Gold diverging from the USD

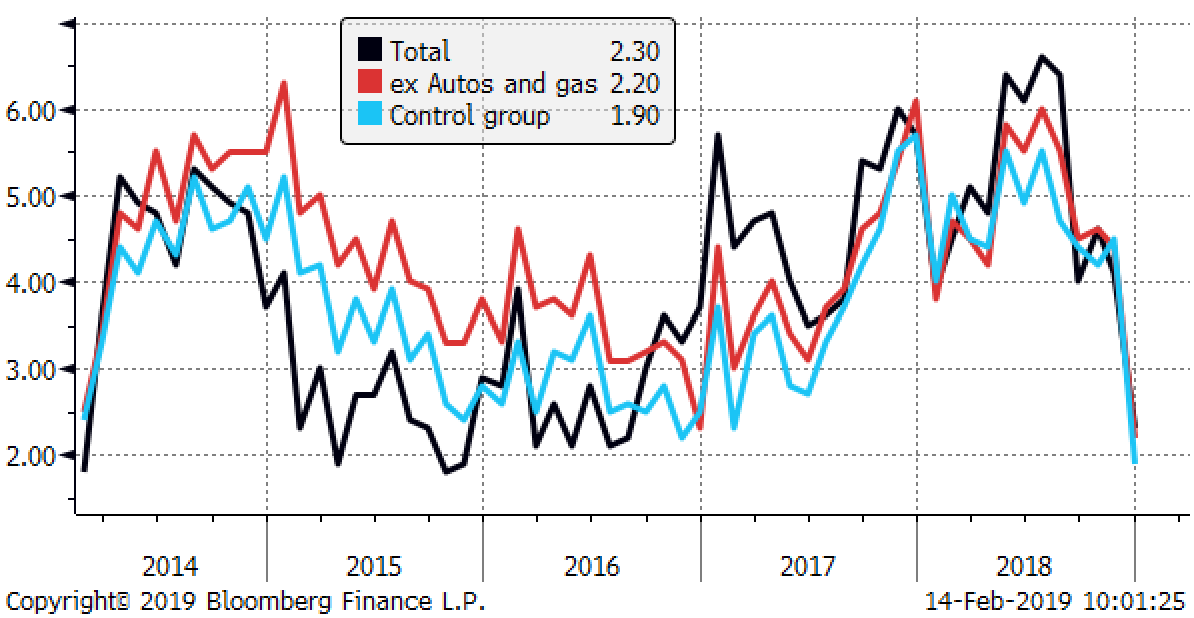
February 14th, 2019

- **US Retail sales shockingly weak, but are being dismissed. Unemployment claims are softer, but consumer confidence may be holding up.**
- **EUR continues to sink on weak data (IP and GDP), but employment data has been more stable.**
- **Chinese trade data recovers, although still lower from earlier in 2018.**
- **US imports to China plummet, China exports to the US weak, displaying the impact of the trade war.**
- **US-China trade talks are dragging on.**
- **UK parliament remains divided, May dogmatic, UK businesses despairing.**
- **Gold diverging from the USD trend, retaining solid uptrend.**
- **Global asset markets are sending mixed signals; we are not convinced USD strength will continue.**
- **A significant amount of negativity is priced into the EUR. There is much talk of central bank demand for gold, but in general, its strength suggests confidence in the USD and state of the global economy is tenuous.**

US retail sales sink in December

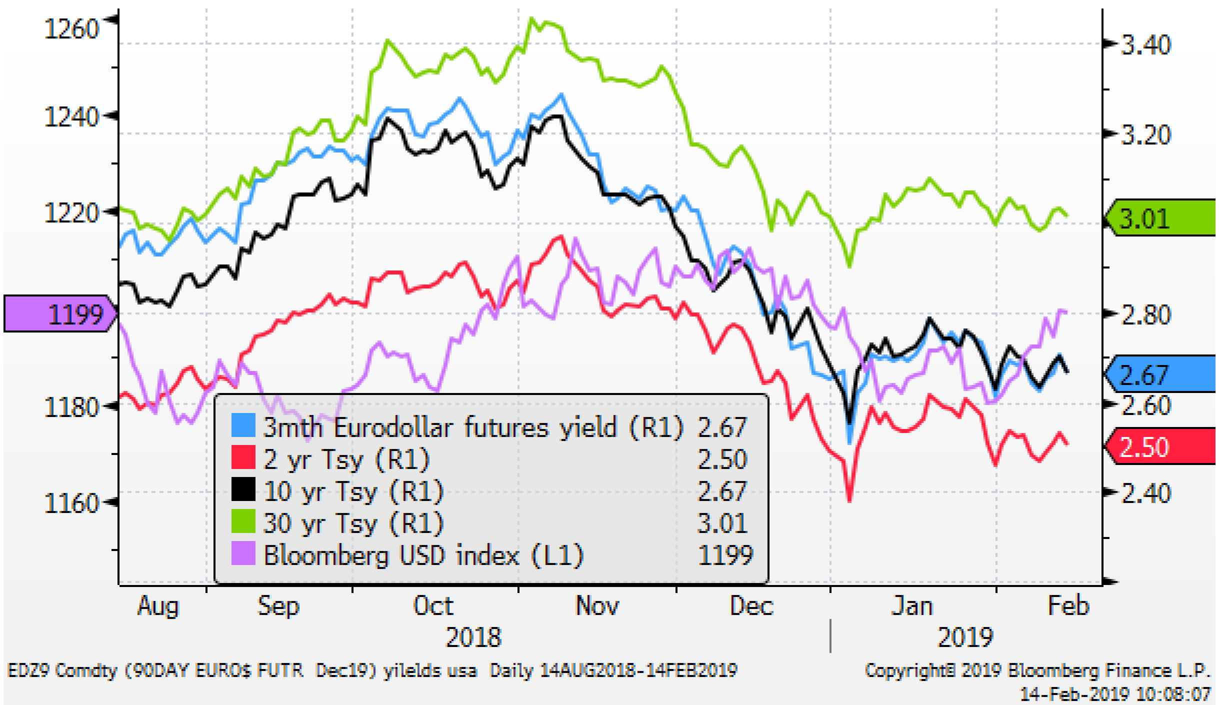
The US retail sales were shockingly weak. So much so that the data is being treated with a grain of salt. Nevertheless it has helped contain recent USD strength, the rise in US equities, and caused another dip in US rates.

