Economic Research

8 July 2019

Week Ahead Economic Preview

Global overview

- **US inflation and FOMC minutes**
- **UK GDP and eurozone industrial production**
- **Export data for China and Taiwan**
- **Special reports on the G20 Summit trade truce and Eurozone inflation**

Contents

Special reports

The focus of the week will be the continued assessment of trade war developments following the G20 Summit (see special report on page 9), and the implications for central bank policy. The Trump-Xi trade truce came at the same time as global PMI surveys showed economic growth stuck at a three-year low in June, with manufacturing declining for the first time since 2012 as trade flows continued to deteriorate.

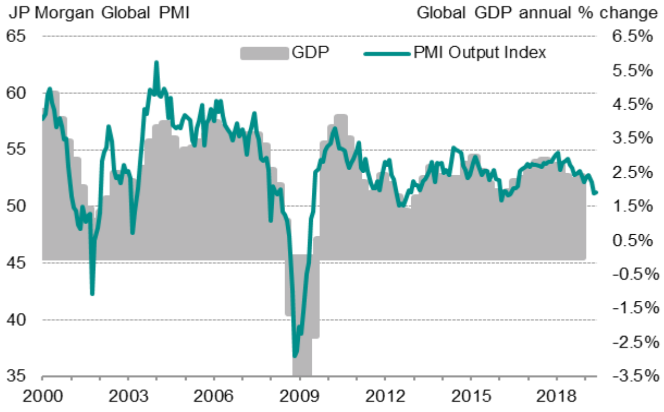
The global slowdown has added to expectations that central banks around the world will increasingly adopt more dovish stances, not least the US Fed. With the FOMC widely touted to cut interest rates at its July meeting, all incoming data will be scrutinised for last-minute policy signals. Updated inflation, job openings and inventory numbers accompany the minutes from the latest FOMC meeting (see page 3).

In Europe, GDP data for the UK will provide an updated official snapshot of the economy's health at the midway point of the second quarter. After a (Brexit-distorted) solid start to the year, both the PMI surveys and our nowcast models point to the economy slipping into contraction, which would raise pressure on the Bank of England to reconsider its hawkish stance relative to market rate expectations.

Meanwhile, official industrial production numbers for the Eurozone will likewise be eyed for additional evidence to support the ECB's recent dovish stance (see page 4). The persistence of stubbornly low euro area inflation forms the focus of our report on page 6.

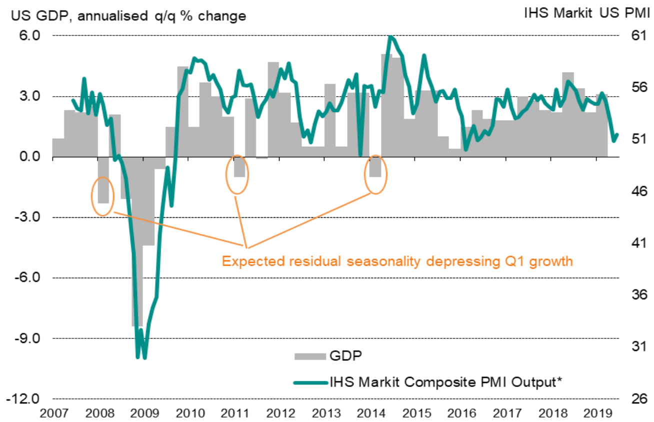
In Asia, trade developments will remain a key theme, with analysts eyeing the export performance of China and Taiwan in particular, as well as industrial production and machinery orders data for Japan and China's vehicle sales. Singapore meanwhile releases an estimate of second quarter GDP and Malaysia's central bank weighs-up whether interest rates need to be cut again (see page 5).

Weak global PMI data have added to expectations of increasingly dovish monetary policy around the world



Source: IHS Markit, JPMorgan.

FOMC meeting minutes will be eyed for stimulus after US economic growth appears to have slowed sharply



* Manufacturing PMI only pre-October 2009.
Sources: IHS Markit, US Commerce Department

Key diary events

Monday 8 July

Japan machinery orders (May)

Taiwan trade (Jun)

Germany trade, industrial production (May)

US consumer inflation expectations (Jun)

Tuesday 9 July

Japan average cash earnings (May), machine tool orders (Jun)

Australia business confidence (Jun)

Malaysia monetary policy

US JOLTs job openings (May)

Wednesday 10 July

South Korea jobless rate (Jun)

Australia consumer confidence (Jul)

Philippines trade (May)

China inflation (Jun)

Italy industrial production (May)

UK trade balance, industrial output, construction output, GDP (May)

Brazil inflation (Jun)

US wholesale inventories (May)

ECB non-monetary policy meeting

Thursday 11 July

FOMC minutes

Australia home loans, investment lending for homes (May)

China vehicle sales (Jun)

Germany and France inflation (final, Jun)

BoE Financial Stability Report

Brazil retail sales (May)

