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Mid Year Update 2019 – Tug of War

Slowing global growth encounters a new round of monetary stimulus

Most financial assets soared in the first half of the year as investors priced in an era of renewed monetary stimulus against a backdrop of benign inflation. While we are pleased with the profound shift in monetary policy, declining global growth, heightened trade tensions and significant structural imbalances pose a risk. Consequently, recent market trends should not be extrapolated indefinitely.

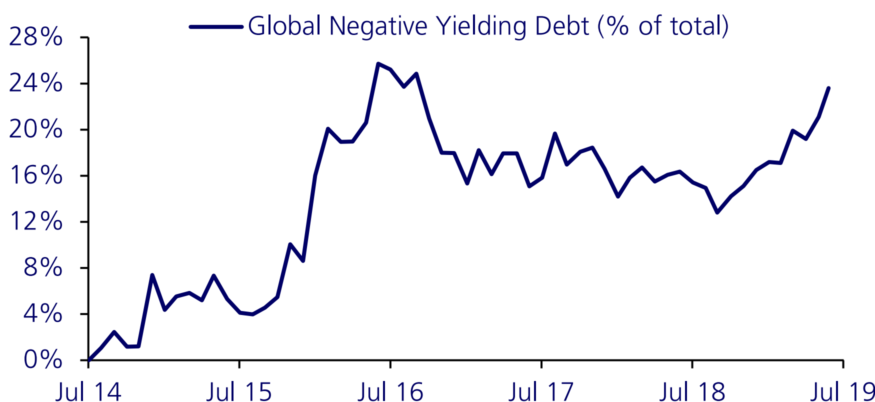
Source: iStock by Getty Images

Policy shift powers assets higher

The first half of the year has been defined by surging asset prices as global monetary policy has pivoted dramatically from tightening to easing. Back in December the US Federal Reserve was forecasting three rate hikes for this year and a further move next, yet by January the message was one of 'patience' as rate hikes were put on hold. As many other central banks took this as a cue to cut their own rates, investors took heart and financial assets surged.

By the end of June, there were some $13 trillion of negative yielding assets, 10yr Bund yields were -0.35% and Greek bond yields had converged with those of Italy. Risk assets were the star performers, with credit spreads closing in on cycle lows and stocks posting new highs. Even the breakdown of trade negotiations in May failed to dent confidence, as domestic Chinese stocks closed the first half of the year up 30% and the S&P 500 17%. Indeed, Brexit, tensions with Iran, and even a global industrial recession were overlooked as liquidity provisioning and hopes of a global central bank 'put' dominated thinking. Bad news was once again seen by investors as good news, as it raised the prospects of further stimulus.

Percentage of negative yielding assets is surging once more



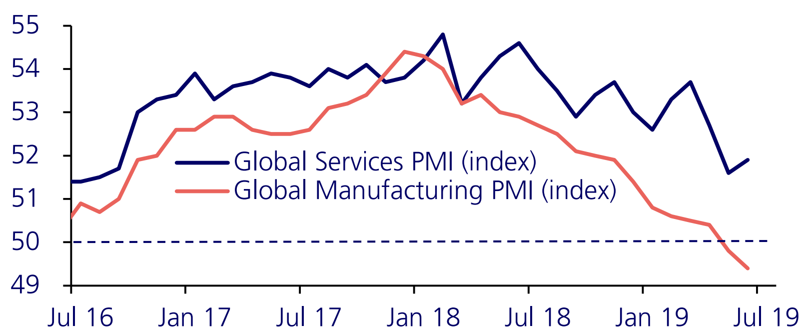
Source: Barclays, Bloomberg

Monetary easing is a reaction to worsening growth prospects

While we welcome the pivot by central banks and their focus on extending the cycle, the reasons behind their shift should not be ignored. Growth is slowing, inflation expectations sliding and global trade is in retreat. The tug of war between risks and stimulus will likely oscillate before a winner can be declared.

