Economic Update

NBK Economic Research Department I 8 August 2019

International Scene

Escalation in US-China trade war puts further rate cuts back on the agenda

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Highlights

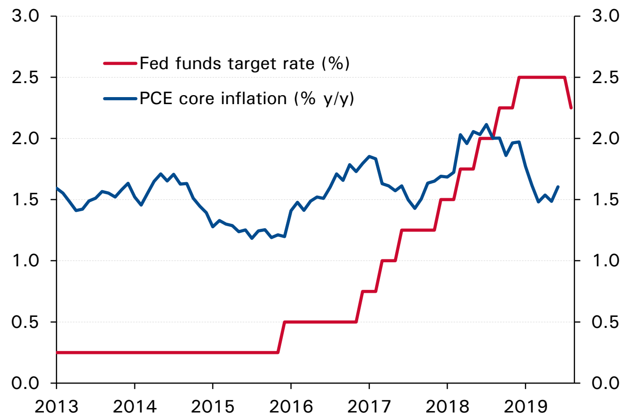
- **The US's latest tariff hike on China and labelling of China as a "currency manipulator" have heightened concerns over global growth, sending benchmark bond yields and oil prices sharply lower.**
- **These developments have put further US interest rate cuts back on the agenda, just days after the Fed signaled that its 25 bps July cut might not be the start of a broader easing cycle.**
- **The ECB is also likely to loosen policy in September, against a backdrop of well-below-target inflation and Eurozone GDP growth of just 0.2% q/q in Q2. In the UK, the pound has been under pressure on the new PM's hardline Brexit stance.**

After rebounding in June, global equities saw a steady increase in July helped by above-consensus US GDP growth for Q2 and continued expectations – subsequently realized in the case of the Fed – of monetary loosening by key central banks. Benchmark bond yields mostly fell, a move that accelerated sharply in early August after US president Trump announced a shock hike in tariffs on imports from China from September and then the US labelled China a "currency manipulator" – ending the recent trade war truce with potentially damaging effects on global growth. This also put oil prices under pressure, with Brent falling 11% from its mid-July peak to back below $60/bbl in early August despite OPEC over-compliance with output cuts.

Fed cuts interest rates for the first time in a decade

The Federal Reserve cut interest rates in July for the first time since the financial crisis, lowering the Fed Funds target range 25 bps to 2.00-2.25%. The move was seen as a precautionary step in light of risks to the global economy, including slowing global trade, as well as below-target inflation, which stood at 1.6% y/y in June on the core PCE measure. (Chart 1.) Financial markets reacted negatively to the cut on news that two FOMC members had voted against the move and then Fed Governor Jay Powell's comments that it was a "mid-cycle adjustment" and not the start of a broader easing cycle. President Trump also continues to pile pressure on the Fed to act to support growth, claiming that Powell had "let us down" by avoiding a larger cut in July. News of the US's latest tariff hikes on China have subsequently put rate cuts firmly back on the agenda however, with futures markets now fully pricing-in a cut at the Fed's next meeting in September.

Chart 1: US inflation and policy interest rates*

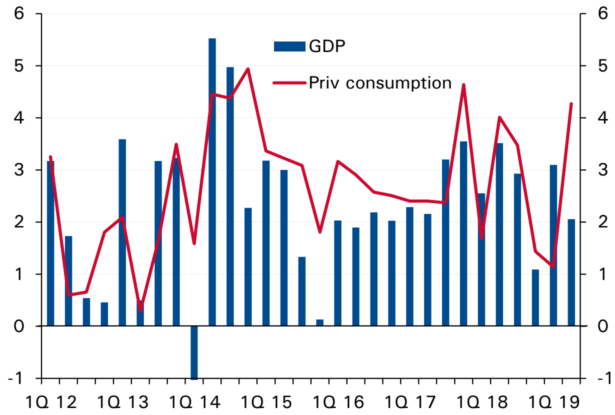


Source: Refinitiv *Upper end of target range for Fed Funds rate

The Fed's task is made still more challenging by data showing mixed signals on the economy. GDP growth came in at an annualized 2.1% in 2Q19, beating the consensus though down from 3.1% in Q1 (which was boosted by inventories). (Chart 2.) Consumer spending surged 4.3% and remains well-supported by a strong labor market, where unemployment was steady and close to record lows at 3.7% in July, and wage growth edged up to 3.2% y/y – well above inflation. But private investment (-0.8%) and exports (-5.2%) contracted in Q2, reflecting a weak housing sector and softening external conditions, and PMI survey measures show the manufacturing sector at or close to recession territory. GDP growth is forecast to be broadly steady at close to 2% in 3Q19, which is slightly below its long-term trend. But in our view, a the risk of a major slowdown that might justify much more aggressive Fed easing remains low, although the risk may have increased with latest tariff news.

