EMBARGOED UNTIL: 11.30AM THURSDAY 10 OCTOBER 2019

THE FORWARD VIEW – GLOBAL

OCTOBER 2019

National Australia Bank

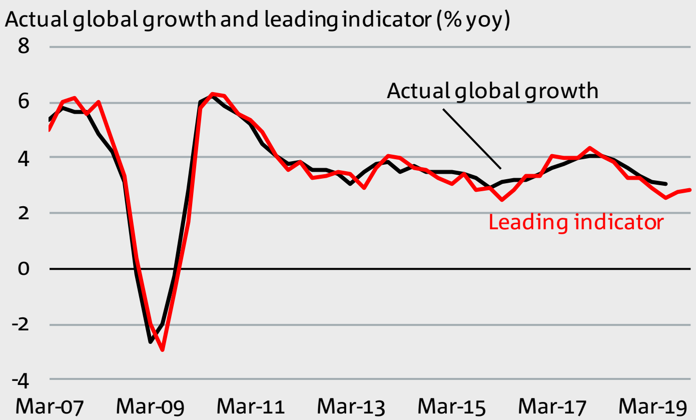
US opens new fronts in the trade war

- The deterioration in the global trade environment has continued – with the US announcing new tariffs on a range of imports from the European Union (in retaliation for EU subsidies for its aerospace sector). Meanwhile, tensions between the US & China could extend beyond trade, with reports suggesting the US is considering restrictions on financial flows with China. These developments highlight the risk of further escalation in tensions that could negatively impact global activity.
- India's economic slowdown is a key driver of weakness in 2019 (given that India is the world's third largest economy on a PPP basis) – largely reflecting its domestic issues rather than global trade. The Reserve Bank of India has aggressively cut its policy rate, which we expect to support an investment-led recovery, however downside risks to consumption persist.
- More timely indicators of activity – such as PMI surveys – suggest that any upturn in Q3 is unlikely. On average, global manufacturing and services readings were weaker in Q3 than Q2, and the recent upturn in manufacturing PMIs reflect the surprisingly strong outcome in China (given weakness in other industrial indicators).
- Our forecasts for global economic growth remain unchanged this month. We expect the global economy to expand by a sub-trend 3.1% in 2019, with little improvement in 2020 (3.2%) before recovering to the long term trend of 3.5% in 2021.
- Critical to the recovery in coming years is the lagged effects of easier monetary policy and cyclical recoveries in India and Latin America. These forecasts also assume no escalation in trade restrictions between the US and trading partners or worsening in geopolitical tensions – with potential tariffs on EU imports and Chinese financial flow restrictions highlighting downside risks.

Global Growth Forecasts (% change)

	2018	2019	2020	2021
US	2.9	2.2	1.6	1.8
Euro-zone	1.9	1.1	1.0	1.4
Japan	0.8	1.0	0.2	0.9
UK	1.4	1.2	1.2	1.5
Canada	1.9	1.6	1.6	1.7
China	6.6	6.3	6.0	5.8
India	6.8	5.7	6.8	7.1
Latin America	1.0	0.4	1.5	2.3
Other East Asia	4.1	3.5	3.7	3.8
Australia	2.7	1.7	2.2	2.5
NZ	2.9	2.1	2.4	2.0
Global	**3.6**	**3.1**	**3.2**	**3.5**

