as the lift from the tax cuts fades. This forecast is consistent with slower growth in disposable incomes as the tax cut boost peters out and with and the fall in expectations indexes in consumer confidence surveys. Nevertheless, sustained job gains, low unemployment and further increases in wages, along with lower energy prices, will support growing consumer spending (Chart 1). The high rate of personal saving provides some flexibility to consumers.

Residential investment will continue to be sluggish

Housing activity will likely remain flat in 2019. Real residential fixed investment is projected to rise by only 0.9%, after declining in 2018. The housing sector is held back by a lack of labour and sufficient land for building, rising raw material costs and higher mortgage rates. High prices in desirable cities and metropolitan areas have dampened home purchases. Some of these constraining factors should ease – smaller mortgage-rate increases, softer home price rises and sharply lower lumber prices will help. We expect residential construction and new home sales to continue to rise and existing home sales to decline further. The bar for improvement in the housing sector in 2019 is very low.

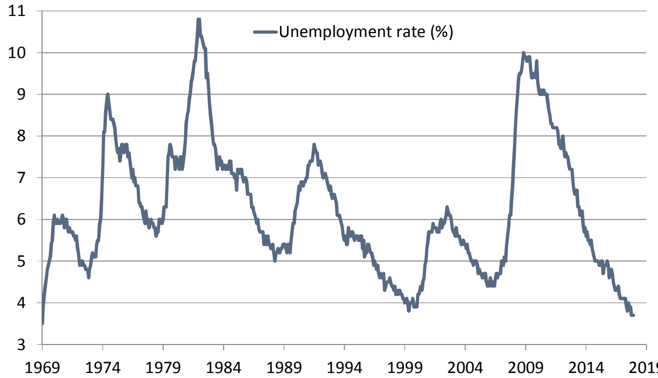
Businesses face mounting headwinds

Real business fixed investment growth is set to slow to 3.9% in 2019 from nearly 7% in 2018. Industrial momentum has slowed and measures of current conditions have declined sharply in regional manufacturing surveys. Future investment spending plans, however, remain solid. Increased tariffs have disrupted supply chains for some industries and slower global growth has dragged on export-dominant manufacturing sectors. The sharp drop in oil prices will reduce investment in oil and gas and supporting sectors, analogous to 2015-16 declines. Whereas extremely elevated measures of confidence and favourable financial conditions boosted investment in 2017-18, any significant fall in confidence – which may be triggered by deteriorating financial conditions in Q4 2018 and ongoing trade policy uncertainties – could adversely affect 2019 investment decisions (Chart 2). However, businesses will continue to benefit from various aspects of tax reform and deregulation.

US exports affected by slower global growth and stronger US dollar

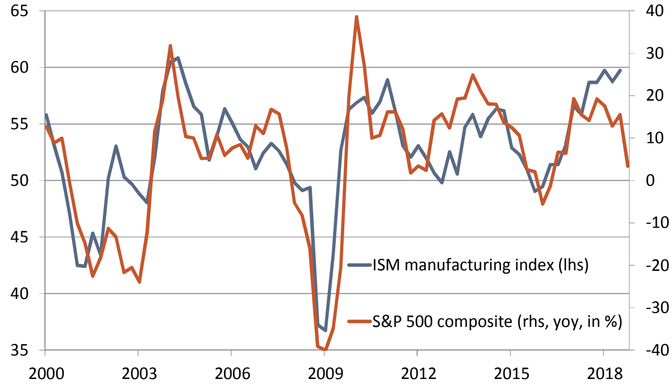
Slower global growth and the stronger US dollar are likely to weigh on US exports. We forecast export growth to slow to 2.6% in 2019 from 4.2% in 2018 and imports to ease to 4.4% growth from 4.9%. Global trade volumes will probably moderate and may even fall in 2019, following their pre-tariff ramp up in 2018. Trade policy uncertainties will linger into 2019. We look for the US and China to reach agreements that will involve China lowering tariffs and non-tariff barriers. Negotiations aimed at ending China's unfair treatment of intellectual property and investment policies will not be resolved in 2019, though. We expect Congress to ratify the new United States-Mexico-Canada Agreement (USMCA).

Chart 1: US – unemployment rate (%)



Monthly data. SA, in %. Source: Bureau of Labor Statistics

Chart 2: US – ISM manufacturing and S&P 500 indexes



Quarterly data. Source: Institute for Supply Management, Standard & Poor's

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Government purchases to contribute sizably to GDP growth

We forecast US government consumption expenditures and gross investment to rise by 2.4% in 2019, the fastest increase since 2009. Our estimates reflect the Bipartisan Budget Act of 2018, which provided additional budget authorisation for defence and select non-defence discretionary programmes in fiscal years 2018 and 2019. Both Democrats and Republicans agree that more infrastructure spending is necessary. However, the chance that they will enact any meaningful and comprehensive infrastructure legislation is low due to budget constraints and differences in opinion on how to finance an infrastructure spending initiative. If House Democrats propose an infrastructure plan that the Trump Administration green lights, chances of successful implementation would rise materially.

Job gains to remain solid and unemployment to fall further

We look for average monthly employment growth to slow. However, rising labour force participation for prime working-age persons will support further healthy job gains and higher potential real GDP growth in the intermediate term (~2.3%) – see Chart 3. We expect the unemployment rate to fall to 3.6% in 2019 from 3.9% in 2018 without pushing up wage growth materially. Wage gains should continue to be tempered by the elastic supply of labour, and firms' growing use of non-wage compensation and work-flexibility to attract staff. A meaningful drop in business sentiment would reduce hiring plans.

Core PCE inflation to climb slightly to 2.0% in 2019 from 1.9% in 2018

Inflation is projected to remain contained and inflationary expectations are expected to remain well-anchored to 2%. Inflation picked up through the first half of 2018, but decelerated in the second half (Chart 4). The sharp drop in energy prices will reduce headline inflation, and smaller gains in medical care, shelter, commodity and import prices (from the stronger dollar) should weigh on core inflation. Relatively low survey and market-based measures of inflation expectations and better productivity growth will also keep a lid on inflation.

