The emerging markets suffer while the US shifts up a gear

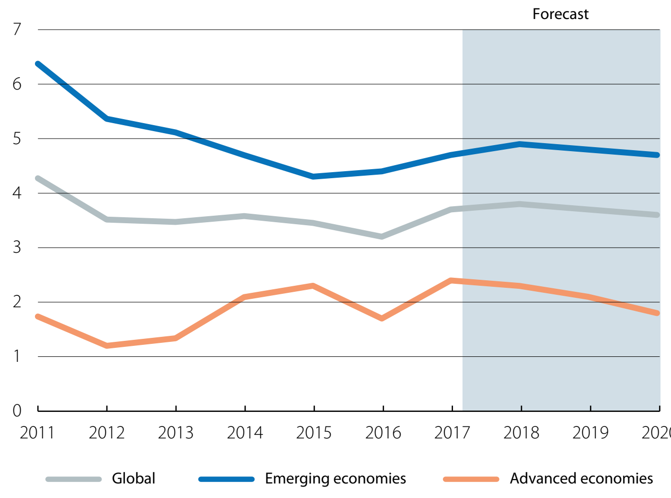
The economic indicators known in the summer months confirm that the growth rate of global economic activity is rebalancing: while there is growing evidence that the persistent economic uncertainty is taking its toll on the growth of some emerging economies, it is also clear that the advanced economies are on a different wavelength. The US is experiencing significant acceleration in its growth rate thanks to the fiscal impulse, while the euro area is seeing only a slight moderation in the growth of its economic activity. Overall, the scenario forecast by CaixaBank Research has been adjusted to account for this progressive weakening. Specifically, the growth figures for the emerging markets expected for the current year and the next have been revised down to 4.9% and 4.8%, respectively (1 decimal point lower than the previous forecast). As a result, the expected global growth will also be slightly lower in 2018 and 2019.

The downside risks remain considerable. Despite the moderation of the outlook set out above, the balance of risks continues to point towards a possible weakening of the economy in the future. The protectionist shift of the US and its possible global implications continue to play a prominent role in this balance. In the last few weeks, there has been a combination of negative and encouraging news in this area. The US has finished implementing the remainder of the package of tariff increases on Chinese products with a value of 50 billion dollars announced months earlier. In contrast, and somewhat unexpectedly, the US and Mexico have reached a bilateral trade agreement in principle which, once approved by the two countries' legislative authorities, will replace the NAFTA (while Canada is yet to be included). The terms of this future agreement have made it possible to balance both the US' demands (with a tightening of the rules of origin and an implicit rise in the minimum wage of the automotive sector) and the matters that Mexico considered important (with an extension of the adjustment periods, minimum terms and review periods, de facto protection against competition from Asia and without adversely affecting the primary sector). Besides the content of the agreement, the very fact that an agreement has been reached at all after months of complex negotiations and heated rhetoric provides some hope that, in the medium term, pragmatism will be able to lead to the resolution of trade tensions.

US

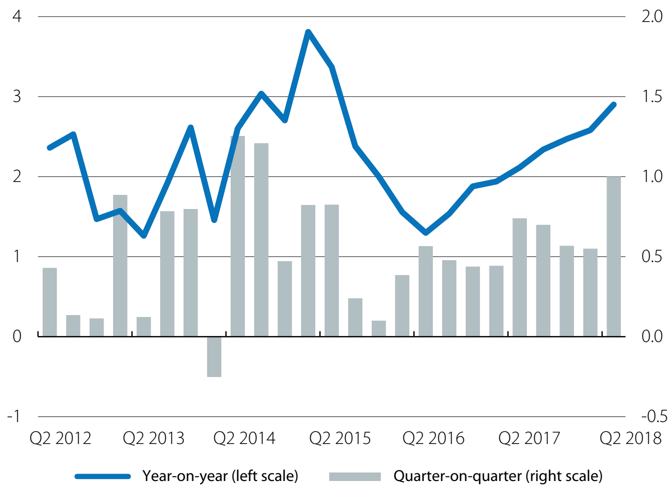
The US economy escapes the predicament of lower growth endured by other economies. The growth data for Q2 2018 (1.0% quarter-on-quarter, 2.9% year-on-year) confirm that the economy has accelerated thanks to the support of temporary and cyclical factors (such as the fiscal stimulus and a labour market that exceeds full employment). In particular, the breakdown of GDP by component of demand confirms that the bulk of the activity continues to come from domestic demand, leaving behind the bump experienced in Q1 thanks

