Economics

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Global update: robust growth, no exuberance yet

- **So far, so good:** In the first half of 2017, none of the key political and economic tail risks that we had discussed in our Global outlook at the start of the year materialised. Instead, our main scenario of resilient economic growth at low inflation is playing out nicely.
- **Steady and broad-based growth:** Growth has strengthened even more than we had expected in the eurozone and Japan, while remaining roughly in line with underlying trends in the US and the UK despite some short-term volatility in the data. Many emerging markets have pulled out of their 2016 crises. Such synchronised steady global growth has not happened in over a decade.
- **More of the same:** We do not detect signs of dangerous exuberance in the advanced world. Although the recovery has now lasted more than eight years already in the US and the UK, even these countries have not yet built up new credit excesses or inflationary pressures that would require a cleansing recession within the next two years. We thus project a continuing recovery with a chance that growth may firm modestly. The upswing has not run its course yet.
- **Inflation is neither too high nor too low:** Moderate inflation in most advanced nations has replaced the concerns from early 2016 about possible deflation. Inflationary expectations remain well anchored.
- **Goldilocks goes to Europe:** Despite firmer economic growth, core inflation remains especially subdued in the eurozone. Due to the euro crisis of 2011-12, the upswing is less mature in the eurozone than in the US and the UK. The risk that inflation may surprise to the upside looks particularly remote in the eurozone.
- **The rate cycle is turning – but only very slowly:** While the US Fed will likely raise rates one more time in late 2017 and start to shrink its balance sheet very cautiously, the European Central Bank will probably phase out its asset purchases only gradually in 2018 before raising its refi rate in the second half of 2019. The BoE may react to the current inflation overshoot by hiking rates this November.
- **China faces longer-run challenges posed by excessive credit growth:** In the next several years, however, the debt burden will likely remain manageable, supported by rapid growth in national income and, if necessary, government intervention. A jarring debt crisis remains a low probability for the time being.
- **Risks persist – they always do:** Fortunately, some of the more acute risks seem to have dissipated. In Europe, the election of the staunchly pro-European reformer Emmanuel Macron as the new French president has promoted renewed hopes of European reform and stronger trend growth. France could be heading for a golden decade. In the US, despite the erratic behaviour of President Donald Trump, his administration has moved toward a more mainstream approach to policy making.
- **A softer Brexit?** In the UK, the inconclusive outcome of the recent snap election has reduced the risk of a hard Brexit, that is of the UK dropping out of the EU in March 2019 without a significant follow-up deal.
- **The return of the mainstream:** In much of continental Europe, the pro-European mainstream is re-asserting itself in the wake of last year's Brexit vote and the rise of Trump. In elections in Austria, the Netherlands and France, the ultra-right fared less well than opinion polls had projected in early 2017. In Germany, chancellor Angela Merkel looks set to be re-elected this September. While the radical Five Stars movement remains strong in Italy, some of its key members are mellowing, discussing whether a call for a euro referendum would really win them votes.
- **Beyond the tide of anger:** By and large, the evidence so far this year supports our base case: the global liberal order and the institutions that underpin peace and prosperity in Europe will survive the onslaught of the politics of anger. While it will take a long time to heal the economic and social wounds that have given rise to the radical populists in the first place, the process seems to be under way.

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Table of contents

Global update: robust growth, no exuberance yet 1

Global overview 3

US: steady growth despite policy uncertainty 5

China: slower, but still fast growth 7

Japan: healthy performance to continue 8

Eurozone: a firmer recovery 9

UK: stable outlook if Brexit risks are avoided 11

Emerging Europe 13

Latin America: favourable outlook 15

India: sustained strong growth 16

Inflation: limited risks for advanced economies 17

Political risks: it could have been worse 18

Global economic forecasts 19

Berenberg compared with consensus 19

Key financial forecasts 20

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Global overview

Steady growth with some upside risks: The economic outlook for the next two years remains more encouraging than it has been for almost a decade. Since the spring of 2009, the advanced economies have gradually recovered from the post-Lehman mega-recession (Chart 1), interrupted only briefly in the eurozone by the euro confidence crisis of 2011-12. The restrained upswing has gone along with sustained gains in employment as companies have preferred to hire more workers than to expand capacities by raising fixed investment.

The economic outlook is more encouraging than it has been for almost a decade

Virtually all advanced economies are now growing at a steady or modestly firming pace, despite various political risks. While the US and the UK remain close to their growth rates of previous years, the eurozone and Japan have gained some momentum over the last six to nine months. They benefit from some recent domestic reforms as well as from the rebound in global trade (Chart 2) as many emerging markets have recovered from their adjustment crises of 2016. Such synchronised steady growth has not happened in over a decade.

Growth in the eurozone and Japan is gaining some momentum

We project more of the same for the remainder of 2017 and for the two years thereafter: We do not detect signs of dangerous exuberance in the advanced world. Although the recovery has now lasted more than eight years already in the US and the UK, even these countries have not yet built up new credit excesses or inflationary pressures that would require a cleansing recession within the next two years. Still scarred by the experience of the great financial crisis and the subsequent euro crisis, neither consumers nor companies are indulging in a credit-fuelled spending boom yet. Wage costs are not rising too fast either.

We do not detect signs of dangerous exuberance in the advanced world

Inflation is neither too high nor too low: Moderate inflation in most advanced nations has replaced the overdone concerns from early 2016 about possible deflation risks. Driven largely by oil price base effects, headline inflation has risen closer to the core rates in the US and Europe. With the exception of the UK, which has imported some inflationary pressures due to the Brexit-related plunge in the sterling exchange rate, core inflation remains below target in the advanced world. Inflationary expectations are well anchored.

Inflation expectations remain well anchored

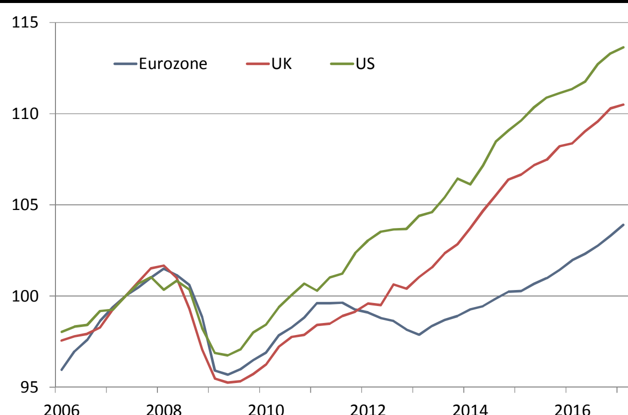
The rate cycle is turning – but only very slowly: Amid economic and inflation conditions that are within a range considered "normal" relative to standard estimates of potential growth and central banks' inflation targets, leading global central banks continue to maintain easy monetary policies. While the US Fed will likely raise rates one more time in late 2017 and start to shrink its balance sheet very cautiously, the European Central Bank will likely phase out its asset purchases only gradually in 2018 before raising its refi rate in the second half of 2019.

Leading global central banks continue to maintain easy monetary policies

Risks persist – they always do – but some of the more acute ones seem to have dissipated: In Europe, France's election of Macron has promoted renewed hopes of European reform and stronger trend growth. In the US, despite the erratic behaviour of President Trump, his administration has moved toward a more mainstream approach to policy making. These improved conditions have lifted confidence.

France's Macron has promoted renewed hopes of European reform

Chart 1: US, UK and Eurozone GDP – on the right track



Index, 2007=100. Adjusted for the one-off bounce in Irish real GDP in early 2015 that reflected the statistical impact of asset shifts of major multinational corporations in Ireland and not a change in underlying growth dynamics. Source: Eurostat, ONS, BEA.

Chart 2: Stock market valuations and world trade are up

Monthly data, annual growth of 3-month averages. Source: Wall Street Journal, CPB Netherlands Bureau for Economic Policy Analysis World Trade Monitor.

Reality check: what has changed so far this year?

Despite Q1 softness in the US the global economy started the year well

Fortunately, the first half of 2017 did not spring major negative surprises. Despite the usual first-quarter softness in the US GDP data, the global economy started the year well. On balance, we have even become slightly more optimistic than we were before. For the global economy, we now project 2.7% instead of 2.6% growth for 2017 while leaving the call for 2018 at 2.7%. A more detailed comparison of the calls we made in our Global outlook at the start of the year to our current forecasts reveals two significant changes (see Table 1).

Political gridlock in Congress is preventing faster fiscal change in the US

- First, we have downgraded our expectations for a meaningful US fiscal stimulus and reform package. Political gridlock in Congress and the antics of the Trump administration are preventing faster fiscal change. Instead of a major boost to be delivered in the summer of 2017, we now look for a scaled-down package to be passed in Q2 2018. As a result, we have reduced our forecasts for US GDP growth from 2.4% to 2.2% for this year and from 2.9% to 2.4% for next year.

The risks to calls for the Eurozone are tilted to the upside

- Second, the eurozone is surpassing our initial expectations. A strong start to 2017, a further gain in most leading indicators in Q2 and the fading of some political risks suggest that the eurozone will expand by 2.0% instead of just 1.5% in 2017 and by 1.8% instead of 1.5% in 2018. For both years, the risks to our calls are tilted to the upside.

Within the eurozone, our calls for Germany have changed only slightly, by 0.2ppts, for each of the two years. Instead, stronger growth for the region as a whole is driven largely by gains in France, Italy, Spain and Portugal. Whereas Spain and Portugal are benefiting from their earlier adjustment efforts during the euro crisis, France and Italy are reaping the first rewards of some recent reforms.

Firmer growth in the eurozone benefits its immediate neighbours

Firmer growth in the eurozone benefits its immediate neighbours. As a result, we have raised our forecasts for UK growth this year and next year by 0.1ppt. Due to the Brexit uncertainties, the risks to our UK calls are at least as much to the downside than to the upside. Among the major emerging markets in Europe, the new softness in oil prices is weighing on the outlook for Russia. We have lowered our growth forecasts for 2017 and 2018 substantially. Turkey, however, is coping with its political problems better than we expected. Partly due to a major fiscal and credit stimulus this year, Turkish GDP will likely expand almost twice as fast in 2017 than we had projected at the start of the year. Long-term risks are rising, though.

