Economic Update

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International Scene

Coronavirus worries hit financial markets and Chinese growth prospects

> Economic Research
+965 2259 5500
econ@nbk.com

Highlights

- Fears over the impact and spread of the Coronavirus in late January hit financial markets which had until then enjoyed a largely upbeat start to the year. Brent crude oil prices fell sharply on possible fallout on Chinese and global oil demand.
- US GDP growth was steady at 2.1% in 4Q19, though recent stronger data on housing and manufacturing – virus impact notwithstanding – give some cause for optimism. The Fed has promised to cease its liquidity injections in Q2.
- The ECB left rates on hold and talk of a new inflation target could make near-term policy changes more complicated. The UK finally left the EU in January and the two sides will look to agree longer-term trading arrangements by end-year.

Fears over the impact and spread of the Coronavirus in late January hit financial markets, which had until then enjoyed a largely upbeat start to the year on brightening economic prospects helped by the US-China trade deal. The US S&P index for example finished January -0.2% m/m having been up 3% mid-month, while global government bond yields also fell back sharply. While the full implications of the outbreak are still not clear, it is expected to have a large impact on Chinese growth in Q1 just as activity in the world's second largest economy appeared to be stabilizing. Worries over the impact on Chinese and global oil demand also hammered oil prices, with Brent crude plunging 20% from its January peak.

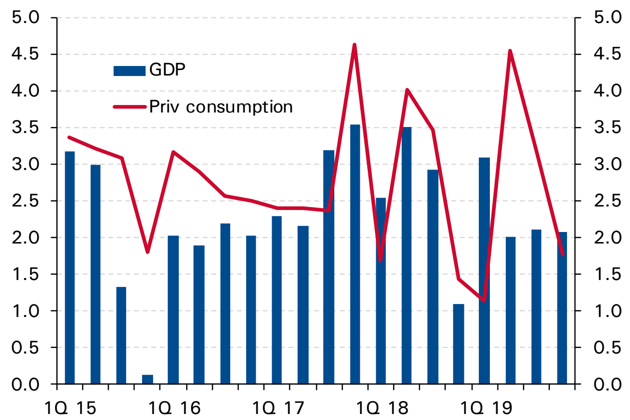
US growth steady in Q4; Fed leaves rates on hold

Economic growth in the US stood at an annualized 2.1% in 4Q19, unchanged from Q3 and in line with expectations. (Chart 1.) Consumer spending moderated to 1.8% from Q3's very strong 3.1%, and a slowdown in inventory growth also weighed on activity. These negative factors were offset by stronger government spending (2.7%) and especially a sharp drop in imports (-8.7%) – the latter perhaps due to the unwinding of strong imports in Q3 when firms had looked to beat September's tariff hikes on Chinese goods. Growth overall in 2019 slowed to 2.3% from 2.9% in 2018 and was the softest since 2016.

Latest high-frequency data suggests that activity may now be picking up, with in particular the housing market recovering (price increases accelerating after a two-year slowdown), the ISM manufacturing index turning positive (50.9) in January for the first time since July and job growth maintaining a strong pace of 225,000 in January. This has eased immediate concerns over a downturn, but uncertainty over trade, the coronavirus and indeed the mature stage of the economic cycle is set to limit the potency of any upswing.

Chart 1: US GDP

(% q/q, annualized)



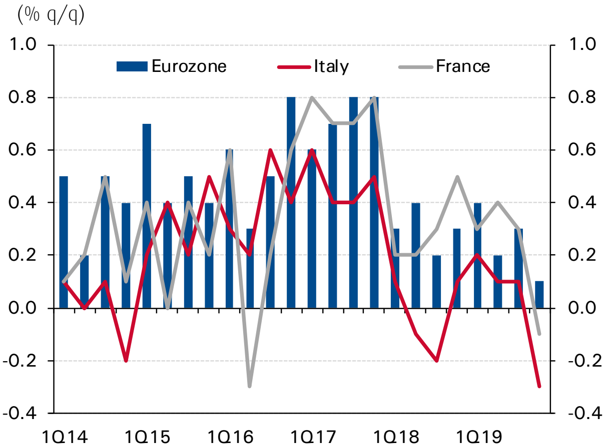
Source: Refinitiv

In a relatively low-key January meeting, the Federal Reserve kept policy rates at their current 1.50-1.75% range, citing the strong labor market, moderate consumer spending growth but core inflation – at 1.6% y/y on the PCE measure in December – below the 2% target. Futures markets are pricing in a more than 80% chance of at least one 25 bps cut by year-end. Fed chairman Jay Powell said that the bank could cease pumping extra liquidity into the market – currently at a rate of $60 billion per month – sometime in Q2. The move was originally portrayed as a technical measure to help keep policy interest rates within their target range, and has pushed the Fed's balance sheet back up to nearly $4.2 trillion from $3.8 trillion last September. But some analysts claim it has been a factor in the strong stock market rally and that the Fed will at least have to manage the phasing out of injections carefully to avoid market disruption.

