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The KWR International Advisor Macro-Outlook

July 29, 2019

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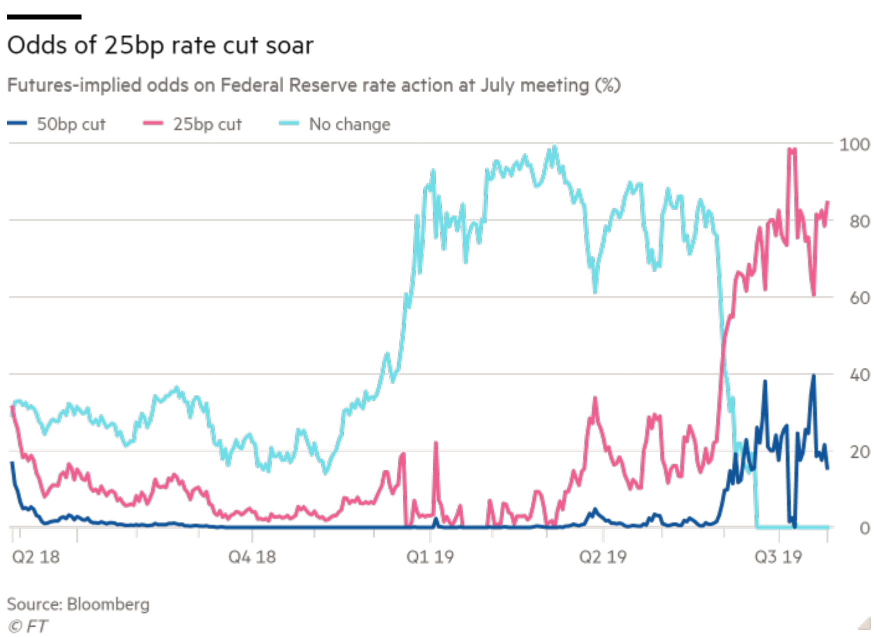
The Perils of Global Growth

Summary: All eyes are on the Fed as the U.S. central bank meets on Wednesday. Consensus is for a 25 bps cut (80% chance), which is what we expect. The big question is what comes next? Most likely the Fed will hedge its language, indicating that another cut is probable later in the year – but that will depend on the data. The likely central bank cut will reinforce the shift in global central banks to more accommodative policies. Other central banks have already taken new measures to improve liquidity; the Bank of Japan meeting on July 30 should reflect ongoing accommodation, keeping its key interest rate at negative 0.1%. Other items to watch in the week ahead include more earnings (among them: Advanced Micro Systems, Mastercard, and General Motors), U.S. jobs reports (end of week with a forecast of unemployment unchanged at 3.7%) and U.S.-China trade talks (we do not have high expectations). There should also be more on what the UK's new prime minister, Boris Johnson, will do; Hong Kong protests, and Persian Gulf tensions. There is a lot of uncertainty out there, which is likely to increase.



Will a 25 bps Fed cut and other central bank actions be enough to stave off a cooling global economy? That question is likely to dog governments and their central bankers through the rest of the year and into 2020. Moreover, the more the world tilts into a trade war mode, the greater the risk there is of a slowdown. Last week the International Monetary Fund (IMF) released an interim report on the global economy, indicating that global growth "remains subdued" with world output shifting from 2018's 3.6% to 3.2% in 2019 and 3.5% in 2020. Growth in the advanced economies slips from 2.2% in 2018 to 1.9% in 2019 and further in 2020 to 1.7% (with a considerable slowdown in the U.S.). One of the main causes for the cooling of global economic growth is trade (no shocker here).

Overview of the World Economic Outlook Projections (real GDP %)

	2017	2018	2019	2020	Change in 2019 from April Forecast
World Output	3.8	3.6	3.2	3.5	-0.1
Advanced Economies	2.4	2.2	1.9	1.7	0.1
United States	2.2	2.9	2.6	1.9	0.3
Japan	1.9	0.8	0.9	0.4	-0.1
Euro Area	2.4	1.9	1.3	1.6	0.0
Germany	2.2	1.4	0.7	1.7	-0.1
France	2.3	1.7	1.3	1.4	0.0
Italy	1.7	0.9	0.1	0.8	0.0
United Kingdom	1.8	1.4	1.3	1.4	0.1
Canada	3.0	1.9	1.5	1.9	0.0
Emerging and Developing Economies	4.8	4.5	4.1	4.7	-0.3
China	6.8	6.6	6.2	6.0	-0.1
Russia	1.6	2.3	1.2	1.9	-0.4
India	7.2	6.8	7.0	7.2	-0.3
Brazil	1.1	1.1	0.8	2.4	-1.3

Source: https://www.imf.org/en/Publications/WEO/Issues/2019/07/18/WEOupdateJuly2019.

