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MACRO UPDATE: GOOD NEWS, BAD NEWS AND BREXIT

Berenberg Macro Flash

CHINA: SIGNS OF HOPE

Is the stimulus starting to work? Probably yes, although it is still early days. China's Caixin manufacturing PMI rose from 49.9 in February to 50.8 in March, the best reading since last July. After a string of measures to stimulate demand in the second half of 2018 (cuts in minimum reserve requirements, increased borrowing limits for local governments), the rebound fits the pattern of a stimulus that is reaching the real economy with the usual lag. Of course, the March gain has to be interpreted with caution. The timing of the Lunar New Year Holidays in February probably weighed on the index in February and accentuated the rise in March. Nonetheless, in line with other data showing less sluggish credit growth in China, the uptick in the PMI supports the view that China's slowdown will come to an end soon. The 31.6% yoy rise in social financing flows to the economy in the three months to February may be an outlier in a volatile series. But at least it is an outlier in the desired direction. The additional stimulus measures including tax cuts worth more than 2% of GDP presented at the People's Congress in early March and optimistic comments about further progress in US-China trade talks by US trade representative Robert Lighthizer - and even President Donald Trump last Friday ("talks going very well") - also point in the right direction.

EUROZONE: STILL A VERY MIXED PICTURE

The downturn in the Eurozone has been largely driven by external factors ranging from trade tensions and China to Brexit. If China's growth rate is indeed bottoming out, the export outlook can improve again. However, it will likely take a few months until European industry starts to notice the impact of easing trade tensions and China's stimulus to domestic demand. At the moment, industry is still feeling the pain. In the EU Commission's sentiment survey for March published on Thursday, the assessment of export orders fell to its lowest level since autumn 2016. In response, we reduced our forecast for Eurozone GDP growth in Q2 to 0.2% from 0.3% qoq. This lowered our call for the full year 2019 from 1.1% to 1.0%, below the Bloomberg consensus of 1.2% - see Forecasts at a Glance. The fall in the manufacturing PMI for the Eurozone from 49.3 in February to a nearly six-year low of 47.5 in March according to today's final reading shows that the industrial recession is still deepening. New orders fell at the fastest rate since late 2012.

Not all Eurozone recent news is bad, though. Data out last week brought more evidence that the domestic economy is holding up well. Even in Germany, which is more exposed to trade woes than most other European countries, employment continued to rise solidly in early 2019 with a 2.0% yoy gain in core employment (subject to payroll taxes) in January. Although consumers worry about external risks, they are keeping their wallets open. After a weird weakness in German retail sales in December (-3.1% mom) that may well be revised up over time, retail sales in January and February have come in 1.7% above their Q4 average. As consumption, government spending and construction continue to prop up demand, the industrial recession is not spreading to the overall economy yet.

Based on the resilience of domestic demand and the outlook for better news out of China, an easing of trade tensions and – hopefully – some non-catastrophic resolution of the Brexit saga, we still expect Eurozone growth to recover to a pace around trend of 0.4% qoq in H2. The economy's return to healthy rates of growth is delayed, but not derailed, in our view. Our call of 1.6% growth for 2020 exceeds the Bloomberg consensus of 1.4%.

BREXIT: CRUNCH TIME

After the UK parliament rejected the EU Withdrawal Agreement by 344 to 286 votes last Friday, the EU27 are losing their patience with the UK. The tone of the debate on the continent has hardened. The UK has nine days left until an EU emergency summit on 10 April to present a credible plan forward. It seems extremely unlikely that the EU27 could unanimously agree to grant the UK more time to make up its mind while finding a procedural trick so that the UK would not have to take part in the EU parliamentary elections on 23 May.

At this stage, it looks likely that the UK will have to **ask for a lengthy Brexit delay and have to hold the EU parliamentary elections to avoid the no-deal hard Brexit**. This is not yet inevitable, though. If the UK were to accept an easy Brexit option (customs union with regulatory alignment for goods or full single market membership) and present that to the EU27 as its choice on 10 April, the EU27 may conclude that this would require merely modest changes to the declaration on future relations. With a lot of goodwill on the EU27 side, that could possibly still be doable by 22 May for a formal Brexit just ahead of the EU parliamentary vote on 23-26 May.

Part of the problem, as seen from the EU27 side, seems to be that none of the theoretical Brexit options ranging from a hard Brexit to no Brexit and any variant inbetween has been ruled out yet in the UK's internal debate. As long as many MPs believe that their favourite option could still make it, they may not yet have enough reason to compromise. By refusing to concede that her own option, the envisaged free-trade deal with an Irish backstop that could theoretically erect a regulatory border between the mainland UK and Northern Ireland, is dead for good, Prime Minister Theresa May has set a bad example in this respect. If the indicative votes in UK parliament scheduled for today yield a clear result or at least narrow the range of options that MPs still consider possible, they could turn into a big step forward – see Kallum Pickering's 10 point guide to the indicative votes. Our best guess remains that the customs union including regulatory alignment for goods has the best chance to secure the backing of parliament. It already came very close in the first indicative vote last Wednesday (with 264 to 272 votes).

Note that the Brexit debate covers two distinct issues, the legally binding **Withdrawal Agreement** (WA) and the **political declaration on future relations** between the UK and the EU27. Except for the extreme scenarios of a no-deal hard Brexit or no Brexit at all, the EU27 will insist that the UK passes the WA. Even if the UK were to go for the hard Brexit, any post-Brexit attempt by the UK to then negotiate a free trade deal with the UK's biggest market, the EU27, would be met by a request from the EU27 to first accept the UK's financial obligations and to guarantee an open border in Ireland. In short, the EU27 would ask the UK to accept the key elements of the Withdrawal Agreement.

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