Europe Watch

BREXIT ROULETTE, CAPEX VIGNETTE

Europe Team

Markets: Brexit dartboard; Northern lights

- **A(nother) critical week for the UK government and for Brexit**
- **We handicap (guess) a range of outcomes and their GBP impact**
- **Separately, we highlight the strength of Skandie economies – next year could finally be their year**

Economics: Clinging on to capex (in charts)

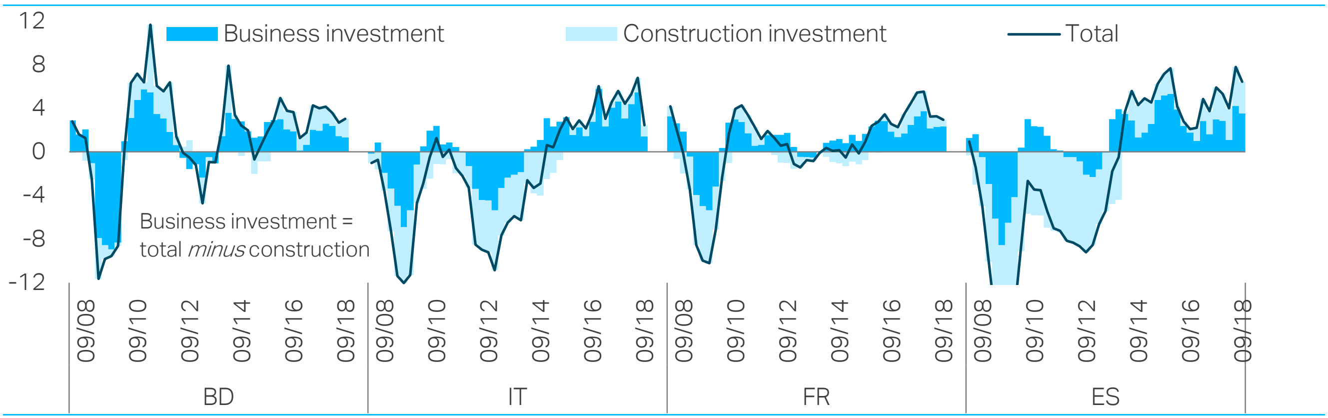
- **New orders and industrial production data point to a weak Q4**
- **Investment growth is slowing but underlying drivers are still healthy**
- **Italian capex remains the weak spot in the euro area**

Politics: Macron in trouble; AKK versus Merz

- **French protests have forced Macron into his first U-turn**
- **Discontent will affect tax and spend policy more than structural reforms**
- **Meanwhile in Germany, the CDU's social market Catholic and business wings are competing for the party leadership**

Construction vs. business investment

National accounts, gross fixed capital formation , SA, YoY% and pp contributions



Source: Eurostat, Datastream, TS Lombard

Markets: The Brexit dartboard

- **A(nother) critical week for the UK government and for Brexit**
- **We handicap (guess) a range of outcomes and their GBP impact**

Next week the UK parliament will vote on Prime Minister May's Brexit withdrawal agreement. We do not expect it to pass, at least on the first vote. In the table below we explore some scenarios and what these might mean for GBP. Bearing in mind 1w GBP/USD volatility is currently around 16% and GBP/USD have moved by at least 0.85% intraday every day this week. We still regard GBP as untradeable and even a 'no change in GBP' outcome could see intraday swings of up to 1%. But we are waiting for the chance to buy the pound, so understanding the path it may take is an important exercise.

On Monday we are holding a Brexit conference call with our political team of Christopher Granville and Constantine Fraser to explore 'the day after tomorrow'. Please contact your account manager for dial-in details.

11 Dec: Parliament votes. The chart below lays out some scenarios and estimates of GBP/USD response, in order of spot level. The list is not exhaustive and by necessity only includes first-order consequences. The highlighted section reflects what we reckon is currently priced-in.

