In case you missed it: Fear factor returns

Despite tariff delays, the chatter about inverted yield curves and the 'r' word has brought back the sombre mood. The fact that Chinese industrial production hit a 17-year low, Germany's golden decade has ended and we've notched up our no-deal Brexit probability to 25% hasn't helped either. All eyes on the annual Jackson Hole symposium next week

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Opinion | 14 August 2019 United States

US: The self-fulfilling threat of an inverted yield curve

The market is worried about a recession. For now we don't see it, but there is a chance the fear becomes self-fulfilling

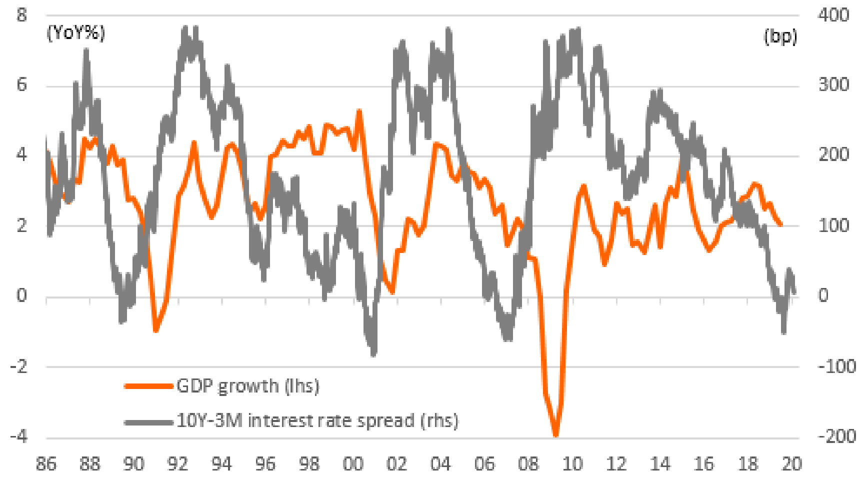
Source: Shutterstock

Yield curve underlines recession fears

On the economics dashboard of doom, we have another flashing warning light. Overnight we have seen the inversion of the 2-10 year part of the Treasury yield curve, the first time this has happened since 2007 when the global financial crisis started to bite. Moreover, an inverted yield curve preceded all nine of the US recessions since the mid-1950s so it is understandable why economists are getting a little nervous.

In normal times investors want to be compensated for the risk of lending for longer periods of time – you do not know what may happen over the next ten years (will inflation spike, will a country get into debt problems etc) – and they feel more comfortable lending over a shorter period of time. Hence why interest rates on 2-year debt are normally lower than 10-year borrowing costs. However, the fact that this has flipped suggests that investors are seriously worried about a downturn, which will keep inflation low. The market is also hinting that it thinks the Federal Reserve is “behind the curve” and that it may not cut short-term interest rates quickly enough to head off a recession.

2-10 year yield curve and GDP growth



Source: Macrobond, ING

Is it different this time? Probably…

Now it is important to point out that an inverted yield curve has given false signals in the past on possible US recessions (around the Russia/LTCM crisis in 1998 for example), while other countries have experienced prolonged yield curve inversion in the past without recession – the UK for example through much of the 1990s. As such it is important to emphasise the obvious point there is no inevitability of recession.

The lagged effects of the Fed's quantitative easing programme has made the curve flatter than it otherwise would be

Then there is always the argument that "things are different this time" and there is certainly a strong case that can offer some comfort. The lagged effects of the Fed's quantitative easing programme has made the curve flatter than it otherwise would be (relative to previous cycles). After all, the trillions they invested in the Treasury market were to stimulate the economy by driving down borrowing costs through the economy, boost liquidity and make higher-risk assets look more attractive.

There have also been arguments about the perceived time value of money given ageing populations around the world, making people more willing to hold such assets, but at the current juncture, the negative yields in Europe are a bigger factor in play. This is making the positive yielding US Treasuries look incredibly attractive and those European managers that have some discretion or flexibility on where they can invest are taking advantage. Throw in the US' safe-haven status and the seeming solidity of the dollar for now and it is unsurprising managers are moving more of their allocations here.

The economic outlook is certainly "mixed"

For now the US economy remains in decent shape and recession is certainly not our base case. The consumer sector is strong and the plunge in longer-dated borrowing costs is a clear boost here. Today we have seen Mortgage Banker Association data showing the typical 30-year mortgage rate has dropped to 3.93% from 5.20% in November last year. This prompted a 36.9% surge in mortgage refinancing to a three year high, which will help to put more cash in the pockets of homeowners. Mortgage demand for home purchases has also been trending higher through 2019.

What is causing the market's fear of recession is, of course, a combination of the weaker global environment – another set of woeful German numbers haven't helped sentiment – and concerns that the protracted nature of the "trade war" with China is sapping business confidence, putting up costs and hurting profits. The result may be weaker hiring and investment in the US that could lead to a broader economic downturn.

