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Draghi trumps Trump

- **Unconventional behaviour US president largely ignored by financial markets**
- **Strong market response to Mario Draghi**
- **Divergence between US and European cyclical indicators continues**

The US president walking out on a G7 meeting because he had more important matters to attend was unprecedented. The US president withdrawing his support for the G7 joint communique was unprecedented. The US president sitting down with the leader of a rogue state was unprecedented. One might have expected financial markets to respond strongly to these events. Not so, markets yawned, apparently expecting this sort of thing.

While financial market players seem to not be surprised by president Trump's unconventional behaviour, I can't quite get used to it. Picking fights with your friends, throwing insults at your most loyal allies and then being best buddies with the leader of a state with a horrible track record on human rights and that poses a nuclear threat to the US seems odd behaviour to me. But who am I? And I do understand that the people you make peace with are your enemies. In the process, you will have to at least pretend to be friendly with them. Indeed, the historic visit of President Nixon to China in 1972 took place during the Cultural Revolution. Nixon was chatting friendly with Mao, who was murdering millions of Chinese at the same time.

To finish a busy week, president Trump OK-ed tariffs on USD 50 bn worth of Chinese exports to the US. This is not a huge thing in itself, but it is another step in the trade conflict. It is, at this stage, hard to see how this process can be stopped any time soon. China had, apparently, made concessions some weeks ago that it would buy more US stuff, but that clearly did not satisfy the US president. For Europe, the big thing hanging over markets is the threat of US tariffs on cars. Germany exports 500,000 cars annually to the US and other country are involved in the supply chain.

Draghi draws strong market response

While president Trump's actions left financial markets unmoved, ECB president Draghi's press conference had a big impact on financial markets. Over a short period of time, bond yields fell some 10bp, European equities gained over 1.5% and the euro lost three big figures.

That reaction, I must admit, surprised me almost as much as the lack of response to Trump. The ECB announced the end of QE, conditional on the economy behaving properly. ECB chief economist had more or less flagged that and while some of the detail may have been different from expectations, those differences cannot have been huge. What triggered the markets' reaction most likely was the ECB's shift to forward guidance and the commitment by Draghi that the ECB will not raise rates soon after the end of QE. We had always pencilled in the first rate hike in September 2019 and we are sticking with that forecast, but markets were expecting something more hawkish and are now moving to our view.

We also have a big question mark over the conditionality of the ECB's policy plans. Cyclical indicators have weakened since the beginning of the year. Draghi is now admitting that this soft patch could last longer than expected earlier. One wonders how the ECB would respond to continued softening and a renewed drop of inflation, should such developments occur. As a result, we think the balance of risk is skewed to the downside as regards monetary tightening by the ECB, meaning that the chance that the first hike will be later than September 2019 is higher than that it will be earlier.

Divergence

The divergence between cyclical indicators in the US on the one hand and Europe and Asia on the other continues. This is something I have focussed on a lot in recent months. Perhaps too much. I ran into one of my former bosses yesterday by chance. He mentioned that he is still following my weekly macro commentary and was wondering if he should be concerned. I don't think so. Cyclical indicators in the eurozone have softened, but from very strong levels and there is no reason to think that he eurozone is heading for an actual downturn any time soon. Growth is just coming down from a level that was actually considerably higher than its long-term trend.

Germany: ZEW index

Source: Bloomberg

France: business confidence

Source: Bloomberg

Having said that, I continue to struggle understanding what exactly is behind this weakness. The June ZEW survey for the eurozone and for Germany was disappointing. As these indices more or less stabilised in May, I was hopeful that the drop was bottoming out. But the June report showed a material further deterioration. The expectations component of the German ZEW index dropped to -16.1, down from -8.2 in May, having peaked above +20 in January. The ZEW index is not my favourite cyclical gauge as it is based on a survey among analysts, nor businesses. Therefore, the index may be more prone to respond to mood swings than business survey which are based on actual trends in activity. The continuing trade conflict and in particular the real threat of US tariffs on

German cars may have affected the ZEW. Having said that, the May reading of the Banque de France's survey of business confidence weakened further in May. It fell to 100, after a peak of 107 last December. Sentiment is still at a higher level than it was during the 2012-2016 period. Looking at the graph of French business sentiment, it looks as though sentiment got a significant boost following the US presidential elections. Just like what happened in the US. Contrary to developments in the US, however, sentiment started to slip just after the start of the current year.

Softening in China, too

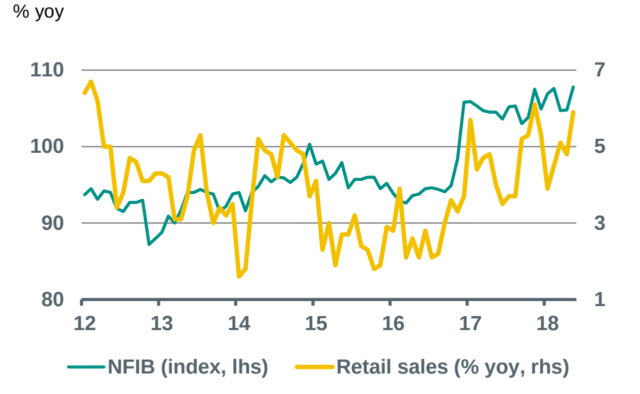
Softening of European cyclical indicators is related to world trade. The domestic economies in Europe are continuing to expand, but the boost from foreign trade has weakened. World trade growth is decelerating. Looking at trade indices in key Asian economies it is not so easy to determine exactly what is happening. After somewhat weaker trade data in various Asian economies earlier this year, the trade numbers have strengthened again in May and June. Unfortunately, this does not seem to help European business confidence, yet.