Deal passed	Very unlikely; GBP heads to BINO level but with some risk premium of another roadblock
Defeat, EEA/Norway option gathers support	GBP to 1.30 as no deal (temporarily) ruled out but May position's hugely weakened and she may well fall
Defeat, second referendum gathers support	GBP to 1.30 temporarily – but second referendum *increases* risk of no deal so rally not sustained
Defeat, period of confusion as government refuses to state next step	No material change in GBP: we reckon this is 'in the price'
Defeat, May plans second vote	No material change in GBP: we reckon this is 'in the price'
Defeat, May resigns	GBP falls on uncertainty but main move is (even) higher volatility. Tory party membership favour Johnson but MPs do not; replacement may be a consensus candidate or caretaker. But fear of Brexiteer steering country to no-deal rises.
Defeat, UK heads to inescapable no-deal	Very unlikely that Tuesday's vote leads directly to this outcome, but if so GBP

GBP/USD levels:

1.50-1.55: No Brexit:

1.40-1.45: Brexit in name only (BINO)

1.2750: current spot

Sub-1.20: No-deal

Markets: Northern lights

- **Upside risk to Norway GDP**
- **Rising inflation expectations support Riksbank tightening**

When it comes to looking ahead to next year, every year I reckon "this will be the time the Skandie currencies return". NOK did rally 4.5% against EUR at one point this year, but has given most of those gains back. And SEK is the definition of currency strategists' insanity: every year it is forecast to strengthen and for the last three years it has done the exact opposite. So I shall utter the immortal words: this time is different. Why?

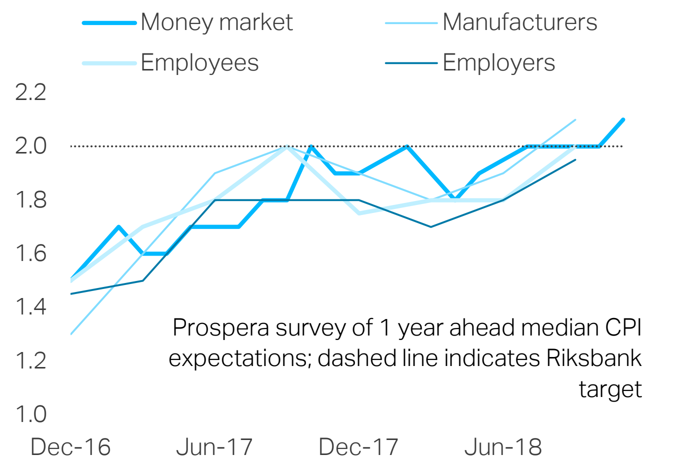
Sweden as a leading indicator. In today's Chartbook we published a chart showing how Swedish industrial activity acts as a leading indicator for euro area manufacturing. Activity peaked in 2017 and may have hit a low in September this year. This means euro area manufacturing is likely to recover in 3-6 months, but more importantly for SEK it means demand has returned.

Inflation expectations continue to rise. One of the Riksbank's key policy tenets has been inflation expectations. Using the Prospera survey data, in December 2016 most participants expected year-ahead inflation at 1.5% or below. On the latest round of surveys, manufacturers and money market participants expect year-ahead inflation above 2%. One can never claim victory in managing inflation expectations, and the Riksbank has been notably cautious in this regard, but finally the data supports tighter monetary policy.

Norway is not just oil. The EUR/NOK-Oil correlation has increased from a low of -15% in March to -45% now. But Norway structurally neutralised oil income through monthly FX purchases for the government pension fund. Currently the FX purchases are negative – effectively the oil prices is lower than this year's budget breakeven – but the process ensures oil prices swings do not create domestic economic swings. And the Regional Network Report, a key input to Norges Bank decision making and an excellent leading indicator for Norway GDP, reflects strong growth.

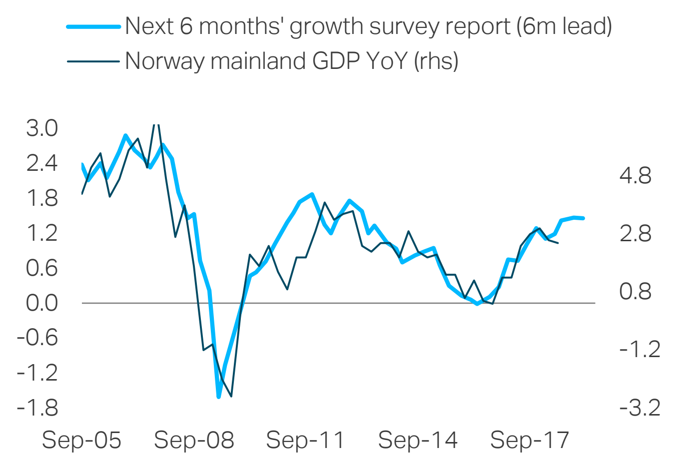
One hike so far this cycle, room for more. Norges Bank raised interest rates by 25bp to 0.75% in September. Since then, the 25% fall in the oil price will likely moderate the central bank's inflation forecast and therefore its tightening path. But the central bank will remain hawkish. NOK is poised for a good year.

