Economic Research

بنك أبوظبي التجاري ADCB

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The Week Ahead: ECB and Turkish central bank meetings

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Europe: ECB to outline monetary policy post-Brexit vote

At its meeting on 21 July – the first since the Brexit vote in June – the ECB will provide its preliminary assessment of the economic and monetary outlook. The broader monetary stance is likely to remain unchanged. However, markets will closely track any estimates by ECB officials of the extent of the slowdown in growth and inflation to gauge the likelihood of QE being extended. With the ECB front-loading its corporate and sovereign bond purchases in recent weeks, the risk of a liquidity squeeze in European financial markets has fallen and equity markets are up, lessening the immediate need for action. However, credit risk in the banking sector, which is critical to the ECB's plan to transmit lower interbank rates to the real economy, has risen sharply. Any comments from officials regarding measures to address the rising risks in the European banking sector will be keenly followed by the markets. We expect the ECB to announce another six-month extension to its asset purchase programme (to 3Q2017) at its September meeting. This could also be accompanied by changes to the proportion of sovereign bonds the ECB purchases under its QE programme so as to favour greater purchase of peripheral sovereigns. Additionally, the ECB might also expand the quantum of its corporate sector asset purchases to reduce the intermediation costs incurred by firms dealing with an impaired banking sector.

Turkey: CBRT to cut overnight lending rates

This week's CBRT meeting (due Tuesday, 19 July) assumes special importance in the aftermath of the failed military coup last week. We expect the CBRT to cut the overnight lending rate by another 50 basis points to 8.50%, in line with the consensus. We will closely follow the CBRT's policy guidance following the political upheaval last week. On the one hand, the political uncertainty following the failed coup may be another blow to tourism growth and investment sentiment, thus arguing for another round of rate cuts. On the other hand, the recent events may fuel a sell-off in Turkish assets, further exacerbating external funding constraints and making it difficult to ease monetary policy. For now, we maintain our view that room for further policy rate cuts remains limited.

US: Housing data for June to remain buoyant

Housing data for June should confirm our assertion that domestic economic momentum remains robust despite increased global macroeconomic uncertainty post the Brexit vote. Housing starts and building permits (both due Tuesday 19 July) are likely to advance further from their May levels. However, even a rebound in economic growth in 2Q is unlikely to result in a 3Q rate hike by the Fed, which is likely to remain cautious over risks to the economy from external financial conditions.

I. Recent Data and Events

A. G4 Economies

UK: BoE holds rates, but signals substantial easing in August

BoE to substantially ease policy rates in August, macro outlook to be fairly bearish

The BoE surprised the markets last week by refraining from cutting policy rates in its first meeting following the Brexit vote, though the decision was in line with our counter-consensual expectation. As we had expected, the comments signalled that the BoE will substantially ease monetary policy only in August, as its Inflation Report due on 4 August will give it a more comprehensive assessment of the economic outlook post the Brexit vote. We believe that the assessment will be considerably bearish, with the BoE indicating risks to business investment due to uncertainty around the exit process and a hit to consumer spending from a weaker GBP and sluggish hiring sentiment.

BoE to emphasise targeted credit easing measures over QE-style asset purchases or negative policy rates

Comments from BoE members suggested that the central bank is unwilling to let the imminent monetary easing impair the functioning of financial markets. We think this conveys the bias of the BoE towards easing monetary conditions through targeted credit easing measures like Funding for Lending rather than massive outright purchases of government or corporate bonds as currently pursued by the ECB or the BoJ. That said, we still expect a quantum of around GBP75-100 billion in asset purchases, smaller than that announced after the Global Financial Crisis, by the BoE to compress credit spreads impacted by the post-Brexit vote sell-off in bond markets. Further, we believe that the BoE is unlikely to cut policy rates by more than 25 basis points this year, staying away from zero or negative policy rates. These could affect profit margins for banks that are likely to face weak credit demand in the coming quarters.

UK: Immediate uncertainty to wane after May's appointment as PM

Article 50 to be triggered in January 2017; fiscal stimulus package likely in interim

UK Home Secretary Theresa May took over as Prime Minister following the resignation of David Cameron in the aftermath of the Brexit vote. The new PM appointed leading proponents of the "Leave" camp – David Davis, Boris Johnson and Liam Fox – as ministers in charge of negotiating a deal with the EU. She also ruled out any possibility of a second EU referendum. We believe the new government will invoke Article 50 and thus trigger formal Brexit negotiations in January 2017, accepting a formal exit by 1Q2019. Further, statements from the new PM suggest that the BoE's monetary easing is likely to be complemented by fiscal stimulus as well. A suspension of budgetary targets set by the previous government and additional corporate tax breaks are likely in our view.

