MACRO UPDATE: US FEEDBACK, GERMAN POLITICAL FARCE

Berenberg Macro Flash

US CLIENT FEEDBACK
Four issues came up almost consistently in the discussions which Kallum Pickering and I held last week with clients in the New York and Chicago regions: (i) the corona pandemic, (ii) the outlook for global, European and German trade, (iii) inflation and (iv) Brexit. Roughly half the clients seemed to share our cautious optimism that none of these actual or potential problems will derail the modest upturn which we expect for trade, manufacturing and GDP over the course of this year. However, quite a few clients were more concerned than we are at the moment.

Coronavirus pandemic
While economists cannot really judge the potential spread, duration and impact of the pandemic, we can summarise our own take on it in two points:

- First, some of the output losses, notably those linked to transport, travel and tourism, will be permanent. In addition, the general standstill of activity in key regions of China will hurt. But this is much more a Chinese/East Asian rather than US/European issue.

- Second, disruptions to global industrial supply chains look set to significantly dent output across major parts of the world including Europe in coming weeks. So far, we stick to our call that, in heavily export-oriented Germany, this may shave 0.1ppt from Q1 GDP growth. The damage could be worse if the problem extends well into March. Most other countries outside Asia should be less affected than Germany. However, as in the case of disruptions caused by strikes of workers, we would expect manufacturing companies to recover at least two thirds of such losses in the months thereafter. The impact on annual GDP and the overall direction of markets should thus be limited in the end. Last week’s upward revision to the German, Eurozone and UK manufacturing PMIs for January shows that the underlying momentum in manufacturing remained positive while the pandemic started to make headlines in the second half of January.

Outlook for trade and industry
Most clients seemed fairly comfortable with our view that four factors should underpin a gradual recovery in global trade and manufacturing over the course of 2020: (i) Trade tensions have eased with the US-Chinese “phase one“ deal and an apparent US reluctance to provoke a costly trade war with the big EU by imposing 25% car import tariffs. (ii) Whereas Trump will continue to sow uncertainty, the world is getting used to it. His tweets now rattle confidence less than before, especially as Trump has so far consistently shied away from really big conflicts (think North Korea, Iran and trade with China). (iii) Brexit uncertainty will be less pronounced and damaging than last year. (iv) The industrial inventory correction, which - for example - subtracted co.9ppt from German GDP growth last year, will likely fade in 2020. If so, GDP growth can gradually return to rates more in line with the still resilient gains in private consumption, government spending and residential construction.

Inflation: not a key risk yet
Inflation remains a wild card. An unexpected drop in core inflation could put monetary easing back onto the Fed and the ECB agenda. More importantly, a serious and sustained surge could
spark a debate about an early tightening. For equity markets, that would be a very unpleasant surprise.

We expect core inflation to edge up slowly over time in the US and the Eurozone. Over a time horizon of 5-10 years, tight labour markets, the aging of societies, the fading disinflationary impact of China and shifts in consumer spending towards labour-intensive services such as entertainment, tourism, health and nursing care could offset the price-dampening effects of ongoing technological progress in other sectors.

For the next few years, however, inflation risks still seem well contained. During the 2019 down-turn in global trade and manufacturing, US wage inflation moderated already. With a lag, German and - to a lesser extent - Eurozone wage inflation will likely ease slightly in 2020. In addition, less subdued gains in productivity will limit the pass-through of higher wages into unit labour costs. In the US, this has already happened. In the Eurozone, this should set in once manufacturing output has started to expand again.

UK: Less uncertainty, more conviction
Most clients agreed with our view that the big election win for Prime Minister Boris Johnson on 12 December decisively improved the UK's near-term economic prospects by reducing political uncertainty. We received little push-back on our projection for a pick-up in UK GDP growth from 1.3% in 2019 to 1.7% in 2020 and 2.1% in 2021. While the risk of a disorderly “no deal” Brexit at the end of the year remains the risk to watch, no client saw this as a likely outcome. Our base case remains that the UK and the EU will instead strike a bare-bones deal for some sectors and a number of interim agreements for other key sectors to smooth the UK's exit from the single market at the end of this year. The eventual UK-EU trade agreement will likely be a semi-hard Brexit with 'Canada-minus' deal covering mainly goods trade with little for services or finance.

While most clients seem to expect some fiscal stimulus this year, few had a strong view on the likely size and scope. We look for fiscal policy to contribute 0.7ppt to headline GDP growth in 2020, focused on public sector investment aimed at raising productivity in the north of the UK. While clients remain bullish on UK risk assets, some specifically asked why sterling and UK-domestic oriented equities had not gained further beyond the initial relief rally following the election. The recent dovish tilt by the BoE and investor caution ahead of the upcoming UK-EU trade talks seem to be overwhelming the rising confidence and pick-up in post-election economic data for now. Looking ahead, further improving economic momentum, the big March 11 budget announcements and a gradually more hawkish tilt by the BoE should lift UK equities, sterling and gilt yields, in our view.

US politics: advantage Trump - or not really?
Separately, clients espoused very different views about the likely outcome of the US elections this year. A few confidently predicted that a Democrat would win the White House. They argued that opinion polls no longer understate support for Trump and that, in a year of average growth, cultural rather than economic factors would be key. However, more clients seemed to see an ad-
vantage for Trump on the back of a solid US labour market. The Iowa caucus mess seemed to strengthen that camp.

THURINGIA TROUBLE: BAD OR GOOD FOR MERKEL?
Outtwitted by the right-wing AfD, the centre-right CDU and the small liberal FDP last week elected a virtually unknown FDP politician as state prime minister of east German Thuringia with AfD support. After a political storm, the FDP candidate has now stepped down and the former state prime minister from the left-wing Left Party will likely return to office shortly. However, the political farce has exposed deep rifts within the CDU and FDP and between their regional subsidiaries in east Germany and their national leaders in Berlin. While the latter firmly reject any - even any accidental - cooperation with the AfD, some of their party members in regions where AfD support stands at 25% are not so sure about that.

Events on the state level usually do not matter much for federal politics in Berlin. Nonetheless, the Thuringia incident could have three consequences:

1) It weakens the leaders of the CDU and FDP while strengthening the right-wing AfD - at least in the near-term.

2) The incident may further reduce the risk that chancellor Angela Merkel could lose office this year. Not tainted by Thuringia, the SPD now has a better chance of winning the Hamburg state election on 23 February, where polls show the party slightly ahead of the Greens. An SPD success in its Hamburg stronghold could stabilise the party in the next few months. In turn, that would make it less less likely that the otherwise badly battered party will walk out of the federal government in Berlin and bring down Merkel this year.

3) That the CDU in Thuringia defied the current CDU chairwoman Annegret Kramp-Karrenbauer (AKK) during heated discussions raises the probability that Armin Laschet or Friedrich Merz rather than AKK will be the CDU/GSU candidate to succeed Merkel at the next federal election to be held in September 2021 (or earlier in the now fairly unlikely case of snap elections later this year).