MARS CAPITAL PARTNERS

Weekly Macro Review

w/c 22 July 2019

Key Themes

Data out this week confirmed lower US growth momentum. The Q2 advance GDP release showed that annual growth slowed to 2.1% (SAAR). Revisions to annual GDP growth had several impacts; the annual growth by quarter was revised higher between Q4 2016 and Q3 2018, while the latest Q4 2018 and Q1 2019 growth was revised notably lower and the overall shape of the trend shows that US growth has been slowing since Q2 2018.

The bright spot for the Q2 GDP release was the much faster growth in personal consumption expenditure.

The data out this week for Jul, especially in manufacturing, indicates continued weakness. The prelim US composite PMI was little changed. Manufacturing activity slowed to zero growth – growth in new orders remains 'marginal', firms appear to be managing inventory in light of slower growth in orders and manufacturing employment indicators are weakening. Services activity improved but noted was the sharper fall in future business expectations.

The two US regional surveys for Jul showed manufacturing activity contracting, with several key areas deteriorating markedly. The advance durable goods orders for Jun showed a small, welcomed improvement in new orders for the month.

Across the manufacturing releases in the US, the dynamic remains unchanged; new orders growth has been slowing (if not declining) and shipment growth has slowed but remains positive. In the absence of accelerating growth in new orders, firms are working through order backlogs and this is helping to support output. As an indicator of future output growth, new orders will remain a key focus.

In Europe, last weeks' fall in the Zew economic expectations index for Jul was backed up by further weakness in the prelim PMI's for Jul. Services activity slowed slightly but much weaker manufacturing activity dragged the overall index lower. The broad Eurozone manufacturing indicators remain concerning with stagnating growth in new orders and an accelerated decline in new export orders. Unsurprisingly, future expectations for output growth declined to the lowest levels since 2014. The prelim PMI's for the largest EU economy, Germany, showed that growth slowed more broadly across both manufacturing and services in Jul.

While the ECB kept policy unchanged, there was a significant shift in guidance signalling the likelihood of policy easing in the near future;

> "The Governing Council expects the key ECB interest rates to **remain at their present or lower levels** at least through the first half of 2020"

> "In this context, the Governing Council has tasked the relevant Eurosystem Committees with examining options**, including ways to reinforce its forward guidance on policy rates, mitigating measures, such as the design of a**

tiered system for reserve remuneration, and options for the size and composition of potential new net asset purchases."

Tensions between the US and EU continue to weigh on sentiment. The EU expects the WTO to give the US approval to apply tariffs on EU imports valued at between $5-7bn. The EU has a similar case pending against Boeing. The US has already opened a second S.301 investigation to identify additional EU products for tariffs.

In Australia, the RBA Governor, Philip Lowe, gave a speech on inflation and inflation targeting. The main feature from a policy perspective was that Governor Lowe provided some forward guidance on rates in Australia;

"Whether or not further monetary easing is needed, **it is reasonable to expect an extended period of low interest rates**.

In the UK, the leadership of the Conservative party was resolved as Boris Johnson won the PM ballot. Johnson has been a strong proponent of leaving the EU on 31 Oct with or without a deal. No details have been released regarding a restarting of negotiations with the EU on the withdrawal agreement. The UK government has instead committed to further spending in preparation for leaving the EU on 31 Oct.

Contents

US Data

Chicago Fed National Activity Index (Jun)

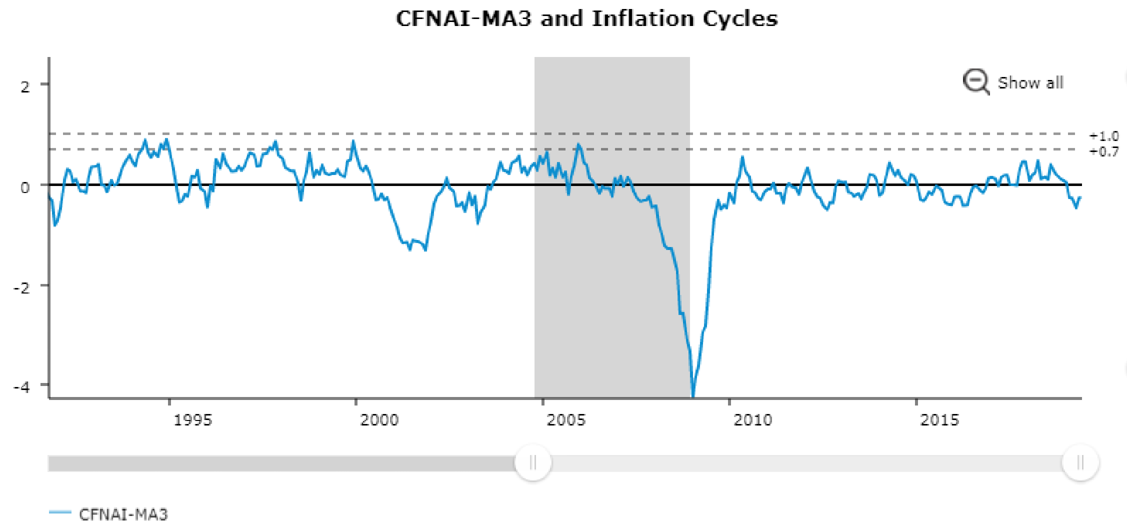
The latest reading of the CFNAI shows that growth in the US economy remains around the long-term trend. The monthly index was mostly unchanged from the month prior indicating growth just slightly below the long-term average trend. The 3-month moving average remained firmly negative.

National Activity Index;

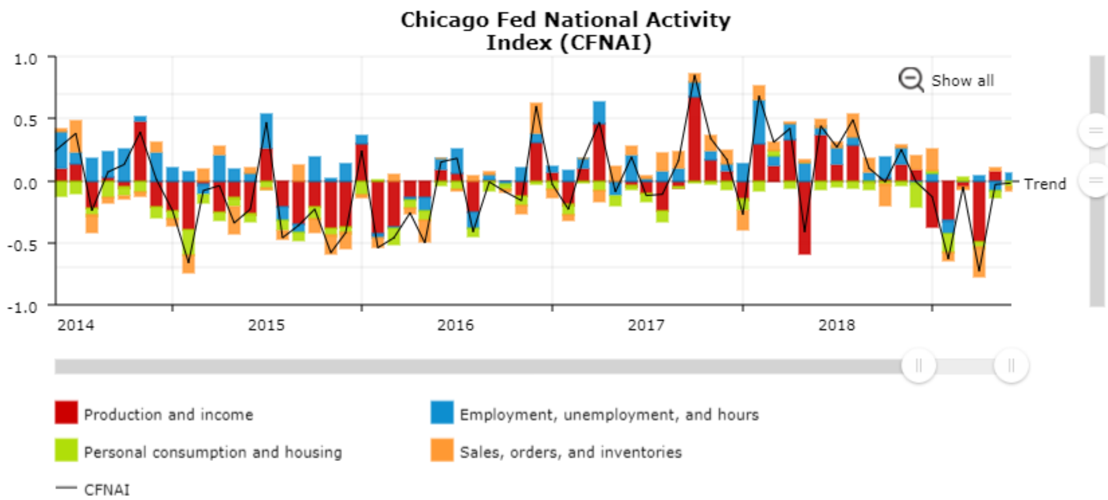
Month change; Jun -0.02 versus May -0.03

3-month average; Jun -0.26 versus May -0.27

This is one of the few indicators where the current period of weakness is at least on par with the prior period of weaker activity in 2015-16;



National Activity Index - Components



There were several offsetting forces this month;

Employment unemployment and hours shifted from below trend growth in May to above trend in Jun; Jun +0.06 versus May -0.08 (as a result of the stronger increase in non-farm payrolls between the two months)

This helped to somewhat offset the slowdown in production and income growth (which slowed to the historical trend level); Jun 0 versus May +0.08

Growth in sales, orders and inventories slowed slightly to below trend; Jun -0.03 versus May +0.02

Personal consumption and housing measures were unchanged and growing at just below the long-term trend; Jun -0.05 versus May -0.05

https://www.chicagofed.org/publications/cfnai/index

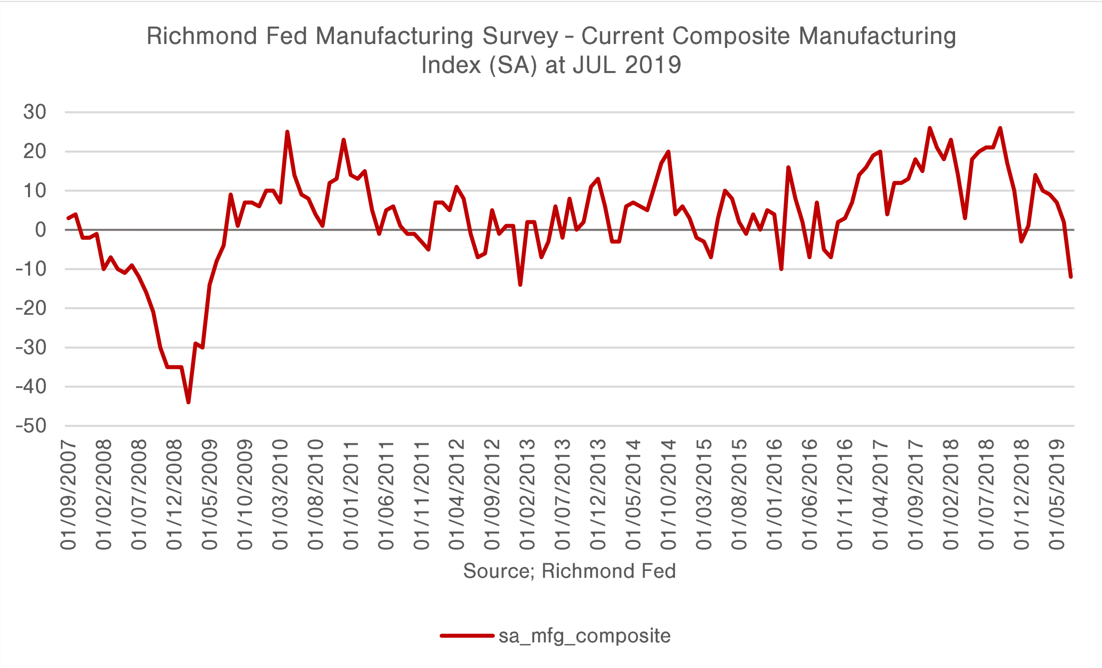
Richmond Fed Manufacturing Index (Jul)

The composite index of manufacturing activity declined sharply in the latest month. Conditions across shipments, new orders and employment were all weaker and in negative territory. Growth in the composite index has been slowing since the rebound in Feb 2019.

Also concerning is that, in the absence of new order growth, growth in shipments may no longer be supported by further reductions in order backlogs, with the decline in backlogs accelerating to a new post GFC low. Inventory growth remains elevated after peaking two months ago. On the positive side, the expectations for new orders (and activity generally) in six-months' time increased at a faster pace.