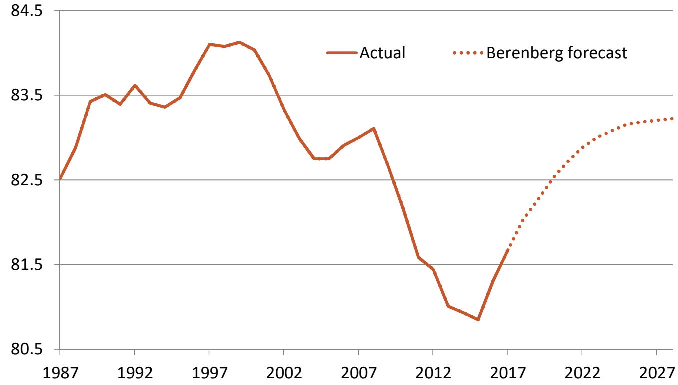
We expect the Fed to hike its policy rate at most once in 2019

The Fed is likely to proceed more gradually with its policy rate normalisation in 2019 and become more circumspect about its balance sheet policy. Although the median Federal Open Market Committee (FOMC) member forecast of the appropriate number of policy rate hikes in 2019 is two, we expect the Fed to increase its federal funds rate target by at most once in 2019 and pause through 2020. Global growth concerns, slower money supply growth, tighter financial conditions, the flatter yield curve, lower inflation expectations and uncertainty around estimates of the neutral policy stance will lead the Fed to take a more cautious approach. The rotation of traditional doves into voting roles on the FOMC in 2019 will also give the Fed a more dovish tilt.

The US faces downside risks from falling confidence and the slowdown in China

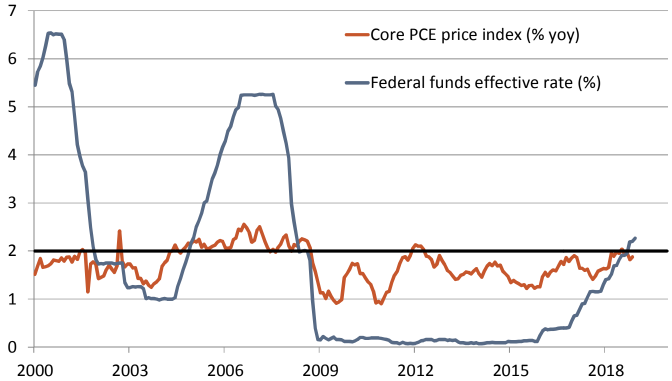
US economic forecasts face downside risks, primarily from two sources: falling confidence at home and softening China. The stock market correction, trade uncertainties and other international issues could result in a significant fall in consumer and business confidence measures, which have hovered near record highs over the last two years, thereby reducing actual consumer spending and business investment. The economic slowdown in China and related moderation in global trade volumes would adversely affect US economic performance.

Chart 3: US – prime working-age cohort labour participation (%)



Annual data. SA, in %. Source: Bureau of Labor Statistics and Berenberg forecasts

Chart 4: US – core PCE price index and Fed funds effective rate



Monthly data. Sources: Bureau of Economic Analysis, Federal Reserve Board

China: moderating growth amid trade pressures

China official GDP growth to decelerate to 6.1% in 2019, but actual conditions likely weaker

2018 was likely a watershed year for China: its economy showed clear signs of slowing and did not respond much to the government's renewed efforts to stimulate growth. Real GDP growth slightly exceeded the 6.5% target established by China's leaders but only through the nudging of government purchases and statistics. The pace of growth moderated significantly in Q4. Actual conditions are weaker than portrayed by official measures. Economic growth looks set to decelerate further in 2019. While we expect aggressive government stimulus to support official real GDP growth of 6.1%, actual conditions will likely be weaker.

Policymakers struggle between efforts to constrain debt and sustain growth

China's potential growth is moderating, reflecting its rising unit labour costs, which are cutting into its international competitiveness, and slower migration of workers into the high-production, high-productivity eastern provinces. For China to achieve real GDP growth targets well above its slowing potential rate requires more and more stimulus and heightened reliance on credit and debt (Chart 5).

Economic indicators failed to respond to stimulus in 2018

Three key themes dominated the economic and policy landscape in 2018. First, the People's Bank of China (PBoC) eased monetary policy, but key economic indicators continued to soften (Chart 6). Five consecutive months of declining auto sales contributed to decelerating retail sales growth. Growth in industrial production softened. The moderation in domestic activity contributed to weaker imports. Imports and exports fell in November, significantly denting year-over-year growth.

Trade tensions contribute to China's decline in confidence

Second, the Trump administration's aggressive negotiating tactics with China on trade, intellectual property, computer hacking and international security issues – highlighted by the imposition of tariffs – contributed to China's decline in confidence. These factors led to the sizable slump in China's stock market and currency. In 2018 the Shanghai Composite Index plunged by 25% in local currency terms while the yuan fell by 5.3% versus the US dollar and 1.9% on a trade-weighted basis. Third, although the weaker yuan favours Chinese export-related manufacturers, it raises the costs of imports for China's vast consumer base and companies that rely on imports of natural resources, materials and capital goods used in production.

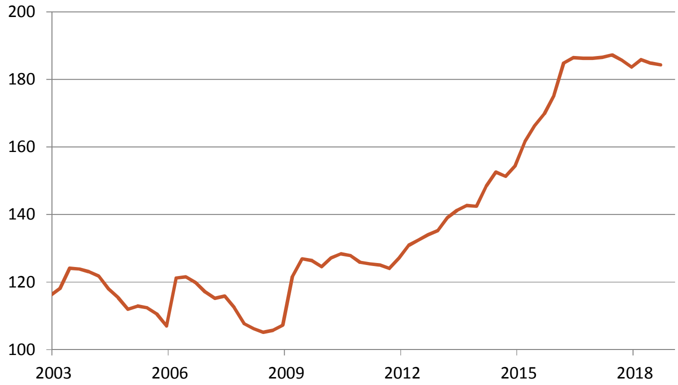
China and the US to reach a series of market-favourable trade agreements

In 2019, the government will provide aggressive fiscal and monetary stimulus in an attempt to arrest the underlying weakness in domestic consumption and investment. We expect import and export growth to decline sharply following recent months of hurry-up shipments in anticipation of higher tariffs. Amid these trends, China and the US are likely to reach a series of market-favourable agreements that ease select trade barriers and related tensions, including a long-term contract for China to purchase liquid natural gas (LNG) from the US. Tough negotiations on more difficult and broad-ranging issues of intellectual property, investment practices and international diplomacy will continue throughout the year.

