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GLOBAL ECONOMIC HIGHLIGHTS

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US & CHINA WORKING TOWARD A MARCH TRADE TRUCE; FED PLANNING TO END BALANCE SHEET REDUCTIONS

CHINA: President Trump announced over Twitter on February 24 that he would extend the March 1 deadline for negotiating a trade truce with China rather than raising tariff rates paid by American importers who buy Chinese imports. The President also said that "assuming both sides make additional progress," he would meet with Chinese President Xi Jinping at Mar-a-Lago "to conclude an agreement." CNBC had reported February 22 that the two governments were working toward a Trump-Xi summit in late March. If so, the deal is likely to be an exchange in which Chinese state-directed companies buy more US energy and agricultural exports in exchange for lower US tariffs on Chinese exports. A deeper trade deal between the countries, one reducing China's behind-the-border restrictions on US exports, is difficult to achieve near-term, but would be very positive if reached and credible. A more likely narrower deal will still boost investment in both countries near-term, as businesses catch-up on capex plans that support cross-border supply chains; many businesses had delayed these investments until the prospects for US-China trade relations were clearer.

UNITED STATES: The Fed is planning to stop shrinking its balance sheet relatively soon, according to the minutes from the January 29 to 30 Federal Open Market Committee meeting. They began shrinking the balance sheet in late 2017 by allowing maturing securities to roll off; it is down from $4.5 trillion at its peak to $3.8 trillion now. According to the minutes, participants expect to end the balance sheet reduction process later this year, with an announcement of that decision to come as soon as the FOMC's mid-March meeting. There was also discussion on the best way for the Fed to reduce its holdings of MBS and GSE debt, and shift toward Treasuries. The Fed will probably slow its balance sheet reduction between now and the end, and opt for a longer taper, than go "cold turkey" in the fall. When the Fed rolls assets off of the balance sheet at the same time the government issues more, the net effect is to increase the sales of Treasuries to private investors, crowding out private investment in risky assets like stocks, bonds, and bank deposits that can be channeled through the financial system into loans to businesses and households. It is hard to measure exactly how much, but balance sheet reductions reduce risk-taking appetite in financial markets and are a headwind to prices of risky assets like stocks and corporate bonds. By extension, the prospect of slower balance sheet reductions in the near-term and an end to them in the next few quarters is supportive of financial market sentiment this year.

EUROZONE: The ECB's upcoming March 7 Governing Council decision will keep the bank's monetary stance unchanged, and could answer four important questions about the monetary policy outlook. First, the release of their March economic projections will inform whether the central bank will make its first post-crisis rate hike this year, as PNC forecasts. The projections will probably lower the outlook for growth in 2019 from the December 2018 projections, which forecasted real GDP growth of 1.7 percent in 2019 and 2020 and 1.5 percent in 2021. If the ECB maintains the 2020-2021 growth forecasts unchanged, it would support PNC's forecast for a deposit rate hike in September. But if the March projections instead downgrade both the 2019 and 2020 growth projections, it would signal the Governing Council plans to delay an initial rate hike until 2020. Second, the ECB will probably give some guidance about how it would respond to a no-deal Brexit in the unlikely case that the UK does not extend its negotiation with the EU by the end of March. Third, the ECB will probably provide detail about if and when it will extend a new round of Targeted Longer Term Refinancing Operation loans, multi-year loans to ECB commercial loans fixed at the current deposit rate;

TLTROs made in the aftermath of the sovereign debt crisis will mature in the next 18 months, and another round of them would roll over the existing loan stock. Fourth, the Governing Council could provide a more granular description of the range of views among its members, and not just the consensus to prepare markets for the ECB's new leadership after President Draghi's term ends October 31. The three leading candidates for the job are the German central bank head Jens Weidmann, French member of the ECB Executive Board Benoit Coeure, and former head of the Finnish central bank Erkki Liikanen. Liikanen and Coeure would likely be moderates on interest rates, while Weidmann is a hawk and advocates faster rate hikes than currently priced in by financial futures markets. President Draghi's successor will likely become apparent to financial markets soon: Draghi was officially nominated for the presidency in May 2011, ahead of assuming office on November 1.