Composite Manufacturing Index; Jul -13 versus Jun 5

This is the lowest reading of the index since 2013;



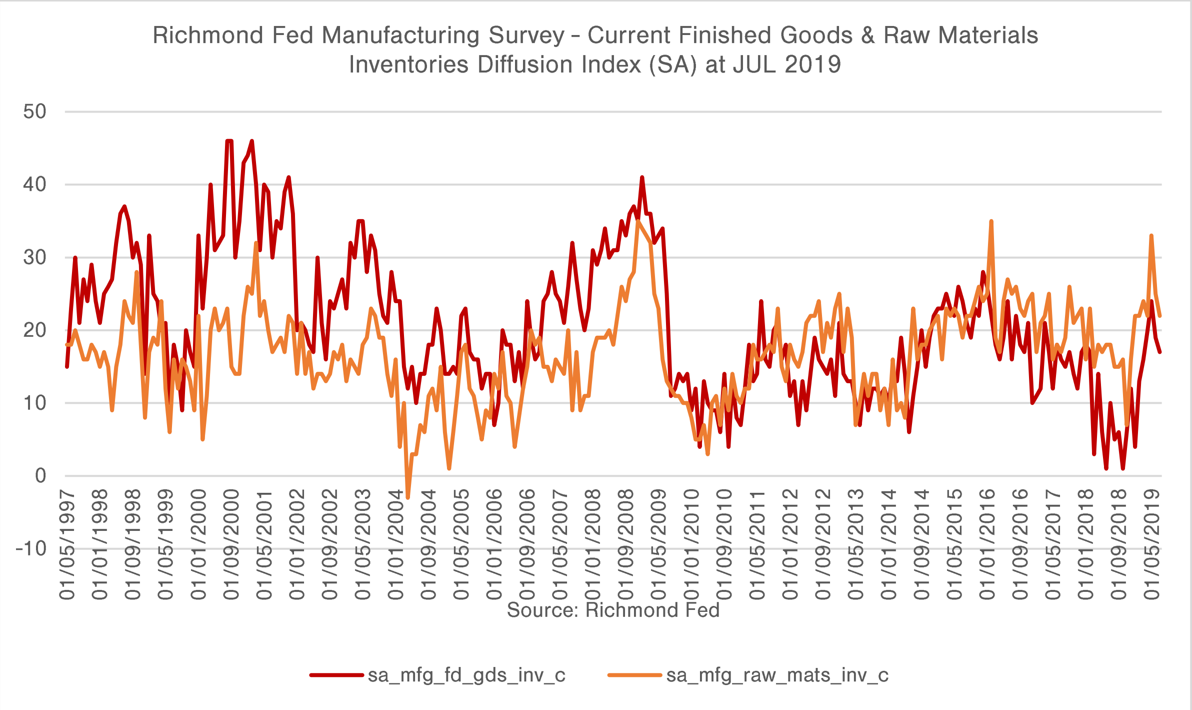
New orders fell further into contraction in Jul reaching -13. This is the equal lowest level since the GFC (for scale, new orders in the GFC fell to a low of -48). The growth in new orders has been slowing since Feb.

In July, the index of shipments declined – not to the same degree as in Dec though. After the larger Dec decline, shipments had rebounded to lower levels of growth between Feb and Jun. This was likely held up by consistent falls in order backlogs – which have been declining since Dec 2018. The decline in order backlogs accelerated in Jul reaching a new low post-GFC. This may no longer be providing support to shipment growth.

More positively, the expected levels of shipments and new orders for six-months' time increased in Jul.

The trend in employment also worsened further in Jul. Employment growth has been slowing since Mar 2019 and fell into contraction in Jul. The level of decline is small at this stage. The underlying trend in the average workweek has been slowing since Oct 2018 and also contracted in Jul – the level of decline in the average work week is the one of the lowest since the GFC.

Exacerbating the problem of employment growth and in the absence of accelerating new order growth is the growth in inventory levels. Two months ago, we highlighted that inventory levels were elevated. Inventory, both raw materials and finished goods, has continued to grow since May peak but at a slower pace.



https://www.richmondfed.org/research/regional_economy/surveys_of_business_conditions/manufacturing/2019/mfg_07_23_19

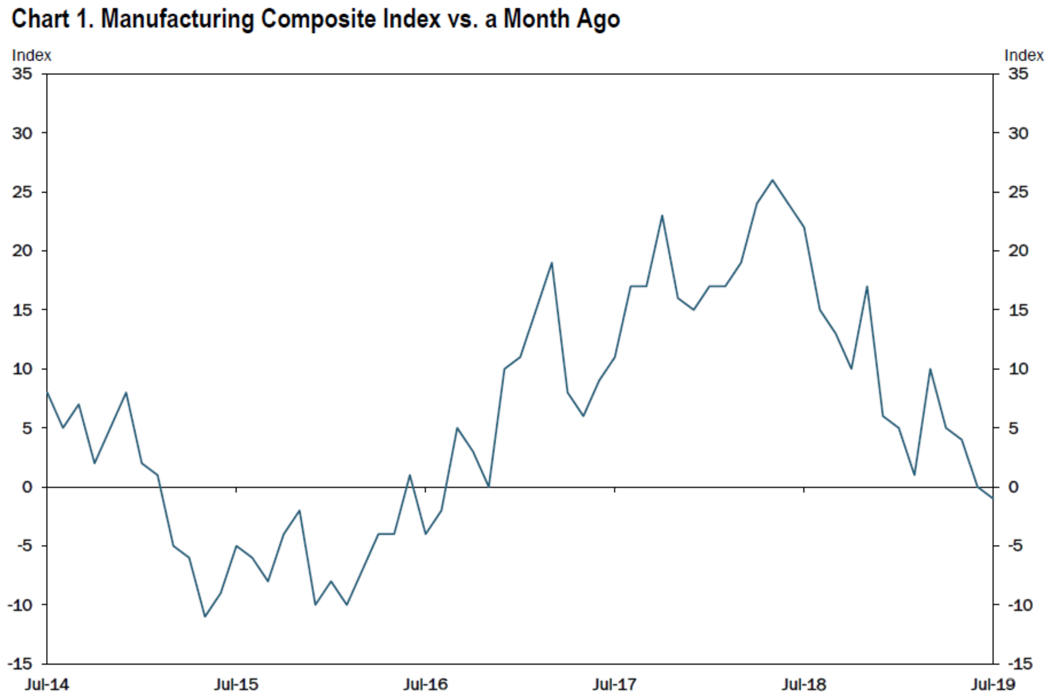
Kansas City Fed Manufacturing Index (Jul)

The headline index of manufacturing activity contracted slightly in the latest month. Despite declines in production and the volume of new orders, firms remained upbeat;

> "However, nearly 80 percent of manufacturing contacts reported confidence in their local economy."

The selected comments on manufacturing are mostly positive with the main negatives revolving around the uncertainty created by tariffs and threat of further tariffs.

Manufacturing Composite Index; Jul -1 versus Jun 0



This month, production declined at a faster pace and the volume of new orders also shifted into decline. The expectation for production and new orders growth in six-months' time was little changed.

The volume of shipments increased to a neutral level as firms continued to work through backlogs (order backlogs declined at a faster pace).

Of concern was that the number of employees and the average employee workweek both shifted into decline in the month. The outlook for six-months' time also deteriorated. The growth in the number of employees slowed from 11 in Jun to 5 in Jul – in Jul a year ago that reading was at 40. The expected average employee work week also shifted further into decline.

The growth in inventory of materials remained low; Jul 1 versus Jun -3. Finished goods inventories declined slightly.

https://www.kansascityfed.org/~/media/files/publicat/research/indicatorsdata/mfg/2019/2019jul25mfg.pdf?la=en

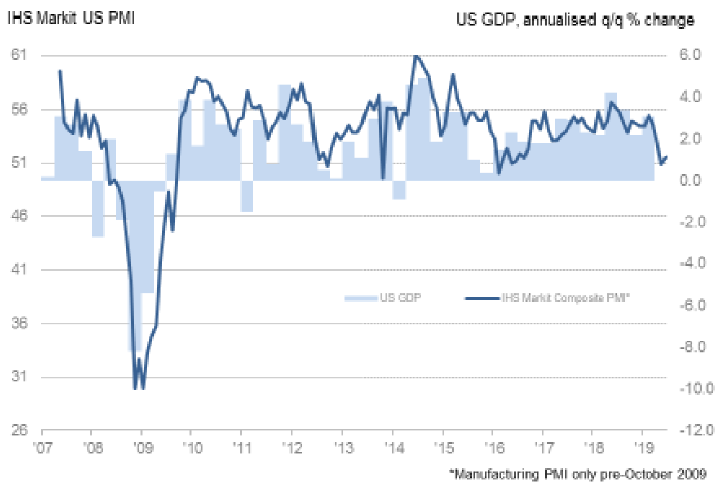
US Composite PMI – Prelim (Jul)

The composite index of private sector activity in the US was little changed in Jul. Slightly faster growth in services activity offset the slower growth in manufacturing. Growth overall remains low. Even with improved activity in the services sector, business expectations fell sharply in Jul.

Composite PMI Output Index; Jul 51.6 versus Jun 51.5

Data collected July 12-23

IHS Markit Composite PMI and U.S. GDP



Sources: IHS Markit, U.S. Bureau of Economic Analysis.

Services Business Activity Index; Jul 52.2 versus Jun 51.5

This was the fastest increase in activity since Apr aided by faster growth in new business. The commentary is far from encouraging though – activity was supported by discounting with average output prices falling to the largest degree since Feb 2016.

Business expectations also fell sharply in Jul, reaching the lowest level since Oct 2009.

Manufacturing PMI; Jul 50 versus Jun 50.6

Weaker activity across manufacturing continues. Output and employment both declined in Jul. Firms also reduced stocks of purchases. New orders growth remains marginal – led by domestic demand while new export orders were 'falling at the fastest pace since Apr 2016'.

Interestingly, firms noted that a 'downturn in the automotive sector and heighted global economic uncertainty' were behind the loss of momentum in the month. The decline in auto production has yet to show up in durable goods or industrial production.

https://www.markiteconomics.com/Public/Home/PressRelease/185bc294d61c400d9b6463a1d54864be

Durable Goods Orders (Advance) (Jun)

In the latest month, there was an increase in Durable Goods new orders and a further increase in shipments for the month. The increase in new orders was a welcome development in the month – and was recorded across both transports and non-transport durable goods categories.

There has been weakness in transport equipment manufacturing over recent months but even ex-transport, the durable goods data exhibits the same trend. The annual dynamic remains unchanged; new orders growth has been slowing, shipment growth is also slowing but remains positive. In the absence of accelerating growth in new orders, firms are working through order backlogs – this is helping to support shipments. Firms also appear to be managing inventory in light of slower growth in orders.

Where there is an inventory increase, especially in the latest month, this can also be attributed to the increase in new orders for Jun.

