INTESA SANPAOLO

Macroeconomic Outlook

Research Department
March 2019

Macroeconomic Outlook

Index

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Quarterly

Intesa Sanpaolo
Research Department

Macroeconomic and
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Based on information available up to 22.03.2019

Death by a thousand cuts for the global economy

Luca Mezzomo

There are still no definite signs that the first quarter of 2019 signalled the end of this stage of slowdown, but some of the temporary factors slowing down growth from the middle of 2018 are receding. However, this long expansion phase is feeling the effects of the stresses and strains of so many uncertainties and local negative shocks.

The results in the first quarter continued to be surprisingly poor

The first few months of 2019 did not provide the hoped-for comfort of a quick re-acceleration of the global economy. Data in the first quarter continued to be surprisingly poor - and this has now been the case for nine months both in developing countries and in the major developed economies. The manufacturing sector output indicators continued to fall, but overall remained at levels that are still compatible with an ongoing expansion (see Fig. 1). The global trade data at the end of 2018 was highly negative, reflecting an abrupt slowdown in volumes imported from developing countries and a significant stagnation of imports growth in developed countries (Fig. 2). The perception of a downward trend has been exacerbated by the reversal of the yield curve in the US, which has been a good predictor of recession in the past. In the current situation, the curve could be too distorted by the intervention of the central banks to serve as a reliable sign; as a matter of fact, economic data was sufficiently negative to ring some alarm bells, but less in the US than in the rest of the world.

Some signs of stabilisation in the automotive sector

There are glimmers of light from the automotive industry, partly responsible for the slowdown in the second half of 2018. In December and January, the contraction of the year-on-year trend for orders and turnover in Germany was at its lowest point since August, although it is still contracting. Vehicle registrations in the four largest countries in the Euro zone and in Japan were virtually unchanged as compared to a year ago, while the decline in the US is slowing. However, Chinese car imports continue to contract, falling by -18% in February, which is only slightly better than figure of -18.7% for January.

The data continue to be surprisingly poor

Source: chart based on CESI and Thomson Reuters Datastream data

Slowdown in exports to China

N.B.: y/y % variations, calculated using rolling quarterly averages converted into dollars at the current exchange rate. Source: national statistical offices

Exports to China were still in net decline in January, but more as a consequence of US tariffs

China is, in fact, still worthy of special attention. All of China's major commercial partners saw a net contraction in flows (Japan, Korea, US) compared to a year earlier, or a net slowdown with largely stagnant rates of change (Germany, Malaysia). The only exception was Australia, which primarily ships raw materials to China. However, unlike 2015, the sharp contraction in trade flows was primarily a reflection of adjustment to the higher tariffs put in place by the US and, secondly, the slowdown in capital spending. Currently, growth is based more on consumption and less on investment and exports. In our opinion, the slowdown, while significant, may be further eased by monetary easing and fiscal stimulus measures in favour of business firms and consumers. This does not rule out the case that the growth trend in the Chinese economy may slow further in the next few years.

The economic policy response is not limited to China. Almost all central banks in developed countries have suspended the withdrawal of stimulus measures. The European Central Bank announced new long-term refinancing operations to replace those expiring within the next few years, and has extended the guaranteed stability period for official rates until December. The Federal Reserve has signalled the suspension of the phase of interest-rate hikes, not anticipating any return to lower rates until 2020. It has also announced that budget reduction through only partial reinvestment of maturities will first be slowed, and then stopped. The impact on the dollar interest-rate curve, which has levelled out considerably, should help developing countries. The Bank of Japan continues to purchase financial assets at the fastest possible pace. In terms of fiscal policies, an overall easing should be seen in 2019, and no restriction is anticipated in the US, various European states and Japan until 2020.

Central banks reacted to the slowdown by halting the withdrawal of monetary stimulus

A number of major factors for uncertainty remain in the short-term. The US could, indeed, still decide to target car imports and parts. In Europe, the risk of the UK leaving without a deal has increased, even though the critical date has been delayed to 12 April. At the time of writing, the likelihood of the agreement being approved is deemed to be very low, but it is not yet clear if Parliament will manage to take control of the process and force a request for a long extension justified by a concrete alternative proposal (Customs Union 2.0 or a second referendum), also considering that the Conservative party is more euroscpetic than ever, and that the government will be under no legal obligation to comply. In the event of a no-deal Brexit and assuming a severe temporary upheaval in import-export flows, the potential impact on Euro zone GDP in the second quarter could be as much as 0.3%, although a partial recovery might be seen in the third quarter.

While one factor for uncertainty is receding uncertainty factor (new tariffs on Chinese goods), others are still a threat

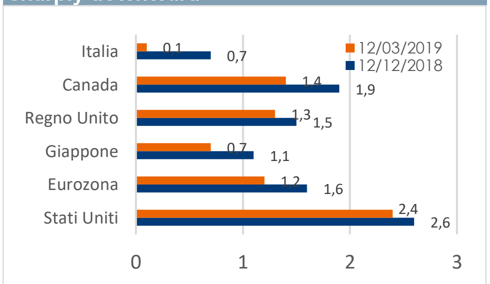
How is this reflected in growth forecasts? Consensus expectations for 2019 have declined significantly in the past three months; a reduction of two tenths of a percentage point for the US and the UK, 0.4% for Japan and the Euro zone, 0.5% for Canada and 0.6% for Italy. However, our projections had already been trimmed in December, so our downwards revision is somewhat more contained (see the table on page 6). Moreover, the new scenario is based on the assumption that quarterly growth will re-accelerate over the course of 2019, explained by the return of temporary factors that contributed to the slowdown in the second half of 2018. In this regard, it should be recognised that OECD leading indicators are not yet signalling a turning point, and that caution is required. However, there are signs emerging that growth is stabilising in France and China – the latter being of particular importance since it usually marks the turning points for the global economy.

Further trimming of 2019 growth estimates.
The overall picture remains positive, with a return to higher quarterly growth rates from the middle of the year

The leading indicators for China are stabilising – a good sign for the world economy

Source: OECD

Consensus estimates for growth revised sharply downward



Source: Consensus Economics

Currency markets: euro still fragile

With the central banks now paralysed by the slowdown in the economy, rate curves have again flattened. This trend compressed the USD-EUR and USD-JPY differentials, given that the Fed was well ahead of the ECB and BoJ with the process of monetary policy normalisation. In theory, this could be negative for the dollar. However, the dollar is bolstered somewhat by the stronger cyclical conditions of the US and the increased sensitivity of exporting economies, such as those in the Euro zone and Japan, to a global trade slowdown and protectionist threats. Economic agents are, indeed, still going long on the dollar in their non-commercial positions. While worries about the sustainability of this expansionary phase may benefit the yen and the Swiss franc, they did not prove negative for the dollar; indeed, the correlation between the effective dollar exchange rate and the VIX index recently increased and has remained firmly in positive territory.

The outlook for the future:

- An improvement in global macroeconomic data could bolster the euro, but we do not believe that it will be sufficient in itself to establish an upward trend against the dollar (there should be major positive surprises on the European front, calling into doubt projections for ECB rates).
- The market still needs to shake off excess expectations of Fed rate cuts, which seem unlikely in 2019. This could boost the dollar, although it must be acknowledged that the decline in expectations has had little detrimental effect in recent months.
- Tensions in emerging currencies should decrease against a backdrop of low US rates, which are still falling (although the last week told a different story). In fact, domestic developments could complicate the picture (as with Turkey).
- The highly uncertain outcome of Brexit is potentially a problem for Sterling, but also for the euro.
- Finally, let us not forget developments in the Chinese economy: major external rebalancing (the current account surplus has now been virtually wiped out), but also, from a cyclical perspective, possible confirmation of more robust economic expansion. This might bolster commodity currencies.

In conclusion, we still expect fluctuations in the euro without any strong directional trends over the next few months, although we continue to forecast a long-term upward trend deriving from the balance of payments situations. We think the yen may once again weaken, against a backdrop of continuing global economic expansion. With regard to sterling, a no-deal Brexit scenario could see the pound drop to 1.25 dollars.

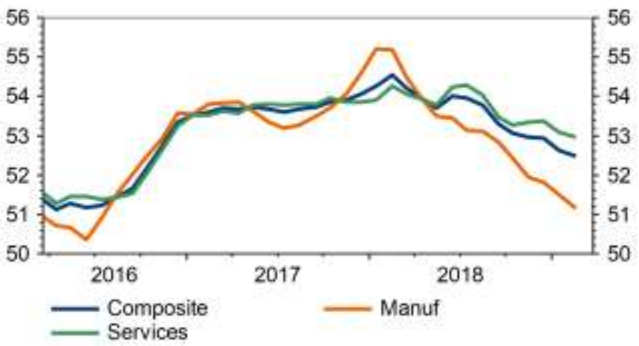
Exchange-rate forecasts

	-24m	-12m	-3m	26/03/2019	+3m	+6m	+12m
EUR/USD	1.08	1.24	1.14	1.13	1.15	1.16	1.20
USD/JPY	111.33	105.40	111.35	110.14	110.7	111.0	112.0
GBP/USD	1.25	1.42	1.26	1.32	1.32	1.32	1.32
EUR/CHF	1.07	1.18	1.13	1.12	1.13	1.13	1.15
EUR/GBP	0.87	0.87	0.90	0.86	0.87	0.88	0.91

Source: Intesa Sanpaolo chart

Global economic trends in 10 charts

Fig. A – Global PMIs

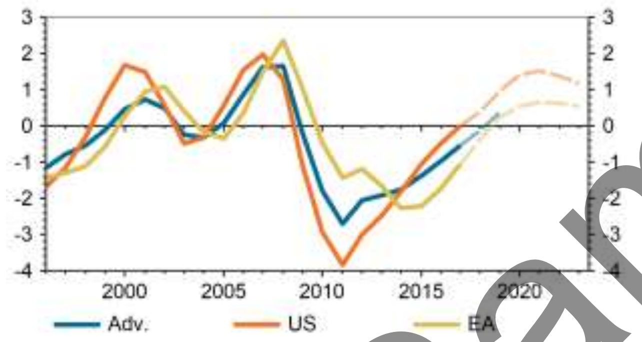


Source: Chart based on Markit Economics, Thomson Reuters-Datastream data

Fig. B – Growth in imports, yoy

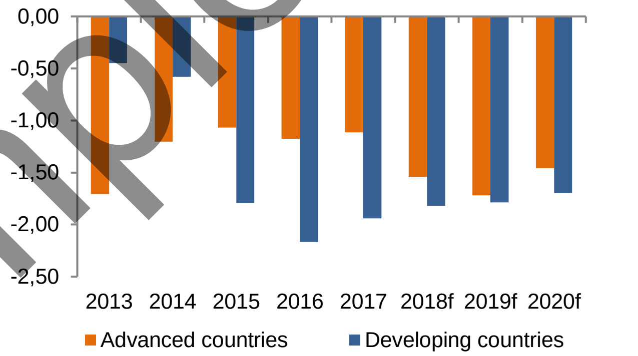
Source: Chart based on CPB World Trade Monitor, Thomson Reuters-Datastream data

Fig. C – Output gap (IMF estimate)



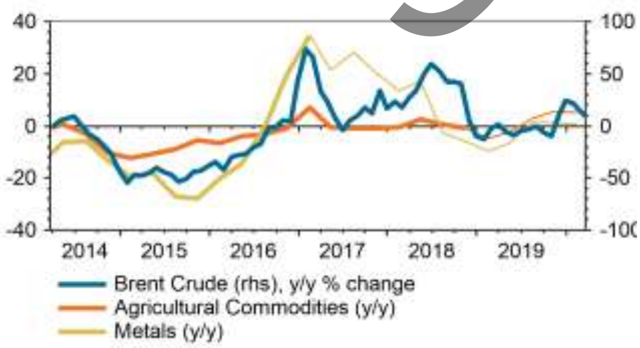
Source: IMF

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



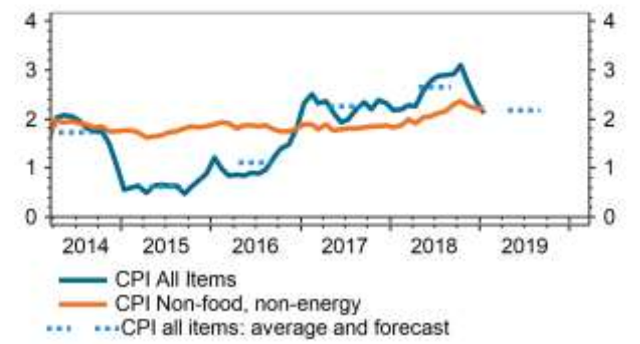
N.B. Figures as a % of GDP. Source: IMF, *Fiscal Monitor,* October 2018

Fig. E – Commodity prices



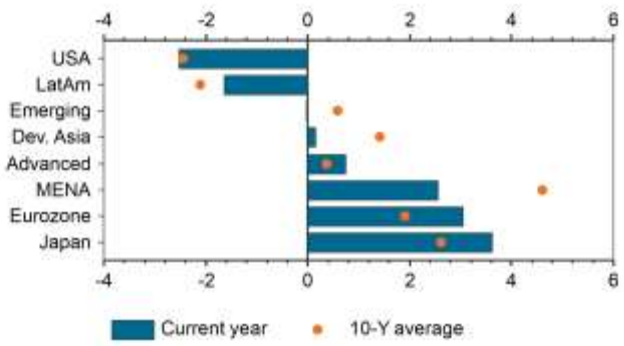
Source: Chart based on Thomson Reuters-Datastream data and Intesa Sanpaolo projections

Fig. F – Consumer price indexes for OECD countries



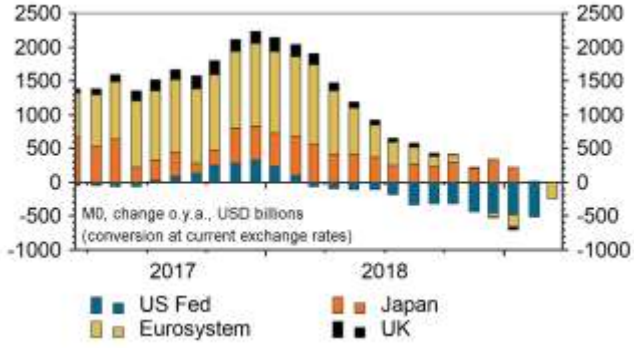
Source: Chart based on OECD, Thomson Reuters-Datastream data

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



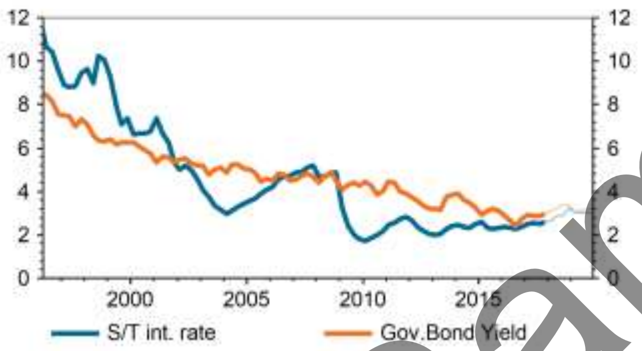
Source: IMF data and estimates, chart based on Thomson Reuters-Datastream data

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
Stati Uniti	2.9	2.4	1.9	1.6	1.7
Giappone	0.8	0.7	0.3	1.0	0.9
Area Euro	1.8	1.2	1.4	1.4	1.3
Europa orientale	3.2	2.5	2.5	2.4	2.2
America Latina	0.8	0.6	2.6	3.2	3.1
OPEC	0.7	-1.6	2.6	3.8	3.9
Cina	6.6	6.3	6.1	5.8	5.8
India	7.3	7.1	7.0	6.9	6.8
Africa	3.5	3.9	4.2	4.3	4.4
World	**3.6**	**3.2**	**3.5**	**3.5**	**3.5**

Source: Chart based on Intesa Sanpaolo data

United States: a soft landing ahead?

Giovanna Mossetti

Twenty-eighteen closed with yearly GDP growth at 2.9%, driven by the strong fiscal stimulus from the tax reform. Growth this year will be held back by reduced fiscal stimulus, distortions tied to the shutdown, and slowing global growth. Data referred to the end of 2018 and to the beginning of 2019 are not yet complete, due to the federal government shutdown. The picture for now is that the **slowdown in domestic demand, transitory in part, is unlikely to interrupt the recovery.** The relevant question is how resilient the recovery is in the face of the risks stemming from the global slowdown, the uncertainty surrounding trade and fiscal policies and the tightening of financial conditions. Our scenario envisages **GDP growth at 2.4% in 2019 and 1.9% in 2020.**

1. The economy is slowing, but not overly so. 4Q GDP and December/January data outline a rather sharp slowdown in **consumption**, probably due in part to the shutdown, likely to last in 1Q GDP but set to reverse in 2Q, as also reported by the Beige Book. Consumption growth should slow to a modest rate around 1% t/t ann., and rebound in the following quarters, towards an average rate of 2.5% in 2019, given the solid trend of wages and of the labour market (Fig. 2). The February Employment Report was surprising, as it showed a sharp slowdown in payrolls' growth (Fig. 1), at odds with all the other positive labour market indications. Although further information will be required in the coming months, we expect job gains to remain solid, averaging around 150k per month. If our forecast is supported by data**, household spending should reaccelerate**.

Non-residential fixed investment growth should also slow in early 2019, due to political uncertainty, weak exports, and the slowdown of the mining sector (Figs. 3-4). 1Q forecast growth is around 2% q/q ann. Orders of durable goods are sluggish, and foreign demand is contributing negatively to growth. Trade tariffs have hitherto had a limited effect on growth, although they have generated uncertainty, together with the shutdown. The agreement reached on the spending bills, and a likely positive outcome of trade talks with China, will reduce uncertainty, although risks remain significant on the trade front, with a possible focus shift to the car sector. The announcement of fiscal stimulus measures in China, and the surprise expansionary turn taken by the ECB reduce global downside risks.

Public spending slowed at the end of 2018 due to the shutdown, but is likely to recover in late 1Q 2019, and more markedly in 2Q. On this front, risks are more concentrated after the summer, when the spending laws expiring on 1st October will have to be renewed, and the Treasury's extraordinary measures to work around the debt ceiling will be exhausted. **Net exports** should contribute negatively to growth this year, although part of risks weighing on the global cycle could be defused by the announcement of major stimulus measures in China, and with monetary policy providing ample support, as well as by the expected removal of the trade tariffs imposed in 2018. By contrast, potential tariffs in the car sector remain a threat.

Financial conditions have become easier in 1Q 2019, after tightening at end-2018 (Fig. 5), thanks to the downward shift of the yield curve, the recovery of stock indices, and the dollar's stabilization. As for **political uncertainty**, fig. 6 shows a return to normality at the shutdown's end.

2. Growth driven by policy in 2019-20. The growth scenario for the next two years is contingent on the **economic policy decisions of Congress and the administration**, and is subject to significant risks, in light of the conflictual attitudes seen during the government shutdown. The key issues relate to trade policy, the debt ceiling and the 2020 budget. Uncertainty remains wide in terms of **trade policy**. The new **NAFTA** has not yet been approved by Congress. Negotiations with **China** are ongoing: an agreement could be reached by the end of April, with a commitment by China to increase its purchases of US products and, potentially, a partial reduction in the 2018 tariffs. However, the Chinese Government's actions will continue to be monitored, with the risk of a flare-up of tensions. If the outcome on the Chinese front is positive, an even thornier chapter could open up - that of **tariffs on the automotive sector**, which are opposed by Congress, manufacturers and trade partners. The President must reach a decision by mid-May on whether he intends to follow up the Commerce Department report, which is fuelling uncertainty and fears of possible downside effects on growth and upside implications for prices. Two aspects of fiscal policy will be crucial in the second half of the year. As of 1 March, the **debt ceiling**, suspended in February 2018, has been back in force. The "extraordinary measures" might finance the Government until the Autumn, when risks of a debt crisis could re-emerge, as happened in 2011. On 1 October, the **spending bills** will expire. Barring an agreement in Congress, the existing legislation establishes lower discretionary spending of around USD 150 billion in 2020. Fiscal policy could either be neutral or restrictive in 2020, depending on any **agreements reached in Congress**. In the worst-case scenario, there could even be a new government shutdown, together with a debt crisis. Although unlikely in a pre-election year, it is not impossible given the President's unpredictability. Expected average growth in 2019 is virtually "bullet-proof", but for 2020, the possible scenarios vary widely and are difficult to predict.

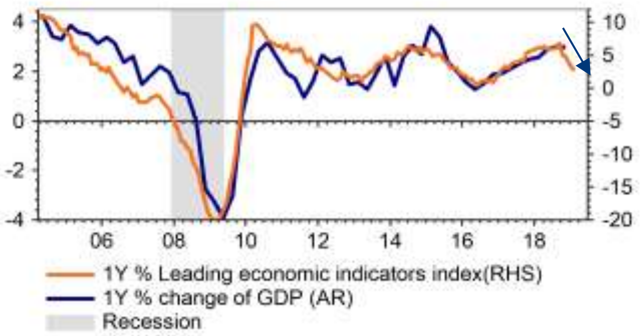
3. Monetary policy: the current rate cycle is probably at an end. The message of patience, heard in January, has been strengthened following the extremely dovish hints given at the FOMC's meeting in March. Revisions to the macroeconomic and rates projections, paint a picture of the "new normality", with inflation impervious to falling slack and - despite a real interest rate just above zero - no signs of the economy over-heating, and spoke even more clearly than Powell's words. From the **dot plot** (Fig. 11), it can be seen there is broad, although not unanimous, consensus on stable rates for the whole year and indications of a further rise in 2020. The projected median average for 2019 is for unchanged rates, with 11 stable points (out of 17). For 2020, seven participants forecast unchanged rates and four forecast a rise, while the other participants have higher projections. It was announced that the **balance sheet runoff** process will be scaled back from May and stopped in September. In May, a maximum of USD 15 billion in Treasuries per month (instead of USD 30 billion) will be allowed to expire. From October, expiring Treasuries will be reinvested, while USD 20 billion per month of any agency redemption payments will be reinvested in Treasuries. It has not yet been decided when the portfolio will be increased again: market conditions and growth of currency in circulation will determine the desired level of reserves and hence that of the securities portfolio. In conclusion, the FOMC has shifted into **'wait-and-see' mode, not only on rates but also on the regime under which the economy operates**, giving more weight to what appears to be the "new normality" of moderate growth, low inflation and very low neutral real rates. As a result, the tools available to counteract a future recession will be less effective than in the past, making it essential that more caution is exercised to maintain the recovery alive. We forecast **unchanged rates until late 2020**.

Macro forecasts

	2018	2019f	2020f	2018				2019p				2020p	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	2.9	2.4	1.9	2.6	2.9	3.0	3.1	2.7	2.5	2.2	2.1	2.4	2.0
q/q annual rate				2.2	4.2	3.4	2.6	0.7	3.2	2.5	2.0	1.8	1.7
Private consumption	2.6	2.5	2.2	0.5	3.8	3.5	2.8	1.3	2.9	2.5	2.3	2.2	2.0
Fixed investment - nonresid.	7.0	4.1	2.9	11.5	8.7	2.5	6.2	2.9	3.8	3.5	3.4	2.8	2.5
Fixed investment - residential	-0.2	-1.5	1.0	-3.4	-1.3	-3.6	-3.5	-2.5	0.8	1.3	1.0	0.8	1.0
Government consumption	1.5	2.2	1.4	1.5	2.5	2.6	0.4	2.4	3.5	2.2	1.4	1.1	1.4
Export	3.9	2.0	2.4	3.6	9.3	-4.9	1.6	3.3	2.3	3.4	2.2	2.1	2.3
Import	4.6	3.5	3.1	3.0	-0.6	9.3	2.7	2.9	3.5	3.1	2.8	3.2	3.1
Stockbuilding (% contrib. to GDP)	0.1	0.3	-0.1	0.3	-1.5	2.7	0.2	0.0	0.3	-0.1	-0.1	-0.1	-0.1
Current account (% of GDP)	-2.3	-2.7	-2.8										
Federal Deficit (% of GDP)	-6.4	-6.5	-6.8										
Gov. Debt (% of GDP)	135.5	136.6	138.3										
CPI (y/y)	2.4	1.5	1.9	2.2	2.7	2.6	2.2	1.6	1.4	1.5	1.6	1.9	1.9
Industrial production (y/y)	4.0	2.7	1.9	0.6	1.3	1.2	1.0	-0.1	0.7	0.7	0.7	0.3	0.3
Unemployment (%)	3,9	3,6	3,3	4,1	3,9	3,8	3,8	3,8	3,6	3,5	3,4	3,3	3,3
Federal Funds (%)	1,9	2,5	2,5	1,5	1,8	2,0	2,3	2,5	2,5	2,5	2,5	2,5	2,5

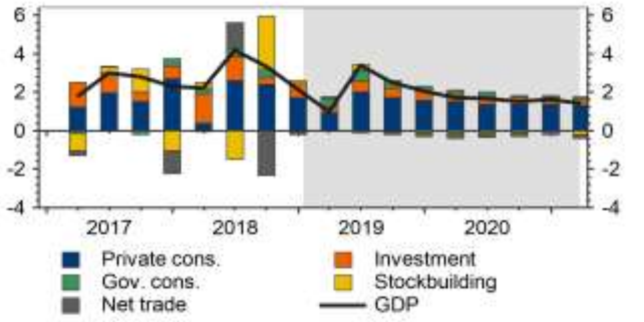
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Growth has peaked...



