Europe forecast update: green shoots begin to sprout in difficult environment

It took a little longer than expected, but European growth has started to recover from the slump seen in the second half of last year. A number of domestic headwinds have faded, but uncertainty over external demand has returned. The escalation in the US-China trade war is likely to mean that Europe should not rely on a recovery in net trade.

In the UK, Brexit-related stockpiling has helped lift growth in the latest quarter, but a delay to the ratification of the Withdrawal Agreement means uncertainty for corporates is set to continue.

Broad-based rebound

At the start of the year, weaker data had stoked fears that the eurozone had plunged into recession. European equities were not only priced for recession, but a potential financial crisis back in January. Since then, sentiment has been slowly recovering along with activity data. Pessimism was clearly overdone.

Europe sees a broad-based recovery in growth in Q1

The preliminary estimate for eurozone GDP growth shows the economy bounced back in the first quarter, as growth rose from 0.2% to a solid 0.4% quarter-on-quarter. The vast majority of member states reported an acceleration, highlighting the broad-based nature of the recovery.

Within member states, Spain led the pack by recording a strong quarter of 0.7% quarterly growth, followed by the Netherlands, Portugal and the UK at 0.5% each respectively. Italy and Belgium were the laggards with 0.2% growth, though the former did mark the end of its post-election recession.

Chart 4: GDP recovery seen across the EU

Source: Eurostat, ONS, Schroders Economics Group. 15 May 2019.

There was relief in Germany as the economy, which had narrowly avoided a technical recession at the end of 2018, rebounded to 0.4% growth in the first quarter. Although a breakdown of the figures is not yet available, the early report from the Federal Statistics Office (Destatis) suggested that strong household consumption offset lower government spending, while the contribution from net trade was mixed.

Meanwhile, France saw another robust quarter as GDP grew by 0.3% for the third consecutive quarter. A breakdown of French GDP showed a rebound in consumer spending, while investment also made a positive contribution. Net trade did however drag on growth, but this was offset by a small build-up of inventories.

Overall, data so far this year has been encouraging. There is clear evidence that domestic demand remains healthy, supported by unemployment rates falling further, and above-inflation wage growth. The key area of weakness remains external demand, but this is unlikely to improve anytime soon.

Eurozone forecast update

Domestic demand remains solid, but the escalation in the US-China trade war will weigh on external demand

Looking ahead, we have revised down the eurozone growth forecast for 2019 from 1.3% to 1.2% (chart 5). Despite the better-than-expected outcome for the first quarter, there are two significant headwinds that have prompted the downgrade.

The first is the escalation in the US-China trade war. The increase in tariffs and threat to apply more to a wider range of products is likely to lead to reduced demand for eurozone exports of capital goods. There may be some positive spillovers into other types of goods, but we doubt they will be big enough.

The second headwind is the recent rise in oil prices. The futures price for December 2019 is now $7.5 per barrel higher (or 12%) compared to our last forecast update. As an oil importer, Europe is likely to see higher energy inflation in the coming months, which will reduce purchasing power and, at the margin, lower consumption growth.

Chart 5: Eurozone GDP forecast

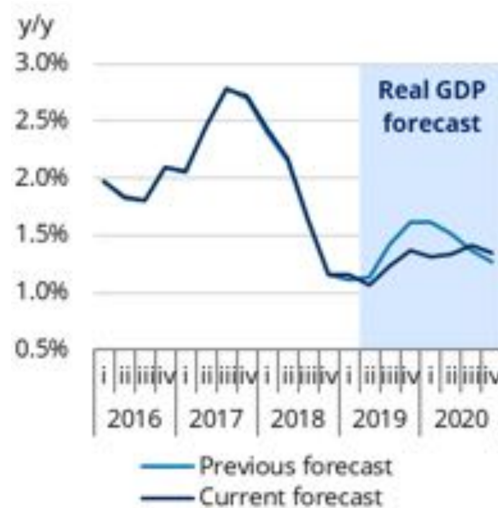
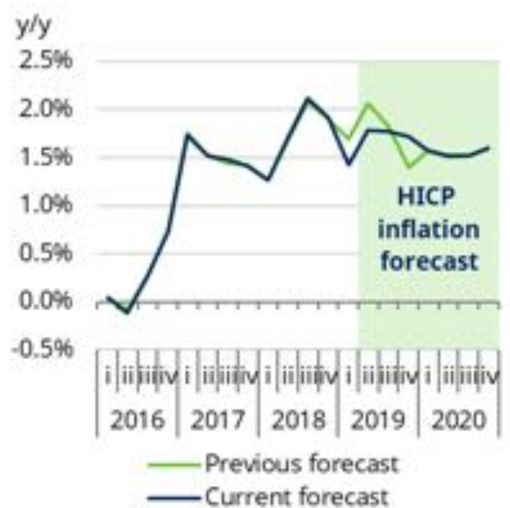


