



Global Leading Indicators

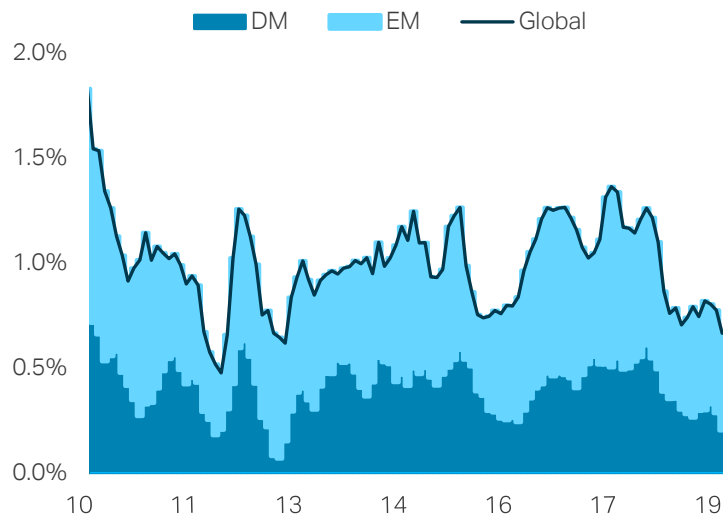
THE PLAYBOOK IS CHANGING

Konstantinos Venetis / Davide Oneglia

- Yield curve inversion says the US slowdown has legs
- Global recovery set on a shallower path than in 2016/17
- Dollar resilience predicated on the 'wrong' reasons
- Macro backdrop points to equities 'catching down' with bond yields

On shaky ground

Global Leading Indicator and components



The playbook is changing

The message from an inverted Treasury curve is that the US slowdown has legs. Deflationary impulses from China, elevated inventory ratios and a resilient dollar point to a shallower recovery for the world economy than in 2016/17 and set the stage for equities to 'catch down' with lower bond yields.

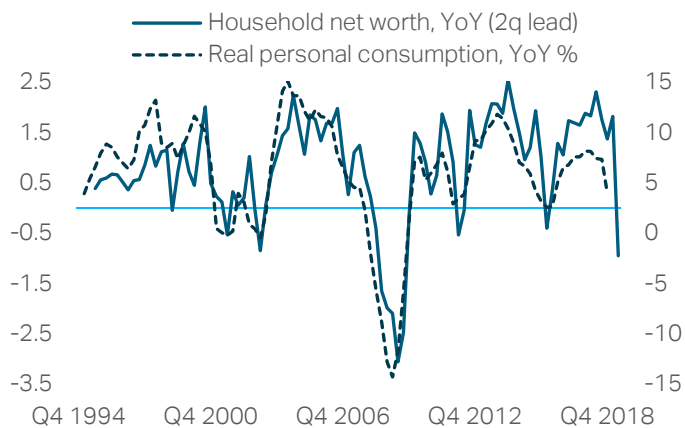
Equity markets extended their advance in March despite persistent signs of weakness in the global business cycle. Investors are taking a page out of the 2017 Goldilocks playbook, marked by dovish central banks and faith in Chinese reflation. Cracks in this narrative are starting to emerge, however. The FOMC's dovish turn this month also exposed policymakers' concerns about soft domestic macro momentum, pushing the Treasury curve lower and further into inversion. This has so far failed to dampen the dollar, which continues to drift higher and, coupled with sustained deflationary pressures emanating from China, is denting the growth outlook for the rest of the world. Against this backdrop, it appears increasingly likely that the yawning gap between rising global equities and falling bond yields that has developed in 2019 will close via stocks 'catching down' with yields rather than the other way around – a break from what has been the norm since mid-2016.

With inversion spreading across the front end of the US yield curve, recession risk is dominating the headlines. To be sure, these fears are not out of place. Inversion in the 3m-10y part of the curve is as reliable a signal of an approaching US recession as any. But there are lags – it takes on average around 18 months between the first inversion and the subsequent recession – and the near-term implications for asset returns are far from conclusive. The message, however, from the shape of the Treasury curve and the sustained drop in real yields since November is clear: there is a good chance that the US economic slowdown will run beyond the first quarter. Whether or not it leads to a recession in 2019/20 (we think not, largely thanks to proactive Fed easing) is a different question.

The US slowdown from above-trend rates of growth should be no surprise. Initial conditions matter: key indicators of the business cycle such as unemployment, jobless claims, consumer confidence and small business sentiment finished 2018 at or near record levels. With the lagged impact from tighter monetary settings kicking in, Trump's fiscal boost fading, macro momentum abroad on shaky ground and the dollar appreciating over the last year, the US economy could appear immune only for so long.

Market sensitivity

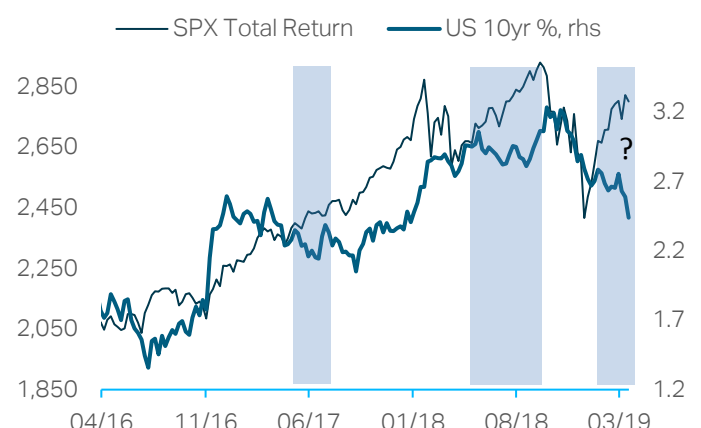
US\$ trillion



Source: Datastream, TS Lombard

Catching up...or down?

Index



Source: Bloomberg, TS Lombard

Renewed weakness in our US Leading Indicator is consistent with evidence of deceleration in the high-frequency data. The Chicago Fed National Activity Index has turned slightly negative for the first time since Q3 2017. The Conference Board’s Leading Economic Indicator remains elevated but momentum has steadily flagged since mid-2018. House prices are weakening, with new home construction data coming in soft. Business investment looks stuck in low gear, with future capex intentions lacking impetus against a backdrop of bloated inventories.

Notably, the sharp stock market correction of Q4 has left its mark on personal spending – a reminder that, with the share of equities in household net worth sitting at record highs, consumption remains sensitive to gyrations in financial markets. Annual growth in expenditure on durable goods, which tends to lead broader consumption, has fallen to its lowest level since 2014. Consumer confidence slipped in March, with souring labour market sub-indices confirming the recent slowdown in hiring and pick-up in job cut announcements. Our US economist, Steve Blitz, thinks it would take sustained weakness in employment growth (i.e. numbers below 100k) to trigger a [Fed rate cut](#) later this year – the chances of such a scenario materialising in Q3 look more than even.

