Economic Outlook

Eurozone, US and Emerging Markets

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Trade Dispute and Brexit are Driving the Outlook

Economic outlook should gradually improve in the second half
Global economic growth continued to suffer in the first half of 2019 due to the trade dispute and the uncertainty surrounding Brexit. By contrast, the prices of economically sensitive assets such as stocks or high yield bonds have performed quite well so far in 2019. This divergence is primarily attributable to the shift in Fed and ECB communication over recent months. The trade war between the US and China remains the most important factor for the economic outlook. As both sides are under pressure, we expect a rapprochement in the second half of this year. As a result of this we expect that the global economy will follow the favorable stock market trend and that the outlook for global growth will gradually improve in the second half of 2019.

Brexit to dampen economic growth in the euro zone in 2019 and 2020
In addition, we expect that the Brexit issue will determine the outlook for economic growth in the Eurozone until the end of October. In light of political developments in the UK (resignation of Theresa May in June) we expect a Hard Brexit on 31 October. As a result of this shock we expect slightly negative growth in the Eurozone in Q4 2019, followed by a gradual recovery beginning in Q1 2020. Regardless of this, based on leading economic indicators the Eurozone economy has so far maintained a stable growth trend in Q2 2019 (expected GDP growth of +0.4% q/q).

Decline in Eurozone inflation expected in 2019
We are forecasting a decline in the headline inflation rate to +1.4%, particularly due to a falling inflation contribution from the energy component in 2019. In contrast, we expect a moderate increase in the core inflation rate compared to 2018 as a result of further progress in the labor market as well as strengthening wage growth.

US economy set to cool down in 2019
US economic growth will slow down this year compared to last year. Interest rate markets in particular were recently quite jittery and seem to be seeing clear indications of a beginning downturn and are consequently pricing in a central bank response. However, we believe that the US economy will level out at a sustainable growth rate. Ultimately the assessment of future developments depends greatly on expectations regarding the trade dispute with China. We expect tensions to ease, as this should be in line with US political interests as well.

Global Economy

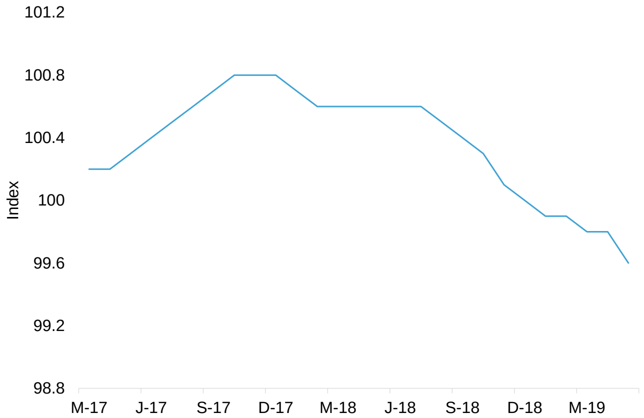
Growth forecasts for the major currency areas decline hand in hand with long term interest rates

The global economic environment has suffered from politically induced uncertainty in the first half of 2019. By contrast, the Fed's decision to forego further rate hikes, in concert with the combative remarks of ECB head Mario Draghi at the end of June, has exacerbated the strong decline in long term yields in the major currency areas (USD, EUR and JPY) since the beginning of the year. From a policy perspective, this has already led to an easing of monetary conditions. On the other hand, Donald Trump triggered fresh uncertainty by escalating the trade dispute with China further in early May, which has put additional pressure on global growth in the short term. In this difficult environment the IMF has (in line with other institutions) once again reduced its global economic growth estimate for 2019 to +3.3% from its previous forecast of +3.5%.

Outlook for global economic growth should gradually improve in the second quarter

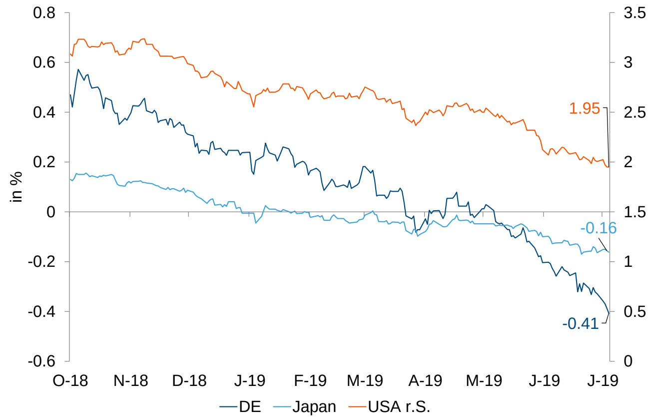
Given that US President Trump will stand for reelection at the end of 2020, we assume that he is interested in improving relations with China so as not to endanger the US economy's growth momentum further. At their summit meeting at the end of June Trump and Xi agreed to resume negotiations as an initial step. We expect a rapprochement between China and the US over the coming 12 months, in the wake of which the global growth outlook should improve as well. The rivalry between the two largest economies of the world is nevertheless bound to continue in coming years. The greatest obstacles potentially stifling the growth prospects of the European economy consist of the threat of US tariffs on car imports (with regard to this, the EU has created some breathing space by boosting import quotas for US beef[1]) as well as the unresolved Brexit issue. However, rising US protectionism also accelerates progress in trade agreements between the EU and economic regions in Asia and South America, which in our opinion improve the long-term growth outlook of all partner countries.