Chart 6: Eurozone inflation forecast



Source: Schroders Economics Group. 15 May 2019. Previous forecast from February 2019. Please note the forecast warning at the back of the document.

For 2020, the GDP forecast remains unchanged at 1.4%, but this does rely on a trade deal eventually being reached between the US and China, which helps lift external demand. The risk is that even more tariffs are applied as President Trump has threatened, and worse still, the US starts a trade war with the EU over car tariffs. These risks are portrayed in the "Trade war: US vs. rest of the world" scenario, which would most likely drive the eurozone into recession.

The eurozone inflation forecast remains at 1.7% for 2019 but is raised from 1.5% to 1.6% for 2020. Within the headline figures, the core inflation forecast is lowered from 1.6% to 1.3% for this year, largely owing to the lower outturn for the first quarter. However, energy inflation is revised up to reflect higher oil prices, hence the headline figure remaining at 1.7%.

As for monetary policy, updated forward guidance from the European Central Bank (ECB) in March led us to push out the next rate rise to March 2020. ECB president Mario Draghi announced that interest rates are likely to remain on hold until at least 2020. Previous forward guidance had suggested that interest rates would remain on hold until the end of this summer, but a perceived deterioration in the near-term

outlook persuaded the ECB Governing Council to extend the period of record low interest rates.

ECB pushed back its rate rise guidance to 2020, but was it premature?

Given the rebound in economic growth, it now seems that the ECB's shift in forward guidance may have been premature. Some members of the governing council may start to sound more hawkish again in the coming months, but the majority of the governing council are likely to remain dovish. We only have one additional rate rise at the end of 2020, which would take the deposit rate up to zero, and the main refinancing rate up to 0.50%.

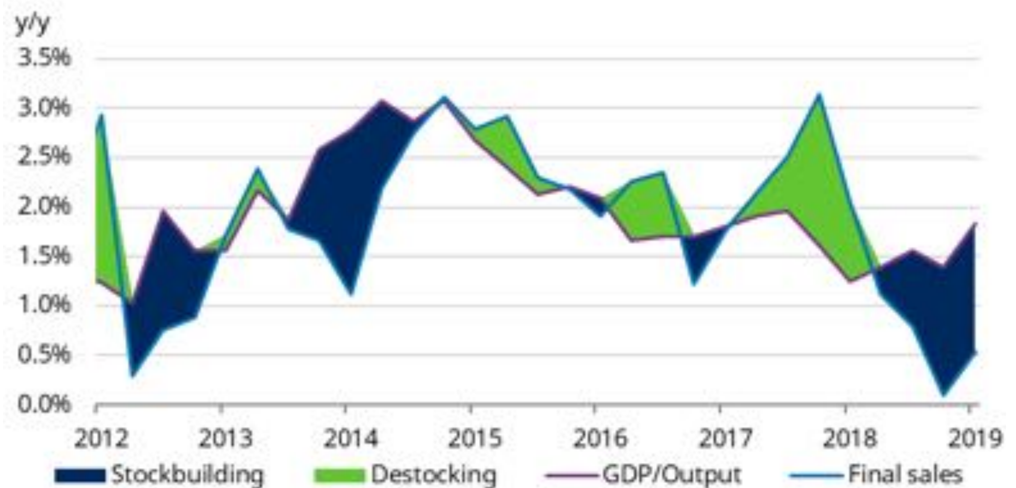
UK forecast update: Brexit stockpiling inflates GDP

Growth in the UK also rebounded in the first quarter, but for a very different reason. Households, firms and even the government appear to be stockpiling goods ahead of Brexit. We discussed this in last month's publication, highlighting the record highs reached by the survey questions on inventories from private business surveys. The latest GDP figures highlight the degree of stockpiling in the economy.

