ECONOMIC WEEKLY

Global Market Turmoil

San Francisco Fed President Mary Daly told *The Wall Street Journal* she is preoccupied with the effort to understand the impact of developments in the US-China trade dispute, but without data to drop into her models, she can only wonder. Traders do not have that luxury. Prices today can't wait for data prints next month. Besides, by then, even those data will be stale anyway. The entire world is in a "trade now, data later" position.

Judging by the performance of stocks, bonds, commodities, and currencies in the past week, a wave of risk-off trading swept through markets and — despite a stock-market rally midweek — may not yet have run its course.

As traders rushed for the exits for risk assets, they made decisions in the same information vacuum as Fed President Daly. In other words, this is one of those times, as we wrote about the meaning of the inverted yield curve two weeks ago, when the market can get it wrong. In the bond market, interest rates no longer reflect the simple intersection of supply of and demand for credit at different tenors. They represent the fear of a possible rout in demand foretold (perhaps) by the fear-driven drop in equities. If it turns out equity traders were right to sell, yields will stay this low, and perhaps fall even lower. If — as was the case following a similar selloff last year — they are wrong, then yields will rise.

In the fourth quarter, in anticipation of, and then in reaction to, the Fed's fourth and final 2018 rate hike, global equites lost 16.46%, with a 10.7% drop in December alone. October and November's whiff of panic in the air became global contagion in December when recession fear ran high. The selloff started in emerging markets and spread to the US, where it continued until the first Fed pivot on January 4, when Chair Powell assured the public the Fed would pause rate hikes.

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Stocks dropped again in May when the White House threatened tariffs against Mexico on the heels of tariff increases on China. The Fed stemmed the damage after a 6% drop by publically contemplating rate cuts. A quick deal between Mexico and the US to manage undocumented immigration and prevent tariffs helped, too. Another Trump tariff tweet, and the Chinese response to it, again sparked the current selloff.

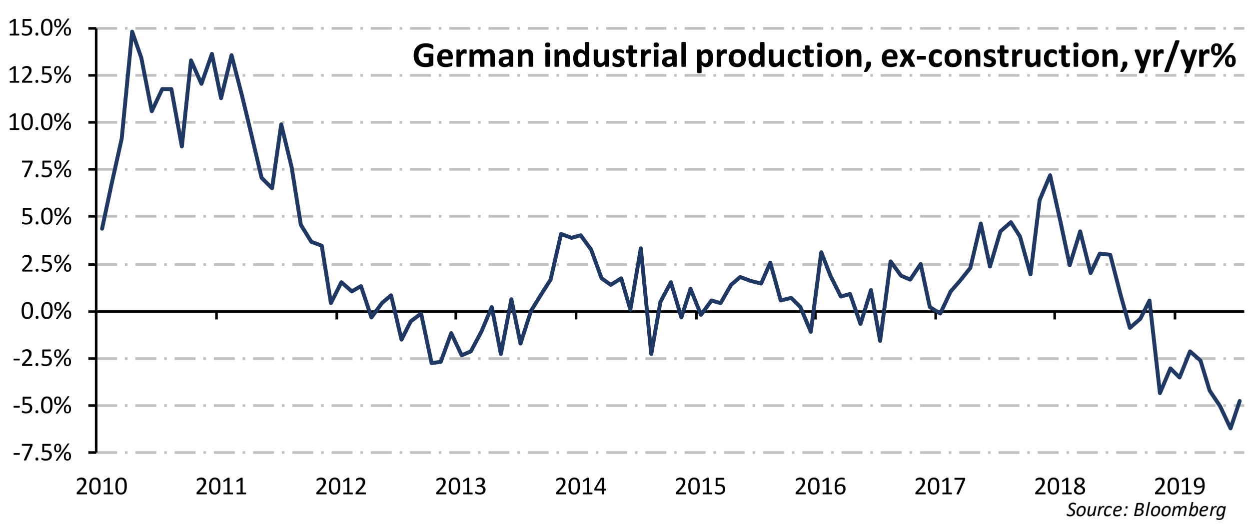
Global for a reason

As Jim Vogel noted in Wednesday's economic and interest rate strategy webinar, interest rates are composed of real-rate expectations and inflation expectations. Solving the real rate piece is easy as it reflects expected Fed policy. Solving the inflation expectations piece is the hard part of a yield forecast, especially given the unpredictability of global trade and global growth. The US-China trade dispute — itself unpredictable — is a key driver of both global trade flows and global economic growth. From there, it's a straight line toward total global demand, which in turn is the short- and medium-term determinant of global inflation.