US Retail sales %y/y



An interesting aside is that the market didn't give the AUD a pass after its retail sales were much weaker than expected in Dec; despite the same discussions around cyber-sales being pulled forward into November.

US yields and USD index – US yields not providing a strong signal for a stronger USD

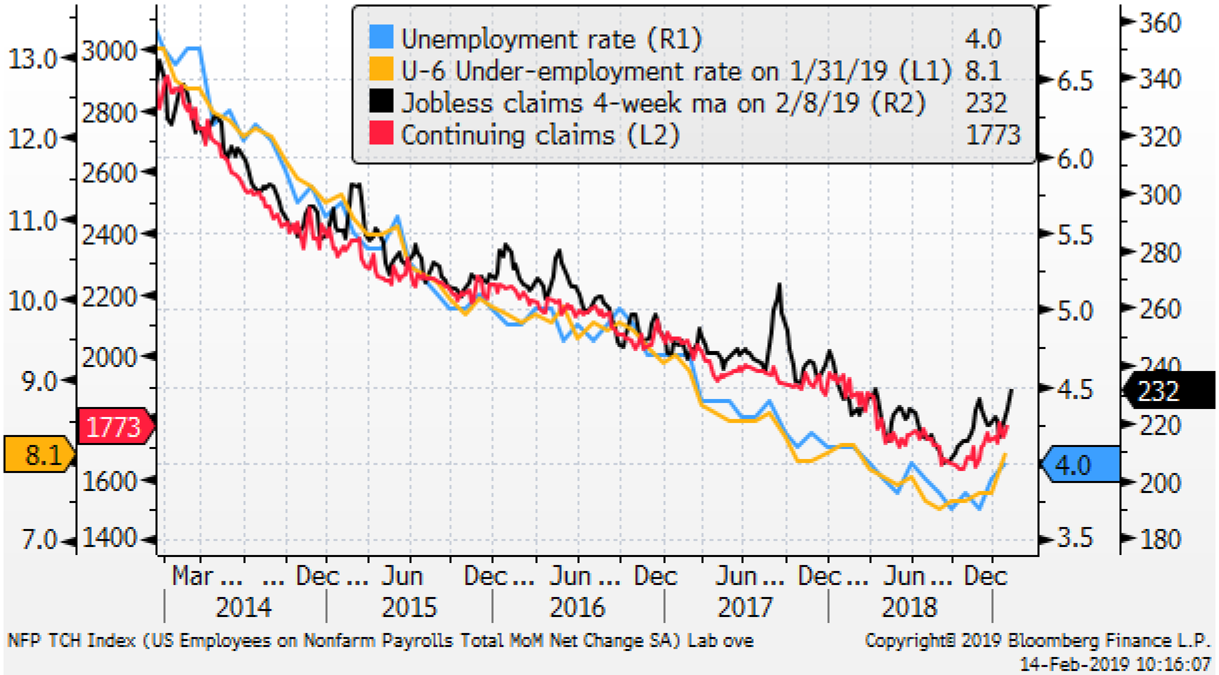


US labour market indicators less strong

US jobless claims were also more elevated for a third week. It may be too soon to interpret much into the data, especially after recent very strong payrolls reports and job-openings in December, and the uncertain effects of the recent government shut-down. Nevertheless, it is a sign of potential step-down in the strength in the labor market and the economy.

The low point for the obless claims 4-week moving average was 14-Sep, the low point for continuing claims was 26-Oct, the low point for the unemployment rate was Sep and Nov (3.7%), the low point for under-employment was August (7.4%).