Swedish inflation expectations breaching 2%



Source: TNS-Prospera, TS Lombard

Norges survey indicates positive growth risk



Source: Norges Bank, Bloomberg, TS Lombard

Cheap crowns. Both NOK and SEK are around 5% cheap to their long-term PPI-adjusted real effective exchange rate averages. As always, there are two-way-risks around the upcoming central bank meetings, but overall both currencies should begin to reflect strong domestic fundamentals over the next year.

Central bank expectations risk. Two-way risks around central bank meetings often manifest themselves as strategists being proved wrong time and again. And we must remain cognisant of expectations. In Sweden, 45bp of tightening is priced over the next 12 months. And in Norway (where rate hike expectations are more subjective as the forward curve is less liquid), there is a risk that Norges bank moderates its tightening path. But overall, strong domestic fundamentals are the signal that these currencies could be – finally- set for a good year.

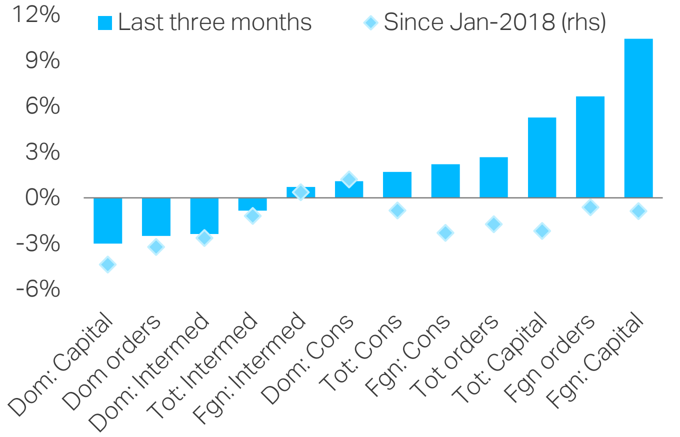
Economics: Clinging on to capex (in charts)

- **New orders and industrial production data point to a weak Q4**
- **Investment growth is slowing but underlying drivers are still healthy**
- **Italian capex remains the weak spot in the euro area**

A strong rebound in Q4 unlikely. The German economy declined in Q3, mostly due to collapsing exports and private consumption. Those expecting a sturdy pick up in Q4 will have been disappointed by the October data on German new orders data and industrial production. Factory output in France are a bit more encouraging.

German orders rebound marginally

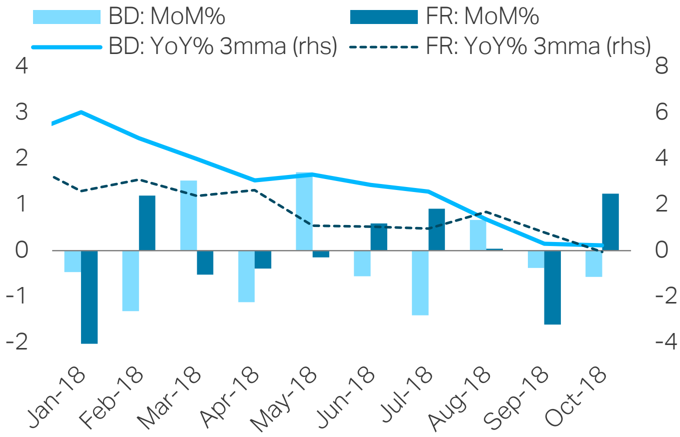
% change in new manufacturing orders, Oct-18



