Sunday Wrap

Happy Sunday,

This is Daniel Vernazza, UniCredit's Chief International Economist. Erik is away this weekend and asked me to step in. But before I do, Erik asked me to flag that in last week's edition he mistakenly referred to Portugal's budget deficit as 3.0% of GDP last year, when in fact it was just 0.5%, which would have strengthened his key point that ECB critics are misguided in their obsession with fiscal positions in the euro area periphery.

Now to this morning and despite the wet weather here in London there are glimmers of sunshine when it comes to trade developments. President Trump announced Friday that the US and China have "come to a very substantial phase one deal" on trade talks. Treasury Secretary Steven Mnuchin said the planned tariff hike from 25% to 30% on USD 250bn of Chinese imports due to take effect this week will now not go ahead. And on Brexit, the UK and the EU are now in "intense" talks to reach a deal, and while it's unlikely to be plain sailing, it looks promising.

Trade tensions are unlikely to be resolved soon, but avoiding a further escalation will be welcomed by firms. Pervasive uncertainty related to trade tensions has seen global trade contract for the last three consecutive quarters, manufacturing in technical recession in many advanced economies, and business investment weak. The latter comes at a point in the cycle where business investment should be doing well: spare capacity has mostly closed, the cost of capital is low, and corporate profitability is still high.

This morning, I'll focus my thoughts on three issues:

- **The UK and EU seem to be heading for a Brexit deal, thanks to a remarkably large helping of "fudge";**
- **What does a Brexit deal mean for the big picture? It's good news short term, bad long term;**
- **The Fed's credibility is at stake as inflation expectations fall to historical lows.**

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1. What's happening with Brexit?

In the first half of this week it looked as though Brexit talks were close to collapsing. The main problem was customs on the Irish border: the UK insisted that Northern Ireland be inside the UK (not EU) customs territory, while Ireland would not accept customs checks along the border between Ireland and Northern Ireland.

But what a difference a day makes. On Thursday, UK Prime Minister Boris Johnson held talks with the Irish Taoiseach Leo Varadkar in Cheshire, England, and both agreed they could see a "pathway" to a Brexit deal by the end of the month. It was pivotal because, on the issue of Brexit, the EU is being guided by Ireland.

The EU and UK negotiating teams are currently in intensive talks towards a deal, with the aim for EU leaders to sign off on a deal at the 17-18 October European Council summit this coming week. One cannot exclude that it's another false dawn, but in my view the signs are promising that a deal is within reach.

The details of who conceded and what have been kept under wraps, a strong sign that the negotiating teams are close to a deal (leaks are typically designed to be trashed by the media and destabilise talks). On Friday, Boris Johnson was asked twice whether he could promise that Northern Ireland would leave the EU customs territory and refused to answer. Instead, he had this to say: "I can tell you that under no circumstances will we see anything that damages the ability of the whole of the United Kingdom to take full advantage of Brexit and that is what people would expect." Reading between the lines, and consistent with media reports, it looks like a deal would consist of the following:

Legally, Northern Ireland would remain part of the UK customs area, but in practice it would be part of the EU customs area. There would be both regulatory and customs checks in the Irish Sea (i.e. on goods moving to Northern Ireland from the rest of the UK), where customs documents would be checked, EU tariffs collected and physical checks carried out. Goods would pass freely between Northern Ireland and Ireland. In the event that the UK tariff was lower than the EU tariff, firms in Northern Ireland would be able to apply for a rebate (because they are legally part of the UK customs area) so they were not financially worse off.

To be sure, it is the ultimate "fudge" to conceal the reality.

It's worth taking a moment to consider why this is so. For goods travelling from Great Britain to Northern Ireland, the UK will collect EU tariffs in the Irish Sea at ports in Northern Ireland and rebate them to Northern Irish firms only if UK tariffs are lower than EU tariffs and firms can prove the goods did not leave Northern Ireland (and, hence, the UK customs territory). In theory, it means Northern Ireland would benefit from any free trade deals that the UK signs – a red line for Mr. Johnson and the DUP. The problem with this is twofold. First, the UK is unlikely to be able to prove that the goods did not leave Northern Ireland – the technology to do so currently doesn't exist, and even if it did the cost of the tracking and paperwork to do it may render it uneconomical. The EU will want proof if it is to prevent lower-tariffed goods from entering the EU and, hence, protect the EU single market – one of the EU's red lines. Second, even if there was a rebate, the costs of hold-up at the border to carry out the customs checks are real costs. Therefore, in effect it would leave Northern Ireland in the EU customs territory.

