Monthly Letter

December 2018

Marc-Antoine COLLARD
Chief Economist, Director of Economic Research

Economic environment

While there are only a few days left in 2018, it is fair to say that global economic growth has been solid this year. However, it will have been lower than expected, as the desynchronization of the economic cycle has caught most investors off guard. In fact, the divergence between the strength of the US on the one hand, and the slowdown in Europe, China and Japan on the other hand, has propelled the dollar to its highest level in more than 15 years. In addition, global economic activity seems to have peaked at the beginning of the year and has since decelerated, facing headwinds related to the exacerbation of trade tensions and the tightening of financial conditions. Some factors have recently reassured financial markets, however, uncertainties remain.

In many countries, unemployment has reached record lows which is supporting household income. In addition, the sharp drop of oil prices will restore consumers' purchasing power in net energy importing countries. It will also prevent some central banks from monetary tightening that could have triggered the impact of high energy prices on overall inflation. That said, it is still too early to determine how much of this drop is attributable to supply side factors – increased OPEC production and less burdensome sanctions against Iran – compared to factors related to demand – deterioration of the world economic outlook.

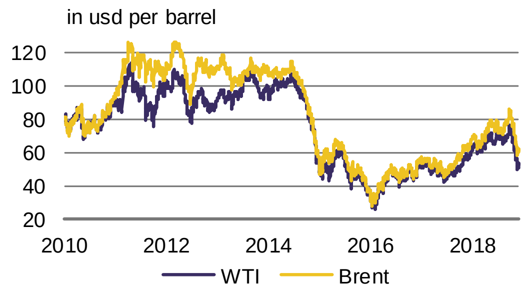
In the US, Fed Chairman Jerome Powell's speech to the Economic Club of New York at the end of November stated that interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy. This "neutral" rate, by definition neither speeding up nor slowing down growth, is a theoretical measure surrounded by uncertainties, and Mr. Powell's comment has been interpreted as the signal for an imminent pause in the normalization of monetary policy. Recent economic data have indeed shown a slowdown in growth in the US, especially in the housing sector. Yet, it is still in line with the Fed's projections in terms of economic growth. What's more, business confidence and labor market data remain robust, as does wage growth. In sum, it would be surprising if the "dots" of the various Fed members to be published at the next meeting on 19 December were to differ significantly from those published last September, indicating a projection of three rate increases in 2019, and one in 2020. Correspondingly, the tightening of global financial conditions could continue for some time, which does not seem to have escaped the attention of the bond market. Indeed, the slope of the US yield curve has continued its relentless flattening, signaling the increased risk of monetary policy error, yet still ignored by almost all Fed officials.

Performances in local currency

	Price as of 11/30/18	1 month % change	2018 % change
Equity markets			
CAC 40	5 004	-1.8%	-5.8%
Eurostoxx 50	3 173	-0.8%	-9.4%
S&P 500	2 760	1.8%	3.2%
Nikkei 225	22 351	2.0%	-1.8%
Currencies			
1 € = ...USD	1.13	-0.1%	-5.7%
1 € = ...JPY	128.99	0.7%	-4.5%

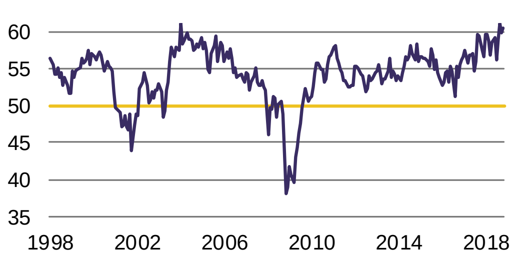
		Price as of 11/30/18	1 month bp	2018 bp
Government bonds				
3 M	Eurozone	-0.70%	6	9
3 M	United States	2.34%	2	97
10 Y	Eurozone	0.31%	-7	-11
10 Y	United States	2.99%	-16	58

World – Oil prices



Source Datastream, Rothschild & Co Asset Management Europe

United States – ISM business confidence index*



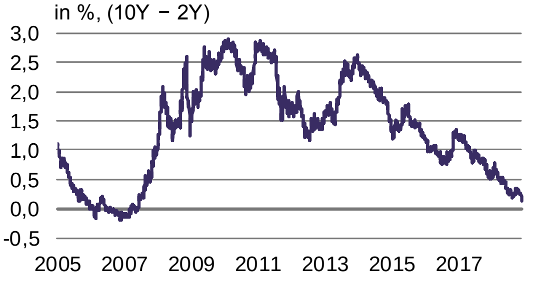
*: 20% manuf., 80% services

Source Datastream, Rothschild & Co Asset Management Europe

Regarding the trade war between China and the US, both countries agreed during a meeting at the G20 Summit in Buenos Aires on a truce of 90 days of which the major implication is the cancellation of the passage of customs duties from 10% to 25%, initially planned for 1 January 2019 on USD 200bn of Chinese goods imported by the US. In return, China pledged to increase its US imports of energy and agricultural goods and to resume talks. While this is undeniably good news, caution is needed because the points of disagreement between the two countries are not only numerous, but also complex to resolve. Furthermore, the Trump Administration warned it could introduce further tariff increases if it believes that China does not make significant progress on the sensitive issues of intellectual property, greater openness of its domestic market or commercial practices which the US has deemed unfair.

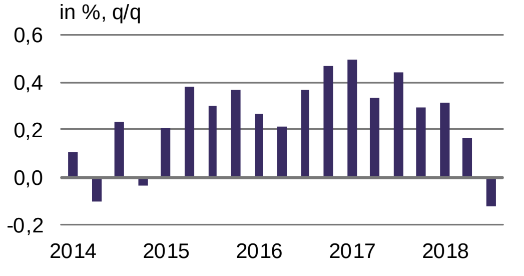
In Europe, the political climate remains complex. In France, the movement of "yellow vests" is likely to have negative effects on economic activity, but the magnitude remains difficult to discern. French President Emmanuel Macron announced that he was abandoning a proposed fuel-tax hike amid fears of more unrest after weeks of nationwide protests. While some protesters celebrated the move as a victory, others said Macron's surrender came too late and is no longer enough to quell the mounting anger. In Italy, Mr. Conte's government seems to be open to make some changes to its twice-rejected budget and thus avoid a disciplinary procedure. That said, no concrete changes have yet been made, as requested by the European Commission. In fact, the change of tone is probably no stranger to the sharp loss of momentum the country has experienced in recent months, as Italy recorded a contraction of GDP of -0.1% q/q in Q3 2018. Finally, in the UK, Prime Minister Theresa May has decided to put her Withdrawal Agreement with the European Union up for a vote on 11 December. At the moment, it seems a majority of MPs are about to reject it, a decision likely to revive the volatility of UK assets, namely the exchange rate. However, investors remain convinced that MPs, under pressure from the financial markets, will eventually accept the text in a second vote given the intensity of the potential negative economic consequences of a "hard Brexit".

United States – Sovereign yield curve



Source Datastream, Rothschild & Co Asset Management Europe

Italy – GDP growth



Source Datastream, Rothschild & Co Asset Management Europe