GDP corresponds with revenue. When a country's GDP shrinks, the revenue of companies doing business in that country shrinks. On a micro-economic level, those companies fight to preserve total revenue by cutting costs and lowering prices to maintain or improve market share. Companies located and operating in still-growing economies must compete or lose market share and inflation tends to abate.

In the US, inflation reflects domestic supply and demand, but also international inflation. This year, German data has dominated US inflation expectations, and as a result, German interest rates have been a primary determinant of US interest rates. Why? Because German companies are most vulnerable to recession.

The best known example of low US inflation despite strong domestic growth and low unemployment is the late '90s, when most emerging markets went into recession. But the European recession and debt crisis, which has flared up repeatedly since 2009, has also limited US inflation, as did the post-stimulus economic slowdown in China in 2015. At the moment, Germany is in the crosshairs because German manufacturing data has deteriorated significantly, as shown in the below chart.



Since July 4, German 10-year yields have whipsawed from -0.40% to -0.21% to -0.60%. The rise in yields reflected the hope that synchronized global easing might boost European growth and inflation. The ensuing drop reflects fear central banks will not or — more likely — cannot do enough, especially in light of new tariffs.

No one buys German sovereign debt for the interest. Rather, traders rushed into German bunds in anticipation of capital gains, which makes it a dangerous play. As long as the yield falls, there will be gains. The gain was about 2.5% in the second quarter, according to Bloomberg. When prices fall, however, there will not be any interest available to cushion the blow. The speed of the 20bp yield backup in the spring is indicative of what to expect if the European economy ever sputters back to life.

Waiting for data

Economic data will determine whether the flight to risk was justified or overdone. These are key dates to watch:

- August 13: August ZEW German investor survey
- August 16: US preliminary consumer sentiment
- August 22: US preliminary Markit PMI
- August 22: German preliminary August PMI
- August 26: German IFO business climate
- August 27: US consumer confidence
- August 29: German CPI
- August 30: China PMIs
- September 1: China Caixin PMIs
- September 2: German final PMI
- September 3: US ISM manufacturing

Note that while the PMIs are almost a month away, the other reports are just the first indicators of the first-round, anticipatory effects of the tariff announcement. The Commerce Department is still compiling the list of goods, and the tax will not be implemented until September 1. It will be another month after that before the effect of the actual tariffs will be visible in the data. One result is likely volatility, as traders compare the actual damage to the anticipation priced into markets.

Summary: Economists have a love/hate relationship with financial markets. They love the feedback loops when prices respond to data releases. They love it when markets confirm their forecasts. They hate the market when it runs in a completely unexpected direction before all the facts are in. When central bankers insist they are data dependent, they sometimes include market information, but more often leave it until later. As many FOMC speakers said this week, you cannot chase every fresh breeze on the chance it becomes a hurricane. But, we have seen respected private economists argue 10s should be at 2.5% or higher, while others suggest the US is not immune to the global push to deeper negative interest rates.
So far this year, as we outlined in the webinar, the market has a better forecasting record than central bankers. There's no bottom line conclusion to draw this week, but in two weeks? We should be in a much better position to translate August volatility and its importance for portfolio decisions.

In the meantime, consider what we learned on Friday morning alone: UK GDP fell in the second quarter thanks to a Brexit-fear-related business investment drop. China's July PPI fell on a year-on-year basis, a sign companies are slashing margins to avoid losing market share to tariff-free competitors. German exports fell 8% year on year in July, the most in three years. US July core PPI fell, indicating US manufacturers are also cutting margins to compete for business. These data all suggest traders are right to worry.

