In the Headlines

**U.S.: Retail sales accelerate, hints of inflation**

The consumer has reappeared, as June retail sales rose a strong +0.5% m/m and May was revised up from +0.8 to an outsized +1.3%. Gains were widespread across industries, but especially in discretionary categories, indicating that consumers are rebuilding their confidence. Food/drinking places rose +1.5% m/m in June and +2.6% m/m in May to +8% y/y, the fastest in three years. Consumer prices rose to +2.9% y/y, a 6.5-year high, with the core rate rising +2.3% y/y. Producer prices also showed inflation, rising to +3.4% y/y. Tariffs are showing up for producers as steel and aluminum products are both up +14% YTD. Industrial production rose +0.6% m/m in June, driven by the second consecutive month of big gains from the mining component. On a y/y basis industrial production grew +3.8% with manufacturing up +1.9%. Fed Chair Powell again described a robust economy, supporting the case for two more rate hikes this year. But, he also noted that regarding tariffs, “We’ve heard a rising chorus of concern, which now begins to speak of actual capex plans being put on ice for the time being.”

**UK: The Softer Brexit bodes well for the sterling**

The Softer Brexit targeted by the UK government, still to be negotiated with the EU, sets the pace for a lower deterioration in economic prospects. Overall, UK GDP growth would decelerate only moderately, to +0.8% in 2021 from +1.3% in 2019 as the regime change would be less dramatic than in a ‘Limited FTA’ scenario that we were previously expecting. The UK government White Paper confirmed that the future agreement with the EU to be implemented in 2021 targets a free trade zone for goods but not for services. We would expect non-tariff barriers (licensing, administrative costs etc.) to represent additional costs of 10%. The financial services would lose passporting rights but gain market access based on regulatory equivalence with the EU. While UK regulation will be different from the one in the EU, both sides will work together to align in order to avoid withdrawal. If PM May’s proposal is accepted without any major political turmoil, we expect the GBP will appreciate against the EUR.

**Turkey: On course for a balance of payments crisis?**

After being sworn in for his second term last week, President Erdogan moved swiftly to strengthen his influence on economic policymaking. Politicians perceived as investor-friendly were excluded from the new cabinet and Erdogan’s son-in-law was appointed to run the now combined Finance and Treasury Ministry. Erdogan also gave himself extensive powers over the Central Bank and the Monetary Policy Committee and renewed his call for lower interest rates. Altogether this sent the TRY to a temporary record low of 4.98 to the USD last Thursday. At the time of writing, the TRY trades at 4.84 to the USD which represents a -21% loss in value YTD. The latest developments are worrisome for a country that relies on portfolio inflows to finance its chronic external deficits. In fact, May was the fourth month in a row where portfolio investment posted a net outflow, bringing the net inflow in January-May down to +USD1bn. During the same period, the cumulative current account deficit rose to −USD28bn (up by +59% y/y). If investor sentiment remains adverse over a longer period, a balance of payments crisis and a hard landing of the economy are on the cards. Our current growth forecast is +3.7% in 2018.

**France: I will survive**

“First, I was afraid, I was petrified” was certainly what could have been said after the worrisome evolution of household purchasing power in Q1 (-0.6% q/q). We have estimated that private consumption grew by a cumulated mere +0.5% from Q3 2017 to Q2 2018. This triggered downward revisions of 2018 growth forecasts by (almost) everyone to +1.8% (after +2.3% in 2017). And? The two major French carmakers published record sales figures for H1 (about +10% each). And? The French soccer team won the World Cup. We calculated that such an event will improve consumer sentiment and nurture consumption growth, revising it from +1.1% to +1.3%. Such an increase will make +EUR2.7bn of additional opportunities (from new TVs, drinks during the competition to new skirts with two stars and an increasing willingness to make holiday trips). Among that, +EURO.7bn will be imported and +EUR2bn will benefit directly GDP growth, triggering a revision of our forecast by +0.1pp to +1.9%.

