Quarterly Economic Outlook
Q3 2019

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Overview

- The global growth outlook has weakened slightly during the past quarter, led by a mid-cycle slowdown in manufacturing across the developed world, and exacerbated by the Trump administration's enforcement of tariffs in pursuit of its trade policy.

- In response, central banks are likely either to reduce interest rates modestly where they have space to do so, e.g. the Federal Reserve (Fed), or by re-starting extraordinary measures such as asset purchases or new lending to banks, e.g. targeted longer-term refinancing operations (TLTROs) by the European Central Bank (ECB).

- At the same time consumer price inflation in many developed economies such as the US, the eurozone, and Japan remains well below the target of 2%.

- US – In response to disappointing growth data (in capex and jobs) and persistently weak, sub-target inflation, the Fed has hinted strongly that it will be cutting interest rates, perhaps as early as 31 July when the Federal Open Market Committee (FOMC) concludes its next meeting, but certainly in September and possibly again in December.

- This July marks the tenth anniversary of the recovery from the 2007-09 recession. If the US economy continues to expand, which I fully expect, the current expansion will become the longest in recorded US financial history. As in the mid-1990s following the Fed's initial interest rate hikes of 1994-95, the US should avoid recession and the economy should continue without overheating.

- Eurozone – The Euro-area, especially Germany, has been hit by slowing exports, and by continued sluggishness in the domestic economy. Inflation, too, remains subdued.

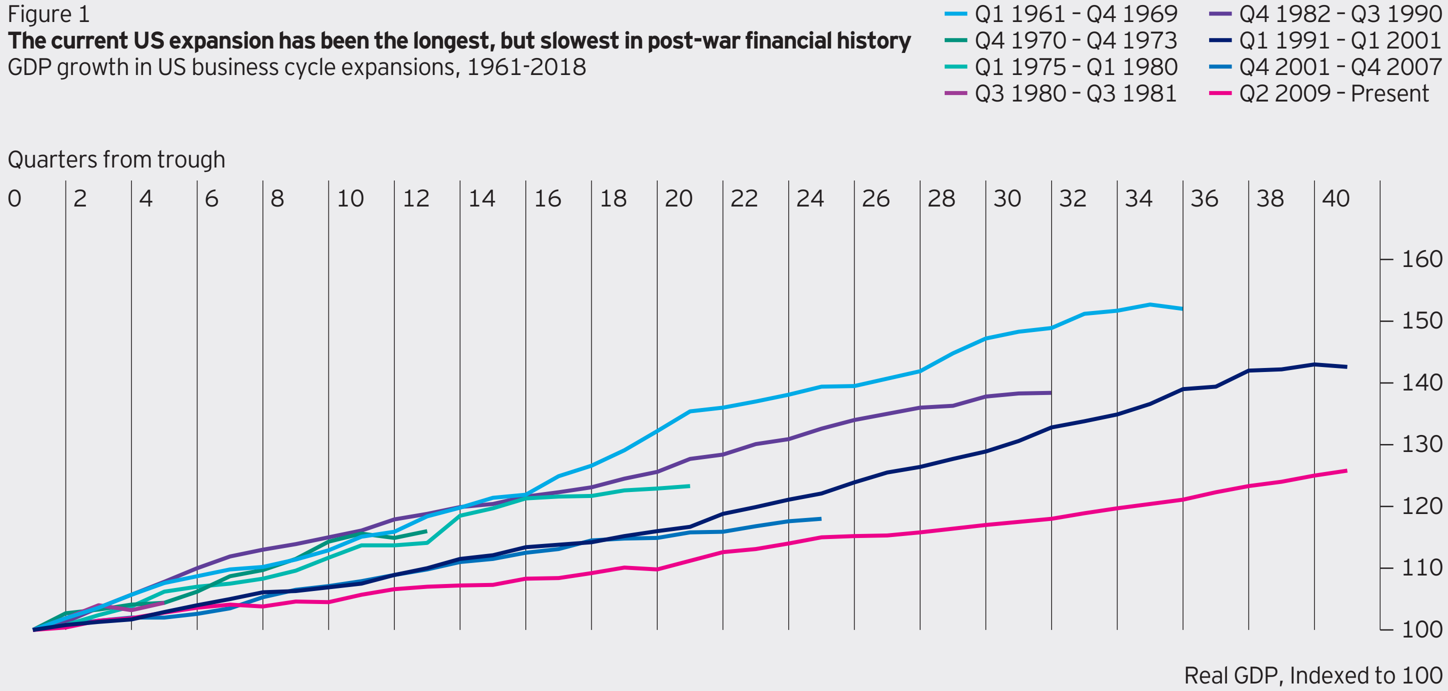
- UK – With the resignation of Prime Minister May, the focus has shifted to the contest for her replacement. Against a backdrop of uncertainty over the Brexit prospects and the Bank of England (BoE) allowing money supply growth of M4x to slow to 2%, it is no surprise that economy remains in low growth mode, with inflation falling below 2%.

