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Group Economics

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A further loss of momentum, but recession can be avoided

- **US business confidence index falls most in ten years**
- **Business confidence falls world wide, with a couple of remarkable exceptions**
- **Markets send a strong message to policymakers**
- **Inflation falls back strongly on oil**

Last year started with business confidence virtually everywhere at exceptionally high levels. But confidence weakened in the course of the year. The US was the exception. The tax reform and tax cuts provided stimulus to the US economy that translated in accelerating growth and continued high business confidence. No more, or so it seems. The long-standing index of US business confidence, the ISM index, took a tumble in December, falling from 59.3 to 54.1. That is still a level indicating decent growth, but it was the biggest monthly drop since 2008 (though the drop was from a much higher level than in 2008). Earlier released regional indices had provided a warning. Most of them had fallen materially in December, but in several cases the accompanying commentary suggested that the falls would not be replicated in the ISM due to methodological differences. That turned out to be incorrect. It must be said, many indicators continue to suggest that the US economy is growing robustly.

US: ISM index

Index, 50=neutral



Source: Bloomberg

What has caused the sharp drop of the US ISM index?

It is unclear whether the sharp fall in the ISM represents an actual deterioration of business conditions or a loss of confidence caused by the ongoing trade conflict with China and the government shutdown. If the latter is the case, confidence can improve if policymakers sort out the various issues. A good American friend of mine told me over the summer that President Trump only watches two data series: his approval ratings and the S&P500. His approval ratings have been fairly stable (very high among Republican voters, low among independents and extremely low among Democrats). But the stock market has taken a serious tumble. The president took credit in the course of 2018 for rising stock prices. One wonders if he would acknowledge that the decline in recent months is perhaps at least partly caused by his trade war and the more recent government shutdown. In the past, these shutdowns did not last long as neither political party wanted to be blamed for them. Instead of trying to resolve the issues involved, Trump appears to put a lot of energy in blaming the Democrats. At the time of writing the differences of opinion persist. From a distance, this looks like a silly argument between stubborn and immature people. Trump wants USD 5 bn for his wall on the border with Mexico. The Democrats are refusing to give him the money. Of course, the wall has great symbolic value. USD 5 bn is a small amount in the greater scheme of things.

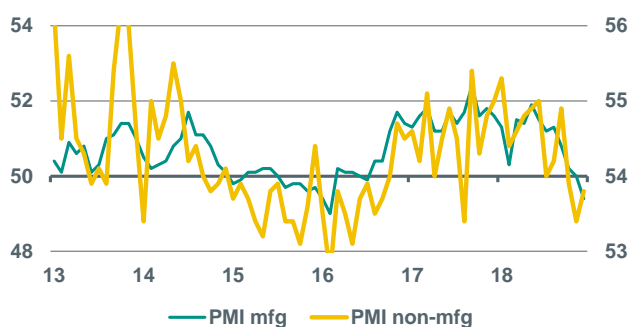
The weakness of the stock market may also lead to pressure on the Trump administration to reach a deal with China. The talks between the two sides appear to be given more urgency now. The Chinese will be acutely aware that the stock market is putting pressure on Trump to end the conflict. Economic indicators, as well as anecdotal evidence, are increasingly suggesting that the trade conflict is harming the US economy. As a result, domestic pressure to resolve the conflict will increase.

China's manufacturing losing further momentum, policymakers respond

China's business confidence in manufacturing, as measured by their various PMIs, also weakened in December. Both the national and the Caixin indicators fell below 50, suggesting a contraction of manufacturing. I am not sure how accurate that is, but it seems clear that the Chinese economy is slowing and probably more so than the authorities are willing to tolerate.

China: PMI manufacturing and non-manufacturing

Index, 50=neutral



Source: Bloomberg

So they keep talking about new measures to boost activity. In fact, the Reserve Ratio for banks was lowered again today by 1%-point, an effort to boost bank lending. We will see when the effects will kick in, but, as I have argued before, history suggests that the Chinese policymakers will continue to add measures until they have achieved their goals. Interestingly, the services sector PMIs were stronger in December. But as China is the manufacturing workshop of the world, the services sector PMIs are less relevant for judging the global business cycle.

I do not normally report on individual companies, but must make an exception for Apple. That is not because of what their recent warning on turnover implies for that company, but because of what it says about the economy. Apple blamed the disappointing turnover on their sales in China. That can imply several things. Disappointing Chinese sales by Apple may reflect a slowing of the Chinese economy. Alternatively, it may reflect Apple losing market share either because of uncompetitive pricing or because Chinese consumers are becoming more reluctant to buy American goods as a result of the trade war.

