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Weekly Macro & Markets View

Highlights and View

- **China and the US step into another round of trade tariff retaliation measures, hitting risk assets**

  We are at a critical juncture, with angst and relief alternating, depending on President Trump's remarks.

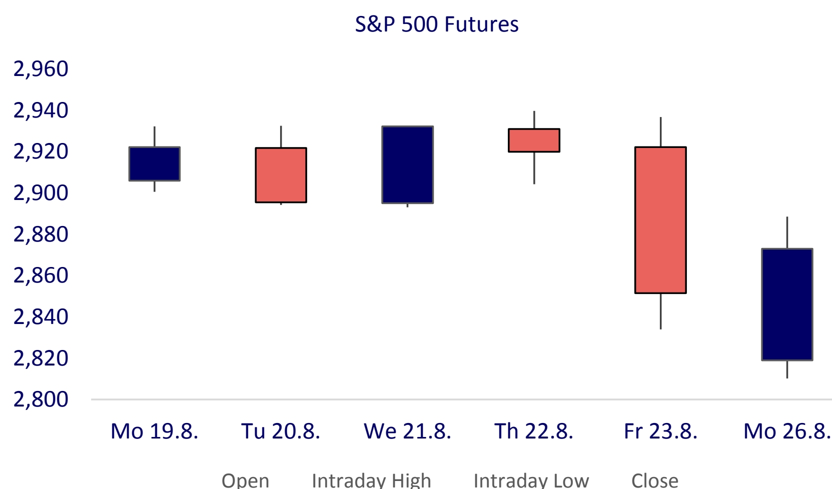
- **US Fed Chair Jerome Powell leaves the door open for another rate cut in September**

  Given the accelerated slowdown in business activity and the trade war escalation we welcome the Fed's willingness to provide more stimulus, although we still worry that it will not act decisively enough.

- **The G3 flash PMIs edged lower in August, this time led by the US while data for the Japan and the Eurozone were broadly stable.**

  The global manufacturing recession remains in place and, as the latest escalation in global trade disputes will weigh on business sentiment and capex spending, growth is set to stay weak.

Dangerous new phase in the US-China trade war



Source: Bloomberg, data for Mo 26.8. as of 12:00 noon

Equity markets and bond yields slumped while the USDCNY spiked shortly after China announced additional tariffs on USD 75bn of US goods. This is the third round of retaliation following earlier measures by the US to tighten the screws on China by adding 10% tariffs on USD 300bn of Chinese goods in September and December. President Trump reacted immediately and hastily announced a further drastic hike in tariffs on China imports. He was quoted saying "We don't need China and frankly, would be far better off without them", while he ordered US companies to start looking for alternatives to China and urged them to move production back to the US. The Office of the US Trade Representative said it will implement the increase in tariffs by another 5% on October 1 following a notice and comment period including a public hearing, which obviously gives some leeway to backtrack if required. However, the increase from 10% to 15% on the next tranche of tariffs does not require a public comment period. We also note that China's retaliation measures are not broad-based, but focus on specific goods like autos, oil and soybeans. These are products that can be sourced from other countries and are believed to increase domestic pressure on Trump from US producers and consumers. We believe markets will remain turbulent, as angst and relief about the impact of the trade war on the global economy seem to be alternating quickly.

US: Further measured easing ahead from the Fed amid growing uncertainties

Investors remain torn between growth worries and the further escalation in the US-China trade war versus the hope for more monetary stimulus. Last week a pragmatic sounding Fed Chair offered some good news on the latter at the Jackson Hole Symposium. We welcome Powell acknowledging trade uncertainty and the loss in global growth momentum. While not overly dovish, he left the door open for another rate cut in September. Certainly the domestic economy is also showing vulnerability. The Markit manufacturing PMI dipped below 50 in August for the first time since the financial crisis. New export orders fell at the fastest pace since August 2009, underlining the fragile state of the world economy. While services have been holding up relatively well so far, the corresponding business activity index fell to a modest 50.9 and business expectations among service providers were the lowest in almost a decade. Overall, the latest survey points to annualised growth of around 1.5%, a significant slowdown from recent levels.

