Major Country Risk Developments
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Global Overview

The U.S. economy added 130,000 non-farm jobs in August compared with projections of 158,000 for the month. This was the weakest jobs report over three months, as uncertainty stemming from the U.S.-China trade war weighed on the labor market. Uncertainty around trade relations between Washington and Beijing has sharpened concerns about future global growth.

U.S. Federal Reserve officials have indicated that a further quarter-point cut in short term interest rates is likely at the next policy meeting in mid-September. There are growing concerns that the trade war with China, plus weak demand in Europe, Asia and Latin America has ushered in a global slowdown. Still, many U.S. businesses remain optimistic about their prospects despite rising tariffs and concerns over trade policy. U.S. GDP growth continues at a steady 2.8% rate for 2019. The Federal Reserve "beige book" report of anecdotes from businesses provides insight. The data confirms that economic activity and employment are growing at a modest pace. Consumer spending appeared mixed, with some districts reporting growth while others reported flat sales. The Atlanta Fed noted that retailers in its district saw "heightened uncertainly" among consumers due to the geopolitical environment; they also expressed concerns about whether this uncertainty will impact consumer confidence and spending behavior during the upcoming holiday season. Increasing numbers of U.S. companies report tariff-related uncertainty.

According to the Institute of Supply Management, new factory orders, employment and U.S. production declined in August. The manufacturing index fell to 49.1 from 51.2 in July, signaling a contraction in manufacturing activity. The contraction in manufacturing is the first time in three years. In fact, manufacturing growth has been in steady decline for months. Since September of 2018, the U.S. industrial production index, a measure of mining and manufacturing activity, has fallen from 3.9 to 0.5. A number below zero indicates contraction. In July, the manufacturing index alone fell to -0.5.

The data shows contraction in new orders, production, and employment. New export orders shrunk for the second consecutive month and fell to their lowest since April 2009, when global trade was hit following the financial crisis. U.S. manufacturers indicate that they are investing less in their factories and workforces as the trade dispute makes it difficult to anticipate costs and demand. As a result, companies are buying fewer machines and at times shortening shifts. U.S. imports of capital goods fell in July to the lowest level since 2017, according to the Census Bureau. That contributed to a narrower U.S. trade deficit that month as manufacturers bought less machinery and supplies. In July new orders for capital goods posted their first year-over-year decline in three years. With diminished orders, manufacturing output down 1.6% since December and capacity utilization at U.S. factories shrinking in August for the first time in three years, the sector is forecast to remain subdued.

Meanwhile, in many parts of the world inflation targets haven't been hit in years and most central bankers understand there is a limited amount of ammunition still available to address weak global demand.

A new law passed by parliament and signed by the queen requires the **UK** government to ask the EU to further delay the exit of the UK until January 31, 2020. That's in case an agreement isn't secured with the block by October 31, 2019. The passage of the law is a serious setback for the government of new Prime Minister Boris Johnson. Mr. Johnson had pledged to not delay the UK's split with the EU, but under the new law the British government must request the agreement of the other 27 member states for an extension. Brexit has been twice postponed from the original date of March 29, 2016.

Hong Kong's chief executive withdrew the controversial extradition bill which was responsible for sparking three months of fierce protests and plunged the city into its worst political crisis since the handover from British to Chinese rule two decades ago. The bill would have allowed criminal suspects in Hong Kong to be transferred to mainland China. However, this concession may not be enough to end the unrest. Protests have continued since.

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Alongside the withdrawal of the extradition bill, protesters want an independent investigation into allegations of police brutality, universal suffrage in Hong Kong, the dropping of charges against arrested protesters and for protests not to be classified as riots. Still, some see the withdrawal as a step forward and hope that it will help to ease the tensions in Hong Kong which have hurt the economy and triggered capital flight. Consumer confidence and tourist arrivals have suffered since the protests erupted.

