Economic Update

NBK Economic Research Department I 11 February 2019

International Scene

Global markets recover as Fed signals policy shift

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Highlights

- **After plunging in December, global equity markets rallied in January on an end to the US government shutdown, progress on US-China trade talks and a dovish policy shift by the US Federal Reserve.**
- **The Fed signaled a pause in rate hikes and hinted that it may slow the pace of its balance sheet normalization amid 'cross currents' facing economic growth. Employment growth remained strong in January, however.**
- **The ECB also faces a tough balancing act between sticking to its policy normalization path and addressing the economic slowdown in Europe. Italy fell into recession in 4Q18 while growth in the Eurozone overall almost stagnated.**

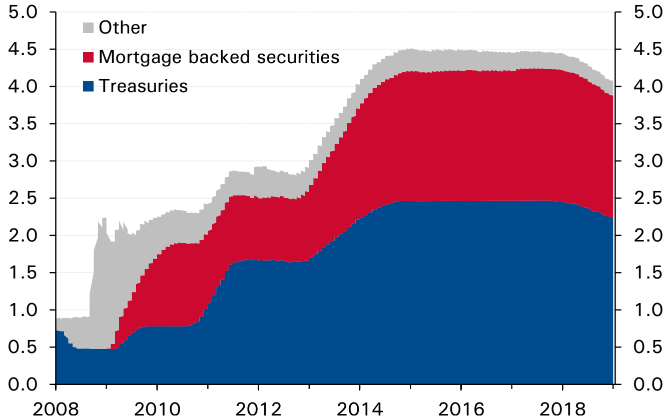
Global financial markets recovered ground in January after a tumultuous December, benefitting from an end to the US government shutdown, tentative signs of progress in US-China trade talks and a dovish policy shift from the US Federal Reserve. Oil prices rallied too, helped by reports of rapid progress by OPEC+ in implementing the production cuts agreed in December. But despite these encouraging developments, evidence that global growth is softening continues to accumulate. In its latest economic update, the IMF revised down again its forecast for world growth this year to 3.5% from 3.7% in October, and warned of mounting downside risks from trade tensions, slowing growth in China, a 'no-deal' Brexit and financial tightening amid high debt levels.

Fed pauses rate hikes, adopts more dovish tone

The Federal Reserve left interest rates on hold in January, but indicated a pause in further rate hikes and that the pace of its balance sheet normalization ('quantitative tightening') might slow. This contrasted with its more hawkish December stance, which pointed to at least two interest rate hikes this year and asset sales remaining on 'autopilot' at up to $50 billion per month – announcements that triggered a sharp market sell-off. (Chart 1.) It justified the shift by citing 'cross currents' including tightening financial conditions and slowing global growth, as well as modest inflation. Some analysts are speculating that the move represents the first step in a pivot towards a loosening cycle, though the consensus is that the pause will extend throughout 2019. Futures markets currently predict an 86% probability of rates being unchanged this year, with a 10% chance of a 25bps cut.

Chart 1: US Federal Reserve balance sheet

($ trillion)

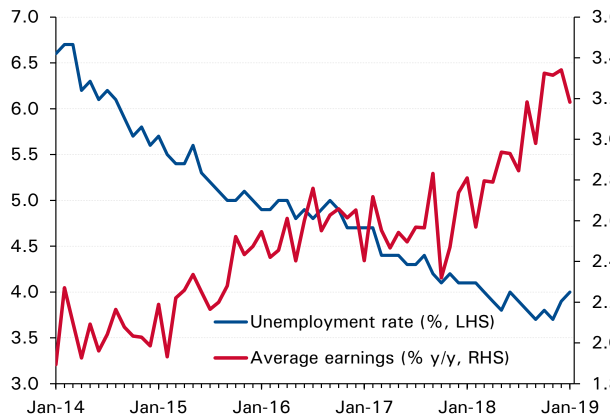


Source: Thomson Reuters Datastream

The partial shutdown of the federal government lasted for a record five weeks, before ending on January 25th without President Trump securing congressional funding for his proposed border wall. Trump however has threatened a fresh shutdown if funding is not approved by February 15th. The Congressional Budget Office estimates that the shutdown cost the US economy $11 billion (0.06% of projected 2019 GDP), though $8 billion of this would be recouped as returning employees received back pay. The shutdown resulted in delays to a host of economic data including the first estimate of GDP for 4Q18, which is expected to show growth slowed to an annualized 2.6% from 3.4% in Q3. This would leave growth for 2018 overall at 2.9%, the fastest since 2015.

