INTESA SANPAOLO

Macroeconomic Outlook

Research Department

September 2019

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Index

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Quarterly

Intesa Sanpaolo
Research Department

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Based on information available up to 23 September 2019

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

The manufacturing crisis starts to look ominous

Luca Mezzomo

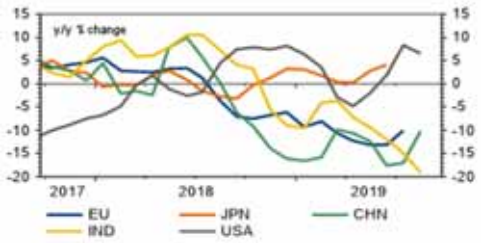
The contraction in global manufacturing shows no sign of having run its course, testing to the limit the capacity of the service and construction sectors to compensate for its adverse effects. The likelihood of a re-acceleration of growth in 2020 seems increasingly uncertain, despite the return to expansionary monetary policy. The easing of fiscal policy has been too cautious to change the outlook. Ultimately, recession will be avoided if the manufacturing sector completes its adjustment before the other sectors reach the end of their own period of inertia and if US domestic demand continues to grow.

Signs of a slowdown continue to dominate. The crisis in manufacturing continues.

Economic activity worldwide slowed further between June and September, according to global PMIs. The manufacturing index dropped below 50, remaining in August close to the lows reached in the previous month. Automobile production figures show that the contraction remained intense in July in the European Union, China and India, while Japan and the United States returned to positive growth rates and South Korea stabilised. In the electronics sector, which has also been contracting worldwide since the boom of 2017-18, global semiconductor sales show an accelerating trend of contraction to June (-17%), their worst performance since 2009, followed by a marginal slowdown in July (-16% yoy), with no further decrease on a quarterly basis. The summer stabilisation of the manufacturing index reflected a modest recovery in the activity of emerging economies, while advanced countries continued to contract at an almost unchanging pace. Global trade volumes declined slightly in June (-0.5% yoy), according to the index compiled by the CPB. The orders sub-index of the PMI shows that the trend remained weak in July and August.

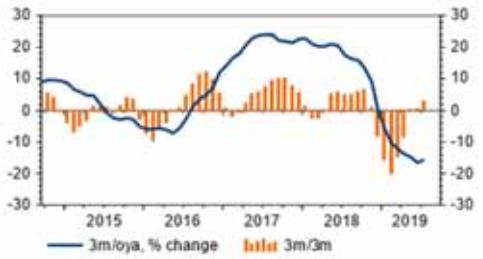
The services PMI was lower on average in the third quarter than in the previous quarter, but remained at levels consistent with an expansion of activity that is enabling global GDP to continue growing.

Fig. 1 – Automobile production contracting overall



Source: Intesa Sanpaolo chart based on National Office of Statistics data.

Fig. 1 - Semiconductor sales stabilising, but remain low compared with the previous year



Source: Semiconductors Industry Association/WSTS.

Le prospettive di breve termine restano negative

In the short term, the outlook is still uncertain, but negative factors predominate. The OECD's leading indicators point to a further slowdown in the Euro area and the US, compared with stability in Japan, China and Brazil. Business sentiment is still negative, according to the ifo Institut's Word Economic Survey. Overall, we can expect a less pronounced contraction in manufacturing, but also less growth in services. Construction should continue to perform well. **Global GDP growth is likely to slow further compared with the first half-year, in the light of the trend in economic surveys**. It is worth considering that global trade will be hit by a new wave of trade tariff increases between China and the United States, which could affect international trade from September to December. Although a further postponement seems likely, the threat of a no-deal Brexit by the United Kingdom on October 31 also remains. This could have significant adverse effects on trade with the EU in the short term. Forecasts of recovery in 2020

rely on the assumption that these shocks will not materialise, or that their effects will, in the end, be limited. In the short term, **particularly in Europe, there is a looming risk that real economic growth will stall.**

The reaction of the central banks has been vigorous, but is struggling to reach the real economy

Monetary policies have reacted to the slowing economic cycle with generalised easing, involving both official interest rates and the balance sheets of the central banks. This easing was anticipated by the markets, and interest rates have fallen on all maturities in the advanced countries. The contraction of excess reserves in the G3 has almost stopped, as can also be seen from the trend in the aggregate monetary base (Fig. H). The process could soon be reversed, due to the resumption of APP net asset purchases by the ECB and the stabilisation of reinvestments by the Federal Reserve. However, in the advanced economies, the effectiveness of monetary policy seems much reduced and the measures implemented this year risk exerting their effect more on the prices of financial and property assets than in the real economy. Companies will remain reluctant to invest while the outlook for demand is unfavourable and there is uncertainty over trade policies. Favourable access conditions to capital markets and lower financial expenses could lead to higher levels of debt and equity buybacks, rather than to more capital expenditures. Lastly, exchange rate depreciation pass-through and external rebalancing have been hindered by the fact that monetary easing is taking place simultaneously in most of the advanced countries.

Fiscal policy space is not being fully exploited

On the other hand, by reducing the cost of debt to unprecedented levels, **monetary policy is increasing fiscal space.** In effect, **fiscal policies are starting to support the economic cycle, to a greater extent than was estimated in June**. China is using fiscal policy to compensate for the effects of the trade war. In the United States, an agreement has been reached to defuse the risk of a fiscal cliff. Fiscal policy in Europe, Germany and Netherlands is easing, although without full exploitation of the fiscal space available. The very weak cyclical situation in Europe will not only result in the activation of fiscal stabilisers in many countries, but will also, we believe, cause a postponement of the fiscal correction efforts required by the Stability and Growth Pact. However, **the scale of the stimulus currently appears to be too limited to offset the weakness of aggregate demand**.

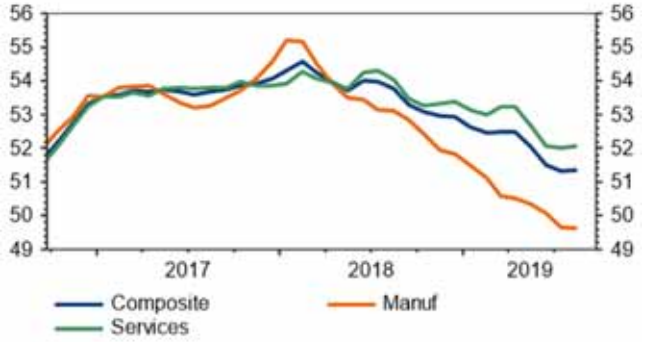
The recovery forecast for early 2020 is uncertain

We expect that average annual GDP growth will be unchanged at the global level in 2020, but will slow in the main advanced economies and in China. Our estimate for the Euro area has been cut to 0.9% and is now lower than the consensus average as well as the ECB forecast.

Despite the acceleration in wages that has begun in both the US and Europe, **we do not expect upward pressure on inflation**. There is no reason for the passing on of higher wages to prices to intensify while businesses, particularly manufacturers, are facing weak demand.

Global economic trends in 10 charts

Fig. A – Global PMIs

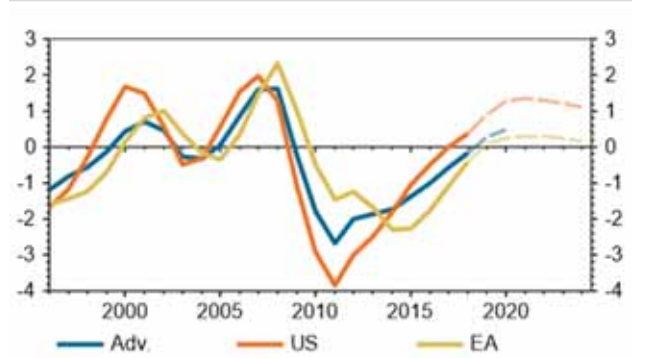


Source: Chart based on Markit Economics, Thomson Reuters-Datastream data

Fig. B – Growth in imports, yoy

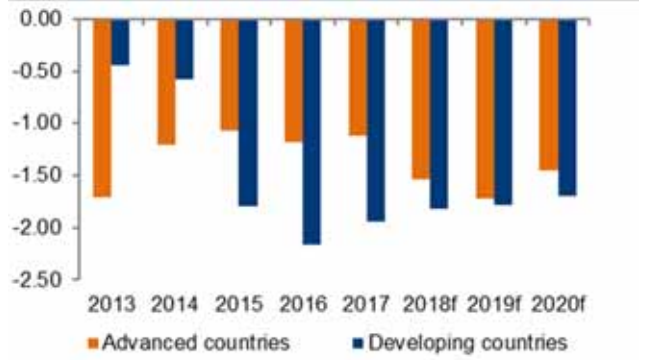
Source: Chart based on CPB World Trade Monitor, Thomson Reuters-Datastream data

Fig. C – Output gap (IMF estimate)



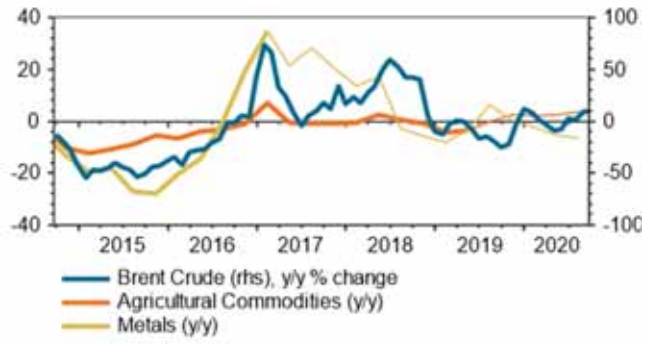
Source: IMF

Fig. D – Public sector primary balance as a % of GDP



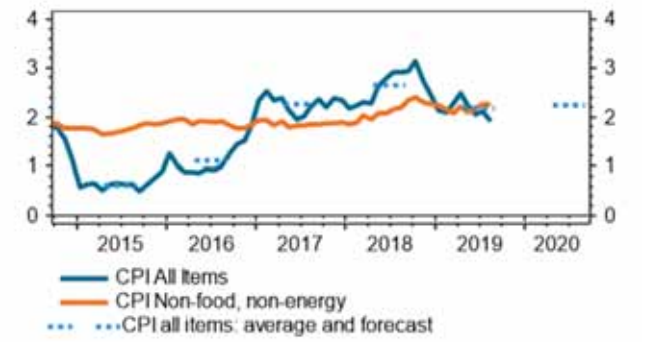
Note: as a % of GDP. Source: FMI, Fiscal Monitor, April 2019.

Fig. E – Commodity prices



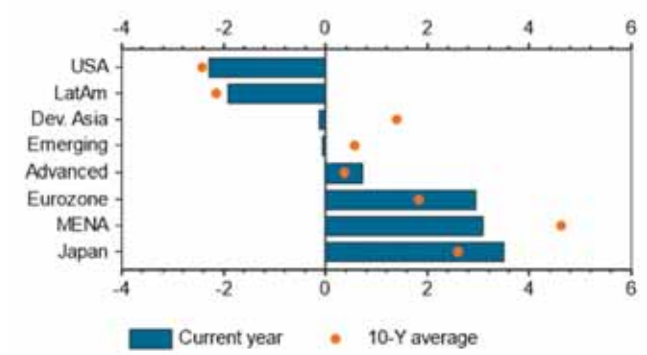
Source: Chart based on Thomson Reuters-Datastream data and Intesa Sanpaolo projections.

Fig. F – Consumer price indexes for OECD countries



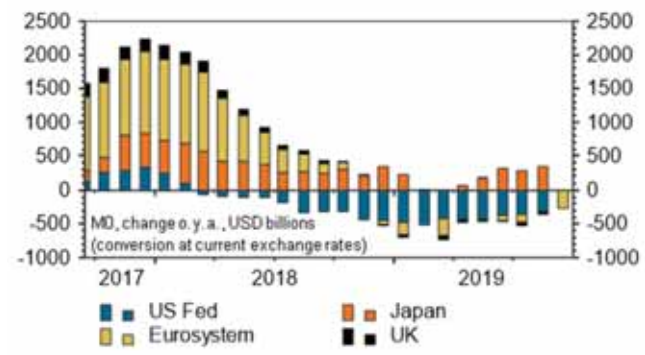
Source: Chart based on OECD, Thomson Reuters-Datastream data.

Fig. G – Balance of payments: current account balances as a % of GDP



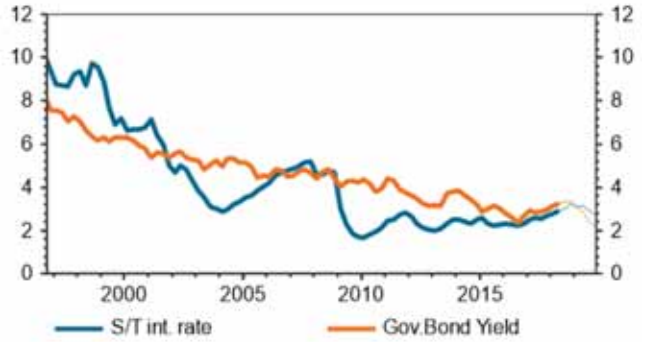
Source: IMF data and estimates, chart based on Thomson Reuters-Datastream data.

Fig. H – Monetary base, G-3 (change, USD Bn)



Source: Chart based on Thomson Reuters-Datastream, central banks data and Intesa Sanpaolo estimates.

Fig. I – Interest rates – global average



N.B.: The aggregate includes 44 advanced and emerging countries. Source: Chart based on Thomson Reuters-Datastream Charting and Oxford Economics data.

Fig. J – Lending to non-financial companies

Source: Chart based on Thomson Reuters-Datastream, ECB (integrated sector accounts), Federal Reserve (Flow of Funds) data.

Economic growth by geographical region

	2018	2019p	2020p	2021p	2022p
United States	2.9	2.3	1.8	1.7	1.8
Japan	0.8	0.8	0.2	0.9	0.7
Euro Area	1.9	1.1	0.9	1.4	1.3
Eastern Europe	3.4	2.6	2.6	2.4	2.3
Latin America	0.6	0.3	1.9	2.6	2.9
OPEC	0.4	-1.3	1.5	2.6	3.0
China	6.6	6.2	5.9	5.7	5.8
India	7.4	5.8	6.8	6.9	6.6
Africa	3.8	3.7	4.1	4.4	4.6
World	**3.6**	**2.6**	**2.7**	**2.8**	**2.9**

Source: chart based on Intesa Sanpaolo data.

United States: a two-faced outlook, dominated by political risks

Giovanna Mossetti

The outlook for the US economy for the rest of 2019 and 2020 has two sides. On the one hand, the **economic data** remain positive and are in line with a moderate slowdown in "endogenous" growth in the next few quarters but no signals of a 2020 recession. On the other hand, **geopolitical shocks** are taking root, increasing risks for the recovery. The escalation of the tariff war in 2019, over and above monthly volatility, confirms the trend of growing barriers to trade and rising political uncertainty, the leitmotiv of the scenario until at least the 2020 elections. However, despite the worsening geopolitical risks, we are not significantly altering our forecasts for 2019-20, which will have greater support from fiscal and monetary policy than was expected in June. **GDP growth is likely to be 2.3% in 2019, 1.8% in 2020 and 1.7% in 2021.** After slowing temporarily at the start of this year, core inflation has been picking up again towards 2%.

1. Macroeconomic framework still moderately positive. The macroeconomic data of the last few months have shown a scenario of modest growth, bolstered by domestic final demand. The driving force of the cycle is **consumer spending**, supported by solid fundamentals on two fronts. First of all, the expansion in the **labour market** has brought all the unemployment measures back to levels consistent with full employment, and excess demand is now pushing up wages (Fig. 4). The recent slowdown in **employment growth** (from average monthly changes of around 220k in 2018 to approx. 140k in the last three months) is consistent, at the moment, with a combination of supply shortages and slower GDP growth, from 2.9% in 2018 to close to 2% now. With monthly growth of 108k jobs and the current participation rate of 62.8%, the unemployment rate in 12 months' time would be stable at 3.7%, as in August. Secondly, consumer spending is being supported by solid **household balance sheets,** with a high **savings rate** (7.7% in August) and record net wealth. **Consumer spending is forecast to grow by 2.7% in 2019 and by 2.5% in 2020**.

Among domestic final demand components, **residential investment** is turning, thanks to lower mortgage rates, and could make a positive contribution to growth in Q3, after six consecutive quarters of decline. Growth for 2019 and 2020 is forecast at -2.2% and +0.8% respectively. **Public spending** is also expanding and, with the bipartisan budget deal in July, should continue to grow, by 2.5% in 2019 and 1.8% in 2020. As far as **foreign trade** is concerned, despite Trump's target to reduce the trade deficit through higher tariffs, the overall negative balance, like that with China, has kept increasing, with considerable reductions in flows on both sides of the trade balance. Net exports are likely to contribute -0.3 percentage points in 2019 and -0.2 in 2020.

The weakest link in the growth chain is **non-residential capital investment**, threatened directly by two main risks: weakness in global demand and geopolitical factors. This is clear from the **manufacturing** data and surveys, which have been slowing considerably towards stagnation/a modest contraction over the summer (Fig. 5). At the moment, the non-manufacturing sector is still expanding and could, as often in the past, be sufficient to counter the weakness in manufacturing (Fig. 5). This phase might therefore simply be a "mid-cycle adjustment", as the Fed indicated in June, to be tackled with a couple of rate cuts to ensure that the recovery continues. If the current shocks were normal economic shocks, the core scenario would, in all probability, be a return to moderate growth in manufacturing due to strong consumer spending and a strong service sector. This is where the geopolitical risks come into play, as they are compelling the Fed to make a series of rate cuts larger than those justified by a simple mid-cycle adjustment.

2. Political uncertainty and tariff war: trend or temporary shock? The risks to the US cycle (and the global economy) are greater than those shown by the macroeconomic scenario. The escalation of the tariff war and progressive erosion of the international trade system created over the past decades act to **curb investments** in two ways. On the one hand, they increase production costs and hit the global value chain. This could be a "one-off" negative shock to supply, reinforced by the simultaneous transmission to the rest of the global economy, which may run its course in a definite space of time. Estimates of the **tariff costs** imply modest curbs on

growth, which are sustainable by an economy that was growing by around one percentage point above potential in 2018. Barring any tariffs on the automotive sector, the US' measures and retaliatory measures by other countries would likely shave around 0.3 percentage points off US growth, according to the Tax Foundation. If the automotive sector is also included, the total costs would come to 0.7 percentage points.

However, there are signs that the US **aggressive trade policy** will persist and that it will be difficult to remove and/or reduce the tariffs already implemented (Fig. 9), while the existing system of bilateral and multilateral agreements could be changed without warning, uprooting the operational framework of the last few decades and introducing **increasing uncertainty**. The Fed constructed two indices to measure this increase in uncertainty over trade policy and estimates a negative effect on GDP by mid-2020 of about one percentage point (Figs. 7 and 8). The implications of this uncertainty, as for tariffs, might be limited to a one-off negative shock to supply. But the developments in the last 18 months suggest that the trend is still under way and has not plateaued. What happens in autumn will be crucial on **several fronts**. On the eve of the resumption of negotiations with **China**, there are no signs of a convergence of views on structural issues (e.g. intellectual property). Currently, our core scenario is that there will be no agreement until 2021 after the US elections. Should this be the case, 2020 would shape up to be volatile, with possible increases in tensions and threats to use the International Emergency Economic Powers Act to up the ante with China. **Tariffs on the automotive sector** will be a crucial pawn in the game with the EU and Japan, to be used as threats if not with the actual imposition of restrictive measures, to influence negotiations on the bilateral agreements with the two areas. For now, we have no evidence that the 2018-19 trend will keep trade tensions at their current levels.

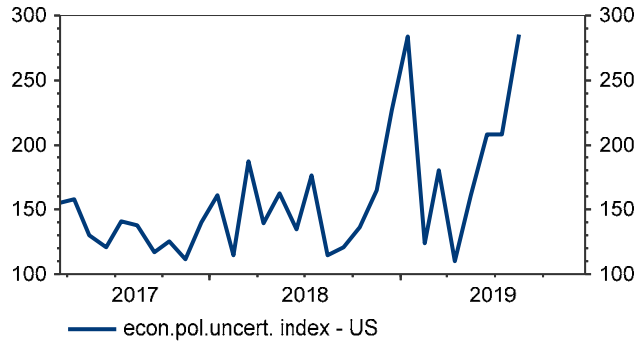
3. **The Fed is a follower in the policy game: further cuts in the pipeline**. The rates path will depend more on the direction of trade policy than on short-term changes in the data. In the FOMC, there is a large dispersion of opinions on expected (Fig. 11). However, if the trend in trade policy does not reverse and political uncertainty increases further, over and above transitory fluctuations, **the Fed will probably be "compelled" by events to cut rates further** to shore up growth, tackling the adverse effects of the tariff war and uncertainty with more expansionary financial conditions. We therefore forecast another **rate cut in December** and a possible further move in the first half of 2020. In the meantime, in order to tackle the emerging liquidity problems, at the next meeting a shift back to increasing the **Fed's balance sheet policy**, may be announced.

Macro forecasts

	2018	2019f	2020f	2018	2019				2020p				2021p
				4	1	2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	2.9	2.3	1.8	2.5	2.7	2.3	1.9	2.3	1.9	1.8	1.8	1.6	1.6
q/q annual rate				1.1	3.1	2.0	1.5	2.6	1.6	1.6	1.5	1.7	1.8
Private consumption	3.0	2.7	2.5	1.4	1.1	4.7	3.0	2.8	2.2	2.0	2.2	2.1	2.0
Fixed investment - nonresid.	6.4	2.7	1.3	4.8	4.4	-0.6	0.2	0.8	1.5	1.8	2.3	2.2	2.1
Fixed investment - residential	-1.5	-2.2	0.8	-4.7	-1.0	-2.9	1.3	1.0	0.8	1.2	1.0	1.0	2.0
Government consumption	1.7	2.5	1.8	-0.4	2.9	4.5	3.5	2.4	1.1	1.4	0.3	0.5	0.6
Export	3.0	0.1	1.3	1.5	4.1	-5.8	2.2	2.0	1.5	1.4	1.8	2.5	2.6
Import	4.4	1.7	2.2	3.5	-1.5	0.1	2.3	1.2	2.8	2.3	3.0	2.8	3.0
Stockbuilding (% contrib. to GDP)	0.1	0.1	-0.1	0.1	0.5	-1.0	-0.2	0.0	-0.1	-0.1	-0.1	-0.1	0.1
Current account (% of GDP)	-2.4	-2.5	-2.7										
Government Balance (% of GDP)	-6.4	-6.7	-6.5										
Government Debt (% of GDP)	137.1	136.7	138.4										
CPI (y/y)	2.4	1.7	2.1	2.2	1.6	1.8	1.7	1.8	1.9	2.3	2.2	2.1	2.1

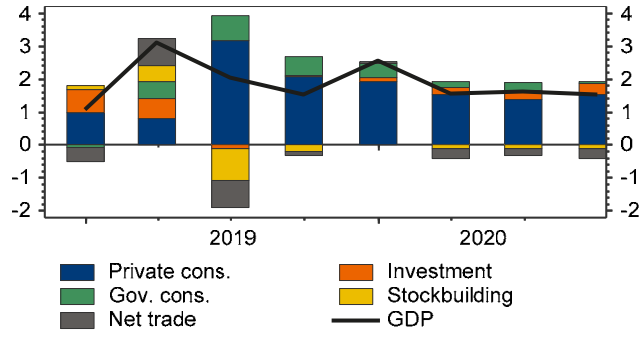
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo

Fig. 1 – Increase in political uncertainty curbs growth...



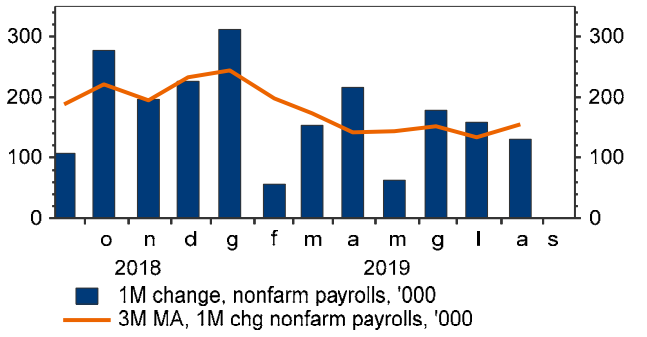
Source: Thomson Reuters-Datastream

Fig. 2 – ... but does not derail the recovery



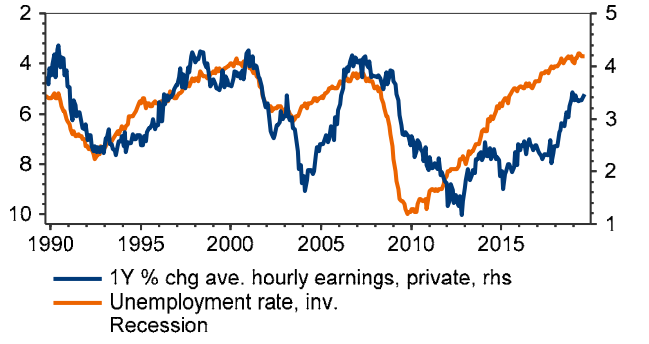
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream forecasts

Fig. 3 – Average monthly growth in job numbers still high, but slowing



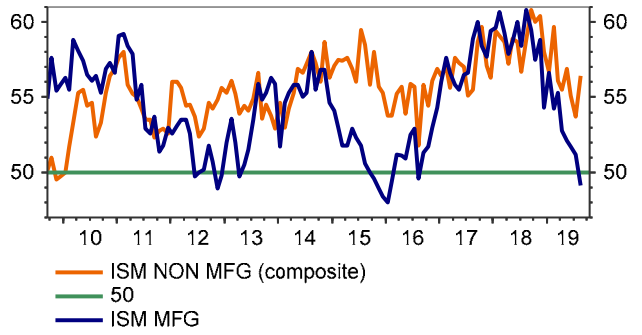
Source: Thomson Reuters-Datastream

Fig. 4 – Lowest unemployment rate since the 1960s and wages growth bolster consumer spending



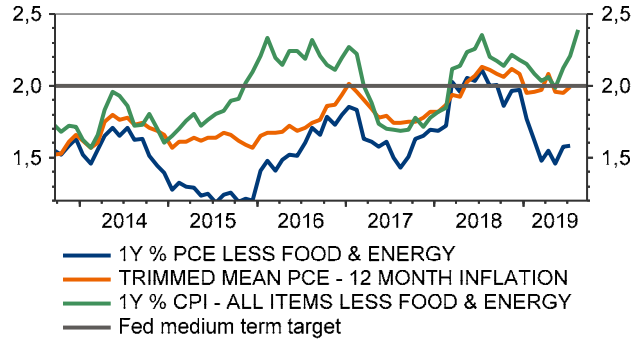
Source: Thomson Reuters-Datastream

Fig. 5 – Average monthly growth in job numbers still high, but down from the beginning of 2019



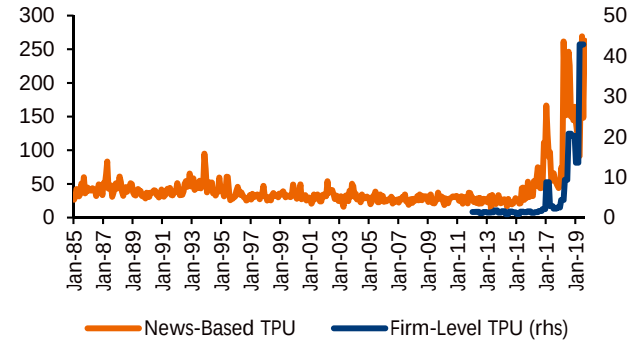
Source: Thomson Reuters-Datastream

Fig. 6 – Core inflation rising again towards 2%



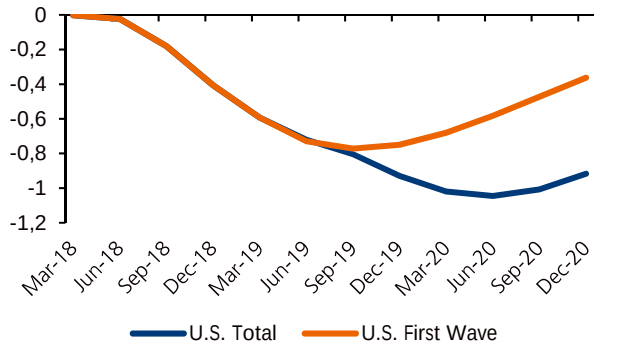
Source: Thomson Reuters-Datastream

Fig. 7 – Uncertainty over trade policy is unprecedented



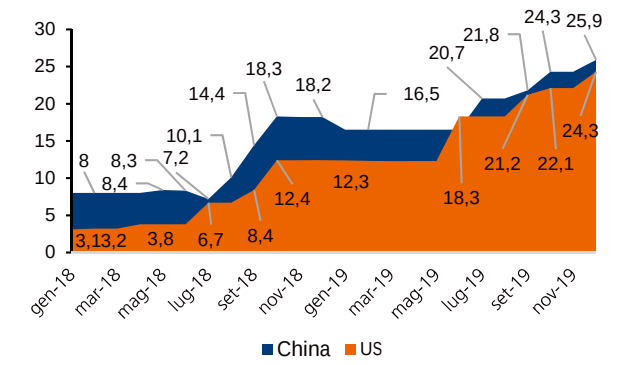
Source: D. Caldara et al. News-based TPU: index based on terms relating to the tariff war and trade policy published in the main US daily newspapers. Index=100 when 1% of the articles contain references to trade policy and/or uncertainty. Firm-level TPU: index based on non-political trade references and/or uncertainty in the quarterly reports of US listed companies

Fig. 8 – Projected effects on US GDP of the two waves of uncertainty (2018 and Spring 2019)



Source: D. Caldara et al., Projected effects on US GDP of the two waves of uncertainty relating to trade policy

Fig. 9 – US tariffs on China and Chinese responses on an upward trend

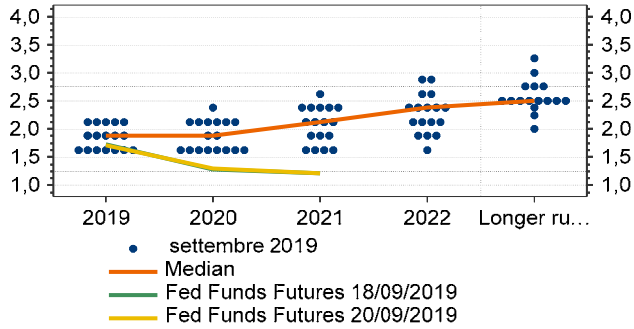


Source: PIIE

Fig. 10 – Tariffs hit imports and exports with China

Source: Thomson Reuters-Datastream

Fig. 11 – Fed's expected rates path has come closer to that of the market, but views within the FOMC are divergent



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream and Federal Reserve Board data

Tab. 1 – Economic projections of Fed members and regional Federal Reserve Bank Presidents

Variables	Median			
	2019	2020	2021	Longer run
Change in real GDP	**2.2**	**2.0**	**1.9**	**1.8**
June projection	2.1	2.0	1.8	-
Unemployment rate	**3.7**	**3.7**	**3.8**	**3.9**
June projection	3.6	3.7	3.8	-
PCE inflation	**1.5**	**1.9**	**2.0**	**2.0**
March projection	1.5	1.9	2.0	-
Core PCE	**1.8**	**1.9**	**2.0**	**2.0**
June projection	1.8	1.9	2.0	-
Federal funds rate	**1.9**	**1.9**	**2.1**	**2.4**
June projection	2.4	2.1	2.4	-

N.B.: Economic projections of members of the Federal Reserve and regional Federal Reserve Bank Presidents – September 2019 GDP and deflator: 4Q/4Q change Unemployment: 4Q average Source: Federal Reserve Board

Euro Area - phase of weakness continues into 2019H2

Luca Mezzomo

The contraction of manufacturing activity is proving more protracted and intense than expected. The effects of the US protectionist measures and sector dynamics (downward phase of the IT cycle, adaptation problems in the automotive and chemicals sectors) are mounting up. The consensus forecasts for real growth and inflation were drastically revised once it became clear that there was no longer a possibility of an upturn in 2H19; monetary policy also embarked on a new expansionary course. For the time being, employment growth and the resilience of services and employment are keeping the risk of recession at bay. Despite this, the contraction in manufacturing output may also compromise the performance of other sectors in the longer term. However, the official and consensus forecasts still point to an increase in economic growth in 2020, and higher than our own estimates.