NAB global leading indicator



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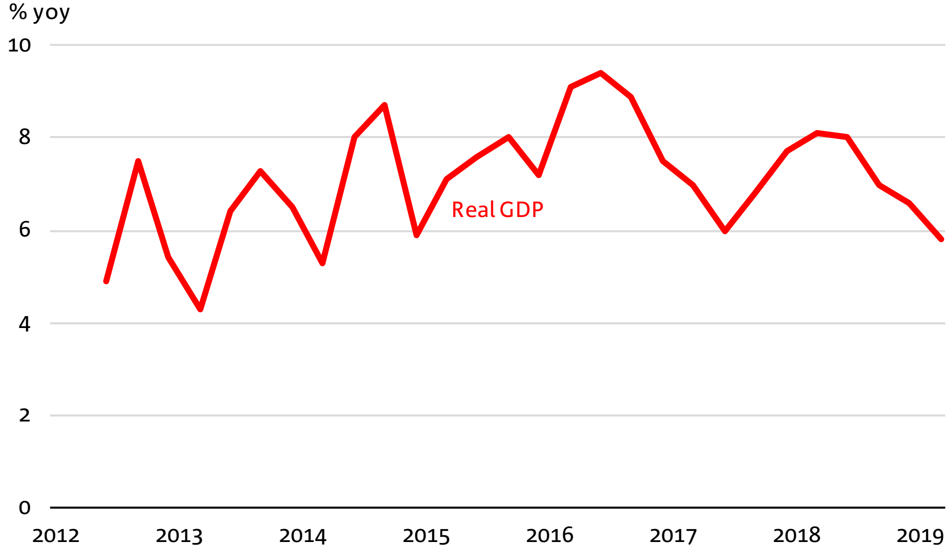
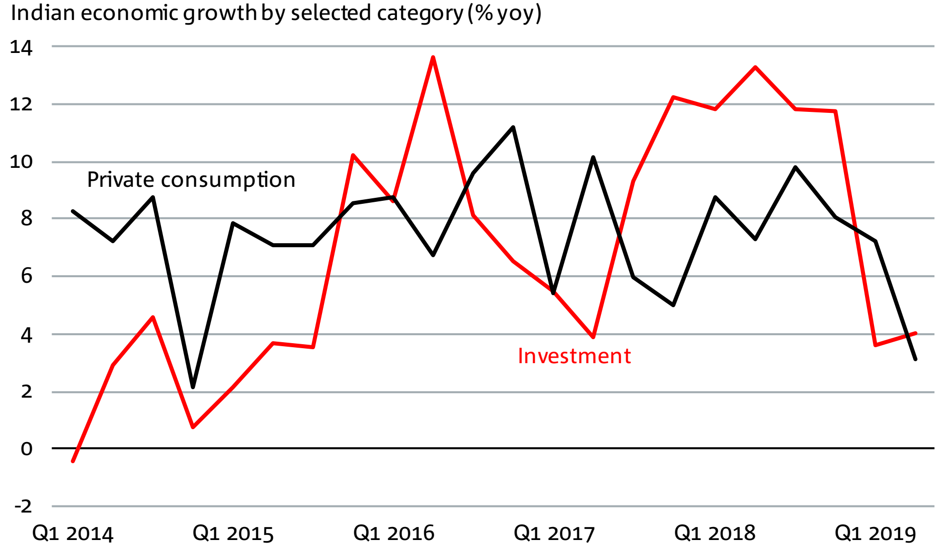
INDIA IS A KEY DRIVER OF THE GLOBAL SLOWDOWN

Growth has slowed in the third largest economy, due more to domestic weakness than global trade. Easing monetary policy is expected to support an investment-led recovery, but downside risks (particularly around consumption) persist

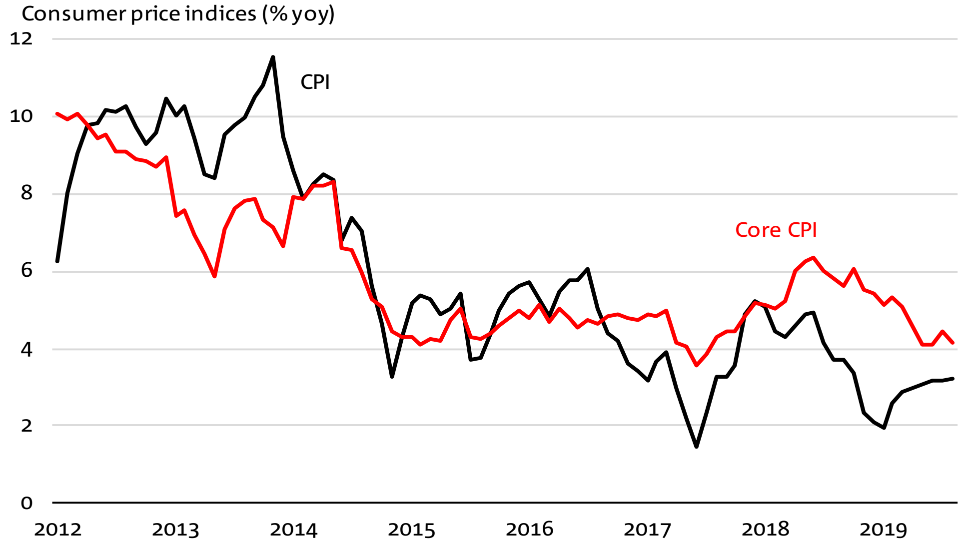
India's economic growth in Q2 was its slowest rate in five years