UNITED KINGDOM: Eight Members of Parliament from the center-left opposition Labour party and three from the center-right ruling Tory party have resigned from their parties and organized a centrist anti-Brexit proto-party in Parliament. The new centrist group, called "The Independent Group," could gain additional converts from both parties. Members joining so far from Labour have objected to the party's weak policing of anti-Semitism within its ranks, its muddled approach to Brexit, and its leftward drift under Jeremy Corbyn's leadership. Ex-Tory MPs object to the Prime Minister allowing Brexit policy to be dictated by the European Research Group, a Tory faction supporting Hard Brexit, and the party's drift right. The Independent Group has said that they do not currently support actions that would trigger new parliamentary elections, but Tory defections clearly narrow the path for Prime Minister May to secure a majority for a deal with the EU. The EU continue to rebuff British proposals to modify the Withdrawal Agreement treaty, which would require the UK to participate in the EU customs union or accept a customs barrier between Northern Ireland and the rest of the UK (a.k.a. "the backstop"). The EU is willing to alter the "political declaration" that accompanies the Withdrawal Agreement, and which lays out the intentions and goals of both parties in negotiations that would follow the UK's withdrawal. But the Withdrawal Agreement is a binding treaty and the Political Declaration is not. Pro-Brexit MPs are so far refusing to accept a Brexit deal that gives the EU considerable veto power over the UK's external trade policies, as the Withdrawal Agreement does.

JAPAN: The Nikkei manufacturing PMI for Japan fell to 48.5 in the February flash estimate from 50.3 in January and was the weakest since June 2016. Bank of Japan Governor Haruhiko Kuroda said in a February 19 speech that the Bank of Japan could intensify its stimulus programs if necessary to keep inflation moving toward the Bank's 2 percent target, echoing Fed and ECB officials' recent dovish shift in their monetary policy stance.

CANADA: Bank of Canada Governor Stephen Poloz signaled that the Bank of Canada's next move will still be a hike, but that the timing of further rate increases is "highly uncertain" and data dependent in a February 21 speech. Poloz's comments echo those of Federal Reserve and ECB central bankers whose forward guidance has become considerably more dovish in the last few months. Financial markets price in little change of a rate hike from the Bank of Canada this year, casting uncertainty over our forecast for a 0.25 percentage point hike in the overnight rate target to 2.00 percent at the Bank's April meeting. However, if sentiment surveys improve after the trade truce with China, job growth stays robust, and the job market tightens further, the data can still convince the Bank of Canada to hike interest rates in April.

MEXICO: Real GDP grew a modest 0.2 percent in the fourth quarter of 2018 from the third, not annualized, and 1.7 percent from a year earlier; real GDP growth for all of 2018 was a disappointingly slow 2.0 percent. The fourth quarter's weakness was concentrated in the industrial sector: Industrial output fell a sharp 1.2 percent from the third quarter and 0.8 percent from a year earlier. Services and agricultural activity grew on both the quarter and the year. Industrial weakness was most pronounced in the oil and other mining sectors, but construction activity also fell from a year earlier, and manufacturing growth was a tepid 1.5 percent. The government's crackdown on fuel theft will slow the economy further in the first quarter of 2019, so Mexico is not yet through the worst of this period of disappointing economic growth. The story could change by the second half of 2019, when energy supply bottlenecks caused by the fuel theft crackdown could end and global business and consumer sentiment improve as trade uncertainties recede; this could help Mexican growth recover as well. But risks of further disappointment are high as the country copes with these headwinds and the continued decline of its tarnished national champion, the state-owned oil company Pemex, which was hit by a credit rating downgrade from Fitch in January.

BRAZIL: Election uncertainty slowed growth in late 2018 and a mining disaster extended the weakness into the first quarter of 2019. Brazil's worst-ever environmental disaster killed at least 179 people on January 25, when a dam containing mining tailings failed and left 179 dead and 131 still missing, according to the Wall Street Journal. The dam and mine were operated by Vale, a Brazilian multinational that is the world's largest producer of iron ore and nickel. The company and its officers are under investigation by Brazilian prosecutors, and its focus will rightly turn to improving safety and preventing other disasters. A justified focus on producing better will take priority over producing more, so Brazilian mining investment will slow. These events follow an election-related slowdown in late 2018: The central bank's monthly proxy for real GDP, the IBC-Br index, grew 0.2 percent in December from November, and closed the fourth quarter an annualized 1.3 percent higher than in October. After large declines in September and October, fourth quarter GDP grew just 0.8 percent annualized, a sharp slowdown from the third quarter's 6.9 percent annualized growth. The IBC-Br rose a scant 0.2 percent in December from a year earlier. Brazil is headed for another sub-potential year of growth in 2019. Against a backdrop of cool Brazilian inflation, high unemployment, and increasingly dovish guidance from advanced economy central banks, there is room for the Central Bank of Brazil to continue to cut its policy rate from the current record low 6.5 percent over the course of 2019.