Economic Research

1 July 2019

Week Ahead Economic Preview

Global overview

- **Worldwide manufacturing and services PMI surveys**
- **US employment report including non-farm payrolls**
- **Special reports on the Bank of England**

A busy week includes key data releases that could steer monetary policy around the globe. The week starts with the publication of worldwide manufacturing PMI surveys, which will be closely watched for the impact of escalating trade wars, followed on Wednesday by service PMIs. The non-farm payroll report for the US completes the week on Friday.

Central banks have grown increasingly dovish on concerns that the global economy is slowing, with PMIs having provided the first such signs of weakening last year, culminating in the latest data for May sliding to a three-year low. The June PMI data will therefore provide important steers for monetary policy in the world's most important central banks.

In the US, the FOMC is under increasing pressure from financial markets to cut interest rates, and any further disappointing data in the form of PMI surveys and the monthly employment report will add to speculation that rates could be cut as soon as July (see page 3).

In Europe, PMI surveys and official industrial production numbers for the Eurozone will likewise be eyed for additional evidence to support the ECB's recent shift to an increasingly dovish stance. In the UK, the fog of Brexit has tied the hands of policymakers, but PMI data will be important in ascertaining the strength of the economy in the second quarter (see page 4). The plight of the Bank of England forms the focus of our special report on page 6.

In Asia, PMI data will give clues as to the impact of trade wars, notably on China but also on the region's other manufacturing hubs. Evidence of supply chains switching as a result of US-China tensions will also be monitored, amid evidence that countries such as Vietnam are benefitting (see page 5).

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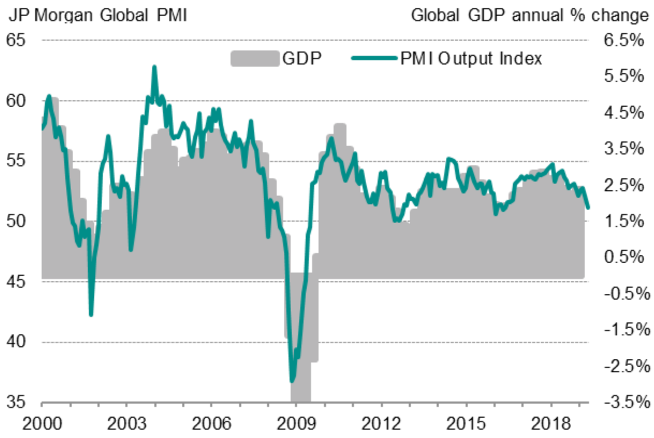
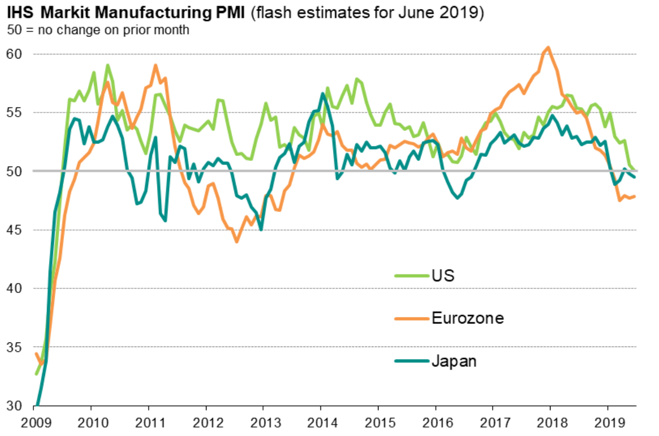
Special reports

The global PMI fell to a three-year low in May, fuelling worries about slowing worldwide economic growth



Source: IHS Markit.

Flash PMI surveys have indicated a disappointing performance for manufacturing in June



Source: IHS Markit.