Moderate pick-up in real growth projected for 2020

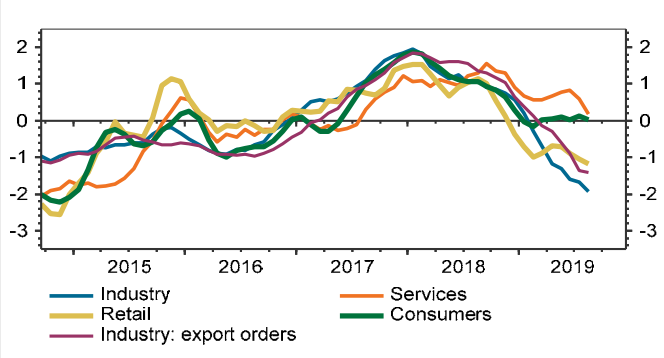
Despite the weakness in industry, GDP growth could remain positive in 3Q: economic surveys are consistent with a quarterly increase of 0.1-0.3% qoq and with a still low, albeit rising, probability of a decline. We are heading for a change in the low part of this interval in both 3Q and 4Q of this year. The European economy's resilience to the contraction in manufacturing activity is the result of greater stability in the services sector, a favourable period for construction and growth in employment and household income. These factors enable the economy to sustain long periods of contraction in manufacturing activity, even if they last longer than a year, provided that they are not too intense. However, we believe that the contraction in manufacturing activity will run its course in the next few months, enabling GDP growth to return to 0.2-0.3% qoq in 2020, despite a less impressive trend in both construction (Fig. 3) and services (Fig. 4) than in 2018.

The extremely accommodative financial conditions could shore up the demand components that are sensitive to interest rates, such as purchases of consumer durables and investment. Nevertheless, capital investment is curbed by demand expectations, uncertainty and a worsening in profitability (see Fig. 10), and we therefore consider it unlikely that it will accelerate in 2020, despite the negative rate policy. Demand for loans to finance investment is unremarkable. Rather, negative rates find an outlet in the property market, by fuelling price growth, and in a search for returns on the international markets.

Although we cannot rule out a modest positive contribution from net exports once the impact of the US tariffs on China have been absorbed, we believe that the bulk of growth will come from domestic final demand, especially household spending (see Fig. 7). The latter will also be boosted by more accommodative fiscal policies, which have already been implemented in Germany, from 3Q19, and announced in the Netherlands with the 2020 budget. To summarise, we expect average annual GDP growth of 0.9% yoy in 2020, broadly the same as in 2019.

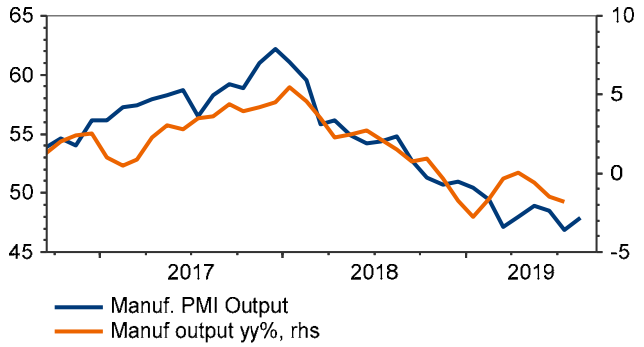
This rate of GDP growth would still be consistent with an increase in employment levels, albeit less pronounced than in 2019, and with a stable unemployment rate, after years of a net decline.

Fig.1 – Confidence survey: by sector



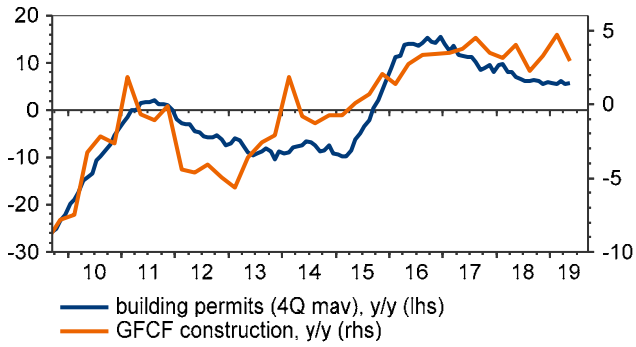
Source: Thomson Reuters-Datastream, Eurostat

Fig. 2 – Manufacturing output and GDP



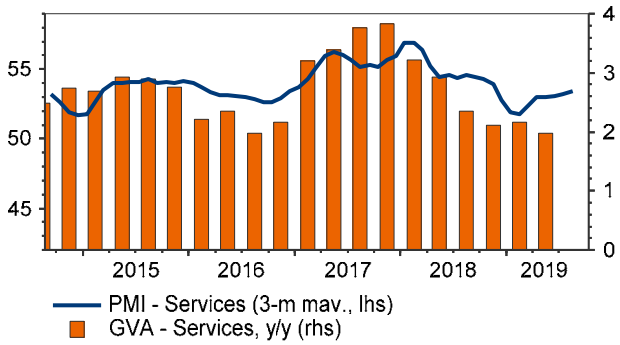
Source: Thomson Reuters-Datastream, Markit Economics, Eurostat

Fig. 3 – Investment in construction and building permits



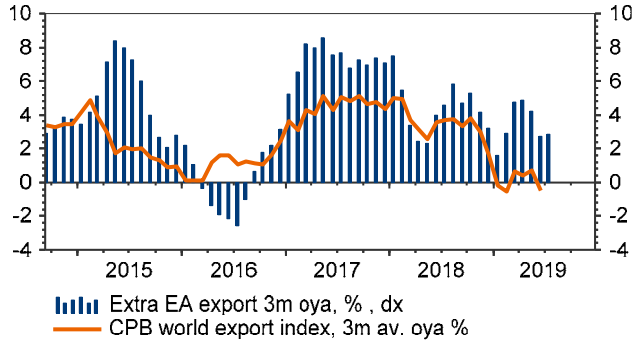
Source: Thomson Reuters-Datastream

Fig. 4 – Services: PMI and value added



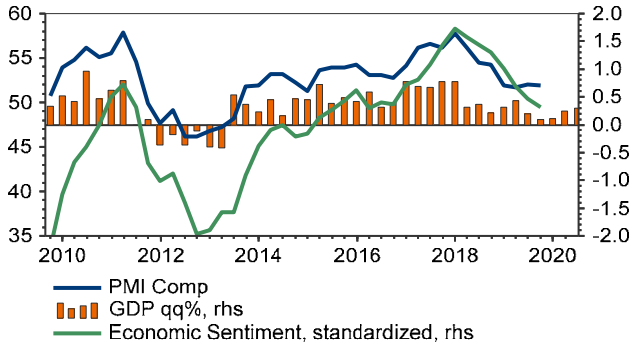
Source: Thomson Reuters-Datastream, Eurostat, Markit Economics

Fig. 5 – Non-EU exports and global demand



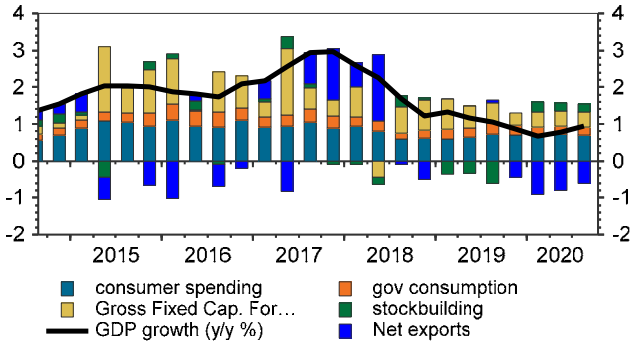
Source: Thomson Reuters-Datastream, CPB, Eurostat

Fig. 6 – GDP and confidence surveys



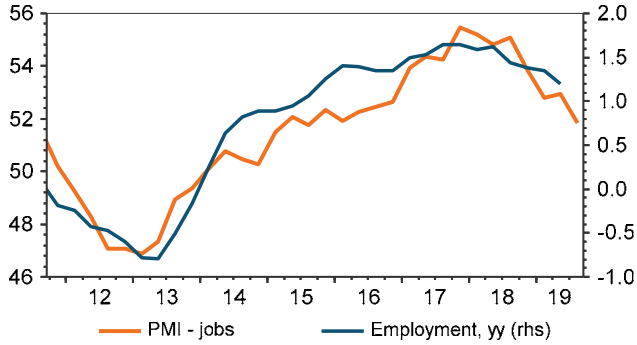
Source: Thomson Reuters-Datastream

Fig. 7 – Contribution of demand components to GDP growth



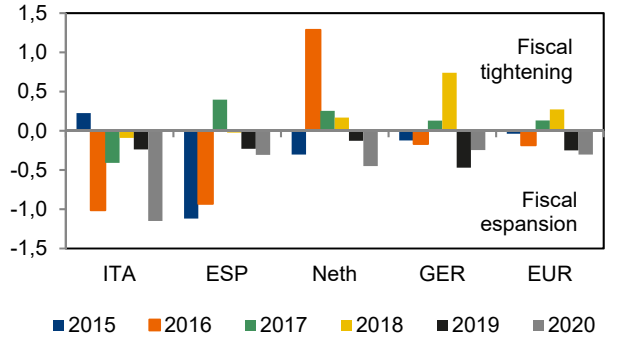
Source: Intesa Sanpaolo chart from Eurostat data. Our forecasts.

Fig. 8 – Employment and company expectations about headcounts



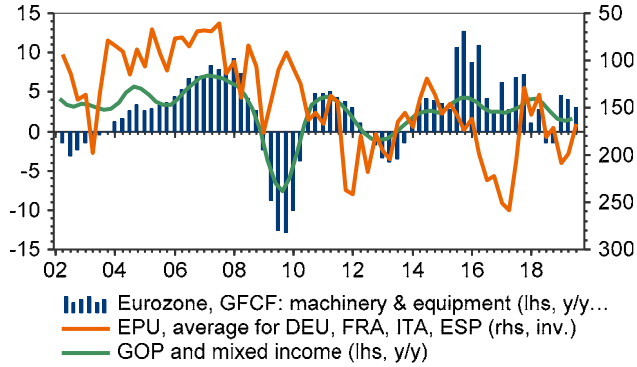
Source: Thomson Reuters-Datastream, Markit, Eurostat

Fig. 9 – Fiscal policy



Source: Thomson Reuters-Datastream

Fig. 10 – Gross capital investment, profitability and uncertainty



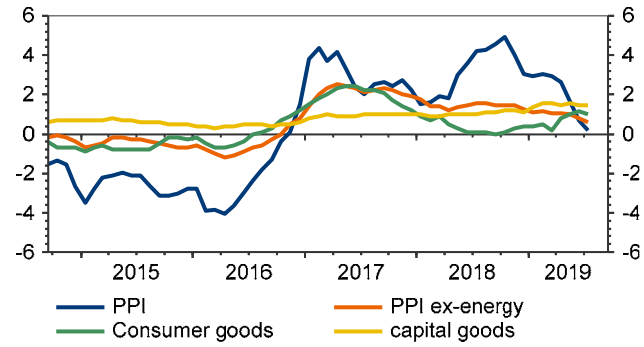
Source: Thomson Reuters-Datastream

Prices: wages pick up but the pass-through to domestic prices is nowhere to be seen

The fall in unemployment, which has reached historic lows in some countries that were unaffected by the debt crisis in 2010-12, is beginning to exert some upward pressure on wages (see Fig. 12) and on hourly labour costs. However, there does not seem to be any transfer to aggregate domestic prices, although there are differences between manufactured goods (curbed by less favourable market conditions) and services (where the price trend is more clearly positive). Producer prices for consumer goods, which have been stable since 2018, accelerated to around 1% qoq in 2019 (Fig. 11). The harmonised consumer price index is slowing due to statistical comparison effects mainly connected with energy goods and services, which will be partly reversed in Q4. Core inflation, however, remains broadly stable at around 1% (Fig. 13).

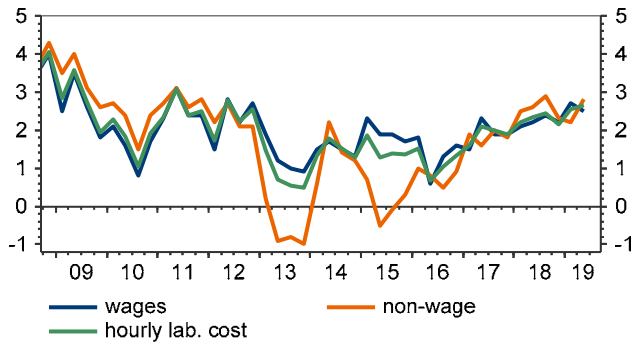
In terms of the outlook, companies are signalling less upward price pressure in line with the weakening of demand conditions (Fig. 14); expectations of household price increases, however, are virtually unchanged at relatively high levels. The contribution of fuel prices will again become positive in September but will not be able to change inflation much in the next few months. We expect core inflation to remain stable again in 2020, with fluctuations of between 0.9 and 1.5% year-on-year and an average annual variation of 1.1% (1.2% for the general index).

Fig. 11 – Producer prices



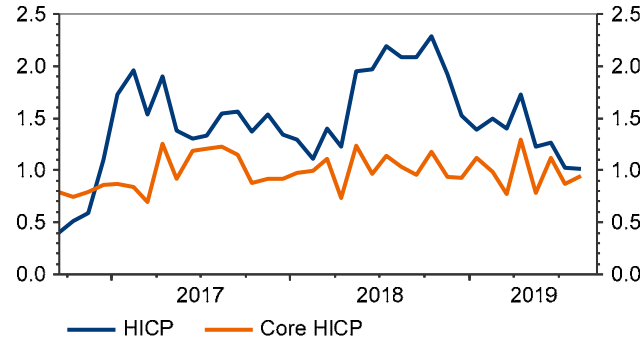
Source: Eurostat

Fig. 12 – Wage growth



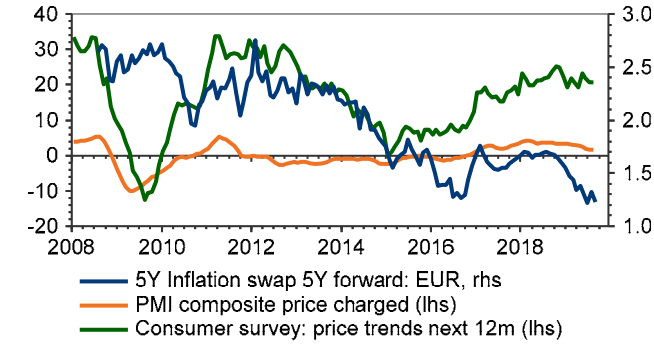
Source: Thomson Reuters-Datastream

Fig. 13 – Inflation trends (HICP)



Source: Thomson Reuters-Datastream

Fig. 14 – Inflation forecasts



Source: European Commission, Markit Economics and Thomson Reuters Datastream.

Monetary policy: end-of-mandate sprint but confidence in monetary stimulus is weakening

After noting that the data published on 25 July had not shown the improvement required to assume convergence of inflation with the medium-term target, on 12 September the ECB announced a package of stimulus measures. Overall, they were close to consensus expectations but with a few surprises. The measures include:

- a **trimming of the deposit rate from -0.40% to -0.50%**, while leaving unchanged the main refinancing operations (MRO) rate and the marginal refinancing rate. Cutting the two other policy rates was not even considered. This is less than the market was expecting (-0.6%), but the door has not been closed to new cuts.
- the **continuation of the easing bias,** with the possibility of further rate cuts until such time as the inflation outlook converges robustly with the target and stabilises at just under 2%.
- a **two-tier system for reserve remuneration** under which part of banks' holdings of excess liquidity will be exempt from the negative deposit facility rate (up to six times the reserve requirement). This measure is intended to contain the risk of perverse effects on credit due to the cost of holding excess reserves – the size of which is due to grow with the resumption of net purchases under the asset purchase programme (APP) – but which has the negative side effect of exerting upward pressure on some segments of the money market. The size of the excess reserves to which the negative rate is applied is quite large, however, in order to keep very short-term rates close to the depo rate.
- the **relaunch of net purchases under the APP at the rate of USD 20 bn per month**, with effect from 1 November, **without a fixed end date**: "as long as necessary to reinforce the accommodative impact of its policy rates", and expected to end shortly before the ECB starts raising rates. The size of the purchases is lower than the consensus estimates but the absence

of a fixed expiry date should be taken as a good sign. This part of the announcement was the most surprising as initially the APP was the tool used to counter the risk of deflation.

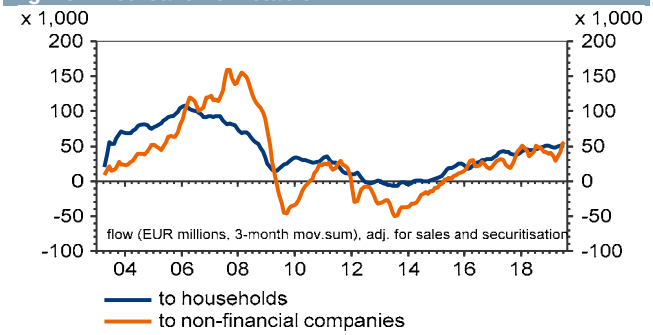
- The policy of reinvesting maturities under the APP will be extended *until the ECB starts to raise policy rates*.
- Lastly, **the conditions of TLTRO III have been made more attractive**: now the average rate on the MROs will be applied, or the deposit rate if loan growth exceeds the benchmark, both calculated on the life of the operation, and will no longer require the 10-bps spread. In addition, the duration of the operations has been extended from two to three years.

The open-ended nature of the purchases programme is the most surprising part of the announcement. Specifically, the statement that it will be terminated close to the raising of rates indirectly implies that net purchases will continue until inflation has reached its target. The ECB staff's forecasts on inflation and growth were therefore trimmed, as expected. Growth is estimated at 1.1% and 1.2% in 2019 and 2020 respectively, with a more pronounced acceleration in 2021. These estimates are slightly higher than our projections: however, as Mario Draghi pointed out, the baseline scenario does not include the no-deal Brexit scenario, which could lead to further reductions in growth if it were to materialise. Inflation, however, is forecast at 1.2% and 1.0% respectively, rising subsequently to 1.5%. The 2020 forecast has fallen by some four-tenths of a percentage point and two-tenths of a point for the aggregate, which excludes energy and food. In this case, the numbers for the first two years are more or less identical to ours.

This implies a greater acceleration in real growth in 2020 than the annual averages would seem to indicate. Thus, if the scenario is correct, there would need to be a significant improvement in the data in the first half of 2020 to avoid a fresh cut in the rates. There could be no better scenario for the ECB than an early pick-up in Europe's economic cycle in early 2020, which would be perceived as proving the success of the aggressive measures implemented this year. However, the ECB is also aware that the effectiveness of monetary policy in this phase is very low. Much will depend on the credibility of the scenario of a pick-up in German growth in 2020, which still seems to be considered the key, and which depends little on the measures implemented and much on the speed of adjustment of German industry.

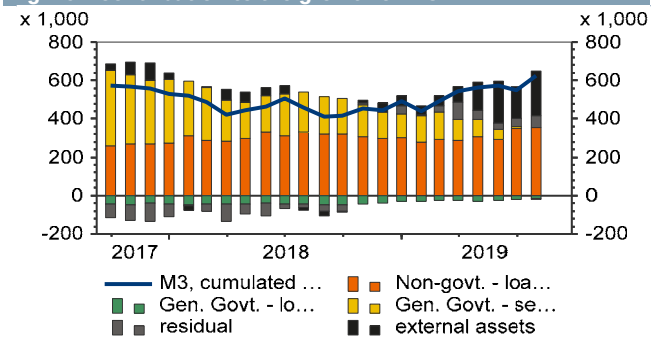
In the second half, however, if the figures have improved, as in the baseline scenario, this could initiate a debate on whether or not to reduce the stimulus, and a reversal would perhaps take place in 2021; this is despite the fact that current inflation projections are a long way from the target. However, the international macroeconomic scenario is so uncertain that the balance of risks could force the central bank to continue with its net purchases into 2021, maintaining a highly expansive bias in monetary policy while hoping that it is fiscal policy that solves the problem with more efficient tools.

Fig. 15 – Net loans flow stable



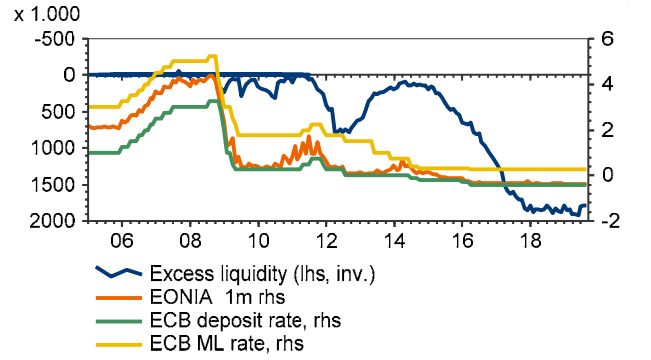
Source: ECB, Thomson Reuters-Datastream

Fig. 16 – Contribution to the growth of M3



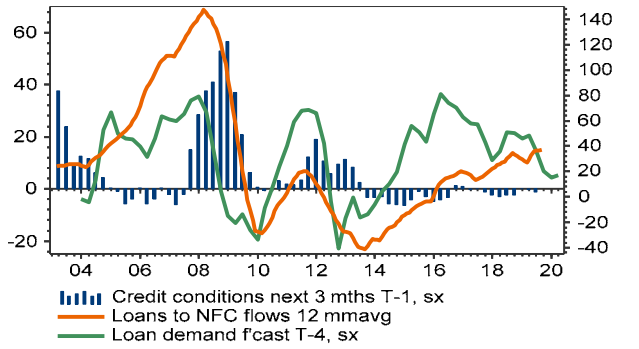
Source: ECB data on monetary developments and ISP calculations.

Fig. 17 – Policy rates and excess liquidity



Source: chart based on ECB and Thomson Reuters 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 to tighten conditions. Source: ECB, Bank Lending Survey.

Macro forecasts

	2018	2019f	2020f	2018	2019				2020p				2021p
				4	1	2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	1.9	1.1	0.9	1.2	1.3	1.2	1.0	0.9	0.7	0.8	1.0	1.2	1.3
- q/q change				0.3	0.4	0.2	0.1	0.1	0.3	0.3	0.3	0.3	0.4
Private consumption	1.4	1.2	1.3	0.4	0.4	0.2	0.4	0.3	0.4	0.3	0.3	0.2	0.3
Fixed investment	2.3	2.8	1.9	1.5	0.2	0.5	0.4	0.4	0.5	0.5	0.4	0.4	0.5
Government consumption	1.1	1.3	1.1	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Export	3.5	2.5	1.8	1.0	0.9	0.0	0.6	-0.1	0.6	0.7	0.7	0.7	0.6
Import	2.7	2.9	3.3	1.0	0.4	0.2	1.0	1.0	1.0	0.7	0.6	0.4	0.6
Stockbuilding (% contrib. to GDP)	0.0	-0.3	0.1	-0.3	-0.2	0.0	-0.1	0.3	0.1	0.0	-0.1	-0.1	0.0
Current account (% of GDP)	3.5	3.3	3.0										
Government Balance (% of GDP)	-0.9	-0.9	-1.0										
Government Debt (% of GDP)	87.1	85.8	84.3										
HICP (y/y)	1.8	1.2	1.2	1.9	1.4	1.4	1.0	1.1	1.3	1.2	1.1	1.3	1.5
Industrial production (y/y)	0.9	-1.3	0.5	-1.9	-0.5	-1.3	-2.4	-1.0	-0.8	0.0	1.3	1.4	1.1
Unemployment (%)	8.2	7.6	7.6	7.9	7.8	7.6	7.5	7.6	7.6	7.6	7.6	7.6	7.6
3-month Euribor	-0.3	-0.4	-0.5	-0.3	-0.3	-0.3	-0.4	-0.5	-0.5	-0.6	-0.6	-0.6	-0.6
EUR/USD	1.18	1.12	1.15	1.14	1.14	1.12	1.11	1.11	1.13	1.14	1.15	1.16	1.16

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

Germany: the economic outlook has darkened further

Andrej Arady

German economy is now in its weakest phase since 2013. After several years of above-potential growth, in 2018 it weakened and in mid-2019 it slipped at the brink of a technical recession. To be sure, German economy opened 2019 on a positive note, growing 0.4% qoq in Q1. However, in Q1 the economy was supported by several one-off factors, which led to a sharp normalization in the following period. GDP thus fell in the second quarter by -0.1% qoq. Business cycle barometers indicate that the contraction could spread to the second half of the year. Later, in 2020, we expect economy to gradually bottom-out. The weakness now originates primarily from export-oriented industries. Hopefully, some of the dragging factors, (e.g. in automotive sector) will gradually fade out over the forecast period, but others (external headwinds) will remain in place. Domestic demand, fiscal policy as well as monetary policy should remain supportive. Compared with our previous forecast note, we have revised our outlook on German economy downwards, by three tenths to 0.5% yoy for 2019 and nine tenths to 0.5% yoy for 2020 (in this case, well below the consensus mean). Both positive and negative risk of this forecast are extremely high, primarily owing to trade wars development and Brexit.

Growth projections for 2019 and 2020 revised downwards substantially

The economy remains marked by ongoing dichotomy between relatively strong domestic and very weak external demand. Although the growth of household consumption decelerated in the second quarter to 0.1% qoq after the buoyant 0.8% qoq seen at the start of the year, sound labor market conditions and fiscal measures should support consumer spending in following quarters. Behind the volatility caused by automotive sales, the average growth in the first half of 2019 was in line with trend seen in the past years and above the weak end of 2018. While private consumption may decelerate somewhat, it will remain a key growth driver in this and next year. Labor market is in a good condition, but it is not able to improve anymore at a pace as seen before. First, labour market is already at full employment and further progress is hard to achieve; secondly the economic downturn has already started to leave a slight mark on the job market. On a sequential basis, adjusted for the seasonal fluctuations, in the second quarter, the number of jobs increased only 0.1% over the quarter. The year-on-year growth thus further decelerated, to 1.0% in 2Q vs 1.1% in 1Q and 1.3% 4Q18, respectively. The rate of unemployment though is forecasted to move only little from current lows of 5%. The effect of aging population will be only partially offset by increased participation of woman and net immigration. Indeed, net immigration has already decreased this year.

Consumer spending should support economy ahead but less than previously

Labour market is in a good condition, but it is not able to improve anymore at the pace seen before

Inflation is declining in the near term. In August, measured by HICP, inflation edged down to 1.0% yoy from 1.7% yoy in 2Q. The latest drop can be attributable primarily to energy prices, which decelerated to 0.6% yoy. In the following months, headline inflation is expected to stay low, almost unchanged, while it should pick up in the final months of 2019. In the course of 2020, subdued economic growth should prevent any significant increase. We expect inflation to decelerate from 1.9% in 2018, to 1.5% in 2019 and 1.4% in 2020.

Inflation edged down

The key culprit of current weakness of economy is an export-oriented manufacturing, which is in contraction since 3Q18. The decrease is broadly spread among individual sectors, the most painful is though the automotive and chemical/pharma sector. The former is in a difficult transition towards a fuels cleaner vehicle which last for more than previously thought. The latter is paying for a cyclical weakening of other customer industries, particularly automotive and also for normalization of the pharma industry after the 2018 boom (+17.7% yoy).

The current weakness is linked particularly to automotive and chemical-pharma industry

On a whole, a current level of business cycle barometers signals an extension of the contraction phase also into a second half of the year. Forward-looking indicators signal an ongoing dichotomy in economy, albeit it should gradually ease. Services and construction are at levels signaling further expansion. While growth of services though should ease, construction probably will accelerate. Manufacturing meanwhile remained in contraction territory when measured by PMIs. According to the IFO survey, business climate in manufacturing has been on a decreasing

Business surveys are pessimistic…

trend since the beginning of 2018. Overall business climate in German economy slipped in August to its lowest level since November 2012. External headwinds remain to dampen economic growth. Neither in automotive, nor in chemical industry is recovery in sight. Nevertheless, later in 2020, we can hopefully expect gradual normalization after a longer than expected adapting on the new WLTP regulations on diesel vehicles. Pharma industry alone should gradually normalize already at the turn of the year.

…a part of previous weakness though, is related to one-off factors…

The recent data covering activity in second quarter were very weak. Many of them though were negatively affected by one-off factors. An original date of Brexit scheduled on March 31st led to an extensive stockpiling in the first quarter which was replaced by opposite moves in the following quarter, exacerbating the weakness of exports in the second quarter (-1.3% qoq in 2Q vs buoyant 1.8% qoq in 1Q). Another factor that dampened growth in the second quarter occurred in construction sector. A favorable weather boosted the activity in the first quarter which was replaced by normalization in the second quarter. Furthermore, a rebound of automotive sales after the weak figures seen at the end of 2018 boosted the first quarter of 2019 but dampened the second quarter.

Fiscal policy is in a loosening stance

As a result of previous budget, since July 1st came into effect supportive measures for households, such as increase of child benefit, increase of child supplement for families with low income, lower social contribution for low earners and more money for 21 million pensioners (in western Germany by 3.18%, in eastern Germany by 3.91% resp.). German fiscal policy is in a favorable position. The debt ratio stood at 61%-of-GDP in the first quarter. Until the end of the year, it is expected to fall to under 60% threshold, for the first time in 17 years below the Maastricht threshold. This paves the way for further support of economic growth. Indeed, a general government surplus is declining. This can be attributable to a loosen fiscal stance, which will be extended also into 2020. Lower economic growth yet had no significant impact on budget revenues. Besides pension benefits and family policy, budget expenditures aim on infrastructure, education and defense.

Revision of historical data showed that Germany in 2018 did not come as close to recession as previously thought

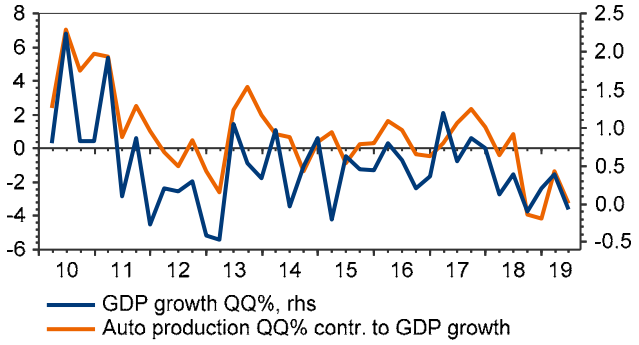
Together with the Q2 GDP release, historical data series of national accounts were revised. The overall picture of German economy remained unchanged, some quarters though were revised markedly. The revision revealed that the economy was not so close to a technical recession in 2018 as posted previously. Growth in the first half of 2018 was revised downwards, but the rate of contraction in 3Q18 was reduced from the previously released -0.2% qoq to -0.1% qoq and stagnation in the final quarter of 2018 was revised up to 0.2% qoq growth. The headline growth in first quarter of current year was left unchanged at 0.4% qoq.