Chart 2: US GDP

(% q/q, annualized)



Source: Refinitiv

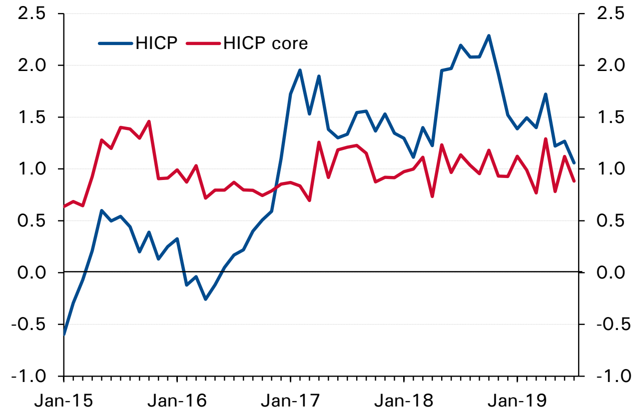
European growth falls as ECB mulls inflation target shift

Meanwhile weaker international demand in particular continues to heighten concerns over growth in the Eurozone. GDP growth slowed to just 0.2% q/q in 2Q19 from 0.4% in Q1, with worries that the German economy (figures are yet to be released) may be tipping towards recession. Germany's manufacturing PMI fell to a seven-year low of just 43.1 in July amid falling export orders, and while the service sector is proving comparatively resilient, industrial weakness could yet spread to other parts of the economy and contrasts earlier hopes of a revival in 2H19. GDP growth also decelerated in other Eurozone countries including Spain (0.5%), France (0.2%) and Italy (0.0%) – growth in the latter having been positive in only one of the past five quarters. The Eurozone labor market remains encouragingly solid, with the unemployment rate ticking down to an 11-year low of 7.5% in June. But the pace of decline was the smallest since October, hinting that the fallout from softer economic growth may be growing.

The European Central Bank (ECB) left policy on hold in July as expected, but signaled a bias towards future easing in a bid to tackle the economic slowdown and stubbornly-low inflation. The bank's forward guidance stated that interest rates would remain "at their present or lower levels" until at least mid-2020, implying that the policy deposit rate could be cut from its current level of -0.4% at the next meeting in September, while a restart of the asset purchase program may also be on the cards. Fueling anticipation of looser policy, the bank is mulling a shift in its long-standing inflation target from "below but close to 2%" to a more symmetrical 2% target, implying greater tolerance for higher inflation, which slipped to just 1.1% in July in the Eurozone. (Chart 3.) But a target shift may not have unanimous support among ECB Governing Council members and with bank president Mario Draghi set to leave his post at the end of October, the decision is likely to fall upon his successor, Christine Lagarde.

Chart 3: Eurozone inflation

(% y/y)



Source: Refinitiv

In the UK, former foreign secretary and London Mayor Boris Johnson was as expected elected leader of the Conservative Party and Prime Minister, promising to take the UK out of the EU at the end of October "come what may" and if necessary without a withdrawal agreement, with parliament having rejected former PM Theresa May's negotiated deal with the EU three times. Johnson has set as a precondition to talks on a new deal the removal of the 'Irish Backstop' component, which so far the EU is refusing. Johnson's room for maneuver is limited by precarious parliamentary arithmetic and a rebel group within his own party, who could eventually bring the government down and force a general election. The uncertainty is piling pressure on the British pound, which fell 4% versus the US dollar in July to a more than two-year low, and GDP may have flat-lined in 2Q19. In the event of a 'no deal' Brexit, the Bank of England is likely to cut interest rates from their current 0.75% while a government budget mooted for early October could announce a sizeable fiscal loosening on top of money already announced to prepare for 'no deal'.