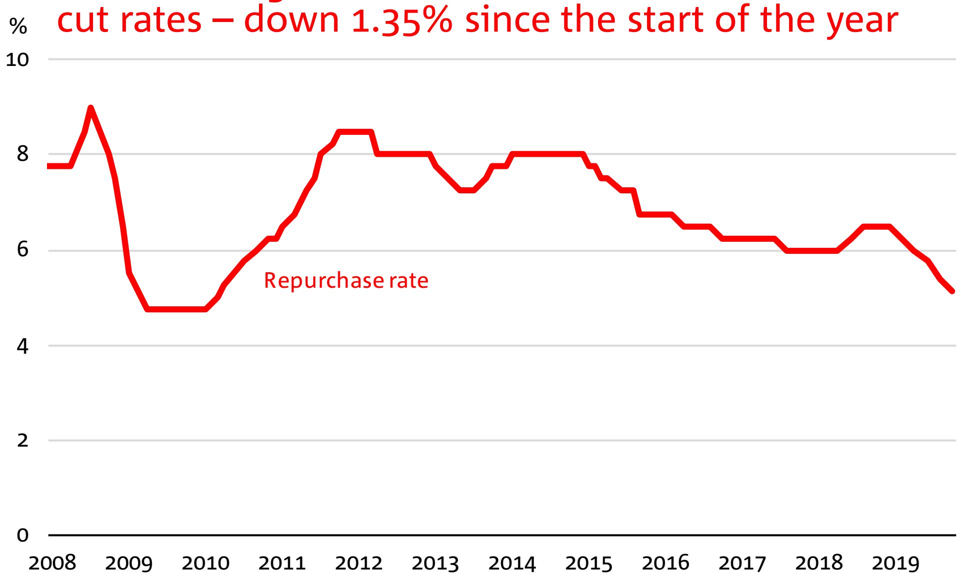
Weakness in the domestic economy key to the downturn – with private consumption and investment growth slowing



Headline inflation remains relatively modest, and reforms have brought core inflation lower…



…which has given the Reserve Bank of India room to cut rates – down 1.35% since the start of the year



Sources: CEIC, Refinitiv, NAB estimates

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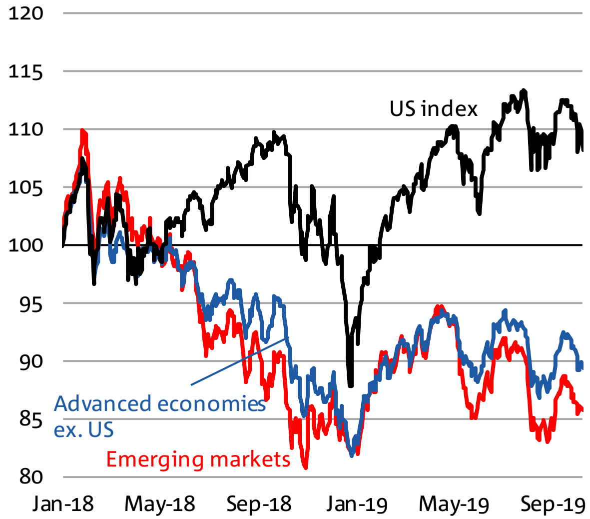
FINANCIAL AND COMMODITY MARKETS

Political and trade uncertainty triggers fresh market volatility

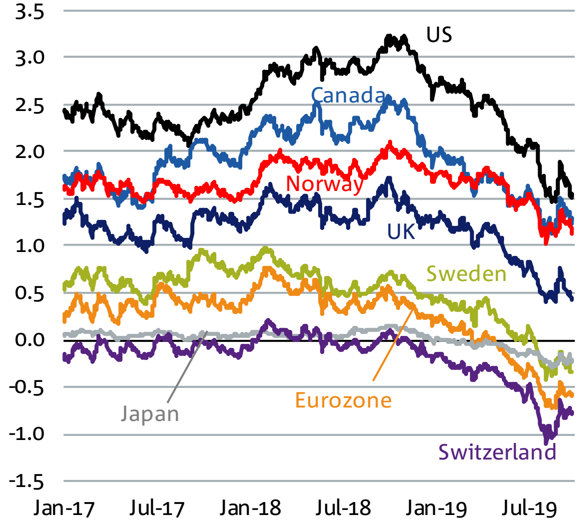
Equity markets declined from late September

MSCI Equity Indices (1 Jan 18=100)



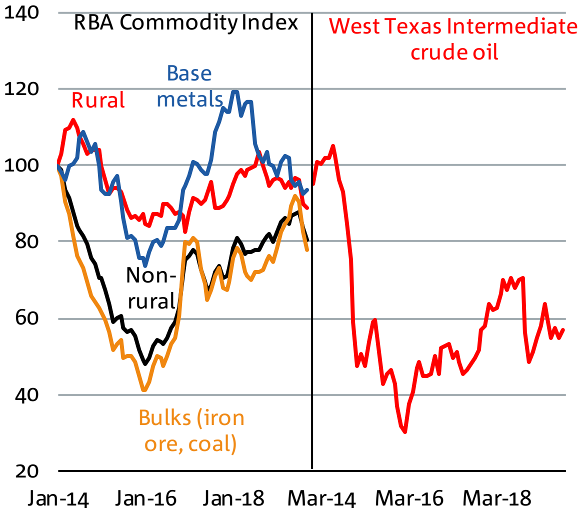
Bond markets highlight deteriorating market expectations

