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GLOBAL ECONOMIC HIGHLIGHTS

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# US-CHINA TRADE WAR ESCALATES MORE; FED CHAIR POWELL HIGHLIGHTS TRADE WAR'S RISK TO GROWTH

**CHINA:** The Chinese government on August 23 announced its plan to retaliate against the US tariff increases scheduled to take effect September 1 and December 15. China plans to raise tariff rates on $75 billion dollars of products imported from the United States by increments of 5 to 10 percent, timed to coincide with the scheduled increases in US tariffs, and will reinstate existing tariffs on US autos and auto components that had been suspended since January. US exports targeted by the latest round of additional tariffs include several categories of products already subject to Chinese retaliatory tariffs, including soybeans and other grains, pork and other meat products, seafood, fruits, crude oil, chemicals, autos, capital equipment, construction equipment, and medical equipment. In response, President Trump "ordered" (his tweeted term) American businesses to relocate Chinese manufacturing operations to other countries, and announced that the US government would raise the tariffs applied to Chinese goods imports to 30 percent from 25 percent on the first $250 billion of goods imports penalized, and to 15 percent from 10 percent on the rest, still coming into effect after September 1. This fits the common definition of a trade war, an intensifying cycle of countries restricting trading partner imports in retaliation to the trading partner's restrictions on exports. The latest round of escalation follows the release of Chinese monthly indicators for July that showed further slowdown from the second quarter, which was already the weakest since at least 1992: Growth of industrial production slowed to 4.8 percent in year-over-year terms from 6.3 percent, growth of retail sales to 7.6 percent from 9.8 percent, and growth of investment in fixed assets to 5.7 percent from 5.8 percent (this latter indicator measured in year-to-date year-over-year terms). The surveyed unemployment rate rose to 5.2 percent in the 31 largest cities and 5.3 percent in all urban areas; the 31-city unemployment rate was the highest on record (data have been released almost every month since 2017, and irregularly going back to 2013) and the urban unemployment rate was the highest since February 2017. China's central bank began easing interest rates August 20 by changing the calculation of banks' loan prime rate (LPR) to require banks to report the LPR as a spread above the central bank's policy rate, the seven-day reverse repo rate. The LPR edged down 0.06 percentage points after the announcement of the change, and its spread above the policy rate will likely narrow a bit more in coming months. In addition, China's central bank is likely to cut the seven-day reverse repo rate by 0.70 percentage points by year-end, to 1.85 percent from 2.55 percent currently. On top of weak domestic growth numbers justifying interest rate cuts, the People's Bank of China is late to the rate cutting party relative to other emerging market central banks including Brazil's, Mexico's, and India's. China has room to catch up, and likely rate cuts from the US, the restart of quantitative easing in the Eurozone, and the intensification of QE in Japan also give China room to cut interest rate and offset the effect of the intensifying trade war on growth. The yuan depreciated to 7.14 per US dollar on August 26 in reaction to the latest trade escalation, the weakest since the first quarter of 2008.

**UNITED STATES:** Federal Reserve Chair Jay Powell used his August 23 speech at the annual Jackson Hole monetary policy conference to discuss the downside risk to growth posed by the trade war. While Powell noted that current US economic conditions are good, he again emphasized that risks are to the downside. In particular, Powell mentioned a "risk management" approach, which suggests that the Fed could cut the fed funds rate again later this year if risks to the outlook remain to the downside. Powell also noted that "while monetary policy is a powerful tool…it cannot provide a settled rulebook for international trade." This suggests that Powell views the Fed as responding to the economic impact of the current trade dispute between the US and China, not trying to preempt it. In one section of the speech, Powell noted that during the long expansion of the 1990s, the Federal Open Market Committee twice temporarily and successfully eased monetary policy in response to threats, allowing the expansion to continue. By bringing this up, Powell seems to be suggesting that the Fed could cut rates a few times in the near term to support growth, without engaging in a full-blow easing cycle. Powell's speech today points to further fed fund rate cuts later this year: PNC is forecasting two 0.25 percentage point cuts in the fed funds rate at each of the next two FOMC meetings, in mid-September and late October. This would take the fed funds rate to a range of 1.50 to 1.75 percent by the end of this year. Economic data released since the July jobs report have been mixed, and show little sign of recovery from recent weakness: The University of Michigan Consumer Sentiment Index dropped to 92.1 in the preliminary release for August from 98.4 in July and was the weakest since January, consistent with August's stock market volatility and negative economic headlines; the index's current conditions sub-index fell to the lowest since November 2016. Industrial production fell 0.2 percent in July, with manufacturing output down 0.4 percent, mining down 1.8 percent, and utilities output up 3.1 percent; from a year earlier, industrial production grew 0.5 percent (the slowest since February 2017), with manufacturing down 0.5 percent, mining up 5.5 percent, and utilities up 0.3 percent. Manufacturing weakness extended into August: The IHS Markit manufacturing PMI fell to 49.9 in the August flash release, the weakest since September 2009. More positively, the National Federation of Independent Business Small Business Optimism Index edged up to 104.7 from 103.3; the index was close to its average since April and above the weaker levels seen between January and March. Housing data also was a bit better: While housing starts fell 4.0 percent in July from June, partially offset by a 1.0 percent upward revision to June's starts, building permits (which lead starts—builders need a permit before they can break ground) jumped 8.4 percent with June's level revised down 1.0 percent, and were the highest since December. Building permits have recovered to a level that is still 5.0 percent below the cyclical peak in March 2018. Existing home sales also rose in July, by 2.5 percent. New home sales fell 12.8 percent on the month in July, but this followed a 20.9 percent surge in June to the highest since July 2007. Both total and core CPI rose 0.3 percent in July from June, and rose 1.9 percent and 2.2 percent respectively from a year earlier. Since CPI runs about a quarter percentage point faster than the Fed's preferred measure of inflation, the PCE price index, the report implies the Fed's preferred inflation measure was close to their 2.0 percent target in July.

