Research

Helaba

Markets and Trends 2020

Melodrama – next act



Values with impact.



Dr. Gertrud R. Traud

Chief Economist/Head of Research

Editorial

> *"Theatre only becomes real when the audience plays along internally."*
> Hermann Bahr (1863–1934)

This observation about theatre is both an invitation and a threat. At present, some parties and heads of government are skilfully casting themselves in the limelight. This has captivated many in the audience who then demonstrate their enthusiasm at the ballot box. Other actors find it difficult to survive on stage with their political correctness.

Will the cast finally see reason and at least do what is necessary? This is the only way to ensure this melodrama has a bearable outcome.

Dear Readers,

Who will provide the script for the great global economic performance in 2020? Will it be Shakespeare, Molière or Brecht? Or will the lead actors also be directing the show? Will it be a tragedy or a comedy, or more akin to a melodrama?

Melodrama enters the political stage

Since the Brexit referendum and Donald Trump's election victory in 2016, politics has held the capital markets firmly in its grip. Up until then, hardly anyone could have imagined that a country would leave the EU or that the largest economies would launch a spiral of tariff increases.

However, it is not only the issues that are new but the style of policymaking as well. The latter is making use of all the various melodramatic techniques: The main actors share their opinions, feelings and sensitivities in an uninhibited fashion with a global audience in a flurry of tweets. The verbal spectrum ranges from exuberant euphoria to spontaneous expressions of opinion and tirades of hatred. In this way, the protagonists deliberately polarise and emotionalise issues in order to advance their interests.

Familiar leads

As of now, we are in the **third year of this melodrama**. Fears are spreading that a slide into tragedy is imminent, adding to the suspense of the next season. Most of the headliners are familiar faces. Like last season, **the tall blond** across the pond will be playing the male lead. His opposite number in London is also expected to be recast in a prominent role. But what kind of theatre are they going to perform?

My preference would be for a comedy. Even if it addresses human frailties, you learn not to take yourself too seriously – for the benefit of everyone. However, it seems more likely that they are going to stage the fourth act of the ongoing melodrama.

A female conductor

A melodrama is often accompanied by music. For the first time, a woman is holding the conductor's baton at the European Central Bank. Whether the **new President Christine Lagarde** will usher in a reversal of Mario Draghi's monetary policy course is more a question for the future. In the short term, at least, she will not deviate significantly from his score. However, she will be wielding the baton quite differently from her predecessor.

Growing discord within the orchestra – in other words, in the Governing Council of the ECB – has led to a cacophony that not only confuses the performers but also the audience. A sure instinct is required in order to take into account the sensitivities of individual groups within the ECB's supreme decision-making body.

> *"To fulfil the mandate and make sure the team works and holds together."*
> Christine Lagarde, asked about her main tasks at the ECB (Die Zeit, 7 November 2019)

Recasting important roles

While 2019 was the year of casting and allocating roles in the EU, a tense global audience is waiting for the performances that have been announced. With the appointment of the new EU Commissioners in November and the expected inauguration of the new Commission in December – also under the auspices of a woman, Ursula von der Leyen – the groundwork is being laid for the EU's institutions to focus more strongly on their actual roles and responsibilities.

Although a lot of things in the EU are long in coming, its audience remains favourably disposed to the company: According to the latest Eurobarometer, **45 % of EU citizens surveyed said they had, on balance, a positive image** of the EU – with a rising trend. In fact, more respondents trust the EU than their own government.

> *"What is essential is invisible to the eye."*
> Antoine de Saint-Exupéry, "The Little Prince"

Much of what is happening at the European level is not immediately visible to the public. Just like technical equipment in the theatre, which is nevertheless vital for the performance. The same applies to the International Monetary Fund, which pulls the strings in the background.

This task, too, remains in the hands of a woman with the appointment of Kristalina Georgieva.

The melodrama turns out well in the end

A complex interplay between the actors and director will be what creates the suspense in the melodrama of 2020. Every event will be celebrated and embellished to delight the audience – while constantly seeking to elevate one side while humiliating the other at the same time.

In contrast to a tragedy, however, it is essential for this genre of theatre that the play **has a happy ending**. For this to happen, the protagonists must see reason in order to do what is necessary. This is where the twist comes in to rescue the situation: after all, neither the lead actor from the United States nor his adversary from China has any incentive to escalate the trade conflict to such an extent that the global economy crashes. With the easing of the trade war and an orderly, lasting Brexit solution, the prospects for the world economy will brighten again.

The stage is set for the asset classes

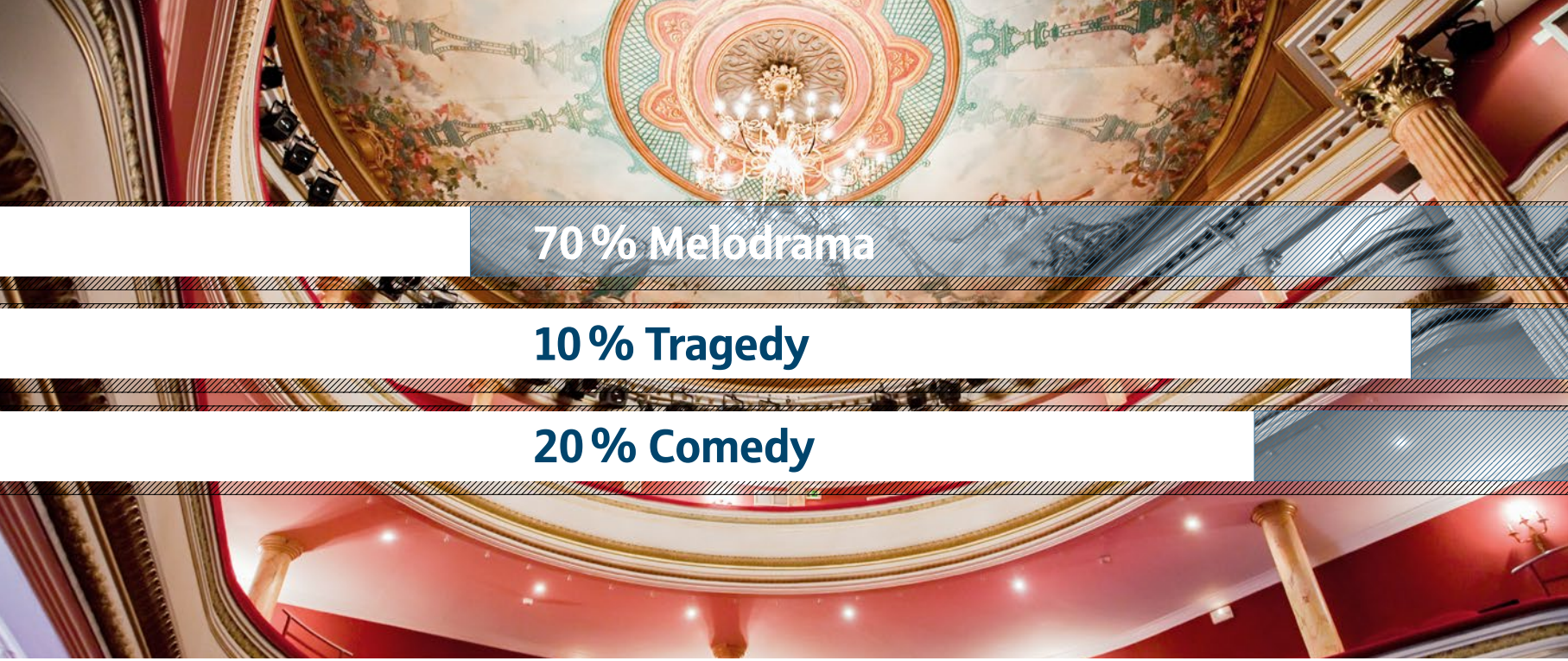
The play to be staged has been decided, the roles have been cast, the instruments have been tuned, the technical equipment, the backdrops and the fly system have been prepared. There is a buzz of activity, both in front of and behind the curtains. The theatre critics are taking up their positions. Now, the big question is: how will everyone perform?

Equities and bonds already made their grand appearance in 2019 and their potential returns will be limited in 2020. However, there may be temporary exaggerations in equities because, in general, the lack of attractive investment alternatives will persist. This setting will also ensure that real estate remains very popular with investors. Gold will be glittering in the limelight. Both monetary and fiscal policy will be the key players in extending the revival of the precious metal into next year.

The melodrama also has something in store for President Trump. After all, he is longing for a weak US dollar to strengthen exports. There are grounds for hope in this respect: the US currency is likely to depreciate against the euro in 2020.

Even Heinrich Heine (1797 – 1856) worked with different scenarios:

> *"Love is a comedy in France,*
> *a tragedy in England,*
> *an opera in Italy*
> *and a melodrama in Germany."*



Negative alternative scenario: Tragedy

In our negative alternative scenario, the world economy is like a classic tragedy. The prevailing conflicts develop their own momentum and lead to a global recession.

In the process, the main protagonists experience **vicissitudes of fate**. With its cast of Brexit villains, the United Kingdom sinks completely into political chaos. Further attempts by the United States' lead actor to save his scalp could see the trade war escalate into a currency war, leading to a vicious circle of devaluations and additional trade barriers.

Positive alternative scenario: Comedy

In our positive alternative scenario, a **fundamentally upbeat sentiment** prevails around the world – just like in a comedy. The disruptive manoeuvres of the two tall blond protagonists fade away and this results in a happy ending.

The sometimes bizarre personality traits of some of the actors are no longer perceived as a burden, but instead culminate in a successful collaboration between nations. The global economy accelerates to full speed again and the stock markets applaud.

As a subscriber to our 2020 programme, I hope you gain some stimulating insights!

Yours

Chief Economist / Head of Research

helaba.com/int/information-for/research

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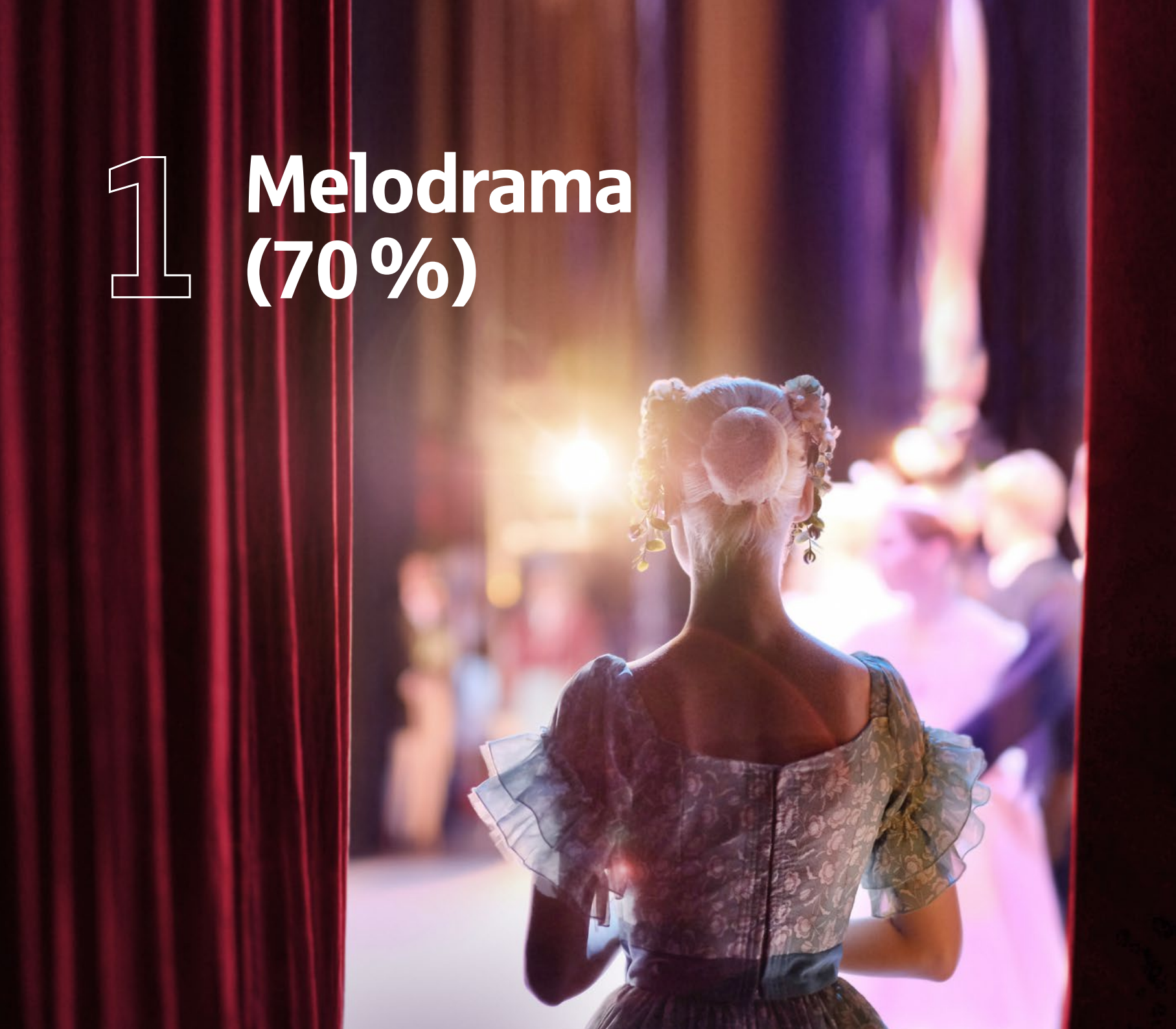


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Editorial date: 14 November 2019

1 Melodrama (70%)



Baseline scenario

Melodrama – next act (70 %)

As 2019 comes to a close, the global economy is teetering on the brink of recession – the economic equivalent of a nervous breakdown. The industrial sector, in particular, is stumbling and many indicators of activity have fallen into contraction territory. However, the hypothesis voiced in some quarters that a global recession is unavoidable in the short term, even foreordained, is anything but compelling. The global economy will regain its momentum as we move into 2020 and will continue to expand, albeit the pace of growth will be limited.

Is this just the proverbial whistling in the dark? There is no doubt that there are considerable risks and uncertainties here. Opinions differ on the causes of the current weakness. The "usual suspects" for a cyclical slowdown or contraction – an oil price shock and a restrictive fiscal or monetary policy – are not available this time. One issue on which there is broad consensus is that one of the most significant factors is trade policy – or, to put it another way, the associated enormous rise in uncertainty about the future of globalised value chains, especially in manufacturing. This explains why the extremely open German economy has been one of the main casualties over the past two years. We rely on the global industrial cycle and a functioning system of international trade more than almost any other major economy. But that also means the upside potential is all the greater when the pressures subside.

