GLOBAL
ECONOMY

6/18

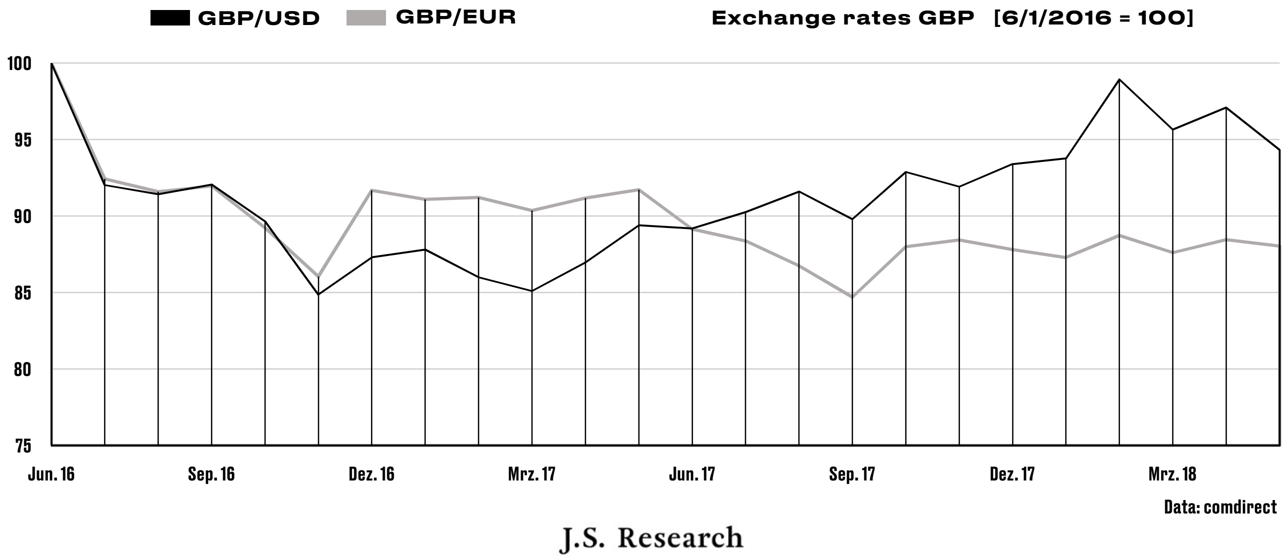
Italian imbroglio certain to return soon

Canadian economy: healthy, but with a weak spot

J.S. Research

Irish border remains the square to circle, while first cabals begin in Westminster

The tone in Brussels is getting rough again. As the deadline for this October set by the EU chief Brexit negotiator Michel Barnier is approaching fast, nerves are increasingly on edge: The most recent round of talks ended with one exasperated EU official speaking his (and most probably Mr Barnier's) mind, the UK needed to wake up from its “fantasy“ land. The already fraught negotiations became even more tense when the British side in effect set an ultimatum to allow the UK's continued participation in the EU's “Galileo“ satellite project; otherwise, Britain would end her security co-operation with the EU, one of areas most coveted by Europeans partners keen to keep their access to intelligence from the “Five Eyes“ alliance between the UK, the US, Australia, New Zealand, and Canada. That ultimatum amounted to a deliberate violation of the erstwhile promise by the British side not to use security co-operation as leverage in the Brexit negotiations, and it was greeted as such. In this heated atmosphere, another spat has emerged over that recurring quandary of the threat of a renewed Irish border and how to avoid it. Eventually accepting that she wouldn't get Cabinet to agree on one of the two traded options on future customs relations with the EU (see last issue of this report), Theresa May offered retaining the existing customs union as well as regulatory alignment with the Single Market for the whole of the UK throughout the transition period, that is to the end of 2020. However, Brussels quickly rejected that proposal out of hand, stating yet again that it will not allow Britain to cherry-pick what she likes about the EU while avoiding the corollary obligations, freedom of movement first and foremost among them. Yet with the death of this option, too, it becomes increasingly impossible to conceive of a way to avoid renewed border checks in Ireland, except for that option hated most by Mrs May's Northern Irish allies, the DUP: To keep Northern Ireland within the EU's regulatory body, customs union and single market included, and thus creating a customs barrier in the Irish Sea. For it is alignment with the regulations of the single market as much as staying in the customs union being necessary to avoid any border checks in Ireland. What is certain to grate Brexiteers even more is the leak from Whitehall that, effectively, there has not been any preparation at all for a no deal-Brexit, thus



undermining the credibility of the threat by the British side to walk away from the negotiations should the EU push too hard. That walk-away option, however, has been being the holy grail of visceral Brexiteers ever since negotiations have begun; and rather contrary to the perception of most observers, we think that the threatening loss of their exit option will bring Brexiteer rebels yet closer to deposing the Prime Minister in a frantic effort to try and stall the negotiations as long as they are still able to do so. Indeed, rumours emerged that cabals among Brexiteers have sprung to life in Westminster, waiting for the right moment to strike. Even though they might not have the numbers to oust the Prime Minister, they can trigger a leadership contest not only open to surprises, but also apt to tie Mrs May's hands should she – more probably than not – emerge from that contest with an unconvincing margin. Amidst this trouble, the Bank of England has issued a stark warning that it presumably would be forced to lower rates back to zero in case of a hard Brexit, in spite of increasing inflation from the Pound devaluing again, in an attempt to prop up the economy. Crunch time, hence, is drawing nearer in Westminster. Expect more spanners to hit the works.

