Macroeconomic Outlook

Research Department

December 2019

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Macro

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December 2019

Quarterly Note

Research Department

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Based on information available up to 13 December 2019

Please read carefully the important disclosures at the end of this publication.

First signs of an upturn

Luca Mezzomo

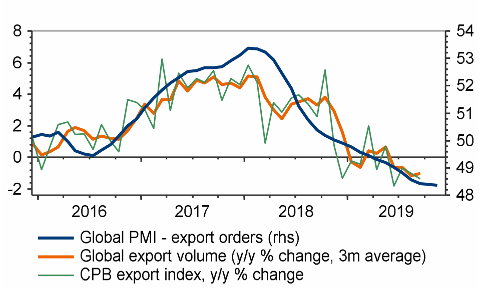
There are convincing signs that economic activity may reaccelerate in the first half of 2020. However, visibility on longer horizons is very limited and expectations for a further strengthening of the economy clash with the opposite trend we expect to prevail in the United States and in China.

At what point will the global slowdown which began in 2018 end? What is the risk of the contraction of manufacturing output in the advanced countries evolving into a global recession? The answers to these questions depend on an articulated set of factors: the inertia of current trends, the economic policy measures implemented by governments and the potential emergence of new, unexpected shocks (whether positive or negative).

Manufacturing output and global trade remain weak. However, short-term signals have improved

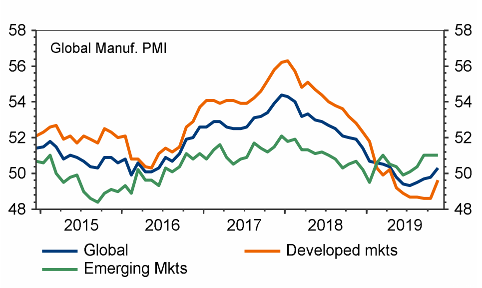
First of all, let's examine the current trends. Monthly surveys, including PMIs, have already outlined a significant rebound of the aggregate manufacturing index, back at levels consistent with positive monthly changes. The improvement, initially limited to the emerging countries, extended in November to advanced countries as well. Furthermore, the decline of the services index ended, enabling the composite PMI to rise back marginally from its trough. A signal that the downtrend may have bottomed out also came from the forward-looking index referred to China, probably in response to the economic policy stimulus measures put in place to counter the slowdown, a signal which typically preludes to a global recovery. The PMI sub-index which measures foreign orders is still on a downtrend and signals that the short-term trend of global trade is still weak, despite the stabilisation of the rate of contraction. World trade will probably only resume growing in the spring of 2020, when the calculation of the changes will no longer include the months in which flows adjusted to US trade tariff hikes. However, the outlook has improved thanks to the forthcoming ratification of USCMA, the provisional agreement reached by China and the United States and, lastly, by the prospect of an orderly exit of the United Kingdom from the EU.

Fig. 1 – Contraction of world trade extending into the end of 2019



Source: IHS Markit and CPB

Fig. 2 – Timid signs of a stabilisation of industrial output



Source: IHS Markit

Fiscal policy is supporting demand in both the advanced and emerging countries

The evolution of fiscal and monetary policies turned to the support of aggregate demand, albeit not decisively so. While the IMF's Fiscal Monitor did not outline a significant decline of the cycle-adjusted primary balance in 2020, the budgets drawn up by the European governments imply a greater loosening than estimated by the IMF and are consistent with a marginal easing in the advanced countries, from the -0.4% rate already observed in 2018 and in 2019. Furthermore, massive easing in the emerging countries in 2019 (-0.8% of potential GDP, according to the IMF) will support demand in 2020.

Central banks still accommodative, albeit with different amounts of leeway

Monetary policies remain generally accommodative: the Bank of Japan and the ECB are implementing explicit quantitative easing programmes, that are squeezing interest rates and risk premiums. In both cases, stimulus will continue throughout 2020; at the same time, the margin available to the two central banks to react to a deterioration of the situation seems very limited. The Federal Reserve is also injecting new reserves, although for more technical reasons, and only recently put on hold its downward action on policy rates. In this case, a poorer than expected evolution of the economy would probably prompt a new loosening of monetary policy.

Real GDP growth forecasts have not undergone significant revisions and are very close to average consensus levels in December

Overall, therefore, forward-looking indicators, monthly survey data and information on the trend of fiscal and monetary policies all support the prospect of a moderate but geographically widespread reacceleration of growth in the course of 2020, albeit not to the point of guaranteeing stronger average annual growth than in 2019. As the trend of GDP in the central months of 2019 did not significantly stray from expectations, GDP growth forecasts for 2020 have not been significantly revised in any of the major advanced countries, nor in China. However, important cuts forecast average annual growth were implemented in India (affected by a particularly weak third quarter of the year) and Latin America. For what concerns average consensus forecasts, there were virtually no changes compared to three months ago for the United States, Japan, the Eurozone, Canada and the United Kingdom; in this case as well, forecasts for Latin America, on the other hand, were revised down sharply, from 2.0% to 1.5%. At present, our growth forecasts do not differ significantly from the average consensus levels.

For what concerns the sustainability of this phase, it is hard to make forecasts. The extension of the expansionary phase, all other conditions being equal, increases the probability of a recession. Several advanced economies are already operating with very low unemployment levels, and we think average annual growth will keep slowing in the United States and China in 2020-21. In the euro area's case, we currently expect economic growth to accelerate in 2021, in line with the forecasts drawn up by the ECB, the European Commission and the IMF. However, there is close to no visibility on 2021 and a number of risk factors could materialise and result in dramatically different outcomes. Specifically, in addition to the usual imponderables tied to geopolitical risk:

1. The trade wars engaged by the United States seem to have been put on hold for the time being. The scenario which underlies our forecasts rules out a resumption of tariff hikes against China following the signing of the so-called "Phase1" agreement, and expects a deal to be signed with the EU preventing the introduction of higher trade barriers. However, there are no certainties on this front (see box below).
2. If the United Kingdom effectively leaves the EU on 31 January, the two sides will have until 31 December to negotiate an agreement governing future permanent relations: probably not enough time, considering the complexity of the process. Therefore, the risk lingers of trade barriers between the EU and the United Kingdom growing in 2021 in much the same way as they would have in the event of a hard Brexit. Our base-case scenario does not consider this outcome, prevented either by a ratification of the agreement in time (which seems unlikely), or by an extension of the transition period to allow negotiations on future relations to be completed.

Update on US trade wars

In December, **the United States and China reached a "Phase 1" trade agreement.** US Trade Representative Lighthizer said that the agreement will probably be signed by himself and Chinese Vice Premier Liu He at the beginning of January, and come into force 30 days later. Both sides have signalled that negotiations will continue, on the aspects not included in Phase 1, but did not provide clear indications on the timing of Phase 2 talks. Trump has said that the negotiations will be delayed until after the presidential elections, whereas China seems set on taking up talks again more rapidly.

The main points of the Phase 1 agreement, based on the details made available to date, are as follows:

- The United States will not proceed with the tariff hikes scheduled to come into force on 15 December and involving 156 billion dollars of products imported from China (mostly consumer goods); furthermore, the tariffs introduced at the beginning of September on around 120 billion dollars' worth of imports will be halved, from 15% to 7.5%.

- China will step up its purchases of US agricultural products by 32 billion dollars in the next two years. According to Trade Representative Lighthizer, China's total purchases of US agricultural products should thus reach 40 billion dollars, with the aim of subsequently increasing them to 50 billion per year. Lighthizer explained that these purchases would be part of a broader framework aimed at increasing total US exports to China by 200 billion in two years.

The lack of a detailed text of the agreement leaves many questions unanswered, strengthened by the discrepancies between communications from the two sides. First of all, we believe the total worth of the purchases of agricultural products indicated by US sources will be hard to achieve, as it would amount to around twice the agricultural produce purchases in the period prior to the trade war. Furthermore, China is still set on refusing to sign agreements in violation of WTO rules, and there is considerable haziness on this front. According to Lighthizer, China has made commitments on other important fronts (protection of intellectual property, technology transfers). On the Chinese side, the vice minister of trade has said that the US have agreed to reduce existing tariffs in subsequent phases, whereas the US trade representative denied the existence of commitments in this direction.

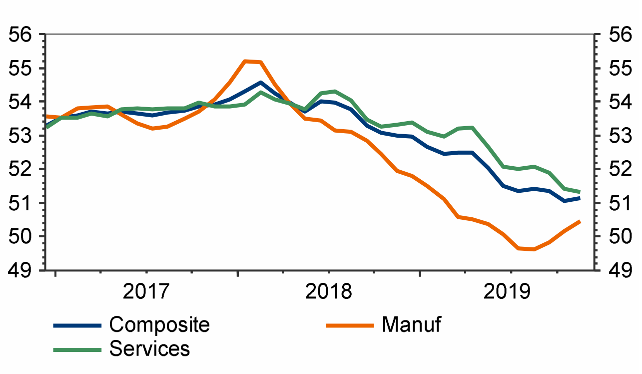
The agreement would not only put on hold the trade war between the two countries in the pre-electoral period, but would also result in lower trade barriers than previously expected in **2020**. However, the lack of details, the different versions provided by the two sides on the state of negotiations, and the need for a Phase 2 agreement, highlight **the fragility of the current truce.** In terms on the effects on the economic scenario in 2020, the easing of short-term uncertainty is surely a pro. Doubts linger on the agreement's implications on business investment, as negotiations with China on the more controversial points will be frozen, with no visibility on general trade policy guidelines. **Any positive effects on growth will be limited lingering uncertainty beyond the near-term.**

In this perspective, the agreement between Congress and the Administration on the **USMCA** (the new NAFTA), reached in the past few days, is different and may, by contrast provide positive indications on the investment decisions of businesses, as it concludes the negotiation process with Canada and Mexico and clarifies the regulatory framework that will govern import-export trade in the North American continent. The changes to the deal were approved by the three governments (albeit with some uncertainties on the Mexican side) and the treaty is now ready for parliamentary ratification.

For what concerns relations with the **European Union,** the United States let the mid-November deadline expire without making any decision on car and component imports. The current dispute (with particular focus on subsidies to the aviation industry) has resulted in reprisal measures affecting around 2% of overall import-export trade. Negotiations are still under way. Average tariff barriers are low (3%), but there are non-tariff barriers the United States in particular would want to lower, in addition to higher tariffs on some categories of goods that the US negotiators are set on reducing (for further details, see the USTR briefing). The aim to reduced trade barriers is also shared in principle by the European Union, which gave the European Commission a mandate in this direction in April 2019. An important point in the evolution of US trade policy is the determination to keep Trump's promise of **abolish trade policy multilateralism, making all negotiations bilateral.** This was made evident by the recent sabotaging of WTO activity with the US veto against the appointment of new WTO Appellate Body judges upon expiration of the mandate of the existing ones at the beginning of December: as the mandates of two out of three judges still in force have expired, the WTO is to all effects no longer in condition to resolve trade disputes. At least three judges are required in order to issue rulings on the cases brought by member countries: at present, with only one judge left in force, there seems to be very little chance of the WTO, now totally derived of power, resuming its activity. Trump has revolutionised global trade policy, generating a structural increase in uncertainty with the definitive overcoming of the WTO.

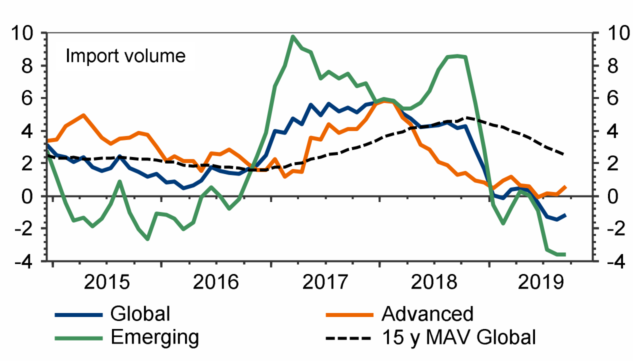
The global economic trends in 10 charts

Fig. A – Global PMIs



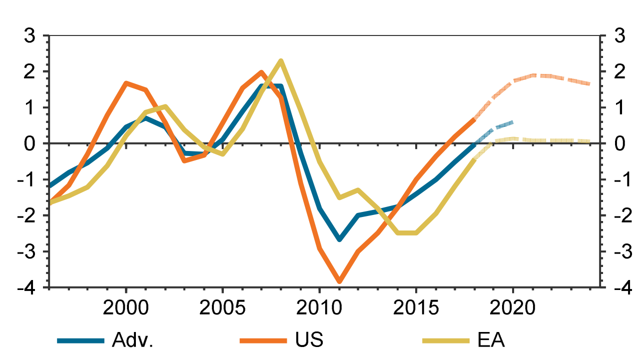
Source: Markit Economics, Refinitiv Datastream Charting

Fig. B – World trade volume (imports), y/y % change



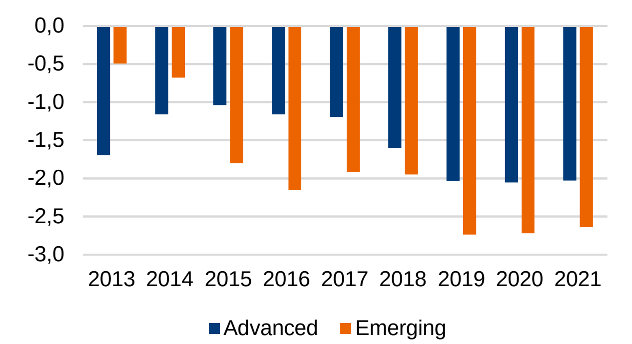
Source: CPB World Trade Monitor, Refinitiv-Datastream Charting

Fig. C – Output gap (IMF estimate)



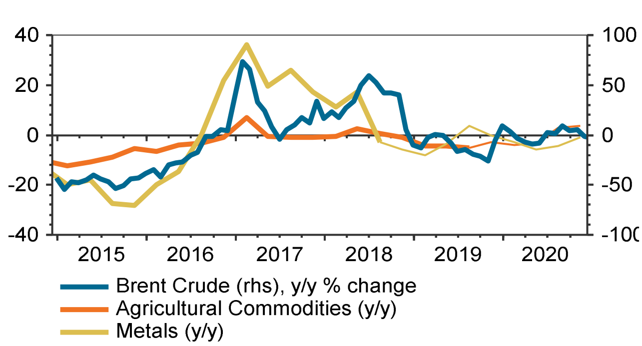
Source: IMF

Fig. D – Government sector, primary balance, % of GDP



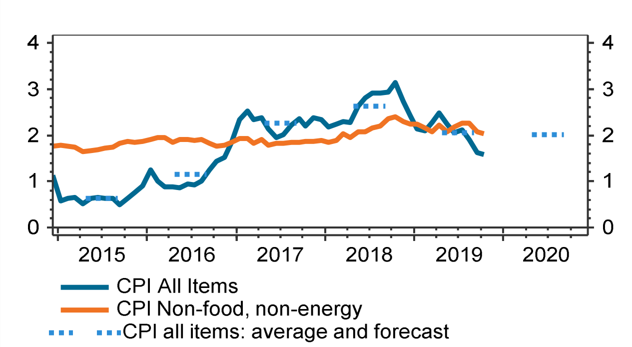
Note: % of GDP. Source: IMF, Fiscal Monitor, October 2019

Fig. E – Raw materials, price indexed, y/y % change



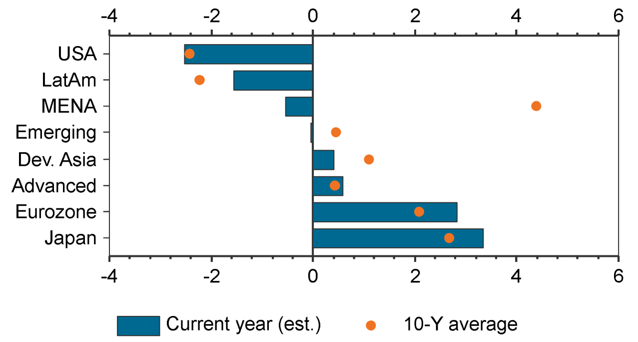
Source: Refinitiv Datastream

Fig. F – OECD consumer price indexes



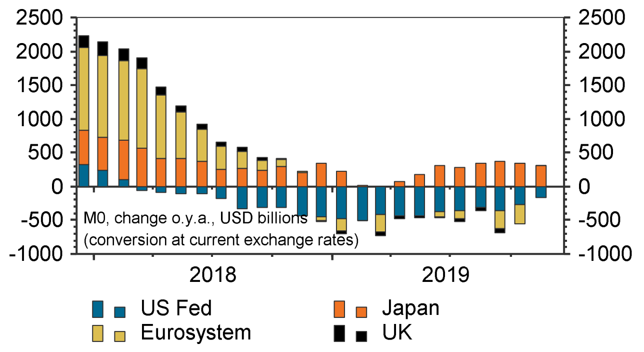
Source: OECD, Oxford Economics

Fig. G – Balance of payments, current account, % of GDP



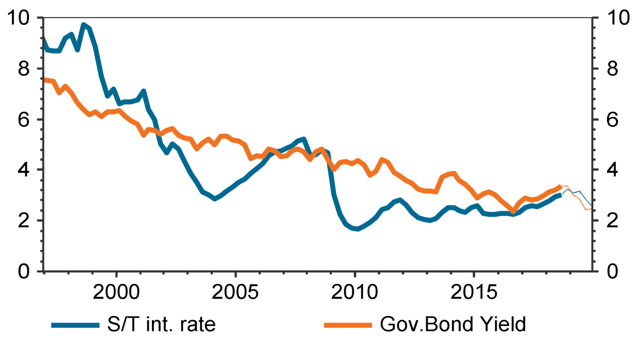
Source: Intesa Sanpaolo

Fig. H – Money base (change, USD billions)



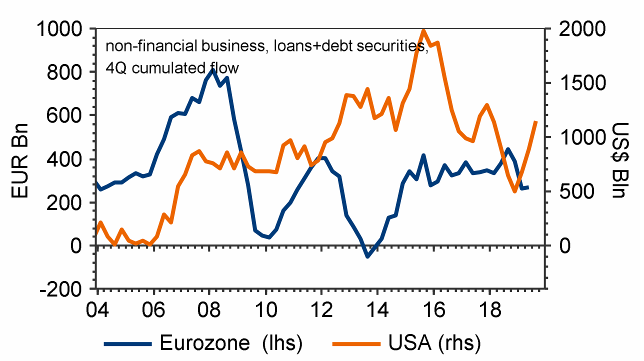
Source: Refinitiv-Datastream Charting, centaral banks and Intesa Sanpaolo estimates

Fig. I – Interest rates, world average



Note: weighted average of 44 countries. Source: Refinitiv-Datastream Charting e Oxford Economics

Fig. J – Credit to nonfinancial companies



Source: Refinitiv-Datastream Charting, ECB (integrated sector accounts), Federal Reserve (Flow of Funds)

GDP growth (y/y % change)

	2018	2019f	2020f	2021f	2022f
United States	2.9	2.3	1.8	1.7	1.8
Japan	0.3	1.0	0.3	0.8	0.8
Euro area	1.9	1.2	0.9	1.3	1.2
Eastern Europe	3.4	2.8	2.5	2.4	2.3
Latin America	0.5	0.0	1.3	2.4	2.8
OPEC	0.5	-1.5	1.3	2.8	3.0
East Asia (excl. Japan)	6.6	6.2	5.8	5.7	5.8
Africa	7.4	5.0	6.2	6.9	6.6
World	3.6	2.8	2.5	2.8	2.9

Source: Intesa Sanpaolo

United States: quo vadis?

Giovanna Mossetti

The **US outlook is for moderate growth (1.8% in 2020, 1.7% in 2021), slowing towards potential**. The survival of the recovery will depend on sustained domestic demand, particularly consumption, while investments are likely to remain weak in the face of domestic and international political uncertainty. The mid-year manufacturing recession appears to have stabilised on the back of signs of an end of the global slowdown (Asia and Europe) and of a ceasefire in the tariff war with China.

Although the overall US picture is fairly calm and encouraging, we believe **there are downside risks to the 2020 outlook**, and they are of two types. The first, which are **exogenous to the cycle** and linked to uncertainty surrounding domestic policy (a divided Congress and now the impeachment process) and trade policy (a possible flare-up in the tariff war, as well as persistent uncertainty) have been seen in the last two years. The **second, however, are internal and depend directly on the ageing of the cycle**. For now, it remains true that "business cycles have not been repealed" (Alan Greenspan): without new external stimuli, demand is set to slow, in line with the supply constraints typical of the current "mature" phase, the job market will head towards a turning point, and the cycle will weaken further. Higher inflation, a typical feature of the final phases of the cycle, does not look likely in this recovery.

With the balance of exogenous risks skewed to the downside, the downward trend in growth due to the maturing cycle could accelerate. This is why **we maintain a bias for new monetary stimulus towards end-2020**, on the assumption that the Fed is ready to take again pre-emptive action if the outlook were to weaken due to exogenous and/or endogenous factors.

The outlook for the US appears to have stabilised, with lower risks of the weakness in manufacturing spreading to the rest of the economy. The Fed's response to the slowdown and reduced risks on the tariff front have helped limit the difficulties in manufacturing to a mid-cycle adjustment. Assuming that the tariff ceasefire holds, despite the continuing difficulty in communications between the US and China, the outlook for the US cycle is of **stabilisation at a rate of growth around potential (1.8% in 2020 and 1.7% in 2021)**, still driven primarily by consumption.

The performance of the **job market will be crucial in this mature phase of the cycle**. Average monthly growth in the number of people in work slowed from 223k in 2018 to 183k in 2019 and is expected to fall even further in 2020 to 110k-120k, levels consistent with GDP growth around potential. In terms of employment demand, after peaking at end-2018, the number of available jobs is falling. On the supply side, there is little room for further increases in the cyclical component of participation in the labour force. The unemployment rate is expected to be unchanged at 3.5% at the end of 2020, with an average monthly increase of 105,000 and participation at current levels (see the Atlanta Fed's Jobs Calculator). The forecast is for a gradual slowdown in wages growth and the resulting moderate slowdown in consumer spending growth towards a quarterly average of around 2%, something that is also hinted at by the correction on the confidence indices. Barring any unexpected shocks, however, consumer spending should still be the driving force behind growth (fig. 2). The high rate of savings and record levels of the net wealth/disposable income ratio should protect household spending from negative shocks; however, this does not alter expectations of a **downward trend in the next two years, dropping from 2.6% in 2019 to 2.4% in 2020 and 2% in 2021**.

The **manufacturing sector in 2019** was the primary risk factor for the survival of the cycle. With the reduced risks of a trade war (thanks to the ceasefire on tariffs with China and the silence on auto tariffs), more stable global demand and the Fed stimulus, the autumn surveys and early figures point to a **stabilisation of activity**, with a temporary recovery in growth expected in the first half of 2020, driven by the automotive and aeronautics industries. The autumn data released after the strike at General Motors, are mixed and point towards a modest improvement for **non-residential fixed investment** in the fourth quarter, but **persistent weakness** in 2020 (0.9%, with forecasts of a modest upturn in 2021 to 2%) owing to risks of a possible flare-up in the tariff war, an only marginal recovery in global growth and pre-election uncertainty. Uncertainty about fiscal policy after 2020 (e.g. In the event that E. Warren is nominated as the Democratic candidate) is expected to further curb investment decisions. **Residential investment** continues to be supported by falling mortgage rates (1.7% and 1.8% in 2020 and 2021 respectively). **Foreign trade**, which has made a negative contribution to growth since 2014, is expected to act as only a marginal brake in 2020 (-0.1 percentage points), not only because of the (expected) ceasefire in the tariff war but mainly because of the narrowing of the gap between growth in the US and the rest of the world.

The factors that should be monitored to confirm this scenario are **manufacturing activity**, a channel that transmits potential global weakness, **trade policy** and **domestic policies**. As regards the impeachment, the House is expected to vote on the articles of impeachment by the end of the year, while the central scenario remains a Senate vote in favour of President Trump, unless polls of Republican voters turn around in coming months. We believe there **are downside risks to growth**, firstly because of the ageing of the cycle, which weakens the employment trend, and secondly because of a combination of potentially negative political factors (trade war, impeachment) and global factors (international growth). Moreover, there are particularly high levels of pre-electoral uncertainty, with very little visibility on the platforms of the two parties' future candidates. For these reasons, the maturity of the cycle and a possible escalation of domestic/foreign political conflict leaves the outlook open to a further slowdown in 2020H2.

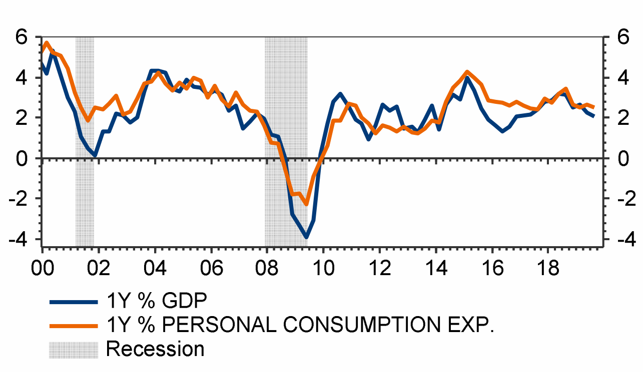
The **FOMC is now in "pause mode, but is committed to step in with new stimulus in the event of "material" changes to the economic picture**. Despite the improvement in the autumn data, in the absence of external stimuli, growth is slowing down with inflation steadily below or around 2%. With interest rates close to the zero lower bound, the Fed is expected to maintain a "pre-emptive" attitude. The projection of steady rates signaled in December pushes out any future rate hike. Moreover, the indication that a rate hike would require inflation "persistently" above 2% is at odds with the FOMC's projections of rates moving up in 2021. We still forecast that the next move will be down, not up. In the meantime, the Fed may announce a new securities purchase program, not strictly QE, in response to the excess demand for reserves shown by the strains on liquidity.

Forecast Table

	2018	2019f	2020f	2019				2020f				2021f	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	2.9	2.3	1.8	2.7	2.3	2.1	2.2	1.8	1.8	1.7	1.7	1.7	1.7
q/q annual rate				3.1	2.0	2.1	1.5	1.7	1.8	1.7	1.7	1.8	1.6
Private consumption	3.0	2.6	2.4	1.1	4.6	2.9	2.2	2.1	2.0	2.2	2.1	2.0	1.9
Fixed investment - nonresid.	6.4	2.2	0.9	4.4	-1.0	-3.0	1.5	1.1	1.8	2.3	2.2	1.7	2.0
Fixed investment - residential	-1.5	-1.6	1.7	-1.0	-3.0	5.1	3.5	0.8	1.2	1.0	1.0	2.0	2.3
Government consumption	1.7	2.4	1.6	2.9	4.8	2.0	2.6	1.1	1.4	0.3	0.5	0.6	0.6
Export	3.0	-0.1	1.1	4.1	-5.7	0.7	0.9	2.2	1.7	1.8	2.2	2.4	2.6
Import	4.4	1.4	1.3	-1.5	0.0	1.2	-1.2	2.1	2.1	2.3	2.4	2.6	2.8
Stockbuilding (% contrib. to GDP)	0.1	0.2	-0.1	0.5	-1.0	0.0	-0.1	0.0	0.0	-0.1	0.0	0.1	0.0
Current account (% of GDP)	-2.4	-2.4	-2.5										
Government Balance (% of GDP)	-6.6	-6.9	-6.5										
Government Debt (% of GDP)	136.7	135.5	137.4										
CPI (y/y)	2.4	1.8	2.0	1.6	1.8	1.8	2.0	2.1	1.7	2.0	2.0	2.1	2.0
Industrial production (y/y)	3.9	0.7	-0.3	-0.5	-0.6	0.4	-0.8	0.0	0.1	0.2	0.4	0.5	0.5
Unemployment (%)	3.9	3.7	3.5	3.9	3.6	3.6	3.6	3.6	3.5	3.5	3.6	3.6	3.6
Fed Funds	1.9	2.3	1.7	2.5	2.5	2.3	1.8	1.8	1.8	1.8	1.6	1.5	1.5
Effective exch.rate (1973=100)													

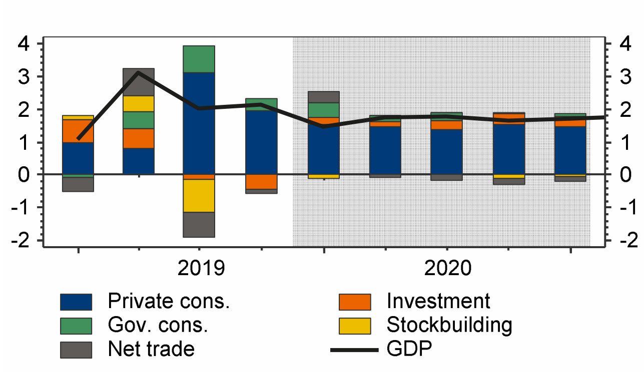
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Refinitiv-Datastream, Intesa Sanpaolo

Fig. 1 – As the cycle matures, growth slows…



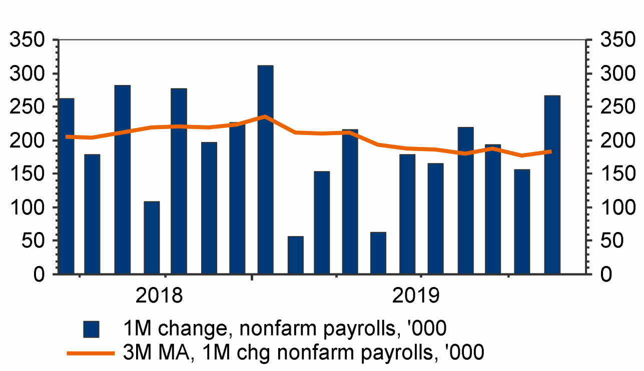
Source: Refinitiv Datastream

Fig. 2 – …and will continue to be supported by consumer spending



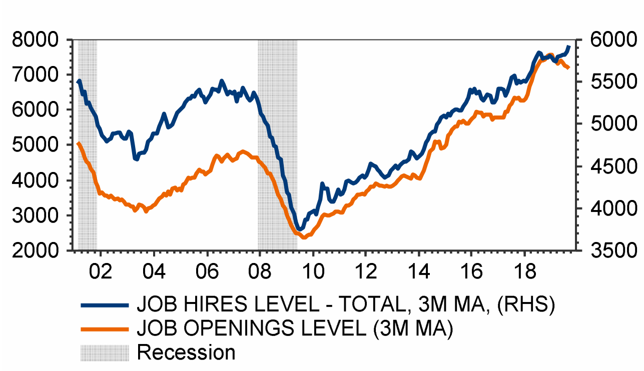
Source: Refinitiv Datastream

Fig. 3 – Payroll growth slowing moderately, beyond the effects of the GM strike



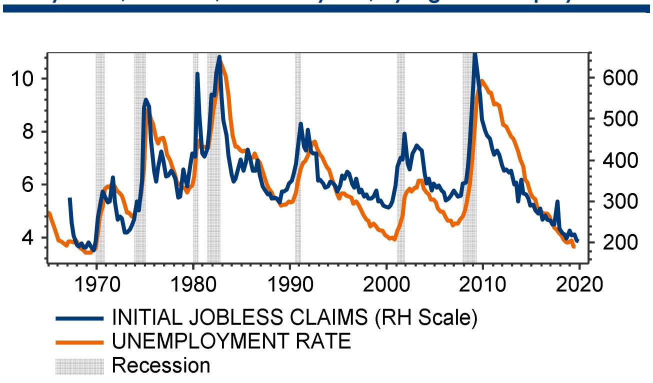
Source: Refinitiv Datastream

Fig. 4 – Job openings reversed at end-2018



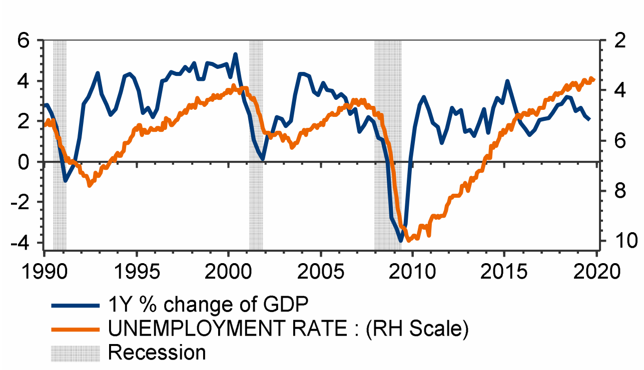
Source: Refinitiv Datastream

Fig. 5 – With an 11-year old recovery, look forward (and back): after new jobless claims stabilise, the unemployment rate has always risen, followed, after two years, by higher unemployment