- Japan – Real GDP growth remains below potential and inflation should continue around 1%, well below the Bank of Japan's (BoJ) target because monetary policy is not working.

- China – With no trade deal at the G20 meeting in Japan, exports will continue to suffer. The authorities are likely to respond with further monetary and fiscal easing measures, but these are not likely to turn the economy around quickly (as in 2009-10).

- Commodities – The expectation of lower interest rates in the US has driven up the gold price, and tensions in the Gulf have temporarily increased the oil price, but these upward moves are the exception in the commodity complex. With global inflation low and domestic demand moderate at best, broad indexes of commodity prices are likely to remain subdued.

Figure 1
The current US expansion has been the longest, but slowest in post-war financial history
GDP growth in US business cycle expansions, 1961-2018



Source: Refinitiv Datastream as at 9 July 2019. Note: Data for 2019 Q2 are an Invesco estimate.

Figure 2
Consensus & Invesco forecasts for 2019

(%)

	2018 Actual		2019 Consensus forecasts (Invesco forecast)			
Consensus Economics	**Real GDP**	**CPI inflation**	**Real GDP**		**CPI inflation**	
US	2.9	2.4	2.5	(2.6)	1.9	(1.5)
Eurozone	1.8	1.7	1.1	(1.1)	1.3	(0.9)
UK	1.4	2.4	1.4	(1.6)	1.9	(1.4)
Japan	0.8	1.0	0.8	(1.1)	0.6	(0.6)
Australia	2.8	1.9	2.0	(1.9)	1.6	(1.5)
Canada	1.9	2.3	1.4	(1.4)	1.9	(1.4)
China	6.6	2.1	6.3	(6.3)	2.3	(1.5)
India	6.8	3.4	7.0	(7.2)	3.8	(3.6)

Source: Consensus Economics, Survey Date: 10 June 2019.

United States

The US economy has been softening in a gradual way during the past few months. The weakness has been in investment (both business and housing), employment, manufacturing and trade, but it is by no means pervasive. Consumer spending has remained buoyant, and equities have held up.

This kind of mid-cycle slowdown is not unusual during a business cycle expansion, and often follows a series of interest rate increases such as the Fed has engineered over the past three years. It happened, for example, in 1995-96. It is also normal for fiscal stimulus - such as that enacted by President Trump's tax cuts at the end of 2017 - to provide an initial boost, followed by a relapse as the financing requirements of the government start to impact financial markets. In the current case, compared with a year ago, the federal government is issuing approximately US$1 trillion of new debt (to fund the deficit), and in addition the Fed was, until 31 May, disposing of Treasury securities at a rate of US$30 billion per month, or US$360 billion p.a. Added to disposals of mortgage-backed securities, this has meant that the private sector has been required to absorb around US$1.4 trillion on an annual basis. Fortunately for the markets, the Fed's disposals have been scaled down since 31 May, and will come to an end in September.