Trade woes, soft inflation fuel chances of BoJ easing

Japanese exports fell for the seventh straight month in June (-6.7% y/y) amid weaker Chinese demand, as the ongoing trade war with the US continues to weigh on manufacturers' demand for intermediate products. Japan's brewing trade war with South Korea could add additional downward pressure on export growth in the near-to-medium term. Imports also fell for the second consecutive month in June by a steeper -5.2% y/y, pointing to continued softness in domestic conditions. Meanwhile, core inflation fell to an almost two-year low of 0.6% in June, fueling speculation of further monetary easing, especially against a backdrop of a softening economy. On the political front, Prime Minister Shinzo Abe declared victory in elections to the upper house, but fell short of winning the two-thirds majority that would give him the power to change the constitution which he planned to do next year.

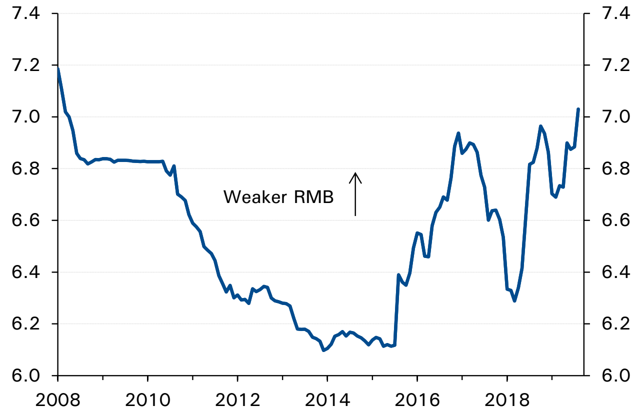
Chinese growth slows to 27-year low, yuan falls

Chinese economic growth eased from 6.4% y/y in 1Q19 to a 27-year low of 6.2% in 2Q19 against a backdrop of softer domestic as well as external conditions. Better-than-expected industrial output (6.3% y/y) and retail sales figures (9.8%) for June offered some solace however, reflecting pockets of strength in the domestic economy, perhaps supported by pro-growth measures laid out over the past couple of months. Indications are the economy continues to weaken bolstering the case for more support to shore up growth especially after the latest flaring up of the trade dispute with the US. The government is likely to roll out further stimulus in the months ahead, having announced that it will remove some foreign ownership limits in the financial sector in 2020 (a year earlier than initially planned) to prop up foreign investment inflows.

Meanwhile, the yuan has felt the pressure from slower growth and the latest US tariff measures, falling past RMB7/US$1 in early August for the first time in 11 years. (Chart 4.) There is a view that the authorities may tolerate a weaker currency as a further stimulus measure, as well as a countermeasure against the US. Indeed the fall led the US to formally designate China a "currency manipulator".

Chart 4: Chinese yuan exchange rate

(RMB/US$1, end month)



Source: Refinitiv Note: latest figure is for early August

Macro concerns take their toll on oil markets

Oil prices have been under pressure again due to concerns about global economic growth sparked by deteriorating US-China trade relations. Brent crude fell 2.1% in July to $65.2/bbl then a sharper 8% to just below $60 in early August on rising trade tensions. (Chart 5.) Such macro concerns have dominated market sentiments in recent weeks, overshadowing the few bullish stories emerging. In the US, the EIA reported last week that commercial crude stocks had by 26 July declined for the sixth consecutive week, a sign that refineries have been busy meeting usually high summer demand for petroleum products. Moreover, on the supply side, while OPEC continues to over-comply with its production cuts (122% for OPEC-11 in June), Venezuelan and Iranian production looks to be in freefall, with indications that disruptions in Libya could also be added to the increasingly fraught geopolitical landscape.

Chart 5: Brent crude oil price

($ per barrel, end of month)

Source: Refinitiv Note: latest figure is for early August

GCC private sector activity moderates in July

Most GCC central banks followed the US Fed in cutting benchmark interest rates by 25 bps, though Kuwait opted to keep its rate unchanged. This should help support non-oil economic growth in the region, which according to the latest PMIs eased slightly in Saudi Arabia and the UAE in July. Headline rates fell to four-to-five month lows in Saudi and the UAE (56.6 and 55.1, respectively) as output and new orders growth tempered. Meanwhile, Saudi Arabia's public finances swung back into a deficit of SAR34 billion, or 4.7% of GDP, in 2Q19, versus a surplus of SAR28 billion in 1Q19. Capital outlays more than doubled as the kingdom ramped up infrastructure spending. Finally, it was reported that Oman would delay rolling out VAT until 2021, a move that unlikely to be viewed positively by the rating agencies concerned about the sultanate's weakening public finances – though the government later denied this. But that did not prevent the country from successfully issuing a dual tranche $3 billion bond at manageable interest rates of 4.95% (5.5-year) and 6.0% (10-year) recently.

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