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GLOBAL ECONOMIC HIGHLIGHTS

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CHINESE GROWTH SLOWEST SINCE 1992; FED CHAIR'S TESTIMONY REINFORCES RATE CUT EXPECTATIONS

CHINA: Real GDP growth slowed to a multi-decade low as expected in the second quarter, while key monthly indicators improved in June. Real GDP grew 6.2 percent from a year earlier, matching our forecast and consensus, down from 6.4 percent in the first quarter, and the slowest since at least 1992 (data on Chinese quarterly GDP go back to that year; annual real GDP grew a slower 3.8 percent in 1990). Secondary sector a.k.a. industrial output growth slowed to 5.6 percent from a year earlier in the second quarter from 6.0 percent in the first, and tertiary sector a.k.a services growth held steady at 7.0 percent. Primary sector a.k.a agricultural output grew 3.3 percent from a year earlier, up from 2.7 percent in the first quarter. June's monthly indicators improved modestly from May. Retail sales grew 9.8 percent from a year earlier, up from 8.6 percent in May and the fastest since March 2018; auto sales bounced as car dealers discounted inventory ahead of tighter emissions standards that came into effect in July. Industrial production growth picked up to 6.3 percent from 5.0 percent and was basically in line with 2018's 6.2 percent average. Manufacturing capacity utilization rose to 76.4 percent in the second quarter from 75.9 percent in the first and was the least weak since the third quarter of 2018; it averaged 73.3 percent in 2016, and so is better now than in that particularly bad year for Chinese manufacturers. Investment in fixed assets grew 5.8 percent in the first half of 2019, up marginally from the 5.6 percent year-to-date growth of the year through May. Investment's sectoral breakdown points to continued drag from the trade war; investment in equipment fell 1.9 percent from a year earlier, offset by faster investment in domestically-oriented sectors: mining, medicine manufacture, chemicals, education, and entertainment industries. Investment in the computer and electronics manufacturing sector grew a solid 8.5 percent from a year earlier, possibly a sign that Chinese tech manufacturers are developing alternatives to US suppliers. Investment in real estate moderated to 10.9 percent in the year through June from 11.2 percent in the year through May; real estate-focused stimulus has moderated since the first quarter as investment and production in other industries improved.

The labor market weakened in June. The survey based urban unemployment rate was unchanged on the month at 5.0 percent; the 31 largest cities' unemployment rate was also 5.0 percent, up 0.3 percentage points from a year earlier. This is the same year-over-year increase as in April and May, faster than February and March's 0.2 percentage point increase and January's 0.1 percentage point rise. China's unemployment rate is not seasonally adjusted, so year-over-year comparisons are more meaningful than monthly ones. Trade data also are weaker than domestic activity indicators. Exports fell 1.2 percent on the year in dollar terms in June after a 1.1 percent increase in May, and imports fell a larger 7.3 percent after May's 8.5 percent drop. Weak imports point to weak domestic demand, and reinforce the signal from Chinese business sentiment surveys: The CFLP manufacturing PMI was unchanged at a contractionary 49.4 in June, the CFLP nonmanufacturing PMI was the weakest since December, the privately-compiled Caixin general manufacturing PMI the second weakest since June 2016, and the Caixin services PMI the weakest since January. Forward-looking surveys suggest weakness will persist in the second half of 2019.

Nor is credit growth riding to the rescue. Growth of aggregate financing to nonfinancial borrowers did pick up modestly to 10.9 percent in June from 10.6 percent in May to the fastest in 12 months, but money supply growth was unchanged for a third consecutive month at 8.5 percent.

For the Federal Reserve, the stabilization of China's monthly indicators in June does not really move the needle on a rate cut at the July 31 policy decision, which is already entirely priced in by financial markets. But China could complicate the Fed's calculus after July: The People's Bank of China is likely to cut its own benchmark interest rate, the seven-day reverse repo rate, by 20 basis points to 2.35 percent in August following the Fed's cut. Chinese credit aggregates will likely grow at a similar rate after a Chinese rate cut, but it could trigger the yuan to depreciate against the dollar: PNC forecasts for the yuan to depreciate four percent from 6.88 per dollar July 16 to 7.15 per dollar by year-end.

Stabilizing Chinese economic indicators are also a reason not to hold one's breath for Chinese concessions in the trade negotiation. The US government believes it holds the upper hand in the negotiations since trade is a larger share of the economy in China compared to the US, while the Chinese government believes it has the upper hand since the US is holding a presidential election in 2020. This setup makes stalemate or escalation more likely than concessions or compromise in the next few quarters.

UNITED STATES: As expected, Fed Chair Jay Powell indicated in his prepared testimony before the House Financial Services Committee on July 10 that a fed funds rate cut is coming soon. Powell's testimony reiterated the Federal Open Market Committee's June 18 statement that "Many FOMC participants saw that the case for a somewhat more accommodative monetary policy had strengthened." PNC's July forecast is for the Federal Reserve to reduce the federal funds target by 0.25 percentage points at both its July 31 and October 30 decisions and to subsequently hold it unchanged at a range of 1.75 to 2.00 percent. These rate cuts will function as "insurance" to prevent downside risks to the economy from materializing and sustain the economic expansion; if economic data weaken, the Fed could cut more than forecast. US retail sales rose 0.4 percent in June, and retail sales excluding auto dealers, gas stations, food services and building materials – the component included in GDP's calculation – rose a solid 0.7 percent, almost all of which was real growth since the CPI index only rose 0.1 percent on the month. Industrial production was unchanged in June due to a large 3.6 percent drop in utilities output offsetting a 0.2 percent increase in mining output and a 0.4 percent increase in manufacturing. Manufacturing output is up 0.4 percent from a year earlier, but after declines between December and April is still down 2.1 percent from its December 2018 peak.

