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Wellershoff & Partners

Quarterly Macro Report

1st Quarter 2019

Growth has been slowing in the Eurozone and in China. In the US, growth appears to have peaked. In the emerging markets, weak forwarding-looking indicators are currently implying sub-trend growth over the coming quarter or two. All in all, we enter 2019 with weaker tailwinds than we had at the start of 2018.

For the US economy, lower growth rates must be expected for 2019. The diminishing effects of the 2018 tax cuts together with rising interest rates and more volatile financial markets are all sources of headwinds. And the decline in US investment in the third quarter of 2018 is a worrying development. Excluding the real estate sector, investment grew at its lowest level in two years. Including real estate also shows only very lacklustre growth figures. Given high corporate profits and the prevailing optimism about the economy, this weak state of investment is remarkable. Companies are optimistic, but apparently at the same time they are also displaying caution. The reasons for this could be manifold. Are they concerned by the current length of the business cycle, the end of low rates, or perhaps by trade tensions between the world's two largest economies?

The longest US expansion?

By the summer of 2019, the current upturn will be fully ten years old, exceeding the previous record, from the 1990s, for the longest economic expansion. While the indicators currently suggest that this new record could well be achieved and that a US recession is nowhere in sight in the short term, the question of the next US recession has understandably become more prominent.

Historically, the combination of higher interest rates, accompanied by high debt levels, elevated valuations as well as imbalances on the trade and current accounts, represented key ingredients for the onset of a recession. This historical mix describes the current backdrop quite well, but not perfectly, of course. There are also some important differences worth noting. Thus,

Fig. 1: Forward-looking GDP indicators have slowed, but still point to above-trend growth

While the survey-based W&P Economic Sentiment Indicator for the global economy (the red line) shows a slowing trend this year, the data still implies the likelihood of continued strong GDP growth over the next quarter. The blue line represents the actual, recorded GDP data. The global economy is currently still growing well above its trend growth rate (the grey line).

Source: Thomson Reuters Datastream, Wellershoff & Partners

the imbalances in the US real estate and mortgage markets are now much less pronounced than before the last crisis. Unlike in the run-up to the subprime crisis, the number of loans granted to persons with a lower credit rating remains relatively low. The risk that we will see the bursting of a real estate bubble, which fed into the last crisis, is therefore less likely at this point. It is also worth recalling how unusual it was for the housing market of the entire United States to have experienced a near-simultaneous correction, as occurred in the period 2007-2013. Historically, weakness in the housing market in one region tended to be offset by growth in other regions, reflecting the demographic and economic diversity of the US economy: Detroit (automobiles) was not Silicon Valley (tech), and Texas (oil) was not Florida (vacation & retirement).

The US real estate market as a good leading indicator

Nevertheless, developments in the real estate sector are good leading indicators, since waning momentum in real estate can have a direct impact on other areas of the economy, feeding a slowdown beyond the real estate sector itself. Not surprisingly, consumption typically suffers when house prices decline. Moreover, the real estate market's status as a useful leading indicator also reflects this sector's sensitivity to interest rates, which makes it one of the first parts of the economy to show that higher rates are slowing economic momentum.

Historically, if the number of new construction projects or houses sold decreases significantly, the end of a recovery was not too far away. Both these metrics have been disappointing in recent months. This contrasts with the robust labour market, which should be feeding demand for housing. One counter-argument here may be that, whereas Americans have jobs, these have been created in lower-paying services. This ties in with the fact that higher house prices (the pre-crisis peak was surpassed in late 2016), and higher mortgage rates are making building or buying a home less affordable. The tax reforms may also have contributed to the weaker market. Tax changes at the federal level with regard to the deductibility of interest rates on mortgages, property taxes as well as state and local taxes, may have negatively impacted the affordability of homes in certain price segments in certain regions.

