Central banks cut rates as manufacturing gloom deepens

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Highlights

- **After a torrid August, financial markets recovered somewhat in September helped by a more stable trade war climate and looser central bank policy. Oil markets were rocked however by drone attacks on Saudi oil facilities.**
- **The US Fed cut interest rates by 25 bps, and given the latest weak growth signals, futures markets expect at least one further cut this year. The Fed has also tackled a liquidity shortage in money markets by expanding its balance sheet.**
- **Survey evidence now points to economic stagnation in Europe, but the ECB has faced criticism over its September policy loosening. The UK's end-October Brexit deadline is approaching amid hope that a late deal can still be struck.**

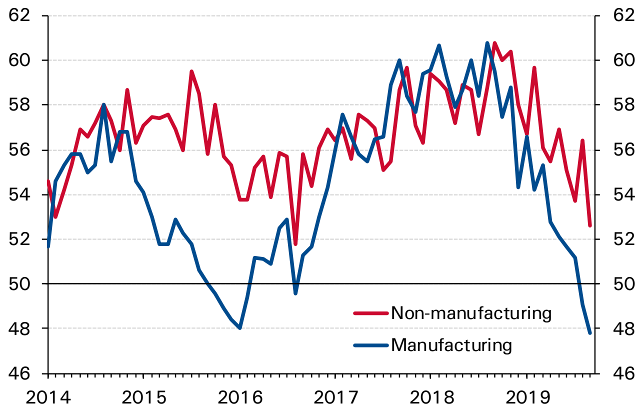
After a torrid August, financial markets recovered somewhat in September, helped by a more stable trade war climate – followed in October by a limited deal between the US and China that removed near-term tariff hikes – and looser monetary policy by both the US Fed and the ECB. Major equity indices rose around 2-5% and bond yields edged back up from September's multi-year lows, though 10-year yields remain negative across parts of Europe and Japan. The oil market however was rocked by attacks on Saudi oil facilities that saw oil prices surge, before falling as Saudi production recovered and markets returned their focus to the deteriorating global growth outlook.

US manufacturing weakens again, but jobs market strong

In the US, there has been more evidence that economic activity is softening. Most alarming was the manufacturing ISM index, which dropped even further into negative territory at 47.1 in September, and a 10-year low amid heavily contracting export orders and trade pessimism. (Chart 1.) But also concerning was the decline in the non-manufacturing equivalent to a three-year low of 52.6. Meanwhile however, the jobs market remains strong, underpinning still reasonable growth in consumer spending. Non-farm payrolls rose a decent 136,000 in September and the unemployment rate fell to a 50-year low of 3.5%. One concern is that the labor market is a lagging indicator, and that slower business activity will eventually generate cracks in the jobs market that cause the consumer sector to buckle; indeed, the pace of hiring has already slowed from the average of 223,000 per month recorded last year. But at the same time, slower jobs growth need not be a sign of economic weakness if it reflects an economy close to full employment.

Chart 1: ISM business activity surveys

(50=no change)

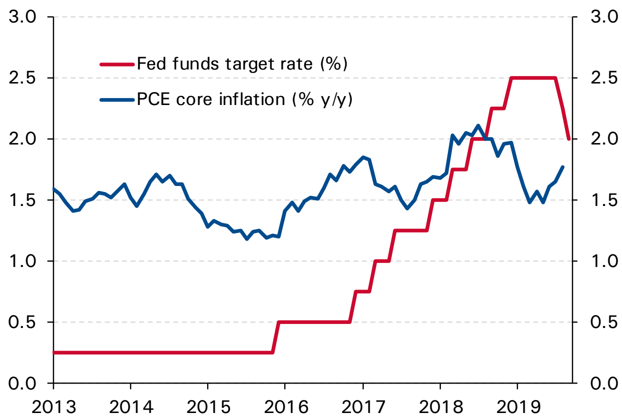


Source: Refinitiv

Against this uncertain outlook, the Federal Reserve as expected cut interest rates by 25 bps in September – the second cut of the year – leaving the Fed Funds target range at 1.75-2.00%. (Chart 2.) The move was however interpreted as somewhat 'hawkish', with two out of 10 members voting for no cut (though one supported a larger 50 bps reduction), and the bank's 'dot plot' projections pointing to no further rate cuts in 2019-20. It also left its forecasts for growth and inflation next year, at 2.0% and 1.9% respectively, unchanged, implying no strong need for further policy action. Markets however continue to take a different view, pricing in an 85% chance of at least one further cut by end year (probably October).

