Global Markets Overview

Asset Research Team

August 2019

Revisiting our outlook in light of changes in central bank policy

1. Monthly overview

- **US and China trade tensions have re-escalated**. US President Trump announced that he would impose 10% tariffs on the remaining $325bn of Chinese imports into the US. This had a knock-on impact in currency markets, with the Chinese renminbi weakening to trade at an FX rate of above 7.0 versus the USD. This FX price action also caused large moves in the currencies of economies that are closely linked to China via trade.
- We think the direct economic impact of this trade development for US and China GDP is small – a negative impact of around -0.1% to -0.2% over two years.
- At the end of July, **the US Federal Reserve cut interest rates for the first time in more than a decade, to a range of 2%-2.25%**. Chairman Jay Powell cited rising trade tensions and linked to this to cooling global demand and weakness in the business sector. We note that the Chairman's forward guidance is becoming increasingly accommodative, signalling the Fed's readiness to provide more monetary support as growth slows. We continue to track the economic data and Federal Reserve commentary to determine the likelihood of further rate cuts.
- **Economic data for Q2 showed negative growth in Germany and the UK**, increasing the probability of sustained easier financial conditions, e.g., low bond yields, in both economies. We see potential for Germany to loosen its fiscal strings to support the economy, however, we note possible political opposition to these measures. With regards to the UK, Brexit uncertainty continues to weigh on business confidence and investment.

2. Our Five-Year Outlook

In January, we published our Five-Year Outlook. A summary of this is provided below:

- **First**, we expected a material slowdown in growth in most of the major economies in 2019, with downside risks rising as we move into 2020.
- The main driver of weaker conditions was expected to be the gradual tightening of financial conditions, as the major central banks had raised interest rates and/or withdrawn money from the financial system.
- We believed that a recession in one or more of the major economic regions is likely over the next three years – a more cautious view than in 2018.
- **Second**, relative to our medium-term outlook, we believed valuations for growth-related assets were still high and expected low returns on average over five years, …
- … which would put pressure on savers' wider financial positions.
- **Third**, achieving investment return targets – and hence meeting savers' expectations – was expected to be difficult in this environment.

We review this outlook in the following pages in light of recent shifts in central bank policy.

Five portfolio priorities for a surprise-free 2019/2020

- Diversify;
- Reduce unrewarded risks;
- Macro & dynamism;
- Innovate through alpha;
- Innovate to find diversity, e.g., China now offers a new and diversifying set of assets for investors.