Recent trading days have been light on Asia macro data. The most important has been data in China. Retail sales growth continues to decelerate: 8.5% yoy in May, after 9.4% in April. Industrial production data softened also: 6.8% yoy against 7.0% in April. However, that was still an excellent reading as it was still higher than the average for the last part of 2017. We stick to our view that China is slowly decelerating. Recent data confirms that, but does not suggest that a rapid cooling is taking place.

Best in 35 years

Business confidence among US SMEs reached a new cyclical peak in May. The NFIB index rose to 107.8 after 104.8 in April. The May reading was the second highest on record. The highest reading in this series was 108 and was achieved in 1983, that is 35 years ago!

US: SME confidence and retail sales



Source: Bloomberg

It is not so hard to see why SME confidence is so strong. Retail sales rose 0.8% mom in May, following a rise of 0.4% in April. The yoy rate of increase moved up to 5.9%. Mind you, these are nominal numbers and the rise of inflation is helping. But these numbers still suggest retail sales are also strengthening on a volume basis.

US inflation, meanwhile, edged higher again on a yoy basis in May: 2.8%, the highest since 2012, versus 2.5% in April. This sounds more alarming than it is. The mom rate was 0.2%, so the jump in the yoy rate was mainly due to base effects as special factors put a strong lid on the price index last year. Base effects could easily push the yoy rate up further in June and July as the monthly price increases in these months last year were only 0% and 0.1%, respectively. Following July, base effects are likely to work in the opposite direction as the average price increase in the last five months of 2017 amounted to 0,3%.

Powell stresses financial stability

The Fed did what was expected; raise rates by 0.25% for the second time this year. They also indicated that two more hikes are very likely this year and a few more next year. This is all broadly in line with our expectations. What was new was that Fed chair Powell emphasised the importance of financial stability. We don't think he meant to say that asset values are too high and that he intends to puncture the 'bubble'. But we think the Powell-Fed will take asset prices more on board than previous Feds. This also supports the view that the Fed will continue hiking even if it considers the inflation risks very modest.

Main economic/financial forecasts

GDP growth (%)	2016	2017	2018e	2019e	3M interbank rate	07/06/2018	14/06/2018	+3M	2018e	+12M	2019e
United States	1.5	2.3	3.0	2.7	United States	2.33	2.33	2.70	2.60	2.90	3.00
Eurozone	1.8	2.6	2.8	2.3	Eurozone	-0.32	-0.32	-0.33	-0.33	-0.33	-0.13
Japan	1.0	1.7	1.7	1.3	Japan	0.07	0.07	-0.10	-0.02	-0.10	-0.10
United Kingdom	1.9	1.8	1.4	1.7	United Kingdom	0.63	0.63	0.70	0.75	1.00	1.20
China	6.7	6.9	6.5	6.0							
World	3.2	3.7	3.9	3.7							
Inflation (%)	**2016**	**2017**	**2018e**	**2019e**	**10Y interest rate**	**07/06/2018**	**14/06/2018**	**+3M**	**2018e**	**+12M**	**2019e**
United States	1.3	2.1	2.4	2.2	US Treasury	2.93	2.95	3.1	3.20	3.00	2.80
Eurozone	0.2	1.5	1.7	1.4	German Bund	0.49	0.43	0.5	0.70	0.90	1.20
Japan	-0.1	0.5	1.0	0.8	Euro swap rate	1.03	0.94	0.9	1.10	1.20	1.25
United Kingdom	0.7	2.7	2.3	1.9	Japanese gov. bonds	0.05	0.04	0.0	0.00	0.00	0.20
China	2.0	1.6	2.5	2.5	UK gilts	1.40	1.34	1.4	1.80	1.70	2.00
World	3.0	3.0	3.4	3.2							
Key policy rate	**14/06/2018**	**+3M**	**2018e**	**2019e**	**Currencies**	**07/06/2018**	**14/06/2018**	**+3M**	**2018e**	**+12M**	**2019e**
Federal Reserve	2.00	2.25	2.50	3.00	EUR/USD	1.18	1.17	1.10	1.15	1.20	1.25
European Central Bank	-0.40	-0.40	-0.40	-0.20	USD/JPY	109.7	110.6	110	110	106	100
Bank of Japan	-0.10	-0.10	-0.10	-0.10	GBP/USD	1.34	1.33	1.30	1.34	1.38	1.42
Bank of England	0.50	0.50	0.50	1.00	EUR/GBP	0.88	0.87	0.85	0.86	0.87	0.88
People's Bank of China	4.35	4.35	4.35	4.35	USD/CNY	6.39	6.40	6.50	6.50	6.60	6.70

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.