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BANK

ECONOMIC SITUATION AND STRATEGY November 16, 2018

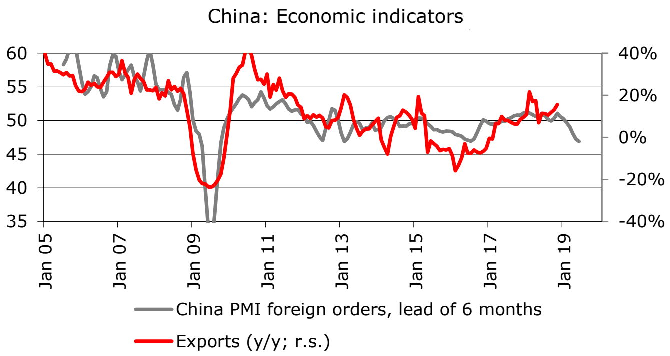
Beijing, we have a problem!

China's economic growth has been exceptionally strong for many years. It is one of the fastest-growing countries in the world, with an average rate of 9.5% since 1980. This is no big surprise, since a nation's economic growth possibilities are largely determined by its demographics and productivity of employed production factors, and China is still the world's most populated country, with almost 1.4 billion people. In the past 40 years, it has advanced from being one of the poorest countries to being the second-largest economy in the world (measured by real GDP in USD). Per capita income has increased so much in this period that more than 800 million Chinese have risen above the poverty line. Some provinces have now reached the development level of major industrialized countries. Considered together, the economic output of these few Chinese regions already exceeds that of Great Britain.

After real GDP growth accelerated again last year due to the upswing of world trade and increased domestic business activity for the first time since 2010, figures for this year are likely to show somewhat less momentum. A year-on-year growth rate for Chinese GDP of 6.6% is expected (2017: 6.9%). That number will be achieved unless economic growth declines significantly in the fourth quarter, which we do not anticipate. The International Monetary Fund (IMF) forecasts growth rates of 6.2% for next year and the year after, followed by reductions of about 0.2 percentage points in each of the subsequent three years. Provided the expectation of only gradually slowing growth proves correct, China could replace the United States as the world's top economic power already in 2030.

However, there are still some obstacles to negotiate before then. For example, signs have been mounting lately that the country might face a severe economic slowdown. Somewhat lower economic momentum is certainly planned and in the interest of the Chinese government, since its aim has been to shift from years-long high-speed growth to high-quality growth. However, a number of challenges obstruct this path. Above all, the threat of a trade war with the United States could cause Chinese growth to dip more than expected next year. Besides the tariffs on steel and aluminum that US President Donald Trump introduced at the beginning of March, further punitive tariffs of 25% on Chinese exports to the United States followed in June, adding up to USD 50 billion. In the same month, further tariffs of 10% were placed on US imports from China totaling USD 200 billion in response to Chinese countermeasures. If there is no resolution of this trade dispute, this tariff will increase from 10% to 25% at the beginning of 2019. Moreover, tariffs of 25% might be levied on all other exports from China to the United States (about USD 250 billion).

So far, the trade restrictions imposed have hardly had appreciable effects. Instead of dampening Chinese exports, a contrary effect has actually been observed. Total exports from China increased in the first nine months of the year by almost 14%, the strongest growth since 2011. Chinese imports increased even more, by a good 20%. This means China's trade surplus will decrease for the third year in a row, so trade will exert a negative effect on economic growth. The negative growth contribution this year will amount to about 0.7 percentage points. On the other hand, to Trump's chagrin, the bilateral trade surplus between China and the United States continues to increase. For, while China's exports to the United States have risen again significantly this year – probably largely owing to anticipatory behavior – that is not the case for imports from the United States. Consequently, the US trade deficit with China will reach a new record level this year.



This suggests that the US government's pressure to achieve a deal in the trade dispute with China will remain high. If China does not move in the direction desired by the United States, the dispute will presumably widen into a trade war. In that case, the effects on world trade will no longer remain primarily psychological, and significant signs of slowing world trade and economic growth will be inevitable. The downward development of foreign orders reflected in China's purchasing manager index already offers a foretaste of what might happen to Chinese exports next year. Instead of significant growth, they could stagnate or even decline. That was the case, for example, in both 2015 and 2016. The effects on economic growth will depend on how imports develop in the coming year. If they likewise shift into reverse, trade's negative contribution to growth could even decrease, with the result that Chinese growth would actually benefit from this development. But this would be negative for the world economy and for China's most important trading partners, including Germany. Weaker imports would signal slower growth of domestic consumer and capital spending.