Short-term uncertainty has waned but long-term damage to growth prospects remains

We believe that last week's announcements will significantly mitigate the uncertainty prevailing in the markets about the timing of formal Brexit negotiations and the fiscal and monetary outlook. Indeed, we now expect a shallower recession in 2016-17, than the markets had previously expected for the forecast period in late June, due to a more aggressive fiscal and monetary stimulus. By keeping liquidity flush in the interbank markets through monetary easing, the actions of the BoE and the ECB should keep Brexit contagion within Europe. However, this has not affected our long-term pessimism regarding the UK economy post-Brexit. For one, trade negotiations between the EU and the UK are unlikely to be as smooth and generous as currently being presumed by the financial markets and British political leaders, especially if they are accompanied by British intransigence regarding curbing EU immigration. Second, by creating non-tariff barriers to trade, Brexit hurts the high-end services sector – the driver of the post-industrial British economy. Unless new engines of growth are found within the economy, the UK is likely to struggle with stagnation and sub-1% growth in the long term post-Brexit.

Europe: Spain and Portugal fail EC's fiscal deficit consolidation test

Spain's decision to raise taxes to meet EU criteria might weigh on growth this year

The European Council concluded last week that Spain and Portugal were unlikely to cut their fiscal deficits to bring them within the EU's fiscal upper limit of 3% of GDP by 2017. While extreme measures, such as the imposition of a fine, are likely to be avoided, we believe that the EU's recent censure of those countries may have an adverse impact on growth and pro-EU sentiment among their citizens. The Spanish government has already announced a EUR6 billion hike in corporate taxes next year, which could hinder investment growth. We believe that a temporary suspension of deficit reduction procedures for member countries would, in addition to the ECB's QE programme, currently be the most effective way to restore growth and popular confidence in the EU post-Brexit.

Japan: Abe's Upper House win to aid fiscal stimulus plans

Convincing victory by Abe could mean bigger fiscal and monetary stimulus than market expects

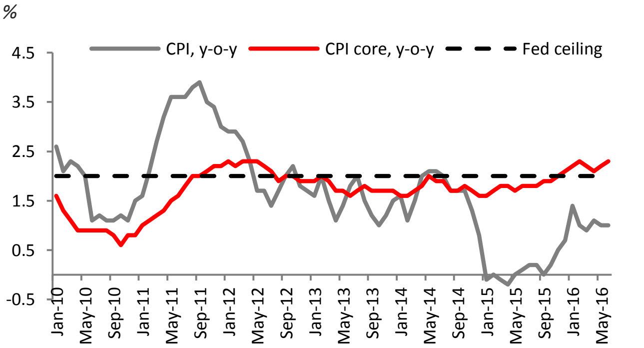
Prime Minister Shinzo Abe's coalition secured a majority in the Upper House elections this week, signalling an endorsement of his fiscal and economic policies by the public. We now expect the government to announce a supplementary budget before the 29 July meeting of the BoJ. Further, given the sharp appreciation of the JPY and the deterioration in recent economic data, we expect the net fiscal stimulus to be bigger than the JPY7-10 trillion forecast by the markets before the Brexit vote. We also expect the BoJ to increase the pace of its asset purchases by another JPY10-20 trillion (JPY80 trillion) to provide additional fiscal stimulus and weaken the currency.

US: Consumption remains economic bright spot

Discretionary spending on services remains buoyant, foreshadowing stronger consumption growth in 2Q

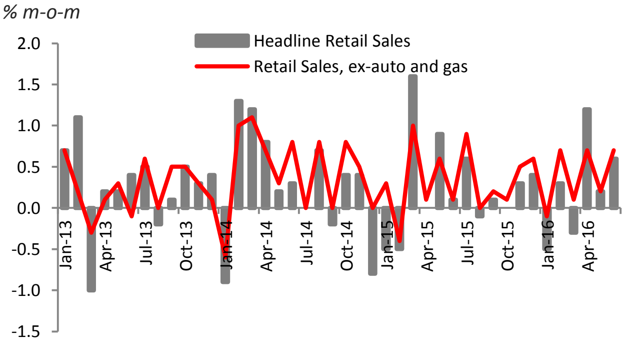
US retail sales surprised market expectations for the second straight month in June, rising 0.6% m-o-m (previous: 0.2%; consensus: 0.1%), with an impressive increase in spending on services by households. The June data showed that, throughout 2Q, there had been a notable increase in spending on restaurants, personal care, sports, entertainment and online merchandise. This complements and bodes well for the strong trend in hiring that we have seen in the very same sectors so far in 2016. We therefore expect 2Q private consumption growth to rebound strongly from the 1.5% q-o-q (saar) level seen in 1Q.

