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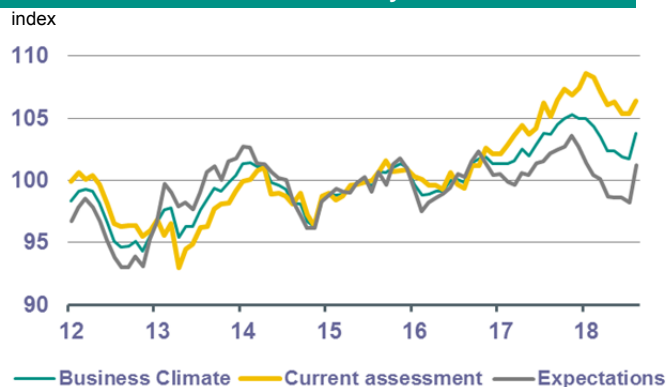
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Ifo provides relief

- **German business confidence jumps in August**
- **China's business cycle and currency stable**
- **US economy continues steady performance**
- **I should not have been on the front page**

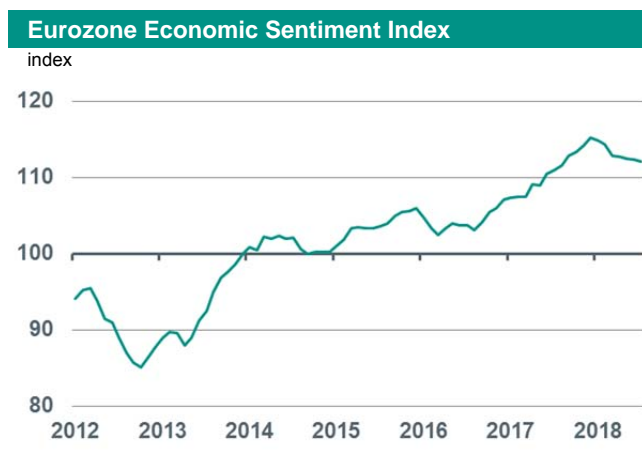
Having drifted lower, from very high levels, since the turn of the year, German business confidence rose strongly in August. Several months of decline were reversed in one move. That is good news. It appears that the trigger for this improvement was the meeting between European Commission president Juncker and US president Trump. This meeting took away some of the fear that European car manufacturers will be hit by high tariffs for cars exported into the US. It also suggests that the slide of confidence earlier in the year is highly related to the trade conflict.

Ifo Business Confidence Germany



Source: Bloomberg

Unfortunately, this spectacular improvement in German business confidence was not reflected in the European Commission's index of Economic Sentiment for the eurozone as a whole, which declined from 112.1 in July to 111.6 in August. And also unfortunately, the trade conflict can easily escalate anew.



Source: Bloomberg

Our view remains that growth rates of the eurozone will stabilise or pick up marginally in the period ahead, having slowed in the first half of this year. Domestic demand remains robust; the slowdown is coming from the international trade side, particularly Asia.

Chinese business confidence up a touch

As I have highlighted before, the most recent trade data for Asia are looking good. And Chinese business confidence is also looking well. The Chinese national business-confidence indices inched a little higher in August. Manufacturing confidence moved from 51.2 to 51.3, services from 54.0 to 54.2. This suggests that the pace of growth is steady. It is not spectacularly strong, neither dramatically weak. Meanwhile, the Chinese currency is stabilising. The yuan started weakening against the dollar in April (when there were 6.3 yuan to the dollar). The depreciation gained significant momentum in June (6.4 yuan per dollar) to peak in mid-August (6.9 yuan per dollar). But measures taken by the authorities have been successful in the last two weeks in stabilising the exchange rate. This is important as it reduces the risk of an uncontrolled slide in the currency and large capital outflows.

US economy steady

The US economy is as solid as a rock. Consumer confidence, measured by the Conference Board, reached a record in August and the personal income and spending report reflects the steady rise in consumption. Income rose 0.3% mom in July, spending 0.4%. Bear in mind that these are nominal numbers so inflation is included. Excluding inflation, so in real terms, consumption is growing at a steady pace of some 2.5-3%.