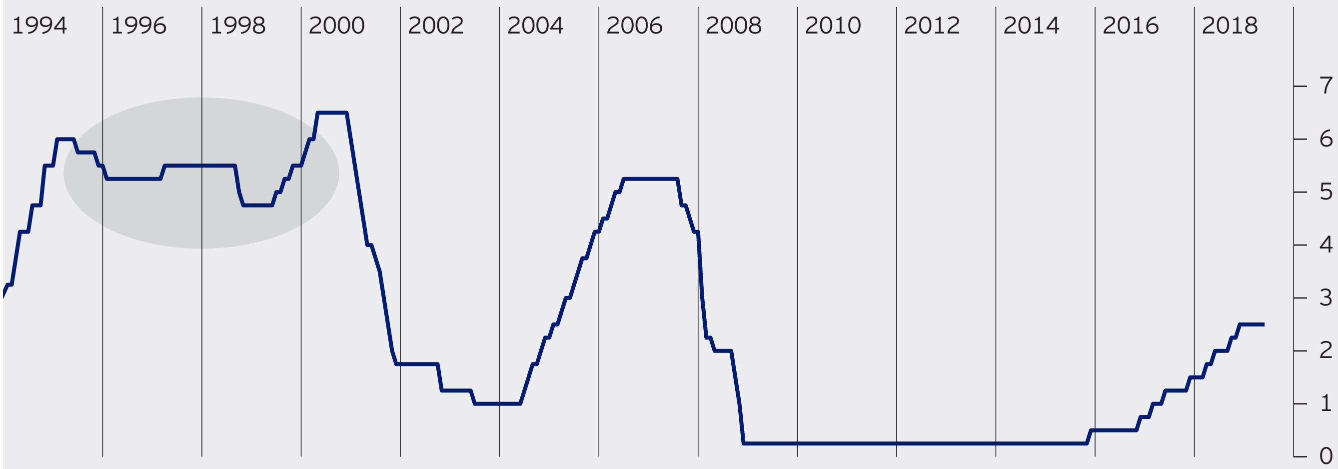
Moreover, the members of the FOMC shifted policy abruptly following their last interest rate increase in December 2018. This "pivot" towards easing has not yet been reflected in actual interest rate cuts from the current Fed funds target of 2.25-2.50%, but the language of Fed governors and presidents as well as the text of the 30 January, 20 March and 1 May FOMC statements has been clearly signalling some degree of easing ahead. The cut in interest rates could perhaps come as early as 31 July when the FOMC concludes its next meeting, but there will be opportunities in September and possibly again in December when the FOMC is scheduled to release participants' forecasts such as the famous dot-plot for interest rate changes over the next 2-3 years.

Again adjustments to interest rates after the initial normalisation phase have happened in the past, and should be considered a sign that FOMC members are attempting to extend the cycle. Following the rate increases of 1994-95, this occurred in 1995-96 when the Fed cut rates, and there were several further adjustments until the end of the cycle in 2001 (see Figure 3).

The key question for investors is not so much when the FOMC will cut interest rates, but whether those rate cuts will be accompanied by any material change in the rate of growth of broad money and bank credit. The reason is that the current deceleration of the US economy and the fall in inflation is in large measure a result of banks only growing their balance sheets at very modest rates of 4-5% over the first six months of 2019. For stronger nominal GDP growth, faster broad money growth is required.

My forecast is for 2.6% real GDP growth and 1.5% CPI inflation in 2019 as a whole.

Figure 3
Following the 1994-95 series of rate increases, adjustments to the Fed funds target rate continued until 2001
US Federal funds target rate



Source: Refinitiv Datastream as at 9 July 2019.

Will new leadership resolve the euro-area's problems?

During the period when this quarterly economic outlook was being compiled, Euro-area bond and stock markets were intensively focused on the impending changes of leadership in the European Commission and at the ECB. Subject to approval by the European parliament in Strasbourg it seems likely that the nominated candidates, Ursula von der Leyen and Christine Lagarde (previously Managing Director of the International Monetary Fund) will assume those positions at the end of September. The real question for financial markets is whether in combination or alone, either candidate has the knowledge and the support to drive through policies that can shift the sluggish growth and sub-target inflation of the euro-area.

The role of the EU Commission in macroeconomic policy is limited largely to enforcing the fiscal rules imposed on member countries by previous treaties of the EU. While fiscal policy is the junior partner to monetary policy in steering the economy, inadequate monetary stimulus exacerbates the difficulties of meeting fiscal targets for those countries suffering weak growth. In this arena Italy has been the main problem-child in the euro-area since the two populist parties of the centre right (Matteo Salvini's League) and the anti-establishment left (Luigi di Maio's Five Star Movement) formed a coalition following the election of 4 March 2018. However, in recent weeks the government in Rome has promised to make nearly €8 billion of cuts in its 2019 budget, and to take further steps to reduce debt in 2020. For the present this is probably enough to enable Brussels to back down.

On the more important monetary side, the prospective appointment of Christine Lagarde has already had some dramatic effects in the financial markets. The euro weakened on the announcement, German 10-year bund yields fell to the same level as the ECB's refinance rate (-0.4%), and the spreads for Italian BTPs over bunds decline sharply. All of this reflected the consensus relief that the EU leaders had not appointed the German Bundesbank president, Jens Weidmann, to the ECB presidency, together with the view that Mme Lagarde would continue the dovish or expansionary policies of Mario Draghi.

The key question, then, is whether this change of leadership at the ECB will really make any difference to policy in the years ahead. Mme Lagarde is not an economist but having had extensive experience of involvement with IMF interventions in crisis economies and proposing solutions to restore growth and reduce inflation, she should have plenty of ideas about how to restore the fortunes of the euro-area. However, the ECB and the euro-area more generally are rule-bound, legally constrained organisations which could inhibit her, even if she comes with new ideas.

