Third Quarter, 2019

July 22, 2019 - Stuart Cowell, Head Market Analyst, HotForex

UNITED STATES

The US economy rebounded back in Q1 2019 to register a final GDP reading of 2.2%, however, current projections for Q2 2019 have a consensus around only 2.0%. Quarter 2 was also pivotal for the Federal Reserve as we moved from comments centered on "patience" and "wait and see" mode and that falls in inflation were only "transitory" to outright dovishness and a need to cut interest rates, as economic data soured and trade tensions with the rest of the world began to bite. The US slowdown is likely to ripple across the world, while markets also appear to anticipate more rate cuts during the year, with this pushing the lowly US yield curve lower still.

Markets may be correct in their assessment of the future, as the risks specified in our previous quarterly outlooks remain. While the ongoing trade war with China can create some short-term gains for the US government in terms of income, it can only be used for so long, as it has already raised prices for most consumer goods and pushed corporate profits down. The Q2 Earnings season kicks off July 15 and is expected to see a squeeze on corporate profits and growth rates. The much anticipated US-China trade truce following the G20 meeting is positive news but again the devil remains in the detail with the main burden of the trade tariffs being borne by the American consumer, with inflation slipping and President Trump not willing to cut back on the tariffs and now focusing attention on Europe, Iran and India. Additionally, the USMCA has yet to get approval from Congress, while Mexico has formally ratified the agreement and Canada has a bill before parliament.

There is no question that global growth slowed in the first half of 2019 amid heightened trade uncertainties, Brexit, and geopolitics. And while economic activity will remain sluggish as those elements remain in place, the truce with China should calm worries over a deeper pullback. Adding to the less dire outlook is the accommodative policy stance from the Fed and other key central banks.

The rate cuts and the expectation of more to come during the second half of 2019 is expected to be beneficial to the US economy, even though the dovish statements hit the **Dollar**. The USDIndex rallied to 98.20 in May before closing Q2 down 2.75% below 95.50. The prospects for the **Dollar** are mixed as lower growth and lower future interest rate differentials weigh against it, however, with all central banks moving in dovish unison, the Dollar retains its appeal. Trump comments are likely to also cause short-term turbulence, especially if the trade war truce stumbles, as it has in the past, on the details.

The **USD10YR** bond yield has been declining as a result of the expectations for lower rates, further amplified by the fact that the slowdown is becoming more visible, with the jobs market also showing signs of waning. Q2 saw a huge decline in yields with 12 consecutive weeks of falls, driven by weakening economic outlook. A sharp rise in geopolitical tensions, particularly in the Middle East, all sapped investor confidence.

The belief that the Fed would slow down its rate hike schedule pushed all indices (**US30, US100,** and **US500**) to all-time highs during Q2. Lower rates are beneficial to the stock market as it would create room for both price-based and volume-based gains. Earnings reports during Q2 also helped to buoy equity markets with 80% of reporting companies in the US500 beating expectations. However, it is expected that the Q3 reporting season could be disappointing with expectations getting ahead of the reality of the data. That said, all-time highs in equity markets tend to be bullish in the long-term and the indices still appear to have room to go. Q2 was certainly volatile; the USA500 continued to move up during April from 2835 to 2955 before suffering a significant sell off during May which ran to 2740 lows in early June before rallying again as we start Q3, to test the key psychological 3000 level.

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EURO AREA

The **Euro** area saw its first quarter economic performance being better than expected, 0.4% q/q, bolstered by stock piling ahead of the original Brexit deadline of March 31 but also undermined by the ongoing global trade tensions. At the same time, the annual inflation rate stood around 1.5% and the core figure is showing signs of weakening much lower than the 2% ECB target. **The major political issue still relates to the Brexit discussions**, where the unprecedented delay, attributed to the non-agreement of the UK Parliament regarding the precise Brexit format they would like to follow, continued, extensions to April 12 or May 22 came and went and October 31 is now the new date in the diary. Mrs May has resigned as UK Prime Minister and former Foreign Secretary Boris Johnston is all but certain to be the next UK PM. He continues to claim a new EU and new UK government can negotiate an amended deal by October 31. Still, given the barrage of delays and inability to agree on the type of Brexit, nothing can be ruled out, with even the possibility of stopping the process altogether still being an option.

