Economic Research

26 August 2019

Week Ahead Economic Preview

Global overview

- **US rate guidance from PCE and GDP updates**
- **Inflation data to steer ECB policy stance**
- **German data eyed for recession risks**
- **Data on industrial production in key Asian economies, plus BoK meeting**
- **Special reports on Eurozone 'super core' inflation and India FDI surge**

Fed watchers will be eager for further insights into the US central bank's thinking after minutes to July FOMC meeting showed policy committee members were split. With flash US PMI data firing a warning shot on US economic growth, indicating the smallest new business growth seen in a decade and hinting at more monetary easing, all data will be keenly eyed for clues of growth momentum and price trends. Home sales data are accompanied by durable goods orders and an updated estimate of second quarter GDP, alongside person income, spending and price data. Core PCE prices will be especially anticipated as this is an inflation gauge favoured by the Fed (see page 3).

With the ECB lining up further stimulus, which we expect to come in September, markets will be watching for flash consumer inflation data for August, which is widely expected to show subdued price growth (see our special report on page 6).

In Germany, a clutch of data, including a final estimate of second quarter GDP with breakdown, as well as business surveys, will be scrutinised for the likelihood of a recession amid growing concerns over the impact of a German economic downturn on the wider euro area economy (page 4).

In Asia, the focus is on the state of manufacturing conditions in the face of intensified trade tensions. Industrial output figures are published for Japan, South Korea, Thailand and Singapore. China NBS PMI data (issued on 31st Aug) will also be under scrutiny, as will industrial profits data. GDP releases from India will meanwhile offered clues as to whether the economic slowdown has deepened (page 5). Our second special report this week looks at how India's initiatives helped to attract greater inflows of foreign direct investments in recent years (page 9).

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Special reports

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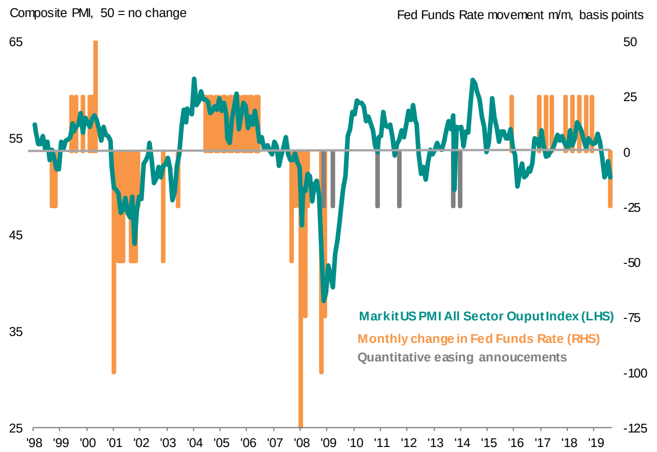
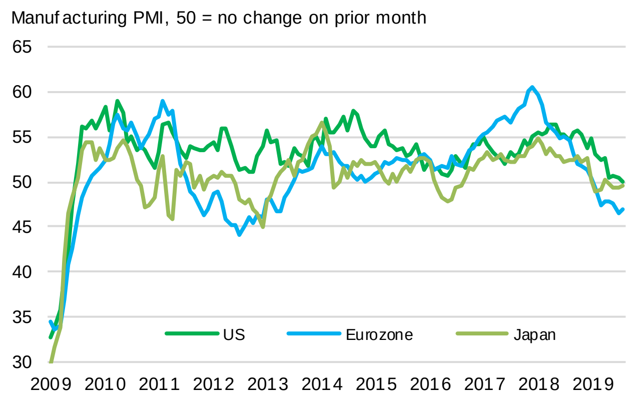
IHS Markit's US flash composite PMI remained in dovish territory in August, raising expectations for further Fed policy easing



Sources: PMI uses Markit post-2008 and ISM pre-crisis, Federal Reserve

Flash PMI surveys indicate the manufacturing downturn continues in August



Sources: IHS Markit, Jibun Bank

Key diary events

Monday 26 August

G7 Summit (24-26 Aug)
Singapore industrial output (Jul)
Hong Kong trade (Jul)
Germany Ifo surveys (Aug)
US durable goods orders, Chicago Fed national activity index (Jul)

Tuesday 27 August

South Korea consumer confidence (Aug)
China industrial profits (YTD, Jul)
Thailand industrial production (Jul)
Hungary interest rate decision
Germany GDP (final, Q2)
France business and consumer confidence (Aug)
UK finance mortgage approvals (Jul)
US Case-Shiller home price (Jun), Richmond Fed manufacturing index (Aug)

Wednesday 28 August

Australia construction work done (Q2)
Germany consumer confidence (Sep)
Italy business and consumer confidence (Aug)

