# Economic Update

NBK Economic Research Department I 12 November 2018

International Scene


# Global markets suffer October sell-off; US growth remains strong in Q3


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## Highlights

- **October was a rough month for financial markets, with sell-offs in both equity and bond markets amid tightening global liquidity conditions, a maturing economic cycle and geopolitical and trade war tensions.**
- **US economic growth stood at a robust 3.5% in Q3 and together with strong labor market data for October, implies support for another Fed rate hike in December despite inflation remaining on target.**
- **Political and economic concerns continue to weigh on the outlook for the Eurozone, where growth slowed to just 1.7% in Q3. However the ECB remains on track to end its stimulus program by the end of the year.**

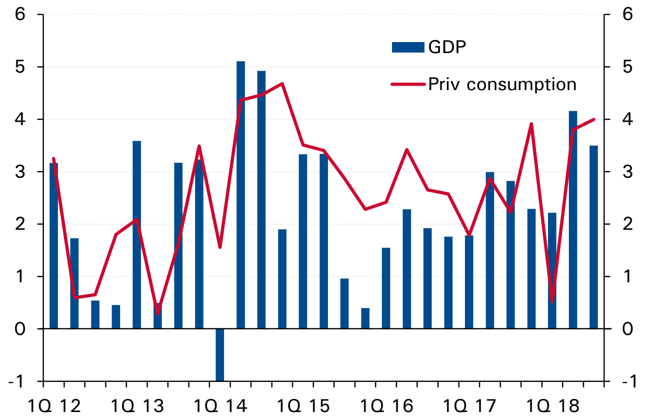
International financial markets suffered a rough October, with sell-offs in both equity and (in the first half of the month) bond markets amid tightening global liquidity conditions, a maturing economic cycle and geopolitical and trade war tensions. Although tighter Fed policy is key to this story, worries over economic and political stability in Europe have also intensified, with rising fears of a 'no deal' Brexit, an escalation of the Italy-EU budget battle and the announcement that long-standing German Chancellor Merkel will step down in 2021 adding to anxiety over slowing growth. In its biannual World Economic Outlook report, the IMF cut its forecasts for global growth by 0.2% to 3.7% for this year and next citing the impact of disruptive trade policies on supply chains, higher oil prices and the risk of continued capital outflows in emerging markets.

### US growth eases in Q3 – but not by much

Although the pace of US economic activity may be easing slightly, data suggest that it remains robust, providing a boost for President Trump and the Republicans going into important mid-term Congressional elections but also keeping up the pressure on the Federal Reserve to stick to its current rate hiking path. After reaching a super strong 4.2% in 2Q18, GDP growth moderated only slightly to 3.5% in Q3 3Q18, once again supported by rapid growth of 4.0% in consumer spending which more than offset a drop in investment and weaker growth in net exports. (Chart 1.) The latter had been boosted in Q2 by a rise in exports as Chinese importers brought forward purchases of US soybeans to beat the imposition of retaliatory tariffs.

**Chart 1: US GDP**

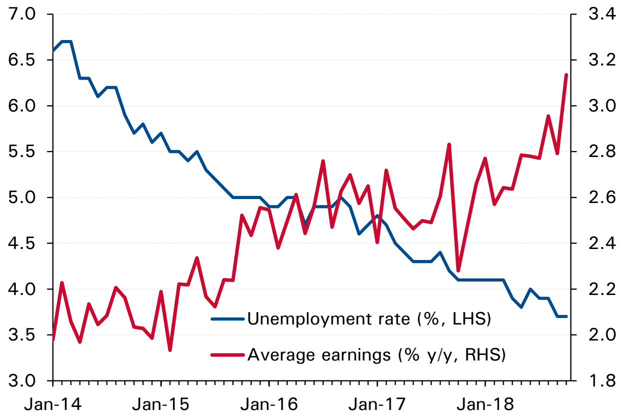
(% q/q, annualized)




Source: Thomson Reuters Datastream

Labor market data was also very strong, with non-farm payrolls increasing by a larger-than-expected 250,000 in October following a soft (possibly storm-affected) September, and unemployment remaining at a 49-year low of 3.7%. (Chart 2.) However there remains uncertainty over how much slack exists in the labor market and therefore the risk of overheating: low unemployment and survey reports of skills shortages contrast with still-strong jobs growth, a low participation rate – meaning many people of working age are still outside the labor market – and moderate wage growth. The latter finally showed notable upward movement in October, reaching a post-financial crisis high of 3.1% y/y and will be closely watched going forward for signs of pipeline inflationary pressures.

Chart 2: US labor market




Source: Thomson Reuters Datastream

For now, inflation remains well behaved. In fact both headline and core – the Fed's preferred gauge of price pressures – personal consumption expenditure inflation stood at 2.0% in September, exactly in line with the central bank's target. The Fed is expected to leave rates unchanged at its November meeting, but the futures market-implied odds of a hike in December stand at above 70%. Reflecting rate hike expectations and strong economic data, the trade-weighted US dollar index gained more than 2% in October, and benchmark 10-year government bond yields reached a cycle high of 3.2%. Rising interest rates continue to put the Fed on a collision course with President Trump, who called the bank "out of control" and blamed it for October's equity market sell-off.

