BearBull
Global Investments Group

Economic Research
WEEKLY ANALYSIS

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1 July 2019

G20 fails to provide solutions but may induce Fed not to act

Power struggle to carry on beyond G20 meeting. Expectations of key rates' cuts too high. Consumption to drive GDP. Reduce equity exposure once again.

Key points

- G20 fails to provide solutions but truce could induce Fed to hold off
- Central bank faced with a difficult choice
- Lowering rates will consolidate recession scenario
- Waiting until September will cause disappointment
- What possible reactions should rates fail to be lowered on 31 July?
- What is the most likely scenario?
- Leading indicators on the threshold of growth
- GDP growth estimated at +2% in Q2
- Consumption will likely be key driver
- Full employment, inflation and interest rates
- Market movements in June herald the return of volatility
- Reduce exposure to US equities

G20 fails to provide solutions but truce could induce Fed to hold off

The G20 summit in Osaka ended with a rather predictable status quo and no tangible progress on the issue of trade between China and the US. Some will feel reassured to know that at least the two protagonists of this saga, which has kept the whole world guessing for months, have met and have finally agreed to keep the door open for negotiations. Trump and Xi Jinping have effectively agreed to resume talks.

In the short term, no new tariffs are expected to be introduced and the Huawei affair could be reconsidered. Both presidents have undoubtedly tried to buy time and give a second chance to a negotiating process which had been severely threatened by the hardening of respective positions in May, an event that had caused equity markets to plunge temporarily.

In the short term, markets might appreciate the fact that the situation did not grow worse during the G20 summit, although this should not conceal the fact that no tangible progress was made and no clear agenda was discussed. China and the US would be well advised to avoid a total trade war. A truce is certainly welcome and rational before any real progress between the two countries may be expected. Although markets do not usually enjoy uncertainty, they might be satisfied with this press release. However, a solution will be needed in the long term if the deterioration of confidence and of leading indicators is to be prevented.

In this regard, time seems to be on the side of China rather than the US. President Xi Jinping is firmly ensconced and seems to be able to count on the political support of the Chinese population who is ready to boycott certain American products. The US President on the other hand is now campaigning for his re-election and might be tempted to broker a deal with China, which could give him political gain, before turning his attention towards Europe with the same objective. In the meantime, the absence of a deal will weigh on the confidence of investors and voters. This underlying concern will likely last throughout the summer and might weaken economic prospects a little further in the next few months. Donald Trump will thus be tempted to carry on his attacks on the Chair of the Federal Reserve to force him to ease monetary policy and thus try to compensate

for the negative effects associated with the uncertainty inherent to the absence of visibility on the issue of trade despite the latest G20.

The next few weeks will be crucial, and we will see at the FOMC's meeting in July if the Fed will decide whether or not to ease its policy by lowering its key rates. For the moment, markets are quite clearly convinced that this will be the case. However, the Fed may choose another path ultimately, especially if it considers that the resumption of negotiations between China and the US may reduce the risks mentioned in its previous comments as risk factors that could support the decision to lower rates.

What possible reactions should rates fail to be lowered on 31 July?

Rate markets took forecasters by surprise by declining further in 2019 by more than 100 points below the consensus forecast for the end of 2019, based on the expectation of a significant deterioration of economic conditions in the US and throughout the world. Indeed, a few economic statistics corroborated a global downturn scenario, especially data from various manufacturing sectors in a growing number of countries. The publication on 26 July of US GDP figures for Q2 might or might not give body to these expectations. For the time being, the decline is visible in the manufacturing and services PMIs as well as in some consumer confidence measures for example. On the international level, in June, more than half of manufacturing PMIs published recorded declines.

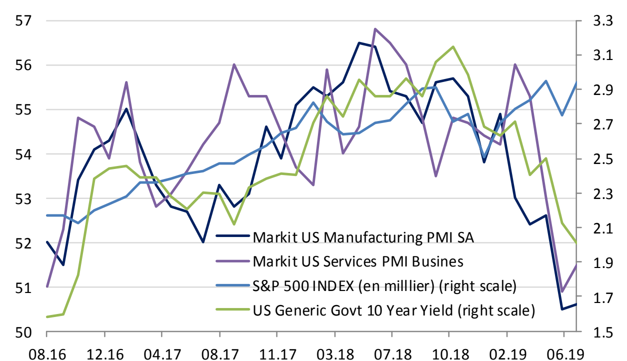
Consequently, we could wonder how rates and equity markets might react if the Fed does not lower its rates as expected at the end of July.

This binary situation is actually not at all reassuring if we consider that the factor that supported the rebound in equity markets in June is precisely the anticipation of a drop-off in rates which was based on the prospect of much weaker economic activity. The Federal Reserve's upcoming decision will clearly be crucial for the short-term future of financial markets, which are relying on a reversal of the normalisation policy in favour of an economic support policy. Indeed, the current situation in the financial markets is very specific and particularly fragile. Ten-year US yields fell by 120 base points between October 2018 (3.2%) and June 2019 (2%) based on the anticipation of a sharp economic downturn in the US and a decline in inflation. In the same period, equity markets experienced high volatility marked by a first period of price correction of close to -20% followed by a sharp, six-month long increase during which the S&P500 returned to the peak levels it reached in September 2018, but in a political context that was just as uncertain (persisting trade tensions) and with declining economic prospects such that a rate cut in July seems like the main factor behind the price rebound observed in June.

