US growth powers ahead, but trade war with China intensifies

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Highlights

- **Although the US and EU reached a truce on further tariffs, the US-China dispute has escalated with both sides threatening fresh measures. Against this backdrop, the Chinese currency has plunged in recent weeks.**
- **Nevertheless the US economy continues to forge ahead, with growth hitting a near four-year high in 2Q18 and seen remaining strong in Q3. The Federal Reserve is expected to hike interest rates in September.**
- **By contrast European growth was disappointing in Q2. The ECB is still set to end its bond purchase program by end-year, but will push back an interest rate hike until H219.**

The economic news flow over the past month was dominated by ongoing global trade tensions and the implications for growth. Although the US and the EU announced a truce on further tariff increases, the US-China dispute has escalated, with both sides threatening fresh measures including the US proposal to impose 25% tariffs on $200 billion in imports from China – around 40% of the total. Partly reflecting trade concerns, the Chinese currency has plunged in recent weeks.

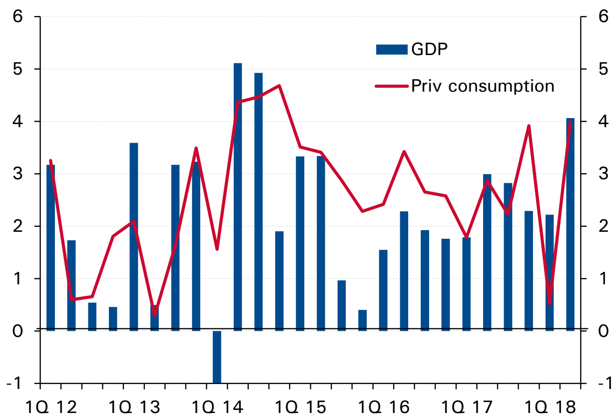
Despite intensifying risks to trade, global central banks are continuing the gradual "normalization" of monetary policy amid still decent growth figures and rising inflation; the Bank of England was the latest to push rates higher in August despite uncertainty over Brexit and the US Fed is likely to raise rates again in September.

US growth surges in Q2, led by consumer sector

As expected, US GDP growth bounced back sharply in 2Q18 after a soft Q1 affected by seasonality issues and delayed tax refunds. Growth reached an annualized 4.1% in Q2, the strongest since 2014 and would have been above 5% were it not for a drag from inventories. (Chart 1.) The still-impressive figure was driven mostly by a rebound in consumer spending to 4.0% from just 0.5% in 1Q18 as well as strength in private investment (+5.4%) and exports (+9.3%) – the latter reportedly lifted by overseas buyers seeking to beat prospective tariff increases. Most analysts see Q2 as the high watermark for economic growth this year, though high frequency data points to activity remaining robust in the third quarter.

Chart 1: US GDP

(% q/q, annualized)



Source: Thomson Reuters Datastream

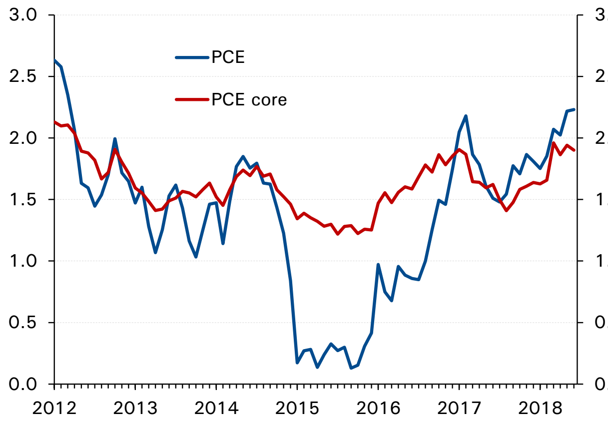
Indicators of the all-important consumer sector remain very strong. Having ticked back up to 4% in June, the unemployment rate fell back to 3.9% in July, close to May's 18-year low. This was despite a more modest than expected rise in non-farm payrolls of 157,000 – well below the 224,000 average in 1H18 perhaps due to emerging capacity limits. Meanwhile consumer confidence unsurprisingly remains at extremely robust levels, helped by tax cuts and decent wage growth. One softer area is the housing market, which shows signs of cooling: house prices rose just 0.2% m/m in May for the second month in a row, while both new and existing home sales fell in June.

