Week ahead

Brexit – Risks of hard Brexit have increased
EA – Manufacturing sentiment continues to slide in November?

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UK's future relationship with EU fully open

The agreement between the UK and EU announced this week is only a stage in the divorce process and not more. It is far from over. The outcome remains completely open, especially as a majority in the British Parliament for the negotiated package is very doubtful from today's point of view. At the same time, however, this is only a snapshot. There is probably a month left before the vote. What will be decisive is how the public debate goes up to that point. Everything seems possible, from a majority vote to the resignation of Theresa May. The intensity of the reaction in the United Kingdom - various ministers and state secretaries have resigned and Theresa May's own party is working on a motion of censure - is an indication to us, however, that a hard Brexit has become more likely since this week. We would therefore like to reiterate here the most important effects on the economy and the financial markets.

A hard Brexit would not only mean customs clearance, but also very likely WTO tariffs between the EU and UK from March 30, 2019. This would require the creation of adequate staff and equipment capacities. It is unlikely that this will be achieved to the required extent by the date of departure. So, delays in delivery are foreseeable. In order to avoid this and the customs duties for the time being, companies would settle as much trade as possible before the departure date. Due to the EU's trade surplus with the UK, this should give the EU economy a boost in the first quarter of 2019, which would then reverse in the second quarter. It is more difficult to assess the impact of an approaching hard Brexit on corporate sentiment. In such an environment, a delay in investment would be very likely in the first quarter of 2019 - with a corresponding negative impact on GDP growth. At the same time, however, we do not believe that a hard Brexit would permanently stifle the current economic upswing in the Eurozone. Therefore, we see the negative effects of a hard Brexit spread around the exit date and would expect a recovery with a stabilization of the situation. A hard Brexit does not mean the end of trade relations between the EU and UK.

Customs clearance and the direct impact on trade are probably the areas for which the consequences cannot be mitigated politically. Beyond that, however, there is a wealth of areas that have the potential to cause massive distortions in the event of a hard Brexit. However, these could be offset by appropriate transitional regulatory solutions. The EU has essentially prepared itself for this and has presented the contingency action plan published this week (before the publication of the agreement) with solutions.

What does all this mean for the financial markets? The political hiccup in the UK is unlikely to subside in the coming weeks. For the markets, the main issue will be the likelihood of UK parliamentary approval of the

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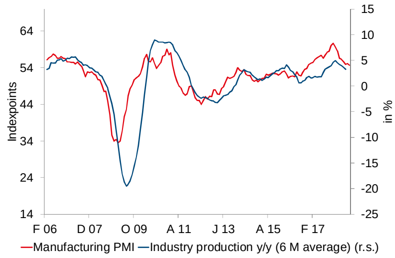
negotiated package. A motion of censure on the prime minister - if it takes place - could soon set the course in this respect. Our current forecast for German government bond yields already takes into account the persistence of uncertainty. However, we originally assumed that the situation would ease in the first quarter of 2019. As any outcome of the divorce between the EU and United Kingdom is currently possible, we do not yet want to reject our original scenario. ***However, if a hard Brexit becomes foreseeable, we would lower our forecasts for yields on German government bonds at least for the first half of next year. Furthermore, the dollar would probably strengthen more against the euro than we currently expect.***

