Monthly Letter

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Economic environment

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While global growth in 2018 remained close to post-crisis highs, the economy is nonetheless weakening at a rate that is much faster than most expected, on the back of disappointing manufacturing activity. Yet, after stumbling in Q4 2018, financial markets have since recovered sharply, supported by the hope that Central Banks will, once again, come to the rescue.

Henceforth, the shift in central bank monetary policy is perceived as a powerful tailwind, after having been a headwind in 2018. Clearly, hope reaches its peak *vis à vis* the Fed. While investors anticipated – and demanded – a patient tone at the first meeting of 2019, this was rather a capitulation. Indeed, for more than three years, the Fed has mentioned that some further gradual increases in the fed funds rate were to be expected. In 2019, two hikes were projected, and one in 2020. However, in its last statement, not only has this reference been removed, but the Monetary Committee (FOMC) implicitly asserted that the next move in the fed funds rate could be a hike… or a cut. In other words, the Fed seems to have come to the conclusion that its monetary policy normalisation is complete, which runs counter to the vast majority of speeches heard in recent months.

In addition, the process of normalising the size of its balance sheet is considered to be much more advanced than previously estimated. If the optimal level is not yet decided, a decision should be made in future meetings. Here again, Fed Chairman Jerome Powell surprised by emphasising that the ultimate size of the balance sheet will likely be much higher than previously anticipated.

In short, between the December 2018 and January 2019 meetings, only six weeks will have passed, but it was enough for the Fed to make a U-turn. This is even more surprising given that during this period, the record 35-days federal government shutdown affected the Department of Commerce, upon which two of the main providers of economic statistics depend, thus depriving investors – and the Fed – from valuable economic indicators of US economic health. What's more, the stock markets have already bounced back quite convincingly.

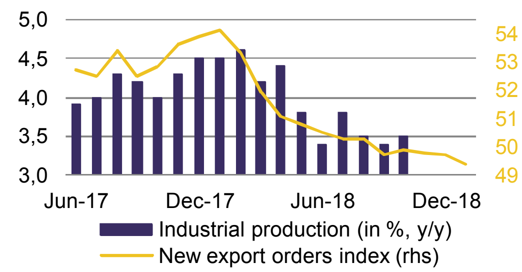
Therefore, it is hard to understand what has convinced the Fed of the sense of urgency. Certainly, it is reassuring that a majority within the FOMC finally recognises the much less accommodative stance of its monetary policy compared to what is generally accepted. On the other hand, the radical nature of the announced changes is perplexing, and at his press conference, Mr. Powell was not very convincing in justifying this drastic change of course. It will thus be necessary to wait for the publication of the new macroeconomic forecasts at the 20 March meeting to attest the sincerity of this change of course. This may explain why these announcements have not triggered the steepening of the yield curve

Performances in local currency

	Price as of 01/31/19	1 month % change	2019 % change
Equity markets			
CAC 40	4 993	5.5%	5.5%
Eurostoxx 50	3 159	5.3%	5.3%
S&P 500	2 704	7.9%	7.9%
Nikkei 225	20 773	3.8%	3.8%
Currencies			
1 € = ...USD	1.14	-0.2%	-0.2%
1 € = ...JPY	124.65	-0.9%	-0.9%

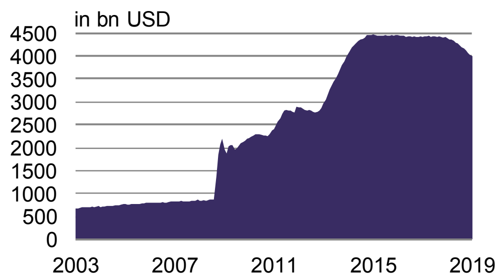
		Price as of 01/31/19	1 month bp	2019 bp
Government bonds				
3 M	Eurozone	-0.54%	32	32
3 M	United States	2.38%	3	3
10 Y	Eurozone	0.15%	-9	-9
10 Y	United States	2.63%	-5	-5

World – Trade and industrial production



Source World Bank, Rothschild & Co Asset Management Europe

US – Fed balance sheet



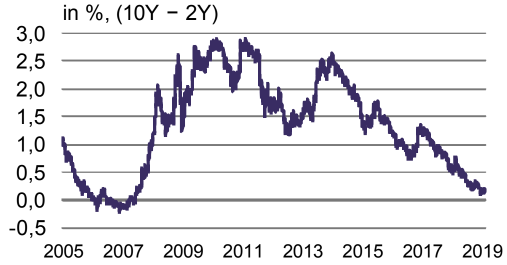
Source Macrobond, Rothschild & Co Asset Management Europe as would be expected, while the continuous improvement of the labour market and the increasingly visible acceleration of wages are likely to challenge the new Fed approach.

Meanwhile, neither the change in tone of the Fed nor the widespread assumption of a successful outcome of the Sino-US trade war will have been able to infuse a reversal in the deterioration of business climate, which is particularly visible in Asia and Europe. As a result, business confidence continues to erode month after month, particularly in the manufacturing sector. In Japan, the Markit index fell sharply to 50.3, with new export orders' sub-index falling at the sharpest rate in two-and-a-half years. In South Korea, the index fell deeper below the 50 threshold (to 48.3) and given the country's close trading ties with China and the US, falling export demand acts as a worrying indicator for global economic growth. In China, the manufacturing index fell to 48.3 in January, the second-consecutive month of contraction and the lowest reading since early 2016.

In the Eurozone, Q4 2018 GDP growth (0.2% q/q) was disappointing amid lower business confidence. Italy has finally succumbed to the impacts of political uncertainty, recording its third recession since 2008. The Italian Markit confidence index has again stumbled in January and fell below 50, confirming a very weak start to the year. Germany has not been spared and is also suffering from the complicated global economic environment. Fortunately, the "yellow vests" movement in France has run out of steam and the first effects of the measures announced last December by President Macron to support household disposable income will be felt in the coming months. More broadly, the decline in oil prices and the higher wage growth in the Eurozone will help support consumers' purchasing power and thus support economic activity. The ECB will nevertheless be forced to maintain an accommodative monetary policy for a prolonged period, especially due to the Fed's wait-and-see attitude and the uncertainty surrounding Brexit.

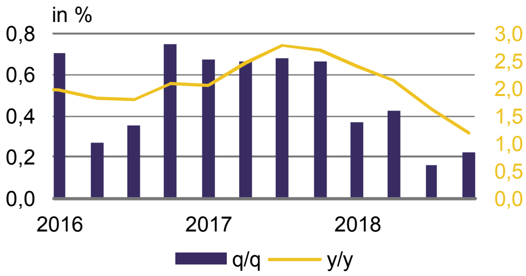
After stumbling against a Parliament fiercely opposed to her Withdrawal Agreement, UK Prime Minister Theresa May was given the mandate to return to the negotiating table with the European Union. On the European side, it is repeatedly stated that certain arrangements can be envisaged, but that the Agreement is broadly the only compromise that can be envisaged if the UK wants to maintain its access to the Single Market until a more comprehensive deal can be negotiated. Both parties have until 29 March to agree and no outcomes can be excluded. The market is nevertheless suggesting that a disorderly exit will be avoided as evidenced by the appreciation of the pound against the dollar and the euro.

US – Yield curve



Source Bloomberg, Rothschild & Co Asset Management Europe

Eurozone – GDP growth



Source Macrobond, Rothschild & Co Asset Management Europe