The absence of a rate cut on 31 July in such a context will have a significant impact on financial markets, which will depend on the macroeconomic data available at that time.

If the Fed's decision can be justified by an encouraging set of economic data, we will likely see an upward adjustment of long-term rates. It is far from certain, in this case, that equity markets will not also react negatively to this increase in long-term rates. We could then see a simultaneous correction in the bond and equity markets potentially favourable to gold prices. If, on the contrary, the Fed's decision is based on the necessity to wait until September to have a clearer view of the economy's evolution, rates might fall further but the correction in equity markets could then be as brutal as it was in December 2018.

Long-term rates, manufacturing PMI and S&P500



Sources: Bloomberg, BearBull

What is the most likely scenario?

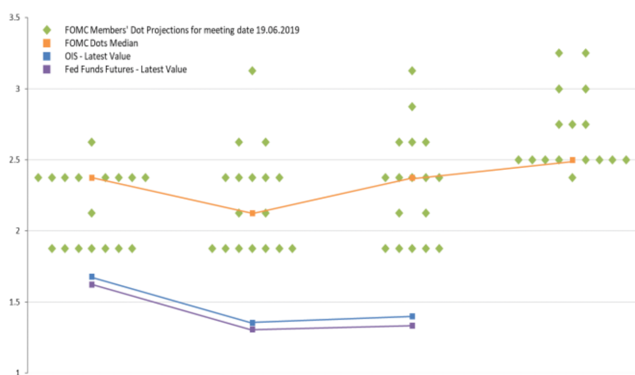
The decline in the manufacturing PMI leading indicators observed in Q4 2018 was only meant to be temporary since it was essentially linked to the uncertainty of the trade negotiations between China and the US after the truce announced on 1 December. Hopes of a concrete resolution before the deadline of March 2019 had then dominated equity markets without really convincing rate markets, which stabilised at a yield rate of 2.6% for ten-year government bonds. These hopes were brutally crushed by the toughening of the negotiators' stance in May, which triggered a drop in both rate and equity markets as well as in growth expectations, as shown by freefalling PMI indicators in May. June ended with a stabilisation of these leading indicators and long-term rates. Will the air of relative calmness between the two super-powers at the end of the G20 summit be enough to improve the sentiment of economic agents and dismiss prospects of a global economic downturn in H2?

The American central bank could well decide to maintain its normalisation policy unchanged until September, especially if economic growth appeared sufficiently robust in Q2. The current dilemma for the Fed is indeed to get through these turbulent times by adopting the most appropriate policy for the long-term, and the truest to their convictions. A rate cut in July could appear as a sign of weakness and dependence in terms of the political pressure exerted by the White House, especially if the Fed remains convinced that the underlying trend remains positive for the American economy as the very high economic sentiment and consumer confidence indicators could suggest. In this case, we would then see a rebound in long-term rates that would trigger a simultaneous correction in rate markets and stock indices during the summer.

In contrast, a cut could also be counter-productive as it could transform the scenario of an upcoming recession. It will indeed be clearly difficult for the Fed to lower its key rates in a “pre-emptive” manner without further supporting already negative macroeconomic expectations.

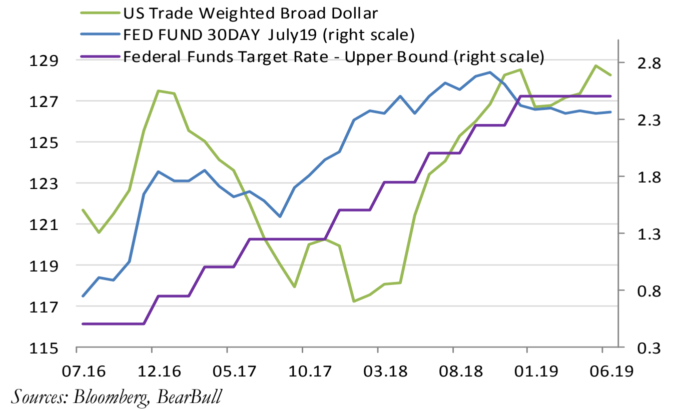
In its last press conference in June, the Fed maintained its GDP growth forecasts of +2.1% and lowered its expectations for the unemployment rate from 3.7% to 3.6%. The Fed declared itself ready to demonstrate great flexibility in managing its monetary policy in 2019, announcing that it would not rule out the possibility of lowering key rates if need be. Nevertheless, we believe that the probability of rates being lowered in July, which amounted to approximately 85% in June, is clearly exaggerated, especially after the G20 meeting, and given the current stabilisation of PMI indicators and the strong performance of consumption.