US inflation (Jun)

Friday 12 July

Singapore GDP (adv, Q2), retail sales (May)

China trade (Jun), FDI (YTD, Jun)

Malaysia industrial output, jobless rate (May)

Japan industrial production (final, May)

India industrial output (May), inflation (Jun)

Spain inflation (final, Jun)

Euro area industrial production (May)

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United States Week Ahead

Inflation, job openings and inventory data accompany FOMC minutes

By Siân Jones
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The release of the full minutes from June's FOMC meeting and an update on inflation data will be keenly watched for signs that increasingly dovish language from the Fed will translate into a rate cut later this month. Also headlining the economic calendar are job openings and inventories data, giving a wider insight into the health of the US economy.

Inflation

With markets increasingly pricing in a rate cut at the end of July, the latest CPI inflation data and consumer price expectations could give a glimpse into how the FOMC will act. Signs of slowing economic growth and ongoing subdued inflation have added to the chances of fresh stimulus as 'insurance' against a more entrenched bout of economic weakness setting in, with the Fed having dropped the urge for patience in their latest press release.

June data from the IHS Markit US PMIs signalled a slight pick-up in the pace of inflation following a sharp slowdown in price increases in prior months. Panellists commonly linked higher charges to greater cost burdens, stemming from tariff pressures and supplier price rises. Consensus expectations suggest the rate of inflation will remain around the 1.8% mark, with core inflation forecast to stay at 2%.

Inventories

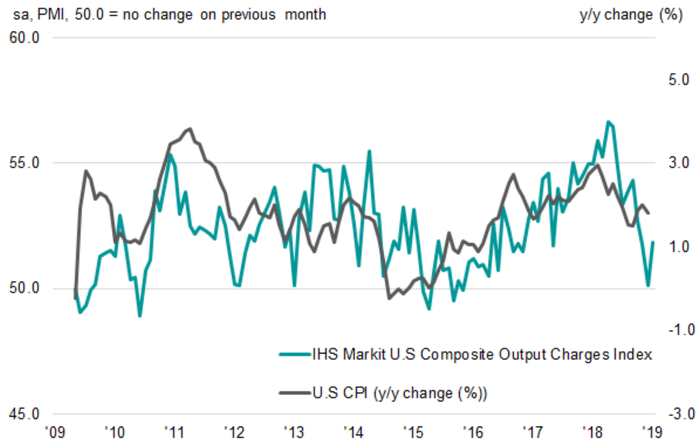
In line with the muted demand seen across the manufacturing sector in June, firms reported lower incentives to hold stocks of finished goods. The survey data therefore suggest inventories will rise only fractionally in June amid ongoing uncertainty towards future new order growth, dampening production growth.

Job openings

Job openings data will also be eyed for policy clues. The number of job openings missed consensus in May, following a drop in demand for workers at business services firms.

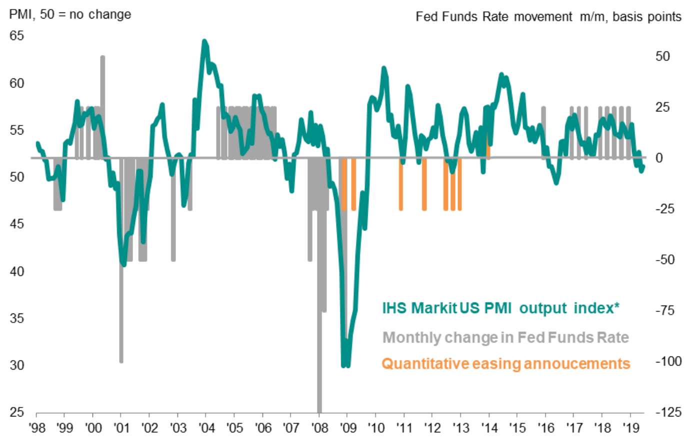
Other key data releases include consumer inflation expectations, jobless claims and PPI updates.

Consumer inflation set to pick up slightly in June



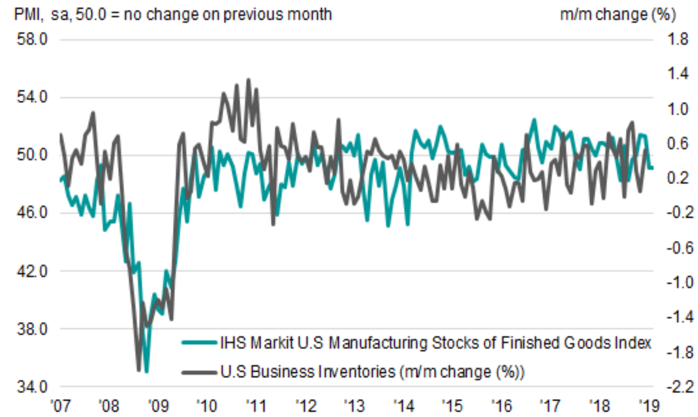
Sources: IHS Markit, Bureau of Labour Statistics, U.S. Department of Labour

FOMC policy decisions and US manufacturing PMI*



Sources: PMI uses IHS Markit post-2007 and ISM pre-crisis, Federal Reserve.