<u>New Orders – Total Durable Goods</u>

After several months of month on month declines, new orders recorded a welcomed increase;

Total Durable Goods - month change; Jun +2% (or +$4.9bn) versus May -2.3% (or -$5.5bn)

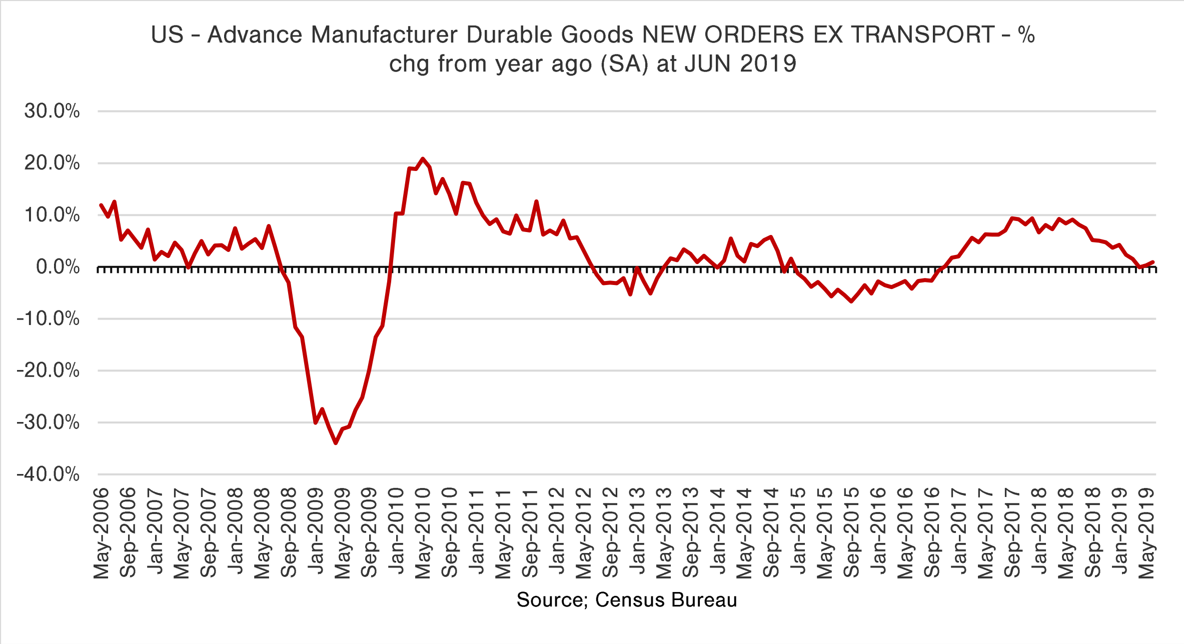
Durable Goods ex transport – month change; Jun +1.2% (or +$2bn) versus May +0.5% (or +$0.7bn)

The month change was led by an increase in orders across most categories, most notable was the increase in transportation new orders; +$3bn in Jun versus -$6.3bn in May. Non-defense aircraft and parts new orders (+$2.7bn) led the increase along with motor vehicles. This offset a decline in defense aircraft and parts.

Despite the improvement in the month, the value of total durable goods new orders remains below a year ago. The decline moderated in Jun;

Annual change; Jun -1.6% versus May -3.7%

Excluding transport, the annual growth in the value of new orders remains positive; Jun +0.9% versus May +0.3%;



Shipments

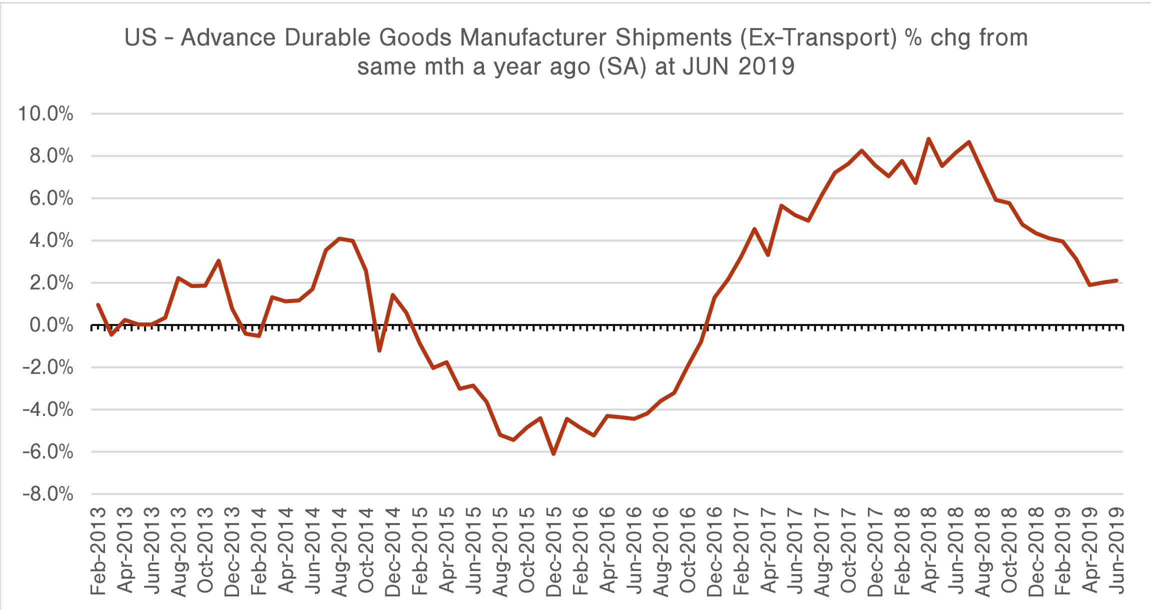
The value of shipments also increased in the latest month;

Month change; Jun +1.4% versus May +0.5%

Higher shipments were recorded across most categories with the bulk of the increase in transport equipment. Trasnport equipment shipments increased by +3.1% in Jun. Higher shipments of motor vehicles was the main feature; Jun +3.1% (+$1.9bn) versus May +0.8%. Shipments of non-defense aircraft also increased by +6% (or +$0.6bn).

The annual growth in shipments was little changed; Jun +2.7% versus May +2.6%.

Excluding transportation; shipments also increased a slightly faster pace; Jun +2.1% versus May +2%.



Unfilled Orders

The value of unfilled orders continued to decline in Jun. This suggests that, given the recent weakness in new orders, firms have been able to maintain growth in shipments via working through backlogs. This has been one of main themes.

Month change; Jun -0.7% versus May -0.8%

The decline unfilled orders for the month wa -$7.8bn. The majority of this was a decline in non-defense aircraft new orders -$4.9bn. Unfilled orders for transportation equipment decreased by -$8.2bn in the month. So even with the growth in new orders for transport equipment of +$3bn for the month, unfilled orders still declined.

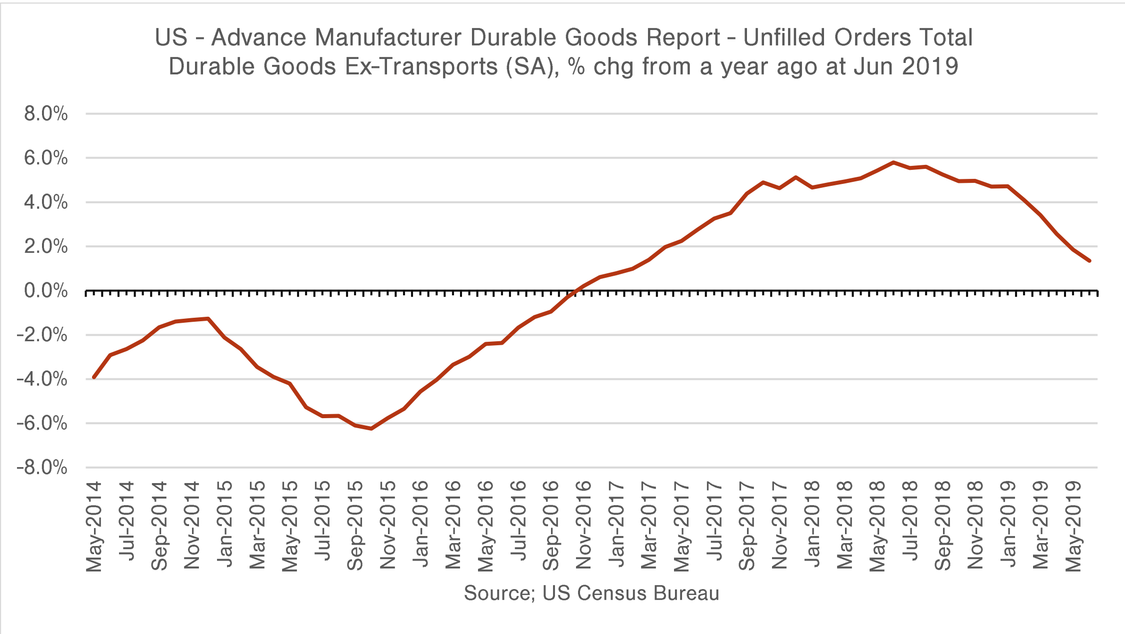
Excluding transportation, unfilled orders increased slightly in the month; Jun +0.1% versus May -0.2%. This suggests that the rate of new order growth in this month was enough to at least halt the decline in unfilled orders.

The annual growth in unfilled orders has continued to slow over the last year. So much so, that unfilled orders for total durable goods recorded the first annual decline since the recovery in late 2016;

Total Durable Goods - annual change; Jun -0.3% versus May +0.6%

Whilst there has been weakness in non-defense aircraft and parts and motor vehicles, the remainder of durable goods ex transportation has also recorded a similar slowdown in the annual change in unfilled orders.

Durable Goods ex-Transportation; Jun +1.3% versus May +1.8%.



The level of unfilled orders for durable goods ex-transports reached a near-term peak in Jan 2019 and levels remain below that point.

Inventory

The total value of inventory increased at a slower pace in Jun.

Durable Goods – month change; Jun +0.3% versus May +0.5%

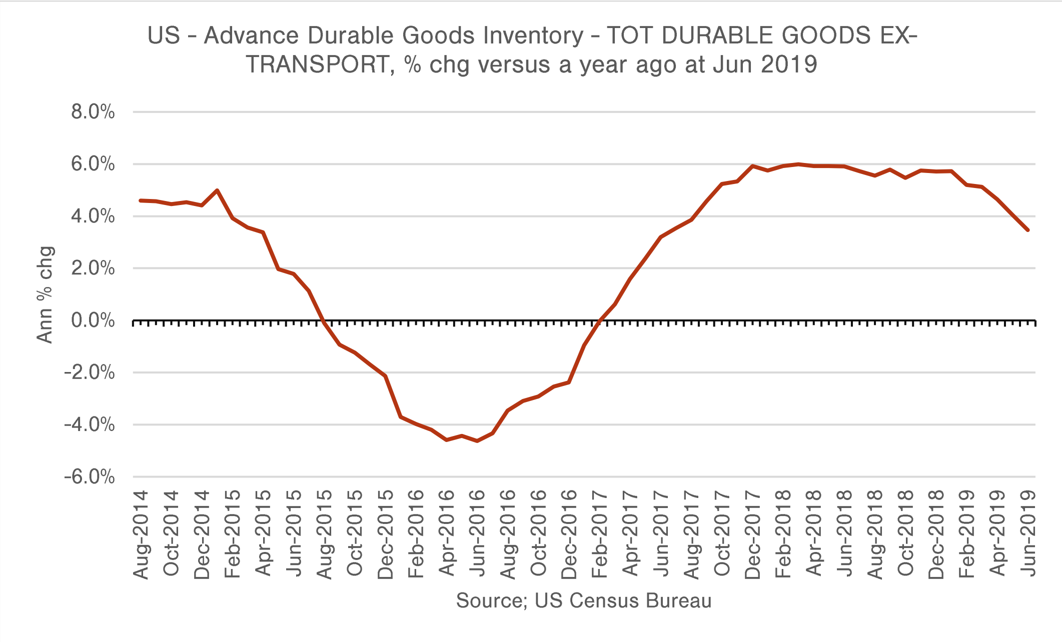
Durable Goods ex-Transpprts – month change; Jun +0.1% versus May -0.1%

Transportation equipment continued to be the main driver of the increase in inventory for the month contributing +$1.1bn of the total +$1.3bn increase for the month. Given the increase in new orders for transports for the month, the increase in inventory is less likely to be an issue.