The Fed has also been tackling a sudden and unexplained liquidity shortage in the money markets, which saw interbank interest rates temporarily spike in mid-September and resulted in the bank offering emergency short-term loans. These injections saw the Fed's balance sheet record its first meaningful rise since it halted its quantitative easing program in 2014, with some analysts dubbing it 'QE lite'. The Fed in October then outlined a larger program of purchases of $60 billion per month of short-term treasury bills through 2Q20.

Chart 2: US interest rates and inflation



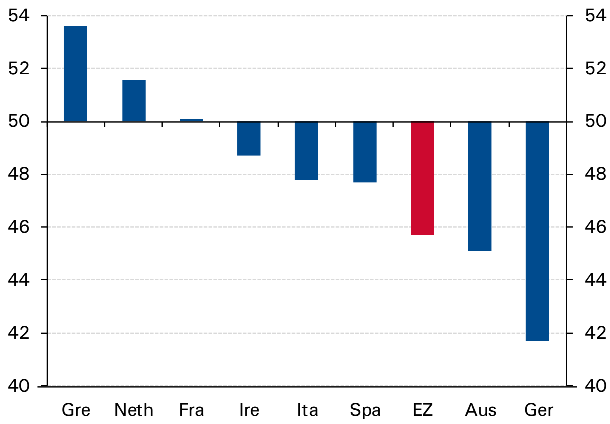
Source: Refinitiv Note: shows upper end of the Fed's target range.

Manufacturing gloom deepens amid ECB policy clash

News on the Eurozone economy has become still more downbeat, with manufacturing in decline in most of the region and growing signs of spillover effects on the until recently more upbeat service sector. Germany's manufacturing PMI plunged to a 10-year low of 41.7 in September amid investment cuts and accelerated job losses on the back of slower trade and Brexit-related uncertainty. (Chart 3.) The broader composite PMI at 48.5, saw its first sub-50 reading since 2013 and points to a decline in GDP in Q3 that would put the economy in recession following a 0.1% q/q contraction in Q2. Equivalent results for the Eurozone as a whole (50.1) point to economic stagnation at the end of Q3, presenting the risk of a fall into recession if momentum continues to weaken going forward.

Despite this worrying outlook, a degree of opposition surrounded the European Central Bank's (ECB) loosening of monetary policy in September. The bank announced a package of easing policies, cutting the deposit rate to -0.5% and restarting its asset purchase program from November. The move drew rare public criticism from some current and former ECB officials, who see 'ultra loose' policy as threatening financial stability, a backdoor attempt to finance highly indebted governments and also unjustified in the absence of a clear deflationary threat (inflation has been at 1% or higher for the past three years). The controversy could set the stage for a battle when Christine Lagarde replaces Mario Draghi as ECB president in November. This is important, as the bank's perceived commitment to looser policy could be key in transmitting its effects through the markets.

Chart 3: Eurozone manufacturing PMIs



Source: IHS Markit

In the UK, PM Boris Johnson's suspension of parliament was ruled unlawful by the Supreme Court, resulting in MPs returning to the legislature. Before leaving, MPs had already passed a law forcing Johnson to request a three-month extension to the current end-October Brexit deadline, should a deal not be agreed with the EU by mid-October. There was optimism that the outline of a deal – with new arrangements to address the sensitive Irish border issue – may be close yet Johnson continues to insist that the UK will leave the EU with or without a deal in October. The EU may still be expecting that the UK could be forced to request an extension, and that a new, more pro-EU government may be elected in a general election. Despite the uncertainty, UK GDP surprisingly rose 0.3% 3m/3m in August following a decline of 0.2% q/q in Q2, thereby reducing the risk of a recession in the near term. However, the services PMI fell back into contraction territory in September with job shedding at its fastest since 2010.