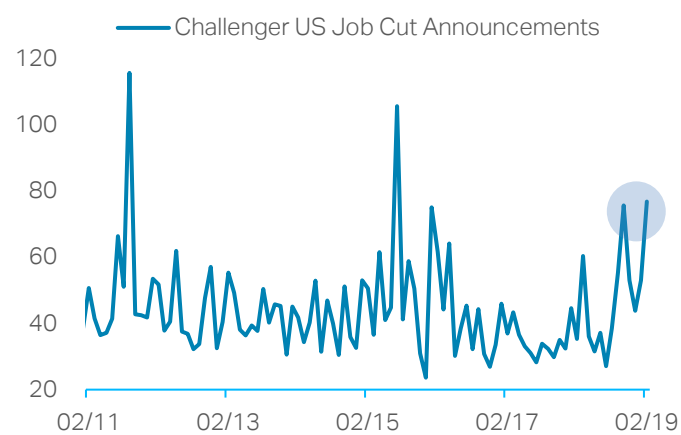
In China, Beijing’s stimulus initiatives have set the stage for the economy to start turning the corner. Yet with the authorities so far maintaining a prudent stance on easing compared to 2008 and 2016, it looks like this recovery will be shallower and take longer to materialise. Policymakers have downgraded their deleveraging objective in favour of growth, but they have not abandoned it; and the fiscal easing measures announced so far are skewed toward tax cuts, which tend to have a lower growth multiplier than infrastructure spending.

The economic news is, on balance, still mixed. Credit creation appears to be gathering pace, but the credit impulse is still weak; similarly, M1 growth is showing signs of life but remains subdued. Importantly, while the PBoC seems to have learnt its lesson from the experience of 2015 and has been expanding the size of its balance sheet since the middle of last year, banks’ reserves at the central bank have been shrinking since Q4, with the YoY rate of decline exceeding 9% in both January and February. This goes some way to explaining why recent cuts in the required reserve ratio have failed to keep a lid on short-term money market rates, complicating the PBoC’s efforts to improve liquidity conditions.

Meanwhile, China is flirting with PPI deflation, which threatens to prolong the contraction in industrial profits (down 14% YoY in January and February) and depress world export prices further.

Cracks in the labour market

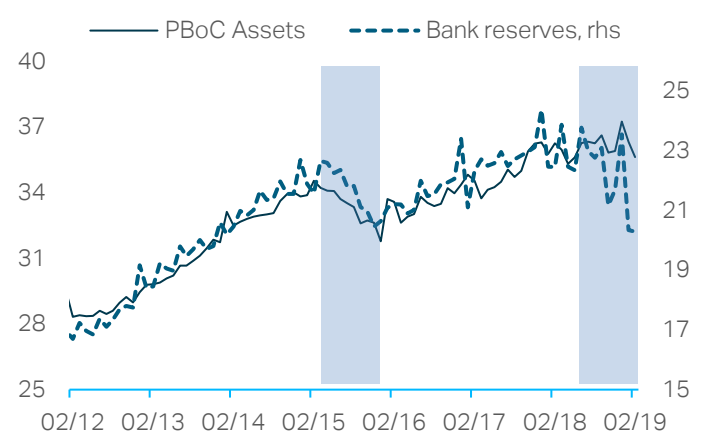
'000s



Source: Bloomberg, TS Lombard

Shrinking bank reserves

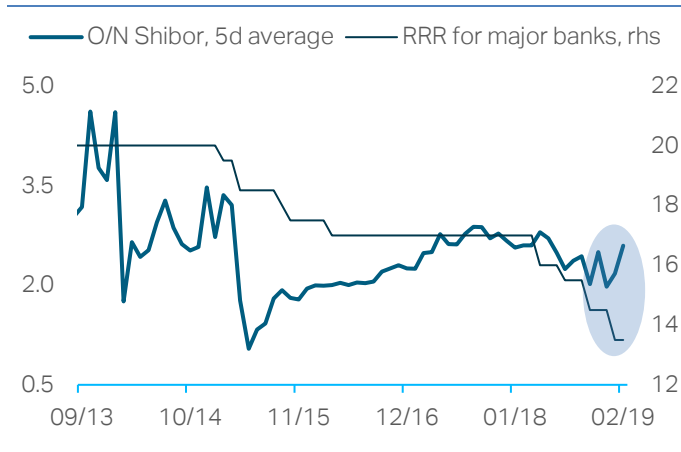
RMB trillion



Source: Bloomberg, TS Lombard

PBoC easing is an uphill struggle

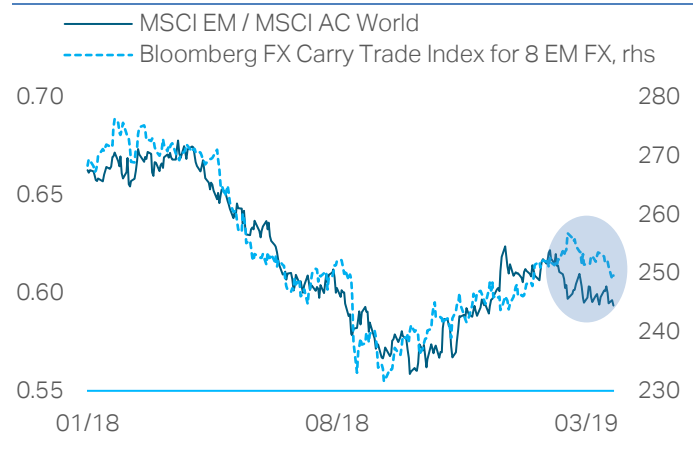
Percent



Source: Bloomberg, TS Lombard

Signs of exhaustion

Ratio



Source: Bloomberg, TS Lombard

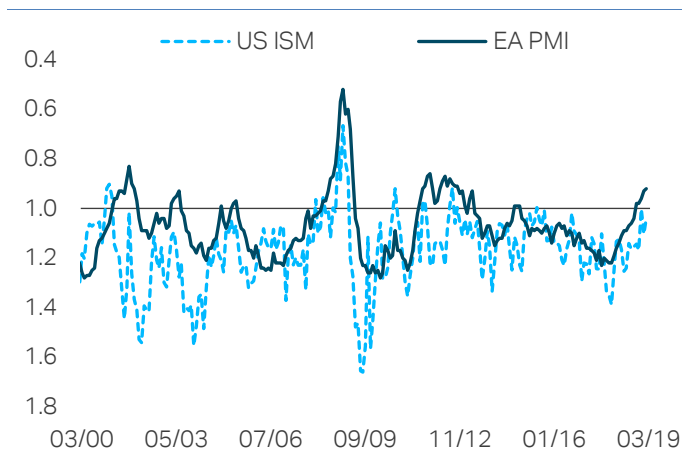
The spill-overs to consumer prices might not take long to show up in the data: besides downward growth revisions, pricing conditions in China are likely a key factor behind the fall in selling price expectations reported by manufacturing firms in the euro area.

The combination of eroding margins and soft demand is keeping the global industrial cycle subdued. Better Chinese growth should put a floor under trade activity going into H2 2019, arresting the negative momentum. To be sure, our Asia-driven [leading indicator](#) for Chinese exports is pointing to more pain ahead; but the rate of deterioration has eased, suggesting a bottom is not far off. In the euro area, particularly in Germany, the PMIs point to very weak manufacturing orders. While it would be unwise to dismiss these signals as pure noise, the PMIs also tend to exaggerate negativity at times of heightened uncertainty and large financial market dislocations. With Brexit risks flashing red, recent depressed readings could be overstating the downside – just as they exaggerated the upside back in H2 2017. That said, both the soft IFO survey data and our own leading indicators corroborate the view that EA growth is set to remain under pressure for the foreseeable future.