Fig. 1. US: Rising spending on services has already pushed core inflation above the Fed's 2% ceiling



Source: Bloomberg

Fig. 2. US: Retail sales remained strong in 2Q; rebound in private consumption likely after weak 1Q



Source: Bloomberg

With core CPI at post-recession high, we expect headline inflation to breach Fed's 2% ceiling in 4Q

The buoyancy in services consumption was also reflected in the inflation data. While headline CPI remained unchanged at 1% y-o-y, core inflation climbed to a post-recession high of 2.3% y-o-y (2.2% previously). Not surprisingly, a strong USD and a subdued manufacturing outlook weighed on goods prices, which continued to soften. We believe the underlying dynamics in the US economy are supportive of inflation breaching the Fed's 2% ceiling for headline CPI in 4Q this year. Further, as markets become more convinced of the localisation of the Brexit pains in Europe, this should open another opportunity for the Fed to resume its hiking cycle, likely in its December meeting, in our view.

B. Emerging Market Economies

India: Overcapacity continues to plague private investment

Investment activity retracted sharply after 1Q2016 recovery

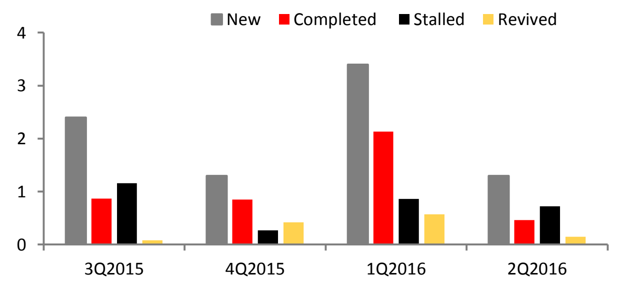
Project data for 2Q2016 was a sobering reminder of the fragility of India's investment cycle. Investment growth continued to lag in the quarter despite the strong consumption-led recovery seen in the recent quarters. The slowdown in investment projects was broad-based with fewer new projects being announced and a lower net worth of projects being completed. As expected, the rate of implementation of investment projects, after having been announced, remained significantly higher for government projects than for the private sector.

Private capital spending to be muted until 1H2017, but public infrastructure spending could be catalyst for medium-term recovery

We expect this trend to continue and believe that sluggish implementation of announced private projects will keep dragging down investment activity until 1H2017 at the earliest, as capacity utilisation in the capital-intensive manufacturing sector remains at its lowest level since the 2008-09 recession. Tighter credit conditions set by banks facing a high level of non-performing loans and weak global export demand are likely to weigh on investment spending in the mining and heavy engineering sectors in the near term. Meanwhile, sectors such as power and telecoms are likely to see muted investment after a substantial excess capacity built-up through aggressive investment between 2010 and 2013. Therefore any policy reforms or rate cuts by the RBI are unlikely to effect a quick improvement in the investment cycle while these constraints remain in place. That said, we expect steady growth in public spending over the coming quarters, particularly in roads and storage infrastructure in 2016-17. This should support India's investment cycle as the slow impact of public investment in infrastructure, accompanied by buoyant consumption demand, is likely to incentivise private firms to resume capex by 2H2017.

Fig. 3. India: Projects data show dramatic decline in investment activity after strong 1Q2016

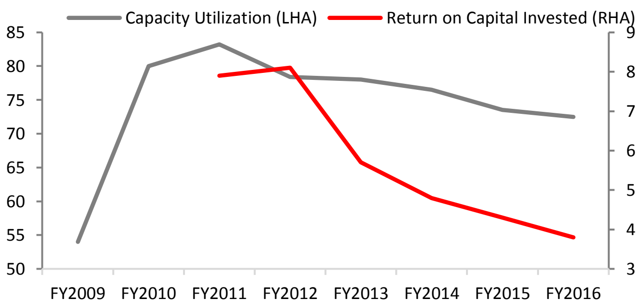
INR trillion



Source: Centre for Monitoring Indian Economy

Fig. 4. India: Private capex likely to remain weak due to falling capacity utilisation and low ROI

% (LHA), % (RHA)



Source: Reserve Bank of India, manufacturing company statistics

CPI remains close to RBI's upper bound of 6%; rate cut in August unlikely

CPI: The June inflation report came in at 5.8% y-o-y, unchanged from the previous month and very close to the RBI's upper inflation bound of 6% y-o-y. Supply-related constraints in certain food items such as pulses, fruits, vegetables and milk have not been adequately addressed by the government yet, and the effects are visible in the food inflation figures, which jumped to 7.8% y-o-y (7.5% previously). While we expect food prices to marginally cool down in 2H2016 following a good monsoon season, core inflation should pick up (4.5% y-o-y currently) as household incomes are boosted by a significant wage hike and good crop harvests. We expect the RBI to keep policy rates on hold at its 9 August meeting.