On an annual basis, inventory growth remains elevated (and higher than the annual growth in new orders and shipments) although has been moderating for durable goods ex-transports (firms managing inventory levels).

Total Durable Goods – annual change; Jun +5.7% versus May +5%

Durable Goods ex-Transports – annual change; Jun +3.5% versus May +4%



https://www.census.gov/manufacturing/m3/index.html

GDP – Advance Q2 2019

US GDP growth moderated in the latest quarter. This release incorporates some large revisions to overall growth rates. Firstly, the overall trend of growth has now changed, with growth slowing since Q2 2018. But the individual rates were revised higher from Q4 2016 to Q3 2018. Both Q4 2018 and Q1 2019 growth rates were revised notably lower.

In the latest quarter, much stronger growth in personal consumption expenditures (across durable goods, non-durable goods and services) and government expenditure helped to offset negative contributions from private fixed investment, inventories and net exports.

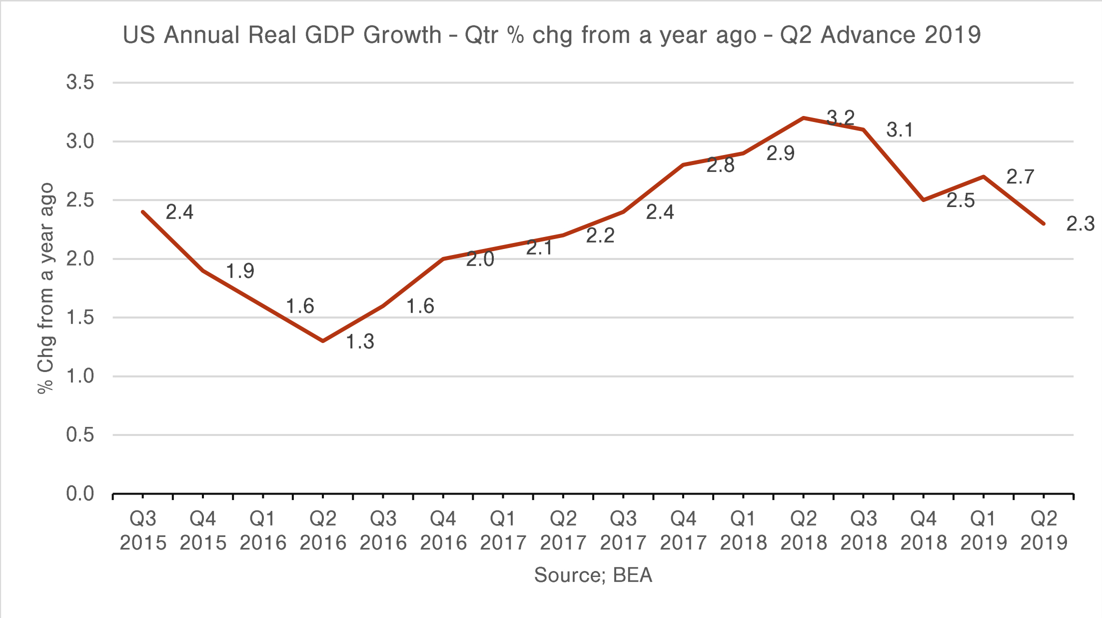
Inventories detracted from growth in Q2 – but the change in inventories was still positive, just lower than in prior quarter. Net exports detracted from growth as exports declined in the quarter and imports were unchanged from the quarter prior.

Annual GDP Growth

On a seasonally adjusted annual rate GDP growth moderated in Q2;

Q2 2019; +2.1% versus Q1 2019; +3.1%

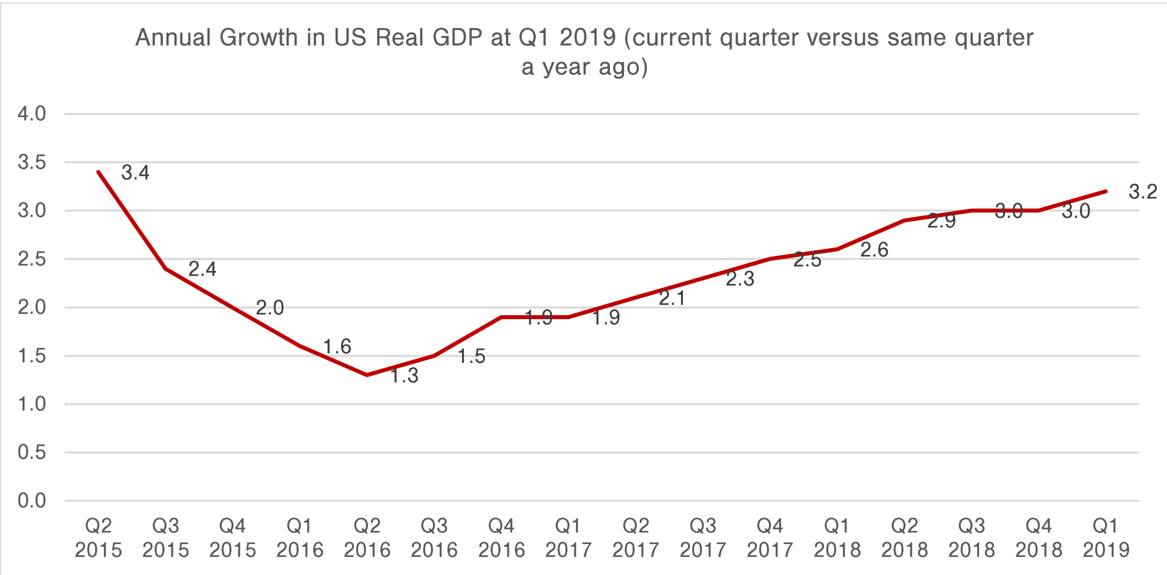
The annual growth on a year ago basis also moderated; Q2 +2.3% versus Q1 +2.7%. This view of GDP growth now shows the rate of GDP growth to be slowing over the last four quarters;



REVISIONS TO GROWTH

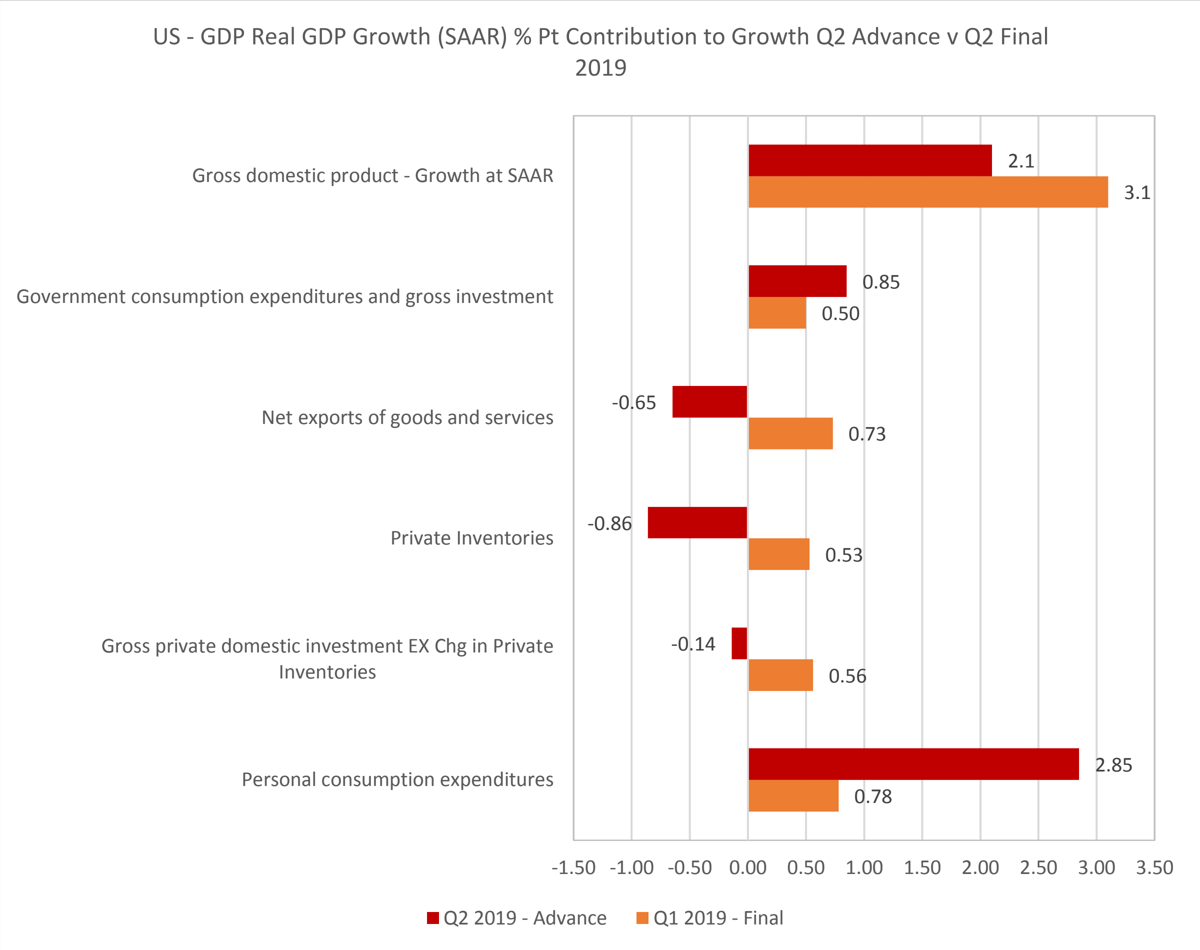
US GDP growth has been revised in this release. The Q1 release (w/c 22 Apr 2019) indicated that growth, on the same year ago basis as above, had been accelerating.

The actual revisions incorporate higher growth from Q4 2016 to Q3 2018. Growth for Q4 2018 and Q1 2019 were both revised significantly lower; Q4 2018 from 3% to 2.5% and Q1 2019 from 3.2% to 2.7%.



Q2 2019 - Contributions to GDP Growth (SAAR basis)

In this quarter, the more robust contribution from personal consumption expenditures helped to offset the negative contributions from private fixed investment, inventories and net exports. Growth in Government expenditure made a larger contribution to growth.



Personal Consumption Expenditure

Growth accelerated in the latest quarter and expenditure was stronger across durable goods, non-durable goods and services. Expenditure growth accelerated across most sub-categories also.