Some exceptions to the rule

While business confidence worldwide has lost further momentum in December, there were several countries where business confidence improved. In Japan, for example, the PMI edged higher: 52.6 against 52.4. This may be a reflection that the economy is overcoming the negative effects of natural calamities a few months earlier. The manufacturing sectors in the UK and the Netherlands also saw stronger business confidence. This may be related to Brexit as importers may be trying to beat the UK's departure from the EU. But business confidence also improved in Hong Kong, Indonesia and Korea, to name a few countries.

Recession can be avoided, messages of the economy and markets are clear

As to the question whether or not key economies are heading for a recession, I am still inclined to think not. The drop in growth momentum and confidence appears to be the result of a variety of factors, most of which can be stopped or reversed. The slowdown in China can be reversed by the policymakers. The uncertainty over the trade conflict and the US government shutdown can be resolved by politicians. And as far as the actual slowdown in the economy is the result of past tightening of US monetary policy, the Federal Reserve can easily pause and even stop its hiking.

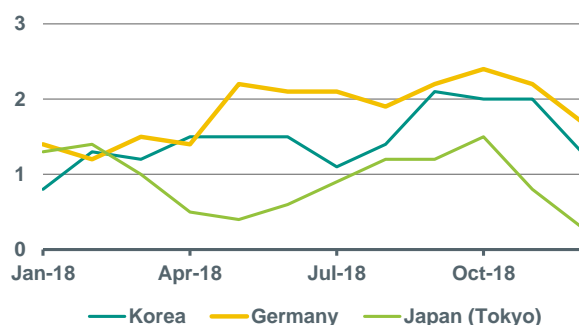
The key messages the markets and economic indicators are sending to policymakers are: end the nonsense of the trade war, end the US government shutdown and stop, or at least take a break from tightening US monetary policy. Now, is that too much to ask?

The collapse of inflation

One development is currently escaping a lot of attention, but it is relevant nevertheless. The fall in oil prices in recent months is putting huge downward pressure on headline inflation. This is clearly a worldwide phenomenon. German headline HICP inflation, for example, fell from 2.2% yoy in November to 1.7% in December. This is important, even if it is not immediately reflected in core inflation. The sharp drop in headline inflation boosts real spending power of households. It also creates room for central banks to take more time to 'normalise' policy. This is evidently particularly relevant to the US where the Fed is trying to establish how long they should continue hiking rates.

Headline inflation

% yoy



Source: Bloomberg

Main economic/financial forecasts

GDP growth (%)	2017	2018e	2019e	2020e	3M interbank rate	27/12/2018	03/01/2019	+3M	2019e	2020e
United States	2.2	3.0	2.7	1.7	United States	2.80	2.79	2.90	2.80	2.70
Eurozone	2.5	1.9	1.4	1.3	Eurozone	-0.31	-0.31	-0.33	-0.33	-0.05
Japan	1.9	0.8	0.9	0.7	Japan	0.07	0.07	-0.10	-0.10	-0.10
United Kingdom	1.8	1.4	1.7	1.9	United Kingdom	0.90	0.91	0.80	1.20	1.45
China	6.9	6.7	6.3	6.0						
World	3.8	3.7	3.5	3.3						
Inflation (%)	2017	2018e	2019e	2020e	10Y interest rate	27/12/2018	03/01/2019	+3M	2019e	2020e
United States	2.1	2.4	1.6	2.0	US Treasury	2.74	2.55	3.1	2.70	2.60
Eurozone	1.5	1.8	1.2	1.5	German Bund	0.23	0.15	0.3	0.50	0.80
Japan	0.5	1.0	1.1	1.6	Euro swap rate	0.83	0.76	1.1	1.25	
United Kingdom	2.7	2.4	1.4	1.8	Japanese gov. bonds	0.02	0.00	0.0	0.30	0.50
China	1.6	2.2	2.5	2.5	UK gilts	1.31	1.20	1.5	1.80	2.10
World	3.0	3.6	3.9	3.3						
Key policy rate	03/01/2019	+3M	2019e	2020e	Currencies	27/12/2018	03/01/2019	+3M	2019e	2020e
Federal Reserve	2.50	2.75	2.75	2.75	EUR/USD	1.14	1.14	1.17	1.25	1.30
European Central Bank	-0.40	-0.40	-0.40	-0.20	USD/JPY	111.0	107.7	111	105	100
Bank of Japan	-0.10	-0.10	-0.10	-0.10	GBP/USD	1.26	1.26	1.36	1.45	1.50
Bank of England	0.75	0.75	1.00	1.25	EUR/GBP	0.90	0.90	0.86	0.86	0.87
People's Bank of China	4.35	4.35	4.35	4.35	USD/CNY	6.87	6.87	6.85	6.70	6.70

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.

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