Perhaps the bigger point is that even if the manufacturing sector soon finds a firmer footing, elevated global inventory-to-shipment ratios suggest that the rebound – whenever it comes – is unlikely to resemble the solid acceleration witnessed in H2 2016. For the time being, both actual and survey data signal a significant inventory build-up in all corners of the world economy, while shipments and new orders are falling. The US wholesale inventory-to-sales ratio has risen close

Manufacturing woes

Order-to-inventory ratios, inverted



Source: ISM, IHS Markit, Datastream, TS Lombard

Stock overhang

Index



Source: US Census, METI, KOSTAT, Datastream, TS Lombard

to its 2016 highs, driven up by durables. Destocking is set to act as a drag on upcoming production and survey figures as businesses work off the inventories accumulated ahead of Trump’s threat, since postponed, to raise tariffs on Chinese imports in January. Similarly, according to NBS data, China is experiencing the highest inventory turnover in years. In Japan, the inventory-to-shipment ratio for machinery has stabilised after a spike in December, but shipments of electronic components from Korea and Taiwan continue to suffer. The combination of capacity cuts and bearish earnings guidance in the [Asian semiconductor sector](#) also suggests it is too early to expect a meaningful turnaround in the tech supercycle.

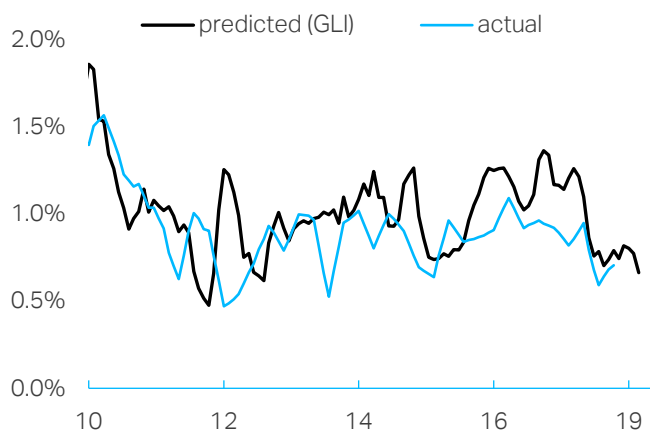
With the US economy set to slow further and high hopes for a swift turnaround in China likely to be dashed, bullish forecasts for EM growth should be taken with a grain of salt – even as falling inflation coupled with a dovish Fed has opened the door for easier monetary policy. Our Global Leading Indicator has turned lower and other market indicators suggest some of the optimism that has been baked in the cake is already starting to get priced out. EM equities began to underperform in early February. Breadth has deteriorated, with Chinese stocks ploughing on while the rest of the MSCI EM index has stayed range-bound. Copper has trended lower in March, coinciding with the end of the yuan’s three-month-long recovery: CNY/USD has been drifting higher after failing to hold below the 6.70 mark, setting the tone for broader EM FX weakness.

The signal from the FX market is important. Dollar strength is playing out even as the trifecta of Fed hike expectations, US growth outperformance and fiscal stimulus that propelled it higher in 2018 has shifted into reverse. Leaving aside its attractive carry, the dollar’s resilience this year seems to be predicated on the ‘wrong’ reasons. It is the symptom of a world economy that is [re-synchronising lower](#) – just like dollar weakness through 2017 and up until the ‘vol shock’ of January 2018 (which marked the top in global equities ex-US) was a reflection of the synchronised global economic upturn.

The dollar’s performance could also be sending a signal for the direction of US (and, by extension, global) stocks. Since mid-2016, periods marked by positive divergence of the S&P 500 versus 10yr Treasury yields have tended to end via yields rising to catch up with equities. Hawkish Fed communications propped bond yields up in October and early November even after US equities had rolled over, with yields eventually ‘catching down’ going into year-end. This year, the backdrop of slowing growth, rising deflationary risks and souring earnings expectations suggests it may be time for a role reversal and for stocks to ‘catch down’ with yields.

Global Leading Indicator (GLI)

