Economic Outlook

Eurozone, US and Emerging Markets

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Global Economy on the Road to Recovery in 2020

Global economy – recovery should take hold in the first half of 2020

The preconditions for a recovery of the global economy in 2020 have significantly improved due to the following factors:

- economic policy uncertainty has decreased;
- the central banks of the largest economic areas have adopted noticeably easier monetary policies in 2019;
- leading indicators on the global level already pointed to an upswing in economic activity in the 4th quarter of 2019.

In view of trade barriers remaining in place, we initially expect just a slow, gradual recovery of the global economy.

Eurozone – stable growth momentum expected in 2020

We are forecasting stable GDP growth of +1.2% for the Eurozone in 2020. We expect that pressures from foreign trade and the reduction of inventories will ease. We believe this will be offset somewhat by a decline in the pace of domestic demand growth (particularly in investment spending, which benefited in 2019 from significant non-recurring effects related to Ireland). However, given the backdrop of a brightening global economic outlook there are upside risks to our growth forecast.

Eurozone – inflation expected to increase moderately in 2020

Headline inflation in the Eurozone should rise moderately to +1.3% in 2020. This forecast is based on the assumption of a largely stable oil price and an increase in core inflation to +1.2%. However, the emerging global recovery could, analogous to historical upswings, trigger a rally in oil prices. Moreover, persistent tensions in the Middle East may support oil prices. Thus our inflation forecast for 2020 is subject to upside risks as well. Regardless of this, the ECB will continue to focus on the trend in core inflation.

USA – economy remains on growth path

US economic growth has held up well, despite a difficult environment. We expect US economic growth to remain stable. As we envisage at least no renewed intensification of the trade dispute with China, no additional pressures should emanate from this front this year. In our opinion there are no signs of imbalances the correction of which could trigger an economic downturn. Overall we expect economic growth of just below 2% this year.

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Global Economy

Asia remains the growth engine of the global economy

Financial markets positioned for upswing

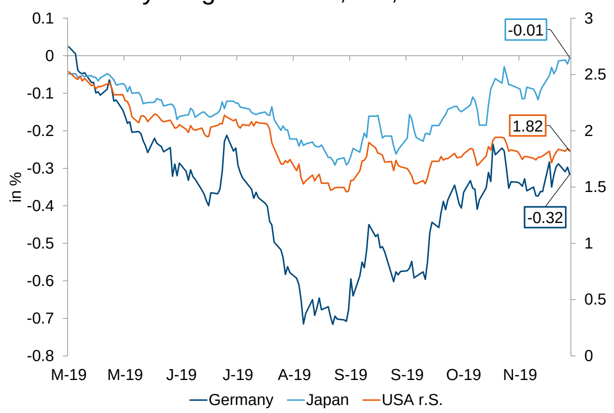
In the 2nd half of 2019 the global economic environment continued to be weighed down by the trade dispute as well as the structural problems of the automotive sector. However, thanks to the rapprochement in the trade dispute and the avoidance of a hard Brexit, political uncertainty decreased. Apart from this, both the Federal Reserve and the ECB eased monetary policy noticeably. This provided a boost to risk appetites in global financial markets, as a result of which inter alia yields on long-term government bonds in the large currency areas (USD, EUR and JPY) increased significantly since the end of August.

Demand for safe haven currencies such as the Swiss franc and the yen also declined in this environment, which enabled the euro to gain a little ground against both currencies since the end of August. However, the trade dispute has done significant damage to global supply chains as well as investment confidence. Thus we initially expect only a slow, gradual economic recovery at the global level.

2020: focus on automotive and semiconductor industries

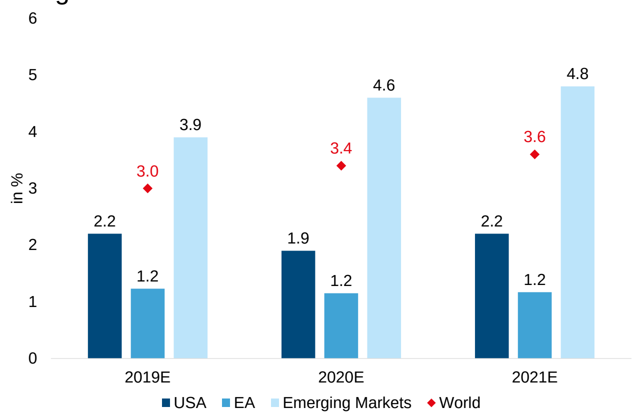
In our opinion two sectors will be particularly in focus in 2020. After the severe slump of last year, global automobile production should recover somewhat in 2020. Following a strong decline in 2019 (around -8%) the global semiconductor market should also recover and resume its long term growth trajectory. The IMF expects global GDP growth to accelerate in 2020, mainly thanks to an acceleration of growth in emerging markets.