In the world at large Mario Draghi's legacy is mostly good, starting with the LTROs launched in late 2011, his famous statement that the ECB was "ready to do whatever it takes" to preserve the single currency at a speech in London in July 2012, and carrying through to the implementation of QE from March 2015 through to December 2018.

However, in my judgment, the LTROs did not work as banks simply substituted lending from the ECB for other sources of funds, and bank lending actually fell from +4% to -4% year-on-year over the period the loans were being granted (Figure 4). Moreover, his QE policy was diluted by buying securities mostly from banks instead of from non-banks. The result was that the purchases did not create enough deposits to boost money growth sufficiently. It remains the case the euro-area aggregate demand (spending) is weak and faster money and credit growth is still required.

I forecast growth of 1.1% in 2019 with consumer price inflation slowing to 0.9%, well below target.

Figure 4
When the ECB did LTROs in 2011-12, bank loans did not increase, they decreased
Eurozone: Total assets of ECB and commercial bank loans

Source: Refinitiv Datastream as at 9 July 2019.

Inflation more likely to slow than accelerate, even in a "no deal" Brexit scenario
For a record tenth consecutive quarter, UK households spent more than they earned in the first quarter of 2019. This is the largest number of consecutive quarters of net borrowing by the household sector since records began in 1987. In addition, the gross household savings ratio also fell, and stood at 4.1% of disposable income in Q1 2019, which is the joint fourth lowest quarterly savings ratio since records began in 1963, according to the Office for National Statistics. The UK is now in a situation where each of the domestic sectors of the economy – the household sector, the government sector, and the corporate sector – are net borrowers. The combined deficit is being financed by capital inflows from overseas and reflects the UK's relatively large current account deficit in comparison to other advanced economies. Lack of domestic net savings combined with Brexit uncertainty should continue to put downward pressure on sterling going forward.

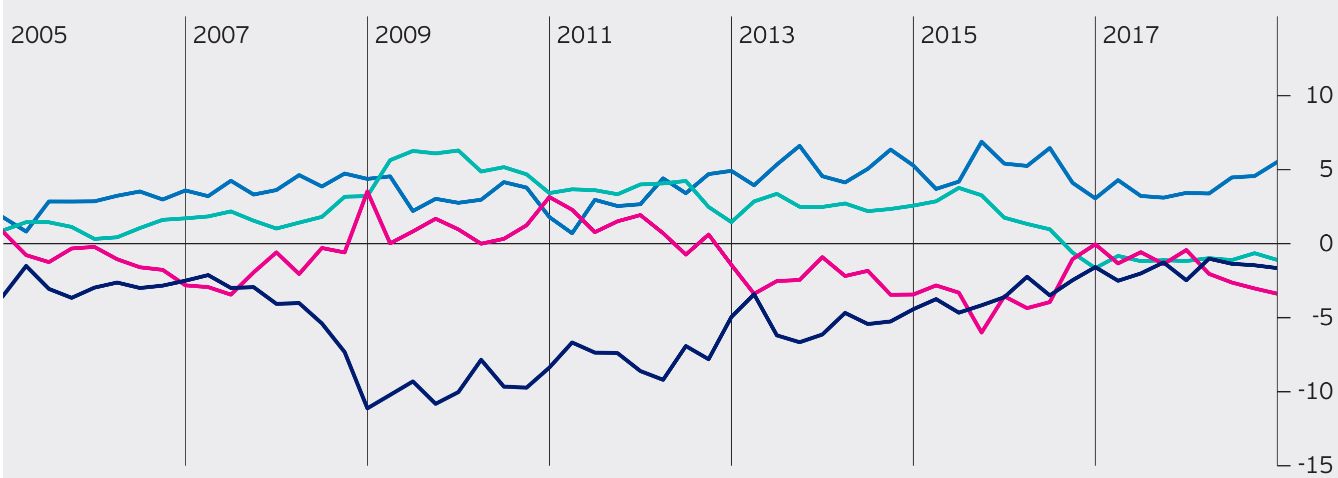
Despite this relative weakness in underlying domestic spending, the BoE was, until very recently, forecasting a steady rise in inflation. For example, according to the Bank's Quarterly Inflation Report in May 2019, "As excess demand emerges, domestic inflationary pressures are expected to firm, such that CPI inflation picks up to above the 2% target in two years' time and is still rising at the end of the three-year forecast period." The reason for this bizarre forecast despite the evident weakness in spending results from their forecasting methodology being fundamentally based on the interaction of supply and demand factors centred on the output gap concept. If the economy reaches their estimate of full supply potential (i.e. the output gap closes), their claim is that inflation will rise. But this is almost certainly a fallacious methodology.