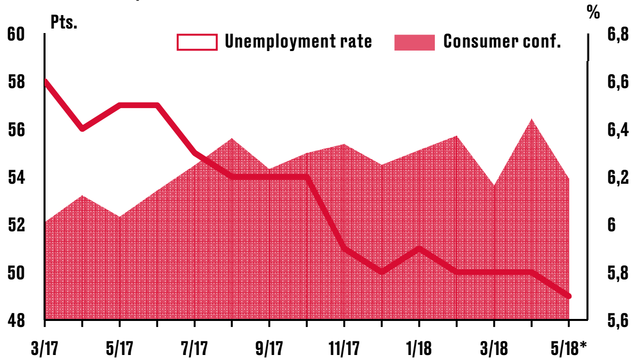
Italian government yet to confront Brussels will spring more tension soon

Political markets are short-legged, as the saying goes. The turmoil in Italian politics in the last weeks provided yet further proof. Or have they? The prospect of a virtual referendum on Italy's remaining in the eurozone by way of fresh elections might have been avoided for the time being, but it has not been rendered impossible in the months ahead. And in an almost breathtaking turn of coats, markets who first had been spooked by the populists reigning in Rome then positively applauded that very outcome, if only fresh elections could be avoided. The intentions and aims of the government constituted by the far-right Lega and the populist-left Cinque Stelle (M5S) however, have not changed a bit and will still present the Eurozone with a daunting challenge in due course. Just as we had been projecting since the beginning of last year (see section 'spotlight' on our website and issue 01/18 of this bulletin in particular), the populists from the left and right have emerged as the new power in Italian politics, forcefully relegating the traditional parties of the centre-left and right to the fringes. In the best of cases, the honeymoon of Italian voters with the populists usually promising rather more than they can deliver will wear off soon; in the worst, though, simmering euroscepticism might become magnified into an outright campaign to abolish the euro in Italy by way of fresh elections triggered by the populist government itself. Presented with the best of PR platforms imaginable, in the case of the EU's stubborn resistance to reform demands from Italy M5S and Lega would be able to assume the role of the people's voice, standing up to an overweening, elitist establishment intent on keeping power; small wonder, then, that in recent polls the Lega is zeroing in on Cinque Stelle's figures, leaving their combined vote share well in excess of fifty per cent, while the Partito Democratico of Matteo Renzi and the recent Prime Minister, Paolo Gentiloni as well as Silvio Berlusconi's Forza Italia are falling into the electoral abyss. More than any other, it has been the Lega's leader, Matteo Salvini who has left no doubt as to his marked hostility towards the euro; only political tactics had tempered that hostility into ambiguous calls for reform in the campaign before March's election. Regarding his cunning manoeuvring so far, it is more likely than not that he will take the matter to fever pitch from here. Inadvertently, President Mattarella and those surrounding him have created a situation where the establishment, trying to stave off a populist government by choice of a former IMF official not known by the nickname of "Mr. Scissors" for nothing, is seen as a conspiracy by those profiting from the 'dictat' of the euro. And Messrs Salvini and Di Maio – even if the latter to a lesser degree – will not fail to scoop on that opportunity. The situation still amounts to one of the greatest dangers for the euro in its history – and markets will wake up to that fact again before the year is out.

Canadian private debt leaves economy more vulnerable than others

Now that the US government has proven its determination to follow through on protectionism, many businesses might be inclined to pay the States' smaller neighbour to the North a closer look: Justin Trudeau has repeatedly made a point about Canada's openness, successfully combining progressive social policies with liberal economic ones. Now, in the face of

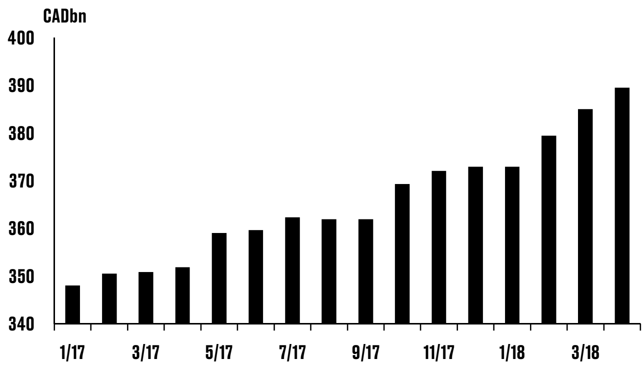
Chart 1: Consumer confidence vs. unemployment rate, Canada