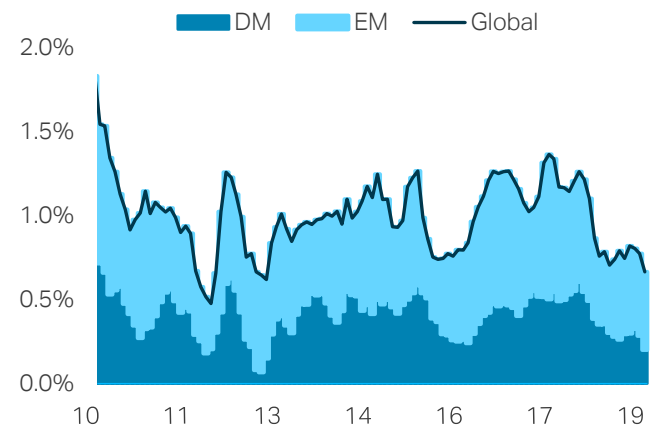
World GDP, QoQ



Source: Datastream, TS Lombard

On shaky ground

GLI and components

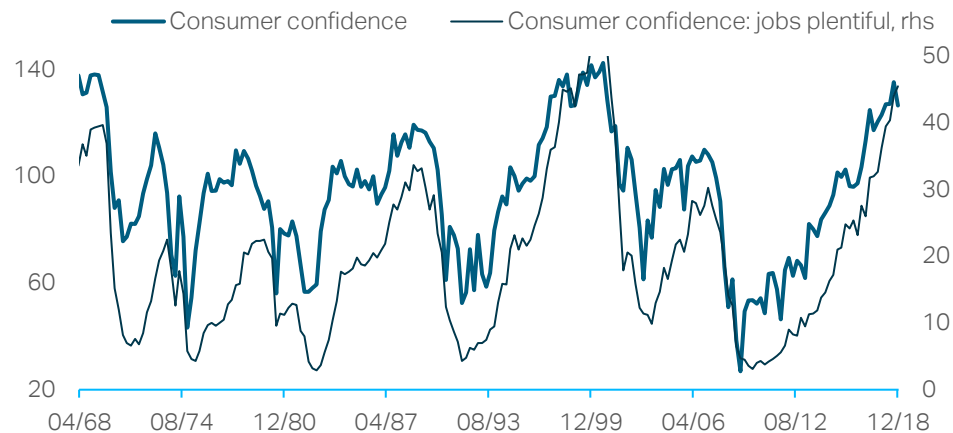


Source: Datastream, TS Lombard

US – initial conditions matter

Consumer confidence still hovering at the highs

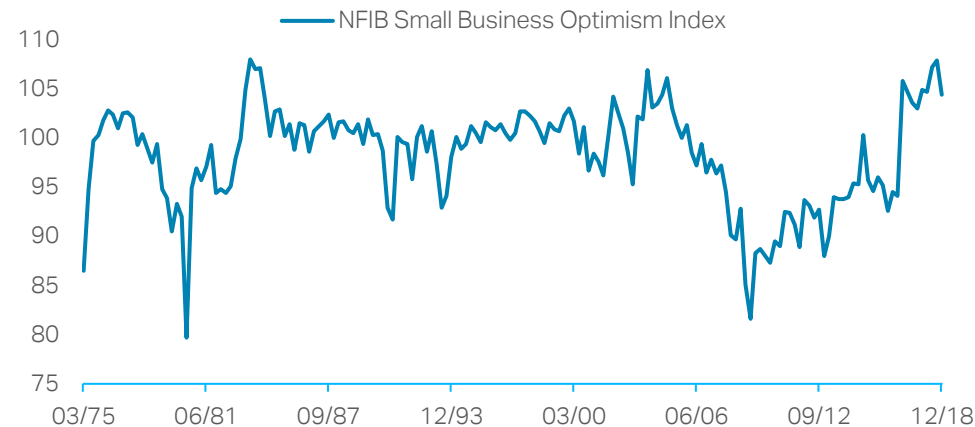
Index



Source: Datastream, TS Lombard

Small business optimism remains elevated

Index



Source: Datastream, TS Lombard

Unemployment near record lows

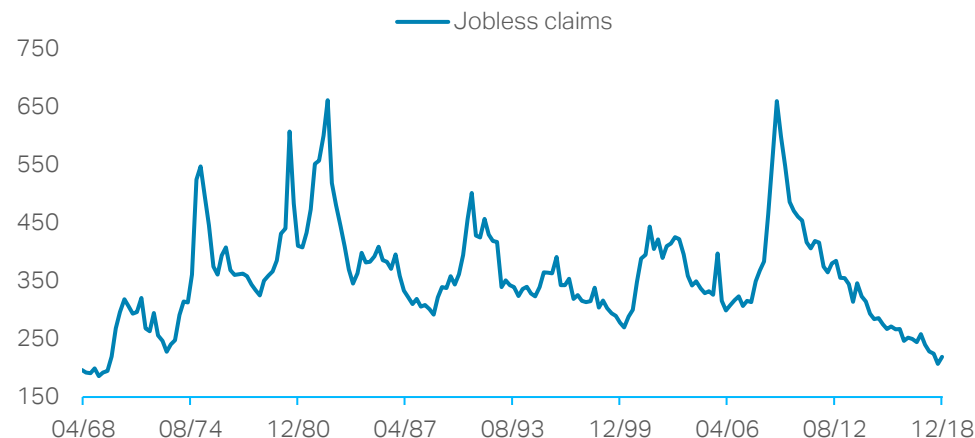
Percent



Source: Datastream, TS Lombard

Jobless claims at depressed levels

'000s, 3m MA

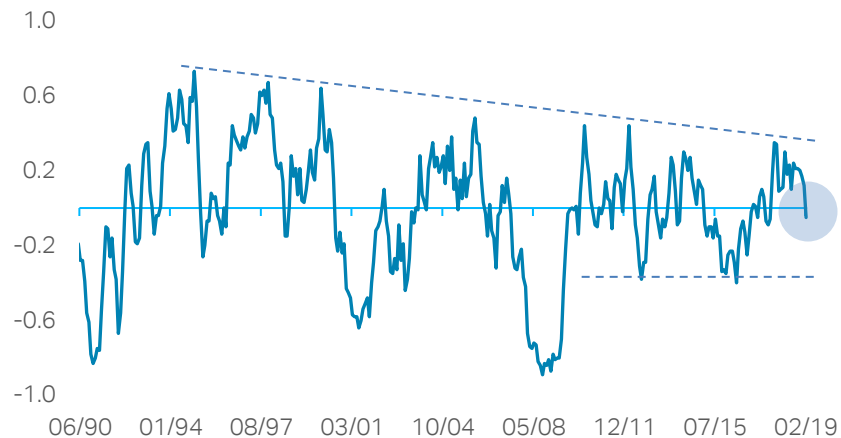


Source: Bloomberg, TS Lombard

US – momentum turning

Slowdown underway

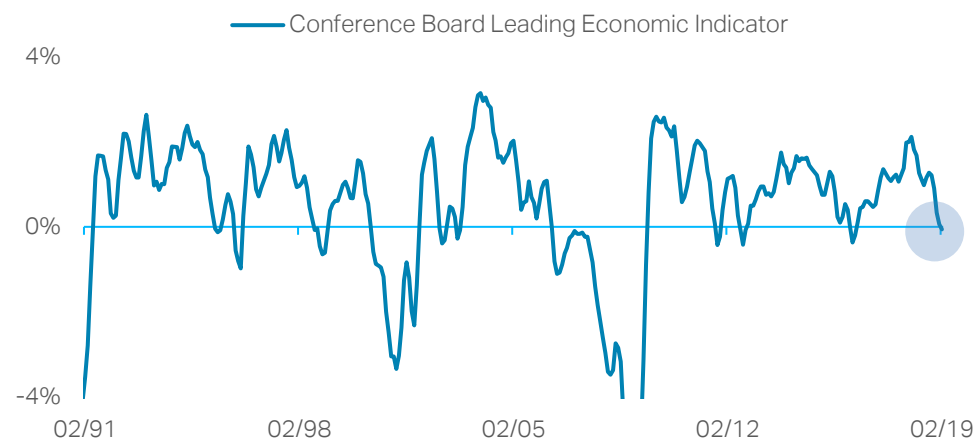
Chicago Fed National Activity Index



