ECONOMIC OUTLOOK

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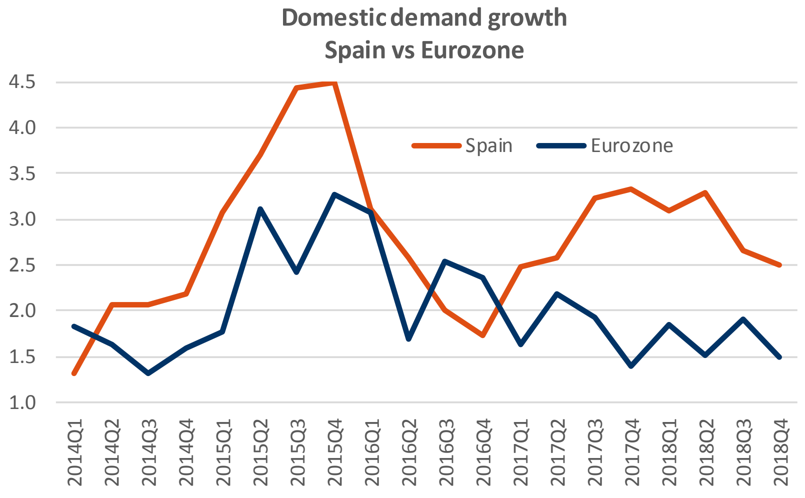
The new chapter on the trade war between the United States and China and its possible extension to Mexico has taken centre stage again in recent weeks, giving rise to high volatility in financial markets. Trade disputes increase scepticism about the evolution of global growth, as pointed out by the European Commission, who estimates that, if protectionism continues to increase, it could take away between 5 and 6 tenths of a percentage point from US and Chinese GDPs. This scenario is coupled with the uncertainty still surrounding the Brexit, the signs pointing to a slowdown in the Chinese economy and some areas of concern in the Eurozone, such as Italy, for example, due to its public debt and its government's euroscepticism, or the possibility of a further slowdown in Germany.

This scenario has an effect on the monetary policy implemented by central banks. The Fed has opened the possibility of a rate cut in the US, changing the monetary policy bias from neutral (in place since the beginning of the year) to downward. With regard to the European Central Bank, it has extended the period in which interest rates will remain unchanged until the first half of 2020. It has even mentioned that it is willing to re-use certain instruments, such as interest rate cuts if an adverse scenario gains strength, or resume its asset-purchasing programmes. With this new monetary policy bias, financial markets reacted by halting the falls accumulated in previous weeks.

Sources of uncertainty are still many and varied and, as a result, international investors prefer safe-haven securities, including sovereign bonds, the Swiss franc, gold and Japanese assets, and they have chosen to sell in most financial markets (May ends with widespread losses). The escalation of trade tension between the US and China, which began at the beginning of May with the establishment of new tariffs, has taken its toll on Wall Street, which closed last May with losses in all three indices, something that had not happened since May 2010. In the case of Spanish Stocks, the impact has been greater due to the commercial retaliation raised by the US on Mexico, a relevant market for some of the large Spanish companies. In the end, it seems that the US government will not impose the 5% tariff (a percentage that could gradually increase to 25% in October) on all imports from Mexico, after having reached an agreement on immigration. This has given some breathing room to stock markets which, also helped by the more moderate tone expressed by central banks, are recovering the losses accumulated in May.

Meanwhile, sovereign bond interest rates continue to fall. Spanish bonds reached an all-time low (below 0.60%), as did French bonds, while the Netherlands settled in negative interest rates. In fact, interest for the 10-year US bond may be set below 2% for the first time since the end of 2016.

These favourable financial conditions are one of the reasons behind the dynamism of the Spanish economy, which, at the beginning of 2019, is higher than that of our main European partners, despite the fact that the effects attributable to international trade are similar. The difference lies, therefore, on the strength of domestic demand. Thus, GDP continued to register notable activity growth rates (GDP grew 0.7% quarter-on-quarter in Q1, 2.4% year-on-year) and employment continued to increase at a good pace, close to 3%, according to the number of people registered with the Social Security. Fundamentals remain solid, thanks to the reforms that have been carried out in recent years, which have improved the resilience of the economy. In addition, certain imbalances have remained subdued (indebtedness, public deficit) and others have experienced a correction (external deficit, unemployment reduction and inflation).



Source: Eurostat and INE

Forecasts for 2019 point to more moderate growth in activity (2.1-2.2%, although the Bank of Spain has raised its GDP forecast to 2.4% in 2019) and in employment, within a context in which financing conditions remain very favourable, job creation will continue and inflation will post very contained growth rates (around 1%). All of this, together with the increase in wages, will contribute to the improvement of family incomes and, therefore, to household consumption, although we should bear in mind those limitations derived from such a low savings rate (4.8%). It is worth highlighting the behaviour of investment, both in capital goods and in construction, as the most dynamic GDP component despite the slowdown in the global economy, the uncertainty at a domestic and international level and the rising costs (wages and taxes, basically). Finally, it should be noted that exports will continue to lose momentum due to weaker activity from our main trading partners and loss of competitiveness.

In the area of macroeconomic imbalances, it should be noted that the European Commission (EC) has recommended Spain's exit from the excessive deficit procedure after having been included in this process for the past 10 years. But, at the same time, it considers that Spain should continue to reduce the deficit to -2% of GDP in 2019, despite the budgetary extension context, and has warned of the risk that Spain will deviate significantly from the fiscal adjustment required for 2019 and 2020. Thus, the Government expects the deficit to fall from -2.5% of GDP in 2018 to -2% in 2019, compared to -2.3% foreseen by the EC, while in 2020 the Government estimates -1.1% in 2020, well below the EC’s -2.0% forecast. The EC, therefore, calls for greater expenditure control to correct Spain’s structural deficit. In this area, the studies being conducted by the Independent Fiscal Responsibility Authority (AIReF) on the spending review process for certain items should be viewed positively, with the aim of detecting possible inefficiencies and overlaps and thus improve the quality of public expenditure in Spain.

As for the external sector, it continued to lose net lending capacity at the beginning of 2019. According to the balance of payments, the twelve-month accumulated balance up to March was set at 15.5 billion, lower than the 17.6 billion recorded in 2018 as a whole.

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