KWR International has begun to prepare a timely Macro-Outlook Bulletin, which is now in beta development. To be placed on the no-obligation trial subscription list or for questions and more comprehensive monitoring, advisory support and research, please email KWR-Macro-Outlook@kwrintl.com . Thank you for your interest and support!

The KWR International Advisor Macro-Outlook

August 12, 2019

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"If you tell the truth, you don't have to remember anything." Mark Twain

Dark Skies Ahead?

Summary: August is supposed to be vacation time, when people get away from the day-to-day grind of jobs and leave their worries behind. This August there are too many fires burning for a relaxed getaway. Last week, markets had another round of volatility, driven by uncertainty over the Sino-American trade relationship, the negative impact of rising protectionism on global economic expansion (look at Germany's and the UK's recent economic data), and ongoing geopolitical tensions (Hong Kong, Russia, the Persian Gulf, Kashmir, Venezuela and North Korea). Related to the risk of stalling global economic growth, we now have competitive central banking in a race to the bottom with an eye to driving currencies down. We also wonder if having $30 trillion of bonds at negative interest rates is a good thing. The economies that issue that debt, like Germany and Japan, are not exactly trailblazers in terms of economic growth. (See table below). Autumn is now only three weeks away and the lineup of macroeconomic and geopolitical issues is going to accelerate: a no-deal Brexit looms; election fever is in the air in the U.S., Italy, the UK, Poland, Portugal, Dominica, Guyana and Argentina; and we could see a Chinese clampdown in Hong Kong. Talk about a recession in the U.S. is also increasing due to policy uncertainty, supply chain disruption and tariffs. In this environment we favor gold, yen and U.S. corporate and municipal bonds look good. Happy summer vacation!

10-Year Sovereign Bond Yields/Real GDP growth

Country	10-Year sovereign bond spread %	Real GDP Growth 2018 %	Real GDP Growth 2019 %
United States	1.71	2.9	2.2
Germany	-0.58	1.4	0.7
Japan	-0.2	0.8	0.9
UK	0.48	1.4	1.3

France	-0.27	1.7	1.3
Italy	1.80	0.9	0.1
Brazil	4.14	1.1	0.8
Mexico	3.42	2.0	1.9

Sources: Bloomberg; International Monetary Fund, July 2019.
https://www.imf.org/en/Publications/WEO/Issues/2019/07/18/WEOupdateJuly2019

What to watch in the week ahead?

The earnings season is heading into its final rounds. Two quick items to consider:

* Chinese tech giants, **Alibaba** and **Tencent**, should provide a more granular look as to how these companies are dealing with the trade war. We do not expect a trade deal in 2019, and the rhetoric is likely to become testier.

* **Walmart** is one of the world's largest retailers, a sector that has been undergoing a reckoning at the hands of Amazon and being whipsawed by U.S. trade wars. Despite challenges from the Trump administration in terms of global supply chains, Walmart has moved quickly to diversify where it buys goods and has used its deep pockets to upgrade its digital channels. The ability of the U.S. consumer to keep buying has held up, which bodes well for Walmart. Its forecast for the rest of 2019 will be closely watched.

During the week ahead, key data worth watching:

- *August 12*: Monday offers up Foreign Direct Investment data from China and consumer confidence out of Ireland.
- *August 13:* Tuesday's Bureau of Labor Statistics release of its consumer price index (we are looking for a number still below 2.0%). Outside the U.S.: Germany provides a look at consumer prices and economic sentiment; Japan on Machine Tool Orders; and Spain on CPI.
- *August 14*: Wednesday has Import and Export Price Indexes (expect negative numbers); Outside of the U.S. **Germany provides real GDP number for Q2 (this is potentially big news if it is negative)**; Europe releases data on employment and industrial production; and India on money supply.

- *August 15*: Thursday has the National Association of Home Builders (NAHB) giving insights to the housing market; retail sales; industrial production; and NAHB home builders index. **The industrial production data should provide insight as to whether talk of increasing chances for a U.S. recession are valid. See chart above;** and
- *August 16*: Friday the University of Michigan releases its Consumer Sentiment Index for August. Consensus is that it will be over 98, which means little change from July. Also housing starts and building permits.

Prospects for a currency war: The trade war between the world's two largest economies increasingly runs the risk of heading into a currency war. Indeed, China let its currency drop against the dollar in retaliation for the latest round of Trump tariffs. The Trump administration promptly labelled China a "currency manipulator". At the same time, President Trump has aggressively gone after the Federal Reserve to lower rates, with a view to weaken the dollar, help exports and stimulate economic growth, all with an eye to his re-election campaign.

The currency landscape is complicated – and the Trump administration's desire for a weaker dollar is also eroding Japan's competitiveness. Remember them? A steadfast U.S. ally. As markets respond to the potential for a deeper global economic slowdown due to spreading trade protectionism, investors have turned to the yen as a safe harbor asset. Indeed, the dollar to yen value has gone from 108.79 on July 31, 2019 to 105.47 in early trading on August 12th. There is speculation that it could go still lower to the 100.00 mark.