**MEXICO:** A recessionary GDP report for Mexico's second quarter: Real GDP was unchanged in the second quarter of 2019 from the first in seasonally-adjusted terms; in the annualized terms used to report US growth, real GDP rose a scant 0.08 percent in the quarter. Agricultural activity fell a sharp 3.4 percent in the quarter, not annualized, industrial activity fell 0.2 percent (a third consecutive quarterly decline), and services activity rose 0.2 percent. From a year earlier, real GDP fell 0.8 percent, with agriculture up 1.4 percent, industry down 3.0 percent, and services unchanged. The monthly GDP index rose a seasonally-adjusted 0.2 percent in June from May, with agriculture down 1.7 percent, industry up 1.1 percent (only partially reversing May's 2.5 percent decline) and services unchanged.

**BRAZIL:** Brazil's consumer price index the IPCA-15 rose 3.2 percent in the 12 months to mid-August, down from 3.3 percent the month before, and the lowest reading in over a year. 43,820 formal sector jobs were created in July according to the Labor ministry, lower than the 45,000 expected by economists and down from 47,319 a year earlier. Brazil's economy ministry approved the immediate release of R$38.5 million ($9.3 million) to fund federal efforts to fight the Amazon fires, as European Union leaders threatened to ditch a trade deal with South American nations to protest Jair Bolsonaro's failure to curtail the fires and fight climate change.

**EUROZONE:** The account a.k.a. minutes of the ECB's August 22 Governing Council meeting reinforce expectations for a strong restart of quantitative easing at the Governing Council's September 12 decision. PNC expects for the ECB to lower the negative deposit rate from -0.40 percent to -0.50 percent, restart open-ended asset purchases (a.k.a. QE) at a pace of €30 billion euros per month, the same as in the first three quarters of 2018, and include at least central government, local government, corporate, and banking-sector bonds in the assets eligible for purchase; purchases of equities are also possible but unlikely. The IHS Markit manufacturing PMI for the Eurozone was 47.0 in the August flash release after 46.5 in July, and has been in contractionary territory for seven consecutive months; the services PMI edged up to 53.4 from 53.2. Italy's Prime Minister Giuseppe Conte resigned on August 20 after the alliance between the anti-establishment left party, the Five Star Movement and the anti-establishment right party, the Lega party, collapsed. Leadership of Italy's various parties are negotiating a possible alternative alliance; if no agreement is reached, Italy will have a new general election.

**JAPAN:** The Jibun manufacturing PMI for Japan was little changed at 49.5 in the August flash release after 49.4 in June, and has been in contractionary territory for six of the last seven months. Financial markets price in just over 50-50 odds of a 0.10 percentage point cut in the Bank of Japan's -0.10 percent overnight rate at the September 19 monetary policy decision and two-thirds odds of a cut at the October 31 decision.

**CANADA:** Existing home sales rose 3.5 percent in July from June in seasonally-adjusted terms according to the Canada Real Estate Association, and were up 7.4 percent from a year earlier to the highest level since the fourth quarter of 2017, before Canadian financial regulators tightened mortgage underwriting standards to make Canada's housing market more resilient to negative shocks. Wholesale sales rose 0.6 percent in June, not enough to offset May's 1.9 percent drop, and were up 2.3 percent from a year earlier, or 1.3 percent in real terms. Consumer prices rose 0.4 percent in July from June, and 2.0 percent from a year earlier, matching June's year-over-year increase; the Bank of Canada's three preferred measures of trend inflation remained tightly clustered around the Bank's 2.0 percent target.

**UNITED KINGDOM:** The unemployment rate edged up to 3.9 percent in June from 3.8 percent between March and May, which had been a multi-decade low; the more timely unemployment insurance claimant count rate was unchanged in July from June at 3.2 percent, up from 3.1 percent in May, and from a cyclical low of 2.1 percent reached in February 2017. British civil servants leaked an analysis of the likely repercussions of a Hard Brexit to the press the week of August 17, which reinforce expectations that a Hard Brexit would cause severe supply chain disruptions and economic damage. Press reports also suggest that the British government is considering proroguing a.k.a. suspending parliament in the run-up to the October Brexit deadline to prevent parliament from forcing the government to extend the negotiation again. Perceptions of Hard Brexit risk continue to rise, but the core reason why Hard Brexit is unlikely is unchanged: A majority of members of parliament oppose it, and they probably have the final say over the decision.



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