perpetual wealth

Wellershoff & Partners

Quarterly Macro Report

2nd Quarter 2019

Despite a deceleration in the forward-looking indicators for economic growth in the United States and Europe in recent months, near-term growth signals still point to above-trend growth for these economies. That is a good sign. In China, however, growth has slowed to below its long-term trend, which is a concern.

As 2018 drew to a close, markets were worried about a looming recession and reduced their bets on the extent to which the US Federal Reserve would raise rates. The Fed reacted to this market uncertainty by promising to be "patient" in its assessment of the steps required to tighten monetary policy. This change in the Fed's communication subsequently boosted market optimism as financial participants revised their expectations of how close the next recession might be. It also helped sentiment that a Fed that said it was "patient" would be a Fed that was less likely to inadvertently trigger a recession by raising rates too far too fast.

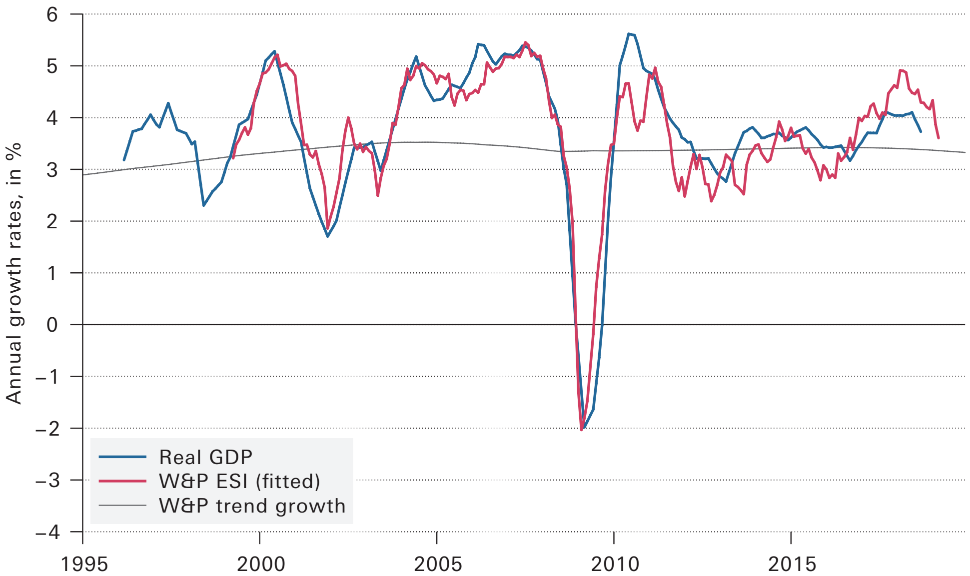
Fed's role is not to boost stocks

The markets have always loved the narrative that there might be a "Greenspan put" that would ride to their rescue when equities were in trouble, but market participants forget that it is not the role of the Fed to deliver positive equity returns. Ultimately, central banks that focus on their mandates are data-dependent, which is why we would advise keeping a close eye on the macroeconomic data, which continue to point to a reasonable global growth rate.

In the US, the leading indicators are not flagging a recession in the near term. On the contrary: the job market is currently still strong and the earlier temporary shutdown of parts of the US administration will affect economic data in the first quarter but have little impact over the medium term.

The shutdown did, however, illustrate two long-term weaknesses of the US economy: first, the country is heavily indebted and, secondly, the political system

Fig. 1: Forward-looking global GDP indicators still point to above-trend growth



The chart shows a very marked slowdown in growth expectations in recent quarters. Despite this, the survey-based W&P Economic Sentiment Indicator (ESI) for the global economy still implies continued above-trend GDP growth over the next quarter.

Source: Thomson Reuters Datastream, Wellershoff & Partners

seems incapable to take the measures required to put the country's finances on a sustainable path. US government debt, as a percentage of GDP, was around 106 per cent of GDP last year, which means that the US economy is carrying a level of government indebtedness last seen in the Second World War.

For the time being, however, these vulnerabilities are not in the forefront and we expect the economy to continue to grow at a good pace. Real interest rates continue to be at historically extremely low levels. It cannot be ruled out that real rates may still be below the "neutral" level. In such a scenario, inflationary pressures should be expected to increase again as soon as temporary factors, such as last year's weaker oil price, wash out of the numbers again.