We continue to make the case for an eventual more stable truce on trade with China as President Trump looks to focus on re-election next year. He will recognise that a strong economy with rising asset prices is critical for his campaign so securing some form of a deal will help lift a huge dark cloud hanging over the global economy while a few more rate cuts from the Federal Reserve and more stimulus from around the world will also help.

But prolonged inversion could make a recession more likely

Even if we are right, we have to be wary that an inverted yield curve driven by recession fears can potentially be self-fulfilling. Banks typically borrow short term and lend longer term so when the yield curve is inverted the interest rate received on assets could be lower than what they pay on their liabilities.

> *So far there is little evidence that the flattening and subsequent inversion of the yield curve is feeding through into reduced credit availability*

This will hit profitability and could decrease risk tolerance, which implies tighter lending standards. Indeed, when asking banks about this for the Federal Reserve's Senior Loan Officers report, the write up concluded an inverted yield curve would be interpreted as 'signalling a less favourable or more uncertain economic outlook and likely to be followed by a deterioration in the quality of existing loan portfolio.'

So far there is little evidence that the flattening and subsequent inversion of the yield curve is feeding through into reduced credit availability (certainly not if you look at today's mortgage lending numbers), but that could change if the inversion persists. A scenario of much tighter credit conditions would clearly add to the headwinds facing the US economy and heighten the chances of a downturn. It's difficult to see the Fed not bowing to the markets' will and cutting rates more aggressively in such an environment.

In this regard, the Federal Reserve's Jackson Hole symposium 22 -24 August will be the next thing to focus on.

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FX: The delay in some US tariffs on China and the implications for FX

The announced delay on some of the US tariffs on China is positive news for USD vs low yielding FX such as JPY, EUR and CHF. On the flip side, the dollar...

Stronger USD vs low yielders, weaker USD vs high yielders

The news of the delay of some US tariffs on certain Chinese goods (from September to December) is positive for risk sentiment, although the full details aren't yet known. You can see this by the initial reaction in FX markets with higher beta, high yielding FX such as AUD in the G10 FX space outperforming USD (due to the "risk-on factor") while the likes of EUR, CHF and JPY under-performing the dollar (mainly via "higher UST yield factor" - this is particularly the case for the euro). In terms of the latter, the front-end UST yields spiked on the news (helped by higher CPI as well), with the hawkish Fed re-pricing supporting the dollar against the low yielding FX segment.

JPY the most at risk for now

Among the G10 FX low yielders, JPY is to be a key underperformer (at least over the short term) as the current mix of the higher UST yields and the risk-on environment is very negative for the currency. JPY to underperform EUR and CHF with the latter two currencies both exhibiting lower correlation with risk (yet nonetheless suffer from higher UST yields)

Don't chase GBP higher

While the positive sentiment is also spilling over into GBP (mainly on the EUR/GBP cross), in our view sterling should be the last currency via which one should position for a positive shift in global risk appetite. We retain a strong view that any GBP upside is a fade given the rising probability of early elections or a hard Brexit, with both being bad news for GBP and the Brexit factor being the overriding driver for sterling. We expect EUR/GBP to head to 0.95 this summer.

AUD to keep outperforming NZD

Interestingly, AUD has outperformed the NZD despite very similar exposure to the US-China trade war. There are at least two reasons that explain the relatively higher appetite for AUD to play a de-escalation in trade tensions: monetary policy and economic outlook. Both the RBA and the RBNZ have been cutting rates, but the rate outlook in New Zealand appears more unsupportive for the currency.

Not only did the RBNZ show a more aggressive approach to monetary easing (50bp cut last week) but recent comments by the NZ Treasury Department also paved the way for negative rates and unconventional tools. On the other hand, the RBA has not sounded dovish enough - after keeping rates on hold last week – to trigger significant downward pressure on rate expectations. Looking at the economic outlook, weaker business activity and confidence indicators in New Zealand keep pointing at a slowing economy, whereas the Australian fundamentals appear more robust and suggest a better resilience to external shocks. We continue to prefer AUD to NZD.

CEE the underperformer in the EM FX space

In the EM space, CEE FX should lag other EM regions in terms of potential gains as one of the by-products of the delay in China tariffs is lower EUR/USD (due to the higher UST yield channel). This should keep the CEE FX gains vs USD limited. In terms of the knee jerk reaction, CEE FX should be the EM underperformer, with LatAm FX outperforming now (given its high beta) and Asian currencies catching up as well.

Don't get carried away with optimism

Still, the lack of visibility on the trade war outlook means that the above should not translate into a long-lasting trend. That means that the USD/JPY upside is unlikely to last long while the EM FX gains should be limited in scope too – particularly as the uncertainty about the global growth outlook remains in place.

