Economics

BERENBERG

PARTNERSHIP SINCE 1590

Global update: Narrowing the transatlantic gap

- **More room to grow:** The global economic upswing has not reached its final stage yet. Despite some serious political risks, economic fundamentals point to further healthy growth across almost all advanced countries and most emerging markets.
- **Political risks meet economic fundamentals:** Unfortunately, resentment against migration and other side effects of globalisation have nurtured the rise of a dangerous political populism on both sides of the Atlantic. Trade tensions stoked by US President Donald Trump are clouding the economic outlook in Europe and other parts of the world.
- **A transatlantic gap:** After strong and broad-based growth in 2017, a transatlantic gap opened up in the first half of 2018. Whereas trade tensions have caused a marked correction in Eurozone business confidence, the impact has been far more muted in the US where businesses benefit from deregulation and tax reform. In the US, rising investment in the energy sector offsets the drag from higher oil prices on demand. This is not the case in Europe where oil and gas extraction plays a much smaller role.
- **A dent to growth:** Largely as a result of trade tensions and higher oil prices, we have reduced our calls for European growth this year significantly over the last six months (Table 1). Despite some recent concerns, China is holding up slightly better than we had projected. We continue to expect solid growth for most major economies in 2019 followed by a slight moderation in 2020.
- **Narrowing the gap:** Looking ahead, we expect the transatlantic gap to narrow again in late 2018 and in early 2019. While US growth may decelerate slightly to a still-healthy pace as the upfront impact of US fiscal measures fades, a modest decline in oil prices and some easing of trade tension could allow Eurozone growth to re-accelerate from current annualised rates of about 1.5% towards roughly 2%.
- **Balance of risks:** Trade war threats have tilted the balance of risks to our growth outlook to the downside. If trade tensions were to escalate much further for much longer instead of receding somewhat before or after the US mid-term elections in November, growth could eventually disappoint on both sides of the Atlantic.
- **What could go wrong?** Beyond the concerns about tit-for-tat protectionism, the list of risks includes (i) a potential debt crisis in Italy if the radical new government in Rome implements too many of its expensive election promises and (ii) an unexpectedly pronounced acceleration of inflation that could force the US Fed to tighten policy faster than we project. While we need to watch these risks carefully, the probability that they may materialise within the next two years still looks small.

Table 1: What has changed? GDP growth forecasts today and six months ago

	2017	2018			2019			2020
		New	Old	Change	New	Old	Change	
World*	2.9	3.0	3.0	0.0	3.0	2.9	0.1	2.8
US	2.3	3.0	2.9	0.1	2.8	2.7	0.1	2.4
China	6.9	6.6	6.4	0.2	6.4	6.1	0.3	6.1
Japan	1.7	1.3	1.5	-0.2	1.1	1.0	0.1	0.9
Eurozone	2.6	2.1	2.4	-0.3	2.0	2.1	-0.1	1.8
Germany	2.5	2.0	2.5	-0.5	2.0	2.0	0.0	1.8
France	2.3	1.9	2.2	-0.3	2.1	2.3	-0.2	2.1
Italy	0.9	1.2	1.6	-0.4	1.2	1.5	-0.3	1.2
Spain	3.0	2.7	2.8	-0.1	2.6	2.7	-0.1	2.4
UK	1.7	1.4	1.8	-0.4	1.8	1.9	-0.1	1.7

Yoy changes in %. Note: 3 July 2018 (new) versus 3 January 2018 (old). Source: Berenberg projections

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Global outlook: Narrowing the transatlantic gap

Economic fundamentals point to healthy growth

Economic upswings do not die of old age. It takes either a major political shock or the need to correct serious excesses to trigger a recession. Despite some serious political risks, economic fundamentals still point to further healthy growth across almost all advanced countries and most emerging markets. In the western world, favourable financing conditions for companies and households and strong gains in employment underpin business investment and consumption. In some major countries such as the US, Japan, France and Spain, current or recent pro-growth reforms strengthen longer-term supply dynamics. Although rates of core inflation are likely to edge up as labour markets tighten, inflation pressures remain under control.

No serious excesses yet that would require a cleansing recession

After more than nine years of the post-Lehman recovery that started in the spring of 2009, advanced economies have not yet developed any of the serious credit, investment or inflation excesses that would require a cleansing recession within the next two years. Even the fast-growing US economy shows the typical traits of a healthy mid-cycle expansion rather than the excesses that often mark the late stage of an upswing. In the recovery from the Great Financial Crisis of 2008/2009, credit and aggregate demand in the advanced world have expanded less vigorously than in previous upturns after lesser recessions. As a result, the current recovery is far less aged than a mere look at the calendar may suggest.

Risks stem mainly from the rise of political populism

While economic fundamentals remain encouraging, resentment against migration and other side effects of globalisation has nurtured the rise of a dangerous political populism. Most importantly, the risk of serious trade wars stoked by US President Donald Trump is weighing on business confidence and clouding the economic outlook in Europe and other parts of the world. Impediments to trade raise prices, reduce output, lock up resources in activities that are no longer viable and impair the supply potential of the economies concerned.

A transatlantic gap

After strong and broad-based growth in 2017, a transatlantic gap has opened up in the first half of 2018 (Chart 1). While US growth has accelerated after a mediocre Q1, the Eurozone has slowed down from yoy gains in real GDP about 2.6% in 2017 to annualised growth rates close to the 1.5% trend. Although economic logic suggests that tit-for-tat trade war threats should hurt all countries concerned, the data show a transatlantic gap. We see two major reasons for this:

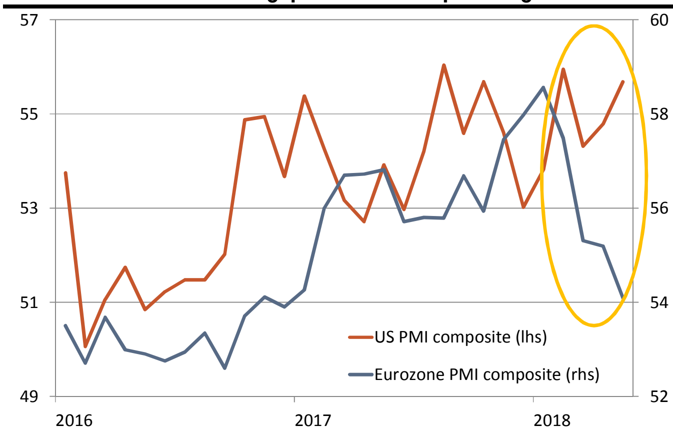
In the US, deregulation and reforms offset the hit from trade tensions

1) Under the impact of the trade tensions, business confidence has receded in the Eurozone from the euphoria of late 2017 to a level only modestly above average largely because export-oriented manufacturers have become less optimistic about the future. In the US, however, the fiscal stimulus and the positive effect of deregulation and tax reform are offsetting the concerns about the outlook for international trade and the damage to consumers and import-dependent businesses from somewhat higher tariffs (Chart 2).

Higher oil prices are neutral for the US but negative for Europe

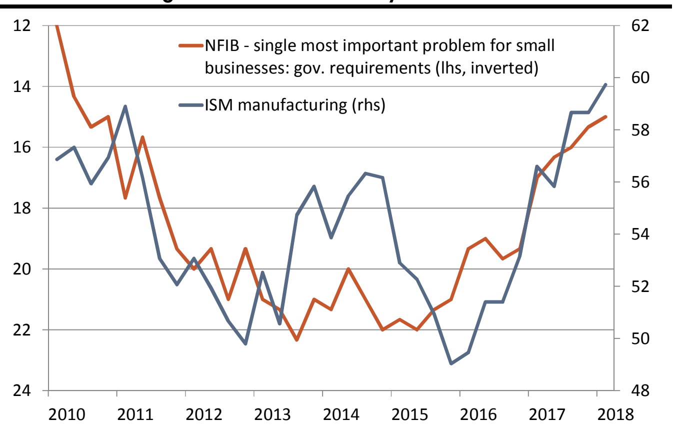
2) The rise in oil prices from an average of $61.5 per barrel Brent crude in Q4 2017 to $75 in Q2 2018 has raised energy costs for companies and petrol prices for consumers across the world. In the Eurozone, this shows up as a visible dent to real GDP growth. In the US, however, rising investment in the energy sector roughly offsets the oil-induced drag on private consumption.

Chart 1: The transatlantic gap – US and Europe diverge



Monthly data. Reading above 50 indicates expansion. Source: IHS Markit

Chart 2: US deregulation drives economy



From the NFIB's report on "Small business problems and priorities". Data shows that government requirements on small businesses is the single most important problem facing small businesses. Sources: NFIB, ISM, Berenberg

Trade tensions: the fear factor matters more than the actual tariff

Chart 3 illustrates the damage that uncertainty about future market access can cause. Shortly after the June 2016 vote to leave the EU, the UK decoupled to the downside from other developed countries. As the UK is still part of the EU, no Polish plumber has been sent packing from London and no tariff has been imposed yet. Nonetheless, the fear that cross-border exchanges will be disrupted post-Brexit is weighing heavily on the UK's economic performance. The fear factor counts for more than the current facts on the ground. In the same vein, the uncertainty about how far trade tensions will escalate and to what extent complex cross-border supply chains will have to be re-jigged weighs heavily on investment decisions although the tariffs imposed so far between, say, the US and the EU are minuscule.

Expect the transatlantic gap to narrow again in late 2018 and in 2019…

Looking ahead, we expect the transatlantic gap to narrow again later in late 2018 and in early 2019. US growth may moderate slightly as the impact of the 2018 tax cuts on demand growth starts to fade gradually over time. Eurozone growth can re-accelerate in late 2018 from a pace of about 1.5% to annualised gains of at least 2% if the temporary factors causing the current dent fade over time. We look for oil prices to decline modestly as both OPEC and the US raise supply. More importantly, our forecasts rest on the political bet that Trump will not want to escalate the trade tensions ever further. He may either strike deals with China and the EU to present himself to voters as a great dealmaker ahead of the November mid-term elections in the US – or at least shift a bit from ever grander threats by tweet to actual negotiations as the retaliation of China and the EU starts to affect parts of his political base.

…unless the trade tensions were to escalate much further

If the trade war threats do not get much worse, businesses will likely get used somewhat to the elevated level of noise over time. As many European companies notice that their exports to the US keep rising courtesy of strong US domestic demand, business confidence and demand growth can recover from the current dent. In May and June, some sentiment indicators for the Eurozone have already started to stabilise. After a potential new setback in July when new US tariffs and the retaliatory measures from China and the EU may come into effect, we look for a gradual recovery in confidence during the autumn.