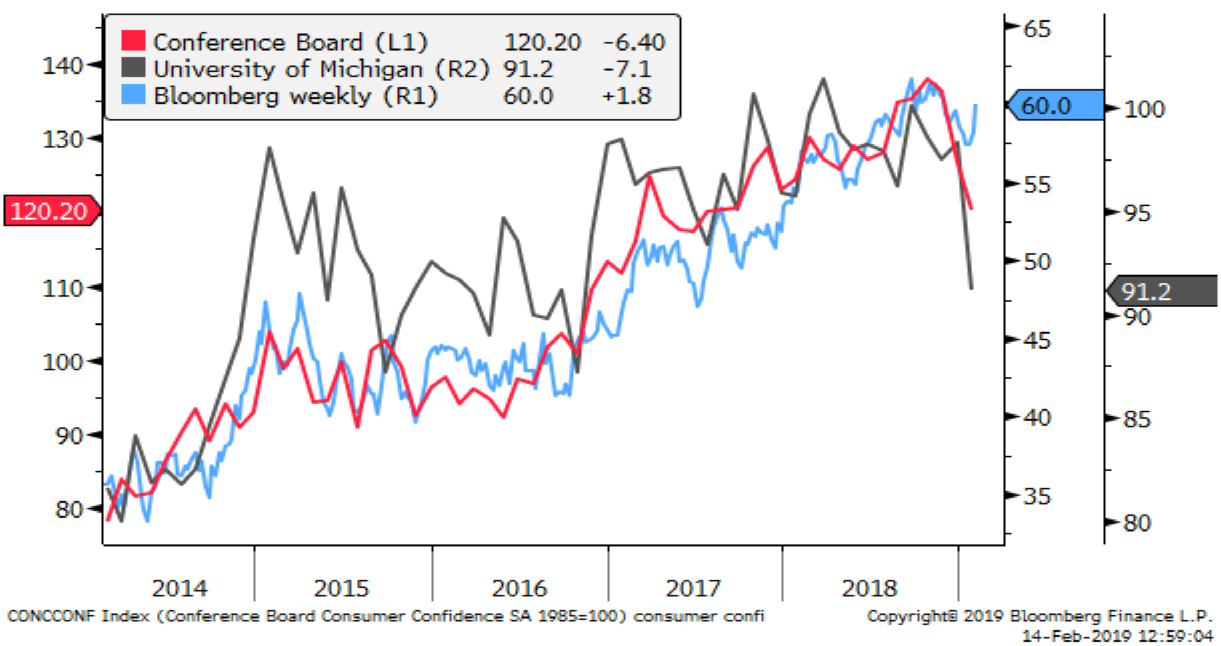
US jobless claims and unemployment rate



US Consumer sentiment stronger

On the other hand, a weekly consumer sentiment reading (Bloomberg Consumer Comfort) rose for a second week to 10-Feb, suggesting US consumer confidence remains relatively strong, pointing to a possible rebound in the University of Michigan survey on Friday.

Weekly consumer confidence recovers



Further on the aside, comparing US and Australian retail sales surprises, consumer confidence also bounced back in Australia in data release for Feb on Wednesday.

Concern over a retailing slowdown in Australia dove-tails with a weak housing market and might warrant more concern, but the parallels with the US suggests that it may also reflect more temporary factors dampening spending late last year.

The AUD continues to look relatively weak, falling to a new low against the NZD. This seems to reflect the ongoing risks associated with the Australian housing market.

Negativity on the EUR persists

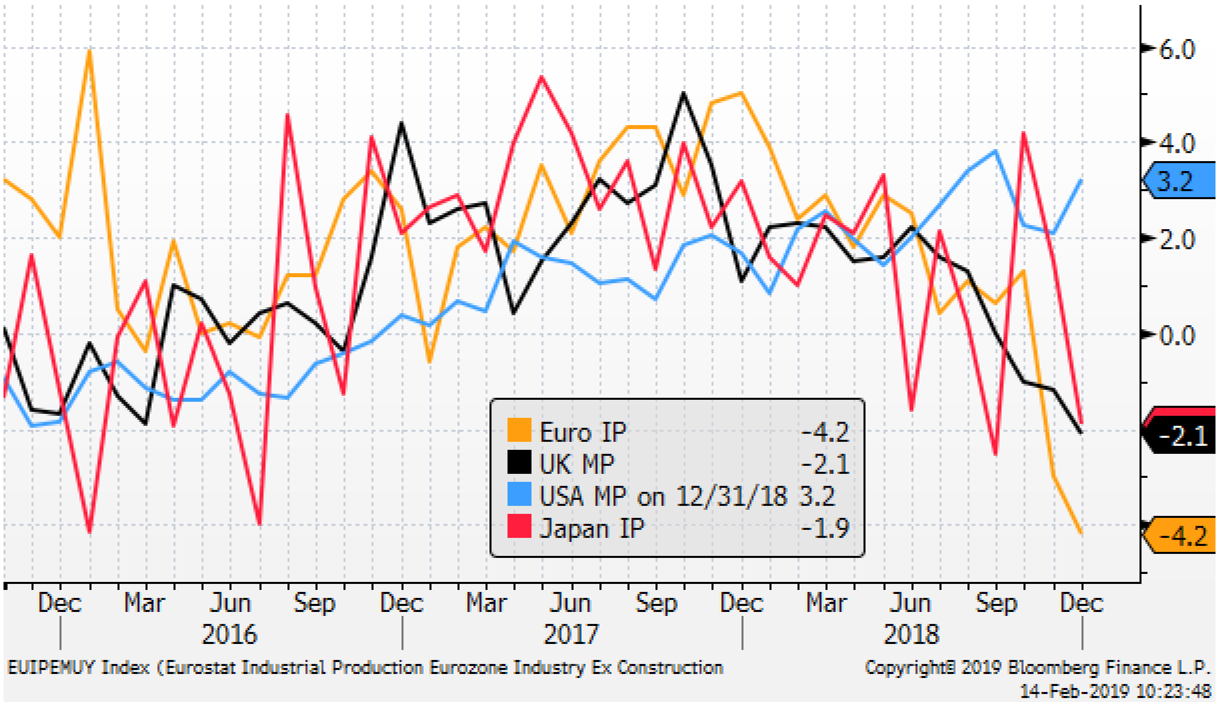
Negativity over the EUR has continued this week. It failed to sustain a bounce on firmer Chinese equities and hopes of progress on a US-China trade deal, and slipped after weak data including:

- A sharp fall in industrial production (-4.2%y/y in Dec, weaker than -3.3% expected) reported on Wednesday;
- and flat GDP q/q in Q4 in Germany, weaker than 0.1% expected, following -0.2%q/q in Q2, which might be regarded as averting a technical recession by the narrowest of margins.