Firms continue to destock following lacklustre demand



Sources: IHS Markit, U.S Census Bureau

Economic Research

8 July 2019

Europe Week Ahead

Euro area industrial output and UK GDP updates

By Joe Hayes

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May industrial production data for the euro area will provide a key guide for the likely direction the single currency economy has headed in the second quarter. Trade statistics for Germany will also shed light on how slowing global growth and heightened protectionism have impacted export markets. Meanwhile, inflation estimates for several eurozone nations are due, and are likely to add to the pressures on the ECB to stimulate the economy (see special report on page 6).

A slew of data from the UK will also be closely watched following the disappointment from the latest PMI data. The monthly GDP estimate for May is the key pick.

Manufacturing and trade

As the ECB prepares to add more stimulus, eurozone industrial production data are expected to confirm the weakness recorded by recent surveys and add to the already high chance of policy action coming in the second half of the year.

German trade and production data are also updated. Germany's manufacturing struggles have been well documented by the PMI surveys, with the latest June data showing the sector stuck in a downturn.

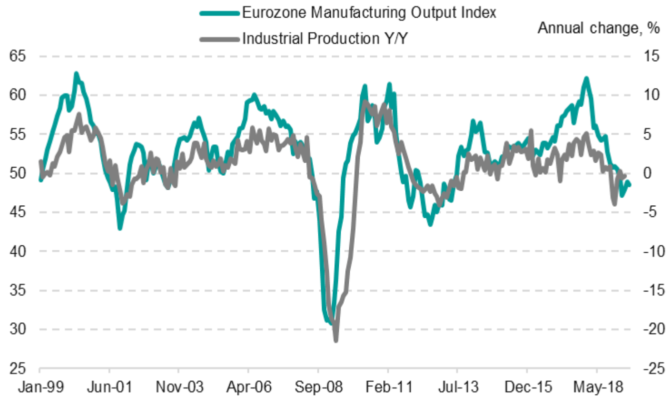
Final June inflation statistics for Germany, France and Spain are also set to confirm the weak price pressures seen in the preliminary readings. PMI survey data suggest there is further room to the downside for inflation across the euro area (see chart), which will add further to expectations of ECB stimulus.

UK economy

The release of May's monthly GDP estimate for the UK will merit extra attention after the latest PMI survey data for June indicated that the UK economy is set to contract by 0.1% in the second quarter.

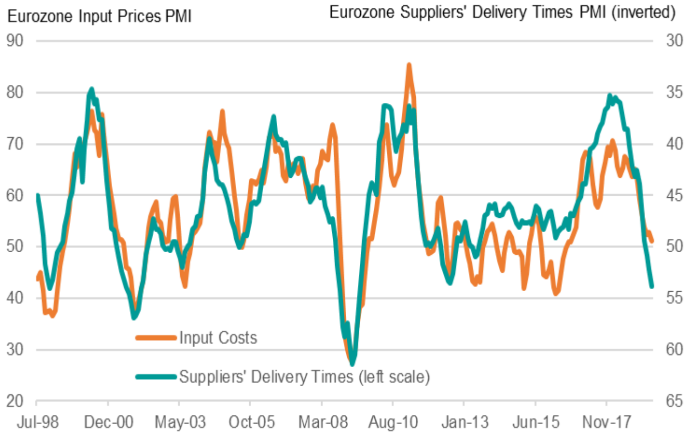
The monthly GDP print for April came in at -0.4% amid Brexit-related shutdowns of automobile production. Since then however, the 'all-sector' PMI has fallen to its second-lowest since April 2009 as a stagnating service sector was accompanied by declines in manufacturing and construction output. While the Bank of England retains a hawkish stance assuming a soft Brexit, increased signs of economic weakness could help tip the scales towards looser policy.

