perpetual wealth

Wellershoff & Partners

Quarterly Macro Report

3rd Quarter 2019

Business cycle risks have increased since our last report. While the data still does not suggest a recession is imminent, we see no major growth drivers on the horizon to reverse this trend anytime soon. The most likely scenario: a period of mediocre growth ahead.

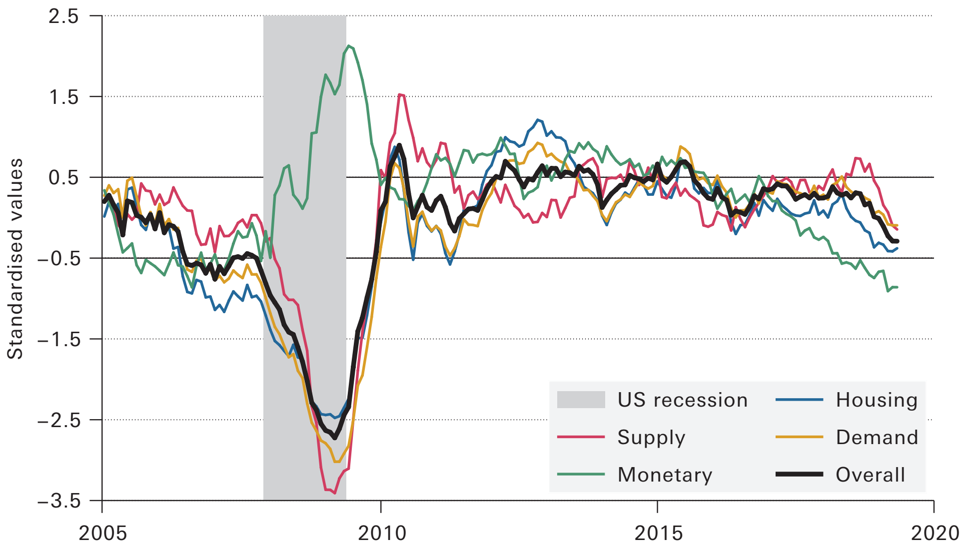
Reflecting apparent market concerns about the next recession, there has been a marked decline in longer-dated government bond yields. The chart below, showing Wellershoff & Partner's proprietary business cycle indicator for the US economy, reflects some of the signals that the bond market has been reacting to.

Less positive news on trade but consumption is holding up

In addition, given the intensifying trade dispute between the world's two largest economies, our indicator for global exports also signals a downturn in sentiment. In view of the latest escalation in the US-China trade spat, a further weakening in export numbers must be expected in the coming months. We would note that this dispute is unlikely to be resolved quickly; nor will it be forgotten any time soon. Its consequences probably will be long-lasting as businesses are forced to rethink their global supply chains. However, we think the price impact at country, sector or product levels could vary widely. For example, we may see prices fall temporarily in one country or sector – say, for US soybean producers whose exports to China are shrinking. But elsewhere prices will increase – in this instance, for Brazilian soybean farmers who are seeing exports to China soar. This is not unlike the impact of a flood, earthquake or other natural disaster that knocks out production in one area for a while. Sometimes such a disruption lasts for many years.

The noise in the trade data linked to the US-China trade dispute comes on top of other major structural developments among key trading economies, includ-

Fig. 1: Business cycle indicators heading the wrong way



This chart presents the latest update of our business cycle indicator, and its subcomponents, for the US economy. Both the monetary and the housing market indicator are already at worryingly low levels. But despite the overall decline in recent weeks, the indicator still does not imply a recession.

Source: Thomson Reuters Datastream, Wellershoff & Partners

ing the economic slowdown in China, which has implications for China's suppliers, from commodity exporters to the Japanese machine tool sector.

A different story on consumption

Despite the cheerless export sector news and the flagging business sentiment, the indices for consumers in the major economies – typically the largest share of GDP in advanced economies – have remained robust. In the US, consumer sentiment is still well above average. In many Euro area countries, too, sentiment surveys remain above their long-term average. The exceptions to this upbeat consumer mood include Japan and the UK. In the latter, Brexit turmoil has weakened consumer sentiment noticeably, and the modalities and timing of the UK's departure from the EU are still unclear.