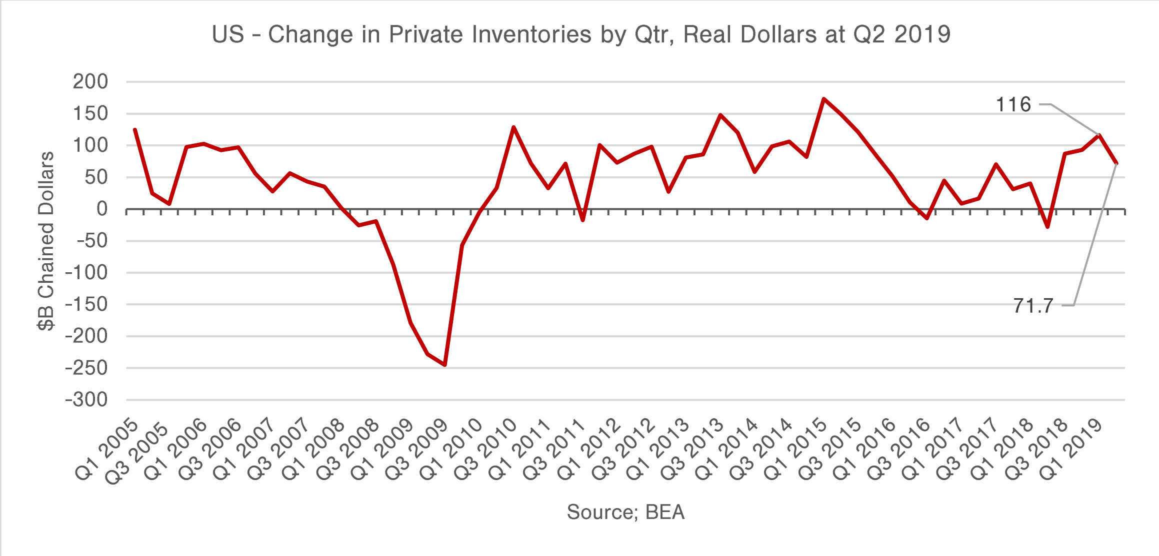
Private Fixed Investment

Real private fixed investment declined in Q2 versus Q1. Both residential and non-residential investment contributed to the decline. Residential investment continued to detract from growth (by a relatively small degree) – now declining eight out of the last nine quarters. Non-residential investment declined mostly on the back of a decline in structures. The contribution across the other categories was smaller than in the month prior indicating some loss of momentum.

Inventories

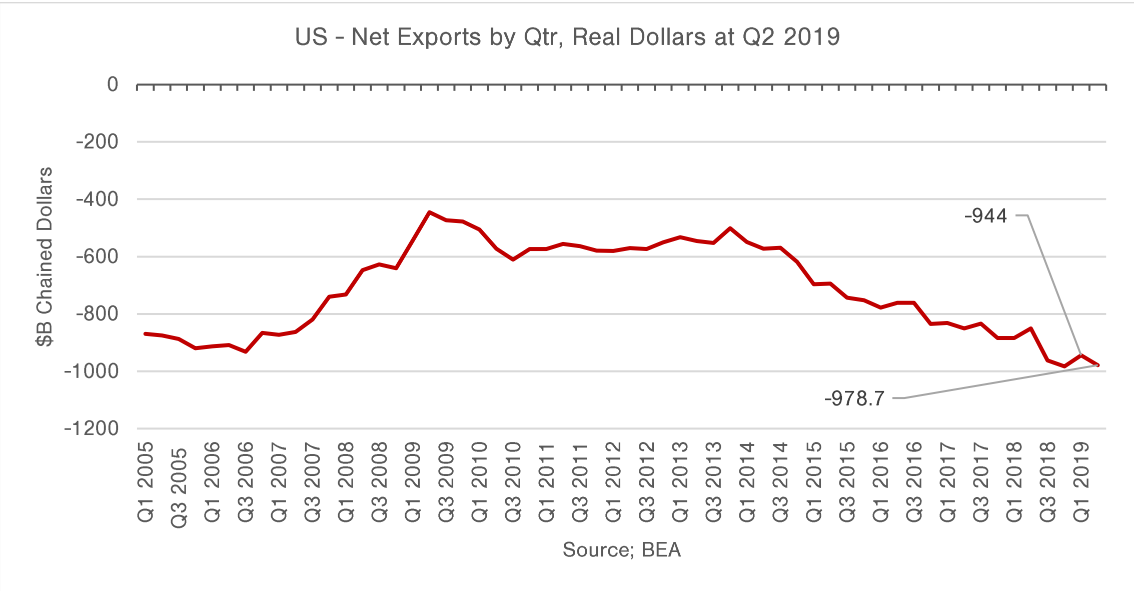
The contribution from inventories detracted from growth this quarter. Note that the change in inventories was still positive, but lower than in the prior quarter.

This is now the fourth quarter where the change in inventories has been positive;



Net Exports

Net exports detracted from growth in the latest quarter as the value of net exports declined versus the prior quarter.



The real value of exports declined in Q2 by -1.6% versus a year ago and -1.3% versus the quarter prior. The real value of imports increased by 2.6% versus a year ago and growth was zero versus the quarter prior.

Government Expenditure

The larger contribution from Government expenditure was the result of an increase in Federal expenditures. This was led by a larger increase in non-defense consumption expenditures.

State and Local expenditure made a similar contribution to growth as the prior quarter.

https://www.bea.gov/data/gdp/gross-domestic-product

Existing Home Sales (Jun)

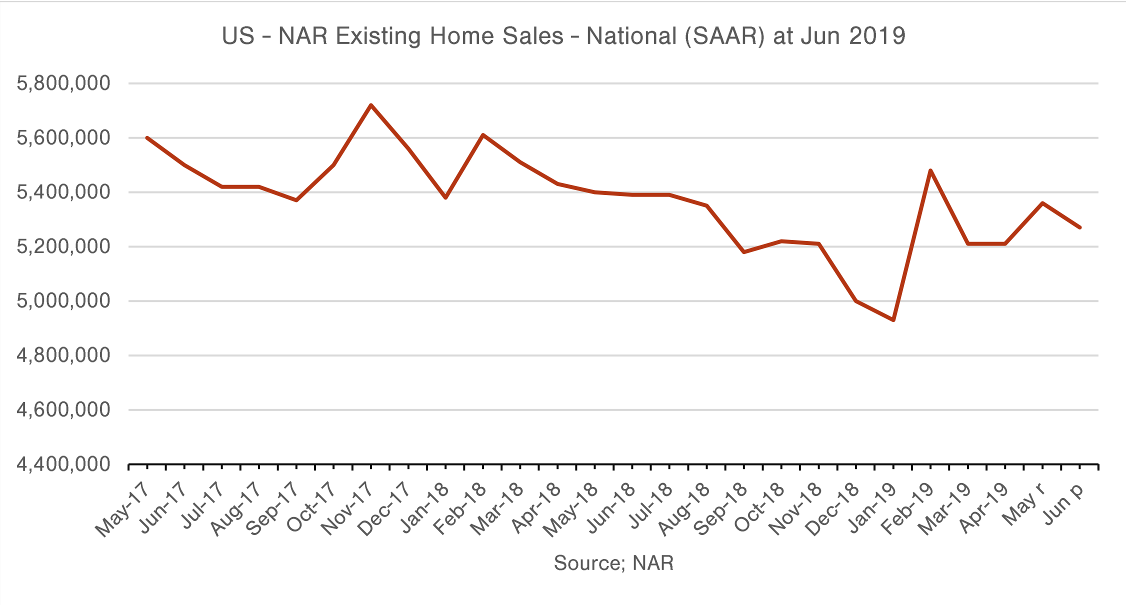
Existing home sales declined in the latest month – led by a fall in sales in the South and the West.

While existing home sales remain below the same time a year ago, the trend since Jan 2019 is somewhat more encouraging – the decline in existing home sales evident throughout 2018, at the very least, appears to have stabilised through 2019 so far. That said, the months of supply of existing homes on the market has continued to edge higher.

Existing Home Sales (SAAR) – month change; Jun 5.27m units (-1.7%) versus May 5.36m units (revised lower).

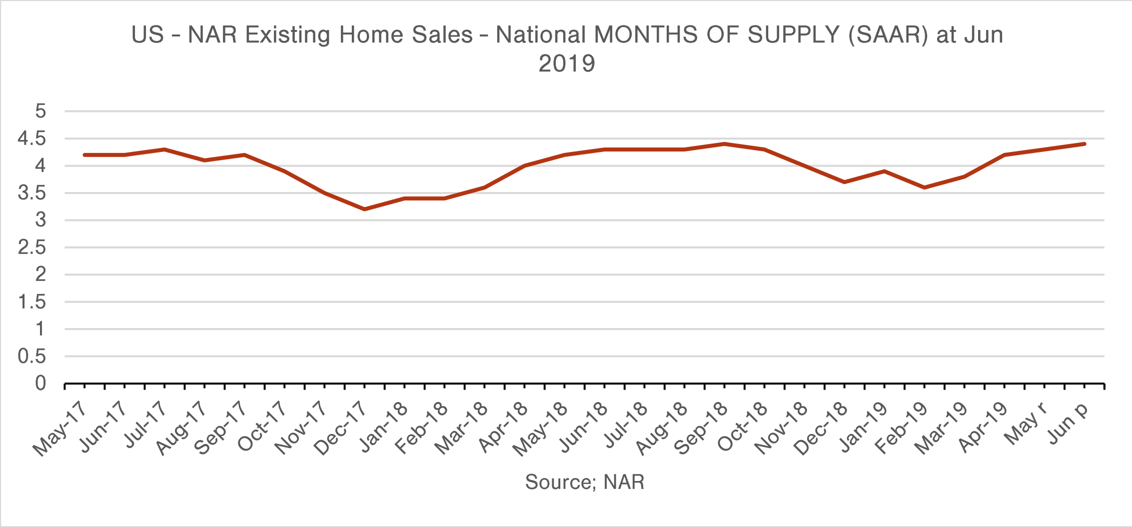
Existing Home Sales (SAAR) – annual change; Jun -2.2%

While the momentum of existing home sales has remained mostly constant over the last three months – clearly arresting the decline of 2018;



Months of Supply

In the latest month, months of supply of exiting homes on the market continued to increase; Jun 4.4 versus May 4.3. This is now on par with the levels recorded throughout 2018;



Regional Performance

The monthly decline of 1.7% was led by larger falls in the West and the South. Sales increased in the Northeast and Midwest.

