Financial markets under pressure in May on fresh concerns over trade

Highlights

- Financial markets were under pressure through May amid a deterioration in the global trade climate; key equity indices fell nearly 7% and benchmark government bond yields drifted significantly lower.
- US growth in 1Q19 was revised down slightly to 3.1% and could slow to below 2% in Q2. Amid low inflation, futures markets are pricing in a larger probability of more than one Fed rate cut this year than before.
- Elections to the European Parliament saw mainstream parties lose out to less traditional rivals and could make consensus on policy issues more difficult. But more positively, German GDP rose a solid 0.4% in 1Q19.

Financial markets were under pressure through May amid a fresh deterioration in the global trade climate and concerns over the impact on world growth. Key equity indices fell nearly 7% and benchmark bond yields drifted significantly lower. US President Trump announced his intention to raise tariffs on imports from Mexico, which he later retracted, and sanctioned Chinese tech giant Huawei, provoking retaliatory tariffs from China and leaving the prospect of a trade deal looking increasingly remote near-term. Brent oil prices also suffered, falling below $65/bbl despite bullish news on supply and heightened geopolitical risks in the MENA region.

US growth revised down, while Fed remains ‘patient’

GDP growth in 1Q19 was revised down a touch to a still-strong annualized 3.1% from the previous estimate of 3.2%, on slightly softer private investment. Growth in Q1 was boosted by a likely temporary rise in inventories and is expected to slow to 2% or less in Q2. The labor market remains strong, although US employment data for May was much weaker than expected, with just 75000 new jobs added against a forecast of 175000. In fact, unemployment held steady at 3.6% in May, its lowest since 1969 and average hourly earnings rose by 3.1% for the ninth consecutive month; this – together with a rebound in consumer confidence – has helped retail spending rebound from an earlier soft patch. The main near-term vulnerability is in the manufacturing sector: the ISM activity index hit a two-and-a-half-year low of 52.8 in April with the export orders component now in contraction territory amid slowing global demand and trade tensions. (Chart 1.) While manufacturing accounts for only 11% of GDP, it is an important lead indicator and the latest below-consensus data suggest that it may be slowing faster than expected.

Minutes from the Federal Reserve’s May policy meeting where it left interest rates unchanged at 2.25-2.50% saw further calls for ‘patience’ before making further moves (until the economic risks and data become clearer). As well as the growth picture, inflation data could be increasingly pivotal for the rate outlook. The Fed’s preferred gauge of inflation – the core Personal Consumption Expenditure measure – remained low at 1.6% y/y in April and below the 2% target (though before any impact from recent tariff hikes); continued softness would challenge Fed Governor Jay Powell’s earlier contention that it was being kept low by transitory factors. (Chart 2.) Although financial markets have long priced-in one rate cut this year, low inflation and growth concerns have seen expectations of a second (and even third) cut gain traction. In a further dovish signal, the 10-year/3-month treasury yield gap again inverted – a technical measure often seen as a good predictor of a recession.
Elections to the European Parliament saw mainstream parties lose out to less traditional rivals in both the pro and anti-EU camps. The fracturing could make it more difficult to forge consensus on policy issues like the budget, regulation, the environment and immigration. It will also affect the scramble for nominations to the region’s top jobs, including for the head of the European Central Bank when current president Mario Draghi departs in October. Although Germany is advancing the case for its hawkish candidate, Jens Weidmann, it may yield to another country’s choice if it manages to secure one of the other top jobs. This could become pivotal given Weidmann’s criticism of the ECB’s ultra-loose monetary policy.

Political upheavals were perhaps greatest in the UK, where Prime Minister Theresa May was forced to resign over her handling of Brexit, and her Conservative Party was trounced in European elections by a combination of the newly-formed Brexit Party and on the other side by pro-Remain parties. May’s replacement as PM could be appointed in July and is likely to take a more pro-Brexit stance, including trying to renegotiate the withdrawal agreement with the EU before the end-October scheduled departure date. Risks of the UK leaving the EU without a deal have risen, but so have the prospects of a general election that could usher in a new left-wing government and perhaps a change of Brexit stance, including another referendum. Given the uncertainty, the pound could remain under pressure, having fallen around 3% versus both the US dollar and euro through May.

**Japan’s growth sees surprise pick-up in 1Q19**

Japanese growth surpassed the upside in 1Q19, accelerating from a revised 1.6% in 4Q18 to 2.1% and defying expectations of a 0.2% decline. Contributions from consumption and investment remained positive, but the external sector continued to struggle on fallout from US-China trade tensions. Indeed, latest trade data showed exports declining for the fifth straight month in April. The surprise jump in economic activity suggests that the Japanese authorities are likely to proceed with the planned sales tax hike in October, despite calls for delays given growing concerns over the external climate.

**Chinese renminbi falls amid growth and trade concerns**

Chinese exports witnessed a surprise drop in April, ahead of potentially higher US tariffs. Exports fell by 2.7% y/y in April reflecting the ongoing weakness in external demand. (Chart 4.) In contrast, imports improved and grew for the first time in five months, which may be indicative of a recovery in domestic conditions thanks in part to stimulus measures that were announced in recent months, including tax cuts and an ease in monetary conditions. Having been relatively stable earlier this year, the Chinese renminbi declined by 2.5% versus the US dollar to RNB6.9/US$1 in May amid trade and growth concerns. The
The central bank has reportedly vowed not to allow the currency to fall past the 7 mark amid fears of capital flight.

**Chart 4: Chinese exports and imports**

Growth fears weigh on oil prices in May

Oil prices recorded their first monthly decline of 2019 in May, with Brent falling 11% m/m to $64.5/bbl. (Chart 5.) Prices were hit by concerns over deteriorating US-China trade relations, suffering their biggest one-day sell-off of the year on the 23 May (~4.5%), and by President Trump’s decision to impose tariffs on imports from Mexico in the last week of May, which he later retracted. Oil’s fall came despite a higher geopolitical risk premium following the alleged sabotage of Saudi oil tankers and oil infrastructure. Nevertheless, while trade tensions and softer US economic data are casting a shadow on global oil demand, oil fundamentals remain supportive: OPEC+ continues to withdraw barrels from the market (OPEC-11 production cut compliance was 150% in April); output from Venezuela and Iran remains in free-fall; and OECD oil stocks are trending downwards, posting a second consecutive month of decline in March to reach 2,849 mb, according to the IEA.

**Chart 5: Brent crude oil price**

($ per barrel, end of month)

In the GCC, PMIs show the private sector non-oil economy continuing to improve. Output and exports were up in Saudi Arabia in May, with the headline PMI reaching 57.3, while in the UAE, the PMI climbed to a four-year high of 59.4 on gains in new orders and output. Inflation continues to trend lower, however, with Saudi inflation falling to -1.9% in April, the fourth consecutive month of deflation. In its recently concluded Article IV consultation, the IMF forecast Saudi non-oil growth and overall growth to reach 2.9% and 1.9%, respectively (slightly higher than our own estimates). The agency noted that fiscal, labor and capital market reforms have generally yielded some positive results, though economic diversification remains a work in progress.

In the UAE, the central bank expects non-oil GDP growth to rise to 1.8% from 1.3% in 2018, though it has revised down total growth to 2% from the previous estimate of 3.5% on lower oil sector output. Meanwhile in Bahrain, the authorities halted their subsidy reform plans due to concerns over social unrest and signaled that they would take longer than 2022 to balance the budget. They later announced that they would not likely meet several key fiscal targets, some of which were linked to the $10 billion GCC financial assistance package.