China's performance critical to global growth

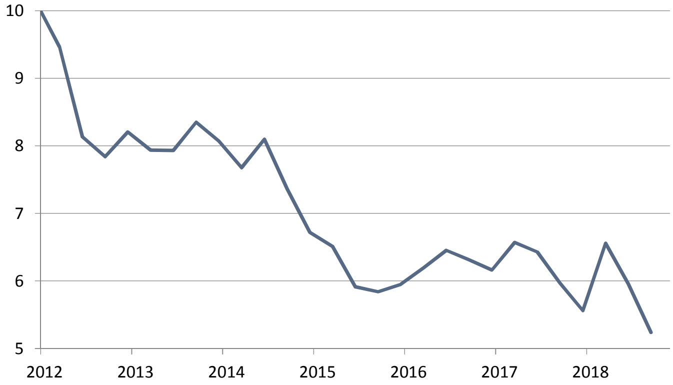
The extent to which China's economy responds to the stimulus is critically important to global trends in trade and growth. Even if China's official data indicate growth in excess of 6%, supported by stepped-up government investment spending, actual conditions affecting global trends will most likely be weaker.

Chart 5: China – private sector credit to GDP (%)



Quarterly data, in %. Sources: People's Bank of China, China National Bureau of Statistics

Chart 6: China – real GDP for secondary industries (% yoy)



Quarterly data. Source: China National Bureau of Statistics

Japan: moderate growth with downside risks

Japan real GDP growth at 0.9% in 2019, but slower global growth poses risk

Following strong growth in 2016 and 2017, choppy quarterly real GDP in 2018 flattened Japan's growth trajectory (Chart 7). We expect real GDP to expand by 0.9% in 2019, with moderate gains in domestic consumption and investment but softening exports that constrain the increase in industrial production. Wage gains are projected to rise further and inflation is expected to remain moderate. The biggest risk facing Japan is slower growth in China and globally.

Japan's export orders and production weighed down by China slowdown

In 2018, Japan's labour markets remained strong with rapid gains in employment. While profits rose, productivity was virtually flat, and consumer spending and business investment were spotty. Uncertainties related to the US-China trade tensions and the material slowdown in growth in China – Japan's largest trading partner – have begun to weigh heavily on Japan's export orders and production.

Japan labour force participation rate continues to rise

The unemployment rate hovered at 2.5% or below, a multi-decade low, but ongoing increases in labour force participation rates of prime working-age women and older people, plus a surprisingly large influx of foreign workers, eased labour market tightness (Chart 8). These trends have been stimulated by the Abe administration's financial incentives and regulatory changes. While the wages of permanent, full-time workers rose by a modest 0.5% yoy, wage gains of temporary staff, who tend to reflect the most dynamic portion of the workforce, have accelerated to 1.5% yoy.

Drop in oil prices to lower inflation, but lift real consumption

In response to these positive trends and firm growth in consumer spending, as well as higher oil prices, inflation drifted up to 1% yoy through October 2018. However, core inflation remained more modest at 0.4%. The recent plunge in oil and energy prices will suppress inflation pressures but add to consumer purchasing power and provide a positive impulse to real economic growth.

QQE and YCC to continue through 2019

We expect the Bank of Japan (BoJ) to continue its massive quantitative-qualitative easing (QQE) and yield curve control (YCC) programme through 2019. Currently, the BoJ holds over 40% of total government debt outstanding and is buying bonds equivalent to more than 100% of budget deficits. The BoJ's objective is to overshoot its 2% inflation target for a while and drive up inflationary expectations.

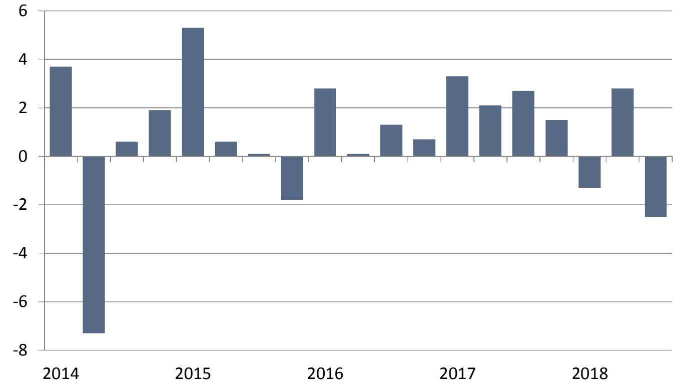
Negative impact of VAT hike to be mitigated

Lurking on the horizon is the next VAT hike to 10% from 8%, scheduled to be implemented in October 2019. The negative economic impact will be mitigated by some tax and spending developments and the BoJ's sustained aggressive monetary accommodation.

Weaker exports are the biggest risk facing Japan

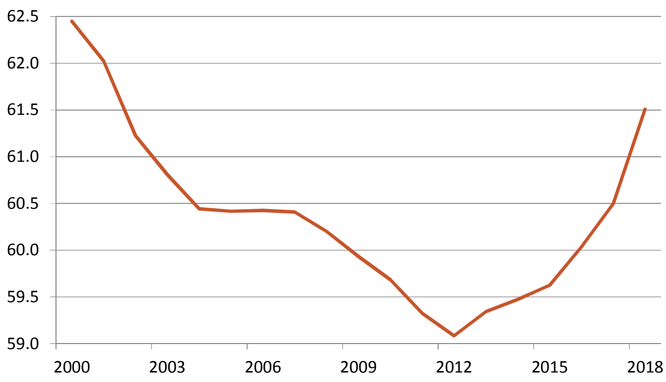
Weaker exports is the biggest risk facing Japan. Nearly 40% of Japan's goods exports go to China (19.0%) and the US (19.3%). Besides autos and consumer electronics, Japanese manufacturers export significant amounts of durable goods used in production processes. While US demand growth is expected to slow, China is the wild card. Materially slower gains in Chinese private sector economic activity would harm Japan.

Chart 7: Japan – real GDP (% qoq)



Quarterly data. Annualized growth rate. Source: Cabinet Office of Japan

Chart 8: Japan – labour force participation rate (%)



Annual data. 2018 estimate calculated through November. Source: Ministry of Internal Affairs and Communications

Eurozone: a new spring after a grim winter?

2018: a serious slowdown instead of just a return to normal

Eurozone growth did not live up to expectations in 2018. Instead of just softening to a more sustainable pace of close to 2% over the course of the year, growth fell well below the 1.5% trend rate in the second half of the year (see Chart 9). After accounting for half of the rapid pace of Eurozone real GDP growth in 2017, net exports gradually turned into a drag over the course of 2018. While investment largely held up in the first three quarters of 2018, gains in private consumption decelerated from a yoy increase of 1.7% in 2017 to just 1.0% in Q3 2018.