Source: Destatis, Datastream, TS Lombard

Industrial production weakness persists

Tot industrial production ex-construction



Source: Destatis, INSEE, Datastream, TS Lombard

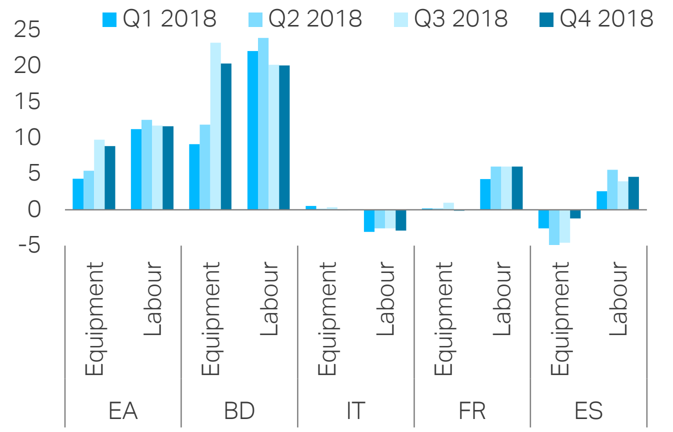
On the German orders front, the change remains negative on a YoY basis (-2.7%), as well as YTD (-1.7%). On a positive note, orders increased by 0.3% MoM beating even more bearish expectations (-0.4% according to Bloomberg consensus). Decent foreign orders of capital goods (especially from other EA countries) helped the bounce, but the risks to factory output from slowing global growth have not disappeared.

Industrial production weakness persists. German industrial production disappointed (-0.6% MoM), missing expectations by a wide margin (+0.3%). Most of the decline is due to non-durables and consumer goods, while the drag from auto sector continues to exert negative pressures. The large build-up in inventory in Q3 will weigh on Q4 real GDP and there remains a risk of a technical recession in Q4. Meanwhile, industrial production in France came in rosier than expected (+1.2% MoM vs +0.7%), but the sector is already in contraction territory on a YoY basis.

Investment growth in the EA is slowing but underlying trends remain healthy. Factory data will likely continue to disappoint due to slowing exports and a deteriorating global growth outlook. The spill-overs from weak exports will hurt domestic demand and especially capex, but the euro area will still continue to grow at an above-trend rate of 1.5% next year. The six charts below illustrate the mixed nature of the current situation. On one hand, capacity utilisation rates are rolling over but they remain close to their historical highs. Similarly, business sentiment and hiring intentions are merely reverting towards their long-term averages. On the other hand, corporate profit growth is slowing across the board and equipment shortages seems to be a problem for Germany only.