Significant increase since the end of August
Yields on 10-year govt. bonds, US, GER and JP



Source: Market data providers, Erste Group Research

Emerging markets - global growth engine
GDP growth 2019E – 2021E



Source: IMF, Erste Group Research

Business Cycle Analysis

Indicators suggest cyclical upswing in 2020

Business cycle impacts capital markets

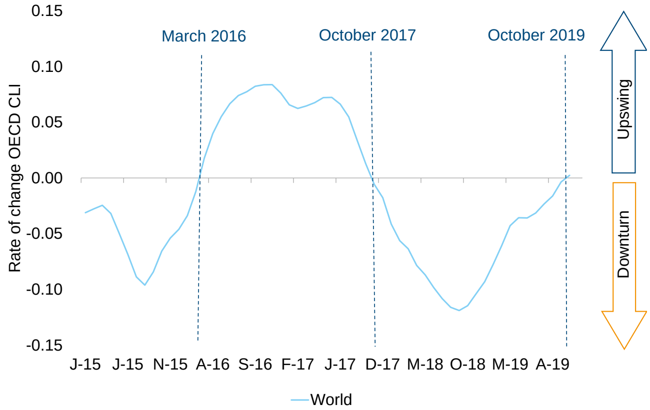
The trend in the global economy is characterized by periods of increasing activity (upswings) and periods of declining activity (downturns). This leads to fluctuations in economic growth, which are referred to as the business cycle. In extreme cases economic growth momentum can significantly overshoot (so-called booms), which is usually followed by strong corrections in the form of recessions (contracting economic output). Since the business cycle affects the price trends of all important asset classes, it makes sense to perform a systematic analysis of economic trends.

Conclusions about the cyclical state of the global economy can be drawn both from the level and the momentum of sentiment indicators. Beyond this, the time factor plays an important role as well, as no upswing or downturn lasts forever. An economic upswing is accompanied by rising sentiment indicators. As an expansion matures, the upward momentum in sentiment indicators wanes and the economy reaches a cyclical peak. This is followed by a downturn, which is characterized by declining sentiment indicators. The momentum of the downtrend in sentiment indicators once again diminishes over time, until the economic downturn stops and a bottom is formed, laying the basis for the next expansion.

Cyclical upswings last around 17 months on average

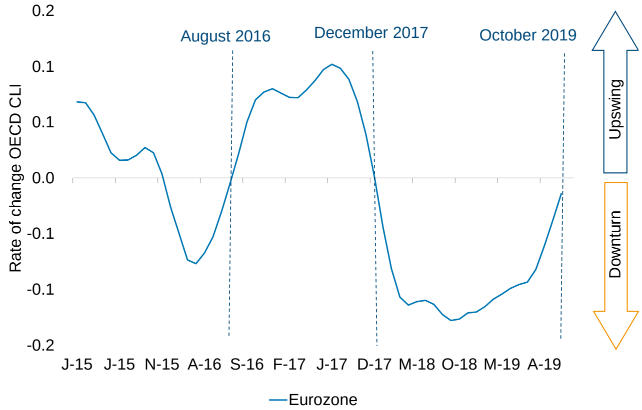
Based on these considerations, a cyclical downturn started in the 4th quarter of 2017. In view of the diminishing downside momentum of sentiment indicators, a bottom in economic growth formed in the autumn of last year. In October, the global OECD leading indicator for the first time exhibited a positive rate of change, suggesting the beginning of an economic recovery. Since upswings (as measured by the OECD composite leading indicator) on average last around 17 months, 2020 should become a good year in terms of economic growth.

Global economy about to enter upswing
OECD leading indicator, world (rate of change)



Source: OECD, Erste Group Research

Eurozone economic cycle lags slightly
OECD leading indicator, Eurozone (rate of change)



Source: OECD, Erste Group Research

Eurozone Economy

Economic recovery should boost foreign trade

Germany and Italy weighed on growth in 2019

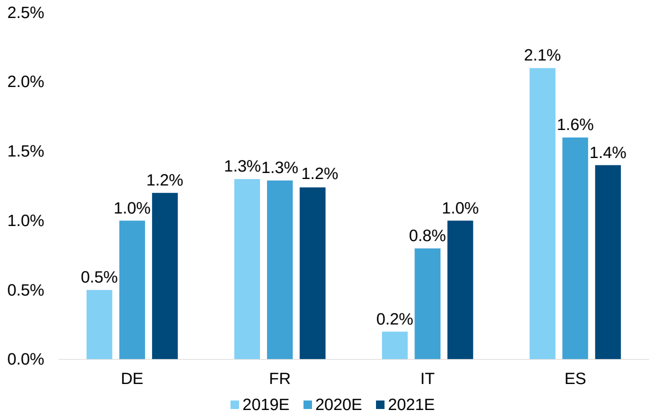
The German manufacturing sector in particular weighed on economic growth in the Eurozone in 2019, as it slid into a severe recession. As a result of the unfavorable global environment, Eurozone exports lost a great deal of momentum, and exacerbated by weakness in inventories, GDP growth was pushed below potential growth. By contrast, the growth momentum of consumer spending remained by and large stable. Investment spending benefited considerably from favorable one-off effects (transfer of assets to Ireland for tax reasons). From a regional perspective, Germany and Italy weighed on growth.