UK growth also rebounded, but for a very different reason

In the year to the first quarter of 2019, GDP grew by 1.8% y/y. However, final sales (GDP excluding inventories) only rose 0.7% y/y. Chart 7 shows these two measures of activity, with the shaded areas highlighting the difference. When final sales are running ahead of GDP (or output), then the economy is consuming its inventories, but when sales are below output (as at present), then the economy is seeing inventories rise. A rise in inventories is typically followed by destocking, which causes growth to slow. We assume this will happen later this year.

Chart 7: UK GDP vs. final sales



Source: Thomson Reuters Datastream, ONS, Schroders Economics Group. 15 May 2019.

The build-up of inventories in the first quarter of the year meant that GDP was far stronger than we had anticipated, leading to an upgrade in our forecast from 1.1% to 1.4% for 2019. 2020 is nudged down from 1.5% to 1.4% thanks to weaker external demand.

Stockpiling helped boost growth to 1.8% y/y, but final sales only grew by 0.7% y/y to Q1

The extension of the Brexit deadline to October means that the GDP growth forecast also needed re-profiling (chart 8). In the near term, companies are likely to remain cautious and hold back business investment. However, once some clarity on Brexit is provided, then we should see a pick-up.

We recognise the situation is extremely uncertain, however, for the purposes of the forecast we assume that the UK will eventually agree a Withdrawal Agreement and leave the EU at the end of October (in-line with the new deadline). The UK will then enter a transition period until the end of 2020, during which time it will negotiate its future relationship.

The UK growth forecast has been re-profiled to account for the delay in Brexit

Chart 8: UK GDP forecast

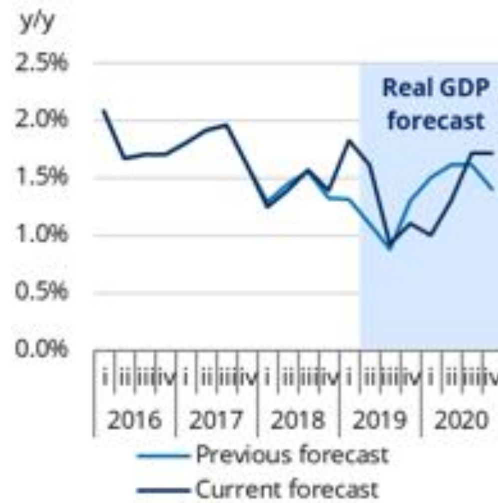


Chart 9: UK inflation forecast

Source: Schroders Economics Group. 15 May 2019. Previous forecast from February 2019. Please note the forecast warning at the back of the document.

The inflation forecast has been revised up from 1.8% to 2% y/y for 2019 due to the rise in wholesale oil prices. It is then nudged down for 2020 from 2.4% to 2.3% due to base effects.

As for the Bank of England, despite attempts to sound hawkish in the presentation of the May Inflation Report, governor Mark Carney admitted that a negative output gap is likely to become larger this year, before potentially excess demand appears in 2020. In other words, spare capacity still exists, and it is likely to increase in the near term, which should weigh on inflation pressures. In our view, the Bank is unlikely to raise interest rates before Brexit. We have therefore pushed out the next rate rise to November, assuming the UK leaves the EU in October. The single rate rise this year takes the main policy rate to 1% by the end of 2019, and we forecast two more hikes in 2020, taking rates to 1.5% by the end of 2020.

No-deal Brexit remains a key risk

Other than the various scenarios outlined earlier, the key risk to our UK forecast is a change in direction of the government on Brexit. Faced with the prospect of a fourth rejection of her withdrawal bill Prime Minister May has resigned and triggered a Conservative Party leadership contest, the winner of which would become Prime Minister in July.

A no-deal Brexit remains a very real risk, especially if a Brexiteer takes over from Theresa May

At this stage, bookmakers have the former Foreign Secretary and Mayor of London Boris Johnson as favourite. The hard-line Brexiteer could easily take the UK out of the EU without a deal, despite Parliament voting in favour of essentially removing the option. He could do this by simply failing to comply with the EU's demands that the UK should continue to follow the rules. This presumably would lead to the EU agreeing to terminate the relationship in October.