> *"Who is our bigger enemy, [Fed Chairman] Powell or [China's president] Xi?"*
> Donald Trump, US President

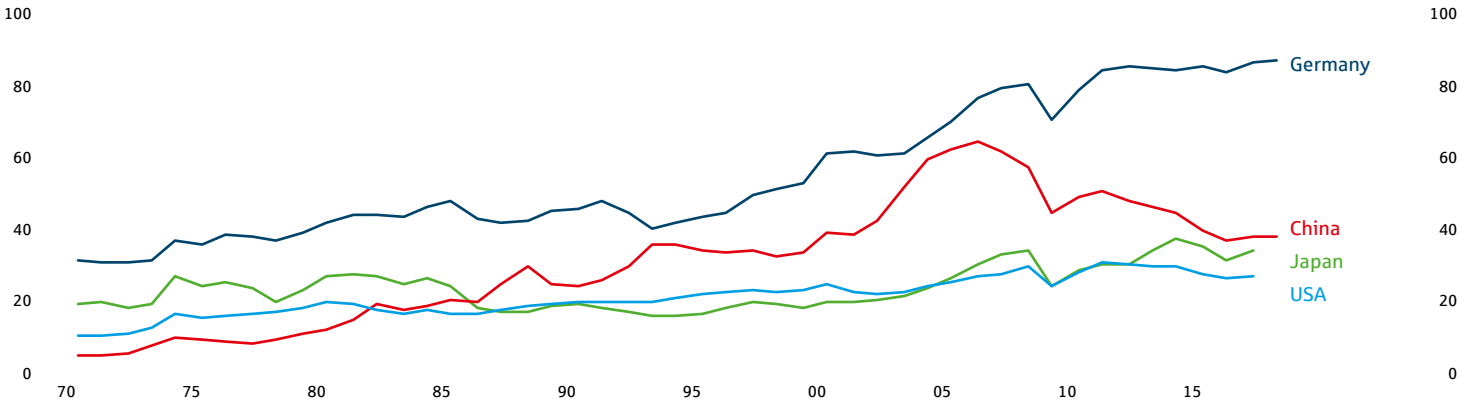
The last time free trade was so suddenly called into question on a global scale was in the 1930s. Consequently, due to our limited experience, we have little understanding of how this will affect the globalised economy of the 21st century. One assumption of our scenario is that the trade conflict does not continue to escalate as it did in 2018/2019 but, at the very least, that the protagonists agree on a ceasefire. It is even conceivable that the United States and China will reach an agreement and succeed in gradually lifting existing tariffs.

Uncertainty the principal negative factor

The well-known annoyances of "Brexit" and the "trade conflict" were supplemented in 2019 by another political issue, which will become even more important in the years to come. The climate debate has the potential to force a major rethink of established economic structures that have developed over the period of decades or even to make them obsolete. This goes far beyond the crucial question, especially for German industry, of "What does the future hold for individual mobility?"

Germany particularly open

Trade openness, sum of exports and imports of goods and services, % of GDP



Sources: Datastream, Helaba Research

> *"[As] we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know.*
>
> *But there are also unknown unknowns – the ones we don't know we don't know. And […] it is the latter category that tend to be the difficult ones."*
>
> Donald Rumsfeld, former US Secretary of Defence

The uncertainty caused by such structural factors can lead to a reluctance on the part of companies to invest or consumers to spend, over and beyond normal cyclical effects. A recession is always a primarily psychological phenomenon. After the euphoria of a boom, during which all risks are suppressed or played down, the pendulum swings the other way. Imbalances that had built up before are corrected. However, this time the **imbalances** are **limited**, perhaps because there never really was any period of euphoria in the real economy during the current expansion that began in 2009. The watchword of this cycle has been restraint: for example, the savings rate of private households in the United States, which are usually so eager to spend, is above average. A wave of carefree over- or misinvestment is not evident, at least not in the major industrialised countries. Accordingly, there is little or no need for correction.

Monetary stimulus to provide support

Fiscal and monetary policy are not the most effective remedies against what are predominantly political problems, especially since their capacity to act is lower than in previous cycles. Nevertheless, **fiscal policy** will probably have a slightly expansionary impact in 2020. The **Fed** and the **ECB** have already embarked upon a turnaround in monetary policy over the course of 2019. The Fed has

switched from hiking to cutting interest rates and its balance sheet will soon start growing again after a noticeable contraction. The ECB has aborted its own interest rate turnaround, lowered the deposit rate and launched a new purchase programme. These measures will have increasingly positive implications for the economy in 2020, even if nothing more is "thrown in". Within both central banks, however, there are signs of a coming intense debate on the fundamental strategy of monetary policy.

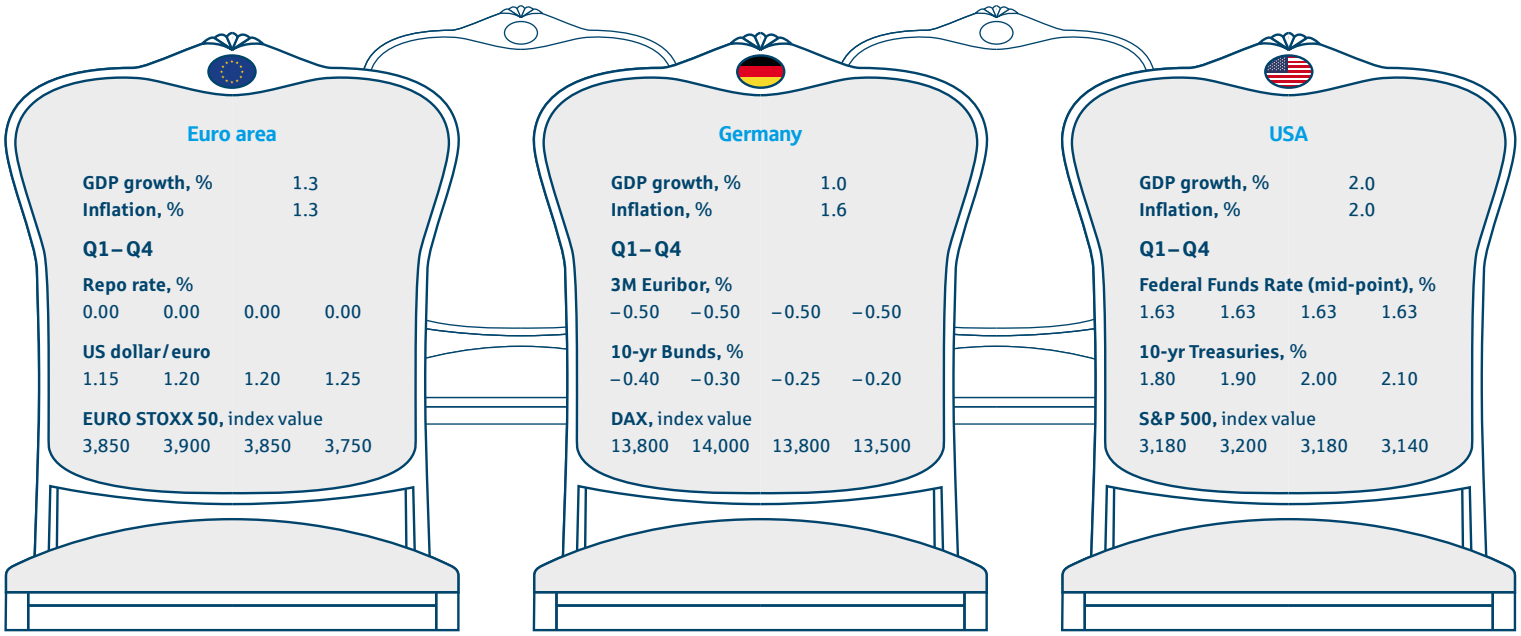
Overview of forecasts in the baseline scenario

In Germany and the euro area, **economic growth** is expected to come in at 1 % and 1.3 %, respectively, a moderate pace despite a rebound in the economy. The United States should expand by 2 %. **Inflation** will remain significantly below the ECB's target in the euro area, while prices will rise by 2 % in the USA.

Our assumption is that the **oil price** will hover around the 60-US dollar per barrel mark and that the fading period of economic weakness will still limit upward pressure on prices. For this reason, inflation in 2020 will not send any strong signals to the central banks as to whether they should pursue a more restrictive monetary policy or a significantly more expansionary one.

In 2019, the monetary policy reversal led to a premiere on the **bond market**. After a spectacular slide, all German government bond yields were in negative territory for a while. In view of the

Selected forecasts 2020



Quelle: Helaba Volkswirtschaft / Research

economic recovery, there is no chance of a repeat performance in 2020. Even a further interest rate cut by the ECB should only temporarily lead to rising bond prices. At the end of 2020, we expect the yield on 10-year German government bonds to be –0.2 %. In addition to the continuation of the ECB's loose monetary policy, persistently low inflation expectations, in particular, suggest that it is unlikely that yields will return to positive territory on a sustained basis. 10-year US Treasuries should yield over 2 % by the end of 2020.

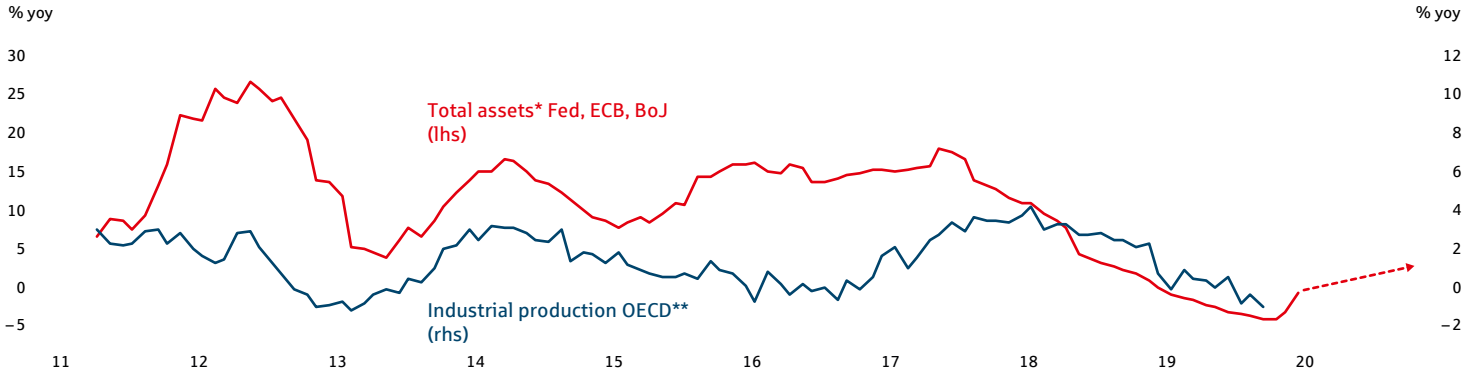
For European **corporates**, spreads will remain at a fairly modest level in 2020 and refinancing costs will stay low. Credit profiles are in solid shape. This will also ensure that the quality of banks' balance sheets remains stable; however, there will be further pressure on their profitability in view of the low interest rate environment, an even tougher competitive landscape and substantial outlays for regulation and digitisation.

Covered bonds, which will remain strong, will face increased demand from the ECB. In view of the persistently low yield level, however, there will only be a slight narrowing of risk premiums.

In defiance of all the political and economic upheavals, **equities** recorded above-average gains in 2019. Although the perceived political and economic uncertainty had reached new highs, investors generally remained calm with only a few brief interruptions. The main reason for this was most likely the ultra-loose monetary policy of the major central banks, which led to a significant decline in yields on safe assets and thus increased the relative attractiveness of equities.

In 2020, equities are once again likely to trade in a conflicting environment of high valuations and a lack of investment alternatives. If growth prospects

Monetary policy volte-face

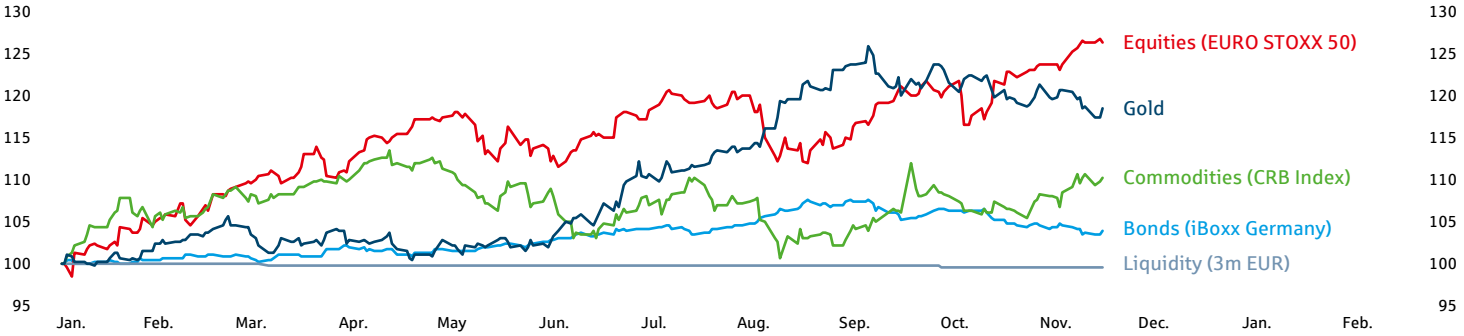


* GDP-weighted aggregate rate of change ** Excl. construction sector

Sources: Datastream, Helaba Research

Above-average performance in equities and gold

Index 31 December 2018 = 100, EUR



Sources: Datastream, Helaba Research

improve, as expected, investors will presumably prioritise returns over risk considerations. This may well lead to temporary periods of overreaction. Should the German DAX temporarily exceed the 14,000-point mark, however, it is unlikely to prove sustainable. Towards the end of the year, we anticipate that it will be trading at around 13,500 index points.

Real estate will remain relatively attractive given extremely low interest rates. However, the recent economic weakness could mean that rents and purchase prices will increase at a slower pace in 2020. The situation on the German housing market will not improve as long as restrictive political measures continue to weigh on new construction activity.

The **US dollar** remained comparatively robust in 2019 – to the chagrin of US President Trump. A weaker US currency would suit his protectionist agenda. In any case, the US dollar is clearly overvalued. Caution is also the order of the day as far as US trade and budget deficits are concerned. Political headwinds for the euro are likely to ease or could even turn to the detriment of the US currency. Moreover, if the euro area shows increasing signs of a cyclical recovery, the euro-dollar exchange rate will rise in 2020.

The turnaround in monetary policy in the summer of 2019 catapulted **gold** above 1,500 US dollars per troy ounce, its highest value since 2013. Since then, the price of gold has remained roughly at this level. The global slide in bond market yields has resulted in lower opportunity costs for gold. In the course of 2020, gold is likely to enjoy further gains and rise to 1,700 US dollars per ounce. Owing to exchange rate developments, the gold price will only move sideways around a level of 1,400 euros per ounce.

Patrick Franke



Interest rates and bonds

ECB ensemble under pressure

The weak economy and monetary policy easing have driven down yields to new historic lows. The effect of this has been a substantial rise in government bond prices in 2019. The world of interest rates is upside down and indications are that this is not going to change. In fact, it is likely that the ECB will go even further and lower the deposit rate yet again. In view of the cyclical recovery over the course of the year, however, the return potential for bonds is set to be low in 2020.

The old year is drawing to close with the baton passing to a new conductor at the helm of the European Central Bank. Whether the new President **Christine Lagarde** will usher in a reversal of her predecessor's monetary policy course is more a question for the future. In the short term, at least, she will not deviate significantly from Mario Draghi's score. On the contrary: the weakness of the economy will force her into playing a classic role. The newly constituted Governing Council is likely to lower the **deposit rate** once again in order to demonstrate its willingness to act, before taking a break from interest rate policy. Many on the Council have had few problems with this instrument of late, despite portents to the contrary. The burden on banks was also alleviated by the introduction of a two-tier system for reserve remuneration.

The audience is getting restless

Reservations are mainly directed at the expansionary **purchase programme** – and do not only emanate from the ECB's Governing Council. On the one hand, this unconventional instrument protects monetary union against any undesirable movements on financial markets by exerting influence over them in addition to providing fiscal policy with greater room for manoeuvre. On the other hand, though, it comes at the price of an **investment plight** of historic proportions. Today, it is almost impossible to generate positive returns with simple and conservative strategies. Investors are forced to venture into unknown territory, with all the associated risks. An expansion of the purchase programme – currently an additional 20 billion euros of assets are bought each month – is therefore not to be expected.

ECB caught between a cacophony and a virtuosic use of instruments

Further **moderate inflation expectations**, in addition to loose monetary policy, continue to point to a low yield level. Structural changes, e. g. ongoing digitisation and optimised global value chains, appear to have a greater impact on inflation than monetary policy. Despite the extreme use of instruments, the ECB has not yet succeeded in achieving its **inflation target** of just under 2 % in the long term. One option for the ECB would be to review and adapt to the changed environment in order to escape the monetary policy dilemma it has manoeuvred itself into. Whether the doves on the ECB's Governing Council will be prepared to allow this is debatable. After all, less ambitious but more realistic targets could cause inflation expectations to slide even further.

