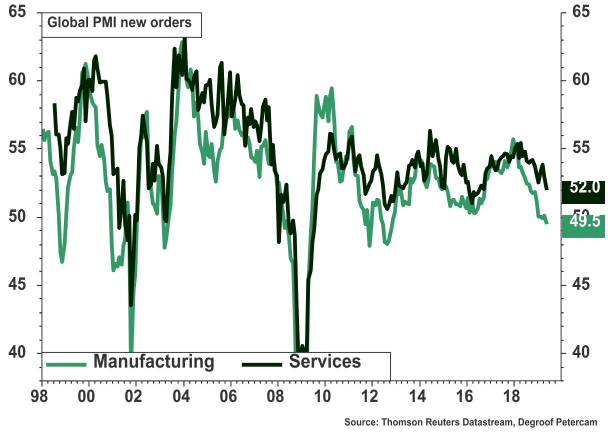
MACRO ECONOMIC UPDATE

July 2019

Disappointing growth, low inflation and political uncertainty push central banks into action

- ✓ Global growth currently hovers around 2.5% with confidence indicators pointing to still slower economic gains in the near future. Manufacturing continues to feel the burn with new orders contracting at the fasted pace in almost seven years. Confidence in the services sector, while still holding up at decent levels, is also coming down. Moreover, labour markets looks set to lose steam.
- ✓ International trade weakness is dragging on and the outlook for investment has weakened significantly. Despite the trade truce announced just after the G20 summit in Osaka, trade uncertainty looks set to continue. Indeed, a US-China deal still remains a distant prospect. It's reminiscent of the G20 meeting at the end of last year in Buenos Aires when the two sides agreed to a truce and deferred an imminent major tariff escalation. That opened up a pathway for more negotiation, but ultimately offered markets little clarity on how or when a final resolution would be achieved. What's more, in the end the tariff rate on Chinese imports worth $200bn was lifted from 10% to 25%. So, as things stand, there's still a real chance that the remaining batch of US imports from China worth $300bn will become subject to tariffs later this year. As a result, the slide in business confidence is unlikely to be reversed.
- ✓ The combination of modest economic activity, (geo)political uncertainty (including trade tensions, congressional dysfunction in the US, Brexit and worries about Italy in Europe) and below target core inflation implies that central banks are absolutely in no hurry to tighten monetary conditions. On the contrary, both their tone of voice and policy has turned significantly more dovish in recent months. It now is close to certain that they will soon engage in more stimulus. In any case, financial markets are already widely anticipating this.



US growth deceleration will prompt the Fed to cut rates in H2

- ✓ Nowcast growth estimates for the second quarter are currently coming in below 2% (annualized). Confidence indicators send mixed signals but in general point towards a continued slowdown in economic activity.

