Taking the temperature of the global economy

Weekly Digest

23 July 2018

– *Richard Stutley, CFA*

Currently the difference between two and ten-year US Treasury bond yields is at its lowest level since 2007, raising fears of an imminent recession. Our base case scenario remains one in which we continue to see a slow, synchronised global expansion. As such we see better value at the front end of the US yield curve and some evidence of mispricing further out, rather than a canary in the coal mine. Nonetheless it is worth spending a minute taking the temperature of the global economy.

An inverted yield curve indicates that investors in aggregate expect future short-term interest rates to be lower than current short-term interest rates. Given that reducing interest rates is expected to increase aggregate demand in an economy and is therefore a tool used by central bankers to try to counter economic downturns, the sight of an inverted yield curve usually means investors are concerned about a recession.

Many investors consider the yield curve to be a reliable indicator of forthcoming recessions. It appears to have some forecasting power when one overlays periods of recession identified by the National Bureau of Economic Research (NBER). However, like most forecasting tools, it is not infallible – it was particularly hypersensitive in the mid-90s – and its usefulness going forwards is likely to be tempered by the increased role of the Fed in markets, through changes to its balance sheet and forward guidance.

There are a lot of geopolitical issues making headlines currently; trade wars, the threat to the Eurozone from populism, Italian politics, Brexit and instability in the Middle East. There is also a lot of change afoot. China is deleveraging, having been the world's biggest credit creator in the last 10 years; the consensus in favour of global supply chains is falling apart, led by Trump's America First agenda; oil prices and interest rates are rising in unison, putting pressure on household spending at a time when wage growth remains weak. These forces have the potential to weigh on global growth and together make for gloomy reading.

Other data points paint a different picture however. Surveys of purchasing managers suggest companies are extremely upbeat about their prospects, with everywhere barring a few isolated areas of emerging markets in expansionary phase. The US economy is currently producing the highest number of jobs in the manufacturing sector since 1998 according to Deutsche Bank, who concludes that the risks of overheating outweigh those of a recession. This is a view endorsed by the Federal Reserve who continue to steer the market towards higher interest rates.

We are conscious of the risks but also see the opportunities. Equity valuations are now more attractive, having traded sideways year to date which has allowed underlying earnings to catch up with stock prices. Meanwhile two-year government bonds in the US are now offering positive real yields for the first time since 2008.

First best is to know exactly what will happen all of the time and to invest accordingly. Few investors have shown that kind of foresight consistently, unsurprising when you consider the number of factors that contribute to key variables like inflation and GDP. Instead, faced with uncertainty, we elect to build robust portfolios that can weather a range of outcomes. Hence, while we do not foresee an imminent recession in the US, contrary to the warnings of the yield curve, we are not wed to a single view of the world.

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The **Marketplace**

- Brent Crude fell 3.0% to $73.07 a barrel
- Gold fell 1.0% to $1229.5 per ounce
- Stocks ended the week roughly flat
- No near-term de-escalation of the trade tensions

Market **Focus**

US

- The Federal Reserve Chair Powell said that the US economy is strong and the best way forward is to keep gradually raising the federal funds rate
- President Trump broke a long standing tradition of respecting the independence of the Federal Reserve by stating that their policy on raising interest rates results in a stronger dollar and takes away the United States competitive edge. Following these comments the dollar index fell 0.1%. Gold prices rose, potentially as a result of this news, however ended the week 1.0% lower
- The weekly initial jobless claims fell to 207,000, below expectations of 220,000 and declined to their lowest level since December 1969.
- US equities ended flat for the week, with neither the release of major earnings reports nor policy developments driving a major move in the indexes.

UK

- UK inflation unexpectedly held steady in June, headline inflation stood at an annual rate of 2.4% in June, unchanged from May and below market expectations of 2.6%.

  The annual core inflation rate fell to 1.9% in June from 2.1% in the May, and below market expectations of 2.2%
- June retail sales fell 0.5% from a month earlier, below market expectations of a 0.2% increase
- On the back of softer CPI and retail sales prints, markets have lowered their expectations that the Bank of England will hike interest rates in August
- Sterling fell 0.7% against the US dollar, notably falling below $1.30 to $1.2980 in the week, as a result of an unexpected drop in consumer spending in June
- Prime Minister Theresa May narrowly won a vote by 307 to 301, enabling the government to maintain the option of Britain entering a customs union if a free-trade deal with the EU is not agreed
- The FTSE 100 index rose 0.2% to end the week at 7678.8

Europe

- The Euro Area core consumer prices index increased 0.90% in June over the same month in the previous year
- The Euro Stoxx 50 had another flat week, ending the week up 0.2% at 3,460

The rest of the world

- The Chinese yuan fell 0.7% against the US dollar this week, falling for six consecutive weeks and to its lowest level against the dollar since July 2017. This follows the intensifying trade discord between US and China
- President Trump says he is prepared to levy tariffs on $500bn of US imports from China, threatening tariffs on what amounts to virtually all of China's imports
- The Hang Seng Index fell 1.1% to 28,224.

