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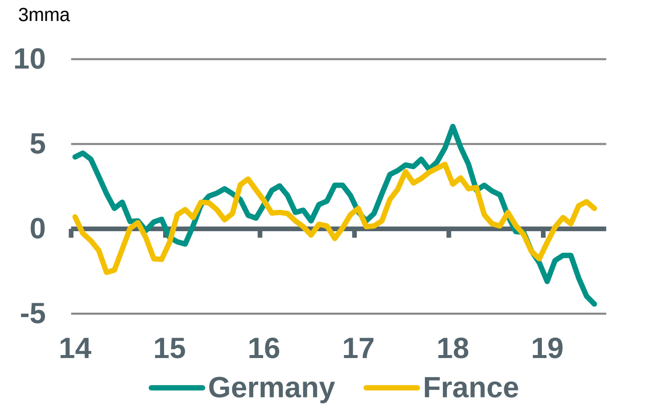
Divergence and boneheads

- **Divergence in European industry**
- **US and China back to serious negotiations?**
- **Higher US core inflation largely due to medical costs**
- **President Trump continues attack of the Fed**
- **ECB eases**

Eurozone industrial production has been contracting on a year-on-year basis for nine consecutive months until July. Output was down 2.0% yoy in July, slightly better than the -2.4% in June. A remarkable divergence is taking place behind these numbers. Germany, an industrial heavyweight, is performing a lot worse than most other countries. German output was down 4.2% yoy in July, but French production, for example, only 0.2%. This divergence probably reflects Germany's greater reliance on global trade and the global corporate investment cycle as well as specific sectoral problems, particularly in the car industry. ECB president Draghi has called on the German government (and the Dutch government, for that matter) to provide fiscal stimulus. The German government's response is that they see no reason to act and will only act in a crisis. It makes you wonder how they define a crisis. True, in 2009 industrial production was down 21.8% yoy at the trough of the cycle, but the July 2019 reading was still the second lowest (after June 2019) since 2009. It looks a little like German football. The defeat of the German national football team at the hands of arch rival Holland (2-4) is apparently also not a crisis. Fine by me.

Industrial production diverging

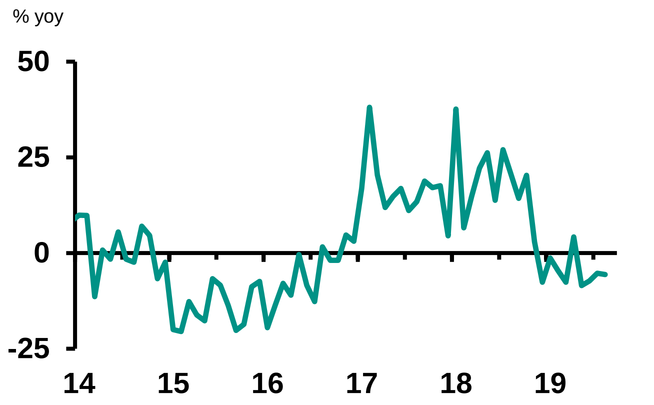


Source: Bloomberg

Chinese trade data shows that imports and exports remain weak. Imports (in USD) were down 5.6% yoy in August, after -5.3% in July. Exports were down 1.0% yoy, against +3.3% in July. The data shows the impact of the trade war. On the import side, imports from the

US were down 22.3% yoy, while imports from the EU were 'only' down 5.2%. Interestingly, imports from Australia were up 32.2%, probably reflecting commodity buying by China, benefiting from lower commodity prices. On the export side, Chines exports to the US were down 16%. This hurts as the US used to be China's largest export market. The EU overtook the US in August as China's largest export market. Chinese exports to the EU were up 3.2% yoy.

Chinese import growth



Source: Bloomberg

Chinese policymakers have been providing targeted, moderate stimulus for some time. It is probably having some impact. M1 growth slowed to 0.4% yoy in January this year and has since improved somewhat, probably reflecting the effects of the stimulus. However, the M1 growth rate has been stuck in the 3-4.5% range for some time. August was no different: 3.4%, against 3.7% in July. The Chinese probably need to continue providing stimulus to achieve a material improvement.