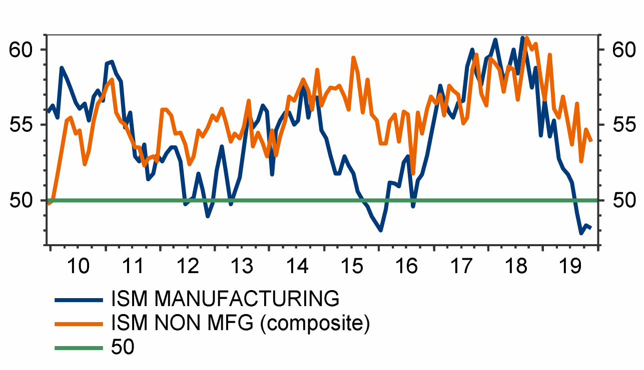
Source: Refinitiv Datastream

Fig. 6 – The reversal in the unemployment rate is also preceded by a reversal in GDP



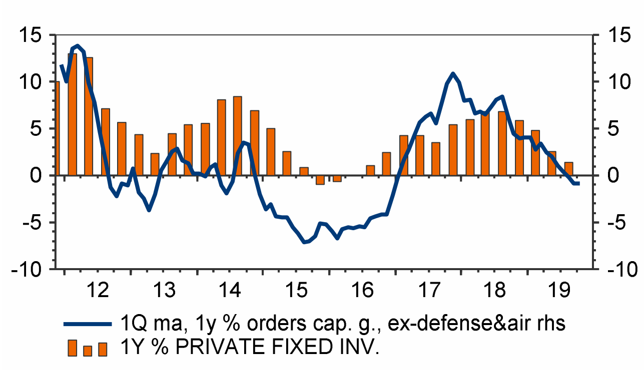
Source: Refinitiv Datastream

Fig. 7 – ISM surveys: stabilisation in line with moderating growth



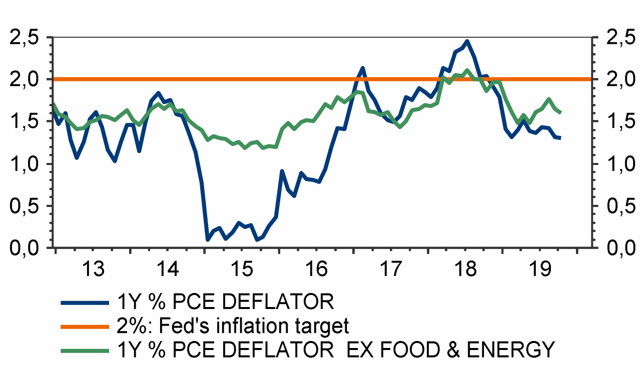
Source: Refinitiv Datastream

Fig. 8 – Corporate fixed investment still the weakest link in the cycle



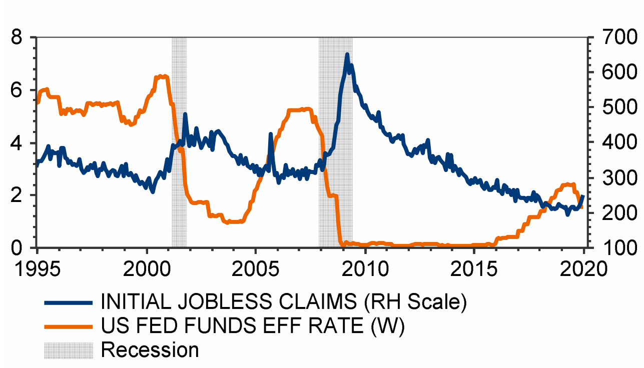
Source: Refinitiv Datastream

Fig. 9 – The "symmetrical" inflation target is still a mirage



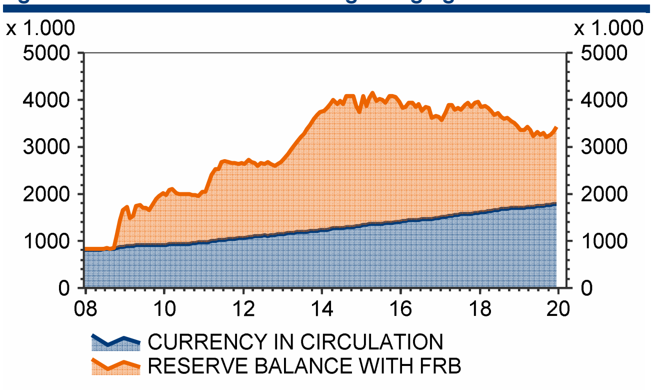
Source: Refinitiv Datastream

Fig. 10 – History suggests that the next move after the rate pause will likely be another cut



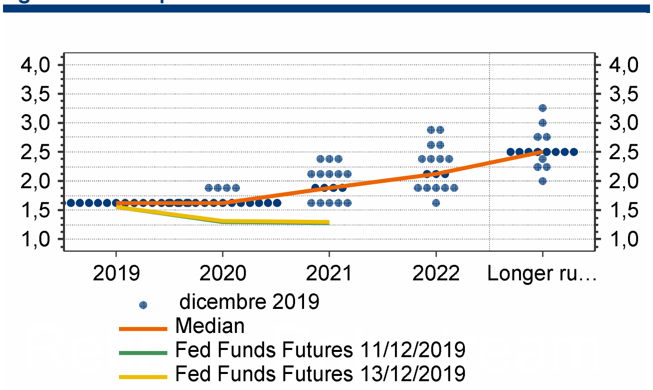
Source: Refinitiv Datastream

Fig. 11 – The Fed's balance sheet is growing again



Source: Refinitiv Datastream

Fig. 12 – Rate expectations of Fed and market continue to differ



Source: Refinitiv Datastream

Euro Area: a moderate rebound after a moderate slowdown

Luca Mezzomo

Our forecasts for the Euro zone are broadly unchanged from September, with real growth likely to accelerate moderately in 1H20 and inflation virtually stable. The European Central Bank (ECB) will probably leave monetary policy unchanged, limiting itself to implementing the measures already announced and completing its planned strategic review.

The trend in economic data over the last few months has been fairly consistent with the scenario envisaged three months ago: ongoing weakness in 2H19, with the possibility of a moderate recovery only from 2020H1, no inflationary pressures, the ECB waiting to see the impact of its expansionary measures, and looser fiscal policy, but not so loose that it radically changes growth prospects. We have made some very minor adjustments to our forecasts for 2020. The downside risks are less pronounced than might have been feared a few months ago. However, very high uncertainty still clouds the outlook beyond 2020.

Recession avoided, but growth not yet rebounding

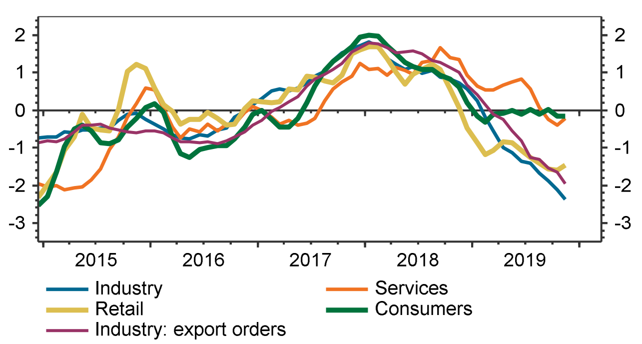
Although the economy remains weak, there are well-founded prospects of an upturn in 2020

The European economy remains gripped by the contraction in manufacturing output that began in 2018, whose effects on GDP have so far been mitigated by the service sector's resilience. Economic surveys are not yet showing a rapid return to industrial growth: the level of the manufacturing PMI is consistent with a stable contraction yoy (see Fig. 2), and confidence continues to decline. In the meantime, construction's contribution to GDP growth will remain modest. The sector's output is slowing, with growth dynamics in France and Spain particularly negative, while building permit data are stable (Fig. 3). Quarterly GDP growth will remain positive thanks to the contribution from the service sector, and the signals of a slowdown from economic surveys are still moderate. We estimate the probability of a short-term recession at 20%, which is lower than three months ago. Our leading growth indicator is signalling a moderate rebound in 2020, with a trough in Q1. However, the qoq increases will be too low to ensure that average yoy growth is higher than in 2019.

On the demand side, the European economy is avoiding a lapse into recession thanks to various support factors. Firstly, consumption is receiving support from employment growth (still positive, although slowing slightly), rising real wages and, lastly, moderately expansionary fiscal policies. In some countries, such as the Netherlands and Germany, the loosening in fiscal policies has been extended to public sector fixed investment. Nevertheless, these two countries are not fully exploiting their room for manoeuvre: convergence to the medium-term objective would free up resources to the tune of 1.2% and 0.7% of GDP in Germany and the Netherlands, respectively. Conversely, the European Union is allowing other countries (France, Belgium, Italy, Spain) not to implement the tightening that the fiscal framework would impose. Overall, the fiscal stimulus is expected to be 0.3% of GDP in 2020. Regarding employment, lower growth is also translating into a lower increase in the absorption of labour. We are therefore coming to a critical juncture when further economic slowdowns could also halt the thus far positive employment dynamics, increasing the risk of recession. But this is not the core scenario.

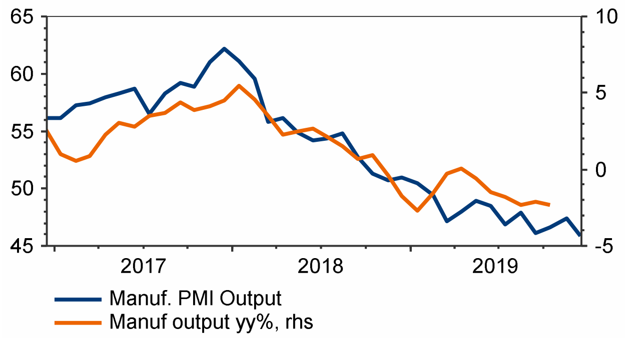
The dynamics of foreign demand should normalise from spring 2020, when the phase of adjusting to increased US tariffs on China falls out of the calculation. However, we estimate that the contribution of net exports to GDP growth will remain negative overall. It will instead be consumption, investment and inventories that ensure growth is positive and higher than in 2019.

Fig.1 – Confidence survey: by sector



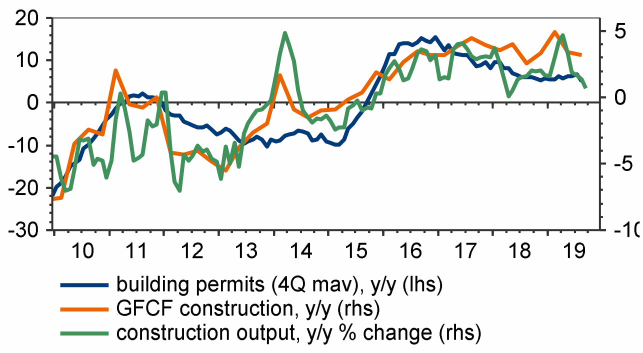
Source: Eurostat, Refinitiv Datastream

Fig. 2 – Manufacturing output and PMI



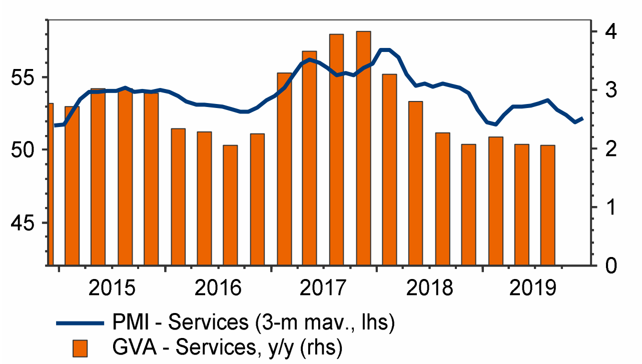
Source: IHS Markit, Eurostat, Refinitiv Datastream

Fig. 3 – Construction output and building permits



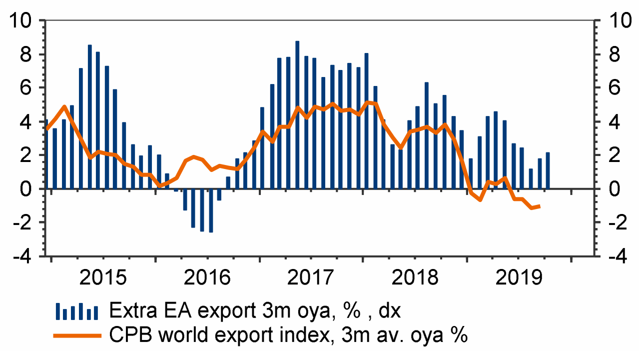
Source: Eurostat, Refinitiv Datastream

Fig. 4 – Services: PMI and value added



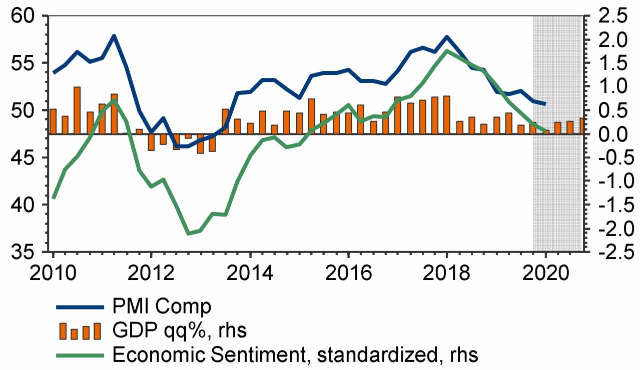
Source: IHS Markit, Eurostat, Refinitiv Datastream

Fig. 5 – Non-Euro zone exports and global demand



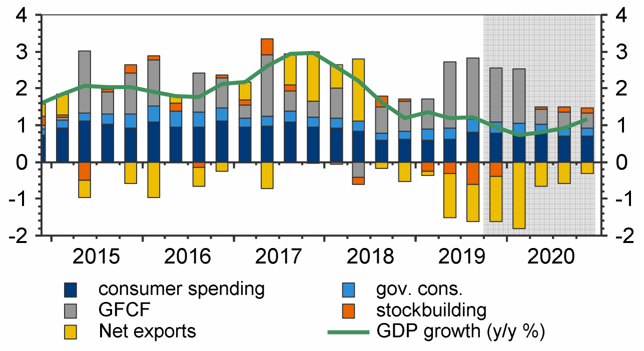
Source: CPB, Eurostat, Refinitiv Datastream

Fig. 6 – GDP and confidence surveys



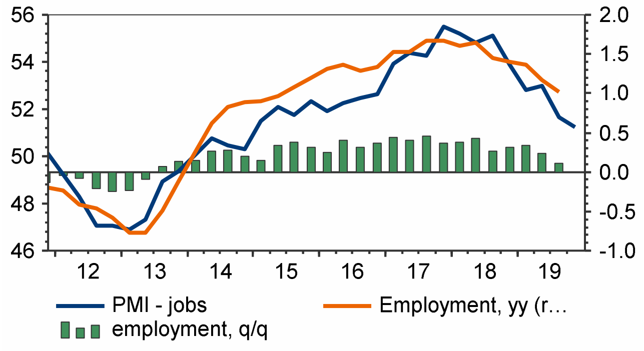
Source: Eurostat, Refinitiv Datastream

Fig. 7 – Contribution of demand components to GDP growth



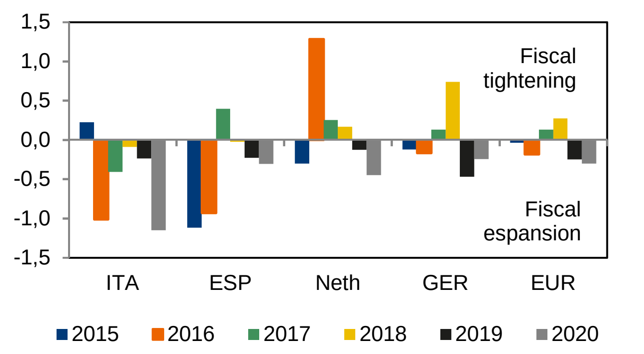
Source: Intesa Sanpaolo chart from Eurostat data. Our forecasts

Fig. 8 – Employment and company expectations regarding headcounts



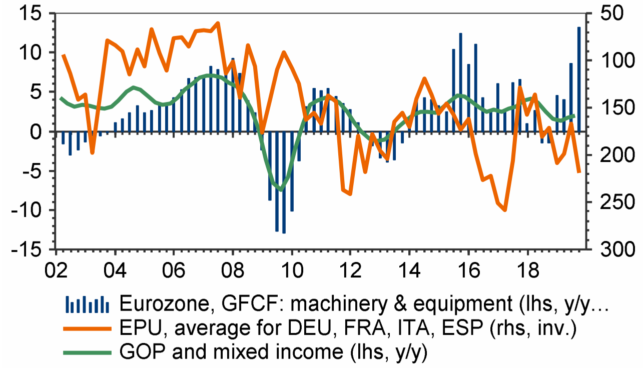
Source: Eurostat, IHS Markit

Fig. 9 – Cyclically adjusted public sector primary balance



Source: chart based on Intesa Sanpaolo data

Fig. 10 – Gross fixed investment, profitability and uncertainty



Source: Eurostat, Refinitiv Reuters

Inflation

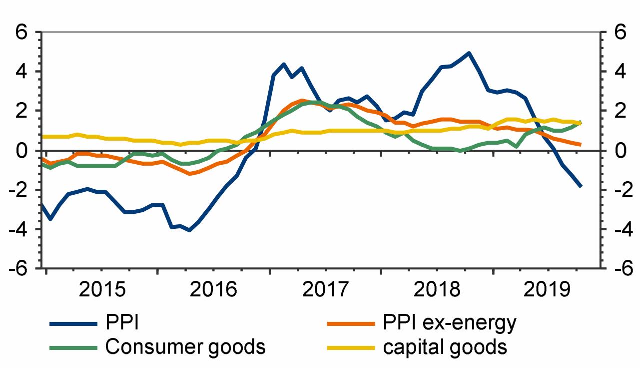
Wage growth is stronger, but inflation will remain static at levels well below the ECB's target

Data on labour costs are showing the strongest growth since 2012, which indicates that wages are still responding to employment trends. This is not the case for prices charged by companies: only producer prices for consumer goods are accelerating moderately, but to a large extent this is simply due to a statistical comparison effect. Harmonised consumer price indices have bounced back from their October lows, but remain way off the ECB's target.

Our forecast scenario does not include pronounced oil price dynamics. Economic surveys are not signalling any inflationary pressure, and the ongoing weakness in demand conditions faced by European companies suggests the transfer of any pressure on production costs to selling prices will remain limited. PMI surveys in recent months have shown declining diffusion indices for inflation, with a return to 2017 levels. Output prices for consumer goods and capital goods are showing growth rates of between 1% and 2%, which in the case of consumer goods marks a recovery. Financial market expectations for future inflation are declining, while consumer inflation expectations are stable.

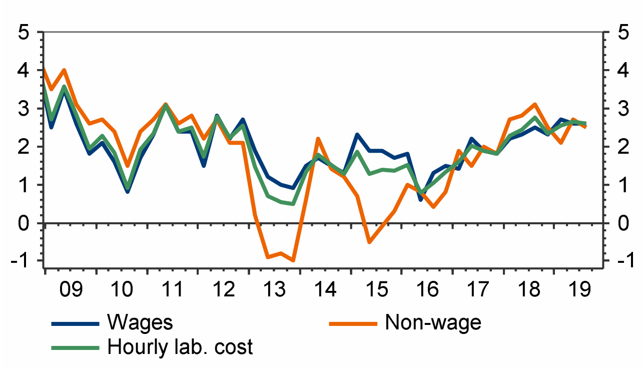
Aggregate demand would need to strengthen significantly for inflation to accelerate. As we expect real growth to accelerate only moderately, inflation should also remain broadly stable at an annual average of 1.3% in 2020. Our forecasts are very close to the consensus average and ECB staff estimates.

Fig. 11 – Producer prices



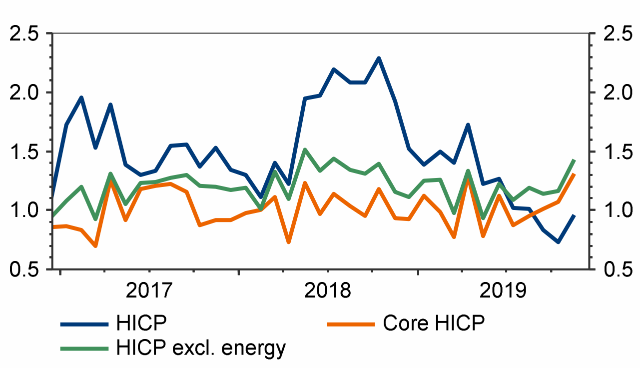
Source: Eurostat

Fig. 12 – Wage growth



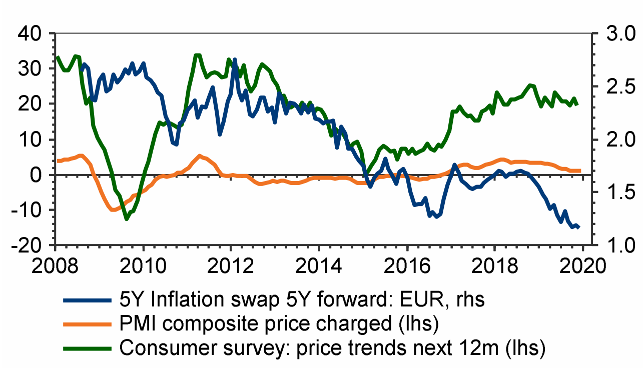
Source: Eurostat

Fig. 13 – Inflation trends (HICP)



Source: Eurostat

Fig. 14 – Inflation forecasts



Source: European Commission, IHS Markit, Refinitiv Reuters

Monetary policy

The CB is likely to keep rates on hold in 2020, while continuing to implement active quantitative programmes

The ECB has entered a wait-and-see phase, having in September announced a package that was controversial as well as full of stimulus measures. There are several reasons why a waiting phase is justified. Firstly, some measures have only just entered the implementation phase.

1. Net purchases under the asset purchase programme (APP) started in November, with volumes (EUR 24.1Bn) temporarily above the official target of EUR 20Bn per month, and government bonds accounting for only 60%, compared with 82% in the two-year period 2017-18. We believe that, in order to ensure the APP's sustainability over time without changing its parameters, the ECB will seek to achieve the maximum possible flows under the CSPP (corporate sector purchase programme) and CBPP (covered bond purchase programme), using the PSPP (public sector purchase programme) as a residual programme to achieve the quantitative targets.

2. A second TILTRO III (targeted longer-term refinancing operations) auction took place in December. The first auction, which was too close to the September monetary policy meeting, had met with little interest from banks. The results of the second auction were not brilliant either, with requests for only EUR 97.7Bn. The TLTRO III programme should be highly successful as its maturity has been extended and, now that its spread above the reference rates has been abolished, it is cheaper. Perhaps, however, the larger volumes will emerge later, in 2020-21.

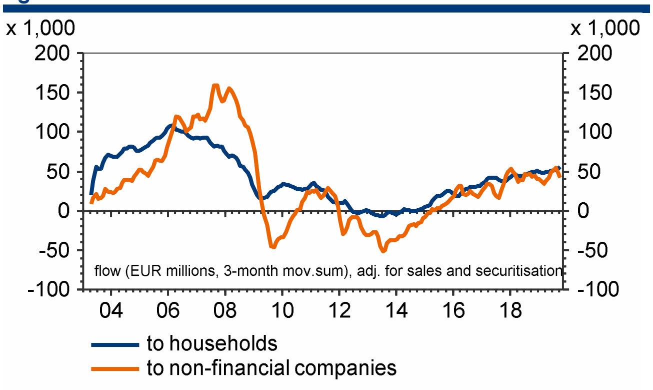
The APP's impact relates to stocks, not flows, so the ECB needs time to assess this. The same applies to the TLTRO III programme, which could squeeze lending rates and/or generate a greater increase in lending volumes over the next two years. The two programmes will lead in the coming months to a further expansion in surplus reserves. This, in turn, will translate into slightly more robust growth in monetary aggregates. The cut in interest rates from -0.4% to -0.5%, on the other hand, is too limited for significant macroeconomic effects to be expected.

The ECB's forward guidance links the possibility of a future interest rate hike to two conditions: a retrospective one, i.e. convergence of observed inflation to target; and a prospective one, i.e. strong convergence of inflation projections to the 2% target. We do not currently believe that the two conditions will be met in 2020. As such, rates will remain on hold and net purchases will continue until at least 2021. Such is the uncertainty surrounding the long-term scenario that the ECB might yet find the economy in recession without even having started a rate hike cycle.

Although there is absolutely no chance of an interest rate hike, the possibility of a cut in official rates in 2020 also seems highly incompatible with our core scenario. Until a few weeks ago, the markets were still expecting rates to be trimmed, but this prospect now seems to have almost disappeared from prices. We have the impression that the bar for fresh expansionary measures has been somewhat raised since the September meeting.

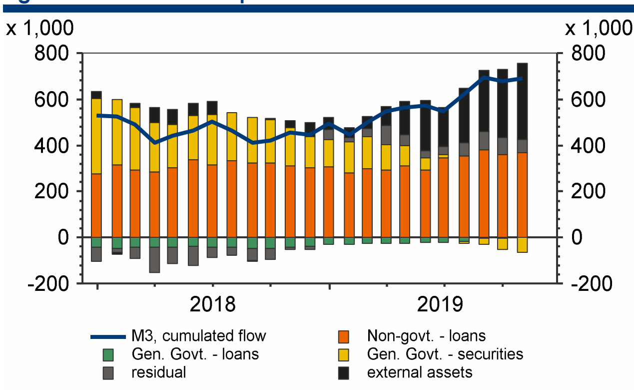
With Christine Lagarde the new President, and the new members of the Executive Board due to take up their posts in early 2020 (Panetta replacing Coeuré, Schnabel replacing Lautenschlaeger), the ECB is also preparing to launch a strategic review of its monetary policy framework, the first since 2003. Christine Lagarde has said the objective is to complete the review by the end of next year, and that it would cover both objectives and instruments. There is known to be debate over whether the definition of price stability should be changed as regards the choice of the preferred price measure, but also as regards the indicator for the target level. In parallel, the ECB is also considering the possibility of issuing electronic money, although it has not yet specified the objectives of this step.

Fig. 15 – Net loans flow stable



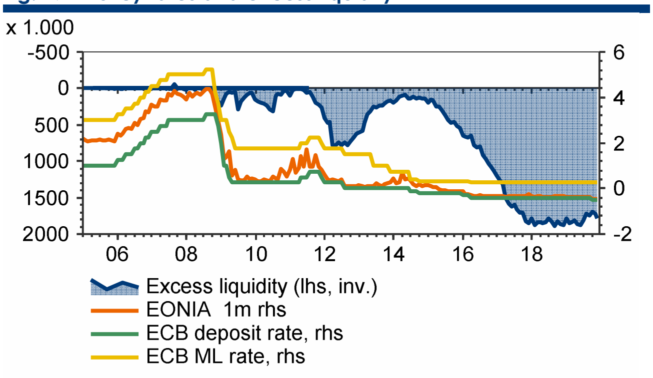
Source: chart based on ECB data

Fig. 16 – M3 and counterparties



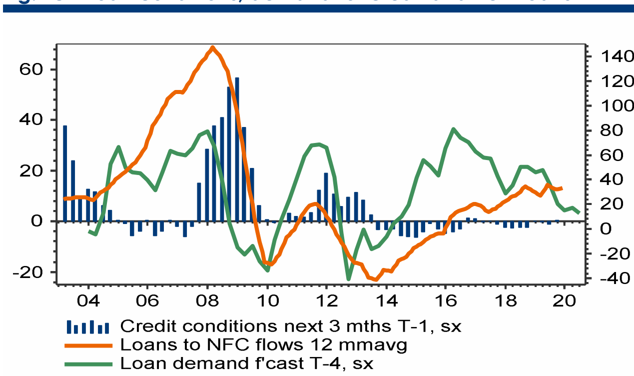
Source: chart based on ECB data

Fig. 17 – Policy rates and excess liquidity



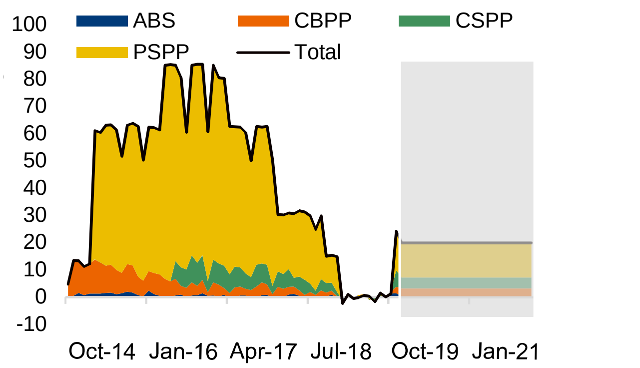
Source: chart based on ECB and Refinitiv Datastream data

Fig. 18 – Loan conditions, demand for credit and new loans



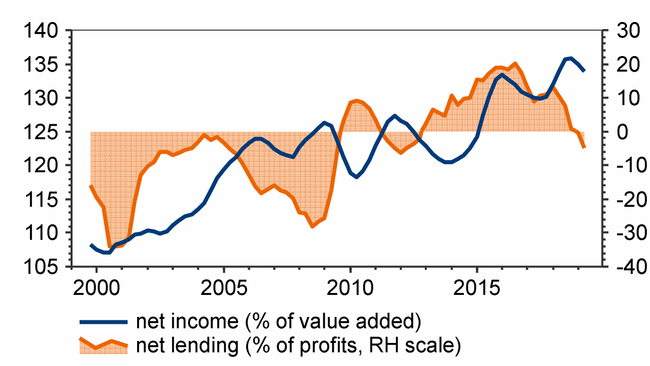
N.B.: a positive value for loan conditions indicates that a majority of banks expect tightening conditions. Source: ECB

Fig. 19 – Net purchases under the APP



Source: ECB and Intesa Sanpaolo trend projections

Fig. 20 – Profitability and net savings of non-financial companies



Note: profitability is calculated as a four-quarter moving average of the ratio of net corporate earnings to value added. Source: ECB

Forecast Table

	2018	2019f	2020f	2019				2020f				2021f	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	1.9	1.2	0.9	1.4	1.2	1.2	0.9	0.7	0.8	0.9	1.2	1.3	1.3
- q/q change				0.4	0.2	0.2	0.1	0.2	0.3	0.3	0.3	0.3	0.3
Private consumption	1.4	1.3	1.4	0.4	0.2	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Fixed investment	2.4	7.0	3.2	0.4	5.7	0.3	0.6	0.5	0.5	0.5	0.4	0.4	0.5
Government consumption	1.1	1.5	1.2	0.4	0.5	0.4	0.3	0.3	0.2	0.2	0.3	0.3	0.2
Export	3.3	2.4	1.8	0.9	0.2	0.4	0.4	0.4	0.5	0.6	0.6	0.6	0.7
Import	2.7	4.7	3.8	0.3	2.8	0.6	1.0	1.0	0.7	0.7	0.5	0.7	0.7
Stockbuilding (% contrib. to GDP)	0.0	-0.4	0.1	-0.2	0.0	-0.1	0.0	0.2	0.0	0.0	0.0	0.0	0.0
Current account (% of GDP)	3.6	3.3	3.2										
Government Balance (% of GDP)	-0.5	-0.8	-1.1										
Government Debt (% of GDP)	87.9	86.4	85.1										
HICP (y/y)	1.8	1.2	1.3	1.4	1.4	1.0	1.0	1.4	1.2	1.2	1.4	1.3	1.2
Industrial production (y/y)	0.9	-1.3	0.3	-0.5	-1.4	-2.2	-1.1	-1.0	-0.1	1.0	1.4	1.0	0.9
Unemployment (%)	8.2	7.6	7.6	7.8	7.6	7.6	7.5	7.5	7.6	7.6	7.7	7.7	7.7
3-month Euribor	-0.3	-0.4	-0.4	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
EUR/USD	1.18	1.12	1.14	1.14	1.12	1.11	1.11	1.11	1.14	1.15	1.17	1.17	1.18

Annualised percentage changes on the previous period – unless otherwise indicated. Source: Refinitiv-Datastream, Intesa Sanpaolo

Germany: the economic outlook has stabilized

Andrej Arady

The German economy surprised on a positive note in the third quarter, avoiding a technical recession. Confidence indicators have bottomed out in recent months. The outlook now carries slightly lower risk than a quarter ago. Real data, though, opened 4Q on a weak note. We leave our GDP forecast for 2019 unchanged at 0.5% y/y while revising up by one tenth our estimate for 2020, to 0.6%. The inflation trend is proving weaker than previously expected. Our HICP forecast for both 2019 and 2020 has been revised down by two tenths, to 1.3% and 1.2%, respectively.

