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What do shocking numbers tell us?

- Germany's Ifo plunges...
- While French business confidence improves
- Unexpected re-emergence of the trade conflict most unwelcome
- May to step down

I remember the second half of 2008. I had then followed economic data for 25 years and what was happening then wasn't anything I had ever seen before. Business confidence indicators dropped more sharply than I had seen ever before. I remember being in meetings with senior management in the bank, telling them a storm was coming and that they should brace themselves. They looked at me without much expression. And I still don't know what they thought of it. At that time, there was more going on in our organisation than a sharply deteriorating economy...the bank was being taken over and in the process of being carved up...

Germany IFO Business Confidence



Source: Bloomberg

The big shocker: Ifo 'current conditions'

I now have ten more years under my belt watching economic data and again I am shocked by some of the data. The German Ifo index of business confidence is one of the most established and respected indicators telling us how the German economy, more precise the German business cycle, and by extension the eurozone business cycle is doing. The recently released May readings were grim. The overall index fell from 99.2 in April to 97.9, well below expectations. The performance of the two main underlying series is of particular interest. The 'current conditions' component plunged from 103.3 in April to 100.6 in May. That is a very unusual drop and it was totally unexpected. It was, thus, a big shock.

The last time such large monthly drops occurred was in 2008. It must be said, there were several months back then that the index fell considerably more than in May of 2019, but still.

The issue this raises is if we should brace ourselves again for an almighty storm. I must admit that I am perhaps biased in this discussion. My view has been that the worst of the growth slowdown is behind us and that the business cycle in Germany and the eurozone as a whole will improve, although not immediately and perhaps not vigorously. The Ifo 'current conditions' suggests I might be too optimistic. The first intuitive reaction of an economist whose view is seriously challenged by the data is arguing that there is something wrong with the data, it is the classic 'in denial phase'. I am aware of this risk. There is nothing wrong with admitting you got it wrong and changing your view. But it is wise not to wait too long, as, otherwise, you will be seen as a laggard. The value of economists' views is debatable at the best of times, but a lagging economist is certainly useless. So if I want to stick to my cautiously optimistic view, I really need a good story and as much data to back it up as I can. Here is my verdict having reviewed the evidence: I am not going to throw in the towel at this point. Therefore, I must argue and explain that this May Ifo 'current conditions' reading is an anomaly. So here goes.

A sudden and sharp deterioration in business conditions in Germany in May does not make much sense to me. I can't see what should have caused that. And looking at other data, I also think this shocking Ifo number looks odd and must be an anomaly. There simply isn't a compelling narrative to suggest the poor April reading heralds an approaching storm.

Economists generally focus more on the 'expectations component' of the Ifo survey as history shows that that component leads the overall index somewhat. In contrast to 'current conditions' expectations improved marginally in May (95.3 versus 95.2 in April). Back in 2008, 'expectations' led 'current conditions'. So the combination of the recently released data is odd. In addition, the rival Markit PMI data showed only a marginal drop in German manufacturing. And for the economy as a whole, the preliminary May number was actually up marginally. The same is true for the eurozone PMI data. French PMI data actually improved across the board and the various confidence indices for France, as they are composed by the French statistics bureau INSEE and the Banque de France, all showed an improvement. The picture such data shows is a bottoming out of the business cycle. Interestingly, eurozone consumer confidence also improved in May to reach the best level since October last year. This pattern is seen in many more indices and also make the Ifo 'current conditions' index for April look odd.

Eurozone consumer confidence



Source: Bloomberg

This begs the question if there is something particularly problematic in Germany? There are a couple of possibilities. First, the trade conflict between the US and China has come back with a vengeance. Between the start of the year and early May, it looked like a deal was coming. Suddenly and unexpectedly, negotiations broke down and the language on both sides has become outright hostile. Given Germany's reliance on the exports of capital goods and cars, a further slowing of the global economy and a contraction of world trade would be more painful to Germany than many other countries. It is possible that German companies filling in the survey let themselves be influenced by emotion.

Another possibility is that there is a problem in manufacturing, which hits Germany harder than other countries as the manufacturing sector is relatively large in Germany. An obvious candidate is the car industry, which is bigger in Germany than elsewhere in Europe.

On balance, I think that the verdict must be that the poor Ifo current conditions number for May should be taken with a pinch of salt. I don't see a convincing narrative and the data is inconsistent with a lot of other data. The biggest risk is a further escalation of the trade conflict.

Manufacturing much weaker than services

In general, there clearly is a global issue in manufacturing. The graph of eurozone PMIs for manufacturing and services shows that the gap between the two is unusually big. This is related to the contraction of world trade. Germany has another specific problem which is the car industry. A big sector in Germany, the car industry is struggling world wide as the largest car market in the world, China, is shrinking and problems related to 'dieselgate' provide an additional challenge.

PMI Eurozone



Source: Thomson Reuters Datastream

The industrial sector develops in cycles with more amplitude than services. One of the reason is that industrial companies run inventories while services companies don't or at least much less so. Any discrepancy between sales and production in manufacturing leads to changes in inventories. In the second and particularly the third quarter last year, German companies built up significant inventories. Most likely that was largely involuntarily as car sales dropped. The recently released German GDP data for Q1 shows that the economy grew 0.4% qoq (as was earlier published). Interestingly, inventories made a negative contribution of 0.6%-points to that. That was the same as in the fourth quarter last year. German companies have thus been running down inventories aggressively for half a year now. By definition, they can only do that if they bring production levels to below sales. That depresses overall activity data, but the good news (well, it is actually not news at all, though it is good) is that it is a temporary phenomenon, by definition. It lasts until either demand picks up or inventory levels have become 'normal' again. My thesis is that pronounced weakness in German (and other countries') manufacturing recently is partly an overshoot as inventories are brought back to normal levels. I think the data is consistent with that view.

