

WEEKLY ECONOMIC COMMENTARY

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I have heard that every good walk in Ireland ends in a pub. I followed that recommendation a couple of Sundays ago in Limerick, when I crossed the River Shannon and traversed what has become a vibrant city center. A squall arose as I made my way over to St. Mary’s and King John’s Castle. (They say that Ireland would be a perfect country if it just had a roof over it.) The warmth of The Curragower was a welcome conclusion to the trek.

As I was strolling, another Irish walk was on my mind, one captured on video by actor Stephen Rea. Rea’s sojourn skirted the border between Northern Ireland, which is part of the United Kingdom, and the Republic of Ireland; the two sides are currently part of the European Union, but Brexit threatens to separate them. The two share substantial commercial ties that are now in jeopardy as well as a difficult history no one wants to relive.

As negotiators from London and Brussels continue to struggle in their search for a separation agreement, countries like Ireland are caught in the middle. As a result, one of the world’s more interesting economic success stories may be at risk.

The Republic of Ireland has achieved strong results by defying prevailing economic patterns. It is a country with low corporate taxes and a balanced budget. It is an exceptionally “open” economy at a time when many other countries are looking inward. It has favorable demographics and has good relations with both the East and the West.

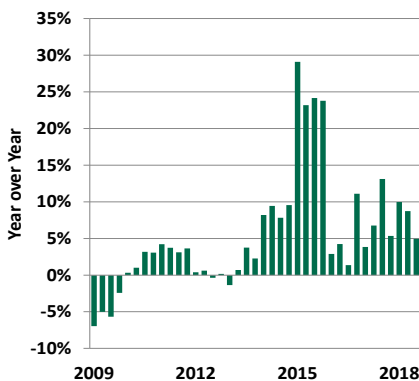
Global Economic Research
50 South La Salle Street
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312-557-8820
ct92@ntrs.com

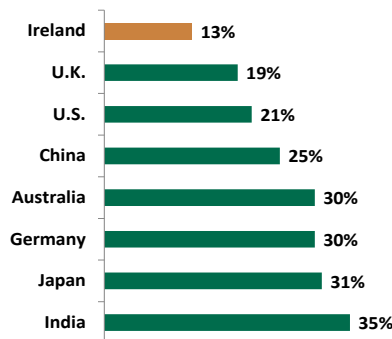
Ryan James Boyle
Senior Economist
312-444-3843
rjb13@ntrs.com

Vaibhav Tandon
Associate Economist
630-276-2498
vt141@ntrs.com

Irish GDP Growth



Selected Corporate Tax Rates



Sources: Haver Analytics, Trading Economics

Ireland is also distinguished by its reaction to crisis. The country entered 2008 as “The Celtic Tiger,” having enjoyed a robust run rivaled only by emerging Asian nations. The crash hit Ireland particularly hard; a difficult recession set in and several leading financial

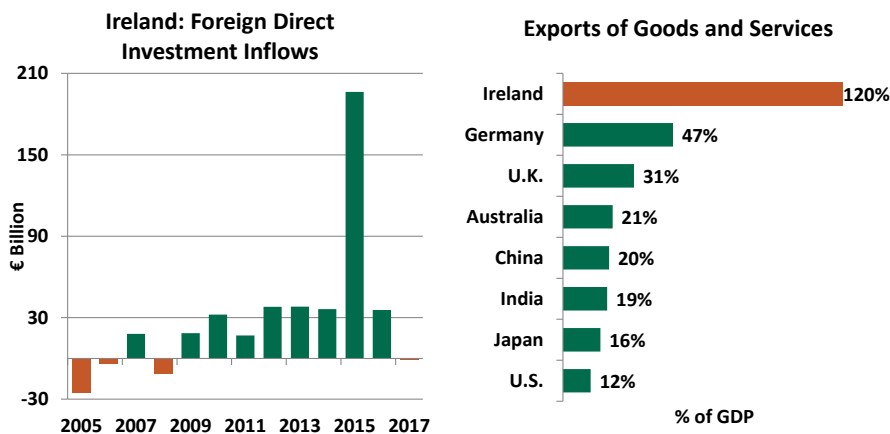
institutions had to be nationalized. In 2010, the International Monetary Fund and European authorities arranged a bailout of €85 billion for the country.

Other bailouts from that era remain problematic. But instead of allowing its problems to fester, Ireland chose to address them head-on. By the spring of 2013, the Irish Treasury had successfully issued debt on the market, and by year's end, the international support program was officially concluded. Today, Irish government bonds carry yields well below the eurozone average. The European Commission's latest forecast projects real growth of 4.5% for Ireland in 2019, the second-highest rate in the eurozone. (Only Malta, which is 26 times smaller than Ireland, is projected to do better.)

A year ago, the United States passed a sweeping tax reform bill lowering the income tax paid by corporations to 21% and offering inducements for U.S. firms to repatriate profits earned overseas. The measure increased competition with Ireland's advantageous tax rates but has not diminished the country's momentum. Ireland's corporate tax rate of 13% is still lower, and American companies have brought home only about 20% of profits that had been "stranded" overseas.

