Week Ahead

Focus: Brexit, ECB Governing Council Meeting, Eurozone PMIs

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Brexit goes into next round

By Monday, Theresa May must present Plan B to the British Parliament for how to proceed after the clear rejection of the divorce package negotiated with the EU. It currently does not look like there will be any magic bullet. Rather, the Prime Minister will have to laboriously sound out all parties to see if a majority can be found for an amended deal. A new proposal will then be put to the vote on January 29. It is our view that the chances of success are poor. The EU has already signaled that there is little room for maneuver in negotiations and Theresa May will have to bring significantly more than 100 MPs to her side after the devastating defeat this week. Labour, the largest opposition party, has already announced that it will not enter into talks. In addition, the clock is ticking. There are already only 70 days left before Brexit if negotiations are not extended, which requires unanimous EU approval, or if Brexit is called off, which the UK could decide unilaterally. The latter seems very unlikely.

After the failure of the vote in the British Parliament this week, there are several options on the table. At the moment, however, there are none in sight on which the British Parliament could agree. Even if there were, any agreement would still have to be approved by the other 27 Member States. Time is really running out. Delaying Brexit by a few months is therefore becoming an increasingly probable option. But the British government would have to promise a concrete plan to the EU. Since Parliament obviously may not succeed in this and neither Parliament nor government want a Hard Brexit, the only viable way seems to consult the people again, despite all the reservations against a second vote. If this also cannot be agreed upon, only Hard Brexit remains. However, Hard Brexit is not the most likely option for us, as it is currently the only alternative against which there is a broad majority in the British Parliament.

With every day that passes without a solution being found, the markets will increasingly prepare for the most unpleasant scenario. The markets are certainly worried at the moment, but we do not yet see Hard Brexit as being priced in. This would mean support for government bonds with the highest ratings (especially in the Eurozone) as well as the US dollar and the Swiss franc. We do not see any breakthrough in negotiations in the near future. The closer we get to March 29, the more sensitive the markets will be to the foreseeable changing events of the coming Brexit negotiations. The uncertainty on the markets should therefore increase for the time being, and if a solution is found, it will probably be relatively close to March 29.

How will ECB Council react to the deteriorating environment?

The ECB Governing Council will meet next Thursday. Market attention will

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focus on how the Council reacts to the deterioration in the environment. After the last meeting on December 13, the sell-off on stock markets accelerated. In addition, the outcome of the Brexit negotiations has become more uncertain and the economic data has remained weak. From an economic point of view, however, it was positive that oil prices remained low and that in France, in the wake of the Yellow Vest protests, the government lowered taxes and raised the minimum wage, although this will increase the deficit.

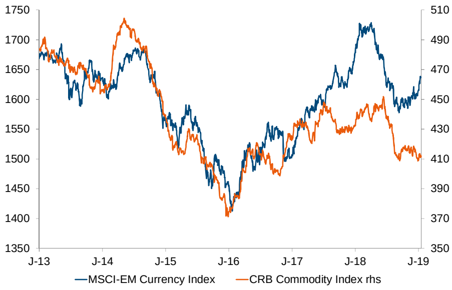
At the last meeting of the ECB Council, the deterioration in the environment had not led to a change in the assessment of the distribution of risks to the economy, which were still described as balanced. However, it was added that the risk distribution was moving downwards. The second formulation chosen to respond to the worsening environment was one of continued confidence with increasing caution. If the Governing Council changes anything next week, it will probably be a tightening of these wordings, which is quite likely. Market reaction to this is possible, but it should be muted, as sentiment is already depressed. The cornerstones of the outlook for monetary policy should, on the other hand, remain unchanged. They still offer the Governing Council so much time that no immediate reaction to the deteriorating environment is necessary. This is all the more likely as the next ECB economist forecasts will not be available until March and these are an important basis for decision-making. The statements that key interest rates are expected to remain unchanged at least through the summer and that reinvestments of the repayments of the securities portfolio will continue long after the first interest rate hike should therefore remain unchanged.

At the press conference, President Draghi could still be asked about a new ECB liquidity program. The background to this question is that from June 2019 the term of the TLTROs of the ECB will begin to fall below one year. This means that banks will no longer be able to use these funds to calculate the net stable funding ratio (liquidity reserve). Banks will therefore need financing with a longer term. The question is whether these will come from the ECB. If not, then banks would have to borrow these funds via the capital market and would probably repay the TLTROs prematurely. This would mean that part of the liquidity generated by the ECB in the course of fighting the crisis would disappear. At the same time, however, the ECB will consider how much longer it wants to commit itself to such a high supply of liquidity. The first TLTRO maturity is in June 2020 and amounts to EUR 399bn. During the following three quarters a further EUR 343bn will be due.