EA – Manufacturing sentiment suffers from weak global trade

EA Manufacturing PMI vs. industrial production



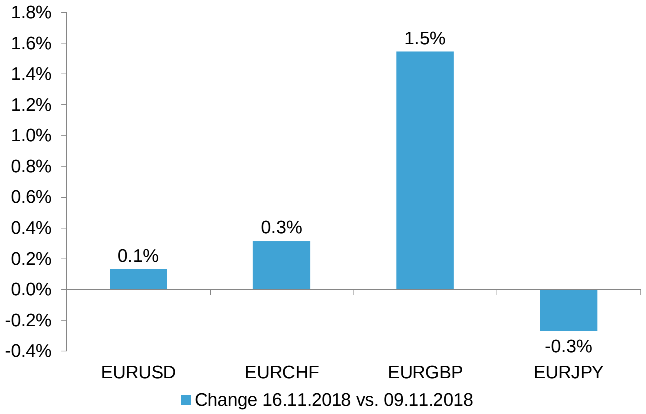
Source: Bloomberg, Erste Group Research

Next week (November 23), a first flash estimate of manufacturing sentiment will be released for November for the Euro Area, Germany and France. Contrary to expectations, the Euro Area's manufacturing sentiment fell again in October. At 52.0 index points, the sentiment barometer dropped to its lowest level in 26 months. Italy was hit hardest, with sentiment now predicting shrinking industrial output for the fourth quarter. After Italy's economy stagnated in the third quarter, these indicators point to no immediate improvement in the economic situation. On the one hand, we attribute this to the uncertainty caused by the Italian Government's budget plans. On the other hand, Italy's economy, like Germany's, also suffered from negative one-off effects from the automotive sector in Q3. Outside Italy, the weak sentiment is attributable to the slowing global economy. For example, incoming export orders fell in October for the first time since mid-2013. Concerns about globally rising protectionist measures additionally clouded the business outlook for the coming months.

At the moment, there are only very few arguments in favor of rising manufacturing sentiment. We therefore at best expect a stabilization of the data in November. *The GDP data for 3Q showed that the Euro Area was no longer able to escape the clouded global environment, even though one-off effects have weighed on the growth as well. Unfortunately, according to our assessment, there is no immediate improvement in sight. The continued subdued currency development of emerging markets shows that it is currently difficult for these markets to attract capital to finance further growth. On the one hand, this reflects the continued cautious attitude of global investors triggered by the trade conflict. Moreover, thanks to the tightening of the Fed's monetary policy, the US dollar is an extremely attractive alternative for investors. In view of this environment, we believe that the growth prospects for the Euro Area export sector remain subdued. Given the key importance of foreign trade for Euro Area growth, we expect GDP growth in this environment to gradually approach its potential of around +1.5%.* ***In order to accelerate growth, the Eurozone would be dependent on impetus from world trade, which, however, is not yet apparent.***

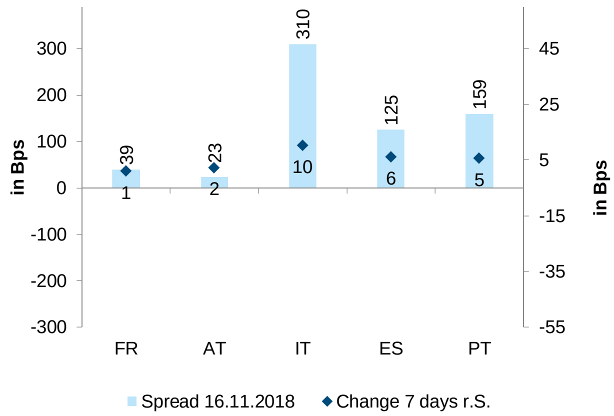
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
change last week
(+ stronger euro / - weaker euro)