It takes more than just a low tax rate to secure economic mass. It requires strong talent, modern infrastructure, a strategic location and a pro-business environment. Ireland continues to offer all of these, and its resident companies seem intent on deepening their investments in the country.

Ireland has bucked prevailing economic trends.



Brexit has provided a boost to that momentum as global firms seek to ensure they can continue to serve their European clients fluidly no matter the outcome of negotiations. Some financial firms, in particular, have moved operations from London to Ireland for this purpose. As Europe's financial landscape shifts, Ireland's potential position as one of only two countries in the European Union with English as an official language is a decided advantage.

But as well as it has worked, Ireland's economic strategy presents certain risks in the current environment. Trade has become a four-letter word in some circles, and international cooperation is under stress. The success of the Irish economy depends critically on both of these things.

The biggest risk to Irish prosperity is the border. Since the Good Friday Agreement ended the sectarian conflict between Irish Catholics and Protestants 21 years ago, peace has reigned and business has boomed. Every day, 30,000 people cross the border for work or leisure; every year, about £5 billion of goods move across it. Those sums would be at risk if Northern Ireland were no longer part of the European customs union. And the return of checkpoints along the border would

be reminiscent of less pleasant times.

It seems fairly clear that most Britons who voted to leave the European Union had little comprehension of the trouble it would create for the Irish. Those politicians who supported the effort glossed over the complications, suggesting any disruption could be minimized. Boris Johnson, the former foreign secretary and a Brexit supporter, called the border issue a “gnat.”

With only a few weeks left before the UK’s scheduled departure date of March 29, negotiators from Westminster and the EU would do well to dispense with that kind of useless rhetoric and get serious about reaching a productive agreement. While those I spoke with in Ireland remain confident of a positive outcome, they were justifiably frustrated that important issues were minimized for political gain.

Perhaps the negotiators should go for a long walk along the Wicklow Way, pausing to observe the lake bordering the Guinness estate (topped with white sand to look like a pint of the brown nectar). They could then adjourn to a pub and indulge in the Irish art of productive conversation. Brexit would be solved in short order, and the delegates wouldn’t have to go far to toast their success.

Fragmented Landscape

Last Friday, Spanish Prime Minister Pedro Sánchez called an early general election for April 28, after his government’s 2019 budget was voted down. It will be Spain’s third election in four years. The budget defeat came on the heels of the government’s refusal to discuss another independence referendum for Catalonia, leading to a loss of vital support. Until a new government can be formed, last year’s budget will simply be rolled over.

The socialist government has been on thin ice, relying on support from Catalan separatists and the anti-establishment party, Podemos. The new elections will likely return a fragmented parliament, with the Socialists in the lead followed by the conservative People’s Party. The current political landscape isn’t unique to Spain; it reflects a broader trend across Europe, where divisive forces are steadily gaining ground. This makes consensus within and across countries difficult to achieve.

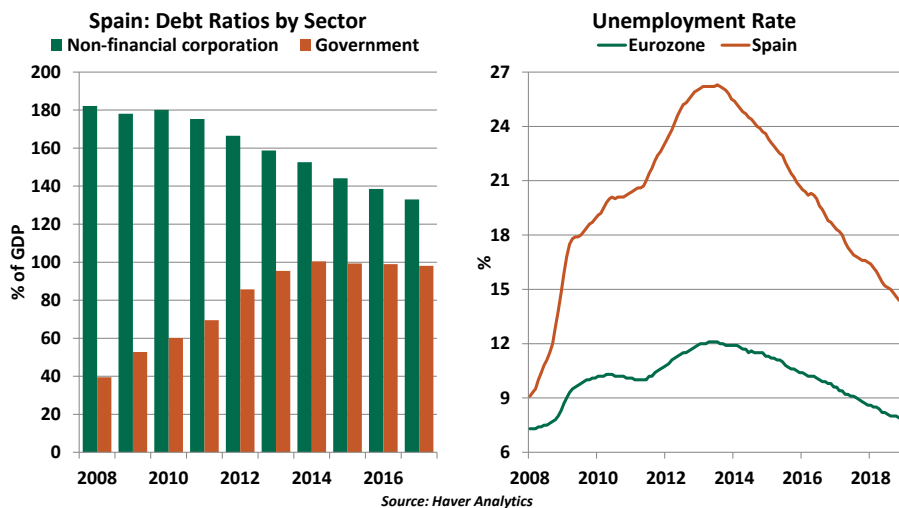
European equity markets and Spanish bond markets have been largely unaffected by recent developments. But the situation could soon change, as indicated by the sudden emergence of Vox, a far-right party, in opinion polls. Vox’s popularity has been fueled by resentment of political scandals, the deep economic contraction and the growing demand for a strong nationalist response to Catalonia’s demands for independence. The ascendance of this faction has heightened concerns that Europe’s fourth-largest economy will fall victim to the already elevated euro-skeptic sentiment. This will also have implications for the European Parliamentary elections in May, as Vox is likely to appoint its first representatives to the body.