EUROZONE: The Accounts a.k.a. minutes of the ECB's June 5 and 6 Governing Council meeting reinforce expectations for additional Eurozone monetary stimulus later in 2019. The Accounts read that "should the environment of too low inflation continue to prevail, considerations of a more strategic nature might be warranted." If growth continues to be weakly positive and core inflation continue to hold in its recent range between 1.00-1.25 percent, the ECB is likely to reduce the benchmark deposit rate 10 bps from -0.40 percent to -0.50 percent at its September monetary policy decision, restart its quantitative easing program, and exempt some commercial banks' excess cash from the negative deposit rate to insulate Eurozone financial sector profitability from negative rates. If economic growth is weaker than expected, or a global shock pushes inflation lower, the ECB is likely to broaden its QE program to include Japanese-style purchases of riskier assets like ETFs and REITs.

JAPAN: Average cash earnings fell 0.2 percent from a year earlier in May, a slightly smaller contraction than the 0.3 percent year-ago decline in April and considerably better than March's 1.3 percent drop. Japanese earnings stalled in the first half of 2019 as capital goods orders fell and business sentiment deteriorated, knock-on effects of both the scheduled October value added tax hike and of global trade tensions. The Bank of Japan also is likely to intensify monetary stimulus in the second half of the year to offset the increase in the value added tax from eight to 10 percent scheduled for October.

CANADA: Existing home sales dipped 0.2 percent in June from May after rising a cumulative 6.5 percent in the prior three months. From a year earlier, existing home sales edged up 0.3 percent. Stabilization of Canadian housing data is another reason why Canadian and US monetary policy are diverging in the second half of 2019, with the Bank of Canada maintaining its policy rate unchanged at 1.75 percent and the Federal Reserve forecast to cut its policy target from a range of 2.25 to 2.50 percent at mid-year to a range of 1.75 to 2.00 percent by year-end. Housing starts rose 21.4 percent in June from May, after May's housing permits fell 13.0 percent from April.

UNITED KINGDOM: Real GDP grew 0.3 percent in May from April, offsetting some of April's 0.4 percent monthly decline; industrial production recovered 1.4 percent after a 2.7 percent drop in April and construction output rose 0.6 percent after a 0.4 percent drop. Service sector GDP was unchanged in May for a second consecutive month. Even after some stabilization in May, the UK is likely in the middle of a mild recession at mid-year. Real GDP is likely to drop again in June given the month's weak manufacturing PMI report and very weak construction PMI report. The two candidates to replace Prime Minister Theresa May, Boris Johnson and Jeremy Hunt, both pledged during debates to demand the EU remove the backstop provision from the Withdrawal Agreement, which requires the UK to stay a member of the EU common market until the EU is satisfied that its exit would not force a hard border between Northern Ireland and the Republic of Ireland. The EU has repeatedly and consistently said that this demand is equivalent to the UK choosing a Hard Brexit. Since the current Members of Parliament already voted March 13 to rule out Hard Brexit under any circumstances and they, not the Prime Minister, have the ultimate say over policy, the candidates' campaign promises are unlikely to translate into action. Even so, the pound sterling has depreciated to the weakest since April 2017 on these signs that the next Prime Minister will renew the brinksmanship with the EU ahead of the October deadline for a deal. Parliament will most likely vote for another extension of the deadline before then.

MEXICO: Inflation is converging toward the central bank's 3.0 percent target. CPI inflation slowed to 4.0 percent in June from 4.3 percent in May, and was even cooler in the second half of May, 3.9 percent; all are reported in year-over-year terms. Finance Minister Carlos Urzua resigned July 9 to protest the government's economic policies; he subsequently said that the last straw was its attempt to force down the cost of public procurement contracts negotiated by the prior government. Like the Lopez Obrador government's cancellation of construction of a new airport for Mexico City in 2018, these attempts to renege on contracts threaten the credibility of government promises, a key component of sovereign creditworthiness.

BRAZIL: The lower house of Congress approved the overhaul of the country's pension system on July 10 by a vote of 379 in favor to 131 opposed, well beyond the 308 votes required. Second round approval and passage in the Senate is needed in order for the pension reform to become law. June IPCA inflation slowed to 3.4 percent on a year-over-year basis from 4.7 percent in May, below the 4.25 percent inflation target. The largest declines were in food and fuel prices. The Central Bank of Brazil's weekly survey of professional forecasters showed the median estimate for real GDP growth in 2019 was 0.8 percent in the July 5th survey, down from 0.9 percent the prior week. The median estimate for real GDP growth has fallen for 19 consecutive weeks. The central bank's monthly proxy for real GDP, the IBC-Br index, rose 0.5 percent in May from April; even so, after declines between February and April, the index has fallen an annualized 2.3 percent in the first two months of the second quarter from the first.

INDIA: CPI inflation picked up to 3.2 percent in June from 3.0 percent in May on faster food inflation; CPI excluding food and energy was unchanged on the month at 4.0 percent, the slowest since July 2017 and matching the Reserve Bank of India's inflation target. Financial markets price in a 0.25 percentage point interest rate cut at the Reserve Bank of India's August 7 monetary policy decision, and an additional one to two 0.25 percentage point interest rate cuts by July 2020.