Eurozone growth slows; UK finally leaves the EU

Eurozone GDP growth slowed to just 0.1% q/q in 4Q19, below expectations and down from 0.3% in Q3. The decline was driven by falls in output in both France (-0.1%) and Italy (-0.3%) – the former affected by ongoing strike action related to President Macron's pension reforms. (Chart 2.) Figures for Germany have not yet been released, but growth was negligible in Q3 and recent optimism over a cyclical recovery helped by falling global trade tensions may now be tempered by the impact of the Coronavirus on exports. The Eurozone PMI index edged up in January to a still-modest 51.3, and analysts continue to expect a tentative pick-up in regional growth later this year, with the further decline in unemployment to a 12-year low of 7.4% in December underpinning the outlook for domestic demand.

Chart 2: Eurozone GDP



Source: Refinitiv

The European Central Bank as expected left policy on hold in January, with the deposit rate at -0.5% and quantitative easing of €20 billion per month. It stated that risks to the outlook were now 'less pronounced' than before (due to reduced trade tensions) but still 'tilted to the downside', though this was before concerns over the Coronavirus outbreak intensified. Inflation ticked up to 1.4% y/y in January from 1.3% in December, but the rise was mostly due to energy prices and core inflation fell back to just 1.1%. Policy is expected to remain on hold going forward and indeed the threshold for a near-term change in policy may now be high as the bank mulls a possible change in the inflation target (currently 'below or close to 2%') as part of its recently-launched strategic policy review. Moreover, bank officials have been vocal on the need for fiscal policy to take on a greater role in supporting the regional economy.

Nearly four years after its 'in-out' referendum, the UK finally departed the EU at the end of January following 47 years of membership. The UK has now entered an 11-month transition period under which regulations on trade, travel and business with the EU are unchanged, while both sides try to agree a trade deal that will govern the relationship beyond 2020. Although there is a range of possible outcomes, initial signs are that PM Boris Johnson will seek a loose relationship that provides for UK regulatory autonomy even at the expense of fresh trade barriers or potentially a return to basic WTO trading arrangements next year. Largely as expected, the event passed with minimal market impact. The Bank of England kept interest rates on hold at 0.75%, though said it would monitor the impact of improving sentiment on hard data over coming months. It did however revise down its 2020 growth forecast to 0.8% from 1.2% before.

BoJ upgrades growth outlook

The Bank of Japan kept monetary policy on hold last month, maintaining its short-term interest rate at -0.1% and its pledge to keep 10-year government bond yields at around 0%. The bank also upgraded its growth outlook for the fiscal year starting in April from 0.7% to 0.9% on the back of planned fiscal stimulus measures amounting to $121 billion. Both headline (0.8%) and core (0.9%) inflation rates remain well below the bank's elusive inflation target of 2%, leaving it ample room to ease monetary policy to support the economy if need be. Meanwhile, both exports and imports continued to fall in December, with exports declining 6.3% y/y (its 12th consecutive month of decline) and imports retreating by 4.9% (albeit an improvement from a 16% drop in November). While the US-China trade deal should offer global trade growth and Japanese exports some support going forward, the economic effects of the rapid spread of the Coronavirus, which has led to the shutdown of various manufacturing plants, may lead to supply-chain disruptions that ultimately hamper global trade growth.