Mostly labour (not capex) shortages

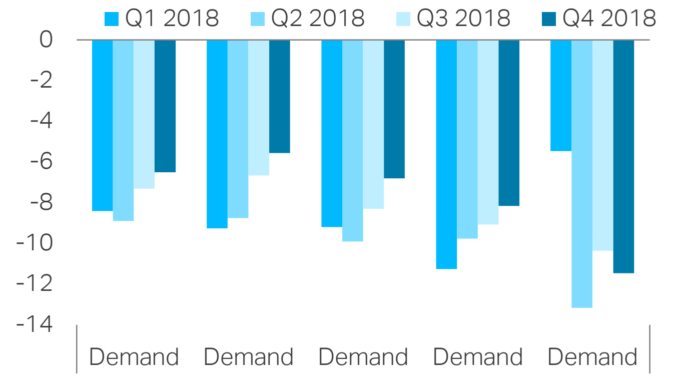
Net percentages



Source: EC survey, Datastream, TS Lombard

Demand tailwind moderating but still large

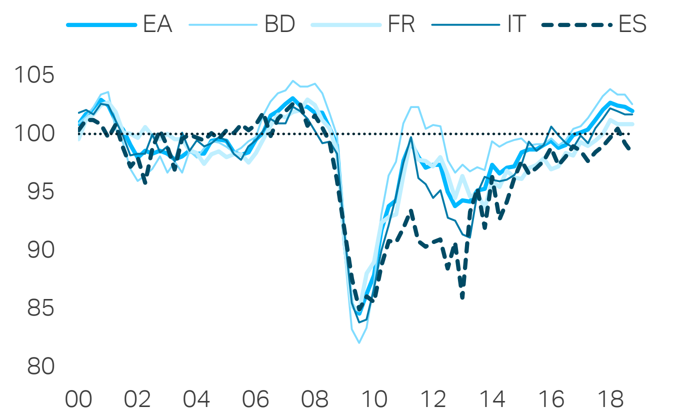
Net percentages



Source: EC survey, Datastream, TS Lombard

Capacity utilisation rates

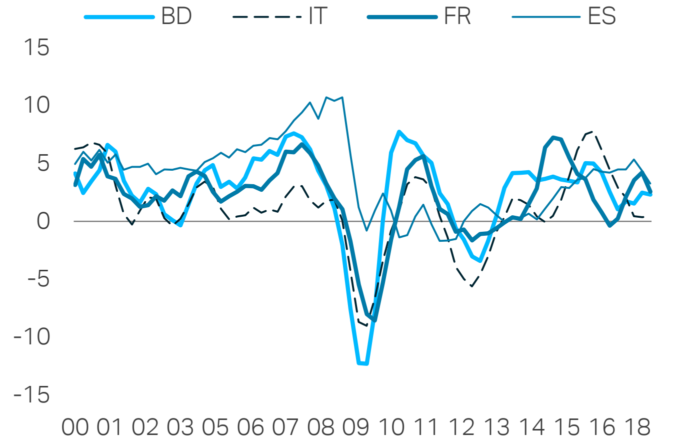
Index: pre-GFC average = 100



Source: EC survey, Datastream, TS Lombard

Slowing corporate profits

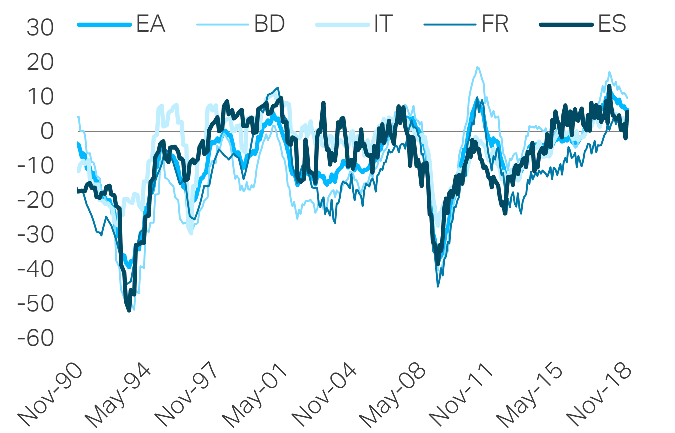
Gross operating profit (NFCs), YoY%



Source: Eurostat, Datastream, TS Lombard

Hiring expectations

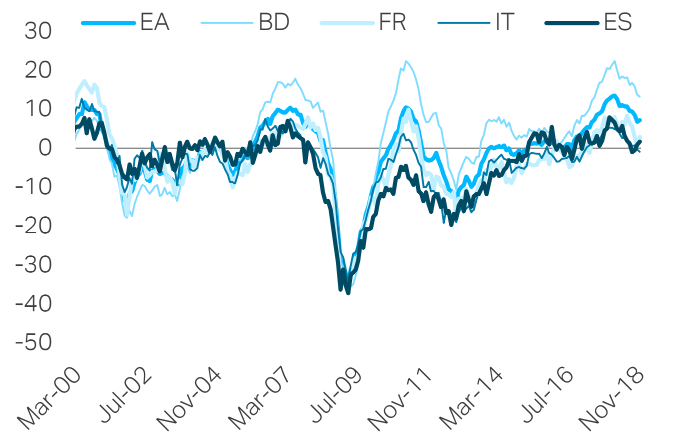
Net balance



Source: EC survey, Datastream, TS Lombard

Business sentiment

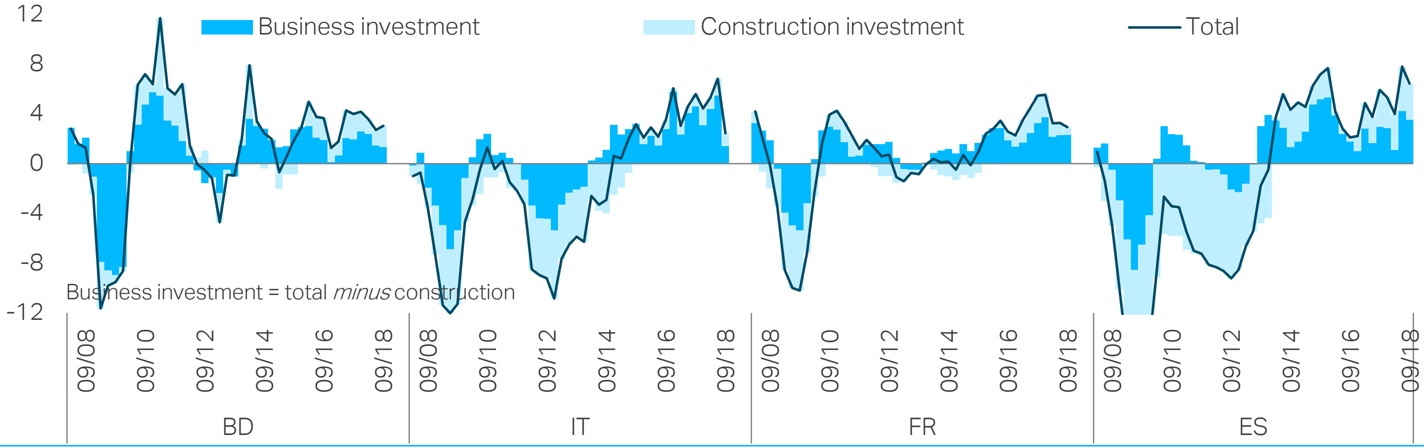
Net balance, diff from LT average



Source: EC survey, Datastream, TS Lombard

Construction vs. business investment

National accounts, gross fixed capital formation , SA, YoY% and pp contributions



Source: Eurostat, Datastream, TS Lombard

To understand the underlying dynamics of capex growth beyond high frequency indicators we look at country- and asset-level national account data.

Capex "building". The chart above shows that business capex (defined as total fixed capital formation excluding construction investment) has been the most important factor behind overall capex growth since the double-dip recession across all four major EA economies ("the Big 4"). However, the chart also highlights the considerable role of construction investment (light-blue bars) especially in the latest phase of capex expansion—roughly since 2017.