Thursday 29 August

Japan consumer confidence (Aug)
Italy industrial orders (Jun)
Germany unemployment rate (Aug)
France GDP (final, Q2)
Euro area business confidence, economic sentiment (Aug)
Germany and Spain inflation (Prelim, Aug)
Brazil GDP (Q2)
US GDP (2nd est, Q2), wholesale inventories, goods trade balance (Adv, Jul), pending home sales (Jul)

Friday 30 August

South Korea industrial output, retail sales (Jul)
South Korea monetary policy decision
Japan unemployment rate, retail sales, housing starts (Jul), industrial production (Prelim, Jul)
Australia building permits, private sector credit (Jul)
India GDP (Q1, FY19-20)
UK consumer confidence, housing prices (Aug)
Italy GDP (Final, Q2)
Germany retail sales (Jul)
Euro area inflation (Flash, Aug)
France and Italy inflation (Prelim, Aug)
US PCE Price Index (Jul)
US Chicago PMI (Aug), Michigan surveys (Final, Aug)

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United States Week Ahead

GDP update, PCE prices and durable goods orders

By Siân Jones
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With flash August PMI providing a clear signal of further economic slowdown and latest FOMC minutes showing the committee split on monetary policy, analysts will look to more data for clues on future Fed policy. This will come in the form of an update to second quarter GDP, durable goods orders and PCE price index. Other key data highlights include wholesale inventories, pending home sales, personal income, personal spending and regional business surveys.

GDP update

The first official GDP estimate detailed how a lack of investment and export growth had dragged on the overall expansion in the second quarter. Flash PMI surveys showed that US economic growth continued to soften in the third quarter, with new business growth falling to its weakest in almost a decade, driven by a sharp loss of momentum across the service sector. This casts doubts on how long the two-speed economy, where a steady service sector expansion has offset a deepening manufacturing downturn, will persist. Our current forecast points towards 2.1% GDP growth in the third quarter.

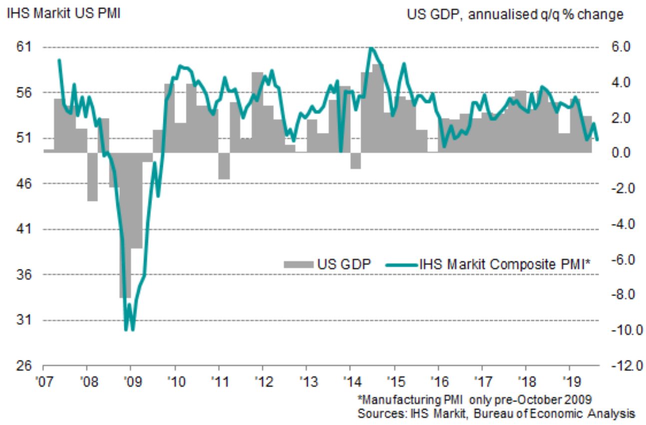
Durable goods

July data is expected to show a further fall in durable goods orders as manufacturers remain in a malaise, driving predictions of another quarterly contraction in manufacturing output. The decline in new business looks set to remain apparent through the third quarter, according to IHS Markit US PMI data.

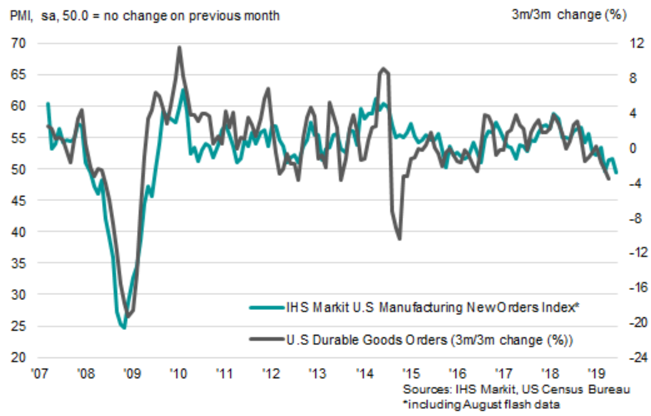
PCE Prices

As signalled by recent PMI data, price pressures are set to remain subdued through the third quarter, with the core PCE price index (less food and energy costs) forecast to post below the 2% target rate yet again. Another month below the Fed's desired rate of inflation could further fuel expectations of further rate cuts, especially amid burgeoning uncertainty abroad.

