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MACRO UPDATE: SIGNALS AND SURPRISES

Berenberg Macro Flash

Recession fears are gripping global markets again. The Brexit mess and the pronounced weakness in global trade do indeed provide reasons to worry. Surveys and some hard data suggest that the industrial recession in Europe and Japan continues to worsen and that US industry is softening as well. Nonetheless, the rationale for our base case remains strong: (i) While US growth will moderate as the 2018 fiscal stimulus expires and US industry feels the pinch from trade tensions and weaker foreign demand, it will not fall below 2% on a sustained basis. (ii) Global industry and hence growth in Europe and Japan will bottom out in a few months and recover thereafter as trade tensions fade somewhat, China's stimulus starts to work and the UK avoids a hard Brexit.

Late last week, two events added to the renewed recession fears: the slight inversion of the US yield curve and the sharp drop in the Eurozone manufacturing PMI to its lowest level since the wake of the euro crisis in autumn 2012. Both signals are noteworthy. But we need to put them into perspective:

- **Bond yields:** Fixed income investors take a keen interest in the economic outlook. As a result, major moves in bond yields – and the shape of the yield curve – often predict economic turning points. However, real interest rates are low mostly for long-term structural reasons, central banks are intervening in bond markets (last Wednesday, the Fed announced the early end of quantitative tightening) and the economic outlook seems to be shaped more by political risks than the usual logic of the business cycle. As a result, bond market signals have probably turned into less reliable predictors of the economic outlook than in the past. Also, the historic lags between yield curve inversions and recessions are so long (often two years) and variable that a marginally inverted US yield curve contains only limited information about the immediate downside risks to growth.

- **Two surprises**: In the Eurozone's manufacturing sector, the largest fall in new export orders since August 2012 pushed the purchasing managers' index down to 47.6 in March from 49.3 in February. The external shocks are hitting export-dependent Germany particularly hard, visible in a plunge in the German manufacturing PMI to a 79-month low of 44.7 in March. The weakness in German and Eurozone manufacturing is more pronounced than we had expected. However, this is partly offset by a second surprise: so far, the domestically-oriented services sector is weathering the industrial downturn even better than expected, supported by ongoing gains in employment and real incomes. The gap between the export-reliant and the more domestic-oriented parts of the economy is not new – see for instance Eurozone construction: a stabilising factor and The two sides of the German story. It has now become a bit more pronounced, though.

At the start of another key week for Brexit, the risks to our call that the downturn in European – and global – industry will bottom out in a few months are obvious. With US-Chinese trade talks not over yet and the Brexit uncertainty going into overtime, a potential turnaround in industry could possibly be delayed once again. However, the resilience of labour markets and the services

sector, for example with a bounce in German business expectations for services in the Ifo survey today, support the call that manufacturing – while keeping GDP growth very subdued for now - will not push the overall economy into recession. Even for the Eurozone, the recent data flow is mixed rather than uniformly bad, with first signs of spring including a further small rise in Eurozone consumer confidence in March alongside worsening news on sentiment in manufacturing.

Three months ago, our calls for Eurozone GDP growth in 2019 were 0.4 percentage points below the Bloomberg consensus. As consensus expectations have shifted down, the gap has narrowed to just 0.1ppt now. The risks to our call for this year (1.1% GDP growth for the Eurozone) are titled clearly to the downside. The weak surveys for manufacturing have highlighted this once again in the last few days. But unless politics gets it badly wrong (hard Brexit, escalating trade wars) and China fails to deliver an effective stimulus, chances are that the worst will be over in a few months. The grey winter could still be followed by a brighter spring, even if this spring is not imminent yet. See Forecasts at a Glance for our full set of projections.

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