Source: Datastream, TS Lombard

More weakness ahead

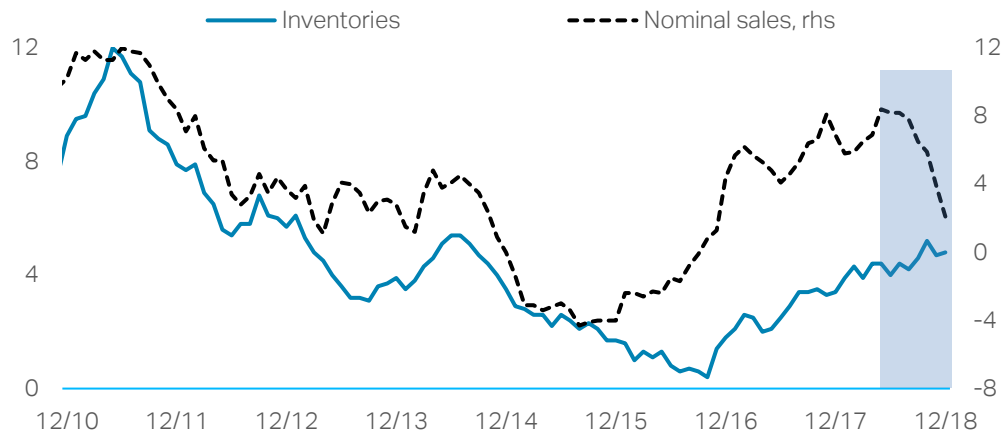
3m/3m rolling



Source: CPB, Datastream, TS Lombard

Manufacturing sector under pressure

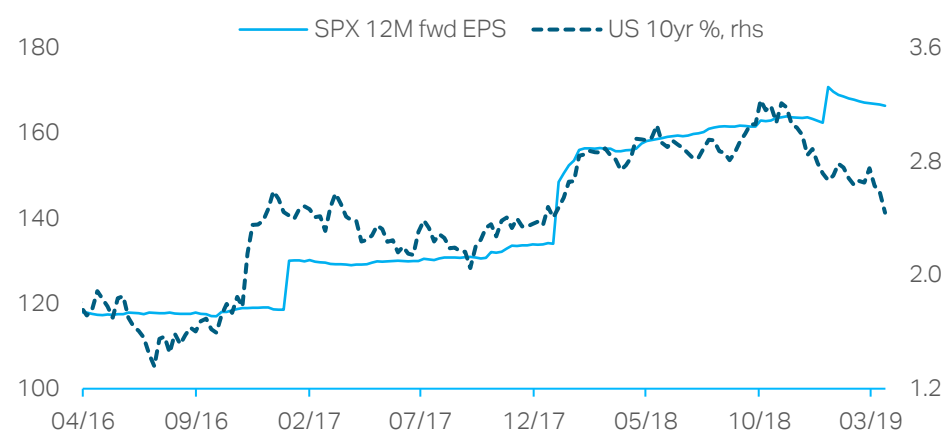
Manufacturing and trade (sa), YoY



Source: Bloomberg, TS Lombard

Earnings expectations souring

US\$

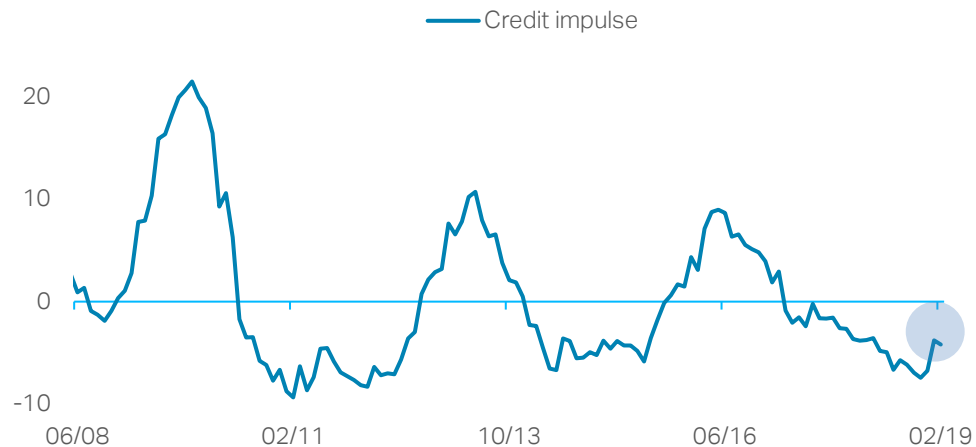


Source: Bloomberg, TS Lombard

China – a shallower path

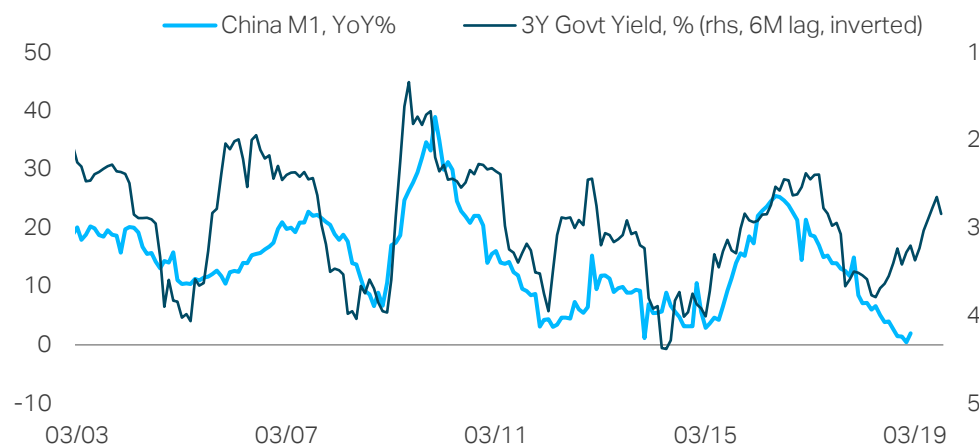
Still early days

12m % change



Source: Bloomberg, TS Lombard

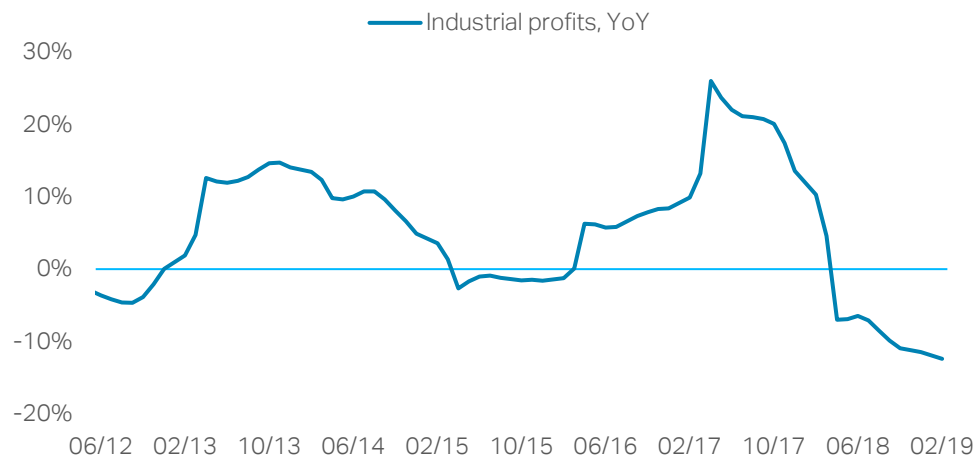
M1 growth slow to catch up



Source: Datastream, TS Lombard

Profits under strain

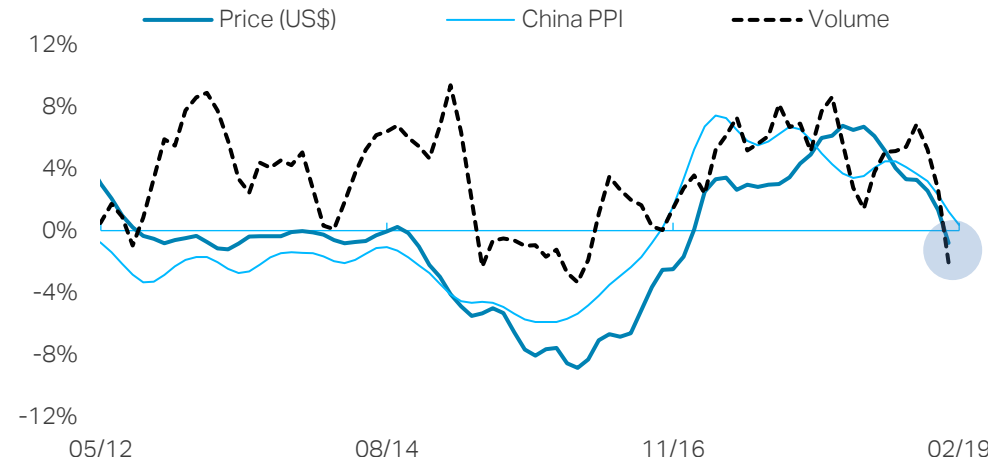
3m MA



Source: Bloomberg, TS Lombard

Deflationary pressures persist

Asian export indices and China PPI, YoY (3m MA)



