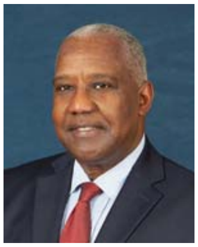
Major Country Developments April 2018



By Byron Shoulton

Overview

Global economic growth remains mostly strong, inflation remains benign and monetary policy is still loose. However, a range of economic and geopolitical risks are emerging as rising U.S. protectionist sentiment begins to negatively influence trade prospects and threaten future relationships with major trading partners. U.S. tariffs initially imposed against aluminum and steel imports have morphed into targeting a wide ranging list of other goods for possible high tariffs that would affect a variety of sectors. Numerous Chinese exports would be subject to 15%-25% tariffs before entering the U.S. The Chinese have responded in kind with similar proposed tariffs on a long list of U.S. goods including pork, airplanes and soy. The U.S. appears set to go all out in using stiff tariffs to rein in perceived bad behavior by China in its trade and investment practices. China has vowed to respond with equal aggressiveness, unveiling its own list of possible counter measures to those of the U.S.

Both sides appear to be anticipating that negotiations will help ease the tensions. The hope is that dialogue would prevent the actual implementation of the several new tariff proposals [by either side]. Without a climb-down from the heightened tense atmosphere, there is a growing risk that the relationship will become increasingly confrontational, to the extent that global trade could actually shrink. This would bring negative knock-on effects for inflation, business sentiment, consumer sentiment and ultimately weaken global economic growth.

U.S. belief that it is losing under existing international trade arrangements [evidenced by growing trade deficits with China, for example] is a core principle guiding the Trump presidency. The recent rounds of proposed tariffs represent concrete actions growing out of the Trump campaign promises. China's reaction and others that are likely to follow [from the EU and elsewhere] could together have adverse consequences for global supply chains. The big concern is that an escalating chain reaction of anti-trade measures could escalate, quickly spreading across multiple sectors, regions, and products. Ultimately, without a meeting of the minds, barriers to trade could include quota restrictions, import/export licensing requirements or outright trade bans.
U.S. investigations into Chinese intellectual property and technology transfer practices have stiffened U.S. resolve that defensive actions are justified and that it is up to the Chinese to make amends toward creating a level playing field.

Furthermore, other risks to global trade are present. The U.S. threat to withdraw from NAFTA (or the uncertainty over whether the U.S. stays in the trade pact) has the potential to un-hook key connections that have kept one of the world's largest free-trade areas thriving over the past 24 years. NAFTA has contributed to lower consumer prices, a boost in manufacturing efficiencies and a build-up of greater industrial capacities in all three NAFTA member countries. An end to a major trade deal such as NAFTA would serve to further fuel global protectionist sentiments, which will only undermine confidence.

Global stock markets are reacting with high sensitivity to the growing uncertainties over trade, concern over monetary policy and whether the bull market run of recent years was due to quantitative easing across much of the developed world. Although company earnings have been increasing, the true impact of recent trends (and trade policies) on future earnings and on company valuations is now being questioned. There is the risk that share prices will fall in the U.S. which would likely lead to contagion around the world. Households would see a decline in financial assets, triggering lower consumer spending. Meanwhile, the credit channel that funnels loans to the private sector could restrict lending. This would be most significant for highly leveraged small and medium-sized enterprises, resulting in lower investment and job creation while increasing the chances for default. Overall, the global economy appears to be moving into a new phase.

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Europe

Across the Eurozone, economic optimism, low interest rates and fierce competition among banks have helped push private-sector lending to its highest level since the financial crisis. This comes on top of an already high regional debt load. Over the past decade, the debt held at Eurozone firms and households rose around 12 percentage points to 160% of GDP, according the Bank for International Settlements. In the same 10-year period, U.S. private sector debt fell around 14%, to 152% of GDP.

Europe's borrowing binge is seen as one of the adverse effects of almost a decade of easy money from the European Central Bank, which slashed interest rates below zero and purchased bonds to reignite an economy reeling from a crisis that was triggered by over-indebtedness in the first place. As the ECB moves to unwind those policies, the debt they contributed to could hurt overleveraged companies and consumers, and hurt the region's now booming economy. Rising interest rates make it harder for people and companies to borrow and service existing debts, eventually crimping their ability to spend and invest, while pushing some into bankruptcy. Major European banking groups acknowledge with some alarm, that there has been no meaningful decline in private debt as a share of GDP in the Eurozone since 2008. Meanwhile, new lending to households and non-financial companies has been accelerating.

National regulators are increasingly concerned that low interest rates might be stoking unsustainable asset-price bubbles. By imposing limits on borrowing, they now hope to discourage households and firms from taking on debts that are only sustainable because interest rates are so low. That task is particularly important in a currency union like the Eurozone because national authorities face differing business cycles but can't set interest rates to cool or stimulate the economy. That responsibility rests with the European Central Bank.