Downward risks to the medium-term scenario remain substantial, but smaller than a quarter ago

Little has changed since our previous autumn forecast note, in which we had sharply revised down our projections of German growth in 2019 and 2020. Downside risks to the baseline scenario are still significant, albeit slightly lower than three months ago. Germany is particularly exposed to the key global risks represented by US trade policy, the fundamental transformation of the automotive sector and shocks tied to Brexit. Compared to three months ago, a no-deal Brexit is now very unlikely. Tensions tied to US trade policy have eased somewhat, although uncertainty lingers. There is no guarantee of trade tensions not resurging, nor of US focus not shifting from China to Europe, resulting in tariff hikes on auto imports (a front not opened in November, contrary to the US administration's previous announcements). The automotive sector is still suffering, and the transition to electric vehicles is highly unpredictable in the medium-term.

The economy avoided a technical recession in 2019

In 3Q 2019 the economy rebounded by 0.1%, beating expectations. Second-quarter data was revised downwards, from -0.1% q/q to -0.2%, while the 1Q reading was revised up by one tenth, to 0.5%. The German economy has therefore avoided a technical recession. The latest rebound was driven by stronger private consumption and government spending. Import-export trade also recovered, mostly on the export side. Fixed investment, meanwhile, continued to contract after booming in 1Q (1.6% q/q), although the pace of the contraction slowed (to -0.1% in 3Q from -0.3% in 2Q). As a result, year-on-year GDP growth edged up from 0.3% y/y in 2Q 2019 to 0.5% y/y in 3Q. Going forward it growth is likely to slow back again, bottoming out at -0.1% at the beginning of 2020. Thereafter, base effects should help drive year-on-year growth back up rather swiftly.

Forecast for 2020 revised up slightly, but still below consensus

The stronger than expected performance in 3Q, together with the recent stabilisation of sentiment in the German economy, has prompted us to revise up our forecast for the final quarter of this year to 0.0% from -0.1% q/q previously. Government investment and private consumption should offset the weakness of the export-oriented manufacturing sector, which opened 4Q very sluggish again. The revision of 4Q data has not affected our full-year forecast of 2019 growth, confirmed at 0.5% y/y, in line with our autumn forecast. Yet, the main leading indicators are failing to point to a significant recovery already in the opening quarter of 2020. Growth is expected to accelerate more visibly only starting in the second quarter of next year. Due to the carry-over effect of stronger-than expected growth in 2H 2019, we have revised up by one tenth our full-year growth forecast for 2020 to 0.6% y/y, adjusted by calendar effects and working days. Our forecast remains slightly below consensus estimates (0.7%). In 2020, calendar effects will play a significant role (worth around 0.4%). GDP growth not adjusted by working days could therefore pick up to 1.0% y/y. This means that it is very important to distinguish between the seasonally-adjusted and unadjusted GDP forecasts for 2020.

Manufacturing remains weak

The key culprit behind the recent weakness of the economy is still the export-oriented manufacturing sector, which in 3Q 2019 incurred the fifth consecutive quarterly contraction. In the medium-term, the main drag will come from the automotive sector, followed by chemicals & pharmaceuticals. Both sectors are undergoing structural changes, with negative effects on current performance. Moreover, in the latter part the year trade disputes have also negatively affected other segments of manufacturing with a vocation for exports. In the medium-term crucial factors will be the evolution of the automotive and the further development of global trade policy. Business expectations for the next six months seem to have bottomed out in the auto sector. However, production is not expected to rise back up already within the next three months. Car production opened 4Q 2019 again on a very weak note, dropping by 5.4% m/m in October. Chemicals & pharmaceuticals, on the other hand, bounced back at the beginning of 4Q, although medium-term business expectations are still at their weakest since 2012. The global trade environment remains uncertain, although apparently slightly less so than previously.

Sentiment has risen from its recent lows

Confidence among businesses and investors finally hit a trough at the beginning of 4Q 2019. Renewed, modest optimism mostly originated in expectations, whereas views on the current situation only improved very marginally. Despite rising from its recent low, confidence is still very low, indicating growth of only around zero in the coming months. The spillover from weak manufacturing to the services sector seems to be easing. While services are expected to keep growing slightly, manufacturing has only stabilised in negative territory for now. The construction sector, supported by ongoing public investments, should continue to grow at a decent pace during the course of 2020.

Inflation remains subdued

Inflation in the autumn months fell short of expectations. EU harmonised inflation averaged at 1.3% y/y in the first eleven months of the year, down from 1.9% in 2018. In recent months, inflation has mostly been dragged down by volatile energy prices. Going forward, at the beginning of the next year overall inflation may peak at close to 2%, before pulling back later in the course of the year (possibly to below 1% again in 2H 2020). In 2020, inflation is expected to average 1.2% y/y, down from 1.3% estimated in 2019.

Labour market conditions still good, but the best is over

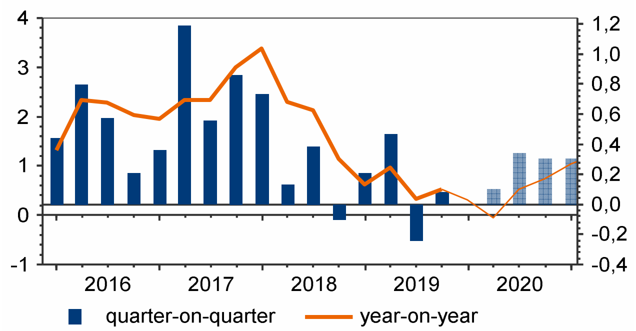
The unemployment rate stabilised at 5% in the second half of the year, just one tenth above its all-time low, remaining supportive of private consumption. The unemployment rate is forecast at 5.0% in both 2019 and 2020, down from 5.2% in 2018. The near-term outlook remains favourable, although labour market conditions may now have peaked. The number of workers on short shifts have gradually increased over recent months, as businesses have opted to cut hours rather than fire employees. Labour shortages are no longer as intense as they were in 2018. In the manufacturing and construction sector in particular, labour shortage has notably decreased, while staying close to its 2018 peak in the services sector.

Forecast Table

	2018	2019f	2020f	2019				2020f				2021f	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	1.5	0.5	0.6	1.0	0.3	0.5	0.3	-0.1	0.5	0.7	1.0	1.2	1.2
- q/q change				0.5	-0.2	0.1	0.0	0.1	0.3	0.3	0.3	0.3	0.3
Private consumption	1.2	1.6	1.4	0.8	0.1	0.4	0.2	0.4	0.4	0.4	0.4	0.4	0.3
Fixed investment	3.6	2.8	1.9	1.6	-0.2	-0.2	0.6	0.5	0.7	0.7	0.5	0.5	0.6
Government consumption	1.4	2.0	1.9	0.6	0.6	0.8	0.4	0.5	0.4	0.4	0.4	0.4	0.4
Export	2.3	1.2	1.6	1.6	-1.3	1.0	0.3	0.4	0.5	0.5	0.6	0.5	0.8
Import	3.7	2.5	2.8	0.8	-0.1	0.1	1.0	1.0	0.7	0.6	0.6	0.8	1.0
Stockbuilding (% contrib. to GDP)	0.3	-0.8	-0.6	-0.9	0.2	-0.7	0.0	-0.1	0.0	-0.1	-0.1	0.0	-0.1
Current account (% of GDP)	7.5	6.9	6.7										
Government Balance (% of GDP)	1.9	0.8	0.3										
Government Debt (% of GDP)	61.9	59.2	56.5										
HICP (y/y)	1.9	1.3	1.2	1.6	1.7	1.0	1.1	1.8	1.0	0.9	1.2	1.2	1.2
Industrial production (y/y)	0.9	-3.3	0.3	-1.7	-4.0	-4.1	-3.6	-3.5	-0.4	2.0	3.2	3.5	3.1
Unemployment (%)	5.2	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.1	5.1	5.1
10-year yield	0.44	-0.23	-0.14	0.10	-0.11	-0.53	-0.36	-0.23	-0.12	-0.10	-0.10	-0.12	-0.14

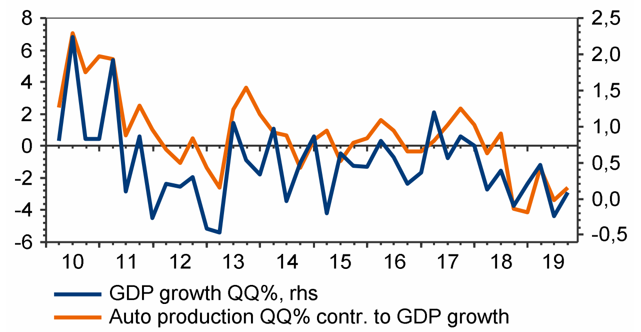
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Refinitiv-Datastream, Intesa Sanpaolo

GDP growth dynamics, y/y vs. q/q, seasonally and calendar adjusted



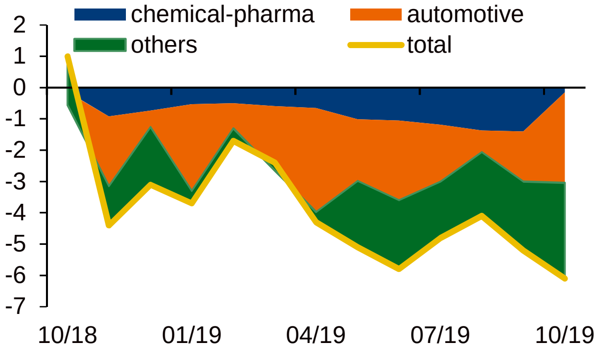
Source: Refinitiv Datastream, Intesa Sanpaolo forecasts

Automotive sector still the main culprit behind anaemic growth



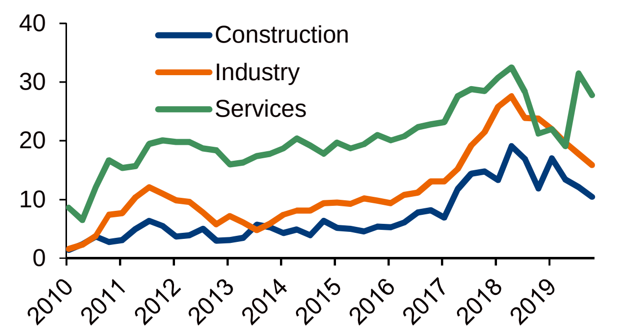
Source: Refinitiv Datastream

Year-on-year growth of manufacturing and contribution of selected sectors



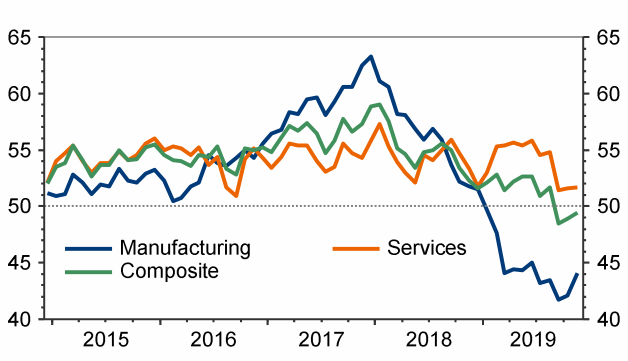
Source: Intesa Sanpaolo elaborations on Eurostat data

Labour shortages in individual sectors



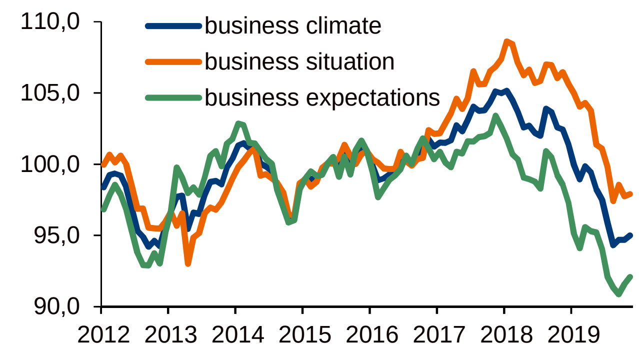
Source: Intesa Sanpaolo elaborations on DG EFCIN data

PMI survey: first signs of a stabilisation



Source: Refinitiv Datastream

Ifo survey: sentiment has finally bottomed out



Source: Intesa Sanpaolo elaborations on Bloomberg data

German fiscal policy is distinctly expansionary

Since 2012, Germany has complied with the medium-term budgetary objective of a structural deficit no higher than 0.5% of GDP and is projected to comfortably respect this in the coming years as well. According to European Commission estimates, **structural surplus** peaked in 2018 at about 1.4% of GDP. In 2019, it is expected to decline to 1.1% of GDP. In 2020, it is forecast to drop further, to 0.7% of GDP, roughly half the level recorded in 2018. **New fiscal measures included in the 2020 Budget will only result in mild expansionary fiscal easing, of close to 0.1% of GDP**, mostly resulting from the Climate Action Programme 2030. The climate package will be implemented gradually, increasing spending by around 0.1% of GDP per year in the next few years. The bulk of the fiscal measures that will turn Germany's fiscal policy expansionary were approved already in 2018 with the previous (2020-2022) financial planning document (implemented in Germany's Draft Budgetary Plan 2019). The key fiscal measures on the revenue side are a reduction of the tax burden for households and tax cuts in support of the construction and housing sectors. Furthermore, starting in January 2021, low and middle-income households will be fully exempted from the "solidarity tax", benefiting around 90% of all taxpayers. Cumulative tax relief in 2019-2021 will amount to 25 billion euros: the largest tax cut in over a decade. On the expenditure side, the key measures are: 1) increased social spending to support pension insurance, health insurance and unemployment insurance schemes, and higher spending on advanced education and training; 2) higher spending in transport infrastructure, education and research. Remarkably, public fixed investments are forecast to grow by nearly 6% y/y in 2020, from 7.5% y/y estimated in 2019, significantly above the pace of growth of GDP.

Budget surplus narrowing in headline terms as well. The overall national budget surplus is forecast by the Economic Commission to narrow from 1.9% of GDP in 2018 to 1.2% of GDP in 2019, and to 0.6% of estimated GDP in 2020. However, the decelerating economy will only have a limited negative impact on tax revenues.

As a result of the budget surplus, the **debt/GDP rate is expected to fall below the 60%** ceiling enshrined in the Maastricht Treaty by the end of this year, for the first time since 2002.

Despite ongoing economic growth, albeit at a subdued pace, the probability of Germany using the fiscal space at its disposal, worth nearly 37 billion euros (the surplus resulting from a budgeted structural surplus of 0.5% of GDP and a medium-term objective of -0.5% of GDP) is very low. German economic growth in 3Q 2019 beat expectations and prevented a technical recession. Going forward, the country is not likely to slip into a recession in the medium-term, although additional fiscal stimulus is not likely either.

France: the economy is holding up despite growing uncertainty

Guido Valerio Ceoloni

In a not particularly positive environment for the Euro zone, the French economy has up to now shown itself to be fairly resilient, as we expected. The fiscal stimulus of the autumn has undoubtedly helped buoy household consumption and more generally domestic demand. On the other hand, exports continue to suffer as a result of global sources of uncertainty and the slowdown in German orders. The labour market is improving every quarter, and wages are rising, but unemployment remains above the Euro zone average, while inflation remains weak at around 1%. Overall, risks to the scenario are balanced for 2020. We forecast a slowdown in GDP growth, from 1.3% this year to 1.1% next year.

Another quarter of 0.3% qoq growth for GDP. Growth around 1.2% confirmed for 2019-2020

The French economy has maintained a constant cruising speed this year, with **GDP** growing by 0.3% qoq again in the third quarter, thanks in particular to the contribution of domestic demand and more specifically manufacturing investment. Net exports made a negative contribution. The annual average also remained steady at 1.4% in line with the first two quarters of the year. We expect a marginal slowdown in GDP growth in the last quarter, to 0.2% qoq, resulting in an annual average of 1.3%, from 1.7% in 2018. For 2020, we forecast a further marginal slowdown to 1.1% against a backdrop of moderate growth for the whole of the Euro zone, slightly below consensus estimates.

Moderate acceleration in household consumption in the next two years compared with last year

Supported by tax cuts, **household consumption** remained positive in the autumn, growing by 0.4% qoq from 0.2% qoq, as did confidence, which improved from September to November, and remains above the long-term average. Consumer spending is therefore on course for growth of 1.3% this year, from 0.9% in 2018. In 2020, we forecast that the rate will remain around 1.3% yoy, supported by fiscal stimulus, wages growth and rising employment, but the risks to the forecast are to the upside, given that the tax cuts of over EUR 9Bn promised by President Macron are expected to drive household disposable income in 2020.

Confidence in manufacturing has stabilised at the historical average after the expansionary phase in 2017-2018

The **manufacturing** segment dipped in March, June and August this year. In the last quarter, we forecast a recovery in **industrial output** growth to around 0.4% qoq, from -1.1% qoq. Confidence among companies has remained broadly in line with the historical average in the last few months but has been progressively falling since the beginning of the year, indicating a return to normal confidence levels after the expansionary cycle in 2017-2018. For 2019-2020, we forecast industrial output to grow at an annual rate of around 0.6%. Confidence remains positive in services, as reflected in PMI indicators, and in construction, where activity in the building component looks set to return to 2008 levels, supported by accommodative financial conditions.

Investments will continue to support GDP at the turn of the year

After its weakness at the beginning of 2019, **capital investment** regained momentum in the middle of the year and grew by 1.2% qoq in the third quarter. The most dynamic component was **investment in manufacturing** and machinery (with an average of 1.3% qoq), while **household investment** peaked in the second quarter and then returned to a more moderate pace (0.7% qoq, from 1.6% qoq). We confirm our previous forecast and estimate that capital investment will grow by 3.5% yoy this year, from 2.8% yoy in 2018. The last INSEE confidence survey for industrial investment pointed to a cooling in investment decisions towards the end of the year, but for 2020, we forecast a marginal slowdown to below 3%.

Exports still weak, with the contribution of foreign trade negative this year and zero next year

Foreign trade is still the weakest link in the outlook for France, with lacklustre global demand. French exports contracted for the second consecutive quarter (to -0.1% qoq from -0.2% qoq). We expect near-stagnation in **exports** at the end of the year, with annual average growth slowing from 3.5% to 1.8%, before rising again next year to around 1%. **Imports** remained fairly stable this year, with growth at around 2.4%, strengthening on 2018 thanks to the upturn in consumption. However, import growth is slowing next year, to around 2%. Foreign trade therefore made a negative contribution this year, with next year's contribution expected to be zero. The balance of payments will remain broadly stable in 2019 compared with 2018, at -0.6% of GDP, before retreating slightly to -0.4% in 2020.

Inflation has slowed marginally since the beginning of the year, falling from 1.2% to just below 1% after the summer. Core inflation excluding energy and food has remained stable at around 1% in 2019, as in 2018. For next year, we forecast a marginal rise in consumer prices, with inflation seen rising to around 1.5% by the end of 2020 (annual average at 1.2%).

Inflation will remain stable in 2019-2020 at around 1.2%

Unemployment has been falling uninterruptedly since the beginning of 2017 and stood at 8.5% at the end of the third quarter; however, it is still above the Euro zone average. This year, we therefore forecast that the rate will fall from 9.1% to 8.6%, and then continue to fall by two- to three-tenths of a point in 2020-2021.

Unemployment is falling, but still remains above the Euro zone average

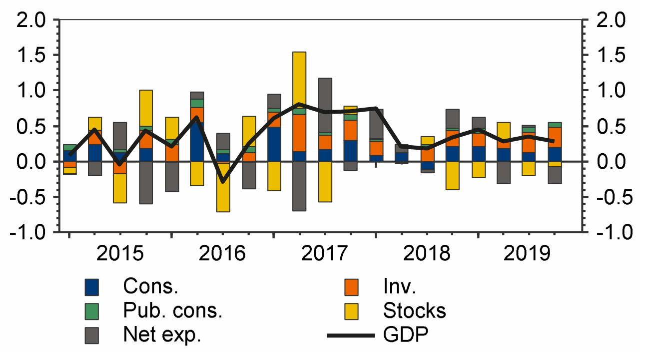
As regards the **public accounts**, Parliament has approved the fiscal measures for 2020, which will see the nominal deficit come in at -2.2%, 0.8 points higher than in 2019, due to the temporary measures adopted by the government to curb "yellow vest" disaffection. We think it is likely that the correction will be only to -2.4%, compared with the -3.1% forecast for 2019. However, the negative rate environment does not pose any particular risk to meeting the objective. Public debt is seen broadly stable at 99%. Risks remain balanced overall: improved purchasing power may provide better-than-expected support to domestic demand, while foreign trade could be impacted by a further deterioration in global confidence.

Forecast Table

	2018	2019f	2020f	2019				2020f				2021f	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	1.7	1.3	1.1	1.3	1.4	1.4	1.1	1.1	1.0	1.1	1.2	1.3	1.5
- q/q change				0.3	0.3	0.3	0.2	0.3	0.2	0.4	0.3	0.4	0.4
Private consumption	0.9	1.3	1.3	0.3	0.2	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Fixed investment	2.8	3.5	2.7	0.5	1.3	1.2	0.6	0.6	0.5	0.5	0.5	0.5	0.5
Government consumption	0.8	1.3	1.3	0.1	0.5	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Export	3.5	1.9	1.4	0.1	-0.2	-0.1	0.3	0.5	0.5	0.5	0.5	0.7	0.7
Import	1.2	2.4	2.0	1.1	-0.3	0.7	0.5	0.5	0.5	0.6	0.6	0.6	0.6
Stockbuilding (% contrib. to GDP)	-0.3	-0.3	-0.3	0.3	-0.2	-0.1	-0.2	-0.1	-0.1	0.1	0.0	0.0	0.0
Current account (% of GDP)	-0.5	-0.5	-0.6										
Government Balance (% of GDP)	-2.5	-3.1	-2.2										
Government Debt (% of GDP)	98.4	98.9	98.9										
HICP (y/y)	2.1	1.3	1.5	1.4	1.3	1.2	1.2	1.3	1.3	1.6	1.7	1.8	1.7
Industrial production (y/y)	0.2	0.5	0.4	0.6	1.6	-0.4	0.3	-0.3	-0.4	1.2	1.0	1.0	1.1
Unemployment (%)	9.1	8.6	8.4	8.7	8.5	8.6	8.6	8.5	8.5	8.4	8.3	8.2	8.2

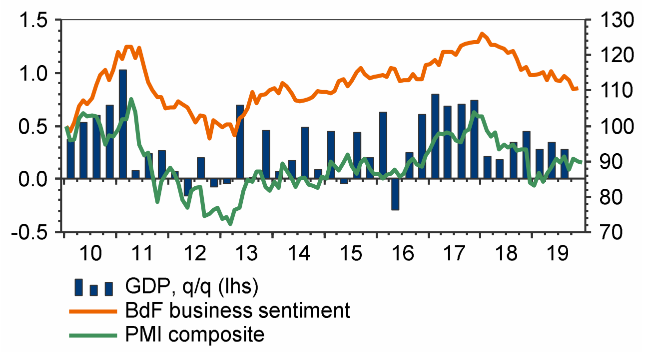
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Refinitiv-Datastream, Intesa Sanpaolo

Fig. 1 – Contribution to GDP



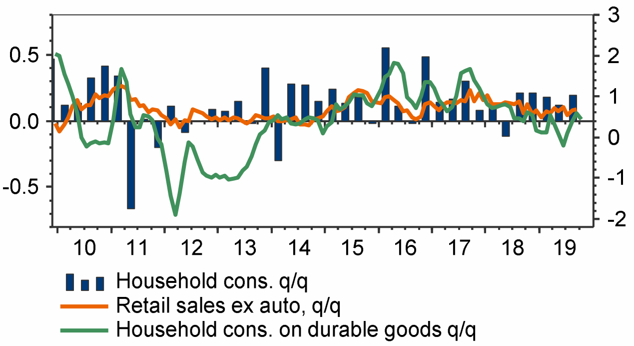
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 2 – GDP and confidence indicators



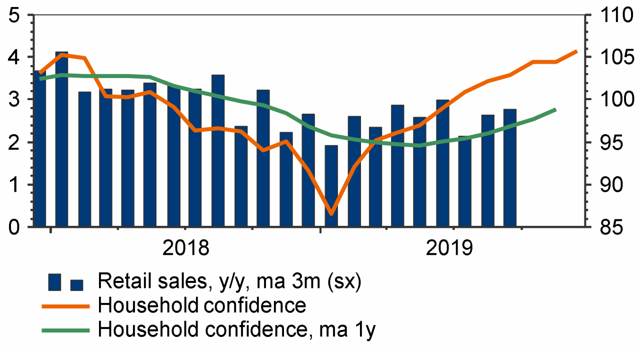
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 3 – Household spending, purchases of durable goods and consumer spending



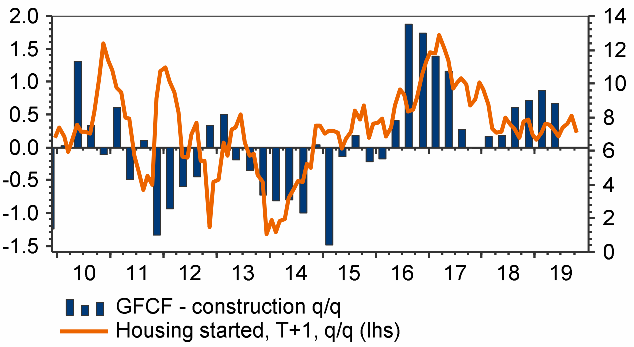
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 4 – Retail sales and household confidence



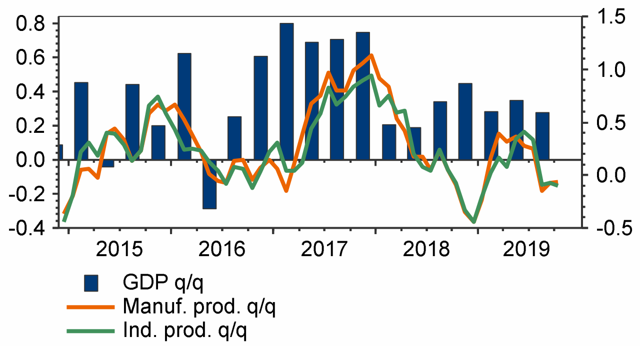
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 5 – Residential investments and building sector activity



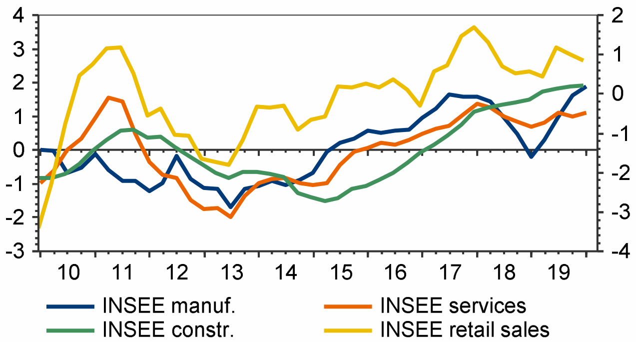
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 6 – Industrial output and GDP



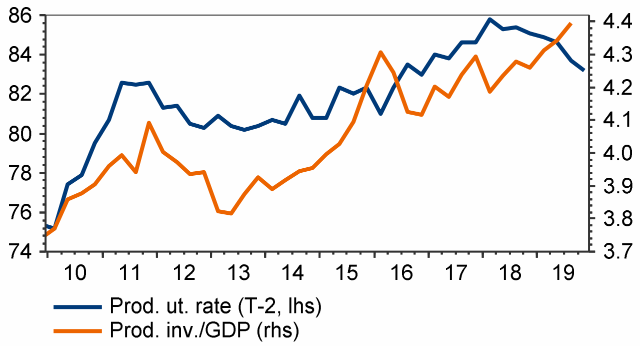
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 7 – Activity indices for the various manufacturing sectors



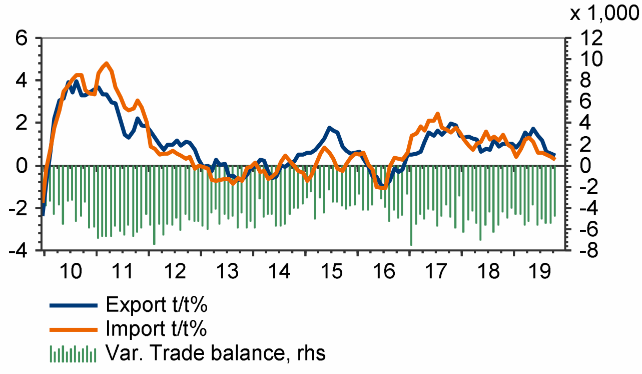
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 8 – Production capacity utilisation and level of investment as a proportion of GDP



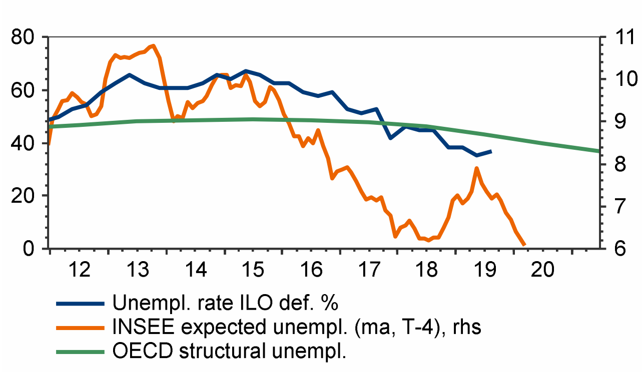
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 9 – Trade balance



Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 10 – Expected and structural unemployment



Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Italy: towards a slight acceleration in 2020, political instability is the risk

The cycle trough may now be behind us, but economic activity will remain weak on the foreseeable horizon. The growth rate of the economy in 2020 may result only slightly stronger than the (anaemic) pace recorded in 2019. Political instability is the main risk.

Paolo Mameli

The Italian economy has not yet fully recovered from the effects of the crisis

After four years of growth between 2015 and 2018 (at an average rate of just over 1%), **the Italian economy essentially stalled in 2019**. In 3Q 2019 GDP level remains lower than in the pre-crisis period (-3.9% compared to end-2017); investment underwent a particularly sharp correction (-17%), especially in construction (-32%), whereas the only component of GDP to achieve significant growth were exports (+14.6%). Nonetheless, both employment and the disposable income of households more than recovered from their previous declines (Fig. 1), although inequality in the distribution of income increased.

The trough in terms of quarterly GDP growth may have been hit in 2018

Indeed, **the stagnation phase of the economy began in 2018,** as in 2018-19 biennium the quarterly growth rate averaged zero. In fact, the cycle trough in quarterly terms seems to have been reached with the "technical" recession observed in the two central quarters of last year. In the following quarters, GDP has picked up at a cruising speed of 0.1% q/q. In annual terms, the low-point was hit at the end of 2018, at -0.1%, followed by a return into marginally positive territory (+0.3% y/y al 3° quarter 2019).

Growth in 2019 was slightly positive, beating our expectations

2019 should end with GDP growth at 0.2%, slightly above the forecasts we had drawn up a few months ago. In the year, domestic demand proved resilient, slowing just marginally, to 0.9% (based on our estimates) from 1.1% in 2018; a positive contribution was also made by foreign demand (+0.4%). A marked depletion of inventories was the main drag, subtracting over one per cent from economic activity: this had only happened before in 2009 and in 2012, against the backdrop of a very sharp contraction in GDP (-5.3% and -3%, respectively).

