Quarterly Economic Outlook
Q4 2019

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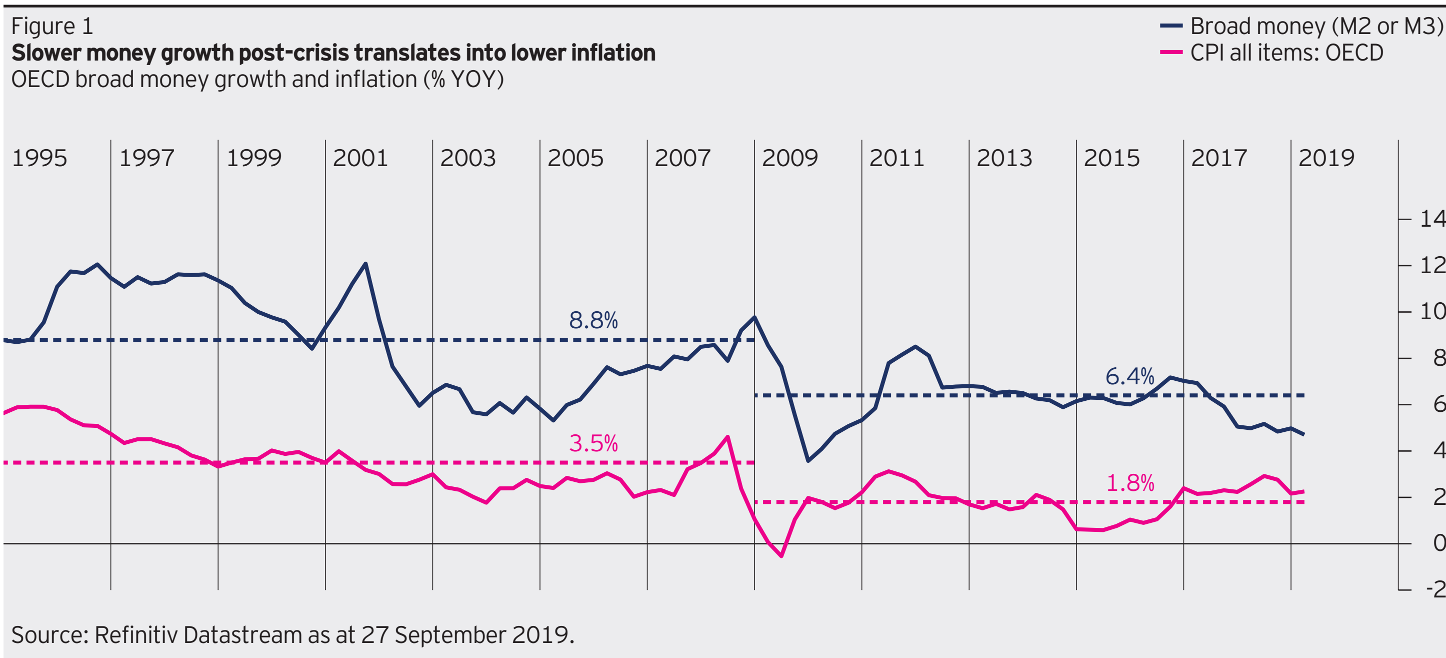
Overview

- The global growth outlook has weakened further during the past quarter, with the contrast between manufacturing and service activity becoming more pronounced. President Donald Trump's tariff measures, though modified to a degree, continue to affect global trade volumes and business expectations adversely.
- In response to the widespread softening of manufacturing, central banks have reduced interest rates modestly where they have space to do so, for example the US Federal Reserve (Fed), or as in the case of the European Central Bank (ECB) there has been a re-start of asset purchases (quantitative easing) and new lending to banks, for example, targeted longer-term refinancing operations (TLTROs).
- At the same time the targeted consumer price inflation in many developed economies such as the US, the eurozone, and Japan remains well below the intended rate of 2%.
- The fundamental driver behind sub-par growth and inflation remains inadequate monetary growth, which in turn is a result of higher capital and liquidity requirements imposed on the banks under Basel 3, and in the eurozone and Japan, flawed implementation of QE.
- The consequence of this cumulation of slow money and credit growth is nominal GDP growth of at least 1-2% less than it would otherwise be across the developed world. Note that it is not the central bank balance sheets or QE that drives spending (nominal GDP), but broad money growth – i.e. M2 or M3, depending on the economy, and broad money growth has generally been too low despite QE.
- US – A recent sharp spike up in repo rates indicates short-term financing pressures in the wholesale and securities funding markets but does not imply that the Fed needs to raise interest rates. Already the Fed's two rate cuts have produced a considerable acceleration in money and credit growth.
- I expect the current US business cycle expansion to continue without overheating or inflation. After the stimulus from President Trump's tax cut in 2018 the US is now facing the problem of financing the increased federal deficit. This will imply some crowding out of private sector borrowing and spending, but not necessarily a spike in rates.
- Eurozone – The Euro-area, especially Germany, has been hit by slowing manufacturing and exports, but service sector activity has remained more buoyant. Eurozone inflation (at 1.0% in August), is well below target.
- UK – With the accession of Boris Johnson as Prime Minister the Brexit debate has become much tenser. The problem is that while the people voted for Brexit three years ago, parliament refuses to deliver it.
- Against a backdrop of uncertainty over the Brexit prospects and the Bank of England (BoE) allowing growth of M4x to slow to 2%, it is no surprise that the economy remains in low growth mode, with inflation falling below 2%. However, once the "regime uncertainty" is out of the way, there is no reason why the UK should not resume growth at normal rates.
- Japan – Revised figures show that Japan's real GDP grew at 1.75% on average in Q1 2019 and Q2 2019. Headline and core-core (i.e. excluding food and energy) inflation for August fell to 0.3% and 0.4% year-on-year respectively, far below the Bank of Japan's (BoJ) 2% target. Again, this is basically because the BoJ's qualitative and quantitative easing (QQE) is not working to increase the quantity of broad money.

- China – With the US holding off from agreeing any trade deal, Chinese exports have languished, growing at an average of only 2.2% year-on-year in US$ terms over the six months to August and will continue to suffer. Domestic growth is also slowing. The authorities have responded with further monetary measures (cutting the reserve requirement rate in September), but these are not likely to turn the economy around quickly (as in 2009-10).

- Commodities – The expectation of lower interest rates in the US and the continuation of negative rates in Europe and Japan have temporarily driven up the gold price about 15% since the beginning of June. Tensions in the Gulf have also increased the oil price, but only slightly. However, these upward moves are the exception in the commodity complex. With global inflation low and domestic demand moderate at best, broad indexes of commodity prices are well below their levels in 2011-14 and are likely to remain subdued.

Figure 1
Slower money growth post-crisis translates into lower inflation
OECD broad money growth and inflation (% YOY)



Source: Refinitiv Datastream as at 27 September 2019.

