Monthly Letter

January 2019

Marc-Antoine COLLARD
Chief Economist, Director of Economic Research

Economic environment

The year 2018 ended in stark contrast to the almost euphoric optimism observed earlier in the year. The economic outlook has darkened in recent months and the worries about the weakening of global trade and sharp political tensions prompted financial markets to react abruptly. In addition, high levels of indebtedness in both the private and public sectors continues to increase the exposure of some economies to rising global interest rates, changes in investor sentiment, and currency fluctuations. In short, this is the first time since 2016 that the beginning of the year is marked by so many fears about the global economy.

The deterioration in business climate indices is most visible in Asia and Europe. In the eurozone, the Markit index (51.1) hit a low of more than four years, weighed down by the fall observed in France (48.7), where the "yellow vests" movement led to the first decline of the index in contraction territory in two and a half years. That said, the deterioration affects the entire region, including Germany. In fact, recent German statistics – industrial production, exports, new orders – suggest that the rebound in GDP in Q4 2018 may be much weaker than expected. The decline in eurozone's unemployment rate, which fell below 8% for the first time in a decade, is nevertheless an important factor that will support economic growth. Yet, in this environment, the ECB is unlikely to start normalisation of its monetary policy and might stick to its "3 P" approach – prudence, patience, persistence – for the foreseeable future.

In China, business confidence is also dampening and for the first time in more than two years both the Markit Manufacturing Index and the official (NBS) index released by the Chinese statistical agency have fallen below 50; synonyms of contraction. However, in recent months, the Chinese authorities have put in place many supporting measures. The Central Bank announced a 1% cut in the reserve requirement ratio (RRR) imposed on banks – a half percentage point on January 15 and another on January 25 – to stimulate the economy. This is the fifth decline in the RRR since the beginning of 2018, but the effects of these measures have so far been modest. What's more, the room for maneuver, particularly with regard to the use of credit and debt, is not unlimited in a country where the debt service ratio in the private sector has reached new heights.

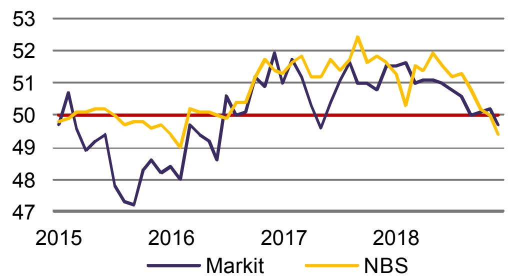
The slowdown in the Chinese economy has become, with the tightening of global monetary conditions, a major challenge for many emerging countries. Protectionism and the trade war led by US President Donald Trump are also partly responsible for slowing growth dynamics. While some of the antagonists' actions may well

Performances in local currency

	Price as of 12/31/18	1 month % change
Equity markets		
CAC 40	4 731	-5.5%
Eurostoxx 50	3 001	-5.4%
S&P 500	2 507	-9.2%
Nikkei 225	20 015	-10.5%
Currencies		
1 € = …USD	1.14	1.0%
1 € = …JPY	125.85	-2.4%

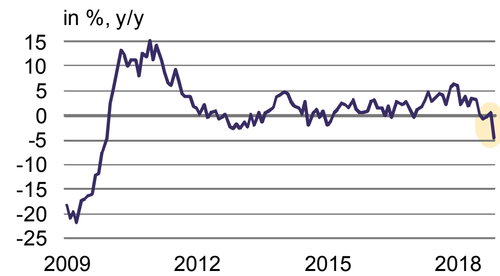
		Price as of 12/31/18	1 month bp
	Government bonds		
3 M	Eurozone	-0.86%	-16
3 M	United States	2.35%	1
10 Y	Eurozone	0.24%	-7
10 Y	United States	2.68%	-30

China – Business confidence index



Source Datastream, Rothschild & Co Asset Management Europe

Germany – Industrial production

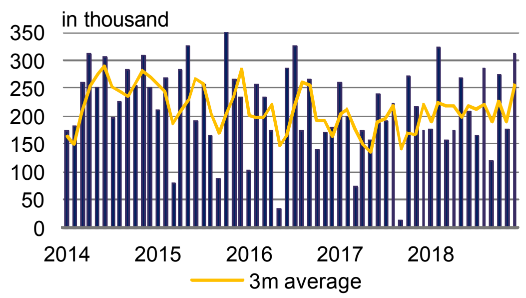


Source Datastream, Rothschild & Co Asset Management Europe be founded on justifiable reasons, they are nevertheless conducted in such an erratic manner that uncertainty has increased. In an environment where a simple tweet has the power to transform a truce on one day into a threat of a tariff offensive the next, it becomes increasingly risky to bet on the future, although it is likely that this uncertainty will persist in 2019.

As the storm clouds brew for the global economy, the drop in the price of oil comes as a breath of fresh air for many countries. Indeed, it will increase the purchasing power of households and support consumption. It will also contribute to the improvement of corporate profit margins, although a disorderly drop in prices could still undermine the oil sector, which has a particularly significant role for the US economy. In addition, the decline in prices will contribute to the patience of central banks because of its disinflationary effect.

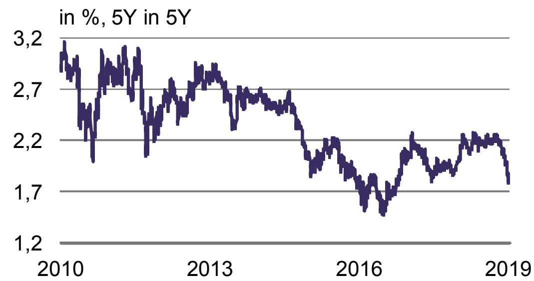
Market participants hope that the Fed will also become a factor of support in 2019 thanks to the bending of its monetary policy. In a speech to the American Economic Association, Fed Chairman Jerome Powell reassured financial markets that he was not implementing a predetermined interest rate policy, implying that the Monetary Committee could pause, if necessary, the tightening of its policy, as it did in 2016. However, Mr. Powell continued by describing a strong economy, supported by a robust labour market which has created an average of 220,000+ jobs in each of the last six months. He also highlighted how wage growth continues to accelerate – albeit gradually – which appears to be the main reason for the pursuit of monetary normalisation. Finally, the 2016 pause came as the ISM manufacturing index remained below the 50 threshold – or slightly above – for almost a year. Yet, while the ISM index (54.1) has fallen recently from its peak reached in August 2018 (61.3), it remains consistent with moderate economic growth. Overall, it may be difficult to convince a majority of Fed members that they should not only consider the effects of rising rates in the US but also beyond its borders, while also considering the high level of uncertainty surrounding the degree of current accommodation, especially as inflation expectations are less firmly entrenched. As a result, the tightening of global financial conditions may continue for some time, or at least until US macroeconomic data begins to deteriorate markedly. This does not seem to have escaped the attention of the bond market as the slope of the US yield curve has continued its relentless flattening, signaling the increased risk of monetary policy error, which is still ignored by many Fed officials.

US – Job creations



Source Datastream, Rothschild & Co Asset Management Europe

US – Breakeven inflation rate



Source Bloomberg, Rothschild & Co Asset Management Europe