Global outlook

March 2019

A swarm of simultaneous hits to activity and confidence

Global growth slowed dramatically at the end of 2018 and to date 2019 is not showing much improvement with implied annual growth rates for advanced economies lagging at less than 1 percent.

There was no single catalyst but rather a swarm of simultaneous hits to activity as well as business and consumer confidence.

Chinese consumption slowed on the back of previous policy tightening (since reversed), capital movement restrictions and the US-China trade battle. European growth has slumped; with underlying cyclical softness exaggerated by idiosyncratic factors such as auto production disruptions related to car emission certification, drought restricting many river-based trade routes and falling demand for its exports – particularly from China.

In Australia the drought, weak consumer spending, and falling residential construction have been conspired to take domestic growth from 3.8 percent annualised in the first half of 2018 to 0.9 percent annualised in the second half[1].

Politics are a chronic and occasionally acute economic head wind; the US-Chinese trade battles and Brexit are expected by markets to be drawn out and economically disruptive. Italy serves as a stark reminder of how populist politics can stall economic reform. In Australia chronic shortcomings like the absence of energy and climate policies to enable planning of business investment have been joined by pre-election concerns over tax policy to erode business confidence.

The glass half-empty sentiment has led to expectations that US growth will sink towards that of its trading partners. This was given a head start by the US administration scoring a political own-goal described in US Federal Reserve surveys as causing "districts to report a slowdown in activity as a consequence of the government shutdown." The implied annual growth of the US economy has fallen to 1.75 percent, from nearly 4 percent during 2018.

The US sanction softening boosted oil supply, lowered oil prices and triggered a disinflationary pulse

To add to the "perfect storm", a global oversupply (see Chart 1) of crude oil together with a short lived demand shock in late December saw a 40 percent fall in oil prices during the fourth quarter. Early in 2018, the Trump administration vowed to enforce sanctions against 100 percent of Iranian oil exports. That tough stance on Iran initially boosted oil prices dramatically, peaking in September. Under pressure from Trump, Saudi Arabia ramped up production to an all-time high; (the Saudi Arabians having the singular ability to significantly and swiftly ramp up output). Russia and the United States also accelerated production.

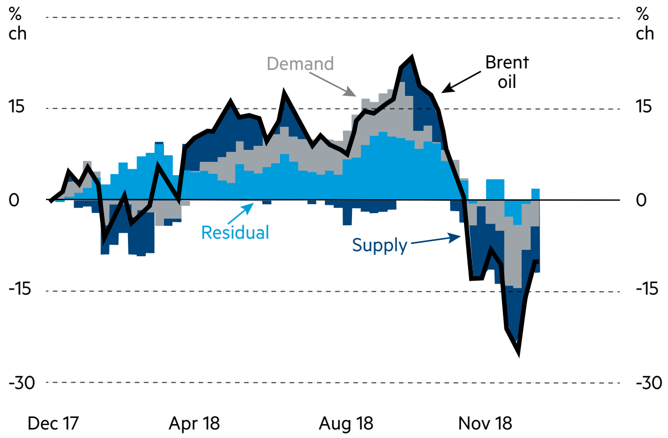
The administration however, shocked the oil market in October by softening their approach. Temporary waivers were granted allowing India, China and other countries to keep buying crude from Iran.

The Iran head fake left the oil market suddenly facing a potential supply glut. Oil prices collapsed with the plunge exacerbated by the unwinding of massive bullish bets by hedge funds.

The Organization of the Petroleum Exporting Countries (OPEC) and Russia have since cut production, demand has recovered, and now oil is 36 percent off its December lows.

Chart 1: Oil Price Decomposition

(cumulative % change)



Source: FRBNY

Oil is pivotal in driving headline inflation (see Chart 2) particularly in Europe and with something of a lag this has sent a disinflationary pulse that is still working its way through markets, adding to the general pessimism in financial markets at the end of 2018.

Given many central banks, particularly the European Central Bank (ECB) have an inflation objective, the unwelcome supply driven oil price swoon has delayed progress on long term Central Bank ambitions to slowly normalise monetary policy.