Trade, China and Turkey weighed on confidence and exports

From March 2018 onwards, a series of external shocks, political risks and home-grown problems hit business confidence, exports and consumers' purchasing power. Eurozone industrial confidence suffered its worst monthly drop since the wake of the euro crisis in March 2018 – right after US President Trump announced his intention to impose tariffs on steel and aluminium imports. As Trump escalated the trade tensions thereafter, sentiment declined further. In H2 2018 export-reliant industries had to stomach further hits as the Chinese economy slowed down and some emerging markets, such as Turkey, fell into a crisis.

Italy, Brexit and German car issues added to the problems

The spending plans of the radical government in Rome took their toll on Italy's economic performance in H2 2018. To some extent, concerns about Italy are also weighing on sentiment in neighbouring countries. Specific problems in the German car sector, stemming mostly from the belated adjustment to new emission testing standards, caused a 19.6% yoy decline in German passenger car production in Q3 and a similar drop in German car exports. For late 2018 and Q1 2019, the shrillness of the current Brexit debate in the UK is likely to exacerbate the ongoing decline in Eurozone business expectations and confidence.

Higher oil price constrained consumers' real purchasing power

The temporary spike in oil prices accentuated the slowdown in the summer and autumn of 2018. Higher oil prices contributed 0.8ppt to the annual rate of headline inflation in the Eurozone in Q3 2018 – Chart 10. The resulting drag on the gain in real disposable incomes explains about half of the deceleration in real private consumption growth.

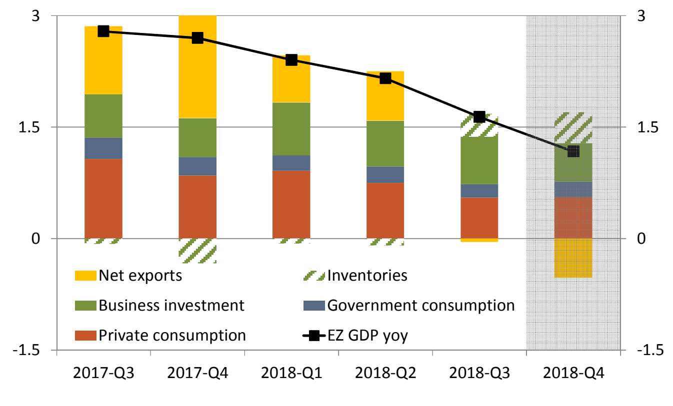
Too early for a recession

Slower growth and weaker sentiment in late 2018 have prompted concerns as to whether the Eurozone economic upswing may come to an end in 2019. These concerns are unusual at this stage of the cycle. On average, Eurozone business cycles last roughly eight years, with real GDP expanding by a cumulative 21% over that period. The current upswing started only in spring 2013 and is thus less than six years old. Since the end of the euro crisis, the economy has grown by less than 11%. Meanwhile, domestic economic fundamentals remain encouraging. The ongoing gains in employment and wages, and the firming of credit growth are just two of many examples to prove the point. Judging by previous cycles and current fundamentals, at least two more years of growth above the 1.5% trend could be in the tank before economic logic may suggest that a genuine downturn could be due.

Current fundamentals and previous cycles suggest upswing can continue

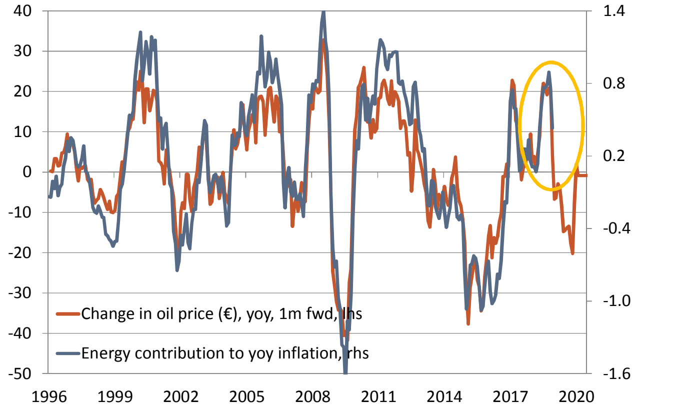
The most recent data, however, show that the external shocks and political risks have started to spread to the domestic economy. Gripped by fear and facing weaker export demand, companies have slowed down the pace of hiring while consumers are also spending more cautiously. These are first signs that the self-reinforcing downward dynamics of the business cycle have started to set in, to some extent. Leading indicators point to a further loss in demand momentum in the next two quarters – Chart 11.

Chart 9: Eurozone – GDP growth and its components



Quarterly data. Yoy change of GDP in %. Contributions to yoy GDP growth in percentage points. Berenberg projections for 2018 Q4. Sources: Eurostat, Berenberg projections

Chart 10: Eurozone – Oil shock has started to fade



Quarterly data. Yoy change in price for barrel Brent crude, in €, adjusted for change in headline consumer prices; energy contribution to Eurozone headline inflation, in ppt; oil price projection based on constant oil prices. Sources: Haver, Eurostat, Berenberg calculations

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That does not mean the outcome has to be even worse than the meagre 0.16% qoq rise in real GDP recorded in Q3, though. A gradual rebound in German car production will probably add slightly to the quarterly real GDP gains in Q4 2018 and Q1 2019, partly offsetting the underlying downtrend in real GDP dynamics. A catch-up effect in France after strike-related losses in late 2018 may also limit the downside for Q1 2019.

Short-term volatility

The start into the new year could be quite rough for the Eurozone. While Brexit uncertainty is reaching its peak, the growth of exports to China is likely to slow down sharply from the 4.5% yoy average gain in the first 10 months of 2018. In addition, concerns that the US may impose a 25% tariff on car imports will continue to weigh on sentiment. However, if our baseline scenario unfolds – that is, if trade negotiations yield at least some results, China implements a more aggressive stimulus to kick its problems further down the road and the UK goes for a soft Brexit or even decides to stay in the EU – sentiment could turn up again in the Eurozone. Some rebound in exports to emerging markets such as Brazil and Turkey and, more importantly, the tailwind from lower oil prices could help to add renewed momentum to the cyclical upswing later in 2019. A competitively valued exchange rate and a small fiscal stimulus to the tune of 0.1% of GDP should also support demand.