Nowhere in the Inflation Reports of February or May is there is any mention (in the text) of either money/money supply or M4/M4x. Yet from hundreds of years of data across many countries we know that broad money growth, best measured in the UK by M4x, is the ultimate driver of inflation. Growth of M4x has been falling steadily since April 2017 from around 4% p.a. and has fallen materially recently to just 1.8% year-on-year in May. Therefore, we foresee inflation in the UK falling to very low levels over the medium term, well below the Bank's 2% target, in stark contrast to the forecasts of the BoE. Even if sterling fell abruptly in the event of a "No Deal" Brexit, there would only be a brief (yearlong) upswing of prices reflecting higher import costs, but this should not be viewed as inflation, but rather a change in relative prices.

Leadership for the Conservative Party has now become a two-horse race between Boris Johnson and Jeremy Hunt, with the former seen as the clear favourite to win. However, between now and the Brexit deadline of 31 October, there will be two recesses of Parliament, allowing incredibly little time for any amendments to a potential deal with the EU, which has been categorically ruled out by the European Commission. The weakness in investment spending is therefore likely to persist, dragged down by Brexit- related uncertainty. Consumer spending, on the other hand, is likely to remain buoyant, reflecting underlying strength in the labour market and real wage growth as inflation slows further. The restraints on government spending growth are also likely to be unwound, albeit to a limited degree, which is positive for real GDP growth, at least in the short term. Recent economic data points to a soft print for real GDP growth in Q2 2019.

For 2019 as a whole I forecast 1.6% real GDP growth and 1.4% consumer price inflation.

Figure 5
UK: All domestic UK sectors are in deficit
UK sectoral surpluses/deficits (% GDP)



Source: Refinitiv Datastream as at 9 July 2019. NPISH: Non-profit institutions serving households.

Both domestic and external sides of the economy under pressure

China's economy has faced challenges on both the domestic side and on the external side during the first half of 2019, and these issues are likely to persist into 2020 and beyond.

On the domestic side the economy has been squeezed by a long but gradual tightening of monetary growth. Since accelerating briefly to just over 13% year-on-year growth in the second half of 2015, M2 slowed to 8% in the final quarter of 2017 and has remained in the 8-9% range ever since. This is by far the slowest growth rate of broad money since the start of the 'Four Modernisations' under Deng Xiaoping in 1978. Although the People's Bank of China (PBC), the central bank, has engaged in numerous "easing" operations – either by cutting repo (interest) rates in 2018, or repeatedly cutting the reserve requirement ratio for banks, or injecting funds by means of money market operations – none of these actions have increased the money growth rate on a sustained basis over the past two and a half years.

The reason why the PBC has not succeeded in engineering faster money growth - if that was their intention - is that with the economy slowing, inflation low and debt levels still high, the demand for credit has been steadily weakening. In these circumstances, in order to stimulate lending and hence money growth, it would be necessary for the PBC's interest rates (such as the repo rate) to be set below the "market" rate. But that has not happened. Therefore the PBC's actions have not been successful in reversing the trend of slow money and credit growth.

Given the excess debt that had built up in the economy since the global financial crisis, the Chinese authorities announced almost three years ago that they were placing priority on de-leveraging the economy and financial system. This was entirely understandable, and the data cited above for the monetary slowdown is consistent with the maintenance of this stance. China's monetary policy, as I wrote earlier this year, is "boxed in" with little scope for significant easing.