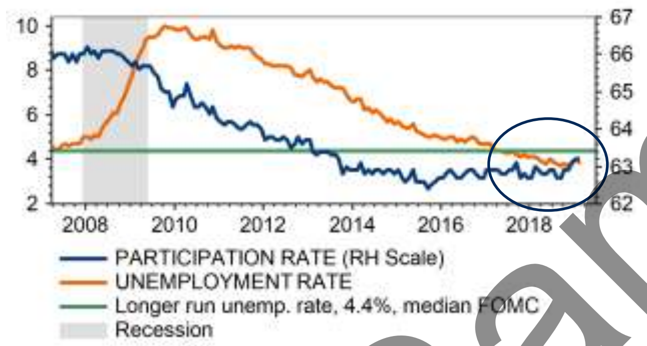
Source: Thomson Reuters-Datastream

Fig. 2 – ...and will be falling from 2019



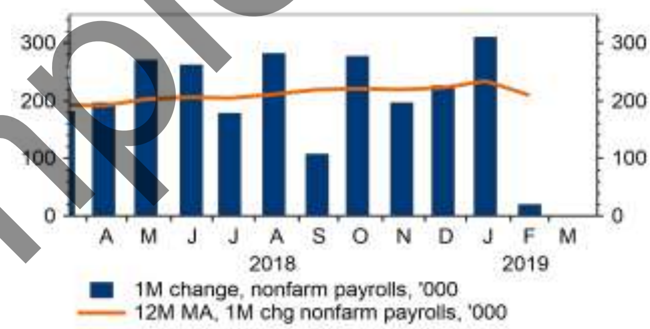
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream forecasts

Fig. 3 – The fall in unemployment has been slowed by the cyclical stabilisation of the participation rate



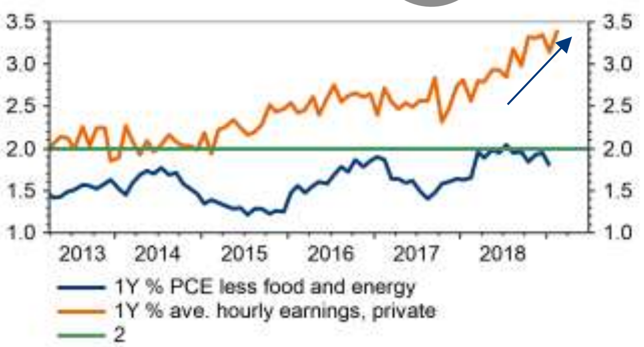
Source: Thomson Reuters-Datastream

Fig. 4 – Monthly average employment growth still high despite the abnormal slowdown in February



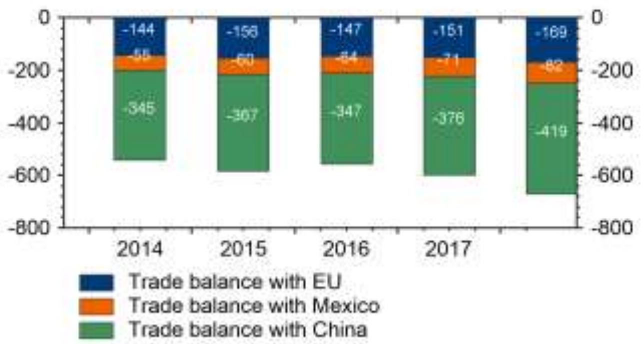
Source: Thomson Reuters-Datastream

Fig. 5 – Wage growth accelerating sharply; core inflation still close to 2%



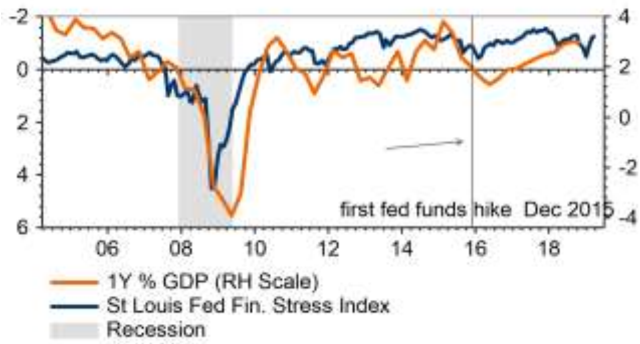
Source: Thomson Reuters-Datastream

Fig. 6 – Trade deficit continues to expand: growth differential prevails over all other conditions



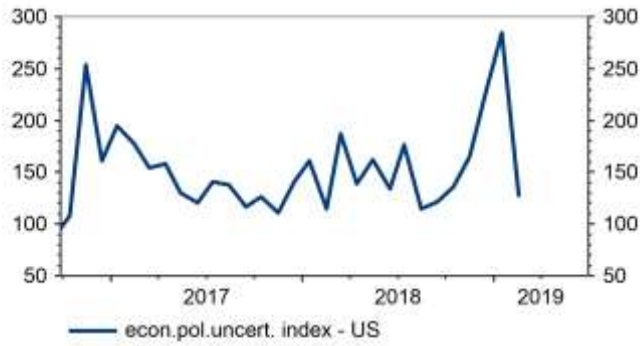
Source: Thomson Reuters-Datastream

Fig. 7 – More accommodative financial conditions…



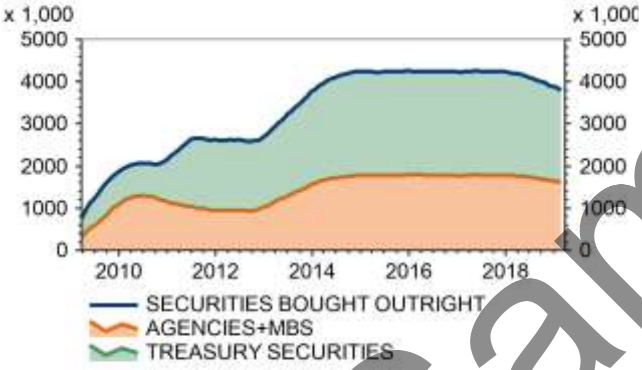
Source: Thomson Reuters-Datastream

Fig. 8 – …and uncertainty about the new 'normal' reduce risks



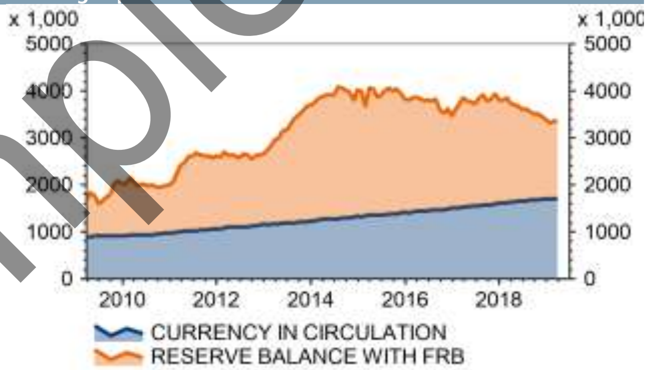
Source: Thomson Reuters-Datastream

Fig. 9 – The Fed's main balance-sheet assets: portfolio assets held outright



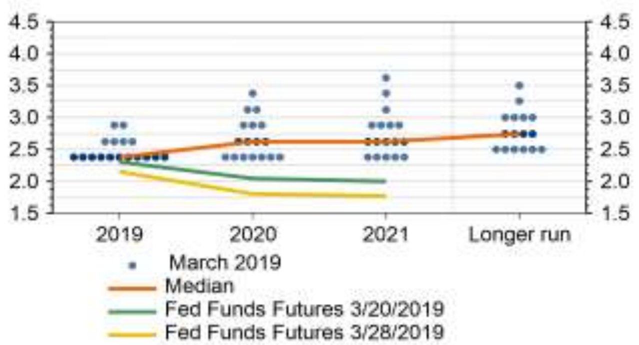
Source: Thomson Reuters-Datastream

Fig. 10 – The Fed's main balance-sheet liabilities: reserves and working capital



Source: Thomson Reuters-Datastream

Fig. 11 – Rate forecasts: dot plot and median at December 2018



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

Tab. 1 - Economic projections of members of the Federal Reserve Board and of regional Federal Reserve Bank Presidents – March 2019

Variables	Median 2018	2019	2020	2021	Longer run
Change in real GDP	3.0	2.3	2.0	1.8	1.9
Sept. projection	3.1	2.5	2.0	1.8	1.8
Unemployment rate	3.7	3.5	3.6	3.8	4.4
Sept. projection	3.7	3.5	3.5	3.7	4.5
PCE inflation	1.9	1.9	2.1	2.1	2.0
Sept. projection	2.1	2.0	2.1	2.1	2.0
Core PCE	1.9	2.0	2.0	2.0	
Sept. projection	2.0	2.1	2.1	2.1	
Federal funds rate	2.4	2.9	3.1	3.1	2.8
Sept. projection	2.4	3.1	3.4	3.4	3.0

N.B.: GDP and deflator: Q4/Q4 change. Unemployment: Q4 average.
Source: Federal Reserve Board

Euro zone: waiting for Godot

Anna Maria Grimaldi

Growth estimates downgraded in 2019, but we still believe the slowdown is temporary and that GDP could speed up from mid-2019

Euro zone growth has failed to meet our estimates of three months ago. The summer slowdown was not so temporary, and even at the end of 2018, GDP had grown by just 0.2% qoq, about half of what was expected (ISP, in line with consensus and ECB's December outlook). This is primarily explained by idiosyncratic factors, such as a longer-than-expected slowdown in car production (see Fig. 2), particularly in Germany, due to difficulties in adapting production lines[1] to the new European diesel legislation, a slowdown in river transport in Germany due to low water levels in the Rhine, protests by yellow vests in France, and tightening financial conditions in Italy. The car sector's weakness is expected to gradually recede in the coming months. Germany built up an overspend on vehicles between mid-2017 and mid-2018, although most of this has probably been absorbed by declines in the summer and autumn – the trend in car orders at end-2018 gives cause for hope. However, apart from idiosyncratic factors, it is now clear that Euro zone manufacturing has been and still is impacted by the slowdown in international trade (see Fig. 5). The EU Commission's composite PMI and ESI confidence surveys fell again between December and February, particularly in the wake of manufacturing and the slowdown in export orders, settling at average levels (see Fig. 1) consistent with GDP growth of more than 0.2%, including in the first quarter of this year. Our reading is that Euro zone growth has returned to potential (0.3% qoq/1.4% yoy) since the middle of last year and that in the final months of 2018 and early 2019, GDP grew below trend due to temporary factors. We remain of the opinion that, from the beginning of spring, growth can accelerate again towards 0.35% qoq (1.4% yoy). But whatever the case, given the weakness between the end of 2018 and the beginning of 2019, the estimate for this year is barely 1.2%, which is below our 1.5% forecast of last December. There are very few signs of re-acceleration at the moment, to say the least, and February saw another fall in expectations for the coming months (see Fig. 4). The only positive signs to emerge in recent weeks are the recovery of industrial production in January and the as yet modest rebound in the ZEW Indicator of Economic Sentiment for the next three/six months.

Less lively contribution by exports. World trade slowing, but not collapsing; we assume a truce in the trade war.

Growth in manufacturing and Euro zone GDP will be held back by the slowdown in world trade, which is partly structural in nature and which could be aggravated by a further drift towards protectionism by the US administration. However, our forecast for Euro zone GDP growth of 1.2% in 2019 and 1.4% in 2020 assumes that the risk of a slide to protectionism subsides and a truce with both China and the European Union prevails. In its November 2018 macroeconomic forecast, the European Commission estimated that **the effect of the measures already implemented should have a limited impact on Euro zone growth** in the short term (one year) of approximately -0.2%[2]. **If the majority of countries retaliate and tariffs increase by 2% overall, the effect on Euro zone growth would be more persistent, at around -0.4% in the medium term**. The ongoing negotiations between China and the US should conclude by end-April, and it is still possible that these will lead to a reduction in some of the tariffs imposed in 2018. The attention of the US administration could then shift to the European Union, the area with which the US has the second-largest trade deficit. There is a definite risk that a 25% tariff could be introduced on cars (and components). President Trump is due to give his opinion by 18 May on

But otherwise, Euro zone growth would settle below potential

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[1] We estimate that the collapse of car production in Germany (see Fig. 2) will have knocked at least 0.1% off Euro zone GDP growth at the end of 2018 (the weight of German car production in total Euro zone value added is 1.6%; car production in Germany fell by 5% qoq between June and November).

[2] The simulations take into account the impact of the measures on uncertainty (measured by an increase in risk premiums) and productivity. If no new measures are introduced, the impact is expected to be reabsorbed from the second year onwards, i.e. from 2020, as the Euro zone can count on trade flows diversifying. The impact on the US and China will be more severe due to loss of market share, at -0.3% and -0.6% respectively, after one year.

whether or not to act by introducing tariffs on cars [3]. Germany would be the most affected of Euro zone countries. The German-based Ifo Institute [4] estimates that tariffs of 25% would have an impact of EUR 5Bn (0.2% of GDP) if car sales to the US drop by about 50% (from the current EUR 34Bn to EUR 17Bn). The impact for the European Union is estimated at around EUR 9Bn.

Tariffs on cars would weigh particularly on German growth

As regards other external variables, the contribution from oil and exchange rates should be about neutral. Compared to our estimates of three months ago, we have downgraded our forecasts of a rise in the average price of crude oil to USD 70 per barrel in 2019 and US 75 in 2020, from our previous estimate of USD 80 earlier this year. The contribution from the price of oil will be about neutral as crude was already averaging around USD 70 in 2018. We expect only a slight change in the next twelve months given the ECB's decision to postpone the first rate increase to 2020 and the announcement of new credit support measures.

Oil and exchange rates neutral

Over the forecast horizon, we expect exports to grow by 2.4%, down from an average of 4.3% over the previous six years, and imports to rise by an average of 3.0%. As a result, foreign trade will shave an average of 0.2% a year off GDP growth. Given the very solid fundamentals, GDP growth should still be underpinned by momentum in domestic demand. Consumption and investments will be supported by growth in new loans (see Fig. 11) and by borrowing costs that remain historically very low (see Fig. 12). The new measures adopted by the ECB are aimed at extending ultra-accommodative lending conditions well beyond 2020.

Domestic demand still supportive

High capacity constraints and still very accommodative monetary conditions should ensure that investment remains stable at around 3.1% in 2019-2020, after 4.8% in 2018 (see Figs. 6 and 7). The risks, however, are to the downside, as the uncertainty over international politics and the development of the Euro zone's domestic politics could lead to companies postponing their spending plans. The outlook for construction remains positive, but we expect it to slow to 2.0%, from 2.9% in 2018. Circolo virtuoso tra minor *slack* nel mercato del lavoro, salari e consumi è intatto

Corporate investments are expected to grow at a good pace, but slower than in 2018

Construction is still expected to grow

The virtuous circle between decreasing slack in the labour market, wages and consumption is pretty much intact (see Fig. 8), despite the cyclical slowdown. Business confidence surveys show only a modest decline in hiring intentions in the first few months of this year and remain at levels consistent with employment growth of almost 2%, so above 2018's 1.5% yoy. The ECB itself notes that the resilience in employment growth is due to structural factors: greater participation (and employment) of those aged 55 to 74 due to retirement-age reforms. According to the ECB[5], the scarcity of labour will put further pressure on wage demands in the coming months; we are therefore confirming our forecast of 2.5% wage growth, after 2.2% in 2018. Real employment income should increase by 2.0%. Headline inflation returned to the ECB's target at the end of the summer on the back of rising crude oil prices, then fell back to 1.5% in February 2019. The underlying price momentum has not changed significantly over the past year (1.2% at the beginning of 2018). Inflation risks are to the downside, in the absence of a lasting rise in domestic prices, so headline inflation is unlikely to stabilise at target. But with growth in line with potential between mid-2019 and mid-2021, the slack in the economy will remain unchanged, with the risk that the rise in core prices may slow. Our super core inflation measure (see Fig. 13) dipped again, albeit marginally, at the end of 2018, pointing to downside risks for our estimate of core inflation rising to 1.4% in 2019 and 1.6% in 2020-2021. An

Virtuous circle between decreasing slack in the labour market, higher wages and consumption is intact

The return of inflation towards target depends on core inflation rising to 1.6%

[3] Under Section 232 of the US Trade Expansion Act, if the President deems that actions are appropriate for national security, the necessary steps must be taken within the following two weeks.
[4] See "Effects of new US auto tariffs on German exports and on industry value added around the world", 15 February 2019.
[5] See ECB working paper series no. 2235, February 2019

increase in domestic prices remains key to ensuring medium-term convergence of headline inflation to target, despite our assumptions of a rise in the price of crude oil to USD 75 per barrel over the next two years, which are more aggressive than consensus estimates and the implied rate in forward contracts.

The ECB has already taken action to support the cycle

Economic policies will continue to support the cycle. The ECB, noting the weaker-than-expected outlook for the economic cycle, revised its interest rates guidance at its March meeting and postponed the start of normalisation until 2020. **Our core forecast is for a first interest rate hike in June 2020**, but we recognise that the outlook is very uncertain and that interest rate expectations are more than ever conditioned by changes in macro data. The markets continue to push out the date of the ECB's first increase (see Fig.15). **The ECB Council has also adopted a series of credit support measures** for the next two years aimed at avoiding funding congestion for banks, caused by the maturity of outstanding bonds and the previous LTRO II. The ECB is seeking to stimulate lending to once again boost the transmission of monetary policy impetus to the real economy. The ECB will also keep the balance sheet level unchanged by continuing to reinvest the APP portfolio "for an extended period of time". The decisions taken at its March meeting extend ultra-accommodative financial conditions in the Euro zone for at least another two years (March 2021). After its March 2019 decisions, the ECB has little room left to counter a potential negative shock, despite attempts at reassurance made by Draghi and several members of the Council. At most, the Council could again postpone normalisation of the deposit rate and the date on which it starts to reduce the balance sheet. The ECB could only consider launching a new asset purchase programme in the event of a recession and deflation risks in the Euro zone as a whole, which seems a remote scenario to us at the moment.

Fiscal policy moderately expansive

In 2019, fiscal policies will become more expansive in Germany, Italy, France and Spain (see Fig. 16). While star performer, Germany, has room for manoeuvre as regards tax policy, the other countries have decided to support the cycle by breaking ranks with Brussels. We believe that in the current scenario of political fragmentation and growing domestic risks, progress on the adoption of an EU budget and reform of European governance will be limited, even after the European elections.

Outlook highly uncertain

The risks for the macroeconomic scenario are to the downside, even though we have downgraded our estimates compared to last December. This is because of the high degree of uncertainty, first and foremost on the US administration trade policies (see Fig. 17) and the repercussions for trade flows (see Fig. 18), but also about the resilience of Chinese and US growth. In addition, the political risks within the Euro zone must not be overlooked. In the short term, the UK's resolutions on Brexit modalities could have significant consequences for the UK and Euro zone economies if, despite exhausting attempts to reach an agreement, the result is a hard exit. Preferences for a short extension to the deadline for reaching an agreement have been be accommodated as Mrs May has managed to gain time until the end of June 2019. However, it is by no means certain that a compromise will be reached, internally, on the long-standing issue of the hard border with Northern Ireland. Aside from the UK, the European political scene remains worrying, with support for traditional parties sharply fragmented almost everywhere. The polls suggest that the European elections on 28 May are unlikely to see the emergence of a populist majority at European level (see Fig. 20), but the protest movements and/or parties will obtain greater representation in the European Parliament. In addition to the European elections, there will be parliamentary elections in Spain (28 April), Portugal (6 October) and Greece (20 October). The formation of governing majorities will require lengthy negotiations, particularly in Spain. Lastly, the risk of early elections in Italy should not be overlooked, given the continuing tensions within the current majority government, in which case Italian rates could come under renewed pressure. Political risk will be contained everywhere by a still positive growth picture, but a combination of low growth and further erosion of support for traditional parties would not be good news for the markets.

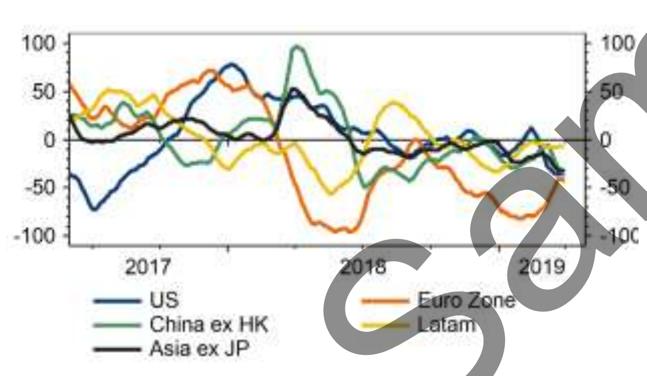
That's politics, isn't it!

Macro forecasts

	2018	2019f	2020f	2018				2019p				2020p	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	1.8	1.2	1.4	2.4	2.1	1.6	1.1	1.0	0.9	1.3	1.4	1.5	1.5
- q/q change				0.4	0.4	0.1	0.2	0.2	0.3	0.4	0.4	0.4	0.3
Private consumption	1.3	1.0	1.4	0.5	0.2	0.1	0.2	0.1	0.4	0.4	0.4	0.4	0.3
Fixed investment	3.1	2.3	2.3	0.0	1.5	0.6	0.6	0.2	0.6	0.6	0.6	0.6	0.5
Government consumption	1.0	1.5	1.2	0.0	0.4	0.0	0.7	0.3	0.3	0.3	0.3	0.3	0.3
Export	3.0	2.4	2.5	-0.7	1.1	0.2	0.9	0.3	0.7	0.7	0.6	0.6	0.6
Import	2.9	3.0	3.0	-0.5	1.3	1.1	0.5	0.6	0.7	0.6	1.0	0.7	0.7
Stockbuilding (% contrib. to GDP)	0.1	0.0	0.1	0.2	-0.1	0.3	-0.4	0.2	-0.1	-0.1	0.1	0.0	0.0
Current account (% of GDP)	3.8	3.6	3.2										
Deficit (% of GDP)	-0.8	-1.0	-0.9										
Debt (% of GDP)	86.9	85.2	82.8										
CPI (y/y)	1.8	1.5	1.5	1.3	1.7	2.1	1.9	1.5	1.4	1.4	1.8	1.9	1.6
Industrial production (y/y)	1.0	0.5	1.7	3.1	2.3	0.6	-1.9	-0.8	-0.2	0.5	2.3	2.6	2.0
Unemployment (%)	8.2	7.7	7.6	8.5	8.3	8.0	7.9	7.8	7.8	7.7	7.7	7.6	7.6
3-month Euribor	-0.3	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
EUR/USD	1.18	1.15	1.21	1.23	1.19	1.16	1.14	1.14	1.14	1.16	1.17	1.19	1.21

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

Fig. 1 – No shortage of negative surprises in the early-2019 data

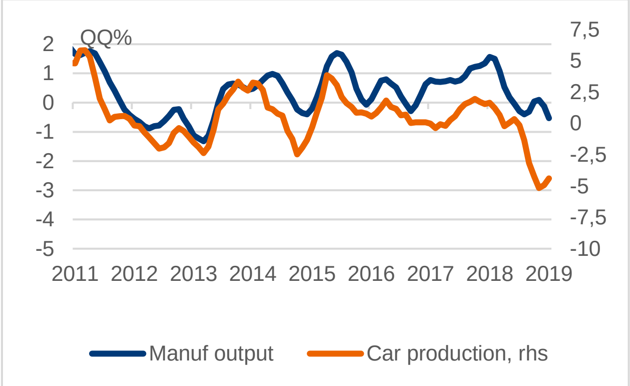


Source: Citibank Economic Surprise indices and Thomson Reuters-Datastream

Fig. 2 – PMI and ESI point to weaker growth in early 2019

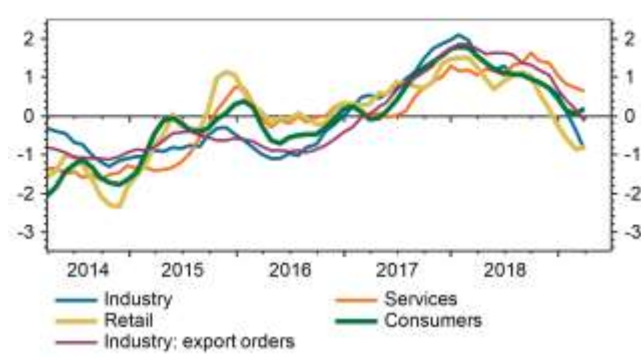
Source: Thomson Reuters-Datastream

Fig. 3 – The slowdown in 2H18 is partly due to temporary factors: lower car production following the entry into force of the new EU diesel legislation



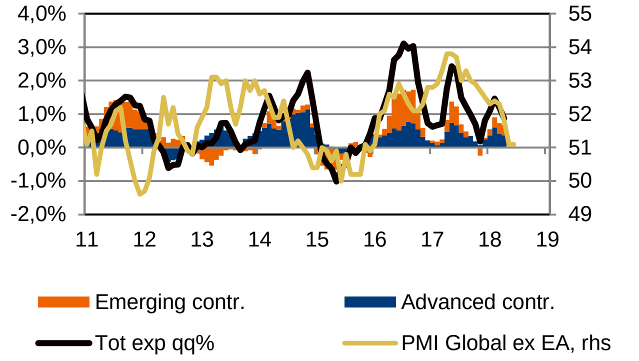
Source: Thomson Reuters-Datastream

Fig. 4 – The expectations and export orders components of the EU Commission's manufacturing survey do not bode well for a rebound in GDP growth in the short term



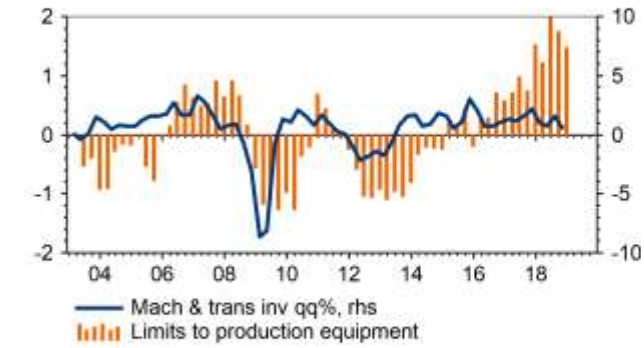
Source: Thomson Reuters-Datastream

Fig. 5 – The slowdown in world trade will continue to weigh on exports



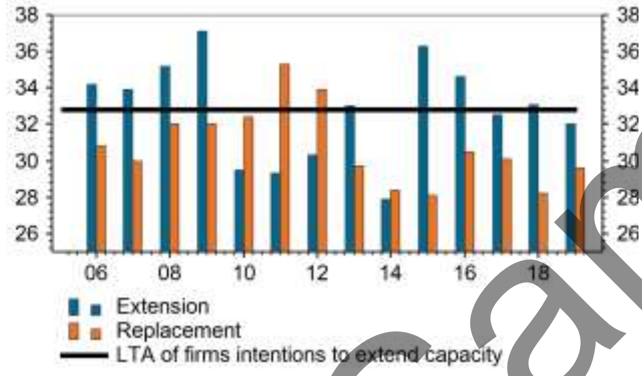
Source: Thomson Ruters-Datastream

Fig. 6 – The Euro zone cycle should benefit from still solid fundamentals: capacity constraints should support capex



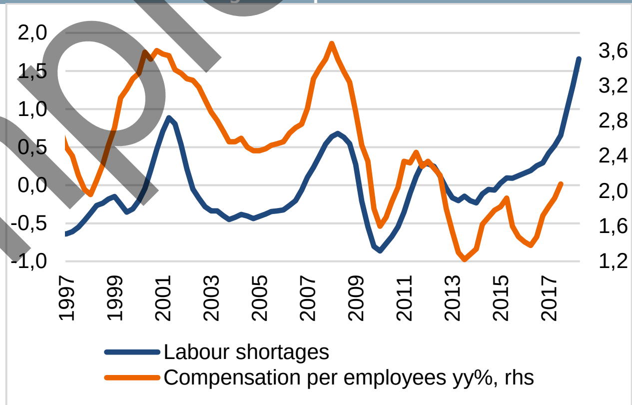
Source: Thomson Reuters-Datastream

Fig. 7 – Companies have only marginally revised spending plans for plant expansion in 2019



Source: Thomson Reuters-Datastream

Fig. 8 – Virtuous circle of reduced slack in the labour market and acceleration of wages and prices is still intact



Note: the labour shortage measure is taken from the quarterly survey of the EU Commission, Source: Thomson Reuters-Datastream

Fig. 9 – Household consumption supported by growth in employment income

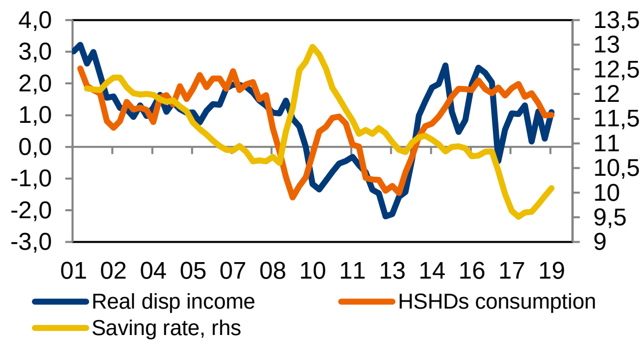
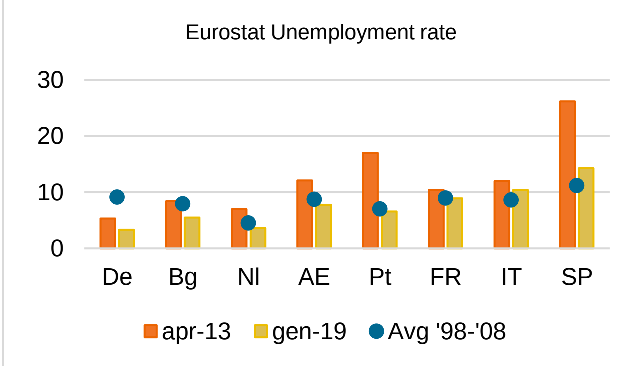