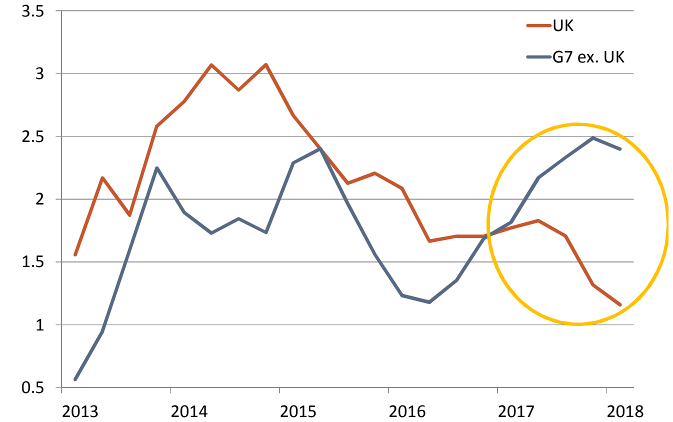
US and China stronger, Eurozone a little weaker

Relative to our year-ahead outlook from 4 January 2018, we have shaved our GDP calls for 2018 from 2.4% to 2.1% for the Eurozone while raising the call for the US marginally from 2.9% to 3.0% (see Table 1 on page 1). While the risks to our forecasts seemed to be skewed to the upside at the start of the year, the trade war threats have tilted the risks to the downside. If Trump continues to escalate the conflict, growth could suffer on both sides of the Atlantic and – temporarily – in China until the authorities have deployed a domestic stimulus to counteract the potential damage.

Key risks: trade wars and an unexpectedly fast surge in US inflation

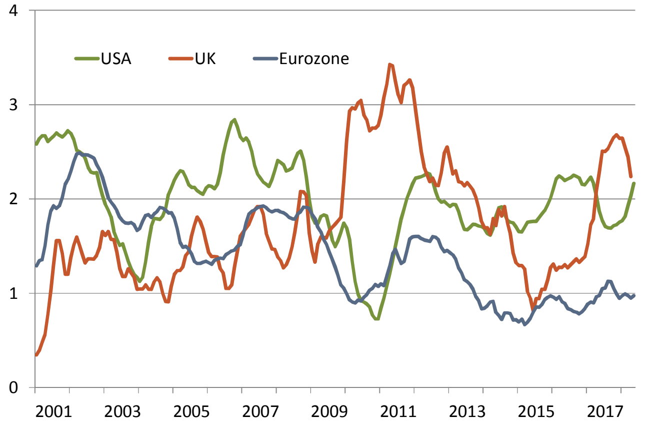
The list of risks also includes an unexpectedly pronounced acceleration of inflation that could force the US Fed to tighten policy faster than we project. However, the still low rates of core inflation on both sides of the Atlantic (Chart 4) suggest that this risk remains under control for the time being despite some upside risk in the US. Structural factors such as globalisation, e-commerce and other technological innovations such as the rise of robots still restrain the rise of underlying inflation pressures. In addition, faster productivity gains as a result of additional business investment can partly offset the gradual uptick in wage inflation. For now, the Fed and the ECB can stay on the course of the gradual normalisation of their policy stance roughly in line with their current guidance.

Chart 3: Trade wars – Brexit-lite for everybody?



Quarterly data. Annual growth of real GDP, in %. Source: ONS

Chart 4: Consumer prices ex. energy and food



Consumer price index excluding energy and food, yoy change in %, 3-month moving averages. Sources: BLS, ONS, Eurostat

US: Strong economic momentum

We expect the US economy to sustain strong momentum through 2019

We expect the US economy to sustain strong momentum through 2019 and then moderate thereafter, with real GDP increasing by 3.0% in 2018, 2.8% in 2019 and 2.4% in 2020 (Chart 5). Momentum is widespread across many industries, with healthy growth in consumption, residential construction, business production and investment, and exports. In the US, the stimulus from tax reform and an easing of regulations, plus supportive financial conditions, outweigh global and domestic uncertainties. Presently, with few imbalances in the real economy and financial markets, and with monetary and fiscal policies stimulating aggregate demand, the probability of recession is very low. We expect core inflation to rise modestly above the Fed's 2% target later this year, and for the Fed to continue to gradually normalise its monetary policy.

Consumers have stepped up spending amid healthy gains in employment

Private consumption, which accounts for more than two-thirds of US GDP, will likely increase by 2.5% again in 2018 before slowing to 2.4% in 2019 and 2.0% in 2020. Consumers have stepped up spending in response to healthy gains in employment, elevated confidence and the boost in disposable incomes from the Tax Cuts and Jobs Act (TCJA) – real consumption is expected to increase 2.8% annualised in Q2. We expect these factors to support spending on big-ticket items and discretionary services. Continued gains in household net worth, which is now more than $100trn, provide an additional boost to demand. Consumption growth will slow as the positive impacts of the tax cuts fade.

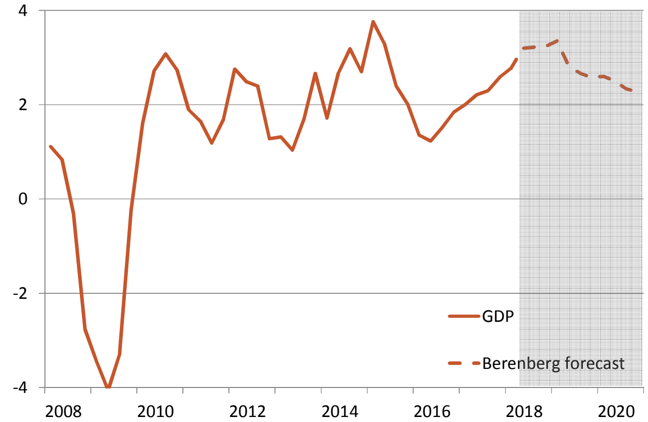
Business production has ramped up to meet the stronger product demand

Business production has ramped up to meet the stronger product demand. Capital spending has accelerated. Real business fixed investment is on track to rise by 7.2% in 2018, markedly higher than the 4.7% 2017 gain (Chart 6) – a favourable but not spectacular response to the TCJA. Businesses will continue to digest the profits and cash flow implications of the new tax regime. We expect this to fuel sustained healthy growth. Improved business perceptions about the easing of burdensome government regulations have contributed to the more optimistic manufacturing sentiment and the pick-up in capital spending and hiring. The sustained strength in business fixed investment gains can lift measured productivity growth to 1.5-2%, a sizable improvement from its below 1% gains between 2010 and 2016.

Housing activity is improving, reflecting the stronger economy

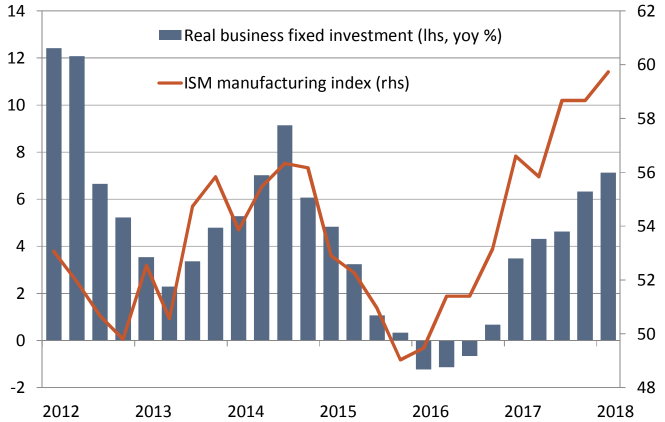
Housing activity is improving, reflecting the stronger economy and labour markets, and favourable demographics. The pace of new household formation by millennials is picking up at the same time as baby boomers retire and move to smaller homes. Home sales are currently being weighed down by an on-going shortage of inventory as construction bottlenecks constrain supply relative to demand. Homeowner vacancy rates across the country are low, and home prices appreciate most in cities where demand from young first-time home buyers is strongest. Supply constraints for builders – a shortage of desirable lots and labour, and rising material and labour costs – will continue to prevent builders from meeting demand. Expect residential construction and new home sales to continue to outpace existing home sales. Because mortgage rates are rising only gradually from historical lows, the increase in borrowing costs will only have a negligible effect on demand for housing.

Chart 5: US – annual change in real GDP



Quarterly data. Yoy changes in %. Sources: BEA, Berenberg projections

Chart 6: US ISM manufacturing index and investment



Quarterly data. Source: BEA, ISM

Strong job gains – averaging 207k per month so far in 2018, a pick-up from the 2016 and 2017 average – have driven the US unemployment rate to 3.8%, nearly a full percentage point below current official estimates of "full employment". Tightening labour markets are gradually pushing up wages (Chart 7). We expect wage gains to exceed 3% in the coming years, but improving productivity will partly mitigate the impact on unit labour costs.

Tightening labour markets are gradually pushing up wages.

Government purchases have picked up because of disaster relief spending and the Bipartisan budget agreement that lifts fiscal spending by $300bn over the next two years. We forecast that government spending will rise by 1.5% and 1.8% in 2018 and 2019, respectively, adding to economic growth, then slow to 0.6% in 2020.

Government purchases have picked up

Inflation has remained subdued through the elongated economic expansion (Chart 8), but risks are now to the upside. We expect headline inflation to increase in response to higher energy prices, and core inflation measured by the PCE index to rise above 2% in coming months. Strong demand for manufacturing inputs, higher energy prices, supply chain bottlenecks and a shortage of workers in key supply chain sectors, such as transportation and warehousing, add upward pressure to producer prices. Strong product demand can provide businesses the flexibility to raise product prices and pass on the higher operating costs. The tariffs on steel and aluminium will add to inflationary pressures at the margins. As long as increases in labour costs are met by commensurate gains in productivity, as we expect, inflation should rise only modestly above 2% and inflationary expectations should remain well-anchored.