Beyond the housing market, this time round, an added headwind is the high level of corporate debt. Valuations on the financial markets are also elevated, which is especially relevant against the backdrop that

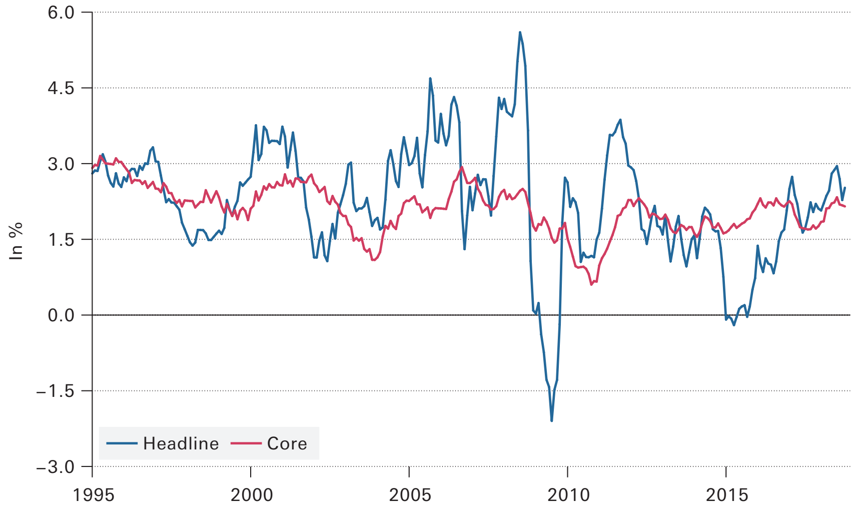
Table 1: Macro-economic estimates

	Real GDP growth in %						Inflation in %					
	2016	2017	2018E	2019E	2018Δ	2019Δ	2016	2017	2018E	2019E	2018Δ	2019Δ
USA	1.6	2.2	2.9	2.3	0.0	-0.3	1.3	2.1	2.5	2.3	0.0	0.0
Euro area	1.9	2.5	1.9	1.4	-0.1	-0.4	0.2	1.5	1.8	1.5	0.1	-0.2
Germany	2.2	2.5	1.6	1.3	-0.3	-0.4	0.5	1.7	1.9	1.7	0.0	-0.2
France	1.1	2.3	1.6	1.4	0.0	-0.2	0.2	1.0	2.0	1.6	0.0	0.0
Italy	1.3	1.6	1.0	0.6	-0.1	-0.4	-0.1	1.2	1.3	1.2	0.0	-0.2
Spain	3.2	3.0	3.3	2.6	0.6	0.4	-0.2	2.0	1.8	1.7	0.0	0.1
United Kingdom	1.8	1.7	1.3	1.3	0.0	-0.2	0.7	2.7	2.5	2.3	0.0	0.1
Switzerland	1.6	1.7	2.7	1.8	-0.3	0.0	-0.4	0.5	1.0	1.1	-0.1	-0.3
Japan	1.0	1.7	0.8	0.6	-0.3	-0.6	-0.1	0.5	0.9	1.0	0.0	-0.1
Brazil	-3.3	1.1	1.1	1.6	-0.3	-0.8	8.7	3.4	3.6	4.5	-0.1	0.3
China	6.7	6.9	6.6	5.9	0.0	-0.3	0.6	-0.5	2.3	2.2	0.1	-0.2
India	7.1	6.6	7.7	7.5	0.4	0.1	4.9	3.3	4.5	4.5	-0.2	-0.4
Russia	-0.2	1.5	1.0	3.0	-0.7	1.2	7.1	3.7	2.7	3.5	-0.1	-1.6
World (PPP)	3.3	3.7	3.8	3.6	0.1	-0.1	2.8	3.2	3.5	3.3	0.0	-0.1

E Estimates Wellershoff & Partners   Δ Deviation from consensus economic forecasts