– Chris Low, Chief Economist

The Week Ahead

This Week's Numbers

		PRIOR	CONSENSUS HIGH	CONSENSUS LOW	CONSENSUS MEDIAN	FTN
Tuesday, August 13	NFIB Small Business Optimism - Jul	103.3	105.0	101.5	104.8	**104.0**
	CPI MoM - Jul	0.1%	0.4%	0.1%	0.3%	**0.2%**
	CPI Ex Food and Energy MoM - Jul	0.3%	0.3%	0.1%	0.2%	**0.2%**
	CPI YoY - Jul	1.6%	1.9%	1.4%	1.7%	**1.6%**
	CPI Ex Food and Energy YoY - Jul	2.1%	2.2%	2.0%	2.1%	**2.1%**
	Real Avg Hourly Earning YoY - Jul	1.5%	--	--	--	**1.5%**
Wednesday, August 14	Import Price Index MoM - Jul	-0.9%	0.5%	-0.3%	0.0%	**-0.2%**
	Import Price Index ex Petroleum MoM - Jul	-0.4%	0.0%	-0.1%	-0.1%	**-0.1%**
	Import Price Index YoY - Jul	-2.0%	-1.9%	-2.0%	-1.9%	**-2.0%**
	Export Price Index MoM - Jul	-0.7%	0.2%	-0.4%	0.0%	**-0.6%**
Thursday, August 15	Nonfarm Productivity - 2Q P	3.4%	2.5%	0.9%	1.4%	**1.5%**
	Unit Labor Costs - 2Q P	-1.6%	3.3%	0.7%	1.7%	**1.5%**
	Retail Sales Advance MoM - Jul	0.4%	0.6%	-0.4%	0.3%	**0.2%**
	Retail Sales Ex Auto MoM - Jul	0.4%	0.7%	0.2%	0.4%	**0.3%**
	Retail Sales Ex Auto and Gas - Jul	0.7%	0.6%	0.3%	0.5%	**0.4%**
	Retail Sales Control Group - Jul	0.7%	0.5%	0.2%	0.4%	**0.4%**
	Industrial Production MoM - Jul	0.0%	0.5%	-0.3%	0.2%	**-0.3%**
	Manufacturing (SIC) Production - Jul	0.4%	0.1%	-0.5%	-0.3%	**-0.5%**
	Capacity Utilization - Jul	77.9%	78.4%	77.5%	77.9%	**77.7%**
	Business Inventories - Jun	0.3%	0.3%	0.0%	0.1%	**0.1%**
Friday, August 16	Housing Starts - Jul	1253k	1342k	1177k	1259k	**1260k**
	Housing Starts MoM - Jul	-0.9%	7.1%	-6.1%	0.5%	**0.6%**
	Building Permits - Jul	1220k	1290k	1250k	1270k	**1270k**
	Building Permits MoM - Jul	-6.1%	4.7%	1.5%	3.1%	**4.1%**
	U. of Mich. Sentiment - Aug P	98.4	100.0	94.8	97.2	**97.0**

Review

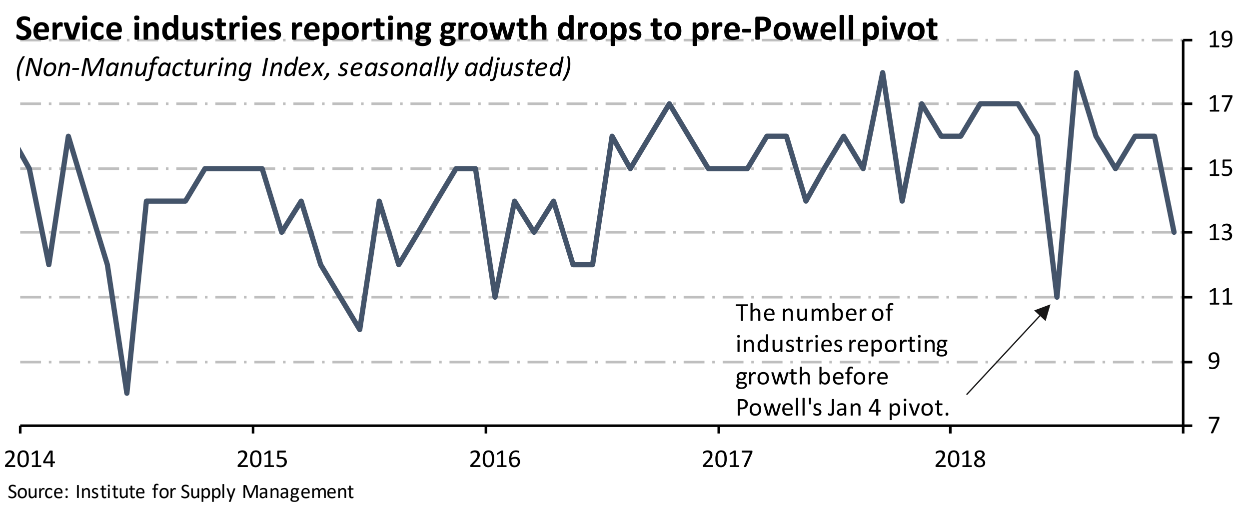
This week, in spite of few US economic releases, there was no end to market moving events. The US-China trade war evolved into a currency war, Germany appears headed for recession, and growth in the US service sector is slowing.