We now project Chinese growth to decelerate only modestly in 2017 and 2018

Outside Europe, we now project Chinese growth to decelerate only modestly in 2017 and 2018. In Japan, the impact of some reforms as well as firmer demand from China and other emerging markets is likely to lift growth to 1.3% this year after 1% last year.

Table 1: Growth forecasts: how have they changed so far this year?

		2016	2017			2018		
	Weight		New	Old	Change	New	Old	Change
World*	100.0	2.4	2.7	2.6	0.1	2.7	2.7	0.0
US	24.7	1.6	2.2	2.4	-0.2	2.4	2.9	-0.5
China	14.9	6.7	6.5	6.3	0.2	6.2	5.8	0.4
Japan	6.6	1.0	1.3	0.9	0.4	1.1	1.1	0.0
India	3.0	6.9	7.5	7.5	0.0	7.7	7.8	-0.1
Latin America	6.6	-1.2	1.5	1.9	-0.4	2.5	2.7	-0.2
Europe	25.4	1.7	2.0	1.6	0.3	1.9	1.8	0.1
Eurozone	15.8	1.7	2.0	1.5	0.5	1.8	1.5	0.3
Germany	4.6	1.8	1.9	1.7	0.2	1.8	1.6	0.2
France	3.3	1.1	1.6	1.2	0.4	1.7	1.3	0.4
Italy	2.5	1.0	1.2	0.8	0.4	1.1	1.1	0.0
Spain	1.6	3.2	3.0	2.6	0.4	2.8	2.4	0.4
Portugal	0.3	1.4	2.5	1.3	1.2	1.8	1.3	0.5
Other Western Europe								
UK	3.5	1.8	1.7	1.6	0.1	1.6	1.5	0.1
Switzerland	0.9	1.3	1.6	1.6	0.0	1.7	1.7	0.0
Sweden	0.7	3.1	2.7	2.4	0.3	2.4	2.1	0.3
Eastern Europe								
Russia	1.7	-0.2	1.2	1.6	-0.4	1.8	2.5	-0.7
Turkey	1.1	2.9	3.4	1.8	1.6	3.2	2.8	0.4

*At current exchange rates, not purchasing power parity. PPP estimates give more weight to fast-growing emerging markets and inflate global GDP. Weights based on IMF World Global Outlook statistics 2016 estimated GDP figures. Note: Forecasts 7 July 2017 (new) versus 3 January 2017 (old). As we have updated the country weights from a 2014 to a 2016 base in the meantime, the aggregates for World GDP and European GDP in this table may differ by 0.1ppt from those we published with old weights on 3 January 2017. Source: Berenberg

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US: steady growth despite policy uncertainty

The probability of a recession in the US is low despite the lengthy expansion

The US economy has expanded for eight consecutive years, but its average annual growth rate of 2% has been well below prior cycles. Despite the lengthy duration of the expansion, the probability of recession is low, insofar as potentially troublesome imbalances in the real economy or financial markets are not apparent and monetary policy remains very easy. On the other hand, there are few signs in current data that growth will break to the upside, despite the recent improvement in confidence. The political turmoil in Washington DC and the failure of the Republican-controlled Congress and Administration to achieve health care reform suggest the prospects of any pro-growth tax and fiscal reforms have been pushed out until 2018. Accordingly, we forecast real GDP to grow by 2.2% annualised in the second half of the year. Based on the expectation of an enactment of tax and fiscal reform in spring 2018, we project real GDP to grow by 2.4% in 2018, with an acceleration in the second half.

Fundamentals are favourable with healthy gains in employment

Private consumption, the engine of the US economy that accounts for almost 70% of output, will continue to support GDP growth. Fundamentals are favourable, with healthy gains in employment having pushed the unemployment rate to a 16-year low, which combined with modest wage gains has generated solid gains in real disposable income (Chart 3). Low prices of oil and energy increase consumer purchasing power. Household net worth has accelerated, reflecting strong stock and bond markets and rising home prices (Chart 4). Consumers fundamentally have been more cautious since the financial crisis and "Great Recession", spending a bit less of disposable incomes. The resulting higher rate of personal saving provides a buffer in case of an adverse shock (see "US consumer spending outlook solid"). Fiscal reform would benefit households primarily through individual income tax cuts, but any boost is likely to be temporary and modest.

Residential fixed investment has lots of room to grow

We project that residential fixed investment will continue on its upward trajectory and has lots of room to grow. It is still 30% below its pre-recession peak, and both cyclical and demographic factors are favourable for housing activity. Strong population growth in the key age cohort of 25-34 will lift new household formation. Low mortgage rates, low unemployment and rising wages, and a depleted housing stock will support new residential construction (see US housing market: plenty of room for improvement).

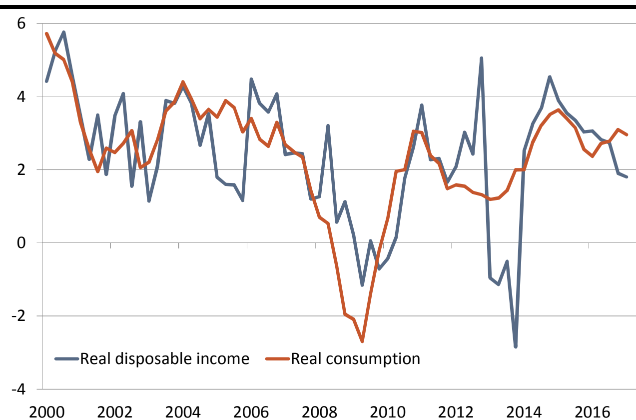
Sustained robust growth in business investment will not happen without reforms

Throughout the expansion, business investment has been the biggest disappointment. Despite the Fed's aggressive monetary ease and low real costs of capital and strong profits, businesses have saved and been reluctant to invest and expand. In part, this reflects the modest growth in the economy and the changing structure of many industries. But government tax and regulatory policies have added to business operating costs and uncertainties, and deterred business expansion plans. Business investment rose at a healthy clip in the first half of 2017, but without tax and regulatory reforms, sustained robust improvement is not expected.

The Trump administration has toned down its vitriolic anti-trade rhetoric

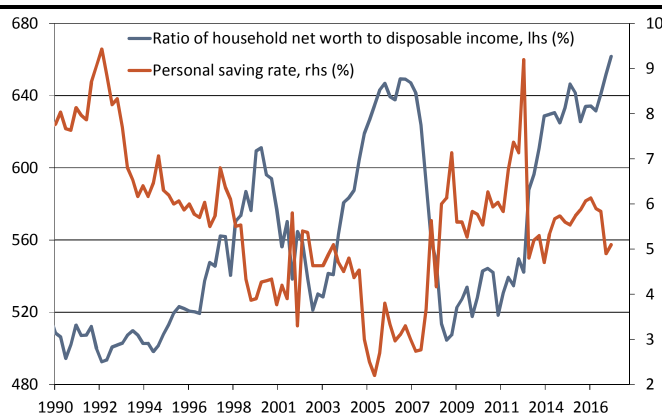
Improving global growth – and dollar depreciation – will boost activity in export-related sectors and drive corporate profits (see Synchronized global growth and profit gains and Positive trends in international trade). The risks, as usual, stem from protectionist measures, but the Trump administration has toned down its vitriolic anti-trade rhetoric and so far has pursued fairly standard approaches to trade negotiations.

Chart 3: US - incomes versus consumption (yoy %)



Quarterly data. Source: BEA

Chart 4: US - household savings and net worth



Quarterly data. Source: BEA, Federal Reserve Board

The dollar depreciation in 2017 may push up domestic prices in the medium term

Inflation has remained soft, despite the very low unemployment rate and mounting anecdotal signs of tightening labour markets (Chart 5). Besides the drag from the renewed drop in energy prices, the weakness has occurred in broader core categories. Although modest increases in wage compensation have exceeded weak productivity gains and pushed up unit labour costs, aggregate demand for all goods and services has remained modest (as reflected by the moderate but non-accelerating rate of nominal GDP growth), which has constrained product prices (Chart 6). In addition, technological changes have suppressed prices of select goods. Durable goods prices have been falling for 20+ years straight. Recently, innovations and efficiencies in retail distribution and in select services are beginning to place downward pressure on prices of other goods and services. The dollar depreciation this year may push up domestic prices in the medium term.

The Fed is likely to gradually raise rates

In this environment, we expect the Fed to gradually raise rates and begin to implement its strategy of passively unwinding its bloated balance sheet. We expect the Fed will no longer reinvest all the maturing assets in its portfolio beginning in September, and raise rates in December 2017. That would lift the Fed funds rate target to 1.25-1.5% by year-end. We forecast three Fed rate increases in 2018, subject to fiscal policy deliberations.

The fiscal policy debate will likely fill the legislative calendar in H2 2017

Washington deliberations on tax policy are a mess. This is contrary to what we had initially expected in light of Republicans controlling both chambers of Congress and the Administration. A flawed strategy of sequencing – putting health care reform as the top priority – was a big mistake and has delayed prospects for tax reform. The fiscal policy debate is starting to fill the legislative calendar in the second half of 2017. Congressional budget and tax committees and the many appropriation committees must debate the fiscal year 2018 budget before the new fiscal year begins on 1 October. This will be difficult in light of the Trump administration's proposals for sharp cuts in discretionary spending programmes and increases in defence appropriations. Around the same time, the government's debt will probably rise to the legislated debt ceiling, posing another obstacle for policy makers.

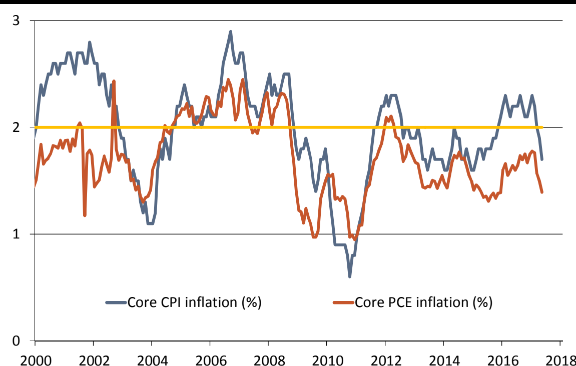
We still expect fiscal legislation before the 2018 mid-term elections

These deadlines leave insufficient time for Congress to adequately debate tax reform, and push out to spring 2018 the expected enactment of tax reform (see "US tax reform – expect delays"). We still expect fiscal legislation because Republican leaders recognise the need to pass such reforms prior to the mid-term elections in November 2018. But with the growing likelihood that the tax cut provisions of the health care reform legislation are modified, subsequent tax reform seems likely to be less-than-comprehensive.