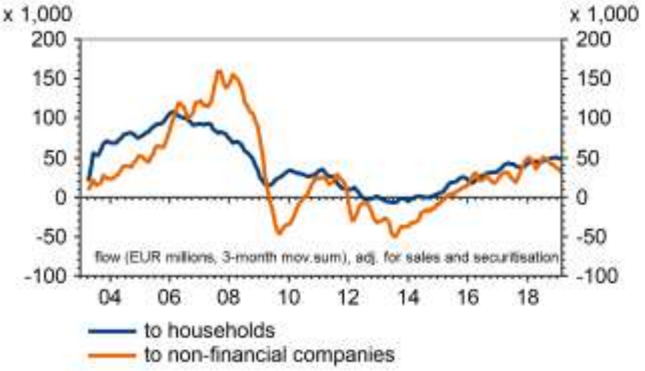
Fig. 9 – Household consumption supported by growth in employment income

Fig. 10 – The unemployment rate is below pre-crisis levels in Germany, Belgium and the Netherlands, but there is still scope for reduction elsewhere



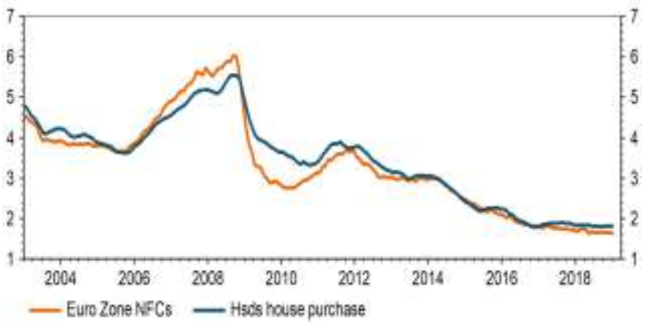
Source: Thomson Reuters-Datastream

Fig. 11 – Credit growth is solid



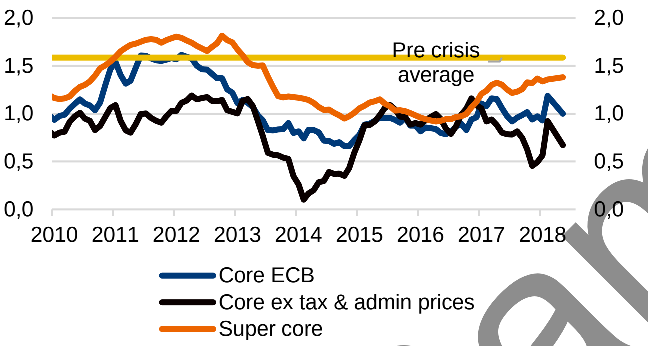
Source: Thomson Reuters-Datastream

Fig. 12 – Funding costs are still at an all-time low



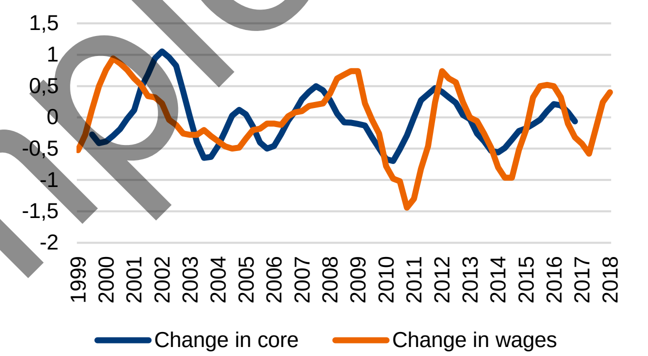
Source: Thomson Reuters-Datastream

Fig. 13 – Downside inflation risks. The various measures of core inflation are not far from the lows seen at end-2014, and our super core inflation measure has also fallen



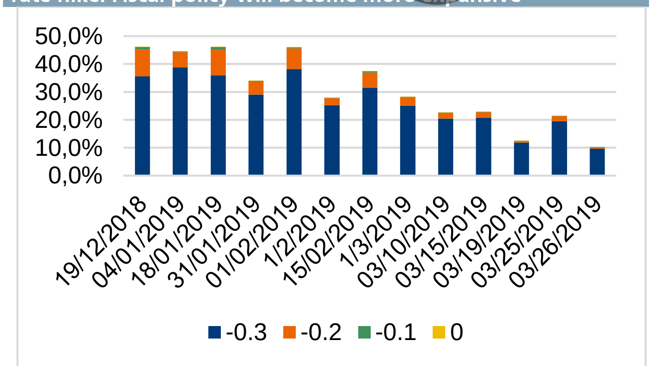
NB: the ISP measure of super core inflation is constructed by selecting CPI core sub-indices, excluding energy, food and tobacco, correlated to the output gap with 2 lag periods above 0.5%. Source: Thomson Reuters-Datastream

Fig. 14 – The relationship between wages and domestic prices remains uncertain



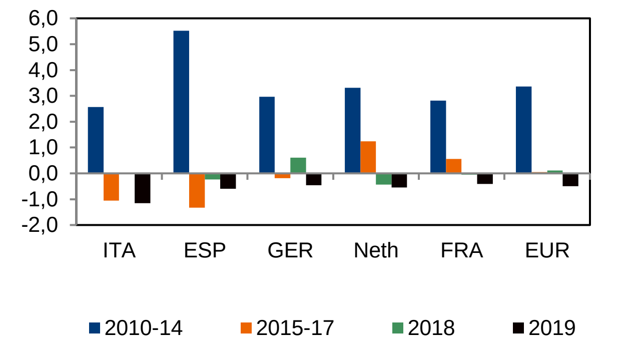
Source: Thomson Reuters-Datastream

Fig. 15 – The market continues to push out the date of the first rate hike. Fiscal policy will become more expansive



Source: Thomson Reuters-Datastream Charting

Fig. 16 – Fiscal policy will become more expansive



NB: Changes in the cyclically adjusted balance. Intesa Sanpaolo estimates
Source: Thomson Reuters-Datastream Charting

Germany: engines coming to a halt as foreign demand fades further

Anna Maria Grimaldi

The German engine, drove the Euro zone recovery between 2014 and mid-2018, has lost momentum since last summer. The contraction in GDP in H2 last year was largely due to manufacturing (-1.7% in the summer and -1.1% qoq in Q4), and to the longer-than-expected decline in auto production (see Fig. 1) that was caused by difficulties adapting production lines to the new WLTP (Worldwide Harmonised Light Vehicle Test Procedure) Regulations, introduced in Europe in September 2018. We estimate that the contraction in car production between June and December shaved -0.4% off GDP growth. Car production dropped further in January, but we think the bulk of the correction is probably over. The automotive sector should see a recovery in the coming months, given the order trend (see Fig. 2), but this will certainly fail to fully offset the correction seen in recent months. Germany continues to spend more on transport compared to the usual momentum (see Fig. 3)[6]. But even stripping out cars and the unusual contraction in the pharmaceutical sector[7], the manufacturing sector recorded a sharp decline at the end of the year. The slowdown in international trade and the Chinese cycle is impacting German industry more severely than expected. Global PMI indicators and IFO data for export orders, as well as the indicators for capital goods orders, net of cars, do not bode well (see Figs. 5 & 6). The manufacturing and car industries would be severely impacted if the US administration introduced 25% tariffs on car sales. As explained in the previous section on the Euro zone, the medium-term impact on German GDP would be negative at -0.2% to -0.3% and German car sales in the US would halve to EUR 17 bn.

No end to the lull initiated in the summer

While the growth slowdown is largely down to the manufacturing sector, the trend in IFO survey expectations for other sectors is not particularly encouraging (see Fig.7). Recent data have led us to significantly downgrade our growth forecast for Germany to 0.9% in 2019, from 1.4% previously. Our forecast factors in a re-acceleration to 0.3% qoq in the first six months of this year, which the composite OFP and PMI indicators suggest is not a foregone conclusion (see Fig. 8). We remain positive about the German economy and expect growth to return to potential in 2020 (1.5%). GDP momentum will be held back by foreign trade (-0.4% in 2019 and -0.2% in 2020): the actual exports trend is gradually slowing (at around 2.2% yoy) in line with the trend in global demand, while imports should continue to grow at a steadier pace (3.4%).

But we still expect growth in line with potential from 2H19

Our forecast for domestic demand is more or less unchanged from last December, with growth expected to remain around 1.6%. **Consumption and investment fundamentals continue to provide strong support**. Despite the slowdown under way, confidence surveys indicate that the country is still operating under tough capacity constraints (see Fig. 9). The financial conditions remain highly accommodative (see Fig. 10) and, together with the positive earnings trend, indicate that corporate spending should continue to grow by an average of 0.8% qoq this year. **Corporate investment is expected to grow by an average of 2.9% in 2019, after 3.1% in 2018**. We expect **construction** to continue expanding (3.6% in 2019, after 3.3% in 2018). Aside from deteriorating expectations in the IFO survey, the orders and permits situation remains consistent with **growth remaining largely positive** in both 2019 (3.0%) and 2020 (2.8%).

We are sticking with our forecast for extremely sound growth in corporate investment and construction

Household consumption is expected to boost domestic demand in IH19. January's figures show that retail sales and car registrations were already re-accelerating in Q1 (see Fig. 12). Household confidence remains high, with employment growth still sound at 1.1% yoy at the end of 2018. Work subject to social security contributions grew much more strongly at 2.2% yoy (0.2% qoq

Household consumption will pick up in early 2019

[6] According to the Bundesbank, the weak demand for cars could reflect a decline in interest from China, although the bulk is due to the introduction of the WLTP. See the box on pages 47 and 48 of the February 2019 Bulletin.

[7] The industrial sector's weakness in the final months of 2018 is partly due to an unexpected correction in the pharmaceutical sector after an unusually strong growth phase in the preceding months.

per quarter). Job creation is concentrated in business services and logistics, but also in health and social services. The German labour market is, in fact, in full employment, and is witnessing a shift from temporary jobs to positions subject to social security contributions, i.e. “good jobs”. The immigrant workforce has filled more than half of the 660,000 positions subject to social security contributions that were created last year[8]. The unemployment rate reached new lows in 2018, falling to 5% from 5.5% a year earlier. Confidence surveys data confirms that job creation remained strong in Q1 this year, but it is reasonable to expect a slowdown of up to 0.7% in the current two-year period. Negotiated wages remained on a clear upward trend in 2H18, averaging 2.8% yoy after 2.2% in the previous three years. Wage agreements in 2019 will affect the services and distribution sectors. Demands published to date have increased between 5.5% and 6%. Overall, wages are expected to continue growing at around 2.8% this year. The entry into force of a cost-sharing system (between businesses and employees) for health costs could have a calming effect. Inflation is expected to be roughly stable at 1.6% in 2019, after 1.7% last year, and then increase to 1.8% in 2020, partly due to a rise in core inflation to 1.5%.

There is no doubt that the risks to growth remain, stemming primarily from international trade and uncertainty about US policies on tariffs and duties. Germany has excess public and private savings to act as a buffer in the event of a protracted slowdown in foreign demand. There are no excesses in lending growth or in price increases for real or financial assets that could give rise to fears of the German economy undergoing a more negative and lasting downturn. In addition, fiscal policy could be leveraged more actively. The public accounts closed with a balance of payments surplus (1.7% in nominal terms and 1.4% net of the cycle) and debt falling to 61% in 3Q18 from 67% in 2017. We anticipate moderately expansive measures in the current two-year period. The balance of payments will, in any case, continue to have a strong surplus in both nominal and structural terms (nominal balance: 1.4% after 1.7%; structural balance 0.9% after 1.4%), continuing to benefit from low interest rates and broadly unchanged tax revenues.

Germany can leverage on fiscal policy in the event of adverse shocks

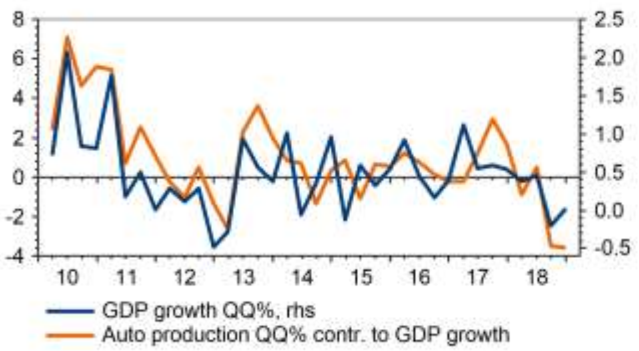
Macro forecasts

	2018	2019f	2020f	2018				2019p				2020p	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y) *	1.4	0.9	1.5	2.1	2.0	1.2	0.6	0.6	0.5	1.2	1.4	1.5	1.5
- q/q change				0.4	0.5	-0.2	0.0	0.3	0.4	0.4	0.3	0.4	0.3
Private consumption	0.9	1.3	1.7	0.4	0.2	-0.3	0.2	0.6	0.5	0.4	0.4	0.4	0.5
Fixed investment	2.7	2.9	2.9	1.1	0.6	0.4	0.9	0.6	0.8	0.8	0.8	0.6	0.7
Government consumption	1.0	2.3	1.8	-0.4	0.8	-0.3	1.6	0.4	0.4	0.4	0.5	0.5	0.4
Export	2.2	1.9	2.6	-0.2	0.8	-0.9	0.7	0.6	0.5	0.9	0.7	0.9	0.3
Import	3.4	3.4	3.4	-0.3	1.5	1.3	0.7	1.0	0.3	0.4	1.4	1.0	0.7
Stockbuilding (% contrib. to GDP)	0.6	-0.3	-0.1	0.0	0.3	0.9	-0.6	-0.1	-0.2	-0.3	0.1	-0.1	0.0
Current account (% of GDP)	7.7	7.2	6.7										
Deficit (% of GDP)	1.2	1.1	0.5										
Debt (% of GDP)	60.1	56.7	53.7										
CPI (y/y)	1.9	1.0	1.4	1.5	1.9	2.2	2.1	1.5	0.9	0.5	1.3	1.9	1.6
Industrial production (y/y)	1.0	0.5	1.7	3.8	2.7	-0.3	-2.1	-2.2	-1.2	1.9	3.4	3.2	2.1
Unemployment (%)	5.2	5.0	5.0	5.4	5.2	5.2	5.0	5.0	5.0	5.0	5.0	5.0	5.0
10-year yield	0.44	0.26	0.68	0.59	0.48	0.33	0.36	0.13	0.11	0.32	0.47	0.53	0.62

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

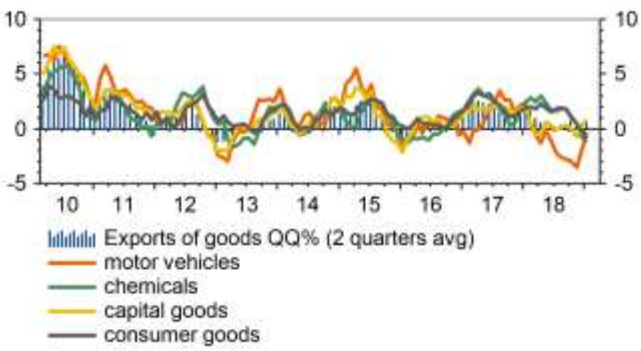
[8] Although immigration from third countries has fallen from a peak of 500,000 in 2016, it remains high and, according to FSO and Bundesbank estimates, is likely to have been around 400,000 in 2018.

Fig. 1 – GDP, manufacturing output and ...



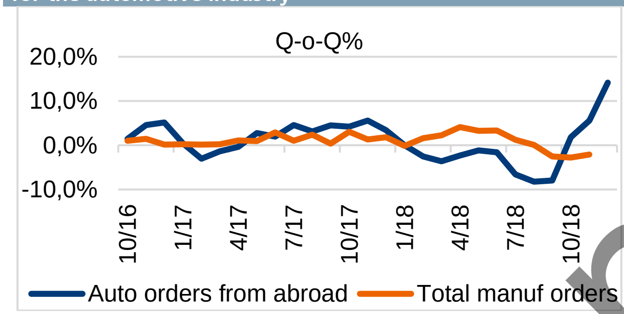
Source: Markit, IFO and Intesa Sanpaolo research

Fig. 2 – ... exports held back by the automotive sector



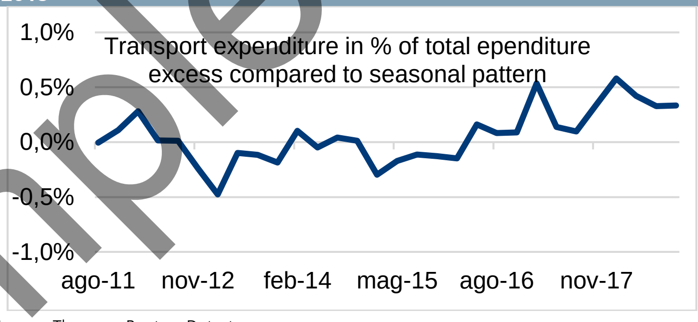
Source: Markit and Intesa Sanpaolo research

Fig. 3 – Orders trend suggests that the worst should be over for the automotive industry



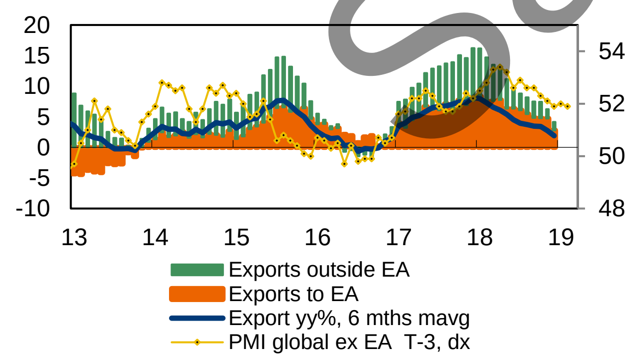
Source: Thomson Reuters-Datastream

Fig. 4 – But the country still had excess spending on transport at end-2018



Source: Thomson Reuters-Datastream

Fig. 5 – Reduced impetus from foreign trade will weigh ...



Source: Thomson Reuters-Datastream

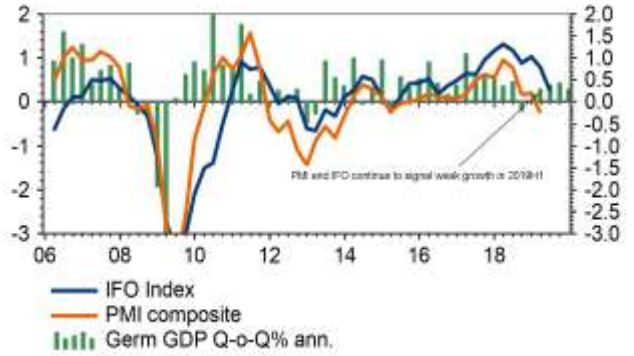
Fig. 6 – ... on industrial output

Source: Thomson Reuters-Datastream

Fig. 7 – But the IFO survey suggests manufacturing is not the only sector slowing

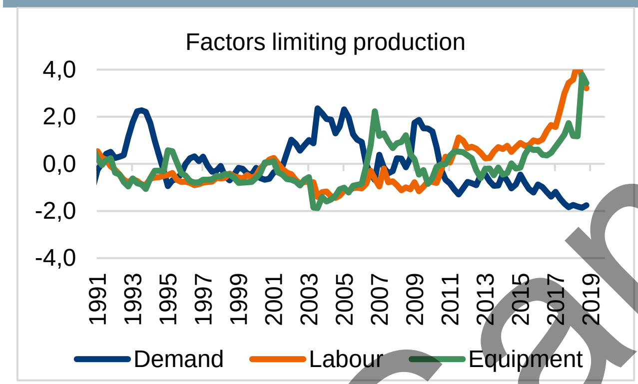
Source: Thomson Reuters-Datastream

Fig. 8 – PMI and IFO report downside risks to our GDP growth forecasts of around 0.3% qoq in 1H19



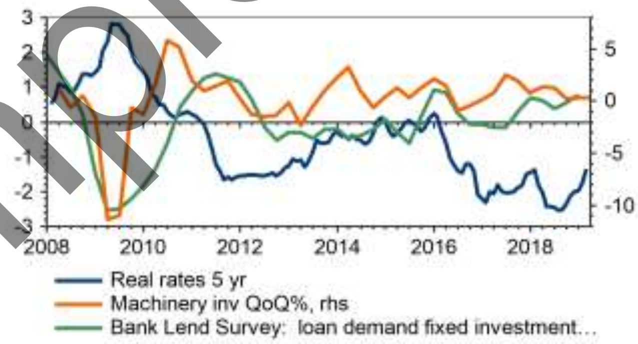
Source: Thomson Reuters-Datastream

Fig. 9 – Severe capacity constraints remain



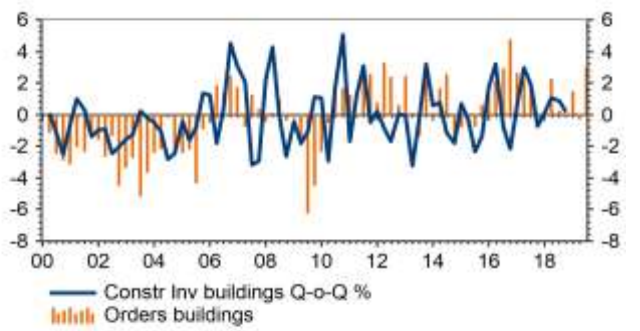
Source: Thomson Reuters-Datastream

Fig. 10 – Theoretically, the capex cycle can continue, but uncertainty could hold back spending decisions



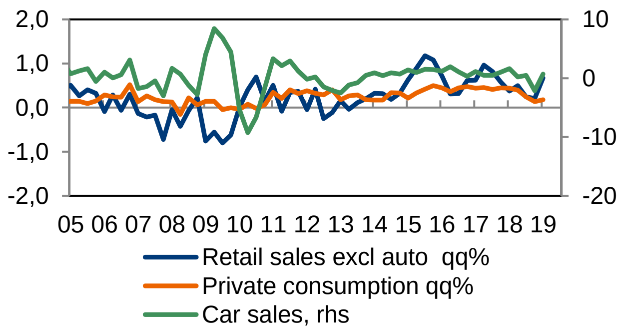
Source: Thomson Reuters-Datastream

Fig. 11 – Construction orders still suggest continued strong growth in the sector



Source: Thomson Reuters-Datastream

Fig. 12 – Retail sales and car registrations indicate that consumption was already recovering in early 2019



Source: Thomson Reuters-Datastream

France: after a lacklustre winter, the economy begins to accelerate

Guido Valerio Ceoloni

The French economy proved to be more resilient than expected

The economic slowdown seen at the end of 2018 should come to an end in the first quarter of the year, when **we expect steady re-acceleration of the cycle**, thanks in particular to the positive contribution of the manufacturing sector, which bounced back significantly in January. Overall, **the economy proved to be more resilient than was initially expected: we therefore predict growth of 0.3% q/q for the current quarter** (the same rate as the previous quarter), but risks to the forecast have shifted upwards. Furthermore, in the first few months of this year, the "yellow vest" protests, while not entirely suppressed, did not have the virulence they did at the end of 2018. In annual terms, growth moved up from 0.9% to 1.0%. **We revised our 2019 growth forecast downwards, with GDP at 1.5%, up from 0.9% in 2018.**

Consumption is stabilising but it remains the first pillar of growth

Consumption fell in December (-1.5% m/m), but bounced back in January (+1.2 m/m), driven by the automotive sector (+3.0% m/m from -4.0% m/m) thanks to new car registrations. Between February and March, consumption should have continued to grow, albeit at a lower rate, with household spending set to make a positive contribution in the first quarter, compensating for the contraction at the end of 2018. Consumer confidence, as recorded by the INSEE, is still lower than the historical average, and the correction seen in the autumn (average index level of 91 down from 97 in summer) seems to be stabilizing slowly, although we believe the height of confidence at the end of 2017/start of 2018 is behind us. **For the current year, we predict that consumption will return to normal, at around 1.2%** (weaker than our last estimate), supported by improvement in the job market and by a marginal reduction in the tax burden on households.

The return on public investment is supporting GDP, albeit poorly

The overall contribution from **investments** was significantly reduced at the end of the year because of the slowdown in manufacturing, and the household property investment component also fell during the autumn, after the stagnation seen in summer. We forecast robust growth in investments for the current quarter, of around 0.7% q/q, up from 0.2% q/q. This is supported by the manufacturing rebound and a continuation of the upswing in the public component recorded at the end of the year. **Household investment is still rather weak**, but should start to pick up again after the spring. The annual average for fixed investments is therefore expected to grow to 2.9%, up from 2.6% in 2018, a slowdown compared to our previous stabilization estimation.

Industrial output rose in the first quarter, services slowed while construction continued to expand

Following December's stagnation, the rebound in **industrial output** seen in January (+1.3% m/m, largely thanks to the manufacturing sector) had a positive impact in the first quarter and is now on course for solid growth (+1.2% q/q from -0.5% q/q), with **a contribution to GDP of more than one decimal point.** Following the slowdown at the end of last year, manufacturing sector confidence surveys conducted by INSEE now point to confidence stabilizing. PMI indexes for January and February also point to a return to above 50 (51.4), indicating a resumption of activity. **Industrial output for the current year is therefore expected to expand at a rate of around 2%**, up from 0.4% in 2018. **Services** also saw a slowdown at year-end, as confirmed by PMI index levels: surveys show the situation in services at the start of the year remains virtually unchanged as compared to December but, from February, the sector began to expand once more (50.2, up from 48.4 in December and January). Finally, the **construction** sector continues to buck the trend of the summer, and continues to expand and is also supported by the confidence indicators for growth in January and February (INSEE indices at 110, up from 109).

External risk will weigh on foreign trade, which will impact growth in 2019

Foreign trade added two decimal points to growth in the fourth quarter, driven by the rise in exports from 0.2% q/q to 2.3% q/q at year-end, which more than offset imports (from -0.3% q/q to 1.4% q/q) thanks to aircraft and shipbuilding orders. We predict growth in imports in the current quarter, supported by the upswing in consumption, only in part offset by exports, which should contract after the surge at year-end. **The prospects for foreign trade therefore remain uncertain this year, due to the presence of external risks** (Brexit, US auto tariffs, Chinese slowdown): exports have so far slowed to 2.5% this year, compared to 3.0% in 2018, but imports should grow more than in 2018, by 2.3% compared to 1.2%, due to increased consumption. Overall, the contribution of foreign trade will be marginally negative this year.

Inflation will slow this year to around 1.3%

Inflation abruptly slowed in January, moving from an average level of around 2% in the last quarter of 2018 and settling at around 1.2% between January and February. The slowdown was in large part explained by the most volatile component linked to food products, while **the underlying index has remained more or less stable, from the autumn until now, at around 0.5%**. We predict that in the next few months the supporting index will remain fairly stable, before gradually accelerating to around 1% in the second half of the year; notwithstanding this, **inflation has stabilized in 2019 to around 1.3% compared with 1.9% in 2018**, revising downwards the previous estimate of approximately three decimal points.

Unemployment will fall to around 8.7% in 2019

The job market continues to improve gradually, with a fall of three decimal points in **unemployment** in the fourth quarter (from 9.1% to 8.8%), having remained stable in the third and fourth quarters. Over the year, this fall should continue at the rate of around 0.1% per quarter, giving an annual average of 8.7%, down from 9.1% in 2018.

