Global markets pummeled by growth uncertainty and policy tightening

> Economic Research
+965 2259 5500
econ@nbk.com

Highlights

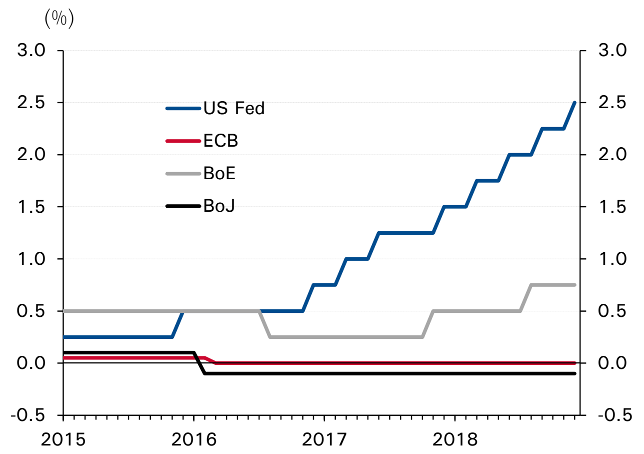
- **International financial markets suffered heavy losses in December amid intensifying concerns over the outlook for the world economy and the impact of tightening monetary policy.**
- **As expected, the Fed raised rates by 25bps in December despite broad signs that the US economy is slowing. Comments by Fed chairman Jay Powell in January however suggest that the bank may be moving in a more dovish direction.**
- **The ECB confirmed the end of its asset purchase program but lowered its projections for growth and inflation. Brexit uncertainty continued, with UK PM May forced to pull the parliamentary vote on her withdrawal agreement.**

International financial markets suffered heavy losses in December amid intensifying concerns over the outlook for the world economy, the impact of tightening monetary policy, the lack of a resolution to the US-China trade war and later in the month the uncertainty caused by the partial shutdown of the US government due to a funding row. Oil prices continued to slump, affected not just by the weaker demand outlook but rising supply that eventually triggered an announcement of production cuts from OPEC+ in an attempt to support the market. The more downbeat climate also generated a large shift in the bond market, with benchmark government yields dropping as investors downgraded the prospects for interest rate hikes given weaker growth and low inflation.

December Fed rate hike to be followed by a pause

As widely expected, the Federal Reserve hiked interest rates by 25 bps at its December meeting, the fourth increase of the year and leaving the target rate range at 2.25-2.50%. (Chart 1.) Although the Fed revised down its forecasts for growth and inflation and its guidance for rate hikes in 2019 to two from three, it also announced no change to its plans to slow or reverse its program of bond sales ('quantitative tightening'). Financial markets interpreted this as hawkish, triggering a sharp sell-off in equities. The Fed's outlook is still at odds with the consensus view on rates: futures markets are now pricing in just a 5% chance of a rate hike in 2019 – a much less aggressive view on policy tightening than a few weeks ago. Comments by Fed chairman Jay Powell in early January however suggest that the bank may be moving in a dovish direction.

Chart 1: Central bank policy rates*



Source: Thomson Reuters Datastream * Upper limit for the Fed's range

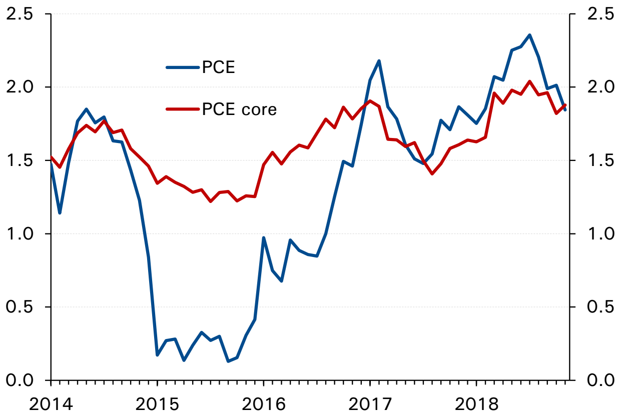
GDP growth for 3Q18 was revised down a touch to 3.4% from 3.5% on fractionally softer (though still strong) consumer spending, but still supported by a decent inventory build. The news flow over the past month has been dominated by downside risks, fueling concerns of a slowdown in 2019. These include the plunge in equity prices and impact of tighter Fed policy, the absence of a resolution of the trade war with China, and from December 22nd the partial government shutdown due a row between President Trump and Congress over funding for the proposed border wall with Mexico. The latter has persisted into 2019 and affected some 800,000 federal employees. Although the direct economic impact of the shutdown is not expected to be large, it underscores fears over policy deadlock and confrontation as the Democrats took control of the House of Representatives in early January.