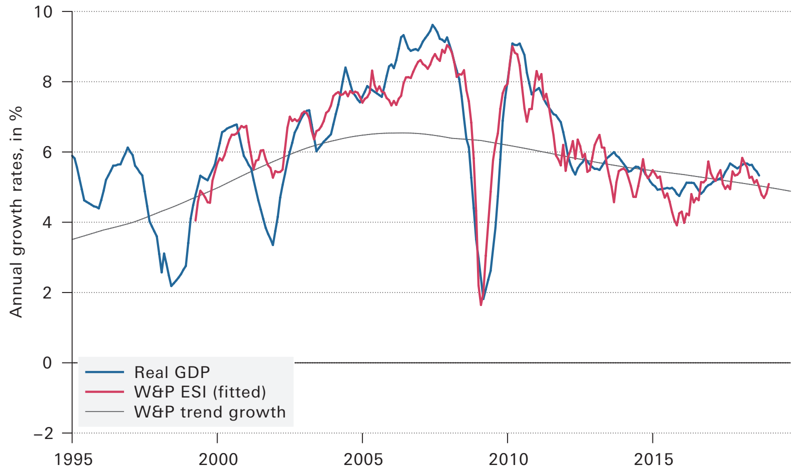
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Inflation in the US broadly on target



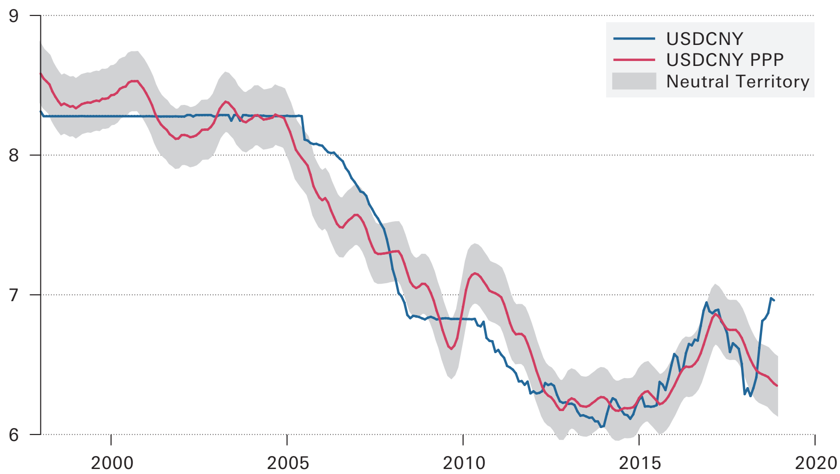
The US Fed's preferred inflation target is 2 per cent for "core PCE" – close to where that number currently stands. Another measure, the headline CPI has fluctuated between 2 per cent and 3 per cent in 2018. The recent drop in oil prices will put some downward pressure on overall inflation, however.

Fig. 3: Sentiment in the emerging markets points to trend growth



The forward-looking growth indicators for the emerging markets (the red line) have fallen to trend growth (the grey line), which suggests that actual GDP growth may be heading for a slower pace than recently recorded (the blue line). Especially China has been struggling recently. Although Chinese sentiment is clearly "adjusted" by the authorities, bottom-up data shows that China's industry is fighting a slowdown.

Fig. 4: The Chinese renminbi deviates from a long-established track



Speaking of China: this chart shows that for the past two decades the USDCNY exchange rate has tracked its US dollar purchasing power parity (PPP). That changed in 2018. The Chinese renminbi is now cheap relative to the US dollar. Considering the active role the Chinese historically took in keeping USDCNY close to its PPP, it seems as if, in light of the recent trade tensions, a policy change has happened.

Source: Thomson Reuters Datastream, Wellershoff & Partners

a long period of unusually low interest rates has come to an end. Last, but not least, there are new geopolitical risks and trade tensions that could negatively impact business and consumer sentiment. Having said that, while the list of concerns is rising, we are as yet unable to see any concrete trigger that will lead to a significant downturn in the US in the near term.