Foreign and domestic political risk will have an impact on the outlook

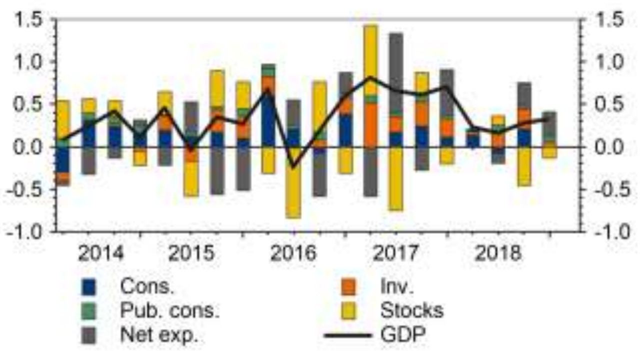
While signs of revitalization in manufacturing have recently become visible, **the domestic situation is still characterized by domestic risk (of a political nature) and by external risk (Brexit), which have an impact on our forecast.** In domestic terms, the increased political risk is still linked to the "**yellow vests**" phenomenon. While this has partially reversed compared to the intensity seen in the autumn, the last few weeks have seen hotbeds of tension reignite, and we predict this will increase as we approach the European elections in May. The risk here is a best-case scenario of a slowdown in the financial agenda of the Macron Government this year, leading to derailment that will dilute the impact of the planned structural reforms, in particular about any reduction of the rigidity of the job market and compression of public expenditure, with a negative impact on 2019-20 growth. **The other main risk is that of a no-deal Brexit, which would undoubtedly have an impact on the French economy, an economy with some of the closest ties to the UK**. Among the external risks is **the possible trade war between the US and Europe, especially the automobile sector**, France being the most exposed country after Germany. Furthermore, a trade war will then have more extensive and generalized effects on the level of confidence in the manufacturing sectors, which **could further compromise the profile of manufacturing investments and foreign trade**.

Macro forecasts

	2018	2019f	2020f	2018				2019p				2020p	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	1.5	1.3	1.4	2.2	1.7	1.3	0.9	1.0	1.2	1.4	1.5	1.5	1.4
- q/q change				0.2	0.2	0.3	0.3	0.3	0.4	0.4	0.4	0.3	0.3
Private consumption	0.9	1.2	1.4	0.3	-0.1	0.4	0.0	0.3	0.5	0.4	0.4	0.3	0.3
Fixed investment	2.9	2.6	2.3	0.2	0.8	1.0	0.2	0.7	0.7	0.6	0.6	0.6	0.5
Government consumption	1.0	1.4	1.5	0.1	0.3	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Export	3.0	2.5	2.7	-0.5	0.0	0.2	2.3	-0.2	0.5	0.6	0.6	0.7	0.7
Import	1.2	2.3	2.7	-0.8	0.6	-0.3	1.4	0.3	0.6	0.7	0.7	0.6	0.7
Stockbuilding (% contrib. to GDP)	-0.4	-0.3	-0.3	-0.1	0.2	-0.4	-0.2	0.0	-0.1	0.0	0.0	-0.1	-0.1
Current account (% of GDP)	-0.6	-0.6	-0.4										
Deficit (% of GDP)	-2.6	-3.4	-2.8										
Debt (% of GDP)	99.0	99.4	97.2										
CPI (y/y)	2.1	1.3	1.4	1.5	2.1	2.6	2.2	1.4	1.2	1.4	1.4	1.4	1.4
Industrial production (y/y)	0.4	2.1	2.1	2.5	0.5	0.4	-1.7	0.9	2.0	2.2	3.5	2.7	2.3
Unemployment (%)	9.1	8.8	8.1	9.2	9.1	9.1	9.0	9.2	8.7	8.6	8.5	8.3	8.2

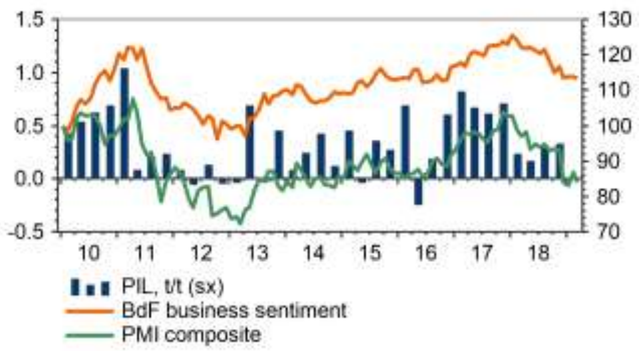
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Contribution to GDP



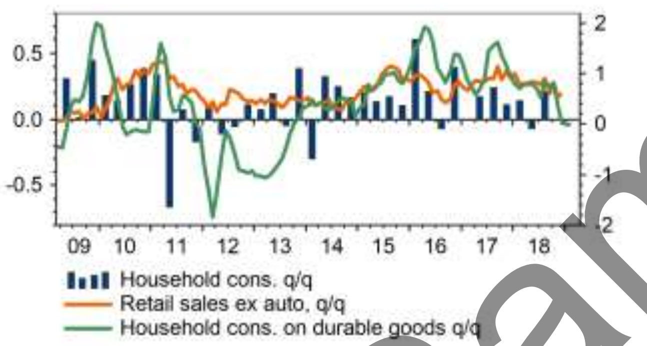
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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

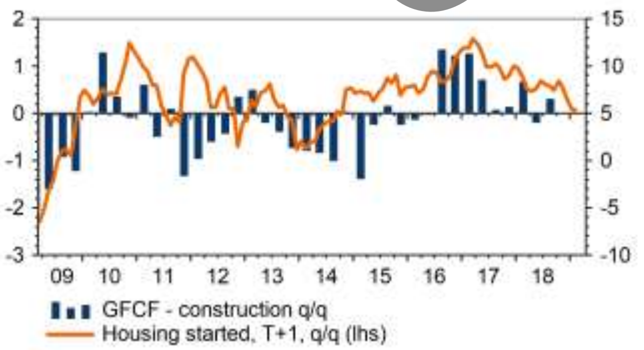


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 4 – Retail sales and household confidence

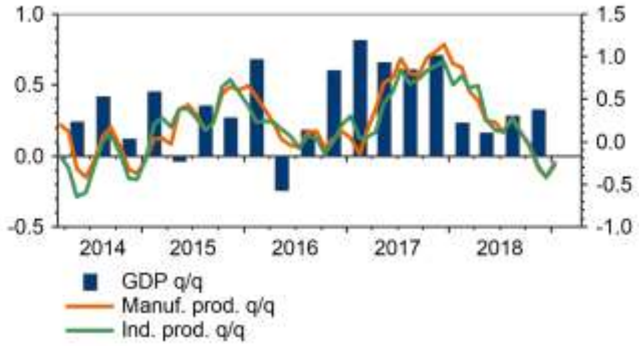
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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

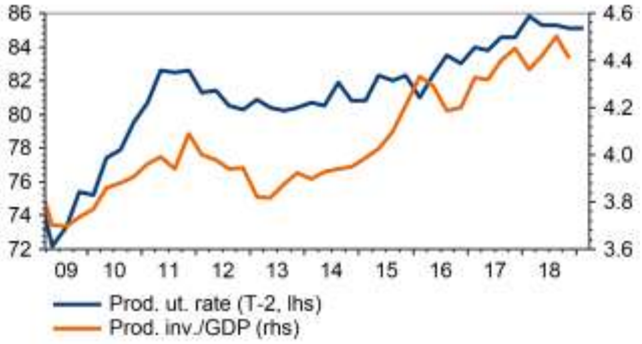


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indexes for the various manufacturing sectors

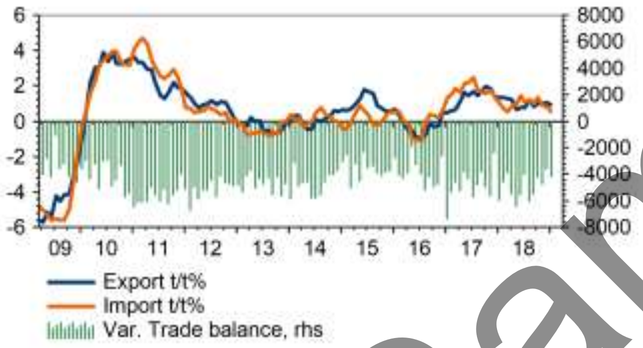
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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



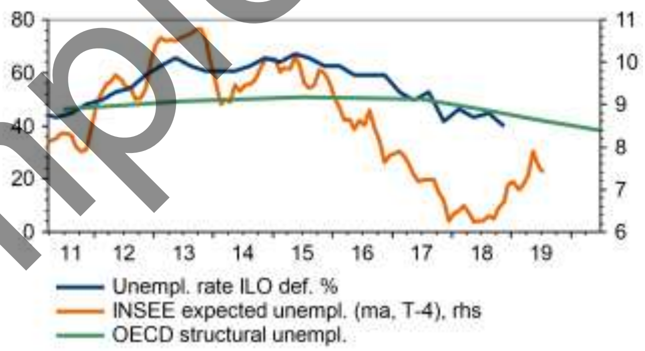
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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: between Scylla and Charybdis

Paolo Mameli

We have revised down our forecast of Italian GDP growth in 2019-20, to 0.2% from 0.6% this year, and to 0.7% from 1% next year. We expect the investment trend to stagnate overall in the current biennium. Despite the revision, risks remain skewed to the downside, mostly in light of the difficult choices that will have to be made in drawing up the next Budget Law: the government will have to navigate choppy waters between the Scylla of excessive austerity, and the Charybdis of financial tensions in the event of fiscal indiscipline (although the situation should not come to a head before next autumn).

The Italian economy will be essentially stagnant in 2019

We have recently revised down our forecast of Italian GDP growth in 2019-20, to 0.2% from 0.6% for this year, and to 0.7% from 1% next year. We had been signalling the existence of substantial downside risks to forecasts for quite some time: monthly indicators on the trend of the Italian economy were unanimously negative until just a few weeks ago, and only the latest releases have sent slightly less negative indications: an upward revision of 4Q GDP, with a relatively encouraging breakdown by components; a monthly rebound in January for exports and the main industrial sector indicators (output, orders and revenues); a recovery of the services and composite PMIs in February (whereas the Istat survey of business confidence continued to worsen in the month, in both the manufacturing and services sectors). Without the improvement of these indicators, forecast GDP growth in 2019 would undoubtedly have been even lower.

In 2019 the Italian economy will be essentially stagnant, after four years of expansion. However, the quarterly trend of GDP could gradually improve in the course of the year. We expect growth to be probably zero at the beginning of the year (from -0.1% q/q in the second half of in 2018), followed by a possible resumption of moderate growth starting in the spring quarter (0.1% q/q), and a slightly more sure-footed trend in the second half of the year (0.2% q/q). Should this cruising speed be kept up also in the course of 2020, average annual growth would accelerate by 0.7% next year. **There are essentially two reasons for this gradual improvement in quarterly terms, one external and one domestic:**

1) **a possible recovery of global trade**, thanks to the removal (or at least the easing) of some factors of uncertainty weighing on the global scenario; this is because in the next few months we expect at least a truce on the tariff war front, a waning of the effects on the car sector of the introduction of new regulations on diesel engines, and the resolution of the issues clouding the outcome of Brexit;

2) **the effects on consumption of the citizen's income**, which should be implemented starting in April (we estimate an impact on the income of households of +0.3% in 2019 and +0.4% in 2020, which could translate into an impact on real GDP of one tenth this year, and two tenths next year).

We expect consumption and investments to diverge

The slowdown in GDP this year (0.2% from 0.8% in 2018) **is all due to investments** (our estimate: -0.2% from +3.2% last year), **whereas consumption should keep up the trend seen in 2018 this year** (0.6%), **subsequently accelerating in 2020** (to 0.9%). Vice versa, we expect business investments to remain essentially stagnant next year as well (0.3%). In essence, we expect somewhat of a divergence between consumption and investments on the two-year forecasting horizon. In fact, the condition of households, as signalled by persistently high consumer confidence, still seems positively set, supported by the ongoing growth of employment and disposable income (driven by the recent increase of contract-based wages, as well as by the implementation of the citizen's income for underprivileged households).

Vice versa, **two different factors are weighing, and will continue to weigh in the near term, on business sentiment and capex spending**:

- **The most important is probably the uncertainty still clouding the scenario** at both the international and domestic levels: on the national front, risks have eased following the agreement reached with the EU at the end of 2018, but uncertainty still persists, due both to the limited predictability of economic policies (not only on the fiscal front but also, for instance, on infrastructures), and to the sword of Damocles represented by the possible increase in the tax burden implied by the safeguard clauses from 2020 onwards;
- **In the past few quarters, businesses have seen a deterioration of their profitability**, at least in terms of gross operating profit, both in year-on-year terms (-0.9% y/y in 3Q 2018, from a peak of +11.9% in 2Q 2016) and as a share of value added (42.4% on average in the past four quarters for which data are available, the lowest level in two and a half years, on the decline from a high of 43.3% hit between end-2016 and mid-2017); so far, non-financial businesses, despite lower margins, maintained a relatively high investment rate, at least as of 3Q 2018 (last available reading: 22.1% in the past four quarters, the highest rate in almost 10 years), but the investment propensity of businesses is likely to have decreased significantly of late;
- **The 2019 Budget Law, while introducing several measures in support of families** (most notably: citizen's income and early retirement scheme), **is ultimately restrictive for businesses** (and for large corporations in particular); furthermore, the Budget did not renew the super-amortisation option for investments in new capital goods, which has played a far from negligible role in reactivating the investment cycle over recent years; on this front, several press sources report that the government could be considering a new decree that would reintroduce super-amortisation of 130% starting on 1st April (with a ceiling placed at 2.5 million and excluding cars, real estate and non-tangible goods), or, as an alternative option, an increase to 60% in deductibility of Imu paid on business properties; other possible growth-supportive measures are slimmer patent box procedures, Sabatini *quater* in an extended version for the investments of SMEs in the digital sector, and less stringent rules on the issue of mini-bonds, a comeback of the fiscal bonus for corporate mergers and stricter rules to fight delocalisation (in addition to measures aimed at boosting the construction sector approved "other agreements notwithstanding" at the Council of Ministers held on 20 March); should this decree effectively be approved, the resulting impact on the investments of businesses could be significant (although no details on financing sources have been disclosed to date).

Among the other components of demand, **we expect inventories to make a significantly negative contribution on average in 2019** (mostly for statistical reasons in relation to the final part of 2018), **whereas foreign trade should contribute positively**, thanks to a more lively recovery of exports than imports (following the slowdown of flows in both directions last year).

Risks to the scenario still skewed downwards

Risks to the scenario, even following the recent revision, remain skewed to the downside, as forecast assumptions include a quarterly acceleration in growth of which there is no sign, for the time being, in the forward-looking indicators (and specifically in businesses confidence indicators in the manufacturing sector, which at least until February continued to worsen). The main risk factors are again two, one of external origin, one domestic:

- **failure to overcome the sources of uncertainty** of an international nature, as described above, with particular reference to the possibility of a re-exacerbation of the tariff war (Italy would be one of the hardest hit countries if tariffs or quotas were imposed on European car imports into the United States, not so much as a direct impact, but mostly due to the negative effects on car component exports to Germany); a no-deal Brexit outcome could also have far from negligible effects, on some specific sectors especially (food, pharmaceuticals); these two factors combined could hold back Italian growth by 0.2-0.3% over a one year horizon;

- **the main risk factor on the domestic front is tied to the political scene:** in our view, the greatest danger is tied not so much to the possibility of early elections (which nonetheless cannot be ruled out, also depending on the outcome of the European elections, anytime starting from mid-2019 on), as to the challenges posed by the next Budget Law session.

The main risk is tied to the difficult choices that will have to be made in the next Budget

The fiscal policy scenario remains crucial, with reference both to the effects on the economic cycle and to potential repercussions on the financial markets. The government, at the end of 2018, proved it pays some attention to the risks tied to a potential European excessive deficit procedure and to adverse developments on the financial front. **At least in theory, therefore, the final outcome this year may again be a compromise** between the understandable need to implement some electoral promises and a reasonable dose of fiscal discipline. However:

- **as was the case last year, the government is unlikely to renounce making the Budget expansionary**, at least at an initial stage, which could generate concern among investors; in fact, the government parties may even raise the stakes, considering that already as we write the political debate is starting to shift back to the main economic policy proposal contained in the "government contract" that has left largely unimplemented so far, i.e. the so-called flat tax (the introduction of which for households, even only in part, would cost, according to its main proponent, the Lega, between 12-15 billion, as opposed to an estimate of up to 50 billion according to impartial commentators).

- **The scenario seems more obstacle-ridden than last year**, as the safeguard clauses affecting 2020 amount to 23.1 billion euros, roughly twice as much as last year. This means that even only in order to prevent a VAT hike (which the government parties have repeatedly said they want to deactivate), financing worth 1.2% of GDP will have to be found, in addition to the revenue required to finance any new expansionary interventions. This means that while last year the final outcome of the Budget Law saga was an essentially neutral budget (net of the sterilisation of VAT increases, that was not priced into the expectations of operators), **this year any compromise will have to involve a non-negligible dose of fiscal tightening** (net of clauses). This could generate resistances and/or frictions between the government parties.

As mentioned above, **our baseline scenario contemplates an acceleration of growth to 0.7% in 2020. However, the evolution of fiscal policy is the main risk weighing on our forecast**. Should the VAT hikes be as indicated (by around three per cent for both the ordinary and reduced rates), the resulting negative impact on growth would be by around half a percentage point (also possible through alternative measures with a high multiplier). Vice versa, if the government does not carry out the required adjustment, the deficit would rise to over 3%, and the resulting effects on the financial markets (accompanied by likely downgrades and the activation of the European infraction procedure) would determine a tightening of financial conditions, also with dampening effects on growth. In other words, **the government will presumably have to navigate choppy waters between the Scylla of excessive austerity, and the Charybdis of financial tensions in the event of fiscal indiscipline.** A "virtuous" mix of the two alternatives would be desirable (a partial correction, worth at least 10-15 billion, with financing measures with not too high multipliers, better if accompanied by structural reforms at zero cost on the balance sheet front, and one-off debt reduction measures). Our baseline is a 2.8% deficit in 2020, as a result of a 50% coverage of safeguard clauses (with low multiplier measures).

In any case, we believe the moment of truth, as was the case last year, should come not before the autumn, with the official opening of the new Budget session, namely with the unveiling of the Update Note to the DEF economic and financial planning document at the end of September. The DEF due to be published by 10 April is unlikely to already outline the government's orientation on how to deactivate the safeguard clauses and which expansionary measures to put in place. In June, the monitoring of Italian public accounts provided for in the agreement signed with the EU will shed light on any discrepancies with the targets agreed with

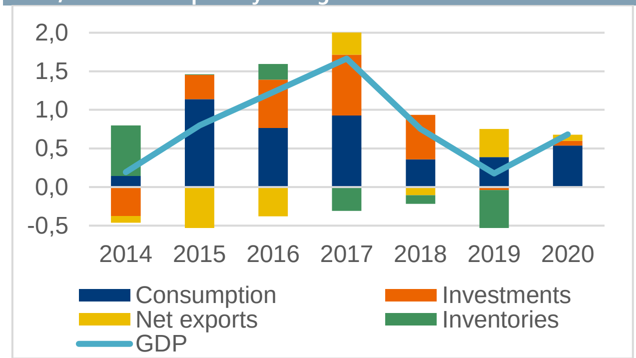
Brussels for this year. In our view, the trend of the deficit will only result in a limited breach in terms of both the nominal deficit (to 2.3% based on our forecasts) and structural (as the worsening of the deficit is entirely due to the cycle). Therefore, there could be no need for an emergency budget. However, **debt will be the most pressing problem, set to rise this year based on our estimates** by over half a point (to 132.8%) even if the goal of achieving one point of GDP from privatisations is reached (as opposed to a one point drop as per the government's policy framework scenario). Focus will be on how the EU Commission reacts to failure to reach the debt target. In our view, Brussels could postpone until the 2020 Budget any request for actions to restore the debt/GDP ratio to a more favourable path (although its evolution in the coming years does not seem reassuring, either). In a nutshell, the autumn budget session is when all the hitches will emerge. Before then, the risks of negative developments on the market seem relatively contained.

Macro forecasts

	2018	2019f	2020f	2018				2019p				2020p	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	0.8	0.2	0.7	1.4	1.1	0.6	0.0	-0.1	-0.1	0.3	0.6	0.7	0.7
- q/q change				0.2	0.1	-0.1	-0.1	0.0	0.1	0.2	0.2	0.2	0.2
Private consumption	0.6	0.6	0.9	0.3	0.0	0.0	0.1	0.1	0.3	0.2	0.2	0.2	0.2
Fixed investment	3.2	-0.2	0.3	-1.3	2.5	-1.3	0.3	-0.5	0.4	-0.2	-0.1	0.0	0.2
Government consumption	0.2	-0.1	0.0	0.0	0.1	-0.1	-0.1	-0.1	0.1	0.0	0.0	0.0	0.0
Export	1.4	3.6	2.3	-2.0	0.7	1.0	1.3	1.2	0.4	0.6	0.6	0.6	0.6
Import	1.8	2.6	2.3	-2.0	1.8	0.4	0.7	0.5	0.7	0.6	0.6	0.5	0.5
Stockbuilding (% contrib. to GDP)	-0.1	-0.5	0.0	0.3	-0.1	-0.1	-0.4	-0.2	0.0	0.1	0.1	-0.1	-0.1
Current account (% of GDP)	2.6	2.6	2.7										
Deficit (% of GDP)	-2.1	-2.3	-2.8										
Debt (% of GDP)	132.1	132.8	133.4										
CPI (y/y)	1.2	1.0	1.5	0.9	1.0	1.7	1.5	1.0	1.1	0.9	1.1	1.4	1.4
Industrial production (y/y)	0.7	0.0	1.0	3.4	1.9	-0.2	-2.4	-1.3	-0.7	0.3	1.8	1.7	1.5
Unemployment (%)	10.6	10.3	10.0	10.9	10.7	10.3	10.6	10.5	10.4	10.3	10.2	10.1	10.0
10-year yield	2.59	2.87	3.79	2.01	2.24	2.83	3.29	2.75	2.61	2.89	3.24	3.62	3.78

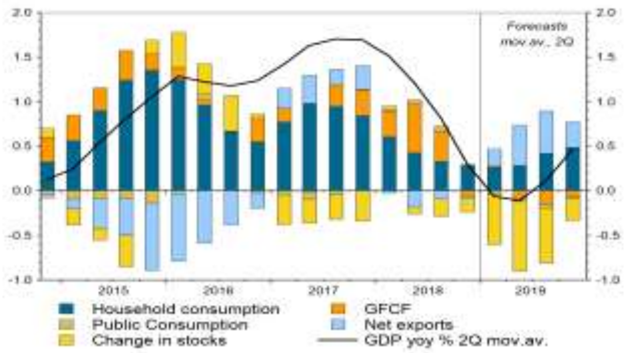
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Consumption will be the main driver of growth in the current biennium. Inventories will slow GDP significantly in 2019, balanced in part by foreign trade



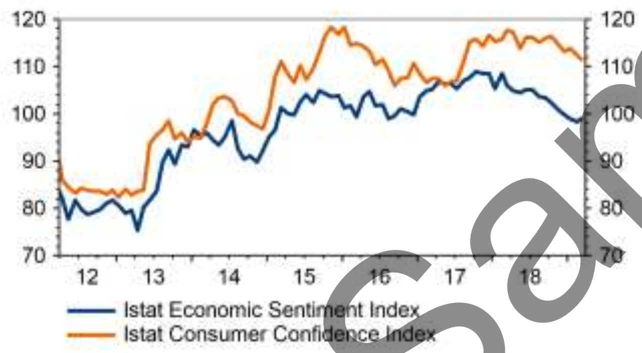
Note: GDP and contributions to GDP, average annual % changes, annual data. Source: Intesa Sanpaolo elaborations and forecasts on Istat data

Fig. 2 – The quarterly profile of growth should improve in the second half of 2019



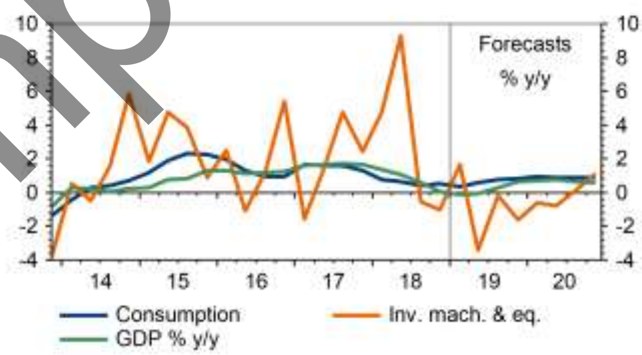
Note: GDP and contributions to GDP, average annual % changes, two-quarter averages, qaurterly data. Source: Intesa Sanpaolo elaborations and forecasts on Istat data

Fig. 3 – The greater resilience of consumer confidence compaerd to business condfidence…



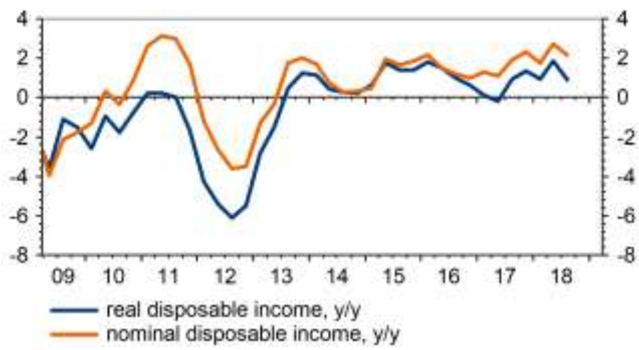
Source: Thomson Reuters-Datastream

Fig. 4 – … will translate in our view into a divergence between households consumption and corporate investments (expected to recover only at the end of the current biennium)



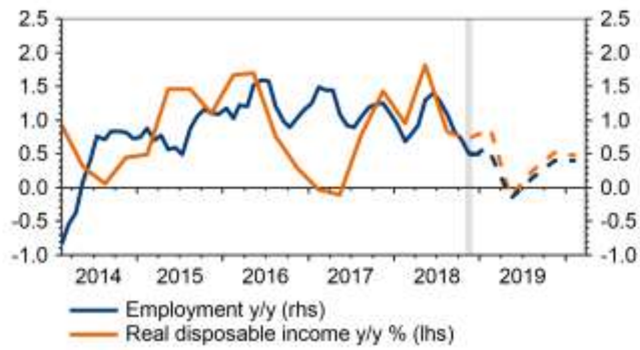
Source: Thomson Reuters-Datastream, Intesa Sanpaolo elaborations and forecasts on Istat data

Fig. 5 – Disposable income of househoulds still postiveiyl set…



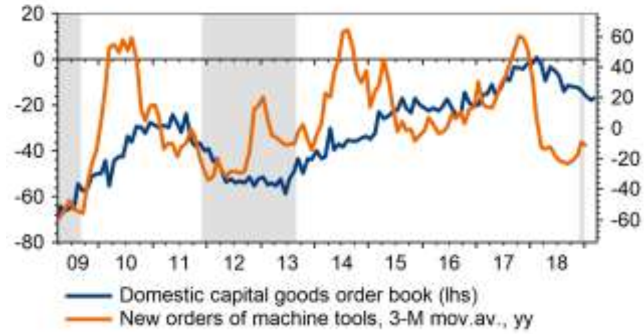
Source: Thomson Reuters-Datastream

Fig. 6 – … expected to resume growing in the second half of the year after possibly declining at the beginning of 2019



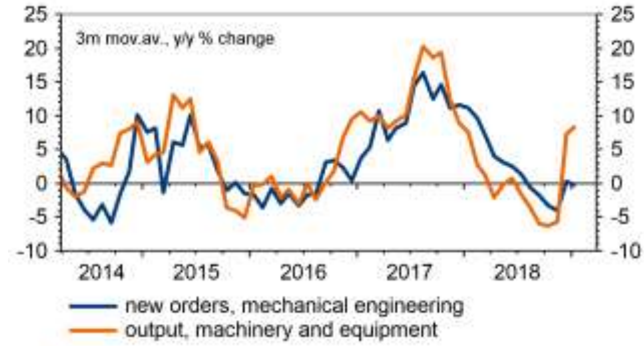
Source: Thomson Reuters-Datastream, Intesa Sanpaolo elaborations and forecasts on ISTAT data