Key diary events

Monday 1 Jul

Worldwide release of IHS Markit manufacturing PMI (Jun)

OPEC meeting

Japan Tankan surveys (Q2), consumer confidence (Jun)

South Korea trade (Jun)

Indonesia inflation (Jun)

Germany unemployment rate (Jun)

Euro area and France jobless rate (May)

UK consumer credit, mortgage lending and approvals (May)

US ISM manufacturing surveys (Jun), construction spending (May)

Tuesday 2 Jul

RBA monetary policy decision

Germany retail sales (May)

Spain unemployment rate (Jun)

UK construction PMI (Jun)

Brazil trade balance (Jun), industrial output (May)

US IBD/TIPP Economic Optimism (Jul)

Wednesday 3 Jul

Worldwide release of IHS Markit services PMI (Jun)

South Korea inflation (Jun)

Australia trade (May)

US ADP employment, ISM non-manufacturing (Jun)

US trade, factory orders (May)

Poland interest rate decision

Thursday 4 Jul

Australia retail sales (May)

Germany construction PMI (Jun)

Euro area retail sales (May)

Friday 28 Jun

Japan household spending (May)

Germany factory orders, industrial output (May)

UK Halifax House Price Index (Jun)

UK BoE FPC meeting

Spain consumer confidence (Jun)

US non-farm payrolls, earnings, jobless rate (Jun)

Russia inflation (Jun)

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United States Week Ahead

PMI surveys, non-farm payrolls and factory orders

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With the FOMC widely seen as edging closer to cutting interest rates, US data updates will be keenly watched, particularly as the calendar includes manufacturing and services PMI data and the monthly employment report. Official factory orders data will also give greater colour to the health of manufacturing.

PMI surveys

Both IHS Markit and ISM update their PMI surveys for June, and early estimates suggest that the end of the second quarter was disappointing. IHS Markit's 'flash' PMI signalled that both manufacturing and service sector firms registered slower upturns in business activity, with the headline manufacturing index notably down to its lowest since September 2009 amid increased destocking. While the ISM's manufacturing index has followed the IHS Markit index down, the service sector surveys have diverged. It will therefore be important to see if the ISM non-manufacturing index will likewise match the recent weakness seen in the IHS Markit services PMI.

Non-farm payrolls

Fed guidance will also be sought from the updated labour market report. The monthly change in non-farm payrolls came in well below market expectations at 75,000 in May, but the underlying pace of hiring looks stronger, with the flash June PMI pointing to payrolls at around 140,000. The increase was supported by the service sector where employment growth has stabilised. Market consensus is currently suggesting an increase of 165,000.

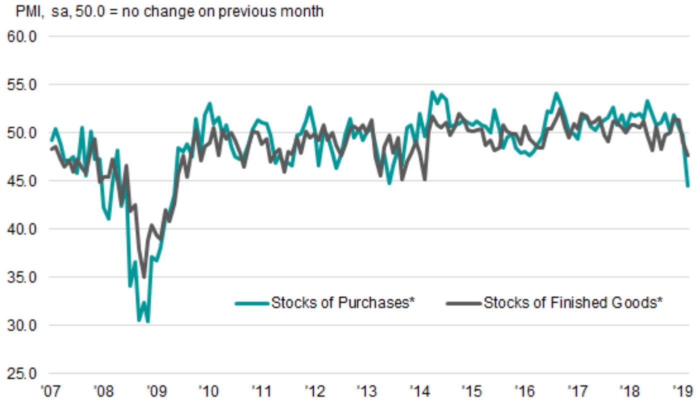
Unemployment and earnings data will also be eagerly awaited. The jobless rate is currently running near a 50-year low of 3.6%, but annual wage growth disappointed despite the historically tight labour market, down to 3.1%

Factory orders

The release of factory orders data for May is expected to signal a further contraction in client demand across the manufacturing sector. Although new business picked up in June, the near-term future suggests demand in the sector will remain weak.

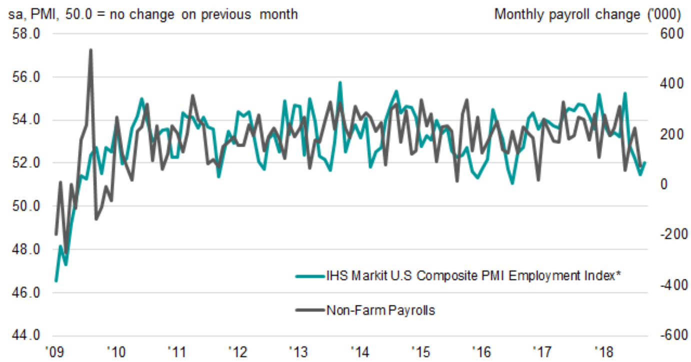
Other key data releases include ADP employment, trade and IBD/TIPP Economic Optimism data.