Global GDP
Year-on-year change (%)



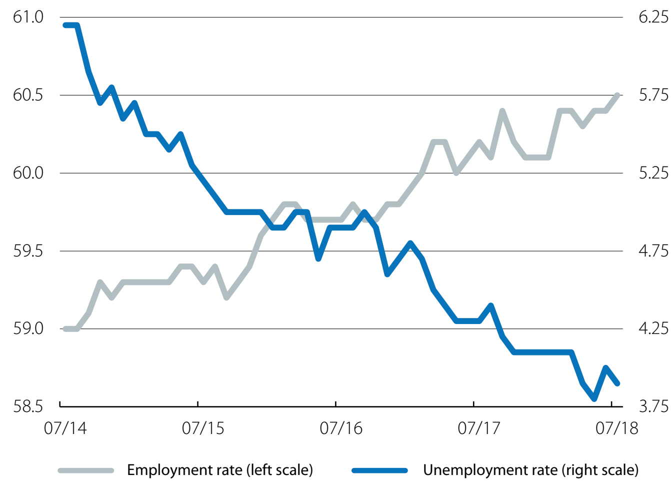
Source: *CaixaBank Research.*

US: GDP
Year-on-year change (%) *Quarter-on-quarter change (%)*



Source: *CaixaBank Research, based on data from the Bureau of Economic Analysis.*

US: labour market
(%) *(%)*



Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics.*

to the renewed strength of private consumption. Furthermore, it is worth noting that the contribution of external demand has also accompanied the acceleration of the economy, thanks to the robust performance of exports being combined with a reduction in imports. This reduction has been unexpected and, to some extent, surprising in light of the strength of domestic demand.

The labour market continues to be a source of stability. The strength of domestic demand is largely attributable to the labour market, which continues to show signs of growth. In July, nearly 160,000 jobs were created (slightly less than in previous months, but still a high figure if we consider that the previous figures have been revised upwards), while the unemployment rate stood as low as 3.9%. Wages, meanwhile, rose by 2.7% in year-on-year terms.

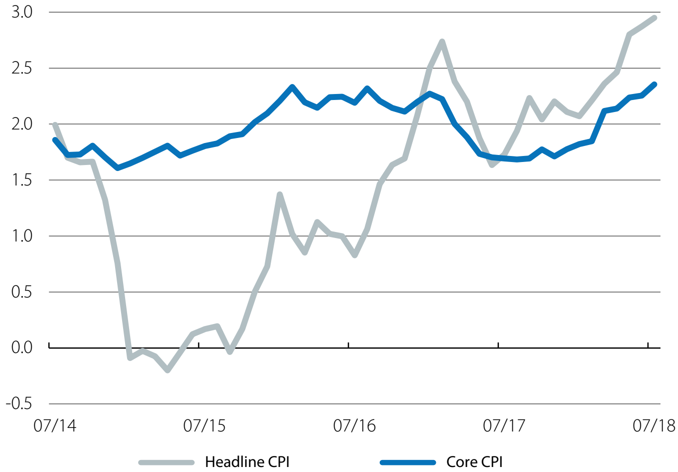
Inflation continues to rise and the Fed will take action soon. In the last few months, inflation has been gradually on the rise, in July reaching 2.9% (the headline index) and 2.4% (the core index, i.e. excluding the most volatile items of energy and food). This is another sign that the US economy is passing through the mature phases of the business cycle. In this context, we expect the Fed to continue its strategy of increasing the reference rate (with two further increases expected in what remains of the year, up to 2.5%). Beyond this, both the macroeconomic scenario and, therefore, that relating to monetary policy become more uncertain. That said, the strong inertia of the current rate of growth in economic activity should be more contained in 2019 when the effect of fiscal policy is reduced.