Fig. 7 – Trend of businesses' assessment of domestic orders of capital goods still on the decline (as also that of hard data on new orders for machinery)…



Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo elaborations

Fig. 8 – … but January 2019 data, on output in particular, are attempting to recover

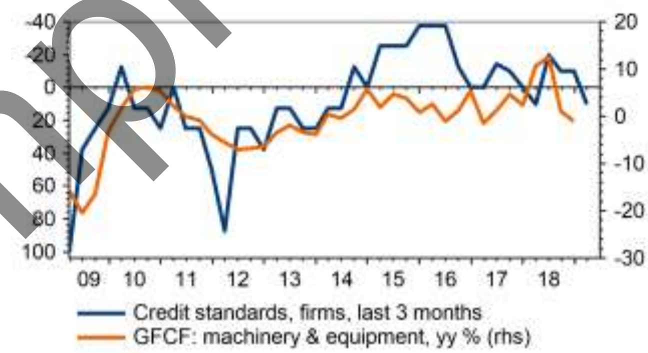


Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo elaborations

Fig. 9 – We believe that in any case investments will be held back by greater uncertainty clouding final demand…

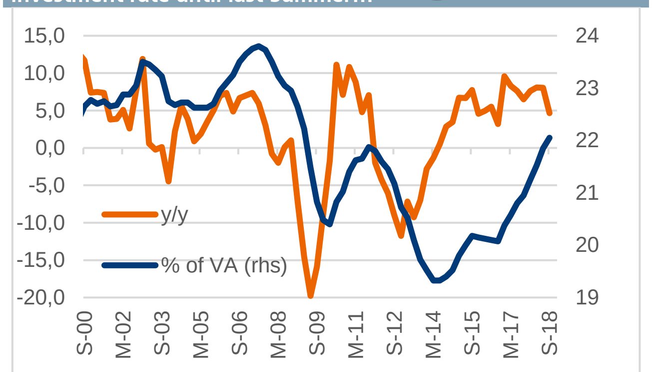
Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo elaborations

Fig. 10 – … as well as by less favourable financial conditions than in the recent past



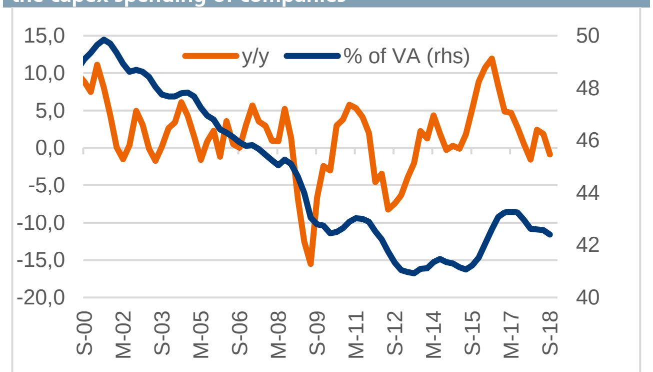
Source: Thomson Reuters-Datastream Charting, Intesa Sanpaolo elaborations

Fig. 11 – Non-financial firms kept up a relatively high investment rate until last Summer…



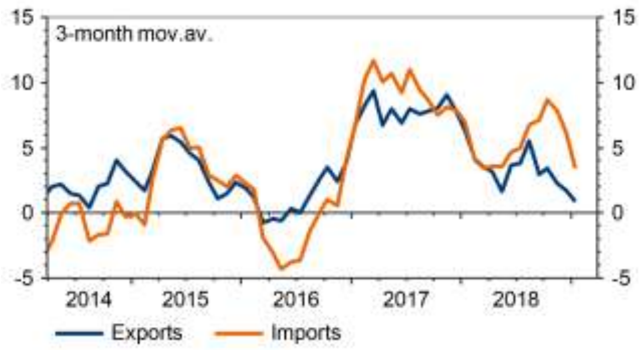
Note: investment rate of non-financial firms, y/y % and share of valued added. Source: Istat and Intesa Sanpaolo elaborations

Fig. 12 – … but the decline in profitability will inevitably impact the capex spending of companies



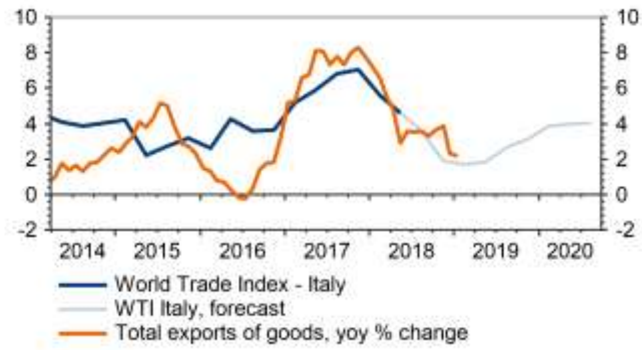
Note: gross operating result of non-financial companies, y/y % chg. And share of value added. Source: Istat and Intesa Sanpaolo elaborations

Fig. 13 – Flows in both directions moderated in the closing part of 2018…



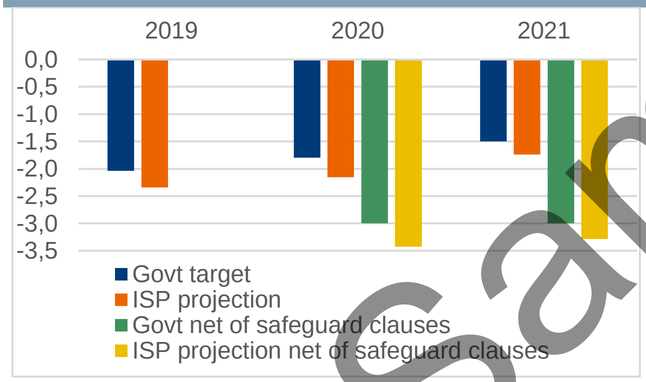
Note: y/y % chg. 3-month moving averages. Source: Thomson Reuters-Datastream, Intesa Sanpaolo elaborations

Fig. 14 – … but we think exports may recover in the course of the year, in the wake of a gradual recovery in global demand addressed to Italy



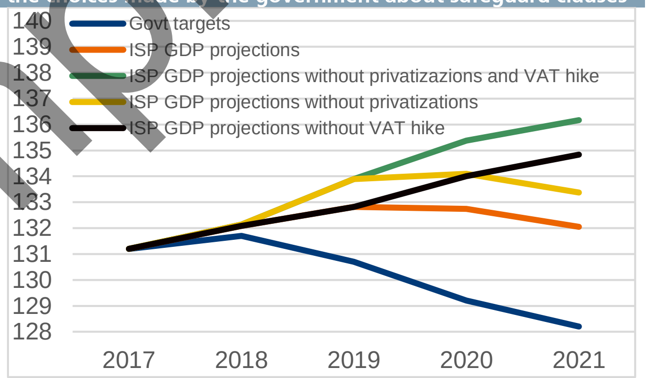
Source: Oxford Economics Forecasting, Thomson Reuters-Datastream, Intesa Sanpaolo elaborations

Fig. 15 – The "genuine" no-policy change deficit in 2020-21 (net of safeguard clauses) is higher than 3%



Source: Intesa Sanpaolo elaborations and forecasts on MEF data

Fig. 16 – The debt/GDP ratio will rise further this year, in our view, and the evolution over the next biennium will depend on the choices made by the government about safeguard clauses



Source: Intesa Sanpaolo elaborations and forecasts on MEF data

Spain: economy remains strong, ignoring political chaos

Anna Maria Grimaldi

The Spanish economy continues to exhibit unusual resilience, unlike the rest of the Euro zone. The national economy grew 2.5% in 2018, slower than the 3.0% recorded in 2017, but still well above expectations for the fourth year running: the most recent European Commission forecasts were for 1.5% growth. GDP rose a further 0.7% qoq in the fourth quarter, outperforming the 0.6% qoq growth recorded in the previous nine months. Fiscal policy helped to boost growth by around 0.4% in 2018 through a combination of tax rate cuts for the lower-to-middle income classes and spending increases. However, the strong finish in 2018 was largely linked to exports picking up: national accounts showed 1.9% qoq exports growth, against virtually zero growth in the previous three quarters. By contrast, corporate investment fell 1.7% qoq, while consumer spending slipped to 0.5% qoq, compared with 0.8% qoq in 3Q18. The geographical breakdown shows that demand for exports fell in developed countries, but was more than offset by higher demand in Asia (see Fig. 4). Post-financial crisis measures designed to restore competitiveness – by reducing labour costs and diversifying destination markets – appear to have yielded lasting results. The composite PMI confidence indicator and the European Commission's Economic Sentiment Indicator (ESI) suggest that momentum is set to slow slightly, down to around 0.5% qoq in early 2019 (see Fig.1). Industrial output was strong at the start of 2019 (see Fig. 2), with substantial positive benefits during the first quarter (see Fig. 2). However, the country will inevitably be affected by the decline in global demand (see Fig. 3). Foreign trade figures reveal a 5.5% mom fall in exports at the turn of the year, which reflects waning demand for finished industrial goods and intermediate goods. Over the forecasting horizon, we anticipate that exports will increase by 2.8% in 2019 and 3.1% in 2021, which will be above the EU average, but lower than the 5.2% recorded in 2017. Export growth will only be partially offset by import volumes over the forecasting period. As a result, foreign trade should continue to make a modest yet positive contribution. The current account surplus is set to continue, but down at 1.0%, rather than the 1.8% recorded in 2018. The goods balance is already back in negative terrain, both net and inclusive of energy. Spain needs to maintain a balanced growth path and a current account surplus, given the continued high levels of foreign debt: 63% of GDP as at September 2018, down from the 2010 record high of 97.3%.

Consumer spending strong but slowing

We think that the growth phase could continue into 2020-21: although the output gap has returned to positive territory, the labour market is still nowhere near full employment. In addition, domestic demand will continue to be supported by expansionary fiscal policies. Household consumption is expected to rise by 1.8% in 2019 and 1.6% in 2020. The slowdown is linked to weaker employment growth, as indicated in the latest confidence surveys (see. Fig. 8), with solid salary growth, albeit no longer at the same pace – up 2.4% in January 2019 compared with 1.7% in 2018 (see Fig. 9) – with inflation rising to around 2%. The prospective slowdown would be welcome in light of the decline in savings rates over recent years (see Fig. 7). The unemployment rate continued to fall, coming in at 14.1% in January; we anticipate that unemployment could drop to as little as 13.4% by the end of 2019 if participation rates increase. Participation began to decline again in the summer quarter and remains below pre-financial crisis levels (see Fig. 10), which suggests that labour market conditions are still fragile and require structural intervention. There has been an upturn in negotiated wages since end-2017 (see Fig. 9) but there is little risk of overheating as there is plenty of slack in the labour market, with the long-term unemployment rate still at 24% from 34% at the peak of the crisis.

Investment in machinery and construction slowing compared with 2018

Corporate investment is expected to continue to grow, sustained by favourable financial conditions. Nonetheless, we anticipate that investment growth will slow to 2.5%, after what seems like an excessive increase in corporate spending (6.0%) given capacity constraints (see Fig. 5), earnings trends and expected demand. **Construction growth beat expectations** in the autumn quarter: 5.5% in 2018, compared with 4.6% in 2017. More moderate quarterly growth rates at less than 1.0% qoq would prevent the formation of additional excesses. We predict 3.2% growth in 2019. Sizeable increases in corporate investment since 2014 – on average up 7% per year – gives us reason to hope that such investment will contribute more to potential growth in the medium term.

The **outlook for public finances is improving due to the extremely favourable cyclical conditions, but the 2019 budget is still in breach of the medium-term targets.** The process of reducing the nominal deficit has shifted from 4.5% in 2016 to 2.7% in 2018. Economic performance suggests that it should still be possible to bring the figure down by around 2% in 2019. In the absence of a budget for 2019, the structural balance is expected to drop three percentage points during the current year to -3.2% of GDP. Debt is expected to fall to 96.2% in 2019 and 95.8% in 2020 (2018: 96.9%).

Risk of a protracted deadlock following the elections on 28 April

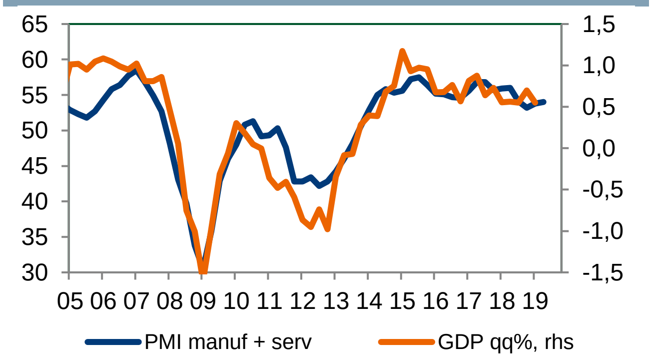
As in the rest of the Euro zone, risks are to the downside and mostly linked to the international situation. There is also significant domestic political risk: the forthcoming elections on 28 April are unlikely to result in a majority government in the near future, given the fragmentation of support for the traditional parties and the need to form cross-party alliances. The most likely scenario is a broad coalition government made up of the People's Party (PP), *Ciudadanos* and the right-wing VOX party, according to recent polls (see figs. 11 & 12), but also in this case the majority is likely to be very narrow. For a country that is used to a bipartisan alternation it is not easy to get used to rule with a coalition. But there are few alternatives as the debate on electoral reform is not advancing either.

Macro forecasts

	2018	2019f	2020f	2018				2019p				2020p	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	2.5	2.3	1.9	2.8	2.5	2.4	2.4	2.4	2.4	2.3	2.1	2.0	1.9
- q/q change				0.6	0.6	0.6	0.7	0.6	0.5	0.5	0.5	0.5	0.5
Private consumption	2.4	2.1	1.4	0.9	0.0	0.8	0.5	0.6	0.5	0.5	0.4	0.3	0.2
Fixed investment	5.4	3.3	1.9	1.0	3.0	0.8	0.3	0.8	0.8	0.7	0.4	0.5	0.5
Government consumption	2.3	2.2	0.6	0.6	0.2	0.8	1.2	0.3	0.3	0.4	0.2	0.1	0.0
Export	2.0	2.3	3.0	0.5	0.3	-0.9	1.2	0.7	0.6	0.8	1.0	0.5	0.8
Import	3.8	4.1	4.0	1.4	0.7	-0.2	1.8	1.4	0.7	0.8	1.0	1.0	1.0
Stockbuilding (% contrib. to GDP)	0.1	0.4	0.8	0.0	0.0	0.0	0.3	0.2	0.0	0.0	0.1	0.3	0.3
Current account (% of GDP)	1.2	1.5	1.1										
Deficit (% of GDP)	-2.9	-2.9	-1.8										
Debt (% of GDP)	97.3	97.0	95.4										
CPI (y/y)	1.7	1.7	2.1	1.1	1.8	2.3	1.8	1.3	1.7	1.6	2.3	2.5	2.2
Unemployment (%)	15.3	14.2	13.6	16.2	15.4	14.9	14.6	14.4	14.3	14.1	13.9	13.7	13.7

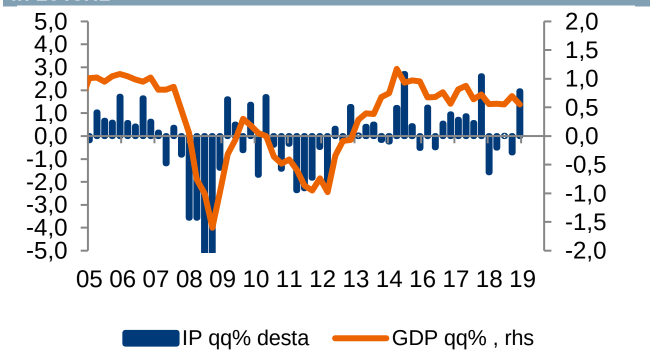
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 - The composite PMI and …



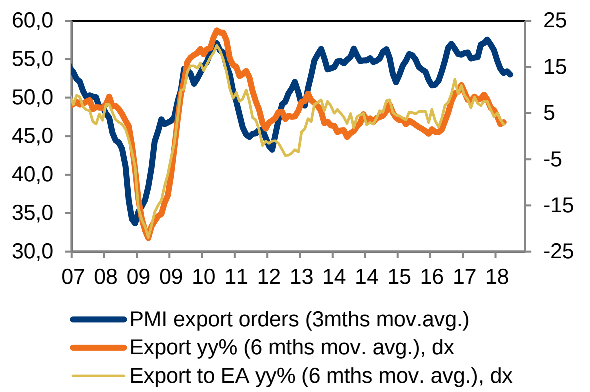
Source: Intesa Sanpaolo chart based on Wikipedia

Fig. 2 – …industrial output figures consistent with GDP growth of 0.5-0.6% qoq in early 2019, broadly the same pace recorded in 2018H2



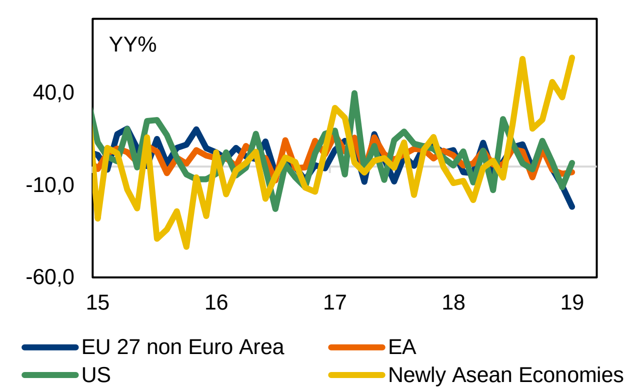
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 3 – The outlook for exports is subdued



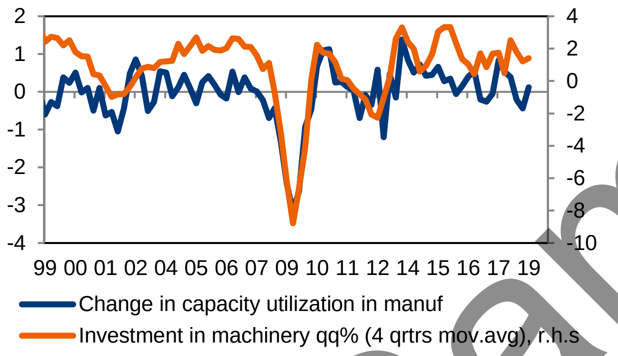
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 4 – Demand in Asia is supportingSpanish exports



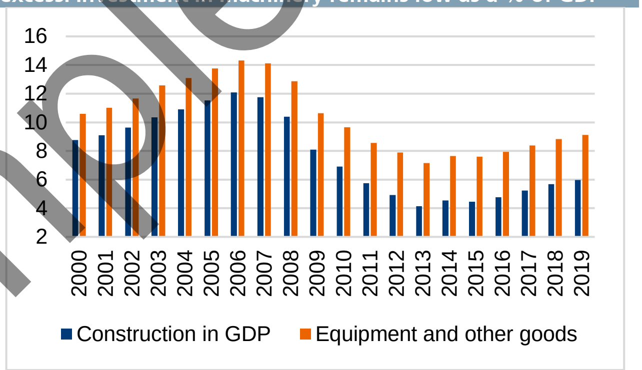
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

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



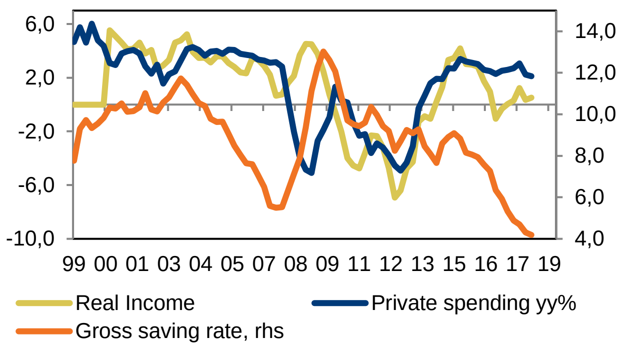
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 6 – Construction has recovered but for now there is no excess. Investment in machinery remains low as a % of GDP



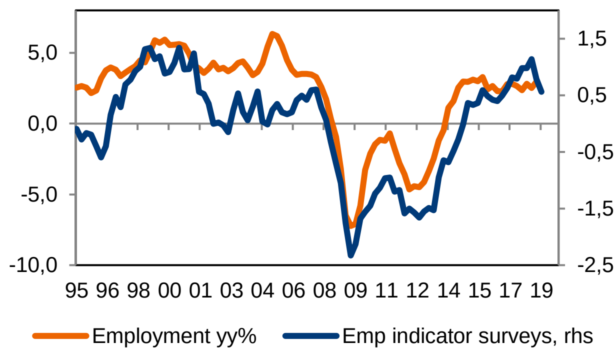
Source: Intesa Sanpaolo chart from Thomson Reuters-Datastream data

Fig. 7 – Consumption has now peaked. Households are spending more of their income. Savings rate still falling and below 2007 lows



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

Netherlands: the economy slows, risks for outlook increase

Guido Valerio Ceoloni

In the context of a slowdown, the fourth quarter was unexpectedly positive

The fourth quarter was unexpectedly positive for the Netherlands, which saw a jump in GDP to 0.5% q/q, up from 0.1% q/q, while the other main economies in the Euro zone slowed or at best remained stable. A detailed analysis shows that the main contribution came from domestic demand (0.5), but foreign trade also made a significant contribution (0.4), which compensated for the virtually full reduction in inventories (-0.4). **We predict a slowdown in growth of two decimal points for this quarter, to 0.3% q/q, with an annual change of 1.6%, down from 1.8%. GDP should normalise to around 1.5% in 2019, down from 2.5% in 2018**, revised upwards by one percentage point compared to the previous estimate.

Household confidence started to fall for the first time since 2015

Having stagnated in autumn, **consumption** increased by 0.5% q/q at year-end, with an annual profile of 2.5% for 2018, up from 1.9% for the previous year. We estimate a slowdown of 0.3% q/q for this quarter, with expected annual growth of 1.5% in 2019. Confidence surveys in January and February showed **a deterioration in household confidence for the first time since 2015**, with the propensity to spend also being undermined; data on household spending in January shows annual growth stationary at 0.9%, the lowest since June 2016. A slowdown in the rate of consumption was expected after four years at a sustained rate and this should not be seen as a warning sign but rather as the unsurprising result of a normalisation of growth, supported by the stability of salary levels. The job market is in fact still extremely positive, with **unemployment figures at pre-crisis levels** (around 310 thousand people, at 3.4% compared to 3.6% in 2008). Over the course of the year we predict that the **unemployment** rate will stabilise at its current level (3.5%) and that employment will remain at its current level of 68.5%.

Investment in moderation, the property bubble risk increases

The **fixed investment** sector recorded a jump to 0.7% q/q, up from -0.1% q/q: in detail, the **production investments** component fell from -2.0 q/q to -2.2% q/q, in line with the weak manufacturing trend for the entire Euro zone. Conversely, **residential investment** was +2.7% q/q, up from -0.6% q/q, still stimulated by constant growth in the property market. Having reached the maximum pre-bubble rates of August 2008 in May of last year, **house prices reached a new record high in January**. Compared to 2013, the average house price is now 35% higher and the number of sales in January and February continues to increase. It is now clear that the slowdown in the residential component in the third quarter was merely a pause, and not yet the start of a reversal of the trend. In this sense, **the trend in property prices poses the main domestic risk** to growth, as it could lead to bursting of a new property bubble, something which removed over half a percentage point from GDP growth between 2012 and 2013. For 2019, fixed investment is expected to slow to 2.0%, down from 4.7% in 2018, with the production component less lively than the residential component, which is still stimulated by accommodating financial conditions.

At the end of 2018 foreign trade remained surprisingly positive

As yet, **foreign trade** does not seem to have suffered from the manufacturing slowdown, having contributed 0.4 to GDP in the last quarter. The abrupt slowdown in **imports** (-2.1% q/q, down from 1.2% q/q) due to the fall in investment in machinery in the quarter helped the trade balance, but despite this there was a fall in **exports** of -1.3% q/q, down from +1.1% q/q due to the drop in German manufacturing. Rebounding of exports in January had a positive impact on the first quarter, in which we expect a positive contribution from foreign trade. The annual average for exports is expected to slow to 1.9% y/y, down from 2.6% y/y, due also to the effect of greater uncertainty in global trade (in particular in the US market, which is the fourth largest for Dutch exports). Imports slowed from 2.6% y/y to 2% y/y due to the reduction in consumption. **This year the net contribution of exports to growth is likely to be negative**.

Inflation: this year it will hover around 1.8%

In harmonised terms, **inflation** remained stable from autumn at around 1.8%, due to the compensating effect of the drop in energy prices on one hand, and the rise in the **core component** on the other, which accelerated by two decimal points in autumn, ascending to 1.2% and then proceeding to grow further at the start of 2019 (in February it was at 1.9%), this time due to the increase in the minimum VAT rate from 6% to 9%. The headline index is currently at 2.6% as of February, but it is expected to moderate in the next few months and result in an annual average of 2%. 2019's core index is moving towards 1.9%.