Manufacturers begin to destock amid ongoing slowdown



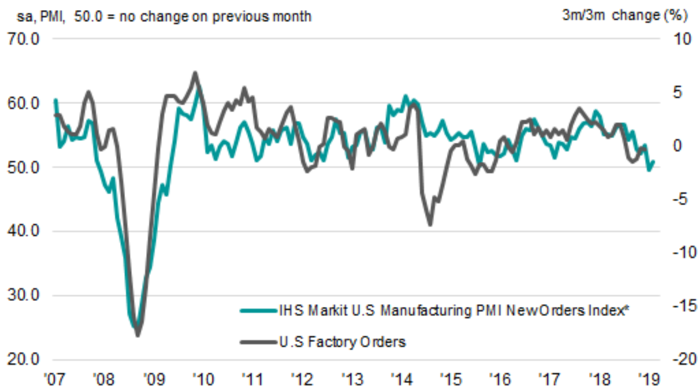
*including June flash data
Source: IHS Markit

Pick up in monthly payrolls signalled



*including June flash PMI data
Sources: IHS Markit, Bureau Labour Statistics, U.S. Department of Labour

New factory orders expected to fall further



*including June 2019 flash data
Sources: IHS Markit, US Census Bureau

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Europe Week Ahead

June PMI data to provide fuller picture of second quarter

By Joe Hayes

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June PMI data for Europe will providing a fuller picture of the likely direction economic conditions have moved in the second quarter. The UK will be of particular focus given renewed political risk and signs that policymakers are becoming more split on the central bank's next move (see our special report on page 6).

Also due are employment statistics for the eurozone and Germany, as well as factory orders and industrial production data for the latter. Poland's central bank meets to set monetary policy.

June PMI update

PMI survey data for the eurozone will be closely watched amid growing expectations of further stimulus from the ECB. According to the 'flash' PMI estimate, the eurozone economy grew at its fastest pace in seven months in June. The survey data put the euro area on track for GDP growth of just 0.2% in the three months to June. Growth is dependent on the service sector, which is benefitting from a resilient domestic market. But faltering trade flows and a weaker global economic backdrop continue to hit manufacturers. A big question remains as to how long this unusual divergence can sustain, and whether the manufacturing decline will infect the service sector.

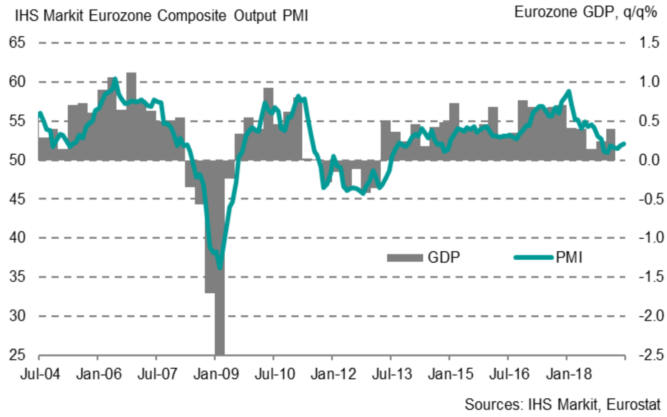
Price data from the surveys will also help guide inflation expectations. Price pressures have been low relative to the ECB's 2% target, fuelling speculation of imminent policy action. We expect more QE and a lower DFR in Q3.

Meanwhile, the UK PMIs have indicated a near-stalling of the economy, adding to signs that GDP may stagnate in the second quarter after pre-Brexit preparations boosted growth in the first quarter.

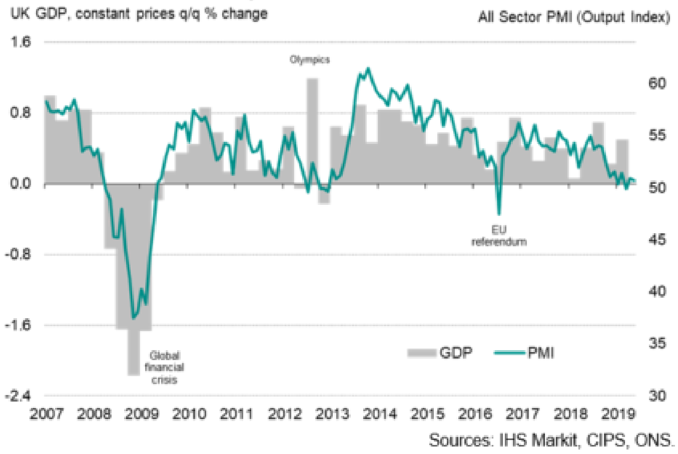
German factory weakness to persist

Our pick from official data to watch includes factory orders and industrial production estimates for Germany. Given the trend in survey data, as well as unfavourable external factors, it's likely that weakness in the German manufacturing sector will persist in the near-term. Labour market statistics are also due, which have been a bright spot for the euro area's largest economy.