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Article | 14 August 2019 United Kingdom

Brexit: Four factors driving the risk of 'no deal'

A 'no deal' Brexit has undoubtedly become more likely in recent days - the EU is unlikely to offer anything big, and Parliament faces an uphill...

Pro and anti Brexit protesters at a 2019 demonstration

The risk of 'no deal' has increased

	ING probability	How scenario could materialise	Article 50 extension?	Market reaction
Parliament forces a general election	40%	Parliament stops 'no deal' by passing no confidence motion + steps in to extend Article 50. Election more likely after October 31	✓ Probably (3 months?)	EUR/GBP: **0.95** GBP/USD: **1.18**
Revamped deal	↓ 20%	To avoid election at all costs, pro-Brexit MPs reluctantly back tweaked deal given there's a Brexiteer in place for next stage of trade talks	✓ Possibly (for legislation)	EUR/GBP: **0.85** GBP/USD: **1.34**
Second referendum	10%	Parliament may struggle to force a 'People's vote'. But can't fully rule out PM triggering one as "least worst" option versus an election	✓ At least 6 months	EUR/GBP: **0.82** GBP/USD: **1.40**
No deal	↑ 25%	EU rejects further A50 extension, or Parliament fails to stop 'no deal' via legislation or 'no confidence' vote process	X	EUR/GBP: **1.00** GBP/USD: **1.10**
Revoke Article 50	5%	Parliament may prefer this over a 'no deal' exit, but like a 2nd ref, MPs could lack a legislative tool to force the new PM's hand on revocation	X	EUR/GBP: **0.78** GBP/USD: **1.47**

Source: ING

'No deal' Brexit is becoming more likely

When British MPs return from their summer holidays at the beginning of next month, there will be less than two months until Brexit on 31 October. Markets are becoming increasingly worried that this won't be enough time for Parliament to block a 'no deal' exit – the pound has fallen by 3% against the euro since Mr Johnson became leader.

So just how likely is a scenario whereby the UK leaves the EU without a deal? We think the probability has risen in recent days - we'd now put it at 25%, maybe higher - but ultimately it all boils down to how you answer four key questions.

1 Will the EU offer the UK something new?

The probability of a tweaked deal passing before 31 October is decreasing. While there are a handful of changes to the current deal the EU would be prepared to offer – for instance a longer transition period or a return to the so-called 'Northern Ireland-only' backstop – the bar to getting them approved by Parliament is set high.

As we noted in our last piece, a deal could still pass for political reasons – for instance, if pro-Brexit Conservatives calculate that the risk of losing control of Brexit altogether has risen (in other words, that they risk losing an election). This was part of the reason why a number of Brexiteers voted for the withdrawal agreement at the third meaningful vote in March, although as things stand, a repeat scenario looks unlikely to happen again come October.

2 Can Parliament find a way to legislate against 'no deal' - or request another Article 50 extension?

Assuming a different deal doesn't materialise, then the risk of 'no deal' will very much depend on Parliament's actions and other domestic political factors.

The most obvious way of preventing 'no deal' on 31 October would be for MPs to force the government to apply for another Article 50 extension. Several Parliamentary experts think this could be both tricky and time-consuming.

To succeed, Parliament will need to make its wishes legally binding. And to do that, MPs will need to secure time in the Parliamentary agenda to force through legislation – something that's ordinarily controlled by the government.

A recent report from the *Institute for Government* goes into the nitty-gritty of how this time could be secured, but the simple message is that getting control over the agenda could be hard. It would also rely heavily on the flexibility of House of Commons Speaker, John Bercow.

3 Will the House of Commons back a no-confidence vote in the government, and if so, is that enough to stop 'no deal'?

If 'Plan A' above fails, then it is almost inevitable that the opposition Labour Party will put forward a motion of no-confidence in the government. But unless such a motion passes on 3 September, the day when MPs return from recess, the rules mean there won't be enough time to hold an election before the Brexit date.

Importantly, there may not be enough backing for a 'no confidence' motion at this relatively early stage. The government's official aim is still formally to seek a revised deal with the EU, and many lawmakers may only be prepared to go down the no-confidence route if 'no deal' seems inevitable. Pro-EU Conservatives will probably also want to exhaust all legislative options before taking an action that could throw their own party out of power.

There may not be enough backing for a 'no confidence' motion in early September

But ultimately Parliament doesn't want a 'no deal' Brexit, so if Mr Johnson's government continues to talk up the possibility as we move closer to the deadline, the numbers could easily begin to stack-up in favour of a no-confidence motion - particularly given the government's wafer-thin working majority.

The problem is that by then there will probably be too little time to hold an election before October 31, so lawmakers will still need to find a way to request an Article 50 extension from the EU.

Only the prime minister of the day has that power, so lawmakers may have little choice but to try and appoint a temporary Government of National Unity, with the sole purpose of asking the EU for an extension and calling a snap election.

But this comes with potential challenges. Firstly, it's not clear whether Mr Johnson would be obliged to resign, even if the House of Commons back an alternative caretaker prime minister. Could the Queen be forced to intervene? The jury is still out on that one.

