BANTLEON
Institutional Investing

Investment Insight

May 2018

Caution advised

After a weak first quarter, the economy can be expected to pick up in the USA and Europe in the spring. However, the upswing cannot really be expected to last. The leading economic indicators show muted growth prospects that could also have a negative impact on the equity markets.

The US employment rate continued to fluctuate in April, as expected. With 164,000 new jobs, the increase exceeded the March results, but still remained below analysts' expectations. However, as the figures for the previous month were corrected upwards, from around 30,000 to 135,000, the overall results for the two months are quite close to expectations. More surprisingly, wages rose slightly once again, increasing by 0.1% compared to the previous month; the annual rate thus remained unchanged at 2.6%. The unemployment rate, however, declined from 4.1% to 3.9%, thereby reaching a new 17-year low. The rate is now only two-tenths away from an almost 50-year record.

The current low wage pressure shows that at present, the risk of inflation generated by the labour market is limited. However, the steadily declining unemployment rate is an indication of growing labour shortages that will lead to greater increases in wage levels sooner or later. The positive labour market trends of recent quarters can be expected to continue in the coming months, as the economic climate is favourable at present. Private consumption, after slumping in the first quarter, is showing a clear recovery, while corporate investments continue to drive the economy. GDP growth should therefore pick up noticeably, from 3.0% to 3.5% (after +2.3% in the first quarter).

Over the longer term, however, the pressure from the tight labour market and interest rates, which recently increased significantly, should not be underestimated. Yields on 10-year government bonds have more than doubled since the interest rate trough of mid-2016; yields on two-year treasury notes have increased fivefold. At the same time, we expect three further interest rate increases of 25 basis points each this year. In addition to the interest-sensitive housing construction investments of private households, corporate investments will also be negatively affected by the worsening financing conditions sooner or later. The latest decline in the ISM Purchasing Managers' Index, from 59.3 to 57.3 points, can already be seen as an early sign of a top being reached in investments. Our leading indicators show a downward trend developing in the second half of the year.

European economic trends took a downward turn at the start of the year

The growth slump in the Eurozone is now official: GDP growth slowed in the first quarter of 2018 compared to the previous quarter, to +0.4%; in each of the previous five quarters, the figure was +0.6% to +0.7%. The annual growth rate declined accordingly (from +2.7% to +2.5%). The weakness will likely be apparent across all demand components. The biggest difference in comparison to the previous quarters, however, was in the area of foreign trade. After increasing strongly in the second half of 2017, foreign trade is not expected to have provided any new impetus in the first quarter of 2018.

Special factors such as the weather, strikes, the flu wave and the early Easter all clearly burdened growth at the beginning of the year. Therefore, the current quarter will see a technical recovery, with GDP growth at +0.6% to +0.7%. This temporary boost, however, cannot disguise the fact that the economic trends took a downward turn at the start of the year. Sentiment indicators have been falling across the board since January. The rate of expansion is slowing, and our own early indicators do not show any end to the downturn.

A decline in momentum from the global economy is foreseeable. There has been a turnaround in monetary policy in the USA and China. Rising interest rates are dampening growth in the real estate market. The UK, meanwhile, is increasingly feeling the negative effects of Brexit. Therefore, export growth in the Eurozone can be expected to weaken further, thereby also reducing investment incentives. Our base scenario is a moderate slowdown in the economic environment. If no major shocks occur, such as an ongoing trade war with the USA or sharp drops in the highly-priced financial markets, average growth for the Eurozone in 2018 should once again lie a little over 2.0%, and therefore above the growth potential.

The trend on the financial markets was recently reversed; in contrast to the first quarter, the Eurozone outperformed the US markets. In the USA, the largely disappointing economic data has given a boost to the bears, who will doubtless receive further encouragement in the medium term. The DAX, in contrast, returned to a level of more than 12,800 points thanks to the sudden weakness in the euro, and is thus once again above the 200-day line. The European stock exchanges should not depend too strongly on the declining currency, however. The weakness of the euro in recent weeks is not due solely to the frequently noted interest-rate differential between the currency areas – after all, if this were the case, it would have been an argument against the prevailing trend of currency appreciation that lasted for 12 months.

Outlook for German bunds remains good in an environment of minimal inflation and ongoing low interest rates

We actually see a muted global economic outlook that generally has a greater negative impact in the Eurozone than in the USA. Therefore, caution is advised.

The bond markets will benefit, in an inverse correlation, from the weak economic data. These include the recent »disappointing« inflation rates – euro core inflation declined in April to 0.7%. Consequently, the exit from the ECB's ultra-expansive monetary policy remains a slow process. We assume that the bond purchases will continue at a low level (approx. EUR 15 billion per month) at least until December. With minimal inflation and ongoing low interest rates, the outlook for German bunds, which recently performed surprisingly well, thus remains good.

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