Eurozone industrial output remains under pressure



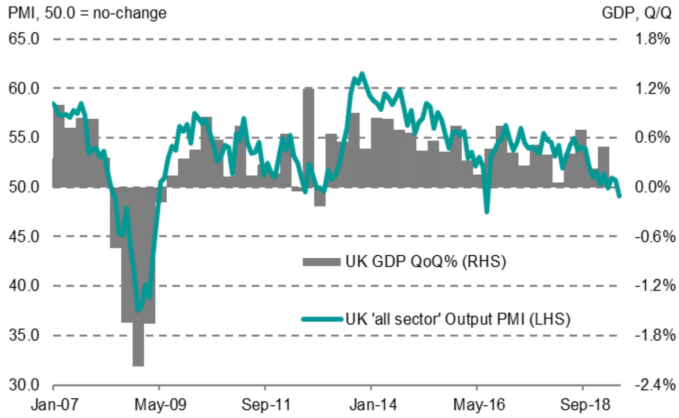
Sources: IHS Markit, Eurostat

Manufacturing price pressures fading in the euro area



Source: IHS Markit

Survey data suggest the UK economy contracted in second quarter



Sources: IHS Markit, ONS

Asia Pacific Week Ahead

China and Taiwan trade, Singapore GDP and Malaysia rate decision

By Bernard Aw

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Trade developments will remain a key theme in the coming week following the trade war truce at the G20 Summit (see special report on page 9), with analysts eyeing the export performance of China and Taiwan in particular. Singapore is releasing an advance estimate of second quarter GDP while Malaysia decides on monetary policy.

Trade data

With latest Caixin PMI surveys pointing to softening economic activity in China during June, market participants will look out for further confirmation of weakening growth momentum amid ongoing trade frictions. The June update to China's trade performance, in particularly exports, will be scrutinised for trade war impact.

Analysts will also monitor Taiwan's export data, widely used as a barometer of tech-related trade, for signs of further weakness. The IHS Markit Taiwan PMI signalled the manufacturing downturn had intensified in June with export orders declining at an increased rate.

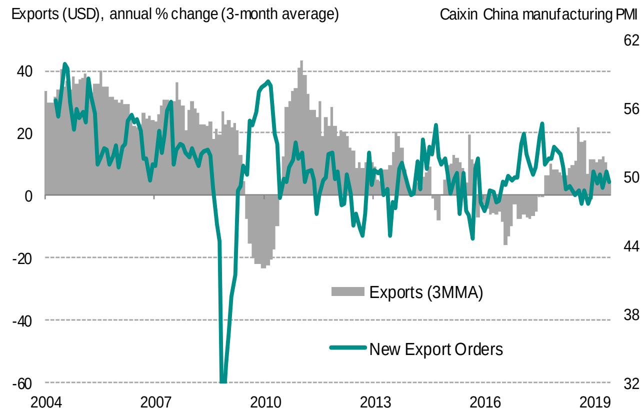
Malaysia monetary policy

Bank Negara Malaysia meanwhile meets next week to decide on monetary policy. While a back-to-back rate cut after easing in May is unlikely, the central bank has room for further rate reductions if needed. Rising external headwinds remain a key concern for the central bank, while expectations of rising inflation (due partially to the switch to targeted fuel subsidies) are not seen as a threat. As indicated by the latest PMI survey, operating conditions remained challenging for Malaysian goods producers in June, reflecting tough trading in export markets, though manufacturers are encouragingly optimistic about future output.

Singapore GDP

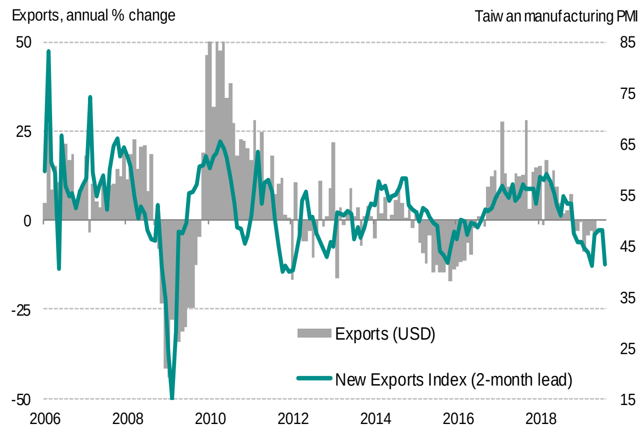
The advance estimate of Singapore's second quarter GDP (based on first two months of the quarter) will be published. IHS Markit expects the economy to expand at an annual rate of 1.2% (SAAR), broadly similar to that in the first quarter. However, June's PMI survey points to worrying trends at the end of the quarter, as growth in business activity, sales and employment all slowed alongside a marked decrease in the PMI's gauge of business sentiment, which fell to its lowest in over two years.

China PMI points to subdued export growth



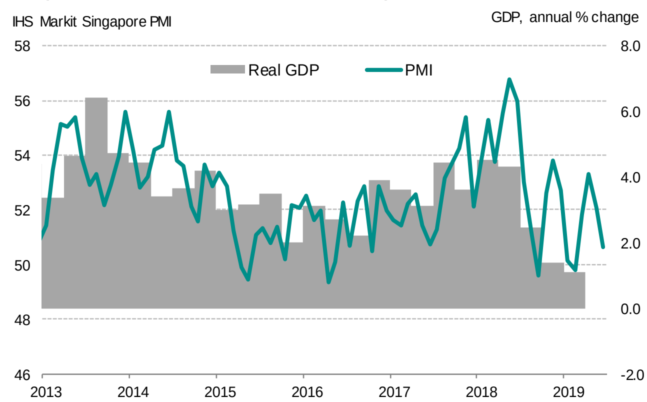
Sources: IHS Markit, Caixin, China Customs

