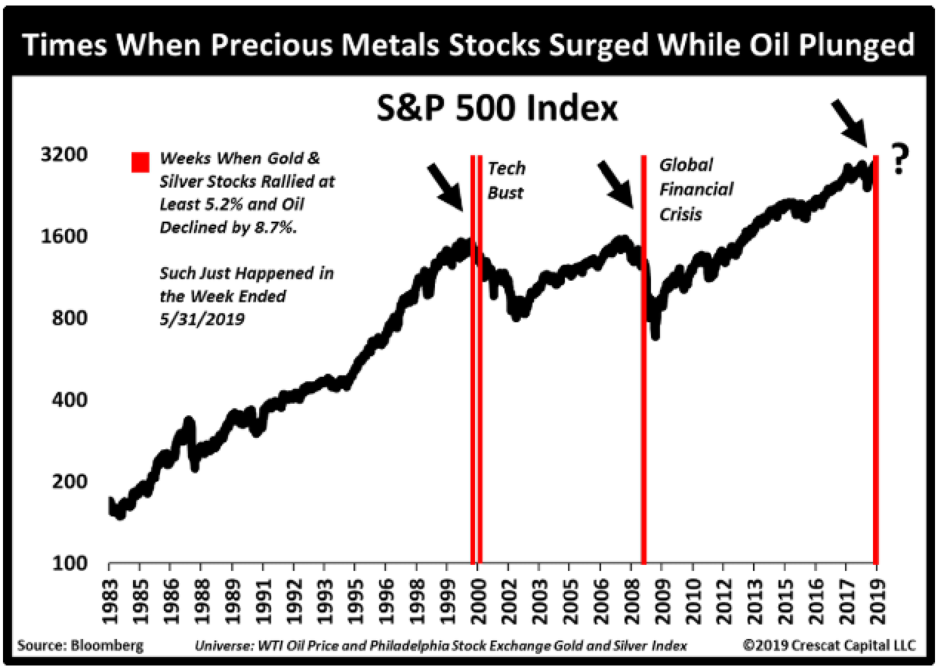
Market Update: 6th June 2019

Recessionary Fears Spread As Trump's Tariff Wars Weighs On Markets

Market movements in May were characterised by weaker global growth, lower confidence and an escalation of trade tensions, culminating in the steepest May decline in equity markets since 2010. Over the month, equity markets declined as risk-off sentiment spread among investors, with weak economic data feeding into recessionary concerns. Credit markets gained over the month, benefitting from a 'flight to safety' effect, with investors favouring government debt and other safe haven assets such as the Japanese Yen and the US dollar. As a result, as economic conditions and sentiment worsened over the month, a number of recessionary indicators began to signal cause for concern, most recently with the inversion of the 10 year- 3month US treasury yield. This essentially means that the yield an investor gets on the 3-month bill is higher than the yield available on the 10-year bond, indicating a significant imbalance in credit markets which has preceded the last nine economic downturns since 1955.

In addition to the traditional equity and credit market characteristics, we also examine price movements in oil and gold during periods of economic weakness. Oil prices are currently hovering around bear-market levels as a result of concerns over slowing global growth and a reduction of demand owing to trade tariffs. At the same time, gold has been gaining in value. In the past, when combined, these movements have delivered worrying consequences for the broader market. In history, precious metals have surged while oil declined only three times, highlighted on the chart below.



As gold and oil are behaving in this way, copper prices are declining, corporate bond spreads are widening (reflecting the higher risk assigned to corporate debt in comparison to government debt) and credit yields are falling sharply, reflecting a significantly weaker global economy with excessive risks within markets.

