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Economic Background – April 2019

Global Central Banks – Goldilocks or a Grimm Tale

The first quarter of 2019 has seen investment markets respond to the abrupt change in stance from the US Federal Reserve at the end of last year. In December the Federal Reserve waved its policy wand (in surrender?) and announced that it was putting its planned interest rate increases on hold.

There were many reasons for the change in direction. Investors were worried that further interest rate rises would drive the US economy into recession and this, together with concerns over the state of US China trade talks, led to a sharp fall in global stock markets. Markets responded quickly to the change of heart and investors appear reassured that the Goldilocks economy (not too hot, not too cold) would continue for the foreseeable future. In March the chair of the Federal Reserve confirmed that the US central bank would not be increasing interest rates in 2019 and was only expecting to increase rates once in 2020 (the current benchmark interest band of 2.25% to 2.5%). The Federal Reserve also indicated that it was looking to cease reducing its balance sheet by the end of September effectively removing another monetary tightening measure. Over the last year the central bank had been gradually reducing the size of its balance sheet by only reinvesting part of the maturity proceeds of bonds in its portfolio (The Fed's balance sheet recently fell below $4 trillion for the first time since 2013).

The European Central Bank (ECB) had continued to buy European debt throughout 2018 but has adopted a more dovish approach since the start of the year. The revival of its "targeted long-term refinancing" (TLTRO) stimulus programme should provide some additional liquidity and financing to a Eurozone economy that has seen growth forecasts for the current year fall from 1.7% to 1.1%. The Bank of England has also confirmed that there were no plans to increase interest rates, reflecting continued uncertainty over the timing and nature of Brexit.

Further east, the Bank of Japan has continued to purchase shares and debt in the open market, but these actions have failed to generate any inflation and the Japanese stock market has fallen over the last year despite this active support. The Chinese authorities have also adopted a number of approaches to stimulate their economy to soften the impact of a slowing growth rate, and the effects of the ongoing trade dispute with America.

The reversal in the stance of the US authorities, and the belief that the US Federal Reserve (and other central banks) would step in to help investment markets if volatility returns, has led to a sharp rise in global equity markets. Global bond yields have also fallen on the belief that the next movement in interest rates is likely to be down rather than up.

Global growth

The US and China remain the major drivers of global growth and following the change of strategy by the US Federal Reserve the possibility of a US recession in 2019 appears to have receded.

The US economy grew by 2.9% in 2018 and, whilst growth for the current year is expected to fall as the impact of President Trump's tax cuts fades, the market has discounted the risk of an imminent recession. The recently released March employment figures were better than expected with the employment count increasing by 196,000. Unemployment remained low at 3.8% and average wages rose by 3.2% over the previous year which should help to sustain spending and growth in the economy. There have also been encouraging statistics from the manufacturing industry with the ISM manufacturers' index rising to 55.3, indicating a continued increase in production.

President Trump's unorthodox economic policies and his protectionist foreign policy agenda remain a cause for concern. In the short term he is pressing the Federal Reserve to cut interest rates so that economic growth can "rocket" but a combination of tax cuts and increased spending have caused the US budget deficit to widen to 5.1% of GDP in 2019 (up from 3.8% last year). February's monthly budget deficit of $234 billion was the largest monthly deficit on record and the deficit for the first 5 months of the US government's fiscal year is up by nearly 40% from the previous year. Proponents of Modern Monetary Theory suggest that deficits are not a major problem whilst interest rates remain low, but the theory remains untested, and we see rising debt levels as a cause for concern.

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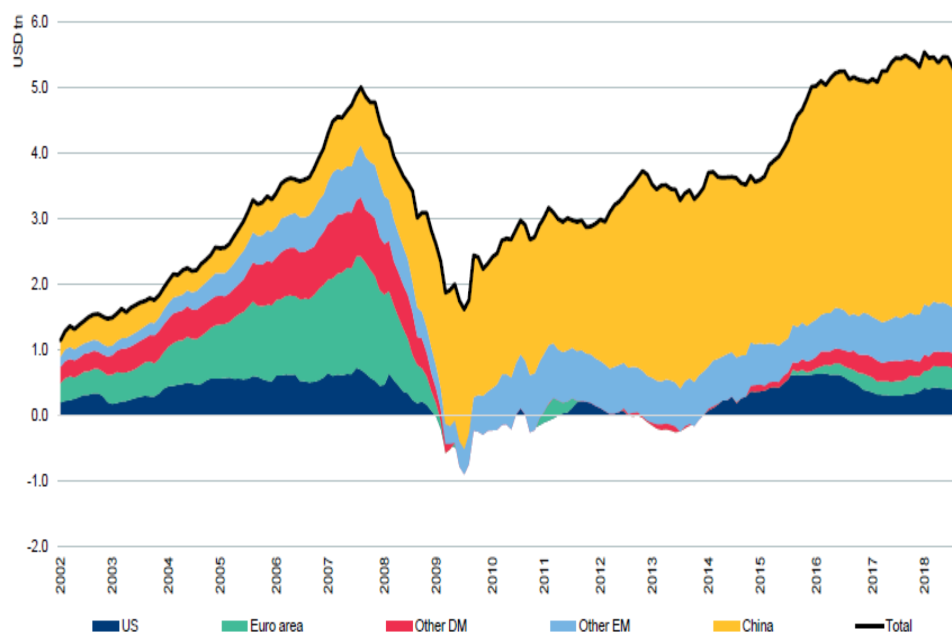
China has also seen debt levels rise substantially over recent years as Chinese authorities have encouraged businesses to borrow in order to maintain high levels of growth. Over the last year the same authorities have started to rein in private sector debt, but as the chart below illustrates, the scale of the existing debt is significant and it remains to be seen what proportion of these loans will ever be repaid.