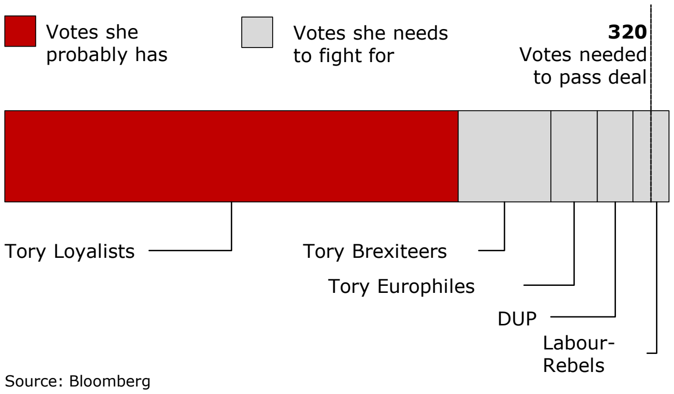
On a positive note, the Chinese government has implemented important reforms over the last few years to reduce the risk of a substantial economic slowdown. Those include improving the social security system, dismantling market entry barriers, and reducing the influence of state-owned enterprises and income inequality as well as focusing more on environmental protection by cutting capacities in the steel and coal industries. In addition, China has recognized that corporate and household debt levels must be reduced to counter the risk of a financial crisis. However, the latter measures may weaken growth in the near term, so a slowing to under 6% next year would not be surprising. But in the long term, the Chinese economy will benefit from these reforms, thus allowing growth to rise above 6% again. We should not forget that China is one of the countries that benefit hugely from the digitization of the (world) economy. Among other things, regulatory conditions there favor e-commerce and fintech companies, especially since there are almost 750 million internet users in China, more than in any other country. So, even if it has many challenges to meet in the near future, China's prospects for growth in the medium to long term are intact.

Weekly outlook for November 19-23, 2018

	June	July	Aug.	Sept.	Oct.	Nov.	Release
DE: Producer prices, m/m	0.4%	0.2%	0.3%	0.5%	0.3%		November 20
DE: Producer prices, y/y	2.9%	2.9%	3.1%	3.2%	3.3%		November 20
DE: PMI, manufacturing – flash	55.9	56.9	55.9	53.7	52.2	52.6	November 23
DE: PMI, services – flash	54.5	54.1	55.0	55.9	54.7	54.5	November 23
EUR19: Consumer confidence – flash	-0.6	-0.5	-1.9	-2.9	-2.7	-3.0	November 22
EUR19: PMI, manufacturing – flash	54.9	55.1	54.6	53.2	52.0	52.4	November 23
EUR19: PMI, services – flash	55.2	54.2	54.4	54.7	53.7	53.9	November 23

MMWB estimates in red

Chart of the Week: Tough fight for parliamentary majority



Source: Bloomberg

After five hours of debate, British Prime Minister Theresa May announced on Wednesday evening that the Cabinet had approved a controversial draft EU withdrawal agreement. That is a first and important step completed towards an orderly Brexit. After that hurdle is cleared, European Council President Donald Tusk will convene a special summit regarding Brexit on November 25. After this second step, the biggest hurdle will come, a vote in British Parliament.

It is uncertain, to put it mildly, whether a majority in favor of the agreement can be obtained. At the moment, Parliament has 650 members in the House of Commons. Of those, the speaker and three deputies are non-voting members. Furthermore, the seven representatives of the Irish Sinn Féin party abstain from attending or voting in Westminster. That leaves 639 members. So, May must get 320 of them behind her to obtain a majority for the Brexit deal. About 235 are considered certain, and another 85 must still be persuaded before the vote on the agreement. If the prime minister succeeds in unifying a majority in Parliament, that will clear the path for an orderly Brexit on March 29, 2019. On the other hand, if the House of Commons rejects the agreement, Great Britain will run the risk of a disorderly withdrawal. In that case, the country would leave the European Union without an agreement, which would give it the status of an ordinary outside country and cause it to lose access to the European Single Market. According to an IMF study, a disorderly Brexit could reduce British economic growth in the period to 2030 by a total of up to 4%.

Yesterday, Dominic Raab, Secretary of State for Exiting the European Union, Esther McVey, Secretary of State for Work and Pensions, and Shailesh Vara, Minister of State for Northern Ireland, have resigned because of the Cabinet vote. Some British media are already speculating that a no-confidence motion against May is imminent. Such a motion would require no-confidence letters from 48 Tory members of Parliament. So, the prime minister now not only has to worry about finding the necessary votes in her own ranks and the opposition, but also about restoring lost confidence. There is talk of December 10 as a possible date for the vote in Parliament. In reaction to the resignations and dissension accompanying the Cabinet vote, stocks in the banking and construction sectors and the British pound have come significantly under pressure.

