Sunday Wrap

Happy Sunday from my favorite spot here in Mitte in Berlin,

I have escaped London this weekend; the idea of being there Friday night when the UK actually left the EU was just too much to contemplate – even though, of course, nothing actually changed. Yes, the UK lost all influence in Europe (but that sort of happened already after the referendum more than three years ago), and during the "standstill period" until the end of the year (oddly called the "transition period" – transition to something still undefined), the UK has agreed to follow all EU rules.

Yes, Boris Johnson got "Brexit done", as he promised during the election campaign, although this hasn't created any certainty, as he claimed. In contrast, all it has done is to initiate at least eleven months of immense uncertainty with respect to what trade and investment agreement the UK will be able to strike with the EU (and others.) And, make no mistake about it, the idea of being able to negotiate and agree a proper new trade agreement, and getting it ratified, in eleven months is nothing less than absurd, although that's what the UK government seems to want us to believe. Instead, we think they'll go for a bare-bones trade deal by the end of the year simply to avoid the imposition of tariff barriers, although that'll do little, if anything, in terms of non-tariff barriers.

And, if the newly draft UK legislation to end the agreement with the EU on fishing rights (an economically rather unimportant area, but politically hugely important) is anything to go by, the battle lines with the EU (and specifically with France) are being drawn as we speak. If this is a sign of the UK negotiation strategy this year, it won't be pretty.

I'll discuss the following three topics today:

- **The illusion of the UK as the most dynamic major economy in Europe, and hence the perceived loss to European productivity and growth prospects of Brexit.**
- **Our global outlook. Why we are different from consensus, and why we feel good about that.**
- **And, partly related, why we are more worried about the economic effects of the spreading of the coronavirus than many others seem to be.**

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1. The British illusion: Which are the innovative and dynamic economies in Europe?

If you inform yourself predominantly from the general business and economics media, you'll be forgiven for thinking that Brexit will remove from the EU its most dynamic and innovative major economy, thereby leading to a more stagnant European economy in the future.

Yet, the facts tell a more nuanced story. It's true that UK real GDP has grown the fastest of the five major European economies during the past 20 years of the euro, namely by an average of 1.9%, vs. 1.8% in Spain, 1.4% in Germany and France, and a dismal 0.4% in Italy.

However, in per capita GDP terms (which is what matters for value-creation in businesses, including total equity returns, and for living standards), average growth has been stronger in Germany during these past two decades, namely at 1.2%, compared with 1.1% in the UK, and ¾% in France and Spain – and basically zero in Italy.

Moreover, UK labor productivity (output per hour worked) is considerably lower than in not only Germany, but also lower than in France, the Netherlands, Scandinavia and several other European countries. And more broadly, TFP (Total Factor Productivity, which captures productivity also beyond labor and capital productivity, and which is usually equated with innovation) has come to a virtual standstill in the UK in recent years, while TFP has continued growth quite nicely in Germany and some of the other Western European countries.

And, maybe worthwhile noting, while German growth was accompanied these past ten years by a massive national savings surplus (the infamous current account surplus) of 7.4% of GDP, UK growth was fueled during this period by foreign borrowing (and other external financing as assets were sold), to the tune of 4% of GDP. Without a doubt, the German surplus is excessive, not least as the return on German foreign assets remains mediocre. But by the same token, the UK deficit has also been excessive, depleting the UK's net foreign asset position – and seeing virtually all the great UK brands (and a lot of prime London real estate) transferred to foreign owners - to an extent where even James Bond's beloved Aston Martin (already foreign owned) had to be rescued – again – this past week via the massive injection of capital by a Canadian.

So, is the UK deficit simply a product of this superior, innovative economy attracting all this foreign financing, thereby generating the 1.1% average per capita growth, as the general narrative has it? Or did, for example, an average budget deficit of 3.6% of GDP generate excessive domestic demand, which had to be financed by selling the crown jewels?

In addition to the productivity data mentioned above, the latest Bloomberg Innovation Index, published two weeks ago, suggests that there may be something to the latter interpretation. The index analyses dozens of criteria using several metrics, including research and development spending, concentration of high-tech public companies and their density, patent activity and manufacturing capabilities.

It places the UK only as the world's 18th most innovative economy, behind nine (all Western European) EU members, including Germany, France, the Netherlands, all of Scandinavia, as well as Switzerland. And behind the US and China. The article and index are here: Germany Breaks Korea's Six-Year Streak as Most Innovative Nation.