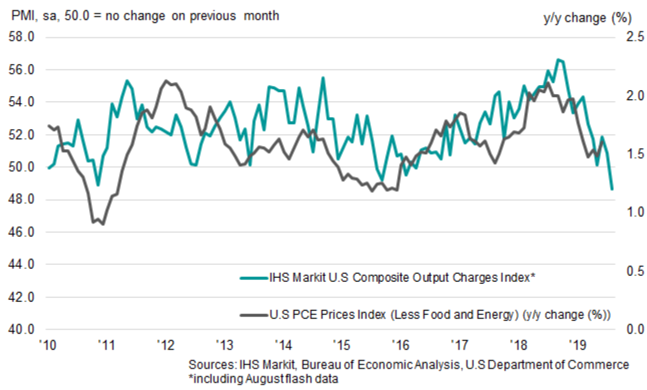
IHS Markit Composite PMI and GDP



Durable goods to contract further



Softer price pressures expected



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Europe Week Ahead

Germany GDP breakdown, euro area jobs and inflation data

By Joe Hayes

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The chance of Germany dipping into a "technical" recession has become an increased risk for the euro area. The release of Germany's second quarter GDP expenditure breakdown will therefore help to formulate expectations for the coming quarter, while employment, retail sales data and Ifo surveys will also provide crucial insight into the domestic market. Eurozone inflation figures will be scrutinised as the ECB stands ready to introduce new stimulus.

Germany recession risk

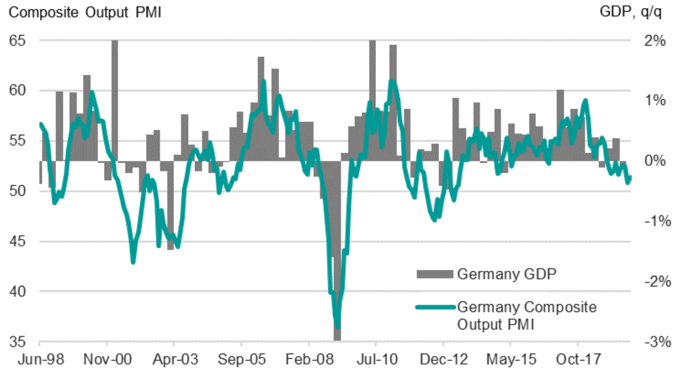
The expenditure breakdown of second quarter GDP should provide vital clues into the trends we can expect to see in the third quarter. Insight into domestic economic conditions, the driving force for Germany so far this year, will come from the release of employment and retail sales figures. However, signs of fragility have begun to appear here (see second chart), with the labour market cooling according to both the 'hard' and survey numbers. The risk here is that this could dampen real wage growth.

Nonetheless, we assume in our baseline forecast that a recession will be avoided, but only just, as domestic demand has been relatively resilient to date (Please refer to our 19 August special report "German recession risk revisited"). However, flash Germany PMI data showed that cracks are appearing in the service sector, with new orders growth dipping and business sentiment turning negative for the first time since October 2014, suggesting increasing risks to the domestic market. Meanwhile, retail sales figures will show whether the softening trends in PMI data is manifesting itself in official statistics.

Building a case for September stimulus

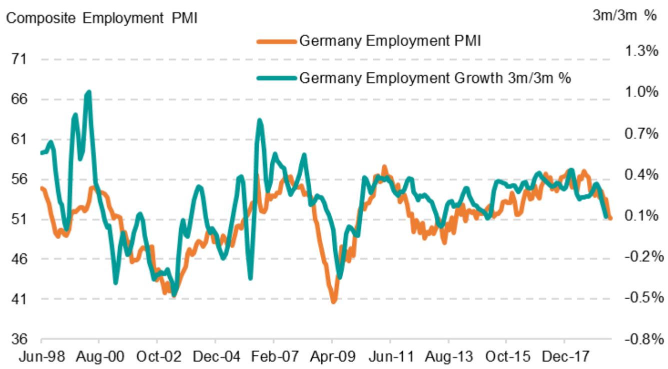
August euro area inflation figures are expected to remain subdued, thereby supporting looser monetary policy. We expect the ECB to launch a fresh package of measures in September, including a lower deposit rate and a restart of net asset purchases, as was strongly signalled by the account of July's meeting. Meanwhile, inflation numbers for individual euro area countries are also due, alongside eurozone sentiment surveys and labour market statistics. Second quarter GDP estimates for Italy and France are expected to remain unchanged from the preliminary prints of 0.0% and 0.2% respectively.