10 year government bond yields (%)



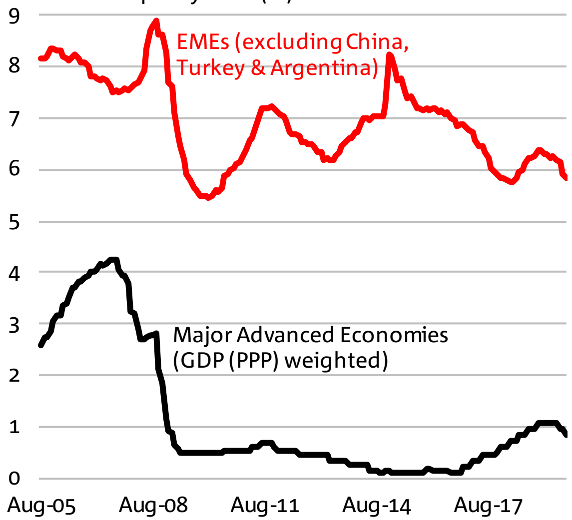
Commodity prices weaker; reflecting weaker manufacturing

Commodity price indices (Jan 2014 = 100)



Central banks continue to cut rates, led by EM banks

Central bank policy rates (%)



- Tensions between the US and China are threatening to extend into financial markets. The US Government is reportedly considering restrictions on financial flows with China, such as preventing Chinese firms from listing on US equity markets (including delisting firms already there), capping the share of Chinese firms included in US managed stock indices and restricting US government pension funds from investing in China. This could be a tactic ahead of trade negotiations on 10-11 October, but it highlights the risk of further escalation that could negatively impact global activity (particularly following the announced tariff measures against the EU – see over).
- Political uncertainty in the US has risen with impeachment proceedings against President Trump initiated in late September. It is too early to estimate any impact, however this could generate further volatility in financial markets and negatively impact US business investment.
- Equity markets have reacted negatively to these developments. Indices for advanced economies and emerging markets strengthened across the first half of September (from late August lows), but fell in volatile trading in early October. At the time of writing, indices for the US, other AEs and EMs were down between 3% and 4% from recent peaks.
- Bond yields highlight the change in market expectations over the past year. From peaks in a number of countries in November 2018, bond yields have plunged across much of 2019, reflecting weaker economic growth forecasts and shifting monetary policy and inflation expectations. 10 year US treasuries have fallen faster than most – down from around 3.25% in late 2018 to around 1.5% at the time of writing.
- Commodity prices trended broadly lower in September – despite a short term spike in crude oil prices following an attack on production facilities in Saudi Arabia. The RBA Index of Commodity Prices fell by around 3% month-on-month, with bulk commodities down by almost 6% on weaker trends in coal markets.
- Central banks continue to ease monetary policy, led by the EMs. The US Federal Reserve cut the fed funds rate in September, while the European Central Bank trimmed its deposit rate by 10 basis points and announced it would restart quantitative easing in November. The Fed also announced asset purchases in October, however this is intended to reduce disruptions in short term repo markets. We see at least one more cut from the Fed, with risks weighted towards more rather than fewer cuts, while policy room for the ECB and Bank of Japan is more limited (given already very low rates).