The UK has little bargaining power, but while a Brexit deal is likely to satisfy most of the EU's requests and address its concerns, it should be most beneficial to the UK. This benefit would likely be reflected in a stronger Sterling, given that uncertainty surrounding the issue will be resolved. The EU's discretion regarding a Brexit extension was bounded by the European Parliament elections in May, which saw a more EU sceptical tranche of MEPs return. A new leadership is yet to be agreed upon, but on the issue of Brexit although the people may change, the EU remains adamant that the withdrawal agreement with the UK remains non-negotiable although there may be amendments available to the political declaration. Huge political uncertainties remain.

Just a month after the abandonment of Quantitative Easing (QE), the ECB retorted with TLTROs, aiming to safeguard the financial sector's access to cheap funding while at the same time ensuring that these funds are aimed at new lending. Growth eased in the first quarter of the year, standing at 1.2% y/y, compared with an annual average of 1.45% in the previous three quarters. **Italy is the region's weakest link**, facing negative growth rates in the last two quarters of 2018 and the first of 2019, and officially entering a recession for the third time in the past 10 years. The country still faces a mountain of issues as the local government does not appear willing to push through economic reforms, and still blames the external environment for the recession. If the low growth regime persists then it would not be surprising to see Italy in need of an official assistance package by the end of the year. However, the European elections delivered a strong mandate for the populist League party led by Matteo Salvini, winning more than 34 percent of the vote and further increasing tensions with the EU. Italy is not Greece of 2008 but the relationship between Rome and Brussels is increasingly strained.

Germany is the other country where growth appears to have stalled, barely avoiding a recession by registering zero growth in the first quarter of 2019. The manufacturing sector is suffering more than most, posting PMI data well below the key 50 level and down as low as 45 in June. The country, whose export sector performance was admired a couple of years ago, appears to have been one of the largest victims of the ongoing trade tensions, with the automobile sector being one of the worst hit. Still, the country's biggest issue lies within the country, as Deutsche Bank, Germany's largest lender, continues to face an array of problems, with investors taking a negative view of the bank's creditworthiness, doubling its funding costs and causing its shares to plummet to all-time lows. The much publicized merger talks with Commerzbank were called off and what was once briefly the world's largest investment bank and bellwether of German economic success awaits some dramatic actions.

The ECB stopped all talk of rate hikes, which were being anticipated to take place towards the end of the year, as other Central Banks are not looking to raise rates and most are now looking to move rates lower. As such, there should be no fundamental change to the **Euro** from an interest rate differential point of view, and while it could benefit from a Brexit agreement, economic growth should remain lower than the United States. On the stock market front, the **GER30** has been following the overall upwards trend and volatility in May but could also register some idiosyncratic effects if the weakening in the German economy continues. The **NETH25** and **FRA40** followed a similar path as the **GER30**, with large falls in May followed by recovery in June.

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JAPAN

The Yen has made significant moves in the past quarter, trading from April highs at 112.40 down to June lows of 108.20**.** While not making strong movements, the Japanese economy appears to be struggling to support a stable inflation rate despite progress earlier in the year. Q2 saw a mixed retail trade, consumer spending, and trade deficit performance. BoJ is certainly now not likely increase interest rates and could even add additional stimulus in the near future, as Central Banks all around the world are preparing for potential rate decreases. A weaker Yen is usually beneficial for the Japanese economy as it assists in funding its huge export industry. The BOJ will be watching the Fed and the key USDJPY 105.00 level. The **JPN225** has been moving positively into the end of the quarter, in line with all the major stock markets in the world, following the dramatic sell off during May which saw the Index lose over 2,000 points. As expectations of a rate hike have evaporated, positive developments are expected in the near future for the Japanese economy, and given its safe haven status, the Yen could potentially benefit in the longer term, even though its negative interest rate differential could be a hurdle.