Both political parties see the need to modernise the US infrastructure

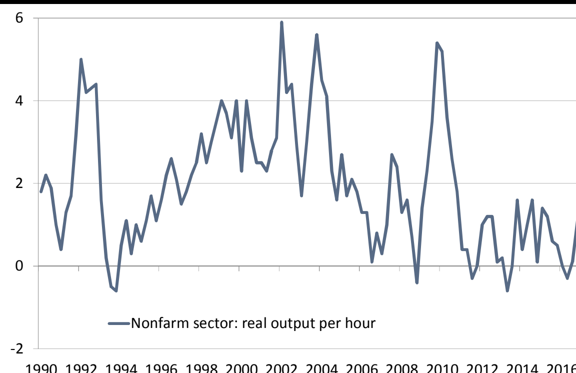
Furthermore, any new legislation that increases budget authority on investment in infrastructure spending is unlikely to be as sizable as advertised. The Trump administration has yet to provide details of its infrastructure programme, how it would be financed and how it would be administered. Both political parties see the dire need to modernise the US infrastructure, so a plan will eventually be agreed upon but, facing budget constraints, its financing is critical.

Chart 5: US – core inflation (% yoy)



Monthly data. Source: BEA, BLS

Chart 6: US – productivity (yoy %)



Quarterly data. Source: BLS

China: slower, but still fast growth

China's rapid growth has been associated with rapid growth in credit

China's economy has been expanding close to 7% yoy, a bit faster than the 6.5% target growth rate established by China's leadership for 2017. Such a rapid sustained performance has been associated with rapid growth in credit provided by the government's stimulus and credit programmes. Rising concerns about the bulging credit expansion and a rapid rise in home prices—an index indicates prices have risen by 18.9% year-on-year – have led the government and People's Bank of China (PBoC) to take steps to rein in money and credit growth. These efforts are expected to moderately slow economic growth in the second half of 2017 to approximately 6.4%.

Exports have been boosted by the decline in the trade-weighted yuan

China's growth has been supported by some positive fundamentals. Importantly, China's international trade volumes have reaccelerated sharply: in the year through May, exports have risen by 15.7% while imports are up by 22.3% (Chart 7). These accelerations follow three years of flat exports and declining imports. Exports have been boosted by the decline in the trade-weighted yuan – it has fallen by 9.7% since Q4 2015 (Chart 8) – and improving global economies (please see Synchronized global growth and profit gains, 1 June 2017). This has reinvigorated China's export-oriented manufacturers and increased the demand for imports of industrial material and capital goods. The Export Leading Index, a composite indicator used to predict exports several months out, is up sharply. Nevertheless, the recent pace of growth in international trade is likely to simmer down.

The lower price of oil and energy is a big plus

Domestic demand has continued to grow at a strong 7% pace, driven by a 10%+ growth in consumption. Consumer confidence and consumer expectations have risen to very high levels, based on surveys conducted by the National Bureau of Statistics of China. The housing sector remains strong. The lower price of oil and energy is a big plus for China. It increases consumer purchasing power and reduces business operating costs. On the negative side, business investment spending growth has decelerated sharply.

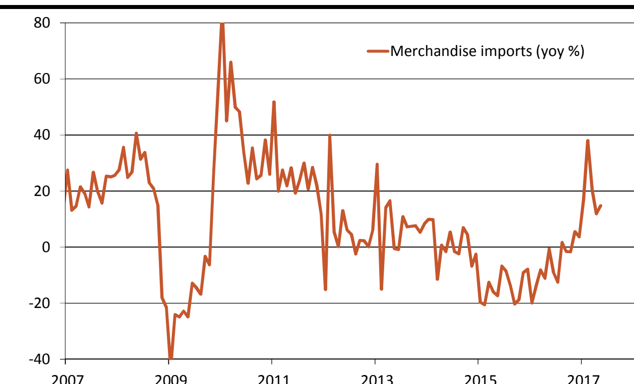
China's potential growth is slowing as it becomes more advanced

The broader issue is that China's potential growth is slowing. China's growth has been three times faster than the average growth in advanced nations and now that it is the second largest economy in the world a slowdown should be expected. One key factor that has contributed to estimates of gradually slowing potential growth is its sharp rise in unit labour costs in recent years, which has cut into China's international competitive advantage. China clearly faces longer-run challenges posed by excessive credit growth, but in the next several years debt burdens will be manageable, supported by rapid growth in national income (nominal GDP growth has averaged 8% annualised) and, if necessary, government intervention. Accordingly, a jarring debt crisis in the intermediate term remains a low probability.

Achieving real GDP targets that China's leaders set too high carries risks

Achieving established real GDP targets that China's leaders set too high requires excessive government-financed investment (like infrastructure) and too much credit creation. Gradually reducing real GDP targets to levels consistent with realistic estimates of potential growth, which is what we expect, would ease pressures on credit growth and reduce misallocation of national resources.

Chart 7: China – annual change in merchandise imports (%)



Monthly data. Source: China Customs, Berenberg calculations

Chart 8: China – trade-weighted yuan (real broad)

Monthly data. Source: JP Morgan, Haver

Japan: healthy performance to continue

Japan has enjoyed the longest sustained period of economic expansion in 10 years and its outlook has brightened. Real GDP has risen for five consecutive quarters at an annualised pace of 1.5%. Sounder fundamentals underlie improving economic performance. We project real GDP to grow at a 1.1% pace through to 2019, slightly above upwardly revised estimates of potential growth. Earlier worries about deflation have dissipated and inflation is very low and expected to persist.

Sounder fundamentals underlie Japan's improving economic performance

Private consumption has been rising at a fairly steady rate, and is beyond the traumatic 5% decline following the sizeable increase in VAT in spring 2014. Retail sales, particularly of motor vehicles, have been strong recently. Household primary incomes have risen by over 1.5% since 2015, well above inflation. Employment has increased fairly rapidly and real wages have also been on the rise. At the same time household disposable incomes are registering gains – the strongest since before the deep recession in 2008-09 – and household net worth is increasing, reflecting strong increases in home values (the residential property price index has risen 4.5% in the last year) and the Nikkei (up by over 25% from its mid-2016 lows) (Chart 9).

Household net worth is increasing, reflecting strong gains in home values

Although Japan's demographics are negative – its population is declining at a very gradual rate – employment and the labour force have improved markedly. Most importantly, the labour force participation rate of women has been rising, reflecting the positive responses to initiatives of the Abe administration. In the last year, employment gains (1.2%) have been outpacing growth in the labour force (1%), resulting in a decline in the unemployment rate to 2.8% (Chart 10), and the lowest unemployment rate since the mid-1990s.

The labour force participation rate of women has been rising

Business investment and production are also on upward trajectories. Exports of Japanese goods have increased by 12.1% in the last year, rebounding from a 1.5 year decline. Business investment has risen by 4.1%. Reflecting these trends, Japan's corporate profits have risen by a robust 17% in the last year and rose again in Q1 2017. Improving global economies, particularly China's ongoing strength, and expected continued gains in domestic demand support expectations for further increases in corporate profits.

Business investment and production are also on upward trajectories

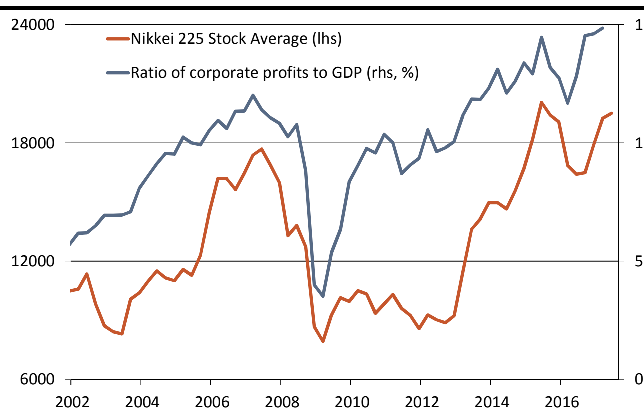
In response to the pick-up in growth and particularly the marked increase in the labour force, the Bank of Japan (BoJ) has bumped up its estimates of potential growth from 0.5% to a new 0.8-1.0% range. Faced with healthy growth and very low inflation – but no longer deflation – the BoJ will probably continue its aggressive quantitative-qualitative easing (QQE), purchasing the equivalent of more than 100% of the newly issued government bonds. However, we expect the BoJ will eventually loosen its yield curve control (YCC) policy that currently anchors the yield of 10-year Japanese government bonds to 0%.

The BoJ has bumped up its estimates of potential growth from 0.5% to around 0.9%

The Nikkei has risen to reflect improving profits – it is up by 3% year-to-date following a robust 15% rise in Q4 2016. We expect sustained economic expansion, healthy export growth and more progress on corporate restructuring, along with the BoJ's QQE to support further increases in the Nikkei.

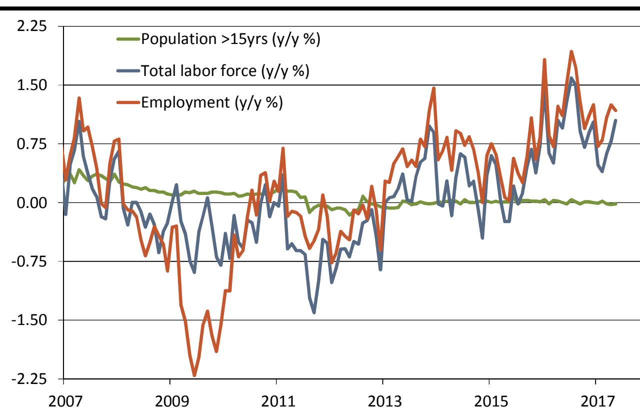
The Nikkei has risen to reflect improving profits

Chart 9: Japan – stock market performance versus profits



Quarterly data. Source: Japan Ministry of Finance, Cabinet Office of Japan, Nikkei and Berenberg Capital Markets

Chart 10: Japan – measures of labour market performance



Monthly data. Source: MHLW, MHLW/H, Berenberg calculations:

Eurozone: a firmer recovery

Goldilocks has made continental Europe her new home for the time being

Not too hot, not too cold. Since spring 2013, the eurozone has enjoyed a gradually firming expansion of output. In the first half of 2017, the pace of growth seems to have picked up further to roughly 2%. Although this is now well above the 1.5% trend rate, inflationary pressures remain subdued. We still detect no signs of exuberance. Instead, Goldilocks seems to have made continental Europe her new home for the time being. We look for steady growth of close to 2% with only a gradual uplift in core inflation over the next two years. The risks to our growth forecasts are tilted to the upside. The broad nature of the recovery shows up in three different ways:

First, all major aspects of economic policy are supporting growth.