Following the announcement of the bill's withdrawal the stock market jumped by 4%. A recent survey of businesses suggests that the beginnings of a serious recession is underway in Hong Kong. The IHS Markit Hong Kong PMI survey came in at 40.8, far below the neutral 50 level. The result is consistent with a roughly 4% to 4.5% contraction in GDP. Most telling is the intense movement of capital out of Hong Kong over these past three months. Equally, new investments in Hong Kong slumped as the protests grew.

China

Fresh U.S. tariffs of 15% on Chinese goods (including clothing, tools and electronics) went into effect on September 1st, while retaliatory Chinese tariffs on imports of U.S. soybeans, crude oil and pharmaceuticals also took effect. The trade war between China and the U.S. has taken a turn for the worse. Both sides seem willing to wait out the unfolding events while the consensus view is that an early resolution is unlikely. Over the past year both countries seem at times on the brink of striking a deal, only to see talks fail to materialize or collapse.

The Chinese renminbi (RMB) weakened in August to a new 11-year low and stock markets in Asia-Pacific fell sharply after the U.S. announced that it intended raising tariffs on Chinese goods even higher. The Trump Administration is showing no sign of backing down in its intent to curb Chinese power by weakening demand for Chinese goods and painting Chinese ambitions as an attempt to surpass the U.S. globally both in influence and as a leader in technological advancement.

The Chinese authorities took an important step to help stimulate the domestic economy by releasing $26 billion to Chinese banks to encourage new lending. The government is in a struggle to revive business sentiment in the face of the protracted trade confrontation with the U.S. The central bank, the Peoples Bank of China reduced the amount of money commercial banks are required to set aside (its reserve requirement ratio) as an enticement for lenders to finance projects that might spur economic activity such as construction and help sustain employment. New drivers of growth for the world's second largest economy are increasingly uncertain as output weakens and business confidence sours. Trade trouble with the U.S. is among Beijing's foremost concerns, including the new tariffs which make its exports more expensive – even while both countries agreed to restart face to face talks in October.

China's current slowdown is testing the government's 2019 6% GDP growth baseline assumptions. The trade fight and other challenges have hit harder than expected, including a major disruption in the supply of China's staple food, pork; as well as the unprecedented turmoil in its traditional bridge to global markets, Hong Kong.

Reducing the reserve requirement which is seen as a near-term response to the increasingly complicated and challenging external environment, compliments a new policy implemented by China's State Council to allocate money for training, construction and a new plan to issue bonds for building railways. The goal is to enhance support for the real economy and is geared toward small and medium-sized firms in particular. The recent half-point reduction in the reserve requirement was the third such move in 2019 and lowered to 13% the amount of reserves China's largest banks are required to set aside. Smaller banks have lower set aside limits. This is the government's response to a series of recent weak economic data and escalating U.S. tariffs.

Unlike the U.S., China changes regular interest rates rarely; its authorities prefer to control the supply of money with the reserve rate and bank lending quotas, rather than rates that affect the cost of funds. The last time China reduced official interest rates was in 2015. In recent weeks the central bank established a new loan prime rate, or LPR, system that some say amounted to a rate cut. That came days after China allowed the U.S. dollar to rise above 7 to the RMB, which can also act as a growth spur and which helps exporters counter the impact of tariffs on Chinese made goods. In addition to spurring banks to lend, China's central government is pressing local authorities to find projects that will create jobs. But some local politicians like mayors fear they could be held personally liable for white elephants following years of construction that has left a heavy debt burden on municipalities across China.

The speculation is that the central bank will ultimately reduce interest rates, but the authorities have expressed apprehension about sparking new speculative real estate activity, when already high property prices are considered risks to the economy and to social stability. Exports from China fell in August as the intensifying trade dispute with the U.S. took a heavier toll on the country's manufacturing sector and after a forecast for temporary increase in orders failed to materialize. China's exports decreased 1% in August while imports declined by 5.6%. The export figures also showed that China's trade surplus fell to $34.8 billion, far below analyst's expectations. This compares to July's trade surplus of $45 billion.

