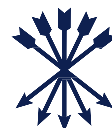
Monthly Letter

April 2019



Economic environment

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Recent asset price swings highlight once more the extraordinarily tight relationship between central banks and financial markets. The latter scrutinise central banks' every deeds and actions, seeking perennial comfort. Central banks, in turn, examine in detail financial markets to better understand what the future holds for the economy. This interaction helps explain, at least in part, the recent flip-flop of the Fed in its normalisation process, and more broadly the decidedly accommodative shift adopted by a majority of monetary policy makers. Yet, the signals sent by the bond market – crushed sovereign rates, flattening, or even inversion of yield curves – are not compatible with a scenario of stronger global growth and inflationary pressures that historically come with it.

Manufacturing business confidence remains globally depressed, penalised by geopolitical uncertainties, notably Brexit, the Sino-US trade war and the slowdown of the Chinese economy. On the other hand, business confidence in the service sector is less gloomy and this sectoral dichotomy is particularly visible in the eurozone. Indeed, the Markit manufacturing index fell further in March to 47.5, a six-year low, while the Markit in the service sector reached 53.3, helped by sustained domestic demand. The strength of the labour market, the distribution of credit, and the ebb of inflation, due to the fall in energy prices, all supported domestic demand. In addition, the mix of public policies has improved. In response to the weakening of growth and inflation prospects, the ECB has further eased its monetary policy, which will be complemented by the expansionary orientation of fiscal policy where a stimulus of 0.5 percentage points of GDP is expected this year.

In Asia, business confidence indexes have sent mixed signals. The Markit manufacturing in South Korea (48.2) and Taiwan (49), both bellwethers of world trade, have recovered, although the indexes remained under 50, in contraction territory. In Japan, the Tankan Index, published quarterly by the Bank of Japan (BoJ), showed sentiment among large manufacturers falling to a two-year low in Q1 2019, representing the biggest point loss since Q4 2012. What's more, the drop in the outlook sub-index came as a surprise, suggesting businesses do not expect a quick end to the gloom surrounding Q1. At its monetary policy meeting in March, the BoJ downgraded its economic forecasts and, while not giving in to alarm, its Governor Mr. Kuroda said he was ready to step up monetary support should the situation deteriorate further.

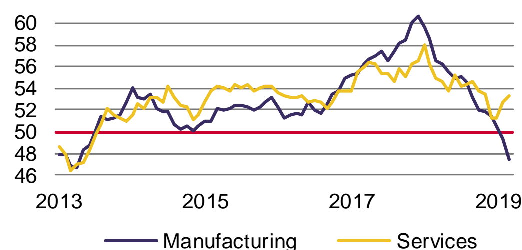
Recent Chinese macroeconomic data have been rather disappointing, in terms of industrial production, as well as property and business investments. However, after three consecutive months in contraction territory, the two main Chinese manufacturing confidence indexes – Caixin/Markit (50.8) and NBS (50.5) – both rebounded in March to above the 50 threshold, their highest since

Performances in local currency

	Price as of 03/28/19	1 month % change	2019 % change
Equity markets			
CAC 40	5 297	1.1%	12.0%
Eurostoxx 50	3 320	0.7%	10.6%
S&P 500	2 815	1.1%	12.3%
Nikkei 225	21 034	-1.6%	5.1%
Currencies			
1 € = ...USD	1.12	-1.3%	-2.1%
1 € = ...JPY	124.16	-2.0%	-1.3%

		Price as of 03/28/19	1 month bp	2019 bp
Government bonds				
3 M	Eurozone	-0.53%	-2	33
3 M	United States	2.38%	-5	3
10 Y	Eurozone	-0.07%	-25	-31
10 Y	United States	2.41%	-31	-28

Eurozone – Markit business confidence index



Source Macrobond, Rothschild & Co Asset Management Europe

China – Industrial production

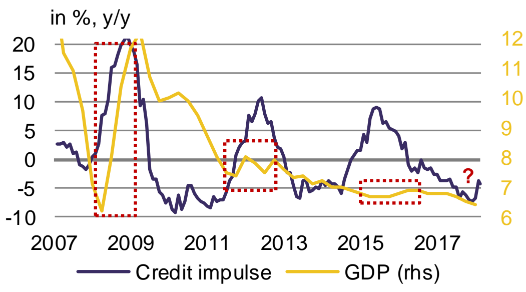
Source Macrobond, Rothschild & Co Asset Management Europe

last summer, thus reviving the hope of a new impetus in the economy, thanks to the support measures put in place by the authorities. More specifically, the monetary stimulus has focused on banks, with the People's Bank of China (PBOC) lowering the reserve requirement ratio, injecting a large amount of liquidity and launching a term-loan facility to support the granting of credit to small businesses. The trajectory of credit growth, however, remains untidy: it had greatly impressed in January, but February data were well below expectations. In any event, the stock market seems to have bet that the Chinese authorities have almost unlimited means to support the economy and that they will use them on a timely basis. That said, the need to contain indebtedness, both for corporates and to some extent households, as well as the necessary efforts related to pollution problems and corruption, represent constraints that could be underestimated by investors.

If the BoJ, the ECB or the BPOC have all aligned in the same effort to soften their policy stance, it is certainly on the side of the Fed that the monetary turnaround was the most spectacular. Admittedly, statistics have somewhat disappointed, especially household consumption. However, temporary factors – government shutdown, weather – are behind what is likely to be a soft patch.

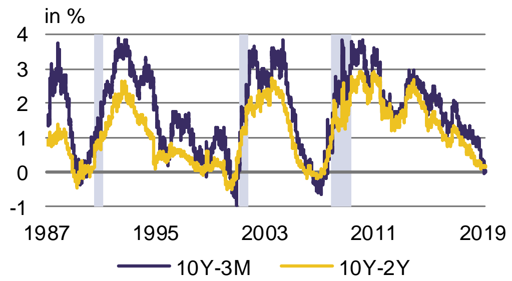
The Fed's capitulation was hailed by the stock market, which is tirelessly continuing its march to new heights. Yet, the reaction of the bond market has been markedly different, sending signals so far almost ignored by equity investors. Indeed, monetary policy easing and the rise in stock prices should have resulted in higher sovereign yields and, at the same time, a steepening of yield curves thanks to a brighter economic outlook and stronger inflationary pressures. Instead, the rate on 10-year German bonds is negative, the rate on 10-year US bonds fell more than 70bps between November 2018 and March 2019, and, above all, the slope of the US yield curve (3 months - 10 years) inverted for the first time since 2007. There is no mechanical pass-through from an inverted yield curve to weakness in the real economy. On the other hand, it is a powerful leading indicator as the yield curve has inverted ahead of every recession in the US over the past 50 years, with only one false positive (in 1998), although it has never been a particularly good predictor of when a downturn might occur. The US economy is admittedly in relatively good shape, but the inversion is arguably reflective of a global expansion that continues to lose momentum. For now, the stock market seems to consider that the signal is today distorted by regulatory changes and the use of unconventional monetary policies. However, one should remember that former Fed Chairman Alan Greenspan explained in 2007 that investors should not worry about the flattening and inversion of the yield curve – his famous "conundrum"– precisely because exceptional factors were at work. The rest is history…

China – Economic growth and credit



Source Bloomberg, Rothschild & Co Asset Management Europe

United States – Sovereign interest rate spread



Source Macrobond, Rothschild & Co Asset Management Europe

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