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Elevated uncertainty slows growth despite lower rates

■ Business surveys in the US paint a diverging picture: manufacturing is worsening significantly but services have picked up nicely. Taking a broader perspective, evidence is building of a slowing economy ■ Less dynamic growth can be observed in engines of growth of the world economy: China and India, although reasons differ ■ In Europe, Germany is probably already in a technical recession whereas France is resilient ■ Central banks are back in easing mode but the effectiveness will be hampered by elevated uncertainty, despite the announcement of a new round of trade negotiations between the US and China

The global manufacturing slowdown has finally reached the US. The latest Institute for Supply Management's report for this sector provides sobering reading. The overall index dropped 2.1 percentage points to 49.1 with the new orders component as well as the employment index registering even bigger declines.

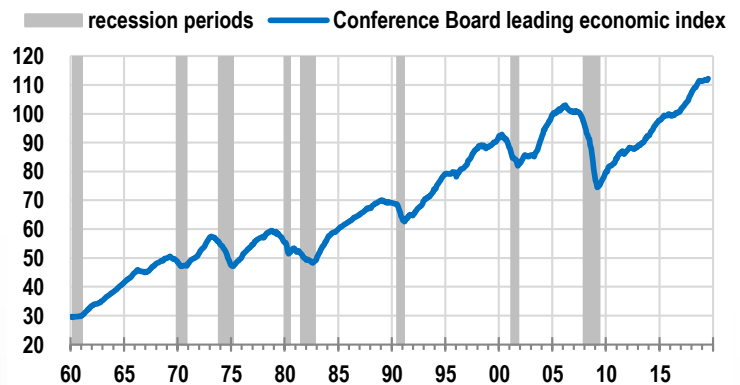
More telling are the comments from survey respondents. In the chemical products sector business is still strong but "there is an undercurrent of fear and alarm regarding the trade wars and a potential recession." Somebody from the machinery sector stated that "business is starting to show signs of a broad slowdown." One manufacturer commented that "we continue to plan for a hard Brexit and a long trade war between the U.S. and China."

Other sectors were however more positive, something which is echoed in the Federal Reserve's Beige Book¹: "the economy expanded at a modest pace through the end of August. Although concerns regarding tariffs and trade policy uncertainty continued, the majority of businesses remained optimistic about the near-term outlook." Those who want to argue that the glass is still half full can refer to the non-manufacturing ISM index, which in August jumped 2.7 percentage points to a healthy 56.4%. Yet, when taking a broader perspective, it is clear there is more at work than tariff-related shocks and uncertainty which are hitting the manufacturing sector: the underlying trend is one of slowing growth. Analyst forecasts of corporate profits have been scaled back, which doesn't bode well for company investments. Growth in residential construction has been negative in recent quarters on the back of a declining trend in affordability and it is unlikely this will change in the near term. For household spending, a lot will depend on how the labour market is doing. For the moment, it remains rather strong although job creations in August came in below expectations.

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¹ The Beige Book is a publication of the Federal Reserve System. It provides a description of current economic conditions and prospects across the 12 Federal Reserve Districts. Anecdotal information gathered by each Federal Reserve Bank is a key input for this report.

THE CONFERENCE BOARD LEADING ECONOMIC INDEX



Source: Conference Board, NBER, BNP Paribas

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Looking beyond the US, evidence of slower growth continues to mount. In China, the slowdown is accelerating as the country is confronted with an uncomfortable combination of a trade conflict with the US, a need to rebalance the economy away from being export and investment-led to becoming consumer led, increasingly cautious households and a policy mix which needs to find a balance between need for stimulus and keeping an eye on stability goals. This implies that monetary policy easing will be gradual and prudent whereas currency depreciation should remain moderate. Fiscal policy on the other hand is supportive for growth. India is also seeing a significant weakening of growth: households adopt a more cautious stance on the back of rising unemployment, declining confidence and a deceleration in non-bank credit.

In the eurozone, German data continue to deteriorate, with a still considerable difference between the manufacturing sector and services, which had been resilient until quite recently. The latest Ifo report also showed a deterioration in services. The Bundesbank also reported that the problems faced by the manufacturing sector were starting to spread to the broader economy. Growth in France however continues to be resilient. In Italy the formation of a new government, has been met with relief because new elections have been avoided. The positive market reaction should provide some support for an economy which is growing at a very slow pace. Finally, in the UK, Brexit uncertainty remains huge and acts more and more as a lid on the economy.

Over the summer months, the demand for safe assets has been boosted by the combination of slowing global growth, the prospect of generalised central bank easing and further increases in uncertainty. Risk hedging strategies have acted as an accelerator, causing a big drop in treasury yields in August which was disproportionate given the data released during the month. This had global repercussions and in the eurozone, 10 year Bund yields even dropped below -70 basis points at some point. The German government even issued a 30 year bond with a negative yield. Unsurprisingly, investor enthusiasm was lukewarm. The moves in treasury yields have caused a further inversion of the US yield curve, which has increased talk about a looming recession. This assessment is however not confirmed by data from the real economy such as the labour market or the Conference Board's index of leading indicators which do not yet display the typical pre-recession dynamics.

Nevertheless, the attitude of central banks is 'better safe than sorry' so more easing is to come, in the US, the eurozone but also in emerging markets, which benefit from the leeway created by the Federal Reserve rate cuts. The effectiveness however to a large degree hinges upon the decline in uncertainty. The announcement that US and Chinese delegations will meet to re-start the trade negotiations has boosted sentiment but, given that we have been there before, this begs the question for how long.

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