Source: Bloomberg, TS Lombard

Global industrials under strain

Asian momentum still negative

YoY, 3m MA

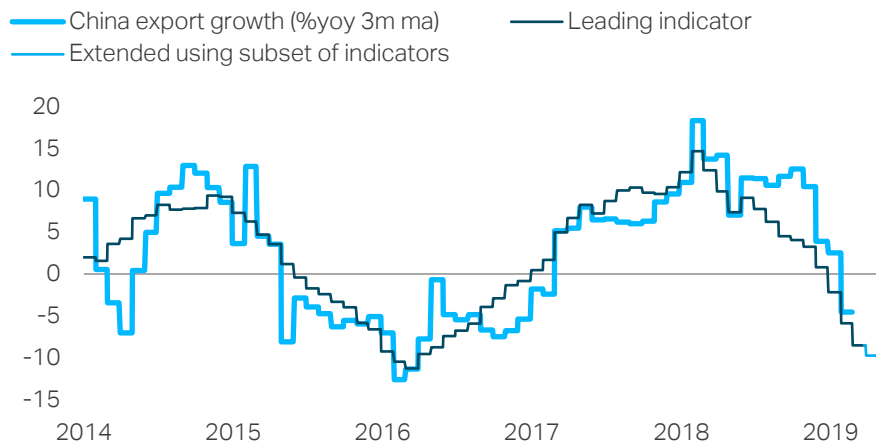


Source: CEIC, TS Lombard

*March forecast

Finding a bottom

Leading Indicator for Chinese exports*

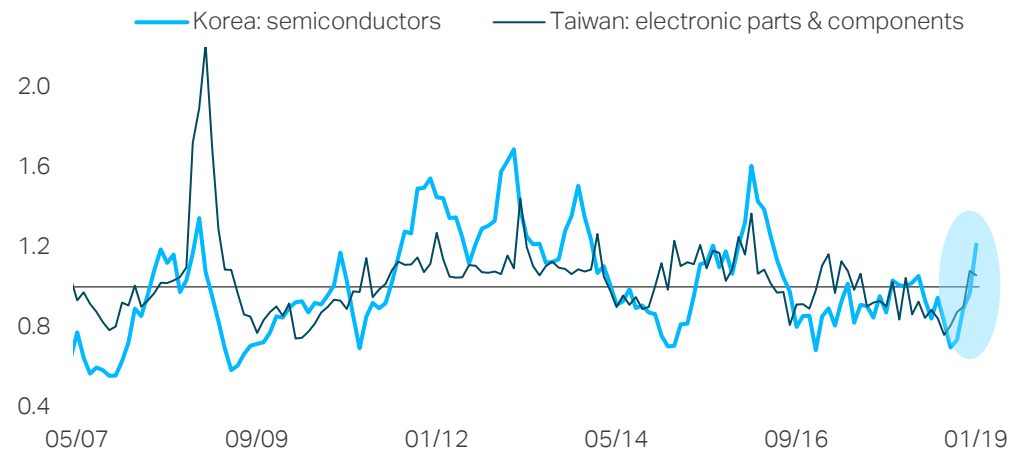


Source: Bloomberg, TS Lombard

*using CH new export orders, TW new export orders, SK exports and JP machine tool orders.

Tech super-cycle in retreat

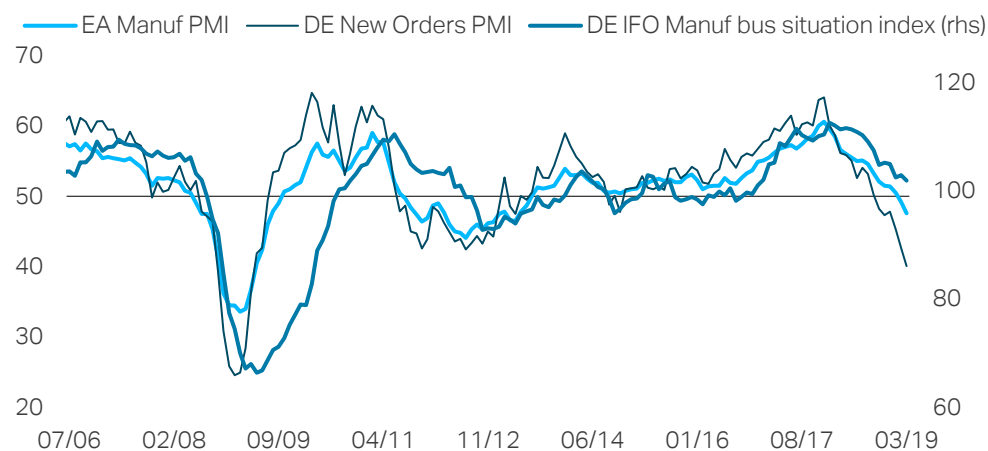
Inventory-to-shipment ratios



Source: Datastream, TS Lombard

EA manufacturers feeling the pain

Indices

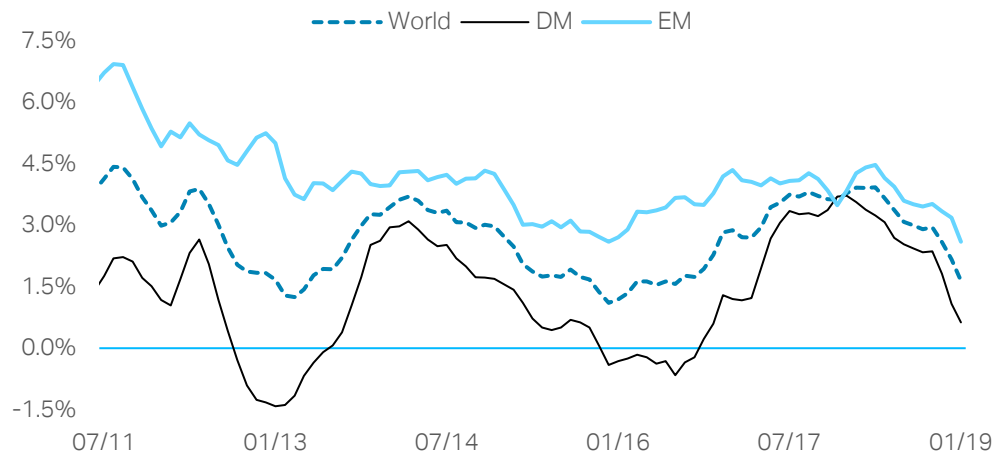


Source: IHS Markit, Datastream, TS Lombard

Manufacturing-trade nexus still weak

Synchronised dimming

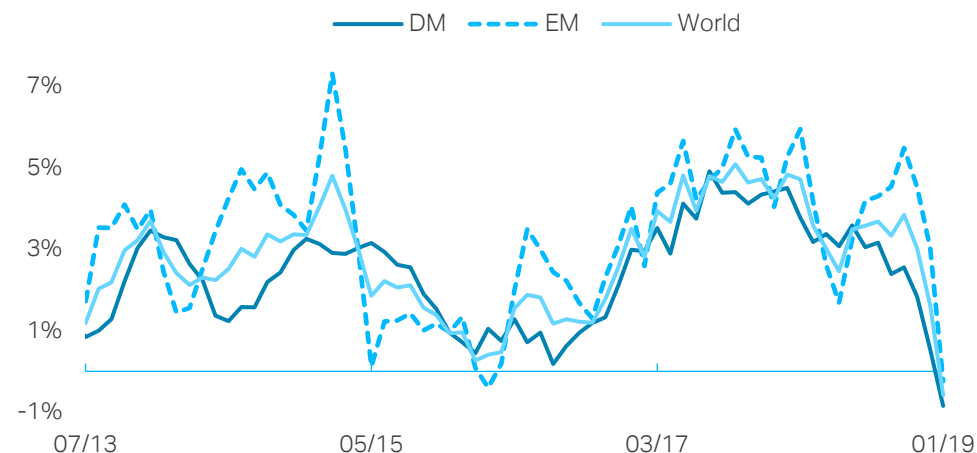
Industrial production, YoY (3m MA)