Renewed momentum after a rough start into 2019

The outlook is particularly challenging for Italy. As a half-reformed economy still saddled with serious structural weaknesses, Italy is very vulnerable to reform reversals. While the government in Rome presents the lowering of the retirement age and an increase in social spending as a fiscal boost, these policies could make Italy even less attractive for business investment. The risks to our call for 0.5% GDP growth in Italy 2019 are tilted to the downside. Disappointing growth may reignite the fiscal dispute between Rome and Brussels.

Italy could get into trouble again

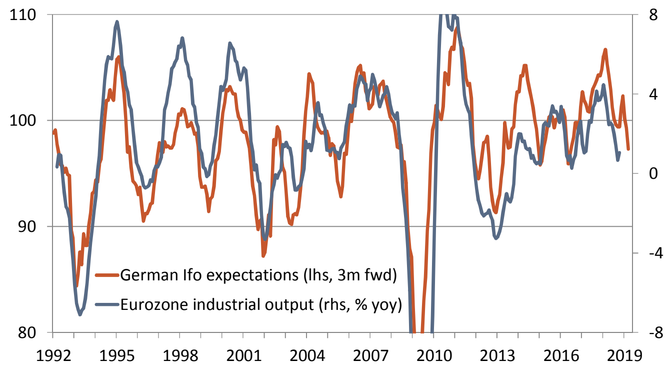
Two major risks could jeopardise our 2019 outlook for the Eurozone. First, politics or the export outlook may go badly wrong – Trump may escalate his trade wars, the UK could fall into the hard-Brexit trap, China could suffer a hard landing or Italy's radical government could steer the country into a disruptive debt crisis despite the late-2018 compromise with the EU. Second, even if these big risks fade over the course of 2019, as we expect, the fear factor may take on a life of its own for a while. Households and companies may now be so nervous that some smaller future disturbances, which they would shrug off in more settled times, could still inhibit their readiness to spend more money again for a few quarters. Fortunately, economic sentiment is still above average. This suggests that the downward cyclical dynamics are not deeply entrenched yet. If and when the external and political risks have receded somewhat, activity could thus start to rebound to a rate around the 1.5% trend.

Two risks: politics and self-reinforcing dynamics

Against the backdrop of heightened uncertainty and with core inflation virtually unchanged at 1% for the last five years, the ECB will maintain an accommodative monetary stance for the foreseeable future. After the end of net purchases in December 2018, a sizeable stock of assets, planned reinvestments and low interest rates will continue to provide ample support. Similar to the ECB, we expect the energy-driven decline in headline inflation to mask a gradual pick-up in wage-led core inflation – Chart 12. Following the Eurozone recent slowdown, a sharp uptick in core inflation looks even more unlikely than before, though. At least until external shocks and politics risks start to fade by spring 2019, the ECB will keep its options wide open. We expect the ECB to return to a symmetrical rate corridor by raising its deposit rate from -0.4% to -0.25% in December 2019 before hiking all rates twice by 25bp each in 2020. Until at least 2020, the ECB will fully reinvest the proceeds from maturing debt, keeping its bond portfolio constant for two years after the end of net asset purchases.

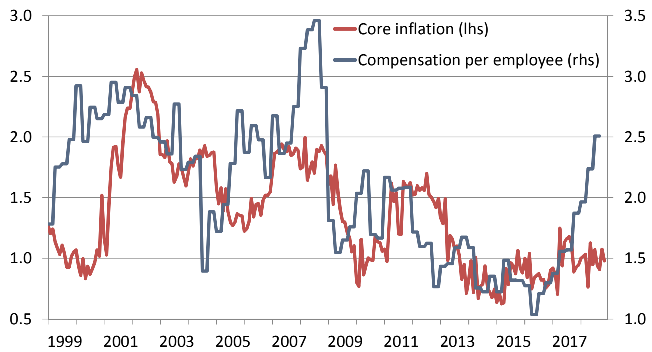
ECB keeps options wide open – first deposit rate hike in December 2019?

Chart 11: German Ifo expectations and Eurozone output



Monthly data. German Ifo expectations (excluding services), advanced by three months; Eurozone industrial output, yoy change in % Sources: Ifo, Eurostat

Chart 12: Eurozone – Core inflation and wage growth



Monthly data. Yoy change in %. Sources: Eurostat, ECB

UK: releasing the Brexit brake in 2019

We see an 80% chance that the UK will avoid a damaging no-deal hard Brexit. While the long-term risks to UK potential growth from Brexit loom large, the prospect of a deal presents considerable upside potential for the UK economy over the medium-term.

80% chance the UK will avoid a hard Brexit

Just as the market consensus overestimated the extent to which the UK economy would soften after the Brexit vote, we think the consensus is now underestimating the extent to which growth will pick-up this year following a deal. We look for UK real GDP growth to accelerate from 1.4% in 2018 to 1.8% in 2019 and 2020. (Bloomberg consensus for 2019 is 1.5% and for 2020 is 1.6% – taken on 3 January 2019)

Above consensus for 2019 and 2020

Rebounding domestic demand: Although real GDP growth has averaged an acceptable 1.7% yoy since the Brexit vote, down from a 2.0% average between the start of the post-Lehman recovery and the EU referendum, Brexit uncertainty has weighed heavily on the domestic economy. Annual real domestic spending growth slowed to 1.9% in 2017 and 1.1% in 2018 from 2.5% in 2015 and 2016.

Brexit uncertainty has weighed heavily on the domestic economy

The jump in inflation following the 16% drop in trade-weighted sterling following the Brexit vote has subtracted from real consumption growth during the past two years. Despite the slowdown in real terms, nominal household spending remained healthy, reflecting solid underlying household demand – Chart 13. Simultaneously, the heightened uncertainty about the future rules governing trade between the UK and its biggest market, the EU, has stifled businesses' appetites for productivity-enhancing capital investment. Business investment has sagged even as the UK has run up against capacity constraints – Chart 14.

The slowdown has been most pronounced in business investment

Both of these trends will unwind if and when the UK manages to avoid a hard Brexit. Consumption growth had already started to pick-up over the course of 2018 – real and nominal – as the headline inflation rate declined from 3.0% at the start of the year to c2.3% by the end of the year. The labour market is showing genuine signs of tightness. With a low unemployment rate, record employment and job openings, UK wage growth is rising at faster rates. At 3.3% yoy, annual wage growth in October 2018 was nearly a full percentage point higher than a year earlier.