Macro forecasts

	2018	2019f	2020f	2018	2019				2020p				2021p
				4	1	2	3	4	1	2	3	4	1
GDP (constant prices, y/y) *	1.5	0.5	0.5	0.6	0.9	0.4	0.4	0.1	-0.1	0.3	0.7	1.1	1.2
- q/q change				0.2	0.4	-0.1	-0.1	-0.1	0.2	0.3	0.3	0.3	0.3
Private consumption	1.2	1.5	1.4	0.4	0.8	0.1	0.3	0.3	0.4	0.4	0.4	0.4	0.5
Fixed investment	3.6	3.1	2.2	0.9	1.5	-0.1	0.4	0.6	0.5	0.7	0.7	0.5	0.5
Government consumption	1.4	1.9	1.7	0.4	0.8	0.5	0.3	0.4	0.5	0.4	0.4	0.4	0.4
Export	2.3	1.1	1.2	0.2	1.8	-1.3	0.4	0.2	0.4	0.5	0.5	0.6	0.5
Import	3.7	2.7	2.8	0.7	0.9	-0.3	0.5	1.0	1.0	0.7	0.4	0.4	0.6
Stockbuilding (% contrib. to GDP)	0.3	-0.7	-0.4	-0.1	-1.0	0.3	-0.4	-0.1	0.0	0.0	-0.2	-0.2	-0.1
Current account (% of GDP)	7.4	6.7	6.5										
Government Balance (% of GDP)	1.0	0.8	0.3										
Government Debt (% of GDP)	60.9	58.4	56.5										
HICP (y/y)	1.9	1.5	1.4	2.1	1.6	1.7	1.1	1.6	2.3	1.4	1.1	0.9	0.8
Industrial production (y/y)	0.9	-4.1	-0.6	-1.9	-1.6	-4.2	-5.0	-5.7	-5.4	-2.0	1.4	4.0	4.2
Unemployment (%)	5.2	5.0	5.1	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	-0.32	-0.68	0.36	0.10	-0.11	-0.57	-0.71	-0.70	-0.68	-0.67	-0.65	-0.62

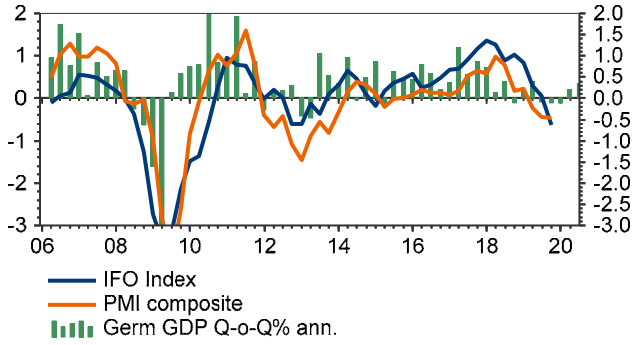
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo

Fig. 1 – The braking effect from the automotive sector is still present



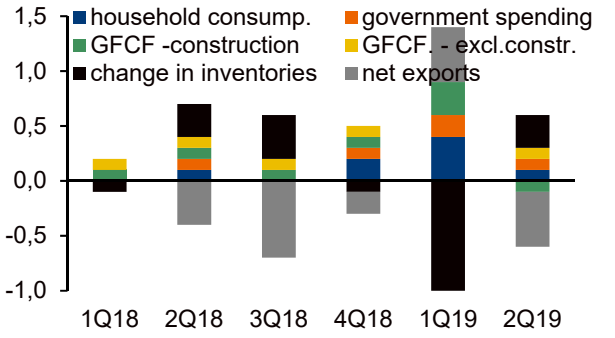
Source: Markit, IFO and Intesa Sanpaolo research

Fig. 2 – PMI and IFO: German economy is at high risk of entering a technical recession



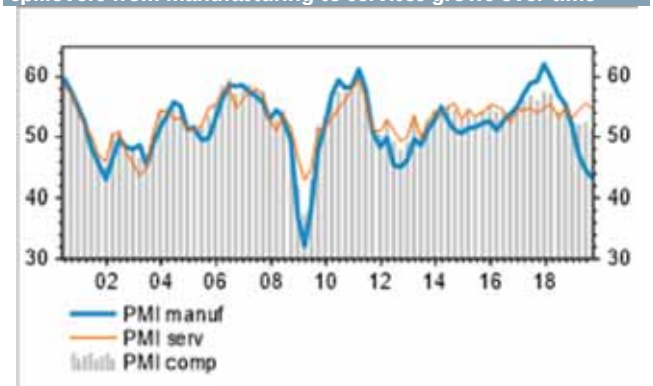
Source: Markit and Intesa Sanpaolo research

Fig. 3 – GDP composition reveals one-off fluctuations, contribution to qoq growth in %-pts



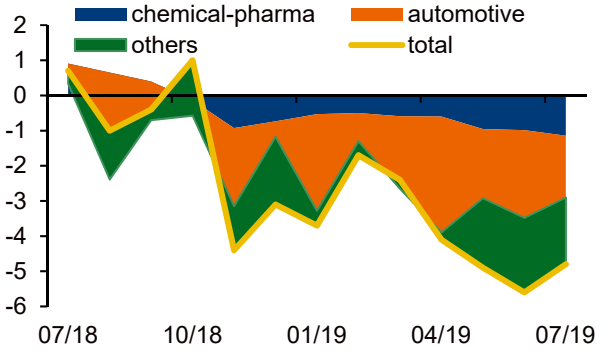
Note: GFCF -gross fixed capital formation; Source: Destatis, and Intesa Sanpaolo

Fig. 4 – The dichotomy of Germany's economy -PMI manufacturing vs PMI services. The likelihood of negative spillovers from manufacturing to services grows over time



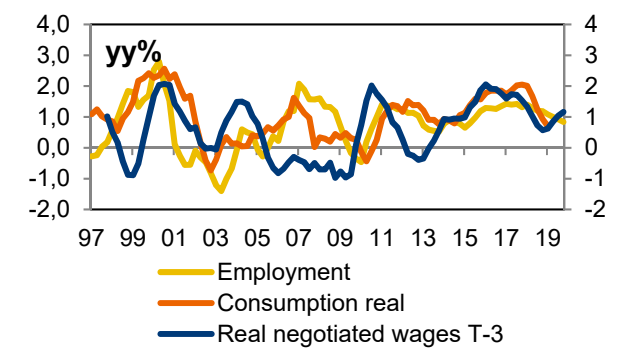
Source: Thomson Reuters-Datastream

Fig. 5 – Yoy growth of manufacturing and contribution of selected sectors



Source: Eurostat and Intesa Sanpaolo

Fig. 6 – Growth still sustained by solid consumption



Source: Thomson Reuters-Datastream

France: the feared slowdown has not yet occurred; the economy is proceeding at a moderate pace

Guido Valerio Ceoloni

French economy at cruising speed: +1.3% confirmed for this year, slowing to 1% in 2020

In the second quarter, the French economy maintained the growth rate seen in the first quarter, i.e. 0.3% qoq; in annual terms, there was a marginal increase to 1.4% from 1.3%, giving year-to-date growth of 1.1%. The contribution from domestic demand was positive, growing compared with the first quarter to 1.6%, as did foreign trade, which increased from +0.1% to +0.3%. Inventories made a negative contribution of half a percentage point. After signs of a slowdown in the Spring, confidence surveys showed activity strengthening over the summer both in manufacturing and, at a more pronounced level, in services, which suggests that this quarter will see further improvement of 0.3% qoq. We therefore confirm our previous GDP growth forecast for this year of 1.3%, while for 2020 we predict a slowdown to 1.0% – a downward revision of our previous estimate, as we believe that the cyclical slowdown factors will have their maximum effect next year rather than in 2019.

Consumption has been recovering since the summer and will be boosted next year by Macron's tax cut

Household **consumption** during the summer should remain positive after July's good data (+0.5% mom) and then remain set for an increase of 0.5% qoq in the third quarter after the stagnant 0.1% qoq of the second quarter. This would be one of the best figures seen since the mid-2017. Confidence surveys had shown a fall in household confidence between winter and spring, which originally suggested a reversal of the trend for household expenditure. Today, however, it seems to have been just a temporary slowdown, which is already in the process of being reversed in the autumn with an annual trend of around 1.3% in 2019 from the 1.0% seen in 2018. For 2020, we forecast further expansion of around 1.2-1.3%: next year, household disposable income should be boosted by the tax cuts of over 9 billion promised by Macron.

Manufacturing showed negative signs in the summer, but the sector is not yet at risk of contraction

The manufacturing sector remains the main source of uncertainty. In the second quarter, industrial production grew by only 0.2% qoq from 1.0% qoq due to the unexpected collapse in June (-2.3% mom) which had a negative effect on activity for the current quarter. Confidence surveys showed a slowdown in activity in August compared with July, especially for the output of intermediate goods; similarly, PMI indicators showed a level oscillating around 50, at the threshold between expansion and contraction. We therefore expect a negative contribution from industrial output for the current quarter of around one tenth of a point, to give an annual change on course for 1.0% this year from the 0.3% of 2018. In **services**, activity remains positive; PMI indicators are around 53, in line with the Euro area average. The Banque de France is also forecasting a stable rate of growth for the sector. Lastly, **construction** remains in an acceleration phase, supported by a positive phase for residential construction in the main urban areas.

Investments, particularly residential, continue to sustain growth, including this year

The **capital investments** component showed itself to be resilient in the second quarter, growing from 0.5% qoq to 0.9% qoq, due mainly to the contribution of **residential investments**, which jumped to +0.7% qoq from 0.1% qoq due to the positive momentum of French residential construction. For the current quarter, we forecast a reduction in this component of around 0.4% qoq, resulting in an annual slowdown to 1.1% from 1.9% in 2018. The property sector, aided by extremely accommodative financial conditions, has had a very positive three-year period 2016-18; 2019 could be the transitional year, moving towards a possible return to normal levels from 2020. **Investment in manufacturing**, tied more closely to the manufacturing cycle, slowed in the second half of the year due to the increasing climate of global uncertainty; nonetheless, in 2019, it will increase at a slightly higher rate than in 2018. Taken as a whole, investments this year are expected to grow at a rate slightly below 3%, as in 2018, and then decline towards 2.0-2.3% in 2020.

Foreign trade again made a slightly positive contribution to growth in the second quarter, just a tenth of a point behind the -0.3 of March. Net **exports** remained stagnant for the second consecutive quarter, while **imports** fell in June by -0.2% qoq from +1.1% qoq: exports and imports are both on course to rise +2.0-2.2% year-on-year. For the current quarter, we continue to forecast an approximately zero or marginally negative contribution by net exports, due to imports being more robust than exports. In 2019, foreign trade will make a negative contribution to growth, hampered by the climate of uncertainty associated with trade wars, and, for 2020, we forecast that its contribution will continue to be approximately zero. The **balance of payments** deteriorated at the start of 2019, declining from -0.4% of GDP to -0.9%, but this should be partly reabsorbed in the second quarter (the official data are not yet available) and then at stabilise at an annual average of around -0.5%.

Negative contribution of net exports to growth confirmed

Inflation seems to have stabilised at around 1.0% in the past few months. From April's peak of 1.3%, the slowdown was uniform until it took the headline index to the current level (1.0%). We think that it will remain at this level for the rest of the year. We therefore see annual average inflation this year as halving to 1.0-1.1% from the 1.9% of 2018, with the core indicator (net of food, alcohol, tobacco and energy) for this year at a little above the 2018 level, at 0.6% compared to 0.4%. In 2020 it should accelerate towards 0.8%, with the headline index also rising marginally towards 1.2%. We therefore confirm the previous price forecasts. **Unemployment** fell by two tenths of a point in the second quarter, to 8.5% from 8.7%, making it probable that in 2019 it will fall to at least 8.6% from the 9.1% seen in 2018. The labor market therefore continues to improve, but unemployment remains above the Euro area average (7.5%). Nonetheless, Macron could be able to bring it down towards 7%, as he promised on his inauguration.

The slowdown in the core index will leave inflation at around 1% this year and at 1.2% next year

Unemployment will fall by at least half a point in 2019 to 8.6%

On the public accounts front, fiscal sustainability is not at risk this year either, thanks to the backdrop of negative interest rates. This should mean the deficit is contained at 3.1% this year, compared to 2.5% in 2018, following the "yellow vests" protests. In 2020, the deficit is expected to return to below the 3% threshold. The structural deficit should remain stable at -2.6%. Public debt is moving towards the 100% threshold next year, having reached 99% this year.

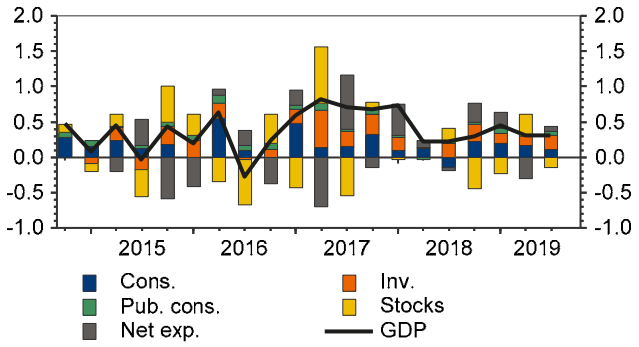
Nominal deficit over 3% this year but a structural balance unchanged at -2.6%. Public debt on course to reach 100% of GDP

Macro forecasts

	2018	2019f	2020f	2018	2019				2020p				2021p
				4	1	2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	1.7	1.3	1.0	1.2	1.3	1.4	1.4	1.2	1.1	1.0	1.0	1.0	1.2
- q/q change				0.4	0.3	0.3	0.3	0.3	0.2	0.2	0.3	0.3	0.4
Private consumption	0.9	1.2	1.3	0.4	0.3	0.2	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Fixed investment	2.8	2.8	2.3	0.6	0.5	0.9	0.6	0.6	0.6	0.5	0.5	0.5	0.5
Government consumption	0.8	1.0	1.2	0.5	0.0	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Export	3.5	2.2	1.6	1.8	0.1	0.0	0.3	0.3	0.5	0.5	0.5	0.5	0.7
Import	1.2	2.1	1.9	1.0	1.1	-0.2	0.4	0.5	0.5	0.5	0.6	0.6	0.6
Stockbuilding (% contrib. to GDP)	-0.3	-0.2	-0.4	-0.2	0.3	-0.2	-0.1	-0.1	-0.2	-0.1	0.0	0.0	0.0
Current account (% of GDP)	-0.6	-0.6	-0.6										
Government Balance (% of GDP)	-3.1	-2.2	-2.7										
Government Debt (% of GDP)	98.4	99.0	98.9										
HICP (y/y)	2.1	1.3	1.5	2.2	1.4	1.3	1.3	1.3	1.3	1.3	1.5	1.6	1.8
Industrial production (y/y)	0.2	1.0	0.9	-1.8	0.6	1.6	0.4	1.2	0.6	0.5	1.4	1.2	1.1
Unemployment (%)	9.1	8.6	8.4	8.8	8.7	8.5	8.6	8.6	8.5	8.5	8.4	8.3	8.2

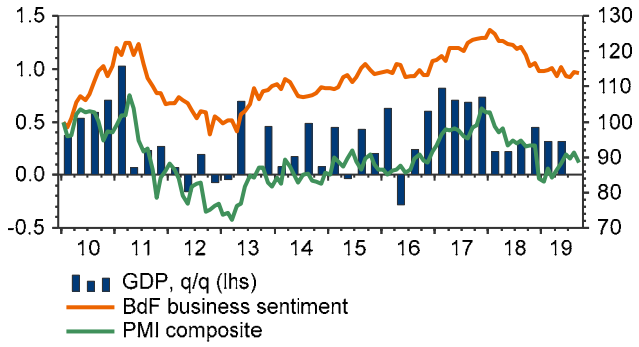
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo

Fig. 1 – Contribution to GDP



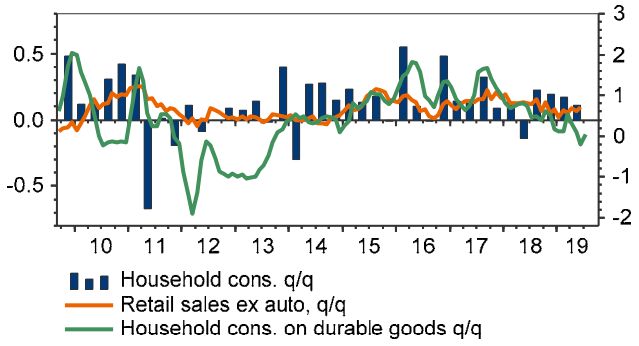
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 2 – GDP and confidence indicators



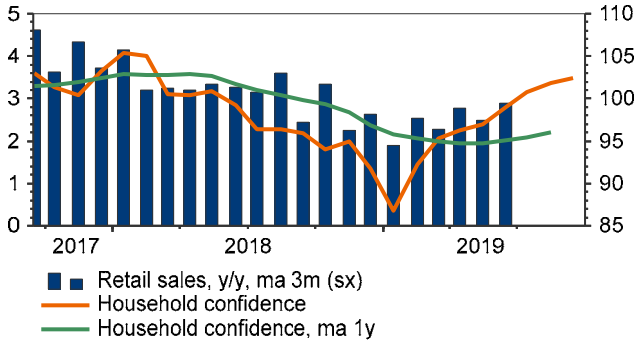
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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



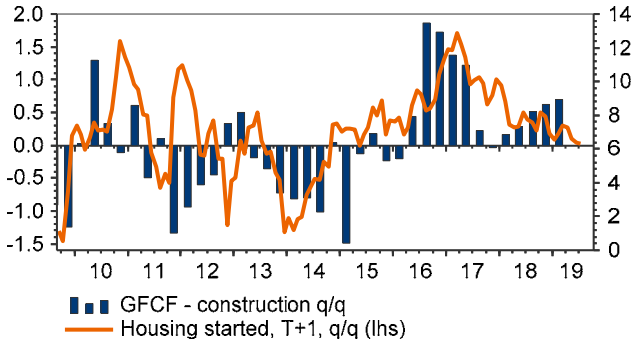
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 4 – Retail sales and household confidence



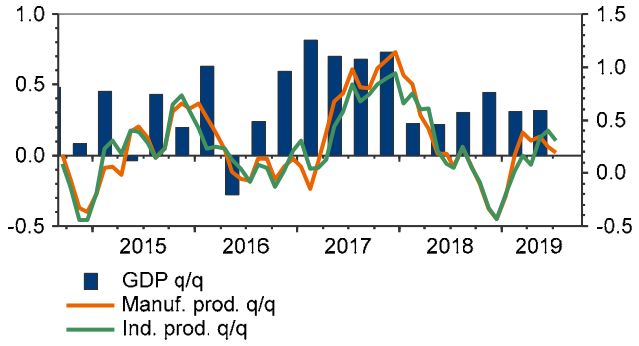
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 5 – Residential investments and construction-sector activity



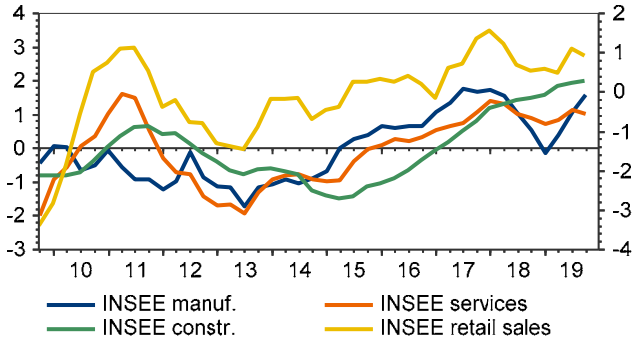
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



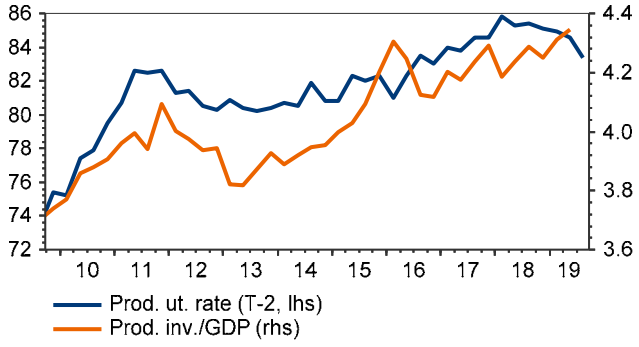
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indexes for the various manufacturing sectors



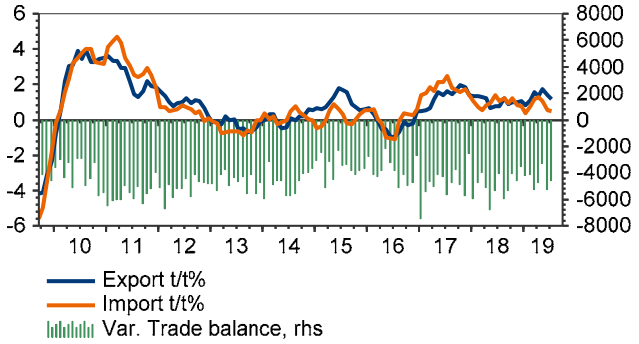
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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



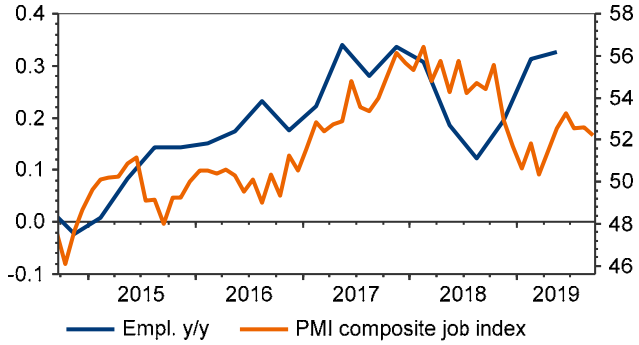
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Trade balance



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 10 – Expected and structural unemployment



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Italy - as good as it gets

Paolo Mameli

In the past few weeks, the Italian scenario in terms of the fiscal outlook and financial conditions seems to have significantly improved, for several reasons:

Improved outlook for debt refinancing and financial stability

- **Projected public finance variables based on unchanged legislation are more favourable**, thanks to signals of higher tax compliance (also due to results of the introduction and extension of electronic invoicing), and to a lower-than-expected take-up of the two welfare programmes introduced by the previous government, namely the "citizen's income" and the "Quota 100" retirement scheme (in our view, the positive effects on the no-policy-change deficit in 2019, already highlighted in July in the so-called "Budget adjustment", should increase next year, both in terms of tax compliance and of savings on welfare measures);

- **The swift resolution of the government crisis** has triggered a positive reaction of financial markets, explained by two factors: (a) the new government is perceived as being more prone (to some extent) to fiscal discipline, also following deletion from the government agenda of a very expensive measure such as the flat tax; (b) the new majority seems inclined to establish a more collaborative relationship with the EU institutions, as confirmed by the appointment of Paolo Gentiloni as new Commissioner for Economic and Monetary Affairs, and has removed from its agenda a measure perceived by investors as a first step towards the introduction of a parallel currency, i.e. the launching of mini-BOTs (on this front, the redenomination risk incorporated into BTP prices has dropped to its lowest since the previous government was formed); this could pay a dividend in terms of greater leeway in drafting the next Budget;

- **The new stimulus package announced by the ECB**, with particular reference to the reopening of a government bond purchase programme, is generating on the one hand significant savings on interest expenditure for the government (close to 20 billion euros in full swing, and around 3-4 billion next year, compared to the estimates contained in the DEF), and, on the other hand, an improvement of financial conditions for private businesses, with a positive impact, in the medium term, for GDP growth (Figure 4).

The 2020 Budget should be at most moderately restrictive (or neutral)

In other words, the evolution of the domestic political, fiscal and financial picture, which three months ago we had highlighted as being the main risk weighing on the outlook, seems undoubtedly more favourable now. In our view, the no-policy-change 2020 deficit could be revised to 1.6% from 2.1% as indicated in the DEF (Table 1). Avoiding the VAT hike in the absence of funding measures, together with "non-deferrable spending", would push the deficit up to close to 3%, whereas a deficit at around 2% should be compatible with respect of EU rules (while implying a fiscal tightening of one per cent of GDP). As the Council and the Commission may embrace a more flexible interpretation of fiscal rules than could be expected only a few weeks ago, we believe that a deficit of between 2% and 2.5% may be "tolerated" by Brussels (probably prompting a moderately positive reaction from the markets). A deficit of 2.3-2.4% would imply a reduction of the initially planned cuts of 23 billion to around 10 billion. **Indeed, the government is hoping to avoid a restrictive package, although even only a neutral Budget would call for a generous dose of flexibility** on the EU's part (not fully justified today, but not to be ruled out entirely within the framework of a "political" negotiation, especially if structural reforms and/or investments to the benefit of the environment and of the digitalisation of the economy are promised in return). Therefore, the task is a difficult one but not impossible: the effects on the economic cycle would be limited overall, and **the risk of new financial tensions** in correspondence with the budget session, as was the case last year, **seems much less likely**. This is a much brighter scenario than could have been imagined only a few weeks ago.

However, it is early days yet to read this improvement of the fiscal and financial picture as preluding to an immediate reversal of the economic cycle as well. The economy remains essentially stagnant (as it has been since 2Q 2018), and this phase could indeed last more than anticipated, at least throughout the second half of 2019, if not until the first part of 2020. This is because while risks on the domestic front seem to have eased considerably, at least for the near term, in light of the improved outlook for debt refinancing and financial stability, **the uncertainties clouding the global scenario are showing no sign of clearing.** In particular, in the months between the end of 2019 and the beginning of 2020, the joint effects of the introduction of new tariffs on Chinese imports and of Brexit could have an impact.

However, the economy remains in an essentially stagnant phase, which could indeed last more than anticipated

In fact, the extension of the essentially stagnant phase into the second half of this year prompts us to **revise down our annual growth forecasts for the Italian economy**, from 0.2% to zero in 2019 and from 0.5% to 0.3% in 2020. **We expect consumption in 2020 to keep up the moderate growth trend observed since 2018,** advancing by around half a point a year. This is because households' real disposable income is still increasing at a markedly livelier pace than GDP (around one per cent per year), and is being split in roughly equal parts between consumption and savings (resulting in an uptrend of the savings rate). The fundamental reason is the resilience of employment, which should be up by 0.6% in 2019, losing some steam compared to the previous years but still in positive growth territory (as opposed to flat GDP). This also explains the relatively resilient trend of consumer confidence compared to business morale (although we expect job gains to slow further in 2020, to around 0.2%, a pace more consistent with GDP growth).

We have revised down forecast growth in 2020 from 0.5% to 0.3%. We expect consumption to prove resilient…

The evolution of investment seems more at risk, forecast to slow further in 2020, to 0.6% from 1.6% estimated this year. The "anomalous" rebound of investments in machinery recorded by national accounts data in 2Q 2019 seems to have been due to the reintroduction of the super-amortization scheme on new capital goods, which had not been included in the Budget Law 2019. In this sense, the new government's promise to confirm, and to possibly extend, the incentives offered by the "Industry 4.0" package bodes well in terms of the resilience of capex spending in the business sector. More in general, the easing of domestic political/fiscal/financial risk holds, *ceteris paribus,* positive implications for the propensity of businesses to invest. However, as mentioned above, uncertainties continue to mar the international scenario, to the detriment in particular of the manufacturing sector. In fact, industry is at the heart of the current cycle slowdown, as it is being hit by an idiosyncratic shock that reaps its most significant effects in countries in which the weight of the manufacturing sector is greater, such as Germany and Italy. The main reason behind this shock, in addition to structural production relocation processes under way in some specific industries (autos, chemicals), lies in the effects of the so-called "tariff war" on the global value chains, especially in terms of uncertainty, and, as a result, on global trade, to which manufacturing is particularly exposed - specifically, in Italy's case, expansion in the services sector is not robust enough to more than offset weakness in the industrial sector, resulting in an essentially stagnant economy overall.

…and investment to slow, as the correction of the industrial sector does not seem over yet

In a nutshell, in the near term (between the end of 2019 and the beginning of 2020) the improvement of the domestic financial picture and the increase in external risks should balance each other, extending the stagnation phase of GDP growth. **We expect the economy to resume growing, especially in terms of investments (and exports), once the uncertainties weighing on global trade will have eased at least in part** (presumably starting in 2Q 2020). To complete the picture prospected for next year, we believe foreign trade will resume contributing negatively to growth, in a context in which exports may slow, as opposed to accelerating imports. Lastly, inventories could stop representing a drag and could contribute positively, after having held back GDP growth by over one per cent in 2019 (as had previously been the case only in 2009 and 2012, two years of deep recession).

The economy will resume growing once uncertainty clouding global trade starts to ease

Effects of some external shocks (trade tariffs, Brexit, oil)

As mentioned above, **the most serious risk to the outlook for the Italian economy** in the next few months **will continue to be the uncertainty surrounding the international scenario,** which requires us to be cautious on the evolution of the cycle (our estimate of GDP growth in 2020 is lower than consensus forecast, at present). We have simulated the effects of **three potential shocks**:

- **TRADE TARIFFS:** Presented here again are our simulations of two potential scenarios obtained using the Oxford Economics Forecasting model: in the first scenario, restrictive measures are limited to the US-China front, with an extension of punitive tariffs to all goods imported into the US from China, followed by a similar move by the Asian giant in retort. The second scenario, on the other hand, sees the trade war extending to the EU, with punitive tariffs of 25% on the import of autos and car components starting in 1Q 2020 (the tariffs on auto imports would affect, in addition to the EU countries, also Japan and Korea, but not Canada and Mexico). Retorsion measures would be proportionate. The result is that the impact of the first scenario on Italian GDP growth is relatively modest (less than one tenth of a percentage point throughout the three-year period), whereas the negative effect of the second scenario is more tangible, averaging two tenths of a point over the 2020-21 biennium (Figure 12). The simulations do not take into account counter-cyclical responses from the fiscal policy or monetary policy fronts, which would evidently buffer the negative effects;

- **BREXIT:** Again assuming a shock in 1Q 2020 (we believe the 31 October Brexit deadline could be plausibly delayed by a few more months), in this case as well we have simulated the effects of two possible scenarios (both of which contemplate a no-deal Brexit): (a) DISORDERLY EXIT: modelled on the BoE's "disruptive" scenario drawn up in November 2018, which points to a sharp immediate contraction of import-export trade (20-30%), largely permanent (-15% compared to the base value after five years), a marked immediate decline in British GDP (-3%), a depreciation of the pound (-5%) and violent inventory movements in adjustment; (b) "GUIDED" EXIT, i.e. aided by mitigation measures, which basically assumes a better level of preparation, so that the initial contraction of trade flows would be smaller (-12%; impact after four years: -5%), as also the immediate drop in British GDP (-0.6%; maximum deviation -2.2% after two years) and the depreciation of sterling (-5% immediately, but subsequently reabsorbed); there would still be adaptive inventory movements, but less violent. The outcome of the simulation (Figure 13) is significant in the case of the first scenario: the effect on Italian GDP in 2020 would amount to -0.8% (and +0.4% the following year); vice versa, the best case scenario contemplates more contained effects (-0.1% in 2020, followed by +0.05% in 2021). In all likeliness, the effective impact will be a sort of weighted average of the two scenarios, which nonetheless in our view will be closer to the best-case scenario than to the worst-case one: as noted by the Bank of England in the letter sent to the Treasury on 3 September, the preparations under way in the public and private sectors reduce the risks of a paralysis of global trade (and 87% of imported goods will not be subject to tariffs, based on the announcement made by the government in March 2019); therefore, the BoE acknowledges that the present worst case scenario is less dramatic than it was a year ago (and, based on our simulations, much more severe for the UK than for the other Eurozone countries, other than the more exposed ones, namely Ireland and Holland);

OIL: Based on our simulations, the current shock to the oil price (+10 USD on the Brent oil forecasts starting in 3Q 2019), if maintained throughout the forecasting horizon, and at like for like other factors, will have an impact of -0.1% on GDP and of +0.3% on CPI in 2020 (Figure 14). Obviously, in case of countervailing movements of the exchange rate, or of a counter-cyclical monetary policy response, the impact would be smaller. It should also be said that today the economy is less dependent on oil than it was in the past, therefore, as the elasticity resulting from the models is calculated based on past evidence, the effective impact could be smaller than estimated.