Figure 2
Consensus & Invesco forecasts for 2019

(%)

	2018 Actual		2019 Consensus forecasts **(Invesco forecast)**			
Consensus Economics	**Real GDP**	**CPI inflation**	**Real GDP**		**CPI inflation**	
US	2.9	2.4	2.3	(2.4)	1.8	(1.8)
Eurozone	1.8	1.7	1.1	(1.2)	1.3	(1.5)
UK	1.4	2.4	1.2	(1.3)	2.0	(1.7)
Japan	0.8	1.0	1.0	(1.1)	0.6	(0.5)
Australia	2.8	1.9	1.9	(1.9)	1.6	(1.5)
Canada	1.9	2.3	1.5	(1.4)	2.0	(1.4)
China	6.6	2.1	6.2	(6.2)	2.4	(2.5)
India	6.8	3.4	6.1	(7.3)	3.6	(3.8)

Source: Consensus Economics, survey date: 27 September 2019.

Fiscal Fantasies

There are currently numerous ideas being advanced in several countries to the effect that:

- Monetary policy has run out of ammunition
- With interest rates at zero or less, monetary stimulus has reached its limits
- More fiscal spending is required to accelerate real GDP growth and overcome the inequalities associated with QE
- With interest rates so low, many public sector projects are profitable at current rates
- After years of reliance on extraordinary measures by central banks to rescue major economies, it is time to switch to fiscal policy

Although there is a widespread but superficial consensus supporting these ideas, the extent of agreement about them is likely to break down when concrete plans are developed. More seriously for the voting public who will have to bear the cost of implementing the schemes, the propositions are almost entirely false both with respect to their underlying premises and their likely policy implications.

First, the foundations of most of these assertions are shaky at best. For example, interest rates may have reached some sort of "lower bound" in Japan and the eurozone, but there are many ways to expand the quantity of money that have not yet been attempted. Although interest rates have been low, monetary policy in a quantitative sense has not been easy; money growth rates have been low across the board in developed economies (see Figure 1). In effect, the past decade has witnessed low interest rates but tight money.

Second, in a similar way, the relation between government spending and total spending or GDP is by no means as straightforward as many of its proponents would claim. In most cases increased government spending comes at the expense of reduced private sector spending, leaving overall spending broadly unchanged. Properly assessed, the multiplier on government spending – i.e. the number of US dollars of GDP created by an increase in government spending – is virtually zero, not two or three as some of the more ardent advocates might suggest. The reason is that this kind of analysis only looks at half the story. The underlying problem is that enthusiasts for government expenditures tend to focus on the spending but ignore the other side of the government's account – that is, how the incremental spending is financed.

There are in fact only three ways to finance an increase in government expenditures. First, the government can increase taxes, in which case individuals or firms will have less to spend, and therefore increased government spending will be offset by reduced private sector spending. Second, the government can borrow the funds, in which case there will be less funds available for private sector firms or households to borrow and invest. Third, the government can arrange for the additional government spending to be financed via the central bank or through the banking system by credit creation – in effect, by the printing of money. In this third case there is no doubt that total spending would rise, but that would also imply that increased fiscal spending is only stimulatory when it is financed through a sustained increase in the quantity of money, i.e. through monetary policy. Moreover, in this latter case the spending could equally well be done by the private sector. For these reasons the benefits of fiscal spending are largely fantasy.

One current adherent of the fiscal cure is President Trump. His tax cuts and accelerated depreciation under the Tax Cut and Jobs Act of December 2017, appeared to provide an immediate stimulus, helping the economy to grow at 2.9% in 2018 compared with 1.6% in 2016 and 2.4% in 2017. However, the federal deficit is now expanding rapidly and will approach US$1 trillion in 2019 as government revenues have fallen and expenditure has increased. The funding of this awesome amount by the private sector was exacerbated by the Fed's run-off of its Treasury holdings, a process that continued until August.

Already the increase in the foreign exchange hedged cost for non-US investors buying Treasuries from late 2018 meant that foreigners had virtually ceased participating in US Treasury auctions. The crunch came on 16 September 2019 and over subsequent days. The coincidence of a large Treasury bond auction (US$54 billion) requiring settlement on the same day as corporate tax payments were due led to a dramatic increase in interest rates in the Treasury repo market with overnight repo rates rising sharply to 5-6%. This brings the argument above into sharp relief; either the authorities must crowd out private sector borrowing with higher rates, or they must step in and provide new funds to finance the enlarged deficit. On this occasion the Fed stepped in with a series of overnight and longer-term "reverse repo" loans ranging from US$40-US$100 billion.

Another high-profile believer in the fiscal fallacy is Christine Lagarde, recently appointed as the new president of the ECB, replacing Mario Draghi. Lagarde's first comments made clear that she wanted more fiscal spending from European countries that have the headroom to do it, adding that "central banks are not the only game in town".

Over the next few weeks and months we will see by which method the increased "Trump deficits" will be funded – either through borrowing from the private sector and some degree of crowding out households and firms from the credit markets, or by the Fed engineering an increase in the broad quantity of money on a sustained basis. Similarly, over the next year or two we will see whether any eurozone governments are willing to commit to higher fiscal spending and if they do, whether, in the absence of a change in monetary policy, this will have any sustained impact on spending and growth in the single currency area.

United States

Steady as she goes

During the first half of the year US real GDP has grown at a moderate rate of 3.1% in Q1 2019 and 2.0% in Q2 2019, giving an average of just over 2.5%. This is slightly ahead of typical estimates for the economy's potential growth rate of 1.9%, for example, from the Congressional Budget Office. At the same time, the labour market remains strong as monthly job gains have been solid, averaging 156,000 in the three months June-August 2019 compared with 143,000 in the three months March-May 2019. The labour force participation rate has risen steadily since May. Also, the unemployment rate has remained low at 3.7%.

While consumer spending has been rising at a strong pace, business fixed investment and exports have weakened. Household incomes have been supported by gradually increasing wage gains and high levels of employment, combined with on-going improvements in consumer balance sheets, according to surveys by the New York Federal Reserve. The main drivers here are rising home prices, rising equity prices and diminishing indebtedness relative to income. The strength of consumer finances is an important reason for confidence that the current business cycle expansion can continue for at least another couple of years, in contrast to the leveraged condition of households immediately prior to the financial crisis of 2008-09. In a broad sense, consumers have been gaining at the expense of businesses, as often happens in the second half of a business cycle expansion.

US businesses appear to have passed peak profitability for this cycle. While profits have still been rising, margins have narrowed and the strength of the dollar has crimped overseas earnings. In the same vein, core capital goods shipments, a lead indicator for business investment, appear to have reached a plateau, and new export orders (from the Purchasing Managers' Index) have been weakening. Housing continues to make progress, aided by declines in mortgage rates in anticipation of the Fed's two rate cuts. Again, housing is a lead indicator for numerous business sectors and is therefore encouraging for employment and for the purchases of a range of raw materials from timber to copper and steel. The Conference Board's measure of business confidence remains at or close to its high for the cycle. All these indicators suggest that business is not in bad shape but has undoubtedly been derailed somewhat by the global slowdown in manufacturing.