But this trend will partly unwind if the UK avoids a hard Brexit

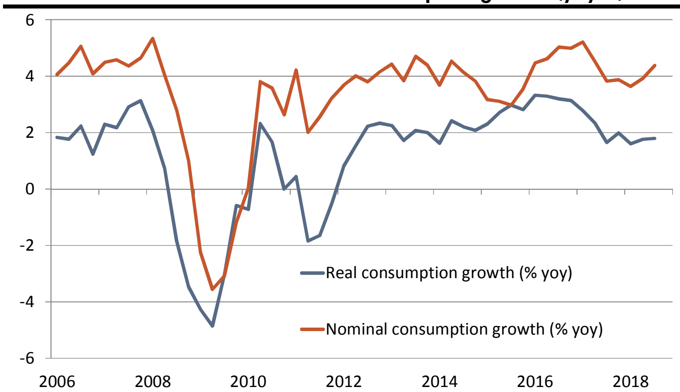
Backed by a continued rise in wage growth and the decline of headline inflation towards 2%, real wage growth will likely hit 1.5% annualised by mid-2019. Two factors suggest that risks to real wage growth, and thus real consumption growth, are skewed to the upside: 1) as of April 2019, the tax-free threshold for income tax will rise to £12,500 from £11,850, while the threshold for the upper rate of tax will rise from £46,350 to £50,000; 2) trade-weighted sterling could appreciate by as much as 10% on the back of a Brexit deal – on its own, the stronger exchange rate would represent a material boost for real household incomes.

The risks to real wage and consumption growth are skewed to the upside

A Brexit deal should herald a temporary pick-up in investment too. Helped by stronger gains in real domestic demand, UK firms will likely feel more confident to step up investment to ease the pressure on stretched productive capacities. Now that the UK has reached full employment, higher investment would drive gains in productivity. When productivity rises, firms can raise wages without putting prices up. We expect growth in gross fixed capital formation – the broadest category of investment – to rise towards 5% yoy by late-2019.

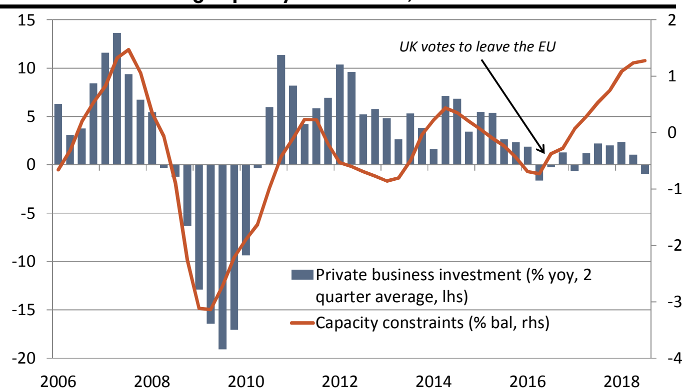
Firms will likely respond to capacity constraints by raising investment

Chart 13: UK – real versus nominal consumption growth (yoy %)



Quarterly data. Source: ONS

Chart 14: UK – rising capacity constraints, but reluctant to invest



Quarterly data. Source: Bank of England, ONS, Berenberg calculations

The BoE is at risk of falling behind the curve if wage growth keeps picking up

Continued monetary policy normalisation: Cautious of adding to the downside risks by hiking rates too quickly, the BoE has trodden carefully since the Brexit vote, increasing rates only twice. But the fundamentals for wage and price setting point to building underlying inflationary pressure over the medium-term. Meanwhile, inflation expectations advanced over the course of 2018 – to 3.2% in Q3 – to well above the BoE's 2% yoy inflation target.

We expect the BoE to continue to normalise monetary policy in 2019

In our view, the BoE will continue to normalise monetary policy as long as three conditions are met: 1) the UK avoids a damaging no-deal hard Brexit; 2) wage growth continues to pick up; and 3) real GDP growth remains at or above the BoE's estimate of potential (1.5% yoy). Still, it is highly unlikely that the BoE would hike rates again before the Brexit question is settled.

We look for two rate hikes in 2019 and 2020

Following just one hike per year for the past two years, we look for the BoE to step up the pace in 2019 and 2020. We expect two hikes in 2019, with the first one in May, followed by at least one additional hike – likely in August. We project two further hikes for 2020 to take the Bank Rate to 1.75% by Q4 2020. Given the recent trends in the fundamentals for price setting (Chart 15), the BoE is starting to run the risk of falling behind the curve. Nevertheless, a further rise in global risks and wobbly financial markets may temper any eagerness at the BoE to normalise monetary policy at a quicker pace.

UK monetary policy will remain highly accommodative even with

Even with a modest continued normalisation in which the Bank Rate increased to 1.25% by the end of 2019, UK monetary policy would stay highly accommodative. In our base case, which seems consistent with the BoE's guidance for "gradual" and "limited" rate hikes, the real policy rate would remain negative and the bank's balance sheet large by historical standards. As long as the external backdrop continues to be stable, a policy of continued gradual rate hikes is unlikely to slow UK domestic demand growth much. The costs of business and consumer credit and mortgages are set by market forces, and not directly by the BoE. The rise in borrowing costs in the real economy is therefore likely to remain low by historical standards and be less than any eventual increases in the Bank Rate (Chart 16).

We see a 20% risk of a no-deal hard Brexit

The hard-Brexit risk dominates the near-term outlook: Despite the current parliamentary gridlock, we maintain our base case that, in the end, the majority pro-EU parliament will do what it takes to prevent the UK from crashing out of the EU on 29 March 2019 without a follow-up deal. Still, we see a 20% risk of a no-deal hard Brexit.

The UK economy will benefit from a Brexit deal as soon as one is struck

We expect UK domestic demand – especially from businesses – to remain subdued until the UK agrees some deal with the EU. In our base case, the UK economy will benefit from a drop in uncertainty as soon as a Brexit deal is struck.

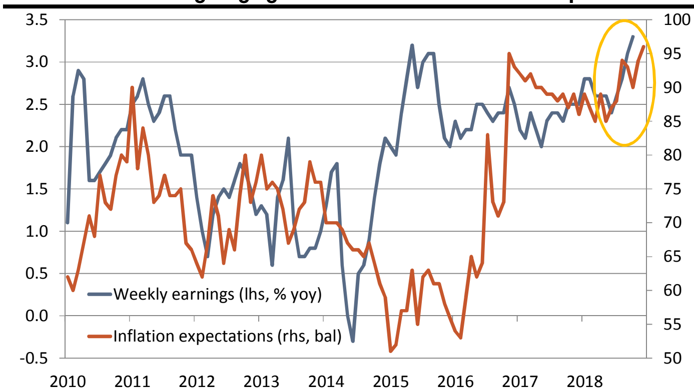
The adjustment to an unmanaged hard Brexit would be wrenching for the

In the long-run, the UK's domestic economy policies will matter more for British citizens than whether it remains a member of the EU or not. Despite this, leaving the EU will require a large economic adjustment. Unlike merely voting to leave the EU in 2016, actually leaving in 2019 implies a genuine change in the state of the world. Without a new partnership deal agreed in time for exit day, or at a minimum some policies to smooth the transition to WTO rules for UK-EU trade, the adjustment could be wrenching.