A departure from Draghi's strategy would lead to noticeable falls in prices – not only for bonds. This is also due to a significant **shift in long-term interest rate expectations**, triggered by the surprising U-turn at the ECB in 2019. While the outlook for 10-year

German government bonds on a four year horizon hovered for a long time between 1.5 % and 2 %, the latest consensus forecast had plummeted to 0.5 %. By contrast, projections for growth and inflation were only marginally reduced. In this constellation, there is a danger that a verbal zigzagging by Christine Lagarde, who had little experience in monetary policy, could trigger sharp price volatility.

Forecast, end of period …	Q2 / 2020	Q4 / 2020
3M Euribor	– 0.50 %	– 0.50 %
10y Bunds	– 0.30 %	– 0.20 %
10y US Treasuries	1.90 %	2.10 %

for more interest rate forecasts see page 57
Source: Helaba Research

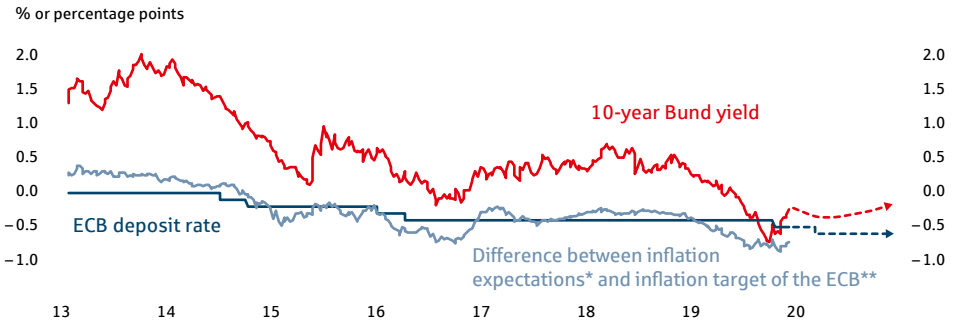
> *"Our measures will stay in place until the economy recovers and inflation robustly converges again towards our aim of below, but close to, 2 %."*
>
> Philip R. Lane, ECB Chief Economist

Nonetheless, even in the event of a satisfactory economic recovery, we do not expect that there will be any reversal of the **permanent crisis mode** of monetary policy. Most of the credit for this policy goes to the ECB's new chief economist, Philip Lane, whose attention is mainly focused on latent economic risks and low inflation expectations. Despite the cyclical recovery, bond yields in Germany are therefore likely to remain predominantly negative in 2020. We expect the yield on **10-year Bunds** at the end of 2020 to reach – 0.2 %, accompanied by an overall steeper yield curve.

Against the backdrop of the ECB's ongoing purchase programme, the acute investment plight and an improved economy, we anticipate that risk premiums on euro government bonds will remain limited.

The US bond market is expected to provide comparatively little impetus. Assuming stable key interest rates, yields on **10-year Treasury bonds** of around 2 % are to be expected.

Another year with negative rates



* 5y / 5y forward inflation ** approx. 2 %

Sources: Datastream, Helaba Research

Ulf Krauss

Covered Bonds

Positions reallocated

2020 will see the ECB making more frequent appearances on the covered bond market again. Nevertheless, spreads will only narrow slightly.

With the revival of the purchase programme, it is likely that 2020 will see a volume of 40 to 45 billion euros in covered bonds being snapped up by the central bank. This would mean that **almost half** of the expected new issues eligible for purchase has already been allocated. Overall, with a volume of around 121 billion euros in upcoming maturities, we expect approximately 140 billion in euro benchmarks to be issued. The new refinancing programme (TLTRO III) and expansion in unsecured debt, driven by regulatory factors, should have no more than a modest impact on the supply of covered bonds. On the other hand, a further rise in the volume of mortgage loans in many European countries and increasing placements by recent or new issuers will have a supportive effect.

The question remains as to how severe the tussle on the covered bond market will turn out to be. Many banks will continue buying, if only to meet regulatory liquidity requirements. In view of the ECB's negative deposit rate, covered bonds have recently retained their attractiveness for some banks, despite their negative yields. The latest introduction of a two-tier system for remunerating excess liquidity holdings and the fact that some central bank deposits have been exempted from the negative deposit facility will not completely change this state of affairs.

Nevertheless, we believe that the **scope for further spread narrowing** is limited to a maximum of 10 basis points for the iBoxx EUR Covered indices of the core markets. As recently as September and October, for example, there were already indications of rising demand for longer maturities and positive yields. After all, **over 90 % of euro benchmarks had negative yields** at the end of October.

The high prices are therefore likely to deter investors with higher yield expectations, such as insurance companies and pension funds, from participating. At the same time, a steadily rising number of investors are entering the market to support the as yet small but fast-growing segment of sustainable covered bonds.

Sabrina Miehs



Credits

No turnaround in sight

The financial debt of European companies is likely to see only a moderate increase in 2020. Refinancing costs should therefore remain very low. For bank bonds, we recommend focusing on issuers with high credit qualities while taking advantage of the yield premium for non-preferred senior bonds.

Corporates: Balance sheets to remain solid

The prospect of a more stable economic environment has recently led to a slight decline in the spreads of euro corporates. In 2020, the downward trend is likely to continue, at least initially, due to a resumption of purchases by the ECB. With this effect easing towards the end of the year, we forecast a slightly higher **spread of around 70 basis points** for the **iBoxx EUR Non-Financials**. Due to base rates remaining extremely low, companies will nevertheless continue to benefit from low refinancing costs for the foreseeable future and this will set the stage for another buoyant year on the primary market for euro corporate bonds.

> *No structural deterioration in credit qualities is discernible at present.*

The debts of European corporates are likely to climb further. In this context, companies will only be able to further delay investments that are necessary as a result of the inexorable progress of technological change (the keyword here being Industry 4.0) to a limited extent. However, the majority of companies have noticeably **improved** their **liquidity positions and internal financing capacities** in recent years. Overall, the increase in borrowing from European companies should therefore be moderate. As a result, the **credit profiles** of the vast majority of companies are likely to **remain solid** in 2020.

Banks: High quality called for

Stable lending activities will support the quality of banks' balance sheets according to our expectations. In view of a marked rise in equity ratios since the financial market crisis, profits will increasingly be allocated to both dividend payments and growth. However, further tightening of regulatory requirements will mean that banks will be forced to **further bolster their capital resources**. Although credit defaults are likely to rise, they will remain below their historical average. Meanwhile, low interest rates will continue to have a negative impact on earnings. Margin competition is likely to become even more intense, with the result that profits will remain under pressure.

For the sector as a whole, costs related to digital transformation and regulatory requirements will continue to exert enormous pressure on the sector and cost-cutting programmes will remain the order of the day. Furthermore, there are increasing regional differences in quality: the Scandinavian countries, for example, are struggling with the consequences of money laundering scandals; in Germany, credit institutions are reeling under structurally low profitability.

In an overall rather volatile environment, we therefore adhere to our previous recommendation to focus on issuers with high credit qualities and, in this regard, to exploit the **yield premium on non-preferred senior bonds**.

Dr. Susanne E. Knips, Ulrich Kirschner, CFA

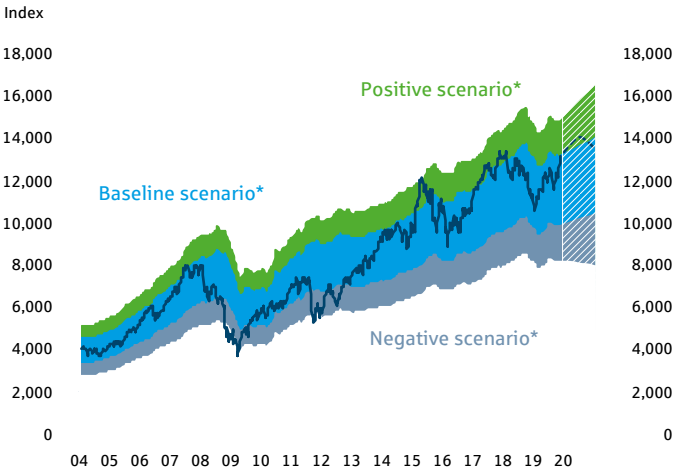
Equities

Tread carefully!

A lot of upside has already been priced into equities in 2019. The valuation-driven boom on equity markets is gradually approaching its limits. In the future, price rises will mainly be fuelled by a recovery in corporate profits. This means that the potential for any further gains in equities will be modest.

Despite all political and economic distractions, equities recorded significant price gains in 2019. The S&P 500 and the two European stock market bellwethers, the DAX and EURO STOXX 50, have been competing in a neck-and-neck race. Japan's Nikkei 225 has not quite managed to keep pace with them and, until recently, the British FTSE 100 has been left far behind.

DAX: Limited upside potential



* Bands: fair value based on earnings, dividends, cash flow, book value

Sources: Datastream, Helaba Research

Although the perceived political and economic uncertainty – measured by reports in the business press – had reached new highs, investors remained calm. For most of the time, implicit stock volatility for the leading international indices has remained below its long-term average.

So, what has prompted investors to be so confident? The main reason was probably the ultra-loose monetary policy of the major central banks, which has led to a significant decline in yields and thus increased the relative appeal of equities. After all, at half-time in 2019 the global volume of government bonds with negative interest rates exceeded the previous record levels of 2016.

In 2020, equity investors have once again to weigh **high valuations against a lack of investment alternatives**. If growth prospects improve, as expected, investors will presumably prioritise returns over risk considerations. This may well lead to temporary periods of overreaction.

US equity markets spellbound by election campaign

As the saying goes, the impact of politics on the market is short-lived. 2020, however, is a presidential election year in the United States and hardly any other US president has ever been as keen as Donald Trump on measuring his (economic) policy successes against a positive performance of equity markets. Price setbacks would enormously diminish his **chances of re-election**.



What trump cards are still left to positively influence the stock market? The tax reduction card has already been played. In addition, Trump has applied massive pressure on the US Federal Reserve to cut interest rates. After three rate cuts so far, most of the Fed's work has largely been done. That leaves a **"big deal" with China** which is not realistic. At best, a phased rollback of existing punitive tariffs could be expected.

Will this détente be enough for a sustained rise in US equity prices or has it already been priced in? Despite stagnating corporate profits in 2019, the S&P 500 has broken one record after another and has risen by more than 20 % to date since the turn of the year. The rally in equities has thus almost exclusively driven by valuations.

Based on the usual metrics, US blue chips have now reached a **high valuation level** and are slightly above the normal long-term range. Even if interest rates remain low, there is little scope for permanently higher valuations.

On the contrary, share prices are likely to climb at a somewhat slower rate than the growth in corporate profits. For the **S&P 500**, this equates to a fair valuation range of 2,500 to 3,200 points in 2020. Consequently, there will be **little upside potential**.

The experience from election cycles over the past 90 years also suggests that caution is warranted. Under Republican presidents, the S&P 500 grew by just under 4 % in election years, while under Democrats it gained around 12 %.

DAX – a prisoner of globalisation

The DAX has also had an exceptionally good year to date. By the turn of 2018/2019, growth fears had led to corrections of more than 20 %. In view of **growing optimism that interest rates would be lowered**, a recovery set in at the beginning of the year, although the highs seen in 2018 have not been matched so far. In the meantime, the ECB has delivered in the form of a rate cut and the revival of its bond purchase programme. There is even the prospect of another interest rate cut.

Given the support provided by monetary policy, what can possibly go wrong? The problem is that monetary easing alone is not enough, as demonstrated by what happened in the spring of 2015. Back then, investors celebrated the ECB's launch of so-called quantitative easing (QE). From January to April 2015, the DAX shot up by 26 %. This was followed by a slump of almost 30 % by February 2016, although the ECB's balance sheet expanded steadily during this period due to bond purchases. Ultimately, the resulting overvaluation proved fatal for the DAX.

This time, too, the price/earnings ratio is too high for the current phase of the cycle. After all, the performance of the **DAX has been driven solely by valuations**, while corporate profits are struggling due to the weakness of international trade. There will be some room for manoeuvre over the course of 2020 as the outlook for growth and earnings brightens.



Forecast, end of period	Q2/2020	Q4/2020
DAX	14,000	13,500
EURO STOXX 50	3,900	3,750
S&P 500	3,200	3,140

for more equity forecasts see page 57
Source: Helaba Research

> *Central banks have delivered. Now is the time for the economy to pick up, otherwise equities are in for a rough ride!*

Given how open the German economy is and the fact that a substantial proportion of DAX companies' sales are generated outside Germany, the importance of stemming the onslaught of protectionism and of ensuring that global trade emerges from a protracted phase of decline will be particularly important factors in this regard. However, since equities began pricing in an economic recovery at an unusually early stage in this cycle, the upside potential is limited.

In our **baseline scenario**, the DAX largely remains in the upper half of a fair valuation range of 10,500 to 14,000 points. Since equities have a tendency to exaggerate, they could temporarily extend valuation levels, enabling the **DAX** to climb **above 14,000 points**, not least due to negative yields on government bonds.

In a similar way to 2015, however, investors should be prepared for the eventuality that relatively sudden **price corrections** may occur. At a DAX level above 13,000 points, the risks will outweigh the opportunities.

Markus Reinwand, CFA

Gold

Structural appreciation

Gold is shining in the limelight. Both monetary and fiscal policy were the key protagonists in helping the precious metal stage a comeback. This will change little in 2020.

The monetary policy reversal by the major central banks at the turn of the year in 2018/2019 resulted in gold breaking out of its sideways range of around 1,200 and 1,400 US dollars per troy ounce. In the summer of 2019, the gold price reached its highest level since 2013 at more than 1,500 US dollars. Since then it has fluctuated around this value.

The departure of the Fed and the ECB from a path of monetary normalisation led to a considerable slide in yields. In the meantime, just over a quarter of the world's outstanding bonds are trading at negative yields. **Opportunity costs** for the safe alternative of government bonds suddenly increased. In turn, the **spotlight shifted to gold**. Interest-free gold is a safe haven in an interest-free world.

> *"Gold's all they care about, gold's wanted everywhere. Alas, we poor ones!"*
> Johann Wolfgang von Goethe (1749–1832), "Faust"

A paradigm shift took place when gold broke through the 1,500-dollar barrier. There is no longer any demand for gold as a hedge against inflation, but it is very much in demand as **safe haven against political risks**. The latter result from a structurally overly expansionary approach to monetary policy. In the euro area, the ECB also has to do its bit in supporting hesitant fiscal policy.



Forecast, end of period ...	Q2 / 2020	Q4 / 2020
Gold $/ounce	1,650	1,700
Gold €/ounce	1,375	1,360

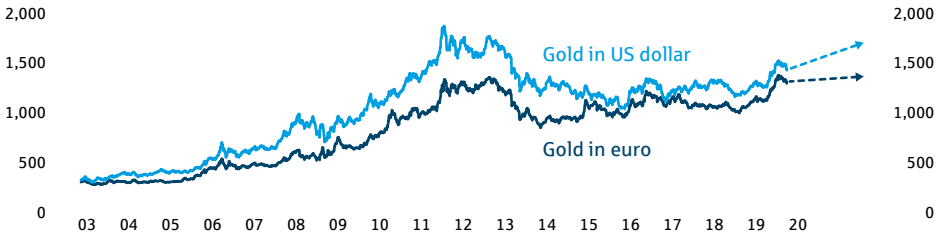
Source: Helaba Research

Overall, monetary policy has lost some of its independence, which leads to a **structural appreciation of gold**. In the course of the year, the precious metal is likely to see further gains, rising to 1,700 US dollars per ounce. In euro terms, the exchange rate will lead to a sideways movement around this year's peak price of 1,400 euros per ounce.

