19 April 2018

Research

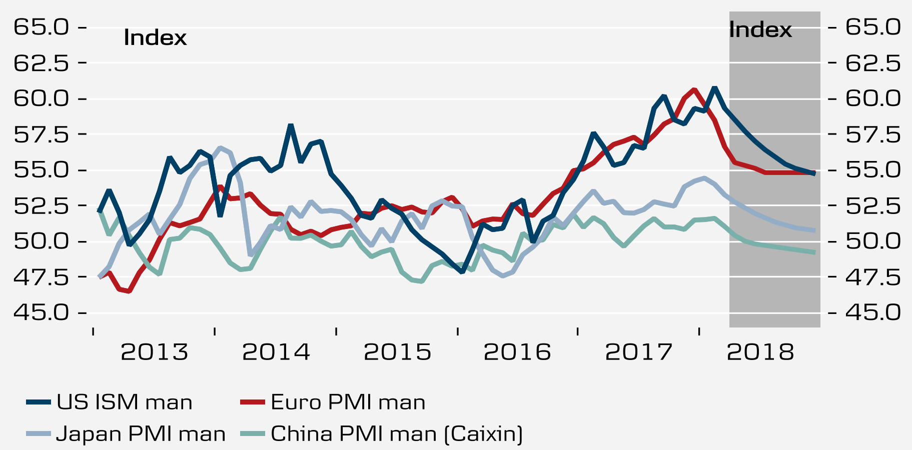
Global business cycle moving lower

- **We see clear signs that the global business cycle has peaked in early 2018 in line with our expectations outlined in *Five Macro Themes for 2018*, 3 January 2018.**
- **Our MacroScope models point to a further deceleration over the coming quarters. The recent uncertainty over a potential trade war is likely to reinforce this picture.**
- **Monetary tightening, higher yields, lower real wage growth, more uncertainty – and in the case of the euro area a stronger currency – are all factors pushing production growth a notch lower in the rest of 2018, in our view.**
- **While the cycle is softening, we still expect growth levels to stay above potential growth in 2018 and 2019. US fiscal easing will temper any deceleration in 2019.**
- **Nevertheless, declining PMI levels across regions tends to cause some anxiety about the strength of the recovery, giving less support to risk assets and putting a cap on bond yields. In a forthcoming piece, we will look at the financial implications of a decelerating business cycle.**

The global industrial cycle

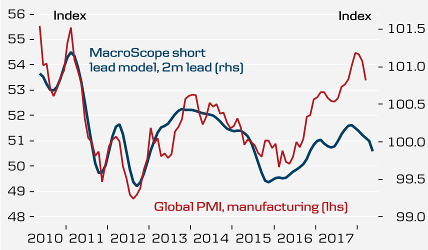
After a strong synchronised upturn in the global industrial cycle since early 2016, we see **increasing signs that the cycle has peaked and that growth is decelerating**. The euro surprise index has fallen sharply (see next page), our MacroScope business cycle models have weakened for three months now and we have witnessed declining upward momentum in global metal prices. All signs of a weakening cycle. We look for further deceleration in the coming quarters due to (a) globally tighter monetary conditions and higher bond yields across regions, (b) lower real wage growth (due to the rise in inflation) and (c) an increased focus on deleveraging in China that has yet to feed through to growth. The rising tensions in the US-China trade dispute may also lead some companies to postpone investments.

Global manufacturing: from acceleration to deceleration across regions



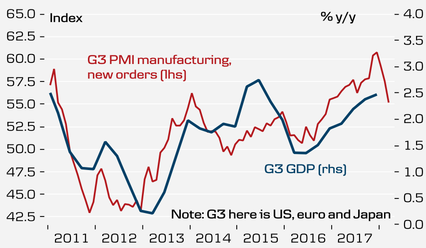
Source: Markit, Macrobond Financial, Danske Bank

Global cycle has turned lower - MacroScope points to more downside



Source: Macrobond Financial, Markit, Dansk Bank

Global PMI new orders lowest in a year



Source: Macrobond Financial, Markit, Danske Bank

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While global growth is decelerating, we do not expect it to turn into a marked downturn. The headwinds are simply not big enough and if growth should slow more than expected, the central banks will be quick to postpone monetary tightening and in the case of China reverse it. We already see a slight easing bias from China in its latest move to reduce the Reserve Requirement Ratio of one percentage point (see below).

