The Global Economy – 02/17

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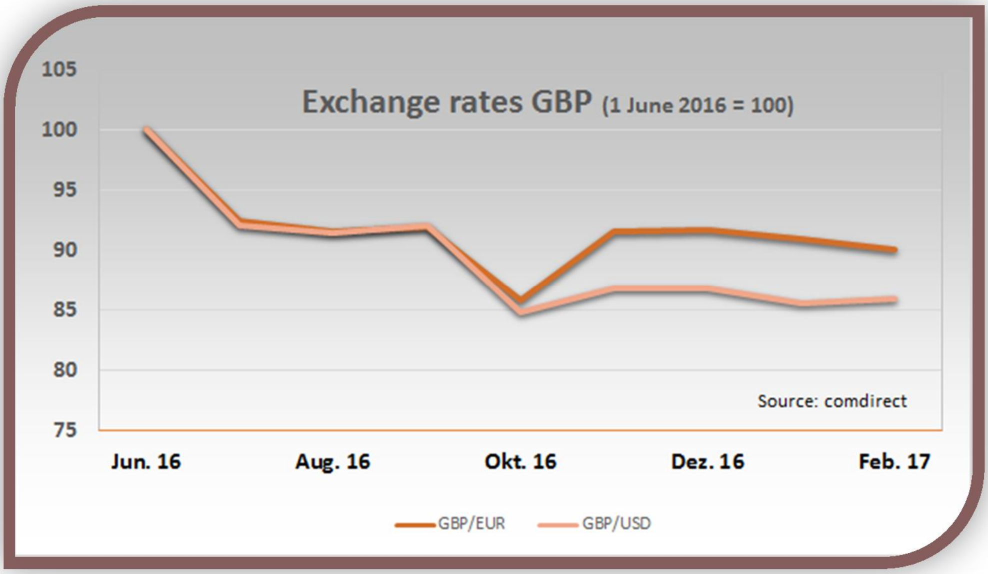
on the most relevant events in the global economy
by J.S. Research KG

Author: Jakob Steffen
steffen@j-s-research.org

Commons leave Brexit bill untouched – but looming divorce bill threatens early crash

It was not a surprise that the Commons voted for the government's Brexit bill by a huge margin far beyond the Tories' majority (the Lords will vote in mid-March); yet what was a surprise was the complete defeat of all mooted amendments, some of which would have been quite irksome for Whitehall. With this unequivocal mandate to kick off the divorce proceedings, Theresa May stands to fulfill her announcement to trigger Art. 50 at the end of March.



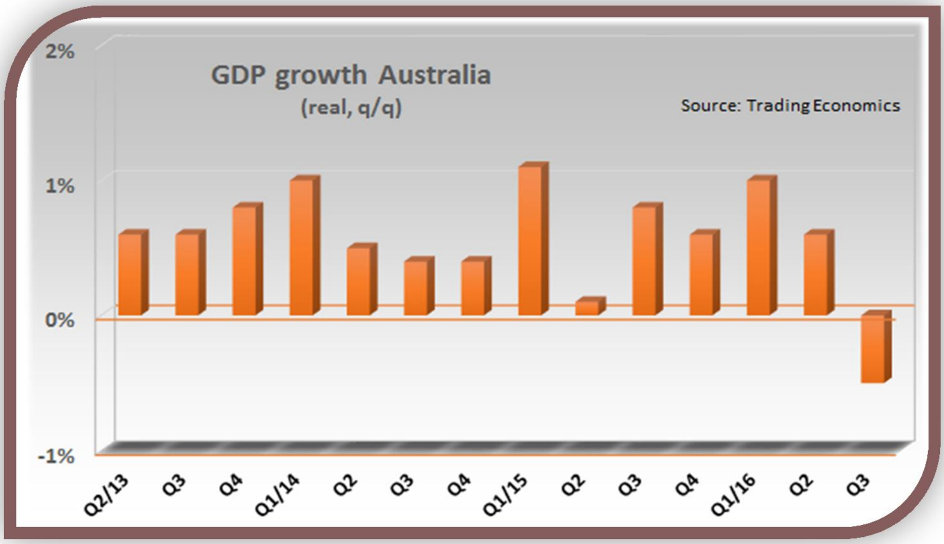
That, however, will only be the point of beginning of the real difficulties lying ahead – not least among them the vast divorce bill to be presented by the EU, so far all but unnoticed by the British people and guaranteed to produce an outcry by the tabloids. The very minimum will be something around €20bn, with the potential to balloon to a sum of €70bn, according to the Centre for European Reform. At the very start of the negotiations, this will be a difficult snag already: For EU mandarins, there really is nothing to negotiate: This is the bill for the UK's underwritten contributions to EU programmes in the running budget, and its figures are as indisputable as is the bill, say, in your favourite restaurant. Into the addition, Michel Barnier, the EU-Com lead negotiator, has stated clearly that there won't be any trade talks until the divorce has been settled. The Prime Minister, by contrast, will be under huge pressure to achieve at least some kind of rebate and a decent slice of the EU's assets; if no side lets go in this early tug-of-war, the negotiations will break down right at the start, with the UK crashing out of the EU calamitously. Even if resolved, the issue has the potential to toxify the atmosphere, making further agreements all the less feasible.