Parts of the eurozone are reaping the benefits of recent structural reforms

- Monetary policy remains highly accommodative. Deflated by the average core CPI so far this year, the real ECB refinancing rate stands at -1.0%. In response, credit growth is picking up gradually.
- Fiscal policy is adding a modest stimulus of 0.1ppt of GDP to demand growth per year. Austerity has been over since 2015.
- The exchange rate is still helping a little. The real effective exchange rate versus 38 major trading partners remains 1.5% below its five-year average.
- Parts of the region are reaping the benefits of recent structural reforms. While this holds especially true for Spain, Cyprus and Ireland, Italy and France have also started to benefit.

GDP is expanding across almost all countries

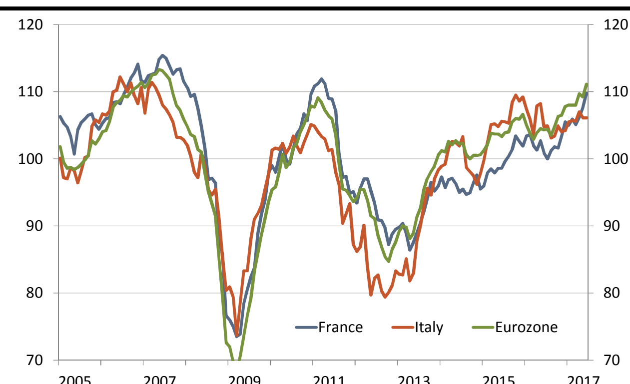
Second, GDP is expanding at a robust pace in almost all eurozone countries (see Chart 11) with the exception of Greece, where the government has not yet implemented reforms energetically enough to rebuild the confidence that Alexis Tsipras had shattered in 2015.

Fundamentals and confidence surveys signal a chance of modestly firmer gains ahead

Third, all major pillars of demand are contributing to the upswing. Significant gains in employment (up by 1.3% in 2016) support real income growth and consumer confidence. Having partly saved the oil price windfall in early 2016, consumers seem ready to offset the fading of the oil price tailwind by reducing their savings rate a little as the employment outlook in the service sector has improved (Chart 12). Private consumption is increasing at an annual rate of around 1.7% in the eurozone, while government consumption continues to expand at a similar rate, reflecting the modest fiscal stimulus. Construction and machinery investment are also rising. Economic fundamentals and confidence surveys signal a chance of modestly firmer gains ahead. After some volatility in early 2016 caused by the emerging market crisis, the export outlook has improved. In the EU Commission's sentiment survey, the sub-index for export orders in manufacturing rose to -1.5 in June. That is well above the long-term average of -18.6 and the best reading since May 2011. As a result, order books in industry are fuller than they have been at any time since early 2008 (see Chart 12).

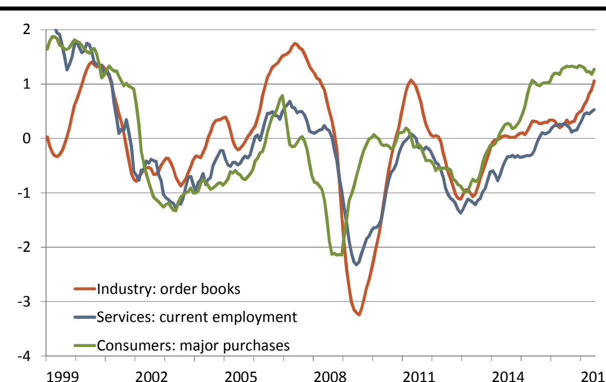
The upswing is based on virtually all countries and sectors of the eurozone and supported by monetary and fiscal policy, as well as structural reforms and a competitively valued exchange rate. It would, therefore, take a major economic or political shock to derail it.

Chart 11: Eurozone – broad-based upswing... across countries



100 = long-term average. Source: European Commission.

Chart 12: ...and across sectors



Volume of order books in manufacturing industry, current employment in services, major purchases at present in consumer sentiment survey, standard deviations from long-term average, three-month moving averages. Source: European Commission.

If in doubt, the ECB will follow the US Fed and err on the side of caution

For the time being, inflation poses no major risk to this outlook. Abstracting from the short-term volatility which calendar effects exert on the prices for package tours, core inflation has drifted up to 1.0% in the last few months after oscillating around 0.9% in the past four years. Most observers, including us as well as the ECB, are looking for a further gradual increase. Over the last six years, however, core inflation has usually come in lower than we and the ECB had projected. That underpins one key conclusion: if in doubt, the ECB will follow the US Fed and err on the side of caution, reducing its stimulus only when the data clearly point that way.

We look for the first ECB rate hike in 2019

We expect the ECB to move towards the exit from its ultra-loose policies at a snail's pace. Responding to solid growth, the ECB has already dropped part of its dovish guidance. The bank no longer sees risks to growth as tilted to the downside and is no longer suggesting that it may cut rates further. We look for the ECB to announce in autumn 2017 a gradual reduction of asset purchases starting in January 2018. After the likely end of such purchases in the autumn of 2018, the first ECB hike in the refinancing rate may follow in 2019.

An abrupt and sustained surge in core inflation does not seem to be on the cards

Recent market concerns that the ECB may choke off the economic recovery by scaling back its stimulus too early should be largely self-correcting. If any resulting rise in bond yields or the exchange rate would be grave enough to potentially impair the outlook for growth and inflation, the ECB would simply maintain its full monetary stimulus for longer. We see no need to worry about that. The ECB will do all it can to keep the economic recovery and, hence, the outlook for employment as well as corporate profits, on track. The one accident that could force the ECB to scale back its stimulus fast, namely an abrupt and sustained surge in core inflation, does not seem to be on the cards.

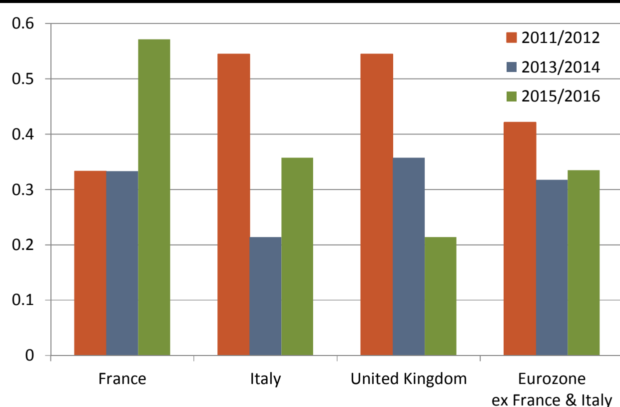
Macron could transform France like Thatcher reformed the UK

More growth for the eurozone, a golden decade for France: France's new president, Emmanuel Macron, has vowed to implement a key reform, a bundle of measures to make the labour market more flexible, by the end of September 2017. His fresh mandate and his solid parliamentary majority give him a unique opportunity to deliver and brave the inevitable street protests. If so, he could transform France like the Thatcher reforms cured the erstwhile sick man of Europe, the UK, some 35 years ago and like the "Agenda 2010" reforms turned Germany from one of the weakest into one of the strongest economies in Europe almost 15 years ago. As economics minister from 2014 to 2016, Macron already advanced France close to the top of the European reform league as measured by the OECD (see Chart 13). Firming economic growth and rising employment in France and across most of Europe provide a favourable backdrop.

Reforms can raise trend growth by 0.3ppt in France

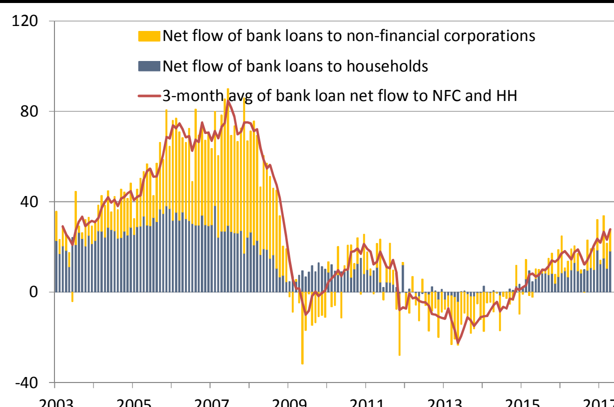
Macron's reforms can raise trend growth by 0.3ppt in France and hence by almost 0.1ppt in the eurozone. We maintain our view that, after the reforms which we expect Macron to implement, France could turn into the strongest of all major economies in Europe in the next decade, outclassing a Germany that is resting on its laurels and a UK that is impairing its long-term growth prospects by losing (some of) its preferential access to its major market, the EU.

Chart 13: Europe – responsiveness to OECD reform proposals



Responsiveness to OECD's Going for Growth reform recommendations. Average results for 2011/12 and 2013/14 and for 2015/16. Source: OECD

Chart 14: ECB policy at work: the credit cycle has turned up



Net flow of bank loans, in bn; from February 2009 onwards adjusted for loan sales, securitisations and notional cash pooling. Net flows to non-financial sector are 3-month moving average. Source: ECB.

UK: stable outlook if Brexit risks are avoided

Brexit uncertainty will lead to caution on decisions with long-term implications

Despite the unhealthy environment of heightened political and economic uncertainty linked to Brexit, real GDP growth is likely to continue to expand at a reasonable pace over the medium term, driven by resilient domestic demand and an improving external backdrop. Uncertainty stemming from Brexit will lead to caution in all areas of spending and policy that will have long-term implications. We forecast real GDP growth of 1.6% in 2018 and 1.7% in 2019, slightly below the UK's post-Brexit potential rate of c1.8%.

Households are still coping well in a tough environment

Households are still coping well in a tough environment. The downside risks to near-term demand that many in markets had predicted immediately after the Brexit vote have not manifested in a serious way. Sentiment among households and firms remains upbeat. The key components of domestic demand, consumption and business investment, are likely to continue to expand modestly even as the UK adjusts to Brexit.