EUROPE

Slowdown in growth in the euro area. The GDP of the euro area grew in Q2 by 2.2% year-on-year (0.4% quarter-on-quarter), a figure similar to the 2.5% registered in the previous quarter, but lower than those observed at the end of 2017. By country, Germany maintained a similar growth rate to the previous quarter (0.5% in quarter-on-quarter terms, 1.9% year-on-year), well above that of countries such as France (which had surprisingly low growth of just 0.2% quarter-on-quarter) and Italy (which also grew by 0.2%, although in this case it was expected and in line with past figures). Outside the euro area, Poland continued to show very buoyant growth, while the United Kingdom recovered a little vibrancy following a somewhat shaky start to the year.

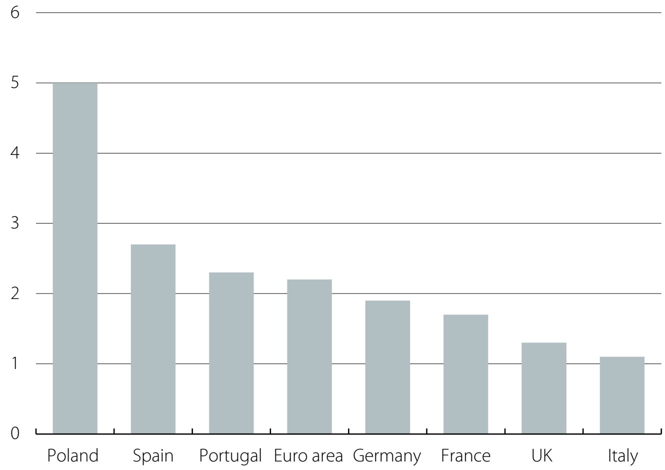
Growth in the euro area: a warning sign or just a bump in the road? The relative disappointment of Q2 was interpreted as a warning signs among analysts. However, in the opinion of CaixaBank Research it should not be treated as a warning, although it cannot be considered an isolated result either. The stability of the PMI indicator of the euro area for August (going from 54.3 points in July to 54.4), together with the gentle decline in other economic sentiment indicators, suggests that growth remains at levels similar to those of Q2. On the whole, although production capacity utilisation remains relatively low, it could be said that the strong cyclical upswing experienced by the euro area in 2017 moderated somewhat faster than expected. Therefore, it is foreseeable that the

US: CPI
Year-on-year change (%)



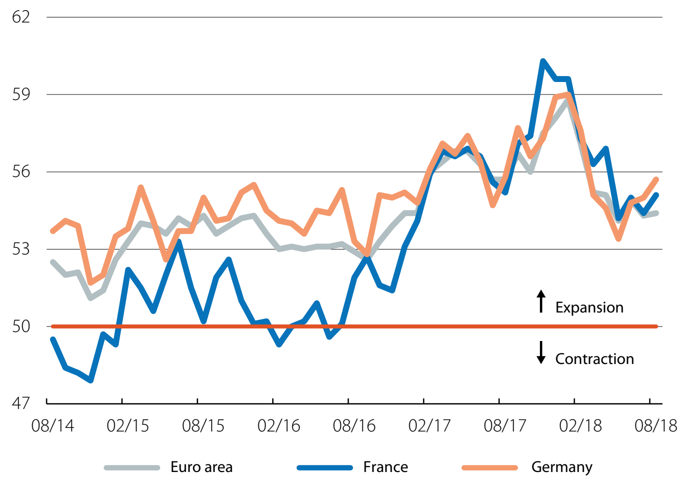
Source: *CaixaBank Research, based on data from the Bureau of Labor Statistics.*

European Union: GDP for Q2 2018
Year-on-year change (%)



Source: *CaixaBank Research, based on data from Eurostat.*

Euro area: composite PMI economic activity indicator
Level



Source: *CaixaBank Research, based on data from Markit.*

growth rate of economic activity in the first semester is representative of the growth to come in the next few quarters. Finally, inflation has continued to follow the same trend of recent months, with modest pressures on prices besides the fluctuations in energy prices. In August, inflation in the euro area stood at 2.0%, just 1 decimal point less than in July.

