August 31st 2018

Mixed news on non-US growth:

1) Incoming data on growth in key economies outside the US (covering July/August) was mixed, with **slightly better-than-expected news from China offset by weaker data from Japan. The Euro area was in the middle**. The bigger picture message is that almost all non-US economies are experiencing weaker growth in 2018 than in 2017 (contrast with the US). Some smaller EM aside, expansions remain alive and well. **The Euro area and China are now probably doing better (in growth terms) than the market currently perceives (or fears)**.

2) In the **Euro area**, the most positive underlying growth news continues to come from the labour market, where **the persistent decline in unemployment is both a reflection of steady (above-trend) underlying growth and a support to future consumer spending** (Chart 1). The pace of decline in Euro area unemployment has slowed from where it was in 2017H2-2018Q1, which is a lagged response to slower growth. **The most encouraging July news came from Italy, where the unemployment rate fell 4-ticks, in sa terms, to 10.4%** (still well ahead of the regional average of 8.2%, plus the youth unemployment rate there remains at 31%). Cyclically, however, **the Euro area remains at a point similar to the US 4-years earlier where above-trend growth has become self-sustaining, supported by a monetary policy that remains wide-open**. Declines in US unemployment have moderated, simply because the stock is now far lower: in January 2010, Euro area unemployment was 16.1m, versus 15m in the US; in July 2018, those stocks were 13.4m and 6.3m, respectively). **German retail sales volumes were weak in July**, however, falling 0.9%m/m, sa, to be 1.7%, saar, below Q2. **I think unusually warm weather could be affecting European summer data**: the further north you go, the weaker the spending data seem to be (Sweden was very weak, but France posted solid July spending data versus Q2). Euro area flash August inflation fell a tick (relative to July), with headline slipping to 2%oya and core to 1%oya.

3) **China's official sector purchasing managers' indices ticked up slightly in August**, confounding expectations for a further decline (Chart 2). This **balanced the positive from recent stimulus against the continued drag from both trade worries** and a slowing supply-side. These official sector PMI data show much less volatility than their private equivalent.

Chart 1
Change in unemployment
'000m/m, sa, 6mma

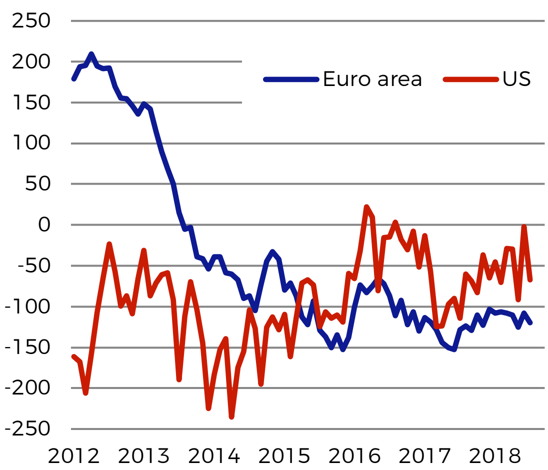
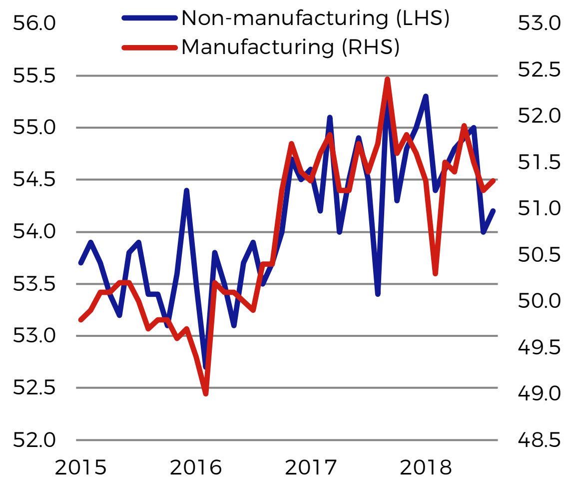