It doesn't help that the devil already waits in a detail further down the road: air travel rights. In principle, there ought to be a decent agreement on some form of mutual free air space akin to the EU's common air zone – if it weren't for Gibraltar. Britain, naturally, will see the rock as part of her territory to be included in any deal, whereas Spain is adamant to oppose that view, refusing to accept British sovereignty over Gibraltar. Since these positions are well beyond negotiable business details, it is very hard to see how an agreement might be reached. If there is no deal on air travel rights, however, huge economic disruption is on the cards – and the tussle over matters of principle such as Gibraltar might prove another point of early rupture.

The President of the European Commission, Jean-Claude Juncker, in any case left no doubt that there won't be any talks of the UK with individual EU member states on the side of the top-level negotiations – certainly no help to sort out the air rights conundrum as well as an array of other intricate challenges.

Muscular Australian economy shows some fatigue – Stubbornly strong Yen stands to hamper Japan's manufacturing – Inflation: How's the story going to continue?

The Australian economy seemed not to know nor brook any weakness. In its 26th year of uninterrupted growth on an annual basis, even the marked Chinese slowdown and its related impact on demand for natural resources, still Australia's predominant export sector, appeared not to drag it down anywhere near the zero line. But then, the unexpected: In the third quarter of 2016, the economy Down Under contracted by 0.5 per cent, the first quarterly degrowth since 2011 and the biggest contraction since 2008. However, the main culprit was not collapsed exports or muted consumer spending, but a rather precipitous, double-digit fall in government investment on a national and local level, respectively. A volatile statistic anyway, government investment thus needs to be seen in perspective: The 3rd quarter of 2016 was not the beginning of the end of Australia's growth bliss, but rather a fit of temporary fatigue. That is why the Reserve Bank of Australia in its most recent board meeting saw no immediate necessity to lower interest rates as markets had come to expect, seeing the Aussie-Dollar quickly recovering from its depths in the wake of Q3's shocking GDP numbers. Yet still, the numbers alerted observers to the fact that all is not well with the fifth continent's economy any longer: Construction and, in particular, manufacturing have been disappointing of last, while GDP from mining has been levelling out, if on very high levels. And healthy consumer spending, driven by erstwhile effervescent house prices, right now stands to normalise as real estate valuations have begun to consolidate. Hence, some caution is in order: Right now, Australia is even more dependent on foreign demand for its natural resources than before. Were that to diminish severely due to, say, a pronounced slump of the Chinese economy, the economy Down Under would suffer, too – and most likely realise its first annual contraction in three decades.