EMERGING MARKETS

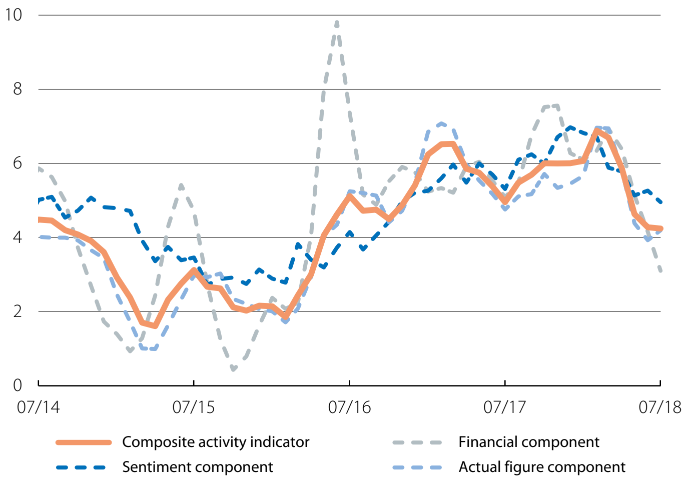
The emerging economies are beginning to acknowledge the adverse environment. In the last few weeks, there has been a notable increase in financial volatility in emerging market assets. This has resulted in significant depreciations of certain currencies, spikes in long-term interest rates and heavy declines in stock market prices. Besides the lead role of countries such as Turkey in this process, there are aspects not of an idiosyncratic nature which we believe are dragging down investor sentiment and which are already affecting the economic activity indicators. As is well known, the underlying context came about as a result of the progressive tightening of global financial conditions, a trend that is largely the result of the toughening of monetary policy in the US. This trend is affecting many emerging markets that previously made use of the lax financial conditions to accumulate debt in dollars and other strong currencies. Now, in addition to this, there is the added effect of the increased uncertainty caused by the escalation of protectionism by the US (although the preliminary agreement with Mexico is an encouraging development), as well as doubts surrounding the extent of the slowdown in China. As a result, indicators that attempt to capture the current rate of growth in the emerging markets, such as the composite activity indicator of the Institute of International Finance, are now showing notable declines that extend back to the end of Q1.

China's GDP slows and the economic activity data suggest more deceleration is to come. The increase in GDP in Q2 was 6.7% year-on-year, after three quarters growing at 6.8%. In addition, the economic activity indicators (such as industrial production) and the sentiment indicators for Q3 point towards a slowdown in economic activity that is somewhat higher than that indicated by the official GDP data. We expect the country's growth will continue to decelerate gradually in the second half of the year. That said, as mentioned previously, this process is not free of uncertainty and it has had an adverse effect on global investor sentiment.

Turkey, at the heart of the financial hurricane. As a result of an accumulation of excessive imbalances over too long-a-period (the most obvious is inflation, which stood at 15.8% in July, although there is also an unsustainable current account deficit of more than 6% of GDP in Q2) and a somewhat questionable economic policy, the Turkish economy is experiencing a sudden halt of capital inflows in Q3. This situation will likely lead to an abrupt slowdown in economic activity when faced with the inevitable credit crunch. Unfortunately, this sudden macroeconomic adjustment may not be the end of Turkey's problems if it is not accompanied by a shift in economic policy that tackles the latent imbalances.

Emerging markets: composite activity indicator

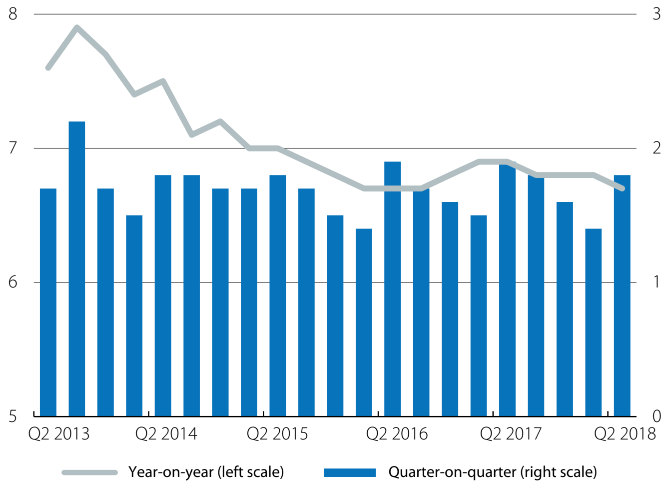
Annualised quarter-on-quarter change (%)



