March 2019

MACRO BRIEF

In association with Cormorant Capital.

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LAST MONTH IN MACRO

ECONOMIC OUTPUT (USA)

More than three

Ahead of expectations for an increase of 2.2 percent, the US economy expanded at an annualised rate equivalent to 2.6 percent during the fourth quarter of last year. If the initial estimate from the Bureau of Economic Analysis is accurate, US output grew by 3.1 percent compared with the same time last year. As it stands I see no reason why the US economy cannot sustain growth into the middle of this year. Indeed, if growth is maintained through to July, that would mark the current expansion, at 121 months, as the longest on record. President Trump's administration are bullish; Kevin Hassett, Chairman of the Council of Economic Advisors, expects another 3-percenter for 2019. Meanwhile the Federal Reserve have pencilled-in growth at something closer to 2.3 percent. I think I'm with the Fed on this one.

INFLATION (USA)

Easing PCE

The Federal Reserve's preferred measure of inflation – in the form of the Personal Consumption Expenditure (PCE) Index – finished 2018 1.7 percent higher. Meanwhile, Core PCE (which excludes energy and food costs) is estimated to have increased 1.9 percent. That, incidentally, is the seventh consecutive year in which inflation has undershot the 2.0 percent target. Accordingly, I see no reason at all why the Federal Reserve might be tempted to increase rates in the first half of this year.

It looks to me like equity investors are going to have their cake and eat it.

MANUFACTURING OUTPUT (CHINA)

Arrested decline

The official Purchasing Managers' Index for the Chinese manufacturing sector came in at 49.2 in February. That's still below the neutral 50.0 mark but not much worse than the 49.5 level registered in January. The unofficial measure was recorded at 49.9 in February and compares favourably with a prior reading of 48.3.

It seems to me that China's downturn is easing. That's probably thanks to government policy at home – in the form of increased infrastructure spending and easier monetary policy – and what looks like reasonable progress in trade talks with the US.

TROUBLE IN KASHMIR (INDIA/PAKISTAN)

Flat broke

On the face of it, heightened tensions between nuclear-armed India and nuclear armed Pakistan are, of course, deeply worrying for all sorts of reasons. Mind you, in the narrow context of the capital markets, I see few reasons for investors to be concerned at this stage. Indeed, since the suicide bomb that initiated the current exchange of fire both the MSCI India and MSCI Pakistan indexes are up a little.

That might change of course but I suspect tensions will ease from here; not least because the stakes are high and both sides have rational minds among those in power. But also because Pakistan is in the process of attempting to secure a $12 billion loan from the International Monetary Fund.

Datasource:Bureau of EconomicAnalysis,Wall St Journal, NationalBureau of StatisticsChina, Markit/Caixin,FE Analytics.

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MONETARY POLICY (EUROZONE)

Reverse ferret

Ever since the European Central Bank's (ECB) Governing Council made public their plans to cease net bond purchases, I've been mumbling words to the effect that the end of eurozone QE may not be quite so nigh. I've grown noisier more recently. Indeed, last month I suggested that the…

'…outside chance I've mentioned – that the ECB might edge toward looser, rather than tighter, policy in the months ahead – looks less unlikely with each meeting'.

Then, last week, Mario Draghi surprised a few of us a bit and still more of us a lot by announcing a third round of cheap loans to Eurozone banks (in the form of 'Targeted Longer-Term Refinancing Operations' or 'TLTRO-III' in ECB-speak). At the same time, prior 'forward guidance' promising to hold rates until the summer was extended to 'the end of 2019'. And, since steps to reduce the Bank's balance sheet will not be contemplated until rates do rise, the ECB has effectively extended the life of its QE programme.

Policymakers are apparently motivated by newly-emerged concerns that 'underlying cyclical momentum is somewhat weaker than previously assessed' owing to a list of both external and internal factors which, I have to say, have been apparent for some time now.