Medium-term inflation risks are tilted to the upside

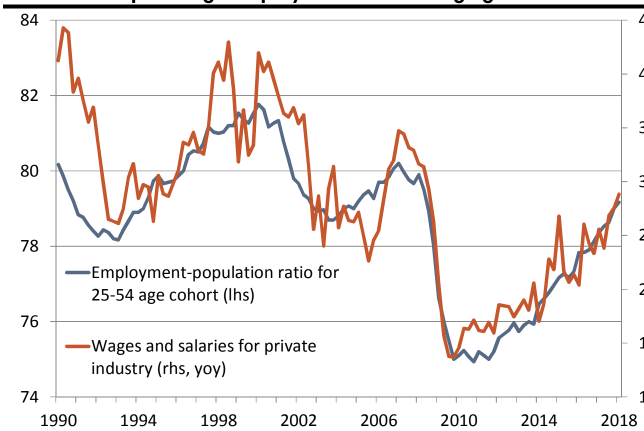
Above-potential demand growth, the labour market above full employment and gradually mounting inflation pressures pose a major challenge for the Federal Reserve. This may be complicated by the very flat yield curve, which the Fed does not want to invert through further rate increases. We expect the Fed to increase its policy rate two more times this year, a total of three times in 2019 and twice in 2020. This will put the Federal funds rate at 3.5-3.75% in late 2020, above the Fed's current estimate of its long-run rate (2.9%). We expect Fed members to gradually upgrade their estimates of potential growth and the natural rate of interest – so-called r* – as they reassess the impact of deregulation and tax reform. If the Fed feels the need to tighten policy more rapidly, we recommend that it considers a more aggressive approach to its balance sheet policy in order to prevent an inversion of the yield curve. A risk is that the Fed may be placing too high of a probability on a perfect Goldilocks evolution in the economy and financial markets without properly assessing and detailing its possible reactions if conditions and expectations deviate significantly from its projections. Sustained stronger real growth or higher-than-expected inflation may force the Fed to raise rates quicker, which could run the risk of jarring financial markets and the economy.

Upside surprise may force the Fed to hike rates quicker than expected

On-going US trade tensions and negotiations will continue to dominate headlines for some time. However, we put a low probability on jarring trade wars. Every nation knows the costs of halting trade. All have room to negotiate and maintain trading channels. The higher tariffs imposed to date have been minor, with a negligible direct impact to the economy. The biggest risk is that the on-going trade disputes and menacing headlines contribute to significant declines in confidence, which would slow consumption, business expansion plans and exports. This has already happened in the Eurozone, but not (yet) in the US (Chart 1 on page 2).

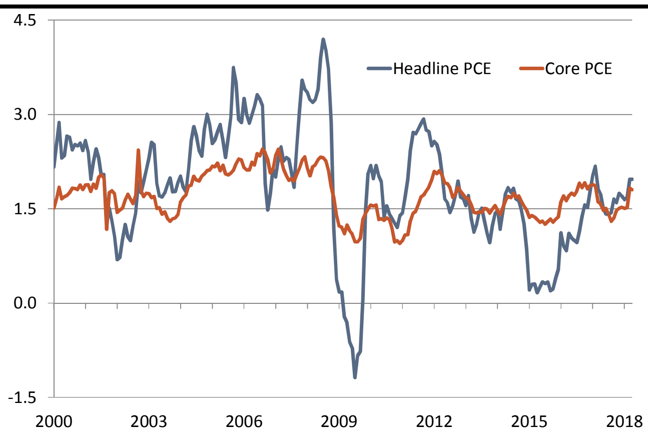
We put a low probability on jarring trade wars

Chart 7: US prime age employment versus wage growth



Quarterly data. Employment-to-population ratio for the 25-54 age cohort. Source: BLS

Chart 8: US PCE inflation



Monthly data. Yoy changes in %. Source: BEA

China: Growth to moderate but remain strong

China's economy looks set for strong growth over the next several years

China's economy looks set to continue its strong growth in the next several years, but the pace of growth will likely moderate, reflecting an underlying gradual slowing of potential growth. We project real GDP to grow by 6.6% in 2018, 6.4% in 2019 and 6.1% in 2020, very strong by global standards, but slower than China's 6.8% average annual growth in 2016-17 (Chart 9). China will continue to shift reliance toward domestic consumption and services, with less reliance on investment and export-related manufacturing. Its high-tech, software and IT sectors, although small as a percentage of GDP, are growing fast and contributing significantly to economic growth and productive capacity. Although the rapid gains in China's domestic economy have reduced exports to 18% of GDP, sustained healthy growth of export-related manufacturing remains very important – to China and to global trade and international economic performance.

Consumer spending is driving the domestic economy

Consumer spending is driving the domestic economy, supported by rising wages and household incomes, while growth in investment continues to moderate. Following years of robust growth in fixed investment, the recent focus has been to address pockets of industrial over-capacity and improve the allocation of capital into more productive activities. This has resulted in some cutbacks in infrastructure, housing and some business sectors.

The trade surplus will fall, despite solid exports, as imports grow strongly

Exports, which have rebounded strongly from a 2015-16 slump (Chart 10), are likely to remain firm, although growth should slow, reflecting a moderation in global growth and trade policy-related tensions. However, imports are expanding faster than exports. This has reduced China's trade surplus to 3% of its GDP. Combined with capital outflows, in Q1 2018 China recorded its first current account deficit since Q2 2001. Reflecting China's strategic tilt toward domestic consumption and services, its trade and current accounts in the coming years are likely to be better balanced than in the past.

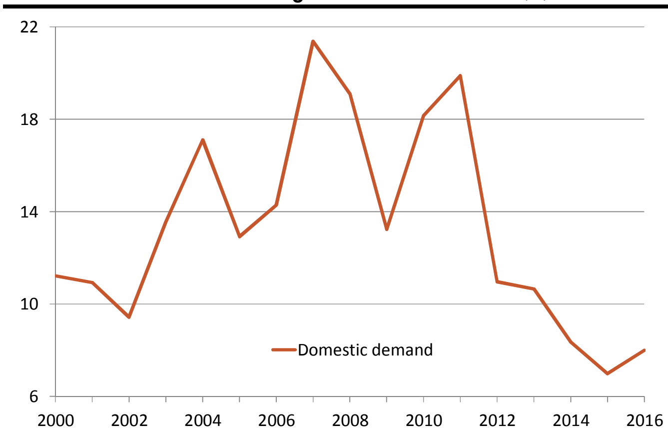
The PBoC is constraining debt growth and keeping financial markets calm

The People's Bank of China (PBoC) has been balancing monetary policy between two objectives – constraining corporate leverage and the rapid expansion of the shadow banking system – and calming financial markets in the face of mounting corporate defaults. These central bank efforts have led to slower rates of credit growth. In response, the PBoC has provided more liquidity to financial markets through cuts in required reserves. Reacting to concerns about corporate debt burdens combined with tensions and uncertainties about trade policies with the US, the stock market has fallen and the yuan has depreciated.

A slowdown in export-oriented manufacturing is the key risk to growth

We expect that the on-going PBoC efforts and related government policies will effectively manage the credit challenges, allowing sustained strong economic growth. The biggest economic risk facing China would be a marked deterioration of its export-related manufacturing sector. This is not part of our baseline forecast, but requires ongoing scrutiny.

Chart 9: China – annual change in domestic demand (%)



Annual data. Source: China National Bureau of Statistics

Chart 10: China – annual change in goods exports (%)

Monthly data. Source: China Customs

Japan: Economy rebounding from transitory dip

The Japanese economy is bouncing back from a dip in Q1

The Japanese economy is bouncing back from a temporary decline in real GDP in Q1 2018. We forecast real GDP to rise by a solid 1.3% in 2018, not as strong as 2017's 1.7% (Chart 11), but well above the Bank of Japan's (BoJ's) estimates of 0.8-1.0% potential growth. The strengths that drove the stellar economic performance throughout 2017 – business investment and exports – will remain healthy, while consumer spending growth will continue to be fairly lacklustre relative to gains in wages and personal incomes. With most trends improving, the biggest obstacle to sustained healthy momentum is the scheduled imposition of another VAT hike in late 2019 that will dent consumption and maybe confidence.

Exports and investment drive economic growth

The pick-up in exports and business investment, both of which are growing faster than GDP, has supported stronger product demand. To meet this demand, the rise in production has involved healthy growth in employment plus gains in productivity. Robust increases in employment of more than 2% yoy have driven the unemployment rate to its lowest level since the early 1990s. Importantly, this has involved a sharp rise in the labour force participation rate of women, induced by incentives provided by Prime Minister Abe's administration. This has lifted growth in the workforce, countering the longer-run demographic of declining working age population.

Consumers remain cautious, with elevated rates of personal saving

Amid tight labour markets and strong gains in corporate profits (Chart 12) and cash flows, wages are rising, particularly for temporary workers. This is positive for two reasons: it lifts disposable incomes and it is consistent with the BoJ's 2% inflation objective. But unlike businesses that are increasing investment spending and gradually raising dividends in response to strong gains in profits and cash flows, Japanese consumers remain cautious, with elevated rates of personal saving. This relates less to any lingering expectations of deflation and more to an ingrained "save mind-set" that the government is trying to loosen.

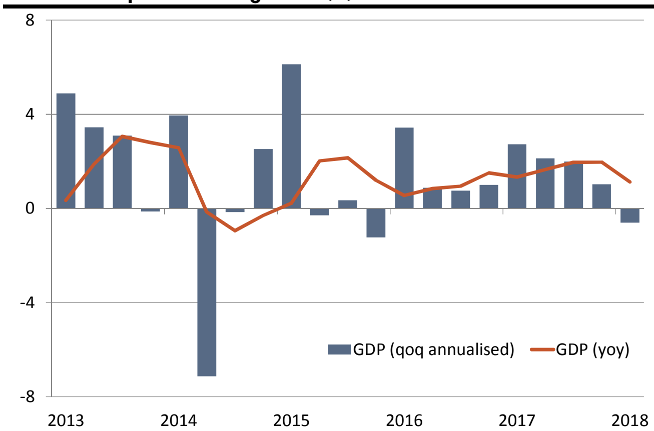
A slowdown in export-oriented manufacturing is the key risk to growth

The BoJ is likely to continue its aggressive quantitative-qualitative easing (QQE) and yield curve control (YCC) programme that targets 10-year JGB yields to 0%. Although Japan's healthy economic performance stems from solid fundamentals rather than the BoJ's on-going financial repression, the central bank will continue to pursue its objective of overshooting its 2% inflation target. Additionally, the BoJ wants to mitigate any economic fallout from the scheduled VAT hike, which in the past (2014 and 1997) generated declines in consumption and investment far larger than anticipated.

