PERSPECTIVES

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How low can they go?

IN SHORT

- Sovereign debt and yield curves have grabbed the spotlight, as yields continue to fall, often into negative territory. We believe that markets paint too negative a scenario, but do not expect a sharp reversal in the short term
- While global growth is slowing, and trade tensions add to fears about the outlook, we do not see an imminent recession, especially as US growth remains solid.
- Equity markets are proving more resilient, albeit volatile. With welcome trade truces and central bank supports, markets can advance this autumn, but earnings growth will be needed.

OVERVIEW

Everything is about bond yields and curves, as the downward momentum has not abated, with sovereign debt yields reaching all-time lows almost on a daily basis. Yield curve inversions have also increased fears of recession, a view we still do not share. Markets are expecting 3 more interest rate cuts after the Fed's September cut. Still, the long end of the curve continues to fall, as investors believe this still would not suffice to prevent a downturn.

Yes, yield curve inversions are ominous, but a recession is not a foregone conclusion. First, even if we do see a recession, there has historically been a 12-24 month lag between the inversion and the downturn. Moreover, yields are being dragged down by political and geopolitical tensions, including worries about the impact the US-China trade war is having on growth. European growth, and Germany in particular, continues to slow, with a contraction in Europe's largest economy during the second quarter. This has sent German Bund yields ever deeper into negative territory, dragging down sovereign debt worldwide, including the US, with it.

We believe that markets are painting too negative a scenario, and that the US economy remains relatively solid, given a still-robust labour market, a healthy consumer, and gradually rising core inflation. Nonetheless, we expect the Federal Reserve to remain under pressure due to external factors, such as trade, and ease one or two more times this year. This could lead to disappointment and some retracement in yields, but we do not expect a sharp back-up. In Europe, while the European Central Bank appears to have less ammunition at its disposal, Mr. Draghi – and later Mrs. Lagarde's – determination should not be underestimated. As such, a rate cut, possible bank deposit 'tiering' and even renewed asset purchases are likely in September.

One year into the trade dispute, we do not expect a swift resolution, as we see little political incentive for President Trump to ease pressure on China. At the same time, Mr. Trump needs to be careful with the US economy, as a significant slowdown in an election year would be unwelcome. As such, we expect some form of short-term détente, but no grand agreement until 2020.

Conversely to bonds, equity markets have taken a much more sanguine approach to recent developments, choosing to focus on possible trade truces and central bank easing rather than growth fears. Indeed, while risk appetite remains fragile, and investors have shied away from European assets due to political tensions, equities have shown some resilience, while bonds and safe havens such as JPY, CHF or gold continue to rally. We expect markets to grind higher in the coming months, amid higher volatility, as long as earnings show some decent growth.

ASSET CLASS DETAILS

Equities

Equity markets have been more sanguine about the recent re-escalation in the US-China trade war, and ensuing global growth fears. Indeed, while markets corrected on the initial announcement, we have not seen the extreme moves witnessed in sovereign bond markets. In our view, risk appetite remains fragile, aware that reversals are possible and likely at any moment, so more volatility should be expected. Nonetheless, we believe that markets can make their way higher in the coming months.

US markets tend to be seen as more defensive and should show some resilience in a tricky environment, especially given higher growth and earnings. But higher valuations can act as a cap on performance. European assets remain shunned as political and growth fears take over. The Brexit saga, the Italian drama and Germany growth worries have kept investors at bay, a trend which is likely to continue in the short term. A possible German fiscal stimulus package, the ECB managing to weaken the euro, or better Brexit news could bring a welcome relief to these markets. Emerging markets remain vulnerable to trade tensions as well as idiosyncratic events, but should follow the rest of the world higher, though to a lesser extent.

Fixed Income

Sovereign debt yields have continued their relentless march downward, on thinner liquidity, central bank support expectations, trade woes and growth fears. The search for yield has also contributed to lower US yields, with the 10-year trading below 1.50%, while the 30-year breached 2% to reach an all-time low. German Bund yields continue to defy gravity, trading around -0.69% for 10-year bonds and dragging the rest of the universe with it – negative yielding debt now totals about USD16 trillion. While we find the move extreme, we expect a stabilization, and possible some retracement if central banks are less dovish than markets hope for, but we do not expect a sharp back-up in the short term.

The inversion of the yield curve is a worrisome sign, but a recession is not a foregone conclusion, given the additional factors bringing yields down. In the short term, we could see the curve flatten as the front end falls on rate cuts and investors move further out in the search for yield, keeping the longer end down as well.

Credit spreads have widened somewhat on growth fears, but should remain contained. As could be expected, high yield has suffered more than investment grade, and we maintain a preference for the more defensive segment given the growth environment. Emerging market debt has held up well given idiosyncratic events. Yield-providing hard currency bonds should remain in demand as long as the US dollar remains stable.