We are forecasting that GDP growth in the Eurozone will stabilize at +1.2% in 2020. We expect the downward pressure exerted by foreign trade and inventory effects to abate. However, we believe that this will be offset by a significant deterioration in the pace of investment spending as well as by slightly weaker growth in consumer spending. After fiscal expansion boosted GDP growth by 0.2% in 2019, we expect fiscal effects on growth to be neutral in 2020 (based on budget projections of the European Commission).

Trade dispute and politics remain uncertainty factors

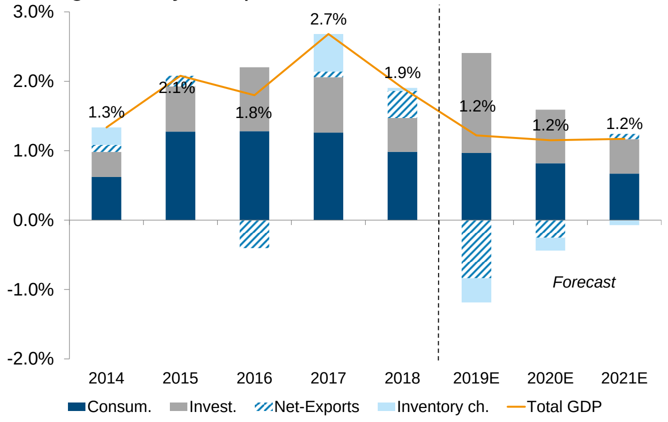
The trade dispute between China and the US remains a major uncertainty factor in 2020. Moreover, political trouble spots in the Eurozone may also generate uncertainty and as a result hamper economic growth. For example, the prospect of the far-left civic movement Podemos joining a government coalition in Spain has already triggered slight jitters in financial markets. Italy remains politically unstable as well and could cause fresh uncertainty in financial markets at any time. Lega, the strongest political party according to polls, has been out of government since May of last year and is therefore actively working toward early elections in Italy.

Strong growth momentum in ES and FR
GDP growth in %



Source: Eurostat, Erste Group Research

Foreign trade weighs on growth
GDP growth by components



Source: Eurostat, Erste Group Research

Eurozone Inflation

Global recovery harbors upside risks for inflation forecast

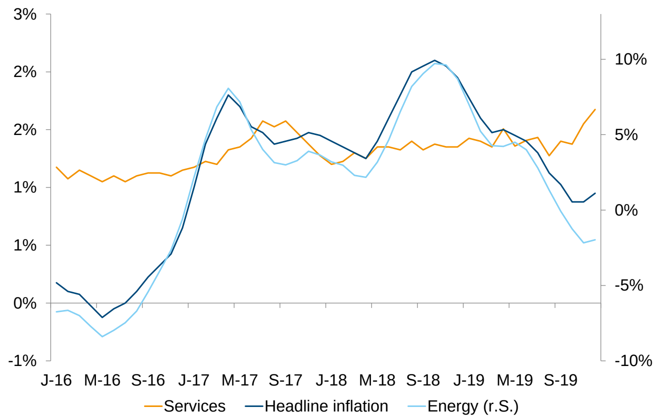
Slump in crude oil prices weighed on headline inflation in 2019

Due to a significant slump in crude oil prices, Eurozone headline inflation declined to +1.2% in 2019 (from 1.7% previously). On the other hand, core inflation stabilized at +1.0% in 2019. The ongoing recovery of the labor market should continue to underpin wage growth. In view of this we are forecasting core inflation to rise to +1.2% in 2020, and headline inflation to +1.3%. Our forecast is based on the assumption of a largely stable crude oil price. However, the emerging global economic upswing could, analogous to historical recovery periods, trigger a rally in oil prices. Moreover, persistent tensions in the Middle East may support oil prices. This results in upside risk for our 2020 inflation forecast. Regardless of this, the ECB will nevertheless focus on the trend in core inflation.

Inflation should gradually approach the target of the ECB

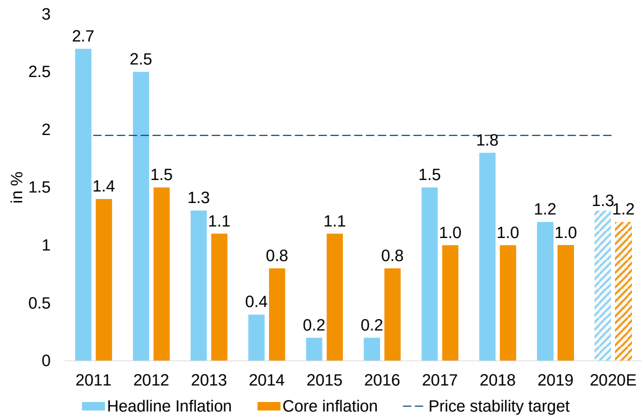
We expect that headline inflation in the Eurozone will move in small steps toward the target of the ECB in coming years – mainly underpinned by a steadily tightening labor market. In 2019 the average Eurozone unemployment rate has decreased by 0.3% to 7.5%. However, the impact of the labor market on the pace of inflation has weakened in recent years. There are several reasons for this; an important one is probably the declining influence of trade unions, which has weakened the bargaining power of employees. Furthermore, the growing globalization of services markets has led to increasing downward pressure on wages in the services sector. As the bulk of economic output in the Eurozone is attributable to services, this affects inflation significantly. As a result we expect inflationary pressures in the Eurozone to remain muted in the medium term as well.