Global sentiment deteriorates further
OECD business confidence indicator



Source: OECD, Erste Group Research

Significant decline in long-term interest rates
US, GER, Japan: 10-year government bond yields



Source: Bloomberg, Erste Group Research

[1] Source: https://www.reuters.com/article/us-usa-trade-eu-beef/eu-seals-deal-to-boost-u-s-beef-imports-sources-idUSKCN1TE2HV

Free Trade Agreements

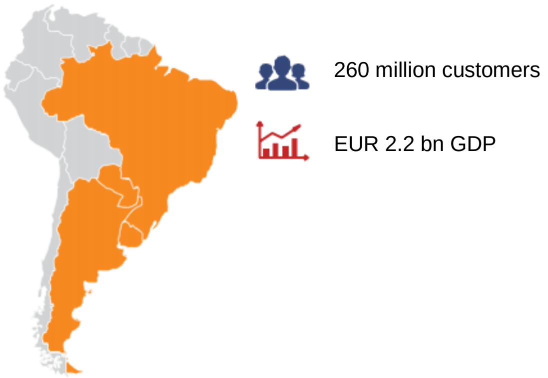
Trade war accelerates adoption of free trade between Europe, Asia and South America

There is actually an upside to the global trade war emanating from the US, as the EU has successfully concluded negotiations on three substantial free trade agreements in the course of this year (with Japan, Vietnam and the South American trade bloc “Mersocur”), the finalization of which was previously subject to delays of several years. In essence these agreements raise the long-term growth prospects of both the EU and the partner regions. Particularly regions that hitherto imposed high tariffs on goods imports from the EU (Vietnam and Mercosur) should offer large growth potential for exports from EU countries. On the country level Portugal and Spain should be the main beneficiaries of the agreement with the Mercosur bloc (largest export share in the Eurozone). On the other hand, the economies of Vietnam and the Mercosur countries stand to benefit from access to high-quality capital goods (machinery and equipment) at more favorable prices. IMF studies show that high tariffs on machinery and equipment weigh on investment ratios in emerging markets, dampening their growth potential[2]. As the agreement with the Mercosur countries includes lengthy transition periods (10 – 15 years), it will take some time before the positive effects of the agreement unfold to their full extent.

Free trade agreements are bound to raise environmental in emerging markets as well

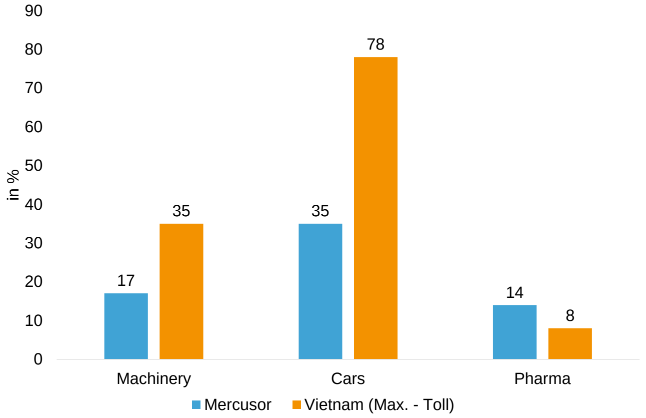
As a result of the crucial role the European market already plays for the agricultural sector of the Mercosur countries today (42.8% of their exports to the EU comprise agricultural products), the European agricultural industry is critical of the agreement on the grounds that environmental standards in South America are less stringent. However, the agreement is inter alia focused on sustainability and climate protection issues, and particularly sensitive product groups (e.g. beef, sugar, honey, rice) will continue to be strongly protected by import quotas. As a result of the agreement, Mercosur countries will receive access to EU know-how on key issues such as animal protection, biotechnology, food security and antibiotics resistance, which increases the probability that economic framework conditions in South America will improve.

Fifth largest economic area of the world
Mercosur Trade Bloc



Source: EC, Erste Group Research

Substantial tariff barriers in emerging markets
Mercosur and Vietnam tariffs



Source: Eurostat, Erste Group Research

[2] Source: https://www.imf.org/en/Publications/WEO/Issues/2019/03/28/world-economic-outlook-april-2019#Chapter%203; chapter 3

Eurozone Economy

Stable growth momentum expected for the Eurozone in Q2

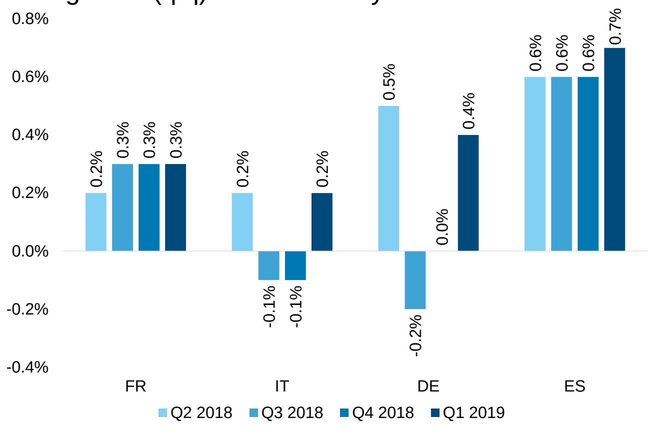
With a growth rate of +0.4% q/q, the economy of the Eurozone gained considerable momentum in Q1 2019. Just as in the second half of 2018, consumer spending and investment were the main pillars of the Eurozone economy, whereas foreign trade continued to weigh on growth. At the country level, Italy and Germany managed to return to growth, while growth momentum in Spain and France stabilized. Based on recent economic indicators, GDP growth in the Eurozone should stabilize at around +0.3% to +0.4% q/q in Q2. On the one hand, a tailwind is currently provided to the Eurozone economy by a significant drop in long-term interest rates, which should benefit investment activity, and on the other hand by a slight fiscal easing due to an expected increase in the structural deficits of almost all important Eurozone member countries (particularly Italy). Italy is bound to remain a trouble spot with its populist government. Since the balance of political power has shifted strongly in favor of the already governing Lega Party after the European elections in May, the probability that new elections will be called within the next 12 months has increased.

