Sunday Wrap

Happy Sunday,

This is Daniel Vernazza, UniCredit's Senior Global Economist. Erik is spending this weekend with family in his native Denmark and asked me to jump in. I have three topics on my mind this morning:

- Is the world economy Goldilocks or a bear with a sore head?
- The fall in eurozone inflation expectations and the ECB's reaction function
- I'll end with a prediction on Brexit

1. Is the world economy Goldilocks or a bear with a sore head?

Back in 2017 it was common to hear the world economy being described as "Goldilocks", an environment where the economy is neither "too hot" (too high inflation) nor too cold (weak growth). Judging by equity markets, some are starting to think this benign state could be returning.

This week the S&P500 hit new all-time highs. More broadly, financial conditions have eased impressively since the turn of the year, reversing the tightening that occurred in the final quarter of 2018.

This reversal was triggered by the volte-face of the Fed and now most central banks have either scrapped or delayed interest rate hikes. Latest, this week the Bank of Canada dropped its tightening bias and Sweden's Riksbank delayed its planned hike to early next year and extended asset purchases. Next week the Fed will surely stay in its patient and neutral stance, while the BoE will probably further downplay its (increasingly odd) tightening bias. As core inflation remains muted in many countries, despite higher wage growth, central banks have the room to be patient. If history is anything to go by, central banks will not shift back to a tightening bias anytime soon.

There has been some progress on trade policy uncertainty too. Reportedly, the US and China are close to a deal. Talks continue next week (30 April) in Beijing and the following week (8 May) in Washington. If so, it would be quick based on the average 18 months it takes for the US to sign a trade deal but, as research by the Peterson Institute has showed, next year's US Presidential election and a Chinese leader with the leeway to carry out reforms favour an agreement (see "How Long Does It Take to Conclude a Trade Agreement with the US?, PIIE, July 2016). In Europe, the European Council's 10 April decision to grant a six-month Brexit delay is at least a temporary reprieve from the economic chaos that a cliff-edge could bring, albeit mostly for the UK.

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Meanwhile, there are early signs of "green shoots" in the real economy. China's growth stabilised in 1Q19, suggesting the monetary and fiscal easing measures taken over the last year are having the desired effect. As we showed in our *Chart of the Week* (Chart of the Week – We are all dancing to the Chinese credit cycle), China's latest credit stimulus is likely to see the global manufacturing PMI stabilise soon and then move somewhat higher over the remainder of the year.

In the Eurozone, better industrial production and construction will likely see the economy expand 0.3% qoq in 1Q19 (the data is released on Tuesday), an improvement from the weak 3Q18 and 4Q18. Notwithstanding a slight disappointment this week, the German Ifo business climate index appears to have turned the corner.

On Friday, the US Census Bureau said GDP expanded a better than expected 3.2% annualised in 1Q19, although the details were weaker as volatile net exports and inventories contributed more than half of total growth. Next Friday the BLS is likely to report the labour market added another strong 195,000 jobs in April.

But the current situation is also a precarious one. I'll offer three reasons for caution (you could call them the three bears):

First, equity valuations are elevated, particularly in the US but also in Europe. As we approach the end of the cycle and tight labour markets, we are seeing upward pressure on wage growth. Not only in the US but in many countries, including in the Eurozone and the UK. At the same time, core inflation remains muted (for the US see our Chart of the Week - A tale of two Phillips curves allows the Fed to stay patient). A recent ECB paper ("The link between labour cost and price inflation in the euro area", ECB Working Paper, February 2019) shows that for the eurozone it is less likely that labour costs are passed on to price inflation now because recent inflation has been low and the economy is weak. As a result, profit margins are going down as real wages rise more than productivity. In the US, in particular, corporate debt has risen quite sharply since the financial crisis and much of the funds have gone into share buybacks. As the earnings cycle turns, overleveraged firms will be most vulnerable. The earnings season in the US has so far seen profits down around 4% year-over-year but there's likely more to come. In our view, equity markets are again in overbought territory and a correction is due.

Second, the US fiscal stimulus is still having an effect with government spending adding 0.4pp. to growth in 1Q19 (the Brookings Hutchins Center Fiscal Impact Measure estimates that government spending and tax policies together added 0.75pp. to growth), but this will fade materially from mid-year and then become a drag. Unlike in 2009, 2013 and 2016, this time around the Chinese credit stimulus is likely to be more moderate (because China's corporate debt remains high) and, in terms of the impact on the global economy, it is unlikely to fully offset a weaker US economy next year.

Third, policy uncertainty could again reveal its ugly head. The 90-day period for President Trump to decide on whether to impose tariffs on autos for national security reasons expires on 18 May. The European Parliament elections on 23-26 May will likely see a shift towards Eurosceptic and populist parties and, while it would likely have little impact on policy making, it probably would not be welcomed by markets (even though opinion polls find support for the EU increasing to very high levels, likely helped by the Brexit mess; latest, a survey by Kantar finds support for the EU above 80% in most member states and Italians want to stay in the EU by a large margin). And neither Brexit nor US-China trade tensions have been resolved.