Flash PMI data highlights recession risk in Germany



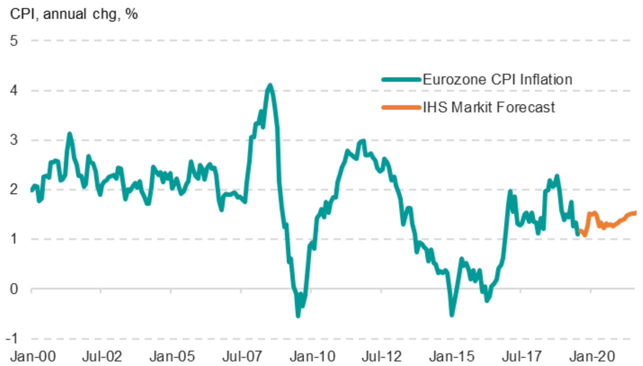
Source: FSO, IHS Markit

Cooling labour market in Germany poses risk to domestic market's resilience



Sources: IHS Markit, Bundesagentur fur Arbeit

Price pressures expected to remain weak, supporting looser ECB policy



Sources: Eurostat, IHS Markit

Asia Pacific Week Ahead

Asia industrial output data, India GDP and Bank of Korea

By Bernard Aw

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The global manufacturing downturn shines a spotlight on next week's release of industrial output numbers across key Asian exporting economies, including Japan, South Korea, Thailand and Singapore. Hong Kong's trade figures will also be watched while updates to China's industrial profits and government-sponsored PMI numbers are eyed for the extent to which fiscal stimulus measures are working. South Korea will decide on monetary policy while India releases its first quarter GDP figures for FY19-20.

Subdued industrial output across Asia

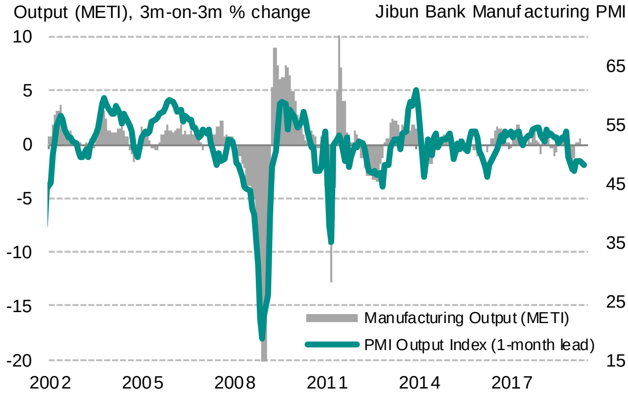
Analysts will monitor industrial output data across Asia for an updated check on the health of the regional industrial sector. Factory production is expected to be weak in July, with Singapore and South Korea likely to see another decline on annual terms (-2.2% and -4.6% respectively), according to our forecasts. While factory output in Japan and Thailand may return to growth, expansions are likely marginal (0.1% and 0.4% respectively). Recent PMI surveys in these countries continued to signal weakness in manufacturing, reflecting a subdued global trade environment that is buffeted by rising trade tensions and slowing capital spending. Meanwhile, China's industrial profit numbers will be scrutinised for signs of whether the Chinese economy requires more fiscal stimulus support

India GDP and Bank of Korea

India's economic growth is likely to have moderated further to an annual rate of 5.5% in the first quarter of FY2019-20, weighed down by softer consumer demand, according to our projection. However, July PMI data signalled a renewed vigour in Indian services activity alongside firmer momentum among goods producers. This suggests that economic activity may improve in coming months, supported also by announced fiscal measures and expected easing in monetary conditions.

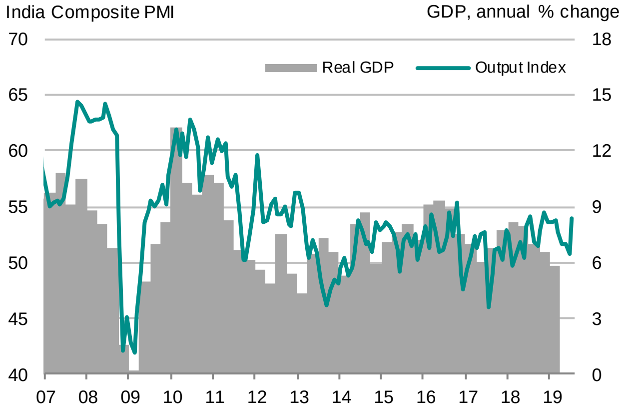
While the Bank of Korea is not expected to cut interest rates again in next week's policy meeting, increasing economic headwinds, such as escalating trade tensions with Japan, slower global trade and a subdued domestic picture, raise the odds of further monetary easing in coming months. Forward swaps markets are pricing in more rate cuts.