In a hard Brexit, the UK would be at serious risk of recession

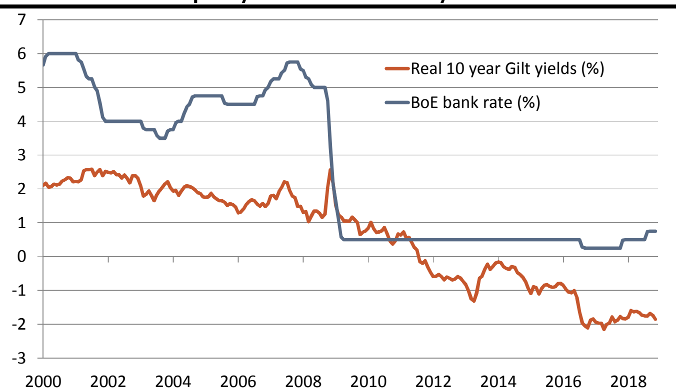
An unmanaged no-deal hard Brexit would probably strike a severe short-term blow to UK and European economic activity and take a sizeable chunk out of the UK's long-term growth potential. In a hard Brexit, the UK would be at serious risk of recession and a surge in inflation following a likely drop in the sterling exchange rate. This is the risk to watch.

Chart 15: UK – rising wage growth and elevated inflation expectations



Monthly data. Source: GfK, ONS

Chart 16: UK – BoE policy rate versus real 10 year benchmark rate



Monthly data. Source: Bank of England

Inflation: tame despite some pressure from wages

The oil price rollercoaster: The short-term gyrations of global inflation trends can be heavily influenced by fluctuating commodity prices. The near doubling of the price of a barrel of oil from June 2017 to October 2018 (c$45 to $80 for a barrel of Brent crude) added between 0.5-1.0ppt to headline inflation across the developed world in the summer of 2018. However, despite the rise in headline inflation above central banks' 2% inflation targets in the US and across Europe, core consumer price inflation remained close to or below the rates that central banks deem desirable in 2018 (see Chart 17).

Inflation remained close to or below central bank targets in 2018

The big disinflation: Three major forces continue to shape inflation trends in the post-Lehman era. First, the decades-long disinflationary effect of globalisation and technological change, which reflects healthy global supply-side developments, continues despite the heightened risk that this positive development could be impaired or even undone by trade-wars. Second, the spare capacity in pockets of Europe and the drop in US labour market participation in the wake of the post-Lehman mega-recession, as well as consumers' reluctance to borrow, have restrained demand-side inflation. Third, inflation expectations – most notably in the Eurozone and Japan – remain anchored below central bank targets after years of below-target core inflation.

Key forces continue to shape inflationary trends in the post-Lehman era

Despite diminishing slack, and early evidence that wage growth has begun to edge up in those economies with the most mature upswings – the US, the UK and Germany (Chart 18) – we do not expect a broad-based surge in inflation in 2019 as the long-term factors continue to outweigh such short-term developments.

We do not expect a broad-based surge in inflation in 2019

US: Despite low unemployment, employment gains are likely to remain healthy as labour participation continues to rebound over the medium-term. The rise in labour supply will temper wage growth. Relatively low survey and market-based measures of inflation expectations and better productivity growth will also keep a lid on inflation. After an increase of 2.4% in 2018, we forecast a 2.2% rise in the consumer price index in 2019 and a further 2.4% in 2020.

Modest wage gains in the US will limit the rise in inflation

Eurozone: Still some two to three years away from full employment or serious supply-side constraints, inflationary pressures are edging up only very gradually in the Eurozone. As the oil effects fade, we look for headline inflation to fall from 1.7% in 2018 to 1.3% in 2019, before rising a little to 1.6% in 2020 as firms begin to pass on higher wage costs to consumer prices.

Spare capacity in the Eurozone should keep a lid on inflation

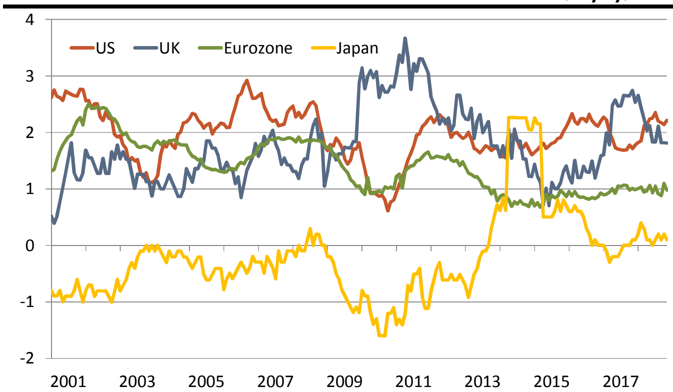
Japan: After years of ultra-accommodative monetary policy, the BoJ is struggling to return core inflation toward its 2% target. Low inflation expectations have become entrenched. The BoJ's objective is to overshoot its 2% inflation target for a while in order to drive up inflationary expectations. Modest wage growth adds to the central bank's challenges. We expect headline inflation to rise modestly from 0.9% in 2018 to 1.3% in 2019 and to 1.4% in 2020.

The BoJ will continue to struggle to meet its 2% inflation target

UK: Headline inflation will likely ease from 2.5% in 2018 to 2.2% in 2019 and 2020 as the post-Brexit vote surge in import prices fades. While a rise in sterling following a Brexit deal would weigh on the price level and boost real incomes, supply constraints will keep inflation modestly above target.