Source – Newton Investment Management

Chinese economic growth is expected to fall slightly to between 6%-6.5% for the current year (having been set at 6.5% for the last 2 years) but the recent National People's Congress announced a further round of economic stimulus aimed at the consumer and Chinese culprits to help offset the recent deleveraging exercise. The Chinese economy is based on a very different set of rules to the developed world, and whilst their centralised control system allows greater control over elements of its economy, it is important that investors recognise that this often comes at a cost to the individual, and that the protections offered to individuals and to minority shareholders are far less than we are accustomed to.

European growth has been disappointing and the IMF has reduced its growth forecast for the year to 1.1%. German exports have fallen sharply over recent months and recent figures suggest that new orders are down by over 8%. Italy has fallen back into recession and there are political concerns in France and Spain which show no sign of an early resolution.

The UK remains transfixed by Brexit. The original Brexit date of 29 March has now passed and politicians of all parties appear more interested in playing politics than finding a resolution that would satisfy the Houses of Parliament and the British electorate. It has been estimated that a hard Brexit could reduce UK GDP by around 3.5% but these figures are highly subjective and the U.K. economy has continued to confound commentators who predicted that the UK would fall into recession immediately after the referendum vote. Instead the UK has continued to create jobs, and increased levels of Income Tax and Corporation Tax. The uncertainty of Brexit and the threat of US/China and US/EU trade tariffs has affected some sectors, particularly the auto market and UK car sales fell in March (down by 2.4% for the year to date). On a more positive note the most recent survey of the Bank of England Decision Maker Panel (which includes Torevell & Partners) reported that employment levels had increased by 0.7% in the first quarter of 2019 over the final quarter of 2018 and that participants expected employment growth to continue.

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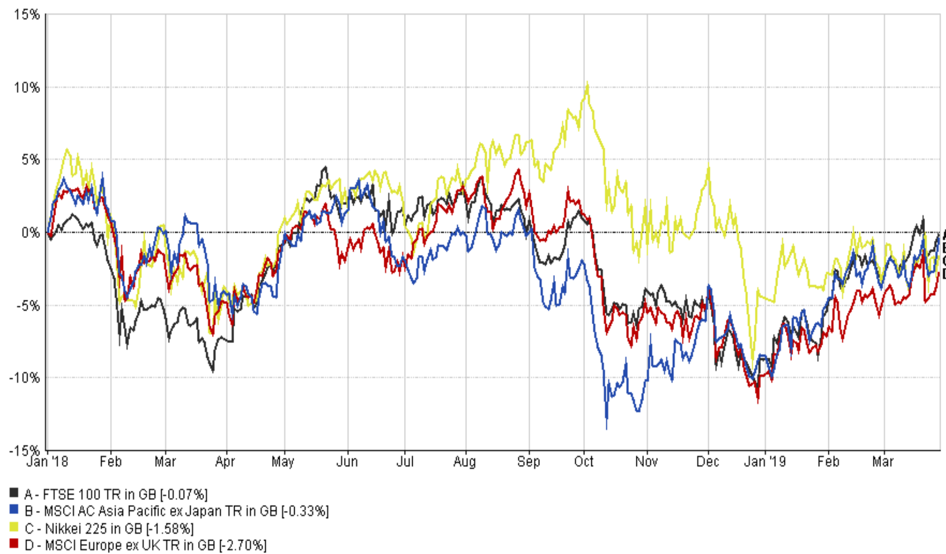
Global equity markets

Global equity markets have risen sharply in response to the central banks' more dovish stance. In the first week of April the S&P 500 index of leading US shares rose to just under 2,900; up 19% from its recent low of 2,351 on 24 December and within 1.5% of its all-time high in September last year.

