September 24, 2018

Weekly Macro & Markets View

Highlights and View

- **The US initiates another round of tariffs and China retaliates swiftly, though by less than expected**

  A near-term solution to the US-China trade dispute remains unlikely and we expect trade to remain a driver of volatility in financial markets.

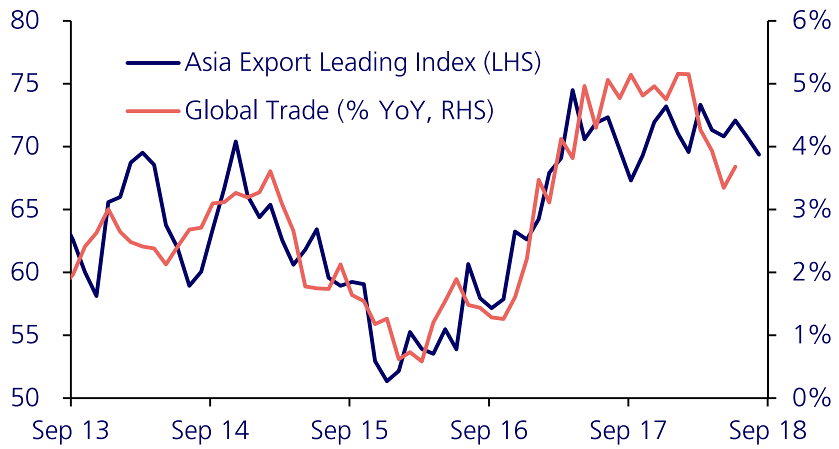
- **The EU rejects Theresa May's proposal regarding the future EU-UK relationship**

  The rejection is a setback but an agreement on the future relationship is not crucial at this point. The real obstacle remains the question of how to avoid a hard border between Northern Ireland and the Irish Republic.

- **Flash Manufacturing PMIs for the G3 economies stabilise, led by the US and Japan**

  Data point to continued healthy global growth, despite tighter monetary conditions and emerging market volatility.

Solid exports in Asia defy escalating US-China trade tensions



Source: Nomura, CPB, Bloomberg

The latest round of US duties has now taken effect, with an additional 10% tariff on USD 200bn worth of imports from China, set to increase to 25% on January 1, 2019. China has announced that it will retaliate with tariffs ranging between 5-10% on USD 60bn of US imports. This was lower than the 5-25% rate previously mentioned, likely contributing to a relief rally in financial markets. Risks around global trade have not diminished though, and we expect trade tensions to drive volatility over the coming weeks.

Attention is shifting to whether the US will eventually impose tariffs on all imports from China. A swift solution to the underlying issue, which centres on intellectual property rights and the 'Made in China 2025' plan, is unlikely. With a booming US economy, the bilateral trade deficit will also not diminish near term. A further extension of tariffs to the remaining USD 267bn of imports from China will, however, increasingly affect US consumers. It will therefore carry a higher political cost, potentially tempering further measures.

While risks around global trade remain high, the latest Asian export data were strong, boosted by strong new orders and exports to both the US and China. Asian exports tend to lead global trade, which now looks set to expand firmly this year, in line with our view that most regions are still committed to facilitating, rather than restricting, trade.

UK: The EU rejects Theresa May's Chequers plan

Not surprisingly, the EU rejected Theresa May's Chequers proposal regarding the future relationship between the UK and the EU at its summit in Salzburg last week. The proposal sees the UK remaining in a free-trade zone for goods with the EU, but risks undermining the EU's single market and four freedoms according to EU representatives. The outright rejection is a setback for Theresa May, but an agreement on the future relationship is not necessary at this stage as the details could be worked out during the transition period that follows the UK's departure from the EU. In fact, it is quite likely that the political declaration on the future relationship will remain very vague. The real obstacle in moving ahead with the withdrawal agreement is the situation regarding the border between Northern Ireland and the Irish Republic. While a pragmatic solution is possible, time is quickly running out, increasing the risk of a no-deal Brexit, particularly given that the transition period is also linked to agreeing on the divorce terms.