On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2%. Market-based measures of inflation compensation remain low at 1.3% while survey-based measures of longer-term inflation expectations are little changed at 2.8% for the year ahead in September. This subdued outlook has allowed the Fed to cut rates by 0.25% in both July and September to 1.75-2.00%. Although most of the focus of Federal Open Market Committee (FOMC) members is on interest rates, it is essential that underlying broad money growth – for M2 or for the now no longer published M3 – is maintained at sober and stable rates of something close to 4-6% p.a. (See Figure 3). Fortunately, this pace has been achieved for much of the past two years, although in the early part of the year growth tended to fall below this rate. However, between May and September the growth rate of M2 accelerated to a substantial 8% per annum on a 13-week annualised basis, the leading asset counterpart being bank acquisitions of Treasury bills. In other words, with the Fed terminating its run-off of securities holdings, the banks have become significant buyers of short-term government debt, contributing in turn to a significant upturn in monetary growth over the summer months.

A five-month period of monetary acceleration, such as we have seen in May-September, is probably not yet enough to move the dial on the US growth and inflation outlook, but it almost certainly does help to explain the buoyancy of the stock market following its corrections in May and August this year. The immediate triggers for those downturns were President Trump's trade measures against China, but the underlying support from a supportive monetary policy and an expanding business cycle should not be underestimated.

My forecast is for 2.6% real GDP growth and 1.5% CPI inflation in 2019 as a whole.

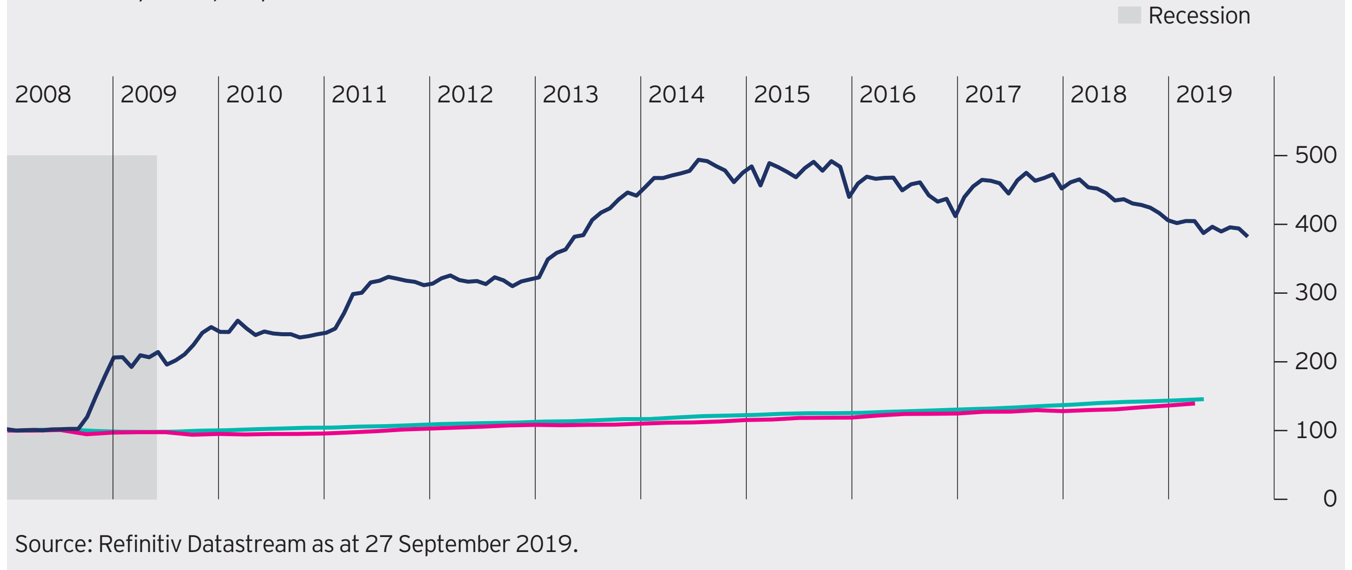


Figure 3
Broad money is the driver of spending (nominal GDP) in the US, not QE
US monetary base, proxy M3 and nominal GDP (Jan 2008 = 100)

Source: Refinitiv Datastream as at 27 September 2019.

Eurozone

A major split in the ECB conceals widespread misunderstandings
Probably the main development in the euro-area during the past three months was the decision taken by the ECB on 12 September – at Mario Draghi's last meeting as President of the Governing Council – to resume asset purchases of sovereign bonds at a rate of €20 billion per month from the start of November 2019 and with no end-date. The announcement that the ECB would add to its €2.6 trillion hoard of securities came along with decisions to cut the interest rate on the deposit facility by a further 10 basis points to -0.5%, to amend its subsidised lending to banks through the TLTRO scheme, and to introduce so-called "tiering" to protect the finances of euro-area banks.

These decisions convey three key messages. First, in practical terms as I have long argued, it shows that the previous asset purchases by the ECB have been a failure largely because they have been poorly designed. If they had been designed to acquire securities from non-banks this would have raised the rate of growth of M3 in the eurozone much more quickly and to a faster growth rate. This in turn would have increased spending growth across the eurozone and there would have been no need to resume QE purchases. Instead the ECB has decided to resume the same policy with the same failed methodology – buying securities from banks – which in my view will absorb substantial amounts of sovereign debt, essentially in an asset swap with the banks, without creating new deposits in the hands of firms and households but only on the books of the ECB itself. M3 growth will therefore likely continue to be too low and the eurozone will remain in its self-induced weak growth environment, low inflation, and negative interest rate trap.