Energy prices cause volatility
Comparison of inflation components y/y (6M average)



Source: Eurostat, Erste Group Research

Core inflation stable at moderate levels
Inflation vs. price stability target (2011 – 2020E)



Source: Eurostat, Erste Group Research

Germany

Government should take advantage of fiscal leeway

Global export champion suffers from cold trade war

Germany's manufacturing sector is licking its wounds after the massive slump in industrial production in 2019. Only thanks to stable growth in consumer spending was a technical recession narrowly avoided to date. Of all Eurozone member countries, Germany - as a result of its large trade surpluses - is the one most susceptible to the negative consequences of the trade war. Moreover, Germany's manufacturing sector is also especially strongly exposed to the far-reaching structural problems of the automotive industry.

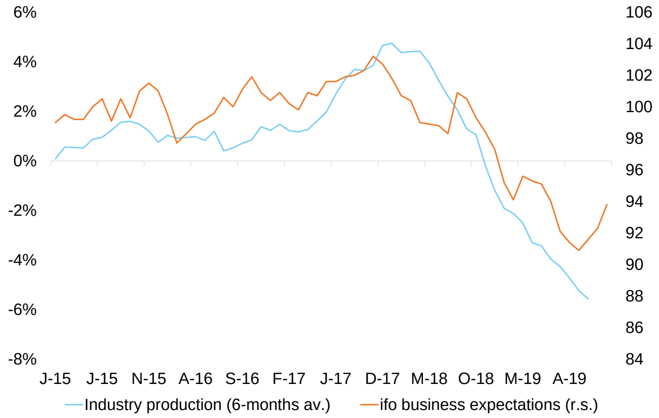
In 2020 we expect GDP growth in Germany to accelerate to +1.0%. After the dramatic downturn, the strongest impetus for this should be provided by a recovery in foreign trade; in addition, government should support economic growth in 2020 through a planned reduction in the budget surplus (around 0.4% of GDP). In fact, Germany would have additional budgetary leeway available, while still remaining in compliance with the Maastricht rules. In light of the challenges faced by German manufacturers, we believe the government should use this leeway for targeted measures (education and innovation) in order to safeguard Germany's long term growth prospects.

Will German industry manage to cope with the digital transformation?

The digital transformation will not stop at the gates of Germany's flagships, the car makers and engineering companies. As an example, experts expect that cars will become supercomputers on wheels in the not too distant future. As a result, different competencies than hitherto are already required today (software, semiconductors, batteries). However, with respect to these issues, the US and Asia have already pulled ahead. Coming years will tell whether Germany will be able to close the gap or not.

Outlook is brightening

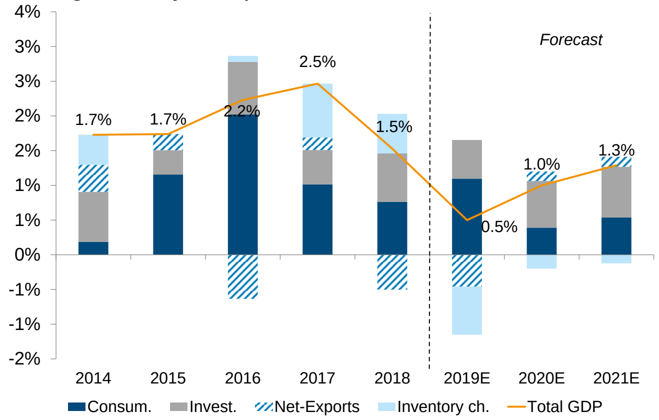
GER industrial production vs. ifo business expectations



Source: ifo Institute, Erste Group Research

Foreign trade / inventory reduction dampen growth

GDP growth by components



Source: Eurostat, Erste Group Research

France

Reforms should be continued (in a socially acceptable manner)