US: Investors are unimpressed by another wave of tariffs

The S&P 500 reached a new record high last week despite the intensifying trade dispute with China. President Trump imposed 10% tariffs on another USD 200bn of imports from China, to be increased to 25% beginning of next year. China responded by imposing tariffs on an additional USD 60bn of US exports to China. Business activity as measured by the Markit PMI softened in September to the lowest since April 2017, driven by weaker services activity. Nevertheless, job creation in the service sector remains strong and average prices charged increased at the sharpest rate in nine years. Manufacturing activity accelerated as expected tariffs encouraged the forward purchasing of materials. While business activity remains reasonably strong, the housing market is showing more signs of weakening, with the number of building permits in August falling to the lowest level since May 2017, mirroring households' reluctance to buy new homes. Home builder sentiment was flat in September, matching the weakest level in a year.

Eurozone: ECB policymakers suggest forward guidance to continue after first rate hike

Inflation fell back slightly in August to 1.0% from 1.1% on the core measure and from 2.1% to 2.0% on the headline measure. The fall appears mainly due to volatility over the summer months in some goods, such as clothing. With wage growth picking up we expect core inflation to move gradually higher, however, it is still likely to be well below the ECB's target in 2019. Indeed, ECB chief economist Peter Praet and ECB executive board member Benoit Coeure, said last week that forward guidance could continue even after the first rate hike, which is expected after the summer of 2019. These were dovish comments, which suggest that the ECB will be very cautious even when it starts raising rates. Elsewhere, the Eurozone flash PMI saw a fall in manufacturing confidence (led by a sharp fall in the new orders and new export orders components), but a pick-up in services confidence. The further drop in manufacturing confidence is a concern, though the overall composite index was little changed and still consistent with above trend growth in the Eurozone.

Switzerland: Dovish tilt from the SNB, despite solid growth

The SNB left policy unchanged last week, as expected. There was some speculation that it would shift policy in a hawkish direction, given solid growth, a rapid rise in headline inflation and a modest rebound in wage growth. Instead, the SNB swayed in the opposite direction, reiterating that the currency is highly valued and forex markets remain fragile, with risks tilted to the downside. The CPI inflation forecast was raised slightly for 2019 but, more importantly, the 2020 forecast was slashed, down from 1.6% to 1.2% percent. We agree with the assessment that headwinds to inflation will persist and maintain our view that the SNB will lag behind the ECB in its first rate hike decision, making it unlikely that it will raise rates before 2019 H2. While the SNB will keep forex interventions in its toolkit for the foreseeable future it has been tapering its forex purchases, with few interventions over the past month despite currency pressure.

Japan: Re-elected LDP leader PM Abe in trade talks with US President Trump

In line with our expectations, PM Abe won the LDP leadership elections by a wide margin against his competitor Ishiba, which forms the basis to remain prime minister for another three years. Abe announced a Cabinet reshuffle, though core positions will remain unchanged. Interestingly, Abe's focus seems to be shifting away from pure monetary policy towards stimulating the labour market and wages by structural measures. Meanwhile, economic indicators were encouraging. The Manufacturing PMI picked up to 52.9, with export orders rising above the 'boom/bust-line' of 50. Price pressures are rising, with the input price component rising to a seven-year high of 61.2. Though this is not reflected in the output price component to the same degree, the core CPI, ex fresh food and energy, keeps inching higher, and was up 0.4% in August. Export data for August remain brisk, with exports to the US not much affected by steel tariffs. PM Abe's dinner meeting with US President Trump yesterday seems to have formed a good basis for encouraging bilateral trade talks later this week.

What to Watch

- The Fed is expected to hike rates for the third time this year at its meeting this week. Markets will focus on the latest update of the Fed's economic projections and expected rate path.
- We expect both the central banks of Indonesia and the Philippines to hike policy rates this week, while Taiwan's CBC will stay on hold. In Japan, many of the relevant economic data for August as well as the Tokyo CPI for September will be released on Friday. August industrial production data for Taiwan, Thailand and Singapore will be in focus as well.
- Investors will watch closely the Italian government budget deficit projections for the next three years, which will be released this week.

Disclaimer and cautionary statement

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