So far, trade tensions and policy uncertainty have affected manufacturing and trade while leaving the dominant services sector largely unscathed. This can be seen from the global manufacturing PMI, which at 50.6 in March is almost 4 index points below its peak in December 2017 of 54.4, while over the same period the global services PMI is broadly unchanged at 53.7.

Reflecting the resilience of services, labour markets have been robust, but this could change if the weakness in manufacturing spills over into services.

National accounts tell us that, in advanced economies, manufacturing is only a small share of the economy. It is around 10% in the US, UK and France; 15% in Italy and relatively high (for an advanced country) in Germany, at 21% (the relatively high share in Germany and Italy probably goes someway to explaining why GDP growth in the former has underperformed the Eurozone average recently and the widening growth gap for the latter). For comparison, the figure for China is 29%. But the risk of spill-over is real.

Larry Summers once quipped (during a speech at the IMF economic Forum in 2013) that "There'd be a set of economists who'd sit around explaining that electricity was only four percent of the economy, and so if you lost eighty percent of electricity you couldn't possibly have lost more than three percent of the economy, and there'd be people in Minnesota and Chicago and stuff who'd be writing that paper... but it would be stupid."

Much of services activity exists to support – and is supported by – manufacturing. Think of after sales services, maintenance, retail services, and financial services for things like car purchases etc.

And while world trade is still dominated by trade in goods, trade in services is increasingly important. On UNCTAD numbers, 30% of world trade is in services, and it's higher for developed economies (40%). The US trade tensions have focussed on tariffs, which explains why goods trade has been hit hardest (tariffs are on goods, not services). Incidentally, a no-deal Brexit (albeit unlikely) would have a bigger effect on non-tariff barriers and services.

My bottom line is that if record high equities imply the current state of the economy is "Goldilocks", we should worry that she's woken by one or more of the three bears above.

2. The fall in eurozone inflation expectations and the ECB's reaction function

The 5Y5Y inflation swap in the euro area (a market measure of inflation expectations over the five-year period starting in five years' time) has fallen back again to 1.37% in the last few days, and is down from 1.7% in mid-November last year. Moreover, the fall in the inflation swap rate in the Eurozone has occurred when the inflation swap in other advanced economies has increased in line with oil prices (the latter hit their highest level since October this week). Compared with the US, the EMU inflation swap rate has fallen 40bp since the start of the year.

It is well-known that the fall in the eurozone 5Y5Y inflation swap was the trigger for the introduction of ECB QE in 2015 and the increase in ECB monthly asset purchases in 2016.

At the ECB press conference on 10 April, Draghi responded that "It's quite clear that the sliding of the five-year-to-five-year inflation expectations corresponds to a deterioration of the economic outlook". However, he said it reflected a fall in the risk premium, not a de-anchoring of central forecasts (i.e. markets are putting more weight on the tail risk of much lower inflation, but their central forecast is unchanged).

It's difficult to know whether this is a fair characterisation of market participants' views. One simple (but imperfect) way to judge is to look at inflation expectations from the ECB Survey of Professional Forecasters (SPF), which provide a central point forecast for longer-term (five years ahead) inflation. This measure of inflation expectations has barely moved, down 0.1pp. to 1.8% in 2Q19 from 1.9% in 4Q18. Under the assumption that professional forecasters and market participants have the same central expectation for inflation (a big assumption), then it suggests Draghi is right that the move in the 5Y5Y inflation swap reflects a change in the inflation risk premium.

Professional forecasters (i.e. market economists) too seem to be more concerned by the tail risk of much lower inflation. You see this in the distribution of inflation expectations in the SPF. Professional forecasters put the cumulative probability that inflation will be below 1% over the next five years at 0.34 in 2Q19, up from 0.27 in 3Q18, and close to its peak of 0.36 in 1Q16. Although 7pp. may not seem like a big move, professional forecasters are notoriously reluctant to forecast anything other than inflation at target with symmetric risks, particularly as far out as five years' time.

As my colleague Marco Valli has argued, this explains the ECB's message to financial markets at its April meeting that the ECB has the policy tools to react to incoming information in order to fulfil its price mandate. Draghi also emphasised that the central bank considers the inflation target to be symmetric: "Our inflation aim doesn't imply a ceiling at 2%; inflation can deviate from our objective in both directions, so long as the path of inflation converges to our medium-term objective". He has said this before, but why the emphasis now if the central bank is not concerned that market expectations of inflation are becoming de-anchored? So far, it hasn't worked.