The US equity market continues to dominate the MSCI World index, but other equity markets have been more subdued. Whilst all of the major global equity markets that we monitor are showing healthy gains in the first quarter of 2019, the MSCI indices for Europe (ex UK), Asia-Pacific (ex Japan), Emerging Markets and Japan are all showing a negative return since the start of 2018 (in Sterling terms).

Whilst most global equity markets have struggled to make progress in 2018/19…

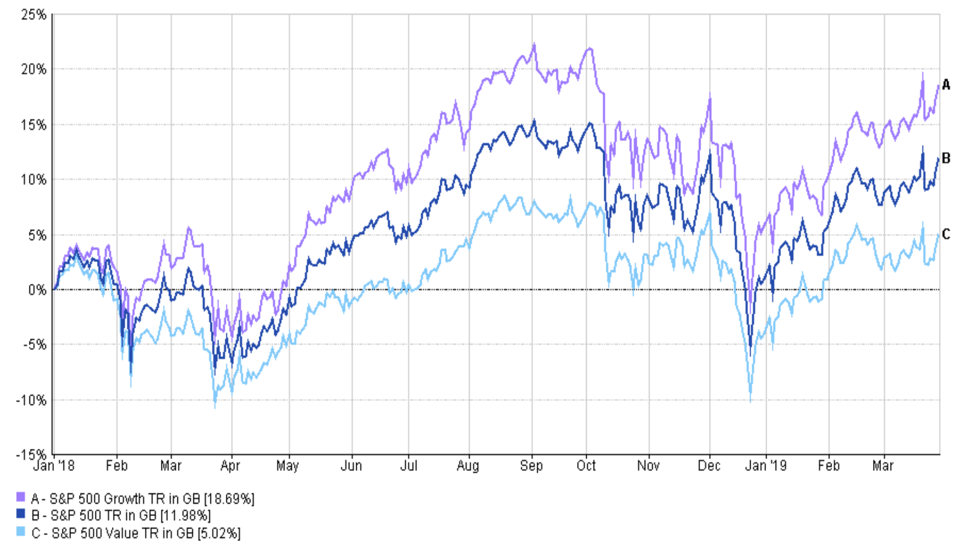


Source – FE Analytics

The US market has recovered strongly over the last quarter, even though earnings expectations for the Q1 reporting season have fallen. In last September, analysts were predicting Q1 earnings growth of 7%. By January the predicted growth figure had fallen to 2.9%, and most recent estimates are suggesting that earnings will fall by 3.7%.

Despite this fall in expected earnings "growth" based shares have continued to outperform the wider index, even though we would have expected their share valuations to be particularly sensitive to any suggestion of faltering growth. Technology stocks exemplify this trend; Apple and Intel are both expected to report lower earnings this quarter, but despite this both stocks have seen their share prices rise by 20% and 15% respectively over the last three months.

The US stock market has continued to move ahead.



Source – FE Analytics

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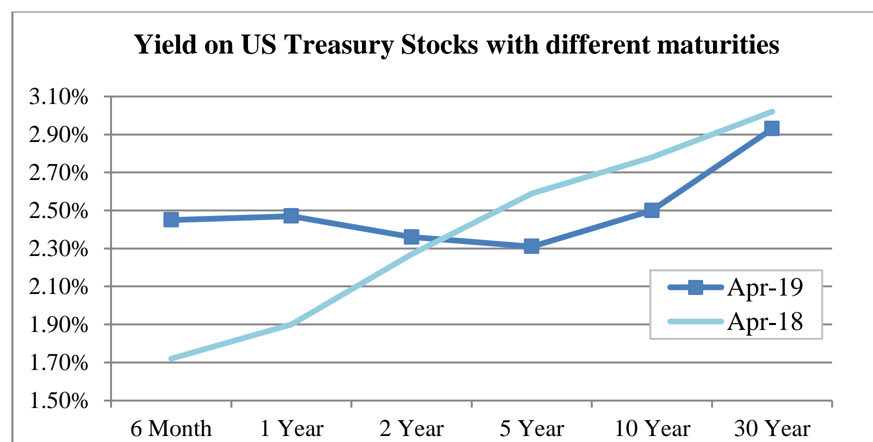
Global debt markets

Global debt markets also rallied on the expectation that interest rates would remain lower for longer than had been expected. The yield on the benchmark 10 year US Treasury has fallen to around 2.5% after rising above 3.2% in November last year.

