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At a crossroads

- **Manufacturing remains in the doldrums**
- **Disappointing Chinese April data after strong March**
- **Also a range of positives to note**
- **But trade conflict poses risk**

Rarely have I experienced a divergence in views on the outlook for the global business cycle as we are seeing right now. Talking to colleagues and clients and reading commentary I think it is fair to say that some believe global growth will strengthen in the course of this year, some believe it will remain near current levels and some argue that recessions can't be far off.

The funny thing is, we are all looking at the same data. So clearly, the existing data does not provide an unambiguous answer to the question where the global business cycle is heading next. That really isn't all that surprising as the data covers the past and will only tell you where we have been, at most where we are, not where we are going. People who extrapolate the data are simply forecasting the past into the future. That will often be correct, but wrong near turning points.

You need a 'story'

To paint a picture of the future, you need a 'story'. And obviously, everyone can have their own story. I like to think about the economic future as the result of the balance of headwinds and tailwinds. I have written before about the major headwinds of 2018: policies aimed at deleveraging the Chinese economy; Fed tightening, dollar strength and the tightening globally of financial conditions; the emergence and escalation of the trade conflict; the problems in the European car industry related to 'dieselgate' and the introduction of new emission testing procedures; etc.

There can be no doubt that global growth slowed last year. While I did not anticipate the magnitude of the slowdown, at least I have a 'story' (with hindsight) that is consistent with the slowdown and explains what happened.

Looking at 2019, I thought that most of these headwinds would disappear and even turn into tailwinds, creating a much more positive environment for growth. And so far, I think I have been right. The Chinese policymakers changed tactics in the course of last year. Instead of giving top priority to deleveraging, they put more emphasis on supporting growth. I think the data in the first few months of this year shows that their efforts are working. The Fed has also changed course. European car manufacturers have been surprisingly slow at overcoming their challenges. But

don't forget that car production in Germany, the UK and Italy contracted almost 10% last year (French car production, surprisingly, grew marginally). Anything better than a drop of 10% this year means an improvement. How challenging is that? Not very.

The trade conflict poses unexpected risks

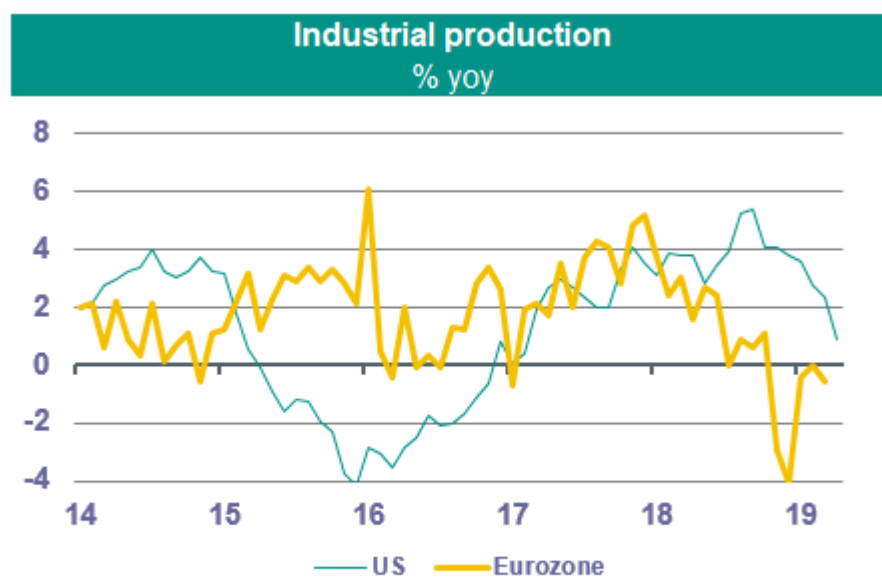
Unfortunately, the US-Sino trade conflict has re-emerged as an important factor. It is hard, if not impossible to quantify the depressing effect the trade conflict had on global activity last year. I suspect the effects were material. And the re-escalation of the conflict has the potential to do a lot more damage this year. This week's Economist makes the point that Chinese leaders have been remarkably disciplined in the conflict. Many people think China has a vulnerable position in the conflict as it has a large bilateral trade surplus with the US. But don't forget, many US companies have large operations in China. China could make their lives very unpleasant. That could have a significant impact on the US and global economies. Perhaps that is the biggest risk to the global economy: that the Chinese lose their cool and are willing to hurt the US seriously even if it implies they will also inflict serious pain on themselves.