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 20 July 2018	Month to date	YTD 2018	12 months
Developed Market Equities					
United States	USD	0.0%	3.1%	5.6%	14.8%
United Kingdom	GBP	0.2%	0.5%	1.9%	6.1%
Continental Europe	EUR	0.5%	2.3%	1.0%	2.0%
Japan	JPY	0.9%	0.8%	-2.9%	9.1%
Asia Pacific (ex Japan)	USD	-0.5%	0.0%	-4.2%	5.0%
Australia	AUD	0.3%	1.5%	5.8%	13.9%
Global	USD	0.2%	2.4%	2.9%	11.0%
Emerging markets equities					
Emerging Europe	USD	-2.7%	-1.2%	-9.5%	-0.9%
Emerging Asia	USD	-0.8%	-0.5%	-5.5%	4.7%
Emerging Latin America	USD	2.8%	7.1%	-4.9%	-0.7%
BRICs	USD	-1.0%	-0.1%	-4.7%	8.5%
MENA countries	USD	0.9%	2.1%	11.2%	10.0%
South Africa	USD	-0.1%	1.9%	-13.9%	1.4%
India	USD	-0.4%	2.5%	-1.9%	5.8%
Global emerging markets	USD	-0.5%	0.5%	-6.2%	3.3%
Bonds					
US Treasuries	USD	-0.4%	-0.1%	-1.3%	-1.0%
US Treasuries (inflation protected)	USD	-0.7%	-0.2%	-0.3%	1.7%
US Corporate (investment grade)	USD	-0.1%	0.9%	-2.4%	-0.8%
US High Yield	USD	0.1%	0.6%	0.7%	2.3%
UK Gilts	GBP	0.5%	0.6%	1.0%	2.3%
UK Corporate (investment grade)	GBP	0.2%	0.5%	-1.3%	0.4%
Euro Government Bonds	EUR	-0.2%	0.0%	0.6%	1.5%
Euro Corporate (investment grade)	EUR	-0.2%	0.2%	-0.4%	0.8%
Euro High Yield	EUR	0.0%	1.2%	-0.6%	1.4%
Japanese Government	JPY	0.0%	0.2%	0.9%	1.5%
Australian Government	AUD	0.1%	0.2%	2.1%	3.7%
Global Government Bonds	USD	0.0%	-0.1%	-1.0%	0.6%
Global Bonds	USD	0.0%	0.1%	-1.4%	0.5%
Global Convertible Bonds	USD	0.0%	0.1%	0.0%	0.8%
Emerging Market Bonds	USD	-0.1%	1.9%	-4.3%	-3.2%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 20 July 2018	Month to date	YTD 2018	12 months
Property					
US Property Securities	USD	-1.4%	-0.4%	0.1%	1.1%
Australian Property Securities	AUD	-0.6%	1.5%	1.8%	9.6%
Asia Property Securities	USD	-0.4%	-0.9%	-3.6%	3.6%
Global Property Securities	USD	-0.8%	-0.3%	-1.2%	4.3%
Currencies					
Euro	USD	0.3%	0.3%	-2.6%	0.6%
UK Pound Sterling	USD	-0.7%	-0.6%	-3.0%	1.1%
Japanese Yen	USD	0.7%	-0.8%	0.8%	0.0%
Australian Dollar	USD	0.0%	0.2%	-5.1%	-6.9%
South African Rand	USD	-1.4%	2.1%	-8.0%	-3.8%
Swiss Franc	USD	0.8%	-0.3%	-2.1%	-4.4%
Chinese Yuan	USD	-0.7%	-2.2%	-3.9%	-0.5%
Commodities & Alternatives					
Commodities	USD	-0.6%	-3.9%	1.7%	11.9%
Agricultural Commodities	USD	1.3%	-0.4%	-1.1%	-8.1%
Oil	USD	-3.0%	-8.0%	9.3%	48.2%
Gold	USD	-1.0%	-2.1%	-5.9%	-1.3%
Hedge funds	USD	-0.2%	0.7%	-0.2%	2.2%

Source: Bloomberg. Past performance is not indicative of future returns

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