Leading indicators in US and Euro area trend lower

Overall, the economic outlook in the US has worsened in recent quarters. Still, in both the US and the Euro area, the initial estimates for quarterly growth were above trend. The details behind the numbers, however, paint a less positive picture. In Europe, the economy was supported by the construction industry, which benefited from the warm weather. Growth in the US received a boost from a couple of quite volatile factors: higher government spending at the local level, and an increase in companies' inventories in anticipation of potential supply shortages due to the US-China trade squabble. Business sentiment, on the other hand, is weakening in both currency areas, even if there are increasing signs in Germany, for one, that the low point may have been reached, at least for the time being. Fortunately, as we noted above, US and Euro area consumers seem largely untroubled by the increased economic risks, which is probably due to their still robust labour markets.

While US long-term bond yields have declined – a famously bearish signal – this development also has a significant, and positive, offsetting consequence: The lower interest rates help support the US housing market. Confirming this effect, the housing market's contribution to recession risk has not increased recently, as shown in the first chart.

Few if any growth impulses from China

In the meantime, we think hardly any sustained, near-term growth impulses can be expected from China. The hoped-for boost that the authorities' recent measures

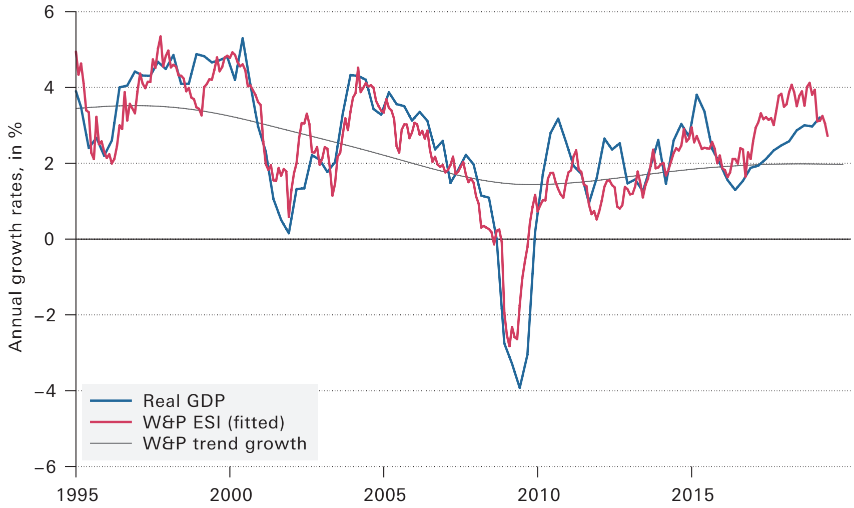
Table 1: Macroeconomic estimates

	Real GDP growth in %						Inflation in %					
	2017	2018	2019P	2020P	2019Δ	2020Δ	2017	2018	2019P	2020P	2019Δ	2020Δ
USA	2.2	2.9	2.3	1.7	-0.3	-0.2	2.1	2.4	1.9	2.5	0.0	0.4
Euro area	2.5	1.8	1.1	1.1	0.0	-0.2	1.5	1.8	1.5	1.8	0.1	0.4
Germany	2.5	1.5	0.8	1.2	0.0	-0.3	1.5	1.7	1.7	1.9	0.2	0.3
France	2.3	1.6	1.2	1.2	-0.1	-0.1	1.0	1.9	1.4	1.7	0.2	0.2
Italy	1.8	0.7	0.3	0.5	0.2	0.0	1.2	1.1	0.8	1.4	-0.1	0.2
Spain	3.0	2.6	2.5	1.7	0.4	-0.2	2.0	1.7	1.5	1.7	0.3	0.1
United Kingdom	1.8	1.4	1.1	1.1	-0.3	-0.3	2.7	2.5	2.5	2.3	0.5	0.3
Switzerland	1.7	2.5	1.2	1.2	0.1	-0.3	0.5	0.9	0.7	1.1	-0.1	0.2
Japan	1.9	0.8	0.6	0.5	0.0	0.1	0.5	1.0	0.9	1.0	0.3	0.1
Brazil	1.1	1.1	0.9	2.0	-1.2	-0.5	3.4	3.7	3.8	4.1	0.2	0.0
China	6.9	6.6	6.0	5.2	-0.3	-0.9	-0.5	0.6	2.2	2.3	-0.1	-0.2
India	7.2	-	7.1	7.4	-0.2	-0.1	3.3	3.9	4.3	4.5	0.4	0.3
Russia	1.6	-	1.5	1.8	-0.1	0.1	3.7	2.9	4.7	4.8	-0.3	0.3
World (PPP)	3.8	3.6	3.2	3.4	-0.1	-0.2	3.2	3.6	3.5	3.8	-0.1	0.1

