BERENBERG

PARTNERSHIP SINCE 1590

MACRO NEWS 13/02/19

Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

RISK UPDATE: US-EU TRADE TENSIONS, ITALY, SPAIN

Berenberg Macro Flash

It will get worse before it can get better. That Europe (and East Asia) will have to live through a grey winter before the outlook may brighten again in spring has been our key theme for more than three months. By and large, the newsflow remains in line with that assessment. While we note serious progress on some issues (US-China trade talks; more dovish US Fed), some other concerns (weak global trade, US-EU trade war risks, Italy's self-inflicted recession, hard Brexit) still loom large. They could make headlines again soon.

TRADE WAR RISKS: US TO TAKE ON THE EU SHORTLY?

Fingers crossed. The ongoing in-depth negotiations between the US and China support the hope that the two sides can agree on enough substance shortly to avert the envisaged rise in US tariffs on $200bn of US imports from China from 10% to 25% on 1 March. Not all issues can be resolved in time. Also, an intrusive regime to regularly check Beijing's compliance with new commitments to abstain from forced technology transfers and scale back anti-competitive behaviour will continue to create tensions in the future. Still, a partial deal or at least an extension of the deadline followed by a deal on some key issues seems likely. If so, it would largely remove the risk of an escalating US-Chinese trade war.

Unfortunately, that would not be the end of the trade war story. The separate US-EU trade armistice which US President Donald Trump and European Commission President Jean-Claude Juncker struck on 25 July 2018 may soon be in jeopardy. On 23 May 2018, US President Donald Trump instructed the US Department of Commerce to investigate whether car and car part imports "threaten or impair the national security" of the US. According to US statutes, the report is due within 270 days, that is no later than 17 February 2019. Trump would then have 90 days to decide whether he wants to levy punitive tariffs on car imports. Although the recent US government shutdown may still make for a delay, it seems likely that the US will soon increase the pressure on the EU with a threat of 25% car import tariffs to come. For Trump, that would probably be part of his usual hardball negotiating tactics.

Unlike the US-Chinese issues, the US-EU talks are not complicated by a geostrategic rivalry. In the US, political support for a trade war against the EU also seems to be much weaker than for one with China. Still, the talks are not easy. The EU wants to strike tariff-cutting deals on industrial goods ("we abolish our car tariffs, you abolish your SUV tariffs."). However, the US is also seeking enhanced access to the EU agricultural market. On this issue, the political room for the EU to yield to US demands is very limited. In France, the "yellow vest" campaign against President Macron started as a largely rural protest against "detached urban elites". Macron will not accept significant changes to EU agricultural policies that could further nurture unrest in rural regions. Similarly, lowering EU standards for foodstuffs (the proverbial "chlorine treated chicken" or genetically modified food) would be so unpopular in major parts of the EU that it could put governments at risk, including German chancellor Merkel's CDU/CSU-SPD coalition.

The exchange of goods and services between the US and the EU is the biggest bilateral trade flow in the world, ahead of US-China trade, with US exports to and imports from the EU estimated at $570bn and $670bn, respectively, in 2018. Depending on the statistical treatment of profit and royalty flows from some EU countries to the US, the US either runs a small current account surplus or a small deficit with the EU. In commercial terms, the EU could hit back at the US much harder than China could. The EU probably has a good idea which sectors may be politically sensitive in the US in the run-up to the 2020 election season. As both sides have too much to lose from an escalating conflict, we expect the US and EU to defuse tensions in the end. But it may get noisy first.

ITALY: TEMPTING FATE AGAIN

Italy's radical government continues to shoot itself in the foot. Having pushed Italy into recession by blowing out risk spreads last summer, only to largely back down in a confrontation with the EU in the end, the government is again stoking a conflict with the EU that can only damage the Italian economic outlook further. Euro-sceptic Lega lawmaker Claudio Borghi has started a discussion about putting the central bank's huge gold reserves (2452 tons) under direct government control and potentially sell some of them to fill gaping holes in the budget. Separately, the radical leaders Luigi Di Maio (5Stars) and Matteo Salvini (Lega) have blamed the Banca d'Italia and financial watchdog Consob for failing to supervise banks properly, thus causing recent banking crises. Di Maio and Salvini want to change the leadership teams of both institutions whenever the terms of the current members are up.