Hard Brexit should weigh on Eurozone economy particularly in Q4 2019 and Q1 2020

In view of the political chaos in the United Kingdom, we are now expecting that there will be a Hard Brexit at the end of October 2019 (probability>50%). We expect that the associated short term shock will trigger slightly negative GDP growth in the Eurozone in Q4 2019 (around -0.2% q/q); from Q2 2020 onward growth in the Eurozone should level out at its potential growth rate again (around +0.4% q/q). Overall, we are forecasting GDP growth of +1.1% in the Eurozone for 2019, followed by +1.0% in 2020.

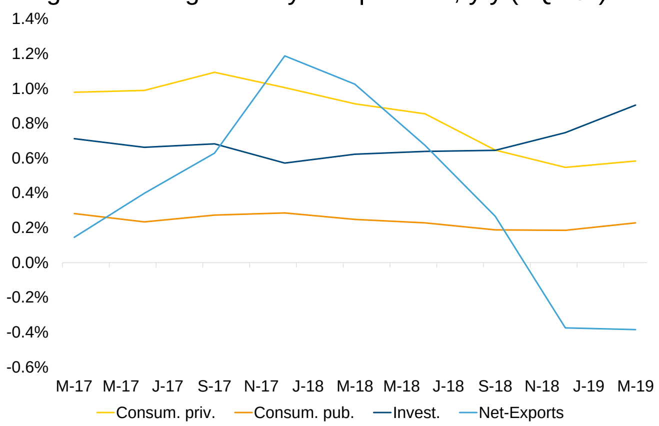
Should the global trade climate improve significantly in 2020, stronger growth momentum in foreign trade would represent an upside risk to our GDP growth forecast for 2020. If a hard Brexit can be avoided, we would alternatively expect GDP growth in 2019 and 2020 to come in around 0.3% higher.

GER and IT manage to return to growth
GDP growth (q/q) on the country level



Source: Eurostat, Erste Group Research

Foreign trade weakens GDP growth
Weighted GDP growth by components, y/y (2Q - Ø)



Source: Eurostat, Erste Group Research

Eurozone Inflation

Core inflation once again disappoints in the first half of 2019

In the first half of 2019 (Jan. - May), Eurozone headline inflation has stabilized at around +1.4% year-on-year. Despite tighter labor markets and a visible acceleration in wage growth, core inflation failed to accelerate. Especially on the country level, considerable differences in core inflation rates are in evidence. While in Germany the average core inflation rate in the past six months stood at +1.4%, it was partly well below the 1% mark in Spain (+0.8%), Italy and France. These substantial regional differences represent an additional problem for the ECB.

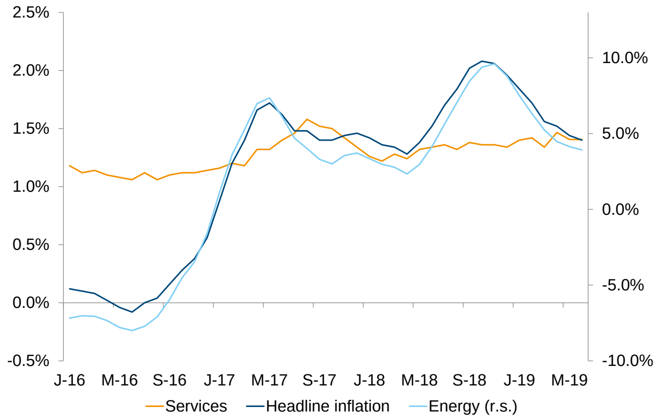
Headline inflation expected to decline to +1.4% in 2019

For 2019 as a whole, we are forecasting a decline in headline inflation to +1.4% from +1.7% in 2018. Since we believe oil prices will largely remain stable until the end of 2019, the expected decrease in headline inflation is primarily attributable to a lower inflation contribution from the energy component. Despite currently muted economic growth, we expect a moderate, gradual increase in the core inflation rate until the end of 2019. The positive correlation between core inflation and wage growth would have to strengthen again in order to generate stronger momentum in core inflation. However, this does not appear likely yet, as companies are currently absorbing the cost of rising wages to the detriment of their profit margins (inter alia because they fear market share losses).

Wage growth exceeds productivity growth

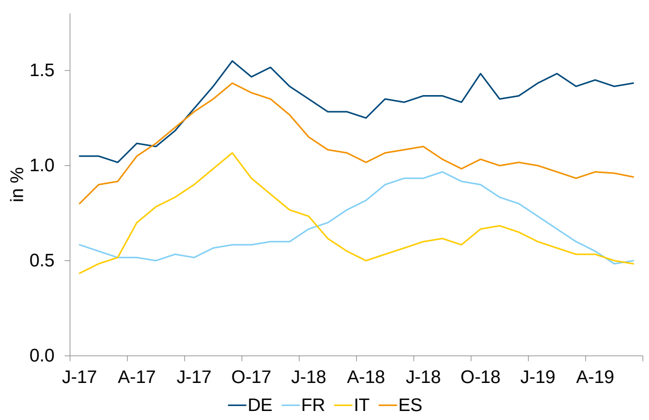
Furthermore, it is currently open to question for how much longer wage growth can be maintained in this difficult economic environment. For example, Italy's competitiveness based on unit labor costs has been steadily declining against the Eurozone average since Q1 2018 due to wage growth significantly exceeding productivity growth. In order to offset this, Italian employees will soon have to exercise more restraint in their wage demands, which should dampen Italy's inflation outlook correspondingly.