A Chinese slowdown presents the biggest risk to the Japanese economy

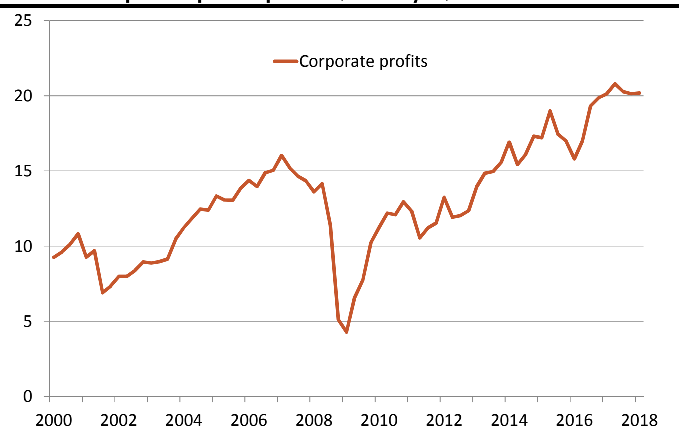
The biggest risk facing Japan would be a sharp slowdown in China's export-related manufacturing sector, which would slow global trade and dent demand for Japanese exports.

Chart 11: Japanese GDP growth (%)



Quarterly data. Source: Cabinet Office of Japan

Chart 12: Japan corporate profits (trillion yen)



Quarterly data. Source: Ministry of Finance

Eurozone: trade, oil and political risks cause dent

After a stellar 2017, growth has moderated in H1 2018 as risks have returned with a vengeance. A rise in financial market volatility and the threat of US-led trade wars have added to the general climate of risk. The election of a radical Italian government and heightened migration fears threaten the cohesion of the EU and the German government. Such risks weigh on confidence and cloud the economic outlook. As a result, after 2.6% in 2017 we reduced our 2018 Eurozone GDP growth call from 2.4% to 2.1% earlier this year.

After a stellar 2017, growth has moderated and risks have returned

The slower growth and a decline in sentiment indicators have prompted concerns as to how long the Eurozone economic upswing may last. Comparing the current expansion with previous Eurozone upswings in the past 40 years shows that these concerns are unusual at such an early stage of the cycle. On average, Eurozone business cycles last roughly eight years from trough to peak, with the real GDP expanding by 21% during the average expansion phase. The current upswing is just five years old – GDP has expanded by 10%. History suggests at least three to four more years of growth of about 2% could be in the tank.

Concerns about durability of upswing unusual at this early stage of the cycle

Eurozone economic fundamentals are in good shape. Underlying momentum remains broad-based and robust across all major countries and pillars of demand. Domestic demand is expanding solidly due to a virtuous cycle of growth in employment, disposable income and consumption. The Eurozone has added almost 8.5m jobs since summer 2013. Healthy job and wage gains more than offset the current temporary drag from rising oil prices. We expect private consumption to accelerate from 1.6% in 2018 to 1.8% in 2019 and 1.9% in 2020.

Concerns are overdone as underlying momentum remains strong

While industrial production and construction output suffered from severe weather and a flu epidemic in Q1 2018, investment remained robust – suggesting that the Eurozone still has plenty of cyclical momentum. We expect investment growth to average 3.2% from 2018-2020 – well above the 1% average since 2010. Economic policies support healthy gains in demand. Fiscal policy can add 0.1-0.2% of GDP this year while monetary policy remains highly accommodative as the ECB normalises its policy stance only slowly. Although net trade will drag on growth a little in 2019 and 2020 as import rise on the back of improving Eurozone household demand, the competitive euro should underpin continued gains in real exports.

A competitive euro should underpin continued growth in real exports

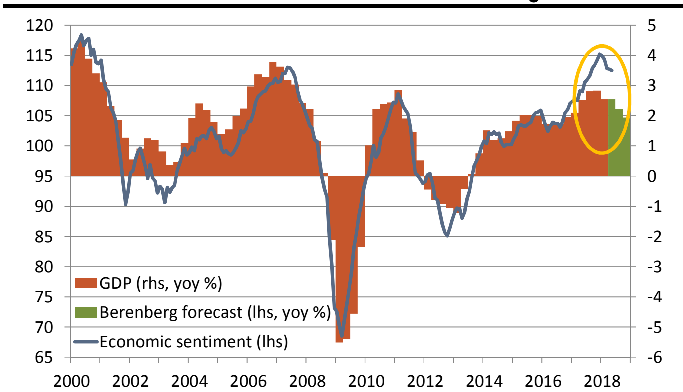
The threat of trade wars has dampened Eurozone sentiment since the start of the year. But the drop should be put into perspective. First, sentiment can be volatile and only provides a very rough guide to economic activity. To some extent, it was just a matter of time until sentiment corrected after surging in H2 2017. Second, the current level of confidence remains consistent with growth above trend. To some extent, sentiment is re-aligning more with actual activity (Chart 13). Third, as surveys seem to have started to stabilise recently, the latest trends suggest that the correction may be over soon.

Putting the drop in sentiment into perspective

An escalating tit-for-tat global trade war poses the biggest risk to our Eurozone outlook. While the risk has not receded yet, the initial fear factor is fading. In time, businesses may simply get used to the noise so long as tension do not escalate further in a major way – see page 15. In any case, Eurozone producers will still be able to rely on a strong domestic economy that will likely benefit from stable or slightly declining oil prices later this year.

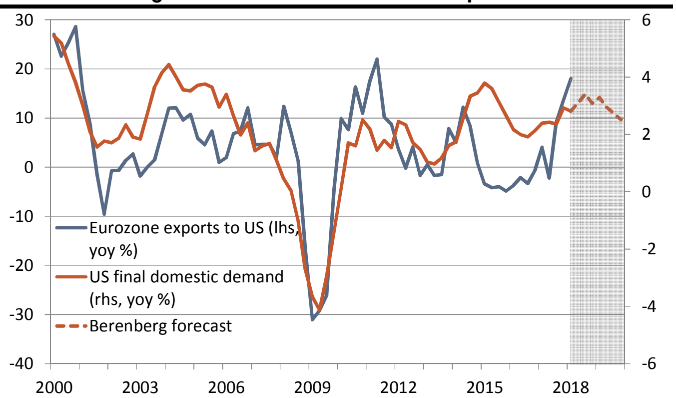
An escalating tit-for-tat trade war poses the biggest risk to our outlook

Chart 13: Eurozone sentiment corrects but remains high



Annual growth rate of real Eurozone GDP, in %, and Eurozone economic sentiment. Sources: Eurostat, European Commission, Berenberg projections

Chart 14: Strong US demand drives Eurozone exports



Yoy change in real terms and in %. Sources: BEA, Eurostat, ECB, Berenberg projections

Expect economy to rebound from autumn onwards

Although we have probably passed peak growth for this Eurozone cycle (2.9% qoq annualised in Q2-Q4 2017), we look for the Eurozone real GDP growth rate to rebound from autumn 2018 onwards after a temporary and modest slowdown to growth rates in line with the underlying trend of c1.5% in H1 2018. While supply bottlenecks may start to constrain demand growth soon as spare capacities are gradually eroded, fundamentals suggest that the Eurozone economy can manage growth rates close to 2% for a few more years until, probably, the upswing is brought to an end by an eventual US recession.

Capacity constraints translate gradually into stronger price pressures

The ECB has won the fight against deflation risks. Supply constraints are gradually translating into stronger wage gains. Compensation per employee growth has accelerated from a low of 1.1% yoy in summer 2016 to 1.9% in Q1 2018 (Chart 15). While faster expected productivity gains can partly neutralise higher wage growth, unit labour cost growth and underlying inflation will continue to edge up slowly. We expect headline inflation to rise to 1.9% by the end of 2020 – a rate consistent with the ECB's inflation target of 'below, but close to, 2%'. In line with its guidance from the June meeting, we expect the ECB to end its asset purchases in December 2018. As the risk of an inflation overshoot remains low, the ECB will only gradually edge toward a rate hike. The ECB has vowed to keep its interest rates at current levels through the summer of 2019. We expect the first 10bp refi rate hike in September 2019, followed by a 15bp hike in December 2019 and two 25bp increases in 2020. For the foreseeable future, the ECB will likely maintain its large balance sheet (currently c40% of Eurozone GDP) as it continues to reinvest the proceeds of maturing bonds. An unwind would start after a series of successful rate hikes.

An Italian crisis would hit the Eurozone, but the euro would survive

Whether Italy will ultimately commit itself to European fiscal rules or choose an outright confrontation with the EU is first and foremost Italy's business. Of course, the Italian risk also matters for the Eurozone – for a detailed discussion of this risk, see page 16.

Germany: trade tensions hurt amid political risk at home

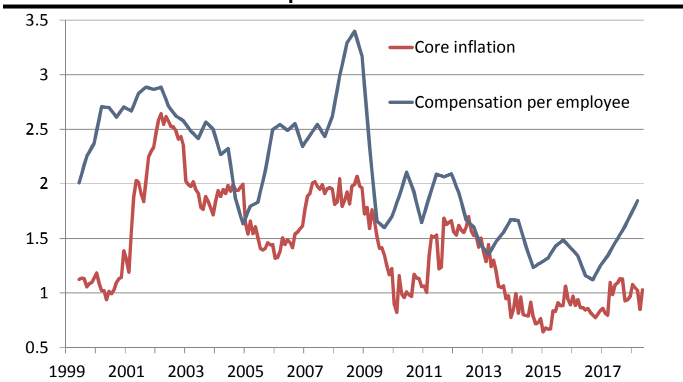
Trade tensions hit export-oriented German economy

Export-oriented Germany relies heavily on international trade. German business confidence softened by more than in most other Eurozone countries following the trade tensions stoked by US President Trump. But even German survey data started to stabilise in May and June. The hit to growth is likely to be only temporary. After slowing from an annualised growth rate of 3.0% in Q3 2017 to 1.2% in Q1 2018, we expect growth to rebound to c2.0% through to the end of 2019 before easing to still-above trend rates of 1.8% in 2020 as supply growth begins to weaken amid capacity constraints.