It begs the question, therefore, whether the Northern Irish DUP would accept this. The support of the DUP is seen as potentially pivotal in getting any deal approved by the UK Parliament. The DUP have 10 MPs in Westminster, and many of the hardline Conservative Eurosceptics who refused to back Theresa May's deal have said they would likely back any deal the DUP supports. The DUP do not want any checks in the Irish Sea so, on the face of it, the deal described above would be worse for the DUP than Theresa May's deal, which at least avoided customs checks in the Irish Sea by keeping the whole of the UK in a customs union with the EU. But my feeling is that the DUP will reluctantly go along with Mr. Johnson's deal, in public because Mr. Johnson will argue that Northern Ireland will remain in the UK customs territory, and in private because the DUP is in a weak position politically (the DUP prop up the minority Conservative government in Westminster, but the Conservatives have already lost their working majority even with DUP support, and elections are very likely just around the corner).

The Leader of the House of Commons, Jacob Rees-Mogg, prepared the ground in this morning's Sunday Telegraph, stating "In the final stages of the Brexit negotiation, compromise will inevitably be needed, something even the staunchest Leavers recognise albeit unwillingly – but as a Leaver Boris can be trusted". In other words, the deal has not really changed but Boris is not Theresa May, which may be enough to get it over the line.

A significant number of Labour MPs are also likely to back a deal. The "MPs for a deal" group of around 20 Labour MPs, led by Stephen Kinnock and Caroline Flint, recently wrote to Michel Barnier to say they would back a deal (most of them voted against Mrs. May's deal).

There's the small matter of overturning some UK legislation aimed at preventing a border between Northern Ireland and the rest of the UK – specifically amendments to the July 2018 Customs Act that rule out a border in the Irish Sea and prevent the UK from collecting tariffs on the EU's behalf. Ironically, these amendments were proposed by hardline pro-Brexit Conservative MPs opposed to Mrs. May's deal, many of whom are now in government essentially agreeing to something very similar to Mrs. May's deal – you couldn't make this up! But the law can be changed.

Assuming there's a deal, there will be a crunch vote in the UK parliament on Saturday, 19 October, for MPs to give their basic approval. The date is significant because 19 October is the date by which the UK Prime Minister is required under the Benn Act to request an extension of Article 50 if he has not received the consent of MPs for either a deal or no-deal.

Saturday is also likely to see a vote on triggering an early general election. Whatever happens, an early general election in either late November of early December is a near certainty. Assuming Boris delivers a Brexit deal, he seems on course to win a comfortable majority, although anything can happen during a five-week election campaign.

2. What does a Brexit deal mean for the big picture?

In the short term, a deal would clearly be good news. It would avoid the worst-case outcome of a no-deal Brexit, which would have both created economic chaos and made it more difficult to agree on a deal subsequently.

The degree of economic chaos of a no-deal Brexit is impossible to predict, but even with recent mitigating measures from the UK government (including issuing EORI numbers, new infrastructure at Dover-Calais, and simplified customs procedures), such an abrupt adjustment would likely hit UK GDP significantly and, to a lesser extent, EU GDP. The magnitude would depend in large part on how the EU decided to manage its side of the border, something which is outside the UK government's control. A no-deal Brexit would also make a subsequent deal (including any transition) harder to agree, both because a no-deal split would likely be acrimonious and because a future deal would be outside of Article 50 TEU and require the unanimous agreement of potentially all EU national and regional parliaments.

Instead, a deal would reduce the rolling uncertainty created by extensions to Article 50, which is significantly weighing on business investment in both the UK and the EU. The UK would enter a standstill transition period to end-2020, during which time the UK will be formally outside the EU but treated as if it were an EU member state (albeit with no voting rights).

But that’s where the good news ends.

Brexit-related uncertainty will not completely go away for many years. The withdrawal agreement only deals with the separation issues, it tells us nothing about the future relationship.

Assuming there’s a deal, a decision on whether to extend the transition agreement will come into sharper focus next year. There’s an option for a one- or two-year extension of the transition period by mutual consent of the UK and the EU, with the decision due to be made by the middle of next year, which will bring back uncertainty. As Mark Carney recently pointed out, every single trade deal signed in the last four years has a transition period of at least 18 months, and Brexit is a trade deal in reverse, which in many respects is a much harder adjustment for firms. Therefore, an extension of the transition period would be desirable. This is particularly so as an agreement on the future UK-EU relationship is highly unlikely to be concluded, ratified and implemented by end-2020. The EU-Canada free trade agreement took seven years.

The UK Department of Trade will be busy trying to sign continuity deals with many of the third countries that the EU has free trade deals with and that the UK currently benefits from. These include important trade agreements with Japan, Canada and Turkey, where engagement is still ongoing.

Meanwhile, the EU27 will remain by far the UK’s most important trading partner, and will be for many years to come. And they won’t be easy to deal with.