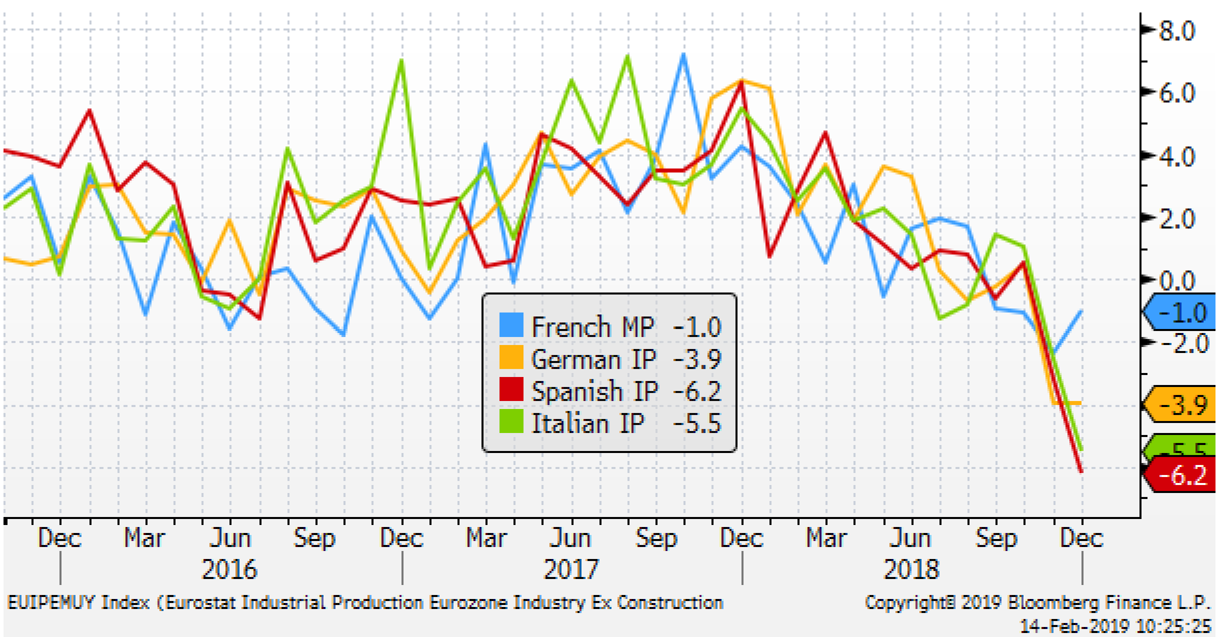
Other Eurozone data has been better:

- Overall GDP growth was at least unrevised and as expected at 1.2%y/y in Q4, down from 1.6%y/y, the weakest outcome since 2013.
- Eurozone employment data was also reasonable, rising 0.3%q/q, firmer that 0.2%q/q in Q2, up 1.2%y/y, the weakest growth since Q4-2015.
- On Wednesday, French unemployment fell from 8.8% in Q3 to a new low since the GFX of 8.5%, stronger than 8.8% expected (maybe too many people were protesting in yellow vests to register as unemployed).
- The stable strength in the labour market and rising wage growth (Labour cost +2.5%y/y in Q3) have been underpinning ECB confidence that the economy can weather its recent run of disruptions. I am not sure what happened in Portugal, but on Wednesday it reported a surge in its labour costs from 1.5%y/y in Q3 to 10.3%y/y in Q4.

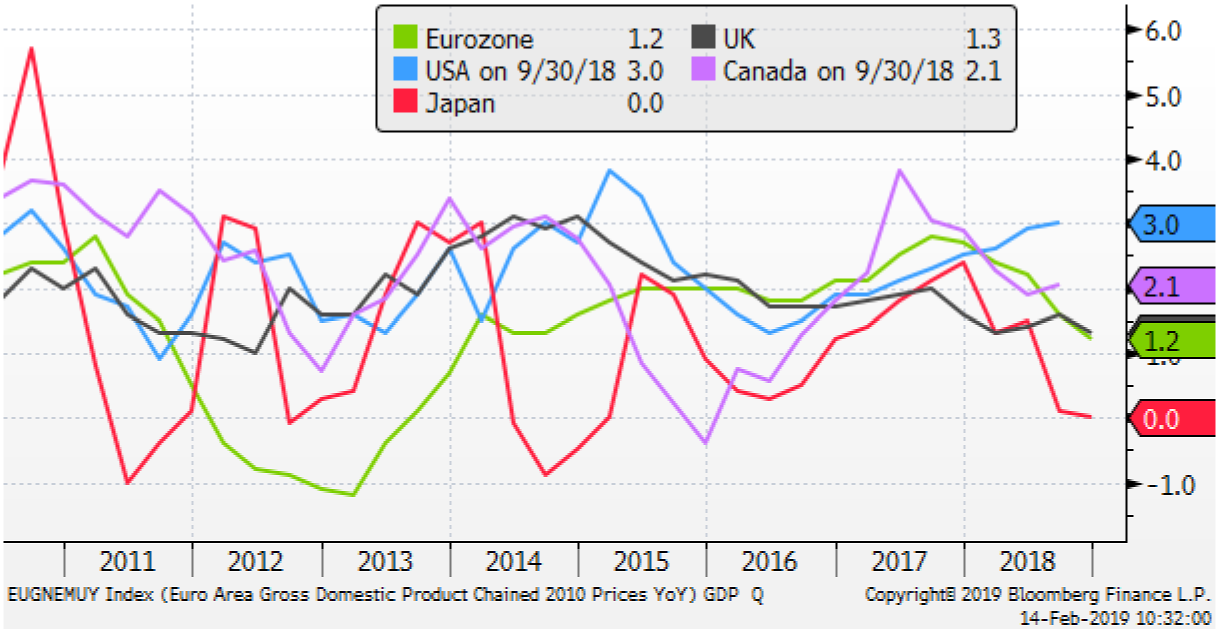
G4 majors industrial or manufacturing production %y/y – Eurozone weakest, only the USA positive in December