Macro forecasts	2018	2019f	2020f	2018	2019				2020p				2021p
				4	1	2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.7	0.0	0.3	0.0	-0.1	-0.1	0.1	0.2	0.1	0.2	0.3	0.3	0.4
- q/q change				-0.1	0.1	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.2
Private consumption	0.6	0.4	0.5	0.3	0.1	0.0	0.2	0.1	0.1	0.1	0.2	0.2	0.2
Fixed investment	3.2	1.6	0.6	0.2	0.7	1.9	-1.8	0.7	0.1	0.2	0.3	0.4	0.2
Government consumption	0.2	0.0	0.0	-0.2	0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Export	1.4	3.1	0.8	1.3	0.3	1.0	0.8	-0.5	-0.3	0.6	0.5	0.4	0.6
Import	1.8	1.2	2.4	1.2	-1.6	1.1	0.6	0.6	0.5	0.5	0.6	0.7	0.5
Stockbuilding (% contrib. to GDP)	-0.1	-1.1	0.3	-0.3	-0.7	-0.3	0.1	0.2	0.2	0.0	0.0	0.0	0.0
Current account (% of GDP)	2.5	2.6	2.7										
Government Balance (% of GDP)	-2.1	-2.0	-2.4										
Government Debt (% of GDP)	132.2	133.8	134.9										
HICP (y/y)	1.2	0.8	1.2	1.5	1.0	0.9	0.5	0.8	1.1	1.1	1.3	1.4	1.5
Industrial production (y/y)	0.5	-0.8	0.4	-2.5	-0.7	-1.1	-1.3	-0.1	-0.7	0.4	1.0	0.8	1.0
Unemployment (%)	10.6	10.1	10.2	10.5	10.3	9.9	9.9	10.0	10.1	10.2	10.2	10.1	10.1
10-year yield	2.59	1.77	0.65	3.29	2.71	2.42	1.29	0.64	0.58	0.55	0.64	0.82	0.99

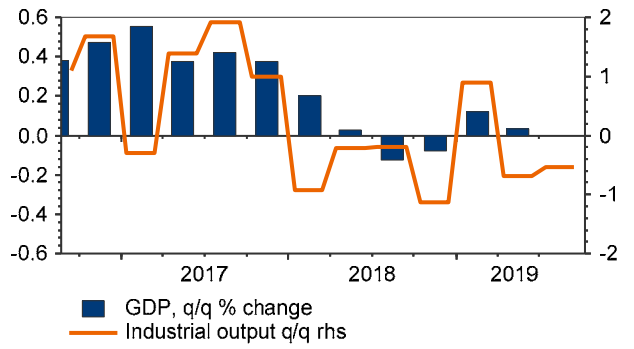
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo

Tab. 1 – Updated forecasts of PA net borrowing in 2019 and 2020 (data in EUR Bn unless indicated otherwise)

	2019 (govt forecast)	2019 (our forecast)	2020 (our forecast)
Budget 2019 adjustment effects	7.6	8.4	7.5
- Higher tax revenue	6.2	6.2	3.8
- Citizen's income and "Quota 100"	1.5	2.3	3.8
- Other	-0.1	-0.1	-0.1
Growth forecast revision effects	0.0	0.0	-0.9
Interest expenditure revision effects	0.0	1.1	3.5
DEFICIT CHANGE	**7.6**	**9.4**	**10.0**
DEF policy framework deficit (% of GDP)	-2.4	-2.4	-2.1
New projected deficit (% of GDP)	**-1.9***	**-2.0**	**-1.6**

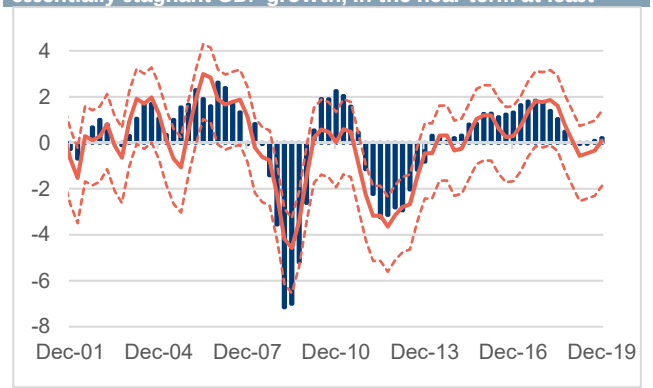
Note: * Policy framework nominal GDP growth as per the DEF. Source: Intesa Sanpaolo elaborations and forecasts on MEF data

Fig. 1 – Industry expected to have held back economic activity again in 3Q



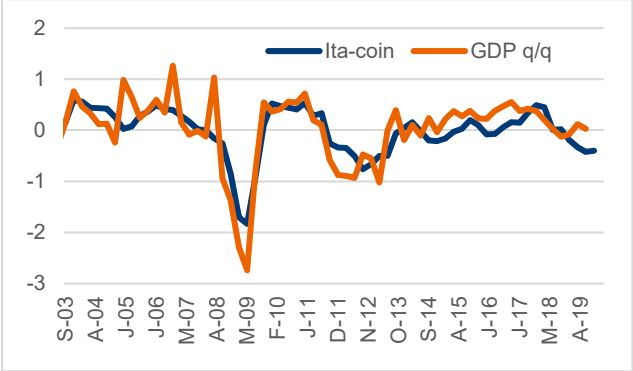
Source: Thomson Reuters-Datastream

Fig. 2 – Forward-looking indicators are consistent with ongoing essentially stagnant GDP growth, in the near term at least



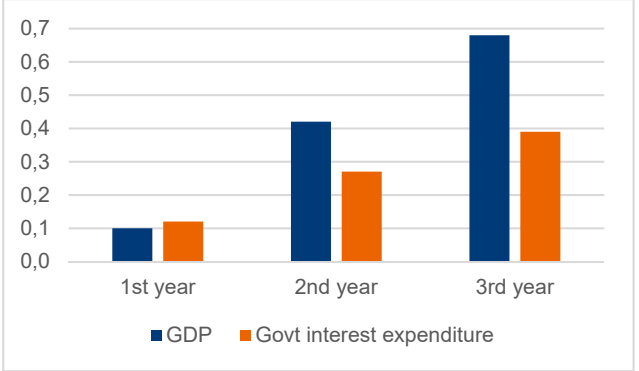
Note: forecasting model run on the annual change of Italian GDP based on the manufacturing and services PMIs (confidence intervals 95%). Source: elaborations Intesa Sanpaolo on Istat and Markit data

Fig. 3 – Indeed, coincident indicators are signaling downside risks on GDP in the short term



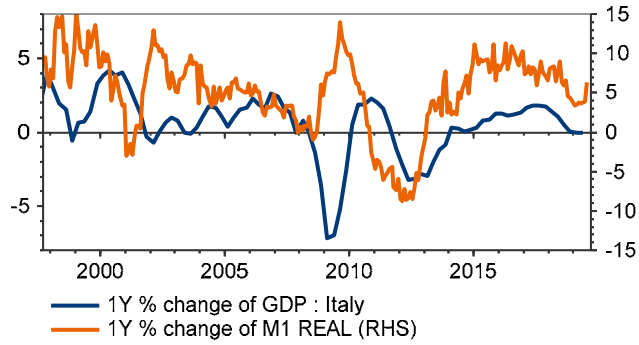
Source: Istat, Banca d'Italia

Fig. 4 – Yet, the drop in government bond yields has an impact not only on PA interest expenditures, but also on GDP growth



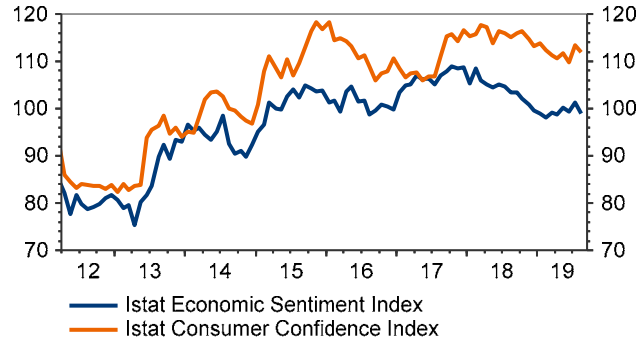
Note: cumulated impact of a 100-bps drop in medium and long term government bond yields (roughly in line with the one recorded in the last 6 months) on GDP (% deviations vs baseline) and on PA interest expenditure (as a % of GDP). Source: Banca d'Italia, MEF, Intesa Sanpaolo calculations

Fig. 5 – The reacceleration of monetary aggregates (the reversal of which has always anticipated the economic cycle's) leaves hope that GDP will resume growing in the medium term



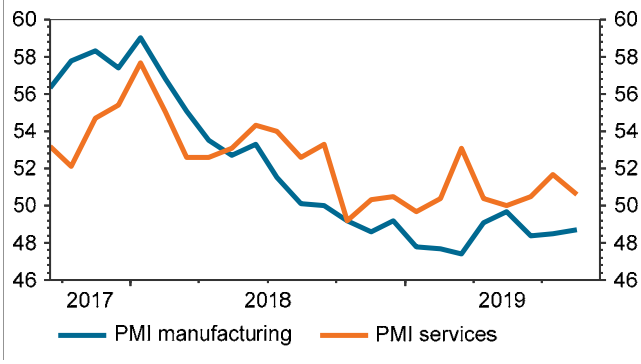
Source: Thomson Reuters-Datastream, Intesa Sanpaolo elaborations

Fig. 6 – In our view, the scenario holds more risk for businesses than for consumers, as indicated by the greater resilience of households' sentiment



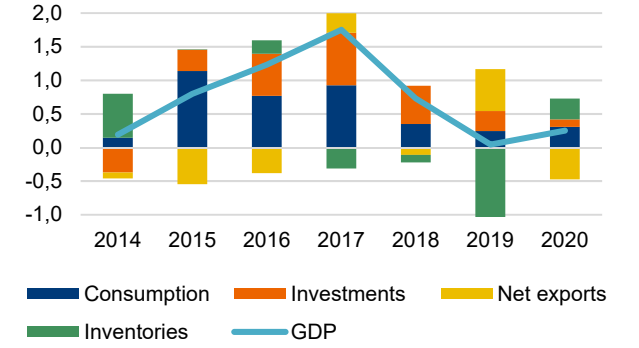
Source: Thomson Reuters-Datastream

Fig. 7 – In the business sector, there is still a divergence between manufacturing (hit by an idiosyncratic shock at the global level) and services



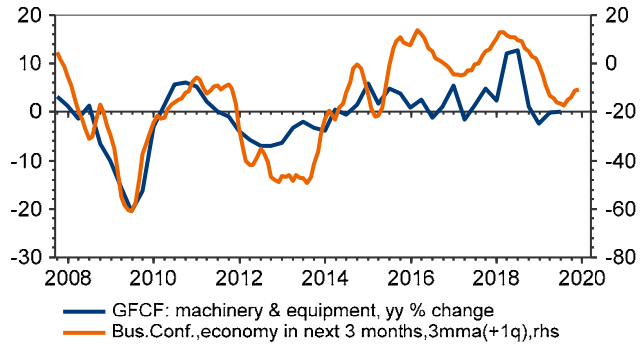
Source: Thomson Reuters-Datastream

Fig. 8 – In 2020 we expect resilient consumption, slower investment and a negative contribution of net exports, outbalanced by removal of the drag represented by inventories



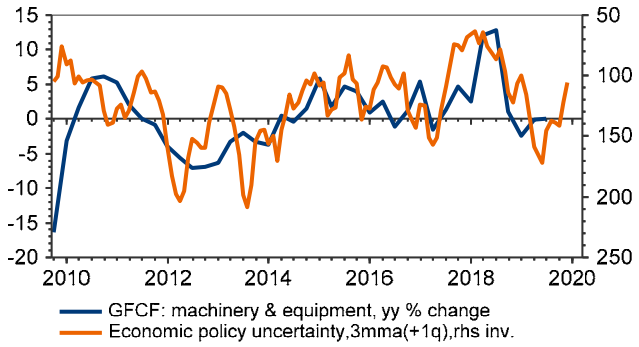
Note: GDP and contribution to GDP, avg. y/y % chg., annual data. Source: Intesa Sanpaolo elaborations and forecasts on Istat data

Fig. 9 – Investments in machinery could be supported by the fact that the low point in businesses' expectations for the economy seems to have been overcome



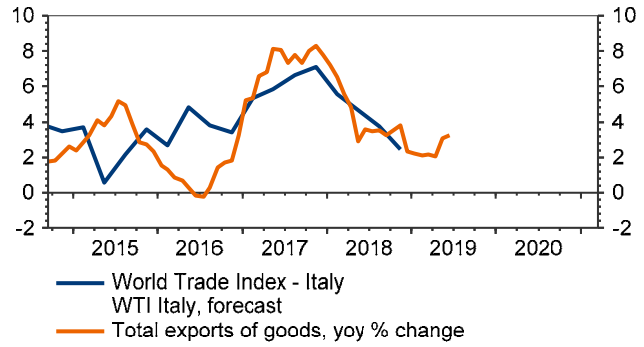
Source: Thomson Reuters-Datastream Charting, elaborations Intesa Sanpaolo

Fig. 10 – Furthermore, easing uncertainty on the domestic political/fiscal/financial front could help propensity to invest among businesses



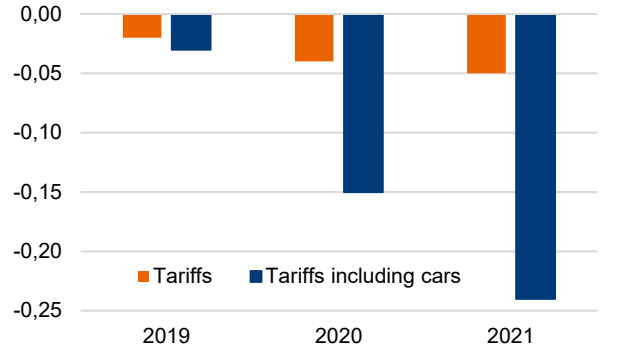
Source: Thomson Reuters-Datastream Charting, elaborations Intesa Sanpaolo

Fig. 11 – Yet, investments and exports will be held back by the current slowdown of global trade, hindered by uncertainties due to the tariff war and to Brexit



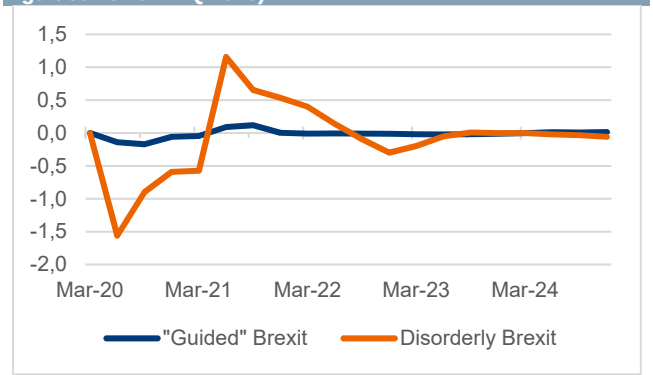
Source: Oxford Economics Forecasting, Thomson Reuters-Datastream, Intesa Sanpaolo elaborations and forecasts

Fig. 12 – Impact on Italian GDP of an escalation of the tariff war (baseline scenario with US-China tariffs and worst-case scenario with tariffs extended to EU autos in 1Q 2020)



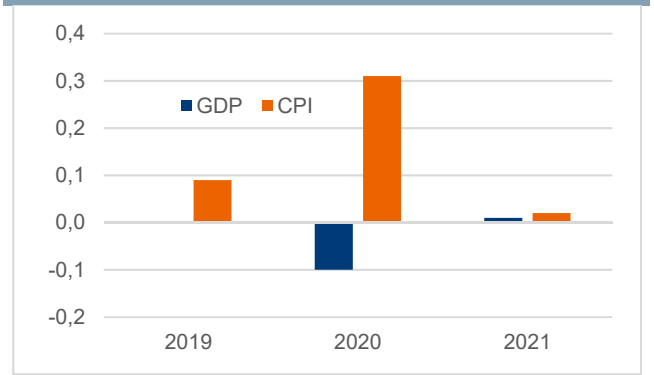
Source: Oxford Economics Forecasting, Thomson Reuters-Datastream, Intesa Sanpaolo elaborations

Fig. 13 – Impact on Italian GDP (y/y % chg., deviation vs. baseline) of two no-deal Brexit scenarios ("disorderly" and "guided" exit in 1Q 2020)



Source: Intesa Sanpaolo elaborations using the Oxford Economic Forecasting model

Fig. 14 – Impact on Italian GDP and CPI (y/y % chg., deviation vs. baseline) of a 10 USD rise in Brent oil prices in 3Q 2019



Source: Intesa Sanpaolo elaborations using the Oxford Economic Forecasting model

Spain: growth slows, but is still above average

Luca Mezzomo

Third-quarter data shows that **economic growth has continued to slow** recently, with Spain too proving to be anything but immune to the general trend in the Euro area. The economic surveys and initial industrial output data are consistent with quarterly GDP growth of 0.5% qoq in Q3, 2019, the same as in the second quarter, which had proved weaker than forecast (see Figs. 1 and 2). The slowdown was more marked for capital investment than for consumption, which continues to be bolstered by healthy growth in real income: the rise in employment is set to slow to 0.5% qoq, but continues however to be positive, and wage growth is now above inflation (Fig. 9). With regard to investment spending, however, construction (Fig. 6) and investment in machinery are set to slow down, both having contracted in Q2 (see Fig. 5) despite accommodative financial conditions. Spain too is facing uncertainty in terms of foreign demand: the recent trend for exports points to an apparent recovery, but the rise of year-on-year growth is largely due to a base effect, and business firms say that **foreign orders are weak**. However, net exports in 2019 should make a positive contribution to growth, even if only marginally, and we expect this to continue in 2020, despite GDP growth higher than that in the rest of the Euro area.

2019 is likely to close with growth of 2.2%, below that forecast at the beginning of the year but consistent with the current average consensus and the Stability Programme forecasts presented by the Government in April. **We anticipate a further slowing of growth in 2020 to 1.7%** (slightly lower than the consensus forecast, which remained unchanged in September at 1.8% of the projected 1.9% for Stability Programme.

There is nothing new as regards inflation. Basic inflation remains below 1% yoy, while inflation based on the general price index declined to 0.3% yoy in August, well below that for the Euro area. **We anticipate that inflation will continue to be very low in 2020 too**, while increasing from the recent lows.

The political situation has stalled. The negotiations to form a government have failed, with the King being obliged to dissolve parliament and **call a new election on 10 November** (the fourth in four years). The electoral system is proving to be inadequate in the face of greater fragmentation of the political offer, which has ceased to be focused on two parties, and the growing personalisation of the parties. The socialist leader, Mr Sánchez, is hoping that the new election will add to his parliamentary seats. For the present, the polls only partially support him in this. A slight fall for Ciudadanos and Unidas Podemos would, however, see little improvement in the numbers required to form a government, and could also rule out the possibility of the PSOE-Ciudadanos coalition mooted after the last election.

With regard to fiscal policy, for all that it may prove impossible to form a government with full powers, the deficit is expected to fall further in 2020 to EUR 23-25 billion, from EUR 27-28 billion in 2019 (around 2.3% of GDP, and above the government target of 2.0%), and should therefore ultimately fall below 2% of GDP. In June, the European Commission called for a structural correction of 0.65% of GDP in 2020 to accelerate the debt reduction that has been ongoing since 2015. The rating trend is positive, and refinancing costs are set to fall again in 2020, thanks to new measures announced by the ECB in September.

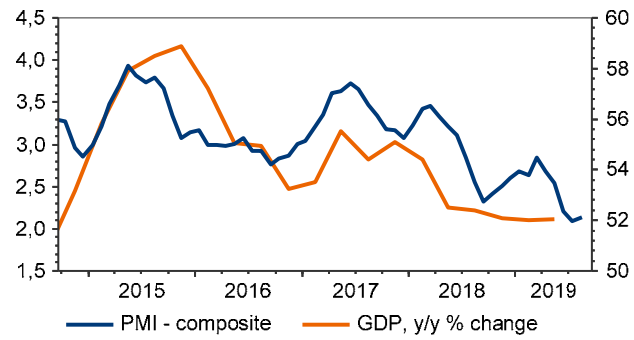
The balance of payments remains in positive territory. We anticipate that the surplus will continue to be positive in 2020, after the 0.9% of GDP seen in 2018 and 0.6% forecast this year. This will make it possible to rebalance the foreign net debt position, which continues to be one of the country's structural weaknesses, along with the high levels of private-sector debt.

Macro forecasts

	2018	2019p	2020p	2018	2019				2020p				2021p
				4	1	2	3	4	1	2	3	4	1
PIL (prezzi costanti, a/a)	2.6	2.2	1.7	2.3	2.4	2.3	2.2	2.1	1.8	1.8	1.7	1.6	1.6
- t/t				0.6	0.7	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4
Consumi privati	2.3	1.5	1.6	0.4	0.4	0.3	0.5	0.4	0.4	0.4	0.3	0.4	0.3
Investimenti fissi	5.3	2.3	1.5	-0.2	1.4	-0.2	0.3	0.4	0.4	0.6	0.4	0.3	0.5
Consumi pubblici	2.1	1.6	0.9	0.4	0.4	0.2	0.4	0.2	0.2	0.2	0.2	0.2	0.1
Esportazioni	2.3	2.1	2.7	0.7	0.0	1.8	0.8	0.5	0.5	0.6	0.8	0.3	0.5
Importazioni	3.5	0.5	2.3	0.0	-0.3	1.0	0.8	-0.2	0.8	0.7	0.6	0.6	0.8
Var. scorte (contrib., % PIL)	0.0	0.0	0.2	0.1	0.0	0.0	0.0	-0.1	0.2	0.0	0.0	0.1	0.2
Partite correnti (% PIL)	0.9	0.9	1.0										
Deficit pubblico (% PIL)	-2.3	-2.0	-2.0										
Debito pubblico (% PIL)	97.1	96.3	95.7										
Prezzi al consumo (IPCA,a/a)	1.7	0.9	1.3	1.8	1.1	1.1	0.6	0.9	1.2	1.3	1.4	1.3	1.4
Disoccupazione (ILO, %)	15.3	14.2	13.6	14.6	14.4	14.3	14.1	13.9	13.7	13.7	13.6	13.5	13.5

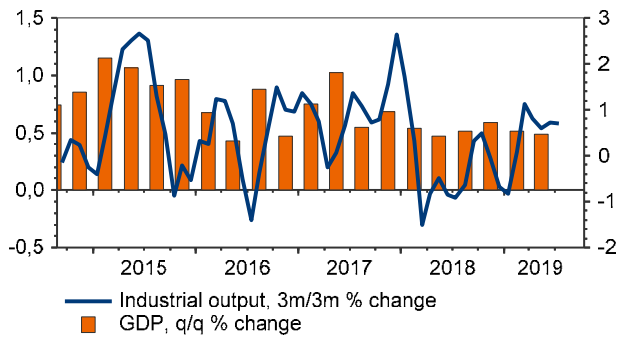
N.B.: percentage changes versus the previous period – unless otherwise indicated. Source: Intesa Sanpaolo calculations and forecasts.

Fig. 1 – Composite PMI pointing to a slowdown in year-on-year growth



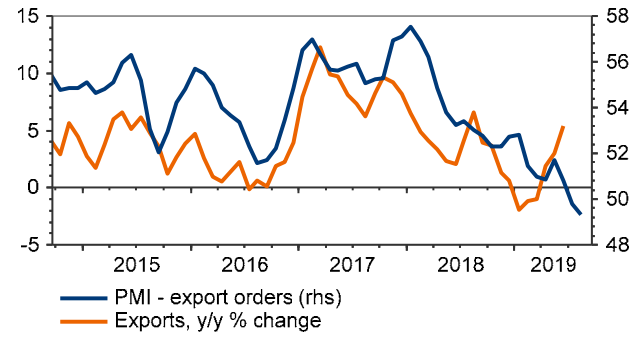
N.B.: quarterly moving average for PMI.
Source: Intesa Sanpaolo chart based on Wikipedia

Fig. 2 – Industrial output remains consistent with GDP growth of around 0.5%



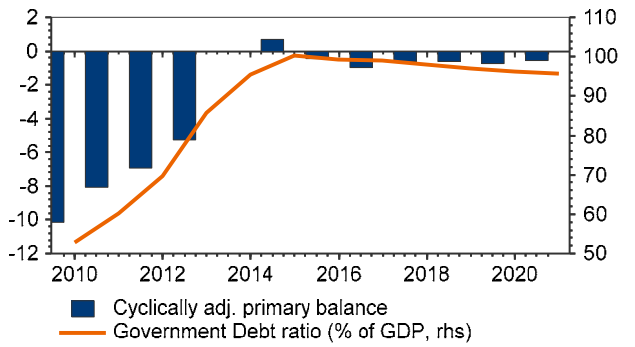
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 - Exports destined to fall again



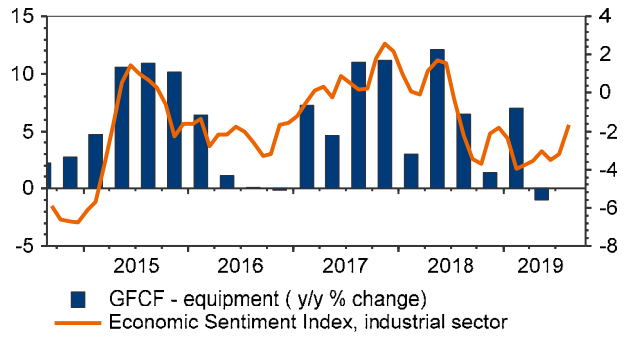
N.B.: Quarterly moving average.
Source: Intesa Sanpaolo chart based on INE and IHS Markit data

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



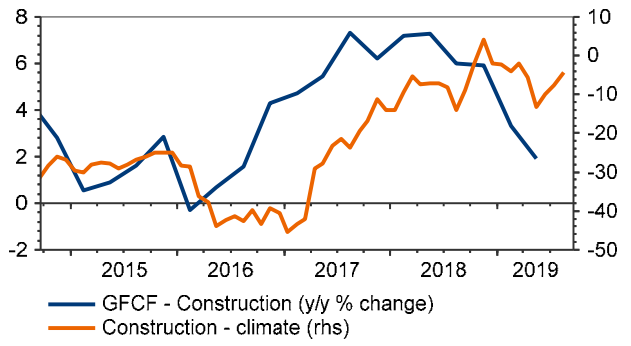
Source: European Commission, AMECO

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



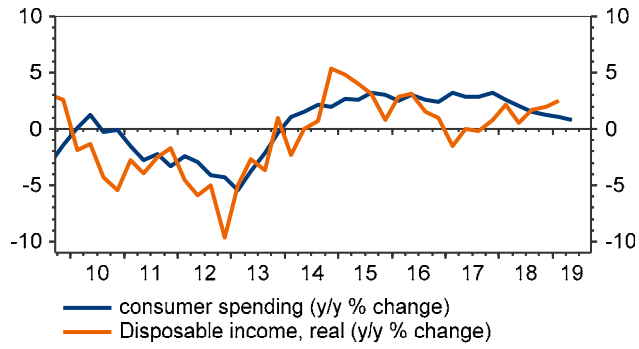
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

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



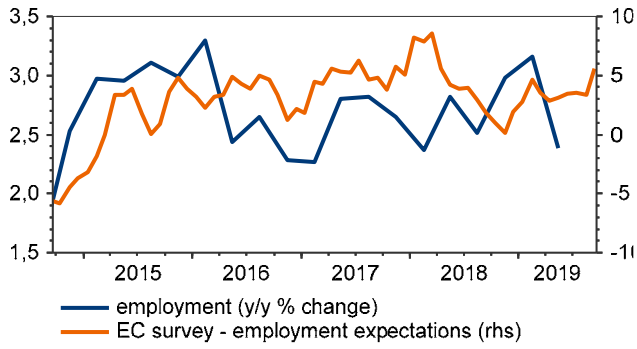
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 7 – Consumption slowdown



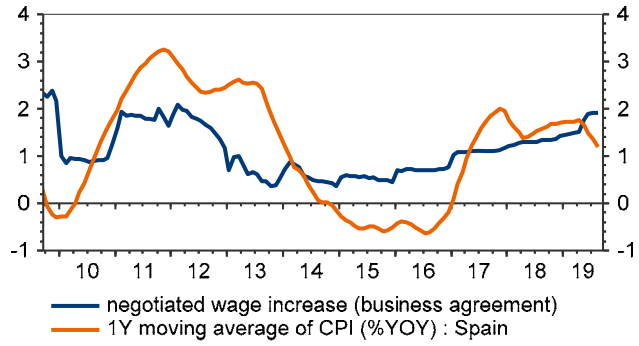
Source: Intesa Sanpaolo chart from INE data

Fig. 8 – Business confidence surveys indicate a slowdown in employment growth



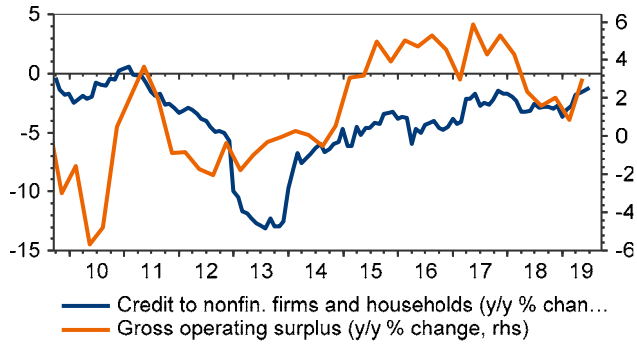
Source: Intesa Sanpaolo chart from INE and European Commission data

Fig. 9 – Wage negotiations are more generous, but barely in line with inflation



Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 10 – Loan volume still decreasing. Corporate earnings deteriorating



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

Netherlands: domestic demand resilient; foreign trade less so

Guido Valerio Ceoloni

In Q2, GDP maintained its cruising speed of Q1, advancing by 0.5% qoq in one of the best results of the Euro area countries, with yoy growth slowing only marginally, to 1.8% from 1.9%, and year-to-date growth of 1.6%. The main contributions came, in equal measure, from domestic demand (0.6) and foreign demand (0.6), while de-stocking made a negative contribution of -0.7. We expect a significant slowdown of around 0.2-0.3% qoq in the next two quarters of the year. GDP growth averaged 1.7% p.a. in 2019 (one-tenth of a point less than the previous estimate), but will slow to around 1.1-1.2% in 2020.