Flash Japan PMI signals weak factory output



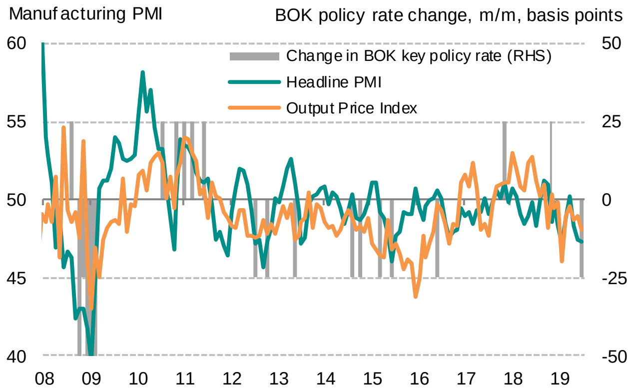
Sources: IHS Markit, Jibun Bank, METI

India PMI signals accelerating growth at start of third quarter on renewed service sector growth



Sources: IHS Markit, CSO

South Korea PMI remains in territory associated with monetary easing



Sources: IHS Markit, Bank of Korea

Europe Special Focus

Eurozone "super core" inflation rate has risen, but worryingly slowly

By Ken Wattret

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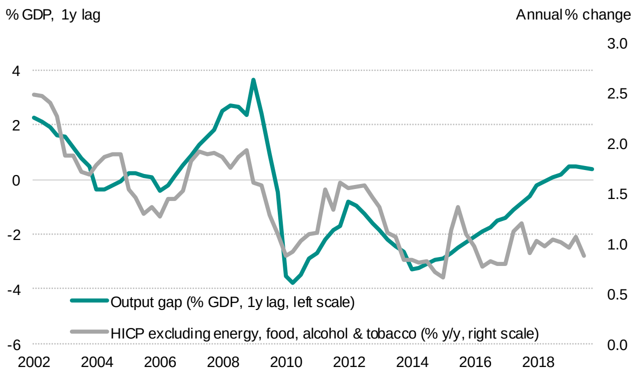
We have replicated the ECB's creation of a measure of core inflation which includes only the HICP items which are sensitive to changes in the eurozone output gap, known as the "super core" rate. Those items account for around 40% of the HICP and are heavily weighted towards services prices, resulting in higher inflation rates than for traditional core measures. The IHS Markit "super core" rate has picked up but at just 1.5% currently, it remains well below the levels consistent with the ECB achieving its price stability goal. With sub-potential eurozone growth to continue, worries about the adverse consequences of low inflation in the eurozone are likely to persist even if the ECB delivers another package of easing measures in September as we expect.

What is "super core" inflation?

Back in 2014, the ECB first outlined the rationale behind the creation of a narrower gauge of underlying inflation in the eurozone. The starting point for the analysis was the historically strong relationship between changes in the eurozone output gap and points of inflection for the core rate of HICP inflation (see chart - the breakdown in the relationship in recent years we discuss below).

Core inflation is low relative to output gap



Source: IHS Markit, Eurostat, EC

The ECB's analysis determined that only a relatively small sub-set of HICP items had a statistically significant relationship with the output gap: these were then used to create a "super core" index. Food and energy prices were excluded as they are heavily influenced by external factors. So too certain goods prices which tend to have a high import content, including computers and other electronic items.

The ECB does not publish time series for its "super core" index or the inflation rate derived from it, nor has it published a list of the items included in the index. Occasionally, ECB speakers refer to how the "super core" rate is evolving and there are also periodic updates on the process of generating the index. But to monitor its evolution regularly, along with the potential implications for monetary policy, we generate our own version. We update the IHS Markit "super core" measure following each monthly final HICP print from Eurostat.

Services prices dominate the index

In our "super core" index, we include 33 of the 72 core HICP items. They account for a little over 40% of the total HICP weights and around 60% of the HICP excluding energy and food prices. The split between services and core goods is around 75% to 25%, respectively. This compares to an equivalent split of 63% to 37% for Eurostat's traditional core HICP which excludes energy, food, alcohol and tobacco.

One would expect a strong bias towards services prices in the "super core" index as they tend to be more sensitive to domestic economic developments (and hence the output gap), with domestic labour costs typically a more important determinant of prices of services than goods.

As inflation rates for services tend to run higher than for core goods, the IHS Markit "super core" rate has historically been higher than the more familiar Eurostat core measure referenced above (see charts). The differential between the two core inflation rates was particularly elevated in the pre-global financial crisis period, peaking at almost a percentage point. This was due to boom conditions across most of the eurozone driving up services inflation, plus the disinflationary effects on goods prices of new, lower-cost producers like China.

