Sunday Wrap

Happy Sunday from my favourite Kaffeerösterei here in Berlin's Mitte!

Last Sunday, I devoted a good deal of this note to the emerging recession in corporate earnings, arguing that we are very likely on our way towards a US recession in about a year's time. In turn, that will then drag European – and global – growth down as well, thereby calling for policy easing around the world.

I still believe that's the most likely outlook, although I need to highlight that a series of data released this past week did not rhyme particularly well with my central theme:

In the US, Q3 GDP growth surprised on the upside (1.9% annualised) and Friday's US jobs report for October was very strong indeed. It appears that Trump's massive December 2017 fiscal expansion (which is boosting the budget deficit by some 50%, to almost a cool trillion dollars), still has some legs.

Meanwhile, the rest of the world released numbers which were, on balance, marginally on the strong side of expectations. The Eurozone, France and Italy all surprised a bit on the upside relative to consensus (although less so relative to the UniCredit forecast, if I may say). For the record, with the Q3 release, the Eurozone clocked the longest continuous expansion since the start of the euro. The Chinese Caixin manufacturing PMI (which focuses on smaller, mostly private, businesses as opposed to the "official" NBS PMI, which surveys mostly state-owned enterprises) saw a small increase to its now highest level since December 2016.

That said, I'm far from the only one worrying about the outlook. This past week, the Fed cut rates, as expected, and while the message was one of a good pause now, that's an opinion they'll likely change next year, as they almost certainly will move their views closer to the forwards. North of the border, the Canadian central bank surprised markets with a message that a rate cut could be imminent because of trouble ahead in the US and the rest of the world – and the Bank of Japan followed suit with an equally dovish statement.

And then on to the talk of the town, namely Christine Lagarde's arrival at the ECB on Friday. She faces this precise dilemma: a most likely troublesome global – and European – economic outlook with her fellow central bankers around the world in easing mode. Yet, she is inheriting an already stretched ECB policy package and a very loud minority on her Governing Council, working their national press, all the way down to the tabloids, in a hope that they can persuade her to reverse policies.

Erik F. Nielsen
Global Head of CIB Research
Group Chief Economist
(UniCredit Bank, London)
+44 207 826-1765
erik.nielsen@unicredit.eu

Bloomberg: UCGR, UCFR
Internet: www.unicreditresearch.eu

So, today:

- I'll first discuss Lagarde's dilemma at the ECB, and reflect on how she may go about it.
- I'll then turn briefly back to the UK, where a general election – widely seen as a proxy referendum on Brexit – has been called for December 12. I see more trouble ahead.

1. Lagarde and the ECB: The struggle ahead…

As I'm sure you are aware, on Friday, Christine Lagarde took her seat as the new president of the ECB, thereby kicking off what's surely going to be a new leadership and communication style. But will she also lead the institution towards new policies? "Ça depend…", as they say in her native France.

To address this critical question, I'll first need to set the stage which will take the shape of one last farewell to Draghi:

Without a doubt, Mario Draghi has entered the history books not only as one of the greatest central bankers ever, but also as one of the most important personalities in the entire European project. This assessment does not mean that I agree with every detail of every policy that he advocated and delivered (e.g. I do not like negative rates), but he got the general direction right and delivered a series of aggressive policies during his tenure as he aggressively pursued the ECB's mandate. How could he have done anything else, even though they were policies made necessary largely because of the lack of – if not even opposing – fiscal policies. And when it really mattered, Draghi stepped in with unprecedented boldness (i.e. "whatever it takes").

As we all know, he did most of all this while facing ferocious opposition, so his leadership style has therefore been criticised by some. I disagree with this criticism. When did "leading from the front" (which is the only way I can describe Draghi's leadership style at the ECB) become the wrong thing to do? Is one of Europe's problems not exactly the tendency to wait for consensus before making decisions, thereby ending up with the lowest common denominator? Draghi broke with this tradition, thereby delivering growth enhancing policies (with risks), and at the critical moment in 2012, may have saved the euro.

The public seems to agree with this positive assessment. According to opinion polls, the support for the monetary union and the euro has been increasing for the past 6-7 years, and has now reached an all-time high of 76%, according to Eurobarometer on August 5. As I have written before, the most problematic aspect of Draghi's opposition is their failure to articulate in any detail how their envisaged counterfactual that they advocated for would have developed.