Political risk at home, but noisy muddling through remains most likely

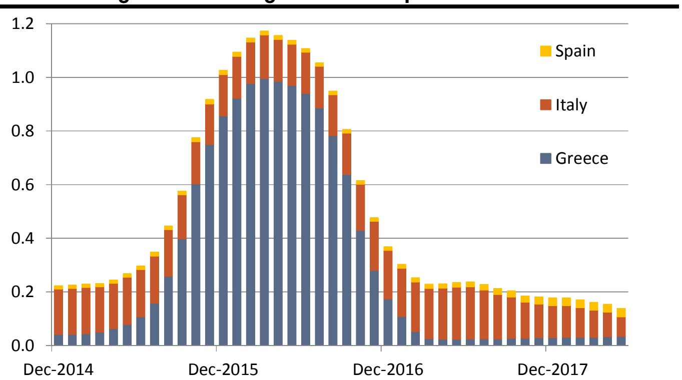
Long a bastion of political stability, domestic politics have turned Germany into a source of political uncertainty in the Eurozone as of late. First, it took Chancellor Angela Merkel's centre-right CDU/CSU six months to form a renewed "grand" coalition with the centre-left SPD after the election in late September 2017. The impasse in Berlin delayed initiatives to reform the EU/Eurozone. Second, after three months Merkel's CDU and its restive Bavarian outreach, the CSU, entered into a bitter dispute about migration. While the number of arrivals into Europe has fallen significantly (Chart 16), differences about how to deal with those asylum seekers threatened to bring down the government. As both the CSU and CDU had to much to lose from a split-up, the two parties eventually found a compromise that partly incorporated unilateral German action which may have some negative repercussions for its neighbours. Although Merkel managed to survive the ordeal, she has been weakened by the conflict, and more than before it is clear this is her final term in office.

Chart 15: Eurozone inflation pressures



Yoy changes in %; core inflation adjusted for short-term volatility of package tours by using a six-month rolling average for this component of inflation. Two-quarter rolling average for compensation. Sources: Eurostat, ECB

Chart 16: Migration – the big issue in Europe



Sea arrivals into Greece, Italy and Spain, plus arrivals over the Turkish-Greek land border since December 2017, 12-month rolling sum, in millions. Source: UNHCR

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France: heading for a golden decade

Macron fixes the roof while the sun is shining a little less strongly

Having gained some momentum in late 2016, the French economy was further boosted throughout 2017 by the election of pro-reform President Emmanuel Macron. However, sentiment and activity have turned more mixed in 2018 amid rising trade tensions. In line with the rest of the Eurozone, growth should pick up again later this year. We project growth of 1.9% in 2018 after 2.3% in 2017. Growth should then accelerate to 2.1% yoy in 2019 and 2020 as the Macron reforms begin to unleash France's pent up supply potential.

On track for a golden decade as Macron has not slackened reform efforts

More than a year after we made our call that France is heading for a golden decade courtesy of the Macron reforms, the evidence still supports our view. Following up on the labour market reform and corporate tax cut passed in H2 2017, President Emmanuel Macron is continuing to reform France in 2018, helped on by broad support in parliament and among the population. Macron did not cave in to the biggest strikes since 1995 and has pushed through a contentious reform of the SNCF railways. Further planned reforms include: shrinking and improving the productivity of the public sector; providing more support for job-seekers; and tackling the skill mismatch problem in the French labour market through changes to the professional training and education system. This last reform could also ease the integration of the young, low-skilled and immigrant population into the labour market. Reforms take time to work. Still, if Macron implements most of his agenda within the next 12 months, as we expect, he would raise the France's long-run potential. As the pace of jobs growth accelerates in the coming years expect France to close the employment gap relative to Germany – currently the strongest economy in Europe (Chart 17).

Italy: an accident waiting to happen

Five Stars and Lega pay lip service to the euro but push for pricey policies

Italy topped the list of potential risks in the Eurozone in our global outlook at the start of the year. Unfortunately, one aspect of the political nightmare scenario has come true. The anti-establishment Five Stars and the radical right Lega won the 4 March election and have formed a coalition. While the new government pays lip service to the euro, it has worried markets by presenting a coalition programme that, if fully implemented, could cost up to 5% of GDP extra. The radical coalition plans to cut income taxes, introduce a minimum income, cancel a 2019 VAT increase and rescind the rise in the pension age.

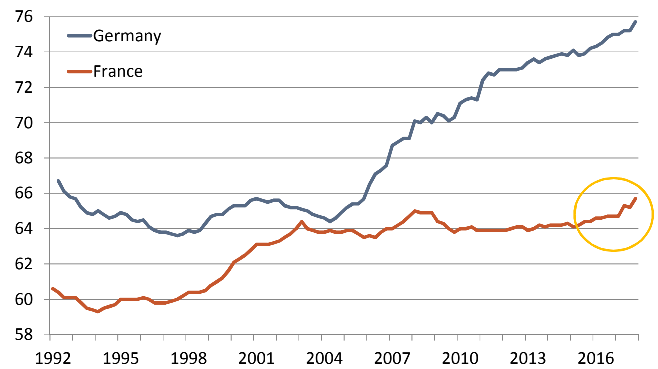
Will the radicals moderate in office?

Italian 10-year yield spreads over Germany widened by more than 100bps soon after the new government formed. The short-term is probably not the biggest concern, though. To limit the costs and avoid a blatant breach of the EU's fiscal rules, the government will probably implement its pricey promises only in stages. Also, with an average duration of its sovereign bonds of 6.9 years, Italy is not very vulnerable to higher yields in the short-term. Even if yields were to rise by, say, another 100bp across the curve, Italy could still refinance most of its sovereign bonds that fall due with lower-coupon paper for the next two years.

Italy – misguided policies worsen already weak growth potential

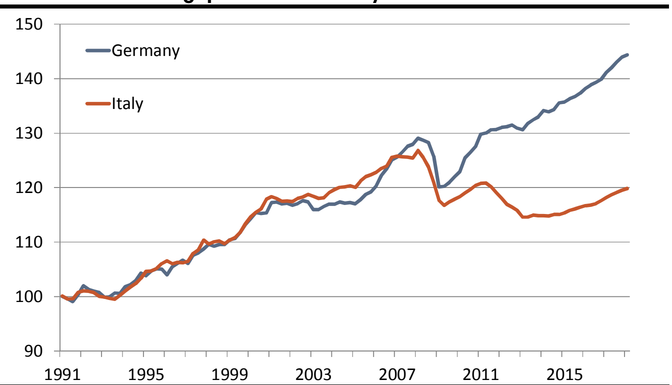
With its low growth potential and misguided economic policies, Italy looks set to stay near the bottom of the Eurozone growth league up to 2020 – average GDP growth of 1.2% yoy. Over the longer-term, risks loom larger. The supply-side matters. Germany and Italy were in lockstep from 1991 to 2006 (Chart 18). Both had serious structural problems. The advent of the euro in 1999 made no difference. Germany outperformed shortly after its 2004 structural reforms. Italy remains a half-reformed country. Reform reversals could further impair Italy's mediocre supply potential and make it even more vulnerable to economic setbacks and bouts of market anxiety. In a debt crisis, due perhaps after a potential 2021 recession, Italy may face the stark choice Greece had to make in 2015: get real and pursue serious reforms or leave the euro and descend into chaos. Like Greece, Italy would probably choose reforms over chaos. For now, Europe will have to live with the risk of an Italian crisis.

Chart 17: The French potential – catching up with German reforms



Employment in % of working age population (16-64 years). Source: Eurostat

Chart 18: The GDP gap – What ails Italy? It is not the euro



German and Italian real GDP, indexed at 1991Q1=100. Sources: Destatis, Istat

UK: Momentum builds as initial Brexit drag fades

2018 is the low point, real GDP growth can pick up in 2019 and 2020

Thanks to the Brexit vote, the UK economy is already about 2% smaller than it would have been had UK voters decided to remain in the EU in June 2016 (see Brexit hurts already, dated 25 May 2018). However, as long as the UK avoids a no-deal hard Brexit, positive trends in global demand should provide a healthy backdrop so that UK annual real GDP growth can accelerate from 1.4% in 2018 to 1.8% in 2019 before slowing a little to 1.7% in 2019. Such gains would be just above the rate the UK can probably sustain outside the EU (c1.6%, Chart 19).

Tight labour markets point to rising real wages over the medium term

Private consumption growth slowed from 3.1% in 2016 to 1.8% yoy in 2017 as the rise in import prices – caused by the drop in sterling after the Brexit vote – squeezed real wages. Tight labour markets indicate there is plenty of room for a strong rise in real wages over the medium term (Chart 20). Although real wage gains are still modest for now (c0.5% yoy), continued employment growth is supporting a rebound in household confidence that should continue into 2019. Before going back to the shops in a major way, households may choose to slow their demand for credit and rebuild savings for a while to compensate for extending their balances sheets last year. As a result, we expect the headline growth rate in real private consumption to fall a little further to 1.2% this year before rising to 1.9% in 2019 and 2020.

Investment growth should improve if the UK avoids a hard Brexit

Gross fixed capital formation (GFCF) – the broadest measure of investment – expanded by 3.4% in 2017, slightly below the subdued post-Lehman average of 3.6%. Business investment increased by 1.6% in 2017 (post-Lehman average of 4.2%). Brexit uncertainty continues to weigh on investment growth in 2018 (GFCF up 1.2% yoy). Low levels of spare capacity, the relief that the UK avoids a hard-Brexit and continued above-trend growth in the UK's major trading partners should underpin stronger GFCF growth in 2019 (4.0%) and 2020 (3.4%).

But a sterling appreciation will turn net-trade from a boon to a drag on growth

Although consumption and investment growth are likely to improve over the medium term, net trade is likely to subtract from real GDP growth in 2019 (-0.2ppt) and 2020 (-0.3ppt) after adding to the growth rate in 2017 (+0.6ppt) and 2018 (+0.3ppt). The boost to demand for UK exports during the past two years from the drop in sterling is already fading. A likely appreciation in sterling as UK growth picks up will retard export growth over the medium term while a rise in household spending growth will boost demand for imports.

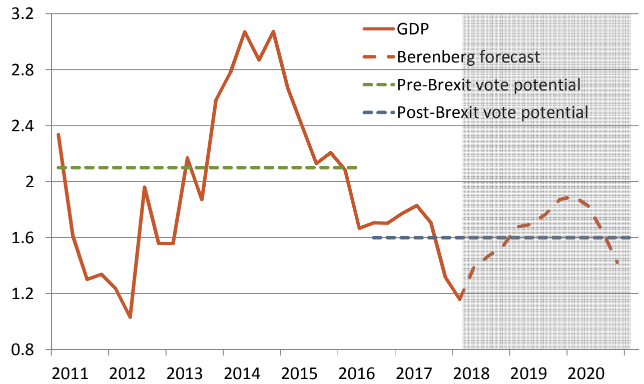
The UK housing market provides a constant source of risk

Looking beyond the hard Brexit risk, an early end to the global upswing provides the biggest external downside risk to our outlook for a modest acceleration in UK growth in 2019 and 2020. As a medium-sized open economy, UK investment, exports and production would suffer badly in an escalating trade war. On the domestic front, the UK housing market provides a constant source of potential risk. However, the current, mainly London and south-east based softness in the housing market that is partly the product of weaker foreign demand is not likely to spread to other parts of the UK where conditions remain buoyant.