E Estimates Wellershoff & Partners   Δ Deviation from consensus economic forecasts

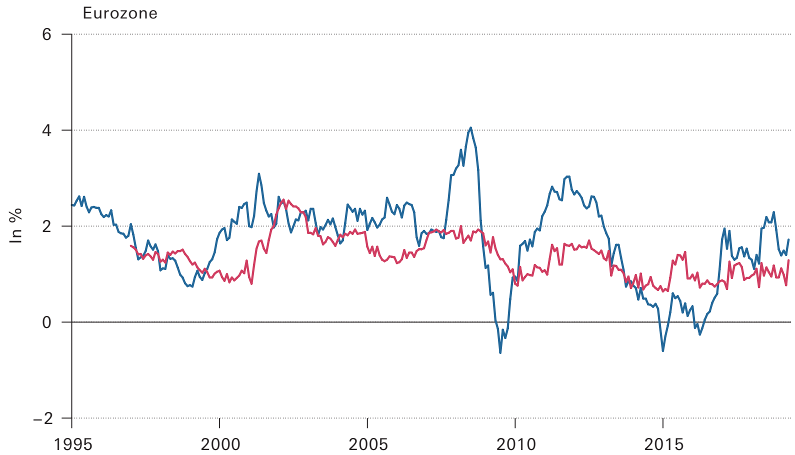
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: A sharp deceleration in US growth expectations



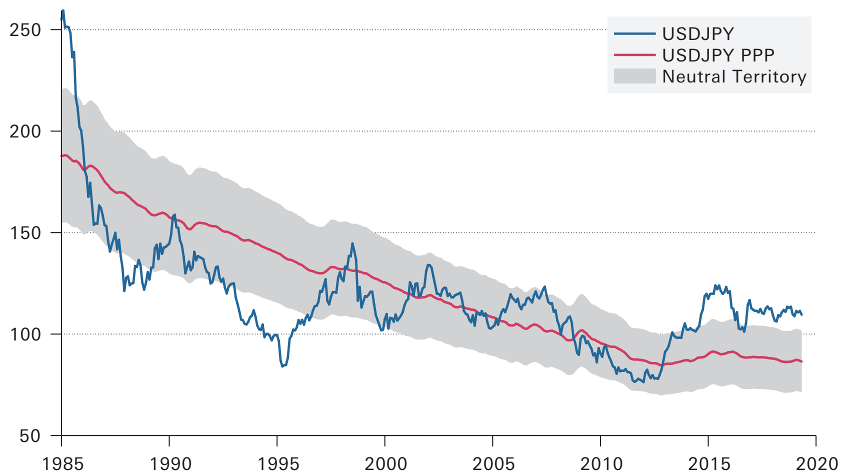
This chart shows that there has been a sharp decline in real GDP growth expectations in the US, from around 4 percent in recent quarters to around 2.5 percent. The blue line shows the actual GDP numbers. This is one of the main reasons for market concerns about the US economy.

Fig. 3: European inflation still leaves ECB with room to manoeuvre



Given that both the headline and core inflation rates are below the European Central Bank's (ECB) 2 percent upper limit, we think the ECB can afford to appear patient about raising interest rates.

Fig. 4: The Japanese yen



According to our purchasing power parity estimates, the Japanese yen appears markedly undervalued against the US dollar. We think this endows the yen with significant appreciation potential.

Source: Thomson Reuters Datastream, Wellershoff & Partners

were supposed to deliver to the economy remains unconfirmed in the latest data. Credit growth seems to have stalled, while industrial production growth has slowed to historically low rates, with individual sectors – car and truck makers, for one – performing particularly poorly. Business sentiment has also weakened a bit in China. At least for the time being, we see no easy actions that the Chinese authorities might take that would kick-start the economy in the short term while not risking longer-term instability.

Fortunately, inflation remains subdued

Our proprietary early warning indicator for inflation in the Euro area continues to show values near the midpoint of their historical distribution. Inflation accelerated at the start of the second quarter, but it still remains below the ECB's upper limit of 2 percent.