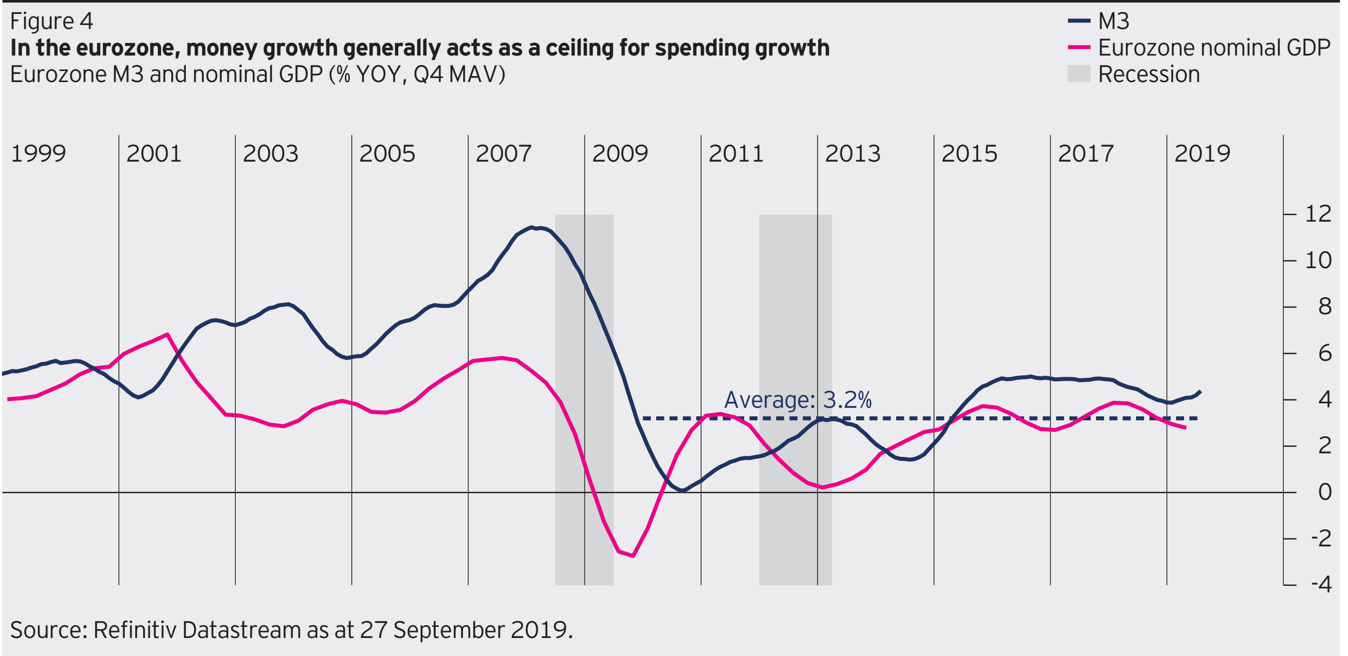
It is money in the hands of the public that drives spending and inflation, not money on the books of the central bank.

Second, in terms of economic theory, the ECB's decisions show that the majority of the Governing Council and its economists have mistakenly believed that lowering interest rates are the key to expanding bank balance sheets and the asset purchase policy gaining traction. However, given that euro-area banks are still struggling to meet the Basel 3 capital and liquidity coverage ratio (LCR) requirements and have barely expanded their balance sheets for a decade, lowering rates further into negative territory does nothing to encourage them to lend and thus expand deposits. The essence of QE, as clearly spelled out by Mervyn King (but not by Ben Bernanke) in 2009 was to increase the supply of money in the economy at a time when the banks were not lending and therefore not creating deposits, which are the major part of broad money. But this has never been the strategy at the ECB, even though bank lending in the eurozone remains very weak. Its failure to reach the 2% inflation target is a direct result of this misconceived strategy.

Third, the ECB's decision to resume QE purchases has subsequently revealed a sharp division of opinion within the Governing Council, with the heads of the German, Dutch, French and Austrian central banks all making public statements in opposition to the decision during the two weeks following the 12 September 2019 meeting. For example, Governor Klaas Knot of the Netherlands complained of low interest rates becoming "a quasi-permanent phenomenon", driving up house prices and causing falling pensions. On 26 September Germany's representative on the ECB executive board, Ms Sabine Lautenshläger, resigned her position, the third German to do so (following Axel Weber and Jürgen Stark, both in 2011).

Sadly, all this controversy reveals a series of misunderstandings at the highest levels of European monetary policy making. The Governing Council members are correct to be anxious about the impact of the ECB's negative interest rate policies on house prices, savers, insurance companies and pension funds – a huge and understandable source of discontent. Continued for long the effect of negative rates will be potentially devastating to the traditional ethics of savers and investors and to the business models of key financial industries across the eurozone. The problem is not with this view, which is entirely correct, but with the diagnosis of what has gone wrong.

Figure 4
In the eurozone, money growth generally acts as a ceiling for spending growth
Eurozone M3 and nominal GDP (% YOY, Q4 MAV)



Source: Refinitiv Datastream as at 27 September 2019.

There is a widespread misunderstanding in Europe that low interest rates indicate easy, that is, excessively expansionary monetary policy. But as I and others have long argued, interest rates are a very poor measure of monetary policy. The truth is that monetary growth, which is really what determines inflation, has been far too low in the eurozone ever since the crisis of 2008-09. M3 growth has averaged only 3.2% p.a. since 2009 – refer to Figure 4. The eurozone, like Japan, has had low rates but tight money. Low interest rates have not stimulated monetary growth nor have they been inflationary because Europe's commercial and other banks have not been willing to lend, either because they are not satisfied with borrowers' creditworthiness or because the banks themselves are struggling to meet regulatory requirements for capital and liquidity and therefore cannot extend loans at the same time. If banks do not create loans then their deposits do not grow and the growth of the money supply remains anaemic.

The answer to this problem is for the central bank – or the government in those countries like Japan where it is feasible – to take actions which create the required deposits, which, in turn, will create the conditions for reasonable spending growth, say 4-5% in nominal terms consisting of about 2% real growth and 2% inflation. The simplest way to do this is for the central bank to buy securities exclusively from non-banks, but not from the banks. Faster money growth in turn will generate expectations about future spending and inflation that will produce interest rates roughly in the range 3-6%, thus restoring the traditional incentives to save, invest and build long-term savings businesses. As Irving Fisher showed a hundred years ago, interest rates follow inflation, they do not lead it. Note that I am not advocating any acceleration of money and credit growth at double- digit growth rates, the long-standing bugbear of European savers; I am advocating only controlled steady and stable growth of deposits and money about 2-3 percentage points per annum faster than since 2009.

Irrespective of who heads up the ECB, it remains the case that euro-area aggregate demand (spending) is weak, and faster money and credit growth is still required. In view of the continued low M3 growth I forecast real GDP growth of 1.2% in 2019 and consumer price inflation of 1.5%, well below target.

United Kingdom

Political divisions hold back exit from the EU and constrain economic growth

The Brexit saga continues to dominate political debate in the UK while having negative effects on economic growth by maintaining a high level of "regime uncertainty" – a lack of clarity about the rules, regulations, tariffs, and competitive position of firms after the country transitions to its new relationship with the European Union.

With Boris Johnson winning the Conservative party's vote for the leadership by almost 2-to-1 in July, the UK has a new prime minister, but because there has been no general election the balance of seats in the House of Commons remains unchanged. In fact, for Mr Johnson's new administration the situation has worsened slightly as some Tories have refused to endorse his "deal or no deal" strategy of exiting the EU by 31 October. Already the Commons have voted to tie the government's hands by insisting on a deal with the EU before departure. In addition, on 23 September the Supreme Court annulled the prime minister's prorogation (suspension) of parliament – a strategy widely believed to be a device to limit the opportunities for parliament to frustrate PM Johnson's bid for a "do or die" exit on 31 October. The political atmosphere in parliament and across the country continues to be very heated and is unlikely to calm down until after there is much greater clarity about the future relationship with the EU.