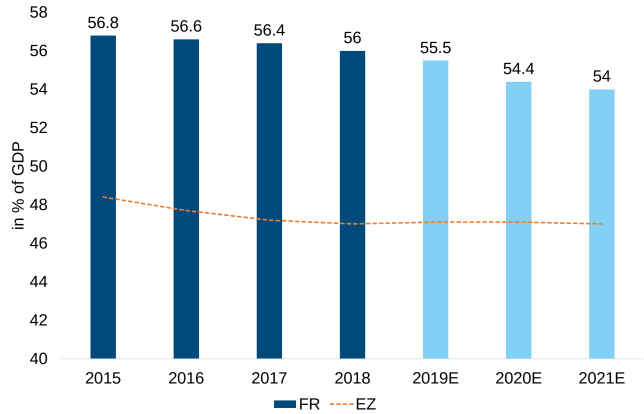
+1.3% is a sustainable pace of growth

Thanks to positive budgetary one-off effects as well as a continuing strong willingness to invest, France's economic growth rate in 2019 is likely to come in above the Eurozone average at +1.3%. We are forecasting GDP growth to remain stable at +1.3% in 2020. French consumer spending should benefit from a further decline in the unemployment rate (the European Commission expects 8% in 2020) and solid wage growth (+2.3% y/y Q1 – Q3 2019). With respect to investment spending, we expect a slight decrease in momentum (after a surprisingly strong pace in 2019). Foreign trade should provide a moderately positive contribution to GDP growth in 2020, thanks to a slight acceleration in export growth. With GDP growth of 1.3%, the French economy is growing exactly in line with its potential growth, therefore the risk of a build-up of economic imbalances is currently small.

2020 should be used to implement further reforms

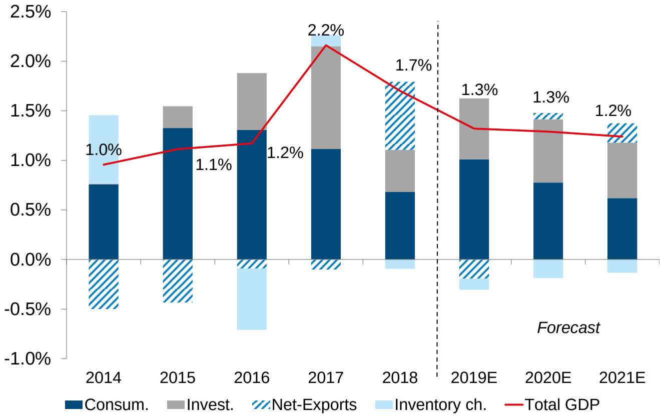
France's economy continues to suffer from a high tax burden as well as inflexible structures and framework conditions. However, the past two years have demonstrated that change can only be implemented in small steps and in a socially acceptable manner. For example, the envisaged pension reform (with the goal of unifying a fragmented and partly very generous system) meets with fierce resistance from trade unions. At least the Macron government has managed to lower the ratio of government spending to GDP noticeably for the first time in 2018 (0.4% of GDP). It is planned to lower it by another 2 percent to 54.0% of GDP by 2021; alas, this figure still stands well above the Eurozone average of 47% of GDP. 2020 is the last year in which Macron still has an opportunity to implement far-reaching reforms (e.g. the “pacte productif”). Since presidential elections are scheduled for the spring of 2022, the French political establishment is likely to enter campaign mode as early as 2021.

The first noteworthy decrease in 2018
Government spending in % of GDP



Source: European Commission, Erste Group Research

Stable GDP growth expected in 2020
GDP growth by components



Source: Eurostat, Erste Group Research

Italy

Italy remains a potential crisis flashpoint in the Eurozone

Structural deficits and demographic are a burden

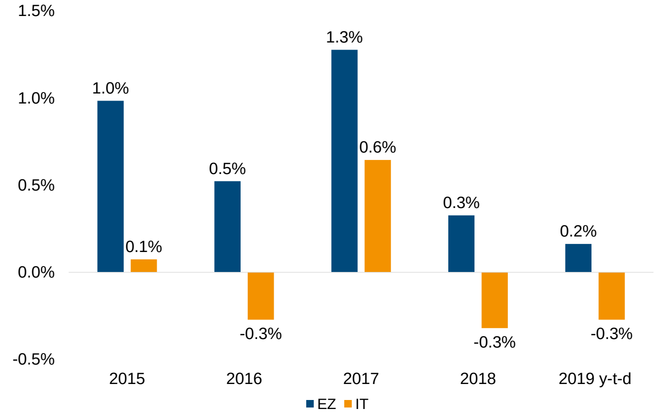
Italy's economic growth essentially came to a standstill in 2019, due to a significant reduction in inventories and a slowdown in the pace of growth of all GDP components. In line with a positive global environment we expect the growth momentum of consumer spending, investment and exports to increase slightly in 2020. We are therefore forecasting Italy's GDP growth to accelerate to +0.8% in 2020. However, due to a rapidly aging population and significant structural shortcomings, Italy's potential growth stands merely at around +0.4% (by comparison, potential growth of the Eurozone as a whole stands at 1.3%). As a result of this, Italy is only able to achieve growth rates exceeding this threshold in economic recovery phases (such as the one expected in 2020).

Debt-to-GDP ratio set to increase further

Since Italy lacks the willingness to implement substantial structural reforms, we expect below-average growth rates relative to the Eurozone to persist in the long term. This harbors the risk that investors – as has recently happened – will rightly begin to doubt the sustainability of Italy's government debt. The European Commission expects a further increase in the debt-to-GDP ratio of Italy to 137.4% of GDP by 2021.