Claudia Windt

Gold still in demand

US-Dollar or EUR per ounce



Sources: Macrobond, Helaba Research

Real Estate

The show keeps running

Real estate continues to enjoy immense popularity among investors. Thanks to extremely low interest rates and a resurgent economy, the curtain for the big real estate show will rise again in 2020.

The German real estate market can look back on a decade of rising prices. There are **no signs of an end to the boom** in 2020 either. The effect of extremely low interest rates, which have given this asset class a leading role, is simply too strong. However, its relative attractiveness compared to fixed-interest securities is still high, while many properties are already expensive in absolute terms. Since property prices in many market segments are likely to rise faster than rents in the coming year, the trend towards greater **overvaluation** will continue. Even if there are no signs of a turnaround yet, the vulnerability of real estate to corrections will grow as a result.

The recent economic downturn could have a delayed impact on the commercial rental market. Job growth in Germany will decrease considerably in 2020, but will probably not come to a standstill. For the office market, this will mean a slower increase in demand for space, which should lead to a lower pace for rising office rents in prime locations. Construction activity will remain moderate. Given the already very low office vacancy rates, we do not expect a further decline. There is structural pressure on retail properties due to the growth of online retail and they will continue to underperform other market segments in 2020.

> *Germany's misguided housing policy is increasingly becoming a negative factor.*

No trend reversal on the housing market

The principal drivers on the housing market will be the same as before: an influx of new residents in conurbations, favourable financing options and inadequate construction activity. The number of new residential building permits was recently lower than in the previous year.

Together with the very high level of capacity utilisation in the construction sector, this suggests that new construction activity will not pick up noticeably. A restrictive **housing policy** with stricter rent controls, rent caps in Berlin and discussions about similar measures in other cities are also not contributing to the creation of more residential space. At best, it will be possible to complete a total of 300,000 new dwellings in 2020. After years of sharp price rises in the major cities, momentum may shift more strongly to their surrounding areas.

Real estate funds important players on the investment market

The performance of open-ended real estate funds in Germany is driven by a further rise in property prices. However, these could be somewhat lower in 2020 due to the high levels already achieved and the recent economic slowdown. As in the previous year, the lack of interest on liquidity will depress yields. However, we do not anticipate any significant change in the performance of funds so that investors can expect an average return for the year of 2.5 %. Given the continued high relative attractiveness of this fund segment, **strong net inflows** are also unlikely to change very much. Newly launched products could presumably take some pressure off the established mutual funds. Market valuations have already reached a high level and the availability of suitable investment properties is limited. Thus it will not be an easy task to expand or establish a portfolio.

Dr. Stefan Mitropoulos



Currencies

US dollar set to slide?

The strong US dollar annoys President Trump. However, there is hope for him: while in the longer term there is a lot to suggest that the US currency will depreciate anyway, signs of an economic revival in the euro area are likely to turn the tide. We presume that the euro-dollar exchange rate will rise in 2020.

No matter how much **President Trump** complains about the strength of the US currency and the "incompetence" of his own central bank, overvaluation is increasing, US debts are mounting and the trade deficit is growing – and none of this has had much impact on the dollar. On the contrary, in 2019 the greenback gained against the euro and many other currencies.

A **protectionist trade policy** usually goes hand in hand with a desire for a weaker currency. Donald Trump's opinion also has its supporters among the ranks of the Democrat opposition. Currency devaluations would be an alternative to customs measures, making imports more expensive whilst giving the domestic economy an edge in price terms against other countries. However, the government´s influence over freely convertible currencies is limited. The US Treasury's financial resources are finite and the Federal Reserve is not blindly following the President. At the same time, though, there are ways that the government could influence sentiment on the currency markets.

Long-term risks for the US currency

Currently, the United States is running an inflated budget deficit as well as a significant, albeit not enormous, current account deficit, which is why it is dependent on foreign capital inflows.



This **„twin deficit"** has the potential to weigh on the US dollar. In addition, using the greenback for political purposes – financial sanctions against certain countries – could reduce its attractiveness. In addition, the **US dollar** has long been significantly **overvalued** based on purchasing power parities or real exchange rate indices.

Dollar to lose cyclical tailwind

However, until now these factors, which tend to have a negative impact in the long term, have been offset by cyclical advantages. The US economy has remained comparatively robust, with key US interest rates clearly in positive territory. Even so, the United States cannot escape the consequences of the trade conflict it has itself instigated. Growth in the US will slow down somewhat. In the euro area, on the other hand, the downturn has already reached an advanced stage and the US growth advantage is likely to fade in 2020.

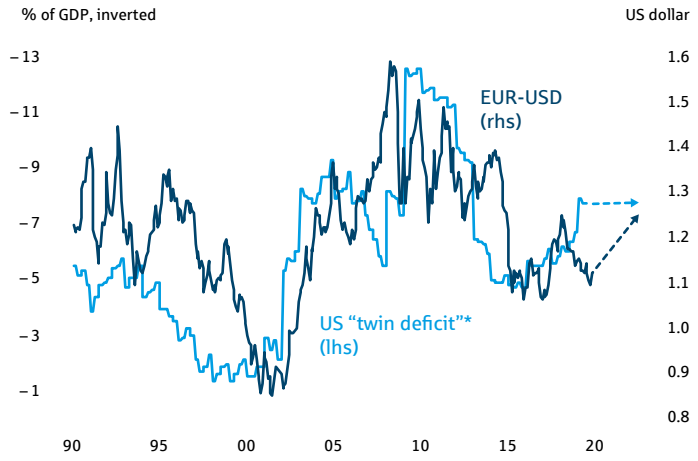
Both central banks initiated a turnaround in 2019. However, the ECB's scope for cutting interest rates is limited compared

with that of the Fed. The **US yield advantage** over the euro has already **declined** noticeably and points to a higher euro-dollar exchange rate.

Moreover, the euro was adversely affected by political factors in 2019. In the meantime, though, the Italian problem has receded into the background and an end to the Brexit drama appears to be within reach. In contrast, the US presidential elections harbour uncertainties that could harm the dollar.

Since, in any case, there are many indications that the US dollar will come under pressure in the long run and the cyclical and political tailwind will subside in 2020, the US currency is likely to weaken. We therefore anticipate that the **euro-dollar exchange rate** will climb towards a level of 1.25. That should finally put a stop to Donald Trump's moaning.

US "twin deficit" as a downside for the dollar



*Sum of current account balance and budget balance (US federal)

Sources: Macrobond, Helaba Research

Forecast, end of period* ...	Q2 / 2020	Q4 / 2020
US dollar	1.20	1.25
Japanese yen	125	127
British pound	0.85	0.80
Swiss franc	1.10	1.15

* vs. euro, for more currency forecasts see page 58
Source: Helaba Research

> *"This is because the Euro and other currencies are devalued against the dollar, putting the U.S. at a big disadvantage. The Fed interest rate way too high, added to ridiculous quantitative tightening! They don't have a clue!"*
>
> Donald Trump, US President

Swiss franc, yen and pound sterling

A rising euro-dollar exchange rate will be partially reflected in its relative value against the Swiss franc. The euro could also benefit against the **Swiss franc** if the economic and political environment stabilises. After a sideways movement, the euro-franc exchange rate should rise towards a level of 1.15.

The **Japanese yen** will presumably also benefit from the problems of the US currency, but will weaken slightly against the euro. The **pound sterling** is cheap, especially as interest rates are higher compared to the euro area. If Britain's exit from the EU occurs in an orderly fashion and no conflicts flare up during negotiations on its future relationship with the EU, there is potential for appreciation here.

Christian Apelt, CFA

2 Countries in the baseline scenario



European Union

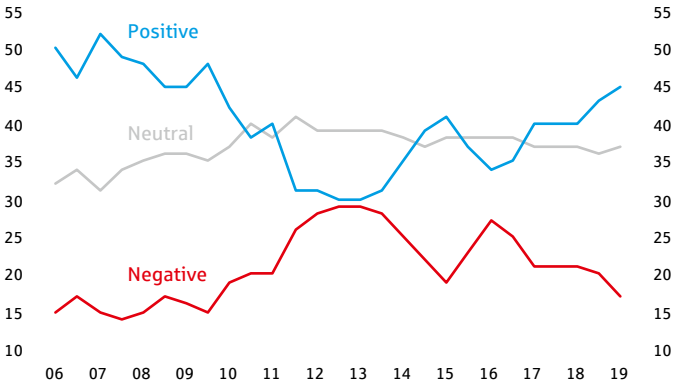
A new season

The EU looks back on a turbulent year – and ahead to another one. While 2019 was the year of casting actors and allocating roles, both the citizens of the EU and a tense global audience are waiting for the performances, some of which have been announced for quite a while now.

Since elections to the European Parliament last May, preparations for Brexit have dominated reporting on the EU. With the appointment of the new EU Commissioners in November and the expected inauguration of the new Commission in December, the groundwork is being laid for the EU's institutions to focus more strongly on their actual roles and responsibilities.

Expectations are high

Image of the EU, survey results (discrepancy from 100 %: "don't know"), %



Sources: EU Commission (Eurobarometer), Helaba Research

Many issues on hold

The challenges at EU level are manifold, e. g. in positioning the Union in the trade dispute with the United States and in the global economy, in developing its Common Foreign and Security Policy and in its approach to the issue of migration.

Another important task will be the adoption of the **new Multiannual Financial Framework** for 2021 – 2027, which was originally scheduled to be approved before the European elections. Against the backdrop of shortfalls in revenue due to Brexit, the aim is to pave the way for a new budgetary framework with the abolition of rebates, less funding for cohesion and the common agricultural policy as well as new sources of revenue (e. g. from emissions trading). The process could last well into 2020. In addition, a plan to make the disbursement of EU funds conditional on Member States' adherence to rule of law criteria is a potentially explosive issue.

High level of trust in the EU

Although a lot of things in the EU are long in coming, its audiences remain well-disposed towards the company: According to the latest Eurobarometer, **45 % of EU citizens surveyed said they had a rather positive image** of the EU – with a rising trend. It would even appear that more respondents trust the EU (44 %) than their own government (34 %). The increasingly positive image provides a solid basis for the work of the new Commission, but at the same time it also represents a duty to honour the trust placed in it. For more than 60 % of respondents are optimistic about the future of the EU – a higher number than at any time since 2009. Many a citizen is now eagerly waiting for the curtain to rise.

Marion Dezenter

Germany

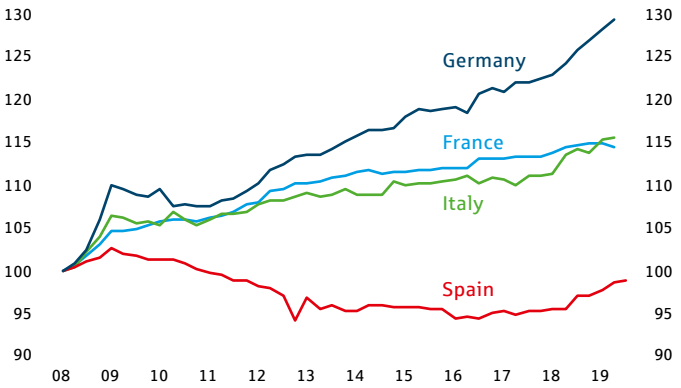
Happy ending with open issues

Germany is on the verge of a cyclical recovery. However, it is only likely to be modest in nature due to structural problems. In recent years, only tentative steps have been taken towards implementing essential reforms. As a result, the country's competitiveness is suffering.

German **economic growth in 2020** is expected to be 1.0 %, almost twice as high as in 2019, adjusted for calendar effects. As the year has four more working days, actual economic growth will be even higher at 1.4 %. Headwinds should disappear for Germany's all-important industrial sector. The latest leading indicators give grounds for optimism.

Germany to become more expensive

Unit labour costs based on persons, index Q1 2008 = 100



Sources: Macrobond, Helaba Research



Industry to play its part again.

There will be no sharp recovery in the manufacturing sector. Uncertainty over the US tariff dispute with China and Europe will continue to weigh on trade in goods and on investment. The Brexit drama is still not over. After a long performance with an undecided outcome, however, the chances of a happy ending have increased. The normalisation of trade with the United Kingdom would be an important step: although only 6 % of German exports still go to the country, in terms of the export surplus it is just under one fifth of the total.

Time to focus on competitiveness

As for industry, the **automotive sector** – a crucial component of Germany's economy – is facing **challenges**. This sector accounts

for almost a quarter of revenues in manufacturing. It is not only struggling with weak demand and the effects of trade conflicts but also with a structural shift away from the internal combustion engine. Thanks to its strong competitiveness, there is a good chance that it will be able to successfully overcome these challenges.

In the last few years, **unit labour costs** in Germany have risen much more rapidly than those of its European competitors.



	2019e	2020f	2021f
GDP real, % yoy	0.6	1.4	1.6
GDP real, % yoy, working day adjusted	0.6	1.0	1.6
Private consumption, % yoy	1.4	1.5	1.6
Government spending, % yoy	1.7	1.7	1.6
Gross fixed capital formation, % yoy	2.2	3.0	3.2
Investment in equipment, % yoy	1.5	4.0	4.5
Construction, % yoy	2.7	2.0	2.0
Exports, % yoy	1.0	4.5	4.0
Imports, % yoy	2.5	5.0	3.5
Consumer prices, % yoy	1.5	1.6	1.9
Unemployment rate, %	5.0	4.9	4.8
Unemployed, million	2.28	2.25	2.20
General government balance, % of GDP	1.3	1.0	0.7
Current account balance, % of GDP	7.2	7.1	7.0

e = estimate, f = forecast
Source: Helaba Research

Significant wage increases were accompanied by scarcely any increase in employee productivity. In addition, the government's economic policy has not done enough to improve Germany's attractiveness as a business location. In this respect, there is some catching up to do. For example, the complete abolition of the solidarity surcharge would reduce the burden on small and medium-sized enterprises, in particular.

An "old" problem is that electricity prices are far too high by international standards, which is likely to be exacerbated by the phase-out of coal. The reduction in the renewable energy levy from 2021, agreed as part of the climate package, will hardly make any difference in this regard. The roll-out of high-speed mobile networks is making too little progress and is consequently putting the brakes on growth.

Buoyant consumption and construction activity

German **fiscal policy** will remain **somewhat expansionary** and will add around 0.5 percentage points to GDP. Basic personal and child allowances will once again be raised and the tax brackets for income tax will be adjusted. Both investment programmes, e. g. for the digital pact or the expansion of broadband networks, as well as the climate package approved by the government in September will have positive effects.

These measures will also stimulate consumer spending, which should once again grow at an above-average rate of around 1.5 % in real terms in 2020. Although leading **labour market** indicators have deteriorated, employment will continue to rise slightly. While there will be a modest reduction in the number of manufacturing jobs on average in 2020, the sectors of public administration, education and training, health care as well as care and social services are likely to drive further growth.

Increases in wages covered by collective bargaining agreements, which amounted to around 3 % in 2019, are likely to be somewhat weaker in 2020. However, there will be a **sharp rise in pensions** in the middle of the year. Inflation will remain moderate in 2020 at 1.6 %, while incomes will rise considerably. This will ensure that consumers will have more in their pockets in real terms. The savings rate is likely to remain at the previous year's level.

> *Recent decisions on the energy-efficient refurbishment of buildings should further boost demand in the construction industry.*

Construction activity will continue to be a safe bet for the German economy. Investments in this area are expected to increase by a further 2.7 % in 2020, having already grown by 2.5 % this year. New construction activity will slow, while the pace of investments in existing properties will accelerate. In 2019, residential building permits even saw a decline. This was most likely due to a lack of suitable building plots, a shortage of personnel in authorities and a housing policy that is having an increasingly negative impact.

Financing conditions remain exceptionally favourable, while high capacity utilisation in all building sectors is leading to significant price increases. The order backlog in residential construction is at a high level and new orders are growing at double-digit rates.

