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MACRO UPDATE: BEYOND THE LIMBO

Berenberg Macro Flash

No term describes the current economic situation in much of the world better than limbo:

- While the unsettling **Brexit drama** has once again gone into overtime with no imminent resolution in sight, the risk that it goes badly wrong remains low. Neither the UK parliament nor the EU27 want a no-deal hard Brexit. In the meantime, the uncertainty weighs on confidence across Europe.
- **US-Chinese trade talks** continue to progress according to consistent reports from both sides. But the talks are taking their time. More importantly, Trump's tweet yesterday scolding the EU for being a "brutal trading partner" with the UK and the US "which will change" and his rule-breaking escalation of the long-standing Airbus-Boeing dispute carry a message: US-EU trade issues will get noisy soon. One way or the other, Trump has to react to his Commerce Department's report on car imports by 17 May. Trade tussles will not be over with a Trump-Xi handshake.
- The **Chinese stimulus** is in the pipeline. Some data (credit flows, March PMIs) are showing early signs that it is reaching the real economy. However, as the multi-stage stimulus is focused more on the local level and on consumers rather than big infrastructure projects, the timing and extent to which it will raise China's demand for imports remains unclear.
- While **export expectations** and **confidence surveys** for the Eurozone as well as **German export orders** point to a deepening industrial recession in coming months, **industrial output data** are holding up less badly than expected. For January and February, further softness in German industry (output ex construction -0.3% on the Q4 average) has been more than offset by a rebound in France (+1.1%) and Italy (+1.3%) after a weak Q4. Judging by these data, the risks to our call of 0.2% qoq GDP growth for the Eurozone in Q1 are no longer clearly tilted to the downside. For now, Eurozone companies seem to be working down their comfortable orders backlog (see chart below). But bridging the dearth in new orders this way cannot continue for much longer. Either orders stabilise in a few months - or the industrial recession will get worse.
- On a grander scale, **domestic-oriented services**, **construction** and the **labour market** in the Eurozone (outside Italy) have so far withstood the recession in export-oriented industry remarkably well. This gap cannot stay or widen for much longer. Either industry turns the corner by, say, mid-year at the latest, or the domestic economy will likely start to tank.
- While **Italy** looks set to miss its 2019 fiscal deficit target of 2.04% by a large margin (a 3.2% deficit would not surprise us), the EU will take up the issue in earnest only in June, that is after the EU parliamentary elections of 23-26 May.

THE BENEFIT OF THE DOUBT

Having overreacted to the downside risks in late 2018, financial markets are now largely giving the optimists the benefit of the doubt. Judging by a series of discussions with investors, many of them seem to agree with our calls that:

- the Chinese stimulus will work,
- the US and China will defuse their trade conflict,
- central banks will be suitably dovish, and
- the UK will probably avoid a hard Brexit in the end.

A good deal of potential good news to come seems to be priced in. Still, many investors seem to share the consensus view that, even if the current troubles recede, global growth is gradually losing momentum as the long post-Lehman recovery continues to mature. We project that industry and overall Eurozone growth will snap back to normal (annualised growth of 1.5% at least) once the industrial recession caused by external shocks is over. Many other observers seem to think that the rebound will be more muted. In our view, industrial cycles can turn fast, especially in open trade-oriented economies such as those of East Asia and Europe. Some uptick in domestic activity in Europe in response to fading risks should add to that. For the outlook from mid-2019 onwards, we are thus a bit more optimistic than the consensus. Not all the potential good news is priced in already, in our view.

KEY ASSUMPTIONS: ITALY, EXPORTS, TRADE TUSSLES

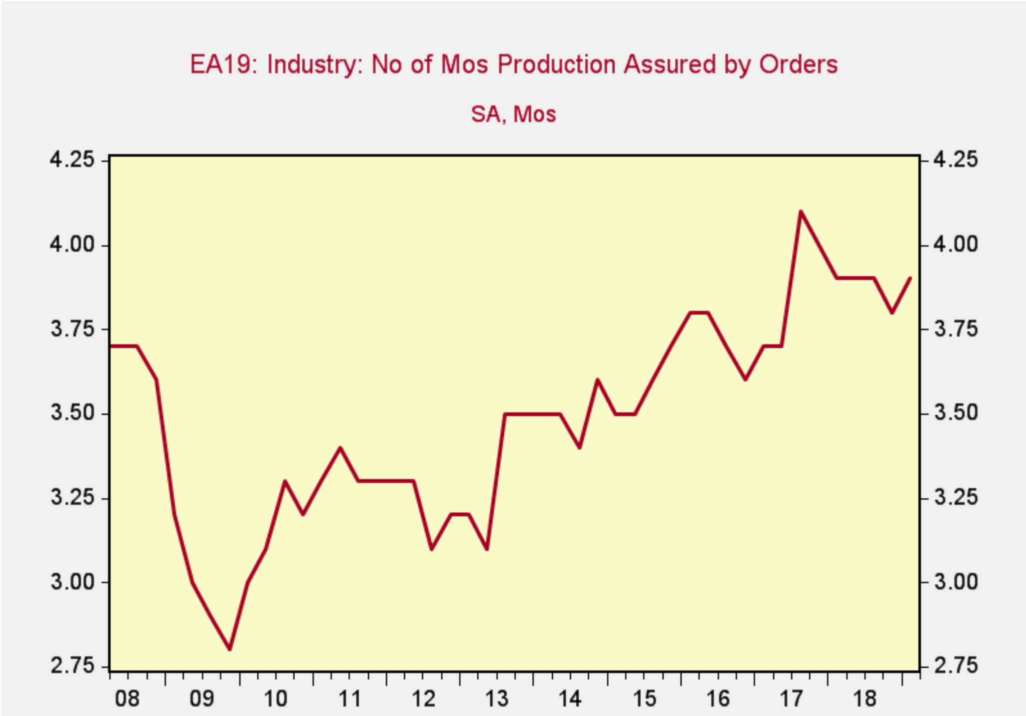
Our Eurozone call rests on three key assumptions beyond the fading of the external risks mentioned above.

1. **Italy will back down** by enough versus an accommodating EU Commission to avoid a genuine debt crisis. One year after the radicals around Salvini/Di Maio came to power in Rome, a crisis would now be their crisis, not one they could blame on previous governments. For the Lega's Matteo Salvini, a blow-out in yield spreads and the resulting financial turmoil could spoil his chances to win potential new elections and become prime minister. It would also hurt his support among Northern Italian small- and medium-sized enterprises who need their banks to grant them credit.
2. **Global trade growth will return to normal** in 2H2019 as US domestic demand continues to expand at a clip above 2% and East Asia as well as other key emerging markets regain some momentum. So far, we see no clear reason to expect a pronounced worsening of the US and global economy in 2H 2019 instead.
3. **The looming US-EU trade dispute will not get out of hand** despite Trump's apparent obsession with German cars cruising along on Fifth Avenue. The ability of the big EU to strike back hard, the lack of support in Congress and among US businesses and the US population for tough action against the EU as well as Trump's need to keep the US economy humming along nicely ahead of his re-election bid in 2020 suggest that a disruptive trade war is not very likely. We will take up the issue of US-EU trade tensions in more detail in a separate message shortly.

On balance, we see good reasons for guarded optimism. Not for the first time in the last 30 months, though, Donald Trump's protectionist inclinations seem to pose one of the top risks to our modestly upbeat outlook for economic growth in Europe and beyond.

Click here for presentation which explains some of our key points in more detail.

Chart: Backlog of orders in Eurozone industry, in months



Source: European Commission/Haver Analytics

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