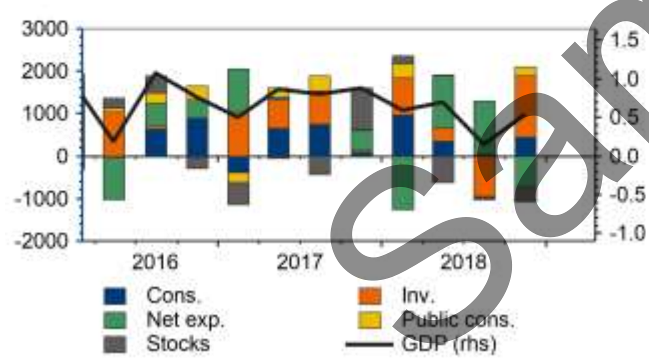
Assessment of the economy cannot but be viewed as positive, particularly when compared with other countries in the Euro zone. However, confidence indicators point to a change in direction after years of economic growth and at the same time **increase risks to the forecast, both on the domestic front**, where the continuing surge in house price levels beyond historical records lead to fears the property bubble is close to bursting, **and abroad**, where turbulent global trade and conflict between the Euro zone and the US on tariffs and duties could have serious repercussions on an economy as open as the Dutch one. **These factors of uncertainty mean our forecast for the current year is slightly tilted to the downside.**

Macro forecasts

	2018	2019f	2020f	2018				2019p				2020p	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	2.5	1.5	1.4	3.1	2.9	2.3	1.8	1.6	1.3	1.6	1.6	1.6	1.5
- q/q change				0.5	0.7	0.1	0.5	0.3	0.4	0.4	0.5	0.3	0.3
Private consumption	2.4	1.5	1.6	1.4	0.2	0.0	0.5	0.3	0.5	0.5	0.6	0.3	0.3
Fixed investment	4.7	2.0	2.0	2.3	0.7	-0.1	0.7	0.5	0.5	0.6	0.6	0.5	0.4
Government consumption	1.1	1.1	1.0	0.4	0.1	0.0	0.5	0.3	0.3	0.2	0.2	0.3	0.3
Export	2.6	1.9	2.9	-0.5	1.3	1.1	-1.3	0.7	0.8	1.0	0.9	0.6	0.6
Import	2.5	2.0	3.4	0.4	0.3	1.2	-2.1	1.0	1.3	1.3	1.1	0.7	0.6
Stockbuilding (% contrib. to GDP)	-0.1	0.0	0.1	0.1	-0.5	0.1	-0.4	0.1	0.3	0.1	0.1	0.0	0.0
Current account (% of GDP)	9.9	9.4	9.3										
Deficit (% of GDP)	1.1	1.0	1.3										
Debt (% of GDP)	53.2	49.6	46.9										
CPI (y/y)	1.6	2.0	1.2	1.3	1.5	1.8	1.8	2.4	2.3	1.8	1.3	0.7	0.8

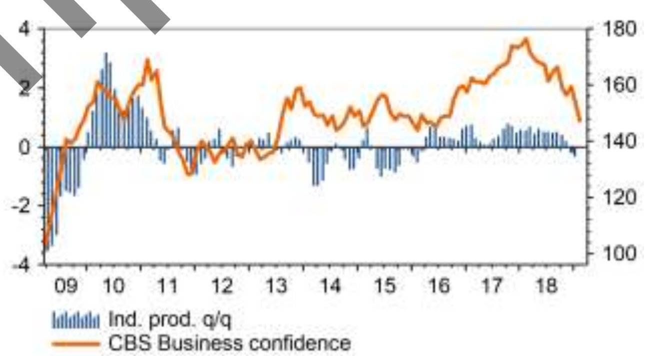
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Contribution to GDP



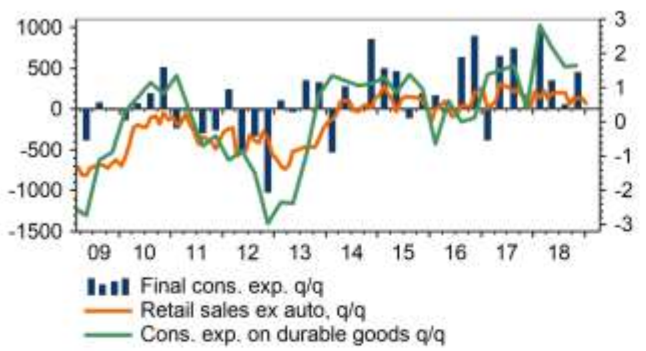
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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

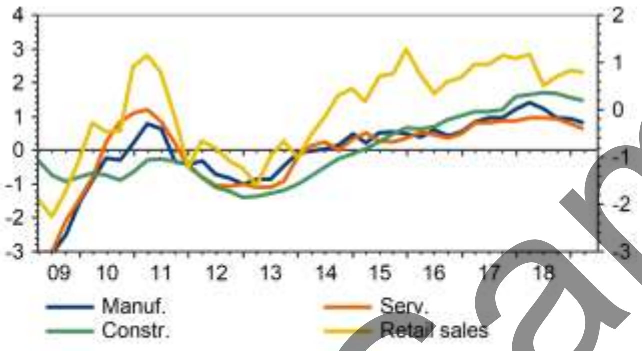
Fig. 5 – Residential investment, construction sector activity and house prices

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

Fig. 6 – Industrial output and GDP

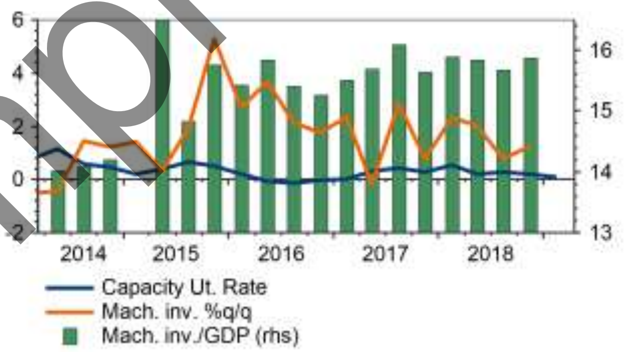
Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

Fig. 7 – Activity indices in the various production sectors



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

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

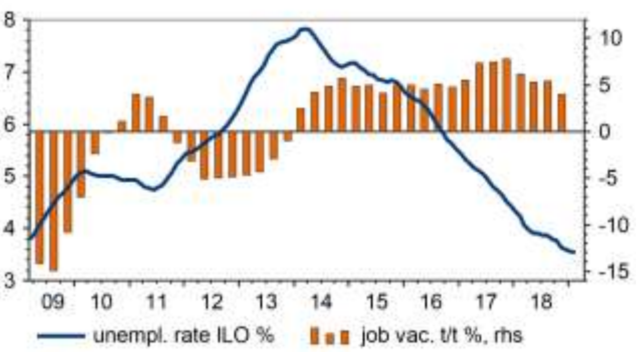


Source: Intesa Sanpaolo Research Department chart from Thomson Reuters-Datastream data

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: clouds gathering over the 2019-20 scenario

Giovanna Mossetti

Japanese growth was volatile in 2018 (fig. 1), but positive, with a yearly change of 0.8%, despite two non-consecutive quarterly contractions. **The scenario for 2019 has been deteriorating** rapidly since the end of 2018. Economic data and surveys are pointing down and the coincident index has dropped into potentially recessive territory. The sharp deterioration of the growth outlook in Japan is mostly due to the contraction of **exports to China**. The current slowdown is particularly risky, given the **consumption tax** (CT) hike from 8% to 10%, scheduled for October.

Forecast **growth is 0.7% in 2019 and 0.3% in 2020,** with risks skewed to the downside. Core **inflation** should stay below 1%, with a likely slowdown late in the year, net of the CT hike. Given this picture, the scenario will be highly dependent on fiscal policy decisions. The budget has set the date of the **CT hike in October, together with expansionary measures aimed at countering its effects.** In case of a further cyclical slowdown, on the eve of the renewal of the Lower House, the government could opt for an emergency budget, or even postpone the CT hike. The **BoJ could signal its readiness to support growth,** although the instruments at its disposal are now limited and would probably prove ineffective.

1. The economic outlook is fragile, rocked by exports and the consumption tax. GDP growth is expected to contract in 1Q 2019 (-0.4% q/q), followed by two solid quarterly increases, thanks to the bringing forward of spending ahead of the CT hike and to the positive contribution of public investments. In the autumn, GDP is forecast to contract sharply, in correspondence with the fiscal tightening. The entry into 2020 should prove weak, although it will continue to be supported by spending tied to the Olympic Games and to the reacceleration of consumption and investments. A central role will be played by net exports, forecast still weak.

The **consumption trend** will be supported by the positive labour market conditions, still in a phase of excess demand, although wages remain on a modest uptrend. As has been the case in the past, households are preparing for the CT hike with an **increase in savings** (Fig. 4). In the second half of the year, the savings trend should correct to finance the pre-tax hike spending spree, supported also by fiscal easing on other fronts. Demographic factors will contribute to increase the saving rate on a structural base in the medium term. In 2019, consumption will be extremely volatile (see forecast table), and an assessment of the underlying trend will be possible only late in 2020, probably pointing to average growth rates of around 0.2%-0.3% q/q. **Personal spending is expected to increase by 1% in 2019, and to drop in 2020 by -0.2%.**

Non-residential investment should slow significantly, in light of the weak survey and activity data (orders and output), in addition to the sharp drop in earnings in 2H 2018 (-7% y/y at year-end). Currently, the main driving force for investment is the need to increase productivity, due to the persistent shortage of labour. The trend should continue in the next few years, also supported by expansionary monetary conditions, with a likely temporary downturn in 4Q 2019, due to the CT hike. On average, investment growth in 2019 should remain positive, helped by spending for the 2020 Olympic Games. **Private capex is forecast to increase by 2.2% in 2019 and by 1.5% in 2020**.

Net exports took a negative turn in 2018 (fig. 5), with a likely negative contribution to overall growth in 2019. The weakness of exports is the dominant factor on the 2019-20 horizon: the outlook depends crucially on the trend of the Chinese economy (Fig. 6). The trade balance will also be affected by the impact of the CT hike, with highly volatile imports in the second half of the year. A surge in imports in the summer should be followed by a sharp correction in the autumn, with the annual **contribution ultimately proving sharply negative (-0.6 pp).**

2. The CT hike will be partly counterweighed by expansionary spending measures. The budget for FY 2019 provides for a CT hike from 8% to 10% (excluding food). Part of the tax revenues generated by the CT increase (around 5.2 trillion, or 0.9% of GDP) will finance extra-spending, among which the cancellation of day-care and some higher education fees, and greater welfare support for the senior citizen cohorts. Temporary expansionary measures will also be put in place to support the lower income brackets (consumption vouchers, home purchase benefits), and public investment for disaster prevention projects. The government has confirmed its fiscal consolidation goal, expecting to cut both the overall and primary deficits in fiscal year 2019 and in the foreseeable future. **The net effect of the CT hike should be moderately restrictive,** by around 2 trillion, i.e. 0.4% of GDP. For the government, the decision to postpone the CT hike would be politically costly, after years of preparation, and would be considered only in case of a recession in the central part of 2019; an emergency budget cannot be ruled out. Twenty-nineteen is an important year on the political front, with local elections throughout the country in April, the abdication of the Emperor at the end of April, and elections for the Upper House in July, in addition to the possible dissolution of the of Lower House, should the prime minister be confident in winning a majority that would allow changes to the constitution. The survival of the recovery will be essential in consolidating consensus for the government on the eve of the CT hike.

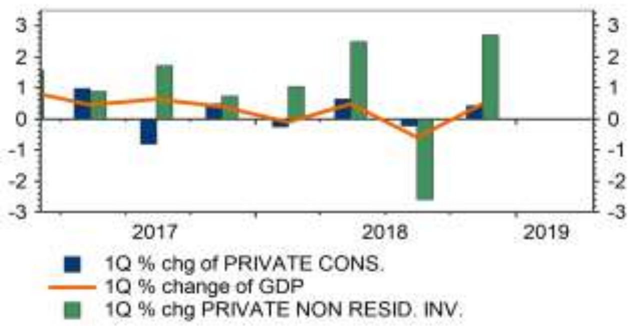
3. Monetary policy: the BoJ's power to support the recovery is close to nil, but ongoing JGB purchases are reducing debt-related risks. The central bank is still forecasting a moderate expansion, although lately it has stressed the downside risks tied to US policies and their impact on the financial markets, tariffs, Brexit, and geopolitical factors. The quantitative and qualitative easing policy, with curve control, will continue until inflation rises stably above the 2% goal, therefore probably at least through end-2020. The BoJ's leeway to add further stimulus is virtually nil, as interest rate targets are at levels hard to go lower (-0.1% for the overnight rate and for the 10-year yield) and targeted net purchases of JGB of around 80 trillion yen have no longer been achieved since curve control was introduced. JGB purchases have levelled off at just below 40 trillion yen in the past year (Fig. 9). The only tool at the central bank's disposal could be increasing ETF purchases, with minimal effects. In case of a further worsening of the economic picture, only fiscal policy has room for action, through the delay of the scheduled CT hike and/or spending increases. However, the **impact of monetary policy on the longer-term scenario** should not be underestimated: in September 2018, the BoJ held 45.7% of JGBs and 43% of total public debt. Public debt amounts to 198% of GDP. The continuation of net purchases, even only at a pace of around 30-40 trillion per year, would increase the BoJ's share to over 50% by the end of 2021. While the fiscal policy path remains oriented towards future consolidation (Fig. 10), public debt held by the market would continue to decrease, dropping below 100%, with limited interest costs. As a result, **Japan's fiscal imbalances are becoming progressively less risky.**

Macro forecasts

	2018	2019f	2020f	2018				2019p				2020p	
				1	2	3	4	1	2	3	4	1	2
GDP (constant prices, y/y)	0.8	0.7	0.3	1.4	1.4	0.2	0.3	0.6	0.4	1.5	0.2	0.3	0.2
q/q annual rate				-0.4	1.9	-2.4	1.9	0.8	1.2	2.0	-3.0	0.9	0.9
Private consumption	0.4	1.0	-0.2	-1.0	2.6	-0.9	1.6	1.6	1.8	4.3	-9.3	2.0	1.5
FI - private nonresidential	3.9	2.2	1.5	4.3	10.4	-10.0	11.3	0.8	2.0	3.2	-1.4	2.1	1.9
FI - private residential	-5.8	1.9	-2.9	-7.8	-7.8	2.3	4.6	2.4	4.4	5.3	-11.8	-5.9	0.0
Government investment	-3.3	-1.6	1.6	-2.9	-2.9	-8.8	-6.8	1.0	2.1	2.2	2.3	1.2	1.2
Government consumption	0.8	1.0	0.7	0.9	0.6	0.9	3.0	0.4	0.5	0.6	0.7	0.7	0.7
Export	3.1	-0.8	3.2	1.4	1.8	-5.6	4.0	-8.5	3.4	4.3	3.1	3.1	3.0
Import	3.2	2.5	1.0	0.2	5.3	-2.6	11.3	-2.8	5.2	6.9	-8.8	2.5	2.4
Stockbuilding (% contrib. to GDP)	0.2	0.1	-0.3	-0.5	-0.2	0.5	0.1	0.5	-0.1	-0.8	0.6	-0.6	-0.6
Current account (% of GDP)	3.5	2.5	3.0										
Deficit (% of GDP)	-3.4	-3.5	-3.2										
Debt (% of GDP)	227.2	227.9	227.7										
CPI (y/y)	1.0	0.9	1.2	1.3	0.7	1.2	0.8	0.3	0.5	0.9	2.0	1.5	1.4
Industrial production	0.9	-2.0	-0.5	2.0	1.3	-0.1	0.7	-2.1	-2.3	0.5	-3.9	-0.5	-0.6
Unemployment (%)	2.4	2.4	2.3	2.5	2.4	2.4	2.4	2.5	2.4	2.4	2.3	2.3	2.3
JPY/USD	110.4	110.7	111.3	108.3	109.1	111.5	112.7	110.2	110.6	110.9	111.3	111.8	111.7

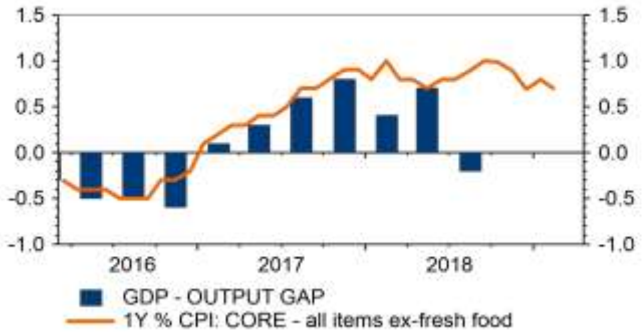
Annualised percentage changes on the previous period – unless otherwise indicated. Source: Thomson Reuters-Datastream, Intesa Sanpaolo

Fig. 1 – Volatility around a moderate growth trend in 2018, but 2019 will be weaker



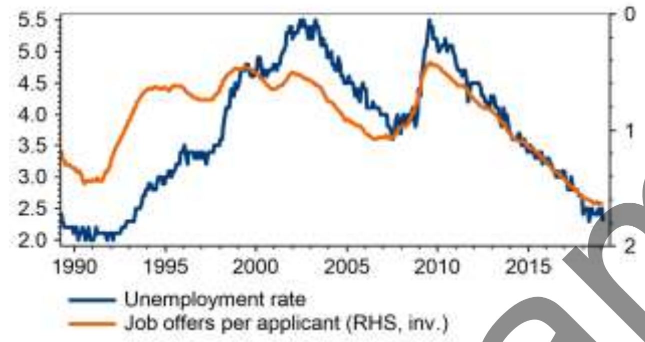
Source: Thomson Reuters-Datastream

Fig. 2 – The slowdown of the output gap does not bode well for inflation



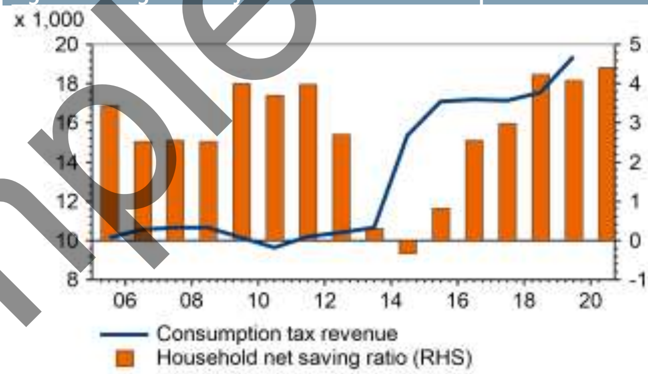
Note: Stime Cabinet Office. Source: Thomson Reuters-Datastream

Fig. 3 – Labour market still in excess demand conditions



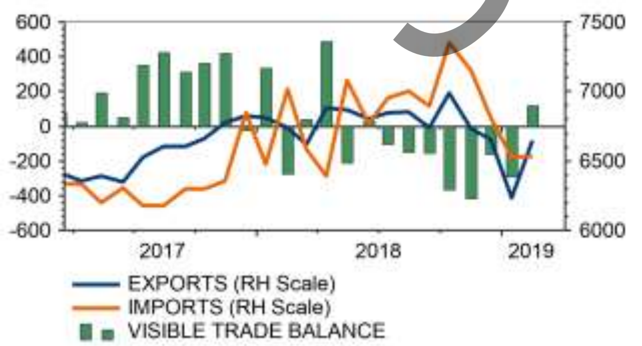
Source: Thomson Reuters-Datastream

Fig. 4 – Savings volatility before and after consumption tax hikes



Source: Thomson Reuters-Datastream

Fig. 5 – – Net exports: negative trend, but with a modest rebound at the beginning of 2019

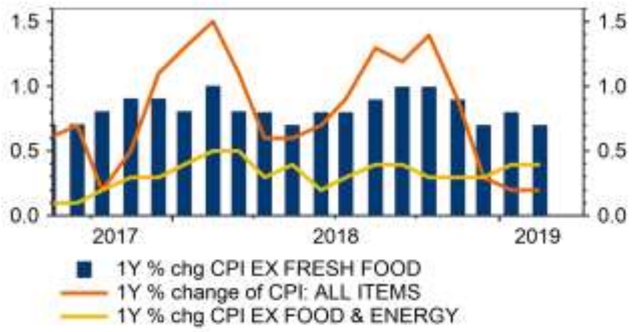


Source: Thomson Reuters-Datastream

Fig. 6 – Trade deficit explained by exports to China and the rest of Asia

Source: Thomson Reuters-Datastream

Fig. 7 – Inflation showing no sign of moving towards 2%...



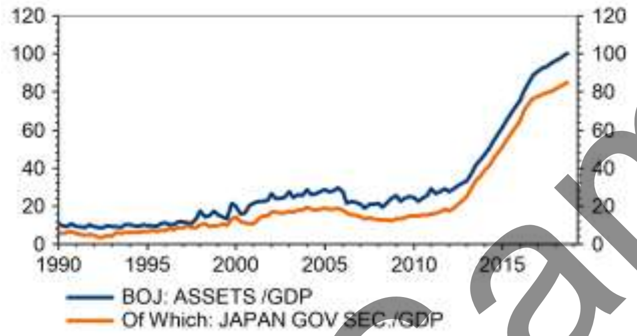
Source: Thomson Reuters-Datastream

Tab. 1 ...and the BoJ keeps revising its forecasts downwards

	Real GDP	CPI less fresh food	CPI less fresh food excluding the effects of the consumption tax hike and policies on free education
FY 2018	0.9	0.8	
forecasts Oct 2018	1.5	0.9	
FY 2019	0.9	1.1	0.9
forecasts Oct 2018	0.8	1.9	1.5
FY 2020	1.0	1.5	1.4
forecasts Oct 2018	0.8	1.6	1.5

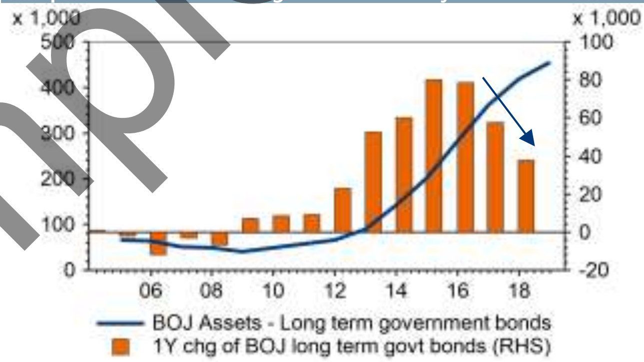
Source: BoJ, Outlook for Economic Activity and Prices, gennaio 2019. La BoJ stima che l'effetto del rialzo dell'IC sia pari a un aumento di circa 0,5pp sull'inflazione core e che l'eliminazione delle rette scolastiche riduca l'inflazione di -0,3pp nell'a.f. 2019 e di -0,4pp nell'a.f. 2020.

Fig. 8 – The BoJ's assets have reached 100% of GDP, and JGBs held by the central bank amount to around 80% of GDP



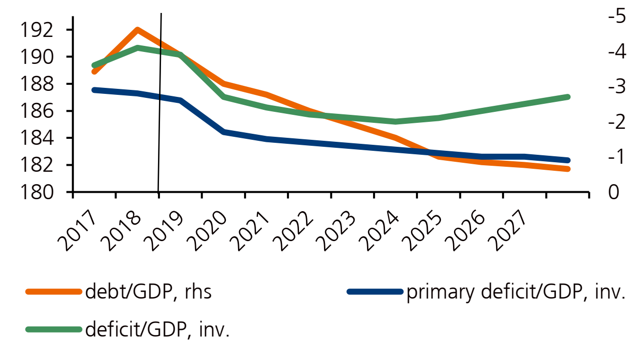
Source: Thomson Reuters-Datastream

Fig. 9 – Annual purchases of JGBs in 2017 declined consistently compared to the initial target of 80 trillion yen



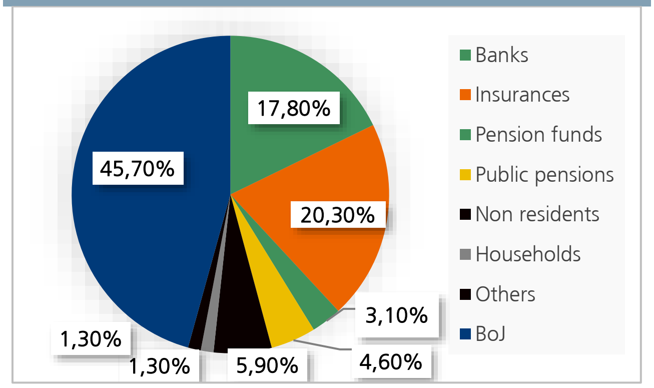
Note: dati in mld di yen. Source: Thomson Reuters Datastream

Fig. 10 - Fiscal policy progressing towards a sustainability scenario



Source: Cabinet Office

Fig. 11 – Share of JGBs held by the BoJ above 45%



Note: data as at the end of September 2018; total JGBs: 994.8 trillion yen. Memorandum: total JGBs+Tbills = 1091.6 trillion yen. Non-residents hold 69.6% of T-bills. The average life of bonds is 8 years and 10 months. Source: Ministry of Finance

China: flexibility to stabilise growth

Silvia Guizzo

In 2018, GDP grew by 6.6%, a moderate slowdown on the figure of 6.8% of 2017 and just above the government's target, with a gradually decelerating trend from 6.8% yoy in 1Q to 6.4% in 4Q. On the demand side, **the more modest pace of growth in 2018** was **primarily the effect of the slowdown in investment**, and in particular **the brake on infrastructure investment** (from 19% in 2017 to 3.8% in 2018); the slowdown in foreign trade also played a role in the last part of the year. **Real household consumption in per capita terms grew by 6.2% yoy in 2018, up from 5.4% in 2017,** but less robustly than in 2015-16 (6.9%), and slightly slowing in 4Q. The deceleration in nominal retail sales (from 10.2% yoy in 2017 to 9% in 2018) could in part be due to the slowdown in public expenditure (from 8.5% yoy in 2017 to 6.5% in 2018), as these also include sales of consumer goods to government and military agencies and institutions. Retail sales were depressed by the fall in car sales (-2.8% yoy) and in cyclical sectors such as sport and leisure goods (-2.7% yoy), with both trends continuing in the first few months of 2019.

The January and February figures, although difficult to interpret due to the variable timing of the Chinese New Year holidays, **were mixed**. **Retail sales growth slowed year-on-year, while the monthly trend improved steadily** from the lows seen in 3Q18, in line with the increase in consumer confidence shown by the National Bureau of Statistics (NBS). The flow of new **aggregate lending**, which fell by 14% in 2018, rose 24.4% yoy in the first two months of 2019, buoyed up by bank lending and the rebound in issues of corporate bonds and local government special bonds, thus **stabilising annual growth in outstanding loans** to 10% yoy in February from the low of 9.8% in December. Growth in total nominal capital investment improved marginally thanks to the **recovery in infrastructure investment** and the upturn in real estate investment. Conversely, **investment in the manufacturing sector weakened further**. Meanwhile, **foreign trade slowed**, as did added value of industrial output, despite the rebound in private sector production and the moderate improvement in domestic orders.

A **further easing of monetary policy, together with the numerous tax measures to support companies and consumers** announced at the recent spring session of parliament[9], **should help stabilise investment and provide support to private consumers in 2019.** Presenting the government's Labour Report, Premier Li Keqiang announced tax cuts equivalent to 2% of GDP, and significantly increased infrastructure spending at both local and central government level in order to achieve a growth target within the range of 6.0%-6.5%.

The Premier stressed the **authorities' opposition to a huge runaway stimulus** and reiterated the message already sent out over the past few months, namely that the government intends **to stabilise growth with the utmost attention to employment**. At the same time, it will continue to pursue the three main objectives announced last year, i.e. reducing financial risk, poverty and pollution. Fiscal and monetary policy will seek to make **countercyclical adjustments to sustain economic growth and stabilise debt**, with a particular focus on alleviating the **difficulties experienced by small and medium-sized enterprises (SMEs)**, for which **conditions deteriorated further in the first two months of the year**. **Overall**, compared with previous years, the authorities have allowed themselves **greater room for manoeuvre to adjust economic policy to changes in the cycle**, as they are aware of the strong downside risks to the scenario.

The governor of the People's Bank of China (PBoC) has commented that there is **room for further cuts in the reserve requirement ratio (RRR), but much less so than in previous years.** He stressed the need to continue interest rate market reform[10], while promoting greater

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[9] For more details, see the China Focus Economy report dated 14 March 2019.

[10] For more details, see the China Focus Economy report dated 6 December 2018.

transparency and a better functioning of bankruptcy proceedings. In addition, Yi Gang repeated that there will be **greater flexibility in determining the renminbi exchange rate; this will continue to be driven by market forces**, leaving the door open to **greater variability in the exchange rate in 2019 too**. We expect that the PBoC will maintain ample liquidity through various refinancing windows in 2019 and make a further **two cuts in RRR** (totalling 200 bps) and **in refinancing operation rates** (totalling 30 bps); at the same time they will still seek to avoid benchmark rate interventions, barring a greater-than-expected slowdown in economic growth.

We therefore continue to forecast a slowdown in GDP growth to 6.3% in 2019 and 6.1% in 2020; we believe that if significant downside risks were to materialise with negative effects on employment, the authorities would be inclined to further relax fiscal and monetary policy to sustain growth. **Consumer price inflation**, which fell to a minimum of 1.5% yoy in February due to a slowdown in food, fuel and service prices, **is expected to remain at or below 1.9% in 2019 and 2.1% in 2020**; this is due to the absence of demand pressure and expectations of only moderate price increases in commodities.