US Consumer Confidence



Source: Bloomberg

The report on personal income and spending also showed a steady pace of inflation. The Fed's favourite inflation measure is the so called core-PCE. This inflation measure rose 0.2% mom in July and 2.0% yoy, up from 1.9% in June. The 2% is bang in line with the Fed's target. Looking at pipe-line pressures, wages and base effects, there is little reason to think that inflation will accelerate significantly from here, though a modest rise in the yoy rate is, by all means, possible in the months ahead. The Fed has often stressed that their target is symmetrical. So they are not going to panic if inflation exceeds the target a little for a while. We have lived through a very long period in which inflation undershot the Fed's target.

US Inflation (core PCE)



Source: Bloomberg

Lira, Argentina, WTO and Italy

There are plenty of developments that deserve the attention of financial markets. The Turkish lira has come under pressure again. I think the chance that the Turkish government will have to seek IMF assistance is rising. But it is hard to see how that can be done without the government suffering a loss of face. Perhaps they will find a way. There is also still a chance that Turkey can weather this storm by itself, but they will need to convince foreign investors. As we have argued before, risks of contagion are limited (though not absent) as the problems are relatively specific for Turkey, other emerging economies have stronger fundamentals than they did during earlier episodes of contagion and emerging currencies are generally not overvalued.

Argentina's peso keeps falling. The Macri government arranged IMF assistance some months ago, but that seems to be insufficient to stabilise the currency. The central bank raised its official interest rate from 45% to 60%. The government has asked the IMF to provide emergency money. At some level the currency will stabilise, but such sharp moves of the currencies are very damaging for the economy and for confidence.

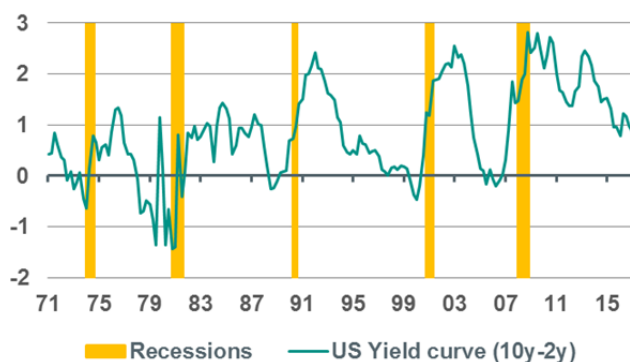
President Trump is calling for reform of the WTO. Since his inauguration he has essentially undermined the WTO by refusing to allow the reappointment of sitting members and appointments of new members of the WTO's Appellate Body. The Appellate Body is a group of judges that rules over cases of infringements of WTO rules member countries bring to this body. The body has seven seats, but cannot legally make decisions with fewer than 3 members. Before too long, they will be down to 3. It is then a matter of time before the Appellate Body becomes paralysed. Not good.

The Italian government is putting together a budget for 2019. Markets are nervous that the budget will show a sharp increase in the deficit, leading to a conflict with the European Commission. As a result, the Italian spread has risen to reflect the risk that Italy will leave the euro and that Italy will, at some stage, renege on its payment obligations. These risks look small to me, but that does not mean the market will not become more nervous in the meantime

I should not have been on the front page

The leading Dutch financial newspaper, Het Financieele Dagblad, ran a front-page article a few days ago about the US yield curve in which I was quoted. The curve has flattened and the spread between 10s and 2s is down to less than 20bp. If this trend continues, the curve will invert before too long. All recessions of the post-war period have been preceded by inversion of the yield curve. So the newspaper article highlighted the risk of recession in the US in the not-too-distant future. I was quoted in that article saying that an inversion of the curve is to be taken seriously. I have been asked since, if we are forecasting a US recession on this basis.