There are still few decisive signs of fallout from recent trade tariff measures – though the risks can expect to rise if further measures are imposed. PMI and ISM activity survey figures all cooled in July, but remain above their long-run averages (especially for manufacturing), and for some analysts this represented a welcome breather for the economy given risks of overheating. However, after three successive months of narrowing, the goods and services trade deficit widened in June to $46 billion as the tariff-related boost from front-loaded soybean exports to China in April and May faded. The trade position will come under greater scrutiny over coming months not just given possible tariff effects, but also recent dollar strength (including versus the Chinese renminbi) and signs of a slowdown in global economic growth.

The Federal Reserve, as expected, left its Fed Funds target rate range unchanged at 1.75-2.00% in August though delivered an upbeat assessment of prospects for the economy that – after 25bps hikes in March and June – leant support to two further rate increases this year. Futures markets are now pricing in a more than 90% chance of the next 25bps rise taking place in September, and a two-thirds chance of a further hike in December. The central bank will be encouraged by news that its preferred inflation gauge – the core personal consumer expenditure measure – was unchanged at 1.9% y/y in June despite the strong consumer sector. (Chart 2.)

Chart 2: US PCE inflation

(% y/y)



Source: Thomson Reuters Datastream

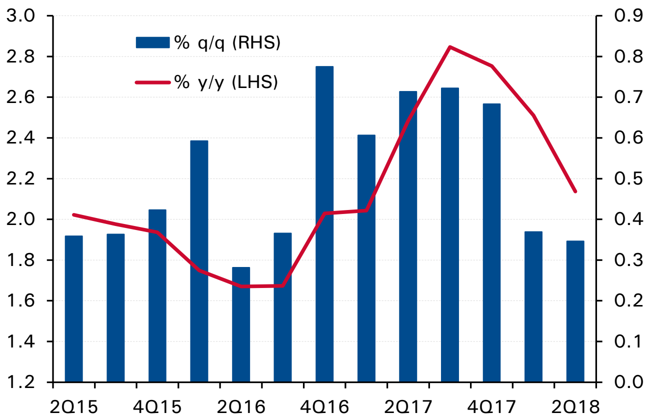
Eurozone GDP growth eases more than expected

Fears of a more persistent slowdown materialized as growth in the Eurozone expanded by a smaller-than-expected 0.3% q/q in 2Q18, following a similarly weak 0.4% in 1Q18. (Chart 3.) The tepid performance was in line with a slew of data that pointed at still weak growth during the second quarter, with both PMI and economic sentiment surveys falling back to levels not seen since before the pick-up in 1H17.

However, there are signs of a potential rebound. Inflation moved above the ECB's 2% target for the first time in July since December 2012, albeit driven by higher energy prices. Meanwhile, credit growth for both businesses and households remained at its strongest since 2009, while unemployment finished 2Q18 at 8.3%, its lowest in almost 10 years.

Chart 3: Eurozone GDP

(% y/y)



Source: Thomson Reuters Datastream

Still at risk, however, is the Eurozone's export-oriented growth model, which caught a break last month after being placed in Mr. Trump's crosshairs earlier in the quarter. In an unexpected turnaround in rhetoric by the American president, the US and EU agreed to work on improving trade relations, cooling trade war concerns between both major economies. If pursued, this could lead to a reduction in tariffs and other trade barriers. Meanwhile, the EU and Japan agreed an outline free trade deal, creating in turn a major free trading economic bloc that covers 600 million people and nearly a third of global GDP. Within the new framework, 99 percent of tariffs that cost businesses in the EU and Japan nearly €1 billion will be eliminated. Much more work is needed for this deal to take effect.