High frequency economic data has generally reinforced the view that growth continues to soften albeit from very robust levels. The composite PMI edged down to 53.6 in December from 54.4 in November, but remains firmly in growth territory. However, there was a major surprise in the December labor market data, with employment smashing through expectations to rise 312,000 and its largest climb since February, while wage growth accelerated to 3.2%. The Atlanta Fed 'nowcast' estimates growth at 2.7% in 4Q18, which if achieved would leave full-year 2018 growth at 2.9% – the highest since 2015. The Fed's revised forecasts put growth at 2.3% in 2019.

Meanwhile inflation rates have continued to come down, mostly reflecting the impact of the recent fall in oil prices on gasoline costs. Personal Consumption Expenditure (PCE) inflation hit an 11-month low of 1.8% in November, though 'core' inflation – which excludes food and energy costs and is the Fed's preferred measure – edged up slightly to 1.9%. (Chart 2.) There is still little sign of recent tariff measures filtering through to consumer prices, but this could change if tariffs on imports from China are increased from 10% to 25% in March when the current truce expires.

Chart 2: US PCE inflation

(% y/y)



Source: Thomson Reuters Datastream

ECB ends asset purchase program

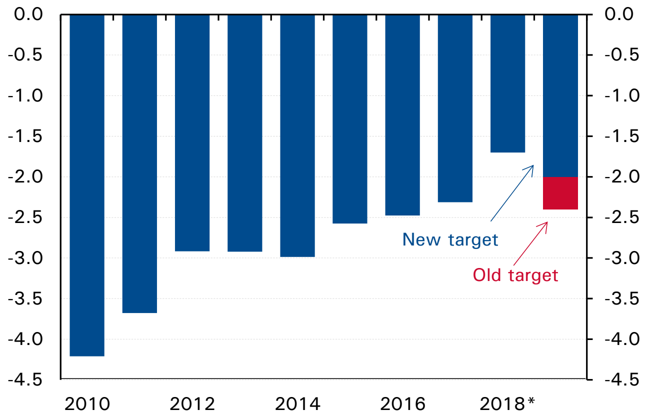
Economic conditions in the Eurozone continued to soften in December. The regional PMI fell to 51.3, its lowest pace of expansion in four years, as political turmoil and trade uncertainty weighed on manufacturing and services activity. The decline was led by a board contraction in France following weeks of street protests. Global trade uncertainty also continued to negatively impact Germany's export sector and business confidence. Wages in the Eurozone however, grew at their fastest pace since the financial crisis, climbing 2.4% in 3Q18, reflecting still tightening labor markets.

The European Central Bank confirmed the end of its asset purchase program in December, but reaffirmed its intention to keep interest rates at their current level "at least through summer of 2019" and adjusted its guidance on the re-investment of proceeds from maturing bonds, which will be maintained well beyond the first rate hike and for as long as necessary. Meanwhile, it lowered its projections for both growth and inflation for 2019 by 0.1% to 1.7% and 1.6% respectively, while 2020 projections were unchanged.

Several weeks of street protests in France over levies on petrol and heating oil saw President Macron scrap environmental tax plans from the 2019 budget. He also announced a package to boost low income households. These measures will push the budget deficit above of 3% of GDP in 2019, but are expected to be temporary as the President still seeks to follow through with his reform agenda. Although the increase in French deficit spending reinforced the resolve of Italy's populist coalition government in its budget battle with the EU, the weakening Italian economy has forced it to backtrack, avoiding a deeper clash with Brussels. The government will now target a deficit of 2.0% of GDP compared to the previous 2.4%. (Chart 3.) Italian GDP fell 0.1 q/q in 3Q18 on softer domestic demand, while the manufacturing PMI was below 50 in December.

