# Sunday Wrap

Happy Sunday from Caffe Nero in Covent Garden in London, where it's a pleasantly cool morning (following rather unpleasant temperatures yesterday). Wherever you are, I hope you are all dealing okay with the heatwave.

It's the end of the second quarter of this rather peculiar year, so let's take stock of where we are, and discuss what the second half of the year might bring. I'll do it in two sections:

- **Economics, monetary policy signals and the amazing markets: Will the tricks continue to work?**
- **Politics: The Trump-China truce at the G20, European leadership nominations, and Brexit in the balance.**

## 1. Economics, monetary policy signals and amazing markets: Will the tricks continue to work?

I'll first summarize the first two quarters of 2019 in a (madly compressed) 4-paragraph version. I'll then outline my hypothesis of what drives the Fed and the ECB now, and finally, I'll give you my two cents worth on how it'll play out from here and what I'll be looking out for:

**The H1 summary:**

Following the heavy market selloff into the end of 2018, the Fed's Jay Powell shifted in early 2019 to a decisively dovish outlook, and markets rallied strongly in the early months of the year. The rally was further supported by the appearance of progress in US-China trade talks, as well as a nice pickup in growth during Q1. The Chinese stimulus seemed to be working, at least in terms of supporting global trade. In the US, three quarters of decelerating growth reversed and delivered annualized GDP growth of 3.1% in Q1, while the eurozone recovered from weak H2 2018 numbers (on account of Germany and Italy) to post annualized growth of 1.5%.

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While we don't yet have many hard numbers for Q2, GDP growth will surely have eased from Q1 in both the US and Europe. Remember, half the US growth in Q1 came from (highly volatile) inventories and from net exports. And European growth was boosted by a rebound in car production, following the drop in late 2018. Our guess is that Q2 will post growth of only about half of what we saw in Q1 in both the US and Europe. And sentiment is poor. The German Ifo is your perfect example: The Ifo's "current situation" index weakened again in early Q2 but remains at a historically strong level. The "business expectations" index, however, hovers at very depressed levels. This picture is very much confirmed by the vast majority of my many conversations with European companies: Life feels okay at the moment, the order books in decent shape, but the fear of the future, particularly as it relates to Trump and his disruptions of the global trading picture, dominates our conversations.

And sure enough, the "Trump Disruptions" hit again in May. After the Fed left rates unchanged at its May 1 meeting, Trump went on the attack against the Fed and Jay Powell, and on May 5 he said that the trade talks with China were moving "too slowly", followed by the announcement on May 10 that tariffs would be increased from 10% to 25% on USD 200bn of imports from China. Maybe also reflecting the more questionable macro data, or maybe just wondering about levels, financial markets turned softer during May – and within a few weeks, market started to price in substantial rate cuts into the fed fund futures. Then came the ECB meeting on June 6 and the extension of forward guidance and Draghi's reference to the possibility of rate cuts and QE, followed by his explosive speech in Sintra on June 18 … and we ended Q2 on a beautifully strong note in financial markets.

So, as my colleague, Michael Rottmann, has pointed out to me, in spite of all the huffing and puffing out there, if you were an ordinary "boring" investor with 60% of your assets in safe fixed income indices (US treasuries or EU government bond total return index) and 40% in equities (S&P500 or EuroStoxx 50), you would have made about 10% return during the first half of this year, whether you are a dollar or euro based investors (slightly better for the latter) - which is nothing less than the best 6-months performance on such a basic investment concept in more than 20 years!

**My hypothesis:**

So, here we are at mid-year in a situation where - on the basis of actual, published economic data and forecasts, as well as existing policies - it seems quite difficult to justify the extent of the latest turn in monetary policy guidance. What has driven the Fed and the ECB to send the messages we are now getting? In my assessment, it's (justified) fear of a sharper than projected man-made global slowdown; a fear monetary policy makers can't articulate very clearly in public because it would require them to spell out just how troublesome the policies of some of our elected key officials really are.

In the US, the Fed most likely worries about two things:

First, they must be worried about the prospect of a 2020-recession (as we, and others, have been forecasting for some time now.) The US expansion is approaching the longest in history and the labor market is as tight as ever, even if the pressure on wages remains somewhat subdued. One of our corporate clients with major operations in the US told me recently that for some time now, they simply have not been able to find additional qualified labor in the US (the vast majority of those turning up for potential hiring don't pass the mandatory drug test, he said!), and as demand has now begun to ease they dare not lay off people out of fear that they'll never find qualified workers again. As a result, profit margins are now being squeezed.

And the Fed must worry about Donald Trump and his deeply troublesome charlatan approach to trade (and other foreign) policies where photo opportunities rule over policy. The Fed knows, as we know, that trade restrictions and bilateralism are bad for growth. Indeed, Jay Powell has said, "Trade turning to greater uncertainty … [raising] concern about… [the] strength of [the] global economy". And they know that it's not just Trump! The US political swing states are heavily based on manufacturing and agriculture and – believe it or not – protectionism is popular in those states. And the Democrats know that too. As a result, as the US is turning into campaign mode (18 months ahead of the election!), the prospect for more trade infringements is rising – whatever positive short-term noise you may get from the "Trump TV Reality Show", including the latest episode at the G20 and the apparent truce between the US and China.