Eurozone GDP vs. Composite Output PMI



UK PMI and GDP compared



No signs of an end to Germany's manufacturing malaise

Asia Pacific Week Ahead

Asia PMI surveys, South Korea exports and Australia rate decision

By Bernard Aw

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The worldwide release of IHS Markit PMI surveys will offer an important steer on global economic conditions at the end of the second quarter, thereby providing clues of future monetary policy. In particular in Asia, the June updates to the Caixin surveys will be scrutinised for signs of a deepening slowdown in China. Australia decides on monetary policy in the same week. Meanwhile, South Korean export figures and Japan's Tankan survey will also be watched as key indicators of the health of manufacturing.

Caixin PMI surveys

Amid heightened trade tensions between the US and China, the Caixin PMI surveys will provide an up-to-date view of China's economic performance. In May, business expectations for the year ahead sank to the lowest in the series history, broadly reflecting rising concerns over the trade war. Service sector data will be eyed for indications as to whether domestic stimulus is helping offset the trade war impact.

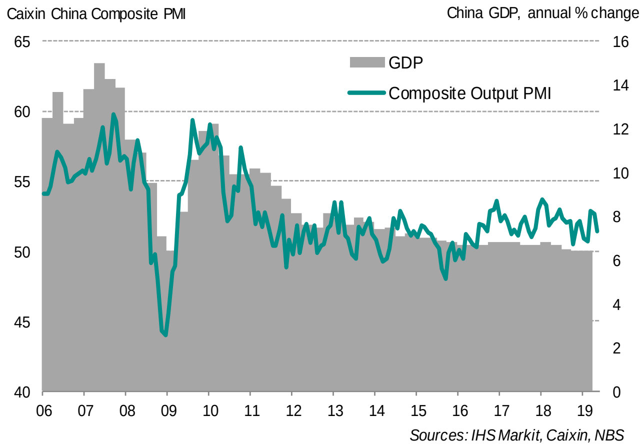
Australia to cut interest rate again

The Reserve Bank of Australia is widely expected to further reduce the cash rate to 1.00% at next week's meeting. RBA governor Philip Lowe recently commented that the June rate cut (to a record low of 1.25%) remained insufficient to boost employment and wages. While flash PMI surveys signalled a firmer economic recovery in June, the PMI Employment Index remained below the historical average, suggesting that the upturn has so far not translated into stronger jobs growth. Final updates to the June PMI surveys will also be available in the coming week.

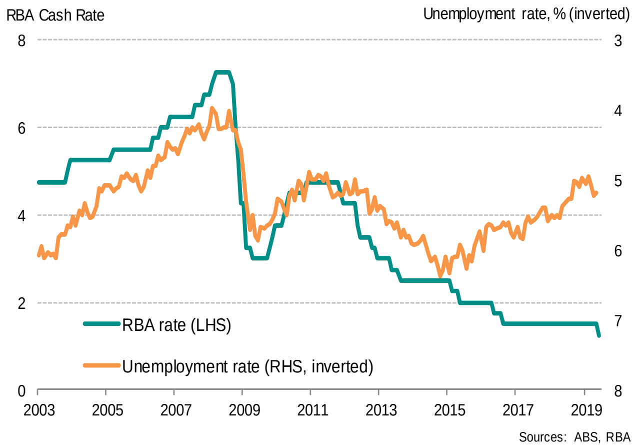
Korean exports

Analysts will eagerly await the June update of South Korean export data for further insights into the extent at which the impact of the deepening US-China trade war have had on the export sector. The PMI New Export Orders Index continued to register below the no-change 50.0 mark in May, indicating falling exports and reflecting weak global trade flows. As such, the upcoming June PMI results will also be closely monitored. Further underperformance in the external sector, a key driver of Korean economic activity, will raise expectations for the Bank of Korea to cut rates to support growth.