West; Jun -3.5% and sales remain 5% below a year ago

South (the largest market); Jun -3.4% but sales are only -0.4% below a year ago

Northeast; Jun+1.5% but sales remain 4% below a year ago

Midwest; Jun +1.6% and sales are 1.6% below a year ago.

https://www.nar.realtor/research-and-statistics/housing-statistics/existing-home-sales

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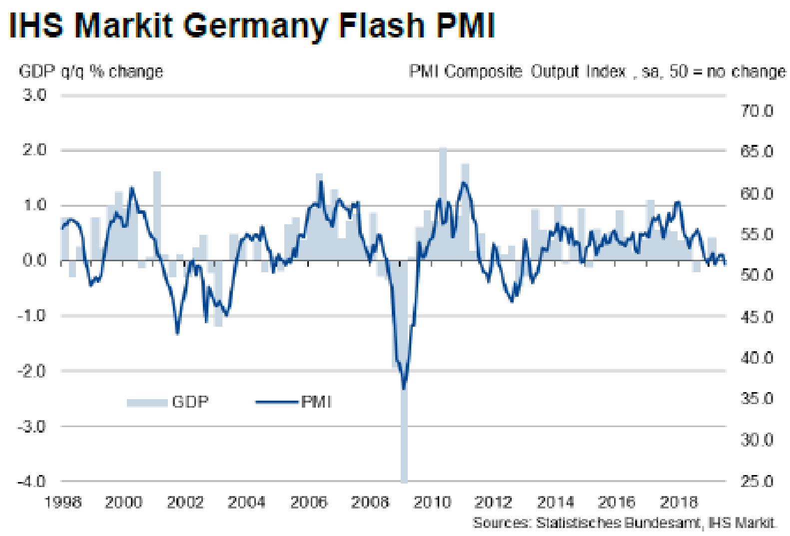
Europe

Germany Composite PMI – Prelim (Jul)

The composite measure of private sector activity showed the growth slowed further in the latest month. This month, manufacturing activity declined at an accelerated pace creating a larger drag at the total level. The manufacturing result was the 'worst' performance in seven years. Growth in services activity also slowed.

Composite Output Index; Jul 51.4 versus Jun 52.6 (-1.2 index pts)

This is the lowest joint reading in over six years;



Services PMI Activity Index; Jul 55.4 versus Jun 55.8

Manufacturing PMI; Jul 43.1 versus Jun 45

Overall; New orders/work returned to contraction for the fifth time in seven months. Manufacturing orders led the decline with new export orders posting the 'sharpest decline in over a decade'. Firms cited weaker orders from China and weakness in the auto sector. Service firms also recorded declines in new export work.

As a result, total outstanding business/order backlogs declined across the private sector. Backlogs fell at the fastest rate since Jun 2009. Services backlogs 'barely' increased.

Employment growth slowed sharply in Jul, reaching the slowest rate of growth since 2015. Services firms continued to expand employment. Employment at manufacturing firms declined at an accelerated pace.

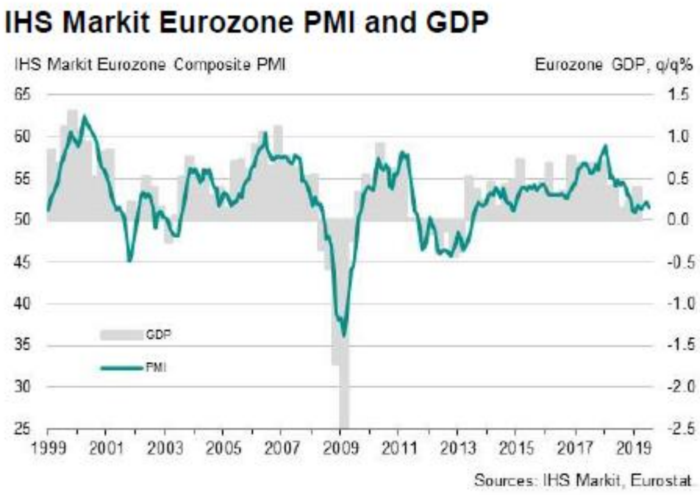
Optimism was weaker across the sectors, now at its lowest point in four and half years. The outlook for manufacturing firms fell sharply in Jul, in part due to concerns in the auto industry. Service providers also expressed weaker optimism.

https://www.markiteconomics.com/Public/Home/PressRelease/1dc4bbe1b1b14a6b930277baa1ec963f

Eurozone Composite PMI – Prelim (Jul)

More news about a renewed downturn in manufacturing activity in Jul. The broad composite index of private sector activity slowed further in Jul. This was led by slightly slower growth in services as well as a continued decline in manufacturing activity across the Eurozone.

Prelim Composite PMI Output Index; Jul 51.5 versus Jun 52.2



Services PMI Activity Index; Jul 53.3 versus Jun 53.6

Manufacturing PMI; Jul 46.4 versus Jun 47.6

Overall; growth in new work/orders stagnated in Jul – the lowest level of growth in five months. Manufacturers recorded the second largest decline in new orders since 2012.

Export orders continued to decline across goods and services, both falling at the fastest rate since data collection first started in 2014. The decline in services was 'muted' while goods exports orders declined at the fastest pace since Nov 2011.

Backlogs of orders declined at an accelerated pace – and fell sharply for manufacturing.

Expectations for future output growth declined to the lowest levels since Oct 2014. This impacted hiring with employment falling for the third month in a row for manufacturers. Employment growth for service providers increased but at the slowest pace in over 4-months.

https://www.markiteconomics.com/Public/Home/PressRelease/fda5991f04e84ea5a76bf1d0c6095af5

ECB Rates Decision 25 Jul 2019

There was no change to current interest rate, deposit rate or monetary settings at the Jul meeting.

Current settings remain unchanged;

Interest rate - main refinancing operations; 0%

Interest rate - marginal lending facility; +0.25%

Interest rate - deposit facility; -0.4%

Principal payments from maturing securities will continue to be reinvested.

Policy Guidance

Guidance has now changed since the Jun 6 statement, now including the chance that rates could move lower;

> "The Governing Council expects the key ECB interest rates to **remain at their present or lower levels** at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to its aim over the medium term."

The statement includes an acknowledgement that medium term inflation has continued to fall short of the target. The ECB clearly indicated willingness/determination to ensure 'a highly accommodative stance of monetary policy for a prolonged period of time'.

The ECB directed staff to investigate policy options on rates, restarting asset purchases, forward guidance and other policy measures to provide accommodation;

> "It therefore stands ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner."

> "In this context, the Governing Council has tasked the relevant Eurosystem Committees with examining options**, including ways to reinforce its forward guidance on policy rates, mitigating measures, such as the design of a tiered system for reserve remuneration, and options for the size and composition of potential new net asset purchases**."

Outlook; Risks tilted to the downside, uncertainties and weaker global trade affecting manufacturing in particular and inflation remains muted under these conditions;

> "The risks surrounding the euro area growth outlook remain tilted to the downside, reflecting the prolonged presence of uncertainties, related to geopolitical factors, the rising threat of protectionism, and vulnerabilities in emerging markets."

> "In this environment, inflationary pressures remain muted and indicators of inflation expectations have declined."

> "Incoming economic data and survey information continue to point to **somewhat slower growth in the second and third quarters** of this year. This mainly reflects the ongoing weakness in international trade in an environment of prolonged global uncertainties, which are particularly affecting the euro area manufacturing sector"

July Statement;
https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190725~52d3766c9e.en.html

Prior June Statement;
https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190606~1876cad9a5.en.html

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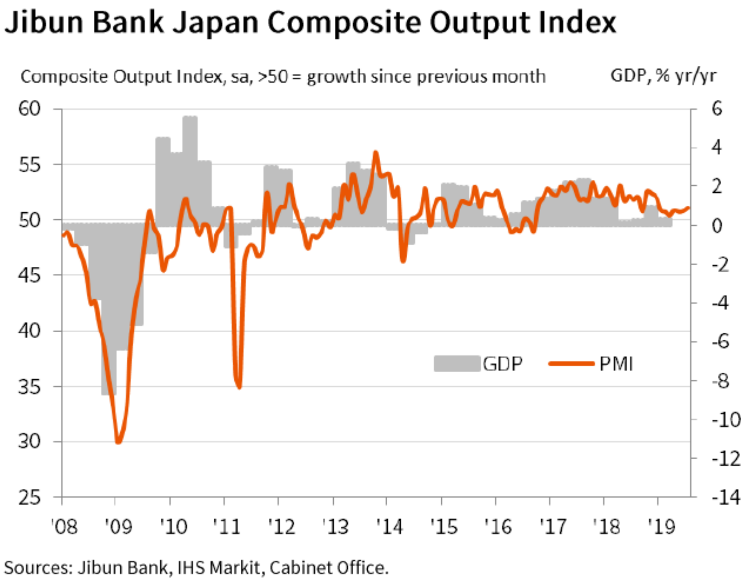
Japan

Japan Composite PMI – Prelim (Jul)

This is the first prelim composite measure of private sector activity. In Jul, the composite index indicated that growth increased at a faster pace. This was led by stronger growth in services activity while the decline in manufacturing continued, albeit at a slower pace.

Composite Output Index; Jul 51.2 versus Jun 50.8

Despite the increase in overall output, both manufacturing and services recorded weaker levels of optimism regarding future output.



Services Business Activity Index; Jul 52.3 versus Jun 51.9

The slightly faster growth in the headline index was the result of faster growth in output of service firms. Growth in new orders and employment continued to slow. Backlogs of work fell into contraction – likely continuing to support output growth.

Manufacturing PMI; Jul 49.6 versus Jun 49.3

The slower/weaker decline was experienced across several key indicators; output, new orders and new export orders. Backlogs of work were unchanged, and stocks of finished goods declined. Employment grew at a faster pace.

https://www.markiteconomics.com/Public/Home/PressRelease/71cb3c8fe4254f65b95c747a92ab4c5d

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United Kingdom

BREXIT

Boris Johnson won the Conservative Party leadership ballot during the week, as expected. The focus shifts back to the Brexit deadline of 31 Oct 2019 with a no-deal Brexit a very real possibility.

The EU has continued to reiterate that it won't renegotiate the Irish border backstop.

The new leadership of the Conservative Party is putting plans in place for a no-deal Brexit on 31 Oct;

> "At the same time, Sajid Javid, the new chancellor, told the Sunday Telegraph there would be "significant extra funding" this week to get Britain "fully ready to leave" the EU on 31 October, with or without a deal."
>
> "Gove and Javid are part of a new "war cabinet" of six key ministers to deliver Brexit by 31 October "by any means necessary""
>
> "Of course we would prefer to [leave] with a new deal, one that removes this anti-democratic backstop," he said. "We are prepared to enter into negotiations with the spirit of friendship and determination but if the EU doesn't want to do that it is right we are absolutely prepared for that. We are turbo-charging preparations for no deal. That is now the government's number one priority." https://www.theguardian.com/politics/2019/jul/28/boris-johnson-turbo-charging-no-deal-brexit-plans-say-ministers

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Australia

RBA Governor Lowe speech – Inflation Targeting and Economic Welfare

While the speech is quite interesting on inflation and inflation targeting, the main feature from a policy perspective is that Governor Lowe provides some forward guidance on rates in Australia;

> "Whether or not further monetary easing is needed, **it is reasonable to expect an extended period of low interest rates.** On current projections, it will be some time before inflation is comfortably back within the target range. The Board is strongly committed to making sure we get there and continuing to deliver an average rate of inflation of between 2 and 3 per cent. **It is highly unlikely that we will be contemplating higher interest rates until we are confident that inflation will return to around the midpoint of the target range**."

On the outlook; Governor Lowe indicates that demand is likely to be supported by the lowering of the cash rate, tax cuts, higher commodity prices, stabilization in the housing market, increased infrastructure spending and a lift in resource sector investment.

> It remains to be seen if future growth in demand will be sufficient to put pressure on the economy's supply capacity and lift inflation in a reasonable timeframe.
>
> But if demand growth is not sufficient, the Board is prepared to provide additional support by easing monetary policy further. However, as I have discussed on other occasions, other arms of public policy could also play a role in this scenario.

