Monthly Letter

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Economic environment

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Global economic growth peaked at nearly 4% in 2017, then declined to 3.6% in 2018, and is expected to slow further in 2019 to 3.3%. If this pace remains reasonable, it would nevertheless be the slowest in a decade, weighed down by factors such as the escalation of trade tensions between the US and China, the disruptions in the German automotive sector, tighter credit conditions in China and the tightening of global financial conditions.

However, after several months of relative disappointment, a rebound in economic growth is expected by most forecasters in H2 2019, extending into 2020. Indeed, three main factors would combine to allow economic activity to regain speed. First, the outlook for trade tensions between the US and China has improved. The latter, accused of unfairly supporting its state-owned enterprises, could announce the abolition of its subsidy system, representing a major concession to the US. Moreover, Chinese authorities might also agree to increase imports, not depreciating the yuan, and stop making technology transfers imposed on foreign firms mandatory. The cessation of several months of trade war should then restore dynamism to global trade, which registered in Q1 2019 its steepest drop since the Great Recession of 2009.

Second, China has stepped up its fiscal and monetary stimulus to counteract the negative impacts of US tariffs, and the effects of these measures are beginning to be felt, particularly in the credit data. Robust Chinese growth would not only serve as an engine for its trading partners, but also support the price of raw materials, primarily the base metals produced by several emerging countries. World trade would therefore be stimulated, amplifying the effects of the end of the Sino-US trade war and supporting, for instance, economic growth in the eurozone whose recent weakness is precisely due to a moribund external sector.

Finally, the dovish shift in central banks monetary policy has become a powerful tailwind, after having been a headwind in 2018. In the US, the Fed's pivot has turned into a breath of fresh air for the housing sector as mortgage rates have fallen by some -75 bps to 4.45%, a low since early 2018, thus contributing to a rise in optimism for this sector hardly hit by higher rates last year. In addition, the Fed's turnaround has prompted central banks in many countries to adopt an accommodating tone in the conduct of their monetary policies, made possible by the absence of inflationary pressures despite closing output gaps.

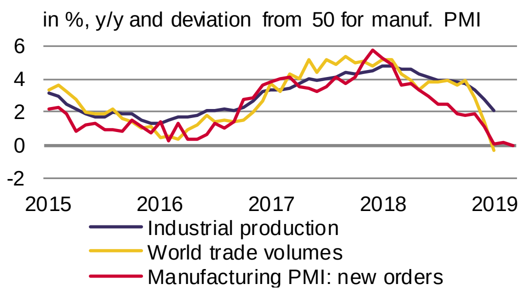
In sum, it is expected that these positive feedback loops will strengthen one another, allowing the global business cycle to accelerate. This is what seems to explain, at least in part, the rather impressive rebound in the equity market since the beginning of the year.

Performances in local currency

	Price as of 04/30/19	1 month % change	2019 % change
Equity markets			
CAC 40	5 586	4.4%	18.1%
Eurostoxx 50	3 515	4.9%	17.1%
S&P 500	2 946	3.9%	17.5%
Nikkei 225	22 259	5.0%	11.2%
Currencies			
1 € = ...USD	1.12	0.0%	-2.2%
1 € = ...JPY	125.02	0.5%	-0.6%

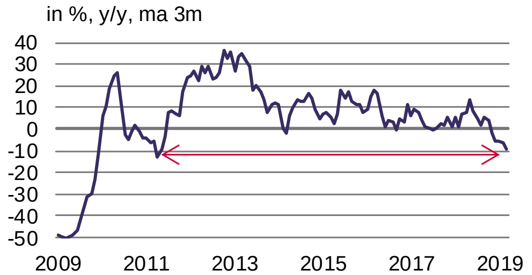
		Price as of 04/30/19	1 month bp	2019 bp
Government bonds				
3 M	Eurozone	-0.57%	-4	29
3 M	United States	2.41%	3	6
10 Y	Eurozone	0.01%	8	-23
10 Y	United States	2.50%	10	-18