Strong revenues for local authorities, including municipalities that are important for construction, continue to drive growth in public-sector construction investments. In the next few years, additional funds will also be made available, for example from the Municipal Investment Promotion Fund. Commercial construction is likely to grow slower than other construction sectors in 2020. Investment projects by Deutsche Bahn as well as the expansion of broadband networks will provide a boost to this segment.

Investment climate set to improve

The reluctance of companies to invest is reflected in equipment investment, which lost considerable momentum in 2019.

> *In an environment of trade conflicts and Brexit, export-oriented companies are cautious.*

Until recently, industrial capacity utilisation had been declining. In 2020, a turnaround in global industrial activity should lead to a gradual **revival in investment** in Germany.

Net exports will have a negative impact on economic growth in 2019, as imports are expected to grow by 2.5 %, significantly faster than exports (1.0 %). With a more robust global economy overall, the **dampening effect of foreign trade is likely to disappear** in 2020. Exports to the United Kingdom have fallen by around 4 % in 2019 due to fluctuations in demand and Brexit uncertainty. If an orderly Brexit is achieved in 2020, exports should pick up again.

Despite the tariff disputes, 2019 saw more exports to the United States, Germany's most important buyer country. Should tariffs on cars, which the US has constantly threatened to impose, not come into force after all, this development is likely to continue. There is still demand for German products across the pond. Since the euro area economy will recover, German exporters should be able to sell more in this important "home market" in 2020, too.

Dr. Stefan Mütze

Focus on: Hesse, Thuringia, North Rhine-Westphalia and Brandenburg

Our selection of German federal states focuses on Helaba's core regions.

Hesse to participate in the recovery in 2020

Frankfurt Airport is a good economic indicator because, with its high volume of freight, it is closely integrated into global trade flows. The economic slowdown was noticeable here as early as mid-2018 and did not only become more pronounced for air freight in 2019. However, Hesse's **economic growth** of 0.8 % is likely to be slightly higher than the national average: Revenues in the industrial sector in the first eight months were up on the previous year and those in the construction sector rose strongly. With real sales growth, the retail and wholesale sectors posted a good performance.

The fact that companies believe in an economic recovery is reflected in the **employment trend**. Temporary employment is the only area in decline. Employment in all other major economic sectors is rising, albeit at a slower pace. In 2020, Hesse's GDP should grow by 1.4 %, at least on a national average. The airport and manufacturing are benefiting from the global economic upturn. Providers of digitisation services are experiencing strong demand from all sectors of the economy.

Tight labour market in Thuringia

Over the next twelve years, almost a quarter of Thuringia's **workforce will be entering retirement**. It will be impossible to close this gap with domestic workers. Even the economic slowdown in 2019 has hardly provided any relief to this situation. However, periods of economic weakness often provide an opportunity to review manufacturing locations. There is a danger that Thuringian production sites will be abandoned because companies are anxious that they will not be able to recruit enough workers in the medium term. For this reason, it is vital for the state to become more attractive to jobseekers – no matter from where they come.

If the **manufacturing sector** is used as an indicator for GDP growth, Thuringia should be able to reach a level close to the average for Germany as a whole in 2019 – so far this sector had posted an above-average performance. This should offset weaker momentum from service sectors which, in view of demographic trends, are not growing at an above-average rate in many areas.



Similar aspects are likely to play a role in 2020, so that overall German growth represents the ceiling for Thuringia.

Growth gap to narrow in NRW

Its above-average student density, the quality of its universities and the large number of patents, trademark rights and designs **form a solid basis for entrepreneurship** in North Rhine-Westphalia (NRW). Start-ups are not an uncommon occurrence. The Rhine-Ruhr metropolitan area with its broad range of consumer segments and companies undergoing a period of transition provides a vast test bed for company founders. The planned compensation payments for phasing out coal mining provide North Rhine-Westphalia's municipalities with a great opportunity: Together with research establishments they can develop coherent concepts for the targeted use of these funds.

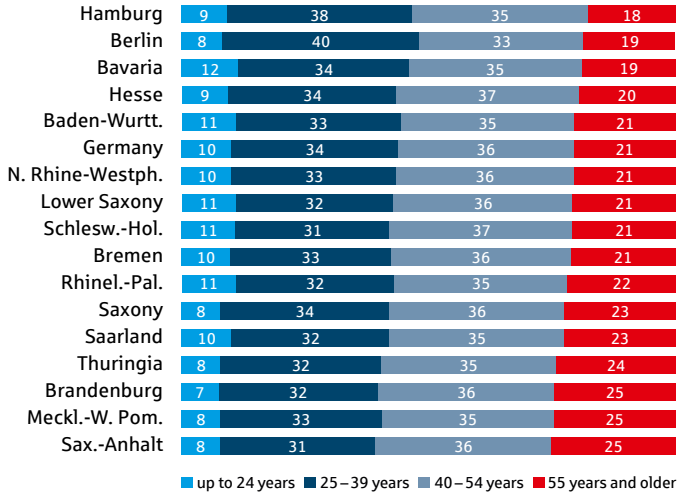
All these activities are absolutely crucial: For a long time now, the below-average development of the manufacturing sector and the only modest rise in the number of service providers have been responsible for a **decline in the economy** of NRW as a whole. Meanwhile, the federal state is 4 % below the level of Germany as a whole and 8 % below that of western Germany. Growth in 2019 is also expected to be weaker than the federal average. The growth gap should narrow again in 2020 as the global economy picks up.

Brandenburg: Airport overture to be completed in 2020?

An opening date has finally been set for Berlin-Brandenburg Airport – October 2020 – although the exact date will be announced before the end of this year. However, it is uncertain as to whether the additional terminal will be completed by then.

Up to 25 % of employees expected to retire soon

Share of age group among employees in %, March 2019



Sources: Bundesagentur für Arbeit, Helaba Research

In this respect, the airport will not be able to operate at full capacity until 2021 at the earliest. For **economic growth** in 2020, the impact of the launch of flight operations should therefore be limited. The economic data for 2019 points to a growth rate that will at least be in line with the German average, as revenues in the manufacturing, construction and hospitality sectors are growing at an above-average rate. Retail sales growth remained only slightly below the national average, while wholesale revenues declined.

Barbara Bahadori

France

A round of applause!

France has been growing at a **faster pace than Germany** since 2018. At 1.3 %, growth in 2019 is likely to be more than double that of its neighbour to the east. The French economy is expected to grow by 1.5 % in 2020 (Germany: 1.0 %). A sizeable fiscal stimulus and the positive effects of Macron's policy of reform will contribute to this. The yellow vest protests have prompted the government to react. Taxes and duties have been reduced and a state wage subsidy increased. The total cost of these measures amounts to about 17 billion euros. The draft budget for 2020 contains further tax cuts of 10 billion euros, including reductions in housing and income taxes. There will be an additional cut in the corporation tax rate.

Reforms are yielding results

The first **steps towards reform** had already been taken during François Hollandes' presidency with the liberalisation of service sectors and tax cuts. So far, under Emmanuel Macron, French employment regulation has been simplified. Companies have now been granted more scope for vocational training. In addition, employees' overtime has been exempted from taxes and social security contributions. Corporate taxes and social security contributions have been reduced and the wealth tax has been reformed so that it only applies to property. The government has also reduced red tape.



	2019e	2020f	2021f
GDP real, % yoy	1.3	1.5	1.6
Consumer prices, % yoy	1.2	1.3	1.6
Unemployment rate, %	8.5	8.0	7.4

e = estimate, f = forecast
Source: Helaba Research

France

For years, French wage levels have been increasing more slowly than in Germany, which has had the effect of limiting the rise in unit labour costs there. Overall, the measures have **improved** the **competitiveness** of the French economy. However, France's current positive development is also due to the fact that manufacturing is less significant.

Fiscal measures and a one-off tax effect are partly responsible for France's failure to meet the European deficit ceiling of 3 % of GDP in 2019, after having succeeded in doing so in the previous two years. Next year, the deficit is expected to fall to 2.2 %. On a positive note, **fiscal policy**, a moderate rise in wages governed by collective bargaining agreements and overall employment levels will support consumer spending. The latter is expected to rise at the same rate as GDP in 2020 as well. Corporate investment will expand at a modest rate and international trade should no longer have a dampening effect in 2020.

Dr. Stefan Mütze



	2019e	2020f	2021f
GDP real, % yoy	0.2	0.8	1.2
Consumer prices, % yoy	0.6	0.8	1.1
Unemployment rate, %	9.9	9.5	9.1

e = estimate, f = forecast
Source: Helaba Research

Italy

No changes to the programme

As in other countries, Italy has been plagued by a cyclical slowdown in 2019 – the economic output is unlikely to rise much at all. In 2020, the economy is also forecast to grow by only 0.8 %. A more serious problem, however, is the **weakness of the country's long-term growth**: Since the introduction of the euro in 1999, gross domestic product has risen by a mere 9 % when adjusted for inflation. This means that the country's economy has grown to a considerably lesser extent than the euro area's approximately 33 % expansion in this period.

This is due to deep-seated **structural problems** that contribute to weak productivity. It is unlikely that the new government under Prime Minister Conte will address these issues. Vital steps would be to raise educational standards, a more efficient bureaucracy, a legal system capable of processing cases more quickly and the dismantling of regulations in the service sector.

The first Conte administration had instead focused on increasing transfers to stimulate consumption. Measures such as the newly introduced basic income scheme will continue to provide a positive fiscal stimulus in 2020. However, the national debt of around 135 % of GDP is not expected to decline. Furthermore, reforms to the pension system, which brought about a reduction in the retirement age, are expensive and are hampering growth.

The second Conte government is now anxious to avoid a VAT increase that was originally planned for January 2020. This was used in 2018 as a "guarantee clause" in negotiations with the EU Commission to dispel concerns about rising deficits. Abandoning this measure will add 23 billion euros to the 2020 budget and is compounded by additional expenditure of around 7 billion euros.



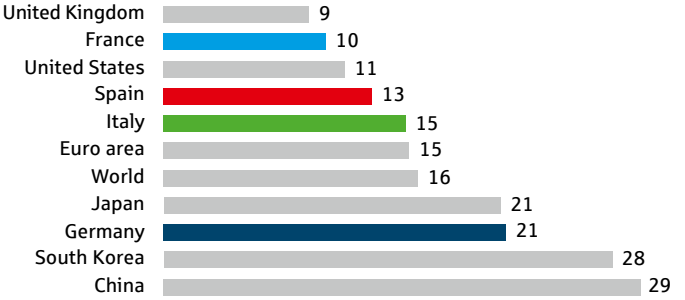
The budget deficit is thus likely to remain at 2.4 %. However, we do not expect any renewed turmoil on the financial markets or a significant rise in yields on Italian government bonds.

No economic surprises will be conjured from a hat.

Despite the accommodative fiscal policy, **private consumer spending** will only grow at a **below-average** rate in 2020. Both wages and employment will hardly rise at all. With the savings rate having fallen to 10 %, it is unlikely to change much next year. Although the improving global economy will stimulate export activity, international trade as a whole is unlikely to contribute to growth due to a marked rise in imports. Investment will also increase in 2020. Business sentiment in the construction industry will remain optimistic. Corporate capital formation is only expected to see moderate growth. We do not anticipate that there will be any additional tax incentives.

Industrial sector plays a minor role in many economies

Manufacturing, value added 2017, % of GDP



Sources: Datastream, Helaba Research

Dr. Stefan Mütze

Spain

Less momentum

For the fourth time in four years, the Spanish were called upon to cast their votes in a general election on 10 November 2019. Whether a majority government can be formed this time and the **stalled reform process** will end, remains to be seen. The uncertainty is weighing on economic growth; **momentum is slowing**.

Spain

Although Spain is likely to expand by 1.8 % in 2020 (2019: 2.0 %), at a faster rate than the euro area, there is still a lot of unfinished business on the economic policy front. Unemployment remains stubbornly high at just over 14 %. Labour market reforms are needed to further reduce the jobless queues as well as the large number of temporary jobs. The Spanish system of education and vocational training is in need of an overhaul.

An important task for the next government will be to restructure the loss-making pension system. The EU Commission has expressed **doubts about the 2020 draft budget**. At just under 98 % of GDP, Spain's national debt is well above the officially permitted level of 60 %. Despite the high growth of recent years and the continued fall in capital market interest rates, it has only declined slightly. Furthermore, it is still unclear as to whether a solution in Catalonia can be found that will lead to lasting peace.

Performance must persuade consumers

The slowdown in Spanish growth is partly due to private consumer spending, which grew at a below-average rate in 2019. Consumers increased their efforts to save money. However, because there has been no significant change in the **strong level of consumer confidence**, this does not appear to mark a turning point. Wages and salaries were substantially raised in 2019, not least because there was a sharp increase in the minimum wage. Although this will not be repeated in 2020, wage growth is likely to be slightly weaker at just under 2 %, well above the inflation rate of 1 %. Despite slower momentum in the Spanish economy, employment will climb by around 2 %. After growing by just over 1 % in 2019, 2020 should see consumption rise by 2 %.



	2019e	2020f	2021f
GDP real, % yoy	2.0	1.8	1.8
Consumer prices, % yoy	0.8	1.0	1.3
Unemployment rate, %	14.2	13.6	12.4

e = estimate, f = forecast
Source: Helaba Research

Equipment investment and construction will also provide a moderate impetus. Tourism, which is a vital sector for the Spanish economy, has recently become a drag on growth. One reason for this was the insolvency of a major package holiday provider. However, 2020 should see a reversal of this trend. In the environment of a more buoyant global economy, there will be a stronger increase in exports. Due to more robust domestic demand, this will also apply to imports, so that Spanish foreign trade will barely make a growth contribution in 2020.



Dr. Stefan Mütze

Sweden

A solid performance

Economic growth in Sweden slowed significantly in 2019, as property prices, which had been falling until the end of 2018, put a damper on consumption. In 2020, however, the country is likely to put in a stronger performance, partly because house prices are rising again.

As a result of weak consumer spending and lower investment, the Swedish economy got out of step in 2019. Although the momentum of net exports has slowed, it has provided considerable support to growth. In the first few months of next year, the economy is likely to appear somewhat unsteady before Sweden regains its attractiveness on the economic stage. With economic growth of 1.7 %, the country will probably manage to outperform other European countries and post a respectable performance in 2020. This will be helped by an easing in the trade conflict and an improvement in consumer and industrial sentiment. **Exports** will again be a **pillar of GDP growth** in 2020.



	2019e	2020f	2021f
GDP real, % yoy	1.6	1.7	1.8
Consumer prices, % yoy	1.8	1.5	1.8
Unemployment rate, %	6.5	6.7	6.5

e = estimate, f = forecast
Source: Helaba Research

Construction sector with potential

Having faltered in 2019, **gross fixed capital formation** is expected to make a **positive contribution to growth** next year, mainly driven by construction activity. A rebound in house prices should lead to an increase in new construction, especially as there is still a severe shortage of affordable housing in Sweden's metropolitan areas.

Following a recent rise in the unemployment rate, the economic situation points to a slight deterioration on the **labour market**. Accordingly, wages will only rise by a moderate 2 %.

Riksbank maintains low interest rate policy

The Swedish central bank has held out the prospect of an end to negative interest rates. An interest rate hike would appear to be a possibility, as the external value of the Swedish krona is historically weak. However, in view of the economic environment and an inflation rate of 1.5 % in 2020, which would be below the 2 % target, the Riksbank will not start a series of interest rate hikes.

Patrick Boldt

Poland, the Czech Republic, Hungary

The tension is rising

After a phase of very dynamic growth, things are set to become interesting in 2020: Can Poland, the Czech Republic and Hungary continue to grow faster than the EU average? To what extent will they be affected by the recent weakness of the EU and problems in the automotive sector? The tension is also rising politically, especially as negotiations on the Multiannual Financial Framework for 2021 to 2027 enter a critical stage.