In the US, the Federal Reserve's preferred inflation metric – personal consumer expenditures – is also below 2 percent. Moreover, the recent decline in inflationary pressures in the US and the lower growth expectations have led the market to price in a higher probability of cuts in US interest rates.

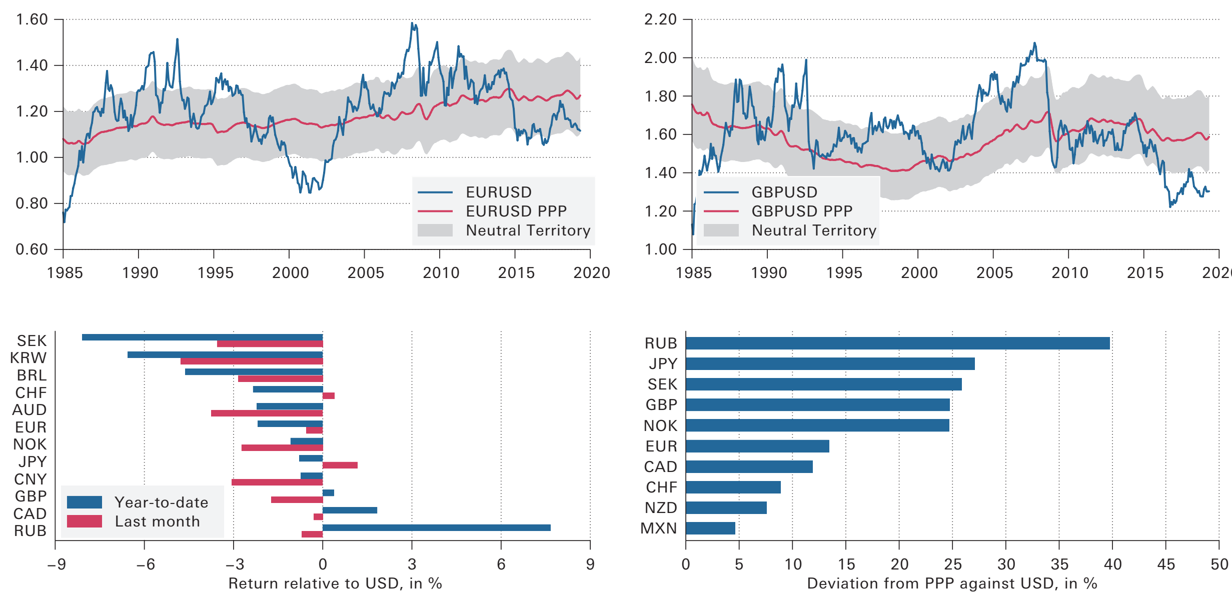
FX overview: Strong dollar/cheap yen

We think the US dollar continues to remain significantly overvalued from a purchasing power parity (PPP) point of view against a broad range of currencies. Among the majors, the cheaper currencies against the US dollar, in PPP terms, include Sterling and the Japanese yen. We are still doubtful about the British pound, however. Further Brexit-derived turbulence should probably be expected for the pound. While the Japanese yen's safe-haven credentials have come into play on a few occasions this year, the yen continues to remain significantly undervalued, according to our purchasing power parity calculations.

Another traditional safe haven, the Swiss franc, was able to benefit somewhat from recent stock market turbulence, despite the ever-present risk of intervention by the Swiss National Bank.

Meanwhile, the euro is balanced between a group of cheaper currencies (JPY, GBP, TRY, SEK, NOK) and those that are on the stronger side of their PPP values (USD, AUD, CHF).

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

Disclaimer

About us

Perpetual Wealth AG is a wealth management boutique offering financial and family office services to a sophisticated international clientele. Perpetual Wealth AG is a member of Aquila & Co., which is regulated by FINMA (Swiss Financial Market Supervisory Authority) as a security dealer and as a bank. Perpetual Wealth AG is a member of SAAM, Swiss Association of Asset Managers, and FINMA regulated with regards to Anti-Money-Laundering regulations.

Wellershoff & Partners Ltd is an independent consulting and research company that focuses on global economics, financial markets and comprehensive risk management. The internationally operating consultancy was founded in 2009 and is based in Zurich.

Imprint

Published by // Wellershoff & Partners Ltd., Zurich
Author // Costa Vayenas
Concept // Wellershoff & Partners Ltd., Zurich
Design // Feinmass Kommunikationsdesign, Lucerne

Editorial deadline: June 4, 2019