Chart 2
China: official sector PMIs
50 = stable activity



4) In some ways, **China today reminds me of the US a year ago, in terms of the policy cycle**. Back then, a major US fiscal policy easing was in the pipeline, but the consensus view was reluctant to embrace it (unsure it would happen but, more importantly, reluctant to embrace its logical Keynesian outcome). Partly reflecting that, USD fell by 11% between January and early-September 2017. Approaching the same point in 2018, CNY is down 5% year-to-date, but **China has put in place a combination of monetary and fiscal easing, which should show up in the economic data over the next 6-to-9 months**. **There are, of course, important differences, most obviously, the issue of trade tensions, which are sure to get worse in coming months**. Another is that **China's stimulus will likely be far less favorable to corporate earnings than was the case in the US**. This, combined with relative supply (the Chinese corporate sector is deleveraging as the US economy re-levers), argues that the US post-stimulus equity playbook may not be the right one to follow.

5) **Japan's real July data were generally weaker-than-expected**. Most notably, IP fell 0.1%m/m, sa (consensus had been for a 2-tick rise; last month, METI had projected a 2.7%m/m rise, based on company plans). The market consensus was that this weakness was largely driven by trade damage. While this is plausible, **I think another factor was extreme bad weather (flooding in July H1), which added more noise to an already volatile pattern of Japanese manufacturing in 2018** (Chart 3; while you are at it, check out recent US weakness). One support for this disruption view is that the METI production projection for August (which had been 3.8%m/m last month) jumped to 5.8%m/m (and September was penciled in at +0.6%m/m). This implies a production disruption story to me (trade damage implies more persistent losses). The unemployment rate rose to 2.5%, sa (where it was earlier in the year). The quirk of recent months has been that the sa unemployment rate has been more volatile than the nsa rate. Finally, note that **inflation is picking back up**. **The Tokyo-area measure ex-food-and energy** was up 0.2%m/m, sa, and its 3m/3m, saar, growth rate has **jumped back to 0.8%**, having been as low as -0.7%, saar, just 2 months ago.

Chart 3
G3: manufacturing production
%3m/3m, saar

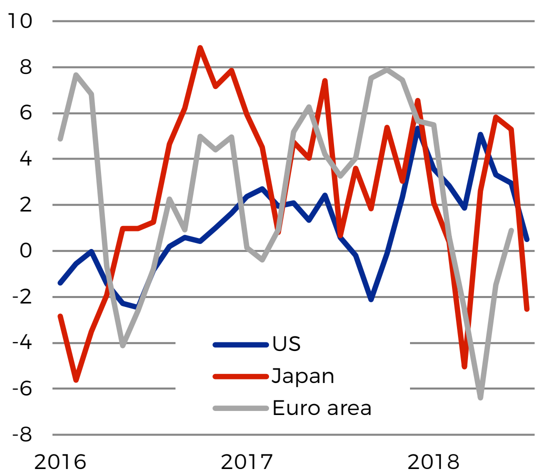
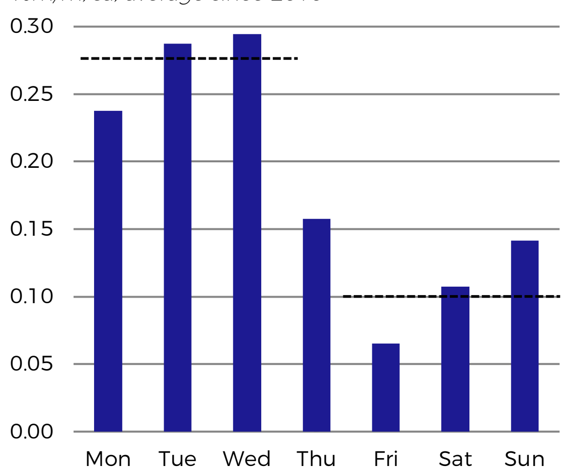


Chart 4
Monthly AHE gain according to day of 12th
%m/m, sa, average since 2010



6) **Brazilian real GDP was surprisingly positive in Q2, given the disruptions of volatile markets and the truckers' strike** (and reported IP, which was down 9.7%q/q, saar). GDP was posted at 0.8%q/q, saar (the third straight anemic quarter; it was up 1%oya). **2017's solid recovery has thus been interrupted in 2018**. The 2019 outlook is something of a binary call on who wins the October election (I will be focused on this topic in my weekly note, next Wednesday).