Revisiting our outlook in light of changes in central bank policy

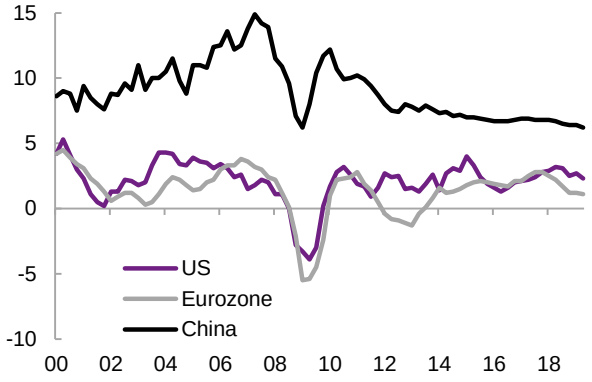
Summary

Outlining our current global outlook

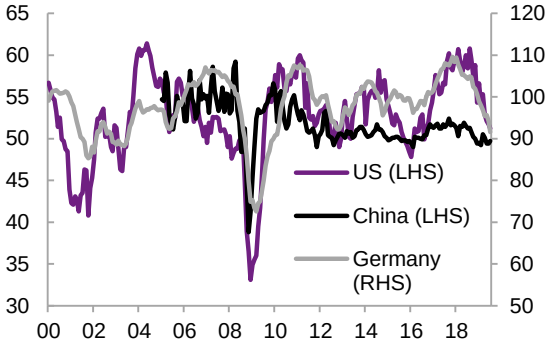
- Following the pivot by central banks towards more accommodative financial conditions and the associated and significant fall in bond yields and borrowing costs, we have made some revisions to our global outlook.
- From a medium-term view, we are still expecting the worlds two largest economies – the US and China – to experience recession at some point in the next five years.
- We also continue to emphasise that developed world central banks have relatively limited firepower via their monetary policy to offset a hard landing. The limited ability of policymakers to engineer additional easing is more true now given the fall in bond yields that has occurred (in the US and Australia especially), flat/inverted yield curves and tight credit spreads (or alternatively high asset prices). Other policies are available, e.g., macro-prudential policy or policies with a greater fiscal link. However, these typically require additional political support and the hurdle for their use is greater.
- While the main messages of our medium-term global outlook are unchanged we have made some revisions to our shorter-term outlook for economic conditions in individual countries. First, we continue to forecast that the Eurozone, UK, and Japan have the highest risk of recession in the next two years. This is because they are most reliant on foreign demand and most policy dependent and/or constrained. Second, for the US, we now think that a "soft-landing," i.e., a period of trend-like or moderately below trend growth, is most likely over the next two years. This is because the fall in US bond yields – from c. 3.2% for 10-year maturities last September to c. 1.6% now – is stimulative and likely to stabilise the current slowdown in US economic growth.

Key indicators: economic data and market pricing

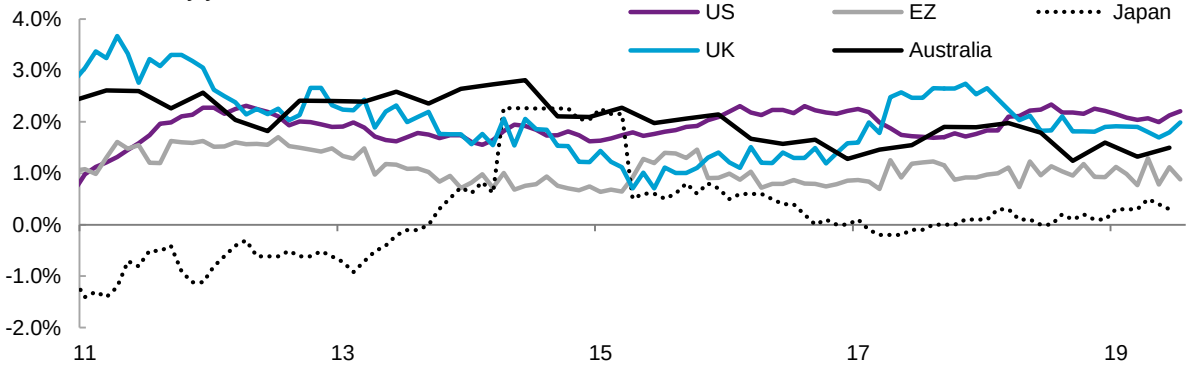
Economic growth has slowed as we expected – US growth remains at reasonable levels but Europe is close to recessionary territory.
GDP growth, %y/y



GDP growth is a lagging indicator – more current surveys of business conditions clearly show the slowdown in production and investment.
Purchasing Managers Index



Developed world inflation has been low – at or below central bank target. This has allowed central banks to be more accommodative in their guidance and actions. Low inflation and slowing growth have also been the driver of investors building up their expectations for interest rate cuts (in the US especially).
Core inflation, %y/y



Source: Willis Towers Watson, FactSet

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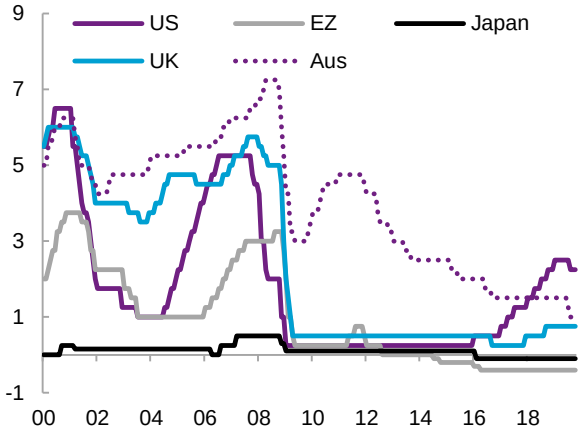
Key indicators: economic data and market pricing

Central bank interest rate policy has reacted to slowing growth and lower inflation – policy rates have either been cut (US and Australia) or tightening has paused (UK). The guidance from central banks has been that they will act to provide supportive financial conditions to the economy.