Expect the BoE to speed up the pace of rate hikes in 2019 and 2020

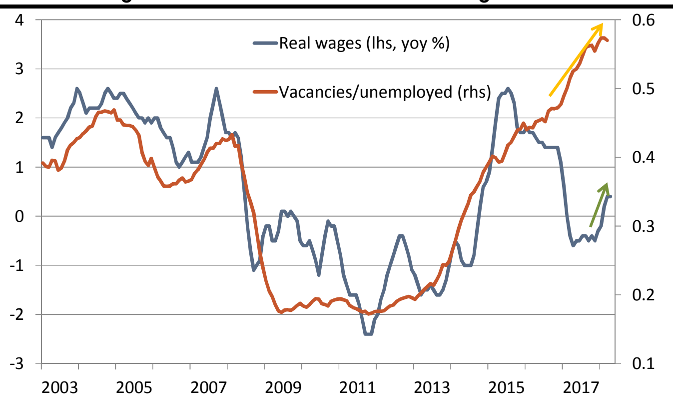
We expect the BoE to continue to gradually normalise its monetary policy over the medium term amid above-target inflation, tight labour markets, rising wages and accelerating demand growth. If the UK avoids a hard Brexit, expect the BoE to pick-up the pace of rate hikes from one per year in 2017 and 2018 to two per year in 2019 and 2020 – with the next hike due in August 2018.

Chart 19: GDP growth pre- versus post-Brexit vote



Pre-Brexit vote potential growth rate of 2.1% yoy. Post-Brexit vote potential growth rate 1.6% - based on our expectation post-Brexit UK-EU trade deal (de facto customs union and single market for goods – no major trade deal in services). Sources: ONS, Berenberg projections

Chart 20: Tight UK labour market heralds real wage rebound



Monthly data. Real wages = average weekly earnings adjusted by headline CPI. Source: ONS

Brexit: Heading for a sensible outcome, sort of

The UK is heading for a semi-soft Brexit – hard Brexit risk is 20%

Amid the often noisy talks between UK and EU negotiators and the public spats among the different Brexit factions of the UK government, one clear trend seems to be emerging: the UK is gradually heading towards a semi-soft Brexit as it slowly but surely loses its illusions about what it can reasonably achieve in a post-Brexit trade deal with the EU. We have therefore altered the probabilities we put on the range of potential Brexit outcomes (Table 2). We have reduced the risk of a hard Brexit to 20% from 25% while increasing the chance of a semi-soft Brexit to 60% from 40%. We have also reduced the chance of a no-Brexit to 5% from 10%, and a soft-Brexit to 15% from 25%.

UK and EU negotiators are stuck on a solution to the Irish border problem

After 15 months of talks between the UK and the EU, two out of the three parts of Brexit negotiations are settled: 1) the Brexit bill – the UK will pay the EU c£40bn; and 2) the transitional arrangement – continued membership of the single market and customs union from the Brexit date (29 March 2019) until the end of 2020. The third and final issue remains open to negotiation, namely an outline deal on post-2020 relations that keeps the border between Southern and Northern Ireland open as laid out in the 1997 Good Friday Agreement.

UK parliament is at odds over whether to remain in the EU customs union...

The EU argues that the UK will need to stay in a customs union for goods after Brexit and maintain a large degree of regulatory alignment with the EU in order to avoid any new infrastructure at the Irish border to process post-Brexit trade between Southern Ireland and the UK. Hard-line Brexiteers within the Conservative Party argue that remaining in a customs union would undermine Brexit by constraining the UK's capacity to negotiate future trade non-EU deals in goods as the UK would be bound by the EU common tariff.

...which provides the only realistic solution to keep the Irish border open

To say both sides are at a stand-off is somewhat of an understatement. The closest the UK and the EU have come to some kind of agreement is that if no solution to the Irish border can be found by the end of the transitional period, the UK will remain de facto aligned with the customs union and its rules in a so called "backstop" agreement. However, the UK and the EU disagree on the details here. The UK wants any "backstop" to be time-limited. The Republic of Ireland, which has an interest in keeping an open border with its biggest market, the UK, rejects such terms as it still leaves the question of what comes after wide open.

Expect the UK to eventually go for a customs union

As this year draws to a close and negotiators come under pressure to secure a deal in time for Brexit in March 2019, we expect the UK in the end to concede to a "backstop" that is not time-limited, but semi-permanent – which could be renegotiated at some future date. There is no majority in UK parliament for a hard Brexit. Two-thirds of UK MPs are pro-EU. Meanwhile, the Conservative Party fears the risk that far-left Jeremy Corbyn could come to power in fresh elections if the party failed to compromise on Brexit and descended into chaos. As a result, when the UK government eventually faces the choice between a semi-soft Brexit on the EU's terms, a hard Brexit, or fresh elections, we expect it to go for the former.

Table 2: Possible scenarios for UK post-Brexit economic relations with the EU

	EU member/No Brexit	Soft Brexit	Semi-soft Brexit	Hard Brexit
Probability	***(5%)***	***(15%)***	***(60%)***	***(20%)***
Free trade within the area	Yes	Yes on almost most goods and many non- financial services	Yes for most goods but very few services	No
Financial passporting within EU	Yes	No – but with some potential for equivalence agreements	No	No
Customs union with EU (no border checks)	Yes	Yes (not official EU customs union) – customs ‚arrangement'	Yes (not official EU customs union) – customs ‚arrangement'	No
Free to set external trade policy	No	Yes in all markets not covered by the customs union	Yes in all markets not covered by the customs union	Yes
Covered by EU external trade agreements	Yes	No	No	No
Free movement of people	Yes	Yes with few exceptions	Some restrictions on EU citizens entering the UK labour market	No
Votes on EU laws/regulations	Yes	No	No	No
Under ECJ jurisdiction[1]	Yes	Yes indirectly	Yes indirectly	No
Contribution to EU budget	Yes	Yes	Some	No
Long-term trend growth (%, pa)	>2.0%	1.7-1.9%	1.5-1.7%	<1.5%

[1] As the European Court of Justice (ECJ) adjudicates on all Single Market issues, countries in the customs union or in agreements with the EU, as well as European Economic Area (EEA) countries are indirectly under the jurisdiction of the ECJ. Source: Berenberg

Emerging Europe

Russia: profiting from higher oil prices

GDP growth is steady, supported by higher oil prices

Following two years of recession, the Russian economy grew by around 1.5% in 2017. For 2018 we expect c1.9% real GDP growth followed by 1.8% in 2019 and 1.7% in 2020. A 65% yoy increase in the oil price and 10% yoy rise in private sector credit growth due to lower interest rates support economic growth. Russian cooperation with OPEC has reduced the rate of global oil production, underpinning the rise prices. At the same time, the Russian economy, currency and government budget balance benefit from rising global demand for commodities. But also other pillars of the economy are contributing to growth such as private consumption. The ban on western food imports and the restrictions on western technology exports to Russia have led to the revival of a small, import-replacing industry. The World Cup, on the other hand, should only provide a very small and short boost of co.1ppt to GDP in 2018.

Inflation remains below central bank target

The Central Bank of Russia (CBR) deserves some praise. The bold interest rate hike at the end of 2014 and a hawkish monetary policy laid the foundation for a ruble recovery and helped to contain inflation. May 2018 CPI rose by only 2.4% yoy, below the 4% central bank inflation target. As the current central bank key rate of 7.25% is significantly above the inflation rate, more rate cuts are possible later this year (Chart 21). Downward risks could stem from sharply falling oil prices (rather unlikely) and geopolitics. Even though the aggressive resurgence of a strong Russian military posture is popular domestically, it increases tensions with the western world. Relations with the US and the EU are at a low point. Western sanctions introduced in response to Russia's aggression against Ukraine are still in place. The Russian ruble and its government bond yields are thus more volatile than usual.

Turkey: under pressure

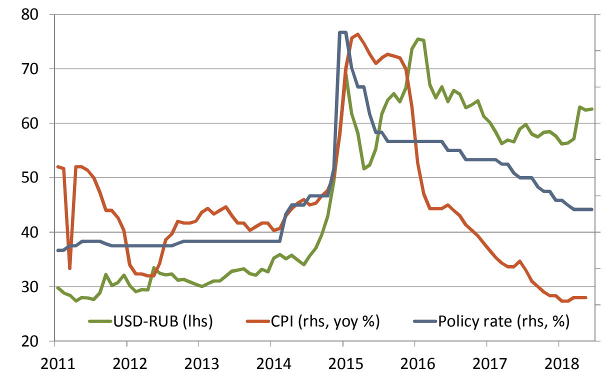
Turkey's economy profited from a large fiscal stimulus

The Turkish economy only looks good at first glance. GDP expanded by 7.4% in 2017 and the government expects 5.5% growth for this year. However, we only expect 4.0% for 2018, 3.4% for 2019 and 3.0% for 2020, and see major downside risks arising from persistent high external vulnerability and the government's purge of the political opposition. While GDP growth numbers look strong in lira terms, the actual size of the Turkish economy in euro terms contracted by 2% since 2015. The powerful fiscal stimulus of 2017 is fading. The export sector remains below potential despite a significant boost from the large fall in the lira exchange rate. Exports of goods and services as a percentage of GDP fell from 24% in 2012 to 22% in 2016.

But inflation is far too high

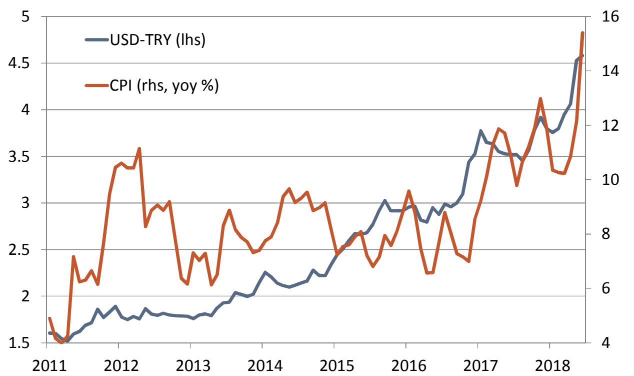
The Turkish economy is caught up in a spiral of a falling exchange rate, high inflation and high interest rates. Consumer prices surged by 15.4% yoy in June, far above the 5% central bank inflation target. The worsening global risk sentiment, a central bank that is not fully independent and tends to raise interest rates far too late, as well as a rising current account deficit weigh on the Turkish lira. The currency has lost more than 20% yoy versus the euro (Chart 22). Foreign direct investment is declining as well. That Turkish President Recep Erdogan won the recent presidential and parliamentary election increases the risk that much-needed structural reforms will not be implemented anytime soon.