On balance, I continue to think that most of the headwinds of 2018 are disappearing, though with one notable exception so far. Weighing these things up, I find it hard to understand why things would get worse for the global business cycle. Some people are watching the US yield curve, concluding that recession risks are rising. I have respect for the yield curve as an early indicator of trouble. However, there is more to look at. Recessions in the US are not only preceded by an inversion of the yield curve, but also by a decline in corporate profits (in the national accounts). That is not happening. The US economy typically falls into recession when consumer spending slumps or when asset prices fall heavily. There is little reason to expect that any time soon. US households have very healthy balance sheets at the moment, with reduced debt levels, historically low debt service burdens and a relatively high savings rate. Their confidence is strong, not surprising.

The story of the bond and the equity market

I was in a discussion yesterday where someone argued that the bond market is forecasting a recession and that the bond market gets these things right. I agree that when the bond market and the Fed disagree, the bond market tends to be right and the Fed tends to be wrong, though not always. While the bond market may signal an approaching recession, the equity market certainly is not. Far from it. A rule of the thumb is that bond investors are better than equity investors in spotting an approaching recession but that equity investors are better at spotting a nascent recovery. So who do you want to put your money on now, bond vigilantes or equity types? With inflation remarkably and persistently low, I would be careful trying to 'read' what the bond market is actually saying.

My 'story' hasn't changed much apart from the fact that the trade conflict has become a negative again. Even so, I think the headwinds are abating on balance and this should create a better environment for global growth.



Source: Bloomberg

The next thing is to see if the data confirms or rejects my 'story'. If the data is consistently disagreeing with my 'story', I must consider changing my 'story'. That is never going to be 100% clear cut. And when it is 100% clear cut, it is fully priced into markets.

Manufacturing still in the doldrums

The manufacturing sector has been very weak in recent quarters and that isn't changing yet. The gap between manufacturing and services is wide. Recent US data shows that industrial production and manufacturing production both fell 0.5% mom in April. Manufacturing output is now down yoy, albeit marginally. Eurozone industrial production isn't doing an awful lot better. It fell 0.3% mom in March and is 0.6% down yoy. The weakness of manufacturing is entirely consistent with the troubled state of world trade growth and it could also be related to the inventory



cycle. The latter would be temporary, of course. For my 'story' to turn out correct, I need these numbers to improve during the next couple of months.

First signs of US business confidence in May are better

Business confidence data released in the US recently paints a more upbeat picture. Confidence among SMEs, as measured by the survey carried out by the National Federation of Independent Business, rose in May to 103.5, up from 101.8. This index had fallen in a straight line from August last year to January, but has now risen in four consecutive months. The Empire State index measuring business confidence in the New York state area improved from 10.1 in April to 17.8 in May. The similar measure for the district of the Fed in Philadelphia, the Philly Fed index, jumped from 8.5 in April to 16.6 in May. Neither are at historically remarkable levels, but the improvement in both is consistent (and I would humbly add: supportive of my 'story').

There wasn't a lot of economic data news in the eurozone in recent days. Apart from the industrial production numbers, the ZEW index for May was released. This measures confidence among analysts. The index for the eurozone fell from 4.5 to -1.6, having risen in the four previous months. It is likely, I think, that the result of the survey was strongly affected by the unexpected re-escalation of the US-Sino trade conflict. The same index for Germany also fell (from 3.1 to -2.1), but interestingly, the ZEW index for Germany expressing not 'expectations' but the 'current conditions' actually improved, rising from 5.5 to 8.2, the first improvement after months of decline.