*unemployment rate: own estimate / data: trading economics

protests from environmentalists as much as the new governor of British Columbia, he has even decided to buy the Trans Mountain pipeline from Kinder Morgan, linking the oilsands of Alberta to the port of Burnaby on the Pacific coast. The Canadian Prime Minister seems intent on proving his business-friendly, pragmatic mettle, aiming to use the proceeds from an upsizing of the Trans Mountain pipeline to promote the country's transformation to a more sustainable economy. That notwithstanding, investing in Canada in our view is now a particularly risky bet on the global macroeconomic backdrop to stay as benign as in the recent past. In general, Canada's economy is in good shape: GDP growth is decent, industrial and manufacturing production are both rising, and business confidence indicators are all but sky-rocketing. With oil prices recovering from their 2015 troughs, and in powerful fashion at that, this nowadays very important part of the Canadian economy has rediscovered its energy, much to the (not completely unwarranted) alarm of said environmentalists. However, there are two areas of concern: Consumers seem to have disconnected from the recent upturn, as both soft indicators such as consumer confidence as well as hard statistics such as consumer spending have been painting a subdued picture. This is all the more odd as non-farm payrolls are expanding by a steep rate of late, just as the overall unemployment rate has hit rock-bottom and continues to fall (see chart 1). There is one explanation left, then: debt. Canadian households boast a comparatively high level of indebtedness, complemented by a pronounced vulnerability to abrupt changes in wealth much dependent on house prices. Those have been running red-hot in the recent past, triggering much concern among financial analysts and even the odd central bank official, too (see issue 6/17 of this bulletin). The total stock of private sector's debt in general todays stands at a hefty 267 per cent of GDP, some 100 percentage points of which are borne by households. Loans to the private sector, indeed, have been ballooning in excess of any healthy rate since 2015 (see chart 2). This leaves Canadian businesses as much as households very dependent on a continuation of the current, decent economic expansion and, thus, strong employment. Any external shock, then, for example from a collapse in oil prices, a break-down of NAFTA, or markedly lower availability of foreign exchange needed to plug an increasing current account deficit stands to hit the Canadian economy relatively harder than other G7 economies. The Canadian Dollar or 'Loonie' as it is known among forex traders thus presents an augmented fx risk into the addition, being prone to sometimes wild swings anyway. Investing in Canada, hence, is a comparatively risky bet on the continuation of the recent goldilocks macroeconomic framework of the world economy – which, in our view, is coming to an end.

Chart 2: Loans to the private sector, Canada



Data: trading economics

Statistical Bulletin

Current account (Q1/18, y/y, nom.)

Portugal: + >300%* ↑ The asterisk marks the obvious: Portugal's current account has jumped from a small deficit a year ago to a remarkable surplus. Though the statistic has been prone to violent swings of late into the addition of not being seasonally adjusted, the figure symbolises the continuous improvement over the last ten years.
Denmark: -90% ↓ Denmark's current account has been deteriorating precipitously over the past year, after stagnating in the three years before. Though a weak start into the year is usual in this non-seasonally adjusted series, it has been pronouncedly weak this year around.

Unemployment rate (Apr., ILO)

Brazil (over the 3 months prior)**: 12.9% ↑** After a tentative easing over the past year, Brazil's unemployment rate has returned to its multi-year highs, demonstrating the country's still weak economic situation.
Netherlands: 3.9% ↓ The employment boom in the Netherlands has been being on the run for almost 48 consecutive months now – and counting. The country is enjoying one of the best economic expansion periods in its modern history, and workers are sharing in it.

Loans to the private sector (Apr., nom.)

Singapore: +5.7% ↑ Singapore is on a credit binge, underlining the animal spirits in the Lion City's economy (see the expectations component of the SiNGES, our one-stop economic indicator for Singapore). The growth rate of debt, however, is far from worrisome and – against a decent macroeconomic backdrop – absolutely sustainable.
Spain: -6.9% ↓ Spain's private sector continues to deleverage in spectacular fashion, after the country has suffered badly from the construction industry's debt-fuelled bubble bursting in the financial crisis. Private debt to GDP now stands at below 200 per cent for the first time since 2003.

Manufacturing production (Apr., real)

Czech Republic: +9% → Though looking very healthy, the figure is somewhat flattering: Manufacturing production in the Czech Republic is very dependent on the German car industry, shaken by an apparently unceasing diesel scandal and the threat from a global trade war.
US: +1.8% ↑ US manufacturing production is purring along, underlining the country's unambiguous economic expansion.

Consumer spending (Q1/18, q/q, real)

Consumer spending has been all but exploding in the Netherlands of late, matching the country's employment boom (see above). Germany is ahead of two thirds of the table, with Canada and Japan bringing up the rear.

Data: Trading Economics, bloomberg, comdirect, own calculations

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