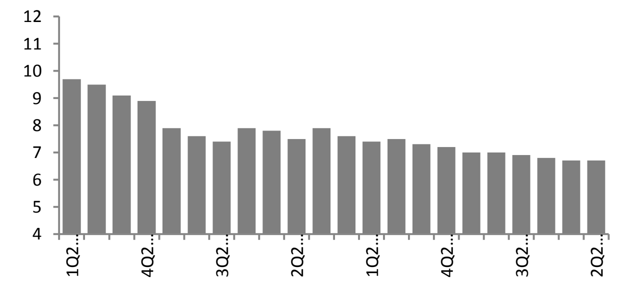
China: Fiscal stimulus keeps economy stable in 2Q

2Q GDP supported by stronger than expected credit growth and public spending

GDP grew by 6.7% y-o-y in 2Q (consensus: 6.6%, previous: 6.7%), beating both our and market expectations. In our view, the upside surprise was entirely driven by stronger than expected growth in consumer credit and public spending. Infrastructure investment surged to c. 20% y-o-y in 2Q (17.3% in 1Q), notably in transportation and urban housing, accounting for almost all the growth in the industrial and construction sectors, even as private spending pulled back. Further, despite reservations expressed by some senior government figures about elevated domestic credit growth, loan growth once again picked up in June, more than offsetting the tight credit stance prevailing in the April and May. Among other indicators, industrial output (up 6.2% y-o-y after 5.9% y-o-y) and retail sales (up 10.3% y-o-y after 10.2% y-o-y) also surprised on the upside.

Fig. 5. China: GDP growth remained stable in 2Q, beating consensus expectations of slowdown

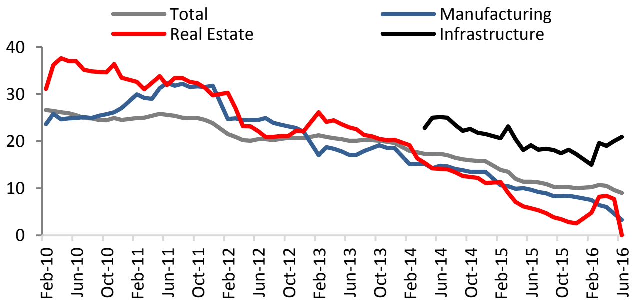
% y-o-y



Source: Bloomberg

Fig. 6. China: Infrastructure investment kept economy stable even as private spending decelerated

% y-o-y, YTD



Source: Bloomberg

Nevertheless, we still expect a slowdown in growth in 2H2016, dragged down by weakness in private capex and tighter credit growth

However, despite stronger than expected growth in 2Q, we still expect a slowdown in growth in 2H2016 towards 6.5% y-o-y. We expect lesser support from residential investment, given that leading indicators of activity suggest a muted pace of new construction and a sizable increase in inventory levels so far this year. Moreover, private investment is likely to contract further, dragged down by a subdued export demand from Europe and rising levels of inventory and bad loans, which even a supportive fiscal stance might not be able to offset. Finally, the significant increase in loan growth in June is likely to raise concerns over shadow banking activities once again, which could prompt another move by the authorities to rein in credit expansion, making the monetary stance less supportive of growth.

