NOVEMBER 2019 MACRO BRIEF

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LAST WEEK IN MACRO

Economic Output (USA)

Still going strong-ish

Last week saw a wave of economic data from over the pond in the USA; including the first estimate for GDP during Q3, October's non-farms payroll report, September's inflation estimate and, of course, an interest rate cut from the Federal Reserve.

If the early estimate is accurate, the US economy expanded by 1.9 percent during the third quarter. That's little changed from the 2.0 percent pace set during the second quarter and, as it happens, broadly in line with expectations. The risks are to the downside, but I think the US economy is still growing at a moderate pace. October's jobs report certainly supports that assertion. Indeed, an additional 128,000 posts were recorded during a month when a much lower number would not have come as a surprise given headwinds in the form of strikes at General Motors plants and a 50,000-strong reduction in federal payrolls.

Meanwhile, at 1.3 percent, inflation – as measured by the Personal Consumption Expenditure index – lies further from the 2.0 percent threshold than is ideal, particularly as it is preceded by a long period of undershoot. And it is partly for that reason that the equity market got precisely what it wanted when the Federal Open Market Committee reduced the upper limit on the target for the Fed Funds rate to 1.75 percent. On the day, the S&P 500 gained just 0.3 percent, but the muted response reflects just how little doubt there was about what the Fed would do.

Far more uncertain is where we go from here. The bond market is priced to reflect the likelihood of a further cut this year at just 12 percent. That sounds about right to me. Given what we know today, I don't see a strong argument in favour of a move in either direction.

Monetary Policy (Japan)

Forward guidance, of sorts

Do you often find yourself wondering what the Bank of Japan will do next? I do. In fact, I've been watching the Bank of Japan for so long that the following passage, for example, doesn't appear as gibberish to me… 'As for the policy rates, the Bank expects short- and long-term interest rates to remain at their present or lower levels as long as it is necessary to pay close attention to the possibility that the momentum toward achieving the price stability target will be lost.' That gem was presented in last week's monetary policy press release. So, given very few signs of any kind of momentum in headline inflation, the Bank of Japan is going to persist with its current stance. Unless things get worse.

Manufacturing Output (China)

You choose

Either Chinese manufacturing is in its sixth straight month of decline or it is in its third consecutive month of expansion. The official Purchasing Managers' Index (PMI) for manufacturing fell to 49.3 in October, further from the 50.0 neutral mark than last September's reading of 49.8. At the same time, the private measure, composed by Caixin/Markit, reports an increase from 51.4 to a near 3-year high of 51.7.

There are differences in the two measures, of course. The official survey has a bias toward large, state-owned enterprises and the Caixin survey leans toward smaller, private businesses. In that case, the mixed picture presented by the data may well be accurate.

Credit Rating (UK)

Moody and negative

On Friday last week, the Financial Times (FT) reported that Moody's had lowered its credit outlook for the UK from 'stable' to 'negative'. I thought little of it, at the time.

Then, earlier today (I'm writing this on Sunday) I heard the BBC's Andrew Marr complain to the Chancellor, Sajid Javid, that Moody's had 'downgraded Britain'. Adding to a sense of peril, Marr asserted that Moody's was a 'a very important global credit rating'.

The FT presents the correct picture. Andrew Marr, on this occasion, does not. In fact, the UK's credit rating has not been downgraded.

The UK still attracts a Aa2 rating, a rating it was given more than 2 years ago. Aa2 is two notches from the top in a series beginning Aaa (Prime), Aa1, Aa2 then Aa3 (all of which are described as 'High Grade'). Indeed, the UK has the same standing as France and enjoys a better rating than that of China, Japan and Saudi Arabia for example.

For the record, Moody's do cite two concerns - both of which are speculative in their nature but reasonable, nonetheless. The first observes eroded 'institutional capacity' and a weaker 'commitment to fiscal discipline'. That is owed to 'paralysis' in parliament and 'widespread political pressures for higher expenditures'. The second concern invokes a 'likely deterioration in fiscal and economic strength'.

