

Monthly Letter



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Marc-Antoine COLLARD
Chief Economist, Head Economic Research

Economic environment

Since the end of January, volatility has made a noticeable comeback in the financial markets. This is a painful reminder that the financial environment will become much more complex as global inflation normalizes and central banks are expected to adjust accordingly. The turbulence is also explained by weaker than expected macroeconomic statistics, which have cast some doubt on the continued acceleration of the global economy expected by the vast majority of market participants. Furthermore, the risk of protectionist escalation has returned to the forefront.

The recent economic indicators have been rather disappointing. In Asia, Japanese business confidence was lackluster in February and industrial production has dropped in surprising proportions. In China, the NBS business climate index fell sharply, particularly in the manufacturing sector. Overall, business confidence surveys still point to an economic expansion, but less so than in previous months.

The reversal of the confidence indexes was the most pronounced in the Eurozone. Although, in absolute terms, they remain high, the Ifo index in Germany, INSEE in France and Markit for the Eurozone as a whole nevertheless indicate some loss of momentum. The appreciation of the euro, the Chinese economic slowdown and political uncertainty all contributed to this recent trend. In Italy, there was no clear majority in the 4 March vote, but the traditional parties' share of the vote was significantly lower compared to previous elections. Indeed, the far-right Lega (LN) party and the Eurosceptic 5-Star Movement (M5S) garnered almost 50% of the votes and, arithmetically, an anti-establishment alliance between M5S and LN has an outright majority. While such an alliance is not the most likely scenario, this shows the power of populism in recent years and composing a new government will be complicated and take time. Brexit is also a factor of uncertainty as the EU has set out its draft guidelines for trade talks which warn that the UK's current position will result in negative economic consequences. On a positive note, members of the German SPD have finally agreed to join Chancellor Angela Merkel's Grand Coalition, which will likely result in an accommodative fiscal policy stance in Germany.

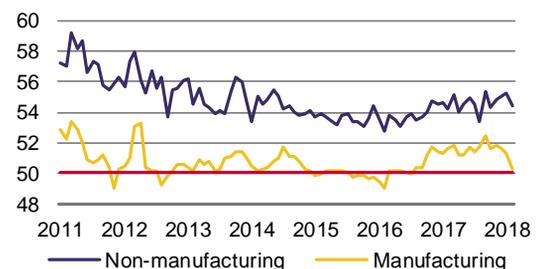
Conversely, confidence surveys in the United States have remained well oriented, particularly in the manufacturing sector where the ISM index has reached its highest level since 2004. That being said, the divergence remains strong between, on the one hand, the aforementioned 'soft data', and on the other, the disappointment of several 'hard data', including retail sales, manufacturing shipments and housing data. In fact, survey data have overestimated the true strength of the economy for some time now and growth projections for Q1 2018 do not show any meaningful acceleration compared to previous quarters despite the very high level of soft data.

Performances in local currency

	Price as of 02/28/18	1 month % change	2018 % change
Equity markets			
CAC 40	5 320	-2.9%	0.1%
Eurostoxx 50	3 439	-4.7%	-1.9%
S&P 500	2 714	-3.9%	1.5%
Nikkei 225	22 068	-4.5%	-3.1%
Currencies			
1 € = ...USD	1.22	-2.1%	1.6%
1 € = ...JPY	130.72	-3.6%	-3.2%

	Price as of 02/28/18	1 month bp	2018 bp	
Government bonds				
3 M	Euro zone	-0.61%	-4	17
	United States	1.65%	20	28
10 Y	Euro zone	0.66%	-4	23
	United States	2.86%	16	46

China – NBS business confidence index



Source Datastream, Rothschild Asset Management

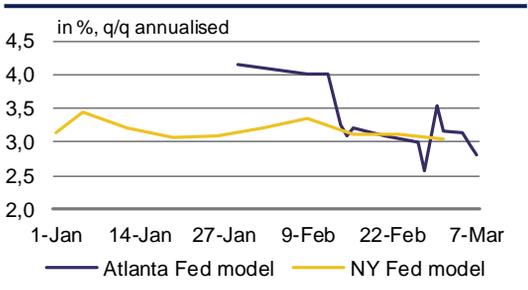
United states – ISM business confidence index



Source Datastream, Rothschild Asset Management

Yet, the new Fed Chair Jerome Powell testified before Congress for the first time and showed clear optimism. The message coming from the written portion of his testimony did not signal any change from the Yellen Fed – i.e. a very gradual normalization – drawing a contrast with Powell’s spoken remarks that point to a risk of a steeper policy rate path. Indeed, he conveyed the message that he has gained confidence that the inflation side of the Fed dual mandate will soon be met, particularly since a series of fiscal measures including tax cuts and increases in spending, have come to pass since December. Correspondingly, if a rate hike is a near certainty at the 21 March meeting, the dots – which summarizes the expectations of Fed members in terms of interest rates – could reveal a less gradual monetary policy normalization.

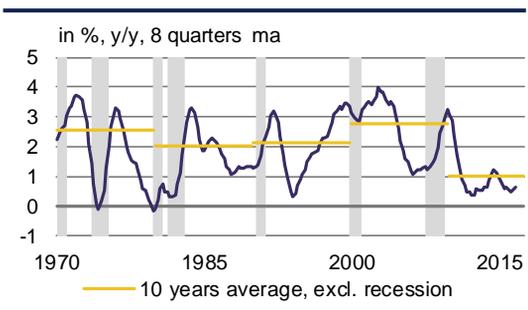
United states – Q1 2018 projected growth



Source Atlanta Fed, NY Fed Rothschild Asset Management

That said, some developments could prompt a number of Fed members to be cautious. First, although it remains limited so far, the small acceleration of certain price indexes and wages in the US has been sufficient to reintroduce volatility into financial markets, which naturally tightens monetary conditions. Second, the debate on the return of cyclical inflation has not been resolved. Indeed, the upward pressure on costs and prices could be less intense than expected. Among the various factors, demographics play a role since the gradual exit of the baby boomers from the labor market weighs on the level of the average wage. In addition, digital disruption is a real challenge for traditional retail players, especially as the giant Amazon continues to enter into a growing number of sectors. What’s more, low productivity is a determining factor in the low growth of wages and price increases.

United States– Productivity growth



Source Datastream, Rothschild Asset Management

Finally, Trump administration’s announcement of introducing tariffs on imports of steel and aluminum is worrying. While this measure is not likely to upset the US or global economy, it nonetheless fuels the risk of cascading response measures, and it comes at a time when global trade has been improving. Trump Economic Advisor Gary Cohn's resignation on 6 March removes a key proponent of free trade from the US administration, and likely further raises concerns about the prospect for protectionism.

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