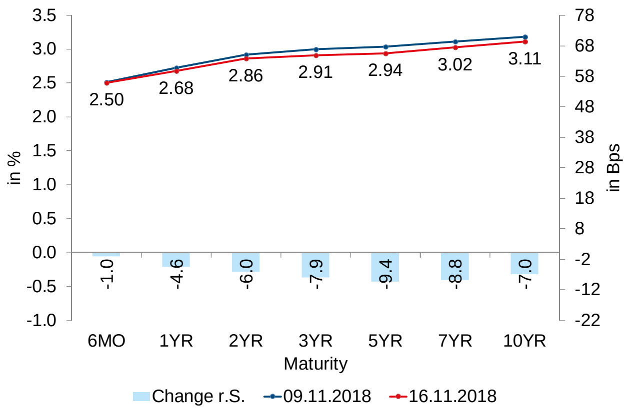
Source: Bloomberg, Erste Group Research

Eurozone – spreads vs. Germany
10Y government bonds



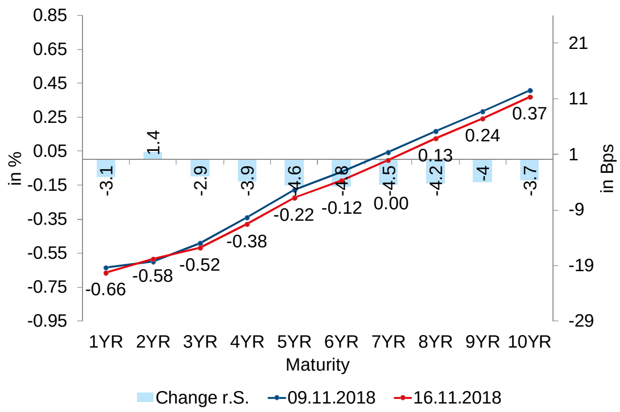
Source: Bloomberg, Erste Group Research

US Treasuries yield curve
change last week



Source: Bloomberg, Erste Group Research

DE Bund yield curve
change last week



Source: Bloomberg, Erste Group Research

Economic calendar

Date	Time	Ctry	Release	Period	Consens	Prior
16-Nov	n.a.	AT	Inflation y/y	Oct		2.4%
		AT	CPI m/m	Oct		0.5%
		US	Ind. Prod. y/y	Oct		5.1%
	11:00	IT	Inflation y/y	Oct F	1.7%	1.7%
		EA	CPI m/m	Oct	0.2%	0.2%
		EA	Inflation y/y	Oct F	2.2%	2.2%
	12:00	IT	Trade Balance	Sep		2564m
19-Nov	10:00	IT	CA Balance (m)	Sep		4994 m
		EA	CA Balance (m)	Sep		24 m
20-Nov	8:00	DE	PPI y/y	Oct	3.3%	3.2%
21-Nov	14:30	US	Durable Goods Orders	Oct P	-1.9%	0.7%
		US	Jobless Claims	-	212.5 thd	216.0 thd
	16:00	US	Existing Home Sales	Oct	5.2 m	5.2 m
		US	Univ. Michigan Index	Nov F	98.2 index	98.3 index
22-Nov		EA	Consumer Conf.	Nov A	-3.0 index	-2.7 index
23-Nov	8:00	DE	GDP q/q	3Q F	-0.2%	-0.2%
		DE	GDP y/y	3Q F	1.1%	1.1%
	9:00	AT	Ind. Prod. y/y	Sep		2.8%
	9:15	FR	PMI Manufacturing	Nov P		51.2 index
	9:30	DE	PMI Manufacturing	Nov P	52.1 index	52.2 index
	10:00	EA	PMI Manufacturing	Nov P	51.8 index	52.0 index

Source: Bloomberg, Erste Group Research

FORECASTS[1])

GDP	2015	2016	2017	2018	2019
Eurozone	2.0	1.8	2.4	2.0	1.8
US	2.9	1.5	2.3	2.9	2.3

Inflation	2015	2016	2017	2018	2019
Eurozone	0.1	0.2	1.5	1.8	1.9
US	0.1	1.2	2.2	2.4	1.8

Interest rates	current	Dec.18	Mar.19	Jun.19	Sep.19
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.32	-0.30	-0.30	-0.30	-0.10
Germany Govt. 10Y	0.37	0.50	0.70	0.90	1.10
Swap 10Y	0.93	0.80	1.00	1.20	1.40

Interest rates	current	Dec.18	Mar.19	Jun.19	Sep.19
Fed Funds Target Rate*	2.20	2.38	2.63	2.88	3.13
3M Libor	2.63	2.70	2.90	3.20	3.40
US Govt. 10Y	3.11	3.00	3.20	3.40	3.50
EURUSD	1.13	1.11 ⇩	1.10 ⇩	1.12 ⇩	1.14 ⇩

*Mid of target range

In case of changes to our forecasts compared to the previous issue, arrows show the direction of the change.

Source: Bloomberg, Erste Group Research

1 By regulations we are obliged to issue the following statement: Forecasts are no reliable indicator for future performance

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