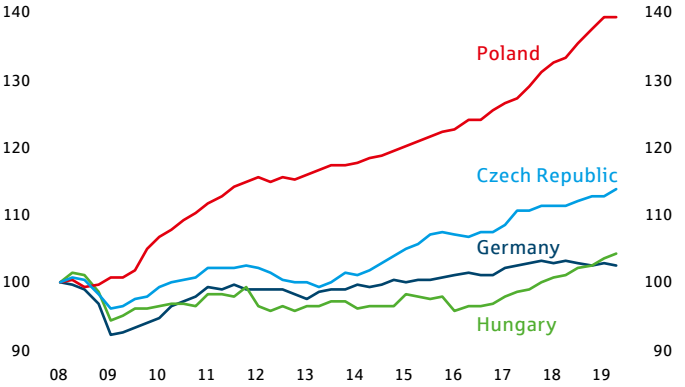
Politics with an eye to the electorate

To support growth, in some cases the governments are digging deep into the public purse: Hungary is providing generous **subsidies for families**, among others to buy houses and cars. Poland has further extended its 500+ family assistance scheme. In a similar vein to planned giveaways for pensioners, the programme represents the fulfilment of election promises. In the Czech Republic, where elections are scheduled for 2021, pensions, parental benefits and salaries in the public sector are slated to rise.



Technology as a chance

Real labour productivity per person, seasonally and calendar adjusted, index Q1 2008 = 100



Sources: Eurostat, Helaba Research

The labour markets remain tight. A string of substantial **wage increases** and measures such as the exemption of young workers from income tax in Poland is helping to stem the trend towards emigration. In addition, the shortage of skilled workers is promoting investments that contribute to economising on staff by boosting automation.

State-of-the-art technologies as an opportunity

The three countries are benefitting from the fact that manufacturing is taking advantage of the latest technical developments, such as a full-flex plant in Hungary or a CO_2-neutral engine production

	2019e	2020f	2021f	2019e	2020f	2021f	2019e	2020f	2021f
GDP real, % yoy	4.2	3.3	3.4	2.6	2.4	2.5	4.8	2.9	2.9
Consumer prices, % yoy	2.2	2.7	2.5	2.7	2.4	2.2	3.3	2.9	2.8
Unemployment rate, %	5.5	5.7	5.6	2.8	2.9	2.9	3.4	3.5	3.5

e = estimate, f = forecast
Source: Helaba Research

facility in Poland. With **corporate taxes well below German levels** and the availability of government subsidies, the red carpet is being rolled out to investors. Productivity in Poland, the Czech Republic and Hungary is making significant progress compared to Germany and the EU. Despite this, there still is some catching up to do in absolute terms and wage hikes put the overall picture into perspective.

Expansionary policies act as a support

Following generous election giveaways, it is unlikely that Poland will change course in the run-up to presidential elections in May 2020. In Hungary and the Czech Republic, too, growth targets will probably take precedence over austerity targets. **Monetary policy remains expansionary in Poland and Hungary**, while the Czech central bank has raised its key interest rate several times since 2017 and, compared to the euro area, has now reached a high level of 2 %.

Central banks in these countries are faced with a dilemma. On the one hand, following the international trend towards low interest rates would help to avoid an appreciation that could jeopardise exports. On the other hand, inflation in all three countries hovers around – and in some cases has exceeded – their respective targets. The **most likely scenario is therefore "wait and see"**. Against this backdrop, the forint and the zloty, in particular, will remain volatile, while the higher key interest rate will stabilise the Czech koruna.

Even if Poland, the Czech Republic, and Hungary continue to grow above the EU average in 2020, this should not detract from **unresolved problems**. During the boom years, the countries failed to develop sustainable solutions to demographic problems and skills shortages.

Furthermore, the outcome of elections in Poland and Hungary suggests there is little hope that progress can be made on the rule of law. Having clarified arrangements for Brexit, the question as to whether the EU will demonstrate any further patience on this issue will be answered in terms of how disbursement of EU subsidies will be handled in future. Tension is rising, not only in the countries concerned.

Marion Dezenter

United Kingdom

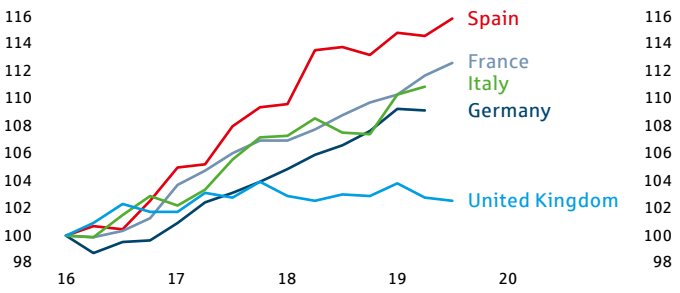
The next act in the Brexit drama

Political upheavals surrounding the country's withdrawal from the EU have Britain firmly in their grip. Though the economy is feeling the pinch, it is not collapsing. If there is an orderly and lasting Brexit solution, the dark clouds over the economy will gradually lift again.

Who is directing the great Brexit drama? Is it Shakespeare or maybe more like Monty Python? Is it a tragedy or a comedy? The audience is being treated to encores that they would probably rather do without. The first act, at least, might actually be finally drawing to a close. A **new withdrawal agreement** between the EU and the British government is ready to be ratified, but only the House of Commons is still dragging its feet while waiting until the upcoming general election has been held.

Brexit paralyses British investment

Gross fixed capital formation, index Q1 2016 = 100



Sources: Macrobond, Helaba Research

There is a realistic chance that Prime Minister Boris Johnson's Conservative Party will win a Commons majority in the **general election**. In this case, he is likely to push his own deal through parliament. If Johnson does not win a majority in the election, parliament could remain paralysed. In this case, nothing can be ruled out, from further extensions to the deadline, a deal or a disorderly exit. Victory by the opposition is the only outcome that would fundamentally call Brexit into question and this is a less likely scenario, however. If this were to happen, opposition parties might decide to hold a second referendum.

> *"I've ended up calling my cat 'Brexit'. It wakes me up meowing like crazy every morning because it wants to go out, but as soon as I open the door, it just sits there undecided and then looks angry when I put it outside."*
>
> Nathalie Loiseau, French Europe Minister

Future relationship

Even if withdrawal from the EU is completed – presumably on 31 January – this does not mean it is the end of the story. This is because, during the subsequent transition phase, arrangements for the UK's **future relationship** with the EU will have to be negotiated. A Conservative government, in contrast to opposition parties, would favour a free trade agreement with a rather loose relationship to the EU. The British could then conclude their own trade agreements with the rest of the world. However, different regulatory standards and customs duties would require additional border controls. Negotiations will prove tricky and will probably lead to the transition phase having to be extended beyond 2020. Without an agreement or an extension of the deadline, the country would yet again face the prospect of a changeover to WTO rules applying to trade with the EU.



United Kingdom

	2019e	2020f	2021f
GDP real, % yoy	1.3	1.0	1.5
Consumer prices, % yoy	1.8	1.7	2.0
Unemployment rate, %	3.9	4.1	4.2

e = estimate, f = forecast
Source: Helaba Research

Resilient, but sluggish growth

Considering the political chaos, the UK economy is holding up well. Although growth has slowed considerably since the EU referendum, the feared recession has failed to materialise. If it was not for the uncertainty that Brexit has created, however, the British economy would undoubtedly have grown more strongly.

The effects of Brexit are most noticeable in terms of **investment**, which has only seen a moderate increase since 2016 – unlike in the euro area. The feeble growth was mainly driven by housebuilding, while equipment investment has stagnated. As **uncertainty** about the future relationship will persist after an orderly exit from the EU, companies will initially remain hesitant. Their willingness to invest will only return very gradually or as pent-up demand increases again.

Consumer spending has also weakened but continues to support economic growth. The very robust labour market, with rising wages, is boosting incomes. The government has more room for manoeuvre and will probably use it. The outlook for exports should pick up slightly. Overall, gross domestic product is expected to grow by 1.0 % in 2020, slightly less than in 2019 (1.3 %). On the positive side, economic momentum will improve over the course of the year.

Bank of England: wait and see

Inflation is likely to fluctuate slightly below the 2 % mark. The tight labour market and significant wage increases will keep inflation relatively high. The Bank of England is nevertheless likely to maintain its wait-and-see stance in 2020 and leave its key interest rate at 0.75 %. At the end of the day, moderate growth and ongoing political uncertainty support this view. **Sterling** may benefit from more stable interest rates compared to the Fed and the ECB and appreciate against the euro and, in particular, the US dollar – provided policymakers play along.

Christian Apelt, CFA

United States

Amateur dramatics in Washington – the sequel?

"Hamilton" is currently one of the most successful musicals on Broadway. It is about the life of Alexander Hamilton, the first US Secretary of the Treasury, who founded what is now the world's largest market for government bonds and is therefore regarded as the father of the US financial market. The recurring drama of government shutdowns, debt ceilings and the prospect of a partial default by the US government would surely have amazed him. In fact, as one of the Founding Fathers of the United States, he would arguably have been appalled by the current president. There is only one issue on which he would have agreed with Donald Trump: Hamilton felt that the United States should protect its "manufactures" from foreign competition with customs duties.



However, it is precisely this kind of protectionist policy which Trump has been pursuing that has driven the US economy to the brink of recession. Instead of the boom he promised, with growth rates of 3 %, 4 % or even more, a downturn quickly followed after the immediate effects of his tax cut at the end of 2017. In particular, the investment boom promised by Trump and his government failed to materialise. Recently, real equipment investment has gone into reverse. In retrospect, 2019 was a year in which the scenario many economists had for 2017 – Trump's first year in office – finally came true, albeit belatedly. In common with other analysts, we then expected considerable uncertainty on the financial markets and among companies, not least due to his attacks on the world's most important bilateral trading relationship, namely that between the United States and China.

Today, fears of a recession are rampant. The truth is that, in past cycles, the 2 % growth mark was something of a "magic threshold": if growth fell below it, the economy lost uplift and slipped into recession. But this was in times of higher trend growth. Before the financial crisis, this ranged from 2.5 % to 3.5 %. Today, 2 % is the **new normal** and no cause for concern. At the moment, this "stall speed" or threshold above which alarm bells should start ringing is likely to be around 1 %. However, we will be a long way from that in 2020 as well: measured by the annual average, real GDP should grow by 2 %, compared with 2.3 % in 2019.

> *"Our economy is the envy of the world. Perhaps the greatest economy we've had in the history of our country."*
> Donald Trump, US President

Compared to Germany and China, the United States is a laggard in this current mini cycle. The downturn set in much later thanks to the fiscal stimulus at the beginning of 2018. **Recovery** from it is also likely to be somewhat more **sluggish**. Although the US economy is relatively closed in comparison with the other two countries, the negative political impact here goes beyond the trade conflict with China and the EU.



	2019e	2020f	2021f
GDP real, % yoy	2.3	2.0	2.5
Private consumption, % yoy	2.6	2.4	2.7
Government spending, % yoy	2.4	2.6	0.9
Non-residential fixed investment, % yoy	2.4	2.0	4.8
Investment in equipment, % yoy	1.5	1.4	5.6
Residential construction, % yoy	– 1.7	1.6	4.0
Exports, % yoy	0.0	1.8	3.4
Imports, % yoy	1.8	3.4	4.7
Consumer prices, % yoy	1.8	2.0	2.0
ex food and energy, % yoy	2.2	2.3	2.0
Unemployment rate, %	3.7	3.7	3.6
Federal budget balance*, % of GDP	– 5.2	– 5.2	– 4.6
Current account balance, % of GDP	– 2.5	– 2.5	– 2.7

* NIPA-basis; e = estimate; f = forecast
Source: Helaba Research

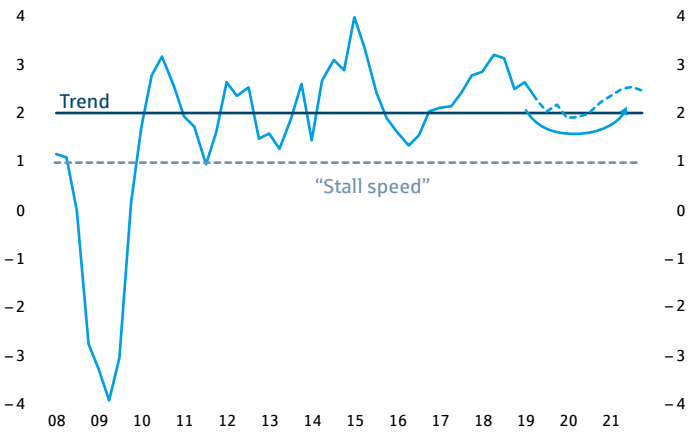
For instance, the future of NAFTA – the **North American Free Trade Agreement** – is of tremendous importance for US companies. An end to the uncertainty in this respect is not in sight: In Congress, the follow-up agreement negotiated by Trump currently has little chance of being ratified. The sudden threat by the president in the summer of 2019 to impose punitive tariffs on all Mexican goods if Mexico does not play ball on immigration policy, casts fundamental doubt on the value of the agreement. In the autumn, it was reported that the White House was seriously considering imposing direct requirements on the automotive industry specifying where auto assemblies should take place.

Recovery despite Trump

Against this backdrop, we do not anticipate significantly higher growth rates in the short term. However, recession fears should recede if leading indicators turn to the upside and **growth** remains **in a corridor of 1.5 % to 2 %**. The relationship with China and the situation with regard to trade will likely not see a return to pre-2018 conditions. Thus, despite our assumption that tensions will ease off somewhat, the United States will probably not see any significant economic impetus from this side. However, the US economy should increasingly benefit throughout 2020 from steps taken in 2019 to loosen monetary policy.

In contrast, there will be barely any stimulus effect from **fiscal policy**. The election campaign will make it practically impossible for the Democrats to cooperate with Donald Trump, which would be essential to enact any major policy measures. The relationship between the Democratic leadership in Congress and the US President is already in a worse state than at almost any time

USA: Expansion continues



Sources: Macrobond, Helaba Research

in the past. The budget compromise struck in 2019 means that automatic consolidation, which was originally scheduled to happen in 2020, is off the cards – and this in the face of a national debt that is already very high by historical standards and of considerable future strain on social security systems due to the rapidly ageing population.

Even with the "help" of increased tariffs on Chinese goods, **inflation** has not exploded. The subdued level of oil prices is having a dampening effect. We expect consumer prices to increase by 2 % in 2020. The core rate should exceed the total rate given the fact that the labour market remains tight and that the full impact of punitive tariffs has yet to make itself felt. Even though we expect average tariffs with China to be lower in 2020, the adjustment process is likely to continue for some time to come, even among domestic competitors. The core rate should initially remain at around 2.5 % before declining somewhat in the further course of the year.

US Federal Reserve in "wait and see" mode

The Fed has already reacted to the economic slowdown during 2019. In retrospect, the abandonment of monetary policy normalisation at the beginning of 2019 turned out to be the right move because, contrary to popular expectations, the US government actually continued to escalate the conflict with China until it was threatening to derail the economy. The three interest rate cuts in the second half of 2019 were sold as "risk management", combined with the statement that things were not really that bad after all. This communication balancing act has not done the credibility of the Fed any good, nor have the constant verbal attacks from the White House. In addition, the Fed has to contend with criticism that the US president only had the leeway for his increasingly confrontational approach to China because its change of course on monetary policy led to positive impulses for the financial markets.

The Fed is **unlikely to change the key interest rate** in 2020. Stabilisation of growth and then recovery should take further expectations of interest rate cuts off the table in the short term. Neither the real economy nor inflation should provide any justification for a renewed change of course.

Patrick Franke

Japan

Temporarily weaker

Japan's growth will suffer a dip in 2020. The labour market is set to remain tight but this will not lead to any inflationary pressure.

