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Group Economics

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Han de Jong

Chief Economist

Tel: +31 20 628 4201

han.de.jong@nl.abnamro.com

“Worse and worse”

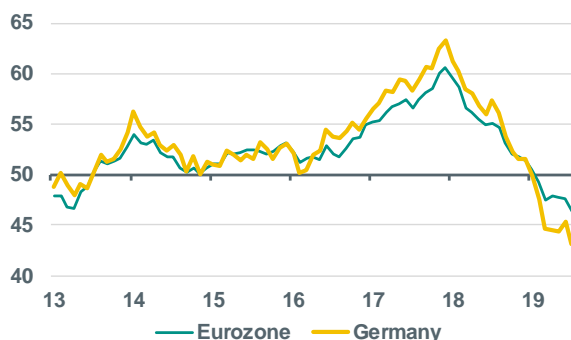
- **Business confidence in manufacturing falls further, almost everywhere**
- **Eurozone heading for stagnation (or worse?)**
- **ECB to provide fresh stimulus in September**

July preliminary business confidence, as measured by PMI data, disappointed across a wide range of countries and by a wide margin. This is bad news. Most negative was the data from the eurozone, particularly Germany. The German manufacturing PMI fell to 43.1, representing a significant drop from an already low 45.0. This is recession territory. The services sector is keeping the economy going, at least to some extent. The German services sector PMI stood at 55.4 in July, down marginally from 55.8. The manufacturing PMI for the eurozone as a whole fell from 47.6 in June to 46.4, driven, of course though not only, by heavy-weight Germany. The same indicator for France also fell back significantly in July, but is at a much higher level: 50.0 in July, down from 51.9 in June.

The authoritative German Ifo index of business confidence across all industries also tumbled in July: 95.7 versus 97.5 in June.

Markit PMI manufacturing

Index, 50=neutral



Source: Thomson Reuters Datastream

Germany: Ifo

Index



Source: Bloomberg

What this data shows is that manufacturing, particularly in Germany is in trouble. This is not new, but the intensifying weakness is a little surprising and, of course, of concern. At least to me, the driving forces of such weakness are not entirely clear. The current situation is the result of a combination of factors. The trade war and the uncertainty it creates worldwide is depressing corporate investment globally. As Germany is one of the most prominent producers and exporters of machinery, this is hitting the eurozone's largest economy hard. In addition, specific sector (automobiles) and company (chemical

sector) related factors are having a negative effect in Germany. There may also be an effect of Brexit. As the UK was originally heading for an EU exit in March this year, UK companies built up inventories late last year and early this year just in case the exit would cause logistic chaos. This may have contributed to economic activity in the rest of the EU earlier this year, but that may now be unwinding and reversing.

In his press conference following the ECB's 25 July policy meeting ECB president Mario Draghi referred to the economic outlook as getting 'worse and worse'. That is clear language. One of the journalists asked if the eurozone might fall into recession. Draghi's answer was no. He mentioned three reasons. First, consumers are in a reasonably good position with employment still growing and wage increases accelerating. Second, momentum in the services sector is much stronger than that in manufacturing. And third, construction is growing on the back of low interest rates and supply shortages in many countries. I agree with the points Draghi made here, but I think the first two (the labour market and the services sector) are more an argument for why the eurozone is unlikely to fall into recession soon, rather than that they are factors that will prevent a recession altogether. The labour market is a lagging indicator and the services sector is unlikely to remain strong if manufacturing continues to weaken. We expect the eurozone economy to show very little growth in the second half this year. A small negative is probably as likely as a small positive. Should we experience two consecutive quarters of contraction, that would technically constitute a recession. It is important to note that such a development might not bother financial markets particularly. They would be more concerned if economic activity contracted sharply and unemployment were to rise sharply. That is not what we expect, however.

ECB stimulus on its way

As my colleagues Nick Kounis and Aline Schuiling wrote following the ECB's press conference, the ECB has clearly announced it will provide [more stimulus](#) at their meeting in September. The ECB opened the door to further rate cuts by stating that official rates will remain at current levels 'OR LOWER' until at least mid 2020. Draghi was also clear about a new asset purchase programme, the details of which are currently being worked out.

There is widespread discussion about the need for and effectiveness of such action. Draghi said several times during the press conference that the ECB is not at all happy with inflation where it is. The ECB is expecting inflation to amount to 1.6% in the medium term and Draghi made it clear that the ECB considers that too low. The ECB has recently downplayed market-based inflation expectations, but Draghi pointed out that the survey of professional forecasters is also showing a fall in inflation expectations. He also stressed that monetary policy cannot do all by itself and that fiscal policy has a crucial role to play in preventing too much economic weakness. This was a clear invitation to the German government to provide fiscal stimulus. Draghi added an interesting observation. He said that negative side effects of the current aggressive monetary policy will be reduced if fiscal policy made a contribution and that the results would show up sooner.

During the press conference a sceptical (American) journalist asked why another rate cut and more asset purchases would work given that all the previous actions 'haven't done the

trick'. Draghi responded with barely concealed irritation by saying that the previous actions clearly 'have done the trick'.

