March 26, 2018

Weekly Macro & Markets View

Highlights and View

- **The US unveils plan to raise tariffs on China imports in response to China's intellectual property practises**

  Risks around global trade have increased, but many regions show restraint and our view is that a global trade war remains unlikely.

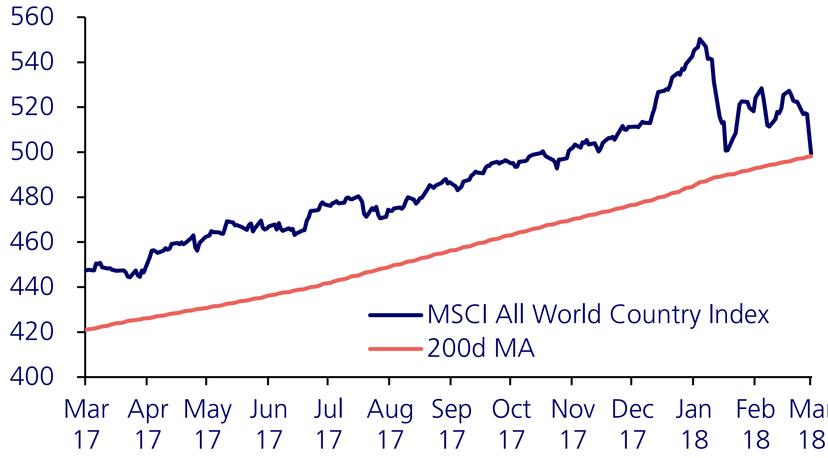
- **The Fed hikes rates, but keeps its path for 2018 unchanged**

  The FOMC expects inflation to overshoot its target in 2019 and 2020 despite ramping up the rate path, underlining its earlier statements that the inflation target is symmetric.

- **Eurozone business confidence falls further in March, but is still consistent with strong growth**

  Despite further falls in Eurozone business confidence, the economy is still set to grow at a well-above trend pace.

Fears of a trade war rattle markets



Source: Bloomberg

Last week President Trump unveiled a plan to raise tariffs to 25% on at least USD 50bn worth of China imports, as an outcome of the Section 301 investigation on China's intellectual property practises. Other measures include filing a case with the WTO on Chinese technology licensing practises and restrictions on investment in high tech sectors. The announcement triggered fears of an escalating trade war and contributed to a sharp sell-off in global equities, with the S&P 500 suffering its worst weekly decline in more than two years.

Although risks around global trade have certainly increased, an outright trade war remains unlikely. China's response has been contained, announcing modest tariffs on US goods in response to the recently introduced steel and aluminium tariffs, while also expressing hopes for constructive trade talks. The US also softened its stance on these tariffs, granting further exemptions, including to the EU (temporarily) and South Korea, and gained some support from the EU and Japan, which stated they will act to address non-market oriented practises that hinder trade and work jointly with the US on disputes in the WTO. This could be a positive development if it helps to bring contentious trade issues to the negotiation table. Finally, as we highlighted last week (Weekly Macro & Markets View, March 19), many countries have accelerated trade negotiations over the past year. We anticipate this will continue.

US: The Fed raises rates and its inflation forecast

As was widely expected, the Fed raised the federal funds target range by 0.25% to 1.5% - 1.75%. The FOMC keeps signalling two more hikes in 2018, but lifted the projected rate path for both 2019 and 2020. The Fed now expects GDP growth to accelerate to 2.7% this year before slowing down to 2.4% in 2019. Interestingly, while inflation is expected to remain below target in 2018 it is now forecast to reach 2.1% in both 2019 and 2020. The Fed thus signals that it is willing to let inflation overshoot for some time, underlining its earlier message that it considers the inflation target to be symmetric. Meanwhile, economic data confirmed the solid state of the US economy, with the Markit Manufacturing PMI ticking up to 55.7 in March from 55.3, while the service PMI receded to 54.1 from 55.9. New orders and payroll numbers signal a continuation of the positive trend. Finally, capital goods orders rebounded by 1.8% in February, recovering from two negative months.