Standard & Poor's recently estimated China's GDP growth will likely slump to 4.6% on average over the next decade, but only if the trade dispute gets to a stalemate. GDP growth would slump to 3.7% if trade tensions worsen according to S&P. The mood at the recent China Development Forum in Beijing was unusually subdued. Attendees confirm that distrust between the world's two largest economies runs deep. Expectations for a breakthrough in trade talks are low, as tensions have risen between both countries. The U.S. has stepped up pressure, portraying China as a national security threat; underlined by suggestions that continued U.S. commercial links with China could have negative security implications down the road. President Trump even suggested that U.S. companies begin to look for alternatives to doing business with China. Pessimism appears to be building among some traders, exporters and investors - who anticipate little progress in upcoming talks. Meanwhile, the Chinese leadership appear resigned to an extended period of strained relations with the U.S. There is speculation that China may be hoping to secure a better deal with the U.S. sometime in the future when another president replaces President Trump. The consensus: both sides have grown further apart from each other.

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U.S. farm and agricultural sector loss of business to China is troublesome for the U.S. administration. The losses cannot be made up via sales elsewhere. U.S. government handouts to farmers to help them cope with the loss of Chinese business are a drop in the bucket and it is not what farm and agricultural businesses want or expect. For now, losing good business in the China market is a fact they must live with.

Meanwhile companies have shifted some manufacturing out of China [to Southeast Asia and Mexico] to get around U.S. tariffs. Others are studying their options. For many companies it is not easy to decouple from China at a whim. Besides, China will remain a very important global market for years to come. Businesses and consumers across the world will continue to do business in China. U.S. government boycott will hamper some U.S. businesses or make it more expensive to do business with China. Nonetheless, U.S. tariffs and pressure won't eliminate China's trade, access and continued presence in markets around the globe.

Argentina

Argentina's government imposed capital controls and now require exporters to repatriate foreign exchange earnings within five days. The proceeds must then be converted to pesos. The government also indicated that it will look to restructure its stock of foreign debt ($101 billion), including $57 billion owed to the International Monetary Fund (IMF).

Argentina is seeking to extend the maturity of its debt (denominated in both local and foreign currencies) hoping to provide stability for the weakening peso as concerns grow about the country's political stability and its ability to repay its debts. The new measures are part of the embattled Macri government's strategy to prevent more capital flight, support the peso and eventually bring prices under control.

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The initiative seeks to extend the maturity for short-term debt issued in Argentina as well as bonds issued abroad without reducing capital or interest. The government also proposed that the IMF restructure the $57 billion bailout package agreed to with Argentina in 2018. Argentina originally agreed to repay IMF debt beginning in 2021. The IMF is assessing the impact of the government's newly proposed measures to extend the maturity profile of its debt obligations. Discussions are reportedly ongoing between the Fund and the Argentine government. The Fund explained that it understands that the Argentine authorities are taking these important steps to address liquidity needs and to safeguard foreign exchange reserves. However, no concrete decisions can be taken with the sitting lame duck government. Hence, it will probably be left to a new government to renegotiate the existing agreement with the IMF. In an effort to shore up the peso, Argentina's central bank sold over $1.5 billion in currency markets during August. This large intervention hasn't been enough to stop the peso from weakening further against the dollar.

The peso saw further weakening after opposition Peronist presidential candidate Alberto Fernandez emerged as the favorite to win October's election by a wide margin. The opposition candidate has lashed out at the IMF and the government, blaming them for the country's economic stagnation, high inflation and steady capital outflows resulting from austerity measures implemented with the IMF's backing. Mr. Fernandez has previously said he will renegotiate Argentina's bailout package with the IMF should he be elected president. The weaker currency has fueled inflation, already one of the highest in the world. The outlook is for inflation to hit 70% within months. More than $10 billion in foreign debt and $8 billion in peso-denominated Argentine bonds will mature later in 2019. About 80% of Argentina's debt is denominated in dollars, and net foreign currency reserves currently cover only 60% of Argentina's financing needs of about $100 billion. This, according to private sector estimates.