7) Looking back on August, **the most notable aspect is extreme divergence in asset market performance**. We have had some very severe crashes in EM FX (most notably ARS, down 41%, and TRY, down 34%; but ZAR is 12% and BRL 11% weaker). Despite this, the Nasdaq is up about 6%. **It is interesting to contrast this performance with the EM-driven crisis of August 1998**. Then, the Nasdaq fell 20% (although it subsequently soared 46% between September and year-end). **The difference, of course, is the actual and perceived strength of the US financial system**. In 1998, EM trauma spread to US institutions (mainly through the woes of LTCM). This time, there is not a hint of contagion or difficulty (yet).

8) **The week ahead**. **Global trade policy issues will remain will front and center**: NAFTA renegotiations continue (as of now, no agreement has been reached, with agricultural tariffs an obvious sticking point). Most importantly, **the announcement of the next (and by far larger) round of 25% tariffs to be levied on $200 billion of Chinese imports could come as early as next week**.

   a) **The Americas**: **Aug payrolls (Fri)** are the key US release: **employment is expected to rebound** (consensus 190k) after a weak-side 157k reading in Jul. Year-to-date, payrolls are up an average 215k m/m; a consensus outcome on payrolls would leave the last 3m average at 200k (seems right). **The unemployment rate** is expected to be unchanged, at 3.9%, but **could edge back down to 3.8%** (given the strength in claims, payrolls and the labor differential in the consumer confidence survey). We are due some upside in average earnings at some point, but **the timing of the August survey** (12th was a Sunday) **tends to bias down the m/m gain** (when the 12th occurs in the last 3 days of the week, the average m/m gain is about 17bp below when it occurs in the first half; Chart 4). The manufacturing ISM (Tue) is expected to edge down again, to 57.8 (Jul was 58.1; cons = 57.6). The **Bank of Canada** meets (Wed) but will remain on hold. I would expect a 3rd hike for 2018 at the October 24th MPR meeting; if a 4th is needed, it would be in December (5th; unlikely). Brazil's Aug CPI (Thu) may reflect more FX weakness, pushing the rate above 4.5%oya. **Argentine Treasury Minister Dujovne will be visiting the IMF and has promised more fiscal detail**.

   b) **Europe**: In the Euro area, the round of regional PMIs (Manufacturing Mon; Services, Wed) is expected to confirm the stability evident in the flash. Of more interest could be relative performance (e.g. Germany better than Italy). The main regional event will the **Riksbank meeting (Thu)**. We are approaching make-your-mind-up time and **I think the Bank will signal (via their rate projections) that they plan to hike in 10bp increments at policy decision meetings (6 per year), starting in October**. **Recent SEK weakness amid OK growth and confidence readings support this view; although inflation and inflation expectations have remained at target, underlying measures have slipped, giving Governor Ingves—the key voice (IMHO)—an out to delay should he so wish**. In EMEA, the focus will be on **damage in fragile economies**, specifically, **Turkish Aug CPI** (Mon) which should reflect deep TRY depreciation on August and **South Africa's Q2 GDP** (Tue), which could also look weak (Q1 was down 2.2%q/q, saar).

   c) **Asia**: The private sector round of China's PMIs (manufacturing Mon; services Wed) could be a little weaker than the official set released Friday (more global exposure). The **Aug FX reserve data (Fri)** will also be a focus to see **how much (if any) support CNY received from intervention**. The RBA meets (Tue): firmly on hold.