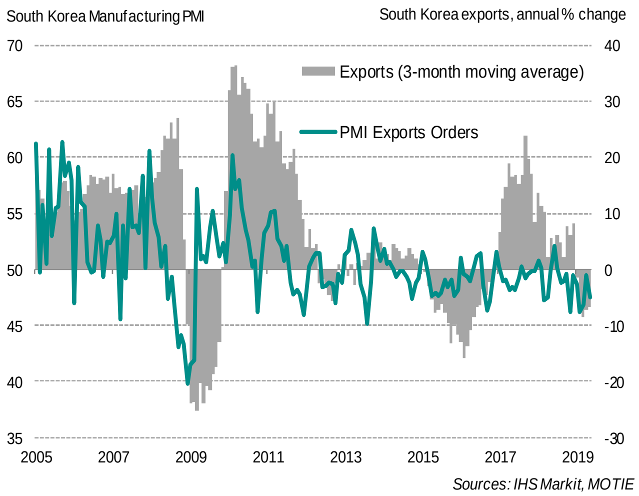
China PMI and economic growth



Australia monetary policy and jobless rate



South Korea PMI and exports



Europe Special Focus

Hawkish Bank of England on hold amid Brexit uncertainty

By Raj Badiani

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The stalled Brexit process and the fact that inflation sits comfortably around target will provide the Bank of England with some breathing space in a period of heightened Brexit uncertainty. The Bank has expressed concern about upside inflation risks from firmer earnings growth alongside supply-demand imbalances. Policy tightening is unlikely near-term, however. We anticipate the next hike to occur only in May 2021.

Holding with a hawkish bias

The nine members of the Monetary Policy Committee (MPC) of the Bank of England (BoE) voted unanimously to keep its policy rate at 0.75% during its 19–20 June 2019 meeting. This was the seventh successive meeting at which the rate was left unchanged. This was preceded by a 25-basis-point rise to 0.75% in August 2018, the first increase since November 2017 and only the second during the past decade.

There appears to be little urgency to raise interest rates, partly due to the fear of making a policy mistake at a time when the economy is struggling to absorb entrenched uncertainties about when and how the United Kingdom (UK) will exit the European Union (EU), alongside a tougher external environment.

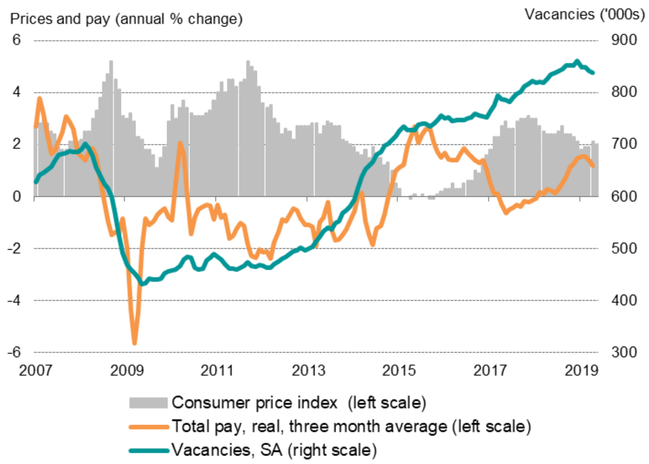
Nevertheless, the BoE continues to signal repeatedly that it wants to raise gradually its benchmark interest rate, which remains at a historic low. The latest BoE minutes suggest it has not joined the growing impetus for a further easing of monetary policy after more dovish signals from the European Central Bank (ECB) and the US Federal Reserve (Fed), but the minutes from the meeting were notably more dovish. Nevertheless, Carney has stated recently that even a moderate positive UK growth surprise would be enough to ring the overheating alarm bells and prompt several hikes.

Overheating worries

The MPC's main concern is that the economy could face shrinking spare capacity because of reduced growth in labour supply and muted productivity growth compared with the pre-crisis average. Labour market pressures are significant, with an unemployment rate close to its equilibrium rate, record-high vacancies, and firmer wage growth (see chart 1). The expansion in demand will continue to outweigh supply growth (limited by the Brexit impact on EU migration, poor productivity growth, and firms' reluctance to invest in the current uncertain climate).