Source: *CaixaBank Research, based on data from the IIF.*

China: GDP

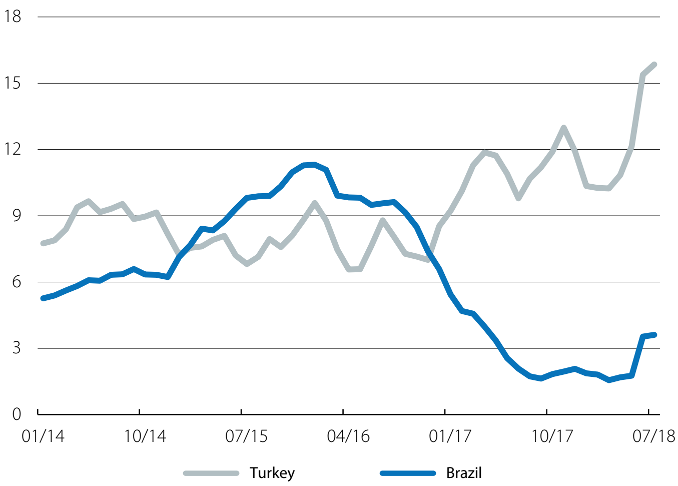
Year-on-year change (%) *Quarter-on-quarter change (%)*



Source: *CaixaBank Research, based on data from the National Statistics Office of China.*

Turkey and Brazil: CPI

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the national statistics institutes.*

Keeping up the pace after a good first semester

The economy consolidates its positive performance. The latest data confirm that economic growth remains firm thanks to the good performance of domestic demand and exports. It is precisely the buoyancy of domestic demand (within which the recovery of the consumption of durable goods and investment are of particular note), coupled with the higher oil price and the high import content of some exports (such as fuels and cars), that is fuelling a significant growth in imports. This, together with the decline in exports to Angola and the United Kingdom, explains one of the dissonant notes of Portugal's macroeconomic environment: a lower net contribution to growth by the foreign sector. Nevertheless, on the whole, the scenario for the Portuguese economy remains positive and over the coming quarters it is expected to maintain the vibrancy of the first six months of the year, with a growth rate slightly above 2%. In addition to this is the good performance of the labour market, where job creation and the fall in unemployment continue to be better than expected, as well as the positive trend in the real estate market, which is benefiting from foreign demand and the growth of tourism. However, the risk factors, particularly those related to trade tensions, the tightening of global financial conditions and the turmoil in the emerging economies, are still present and could trigger changes to the country's economic scenario.

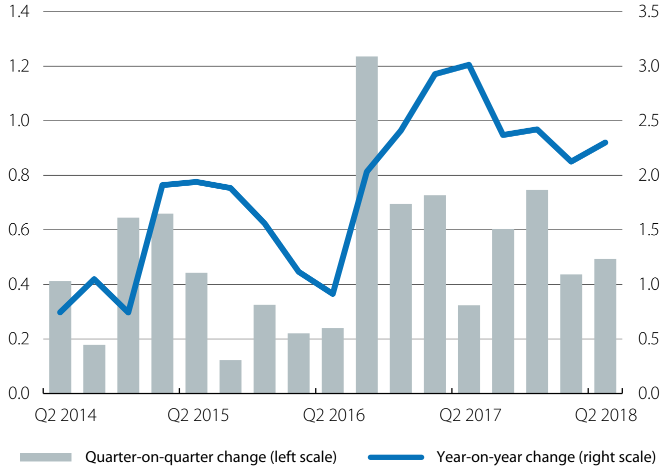
Economic activity continued to grow at a solid rate in Q2. In particular, in Q2 GDP growth accelerated to 2.3% year-on-year (0.5% quarter-on-quarter), 0.2 pps above the figure for Q1. The breakdown by component published by the National Statistics Institute shows that domestic demand played a prominent role, contributing 2.9 pps to growth (2.6 pps in Q1) driven by the strong increase in private consumption (2.6% year-on-year) and investment (6.4%). External demand, on the other hand, had a negative contribution for the fourth consecutive quarter (–0.7 pps) despite the acceleration in exports (6.8% versus 4.7% in Q1), given that imports accelerated even more (7.9% versus 5.6%).