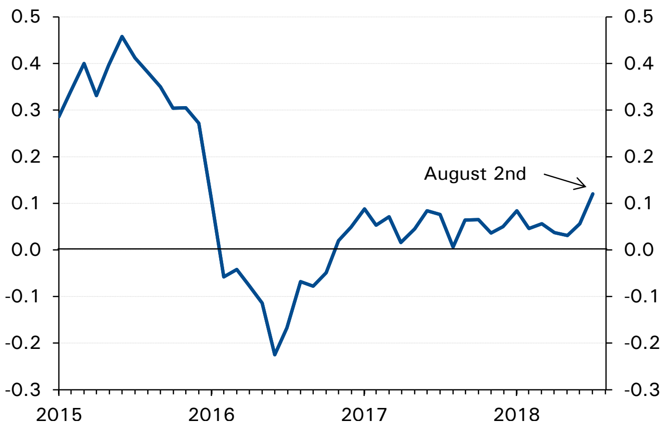
Despite signs of moderating growth and risks to the trade outlook, the European Central Bank looks set to press on with reducing its support for the Eurozone economy by ending its bond-buying program in December, though in a sign of mild caution looks to have pushed back its rate hike window to after summer 2019.

BoJ leaves policy unchanged but bond yields climb

The Bank of Japan held monetary policy steady, maintaining its target for the 10-year government bond yield at or around 0% and the short-term interest rate target at -0.1%. However, it added that it will adopt a more flexible approach for its long-term yield target, allowing for greater movement in 10-year yields. The announcement comes after reports that the bank was mulling ways to improve policy sustainability, which lifted government bond yields. Yields on government 10-year bonds stood at above 0.1% in early August, their highest in more than two years. (Chart 4.) The BoJ also acknowledged that more time was needed to achieve its 2% inflation target. Meanwhile the first estimate of 2Q18 GDP due this month is expected to show a return to positive growth of 0.3% q/q after falling in the first quarter.

Chart 4: Japanese 10-year government bond yields

(%)



Source: Thomson Reuters Datastream

Chinese growth slows, currency weakens

GDP growth slipped to 6.7% y/y in 2Q18 from 6.8% in Q1 amid concerns over high debt levels, slower infrastructure spending and the escalation in trade tensions with the US – though remains slightly above the government's target of "about 6.5%" for the year overall. Survey evidence suggests that growth may soften further in 3Q18. The official purchasing managers Index (PMI), for example, showed manufacturing activity weakened slightly in July, slipping to 51.2 from 51.5 in June and its lowest reading since February, while the official services PMI also fell for the first time in five months, to 54.0 from 55.0 in June. Growth concerns combined with trade tensions have seen the value of the renminbi plunge in recent weeks, down 8% for example against the US dollar since the start of April.

Oil prices see first monthly decline since February

The price of Brent crude oil suffered its first monthly decline in five months in July, down 6.5% to $74.3/bbl. (Chart 5.) The downward move comes after a sustained rally that had pushed crude prices up by two-thirds since mid-2017 on tighter market fundamentals driven by supply cuts by key OPEC and non-OPEC producers, solid global demand and falling global inventories. July's decline was driven by a combination of concern over global trade tensions and signs that key OPEC producers were starting to ramp up output following the decision to ease past supply restrictions which took effect from July. Initial reports suggested that production by OPEC linchpin Saudi Arabia, for example, may have neared an all-time high of 10.65 million b/d in July – although OPEC officials later said that it had in fact edged lower. Higher production has helped ease fears over the impact of falling Iranian supplies as US sanctions kick in over coming months.

Chart 5: Brent crude oil price

($ per barrel, end of month)

Source: Thomson Reuters Datastream

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