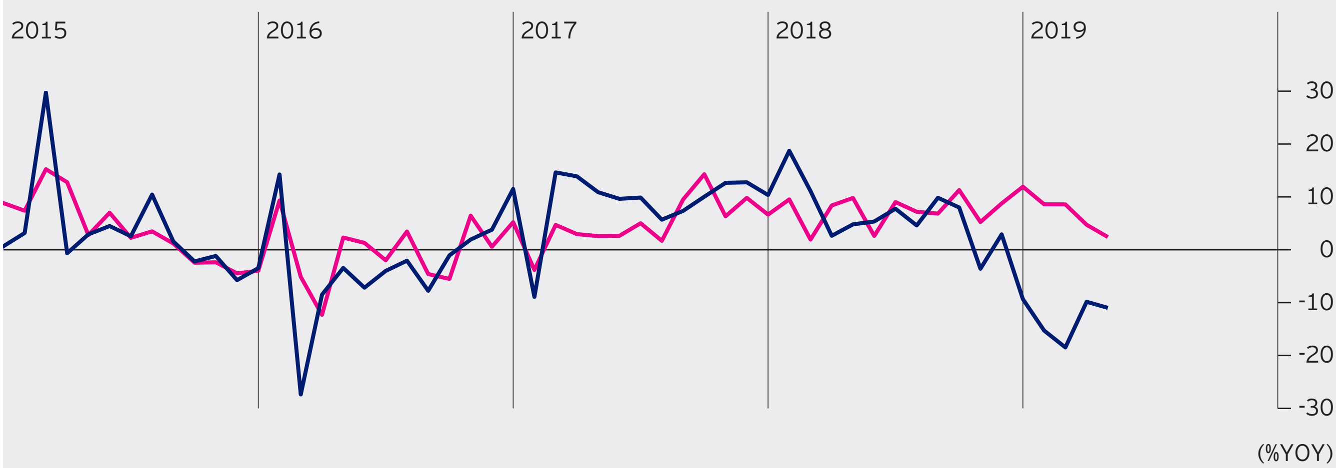
Among the domestic consequences of this persistently tight monetary policy are slowing nominal and real GDP growth rates, producer prices that have slowed from 6.9% in October 2017 to 0.6% in May 2019, and consumer prices that have been range-bound between 1.5% and 3.0% since 2016. It is only the sharp rise in food prices during the first half of 2019, especially pork prices following an epidemic of African swine flu that has kept overall producer prices in positive territory.

On the external side the year has been dominated by the Trump administration's imposition of tariffs on Chinese exports to the US and related trade negotiations. Tensions started rising in May when, in a sudden reversal during trade talks, President Trump tweeted that the US would increase the 10% tariff on US$200 billion of imports from China to 25% on 10 May 2019. He also indicated he would soon impose 25% tariffs on the rest of US imports (US$325 billion) from China not yet targeted with his Section 301 tariffs. These tariffs targeted final consumer products such as toys, footwear, clothing, and electronics. Retaliatory Chinese tariffs on US$36 billion of US exports to China followed on 1 June. Talks between the two sides were broken off in May and not revived until after the G20 meeting in Osaka at the end of June when a temporary ceasefire in the trade war was called.

The effects of President Trump's on China's trade and GDP growth have been significant. US imports from China have fallen steeply, down 18.5% year-on-year in March, and recovering modestly to down 11% in May. By comparison, US imports from the rest of the Pacific Rim (excluding Japan and China) had slowed to 2.4% in May (see Figure 6). Other East Asian economies such as Taiwan, Korea and Vietnam are starting to see trade gains relative to China as parts of the international supply chain are shifted towards those economies not yet targeted by the Trump measures.

Looking ahead, given the range of China issues that the Trump administration is targeting – the theft of intellectual property, subsidies to state-owned enterprises, and the opening of domestic sectors to foreign competition - it seems unlikely that there will be any sustained truce in the trade war with China. Although the timing of the next US presidential election may encourage President Trump's team to declare victory at some point in 2019-20 and end the trade war, it is more likely that any forthcoming ceasefire is likely be temporary.

Figure 6
China: Exports to the US have fallen sharply compared with other Pacific Rim economies
Imports into US from China & Pac Rim (ex China & Japan)



Source: Refinitiv Datastream as at 9 July 2019.

Despite better activity figures, inflation continues to undershoot BoJ's target
Real GDP data for the Japanese economy accelerated to 0.6% quarter-on-quarter in Q1 2019 (2.2% annualised and 0.9% year-on-year) following 0.5% in Q4 2018. Public sector investment contributed a 1.2% increase thanks to a second supplementary budget, net exports improved, adding 0.4% to growth, while business investment advanced by a modest 0.3%. Private and government consumption expenditure both contracted.

These stronger national account figures may strengthen the case for going ahead with the next phase of the consumption tax, raising it from 8% to 10% in October. However, when the tax was last increased in 2014 the economy plunged into recession, so unless the economic improvement continues through the summer and into autumn it is probable that the Abe government will postpone its implementation. In this respect the BoJ's "Tankan" survey of the short-term business outlook for the second quarter was disappointing in almost all areas except current conditions for large non-manufacturing firms. This suggests that underlying economic conditions remain too fragile for such a strong policy initiative.