Currencies

Currencies have remained broadly stable, although USD has strengthened somewhat on safe haven demand. Even though President Trump wishes for a softer USD, trade and growth worries have kept the greenback underpinned. EURUSD remains in a 1.10-1.13 range, despite the ECB’s dovish tone and expected additional stimulus in September. Cable (GBPUSD) has also remained in a tight range around 1.21, with markets pricing a higher risk of no-deal Brexit since the summer. The Yuan weakened past 7 in the latest trade escalation, with some spill over onto other regional currencies. Argentina contagion was limited, but emerging market currencies could struggle with a stronger USD.

Commodities

Growth and trade fears continue to be the dominant drivers of commodity markets, with oil prices dropping, despite OPEC trying to curb production and Middle East geopolitical tensions. We expect this trend to persist for now, and believe that shale production can also act as a cap in the longer term.

Gold continues to see safe haven demand amid lower rates and rate cut expectations, despite some USD strength. With ongoing growth fears and trade uncertainty, the momentum is likely to continue.

Alternatives

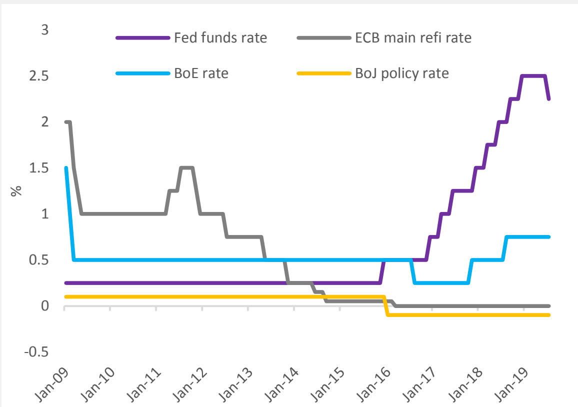
We continue to see a place for alternatives in portfolios, as we look for de-correlating and diversifying strategies to complement traditional asset classes, particularly with liquid alternatives.

INSIGHT – Central banks to infinity… and beyond

Central bank policymakers have been holding markets in the palm of their hands since the financial crisis. While this may have abated temporarily as markets boomed ahead between 2016 and 2018, with the cycle advancing and markets growing more worried about the next downturn, central bank action is in the spotlight again.

The most accomodative of them all

The European Central Bank (ECB) looks set to take the crown as the most accommodative central bank in September, as it embarks on another round of monetary stimulus. Indeed, Mr. Draghi, is likely to announce an interest rate cut from the current -0.4% of its main refinancing rate, a possible ‘tiering’ for bank deposits in an effort to protect the sector, and even renewed asset purchases. This in addition to the latest targeted longer-term refinancing operations (TLTRO III) to inject liquidity into banks, set for September as well. As such, in his last months as ECB chief, Mr/ Draghi will leave Mrs. Lagarde with a clear path of support.



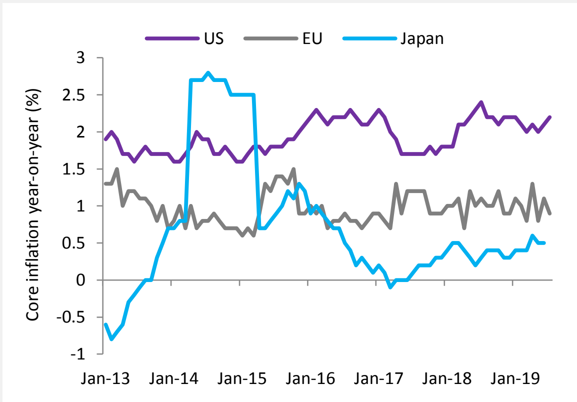
For its part, while the Federal Reserve (Fed) appears to have more room to ease, the US economy does not require the same amount of support. Mr. Powell set a relatively dovish tone during his recent speech in Jackson Hole, (re)assuring markets about the Fed’s readiness to act if needed, but trying to prepare markets for less easing than priced in, given a still-solid US economy. Mr. Powell is navigating a difficult path, trying to support sentiment, while avoiding fuelling asset bubbles, and the wrath of President Trump who continues to pressure the Fed about more aggressive cuts.

In our view, a September cut is a given – and already firmly priced into markets – but expectation for another three cuts after this seems excessive. One or two more cuts in 2019 if trade tensions persist and pressure on Mr. Powell remains are likely, but the US economy does not currently need much more support.

Is this really needed?

US growth is slowing, but looks to be stabilising around 2%. Indeed, the US consumer remains healthy as seen in strong retail sales, the labour market – despite little wage pressures – remains tight, and the housing is benefitting from lower rates. In addition, core inflation has been ticking up in recent months, reaching 2.2% in July.

However, long-term expectations for inflation remain low and have not risen, pulled down by growth concerns due to the US-China trade dispute. The Fed looks at current core inflation as well as expectations for the future, giving the Committee ammunition to justify more support. Moreover, ongoing global trade tensions are weighing both on the global growth environment, but also on the US outlook, in terms of exports and in terms of business sentiment and investment. As such, while one could argue that rate cuts are not currently necessary, a few insurance cuts can be justified.