And while staff projections for this year have been revised sharply downwards, from as much as 1.7 percent projected in the December report to as little as 1.1 percent in the March publication, expectations for next year have edged down just 0.1 percent and those for 2021 remain unchanged.

In that case, I wonder what effect, if any, the ECB's change of heart might have on the broader eurozone economy. Will another TLTRO help to insulate the eurozone economy from protectionism? From Brexit? From structural changes in the automotive sector?

When asked by the press what he hopes to achieve from this programme of changes, Mario Draghi responded thus… 'Basically, our actions increase the resilience of the eurozone economy and so make us confident, keep us confident that convergence to a sustainable rate of inflation – our objective – will happen'. The thing is, there's just no way of knowing if what he is saying is actually true.

EMPLOYMENT SITUATION (USA)

Oh my giddy aunt

After increasing 227,000 in December and 311,000 in January, expectations were comparatively modest for February. Expectant economists had pencilled-in 180,000 newly filled job posts. In the event only 20,000 were recorded in the Labor Department count. That's what you might call a slump. That shockingly low, but still positive, number coincides with all kinds of signs of a slowing US economy. The Atlanta Fed's 'GDP Now' estimate – which tracks the lot of them – is indicative of an economy growing at an annualised rate of 0.5 percent during Q1. That compares with something closer to 3.0 percent for 2018 as a whole.

I'm not overly concerned about the immediate outlook for the US economy. I'm not altogether unconcerned, mind. I just think there's a good chance that some of the less than-good news that we have seen of late will improve as the effects of the government shut down fade. Even better if we see good progress in Sino-US trade talks.

Datasource:ECB, Wall St Journal,AtlantaFed, LaborDepartment.

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INFLATION (EUROZONE)

Close to 'close to'

The European Central Bank targets inflation 'below, but close to, 2.0 percent over the medium term'. The most recent data, covering the 12 months to February, show inflation to be rising at a rate of 1.5 percent; some why short of that target. Aside from six months during last year and just one month in the middle of the preceding year, inflation has been some way below target for five years now. In fact, the average rate of inflation over the last 72 months comes in at less than 1.0 percent.

It makes you wonder how low inflation might have gone had the European Central Bank not pumped €2.6trillion into the euro zone economy over that time.

INDUSTRIAL PRODUCTION (EUROZONE)

Picking up, or stabilising

Industrial production – the non-services, non-construction part of the economy – rose 1.4 percent across the eurozone as a whole in January. That compares favourably with expectations for something closer to 1.0 percent on the month and a fall of 0.9 percent in December. If I were feeling super-optimistic I'd suggest that might be indicative of some kind of improvement in the outlook. Realistically though, it's just too early to tell. Mind you, the year-on-year comparison, at -3.0 percent, is less promising. Ireland and Germany saw the worst of it with output declining -6.2 percent and -3.4 percent respectively. Meanwhile production is flying in Slovakia and Poland with output increasing 7.2 percent and 6.1 percent respectively.

ECONOMIC OUTPUT (UK)

Stalling, stalled

The Office for National Statistics is the only major-economy statistical authority to publish monthly estimates for gross domestic product. Good, eh.

Anyway, the most recent reckoning rates a 0.5 percent increase in output during January. That's good news, especially since it follows a 0.4 percent decrease during December.

Growth over the most recent three-month period amounts to 0.2 percent and has invariably been described as 'stalled' or 'stalling'. Given the flipping and flopping over Brexit though, I'd say the British economy is displaying a pleasing degree of resilience.

COMPOSITE LEADING INDICATOR (GLOBAL)

A mixed bag

'Easing growth momentum remains the assessment' from the Organisation of Economic Cooperation and Development (OECD) for near-term economic prospects in the 'United States, Canada, the United Kingdom and the euro area as a whole'. Meanwhile the assessment for France 'now points to signs of stabilising growth momentum' with similar signs emerging in China and 'stable growth momentum remains the assessment for India'. 'In Brazil, the tentative signs of growth gaining momentum flagged in last month's assessment have now been confirmed'.