There are two key factors contributing to Japan's persisting economic weakness. First, on the real side, the population peaked in 2010 and the labour force (or working age population aged 15-64) peaked in 1992. Declines in these key figures automatically limit the potential real GDP growth rate. Add to this the slowdown of labour productivity in recent years to just 0.7% p.a. since 2010 compared with 1.3% p.a. between 1990 and 2007, and it is easy to see why Japan's potential growth rate has slowed to 0.9% (according to Mizuho)[1]. Therefore despite a very low unemployment rate of 2.4% in April and the highest level of the job offers-to-applicants ratio (1.6%) since 1974, wage growth remains tepid, and there are no signs of overheating in the economy (see Figure 7).

Second, the explanation for the weakness in nominal magnitudes – inflation, wages, nominal GDP etc – is entirely due to the perennially slow rates of broad money growth. Ever since 1992 Japanese M2 has averaged only 2.6% p.a., far too low to achieve the BoJ's 2% inflation target. Six years after his appointment, and following his re-appointment in April 2018 for a further five years, Governor Kuroda at the BoJ has signally failed to raise Japan's consumer price inflation rate to 2%. This is despite large-scale asset purchases that have resulted in a near-quadrupling of the BoJ's balance sheet from JPY 144 trillion in March 2012 to 565 trillion in July 2019 under a much trumpeted policy known as "Quantitative and Qualitative Easing" (QQE), supplemented since September 2016 by "yield curve control" (YCC).

On the latest figures (for May 2019) the headline CPI and the core CPI - which excludes fresh food - both increased by 0.8% year-on-year, while the "core-core" CPI - which excludes food and energy prices - was up 0.5% over the twelve months. Something is clearly amiss with Japan's monetary policy, but the question is precisely where have things gone wrong?

As I have argued consistently over the past two decades, the failure to increase broad money or M2 at a rate of 5-6% p.a. has meant that nominal GDP has been constrained to grow at the M2 growth rate (2.6%) adjusted for the change in money holdings by households and firms. Since this figure (income velocity for M2) declines by 2.1% p.a., this leaves only 0.5% to fuel the economy and inflation. Not surprisingly, nominal GDP growth since 1992 has averaged just 0.4% p.a. Unfortunately Japan's macroeconomic outlook will not change significantly until this basic problem with monetary policy is fixed. Whatever the BoJ may say, QQE and YCC are not succeeding in restoring Japan's inflation rate to 2%.

[1] https://www.mizuho-ri.co.jp/publication/research/pdf/eo/MEA170321.pdf

Figure 7
Japan's tight labour market has failed to push up wages
Japan: Job offers/applicants ratio & wage growth

Source: Refinitiv Datastream as at 9 July 2019.

Commodities

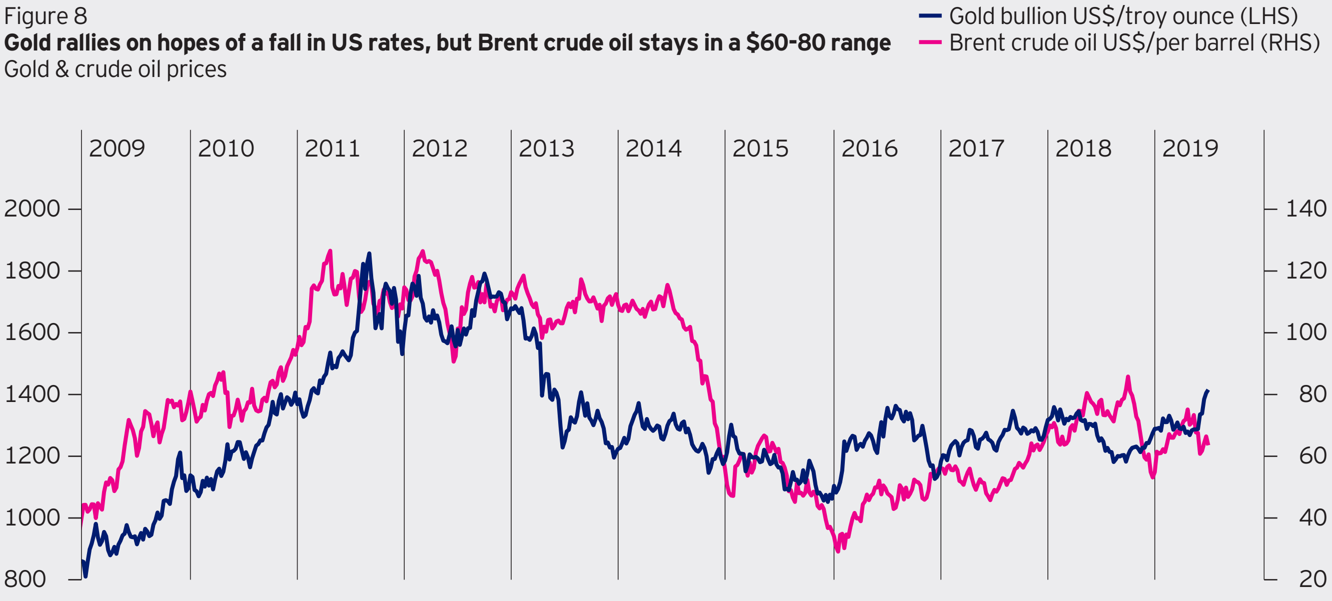
Global manufacturing indicators have continued to weaken through the first half of 2019, especially in the eurozone and in the UK. The buoyancy in manufacturing output evident in the more advanced economies such as the US and the eurozone in 2017-18 has completely vanished, and now emerging markets are leading manufacturing growth in the global economy. Based on the PMI indicators, manufacturing activity is contracting in the vast majority of advanced economies (but not in the US), as well as in China and Russia. Reflecting this continuing softening in manufacturing, commodity prices (excluding oil) have fallen in the second quarter of 2019, and are essentially flat year-to-date, as measured by the Commodity Research Bureau Index of commodity prices.