Options markets reflect an increasingly stronger view that President Trump may opt to intervene in markets to further weaken the dollar. As he recently stated, "As your president, one would think that I would be thrilled with our very strong dollar. I am not! The Fed's high interest rate level, in comparison to other countries, is keeping the dollar high, making it more difficult for our great manufacturers like caterpillar, Boeing…John Deere, our car companies, & others, to compete on a level playing field." If Trump opts to intervene in currency markets the main targets are going to be the euro and yen; going after the yuan is likely to see a Chinese retaliation.

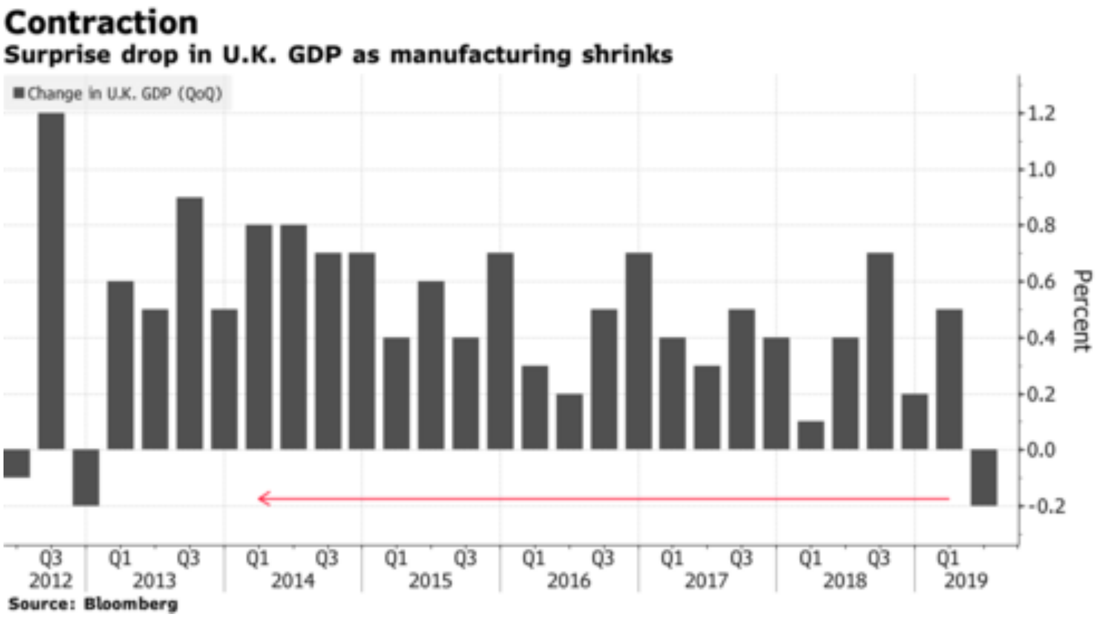
A currency war driven by the U.S. would certainly dampen global economic prospects and ripple into stock markets. Although intervention chances currently are not high, frustration with the Federal Reserve and any further cooling off of the U.S. economy could give that idea momentum. The consequences could be a spiral of competitive currency devaluations, greater tension between trading partners and a push to further diminish trade leading to recession (much like the Great Depression).

Europe's struggle to stay afloat: The European economic recovery is at risk of stalling and the potential for a recession is rising. Part of the problem is that the European economic locomotive is supposed to be Germany, but growth in that country has faltered due to problems in its auto business, deteriorating demographics, and the Sino-American trade war. In June German imports increased 0.5%, more than the 0.3% economists had forecast. Exports however declined at an expected 0.1% from a month earlier, plunging 8% from the same month in 2018. Imports showed a fall of 4.4% from a year prior. Although the trade balance remained in surplus at euro 16.8 billion in June, it was down year-on-year from euro 22 billion in 2018.

Recession talk is also being fueled by a cooling in the rate of expansion in services and business optimism – which is now at its lowest in more than four years. Another issue has been longstanding resistance to fiscal stimulus. One talking head on Bloomberg quipped, "There appears to be no word in German for stimulus."