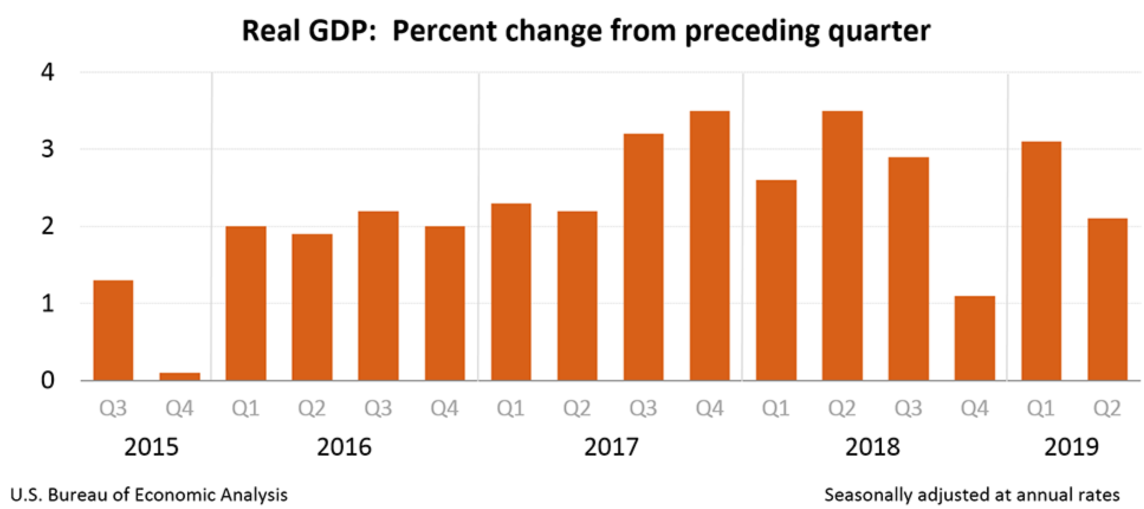
What was noteworthy in the IMF report was that risks in the forecast were mainly to the downside. As the IMF stated of the risks, "They include further trade and technology tensions that dent sentiment and slow investment; a protracted increase in risk aversion that exposes the financial vulnerabilities continuing to accumulate after years of low interest rates; and mounting disinflationary pressures that increase debt service difficulties, constrain monetary policy space to counter downturns, and make adverse shocks more persistent than normal."

The IMF report specifically mentioned the need to reduce tensions and uncertainty over trade agreements, including between the UK and the European Union, the free trade area encompassing Canada, Mexico, and the US (now held up in the U.S. Congress and probably not to see passage until after the November 2020 U.S. elections), and between the U.S. and China. It also warned, "…countries should not use tariffs to target bilateral trade balances or as a substitute for dialogue to pressure others for reforms."

Considering that language, we would add the increasing path toward more narrowly gauged nationalistic trade objectives (in which one side wins and the other loses) is on the upswing. Tariffs have become the weapon of choice for the Trump administration, with some of the latest tariff threats being leveled against first Mexico and then Guatemala on the immigration issue. Japan and South Korea are also locking themselves into a potential trade war, motivated in part by historical issues.

Policymakers should remember that when the global economy threatened to slip into another Great Depression in 2008, it was a concerted multilateral effort among the G20 nations that averted a repeat of the 1930s. Indeed, it is generally agreed that one of the major causes of the 1930s depression was the passage of high tariffs in the U.S. under the Smoot-Hawley Tariff Act (1930), which provoked retaliatory measures by other countries, the cumulative effect being a sharp decline in international trade and reduced growth. While central bank accommodative policy is needed to help stimulate economic expansion, it is likely that it needs to be complemented by government actions and multilateral efforts.

This puts the U.S. economy's Q2 2019 real GDP into focus…



The U.S. economy slowed in Q2 2019 to 2.1%. Although this was down from Q1's 3.1%, it remains at a healthy clip, reflecting strong consumer demand (up 4.3%). The main reasons for the slower pace were trade tensions and uncertainties over economic policy. In particular, businesses assumed a more cautious approach, causing a key indicator of their investment, nonresidential fixed investment (includes spending on software, research and development, equipment and structures), to decline by 0.6%, compared with a 4.4% rise in Q1. Trade was a brake on growth as exports fell at a 5.2% rate while imports increased marginally, expanding the trade deficit.