On inflation targeting and why some countries achieve or miss their targets (in fairness Governor Lowe acknowledged that there was no 'one reason' why).

> **"…countries that are operating nearer to full capacity are more likely to have inflation close to target."**

[In context of Australia, recent high demand for employment was met with an increase in participation. Although employment growth has been higher, participation has increased notably over the last several years. Despite the employment growth, underemployment remains elevated – indicating that we are still not operating at full capacity – hence inflation falling short of targets.]

Some further comments from Governor Lowe on inflation targeting;

In my view, an inflation targeting regime should consist of the following four elements.

The inflation target should establish a clear and credible medium-term nominal anchor for the economy – to create certainty about future investment decisions.

The inflation target should be nested within the broader objective of welfare maximisation.

The inflation target should have a degree of flexibility – the tolerance of the movement of inflation around the target range.

The inflation target needs to be accompanied by a high level of accountability and transparency.

Problems can arise if the community doesn't understand the central bank's actions, or if they see it as acting unpredictably or inconsistently with its mandate. This means you should expect us to explain what we are doing, why we are doing it and how we are balancing the various trade-offs.

https://www.rba.gov.au/speeches/2019/sp-gov-2019-07-25.html

NAB – SME Business Survey Q2

The SME business survey measures trading conditions and confidence of small-medium businesses in Australia.

In Q2, trading conditions for SME's continued to deteriorate, with some indicators falling into negative territory, while confidence improved slightly. The improvement in confidence was likely to reflect the election outcome and rate cut expectations. The broader NAB business survey in Jun retraced the bump in confidence.

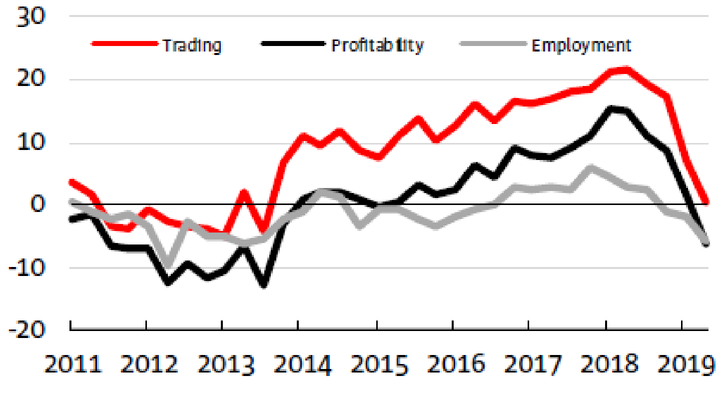
Business Conditions

The headline index continued to decline; Q2 index -4 versus Q1 index 2.

A further decline in conditions was recorded across all firm tiers (low-med-high turnover).

All of the component indicators of conditions deteriorated with profitability and employment now in negative territory. Trading conditions has fallen from a reading of 17 in Q4 2018 to zero now in Q2 2019;

CHART 2: SME BUSINESS CONDITIONS COMPONENTS (NET BAL., S.A.)



Conditions were weaker across all states, with Vic the only state where conditions remained positive (but has also deteriorated).

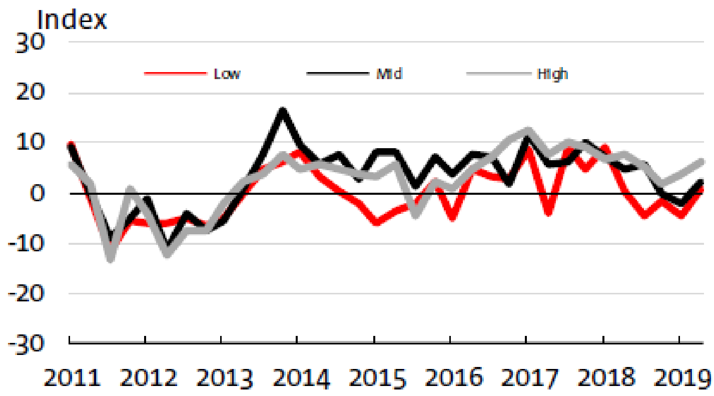
Business Confidence

After tracking along at zero for the prior two quarters, confidence increased in Q2;

Q2 2019; 3 versus Q1 2019; 0

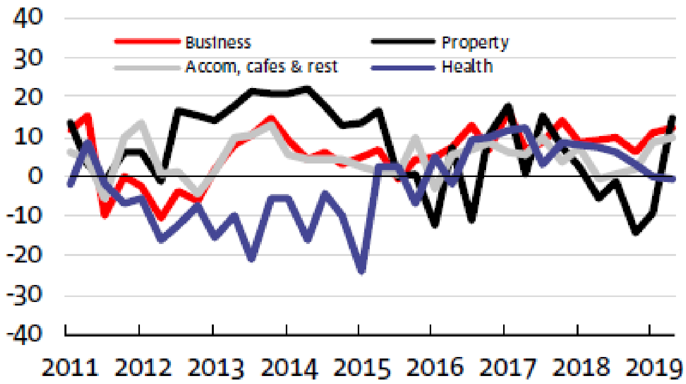
Confidence is tracking slightly higher for the larger firms in the study;

CHART 9: BUSINESS CONFIDENCE BY FIRM SIZE (NET BAL., S.A.)



Across key industries, business confidence improved notably in property as well as cafes and finance;

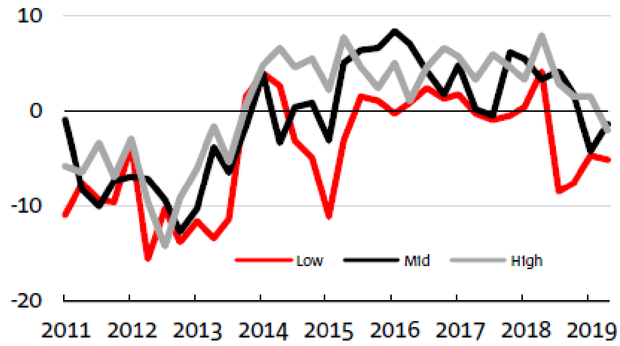
CHART 29: SME BUSINESS CONFIDENCE BY INDUSTRY (NET BAL., S.A.)



<u>Forward Orders</u>

Measures of forward orders remained negative in Q2 but there was some easing in the decline for the mid-sized firms in the SME group.

CHART 15: FORWARD ORDERS BY FIRM SIZE (NET BAL., S.A.)



https://business.nab.com.au/nab-sme-business-survey-quarter-2-2019-35872/

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Trade

US-China Trade Negotiations

US negotiators are reportedly headed to China for further talks on trade early this week for a two-day meeting in Shanghai.

The progress of talks likely hinges on whether the US and China can move forward on the Huawei/agriculture compromise. https://www.reuters.com/article/us-huawei-tech-usa-blacklist-exclusive/exclusive-u-s-firms-may-get-nod-to-restart-huawei-sales-in-2-4-weeks-official-idUSKCN1U90ON

The Xinhua news agency reports that;

> "The new purchase of American farm products has shown that China is honouring its commitment and also a response to the recent signals of goodwill by the US side," the Xinhua commentary said.
>
> But it also said China had diversified its imports to include agricultural products from countries such as Brazil and Australia, and to uphold the spirit of self-reliance and ensure a firm grip of its own "rice bowl", meaning it would rely on domestic output for its food supply.
>
> "No matter how much uncertainty lies ahead of us, China will continue its own path, do its own thing and to strengthen its ability in handling risks and challenges." https://www.scmp.com/news/china/diplomacy/article/3019558/china-us-trade-talks-could-resume-soon-washingtons-tariffs

The threat of talks stalling is likely still high – nothing has really changed;

> "There have been no signs either side is willing to back down from their red lines, which begs the question: if one side must back down, which will it be? Surely, whether a deal can be made will depend on how much Beijing agrees to Washington's terms, rather than vice versa. Trump has repeated often that China should be ready to strike a deal or tariffs will rise "very, very substantially"." https://www.scmp.com/week-asia/opinion/article/3017495/us-china-trade-war-ignore-hype-trump-and-xi-are-no-closer-deal
>
> "China and the United States remain divided over which negotiating text to base their revived trade talks on, with Washington demanding a longer document be used that lists earlier promises made by Beijing, according to observers." https://www.scmp.com/news/china/diplomacy/article/3019373/china-us-said-be-wrangling-over-text-trade-talks-can-resume

The issue of intellectual property remains a key obstacle to the deal;

> "Indeed, China's Vice Premier Liu He has only reiterated Beijing's position that a deal must be balanced and "expressed in terms that are acceptable to the Chinese people and do not undermine the sovereignty and dignity of the country." https://www.cnbc.com/2019/06/29/g20-summit-trump-and-xi-agree-to-talks-but-offer-no-clear-path-to-end-the-trade-war.html

Reconfirming what a 'win' in the negotiations with China looks like – a statement of the key negotiating goals as outlined by the USTR (emphasis added);

> The meetings were held as part of the agreement reached by President Donald J. Trump and President Xi Jinping in Buenos Aires to engage in 90 days of negotiations **with a view to achieving needed structural changes in China with respect to forced technology transfer, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft of trade secrets for commercial purposes, services, and agriculture**.

https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/january/statement-united-states-trade

Special 2019 Section 301 Review

No further notification on progress.

The USTR released its annual Special 301 Report on Intellectual Property Protection and Review of Notorious Markets for Piracy and Counterfeiting late last week.

> "Specifically, over the coming weeks, USTR will review the developments against the benchmarks established in the Special 301 action plans for countries that have been on the Priority Watch List for multiple years. For such countries that fail to address U.S. concerns, USTR will take appropriate actions, such as enforcement actions under Section 301 of the Trade Act or pursuant to World Trade Organization or other trade agreement dispute settlement procedures, necessary to combat unfair trade practices and to ensure that trading partners follow through with their international commitments." https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/april/ustr-releases-annual-special-301

The report prepared a 'priority watch list', a 'watch list' and a 'notorious markets list". The report highlighted;

"trading partners that do not adequately or effectively protect and enforce intellectual property (IP) rights or otherwise deny market access to U.S. innovators and creators that rely on protection of their IP rights.

Trading partners that currently present the most significant concerns regarding IP rights are placed on the Priority Watch List or Watch List. USTR identified 36 countries for these lists in the Special 301 Report:

Algeria, Argentina, Chile, China, India, Indonesia, Kuwait, Russia, Saudi Arabia, Ukraine and Venezuela are on the Priority Watch List.

Barbados, Bolivia, Brazil, Canada, Colombia, Costa Rica, Dominican Republic, Ecuador, Egypt, Greece, Guatemala, Jamaica, Lebanon, Mexico, Pakistan, Paraguay, Peru, Romania, Switzerland, Thailand, Turkey, Turkmenistan, the United Arab Emirates, Uzbekistan and Vietnam are on the Watch List."

Notorious Markets List

> "The Notorious Markets List highlights 33 online markets and 25 physical markets that are reported to engage in and facilitate substantial copyright piracy and trademark counterfeiting"
> https://ustr.gov/sites/default/files/2018_Notorious_Markets_List.pdf

The link to the notorious markets reports is here;
https://ustr.gov/sites/default/files/2018_Notorious_Markets_List.pdf

The first country on the list is China.