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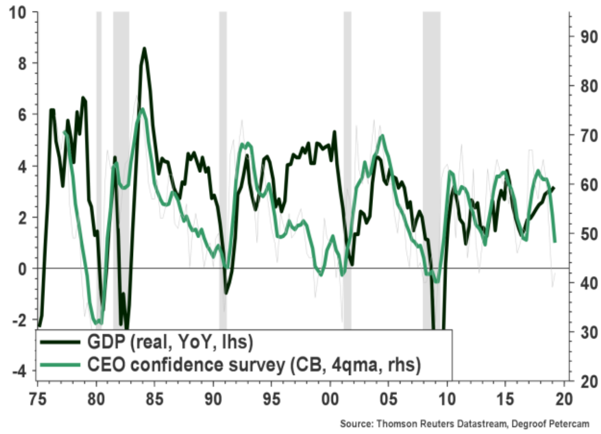
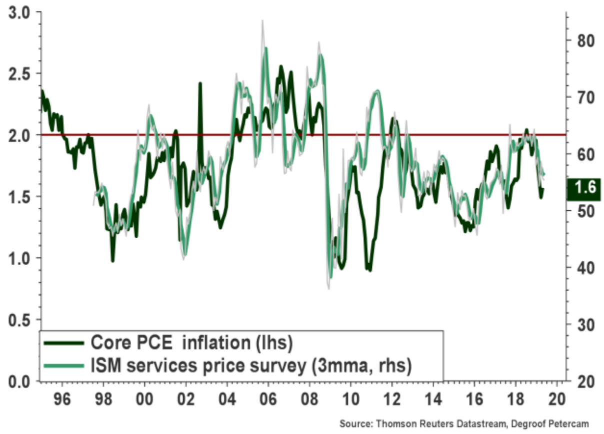
- ✓ Sluggish global industrial activity in combination with the strong dollar is eroding confidence in the manufacturing industry. Prospects for corporate profits and capex are weakening. What's more, the positive impact of the Trump tax cuts is fading away.
- ✓ Household consumption, on the other hand, should still see decent growth as consumer confidence (even though weakening somewhat) and real disposable income growth hold up fairly well for the time being. Developments in the labour market will be key in this respect.
- ✓ June's payroll report is not yet available at the time of writing but a slowdown from recent years looks evident. Nonfarm employment increased only 75K in May, one of the softest monthly gains in recent years. Smoothing through some of the noise in the monthly data, the three-month average for job growth has cooled from almost 250K in January to about 150K in May. In addition, initial jobless claims (though still at low levels) have risen a touch and the Conference Board measure of labour market tightness fell.
- ✓ Meanwhile, underlying inflation pressures have softened in recent months with core PCE inflation (the Fed's preferred inflation metric) now at 1.6% only. The Fed has downplayed this figure by saying that idiosyncratic factors were behind it. The more likely driver, though, is the decline in unit labour cost growth which started earlier.
- ✓ With soft economic activity, downbeat business sentiment, modest inflation and risks to the economic outlook skewed to the downside, the Fed is on track to ease monetary policy and cut rates in the second half of the year. Financial markets are already penciling in a 3 rate cuts by the end of the year and thus are convinced that the first rate cut will come in July. It's a close call, but because of the trade truce and the Fed not wanting to be seen as giving in to President Trump's attacks on monetary policy, we think it's slightly more likely that he Fed will wait until September (before cutting again in December).