1 Source: ABS

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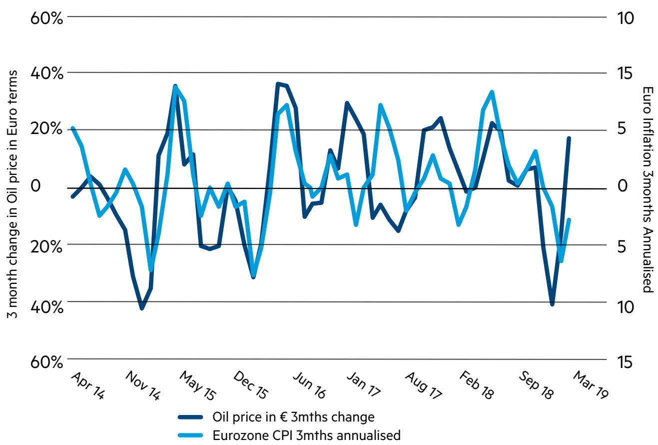
Chart 2: Oil Price Changes Drive European Inflation
ECB only has an inflation mandate



*Source: Bloomberg and Altius

In Australia persistent low wages growth has also contributed to core inflation remaining consistently below the Reserve Bank of Australia (RBA) target band for the last three years, promoting growing speculation that policy will need to be eased. At the time of writing, Australia has priced in a 70 percent probability[2] of two 0.25 percent interest rate cuts by the end of 2019.

Will this be a meaningful cyclical downturn?

Financial conditions in the US tightened significantly over 2018, thereby playing a large role in sparking the correction to asset markets. Interest rates lifted on not only the expectation of future rate rises, but also as the full size of the budget deficit financing burden began to weigh on investors, not to mention the spill over effects of the Fed's balance sheet reduction.

As market dislocation turbo-charged the carefully graduated plan for tightening policy, Chairman Jerome Powell reacted by changing guidance. Cash rate hikes are now off the table until such time as inflation is observable. A cessation of its balance sheet sell down has also been muted. In typical fashion the change in tone has seen markets perform a 180 degree turn in expectations, eschewing the idea of a pause and pricing in a rate cut instead.

The effect of the Fed's move has been to ease financial conditions considerably. Asset prices have stabilised, helped by solid employment conditions and buoyant wages. Helpfully the dampening impact of the government shutdown is also receding. Stimulus also continues to accrue from the US tax cuts and associated budget deficit which will contribute approximately 0.50 percent[3] to GDP growth in 2019 before becoming a headwind by 2020. On this basis, the US economy should remain reasonably resilient to slower global growth. As for much of the past few years, well contained inflation and low European bond yields will support US treasury bonds if, as expected yields rise modestly, noting that the current pricing of Treasuries reflects a particularly gloomy scenario.

Chinese officials expect annual growth to be slower than previous years at between 6 percent and 6.5 percent[4]. The government is sensitive to social unrest if growth slows excessively. The tightening in monetary and capital conditions which began in 2017 has dampened consumer activity, whilst the trade battle with the US has curtailed export activity. This provides Chinese authorities with the impetus to expedite a trade deal with the US. Moreover, the Chinese government has announced a significant fiscal package (3 percent of GDP)[5] to offset the trade battle impact, including cuts to VAT and a lift in infrastructure spending. The former is designed to lift Chinese consumption and will help moribund European export growth, helping lift demand for commodities.

Brexit has been in sharp focus recently. We are looking for an extension to article 50. Ultimately, we see a second referendum as the most likely (distant) scenario. This leaves business uncertainty in place – but removes the catastrophic consequences of a hard Brexit.

Idiosyncratic issues within Europe are slowly resolving. Auto manufacturing, which constitutes approximately 6-7 percent of European GDP[6], is recovering. The European drought has broken meaning goods can once again be shipped along river transport routes. European unemployment is low in the north and although higher in the south, it is falling quite quickly toward pre GFC levels.

Our view remains that the ECB's negative cash rates and government bond buying has created excessively flat yield curves and hampered bank lending. Inflation has not lifted sufficiently to change this policy stance, even though its efficacy is debatable. The ECB has announced a new tranche of Targeted Longer Term Refinancing Operations (TLTRO) to keep credit available to companies in the Eurozone. Demand for funding is moribund and recapitalisation via retained earnings virtually impossible at current levels of activity. We expect major European government bond rates to remaining extremely low for the foreseeable future (German 10 year government bonds currently yield less than 0.10 percent)[7].

The implications

We see oil prices/inflation nexus as crucial for the bond yields and therefore note with interest the extent of recovery in oil (see Chart 1). The oil-induced disinflation pulse that has been observed over 2018 should pass, reflecting this bounce in oil prices. A consequent lift in inflation should moderate the gloomy outlook reflected in global bond yields, with equities seemingly ahead of the curve in this regard.

