Tightening global financial conditions amid trade tensions accelerated capital outflows from emerging markets

Highlights

- The US imposes 25% tariffs on $34 billion worth of Chinese goods imports, with $200 billion more to maybe follow.
- Capital outflows from EMs accelerated in June on higher interest rates, a stronger US dollar and trade tensions.
- The US labor market created 213,000 new jobs in June amid improving economic indicators.
- Eurozone activity continues to trail the US, with 2Q18 PMI’s the softest in six quarters and economic sentiment easing on trade worries and political uncertainties; ECB monetary policy tightening to proceed gradually.
- GCC economies continues to recover amid higher oil prices and fiscal stimulus; 1Q18 non-oil growth accelerates in Saudi Arabia, Qatar and Kuwait.

Trade tensions continued unabated and are likely to accelerate. On July 6, the US imposed 25% tariffs on hundreds of Chinese products, and is considering another 10% duty that may result in $200 billion in tariffs. China did retaliate with tariffs of its own on some American products. Europe has detailed a plan to slap tariffs on $300bn of US products if Mr. Trump goes ahead with his plan to hit European cars with punitive tariffs. These tensions have raised risks and rattled markets, with China’s stock market and the renminbi coming under severe pressure. China experienced large capital outflows as part of a more generalized phenomenon in emerging markets.

Investors continue to pull out of emerging economies, with outflows accelerating in June, prompted by higher interest rates, a strong US dollar and trade tensions. According to the IIF, the flight to safety from emerging markets increased to $8.0bn in June following an exodus of $6.3bn in May. These outflows were split evenly between debt markets, which recorded a net loss of $4.2bn, and equity markets at $3.8bn. Outflows are set to continue in the months ahead with the expected further tightening in the US. Growth in highly indebted emerging markets will take a hit on the back of an appreciating US dollar, and will be compounded by likely further interest rate hikes by the emerging economies as they move to stem the loss of capital.

US continued to show good performance

US strong growth momentum continued apace with a steady flow of robust data in the second quarter, following a soft start in the first quarter of the year. Both May and June’s economic indicators were good. Inflation logged its sixth straight rise this year, increasing to 2.9% in June, while the economy added a more-than-expected 213,000 new jobs. May’s figures were also revised higher. Unemployment, however, ticked up slightly from May’s 18-year low of 3.8% to 4.0% in June as more idled workers rejoined the labor market encouraged by the improved employment prospects. The ISM manufacturing survey registered its second consecutive strong pick-up, reaching 60.2. (Chart 1.) Business sentiment, however, was down partly on trade tensions, with the Federal Reserve Bank of Philadelphia business outlook survey easing to 19.9 in June from 34.4 in May.

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T: (965) 2259 5500, F: (965) 2224 6973, econ@nbk.com, © 2018 NBK www.nbk.com
With strong economic performance and inflation approaching its target, the case for an increase in the Fed policy rate has been strengthened. It is now expected that the Fed will hike the rate twice before year-end and possibly three more times in 2019. In its just-released US consultations report, the IMF called for a faster pace of increase in the rate given the large tax cuts and the increase in spending which would lead to larger budget deficits and higher public debt, which is already judged to be unsustainable.

**Monetary policy in the Eurozone will tighten in 2019**

Europe has not been performing as well as the US. The second quarter PMI averaged 54.7, the weakest in six quarters, but it improved slightly in June to 54.8, driven by higher new orders and hiring. (Chart 2.) Meanwhile, economic sentiment eased less than expected and still hovered at levels that bode well for future growth. Nevertheless, headwinds persist, with trade worries and political uncertainties weighing heavily on the Eurozone’s outlook. Mr. Trump’s threat to impose heavy tariffs on car imports could have a severe impact, mainly on Germany’s auto industry (one third of total EU cars produced), with the German ZEW survey for economic sentiment retreating significantly to -25 in July, the lowest since 2012. An EU summit over immigration revealed a changing European political landscape that has perhaps cast some doubt on the durability of the Union’s status quo and Chancellor Merkel’s survival, which was briefly challenged last month by the threat of her interior minister to resign and bring to an end the nascent coalition. However, things are calmer now but still fraught with risks.

**Oil Markets**

Oil prices closed in June back up at $79/bbl for Brent and $74/bbl for WTI. (Chart 3.) Oil’s rise to near three-and-a-half year highs came despite OPEC+ agreeing to resupply the markets with a nominal 1 mb/d of crude over the next six months to prevent oil prices from spiking amid supply declines in Venezuela, Angola, Libya and potentially Iran once US sanctions kick-in. With spare production capacity among OPEC+ members limited to Saudi Arabia, the UAE, Kuwait and Russia, the real output increase could turn out to be less.

June’s inflation in the euro zone rose to 2% for the first time since 2013 on higher energy prices, but core inflation remained low; this may justify further caution from the ECB going forward. The European Central Bank announced in its June meeting that asset purchases will end in 2018, as expected. However, Mr. Draghi later announced that the ECB was not in a rush to raise the policy rate and the next hike was pushed from June to the autumn of 2019.

**Improved outlook for the GCC**

The regional outlook is improving amid higher oil prices and regional government’s economic stimulus programs. GCC non-oil activity continues to improve, with real GDP data for 1Q18 showing Saudi Arabia’s non-oil sector growing by 1.6% y/y in
1Q18, Kuwait’s by 3.1% y/y and Qatar’s by an impressive 5.0% y/y. (Chart 4.) The UAE, for its part, redoubled its efforts to improve the local business environment and attract FDI. Abu Dhabi in turn announced an economic stimulus package of $13.6bn to boost growth.

In a boost to GCC financial markets, the $520bn Saudi bourse entered the MSCI EM index for the first time in June, while Kuwait’s stock market was included on MSCI’s watchlist for potential reclassification to EM status in 2019. Meanwhile, Bahrain’s currency and bonds were the focus of intense speculation in June after concerns resurfaced about the kingdom’s ability to refinance its obligations in the context of its large fiscal deficits and debt levels. The sell-off saw the Bahraini dinar fall to a 17-year low against the US dollar, the kingdom’s main CDS on five year debt climb to a near 10-year high of 571 bps and the spread between its US dollar conventional bonds and its Islamic bonds swell to record levels. The pressure prompted the central bank to reaffirm its commitment to the US dollar peg. Saudi Arabia, the UAE and Kuwait pledged to support Bahrain, leading to a rebound in the market. However, the timing and size of this support package have not been announced.

**Japan unlikely to tighten monetary policy soon**

Export growth rose 8.1% y/y in May, amid a pick-up in demand for manufacturing equipment, cars and car parts, while import growth accelerated from 5.9% y/y to 14.0% y/y on imports of aircraft and higher oil prices. (Chart 5.) Meanwhile, Japan’s trade surplus with the US fell to its lowest level since 2013 due to US aircraft and coal imports. Japan, like China and the EU, albeit to a lesser extent, has come under pressure from the US about unfair trade policies. Inflation in May came in at 0.7% y/y, suggesting that monetary policy tightening will not take place soon.