BANTLEON
Institutional Investing

Investment Insight

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Lean times ahead

Growth in China and Europe is slowing down. Robust economic growth is now restricted to the USA. But here too, the medium-term prospects are deteriorating. Yields have risen lately but can be expected to move into reverse again as central banks continue to pursue expansionary policies.

The US employment engine is still running smoothly. While the number of newly created jobs in July, at 157,000, was lower than expected, the employment growth figures for the two previous months have been revised upwards by a total of 59,000. Overall, some 214,000 new jobs have been created per month during the first seven months of the year. Compared with the previous year (+180,000), this represents a respectable upturn, on the same scale as the increase in GDP growth (+3.2% in H1 2018 (annualised) compared with +2.6% in 2017).

As far as the current quarter is concerned, the robust expansion in employment can be expected to continue for the time being. However, the first signs of a negative turnaround are starting to emerge. There was a surprisingly marked fall in the ISM Purchasing Managers' Index for manufacturing in July, from 60.2 to 58.1 points, putting the index at the lower end of its recent sideways range. The orders component, generally a leading indicator, fell even more strongly, dropping from 63.5 to 60.2 points, its lowest level for more than a year.

For its part, the Fed is sticking to its pattern of raising key interest rates at every second FOMC meeting. Following the hike in mid-June, the central bank last opted to leave key rates in a band of 1.75% to 2.00%. We expect the economic parameters in the fourth quarter of 2018 to continue to justify interest rate hikes, resulting in a band of 2.25% to 2.50% by the end of the year.

In 2019, however, things look set to change. Core inflation (currently at 1.9%) is likely to rise slightly above the Fed’s 2.0% target. Yet we also expect to see the economy lose considerable momentum on the back of poorer financing conditions, which are clearly visible in our downward-trending long-term Financial Conditions Index. On this basis, we are anticipating a total of four 25-bp interest rate hikes in 2018 followed by just two more next year to give a range of 2.75% to 3.00%.

The economic slowdown has long been a reality in Europe. GDP growth in the Eurozone was even more of a disappointment in Q2 than it had been in the first quarter of 2018. Rather than picking up speed, as expected by many analysts after the meagre +0.4% recorded in Q1, the economy actually weakened a bit more. According to the first Eurostat estimate, GDP grew by a mere +0.3% in the second quarter (compared with the previous quarter). This means that growth during the first six months of the year has only been half as high as during the previous four quarters. The previous average figure of +0.7% (annualised +2.8%) has been slashed to +0.35% (annualised +1.4%).

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To date, France has been one of the obvious disappointments in 2018. For the second time in a row, economic performance there has merely expanded by +0.2%. Equally striking, however, is the fact that Spain, previously the growth engine, has been losing ground. Until just recently, it was a safe bet that Spanish economic growth would outstrip the Eurozone average, thanks not least to smart political decision-making in the wake of the financial market and euro crisis (e.g. implementation of the 2013 labour market reform). In addition, there was a huge need for catch-up purchases of consumer durables such as cars and electric appliances, as well as for catch-up investment in machinery and equipment.

Now, however, the picture is not quite so rosy. There has been a political standstill in Spain for more than two years now, and the catch-up effects are starting to dry up in some areas of the economy. The latest indication of this comes from the Spanish Composite Purchasing Managers' Index, which reached its lowest point for many years in July.

The most up-to-date GDP figures for the Eurozone are definitive proof that it was not just temporary factors that were hampering growth at the start of the year. Rather, there is a more general gloom descending on the economy. While it was primarily the export sector that was losing speed in the first three months, all major demand components came under pressure during the second quarter of the year. Some sort of recovery is expected during the third quarter, but the clouds darkening over the global economy mean that it will lack substance and come to an end again by the fourth quarter.

China is currently giving out mixed signals. While the Chinese government is intensifying its efforts to combat the negative impact of the trade row with an expansionist fiscal policy, tax cuts and investment in infrastructure, the latest purchasing manager indicators show that the economy is still losing momentum. The Bureau of Statistics' manufacturing PMI fell from 51.5 to 51.2 points, while the Markit equivalent slipped from 51.0 to 50.8 points. Once again, it is the gloomy prospects for foreign trade that are impacting performance. The partial index covering demand from abroad also slipped back from 48.8 to 48.4 points. We expect the uncertainty to continue, as a result of the trade dispute, with the government continuing to take supportive action. At best, expansionary impetus from a temporary increase in credit growth again should, however, curb the overriding downward movement in economic growth. GDP growth can therefore be expected to shrink further in the second half of the year. With regard to Q4, we expect a figure of +6.5% (after +6.7% in Q2).

At the end of the month the markets were dominated by concerns about the possibility of a new strategy in Japanese monetary policy. Speculation was rife across the globe about a potential reduction in the Bank of Japan's monetary stimulus programme. *Yields on Bunds and T-Notes were driven upwards by rising JGB yields. When the BoJ finally announced its decision, there was little sign of any exit, however.* The central bank has introduced explicit »forward guidance« for the time being, according to which it intends to maintain the »current extremely low levels of short- and long-term interest rates for an extended period of time«. In other words, any exit from the programme has been pushed even further into the future. Yields fell again across the globe in response to the news.

The potential for economic disappointment in Europe, Japan and the UK is high

With the exception of the USA, the global economy is in any case beginning to stall. The potential for economic disappointment in Europe, Japan and the UK is high. Despite downward corrections, the BoJ, for example, is still expecting to see inflation rise relatively strongly. Meanwhile, the Bank of England is predicting that Brexit will have a fairly mild impact on GDP growth. We tend to be more sceptical and are expecting the global economy to continue to weaken over the course of the year. Consequently, yields and equity prices can be expected to dip further too.

BANTLEON BANK AG
Bahnhofstrasse 2 | CH-6300 Zug
Telephone +41 (0) 41 728 77-58 | bantleon@bantleon.com