Chart 3: Italy budget balance

(% GDP)



Source: Thomson Reuters Datastream / IMF

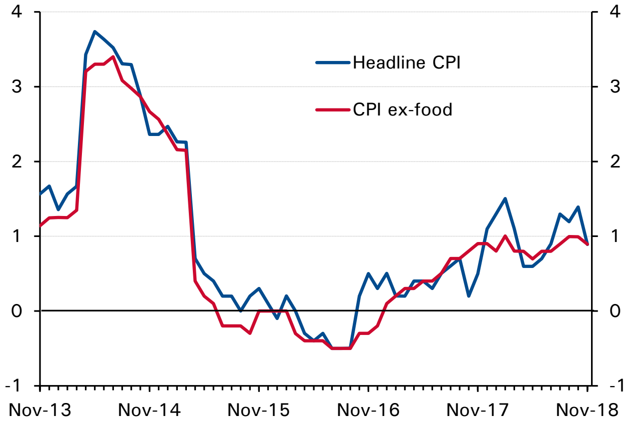
In the UK, tensions over Brexit continue with Prime Minister Theresa May forced in December to pull the parliamentary vote on her negotiated withdrawal agreement with the EU facing heavy defeat. The vote was postponed until mid-January, with May looking to secure further concessions from the EU before then to help secure a still-improbable win. If the deal is not passed, the prospect of the UK leaving the EU without a deal in March and facing a lengthy period of economic and financial disruption will loom closer.

Japan's GDP sees biggest drop in over four years

Revised data showed Japan's annualized GDP contracting by 2.5% in 3Q18, more than previously estimated and the biggest decline in over four years as the effects of sluggish demand were compounded by natural disaster-related effects. The weakness in demand also continues to be reflected in price data, with core inflation coming in at just 0.9% in November. (Chart 4.) With downside risks set to persist, the Japanese government lowered its economic growth and inflation forecasts for the 2018 fiscal year ending in March and FY2019. Growth is now expected at 0.9% in FY2018 versus 1.5% initially, while inflation is expected to come in at a slightly lower 1.0%. In an effort to support growth, the Bank of Japan stood pat on its ultra-loose monetary policy last month.

Chart 4: Japan inflation

(% y/y)



Source: Thomson Reuters Datastream

Weak demand takes toll on Chinese manufacturing

Slower demand growth together with the ongoing trade war with the US led to weaker Chinese manufacturing data. The Caixin/IHS Markit purchasing manager's index slid into contractionary territory for the first time in over one-and-a-half years. This was broadly in line with the official PMI data which pointed to a contraction in manufacturing activity for the first time in over two-and-a-half years. China has pledged to up its efforts to support the economy not least through the slashing of taxes and by maintaining sufficient levels of liquidity. In a bid to ease trade tensions with the US, China removed import and export tariffs on selected goods as of January 1st. A further round of negotiations will take place this month in Beijing as the two parties seem keen to reach a deal.

Oil prices continue to decline amid demand fears

The price of Brent crude suffered further losses in December (though recovered slightly in January), dropping 8% to end 2018 down almost 20% at $53.8/bbl. (Chart 5.) Amid a broader financial market sell-off, oversupply concerns and a softer oil demand outlook have sent oil prices down almost 40% from a peak of $86/bbl in early October. Resurgent US crude production, which soared 1.9 mb/d (+20%) in 2018, was among the triggers for the downturn, but higher OPEC+ output was also a factor. In this context, President Trump's decision to offer 180-day sanctions waivers to Iran's major crude customers caught the market off guard, forcing OPEC+ to reconvene in December and reinstitute production cuts of 1.2 mb/d (starting January 2019 for a minimum of six months) to bring supply and demand back into balance. Moreover, Qatar announced that it would be withdrawing from OPEC effective January, ostensibly to refocus on its predominant export, gas.

Chart 5: Brent crude oil price

($ per barrel, end of month)

Source: Thomson Reuters Datastream

In the GCC, non-oil sector indicators continued to improve, with the Saudi PMI rising to a year-high of 55.2 in November and the UAE PMI edging up to a four-month high of 55.8. Recently-released preliminary estimates of Saudi GDP confirmed the general improvement in activity, with growth in 3Q18 at 2.5% y/y from 1.6% y/y in 2Q18. Moreover, with the publication of their largest ever budget for 2019, which envisages spending rising by 13% y/y budget-on-budget and the deficit narrowing slightly to 4.2% of GDP, the Saudi authorities clearly intend to continue to support the non-oil economy through private sector stimulus, austerity-mitigating social allowances and productive infrastructure investments. Borrowing costs in the region are on the rise, however, after Saudi Arabia, the UAE and Bahrain responded to the US Fed's fourth rate hike of 2018 by increasing lending rates by 25 bps. Qatar, like Kuwait, raised its key deposit rate by 25 bps. Outside of the GCC, Egypt kept interest rates on hold in December with inflation having fallen back to within the central bank's 10-16% target range, and with prices expected to increase following the planned reduction in fuel subsidies later this year.

Head Office

Kuwait
National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait
(International) Plc
Paris Branch
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353