If this were to happen, we would anticipate the economy to slow and fall into recession around the turn of the year. While the Bank would probably cut interest rates eventually, the expected depreciation in the pound would cause inflation to spike. The household sector has already run down its safety buffer in the form of its savings rate, therefore a contraction in demand is very likely.

Schroders Economics Group: Views at a glance

Macro summary – June 2019

Key points

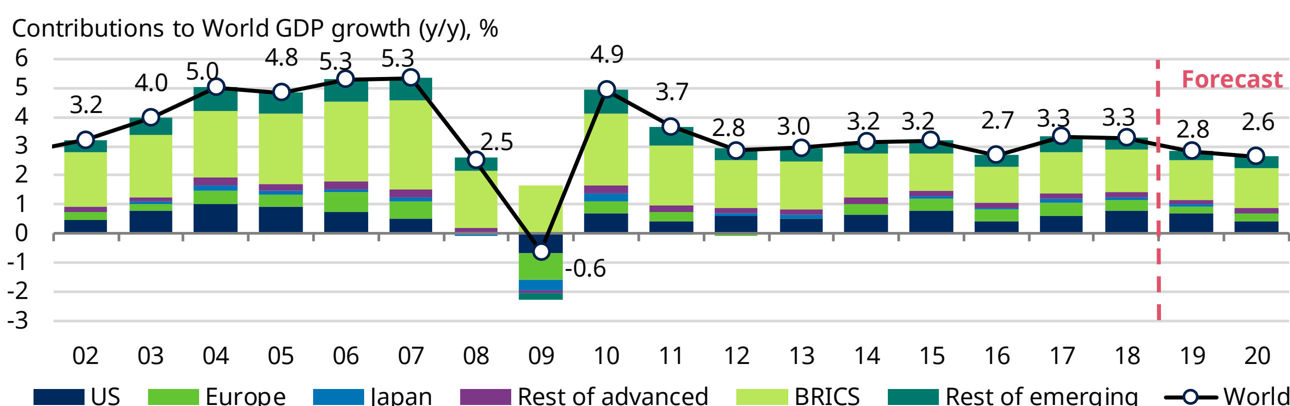
Baseline

- After expanding by 3.3% in 2018, global growth is expected to moderate to 2.8% in 2019 and 2.6% in 2020. Inflation is forecast to decline to 2.6% this year after 2.7% in 2018 and then rise to 2.7% in 2020. Meanwhile we expect the US and China to sign a trade deal in December, although the impact of actions so far will still be felt in 2019 and 2020.
- US growth is forecast to slow to 2.6% in 2019 and 1.5% in 2020. Following recent statements from the Fed we do not expect any further rate hikes. As US fiscal stimulus fades and the economy slows, the Fed is forecast to cut rates twice in 2020 after ending quantitative tightening in September 2019.
- Eurozone growth is forecast to moderate from 2% in 2018 to 1.2% in 2019 as the full effects from the US-China trade war and Brexit hit European exporters. Inflation is expected to remain under 2%, with higher energy price inflation in 2018 replaced by higher core inflation in 2019. The ECB has ended QE and is expected to raise interest rates only twice in 2020. The refinancing rate is forecast to reach 0.50% and the deposit rate zero by the end of 2020.
- UK growth is likely to remain constant at 1.4% this year, unchanged from 2018. Assuming that a Brexit deal with the EU passes parliament in Q4 ahead of a transition period that preserves the status quo of single market and customs union membership, growth is expected to remain at 1.4% in 2020. Inflation is expected to fall to 2% in 2019 thanks to an expected rise in sterling, but stronger quarterly growth is expected to push inflation up to 2.3% in 2020. Meanwhile, the BoE is expected to hike once in 2019 and twice in 2020 (to 1.5%).
- Growth in Japan should fall to 0.9% in 2019 from 1.1% in 2018, however the path of activity should be volatile owing to the consumption tax hike in October this year. A slow recovery should follow resulting in 0.2% growth in 2020. We do not expect the BoJ to alter yield curve control as inflation remains well under 2% in our forecast horizon.
- Emerging market economies should slow to 4.4% in 2019 after 4.8% in 2018, but pick-up slightly to 4.6% in 2020. We are optimistic that for most of the BRIC economies' domestic factors can outweigh global problems in 2020. China benefits from an easing of trade tensions with the US, but against a backdrop of secular decline the PBoC should continue to ease.