There is also plenty of disagreement over who might fill the role of a temporary prime minister - Labour are adamant it must be their leader Jeremy Corbyn, but many Lib Dem and moderate Conservative MPs have signalled they would be reluctant to back him.

If 'no deal' does happen, a failure to appoint an alternative caretaker government and therefore ask for another Brexit delay, seems like a plausible trigger.

4 Is a post-Brexit election really in Mr Johnson's best strategic interests?

Put simply then, there's no guarantee that either legislation or a vote of no confidence will be enough to stop Mr Johnson in his tracks if he is set on pursuing 'no deal'.

We have notched up our 'no deal' probability from 20% to 25%, and even that may be a little low. In the end, it may well come down to election strategy.

Assuming an election is more-or-less inevitable, then conventional wisdom suggests Mr Johnson would fare best if Britain goes to the polls after the UK has left the EU. The theory goes that it would give him the best chance of limiting the surge of the Brexit Party at a national vote. Some Conservatives may also conclude that a 'no deal' Brexit is worth the risk if it prevents a Labour-led government and the possible break-up of their own party.

We have notched up our 'no deal' probability from 20% to 25%, and even that may be a little low

That may all be true, but an election in the initial days or weeks of a 'no deal' Brexit could be incredibly challenging for Mr Johnson's Conservative Party, given the likelihood of supply chain disruption and financial market volatility, amongst other things.

Fighting an election having left the EU with a deal could be equally challenging. The EU is unlikely to offer meaningful changes to the current withdrawal agreement, leaving Mr Johnson vulnerable to criticism from the Brexit Party in a general election campaign.

So should the government try and call an election before Brexit has happened, to capitalise on the Conservative's current lead in the polls? Don't forget that this strategy backfired for former prime minister Theresa May back in 2017, and it could leave Mr Johnson open to accusations of failing to live up to his promise of leaving Europe by 31 October.

Perhaps then, the best strategic outcome for Mr Johnson would actually be if Parliament forces an election and Article 50 extension upon him. This would allow him to campaign on a tough Brexit stance, without risking the economic impact of a pre-election ‘no deal’. It would also allow him to tell voters that he didn’t want this election or delay, and attack the opposition that for trying block Brexit from happening.

Our conclusion

Of course, there's plenty of uncertainty surrounding all of this and we suspect we'll be revisiting our probabilities frequently over coming weeks. But for the time being, we think the most likely scenario is one where Parliament back a no-confidence motion and force an Article 50 extension at some point in October, setting the scene for a general election in late November or December. We’d put a 40% probability on a general election taking place, coupled with a further Brexit delay.

The latest Brexit odds and options

With fewer than 80 days left before the UK is set to leave the European Union, ING's James Smith looks at the latest Brexit options and possibilities

Watch video

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Article | 14 August 2019

FX | Italy

Italian politics: What now?

While speculations about an alternative majority have mounted in Italy, elections still seem the most likely outcome. Uncertainty is likely to linger, and...

Luigi Di Maio (left) and Matteo Salvini

As the political situation in Italy becomes more turbulent, we identified three different political scenarios for Italy: a new election, a continuation of the current government or a new majority. Since last Friday, there have been two key developments.

1 Renzi's proposal for a coalition

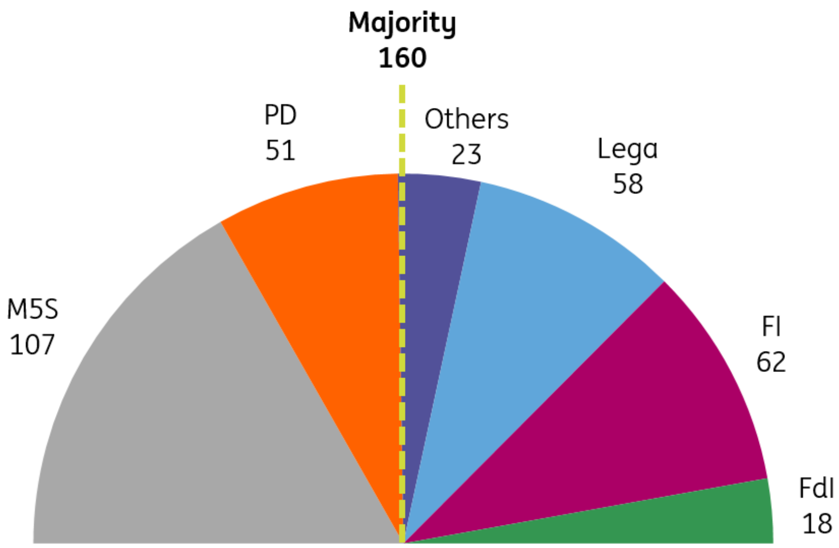
The former prime minister and member of the Democratic Party (PD), Matteo Renzi, proposed a coalition with the Five Star Movement to form a new government, to deliver an autumn budget, making crucial spending cuts and thus averting a VAT hike. Speculations about this possibility have mounted after both parties voted against Matteo Salvini's timeline to force an early no-confidence vote yesterday. Many have argued this option may still be quite impractical, for a number of reasons:

- The actual leader of the PD, Nicola Zingaretti, along with a number of other party members has categorically excluded an alliance with the Five Star Movement.
- Most of the Five Star MPs have also displayed extreme reluctance to a deal with what they consider their number-one political enemy.
- The factions have opposite views on a number of subjects – including the rail link with

France, which broke the previous coalition.