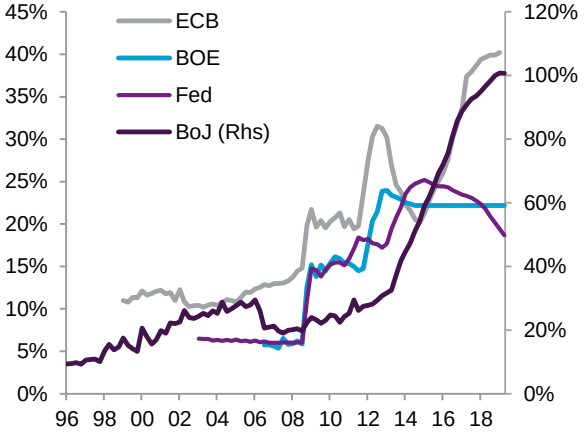
Central bank policy rates, %



Source: Factset, Willis Towers Watson

In the US, the Fed's use of non-interest rate monetary policy tools is consistent with this move to easing financial conditions – its unwinding of quantitative easing by selling assets has stopped. In Japan and the Eurozone, the slowing of asset purchases is a net tightening of financial conditions.

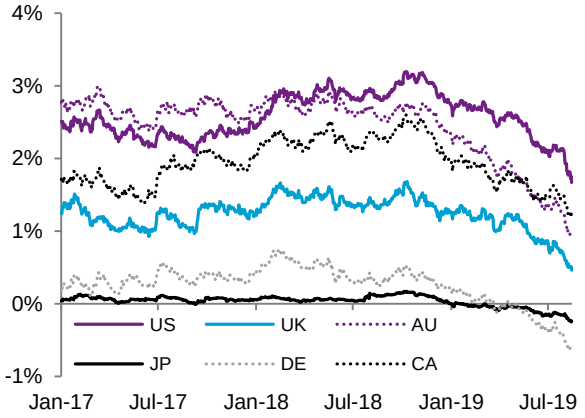
Central bank balance sheets, % GDP



Source: Thomson, Willis Towers Watson

Global bond yields have fallen significantly YTD and in the last month – yield falls have been much larger than the actual change in central bank policy rates. For example, in the US the bond yield curve is now pricing-in around 0.5% to 0.75% of additional policy rate cuts by the end of 2020. We think US real economic growth will stabilise at 1.5% to 2.0% and US policy rates may not be cut more materially. This would put upward pressure on US bond yields.

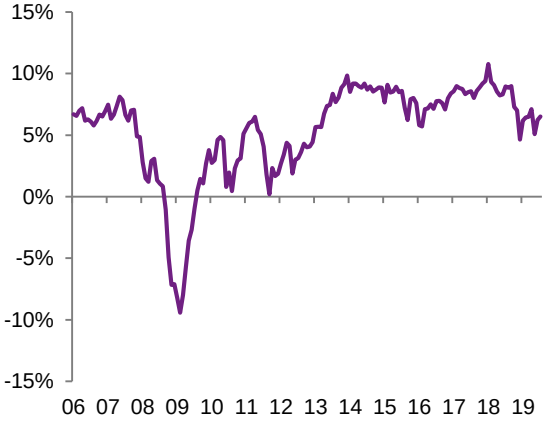
Bond yields (10 year)



Source: Factset, Central Banks, Willis Towers Watson

We can analyse the link between bond yields, equity prices and investor expectations for future earnings and economic conditions. Falling bond yields lower the rate at which future equity cash flows are discounted, which would increase the current equity price. Our analysis suggests that – with some wiggles – the YTD rise in US equity prices has fully reflected the reflationary impulse from falling bond yields. This is because the long-term earnings growth implied by the US equity price has been broadly flat YTD

Long-term US earnings growth implied by S&P 500 price



Source: Factset, Willis Towers Watson

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