That sounds about right to me. The immediate outlook is neither particularly good nor bad.

Datasource:Eurostat, ONS, OECD.

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YIELD CURVE (USA)

Twisted

There are all kinds of things to be said about the US yield curve, but the hot potato is an 'inversion' which saw the yield on the 3-month US treasury bond register a higher rate than that on the 10-year treasury; an reversal of the normal relationship which sees longer-term rates higher than shorter-term rates. Cue panic about an imminent recession.

I have to admit that I am not especially concerned about the 10y-3m inversion. While it persisted for 5 days (from Friday the week before to Thursday last week), it wasn't matched at the 10y-2y level – where the spread remains positive – nor have we seen a similar inversion in the corporate bond market. Indeed, on a slightly different note, credit spreads (see p.70) look horribly tight to me still and that is not consistent with a significantly poor outlook as implied by bond market participants.

For those reasons(and others),a recession in the US during 2019 is not my baseline expectation.

Having said that, I'm not taking the 10y-3m inversion lightly. It's a mixed picture but my reading of a lot of the academic research on the subject is that the 10y-3m inversion is indeed the more accurate of the many inversions that might signal trouble. But accuracy even there is not perfect and where it does have a strong record the inversion has to persist, on and off, for something like 90 days – a condition way off being met.

No matter, we can still expect equity markets to shift nervously while an inversion does persist.

More generally, the inversion phenomenon's track record has been established during what I would call 'normal' market conditions.

I argue that quantitative easing has changed the dynamic.

It may also be the case that inflation targeting (as the primary goal of independent central banks) might have similarly altered the market dynamic too. There is, for instance, some evidence to suggest that the 'term premium' has been wafer-thin for a while now, and unusually so. Quite how or why is more controversial than the observation itself but if that is indeed the case I'd say the inversion-recession hypothesis is fatally flawed in today's markets – I think the whole thing hinges on there being a functioning term premium.

Naturally, I'm nervous of suggesting that 'this time is different' - and, I don't think I am saying that exactly - but here's ultimately what I have a problem with…

The broadly held market narrative is that an inverted yield curve will precede a recession. (Which further implies that a recession will be preceded by an inverted yield curve).

I'm not convinced of that. I think there is a good chance that either a recession will occur without a preceding inversion or that an inversion my occur without a proceeding recession.

At this moment in time I think the later is the more likely but I'm on guard whatever, and I think the 'defensive side of neutral' remains the optimal position.

Finally, I'm not at all convinced that the next crisis is going to be much of a crisis in the 1997/98 or 2000/2001 or 2008 mould. In my view, a more common short-and-shallow recession is the most likely outcome – whenever that comes. If I'm right, and we encounter it holding anything like a reasonably defensive position, we can focus on the opportunities it presents rather than the associated dangers that others with obsess about.

Data source: US Treasury.

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‘India signalled its intent to modernise its air force well over a decade ago, when it launched a hotly contested international tender process to acquire 126 new fighter jets to replace its ageing fleet of MiGs, which had begun to crash with alarmingly regularity during practice missions. In 2011, India announced it had selected Dassault’s Rafale fighter jet as its preferred plane, but the negotiations over the precise details of the deal got bogged down and were never completed. Four years ago, Mr Modi shocked the aerospace industry when he unexpectedly declared New Delhi was ditching the ongoing talks to acquire the 126 planes from Dassault, and would instead buy just 36 Rafale fighter jets directly from the French government. That deal has come under scrutiny with the Congress party accusing Mr Modi of making the change in order to arrange a sweetheart deal for businessman Anil Ambani, who is supposed to be Dassault’s offset partner for the purchase’.

Source: Financial Times, 03/03/2019.