Indeed, the 2020 index ranks Germany as now the world's most innovative economy, pushing South Korea into second place for the first time in six years, followed by Singapore in third place (which, incidentally, makes me wonder about the pie-in-the-sky claim by some Brexiteers of turning the UK into "Singapore-on-Thames" – but of course, turning the UK into "Germany-on-Thames" might not have sounded as good in this absurd political fog called

Brexit). To be sure, Germany's impressive leadership position in terms of innovation does not take away the need for Germany to boost domestic demand to both award Germans more of the value-added they produce, thereby lowering the current account surplus to more reasonable levels, but it does tell a story of an impressive economy which probably will do just fine without "UK policy leadership" in the EU, so to speak.

My point is this: The UK has played a constructive role in the EU by pushing an agenda of a more market-based economy, including by being a key driver of the Single Market, but I'm skeptical that the UK injected quite the dynamism and commitment to , and therefore to productivity, into EU policymaking that seems to be the common wisdom. Or at least, they didn't apply it to the UK economy as much as most of the other Western European countries did. So, yes, it's very sad the UK has left, but I'm far from convinced that it'll have a negative impact on the direction of policies in Europe.

2. Our global outlook. Why we are different from consensus, and why we feel good about that.

As you hopefully know, we at UniCredit Research expect global growth to ease further this year – from 3% last year to about 2.7% - before then recovering again in 2021. This is well below, e.g., the IMF's forecast of 3.3% for this year, which seems to be close to consensus. The key difference is the outlook for the US, where we think the odds are for a measurable slowdown in the US to something around an NBER-defined recession in about a year. This means that we expect average US annual GDP growth of no more than 1.2% in 2020, vs. the IMF's 2.0%, and consensus' 1.9%. Needless to say, if we are right, there'll be a negative effect on growth around the world, including in Europe and in EM.

To be sure, we may be overly pessimistic in terms of the US slowdown, but I'm confident about the direction, as I have discussed on several earlier occasions. Indeed, in a year of such political and economic uncertainty, I find it stunning how little variety there is in the forecasting community with respect to US growth. The international institutions may have their reasons not to forecast recession in major economies (on their own data, they basically never predicts them), but even of the 26 forecasting houses submitting their US forecast to Consensus Forecast (we are not included for the US), the lowest forecast is 1.6%, and the highest is 2.6%. A gap of one percentage point for an annual forecast in January is in the very lowest range of what's normal.

And indeed, the uncertainties (and US misguided policies) are already taking their toll:

This past Thursday, the BEA said that US GDP likely grew by a seemingly robust 2.1% qoq annualized in the last quarter of 2019, but the underlying numbers were much weaker than the headline number suggests. As my colleague, our chief international economist, Daniel Vernazza, noted, consumer spending slowed to 1.8%, down from 3.2% in Q3. Net exports contributed a huge 1.5pp to GDP growth because of a whopping 8.7% decline in imports, while exports remained subdued at +1.4%. Yes, the large fall in imports in Q4 is probably temporary because of frontloading ahead of the 15% tariff on USD 110bn of Chinese imports which came into effect on September 1, and importers may have anticipated the phase-one deal (coming into effect mid-February) by holding off on imports in Q4. Meanwhile, business investment remained very weak, falling 1.5%, the third consecutive quarter of decline.

It all means that US growth is – and is likely to continue to be – highly dependent on personal consumption growth, and that's a questionable pillar as firms are facing a series of concerns, causing a very likely weakening in labor markets.

And on Friday, we learned that the eurozone expanded by just 0.1% qoq in Q4 (1.0% yoy), dragged down by France and Italy, while most other countries, including Spain, Belgium and Austria continued to expand pretty robustly. French GDP (-0.1% qoq) was, of course, hampered by strikes, and the Italian GDP (-0.3% qoq) dragged down by both domestic and external uncertainties, and by changes in inventories. For both France and Italy, and therefore also the euozone as a whole, one should expect some modest recovery early this year.

Yet, the ongoing heightened uncertainty around the world is unlikely to evaporate any time soon – and that'll continue to cause trouble for GDP growth.

In late January, pwc published its 23rd Annual Global CEO Survey – and it is not a pretty picture. As you may know, every year, pwc surveys more than 1500 CEOs around the world in 83 territories, and this year saw record pessimism among these global CEOs. 53% of the surveyed CEOs thought global economic growth will decline this year, while only 22% thought it'll improve, with the remaining expecting broadly unchanged global growth of around 3%.