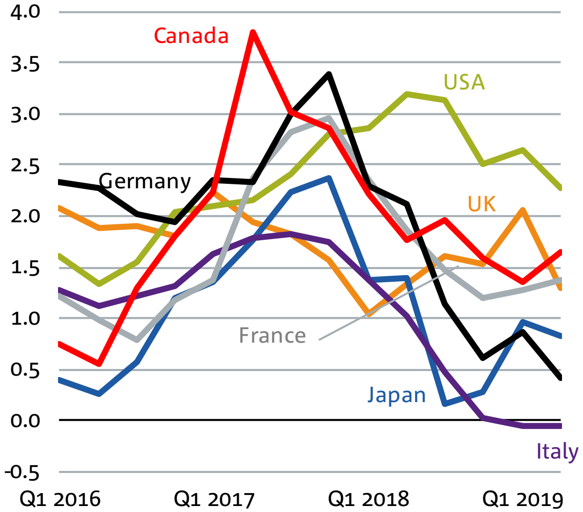
 Sources: Refinitiv, RBA, NAB Economics

ADVANCED ECONOMIES

US adds trade measures against Europe, increasing downside risk for AE growth

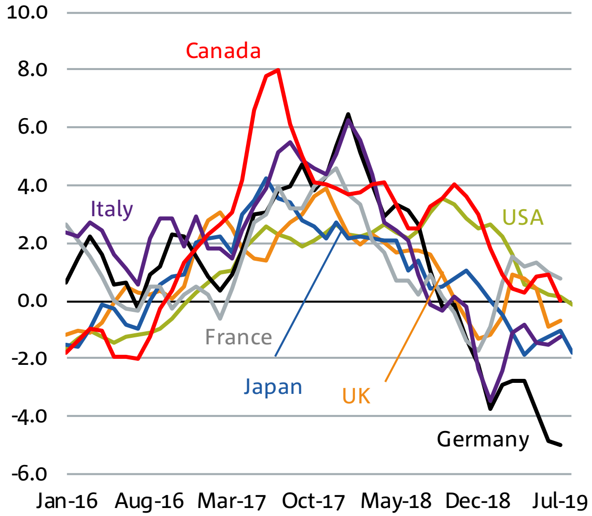
Broad based downturn in major AE growth since late 2017

G7 economic growth (% yoy)



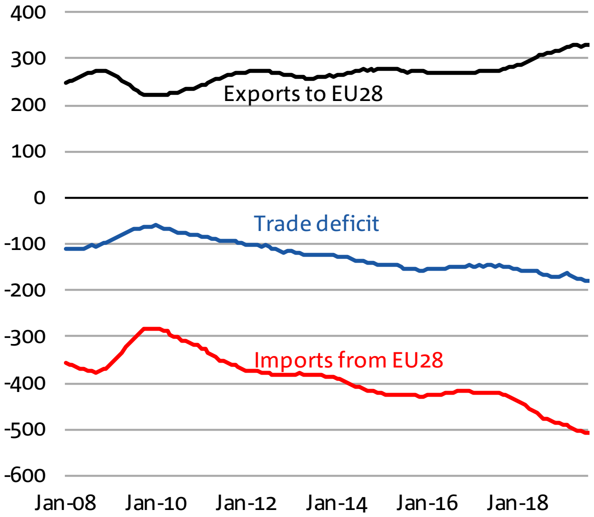
AE industrial sectors generally struggling, particularly Germany

G7 industrial production growth (% yoy 3mma)



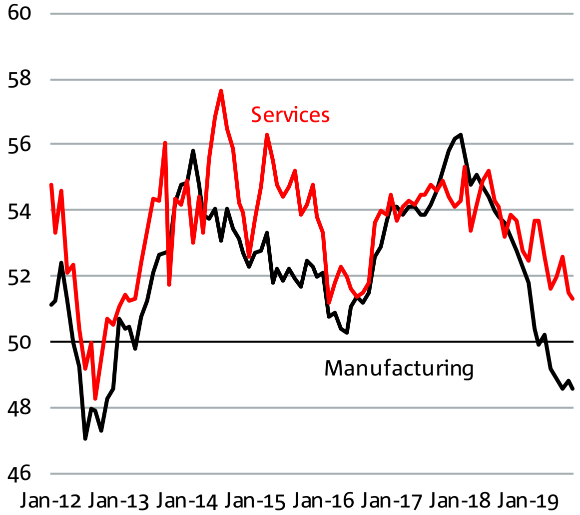
US trade deficit with Europe has steadily increased since 2010

US goods trade with the EU28 (US$b) (12 month sum)



PMI surveys highlight deterioration in advanced economies

Advanced economy PMI (Breakeven = 50)



- Growth in the major advanced economies slowed to 1.6% yoy in Q2 2019, having trended down from a cyclical peak of 2.6% in Q4 2017. Growth in most of this group declined across 2018 and the first half of 2019 – led by Germany, where growth slowed from 3.4% yoy in Q4 2017 to just 0.4% yoy in Q2 2019. Headwinds to growth are likely to persist – with the boost from US fiscal stimulus in 2018 having faded while Japan hiked its consumption tax on 1 October.
- The weakness in Germany has been attributed to a crisis in the country's auto sector, the uncertainty around Brexit (which remains unresolved following the breakdown of talks) and weaker demand in the US and China (in part related to the trade war) – with the UK, the US and China major export markets for Germany. Investment in construction was also weak in Q2 and risks of a recession have increased. There are concerns that the weakness in Germany has negatively impacted growth in other European economies – reflecting the integrated nature of the European Union, with growth in France and Italy weaker than late 2017 (notwithstanding domestic issues in these markets).
- The United States expanded its trade actions beyond China in early October, announcing 10% tariff on European aircraft imports and a 25% tariff on selected European agricultural, industrial and other goods imports, commencing 18 October. This action followed the World Trade Organization approving US tariffs on around US$7.5 billion of EU goods in retaliation for EU aerospace subsidies.
- It is worth noting that the US has a sizeable trade deficit with the European Union that has steadily widened since early 2010. In the twelve months to August 2019, the deficit totalled US$178 billion – a little under half the size of the US's trade deficit with China. Reports suggest that EU officials are considering their own trade measures in response, while a WTO ruling on alleged US aerospace subsidies is expected early next year. The potential for escalating trade tensions between these trading partners adds additional downside risk to growth in advanced economies.
- More generally, advanced economy export volumes have fallen in recent months – down 0.3% yoy (on a three month moving average basis) in July, compared with growth above 3.0% yoy across 2017 and the first eight months of 2018.
- Aggregate PMI measures for advanced economies show continued deterioration in both manufacturing (where surveys have been negative since May) and services.

