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MACRO UPDATE: TRADE TROUBLE, BREXIT

Berenberg Macro Flash

TRADE: MAJOR DAMAGE, MINOR RELIEF

US-CHINA: Equity markets got it right on Friday. US President Donald Trump‘s threat to impose a 10% tariff on the not-yet penalised $300bn worth of imports from China if Beijing does not budge before 1 September is a significant setback. The potential direct damage to US consumers and to producers in China and elsewhere along the supply chain may be limited. However, the additional uncertainty about the outlook for global trade and the resulting blow to confidence matters much more. Of course, it may just be a Trumpian tactic meant to hasten talks on a US-Chinese deal. Still, almost 18 months after Trump started to put such pressure on China, the lesson so far is that tactics he has honed in the New York real estate market may work against vulnerable smaller economies such as Mexico or Guatemala. But they do not seem to work well against bigger targets such as China.

As Mickey Levy writes our base case remains that the US and China will eventually reach some kind of trade agreement that will ease tensions about tariffs. But the risk that they may fail to do so, or that it may take well into 2020 or even longer before we may get a breakthrough, looms larger than before.

US-EU: On a less negative note, Trump also delivered a small pleasant surprise on Friday. The surprise was not that the EU will import slightly more US beef in the future. The new mini-deal, which merely resolves a technical issue from a previous deal on beef, had been in the making for months. The surprise was that Trump called a press event to announce – and dress up - such a minor detail himself. He apparently wanted to use the opportunity to score a point with a key domestic audience, US farmers. That keeps the hope alive that, for his re-election campaign next year, he wants to present himself to voters as “master of the deal” rather than as the trade warrior who faces down presumed adversaries even if it hurts US consumers and producers. Unfortunately, the verdict as to which role Trump will really play next year is still wide open. This illustrates the uncertainty that is holding back business investment and industrial activity across much of the developed world.

For US-EU trade, the biggest bilateral economic relationship in the world, the near-term outlook for talks on three somewhat separate issues remains mixed. (i) According to the World Trade Organisation (WTO), both sides have subsidised their airplane makers too much. In line with WTO rules, the US looks set to impose countervailing duties on some EU imports in September. Under the same WTO rules, the EU will likely follow six months later. While this Boeing-Airbus dispute makes occasional headlines, this issue is fairly contained so far as both sides are basically acting within the rules of the global trade system. (ii) Separate negotiations on the mutual recognition of technical standards for goods seem to be making some progress. (iii) However, the big issue – the US threat to impose a 25% tariff on car imports if the EU does not open its agricultural market beyond small gestures – is not close to any resolution. Our best bet remains that the US will not impose car tariffs in the end as there is little political support in the US for such a measure.

Taking account of continuing trade tensions and the diminished chance of no more than 30% that Brexit could be resolved amicably by 31 October, we reduced our European growth forecasts last Wednesday. We now project very mediocre growth for the Eurozone and near-stagnation for export-dependent Germany until the end of 2019, followed by some easing of tensions and a gradual return to trend growth by spring 2020. Trump's renewed trade threat shows that the risks to this call are tilted to the downside. As long as trade tensions and the resulting uncertainty continue to prevail unabated, the gradual erosion of confidence and the slow spread of damage from trade-oriented industry to other sectors of the economy and labour markets in exposed countries such as Germany will continue.

BOJO MAKES A SPLASH

Four weeks ago, the EU27 had given some credence to the assumption that Boris Johnson would adopt a hard-enough line on Brexit to easily secure his election as Tory leader and UK prime minister. Once in office, flexible Boris would then sound out compromises with the EU to sell a slightly amended Brexit deal to the UK parliament for an orderly exit from the EU on 31 October or shortly afterwards. This hope has been partly shattered by his "do or die" rhetoric in the last stages of his campaign and by his first actions as prime minister. His choice of key ministers and advisers as well as his campaign-style promises of more cash for all sorts of causes left, right and centre are widely interpreted on the continent as a prelude to a UK general election. The key uncertainty at the moment seems to be whether that election may still happen before or – more likely – after 31 October.

The EU27 was – and is – ready to dress up the commitments made to Theresa May already, notably to change the declaration on future relations to suit whatever model the UK may prefer and to solemnly promise to do the utmost to make sure that the Irish backstop would never need to be activated. If anything, Johnson's rhetoric ("negotiations only if the backstop has been ditched") and actions make it even more difficult for the E27 to offer him any further concession of substance. The prospect of new elections in the UK does not encourage the EU27 to accommodate the current prime minister either. After new UK elections, the UK position may still be as hard as the current rhetoric – or it may not. That the EU27 would ditch the negotiation position it has consistently maintained for more than two years to accommodate a prime minister who has merely a one-seat majority in the current parliament seems unlikely.

A "no-deal" hard Brexit would hurt all sides. However, as the big EU27 believes that it would be less affected than the UK itself, the EU may steel itself to wait and see how political developments play out in the UK just ahead of 31 October, for example to see whether the UK parliament may force the government to ask for an extension. Some UK observers seem to believe that Ireland would have even more to lose than the UK from a hard Brexit. Ireland may thus be ready to drop its insistence on a "backstop" guarantee against a hard border in Ireland at the last minute. Of course, we will not rule that out completely. However, the political discussion in Ireland does not suggest that Ireland is tilting this way in complex considerations about the long-term future of Ireland which go well beyond short-term economic considerations. The EU27 position seems to be unchanged: If Ireland were to shift its stance, the EU27 would go along with it. But the EU27 will not put heavy pressure on Ireland to soften up. As seen from Brussels and Berlin, it is still up to the UK to decide what it really wants.

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