Risks

- Risks are tilted toward deflation with the highest individual risk going on the US recession 2020 scenario where the economy proves more fragile than expected as fiscal stimulus is withdrawn. We also see a risk of an escalation in the US-China dispute with the US extending the trade war to Europe.

Chart: World GDP forecast



Source: Schroders Economics Group, May 2019. Please note the forecast warning at the back of the document.

Schroders Forecast Scenarios

Scenario	Summary	Macro impact	Cumulative 2019/20 global vs. baseline		
			Probability*	Growth	Inflation
Baseline	Our forecast for global GDP growth in 2019 is unchanged at 2.6%, but we have trimmed our projection for 2020 to 2.6% (previously 2.7%). Although unchanged the forecast for this year reflects upgrades to the US, which are offset by downgrades to eurozone, Japan and the emerging markets. In 2020, the downward revision is across the board with US growth cut to 1.5% and China to 6%, for example. Meanwhile, our inflation forecasts have been raised for this year and next with increases across all regions largely driven by the rise in oil prices which are now expected to be significantly higher over the forecast period than at the time of our last outlook in February. US inflation is also higher as a result of the latest increase in tariffs on imports from China which also have an adverse effect on growth.	The US Fed funds rate is assumed to have peaked with the next move expected to be a rate cut in June next year in response to a weakening in growth. We have pushed out rate increases in the UK and Eurozone with only one move from the Bank of England now expected this year whilst the ECB waits until 2020 before tightening. We expect the BoJ to leave policy unchanged rather than tightening its yield curve control policy further. China is expected to ease further through a lower RRR which is now expected to reach 10% by end 2020 (previously 11%). The USD is expected to remain firm in the near term but to weaken later in the year as rates peak in the US whilst beginning to rise in the Eurozone and UK. GBP is also boosted by our assumption that the economy enters a transition period in October rather than crashing out of the EU.	60%	-	-
1. Italian debt crisis	Although Italy has reached an agreement with the European Commission on its budget for this year, we would expect renewed tension between Rome and Brussels in the autumn as the next budget is formulated. Markets fear another more serious dispute, pushing the 10yr BTP yield up to 6%. After a couple of failed auctions, the government is forced to seek help from the rest of the EU in the form of a bail-out. There is some knock-on effect to other peripheral bond markets. A technocrat is installed as Italian PM, and the ECB's OMT programme is activated. QE is also restarted in 2019 as the Eurozone faces a deep recession. The threat of restructuring/default on Italian debt remains, but yields return to more manageable levels thanks to the ECB and change in domestic policy.	Stagflationary. The principal impact is weaker global growth with all regions affected as Italy drags Eurozone growth lower and the increase in uncertainty weighs on confidence and spending around the world. On inflation the picture is more mixed: for the eurozone, this is a stagflationary scenario due to EUR falling to 0.99. The US and Japan see their currencies appreciate, and combined with lower oil prices and a shock to financial markets, both see lower growth and inflation compared to the base. The impact on EM is more mixed. China intervenes to prop up the CNY, but Brazil, India and Russia all see FX depreciation as global risk aversion rises, making this a stagflationary scenario in EM.	4%	-0.6%	+0.1%
