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GLOBAL ECONOMIC HIGHLIGHTS

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FED REINFORCES EXPECTATIONS FOR A SEPTEMBER RATE HIKE; CHINA ACTS TO CURB YUAN DEPRECIATION

UNITED STATES: The minutes of the Federal Reserve's July 31 to August 1 Open Market Committee meeting reinforce our forecast that the Fed will raise the Federal Funds target a quarter percentage point to a range of 2.00 to 2.25 percent at its next decision September 26. The minutes noted the strength of the expansion in 2018 and that inflation had moved close to its target; they also mentioned "trade" 22 times and "tariff" five times; Fed policymakers see trade frictions as a downside risk to growth, but believe tariffs' medium-term implications for inflation are hard to anticipate. The minutes also said that the Fed is likely to re-examine its "operating framework" in the fall, meaning the relationship between the tools it uses to keep the effective federal funds rate near the targeted level. In addition, "a few participants" discussed raising the countercyclical capital buffer to manage financial stability risks in the context of high asset prices. Fed Chairman Jay Powell made a case for the Fed to keep moving gradually in raising interest rates in his speech at the Jackson Hole monetary policy conference August 23: Powell cited historical examples of when the Fed misjudged the neutral interest rate, the level of the policy rate that would neither add to nor subtract from growth, or misjudged the minimum level of the unemployment rate that would not cause inflation to accelerate, to argue against accelerating rate hikes in reaction to the low unemployment rate. Powell's speech might also imply that the Fed should consider slowing rate hikes in response to a flattening yield curve, which might be a meaningful contemporaneous signal of the appropriate long-run interest rate. The premium of the ten-year government bond over the two-year government bond fell to 0.19 percentage points during the week of Chairman Powell's speech, on the news of the conviction of President Trump's campaign manager Paul Manafort and guilty plea of his lawyer Michael Cohen; when that measure of the steepness of the yield curve turns negative, a recession usually follows. The Fed will continue to raise interest rates gradually as long as inflation expectations remain well anchored and trend inflation does not move significantly above the Fed's target.

CHINA: As expected, the low-level bilateral meeting between China's Vice Minister of Commerce and the US Treasury Undersecretary for International Affairs yielded no breakthrough in the trade dispute; both the US and China imposed 25 percent tariffs on another $16 billion dollars of the other's exports on August 23. We see little prospect that the tariffs will be reversed before the US mid-term election. The People's Bank of China announced on August 24 that they are reinstating the use of a "countercyclical factor" in setting the daily fix around which the bilateral yuan-to-dollar exchange rate is permitted to fluctuate. The policy change will limit depreciation of the yuan, and signals that Chinese policy now actively supports a stronger yuan. The yuan recovered to 6.81 per dollar, the strongest since July 31, on the news.

EUROZONE: The Account (a.k.a. minutes) of the European Central Bank's July 25 and 26 Governing Council meeting reported that "measures of underlying inflation remained muted overall but had been increasing from earlier lows." The ECB's forward guidance is that an initial rate hike would come no earlier than the summer of 2019. Current data are consistent with that hike occurring in June, timed to the release of the mid-year quarterly economic projections. German government sources report that Chancellor Angela Merkel could be scaling back efforts to help Bundesbank President Jens Weidmann become President of the ECB when President Draghi retires in October 2019, and instead focusing Germany's political capital on securing the European Commission Presidency for a German. Weidmann's well-known hawkish stance on monetary policy and his willingness to publicly dissent from the ECB consensus during Draghi's Presidency are obstacles to convincing other euro area nations that he is the right candidate to lead their central bank.

CANADA: Retail sales fell 0.2 percent by value and 0.3 percent by volume in June, and wholesale sales fell 0.8 percent by value and 1.1 percent by volume. Even after the monthly pullback, retail sales still rose 3.8 percent by value and 0.7 percent by volume from a year earlier, and wholesale sales rose 3.9 percent in both value and volume terms over the same period. New claims for employment insurance fell 3.5 percent in year over year terms in June after a 2.1 percent year over year decline in May, further evidence that the labor market is solid despite the housing market's downturn.

JAPAN: CPI inflation edged higher to 0.9 percent in year over year terms in July from 0.7 percent in June on faster increases of volatile fresh food prices. Core CPI excluding food and energy was 0.0 percent in year over year terms in July, versus deflation of 0.1 percent in July 2017, inflation of 0.3 percent in July 2016, and inflation of 0.6 percent in July 2015. While core prices are no longer in deflation, they are still very far from the Bank of Japan's 2.0 percent inflation target.

MEXICO: President Trump announced at a political rally August 21 that his administration had reached a bilateral understanding with Mexico about issues related to the NAFTA renegotiation and were ready to restart trilateral negotiations including Canada; anonymous sources said on August 26 that the US and Mexico were near a deal. After months (or is it years?) in which negotiators said a deal was just around the corner, these statements deserve to be taken with a grain of salt. Even so, President Trump's comments further reduce the likelihood that the US unilaterally withdraws from NAFTA. The Mexican peso strengthened on the news. Mexican real GDP fell 0.6 percent annualized in the second quarter of 2018, giving back some of the solid 4.0 percent annualized growth of the first quarter and 3.3 percent annualized growth of the fourth quarter of 2017. Much of the second quarter's pullback was due to a big 8.2 percent drop in the agricultural sector, which tends to be very volatile and not indicative of the overall business cycle. Construction activity also fell in the second quarter, possibly due to uncertainty ahead of the July 1 election or to higher local currency long-term interest rates; both of these headwinds abated somewhat after the election. Mexican employment rose 3.0 percent from a year earlier in the second quarter, faster than the 1.6 percent year-over-year growth of real GDP. The cross check between employment and output suggests jobs data might overstate the strength of the economy, and the GDP report might overstate its weakness. Mexican growth will likely be moderate in the second half of 2018 since election-related uncertainty has abated and the risk of a unilateral US withdrawal from NAFTA has fallen.

BRAZIL: The Brazilian real depreciated to its weakest since the commodity price collapse of early 2016 after polls reported that support for the centrist candidate for the October Presidential election lags far behind other candidates, who are less likely to support deficit reduction policies. We expect political uncertainty to weigh on Brazil's currency until the election, after which it will probably abate to some degree (like Mexico's currency did after Mexico's July 1 election).

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