Japan moves ahead with sales tax hike

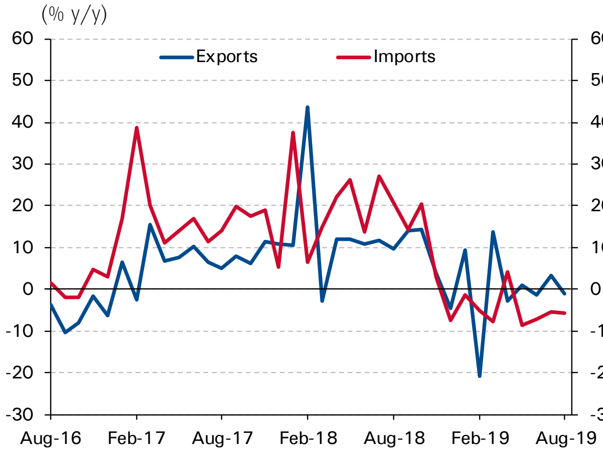
After delaying twice, Japan decided to stick with its decision to raise its sales tax from 8% to 10% this month – a move aimed at improving its weak public finances – even as growth concerns persist. Indeed, the economy slowed more than initial estimates suggested in Q2 after annualized growth was revised down from 1.8% to 1.3%. The economy continues to face headwinds from weaker global growth and the ongoing trade war between the US and China, which have weighed heavily on Japan's external sector. Exports fell for the ninth consecutive month in August (-8.2% y/y), while imports declined for the fourth straight month (-11.9%) reflecting ongoing softness in the domestic economy. While the Bank of Japan stood pat on monetary policy last month, it reportedly discussed the possibility of unleashing further stimulus measures in the near-to-medium term to prop up the economy.

China cuts reserve ratio, more stimulus could follow

China cut its required bank reserve ratio by 50 basis points, the third cut this year, in a bid to prop up growth weighed down by trade tensions with the US and a softer global economy. Indeed further stimulus measures are likely going forward. Chinese exports witnessed a surprise decline in August, falling by 1% while imports fell for the fourth straight month, reflecting the ongoing weakness in the domestic economy as well. (Chart 4.) Meanwhile, PMI manufacturing data for September was mixed. While the official PMI series pointed to a continued contraction in the manufacturing sector, private PMI data pointed to a better-than-expected improvement, which might in part be attributed to pro-growth reforms announced by the government over the past couple of months. Separately, the depreciation in the yuan went into mild reverse through September, with the central rate finishing the month up 0.2% at RMB7.07/US$1 ahead of the restart of US-China trade talks.

Chart 4: Chinese goods trade

(% y/y)



Source: Refinitiv

Oil prices fall back after spiking on Saudi attacks

September closed with oil prices trading at or below where they were on the eve of the Houthi-claimed missile strike on Saudi Arabia's oil infrastructure. The price of Brent spiked in the immediate aftermath of the Abqaiq/Khurais attacks by more than 20% to $71.9 in intraday trading – the biggest surge in oil prices since the 1990 invasion of Kuwait. However it ended the month at $60.8, up just 0.6% m/m and remained around the $60 mark in early October. (Chart 5.)

The 14 September attacks knocked out 5.7 mb/d of Saudi crude output, close to half of the kingdom's capacity, and 5% of global oil supplies. But the geopolitical risk premium that initially pushed oil prices higher has all but evaporated, partly due to Saudi reassurances of export commitments, ample global stocks and a faster-than-expected recovery in Saudi oil production but also due to the markets' refocusing on the poor health of the global economy. The narrative of weakening economic growth was given extra impetus by weaker-than-expected US data and the re-emergence of US-Europe trade tensions.

Chart 5: Brent crude oil price

($ per barrel, end of month)

Source: Refinitiv

GCC developments

It was a mixed bag in terms of economic indicators for the GCC in September. The PMI for Saudi Arabia showed private sector activity continuing to gain traction, improving for the third month in a row to 57.3 on gains in output and new orders. Official data meanwhile showed Saudi non-oil GDP growth of 2.9% y/y in 2Q19 (from 2.1% in 1Q19). By contrast, the UAE PMI continued to ease at 51.1 in September from 51.6 in August, amid weakening domestic demand. Meanwhile Bahrain's fiscal deficit narrowed by 38% y/y in 1H19 to 3.4% of GDP, on the back of cost-cutting measures and revenue-boosting reforms, including the addition of VAT, under the Fiscal Balance Program. Earlier in September, central banks in Saudi, the UAE and Qatar followed the US Federal Reserve in cutting their benchmark interest rates by 25 bps. Taking advantage of lower rates, GCC bond issuance proceeded apace in September: Abu Dhabi issued $10 billion and Bahrain sold $2 billion worth of conventional/Islamic bonds.

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