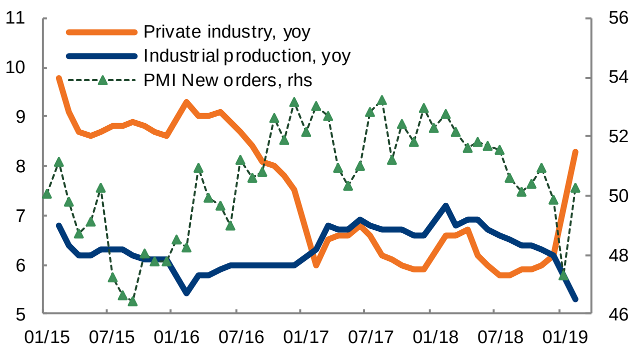
Risks to the outlook remain to the downside and stem from **the uncertainty as to how the trade dispute with the USA will develop**, even after a probable agreement in principle that will have positive short-term effects, and a **greater-than-expected slowdown** in lending, given the authorities' repeated desire to keep debt levels stable. The hoped-for increase in lending to small and micro-enterprises (30% yoy from the large banks according to government indications) could lead to a reduction in the other components of the total aggregate; this would limit growth, which has already been curbed by the increase in non-performing loans. Moreover, despite the announced tax cuts, the increase in the deficit target is very small (from 2.6% to 2.8%), which suggests there will be a **reduction in public spending trend growth and/or a search for new sources of revenue**. Lastly, **consumer spending could be adversely affected by the expected slowdown in the property market and a cyclical deterioration in the labour market.** The ratio of labour demand and supply remains comfortably above 1, due *inter alia* to the fall in the working age population which started in 2014 and will continue in the years to come. Nonetheless, weaker labour market conditions are indicated by the increase in the urban unemployment rate to 5.3% in February from a low of 4.8% in October, the slight fall in the Manpower survey for 2Q19, and the worsening of the employment component of the PMI, including in the service sector.

Forecasts

	2015	2016	2017	2018	2019	2020
GDP (constant prices)	6.9	6.7	6.8	6.6	6.3	6.1
Private consumption	8.1	8.2	6.7	6.7	6.9	6.7
Public consumption	7.7	9.7	8.9	11.2	6.8	5.9
Fixed investment	7.3	6.7	4.8	4.4	4.5	4.7
Exports	0.1	1.8	6.5	4.7	2.3	4.2
Imports	0.8	3.3	7.7	6.9	3.4	5.4
Industrial output	6.2	6.3	5.9	5.8	5.1	4.7
Inflation (CPI)	1.4	2.0	1.5	2.1	1.9	2.1
Unemployment rate (%)	4.0	4.0	3.9	3.8	3.8	3.8
Average salaries	9.7	9.5	10	8.9	7.6	7.4
90-day interbank rate (average) (%)	3.80	3.00	4.70	4.00	2.95	2.80
10-year government bond yield (average) (%)	3.05	2.91	3.85	3.45	3.10	3.15
USD/CNY exchange rate (average)	6.28	6.64	6.76	6.62	6.76	6.75
Current account balance (CNY Bn)	1912	1335	1109	353	255	230
Current account balance (% of GDP)	2.8	1.8	1.4	0.4	0.3	0.2
Budget Balance* (% of GDP)	-2.8	-3.7	-3.9	-4.1	-4.1	-4.1
Public Debt - Central Government (% of GDP)	15.1	15.7	15.8	16.0	16.4	16.9

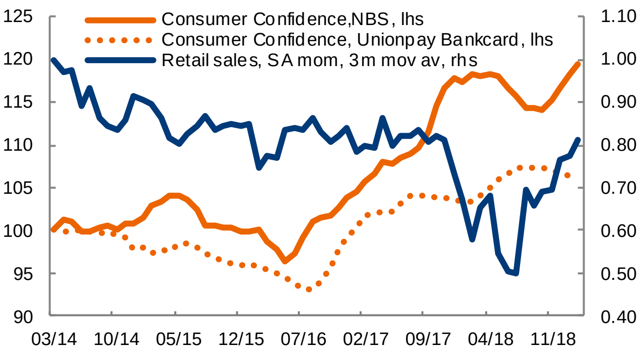
NB: Percentage change versus previous period – except where otherwise indicated; *IMF Article IV, July 2018. Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

Industrial output and orders



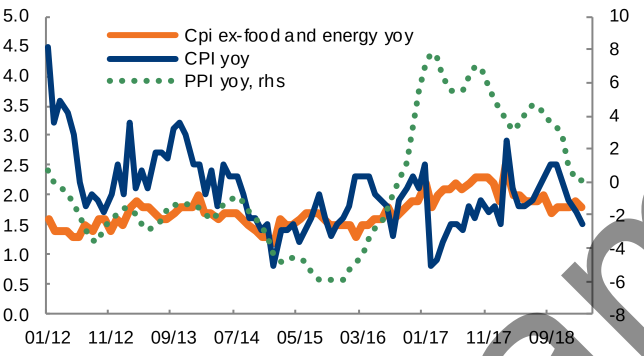
NB. cumulative industrial output, yoy change
Source: CEIC, IHS Markit

Retail sales and consumer confidence*



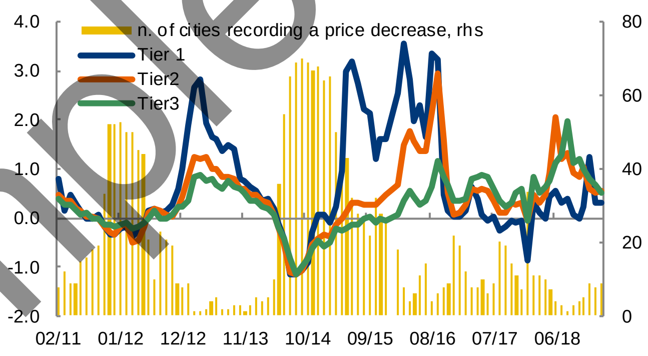
NB. * 3-month moving average, rebased to March 2014=100. Source: CEIC

Inflation



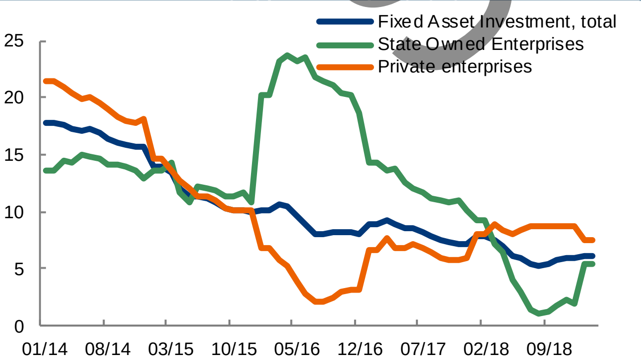
Source: CEIC

Property prices



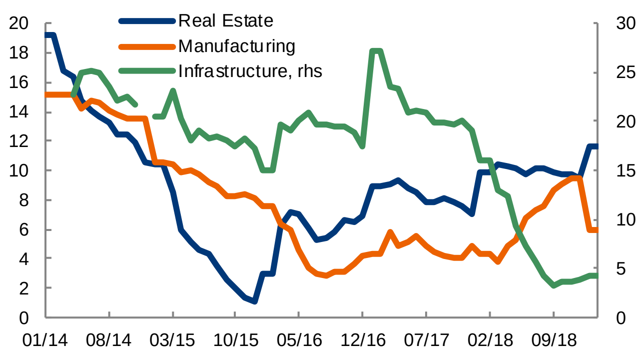
NB. mom average change for 70 cities surveyed, primary market.
Source: Intesa Sanpaolo chart from CEIC data

Nominal investment by type of company, yoy



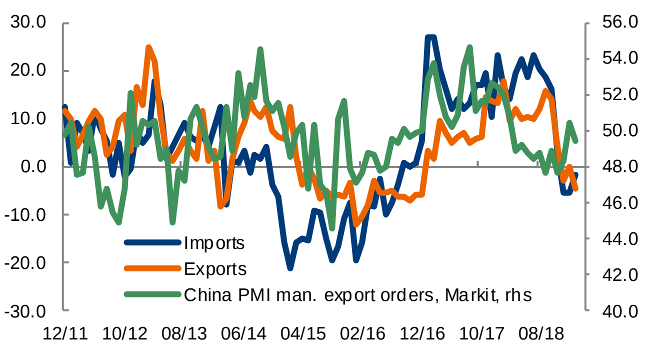
Source: CEIC

Nominal investment by sector, yoy



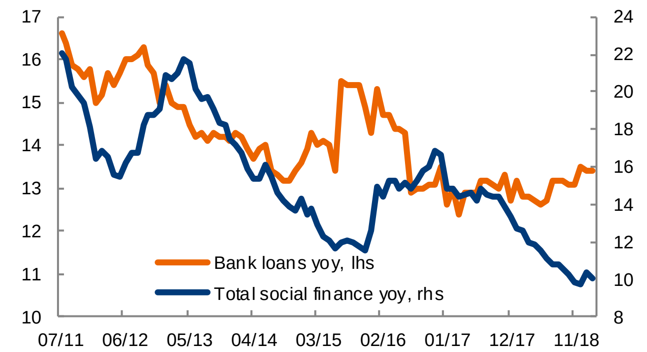
Source: CEIC

Foreign trade



NB. Seasonally-adjusted data, average for January and February.
Source: Intesa Sanpaolo chart from CEIC and IHS Markit data

Aggregate lending

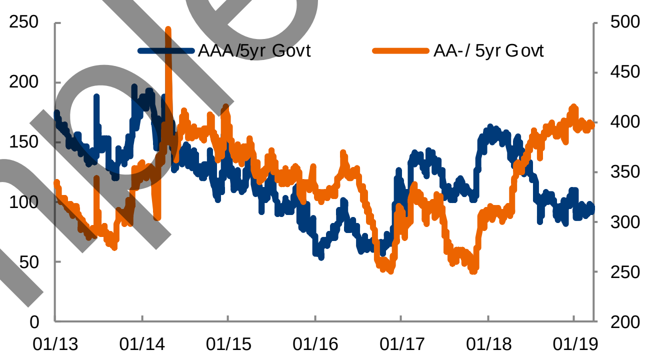


Source: Intesa Sanpaolo chart from CEIC data

Stock markets

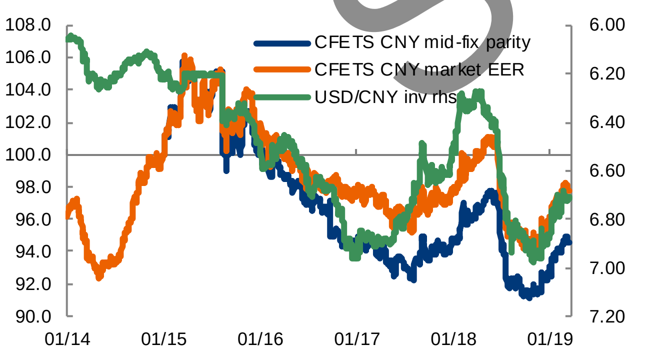
Source: Bloomberg

Corporate spread



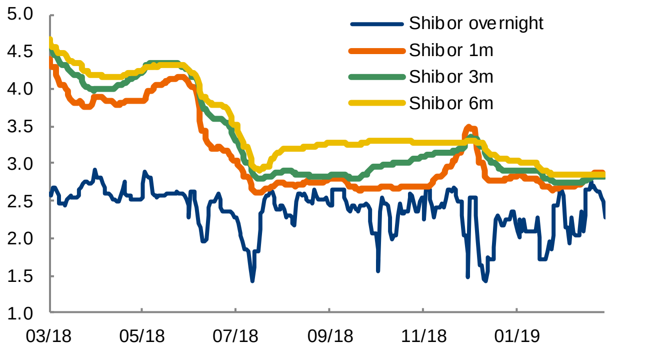
Source: CEIC, Bloomberg

Exchange rate



Source: Bloomberg

Monetary rates



Source: Bloomberg

India: economic slowdown and "competitive populism"

Silvia Guizzo

At the end of February, the Central Statistical Office sharply upgraded its GDP figures for 2016 and 2017. **GDP growth was revised** from 7.9% **to 8.6% for 2016 and** from 6.2% **to 6.6% for 2017,** these upwards revisions relating to the last three quarters of each year. Annual growth in 2018, which had been revised down slightly in 2Q and 3Q, gradually slowed from 8% yoy in 2Q to 6.6% yoy in 4Q. **2018 closed with growth of 7.3%**, two-tenths of a percentage point below our forecast. The combination of a significant unfavourable base effect, the moderation in public spending and the ongoing negative contribution of foreign trade led to a slowdown in Q4. Consumer spending continued at a sustained pace (8.4% yoy), although slightly lower than the peak of 9.8% in 3Q; meanwhile, investments continued their upward momentum (10.6% yoy compared with 10.2% in 3Q). On the supply side, growth in value-added GDP slowed to 6.3% yoy in 4Q, from 6.8% in 3Q, weighed down by the slowdown in the agriculture and services sectors.

The year-end figures continue to generate mixed signals. Three-monthly **industrial output** slid from 6.0% 3m yoy in October to 1.5% 3m yoy in January due to the decrease in the output of capital and intermediate goods. The improvement in the manufacturing sector PMI, which rose from a low of 53.2 at the end of December to 54.3 in February as a result of an **increase in domestic orders**, should, however, lead to a reversal of this trend in the next few months. Conversely, the moderate decline in the PMI services index compared with the last few months of 2018, and the slowing of tourist numbers and passenger traffic indicate that the sector is moderating.

Business confidence surveys gave conflicting messages for 1Q: the RBI survey was up in line with the trend for the PMIs, returning to the levels seen in the first half of 2018, while the D&B survey dipped to the low seen in 4Q17. Foreign trade continued to decelerate in the first two months of the year; this was also the case if oil is excluded. A moderate **deceleration in foreign orders** from their November peaks and the **yoy fall in international freight traffic** indicate that exports could slow further in the next few months. In contrast, domestic orders and domestic freight traffic continue to show a moderate improvement. The recovery of **investments** would seem, for the most part, to be driven by public infrastructure, and the outlook for private investment growth is still uncertain. Machinery imports have also shown signs of weakness and the modest rise in lending to industry (5.1% yoy in January) is still being driven by loans to the construction and infrastructure sectors, while lending to other sectors has flattened out.

According to the RBI survey, despite the moderate improvement in 4Q, **consumer confidence has remained firmly in negative territory** (below 100) since mid-2017. However, expectations have bounced back to near end-2016 highs, opening up the biggest gap with the current assessment since the series was launched. Passenger traffic also slowed in January and yoy growth in car sales continues to slide, dragged down primarily by the fall in sales of two and three-wheeled vehicles. The Centre for Monitoring the Indian Economy (CMIE) forecasts a rise in unemployment rate from 5.9% in February 2018 to 7.2% in February 2019, with a fall in the participation rate. The improvement in consumer confidence confirmed by the BSE survey, which exceeded 100 in the first two months of the year, is the only positive element in the overall picture of a slowdown in consumer spending.

In February, the government presented its **interim budget for the 2019-20 financial year**, which will be put before the new parliament following the elections scheduled to be held between 11 April and 19 May. Given the slowdown in government revenues, and particularly revenue from indirect taxation and the proceeds of public sell-offs, the government has slightly **revised its estimate of the public deficit for the 2018-19 financial year to 3.4% of GDP from its initial target of 3.3%**. It has proposed a **target that is stable at 3.4% of GDP for the 2019-20 financial year,** but much higher than the target of 3.1% announced last year, **further postponing to next year the reduction to 3%.** The key measures relate to a support package for farmers and tax incentives for individuals that will benefit the middle class. The **support package for farmers was widely anticipated** following the strong protests in 2018 and the disappointing electoral results for the BJP in the regional elections in December, and particularly in light of the forthcoming political elections and the aggressive electoral campaign conducted by the opposition. The Congress party, led by Rahul Gandhi, has already called for a reduction in farmers' debt in the provinces it governs and promised a guaranteed minimum income for poor people in its current electoral campaign, against a backdrop of spiralling competitive populism. The package targets some 120 million small farmers (owning up to 2 hectares of land) and provides for the direct transfer of INR 6,000 (around EUR 77), split into three instalments with the first scheduled to be paid by 31 March, together with beneficial interest rates on certain types of loan. The reduction in personal income tax has taken the form of tax repayments, exemptions, allowances and deductions. One of the key measures was an increase to INR 50,000 of the standard deduction from earned income of 40,000 rupees. The Government then announced a monthly pension of INR 3,000 from the age of 60 for workers in the informal sector who earn up to INR 15,000 a month, a measure that is expected to encompass 100,000 workers and for which INR 5Bn has been earmarked, although this figure is set to rise in the long term.

The fall in inflation led the **RBI** not only to change the its monetary policy from calibrated tightening to neutral at its meeting on 7 February, but also to cut its rates by 25 bps, bringing the repo rate to 6.25%. Consumer price inflation continued to hover at the lower end of the RBI's target range (4% ± 2%) in the last few months of 2018, falling to a low of 2% yoy in January, due to the fall in food and fuel prices and the moderation of core inflation. Inflation rose to 2.6% in February as a result of an adverse base effect and ongoing sustained growth in housing, health and personal-care costs. A favourable base effect should limit upward pressure stemming from the normalisation of food prices and the modest increase in oil prices during the year. **Inflation is expected to fall from 3.9% in 2018 to 3.3% on average in 2019, and then climb to 4% in 2020**.

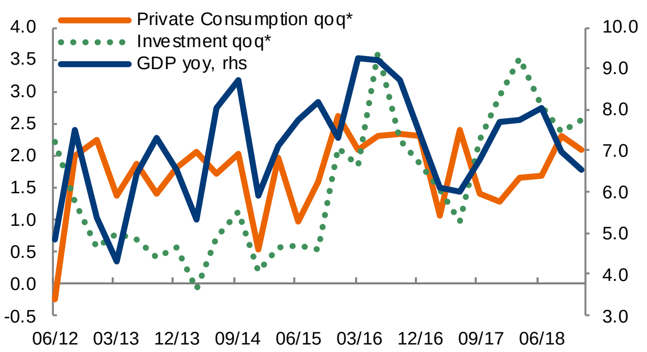
We expect a **moderate slowdown in GDP growth to 7.1% in 2019 and 7.0% in 2020**, with consumer spending and investments slowing from their peaks in 2018. Growth will still remain at high levels, bolstered by a price of oil on average lower than last year, favourable tax policy and a modest **relaxation of monetary policy, with rates expected to fall by no more than 25 bps in 2019,** followed by a period of steady rates. Risks to the outlook remain to the downside and derive from the weak growth in lending due to the slow settlement of non-performing loans, the restriction in non-bank lending and the volatility of agricultural production.

Forecasts

	2015	2016	2017	2018	2019	2020
GDP (constant prices)	7.6	8.6	6.6	7.3	7.1	7
Private consumption	7.3	9.3	6.3	7.9	7.4	7.2
Public consumption	3.7	4.6	15	9.9	10.5	9
Fixed investment	3.9	9.9	7.8	11.7	7.1	9.5
Exports	-6.2	2.5	5.8	10.8	5.4	6.2
Imports	-5.9	1.6	15.4	14.5	3.2	5.3
Industrial output	2.5	5.2	3.5	5.1	5.1	5.8
Inflation (CPI)	4.9	4.9	3.3	3.9	3.9	3.1
Unemployment rate (%)	3.0	3.3	3.4	3.5	3.5	3.6
Average salaries	8.7	11.5	10.2	11.8	12.8	12.8
3-month MIBOR (average)	8.00	7.20	6.50	7.30	6.90	6.90
Rendimento titoli governativi 10 anni (media) (%)	7.80	7.20	6.70	7.70	7.40	7.40
USD/INR exchange rate (average)	64.15	67.21	65.12	68.42	70.19	66.97
Current account balance (INR Bn)	-1451	-815	-2528	-4709	-3926	-4741
Current account balance (% of GDP)	-1.1	-0.5	-1.5	-2.5	-1.9	-2.1
Budget Balance (% of GDP)	-3.4	-3.7	-3.9	-3.6	-3.3	-3.4
Public Debt (% of GDP)	47.1	46.9	45.6	45.0	44.4	43.8

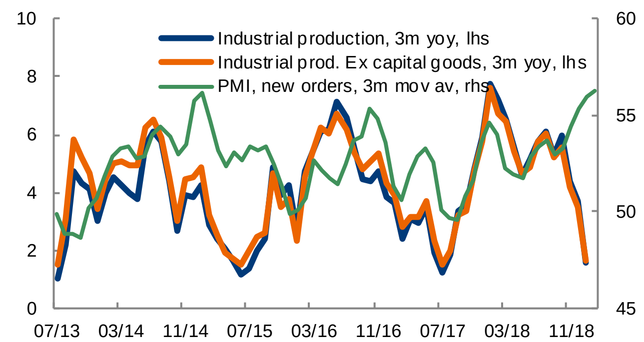
NB: % changes compared with the previous period – except where otherwise indicated. Figures relate to the calendar year. Source: Intesa Sanpaolo chart based on Oxford Economic Forecasting data

GDP and its components



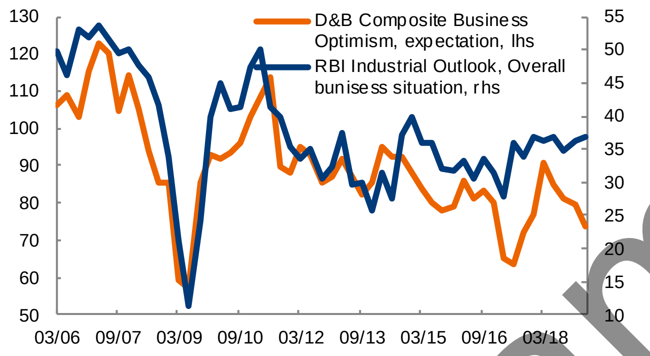
*Four-quarter moving average. Source: CEIC

Industrial output



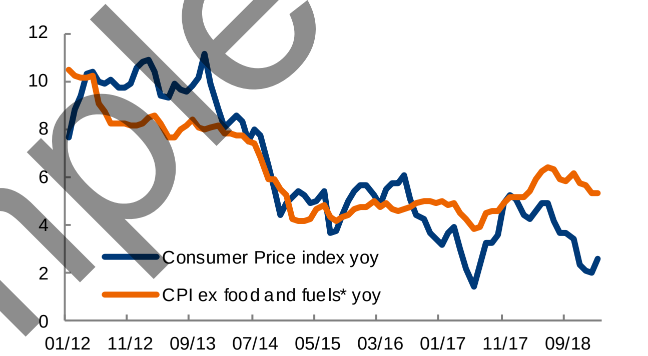
NB: Three-month moving average. Source: IHS-Markit, CEIC

Business confidence



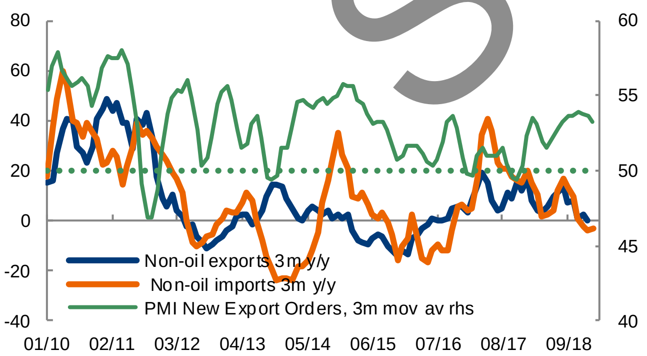
Source: CEIC

Inflation



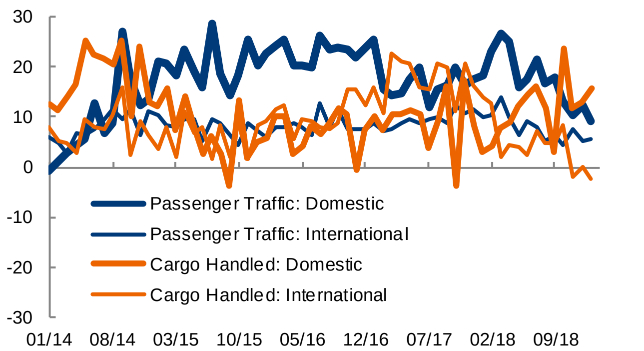
NB: (*) Intesa Sanpaolo estimates. Source: CEIC

Foreign trade



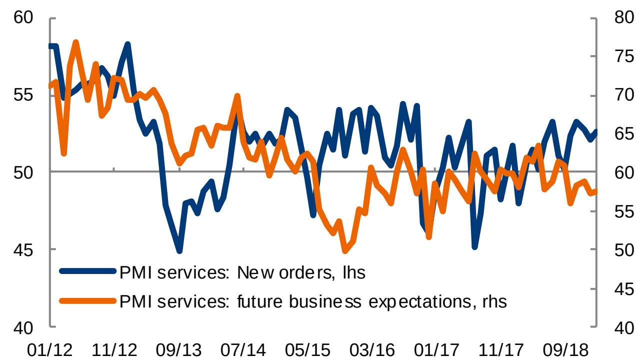
NB: Three-month moving average. Source: Intesa Sanpaolo chart based on Bloomberg and Markit data

Passenger and freight traffic



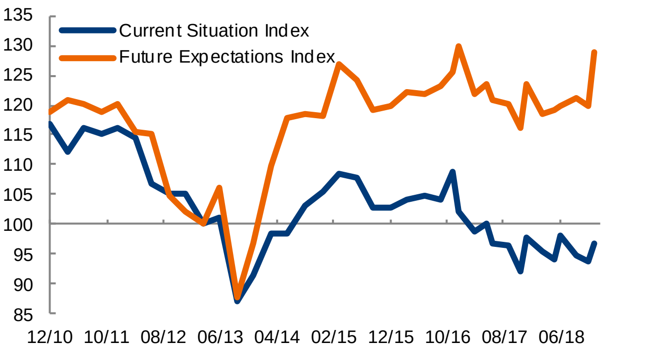
Source: CEIC

Services



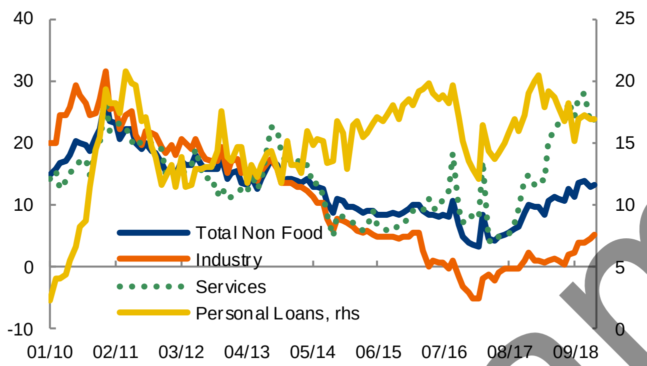
Source: IHS-Markit

Consumer confidence



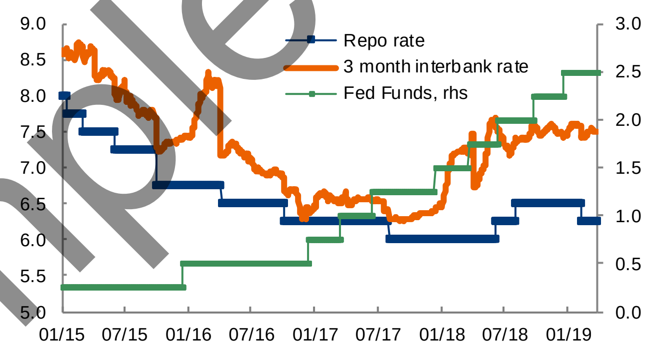
NB: Quarterly consumer confidence survey by the RBI. Source: CEIC

Loans (% change yoy)



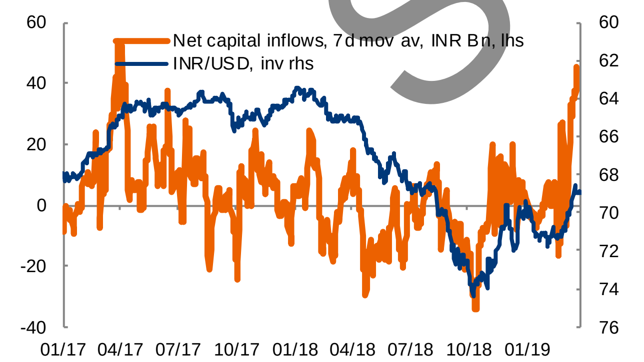
Source: CEIC

Official and money market rates



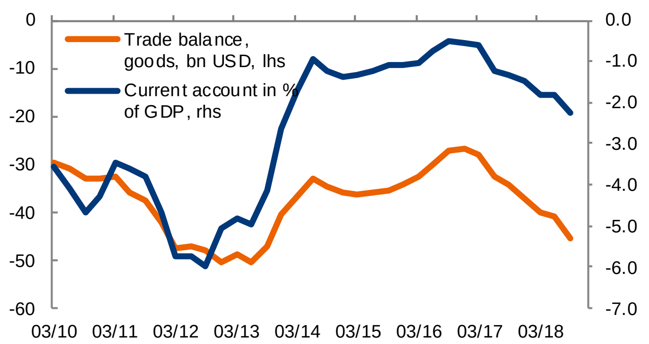
Source: CEIC

Portfolio inflows (INR Bn) and exchange rate



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

Current accounts (four-quarter moving average)



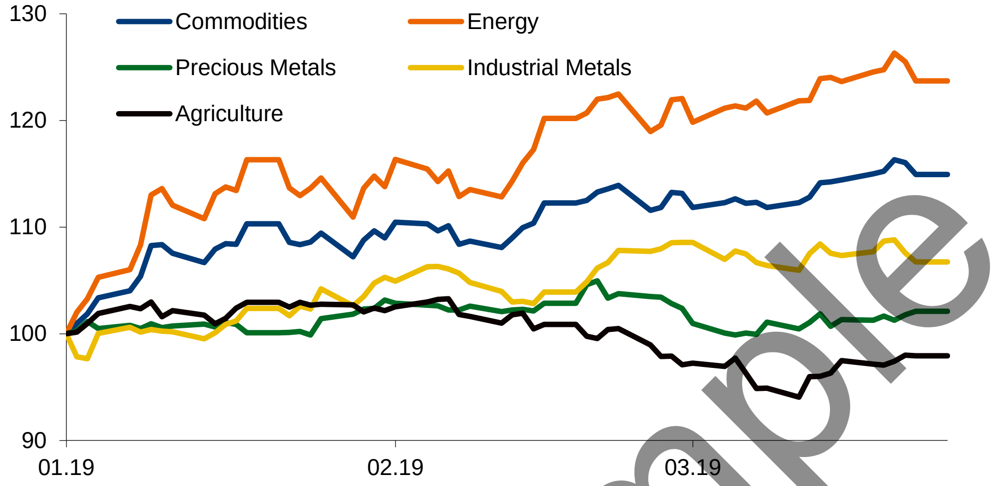
Source: Intesa Sanpaolo chart from CEIC \data

Commodities: market sentiment turned more positive

Daniela Corsini

Over the next months, we envisage some developments in trade talks and a fragile, but still positive, macroeconomic environment. These factors would be coherent with a modest increase in commodity prices over the next couple of quarters. After the summer, the level of uncertainty will grow amid serious threats weighting both on the global economic cycle and commodity demand.