Chart 21: Russia – inflation close to record low



Source: Bloomberg

Chart 22: Turkey – inflation at 15-year high



Source: Bloomberg

Poland: strong economic growth continues

Poland outperforming expectations due to accelerating consumption

Poland's economy exceeded all expectations in 2017. GDP growth accelerated to 4.6% (Chart 23), the fastest growth since 2011 due to strong gains in private consumption and exports. Fast-rising employment (3.7% yoy), increasing wages (7.0% yoy) and stable credit growth of about 5% yoy (all data as of May 2018) provide a good basis for another year of strong growth in 2018. Inflation of 1.7% yoy in May is still far below the central bank's target of 2.5%. This limits the pressure on the central bank to increase rates, which had been on hold at 1.5% since spring 2015. We expect 4.5% GDP growth in 2018, 3.5% in 2019 and 3.0% in 2020. The main risk to Poland's long-term positive economic development is an escalation of the fight between the ruling EU-critical PiS party and the EU.

Czech Republic: performing very well

The economic role model for emerging Europe. High growth, low risks

The Czech economy had an outstanding year in 2017, growing by 4.4% and enjoying the second-fastest annual gain since 2008 (Chart 23). Investments and private consumption growth are both accelerating. The positive trend is likely to continue as leading indicators, such as the European Commission economic sentiment index, rose to multi-year highs in H1 2018 (Chart 24). We expect 3.9% GDP growth in 2018, 3.2% in 2019 and 2.9% in 2020. The fiscal budget balance is set to remain positive in 2018. The Czech National Bank (CNB) increased its interest rate by 25bp to 1.0% in June. We look for more rate hikes over the next 12 months as the Czech koruna is below the CNB's forecast and consumer prices rose by 2.2% yoy in May 2018, above the 2.0% CNB target.

Hungary: the economy shows signs of overheating

The economy roars ahead, but a complacent central bank risks overheating

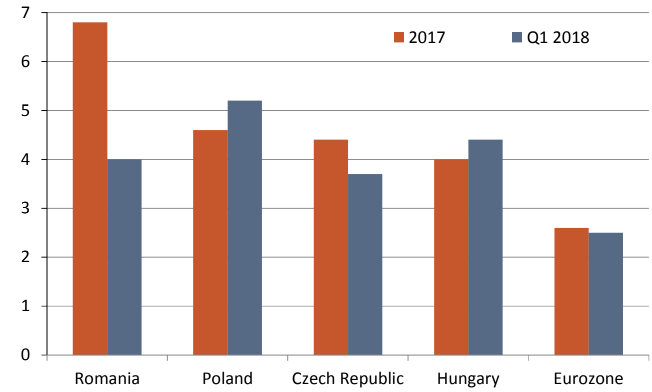
Hungary shows signs of overheating, similar to Romania. But unlike Romania, Hungary has a current account surplus and a lower budget deficit. This makes the country less vulnerable in a global economic downturn. The economy is expanding above its potential at a rate of c4% thanks to a large fiscal stimulus including tax cuts initiated last year and significant inflow of EU funds (Chart 23). The unemployment rate of 3.7% in May is the lowest on record while average gross wages increased by 12.6% yoy in April due to a significant labour shortage. However, productivity growth does not keep up with wage growth. The sharp increase in wages makes Hungary less competitive. Nominal unit labour costs increased by 10% since 2015. We expect GDP growth of 4.2% in 2018, 3.2% in 2019 and 2.6% in 2020, versus 4.0% in 2017. The Hungarian central bank may be too complacent. Despite strong growth, a sharp drop in the Hungarian forint exchange rate and CPI inflation of 2.8% yoy in May 2018, the central bank does not plan to increase its interest rate of 0.9% before H2 2019. This increases the risk that the Hungarian economy may overheat.

Romania: facing serious headwinds

Economy shows clear signs of overheating

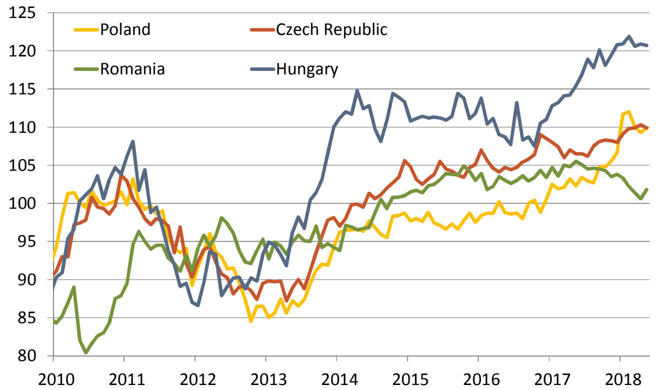
After five years of above-trend growth Romania, the eastern European growth tiger, the economy is starting to overheat. Inflation accelerated above 5% yoy in May, the current account deficit is widening and might reach 4% of GDP in 2018. Meanwhile, the budget deficit is rising to above 3% of GDP due to tax cuts and higher public service wages. The difficult economic environment puts pressure on the central bank which already increased interest rates by 75bp this year to 2.5%. More hikes will be needed to keep the EU's highest inflation rate under control. We expect 4.0% GDP growth in 2018, 3.3% in 2019 and 3.0% in 2020 after 6.8% in 2017. However, we see a serious risk that the budget deficit will breach the 3% threshold in 2018. In the worst case, this could lead to a freezing of EU cohesion funds.

Chart 23: CEE real GDP growth versus Eurozone



Yoy changes in %. CEE: Central and Eastern Europe. Source: Bloomberg

Chart 24: Economic sentiment index at high level



Sources: Bloomberg, European Commission

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The top risks to watch

The advanced world is in better shape now than it was before the 2008/09 financial crisis. When fundamentals are healthy, we can weather the occasional headwind. However, we see three major risks to our outlook for continued above-trend growth in the western world through to 2020 that are worth watching: 1) the break out of full-blown trade wars; 2) an unexpectedly fast surge in US inflation that forces the Fed to throttle the US upswing; and 3) a political accident in Italy if the radicals in government stoke a major conflict with the EU and/or revive earlier ideas about a potential exit from the euro.

When fundamentals are healthy, we can weather the occasional headwind

The trade war risk

US President Donald Trump seems ready to upset the global order, taking aim at China and the EU due to his misguided concerns about bilateral trade imbalances. He is not sparing the US's neighbours north and south of its borders, either. The risk of a full-blown trade war between the major economic powers – the US, the EU and China – poses the biggest risk to our medium-term economic outlook. The current global upswing depends on continued global trade growth. As global equities reflect expectations for global economic growth, unsurprisingly, softness in trade that resulted from a trade war would jar markets (Chart 25).

The risk of a full blown trade war is the biggest risk to our outlook

Although the US has threatened tariffs on some $450bn of imports from China, for now the US has imposed tariffs on just $35bn-40bn of Chinese goods (including tariffs planned from 6 July onwards). Similarly, while the US threatens 20% tariffs on imports of cars from the EU, current tariffs imposed on steel (25%) and aluminium (10%) amount to less than 0.02% of Eurozone GDP. In other words, although the key players in global trade currently have some big guns pointing at one another, few triggers have been pulled yet.

The current economic impact of tariffs is negligible...

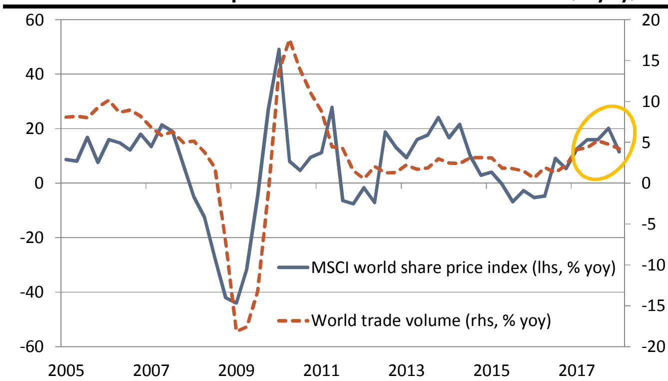
The current risk from trade-tensions is not from the measurable economic effects which remain small. The major impact is through a hit to confidence, especially in Europe – which is more exposed to global trade than the more domestic-oriented US. The continued threat of trade wars may prevent, for instance, growth in the Eurozone economy rebounding to an above-potential rate in late 2018 after growth hit a soft patch at the start of 2018. Economic data in the Eurozone has disappointed by much more than in the US in 2018 (Chart 26). Our base case remains that the trade tensions will fade somewhat in coming months either because Trump finally strikes some trade deals with China and possibly even with the EU or because markets and businesses get used to the noise. One key issue may well be US domestic politics. As the November midterm elections draw closer in the US, will Trump be more inclined to impress his base by "deals" he has struck, thus defusing tensions, or by stepping up threats against alleged adversaries from abroad, thus stoking tensions further?

...but the risk remains that the trade threat hurts confidence and growth

Would a full blown trade-war cause a global recession? Probably not. But it could be enough to lower global growth from its current above-trend rate to below potential. A risk-off mode in markets would probably lead to an appreciation of the US dollar and put some emerging markets with high exposure to dollar denominated debt under pressure. Brexit tells a sobering tale: for long, the UK had outperformed other major developed economies. Shortly after the Brexit vote, the UK started to lag behind badly. Trade wars could mean a dose of Brexit-lite for everybody (Chart 3 on page 3). We remain cautiously optimistic that Trump will go for deals (25% chance) or at least not escalate tensions much further so that we can get used to it (55% chance). Still, the risk of a protracted trade war has risen to at least 20%.

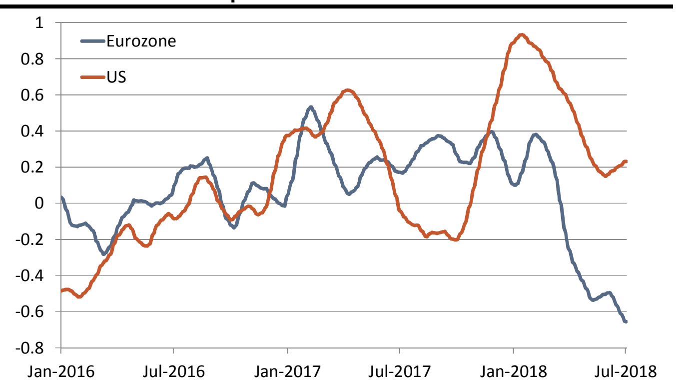
Trade wars would mean Brexit-lite for everyone

Chart 25: World share prices versus world trade volumes (% yoy)



Quarterly data. Last data point 2018 Q1. Sources: MSCI, Netherlands Bureau for Economic Policy Analysis.