The fluctuations in the Brexit debate continue to be reflected in two key areas: the foreign exchange market for sterling and the domestic investment scene. Elsewhere, in areas such as the labour market, personal consumption spending or inflation trends, the UK economy continues to perform much as it did before the referendum of June 2016.

In any economy with a floating exchange rate where the economy is subject to high levels of political (or other) uncertainty, the exchange rate is invariably the most sensitive barometer of developments on the political front. The reason is that if investors want to move capital out of the country, they must first sell their businesses or buildings and then sell the proceeds in the foreign exchange market. This was most striking in the case of Hong Kong when the Sino-British negotiations were being conducted in the early 1980s and resulted in a major collapse of the Hong Kong dollar. Currently the same logic applies to the British pound; greater prospects of a deal with the EU tend to strengthen the currency and vice-versa.

The question for the longer term is: what is the proper, or equilibrium value for the pound? On my estimates purchasing power parity for the pound against the US$ is between US$1.50 and US$1.60. With sterling currently trading around US$1.25 it is some 20% undervalued. Consequently, even if there is a No Deal exit from the EU it is hard to envisage the currency falling much below current levels for any extended period.

Concerning investment, the downturn in capital expenditures by businesses is abundantly clear in "hard data" such as the GDP data on fixed capital formation as well as in "soft data" such as the CBI surveys on plant and equipment expenditure and the state of order books (Figure 5). Unfortunately, these trends seem unlikely to change much until after the political and trading relationships between the UK and the EU are well on the way to resolution.

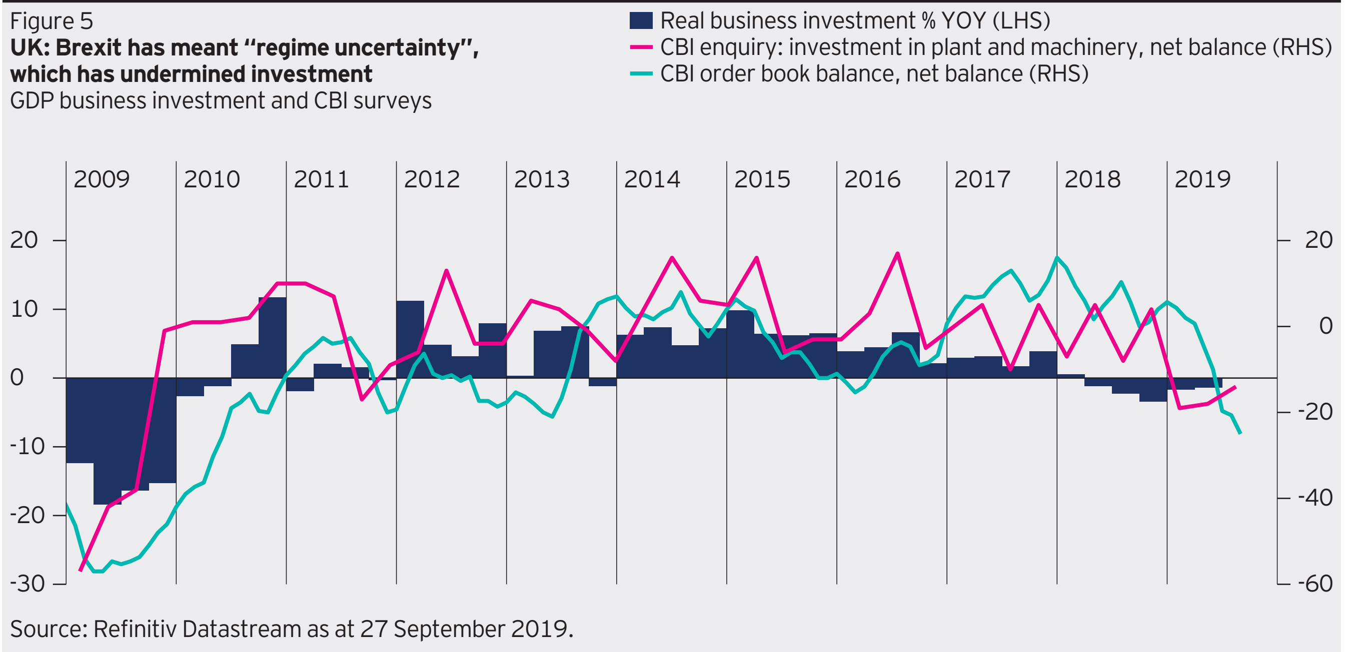
However, key areas of the economy remain relatively unaffected. For example, consumer spending has continued to stay buoyant with personal consumption expenditures in the GDP rising 2% on an annual basis in Q2 2019 from the previous quarter, and retail sales rising 3.3% over the three months June-August from a year earlier. The backdrop to this buoyancy is that the labour market remains very healthy with employment levels and participation rates at or near all time highs and unemployment continuing at just 3.8% – the lowest levels since the early 1970s. In addition, wages have been steadily improving. UK workers' total earnings, including bonuses, advanced by an annual 4% to £542 per week in the three months to July 2019, the fastest pace since the three months to June 2008, following an upwardly revised 3.8% gain in the prior period and above market expectations of a 3.7% rise. These positive signals suggest that the competitiveness and flexibility of the UK economy will enable it to survive and prosper after the transition to a new relationship with the EU.

On the monetary policy front the BoE has been shifting its ground. As previously reported here the BoE had been taking the strange view that Brexit would inevitably be an "inflationary event", meaning that a lower exchange rate and new, adverse tariffs would be passed through to businesses and consumers in the form of higher prices. (Note that this is not strictly inflation in the sense of sustained rises in prices but rather a one-time shift in relative imported prices.) Also, the BoE's framework in which rising aggregate demand was about to collide with the economy reaching maximum potential supply inevitably translated, in their eyes, into higher inflation, regardless of the monetary background.

In contrast with the official view, I have emphasised that the UK economy has been experiencing a period of very slow monetary growth as measured by M4x. This slowdown in M4x has been in effect since September 2018 and, in a monetary framework, was pointing to a much lower inflation environment. The results are now becoming evident: in the CPI report for August the headline figure was only 1.7% year-on-year while the core CPI printed as low as 1.5% year-on-year – both well below the BoE's 2% target. Too late to prevent a period of sub-target inflation key members of the BoE's Monetary Policy Committee have started, in recent speeches, to concede that inflation may turn out lower than they had previously forecast. It will be interesting over the next few months to hear what justification they give for their forecasting errors.

For 2019 as a whole I forecast 1.3% real GDP growth and 1.7% consumer price inflation.

Figure 5
UK: Brexit has meant "regime uncertainty", which has undermined investment
GDP business investment and CBI surveys



Source: Refinitiv Datastream as at 27 September 2019.