II. Economic Calendar

Fig. 7. Upcoming events and releases

Time*	Country	Data point	Period	Prior	Survey
Expected this week					
	Saudi Arabia	CPI, y-o-y	Jun	4.1%	
	Oman	CPI, y-o-y	Jun	1.1%	
	Bahrain	M2 Money Supply, y-o-y	May		
	Bahrain	CPI, y-o-y	Jun	3.7%	
	Qatar	GDP Constant Prices, y-o-y	1Q	4%	
	UAE	Central Bank Foreign Assets	Jun	296.5B	
	UAE	CPI, y-o-y	Jun	1.6%	
	UAE	M2 Money Supply, y-o-y	Jun	-1.4%	
	Kuwait	GDP Current Prices, y-o-y			
	Kuwait	M2 Money Supply, y-o-y	May		
	Kuwait	CPI, y-o-y	Jun	2.8%	
Monday 18 July					
5:00	UK	Rightmove House Prices, m-o-m	July	0.8%	
Tuesday 19 July					
0:00	US	Net Treasury (TIC) flows, USD billion	May	80.4	
12:30	UK	CPI, y-o-y	Jun	0.3%	0.4%
15:00	Turkey	CBRT Monetary Policy Meeting		9%	8.5%
16:30	US	Housing Starts, ('000)	Jun	1164K	1165K
16:30	US	Building Permits, ('000)	Jun	1136K	1150K
Wednesday 20 July					
12:30	UK	Change in Employment, 3M/3M	May	55K	71K
12:30	UK	Unemployment Rate	May	5%	5%
12:30	UK	Average Weekly Earnings, 3m/y	May	2%	2.3%
15:00	US	MBA Mortgage Applications	15-Jul	7.2%	
18:00	Eurozone	Consumer Confidence	May	-7.3	-8
Thursday 21 July					
8:30	Japan	All Industry Activity Index, m-o-m	May	1.3%	-1.1%
12:30	UK	Retail Sales ex-Auto, m-o-m	Jun	1%	-0.6%
12:30	UK	Retail Sales ex-Auto, y-o-y	Jun	5.7%	4.8%
15:45	Eurozone	ECB Monetary Policy Meeting		-0.4%	-0.4%
16:30	US	Initial Jobless Claims, ('000)	16-Jul	254K	265K
17:00	US	FHFA House Price Index, m-o-m	May	0.2%	0.4%
18:00	US	Existing Home Sales	Jun	5.53M	5.48M
18:00	US	Leading Index	Jun	-0.2%	0.2%
Friday 22 July					
6:00	Japan	Manufacturing PMI	July	48.1	
12:00	Eurozone	Manufacturing PMI	July	52.8	52
17:45	US	Manufacturing PMI	July	51.3	51.5

**UAE time*

Source: Bloomberg

Fig. 8. Last week's data

Time*	Country	Data point	Period	Prior	Survey	Actual
Released last week						
	Qatar	CPI, y-o-y	Jun	2.6%		2.5%
	China	Aggregate Financing, RMB bn	Jun	660	1100	1630
	China	New Yuan Loans, RMB bn	Jun	986	1000	1380.0%
	China	M2 Money supply, y-o-y	Jun	11.8%	11.4%	11.8%
Tuesday 12 July						
16:00	India	Industrial Production, y-o-y	May	-1.3%	-0.3%	1.2%
16:00	India	CPI, y-o-y	Jun	5.8%	5.8%	5.8%
Wednesday 13 July						
11:30	China	Exports, y-o-y	Jun	-4.1%	-5%	-4.8%
11:30	China	Trade Balance, USD billion	Jun	50	46	48.1
13:00	Eurozone	Industrial Production, m-o-m	May	1.4%	-0.8%	-1.2%
15:00	US	MBA Mortgage Applications	8-Jul	14.2%		7.2%
Thursday 14 July						
11:00	Turkey	Industrial Production, y-o-y	May	0.7%	3.6%	5.6%
11:00	Turkey	Current Account Balance, USD bn	May	-2.97	-2.72	-2.86
15:00	UK	BoE Monetary Policy Meeting				
Friday 15 July						
6:00	China	Industrial Production, y-o-y	Jun	6%	5.9%	6.2%
6:00	China	Retail sales, YTD y-o-y	Jun	10.2%	10.2%	10.3%
6:00	China	Fixed Asset Investment, YTD y-o-y	Jun	9.6%	9.4%	9%
6:00	China	GDP, y-o-y	2Q	6.7%	6.6%	6.7%
13:00	Eurozone	CPI, y-o-y	Jun	0.1%	0.1%	0.1%
13:00	Eurozone	CPI Core, y-o-y	Jun	0.9%	0.9%	0.9%
16:30	US	CPI, y-o-y	Jun	1%	1.1%	1%
16:30	US	CPI core, y-o-y	Jun	2.2%	2.2%	2.3%
16:30	US	Retail Sales, m-o-m	Jun	0.2%	0.1%	0.6%
16:30	US	Retail Sales ex-Auto, m-o-m	Jun	0.4%	0.4%	0.7%
17:15	US	Industrial Production, m-o-m	Jun	-0.3%	0.3%	0.6%
18:00	US	University of Michigan consumer confidence	Jun	93.5	93.3	89.5

**UAE time*

Source: Bloomberg

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