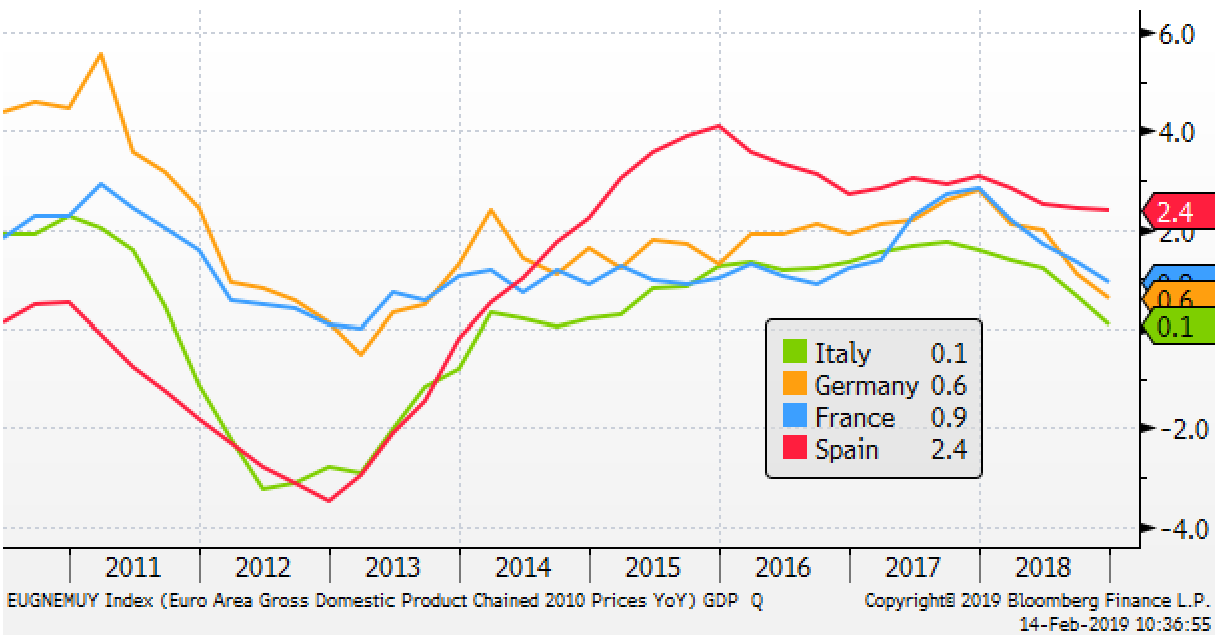
Larger European countries industrial production – Spain and Italy falls largest in December, France shows some recovery



G7 GDP %y/y – EU weakest %y/y growth since 2013, UK weakest since 2012, USA strongest since 2015



Large European countries GDP %y/y- deterioration led by Germany, Italy and France.



China Trade data improves

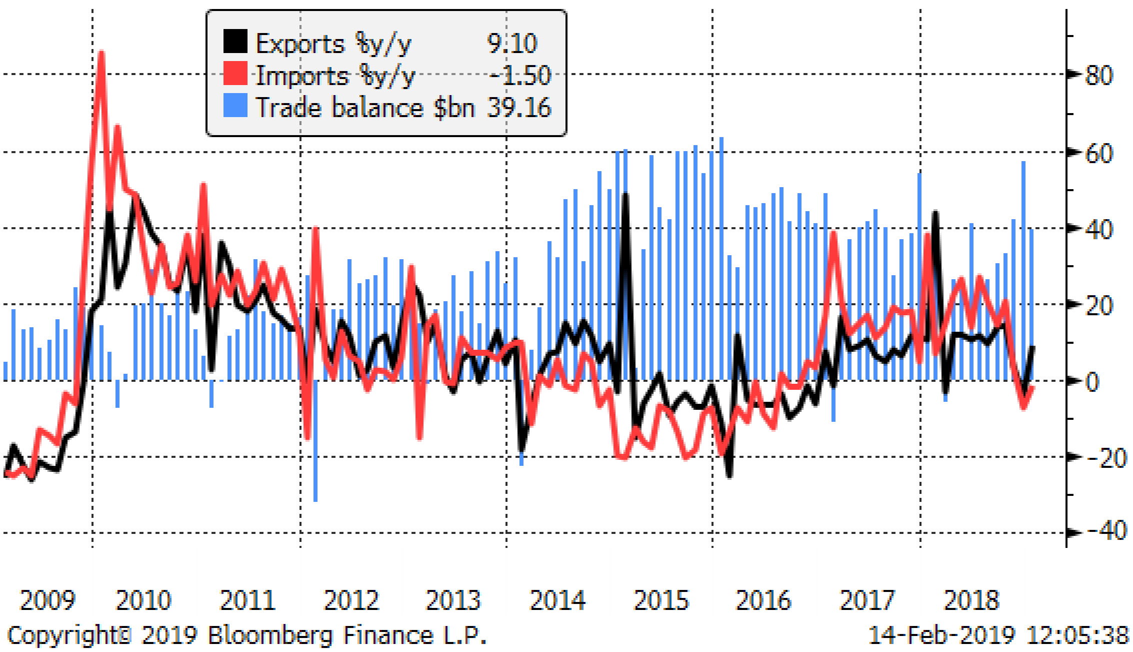
The EUR and AUD rose somewhat after the release of stronger than expected Chinese trade data on Thursday, although gave back gains on negative news related to the US-China trade negotiations.

Chinese exports rebounded from -4.4%y/y in Dec to +9.1%y/y in Jan, stronger than -3.3% expected (in USD terms).

Chinese imports recovered from -7.6%y/y in Dec to -1.5%y/y in Jan, stronger than -10.2% expected.

The data may have been boosted by a pull-forward for Lunar New Year, that occurred earlier this year (5-Feb) compared to 2018 (16-Feb), suggesting we should wait for Q1 to play-out before over-interpreting the trade data. This is a notoriously difficult time of year to interpret Chinese data.