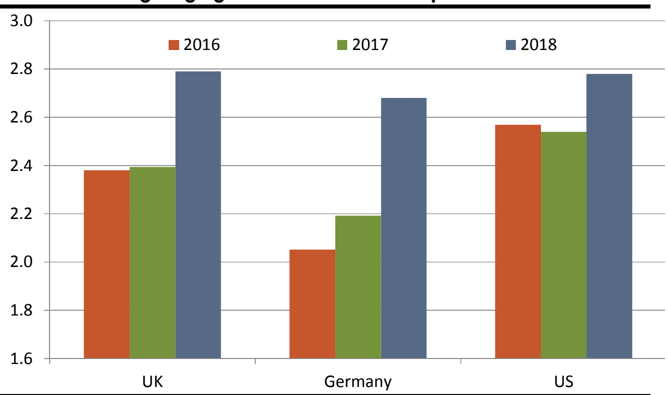
Supply constraints add to inflationary pressures in the UK

Chart 17: Core inflation rates across the advanced world (% yoy)



Monthly data. US data shows consumer price index minus food and energy. UK data shows consumer price index minus energy, food, alcohol and tobacco. Eurozone data shows consumer price index minus energy, food, alcohol and tobacco. Japan data shows consumer price index excluding fresh food. Source: BLS, ONS, Eurostat, Ministry of Internal Affairs and Communications

Chart 18: Rising wage growth in some developed economies



Annual data is based on monthly series. 2018 includes data to and including October. UK data is based on total weekly pay for the whole economy. German data is based on negotiated hourly earnings. US data is based on average hourly earnings for total private industries. Source: ONS, Deutsche Bundesbank, BLS

Risks mar the outlook for 2019

The weak end to a poor 2018 for equity markets reflects the heightened sense of risk heading into 2019. While the most serious threats to the outlook stem from politics, markets are becoming increasingly concerned about the sustainability of the post-Lehman expansion. Although we do not believe that any of the risks will play out badly, we expect markets to focus on the following issues over the course of 2019.

The wobbly end to a poor 2018 for equity markets reflects the heightened sense of risk

End of cycle – recession risk: Economic logic suggests that 2019 is still a few years too early for a recession. In the long but mostly shallow upswing since the great financial crisis, the advanced economies have not thrown much of an economic party yet outside pockets of some financial markets (US tech, US energy sector bonds). We find no signs of excess in credit, investment, wages, inflation, production and spending that would signal the need for a corrective recession soon – Chart 19. Even in the US, where the cycle is more mature than elsewhere, the still-modest wage pressure and continued solid employment gains suggest that the upswing has more road ahead to run.

Economic logic suggests that 2019 is still a few years too early for a recession

A loss of confidence: The business cycle is partly driven by animal spirits. While the economic logic does not point to a corrective recession, fear could weigh demand down nonetheless. If market and economic participants worry more than is justified, they may collectively spend too little, frightening themselves into a downturn. On a small scale, we have seen the beginnings of such self-reinforcing downside dynamics in the Eurozone in late 2018. The recent turning of US consumer confidence suggests the problem may be spreading – Chart 20. Still, it would take a big fear factor to really derail rather than just temporarily dampen the economic cycle. Fundamentals remain solid enough and central banks can serve as the buffer against any unexpectedly sharp loss of momentum if need be.

In it would take a big fear factor to really derail the economic cycle

Correction in China: China's potential growth rate will continue to slow as its economy matures. This is normal. But problems of excess debt, an ageing population and capital misallocation have brought China risks to the fore once again. The same happened in late 2015. Then, as now, its cash-rich authorities will turn on the taps bit by bit to send the problems further down the road. When China eventually runs out of policy headroom, it will have to face its problems. For now, it still has tools to delay the pain.

Despite slowing potential growth, China has to tools to delay a correction

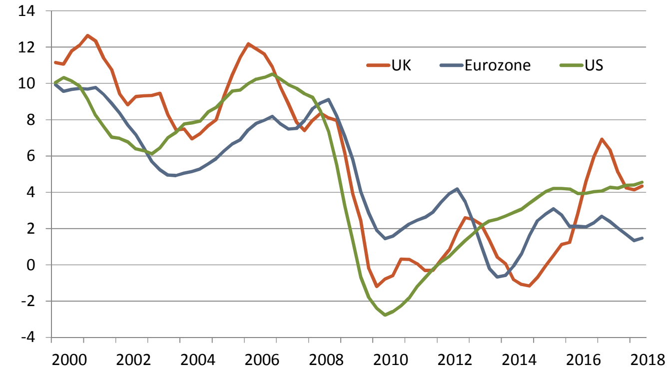
Extraordinary political mistakes could trump economic logic and cause a major downturn. For example, such mistakes would be: a) for Italy's radical government to plunge its country into a genuine Greek-style debt crisis; b) for Britain's mostly pro-EU political class to simply let the train roll towards and then over the hard Brexit cliff instead of using the 10 weeks between the likely death of Theresa May's Brexit deal and Brexit day on 29 March 2019 to stop it through a softer option or a new vote to stay in the EU; and c) for Donald Trump to hurt the US economy and impair his chances of re-election in late 2020 by going too far in his costly trade wars in 2019.

Watch the politics – Italian populists, Trump and Brexit

Although the political risks are significant, politics would have to go substantially wrong to cause a recession that is not warranted by underlying economic fundamentals. We have to watch the risks carefully, with a focus on potential hits to confidence from the political and economic newsflow. On balance, the risks are unlikely to materialise to an extent that could turn the current wobbly phase of demand growth into a genuine recession.

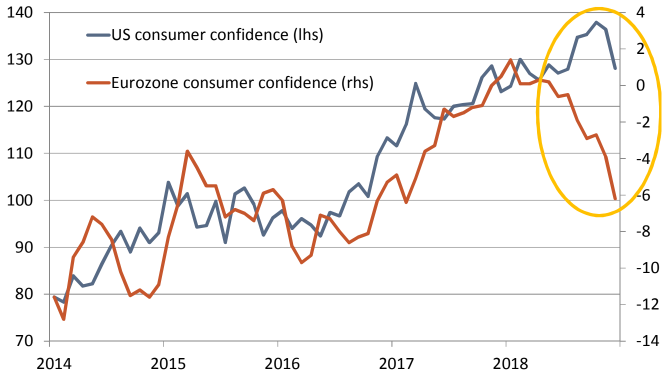
However, seldom do political risks cause the economic cycle to turn by themselves

Chart 19: Credit still growing only modestly in the western world



Quarterly data. Credit to the non-financial private sector, including debt securities, Eurozone 2015 adjusted for one-off surge due to a re-classification of some debt. Source: BIS

Chart 20: Confidence crisis spreading from Eurozone to US



Monthly data. Source: The Conference Board, European Commission

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