Germany slows down Europe's economy

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'Germany and Chancellor Angela Merkel is back in the center of the storm, and this time, it affects the financial markets.'

THE political situation in Germany is currently moving rapidly at a pace that affects even the financial markets. This applies to both the impact on the domestic German economy and the outlook for the whole Eurozone in a broader perspective.

This should be seen from a perspective where the planned French-German announcement of major reforms for the Eurozone was delayed in March, due to the six-month long government formation in Germany.

In addition, the financial market has been quite optimistic about the growth outlook for Germany, as well as the entire Eurozone since the start of the year – in my view, the risk for a disappointment concerning the growth is growing rapidly, and my assessment is that this weaker scenario has not yet been priced in the stock market, nor the euro exchange rate.

When French President Macron was elected, it, in reality, stood on page four in his electoral program that his economic reform of France was based on some financing from the German fiscal budget.

As mentioned, it was Macron's dream that this should have been presented in March at an EU summit, but it was postponed to the EU summit that just took place. It is primarily Macron that pushes for the major reform of the EU, especially the Eurozone. It had even come so far that Merkel would give some support to the reforms, but as everyone has observed the EU Summit went under in a major European dispute about migration.

Seen from Macron's perspective, the situation is pretty bad. Chancellor Merkel's own government internally completely disagrees about the refugee policy, which in reality means that she does not know if she has a government to be at the forefront or not. Important for the financial markets is the link to Macron in terms of Merkel's support for the economic reforms of the Eurozone.

Without Germany, a change of anything in the Eurozone is impossible, but Merkel does not have political backing to enter into any agreements right now. Ahead of the EU summit, several from her parliamentary base even clearly stated that Germany should not open the fiscal budget to other countries in the Eurozone, which underlines the headwind for Macron's dream.

To make a bad day in the office for President Macron even worse, the grouping called the "Hanseatic League" also addressed their view before the EU summit. The grouping consists of 12 fiscal conservative EU countries, and according to some press reports, the Dutch Finance Minister Wopke Hoekstra was the master behind a letter taking a clear distance to the French dream of a common fiscal budget. Maybe the "Hanseatic League" is less afraid of the fiscal expansion. However, the French idea seems to have something written in fine print about allowing the EU to collect some sort of a mutual tax which really alarms many of the small EU members.

In general, it shows that the EU as a whole is not yet able to generate economic impetus, which has been the financial market's dream since Macron took over the office. On the contrary, economic reforms and initiatives are still largely left to individual member states where the Southern European members, including France, will continue to have difficulties.

Last year, the euro rose throughout the year, which was partly due to the weaker US dollar. However, a part of the positive development was also based on the aforementioned optimism created by Macron. I expect that disappointments from the lack of progress with the reforms will affect the euro in the coming months. The optimism needs to be corrected, where I estimate that it means a further euro decline of four to five pct. towards the dollar - but what about the stock market?

The European stock market also rose, as influenced by Macron's optimism, but this year, the stock market is showing signs of fatigue. In my view, the sour market primarily is caused by the pressure of the US interest rate hikes and the threat of an expanding trade war. If my arguments reflect reality, then there is an increasing risk that a further pressure will hit the European stock market – originating from Germany, partly politically driven as described, but the German economic development will contribute as well.

Throughout the spring, I have met many asset managers who have maintained the optimism about the stock market with reference to a higher global GDP growth, or at least a high growth at a stable level. In Europe, there has generally been the same expectation about a continued high economic growth in Germany.

In this year's first quarter, a number of countries in Europe including Germany have experienced that growth did not fulfil the expectations. Although explained through various reasons that may be right, the persistent political row in Germany obviously does not contribute to further optimism among consumers and businesses. However, the immediate and direct effect in the financial markets I expect to be the mentioned growing pressure on the euro - in the first round.

The European stock market will react negatively if growth rates for the second quarter disappoints again, and I do not regard this risk as priced in the market yet. My concern is that Germany misses out on the GDP growth again in the second quarter. The business expectations among the large German corporations (graphic one) were pretty much in line with the market forecasts in the latest survey but the readings have been declining for a period now. The detailed developments in the survey show that the construction sector continues its optimism like in all other countries. On the other hand, retailers are significantly less optimistic, and therefore the key figures for German consumer confidence and retail sales during the coming months will be unbelievably exciting. The retail sales data for May that was announced on Friday the 29th June showed the biggest drop in seven years, which contributes to the worry about Germany.

