CLIENT FEEDBACK

Berenberg Macro Flash

Much like last year, two issues topped the agenda in our discussions with clients at Berenberg’s annual conference at Pennyhill Park this week: the US-China trade war and Brexit. But in wide-ranging discussions, three other key issues came up consistently as well: continental European politics, the pro-democracy protests in Hong Kong, and fiscal policy.

Our main takeaways from these discussions:

1) **Trade progress - when not if:** Escalating tensions between the US and China tipped global trade and manufacturing production into a mild contraction this year. Nonetheless, clients were more optimistic now than a year ago. In December 2018, they asked ‘if’ there would be a positive breakthrough on trade in 2019. Seeing the market selloff at the time as a harbinger of bad news to come in 2019, they worried that the lagged impact of the 2018 Fed rate hikes, the slowdown in China and trade wars could cause a genuine recession in 2019. This time, most clients asked ‘when’ rather than ‘if’ trade tensions would be defused at least somewhat ahead of the US election in 2020. The recovery in global equities during 2019 reflects this positive shift in sentiment. With much of the potential good news already priced in, equities may only rise modestly over the course of next year if economic data improve. On the flip side, this implies that the market is vulnerable to a correction if politics goes badly wrong or the economic rebound falls far short of expectations.

Despite the recent noise about a ‘Phase 1’ deal between the US and China, few clients saw this as a real prospect before Christmas, if at all. In our view, tensions simply need to remain as contained as they have been since September in order for global trade and manufacturing to recover gradually next year. No news on trade, that is the absence of bad news, would already count as good news, in our view. A partial US-China deal that deescalated tensions significantly would be a welcome bonus. We expect a **gradual return to modest growth in trade** and manufacturing to benefit trade-dependent Europe more than the US. In markets, flows out of safe havens can lead to a less overvalued US dollar, higher bond yields and a rotation in equity markets back into more cyclical and risky sectors.

2) **Brexit – waiting for the election outcome:** On the whole, clients agreed that the hard Brexit risk has receded materially since Prime Minister Boris Johnson struck a new Brexit deal with the EU some seven weeks ago. The risk that the 12 December general election could result in a hard Brexit on 31 January is virtually zero, in our view. Clients are paying a lot of attention to the **opinion polls that point to a Conservative majority** at the upcoming election. Most clients thought that outcome would be positive for UK risk assets (no hard Brexit, fiscal stimulus, no Corbyn) while a Labour victory would be a big negative surprise – despite the chance of reversing Brexit.

Clients continue to keep in mind the Brexit upset of 2016 and the poor performance of the opinion polls at predicting the outcome of the 2017 general election. As one client put it, ‘if
you could trust the polls you would be piling into the UK right now’. On a sector basis, clients saw value in UK construction firms, UK banks, and some UK retailers. With the good news already partly priced into sterling and UK equities, investors seem inclined to hold off increasing their UK exposure until the election result confirms expectations of a Johnson majority. Only a handful of clients seemed very concerned about the potential risk of a hard Brexit at the end of 2020, although this may become a more real issue next year.

3) **European politics**: This time, clients worried much less about political risks in France and Italy than they did a year ago. Instead, many clients asked whether German Chancellor Angela Merkel can remain in office and whether her possible departure could herald a bigger fiscal stimulus and a softer German line on Eurozone reform issues such as a joint deposit insurance scheme. We replied that, yes, we see a 40% probability that Merkel will be out of office in a year’s time. But no, her departure would probably not mark a major shift in German policies. Any German government that includes the CDU/CSU would pursue fairly similar fiscal and European policies. And even in the case that new elections brought a green-red-red alliance to power instead (10% probability), the CDU/CSU would still use its veto in the upper house of parliament (Bundesrat) to prevent major shifts in fiscal and European policies. However, such a leftist alliance could impose some significant regulations on parts of the domestic German economy including tighter rent controls. Some clients asked whether we maintain our bullish view that Macron’s reforms will usher in a golden decade for France. Answer: yes, we see even more evidence for that than last year.

4) **Hong Kong**: A violent clampdown of pro-democracy protests in Hong Kong is the most market-relevant geopolitical risk for 2020, in our view. Serious bloodshed would be a human tragedy. The US and the EU would probably respond with sanctions against China rather than striking any trade deal with it. China and global trade would suffer as a result. Those clients who raised the issue largely agreed with this assessment. As China seems to be aware of the risk, Beijing will - hopefully - shy away from it.

5) **Economic policy – shifting focus from monetary to fiscal**: The discussion about the fiscal response to slower growth in advanced economies has largely replaced the previous focus on what central banks will do next. Most clients thought that major central banks are likely to sit tight for the foreseeable future with the exception of the UK where the BoE could raise rates if Johnson wins the election. Amid a gradual recovery in global momentum, but without major inflation risks or credit excesses to contend with, central banks have little reason to change their stance in 2020. The consensus among clients is that, while central banks can still prevent serious market turmoil by injecting more liquidity in times of stress, already low interest rates meant that they could do little more to lift demand in the real economy – hence the shift in focus to fiscal policy. However, client’s views on how much fiscal stimulus would eventually come through varied considerably. While some expected a major shift towards borrowing and spending across most of the Western world, others – highlighting debt and deficit constraints – anticipated a much smaller boost mostly by countries that can afford it (i.e. Germany and to a lesser extent the UK).
We expect a **major fiscal stimulus in the UK** and a modest fiscal expansion in the US and across much of the Eurozone. Blessed with full employment, Germany will not embark on any major one-off fiscal boost to counteract the current downturn in manufacturing. However, Germany’s ongoing expansion of public investment (up nominal 8.6% in 2018 already), rising outlays for the transition to cleaner energy and some additional social spending will likely add up to a fiscal expansion of 0.5% of GDP in 2020. Barring a new major external shock to confidence, the outlook for domestic demand remains favourable.