US recessions and yield curve



Source: Bloomberg

Let me clarify my position here. The yield curve has been a very good forecaster for US recessions, but there are a couple of things one needs to keep in mind. First, the curve is not inverted yet and it cannot be a forgone conclusion that it will invert. Second, even if it does, it needs to remain inverted for a while to signal an approaching recession. Third, the lag between the curve inverting and the recession starting can vary greatly. In the past, it has varied from two quarters to three years. So let's not panic, and let's certainly not panic now. In fact, I failed to see why such a story was front-page news, but perhaps it sells newspapers. And for me? Well, no harm being on the front page.

My colleagues and I have ongoing discussions about this topic. One of the questions is what makes the curve go inverse. Our interpretation is that it is a sign that the market thinks the central bank is overshooting in its tightening policy. And apparently, the market gets this more often right than wrong. That raises the question why the central bank tends to overshoot. It can do so deliberately. In my view, that is what the Paul Volcker Fed did in the early 1980s. Inflation and inflation expectations had spiraled out of control and the Fed needed to stamp inflation out of the system. There is no reason whatsoever at this particular point in time for the Fed to overshoot deliberately and push the economy in recession. Inflation is not excessive. Nor are there other excesses that require such a forceful approach. But a central bank may also overshoot by accident. That can happen easily as central bankers are mere humans and the equilibrium rate cannot be observed. So knowing when to stop tightening is a bit of a guess. Having followed Fed policy making and communication for many years, I think it is fair to say that the Fed and more specifically many FOMC members are more talking about the messages the yield curve is sending and the natural rate of interest, than ever before. So it seems to me they are more determined not to overshoot than ever before. That does not guarantee that they will not make mistakes, but it does mean they will be cautious.

Main economic/financial forecasts											
GDP growth (%)	2016	2017	2018e	2019e	3M interbank rate	23-8-2018	30-8-2018	+3M	2018e	+12M	2019e
United States	1,6	2,2	3,0	2,7	United States	2,31	2,32	2,70	2,60	2,90	3,00
Eurozone	1,8	2,5	2,2	2,1	Eurozone	-0,32	-0,32	-0,33	-0,33	-0,33	-0,20
Japan	1,0	1,7	1,1	0,9	Japan	0,07	0,07	-0,10	-0,02	-0,10	-0,10
United Kingdom	1,8	1,7	1,4	1,7	United Kingdom	0,81	0,80	0,70	0,75	1,00	1,20
China	6,7	6,9	6,5	6,0							
World	3,4	3,8	3,8	3,6							
Inflation (%)	2016	2017	2018e	2019e	10Y interest rate	23-8-2018	30-8-2018	+3M	2018e	+12M	2019e
United States	1,3	2,1	2,4	2,2	US Treasury	2,82	2,86	3,1	3,10	3,00	2,80
Eurozone	0,2	1,5	1,7	1,4	German Bund	0,34	0,35	0,2	0,40	0,60	0,80
Japan	-0,1	0,5	1,0	0,8	Euro swap rate	0,89	0,90	0,9	1,10	1,20	1,25
United Kingdom	0,7	2,7	2,3	1,9	Japanese gov. bonds	0,10	0,11	0,0	0,00	0,00	0,20
China	2,0	1,6	2,0	2,5	UK gilts	1,27	1,46	1,4	1,50	1,70	1,80
World	3,0	3,0	3,4	3,3							
Key policy rate	30-8-2018	+3M	2018e	2019e	Currencies	23-8-2018	30-8-2018	+3M	2018e	+12M	2019e
Federal Reserve	2,00	2,25	2,50	3,00	EUR/USD	1,16	1,17	↑ 1,15	1,15	1,20	1,25
European Central Bank	-0,40	-0,40	-0,40	-0,30	USD/JPY	111,3	111,0	110	110	106	100
Bank of Japan	-0,10	-0,10	-0,10	-0,10	GBP/USD	1,28	1,30	1,30	1,34	1,38	1,42
Bank of England	0,75	0,75	0,75	1,00	EUR/GBP	0,90	0,90	↑ 0,88	0,86	0,87	0,88
People's Bank of China	4,35	4,35	4,35	4,35	USD/CNY	6,88	6,83	6,50	6,70	6,60	6,70

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.

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