Households can temporarily rely on their balance sheets to smooth consumption

Import costs jumped at the start of 2017 following the 15% depreciation in trade-weighted sterling after the Brexit vote, causing a temporary decline in real incomes. But household demand has continued to expand – albeit at a slower pace. Household fundamentals have strengthened during the post-Lehman expansion. Real household income and real net wealth are around 30% higher than the pre-crisis peak. Households can afford to temporarily rely on their balance sheets to smooth consumption as real incomes fall, saving less and borrowing a little more than before to target a level of real consumption growth.

The major risk to household spending comes from falling house prices

In 2018 and 2019, as inflation slows and nominal wage growth accelerates, households will see real incomes begin to grow modestly again. This should drive a sustainable acceleration in real consumption growth toward the end of our forecast horizon. The major risk to household spending comes from falling house prices. The bulk of household assets and liabilities are linked to the housing market. A nationwide fall in house prices would place significant stress on household balance sheets.

Even modest declines in house prices could negatively affect consumption

Historically, house prices and household consumption have tracked closely at a ratio of around four to one. A 10% rise in house prices yoy would normally imply 2.5% growth in consumption. Even modest declines in house prices could affect the regular spending habits of homeowners who are highly leveraged. A country-wide fall in house prices would probably cause a recession. But this remains a fairly remote prospect (less than 20% risk).

Excess demand in the housing market

While measures of house price growth show a softening since the UK voted to leave the EU some 12 months ago, much of the weakness is concentrated in the prime London market that saw considerable price growth during the upswing. Foreign demand for London property has dropped amid Brexit uncertainty and the introduction of higher taxes on second buy-to-let mortgages in April 2016. Outside of the capital, market conditions remain stable. Measures of supply and demand are healthy and excess demand supports continued modest increases in house prices.

The weaker sterling reflects markets lowering their estimates of potential growth

Growth is rebalancing somewhat: Trade-weighted sterling is c18% below its November 2015 peak. This reflects markets lowering their long-term estimates for UK growth. Through its impact on trade, the more competitive exchange rate is helping to reduce the UK's current account deficit. The cheaper sterling makes UK exports more competitive on the global market. Along with the cyclical upturn in global demand – especially in the EU27 – UK exports orders have picked up sharply since the Brexit vote. In addition, the higher price of imports will reduce demand for them by encouraging UK households to substitute towards domestic products. With sterling expected to remain below its fair value versus the currencies of the UK's major trading partners, we expect the UK's current account deficit to fall from its 4.4% of GDP in 2016 to 2.0% of GDP in 2019.

Firms are likely to continue to invest and hire at a cautious pace

Amid low levels of slack in the labour market and high levels of capacity utilisation, UK firms are in a bind. If they worry too much about Brexit, and choose not to hire and invest to increase production, they risk missing out on the continued expansion of domestic and foreign demand. To avoid that risk, firms are likely to continue to invest and hire at a cautious pace. We expect real capital spending growth of around 1.5-2.5% per annum – still well below the 3.3% yoy post-Lehman average. Meanwhile, as unemployment falls towards 4.5% by late 2018, nominal wage growth can pick up modestly to 3-3.5% yoy from the current low growth rates of around 2-2.5% yoy.

With little slack in the economy, domestic inflationary pressures will prevent headline inflation from returning to the 2% target after the imported inflation passes. Core inflation has risen sharply in recent months in response to bottlenecks caused by resilient demand growth and caution by firms increasing supply. We expect headline inflation to remain above the BoE's 2% target beyond the end of 2019.

We expect headline inflation to remain above 2% target beyond the end of 2019

Keep an eye on the BoE: Communicating its policy guidance amid lower long-term growth adds to the BoE's set of challenges. We look for a first hike of 25bp in Q4 2017. Although we expect the BoE to wait for evidence that the economy holds up in Q3 after the election we see some chance – 25% – of the first hike coming in Q3. A continued tightening thereafter will be very, very gradual. We look for two more hikes in 2018 and one further hike in 2019.

Communicating its guidance amid lower long-term growth adds to the BoE's challenge

The hung parliament lowers the risk of a hard Brexit: The recent snap election has changed the Brexit calculus in a positive way. Before the election, medium-term uncertainty was low, but the long-term economic risks from a hard Brexit loomed large. We had expected the UK to focus on controlling migration and thus lowering the scope for a comprehensive trade agreement with the EU. In our base case, with modest limits on the number of EU migrants and a UK-EU trade deal that covers goods and most non-financial services, UK trend growth would fall to 1.8% from 2.1% pre-Brexit. In case of a hard Brexit, trend growth could fall to 1.5%.

The recent snap election has changed the Brexit calculus in a positive way

Now, the hung parliament election outcome resulting in the fragile alliance between the Conservatives and the Northern Irish DUP has strengthened the pro-EU versus the EU-sceptic forces inside Westminster. We reduce the risk of a hard Brexit from 40% to 30%. While the election result raises the prospect of a softer Brexit – lower restrictions on migration and a more comprehensive trade deal – it has also increased medium-term uncertainty. If the Tories manage to rule with the Northern Irish DUP, as they are trying to do, the government will need support from virtually all Tory and DUP MPs to pass key votes in the House of Commons.

We reduce the risk of a hard Brexit from 40% to 30%

While the political uncertainty coming from the fragile government creates additional downside risk in the near term, by limiting the scope for a damaging Brexit deal, risks to long-term growth are less skewed towards a hard Brexit than before. However, since Brexit negotiations are yet to begin in earnest, there is no clear evidence that UK is heading for a softer exit yet.

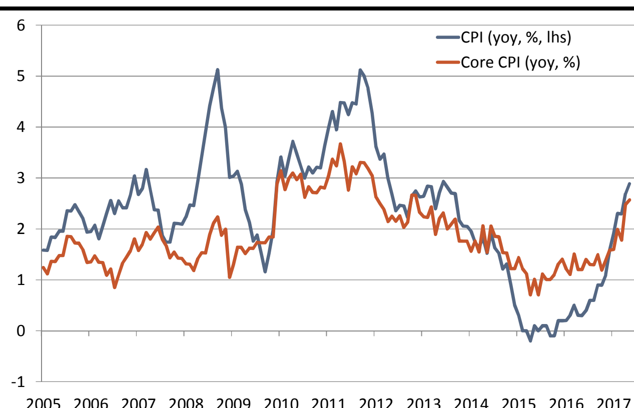
Brexit could reduce UK trend growth to 1.8% from 2.1% before Brexit

Currently, the UK is at the top of the mountain in terms of risks and uncertainty. It is therefore unsurprising that the market currently takes a negative view on the UK. In a year's time, if the Brexit negotiations point to a soft rather than a hard Brexit and if domestic demand holds up, the markets could begin to view the UK in a more positive light.

If Brexit negotiations go well the markets can begin to view the UK in a more positive light

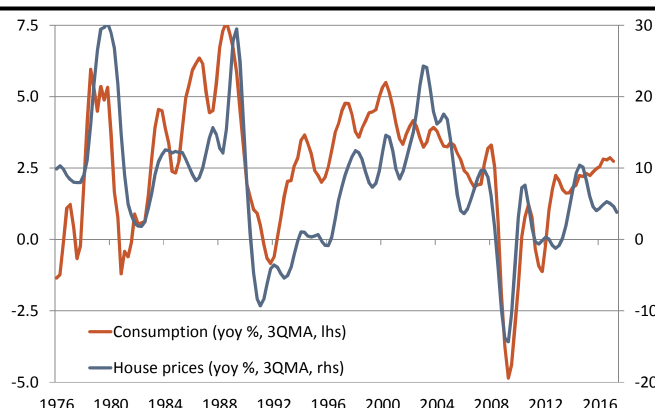
For more analysis on the outlook for Brexit, please see our note from the 20 June 2017, [Analysing Brexit: the options and outlook]().

Chart 15: UK – headline and core inflation (% yoy)



Monthly data. Source: ONS, Berenberg calculations

Chart 16: UK – house prices versus real consumption (% yoy)



Quarterly data. Source: ONS, Nationwide, Berenberg calculations

Emerging Europe

Russia: the economy is slowly recovering but weak oil price is dangerous

GDP outlook improving but downside risks amid the low oil price

Russia's economy is slowly recovering from the drop in GDP last year and in 2015. In Q4 2016, real GDP expanded yoy for the first time since the end of 2014. In Q1 2017, GDP rose by 0.5% yoy after 0.3% in Q4 2016 amid an increase in household consumption and investment. We expect growth of 1.2% for 2017 and 1.8% in 2018, driven mainly by domestic demand. However, the downside risks to this positive scenario have recently increased as the oil price fell to new ytd lows in mid-June. Russia relies heavily on energy exports. The oil price is a key determinant of its economic performance; every USD10/bbl increase raises GDP growth by c1.3ppt. The latest leading indicator readings – such as the PMIs – show the fragility of the recovery. Chart 17 shows how volatile Russian GDP is in USD terms (from -35% yoy in 2015 to +27% yoy in Q117)

Trump won – but Russia did not receive any sanctions relief

The combination of low oil prices and the failed hopes that Trump would pursue a more pro-Russian agenda – by removing economic sanctions – caused a sharp decline in Russian equities in 2017 ytd. Together with Qatar, Russia is the worst performer in 2017 ytd among the major global indices. Another political risk remains the Syrian conflict, where the US and Russia recently had a major argument about the shooting down of a Syrian fighter jet.

The CBR managed to bring inflation under control, more rate cuts to follow

The Central Bank of Russia (CBR) reached its inflation target of 4% in Q2 2017. Inflation has fallen from 15% in 2015. The CBR used this opportunity to cut the key rate from 10% in March 2017 to currently 9%, but there is room for significantly more rate cuts as the real interest rate is still around 5%, one of the highest in the world. Furthermore, faster rate cuts would help to weaken the RUB which would be positive for Russian GDP growth. We expect that the CBR will cut the key rate to 7% towards the end of the year. The government's budget deficit was cut in half in 2017 ytd versus the same period in 2016 and the Finance Ministry expects a 2.1% of GDP deficit in 2017 versus 3.9% in 2016. However, there is a risk that government spending will increase in H2 2017 ahead of the upcoming presidential election in March 2018.