High frequency data generally confirm the limited impact of the shutdown on economic activity and that growth for now looks solid going into 2019. The standout figure over the past month was from the labor market, with non-farm payrolls surging 304,000 in January, more than double expectations, and government employment also rising. Unemployment ticked up to 4.0% due to a rise in participation, but hourly earnings growth decelerated to 3.2% y/y, helping the case for the Fed's rate hike 'pause'. (Chart 2.) Flash PMI data for January was also upbeat, with the composite index rising to 54.5 signaling decent growth in both services and manufacturing. Not all data has been positive however. The University of Michigan's consumer confidence gauge fell sharply to a two-year low of 91.2 in January no doubt affected by the lingering shutdown. The strong labor market suggests that the dip in confidence should be temporary.

Chart 2: US labor market



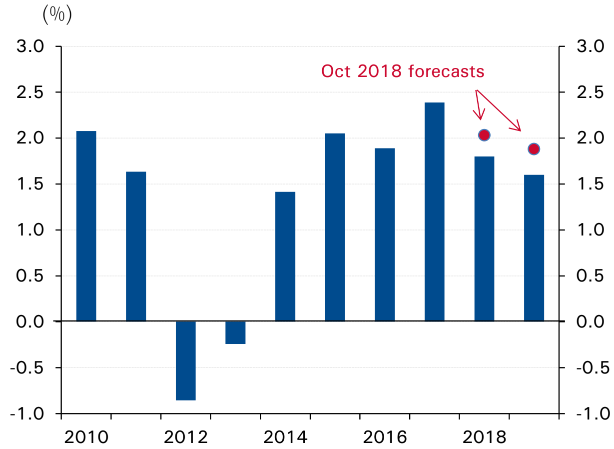
Source: Thomson Reuters Datastream

Consumer price inflation declined further in December to 1.9% y/y from 2.2% in November and a recent peak of 3.0% last summer. The fall was driven by lower energy costs due to lower oil prices, while core inflation was steady at 2.2%. Tame inflationary pressures continue to be one of the puzzles of the current economic cycle, given strong economic growth and the tight labor market. Inflation risks could ease further if the US and China can agree a trade deal ahead of a March 1st deadline, when US tariffs on $200 billion of imports from China are scheduled to rise from 10% to 25%.

Italy falls into recession, ECB now more cautious

A combination of slowing world growth, global trade tensions, the withdrawal of monetary stimulus by the European Central Bank (ECB) and Brexit concerns, all continue to dampen the economic mood in Europe. The Ifo economic sentiment index for 1Q19 fell to a four-year low of -11.1 points, with France particularly affected against a backdrop of street protests against President Macron's economic reforms. The Italian economy was confirmed as already in recession with GDP falling 0.2% q/q in 4Q18 after a 0.1% drop in Q3, which could put pressure on its latest budget deficit agreement with the EU. Growth in the Eurozone overall came in at just 0.2% q/q. The IMF downgraded its forecast for Eurozone growth for 2019 by 0.3% to 1.6% (1.8% in 2018), reflecting in particular slower growth in Germany, and warned of the risks to financial stability from stress on Italian banks. (Chart 3.)

Chart 3: Eurozone GDP growth (IMF forecasts)



Source: IMF WEO Database Oct 2018 / Jan 2019 update

Having ended its asset purchase stimulus program in December, the ECB now faces a tough balancing act between sticking to policy normalization and addressing the growth slowdown – particularly given the more dovish signals from the Fed. ECB President Mario Draghi noted that the risks to growth had tilted to the downside but stopped short of announcing a shift in policy guidance, which is for interest rates to remain on hold until after the summer. Eurozone inflation fell to 1.4% in January, below the ECB's "below but close to 2%" target.

With the UK's planned March 29th departure date from the EU edging closer, uncertainty continues to prevail with no political agreement over the manner of the UK's withdrawal. Prime Minister May's negotiated deal with the EU was voted down heavily in the UK parliament, but could yet pass if the EU agrees to change the so-called 'backstop' component, which they have so far ruled out. Although UK economic growth has been resilient and is forecast at a reasonable 1.5% this year – close to the Eurozone average – the uncertainty is weighing on investment, with the construction PMI falling to a 10-month low of 50.6 in January. A Brexit deal would improve the near-term outlook, and possibly see UK assets rally.

