Monthly Letter

April 2018

Marc-Antoine COLLARD
Chief Economist, Head Economic Research

Economic environment

Between the decline of the stock markets and a less favorable tone of business surveys, the economic and financial landscapes have somewhat deteriorated. If it is too early to declare the reversal of the cycle, market participants were nevertheless contradicted by events. Indeed, it was widely accepted that the synchronization of economic activity along with US tax reforms would generate solid growth around the globe, opening the door to a rise in commodity prices and a strengthening of wages and inflation.

Yet, after last year's improvement, the potential for further acceleration of global growth now seems limited and certain indicators need to be monitored with vigilance. In the US, the flattening of the yield curve continues as the spread between the 10-year and 2-year US government bond rates fell below 50 basis points. The inversion of the yield curve is fortunately still a long way off as, in the past, an inverted curve proved a reliable indicator of an impending recession. Meanwhile, the expected benefits of the tax reform are, for the moment, hardly visible. The confidence indices of households and businesses remain at high levels, but still seem disconnected from the accounting reality of economic activity. While business investment remains healthy, net exports continue to deteriorate despite the weak dollar, household consumption has weakened, and housing investment is suffering from rising interest rates. In sum, the pace of US growth remains modest to moderate. If this trend were to continue without the Fed tempering its optimism and changing its projections of rate increases, then monetary policy could paradoxically become too restrictive despite the historically low level of the Fed's funds rate.

In Asia, last year's momentum seems to be fading. In Japan, the Markit index of business confidence fell in March, both in the manufacturing and services sectors, returning to its September 2016 level. In China, the Markit index also declined and, more broadly, Markit's aggregate emerging markets manufacturing index declined to a five-month low of 51.3 last month, down from 51.9 in February and the five-year high of 52.2 in December. Overall, these surveys are still strong by the standards of the past five years, but they add to the evidence that growth in the emerging economies slowed over the course of the first quarter. What's more, exports in South Korea and Taiwan, two emblematic countries of world trade, are showing a clear downward trend.

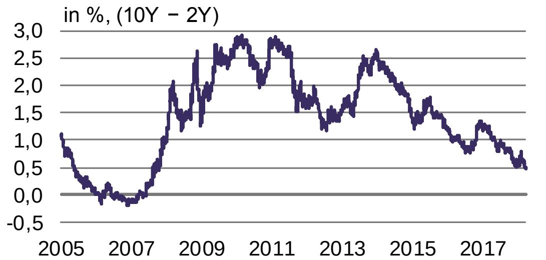
That said, the reversal of the confidence indexes was most pronounced in the Eurozone, particularly in the manufacturing sector which recorded a third consecutive monthly decline.

Performances in local currency

	Price as of 03/31/18	1 month % change	2018 % change
Equity markets			
CAC 40	5 167	-2.9%	-2.7%
Eurostoxx 50	3 361	-2.3%	-4.1%
S&P 500	2 641	-2.7%	-1.2%
Nikkei 225	21 454	-2.8%	-5.8%
Currencies			
1 € = …USD	1.23	0.8%	2.4%
1 € = …JPY	131.15	0.3%	-2.9%

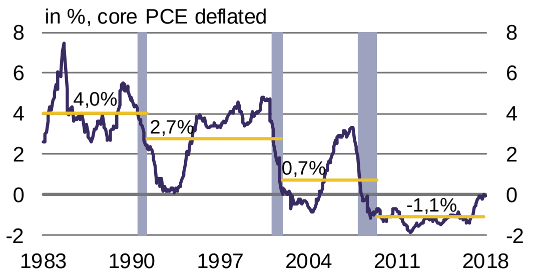
		Price as of 03/31/18	1 month bp	2018 bp
Government bonds				
3 M	Euro zone	-0.57%	3	21
	United States	1.70%	5	32
10 Y	Euro zone	0.50%	-16	7
	United States	2.74%	-12	33

United States – Yield curve



Source Bloomberg, Rothschild Asset Management

United states – Fed's funds real rate



Source Datastream, Rothschild Asset Management

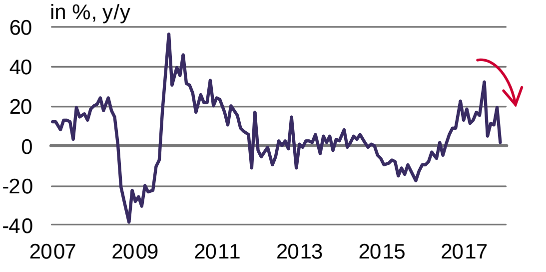
Rothschild
Asset Management

If confidence remains, in absolute terms, at a high level, the rise of the euro and the slowdown in China are all factors that weigh on the morale of businesses in the Eurozone, in addition to the uncertainty surrounding the threat of protectionism.

The introduction of customs tariffs on steel and aluminum imports, announced by US President Donald Trump in early March, has probably marked the first step in the tightening of the President's protectionist rhetoric, in part because of the amount involved and because the tariffs affected all trading partners. Granted, since then, several exemptions have been made, namely for the European Union and NAFTA members, but they are temporary and subject to further negotiations. Subsequently, President Trump directed US trade officials to identify a further $100bn worth of tariffs on Chinese imports, upping the prior proposed $50bn. The response from the Chinese authorities has been much stronger than most observers anticipated with the publication of a list of US products that would potentially be subject to a tariff if the Trump Administration decided to go forward with its plans. However, both countries are trying to reassure financial markets by opening the door to negotiations to avoid escalation that could undermine global growth.

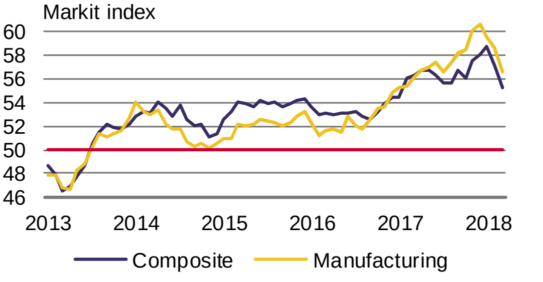
Still, the latest changes in the Trump Administration suggest that protectionist and isolationist rhetoric seem to be gaining momentum. Indeed, several members deemed “moderate” – Gary Cohn as Economic Adviser and Rex Tillerson as Secretary of State – have left and were replaced by known hardliners on economic and geopolitical issues. It remains to be seen whether the renewed uncertainty concerning the dynamics of international trade that these changes have brought will be validated or not by concrete actions. In this regard, the upcoming decision in May on the Iran Nuclear Agreement will be an important test. Since his election campaign, Trump has steadfastly declared his will to end it, even issuing an ultimatum to the signatory European states to correct the shortcomings of the agreement, which he considers “the worst in American history”. Otherwise, the US will come out with the reintroduction of sanctions against Iran, potentially heralding a rise in geopolitical risks.

South Korea and Taiwan - Exports



Source Datastream, Rothschild Asset Management

Eurozone – Business confidence



Source Datastream, Rothschild Asset Management