Construction investment has been a considerable driver of overall capex growth especially in Spain – where it contributed for almost half of total cumulative growth since the beginning of 2017 – and Germany. As far as recent trends go, interestingly the acceleration in construction capex accounts for all fixed investment growth in Germany. France, on the other hand, shows the opposite dynamics, as business investment remained stable while construction slowed.

The distinction between business and construction investment is also relevant because business capex growth is directly associated with the expansion of productive capacity and resources, while construction investment includes dwellings, which are a large portion of the total, and are not necessarily a signal of increasing future production.

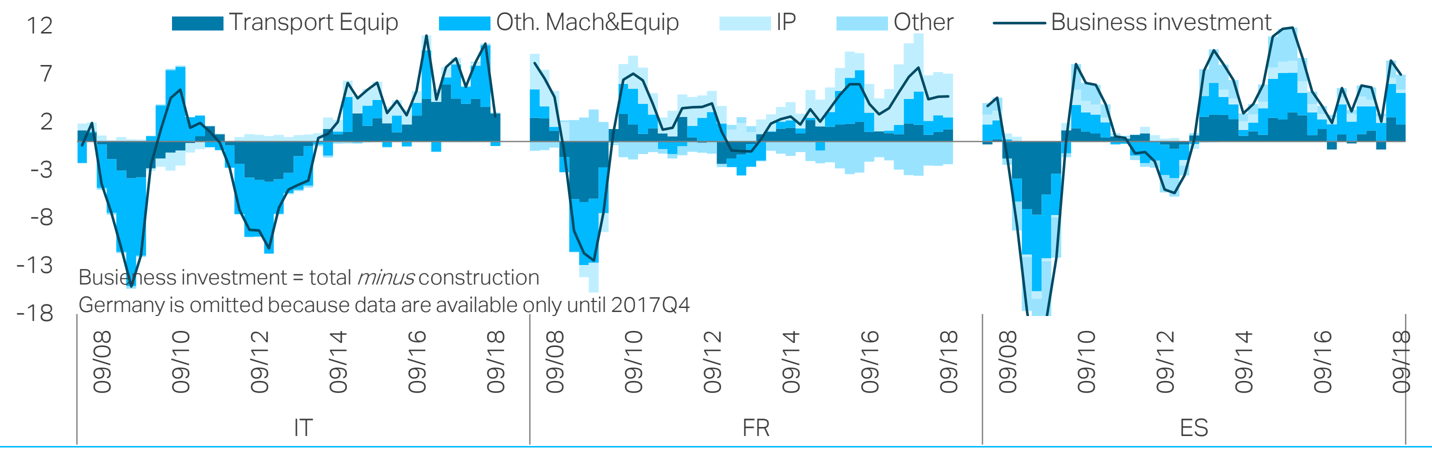
Of course, the story changes if new dwellings are built to make space for migrants adding to the labour force such as in Germany (about 80% of German construction capex growth in 2018 is due to dwellings) rather than because of a developing housing bubble. On the other hand, Spain saw a significant pick-up in non-residential construction over the past two quarters.