European growth likely to accelerate again

In assessing the current economic situation in Europe, the challenge still remains to distinguish between cyclical developments (i.e. a synchronised global slowdown) and various special factors. In Germany, car production has been impacted by exhaust gas tests and logistical problems due to the low water level of the Rhine. Elsewhere, riots in France and budget negotiations in Italy have weighed on these big members of the Eurozone. Apart from these special factors, the leading economic indicators continue to point to above-trend growth, i.e. the Eurozone is still doing better than implied by its growth potential.

Of course, Britain's relationship with the European Union continues to be another large special factor to consider.

China in unchartered waters

In China, the economic outlook has weakened since our last report. Although there are indications that the measures taken by the authorities in terms of boosting investment and credit have already had some effect, the Chinese government does not want a repeat of the huge increase in debt that occurred during the global financial crisis. The authorities realise that making the Chinese economy even more indebted is not the route to high-quality growth. Chinese data at sectoral level continue to send out mixed signals about the state of the economy. Business sentiment has continued to weaken though. Our proprietary index for estimating China's GDP growth currently suggests a number around 5.7 per cent, which is below the official number and below our own measure of the long-term trend.

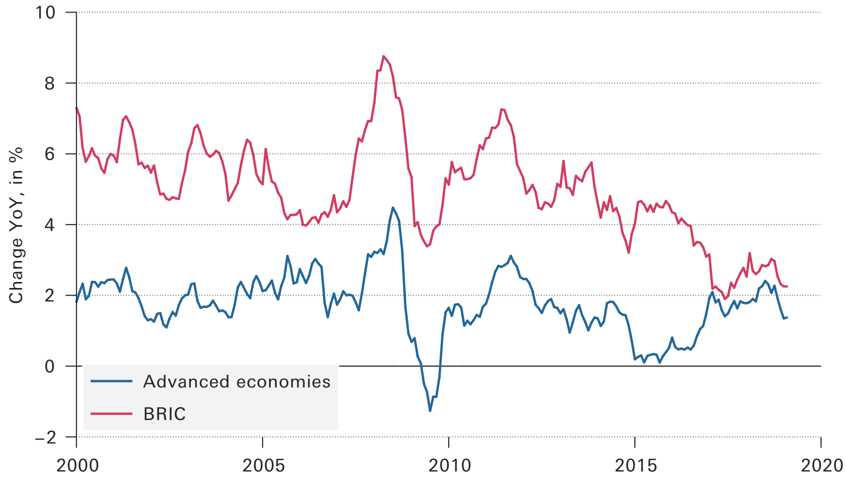
Table 1: Macroeconomic estimates

	Real GDP growth in %						Inflation in %					
	2017	2018	2019P	2020P	2019Δ	2020Δ	2017	2018	2019P	2020P	2019Δ	2020Δ
USA	2.2	2.9	2.2	1.8	-0.3	-0.1	2.1	2.4	1.8	2.3	-0.1	0.1
Euro area	2.5	1.8	1.0	1.2	-0.3	-0.2	1.5	1.8	1.5	1.7	0.1	0.2
Germany	2.5	1.5	0.7	1.2	-0.5	-0.3	1.5	1.7	1.7	1.9	0.0	0.2
France	2.3	1.5	1.2	1.2	-0.1	-0.2	1.0	1.9	1.4	1.7	0.1	0.2
Italy	1.7	0.8	0.3	0.5	0.0	-0.2	1.2	1.1	0.8	1.4	-0.1	0.1
Spain	3.0	2.5	2.9	1.7	0.7	-0.2	2.0	1.7	1.5	1.7	0.2	0.2
United Kingdom	1.8	1.4	1.1	1.1	-0.3	-0.4	2.7	2.5	2.5	2.3	0.5	0.2
Switzerland	1.7	2.5	1.1	1.4	-0.5	-0.3	0.5	0.9	0.7	1.1	0.0	0.2
Japan	1.9	0.8	0.6	0.5	-0.3	0.1	0.5	1.0	0.9	1.0	0.1	-0.2
Brazil	1.1	1.1	1.5	2.4	-1.0	0.2	3.4	3.7	4.0	4.3	-0.1	0.3
China	6.9	6.6	5.6	5.2	-0.6	-1.0	1.6	2.1	2.2	2.3	-0.2	-0.4
India	6.7	-	7.3	7.4	-0.2	-0.3	3.3	3.9	4.6	4.8	-0.3	0.2
Russia	1.5	-	1.8	1.8	0.2	0.1	3.7	2.9	4.5	4.8	-0.6	0.0
World (PPP)	3.8	3.7	3.4	3.5	-0.1	-0.3	3.2	3.8	3.5	3.6	-0.1	0.1