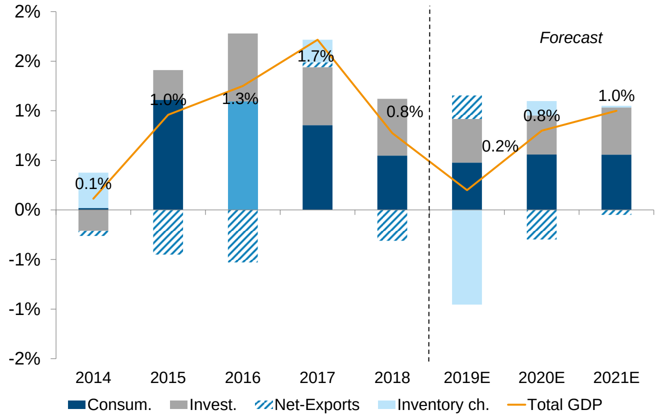
As a result of its bleak growth prospects, Italy is likely to dampen the inflation outlook for the Eurozone as a whole for quite some time. Due to below-average growth in labor productivity, Italy's competitiveness has declined against that of other Eurozone countries for several years. As Italy does not issue a currency of its own, wage restraint is the country's only means of offsetting its poor productivity. Weak wage growth in turn dampens the pace of inflation.

Italy is losing ground continuously
Real hourly labor productivity (annual rate of change)



Source: Eurostat, Erste Group Research

Inventory-related effects cause volatility
GDP growth by components



Source: Eurostat, Erste Group Research

Spain

Left-wing government may roll back reforms

Thanks to strong domestic economic growth, Spain's economy is likely to grow at an above-average rate of around 2.1% in 2019. We expect GDP growth to slow further to around 1.6% in 2020 as the momentum of domestic growth slows. In 2021 Spain's growth should continue to move closer to its potential growth rate of around 1.3%. If Spain's economic growth levels out at this rate, no major imbalances should build up.

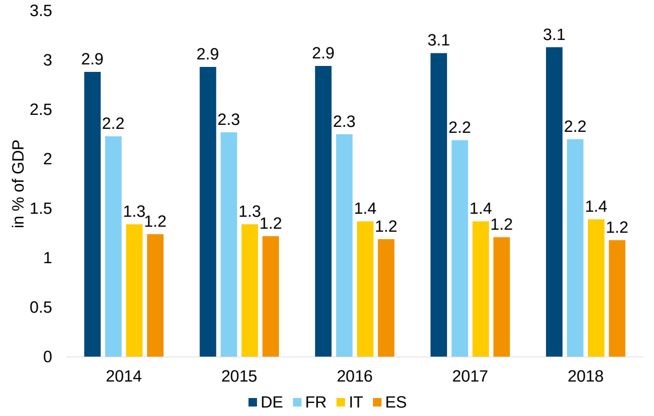
Left-wing government generates uncertainty

Politically speaking, Spain has a left-wing minority government led by the Social Democrats since January 2020. In this left-wing coalition the strongly left-wing citizens' movement Podemos represents a factor of uncertainty. However, as Podemos is the junior partner, it is open to question how strong its influence on the government will actually be. Since Spain neglected to put its public finances on a sound footing during the economic expansion, the new government theoretically has no fiscal leeway whatsoever. That said, political representatives of Podemos in particular would be willing to increase government spending substantially. Thus financial markets are quite skeptical toward Podemos participating in a governing coalition.

Shortcomings in research & development

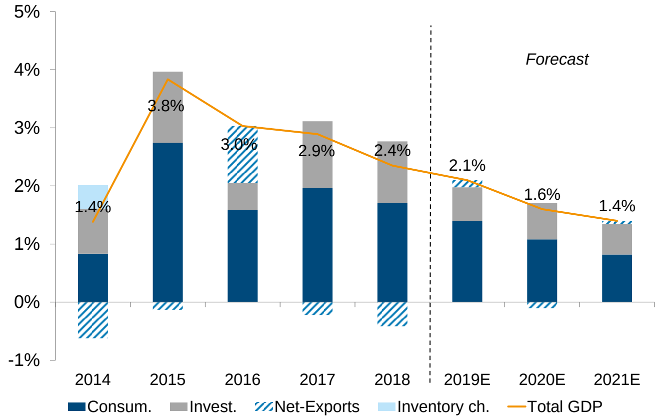
In order to improve its long-term growth prospects, Spain should provide incentives in the areas of education as well as research and development. A good education system and a high level of innovation have a positive effect on productivity, which can lead to a sustainable increase of the potential growth rate of an economy. However, hitherto there is a distinct lack of specific policy measures targeting these areas. Spain's expenditures on research & development (as a percentage of GDP) lag significantly behind those of countries such as e.g. Germany or France.