That all said, Draghi has handed over a monetary toolbox to Lagarde and the rest of the Governing Council in which the main compartment has been depleted of effective instruments, while the "previously politically locked" compartment (with tools like QE and negative rates, unlocked by Draghi) will lose some of its teeth within 12-18 months. What's then left is the increasingly nuclear stuff (e.g. equities or even a version of "Go Direct"), which remains solidly locked away by convention and political considerations.

And Draghi has handed over a policy stance which – along with regulations and still low growth (partly because of the lack of fiscal help) – has put the European financial sector on de facto life support, and therefore at risk.

So, here are the four scenarios Christine Lagarde faces as she settles in in her new office at the top of the EuroTower – in descending order of desirability:

First best, we get an early turn in the global business cycle (e.g. if Trump were to change his foreign policy approach), and that'll see European growth recover "by itself" back towards (and hopefully beyond) trend growth, while inflation moves gradually towards 2% – maybe even a bit higher. This feels like a very low probability within the next 12-18 months – but if it did, it would leave Lagarde and the ECB an easy way back towards a more normal monetary policy stance.

Second best, the Eurozone fiscal authorities, starting in Germany and the Netherlands but also including most other member states, see the light and deliver – soon - a sizable fiscal easing to stimulate domestic demand. My rough guess is that it'll need to be at least about 1% of GDP, and well targeted and timed, to have an effect before the existing QE run up against the ECB's (self-imposed) constraints, and also to leave room to move rates back towards zero (possibly first via an adjustment to the tiering). The probability of this scenario is probably as low as the first one, unfortunately, which I'll come back to.

Third best, in a scenario without an early turn in the global economy, and without the necessary fiscal determination, Lagarde forces open the door to the nuclear arsenal in the monetary toolbox and they begin to buy, e.g. senior bank bonds and/or equities – and/or (a very long shot) they even move towards putting money straight into circulation. Hopefully, this would happen only in coordination with the fiscal authorities, e.g. as laid out by Stan Fischer, Philipp Hildebrand et al. in their thought-provoking BlackRock paper "Go Direct", which I have discussed before. (Of course, before we get to that, an easier route would be a fiscal expansion proportionately across the Eurozone, "incidentally coinciding" with a new round of QE.)

The fourth and final scenario (the disaster scenario) is the "do nothing" outlook: no external economic recovery, no fiscal help, and monetary policy remaining unchanged, accepting its waning power. This would most likely see European growth grind to a halt, which along with negative rates and yields would starve the financial sector to a slow death. While on life support from the ECB (and the "political underwriting" in most countries), banks will eventually struggle in this scenario to attract the required capital from private markets (leading then to closure or nationalisation?), and insurance and pension funds (many of which pretending to be solvent because of an artificially high – administratively determined – discount factor) would presumably run into trouble unless politicians release them from presently legally binding future obligations.

Here is my hypothesis of Lagarde's game plan:

Her main objective is to help deliver Scenario Two above, but recognising the risk of being able to sway the governments to deliver a sufficient dose of fiscal easing, she has asked for a comprehensive policy review, which could – just could – be a way of telling the world that she'll be prepared to force that door in scenario three open, if needed.

But how does she persuade particularly Germany to ease the fiscal purse? From her IMF position she has advocated this for some years, but in spite of her close relationship with then finance minister Schäuble, he never once – as far as I know – even brought the idea of fiscal expansion and more public investment to any committee for evaluation.

Admittedly, I was nothing less than shocked when Lagarde refused to say that she would do (within the mandate) "whatever it takes" when asked at her European Parliamentary hearings, and – rubbing salt into my wounds – she even suggested that if it ever came to a need for that, it would reflect insufficient policies by governments. To me, that suggested a worrisome lack of understanding of the need for a central bank to stand ready as lender of last resort and/or an unrealistic trust in the forces for financial markets to "police politicians" (if in doubt about the absurdity of relying on markets for such a role, revisit the market reaction to Monti's massive policy adjustment in Italy in 2012 versus the reaction to the political melt-down in the UK since 2016 - think rates vs FX and the effect on growth!) Furthermore, at this past week's ECB event to hand over the leadership she seemed to pride herself of her refusal to state (even within the ECB's mandate) to do "whatever it takes" by volunteering that those three words had been said enough. (Note my parentheses in this paragraph: Draghi said that "within our mandate" we'll do whatever it takes. Why has this become controversial, and why will she not say it?)