Deflationary pressures starting to show up

Over the past decade China's economy has gone through a roller-coaster. Initially between 2009 and 2016 there was a series of monetary and debt expansion episodes which have been followed in the past three years by the opposite – persistently slowing money and debt growth. Not surprisingly, the effects are now starting to show up in the economy.

On the monetary side the economy has been squeezed by a long, but gradual tightening of M2 growth. Since accelerating briefly to just over 13% year-on-year growth in the second half of 2015, M2 slowed to 8% in the final quarter of 2017 and has remained in the 8-9% range ever since. This is by far the slowest growth rate of broad money since the start of the Four Modernisations under Deng Xiaoping in 1978. Although the People's Bank of China (PBC), the central bank, has engaged in numerous "easing" operations – by cutting repo (interest) rates in 2018, repeatedly cutting the reserve requirement ratio for banks and injecting funds by means of money market operations – none of these actions have increased the money growth rate on a sustained basis over the past two and a half years. In June 2019 M2 growth remained at 8.5% year-on-year.

On the debt side, between 2009 and 2016 the central government and the regulators were willing to allow local government entities, state-owned companies and non-bank financial institutions to increase their indebtedness on a huge scale, all in the name of growing the economy after the shock of the global recession in 2008-09. But since 2016 there has seemingly been a sea-change in official attitudes.

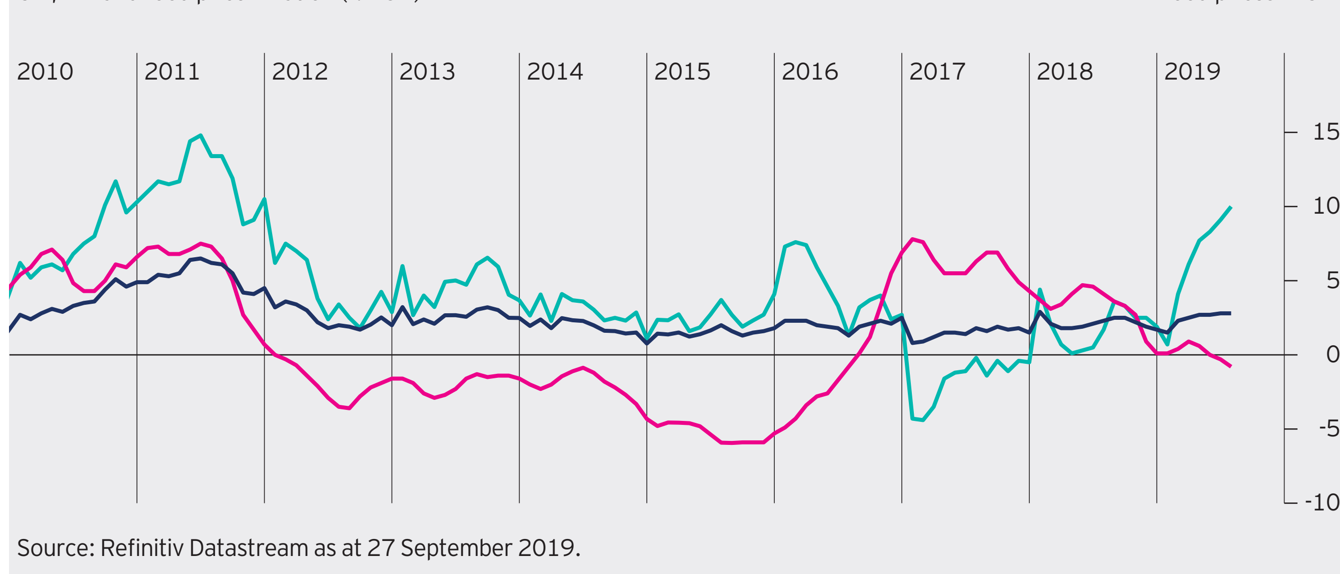
First to feel the impact of the new stance were the shadow banks. Funding to non-bank financial institutions was curtailed abruptly from the start of 2017 and continues to fall. Given the excess debt that had built up in the economy since the global financial crisis, the Chinese authorities announced almost three years ago that they were placing priority on de-leveraging the economy and financial system. In November 2017 a new co-ordinating committee on Financial Stability was set up directly under the State Council (China's cabinet) and chaired by vice-premier Ma Kai to supervise all aspects of monetary, debt and financial market developments. The need for better financial management has been given added urgency by the closure of three banks during the past few months. Baoshan Bank and Heng Feng Bank failed in the wake of corruption investigations, while Bank of Jinzhou was punished for regulatory violations.

More generally, many of China's industrial sectors have suffered from excess capacity problems due to capital misallocation, stemming in turn from the implicit government guarantee policy attaching to state-owned industries. Ending such guarantees is structurally positive for China's fixed income market as it addresses moral hazard and should improve credit pricing.

Returning to monetary topics, one of the intriguing developments in China recently has been the marked divergence of reported inflation trends. On the one hand the producer price index (PPI), which had slowed from 6.9% year-on-year in October 2017 to 0.6% in May 2019, fell to -0.3% in July and -0.8% in August. On the other hand, the consumer price index which had been range bound since 2012, has started moving upwards, led by food prices (Figure 6) hitting +2.8% year-on-year in August. Food prices have been impacted by the shortage of pork – China's staple meat source – following an epidemic of African swine fever, but this is clearly a sector-specific or relative price movement, not an indication that generalised inflation is imminent. Consequently, the move into negative territory by the PPI is a far better signal as to what is really going on in China than the temporary uptick in the CPI.

On the external side the trade dispute between the US and China has not eased up. From 1 September 2019 China and the US imposed additional tariffs on each other's goods in the latest escalation of their current confrontation. The US began collecting 15% tariffs on more than US$125bn in Chinese imports, including numerous consumer goods such as smart speakers, Bluetooth headphones and many types of footwear. In retaliation, China started to impose additional tariffs on some of the US goods on a list of US$75bn of goods. Beijing did not immediately specify the value of the goods that faced higher tariffs from 1 September, but the extra tariffs of 5% and 10% were levied on 1,717 items of a total of 5,078 products originating from the US. Included in the new round of tariffs was a levy of 5% on US crude oil marking the first time the fuel has been targeted. The Chinese authorities will start collecting additional tariffs on the rest of US imports from 15 December.

Figure 6
China: Food prices and producer prices diverging sharply
CPI, PPI and food price inflation (% YOY)



Source: Refinitiv Datastream as at 27 September 2019.

China (cont.)

The effects of President Trump's trade measures on China's trade and GDP growth are starting to have a significant impact. US imports from China have been falling since November and were down 12% year-on-year in July. China's share of US imports has fallen from a peak of 21.8% in March 2018 to 19.7% in July 2019. By contrast, US imports from South Korea and Taiwan were up 10.6% while US imports from the Pacific Rim (excluding Japan and China) increased by 5.4% over the same period. Some of the smaller East Asian economies such as Taiwan, South Korea and Vietnam are starting to see production and trade gains relative to China as parts of the international supply chain are shifted towards those economies not yet targeted by the Trump measures.

