Economic Update
NBK Economic Research Department I 12 January 2020

International Scene

Further rise in geopolitical tensions could set back markets after strong end to 2019

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Highlights

- Financial markets enjoyed a strong end to 2019 as optimism grew helped by the agreement of a partial US-China trade deal. But some of this optimism was later punctured by an escalation in US-Iran military tensions.
- Given largely positive recent data on jobs and housing, the Atlanta Fed estimates that US growth in 4Q19 could have picked up to 2.3% from 2.1% in Q3. This would support the view that the Fed will leave policy on hold this year.
- By contrast PMI figures suggest growth in the Eurozone slowed to a crawl in Q4. In the UK, the Conservative Party's resounding general election victory clears the way for the UK to leave the EU at the end of January.

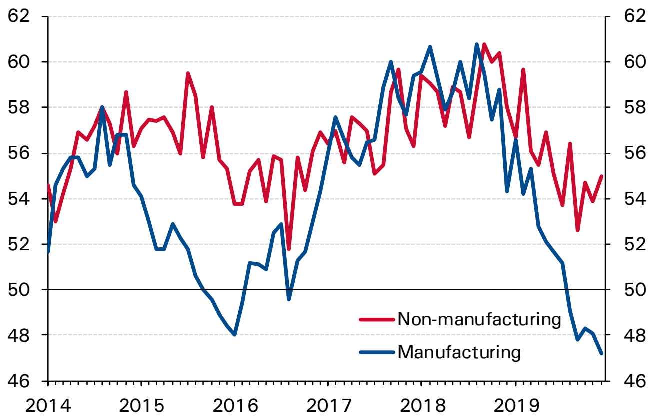
Financial markets enjoyed a strong end to 2019 with the US S&P equity index up 3% m/m and 10-year treasury yields edging back above 1.9% as optimism grew over the outlook for global growth amid mildly encouraging economic data and the agreement of a 'phase one' trade deal between the US and China. Some of this optimism was punctured in January however with the escalation in military tensions between the US and Iran that if sustained could jeopardize conditions in the broader Middle East region. These developments saw the price of Brent crude oil spike to nearly $70/bbl having already finished 2019 on a strong note thanks to the better global demand outlook and fresh OPEC+ supply cuts announced in December.

Trade deal helps lift optimism over US outlook

Pessimism over the US growth climate has mostly ebbed over the past month amid decent economic data especially on jobs, housing and service sector activity and also the boost to sentiment from the partial US-China trade deal which could ease pressure on the still-weak US manufacturing sector (see below and chart 1). Estimates of fourth quarter GDP growth have been rising and the Atlanta Fed 'nowcast' suggests growth could even have reached an annualized 2.3% in 4Q19 from 2.1% in Q3. This would leave growth at a decent 2.4% for 2019 overall, though still down from 2.9% a year earlier and versus a consensus forecast of 1.6% for 2020. A reasonably solid economic picture, a strong stock market, contained inflation and reduced risks from overseas trade point to little urgency from the Federal Reserve to change interest rates from current levels, a view supported by minutes from the bank's December meeting that showed a growing consensus among officials for keeping policy on hold through 2020. (Chart 2.)

Chart 1: US ISM activity surveys

(index, 50=no change)

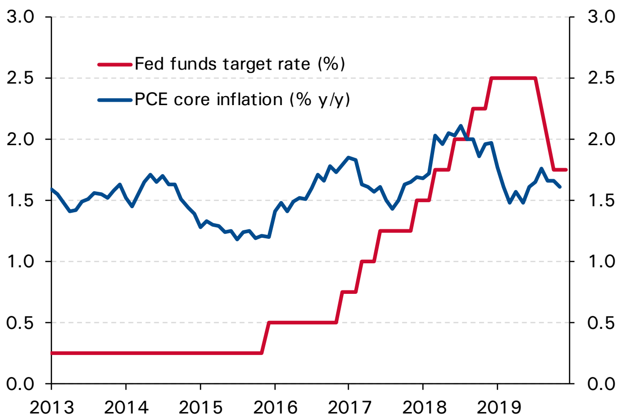


Source: Refinitiv

There was at last some positive news on trade with the US and China agreeing a 'phase one' deal that effectively calls a provisional truce on their now 18-month dispute, and is scheduled to go into force from January 15th. The deal sees China purchase $40 billion more US agricultural goods per year, take steps to end forced technology transfer and also avoid currency devaluation to gain competitive advantage. The US on the other hand will halve the 15% duties on imports from China introduced in September and shelved further tariff hikes that were scheduled for December.