In my opinion, Lagarde is playing with fire here, but it's probably part of a strategy to buy credibility with the Northern European hawks before unleashing a bigger front on their fiscal stance. Certainly, this past week, figuratively on her way from Washington to Frankfurt, she stopped by Paris and gave an interview with RTL Radio, in which she called – by name – on Germany and the Netherlands to put their fiscal surpluses to better use. And in an elegant defence of present ECB policies, she argued that people should be happier to have a job than a higher savings rate.

So that's where we stand when she flies into Berlin tomorrow, Monday, to deliver her first speech as ECB president. And what better occasion than this: the laudatory speech to honour Bundestag president, and former finance minister, Wolfgang Schäuble, as he receives the German magazine publishers' (VDZ) annual "Ehren-Victoria" award for his strong commitment to a united, democratic Europe and a stable democracy in Germany.

Of course, this event has been booked long before anyone knew that Lagarde would be heading to the ECB, but while her other many commitments from her IMF days for November were generally handed over to others after she learned about her ECB appointment, this one stayed – and for good reasons:

First, Schäuble surely deserves recognition for his life-long, and undisputed, commitment to Europe (although I don't agree with his apparent view of what it takes for the currency union to work). Second, what better occasion for Lagarde to address up front the centre of "political Germany", which has turned so hostile towards the ECB!

Let's see what she says tomorrow, but it feels as if she is putting down her markers – but whether they'll be effective is a whole other matter. Will she be prepared to show the finance ministers both the carrots and the sticks that she has at her disposal? - i.e. the promise of monetary policy normalisation versus the threat of going nuclear if they don't change their stance on fiscal policy. Does she have the ability and willingness to make the threat realistic, by swaying (or ignoring) the Bundesbank and the hard-core German media? This remains to be seen, but I have severe doubt, not least as CDU is now moving to the right to attract conservative voters.

The bad news is that it'll be a race against time. Certainly, it seems unrealistic to think the fiscal attitude here in Berlin will change until the labour market turns South in a measurable way, and that's almost certainly still at least 9-12 months away. You then add some months for decision making and implementation, let alone effect, and you'll pass Weidmann's "red line" of not raising the limits for sovereign purchases, without which the important QE component of the September package loses steam.

Which leads me to the policy review that's about to start at the ECB. In the US, the Fed's review is scheduled to be concluded next year, after more than a year's work. But Lagarde and the ECB don't have even a year. I suspect the entire ECB may have to cancel their vacations for the next 6-9 months and get to work…

Stay tuned – and while we wait I recommend Der Spiegel's International Edition's excellent portrait of Lagarde. It's here: Christine Lagarde Brings a New Style to the ECB

2. Brexit: A last chance, but don't bank on it.

So, through all the fog at Westminster, the UK Parliament ended up granting PM Johnson his wish of early elections, now to take place on December 12. This comes after the EU granted the UK a three-month Brexit extension to January 31, 2020, with the option to leave the EU sooner if the UK ratifies the Withdrawal Agreement before then.

The election is, of course, seen as a proxy referendum on Brexit, although within the severe constraints of many people's party loyalty (or at least adversity to vote for a different party) as well as the practical issues associated with translating a one-topic issue into a general election in the UK's first-past-the-post system.

The opinion polls (which are not necessarily good at capturing these issues) suggest that Boris Johnson will win a comfortable majority on December 12, in which case the next UK Parliament will ratify the deal and the UK would likely leave the EU in early 2020 – for symbolic reasons maybe on January 1.

Of course, as through this entire ordeal, the joker in the game, Nigel Farage, has popped up again with a threat to run candidates from his new Brexit Party in all constituencies, unless Johnson will negotiate a deal with him that – reportedly – will assure the UK leaves the EU within a few weeks, without a deal. But this is nothing more than Nigel Farage trying to milk the last bit of his 15 minutes of fame (which turned into a near eternity for many of us) before Brexit happens. In other words, a threat with no teeth. Not surprisingly, Boris Johnson has ruled out any deal with Farage.

That all said, as I have discussed before, the real story in all this is two-fold, namely the collapse in UK governance as society has split down the middle, and the beginning of a long period of uncertainty as the UK struggles to define its commercial relationships with Europe and the rest of the world. In my assessment, both issues will haunt the UK for at least the next 5-10 years.