Italy: the weak link once again. Unlike the other major EA economies, Italy's capex growth is almost entirely attributable to business investment. But what exactly *is* business investment? In the chart overleaf, we break down business investment into transport equipment, other machinery and equipment (e.g. production plants, basically what most people have in mind when thinking of capex), intellectual property products, and other (e.g. agricultural resources).

The good news is that all the marginal growth of business capex in Italy from the second half of 2017 to 2018Q2 has come from other machinery and equipment –the first positive development since the Global Financial Crisis. Transportation equipment, actually slowed over

Breakdown of business investment by asset

National accounts, gross fixed capital formation, SA, YoY% and pp contributions



Source: Eurostat, Datastream, TS Lombard

the same period. Unfortunately, investment in other machinery and equipment stalled altogether in Italy, causing the large drop shown in the chart above.

We are not surprised. In effect, potential, future public spending is already crowding out private investment via the credit channel through higher lending rates and marginally tighter lending conditions. Moreover, other factors directly related to government policies are likely to be at work; for example, the uncertainty about the extension of the favourable depreciation regime for firms' investment in capital goods and the recent decision to cut on the so-called "Industry 4.0" package – which has supported capex expansion in the past years – will likely weigh on businesses' investment decisions. Slower operating profits will be a headwind too.

On the other hand, despite the differences in the structure of the economy (e.g. see the important role of intellectual property products in France), capex growth in France and Spain remains on a robust footing.

Politics: Germany - AKK versus Merz

- **The CDU is holding a closely-fought leadership contest this week**
- **The choice is between a pro-business liberal and a social market centrist**
- **But remember: the CDU right aren't Eurosceptics**

This week, the CDU will choose its new party chair. At Friday's CDU conference in Hamburg, the party will choose Angela Merkel's presumptive heir, and the party's likely next candidate for the chancellery. This is a rare event: there have only been 3 CDU party leaders since 1973. Although Merkel insists that she intends to continue as head of government until the next election, Germany's political and policy future will all depend on the CDU's choice.

1,001 delegates will vote on the new leader – they have a Catholic, West German centre of political gravity. These are representatives of the CDU's state-level party organisations, with the size of the delegations proportional to that of their membership and the CDU's share of the vote in their state. With Bavaria going without representation (as the CDU does not compete there), this is a delegation heavily skewed towards prosperous, Catholic regions of former West Germany.

The battle will be close-fought between different factions of the CDU. This is essentially a two-horse race, to simplify somewhat between "Catholic" and "business" currents within the party. Merkel's favoured successor is Annegret Kramp-Karrenbauer, the former Saarland premier and current party general-secretary. She is up against Friedrich Merz, Merkel's old political rival from the early 2000s, who has spent the last decade working in the private sector and is currently (among several other jobs) chair of Blackrock Germany. "AKK" has deep roots in the party machinery and according to the polls a lead among would-be CDU voters. Merz has the support of party grandees including Wolfgang Schaüble and of the CDU's pro-business "economic wing", and is popular among a grassroots anxious to differentiate the party more sharply from its coalition partners in the SPD. The race is genuinely open.