Energy prices are driving headline inflation
Comparison of inflation components, y/y (6-month avg.)



Source: Eurostat, Erste Group Research

Large divergences on the country level
Core inflation (y/y, 6-month average) GER, FR, IT, ES



Source: Bloomberg, EC, Erste Group Research

Germany

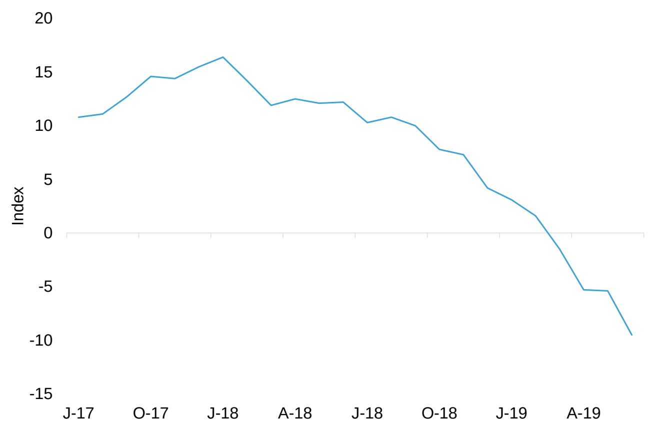
Weakness in foreign trade and consumer spending weighs on GDP growth in 2018 (+1.4%)

In view of the crucial importance of foreign trade for the German economy, the slowdown in growth from the 2nd half of 2018 onward was not entirely unexpected. However, negative one-off effects (e.g. delays in new emission tests) have weakened GDP growth additionally (2018: +1.4%). Export growth declined significantly to +2.0% in 2018 (+4.6% in 2017), as a result of which the contribution from foreign trade weighed strongly on Germany's GDP growth last year. However, in Q1 2019 a slight acceleration in export growth was recorded for the first time since Q4 2017. As a result of strongly rising energy prices, growth in consumer spending also suffered a steady loss of momentum until the end of 2018 and growth in 2018 as a whole experienced an unexpectedly severe decline to +1.1% (compared to +1.8% in 2017). However, thanks to a stabilization of energy prices and a strong labor market, growth in consumer spending accelerated markedly again in Q1 2019. Investment growth momentum decreased only moderately in 2018 (investment growth declined to +2.6% in 2018 from 2.9% previously), which inter alia reflects the favorable financing environment. In Q1 2019 investment growth stabilized at +3.0% y/y.

Weak global trade and Brexit dampen growth outlook for 2019 (+1.0%)

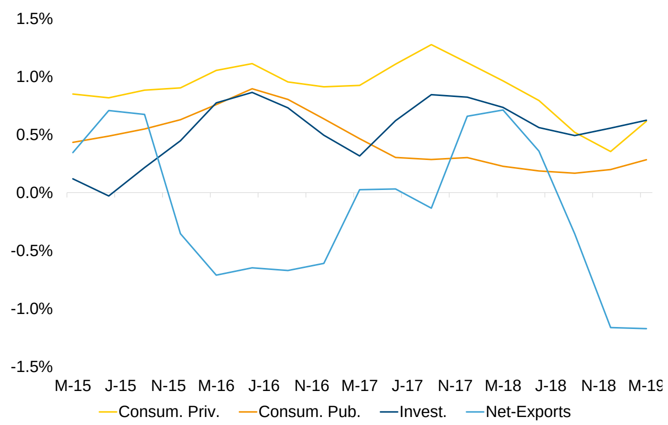
Due to the absence of stimulus from global trade combined with our base case scenario of a Hard Brexit, we expect Germany's GDP growth to decelerate further in 2019, to around +1.0%. The strong labor market and growth in real wages (+1.0% in 2018) should support consumer spending in 2019, and we expect consumption growth to stabilize as a result. In view of above-average investment ratios in the recent past, we are forecasting a further slight decrease in the growth momentum of investment spending in 2019, in line with the difficult global environment. A favorable development from the perspective of Eurozone stability is the fact that Germany's price competitiveness has gradually diminished since 2008 (after growing strongly from 2000 to 2008). By contrast, countries such as France and above all Spain were able to improve their price competitiveness since 2008.

Industry sentiment has deteriorated substantially
Germany industry confidence indicator



Source: EC, Erste Group Research

Foreign trade weighs significantly on GDP growth
Weighted GDP growth by components, y/y (Q2 - Ø)



Source: Eurostat, Erste Group Research

France

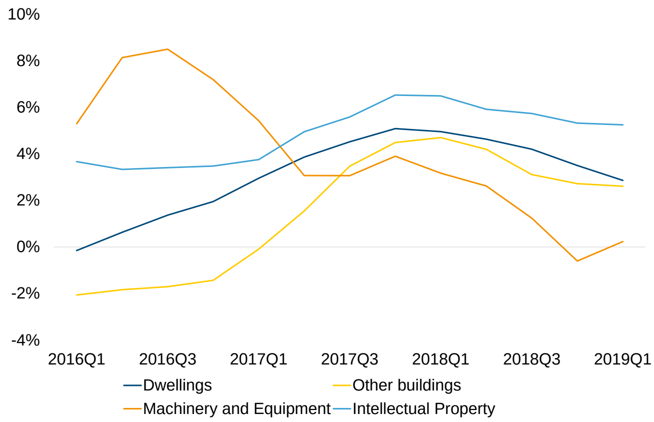
France achieves respectable performance in a difficult environment