USA

The U.S. economy disappointed forecasters somewhat in March, creating only 103,000 non-farm jobs, compared to 326,000 jobs that were added in February. The cooling U.S. job growth could be a mirror of growing uncertainty among businesses and investors, that the nine year-old economic recovery will begin facing strong headwinds over the coming months. This trend would likely dampen short-term consumer confidence and business investments. Sectors dependent on trade flows including agriculture, auto parts, steel, aluminum, chemicals, etc., are bracing for the fallout from ongoing trade tensions among the U.S., China, Mexico, Canada et al., over proposed tariffs, counter measures to those tariffs and the future of NAFTA. New hiring may be impacted. The U.S. labor market has tightened dramatically since the end of the 2008-09 recession, pushing the unemployment rate to 4.1%, a level considered as consistent with its natural level [i.e. full employment]. Forecasts by the Federal Reserve anticipate unemployment falling further over the next two years to 3.6%, the lowest since the 1960's. This may be too optimistic a forecast, although several indices are pointing to a current shortage of workers to fill many vacant positions in the U.S. Meanwhile, hiring in the construction sector declined by 15,000 jobs in March, part of a slowdown by producers.

Despite mounting trade jitters, the near-term outlook for the U.S. economy remained fairly positive. The average prediction for U.S. GDP growth in 2018 is 2.9%, accelerating from 2.5% growth at the end of 2017. This outlook could weaken in light of the recent intensification of the trade tensions with China. Forecasters in March saw rising odds that U.S. GDP growth will come in below expectations this year because of the ongoing foreign trade disputes. More than half of those polled said tariffs will reduce U.S. employment modestly, but increasingly worry that foreign trade disputes could escalate and damage the U.S. economy. This is a jump from 30% of those responding who held a similar view in February. One estimate predicted that up to two million American jobs could be lost in a trade war. A greater number of those surveyed (30%) now expect the U.S. to withdraw from NAFTA. This is up from 26% who thought so in November 2017.

Over the next six-months to one year the stage will be set for a possible negotiated settlement on tariffs between the U.S. and its major trading partners; or alternatively, a decision to go forward with the actual implementation of the proposed tariffs by either side. China has indicated it will appeal to the World Trade Organization to challenge what it says are serious violations of WTO rules by the U.S. The U.S. plans similar WTO challenges against China over intellectual property theft. In the meanwhile, we expect that many decisions to invest, buy equipment, pursue new markets, hire new workers, etc., are likely to get placed on hold until some resolution is found to the ongoing trade disputes.

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If implemented, the proposed Chinese tariffs [in reaction to U.S. tariffs proposals] will have a negative effect on U.S. farmers and the agricultural sector, among others. The U.S. Administration is promising that a plan to protect U.S. farmers and agricultural interests will be launched in the event that Chinese tariffs are eventually implemented. In addition, tariffs under consideration by the U.S. could hurt the manufacturing sector. For example, while U.S. makers of aluminum and steel hope that tariffs under consideration will heat up demand for their products, steep duties and quotas could hurt U.S. manufacturers dependent on imported metal, without helping U.S. operators of aluminum smelters from overcoming high hurdles to domestic production.

The U.S. remains an expensive location to make steel and aluminum. And while steelmaking has rebounded somewhat with an improving U.S. economy, aluminum smelting capacity remains severely diminished. Aluminum imports have increased in recent years, while U.S. production has fallen. About 15 U.S. aluminum smelters have closed since 2000. Most of those plants were demolished. Currently only two U.S. aluminum smelters are running at full speed. Three others are partially operating, according to industry sources. The U.S. ceased being a major aluminum producer over the past two decades. Electricity costs for smelters in the U.S. fell by more than 20% since 2013 and now rank in the middle of the pack among major aluminum-producing countries. However, the amount of electricity used by U.S. smelters to produce a ton of aluminum is among the highest in the world. This reflects the age and inefficiencies of the equipment which U.S. producers use. The Administration's options for dealing with Chinese overcapacity in both sectors are a blanket 10% tariff on all imported aluminum and a 25% duty on imported steel.

While the data gives no indication that U.S. inflation is about to accelerate, the Federal Reserve continues to hint that at least two more interest rate hikes are likely in 2018. And while some in the U.S. financial sector have warned of the possibility of the economy overheating, there remains little evidence that domestic demand is outpacing supply of most goods and services; or that price increases are anywhere close to being out of control.