Spain with noticeable need to catch up
R&D spending in % of GDP



Source: Eurostat, Erste Group Research

Investment the most important growth driver
GDP growth by components



Source: Eurostat, Erste Group Research

US Economic and Inflation Outlook

US Economic Growth Remains on Track

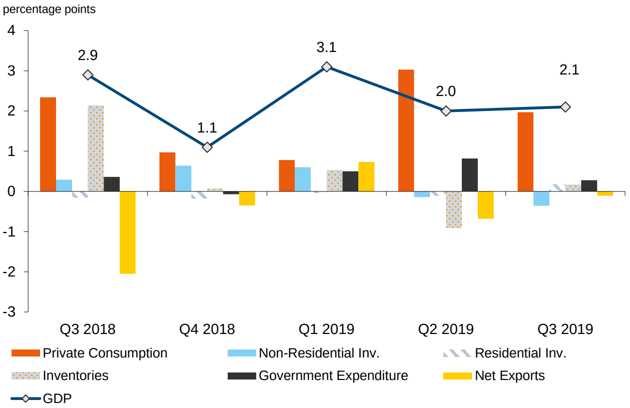
Continued solid growth expected

US economic growth held up well in the face of a difficult environment in 2019. 2nd and 3rd quarter growth rates were in line with the US economy's growth potential and economic data released to date suggest that a similar growth rate will be posted in the fourth quarter. Economic growth was mainly driven by consumer spending and to a significantly lesser extent by government expenditures. Not surprisingly, corporate investment and net exports suffered most from the escalation in the trade dispute with China as the year progressed. We expect US economic growth to remain stable. As we expect at a minimum no renewed intensification of the trade dispute with China, no additional pressure should emanate from this front this year. In our opinion there are no signs of imbalances of the US economy the correction of which could trigger an economic downturn. A robust labor market suggests continued growth in consumer spending. There is some hope for corporate investment, as the downturn has already lasted a long time by historical standards. However, indications for a turnaround remain weak for the time being. All in all, we expect economic growth of just below 2% this year.

Inflation slightly below 2%

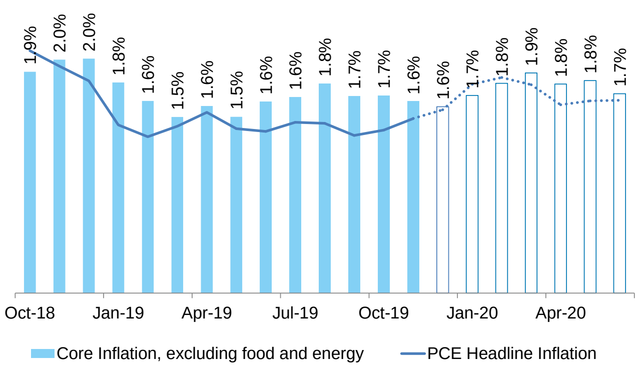
The labor market continues to be characterized by strong jobs growth and the unemployment rate stands at a 50-year low. Nevertheless, the labor market still shows no signs of overheating. On the contrary, wage growth has barely changed for quite a long time and thus provides no evidence of a build-up of inflationary risks. The underlying trend of inflation is determined by the core inflation rate. Monthly change rates were volatile in the course of 2019, resulting in annual inflation rates ranging from 1.5% to 1.8%. This should not change this year. Our expectation for economic growth in conjunction with no signs pointing to accelerating wage growth suggests that core inflation should remain range-bound below 2%. Fluctuations in energy and food prices should lead to occasional spikes in headline inflation.

US economy has held up well in a difficult environment
GDP growth q/q annualized with components



Source: Bureau of Economic Analysis, Erste Group Research

Inflation rates should remain range-bound
PCE, y/y in %



Source: Bureau of Labor Statistics, Erste Group Research

Emerging Markets

Focus should be on strengthening institutions

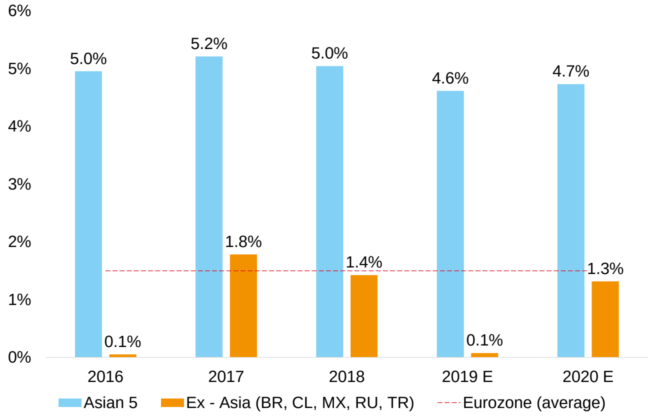
Easing of monetary policy by the Fed lends support

The economic outlook for emerging markets has improved thanks to the partial rapprochement in the trade dispute and the noticeable easing of monetary policy by the Fed. In the wake of the Fed's policy u-turn, the central banks of large emerging market economies (China, India, Indonesia, Malaysia) were able to adopt an easing bias as well. We therefore expect an acceleration of economic growth in a number of emerging market countries in 2020. However, the trade dispute poses a long-term challenge for emerging markets, as global supply chains that have been established over the past 20 years are put to the test. In the future it may no longer be as easy as it once was to quickly gain valuable know-how by means of integration into supply chains.