Political fragmentation, which has taken a toll on Italy’s economy, hasn’t yet weighed on growth in Spain. The Spanish economy has done reasonably well after years of austerity under the previous regime. In fact, owing to robust private and public spending, Spain has been quite resistant to the broader slowdown in economic activity across European economies. Spanish unemployment, while still elevated, is about half of what it was five years ago.

In the years since the European sovereign and banking crisis, Spain has also made significant progress in correcting its macro imbalances. Structural reforms have advanced growth- and export-oriented measures that have helped Spain regain its regional competitiveness.

**Brexit could place
Ireland’s post-crisis
success at risk.**

Spain's current account balance has moved from a large deficit of 9.3% of gross domestic product (GDP) in 2008 to a surplus of 1.8% of GDP in 2017. Government balances have also witnessed a turnaround, with the deficit improving from 10.5% of GDP in 2012 to 3.1% of GDP in 2017. Public sector debt appears to have stabilized, while the private sector has gone through significant deleveraging. The health of the banking sector has also improved.



Spain could become another victim of euro-skepticism.

All of this should augur well for the Spanish budget, but lingering unemployment will keep benefits expenditures elevated. Consumption will be supported by an extraordinary 22% hike in the minimum wage and a large public sector hiring program Sánchez recently unveiled.

Persistent uncertainties won't necessarily have a material impact on Spanish growth, which has coped well with volatile politics in the past. But the magnitude of external threats (like Brexit) and internal dissonance could escalate significantly in the coming weeks. The tourism sector, which accounts for a sizeable 15% of gross domestic product, would likely suffer the most.

Hopefully, cooler heads will prevail as the election approaches, allowing Spain to remain on its recent course of improvement. But ever-increasing political fragmentation in Europe is threatening Spain at a delicate time.

Not a Trend Yet

In the aftermath of the U.S. government shutdown, statistical agencies are working hard to return to the normal schedule of data releases. Recent publications have contained mixed news, including a retail sales reading showing a notable decline in the month of December and an industrial production measure indicating an improbable slowdown.

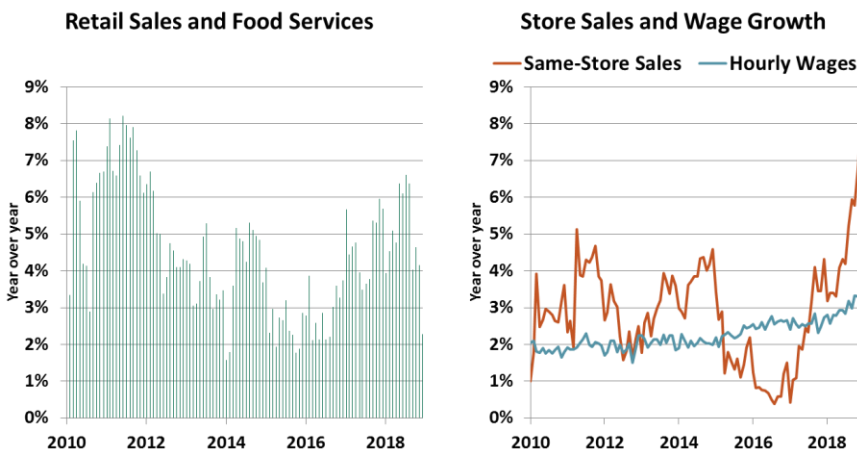
The disappointing announcements caught many observers by surprise. Other readings on the economy, from proprietary indices to individual retailers' operating results, have suggested consumer spending ended 2018 with a flourish. The severe weather that can impair spending did not start until January. Unemployment remains low and wage growth is outpacing inflation, suggesting an empowered consumer. These are not circumstances that should have led to a spending retreat.

A few drivers may have worked together to complicate the retail results. Thanksgiving fell early in 2018, allowing shoppers more time in November to complete their holiday shopping. Lower energy prices led to lower receipts at gasoline stations. And while e-commerce results are included in the

Census Bureau’s panel of approximately 5,500 employers, the growing concentration of online retailers may make estimation more difficult. Meanwhile, the fall in industrial production was led by a decline in vehicle production that followed several months of high output from automobile plants. The decline observed in the most recent reading may have been less of a contraction than a return to the mean.

Despite a significant decline month-over-month, retail sales have increased on a year-over-year basis since November 2009. The current level of 2.3% annual growth is still above rates observed as recently as 2016, and this was not the first monthly decline observed in the current growth cycle. Like most metrics, any reading can be volatile, but the overall trend for retail sales remains solid.

American consumers remain in a very strong position.



Sources: Census Bureau, Johnson Redbook, Bureau of Labor Statistics, Haver Analytics

The drops in retail sales and industrial production will weigh significantly on the estimate for fourth-quarter gross domestic product growth, due on February 28. GDP calculations are an amalgam of inputs reflecting economic activity, and given the importance of consumer spending to the U.S. economy, slow retail sales lead directly to slow overall growth. All measures will be revised at least once more in March. We expect 2019 to be a year of transition to a slower rate of growth, and a slowdown may lead to some confusing readings. Although a reading may appear alarming, a single data point does not always start a trend.

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@NT_CTannenbaum

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