The full report; https://ustr.gov/sites/default/files/2019_Special_301_Report.pdf

NAFTA/USMCA

The Democrats continue to work with USTR Lighthizer on changes required to the USMCA before the deal can go to Congress for approval.

> Republican President Donald Trump views ratification of the trade deal as a top priority, but Democrats say they will not move forward until their concerns over labor, environmental issues and access to medicine have been addressed.
>
> Officials on both sides now say the deal could move forward in September after lawmakers return from the August recess. https://www.reuters.com/article/us-usa-trade-usmca/democrat-calls-for-good-faith-talks-with-ustr-on-trade-deal-idUSKCN1UL2A3

Once the US approves/ratifies the USMCA, Canada will take steps to approve the USMCA in parliament.

Section 232 – Car and Truck Imports

President Trump has agreed to delay the decision to impose tariffs on auto imports as a part of the s.232 investigation on car and truck imports on national security grounds. But he has **stated that he agrees with the conclusion of the Commerce Dept report that imports harmed national security by causing declining market share for US-owned carmakers.**

> ""I concur in [Commerce Secretary Wilbur Ross'] finding that automobiles and certain automobile parts are being imported into the United States in such quantities and under such circumstances as to threaten to impair the national security of the United States," Trump said in a proclamation outlining his

> decision.” https://www.politico.com/story/2019/05/17/donald-trump-auto-tariffs-1330014

As a part of the announcement, US President Trump also…

> “directed U.S. Trade Representative Robert Lighthizer to pursue the negotiation of agreements with the EU, Japan and other countries that address the alleged national security threat posed by auto imports.
>
> Lighthizer was directed to update the president on the status of those talks within 180 days.” https://www.politico.com/story/2019/05/17/donald-trump-auto-tariffs-1330014

The tariffs remain as negotiating leverage between the US and Japan and the EU. The S.232 report has not been made public, but President Trump’s statement provided some insight as to how the Commerce Dept justified the ‘national security’ grounds;

> “The rapid application of commercial breakthroughs in automobile technology is necessary for the United States to retain competitive military advantage and meet new defense requirements,” the proclamation said.
>
> The proclamation added that the U.S. defense industrial base depends on the “American-owned automotive sector” for development of technologies essential to military superiority. Foreign imports have eroded the ability of U.S. companies to compete and research and develop new technologies, the proclamation said.
>
> “The lag in R&D expenditures by American-owned producers is weakening innovation and, accordingly, threatening to impair our national security,” the proclamation stated. https://www.politico.com/story/2019/05/17/donald-trump-auto-tariffs-1330014

US-Japan Trade Talks

After ‘working-level’ meetings during the week, there has been an agreement to speed up negotiations between the US and Japan. A ministerial-level meeting has been suggested for early Aug.

> “With U.S. President Donald Trump pushing for a deal to be reached after Japan's House of Councillors election held last Sunday, a key issue is whether Tokyo and Washington will be able to achieve a win-win agreement in September -- the perceived goal of the White House.” https://japantoday.com/category/politics/japan-u.s.-vow-to-speed-up-talks-for-bilateral-trade-pact

Key issues for the US remain the trade deficit, access for agriculture and auto exports, as well as currency clauses to ‘prevent competitive devaluations’. https://www.washingtonpost.com/business/whats-at-stakein-us-japan-trade-talks/2019/05/24/62d6104a-7e5d-11e9-b1f3-b233fe5811ef_story.html?utm_term=.776b6d909b48

The summary of US negotiating objectives for the US-Japan trade talks have been published;

https://ustr.gov/sites/default/files/2018.12.21_Summary_of_U.S.-Japan_Negotiating_Objectives.pdf

US-Europe Trade Talks

There are several fronts to the US-Europe trade talks; the outstanding dispute and pending WTO decision on airline subsidies, the main trade negotiation and the special trade channel (Instex) set up to bypass the US sanctions on Iran to enable trade between Europe and Iran.

One of the main issues standing in the way of a trade deal is that agriculture has been exempt from the negotiations by the EU.

Tariff threats escalated again during the week. It is now expected that the WTO would rule in favour of the US over illegal European subsidies to Airbus. The EU also has a similar case related to Boeing. Both sides have already identified potential areas for further sanctions if matters escalate and the US has already instigated a second process to identify further targets for tariffs.

> "An arbitrator for the WTO is expected to decide in September what level of sanctions Washington can impose after winning a case before the WTO about European subsidies to Airbus, with the EU likely to get a decision in its favor several months later." https://www.reuters.com/article/us-usa-trade-eu/eu-redoubles-threat-to-retaliate-if-u-s-raises-auto-tariffs-idUSKCN1UH1N5?il=0

> In addition to helicopters and aircraft parts, the U.S. tariffs may also be aimed at goods such as cheese, olives and pasta, along with some types of whiskey in **what the officials see as an effort to gain concessions from EU members to the American agricultural sector.** bloomberg.com/news/articles/2019-07-15/europe-braces-for-7-billion-u-s-tariff-hit-over-airbus-dispute

Airline Subsidies

The USTR has commenced another review; "Additional Products for Tariff Countermeasures in Response to Harm Caused by EU Aircraft Subsidies" (1 Jul 2019) https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/july/ustr-proposes-additional-products#

The US is considering more products for tariffs thereby reinstating the threat of tariffs in the EU.

Among other things, this announcement builds on the current investigation "to enforce U.S. rights in the World Trade Organization (WTO) dispute against the European Union (EU) and certain EU member States addressed to EU subsidies on large civil aircraft."

[As outlined previously…key dates for that investigation; May 6, 2019: Due date for submission of requests to appear at the public hearing and summary of testimony. May 15, 2019: The Section 301 Committee will convene a public hearing. Details; https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/may/public-hearing-proposed-countermeasures. May 28, 2019: Due date for submission of written comments, including post-hearing rebuttal comments.

https://www.federalregister.gov/documents/2019/04/12/2019-07267/initiation-of-investigation-notice-of-hearing-and-request-for-public-comments-enforcement-of-us-wto]

According to the Federal Register announcement during the week;

> "A number of public comments submitted in response to the April 12 notice requested that the U.S. Trade Representative consider additional products that were not included in the April 12 list for possible inclusion on the final list of products to be subject to additional duties."
> https://ustr.gov/sites/default/files/enforcement/301Investigations/Notice_for_Additional_Products.pdf

The dates for this latest review;

July 24, 2019: Due date for submission of requests to appear at the public hearing and summary of testimony.

August 5, 2019: Due date for submission of written comments. August 5, 2019: The Section 301 Committee will convene a public hearing in the Main Hearing Room of the U.S. International Trade Commission, 500 E Street SW, Washington DC 20436 beginning at 9:30 a.m.

August 12, 2019: Due date for submission of post-hearing rebuttal comments.

Also, from the USTR announcement this week, if there is a decision on the case before the end of the public comment phase, then additional duties could be imposed before that process is complete;

> "In the event the Arbitrator issues its decision prior to completion of the public comment process on the supplemental list, the USTR may immediately impose increased duties on the products included in the initial list, and take further possible actions with respect to products on the supplemental list."

Also hanging over the negotiations are the US threats of tariffs on auto imports from Europe.

Trade Negotiations

The key sticking point remains agriculture. The EC authorised negotiations to commence between the EU and the US – but excluding agriculture. Emphasis added;

> "Today's adoption of the EU negotiating directives gives a clear signal of the EU's commitment to a positive trade agenda with the US and the implementation of the strictly defined work programme agreed by Presidents Trump and Juncker on 25 July 2018. **But let me be clear: we will not speak about agriculture** or public procurement."

https://www.consilium.europa.eu/en/press/press-releases/2019/04/15/trade-with-the-united-states-council-authorises-negotiations-on-elimination-of-tariffs-for-industrial-goods-and-on-conformity-assessment/?utm_source=dsms-auto&utm_medium=email&utm_campaign=Trade+with+the+United+States%3a+Council+authorises+negotiations+on+elimination+of+tariffs+for+industrial+goods+and+on+conformity+assessment

> ""I do not think we will reach an agreement if agriculture is not included," McKinney told reporters on a teleconference during his visit to Brussels, citing

concerns raised by U.S. lawmakers and Trump."
https://www.reuters.com/article/us-usa-trade-eu/no-u-s-eu-trade-deal-without-agriculture-u-s-official-idUSKCN1TS2SH

Instex

The EU confirmed that Britain, France and Germany had established a special trade channel (Instex) that would enable trade with Iran that circumvents the US sanctions. It was announced last year that the EU would work on developing the channel.
https://www.reuters.com/article/us-iran-nuclear-talks-statement/europe-says-iran-trade-channel-operational-statement-idUSKCN1TT2RL

President Trump made some mention of this development at the G-20;

> "President Donald Trump said there was "absolutely no time pressure" in dealing with Iran as European nations pushed to salvage what remains of the 2015 nuclear accord and avert a slide toward war."
> https://finance.yahoo.com/news/trump-chats-putin-shakes-hands-081017994.html

The Instex system enables trade with Iran without the use of U.S. dollars or US banks. The US has previously stated opposition to this;

> "According to Bloomberg, the Treasury Department's undersecretary for terrorism and financial intelligence, Sigal Mandelker, sent a letter on May 7 warning that Instex, the European SPV to sustain trade with Tehran, and anyone associated with it could be barred from the U.S. financial system if it goes into effect."
>
> "Separately, during a visit to London on May 8, Mike Pompeo also warned that there was no need for Instex because the U.S. allows for humanitarian and medical products to get into Iran without sanction."
>
> ""When transactions move beyond that, it doesn't matter what vehicle's out there, if the transaction is sanctionable, we will evaluate it, review it, and if appropriate, levy sanctions against those that were involved in that transaction," Pompeo said. "It's very straightforward.""

Digital Services

Undeterred by the USTR investigation into the digital services tax to be approved by the Govt of France, the EU has opened its own investigation into possible anti-competitive conduct of Amazon;

> "The European Commission has opened a formal antitrust investigation to assess whether Amazon's use of sensitive data from independent retailers who sell on its marketplace is in breach of EU competition rules."
> https://ec.europa.eu/commission/presscorner/detail/en/ip_19_4291

Last week the USTR opened a S.301 investigation into the digital services tax approved by the French government;

> "The services covered are ones where U.S. firms are global leaders. The structure of the proposed new tax as well as statements by officials suggest that France is unfairly targeting the tax at certain U.S.-based technology companies." https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/july/ustr-announces-initiation-section-301

> On Wednesday trade representative Robert Lighthizer said an investigation would "determine whether it is discriminatory or unreasonable and burdens or restricts United States commerce". https://www.bbc.com/news/world-europe-48947922

Background

The summary of US negotiating objectives for the US-EU trade talks have been published;

https://ustr.gov/sites/default/files/01.11.2019_Summary_of_U.S.-EU_Negotiating_Objectives.pdf

US-UK Trade Talks

During his visit to the UK, President Trump announced that the US would begin talks with the UK on a trade deal as soon as Brexit was completed.

The USTR has now published the summary of specific negotiating objectives for the US-UK trade negotiations; https://ustr.gov/sites/default/files/Summary_of_U.S.-UK_Negotiating_Objectives.pdf

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