Chinese money supply (M1)

Source: Bloomberg

The Manpower survey which provides an indication of companies hiring intentions paints an interesting picture. It shows a softening labour market in China and in other economies in the region. I think it reflects Chinese weakness. Interestingly, countries a little show a more favourable trend.

Companies hiring intentions (%)		
Country	Q4 2019	Q3 2019
China	4	8
Taiwan	20	25
Hong Kong	14	16
Singapore	5	12
Australia	12	11
New Zealand	16	10
Japan	26	25
India	20	13

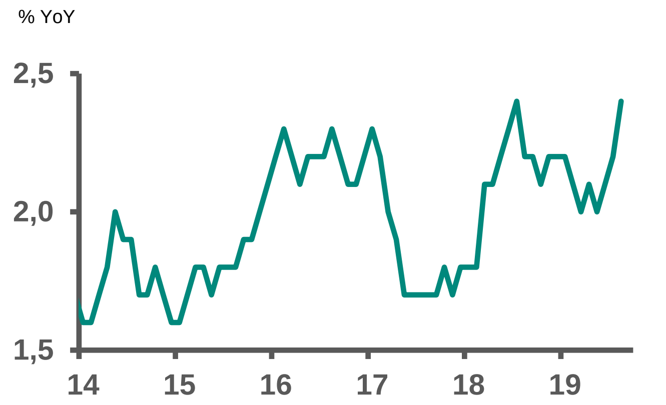
Source: Manpower

Learning from clients

I was in London this week, presenting our views to UK corporate clients. Our views on the global business cycle are more cautious than the consensus and I produced lots of graphs. I got two interesting challenges. One is that my focus was heavily on manufacturing, not services. I knew that, of course. History shows that services ultimately follow manufacturing in the cycle. But this could be changing. Many services used to be linked to manufactured products, but perhaps that is changing. Perhaps a larger part of services is independent of manufactured goods and perhaps that allows for some decupling of manufacturing and services.

Also interesting were remarks from some people in the container-leasing business, operating globally. They said they did not recognise my observation that world trade is contracting. They said their business is strong. I have been wondering how I can reconcile these two. The data on world trade don't lie, I would think. But maybe an improvement is on the cards. Hopefully that is the case, but I must say that I believe that when I see it. Another possibility is that the US-China trade conflict is leading to a material diversion of trade flows. Perhaps Chinese producers are first shipping their goods to other countries and from there to the US. Trade thus become less efficient, requiring more containers. But I cannot be sure of this, far from it actually. In fact, I was positively surprised how many of the corporates I met were optimistic about their own business outlook.

US core CPI

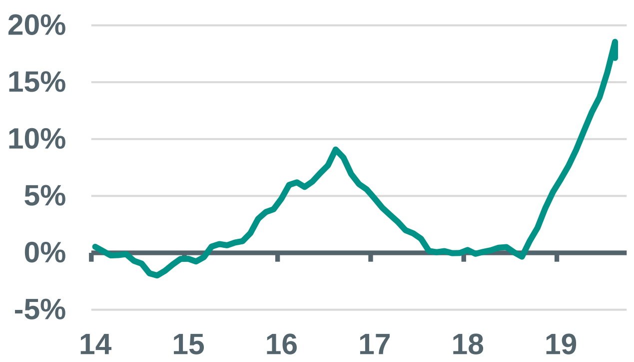


Source: Bloomberg

US core inflation on the rise

US headline inflation, on the CPI measure, eased from 1.8% yoy in July to 1.7% in August. This was largely thanks to the easing of energy prices. The core-CPI measure amounted to 2.4% yoy, up from 2.2% in July, the third consecutive month of accelerating inflation. The Fed's preferred inflation measure is core PCE inflation, which only stood at 1.6% yoy in July. The acceleration of core-CPI inflation was largely caused by a faster increase in medical care costs: 4.3% yoy. Medical care has an 8.9% weight in the core basket, so it is responsible for some 0.3%-points of the yoy change of the core CPI. Health insurance has a weight of only 1.5% in the core basket. But health insurance is becoming more expensive very rapidly. In August, it was up a staggering 18.6% yoy, also responsible for 0.3%-points of the 2.4% yoy rise of the core CPI.