GDP remained buoyant in Q2, but we expect a slowdown in the last quarter of the year

Domestic demand in Q2 grew with the surge in consumption (+0.8% qoq from +0.2% qoq), supported by car sales. However, we believe the underlying trend is one of normalization, which should become evident in the current and next quarter, when we expect consumption to grow by only around 0.2-0.3% qoq. The household confidence indicators, though still positive, are clearly returning to normal levels. The peak in confidence in the ESI index goes back to 2018. However, domestic consumption remains the principal source of optimism for GDP growth, mainly because the labor market is still exceptionally positive, with unemployment stable at an all-time low of 3.4% in Q2. Employment was stable at just under 69%, but the number of hours worked fell further (-1.8% qoq from -2.4% qoq). Wage growth accelerated sharply in July (+2.8% yoy), confirming the positive trend in household purchasing power.

The jump in consumption in Q2 hides the fact that household spending is normalising, with disposable income still very strong

Investments slowed in Q2 to 1.7% qoq from 2.7% qoq, with machinery at 1.3% qoq from 3.5% qoq and the residential sector still positive and stable at 1.2% qoq, as it was in March. The ESI economic confidence indicators show confidence stabilising compared to the peaks of a year ago, with the manufacturing sector growing even faster than the Euro area average; construction confidence, although lower than last year's levels, likewise remains positive, as is also the case in services and retail. The overall picture points to a uniform economic slowdown in line with potential. We therefore expect investment growth to stabilise to the end of the year, although there could still be a surge in the current quarter due to the favourable comparison with last autumn's slump. However, the trend remains one of normalisation against a background of rising commercial uncertainty that will impact corporate investment. The weakness in private investment will be partly offset by public investment in education, defence and welfare.

The economy is returning to normal levels, but is still growing faster than the Euro area average

Exports jumped to 1.3% qoq in 2Q, from 0.6% qoq, but we expect foreign trade to weaken in the coming months in line with the turbulence affecting global trade and the consequent slowdown in the economic growth of the country's main trading partners (primarily Germany). Exports are therefore expected to slow this year to below 2% between 2019 and 2020, after 3.7% in 2018, while we see imports at 2.4% this year and 2.0% next year, after 3.3% in 2018. Overall, therefore, foreign trade is expected to make a zero contribution to growth both this year and next, after a robust 0.7 in 2018. The current account balance has fallen from 10.8% of GDP in 2018 to 9.5% this year.

Net exports will make a zero contribution to GDP between 2019 and 2020

Inflation accelerated from 2.5% to 2.8% in August and remains one of the highest rates in the Euro area, with the underlying index firm at 2%, suggesting that wage growth is now being passed on to prices. We expect it to peak at around 3% in the coming months, and then slow in early 2020. We see harmonised consumer prices rising by an average of 2.8% this year, up from 1.6% in 2018, but they should slow to 2% in 2020, in the wake of the unfavourable statistical effect of this year's VAT increases.

Inflation is close to 3% and one of the highest rates in the Euro area, but should slow to 2% in 2020

Fiscal policy will remain expansive this year to support household income and corporate earnings, but will have no particular impact on public finances. Cuts in personal and corporate taxation will leave the **nominal deficit** on course for a primary surplus of around 1.4% in 2019 and 1.0% in 2020, after 1.5% in 2018. Public debt, on the other hand, will remain on a downward trajectory at just under 50% this year and around 47% in 2020, after 52.4% in 2018.

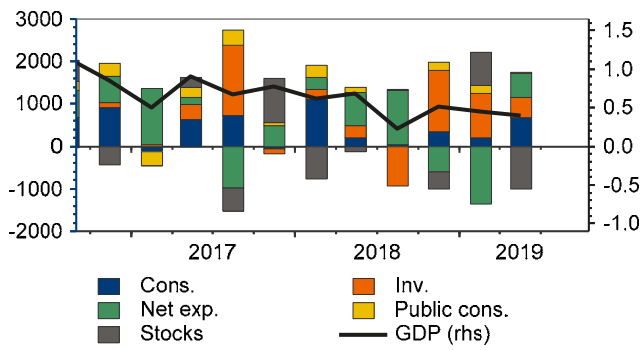
Expansive fiscal measure implemented by the third Rutte cabinet will not affect public finances

Macro forecasts

	2018	2019f	2020f	2018	2019				2020p				2021p
				4	1	2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	2.5	1.7	1.2	2.1	1.9	1.8	1.7	1.5	1.3	1.1	1.2	1.2	1.3
- q/q change				0.5	0.5	0.5	0.2	0.3	0.3	0.3	0.3	0.3	0.4
Private consumption	2.3	1.5	1.4	0.4	0.2	0.8	0.3	0.4	0.3	0.3	0.3	0.3	0.3
Fixed investment	3.2	5.8	1.7	3.9	2.7	1.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4
Government consumption	1.6	1.0	1.0	0.4	0.4	-0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Export	3.7	2.1	1.8	-1.2	0.6	1.3	0.4	0.2	0.3	0.5	0.6	0.5	0.5
Import	3.2	2.4	2.0	-1.1	1.6	0.7	0.5	0.4	0.4	0.6	0.6	0.5	0.6
Stockbuilding (% contrib. to GDP)	-0.2	-0.3	0.0	-0.2	0.4	-0.7	0.0	0.1	0.1	0.0	0.0	0.0	0.1
Current account (% of GDP)	10.8	10.0	9.7										
Government Balance (% of GDP)	1.4	0.8	0.9										
Government Debt (% of GDP)	52.4	49.1	46.7										
CPI (y/y)	1.6	2.8	2.1	1.8	2.5	2.7	3.1	2.9	2.2	2.1	1.8	2.3	2.5

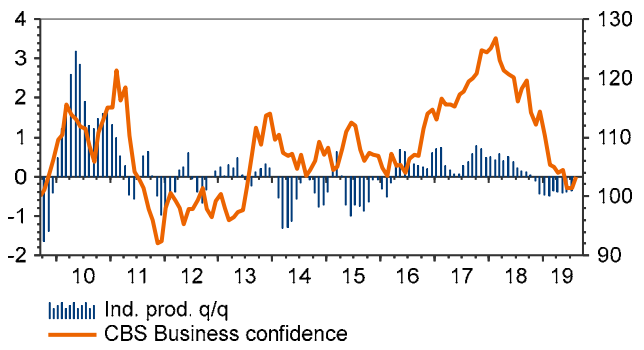
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo

Fig. 1 – Contribution to GDP



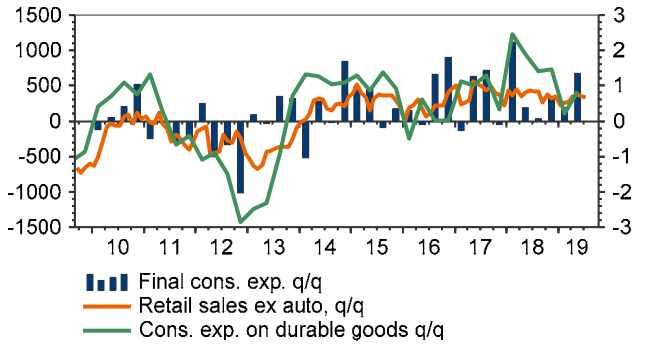
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 2 – Economic confidence and GDP



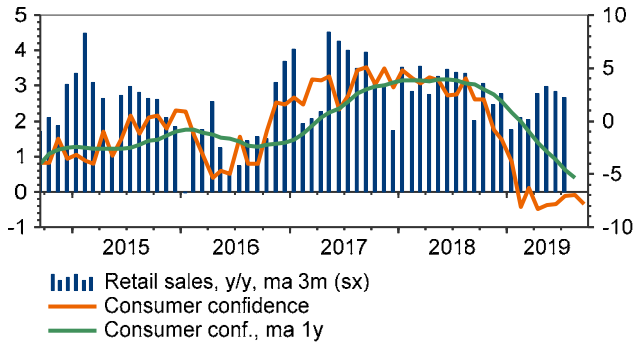
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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



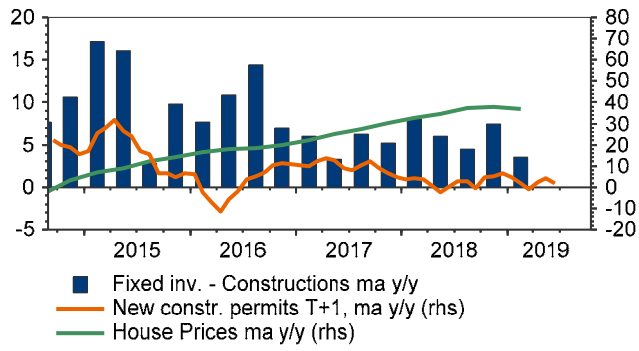
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 4 – Retail sales and household confidence



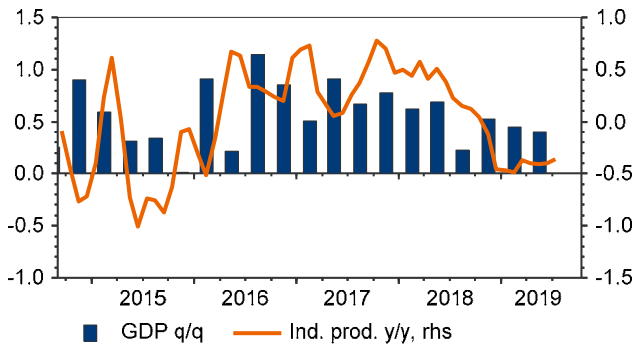
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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



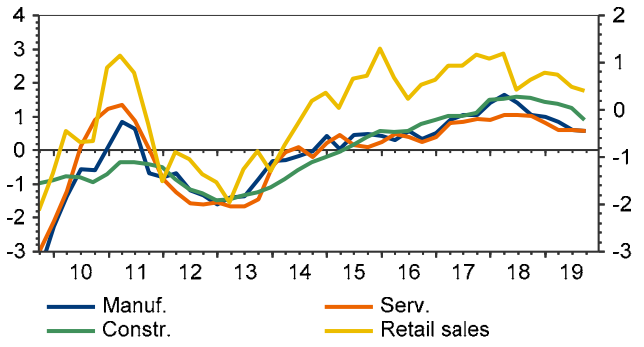
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 6 – Industrial output and GDP



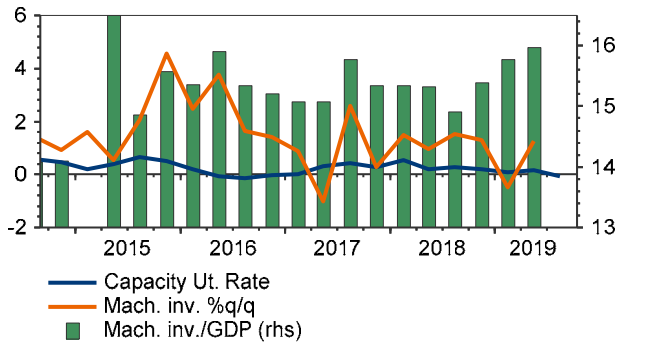
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indexes in the various manufacturing sectors



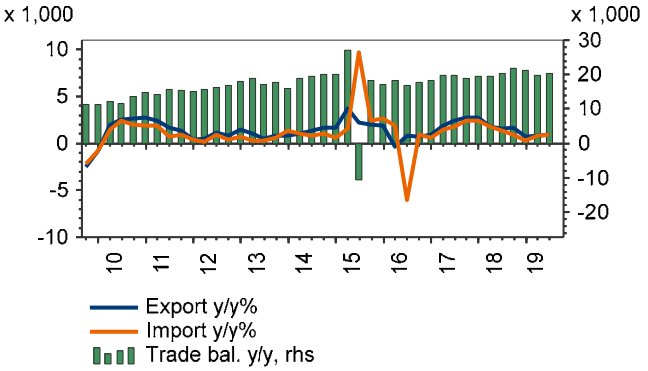
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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



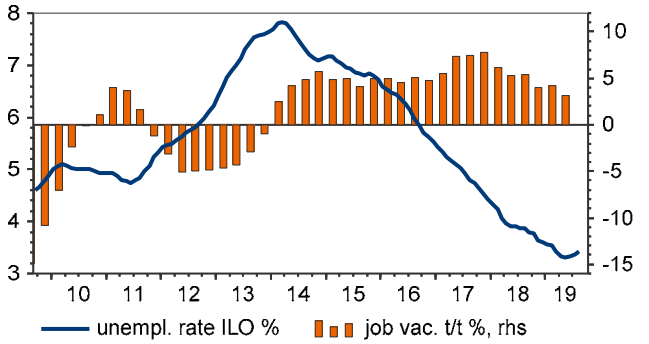
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 9 – Exports, export orders and global PMI



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 10 – Unemployment and job vacancies



Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Asia

Japan: consumption tax increase dampened by fiscal countermeasures

Giovanna Mossetti

The Japanese economy is about to experience the **fiscal shock** caused by the **consumption tax (CT) hike from 8% to 10%, as of 1 October**. The last three times that CT was increased (1989, 1997 and 2014), the economy went into recession, but the outlook for 2020 seems more reassuring than in the past cases. The different way in which the CT rise is being implemented and the fiscal "countermeasures" announced by the government (see below) seem to have averted the substantial pre-emptive spending on durable goods which preceded the large contractions of 1997 and 2014. Therefore, the correction following implementation of the new tax rates should be moderate, both in length and extent. Apart from fiscal tightening, Japan's weak external position and uncertainty about US trade policy remain a drag on investments and exports. Positive factors, on the other hand, are the increased spending on the 2020 Tokyo Olympics and growing participation in the workforce by women, older people and immigrants.

The forecast for the rest of 2019 and for 2020 remains one of volatile growth, probably negative in 4Q and weak in 1Q20, followed by a gradual, modest recovery. GDP is forecast to grow by **0.8% in 2019, 0.2% in 2020 and 0.9% in 2021**. Inflation is in a correction phase; the index ex-fresh food is moving close to zero again, net of the impact of the CT increase. The BoJ is keeping to its present expansionary course and remains open to increasing monetary stimulus (see below).

1. The macroeconomic picture is dominated by the consumption tax hike and the slowdown in foreign trade. Growth in 2019-20 is influenced by the impact of the CT hike planned for 1 October, during a period of manufacturing weakness linked to the slowdown in world demand. The CT hike in October will be a negative shock but the extent of fiscal tightening and its implementation it will likely be much more limited compared to the past negative experiences. The 2 pp tax rate hike is expected to increase revenues by JPY 5.6Trn (the equivalent figure in 2014 was JPY 8.2Trn), but thanks to accompanying measures (exemption of food and other basic necessities, elimination of pre-school fees, pension income support, cashless payment rewards, post-CT increase car incentives), the net tightening effect is estimated at JPY 2.2Trn, about 25% of the tightening implemented in 1997 and in 2014. In addition to cashless payment rewards, the government has announced tax incentives for buying durable goods (i.e., cars) after the tax hike, with the aim of limiting volatility in consumption when the CT hike comes into effect.

At present, **consumption** data seem to indicate that the measures have been relatively successful. Unlike in previous instances, there is no sign of large pre-hike rush to buy, implying that the subsequent correction may also be modest Fig. 2). The failure of household consumption to accelerate may be caused by increased uncertainty linked to geopolitical risks. However, it seems probable that the new modulation, in addition to the smaller scale, of the CT increase is the chief explanation for the moderate trend in household spending. The **labour market** remains in full employment, with the jobless rate at 2.2% in July, the lowest since 1992. Persistently moderate wage growth, despite excess demand, is in part attributable to the continued expansion of the workforce, due to higher participation of women and older people, in addition to larger immigration flows following the relaxation of regulations. Consumption in 3Q is forecast to grow 0.5% qoq, followed by a correction of -1.6% qoq in the autumn and a subsequent recovery, with qoq changes in 2020 averaging 0.3%. On an annual basis, **consumption should grow 0.6% in 2019, stabilise in 2020 and return to growth of 0.8% in 2021.**

Non-residential investment has been on a weak trend since the end of 2018 (Figs. 1 and 4), due to trade tensions and weakening exports. In 2019, after a contraction in 1Q, the modest recovery in 2Q and 3Q should be followed by a quarterly decline linked to the CT hike, producing yearly of 1.4%, boosted in part by the strong close to 2018 (yearly: 3.9%). The forecast for **2020 is for growth of 0.8%,** supported by spending on the Olympics. **Foreign trade** has been a brake on growth since 2018 (Fig. 5). The uptick in exports to the US and Europe has failed to offset falling

exports to China and the rest of Asia, even though the share of exports to the US (20.4% in July 2019) has outstripped that of China (18.5%) since end-2018. Net exports should **contribute negatively to growth in 2019 (-0.3 pp) and recover modestly in 2020 (+0.1 pp).**

Inflation is not reacting to persistent monetary expansion. The gradual slowdown seen in the middle of the year (Fig. 7) should become more marked in the autumn, due to the expected decrease in mobile phone charges. Inflation ex-fresh food and net of the CT increase is forecast to move close to zero. Yearly inflation ex-fresh food should be around 0.5% yoy at end-2020.

2. Fiscal policy: a mix of measures calibrated between the short and medium terms. The government is proceeding with its mix of "economic revitalisation" and "fiscal consolidation". The target of structurally raising revenues, with the CT rate at 10%, has been mitigated by the exclusion of basic necessities and short-term expansionary countermeasures (see above). On the "economic revitalisation" side, the focus remains on labour supply and a fertility rate target of 1.8, with measures aimed at increasing participation, in particular by women. The government aims for a 2025 base case of -0.8% primary balance and lower debt/GDP (Fig. 10) through a combination of spending reform, increased revenues and stronger potential growth. Despite the difficult international economic situation, the combination of fiscal measures should help support domestic final demand, thereby maintaining moderate growth over the next two years.

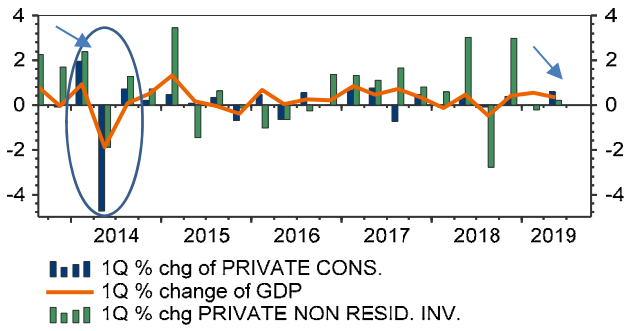
3. Monetary policy in search of lost stimulus. The monetary stimulus aimed at bringing inflation back to 2% are still ineffective but has helped increase fiscal space with lower debt servicing and solvency risks (Figs. 8 and 11). The Bank of Japan (BoJ) has opened the door to further policy rate cuts, also signalled by Kuroda's statement that cutting the short-term rate is always an option. Moreover, the central bank opened to further action stating at its last meeting that it "will reexamine economic and price developments at the next MPM".to assess if momentum towards the inflation target could be lost. As for the 10-year yield, the corridor of +/-0.2 pp around zero has been breached to the downside several times in the last month. Even with some hesitation, a widening to -0.3 pp may be accepted in the near future, perhaps in October. The role of monetary policy is increasingly limited and dependent on the interaction with fiscal policy, but within the forecast horizon, we believe this is not an obstacle to the expected path of moderate growth.

Macro forecasts

	2018	2019f	2020f	2018	2019				2020p				2021p
				4	1	2	3	4	1	2	3	4	1
GDP (constant prices, y/y)	0.8	0.8	0.2	0.3	1.0	0.8	1.3	0.1	-0.2	-0.2	0.0	1.1	1.0
q/q annual rate				1.8	2.2	1.4	0.0	-3.2	1.2	1.0	1.0	1.0	0.9
Private consumption	0.4	0.6	0.0	1.5	0.0	2.5	2.0	-6.4	1.5	1.4	1.2	0.8	0.7
FI - private nonresidential	3.9	1.4	0.7	12.4	-1.0	0.8	0.4	-2.0	1.6	1.6	1.6	1.6	1.5
FI - private residential	-5.9	1.4	-1.5	5.5	3.1	0.3	-0.8	-4.7	-1.3	-0.7	-0.3	0.0	0.3
Government investment	-3.4	0.8	0.9	-4.5	6.1	7.2	1.2	0.4	0.4	0.4	0.4	0.4	0.4
Government consumption	0.8	1.4	0.6	2.9	-0.4	4.9	-1.0	0.5	0.5	0.5	0.5	0.5	0.5
Export	3.4	-2.0	1.9	4.9	-7.6	-0.1	-1.5	1.6	2.8	2.8	2.8	2.8	3.0
Import	3.3	-0.5	1.4	15.4	-16.0	7.0	6.9	-8.2	3.1	2.6	2.6	2.6	3.2
Stockbuilding (% contrib. to GDP)	0.2	0.2	-0.1	0.3	0.3	-0.3	0.4	-0.9	0.1	-0.1	-0.1	0.1	0.2
Current account (% of GDP)	3.5	3.2	3.0										
Government Balance (% of GDP)	-2.5	-2.8	-3.2										
Government Debt (% of GDP)	224.2	223.2	223.4										
CPI (y/y)	1.0	0.6	0.7	0.8	0.3	0.8	0.3	1.2	0.7	0.7	1.2	0.4	0.4
Industrial production	1.0	-1.7	-0.6	0.6	-1.1	-1.2	-0.9	-3.6	-1.5	-1.2	-0.7	1.1	1.6
Unemployment (%)	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
JPY/USD	110.4	108.3	109.0	112.7	110.1	110.0	107.2	106.2	107.7	108.7	109.7	110.0	110.0

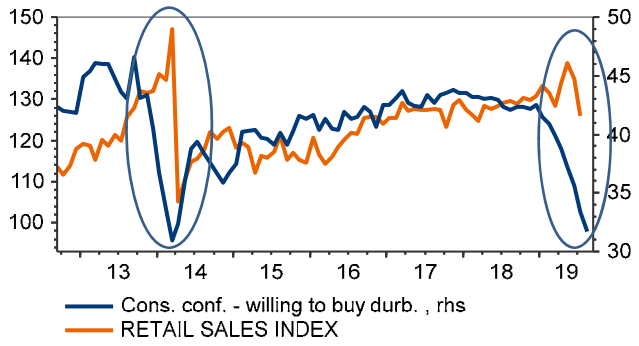
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Intesa Sanpaolo

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



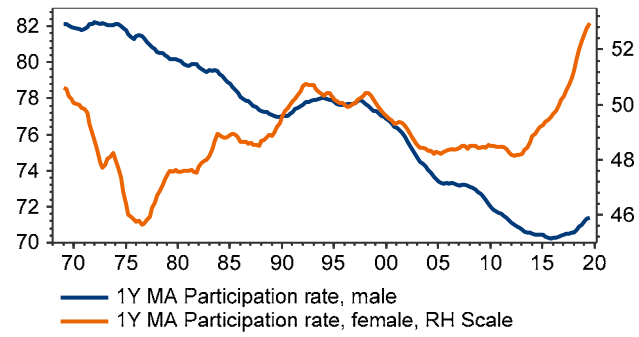
Source: Thomson Reuters-Datastream

Fig. 2 – Consumption in 2019 has not experienced the pre-tax increase spike seen in 2014



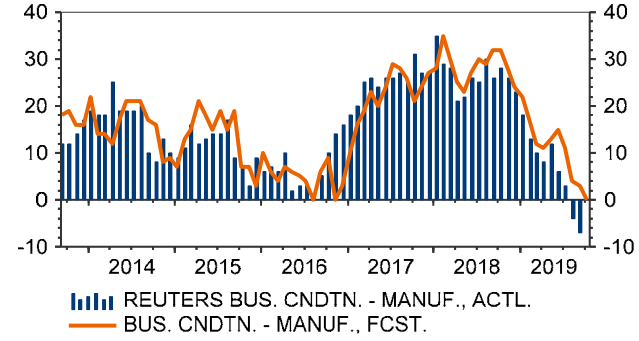
Source: Thomson Reuters-Datastream

Fig. 3 – Excess demand on the labour market mitigated by increased participation of women and people over 65



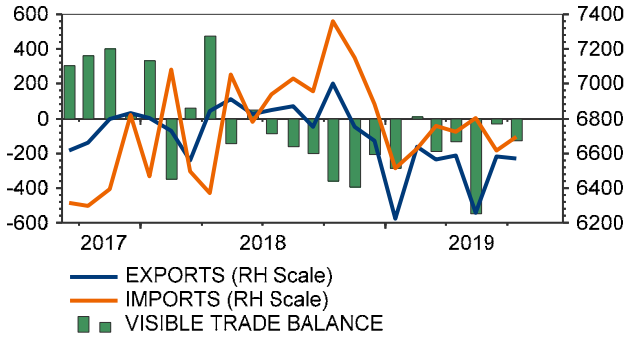
Source: Thomson Reuters-Datastream

Fig. 4 – The manufacturing sector is contracting



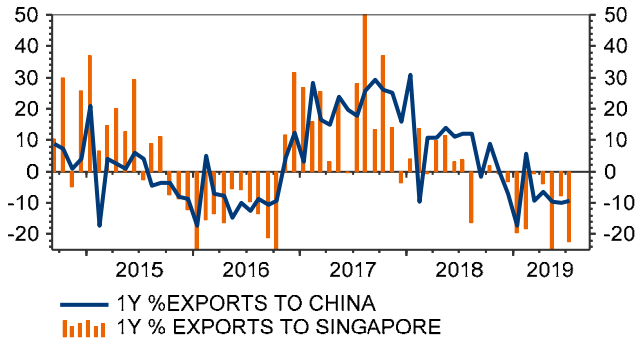
Source: Thomson Reuters-Datastream

Fig. 5 – Foreign trade: the negative trend continues…



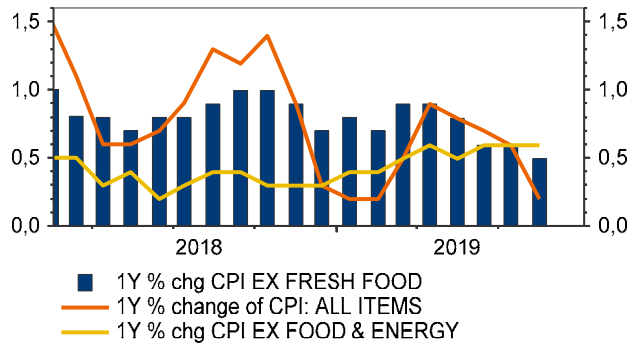
Source: Thomson Reuters-Datastream

Fig. 6 – …in the wake of Chinese and Asian weakness



Source: Thomson Reuters-Datastream

Fig. 7 – Inflation falling again…



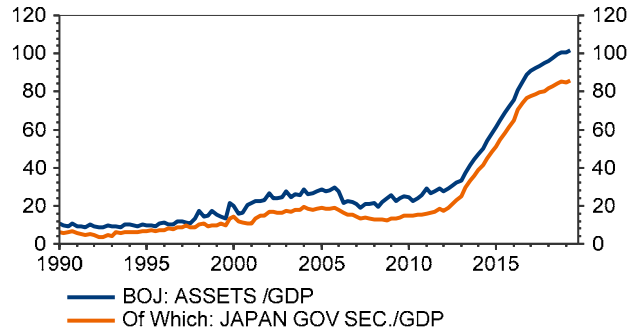
Source: Thomson Reuters-Datastream

Tab. 1 – … and the BoJ continues to downgrade projections

	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)	0.7	1.0	0.8
forecasts April 2019			
FY 2020 (July 2019)	0.9	1.4	1.3
forecasts April 2019			
FY 2021 (July 2019)	1.1	1.6	
forecasts April 2019	1.2	1.6	

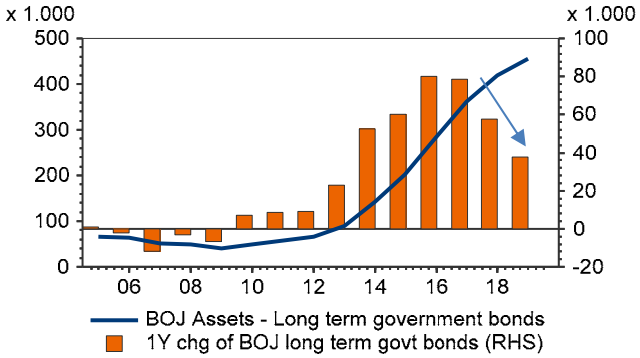
Source: BoJ, Outlook for Economic Activity and Prices, July 2019. The BOJ estimates that the effect of increasing CT equates to a rise of approximately 0.5 pp in core inflation and that the abolition of school fees will reduce inflation by -0.3 pp in fiscal 2019 and by -0.4 pp in fiscal 2020.

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



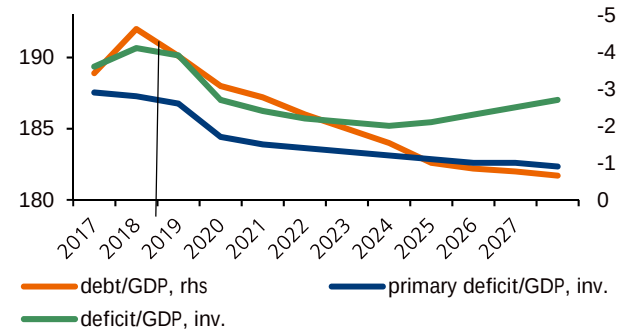
Source: Thomson Reuters-Datastream

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



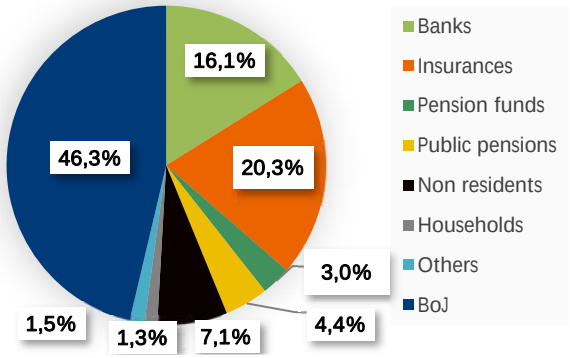
N.B.: Figures in JPYBn. Source: Thomson Reuters-Datastream

Fig. 10 – Fiscal policy making progress towards a sustainable scenario



Source: Cabinet Office

Fig. 11 – The BoJ's holding of JGBs is over 46%



N.B.: Figures at end-December 2018; total JGBs: JPY 1,028Trn. N.B.: Total JGBs+T-bills = JPY 1,125.4Trn. Non-residents hold 69.5% of T-bills. Average life of debt is 9 years and 1 month. Source: Ministry of Finance

China: increasing uncertainty but monetary stimulus remains moderate

Silvia Guizzo

GDP growth, having remained stable at 6.4% yoy for two quarters, slowed further **to 6.2% yoy in the second quarter**, pushed downwards by the slowdown in manufacturing; this more than offset the upturn in the agricultural sector, while services were stable. On the demand side, consumption has slowed as well as investments, while exports, although hindered by the impact of tariffs and weak foreign demand, have remained stronger than imports. Overall, the **July and August** data showed a **further slowdown in economic activity, though not generalised**. The easing of monetary conditions, which is not yet complete, and the measures to support consumer spending announced in recent weeks should, however, help to alleviate this slowdown.