- Monday, China's yuan fell below the seven to one USD threshold for the first time in 11 years. Global equities sold off, the Dow plunged nearly 1,000 points before stabilizing, and the Treasury curve flashed its strongest recession signal since 2007. The PBOC allowed its currency to weaken by setting its daily fixing USD/CNY exchange rate to 6.9225 versus Friday's 6.8996. (Traders expected it to defend the 7.0 threshold.) The move prompted market participants to call the move a competitive devaluation. PBOC Governor Yi Gang explained the exchange rate by citing new developments in global trade, the recent depreciation of many currencies against the USD, and market forces. This did little to appease President Trump, who later called the move "currency manipulation."

Late Monday, the Treasury formally labeled China a currency manipulator. The consequences of the accusation appear benign[1], but market reaction was not. Equities resumed their selloff and Treasuries rallied on safe haven buying. Tuesday, the PBOC denied the accusation, citing BIS data from 2005 to June 2019, which points to the yuan strengthening more than any other G20 currency.

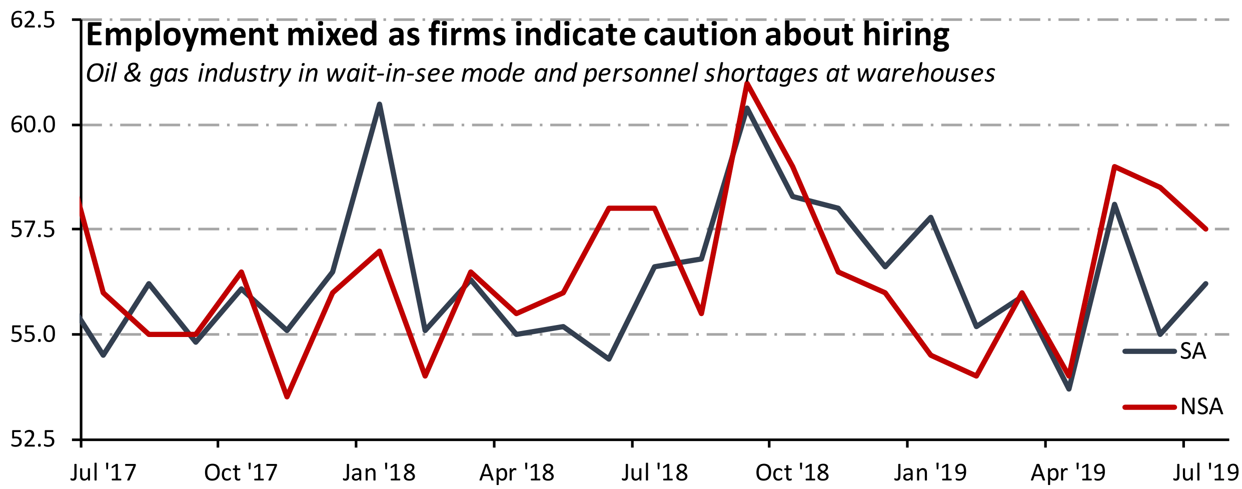
- Wednesday, the White House Office of Management and Budget implemented interim rules banning Huawei equipment from federal government contracts, grants, and loans. The ban passed into law last year through the National Defense Authorization Act (Section 889). It prevents federal agencies from procuring, renewing, or extending contracts with Huawei and four other Chinese companies. (ZTE Corp, Hytera Communications, Hikvision Digital, and Dahua were also named along with their affiliates and subsidiaries.) It allows entities to apply for a one time, two-year waiver.

- July's ISM Non-Manufacturing Index indicated growth cooling in the services sector. The index fell from 55.1 to 53.7, a three-year low. Business activity posted the largest decline, plunging 5.1 points to 53.1. New orders also contributed, falling from 55.8 to 54.1. The number of service industries reporting growth over the month fell to 13, its lowest level since January before Jay Powell's pivot.



Employment was most concerning, as it appeared tilted to the downside. Seasonally adjusted, it rose (+1.2 points) to 56.2, but non-seasonally adjusted, fell (-1 point) to 57.5. These are strong levels, but with reports of driver and warehouse personnel shortages (resulting in longer supplier lead times) and oil and gas firms in wait-and-see mode on hiring and capex plans, the industry appears to be at a turning point. That said, reports of labor shortages continue, now for the tenth straight month. (Construction, advanced digital analytics, and medical services workers were particularly in short-supply.)