Volatility in financial markets is being driven by changes in perception that political influences will begin to have a negative impact on U.S. economic performance and could eventually interrupt cross-border trade flows. Companies with significant foreign trade components in their portfolios, have become increasingly nervous over what effects political interferences (and anti-trade policies) will have on their medium term business outlook. Lack of clarity on what future trade policies will look like, will weigh on medium-term economic growth prospects. This is in sharp contrast to the strong, pro-business sentiment that prevailed until early this year. Further escalation and fraying trade relations between the U.S. and several of its trading partners remain a distinct possibility. Combined, these negative trends could lead to weakened demand and a reduction in trade flows. Escalating China-U.S. trade tensions will be bad for global growth and for oil demand growth down the road. Also, a weaker dollar will tend to make oil cheaper for foreign buyers.

Turkey

Strong growth and demand in Europe have helped boost Turkish exports. In 2017 real GDP grew by 7.4%. Domestic consumer spending and construction activity have been fueled by a government-backed loan scheme, employment incentives and tax breaks. However, that growth has created imbalances. Core inflation now stands at around 13%. Recent data show Turkey's current account deficit widened to $7.1 billion in January, with a rolling 12-month figure equal to 6.1% of GDP.

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To finance the deficit Turkey relies heavily on short-term flows of money that can quickly evaporate if sentiment toward the country shifts. For now, Turkey's attractive returns and an appetite for risk among some investors have kept inflows of funds at adequate levels. However, Turkey's uneasy relationship with the U.S., the European Union, its military intervention in Syria and its tense domestic politics all pose risks.

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President Recep Erdogan has a long-standing opposition to high interest rates, insisting that raising rates will lead to high inflation. The government continues to make clear that there will be no concessions on raising interest rates. Instead, the president wants the central bank to reduce rates. So far, the central bank has compromised by keeping rates on hold while compelling commercial banks to borrow at the liquidity window rate of 12.75%. The concern is that if there is a shift in sentiment the central bank is unprepared to adjust quickly. With the Turkish lira continuing to weaken against the dollar and the euro, banking sources in Turkey suggest that the Turkish central bank may opt for a modest hike at a time when rates are perceived as being too low.

The government is playing down the prospect of a sudden halt in the inflow of foreign funds. They insist that even in a worst-case scenario Turkey will not experience a drying up of capital flows. In the case of a slowdown in the flow of funds, an Erdogan spokesperson explains that the central bank would do whatever is necessary to maintain adequate liquidity. In other words, at such a time the central bank would raise interest rates as needed. Of note is the fact that as part of its rationale for downgrading Turkey's long-term sovereign rating to Ba2 (fromBa1) in early March, Moody's cited the weakening of the Turkish government's capacity to provide support to the country's banking system, in the case of such need.

In March prices increased in almost all categories of goods and services. About half of the rise in consumer prices was due to a 2% month-on-month increase in food and beverage prices. The Turkish lira has been volatile for some time, remaining generally on a depreciating trend since 2013, shedding more than 25% of its value. Since the end of 2017 the lira recovered partially to TL 3.79:U.S. $1 from a record low of TL3.96:U.S. $1 on November 23, 2017. The depreciation of the lira has helped to boost the competitiveness of Turkish goods and services exports; they rose by 12% in 2017 after contracting in 2016. However, it has also pushed up the cost of imported inputs, compounding the negative effect of higher international commodity prices on Turkey's large current account deficit, and of servicing the private sector's large foreign-currency debt. Furthermore, exchange-rate volatility combined with Turkey's political instability (since the coup attempt in July 2016) is likely to have complicated business planning, possibly leading to deferred investment decisions in the private sector.

In March the Turkish military announced the capture of Afrin, a Kurdish stronghold in Syria, following two months of relentless attacks. That is seen as more evidence of President Erdogan's confidence and assertiveness as a major regional force to be reckoned with. President Erdogan also scored another victory when one of his allies snapped up the last bastion of semi-independent journalism in Turkey, the Dogan Group for a reported $1.2 billion. Some regard the sale of one of the nation's largest media groups, as a coup of sorts for the Mr. Erdogan. Dogan outlets, including two of the country's biggest newspapers; a leading television channel; a news agency, among many others, have been squirming under government pressure for years. The group's aging owner, one of the symbols of Turkey's deposed secular order, has been hounded by tax inspectors and prosecutors. The 71-year-old Mr. Dogan reportedly conducted the sale of the group without any consultation with associates in the Group. Some speculate he faced arrest unless he sold his empire to one of the president's allies. If he were arrested he would be one of over one hundred other Turkish journalists already in prison, most of them jailed since the failed coup of 2016.

The sale of the Dogan group leaves allies of President Erdogan in control of almost all big media outlets ahead of parliamentary and presidential elections due in 2019. One study concluded that two out of three newspapers in Turkey, representing 90% of total national circulation, are now in the hands of businesses close to the government.

