Global growth concerns weigh on markets; Fed to hike rates in December

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Highlights

- **International financial markets remained under pressure in November as concerns over global economic growth weighed on equities, benchmark bond yields fell and oil prices saw the largest monthly drop in ten years.**
- **Activity in the US has remained strong, but shows signs of moderating. With core inflation back below the 2% target, expectations for rate hikes in 2019 have been scaled back, though a further 25bps hike is still expected this December.**
- **GDP in Japan fell by an annualized 1.2% in 3Q18, while core inflation was unchanged at 1.0% in October. These developments lend support to the Bank of Japan's ultra-loose monetary policy.**

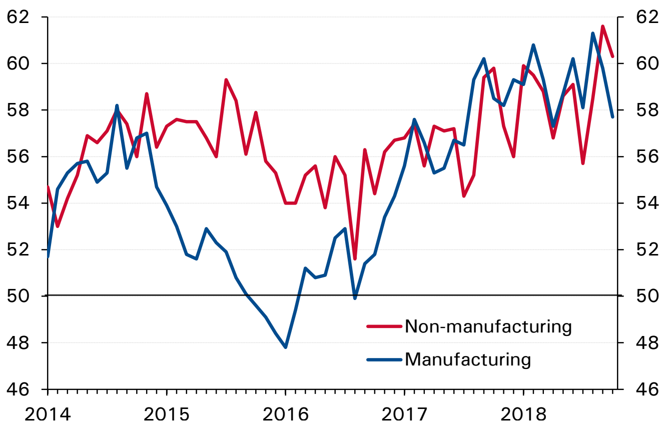
After a rough October, international financial markets remained under pressure in November as concerns over global economic growth weighed on equities and benchmark bond yields fell. Worries over the demand outlook and a potential market glut also saw oil prices continue the plunge that started in October, with November seeing the largest monthly fall – some 22% – in ten years. There was positive news in early December however, with the US and China striking an agreement on trade that sees the US hold off from tariff hikes on imports from China scheduled for January and China purchase more US goods to reduce the trade gap. Although the 90-day deal could yet break down as talks on a permanent arrangement proceed, it at least signals both sides' willingness to reach an accord and also eases immediate fears over the impact of an escalating trade war on world growth.

US growth expected to remain strong in Q4

Activity levels in the US economy remain in good shape, with the second estimate of GDP confirming growth of 3.5% in 3Q18 backed by robust consumer spending, while high frequency indicators point to a strong, if more moderate, outcome in Q4. ISM surveys of both manufacturing (57.7) and non-manufacturing (60.3) activity for October eased slightly from September, but both remain well above historical averages and some softening from previous levels is welcome on sustainability grounds given reported capacity pressures. (Chart 1.) Indeed, 'nowcasts' from the Atlanta and New York Fed point to annualized growth of 2.5% in Q4 and a consensus view of 2.7%, which are still above estimates of the economy's long-term potential.

Chart 1: US ISM activity surveys

(50=no change)