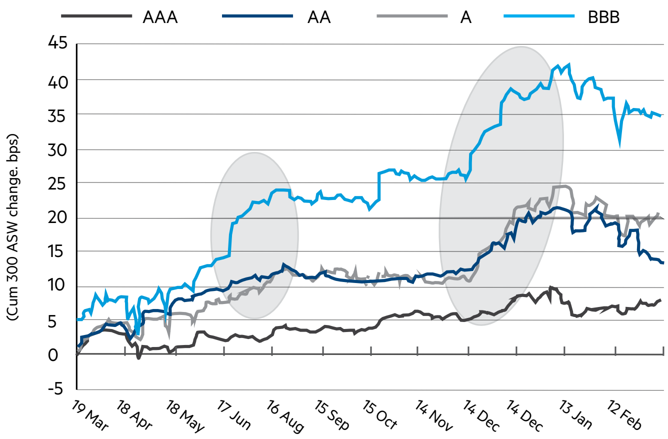
We believe the RBA will cut cash rates twice before the end of the year. For the past few years we have been confident that whilst uninspiring, growth would be sufficient to support stable to falling unemployment and benign inflation would keep the RBA on the sidelines. However, the exogenous regulatory tightening of financial conditions has impacted the ability to obtain finance in wide cross-section of the local "sub-prime" construction industry adding to the confidence sapping downturn in both house prices and turnover. According to Governor Philip Lowe, "credit conditions tightened more than was probably required". Whilst the pipeline of residential construction (apartments in particular) remains reasonable during the first half of 2019, projects roll off appreciably in the second half. This likely puts at risk 75,000 to 125,000 construction jobs. The RBA are likely expecting upward pressure on the unemployment rate and may see a need to pre-empt such an outcome.

2 Source: Bloomberg
3 Source: Bloomberg
4 Source: Peoples Bank of China
5 Source: Chinese Government
6 Source: Bloomberg
7 Source: Bloomberg

Is this already priced and are bonds too expensive at these rates?

The increasing likelihood of an RBA cash rate cut underpinned our increase in duration during January. The market, however, has since moved to price in nearly two interest rate cuts. It has pushed shorter dated bond yield below bank funding rates. For financial institutions funding via repo (repurchase agreements); there is now negative carry on many Australian Government Bonds. We believe bonds will be hard pressed to maintain a sub-2 percent yield unless the RBA cuts cash rates earlier than widely expected. We have sold some of our duration into this rally, but in the current climate will look to buy back as better value is offered and expect to be more tactical in positioning than normal given the flighty nature of markets at present.

Chart 3: Cumulative change (widening) of credit spreads by rating band



Source: CBA

More strategically, the recent widening of credit spreads (see Chart 3) has provided a good opportunity to increase our corporate bond holdings. The consequence of a more prolonged period of lower bond yields, and stable to lower cash rates, is support for credit spreads as the "global hunt for yield" is re-ignited.

Bill Bovingdon

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Chief Investment Officer

Co-founder of Altius Asset Management

Bill is well-known and highly regarded as a 33 year veteran in fixed interest asset management.

Prior to co-founding Altius in 2011, Bill was with Aberdeen Asset Management where he was head of Australian fixed income and chief executive officer. He also has worked as head of fixed income for Schroder Investment Management and Deutsche Asset Management. In his many investment roles, Bill has built successful fixed income businesses by developing proven investment processes and assembling strong investment teams.

Bill's career in investment and financial services began in 1984 with the Treasury Corporation of Victoria as a fixed income portfolio manager. He has a long working relationship with both Chris Dickman and Gavin Goodhand, formed over many years.

Bill holds a bachelor of economics from Monash University.

Chris Dickman

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Senior Portfolio Manager

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Chris has 29 years of experience in investments and financial services, with particular expertise in fixed interest.

Before co-founding Altius, Chris was with ANZ Bank as director of the funds management and public sector business.

Prior to this he worked as director, fixed income at Credit Suisse Australia and head of Australian institutional fixed income and money markets at Commonwealth Bank of Australia. He has also been fixed income dealer at Deutsche Bank Australia, and dealer and portfolio manager at National Australia Funds Management. He has particular experience in new issues in debt capital markets, and debt and derivatives sales.

He holds a Bachelor of Economics from La Trobe University in Victoria, is accredited by the Australian Financial Markets Association and is a member of the Institute of Company Directors.

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