Some of Argentina's big creditors have reportedly given a cool reception to the recently announced government plan to delay payments on the debt. However, they accept that such a plan would alleviate some of the country's immediate funding pressures. One proposal is to postpone payment on $47 billion of short-term local debt for up to six months while pursuing "voluntary reprofiling" of $50 billion of longer-dated debt, the majority of which is owned by foreign investors. The government also plans to delay the repayment of $44 billion of loans already disbursed by the IMF. Prices of Argentine bonds are now below levels investors believe are in line with potential recovery values, once the debts have been restructured. Many investors cite progress made by the embattled Macri government in eliminating Argentina's budget and current account deficits. The next government would inherit a situation probably as good as its been in eight years. Still, most creditors are watching the situation cautiously as there remain many unknowns. For example, Mr. Fernandez has offered little clarity as to what economic policies he will pursue. He has also provided little guidance on how stringently he will stick to the austerity program he will inherit, and what relationship he seeks to have with the IMF.

Argentina is now insolvent, with the country's debt now at nearly 100% of GDP. The ratio is unlikely to come down anytime soon, as Argentina's record on stimulating new growth is poor. Investors seem resigned to the move to force holders of short-term Argentine sovereign debt to collect their payments at a later date, given that the government has approximately $30 billion in debt falling due this year alone; while foreign exchange reserves has dwindled to an estimated $10 billion.

Mexico

Mexico recorded its second quarterly current account surplus since the peso was floated in 1994. However, the surplus was largely driven by a collapse in imports of capital goods, suggesting both a souring of business sentiment amid a sharp slowdown in economic growth, and the likelihood of further weakness ahead as output falls. The government of President Lopez Obrador has unveiled what it calls a "realistic but conservative" 2020 budget that targets a 2% rise in economic growth and a wave of social spending which some analysts are warning rely on key assumptions that are too optimistic.

The government acknowledges that a difficult international outlook had forced Mexican officials to rework their calculations [following an escalation in U.S.-China trade frictions] which helped in weakening the Mexican peso and oil prices. Mexico's finance minister stressed that the 2020 budget would include no tax increases or spike in new debt. Mexico, Latin America's second largest economy, is teetering on the brink of recession after a 0.2% contraction in the first three months of this year.

The 2020 projection in the budget would represent a jump in GDP growth, from 0.6% to 1.2% this year and is based on assumptions of a 15% rise in oil production and an increase in tax revenues that are deemed too optimistic by some. The revenue projections appear difficult to reach. While the increased oil production target of 1.95 million barrels per day might be overambitious, the fact that they included output from the private sector rather than Pemex alone, was welcomed by markets. Pemex the state oil company, has suffered 14 years of falling production and currently produces around 1.7 million barrels per day.

President Lopez Obrador's government has sought to reassure markets that it has a strong fiscal discipline since it presented its first budget last December- despite some decisions that shocked investors, such as the abrupt cancellation of a partially built $13 billion new airport for Mexico City. The Mexican Finance Minister has committed to meeting the 2019 goal of generating a primary budget surplus (excluding interest payments) of 1% of GDP; and has set a target for next year of 0.7%, within a 2.1% overall budget deficit in 2020 (inclusive of interest payments).

The government has implemented spending cuts to state bureaucracy in order to spend more on the president's signature social programs. But those moves have hit growth, which registered zero in the second quarter. Risks to Mexico's growth includes the global slowdown and further delays in ratification of the U.S.-Mexico-Canada Agreement (USMCA) free trade pact.