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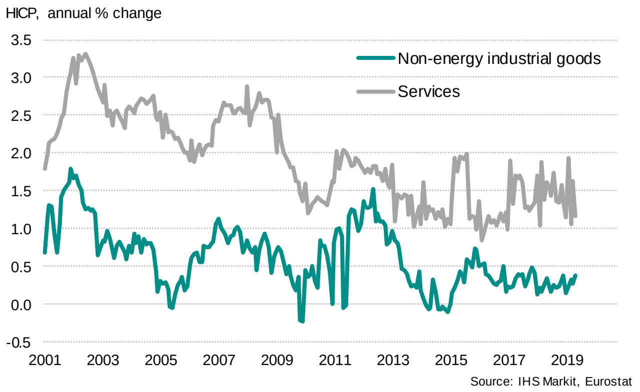
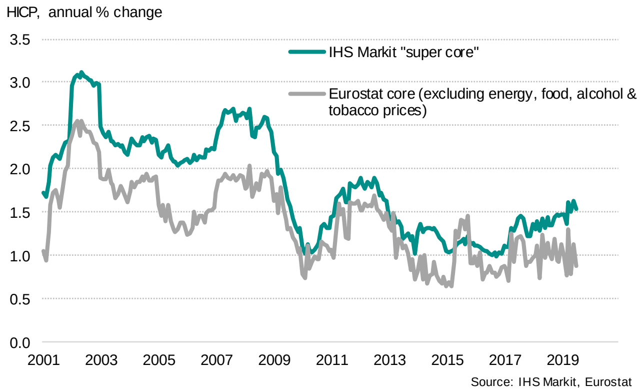
Eurozone services inflation higher than core goods



Eurozone "super core" inflation rate trending up



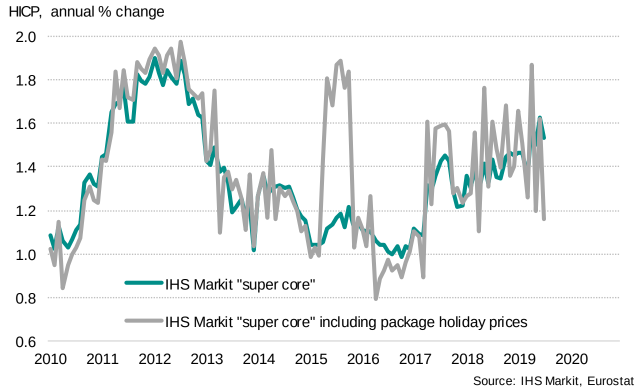
Two key aspects of the comparison of core eurozone inflation rates merit comment. First, the “super core” rate is less volatile than the traditional measure. Second, it is striking that the “super core” rate has picked up in recent years whereas the more familiar core rate has been going sideways. We consider both issues below.

Reduction in inflation volatility

One of the advantages of the “super core” inflation rate is that it is less susceptible to swings in the more volatile HICP items which can distort traditional measures of core HICP inflation at certain times of year. Monitoring the “super core” rate can therefore help in identifying turning points and emerging trends.

As regular readers will know, swings in package holiday prices are a major complication during the spring and early summer, particularly in recent years. Package holiday prices are not included in the IHS Markit “super core” index. When they are included, the volatility of the inflation rate increases markedly, so assessing the underlying trend becomes very difficult (see chart).

Swings in package holiday prices generate huge volatility



“Super core” rate inflation has picked up but remains untypically low

Based on the most recent HICP data, for July, the “super core” rate edged down from 1.6% to 1.5%, though it remained around half a percentage point above the traditional core measure. Having bottomed out at around 1% in late 2016, there has been a clear, albeit gradual, upward trend in “super core” inflation over the period since. This suggests that the changes in economic conditions in the eurozone as the expansion developed – i.e. above trend growth rates and closure of the output gap – did eventually start to impact on domestically-driven prices. This contributed to the ECB’s decision to cease its net asset purchases in December 2018.

That said, the pick-up in the “super core” rate arrived rather late in the expansion compared to the past, while its current level remains comparatively low. During previous periods when inflation in the eurozone has been running in line with the ECB’s definition of price stability (i.e. below, but close to, 2%), the “super core” rate has been ranging between 2-3%. Furthermore, as the first chart illustrates, based on the historic relationship with the eurozone output gap, one would have expected the traditional measure of core inflation also to have accelerated by now.

There are various explanations for the comparatively slow pick-up in “super core” inflation and the disconnect between the closure of the output gap and the persistently flat trajectory of the traditional core inflation rate. These include: difficulties in measuring potential growth and the output gap; a flattening of Phillips curves in the eurozone due to a range of factors including increased globalisation and labour market reforms; persistent low inflation expectations; the slow response of the ECB to the emergence of disinflationary forces (QE did not begin until spring

2015); and the theory of persistent large output gaps (or PLOG).

Failure to generate positive output gap a key concern

All of these are credible to some extent. The PLOG theory, pioneered by the IMF during the post-global financial crisis period, has probably received insufficient attention. In short, the analysis suggests that following a relatively mild recession, an economy's subsequent return to an above-potential growth rate can lead to "speed limit effects", pushing up underlying inflation. However, following large, persistent output gap episodes, such effects typically do not materialise. Rather, core inflation rates only pick-up markedly once output gaps have become significantly positive (absent shocks, such as the surge in commodity prices in 2011-12).