France's GDP growth in 2018 (+1.7%) has lost considerably less momentum than Germany's, despite France suffering from strikes and the yellow vests movement. Global turmoil notwithstanding, at +3.5% French export growth barely slowed down in 2018. In Q1 2019 export growth already accelerated to 3.6% y/y again. This reflects the fact that the price competitiveness (in terms of unit labor costs) of the French economy within the Eurozone has improved, particularly relative to Germany and Italy. Consumer spending growth (2018: +0.9%) has slowed down more significantly as a result of rising energy prices. In Q1 2019 consumer spending growth remained largely stable at +0.9% y/y. After a multi-year high was posted in 2017 (+4.7%) growth in investment spending declined to +2.8% in 2018, which was not overly surprising. However, a moderate acceleration in investment spending growth was already detectable again in Q1 2019. By focusing on the importance of investment in intellectual property, the French economy is laying a strong foundation for future productivity-driven growth.

Macron advocates a rapid Brexit, if need be without a deal

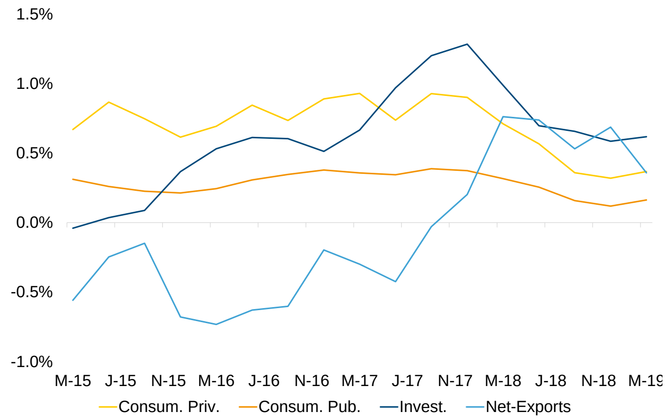
Despite a solid domestic economic performance, the French economy is bound to suffer as a result of the Hard Brexit we envisage, particularly in Q4 2019. As an aside, of all people, Macron is an advocate of finalizing the Brexit as quickly as possible, if need be without an agreement. Thus we are forecasting a further slowdown in France's GDP growth to around +1.1% in 2019. We expect that particularly foreign trade and investment spending will be a drag on growth momentum in 2019, while consumer spending should receive a moderate tailwind from softening inflation. In light of the high indebtedness of government, households and companies, France currently has no choice but to raise its long-term growth potential by implementing productivity-enhancing reforms. As the government budget affords him no room for maneuver, Macron is trying to reorient the composition of government spending in a manner that promotes growth (e.g. by focusing on education).

Focus on investment in intellectual property
Investment growth by sectors, y/y (Q4 - Ø)



Source: Eurostat, Erste Group Research

Investment and foreign trade are driving growth
Weighted GDP growth by components, y/y (Q2 - Ø)



Source: Eurostat, Erste Group Research

Italy

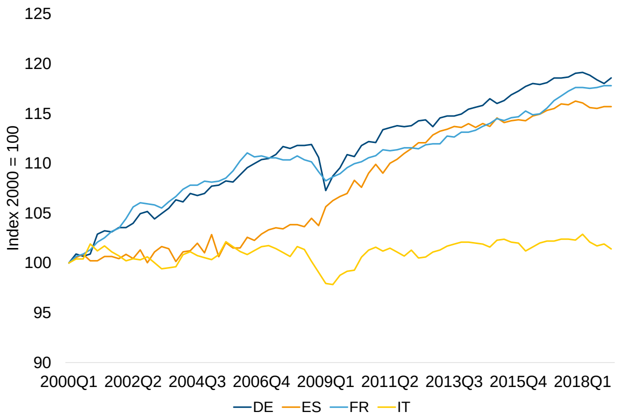
Italy's economy suffers from the negative influence of the populist government

Italy's economy drifted into recession in the second half of 2018 and along with Germany was one of the big disappointments in the Eurozone (GDP growth 2018: +0.9%). Under the negative influence of the populist government, both foreign trade and domestic economic growth weakened significantly. Consumer spending growth slowed to +0.6% in 2018. Weakness in household consumption continued in Q1 2019, with growth slowing to +0.2% y/y. Investment spending growth decelerated as well in 2018, to +3.4%. After stagnating in the second half of 2018, investment growth finally picked up again in Q1 2019. Export growth in 2018 (+1.9%) was disappointing as well, but in Q1 2019 momentum accelerated markedly to +3.5% y/y.