Taiwan PMI signals continued export decline



Source: IHS Markit, DGBAS

Singapore PMI and economic growth



Sources: IHS Markit, MTI

Europe
Special Focus

Why persistent low inflation in the eurozone could end up being a major problem

By Ken Wattret

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Looking through the usual spring volatility, underlying inflation in the eurozone remains stuck at around 1%, confounding the ECB's long-standing expectation of a pick-up. Growth rates in compensation and unit labour costs have accelerated but this has led to compressed profit margins rather than higher underlying inflation rates. The ECB has been aiming for a much larger buffer against potential deflationary risks in case the eurozone ends up being hit by a severe adverse shock in the future. Its inability to achieve that objective is a cause for concern.

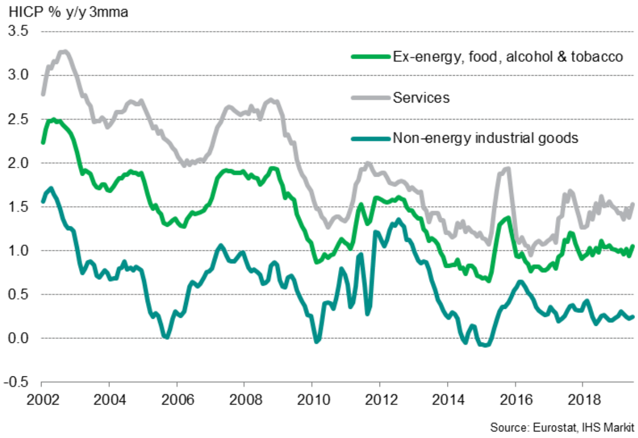
Stubbornly low inflation

The period from March to June is often characterised by exceptionally high volatility in inflation rates in the eurozone due to seasonal distortions. This year has been no exception, with headline and core harmonised index of consumer price (HICP) inflation rates yo-yoing during this period.

The recent "flash" HICP data for June showed the inflation rate excluding food, energy, alcohol and tobacco (henceforth the core rate) accelerating from 0.8% to 1.1%. But this merely brought it back in line with the underlying trend. Core inflation has been stuck steadfastly at around 1% for the best part of two years now.

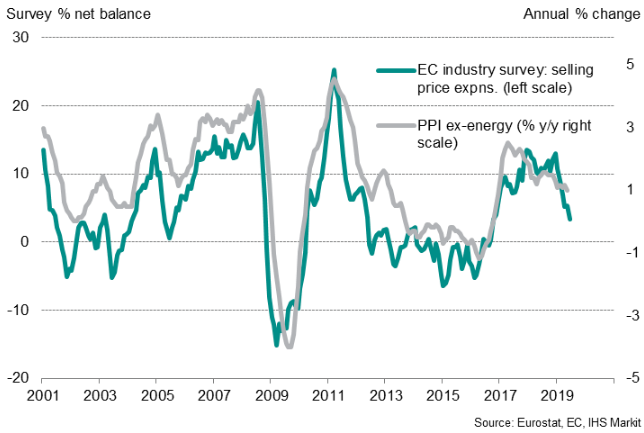
Looking at June's breakdown by type of good, the inflation rate for industrial goods excluding energy (core goods) slipped back to just 0.2%. This sub-component accounts for 37% of the core HICP and has been bumping along at a little above zero since late 2016 (see first chart). Various indicators of underlying price pressures in the goods sector suggest that these very low inflation rates are here to stay.

Eurozone core HICP inflation trending around 1%



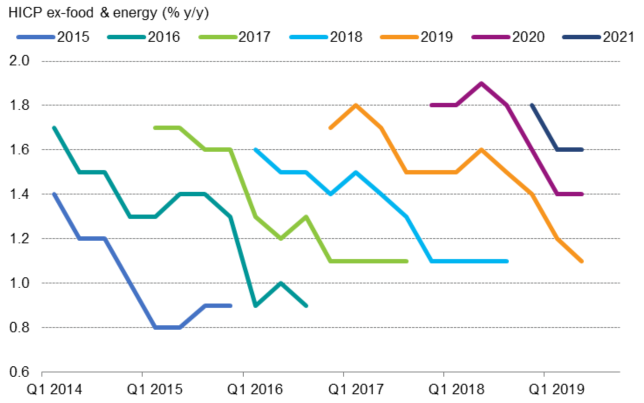
May's core producer price data (i.e. excluding energy) are one such example. The annual inflation rate has slowed to just 1.0%, the lowest since December 2016. At the same time, surveys of industrial firms' pricing, including IHS Markit's manufacturing PMI, have been weakening and point to further downward pressure on core PPI inflation (see second chart).