Turkey: surprisingly resilient economy

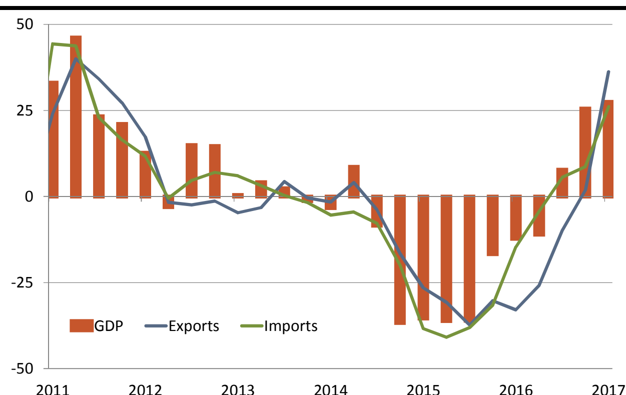
Turkey's economy profited from a large fiscal stimulus Lower oil prices underpin a recovery in economic confidence

Turkey's economy was on its knees in the third quarter of last year (-1.3% yoy) after a failed coup d'etat. However, the Turkish government successfully introduced short-term economic boosting measures such as: (1) temporary tax breaks, (2) increasing the size of its Credit Guarantee Fund more than tenfold and (3) boosting spending (public consumption rose by 9.9% yoy in Q1 2017) ahead of the April presidential referendum. This helped to turn around the economic momentum. GDP surged by 3.5% yoy in Q4 2016 and even more by 5.0% yoy in Q1 2017. Furthermore, the strong EU economy and weak Turkish lira boosted exports by 10.6% in Q1 2017, while imports rose by only 0.8% yoy.

Lower oil prices underpin a recovery in economic confidence

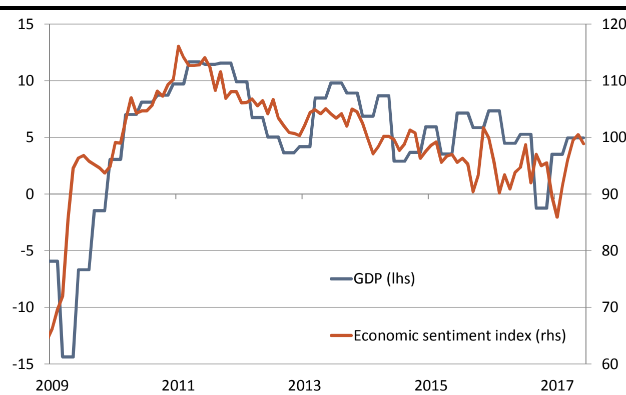
As Turkey has to import around 90% of its energy needs, the drop in the oil price over the last few months is a clear positive for the country's economy and inflation outlook. We expect inflation to peak this year at 10.6% but then to fall in 2018 back to 8.8%. Furthermore, leading indicators – such as consumer confidence and PMIs – have turned north recently, while the Turkish lira has stabilised following a large decline in 2016. We think that Turkey's economy will grow by around 3.4% in 2017 and 3.2% in 2018.

Chart 17: Russia - GDP versus trade (USD, yoy %, nominal)



Source: *Bloomberg*

Chart 18: Turkey – real GDP (yoy %, lhs) versus sentiment



Source: *Bloomberg*

Poland: strong consumer, strong economy

Employment and wage growth drive consumption higher

Poland's growth accelerated in Q1 2017 to 4.0% yoy from 2.7% in 2016. Similar to the other CEE economies, the economic upswing is driven by strong private consumption and, to a lesser extent, by rising exports. (Employment rose by 4.5% yoy in May while wages increased by 5.4%, indicating a significant rise in spending power for the Polish economy.) On a negative note, investments are still declining (-0.4% in Q1 2017 after -7.9% in 2016) amid a lack of EU cohesion funds so far this year caused by the cyclicality of those funds. We expect those funds to return later in 2017, supporting GDP growth (3.7% for 2017 and 3.6% in 2018).

The Czech Republic: full speed ahead

Blue sky scenario for the economy in the Czech Republic

The Czech economy had a great start into 2017, growing by 3.0% in Q1 2017. We expect 3.2% growth in 2017, up from 2.6% in 2016. The economy is driven by good momentum in household consumption and exports. The unemployment rate fell to 3.3% in Q1 2017 – the lowest rate in Europe. The budget balance is likely to be positive again in 2017 after the first fiscal surplus in decades in 2016 (+0.6% of GDP). The CZK appreciated versus the EUR after the Czech National Bank gave up the CZK27 versus EUR1 threshold. The appreciation will likely continue over the coming quarters. The stronger CZK and weak commodity prices have prevented CPI from rising too quickly, but the CPI level of 2.4% yoy in May remained above the 2.0% CNB target. It is a question of when, not if, the CNB will raise interest rates this year.

Hungary: flying high

Large fiscal boost and rising wages elevate GDP growth ahead of elections in 2018

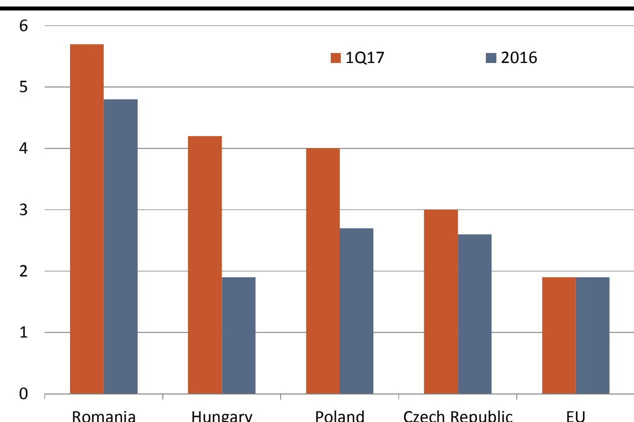
Ahead of the 2018 spring parliamentary elections, Hungary introduced the largest fiscal stimulus package in Europe in 2017. The package was worth c2% of GDP and included a cut to corporate income tax (CIT) to the lowest level in Europe, a significant rise in the minimum wage and a 5ppt cut to payroll taxes. It is not too surprising that, in Q1 2017, Hungary's economy expanded by 4.2% yoy, up from a 1.9% pace in 2016. For 2017, we expect real GDP growth of 3.5%. The economy is driven by huge wage increases (up 14.6% yoy in April) amid a significant labour shortage as well as a 30% yoy increase in investments in Q1 2017 supported by a low base effect. The current account reached a record surplus last year (5.5% of GDP in 2016) while the debt-to-GDP ratio fell from around 84% in 2010 to around 74% in 2016.

Romania: the fastest growing economy in Europe

Impressive GDP growth, but budget deficit needs to be watched

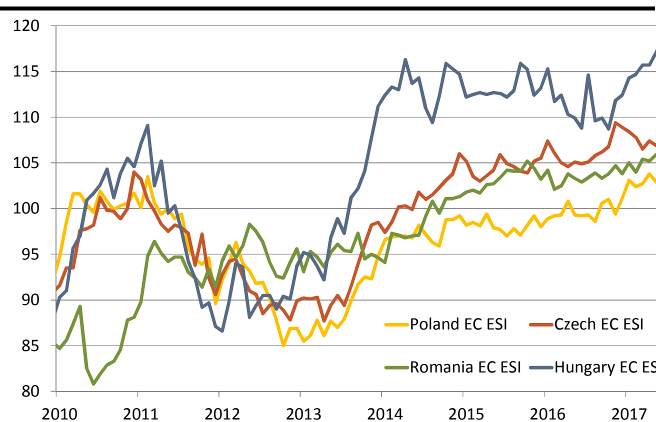
Romania's economy is going from strength to strength. After expanding by 4.8% in 2016, GDP growth accelerated in Q1 2017 to 5.7%, supported by a 7.4% yoy increase in households' consumption and 11.7% yoy increase in exports. Growth is driven by strong wage and employment rises. We expect at least 4.5% GDP growth in both years, but the risk to the downside has increased recently due to political developments. The leading PSD party forced the prime minister and his cabinet to step down after not even six months of being in power. This created political instability and uncertainty about the future fiscal programme and fight against graft, which could have a negative impact on investor sentiment, the budget deficit and the long-term growth potential. We see a risk arising from a budget deficit above 3% in 2017 or 2018 which could lead to a freezing of the all important EU funds, as the PSD promised significant social spending programmes. It has also created uncertainty about the tax income amid promises to cut personal income tax and possibly replace the corporate tax by a turnover based levy.

Chart 19 – CEE real GDP growth versus EU



Source: CEE: Central and Eastern Europe. Source: Bloomberg

Chart 20 – EC economic sentiment index on the up



Source: Bloomberg, European Commission

Latin America: favourable outlook

Economic performance in the Americas is picking up

Economic performance in the Americas is picking up. **Brazil**, Latin America's largest economy, has begun to stabilise following three years of deep recession during which real GDP fell by 9% and gross fixed capital formation fell by 27% (Chart 21). This contraction was self-inflicted, stemming from a loss of confidence related to government corruption and ineptness. Consumption and investment are still drifting lower, but a weakened currency is helping to stabilise exports. The recent corruption charges against President Temer add pressures on the rickety presidency and threaten to extend uncertainties that could forestall the economic recovery. Brazil's stock market fell and its currency depreciated further in H2 2016, but has stabilised in spring this year.

It will take Brazil years to recover from the recent economic devastation

The jury is out on how the corruption charges will unfold. If they simmer down – or if businesses and households take them in stride – the economy can grow modestly in 2017. While this would represent a significant turn from several years of sharp contraction, it will take years to recover from the recent economic devastation and an above 13% unemployment rate. And even if the government's latest corruption charges dissipate and credibility is restored, economic performance will be inhibited until much-needed pension and fiscal reforms are enacted and the inefficiencies of the government are reduced.