Retail sales have continued to slow, above all in urban areas, but car sales, though they have kept contracting, showed an improvement from May's lows. Despite the slowdown in the added value of **industrial production**, the production volume of the major industrial metals increased moderately in August and the production of semiconductors and microcomputers continued to improve. Growth in **nominal capital investment** slowed further, pushed downwards by the decreased pace of private investment. **Infrastructure investments**, on the other hand, have **once again accelerated slightly** (4.2% yoy in August versus 3.8% yoy in July), while **property investments have maintained a high rate of growth** (10.5% yoy), only a little lower than in the preceding month; there has been a similar trend in residential property investment. The slowdown in residential properties sold and in building activity continues, however, to point to **more moderate property investment growth in the coming quarters**. Moreover, the authorities once again emphasised during the summer that "houses are for living in and not for speculation", and that **supporting the property market will not be used as a short-term measure to stimulate the economy**. The PBoC declared that it would show increased vigilance in preventing improper use of consumer credit, savings management products or other financial instruments to finance property purchases, and that it would be stepping up checks on the financing activities of large property development companies and their balance sheet strength ratios.

Foreign trade has weakened and the trade war between the US and China intensified further during the summer, with the announcement of measures and countermeasures from both sides to increase tariffs and cover total imports of the respective countries in two phases from 1 September and 15 December. However, China has declared itself ready to continue negotiations, and talks should resume in October. Within our main scenario, the most favourable forecast is that the situation will remain in limbo, with the outlook for foreign trade remaining negative. **The development of the dispute remains the greatest uncertainty factor** in the scenario for China and the world economy.

Consumer price inflation remained stable at 2.8% between July and August. The trend continues to be determined by food price increases (10% yoy in August), in particular pork prices (46.7% yoy). Meanwhile, **inflation** excluding food decreased to 1.1% yoy in August from 1.3% in July, its lowest level since June 2016; **excluding food and energy, it decreased to 1.5%** from 1.6% in July. **Producer prices decreased by 0.8% yoy** after the decline of 0.3% recorded in July, driven downwards by the fall in prices of both commodities and manufactured goods, including consumer durables (-2% yoy in August). **We confirm our inflation forecasts of 2.6% in 2019 and 2.3% in 2020.**

Lending growth still continues to be negatively impacted by the slowdown in the non-banking sector and the increase in non-performing loans, in particular for rural and smaller banks. **The PBoC** has cut the **required reserve ratio (RRR) by 50bps for all banks** with effect **from 16 September**. In addition, **the commercial banks of cities** which operate solely within their respective provinces will benefit from **a further cut of 100bps**, to be implemented **in two tranches of 50bps** each, **on 15 October and 15 November**. The PBoC reiterated its position that it was **against a massive and generalised monetary stimulus**, explaining that the rate cut was above all aimed at guaranteeing sufficient liquidity, particularly in view of mid-September's tax

deadlines, and facilitating lower financing costs for small and medium-sized enterprises. It confirmed that monetary policy will remain prudent, in line with statements by the Financial Stability and Development Committee and the Council of State. Both entities had also hoped for the use of **further countercyclical, targeted measures** to support the economy and **greater coordination between monetary policy and fiscal policy**. The **recent redefinition** (from 20 August) of the **calculation of the prime lending rate on customer loans** (with a rate spread applied in long-term refinancing operations) and its **application to all new loans**, including mortgages, will contribute to the ongoing replacement of the dual interest rate system and the gradual abandonment of benchmark rates. This will improve the **monetary transmission mechanism**, which **at the moment remains weak**. Between March 2018 and mid-2019, the required reserve ratio was reduced by 350bps for the big banks and by 550bps for rural banks, but while three-month rates in the money market fell by about 180bps, the average rate applied to customer loans decreased by only 30bps.

Given the growing downside risks to the scenario, **we anticipate that the PBoC** will again cut the RRR (by another 100bps in 2020), lastly also **cutting rates on refinancing operations** to counter the negative economic impact of tariffs (25bps in 2019, followed by a further 50bps in 2020). On the economic and fiscal policy front, **at the end of August** the government announced further **measures to support consumer spending** (including incentives to purchase electric cars and tariff exemption for certain products) and **to further open the market to foreign investors** (including the abolition of quotas for qualified institutional investors and the designation of six new free exchange zones, with the expansion of that around Shanghai). It also seems increasingly likely that there will be an increase in the special emissions allowance for local government, or that the increase planned for 2020 will be brought forward to provide **support for infrastructure financing**. **We are therefore maintaining our scenario,** which already included the increase in tariffs announced in the summer, **of a slowdown in growth to 6.2% in 2019 and to 5.9% in 2020**.

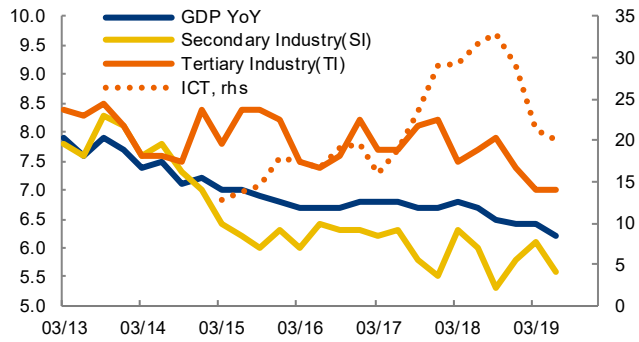
The **renminbi crossed the important psychological threshold of 7.0 against the dollar** at the beginning of August **when the trade dispute worsened**, **to hit the 7.18 mark**, with an overall depreciation of 7% since April. On several occasions the central bank has emphasised its opposition to a competitive devaluation, reiterating that the exchange rate will be increasingly determined by the market and thus be subject to greater volatility. The exchange rate may **hit 7.30 at the end of the year** if negotiations stall, before regaining value in 2020 in line with the anticipated stabilisation of the economic and trade situation.

Forecasts

	2015	2016	2017	2018	2019	2020
GDP (constant prices)	6.9	6.7	6.8	6.6	6.2	5.9
Private consumption	8.1	8.2	6.7	7.2	6.9	6.8
Public consumption	7.7	9.7	8.9	16.3	5.5	6.2
Fixed investment	7.3	6.7	4.8	4.7	4.2	4.4
Exports	0	1.9	6.8	4.3	0.3	0.9
Imports	0.7	3.3	7.7	6.5	-2.5	2.8
Industrial output	6.2	6.3	5.9	5.8	5.4	4.5
Inflation (CPI)	1.4	2.0	1.5	2.1	2.6	2.3
Unemployment rate (%)	4.0	4.0	3.9	3.8	3.6	3.6
Average salaries	9.7	9.5	10	9.4	8.7	8.4
90-day interbank rate (average) (%)	3.80	3.00	4.70	4.00	3.00	2.80
10-year government bond yield (average) (%)	3.05	2.91	3.85	3.45	3.15	3.15
USD/CNY exchange rate (average)	6.28	6.64	6.76	6.61	6.94	6.88
Current account balance (CNY Bn)	1912	1335	1313	353	1182	778
Current account balance (% of GDP)	2.8	1.8	1.6	0.4	1.2	0.7
Budget Balance (% of GDP)	-3.4	-3.8	-3.7	-4.2	-4.5	-4.2
Public Debt - Central Government (% of GDP)	15.1	15.8	16.0	16.2	17.1	18.1

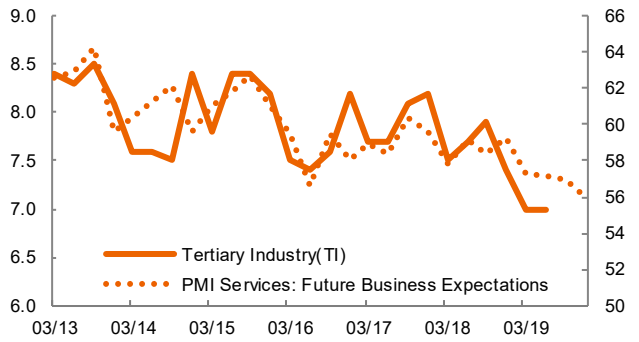
N.B.: Percentage change versus previous period – except where otherwise indicated; Source: Oxford Economic Forecasting and Intesa Sanpaolo.

GDP yoy



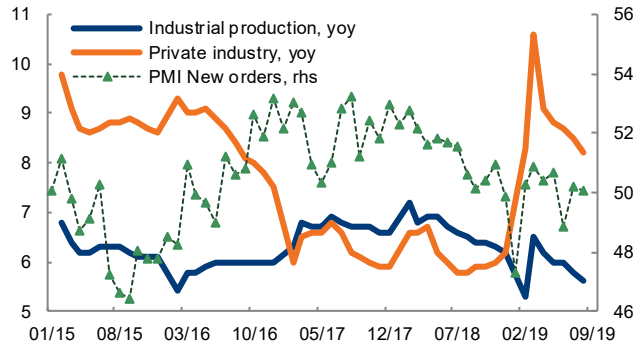
Source: CEIC.

Services



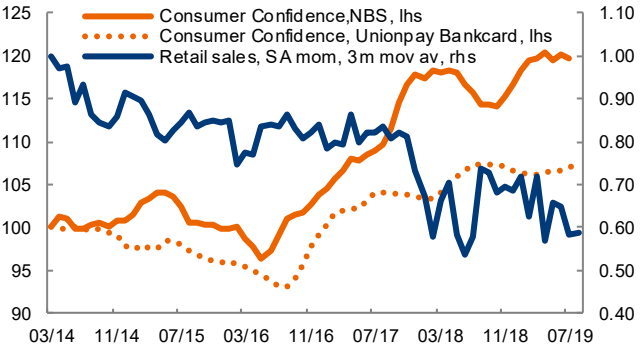
Source: CEIC; IHS Markit.

Industrial output and orders



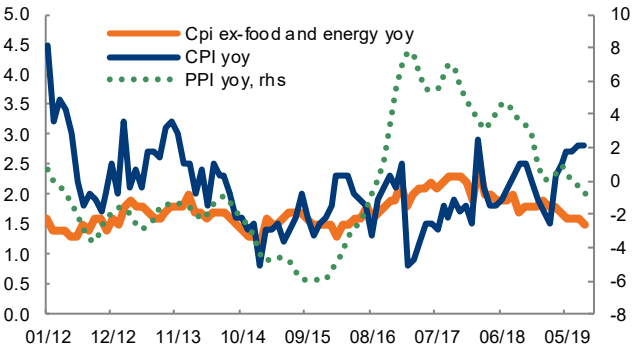
NB. cumulative industrial output, yoy change
Source: CEIC, IHS Markit.

Retail sales and consumer confidence*



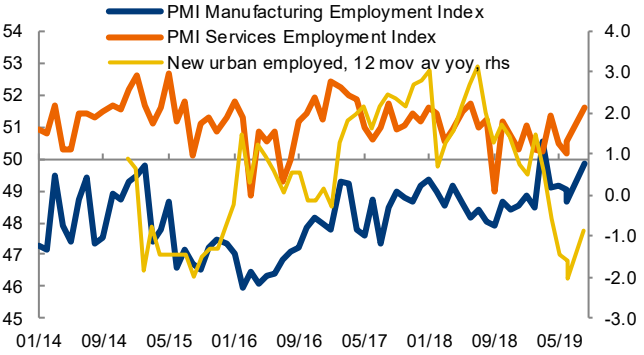
NB. * 3-month moving average, rebased to March 2014 = 100. Source: CEIC.

Inflation



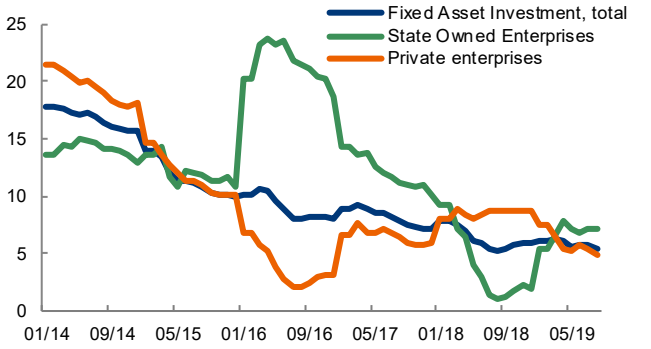
Source: CEIC.

Labour market



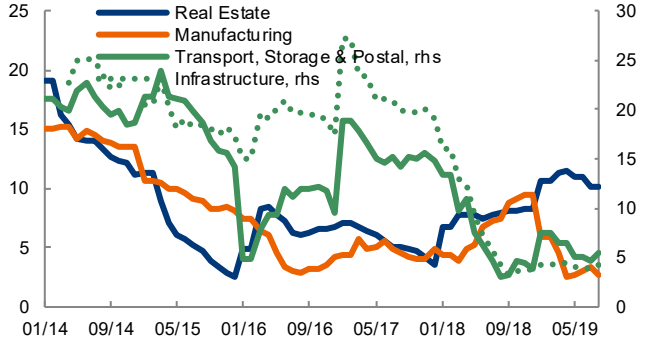
Source: CEIC and Intesa Sanpaolo chart.

Nominal investment by type of company, yoy



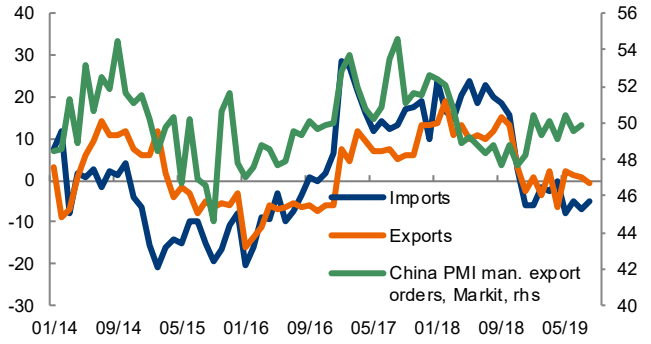
Source: CEIC.

Nominal investment by sector, yoy



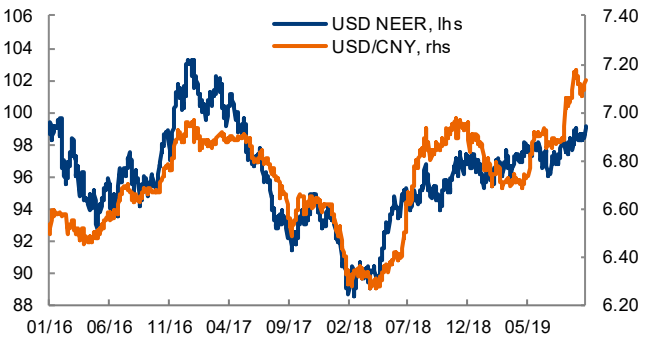
Source: CEIC.

Foreign trade



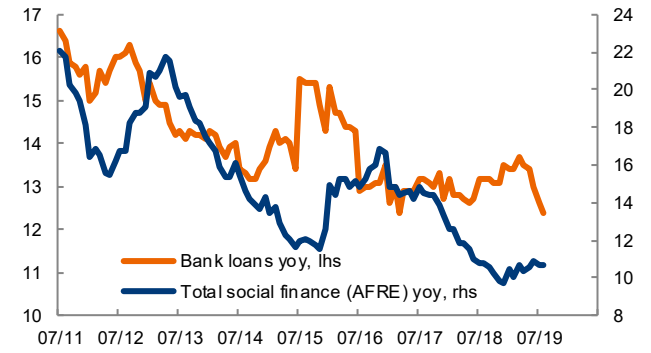
NB: seasonally adjusted figures Source: CEIC, IHS Markit.

Exchange rate



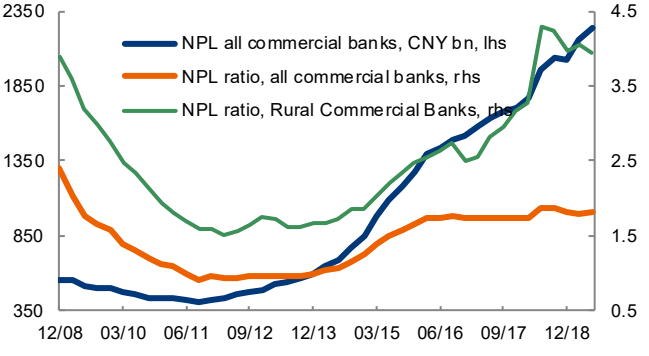
Source: Bloomberg.

Aggregate lending



Source: CEIC and Intesa Sanpaolo chart.

Non-performing loans



Source: Bloomberg.

India: Disenchantment

Silvia Guizzo

In 2Q, GDP growth at 5% yoy was **well below expectations** (5.7 and the figures for 1Q (5.8%), marking the fifth consecutive quarter of gradual slowdown from the peak of 8.1% yoy in 1Q18. The slowdown in consumer spending (to 3.1% yoy from 7.1% in 2Q) outstripped the modest increase in investments and a marginally positive contribution by foreign trade. On the supply side, the slowdown affected both the services and industrial sectors, and in particular manufacturing and construction. Both have suffered from the slowdown in lending by the non-banking sector, made all the more marked by the collapse of the giant IL&FS in autumn 2018. Moreover, the export industry segment (textiles and clothing, jewellery) continue to be weighed down by the slowdown in foreign demand.

Both the Dun & Bradstreet and RBI surveys report a **decline in business confidence and a sharp deterioration in order book expectations** in 3Q, confirmed by the trend of the PMI order components. The **improvement in the PMI services index,** together with growing mobile phone subscriptions and increasing revenues from tourism services should help sustain the prospects for the services sector better than those for manufacturing. Both exports and imports followed a downwards trend in 2Q, which intensified over the summer, but more markedly for imports. A weak increase in lending, together with the persistent slowdown in machinery imports and the decline in business confidence, means that **the prospects of a recovery in investment are still limited.** Passenger traffic continues to be sluggish and car sales continue to contract sharply (-31% yoy in July), as do sales of two-wheeled and three-wheeled vehicles, suggesting a decline in consumption is still to come in both urban and rural areas. The July **consumer confidence survey** pointed to greater pessimism in the face of current conditions and a decline in spending expectations and intentions for the coming year. The delayed summer monsoon has led to a significant reduction in land sown leading the Center for Monitoring India Economy (CMIE) to estimate that agricultural production from the autumn harvest (Kharif crop) will be down from last year, with a negative impact on the performance of the **agricultural sector** that could translate into lower incomes for rural households.

The monthly indicators for 3Q are hence still weak for both consumer spending and investments. The expected recovery in the second half of the year, partly boosted by a favourable comparison effect with 2018, therefore looks set to be slower than anticipated. These factors, together with the greater slowdown in Q2 than we had expected, leads us to **revise down the GDP growth forecasts for 2019 from the previous 6.8% to 5.8% yoy.** The impact of the rate cuts (110 bps since the beginning of the year) and a further easing of monetary policy, as well as the specific measures to help businesses, should stimulate an acceleration in investment and subsequently in consumer spending, and lead to a pick-up in growth to **6.8% yoy in 2020**, revised down from the previous 7.1%. The implications of the non-banking financial sector's problems relating to consumption and investment, the growing attempts by government to interfere in the management of monetary policy and the questionable manner with which the special status of the state of Jammu and Kashmir was withdrawn justify a **downgrading of the long-term prospects** for the country as compared with the highly positive expectations of a few years ago, which incorporated stable growth forecasts of around 7-8%.

The government has approved the **budget for the 2019-20 financial year** setting a **target** for the **deficit/GDP ratio of 3.3%, compared with** 3.4% for the 2018-19 financial year. The budget is broadly in line with that provisionally approved before the elections as regards the allocation of expenditure, which continues to be concentrated in agriculture, the development of rural areas, transport infrastructure (in particular motorways and the railways) and education. The measures are generally aimed at **improving the business climate and reassuring foreign investors rather than supporting consumer spending**, with a view to the longer term overall. Certain measures, aimed at promoting the "Make in India" programme, could lead to a rise in manufacturing and operating costs in the short term and have a negative impact on consumer spending. The increase in revenues postulated seems ambitious, making it likely that there will be **a slight overshoot of the deficit** this financial year.

The government also approved other important measures to support the financial sector, made more urgent by the non-performing loans of public sector banks and the liquidity crisis in the non-bank financial sector. The government has announced a wide-ranging **consolidation programme for public sector banks** (Public Sector Undertakings, PSU) which will reduce their numbers from 27 to 12 through four major mergers of ten smaller banks. To this end, provision is made for a capital injection of INR 553Bn of the INR 700Bn planned in the budget. The government then provided for specific measures **to improve the governance of the public sector banks**, strengthening the central bank's powers of control over non-bank financial corporations (NBFC) and extending it to the housing finance sector.

Consumer price **inflation** rose very slowly from 3% in April and May to 3.2% yoy in August, primarily due to the return of inflation to the food sector. The stabilisation of core inflation (below the figure of 5% in April) and the fall in inflation expectations seen in the RBI survey do not point to demand pressures. We are revising down our **inflation forecasts for 2019 from 3.3% to 3.1% yoy, rising to 4.1% yoy in 2020.**

The central bank **lowered interest rates by 35 bps at its meeting on 7 August**, bringing the repo rate down from 5.75% to 5.40%. The cut, of an unusual amount, follows another four cuts of 25 bps each in the first half of the year. The RBI maintained its accommodative stance, reiterating that the subdued inflation dynamic leaves scope for further monetary easing to close the negative output gap. **We expect** the economic slowdown to lead the RBI to make **another cut of 15 bps at its October meeting** (which, added to the 35 bps in August, would bring the repo rate down to 5.25%), followed by a further cut of **25 bps between December and February**, and then to stop.

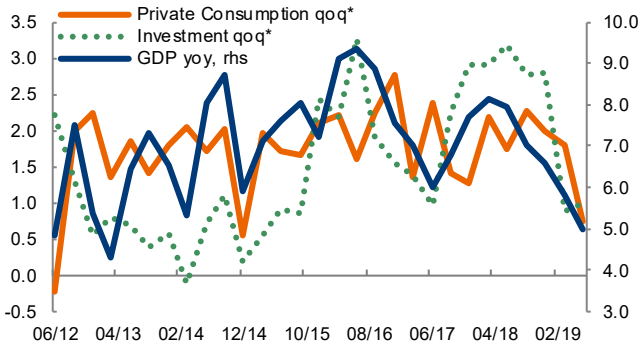
The **rupee** firmed to around 68 against the dollar in July and then depreciated in August, before reaching a high of 72.4 in early September. The exchange rate was negatively affected by the proposals in the budget of a tax on foreign capital - then discarded - the unexpected move by the government on the Kashmir region and the deepening of the China-US trade dispute. Further monetary policy easing and the weak economic environment will keep the rupee **under pressure in the 71-73 area until the end of the year**. The exchange rate is then expected to start climbing again in 2020, in line with the acceleration of economic growth.

Previsioni

	2015	2016	2017	2018	2019	2020
GDP (constant prices)	7.5	8.7	6.9	7.4	5.8	6.8
Private consumption	7.7	9.1	6.6	8.5	5.2	7.4
Public consumption	4.2	4.2	13.7	10.7	11	7.6
Fixed investment	4.8	9.2	7.7	12.2	5.3	7.4
Exports	-6.2	2.5	5.8	10.6	4.2	5.4
Imports	-5.8	1.6	15.5	16.1	3.9	5.8
Industrial output	2.5	5.2	3.5	5.2	2.7	6
Inflation (CPI)	4.9	4.9	3.3	3.9	3.1	4.1
Unemployment rate (%)	4.5	5.2	5.5	5.6	5.5	5.5
Average salaries	11.9	14.3	9.8	11.8	7.1	8.4
3-month MIBOR (average)	8.00	7.20	6.50	7.30	6.90	5.50
10-yr government bond yield (average)	7.80	7.20	6.70	7.70	7.00	6.30
USD/INR exchange rate (average)	64.15	67.2	65.11	68.40	70.77	69.34
Current account balance (INR Bn)	-1451	-815	-2528	-4511	-3432	-4514
Current account balance (% of GDP)	-1.1	-0.5	-1.5	-2.4	-1.7	-2.1
Budget Balance (% of GDP)	-3.4	-3.6	-3.9	-3.6	-3.2	-3.5
Public Debt (% of GDP)	47.1	46.9	45.5	44.9	46.2	46.4

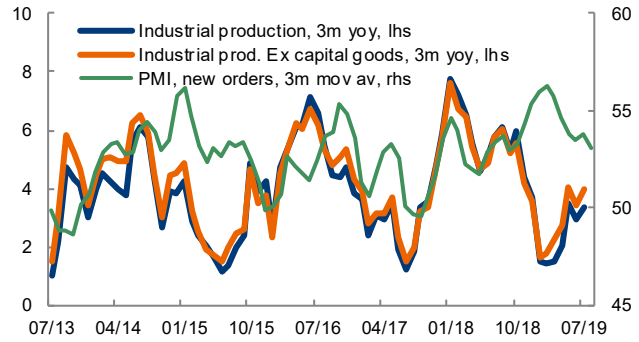
N.B.: % changes compared with the previous period – except where otherwise indicated. The figures are for the calendar year. Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

GDP and its components



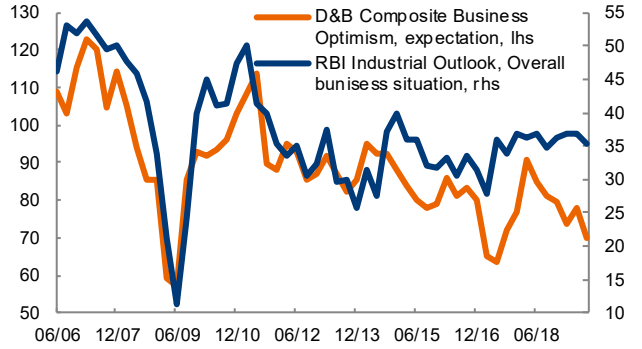
*Four-quarterly moving average. Source: CEIC

Industrial output



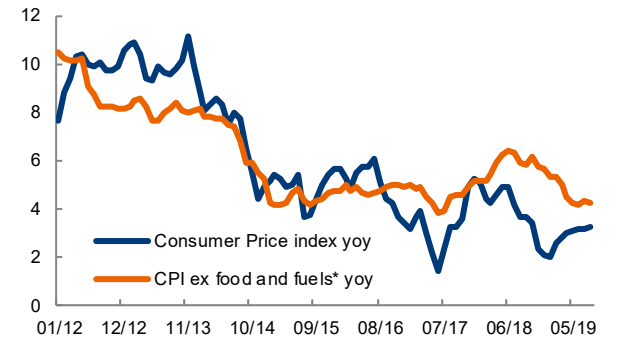
N.B.: Three-month moving average. Source: Markit, CEIC

Business confidence



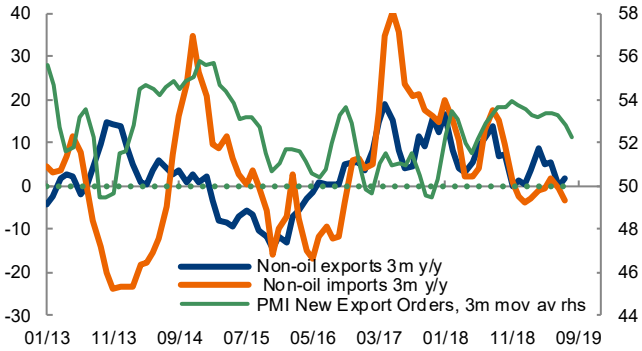
Source: CEIC

Inflation



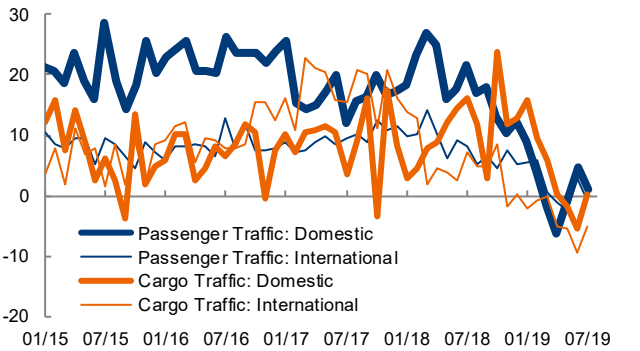
N.B.: (*) Intesa Sanpaolo estimates. Source: CEIC

Foreign trade



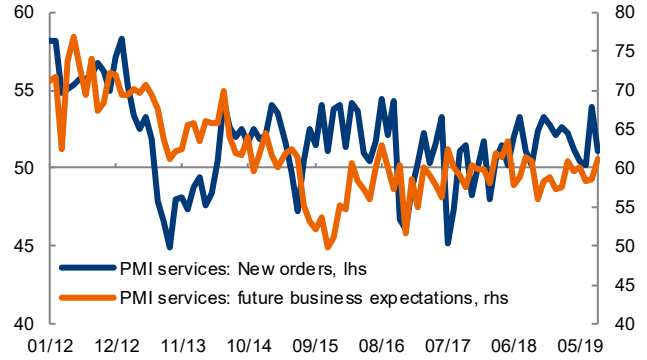
N.B.: Three-month moving average. Source: Intesa Sanpaolo chart based on Bloomberg and Markit data

Cargo and passenger traffic yoy



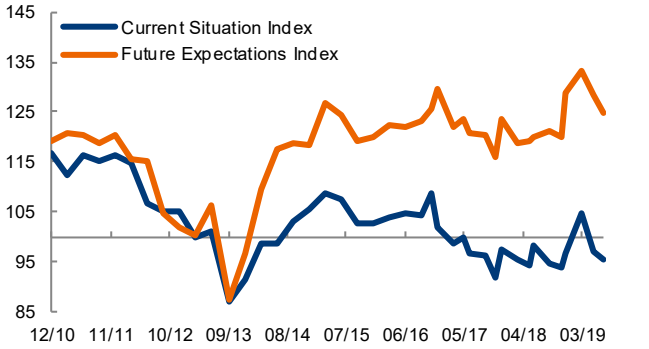
Source: CEIC

Services



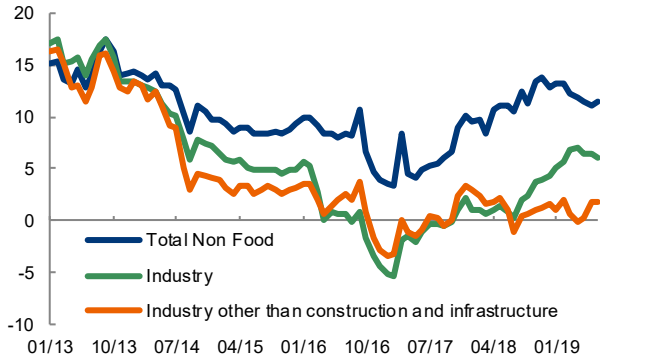
Source: Markit

Consumer confidence



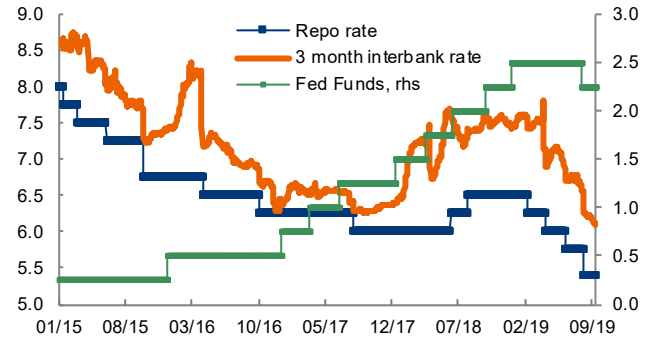
N.B.: Quarterly consumer confidence survey by the RBI. Source: CEIC

Loans by sector (% change yoy)



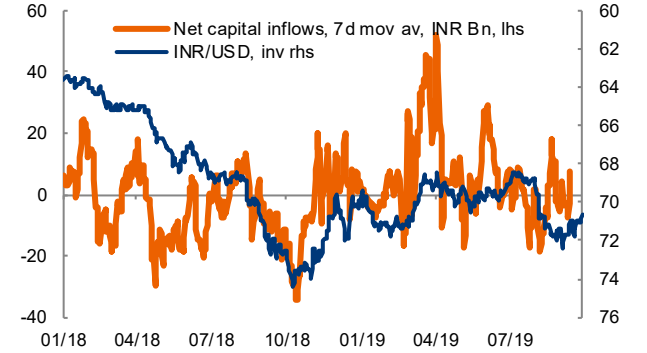
Source: CEIC

Official and money market rates



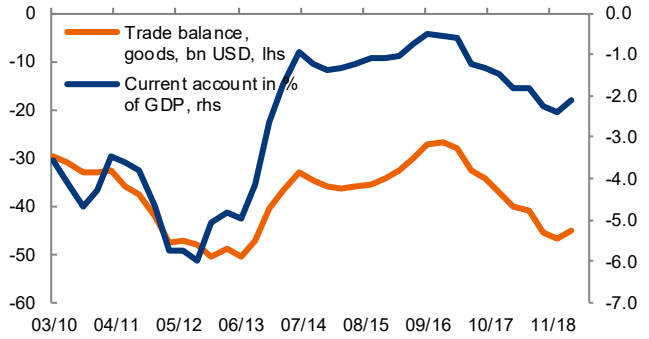
Source: CEIC

Portfolio inflows (INR Bn) and exchange rate



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

Current account (four-quarterly moving average)



Source: CEIC and Intesa Sanpaolo chart

Currency markets: currencies with the greatest efficiency of monetary policy action are favoured

USD – Tariff war unfavourable to the US Dollar; further monetary stimulus may not necessarily be so.