And, importantly, CEOs in North America are the most worried, with a record 63% of the surveyed CEOs expecting slower global growth this year, and only 10% expecting better growth. And their key concern? The uncertainty imposed by the changing trade regime (Mr. Trump!), and – more pronounced in Europe (Ms. von der Leyen!) – concern about additional regulation. The survey is here: Navigating the rising tide of uncertainty

My point is this: The US economy is considerably more vulnerable than markets seem to appreciate, depending on really only one driver, namely private consumption. Investment is nowhere to be found, and exports look to remain weak. As the huge fiscal stimulus (having supported private consumption so far) is petering out, the one-legged US growth is likely to suffer. Furthermore, weaker labor markets will almost certainly weaken as companies' earnings move lower and worried CEOs hold off on business plans.

And then enter the new big unknown: The new coronavirus! This past week, the WHO declared it a global emergency, the first person-to-person transmission in the US, and the first death outside China, were confirmed – and American Airlines pilots' union sued to stop flights to and from China.

Which leads me to my third topic:

3. The new coronavirus: Lots of uncertainty – and the economics of fear.

In my team, we have been puzzled by the media's and investors' seemingly great reliance on the SARS epidemic in 2003 as a way of viewing the likely economic effects of the new coronavirus. The economic costs of SARS were modest and relatively short-lived, and predominantly focused on East Asia, so the conclusion of all this seems to be: Don't worry too much; markets will soon be back to recent strength.

But we are not convinced. While useful lessons can be drawn from the SARS experience, we risk being too complacent by using it as benchmark.

First, we still don't know much about the new virus, but compared to SARS it seems – so far - that while it spreads faster, the ratio of deaths to infected cases is lower. That said, at more than 300, there are already considerable more deaths from this new virus than there was from SARS at the comparable time after the discovery of SARS. In addition, we know the incubation period is rather long, and that people are infectious before showing any symptoms themselves. And, so far, it is spreading faster across China than SARS did, albeit current mathematical simulations by the WHO suggest that it is likely to remain a regional challenge.

Second, while SARS may provide an interesting parallel, China and the global economy are now much more integrated than in 2003. Chinese citizens travel the world almost six times more than they did in the early 2000s. And, structurally, the Chinese economy has changed considerably. Back then, China still expanded at a 10% annual pace and was on an upward trend growth (GDP growth peaked at 14.2% yoy in 2007), while at present Chinese growth is "only" 6%, and on a downward trajectory. Finally, the vast expansion in global value chains means that disruptions to production in China might have a larger global impact now than then, especially if multinationals shut down their Chinese factories for long periods.

Of course, there are also mitigating factors, including the increased use of online sales. And Beijing, as it did during the outbreak of SARS, might intervene to directly support the economy in two major ways: A further loosening of monetary policy, bringing forward some of the planned RRR cuts and/or injecting liquidity into the banking system through other credit facilities, and further fiscal policy expansion. A deliberate weakening of the CNY is not likely following the phase-one trade deal with the US.

That all said, if the outbreak does not dissipate soon, the authorities in both China and elsewhere are likely to extend travel bans, people will stay at home, and the increase in uncertainty will cause consumers to delay consumption and firms to defer investment.

In other words, we think it's way too early to dismiss this outbreak as just a brief interruption of constructive markets – as much as we wish it is.

My colleagues have already published a good deal on these issues, in case you are interested:

Edoardo Campanella and Daniel Vernazza from our Macro team published a piece this past week on the parallels, and lack of parallels, to SARS, as well as likely policy responses and effects: New Coronavirus: The SARS comparison is useful, but limited

My colleagues in our Strategy team published a piece in Macro & Markets on the likely impact on markets: Markets unnerved by new coronavirus

And Christian Aust in our Credit Research team published a piece on the impact on the most impacted sectors, namely the airline and travel industries: Airlines & Travel: Risks from new coronavirus

And on that note, I'll enjoy the rest of my Sunday here in lovely Mitte, before heading to Warsaw tomorrow, while waiting (sort of) for Iowa to kick off the US Democratic party's process of picking its candidate to challenge Donald Trump in November. I'll refrain from predictions for the primaries (what do I know beyond what we can all read in the polls?), but I note that none of the candidates, with the exception of Mike Bloomberg, seems to be a big supporter of free trade. That said, all of the candidates appear to be bigger believers in multilateralism than the sitting president. I'm sure this is a topic I'll be coming back to later in the year.

Best

Erik

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