Japan: industrial production

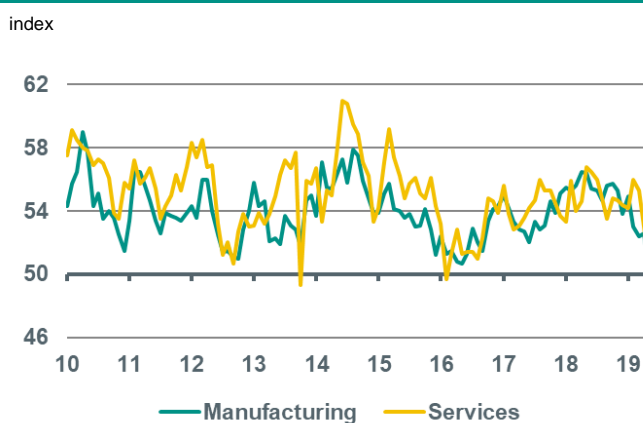


Source: Bloomberg

Japan manufacturing not great either

Recent Japanese data shows that the manufacturing sector there is not in great shakes either. The final data for March showed a modest upward revision compared to the preliminary data, but output was still down 0.6% mom and 4.3% yoy. Japan's Q1 GDP on the other hand, exceeded expectations growing 0.5% qoq, or 2.1% annualised. As my colleague Bill Diviney explained in a daily comment at that time, the composition of growth was unimpressive and suggests that the numbers for the second quarter will be weaker. In fact, what he argued was that the Q1 data provided a unjustified flattering picture of the underlying economy. As I mentioned above, the composition of German Q1 GDP was also released recently. That wasn't too bad. GDP expanded by 0.4% qoq, in line with trend. Domestic demand and net exports contributed positively while inventories were, as mentioned above, a drag. It must be said that the data probably benefited from the mild weather and one should expect a somewhat lower overall growth number in Q2.

US Business confidence (PMI) mfg



Source: Bloomberg

US business confidence also under pressure, but what about the trade conflict

Preliminary PMIs reflecting business confidence were also released for the US. They showed continued softening with all series moving towards the 50 level. The question here is also to what extent the survey was affected by the unexpected reappearance and tone of the US China trade conflict.

It is impossible to say with any certainty what will happen in the trade conflict. The rhetoric has become very hostile. We still think that could be a normal pattern in tough negotiations. And we still think both sides have an incentive to do a deal before too long. President Trump wants to be re-elected next year. He needs a deal to show that he is a 'deal maker' as he claims. In addition, a complete breakdown of talks and stepping up of protectionists measures will harm the economy and the stock market. That will not be favourable to Trump's re-election chances. A surge in protectionist measures will not be in the interest of the leaders in Beijing either as a further slowdown of the economy may cause them

economic, social and political problems. So our main scenario remains that a deal will, eventually, be done.

There is a lot of uncertainty, however. It can be argued that the trade conflict is just a small element in the quest for global political, economic and technological leadership. In such a battle, doing a trade deal is not that important. Political leaders who consider themselves involved in such a battle for global leadership will, most likely, be willing to accept inflicting pain on their own people as long as they think they are inflicting more pain on the other party.

May will resign

UK PM Theresa May has announced that she will step down on 7 June. This was probably inevitable. I don't often write about Brexit as I have no clue where it is going. Much will depend on who will be the next Tory leader and PM. I hear people say that the UK will be heading for a hard Brexit if Boris Johnson lands the job. That may be true. On the other hand, it may also work out very differently. As a key leader of Brexiteers he may be one of the few people able to convince Brexiteers they cannot have Brexit on the terms they want and that a complete rethink is required. Who knows? I, for one, don't have a clue. Sorry.

Main economic/financial forecasts										
GDP growth (%)	2017	2018	2019e	2020e	3M interbank rate	16/05/2019	23/05/2019	+3M	2019e	2020e
United States	2.2	2.9	2.3	1.9	United States	2.52	2.52	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	0.80	0.80	1.00	1.00	1.25
China	6.9	6.6	6.3	6.0						
World	3.7	3.6	3.2	3.3						
Inflation (%)	2017	2018	2019e	2020e	10Y interest rate	16/05/2019	23/05/2019	+3M	2019e	2020e
United States	2.1	2.4	1.6	2.0	US Treasury	2.41	2.30	2.6	2.60	2.50
Eurozone	1.5	1.7	1.2	1.2	German Bund	-0.09	-0.12	0.1	0.20	0.50
Japan	0.5	0.9	1.1	1.6	Euro swap rate	0.45	0.40	0.7	0.80	1.10
United Kingdom	2.7	2.5	1.4	1.8	Japanese gov. bonds	-0.06	-0.06	0.1	0.10	0.30
China	1.6	2.1	2.5	2.5	UK gilts	1.08	0.95	1.7	1.50	1.80
World	3.0	3.5	3.7	3.2						
Key policy rate	23/05/2019	+3M	2019e	2020e	Currencies	16/05/2019	23/05/2019	+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	109.9	109.6	110	108	105
Bank of Japan	-0.10	-0.10	-0.10	-0.10	GBP/USD	1.28	1.27	1.33	1.35	1.45
Bank of England	0.75	0.75	0.75	1.00	EUR/GBP	0.87	0.88	0.85	0.86	0.86
People's Bank of China	4.35	4.35	4.35	4.35	USD/CNY	6.88	6.91	6.60	6.60	6.60

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.

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