Will Eurozone industrial sentiment fall further?

Next week (January 24) the first flash estimate of Eurozone industrial sentiment for January will be released. In December, sentiment fell to its lowest level since February 2016. The poor sentiment is due to several factors. For example, the automotive sector, which is important for some countries, is struggling not only with economic headwinds, but also with structural problems, which are additionally affecting production and sales. In addition, export orders have fallen significantly as a result of the global trade conflict. The problems are now clearly visible in the Eurozone industrial production data for October and November last year. On average, industrial production fell by 0.7% in this period compared to the average of the previous quarter. Germany and France were the main contributors. This is already visible in Germany's weak GDP data for 2018 (GDP growth fell from +2.2% to +1.5% in 2018).

Emerging Markets currency index vs. commodity price index

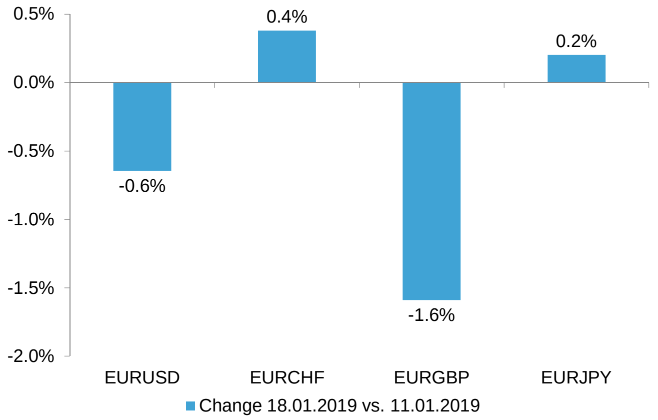


Source: Bloomberg, Erste Group Research

As global economic environment continues to be marked by major uncertainties, we expect industrial sentiment in the Eurozone to stabilize at December's low level. Accordingly, we assess the immediate growth prospects for the Eurozone as subdued. To transform the situation into a positive one, the Eurozone is dependent on impetus from global trade. The data situation for the outlook for world trade is currently unclear. The currencies of the emerging markets have been on an upward trend against the US dollar since November last year. This indicates that capital is flowing into these economies and improving the growth prospects of these countries, which in turn would benefit global trade. On the other hand, the continuing restrained development of raw material prices does not yet indicate an acceleration of economic momentum at the global level. However, if commodity prices were to rise as well, we believe that the growth outlook for the Eurozone export sector would improve significantly. This would also benefit the domestic economy of the Eurozone.

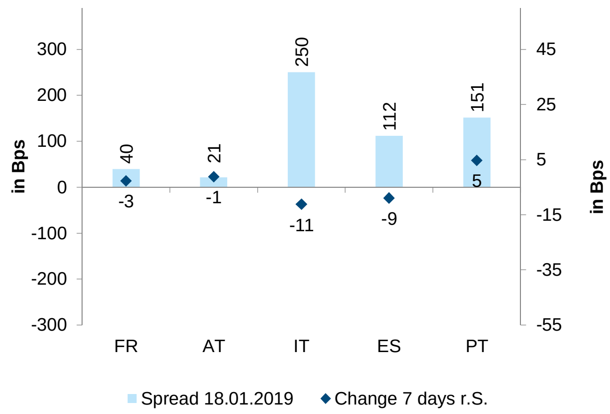
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
Changes compared to last week