German GDP expanded by 0.4% qoq in Q1. That was in line with expectations, though these expectations had been affected by better than expected GDP numbers elsewhere. It is interesting to note that in the US, China and the eurozone GDP growth in Q1 exceeded original expectations and were higher than in the previous quarter. In all cases one can point to incidental factors flattering the numbers, but it is better to have positive surprises than negative surprises, regardless of what causes them.



China's April economic data disappointed. Industrial production growth amounted to 5.4% yoy, the lowest for many years. It triggered quite a bit of negative commentary. We have to bear in mind, though, that the March number was 8.5%, which was the highest for almost five years. If you take an average for these two months, the growth rate is still considerably above what we have seen in recent years. Something similar, but perhaps a little less pronounced is true for retail sales growth which slowed from 8.7% yoy in March to 7.2%.



I have taken some time in recent days to dig a little deeper into the Chinese PMI reports. What I found interesting is the assessment of export orders and of imports.

Both series show a significant deterioration in the course of 2018, consistent with what seems to have happened to the global economy and in particular world trade. But these Chinese PMI details also show both series recovering. I interpret that supportive of a cautiously optimistic view, certainly in the sense that the worst of the global slowdown is behind us.

No reason to change my 'story'

All in all, I see little reason to change my 'story' that the global economy is likely to continue to grow this year and that the growth rate is likely to gain some momentum. Mind you, I am not saying we will experience spectacular growth. The trade conflict is a risk, but the balance of headwinds and tailwinds is shifting favourably despite the unfortunate turn of events in the trade conflict so far.

GDP growth (%)	2017	2018	2019e	2020e	3M interbank rate	09/05/2019	16/05/2019	+3M	2019e	2020e
United States	2.2	2.9	2.3	1.9	United States	2.54	2.53	2.60	2.60	2.50
Eurozone	2.5	1.8	0.8	1.3	Eurozone	-0.31	-0.31	-0.30	-0.30	-0.20
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	0.8	1.7	United Kingdom	0.81	0.81	1.00	1.00	1.25
China	6.9	6.6	6.3	6.0						
World	3.7	3.6	3.3	3.4						
Inflation (%)	2017	2018	2019e	2020e	10Y interest rate	09/05/2019	16/05/2019	+3M	2019e	2020e
United States	2.1	2.4	1.6	2.0	US Treasury	2.46	2.41	2.6	2.60	2.50
Eurozone	1.5	1.7	1.2	1.2	German Bund	-0.05	-0.09	0.1	0.20	0.50
Japan	0.5	0.9	1.1	1.6	Euro swap rate	0.48	0.45	0.7	0.80	1.10
United Kingdom	2.7	2.5	1.4	1.8	Japanese gov. bonds	-0.05	-0.06	0.1	0.10	0.30
China	1.6	2.1	2.5	2.5	UK gilts	1.12	1.08	1.7	1.50	1.80
World	3.0	3.5	3.7	3.2						
Key policy rate	16/05/2019	+3M	2019e	2020e	Currencies	09/05/2019	16/05/2019	+3M	2019e	2020e
Federal Reserve	2.50	2.50	2.50	2.50	EUR/USD	1.12	1.12	1.13	1.16	1.25
European Central Bank	-0.40	-0.40	-0.40	-0.30	USD/JPY	109.8	109.9	110	108	105
Bank of Japan	-0.10	-0.10	-0.10	-0.10	GBP/USD	1.30	1.28	1.33	1.35	1.45
Bank of England	0.75	0.75	0.75	1.00	EUR/GBP	0.86	0.87	0.85	0.86	0.86
People's Bank of China	4.35	4.35	4.35	4.35	USD/CNY	6.83	6.88	6.60	6.60	6.60

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