In 2020 we expect growth to continue at only slightly stronger rates than in 2019. Consumption will prove resilient…

In 2020 we expect a modest acceleration, which should mostly be the result of a reversal of the exceptional drag from warehouse inventories seen in 2019 (Fig. 2). Indeed, final domestic demand should slow further, to 0.6%. The **consumption trend,** which has recently sent positive signals (Figs. 3 and 4), mostly thanks to resilient employment (Fig. 5), **is expected to keep up the same cruising speed as in 2019** (0.6%) thanks to households' resilient real disposable income (2020 will be the first year of full implementation of the "citizen's income" programme), and despite a likely slowdown in job creation (in our estimate to 0.2% from 0.7% in 2019, with the unemployment rate stable at 10%: Fig. 6) and an uptrend in the savings rate (Fig. 7).

…whereas we expect a slowdown of both investment…

Risks seem more relevant to the investment trend, which after picking up at an average pace of 3% in 2015-19 is expected to slow to less than 1% in 2020. While uncertainty clouding the short-term political, fiscal and financial outlook has decreased compared to a few months ago (Fig. 8), as also the risks to global trade stemming from a possible escalation of the tariff war and from Brexit, they have not been entirely overcome (and may simply be pushed back by a few months, or years). Furthermore, the expectations of companies for final demand, while apparently having hit a trough, are still failing to show a significant recovery (Fig. 9). Lastly, a composite indicator of demand and supply of credit to firms (which we have built based on the ECB's bank lending survey: Fig. 10) still outlines weakness. On the other hand, investments should keep up a positive growth rate, benefiting from both persistently accommodative financial conditions and the renewal of the "Industry 4.0" package incentives.

…and exports

Uncertainty also lingers on the outlook for exports. In the closing quarter of 2019, exports are estimated to have rebounded quite sharply thanks to the delivery of a ship, but survey data are still not signalling an appreciable recovery in foreign orders (Fig. 11). Global demand addressed to Italy is expected to grow back slightly in 2020 (to 2.1% from 1.7% in 2019: Fig. 12), although Italy's geographical and sector specialisation, which was rewarding in 2019 (and allowed the country to outperform German exports: Fig. 13), could turn penalising in 2020. In essence, we expect a moderate slowdown of exports in 2020 (to 1.5% from 2.2% in 2019), which within a picture of recovering imports (estimated at 2.2% from 0.9%) would be consistent with a **moderately negative contribution of foreign trade to GDP in 2020** (-0.2% from +0.4% in 2019).

It should be said that our forecast on 2020 GDP (0.3%) is based on the reading adjusted by calendar effects (consistent with the quarterly series of national accounts). Taking into account the fact that 2020 will have two extra working days, **the reading not adjusted by calendar effects** (which matters for public finance ratios) **should point to stronger growth by at least one tenth (0.4%).** When adjusting annual growth not only by the different number of workdays, but also by the statistical carry-over effect due to the previous year (Tab. 1), GDP growth "within the year" seems to have hit a trough in 2018, with a modest recovery starting already in 2019 and expected to continue more or less at the same pace in 2020-21.

Favourable calendar effects will boost GDP in 2020

Based on our forecasts, **the quarters at the turn of the year are those most at risk of a slowdown, as monthly surveys are consistent with quarterly growth rates of between -0.1% and +0.1% q/q,** therefore signalling a possible slowdown from +0.1% q/q. On the other hand, in the recent period GDP growth has been stronger than suggested by confidence surveys (not only by sentiment among manufacturing companies, but also by the "broader" indices, due to the way they are built, in ascending order of "inclusiveness": composite PMI, Istat Economic Sentiment, EU Commission index, and Bank of Italy Ita-coin index: Fig. 14). However, **the main forward-looking indicators,** while still failing to outline an appreciable recovery, **seem at least to have stopped worsening,** also as a result of improving financial conditions (Fig. 15). This suggests that the q/q evolution of GDP could strengthen gradually in the course of 2020, although the quarterly average should not stray from the 2019 average (0.1% q/q).

Surveys point to the risk of a slowdown in the quarters at the turn of the year…

Therefore, **the cycle trough was probably hit in the second half of 2018, when uncertainty of both external origin and tied to the domestic political and fiscal scenario peaked.** Furthermore, the manufacturing sector at the global level had been hit by two idiosyncratic shocks in the auto and chemicals sectors, as well as by weakening demand from China. Italy was impacted by the effects of these shocks both directly (in its role as the most important manufacturing country in Europe after Germany), and as a result of the interconnections with German industry (especially in terms of the effects of weaker demand from China, which accounts for a relatively small share of Italian exports). On both the international and domestic fronts, risks persist, but barring new shocks, the worst of uncertainty should now be past.

…although the trend should strengthen later on, as the shocks that had hit the economy in the closing months of 2018 have eased

In 2020 fiscal policy will be moderately expansionary (the EU Commission estimates an easing of the cyclically-adjusted primary balance by four tenths compared to 2019), roughly in line with the Eurozone average. The government, in the 2020 Budget Law, managed to strike a "reasonable" compromise between risks to the economy of an excessive tightening (full respect of the EU structural balance rule would have had a negative impact of -0.6% on 2020 GDP, in our estimate) and the consequences, in terms of relations with the European institutions, with the rating agencies and investors, of a slackening of fiscal discipline. A moderate easing looks in some way justified, as the output gap is still negative (Fig. 16). On the other hand, it is illusory to imagine that the growth-supportive budgets being put in place in other European countries may reap a "healing" effect on the Italian cycle (based on our estimates, full use of the "fiscal space" in the euro area countries which enjoy such a margin – namely Germany and the Netherlands– would only boost Italian GDP by one tenth after one year and by two tenths after two years: Fig. 17). **We believe Budget Law implementation risks are contained overall:** any potential shortfall on the government's deficit target for 2020 (2.2%) would be limited to one or two tenths, in our view. However, as our forecast of nominal GDP growth is more cautious than the government's, **we believe the debt/GDP ratio will rise further** in 2020 (to over 136% of GDP). Furthermore, the fiscal policy path remains very narrow, as the budgets in the next few years will again have to tackle the challenge of deactivating safeguard clauses of similar worth to those faced this year (Fig. 18).

Fiscal policy will be moderately expansionary, with limited risks for the deficit, but debt still on the rise

Risks to our growth forecast for 2020 (0.3%), which we considered to be skewed downwards a few months ago, now seem to be tilted slightly to the upside, thanks to the carry-over effect of a stronger than expected 2019 and to partial easing of uncertainty, on both the external and domestic fronts. However, there are two sources of downside risk to the growth outlook: 1) a more negative evolution of global trade, triggered by a potential re-exacerbation of the tariff war or by an adverse evolution of the Brexit saga; 2) resurging political instability on the domestic front. Of these two risks, in the past few weeks the relative importance of the domestic factor seems to have increased.

Downside risks to the scenario are less worrying today than they were a few months ago

The main risk is political instability

In effect, **conflicts within the government coalition have increased of late** (especially on the amendments to the Budget Law and on the ESM reform). None of the parties that form the majority have any interest in the legislature coming to an early end. Yet, the force of attraction exerted by the right-wing coalition, tipped to win at the next political elections based on the latest voting intention polls (Fig. 19), may result in the government losing the slim majority of seats it can count on in the Senate, considering in particular the internal travails of the most represented party in Parliament (the Five-Star Movement). A potential trigger-event could be a defeat of the government forces at the regional elections, to be held at the end of January in Emilia Romagna and Calabria and in May-June in Campania, Liguria, Marche, Puglia, Tuscany and Veneto.

Rather than by the constitutional reforms, important effects could be reaped by changes to the electoral system

The political calendar is made more complex by the interweaving with the possible institutional reforms: 12 January is the deadline by which a potential confirmative referendum will have to be requested on the reduction of the number of members of parliament (which would be held next spring), whereas on 15 January the Constitutional Court will rule on the admissibility of the abrogation referendum on the proportional share of the current electoral system (in this case, the referendum would be held between mid-April and mid-June). Meanwhile, **the majority seems to have reached an agreement on the proposal of a new electoral law skewed towards a proportional system.** If approved, in our opinion such a law would have the following consequences: 1) in the near term, it would reduce the risk of political instability (the prospect of "safe seats" within the right-wing coalition in first-past-the-post constituencies may represent an incentive for some majority MPs to trigger a government crisis); 2) in the long term, a proportional system would on the one hand reduce the probability of ample majorities emerging in favour of governments positioned at the extremes of the political spectrum, while on the other also reducing governability and increasing the risk a "hung parliament" following the election.

Our baseline scenario does not contemplate a government crisis, which would in all likeliness have negative consequences

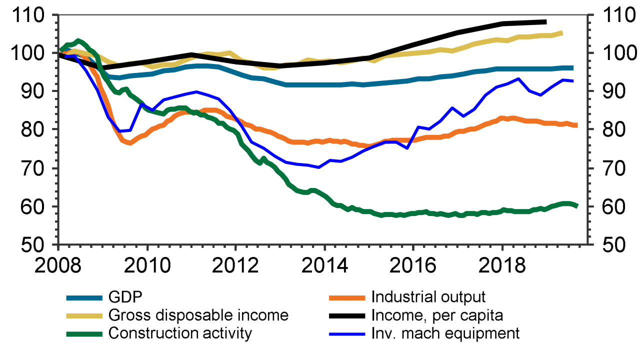
In any case, we believe that: **1) a government crisis, different from last Summer, would almost certainly lead to an early election; 2) political instability would have a negative effect** on Italy's country-risk indices on financial markets, albeit mitigated by the ECB's persistently ultra-accommodative monetary policy; **3) the approval of a proportional electoral system could be welcomed by investors,** as it would reduce the probability of "tail-risk" events; **4)** even in the event of the outcome of a potential early election confirming the indications provided by the latest polls, **the market may realise that in the recent past it had overestimated the probability of a potential "Italexit"** (recently, Lega leader Matteo Salvini has repeatedly stressed the irreversibility of the euro; furthermore, contrary to its behaviour within the previous government coalition, the Lega, should it win enough votes to lead a new majority with an ample margin, could take a more moderate approach, as it would be more prone to internalising the negative consequences of a conflictual relation with the European institutions and the financial markets). In essence, **while our baseline scenario does not contemplate an early election in 2020 (or in 2021), we consider political instability the main risk** weighing on the economy and on the markets.

Forecast Table

	2018	2019f	2020f	2018	2019				2020f				2021f
				4	1	2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.7	0.2	0.3	0.0	0.1	0.3	0.3	0.2	0.3	0.3	0.4	0.5	0.5
- q/q change				0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.2	0.1	0.1
Private consumption	0.8	0.6	0.6	0.0	0.1	0.4	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Fixed investment	3.0	2.5	0.8	2.4	0.2	-0.2	0.5	0.1	0.2	0.3	0.4	0.2	0.2
Government consumption	0.4	0.5	0.2	0.4	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.1	0.1
Export	1.3	2.1	1.5	-0.4	0.9	-0.1	2.0	-0.4	0.0	0.2	0.4	0.6	0.6
Import	2.4	0.9	2.2	-2.4	1.1	1.3	0.2	0.2	0.5	0.6	0.7	0.5	0.5
Stockbuilding (% contrib. to GDP)	-0.2	-1.1	-0.1	-1.0	0.0	0.3	-0.7	0.1	0.2	0.1	0.1	-0.1	-0.1
Current account (% of GDP)	2.6	2.8	2.7										
Government Balance (% of GDP)	-2.2	-2.2	-2.3										
Government Debt (% of GDP)	134.8	135.9	136.2										
HICP (y/y)	1.2	0.6	0.7	1.0	0.9	0.3	0.3	0.5	0.5	0.8	1.1	1.2	1.3
Industrial production (y/y)	0.5	-1.1	-0.3	-0.7	-1.2	-1.5	-1.0	-1.6	-0.5	0.3	0.7	0.9	1.2
Unemployment (%)	10.6	10.0	10.0	10.3	9.9	9.8	9.8	9.9	9.9	10.0	10.0	10.0	9.9
10-year yield	2.59	1.90	1.30	2.71	2.42	1.32	1.14	1.15	1.23	1.33	1.48	1.58	1.66

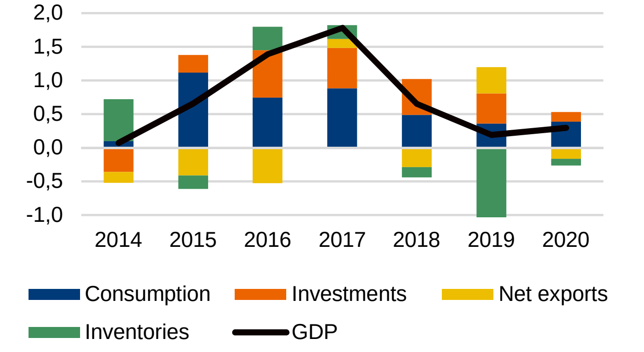
Annual percentage changes on the previous period – unless otherwise indicated. Source: Refinitiv Datastream, Intesa Sanpaolo

Fig. 1 – Italian GDP still lower than pre-crisis levels. Industry and construction hit hardest.



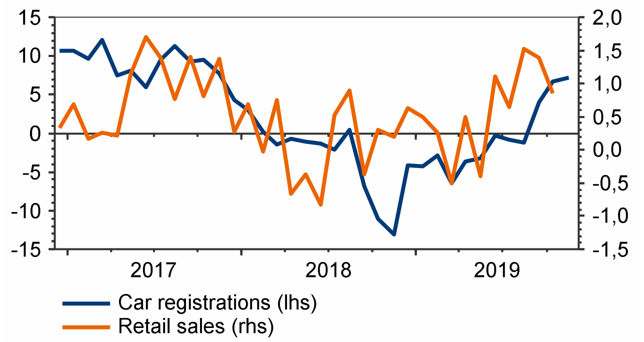
Source: Refinitiv Datastream, Intesa Sanpaolo elaborations

Fig. 2 – In 2020 we expect GDP to accelerate moderately, mostly thanks to the removal of the drag from inventories



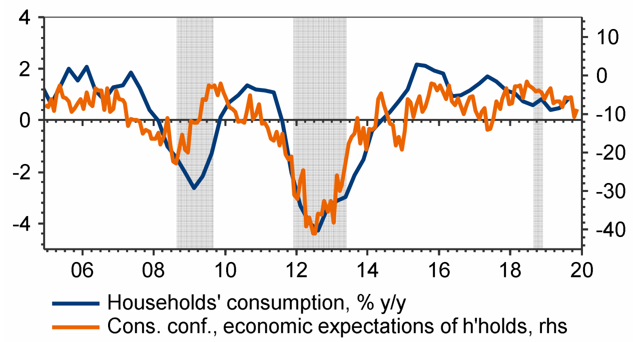
Source: Istat, Intesa Sanpaolo forecasts and elaborations

Fig. 3 – In the past few months the consumption trend has shown signs of reaccelerating…



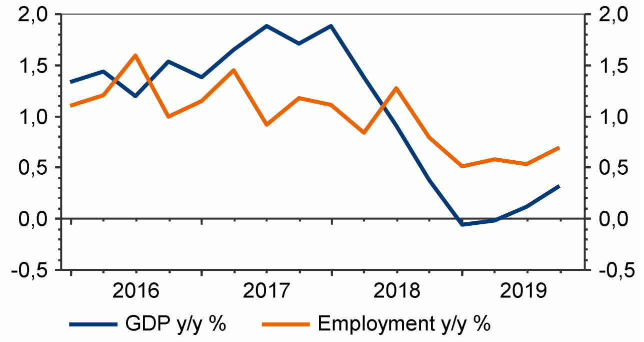
Source: Refinitiv Datastream, Intesa Sanpaolo elaborations

Fig. 4 – …although consumer spending could lose some steam in the near term, on weakening households' confidence



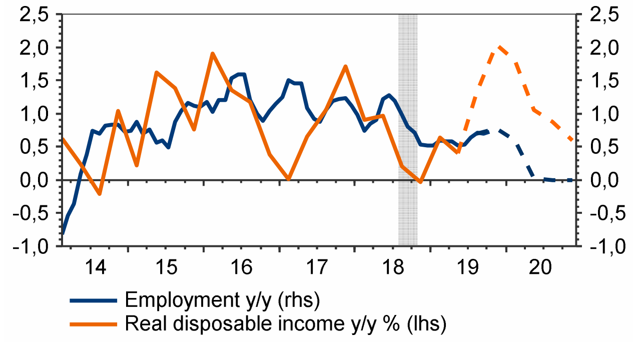
Source: Refinitiv Datastream, Intesa Sanpaolo elaborations

Fig. 5 – Employment growth still outpacing GDP



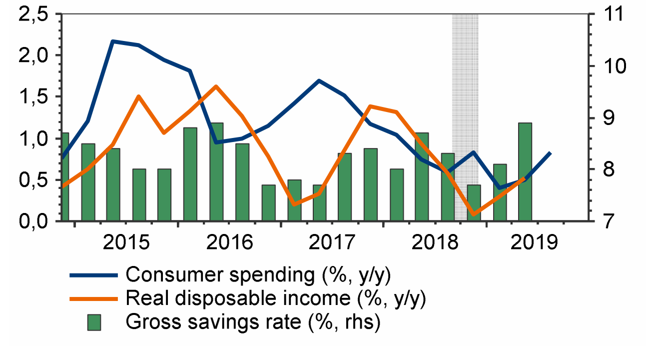
Source: Refinitiv Datastream, Intesa Sanpaolo elaborations

Fig. 6 – However, the trends of jobs and disposable income are expected to slow in 2020



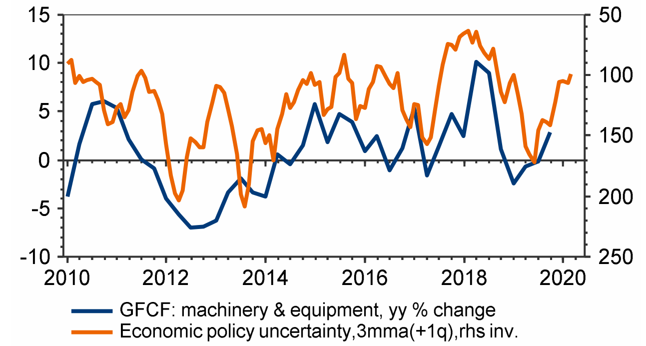
Source: Refinitiv Datastream, Intesa Sanpaolo forecasts and elaborations

Fig. 7 – Households experiencing resilient disposable income, but propensity to save is on the rise



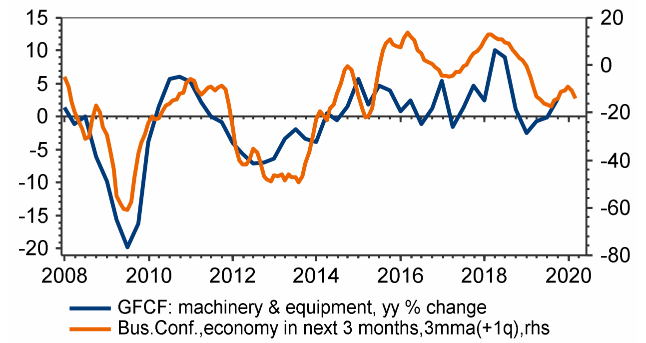
Source: Refinitiv Datastream, Intesa Sanpaolo elaborations

Fig. 8 – Investment could benefit from easing policy uncertainty (but only in a context of political stability)



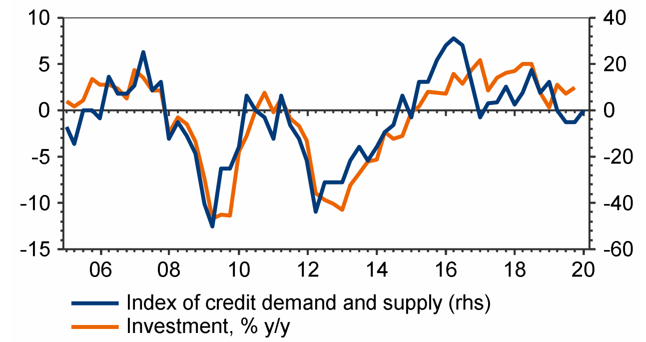
Source: Refinitiv Datastream, www.PolicyUncertainty.com (Scott Baker, Nicholas Bloom and Steven J. Davis), Intesa Sanpaolo elaborations

Fig. 9 – Business expectations on final demand have stopped deteriorating, but are still failing to show a significant recovery



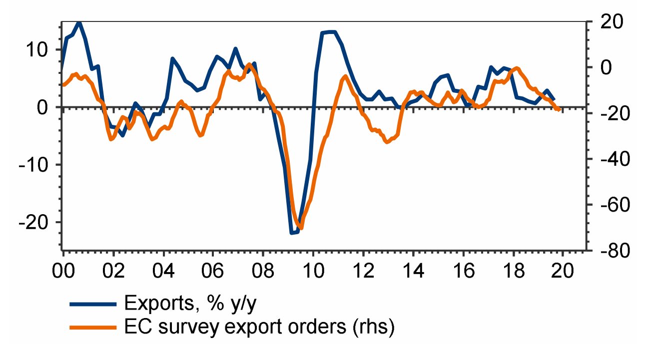
Source: Refinitiv Datastream, Intesa Sanpaolo elaborations

Fig. 10 – However, signals from the credit front (on both the demand and supply side) are not encouraging



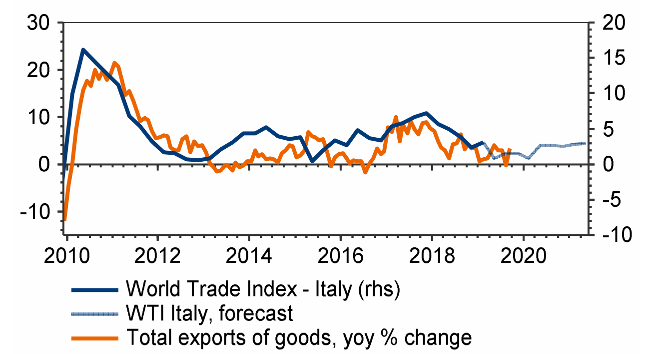
Source: Refinitiv Datastream, ECB BLS, Intesa Sanpaolo elaborations

Fig. 11 – Survey data are still outlining weak exports



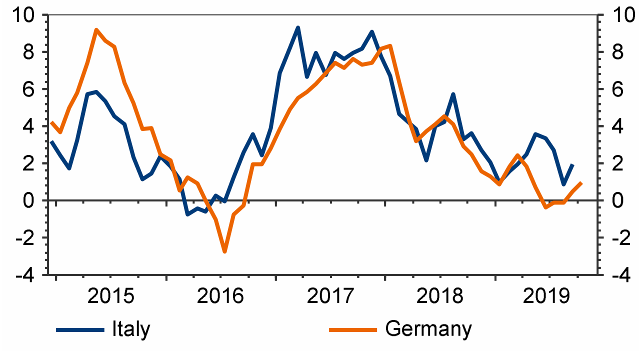
Source: Refinitiv Datastream, Intesa Sanpaolo elaborations

Fig. 12 – Global demand addressed to Italy should improve slightly on the foreseeable horizon



Source: Refinitiv Datastream, OEF, Intesa Sanpaolo forecasts and elaborations

Fig. 13 – In the recent period, Italian exports have outperformed Germany's (y/y % chg.)



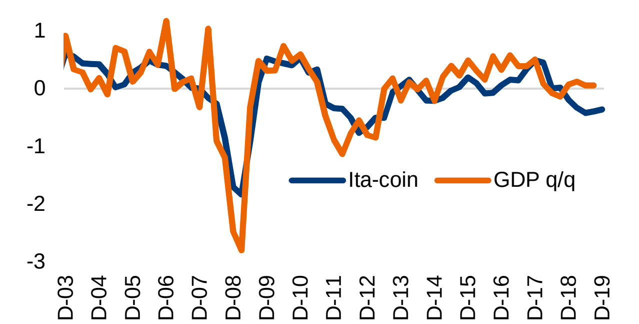
Source: Refinitiv Datastream, Intesa Sanpaolo elaborations

Tab. 1 – Growth adjusted by calendar and carry-over effects is forecast in 2020-21 at similar levels as in 2019

	2017	2018	2019	2020	2021
GDP growth (wda)	1.8	0.7	0.2	0.3	0.5
Calendar effect	-0.1	0.1	0.0	0.1	0.0
GDP growth (not wda)	1.7	0.8	0.2	0.4	0.5
Carry over effect (wda)	0.6	0.7	0.0	0.1	0.2
Growth "within the year" (wda)	1.2	0.0	0.2	0.2	0.3

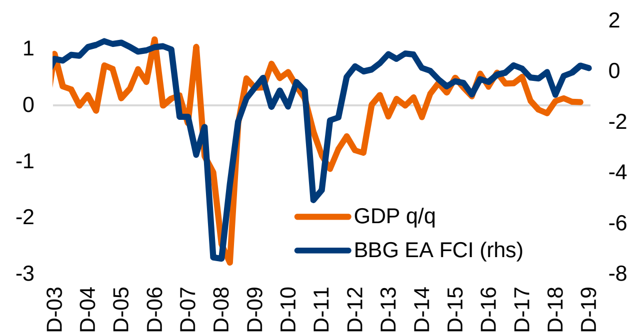
Source: Intesa Sanpaolo forecasts and elaborations

Fig. 14 – Forward-looking indicators not encouraging in the near term



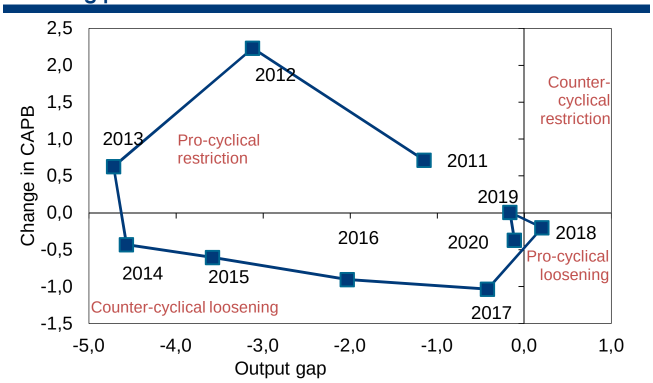
Source: Bank of Italy, Istat, Intesa Sanpaolo elaborations

Fig. 15 – But the improvement of financial conditions bodes well



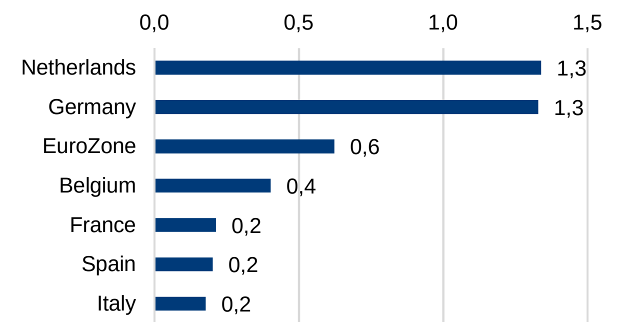
Note: Bloomberg index of financial conditions in the euro area. Source: Bloomberg, Istat, Intesa Sanpaolo elaborations

Fig. 16 – Fiscal policy is experiencing a moderate counter-cyclical loosening phase



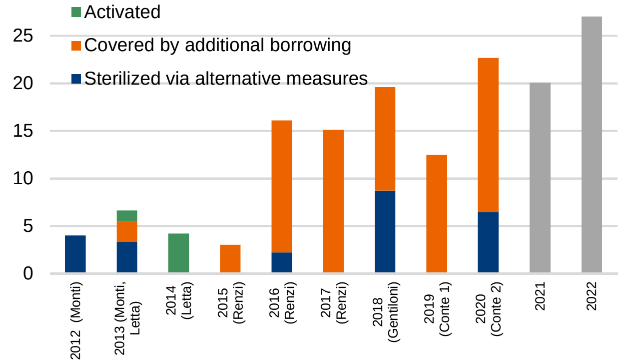
Note: CAPB= cyclically-adjusted primary balance (change). Source: Eurostat, Intesa Sanpaolo elaborations

Fig. 17 – Cumulated effect on GDP after 2 years of full use of "fiscal space" (gap vs MTO) by Germany and the Netherlands



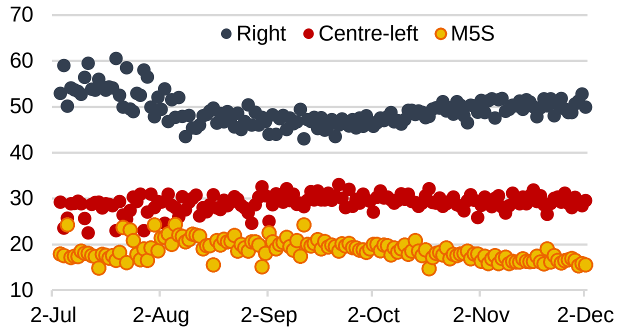
Source: Intesa Sanpaolo elaborations on OEF model and Eurostat data

Fig. 18 – The Budget Laws for 2021 and 2022 will face safeguard clauses of similar worth to those deactivated in the 2020 budget



Source: Intesa Sanpaolo elaborations on MEF data

Fig. 19 – Right-wing coalition clearly in the lead, based on voting intention polls



Source: Intesa Sanpaolo elaborations on Euromedia, EMG, SWG, Ixè, Piepoli, Tecné, IPR, Ipsos, Demopolis, Datamedia data (avg. of past 3 polls)

Spain: growth slows despite being driven by domestic demand

Aniello Dell'Anno

Spanish GDP growth is down in 2019, albeit higher than the Euro zone average. Domestic demand strengthened in 3Q, while net exports declined. Growth in 2020 is expected to be lower than estimates made in the summer. The greatest risk remains political instability.

Data for 3Q showed a **slowdown in economic growth** in Spain, in line with general trends in the Euro zone. The economic surveys and initial data on industrial output seem to be forecasting a GDP growth rate in 4Q19 of around 0.4% qoq. This is in line with growth in 2Q and 3Q, which were both weaker than expected (see Figs. 1 and 2). Growth was also below expectations in 3Q, driven only by domestic demand, with increases in private consumption (+1.1% qoq), investments (+1.3% qoq) and public spending (+0.9% qoq). On the investment front, 3Q expenditure on plant and machinery increased (+7.1% qoq) and construction decreased (-2.6% qoq). These figures appear to run counter to the Commission's autumn forecast. The second quarter had suggested an increase in precautionary savings driven by strong uncertainty and weak domestic demand, with private consumption stagnating, investment falling and a general backdrop of growth in GDP, employment and real wages (Fig. 9). However, 3Q data on domestic demand growth seem to rule out excessive precautionary savings.

Spain faces **uncertain export prospects** (Fig. 3), with net exports falling -0.7% qoq as a percentage of GDP. Companies are reporting that **foreign orders remain weak**. We expect a slight recovery in 4Q, with a positive although marginal contribution to growth in 2019. We expect the same for 2020, despite Spain outperforming average Euro zone growth.

2019 could close with GDP growth around 2.0%. This is below expectations at the beginning of the year but consistent with the European Commission's autumn economic forecasts, which downgrade this year's growth to 1.9% (0.4 pp below its summer estimate). **The downgrade also extends to 2020, with growth expected to fall to 1.6%**, 0.1 pp above the Commission's autumn forecast.

The inflation trend remains low, as shown by November's preliminary data. The Consumer Price Index (CPI) rose slightly in November to 0.2% mom and 0.4% yoy, whereas the harmonised index (HCPI) was stable mom and grew by 0.5% yoy. **We expect inflation to remain very low in 2020, too**, although higher than the recent lows.

The Spanish political situation is at a standstill and characterised by great uncertainty. The elections on 10 November confirmed Pedro Sánchez' PSOE (Socialist Workers' Party) as the leading party (120 seats out of 350), but this is way off the 176 seats needed to form a government. A left-wing alliance is the only way forward since there is no chance of building a "German-style" coalition between the PSOE and the PP (People's Party). **A coalition government of the PSOE, UP ("United We Can") and ERC (left-wing Catalan separatists) remains, therefore, the only possibility**. The Catalan question, despite the PSOE leader's openness, has a significant bearing on national political stability, and any agreement with the separatists, apart from the risk of triggering a domino effect, would appear to be a short-term solution. That is why the political crisis Spain has been going through for years seems to be continuing, with instability threatening to harm the real economy. Political uncertainty and Catalan secessionist pressures, combined with high external uncertainty, could curb business investment.