- Renzi can probably rely on the majority of the PD Senators (35-40 of the 51), but even if the entire party was to agree on the proposal, the new PD - Five Star coalition would still be two votes short from a majority in the Senate.
- Given the high risk, the government may prove to be highly unstable and President Sergio Mattarella may be quite reticent to give his approval.

Seats in the Italian Senate



Source: Italian Parliament, ING

2 MPs kicking the can down the road

Encouraged by the polls, deputy prime minister Salvini has been pushing for prime minister Giuseppe Conte's resignation to hold elections as soon as possible.

Normally, 60 days are required after elections are announced, and timing is key given the necessity to approve the budget by the end of the year. The Lega proposed a timeline to have a no-confidence vote this week, but the motion was defeated yesterday. Instead, the new date for the no-confidence vote is 20 August. If parliament votes in favour and forces PM Conte to resign, much will depend on President Mattarella's decision to call immediate elections or try and find a new majority. In the opposite case, the parties who voted against the no-confidence motion will be asked to form a new coalition.

If this attempt fails, elections will inevitably be the only solution.

Elections remain the most likely option

According to the Italian press, the prevailing opinion is that there will be new elections, either at the end of October or early in November. We believe this scenario is likely to prove to be quite negative for risk sentiment in the eurozone, mainly because the new government (led by Salvini) will have very limited time to deal with the key 2020 budget proposal.

This increases the risk of the "provisional system" automatically coming into force, which limits government spending to a limited amount each month and would likely add more clouds to the

Italian economic outlook. In addition, Salvini's hard stance in negotiations with the EU and speculations of Italy possibly leaving the common currency may be another dragging factor on sentiment.

Fig. 2 - Political risk has weighed on Italian bonds

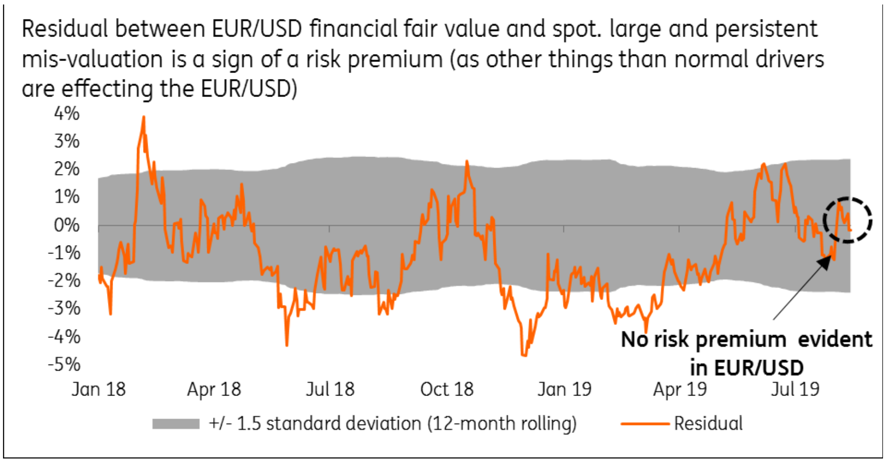
Source: Bloomberg, ING

FX Markets: EUR resilience may not last much longer

Since Salvini announced to break-up the coalition, Italian bonds have come under severe pressure and the 10-year BTP-Bund spread has widened by about 25bp. By contrast, the euro has not faced a similar pressure so far.

On a trade-weighted basis, the common currency has actually been broadly stable and the same is the case of EUR/USD, which currently reacts more to the market re-pricing of the Fed. At this point, markets seem to be reluctant to price in a meaningful Italian risk premium into EUR. This is corroborated by our short-term fair value EUR/USD model, which currently exhibits no risk premia for the cross. This contrasts with the more reactive Italian bond market (Fig. 2)

EUR/USD still in line with its fair value



Source: ING

The possibility of new elections and the threat of an extended period of political uncertainty in Italy continues to hint at downside risks for the euro, alongside the possible dampening effect of the ECB's easing package to be delivered in September. Given the historically high correlation of the EUR/CHF cross with the movements in the BTP-Bund spread, we think that a non-negligible EUR weakness will be concentrated on the pair.