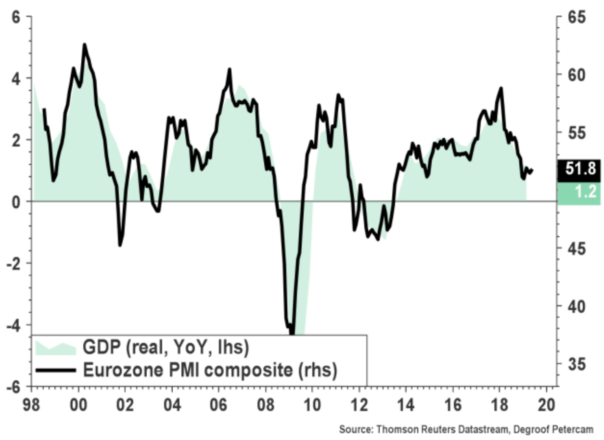


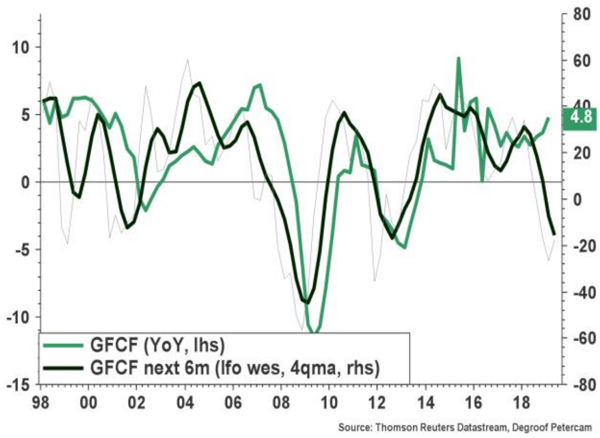


ECB set to strengthen forward guidance, cut the deposit rate and resume QE

- ✓ The eurozone's unemployment rate fell to 7.5% in May, the lowest rate since July 2008. Of course, the bigger story is that economic activity has weakened significantly over the course of 2018. And, even though there are early signs of stabilization, prospects still look rather bleak according to the latest confidence indicators, especially in the manufacturing sector. Industrial production growth has turned negative on the back of weaker external demand and ongoing (geo)political uncertainty, with the downturn showing no signs of an imminent end. Meanwhile, the outlook for both exports and investment has deteriorated quite a bit and the risk of a no deal Brexit remains significant.
- ✓ Consumer confidence is coming down too, albeit from elevated levels. All in all, household consumption should hold up reasonably well as the increase in real wage growth should help to support spending. By the same token, it's encouraging to see that, up so far, confidence in the services sector remains at decent levels.

✓ Underlying inflation remains stuck at around 1% and show little signs of picking up despite the acceleration in wage growth over the past two years. In addition, inflation expectations have come down aggressively more recently.





✓ Logically, the combination of downbeat growth prospects and undershooting inflation figures has led the ECB to become much more cautious in recent months. June's ECB meeting saw more details on the terms of the TLTRO-III programme which will be offered at 10bp above the refi and deposit rates, depending on whether banks hit their lending targets. The ECB also extended its forward guidance by six months through mid-2020 (though in reality it will probably be significantly longer). And more importantly, it also signalled a clear willingness to cut rates and restart QE if the growth and inflation outlook would not improve materially.

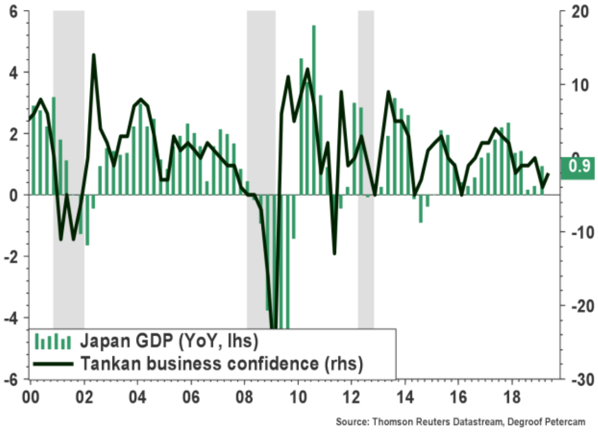
✓ All told, the question is not whether the ECB will take action but rather when and how much stimulus is forthcoming. The ECB's next move is likely to cut the deposit rate from -0.4% to -0.5% in September (while at the same time introducing a tiered deposit rate to limit the impact on commercial bank profitability). That's not all. There's a big chance that the ECB will also announce that it will resume its QE-program.

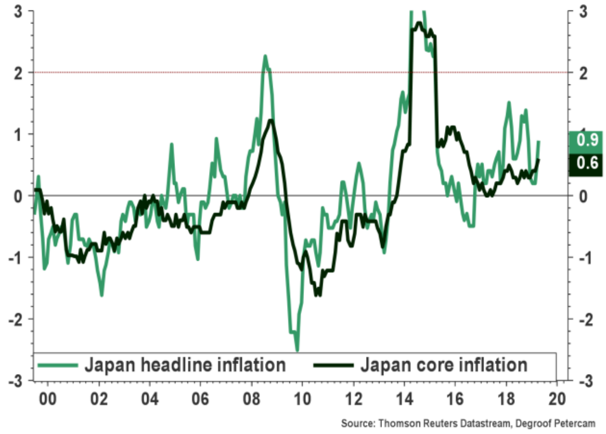
✓ Whether that will have a meaningful impact on economic activity is very doubtful. Probably not in itself. Monetary policy is constrained by the zero lower bound (true, not exactly zero) and QE-programmes are subject to diminishing returns. Fiscal policy would prove more efficient. That said, even though the current stance is slightly expansionary on a eurozone level, the overall intellectual bias and eurozone institutional structure is still leaning towards more restrictive policy. Indeed, the European Commission has been fairly flexible in interpreting the fiscal rules in countries like Spain, Italy and France. However, that's still far from a coordinated pan-European fiscal investment program.