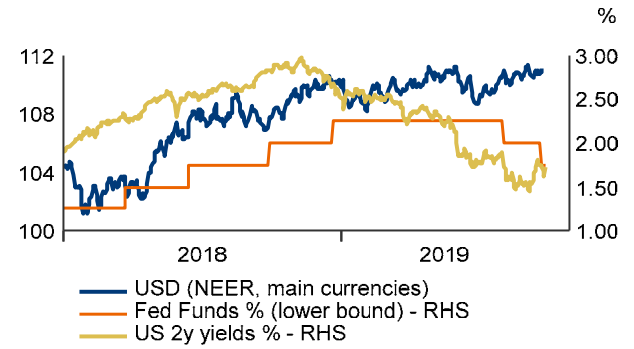
Asmara Jamaleh

The US Dollar has been appreciating this year, but at a rather moderate rate, and the overall strengthening was limited in scale (Fig. 1). The combination of the fundamental robustness of the US economy and elevated interest rates (relatively speaking, the highest among the industrialised countries) favoured the continued upward trend, which was already under way last year. Factors which have been slowing the trend were the international slowdown, the risks from deterioration of trade flows caused by the US-China trade war and the consequent fall in US rates/yields with the emergence of rate cut expectations, which the Fed indeed implemented cutting rates in July and September (the current Fed funds target range is 1.75-2.00%).

The expectations for the coming months are similar: **a largely positive picture for the US economy but with downside risks due mainly to external factors – the global slowdown and trade policy uncertainties** – with the possibility of a further Fed stimulus. The reality is that the Fed board members are split, being almost equally divided into three groups: those favouring a rate cut, a rate rise or stable rates respectively. The uncertainty generated by this situation could be negatively interpreted for the dollar, but in this case the Fed board's indecision could, if anything, lend itself to a favourable interpretation: the indecision is not only between a cut and unchanged rates, but actually involves the possibility of a rise (by the end of the year), which confirms that the Fed's overall assessment of the US economy is positive.

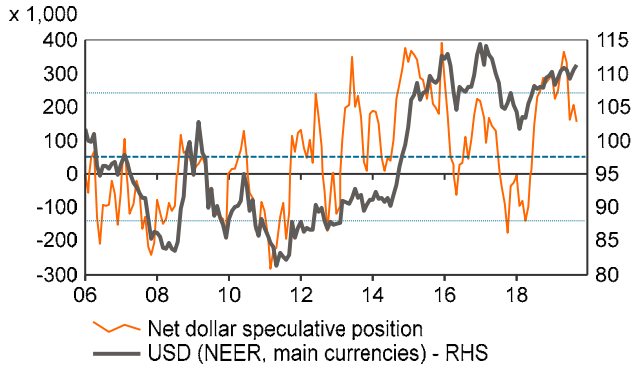
This scenario should therefore favour a **consolidation** or, if nothing else, a **stabilisation of the dollar**. Technically, this would represent the "natural" continuation of the softening of the upward trend seen in the course of the year.

Fig. 1 – Dollar rising in 2019, but more slowly, with rates falling



Source: Thomson Reuters-Datastream.

Fig. 2 – Speculative long positioning may expose it to downside risks



Source: Thomson Reuters-Datastream.

The prospect of further monetary easing by the Fed should not be interpreted as a development that is in itself **unfavourable for the dollar**, for at least three reasons: **(i)** the total extent of the expected stimulus is limited; **(ii)** the other main economies are also going through a period of slowdown and are therefore more or less implicitly leaving the doors open to renewed monetary expansion, which they have either already initiated (such as in the Euro area, Australia and New Zealand) or have not (yet) undertaken; **(iii)** the starting level of US rates, which are higher and in clearly positive territory, allows good marginal efficiency of monetary policy action, especially compared with economies that have, conversely, zero or negative interest rates (first and foremost the Euro area and Japan).

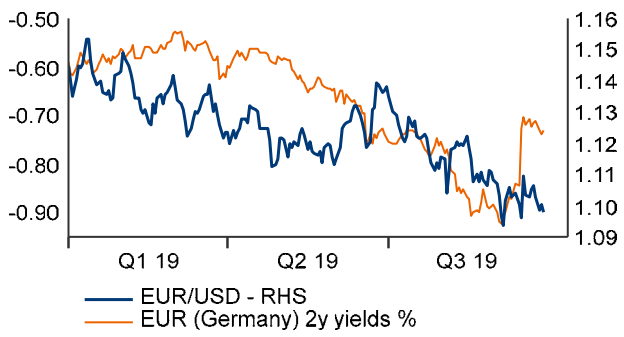
However, the **balance of risks** for the dollar is slightly on the **downside** due to the uncertainty as regards trade policies, particularly in a context of a speculative long dollar market (Fig. 2). October will see the start of the official negotiations between the United States and China to try to find an agreement on tariffs; however, it seems that the road will be neither easily nor rapidly travelled, leaving aside the unfavourable impact of the protectionist measures that have already been announced.

Another variable which could soon start to determine the course of the dollar is the **polling for the 2020 presidential election**: possible signs indicating that Trump will not be re-elected may operate in favour of the dollar, since the market would read into these the prospect of improving trade relations between the US and China. At the moment, however, with projections giving the Democrats a slight advantage over the Republicans with a majority of 232 to 219 (https://www.270towin.com/), there is still everything to play for.

EUR – Reduced marginal efficiency of the ECB's policy action is the euro's main weak point.

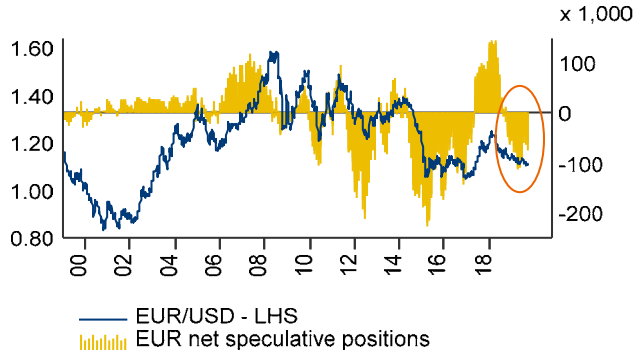
Symmetrically to the US Dollar, **the euro has been depreciating** this year, from a high of 1.15 in January to a low of 1.09 EUR/USD in September. This is completely in line with the development of the fundamentals of the Euro area: **a slowdown in growth, a fall in inflation** (which remains below target), a decrease in rates/yields (Fig. 3) and a further **easing of monetary policy** by the ECB in September, with a composite stimulus package comprising, among various non-conventional measures, a cut in the deposit rate from -0.40% to -0.50% and the resumption of the APP asset purchase programme. The ECB has also **revised downwards its projections** for both growth and, above all, for inflation; and while confirming that it is ready to intervene again in future, if necessary, to comply with its own mandate, it has let it be understood that in the current situation of negative interest rates, **the efficiency of monetary policy is limited**. Mario Draghi has indeed expressly invited the other authorities responsible for economic policy, primarily fiscal policy, to play their part. Reduced efficiency in this phase of monetary policy does not speak in favour of the euro; on the contrary, it represents the main source of downside risk, because it creates a significant difference with respect to the Fed. Even in the case of US rates coming down more than those of the Euro area in the next few months, decisively greater efficiency of policy action would nevertheless be guaranteed, because US interest rates are not only higher but above all firmly in positive territory.

Fig. 3 – Euro trend in line with rates/yields trend



Source: Thomson Reuters-Datastream.

Fig. 4 – Speculative positions short Euro for about a year



Source: Thomson Reuters-Datastream.

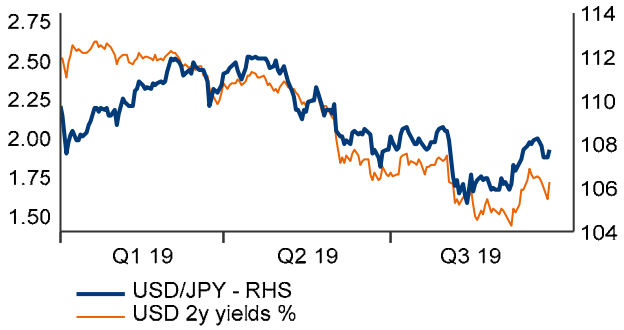
Using these assumptions, the short-term scenario for the exchange rate, from now until the end of the year, should be one of **substantial stabilisation** around the range of the last two months of 1.09-1.12 EUR/USD. Technically speaking, the levels to monitor are those of the 1.1070-1.1170 EUR/USD resistance range, because a possible breakout through this area would signal the end of the downside trend in place since last year. There would not, however, be the indications of a possible (upward) trend reversal at least until the 1.1450-1.1500 EUR/USD level

were broken through. Beyond the short-term, over the next year, the euro could conversely resume a gradual rise towards 1.15-1.17 EUR/USD over 6 to 12 months when it enters the mature (expansionary) phase of the monetary policy cycle.
The balance of **risks** in the scenario is, however, slightly **on the downside**, because the Euro area growth and inflation situation is weaker than a few months ago and less robust than the US, against a not very favourable international background (global slowdown, US-China trade tensions and Brexit). The speculative positioning of the market, which has been shorting the Euro for about a year (Fig. 4) indicates that sentiment is not very favourable. In this regard, the ECB itself at its September meeting enhanced the forward guidance indicating that rates will stay at current levels or lower until inflation has shown stable and convincing convergence towards the target, whereas the commitment in July was "only" until mid-2020. The downside would extend to the 1.08-1.05 EUR/USD range, in the event of disappointing Euro area data or positive surprises from the US.

JPY – Global risks are mitigating the downside for the Yen due to the prospect of new BoJ stimulus.

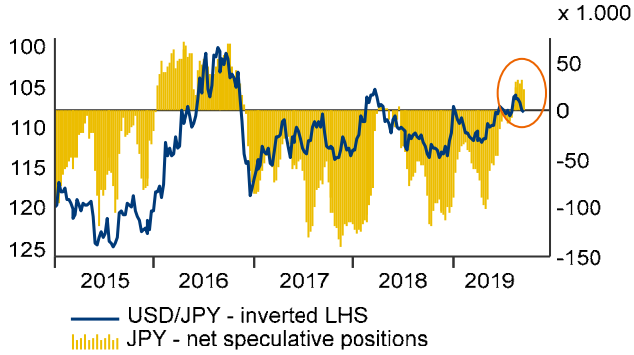
The yen, having started the year with a moderate fall to 112 USD/JPY, **has turned round** since the spring, appreciating to a high of 104 USD/JPY in August. The exchange rate trend was in line with the development of US and Japanese economic and financial variables, showing a **strong correlation** (82%) **with short and long US yields** (Fig.5) **and spreads-to-the corresponding Japanese yields** (zero or negative and with much smaller movements than in the US). Therefore, the appreciation of the last few months does not reflect the strength of the Japanese currency but rather the decrease in American yields due to signs of the US economy slowing down and consequent Fed decisions to cut rates.

Fig. 5 – Strong correlation between USD/JPY and US yields



Source: Thomson Reuters-Datastream.

Fig. 6 – Unusually long speculative positioning on the yen



Source: Thomson Reuters-Datastream.

The Japanese economy is going through a slowdown phase in common with the rest of the world. Consequently, in view of the consumption tax hike planned for 1 October, and above all in the light of the continued inability to achieve the target inflation level (inflation remains too low and far from target), at its last meeting in September, the **BoJ indicated that it could announce a new monetary stimulus as early as its next meeting, in October**. The central bank has in fact noted that downside risks have increased, due mainly to international developments where, in addition to the weak global economy, US trade policy (in particular as regards the export of Japanese cars) and the uncertainties around Brexit are weighing heavily.

The basic trend of the yen beyond the very short term should therefore be downward, towards 110-112 USD/JPY over the next 6 to 12 months. The extent of the expected fall appears relatively limited, because the heightened uncertainty still affecting international markets – particularly as regards the US-China trade war, but also Brexit – could translate into increased risk aversion. This could have a favourable effect on the Japanese currency, as happened

recently (to the point where speculative positioning between August and September gave rise to an unusual net long yen exposure: Fig. 6). The (temporary) upside in the event of further deteriorating sentiment should remain contained within the summer highs of 105-104 USD/JPY.

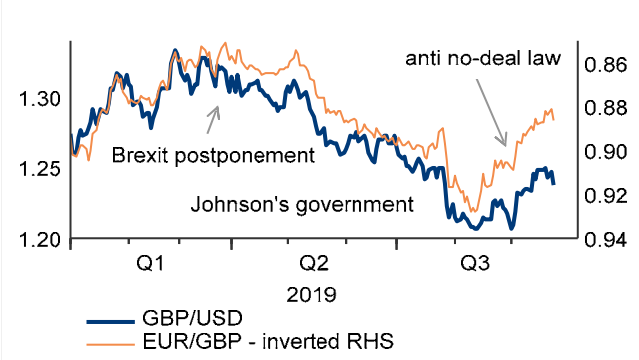
Similar considerations apply to the **cross with the euro**, against which the yen started the year with a fall to a low of 127 EUR/JPY in March, after which it returned to a high of 115 EUR/JPY at the beginning of September. Also in this case, the basic trend beyond the short-term should be a weakening of the Japanese currency towards the 125-130 EUR/JPY area over the next 6 to 12 months. The expected decline against the single currency seems likely to be greater than against the dollar due to the expected simultaneous strengthening of the EUR/USD over the next year.

GBP – Sterling might strengthen further if the recent favourable Brexit news flow translates into positive concrete developments.

Sterling, after an upward move at the beginning of the year, then went into reverse, coming down from a high of 1.33 GBP/USD in March **to a low of 1.19 GBP/USD** in September. This was similar to the trend against the euro, where, however, the fall started later, in May, from a high of 0.84 EUR/GBP to a low of 0.93 EUR/GBP in August. The new corrective phase was produced by the **renewed uncertainties regarding Brexit: firstly, with the postponed exit from the EU, initially set for March 2019, then the replacement of Prime Minister Theresa May at the end of July by Boris Johnson**, who set the new leaving date at 31 October, with or without a deal. Johnson's uncompromising policy has increased the risk of a hard Brexit, further weighing down sterling; the currency, however, has recovered in recent weeks thanks to the unexpected (though still highly uncertain) slightly brighter outlook.

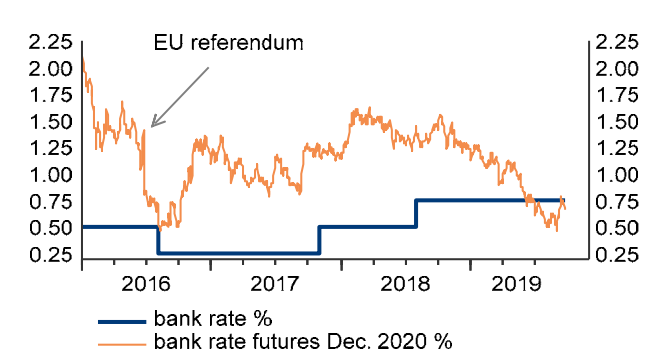
Parliament, to avoid a no-deal Brexit, has passed a law requiring EU withdrawal to be postponed by three months, to 31 January 2020, **if Johnson is unable to reach a new agreement with the European Union at the EU summit on 17-18 October**. This will therefore be the key date for exchange rate trends in the short term. The main knot to be untied is the question of the **Irish "backstop"** (i.e. the safety net designed to prevent the re-emergence of a physical border between Ireland and Northern Ireland), which Boris Johnson wants to remove from the agreement. The EU, which initially opposed this, has partly softened its own position, requiring the British government to propose a concrete alternative to the "backstop"; having met with Johnson, the EU Commission President Juncker said he was optimistic about the possibility of reaching a deal, provided that an alternative to the backstop can be found.

Fig. 7 – Sterling exchange rate driven by Brexit developments



Source: Thomson Reuters-Datastream.

Fig. 8 – BoE does not exclude a cut in the event of a "hard Brexit"



Source: Thomson Reuters-Datastream.

These are certainly favourable developments, but it now remains to be seen whether there will be concrete progress. Meanwhile, political uncertainties remain, mainly due to the prospect of **early elections** in the autumn (Boris Johnson had requested 15 October, but Parliament blocked his requests, while the Labour party is also considering the option of another Brexit referendum).

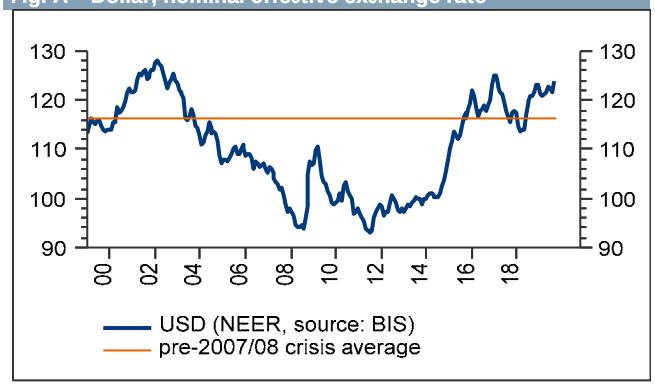
In the meantime, the **Bank of England has reduced its growth forecasts for 2019 and 2020** from 1.5% to 1.3% and from 1.6% to 1.3% respectively, while leaving its 2019 inflation forecast unchanged at 1.6% and raising its 2020 forecast from 2.0% to 2.1%. It has also signalled that the uncertainty due to the postponement of Brexit will probably lead to weaker growth and lower domestic inflation. Finally, it has reiterated that **in the event of a "soft Brexit" and a recovery in the global economy, it will again increase the bank rate, but in a gradual and limited manner, while in the event of a "hard Brexit" it will have to assess the trade-off between the higher inflation** produced by the expected depreciation in the exchange rate and **lower growth** due to the uncertainty regarding new trade agreements. This opens the door to further monetary easing if necessary, which is a possibility that the market has also once more taken into account, albeit temporarily (Fig. 8). However, it stated that the worst-case scenario in the event of a no-deal exit should be less negative than predicted a year ago, thanks to the preparations made in the meantime to cope with the various alternative scenarios.

Sterling forecasts are still dependent on unforeseeable Brexit developments. For this reason, if an agreement is reached, in particular at the EU summit in October, the currency may appreciate beyond present levels both against the Dollar (to 1.30 GBP/USD) and against the Euro (to 0.86 EUR/GBP). If, on the other hand, there were a no-deal withdrawal, it would further depreciate (to at least the recent lows of 1.19 GBP/USD and 0.92-0.93 EUR/GBP). In the case of a "hard Brexit", in line with comments from the BoE itself regarding the preparations made to cope with the possible alternative exit scenarios, the correction in the exchange rate could be more limited than that seen after the 2016 referendum. This is because, following the postponement of the withdrawal date, there has been more time to make further preparations; the market has at least in part already discounted the negative effects; and the BoE has reiterated that it will continue to shore up the economy through policy action. In this last respect, it has already acquired credibility, as shown by the recovery in the exchange rate after the initial post-referendum correction.

At present, as it is not possible to predict whether withdrawal will be with or without an agreement, we are opting for an **assumption similar to that adopted by the BoE** in making its forecasts, i.e. that there will be an **orderly and gradual transition** to the new post-Brexit order. As a consequence, **the British currency should, in the short term** – where there is still uncertainty regarding the way of leaving the EU – **stabilise** approximately within the range of 1.22-1.25 GBP/USD within a 1 to 3 month time frame; **later, when the uncertainty as regards the method of withdrawal has dissipated, it should strengthen again** towards 1.28-1.32 GBP/USD over the next 6 to 12 months. Against the euro, this should translate into a stabilisation at 0.90-0.89 EUR/GBP over 1 to 3 months and 0.89-0.88 EUR/GBP over 6 to 12 months, with the simultaneous expected strengthening of EUR/USD.

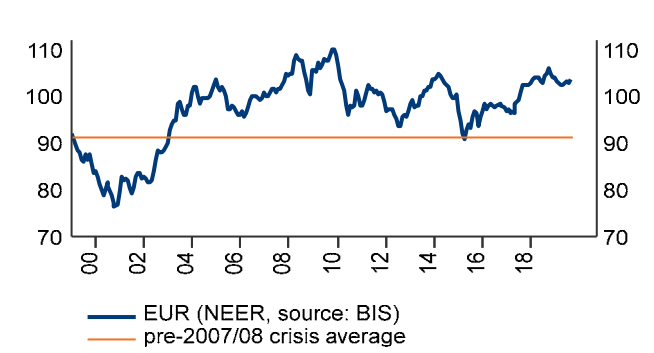
The **risks** in the scenario are **to the downside**, both in the short term due to the uncertainty regarding the form Brexit will take, and subsequently, as even in the event of an orderly and gradual transition there will be after-shocks due to the change, at least initially (primarily due to the improvised reshaping, from one day to the next, of customs arrangements and the associated checks).

Fig. A – Dollar, nominal effective exchange rate



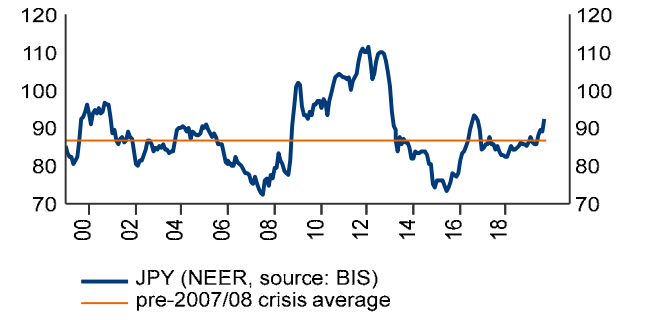
Source: Thomson Reuters-Datastream

Fig. B – Euro, nominal effective exchange rate



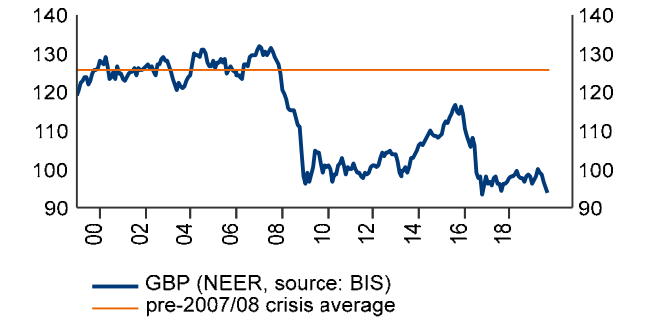
Source: Thomson Reuters-Datastream

Fig. C – Yen, nominal effective exchange rate



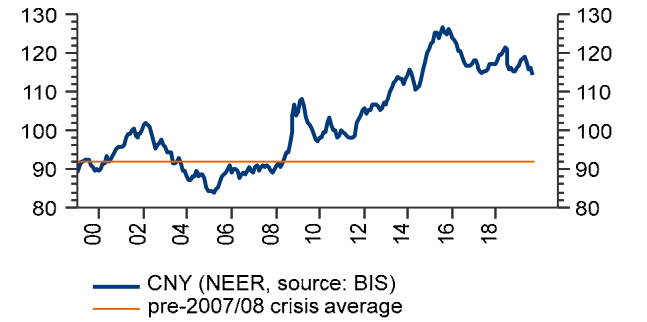
Source: Thomson Reuters-Datastream

Fig. D - Sterling, nominal effective exchange rate



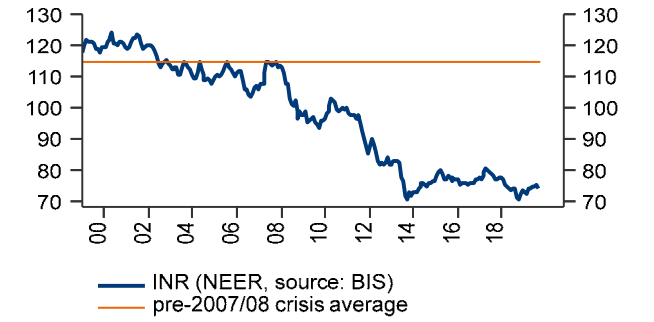
Source: Thomson Reuters-Datastream

Fig. E – Yuan renminbi, nominal effective exchange rate



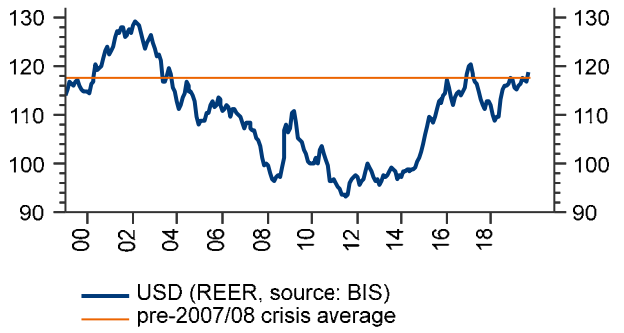
Source: Thomson Reuters-Datastream

Fig. F – Indian rupee, nominal effective exchange rate



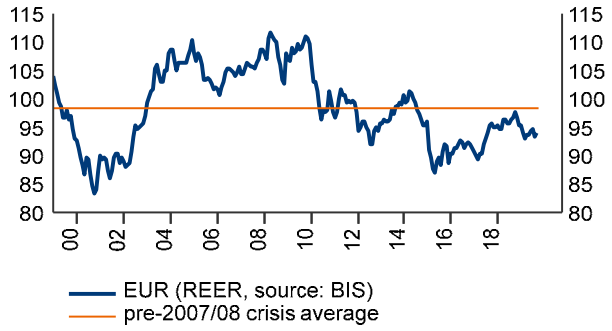
Source: Thomson Reuters-Datastream

Fig. G – Dollar, real effective exchange rate



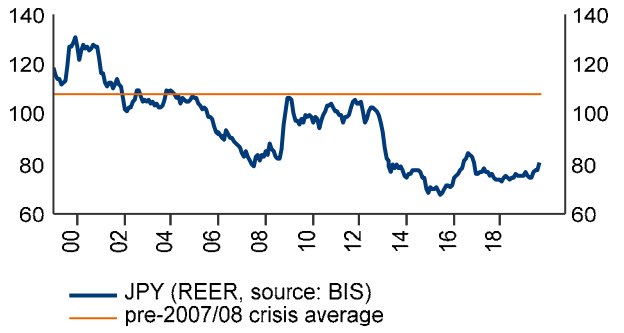
Source: Thomson Reuters-Datastream

Fig. H – Euro, real effective exchange rate



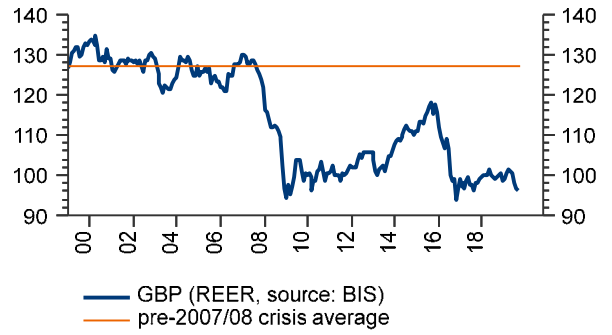
Source: Thomson Reuters-Datastream

Fig. I – Yen, real effective exchange rate



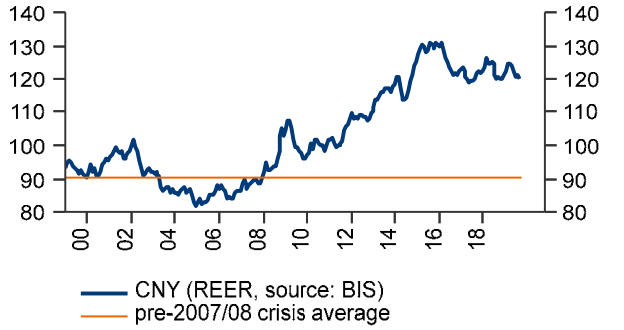
Source: Thomson Reuters-Datastream

Fig. J - Sterling, real effective exchange rate



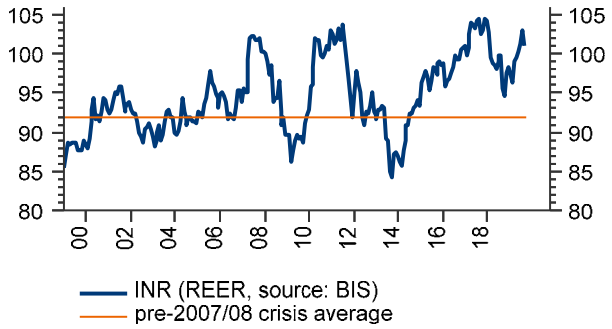
Source: Thomson Reuters-Datastream

Fig. K – Yuan renminbi, real effective exchange rate



Source: Thomson Reuters-Datastream

Fig. L – Indian rupee, real effective exchange rate



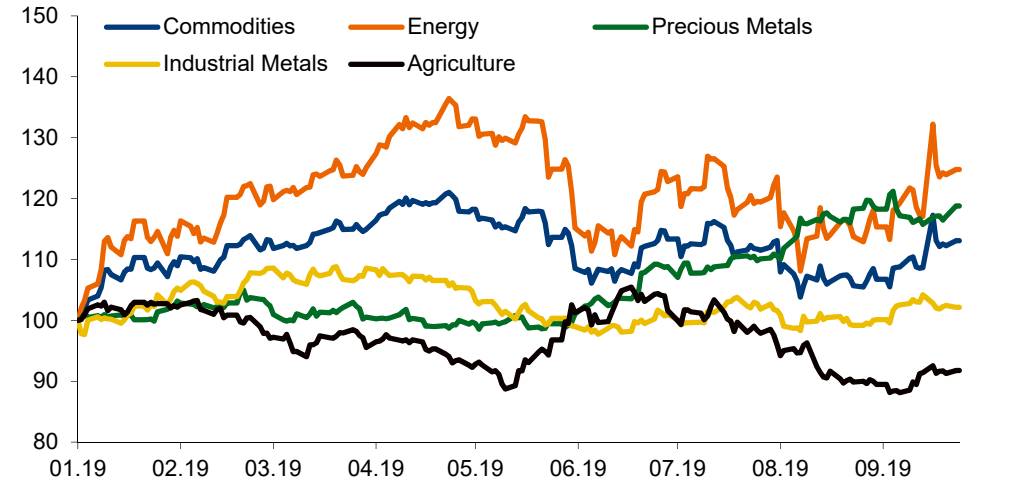
Source: Thomson Reuters-Datastream

Commodities: volatility is here to stay

Daniela Corsini

In our opinion, most sources of uncertainty weighting on the global economic outlook will persist up to the end of 2020: the U.S.-China trade war will not end before the U.S. presidential elections and more tensions could rise between the U.S. and its historical allies, notably the E.U., about the automotive sector. Brexit remains a remarkable source of uncertainty. Political tensions in Asia are likely to escalate, as the U.S. relinquished its role of supervisor, which contributed to maintain the historical acrimonies under control for several decades. As a consequence, volatility is here to stay. Announcements from central banks and governments, geopolitical events, surprises in macroeconomic data will easily become the trigger of sharp directional movements, as portfolios rotate seeking higher yields.