If early elections are confirmed, we see EUR/CHF touching 1.08 in the near future unless trade tensions de-escalate further. Looking at EUR/USD, some Fed-easing re-pricing may put a floor below the dollar, but we still see the pair edge lower to 1.10 on the back of Italian political uncertainty.

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Article | 15 August 2019 Germany | Video

Watch: Germany, the end of a golden decade

A lack of structural reforms and infrastructure investment has led to the end of Germany's 'golden decade', according to ING's Carsten...

Germany: The end of a golden era

ING's Carsten Brzeski looks at the prospects for Germany as its economy contracts

Watch video

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A weak Chinese economy

Chinese industrial output reaches a 17-year low, echoing the recent slow credit growth. It's the result of the government opting for stability rather...

People crossing a Shanghai road

Stable growth, but industrial production hit hard

Chinese fixed asset investments grew by 5.7%YoY in July, slowing slightly from 5.8% a month ago with infrastructure projects still the main driver of investments.

But industrial production was hit hard and grew by only 4.8%YoY from 6.3% previously. This kind of growth was last seen in January 2002, which effectively means the current manufacturing situation is worse than it was during the global financial crisis.

- The main cause is the contraction of cars and related manufacturing parts , which has led to very weak headline industrial production growth.
- Infrastructure projects have begun to enter the construction phase after projects received funding from local government special bonds. But the details show their contribution to industrial production was quite small compared to the negative impact of car-making on overall production.

Retail sales have slowed down to 7.6%YoY from 9.8% in June. Consumption sentiment hasn't been helped by tax and fee cuts, as consumers tend to save the additional income rather than spend during challenging times. We see that spending on luxury items such as jewellery and cars declined while spending on essential items grew steadily.

4.8% Chinese industrial production

The weakest since Jan 2002

China needs to speed up stimulus

The stability picture echoes the recent slower credit growth and a shrinking in shadow banking activities and implies that the government prefers stable quality growth over exponential growth.

But it's also time to consider whether the Chinese economy needs more stimulus. It's mow divided into two parts; one is stimulus driven, another is regular activities. When regular activities face headwinds, there is a need for stimulus to keep the economy running to avoid rising unemployment.

To keep GDP growth above 6%, infrastructure projects that have received funding from local government special bonds should increase their pace, which in turn should help industrial production. At the same time, fiscal stimulus should be accompanied by easing monetary policy to divert liquidity to targeted borrowers, especially exporters.

Target required reserve ratio (RRR) cuts of 50 bps, together with targeted short-term interest rate cuts of 5 bps are expected in 3Q as well as 4Q.

Tariff delays provide temporary respite, but tech firms to suffer longer

The US administration has delayed imposing the additional 10% of tariffs on some of the $300 billion goods to 15 December, originally due to come into effect on 1 September.

So Chinese exporters and manufacturers don't need to front load shipments for the American holiday season, but unless the demand from the US is very strong, we don't expect this temporary delay to cheer up Chinese exporters.

China has not claimed victory on this tariff delay, and it should not, as the US administration could add other hurdles for Chinese companies, especially technology companies. American companies continue to be banned from doing businesses with Chinese technology companies that have been included in the US' entity list.

It is not all bad for China's future. We have argued this will force China to innovate its own hardware such as chips and its own operating system, for instance. Even though this may take a few years, China's threat to the US will not disappear. China realises this, and will continuously pour in more resources to achieve technology independence.

USD/CNY has followed its own orbit

After crossing the 7 handle, USD/CNY seems to have its own orbit. Overnight, even the US dollar jumped on the back of the tariff delay announcement while the offshore yuan strengthened from 7.10 to 7.04 at the time of writing this note.

Crossing that 7 line is a mere gesture on China's part to show its discontent with the progress of the trade talks. But this is not really a solution for exporters when they face high tariffs and fewer export orders.

So the activity data and the delay of tariffs doesn't change our forecast of USD/CNY at 7.10 by the end of 2019.

Upcoming trade and stimulus plans may help

The activity data in July was weaker than our expectations but we need to see if there will be more stimulus coming to speed up the growth slightly so that it won't touch the 6% target line in 3Q. Infrastructure projects should help too.

Upcoming trade talks and stimulus plans will help us decided if we need to revise our GDP forecast for 3Q and 4Q, but for now, we maintain them at 6.3% for 3Q and 4Q, respectively.

The Netherlands GDP: Stubbornly steaming ahead

Dutch economic growth beat the eurozone average by some margin as it came in at 0.5% QoQ in the second quarter. The question is how long this resilience...

Source: Shutterstock

0.5% GDP growth rate

2Q19 (QoQ)

A Dutch saying goes that when the German economy sneezes, the Netherlands gets a cold. However, that loud sneeze (-0.1% QoQ) from the east in 2Q19 seems to have largely passed the Dutch economy by. The Dutch seem to have taken their flu shot in the form of strong domestic demand, but also delivered a favourable trade performance.