Below, we will take a closer look at the main global regions.

US: ISM set to decline in coming quarters but stay well above 50

The US is so far the region performing the best this year, although there are tentative signs of a turn lower here too. **The surprise index has started to move lower and retail sales have been quite soft in recent months**. While it is probably a temporary pause following very strong retail sales at the end of 2017, it should nevertheless have a dampening effect on manufacturing in coming months. One of the factors keeping consumption in check despite a robust labour market is that real wage growth has declined from above 2% in 2015 to now around 0%, due to the rise in inflation amid subdued wage growth.

One of the big puzzles has been the big divergence between the PMI and ISM manufacturing indices, which are supposed to measure the exact same thing (although with slightly different weights) and historically have also followed each other closely. For some months, ISM has hovered around 60, which has been at odds with Markit PMI, other soft indicators and hard data. The PMI indicator has been more accurate for some time but gets much less market attention. **The fact ISM has overestimated the actual manufacturing expansion speaks by itself in favour of ISM manufacturing moving lower in coming months.**

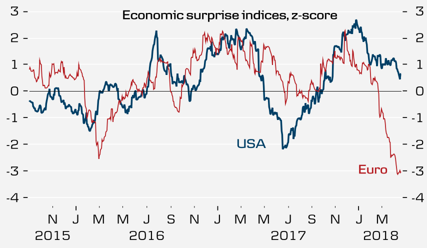
Looking at indicators like the demand/inventory balance and our MacroScope models, we see signs that the phase with *increasing* manufacturing growth is over. That said, nothing suggests we are heading for a period of significantly slower US manufacturing growth: Business optimism remains high, demand/inventory ratios are positive, tax cuts support investments, financial conditions are still easy despite the recent tightening and global demand is expected to hold up despite some softening. We do not see signs we are heading for a manufacturing downturn as in 2014-16, where the oil sector recession spread to the rest of the manufacturing sector. In 2019 a further fiscal boost is also set to underpin growth.

To sum up, we believe ISM manufacturing will fall down to around 55 in 3-6M. This is a quite big drop but remember the starting point is that ISM is already too high. 55 is consistent with continued manufacturing growth. We expect PMI to fall only moderately as the level is already lower to begin with.

Global monetary conditions are tightening

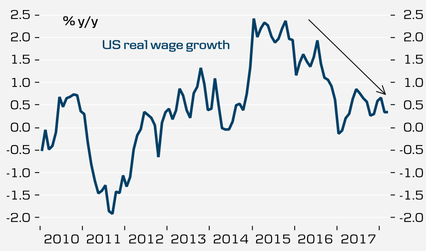
Source: Danske Bank, Macrobond Financial

Euro surprise index has fallen sharply – US still holding up for now



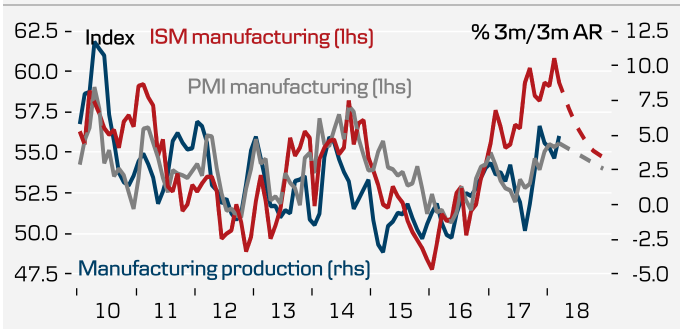
Source:, Macrobond Financial, Danske Bank

US real wage growth has deteriorated due to rising inflation



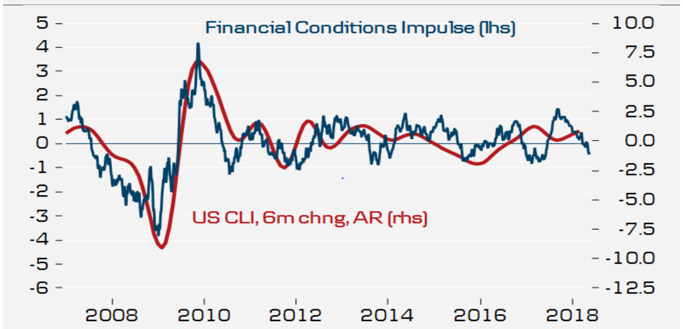
Source: Macrobond Financial, Danske Bank