So, what will actually trigger the onset of recession at a time when interest rates are low and the Fed is easing? Tough to say, but a tightening of financial conditions would be my prime suspect. Hence, the Fed's increased focus on financial markets, and in particular the stock market. So far, it's been held up in the US by buybacks and M&A, funded by a huge increase in corporate indebtedness, but as profits start to struggle, the game will be increasingly difficult to sustain.  And a stronger dollar won't help them either…

So much for the Fed, but what drives Draghi's latest rhetoric – what worries Draghi? I suspect the following three things are top of his list:

First, I'm sure Draghi worries about the global outlook, and particularly about the global trade regime (read: Trump). It's hardly a coincidence that former Fed vice president Stan Fischer was speaking in Sintra – or that he ended his speech with his biggest fear, namely Trump being re-elected next year because, as he said, if that happens, "we may have to start thinking about the US as a third world country." Those are unbelievably strong words from a man of Fischer's caliber. But I think Draghi – like many of us – agree. (If still in doubt, watch the Trump family show at the G20, including the cringe video of Ivanka Trump trying to participate in a conversation between Macron, Trudeau, Theresa May and Christine Lagarde – kindly released by the Elysee.)

Second, Draghi almost certainly worries about the Fed and what their action might do to the dollar – and the euro. In Sintra, Draghi said that with negative rates, the FX has a stronger pass-through to inflation in the eurozone than in the US. Even though he reiterated during a panel discussion later at the Forum that the ECB is not targeting the FX, the message was clear: we don't want a stronger euro – and they took immediate notice in Washington where someone alerted Trump, who then sent (before 5am EST!) the first of his four tweets on Europe that day, whining about Draghi, Europe, and the Fed.

Third, determined to cushion Europe to the extent possible against these risks, Draghi has wanted to fertilize the land for his successor, so that the necessary policies (as they now seem likely to be needed) can be put in place post-Draghi without too much time wasted on preparing the ground. So, at the June ECB meeting Draghi pushed through an extension of forward guidance to now cover the next 12 months, and in Sintra, he adjusted down the threshold for further easing (i.e. it'll now be needed unless the economy improves from here), and he emphasized that the symmetric inflation target means that a period of undershooting needs to be followed by a period over overshooting (i.e. inflation level targeting in all but name.)

I also suspect that Draghi has been worried about the selection of his successor and the risk of not only insufficient policies, but of a reversal of his good work (not only my assessment; Draghi reportedly received a standing ovation by the political leaders at the European Council, which is quite something.) Hence, in Sintra, he noted in his discussion of the challenges having faced the ECB that "some even questioned the legality of asset purchases in Europe and their effectiveness in our bank-based economy." (No help with interpretation necessary…) Within hours, Mark Schieritz of Die Zeit had the scoop: Jens Weidmann had called from Sintra to clarify that he thinks asset purchases (and the OMT) are legal and recognizes that its part of the ECB's toolbox. But the damage of having opposed these key policies in such a public fashion,a nd without ever having spelled out the counterfactual, was irreparable. As I have discussed before, the political price for putting Weidmann into the ECB presidency was always going to be unacceptably high for Berlin.

**So how will it all play out?**

First, let me summarize in super-compressed format our central forecast, as discussed in much detail in my team's Chartbook and the CEE Quarterly, published this past week. As you'll see, we kept our growth forecasts broadly unchanged, i.e. a US slowdown from here, ending in a mild recession in mid-2020, followed by recovery. In the eurozone we expect average annual eurozone growth to hover around 1%, helped by healthy domestic demand and the Chinese stimulus.

But we have moved our expected first Fed cut forward to September, and added one more cut through the downturn for a total of four 25bp cuts. For the ECB, we now expect a 10bp rate cut also in September (with some mitigating measures for banks), and we assign a considerable probability to another round of QE around year-end. In the EU-part of the CEE region, we expect growth to drop slightly below potential growth (2.8%) next year, with the region's central banks remaining on hold. We expect Russia to be in recession already, followed by an only modest recovery. Turkey could exit recession later this year, assuming they ask for – and receive – financial support from the IMF. Otherwise, a deeper recession is a distinct possibility. For the full story and forecasts, our Economics Chartbook is here: Monetary easing in the pipeline and our CEE Quarterly is here: CEE Macro & Strategy Research: CEE Quarterly

Beyond this central forecast, let me highlight three key issues, which I suspect will dominate much of the picture during the next 6-12 months.

First, despite the Fed's best efforts, I strongly doubt that they'll be able to prevent the 2020 recession, but they might be able to cushion the blow somewhat. If you have convinced yourself (as I often hear people say) that the US will not go into recession in a presidential election year, then I'm pretty sure that you'll need to assume another measurable fiscal expansion. Needless to say, now that Democrats have a majority in the House of Representatives, this is not a trivial matter. But will it happen? I don't know, but if Trump is smart, he'll propose a tax cut for the poor and middle class – which might be difficult for Democrats to reject. We shall see.