Looking ahead, given the range of China issues that the Trump administration is targeting – the theft of intellectual property, subsidies to state-owned enterprises, and the opening of domestic sectors to foreign competition – it seems unlikely that there will be any sustained truce in the trade war with China. Although the timing of the next US presidential election may encourage President Trump's team to declare victory at some point in 2019-20 and end the trade war, it is more likely that any suspension of US trade measures targeted at China is likely be temporary.

Japan

Despite the BoJ's huge QQE programme, broad money has not accelerated

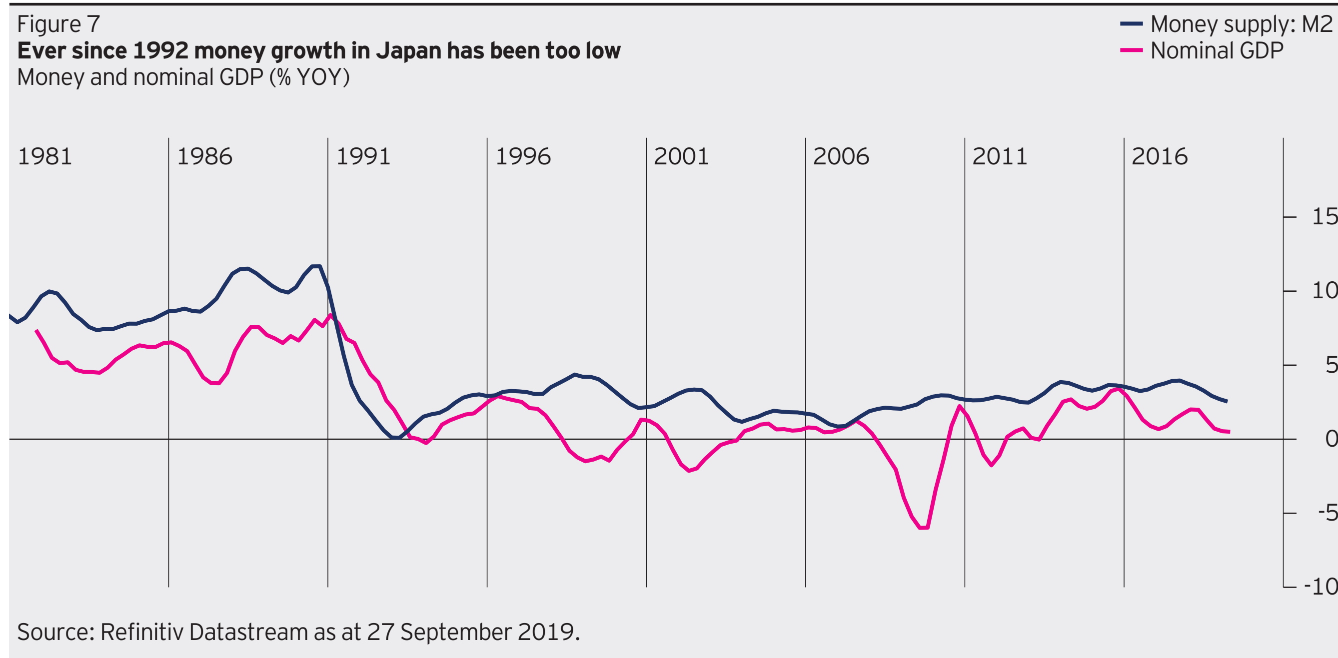
Revised real GDP data for the Japanese economy showed that it slowed from 2.2% at an annualised rate in Q1 2019 to 1.3% in Q2 (0.3% qoq). The private and public sectors each contributed 0.3% but there was negligible contribution from residential or non-residential investment. The slowdown in real GDP growth did not prevent Prime Minister Abe from finally implementing the twice-delayed increase of the consumption tax on 1 October, raising it from 8% to 10% – still a low figure compared with an OECD average of 19.2%. The tax increase covers almost all purchases, from electronics and alcohol to books and cars. The government has, however, made a few exceptions for magazines, newspapers and food items purchased for consumption off-site.

When the tax was last increased in 2014 the economy plunged into recession, so the government has taken some measures to try to forestall another downturn on this occasion. Nevertheless, there was clear evidence of consumers buying big-ticket durables ahead of the imposition of the higher tax rate. More generally, with Japanese wages basically unchanged over the past few years, underlying economic conditions remain fragile.

There are two key factors contributing to Japan's persisting economic weakness. First, on the real side, the population peaked in 2010 and the labour force (working age population aged 15-64) peaked in 1992. Declines in these key figures automatically limit the potential real GDP growth rate. Add to this the slowdown of labour productivity in recent years to just 0.7% p.a. since 2010 compared with 1.3% p.a. between 1990 and 2007, and it is easy to see why Japan's potential growth rate has slowed to 0.9% (according to Mizuho)[1]. Therefore, despite a very low unemployment rate of 2.3% in July and the highest levels of the job offers-to-applicants ratio (1.59% in July) for 45 years, wage growth remains tepid, and there are no signs of overheating in the economy.

[1] https://www.mizuho-ri.co.jp/publication/research/pdf/eo/MEA170321.pdf

Figure 7
Ever since 1992 money growth in Japan has been too low
Money and nominal GDP (% YOY)



Source: Refinitiv Datastream as at 27 September 2019.

Japan (cont.)

Second, the explanation for the weakness in nominal magnitudes – inflation, wages, GDP in current prices, etc – is entirely due to the perennially slow rates of broad money growth. Ever since 1992 Japanese M2 has averaged only 2.6% p.a., far too low to achieve the BoJ's 2% inflation target. Six years after his appointment and following his re-appointment in April 2018 for a further five years, Governor Kuroda at the BoJ has signally failed to raise Japan's consumer price inflation rate to 2%. This is despite large-scale asset purchases that have resulted in a near-quadrupling of the BoJ's balance sheet from JPY 144 trillion in March 2012 to 572 trillion in September 2019 under a much-trumpeted policy known as "Quantitative and Qualitative Easing" (QQE), supplemented since September 2016 by "yield curve control" (YCC).

On the latest figures (for August 2019) the headline national CPI increased by just 0.3% year-on-year, while the "core-core" CPI – which excludes food and energy prices – was up 0.4% over the twelve months. Something is clearly amiss with Japan's monetary policy, but the question is precisely where have things gone wrong?