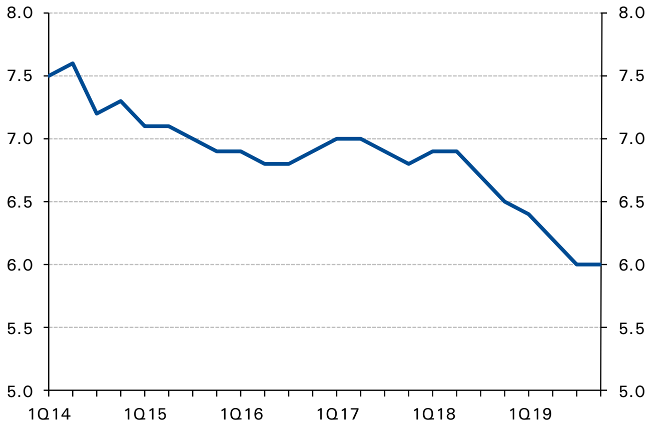
Chinese economy hit by virus outbreak

The death toll in China from the Coronavirus outbreak topped 490 by early February with more than 24,000 confirmed cases, much higher than during the 2002-2003 SARS outbreak. This has and will continue to have negative ramifications on the economy, as both local and international authorities take further urgent measures to limit the spread of the virus. The government extended the Lunar New Year holiday and a number of international firms including Starbucks, Apple and Hyundai have halted operations indefinitely.

This will weigh on economic activity in 1Q20, coming soon after data showing that growth stabilized at 6.0% y/y in 4Q19, unchanged from the previous quarter. For 2019 as a whole however, growth slowed to an almost three-decade low of 6.1% in 2019 from 6.6% in 2018, though still within the government's target of 6-6.5%. (Chart 3.) The slowdown was led by a weaker external sector and as investment and consumer spending came in softer. The official PMI for January showed manufacturing activity stagnating at 50.0 versus 50.2 in December, but it may not yet be reflecting the full impact of the virus outbreak. Meanwhile, in a bid to provide support to the economy, China's financial regulators announced $242 billion in liquidity injections and an ease in lending restrictions to help business. The authorities are also reportedly seeking some flexibility on pledges made under the 'phase one' trade deal with the US. The stock market fell 7.7% – its largest daily drop in years – the day markets reopened after the extended holiday and the yuan fell back towards RMB7/UD$1.

Chart 3: Chinese GDP

(% y/y)



Source: Refinitiv

India proposes modest reforms to support growth

In its 2020 budget on February 1, the Indian government unveiled a series of modest reforms aimed at boosting spending and investment, in a bid to support a faltering economy. The reforms include a personal income tax cut and proposed amendments to the definition of income tax residency in India, aimed at boosting tax revenues. The Indian government is also planning a $30 billion public asset sale program to help curb the fiscal deficit. Import tariffs were also proposed on certain goods, including furniture and footwear.

The growth rate has been in decline for six consecutive quarters and stood at 4.5% y/y in 3Q19, despite a combined 135 bps of interest rate cuts and considerable corporate tax cuts in 2019. Growth was weighed down by weaker investment, stemming from tighter credit conditions and a banking sector burdened with bad debt, which could impede lending going forward. Private spending has also been relatively weak, despite a modest recovery in 3Q19, and may remain subdued under rising inflationary pressures. However, there are some promising signs: industrial production increased for the first time in four months in November, and the composite PMI hit a seven-year high in January. Looking forward, the consensus view is that growth will pick up to a downwardly-revised 6% in FY20/21, from an estimated 5% in the current fiscal year, an 11-year low.

Oil prices slide on Coronavirus epidemic

The Chinese Coronavirus epidemic has pushed international benchmark Brent crude into bear-market territory as fears grow about the likely impact on Chinese consumption and, by extension, energy demand. As of 5 February, Brent had fallen 20% from its January peak to $55.3 and its lowest in over a year. (Chart 4.) Indeed this is possibly oil's worst start to a year since 1991, with Chinese oil consumption estimated to have dropped by at least 20% (3 mb/d) – the biggest oil demand shock since the financial crisis – as the country remains in lockdown and international flights suspended.

Chart 4: Brent crude oil price

($ per barrel, end of month)

Source: Refinitiv

Oil's precipitous decline has prompted the OPEC+ group to consider bringing forward its scheduled March meeting to formulate a response to the crisis, perhaps through further production cuts. Talks among an OPEC+ technical panel in early February recommended additional oil production cuts of 600,000 bpd. All indications are that with oil demand weaker, global supply and stock levels are only going to get larger; the Brent forward curve structure has already slipped into contango (where futures prices trade above spot prices) for the first time since last July. Oil's bearish move has occurred despite the loss of an estimated 1 mb/d of crude from Libya, as forces loyal to General Haftar blockade the country's ports. Libya's production is reportedly below 0.3 mb/d, its lowest level since the ousting of Gaddafi in 2011.

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: 22043-22451 NATBANK
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 346, Road 4626
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 Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia

National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan

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

Lebanon

National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq

Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt

National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America

National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom

National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 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 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China

National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait

NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO 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
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353