




The balance is starting to wobble

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In the first half of 2019, financial market trends were shaped by return to a balance of sorts between the prospect of slowing world economy and the announcement by central banks of supportive policies. But that balance got shakier by the end of the summer.

It became increasingly apparent that the stimulus policies on the agenda wouldn't be enough to counter a global economic slowdown that shows signs of deepening. Leading indicators for the US economy in fact suggest that the global softening is spilling over to the country. In addition, the big difference with 2016 (and even more so with 2009 and 2012) is that this time China clearly doesn't intend to bear the brunt of powering a worldwide economic recovery.

So that basically leaves it up to the Federal Reserve to prevent the global slowdown from getting any deeper. Unfortunately, in his speech on 23 August, Fed chairman Powell didn't express a strong inclination to loosen monetary policy any time soon.

The current balance is therefore threatened by a possible US monetary policy lag behind the global economic slowdown that justifies the bearish mood in equity markets today.

The global economic slowdown spills over to the United States

The resilience of the US economy to date is due in part to standard economic stabilisers that include an accelerating decline in interest rates in 2019, falling commodity prices, which have lifted disposable income, and lastly a strong dollar, which has lowered the cost of imported goods.

But we should also bear in mind that those stabilisers are the reflection of an ongoing economic slowdown. Falling long-term yields drive down banks' profit margins while a high dollar hobbles exports, increases deflationary pressure and hurts emerging markets.

At the same time, a number of US economic indicators with major ramifications for the future have already lost ground, most notably business spending. There is reason to fear at this stage that the uncertainty created by Donald Trump's erratic behaviour at the negotiating table with China has done lasting damage to confidence among US company leaders. Though the two parties would appear to have a mutual interest in clinching a deal swiftly, such an eventuality can hardly provide the basis for an investor's core scenario given the political and geostrategic agendas on both sides.

A struggling Germany

For obvious reasons, contagion from a slowing global economy has affected Germany much more directly and for longer than the United States, meaning Germany is feeling more of an impact than the US today. The country's governing coalition is now toying with the idea of a fiscal stimulus plan. Unfortunately, the plan's size and timetable will depend on what happens to the fragile coalition in power. That raises doubts about whether it will soon be implemented or effective.

The good news for Europe – i.e., Germany's conversion to a fiscal stance supportive of growth – may well come too late.

China is no longer a lifeline for the West

The hope that China would introduce new policies to stimulate the domestic economy and thereby also revitalise global growth is fading. Our interpretation of Beijing's attitude is that China has less scope for stimulus today than in the previous soft patches. Moreover, in light of the high strategic stakes in its relationship with the US, the Chinese government is willing to risk having to pay a high economic price in the short term. So it looks like a fairly high "tolerance for pain" will continue to characterise Chinese policy for a while.



Further hesitation at the Fed

With major stimulus to be expected from China, the Fed is the only institution that has sufficient ammunition to – perhaps – keep the current slowdown from getting much worse. But that brings us to the second disappointment of these past few weeks. The Fed’s working hypothesis is that it’s still too soon to kick off an extended easing cycle.

The outlook taking shape thus seems to include an ongoing slowdown in the global economy that won’t trigger powerful countercyclical policies until late in the game.

Consequences for investment strategy

Market behaviour as of the end of the summer can be characterised as quite efficient. The worsening global economic outlook has been adequately reflected in falling long-term interest rates, while equity investors have evinced a strong preference for defensive stocks and stepped up their cash holdings. So there is a chance of recovery in technical terms. But even so, maintaining a strategically cautious stance is warranted. That will involve low exposure to duration risk and keeping portfolios focused on growth sectors and consumer staples. In light of the superior performance achieved by the latter, what is required is careful stock-picking. But provided that asset managers proceed in a disciplined fashion, they can still dig up stocks with good income and earnings prospects that will translate into rising share prices.

Source: Bloomberg, 30/08/2019

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