As I have argued consistently over the past two and a half decades, the ultimate cause of the failure is that M2 has increased at an average pace of only 2.6% p.a. ever since 1992. This is despite the introduction of QQE and the BoJ's much vaunted YCC. Fundamentally Japan needs a growth rate of M2 of 5-6% p.a. This is derived from the quantity theory which requires a money growth rate that will satisfy the need to finance real growth (about 1%) plus the inflation target (2%) plus a further amount to satisfy the demand for increased money balances (another 2%). The reason the BoJ's policies have failed to meet this target is that instead of buying securities from the non-banks (which would create new deposits in the banking system), the BoJ has bought most of the Japanese government bonds (JGBs) for its QQE programme from the banks (which amounts to an asset swap with the banks, and does not create deposits or money in the hands of firms or households). Unfortunately, Japan's macroeconomic outlook will not change significantly until this basic problem with monetary policy is fixed. Whatever promises the BoJ may make, QQE and YCC are failing to restore Japan's inflation rate to 2%.

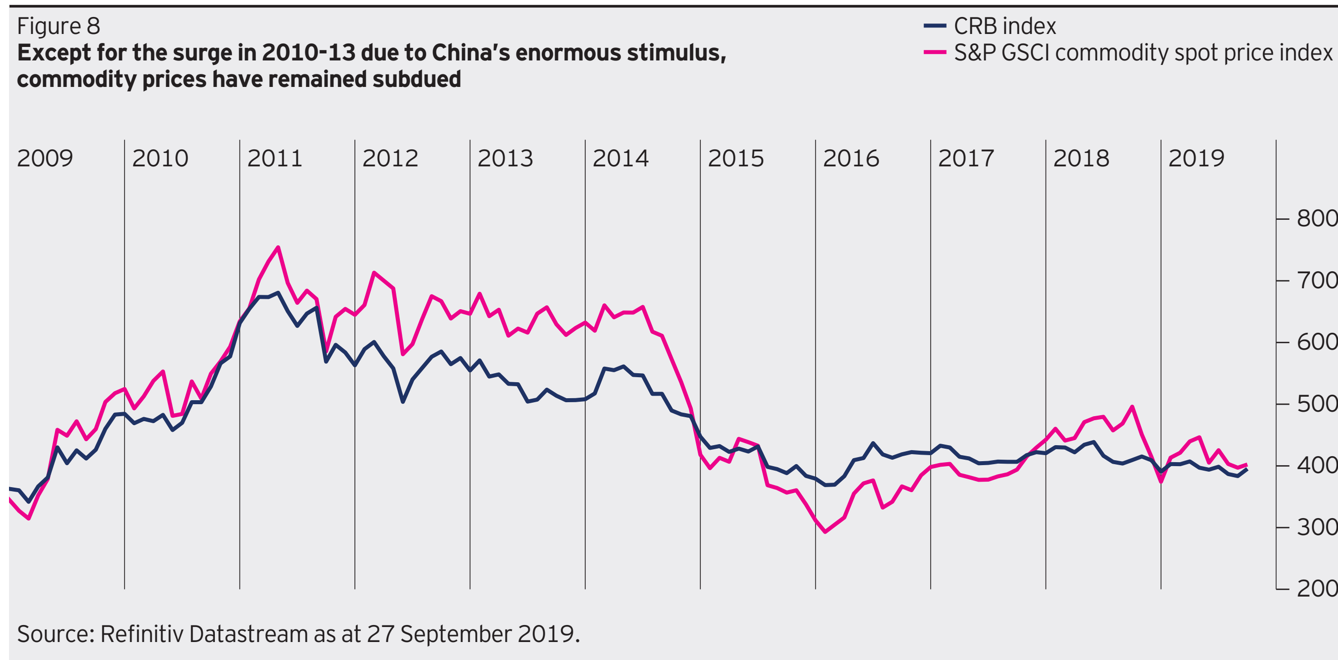
Commodities

The strength or weakness of global manufacturing is the key driver of industrial commodity prices. Indicators such as the PMI have continued to weaken through the first nine months of 2019, especially in the eurozone and in the UK. The buoyancy of manufacturing output evident in the more advanced economies such as the US and the eurozone during 2017-18 has completely vanished, and even some emerging markets are being adversely affected by the manufacturing slowdown. Based on the PMI indicators, manufacturing activity is contracting in the vast majority of advanced economies (and since August even in the US), as well as in China and Russia. Reflecting this continuing softening in manufacturing, commodity prices as measured by the Commodity Research Bureau Index (which excludes oil) and the S&P GSCI Index have mostly fallen in the second and third quarters of 2019.

The two main exceptions to the story of declining commodity prices in recent months are crude oil prices and gold. Brent and WTI crude prices spiked briefly when Iran attacked tankers in the Straits of Hormuz in June, with WTI prices rising from US$51 to US$60 over subsequent days, but by the end of September prices had fallen back to US$55 per barrel. The ability of the US to supply more shale oil relatively quickly and the decision by President Trump to make the US Strategic Petroleum Reserves available following the drone attack on Saudi Arabia's main oil refinery at Abqaiq have kept a lid on possible price rises.

The gold price has increased from around US$1,300 at the end of May to a peak of US$1,550 in early September. This appears to have been driven by two sets of factors. First, several central banks have been steadily buying gold over the past year, adding 651.5 metric tonnes to their official gold reserves in 2018 (according to the World Gold Council), up 74% from 2017 and the second highest yearly total on record. The central bank buyers have been led by countries like Russia, China and Turkey which have been in dispute with the US and therefore feel uncomfortable holding US dollar reserves that may become hostage to any further deterioration in diplomatic relations. The second driver has been the further shift into negative interest rates for yields on bonds across Europe and Japan. Rather than pay money to hold bonds, investors seem to prefer to hold zero-yielding gold.

Figure 8
Except for the surge in 2010-13 due to China's enormous stimulus, commodity prices have remained subdued



Source: Refinitiv Datastream as at 27 September 2019.

Conclusion

Global equity markets sold off in August but recovered most of the lost ground in September with the S&P500 US equity index approaching its all-time highs of July 2019. This is consistent with my long-argued view that asset prices are largely driven by monetary policy and the business cycle. With US consumer balance sheets in good shape, the non-farm payroll employment data holding up well in the three months June to August (with an average gain of 156,000), and inflation remaining below target, there is little or no reason for the Fed to tighten. On the contrary, the FOMC has now cut rates twice in a "mid-cycle adjustment" (according to Chairman Jay Powell) and could cut rates again to extend the expansion, which in turn means that the peak in risk assets such as equities and real estate could be some distance ahead.

The bond market, on the other hand, is driven by expectations about the direction of short- term rates and inflation. Following the Fed's pivot towards easier policy in the early weeks of 2019, the yield on 10-year Treasury bonds fell from 3.23% on 6 November 2018 to 1.46% on 3 September 2019, an exaggerated reflection of growing expectations of three rate cuts amounting to 0.75% by year-end. There was also some additional downward momentum for yields provided by continued negative yields in Europe and Japan. Since US money growth has been accelerating on a 13-week annualised basis since May (from 2% to over 10% in August) it is likely that the US economy will regain some momentum and bond yields will rise again. If continued, this would transform an environment of falling yields into one of rising yields as inflation concerns would start to replace the direction of short-term rates as the key driver of bond yields.

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30 September 2019

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