I expect that many in the financial market will look out for hints about the German GDP growth for the second quarter. Another hint is the the factory orders (graphic two) that started the quarter badly in April with a reading below the expectations. Therefore, the next four to six weeks will be incredibly exciting where I see an increased risk that the pressure on the European stock market will continue.

China, Japan factory growth declines as trade tensions rise

Feeling the pinch. China's economy has already felt the pinch from a multi-year crackdown on riskier lending that has driven up corporate borrowing costs, promoting the central bank to pump out more cash by cutting reserve requirements for lenders. (Reuters Photo)

BEIJING- Growth in China's manufacturing sector slowed in June after a better-than-expected performance in May, official data showed, as escalating trade tensions with the United States fuel concerns about a slowdown in the world's second-biggest economy.

China's economy has already felt the pinch from a multi-year crackdown on riskier lending that has driven up corporate borrowing costs, promoting the central bank to pump out more cash by cutting reserve requirements for lenders.

The official Purchasing Managers' Index (PMI) released on Saturday fell to 51.5 in June, below analysts' forecast of 51.6 and down from 51.9 in May, but it remained well above the 50-point mark that separates growth from contraction for a 23rd straight month.

The findings are in line with recent data including credit growth, investment and retail sales pointing to slowing growth in China's economy, as policymakers navigate debt risks and a heated trade row with the United States.

Significantly, the June new export orders index contracted for the first time since February, dropping to 49.8 from 51.2 in May.

A production sub-index fell to 53.6 in June from 54.1 in May, while a new orders sub-index declined to 53.2 from 53.8.

The PMI for large-sized firms fell to 52.9 in June from 53.1 in May, the index for medium-sized firms dipped to 49.9 from 51.0 while that for small firms rose to 49.8 from 49.6.

"Domestic demand is weakening and external demand faces pressure from escalating trade frictions between China and the United States," said Wen Bin, senior economist at Minsheng Bank in Beijing.

Wen said he expected the central bank to continue to lower banks' reserve requirement ratios (RRR) in the coming months to help ward off a sharper economic slowdown.

The central bank said on June 24 it would cut the RRR by 50 basis points for some banks to accelerate the pace of debt-for-equity swaps and spur lending to smaller firms.

After May's official factory PMI touched an eight-month high, there have been increasing signs that China's economy is finally slowing.

Credit growth has slowed this year as the government cracks down on many types of lending, and the tighter liquidity environment appears to be impacting growth.

On July 16, the government is due to release data on second-quarter growth in gross domestic product (GDP) and other key indicators.

Analysts at ANZ forecast second-quarter growth of 6.7 percent, from 6.8 percent in the first quarter.

In May, industrial output, retail sales and fixed asset investment all missed expectations as auto sales dropped, and local governments scaled back building projects amid scrutiny from Beijing over their borrowings.

While the economy could likely handle these domestic challenges without growth slowing dramatically, the trade dispute with the US is adding to uncertainty about how China's economy will react.

As US President Donald Trump has ratcheted up the pressure on China with threats of new tariffs and investment restrictions, China's stock markets and currency suffered one of their worst months in years in June.

Meanwhile, Japan's industrial output declined far less than expected last month and the jobless rate hit its lowest in over 25 years in a sign of a gradual economic recovery from a slump in the first quarter, though risks to the outlook have increased from US trade protectionism.

A bitter trade dispute between the United States and major economies, including Japan's big export market China, has unnerved investors and policy makers worried the tariff spat could deal a body blow to the global economy.

How well Japan's manufactures perform will likely be key to the growth outlook, and so Friday's data showing industrial output fell 0.2 percent month-on-month in May is not all bad news, coming off better than the median forecast for a 1.1 percent decline. Output rose 0.5 percent in April.

Manufacturers surveyed by the Ministry of Economy, Trade and Industry expected output to rise 0.4 percent in June and 0.8 percent in July in an encouraging sign for capital expenditure.

Economists expect output to continue to rise gradually as overseas economies gather strength, though the trade friction with the United States poses the biggest risk to the outlook.

"It is safe to say the economy is on the recovery path," said Hiroaki Muto, economist at Tokai Tokyo Research Center.

"As long as the level of inventories comes down there should not be any major problems. I am worried about trade protectionism, but it is hard to predict what will happen."

The jobless rate fell in May to 2.2 percent, the lowest in over 25 years as companies grappled with labor shortages. The jobs-to-applicants ratio, a measure of demand for workers, rose to 1.60 from 1.59 in April to the highest since January 1974.