The world's third-largest economy is facing a number of **special effects** in 2020: reticence on the part of consumers as a result of a VAT hike in the autumn of 2019 and a trade dispute with South Korea. With a weak domestic economy and a dominant industrial base, Japan is generally sensitive to global trade conflicts, especially when they occur between its two largest overseas markets, the United States and China. Japan's external vulnerability is demonstrated by the high share of industrial production as a proportion of GDP, at just over 20 %.

> *As an economy with a dominant industrial base, Japan is sensitive to global trade conflicts.*



	2019e	2020f	2021f
GDP real, % yoy	0.8	0.3	1.0
Consumer prices, % yoy	0.6	1.2	1.0
Unemployment rate, %	2.4	2.2	2.2

e = estimate, f = forecast
Source: Helaba Research

Japan is nonetheless **unlikely to slide into recession** as a result of fiscal policy measures and the Olympic Games in Tokyo. The Trans-Pacific Partnership (CPTPP) and the comprehensive trade agreement with the EU signed at the beginning of 2019 should also have a positive impact, as should the fact that trade disagreements with the United States have been settled, at least for the time being. Here, a bilateral trade agreement for agriculture and digital goods was concluded in late summer of 2019, although the crucial automotive sector was excluded.

Low unemployment

Due to a low level of Japanese GDP at the beginning of 2020, growth for the whole year is expected to be only 0.3 %. Despite this dip in growth and targeted structural measures, which even include a tentative move to facilitate access for foreign workers, the labour market should remain tight. After all, the Japanese population continues to shrink. However, the labour market situation is only having a limited impact on wage growth, as a significant proportion of the workforce is in irregular, low-paid jobs. For this reason, inflation is likely to remain low and only rise temporarily due to the VAT increase.

Ulrike Bischoff

China

The art of the trade war

Since the spring of 2018, the United States and China have been engaged in a tit-for-tat trade conflict. Beyond the imposition of tariffs, the relationship between the two economic heavyweights has palpably deteriorated.

It is conventional wisdom that China is being adversely affected by the trade dispute with the United States. However, it is almost impossible to quantify reliably how important this effect might be. This is not only due to a lack of meaningful economic data. A fundamental problem is the **structural slowdown in growth**.

In China, this slowdown is of such magnitude that it can overshadow cyclical fluctuations. In this sense, the expected deceleration in economic growth from 6.2 % in 2019 to 5.8 % in 2020 primarily reflects a trend that is weakening towards 5 %. In purely cyclical terms, things are actually likely to be better in 2020 than in 2019.

This cyclical recovery is also a result of a strong **economic policy stimulus**. Thanks to fiscal and credit policy measures of various sorts, China's government is exerting a stronger and more direct influence on the economy than is the case in industrialised countries. The consolidation of 2016/2017 noticeably slowed the economy. Since the summer of 2018, politicians have once again been opening the throttle. This has had the effect of neutralising some of the negative fall-out of the trade dispute.





	2019e	2020f	2021f
GDP real, % yoy	6.2	5.8	5.5
Consumer prices, % yoy	2.9	3.3	2.0
Unemployment rate, %	3.6	3.8	3.8

e = estimate, f = forecast
Source: Helaba Research

But they will not be fully compensated for. Average tariffs on US goods exports to China have risen from 8 % at the beginning of 2018 to over 21 % today. This compares with an increase from 3 % to 21 % of US tariffs on imports of Chinese goods. A weaker yuan may be able to offset this rise to some extent but, on balance, the effect of the **trade conflict** on the Chinese economy is negative. In view of President Trump's constant provocations, President Xi's government has so far steered an astonishingly conciliatory course – especially since it has to be mindful of the population's national pride. For this reason, it can only tolerate a limited amount of humiliation from the US government.

> *"He who knows when he can fight and when he cannot will be victorious."*
> Sun Tzu (5th century BC)

At the moment it looks as if the situation on the trade front is easing somewhat. But short-term concessions by the Chinese will not solve the underlying issue of the high US trade deficit with China, which Trump has turned into a something of a fetish. Moreover, they will not lead to any progress on the actual **sticking points of the conflict**: the question of how industrialised nations will deal with state-controlled companies from China going forward, how China's future development strategy can be reconciled with industrialised countries' fears of competition and whether China's geostrategic conflict with the United States will continue to escalate.

Donald Trump has more or less explicitly declared it to be his goal that China should not overtake the United States as the world's largest economy (in terms of nominal GDP). As long as he remains president, it is difficult to imagine there will be any grand bargain. But regardless of the outcome of the US presidential election, a return to the pre-2018 peaceful coexistence is not a plausible scenario. Even the Democrats in the US Congress have been taking pot shots at China's economic policies.

However, a **limited agreement** on some controversial issues is within touching distance. China may be willing to cooperate on the question of the exchange rate and negotiate in a constructive manner on symmetrical market access. In our baseline scenario, tariffs will not continue to rise in 2020, but will remain higher than in pre-trade conflict times. Positive impulses from trade policy can mainly be expected because companies will no longer need to keep an eye on Twitter every day, dreading the announcement of new tariffs or sanctions.

Inflation has recently jumped to nearly 4 %. This is not the result of overheating or the depreciation of the yuan, but almost exclusively due to swine fever. In the autumn of 2019, the price of one of China's staple foodstuffs, pork, rose by almost 150 % year-on-year. Inflation is likely to remain high at more than 3 % in 2020. In view of the particular circumstances in this case, however, there will be no need for action on the part of the central bank.

Patrick Franke

Russia

A feeble showing

The Russian economy will grow by 1.7 % in 2020, slightly more than in the previous year; but this should not detract from the fact that overall **growth rates since 2013** have been **disappointing**. After all, the Russian economy grew at an average rate of 5.5 % per year in the first decade of this millennium. Private consumption is still feeling the brunt of the VAT hike at the beginning of 2019, which lifted inflation to almost 5 %. For 2020, we expect consumer price inflation to fall to 4.2 %, which is roughly in line with the 4 % inflation target. In view of sanction that are still in place and low oil prices, exports are also expected to provide little support.

The government is trying to improve the weak performance of the economy. President Putin had already set the course for the next six years in the 2018 election campaign: raising economic growth above the global average, reducing poverty by half, increasing life expectancy. 13 “National Projects” with a focus on developing infrastructure, health and education were launched to achieve these goals.

	2019e	2020f	2021f
GDP real, % yoy	1.3	1.7	1.7
Consumer prices, % yoy	4.8	4.2	4.0
Unemployment rate, %	4.7	4.7	4.6

e = estimate, f = forecast
Source: Helaba Research

At the same time, it does not want to overburden public finances. Overall, **budget surpluses are expected to continue**, although they will decline slightly in the future. At around 10 %, Russia’s debt-to-GDP ratio is exceptionally low, while the government has a welfare fund into which revenues from oil and gas activities flow. This has reached a volume of over 120 billion US dollars (approx. 7 % of GDP).



The challenging business climate is weighing on investment.

In addition to fiscal policy, the country is also pursuing an expansionary **monetary policy**. After the central bank reduced its key interest rate in four steps to 6.5 % in 2019, we anticipate a further rate cut in 2020. However, this has not yet given any significant boost to investment. First and foremost, this would require an improvement in the business environment (which is characterised, among other, by corruption and high import duties).

Patrick Heinisch



	2019e	2020f	2021f
GDP real, % yoy	1.2	2.1	2.6
Consumer prices, % yoy	3.8	3.7	3.8
Unemployment rate, %	11.8	11.6	11.3

e = estimate, f = forecast
Source: Helaba Research

Brazil

Reforms in the limelight

The high hopes that the private sector had placed in the new President, Jair Bolsonaro, and his Minister of Economy, Paulo Guedes, have not yet been fulfilled. At 1.2 %, economic growth in 2019 was only just about on a par with the previous year. Investors and companies breathed a sigh of relief when pension reform was finally passed by Congress in October 2019. In 2020, the **liberal reform agenda** (including tax simplifications and privatisations) will continue to be implemented in a step-by-step approach. We therefore expect a growth rate of around 2 % in 2020.

Consolidating public finances is one of the government's most important tasks, as the country's debt-to-GDP ratio rose from around 50 % to over 80 % between 2013 and 2019. Although the primary balance is now close to zero, the high interest payments will continue to weigh on the budget for some time to come and will result in a significant budget deficit. Serious consolidation is only possible by reducing the high level of spending on pensions. These recently amounted to 45 % of total expenditure (excluding interest payments). The pension reform will lead to savings of 800 billion reals (around 200 billion US dollars) in the next ten years, with government debt stabilising at approximately 80 % of GDP.

Pension reform is an important step towards restoring public finances to health.

In view of muted economic growth and inflation slightly below the target of 4.25 %, the central bank trimmed its **key interest rate to a record low** of 5 % in October 2019. We do not expect any further steps in 2020. In the wake of the devaluation of the Argentine peso, the Brazilian real also lost about 10 % of its value against the US dollar in August 2019, before stabilising again. The risk of contagion from the collapse of currencies in other emerging markets is low. The large **currency reserves** are more than five times higher than short-term external debt and provide an effective cushion against external shocks.

Patrick Heinisch



3 Tragedy (10 %)

Alternative scenario

Tragedy (10 %)

As the classic tragedy shows, catastrophic consequences can occur even if all the characters pursue noble yet contradictory aims. In this case, there is scarcely anything selfless about the actors' intentions. It is therefore easy to imagine that conflicts will develop a momentum of their own which the protagonists would not be able to stop without incurring unacceptable political costs.

The main brake on the global economy in 2019 was political uncertainty, mainly due to the trade conflict. The logic of our baseline scenario for 2020 is based on the insight that neither President Trump nor China ultimately have any incentive to **escalate the trade conflict** to the point of causing the global economy to crash. A continuation of the 2018/2019 escalation in the US-China row and/or an intensification of the current skirmish with the EU would be toxic for growth. For Germany, the threatened US tariffs on cars would be a particularly serious body blow.

In view of the downward momentum in the manufacturing sector at the end of 2019, a prolongation or exacerbation of the trade war would easily pull the rest of the economy, which was previously relatively healthy, down with it. The result: **a global recession**.

A trade war could also easily evolve into a currency war. As in the 1930s, this could trigger a spiral of devaluations and additional trade barriers. If signs began emerging that globalisation was not only losing momentum or experiencing a temporary stagnation, but that it was actually being rolled back, many business models would have to be fundamentally re-examined. The resulting

slump in investment would quickly spread to the labour market and other components of demand.

Central banks with their backs to the wall?

Pessimistic expectations are the hallmarks of typical downward spirals into recession. In the current situation, this is fuelled by widespread **doubts about the ability** of fiscal and monetary policy to act. In the United States, deadlock between Democrats and Republicans is now the norm and, in an election year, the willingness to cooperate is almost non-existent. In China, strong fiscal stimulus is at odds with other important government goals. In the euro area and in Germany, self-imposed rules and an already high level of government debt tie the hands of politicians.

Central banks have more room for manoeuvre than fiscal policy, which they would demonstrate with gusto in the negative scenario. However, given that interest rates have already reached record lows and that central banks' balance sheets have become bloated, more and more observers are asking themselves the question: how much can this actually achieve? Note that it is not, in fact, necessary for the effectiveness of monetary policy to be impaired in order to exacerbate a negative sentiment. It is sufficient if a large enough number of protagonists have doubts about it.

In the last global recession, the G20 reacted in a concerted, albeit nuanced way. This time, though, the willingness to cooperate that was on display at the time is likely to be much less pronounced. It's not just the so-called populists who, in recent years, have been championing a nationalistic or egoistic political line. If it is simply a case of everyone for themselves, the scope for coordinated action to stabilise the situation will dwindle. Foreign countries will be perceived less as partners or markets, but more as competitors or potential enemies. Experience also shows that **international cooperation** becomes **more difficult** in economically challenging times. This is even true in the clubs of the EU and the euro area, where a number of simmering conflicts could flare up in a fresh crisis.

The imbalances in the real economy are relatively small this time, as explained in the baseline scenario; however, on closer inspection, this does not necessarily apply to all asset classes in the financial markets. Indeed, in some cases one could postulate rather ambitious valuations. In times of recession, asset prices that had previously been accepted as appropriate are always suddenly called into question. Debt, especially in the private sector, can act as a catalyst in this respect. Ten years after the financial crisis, there are no signs of any debt bubbles in either the United States or the euro area. However, the worldwide burden of debt has risen since 2008; and in some countries, such as China, this increase has been dramatic.

Overview of forecasts in the negative scenario

Germany and the euro area fall into recession with a decline in gross domestic product of more than 1 %. **Growth** also comes to a standstill in the United States. Economic weakness has a noticeable dampening effect on **inflation**, but there is no broad-based decline in prices in 2020.

In a recession, safety is the order of the day. The fact that premiums for this are already very high is unlikely to deter investors. Preserving capital and safeguarding assets are paramount if you want to be around for the next season.

Prices for **German government bonds and US Treasuries** are likely to rise sharply, similarly driven by monetary easing. The yield on 10-year German government bonds falls to new historic lows of –1.5 %. Although the risk premiums on other euro government bonds rise, an expansion in the ECB's asset purchase programme prevents a renewed sovereign debt crisis.

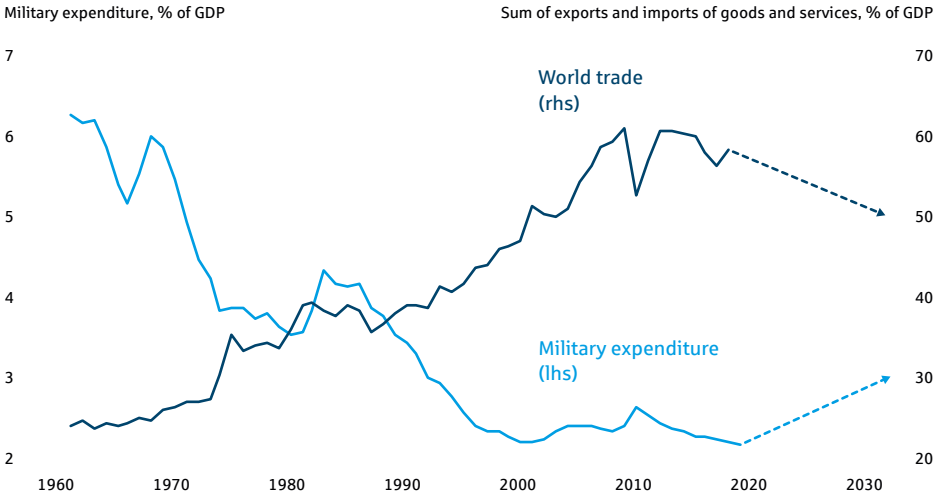
Defaults among European corporates increase significantly. A sharp rise in risk premiums on **corporate bonds** makes funding costs more expensive. Rising margins at banks cannot keep up with escalating credit defaults. In the **covered bond** segment, however, the impact on credit quality remains limited. Covered bonds from core countries are sought after as safe haven investments.

> *"Exit, pursued by a bear."*
> William Shakespeare (1564–1616), stage direction in "The Winter's Tale"

Corporate profits suffer a sharp decline in 2020. Despite plummeting yields and a consequent worsening of the lack of alternative investment opportunities, risk aversion increases significantly. This leads to steep valuation haircuts on equities, which enter a bear market. The **DAX** falls below 9,000 points.

The difficult economic situation results in a slump in demand for **real estate**, with falling rents and a correction in property prices, especially in the commercial segments of the market. In view of more acute conflicts over redistribution, policymakers resort to even tougher unconventional measures to intervene in the German housing market. This deters private investors and new construction activity collapses.

Decade of rearmament and isolation ante portas?



Sources: Datastream, Helaba Research

In the global race of tit-for-tat devaluations, the US dollar becomes an involuntary winner, i. e. it appreciates. In times of considerable uncertainty, the greenback remains in demand as a safe-haven currency. The euro, on the other hand, struggles in the face of increasing political conflicts within in the monetary union. The **euro-dollar exchange rate** falls to 0.95.