The problem for the eurozone is that the output gap only turned marginally positive in 2018. Moreover, as we expect growth to be below potential through 2019-2021, it will not increase from this point but will turn slightly negative. Were the eurozone economy to fall into recession, a sizeable negative output gap would re-emerge, leaning down on core inflation from an already low level, threatening a deflation-type scenario.

The obvious conclusion for the ECB is to provide additional policy accommodation to try to get the economy growing back above its potential rate again. Hence our expectation of another package of stimulus measures in September. The lags involved before this passes through to the economy, however, plus diminishing returns from monetary policy measures, suggest the ECB is going to find it very difficult to achieve this objective. Worries about the potentially adverse consequences of low inflation in the eurozone are likely to therefore continue to build. (Please refer to the 17 June Special Report 'ECB opens the door to more policy easing but will it be enough?')

Asia Pacific Special Focus

India's surging foreign direct investment inflows

By Rajiv Biswas

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Since the Bharatiya Janata Party (BJP), led by Prime Minister Narendra Modi, took office in 2014, foreign direct investment (FDI) into India has surged. Total FDI inflows reached USD 64 billion in the 2018-19 fiscal year, according to estimates, compared with USD 36 billion in fiscal 2013-14 and just USD 4 billion in fiscal 2000-01.

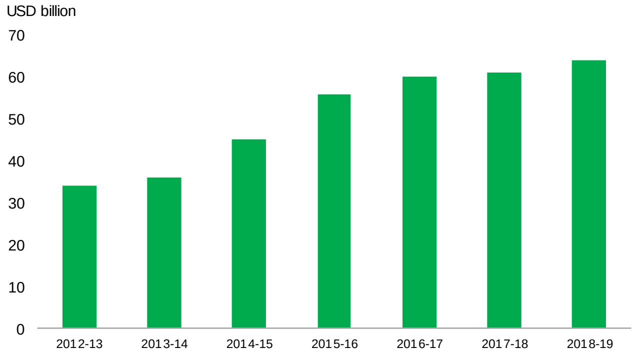
The announcement on 12th August 2019 by Saudi Aramco that it would acquire a 20% stake in Reliance's oil to chemicals business highlights the increased focus by multinationals on India. The Saudi Aramco investment will result in an estimated USD 15 billion FDI inflow into India.

Buoyant FDI Inflows

The strong upturn in foreign direct investment into India since the Modi administration took office is a positive signal that foreign private capital inflows are playing an increasing role in financing India's economic development. PM Modi has given a high priority to attracting foreign investment since he took office, meeting with business leaders during state visits to major capital markets such as the US, EU, China, Japan and Singapore.

PM Modi has also put a strong policy focus on reducing regulatory barriers to investment by both foreign and domestic firms. When the BJP took office, India was ranked at 142nd out of 189 countries in the World Bank's Ease of Doing Business ranking for 2015, which is based on results from the annual survey undertaken during the 2014 calendar year. Reflecting significant progress in reducing barriers to business investment, India climbed to 77th position out of 190 countries included in the World Bank's Ease of Doing Business Index in 2019.

India FDI Inflows



Source: India's Ministry of Commerce and Industry

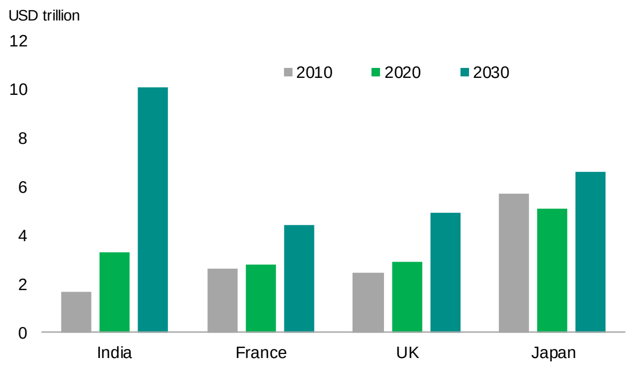
The improving macroeconomic environment since 2014 also helped to improve India's attractiveness as an investment destination, as falling world oil prices helped to reduce inflation pressures and trimmed the current account deficit as a share of GDP on a moderation in India's oil import bill. Sustained strong GDP growth over the past decade have also reinforced confidence among international investors towards the Indian economy.

An important economic reform that has improved the competitiveness of India for manufacturing has been the introduction of a unified Goods and Services Tax (GST) across all Indian states in 2017. This has helped to significantly reduce the regulatory burden on interstate transportation of goods. The unified GST is estimated to have substantially reduced logistics costs for firms, as well as improved efficiency and competitiveness of the domestic manufacturing sector.