Political fragmentation and a government restricted to ordinary business are the causes of the **sluggish fiscal scenario**. The only measures planned for 2020 are those already scheduled in the previous Sánchez government: increased public sector wages, increased pensions and a cut in current expenditure based on the spending review recommendations of the AIReF (Independent Authority for Spanish Fiscal Responsibility). According to the Commission's autumn forecast, **the deficit is set to fall slightly in 2020** to EUR 28.3Bn (around 2.2% of GDP) from an estimated EUR 29Bn in 2019 (around 2.3% of GDP). These data, as highlighted by the Commission, show that fairly marginal progress has been made with regard to the fiscal adjustments contained in the recommendations of 9 July 2019. Despite this, the measures taken by the European Central Bank (ECB), resulting in lower borrowing costs, and the modest growth rate in nominal GDP have improved the sustainability of Spanish debt. The public debt/GDP ratio continues to fall (a trend that began in 2015), albeit much more slowly, and is predicted to be 96.6% in 2020 (Fig. 4), compared with around 96.7% in 2019.

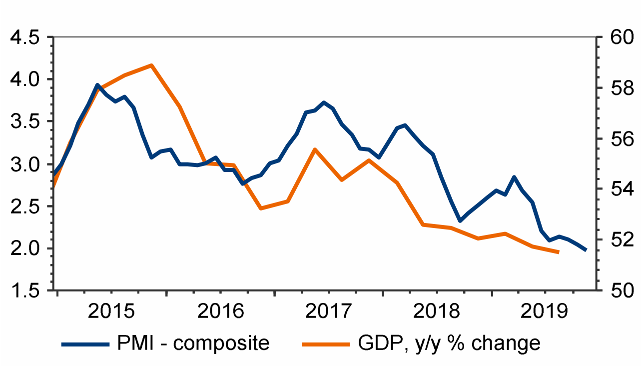
The current account on the balance of payments remains in positive territory. The September figure shows a current account surplus of EUR 741M, down on the previous months. The European Commission's estimates show 2019 closing with a current account surplus of around EUR 29.8Bn, and suggest a positive trend for 2020 as well, with an expected surplus of EUR 32.1Bn. This will enable Spain to continue rebalancing its net international investment position, which remains one of the country's structural weaknesses, along with high levels of private sector debt (although this has fallen markedly in the last few years).

Forecast Table

	2018	2019f	2020f	2019				2020f				2021f	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	2.4	2.0	1.6	2.2	2.0	2.0	1.8	1.6	1.6	1.6	1.5	1.6	1.6
- q/q change				0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Private consumption	1.8	1.2	1.7	0.2	0.0	1.1	0.4	0.3	0.3	0.4	0.4	0.3	0.3
Fixed investment	5.3	2.6	1.8	1.4	-0.2	1.3	0.0	0.7	0.3	0.5	0.3	0.7	0.3
Government consumption	1.9	2.2	0.8	0.5	0.4	0.9	0.2	0.1	0.0	0.0	0.1	0.1	0.0
Export	2.2	1.7	2.1	0.6	1.7	-0.8	0.5	0.5	0.8	1.0	0.3	0.5	0.8
Import	3.3	0.7	2.5	0.1	0.9	1.3	-0.2	0.5	0.9	0.8	0.6	0.2	0.8
Stockbuilding (% contrib. to GDP)	0.1	0.0	0.2	-0.1	0.0	0.1	-0.1	0.0	0.2	0.0	0.2	0.0	0.1
Current account (% of GDP)	2.1	2.4	2.5										
Government Balance (% of GDP)	-2.5	-2.3	-2.2										
Government Debt (% of GDP)	97.6	96.7	96.6										
HICP (y/y)	1.7	0.8	0.8	1.1	1.1	0.4	0.5	0.7	0.8	0.8	0.9	0.9	0.9
Unemployment (%)	15.3	14.2	13.6	14.4	14.3	14.1	13.9	13.7	13.7	13.6	13.5	13.5	13.4

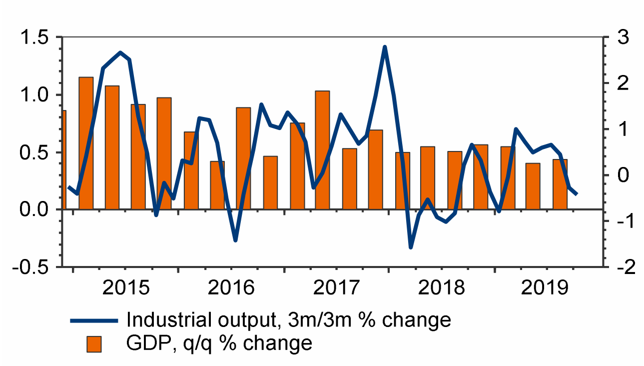
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Refinitiv-Datastream, Intesa Sanpaolo

Fig. 1 – Composite PMI pointing to a slowdown in yoy growth



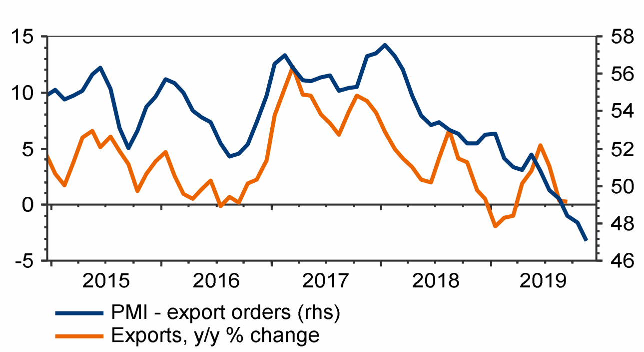
N.B.: quarterly moving average for PMI. Source: Intesa Sanpaolo chart from UHS Markit data

Fig. 2 – Industrial output remains consistent with GDP growth of around 0.4%



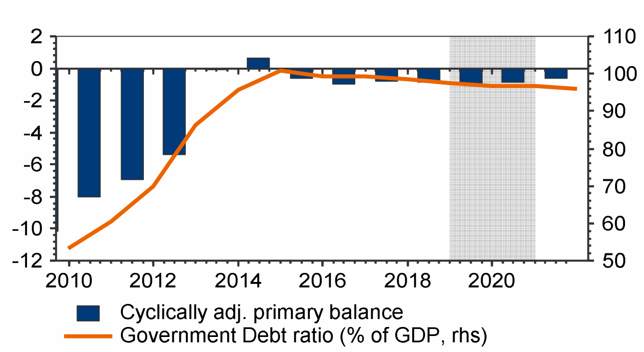
Source: Intesa Sanpaolo chart from Refinitiv Datastream data

Fig. 3 – Exports seem destined to slow again



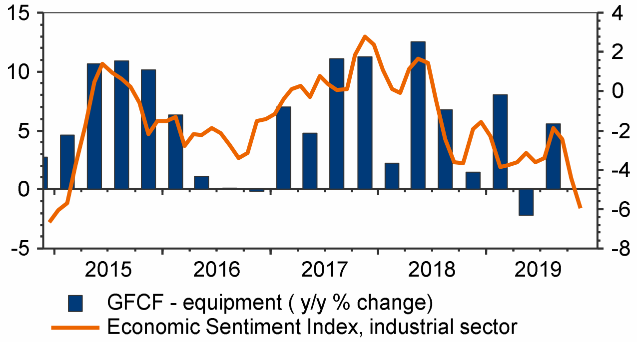
NB: quarterly moving averages.
Source: Intesa Sanpaolo chart from INE and IHS Markit data

Fig. 4 – Public debt falling since 2015. Primary balance slightly negative but stable



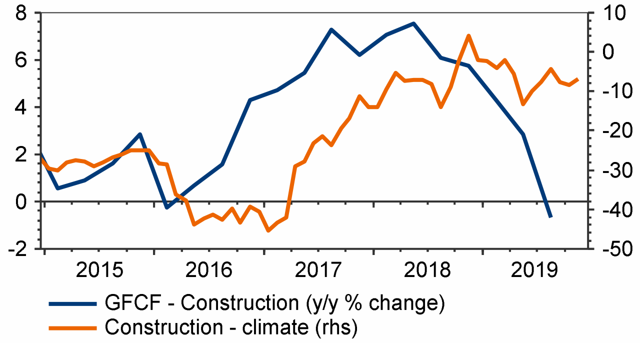
Source: European Commission, AMECO

Fig. 5 – Investment has now peaked but sustained growth phase may continue



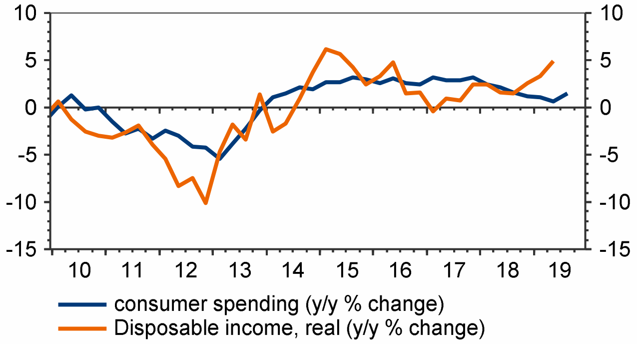
Source: Intesa Sanpaolo chart from Refinitiv Datastream data

Fig. 6 – Construction: spending down from the peaks of 2018



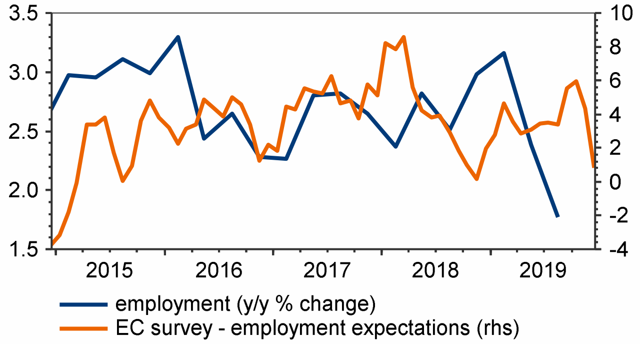
Source: Intesa Sanpaolo chart from Refinitiv Datastream data

Fig. 7 – Consumption increasing



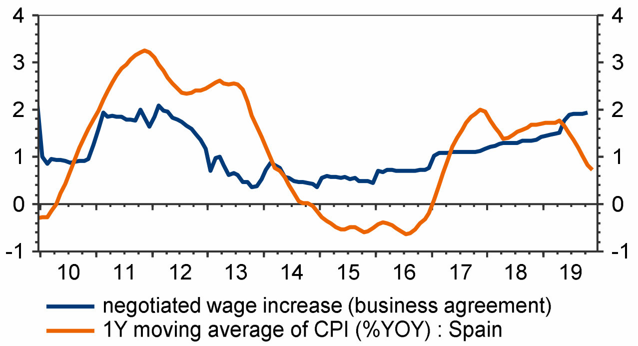
Source: Intesa Sanpaolo chart from INE data

Fig. 8 – Labour dynamics slowing



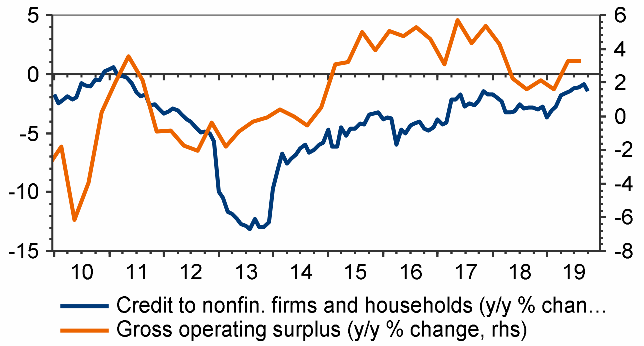
Source: Intesa Sanpaolo chart from INE and European Commission data

Fig. 9 – Wages growing faster than inflation



Source: Intesa Sanpaolo chart from Refinitiv Datastream data

Fig. 10 – Loan volume still decreasing. Slight upturn in corporate earnings



Source: Intesa Sanpaolo chart from INE and Bank of Spain data

Netherlands: the strong growth cycle has run of steam

Guido Valerio Ceoloni

The Dutch economy has completed its expansionary, above-potential growth cycle, which has lasted four years; we forecast an annual slowdown in GDP growth of around one percentage point in 2019 and 2020. Domestic demand will still be the driving force behind growth, fuelled by still-buoyant consumer spending and bolstered by one of the strongest labour markets in the eurozone. Foreign trade, however, is suffering from the climate of uncertainty, although exports have remained stronger than expected; even so, the overall contribution to GDP growth will be negative in 2019 and 2020.

All the main economic indicators confirm that the expansionary cycle that started in 2015 has now come to an end. After four years of average growth of 2.5%, the Dutch economy is heading for a slowdown to 1.7% this year and 1.2% next year. In the third quarter, the economy maintained a cruising speed of 0.4% qoq, as in the previous two quarters, bolstered purely by domestic demand, while foreign trade made a negative contribution; growth achieved came to 1.6%. For the current quarter, we forecast a slight slowdown to around 0.3% qoq, with an annual contribution of one-tenth of a percentage point to **GDP**; risks to the forecast are slightly to the upside and the Dutch economy remains one of the healthiest in the eurozone.

Household spending slowed this year and will slow further next year, but the labour market continues to provide solid support

Household spending slowed more than expected in the summer, falling from 0.8% qoq to 0.2% qoq; the figure for the year is expected to be a slowdown from 2.3% last year to around 1.4%. Household confidence, as measured by the European Commission, has deteriorated since the start of the year and is now below the historical average. This leads us to believe that consumer spending will slow further next year to around 1.1-1.2%; this is primarily due to the rising propensity to save of households, which had already started to become evident in the third quarter of this year. The labour market is clearly still a strong element in support of households' purchasing power, with wages rising by around 2.5% this year and the participation rate conclusively at pre-crisis levels: 2019 will close with employment up by over 160,000, and nine million people in jobs (69% of the workforce). **Unemployment** hit an all-time low in March of this year and then started to climb again slightly due to the increase in the participation rate; it is, however, heading for a fall, from 3.8% in 2018 to 3.4% this year. We forecast a return to normal levels of around 3.4-3.5% in 2020.

Activity is starting to be on a more even keel across all sectors: industry, services, construction and trade

Capital investment recorded a blip in the third quarter (from +0.9% qoq to -0.2% qoq); **investment in machinery** also contracted in the quarter (from +2.7% qoq to -2.0% qoq), a sign that companies are starting to postpone new investment given the ongoing climate of uncertainty: on average, the rate has been slowing by around 1% yoy per quarter. For the year as a whole, the investment component will pick up, due to a statistical comparison effect with last year, to 5.1% (albeit lower than the estimate of 5.7% at the start of the year), from 3.2%, but we expect a pronounced slowdown to around 1.4% in 2020. The ESI economic confidence index is still in line with the historical average but has visibly decreased this year compared with 2018 (to an average of 103 from 110). Confidence is also returning to normal levels compared with last year in the services, construction and retail sectors. The overall picture is therefore consistent with a return to normal levels of activity in all manufacturing sectors in 2019 and 2020.

Net exports will make a negative contribution to growth in 2019 and 2020

Foreign trade was stagnant this year, with zero contribution to growth. In the last quarter, **exports** maintained a rate of growth of 1.1% qoq, similar to the previous quarter; overall; they have proved more resilient during the year than initially anticipated. However, import growth, which also rose from 1.0% qoq to 1.2% qoq, effectively wiped out the net balance in 2019. The annual average for exports will slow from 3.7% to around 2.3%, while in 2020, we forecast a further marginal slowdown to just below 2%, according to the confidence surveys of export companies and the expectations of foreign orders for industry. **Imports** have remained healthy this year (3.1%) and will be slightly less so next year (2.5%), but we believe they will be bolstered by domestic consumer spending. The net contribution, therefore, will be negative by over half a percentage point of GDP this year; we forecast that this will stay the same next year too. The current account balance is therefore expected to contract more than expected, as early as this year, from 10.8% in 2018 to 7.6%, before climbing back above 8% next year.

Inflation slowing next year from 2.7% to 2.3%

Inflation remains firmly above 2%, one of the highest rates in the eurozone (which is at around 1.2% on average), due not least to higher energy duties and VAT. The Harmonised Index of Consumer Prices (HCIP) stood at 2.6% in November, from which we forecast an annual average of 2.6%, up from 1.6% last year. For 2020, the HCPI looks set to slow to 2.3% due to an unfavourable statistical effect. The *core* index is also stable at 2.7%, resulting in an annual average at 2.2% this year and 1.8% in 2020.

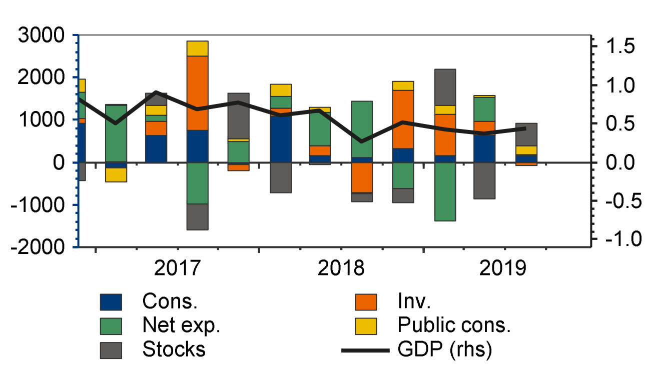
Lastly, **fiscal policy** once again this year does not give any cause for concern. The headline budget balance is expected to fall from 1.5% this year to around 0.5% next year, before stabilising in 2021. In 2020, the Government will introduce an expansionary fiscal measure aimed at shoring up household spending through incentives for the construction and green sectors, as well as higher public spending on defence and infrastructure. The structural budget surplus will trend towards zero in 2020-2021, compared with the figure of +0.7% estimated for 2019. Public debt continues its downward path, for the sixth year running, to 49% this year (47% in 2020 and 45.5% in 2021).

Forecast Table

	2018	2019f	2020f	2019				2020f				2021f	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	2.5	1.7	1.2	1.9	1.6	1.8	1.5	1.3	1.2	1.1	1.2	1.3	1.4
- q/q change				0.4	0.4	0.4	0.2	0.3	0.3	0.3	0.3	0.4	0.4
Private consumption	2.3	1.4	1.3	0.2	0.8	0.2	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Fixed investment	3.2	5.1	1.4	2.5	0.9	-0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Government consumption	1.6	1.3	1.1	0.5	0.1	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Export	3.7	2.3	2.1	0.6	1.2	1.1	0.2	0.3	0.5	0.6	0.5	0.5	0.4
Import	3.2	3.1	2.4	1.7	1.0	1.2	0.4	0.4	0.6	0.6	0.5	0.6	0.6
Stockbuilding (% contrib. to GDP)	-0.2	0.1	0.1	0.5	-0.5	0.3	0.0	0.1	0.0	0.0	0.0	0.1	0.2
Current account (% of GDP)	10.8	9.6	8.9										
Government Balance (% of GDP)	1.4	1.3	0.2										
Government Debt (% of GDP)	52.4	48.9	47.1										
CPI (y/y)	1.6	2.6	2.0	2.5	2.7	2.8	2.6	1.9	1.9	1.7	2.4	2.2	1.7

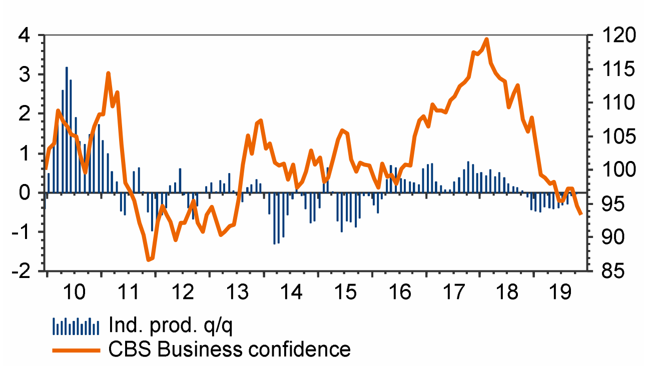
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Refinitiv-Datastream, Intesa Sanpaolo

Fig. 1 – Contribution to GDP



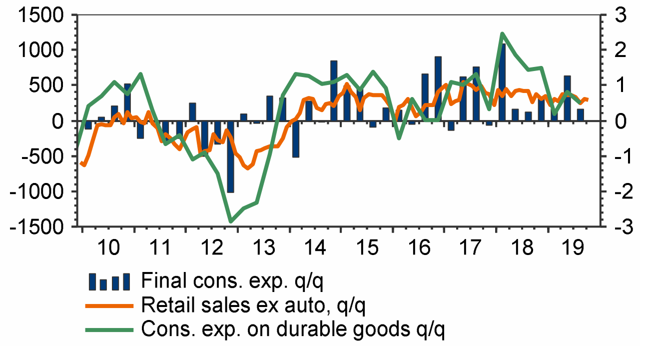
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 2 – Economic confidence and industrial production



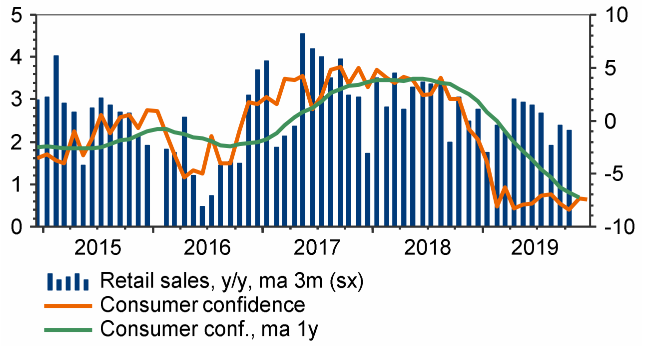
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 3 – Household spending, purchases of durable goods and consumer spending



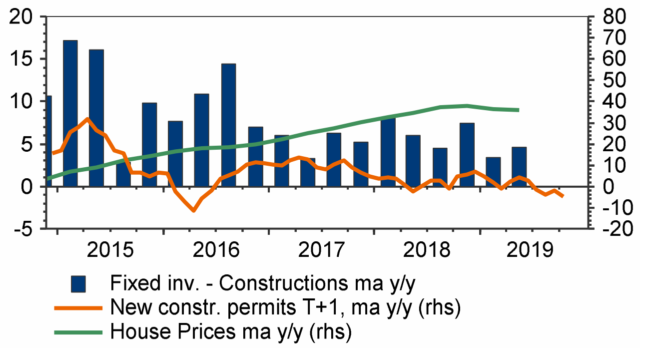
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 4 – Retail sales and household confidence



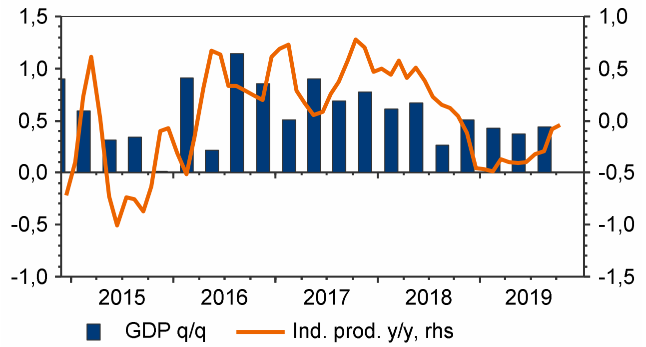
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 5 – Residential investment, construction sector activity and house prices



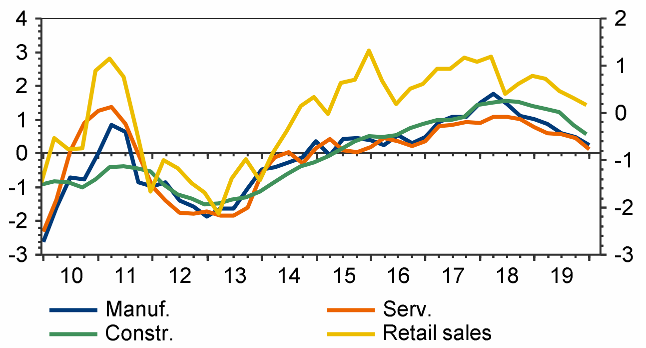
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 6 – Industrial output and GDP



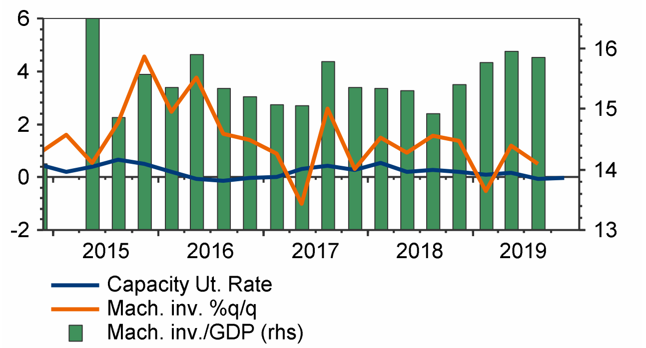
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 7 – Activity indices in the various manufacturing sectors



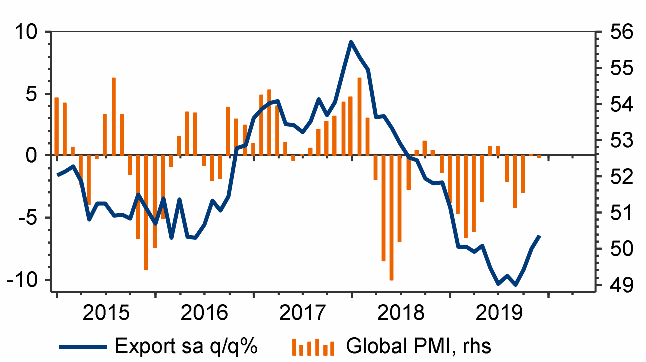
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 8 – Production capacity utilisation and level of investment as a proportion of GDP



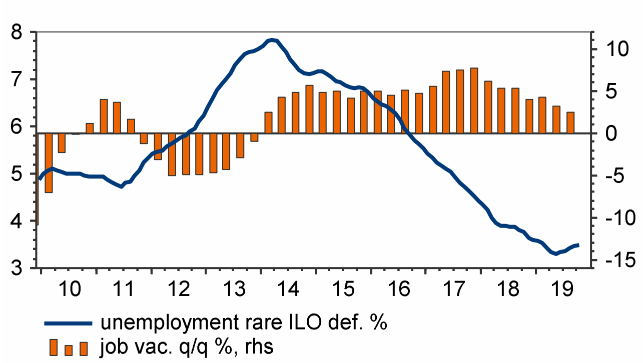
Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 9 – Exports, export orders and global PMI



Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Fig. 10 – Unemployment and job vacancies



Source: Intesa Sanpaolo Research Department chart from Refinitiv-Datastream data

Asia

Japan: 2020 - a transition year

Giovanna Mossetti

The year 2020 will be affected by the consumption tax hike implemented in October 2019, resulting in a weak start and a gradual recovery during the rest of the year. Growth should be driven by investment, both public and private, also supported by the fiscal stimulus to be introduced by the expected supplementary budget. Inflation will remain well short of 2%, although we do not expect any action from the BoJ. Counter-cyclical policy now rests fully with fiscal authorities.

Japan's economic outlook in 2019-20 will feel the impact of the hike from 8% to 10% of the consumption tax (CT), which was implemented in October. The contraction in GDP forecast for Q4 following a strong Q3 is expected to take **growth at end-2019 to 1%**. The weak opening to the year, due to the fiscal tightening, means that the yearly growth in **2020 will slow to 0.3%**. The preliminary signs of global demand stabilising, the boost in spending for the Olympics and the support from fiscal policy suggest that growth will accelerate again from mid-2020.

Despite the implementation of expansionary measures aimed at mitigating the impact of the consumption tax hike on household spending and the likely introduction of a supplementary budget in early 2020, the **composition of growth next year could shift more towards investment and foreign trade than in 2019**. There are mounting signs that the global slowdown is coming to a halt and that global growth could recover in 2020, generating a moderate uptick in manufacturing and foreign trade. Inflation should remain way off 2%, leaving **monetary policy** in its current accommodative stance: the Bank of Japan (BoJ) has little room for manoeuvre, which is limited to forward guidance and, potentially, additional cuts of short-term rates into more negative territory. **Fiscal policy**, on the other hand, will be active in 2020, with short-term expansive measures aimed at countering the brake applied by the consumption tax hike and a likely supplementary budget. The consolidation in public spending is set to continue gradually, supported in part by the containment of interest costs.

Growth: post-consumption tax hike adjustment and rotation of demand components. Both 2019 and 2020 are influenced by the consumption tax hike from 8% to 10% and by the fiscal measures implemented to mitigate the impact of fiscal tightening. This time around, compared with previous consumption tax hikes, the scope of fiscal tightening is more limited (exemption of some spending components, change more limited) and mitigated by direct expansionary measures for households. Q3 GDP grew by only 0.2% qoq, with domestic demand up 0.3% qoq and the Q4 forecast contracting by -0.9% qoq. In 2020, quarterly growth is expected to normalise, thanks to fiscal support measures that are focused in particular on households.

Consumption in the three quarters preceding the consumption tax hike increased more moderately than with the previous hike (2013-14), partly due to the composition of the tax package, which includes direct support to families (elimination of school fees, bonuses for digital payments, support for pensions, bonuses for car purchases in 2020). This is why the forecast for consumption at the end of 2019 and in 2020 is less volatile than in 2014. The labour market remains at full employment, with the lowest unemployment rate since 1993. Wage growth is not accelerating, partly due to growing participation by women and people over 65, as well as openness to more immigration. Forecasts remain moderately positive, with **consumption set to fall by -0.2% in 2020 and grow by 0.8% in 2021**.

Q4 **non-residential private investment** was affected by two negatives – typhoon Hagibis in October and the consumption tax hike. Industrial output, which fell by -4.2% mom in October, is expected to shed around -4% qoq in the autumn, before gradually recovering from early 2020. The expected stabilisation of the trade war, together with the consequent resumption of international trade flows in 2020 and activity related to the Olympics and fiscal stimulus, will help support investment, which is **set to grow by 2.3% in 2020 and 1.4% in 2021. Foreign trade** should become a progressively less negative factor in the coming year (Figs. 5 and 6), thanks to the expected improvement in China's economy.

Inflation remains well below 2%, even including the impact of the tax hike. Compared to previous indirect tax hikes, the impact of the tax is limited by countermeasures (reduction in school fees and lower taxes on digital payments) and should be between 0.1 and 0.2 pp. **The inflation forecast for 2020, net of fresh food and taxes, is around 0.7%**.

Fiscal policy lies at the heart of the forecasts for 2020. The 2019 fiscal package produces tightening of approx. JPY 2.2 trillion (0.4% of GDP), which is about a quarter of that applied in 2014 and includes direct support to households to offset the initial effects of the consumption tax hike. In light of the weak autumn data and natural disasters, the Government announced a **fiscal package of 13.2 tln yen, which could contribute app. 0.2-0.3 pp to 2020-21 growth**. Next year's spending will be financed by a supplementary budget of 4.3 tln yen, to be implemented between mid-22020 and mid-2021. The two typhoons that hit the country in H2 caused damage to infrastructure estimated at JPY 1.5 trillion and will require approx. JPY 1.3 trillion in new funds. On top of this, new funding is expected for new infrastructure spending (about 1.5 trillion), subsidies to farmers, additional incentives for digital payments by consumers. The Government maintains its ambitious targets for consolidating public finances (Fig. 10). The path towards lower deficits and debt/GDP will be aided in part by lower interest costs, but is likely to require further rationalisation on both the revenue and expenditure sides.

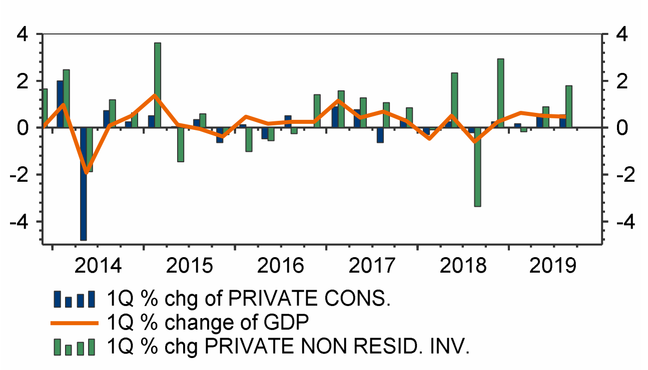
Monetary policy has stalled. The inflation target remains unachievable, and the tools available to the BoJ are now blunted. At its October meeting, the central bank strengthened and expanded its **forward guidance, extending it temporally** (now on an indefinite horizon) **and substantially**, indicating rates at current or lower levels until necessary. The new forward guidance explicitly signals the **commitment to cut interest rates without hesitation in case of need**: according to Kuroda, the BoJ has room to deepen negative rates more than other central banks. However, the minor impact of lower rates suggests that unless international risks start seriously deteriorating again**, the BoJ will maintain the current level of interest rates throughout 2020**.

