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

RECESSION RISK? MIND THE BASICS

Berenberg Macro Flash

The world economy is not heading for a recession in 2019 or 2020. As a result, it is too early for a genuine bear market in equities. This has been our key call for the last three years. While a lot has changed in the past six months, the basis for this forecast remains solid, in our view. More precisely, two changes largely offset each other: whereas US President Donald Trump has accentuated the political risks to growth, the economic rationale for our call has become even slightly stronger.

THREE KEY ASSUMPTIONS

To simplify a complex picture, our call rests on three major assumptions:

1. Inflation will remain contained in the Western world. This will allow central banks to act as a buffer, adjusting their stance as required to support demand.
2. Trump will want to be re-elected in 2020 as a president who helped to create jobs rather than as a trade warrior who inflicted serious pain on the US in the hope that other countries would suffer even more.
3. China will do what it takes to prevent mass unemployment and social unrest ahead of the 70th anniversary of communist party rule in Beijing in October 2019.

In the economic sphere, core inflation rates continue to surprise on the downside in the US, the Eurozone and - to a lesser extent - even in the UK. On this count, fears that central banks may have run overly accommodative policies in recent years have been proven wrong. The US core PCE deflator has come in at just 1.6% yoy so far this year after 1.9% in 2018, Eurozone core inflation is still hovering around 1%, as it has since 2013, UK core inflation has receded to1.8% after 2.05% in 2019. Central banks are free to do what they need to do to contain the damage from the ongoing industrial downturn that started in mid-2018.

In the realm of politics, Trump has escalated his trade war against China and issued a sharp threat to Mexico while allowing for significant more time for negotiations with Japan and the EU. On balance, these developments look set to weigh further on business sentiment, investment and industrial production near-term across the Western world. After earlier reports about significant progress in US-China talks and ahead of the bid to ratify the new US-Canada-Mexico trade agreement, Trump's hardline stance against China and Mexico came as a negative surprise. It overshadows his less surprising softer line versus the EU and Japan. Beyond the initial confidence effect, though, the balance of Trump's recent turns is less negative. Because of the EU's role as the No. 1 in global trade, we see a US-EU trade war as by far the worst potential risk to our call for continued growth in the Western world. This risk has receded somewhat. Would Trump really want the EU to stop all soybean imports from the US in late 2019, just ahead of the US presidential primary in Iowa, in response to US tariffs on car imports – to name just one of many ways in which the EU might strike back? As the UK Brexiteers had to learn the hard way, the EU is fully capable of throwing its commercial weight around despite whatever internal arguments about Italy's fiscal stance it may have. As both sides, the US and the EU, could hurt each other badly, we

expect mutual deterrence to work. Political support for car tariffs seems to be very low in the US anyway – see Trade: more good news than bad news:

Seen from a macro angle, **many of the concerns haunting markets should be self-correcting after a while**. If growth softens more than expected, central banks will hold against it. The top central bank of the world, the US Fed, has significant ammunition left to do so. The ECB would have to break new ground. But it would do so eventually if need be even under a hypothetical German ECB president. Unexpectedly robust growth in early 2019 may have encouraged Trump to escalate trade tensions in the last four weeks. If US growth now falls short of expectations and/or equity markets suffer badly, he may become more inclined to strike partial trade deals so that he can still campaign for re-election on an "I created jobs" platform. If China's needs to deliver a further stimulus to contain the domestic damage from trade tensions, it probably would not hesitate for long but just go ahead. With a high domestic savings rate, a healthy external balance and low inflation, China could afford to do so for quite a while despite the potential long-run costs of running up more domestic debt.

The key risks to our call are obvious: an escalating US-EU trade war or a dramatically worsening Chinese downturn could push the Western world to the brink of recession despite largely healthy economic fundamentals. An unexpected massive and lasting spike in inflation could tie the hands of central banks, leaving them no room to cushion political or external shocks. In the Eurozone, an Italian fiscal suicide – which we deem highly unlikely as the cards are stacked against Italy in any confrontation with bond markets and the EU – could also cause a significant upset for a while.

WATCHING THE YIELD CURVE

In the past, an inverted US yield curve has often predicted a US recession. We thus need to take the US curve seriously. The current flight to safety reflects heightened concerns about the economic outlook after ten years of expansion amid unusual political risks. Still, in an environment of unusually subdued inflation risks and an excess of savings over investment intentions, economic logic suggests that nominal and real yields should be significantly lower than they have been in previous cycles. As a result, it may take an inversion of, say, 50bp, to send the same recession risk message than a simple inversion did in the past.

WHAT ABOUT BREXIT?

Confidence drives much of the business cycle. The near-term impact of shocks on confidence and activity depends more on the surprise factor than the nature of the shock itself. In late 2018, a no-deal hard Brexit would have been a huge surprise. It could have pushed the UK into recession and the Eurozone into stagnation. We currently see a 35% risk for a hard Brexit on 31 October. More likely, a new UK prime minister such as Boris Johnson will have the credibility with Conservative members of parliament and voters to achieve what Theresa May did not: he may get the UK parliament to ratify a – marginally amended – deal with the EU. Of course, that is a close call. More importantly, a hard Brexit would no longer be a huge surprise. By now, we have all had time to mentally prepare for it. Regulators have thought about ways to lessen the blow, companies have

stocked up on inventories. As a result, a hard Brexit in late 2019 would have only a very modest impact on the Eurozone. Even for the UK, the blow would probably not push the economy into recession.

FORECAST CHANGES

Central banks: in response to persistently low core inflation and the recent escalation of US-Chinese trade tensions, we adjust some of our key forecasts for 2H 2019.

- **US Fed**: we now expect 25bp rate cuts in July and October 2019 followed by stable rates thereafter through 2020 instead of no change in rates during this entire period.
- **ECB:** we postpone our call for the first refi rate hike from Q2 to Q4 2020
- **BoE:** we no longer forecast a 25bp BoE rate hike in 2H 2019; we still look for two 25bp hikes in 2020.

Economic growth: as the US-stoked trade tensions weigh on sentiment near term, we downgrade our forecasts for 2H 2019 slightly for the US and the Eurozone. The industrial downturn, which we had originally expected to hit bottom in Q2, will likely drag on for at least one more quarter.

- **US GDP:** We now project annualised rates of 2.0% instead of 2.3% for 2H 2019. This shifts our calls for average annual growth to 2.5% instead of 2.6% for 2019 and to 2.1% instead of 2.2% for 2020
- **Eurozone GDP:** We now project 0.2% instead of 0.3% qoq non-annualised growth for Q3 2019. The lower starting level reduces our call for average annual growth in 2020 to 1.5% from 1.6%. We adjust the growth forecasts for Eurozone member countries accordingly. For 2019, we now expect German GDP to expand by 0.7% instead of 0.8%.

For full details, see Forecasts at a Glance.

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