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Available indicators suggest that the Turkish economy has remained strong in early 2018. However, global monetary tightening, pressure on the lira and rising market interest rates are threatening to dampen economic activity ahead of the 2019 elections. Against this background, the government currently has ample fiscal space for stimulus measures – but these will likely reinforce high inflation, stoke imports and widen the already large current-account deficit. Turkey's dependence on short-term foreign capital inflows limits the government's ability to shore up the economy if global monetary tightening is more rapid than expected, or if international financial sentiment turns against emerging markets, or Turkey in particular, because of mounting domestic and international political tensions.

A bill approved by parliament in late March extends and expands incentives to boost employment and introduces a range of new tax breaks for companies and individuals. The legislation reflects the government's concern about keeping economic activity and employment rising ahead of the series of elections that are due in 2019 (but which could be held earlier). Its approval coincided with a fresh bout of lira weakness that has added to fears that the economy is overheating and is heading for an abrupt slowdown (2018 GDP growth projected at around 4.2% compared with 7.4% recorded in 2017).

Saudi Arabia

Saudi Arabia plans to use surplus oil revenues to bolster the financial firepower of the kingdom's $230 billion Public Investment Fund (PIF). The ongoing attempts to launch an economic modernization effort in Saudi Arabia, the brainchild of crown prince Mohammed bin Salman, will be underwritten by the PIF, the country's wealth fund. Therefore there is a high need to shore up the PIF.

Should oil prices exceed the level required to balance the Saudi budget, any extra revenues would be funneled into the PIF, according the Saudi Ministry of Economy and Planning. Whenever oil is above Saudi's break-even point, the excess will go into the PIF. The shift in strategy seems designed to place the crown prince – who has cracked down on corruption and plans to transform the oil-dependent economy – more directly in control of funds that have historically been managed by the central bank.

According to the IMF, Saudi Arabia needs oil prices to be at $70 per barrel in 2018 to break even on its budget. Crude prices are currently at $64 per barrel. The focus on the wealth fund shed some light on how Prince Mohammed, the apparent heir to the throne, is overhauling longstanding government processes. With about $500 billion in foreign exchange reserves, the Saudi Monetary Authority [SAMA] has been the traditional custodian of the kingdom's wealth, investing in conservative instruments such as bonds. Shifting the balance of financial power from the central bank – a conservative institution and decades-old bureaucracy – towards PIF should allow the kingdom to magnify returns on investment overseas through big bets on global companies. It will also enable greater investment in schemes designed to diversify the oil-dependent economy.

The new disclosure also implies that the kingdom will continue to manage the oil market through production cuts. Although long maintaining that Saudi Arabia doesn't have a price target, since 2016 Saudi officials have been discussing the need to prop up prices to fund social and economic reforms required inside the country. Separately, the Saudi oil ministry asserted recently that global producers including OPEC and Russia, would rather persist with production cuts and bring about a slight supply shortage than unwind the agreed production curbs too early. The Saudis have welcomed the higher oil prices which have come about over the past 18 months as a result of the agreement reached on production cuts among major producers.

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The PIF was set up in the early 1970's to fund projects deemed as strategically important, largely focusing on domestic investments. In recent years, the Fund has been used as a vehicle to make large foreign investments. The Fund aims to have $400 billion of assets under management by 2020. Records show that in 2016 the PIF injected $3.5 billion into ride-hailing company Uber and later that year agreed to plough $45 billion into an investment fund managed by Japanese conglomerate Softbank. In March it was announced that PIF would invest $400 million into Magic Leap, which makes "mixed reality" headsets. Critics say such a strategy is a bet on the kingdom's money managers generating better returns than the country's vast oilfields which are some of the cheapest to exploit. Supporters say the new strategy marks a cultural shift in the way the kingdom's economy is run.

The PIF has come under fire in the past for a lack of transparency. The finance ministry revealed in March that the planned flotation of state energy giant Saudi Aramco and other future privatizations will be channeled into PIF. In addition, any savings from the removal of energy savings and other spending cuts across government's departments will be placed into the PIF. The new Saudi administration under crown prince Mohammed bin Salman, asserts that by using this process the kingdom has saved "significant billions of dollars" and will continue to do so going forward.

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FCIA's Deals Of the Month

Single Buyer Policy: $8 million limit of liability on non-payment risk in the U.S. Domestic Auto sector.

Non-Cancelable* Multi-Buyer Policy: $6 million limit of liability covering the non-honoring of letters of credit issued by South Asian banks in the Industrial and Petrochemicals sector.

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If you are a company selling products or services on credit terms, or a financial institution financing those sales, you are providing trade credit. When you provide trade credit, non-payment by your buyer or borrower is always a possibility. FCIA's Trade Credit Insurance products protect you against loss resulting from that non-payment.

* ***Non-Cancelable Limits:*** *Subject to policy terms and conditions, after issuing the policy, the insurer may not unilaterally reduce any country or buyer limits.*