2. China reopens the spigots	China reverts to its old playbook to avert a deepening economic slowdown. Casting aside the relative timidity of current stimulus measures, policymakers embark on large-scale fiscal and monetary stimulus, embodied in massive infrastructure spending and a resurgent property sector. Global commodity demand skyrockets, to the benefit of a number of emerging markets, and Chinese demand for manufactured goods also jumps.	Reflationary. Stronger demand from China boosts world trade and increases commodity prices with the result that both global growth and inflation are higher than in the baseline. The trade sensitive Eurozone sees a significant boost to growth in 2020 with the EM also benefitting. Interest rates are higher across the DM and in the EM (ex. China).	5%	+0.7%	+0.6%
3. Trade war: US vs. RoW	The US administration decides to impose tariffs on auto imports from the rest of the world thus extending the trade war into new territory. Meanwhile the dispute with China worsens as trade talks fail and the US imposes further tariffs on the remainder of imports from China.	Stagflationary. Higher import prices push inflation higher whilst weaker trade weighs on growth. Capex is also hit by the increase in uncertainty and the need for firms to review their supply chains. Central banks are expected to focus on the weakness of activity and ease policy by more than in the baseline.	8%	-0.8%	+0.1%
4. Oil jumps to $100	President Trump's withdrawal from the Iran nuclear deal and imposition of sanctions results in 1 million barrels per day being removed from global oil supply, as the agreement collapses. Risk premium on oil rises as threat of conflict in the region between Iran, Saudi Arabia and Israel spreads beyond Syria. Given the tightness of the oil markets, oil prices surge to $100 p/b where they remain over the forecast period.	Stagflationary. Higher oil prices feed through rapidly into inflation putting a squeeze on oil consumers world wide. Oil producers benefit but do not increase spending rapidly enough to offset cut backs elsewhere. In the US, stronger shale gas capex and output initially offset the shock, but once this fades, the effect on household budgets and global trade drag on growth. Policy tightening by the Fed is more limited as the central bank weighs higher inflation against weaker growth.	4%	-0.4%	+0.7%
5. US supply side surprise	The US labour market proves to be more flexible than expected with labour supply continuing to rise through a higher participation rate as more people return to the workforce. This extends the cycle by containing wages and inflation in the US for longer than in the baseline allowing stronger growth. There is a knock-on to growth in the rest of the world though stronger US demand although slightly higher commodity prices raise inflation.	Reflationary. Stronger real growth allows the Fed to increase real rates slightly more in 2019 and as the economy continues to expand in 2020 the central bank does not cut rates as in the baseline. Interest rates are slightly higher elsewhere in line with stronger activity.	5%	+0.4%	+0.2%
6. US 2020 recession	The US economy proves to be more fragile than expected, as tighter monetary policy combined with the end of fiscal stimulus slow demand and cause business and households to retrench. Output begins to contract at the start of 2020 thus bringing an end to the cycle whilst commodity prices and inflation fall. The Fed eases, but markets slump on fears of a wider global recession.	Deflationary. Weaker US growth drags global trade lower, hitting the eurozone, emerging markets and Japan particularly hard. Increased market volatility also hits demand through tighter financial conditions and weaker confidence and consequently global growth slows sharply. Monetary policy is eased significantly across both the DM and EM economies in 2020.	9%	-0.7%	-0.5%
7. Recession ex. US	The slowdown in Europe, China and Japan gathers momentum as contracting export growth undermines business confidence causing capital spending to contract. Firms retrench and unemployment rises hitting consumer spending. Commodity prices weaken and inflation falls.	Deflationary. Weaker growth drags global trade lower, hitting the US which is also affected by increased market volatility and tighter financial conditions. The USD is expected to strengthen putting added pressure on EM. Monetary policy is eased around the world.	5%	-1.0%	-0.7%
8. Other			0%	-	-