Source: CPB, Datastream, TS Lombard

World trade on the back foot

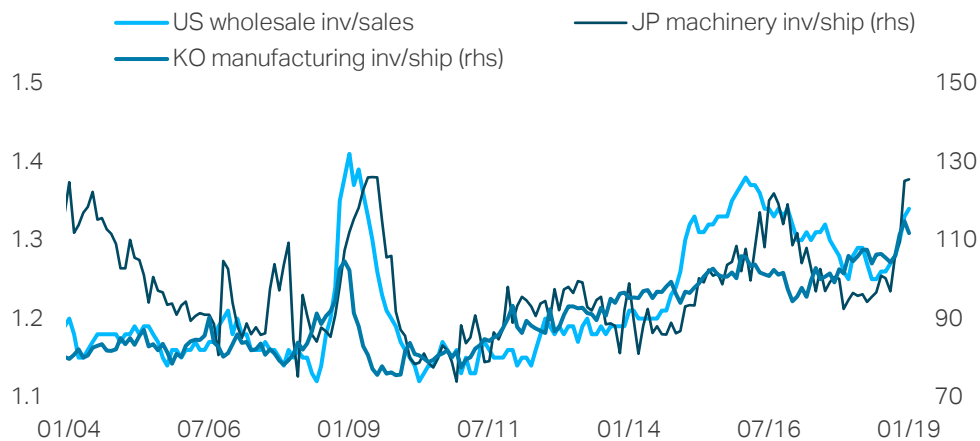
Export volumes, YoY (3m MA)



Source: CPB, Datastream, TS Lombard

Elevated inventories keeping a lid on output

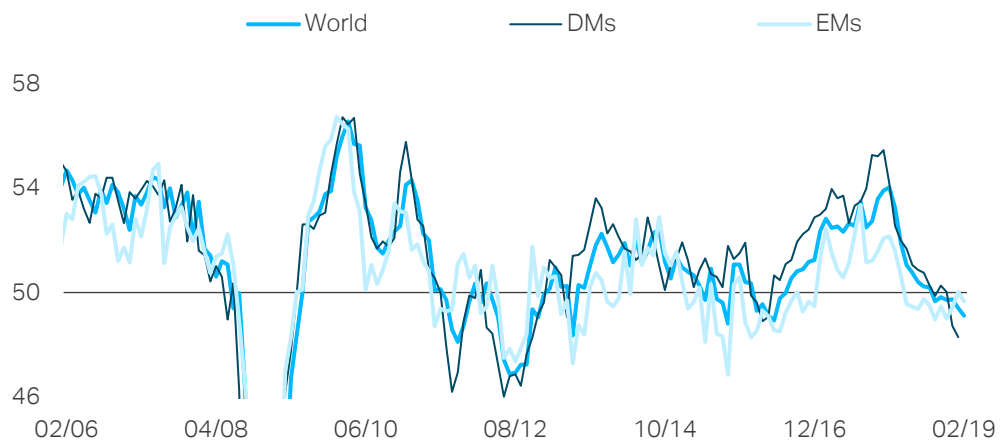
Ratios



Source: Datastream, TS Lombard

Deflating orders

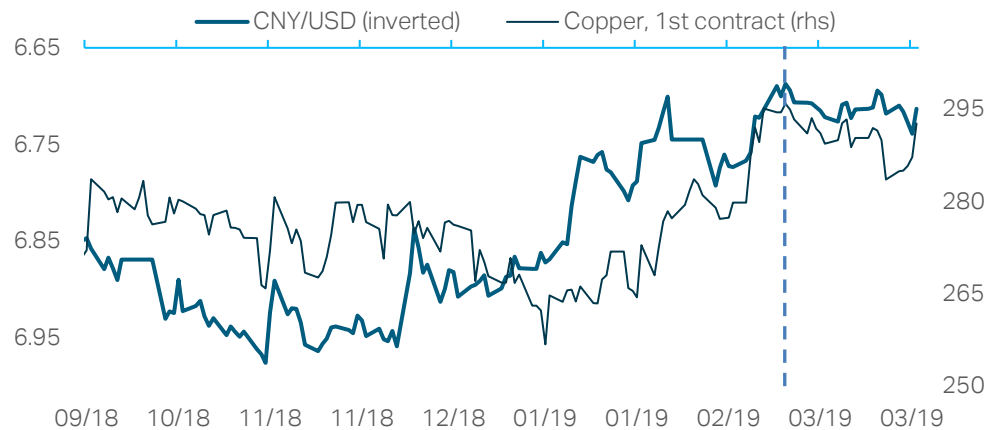
PMI Manufacturing: new export orders indices