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'At first blush the job market behaved strangely in February. Nonfarm payrolls barely grew, by 20,000, far less than expected. Yet unemployment dropped to 3.8% from 4%. Payrolls are based on a survey of employers while unemployment is drawn from a survey of households. In recent months the two had moved in opposite directions, producing strong payroll growth but rising unemployment. February's moves correct some of that divergence. Both have likely been distorted by the partial federal government shutdown and cold weather. Averaging over the last three months eliminates those distortions and sends a reassuring message: payroll growth averaged 186,000, about double its underlying demographic trend. The unemployment rate, averaged over three months has still edged up, but may be trending down again. Bottom line: the economy is slowing from last year's robust 3% pace, but the job market gives no reason to think it's in trouble.'

Source: Wall St Journal,10/03/2019.

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'A top European Central Bank official called Friday for a review of the ECB's strategy and policy toolbox after its latest economic forecasts suggested it won't hit its inflation target for years.

The comments from Olli Rehn, Finland's central-bank governor and a lead contender to succeed Mario Draghi as ECB president, underscore concerns among economists that the goals of major central banks may be unattainable amid deep changes in the global economy since the financial crisis.

They come a week after the ECB unleashed a fresh burst of stimulus to help bolster persistently weak inflation, less than three months after phasing out a major stimulus program.

"The deviation of inflation expectations from the ECB's target is worrisome in terms of the effectiveness of, and strategy for, monetary policy," Mr. Rehn wrote in an editorial published by the Bank of Finland.

He called for "a re-examination of the principles, key assumptions and instruments underlying [the ECB's] monetary policy."

Source: Wall St Journal,15/03/2019.

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“I would define this environment, year to date, as fascinatingly counterintuitive,” Michael Arone, chief investment strategist at State Street Global Advisors, told Barron’s. “Stocks are rallying, but bond yields are reflecting much lower growth.” Stocks rose during the quarter because the Fed backed away from raising interest rates, and investors grew more confident that the U.S. and China would sign a trade deal, Arone said. The market was also rebounding from a very rough fourth quarter—“conditions at the end of the year were wildly oversold,” he noted.

Source: barrons.com, 31/03/2019.

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NOTES

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(1) MSCI United Kingdom Value, Bats 100, Bats 250, Bats UK Small Companies, S&P 500, Euro Stoxx 50, Nikkei 225, MSCI Brazil, MSCI Russia, MSCI India, MSCI China, Financial Analytics (2) MSCI United Kingdom, MSCI World ex Value, MSCI Emerging Markets, MSCI United Kingdom Value, Bats 100, Bats 250, Bats UK Small Companies, Barclays Gilt 1 – 5 Years, Barclays Sterling Gilts, Barclays Sterling Gilts 15+, Barclays UK Government Inflation Linked Bond, Financial Analytics (3) MSCI World, Barclays Global Convertibles, Barclays Global Treasury, MSCI World ex UK Large Cap, MSCI World ex UK Small Cap, MSCI World ex UK Value, MSCI World ex UK Growth, MSCI World, MSCI World Equal Weighted, MSCI World High Dividend, MSCI World Minimum Volatility, MSCI World Momentum, Financial Analytics (4) MSCI World Consumer Discretionary, MSCI World Consumer Staples, MSCI World Financials, MSCI World Health Care, MSCI Industrials, MSCI World Materials, MSCI World REITs, MSCI World Technology Hardware & Equipment, MSCI Telecommunications Services, MSCI World Utilities, Financial Analytics (5) SPDR FTSE UK All Share ETF, SPDR S&P 500 ETF, SPDR MSCI EMU ETF, SPDR MSCI Japan ETF, SPDR MSCI Emerging Markets ETF, SPDR Barclays Gilt, iShares Index-Linked Gilts, iShares Global Corporate Bond ETF, iShares Global High Yield Corporate Bond ETF, Mixed Assets assume separate equal weighted parcels of equity and bond exposure (6) Financial Analytics, overseas exposure assumes equal weight in US, Europe, Japan and Asia (7) Reference National Life Tables, Office for National Statistics, sustainable income assumes life expectancy, a gross 5 percent growth rate, annual income paid out at the start of the period.

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