*Scenario probabilities are based on mutually exclusive scenarios. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2018	2019		Prev.	Consensus	2020		Prev.	Consensus
World	100	3.3	2.8		(2.8)	2.8	2.6	↓	(2.7)	2.8
Advanced*	61.4	2.3	1.8		(1.8)	1.8	1.4	↓	(1.5)	1.6
US	26.5	2.9	2.6	↑	(2.4)	2.6	1.5	↓	(1.6)	1.9
Eurozone	17.2	2.0	1.2	↓	(1.3)	1.1	1.4		(1.4)	1.3
Germany	5.0	1.9	0.9	↓	(1.0)	0.8	1.2	↓	(1.4)	1.5
UK	3.6	1.4	1.4	↑	(1.1)	1.4	1.4	↓	(1.5)	1.4
Japan	6.7	1.1	0.9	↑	(0.7)	0.6	0.2	↓	(0.4)	0.4
Total Emerging**	38.6	4.8	4.4	↓	(4.5)	4.4	4.6	↓	(4.7)	4.6
BRICs	25.3	5.7	5.5		(5.5)	5.5	5.5		(5.5)	5.5
China	16.7	6.6	6.3		(6.3)	6.3	6.0	↓	(6.1)	6.1

Inflation CPI

y/y%	Wt (%)	2018	2019		Prev.	Consensus	2020		Prev.	Consensus
World	100	2.7	2.6	↑	(2.4)	2.5	2.7	↑	(2.5)	2.5
Advanced*	61.4	2.0	1.8	↑	(1.7)	1.6	2.0	↑	(1.9)	1.8
US	26.5	2.4	2.3	↑	(1.9)	1.9	2.4	↑	(2.3)	2.1
Eurozone	17.2	1.7	1.7		(1.7)	1.4	1.6	↑	(1.5)	1.4
Germany	5.0	1.8	1.8		(1.8)	1.5	1.7		(1.7)	1.6
UK	3.6	2.5	2.0	↑	(1.8)	2.0	2.3	↓	(2.4)	2.0
Japan	6.7	1.2	0.3	↓	(0.5)	0.6	1.2	↑	(1.0)	0.9
Total Emerging**	38.6	3.8	4.0	↑	(3.7)	4.0	3.8	↑	(3.5)	3.7
BRICs	25.3	2.8	2.8	↑	(2.6)	2.9	3.1	↑	(2.8)	2.9
China	16.7	2.2	2.4	↑	(2.0)	2.3	2.7	↑	(2.2)	2.2

Interest rates

% (Month of Dec)	Current	2018	2019		Prev.	Market	2020		Prev.	Market
US	2.50	2.50	2.50	↓	(2.75)	2.35	2.00	↓	(2.25)	2.06
UK	0.75	0.75	1.00		(1.00)	0.89	1.50		(1.50)	0.99
Eurozone (Refi)	0.00	0.00	0.00	↓	(0.25)	-0.33	0.50	↓	(0.75)	-0.26
Eurozone (Depo)	-0.40	-0.40	-0.40	↓	(-0.20)		0.00	↓	(0.25)	
Japan	-0.10	-0.10	-0.10		(-0.10)	0.03	-0.10	↓	(0.00)	0.02
China	4.35	4.35	4.00		(4.00)	-	3.50		(3.50)	-

Other monetary policy

(Over year or by Dec)	Current	2018	2019		Prev.	Y/Y(%)	2020		Prev.	Y/Y(%)
US QE ($Tn)	4.0	4.1	3.7	↑	(3.5)	-9.8%	3.7	↑	(3.4)	0.0%
EZ QE (€Tn)	2.4	2.4	2.4		(2.4)	0.0%	2.4		(2.4)	0.0%
UK QE (£Bn)	422	435	445		(445)	2.3%	445		(445)	0.0%
JP QE (¥Tn)	557	552	573	↓	(575)	3.8%	593	↓	(595)	3.5%
China RRR (%)	13.50	14.50	12.00		12.00	-	10.00		10.00	-

Key variables

FX (Month of Dec)	Current	2018	2019		Prev.	Y/Y(%)	2020		Prev.	Y/Y(%)
USD/GBP	1.27	1.27	1.34	↓	(1.42)	5.2	1.38		(1.38)	3.0
USD/EUR	1.12	1.14	1.14	↓	(1.17)	-0.3	1.18	↓	(1.20)	3.5
JPY/USD	109.5	109.7	110		(110)	0.3	108		(108)	-1.8
GBP/EUR	0.88	0.90	0.85	↑	(0.82)	-5.2	0.86	↓	(0.87)	0.5
RMB/USD	6.90	6.87	6.85		(6.85)	-0.2	7.00		(7.00)	2.2
Commodities (over year)										
Brent Crude	67.8	71.6	70.2	↑	(62.7)	-1.9	69.1	↑	(62.3)	-1.6

Source: Schroders, Thomson Datastream, Consensus Economics, June 2019
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 28/05/2019
Previous forecast refers to March 2019
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