Market data overview

Stock marktes	As of 16.11.2018 10:09	Change versus 09.11.2018 -1 week	15.10.2018 -1 month	15.08.2018 -3 months	15.11.2017 -1 year	29.12.2017 YTD
Dow Jones	25289	-2,7%	0,2%	0,5%	8,7%	2,3%
S&P 500	2730	-1,8%	-0,7%	-3,1%	6,5%	2,1%
Nasdaq	7259	-2,0%	-2,3%	-6,6%	8,2%	5,2%
DAX	11403	-1,1%	-1,8%	-6,3%	-12,1%	-11,7%
MDAX	23879	-1,2%	0,5%	-8,9%	-8,7%	-8,9%
TecDAX	2594	-2,7%	0,2%	-8,8%	5,5%	2,6%
EuroStoxx 50	3208	-0,7%	-0,1%	-4,5%	-9,5%	-8,5%
Stoxx 50	2937	-1,2%	0,8%	-3,8%	-6,1%	-7,6%
SMI (Swiss Market Index)	8931	-1,6%	3,2%	0,1%	-1,7%	-4,8%
Nikkei 225	21680	-2,6%	-2,7%	-2,4%	-1,6%	-4,8%
Brasilien BOVESPA	85973	0,4%	3,1%	11,5%	21,4%	12,5%
Russland RTS	1139	1,6%	-0,7%	7,9%	2,0%	-1,3%
Indien BSE 30	35433	0,8%	1,6%	-6,4%	8,2%	4,0%
China Shanghai Composite	2679	3,1%	4,3%	-1,6%	-21,3%	-19,0%
MSCI Welt (in €)	2026	-1,8%	0,6%	-4,5%	4,6%	1,8%
MSCI Emerging Markets (in €)	981	0,4%	3,0%	-4,4%	-7,9%	-10,5%
Bond markets						
Bund-Future	160,81	78	222	-290	-183	-87
Bobl-Future	131,66	28	83	-88	-9	5
Schatz-Future	111,99	3	11	-8	-28	1
3 Monats Euribor	-0,32	0	0	0	1	1
3M Euribor Future, Dec 2017	-0,31	0	0	-3	-3	0
3 Monats $ Libor	2,63	1	18	32	121	93
Fed Funds Future, Dec 2017	2,28	-1	2	7	57	0
10 year US Treasuries	3,12	-8	-4	26	77	70
10 year Bunds	0,37	-4	-13	7	-1	-5
10 year JGB	0,10	-2	-4	1	6	6
10 year Swiss Government	-0,02	-3	-10	10	7	11
US Treas 10Y Performance	555,15	0,5%	0,1%	-1,8%	-4,9%	-4,5%
Bund 10Y Performance	620,22	0,5%	1,4%	-0,5%	1,7%	2,1%
REX Performance Index	485,59	0,4%	0,7%	-0,1%	0,3%	1,0%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,84	1	-2	20	16	16
IBOXX BBB, €	1,89	8	11	34	69	65
ML US High Yield	7,25	26	51	67	90	109
JPM EMBI+, Index	780	-0,5%	-0,8%	0,3%	-5,5%	-6,7%
Convertible Bonds, Exane 25	7146	0,0%	-0,4%	-2,6%	-2,6%	-3,4%
Commodities						
CRB Spot Index	415,17	0,2%	-0,9%	0,2%	-3,3%	-4,0%
MG Base Metal Index	305,22	0,7%	-3,3%	1,2%	-9,8%	-14,9%
Crude oil Brent	67,69	-3,4%	-16,2%	-3,9%	9,1%	1,6%
Gold	1216,30	0,5%	-0,9%	3,1%	-4,9%	-6,7%
Silver	14,27	0,8%	-3,2%	-1,3%	-16,1%	-16,1%
Aluminium	1907,50	-2,0%	-5,8%	-4,5%	-8,6%	-15,4%
Copper	6198,00	2,0%	-1,7%	7,6%	-8,0%	-14,0%
Iron ore	74,95	-0,8%	6,2%	10,7%	22,4%	5,1%
Freight rates Baltic Dry Index	1020	-11,1%	-35,6%	-40,9%	-25,8%	-25,3%
Currencies						
EUR/ USD	1,1351	0,0%	-2,0%	0,3%	-4,1%	-5,4%
EUR/ GBP	0,8867	1,7%	0,6%	-0,7%	-1,1%	-0,1%
EUR/ JPY	128,64	-0,5%	-0,7%	2,4%	-3,6%	-4,7%
EUR/ CHF	1,1428	0,1%	0,0%	1,2%	-2,1%	-2,3%
USD/ CNY	6,9482	-0,1%	0,4%	0,2%	4,9%	6,8%
USD/ JPY	113,64	-0,2%	1,7%	2,6%	0,7%	0,8%
USD/ GBP	0,78	1,8%	2,7%	-1,0%	2,9%	5,7%

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