World – Confidence, industrial prod. and trade



Source IMF, Rothschild & Co Asset Management Europe

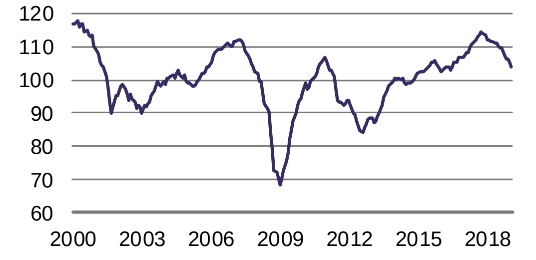
United States – Housing starts



Source Macrobond, Rothschild & Co Asset Management Europe

However, some elements are in contradiction with this scenario of stronger global growth. Indeed, business confidence, especially in the industrial sphere, is struggling to recover as evidenced by the weakness of the Markit global manufacturing index. The rebound in Chinese business confidence in March will not have lasted and reversed in April, and US sentiment is also eroding, even as expectations of a Sino-US deal have never been so high. In the eurozone, the European Commission's index of economic confidence is trending downwards and the industrial sub-component has hit a low point since 2014, when Europe had put in place retaliatory measures against Russia for having annexed Crimea.

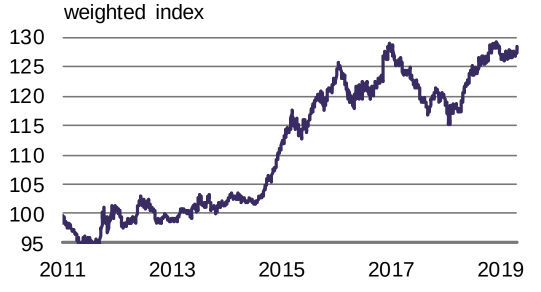
Eurozone – Economic confidence index



Source Macrobond, Rothschild & Co Asset Management Europe

The low sovereign rates also do not seem to indicate a global economy in the process of getting back on track. German rates are slightly negative, French rates are at their lowest since 2016, just before the Brexit vote, and the slope of US yield curve remains flat, having even momentarily inversed on the (3 mo–10 yr) segment. Inflation expectations remain sluggish, especially in the eurozone, where the “5 years in 5 years" inflation rate, a measure closely monitored by the ECB, has hit a bottom since 2016, when uncertainties regarding Chinese and US growth were at their peaks and the price of oil was 25 USD, against nearly 75 USD today.

United States – Effective exchange rate



Source Bloomberg, Rothschild & Co Asset Management Europe

Furthermore, the foreign exchange market seems to contradict the scenario that seems to favour the equity market. Historically, the USD appreciates when global growth is sluggish, and conversely, suffers from a buoyant and more synchronised economic environment. Thus, from 2011 to 2017, the strength of the USD accompanied the gradual slowdown in the global economy. The depreciation observed next in 2017 can be explained by the hopes of a revival of global growth coupled with a rise in inflation, the so-called "reflation trade". However, as these hopes were not realised, the USD appreciated again in 2018, a trend that should have reversed this year in the light of the optimistic outlook for growth.

In short, neither business confidence, nor the sovereign bond market or the foreign exchange market seem to align with the consensus economic scenario. Since the stall speed of the world economy is estimated at around 3%, the weak activity recorded in recent quarters offers little room for manoeuvre to absorb any exogenous shock. In this context, the effects of the rise in the price of oil, mainly due to a supply stock, deserve attention. What’s more, the latest credit cycle was characterised by a growing proportion of lower-rated issuers in the corporate bond market and by a growing volume of leverage loans to heavily indebted businesses with weaker credit underwriting standards, thus providing limited protection to investors in case of default. Correspondingly, lower economic growth could amplify these financial weaknesses and strengthen the slowdown, also something worth keeping in sight.