The (big) problem for the ECB is the constraint of the effective zero lower bound. Interest rates are close to zero across the whole curve (this past week the German 10Y government bond yield went below zero again), and not just in Germany, but everywhere except the periphery. Ultimately, whatever tools the ECB has, and it does have many (forward guidance on rates, reinvestment, net asset purchases, possible tiring of reserves to take rates even more negative), rates in the core can't go much lower since investors can always opt to store cash at zero nominal yields (excluding the cost of storage). When the next downturn inevitably comes, and unless the ECB is going to follow the BoJ into buying hard assets (unlikely), then fiscal policy will have to do more while the central bank ensures accommodative monetary conditions are preserved and the transmission mechanism does not once again become fragmented.

3. Brexit: going through the motions until the inevitable Conservative leadership election (likely in early summer)

As much as I tried, I could not quite get away from the Brexit topic this past week. Parliament returned from its Easter recess on Tuesday, but there was no vote on Brexit and no progress made in cross-party talks to break the impasse. A Conservative backbench attempt to give Mrs. May's critics a chance to remove her in June failed: the executive of the 1922 Committee of backbench Conservative MPs narrowly decided (by 9 votes to 7) not to shorten Mrs. May's period of immunity from a Conservative leadership challenge to six months from the current twelve months (expiring 12 December).

In theory, it means Mrs. May cannot face a Conservative leadership challenge until 12 December. However, the 1922 Committee executives did overwhelming agree that Mrs. May should set out a "roadmap" for her departure if MPs again reject her Brexit deal (she has already promised to stand down if MPs approve her deal).

In reality, Mrs. May has a few more weeks to try to push Brexit through. She wants (and needs) a deal before 23 May to avoid holding European Parliament elections and a heavy defeat (according to opinion polls). But it looks an impossible task. The government is currently akin to a super-tanker heading for the European Parliament election iceberg.

Tuesday's cabinet meeting ended without a clear strategy on what to do next. The dilemma for the government is that it knows it needs to do something – because it faces a heavy defeat in the European Parliament election on 23 May if it can't deliver Brexit before then – but it cannot bring forward the EU Withdrawal Agreement Bill for a vote until it has a good chance of passing (because of the Speaker's ruling that MPs cannot vote on essentially the same motion twice in the same parliamentary session).

To remind you, Theresa May's Brexit deal has been defeated three times in the House of Commons. Almost all opposition MPs have voted against it, and a hard-line group of pro-Brexit MPs in Mrs. May's own party have continued to vote against it (largely because they are unhappy with the Irish border backstop tying the UK's hands). Since Mrs. May's own MPs refuse to pass it, and the UK government and the European Council have agreed the withdrawal agreement will not be reopened, Mrs. May is currently seeking the support of the main opposition Labour party. For its part, Labour accepts the withdrawal agreement but wants a change to the non-binding political declaration in favour of a customs union and closer ties to the single market (whatever the latter means).

Although one couldn't really get a cigarette paper between the government and the Labour leadership on Brexit, the cross-party talks are highly likely to fail and almost no-one in Westminster thinks they have a chance of succeeding. Labour is in no rush to reach a deal and help the Tories out – they want to see the Tories crushed in the European Parliament election on 23 May. The Labour party is also split over a second referendum and is keen to delay taking a stance. And, Mrs. May won't agree to the Labour demand for a "customs union" (even though the current Withdrawal Agreement talks about building on the single customs territory in the Irish border backstop, which itself is a customs union that could endure indefinitely) because her MPs would be in open revolt. Not to mention the political toxicity of the Conservatives relying on opposition votes to pass their main piece of legislation.

May's backup plan of letting MPs choose between a few options also looks destined to fail. That's because however many Labour MPs Mrs May could win over by offering a softer Brexit, she will likely lose the support of a similar number of her own MPs seeking a harder Brexit. On Thursday, the Leader of the House of Commons (Andrea Leadsom) did not include the withdrawal agreement bill in next week's business. So, there's unlikely to be a vote before the local elections on Thursday next week, which is also likely to result in a bad defeat for the Conservatives. The UK is very likely to hold European elections on 23 May.

And if the opinion polls are right then the European Parliament election will be incredibly damaging for Mrs. May. Previously Mrs May suggested that, as PM, she would not be able to accept an extension of Article 50 beyond end-June. The significance of the end-June date is that it's just before the new European Parliament sits for the first time on 2 July. So, I expect Mrs. May will not last as PM beyond June. It would trigger a Conservative leadership election, with the new leader crowned by the time of the Conservative party conference in late September. The new leader is likely to be pro-Brexit.

If so, it's possible that simply removing Theresa May's name from the Brexit deal and replacing her with a pro-Brexit Conservative leader pledging a looser future relationship with the EU will be enough to get the deal (Mrs May's deal) over the line. Alternatively, a pro-Brexit Conservative leader and PM could seek to renegotiate the Irish border backstop, the most contentious part of the withdrawal agreement, which possibly the EU may entertain (if events change then people change their mind). And a snap general election seems inevitable sooner rather than later, irrespective of whether the withdrawal agreement is ratified.

And on that note, I've promised my family lunch in the sun.

Best,
Daniel

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