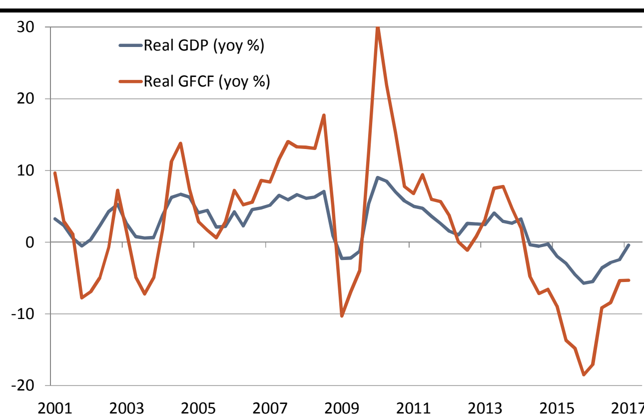
Argentina's economy is beginning to grow under reform-oriented leadership

Argentina's economy is beginning to grow modestly under the reform-oriented leadership of President Macri, following years of gross mismanagement that involved soaring inflation, sharp currency depreciation and a long-running sovereign debt crisis. The economic recovery is fragile, as the combination of fiscal restraint plus the central bank's disinflationary monetary policy is constraining domestic demand. We expect inflation to average approximately 22% in 2017, down sharply from nearly 40% in 2016. Inflationary expectations are receding—based on a survey conducted by the Central Bank of Argentina, inflation expectations for December 2018 are 15% and 10.2% in December 2019. These receding expectations of inflation are improving financial conditions and supporting consumption and investment. We forecast real GDP growth of approximately 2-3% in 2017, a marked turnaround from the abysmal performance in recent years.

Mexico's growth remains steady despite Trump's unfriendly posture

Mexico's economic growth remains surprisingly steady, despite the unfriendly posture toward the country by US President Trump. The Bank of Mexico has raised its policy rate in June, to 7%, up from 5.25% before the November 2017 US election. Inflation has jumped to over 6% from 2.6% a year ago, in direct response to the post-US election collapse in the Mexican peso. But the Bank of Mexico's strategy has been working: the Mexican peso has appreciated significantly back to 18 per US dollar, even stronger than its pre-US election level (Chart 22), and inflationary expectations have remained moderate. As a consequence, following a spike in bond yields in November-December 2016, yields have receded to 3.6%.

Chart 21: Brazil – annual change in real GDP and investment (%)



GFCF: gross fixed capital formation. Quarterly data. Source: Instituto Brasileiro de Geografia e Estatística, Berenberg calculations

Chart 22 Mexico – new peso/USD spot exchange rate

Daily data. Source: Wall Street Journal

US trade policy presents risk to the outlook for Mexico's trade

The Bank of Mexico's aggressive rate hikes will constrain inflation, which is likely to fall back below 3%, but probably will dent domestic demand. Fortunately, the Trump administration seemingly has backed off its earlier threats to dismember NAFTA. Trade negotiations will likely be relatively narrowly focused and will not unduly harm trade between Mexico and the US. In fact, since the US elections, Mexico's trade volumes—exports and imports--have risen modestly internationally and also with the US. A continuation of these trends would facilitate further economic expansion in Mexico. Obviously, however, this favourable outcome hinges on a more mainstream approach to international trade on the part of the Trump administration.

India: sustained strong growth

India continues to grow rapidly, slightly outpacing China

India continues to grow rapidly, by more than 7% year-over-year, which is somewhat faster than China. We expect that trend to continue. India's real GDP per capita based in US dollars has been rising rapidly—over 50% in the last 10 years--but at $1,750 is roughly one-quarter of China's real GDP per capita. India's economic future is bright.

India can benefit from a simplification of its tax policies

India is benefiting from the gradual reforms being implemented under Prime Minister Modi. The new Goods and Services Tax, implemented on 1 July following 10 years of legislative deliberations, is a type of consumption levy that replaces a web of different taxes and fees imposed by various governmental levels. This change is aimed at simplifying the tax system, improving tax compliance and reducing double taxation of some activities. This would be positive for the economy.

Reducing the reliance on currency can help to curb some of India's corruption

Innovations in financial and personal record keeping that rely on digital identities and mobile phones, as well as medical and employment records, for financial transactions, along with phasing out most (86%) of its currency notes, are contributing to rising standards of living and helping to generate efficiencies in government bureaucracies. The reduced reliance on currency will make more transparent some of India's corruption and pave the way to reducing it.

India faces many challenges, but further economic progress is anticipated

Gross fixed capital formation has been increasing, including government investment in infrastructure. Both consumers and businesses benefit from lower prices of oil and energy. Obviously, India faces many challenges and improvement has a long way to go, but further economic progress is anticipated.

Inflation: limited risks for advanced economies

Inflation rates across advanced economies have been volatile since 2008

Inflation rates across advanced economies have been unusually volatile since the Global Financial Crisis. The most recent period of such volatility began in 2014 when increased oil production by US shale caused global oil prices to fall by 60%. Although headline inflation temporarily dropped below zero in some advanced countries in 2016, triggering – exaggerated – deflation worries, the net effects were positive. The current upswing in demand is partly thanks to the boost to real incomes from the low inflation in 2015/16.

Underlying inflationary pressures across advanced economies remain modest

Although headline inflation rates have drifted up in 2017 as the effects of the drop in the oil price have faded, underlying inflationary pressures across advanced economies remain modest in most places. Across the developed world there are no major signs of excessive growth in labour costs or major capacity constraints that would lead to a sudden surge in inflation. Instead, a continued expansion in real GDP at close to trend rates for major economies will continue to gradually eliminate remaining slack, causing underlying inflation to gradually tick up over the coming years. Note that this outlook is predicated on no major volatility in the price of oil and other commodities over the forecast horizon.

In the eurozone, inflation will remain below 2% through to 2019

Economies with more advanced recoveries, such as the US and UK, have relatively stronger domestic inflationary pressures relative to the eurozone – Chart 23. As Chart 24 shows, the estimated output gap – the difference between aggregate demand and aggregate supply – is largest in the eurozone where the economic recovery is some three years behind the US and the UK. With yoy percentage wage growth hovering at around 1-1.5% in the eurozone over the past year, core inflation has remained broadly unchanged at close to 1%. Even as unemployment falls below 8% by 2019 from its current rate of 9.3%, headline inflation will likely remain below the ECB's target of close to but below 2%, all the way out to 2019.

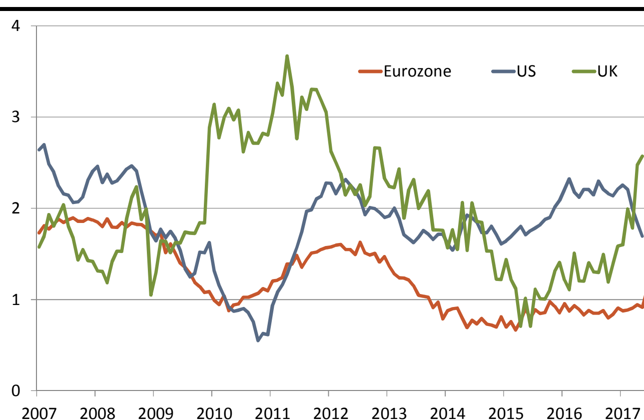
US inflation risks are skewed to the upside if fiscal policy is misdirected

In the US, inflationary pressures have eased a little since the start of the year due to lagged effects of price dollar appreciation and peculiar factors such as price-wars in the cell phone sector and declines in prescription drug prices. Looking ahead, underlying inflationary pressure will rebound from its recent dip as tight labour market conditions cause wage growth to pick up a little from current rates of around 2-2.5%. If the Fed continues to gradually tighten its monetary policy, with three hikes per year in 2018 and 2019, headline inflation will likely remain close to the Fed's 2% target over our forecast horizon. But risks to the longer-run outlook are skewed to the upside if the Trump fiscal policies simply raise demand rather than boost the US's supply potential.

The BoE may be too cautious – the UK is most at risk of an inflation overshoot

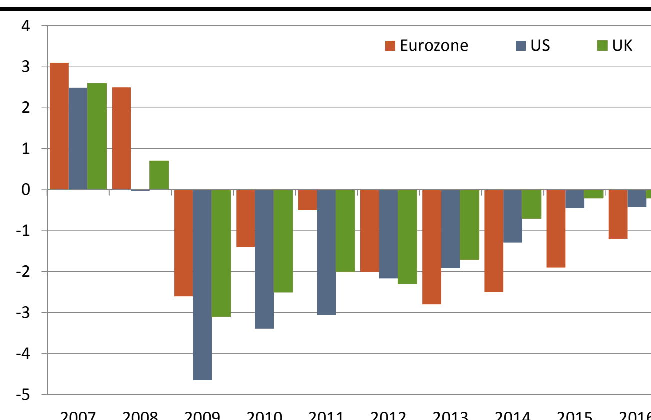
Thanks to Brexit, which triggered a 15% depreciation in sterling, headline inflation in the UK has surged to almost 3%. As long as sterling remains at or above current levels, headline inflation will fall a little in the coming years, but will remain above the BoE's 2% target over the medium-term. Since mid-2015 core inflation has risen from below 1% to 2.6%. Amid tightening labour market conditions, the BoE's cautious approach to tightening monetary policy will probably allow headline inflation to remain above the 2% target throughout our forecast horizon. Risks to the UK inflation outlook are skewed to the upside if the economy continues to outperform expectations and wage growth surprises to the upside.

Chart 23: US, Eurozone, UK – core inflation (% yoy)



Monthly data. Source: Eurostat, BLS, ONS, Berenberg calculations

Chart 24: US, Eurozone, UK – output gap as % GDP



Annual data. Source: IMF

Political risks: it could have been worse

After six months, the major risks we had discussed in our Global outlook at the start of the year have receded somewhat. Most importantly, US president Trump is being tamed by reality, Congress and the courts. He has neither started a trade war with China nor struck a deal with Putin at the expense of Europe. However, major risks remain. They range from geopolitical conflicts (North Korea, Syria/Iraq) to a potential tit-for-tat escalation of trade conflicts as the Trump administration levies more anti-dumping duties on a wider range of imports.

The major risks we had discussed at start of the year have receded somewhat

In much of Europe, we detect signs that the pro-European mainstream is re-asserting itself in the wake of last year's Brexit vote and the rise of Trump. In Austria, the Netherlands and France, the ultra-right fared less well than opinion polls had projected months before the votes. In Germany, support for the three traditional mainstream parties – chancellor Angela Merkel's CDU/CSU, the centre-left SPD under its new leader Martin Schulz, and the small liberal FDP – is now stronger than it had been six months ago. Germany's nasty AfD has fallen back to below 10% in opinion polls (see Chart 25).