Eurozone core PPI inflation heading south



HICP inflation rates for goods are typically more sensitive to external influences on prices than inflation rates for services. The latter, which account for the remaining 63% of the core HICP for the eurozone, are more domestically-driven. The ECB has been expecting the sharp pick-up in compensation and unit labour cost growth rates (both have increasing by over 2% year-on-year in the past few quarters) to filter through to higher services and in turn core inflation rates. But this has not been happening, and the pattern of ECB forecasts of core inflation having to be repeatedly revised downwards has continued (see third chart).

ECB core inflation projections revised downwards



Source: ECB, IHS Markit

While services inflation is running well above the core goods rate, at around 1½% currently, its periodic accelerations over recent years have proved short-lived. It remains at least a percentage point below the rates typically consistent with a core inflation rate in line with the ECB's "below but close to 2%" objective (again see first chart).

Margins squeezed as labour costs rise

The ECB initially ascribed this lack of pass-through to lags, but as the acceleration in unit labour cost growth has been evident since late 2017, it is clearly more than that. The squeeze on profit margins has in fact proven very persistent and, while firms would like to rebuild their margins, there are signs from surveys that they are reluctant to do so in the current sluggish economic environment for fear of losing market share.

As many of the wage agreements struck in early 2018 last for a couple of years, compensation growth will remain elevated in the next few quarters. But as those deals expire, with headline inflation likely to stay rather low absent an oil price surge, a deceleration is likely. At the same time, the plunge in productivity growth which contributed to the pick-up in unit labour costs is likely to reverse, at least in part, as employment growth slows to reflect the weaker path of output growth. The result, therefore, is likely to be a slowdown in unit labour cost growth a few quarters down the line in the absence of a marked improvement in economic conditions, which looks unlikely.

Despite 2019 being the seventh year of the current expansion, the eurozone output gap is only marginally positive (+0.3% this year according to our estimates, similar to the European Commission's forecast), due to the large amount of slack generated during the prior crises. With the economy now growing around its potential rate, slack is no longer being eroded. While we assume in our baseline forecast a modest and gradual pass-through from prior gains in labour costs into core inflation over the next few years (forecast at 1.4% in 2021), the risks increasingly look skewed to the downside.

Indeed, this could become a major problem should the eurozone find itself impacted by a severe adverse shock. In the period after the eurozone crisis, from 2013 to 2016, the ECB was rightly anxious about the threat of a debt-deflation trap emerging. Those concerns faded as the stream of policy stimulus boosted economic growth and the output gap narrowed. But the inflationary "buffer" which the ECB was hoping to generate ahead of a subsequent downturn has proved elusive.

Larger inflation cushion required, but not achieved

A reprise of the ECB's analysis on this issue in the post-crisis years is instructive as it highlights multiple concerns associated with low inflation. One is that it complicates relative price adjustments between eurozone member states. In other words, in the absence of higher inflation rates in the hitherto more competitive countries (e.g. Germany), those seeking to improve their relative competitiveness could be more susceptible to deflation, which would worsen already onerous debt burdens in many of them.

Another concern is the need to anchor expectations to make sure that temporary movements in inflation do not feed into wages and prices, and hence become permanent. As we have highlighted previously, this has looked increasingly worrisome for the ECB recently, contributing to the signals that additional policy stimulus is imminent. As inflation expectations fall, real interest rates rise and, given the limits to how far nominal short-term rates can be lowered, monetary conditions can potentially tighten.

Japanese lessons

Parallels were also drawn with the post-bubble Japanese experience of successively lower peaks in underlying inflation during each expansion, followed by a series of downturns which eventually tipped the economy into deflation. A key ECB objective, therefore, was to build some leeway to avoid such an outcome via large-scale policy stimulus aimed at generating sustained well above potential growth rates, a large positive output gap and in turn higher underlying inflation.

Arguments against a Japan-like scenario occurring in the eurozone include the continued ability of policy makers, when working in concert, to reflate the economy, plus the historical downward rigidity of wages and prices in Europe. But how convincing are those arguments currently?

Regarding the former issue, the ECB has already signalled that the door is open to additional QE and a lower deposit facility rate. We expect both to be announced in Q3. But as we outlined in our recent Special Report, the impact of additional monetary policy easing will be limited. Other policy levers, including fiscal stimulus, will need to be used much more effectively and we have doubts about the efficacy of the policy framework in the eurozone. Regarding the latter issue, historically there have been rigidities in wage and price setting. But that may not apply to the same extent post-crisis given the various supply side reforms which have been introduced.

In our baseline scenario we do not expect a severe shock to push the eurozone into a downward spiral. We expect low, but relatively stable, growth and inflation rates in the coming years. However, we are cognisant of alternative scenarios, particularly those which have a low probability but threaten to have a very big impact. The absence of an inflation buffer in the eurozone so late in the cycle is a cause for concern in this respect.