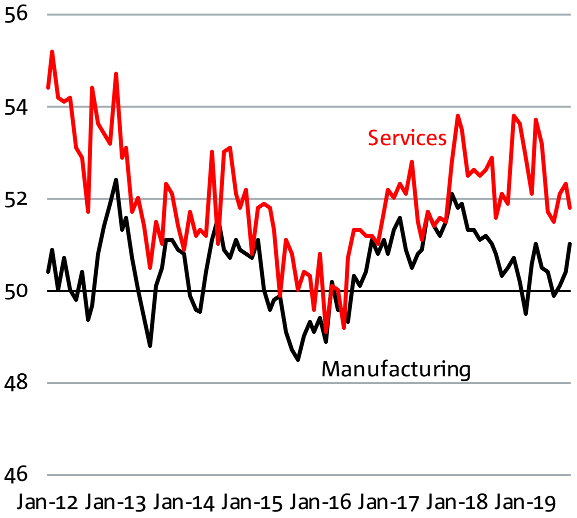
 Sources: Refinitiv, Markit, NAB Economics

EMERGING MARKET ECONOMIES

Mixed signals in EMs, with surveys surprisingly strong in current global environment

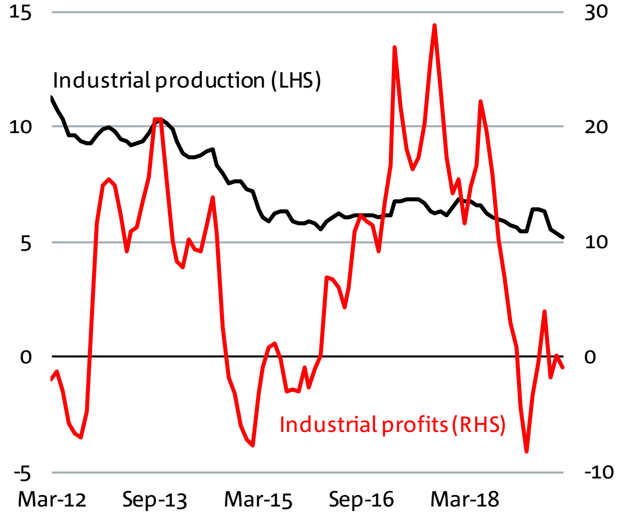
Surprise strengthening in MFG PMI; services still holding up

Emerging market PMI (Breakeven = 50)



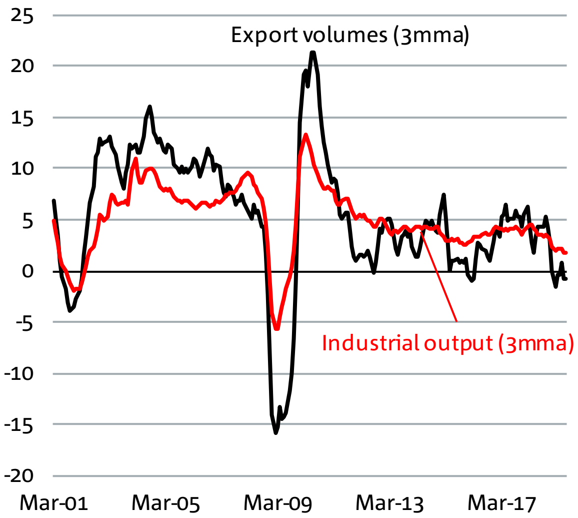
Official Chinese data shows weakness in the industrial sector

China industrial production and profits (% yoy 3mma)



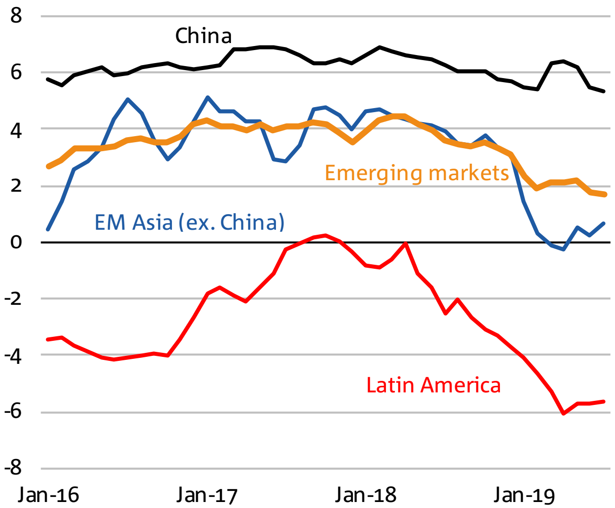
EM trade volumes and industrial production growth weaker