While the agreement represents a first step in deescalating the quarrel which has dented confidence, trade, and manufacturing worldwide and should ensure no further duty hikes, it leaves tariffs on around $250 billion in US imports from China imposed before September in place and difficult issues such as Chinese state subsidies and cyber intrusions unresolved. Prospects for a substantive 'phase two' deal could be influenced by political factors ahead of the November presidential election and to the extent that the deal discourages the Federal Reserve from further policy loosening, the net boost to the US economy could be positive but modest.

Chart 2: US policy interest rates and inflation

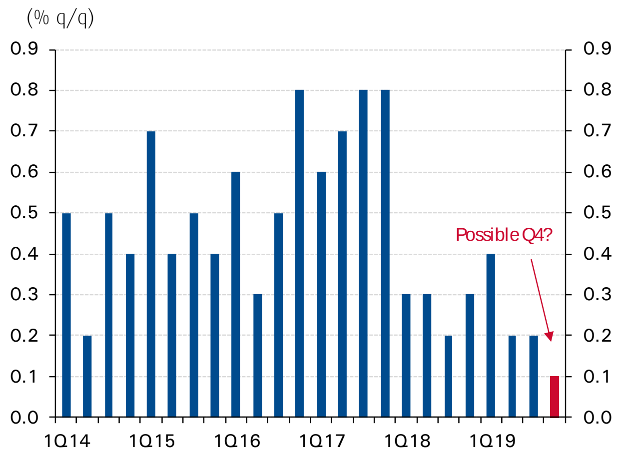


Source: Refinitiv

Eurozone activity weak in Q4; UK to proceed with Brexit

In the Eurozone, the December composite PMI edged up to 50.9 from 50.6 in November, but points to overall growth remaining at negligible levels. Based upon previous trends, this could be consistent with GDP growth of just 0.1% q/q in 4Q19, well below trend and even lower than the 0.2% growth recorded in Q2 and Q3. (Chart 3.) Other sentiment surveys suggest that the worst of the downturn in activity may be over, but any pick-up is likely to be gradual given the still-fragile external climate, signs of a cooling job market and the continued reluctance of the German government to provide significant fiscal stimulus.

Chart 3: Eurozone GDP



Source: Refinitiv / NBK

The European Central Bank, having cut interest rates to -0.5% in September and restarted quantitative easing in November may look to loosen policy a bit further over coming months given that core inflation at 1.3% y/y in December remains well below the ECB's 'close to but below 2%' target. But the extent could be limited by concerns over the impact on financial stability of negative interest rates, the recent departure of the dovish but influential Mario Draghi as president and as the bank assesses the consequences of ultra-loose policy as part of its broader strategic review of monetary policy this year.

In the UK, the Conservative party won a resounding victory at the December 12 general election, leaving PM Boris Johnson with a large 80-seat majority in the 650 seat House of Commons for the next five years. The following week, parliament easily approved Johnson's renegotiated Brexit deal, clearing the way for the UK to leave the EU at the end of January 2020. The UK will enter into an 11-month transition period from February during which the two sides will look to negotiate an agreement to govern their future trading relationship, with the EU likely to insist on considerable regulatory alignment from the UK in exchange for better access to EU markets. Johnson prefers a looser arrangement and has ruled out extending the transition period beyond 2020, which could see the UK default to trading on WTO terms if no agreement is reached by then. Worries about 'no deal' saw the pound give up its immediate post-election gains, though somewhat reduced political uncertainty and the prospect of an expansionary budget in March should help keep economic growth above 1% in 2020 and interest rates on hold.

Japanese growth in Q3 upgraded

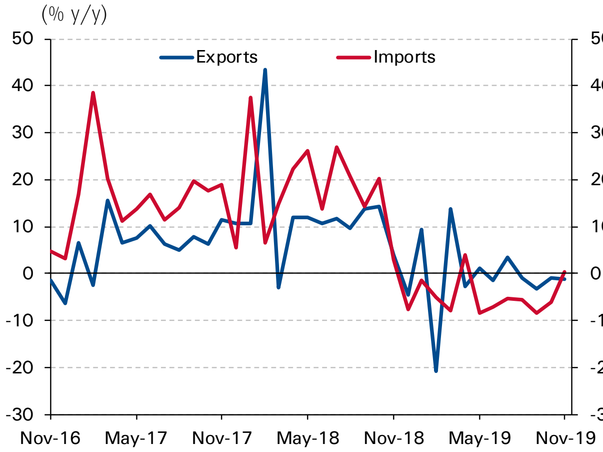
Japan's third quarter growth was revised up to an annualized 1.8%, well above the initial estimate of 0.2% mainly thanks to an increase in investment and household spending. However, the pick-up in household spending was likely driven by consumers' looking to beat the sales tax hike in October, and is therefore unlikely to be sustained in Q4. As one indicator of this, the decline in import growth moderated to 4.8% y/y in 3Q19, but had returned to a much steeper 15% fall by November, reflecting underlying weakness in domestic demand. Meanwhile exports continue to struggle, having fallen for a year and were down 7.9% in November. Nonetheless, during its monetary policy meeting in December, the Bank of Japan maintained a largely positive stance on the economy and refrained from policy easing measures, as uncertainty over the global economy waned not least because of the US-China trade agreement.