UNITED KINGDOM

Sterling gained and lost again with respect to both the Euro and the Dollar as the UK Parliament was incapable of reaching an agreement with regards to the desired form of Brexit, Mrs May tendered her resignation and Boris Johnson waits in the wings as her replacement. Markets have accepted that a no-deal scenario is a distinct possibility, with a General Election in September as the most likely case. **Sterling** collapsed back to lows of 1.2505 in June, from highs at 1.32, before recovering to 1.2700 by quarter end. The December lows at 1.25 may not appear so improbable, and it cannot be over emphasized what a key level this is. No-deal Brexit should be overall negative for both the **Sterling** and the UK economy, as it would likely lead to lower exports, in both services and goods, coupled with higher inflation rates. BoE is likely to intervene and raise interest rates around the no-deal day, which should provide an additional obstacle for growth. The current market expectations are a 25% probability of a no-deal Brexit, a 60% chance of a General Election and delayed Brexit and only a 15% chance of a "new amended deal" and smooth exit from the EU for the UK by October 31.

As a result of the above, the **UK100** has been underperforming most other European and international indices, as the market drops each time the UK Parliament fails to make a decision. The Index, which will likely react positively to a Brexit deal, as will the rest of the economy, will also react with losses in the face of no-deal Brexit, coupled with higher inflation and rate hikes, which will harm both profits and future potential. Increased risk aversion in the country has also pushed the **UK Gilt** higher, lowering the yield. Again, expectations are that the BOE will have to cut rates by 50 bps and restart QE by year end if there is a no-deal Brexit, and a General Election, depending on the outcome would also probably mean a rate cut by year end, while a smooth managed exit with a deal could stave off rate cuts initially but they could become necessary during 2020.

AUSTRALIA

House prices continue to decline in Australia, something which could affect the already large amount of interest-only housing loans. As the RBA has acknowledged the decline in housing, focus now turns to how important housing's effect will be on the banking sector, which has already been reducing the availability of credit, and how this deleveraging will affect the overall economy. The surprise Election results in May bolstered the AUD, however, the RBA acted to **cut rates in June** and it would not be surprising if Australia's central bank follows with further rate cuts by the end of year**,** following a similar path as the RBNZ, in an effort to stimulate the economy and ease pressures on borrowers. The **Aussie** has been under pressure against the **Euro** and against the **Dollar**. AUDUSD fell from highs of 0.7200 to under 0.6900. Despite currency troubles the **AUS200** still remains strong, even though underperforming the US and European indices. The country's exporting sector is reliant on the growth of the Chinese economy and is expected to face serious issues in the case Chinese growth continues to decelerate, a result of both domestic and international issues.

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CANADA

The **Loonie** has been on the winning end of its exchange rate versus the **Dollar**, while it has also been gaining ground against the **Euro**. USDCAD lost close to 500 pips over quarter 2 and trades at 1.3050 at the beginning of Q3. BoC appears to be breaking with the Fed's dovish footsteps regarding interest rate movements, with the latest communication being to hold the "wait-and-see" stance, even though this could potentially change to rate cuts by the end of the year, especially if trade tensions continue and a volatile Oil price prevails. Canadian GDP remained sluggish in the first quarter of 2019, growing by just 0.4%, its lowest level since 2016Q2 and below analyst forecasts of 0.82%. The overall fallout from the corruption scandal involving the former attorney general has not hurt the Canadian economy so far, however, as the federal elections are now on the horizon a change in the political regime may occur. As such, the Loonie is more likely to be affected by the USMCA deal and the US-China trade war, and mostly from the price of Oil, which, if OPEC sticks to its production cut schedule, should be beneficial for the currency.

EMERGING ECONOMIES

Of all the emerging countries, Mexico is the one which has registered relative stability in both its exchange rate and its economy in general, even though it is also a claimed victim of the global slowdown, with growth declining -0.2% in Q1. The lower-than-expected economic growth is attributed to a slowdown in the industrial sector. Mexico, which faced a presidential change in December, could benefit from the USMCA agreement, although this is yet to be ratified by Canada and the USA. The **Peso (MXN)** weakened overall during the quarter against the USD, recovering towards the end of June as Fed policy changes were anticipated.