Really though, there is no new information here. As far as I can tell, Moody's are simply catching up with the negative outlooks assigned by Fitch in February this year and S&P back in June 2016.

Indeed, if there is anyone out there selling British government bonds on the back of this update, they are in the minority. On the day of Moody's announcement, the yield on the 10-year gilt finished a tad lower than it had on the previous day.

In re-affirming its Aa2 rating, Moody's point to an economy with 'significant strength' as a 'function of its large size, diversification, and flexibility'. Furthermore, the 'government… enjoys very low financing risks and a very high average debt maturity'. And 'while the UK's institutions have weakened, in part due to the serious challenges raised by Brexit, they remain strong in comparison to global peers and the monetary policy framework and central banking arrangements continue to be excellent'.

Monetary Policy (UK)

Nothing much to see here either

Speaking of monetary policy, last week saw policymakers at the Bank of England vote to hold the main rate of interest at 0.75 percent. That was in line with my expectations, and pretty much everyone else's for that matter. Mind you, I must confess to being slightly surprised to learn of a split in the pattern of votes during that meeting. The decision to hold rates steady was not one of unanimity; the majority won 7-2. The dissenters, Jonathan Haskel and Michael Saunders, voted instead for a 25 basis point cut. That confirms my view that we are closer to a decrease than we are to an increase. But who knows, the general election might alter the outlook quite substantially.

Economic Output (UK)

A slow pace

The Office for National Statistics estimates that the UK economy expanded by around 0.3 percent during the third quarter. That's a little less than was expected but enough to reverse the 0.2 percent contraction during the second quarter, nonetheless. For those that prefer the year-on-year rate, it comes in at 1.0 percent. As far as I can see, that's the slowest pace of increase since the opening quarter of 2010 when our emergence from the 2008 recession first inspired a limping gain of 0.8 percent. 1.0 percent also represents a little over half of the average of year-on-year growth since then.

The monthly breakdown of the third quarter runs like this; +0.3 percent in July, -0.2 percent in August and -0.1 percent in September. If September gives us an insight into how growth might be shaping up in the fourth quarter, it is not a happy one. Output in services was flat, production lost 0.3 percent, manufacturing was down 0.4 percent, construction contracted 0.2 percent and agricultural output fell 0.2 percent too. Brexit – or lack thereof, depending on your view – is part of the problem. That's most likely why business investment has stalled. But it is not the whole. Poor productivity growth can be traced back years before the referendum.

Mind you, it seems to me that anticipation of something approximating an apocalypse is already present in the price of UK-listed stocks, particularly those outside of the FTSE 100. I have spoken to very few investors that don't recognize good value there. Of course that value might take a while to manifest in higher prices. And who knows, it might get worse before it gets better. But, in my experience, opportunity most often resides in uncertainty.

Monetary Policy (USA)

In agreement

The next meeting of the Federal Open Market Committee falls on the 11th of December. As it stands it seems unlikely that another rate cut will be forthcoming. Indeed, the bond market reflects a 93 percent chance that the Federal Reserve opts to hold the upper limit at 1.75 percent. Having read the minutes from the last meeting (released a few days ago), I'm inclined to concur with that assessment.

Looking further ahead, prices reflect a likelihood that rates will be lower come this time next year. If the CME Group's 'FedWatch Tool' is an accurate gauge, the futures market assigns a 32 percent probability that rates will be at the same level as today (note: that's not equivalent to the rate remain static until then) and a 66 percent chance that they will be lower. The remaining 2 percent accounts for the likelihood rates will be higher than they are currently.

Interestingly, the chance that rates will be lower by a full 1.0 percent in the next 12 months comes in at just 1.3 percent. Since rates that low would likely be associated with a recession, it seems that the market is discounting that possibility, expecting growth to be sustained in its stead, albeit at a lower rate than the circa 2.0 percent level we're seeing today. At the same time, the Wall St Journal's survey of economists reveals that only a third of respondents expect the next recession to begin during 2020.

I must admit to being a little nervous about some of the data I have seen over the course of last week. Having said that, my central forecast remains one of sustained low-to-moderate growth. I think that puts me very much in and among the herd in that regard.

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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