ISM manufacturing has overestimated actual manufacturing growth – Markit PMI has been more accurate



Source: ISM, IHS Markit, Federal Reserve, Macrobond Financial

US financial conditions impulse has tightened due to higher bond yields, easing tailwind from USD and weaker equities



Source: Danske Bank, Bloomberg, OECD (CLI is composite leading indicator)

China: Moderate slowdown

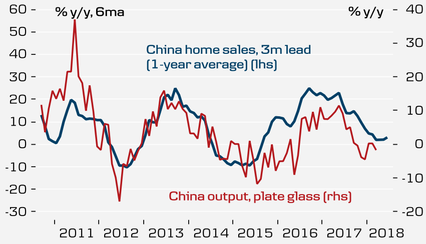
In China we see **increasing signs that the business cycle is softening in 2018**, see *China Leading Indicators: More signs of (moderate) slowdown*, 11 April 2018. First, the new home sales have slowed, which normally feeds into *construction investments* with a lag of 6-9 months. The slowdown is confirmed when looking at for example the production of plate glass, where growth has fallen from 10% in mid-2017 to below 0% in early 2018. Second, overall credit tightening and a stronger push for deleveraging is likely to weigh on *infrastructure investments*. We see a rising number of regional infrastructure projects that don't get approval by Beijing due to concerns over high debt. Third, there are signs that the recovery in *export growth* is fading, which we subscribe to an appreciation of the CNY and a bit lower growth on export markets.

M1 growth is normally a good leading indicator for China PMI manufacturing as it captures the overall monetary stance of the Chinese central bank. It has weakened quite a lot going into 2018 adding to the case for weaker growth. It may explain why the People's Bank of China decided to make a small easing of monetary policy on 17 April by reducing the reserve requirement ratio by one percentage point from 17% to 16% (although the effect is partially neutralized by liquidity being withdrawn on the Medium Lending Facility). Chinese money market rates have moved lower lately after rising throughout 2017 and the small easing by the People's Bank of China added to the decline.

While we look for the cycle to turn lower, we also see limited risk of a hard landing in China. The inventory of houses is low on average, which cushions the slowdown in construction. Also while exports are set to slow, we do not look for a sharp deceleration. We also look for rising investment growth within the high-tech manufacturing sector as China is channelling more money to innovation and high-tech as part of their "Made in China 2025" strategy. Also, as noted above, there are already signs that the central bank is easing the foot slightly from the break.

The moderate slowdown of the Chinese economy is expected to dampen the global inflationary impact from China further over the coming year with PPI inflation declining further to around 1% by the end of 2018 down from a peak at 7.5% in early 2017. The inflationary impact of reductions in overcapacity is also set to fade, as China has already come quite far in cutting overcapacity and steel prices and other commodity prices have recovered to more 'normal' levels.