This month marks the longest period of US economic expansion, as the 121

Manufacturing contraction bodes ill for the global economy



Source: JP Morgan, Bloomberg

months eclipse the golden period of the 1990s. That noted, the level of growth has been rather unspectacular as demographics and disappointing productivity have been powerful constraints. It is true that employment conditions in most regions have been impressive, with unemployment falling to multi-decade lows and wage growth at least showing a modest tick higher. However, prospects are deteriorating and global growth is indeed in a pronounced down track, as we predicted in our 2019 outlook, 'Choppy Waters '.

Despite the employment conditions supporting domestic demand in many countries and helping the service sectors, manufacturing and industrial production have suffered badly. Slowing Chinese growth has played a part, but so too has technological shifts in the Auto industry and, of course, the uncertainty that has been created around tariffs, trade and corporate embargos. Consequently, as can be seen from the chart, the global manufacturing PMI is in contractionary territory. Historically this has exerted a gravitational pull on the rest of the economy when it has remained in that state for any length of time. Unfortunately, there still appears to be downside risk on this front. Though trade discussions between the US and China have been re-started, we suspect negotiations are likely to be protracted and any agreements unlikely to be definitive. Uncertainty will prevail, particularly around technology sharing and integration, which will affect business sentiment and inhibit corporate investment.

The desire of central banks to normalise policy was an error

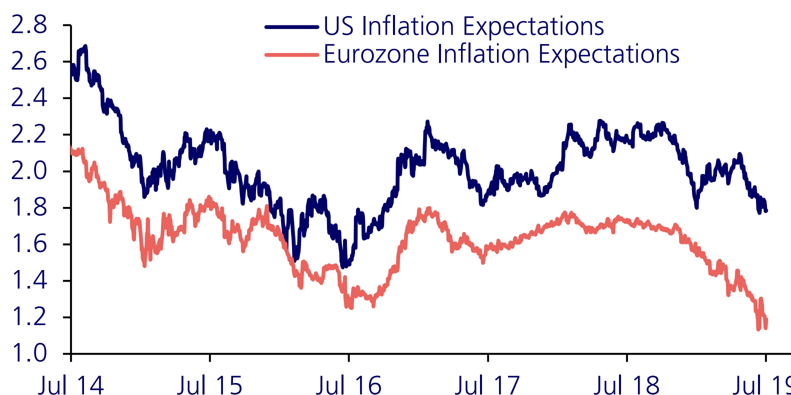
One key element behind the slowdown has been the monetary policy of the past couple of years. Growth is slowing by intent. The US hiked rates nine times and global financial tightening was pervasive, so in many ways the slowdown should be no surprise. What is disappointing is that, with hindsight, it appears that policy errors were made. The deep-rooted fears of inflation continue to shape monetary policy and once again this was the case in the US and Europe. The start of policy normalisation occurred despite inflation being a long way from targets, with an ill-judged extrapolation being made of growth translating into persistent inflationary pressures. Yes, it would be 'nice' to normalise policy and have greater rate cutting potential to fight the next downturn, but not at the cost of undermining momentum and the potential for a self-sustaining recovery. That in effect is what has happened. Inflation is low and falling, and inflation expectations in both the US and the Eurozone have become de-anchored, as can be seen in the chart. This is a profound development and implies that investors no longer believe that inflation targets can be achieved. The fact that the Fed and the ECB have had to do a volte-face undermines their credibility and the Fed's claims of symmetrical inflation targeting.

Renewed monetary easing is needed, but may not be enough to mitigate slower growth

While easier policy is welcome, with India, Australia, the Philippines and New Zealand just some of the countries now in rate cutting mode, the slowing growth dynamic and trade risks will be hard to overcome. While we expect the Fed to cut rates in July and again in September, the US has little spare capacity to allow growth to rebound and fiscal drag will remain into 2020. We are not anticipating that the next $300bn of Chinese imports will be subject to higher tariffs, but nor are we expecting existing tariffs to be removed anytime soon. Consequently, this uncertainty, in combination with a lack of spare capacity, leads us to maintain our forecast of a mild US recession in 2020, though we acknowledge that policy could soften or even postpone this outcome.