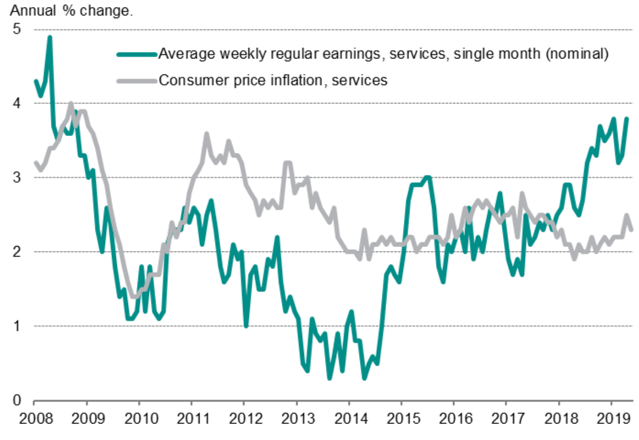
In addition, the services sector, which accounts for 80% of GDP, is reporting firmer price and wage pressures when compared to the rest of the economy (see chart 2). The sector also reported some 744,000 vacancies in the three months to May out of a near-record high 837,000 vacancies for the economy as a whole.

Chart 1: UK labour market, real wage and inflation developments



Source: IHS Markit, Office for National Statistics.

Chart 2: UK service sector price and wage developments



Source: Office for National Statistics, IHS Markit.

Dovish dissent?

However, narrative from the MPC members is increasingly dispersed despite the unanimous vote to leave the Bank rate unchanged at the latest meeting.

Some members of the MPC are more hawkish, illustrated by statements made by the Deputy Governor Ben Broadbent, Michael Saunders and the Bank's chief economist, Andy Haldane, prior to the latest MPC meeting. Their stance is that the UK needs to raise interest rates several times over the next couple of years, regardless of mounting global trade risks and the growing probability that the US Fed and ECB are set to cut. Haldane said the time is nearing when a small rise in rates would be prudent to nip any inflationary risks in the bud, while Saunders believes Brexit uncertainty is not a reason to delay rate rises.

However, another MPC member, Gertjan Vlieghe is at odds with the hawkish comments from some of the MPC members of late, when noting that "the news since May I think has been ... a little disappointing and in terms of both the global downside risks and the domestic downside risks my read is that they have both intensified."

Indeed, his view was more in line with the MPC minutes from the June meeting, which laid out a more downbeat UK growth assessment, estimating that the economy stagnated during the second quarter. The BoE notes "an unwind of the positive contribution to GDP in the first quarter from companies in the United Kingdom and the European Union building stocks significantly ahead of recent Brexit deadlines". Also, the main narrative of the first half of 2019 remains persistently weak business investment against still resilient household consumption.

Lower growth projections

The BoE projections from the May Inflation Report expect the UK economy to expand by 1.5% in 2019, 1.6% in 2020, and 2.1% in 2021. The 2019 growth projection is likely to be lowered in the August report in line with a more downbeat assessment of the second quarter. The Bank now suggests that GDP growth will be "a little below potential during 2019", with the latter estimated at 1.5% from 2019-2022 Q2. Growth is then expected to exceed limited potential supply growth, "such that excess demand was rising above 1% of potential output by the end of the forecast period." This could bring about firmer domestic inflationary pressures, lifting consumer price inflation above the 2% target in two years' time and even higher at the end of the three-year forecast period. Currently, the BoE projects consumer price inflation to average 1.6% in the final quarter of 2019 and 2.0% and 2.1% in the equivalent quarters of 2021 and 2022.

Nevertheless, the BoE acknowledges that Brexit continues to cast a dark shadow over the economic outlook, which will depend "significantly on the nature and timing of EU withdrawal". Despite the lack of clarity regarding the Brexit timeline, the central bank still assumes a "smooth adjustment to the average of a range of possible outcomes for the UK's eventual trading relationship with the EU". Overall, it concluded that any future increases in the policy rate were likely to be at a "gradual pace and to a limited extent". Specifically, the conditioning path for the Bank Rate implied by forward market interest rates suggests that the end values for the policy rate will be 0.7% in 2019, 0.9% in 2020, and 1.1% in 2021.

Too optimistic?