Chinese housing has slowed

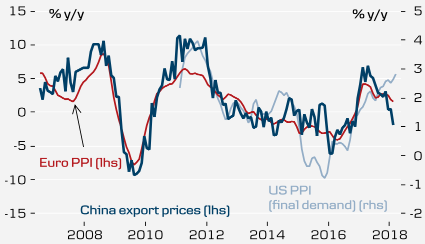


Source: NBS, Macrobond Financial

Rates and yields declined further on surprise RRR cut by PBoC

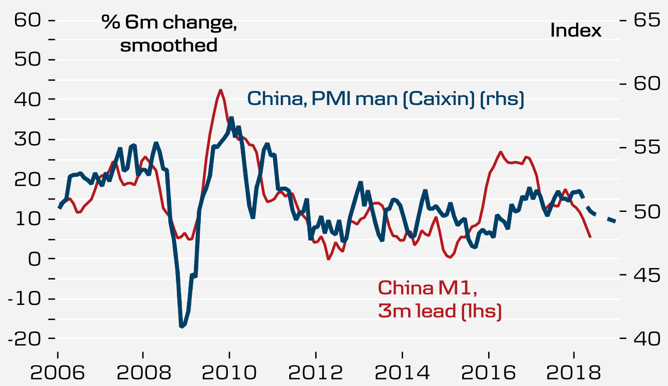
Source: Bloomberg, Macrobond Financial

China's reflationary impact is fading



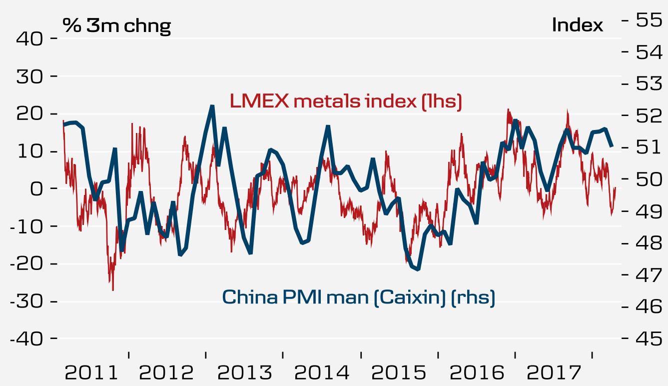
Source: NBS, Macrobond Financial

China monetary tightening to dampen growth this year



Source: Markit, PBoC, Macrobond Financial, Danske Bank

Lower metal price inflation support picture of China slowing



Source: Markit, Bloomberg, Macrobond Financial, Danske Bank

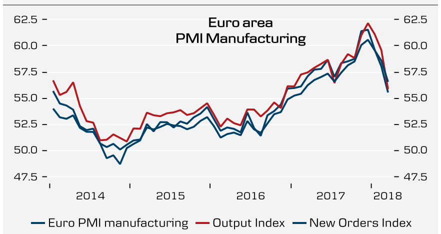
Eurozone: a bit more downside but stabilisation soon

The euro area is the region where we have seen the clearest signs of weakening. As shown on page 2, the economic surprise index has fallen sharply recently. PMI manufacturing has also been in decline since December 2017 driven by the new orders (and output) index. A moderation in euro area PMIs was in line with our expectations, given the very high levels reached in Q4 17. We believe the recent decline in manufacturing PMI is a reflection of increasing capacity constraints impeding output and the lagged impact of the stronger EUR as well as increasing business uncertainty in light of US-China trade conflicts adversely affecting especially the new (export) orders index.

Our PMI model which uses the order-inventory balance as input foresees PMI falling to 55.5 in April from 56.6 in March, particularly in light of the recent flare up of US-China trade war concerns. But among signs of calming tempers and our expectation of a deal solution with China possibly opening up even more for foreign companies, we expect the impact on PMI to be moderate/fleeting and mainly act through the confidence channel rather than the direct export channel. **Although we look for further moderation in PMI manufacturing in the next 3-6 months, we expect the magnitude of declines to decrease**, with PMIs stabilising around the 54.5-55.0 level, as the negative impact of the euro appreciation is waning and trade conflict concerns abate. Such a stabilisation is also in line with our quantitative business cycle model, Macroscope, and a simple medium-term model that uses real money growth and the effective euro. The manufacturing cycle will continue to benefit from continued loose financial conditions in Europe. EONIA forwards have repriced lower, pointing to a 10bp hike in July 2019 as financing conditions for euro area non-financial corporations continues to be very favourable.

Despite PMIs tapering off, we do not see reason to be concerned about the near-term growth outlook in the eurozone, which will remain robust in our view. Also, actual GDP growth was never as high as predicted by PMIs in Q4 17 and hence we do not expect a similarly sharp growth deceleration ahead as PMI manufacturing has exhibited.

