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The KWR International Advisor Macro-Outlook

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Scott B. MacDonald, Ph.D.

Keith Rabin

More Earnings, Iran and Central Bank Talk

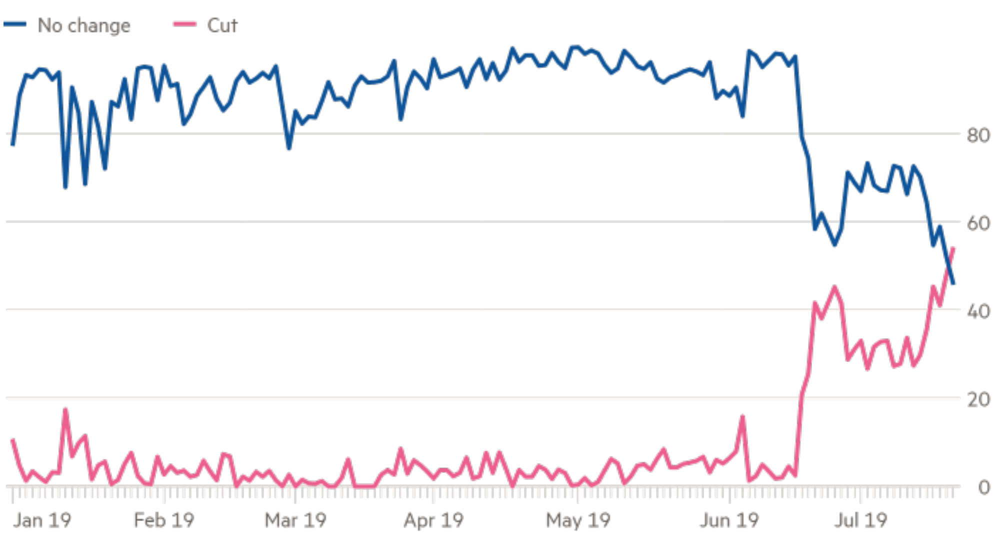
Summary: The past week was dominated by economic data dumps by China (exports down and real GDP growth at its lowest in over 20 years); news that U.S.-China trade talks are not likely to go anywhere soon; and disappointing earnings from financial companies. The geopolitical front was largely negative as tensions in the Persian Gulf rose with the U.S. shooting down an Iranian drone, the UK seizing an Iranian ship, and Iran seizing a tanker.

To this backdrop the world's central banks are becoming more dovish. Last week the central banks for South Korea, Indonesia, South Africa and Ukraine dropped rates, moves generally justified by concerns from cooling exports and economic growth. Adding to the mix is that a number of governments are worried that central bank rate lowering will not be enough to halt the slide to a major global slowdown. This has brought calls for governments to do more, including weakening their currencies. Indeed, PIMCO is warning that with all the complications around managing trade, a currency war cannot be ruled out. Such a development would have more than a whiff of the 1930s, when tit-for-tat actions on the trade front killed global trade and growth. We think it is too early to take such a grim view, but the global economic trajectory and increasing weaponization of trade policy point in the wrong direction will make central bank efforts to stimulate growth more difficult.

All eyes on the ECB: With the Fed's FOMC meeting set for July 30-31, attention is focused on Thursday's ECB meeting. In contrast to the U.S., Eurozone GDP growth has trended weaker. Moreover, Eurozone 'supercore' CPI inflation and inflation expectations remain substantially softer than in the U.S., and geopolitical risks such as Brexit loom large. At issue is whether stimulus is offered now, or stronger hints are dropped in favor of moving toward stimulus at a subsequent meeting such as on September 12th.

Rising probability of ECB deposit rate cut in July

Odds implied by overnight indexed swaps (%)



Source: Bloomberg

The dovish central bank push comes as Europe wrestles with whether Eurozone growth is on the mend. One indication of this is that the composite Eurozone PMI has been marginally improving since the end of last year. Given the correlation with GDP growth, this may portend firmer prospects into Q2–Q3. Consequently, investors and policymakers will be closely watching the July readings for PMIs due out on Wednesday.