E Estimates Wellershoff & Partners Δ Deviation from consensus economic forecasts

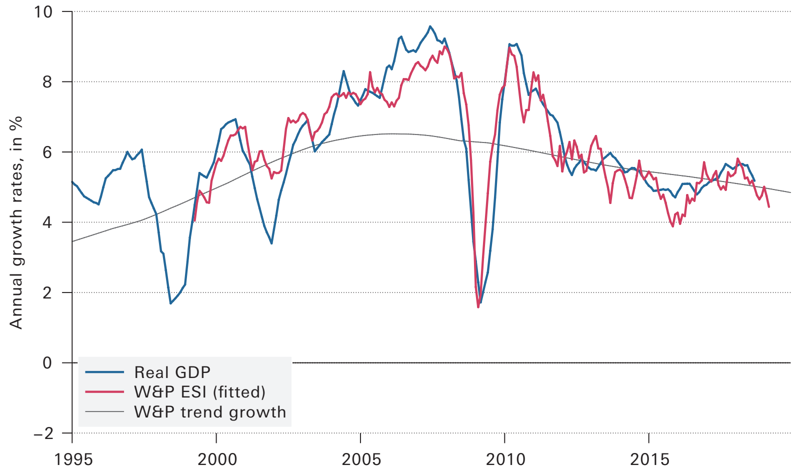
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Global inflation still moderate



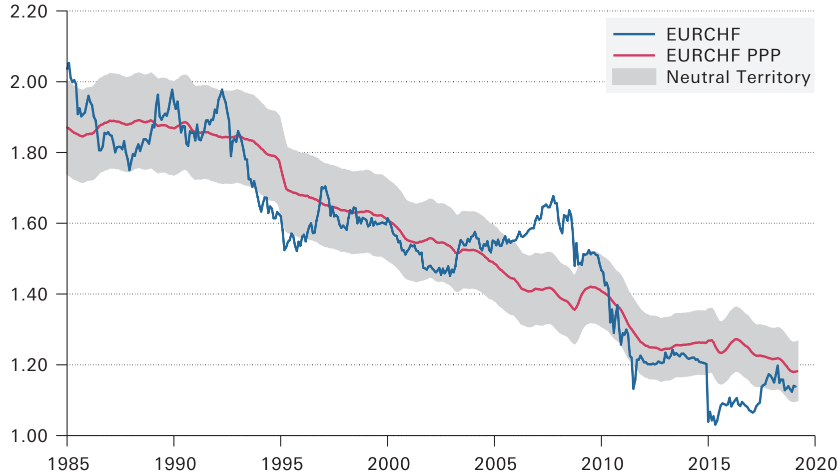
The inflation in advanced economies (the blue line) shows that central banks are struggling to reach their inflation target of around 2 per cent. Inflation in the BRIC economies is also at multi-year lows.

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



The forward-looking growth indicators for the emerging markets (the red line) have fallen below trend growth (the grey line), which suggests that actual GDP growth may be heading for a slower pace than recently recorded (the blue line). The emerging markets are thus continuing to feel the down draft from China.

Fig. 4: The Swiss franc no longer expensive against the euro



We estimate that the purchasing power parity rate of the Swiss franc against the euro stood at 1.18, with a neutral range of 1.10 to 1.26. The spot rate at the end of February was 1.13, suggesting that the Swiss franc was fairly valued in purchasing power parity terms.