BoJ leaves policy on hold, cuts inflation forecast

The Bank of Japan maintained its ultra-loose monetary policy last month, amid continued economic headwinds. Indeed, Japanese exports fell at their fastest pace in two years in December, as external demand slowed, particularly from China.

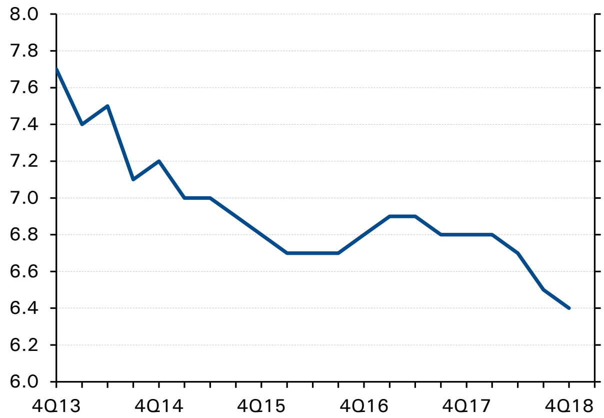
Exports fell by 3.8% y/y while imports grew by a mere 1.9% y/y, a multi-month low, as domestic demand remained weak and as the impact of higher oil prices waned. Additionally, core inflation, which excludes food costs, slowed to just 0.7% y/y in December and logged an annual average of 0.8% for 2018, far below the central bank's target of 2% but still an improvement from 0.5% and -0.3% in 2017 and 2016, respectively. The central bank cut its inflation forecast again for the 2019 fiscal year from a range of 1.5% to 1.7% to a range of 1% to 1.3%, on the back of limited upward inflationary pressures.

Chinese growth hit a 28-year low in 2018

Growth in China's economy continued to decelerate in 2018, prompting the government to announce measures to support activity. Economic growth slowed from 6.5% y/y in 3Q18 to 6.4% y/y in 4Q18 and logged an annual average rate of 6.6%, a 28-year low, on the back of weaker domestic conditions and a slowdown in external demand, not least due to US tariffs. (Chart 4.) In response to the slowdown, the government has announced a raft of growth-stimulating measures including fiscal policy reforms (additional tax and fee reductions for small firms) and a cut in the reserve requirement ratio (RRR). The central bank cut its RRR (the amount of money that banks must keep on reserve at the central bank) last month for the fifth time in a year, to help bolster lending.

Chart 4: Chinese GDP

(% y/y)



Source: Thomson Reuters Datastream

Oil prices rebound as supply cuts take effect

Oil prices recovered in January, rising 15% m/m as OPEC, led by Saudi Arabia, looked to cut output quickly to comply with the December OPEC+ production agreement. By January's end, Brent crude had reached a two-and-a-half month high of $61.9/bbl, buoyed by the imposition of sanctions on oil producer Venezuela by the Trump administration and by ongoing discussions to end the trade tariff dispute between China and the US. (Chart 5.) The risks to the outlook for oil demand growth in 2019 stemming from deteriorating US-China trade relations and a slowing Chinese economy, though, are skewed to the downside, and the International Energy Agency is expected to follow the IMF's lead and revise down its forecast slightly from 1.43 mb/d. Despite record high US crude production of 11.9 million b/d, OPEC cuts together with still-decent demand growth should help the oil market return to balance by mid-year.

Chart 5: Brent crude oil price

($ per barrel, end of month*)

Source: Thomson Reuters Datastream *Latest figure is early February

In the GCC, according to official reports, the Saudi economy recovered from its contraction in 2017 (-0.7%) to grow by 2.2% in 2018. The rebound was led by the oil and non-oil public sector, with the latter underpinned by record government spending. Growth in consumer spending and private sector credit, at 10.4% y/y and 2.9% y/y respectively in December 2018, also support the narrative of recovery. The unemployment rate for Saudi nationals also improved, falling to 12.8% in 3Q18 from 12.9% in 2Q18. The government is reportedly considering introducing a private sector cash allowance to encourage more Saudis to move to the private sector and is also mulling revising the expat fee structure amid complaints from businesses of rising costs and a shortage of skilled personnel. Some 1.3 million expats have left the country since the start of 2017.

There was positive news on activity, with PMI indices for both Saudi Arabia (56.2) and the UAE (56.3) ticking up to multi-month highs in January. In Egypt however, the PMI fell further into contractionary territory at 48.5 with falls in the output and new orders sub-indices, while price pressures eased.

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