The labour market continues to produce pleasant surprises and spur consumption. In Q2, the unemployment rate stood at 6.7%, with a reduction of 2.1 pps compared to the level recorded in Q2 of 2017. This decrease is largely due to the reduction in the number of long-term unemployed. This is a particularly positive sign because, typically, this group has more difficulties in rejoining the labour market. Furthermore, job creation maintained a good rate of growth (2.4%), with a significant contribution from the services sector and especially from those associated with the general government.

Inflation slowed in August. After rising to 2.2% in July, driven by the increase in energy prices (7.9%), in August headline

Portugal: GDP

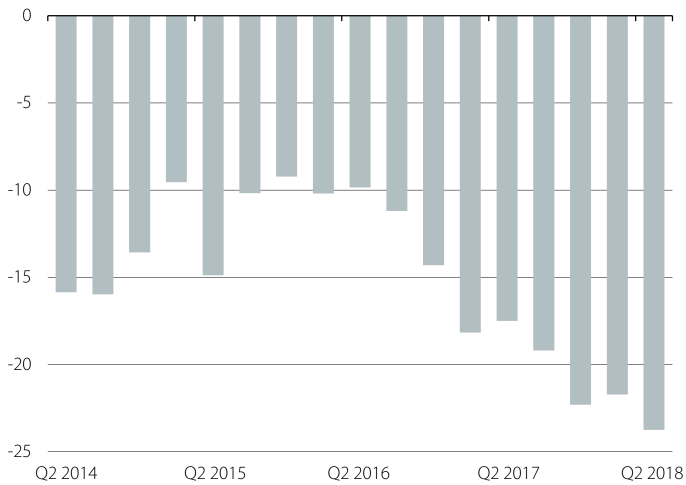
Quarter-on-quarter change (%) *Year-on-year change (%)*



Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

Portugal: unemployment

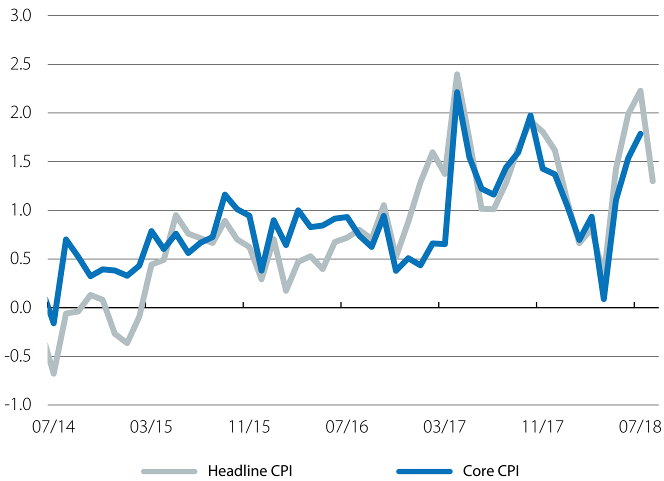
Year-on-year change (%)



Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

Portugal: CPI

Year-on-year change (%)



Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

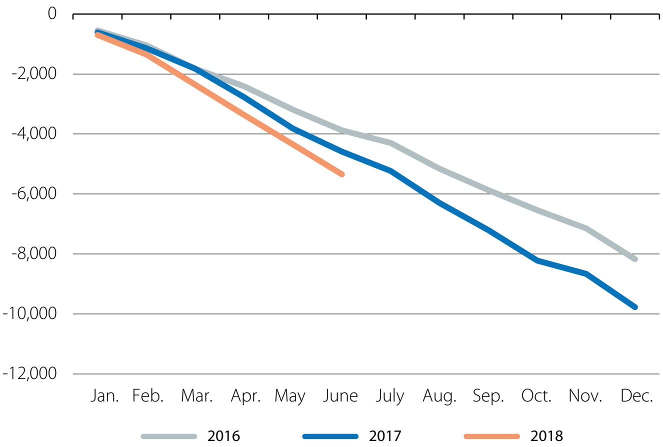
inflation stood at 1.4%. While the breakdown by component is not yet known, the slowdown would appear to be largely due to the underlying component (which excludes changes in the particularly volatile prices of energy and unprocessed foods), which in July rose to 1.8%.