India's Fast-Growing Consumer Market

India's large and fast-growing domestic consumer market is a key attraction for foreign multinationals. Total nominal GDP in India is estimated to reach USD 3 trillion in 2019, overtaking the UK to become the world's fifth largest economy.

India GDP (in nominal terms) compared to major economies (2010-2030)

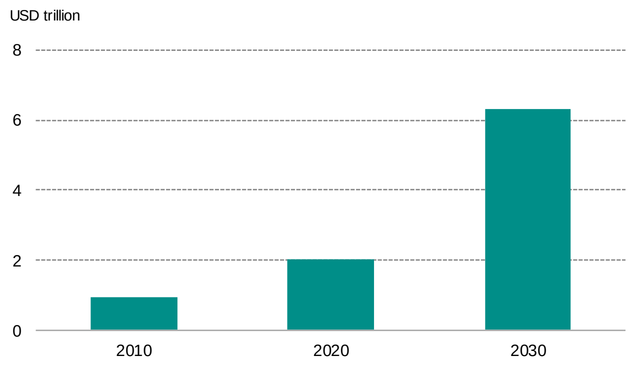


Source: IHS Markit.

The total size of India's consumption is projected to exceed USD 2 trillion in 2020, according to forecasts by the IHS Markit Global Consumer Markets Service, doubling from around USD 1 trillion in 2011. By 2025, Indian consumption is forecast to exceed USD 3.5 trillion.

India's fast-growing consumer market offers multinationals in a wide range of manufacturing, construction and service sector industries one of the world's most attractive opportunities for revenue growth among emerging markets. Furthermore, markets in developed countries are facing protracted low growth in consumption spending, reflecting weak per capita GDP growth and the impact of demographic ageing on consumer spending patterns.

Size of India's consumer market



Source: IHS Markit.

The attractions of the Indian consumer market have triggered a wave of FDI inflows across a wide range of industries. In 2018, Walmart acquired a majority stake in Indian e-commerce company Flipkart, involving FDI of USD 16 billion into India for the acquisition. Foxconn Technology Group opened a factory near Chennai this year to assemble new model Apple iPhones, in addition to two other facilities in India for assembly of Xiaomi and Nokia smartphones. A large number of multinationals have also invested in R&D hubs across India, building up their presence over the past decade. Among the hundreds of foreign multinationals with Indian R&D hubs are Amazon, Boeing, General Electric, Google, Huawei, Hyundai Motors and Samsung.

International private equity funds are also investing in a wide range of Indian assets, such as infrastructure projects and technology firms. For example, Canada's Brookfield Asset Management has invested USD 1.9 billion in early 2019 to acquire Pipeline Infrastructure Private Limited, which owns an Indian natural gas pipeline. Blackstone has been a leading international private equity investor in India since 2006, having committed USD 9.8 billion of investments in India through private equity and real estate, including co-owning India's first Real Estate Investment Trust, the Embassy Office Parks REIT, which was launched in April 2019.

Medium Term Outlook

Despite the strong FDI upturn since 2014, total FDI inflows into India remain less than half the total of annual FDI inflows into China. Indian FDI inflows reached USD 64 billion in fiscal year 2018-19, while inbound FDI into mainland China reached USD 135 billion in 2018.

However, with China facing a combination of rapidly rising manufacturing wage costs as well as the impact of the US-China trade war through higher US tariffs, many multinationals are diversifying their global manufacturing supply chains towards other Asian manufacturing hubs. India may be able to benefit from this trend over the medium term, with global manufacturers increasingly focused on the rapidly growing Indian domestic consumer market.

In trying to attract manufacturing FDI, India faces significant competition from other Asian developing countries, with many manufacturers from Japan, South Korea, mainland China and Taiwan investing in establishing or expanding their manufacturing production facilities in countries like Vietnam, Malaysia, Thailand, Philippines and Indonesia.

When PM Modi launched the Make in India strategy in 2014, he set a target of increasing the contribution of manufacturing to GDP to 25%. However, by 2018, the manufacturing sector share of GDP was still at 18%, which leaves a substantial gap to bridge in order to achieve this vision.

Continuing to drive the transformation of India's industrial sector through PM Modi's 'Make in India' strategy is a key strategic priority for the Indian government, in order to improve manufacturing sector output growth and generate stronger job creation.

Catalysing more dynamic growth in the manufacturing sector will therefore be very important as a key pillar to achieve India's objective of becoming an upper middle-income economy by 2025. Strong FDI inflows into India can play an important role in achieving that vision, as multinationals build manufacturing plants in India to both tap on the fast-growing domestic consumer market and diversify their Asian manufacturing supply chains.