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Credit: Looks set to underperform equities

We believe that credit markets are at a point where relative risk reward versus other risk assets, particularly equities, appears to be skewed to the downside. Credit spreads seem fundamentally very expensive, while risks of a growth slowdown are rising not least due to uncertainty around trade disputes, as was seen during the volatility last week. Furthermore, credit typically starts to underperform equities before a recession, while corporate actions continue to favour shareholders over bondholders. While last week still saw credit outperforming other asset classes, we believe this should ebb soon. Flows into riskier parts of credit such as high yield have turned negative, while spreads rallied on muted activity, which was also seen in primary markets. Some borrowers are taking advantage of rich valuations, with BerlinHyp issuing a short-dated covered bond at a yield of -0.6%, although the lacklustre interest in the 30yr German Bund with negative yield suggests investor appetite may now be reaching its limit at current price levels.

Eurozone: A modest uptick in the composite PMI, but downside risks remain high

Despite a modest pickup in the Eurozone composite PMI from 51.5 in July to 51.8 in August, downside risks remain high. Indeed, the details of the survey were less encouraging than the headline. Although business activity in the service sector rose modestly, the incoming new business, business expectations and employment sub-indices were all lower. In manufacturing, there were some signs of stabilisation, but at very weak levels, while the further escalation in global trade tensions last week will do little to help bolster business confidence going forward. Overall, the composite PMI is still consistent with positive growth in the Eurozone, but risks of a further slowdown in activity remain high. The release of the ECB minutes confirmed that it is preparing a package of measures for its meeting on September 12, including cutting interest rates and re-starting QE. While this will likely help investor risk appetite in the short term, unless it is combined with a boost from fiscal policy and a de-escalation in trade tensions, it will only have a limited impact on the real economy in our view.

Japan: Muddling through

Don't be blinded by the recent encouraging GDP statistics for Q1 and Q2, as some of the latest economic indicators for July and August are not impressive. Nationwide department store sales fell nearly 3% YoY in July, while supermarket sales plunged more than 7%, the biggest drop in four years. Though bad weather may have had an impact, we believe these disappointing numbers are finally reflecting falling consumer sentiment before the next consumption tax hike on October 1. We also note that the number of tourists from South Korea has fallen significantly following the latest trade dispute between the countries (see our recent paper, "A trade war below the radar"). We are also discouraged by the fact that the August manufacturing PMI inched up only marginally and, at 49.5, remains below the boom/bust line of 50. There are no indications of any increase in production to meet strong front-loading demand ahead of the consumption tax hike. Furthermore, the new export order index fell by 0.4 points to 47.2, a weak reading. On a positive note, the Service PMI moved up by 1.6 points to 53.4, matching the cycle high of 2017.

South Asia / ASEAN: Further rate cuts were delivered

Bank Indonesia cut its benchmark rate by 25bps to 5.5% while the Central Bank of Sri Lanka lowered both its deposit and lending rate by 50bps to 7% and 8% respectively, making the number of central banks cutting rates in August six out of seven. Given each economy's diversity and uniqueness, each individual central bank has its own challenges and concerns. However, this time curbing deteriorating growth has become a common goal. Meanwhile, Thailand's Q2 GDP slowed from 2.8% to 2.3% YoY, dragged down by weak exports and soft fixed investment. The Thai Cabinet approved a USD 10bn fiscal stimulus, primarily through loans to low income households and SMEs. However, a lack of incentives to take loans during the downturn will limit the impact of these fiscal measures. Singapore's core CPI was down from 1.2% to 0.8% YoY in July, falling below the MAS's inflation forecast range of 1-2%. Overall, the recent rate cuts and fiscal stimulus measures in the region should help to arrest the pace of the economic slowdown, as already visible in a stabilisation of the latest PMI readings.

What to Watch

- In the US, consumer confidence is expected to have receded somewhat while core inflation is likely to have stabilised in July.
- In the Eurozone, business confidence surveys and bank lending data, as well as the second estimate of German Q2 GDP, will provide a snapshot on the state of the economy. In Italy, we should also get greater clarity as to whether the PD and Five Star Movement can form a coalition government, or if new elections will be called instead.
- We do not expect the Bank of Korea to cut its policy rate further on Friday, though a minority vote by one member may lay the ground for another cut later this year. In China, the focus is on the NBS Manufacturing PMI for August, which will be released next weekend, while Hong Kong retail sales for July will draw attention. A double-digit percentage decline would be no surprise. Japan will release major July statistics on Friday, while Australia's Q2 capex spending and July building approvals need to be watched.

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