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GLOBAL ECONOMIC HIGHLIGHTS

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BREXIT CLIFF EDGE PUSHES POUND STERLING TO WEAKEST SINCE 2016; UK LIKELY IN RECESSION IN MID-2019

UNITED KINGDOM: The pound sterling depreciated to $1.20, near the weakest since May 1985, on September 3 in response to mounting political brinksmanship. Prime Minister Boris Johnson on September 2 threatened to call a general election if Members of Parliament (MPs) do not give his government the latitude to “Hard Brexit” at the end of October. Johnson’s government has demanded concessions from the EU on the Brexit agreement since he assumed office July 23, which the EU refuses; Johnson argues that the threat of Hard Brexit will cause the EU to cave, while his critics believe the request is an excuse to push through Hard Brexit. A Tory MP quit his party and joined the opposition Liberal Democrats September 3, meaning the government’s coalition no longer command a majority in Parliament. While it is still possible for Prime Minister Johnson or a replacement to regain the support of a majority of MPs, a general election seems increasingly likely in coming weeks. MPs will likely hold another series of votes on Brexit policy options the week of September 3. A narrow majority of MPs voted to rule out no-deal under any circumstances March 13. Their options are still the same five: Exit with no deal; accept the existing deal; negotiate a closer deal, like Customs Union membership; extend the negotiation, or cancel Brexit. All are still on the table. The cancellation of Brexit still seems like Brexit’s most likely outcome, but no deal still is possible if a general election delivers a majority in support of Johnson’s hard line, if political paralysis causes an accidental Hard Brexit, or if Johnson uses the government’s control of parliamentary process to prevent MPs from voting against Hard Brexit. A reasonable albeit subjective assessment of Hard Brexit risk is about 10 percent, unchanged from earlier this year. British politics have looked this disheveled for over a year, but Prime Minister Johnson, and Prime Minister May before him, were able to keep the mess out of the headlines. Economic data point to a British recession in mid-2019. The Markit/CIPS construction PMI for the UK fell to 45.0 in August from 45.3 in July, with new orders contracting the most in ten years. The Markit/CIPS manufacturing PMI fell to 47.4 in August from 48.0 in July and was the weakest in seven years. The Lloyds Business Barometer weakened to the weakest since December 2011 in August. And the Confederation of British Industry’s sales activity survey was the weakest since December 2008 in August. Financial markets price in over 50-50 odds of a Bank of England bank rate cut by year-end 2019, likely lowering bank rate to 0.50 percent from 0.75 percent currently.

UNITED STATES: GDP growth was moderate in the second quarter, but is slowing in the second half of 2019. Real GDP rose 2.0 percent annualized in the second quarter by the Bureau of Economic Analysis’ second estimate, revised down a hair from 2.1 percent in the advance estimate. Growth was 3.1 percent in the first quarter. On a year-over-year basis, real GDP growth slowed to 2.3 percent in the second quarter from 2.7 percent in the first; GDP growth has gradually slowed since peaking at 3.2 percent in year-ago terms in the second quarter of 2018. The second estimate revised down government spending, exports, investment in inventories, and investment in housing in the second quarter. Consumer spending was the strongest support for the quarter’s growth, rising almost 5 percent at an annual rate, and was revised up in the second estimate. But both business fixed investment and investment in housing fell. Government was a net positive for growth in the second quarter, while trade and inventories were substantial drags. Gross domestic income, an alternative measure of the size of the economy based on incomes of households and businesses, also grew 2.1 percent at an annual rate in the second quarter and 2.3 percent from a year earlier. Corporate profits, unadjusted for inflation, rose $105.8 billion at an annualized rate in the second quarter, an increase of 5.3 percent (not annualized). Profits had fallen in each of the two previous quarters.