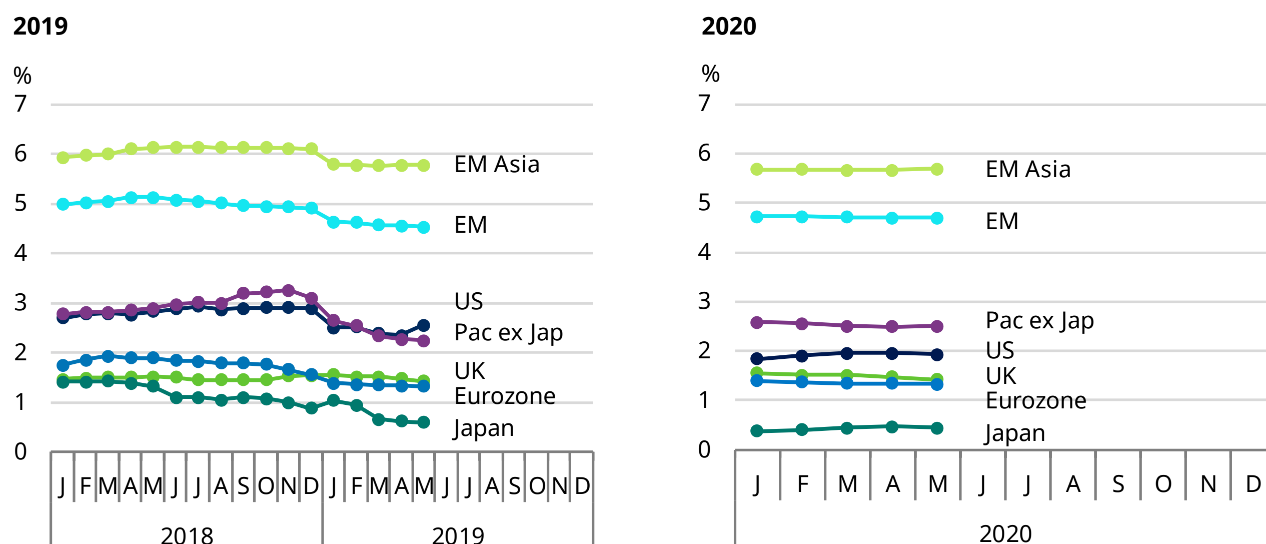
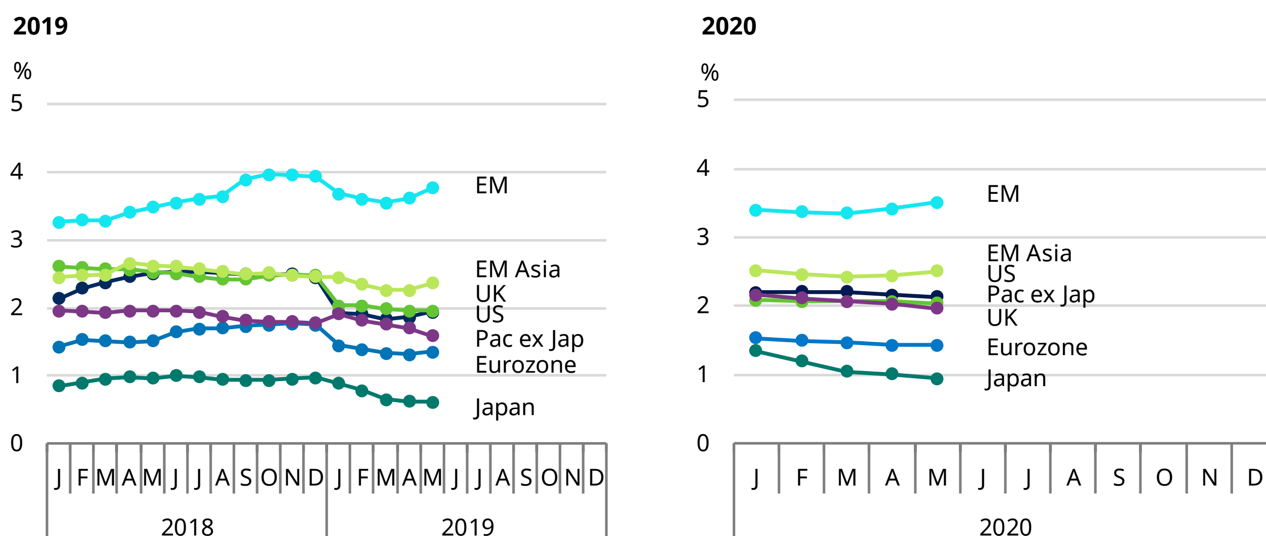


Chart B: Inflation consensus forecasts



Source: Consensus Economics (27 May 2019), Schroders.
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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