Outlook for Chinese economy more promising

China's economy will be offered some reprieve as a 'Phase-One' trade deal with the US comes into effect from January 15th. This should give its external sector a much-needed boost after exports were down (-1.2% y/y) for the fourth straight month in

November. (Chart 4.) Meanwhile, additional monetary and fiscal easing measures are expected to further support the economy. The central bank announced a 50bps cut in the reserve ratio (effective January 6th) that will inject RMB800 billion ($115 billion) of liquidity into the banking system, allowing banks to reduce lending costs to the private sector, SMEs in particular. It is also likely to give cash demand a boost ahead of the Chinese New Year holiday. The bank has vowed to maintain a "prudent, flexible and appropriate" monetary stance. The series of pro-growth measures appears to be working so far, with recent manufacturing PMI data pointing to signs of stabilization in the economy. As such, the yuan appreciated for the fourth consecutive month in December, with the central rate rising by 0.8% to RMB6.98/US$1.

Chart 4: Chinese international trade



Source: Refinitiv

Growth in India slows in Q3, but grounds for optimism

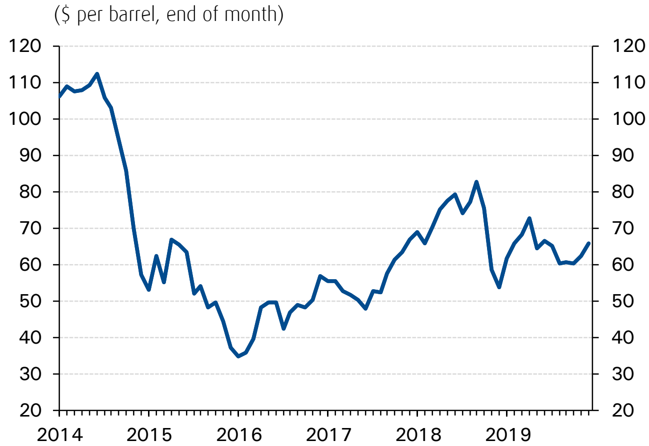
GDP growth slowed to a more than six-year low of 4.5% in 3Q19 from 5.0% in Q2, marking the sixth consecutive quarterly decline in growth and affected by the slowest pace of investment since 2014 (1%). Investment has been hit by tighter credit conditions after the collapse of a major non-bank lender in 2018. Exports meanwhile contracted by 0.4%, likely affected by softer world demand. Growth in private consumption, while still relatively soft, rose to 5% from a five-year low of 3.1% in Q2. However more recent data suggest some grounds for optimism. PMI activity indices have gradually risen, with the manufacturing and services measures at 52.7 and 53.3 respectively in December, lifted by new orders and higher employment. The outlook has been helped by interest rate cuts of a combined 135 bps in 2019 and a reduction in corporate tax (from 35% to 25% and 17% for manufacturing) in September. But given that the scope for further fiscal and monetary stimulus may be limited by rising twin deficits and inflation, and the banking sector remains burdened with bad debt, the consensus view is that any pick-up in growth will be modest over coming quarters.

Oil prices up as US-Iran tensions spike

The new year started with geopolitical risk back on the oil market's agenda. The price of Brent crude oil jumped more than 3% to $69/bbl after a US drone attacked killed Iranian general Qassem Soleimani while in Iraq. (Chart 5.) With regional tensions spiking and Iran later retaliating with a strike on a US military base in Iraq, oil prices look set to benefit (only for a short period) from elevated geopolitical risk premia in the near term, as well as more constructive demand-supply dynamics that emerged towards the end of 2019. The latter helped Brent finish the year with annual gains of 23% – its best performance since 2016. These included the US-China trade agreement and the OPEC+ decision to cut oil production by an additional 500 kb/d from current levels (taking total cuts to 2.1 mb/d) until at least March. Markets expect the new deal to help reduce the supply overhang and minimize stock increases.

Meanwhile, on 1 January, tighter regulations on sulphur emissions in shipping (bunker) fuels by the International Maritime Organization (IMO) went into effect. Seaborne freight is mandated to run fuel containing no more than 0.5% sulphur from the previous limit of 3.5%. These regulations should favour light, sweet crude oils such as Brent and WTI that yield greater quantities of low sulphur shipping fuels compared to the regionally more prevalent medium, sour crudes that yield less after refining.

Chart 5: Brent crude oil price



Source: Refinitiv

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