While surveys pointed to a stabilisation in consumer confidence in 2Q19 after a long period of increased pessimism, the strong labour market boosted households to continue spending (0.8% QoQ). Investment growth (+1.3% QoQ) held up well too: businesses are still investing more in transportation equipment (3.6% QoQ), intangible assets (2.9%) and machinery (1.2%) as well as new homes (1.2%). A large contribution of net trade (0.6%-point), with exports growing 1.3% QoQ, did the rest. Even though global worries do cloud the outlook, we stick to our relatively optimistic growth outlook of 1.7% GDP growth for this year.

Domestic demand flourishes on the back of the labour market breaking record after record: vacancies have never been higher, quarterly unemployment has never been lower. Searching carefully, we see some hints of the impact of the trade war in the numbers: jobs at temp agencies hardly grew and vacancies in the transport sector also declined somewhat. But we certainly need a looking glass to find these, while supply-side constraints were probably a more important limitation to employment growth in 2Q19.

> *The continuation of a cruising speed for the Netherlands is all the more remarkable*

Strong growth figures for the recent past by no means promise full immunity for future developments. The sensitivity of this exporting nation to a German slowdown in industry and a no-deal Brexit is relatively high. Proof of sensitivity to worsening external conditions is already visible in this year's growth number, a slowdown from last year's 2.6% to 2.0% in 2Q19 year on year. With two strong quarters of growth already in the pocket, our outlook means we do see this trading nation losing some steam in the second half of this year. But for now, the glass is half full and given problems elsewhere, the continuation of a cruising speed for the Netherlands is all the more remarkable.

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Article | 13 August 2019

United Kingdom | Video

Watch: No deal Brexit chances are rising; this is what's happening

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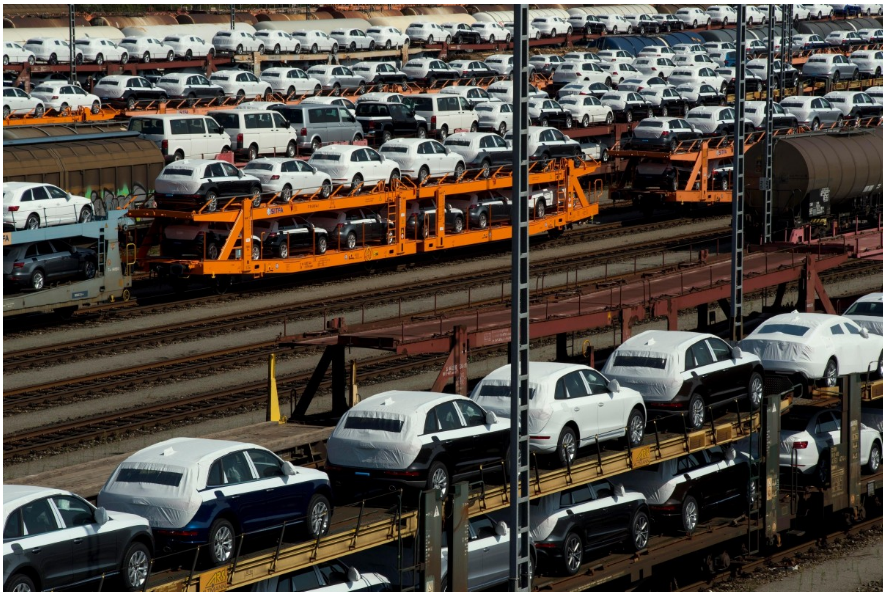
German recession fears, should we blame the Chinese car market?

The current slowdown of the German economy is closely linked to problems in the automotive sector. What role does China play in all of this?



Source: Shutterstock

The German economy appears to be stuck between solid domestic fundamentals and external risks. The industrial slowdown is beginning to have an impact on the domestic economy while the entire economy seems to be flirting with recession.

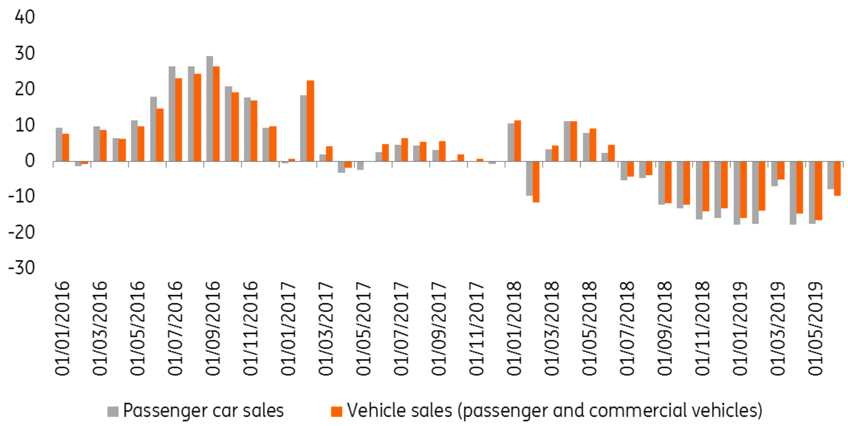
Cars have played and will continue to play an important role in this situation and among the multiple explanations for the problems in the automotive sector, surprisingly is China. Understanding recent developments in the Chinese automotive market is an important piece of the puzzle in comprehending the outlook for the German automotive market.