Chinese trade data

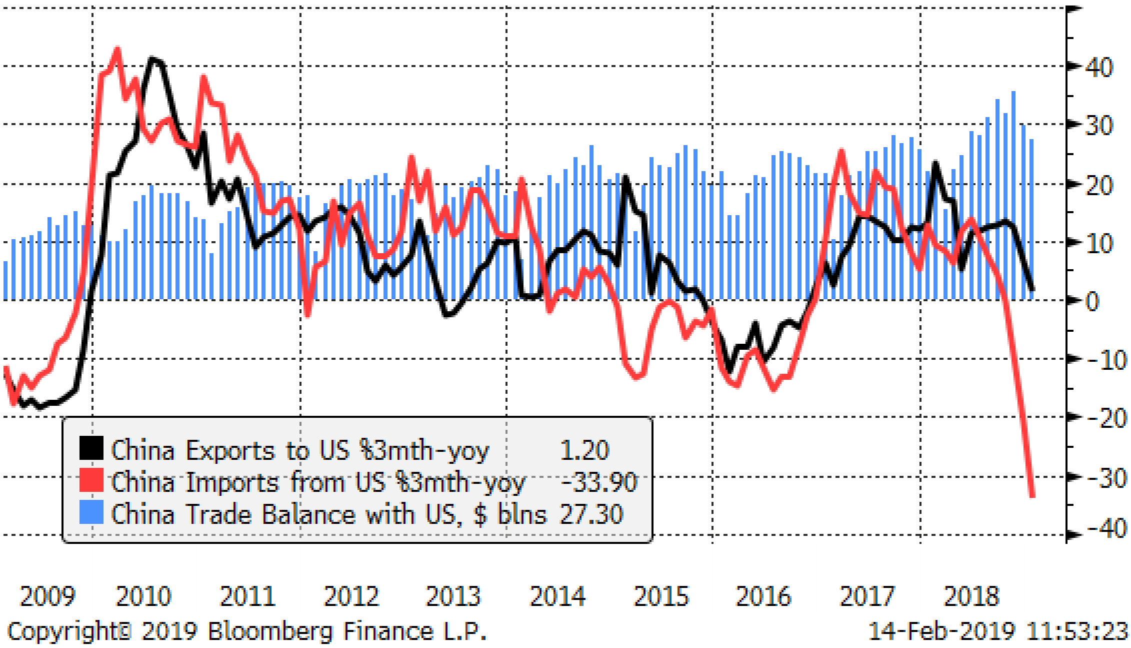


US-China trade dispute apparent in the data

Interestingly, the bounce back in exports was not there to the USA (-2.8%y/y in Jan, up from -3.5%y/y in Dec). This may suggest that the trade dispute is dampening Chinese exports to the USA, but China may be retaining broader export market penetration.

The trade dispute also appears to be dampening US exports to China, so much so that it does not appear to be resulting in any narrowing in the US-China trade balance. Chinese imports from the USA fell a whopping 41.1%y/y in Jan, down from -35.8%y/y in Dec. This suggests that the trade war is hurting the US economy; although much of this may be farm products, and presumably US farmers may be able to find other markets in these highly fungible goods.

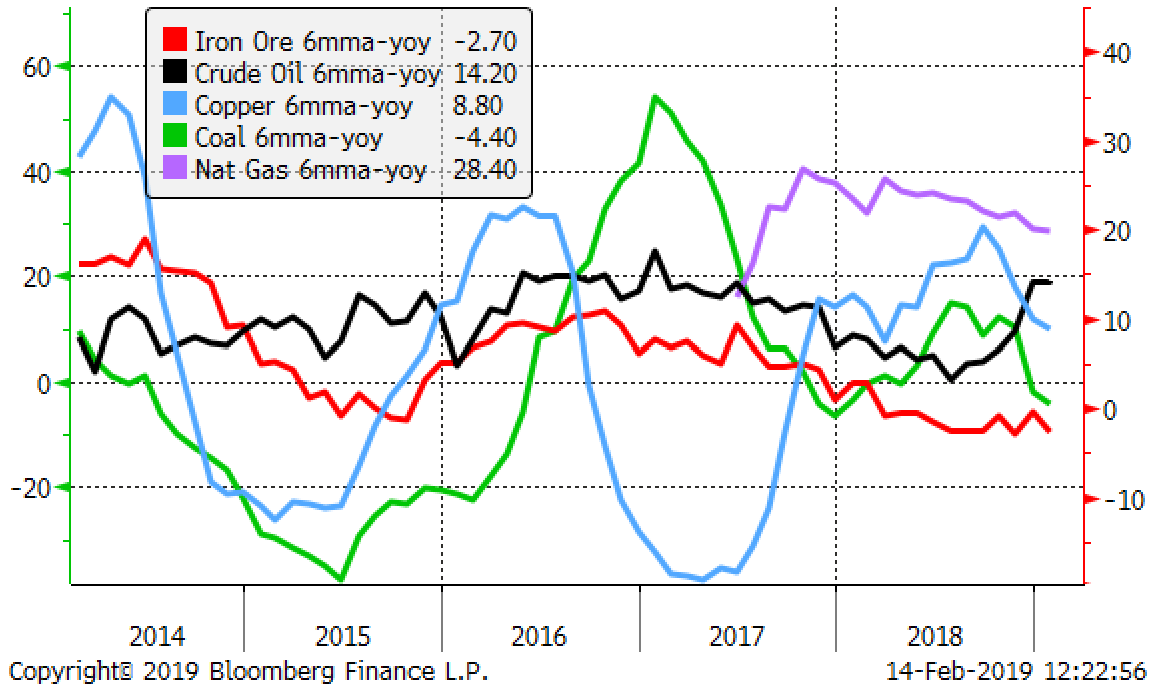
China trade with the USA – trade war hurts both China and the USA



Chinese commodity Imports

In terms of imports of commodities by volume, energy imports have been strong (oil +14.2% 6mth-yoy, natural gas +28.4% 6mth-yoy, coal -4.4%6mth-yoy); imports of iron ore has weakened a bit (-2.7% 6mth-yoy), copper was solid but possibly slowing (8.8% 6mth-yoy, down from a peak of 20.2% 6mth-yoy in Sep).

China Commodity imports by volume



Trade talks dragging on

News on the trade talks was mixed. During Asia trading, there were reports speculating that the US administration (Trump) was considering an extension in the trade talks by 60 days beyond 1-March, before raising existing tariffs from 10% to 25%. The news suggests a willingness to give negotiators more time to avoid potentially more damaging measures.

However, reports in US trading suggest that the negotiators are far apart on key issues over US demands for China to scale back on industry policies that seek to give a competitive edged for Chinese companies in domestic and foreign markets.

All the news remains hear-say, and global markets largely remain on edge.

Take-outs from Bloomberg reporting
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Negotiations this week are focused on how to enforce the trade deal and putting on paper a framework agreement to present to the two presidents.

In the talks, the U.S. is pushing for wide-ranging changes in the way China manages foreign trade and its own economy. Specifically, Lighthizer has zeroed in on China's alleged abuses of intellectual property and state sponsorship of companies.

