JULY 2019 MACRO BRIEF.

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TOWN CLOSE
Financial Planning

LAST WEEK IN MACRO

EMPLOYMENT SITUATION (USA)

Reverting to mean

The Bureau of Labor Statistics counts a total of 224,000 new posts in June's nonfarm payroll report. At the same time, estimates for April and May were revised down a little bringing this year's average monthly gain to 172,000 compared with 223,000 for last year.

Actually, 172,000 newly recorded posts might be lower than the average for 2018 but it is in line with that recorded in 2017. It looks to me like the US economy is reverting to a moderate pace of growth following what was widely expected to be a temporary boost from The Donald's fiscal stimulus.

The US economy is slowing, but I see few signs of anything more than that.

MONETARY POLICY (USA)

Nutty

The bond market prices the likelihood of anything but a rate cut later this month at close to zero percent. Following last week's rebound in jobs data, a 25 basis point cut in the Fed Funds rate (lowering the upper limit to 2.25 percent) is the clear consensus with the probability of a 50 basis point reduction slashed from 30 percent a week ago to less than 5 percent today. In my view, expectations for a half percent cut were a little nutty.

Generally, rate cuts are not a good thing for stocks. That is because they tend to coincide with horrible slowdowns in economic output and, in turn, lower corporate profits. There are exceptions though. And with few signs of a significant slowdown, I suspect this is one of those exceptions.

MONETARY POLICY (EUROZONE)

Even nuttier

Mario Draghi's term as President of the European Central Bank comes to a close in October. Weirdly, Christine Lagarde, the head of the International Monetary Fund (IMF), will likely replace him. That's weird – in central banking circles – because Ms Lagarde has no formal training in the field of economics and no background in central banking.

She's not the natural successor to one of the more decisive central bankers of our generation. Benoît Cœuré, a member of the ECB's executive board, would have been my first choice but posts among the European Union's elite institutions are not, it seems, filled on merit.

Instead those positions are traded among the political classes behind closed doors. As far as I can tell, a German in a top post here automatically disqualifies a German for a top post there and, of course, roles have to be found for a French national, an Italian, a Spaniard and, if at all possible, one soul from among the little countries for the sake of appearance.

Of course the problem with Ms Legarde's nomination, coming out of the blue as it has, is that we don't really know what to expect; she has no prior relevant established pattern of behaviour to study.

That said, she has, in her role at the IMF, previously displayed support for Mario Draghi's innovations. She is, I think, a dove.

In any case, with headline inflation still some way from the 2.0 percent target, I speculate that Mario Draghi's last act as President will be to open the taps on bond purchases again – or at the very least institute further rate cuts.

Such a course of action will likely tie his successor into doing more of the same for the foreseeable future.

Sources: Bureau of Labor Statistics, CME Group, Eurostat.

COMPOSITE LEADING INDICATOR (GLOBAL)

Large margin of error

The boffins over at the Paris-based Organisation for Economic Cooperation and Development (OECD) have released the results of their latest reading of the runes. As usual, their conclusions are drawn together in a single Composite Leading Indicator (CLI) – a mixed analysis 'designed to anticipate turning points in economic activity relative to trend six to nine months ahead'.

Between you and me, I'm not particularly moved by their work but I know that there are some segments of the market that are, and I like to keep an ear to the ground.
So, here's their latest announcement…

'Among large OECD economies, only Japan and Canada have seen a change in assessment this month (to stabilising growth momentum from easing growth momentum last month) while in the United Kingdom last month's tentative signals of stable growth momentum have now been confirmed, although large margins of error exist due to continuing Brexit uncertainty.

Among other major OECD economies, the CLIs continue to anticipate stable growth momentum in France and easing growth momentum in the United States and the euro area as a whole, particularly in Germany and Italy.

Among major emerging economies, the CLIs continue to anticipate stable growth momentum in China(in the industrial sector), India and Russia, and now also in Brazil'.

Overall, then, the outlook isn't too bad. I mean, it's not exactly good, but it certainly isn't bad. Let's hope they are right.

ECONOMIC OUTPUT (UK)

Still good value

There's a good chance that British economic output declined during the second quarter of this year. If that turns out to be the case, brace yourself for front-page recession stories.

Last week, the Office for National Statistics suggested that growth in the three months to May increased just 0.2 percent following a 0.0 percent reading for the three months prior. That is consistent with the Bank of England's reading…

'Growth in the second quarter will be considerably weaker, in part due to the absence of that stock building effect and Brexit-related, temporary shutdowns by several major car manufacturers. Recent data also raise the possibility that the negative spill overs to the UK from a weaker world economy are increasing and the drag from Brexit uncertainties on underlying growth here could be intensifying .The latest surveys point to no growth in UK output'.