Weaker Global Growth

Earlier this week, the World Bank cut its 2019 global growth outlook, citing a slowdown in trade growth to the weakest level since the financial crisis a decade ago and a drop in investment as key factors dragging down growth expectations. The bank now forecasts the world economy will expand 2.6% this year compared with the forecast of 2.9% back in January and 3.0% last year. According to World Bank President David Malpass, “There’s been a tumble in business confidence, a deepening slowdown in global trade and sluggish investment in emerging and developing economies”. The bank also warned that risks are now increasingly skewed to the downside, citing reignited trade tensions between the US and China, financial turbulence in emerging markets and sharper than expected weakness in advanced nations. At the same time, political uncertainty in key developed nations has exacerbated economic weakness. The bank joins the IMF in lowering its forecast over concerns that trade tensions will undermine global growth, highlighting significant weaknesses in the Euro-area which has been a key casualty of falling demand and global trade in recent months.

A Weaker US Economy

Considering the current economic backdrop, where global growth is being revised down, economic data is weakening and corporate earnings are being squeezed by the impact of trade tariffs, the market gained on Tuesday and Wednesday this week on the back of optimism that the Fed would be cutting rates later this year.

The rate speculation comes as President Trump announced plans to impose tariffs on Mexican imports next week unless it halts the flow of migrants reaching the US border, worsening the US trade outlook. On Tuesday, Fed Chairman Powell signalled an openness to reduce interest rates if necessary, keeping a close eye on the implications of increasing trade tariffs and inflation. As a result, financial markets are now pricing in two to three cuts by January. The Fed only pivoted from its tighter stance on monetary policy earlier this year, therefore the possibility of three rate cuts before January seems far off, with room for disappointment on the specifics. A rate cut at this stage of the cycle is never typically a bullish signal, therefore investors should pay greater attention to the underlying health of the US economy.

While markets gained on optimism that a rate cut would stimulate the economy in the short term, the Fed’s dovish comments reaffirmed that economic conditions are weakening and risks increasing, with the Fed becoming concerned about ‘sluggishness’ within the fragile US economy. One senior economist has since likened the situation to visiting the doctors and being told they are considering emergency treatment. The stock market is clearly susceptible to bouts of bullish sentiment; however, the overall fundamental data cannot be ignored, and the Fed’s actions reiterate that the economic outlook is worsening.

A Move Towards Looser Monetary Policy?

Following on from the Fed’s more dovish policy stance, the European Central Bank decided today to keep interest rates at a record low given the backdrop of a recession-threatened global economy, but highlighted that the ECB would not shy away from action to support the Euro-area economy as growth weakens, with “considerable headroom” for more quantitative easing to stimulate growth. At the same time, ECB economists downgraded their outlook for growth amid plunging inflation expectations and escalating international trade tensions. It is now expected that the Eurozone economy will expand by 1.4% in 2020 (down from 1.6% back in March).

The ECB discussion takes place as central banks are moving towards a looser monetary policy stance. Australia cut rates on Tuesday for the first time in 3 years, the Fed is becoming more dovish and the Bank of Japan is expected to add further stimulus. Unlike the Fed and the BoE who have tightened in recent years, ECB interest rates are still at record lows (-0.4%). Another cut would be painful for savers and banks who are struggling to pass the charge onto their customers, putting the European banking sector under further pressure. It will be interesting to see what tools the ECB utilises to stimulate the weak economy, with little left in the toolbox in reality to prop up the economy.

Overall

Market conditions over May reflected a much weaker global economy than in the previous quarter of the year, as risks intensified and investor sentiment turned negative on equities. It is now clear that the global economy is weakening, with central bankers' stances beginning to turn more dovish when considering downside risks and an increasingly negative outlook. With these risks in mind, we remain content in our defensive positioning, and are well positioned to benefit from a decline in markets as the effects of an escalation in trade wars, political uncertainty and economic weakness continue to materialise over the month. It is our view that even if markets are boosted in the short term by a more dovish Fed tone, the weakness in the underlying US economy will quickly offset any positive sentiment, resulting in a decline in equity markets. As it stands, we do not think a recession is ahead in the near term, rather that it will be prolonged into next year, however we continue to see a sell off on the near horizon given current elevated equity valuation levels and weaker corporate earnings expectations.