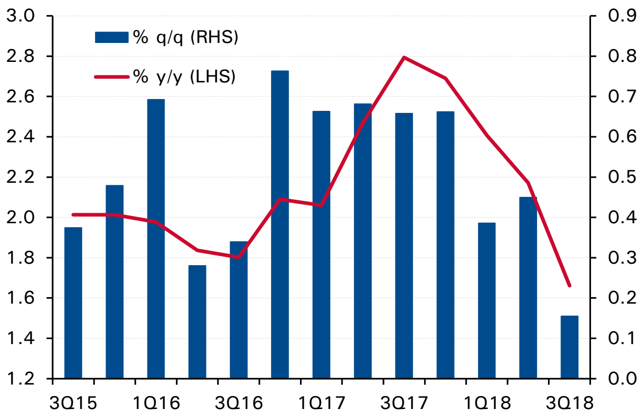
Trump may also be disappointed with the trade deficit, which has continued to widen despite protectionist policies and claims that the US is 'winning' the trade war with China. The goods and services deficit reached $54 billion in September (around 3% of GDP) from $53 billion in August and the bilateral deficit with China widened to a record $40 billion. Import growth at 9.8% y/y outpaced export growth of 7.2%.

## Political and economic concerns weigh on Europe

Both the economic and political outlooks in the Eurozone deteriorated last month. Data showed that growth momentum has eased and business confidence waned further. In addition, Italy's fiscal imprudence, the resignation of chancellor Merkel as leader of her party and the now increased prospect of a 'no deal' Brexit invited greater speculation over the future of the EU. While aware of these developments, the ECB announced at its latest meeting that it still believes, albeit now less enthusiastically than before, that overall conditions permit it to end its stimulus program by the end of 2018. However, these developments greatly cloud the outlook for the EU, particularly ahead of major political events in 2019, when a new EU parliament and ECB president are due to be elected.

European growth eased more than expected in 3Q18, coming in at 0.2% q/q (1.7% y/y) compared to analyst expectations of 0.3%. (Chart 3.) This was the region's slowest quarterly expansion since 2014, and potentially reflects weaker momentum in Germany due to a softer global trade environment, and no growth in Italy. October's PMI data also suggests that momentum may weaken further in 4Q18, with the composite index dropping to a two-and-a-half year low of 52.7 over the month. Meanwhile, inflation hit its highest in six years at 2.2% on the back of rising energy prices. Core inflation, although up to 1.1%, increased less than expected.

Chart 3: Eurozone GDP




Source: Thomson Reuters Datastream

## BoJ keeps policy on hold amid soft demand

Japan's trade sector continues to struggle, not least because of the ongoing trade war between China and the US. In September, Japanese exports fell for the first time since 2016 on the back of a fall in demand from both China and the US as well as supply constraints following a series of natural disasters. The continued weakness in domestic demand also weighed on imports. Tepid demand and natural disaster-related effects are likely to have caused GDP growth to slow in 3Q18 (data due November 14th). Subsequently, to remain supportive of the economy, the Bank of Japan kept its monetary policy steady in October as widely expected. Monetary policy is likely to stay loose for the time being, especially after the central bank revised down its 2018 and 2019 inflation forecasts to 0.9% and 1.4%, respectively.

## Chinese growth slows to nine-year low

The Chinese authorities announced a slew of pro-growth policy measures over the past month in an attempt to shore up the economy, after third quarter GDP growth slowed to 6.5% y/y, its lowest rate since 2009. (Chart 4.) In addition to a 100 basis point cut in the reserve requirement ratio to prop up credit growth, the measures included income tax cuts and more deregulation, while some analysts also expect cuts in corporation tax. The government also promised to lower import tariffs in an effort to mend its trade ties with the US. Furthermore, the central bank announced that it would adopt a more flexible and preemptive approach to monetary policy in 2019 to further support lending activity whilst ensuring financial stability. Separately, after a seven-year hiatus, the Chinese government held a formal meeting with the Japanese Prime Minister, Shinzo Abe, to strengthen their economic ties, particularly in the financial and trade sectors.

**Chart 4: Chinese GDP**

(% y/y)


Source: Thomson Reuters Datastream

## Oil prices drop on softer demand, supply optimism

Having reached a near four-year high of $86/bbl in early October, Brent crude oil closed down almost 9% m/m at $76/bbl by month's end. (Chart 5.) The bearish turn was linked to a weaker global demand outlook and the expectation that US sanctions on Iran will not be so aggressive as to leave the market short-supplied. Informing the latter was the US decision to temporarily extend sanctions waivers to eight of Iran's largest customers, including China, India and South Korea. Moreover, on the supply front, OPEC production increased in October by 430,000 b/d to a two-year high of 33.3 mb/d, according to preliminary estimates, while US crude output set another all-time record, reaching 11.2 mb/d, in the last week of October. Indeed, according to the IEA, supply is likely to have exceeded demand in every quarter of 2018.

**Chart 5: Brent crude oil price**

($ per barrel, end of month)


Source: Thomson Reuters Datastream

## Oil prices, government spending support GCC economies

Regional economies continue to benefit from the higher oil price environment and elevated government spending. PMIs for Saudi Arabia and the UAE were in expansion territory in October, at 53.8 and 55.0, respectively. Credit growth in both countries has also gained momentum: the UAE posted growth of 3.7% y/y in September, the fastest in a year, while in Saudi, private sector credit rose 1.5% and the fastest since December 2016. Fiscal outcomes also continue to improve, with Saudi Arabia reporting a sizeable reduction in its deficit to 2.3% of GDP in the first nine months of 2018, from 6.4% of GDP for the same period in 2017.

The outlook for Bahrain's finances also improved in October after Saudi Arabia, Kuwait and the UAE agreed to provide the kingdom with a financial aid package worth $10 billion. The offer appears to be contingent on the implementation of fiscal reforms, with the Bahraini authorities announcing soon afterwards a program of spending cuts and revenue generating measures designed to balance the budget by 2022. Parliament also approved draft VAT and pension laws.

Meanwhile, after a brief period in expansionary territory in July and August, Egypt's PMI fell from 48.7 in September to 48.6 in October, the lowest reading of 2018. This indicates that there remains some weakness in the economic recovery as the reform program continues.

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