Year-to-date performance of commodity indices



Source: Intesa Sanpaolo chart from Bloomberg data

If asked to pick a single word to describe the mood prevailing on financial markets over the whole 2019, I would certainly choose "uncertainty". Known unknowns (situations we are aware of, but whose outcome we cannot forecast) have become the rule in the age of U.S.-China trade war, Brexit, unprecedent escalations of political tensions in Asia and an unexpected acceleration of global warming's impact on the most exposed environments.

As a consequence, markets are set to remain volatile for a long period of time, vulnerable to sharp repricing movements and quick portfolio rotations, driven by macroeconomic surprises or unexpected political announcements.

In such an unstable world, assumptions about future events become crucial to elaborate forecasts on the forthcoming path of commodity prices. Let's discuss the three main long-term issues currently clouding the commodity universe.

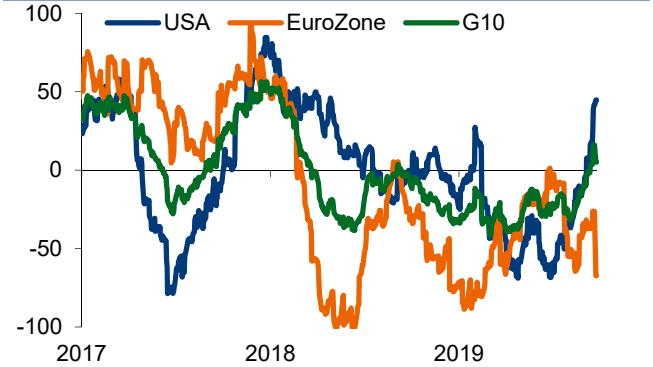
1. Trade wars

Although U.S.-China trade talks are under the spotlight, we have several other examples of tense trade and political relationships. The most concerning ones are: U.S. vs. U.E., especially relevant for the global automotive supply chain; Japan vs. South Korea; U.S. vs. Mexico and Canada; U.S. vs. Japan; China vs. Taiwan, also complicated by the recent U.S. deals. We currently rule out significant improvements in those open trade disputes, as we think that trade tensions are set to remain a structural market feature as long as the Trump Administration will maintain the power. We assume in our baseline scenario that all the parties involved will seek to postpone any deal after the 2020 U.S. presidential election. If President Trump is confirmed, the

current framework of tense and confrontational relationships will probably remain in place over the following years. Clearly, as long as such uncertainty persists, downward revisions to global economic growth estimates are to be expected, business confidence will continue to suffer negative pressures and economic indicators will point toward weaknesses in manufacturing activities, corporate investments and trade flows. However, consumer confidence will not be significantly affected as long as global equities in general, and U.S. equities in particular, remain close to the trading levels prevailing over the past quarters. Then, when downward revisions to global economic growth estimates transfer into downward revisions to companies' profit margins estimates, household wealth will shrink, consumer confidence will drop and the inevitable sell-off in risky assets will accelerate. This waning confidence could anticipate an economic recession.

So far this year, **macroeconomic data missed expectations in most areas and concerns about a weakening global growth intensified**. We expect more downward revisions to macroeconomic forecasts will be announced over the next months, as political tensions do not ease.

Citi Economic Surprise Index, developed countries



Source: Intesa Sanpaolo chart from Citi, Bloomberg data

Citi Economic Surprise Index, emerging countries

Source: Intesa Sanpaolo chart from Citi, Bloomberg data

2. Central banks' interventions and currency wars

Monetary policies in the U.S., Europe, Asia and emerging markets are becoming more expansionary. Several commentators warned about the serious consequences of the Fed cutting rates to counterbalance a more aggressive stance in U.S. trade policy, as it would create room for an even more confrontational attitude of the Trump Administration. However, apparently the Fed will continue to ease as long as deemed necessary in order to support the domestic economy. All the other central banks will follow, sooner or later, through conventional or non-conventional intervention. This big easing wave clearly shows how the current trade war could become a full-scale currency war. All the main central banks try to weaken their currency in order to protect the attractiveness of exports from their country or region.

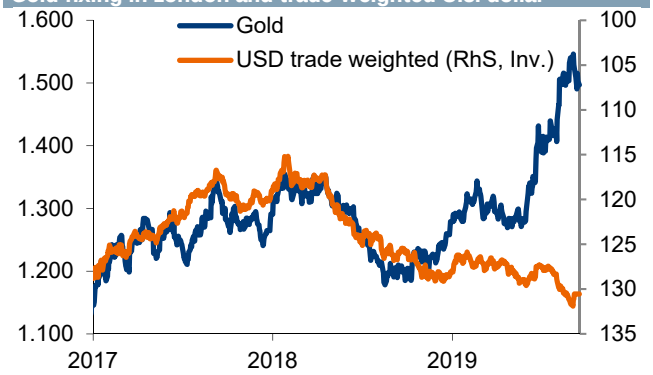
3. The U.S. dollar's "unusual" strength

As we expect that the central banks will maintain a proactive stance to cushion the impact of trade wars and that currency wars will not ease, in our baseline scenario we now expect that the U.S. dollar will remain relatively strong in trade weighted terms. On one hand, interest rate differentials with other developed countries will remain close to the current levels, while the differentials with most emerging countries will remarkably shrink, having those economies more room to cut aggressively. On the other hand, we believe that the U.S. dollar is now perceived as a safe-haven asset: one of the few safe long-term bets in a sea of uncertainty together with the Swiss franc, the Japanese yen and sovereign bonds of virtuous developed countries. Therefore, we expect that the global quest for U.S. dollars and U.S. dollar-based assets (like equity and Treasuries) will continue over the foreseeable future.

Our assumption of a strong trade weighted U.S. dollar is implying negative returns on energy and industrial metals over the long term. As evident in the graphs below, the negative correlation between the U.S. currency and industrial metals has been very strong over the past quarters. Although we now expect that this correlation could weaken, we see a strong dollar as one of the main factors fuelling a negative market sentiment on industrial metals.

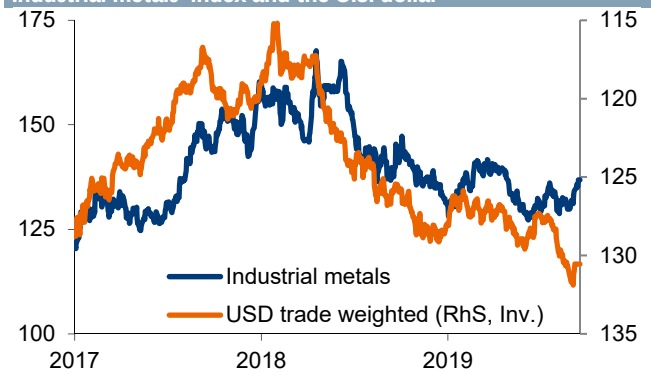
On the contrary, the negative correlation between the U.S. currency and gold waned in the 4Q18 and in 3Q19. We read these periods of discontinuity as hints that both gold and the U.S. dollar are now perceived as safe haven assets against the mounting uncertainty.

Gold fixing in London and trade-weighted U.S. dollar



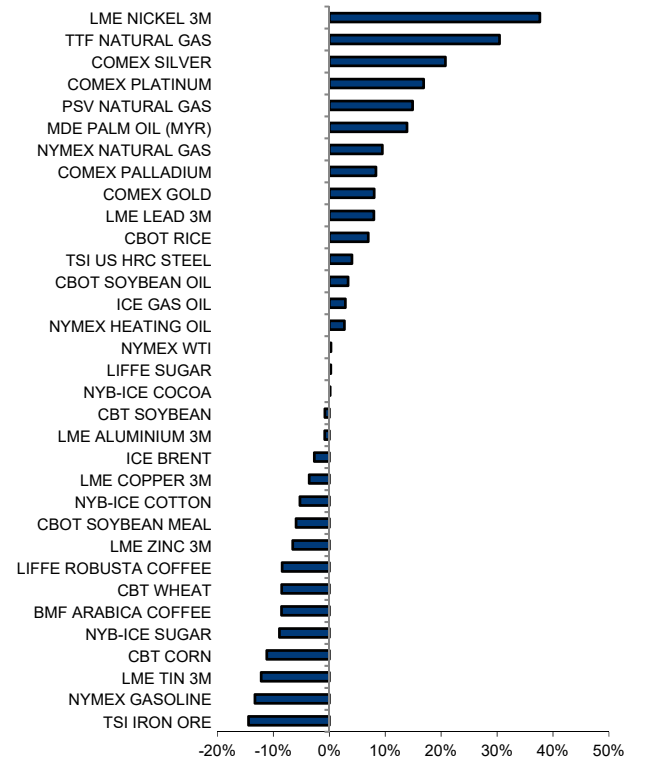
Source: Intesa Sanpaolo chart from Bloomberg data

Industrial metals' index and the U.S. dollar



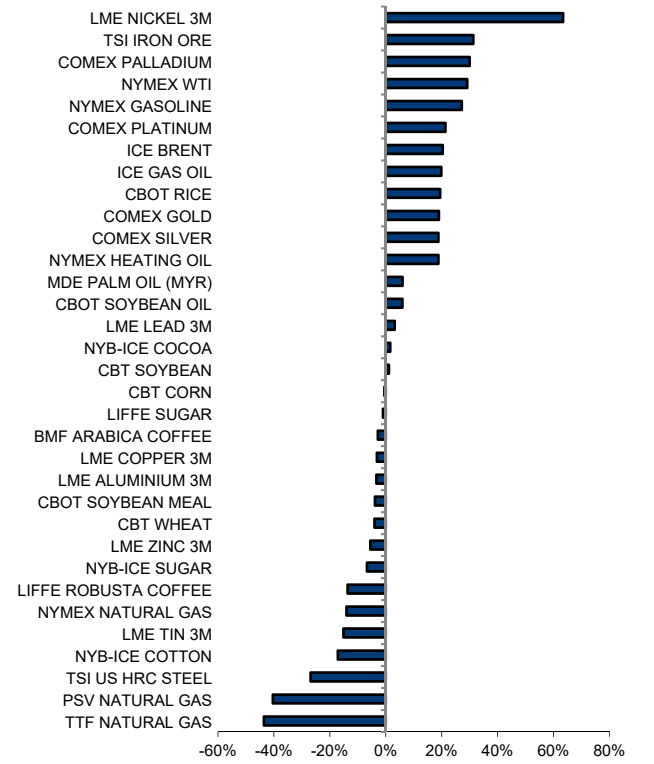
Source: Intesa Sanpaolo chart from Bloomberg data

3Q19, QTD performances as at 23.09.2019



Source: Intesa Sanpaolo chart from Bloomberg data

2019, YTD performances as at 23.09.2019



Source: Intesa Sanpaolo chart from Bloomberg data

Forecasts for the commodity universe

In our opinion, most sources of uncertainty weighing on the global economic outlook will persist up to the end of 2020: the U.S.-China trade war will not end before the U.S. presidential elections and more tensions could rise between the U.S. and its historical allies, notably the E.U., about the automotive sector. Brexit remains a remarkable source of uncertainty. Political tensions in Asia are likely to escalate, as the U.S. relinquished its role of supervisor, which contributed to maintain the historical acrimonies under control for several decades.

As a consequence, volatility is here to stay. Announcements from central banks and governments, surprises in macroeconomic data will easily become the trigger of sharp directional movements, as portfolios rotate seeking higher yields.

Over summer months, most commodity prices undertook a significant correction, as markets priced in a new pessimistic scenario of lower than earlier expected interest rates, slowing global economic growth and unsolved political tensions. However, in our opinion the low summer volumes helped pushing the prices of most energy, industrial metals and agricultural commodities to levels not coherent with the current macroeconomic framework. Indeed, despite an evident deterioration of growth expectations for commodity demand in the next 2-3 years, global commodity consumption is still growing, and several commodity markets are in deficit, notably among industrial metals and agricultural goods.

Therefore, we expect that most commodity prices will rebound over the 4Q19. Then, under our baseline scenario, in 2020 most market will trade flat, as uncertainty will fuel pessimism on prospects about global economic growth, but monetary and fiscal stimuli (where possible) and expectations about the forthcoming U.S. presidential elections could spark temporarily waves of optimism.

After 2020, assuming no political shifts in the U.S., an ongoing deterioration of global trade and a further slowdown in Chinese economic growth, we expect that most commodity prices will progressively decline toward the average levels prevailing in 2015-16.

Energy. Despite the downward revisions to global crude demand, the global crude market is still expected to record a balance over the whole 2019, a small deficit in the 2H19 and a small surplus in 2020, as OPEC+ are expected to keep their output limits and supply disruptions related to geopolitical crisis will persist. Up to end 2020, 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 65.5 dollars for Brent and 60.5 dollars for WTI. Therefore, we expect a moderate rebound from the low levels recorded in early September. Also gas prices are expected to increase both in the U.S. and in Europe in the 4Q19, thanks to a seasonal pick-up in demand. Then, over the whole 2020 we expect an average price close to the 2019 average in the U.S., but lower than the 2019 average in Europe. Longer term, from 2021 onwards, we forecast a decline in both crude oil and gas prices.

Precious metals. Safe haven assets are the clear beneficiaries of persistent uncertainty and volatility. Over summer, gold and silver broke their previous trading range and are now trading at multi-year highs as our worst-case scenario realized: in July, serious concerns about global growth intensified and triggered a new spike in risk aversion and a consequent fall in cyclical assets, while the Fed promised to intervene easing interest rates and decreasing the opportunity cost of holding precious metals. In the short term, the expected volatility could temporarily weaken gold and silver prices, if over the 4Q19 optimism prevail and cyclical assets recover part of the lost ground. However, over the long term, we remain positive on gold and silver and we favour palladium to platinum due to the ongoing trends in the automotive sector.

Industrial metals. The industrial metals' sector is endowed with the strongest fundamentals in the commodity complex, as most metals are expected to record deficits in both 2019 and 2020, global stocks are declining, low prices discourage secondary supply and investments were low during the past years. However, it is also the sector with the biggest exposure to China. Therefore, it is suffering the most from the ongoing U.S.-China trade war and from expectations of a slowdown in Chinese commodity consumption. We expect that volatility will be an important feature shaping metals' prices. We currently forecast that up to end 2020 industrial metals will trade in a wide range, but average prices will remain close to their 2H19 average. Longer term, from 2021 onwards, we forecast a sharper decline in all industrial metals' prices, which will likely drop closer to their 2016 lows.

Agricultural commodities. This summer, most agricultural goods recorded important price swings amid weather-related risks, concerns about supplies, volatility related to trade wars' announcements and movements in the currencies of important producing countries. Despite the short-term expected volatility, in the longer term we remain positive on this sector as climate change will continue to impact crop prospects and unexpected weather-related disruptions will rise the question of security of supplies. Moreover, some agricultural goods, like soft commodities, are expected to be less influenced by global political tensions, and prices should 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

As at 02.09.2019		4Q19	1Q20	2019	2020	2021
CO1 Comdty	ICE BRENT	64.0	65.0	64.3	65.5	60.0
CL1 Comdty	NYMEX WTI	59.0	60.0	57.4	60.5	55.3
NG1 Comdty	NYMEX NATURAL GAS	3.00	2.80	2.67	2.65	2.50
GOLDLNPM Index	LME GOLD	1,500	1,500	1,396	1,505	1,575
SLVRLND Index	LME SILVER	19.0	19.0	16.7	19.0	19.00
PLTMLNPM Index	LME PLATINUM	825	825	835	825	800
PLDMLNPM Index	LME PALLADIUM	1,500	1,500	1,454	1,550	1,530
LMCADS03 Comdty	LME COPPER 3M	5,800	5,800	5,988	5,788	5,244
LMAHDS03 Comdty	LME ALUMINIUM 3M	1,800	1,800	1,822	1,795	1,698
LMNIDS03 Comdty	LME NICKEL 3M	17,500	17,500	14,537	16,500	15,750
LMZSDS03 Comdty	LME ZINC 3M	2,300	2,300	2,483	2,295	2,148
LMPBDS03 Comdty	LME LEAD 3M	2,000	2,000	1,985	1,995	1,848
LMSNDS03 Comdty	LME TIN 3M	16,500	16,500	18,394	16,500	16,250
SCO1 Comdty	SGX IRON ORE	85	80	91	75	70
NASS000C Index	TSI US HRC STEEL	550	550	610	550	550
JBO1 Comdty	LME SCRAP	300	300	303	300	300
JBP1 Comdty	LME REBAR	450	440	463	420	420
C 1 Comdty	CBOT CORN	390	420	386	458	490
W 1 Comdty	CBOT WHEAT	480	490	482	498	500
S 1 Comdty	CBOT SOYBEAN	875	880	880	890	925
KC1 Comdty	NYB-ICE ARABICA COFFEE	105	110	100	113	120
DF1 Comdty	LIFFE ROBUSTA COFFEE	1,350	1,375	1,392	1,455	1,545
SM1 Comdty	CBOT SOYBEAN MEAL	300	300	304	300	300
BO1 Comdty	CBOT SOYBEAN OIL	28.0	28.0	28.4	28.0	28.0

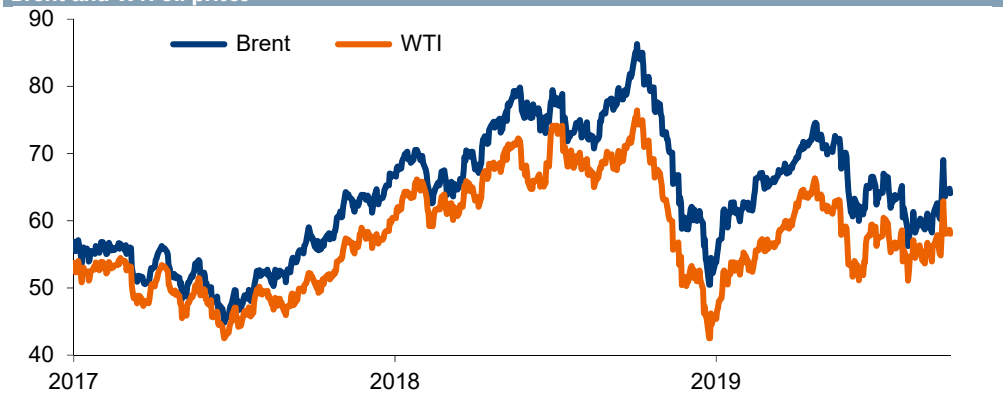
Source: Intesa Sanpaolo estimates. Iron: one-month futures contract listed on the Singapore stock exchange and based on a basket of reference prices published by the Steel Index. Steel: The Steel Index: index calculated as the weighted average price paid for US hot-rolled coil steel trades

Crude oil: weak fundamentals, but geopolitical risks

Daniela Corsini

The global crude market is expected to record a balance in 2H19 and a small surplus in 2020, as OPEC+ are expected to keep their output limits and supply disruptions related to geopolitical crisis will persist. Up to end 2020, crude oil prices could remain in a broad range. We currently forecast an average level of 65.5 dollars for Brent and 60.5 dollars for WTI.

Brent and WTI oil prices



Source: Intesa Sanpaolo chart from Bloomberg data

During July and August, concerns about escalating trade tensions and their negative impact on global economic growth intensified and led to downward revisions to official forecasts about crude oil demand. Crude oil prices declined accordingly.

Then, after weeks of concerns about the expected weakness in global crude demand, the unexpected attack performed on Sunday 15th September against Saudi Aramco facilities pushed concerns about security of supplies under the spotlight. In particular, for the first time the market started to price the vulnerability of Saudi infrastructure, while the kingdom used to be perceived as one of the most reliable and safe suppliers. That's the main reason for which backwardation widened, and geopolitical risk premiums sharply rose.

On Tuesday 17th, Saudi Arabia revealed that it estimates to fully restore operations at the Abqaiq crude-processing facility earlier than expected. Despite the retracement in market prices, crude remained almost 8% higher than the pre-attack level as a geopolitical risk premium has been permanently incorporated in market prices.

Now, the biggest issue is how Saudi Arabia and the U.S., its historical ally, will respond to the attacks. Officials from both countries blamed Iran as the responsible. The Pentagon is preparing an assessment and it is planning to make it public soon. In our opinion, if Iran is proved responsible, a targeted strike performed by the U.S. or Saudi Arabia against Iranian military facility is the most likely response and it could take place over the next couple of months. Then, we think that the diplomatic talks will be the preferred tool to de-escalate the tensions in the area. Overall, volatility is expected to remain a prominent feature on crude markets over the next months and upward risks to prices will strengthen.

Even before the impressive supply disruption, physical markets' fundamentals were tight, as the significant backwardation correctly signalled, and were expected to remain so over the 4Q due to production cuts from OPEC+ countries, favoured by constrained exports from Venezuela and Iran.

The data published in September by the U.S. Energy Information Administration (EIA) show that the global market crude market will be balanced on average over the 2H19, but given the excess supply recorded in the 1H19, the full year 2019 will probably record a small surplus of about 0.2 million barrels per day (mb/d).

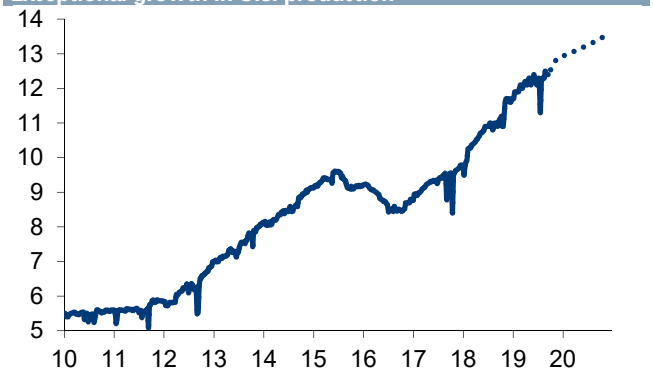
In 2020, the surplus is expected to modestly increase to about 0.4 mb/d, as non-OPEC output growth is expected to remain exceptionally strong, rising much quicker than total consumption. A rollover of the current OPEC+ deal and unchanged U.S. sanctions against Iran and Venezuela will not be enough to avoid a stock building.

Supply and demand estimates published by U.S. EIA in September 2019

Estimates published in September 2019 in mb/d	Global Demand	Non-OPEC Supply	U.S. Supply	LNG OPEC Supply	Crude OPEC Supply	Call on OPEC crude*	Market balance**
2018	99.9	63.5	11.0	5.3	32.0	31.1	0.9
2019	100.8	65.7	12.2	5.4	30.0	29.8	0.2
y/y change	0.9	2.2	1.3	0.0	-1.9	-1.3	
2020	102.2	67.9	13.2	5.1	29.6	29.3	0.4
y/y change	1.4	2.2	1.0	-0.3	-0.4	-0.5	

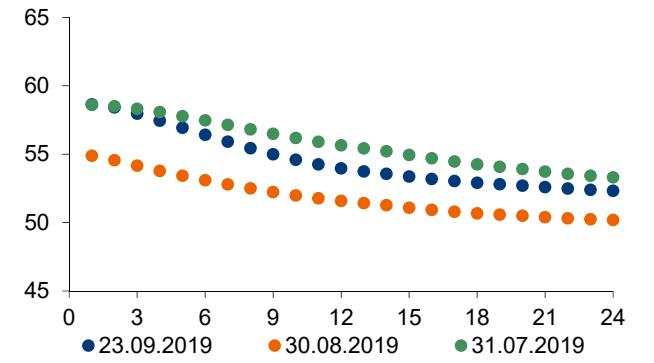
Note: (*) Call on OPEC crude = World Consumption – Non-OPEC Supply - OPEC LNG supply; (**) Market balance = OPEC crude supply - Call on OPEC crude. Source: Intesa Sanpaolo chart based on US EIA data

Exceptional growth in U.S. production



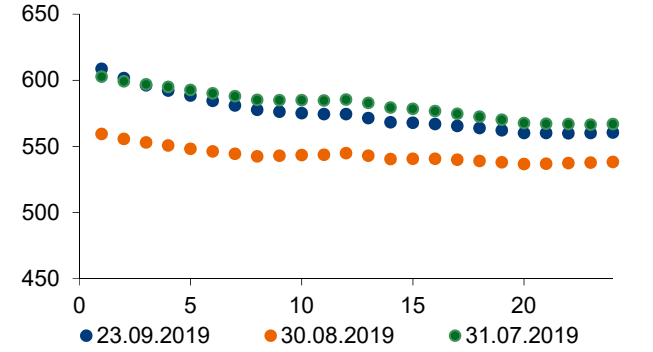
Source: Intesa Sanpaolo chart based on U.S. EIA data

WTI forward curve



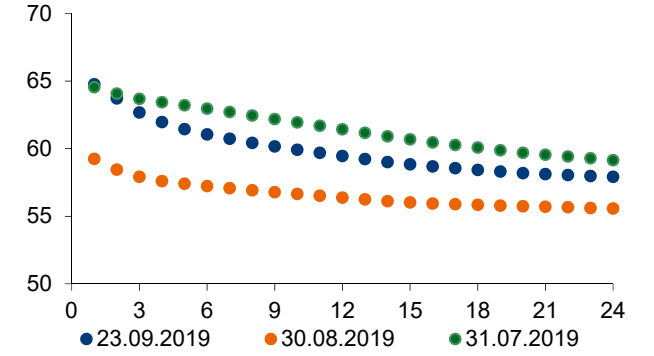
Source: Intesa Sanpaolo chart based on Bloomberg data

Gasoil forward curve



Source: Intesa Sanpaolo chart based on Bloomberg data

Brent forward curve



Source: Intesa Sanpaolo chart based on Bloomberg data

In the medium-long term, our global macroeconomic outlook is not favourable to cyclical assets, like energy and industrial metals. However, in the short term we remain constructive as most markets are tight and the market sentiment could turn more optimistic over the next months if concerns about trade tensions temporarily ease.

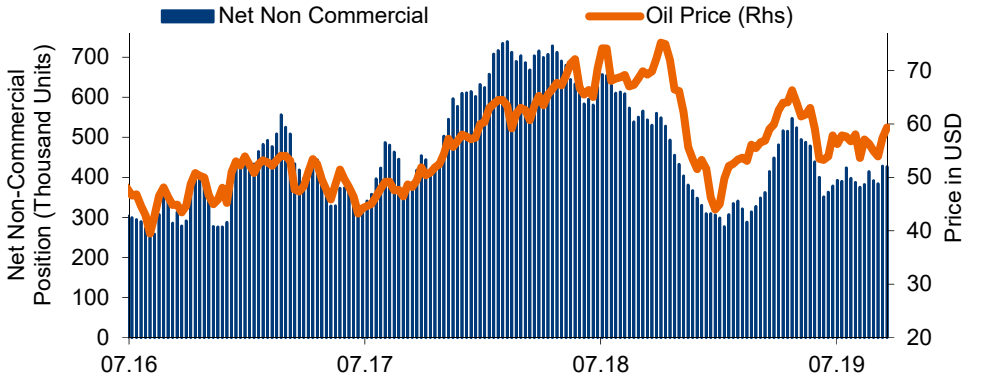
In particular, concerning crude markets, up to the 4Q20 we expect prices to remain most of the time in the trading ranges prevailing year-to-date, with volatility remaining a predominant market feature. In the case of Brent, the interval has been about 50-75 dollars year-to-date. We expect an average price in the upper band of the range, 65.5 dollars for Brent in 2020, as we

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.

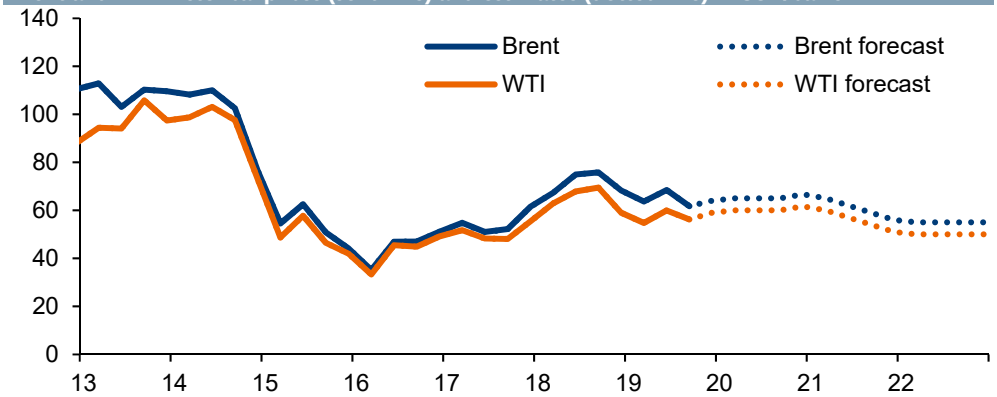
We highlight that our forecasts are subject to important upside risks, given the current uncertainty weighting on the geopolitical framework.

WTI (right-hand scale) and speculative positions



Source: Intesa Sanpaolo chart from U.S. 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 at 16.09.2019	4Q19	1Q20	2019	2020	2021	2022
ICE BRENT	64.0	65.0	64.3	65.5	60.0	55.0
Median, Bloomberg	63.6	65.0	65.0	63.5	64.0	65.0
Forward Curve	65.9	63.7	65.8	60.2	56.7	56.5

Source: Intesa Sanpaolo chart from Bloomberg data

Price estimates for WTI

As at 16.09.2019	4Q19	1Q20	2019	2020	2021	2022
NYMEX WTI	59.0	60.0	57.4	60.5	60.0	55.0
Median, Bloomberg	59.0	58.0	58.6	59.3	60.0	59.5
Forward Curve	60.4	58.3	59.4	56.0	51.4	50.4

Source: Intesa Sanpaolo chart from Bloomberg data

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Appendix

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