Emerging market exports and industrial output (% yoy)



Impact of trade deterioration on industry larger outside China

Emerging market industrial production (% yoy 3mma)



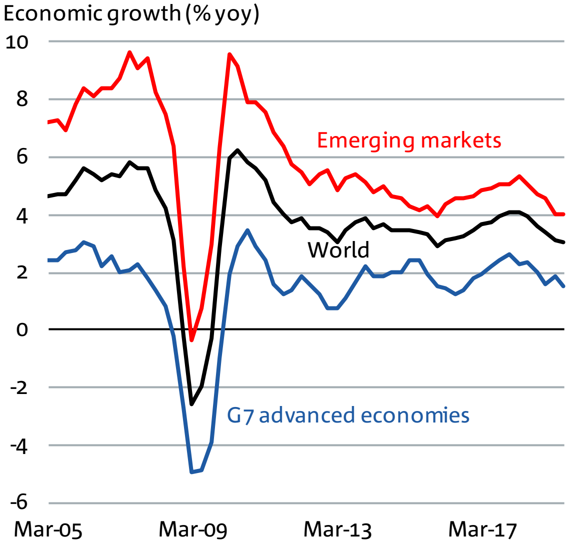
Sources: Refinitiv, Markit, NAB Economics

- Business surveys provide more timely indicators of underlying conditions than lagging measures such as GDP. Emerging Market manufacturing PMI measures strengthened in September – somewhat surprising given the deterioration in the US-China trade relationship – to a moderately positive 51.0 points (from 50.4 points previously).
- China was a key driver of the improvement in the aggregate EM manufacturing PMI. That said, the strength in this measure is at odds with recent weakness in Chinese industrial production and profits. Since early 2018, growth in industrial production has slowed to its weakest rate since the GFC, while industrial profits have plunged – turning negative this year. Producer prices have turned negative, suggesting that manufacturers have cut prices to maintain volumes.
- Emerging market services PMIs have held up comparatively well, with the aggregate remaining firmly in positive territory. That said, there was a sharp drop in the Indian services PMI, while China's measure also fell (albeit still above the 50 point breakeven mark).
- Growth in emerging markets is generally more dependent on international trade than is the case for advanced economies – meaning that these countries have suffered from the slowdown in global trade since late 2018. According to the CPB World Trade Monitor, emerging market export volumes fell by 0.8% yoy (on a three month moving average basis) in July – with this outcome ahead of more recent trade barriers imposed by the United States and China.
- Weak trading conditions have particularly impacted emerging market manufacturers – with growth in industrial production slowing from around 4.5% yoy (3mma) in early 2018 to just 1.7% yoy (3mma) in July 2019. Weakness has been particularly evident in Latin America and East Asia (outside of China).
- China introduced reforms to its monetary policy in late August, with bank lending to be priced off the benchmark Loan Prime Rate (LPR), which is influenced by the PBoC's Medium Term Lending Facility rate. The LPR was cut by 10 basis points at its introduction in August and a further 5 basis points in September.
- Weak conditions in India's economy has prompted further action from the Reserve Bank of India – cutting policy rates in October to 5.15%. Since the start of the year, India has cut official rates by 1.35%.

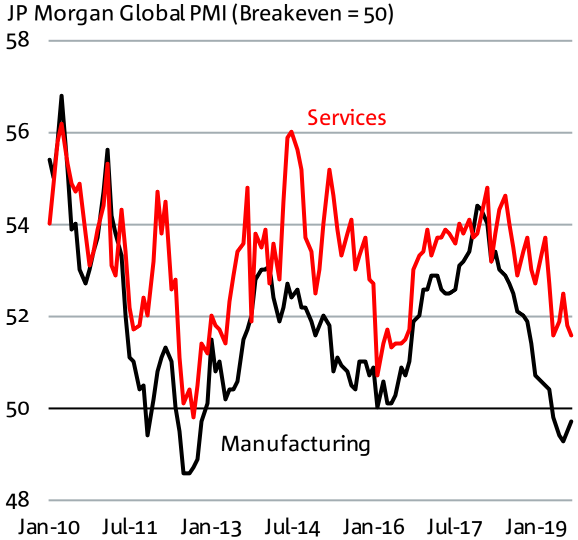
GLOBAL FORECASTS, POLICIES AND RISKS

Little prospect of a short term growth recovery, while new trade war fronts present downside risk