US prices for medical insurance



Source: Bloomberg

Boneheads and getting back to the negotiating table on trade

It is not likely that the Fed will reconsider its easing strategy because of this. The rise in core CPI would not really appear to be part of a broad-based acceleration of inflation. President Trump has called the Fed 'boneheads' for not easing faster and he has effectively praised the ECB for their most recent measures. This is not at all helpful, but president Trump realises that he needs to prevent too much of an economic slowdown next year if he wants to be re-elected. Perhaps that is also a reason to restart serious talks with the Chinese about trade issues.

The most recent indications suggest that the Chinese and the US are getting back to the negotiating table and they are making all sorts of constructive noises. That would be very positive for the world economy. While I am an optimist by nature, I must say that I believe it when I see it as regards an actual deal. We have seen constructive moves before, only to be disappointed later. Perhaps the difference now is that the US presidential election are approaching. They are still over a year away, but the economic effect of a trade deal or no trade deal will occur gradually. To have the economy in top-fit condition, a trade deal should be done within the next couple of months.

ECB eases

The ECB cut its deposit rate as expected by 10 bps to -50 bps. The ECB also announced a so-called tiering system of interest rates aimed at relieving the pain for banks of these negative rates. My colleagues Tom Kinmonth and Nick Kounis wrote a note about this some weeks ago. They said that it would be difficult for the ECB to reach their goals with tiering and stressed that the ECB might therefore not take that path. While it thus looks like our assessment was incorrect, I think that would be the wrong conclusion. The tiering does little to alleviate the problems for the banks in Germany, France and the Netherlands, the countries of the banks with the largest deposits at the ECB. That was probably the reason why the ECB also announced more generous terms for coming TLTROs. My colleagues have written a commentary about the ECB's actions, so I do not need to repeat that. Our conclusion is that this package is not exactly a game changer. One can wonder whether the economic circumstances justify restarting QE, but that is another matter. The ECB also announced a lowering of their growth and inflation forecasts, not the first one. Our forecasts are still below the new ECB ones.

Main economic/financial forecasts

GDP growth (%)	2017	2018	2019e	2020e	3M interbank rate	5-9-2019	12-9-2019	+3M	2019e	2020e
United States	2,4	2,9	2,2	1,3	United States	2,10	2,13	1,43	1,43	1,55
Eurozone	2,7	1,9	0,8	0,6	Eurozone	-0,44	-0,43	-0,55	-0,55	-0,55
Japan	1,9	0,8	1,0	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	3,6	2,9	2,9						
Inflation (%)	**2017**	**2018**	**2019e**	**2020e**	**10Y interest rate**	**5-9-2019**	**12-9-2019**	**+3M**	**2019e**	**2020e**
United States	2,1	2,4	1,8	2,0	US Treasury	1,57	1,79	1,5	1,50	1,50
Eurozone	1,5	1,7	1,1	0,9	German Bund	-0,59	-0,54	-0,8	-0,80	-0,80
Japan	0,5	0,9	1,1	1,6	Euro swap rate	-0,16	-0,07	0,2	0,20	0,35
United Kingdom	2,7	2,5	1,9	1,8	Japanese gov. bonds	-0,27	-0,21	-0,1	-0,10	0,00
China	1,6	2,1	2,5	2,5	UK gilts	0,60	0,67	0,3	0,30	0,30
World	3,0	3,4	3,7	3,3						
Key policy rate	**12-9-2019**	**+3M**	**2019e**	**2020e**	**Currencies**	**5-9-2019**	**12-9-2019**	**+3M**	**2019e**	**2020e**
Federal Reserve	2,25	1,50	1,50	1,50	EUR/USD	1,10	1,10	1,12	1,12	1,15
European Central Bank	-0,50	-0,60	-0,60	-0,60	USD/JPY	106,9	108,1	104	104	100
Bank of Japan	-0,10	-0,10	-0,10	-0,10	GBP/USD	1,23	1,23	1,24	1,24	1,30
Bank of England	0,75	0,75	0,75	0,75	EUR/GBP	0,90	0,89	0,90	0,90	0,88
People's Bank of China	4,35	4,10	4,10	3,85	USD/CNY	7,16	7,08	7,20	7,20	7,50

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.