Forecast Table

	2018	2019f	2020f	2019				2020f				2021f	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	0.3	1.0	0.3	0.8	0.8	1.9	0.6	0.2	0.0	-0.2	1.0	0.9	0.8
q/q annual rate				2.6	2.1	1.8	-4.0	1.3	1.1	1.0	0.7	0.8	0.8
Private consumption	0.0	0.5	-0.2	0.6	2.4	2.2	-7.2	1.6	1.2	1.0	0.7	0.7	0.7
FI - private nonresidential	2.2	2.3	1.4	-0.6	3.5	7.3	-1.6	0.3	1.5	1.5	1.5	1.8	1.8
FI - private residential	-6.7	2.5	-2.4	4.6	2.1	6.5	-6.2	-7.3	-1.5	-0.1	0.0	0.3	0.5
Government investment	0.3	2.5	1.6	8.1	6.7	3.7	1.1	0.9	0.7	0.7	0.6	0.4	0.3
Government consumption	0.9	1.8	1.0	-1.1	6.4	2.7	-1.0	0.7	1.2	0.5	0.5	0.5	0.5
Export	3.4	-1.9	1.0	-8.0	2.0	-2.5	0.0	1.8	1.8	1.8	1.8	3.0	3.0
Import	3.3	-0.6	0.3	-15.4	8.8	1.3	-8.1	1.6	2.1	2.4	2.4	2.8	2.8
Stockbuilding (% contrib. to GDP)	0.0	0.0	-0.2	0.5	-0.3	-0.8	-0.8	0.3	0.0	0.2	0.1	-0.1	-0.1
Current account (% of GDP)	3.5	3.5	3.3										
Government Balance (% of GDP)	-2.4	-2.7	-3.2										
Government Debt (% of GDP)	224.0	224.8	226.2										
CPI (y/y)	1.0	0.4	-0.1	0.3	0.8	0.3	0.3	-0.2	-0.2	-0.2	0.4	0.4	0.4
Industrial production	1.0	-2.3	-1.7	-1.1	-1.2	-1.1	-5.8	-2.8	-3.0	-2.3	1.5	1.1	0.9
Unemployment (%)	2.4	2.4	2.4	2.4	2.4	2.3	2.4	2.4	2.4	2.4	2.4	2.4	2.4
JPY/USD	110.4	109.0	110.9	110.1	110.0	107.3	108.8	109.7	110.7	111.4	111.9	112.4	112.9

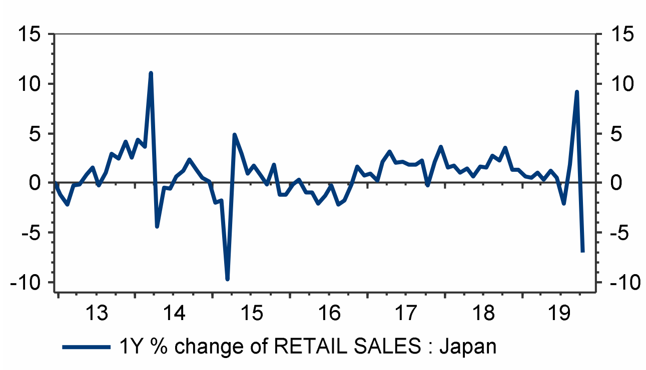
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Refinitiv-Datastream, Intesa Sanpaolo

Fig. 1 – Volatility of consumption and investment in response to the consumption tax hike more limited than in 2014



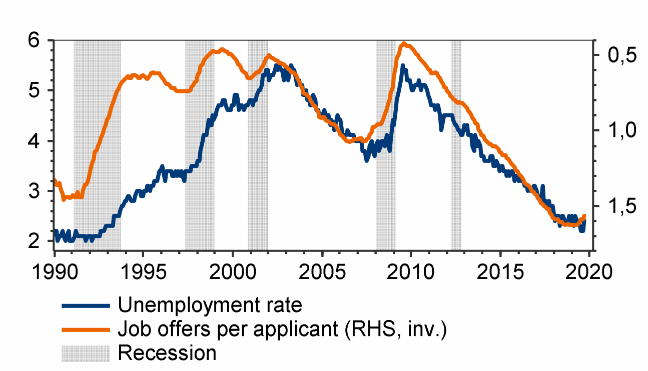
Source: Refinitiv Datastream

Fig. 2 – Volatility of retail sales after the consumption tax hike, amplified by the typhoon in October



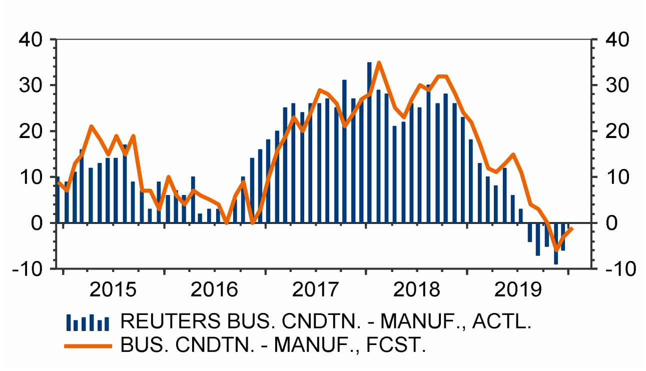
Source: Refinitiv Datastream

Fig. 3 – The labour market is still at full employment



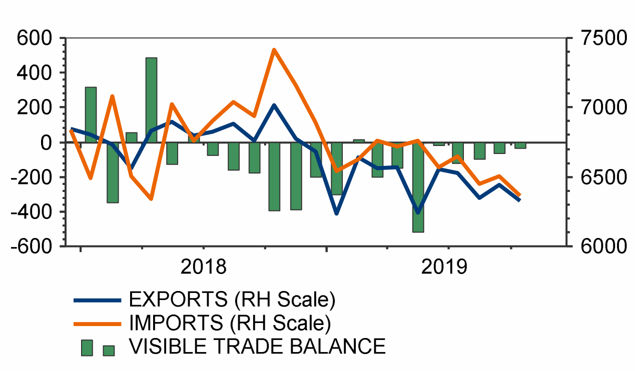
Source: Refinitiv Datastream

Fig. 4 – Recession in manufacturing may have bottomed out



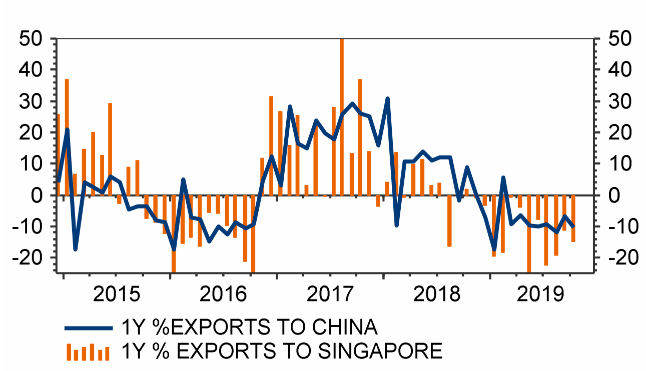
Source: Refinitiv Datastream

Fig. 5 – Foreign trade: balance less negative due to the decline in imports ...



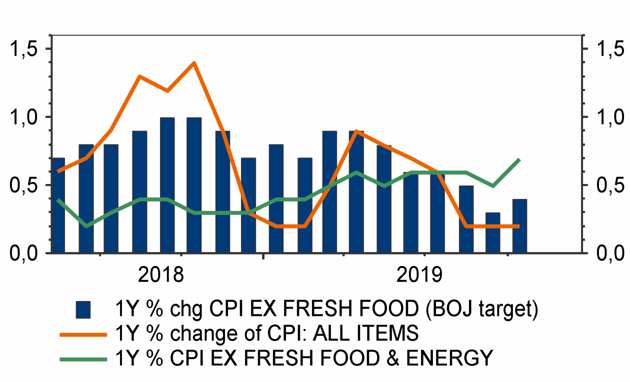
Source: Refinitiv Datastream

Fig. 6 – ... with exports still weak, especially to China and the rest of Asia



Source: Refinitiv Datastream

Fig. 7 – Inflation showed a modest increase in October, due to the consumption tax hike, which has contributed 0.2 pp



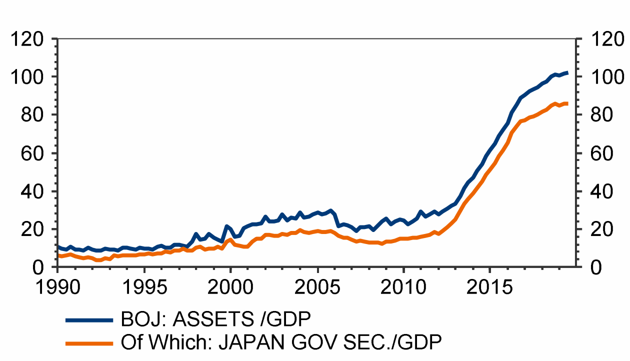
Fonte: Refinitiv Datastream

Tab. 1 – The BoJ continues to downgrade its forecasts, but has no room for manoeuvre, apart from forward guidance

	Real GDP	CPI less fresh food	CPI less fresh food excluding the effects of the consumption tax hike and policies on free education
FY 2019 (July 2019)	**0.6**	**0.7**	**0.5**
forecasts July 2019	0.7	1.0	0.8
FY 2020 (July 2019)	**0.7**	**1.1**	**1.0**
forecasts July 2019	0.9	1.4	1.3
FY 2021 (July 2019)	**1.0**	**1.5**	
forecasts July 2019	1.1	1.6	

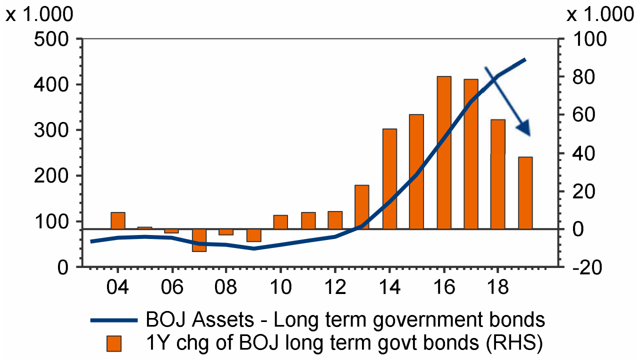
Source: BoJ, Outlook for Economic Activity and Prices, October 2019. The BOJ estimates that the effect of increasing consumption tax is equal to a rise of approximately 0.5 pp in core inflation in 2019 and 2020 and that the abolition of school fees will reduce inflation by -0.3pp in fiscal 2019 and by -0.4pp in fiscal 2020

Fig. 8 – BoJ's assets have exceeded 100% of GDP, and its Japanese Government Bond (JGB) holding is over 80% of GDP



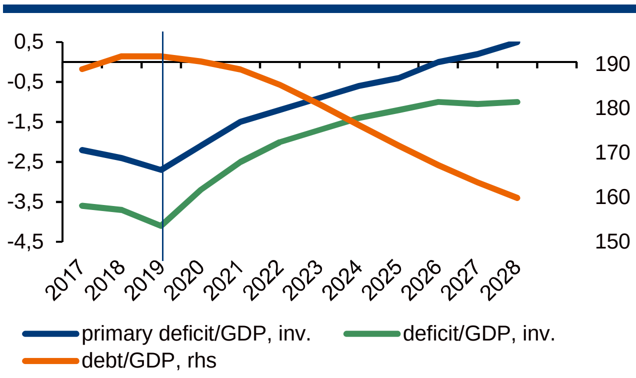
Source: Refinitiv Datastream

Fig. 9 – Annual purchases of JGBs are in continuous decline compared to the target of "about JPY 80 trillion"



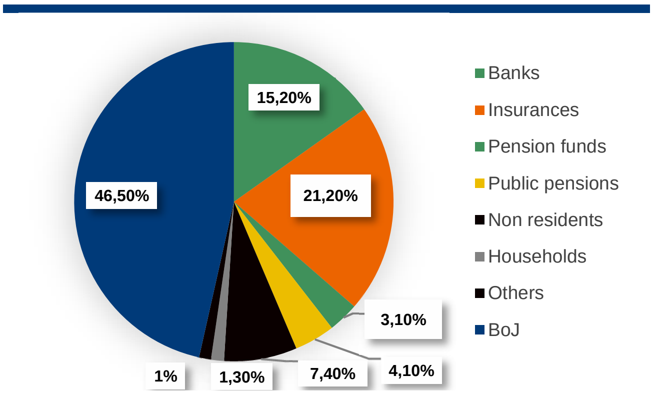
N.B.: Figures in JPY bn. Source: Refinitiv Datastream

Fig. 10 – Fiscal policy targets for sustaining the public finance framework remain ambitious



Source: Cabinet Office. Cabinet Office forecasts to the right of the vertical line

Fig. 11 – JGBs held by the BoJ are 46.5% of the total in circulation



N.B.: Figures at end-June 2019; total JGBs: JPY 1,041 trillion. N.B.: Total JGBs+T-bills = JPY 1,136.9 trillion. Non-residents hold 71.6% of T-bills. Average life of debt is 9 years and 1 month. Source: Ministry of Finance

China: the control of financial risks will guide economic policy

Silvia Guizzo

The control of financial risks will continue to be the primary focus for the Chinese authorities in 2020, limiting the degree to which fiscal and monetary policy is loosened and pushing economic growth below 6%. Inflation will still be high (3.3% in 2020) because of a continued sharp rise in food prices at the turn of the year.

GDP growth was at 6% yoy in the third quarter of 2019, in gradual slowdown compared with 6.4% in the first quarter of the year, with a sharp downturn in both the farming and manufacturing (from 5.5% yoy in the second quarter to 4.8% yoy) sectors. By contrast, the services sector saw growth accelerate to 7.2% yoy, following two quarters of stability at 7%. The data for September and October continued to point to a slowing of consumption and investment, however **there were a few positive signs for the 4th quarter** emerging from some data in volumes of industrial production (metals, chemical fibres, plastic, electronic circuits) and imports (industrial metals, agricultural commodities, electronic circuits) and from PMIs, which also climbed in November, notably in the services sector. **We are therefore keeping our 2019 GDP growth forecast unchanged at 6.2%.**

The added value **of industrial production** has moderately improved on average compared with the summer months, driven by renewed acceleration in production by state-owned and foreign businesses. **Capital investment** decelerated once again because of the slowdown in private investment that has persisted since the start of the year. In terms of sectors, investments in infrastructure and manufacturing have shown signs of stabilising compared with the mid-year lows, while real-estate investments continue to soar (10.3% cum. yoy in October) driven by residential construction (+14.6% cum. yoy), albeit at a slightly slower rate.

We expect the growth in **real-estate investments** to continue to slow in 2020. The changes in completed and unfinished projects indicates that the reduction in unsold stock may be close to an end. Property prices have showed signs of easing in the last few months, particularly in the second-tier cities, and the number of cities where prices fell compared with the previous month has increased. There has been a slowdown in short- and long-term household loans, and the outlook is for stabilisation at most. The authorities are pursuing their anti-speculative measures in the real-estate market, and in its Financial Stability Report published in November the People's Bank of China (PBOC) expressed concern about the speed at which **household debt**, which doubled between 2014 and 2018 and stood at 60.4% of GDP at the end of 2018, has increased.

The picture for consumption remains mixed In the third quarter, real per capita spending increased by 5.7% yoy, compared with 5.2% yoy in the second quarter, in line with the increase in disposable income; this was despite the deterioration of the jobs market and slowing retail sales. The year-on-year trend in car sales, although still downward, has recovered from the lows of a few months ago, while sales of other durable goods (domestic appliances, furniture and construction and decorating materials) continued to stall or drop. Passenger traffic remains very weak and consistent with another slowdown in sales in the fourth quarter. However consumer confidence remains at record high levels, online sales continue to enjoy comfortably double-digit growth and there has been a slight improvement in labour market indicators. Consumption should receive a moderate boost from another reduction in the family tax burden, particularly for lower-income families, which is something the government intends to do in 2020. **Core inflation** remains stable (1.4% yoy in November) at the very low levels witnessed in recent years, and producer price inflation continues to decline (-1.4% yoy) owing to lower prices of industrial goods. However, total inflation continues to be severely affected by higher food prices caused by the impact of swine flu on pork meat (+110.2% yoy in November) and increased from 3.0% yoy in September to 4.5% yoy in November, which was beyond our expectations. As a result, **we are revising upwards our inflation forecasts for 2019 (from 2.6% to 2.9%) and 2020 (from 2.3% to 3.3%).**

In various proclamations in recent months, the authorities have reiterated their preference for a moderate slowdown in growth, as long as it provides a reduction in financial risks but does not have too much of an impact on employment levels. The Financial Stability Report clearly showed that the **attention of the authorities** will **remain focused on the control of financial risks in 2020**, with renewed attention paid to online finance, P2P loans, cryptocurrencies and asset management. This focus will limit the degree to which fiscal and monetary policy will be loosened, all the more so given the increase in non-performing loans and the issues facing small rural and urban banks. Lending therefore will continue to offer limited support for investment and consumption, and the credit impulse, which has improved marginally throughout 2019, may wither again as early as the fourth quarter. The growth in total lending continues to be limited by the shrinking of certain non-banking credit areas and recently by the slowdown in issues of special purpose local government bonds aimed at financing infrastructure, now exceeding the quota for 2019 (CNY 2,150 bn), so that at the end of November the MOF announced that CNY 1,000 bn of the 2020 quota would be brought forward in 2019.

Only moderately accommodative monetary and fiscal policies and a persistently modest lending dynamic will push economic growth below 6% in 2020. On top of these factors is the trade dispute which, despite the prospect of an agreement being signed, remains some way from being resolved as regards the structural issues and will continue to have a negative impact on global trade. We still believe it likely that the domestic GDP growth target for 2020 will be lowered to around 6% from the 2019 range of 6-6.5%, and we **are trimming our 2020 growth forecast from 5.9% yoy to 5.8%.**

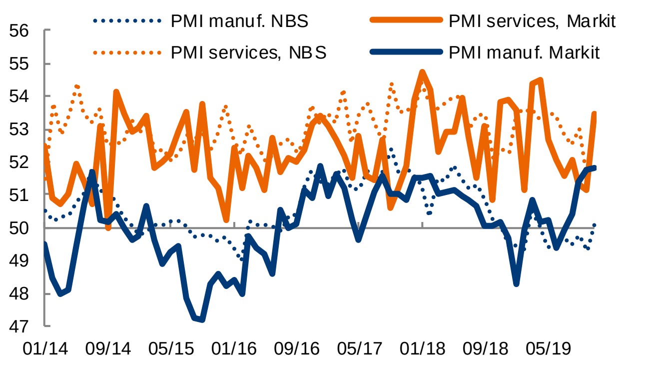
On November 5, the PBOC cut the one-year rate for medium-term lending facilities (MLF) by 5 bps to 3.25%. The Loan Prime Rate, the rate against which new bank loans are now priced (fixed with a spread on the MLF rate) was reduced from 4.25% at the end of August to 4.15%. The **transmission mechanism of monetary policy remains slow for now**, which is why we are maintaining our forecast of refinancing rates being cut by 70 bps by the end of 2020 and of the required reserve ratio dropping by a total of 100 bps. The **renminbi** should continue to trade at 7.00-7.10 in the coming months, before appreciating over the course of next year. Only an unexpected escalation in the trade dispute or the PBOC relaxing monetary policy more aggressively than expected could bring the exchange rate back towards 7.25-7.30.

Forecast Table

	2015	2016	2017	2018	2019	2020
GDP (constant prices)	6.9	6.7	6.8	6.6	6.2	5.8
Private consumption	8.1	8.2	6.7	7.2	6.9	6.9
Public consumption	7.7	9.7	8.9	16.3	5.4	6.7
Fixed investment	7.3	6.7	4.8	4.7	4.1	4
Exports	0	1.9	6.8	4.3	1.4	1.7
Imports	0.7	3.3	7.7	6.5	-1.7	2.5
Industrial output	6.2	6.3	5.9	5.8	5.1	4.3
Inflation (CPI)	1.4	2.0	1.5	2.1	2.9	3.3
Unemployment rate (%)	4	4.0	3.9	3.8	3.6	3.6
Average salaries	9.7	9.5	10	9.4	8.7	8.4
Chibor rate 3m (average) (%)	3.80	3.00	4.70	4.00	3.20	2.90
10-year government bond yield (average) (%)	3.05	2.91	3.85	3.45	3.20	3.15
USD/CNY exchange rate (average)	6.28	6.64	6.76	6.61	6.91	6.92
Current account balance (CNY Bn)	1912	1335	1313	353	1094	1026
Current account balance (% of GDP)	2.8	1.8	1.6	0.4	1.1	1.0
Budget Balance (% of GDP)	-3.4	-3.8	-3.7	-4.2	-4.4	-4.9
Public Debt - Central Government (% of GDP)	15.1	15.8	16.0	16.2	17.2	18.3

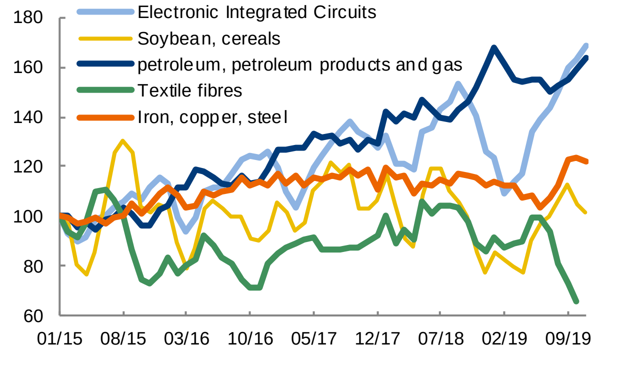
N.B.: Percentage change versus previous period – except where otherwise indicated; Source: Oxford Economic Forecasting and Intesa Sanpaolo

PMI index



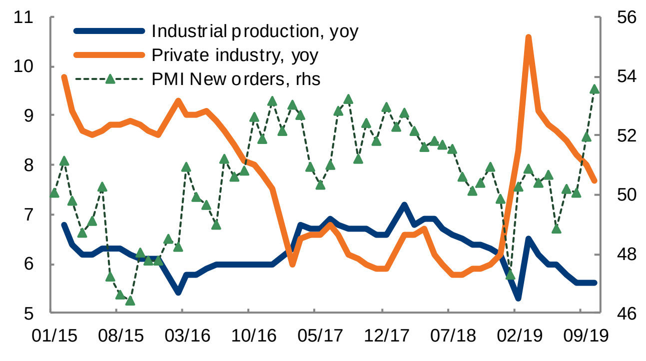
Source: CEIC

Imports in volume: January 2015=100



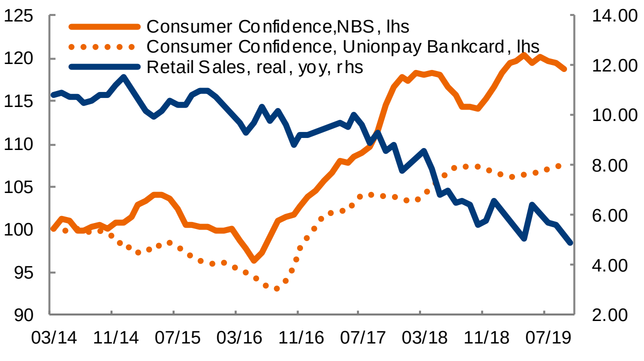
N.B. 3m moving average. Source: CEIC and Intesa Sanpaolo Chart

Industrial output and orders



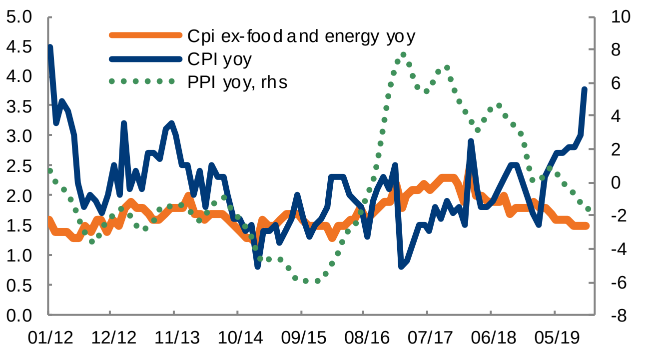
NB. industrial output ytd, yoy change
Source: CEIC, IHS Markit

Retail sales and consumer confidence*



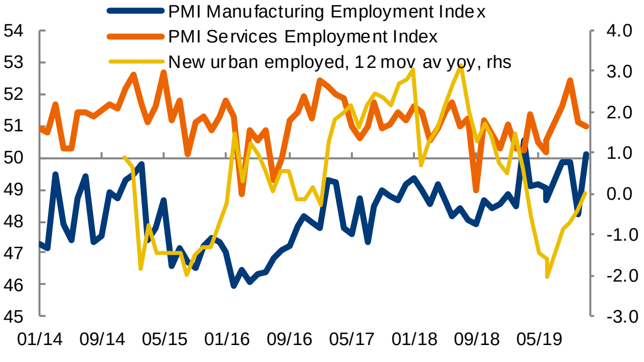
NB. Consumer confidence: 3-month moving average, rebased to March 2014 = 100. Source: CEIC

Inflation



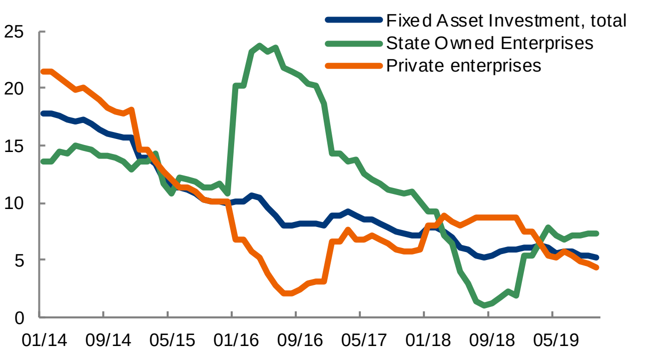
Source: CEIC

Labour market



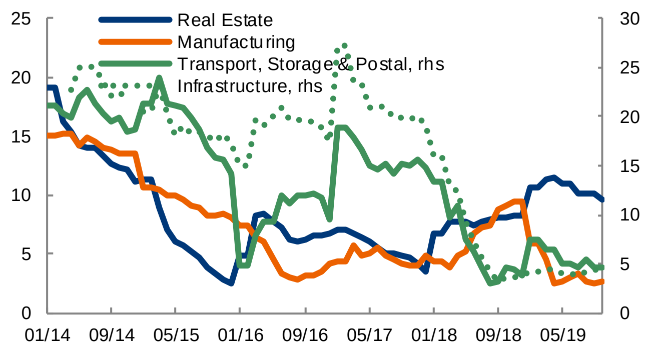
Source: CEIC and Intesa Sanpaolo chart

Nominal investment by type of company ytd yoy



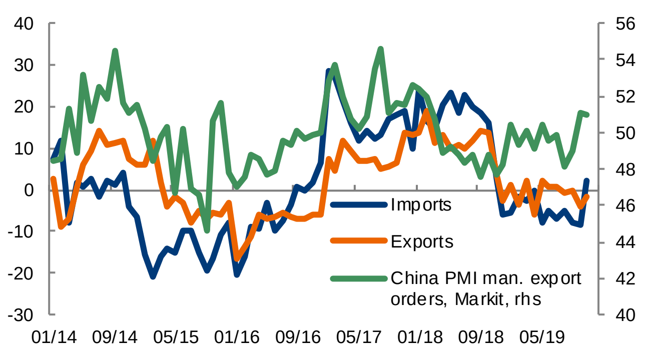
Source: CEIC

Nominal investment by sector ytd yoy



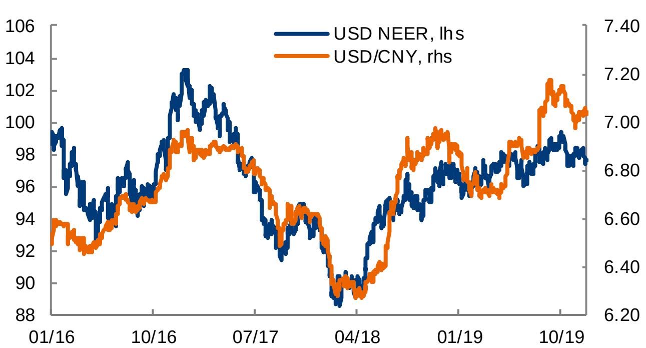
Source: CEIC

Foreign trade yoy



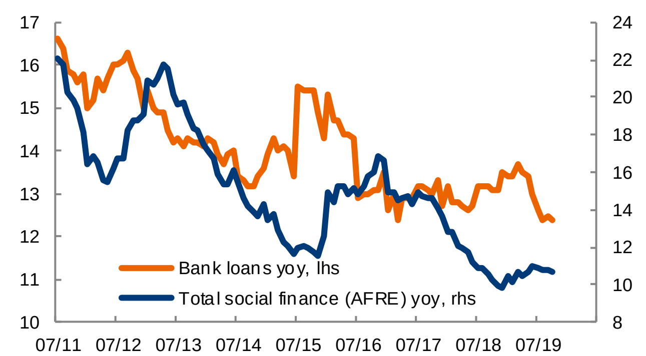
NB: seasonally adjusted figures Source: CEIC, IHS Markit

Exchange rate



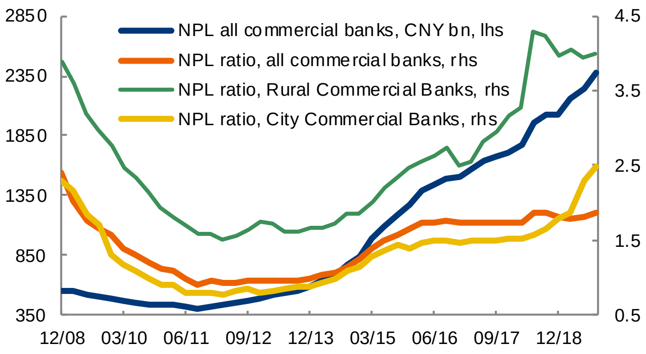
Source: Bloomberg

Aggregate credit yoy



Source: CEIC

Non Performing Loans, NPL



Source: CEIC

India: credit crisis slows growth

Silvia Guizzo

The credit slowdown, exacerbated by the crisis in the non-banking financial sector, continues to undermine domestic demand with a severe negative impact on corporate and household confidence levels. GDP growth is expected to close 2019 with a sharp reduction from 7.4% in 2018 to 5%. The support of fiscal policy, together with the impact of monetary easing and a positive contribution from foreign trade should foster a recovery to 6.2% in 2020.

GDP growth slowed for the sixth consecutive quarter to 4.5% yoy in 3Q, the lowest level since 2014. The slowdown of fixed investments (+1.0% yoy), combined with the fall in investments in valuables and the decrease in inventories, exceeded the increase in both private and public consumption and the positive contribution of foreign trade. On the supply side, the dramatic slowdown in the industrial sector (+0.5% yoy), driven by the decline in the manufacturing sector, (-1.0% yoy) was accompanied by a marginal slackening in services and resilience in the agricultural sector.

Economic activity will remain weak in 4Q In keeping with the negative performance of international freight traffic, imports continued to decline from August to October at a faster pace than exports, including net of oil and precious metals, thus underscoring the slowdown in domestic and foreign demand. Industrial output dropped by 3.8% yoy in October, driven down by the decline in the production of capital goods. The production of the main industrial and energy commodities dropped by 3.6% yoy, and electricity production was down by 5.3%. Business confidence indices relating to 4Q expectations crashed to levels below the lows reached in 2017 and 2013 in the RBI survey and to levels close to the 2009 lows in the D&B survey. Both surveys reflected a marked worsening in orders although this was not entirely confirmed by the PMI indices; the latter reflected only a slight decrease in the growth rate of the manufacturing sector compared with 3Q, showing an improvement in November that was more pronounced for services. This single positive sign is confirmed by the marginal improvement in domestic freight traffic performance.