The foreign sector sees a moderation in the current account balance. Despite the sustained surplus in the trade balance in services and the positive performance of certain segments of exports of goods (such as cars), over the course of the first half of 2018 the current account balance has gradually deteriorated, worsening by 0.4 pps compared to the same period in the previous year and reaching 0% of GDP in June (12-month cumulative balance). This is due to the higher price of oil in recent quarters, as well as to the recovery of the consumption of durable goods and the buoyancy of investment, which have a high import content. However, the foreign surplus in terms of services, with tourism at the helm, continues to serve as a mitigating factor. Finally, it should be noted that there has also been a reduction of the deficit in the primary income balance, both due to a decline in revenues received and due to an increase in outgoing payments.

The public accounts continue to benefit from the positive economic context and the growth of the labour market. Based on the cumulative data up to July, the budget deficit stands at 2,624 million euros (–2.2% of GDP), which represents a reduction in the deficit of 1,110 million euros compared to the same period last year. The collection of taxes continued to grow at a faster rate than expected by the Government and accounted for 77% of the increase in collections settled up to July. Nevertheless, compared to last year, a substantial portion of the increase in corporate tax net incomes in 2018 to date is due to the deferment of the payment of state reimbursements payable to companies. Therefore, its effect should fade over the coming months. At the same time, contributions to Social Security continue to benefit from the growth in the labour market, while expenditure continues to grow below the budget projections (of particular note is the lower investment, with 39% up to July compared to 49% up to July 2017).

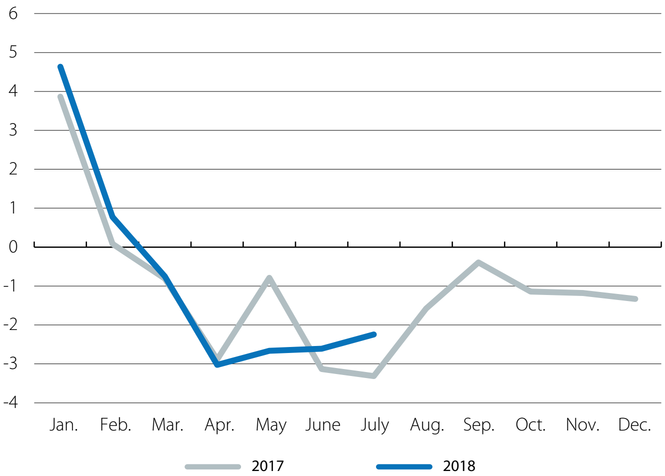
New bank lending grows in line with economic activity. New bank lending to individuals has shown steady growth in the first half of the year, in line with the acceleration in private consumption. In particular, the two main segments (lending for housing and for consumption) have experienced growth of 25.5% and 14.9% year-on-year up to June (new operations and annual cumulative lending). New bank lending to companies has also followed a positive trend, both for SMEs (2.5%) and for large firms (18.5%). However, lending to the non-financial private sector has continued to decline (–1.6% year-on-year).

Portugal: trade balance in goods (excl. energy)
Annual cumulative balance (EUR millions)



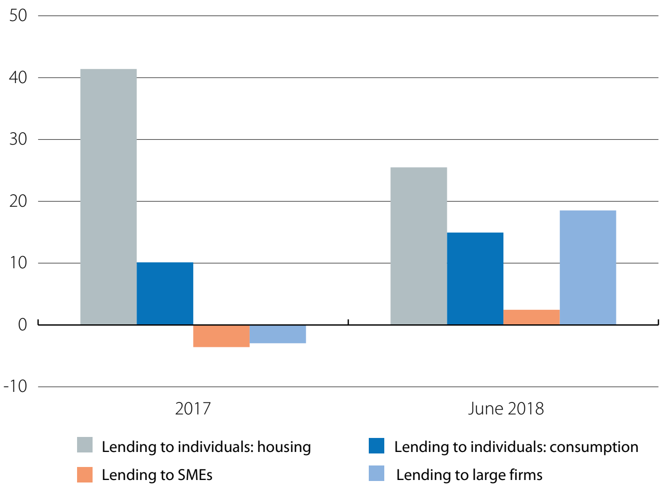
Source: *CaixaBank Research, based on data from the National Statistics Institute of Portugal.*

Portugal: central government balance
(% GDP)



Source: *CaixaBank Research, based on data from the DGO.*

Portugal: new credit operations
Year-on-year change in the annual cumulative balance (%)



Source: *CaixaBank Research, based on data from the Bank of Portugal.*