Q2's consumer spending made up for some of the lost ground in trade and nonresidential fixed investment, easily beating Q1's anemic 1.1% pace. Indeed, Q2 consumer spending was the strongest since late 2017.

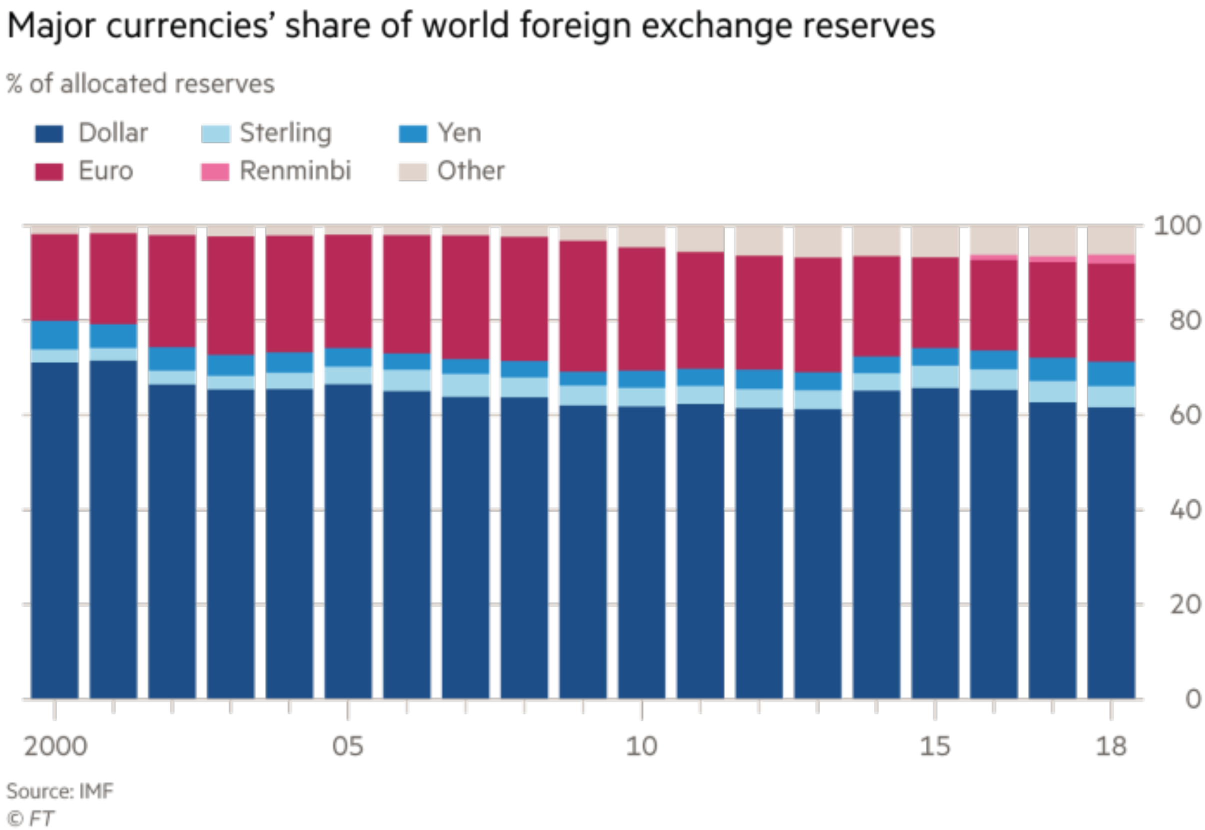
What to take from the Q2 2019 real GDP number?

> **1. The slower pace of economic expansion is likely to make it easier for the Fed to make a 25 bps cut.** At the same time, strong consumer spending indicates the U.S. economy is not about to collapse any time soon. We see the Fed splitting the difference, making the 25 bps cut, but leaving the language open to possible further cuts if growth slows any further.
>
> **2. President Trump will continue to heckle the Fed**. He tweeted that Q2 growth was "not bad considering we have the very heavy weight of the Federal Reserve anchor around our neck." Trump would be quite happy to see rates go much lower as he needs an economy in strong growth mode to win reelection in 2020.
>
> **3. We expect that markets will look to the Fed to make up for the uncertainty represented in U.S. trade policy side and how it is affecting U.S. business**. Corporate America is going to remain cautious. During Dow's (a major materials company) earnings call, its CEO Jim Fitterling stated, "The macro environment is cautious, largely driven by geopolitical volatility and prolonged trade negotiations, which continue today." Thus far earnings for the S&P 500 are their slowest since mid-2016.