Signs of investment recovery continue to be isolated and still weak, and the outlook for 2020 is still poor due to the credit slowdown. Investments of industrial companies rose by 15.6% yoy in October following a very weak period, while machinery imports, after stabilising in 3Q, improved somewhat compared with the lows seen in the summer, due in part to a favourable base effect. However, in the RBI survey on industrial companies, companies lamented a reduction in both domestic and foreign sources of financing with increased costs, and expressed pessimism regarding business margins due to weak demand. Bank lending once again slowed in line with **the credit slowdown in the non-banking financial sector**, which has been dragging on since the failure of the IL&FS giant in September 2018, and which has been fuelled by other failures, not least of which that of Dewan Housing Finance Limited, with repercussions on the system's liquidity and the entire economy. Based on Bloomberg data, defaulting bonds rose from 23 in 2018 to 180 in 2019 with a sharp increase in the second half of the year. The RBI's recent decision to refer cases of failures of non-banking financial institutions to the national bankruptcy court, which was initially only responsible for cases relating to non-financial companies, should help resolve the crisis together with other measures to increase the RBI's supervisory powers and consolidate public banks.

On the whole, the outlook for consumption continues to be weak. Partially bolstered by a favourable base effect, private consumption rose by 5.1% yoy in 3Q from a low of 3.1% yoy in 2Q. Sales of two- and three-wheel vehicles continued to decline but at a lower rate than in the summer, while sales of passenger vehicles rose marginally in October after months of year-on-year falls, boosted by commercial promotions. Passenger traffic is still weak, albeit improving since the mid-year, while consumer confidence declined further, dipping below the 2013 lows in November; expectations, although falling sharply, continue to be optimistic. Spending plans for essential goods remained stable, while plans for non-essential goods declined, accompanied by greater pessimism regarding income prospects, inflation and the labour market. The Centre for Monitoring the Indian Economy (CMIE) estimates that the unemployment rate has risen to a series high (8.5% in November) with a drop in the participation rate, and thus will have a negative impact on income.

Consumer price **inflation** rose to 5.5% yoy in November from 3.3% in August, pushed up by an increase in food prices (+8.7% yoy in November), and especially by a sharp increase in the price of vegetables given the excessive rainfall in the season. Inflation slowed in other segments to such an extent that we estimate that core inflation has remained stable at 3.5% in October and November compared with 4.2% in August. A gradual fall in food prices and favourable base effect point to decreasing inflation in 2020, although **as a yearly average, it will rise to 4.6% from 3.6% in 2019**. Three-month and one-year inflation expectations rose in the RBI's latest two surveys. This increase led the central bank to leave rates unchanged at its meeting on 5 December following the 25-bp cut in October that brought the repo rate to 5.15%. The RBI maintained its accommodative stance in monetary policy because it believes that the output gap is still negative, but it has taken a break to better assess changes in inflationary trends. The reduction in policy rates totalling 135 bp in 2019 has, for the time being, passed through more quickly to the money and bond market than to bank rates. In the absence of an increase in inflationary expectations, and based on further negative signs from macroeconomic data, we expect a maximum 50-bp additional rate cut by the end of 1H20.

Support for growth should also come from fiscal easing measures for companies that were already approved in the summer, and from further measures expected in the budget for next year, which will be presented in February. The slowdown in tax receipts is forcing the government to implement the state company privatisation programme more rapidly, but there is likely to be a deficit overrun both in this financial year and next. This will continue to leave the rupee under pressure at least for the entire first quarter of 2020.

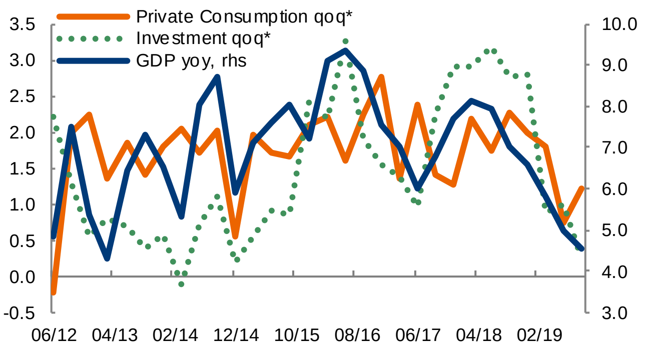
In light of the worse-than-expected national accounting data in 3Q, and the monthly data for October and November, **we are lowering GDP growth projections for 2019 from 5.8% to 5.0%.** This revision will also reduce the growth **profile in 2020 from 6.8% to 6.2% yoy**. The support of fiscal policy and the easing of monetary policy should drive the recovery in 2020. Risks to the outlook remain to the downside due to both the worse-than-expected negative repercussions of the non-banking financial sector crisis and a further slowdown in foreign demand if China-US tensions were to worsen again.

Forecast Table

	2015	2016	2017	2018	2019	2020
GDP (constant prices)	7.5	8.7	6.9	7.4	5	6.2
Private consumption	7.7	9.1	6.6	8.5	5.2	5.9
Public consumption	4.2	4.2	13.7	10.7	12.9	10.6
Fixed investment	4.8	9.2	7.7	12.2	2.6	5.1
Exports	-6.2	2.5	5.8	10.6	3.4	4
Imports	-5.8	1.6	15.5	16.1	1.6	4.2
Industrial output	2.5	5.2	3.5	5.2	1.1	4.9
Inflation (CPI)	4.9	4.9	3.3	3.9	3.6	4.6
Unemployment rate (%)	4.5	5.2	5.5	5.6	5.6	5.6
Average wages	11.9	14.3	9.8	11.8	6.9	7.2
3-month Mibor (average) (%)	8.00	7.20	6.50	7.30	6.70	5.40
10-year government bond yields (average) (%)	7.80	7.20	6.70	7.70	6.90	6.30
USD/INR exchange rate (average)	64.15	67.2	65.11	68.40	70.48	70.06
Current account balance (INR Bn)	-1451	-815	-2528	-4511	-2695	-3532
Current account balance (% of GDP)	-1.1	-0.5	-1.5	-2.4	-1.4	-1.6
Budget balance (% of GDP)	-3.4	-3.6	-3.9	-3.6	-3.9	-3.6
Central government public debt (% of GDP)	47.1	46.9	45.5	44.9	46.7	47.2

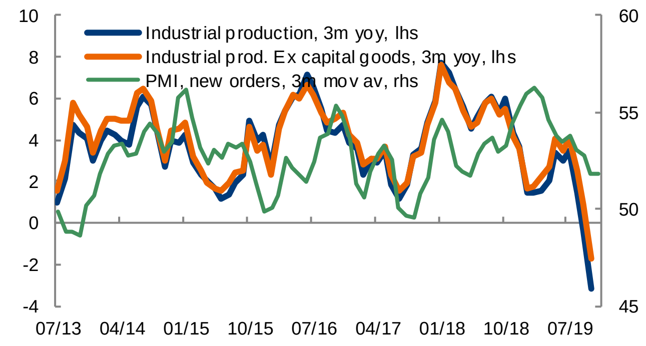
N.B.: Percentage change on the previous period – unless otherwise stated. Calendar year. Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

GDP and its components



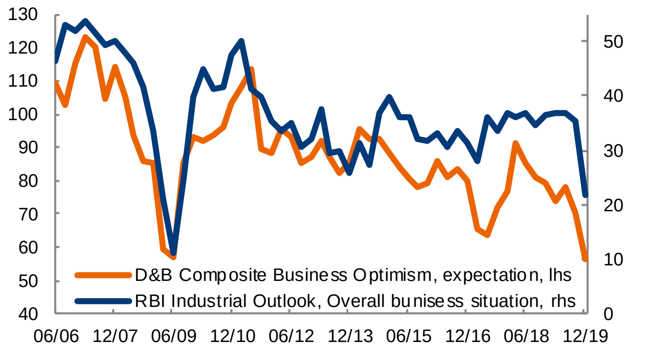
* four-quarter moving average. Source: CEIC

Industrial output



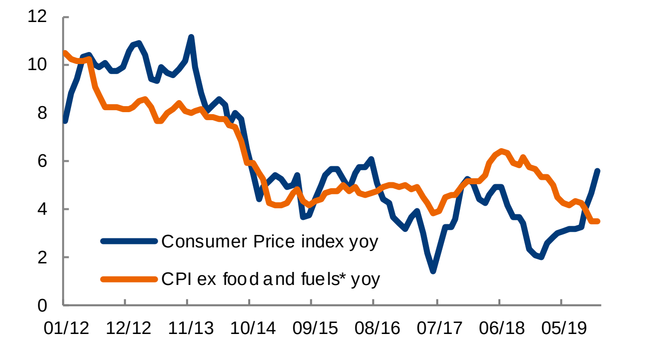
N.B.: Three-month moving average. Source: Markit, CEIC

Business confidence



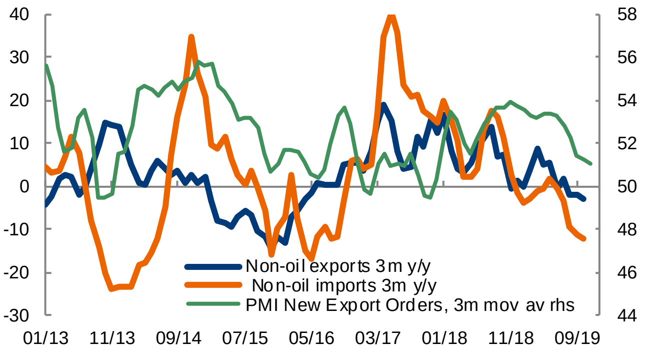
Source: CEIC

Inflation



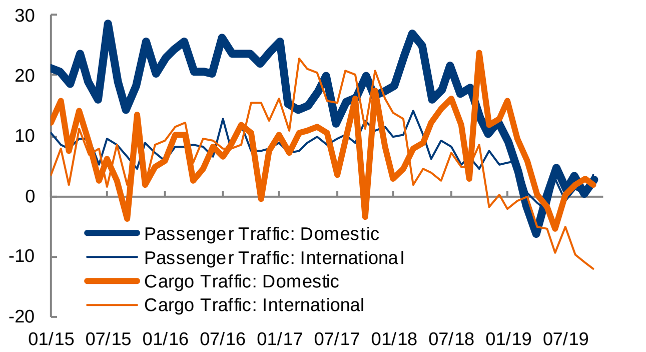
Note (*): Intesa Sanpaolo estimates. Source: CEIC

Foreign trade



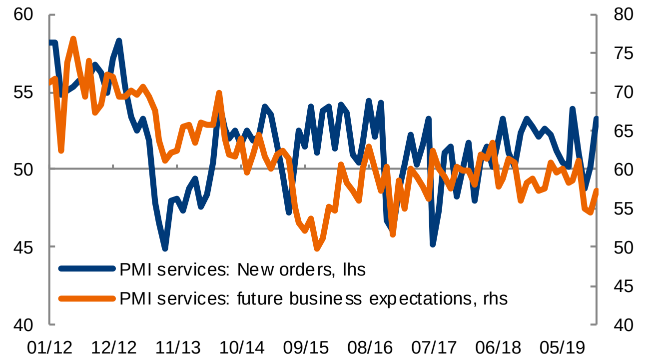
N.B.: Three-month moving average. Source: Intesa Sanpaolo chart based on Bloomberg and Markit data

Passenger and freight traffic



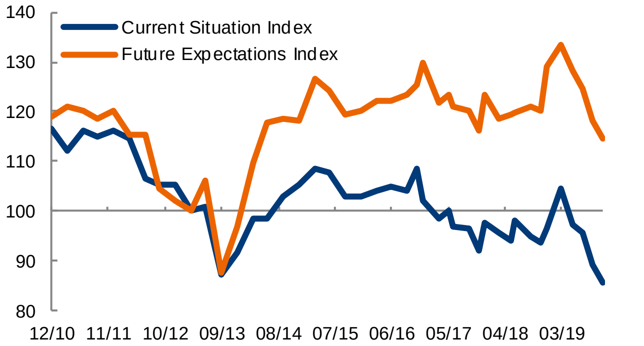
Source: CEIC

Services



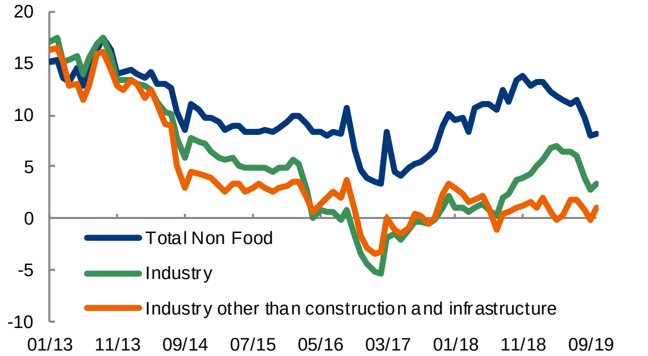
Source: Markit

Consumer confidence



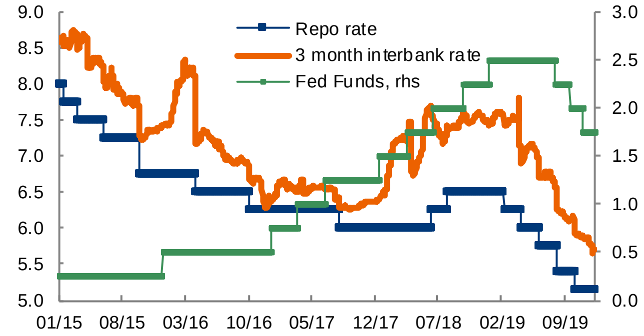
N.B.: Quarterly consumer confidence survey by the RBI. Source: CEIC

Bank lending (% chg. yoy)



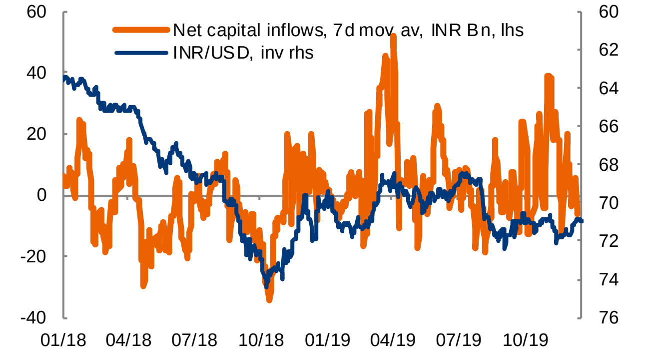
Source: CEIC

Official and money market rates



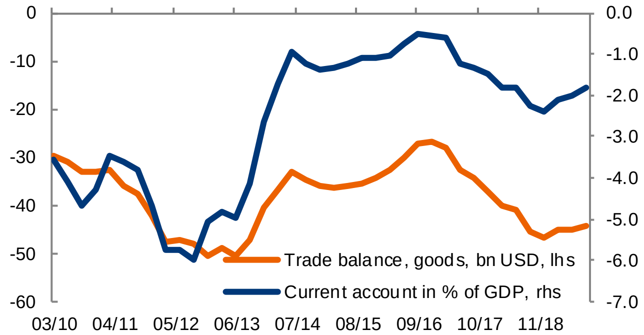
Source: CEIC

Portfolio inflows (INR Bn) and exchange rate



N.B.: (*) Net purchases by foreign institutional investors. Source: CEIC

Current accounts (four-quarterly moving average)



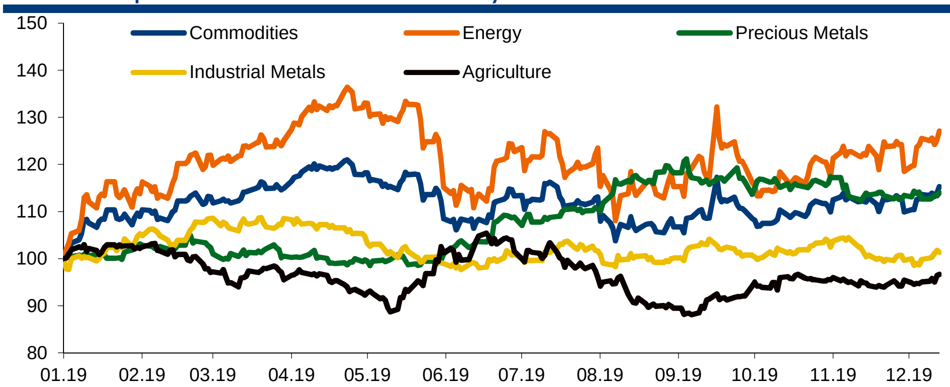
Source: CEIC and Intesa Sanpaolo chart

Commodities: political risks prevail

Daniela Corsini

In our opinion, although a cautious optimism currently prevails, most sources of uncertainty weighing on the global economic outlook are set to persist up to the end of 2020: a final and comprehensive deal between the U.S. and China trade will not be reached before the U.S. presidential elections and more trade tensions could rise on other fronts. Political tensions in Asia and Middle East are likely to remain high, as the U.S. relinquished its historical role of supervisor. As a consequence, under our baseline scenario, in 2020 most commodity markets will trade flat, as global economic growth will probably slow down, but economic stimuli and expectations about the forthcoming U.S. presidential elections could temporarily spark waves of optimism.

Year-to-date performances of the main commodity sectors



Source: Intesa Sanpaolo chart based on Bloomberg data

This year, commodity markets are set to record a positive performance, although smaller than expected one year ago. In fact, despite positive fundamentals, the prices of several cyclical commodities have been depressed by macroeconomic and political risks. In particular, the industrial metals sector has posted a flat performance year to date, mainly due to the deterioration of the macroeconomic cycle and the ongoing tensions between the U.S. and China, even if in 2019 most metals recorded physical markets in deficit and shrinking stocks.

We think that also in 2020 commodity markets will be more influenced by macroeconomic and political risks than by their specific supply and demand fundamentals. In particular, uncertainty about political developments is set to remain a predominant theme on financial markets. On one hand, most political and geopolitical risks remain in place: U.S.-China talks; political tensions in Asia and in the Middle East. On the other hand, the focus on political risks is set to further intensify ahead of the primaries of the U.S. Democratic Party, scheduled between February and June, and the U.S. presidential elections, scheduled on November 3rd.

Forecasts for the commodity universe

Our baseline scenario remains in line with the previous quarterly outlook envisaged in September. In our opinion, although a cautious optimism currently prevails, most sources of uncertainty weighing on the global economic outlook are set to persist up to the end of 2020: the U.S.-China talks will not end before the U.S. presidential elections and more trade tensions could rise on other fronts. Political tensions in Asia and Middle East are likely to remain high, as the U.S. relinquished its historical role of supervisor.

As a consequence, under our baseline scenario, in 2020 most commodity markets will trade flat, as global economic growth will probably slow down, but economic stimuli and expectations about the forthcoming U.S. presidential elections could temporarily spark waves of optimism.

Longer term, assuming no political shifts in the U.S. in 2020, we envisage a significant risk of a further deterioration of global trade and a further slowdown in Chinese economic growth. Therefore, we expect that most commodity prices will progressively decline.

Energy

The global crude market is expected to regain a balance in 2020, as OPEC+ committed to maintain their output limits and supply disruptions related to geopolitical crisis will persist. Given the fragile, but still supportive macroeconomic environment, crude oil prices could remain in a broad range and trade most of the time between 50 and 75 dollars. We currently forecast an average level of 63.5 dollars for Brent and 58.5 dollars for WTI in 2020. Natural gas prices are expected to record next year an average price close to the 2019 average in the U.S., but lower than the 2019 average in Europe. Longer term, in 2021 and 2022, we forecast a decline in crude oil and natural gas prices in all the regions.

Precious metals

Safe-haven assets, including gold and silver, benefit from expectations of a slowdown in global growth and from persistent uncertainty related to political risks. Low interest rates decrease the opportunity cost of holding precious metals, which are expected to record positive performances on average in 2020. Also in the longer term, we remain positive on gold and silver and we favor palladium to platinum due to the ongoing trends in the automotive sector.

Industrial metals

So far this year, most industrial metals have recorded deficits and global stocks are declining. In most cases, uncertainty related to political risks discouraged investments in mining and refining capacity and low prices curtailed secondary supply. In 2020, the fundamentals of most industrial metals are set to deteriorate amid expectations of a slowdown in Chinese commodity consumption. Some markets will probably record a balance, while other markets will probably turn into a modest surplus. We currently forecast that up to end 2020 industrial metals will trade in a wide range, with average prices in most cases lower than their 2019 average. From 2021 onwards, we forecast a sharper decline in industrial metals' prices, as global consumption is set to slow down further.

Agricultural commodities

We remain positive on the agricultural sector as weather-related risks will probably continue to fuel concerns about supplies, especially in the long term. Moreover, some agricultural goods, like soft commodities, are less influenced by global political tensions, and prices are expected to follow more closely their positive fundamentals. Therefore, several agricultural commodities will come under the spotlight as interesting diversification tools.

Price forecasts for the main commodities

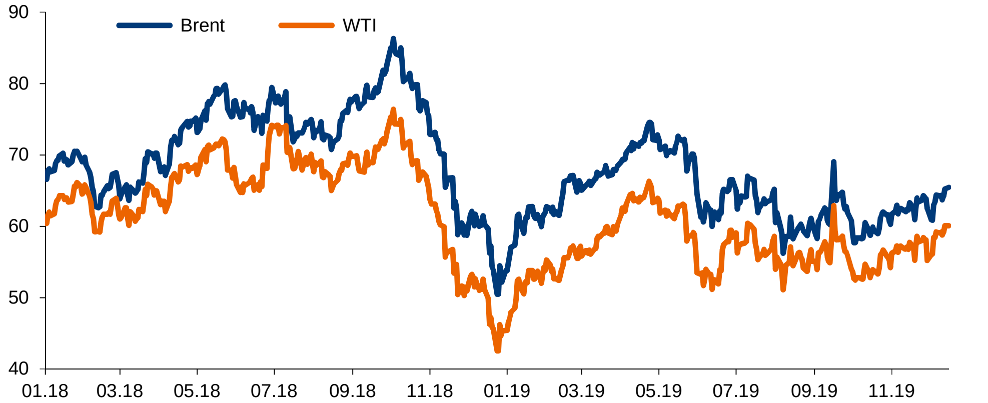
		1Q20	2Q20	3Q20	2019	2020	2021
CO1 Comdty	ICE BRENT	62.0	65.0	65.0	63.2	63.5	60.0
CL1 Comdty	NYMEX WTI	57.0	60.0	60.0	56.2	58.5	55.0
NG1 Comdty	NYMEX NATURAL GAS	2.80	2.50	2.50	2.57	2.65	2.50
GOLDLNPM Index	LME GOLD	1,475	1,500	1,500	1,395	1,500	1,575
SLVRLND Index	LME SILVER	17.5	18.0	18.5	16.4	18.3	19.00
PLTMLNPM Index	LME PLATINUM	870	860	850	858	858	830
PLDMLNPM Index	LME PALLADIUM	1,750	1,730	1,690	1,561	1,705	1,650
LMCADS03 Comdty	LME COPPER 3M	5,860	5,800	5,800	5,987	5,803	5,250
LMAHDS03 Comdty	LME ALUMINIUM 3M	1,750	1,750	1,750	1,796	1,740	1,670
LMNIDS03 Comdty	LME NICKEL 3M	15,000	15,000	15,000	14,429	15,000	15,000
LMZSDS03 Comdty	LME ZINC 3M	2,300	2,300	2,300	2,510	2,295	2,150
LMPBDS03 Comdty	LME LEAD 3M	1,950	1,950	1,950	2,035	1,950	1,825
LMSNDS03 Comdty	LME TIN 3M	16,500	16,500	16,500	18,382	16,500	16,250
SCO1 Comdty	SGX IRON ORE	80	75	75	89	75	70
NASS000C Index	TSI US HRC STEEL	550	550	550	586	550	500
JBO1 Comdty	LME SCRAP	240	240	240	274	240	240
JBP1 Comdty	LME REBAR	400	400	400	439	400	400
C 1 Comdty	CBOT CORN	390	420	420	383	410	440
W 1 Comdty	CBOT WHEAT	510	500	500	495	503	510
S 1 Comdty	CBOT SOYBEAN	900	900	900	901	900	910
KC1 Comdty	NYB-ICE ARABICA COFFEE	130	125	120	99	124	125
DF1 Comdty	LIFFE ROBUSTA COFFEE	1,380	1,360	1,360	1,371	1,360	1,360
SM1 Comdty	CBOT SOYBEAN MEAL	310	310	310	305	310	310
BO1 Comdty	CBOT SOYBEAN OIL	30.0	30.0	30.0	29.2	30.0	30.0

Source: Intesa Sanpaolo estimates

Crude oil: OPEC agreed to deepen output cuts

The global crude market is now expected to be close to balance in 2020, as OPEC and non-OPEC allies promised to deepen their output cuts and supply disruptions related to geopolitical crises remain a significant risk.

Brent and WTI oil prices



Source: Intesa Sanpaolo chart based on Bloomberg data

After two days of intense talks, on December 6th OPEC+ delegates managed to surprise the market promising deeper output cuts for next year. In fact, OPEC+ announced an additional adjustment of 500 thousand barrels per day (b/d), leading to a cumulative output limitation of 1.7 million b/d (mb/d) from the current target of 1.2 mb/d. In addition, the press release states that "several participating countries, mainly Saudi Arabia, will continue their additional voluntary contributions, leading to adjustments of more than 2.1 mb. This additional adjustment would be effective as of 1 January 2020 and is subject to full conformity by every country participating in the Declaration of Cooperation".

This sentence is important at several levels. First, it highlights the personal success of the new Saudi Energy Minister, Prince Abdulaziz bin Salman. He managed to broker an important deal and, apparently, restore cohesion in the group.

Second, Saudi Arabia is explicitly threatening to increase output if other countries continue cheating on their quotas. Saudi will again accept the highest burden if and only if compliance improves. According to the official numbers attached to the press release, Saudi Arabia will be responsible of cutting an extra 167 thousand b/d of the cumulative 503 thousand b/d, representing 33% of the total. For comparison sake, Russia's cuts correspond to just 14% of the total, slightly higher than the share accepted by the UAE (12%) or Kuwait (11%). In addition, in the final press conference, Prince Abdulaziz bin Salman stated that Saudi Arabia would pump even less than mandated, further cutting its output by about 400 thousand b/d. Therefore, Saudi would probably pump an average 9.75 mb/d from January to March, vs. a November output of about 10.0 mb/d, according to Bloomberg estimates.

Third, the press release stressed the importance of monitoring the "fair, timely and equitable implementation" of the agreement. A sharper focus on compliance monitoring is the main reason for which extraordinary OPEC and OPEC+ meetings are scheduled in March 2020, with the OPEC and non-OPEC Ministerial Meeting planned on March 6th. OPEC and non-OPEC Ministers will also convene on June 10th.

Crude markets reacted positively to this announcement. However, these additional cuts are more a confirmation of the status quo rather than a deeper intervention on physical markets. In fact, the cumulative OPEC+ production will probably remain flat over the next months as this year OPEC's compliance has been exceptionally high, with a total reduction 40% higher than the stated target in November.

Supply and demand estimates published in the Short-Term Energy Outlook by the U.S. Energy Information Administration

December 2019, in mb/d	World Demand	Non-OPEC Supply	US Supply	OPEC LNG Supply	OPEC Crude Supply	Call on OPEC crude*	Market balance**
2018	100.0	63.5	11.0	5.4	32.0	31.1	0.9
2019	100.7	65.6	12.3	5.4	29.8	29.7	0.1
y/y change	*0.8*	*2.1*	*1.3*	*0.1*	*-2.2*	*-1.4*	
2020	102.1	67.9	13.2	5.1	29.3	29.2	0.1
y/y change	*1.4*	*2.3*	*0.9*	*-0.4*	*-0.5*	*-0.5*	

Note:* "Call on OPEC crude = World Consumption - Non OPEC Supply - OPEC LNG supply"; ** "Market balance = OPEC crude supply – Call on OPEC crude" Source: Intesa Sanpaolo chart based on US EIA data

In its December Short-Term Energy Outlook (STEO), the U.S. Energy Information Administration (EIA) forecasts that the global crude market will be close to balance next year, thanks to the aggressive OPEC+ cuts. Crude prices are expected to remain flat, with Brent price close to a 60 USD average, while the Brent-WTI spread is expected to average 5.5 USD in 2020.

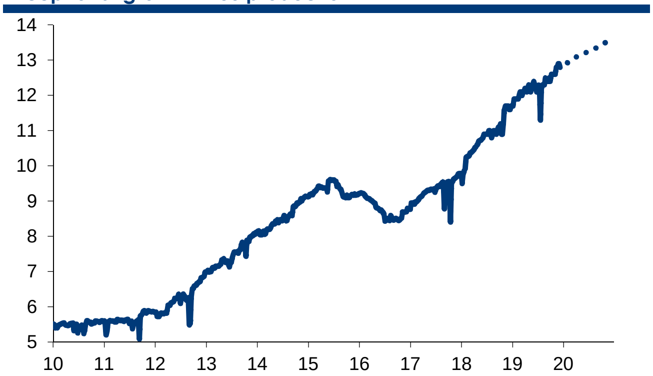
Now, EIA envisages a tiny surplus of about 0.1 million barrel per day (mb/d) in both 2019 and 2020 (vs. November forecasts envisaging a 0.3 mb/d surplus in 2020). World demand is estimated to rise to 100.7 mb/d in 2019 (+0.8 mb/d y/y, revised downwards from 100.9 mb/d one month ago) and to 102.1 mb/d in 2020 (+1.4 mb/d y/y, down from 102.3 mb/d).

Non-OPEC supply is estimated to expand to 65.6 mb/d in 2019 (+2.1 mb/d y/y, down from 65.7 mb/d) and to 67.9 mb/d in 2020 (+2.3 mb/d y/y, down from 68.0 mb/d). U.S. crude oil production should rise to 12.3 mb/d in 2019 (+1.3 mb/d y/y, unchanged) and to 13.2 mb/d in 2020 (+0.9 mb/d y/y, down from 13.3 mb/d).

It's interesting to note that as of the 4Q19 the U.S. will be a net exporter of crude oil and petroleum products. EIA expects total crude oil and petroleum net exports to average 570,000 b/d in 2020 (down from 750,000 b/d in November) compared with average net imports of 490,000 b/d in 2019 (down from 520,000 b/d) and average net imports of 2.3 mb/d in 2018. In fact, according to EIA calculations based on preliminary data and model estimates, during the past months the U.S. have been net exporters of petroleum and other liquids and it would be the first time since EIA records began in 1949.

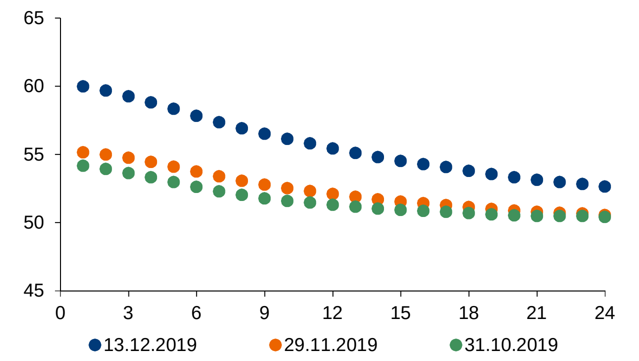
OPEC crude oil supply should decline to 29.8 mb/d in 2019 (-2.2 mb/d y/y, unchanged) and to 29.3 mb/d in 2020 (-0.5 mb/d y/y, down from 29.5 mb/d). OPEC surplus crude oil production capacity should increase from 1.5 mb/d in 2018 to 2.0 mb/d in 2019 (unchanged) and 2.3 mb/d in 2020 (up from 2.1 mb/d).