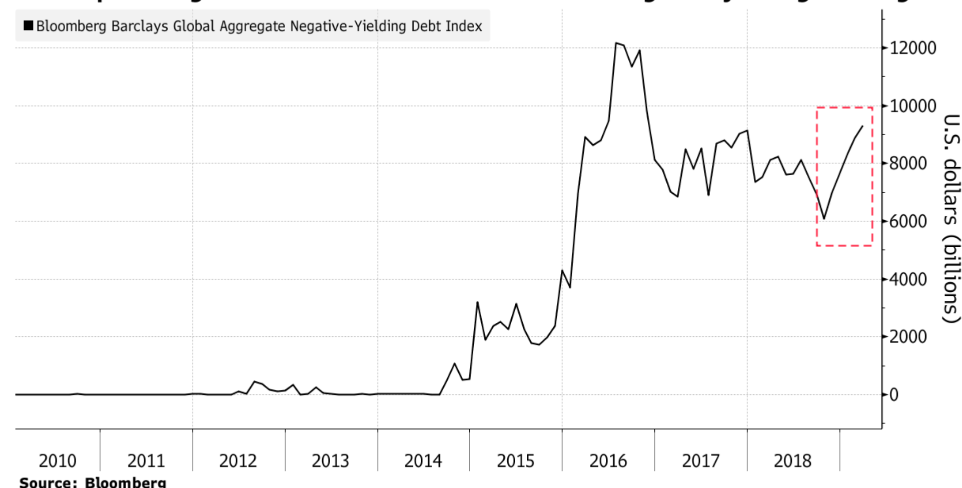
The US yield curve has also seen a "partial inversion" with the yield on the 5 year U.S. Treasury lower than the yields for Treasuries with shorter maturities of 2 years or less.



Source data taken from Financial Times and Bloomberg

A full yield inversion (when the yield on the 2 year Treasury is higher than the 10 year yield) is traditionally seen as a sign of an impending recession, but the correlation for partial inversions appears far weaker and past experience has shown that equity markets can continue to rise for some time after an inversion has taken place. Furthermore, when yields are persistently low, for example in Japan, the link between inversions and recessions appears to break down. We see current yield curves as a reflection of the distortions in US and global debt markets but remain concerned that the global economies' addiction to low interest rates is far from healthy.

Yields on Eurozone debt have fallen since the final quarter of last year. At the end of March the yield on the ten-year German Government Bond index was negative having been as high as 0.57% in October and 0.77% in the early 2018. An index of negative yielding debt produced by Bloomberg and Barclays indicates that levels of negative yielding debt have grown by over $3 trillion (or 60%) since last October to around $9 trillion in mid-March.



Investors' continued appetite for yield has been demonstrated recently by the huge demand for Saudi Aramco's (the Saudi state owned oil company) debt issue. Over $100 trillion of orders were lodged for the $12 billion Bond issue with yields lower (and therefore prices higher) than for Saudi sovereign debt.

There are also signs that market leverage is increasing and that the quality of the covenants over these debt issues is reducing. An analysis of Moody's data for US corporate debt for the first three months of this year shows 97 downgraded debt issues and 75 upgrades. The downgrades include 8 "fallen angels" which have moved from investment grade to high yield or junk status. Whilst there are concerns that an increase in defaults could overwhelm high yield markets, the recent increase in the oil price (which helps the heavily indebted US shale oil producers) and low levels of general interest rates have helped ensure that current interest coverage remains strong.

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Summary

Global growth is expected to slow in 2019 after a period of strong synchronous growth in 2017 and 2018.

The strong recovery in investment markets over the last quarter suggests that investors are taking a relaxed view about slowing global growth and the ongoing US and China trade dispute. There is no guarantee that the outcome will be as benign as hoped and President Trump's recent threats to close the Mexican border and to impose tariffs on EU car exporters suggests that protectionism continues to pose a threat to the global economic system.

At the same time debt markets suggest that investors expect global interest rates to remain low for longer than expected. Whilst this may help countries and companies cope with their increased debt burden, high levels of global debt increase the risks of a future financial crisis. With yields low (and in some cases negative) we fail to see how this asset class can produce attractive returns over the next 3-5 years.

The outlook for 2019 remains uncertain. The support of the global central banks has helped to lift market spirits in the short term, but many market valuations remain stretched and the rise in global debt remains a cause for concern.

Events of the final quarter of 2018 have shown that equity markets can be volatile, and that fixed interest markets continue to be seen as a "safe haven" in times of uncertainty. Despite this we retain our preference for well-managed equities over fixed-income investments. Whilst some equity markets appear expensive there are significant variations between companies which we believe will provide the opportunity for experienced fund managers to pick stocks that will produce excellent long term returns.

Against this uncertain economic and political backdrop we continue to recommend that you hold sufficient cash reserves to enable you to take a long term view with your investments.

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