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Uncertainty on the rise

Donald Trump seeks trade war against the rest of the world, and political turbulence in Italy continues. These factors are likely to take their toll on the already weakening world economy. A slowdown in growth is to be expected for the second half of 2018. The financial markets are prepared for a state of emergency.

Economic momentum in the Eurozone had slowed even before the recent US trade disputes and Italian nonsense came to a head. This is most evident from the Purchasing Managers' Index for manufacturing, which fell from 60.6 to 55.5 points between December 2017 and May 2018. Although the business climate in the Eurozone is not quite so gloomy, the trend has also clearly taken a downward turn. The decline in foreign demand is a major reason for the slowdown. Evidence of this can be found, among other sources, in the export components of the Purchasing Manager's Index, which have fallen even more drastically than the index as a whole in recent months. The escalation of the trade dispute with the US will likely reinforce this trend. The US took the first step by imposing tariffs on steel and aluminium imports from the EU (of 25% and 10% respectively).

The consequences of this alone were minor, but the trade war is set to get worse. The EU has already announced its retaliation. This in turn may cause the US to impose tariffs of 27.5% on car imports, which would affect just under EUR 40 billion of goods exports from the Eurozone (0.35% of Eurozone GDP). The majority of this is attributable to Germany (EUR 28 billion, or 0.9% of German GDP). Assuming that the potential punitive tariffs push exports back by 30%, this alone would reduce GDP growth in Germany by 0.25%, in Slovakia by as much as 0.5% and in Italy and the Eurozone on average 0.1%.

Europe: Slovakia and Germany would suffer most under car tariffs

But these are just first-round effects; the actual impact would be much greater. The declines in automotive production would have a knock-on effect on other sectors as well and impact consumer and investor sentiment in general. Eurozone GDP would be pushed down by several tenths overall. However, growth was already set to slow down by the beginning of 2019 according to our forecast, from 2.5% towards 1.5%-2.0%. The Italian government crisis is also likely to be negatively reflected in business sentiment. If the new leaders continue to confront Brussels, Italy will be on a clear path to stagnation.

The current economic situation in China appears more positive than that of the Eurozone. The Chinese purchasing managers' indices showed positive development in May, with the barometer for manufacturing and services improving, according to surveys by the National Bureau of Statistics (NBS) (from 51.9 to 51.4, and 54.9 to 54.8 points respectively). The Markit results point in the same direction. However, the Chinese economy remains divided.

Economy in China currently divided

On the one hand, the Chinese economy is feeling a headwind from foreign trade, affected by the trade disputes with the US. On the other hand, however, monetary policy easing seems to be working and more than making up for the stricter regulation of the shadow banking sector. Domestic economic momentum is therefore offsetting the foreign trade headwind. Consequently, the chances are increasing that GDP growth will not slow down this quarter, contrary to our original expectations, but will remain at 6.8% compared to the previous year.

China: Headwind from foreign trade and tailwind from domestic economy

It is clear from the latest US labour market report that the US economy is still booming. The increase in new jobs of 223,000 exceeded both that of the previous month (159,000) and the consensus estimate of around 190,000. At the same time, the unemployment rate (3.75%) is the lowest in almost 50 years, and wages rose by 2.8% year on year, the highest rise since 2009. Moreover, private household spending increased by 0.6% from the previous month, which should help expand consumption this quarter by more than 3.0%. The preliminary estimate for the balance of trade in April also points to moderate momentum from foreign trade. Given all these pleasant surprises, we are raising our GDP growth forecast for the current quarter by half a percentage point, from what was already an optimistic 3.5%, to 4.0%.

However, growth in US will have its limits. The overarching trend in the US economic cycle is already heading down. The rise in interest rates will cause increasing deceleration in the coming quarters. The recently worsening trade dispute will also take its toll on sentiment in businesses. In light of these deteriorating prospects, we expect a considerable decline in GDP growth rates in the second half of this year.

Donald Trump's style of politics shrouds the entire world economy in a haze of uncertainty

The financial markets are prepared for a state of emergency. Equities and Southern European government bonds recently reacted negatively to the turmoil in Italy and Spain with major price drops. On the other hand, investors with large German government bond positions in their portfolios barely noticed a thing. The tendency to seek safe havens may continue in the medium term. Corporate profits are already suffering due to rising interest, labour and commodity costs. The tariff conflict is an additional hazard, even if Europeans refrain from retaliation measures. Donald Trump's style of politics shrouds the entire world economy in a haze of uncertainty. We believe this points to rising »risk premiums« in future, with lower equity market evaluations as a result.

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