Chart 26: Economic surprise index – Eurozone versus US



Daily data, 30-day rolling average. Source: Bloomberg

The Fed decides to throttle the US upswing to control inflation

The US fiscal stimulus will add to inflation risks

The Tax Cuts and Jobs Act (TCJA) and the Trump administration's deregulation policies have lifted US disposable incomes, consumption, production and confidence. However, along with some of the reform-oriented tax provisions and favourable regulatory environment, the deficit-financed tax cuts may stimulate aggregate demand faster than the pickup in productive capacity. The excess demand seems likely to push up inflation, especially at a time of low unemployment and tightening labour markets (Chart 27). Rising wage growth may trigger higher inflationary expectations.

Watch the risk that the Fed has to tighten sharply to tame inflation

If the fiscal stimulus pushes inflation well above the Fed's 2% target for a prolonged period, it might bring forward the horizon at which the Fed is induced to dampen the expansion through a quicker pace of policy tightening in order to bring inflation closer to target. If the Fed finds itself in a situation where it has to throttle the US upswing – by creating some unemployment to tame excess wage growth - in order to meet its 2% inflation target, a likely downturn in US demand that could follow would likely drag the rest of the global economy down too.

A political accident in Italy linked to the radicals in government

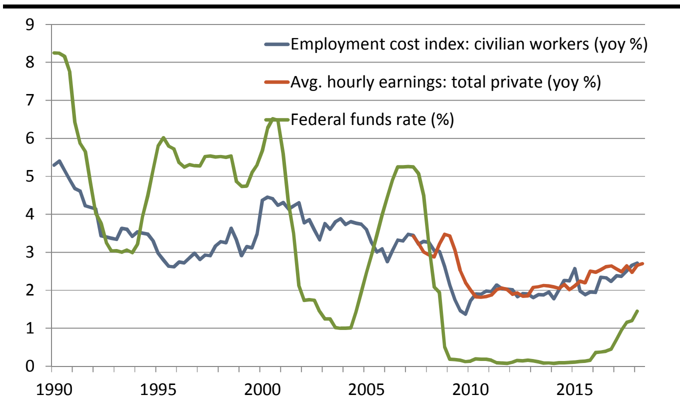
An Italian debt crisis has become an accident waiting to happen

Italy's radical government coalition made of up right-wing Lega Nord and far-left Five Stars plans to raise spending, cut taxes, reduce the retirement age and reverse some pro-growth reforms introduced by previous governments. Such a combination of economic policies would worsen Italy's fiscal deficit and lower its supply potential. With more debt and less trend growth, an Italian debt crisis could become an accident waiting to happen. Our base case remains that Italy will make its fiscal plans much more realistic over time and muddle through somewhat noisily without a dramatic crisis for the time being. Nonetheless, Italy may well suffer a genuine debt crisis once the next recession (due perhaps in 2021 on current US cyclical dynamics) has exposed the underlying weaknesses of Italy while denting investor appetite for risk at the same time.

The risk of systemic crisis spreading to the rest of the Eurozone remains low

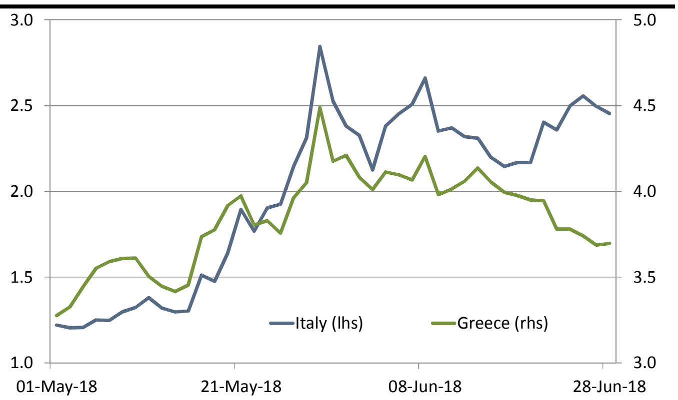
If Italy decided to head for a full-blown conflict with Brussels, or seriously flirted with the idea of leaving the euro as some members of both Lega Nord and Five Stars have suggested in the past, financial markets rather than the EU would likely pass the decisive judgement on Italy. Italy would likely pay a price in bond markets in the form of sharply rising government bond yields, as Greece did in 2010 and 2015. Much like the UK after the Brexit vote, Italy would suffer the most from any policies that damaged its long-term economic fundamentals. The risk that an Italian problem could turn into a protracted systemic crisis for the Eurozone system as a whole seems low. If, in an unlikely worst case scenario, Italy decided to leave the euro, Italy would likely descend into a deep crisis. Hit by the fallout, the Eurozone economy may stagnate for a couple of quarters. However, the major institutions of the EU, including the European Stability (ESM) and the ECB, would deploy all their instruments to contain any contagion. As a result, Eurozone growth would likely recover after a pause. See Italy: A timeline for potential trouble. A costly debt workout would likely take longer, though.

Chart 27: US employment costs and hourly earnings



Yoy change in % for Employment cost index and avg. hourly earnings. Federal Funds rate in % p.a. Source: BLS

Chart 28: Spread of peripheral bonds over German Bunds (ppt)



Daily data. Chart shows spread on 10 year government mid yield. Source: Tullett Prebon Information

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Global economic forecasts

		GDP				Inflation				Unemployment				Fiscal balance			
	Weight	2017	2018	2019	2020	2017	2018	2019	2020	2017	2018	2019	2020	2017	2018	2019	2020
World*	100.0	2.9	3.0	3.0	2.8												
US	24.4	2.3	3.0	2.8	2.4	2.1	2.5	2.3	2.4	4.4	3.9	3.6	3.4	-3.6	-4.1	-4.5	-4.5
China	15.1	6.9	6.6	6.4	6.1	1.6	2.2	2.2	2.0	3.9	3.9	3.9	3.8	-4.0	-4.1	-4.1	-4.2
Japan	6.2	1.7	1.3	1.1	0.9	0.5	0.9	1.2	1.3	2.8	2.4	2.3	2.2	-4.2	-3.8	-3.4	-2.8
India	3.1	6.4	7.5	7.9	7.6	3.1	4.0	4.8	4.5					-4.0	-3.6	-3.3	-3.0
Latin America	6.9	1.8	2.4	2.7	3.0	3.3	5.5	7.5	7.0					-6.8	-5.8	-5.0	-4.8
Europe	25.3	2.5	2.1	2.0	1.9												
Eurozone	15.8	2.6	2.1	2.0	1.8	1.5	1.7	1.6	1.9	9.1	8.3	7.7	7.2	-0.9	-0.7	-0.7	-0.5
Germany	4.6	2.5	2.0	2.0	1.8	1.7	1.9	1.7	1.9	3.8	3.4	3.3	3.2	1.3	1.0	0.8	0.7
France	3.2	2.3	1.9	2.1	2.1	1.2	2.0	1.7	1.8	9.4	9.0	8.3	7.6	-2.6	-2.4	-2.5	-2.1
Italy	2.4	1.6	1.2	1.2	1.2	1.3	1.2	1.3	1.5	11.3	10.7	10.2	9.8	-2.3	-2.4	-3.0	-3.0
Spain	1.6	3.0	2.7	2.6	2.4	2.0	1.7	1.6	1.8	17.2	15.7	14.4	13.5	-3.1	-2.7	-2.3	-2.1
Portugal	0.3	2.7	2.3	2.2	2.1	1.6	1.5	1.5	1.7	9.0	7.3	6.7	6.2	-3.0	-1.1	-1.0	-0.9
Other Western Europe																	
UK	3.2	1.7	1.4	1.8	1.7	2.7	2.5	2.2	2.2	4.4	4.2	4.1	3.9	-2.7	-2.1	-1.5	-1.0
Switzerland	0.9	1.1	1.9	1.8	1.7	0.5	0.7	1.0	1.0	3.2	3.1	3.0	2.9	1.1	0.4	0.2	0.2
Sweden	0.7	2.5	2.7	2.5	2.2	1.8	1.9	2.0	2.1	6.7	6.4	6.1	5.9	1.3	0.6	0.5	0.4
Eastern Europe																	
Russia	1.9	1.5	1.9	1.8	1.7	3.7	3.3	3.8	4.0	5.2	5.2	5.1	5.0	-1.7	-0.3	-0.5	-0.5
Turkey	1.1	7.4	4.0	3.4	3.0	11.1	10.9	9.8	8.6	10.9	10.9	11.0	11.0	-2.4	-3.0	-2.9	-2.9

Unemployment rate: Harmonised definition (ILO/Eurostat); fiscal balance: general government deficit in % of GDP excluding one-off bank support.
*At current exchange rates, not purchasing power parity. PPP estimates give more weight to fast-growing emerging markets and inflate global GDP.
Weights based on IMF World Economic Outlook statistics 2017 GDP figures. Source: Berenberg

Key financial forecasts

	Current[1]	End-2018	Mid-2019	End-2019
Central bank rates				
US Fed	1.75-2.00%	2.25-2.50%	2.75-3.00%	3.00-3.25%
ECB	0.00%	0.00%	0.00%	0.25%
BoE	0.50%	0.75%	1.00%	1.25%
BoJ	-0.10%	-0.10%	-0.10%	-0.10%
10-year bond yields				
US	2.87%	3.10%	3.30%	3.60%
Germany	0.32%	0.70%	1.10%	1.40%
UK	1.26%	1.70%	1.90%	2.00%
Currencies				
EUR-USD	1.16	1.21	1.22	1.25
EUR-GBP	0.89	0.87	0.86	0.86
GBP-USD	1.32	1.39	1.42	1.45
USD-JPY	111	114	117	117
EUR-JPY	129	138	143	146
EUR-CHF	1.16	1.18	1.20	1.22

[1] *Taken on 3 July 2018 at 7:30 am UK time. Currency forecasts may not add up due to rounding.*

For a full set of detailed forecasts, please see Forecasts at a glance: ongoing upswing despite trade tensions and Italian risks.

Forecasts and comments for US, China and Japan supplied by Berenberg Capital Markets

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