I reckon that if we all spent enough to eke out a 0.3 percent increase in output during the month of June, the second quarter ought to come in on a positive note. If we kept our collective hands in our pockets we'll likely see a small decrease in output, giving rise to fears for a recession.

Of course, there are recessions and there are recessions. If we are to witness a recession, it seems likely that the requisite consecutive quarterly declines will prove slight – I see few credible forecasts for anything other than a short and shallow decline. That could change with the fullness of time, of course. For now though, I see little reason for investors in UK assets to be concerned. UK equities in particular have already priced in a great deal of uncertainty and still offer, in my view at least, very good value indeed.

Data source: OECD, ONS.

ECONOMIC OUTPUT (CHINA)

More jam today, less tomorrow

In its preliminary estimate, the National Bureau of Statistics of China calculates a 1.6 percent increase in gross domestic product (GDP) during the second quarter of the year. The equivalent year-on-year rate comes in at 6.2 percent. That's an increase which is shy of expectations for 6.3 percent and which falls short of the 6.4 percent increase in the prior period. Indeed, the most recent estimate represents the slowest pace of economic growth in a record that stretches back 27 years.

Looking ahead, it seems unlikely that the official measure of output growth will miss the 6.0-to6.5 percent target for the calendar year but a credible estimate will more likely trend toward the lower limit of that range. And then, perhaps only if further steps are taken to boost activity.

Additional stimulus – even more stimulus that is – may come in the form of lower interest rates, lower reserve requirements, relaxed local-government borrowing restrictions, eased limits on home sales and/or purchase subsidies for big-ticket consumer items. The net effect, in varying degrees, will be to encourage greater investment in the first instance and, with luck, additional consumption in the second.

But support for high rates of growth is not without consequences.

Yet more debt will be added to a stockpile which, according to the Institute for International Finance, now amounts to a whopping 304 percent of GDP. At the same time, further support for state-run heavy industry and likely downward pressure on the yuan will not be welcomed by trade negotiators over in the US.

INFLATION (UK)

Spot on

The Office for National Statistics (ONS) calculates a headline increase in the Consumer Price Index of 2.0 percent in the 12-months to the end of June – exactly in line with the Bank of England's target rate.

Downward pricing pressure was apparent in the cost of motor fuels (crude oil is down 11.4 percent in sterling terms compared with this time last year), other fuels and accommodation services while upward pressure persisted in prices for clothing and food. Meanwhile, core inflation rose 1.8 percent and the older Retail Price Index is up 2.9 percent.

EMPLOYMENT SITUATION (UK)

Still good

There's little doubt that the British economy is softening. I reckon output growth slowed to a standstill during the second quarter of this year. The labour market, though, remains firm by comparison. The ONS counts the number of unemployed at around 3.8 percent of the economically active population – a rate not bettered since 1974.

Happier still, the most recent data headlines a faster increase in total pay. Nominal earnings are up 3.4 percent compared with this time last year. Real wages are up 1.7 percent compared with an average real-terms yearly decline of 0.1 percent over the last 10 years or so.

MONETARY POLICY (EUROZONE)

Not bright

During the press conference that followed last week's meeting of the Governing Council at the European Central Bank (ECB), Mario Draghi painted his impression of eurozone prospects. It wasn't pretty.

'…this outlook is getting worse and worse and it's getting worse and worse in manufacturing especially. It's getting worse and worse in those countries where manufacturing is very important. But because of value chains, this propagates all over the Eurozone…'

That is why we can expect rates (currently set at 0.0 percent and -0.4 percent for 'main refinancing operations' and 'overnight deposits' respectively) to 'remain at their present or lower levels at least through the first half of 2020'. In other words, the main tenets of monetary policy will not be tightened for at least a year.

The reasons given, and which colour the gloomy outlook, are a little wishy washy. They are, we are told, '…basically found to be in the general uncertainty that's now been with us for several months, actually more than a year, and which relates… to trade wars, to geopolitical tensions too'.

Anyway, whatever the cause, likely further deterioration in economic output only serves to undermine the ECB's efforts to draw inflation back toward the 2.0 percent target. The most recent reading for the consumer price index measures just 1.3 percent.

I think we are soon going to see something a little more imaginative than a mere rate cut.