AKK means continuity. A victory for Kramp-Karrenbauer would spell more continuity than change with the Merkel era. Although she is more socially conservative than Merkel on issues like LGBT rights and abortion, she is committed to a "big tent" path for the CDU, and is grounded in the social market tradition on economics: she supported the German minimum wage and higher taxes on high income earners, for example. Nor would her rise to the head of the CDU disrupt Germany's party political scene too much.

Merz would shake things up more. In some ways, Merz is the more interesting candidate. He would want to take the CDU in a more "Thatcherite", pro-business direction: for example, we would expect him to spend Germany's surplus on incentives for private and corporate investment, rather than on tax cuts for consumers and families. And a more sharply right-wing CDU could shake up the German political scene: could the Greens pick off more centrist voters to draw neck-and-neck in the polls? Could the Grand Coalition survive?

He also has some interesting thoughts on Europe. It's easy to forget that the old-fashioned CDU right (Schaüble included) are conservative federalists, not soft Eurosceptics. In recent weeks, Merz has flirted with a European unemployment insurance scheme (although we suspect this is mostly to burnish his European credentials), has insisted that the benefits Germany derives from an artificially weak euro give it an obligation to do more for Europe, and has suggested that Macron deserves a more comprehensive and honest response to his proposals for Eurozone reform. We don't think Merz will suddenly unblock the single currency; but after the Merkel era's years of stalling, shaking up the euro debate in Germany might be no bad thing.

Politics: France – Macron caves

- **Massive protests have forced Macron into his first U-turn**
- **His structural reforms are safe, but tax and spend policy could change**
- **We would not be surprised by a centre-left-ish, consumer-focused turn**

Massive French protests have forced Macron to U-turn on fuel taxes. In a country which grants its head of state near-monarchical powers, it's only fitting that the real opposition to the French presidency is not the French political system but the French street. Over the last couple of weeks, the *gilets jaunes* protests have become the most significant challenge Macron has faced since his victory in last spring's presidential elections. They have now forced him into his first U-turn. The question is, will there be more to come?

It is unclear how much more will be necessary to buy off protestors. With Macron's approval rating plummeting (to only 23%, according to a recent IFOP poll), his government has now announced that the fuel tax rises which sparked the protests will be cancelled and a rise in energy prices suspended by 6 months, at a total cost of around €4bn. The government has said it will make up the shortfall rather than allow the deficit to rise, but this is only a weak constraint: while the government is aiming for a 2.8% deficit next year to stay within EU budget rules, excluding one-off measures the deficit will only be 1.9%.

But with the scope of the protests now expanding to issues of public services, taxation and the aloofness of the French ruling classes, and with the vast majority of French voters sympathetic to the protests, it is unclear whether these concessions will be enough. Macron this week had to rebuke his ministers for airing the possibility that this year's elimination of the wealth tax on non-property wealth could eventually be reviewed if it turns out it has not stimulated investment.

Investors should not be too concerned by the consequences of the protests for Macron's structural reform programme. Some of the most important steps, in particular his labour market changes, have already been completed. Of the items currently at the top of the government's agenda, the tweaks under discussion to the unemployment benefit system will not revolutionise France's political economy; and a wholesale transformation of pensions to be unveiled next year, while important for the system's sustainability and for cross-sector labour mobility, is unlikely to start coming into force until the mid-2020s, well beyond any plausible investing timeline.

It is in the areas of fiscal and tax policy that public discontent might force changes. The government is so far attempting to reduce the tax burden and the deficit in tandem, while shifting the tax mix away from labour charges. The pain resulting from this process – and particularly from the front-loading of compensatory tax rises – has been a major factor behind the protests. And this is where any likely change of course will come. Although Macron has been adamant he will not reverse changes he has already made – such as the important reduction in payroll taxes - but the pace of fiscal consolidation could be slowed, or plans for future tax changes (such as the staggered fall in corporation tax over the coming years) could be altered.

We may see a pivot to the centre-left in the second half of this presidency. The traditional response of a French president in difficulty is to sack his prime minister, and there are already rumblings of discontent towards the centre-right Edouard Philippe within the more leftish parts of Macron's LREM party. Although it is early days yet, we would not be surprised if the second half of Macron's tenure is less overtly pro-business, and more standard-of-living and consumer-focused. Plans to tax the tech giants may be only a first step.

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