Note: WERO is taking a break. The next issue will be 22 August 2018.
Countries in Focus

Canada: Bank of Canada raises rates

The Bank of Canada (BoC) raised its overnight rate from 1.25% to 1.5%, the fourth hike in 12 months. The accompanying statement was more hawkish in tone: “Governing Council expects that higher interest rates will be warranted to keep inflation near target... economy continues to operate close to its capacity... CPI inflation is expected to edge up...” The BoC also upgraded its GDP and inflation forecasts. And like the Fed, the BoC noted trade worries: “The possibility of more trade protectionism is the most important threat to global prospects...” In addition, the hike may hurt the housing market. Government measures have cooled prices and sales, but perhaps too rapidly. Toronto prices have fallen -2.8% y/y. Sales nationwide have also fallen -15% y/y to the lowest level in five years. But the BoC’s rate hikes have also driven mortgage rates up. The Bank is likely to hike one or two more times this year, putting additional pressure on the housing market.

Central and Eastern Europe: Inflation on the rise

In June, y/y consumer price inflation increased in 10 out of the 11 EU member countries in the CEE region. The only exception was Lithuania where inflation edged down to 2.6% from 2.9% in May. In the Czech Republic (2.6%) and Hungary (3.1%), inflation came in above the Central Banks’ targets (2.0% and 3.0%, respectively) but remained within the ±1pp tolerance ranges around those targets, for now. In Romania, inflation remained elevated at 5.4% (unchanged from May) and has now exceeded the 3% ±1pp target range for six months in a row. Rising price pressures call for an end to the very loose monetary policy stance in the region in the next 12 months. The Czech Republic and Romania have already embarked on monetary tightening over the past year, the former appropriately but the latter too timidly in our view (for more details see WERO 4 July 2018). In Hungary, the key policy interest rate was again kept at 0.9% in June (unchanged since May 2016), however, the statements accompanying the decision gave some hints that the era of very loose monetary policy may end in the foreseeable future. In Poland (2.0% inflation in June) rate hikes are unlikely this year but should come next year.

South Africa: Honeymoon in reverse

After President Ramaphosa’s announcement, South Africa benefitted from a financial boost triggered by lower interest rates and a ZAR appreciation by about +15%. It added to a partial rebalancing of the economy engineered by the corporate sector during the low growth period. These cumulative forces helped reduce inflation to +3.8% y/y in March, the lowest figure in the last seven years. However, the recent oil price increase and renewed ZAR weakness (reverting it to its informal band observed before Ramaphosa’s appointment) have clouded the outlook. Retail sales lost their 2017 momentum and should remain contained in the near term as inflation is set to accelerate to above +5.5% by year-end. The mining sector was hit by new strikes (the gold output decreased by -7.8% y/y). As a result, GDP growth should now need one more year to be back to the +2% mark (forecast in 2019), and our 2018 growth forecast is revised down from +2% to +1.5%.

China: Q2 GDP – strong despite protectionism

Economic growth continues to show resilience despite rising trade tensions. China’s real GDP rose by +6.7% y/y in Q2 (after +6.8% in Q1). The tertiary sector accelerated to +7.8% y/y in Q2 (up from +7.5% in Q1) and remains the main growth driver. The industrial sector posted slower growth of +6% y/y (down from +6.3% in Q1). Short-term indicators suggest that economic growth is slowing, yet consumer spending is still acting as a buffer. Industrial production was held flat (+6% y/y in June, after +6.8% in May). Nominal urban fixed asset investment growth edged down to +6.4% y/y in January-June (from +6.1% y/y in January-May). Yet, growth of nominal retail sales of consumer goods accelerated to +9.8% y/y in June (from +8.5% in May). Against this background, we maintain our full-year GDP growth forecasts of +6.6% in 2018 and +6.3% in 2019.

What to watch

- July 23 – Turkey July consumer confidence
- July 24 – Eurozone July Manuf. and Services PMIs
- July 24 – Hungary monetary policy meeting
- July 24 – Turkey monetary policy meeting
- July 25 – Turkey July business confidence
- July 26 – ECB meeting
- July 27 – France Q2 GDP
- July 27 – U.S. Q2 GDP
- July 31 – EU and Eurozone Q2 GDP (1st estimates)
- July 31 – Eurozone July inflation
- July 31 – France July inflation
- August 2 – BoE meeting
- August 7 – Germany June industrial production
- August 10 – UK Q2 GDP (preliminary estimate)
- August 14 – EU and Eurozone Q2 GDP (2nd estimates)

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