1 The IMF prohibits countries from manipulating their currencies to gain an unfair trade advantage, but it cannot force a country to change exchange rate procedures. On the flip side, the WTO has an enforcement mechanism but no specific mention of currency manipulation. Nonetheless, WTO rules forbid subsidies, and currency manipulation might be considered a type of subsidy. In any event, a country that believes another country has violated WTO rules, can request a dispute settlement panel be setup to review the arguments and issue a judgment. If the losing party does not comply with the WTO ruling, the WTO may authorize retaliatory measures usually in the form of customs duties, i.e., tariffs. For more on the topic, see Brad Setser and *The Week*.



Source: Institute for Supply Management

Inventories were unchanged indicating firms are "letting supplies run lower than normal to keep expenses down." Inventory sentiment (+2 points to 60.5) indicated managers see levels as "still too high."

- Monday's Sentix Investor Confidence for the Eurozone fell to a near five-year low, from July's -5.8 to -13.7 in August. (Current sentiment fell from 1.8 to -7.3, and expectations from -13.0 to -20.0) The survey noted central bank promises of more accommodation have not only failed to turn investor sentiment around, but actually intensified the downturn. Germany in particular is facing difficult times on unwinding globalization and flat exports. Its overall index fell from July's -4.8 to -13.7, its lowest level since October 2009, prompting survey economists to call "a recession in Germany…inevitable."

The Atlanta Fed Q3 GDPNow forecast was unchanged this week at 1.9%, and New York's Nowcast stands at 1.6%.

Preview

Note: ★ = High Impact Event
All times Eastern Daylight

Sunday, August 11

- China: Indian Foreign Minister Subrahmanyam Jaishankar visits China ahead of a summit between Prime Minister Modi and President Xi.
- Italy: Deputy Prime Minister Matteo Salvini speaks at rally in Sicily. His League party called for early elections after policy disagreements with its governing partner, Five-Star. (Support for the Five-Star party has reportedly diminished more than 50% since the last Italian election.)

Monday, August 12

- 11:30am – US: $42b 3M and $42b 6M Treasury Bill Auctions
- ★ 2:00pm – US: Monthly Budget Statement – Jul (Last: -$8.5b, Con; -$123.0b)
- 7:50pm – Japan:
  - PPI – Jul (Last: -0.1% y/y)
  - PPI – Jul (Last: -0.5% m/m)

Tuesday, August 13

- 12:30am – Japan: Tertiary Industry Index – Jun (Last: -0.2% m/m)
- 2:00am – Japan: Machine Tool Orders – Jul P (Last: -37.9%)
- ★ 2:00am – Germany:
  - CPI – Jul F (Last: 0.5% m/m)
  - CPI – Jul F (Last: 1.7% y/y)
  - CPIH – Jul F (Last: 0.4% m/m)
  - CPIH – Jul F (Last: 1.1% y/y)
- ★ 4:30am – UK: Labor Market Report – Jun
- ★ 5:00am – Germany:
  - ZEW Survey Current Situation – Aug (Last: -1.1)
  - ZEW Survey Expectations – Aug (Last: -24.5)
- 6:00am – US: NFIB Small Business Optimism – Jul (Last: 103.3; Con: 104.9)
- ★ 8:30am – US:
  - CPI – Jul (Last: 0.1% m/m; Con: 0.3% m/m)
  - CPI – Jul (Last: 1.6% y/y; Con: 1.7% m/m)
  - Core CPI – Jul (Last: 0.3%; Con: 0.2% m/m)
  - Core CPI – Jul (Last: 2.1% y/y; Con: 2.1% y/y)
  - Real Average Hourly Earnings – Jul (Last: 1.5% y/y)
- ★ 11:00am – US: The New York Fed releases its Quarterly Report on Household Debt and Credit. Q1's release showed rising delinquencies in auto and student loans.
- ★ 1:00pm – US: $28b 1Y Treasury Note Auction
- ★ 7:50pm – Japan:
  - Core Machine Orders – Jun (Last: -7.8% m/m)
  - Core Machine Orders – Jun (Last: -3.7% y/y)
- ★ 10:00pm – China:
  - Fixed Assets Ex Rural – Jul (Last: 5.8% y/y; Con: 5.9% y/y)
  - Industrial Production – Jul (Last: 6.3% y/y; Con: 6.0% y/y)
  - Retail Sales – Jul (Last: 9.8% y/y; Con: 8.6% y/y)