PMI decline driven mainly by new orders

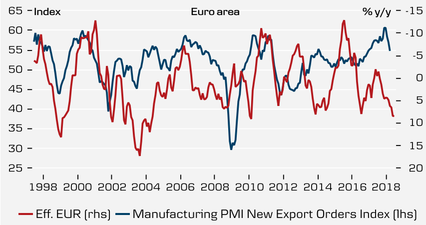


Source: Markit, Macrobond Financial, Danske Bank

More near-term downside from trade conflict risks

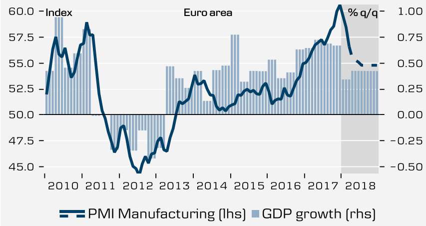
Source: ifo, Macrobond Financial, Danske Bank

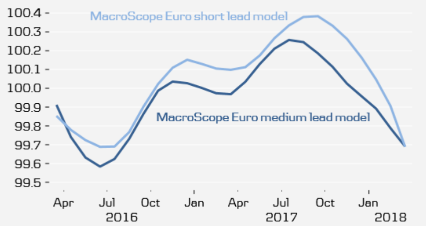
EUR appreciation still a negative factor in the next months

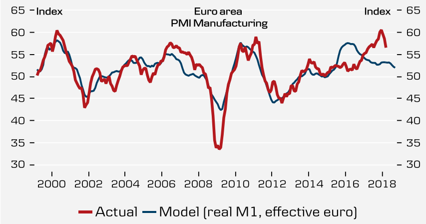


Source: Markit, Macrobond Financial, Danske Bank

Euro PMI expected to level off, as predicted by Macroscope







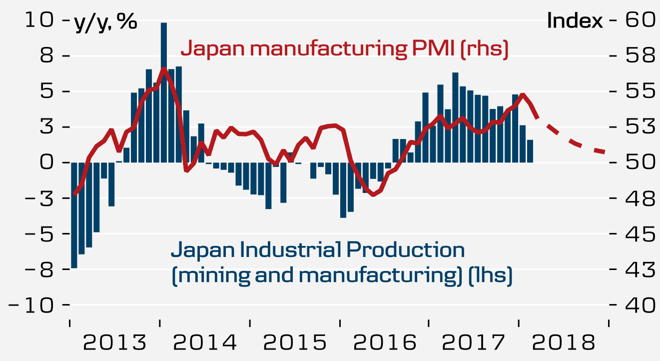
Source: Markit, Eurostat, Macrobond Financial, Danske Bank

Japan: deceleration but still above trend growth

Several leading indicators point to some slowdown in Japan this year after a very strong 2017, by Japanese standards. The yen strengthening has contributed to a decrease in exports already and PMIs point to continued weakening of industrial production as the pace of new orders ticking in seems to be slowing down. In line with PMIs, business conditions in Q1 and expectations for Q2 have decreased according to the Bank of Japan's business Tankan survey. Also, capex expectations for fiscal year 2018 are more moderate than for 2017. Machinery orders have come out quite strong in recent months though, so a capex slowdown does not seem to be right around the corner. Housing starts on the other hand decreased significantly at the beginning of the year, and thus the already weak residential investments could be slowing further.

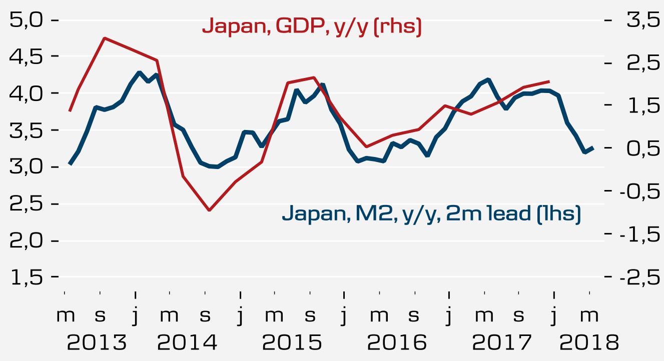
Also M2 money growth, which has been a good indicator in recent years, points to a decrease in GDP growth. Overall, we look for a deceleration in 2018, but as long as the Bank of Japan’s ultra-easy policy stance remains unchanged and the yen stays around current levels, exports are still bound to drive growth in Japan and **we still expect growth on the positive side of trend in 2018.**

Weakening manufacturing sector



Source: Japanese Ministry of Economy, Trade & Industry, IHS Markit, Macrobond Financial

Money growth indicates slowdown



Source: Japanese Cabinet Office, Bank of Japan, Macrobond Financial

Disclosures

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None.

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