Economy loses competitiveness in 2018

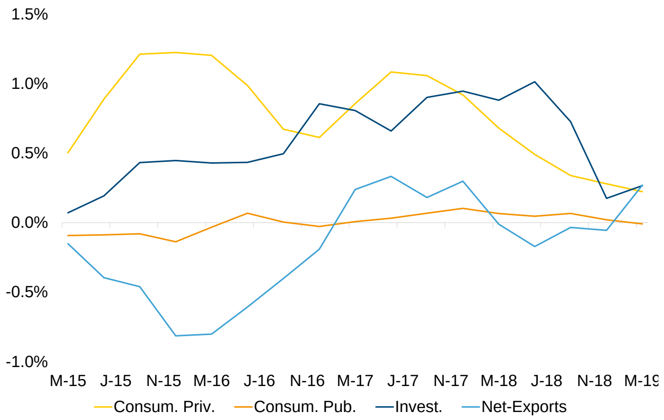
For 2019 as a whole, we are forecasting significantly weaker GDP growth of +0.3% for Italy. We expect a temporary slump in economic growth in Q4 2019 on account of a Hard Brexit in Italy as well, followed by a gradual recovery in subsequent quarters. Since there is no willingness to implement substantive structural reforms in Italy, we expect that the country will continue to post below-average growth rates compared to the Eurozone as a whole in the long run. This entails the risk that investors – as has recently happened – could increasingly doubt the sustainability of Italy's government debt. Structurally Italy's continuous welfare losses (GDP per capita) relative to the Eurozone will continue, which could make political cooperation even more difficult in the future. Italy's clouded growth prospects will probably dampen the inflation outlook of the entire Eurozone for quite some time. Italy's competitiveness has weakened again in recent quarters, due to an increase in unit labor costs (triggered by below average productivity growth). Wage restraint is therefore Italy's only chance to regain some ground.

Italy loses further ground since Q1 2018
Real labor productivity per hour



Source: Eurostat, Erste Group Research

Domestic economy, foreign trade weigh on growth
Weighted GDP growth by components, y/y (Q2 - Ø)



Source: Eurostat, Erste Group Research

Spain

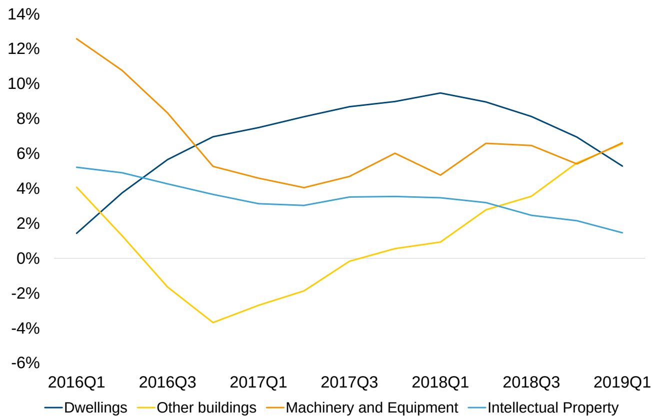
Spain posts above-average growth thanks to improved competitiveness (2018: +2.6%)

Spain's economy has weathered recent turmoil quite well thanks to a strong domestic economic performance and its GDP growth in 2018 exceeded the Eurozone average significantly. In Q1 2019 GDP growth stabilized at 2.4% y/y, primarily driven by consumption (both government and household) and investment spending. In principle the growing importance of investment in equipment and non-residential buildings relative to residential construction is a favorable indicator of sustainable, productivity-driven growth. However, we expect that after a strong showing in 2017 and 2018 (around +5%), growth in investment spending will gradually lose momentum in 2019 and 2020. By contrast, export growth (which weakened further in Q1 2019) should gradually recover, and foreign trade should once again provide a positive contribution to GDP growth as a result.

Political instability threatens medium term growth prospects

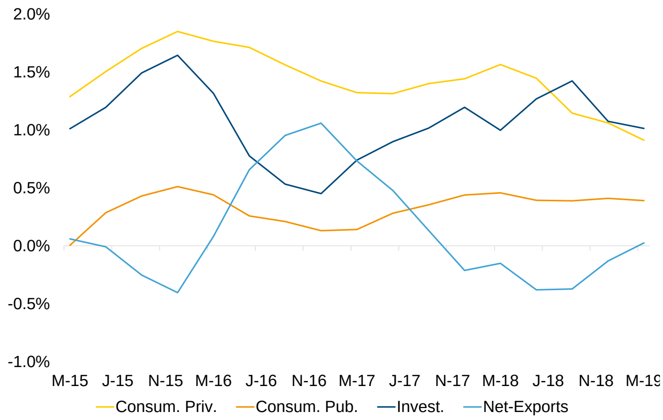
Based on our expectation of a Hard Brexit, we are forecasting a slowdown in Spain's GDP growth to +2.2% in 2019. In principle the Spanish economy has stabilized since the financial crisis and its price competitiveness has improved considerably. We believe this suggests that Spain is likely to achieve growth rates above the Eurozone average in 2019 and 2020 as well. However, a greatly fractured parliament prevents the formation of a stable government. Political paralysis already prevails since mid 2018 in Spain and this prevents the implementation of further reform measures to secure the country's competitiveness. In our opinion this threatens Spain's medium term growth prospects. The head of the largest faction in parliament (Social Democratic Party) will make a first attempt to form a new government at the end of July.

Productivity-enhancing investments are gaining
Investment growth by sector, y/y (Q4 - Ø)



Source: Eurostat, Erste Group Research

Investment spending most important growth driver
Weighted GDP growth by components, y/y (Q2 - Ø)



Source: Eurostat, Erste Group Research

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US Economy and Inflation

Markets have been betting on an economic downturn since the end of last year

US economic growth will be lower this year compared to last year. GDP growth in 2018 was boosted significantly by tax cuts and higher public spending. These effects are now tailing off and as a result economic growth is returning to a level that is sustainable in the long term. However, in financial markets concerns over a sustained slump predominate. The first quarter has not confirmed these fears, while it is becoming apparent that growth will weaken again in the second quarter. It seems nevertheless likely that the US economy has grown above its potential in the first half of the year.