The budget's forecast of a 3.7% rise in non-oil tax revenue and a projected decline in operational spending is viewed as overly ambitious. Rating agencies have warned that lower growth and increasing cash transfers to Pemex could spark downgrades. While Mexico's sovereign debt is comfortably investment grade, Pemex was downgraded to junk by Fitch in June and a second junk rating could spark a wave of forced selling of Pemex debt by institutional investors.

Rating agency Moody's has calculated that Pemex would need about $7 billion this year to plug a cash flow hole. Once debt maturities are added in, it estimates that Pemex would need $20 billion this year and $17 billion in 2020

The government plans to provide a $2.4 billion injection boost to Pemex, together with tax breaks for the company that would yield another $2 billion. Rating agency Moody's has calculated that Pemex would need about $7 billion this year to plug a cash flow hole. Once debt maturities are added in, it estimates that Pemex would need $20 billion this year and $17 billion in 2020 - well beyond the aid outlined by the finance ministry. This leaves many believing that the newly announced 2020 budget does not do enough to dispel the risk of further downgrade for Pemex.

Saudi Arabia

Saudi Arabia dismissed former oil minister Khalid al-Falih and replaced him with Prince Abdul Aziz son of King Salman, in a dramatic shake-up at the heart of the kingdom's economy. Saudi Arabia, the de facto leader of OPEC and its oil producing allies have struggled to raise crude prices. The Saudi economy is beset with continuing subdued GDP growth since the slump in oil prices in 2015. The government has also faced a widening budget deficit, which the IMF projects will rise to 6.5% of GDP this year.

Saudi Arabia has cut its oil production to fewer than 10 million barrels per day as part of an agreement between OPEC and its allies in a bid to bolster prices. The sudden change at the top of Saudi's oil industry suggests that the country is dissatisfied with oil prices at $60 per barrel.

The removal of Falih – who had become the international face of Saudi oil policy since his appointment in 2016, caps a series of changes in top positions in the kingdom's oil sector. Falih was also replaced as chair of Saudi Aramco just as efforts are being stepped up to prepare the state-owned oil company for an initial public offering. The government also separated the ministry of industry and mineral resources from the energy portfolio, removing Mr. Falih's oversight of industrial policy.

The veteran oil executive's dismissal is indicative of crown prince Mohammed bin Salman's [MBS] focus; as he spearheads a highly ambitious economic reform program. MBS has injected new impetus into the IPO sale in recent months. A targeted valuation of Aramco at $2 trillion has been criticized as being overly optimistic. Minister Falih was apparently perceived as being less than enthusiastic over the delayed public offering, the centerpiece of MBS's economic transformation plan which is expected to be the biggest in history. Falih may have not been aggressive enough in driving the IPO forward. His replacement as chair at Saudi Aramco is a close confidant of the crown prince. This is viewed as further evidence that the crown prince will be relying more heavily on a new generation of advisers going forward.

The Saudi oil minister's job has long been viewed as one of the most secure government positions in the kingdom and above internal politics, reflecting Saudi Arabia's position as the world's top oil exporter and swing producer. Mr. Falih's predecessor, Ali al-Naimi, held the post for 21 years. Some observers believe Mr. Falih is the victim of underperformance of a portfolio that was too big. His ministry touched many areas of the economy and many people [including MBS] were believed to be unhappy with a lack of progress on the industry front.

In the three years since MBS was appointed crown prince, he has upended conventional Saudi decision making with his aggressive drive to reshape the conservative nation in line with a new vision for the future. In the current environment no senior official is guaranteed job security. The labor minister has been changed three times as unemployment has soared above 12%. While the new plan is ultimately designed to wean Saudi Arabia's economy off its addiction to oil, in the short term the country needs higher oil prices to finance the crown prince's agenda. With oil prices remaining stubbornly below the $70-$80 range needed in Saudi Arabia to address the persistent weakness of the kingdom's economy, the government will become more dependent on the proceeds from an Aramco IPO to finance its long term goals.

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