The Turkish **Lira** weakened again during the quarter after initially stabilizing after Turkey's central bank raised interest rates and the government proposed a plan which included a cut in spending in order to control the unfolding currency crisis and mounting inflationary pressures. Nonetheless, after the central bank's decision to forbid overnight lending and push banks to borrow at a higher rate on a weekly basis, the **Lira** plummeted reaching values over the key 6.0 level. While currently still trading at highs, pressures have relatively eased but pressure on the banking sector and borrowers remains, as inflation remains at 15.72% in June having cooled from close to 20%. Citizens have reportedly started exchanging their **Liras** for **Dollars** or **Euros** adding further pressure to the currency; those who borrowed in foreign currencies, including the Turkish government, now see the value of their loans increase, while their income sources still remain rooted in **Liras**. **The outlook is not favourable for the Lira.** The situation led the Central Bank of the Republic of Turkey (CBRT) to hike its benchmark interest rate to 24 percent. They next meet on July 25.

Following a rate hike from the SARB in mid-December, the **ZAR** appeared to be gaining ground against the Dollar, but this has reversed, and despite staving off the recession last year the economy slumped in Q1 with a decline of -3.2%. Agriculture suffered and construction was extremely weak but mining improved as commodity prices rose during the first half of 2019. Services remains a glimmer in the depressed economy. News of power cuts dominated the news after problems in the state power utility in the run up to the May Elections, which returned the ANC but with a reduced mandate. The Rand's prospects appear mixed in the near future and will undoubtedly heavily depend on commodity prices and the next moves by the Fed. USDZAR moved from over 15.00 to close the quarter approaching 14.00.

In Asia, the **Yuan** has weakened as the effect from the Trump tariffs, and the lack of progress in the trade talks, drags on, trading as low as 6.97 versus the USD during June. While Donald Trump commented that tariffs are expected to continue in the near future, hopes of a trade agreement are moving sentiment in the Chinese markets following the G20 truce. The Chinese economy appears to be at its worst stage in years, despite government efforts to boost domestic consumption. The ongoing property bubble, with prices rising by as much as 31% since June 2015, an increase in official non-performing loans, and an overall heavy reliance on export markets suggest that China may have not yet experienced the worst part of its year. Q1 growth was confirmed at 6.4% with Q2 expected to slip to 6.2% which would be its lowest level in over 25 years.

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COMMODITIES

Gold has been on an increasing trend since the beginning of the year as a result of the expected slowdown in world GDP growth, supported by lower than predicted GDP results. During June the price of **Gold moved over $100** from under $1,300 to peak at $1438 and close the quarter over the key $1400 level. Uncertainty over the world's trade future, the overall indecisiveness regarding the whole Brexit process and, most importantly, expectations of interest rate cuts by Central Banks in 2019, were enough to propel Gold on its upwards trend, something also aided by the declining US Treasury yields, and despite stock markets being at record highs. **As both developed and developing economies see their forecasts being downwards revised, Gold is expected to continue to benefit in the near future.** This has been the case during June as central banks begin to cut interest rates making asset returns lower, increasing stock markets prices and increasing demand for the non-yielding yellow stuff.

Despite its close correlation with the price of **Gold**, **Silver** had been in a downwards trend since February, until June's turn around at $15.00. The more dovish stance assumed by the world's central banks is expected to have a positive effect on the price of **Silver**, which derives most of its differences from **Gold** to the fact that it actually possess industrial uses. Even though these are forecast to grow moderately in 2019, uncertainty still remains regarding the precious metal's future. In the case forecasts materialize, demand could push the price higher, conditional on world **Silver** supply remaining constant, something which has not always been the case in the past.

The price of **Oil** has been moving upwards since the beginning of the year, as OPEC has agreed to cut production. The decline in **Oil** supply appears to have been much stronger than the forecasted reduction in Oil demand, while downwards pressures are expected to continue especially if the slowdown in the Asia Pacific region, a previous growth engine, continues. USOIL prices peaked in April at $64.00 and then fell dramatically to June lows at $51.50 before recovering to $58.00. Short-run wild fluctuations in US crude inventories driven by gasoline demand and increasing geopolitical tensions and trade concerns have all contributed to these significant bouts of volatility. **The long-run forecast for Oil remains that prices are expected to grow slowly but persistently**, following the latest extension of production caps from OPEC and in the case that trade issues among the US and its partners are resolved.

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