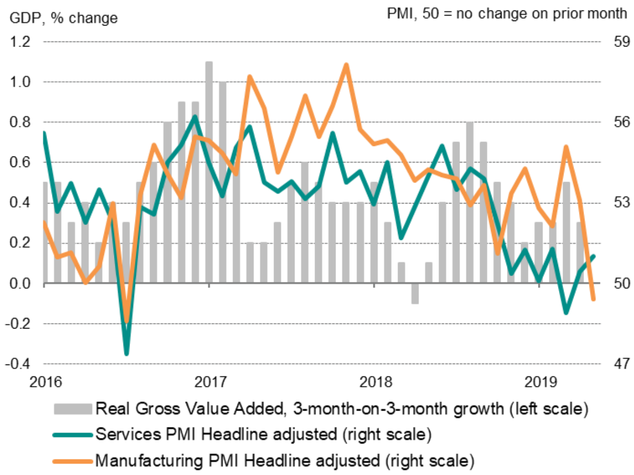
But, IHS Markit assumes that the Bank rate will remain at 0.75% during the rest of this year and 2020, with the first hike expected in May 2021. Our end-values for 2021 and 2022 are projected at 1.00% and 1.25%, respectively. Our assessment is closer to Vlieghe's view that the UK economy is facing accumulating domestic and external risks, and we also argue that Brexit uncertainty will spill into 2020. Therefore, we believe that the Bank of England is too optimistic about the UK's short-term growth prospects. According to our June forecast, we expect the economy to expand by 1.2% in 2019, 1.0% in 2020, and 1.4% in 2021. Our more cautious assessment partly results from the latest survey and hard data flashing red to signal underlying growth tensions, and they include.

- Real GDP in the three months to April 2019 grew 0.3% compared with the three months to January 2019. This compares with three-month gains of 0.5% in March and 0.3% in February 2018 (see chart 3). Services grew only moderately in the three months to April, rising by 0.2% when compared to previous three months, the weakest performance since the three months to April 2018.

- The economy shrank by 0.4% month-on-month (m/m) in April, after a 0.1% m/m drop in March. The decline was in part due to a cut in car production, with Brexit impasse triggering shutdowns, while manufacturers reduced their precautionary stock-piling after EU exit delayed to 31 October 2019.

- Services PMI data reveal activity barely grew in April and May 2019, while new business rose only marginally in May after contracting the previous four months (see chart 3). The PMI surveys also signalled falling manufacturing and construction output (the latter showing the sharpest decline since early 2018) during the same month.

Chart 3: UK real GDP and PMI developments

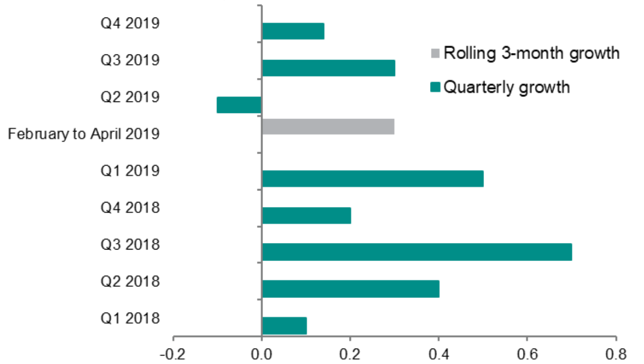


Source: IHS Markit and Office for National Statistics

Outlook

We believe the economy will shrink by 0.1% quarter-on-quarter in the second quarter, with the one-off factors that boosted growth in the first quarter being a drag on activity. But, modest growth could return in the second half of 2019, elevated by precautionary consumer and firms' purchases as the UK approaches its next EU exit point on the 31st October (see chart 4).

Chart 4: UK GDP growth and outlook



Notes: 2019Q2 TO 2019Q4, IHS Markit growth estimates

Source: Office for National Statistics, IHS Markit

Finally, we anticipate that growth in 2020 is likely to disappoint. Even in the event of a smooth Brexit exit process, we suspect that the complex and uncertain trade negotiations will continue to squeeze business investment plans and could begin to push back record-high employment, with firms currently uncertain about their free EU market access after the negotiations are complete. Indeed, the majority of businesses surveyed by the BoE's networks of regional agents across the UK believe Brexit uncertainty is unlikely to be resolved by the end of 2019. Only a fifth said they thought there would be clarity.