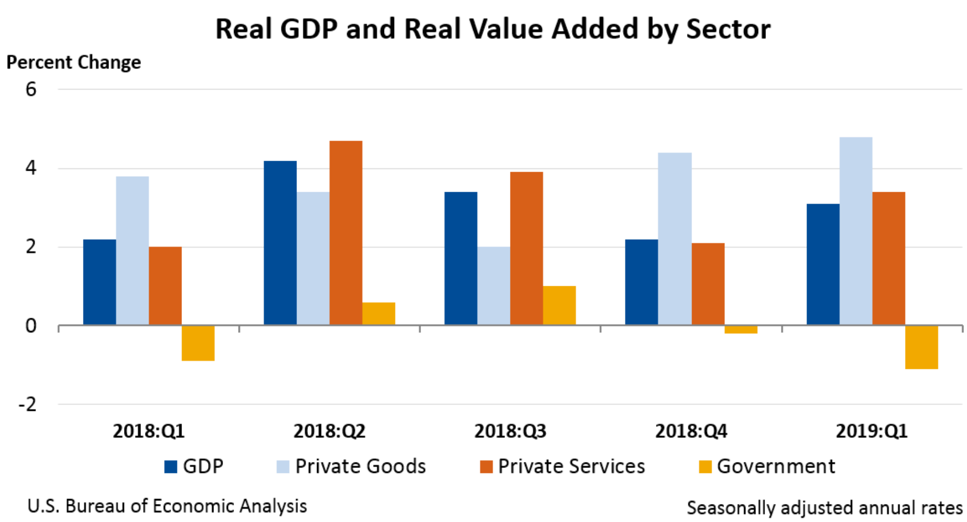
Germany also releases the July edition of the IFO business confidence gauge on Thursday. Germany matters considerably in this process, due to its role as the engine of European growth. That engine needs to do a little more than its current sputters. Goldman Sachs noted last week that incoming data from Germany indicate that its economy contracted during the second quarter. As Goldman's economist, Soeren Radde, noted, "German economic activity has continued to slow in recent months, with the industrial sector exerting the strongest drag."

Markets would be more positively surprised by immediate action relative to what is priced and so President Draghi's past inclinations toward shocking markets to secure maximum effect may well manifest themselves once again. The final months of the Draghi ECB could be much more exciting than what investors want to see, leaving more heavy lifting to the incoming President Christine Lagarde. We think that there is a good chance that the ECB will cut rates, keeping pressure on much of Europe to maintain negative rates.

Beyond the ECB, rate cuts are expected from Russia's central bank (Friday) and Turkey's (Thursday).

Meanwhile in the UK…Also on tap next week is the likely confirmation of Boris Johnson as the new UK Prime Minister as postal ballot results of the Conservative Party's leadership contest are due. Ironically, Johnson's quest for Brexit may be put on the backburner as his first order of attention may be to Iran's seizure of at least one British oil tanker. How he handles this could well influence his leadership credibility toward Brexit.

U.S. Growth Data



One of the major pieces of economic data for this week is the report on U.S. real GDP for Q2. Q1 was 3.1%, but the impact of the trade war may lead to a post of 2.0%, possibly under. Some analysts are calling for 1.8%. The combination of slower real GDP growth and a flaccid earnings season could guarantee the Fed cut at end-July. The bottom line is that the Fed's concerns over trade wars, the global economic slowdown and low inflation set the path for a rate lowering cycle to begin. The old mantra of lower, longer seems to be back.

As for earnings, thus far close to 77% of the roughly 80 companies reporting had beaten earnings estimates, and 65% topped revenue forecasts according to Refinitiv. Based on actual reports and forecasts, earnings per share for the S&P companies are expected to be up 1% in Q2. This is better than earlier expectations, which were slightly negative. Nonetheless, earnings are hardly stellar.

The weak nature of U.S. earnings is feeding the call by some economists that a recession is looming. Gluskin Sheff's David Rosenberg is warning that earnings are "rolling over" and economic data is indicating the economy is on the brink of a recession. Most economists still see growth through 2019 and into 2020. That stated, what goes up, eventually goes down. The U.S. growth streak is the longest in the country's history, but there are a number of drags, in particular, the trade wars with friend and foes. The tariffs remain a tax on U.S. consumers. Growth is held up in the U.S. because of the consumer. Companies are passing the costs of tariffs through to consumers and jobs are lost due to lost market access (as with agricultural goods to China for American goods).

Briefs

Japan – Shinzo Abe's Liberal Democratic Party-led coalition government handily won a majority in lections to Japan's upper house, indicating his hold over his country's politics remains intact after seven years in office. With firm control of both houses, it is now expected the Prime Minister will advance a rise in consumption tax from 8 to 10 percent in the fall. Japanese commentators noted that most Japanese prefer to have a strong and familiar leader at a time when the global environment is threatening, a budding trade war with South Korea, ongoing tensions with China and difficult trade talks with the U.S.

Ukraine – Exit polls in Ukraine indicate that President Volodymyr Zelensky's the Servant of the People's Party won 43-44 percent of the vote, but fell short of securing an outright ruling majority. Zelensky has promised cleaner government and has maintained Kiev's defiant stance towards Russia and ruled out the pro-Moscow Opposition Platform-For Life party. The pro-Russian party finished second with 11-13 percent of the vote.