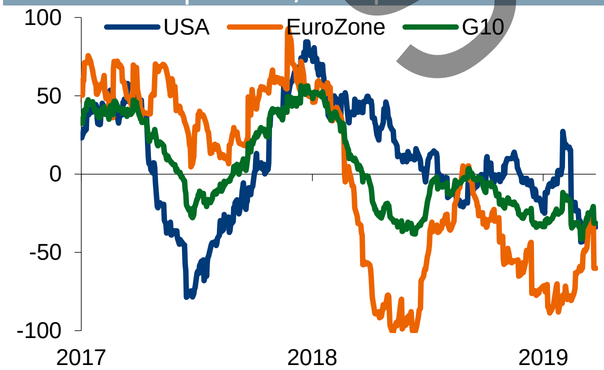
Year-to-date performance of commodity indices



Source: Intesa Sanpaolo chart from Bloomberg data

In the 4th quarter 2018, concerns about a weakening global growth intensified and effectively anticipated a series of downward revisions to macroeconomic forecasts. Europe and Asia have been the regions suffering the most negative surprises amid weaknesses in key sectors (in particular, the automotive sector in Europe), a clear slowdown in global trade and political concerns, like scarce progresses in U.S.-China trade talks and the risks of hard Brexit.

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

Early indicators pointing toward downside risks to estimates about regional and global growth triggered the correction in risky assets recorded in the final months of last year, but seasonality and other trading-related factors pushed commodity prices much lower than the levels justified by supply and demand fundamentals.

Then, three main developments contributed to revert investments' flows, fuelling the best January rally since 2003 (considering as a benchmark the Bloomberg Commodity Index).

- **Central banks' intervention**. In its pivotal meeting in January, the Fed reassured global markets that liquidity will remain abundant and further interventions will be data driven, implying that monetary policy will remain supportive to economic growth if necessary. Over the following weeks, all the main Central Banks reassured markets. In March, the European Central Bank signalled that interest rates will remain in negative territory for several more months and announced new plans to provide targeted liquidity to financial markets.

- **Progresses in U.S.-China trade talks**. The threat of a punitive increase in U.S. import tariffs on Chinese goods worth 200 billion dollars as of March, 1st evaporated amid constructive talks between the two economic superpowers. Optimism prevailed as more high-level talks were scheduled and all the parties involved expressed satisfaction for the positive trend of official discussions.

- **Tightening physical markets**. Most commodities faced tighter markets in the early months of 2019. Apparently, crude oil markets swung into deficit as OPEC+ and Canada progressed with the announced output cuts and Iran, Venezuela and Libya faced constraints related to exogenous factors. Industrial metals (although with some notable exceptions) exhibited shrinking stocks amid resilient global demand and insufficient investments in capacity expansion.

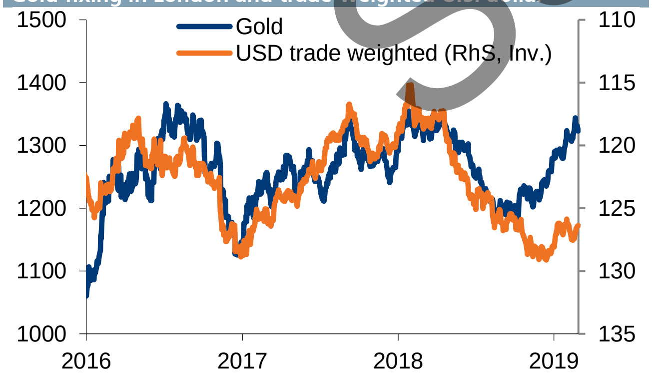
Thanks to these supportive developments, commodity prices recovered part of last year's losses and market sentiment turned more positive toward risky assets, including commodities.

Over the next months, we expect that this positive market framework will persist:

- In our opinion, **we probably reached the bottom of downside revisions to forecasts about economic growth** in March and we are likely to see more positive surprises to macroeconomic data in the weeks ahead.

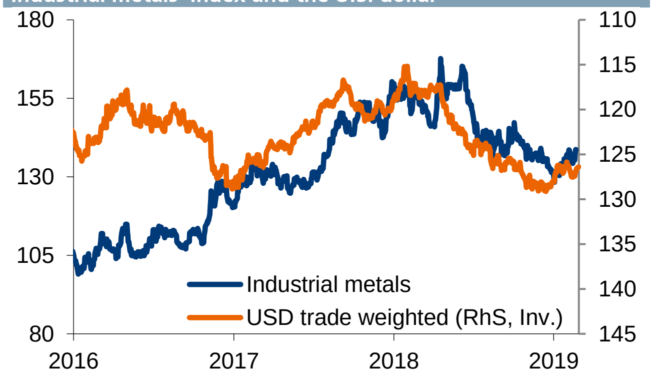
- We currently forecast that **the trade weighted U.S. dollar will modestly depreciate** over the next months. A flat or weaker U.S. currency would benefit the commodity complex due to the traditionally negative correlation between these assets.

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

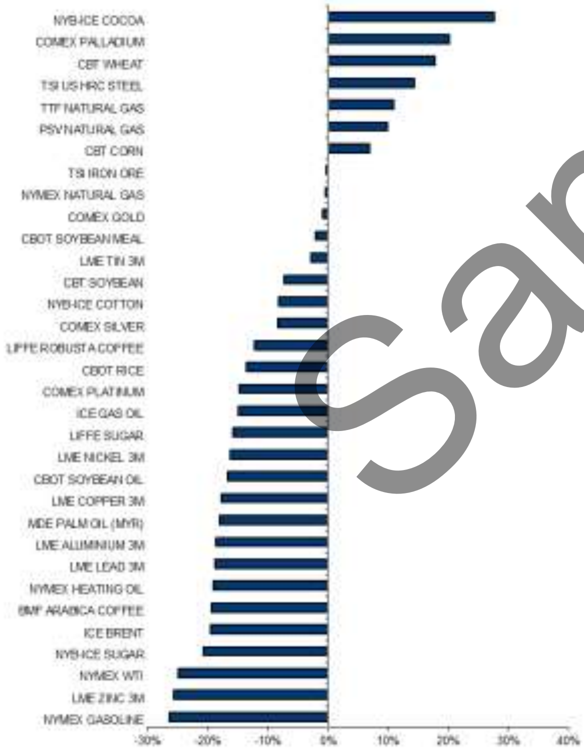
- **We expect further progresses in trade talks**. In our baseline scenario, we assume that the U.S. and China will reach a draft agreement on selected trade-related issues. For instance, the threatened U.S. tariff increase could be scrapped in exchange of higher Chinese imports of agricultural and energy goods from the U.S., especially benefitting U.S. producers of commodities which are difficult to store (LNG) or divert toward alternative markets (soybeans). U.S. and Chinese diplomatic efforts would therefore switch toward other more complex issues, like intellectual property rights, telecom technologies and geopolitical equilibria.

It is very important to note that the whole global economy will gain from such a preliminary deal between the U.S. and China, as it would imply higher trade flows, more positive business and consumer confidence indexes and a renewed appetite for risk on financial markets.

Such favourable environment would be coherent with a modest increase in commodity prices over the 2nd and 3rd quarter relative to the current levels. However, the increase will not be strong enough to negatively affect the fragile global growth, as most commodity prices will remain lower in y/y comparisons.

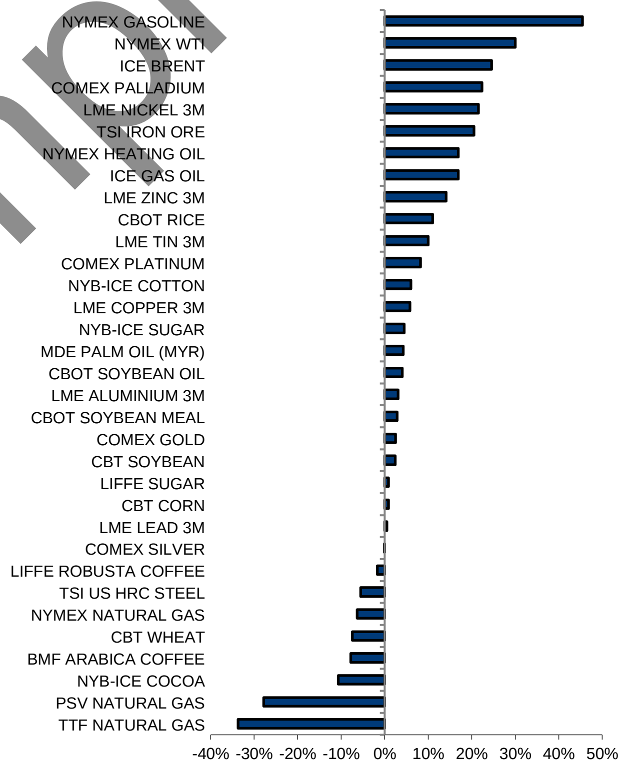
After the summer months, the level of uncertainty on our scenario will grow as economic forecasts depend on several hypotheses about future developments in macroeconomic data, trade talks and political factors (European elections, start of the campaign for the U.S. presidential elections, geopolitical tensions). So far, we envisage in the 4th quarter 2019 and over the whole 2020 a benign framework of modest economic growth and flat commodity prices, but we warn about the strong downside risks weighting on our forecasts for next year. In particular, our main concerns are the risks of a more restrictive fiscal policy in the U.S. and of trade limitations in the automotive sector.

Performances on the full year 2018



Source: Intesa Sanpaolo chart from Bloomberg data

2019, YTD performances as at 13.03.2019



Source: Intesa Sanpaolo chart from Bloomberg data

Forecasts for the commodity universe

Energy. We maintain our faith in OPEC+: in our baseline scenario output cuts will be maintained over the whole 2019 and exports from Iran and Venezuela will continue to shrink. We do not expect significant surprises from global consumption data, while we assume modest negative revisions to estimates about non-OPEC growth. Therefore, the global crude market will be closer to balance than currently expected in consensus forecasts. For gas, we forecast that prices will remain about flat in the U.S. amid abundant supply and rising LNG exports, while they will recover part of their recent losses in Europe amid a structural widening of the continent's import dependency.

Precious metals. We maintain our forecast of a moderately positive environment due to a weakening U.S. dollar, more demand for safe-haven assets and significant purchases from Central Banks for diversification purposes. However, absent inflation risks and severe episodes of stress on financial markets (for instance an unexpected drop in global equities), we think gold will lack the support to reach new multi-year highs. Platinum and palladium continue to follow the rapidly evolving dynamics in the automotive sector, with the latter metal being the clear beneficiary of the contraction in diesel-powered vehicles market shares.

Industrial metals. Industrial metals benefit from the strongest fundamentals in the commodity complex. Most metals are expected to record deficits in both 2018 and 2019, global stocks are declining, low prices discourage secondary supply and investments have been low over the past years. According to our analyses, prices should increase in the next 3-5 years to incentivize investments in mining.

Agricultural commodities. Relative to other sectors, the expected performances from the agricultural complex are much more variegated. Some commodities are expected to benefit from eased trade tensions between the U.S. and China and higher Chinese import volumes (like soybean, corn, cotton). Other commodities are expected to follow more closely their fundamentals, like sugar, which is likely to trade about flat amid well supplied markets; like Arabica coffee, which should trade much above the current price levels when the overhang inventories in Brazil are cleared. All the sector remains extremely vulnerable to weather risks and currency movements.

Price forecasts for the main commodities

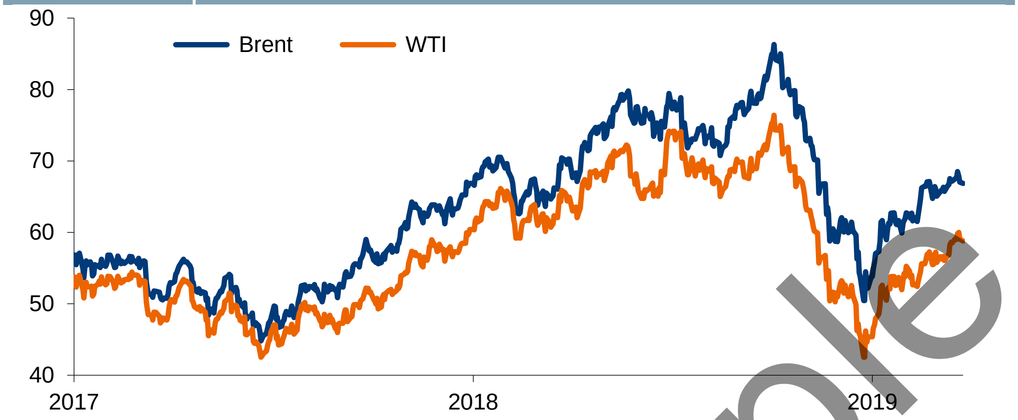
As at 14.03.2019		1Q19	2Q19	3Q19	2019	2020	2021
CO1 Comdty	ICE BRENT	64.0	70.0	73.5	70.0	75.0	80.0
CL1 Comdty	NYMEX WTI	55.0	60.0	64.5	60.9	68.0	75.0
NG1 Comdty	NYMEX NATURAL GAS	2.90	2.80	2.80	2.88	3.00	3.00
GOLDLNPM Index	LME GOLD	1,300	1,275	1,300	1,288	1,300	1,325
SLVRLND Index	LME SILVER	15.7	16.0	16.4	16.2	17.0	17.5
PLTMLNPM Index	LME PLATINUM	816	800	800	804	800	800
PLDMLNPM Index	LME PALLADIUM	1,425	1,600	1,650	1,569	1,600	1,600
LMCADS03 Comdty	LME COPPER 3M	6,200	6,400	6,600	6,500	7,000	7,250
LMAHDS03 Comdty	LME ALUMINIUM 3M	1,890	1,950	2,025	1,991	2,150	2,250
LMNIDS03 Comdty	LME NICKEL 3M	12,350	13,500	14,000	13,463	14,500	15,000
LMZSDS03 Comdty	LME ZINC 3M	2,650	2,900	3,000	2,888	3,100	3,150
LMPBDS03 Comdty	LME LEAD 3M	2,060	2,100	2,120	2,105	2,160	2,180
LMSNDS03 Comdty	LME TIN 3M	20,900	21,200	21,350	21,238	21,750	22,000
SCO1 Comdty	SGX IRON ORE	83	82	80	80.8	75	72
NASS000C Index	TSI US HRC STEEL	695	700	700	699	700	700
C 1 Comdty	CBOT CORN	370	375	370	371	380	385
W 1 Comdty	CBOT WHEAT	490	460	470	475	500	500
S 1 Comdty	CBOT SOYBEAN	910	950	975	959	1,000	1,000
KC1 Comdty	NYB-ICE ARABICA COFFEE	100	120	132	122	138	138
DF1 Comdty	LIFFE ROBUSTA COFFEE	1,510	1,620	1,680	1,628	1,700	1,700
SM1 Comdty	CBOT SOYBEAN MEAL	305	310	315	313	330	340
BO1 Comdty	CBOT SOYBEAN OIL	29.5	30.0	30.5	30.2	31.0	31.2

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: weaker fundamentals

OPEC and non-OPEC allies (currently referred as OPEC+) maintained their promises to reduce output and exogenous constraints limited supplies from Iran, Venezuela and Libya. Therefore, the global crude market will probably record a deficit in the 1st half, but according to official forecasts it is likely to come back in surplus as of mid-2019.

Brent and WTI oil prices



Source: Intesa Sanpaolo chart from Bloomberg data

In January, the crude price rally was mainly driven by tightening markets: Canada and OPEC+ maintained their promises to reduce output and other exogenous constraints limited supplies from Iran, Venezuela and Libya. As expected, Saudi Arabia took the heaviest burden and aggressively cut its exports.

As a consequence, apparently the global crude market fell back in deficit in the 1st quarter and the International Energy Agency envisages that a deficit will also be recorded in the 2nd quarter. However, if OPEC+ (pushed by Saudi Arabia) do not commit to deeper cuts over the 2nd half, the global crude market balance will likely revert into a small surplus as of mid-2019 until the end of the forecasting horizon. As usual, the main responsible for this persistent oversupply is the impressive growth in non-OPEC production.

The data published in March by the U.S. Energy Information Administration (EIA) assume that OPEC will maintain a flat cumulative output over the foreseeable future. Despite OPEC efforts and the impact of U.S. sanctions against Iran and Venezuela, in both 2019 and 2020 non-OPEC supply is expected to grow more than global demand and the market will remain very well supplied. In particular, the U.S. EIA now forecasts a surplus in contraction this year (to +0.2 mb/d from +0.6 mb/d in 2018) and in expansion next year (to +0.4 mb/d).

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

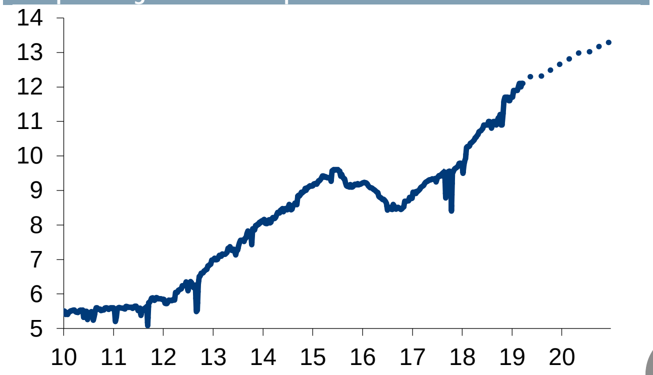
Estimates published in March 2019 in mb/d	Global Demand	Non-OPEC Supply	U.S. Supply	LNG OPEC Supply	Crude OPEC Supply	Call on OPEC crude*	Market balance**
2018	99.9	63.2	11.0	5.3	32.0	31.4	0.6
2019	101.4	65.6	12.3	5.4	30.6	30.4	0.2
y/y change	*1.5*	*2.4*	*1.4*	*0.1*	*-1.4*	*-1.0*	
2020	102.9	67.7	13.0	5.2	30.4	30.0	0.4
y/y change	*1.5*	*2.1*	*0.7*	*-0.2*	*-0.2*	*-0.4*	

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

Moreover, the current OPEC cuts and the U.S. sanctions imply that the global production spare capacity expanded toward comfortable levels and will remain relatively high over the forecasting horizon, limiting the potentially negative impacts of geopolitical risks on crude supplies.

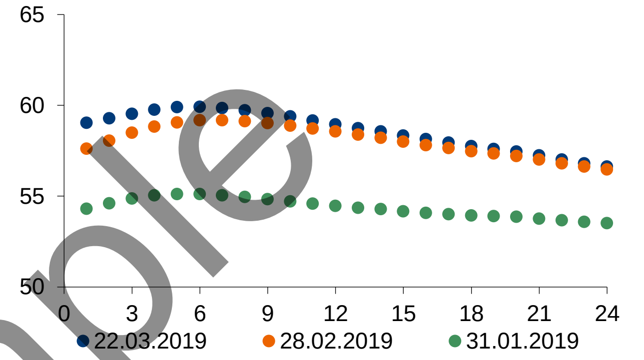
The shape of the forward curves reflects the strength of the U.S. output growth: the front-end of the WTI curve is in contango, signalling a very well supplied domestic market, where infrastructural constraints have limited takeaway capacity from shale basins toward the Gulf Coasts. However, these bottlenecks are likely to ease as of mid-2019 thanks to pipelines' capacity expansion and flow reversals. On the contrary, the Brent curve is in backwardation, reflecting the combined impact of ongoing supply cuts and resilient global demand.

Exceptional growth in U.S. production



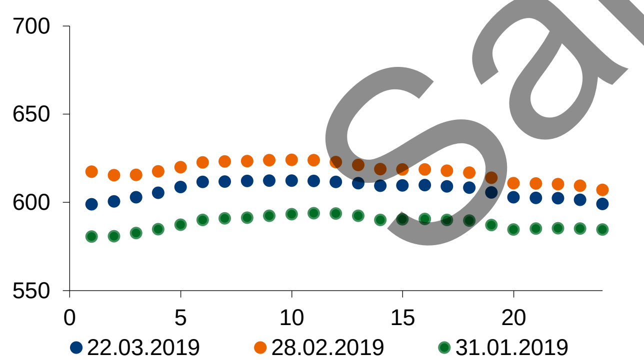
Source: Intesa Sanpaolo chart based on U.S. EIA data

WTI forward curve



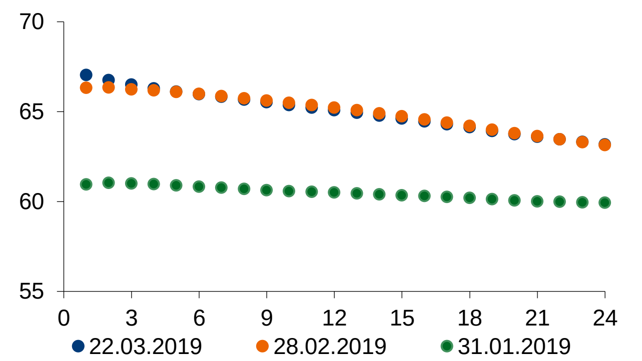
Source: Intesa Sanpaolo chart based on Bloomberg data

Gasoil forward curve



Source: Intesa Sanpaolo chart based on Bloomberg data

Brent forward curve



Source: Intesa Sanpaolo chart based on Bloomberg data

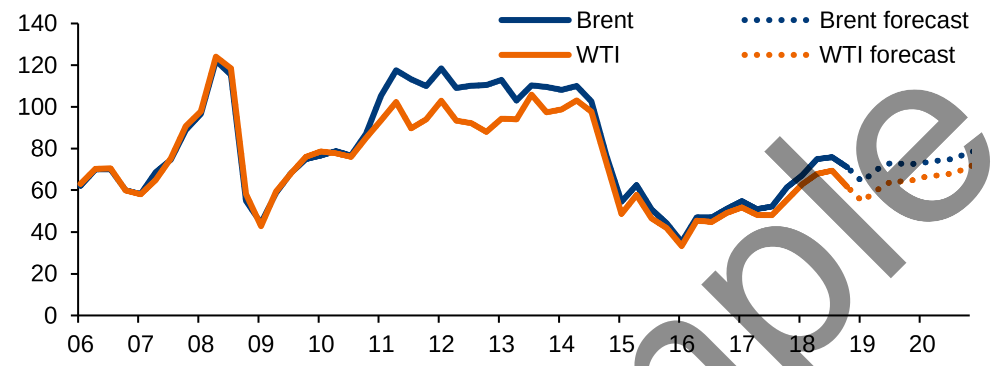
Despite official forecasts pointing toward weak fundamentals, we maintain a positive outlook on crude prices. On one hand, the sentiment on financial markets improved as effective output cuts are temporarily restoring a deficit. The macroeconomic environment should remain coherent with moderately higher commodity prices and trade tensions should ease, boosting investors' appetite for risk and favouring a small appreciation of cyclical assets.

On the other hand, lower WTI prices over the past months should lead to more declines in oil rig count over the next weeks, possibly leading to downside revisions to U.S. output growth. The seasonal pick-up in crude demand ahead of the U.S. driving season should contribute to a drop in U.S. commercial stocks, sharpening the perception of a tightness on physical markets over the 2nd quarter.

In our baseline scenario, we do not expect significant surprises from global consumption data, while we assume modest negative revisions to estimates about non-OPEC growth. Therefore, we think that the global crude market will be closer to balance than currently expected in consensus forecasts.

Moreover, we reaffirm our hypothesis that Saudi Arabia will remain deeply committed on tightening the global crude market and supporting prices in a comfortable range closer to its budget breakeven price. Therefore, Saudi will not adjust their production levels in the event of new unexpected supply disruptions in other countries, while they could be ready to cut even more than agreed in December if deemed necessary to avoid lower crude prices.

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 14.03.2019	1Q19	2Q19	3Q19	4Q19	2019	2020	2021
ICE BRENT	64.0	70.0	73.5	72.4	70.0	75.0	80.0
Median, Bloomberg	63.0	67.4	70.0	70.0	67.3	70.0	68.9
Forward Curve	65.0	67.0	66.6	66.2	66.2	65.0	63.1

Source: Intesa Sanpaolo chart from Bloomberg data

Price estimates for WTI

As at 14.03.2019	1Q19	2Q19	3Q19	4Q19	2019	2020	2021
NYMEX WTI	55.0	60.0	64.5	64.1	60.9	68.0	75.0
Median, Bloomberg	55.0	60.0	62.0	63.0	60.3	64.0	63.6
Forward Curve	56.7	59.3	60.0	59.9	59.0	58.5	56.5

Source: Intesa Sanpaolo chart from Bloomberg data

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Appendix

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