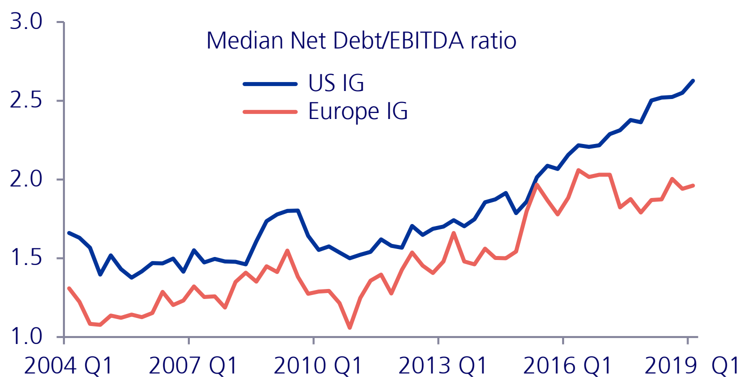
China's growth has disappointed, but the country maintains the resolve and the capability to bolster its domestic growth. This is being undertaken with caution as tax cuts and targeted stimulus are deployed, but it is not having the same spillover effect on the Asia Pacific region as prior stimulus measures had. With employment indicators looking weak, however, it is increasingly likely that a rate cut will be forthcoming in the next few months, in combination with potentially more infrastructure investment. This is in contrast to Japan, where the BoJ is not expected to be proactive in providing additional stimulus to the languishing economy.

Long term inflation expectations have plunged



Source: Bloomberg

Credit markets are fundamentally expensive, with leverage high



Source: Bloomberg

The Eurozone remains vulnerable and we suspect that a further small rate cut will be forthcoming, combined with some tiering of rates to help soften the impact on the banks. Rate cuts from current levels are likely to be ineffective and we suspect that QE will be re-introduced with some modifications to the issuer holding limits, and possibly around the capital key purchase framework as well, which will help the process. Although we feel strongly that fiscal measures are also needed, in line with recent comments from ECB President Draghi, political alignment is still missing and thus it is unlikely in the short term.

Brexit uncertainty likely to linger for longer with hard exit increasingly likely

As the Brexit saga drags on, the uncertainty that it creates is undermining business investment. While we still hope that some compromise agreement will be reached, it is unlikely that the EU will agree to any significant concessions and the risk of a hard exit is now close to 50:50. The economic implications of such an outcome are penal, at least in the short to medium term. This is at a time when the EU has just completed bilateral trade deals with Japan and now creating the largest trading partnership with the Latin America trading bloc of Mercosur – following 20 years of negotiations. This shows the difficulty the UK will face in undertaking such bilateral deals, as well as what it is about to give up.

Bond yields likely to stay very low, while credit markets are running on borrowed time

The combination of anaemic inflation, slowing growth, high levels of indebtedness and renewed monetary easing is likely to keep bond yields low for a very, very, long time. Indeed, unless the extent of both fiscal and monetary policy support turns out to be a surprise to investors, yield curves are unlikely to reverse their flattening/inverting trend. This is likely to continue to support risk assets, at least for the time being. Corporate leverage is extreme and continuing to build, but the hunt for yield and pull from lower and in many cases negative bond yields will lend support to the credit markets in the very short term. That noted, the cycle is mature and risks are increasingly skewed to the downside, and we would expect spread widening before year-end. It may still be too early to short credit given the carry that remains on offer, but vigilance is required and the primary markets will be a good indicator of when the tide starts to turn.

Equities have further to run, based on liquidity and positioning rather than fundamentals

Despite the rally in equities, we fail to detect any real exuberance and most valuation metrics do not look particularly extended. Corporate repurchases remain a decent tailwind, particularly for US stocks, and the rotation that has been visible between sectors within the market in recent months is encouraging. Corporate earnings and profits are under pressure, with analyst estimates still declining. While this is a concern, it is clear that investors are back in liquidity driven mode, which is likely to push stocks higher for some time yet. The risk is that with fundamentals unlikely to keep pace with the rally, a more substantial correction may well been seen later in the year.

Stocks are driven by policy hopes after fears of over-tightening

Source: Bloomberg

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