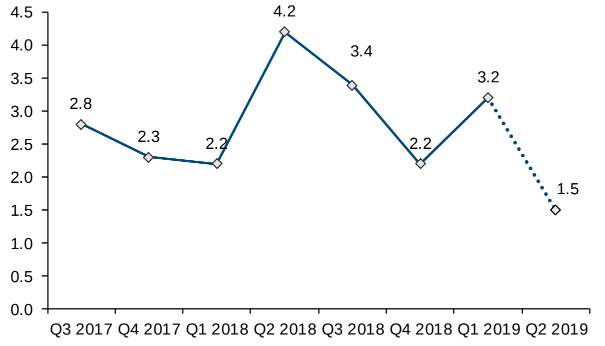
Growth in the first half above the economy's potential

Market fears were stoked by a number of weak economic indicators for May. However, we attribute those to elevated stock market volatility, triggered by the escalation in the trade dispute with China. Recent data included a weakening ISM index, which points to a slowdown in the manufacturing sector. Employment growth was also weak in May. At the same time, consumer spending was strong. Based on currently available data, economic growth of 1.5% annualized should be expected in the US. However, the data for June are still outstanding and should indicate improvement considering that the month of May was marked by the negative environment. Interest rate markets were particularly jittery and seemed to see clear indications of a beginning economic downturn and hence of a central bank response. By contrast, we believe that the US economy will level off at a sustainable growth rate. Ultimately the assessment of future developments depends greatly on expectations regarding the dispute with China. We expect tensions to ease, as this should be in line with US political interests as well.

Trade dispute with China an uncertainty factor

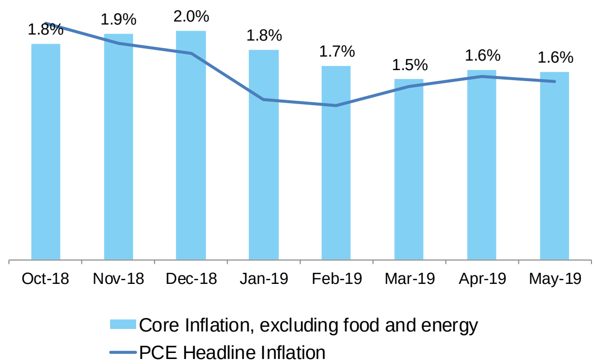
The US inflation rate decreased steadily from the beginning of the year and only gained some ground again very recently. The decrease was not evenly distributed. For example, there was a particularly strong decline in financial services inflation. In our opinion there are currently no indications that the inflation rate is changing significantly and consequently we expect it to remain stable slightly below the Fed's target.

Q2 weak, after strong Q1
GDP growth, quarterly annualized in %



Source: Bureau of Econ. Anal., Atlanta Fed, Erste Group Research

Inflation should by and large remain stable
PCE, y/y in %



Source: Bureau of Labor Statistics, Erste Group Research

Emerging Markets

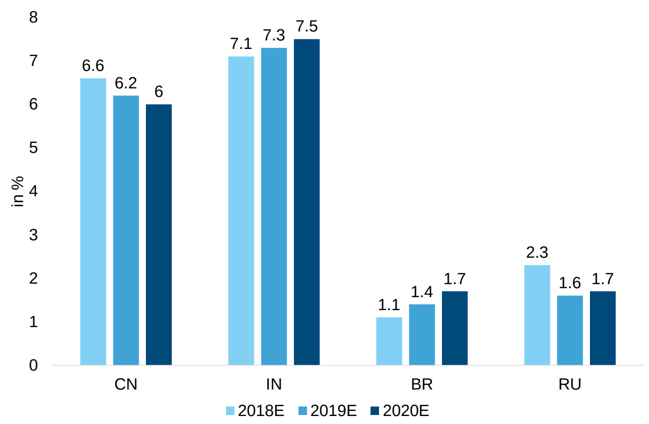
Easing of trade tensions should improve outlook

The economic outlook for emerging markets in the second half of 2019 depends greatly on developments with respect to the trade war as well as upcoming policy decisions by the Federal Reserve. In view of the pressure on both sides, we expect a rapprochement in the ongoing trade dispute, and growth prospects for emerging markets should brighten as a result. This is also why we expect the Fed to refrain from a rate cut this year. Should trade tensions fail to ease and the outlook for the US economy possibly become clouded as a consequence, emerging markets could stand to benefit from US rate cuts. Currently financial markets are already pricing in a minimum of two US rate cuts in the second half of 2019. Alas, this raises the question whether an easing of monetary policy by the Fed would be sufficient to stimulate capital flows into emerging markets (and hence stimulate growth) in an environment in which the trade war persists.