Second, will another dose of ECB easing help the real economy? This is getting increasingly difficult to be convinced about because there already is so much cheap liquidity around. The financial sector is being killed because regulation prevents pension funds and insurance companies (which sit on a vast part of the savings surplus) from taking more risk, and banks are being squeezed by negative rates, a flat curve and mediocre growth already from a position where they haven't generated a competitive return on equity for years.

I hear, and appreciate, Draghi's commitment to "mitigating measures" for the banks if/when rates get cut again, but after so many years of negative rates and a flat curve, I think a more fundamental assessment of what policies (combined) do to the viability of banks is called for.

And don't just give me the "banks need to cut cost" answer… To be sure, further cuts may be needed, investments are needed in digitalization etc. etc, but banks in the periphery, in general, have already adjusted their cost base down substantially, yet, lending to the corporate sector continues to shrink in both Spain and Italy because the demand for loans is so weak. And, of course, in Germany, where banks have been protected by the state (explicitly and implicitly), the cost cutting hasn't started yet (although it's now reported that Deutsche Bank is contemplating a reduction in staff by thousands). Here lending to the corporate sector is growing in excess of 5% - and even more so in France, where corporates have been particularly good at taking advantage of the low funding costs to strengthen their balance sheets.

Third, and more broadly across the eurozone, it's not clear what firms will do with additional cheap (read: free) liquidity, and how it'll support growth. Like in France, you may buy back older and more expensive debt (and equity), or chase real estate and other real assets – or, lo and behold – you could buy gold and Bitcoin. Gold is up 14% since the beginning of May; Bitcoin has virtually doubled in price during the past two months (also helped by confusion about Libra.) I wish the buyers luck, but – you heard it from me – you'll lose out eventually because cryptocurrencies are "nothing". No underlying asset, no usefulness and no authority to back it up. And such "asset" appreciation won't have any positive effect on the overall economy.

So, here's my point: For the ECB's additional easing to have a positive impact on growth, the fiscal authorities need to get to work – to take advantage of their negative funding costs (or near-zero) to fund public sector investment projects (particularly in digitalization and climate related areas), to boost education and to cut taxes on labor for the young and working poor. That this is even a matter of discussion for our elected officials is mindbogglingly difficult for me to understand.

## 2. Politics: European leadership nominations, Brexit and Trump.

It's already late morning here at Caffe Nero and I'll spare you from a summary of what has been achieved (or not achieved) on the political front during these past two quarters, with one important exception in these days of Trump and Brexit and the threat to global trade:

This past week, the EU and South America completed the biggest-ever trade agreement between two regions of the world, covering EUR 88bn in traded goods and EUR 34bn in services, with an estimated savings (in tariffs) for European companies of close to EUR 4bn. In addition, it's reported that the trade agreement with Vietnam will be signed today. I hope Donald Trump takes notice – and the Brexiteers too. Since Trump was elected (and hence also since the UK voted for Brexit), the EU has signed trade agreements with Argentina, Brazil, Canada, Japan, Paraguay, Uruguay and Vietnam. I say no more.

For the next two quarters, I'll make the following three predictions for the global political sphere:

In terms of the European appointments to key leadership positions, I think the FT had the scoop on Friday: We'll get Dutch Social Democrat, and hugely experienced, Frans Timmermans as Commission president. German (CSU politician) as president of the Parliament, and French Governor Francois Villeroy de Galhau as ECB president. In addition, I suspect the Council presidency will go to a woman from CEE, most likely Lithuanian President Dalia Grybauskaite. If confirmed, my personal (and completely biased) opinion is that Europe will have done very well by putting in place four outstanding people for these key positions – even if the gender diversity is less than desirable. (Ultimately, the ever so capable female candidate for the Commission, Margrethe Vestager, suffered from being a national from the outer ring of European cooperation with a lukewarm – at best – endorsement from her own government, and as I have argued before, you won't get top positions as a half-hearted member.)

In Brexit-land … who knows. Incoming PM Boris Johnson is as unpredictable – and as obsessed with photo opportunities rather than policy – as Donald Trump. I'll give it 51% probability that the UK will leave the EU at the end of October, with de facto Theresa May's deal, including a transition period until the end of next year. If that doesn't happen, it'll be because Johnson can't sway a sufficient number of his party's MPs to change their mind and support that deal (despite the prospect of a surely devastating – for the Tories – early election) – leading thereby the UK into political abyss. It's still possible that a second referendum could emerge from the mess, but it's a low probability (and its outcome would be far from certain.)

In Trump-land, well, it'll be six more months of random tweets, probably increasingly focused on domestic issues and the Democrats as he turns his attention to the re-election campaign. But as growth eases and "America doesn't look so great" for a vast number of swing voters, Trump will be stepping up his attack on someone else to blame. Beyond foreign trading partners, I suspect Jay Powell and the Fed will be in for a good dose of absurd harassment.

And on that note, I wish you a continued good Sunday afternoon – and a great Q3.

Best

Erik

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