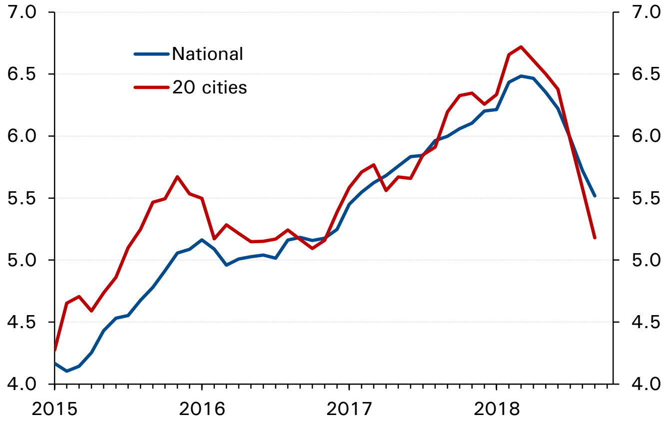
Source: Thomson Reuters Datastream

Backed up by steadily rising wage growth, solid employment gains and unemployment at its lowest levels since the 1960s, consumer spending rose by a stronger-than-expected 5.0% y/y in October, slightly softer than average for Q3 but above income growth of 4.3%. With subdued news on inflation (see below), spending is also robust in 'real' terms. There are hints however that the labor market could be approaching a turning point. The weekly jobless claims figures have been gradually edging up and rose for the third consecutive week up to November 24th, which could point to a less-than-stellar November employment report when it is released mid-December.

The weakening housing market could eventually start to weigh on the consumer sector going forward, with latest data pointing to further deterioration. The decline in new and existing home sales has gathered pace, with the former down 12% y/y in October, and house price increases have slowed. (Chart 2.) Housing is often seen as a bellwether of the broader economy, but the Federal Reserve, while concerned about possible weakness, sees the slowdown as an appropriate moderation due to rising mortgages rates, recent changes in taxation and pressures on affordability affected by rising material and labor costs. Improvements in household balance sheets over the past decade should also limit the macroeconomic impact of any housing market downturn.

Chart 2: US S&P/Case-Schiller house price index

(% y/y)



Source: Thomson Reuters Datastream

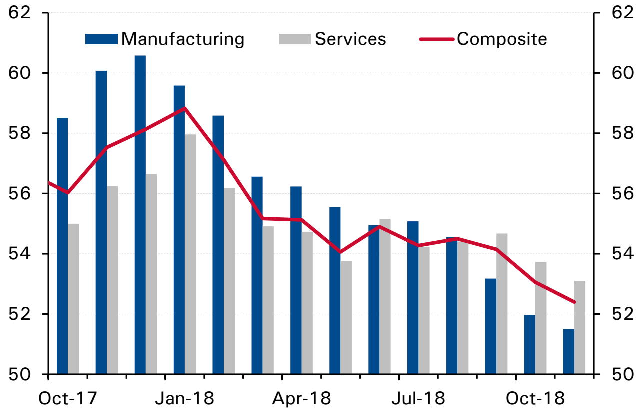
Inflation under the Fed's preferred gauge – the core personal consumer expenditure measure – eased back to 1.8% y/y in October and below the bank's 2.0% target. In further dovish news, Fed Chairman Jay Powell said in a late November speech that interest rates were now closing in on 'neutral' levels, implying that the Fed Funds target rate may not need to rise as fast as initially expected. Futures market expectations for a rate hike following the Fed's December 18-19th meeting have in fact firmed to 83% from 70% a month ago, but policy next year is now expected to be tightened less quickly than before, with a more than 70% chance of at most one further hike through 2019. This would suit President Trump, who said the Fed is "way off base" with its policy tightening.

Eurozone activity data continue to soften

Momentum in the Eurozone economy continued to falter in November, as the month's composite PMI of 52.4, the weakest in four years, reflected further softness in both manufacturing and services, underpinned by declining export momentum and demand for new orders. (Chart 3.) Economic sentiment (109.5) was also down for an eleventh consecutive month and echoed the aforementioned risks. Meanwhile, November's core inflation eased to 1.0%, lower than analysts had expected, with suspicions that the weaker business climate is discouraging businesses from passing through higher input prices to consumers. Despite the slowdown, however, ECB president Mario Draghi reconfirmed the bank's desire to end its asset purchase program in December 2018, attributing economic weakness to a return to normal growth levels after outperforming in 2017.

Chart 3: Eurozone PMI

(50=no change from previous month)



Source: IHS Markit

On the political front, tensions persist over the stand-off between Italy and the Eurozone, while on a more positive note, France and Germany agreed to push for an independent budget for the single currency area, paving the way for greater integration that might help avoid or mitigate future crises. Political tensions in the UK over Brexit also remain high despite the government finally striking a withdrawal agreement with the EU. The deal faces stiff opposition in the UK parliament and if voted down mid-December, the UK may be forced to exit the EU without a deal, triggering financial and economic disruption.

