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Market Update: 19th June 2019

Economic Health and Monetary Policy

As we approach the halfway point of the year, it is clear that economic conditions are beginning to deteriorate, with weaknesses being exacerbated by key events such as Brexit and an acceleration of US-China trade tensions. As a result, the IMF and the OECD have continued to lower their forecasts for global economic growth as the year has gone on. The IMF is now expecting 2019 global growth of 3.3%, 0.6% lower than its original forecast a year ago, and the OECD is now forecasting 3.2% growth, 0.7% lower than this time last year. With economic conditions weakening, investors are turning to the central banks for signs of optimism via potential economic stimulus. This week particularly, all eyes are on the US Federal Reserve for hints on a potential July rate cut.

A Weakened Global Economic Backdrop

It is becoming increasingly evident that the global economy is weakening on the back of lower global growth, with the economic data now considerably tilted towards the downside, exacerbated by recent trade tensions around the world. In the US, first quarter GDP growth came in surprisingly strong at 3.2% annualised q/q, however beneath the headline there were key areas of weakness, with growth expected to slow in the coming years as fiscal policy stimulus abates. Over recent months, weaknesses are beginning to show via declining consumer confidence, weaker services and manufacturing data and cracks appearing in the strong US jobs market. The longer the trade war with China wages on, the longer this will weigh on economic activity.

Eurozone growth has also been revised down in recent months as key economies within the bloc continue to show weakness, with concerning activity in key manufacturing and export sectors. Eurozone manufacturing PMI has been in contraction for four months and investor sentiment in Germany fell this month to its lowest level since January after a sharp monthly decline.

UK economic growth remains uncertain, with the Brexit issue still unresolved and with the conservative leadership contest still ongoing, leaving the potential Brexit outcome unknown. With no clear outcome in sight, the ongoing uncertainty will continue to weigh on UK companies, depressing business confidence and investment spending.

China's economic growth is expected to continue to decelerate in 2019 and 2020. While weak global demand and rising trade tensions with the US are weighing on the economy, the Chinese economy is being propped up by government stimulus, however this could be problematic should the trade war stretch out for a prolonged period of time.

Given this backdrop, markets are becoming increasingly reliant on central banks in order to keep the global economy in check, however there are signs that investors are expecting too much from the central banks by way of stimulus, leaving room for disappointment. Additionally, questions remain over the role of central banks in propping up problem economies at the end of the cycle and the potential for central bank stimulus to create a more severe recession later down the line.

Central Bank Expectations- Cuts happen for a reason

This week is a busy one for central bankers, with the ECB's Mario Draghi announcing on Tuesday the potential for further Eurozone stimulus should economic conditions continue to decline, followed by the Federal Reserve interest rate decision later today and the Bank of England's rate decision on Thursday. In reaction to Mr Draghi's comments on Tuesday, markets rallied on the expectation of further stimulus to prop up the flailing Eurozone economy, however it is our view that this reaction is temporary, as the decision to add further stimulus is based on the identification of significant weaknesses in the economy which will continue to feed through into lower growth and corporate profitability expectations. Stimulus typically takes around 6 months to feed through properly into the economy, therefore in our view, any boost to equities on the back of this news is a temporary reaction which will likely be reversed over the coming months.

The US Fed is expected to announce its June policy decision later today, with expectations that the FOMC will provide more detail on when a cut can be expected. As it stands, nearly 40% of economists expect a cut from the US central bank next month, and federal-funds futures are suggesting a 26% chance of easing this month. Any rate cut at this point in time would be regarded as an insurance cut to curtail the effect of a protracted China-US trade conflict. It can be argued that the domestic economy has not weakened sufficiently to justify a rate cut at this point, and with the market expecting three cuts before the end of the year, this could be an ambitious hope for investors, with any disappointment being met by a decline in equity markets.

The Bank of England is expected to maintain rates at current levels on Thursday, awaiting further clarity on the Brexit outcome. While political uncertainty remains significant, the UK central bank is keeping all avenues open for monetary policy, with significant stimulus expected in the case of a no-deal Brexit, and a potential rake hike on the horizon in the case of a positive Brexit deal.

The Defensive Investor

The recent deterioration of economic conditions has not gone un-noticed by investors. According to the Bank of America fund manager's survey, investors haven't been this pessimistic since the global financial crisis of 2008. The well-respected survey revealed that equity allocations are now at their lowest since March 2009, while cash holdings have jumped by the most since the 2011 debt-ceiling crisis. This was mainly put down to concerns about the trade war, a recession and monetary policy impotence, creating bearish sentiment among investors.

While stocks started June in the green after May's sell-off, they have struggled to gain momentum. Investors worried about lack of progress in UK-China trade talks and weak economic data, with all eyes on the upcoming G-20 meeting at the end of the month and the Feds decision this week. Global growth expectations declined, with 50% of the managers surveyed forecasting weakness over the next 12 months. Relative exposure to equities over bonds narrowed to the tightest level since May 2009, implying that managers are becoming increasingly concerned about the market outlook, favouring more defensive assets over those rising on growth and inflation. The survey highlighted favourite trades among investment managers were long US treasuries and short European stocks.

Overall

It is clear that risks within the global economy are now skewed heavily towards the downside, with recent market movements being driven by optimism over central bank stimulus in the absence of positive economic data. It is our view that the Fed will not cut today, and that there is insufficient evidence to support three rate cuts to US interest rates before the end of the year, with the real impact of the trade tariffs still yet to fully feed through into markets. While European equities have gained on the prospect of stimulus following Draghi's announcement yesterday, the Eurozone economy is weakening, with the outlook and corporate earnings expectations likely to remain poor for at least 6 months as the stimulus feeds through into the Eurozone economy. For these reasons, we see room for disappointment in equity markets, and with little changed in terms of the economic data and global growth, we fail to see a significant growth rebound in the coming months, and therefore reiterate our expectations for further equity market weakness in the near term.