Asia Pacific Special Focus

Another G20 Summit, Another G2 Trade War Truce

By Rajiv Biswas

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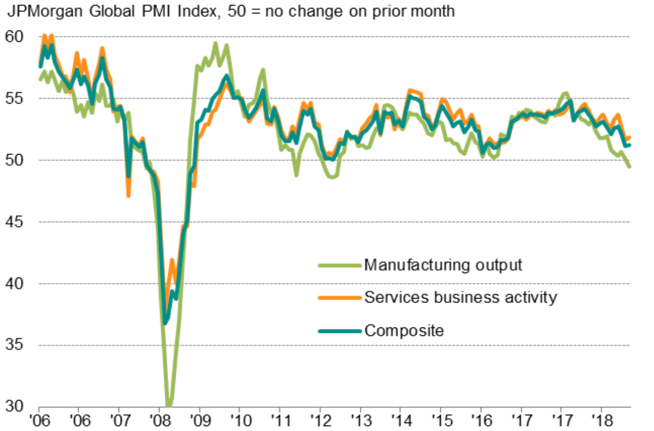
The G20 Summit on 28-29th June in Osaka was notable primarily for the successful bilateral G2 meeting held on the sidelines between President Trump and President Xi. The announcement of a new US-China trade war truce as both sides resume negotiations to try to conclude a US-China trade deal was welcomed in international financial markets. The new trade war truce defused the imminent risk that the US could have decided to implement another round of tariff hikes on China.

G20 Summit highlights rifts among members

Aside from the successful Trump-Xi bilateral meeting, the G20 Summit itself showed little in the way of other substantive outcomes. The final G20 Communique stated that "Global growth appears to be stabilising, and is generally projected to pick up moderately later this year and into 2020." However, the latest IHS Markit PMI surveys for June indicated stagnation in the US manufacturing sector, with continuing contraction in the manufacturing sectors in the Eurozone as well as in East Asia's largest industrial economies of China, Japan and South Korea. IHS Markit forecasts that world GDP growth will moderate from 3.2% in 2018 to 2.8% in 2019, then edge lower to 2.7% in 2020.

Global PMI



Source: IHS Markit, JPMorgan

The final G20 Communique rolled out the usual list of platitudes from the G20 leaders about solving all of the world's problems, without any substantive co-ordinated action plans for most of these aspirations. However, highlighting the many underlying rifts between G20 members on various issues, immediately after the G20 Summit had concluded, Japan announced restrictions on a number of specific exports to South Korea, another G20 member, adding to global trade tensions. These export restrictions were imposed on certain critical materials used for semiconductors and display production, which are key segments of South Korea's electronics industry. The South Korean Minister for Trade, Industry and Energy, Mr. Sung Yun-mo, has stated that South Korea would "take necessary countermeasures including filing a complaint with the World Trade Organisation."

New trade war truce

The outcome of the meeting between President Trump and President Xi at the G20 Summit was positive for world trade and for the Chinese economy as it has put in place a new trade war ceasefire and restarted the US-China trade negotiations to try to find a trade deal.

An important result from the meeting is that President Trump has said that no new US tariffs will be put on Chinese exports for the moment. That is good news for China's export sector, as the US had previously been planning to impose a 25% tariff on an additional USD 300 billion of Chinese products, which would have triggered an additional large negative shock for the Chinese economy as well as for the wider Asian manufacturing supply chain.

Furthermore, President Trump has said that US firms will again be allowed to sell products to Huawei, which will be very helpful for Huawei's business operations. On May 15th, the US Department of Commerce's Bureau of Industry and Security had placed Huawei Technologies Co Ltd and 70 of its affiliates to its Entity List. This had resulted in an immediate ban on US firms selling or transferring technology to Huawei without first obtaining a US government license. However, the full implications of President Trump's decision to permit US firms to sell products to Huawei will depend on further details from the US Department of Commerce of how this will be implemented.

Next tranche of US tariff hikes put on hold

The decision by President Trump to suspend any further tariff hikes on China for the moment has removed an important downside risk to global growth and world trade at a time when world growth momentum is moderating and world export growth has slowed significantly.

However, the status quo of existing tariff measures will remain in place, so the negative impact of the current structure of bilateral tariffs will continue to hurt bilateral trade flows. Furthermore, wider contagion effects will continue to hit the export sectors of other countries that are part of the supply chains impacted by these tariffs.

Global manufacturing export orders

Sources: IHS Markit, CPB Wortld Trade Monitor.