Bank of Japan remains firmly in easing mode

✓ Growth in Q1 came in strongly at 2.3% QoQa. But this is not a true reflection of the state of the Japanese economy as it can be largely explained by a big contraction in imports. Most confidence indictors point to a rather weak momentum. The outlook for industrial production and consumption remains downbeat, reinforcing rumours that the planned consumption tax hike to 10% (from 8%) could be postponed.

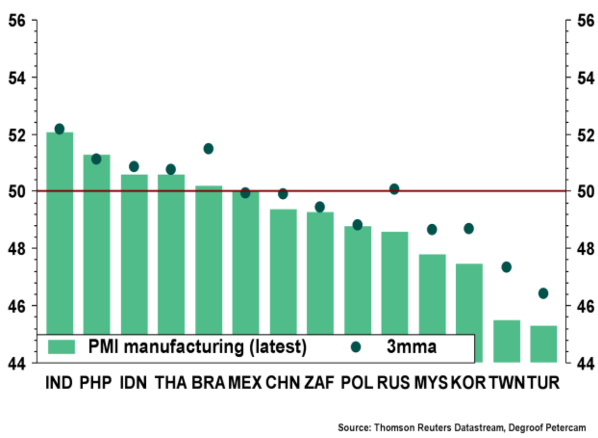
✓ Despite tight labour market conditions, wage growth and inflation remain tepid. As a result, even though the BoJ has been emphasizing the risk of unwelcome side effects of its policy, monetary policy will remain firmly in easing mode. If anything, given the subdued outlook for growth and inflation, the BoJ is likely to do more.





Soft EM economic activity and modest inflation provide room for more stimulus

- ✓ The situation in the emerging world is very different from region to region and from country to country. On aggregate, though, EM industrial production has slowed markedly in recent months. Moreover, manufacturing confidence remains under pressure.
- ✓ Meanwhile, inflation is softening again according to surveys. This follows a significant rise over the past few months on the back of the increase in China, where the spread of African swine fever had caused food inflation to rise sharply. Broadly speaking, core inflation in the emerging world is fairly modest. This should provide central banks with room to continue loosening monetary conditions.
- ✓ Budgetary and monetary policymakers in China have been stepping up efforts via lower interbank interest rates, targeted RRR cuts, tax cuts (mostly directed towards families and SME's) and some extra investment spending. So far, results are unimpressive. Broad credit growth has been showing more signs of stabilization, which is positive, but current levels still suggest that economic activity remains under pressure. What's more, PMI manufacturing confidence dipped below 50 in June. All in all, while Chinese policymakers look set to succeed in arresting the growth slowdown, the relatively modest stimulus measures taken so far (i.e. compared to the 2015/16 slowdown) are unlikely to lead to a significant and sustainable demand boost. Moreover, longer term concerns remain present. Slowing productivity growth, a rapidly ageing society and the unsustainable trajectory of credit growth still call for caution.



Forecasts for 2019-2020

	GDP				Inflation		
	2018	2019	2020		2018	2019	2020
US	*2.9*	**2.4**	**1.5**		*2.4*	**1.7**	**1.9**
		2.6	*1.9*			*1.9*	*2.1*
Eurozone	*1.9*	**1.0**	**1.0**		*1.7*	**1.2**	**1.3**
		1.1	*1.3*			*1.4*	*1.4*
Japan	*0.8*	**0.7**	**0.5**		*1.0*	**0.6**	**0.8**
		0.6	*0.4*			*0.6*	*0.9*
China	*6.6*	**5.5**	**5.0**		*2.1*	**2.0**	**2.5**
		6.3	*6.1*			*2.3*	*2.2*

Update July 2019, *Consensus forecasts*