Global economy remains on firm footing despite risk of protectionism in the US

Global economic conditions remain largely healthy, though recent protectionist moves by the US increase the risk of costly trade wars. Equities, which had already been rocked by concerns of accelerated monetary policy tightening in February, were hit again in March after the US imposed tariffs on Chinese goods. As a result, the S&P 500 remained in correction territory having lost over 10% of its value from its late-January peak (Chart 1). Nonetheless, we do not think a trade war is likely at this point, and economic fundamentals remain robust, with a further boost expected from fiscal stimulus in the US.

Fed hiked rates in March and upped economic forecast

The US economy continued to look solid, with data indicating healthy activity and a robust labor market. The Philly Fed survey remained exceptionally strong at 22.3 for March, with new orders and unfilled orders particularly healthy. February’s industrial production was also solid gaining 1.1% on the month following several months of weakness. Employment data was also stronger than expected in February with non-farm payrolls rising 313,000, well above a consensus of around 200,000. Durable goods orders also came in solid for February.

Inflation, while still relatively subdued, has shown signs of pick up. Both consumer and producer prices were softer in February, easing concerns over stronger price pressures that had rocked markets a month ago. The softer data was also apparent in February’s wage growth figure. Still, annual core CPI inflation continued to increase, albeit slowly, standing at 1.8% y/y. The core PCE price index, which the Fed looks at more closely, also expected to continue to increase toward its 2% target (Chart 2).

Solid data and the improving inflation picture should keep monetary authorities firmly on track to normalize policy. The Fed hiked its interest rate target by 25 basis points to 1.50-1.75% at its latest meeting, as was widely expected. The Fed also revised its economic outlook for the second time this year, forecasting growth of 2.7% and 2.4% for 2018 and 2019, respectively, from 2.5% and 2.1% previously. Fed officials also adjusted their outlook for rate hikes slightly upward. Though the median projection still points to two more rate increases in 2018, a third hike is not ruled out. Three more hikes are now also seen in 2019 and two in 2020. Generally, the dot plot forecasts indicate a slightly more hawkish consensus among Fed board members.

Meanwhile, President Trump’s recent tough stance on trade with China could threaten to spark off a damaging trade war, though we think the chances of that are slim. Precisely because trade wars can be costly and could seriously hamper global growth, chances of them breaking out at this point remain low. The US move to impose tariffs on $60 billion of goods from China appears to have been met by a more measured Chinese response. Indeed, they countered with tariffs on just $3 billion in US goods and appear willing to discuss reaching an agreement that might avoid escalating matters. The US treasury secretary also left the door open for negotiations.
Eurozone recovery remains on track

The economic recovery in the eurozone remains on track, though some data has been underwhelming. The eurozone’s flash PMI eased more than expected in March to 55.3, pulled down by cold weather, a stronger euro, and geopolitical uncertainty. Nonetheless, the reading remains relatively strong, associated with GDP growth of around 2-3%. Labor markets in the eurozone have also been tightening, with unemployment in January hitting a new low of 8.6%.

Meanwhile, eurozone inflation remains a concern as core inflation has remained subdued, standing at 1% y/y in February (Chart 4). The European Central Bank (ECB) is sticking to its monetary easing “well past” the ending of the bank’s asset purchase program, but there are already signs that views are shifting to a neutral stance. In any case, asset purchases by the ECB are not expected to end before later in the year and rate hikes could begin in 2019.

Japanese economy continues to show resilient growth

In Japan, the economic recovery remains on firm ground. The latest figures show growth in 4Q17 was revised upward from an annualized 0.9% y/y to 1.6% on better expenditure and inventory data. Nonetheless, subdued inflation has kept monetary policy on an accommodative footing. Inflation excluding energy and food stood at 0.4% y/y in February, though the data did surprise slightly on the upside. As a result, the Bank of Japan (BOJ) kept policy unchanged at its most recent meeting and expects inflation to hit its 2% target by March 2020. The BOJ also maintained an upbeat outlook for the economy.

Oil prices are again touching 3-year highs on talk of extending OPEC cuts

After retreating in February from recent highs, oil prices have rallied on a perceived increase in geopolitical risk. The appointment by President Trump of two foreign policy hawks to the posts of secretary of state and national security advisor increased the chances of the US pulling out of the Iran nuclear agreement, leading to escalation of tensions in the MENA region. Oil prices have also been buoyed by talk that Saudi Arabia is willing to extend the OPEC production cuts into 2019, and the possible reduction in Venezuela’s oil production. This has all helped push Brent past $70 per barrel in recent days (Chart 5). Still, oil prices are likely to face some downward pressure over the next few months from US oil production, which sets new highs every week. These forces are roughly balanced at this time and, barring major developments on any of these fronts, the oil price could remain in the $60s range.
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 NATHANK KU
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 146, Road 4265
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 Rashid Bin Saed Al Maktoum, (Old Airport Road)
P.O.Box 11356, Abu Dhabi, U.A.E.
Tel: +971 2 4199 555
Fax: +971 2 2224 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
AlKhaldiya District,
Al-Mamal Tower, Jeddah
P.O.Box 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6309
Fax: +966 2 603 6318

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

Lebanon
National Bank of Kuwait (Lebanon) SAKP
BAC Building, Juristin Street, Sarayeh
P.O. Box 11-5727, Rod El-Silh
Beirut 1107 2201, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoun Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188048/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26134900
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10017 USA
Tel: +1 212 303 9800
Fax: +1 212 319 8289

United Kingdom
National Bank of Kuwait (International) Plc
Head Office
13 George Street
London W1U 3JG UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2210

National Bank of Kuwait (International) Plc
Portland Square Branch
7 Portland Square
London W1H 6QB, UK
Tel: +44 20 7244 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 Raaffles Place # 44-01
Republic Plaza
Singapore 049619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Representative Office
Suite 3003, 10th-Floor, Asia Center
1233 Liqiazi Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

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NBK Economic Research, T: (965) 2259 5500, F: (965) 2224 6973, econ@nbk.com, ©2018 NBK

www.nbk.com

NBK Capital

Kuwait
NBK Capital
Bligh Floor, Araya 8 Building, Bligh 6
Shuhada’a street, Sharq
P.O. 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
ValisinaqCad. 7
Nisantasi, P.O.Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353

NBK