China wants to have the tariffs that have been imposed so far removed. To get the U.S. to do that, negotiators are trying to focus attention on their efforts to reduce China's more than $300 billion goods trade surplus. Beijing has offered to ramp up its purchases from the U.S. massively over the next six years in order to even the scales.

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The U.S. has not relented on demands for China to dial back government subsidies for state-owned enterprises and improve corporate governance, one of the people said, an extremely sensitive issue that is seen as a non-starter for Chinese leaders.

The hurdles raise questions about whether negotiators can meet Trump's criteria for pushing back the March 1 deadline for more than doubling tariffs on $200 billion of Chinese goods. On Tuesday he said he was open to doing so if the two countries were close to a deal that addresses deep structural changes to China's economic and trade policies.

Negotiators in Beijing "are soldiering on" and the "vibe" is good, Kudlow said on Fox News, adding that he was briefed by U.S. officials earlier Thursday. "They are going to be meeting with President Xi tomorrow, which is a very good sign. They are moving through all of the issues. They are getting the job done."

Kudlow later told reporters at the White House that he's "cautiously optimistic" on the outcome of the talks with China.

US to avoid another Govt Shut-down, but a national emergency planned

Trump says he will sign the funding bill negotiated in Congress, but then declare a national emergency to get more funding for his wall.

The good part of the news is that a bill will be signed and another government shutdown averted. This was largely expected, and perhaps should not have much impact.

The bad news is that declaring a national emergency will end up in the courts and fuel an ongoing battle between Democrats that control the House and Trump and Republicans that control the Senate. This might be seen as reducing chances for further reform or compromise, and dampen business sentiment. It highlights that US politics is becoming more partisan and is now largely focused on point-scoring in the run-up to the next Presidential election in 2020. However, this was not unexpected either.

Brexit drift

The GBP is sinking as PM May has resisted pressure to rule out a no deal Brexit, and pushes on with her strategy of renegotiating the Irish backstop with the EU.

In the UK parliament today, May lost a vote of support after the Eurosceptic European Research Group (ERG) in her own party reversed their decision to vote in her favour this time, after supporting her a month earlier. But this changes little. The vote is non-binding, and PM May and the ERG's positions have not changed. She wants to renegotiate the Irish backstop, and the ERG wants to replace it with "Other arrangements"; symantics.

Support for the GBP may come from hopes that a cross-party push to vote for averting a 'no deal' Brexit may gain momentum and make come to pass on 23 Feb.

Take-outs from Bloomberg's coverage {NSN PMXMGV6KLVR4 <GO>}

The House of Commons voted on Thursday by 303 to 258 against a motion endorsing the prime minister's approach to resolving the Brexit deadlock, after a revolt from Euroskeptics in her Conservative Party. The defeat effectively strips May of her political mandate to demand changes to the withdrawal agreement in Brussels, and suggests she has little chance of fending off an attempt by Parliament to take control of the process on Feb. 27.

Thursday's vote is not binding on the government, but the motion was an attempt by May to buy herself more time to secure concessions from the EU. Her aides fear defeat will undermine her negotiations.

There's growing support for a cross-party plan to force May to take no-deal off the table. In a vote on Feb. 27 these MPs will begin the process of trying to pass a bill that would require May to seek an extension to Brexit talks if there's no deal by March 13.

"Another day of failed politics, another day closer to no deal chaos," Carolyn Fairbairn, director general of the U.K.'s business lobby, the Confederation of British Industry, said on Twitter. "Politicians must find a deal that protects our economy. Failure would be unforgivable."

Brexit damage becoming permanent

The news feed on Brexit continues to report on a steady stream of companies moving at least some of their operations from the UK to mainland EU, and deciding against investment in new projects in the UK. Such news suggests that it is almost too late for the UK government to derive a strategy and instil a sense of certainty over the path for its future trade and economic relations with the EU and the rest of the world. The UK economy might begin to recover if it does, but much of the damage already wrought by Brexit appears to be permanent.

The fact that the GBP has not fallen further already or that the economy is not already in deeper retreat probably reflects some confidence that UK policymakers will not allow a 'no deal Brexit' and the current phase of more intense uncertainty will give way to clearer policy direction relatively soon (say over the next three months or so).