Less wind also in Europe's sails, but growth still above potential

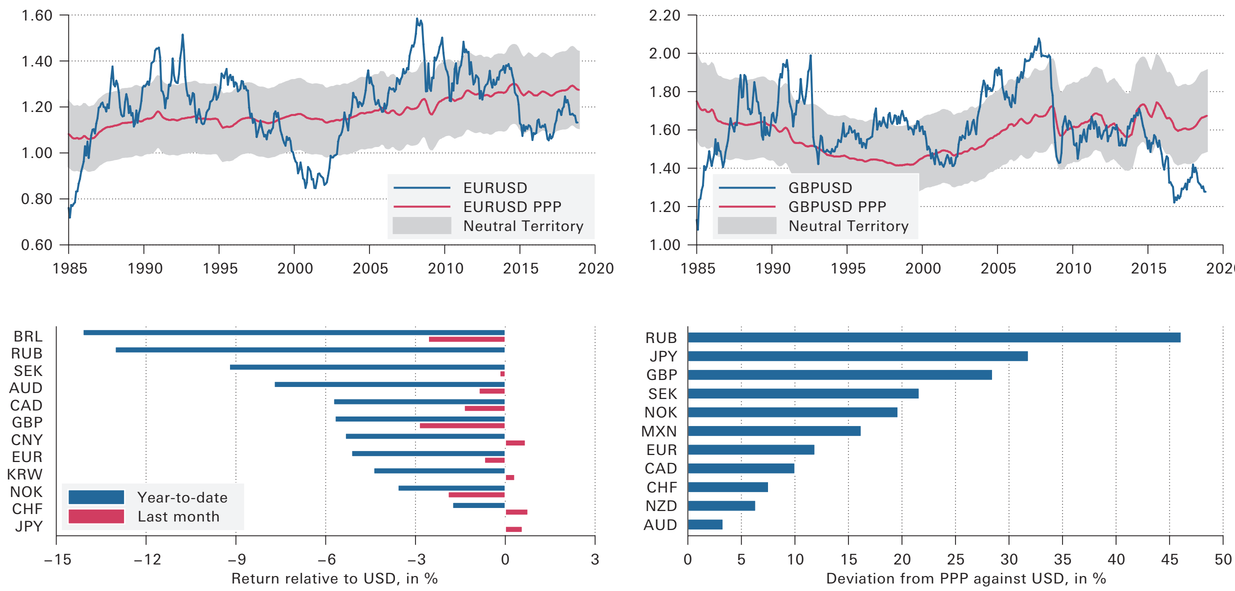
In Europe, the high momentum of 2017 faded in 2018. Special factors dragging down growth came to the fore recently. The delivery of vehicles by the German car industry was delayed due to a new test cycle for exhaust emissions. In Italy, political uncertainties have reduced growth rates. Yet the good news is that the leading indicators continue to point to growth rates above potential in all Eurozone economies. Even if no significant additional stimulus from monetary or fiscal policy can be expected in 2019, European interest rates remain low and continue to provide support. Of course, if a recession were to break out in the United States, the room for manoeuvre of the European Central Bank would be less limited compared to that currently available to the US Fed, given the much lower ECB rates.

US dollar over-valued, yen cheap, euro fairly valued

Valuation differentials in the currency markets remain at extreme levels when measured in purchasing power parity terms. The US dollar is currently at its most extreme level of overvaluation against a broad group of currencies since 2000, deviating by around 15 per cent from its trade-weighted fair value. At the other end of the spectrum are the Japanese yen and the British pound, which are both around 20 per cent undervalued against the currencies of their major trading partners.

On the other hand, the overvaluation of the Swiss franc and the Chinese renminbi has almost completely evaporated since the beginning of 2018, while the euro is currently neither overvalued nor undervalued on a trade-weighted basis.

Fig. 5: FX performance and valuations



PPP estimates based on producer price indices
Positive deviations from PPP indicate an undervaluation against the respective currency and vice versa.

Source: Thomson Reuters Datastream, Wellershoff & Partners

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