G20 - Where We Now Stand

• China & US agree to restart talks
• Risk reacts positively but for how long?
• Much will depend on policymakers' reactions

Agreement between the US and China to restart trade talks has induced a healthy bounce to the risk trade in Asia today.

But as my colleague John Velis contended yesterday, just because the ‘pendulum’ is swinging in a favourable direction doesn’t mean the chances of it reversing course in short order are trivial.

Much will depend on the response from central banks.

Officials may feasibly look to talk-up the greater positivity that has emerged from Osaka; but in the prevalent low growth, low inflation environment, central banks are unlikely to be eager to amend their downbeat forecasts without seeing some tangible evidence of improved optimism.

Perhaps an acid test of what to expect will be tomorrow’s policy declaration by the RBA. The justification for a rate cut – which has been given a 70% market probability – can be surely expected to convey a fairly cautious interpretation of the weekend’s events.

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Newswatch

1. The US and China have agreed to restart trade talks >

2. Official and Caixin PMIs underline struggle of Chinese manufacturers >

3. 
Indeed, officials and markets alike will be only too aware of the underlying political realities that lay behind last week’s confusing rhetoric and this may well be impossible to ignore as remaining issues are ironed out.

The angle the Fed takes will of course be particularly important. In the run up to this weekend’s meeting in Osaka, Mr Powell cast doubt on the Fed’s commitment to multiple rate cuts by questioning “whether [prevailing] uncertainties will continue to weigh on the outlook”.

If it is believed that a major element in this uncertainty has now been seriously reduced, then the risk is that markets obligingly reduce their expectations for cuts even further. According to CME data, the prospects of 75bp cuts this year had already fallen to 36% on Friday from 39% a week earlier.

Another important issue to consider is the Chinese policy response. Of course, it will be hoped that the deal will breathe life into a much pressed Chinese economy, but few can expect it to constitute a panacea. As we noted last week, the deal alone may well be insufficient to prevent China’s GDP growth from sliding below the 6-6.5% target this year.

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Note the official and Caixin PMIs published overnight: the official manufacturing index was unchanged in contractionary territory at 49.4; the Caixin/Markit PMI – also in contractionary territory - posted the worst reading since
January. It has been some time since these growth gauges gave the markets any genuine cheer.

Although we expect that the deal will once more postpone any question of a near-term weakening in the CNY, China may therefore feel that more stimulus is still needed. However, one brewing uncertainty on this front is whether it would be well received. In a world in which there is a race to the bottom on interest rates, it is certainly pertinent to question the possibility of policy exhaustion in China.

The weekend has raised more questions. It will be in the markets’ interests for them to be addressed by policy makers sooner rather than later.

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