In much of core Europe the pro-European mainstream is re-asserting itself

In France, voters have given the staunchly pro-European reformer Macron a strong mandate to transform his country and strengthen the cohesion of the EU27 and the eurozone. We expect him to do that jointly with a Germany where Chancellor Merkel looks set to win a fourth term on 24 September. In turn, firmer growth and some European reforms will help to defuse the residual political tail risks, including those lurking in Italy.

Macron's reforms can help to defuse the residual political risks

Although the risk of early elections in Italy in late 2017 has not evaporated completely, voters will probably not be called to the polls before the regular election date in April or early May 2018 after major parties failed to pass on a new election law. The radical Five Star movement remains neck-and-neck with the ruling centre-left Democrats, who form the core of the current government (see Chart 26). Fortunately, the Five Stars seem to be backing away from their demand for a euro referendum, with some prominent members of the somewhat disorganised movement suggesting that they would prefer to negotiate changes to European institutions instead. Railing against the euro proved to be a vote-loser in France. Italy may be heading for a not unusual state, namely potentially unstable coalition governments, in 2018 rather than a serious risk of euro exit.

In Italy, the Five Stars remain strong – but they are becoming a little less radical

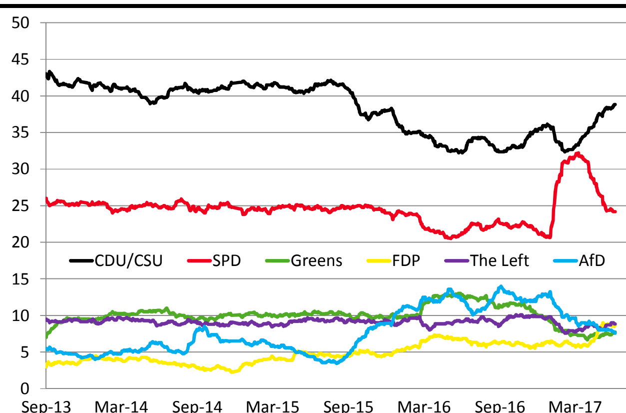
Across the Channel, the UK Conservatives are gradually realising that leaving the EU will involve far more painful trade-offs than the Brexiteers had claimed in their campaign last year. The UK cannot have its cake and eat it. Upon leaving the EU, it will lose most of the privileges of membership. See this report for more on the choices facing the UK.

The UK is finally coming to terms with the real trade-offs from Brexit

By and large, the evidence so far this year supports our base case: the global liberal order and the institutions that underpin peace and prosperity in Europe will survive the onslaught of the politics of anger. While it will take a long time to heal the economic and social wounds that have given rise to the radical populists in the first place, the process seems to be under way.

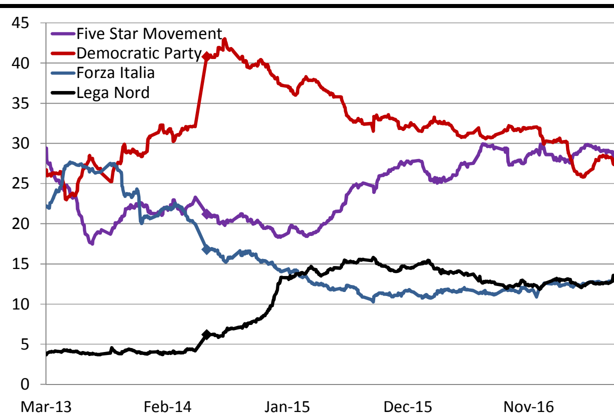
The institutions that underpin the European project will survive the politics of anger

Chart 25: German opinion polls: Advantage Merkel



Support in % for centre-right CDU/CSU, centre-left SPD, liberal FDP, centre-left Greens, radical-right AfD and radical-left Left Party; average of last six opinion polls. Source: national opinion polls

Chart 26: Italian opinion polls: the Five Star threat



Support in % for centre-left Democrats, radical Five Star movement, centre-right Forza Italia and radical-right Lega Nord; average of last six polls. Source: national opinion polls

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Global economic forecasts

		GDP				Inflation				Unemployment				Fiscal balance			
	Weight	2016	2017	2018	2019	2016	2017	2018	2019	2016	2017	2018	2019	2016	2017	2018	2019
World*	100.0	2.4	2.7	2.7	2.8												
US	24.7	1.6	2.2	2.4	2.4	1.3	2.1	2.3	2.5	4.9	4.4	4.1	4.0	-3.0	-3.2	-3.6	-4.1
China	14.9	6.7	6.5	6.2	5.8	2.0	1.9	2.3	2.2	4.0	4.1	4.1	4.1	-3.0	-3.0	-3.0	-3.2
Japan	6.6	1.0	1.3	1.1	1.0	-0.1	0.5	0.7	0.8	3.1	3.0	2.9	3.0	-6.3	-5.0	-5.1	-5.3
India	3.0	6.9	7.5	7.7	7.9	5.0	4.5	4.7	4.8					-5.0	-4.0	-3.6	-3.3
Latin America	6.6	-1.2	1.5	2.5	3.0	6.9	25.8	15.3	9.6					-6.9	-6.5	-6.0	-5.4
Europe	25.4	1.7	2.0	1.9	1.9												
Eurozone	15.8	1.7	2.0	1.8	1.7	0.2	1.5	1.4	1.6	10.0	9.2	8.6	7.9	-1.5	-1.3	-1.1	-0.9
Germany	4.6	1.8	1.9	1.8	1.7	0.4	1.5	1.4	1.6	4.2	3.9	4.0	4.2	0.8	0.7	0.5	0.4
France	3.3	1.1	1.6	1.7	1.8	0.3	1.2	1.4	1.6	10.4	9.3	8.6	7.9	-3.4	-3.1	-2.9	-2.7
Italy	2.5	1.0	1.2	1.1	1.3	0.0	1.3	1.2	1.3	11.7	11.1	10.5	9.9	-2.4	-2.3	-2.1	-1.9
Spain	1.6	3.2	3.0	2.8	2.7	-0.3	1.8	1.2	1.4	19.6	17.4	15.6	14.4	-4.5	-3.5	-3.0	-2.5
Portugal	0.3	1.4	2.5	1.8	1.9	0.6	1.5	1.3	1.4	11.2	9.6	8.9	8.3	-2.0	-1.6	-1.3	-1.1
Other Western Europe	0.0																
UK	3.5	1.8	1.7	1.6	1.7	0.6	2.8	2.7	2.3	4.9	4.6	4.5	4.5	-3.0	-2.7	-2.5	-2.3
Switzerland	0.9	1.3	1.6	1.7	1.6	-0.4	0.3	0.6	0.9	3.4	3.4	3.3	3.2	-0.2	-0.1	0.4	0.2
Sweden	0.7	3.1	2.7	2.4	2.1	1.0	1.6	1.8	2.0	6.9	6.7	6.5	6.3	-0.5	0.1	0.3	0.4
Eastern Europe	0.0																
Russia	1.7	-0.2	1.2	1.8	1.9	7.1	4.3	4.6	4.5	5.5	5.4	5.3	5.2	-3.9	-2.5	-2.0	-2.0
Turkey	1.1	2.9	3.4	3.2	3.2	7.8	10.6	8.8	8.5	10.9	12.0	11.5	11.3	-3.1	-2.8	-2.7	-2.7

Unemployment rate: Harmonised definition (ILO/Eurostat); fiscal balance: general government deficit in % of GDP excluding one-off bank support.
*At current exchange rates, not purchasing power parity. PPP estimates give more weight to fast-growing emerging markets and inflate global GDP.
Weights based on IMF World Economic Outlook statistics 2016 GDP figures. Source: Berenberg

Berenberg compared with consensus

	GDP			Inflation			Unemployment			Fiscal balance		
	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019
US	0.0	0.1	0.2	-0.1	0.1	0.3	0.0	-0.1	-0.3			
China	-0.1	-0.1	-0.3	0.0	0.1	-0.1	0.1	0.0	0.0	0.5	0.4	0.6
Japan	0.0	0.1	0.3	-0.1	-0.1	-0.2	0.2	0.1	0.3	-0.3	-0.8	-1.8
UK	0.1	0.3	0.1	0.1	0.1	0.0	-0.1	-0.5	-0.5	0.2	0.0	-0.5
Eurozone	0.1	0.2	0.3	-0.1	-0.1	0.0	-0.1	-0.3	-0.5	0.2	0.3	0.3
Germany	0.1	0.2	0.3	-0.2	-0.2	-0.2	n/a	n/a	n/a	0.3	0.2	0.1
France	0.2	0.2	0.4	-0.1	0.1	0.2	-0.2	-0.6	-0.9	-0.1	0.1	0.0
Italy	0.0	0.1	0.3	-0.1	-0.1	-0.2	-0.4	-0.6	-0.4	0.1	0.2	0.0
Spain	0.2	0.5	0.8	-0.3	-0.3	-0.3	-0.2	-0.5	-1.1	-0.2	-0.2	-0.2
Portugal	0.0	0.3	0.6	0.0	-0.1	0.0	-0.3	-0.4	-0.2	0.3	0.4	n/a

Key financial forecasts

	Current[1]	End-2017	Mid-2018	End-2018	End-2019
Central bank rates					
US Fed	1.00-1.25%	1.25-1.50%	1.50-1.75%	2.00-2.25%	2.75-3.00%
ECB	0.00%	0.00%	0.00%	0.00%	0.25%
BoE	0.25%	0.50%	0.75%	1.00%	1.25%
BoJ	-0.10%	-0.10%	0.00%	0.00%	0.00%
10-year bond yields					
US	2.38%	2.50%	2.80%	3.00%	3.30%
Germany	0.56%	0.60%	0.90%	1.10%	1.40%
UK	1.32%	1.40%	1.60%	1.80%	2.00%
Currencies					
EUR-USD	1.14	1.12	1.15	1.18	1.22
EUR-GBP	0.88	0.87	0.87	0.87	0.87
GBP-USD	1.30	1.29	1.32	1.36	1.40
USD-JPY	114	112	113	114	116
EUR-JPY	130	125	130	135	142
EUR-CHF	1.10	1.10	1.11	1.11	1.12

[1] *Taken on 7 July at 7:00h GMT. Currency forecasts may not add up due to rounding.*

For a full set of detailed forecasts, please see Forecasts at a glance – Steady growth, no exuberance yet.

Forecasts and comments for US, China and Japan supplied by Berenberg Capital Markets

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