MANUFACTURING OUTPUT (GERMANY)

Scary

Last week's 'flash' estimate for the German manufacturing Purchasing Managers' Index (PMI) was a horror show. The PMI takes the form of a diffusion index with anything above the neutral 50.0 mark indicating output which has increased and anything below characteristic of a contraction. July's reading jumped out at 43.1. Actually, it's not all that bad I suppose. Germany's services companies are sustaining solid growth – the flash estimate in that sector measured 55.8 – meaning that the composite index sees Europe's largest economy just about holding it's head above the water. As an aside, the worse the economic data gets in Germany, the more I like German stocks. They, with UK stocks a close second, offer terrific value by my estimations.

MONETARY POLICY (USA)

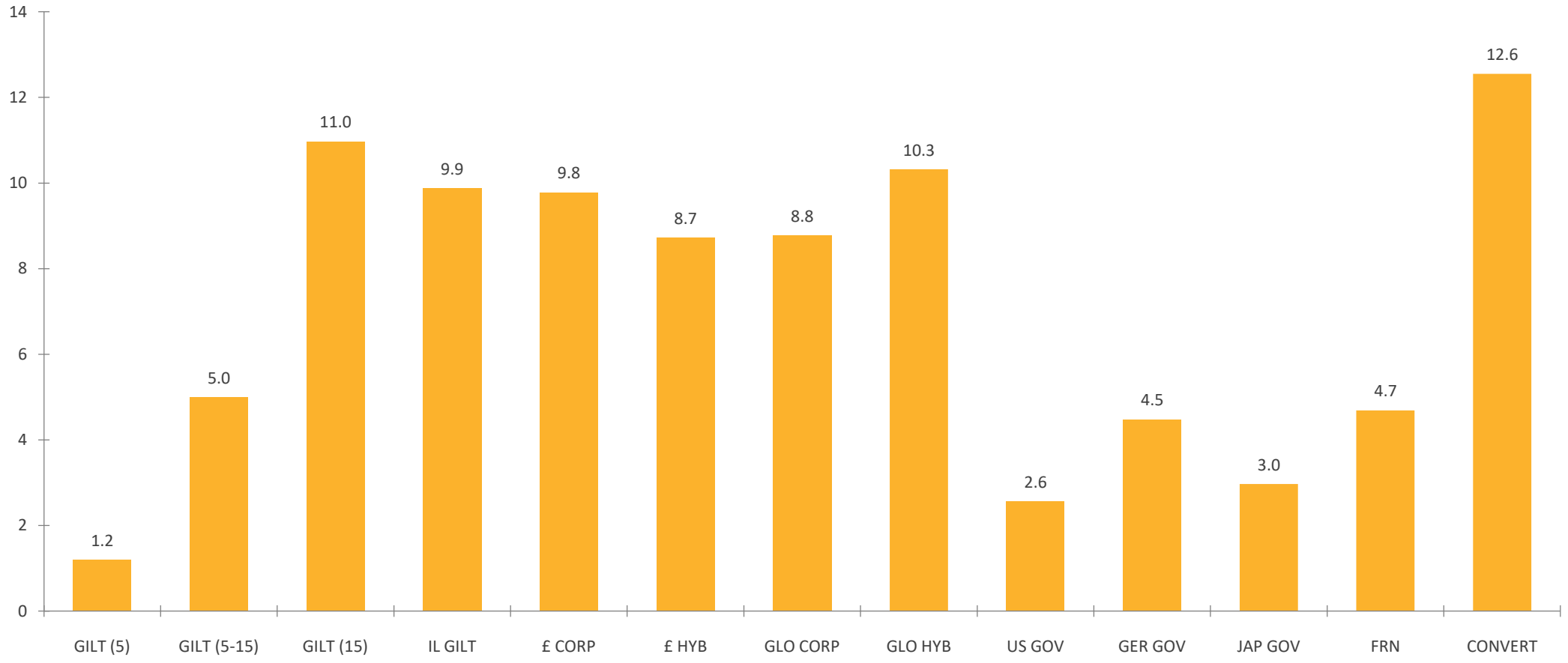
Going down

Expect the Federal Open Market Committee to reduce the upper limit on the target range for the Fed Funds rate from 2.5 percent to 2.25 percent during the course of next week. Everybody else does.

Indeed, the market-implied probability of a 25 basis point rate cut is 100 percent. Not 95 percent, 100 percent.

And that is in spite of a solid 2.1 percent expansion in economic output during the second quarter – marking, incidentally, this US expansion as officially tied for the longest on record.

YEAR TO DATE IN BONDS



Source of data: Financial Express Analytics, total return, local currency terms.

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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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