Lionel Barber, the FT's editor, expresses the same sentiment very well in his piece in this weekend edition of the FT: "Whatever the final verdict on Boris Johnson's withdrawal deal, Brexit has been a sobering experience for British statecraft" – and he concludes that "Whatever the outcome [of the election], hard choices are unavoidable. And we have only reached the point of departure." The entire piece is highly recommended. It's here: The point of departure: Lionel Barber on Brexit and beyond

And on that note, I'll get out and enjoy this wonderful city which is gearing up to Saturday's 30th anniversary of the fall of the Berlin Wall. It'll be a great party – and hopefully a good reminder of what the entire European project, with or without the UK, is all about.

Best

Erik

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g) Zagrebačka banka d.d., Trg bana Josipa Jelačića 10, HR-10000 Zagreb, Croatia. Regulatory authority: Croatian Agency for Supervision of Financial Services, Franje Račkoga 6, 10000 Zagreb, Croatia

h) UniCredit Bank Czech Republic and Slovakia, Želetavská 1525/1, 140 92 Praga 4, Czech Republic. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praga 1, Czech Republic

i) ZAO UniCredit Bank Russia (UniCredit Russia), Prechistenskaya nab. 9, RF-119034 Moscow, Russia. Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia

j) UniCredit Bank Czech Republic and Slovakia, Slovakia Branch, Šancova 1/A, SK-813 33 Bratislava, Slovakia. Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic and subject to limited regulation by the National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia. Regulatory authority: National Bank of Slovakia, Imricha Karvaša 1, 813 25 Bratislava, Slovakia

k) UniCredit Bank Romania, Bucharest 1F Expozitiei Boulevard, 012101 Bucharest 1, Romania. Regulatory authority: National Bank of Romania, 25 Lipscani Street, 030031, 3rd District, Bucharest, Romania

l) UniCredit Bank AG New York Branch (UniCredit Bank, New York), 150 East 42nd Street, New York, NY 10017. Regulatory authority: "BaFin" – Bundesanstalt für Finanzdienstleistungsaufsicht, Marie-Curie-Str. 24-28, 60439 Frankfurt, Germany and New York State Department of Financial Services, One State Street, New York, NY 10004-1511

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UniCredit Research* — Macro Research


Erik F. Nielsen
Group Chief Economist
Global Head of CIB Research
+44 207 826-1765
erik.nielsen@unicredit.eu


Dr. Ingo Heimig
Head of Research Operations
& Regulatory Controls
+49 89 378-13952
ingo.heimig@unicredit.de

Head of Macro Research


Marco Valli
Head of Macro Research
Chief European Economist
+39 02 8862-0537
marco.valli@unicredit.eu

European Economics Research


Dr. Andreas Rees
Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de


Dr. Loredana Federico
Chief Italian Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu


Stefan Bruckbauer
Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at


Daniel Vernazza, Ph.D.
Chief International Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu


Tullia Bucco
Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu


Edoardo Campanella
Economist
+39 02 8862-0522
edoardo.campanella@unicredit.eu


Walter Pudschedl
Economist
+43 50505-41957
walter.pudschedl@unicreditgroup.at


Chiara Silvestre
Economist
chiara.silvestre@unicredit.eu


Dr. Thomas Strobel
Economist
+49 89 378-13013
thomas.strobel@unicredit.de

EEMEA Economics Research


Dan Bucşa
Chief CEE Economist
+44 207 826-7954
dan.bucsa@unicredit.eu


Gökçe Çelik
Senior CEE Economist
+44 207 826-6077
gokce.celik@unicredit.eu


Mauro Giorgio Marrano
Senior CEE Economist
+43 50505-82712
mauro.giorgiomarrano@unicredit.de


Florin Andrei, Ph.D.
Senior Economist, Romania
+40 21 200-1377
florin.andrei@unicredit.ro


Artem Arkhipov
Head, Macroeconomic Analysis
and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru


Hrvoje Dolenec
Chief Economist, Croatia
+385 1 6006-678
hrvoje.dolenec@unicreditgroup.zaba.hr


Dr. Ágnes Halász
Chief Economist, Head of Economics and
Strategic Analysis, Hungary
+36 1 301-1907
agnes.halasz@unicreditgroup.hu


Ľubomír Koršňák
Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk


Kristofor Pavlov
Chief Economist, Bulgaria
+359 2 923-2192
kristofor.pavlov@unicreditgroup.bg


Pavel Sobíšek
Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

UniCredit Research, Corporate & Investment Banking, UniCredit Bank AG, Am Eisbach 4, D-80538 Munich, globalresearch@unicredit.de
Bloomberg: UCCR, Internet: www.unicreditresearch.eu

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