As this tragedy unfolds, **gold** serves as a safe haven: a dramatic fall in opportunity costs i. e. bond yields, combined with heightened political risks, help the precious metal to easily beat its previous all-time high of 1,921 US dollars per troy ounce. In euro terms, the rise is even stronger.

Patrick Franke

4 Comedy (20 %)



Alternative scenario

Comedy (20 %)

In a downturn, doom and gloom invariably spreads. The laughter stops. The silver lining is ignored, optimists are ridiculed as naive: where is the upturn supposed to come from? It may seem like a platitude, but a rebound typically comes from the very place where cyclical weakness was previously concentrated: The stage is set for a recovery in the global industrial cycle!

Cyclical volatility in the manufacturing sector is considerably more pronounced than in the service industry, which is much more important in rich countries. Although there was a sharp downturn in manufacturing, this points to a vigorous rebound. As of the autumn of 2019, there are tentative signs that the global industrial cycle is bottoming out. A rapid and dynamic recovery in the manufacturing sector is therefore a plausible scenario.

This is especially true if the constant disruption from the political arena of recent years finally blows over or is at least driven into the background. A comprehensive deal between the United States and China, an easing of tensions between the EU and the United States and an orderly Brexit – these factors would eliminate some of the major reasons for the dominant mood of pessimism. It is unlikely that Washington and Beijing will be able to reach

agreement on absolutely all outstanding issues. Tariffs are unlikely to return quickly to their pre-trade conflict level. But the fundamental uncertainty about the international commercial environment – the crux of the trade dispute – which is undermining the confidence of businesses and their propensity to invest, would no longer be an issue.

U-turn by the central banks

Then there is the easing of monetary policy in 2019. The Fed has already completely reversed its tightening of 2018. In the euro area, record low interest rates are stimulating construction and corporate investment. China's government has had its foot on the accelerator for some time. The question is not whether this stimulus will have an effect, but when.

In many important economies, even after one to two years of downturn in the industrial sector, overall capacity utilisation remains good to high. In the United States, the unemployment rate has reached its lowest level since 1969; in Germany, it has fallen to a post-reunification low. A recovery would therefore not start from a situation in which there is a significant under-utilisation of capacity, as was the case in past recessions. Even if the relationship between unemployment on the one hand and wage growth and inflation on the other may no longer be as close as it used to be, the **central banks**, which have been clearly geared towards easing, **would be caught on the wrong foot**. Accordingly, they would likely initiate a rapid change of course. Key interest rates would start to rise again in 2020 in the United States and, albeit in homeopathic doses, in the euro area.

In terms of fiscal policy, most governments are unlikely to use any cyclically-induced extra revenues to pay down debt, but instead to **distribute new handouts**. In particular, euro countries subject to the Stability and Growth Pact would probably seize every opportunity to increase spending and / or lower taxes.

Negative structural issues remain significant factors in our positive scenario. The ageing of society and the climate debate, for example, will not suddenly disappear. But trends such as digitisation and the fact that the implementation of all the new technologies is still in its infancy in many countries and industries arguably hold considerable potential for **productivity improvements**. Furthermore, a healthy economy makes it easier to deal with most structural problems: debts can be serviced more easily, redistributive measures are more likely to be implemented and, when public coffers are full, economic conflicts between governments are defused. The ability – but sadly not necessarily the tendency – to implement politically-sensitive structural reforms increases.

> *"It is not because things are difficult that we do not dare – it is because we do not dare that they are difficult."*
> Seneca (1st century AD)

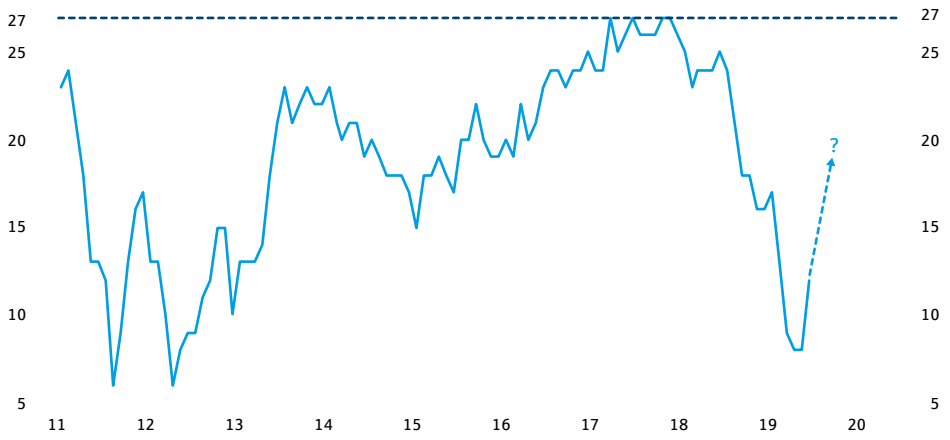
Overview of forecasts in the positive scenario

Economic growth accelerates rapidly. In Germany and in the euro area, GDP grows by around 2.5 % while in the United States it expands even faster. In this environment, **inflation** gains momentum. Prices rise by 2 % in the euro area and, in the United States, they may climb by more than 3 % on average over the year.

The positive economic environment supports the ECB's President Christine Lagarde in completing a **turnaround in monetary policy**: in a first step, the expansion of the ECB's balance sheet is halted and then the deposit rate raised slightly. At 0.8 %, **10-year**

Past the turning point?

Number of countries (of 27) with PMIs manufacturing over 50



Sources: Macrobond, Helaba Research

German government bonds reach the cyclical yield highs of early 2018. In the United States, a much more active US Federal Reserve drives yields well above the 3 % mark.

Rising profits strengthen the balance sheets of most **corporate bond** issuers. Against this backdrop, an increase in refinancing costs remains manageable. Banks continue to expand their lending volumes and rising interest rates enable them to increase their margins again.

As a result of higher credit volumes, there is a significant increase in **covered bond** issuance. Higher yields entice previously aggrieved covered bond investors to return to the market.

Strong economic growth leads to a sharp rise in revenues. Companies take advantage of their scope for price increases to expand their profit margins. Net earnings therefore increase at an above-average rate. In view of investors' growing appetite for risk, valuations also increase. The German **DAX** index breaks through the 15,000-point barrier.

Rapid economic growth boosts demand, especially for office **real estate**, with corresponding increases in rents. On the other hand, retail properties only benefit to a limited extent due to tougher competition from e-commerce. More market-oriented policies could stimulate new construction activity on the German housing market, with the result that the shortage of residential properties does not increase despite significant demand for residential space.

The turnaround in the economic cycle and in monetary policy is particularly helpful for the euro, especially as political obstacles recede into the background. The **euro-dollar exchange rate** rises to 1.35.

In the comedy, **gold** is relegated to the sidelines. The more government bond yields return to positive territory, the more rapidly its opportunity costs rise. Demand for the precious metal as a means of hedging inflation is equally low. The gold price falls below 1,200 US dollars per troy ounce (about 900 euro/ounce).

Patrick Franke



5 Tables of forecasts in the baseline scenario

Financial markets forecasts

	Change since 31.12.2018	Curent*	Forecast horizon at end… Q1/2020	Q2/2020	Q3/2020	Q4/2020
	in basis points	interest rate in %				
ECB deposit facility rate	–10	–0.50	–0.60	–0.60	–0.60	–0.60
Repo rate	0	0.00	0.00	0.00	0.00	0.00
Overnight rate €STR**	–9	–0.53	–0.65	–0.65	–0.65	–0.65
3M Euribor	–9	–0.40	–0.50	–0.50	–0.50	–0.50
6M Euribor	–10	–0.34	–0.45	–0.45	–0.45	–0.45
12M Euribor	–14	–0.26	–0.40	–0.40	–0.40	–0.40
2-yr Bunds	–1	–0.62	–0.75	–0.65	–0.60	–0.60
5-yr Bunds	–25	–0.56	–0.65	–0.55	–0.50	–0.50
10-yr Bunds	–54	–0.30	–0,40	–0.30	–0.25	–0.20
2-yr swap rate	–17	–0.34	–0.45	–0.35	–0.30	–0.30
5-yr swap rate	–41	–0.21	–0.30	–0.20	–0.10	–0.10
10-yr swap rate	–71	0.10	0.00	0.10	0.15	0.20
30-yr swap rate	–85	0.53	0.45	0.55	0.60	0.70
Federal funds rate***	–75	1.63	1.63	1.63	1.63	1.63
3M USD Libor	–90	1.91	1.70	1.80	1.85	1.90
10-yr US-Treasuries	–80	1.89	1.80	1.90	2.00	2.10
	in local currency, %	index				
DAX	25.3	13,230	13,800	14,000	13,800	13,500
EURO STOXX 50	23.3	3,700	3,850	3,900	3,850	3,750
Dow Jones	19.1	27,784	28,500	28,800	28,500	28,000
S&P 500	23.4	3,094	3,180	3,200	3,180	3,140
Nikkei 225	16.5	23,320	24,300	24,700	24,300	23,800
	%	price				
Brent crude $/bbl	15.9	62	60	60	60	60
Gold $/oz	14.1	1,464	1,600	1,650	1,680	1,700
Gold €/oz	18.9	1,330	1,390	1,375	1,400	1,360

*13.11.2019 **Eonia = €STR + 8,5bps ***mid point Sources: Bloomberg, Helaba Research

Currency forecasts

	Change since 31.12.2018	Current*	Forecast horizon at end… Q1/2020	Q2/2020	Q3/2020	Q4/2020
gg. Euro	**vs. Euro, %**	**exchange rate**				
US dollar	4.2	1.10	1.15	1.20	1.20	1.25
Japanese yen	5.1	120	122	125	125	127
British pound	5.0	0.86	0.85	0.85	0.80	0.80
Swiss franc	3.3	1.09	1.10	1.10	1.15	1.15
Canadian dollar	7.2	1.46	1.50	1.54	1.54	1.58
Australian dollar	1.1	1.61	1.64	1.67	1.67	1.69
Swedish krona	–5.2	10.71	10.40	10.30	10.20	10.10
Norwegian krone	–2.0	10.11	9.90	9.70	9.60	9.50
Chinese yuan	1.8	7.73	8.05	8.28	8.28	8.50
vs. US-Dollar	**vs. USD, %**	**exchange rate**				
Japanese yen	0.8	109	106	104	104	102
Swiss franc	–0.8	0.99	0.96	0.92	0.96	0.92
Canadian dollar	2.9	1.33	1.30	1.28	1.28	1.26
Swedish krona	–9.0	9.73	9.04	8.58	8.50	8.08
Norwegian krone	–5.9	9.18	8.61	8.08	8.00	7.60
Chinese yuan	–2.1	7.02	7.00	6.90	6.90	6.80
US-Dollar vs. …	**vs. USD, %**	**exchange rate**				
British pound	0.8	1.29	1.35	1.41	1.50	1.56
Australian dollar	–3.0	0.68	0.70	0.72	0.72	0.74

*13.11.2019

Sources: Bloomberg, Helaba Research

Gross domestic product, inflation, budget deficit

	Gross domestic product Real change, % yoy				Consumer prices Change, % yoy				Budget deficit % of GDP			
	2018	2019e	2020f	2021f	2018	2019e	2020f	2021f	2018	2019e	2020f	2021f
Euro area	**1.9**	**1.2**	**1.3**	**1.6**	**1.8**	**1.2**	**1.3**	**1.5**	**–0.5**	**–0.9**	**–0.8**	**–0.8**
Germany	1.5	0.6	1.0	1.6	1.8	1.5	1.6	1.9	1.9	1.3	1.0	0.7
France	1.7	1.3	1.5	1.6	2.1	1.2	1.3	1.6	–2.5	–3.2	–2.2	–2.2
Italy	0.7	0.2	0.8	1.2	1.2	0.6	0.8	1.1	–2.2	–2.4	–2.4	–2.2
Spain	2.4	2.0	1.8	1.8	1.7	0.8	1.0	1.3	–2.5	–2.3	–2.1	–1.7
Netherlands	2.6	1.8	1.6	1.7	1.6	2.5	1.8	1.9	1.5	0.5	0.2	0.1
Austria	2.3	1.5	1.5	1.7	2.0	1.5	1.6	1.8	0.2	0.4	0.3	0.3
Ireland	8.2	3.5	3.0	3.0	0.7	0.9	1.2	1.5	0.0	0.0	0.2	0.3
Portugal	2.1	1.8	1.7	1.9	1.2	0.5	0.9	1,3	–0.2	–0.2	0.0	–0.5
Greece	1.9	1.9	2.0	2.0	0.6	0.8	1.1	1.5	1.1	0.3	–0.6	–1.5
Sweden	**2.4**	**1.6**	**1.7**	**1.8**	**2.0**	**1.8**	**1.5**	**1.8**	**0.9**	**0.7**	**0.8**	**0.8**
Norway	**1.6**	**1.6**	**1.8**	**1.9**	**2.8**	**2.3**	**1.9**	**2.0**	**7.3**	**6.1**	**6.2**	**6.5**
Poland	**5.2**	**4.2**	**3.3**	**3.4**	**1.6**	**2.2**	**2.7**	**2.5**	**–0.2**	**–1.0**	**–0.5**	**–0.8**
Czech Republic	**2.9**	**2.6**	**2.4**	**2.5**	**2.1**	**2.7**	**2.4**	**2.2**	**1.1**	**0.2**	**–0.2**	**–0.3**
Hungary	**5.1**	**4.8**	**2.9**	**2.9**	**2.8**	**3.3**	**2.9**	**2.8**	**–2.3**	**–1.8**	**–1.5**	**–1.5**
United Kingdom	**1.4**	**1.3**	**1.0**	**1.5**	**2.5**	**1,8**	**1.7**	**2.0**	**–2.3**	**–2.2**	**–2.5**	**–2.7**
Switzerland	**2.8**	**0.8**	**1.5**	**1.4**	**0.9**	**0.4**	**0.5**	**0.8**	**1.2**	**1.0**	**0.4**	**0.4**
United States	**2.9**	**2.3**	**2.0**	**2.5**	**2.4**	**1.8**	**2.0**	**2.0**	**–5.0**	**–5.2**	**–5.2**	**–4.6**
Japan	**0.8**	**0.8**	**0.3**	**1.0**	**1.0**	**0.6**	**1.2**	**1.0**	**–2.5**	**–3.0**	**–2.8**	**–2.7**
Asia ex Japan	**5.6**	**5.1**	**5.1**	**5.0**	**2.6**	**3.0**	**2.9**	**3.0**	**–3.0**	**–3.4**	**–3.4**	**–3.1**
China	6.6	6.2	5.8	5.5	2.1	2.9	3.3	2.0	–4.8	–6.2	–6.3	–6.2
India	6.8	5.6	6.4	6.8	3.9	3.6	4.2	3.9	–3.5	–3.5	–3.4	–3.0
Russia	**2.3**	**1.3**	**1.7**	**1.7**	**2.9**	**4.8**	**4.2**	**4.0**	**2.6**	**2.1**	**1.5**	**1.4**
Turkey	**3.0**	**–0.3**	**4.0**	**3.6**	**16.3**	**15.6**	**10.1**	**9.4**	**–2.0**	**–2.9**	**–3.1**	**–3.0**
Latin America	**0.8**	**1.1**	**2.2**	**3.0**	**6.7**	**8.3**	**7.4**	**5.9**	**–4.2**	**–3.8**	**–3.6**	**–3.4**
Brazil	1.1	1.2	2.1	2.6	3.7	3.8	3.7	3.8	–6.9	–5.7	–4.9	–4.8
World	**3.6**	**3.2**	**3.2**	**3.4**	**2.8**	**2.9**	**2.8**	**2.7**	**–**	**–**	**–**	**–**

GDP growth working day adjusted if available; e=estimate, f=forecast

Sources: EIU, Macrobond, Datastream, Helaba Research

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