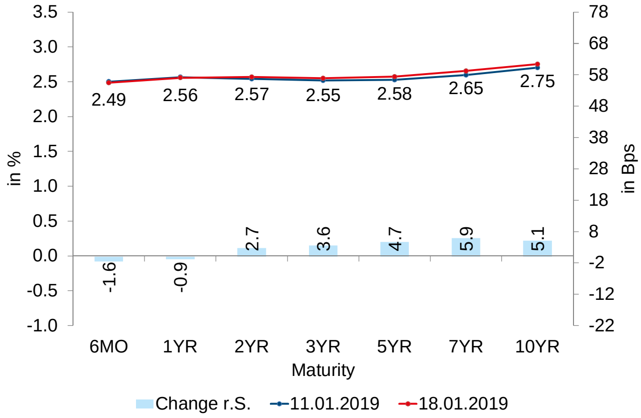
Source: Bloomberg, Erste Group Research

Eurozone-spreads vs. Germany
10Y government bonds



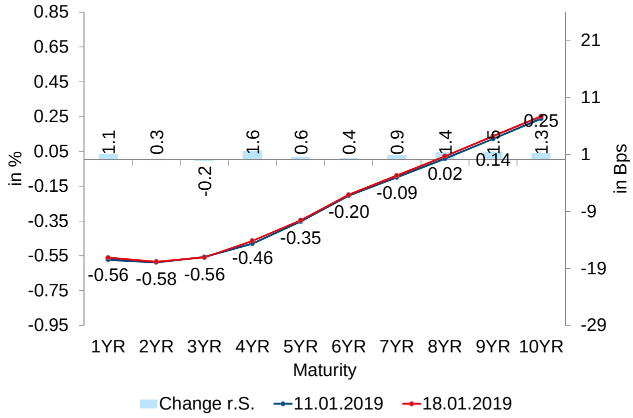
Source: Bloomberg, Erste Group Research

US Treasuries yield curve
Changes compared to last week



Source: Bloomberg, Erste Group Research

DE Bund yield curve
Changes compared to last week



Source: Bloomberg, Erste Group Research

Economic calendar

Date	Time	Ctry	Release	Period	Consens	Prior
18-Jan	**n.a.**	**US**	**Ind. Prod. y/y**	Dec		3.9%
	10:00	**IT**	**CA Balance (m)**	Nov		6081 m
		EA	**CA Balance (m)**	Nov		23 m
	16:00	**US**	**Univ. Michigan Index**	Jan P	96.5 index	98.3 index
21-Jan	**n.a.**	**CN**	**Ind. Prod. y/y**	Dec	5.3%	5.4%
		CN	**Unempl. Rate**	4Q		3.8%
	8:00	**DE**	**PPI y/y**	Dec	3.0%	3.3%
22-Jan	**n.a.**	**US**	**Retail Sales mom**	Dec	0.1%	0.2%
		US	**Trade Balance**	Nov		-55m
	16:00	**US**	**Existing Home Sales**	Dec	5.3 m	5.3 m
23-Jan		**EA**	**Consumer Conf.**	Jan A	-6.9 index	-6.2 index
24-Jan	**9:15**	**FR**	**PMI Manufacturing**	Jan P	49.6 index	49.7 index
	9:30	**DE**	**PMI Manufacturing**	Jan P	51.3 index	51.5 index
	10:00	**EA**	**PMI Manufacturing**	Jan P	51.3 index	51.4 index
	13:45	**EA**	**Target Rate (lending)**	-	-0.40%	-0.40%
		EA	**Target Rate**	-		0.00%
	14:30	**US**	**Jobless Claims**	Jan 19	222.4 thd	213.0 thd
25-Jan	**9:00**	**AT**	**Ind. Prod. y/y**	Nov		5.0%
	14:30	**US**	**Durable Goods Orders**	Dec P	0.8%	0.8%
	16:00	**US**	**New Home Sales**	Dec	568.4 thd	544.0 thd

Source: Bloomberg, Erste Group Research

Forecasts[1]

GDP	2017	2018	2019	2020
Eurozone	2.4	1.9	1.5	1.4
US	2.3	2.9	2.3	2.1

Inflation	2017	2018	2019	2020
Eurozone	1.5	1.7	1.7	1.7
US	2.2	2.4	1.8	1.9

Interest rates	current	Mar.19	Jun.19	Sep.19	Dec.19
ECB MRR	0.00	0.00	0.00	0.00	0.25
3M Euribor	-0.31	-0.30	-0.30	-0.10	0.10
Germany Govt. 10Y	0.25	0.50	0.70	0.80	1.00
Swap 10Y	0.80	0.80	1.00	1.10	1.30

Interest rates	current	Mar.19	Jun.19	Sep.19	Dec.19
Fed Funds Target Rate*	2.40	2.38	2.63	2.88	3.13
3M Libor	2.78	2.70	2.90	3.20	3.40
US Govt. 10Y	2.75	2.90	3.10	3.30	3.50
EURUSD	1.14	1.11	1.12	1.14	1.16

*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] Note: By regulations we are obliged to issue the following statement: Forecasts are no reliable indicator of future performance.

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