China should be the biggest beneficiary of a rapprochement in the trade dispute

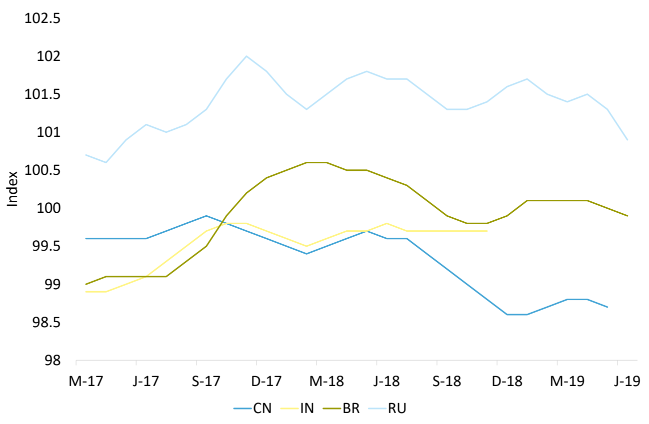
On the country level China should be the main beneficiary of a rapprochement in the trade dispute. In our opinion, a revival of economic growth in China should subsequently impart growth momentum to other emerging market countries as well, e.g. through increasing demand for commodities. However, US economic sanctions continue to weigh on the outlook of countries such as Russia, Turkey (recession expected in 2019) and lately also Iran. In Brazil, President Bolsonaro is wresting with the implementation of pension reforms that are urgently needed in view of high government debt (around 90% of GDP). Brazil is suffering from global weakness in demand, with GDP growth of just slightly more than 1% expected in 2019. As a result of structural problems and a weak institutional framework, we expect Brazil's GDP growth rate to remain muted in the long run. By contrast, we continue to expect India to post above-average growth rates on account of improving economic conditions and a rapidly growing working age population.

Strongest growth momentum expected in India
GDP growth 2018 – 2020E



Source: IMF, OECD, Erste Group Research

Obvious slowdown in Q2 2019
OECD business confidence index



Source: OECD, Erste Group Research

China

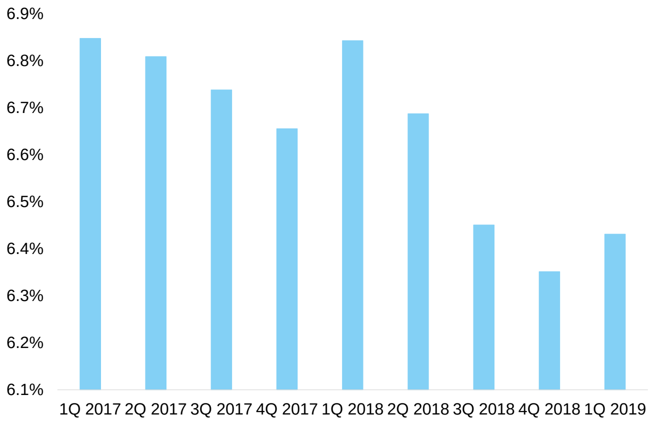
China's government supports the economy with fiscal and monetary policy measures

In light of recent developments in the trade dispute, there is an especially strong focus on China at present. GDP growth has already lost momentum since mid of 2018. China's manufacturing sector is particularly badly affected, growth in industrial production decelerated to +5% y/y in May, a multi-year low. China is making an effort to limit the slowdown in economic growth through fiscal (including substantial tax cuts worth around 4% of GDP) and monetary policy measures (inter alia via easing of credit access for SMEs). The rapprochement in the trade dispute we envisage should provide a short term tailwind to the economy by 2020 at the latest. However, high household and corporate debt levels dampen the country's medium term growth prospects.

China has to implement market reforms in order to safeguard its medium term growth prospects

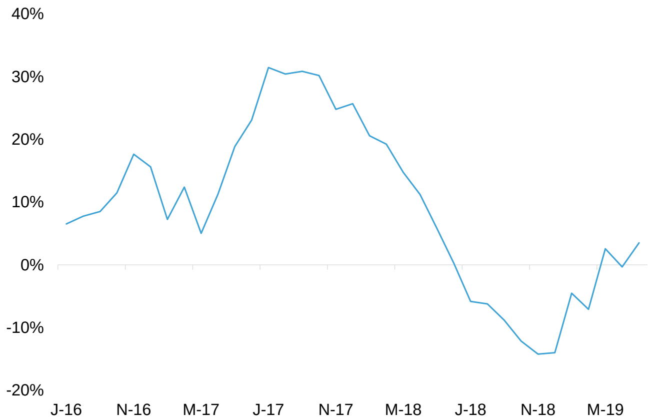
We nevertheless expect that even in the event trade tensions should ease, multinational companies will make a conscious effort to broaden the geographical diversification of their value creation activities to the detriment of China. In Asia e.g. Vietnam or Thailand will benefit from this (however, Vietnam has already attracted Mr. Trump's attention as well). We believe that Mexico as a country directly bordering the US with a valid free trade agreement in place, also stands a good chance to benefit from this development (provided there is no further escalation in the immigration/ border dispute). In order to improve its future economic growth prospects, China must therefore strengthen its domestic economy – e.g. by adopting market reforms that promote competition. Interestingly, concessions to the US required for the resolution of the trade dispute would strengthen the efficiency of China's domestic market (inter alia improved market access for foreign companies, stronger protection of property rights). However, we expect China to proceed very slowly and cautiously with respect to market reforms.

Growth losing momentum
China GDP-growth y/y



Source: National Bureau of Stat. of China, Erste Group Research

Lending starts to recover
China loan growth y/y (12-month total)



Source: PBOC, Erste Group Research

Forecasts[3]

GDP	2017	2018	2019	2020
Eurozone	2.4	1.8	1.1	1.0
US	2.3	2.9	2.5	2.1

Inflation	2017	2018	2019	2020
Eurozone	1.5	1.7	1.4	1.5
US	2.2	2.4	1.8	1.9

Source: Erste Group Research (own calculations)

[3] Note: In accordance with regulations, we are obliged to issue the following statement: Forecasts are not a reliable indicator of future performance.

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Published by:

Erste Group Bank AG
Group Research
1100 Vienna, Austria, Am Belvedere 1
Hauptsitz: Wien
Firmenbuchnummer: FN 33209m
Handelsgericht Wien

Erste Group Homepage: www.erstegroup.com