Eurozone: Business confidence declines, but is still consistent with well-above trend growth

For a second month, Eurozone business confidence fell sharply. The Eurozone composite PMI fell almost 2 points to 55.3 in March from 57.1 in February, with confidence in both the services and manufacturing sectors lower. The German Ifo Business climate index also fell in March, led by the expectations component. Business confidence was affected by a number of things including recent market volatility, concerns around protectionism and the stronger euro. Bad weather and strikes in France may have also played a part. Companies are reporting increasingly stretched supply chains as well. However, it is important not to over interpret the recent falls in business confidence, as the declines are coming from exceptionally high levels. For example, the current conditions component of the German Ifo Survey was still at its third highest level on record in March. Overall, the monthly average for the Eurozone composite PMI in Q1 is consistent with growth of 0.6% to 0.7% QoQ, which would still represent a well-above trend pace of growth.

UK: The BoE gets ready for a rate hike

Headline CPI inflation continues to weaken with the annual rate falling to 2.7% in February from 3.0%. Core CPI softened to 2.4% from 2.7%. PPI dropped to 3.4%, the lowest since June 2016, indicating that price pressures are further receding, mitigating the headwinds for consumers. At the same time, wage growth accelerated to 2.8% YoY in January from an upwards revised 2.7%. Retail sales may already be starting to reflect the rise in real income with a monthly pickup of 0.6% in February from a 0.2% fall the month before. The Bank of England kept rates on hold although two members of the Monetary Policy Committee voted in favour of a rate hike. The acknowledgement of the stronger labour market and the fact that the MPC did not try to soften market expectations make a rate hike in May increasingly likely. Finally, the EU and the UK have agreed on a 21-month transition period beginning on Brexit day in March next year. However, the agreement is conditional on signing the final withdrawal bill.

Japan: Hang in there

Most of the economic indicators published last week pointed to a slowdown in growth. The Manufacturing PMI fell for the second month in a row, while the output component marked a seven-month low. However, both remain above the boom/bust level of 50. The Manufacturing component of the Reuters Tankan, though strong, showed signs of peaking, while the Non-manufacturing diffusion index improved, mainly driven by the retail component, which again benefitted from inbound tourism. A somewhat bigger concern is another drop in export volume in February, predominantly driven by a steep drop in general machinery and chemical products exports to China. We believe that statistical distortions due to the Lunar New Year are still playing a major role and are not too concerned about the fact that Japan's trade balance marked a deficit on a seasonal adjusted basis. It is worth watching industrial production statistics for February, which will be published on Friday. While we believe that the forecasted 9% MoM rise looks overly optimistic, a rebound is still expected. Though growth may be slowing, it remains solid.

China: Premier Li elaborates on reforms as the NPC concludes

China's National People's Congress (NPC) concluded with Premier Li and four new Vice Premiers holding a press conference. Referring to the trade dispute with the US, Li's stance sounded conciliatory, encouraging US companies to make use of China's latest moves to improve access to the domestic market, while promising to protect intellectual property rights. We suspect that the US wants to see deeds, not words, in that respect. Service sector liberalisation will be brought forward, with further access promised particularly in the financial sector, healthcare and education, while the manufacturing industries will be fully liberalised. Medical and pension reform will be brought forward, which should in the medium term encourage a shift from domestic savings to consumption. On fiscal policy, Li reiterated China's 'proactive' fiscal stance, even though he projected a further reduction of the budget deficit, which suggests a solid economic growth assumption. Financial regulation is targeting loopholes to contain financial risks, while the overall approach is rather careful so as to avoid a sudden increase in defaults.

What to Watch

- The PMIs are expected to show that global growth is slowing, though it still remains at a good level.
- There are no Easter holidays in Asia, with much economic data scheduled to be published next Friday, Saturday and Sunday, such as China's Manufacturing PMI for March as well as South Korea's statistics on industrial production and exports. Major economic indicators for Japan will be published towards the end of this week, while many of the March PMIs for the region will be released on Easter Monday.
- Eurozone data on lending activity and the European commission business and consumer confidence surveys will be important to watch given the recent weakness in Eurozone data.

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Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

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