The vast majority of the UK economy, 80%, is services activity, and there will likely be very little coverage of services in a future UK-EU trade agreement. That was true for Mrs May’s deal and it will be even more true for Mr. Johnson’s since he is insisting that the fair playing field rules that Theresa May signed up to in order to get a UK-wide customs union with the EU are now removed from the withdrawal agreement.

On goods trade, Mr. Johnson’s (in effect) Northern Ireland-only backstop means that the rest of the UK will have a much looser future relationship with the EU than Theresa May’s deal had in mind. Mr. Johnson wants a free trade agreement (FTA), similar to EU-Canada, not the half-in-half-out proposal of Theresa May that would have effectively kept the UK in the single market for goods and a customs union. So, expect the political declaration to be re-written along Boris’ FTA lines.

Consequently, UK firms will face substantial regulatory barriers to trade with the EU (two sets of checks, and two sets of standards if UK regulations diverge from that of the EU) and UK exporters (excluding Northern Ireland) will face the EU customs code in full.

The UK government will argue that it can offset this by signing trade deals around the world, but the reality is that any deals will likely not come close to making up for the loss of being part of the EU single market and customs union, both in terms of the volume of UK trade covered and the depth of agreements. Any deal on services would require agreeing to a set of common standards and enforcement, just like in the EU – the interlocutors may change, but the fundamental issues and trade-offs will not.

Yes, the UK may be set free to deregulate and lower taxes, but UK politics has become more polarised, with the Conservatives scared of the far right and the Labour party shifting to the left. Boris Johnson may well be on course to win a comfortable majority at an early general election, but he won't be able to transition the UK economy into Singapore-on-Thames in five years, and what then? Labour wants more regulation, not less.

3. Fed credibility

After the Fed's September rate cut, the FOMC's median projection for the fed funds rate was for unchanged rates through to end-2020 and then for rates to rise in 2021. Only 7 of 17 FOMC members expected a further 25bp cut by the end of this year, and no-one saw any further cuts beyond that. In contrast, the market now expects the Fed to cut at the end of this month and in December, followed by further cuts next year.

On Friday, a key measure of US household long-term inflation expectations, produced by the University of Michigan, fell to 2.2% – the lowest reading since the series began in 1978. This was no mere aberration; the measure has been low and edging further down for a while. To be sure, the level per se is not particularly informative – average responses for inflation perceptions tend to be somewhat higher than published inflation data – but the level relative to the long-run average is and, at 2.2%, the level is now well below the 2001-2019 average of 2.8%.

Market-based measures of inflation compensation are also historically low.

Meanwhile, actual inflation is well below target with the PCE deflator at 1.4% yoy in August. The core PCE deflator – the Fed's preferred measure of underlying price pressure – is at 1.8% yoy. US core CPI rose a muted 0.1% mom in September.

What makes below-target actual and expected inflation more striking is that household spending in the US is robust. Hiring has eased but so far, it's been enough to apply further downward pressure on the unemployment rate (weekly initial jobless claims figures have remained very low). There is no spare capacity in the US economy. And with GDP growth of 3.1% in 1Q19 and 2.0% in 2Q19, the US economy is still growing above its potential rate (which we put at around 1.8%), fueled by the fiscal stimulus.

The assertion then is that the sensitivity of inflation to spare capacity appears to have fallen (a flatter Phillips Curve) and that several years of mostly below-target inflation are spilling over into inflation expectations.

The September FOMC minutes, published this past week, stated, "many participants cited the level of inflation or inflation expectations as justifying a reduction of 25 basis points in the federal funds rate at this meeting".

The outlook isn't favourable either. So far trade tensions and slower global growth have hit US business confidence and investment, while the US consumer has largely looked through the uncertainty and continued spending. Eventually these two will have to be reconciled. Typically, this would occur through a slowdown in hiring, a rise in unemployment, and slower wage growth, which would force the US consumer to rein in spending. The fading of the fillip from the fiscal stimulus will work to quicken this adjustment. Our long-held view is for the US economy to enter a mild recession next year. As aggregate demand slows towards – and then below – that of supply, demand-pull inflationary pressure will ease.

Even with a (temporary) truce in US-China trade tensions, the need to centre inflation and inflation expectations around the Fed's 2% objective will likely warrant further cuts. We expect the next Fed rate cut to come in December, but there's a strong argument for it to come sooner.

Finally, this past week the Fed announced it would resume purchases of short-dated US Treasury bonds in an attempt to prevent a repeat of the spike in money market rates that occurred in September. Something is not right among US banks since they are back on Fed life support now. The concentration of reserves in large banks and their unwillingness to lend it out, despite the potential to earn a higher interest rate, suggests a reluctance to lend. On Monday, the FT reported that Federal Reserve Bank of Boston President, Eric Rosengren, does not believe that bank supervision requirements are fully responsible.

And on that note, the rain has stopped and my family and I are off to lunch at our local pub.

Best wishes,

Daniel

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