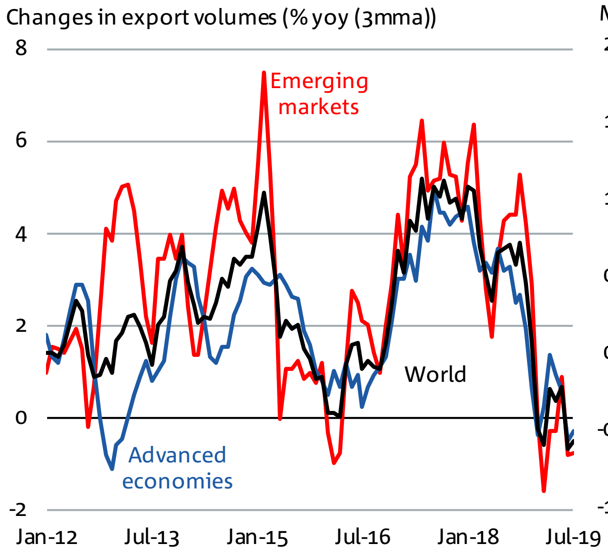
Global growth has slowed considerably since early 2018



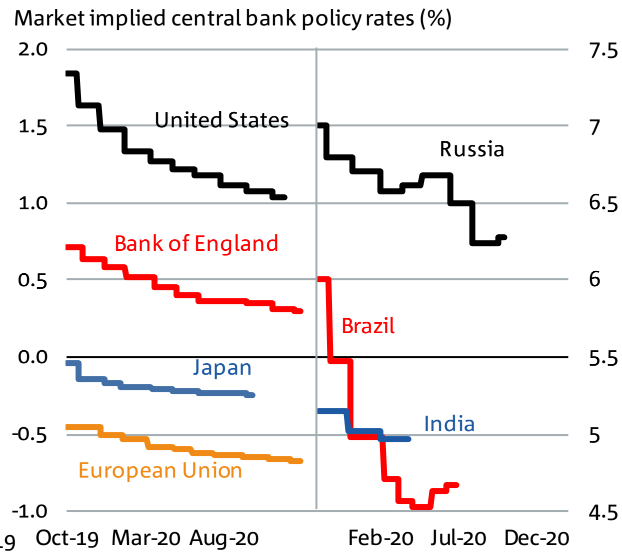
PMI surveys suggest little prospect of a turnaround in Q3



Trade volumes have plunged; goes beyond US-China issues



Markets anticipate further cuts to global policy rates



- According to our estimates of quarterly economic growth, the current global cycle peaked in Q1 2018 at 4.1% yoy and growth has slowed subsequently – down to 3.0% yoy in Q2 2019. Slowing growth in emerging markets – primarily in India and Latin America – provided a slightly larger contribution to this downturn than advanced economies, although the United States led the slowdown in Q2.
- More timely indicators of activity – such as PMI surveys – suggest that any upturn in Q3 is unlikely. On average, global manufacturing and services readings were weaker in Q3 than Q2, and the recent upturn in manufacturing PMIs reflect the surprisingly strong outcome in China (given weakness in other industrial indicators).
- The weaker conditions for manufacturers have been driven in part by the deteriorating global trading environment. These data lag PMI measures, however data available to July highlight the rapid deterioration over the past year. Global export volumes fell by 0.5% yoy (on a three month moving basis) in July, compared with an average increase of around 3.0% in 2018.
- Weakness in trade extends well beyond the direct US-China dispute. The drop in volumes for Japan and emerging Asia (excluding China) in part reflects the flow-on effects of the dispute (with China sitting in the middle of a manufacturing value chain), along with the decline in global demand. Falling export volumes in the Euro-zone are less connected to the trade dispute, instead reflecting the ongoing uncertainty with Brexit and conditions in key trading markets such as Turkey. The general uncertainty around trade is also a negative for global business investment – which could potentially have a larger and more long lasting impact on economic activity.
- Our forecasts for global economic growth remain unchanged this month. We expect the global economy to expand by a sub-trend 3.1% in 2019, with little improvement in 2020 (3.2%) before recovering to the long term trend of 3.5% in 2021.
- Critical to the recovery in coming years is the lagged effects of softer monetary policy and cyclical recoveries in India and Latin America. In contrast, growth in China is forecast to continue to slow – a long held view. These forecasts also assume no additional trade measures between the US and trading partners or worsening in geopolitical tensions – with potential tariffs on EU imports and Chinese financial flow restrictions highlighting downside risks.

Sources: Refinitiv, Markit, NAB Economics

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