The gold initiative will likely come to naught, as have similar initiatives in Italy (and Germany) in previous decades. That the threat to change Banca d'Italia and Consob leadership teams includes those leaders whose remit has nothing to do with banking supervision suggests that Di Maio and Salvini are pursuing a diversionary tactic here. They are trying to shift the blame for Italy's current banking woes away from their own growth-impeding policies. The net effect is an elevated Italian risk spread and further damage to Italy's growth prospects.

We maintain our view that, with a radical government heading in the wrong direction, Italy is an accident waiting to happen. As the starting situation (solid current account surplus, interest payments on public debt just 3.6% of GDP) is not too bad, we expect Italy to muddle through for a few more years without a genuine debt crisis. But an unexpectedly harsh 2019 recession or major government follies could raise the risk. Long-term, Italy will either have to return to a pro-reform government or face a rising risks of a Greek-style debt crisis eventually.

SPAIN: THIRD ELECTION WITHIN LESS THAN THREE YEARS?

Spain's minority government may announce snap elections as early as today, with likely dates for the election being 14 or 28 April. Prime Minister Pedro Sanchez' centre-left government and the far-left Podemos have so far failed to secure the backing of Catalan regional parties for a crucial

vote on the 2019 budget today. The government needs the Catalan votes to pass legislation. Talks between the government and the Catalan regional parties broke down ahead of Tuesday's start of the trial of Catalan independence leaders.

A swing to the right? In current opinion polls, Sanchez' Socialist party leads with 25% of the votes, followed by the centre-right PP slightly above 20% and the centrist Ciudadanos just below 20%. Left-wing Podemos could get around 15%. The centrist Ciudadanos could turn out to be the kingmaker. They could either support Sanchez, as they have done in Andalusia last December or upon ratifying the excessive 22.3% increase in the minimum wage this January. More likely, Ciudadanos could tilt right and form a coalition with the centre-right PP. Crucially, such an alliance would likely need support from the new right-wing Vox party which scores around 10% in the polls. Under what terms Vox would support a centre-right alliance could turn into a key issue.

It probably would not matter much: A PP-Ciudadanos led alliance would be mildly positive for the Spanish economy as the risk of big social give-aways - such as the 22.3% hike in the minimum wage - that threaten to constrain Spain's long-term growth potential would be lower. Going forward, Spanish politics may remain noisy. The impact on the economy will likely be limited. In a new election, parties advocating growth-inhibiting measures will probably struggle as much as those that call for further pro-growth reforms. Following the strong reform drive in the years after the euro crisis, political gridlock or weak governments that struggle to push through major changes may not be too bad after all. Beyond the rise in the minimum wage, which will likely slow the pace of job creation in services and lead to more temporary instead of permanent work contracts, we do not expect major reform reversals under any of the realistic political scenarios.

This message has been produced for information purposes for institutional investors or market professionals, it is not a financial analysis within the meaning of § 34b or § 31 of the German Securities Trading Act (Wertpapierhandelsgesetz), no investment advice or recommendation to buy financial instruments. The message does not claim completeness regarding the information on the developments referred to in it. On no account should it be regarded as a substitute for the recipient's procuring information for himself or exercising his own judgements. The message may include certain descriptions, statements, estimates, and conclusions underlining potential development based on assumptions, which may turn out to be incorrect. Berenberg and/or its employees accept no liability whatsoever for any direct or consequential loss or damages of any kind arising out of the use of this message or any part of its content. -- For full economics reports please visit our website or contact capitalmarkets@berenberg.de.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7889
www.berenberg.com
holger.schmieding@berenberg.com