Source: Thomson Reuters Datastream, Wellershoff & Partners

How strongly is China's current growth slowdown impacting the global economy? Here are some numbers that provide some insight on this issue. China is the world's third largest importer of goods after the US and the EU. Let's take the example of Germany, where the share of exports to China amounts to approximately 2.5 per cent of GDP. German export growth to China has slowed from 15 per cent in the fourth quarter of 2017 to just over 5 per cent in the fourth quarter of 2018. This would have resulted in a decline in overall economic growth in Germany of about 0.25 percentage points. The weakness of China will, therefore, definitely knock growth in Germany, but Chinese imports would have to collapse dramatically to have a much bigger effect on German growth figures. Arguably, the bigger impact of trouble in the Chinese economy would stem not so much from the narrower trade numbers, but from the impact on global economic sentiment and confidence. For the moment, however, we do not deem such a scenario very likely.

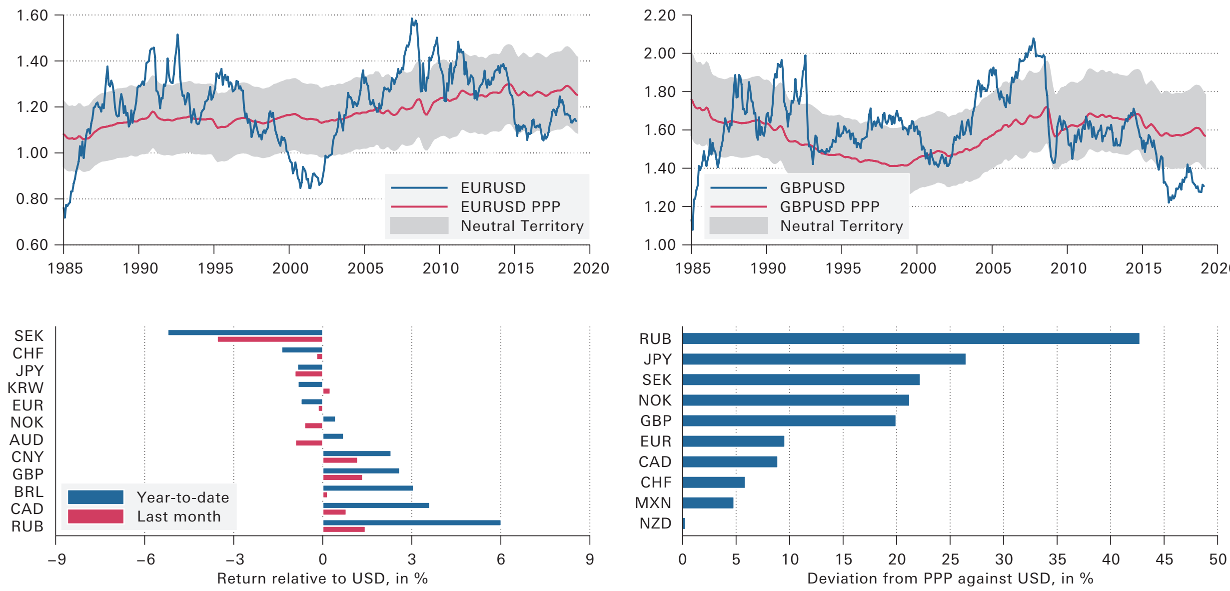
The dollar starts 2019 overvalued

The US dollar started 2019 overvalued against a broad range of G7 currencies as well as versus some major emerging market currencies. The dollar's current strength is not only a reflection of strong US growth, but also of developments outside the US. History shows that phases of noteworthy over- and undervaluation eventually correct, however.

It is noteworthy that some of the largest valuation gaps have emerged versus G7 currencies, including Sterling and the Japanese yen, which were trading around 15 per cent and 22 per cent below their respective purchasing parity rates of GBPUSD 1.58 and USDJPY 87 as of the end of February 2019. In purchasing power parity terms, the dollar's overvaluation against the euro and the Canadian dollar was more modest – 10 per cent relative to a EURUSD PPP rate of 1.26 and 8 per cent relative to a USDCAD PPP rate of 1.21.

Against the Swiss franc, the dollar traded just 6 per cent stronger than our PPP rate estimate of USDCHF 0.94. Our estimated neutral range for USDCHF is 1.06 to 0.82, meaning that we do not currently see any extreme valuation of the dollar relative to the Swiss franc.

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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