Consumer spending continued to support the economy in July, rising a strong 0.6 percent, with nondurable goods spending up 1.1 percent, durable goods spending 0.6 percent, and services spending 0.5 percent. Inflation by the Fed's preferred measure, the price index for personal consumption expenditures, rose 0.2 percent in July from June and 1.4 percent from a year earlier, up from 1.3 percent in June; the core PCE price index rose 1.6 percent on the year in both months, below the Fed's 2.0 percent objective. Personal income rose a modest 0.1 percent in July, held back by a sharp 1.8 percent drop in interest income caused by the federal funds rate cut. Labor income rose a moderate 0.2 percent on the month. Consumer sentiment was flat to down in August on the month's stock market volatility, trade war escalation, and inverted yield curve headlines. The University of Michigan Consumer Sentiment Index fell sharply to 89.8, the weakest since October 2016, from 98.4 in July, while The Conference Board Consumer Confidence Index dipped to 135.1 after 135.8 in July, which had been the strongest since November. The weekly Bloomberg Consumer Comfort Index recovered slightly in the second half of August after falling to the weakest since May in the first half of the month. The Markit manufacturing PMI was revised up to 50.3 in the August final release from 49.9 in the flash estimate, but was still the weakest since September 2009. The ISM manufacturing PMI fell to 49.1 in August from 51.2 in July and was the weakest since January 2016. Mortgage applications for home purchase again edged lower the week of August 23, and are down a cumulative 16.6 percent from their cyclical peak the week of April 12. PNC forecasts for the August employment situation summary, to be released September 6, to show nonfarm payroll jobs up a moderate 160,000 from July, the unemployment rate down to 3.6 percent from 3.7 percent, and average hourly earnings up 0.3 percent on the month and 3.2 percent on the year.

CHINA: The US government raised tariffs on roughly $110 billion of Chinese goods imports by 15 percentage points on September 1, and China retaliated as promised with 5 to 10 percentage point incremental tariffs on a variety of US exports to China. Many of the targeted US products, like soybeans and crude oil, were already subject to retaliatory tariffs. The next milestone in the trade war is scheduled for October 1, when the US government plans to raise the incremental tariff on the $250 billion of Chinese goods imports first targeted by Section 302 tariffs to 30 percentage points from 25. The US plans to impose 15 percentage point Section 302 tariffs on the rest of Chinese goods imports on December 15. The Caixin general manufacturing PMI rose to 50.4 in August from 49.9 in July, supported by increases in the output and employment sub-indexes, but the forward-looking export orders and output expectations worsened. The CFLP manufacturing PMI dipped to 49.5 in August from 49.7 in July; it averaged 49.6 in the second quarter. China's central bank is likely to cut its policy rate, the seven-day reverse repo rate, by 0.70 percentage point by year-end, to 1.85 percent from 2.55 percent currently, to offset the drag of rising tariffs on exports, capital spending, and business and consumer sentiment.

MEXICO: Private employment fell 0.3 percent in July, reversing June's 0.4 percent gain, and was up a modest 0.5 percent from a year earlier; Mexico's statistical agency does not release a monthly estimate of the level of private or total employment. The IHS Markit manufacturing PMI fell to 49.0 in August from 49.8 in July and was the weakest since the survey's start in April 2011. Financial markets price in just under 50-50 odds of a Mexican policy interest rate cut at the Bank of Mexico's September 26 decision, rising to nearly four in five odds by the November 14 decision.

BRAZIL: Real GDP grew by 0.4 percent (quarter over quarter, not annualized) in the second quarter after a revised 0.1 percent decline in the first quarter. Agricultural output, which is volatile quarter to quarter, fell 0.4 percent, while industrial output rose 0.7 percent. Mining fell 4.0 percent. Mining activity remains weak in the aftermath of the collapse of Vale's tailing dam in January. Business investment rose 3.2 percent following two consecutive declines. Household consumption, which accounts for about two-thirds of demand, rose 0.3 percent. Real GDP grew 1.0 percent from year-ago levels, rising from 0.5 percent in the prior quarter. This is the tenth consecutive quarter of growth. The unemployment rate fell to 11.8 percent in July from 12.0 percent in June, and was down from 12.3 percent a year earlier. The IHS Markit manufacturing PMI rose to 52.5 in August from 49.9 in July and was the strongest since March; Brazil's manufacturing business cycle often decouples from the global manufacturing cycle.