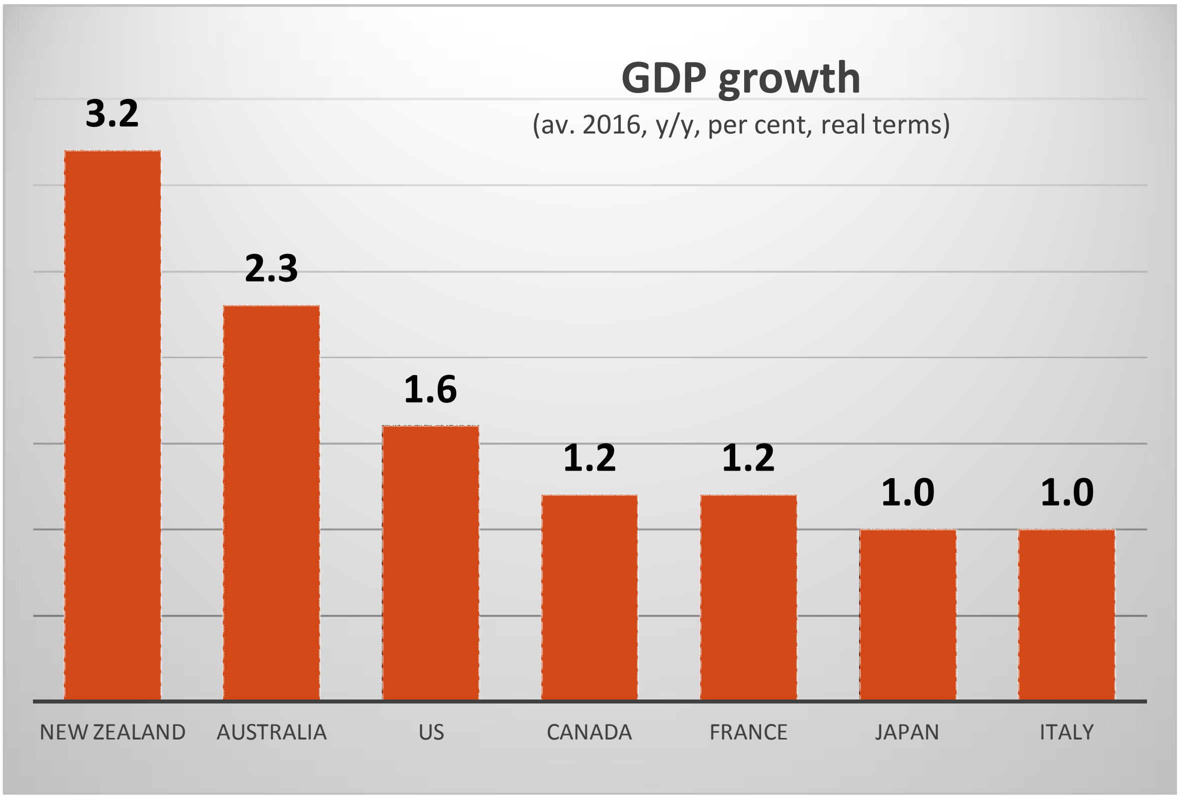
Though it has depreciated somewhat from its highs of 2015/16, **the Yen** continues to be too strong for Japan's liking. And there is an important caveat to that recent depreciation: It was not driven by weak demand for Nippon's currency, but rather by a relatively strong US-Dollar and Euro, respectively. Both currencies, however, for different reasons stand to stop their strong performance for the time being – relatively so in the case of the former, and possibly hazardously in the case of the latter. Donald Trump's bumpy start into his tenure has left markets fretting about his manifest incalculability, temporarily weakening the dollar in the process. Though, in the long run, we project the US currency to appreciate markedly once Congress and President agree on the intended fiscal stimulus and deregulation package (see issue 11/16 of this report), in the short run psychology rules supreme, twitched and tweaked by Trump's every tweet. And what weakens the dollar, in this case simultaneously strengthens the Yen as the world's safe haven of choice. The latter effect will play out even stronger in the case of Europe's common currency: There is an increasing and non-negligible risk of outright unravelling of the monetary union if anti-euro populists take the helm in France and Italy. This has put a lid on further depreciation of the Yen even now, threatening to countereffect Abenomics' efforts to weaken Nippon's currency, thereby breathing life into still subdued inflation. Accordingly, the minister for Regional Revitalisation and key economic advisor to Prime Minister Shinzo Abe, Kozo Yamamoto, pleads for further fiscal stimulus during this year. Since Japan operates at capacity and close to full employment, the hope is that further stimulus might finally kick-start sluggish prices. Meanwhile, the Bank of Japan has been refraining from further easing due to the helpful appreciation of the US-Dollar ever since the election of Donald Trump. Yet the safe haven mechanism always lingers: If the Eurozone descends into political chaos and even outright dissolution, Nippon's currency is guaranteed to appreciate sharply. Any populist turn in European polls related to France's presidential election in April and May as well as renewed political gambling on the part of Matteo Renzi, former Italian Prime Minister, possibly resulting in a surge of populists to power in Italy, already sees the Yen rising these days.