Japan's economy is expected to rebound in the second quarter from a contraction the first quarter that ended the longest growth streak since the 1980s bubble economy.

The smaller-than-expected decline in output and the tightening labor market may offer some encouragement for the Bank of Japan.

In theory, a tight labor market should put upward pressure on wages, which would in turn push up prices. However, Japan has deviated from this textbook scenario.

The labor market has steadily tightened, but wages have been slow to rise and some measures of consumer spending remain very weak.

Data due next week are forecast to show household spending fell for a fourth straight month in May, a Reuters poll showed on Friday.

The BOJ will conduct a quarterly review of its projections at a rate review in July and will examine whether recent weakness in consumer prices is temporary.

The May output decline was driven by a 6.9 percent drop in production of vehicles and a 1.9 fall in output of steel used in construction, the data showed.

Output of cars fell as some auto makers stopped production lines during Japan's annual Golden Week holiday during the first week of May, a government official told reporters.

Inventories rose 0.6 percent in May, following a 0.6 percent decline in the previous month, due to higher stocks of steel, motorcycles, and semiconductors, the data showed. – ***Reuters***

UK economy thaws; rate rise seen

LONDON- Britain looks closer to shrugging off a weak start to 2018 that has kept Bank of England interest rates on hold, after official figures showed the services sector gathered steam in April and first-quarter economic growth was faster than thought.

However the outlook for growth remains modest, as businesses and households grapple with the uncertain impact of Britain's departure from the European Union in less than a year.

Services output, which makes up four-fifths of Britain's economy, rose by 0.3 percent in April, its fastest pace since November 2017, the Office for National Statistics said.

Compared with a year earlier, services output was 1.6 percent higher, picking up speed from the first quarter when it grew at an annual rate of 1.2 percent.

Sterling rallied against the dollar and the euro after the data, and interest rate futures priced in a roughly 60 percent chance of an August rate rise by the BoE, up from 50 percent before.

Britain's economy as a whole grew 0.2 percent on a quarterly basis in the first three months of 2018, when the country was beset by unusually icy weather, an unexpected upward revision from an initial estimate of 0.1 percent.

The ONS said the construction sector had shrunk less than it first thought, after carrying out a major review of its methods that should lead to smaller data revisions in future.

"The barriers to an August rate rise have come down as a result of this release," Investec economist Philip Shaw said. "In terms of the dynamics of how Q2 growth is playing out, it looks better than previously."

On the year, Q1 GDP growth was unrevised at 1.2 percent, its weakest annual expansion since Q2 2012 and less than half the rate of growth in the euro zone over the same 12-month period.

During the early part of the year, Britain was hit by heavy snow, on top of a squeeze on consumers from inflation caused by a weak pound and many businesses' reluctance to invest while the exact terms of Brexit remain unclear.

No interim deal has been finalized with Brussels ahead of Britain's departure from the EU in March 2019, and UK ministers have yet to agree exactly what longer-term relationship they want with Britain's biggest trade partner.

Business and consumer surveys released overnight showed Brexit worries and inflation continued to hurt business and consumer morale this month, and the BoE reported that consumer lending growth last month was the weakest since November 2015.

Households funded increased spending earlier this year by reducing the amount they save, and Friday's data showed household savings ratios falling to 4.1 percent, the third-lowest level since records began in 1963.

Other surveys have shown households want to save more, so future spending growth may be limited, even if falling inflation reduces the squeeze on household disposable income.

"Deterioration in surveys of employment intentions and the recent increase in minimum pension contributions also suggest that growth in households' real spending will remain weak," Samuel Tombs of consultancy Pantheon Macroeconomics said.

Nonetheless, the Bank of England predicts quarterly GDP growth will rise to 0.4 percent in the three months to June, as the economy rebounds from February and March's snow.

Investec's Shaw said this still looked realistic after the latest data, and most economists polled by Reuters expect the BoE to raise rates, for only the second time since the 2008 financial crisis, after its next rate meeting in August.

Friday's ONS data also showed that Britain's current account deficit narrowed to 17.7 billion pounds ($23.3 billion) in the first quarter, slightly better than economists' expectations.

As a share of GDP, this amounts to 3.4 percent, its lowest in a year, though high by international standards.

On Wednesday, the BoE said Britain's current account deficit made it vulnerable to a fall in foreign investors' appetite for British assets, which could lead to higher borrowing costs for businesses and households.

"Sterling remains vulnerable to fall sharply in the event of another sudden deterioration in overseas investors' perceptions of the UK economy's outlook," Pantheon's Tombs said. – ***Reuters***