From WLTP to the US-China trade conflict

The delayed introduction of the new emissions standard - the worldwide light vehicles test procedure, or WLTP - and delays in complying with these new standards led to severe disruptions in German automotive production and delivery. The US-China trade war and subsequent slowdown of the Chinese economy have also contributed to Germany's car problems.

But the data shows a more nuanced picture. In 2018, vehicle sales in China dropped by some 3% YoY, while passenger car sales dropped by more than 4%YoY - the first decrease in over twenty years. However, German car manufacturers saw their sales increase by 2%.

New vehicle sales have dropped 13 months in a row



Source: Refinitiv Datastream

Direct impact of the trade conflict on the German automotive sector

The Chinese market is the most important market for the majority of German car manufacturers. In 2018, almost one-quarter of all cars sold in China were German. BMW and Daimler sold more than one-third of their total car sales in China. For Volkswagen, the share is even bigger at 40%.

Looking ahead, things aren't looking too good for German car manufacturers. New car sales in China have fallen for 13 months in a row, a slump that started in the second half of 2018 when the trade war between China and the US began to heat up.

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With the introduction of tariffs, US customs duties on Chinese goods worth US$ 250 billion (with US$ 300 billion to follow on 1 September) and Chinese customs duties on US goods worth US$ 110 billion, car and car parts from China are being taxed at 27.5% in the US since July 2018, while China temporarily increased customs duties on US vehicles from 15% to 40%. However, China removed these additional tariffs, so US autos are subject to China's standard tariff rate of 15%.

Given that some German car manufacturers actually export US-produced cars to China, there has been a clear and direct impact of the trade conflict on the German car industry. Having said that, the larger impact seems to be coming indirectly from lower Chinese consumer confidence. According to media reports, BMW and Mercedes car exports from the US to China have suffered due to the tariff hikes, which is probably why BMW has started to manufacture locally in China.

Structural factors and shift in the Chinese automotive market

Another factor, which is well known in Europe and has probably weighed more heavily on sales in recent months, is the switch to the new emission standard. By July 2020, all light vehicles in China need to comply with the China 6a emission standard, based on European and US regulations. But many provinces rushed ahead and made the new standard mandatory a year earlier to comply with environmental protection campaigns.

In Europe, the impact of adopting this new standard placed a huge strain on the passenger car market last year such that new passenger car registrations fell more sharply (in absolute terms) than during the global financial crisis.

In China, although car dealers substantially discounted prices for China 5-standard vehicles before the deadline, consumers were reluctant to make purchases, probably waiting for passenger cars with the new emission standard instead. Automotive retail sales saw a surge only in June, with car dealers offering heavy price reductions. The destocking of China 5-emission standard vehicles might be responsible for lower orders from dealers too. But with the new standard now in place, a rebound in car sales might be round the corner.

> *Forecasts of the Chinese car market have assumed low ownership rates projecting plenty of growth potential in the coming years, but it's quite possible that this growth potential will be impaired by ride-hailing and/or car-sharing*

The phasing out of tax incentives for small cars from the end of 2017, a government programme that ran for three years, is also likely to continue to have an impact on the Chinese market, as car purchases were brought forward.

Alongside cyclical developments, there are also structural changes in the Chinese automotive market affecting German car sales. China is already the largest ride-hailing market in the world, with over 459 million customers and a turnover of around US$ 53 billion. In the US, there are currently 66 million users generating US$ 49 billion in turnover. To put things into perspective, one-third of the Chinese population already uses alternative mobility solutions, while in the US the figure is around 20 percent and in the EU it is just 18 percent - a trend that is likely to grow in the coming years. Admittedly, it's impossible to tell whether users are exclusively using ride-hailing or whether it is complementary to owning a car.

To date, forecasts of the Chinese car market have assumed that low ownership rates offer sufficient growth potential in the coming years, but it's quite possible that this growth potential will be impaired by ride-hailing and/or car-sharing.

Another structural change is the transition towards electric car production and sales, which the Chinese government is supporting. Indeed, sales of electric cars in China are still going strong, increasing by 50 percent in the first half of 2019 compared to 1H18, but the subsidies in this segment will be phased out between 2020 and 2021.

The biggest threat to German automotives is...

So, we think the current crumbling of the Chinese car market appears to be a simultaneous combination of cyclical factors, one-off effects and structural changes.

And for the German economy, it's not actually the trade conflict that is most concerning but the structural shifts in the Chinese automotive market, which could turn out to be one of the biggest threats in the years ahead.

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