Wednesday, August 14

- US: SEC Form 13F filing deadline for money managers with more than $100m of US traded equities.
- 1:30am – France: ILO Unemployment Rate
- ★ 2:00am – Germany:
  - GDP – Q2 P (Last: -0.4% q/q)
  - GDP – Q2 P (Last: 0.6% y/y)
- ★ 2:45am – France:
  - CPI – Jul F (Last: -0.2% m/m)
  - CPI – Jul F (Last: 1.1% y/y)
- ★ 4:30am – UK:
  - CPI – Jul (Last: 2.0% y/y)
  - Core CPI – Jul (Last: 1.8% y/y)
  - PPI Output – Jul (Last: 1.6% y/y)

- ★ 5:00am – EU:
  - GDP – Q2 P (Last: 0.2% q/q)
  - GDP – Q2 P (Last: 1.1% y/y)
  - Industrial Production – Jun (Last: 0.9% m/m)
  - Industrial Production – Jun (Last: -0.5% y/y)
  - Employment – Q2 P (Last: 0.3% q/q)
  - Employment – Q2 P (Last: 1.3% y/y)
- 8:30am – US:
  - Import Price Index – Jul (Last: -0.9% m/m; Con: 0.0% m/m)
  - Import Price Index – Jul (Last: -2.0% y/y)
  - Import Price Index ex-Petroleum – Jul (Last: -0.4% m/m)
  - Export Price Index – Jul (Last: -0.7% m/m)
  - Export Price Index – Jul (Last: -1.6% y/y)
- 9:30pm – China: New Home Prices – Jul (Last: 0.66% m/m)

Thursday, August 15

- ★ Mexico: Mexico's central bank announces its monetary policy decision.
- 12:30am – Japan:
  - Industrial Production – Jun F (Last: -3.6% m/m)
  - Industrial Production – Jun F (Last: 4.1% y/y)
  - Capacity Utilization – Jun (Last: 1.7% m/m)
- ★ 4:30am – UK:
  - Retail Sales – Jul (Last: 1.0% m/m)
  - Retail Sales – Jul (Last: 3.8% y/y)
- ★ 8:30am – US:
  - Retail Sales Advance – Jul (Last: 0.4% m/m; Con: 0.3% m/m)
  - Retail Sales Ex-Autos – Jul (Last: 0.4% m/m; Con: 0.4% m/m)
  - Retail Sales Ex-Autos and Gas – Jul (Last: 0.7%; Con: 0.5% m/m)
  - Retail Sales Control Group – Jul (Last: 0.7% m/m; Con: 0.4% m/m)
  - Empire Manufacturing – Aug (Last: 4.3; Con: 1.2)
  - Philadelphia Fed Business Outlook – Aug (Last: 21.8; Con: 10.0)
  - Nonfarm Productivity – Q2 P (Last: 3.4% q/q; Con: 1.4% q/q)
  - Unit Labor Costs – Q2 P (Last: -1.6% q/q)
- 9:15am – US:
  - Industrial Production – Jul (Last: 0.0% m/m; Con: 0.2% m/m)
  - Capacity Utilization – Jul (Last: 77.9%; Con: 77.9%)
- 10:00am – US:
  - NAHB Housing Market Index – Aug (Last: 65; Con: 66)
  - Business Inventories – Jun (Last: 0.3% m/m; Con: 0.1% m/m)
- ★ 3:00pm – US:
  - Net Long-term TIC Flows – Jun (Last: $3.5b)
  - Total Net TIC Flows – Jun (Last: $32.9b)

- 8:30pm – Singapore:
    - Exports – Jul (Last: -17.3% y/y)
    - Exports – Jul (Last: -7.6% m/m)
    - Electronic Exports – Jul (Last: -31.9% y/y)

Friday, August 16

- ★ 4:30am – Hong Kong:
    - GDP – Q2 F (Q2 P: 0.6% y/y)
    - GDP – Q2 F (Q2 P: -0.3% q/q)
- 5:00am – EU: Trade Balance – Jun (Last: €20.2b)
- ★ 8:30am – US:
    - Housing Starts – Jul (Last: 1,253k; Con: 1,259k)
    - Housing Starts – Jul (Last: -0.9% m/m; Con: 0.5% m/m)
    - Building Permits – Jul (Last: 1,220k; Con: 1,270k)
    - Building Permits – Jul (Last: -6.1% m/m: Con: 3.1% m/m)
- ★ 10:00am – US: University of Michigan Consumer Sentiment – Aug (Last: 98.4; Con: 97.2)

– Rebecca Kooshak, Economic Analyst