INDIA: Real GDP grew by 5.0 percent in the second quarter from a year earlier, the slowest pace since March 2013. Construction rose by 5.7 percent, slower than the first quarter's 7.1 percent. The manufacturing sector grew 0.6 percent, the slowest pace in over a year. The agriculture sector grew 2.0 percent compared to 5.1 percent a year earlier. The Markit manufacturing PMI fell to 51.4 in August from 52.5 in July and was the weakest since May 2018.

EUROZONE: Christine Lagarde, who will become President of the European Central Bank on November 1, gave important signals about the direction of monetary policy in written testimony to the European Parliament published August 29. In a wide-ranging Q&A, President-elect Lagarde implied that the ECB would consider broadening assets eligible for asset purchases a.k.a. QE under her leadership, writing, "In view of the fact that intermediation in financial markets and the regulatory setting have changed, operational frameworks are likely to look different than those before the crisis, including the size and structure of balance sheets and the instruments with which to implement the monetary policy stance." Even if the ECB does not broaden asset purchases to include Japanese-style ETF purchases at its September 12 Governing Council decision, the option is still a possibility once President-elect Lagarde takes the reins. Italy avoided a political crisis on August 28 when the anti-establishment left party the Five Star Movement and the establishment left party the Democratic Party agreed to form a new coalition government, retaining Giuseppe Conte as Prime Minister. The leader of the anti-establishment right party Matteo Salvini, who had clashed with the European Commission over Italy's deficit reduction targets, will be sidelined if the new government holds together. The unemployment rate was unchanged in July from June at 7.5 percent, the lowest in 11 years. The benchmark HICP consumer inflation index rose an unchanged 1.0 percent in year-over-year terms in the August flash estimate, undershooting the ECB's target of below but near two percent; measures of core HICP were 0.9 to 1.2 percent in year-over-year terms, close to the total index. The German Ifo Business Climate Index fell to the weakest since 2013 in August, and the European Commission's Economic Sentiment Indicator was little changed at 103.1 after 102.8 in July, which was the lowest since March 2016. The Markit manufacturing PMI was 47.0 in the August final release, unchanged from the flash estimate and up slightly from 46.5 in July; the PMI has signaled contraction of the manufacturing sector for seven months.

JAPAN: The Jibun manufacturing PMI for Japan was little changed at 49.3 in the August final release after 49.4 in June and a bit below the 49.5 flash estimate; the PMI has been in contractionary territory for six of the last seven months. Financial markets price in roughly 50-50 odds of a 0.10 percentage point cut in the Bank of Japan's -0.10 percent overnight rate by year-end.

CANADA: Real GDP grew a strong 3.7 percent annualized in the second quarter of 2019 after 0.5 percent in the first quarter and 0.3 percent in the fourth quarter of 2018, but details point to slower growth in the second half of 2019. Much of the second quarter's strong growth was due to a bounce in net exports, with exports up 13.4 percent annualized and imports falling 4.0 percent (lower imports mean more domestic spending directed at domestic production). Negatively, gross fixed capital formation fell 6.4 percent in the second quarter, and has declined in four of the last five quarters; the decline was concentrated in nonresidential investment, with residential investment recovering modestly after drops in the five prior quarters. The IHS Markit manufacturing PMI fell to 49.1 in August from 50.2 in July with new orders the weakest since December 2015. The PMI survey and low prevailing crude oil prices suggest Canadian capital spending will continue to weaken. After two consecutive months of job losses in June and July, the August escalation of the US-China trade war, and the inversion of both the 2s10s and 3s10s US yield curves, the Bank of Canada is likely to keep monetary policy on hold at its September 4 decision, then cut its overnight rate target 0.25 percentage points at its October 30 and January 22 monetary policy decisions in an echo of the Fed's "mid-cycle adjustment." If downside tail risks from the trade war materialize, the Bank of Canada will cut more than in this baseline forecast.

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