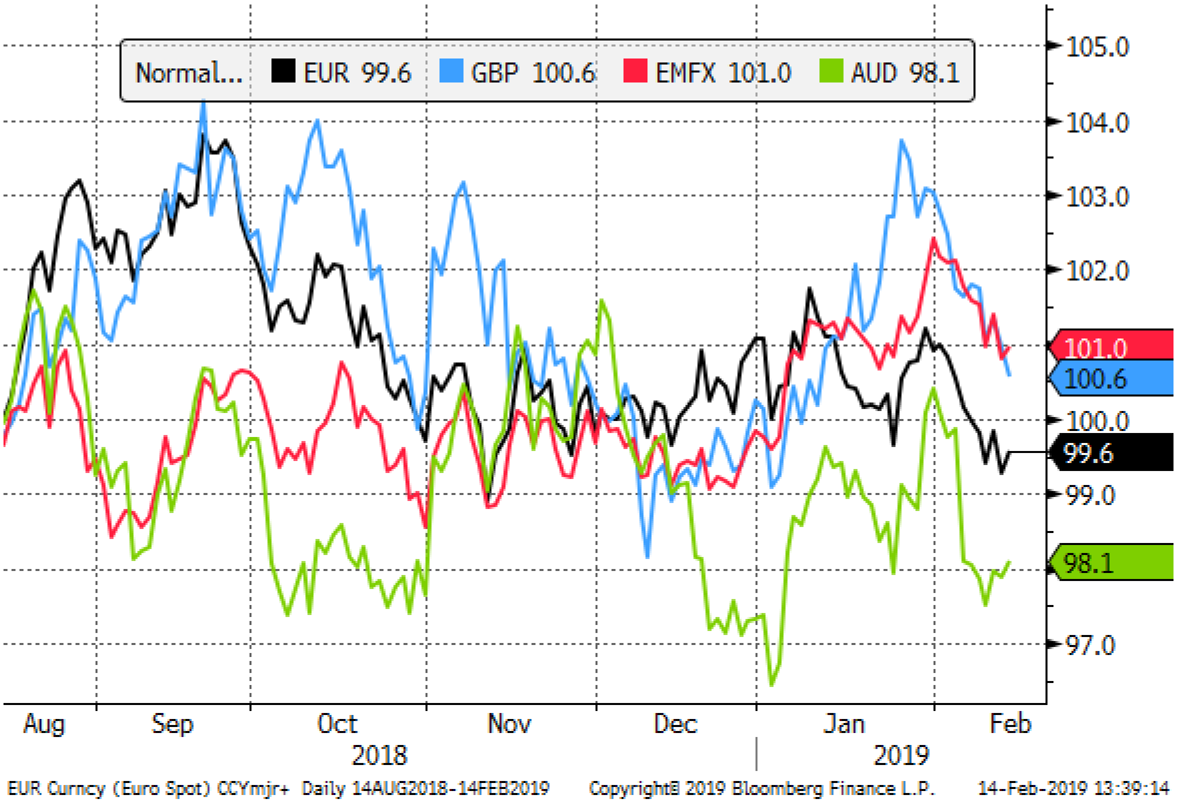
However, even PM May's deal only moves the UK into a two-year transition period in which a trade deal must be negotiated. Judging by the events over the last two and a half years of Brexit negotiations and the EU's management of its Euro crisis from 2010 to 2014, these trade negotiations will be prolonged and fraught, and likely extend well beyond two years. As such, uncertainty for businesses in the UK is unlikely to be fully resolved for the foreseeable future (if PM May gets her way). Such thoughts may be encouraging companies to shift operations to the EU now before they know the Brexit outcome. They have little lose if they do, and much risk of loss if they don't.

The three month outlook for the GBP retains a large component of a binary outcome, with a significant rise if a deal is struck, especially if it is not the PM May deal, but one that seeks permanent UK access to a customs union with the EU, or opens the door for a new referendum that may reverse course on Brexit. And the risk of a significant fall if the UK opts to exit with no deal.

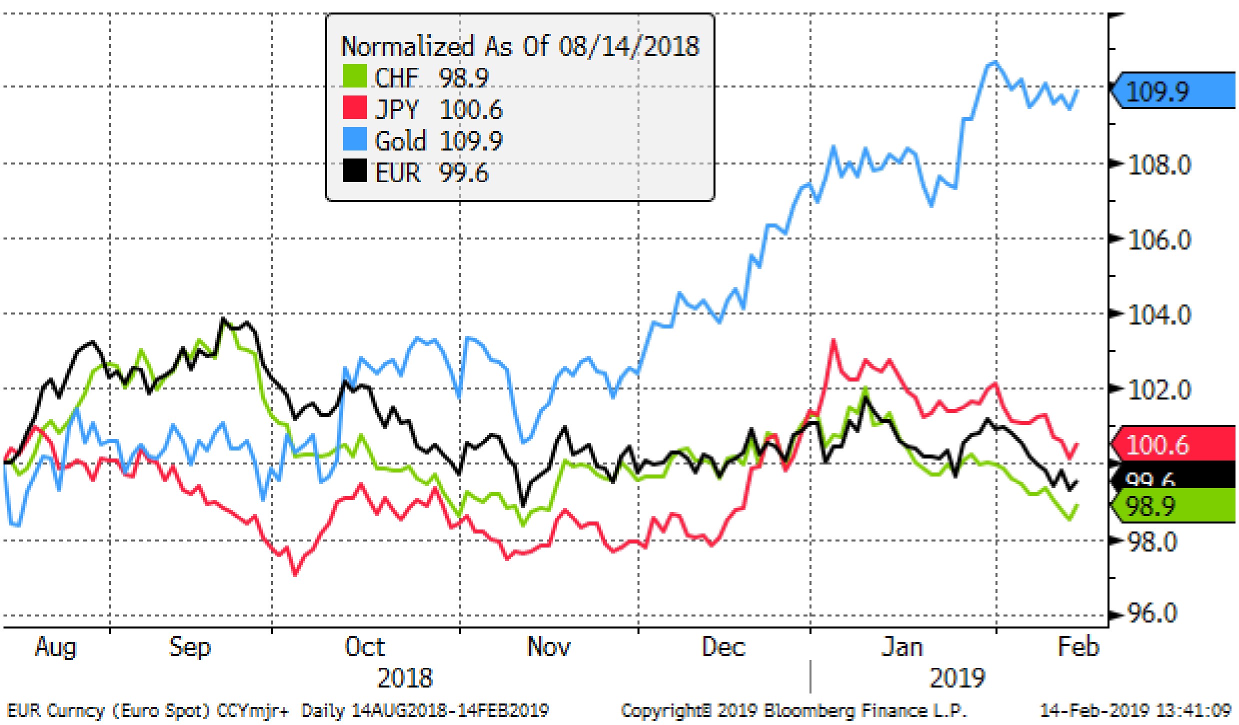
However, there is also a significant probability that the GBP drifts sideways to lower for a more prolonged period if policymakers allow the 29-March deadline to be kicked forward and PM May is allowed to continue to pursue her deal with the EU, prolonging the debate over the Irish border.

We are now in a phase where companies are responding to the uncertainty with their feet and delay appears to be increasingly damaging for the UK economy. The longer this process goes on, even if and when a deal is struck, the potential upside bounce for GBP is diminishing in size. This might explain the drift down in GBP implied volatility, even if it spikes a bit into events such as the UK parliamentary Brexit amendment votes.

USD retains a rising trend so far in Feb, reversing losses in January.



Gold is diverging from other currencies, holding gains in Feb, despite broad strength in the USD



Long Term real yields continue to offer hope for EUR

JPY weakness running ahead of US yields recently

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