Dutch consumers more optimistic

Despite the malaise in the eurozone manufacturing sector, some cyclical indicators are stabilising or even improving. Take Dutch consumer confidence. That fell strongly in the last couple of months of 2018 and the first three months this year. But after reaching a low in March, Dutch consumer confidence has improved in four consecutive months. If and when the weakness in manufacturing spreads to other sectors and impacts the labour market, consumer confidence is unlikely to hold up. But for now, this seems to support Mario Draghi's observation that consumers are in good shape which will prevent a serious contraction of the economy at large. As I argued above, I think he is right, at least as far as the next few quarters are concerned.

Netherlands: consumer confidence



Source: Bloomberg

US doing better, same old story

The US economy is clearly enjoying more growth momentum than the eurozone. However, the manufacturing sector there is also weakening. The preliminary manufacturing PMI in the US fell to 50.0 in July, from 50.6 in June. Momentum in services rose as the PMI in that sector came in at 52.2, from 51.5.

US: Markit PMI manufacturing



Source: Thomson Reuters Datastream

Durable goods orders were strong in June, although data for the previous month were revised down. Total durable goods orders were up 2.0% mom in June, after falling 2.3% in May. More relevant for business investment, non-defense, ex aircraft durable goods orders were up 1.9% mom, after rising 0.3% in May. Shipments of durable goods, non-defense and excluding aircraft were up 0.6% mom, after +0.5% in May. The year-on-year rate of change of these shipments continued to fall, however and is now up between 1 and 2% yoy. The latter number shows that corporates are cautious, but the data for the last couple of months suggest that a contraction is unlikely.

There are several reasons why the US economy is holding up so much better than the eurozone. One is that the US economy is still benefitting from the tax cuts implemented last year. The effects, however, will soon fade. More important is that the US economy is considerably less open than the eurozone economy, reducing the US's vulnerability to the weakness in global trade growth.

Asian data mixed bag

Last week's Chinese data had shown an improvement in retail sales and industrial production in June. This may be the result of stimulus measures by the policymakers. It would be a big plus for the global economy if China's deceleration were stopped and reversed. Data from countries in the region show a mixed bag. Japan's manufacturing PMI was up marginally in July: 49.6, versus 49.3 in June. But Korea's data on exports continued to paint a depressing picture. Korean statisticians release data on exports for the first 20 days of the month on the 21st day of the month. In July, exports were down 13.6% yoy, worse than June's 10.0%, but still in the recent range.

Japan: PMI manufacturing

Index, 50=neutral



Source: Thomson Reuters Datastream

Taiwan's data on June export orders provide an interesting insight into what is happening in world trade. Export orders were down 4.5% yoy, a little better than the -5.8% of June. Export orders from mainland China plus Hong Kong were down a staggering 14.6% yoy. This was a little worse than in preceeding months. Export orders from Europe were down 5.3% yoy. The only positive was orders from the US: +6.8%, which was better than in preceeding months. The US is Taiwan's largest export market with China a good second. Orders in the electronics sector, the largest export sector of Taiwan, were 4.3% yoy which was an improvement on previous months. The second largest export sector, information and communication technology, registered a +4.7% yoy in export orders. There is some hope yet...

Main economic/financial forecasts										
GDP growth (%)	2017	2018	2019e	2020e	3M interbank rate	18/07/2019	25/07/2019	+3M	2019e	2020e
United States	2.2	2.9	2.2	1.5	United States	2.28	2.26	2.20	1.90	1.80
Eurozone	2.6	1.9	0.7	0.9	Eurozone	-0.37	-0.38	-0.45	-0.45	-0.52
Japan	1.9	0.8	0.7	0.3	Japan	0.07	0.07	-0.10	-0.10	-0.10
United Kingdom	1.8	1.4	1.2	1.2	United Kingdom	0.77	0.78	0.80	0.80	0.80
China	6.9	6.6	6.2	5.8						
World	3.8	3.5	2.9	3.0						
Inflation (%)	2017	2018	2019e	2020e	10Y interest rate	18/07/2019	25/07/2019	+3M	2019e	2020e
United States	2.1	2.4	1.8	2.0	US Treasury	2.04	2.07	2.0	1.90	2.00
Eurozone	1.5	1.7	1.1	1.0	German Bund	-0.31	-0.36	-0.4	-0.50	-0.30
Japan	0.5	0.9	1.1	1.6	Euro swap rate	0.13	0.05	0.3	0.20	0.35
United Kingdom	2.7	2.5	1.4	1.8	Japanese gov. bonds	-0.14	-0.15	-0.1	-0.10	0.00
China	1.6	2.1	2.5	2.5	UK gilts	0.76	0.71	0.8	0.80	1.00
World	3.0	3.4	3.9	3.4						
Key policy rate	25/07/2019	+3M	2019e	2020e	Currencies	18/07/2019	25/07/2019	+3M	2019e	2020e
Federal Reserve	2.50	2.25	2.00	1.75	EUR/USD	1.12	1.12	1.12	1.12	1.20
European Central Bank	-0.40	-0.50	-0.50	-0.60	USD/JPY	107.3	108.6	104	100	95
Bank of Japan	-0.10	-0.10	-0.10	-0.10	GBP/USD	1.25	1.25	1.24	1.24	1.40
Bank of England	0.75	0.75	0.75	0.75	EUR/GBP	0.90	0.89	0.90	0.90	0.86
People's Bank of China	4.35	4.10	4.10	3.85	USD/CNY	6.88	6.87	6.90	6.90	6.70

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.

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