Japan's GDP contracts in Q3, reaffirms BoJ's policy stance

Tepid demand and natural disaster-related effects led to a 1.2% decline in Japan's annualized GDP in 3Q18, its second decline this year, and lending support to the Bank of Japan's (BoJ) ultra-loose monetary policy stance. (Chart 4.) Nonetheless, thanks to strong second-quarter data, GDP growth has so far averaged 0.9% for the 2018 fiscal year ending in March 2019 and is expected to recover in the near-to-medium term mainly thanks to continued strength in capital spending. To this end, growth appears on track to meet government projections of 1.5% for FY2018. Meanwhile, core inflation was unchanged in October at 1.0% y/y, still well below the BoJ's 2% target.

Chart 4: Japan GDP

(% q/q, annualized)

Source: Thomson Reuters Datastream

Chart 5: Brent crude oil price

($ per barrel, end of month)

Source: Thomson Reuters Datastream

Chinese manufacturing activity flat in November

Newly-released manufacturing data pointed to further signs of a slowdown in the Chinese economy. The official purchasing manager's index fell from 50.2 in October to 50.0 in November, indicating no month-on-month growth for the first time in over two years, as new orders continued to struggle to eke out gains and as export orders fell for the sixth consecutive month. However, the recently-agreed tentative trade deal with the US, under which the US will for now refrain from increasing tariffs at the start of next year, is likely to offer the external sector some reprieve.

Falling oil prices prompt OPEC rethink on output

Oil markets have been roiled by oversupply concerns and anxieties over weakening oil demand against a backdrop (now somewhat eased) of US-China trade frictions. Brent crude closed out a second consecutive month of declines in November, falling by 22% during the month to $58.7/bb for the steepest one-month fall since the 2008 financial crisis. (Chart 5.)

Market sentiments have shifted overwhelmingly bearish amid record high US crude production (averaging 11.7 mb/d in November) and near two-year high OPEC supplies (+130 kb/d to 32.9 mb/d in October). Money managers' bets on Brent falling further are at their highest in fifteen months. November's precipitous price drop has forced OPEC to consider once again cutting production to stabilize prices; the group's advisory board recommended cuts of 1.3 mb/d, or 4%, from October levels to bring supply and demand back into balance. More clarity should come after the meeting of OPEC and Russian-led non-OPEC producers on 6 December.

GCC development plans continue apace

Non-oil activity in the region continues to tick along, although with oil prices falling below the fiscal break-even price level for most GCC states, diversification drives and non-oil revenue-generating plans are once again in the spotlight. Saudi Arabia embarked on a major multi-billion dollar provincial investment drive in November and rolled out the second phase of the $19 billion private sector stimulus program. The Emirati authorities, meanwhile, continued with their plans to boost FDI, legalizing 100% foreign ownership of companies operating throughout the emirate from the previous threshold of 51%. 10-year visas for highly skilled expatriates were also approved, in a bid to attract top-tier talent. Inflation ticked up a little in Saudi Arabia in October (2.4% y/y) due to higher food costs but nearly halved in the UAE (to 1.6%) on the back of a steep decline in housing costs. Lending activity continued to gain traction in both countries, with private sector credit growth in Saudi Arabia rising to a sixteen-month high of 1.7% y/y in October.

Meanwhile, the Egyptian government is proposing an amendment to taxes on banks whereby banks holding more government debt will pay higher taxes. If adopted, this could lead to higher private sector lending, make government debt less attractive and thereby raise government borrowing costs. The central bank has decided to terminate its FX repatriation mechanism, which commits it to allow foreign investors to repatriate investments in local securities. By forcing investors to go to the interbank market, this move could lead to more exchange rate flexibility.

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