Europe, on the other hand, remains stuck in the middle of a trade spat it cannot influence, while suffering the growth consequences. With more export-oriented economies, more dependent on Chinese growth and demand, the Eurozone economy is struggling. Indeed, while the region showed some tentative signs of stabilisation, it is flirting with recession yet again, and certainly needs further support.

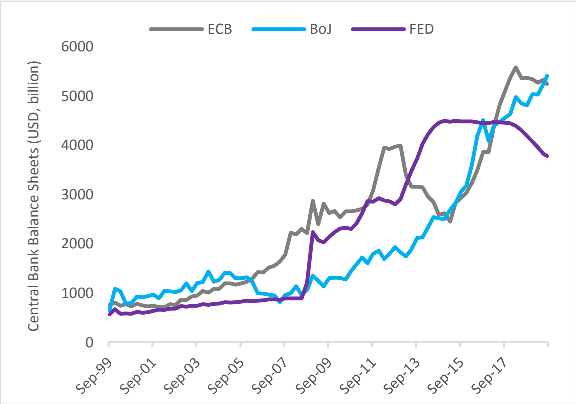
The euro area grew around 1.1% in the second quarter, but Germany and Italy both contracted, and are likely to show a similar pattern during Q3. Political tensions between the EU and Italy, and of course the ongoing Brexit saga, contribute to uncertainty and downside risks. In addition, inflation remains missing in action, stuck around 1%, justifying additional measures by the ECB. And despite the ECB’s best efforts, the euro has not weakened much, which would be a welcome boost to assets and to inflation.

Chart sources: Bloomberg, Natixis Investment Managers, 22 August 2019

INSIGHT – Central banks to infinity… and beyond

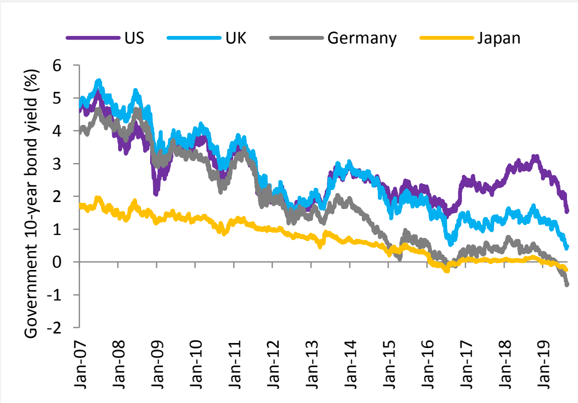
The limits of monetary policy

The dovish tone is set. The question we now face is whether all these actions will work, or if we have reached the limits of monetary policy. Indeed, we have seen a decade of ultra-accommodative policies, with mixed results.



In Europe, we do not believe it will succeed in lifting the Old Continent and its structural struggles. Mr. Draghi has been both aggressive and creative with his policies, and remains convinced we have not reached the end of monetary policy efficacy, but the scope for additional easing is limited and the effects have been underwhelming. Mr. Draghi is aware of this, and has often called for fiscal measures as a complement to monetary ones. With the arrival of Mrs. Lagarde at the ECB's helm in November, pressure on European institutions is set to increase, but in any case it will take time.

Yes, talk of a German fiscal stimulus package has begun, but the German Constitution does not make this a straightforward matter, requiring 'special circumstances' or an economic 'emergency'. It is nonetheless still a welcome development. It might also be the catalyst needed to halt the fall in global yields, as Bunds have been dragging the rest of the world with them, into evermore negative territory.



In the US, the Fed has been more successful in lifting growth, and especially markets. Indeed, we believe that one risk is that the Fed becomes too market-dependent instead of data-dependent – following market expectations rather than leading them. And ongoing pressure from Mr. Trump is not helping. From his perspective, the Fed is a safety net for his trade wars, and a tool for a weaker USD. However, the flight to safety precipitated by trade tensions is actually supporting USD instead of weakening it, despite an accommodative Fed.

Global synchronised easing

Elsewhere, the Bank of Japan (BoJ) remains in perpetual accommodative mode, with limited room to increase its stimulus scope, with debatable success. Growth remains anaemic, but the BoJ has managed to lift the economy out of deflation, though it remains far from its 2% target.

China might be the partnership model the West should aspire to, as the People's Bank of China (PBoC) is supported by targeted fiscal measures. This synchronised approach helped lift China out of the global financial crisis, and out of the 2015 slum. It also helped with painful economic rebalancing, and to manage the gradual structural slowdown.

We are also seeing a slew of emerging and developed central banks taking advantage of the Fed's cuts to cut interest rates themselves, while avoiding too much currency devaluation.

Conclusion

We have yet to see the end of monetary stimulus, as central banks work to extend the cycle and postpone the next downturn with never-ending accommodative policies. However, the longer these measures last, the less impact they seem to have, and while we do not see an imminent recession, we believe that the ECB will not manage to jump-start the European economy on its own.

Chart sources: Bloomberg, Natixis Investment Managers, 22 August 2019

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