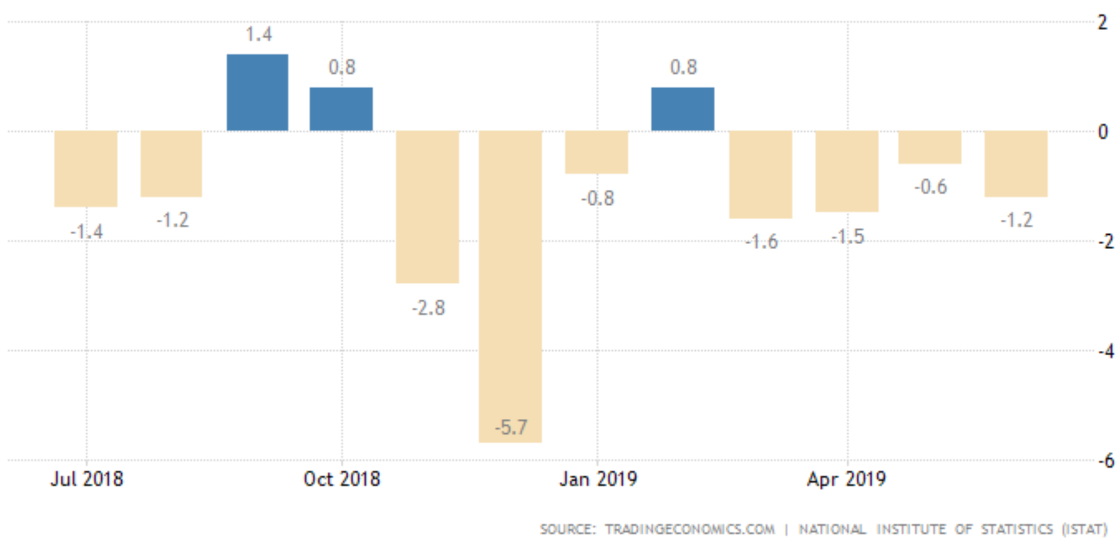
Germany's public finances have long been prudently managed and in recent years been modestly in surplus. The guiding thought is that it is important to reduce debt in economic good times and not to burden future generations with even more debt in light of Germany's aging population. But pressure is mounting from both within Germany as well as from other EU members. That said, one has to wonder how much of a benefit will be gotten by Germany issuing more negative yielding debt? The trend here is not Germany's friend and has stimulated talk of recession.

The UK economy is another worry. A recession increasingly appears on the cards – even before Brexit. In Q2 2019 the economy unexpectedly contracted by 0.2%, the first since the aftermath of the financial crisis. If it is followed by another contraction in Q3, then the country is technically in a recession. The situation was well summarized by Appesh Paleja, lead economist for at the Confederation of British Industry, "Underlying momentum remains lukewarm, choked by a combination of slower global growth and Brexit uncertainty. As a result, business sentiment is dire."



With Brexit on the mind of most British business chiefs, there was a move to run down inventories which had been built up in anticipation of an earlier Brexit. At the same time, many companies brought forward their summer maintenance shutdowns to April to avoid the threat of supply disruptions around the original Brexit deadline (March 29, 2019). The Johnson government shrugged off the bad news, indicating that a recession was not likely and that new spending will help bolster activity. The macroeconomic trend in the UK remains negative and we believe that a recession is likely. The situation on the policymaking front is not helped by the fact that the Johnson government holds a one seat majority in Parliament, which leaves it vulnerable and could send the country down the election road sooner rather than later.

Italy Industrial Production



Italy is the other major point of concern. On August 9th, the rating agency Fitch confirmed Italy's BBB rating, but left its outlook at negative. Fitch stated that the rating and outlook "reflect the extremely high level of general government debt, very low trend GDP growth, policy risk and uncertainty arising from the current political dynamic and associated downside risks to our public debt projections". They also pointed to high public sector debt and "still-weak" banking sector. It appears highly likely that Italy will be off to elections in September as the head of the eurosceptic League, Matteo Salvini, has aspirations to upgrade his status from Minister of the Interior to Prime Minister.

The League is leading in opinion polls and it is possible that, together with a number of smaller rightwing parties, Salvini could form a new government. As a League-dominated government would probably be likely to cut taxes and move away from fiscal austerity, Rome would find itself in a more blatant adversarial position with the EU. In turn, this would likely ripple through European markets and raise concerns over Italy's debt burden, which is over 130% of GDP, one of the world's largest.

Adding spice to the froth of Italian politics, Milan prosecutors in July opened up a corruption probe into the League over allegations it received funds from Moscow ahead of European elections earlier this year. In the days ahead, look to a vote of no confidence, the fall of the Conte government, a search for a non-elective alternative (the President will ask other parties for form a government) and, most likely a snap election in September, possibly October.

Europe faces big questions on the economic front, a situation compounded by political uncertainty that could see changes of government in Italy, the UK and Spain (to be discussed next week). Moreover, a tariff-loving U.S. president raises the potential of further trade tensions between the U.S. and Europe, especially over autos - which strikes at the heart of the German economy. Even the U.S.-UK trade deal (set to begin work on after Brexit) could be complicated by the U.S. demand for entry of GMO crops into the UK, something which a large bloc of British citizens are opposed. All of this leaves Europe looking to the European Central Bank (ECB) for relief. However, ECB actions to stimulate growth (probably through a reactivation of quantitative easing), could lead to greater friction with the U.S. if such measures weaken the euro. Europe faces a very challenging landscape for the remaining months in 2019.