Muted growth prospects outside of Asia

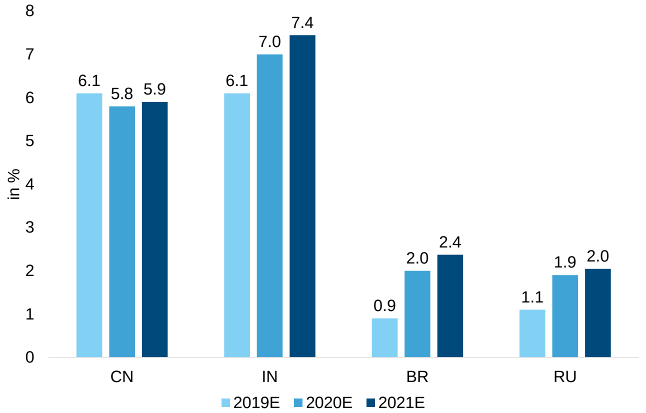
Developing economies in Asia have succeeded in boosting prosperity (GDP per capita) significantly in the recent past as well. By contrast, countries such as Russia, Turkey, Brazil, Mexico or Chile partly had to partly put up with losses in economic welfare, and/or have experienced a decline in prosperity relative to the Eurozone. The reasons for this are high levels of corruption, poor quality of public institutions as well as in the case of Russia and Turkey economic sanctions imposed by the US. Thus the IMF emphasizes in a recent study that for many developing countries the key to greater prosperity lies in improving the quality of public institutions. Only then will they succeed in attracting long term-oriented foreign investment capital. However, attempts to strengthen public institutions are often undermined by corrupt ruling elites. If their framework conditions do not change, countries such as Russia, Brazil or Chile can only hope for a sustained increase in commodity prices (such as crude oil or copper) to at least provide a stimulus to economic growth in the medium term.

Only Asia is still growing dynamically
GDP per capita growth



Source: IMF, Eurostat, Erste Group Research

Acceleration in growth expected for 2020
GDP growth CN, IN, BR and RU 2019E – 2021E



Source: IMF, Erste Group Research

China

Growth momentum will decline further for structural reasons

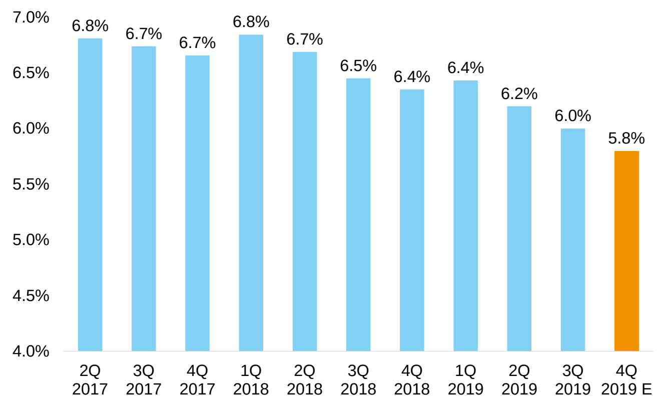
Reaching higher stages of development dampens growth

China's economic growth is steadily losing momentum since 2010. There are two major reasons for this. For one thing, from 1990 to 2010 China's growth benefited substantially from strong growth of its working-age population. However, since 2010 China's working-age population has begun to shrink (just as in Europe and Japan). For another thing, the rising degree of development of the Chinese economy exerts a dampening effect on growth dynamics as well. As recently as 1990 China's GDP per capita was a mere 4% of that of the US, but it has rapidly increased to 30% by 2018. This has resulted in the services sector gaining in importance, but services are not as easily scalable as manufacturing.

Credit growth turns up

However, due to the negative impact of the trade war, growth momentum in 2019 has decreased even more strongly in 2019 than before (Q1 – Q3 2019: 6.2%). Based on leading indicators we expect a further decline in the pace of growth in Q4 2019 to +5.8% (y/y). In the short term cyclical upswings and downswings in the Chinese economy can be identified quite well by looking at the growth momentum of German exports to China. These data show a steady decrease in the pace of growth since the end of 2017 until October 2019. Having said that, credit expansion in China has resumed in May of 2019 (driven by a significant easing of monetary policy coupled with expansionary fiscal policy), which we believe should soon exert a positive effect on the growth of German exports to China. It would nevertheless be quite important for China's growth prospects in 2020 to conclude a partial trade agreement with the US.

Slower growth expected in Q4
China GDP growth y/y



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

Credit expansion should help German exports
China lending vs. GER exports to China

Source: Federal Statistics Office Germany, PBoC, Erste Group Research

Forecasts[1]

GDP	2018	2019	2020	2021
Eurozone	1.9	1.2	1.2	1.2
US	2.9	2.2	1.9	2.2

Inflation	2018	2019	2020	2021
Eurozone	1.7	1.2	1.3	1.5
US	2.4	1.9	2.1	2.1

Source: Erste Group Research (own calculations)

[1] 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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