Exceptional growth in US production



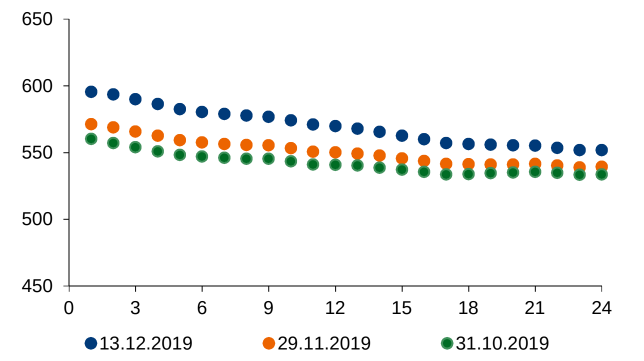
Source: Intesa Sanpaolo chart based on US EIA data

WTI forward curve



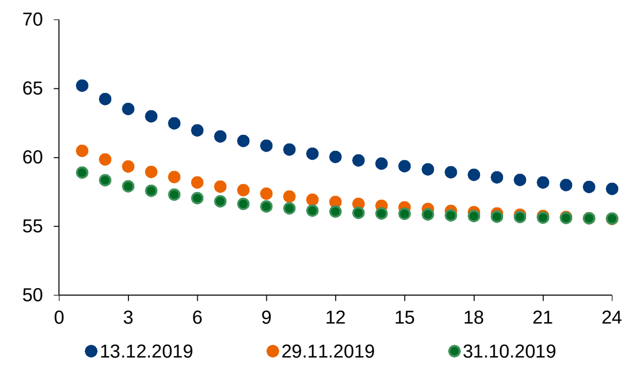
Source: Intesa Sanpaolo chart based on Bloomberg data

Diesel forward curve



Source: Intesa Sanpaolo chart based on Bloomberg data

Brent forward curve

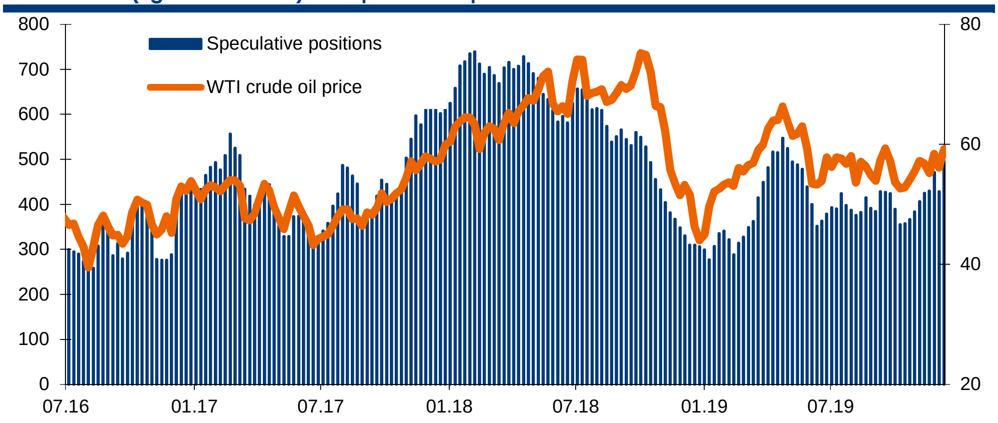


Source: Intesa Sanpaolo chart based on Bloomberg data

In our baseline scenario, we expect that next year crude prices will remain most of the time in the trading ranges prevailing in 2019. In the case of Brent, the range has been about 50-75 dollars year-to-date. We expect an average price of 63.5 dollars for Brent in 2020. We still think that crude oil remains an attractive asset to hold in financial portfolios thanks to its backwardation, granting positive roll yields.

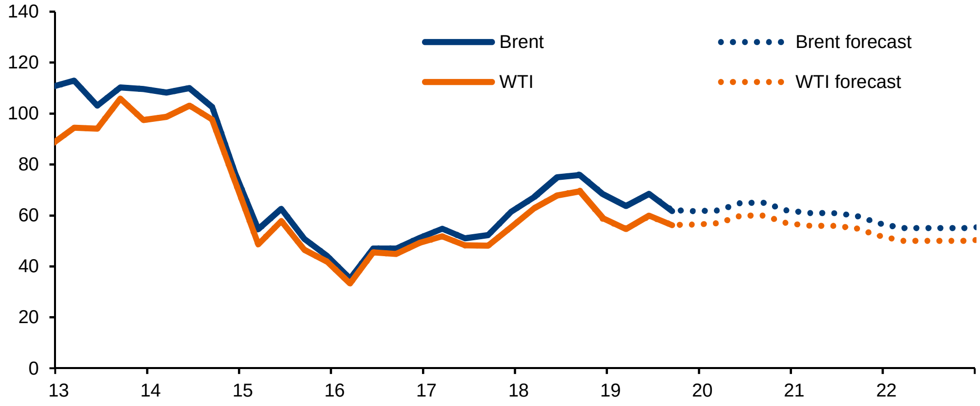
Therefore, as long as backwardation remains in place, we expect that speculative positions will remain net long. We define as speculative positions the non-commercial holdings recorded by the U.S. Commodity Futures Trading Commission (CFTC), usually held by money managers and hedge funds.

WTI crude oil (right hand scale) and speculative positions



Source: Intesa Sanpaolo chart from US CFTC and Bloomberg data

Brent and WTI: historical prices (solid line) and estimates (dotted line) in USD/barrel



Source: Intesa Sanpaolo estimates. Intesa Sanpaolo chart based on Bloomberg data

Price estimates for Brent

As of 12.12.2019	1Q20	2Q20	3Q20	2019	2020	2021	2022
ICE BRENT	62.0	65.0	65.0	63.2	63.5	60.0	55.0
Median, Bloomberg	60.0	60.5	60.0	64.0	61.8	63.5	65.0
Forward Curve	62.2	60.8	59.8	64.4	60.5	57.8	56.7

Source: Intesa Sanpaolo chart based on Bloomberg data

Price estimates for WTI

As of 12.12.2019	1Q20	2Q20	3Q20	2019	2020	2021	2022
NYMEX WTI	57.0	60.0	60.0	56.2	58.5	55.0	50.0
Median, Bloomberg	55.3	55.0	55.7	57.0	56.5	58.7	58.8
Forward Curve	58.3	57.0	55.8	58.2	56.5	53.1	51.5

Source: Intesa Sanpaolo chart based on Bloomberg data

Forex Markets: rangebound or cautious trends, with prudent central banks

Asmara Jamaleh

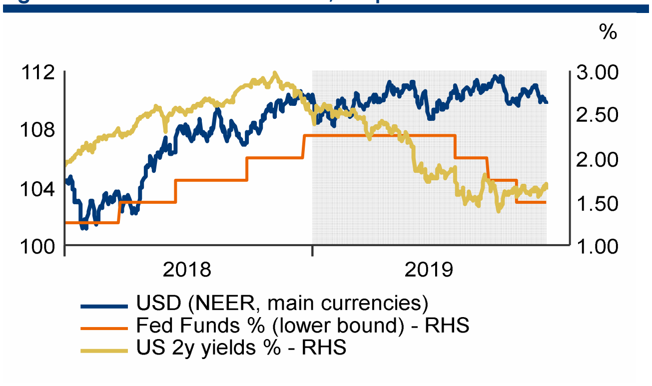
The level of US rates is supporting the dollar, whereas the Fed's caution is limiting upside, resulting in a more rangebound trend. The decline of the euro should end thanks to the expected stabilisation of euro area growth. Rangebound dynamics for the yen, with a downward bias. Sterling strengthening thanks to the removal of part of the uncertainty tied to Brexit.

Dollar

In 2019 the dollar built on the uptrend recorded in 2018, but only modestly (Fig. 1). The main factors which allowed it to strengthen further were: **(a)** the high level of US interest rates (relative level, i.e. compared to the other advanced economies, in some of which rates are at zero or in negative territory, most notably the euro area) and **(b)** the generally strong fundamentals of the US economy. On the other hand, the developments which limited the upswing were **(a1)** the slowdown of US growth in 2019 and **(b1)** the fed funds rate cuts (which almost balanced the 2018 hikes - Fig. 1).

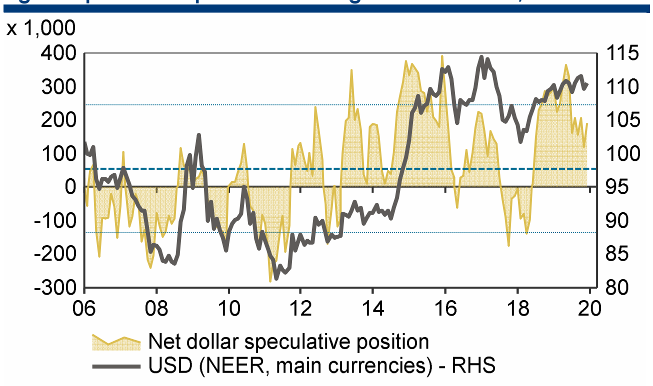
In some ways, 2020 will be similar to this year. Taking as a reference the factors listed above, **(a)** the level of US rates will remain high in relative terms (compared to the other economies), **(b)** the fundamentals of the US economy will stay positive overall, **(a1)** domestic growth could slow further and **(b1)** the Fed, despite keeping rate cuts on hold, will retain an easing bias at least for some time.

Fig. 1 – 2019: the dollar did not fall, despite the Fed's cuts



Source: Refinitiv-Datastream

Fig. 2 – Speculative positions still long on the US dollar, but less so



Source: Refinitiv-Datastream

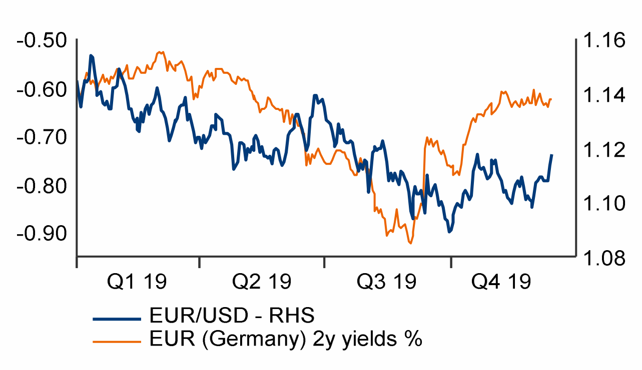
However, our conclusion on the expected trend of the US currency is slightly different. This is because **the likeliest outlook for next year seems to be a broad stabilisation of the dollar, rather than a further strengthening.** An appreciation should mostly be prevented by **(1)** the expected further slowing of US growth – in addition to the one already recorded this year, **(2)** combined with the fact that risks are slightly skewed to the downside (trade war, global cycle, pre-electoral uncertainty ahead of the US presidential elections in November 2020 and political uncertainty tied to Trump's impeachment). Symmetrically, a depreciation should be once again prevented by **(1)** the high level (in relative terms) of US rates (even in the event of the Fed deciding to loosen monetary policy further, it would probably implement a single, final "insurance" cut rather than a new rate cut cycle, therefore the downtrend of yields should be coming to an end); also **(2)**, at least part of the uncertainties which linger at the global level generally constitute downside risks for the other economies as well, albeit with some differences, limiting the upside potential of the other currencies and therefore allowing the dollar to stabilise rather than to drop.

This scenario seems consistent overall with the **speculative positioning** of the market, which **remains long on the US dollar, although exposure has decreased** in the past few months **(Fig. 2)**. Risks to the forecast scenario are essentially balanced, as domestic factors of uncertainty should roughly balance those of international origin.

Euro

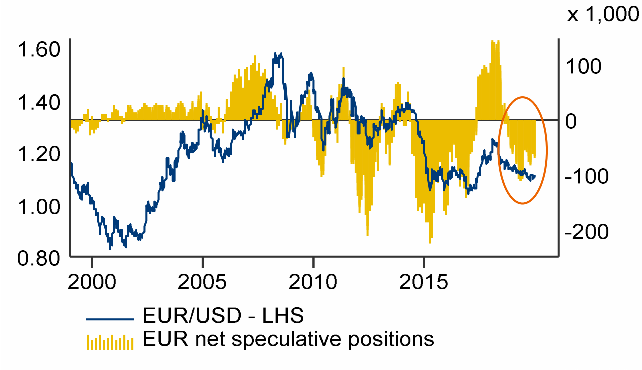
In 2019 the euro weakened, from a high of EUR/USD 1.15 to a low of 1.08. The trend of the exchange rate was consistent with the evolution of fundamentals, as in the euro area (as well) growth slowed and inflation dropped, with the ECB loosening monetary policy again as a result. In addition to the evolution of trends, the aspect which remains important for the single currency is the absolute level of interest rates, which are at zero/negative and – symmetrically to the considerations made above for the dollar – could represent, at least in some situations, a factor of weakness for the euro. Part of the recent misalignment of the exchange rate compared to the trend of yields – which had dropped simultaneously for the better part of the year (Fig. 3) – is probably also explained in light of this situation, justifying the (episodically) asymmetric reactivity of the EUR/USD to (negative) euro yields.

Fig. 3 – Reactivity of the exchange rate reactivity to yields (episodically) asymmetric



Source: Refinitiv-Datastream

Fig. 4 – Speculative positions still short on the euro… for over a year



Source: Refinitiv-Datastream

The year 2020 should bring a more favourable context for the euro, for at least three reasons: **(1)** euro area growth should tend to stabilise, after slowing this year; **(2)** the ECB is not expected to further slacken monetary policy, barring a significant deterioration of the scenario; **(3)** political developments in the US (tied principally to the presidential elections) cast greater new uncertainties over the US scenario for next year, as opposed to a lack of important new criticalities in the euro area, which makes the dollar potentially more exposed to weakness – in relative comparison terms – than the euro.

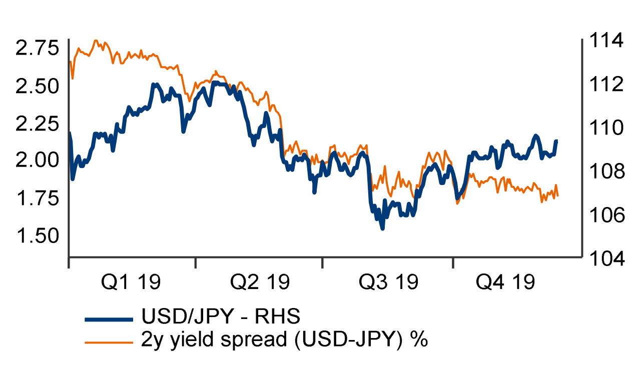
The downtrend of the EUR/USD, underway already since 2018, **should therefore be coming to an end and should be followed by a broad stabilisation** of the exchange rate, with fluctuations mostly concentrated at the mid-upper end of the EUR/USD 1.08-1.12 range observed over recent months **and, subsequently, towards the second half of 2020, by an appreciation towards EUR/USD 1.15-1.17** on approximately a 6m-12m horizon. The positioning of the speculative market, on which short euro exposure has prevailed for over a year now (Fig. 4), should also aid the start of a moderate upward trend once the fundamental conditions are in place.

Risks to the scenario are skewed slightly downwards, i.e. the euro could prove weaker than expected in the event of a deterioration of the economic picture in the Eurozone, or of the US scenario proving stronger than expected, mostly due to the fact that ECB rates at close to zero/negative remain an inherent factor of weakness for the single currency, both in consideration of the weaker appeal of euro yields and of the reduced effectiveness – given the very low starting levels – of further potential monetary policy accommodation.

Yen

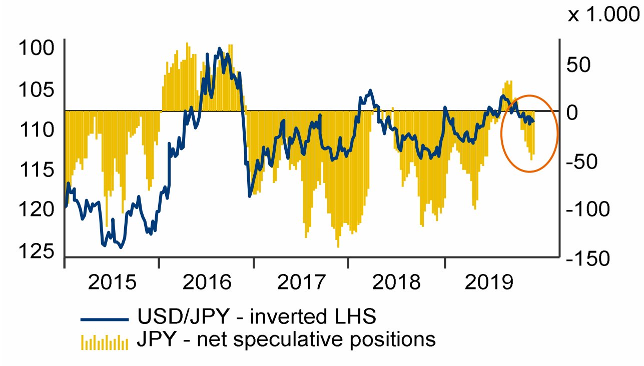
In 2019 the yen strengthened overall, albeit limitedly, after experiencing ups and downs especially against the dollar: on the decline initially, it then rose back in the course of 2019, only to dip back down towards the end of the year (Fig. 5). There were two main **drivers** of the Japanese currency: **(1) yield differentials,** especially compared to the United States (more relevant because US rates are high in relative terms and in markedly positive territory), and **(2)** the evolution of **risk aversion**.

Fig. 5 – Yield differentials have been an important driver of the yen



Source: Refinitiv-Datastream

Fig. 6 – Speculative market: short yen positions rising back up



Source: Refinitiv-Datastream

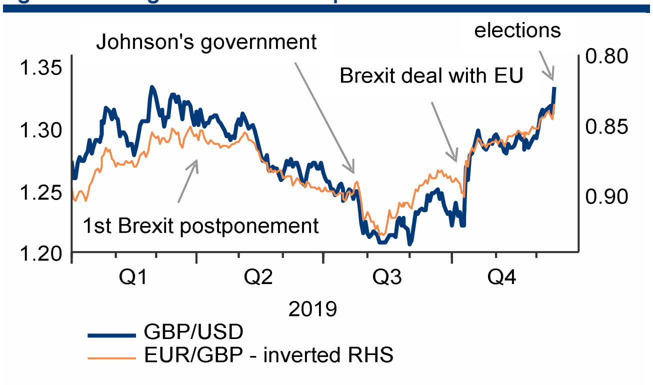
In 2020, the main factors which will guide the yen will be essentially the same, although the final effect could change, as the Japanese currency should tend to stabilise rather than appreciate further. This is because the fundamentals of the Japanese economy remain virtually unchanged, with forecast growth in 2020 on a par with the level recorded this year and inflation still stubbornly distant from the goal targeted by the BoJ, which will keep policy parameters ultra accommodative as a result (zero/negative rates), confirming its readiness to act by adding even further stimulus if needed – a scenario that warns against forecasting an appreciation trend of the yen. By contrast, two factors should help prevent the start of a marked downtrend of the yen: **(1)** lingering uncertainty at the international level, albeit somewhat less than his year, which may result in new waves of risk aversion, to the advantage of the yen, and **(2)** in the United States, the forecast lateral trend of the dollar and of US yields as well, or in any case a stickiness hindering yields from beginning an upside reversal, at least in the first part of the year.

Against the dollar, therefore, the yen should mostly stay at the mid-upper end of the range outlined this year, moving towards USD/JPY 112 or just above in the course of 2020, once the picture, at both the global level and in the US, will have stabilised. **Against the euro, beyond the near term, the yen should tend to weaken**, towards EUR/JPY 125-130 approximately on the 6m-12m horizon, due to the expected strengthening of the EUR/USD exchange rate. **Risks to the scenario are skewed slightly upwards,** i.e. the yen could prove a little stronger than expected, given the factors of uncertainty that linger at the international level and which may not only accentuate new waves of risk aversion, but also still induce the central banks (the Fed and the ECB first among them) to keep a cautious approach, opting to delay rather than to bring forward the reversal geared to normalising monetary policy. The recent "normalisation" of speculative exposure seems consistent with a slight prevalence of upside risks to the scenario, as market positioning turned short on the yen again after staying unusually long on the currency between August and October (Fig. 6).

Sterling

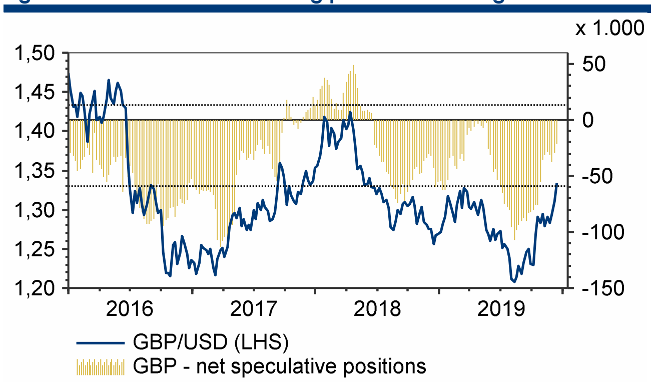
In 2019 sterling was significantly influenced by developments on the Brexit front, dropping from GBP/USD 1.33 to 1.19 between March and September, following the postponement of the UK's exit from the EU under the Theresa May government and then the crisis of the government itself, managing to rise back subsequently thanks to the signing of withdrawal agreement with the EU by Boris Johnson's government in October (Figs. 7-8). The pound finally hit a **new high for the year at GBP/USD 1.35 on the outcome of the general election held on 12 December, which awarded an overwhelming victory to the Conservatives**. Against the euro, sterling depreciated from EUR/GBP 0.84 to 0.93 between March and August, rising back subsequently to a post-election high of EUR/GBP 0.82. The fact that the Conservatives won the election and managed to secure an absolute majority in Parliament is crucial for the Brexit process, **as a Tory government will comfortably and single-handedly approve the Brexit deal negotiated by Johnson: therefore, the UK's exit (soft Brexit, i.e. with a deal) from the EU will take place by and not later than the 31 January 2020 deadline,** thus removing much of the uncertainty that in the course of 2019 had weakened the pound and held back the British economy.

Fig. 7 – The weight of Brexit on the pound



Source: Refinitiv-Datastream

Fig. 8 – Reduction of short sterling positions following the Brexit deal

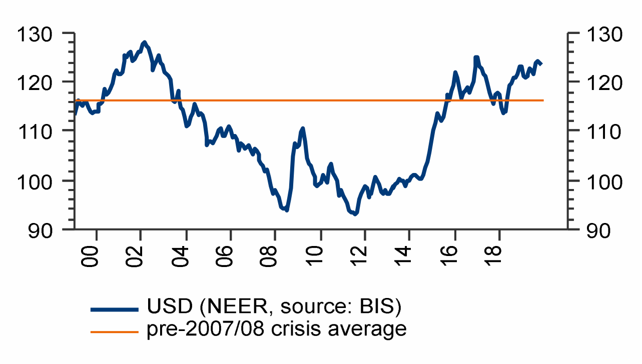


Source: Refinitiv-Datastream

In 2020 the trend of the exchange rate will therefore resume depending more significantly on domestic data, that will be positively impacted by **easing uncertainty tied to Brexit**. As also noted by the Bank of England on occasion of its November meeting, this **should aid already in the course of 2020 a gradual resumption of economic growth in the UK, that will also be supported by a more expansionary fiscal policy and by the (expected) improvement of the global growth picture**. The BoE's forecasts point to growth of 1.25% in 2019-2020 and to an acceleration to 1.75%-2.0% in 2021-2022, with inflation stable at 1.25% in 2019-2020 and on the rise to 2.0%-2.25% in 2021-2022. The BoE has in any case indicated that, should the picture of global growth fail to stabilise, or uncertainty tied to Brexit fail to adequately clear, it would consider injecting new monetary stimulus (cutting the bank rate from its present level of 0.75%) to support the recovery.

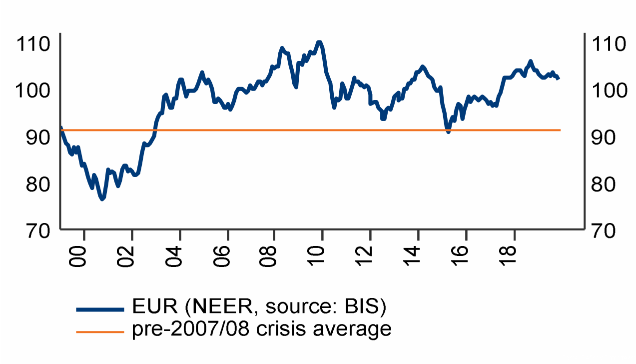
Sterling should therefore appreciate against the dollar in the course of next year, heading towards GBP/USD 1.40-1.43 on a 6m-12m horizon. **Against the euro, this would translate into a blander strengthening, with a tendency to stabilise in a range** of between EUR/GBP 0.81-0.82 due to the simultaneous expected appreciation of the EUR/USD. **Risks** to the forecast scenario are **skewed slightly downwards**, both because transition towards the new regime with the United Kingdom out of the EU, as gradual and as orderly as it may be, will in any case mark an epochal change, on a par with a structural break, and because the real challenge next year will be negotiating a new trade agreement with the EU. This latter task will prove far from simple and swift, and the risk lies in the potential failure to reach a deal by the end of the transition period on 31 December 2020.

Dollar, nominal effective exchange rate



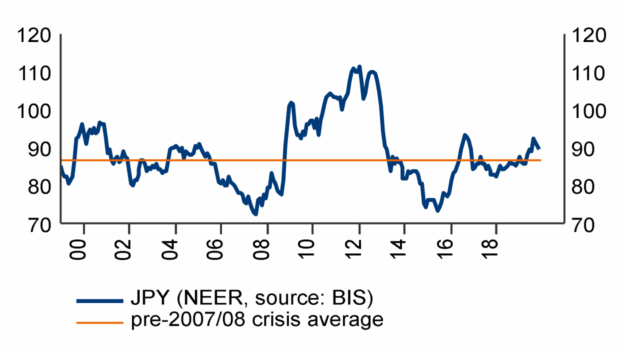
Source: Refinitiv-Datastream

Euro, nominal effective exchange rate



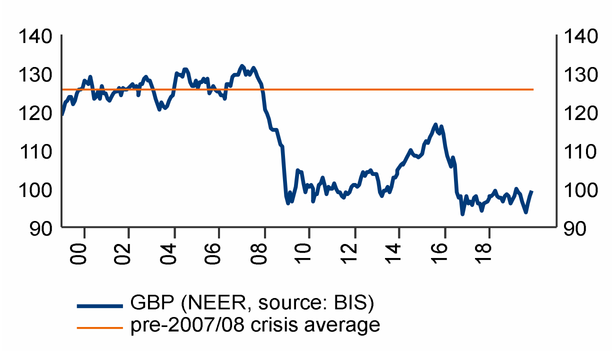
Source: Refinitiv -Datastream

Yen, nominal effective exchange rate



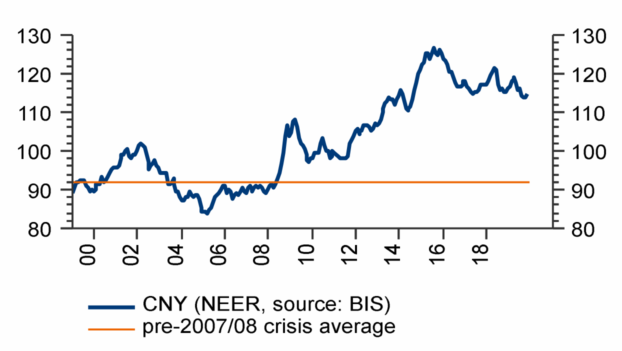
Source: Refinitiv-Datastream

Sterling, nominal effective exchange rate



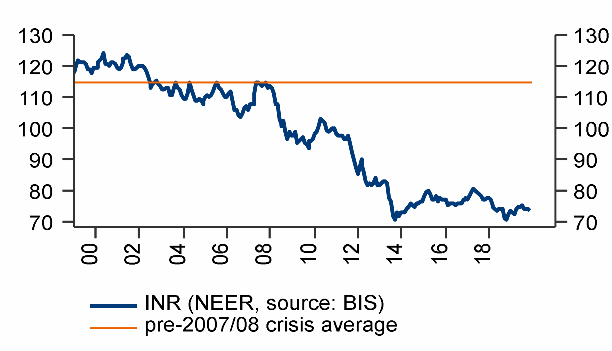
Source: Refinitiv -Datastream

Yuan renminbi, nominal effective exchange rate



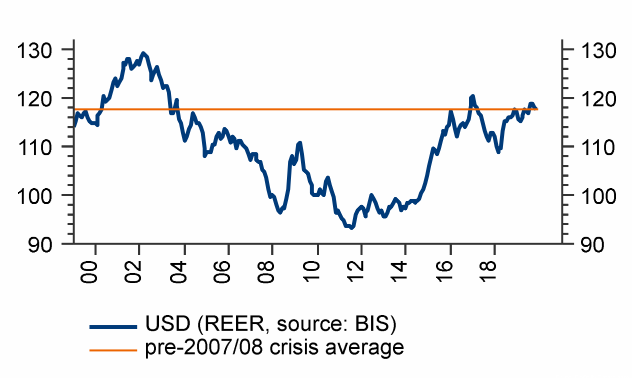
Source: Refinitiv-Datastream

Indian rupee, nominal effective exchange rate



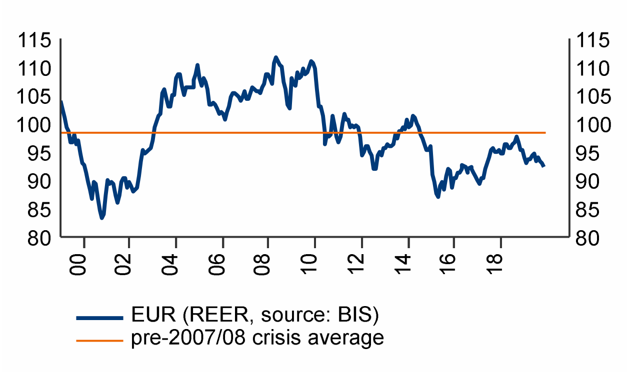
Source: Refinitiv -Datastream

Dollar, real effective exchange rate



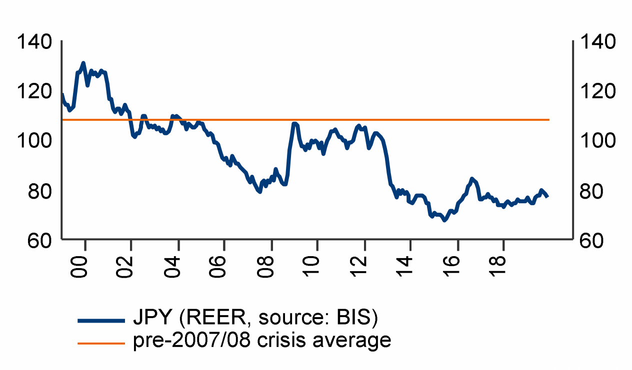
Source: Refinitiv-Datastream

Euro, real effective exchange rate



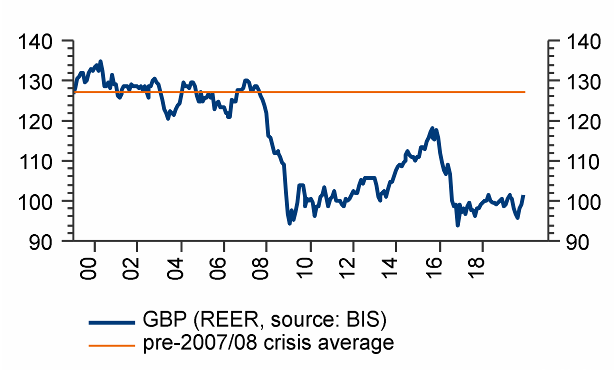
Source: Refinitiv -Datastream

Yen, real effective exchange rate



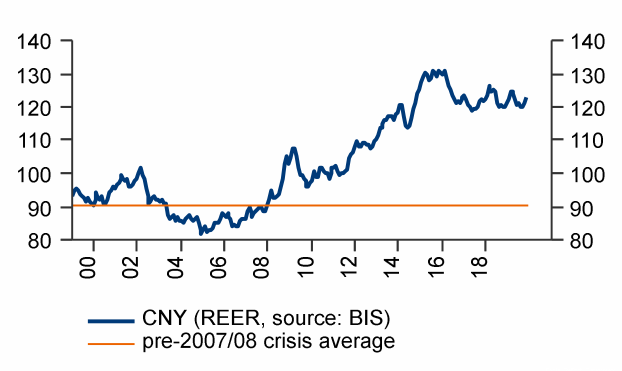
Source: Refinitiv-Datastream

Sterling, real effective exchange rate



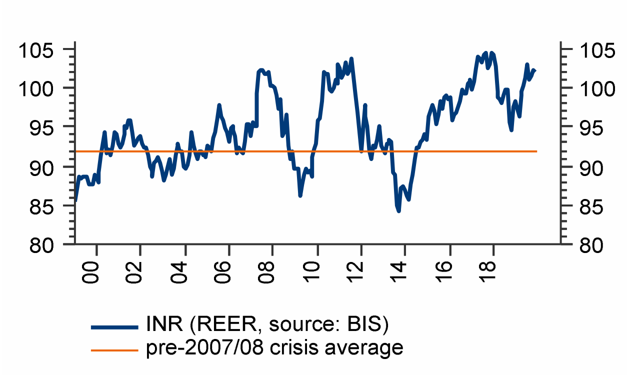
Source: Refinitiv -Datastream

Yuan renminbi, real effective exchange rate



Source: Refinitiv-Datastream

Indian rupee, real effective exchange rate



Source: Refinitiv -Datastream

Appendix

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