Brent crude oil prices rose from a low of US$50.47 on 24 December to US$75.15 on 25 April, a rise of almost 50%. Oil prices have fallen back since the end of April, trading at around US$67 as of the end of Q2 219. Decisions by OPEC and temporary disruptions to oil supply due to political and other factors in Venezuela, Libya, Iran and elsewhere have accentuated the rapid recovery in oil prices, but the longer-term outlook for oil and commodity prices in general will be shaped by global demand, driven in turn by the business cycle outlook and the monetary policies of the central banks.

Consistent with the demand-side drivers that formed the focus of earlier sections of this report, the overall picture is one of softness, rather than strengthening demand. As long as aggregate spending is restrained by slow-to-moderate rates of growth of money and credit, and inflation pressures therefore remain under control, the medium-term demand-side outlook for commodity prices should be subdued, except for those specific sectors which are subject to supply-side disturbances. One notable exception is gold whose price has risen by 10% since 29 May, from US$1,280 to around US$1,425 per ounce, driven largely by expectations of cuts in US interest rates.

Reviewing the performance of commodity prices as a whole since 2008 (in Figure 8) confirms this lesson. The big surge in commodity prices between February 2009 and April 2011 was almost entirely due to the huge surge in Chinese domestic spending resulting from the massive acceleration of money and credit at that time. Subsequently, the growth of Chinese spending in both real and nominal terms has slowed, and with it the overall performance of global commodity prices. It follows, therefore, that unless China's domestic spending and/or that of the OECD nations increases significantly in real or nominal terms over the next year or so, commodity prices are generally likely to remain subdued over that time horizon.

Figure 8
Gold rallies on hopes of a fall in US rates, but Brent crude oil stays in a $60-80 range
Gold & crude oil prices



Source: Refinitiv Datastream as at 9 July 2019.

Conclusion

Equity markets sold off in May, but recovered most of the lost ground in June with the major US equity indices hitting new highs. This is consistent with my long-argued view that asset prices are largely driven by monetary policy and the business cycle. With US consumer balance sheets in good shape, the non-farm payroll employment data holding up well in June (with a gain of 224,000), and inflation remaining below target, there is little or no reason for the Fed to tighten. On the contrary, it is more likely that the FOMC will cut interest rates to extend the expansion, which in turn means that the peak in equity prices could be some distance ahead.

The bond market, on the other hand is driven by expectations about the direction of short term rates and inflation. Following the Fed's pivot towards easier policy in the early weeks of 2019, the yield on 10-year Treasury bonds fell from 2.78% on 21 January to 1.95% on 4 July, broadly reflecting growing expectations of three rate cuts amounting to 0.75% by year-end. There was some additional momentum provided by the news that Mme Lagarde was being nominated to be the next ECB president, particularly in the euro-area fixed income markets.

These expectations are only reasonable if the Fed acts to satisfy bond market expectations, which is not inevitable, and if the rate cuts are not accompanied by any acceleration in the growth of money and credit. If, however, money and credit do accelerate following the rate cuts, economic activity will strengthen, the demand for credit will increase, and inflation will rise. All this would transform an environment of falling yields into one of rising yields as inflation concerns would replace the direction of short term rates as the key driver of bond yields.

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9 July 2019

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Data as at 9 July 2019, unless otherwise stated.

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