FOMC projection of fed funds



Sources: Bloomberg, BearBull

Fed funds, key rates & trade-weighted dollar

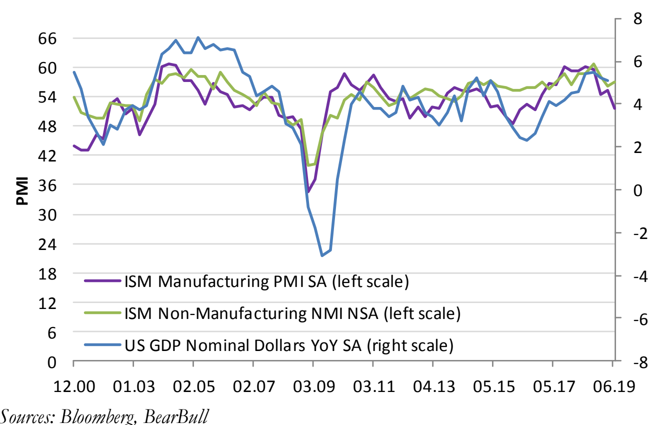


Sources: Bloomberg, BearBull

Leading indicators on the threshold of growth

May will have been particularly negative for purchasing managers’ confidence. Indeed, the renewed tensions between Washington and Beijing greatly impacted their perception of economic risks and opportunities.

GDP & PMI



Sources: Bloomberg, BearBull

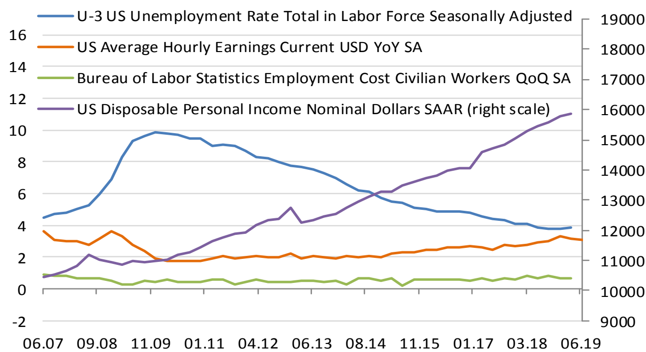
Manufacturing PMIs fell once again from 52.5 in April to 50.5 in May, fast approaching the threshold of negative growth. The services PMIs, more resilient until March, also dropped from 55.3 to 50.9.

Full employment, inflation and interest rates

The statistics for job creation were deeply disappointing in May. The published figures show an unexpected setback in job creation, with 75,000 new jobs instead of the estimated 175,000. Still, the unemployment rate has decreased to 3.6%, the US economy thus gradually closing in on full employment. Wage pressures are increasing and thanks to rising disposable income, consumption will likely remain high and push price indices up. In the context of a relatively tight employment market, wage growth is logically continuing in the US, strengthening the outlook for private consumption, which remains the main driver of economic growth.

In this context, average hourly earnings in May decreased slightly to +3.1%, which remains high in statistical comparison to the last ten years. If household income growth is not interrupted by geopolitical issues and by the uncertainty associated with the trade war, economic growth will likely follow a sustained positive trend close to +2% in Q2 and H2.

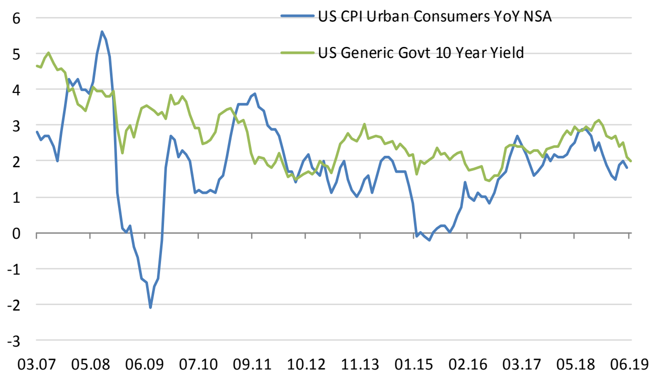
Unemployment, earnings, labour cost, income



Sources: Bloomberg, BearBull

Inflation stabilised in May (+1.8%) just below the Fed's target (2%) despite high volatility observed in energy prices in Q2. For the moment, the dominant economic scenario in rate markets is still one of weakening growth, pending an improvement in leading indicators. Nevertheless, we believe it is likely that a rise in ten-year yields will go hand in hand with better economic statistics during the summer.

Inflation & 10-year US Treasury notes



Sources: Bloomberg, BearBull

Reduce exposure to US equities

The rise in equity indices in June places the asset class back into a high-risk zone and increases the probability of an upcoming price correction in the two scenarios considered. If the slowdown turns out to be real, equity valuations will not be able to withstand the likelihood of profits collapsing, even if the Fed lowers its key rates in July. Otherwise, if growth turns out to be robust and the outlook remains sound, expectations of a reduction in key rates will fade and make way for a rise in long-term rates. Equity markets will likely also be penalised by this phenomenon. We once again recommend reducing exposure to equities in this context, which is unlikely to trigger a new wave of price appreciation.

S&P 500, Nasdaq and GAFA

Sources: Bloomberg, BearBull

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