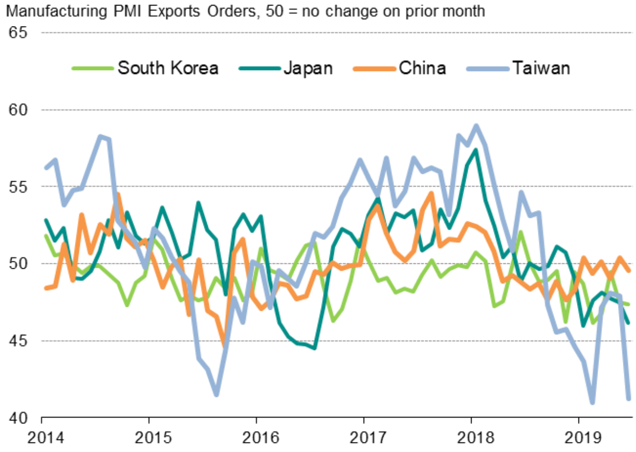
Despite Trade War Truce, APAC Exports Still Face Strong Headwinds

The latest IHS Markit PMI surveys for the Asia-Pacific region continue to show that manufacturing export orders are contracting in many of Asia's largest industrial economies, including China, Japan and South Korea. The combined effects of the US-China trade war, the downcycle in global electronics sector new orders and moderating growth momentum in the US and EU imply that many APAC economies will continue to face significant near-term headwinds.

Concerns are increasing among policymakers in many Asian economies about the impact of weakening exports on economic growth. Several of Asia's most export-dependent economies have experienced a significant deterioration in exports in the first half of 2019. The Monetary Authority of Singapore warned on 27th June that Singapore's GDP growth rate for 2019 is likely to be weaker than previously forecast, with Singapore's non-oil domestic exports estimated to have contracted by 9.3% since the beginning of 2019. In South Korea, GDP contracted by 0.4% quarter-on-quarter in the first quarter of 2019, with the export slump intensifying in June, when exports fell by 13.5% year-on-year.

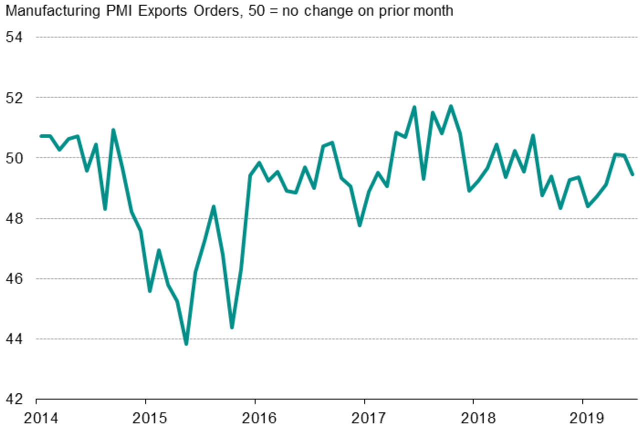
However, for some countries, the protracted US-China trade war has reinforced trade diversion effects, as US buyers shift their orders to other manufacturing hubs, while manufacturers also restructure their output across their global supply chains to reduce their exposure to the US tariff measures.

New manufacturing export orders



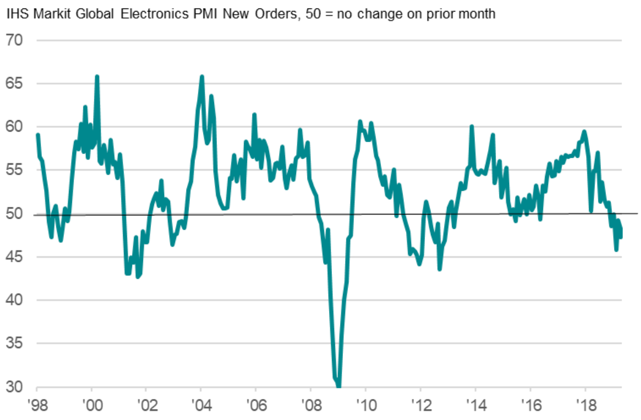
Source: IHS Markit, Caixin.

ASEAN new manufacturing export orders



Source: IHS Markit.

Global Electronics PMI New Orders



Source: IHS Markit.

Therefore, some emerging APAC manufacturing hubs will likely gain some export orders from the US as a result. In particular, ASEAN manufacturing hubs such as Vietnam, Malaysia and Thailand are likely to benefit from some diversion of export orders as well as stronger foreign direct investment flows over the medium-term as multinationals diversify their global supply chains away from China. While intensified by the US-China trade war, this diversification had already been underway since 2012 due to rising Chinese manufacturing wage costs and concerns about potential supply chain disruptions due to concentration of production in China.

Outlook for US-China trade talks

Although the restart of US-China bilateral trade negotiations is positive news for world trade and for China's economy in particular, such complex trade negotiations can often be protracted. Therefore, the likelihood is that the bilateral trade talks may still take some time before any final trade agreement can be reached. While progress has been made towards reducing the bilateral trade deficit, finding a mutually acceptable deal on intellectual property rights is a complex negotiation which may take more time.

The technology war is also unlikely to be easily resolved, with a number of senior Republican lawmakers signalling their concerns about President Trump's decision to ease restrictions on Huawei, with the potential for introducing new legislation in the US Congress to reimpose these restrictions.