Inflation, finally, is back. Thus, the relevant question has changed from 'when' to 'how much': For the energy prices-related base effect behind this first bout of inflationary pressure is but the beginning. With the spectre of inflation seemingly having all but disappeared in spite of all the excess money central banks have been pumping into the system, many commentators seem to forget that there is no such thing as a singular, isolated rise in energy prices in oil-dependent economies. Witness, for example, UK producer prices: The related RPI figure was a full 3.5 per cent higher in January than a year ago. With wages having risen faster than prices in 2016, there is no way this pressure on manufacturers' margins will not feed back into consumer prices soon. And Sterling's Brexit-induced feebleness adds further to that pressure: Already, rising import prices have begun to feed through to supermarket shelves and store windows. In the US, meanwhile, wages may have been failing to pick up noticeably so far; but don't you believe for a second that, with unemployment down to 4.8 per cent, any type of fiscal stimulus won't result in upward pressure on workers' remuneration. So, how's the story to continue from here? Three critical aspects rule inflation prospects right now: Further development of energy prices, eventual implementation of Trumponomics, and the survival of the Euro (the latter is not as far-fetched as it seems; in next month's issue, we are going to examine the Euro's fate in greater detail). The effects of higher crude prices on a yearly basis depend on those prices either to keep current levels, their feeding through the price system (what we fully expect), or both. We expect crude prices at least to remain in price band of 50-55 US-Dollar per barrel in the months ahead, if not even higher, provided OPEC discipline holds. Thereafter, energy prices stand to rise even further with the oil market slowly rebalancing from the vast oversupply of the recent past. Trumponomics, then, could take some hot air out of inflation's balloon – if the President's fiscal stimulus gets stuck on Capitol Hill as is well heeded custom. Perhaps so; but with President and Congress basically agreeing on the intention of the package, there's more scope for speedy implementation than procrastination. Price expectations, then, stand to err on the negative side; if Congress acts on the stimulus faster than anticipated, inflation expectations will boil over. So it's down to the Euro: If the common currency survives this year of dangerous pitfalls, the scenario develops as described. If it fails, however, the resulting deflationary shock renders the scenario null and void. Hence, for the UK as well as the US we project inflation to stay around 3 per cent for the remainder of the year. In the Eurozone, the return of inflation will be unevenly spread, thus contributing to this year's centrifugal forces tearing at the cohesion of the currency union; the job of Mr. Draghi and his colleagues becomes ever more unenviable.

Statistical bulletin – facts & figures

--- **Retail sales** in the UK finally showed the stark slump as projected by us, collapsing from over 4 per cent year-on-year growth to a paltry 1.5 per cent and falling. In the US, by marked contrast, they all but boomed, apparently buoyed by the election of Donald Trump to the Presidency. --- **Imports** of the Japanese economy grew by a frothing 8.5 per cent in January, corroborating the improving impression of Nippon's economy potentially about to escape its prolonged deflation quagmire. Even more exuberant - whether in spite or because of demonetisation is hard to tell right now - were imports into India; in US-Dollar terms, into the addition. Though doubtlessly dented by the rather brutish monetary reform, the Indian economy seems to keep its spirits for the time being. --- **Manufacturing PMIs** in both Australia and Hong Kong deteriorated, if with different slopes to different levels. In Australia, the statistic confirmed the somewhat more subdued outlook for its still sinewy economy (see above). In Hong Kong, by contrast, the figure even fell below the neutral level of 50, indicating a mild recession. The city state becomes ever more embroiled in political tussles with mainland China, leaving business morale and foreign investor's confidence slumping. --- **Unemployment** in Canada remains somewhat elevated, due to the near collapse of Alberta's oil industry during the slump of crude prices over the last year. With the latter improved now and combined with a recently strong performance of the country's manufacturing sector, the labour market has stabilised at least. In Mexico, the labour market demonstrates what the country stands to lose if trade becomes as restricted as intended by the new US President, sporting an unemployment rate at new troughs. ---

Retail sales (Dec., nom., y/y)	Imports (Jan., nom., y/y)	Manufacturing PMI (Jan., Pts.)	Unemployment (Jan., ILO)
•UK: +1.5% ↓	•Japan: +8.5% ↑	•Australia: 51.20 ↓	•Canada: 6.8% →
•US (Jan.): +5.6% ↑	•India: +10.7% ↑	•Hong Kong: 49.90 ↓	•Mexico: 3.4% ↓



Sources: Trading Economics, bloomberg, comdirect, own calculations

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Imprint:
J.S. Research KG
represented by Jakob Steffen, owner & executive director
Dohlenweg 10, D-42115 Wuppertal
Germany
Tel. +49-202-27258653
office@j-s-research.org