The U.S. remains the fastest expanding economy in the G7. Deregulation, a tax cut and a still relatively accommodative Federal Reserve (despite the U.S. President's complaints) have pushed growth along at a pace well ahead of Germany, France, Japan and the UK. While the consumer continues to be the motor for growth, there are some serious weaknesses, including a lack of fiscal discipline, rising public sector debt, and a stalled housing market. The Trump administration's plans are to keep the economy moving through 2020 and to have victory over China and possibly Europe in trade wars. However, not everything goes according to plan. As comedian Woody Allen stated, "If you want to make God laugh, tell him about your plans."

Currency wars?: President Trump has repeatedly suggested the U.S. should intervene to weaken the dollar in response to what he said was currency manipulation by competitors (namely China and Europe). However, two of the President's closest economic advisors remain opposed. Larry Kudlow announced on July 26th that the U.S. has "ruled out" intervening in the markets. It is known that Kudlow as well as Treasury Secretary Steven Mnuchin are strongly opposed to this. White House trade advisor and China hawk Peter Navarro has argued for currency intervention.

We believe that talk about intervention could re-emerge if there is a surge in the dollar's value vis-à-vis either the euro or renminbi. Another scenario would be if the U.S. economy slows, the weaker dollar option could resurface in President Trump's mind. This clearly has a major impact around the world considering that the dollar remains the dominant currency and constitutes the bulk of world foreign exchange reserves.



Johnson on the Iron Throne: For those not acquainted with the Game of Thrones, the Iron Throne was the prize to be captured. However, the Iron Throne was a difficult to capture and many of those who sought it perished in the struggle. Being prime minister of the UK has assumed some of those characteristics. Since the Brexit vote in 2016, the country has had three prime ministers, David Cameron, Theresa May and now Boris Johnson. What lies ahead is a treacherous political landscape – Johnson's new hardline Brexit administration will face a vote of no confidence at some point; pressures for a new election have mounted; and the UK is supposed to depart from the EU on October 31st, 2019. That date looms.

What to expect from Prime Minister Johnson? Our most likely scenario is a no deal Brexit; possibly a new general election; and a rapid pace U.S.-U.K. trade deal (if Johnson survives a new election). The UK confirmed that talks between the two leaders had taken place in late July and that they would meet at a G7 summit in Biarritz, France in August. The British prime minister's office also stated that Trump had expressed his commitment to an "ambitious free trade agreement" with formal talks to start "as soon as possible after Britain leaves the EU." We will see if King Boris lasts long enough for a treaty agreement with the U.S. Bets anyone?

Hong Kong continues to spiral into political instability. Over the past weekend the Special Administration Region (SAR) was rocked by some of the worst clashes between police and demonstrators yet observed. The protests, ignited by an extradition bill that would allow suspects to be sent to China for trial, have sparked the SAR's worst political crisis since its handover from the UK to China in 1997. While the government initially backed down by putting the extradition bill on hold, pro-democracy groups have been critical of the authorities for not agreeing to any further demands such as an independent inquiry into police conduct.

Hong Kong's situation is an increasingly sensitive issue for President Xi Jinping. Facing economic pressures from the trade war with the United States as well as concerns from hardliners that Hong Kong's demands for more political freedoms could spread, the Chinese leader appears to be gradually putting more paramilitary forces into Hong Kong and playing harder to bring matters under control without yet using the iron fist of the People's Liberation Army (PLA). The problem is that the political unrest in Hong Kong is beginning to hit the local economy. Support for Hong Kong's pro-democracy forces from Taiwan is also helping stir the cauldron.

Protests are now reaching out to Hong Kong's international airport. The Cathay Pacific Airways Flight Attendants Union has been called upon by some of the protesters to "stand up for human rights" and use protest in Kong Hong airport's arrival hall to "tell people from all over the world" about the situation in the city. If the protests spread to the airport in a meaningful fashion, we believe the chances for a more fulsome Chinese demonstration of control will be forthcoming. **In a departure from Beijing's usual caution in making statements over the SAR, a Chinese military spokesman stated that the Hong Kong government could request that the People's Liberation Army (PLA) be called to "restore order." This has the potential to be a replay of Soviet interventions into Hungary in 1956 and Czechoslovakia in 1968, not a pretty picture.**

No doubt China wishes to avoid using outright military force on Hong Kong, but the rising pressure from demonstrators could eventually force President Xi to act. **If the PLA were used to crush the demonstrations, Asian markets would certainly feel the impact. International markets would also pause to assess what such an action means and how the U.S. and other countries respond. This situation needs to be watched closely and is rising as a geopolitical risk for global finance.**