Source: IHS Markit, Datastream, TS Lombard

The playbook is changing

Joined at the hip



Source: Bloomberg, TS Lombard

Re-pricing lower

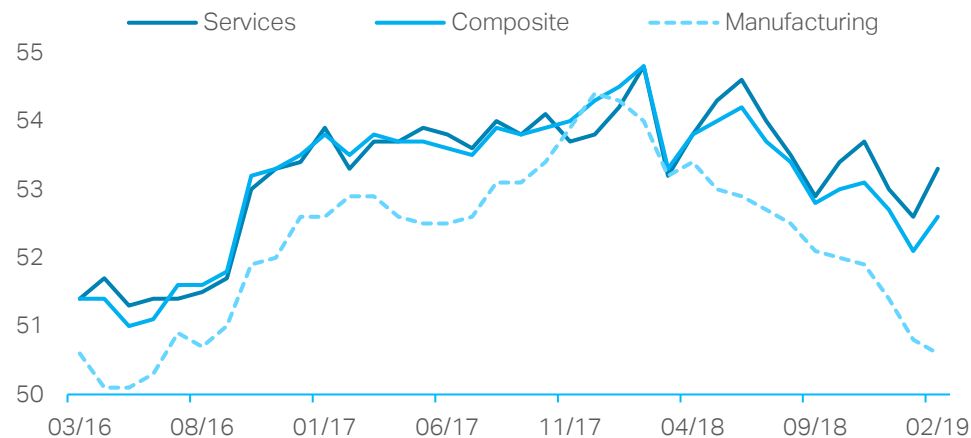
YoY



Source: Bloomberg, TS Lombard

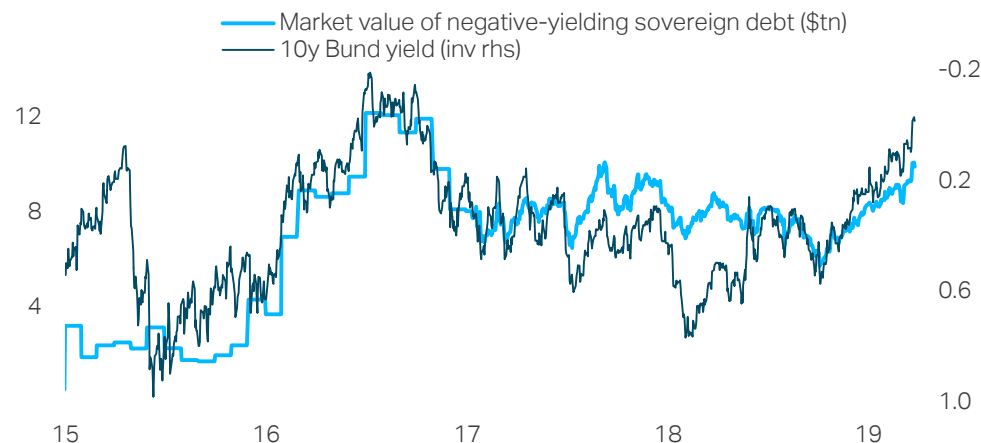
Services soft but holding up

Global PMIs



Source: Datastream, TS Lombard

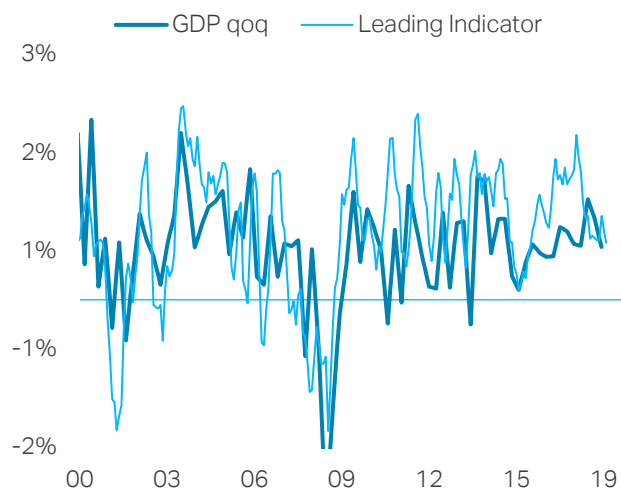
Dash for liquidity



Source: Bloomberg, TS Lombard

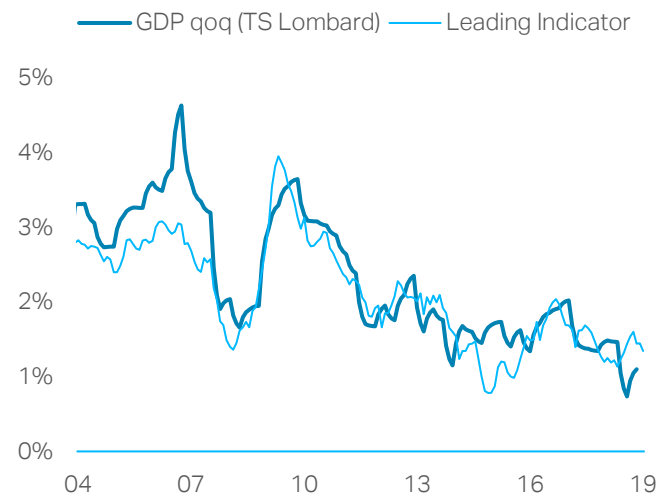
Appendix: TS Lombard Leading Indicators

United States



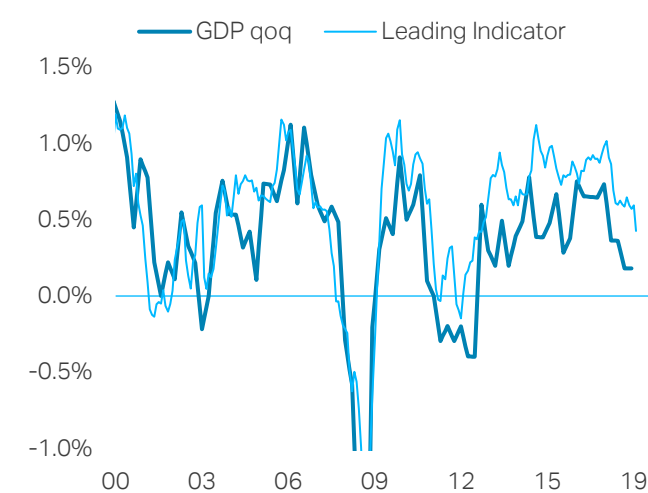
Source: TS Lombard

China



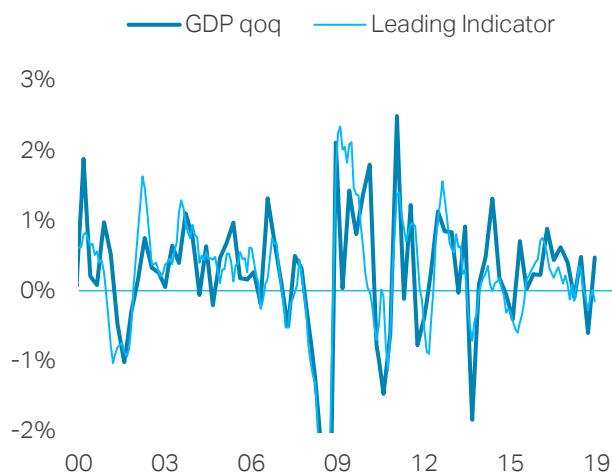
Source: TS Lombard

Euro area



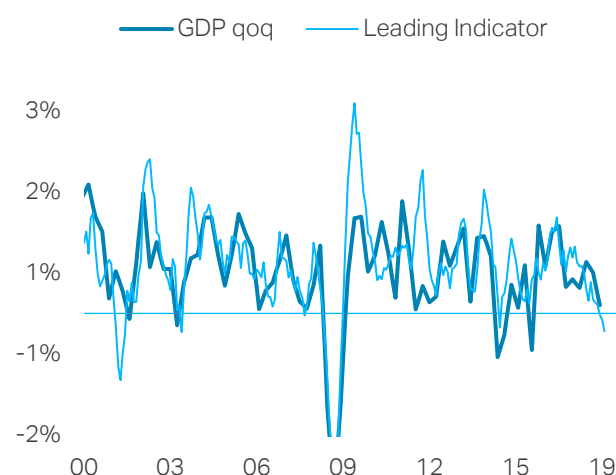
Source: TS Lombard

Japan



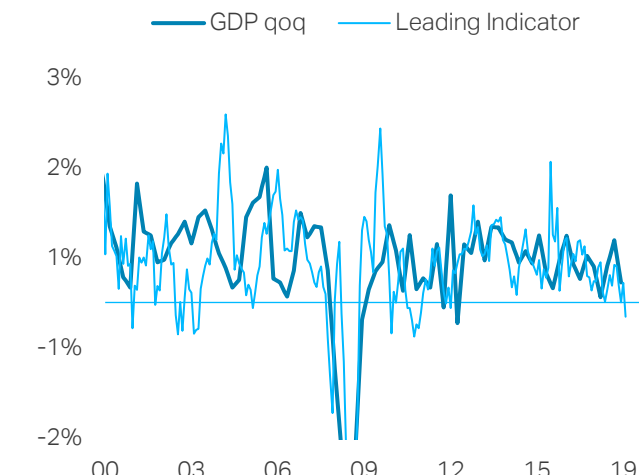
Source: TS Lombard

Canada



Source: TS Lombard

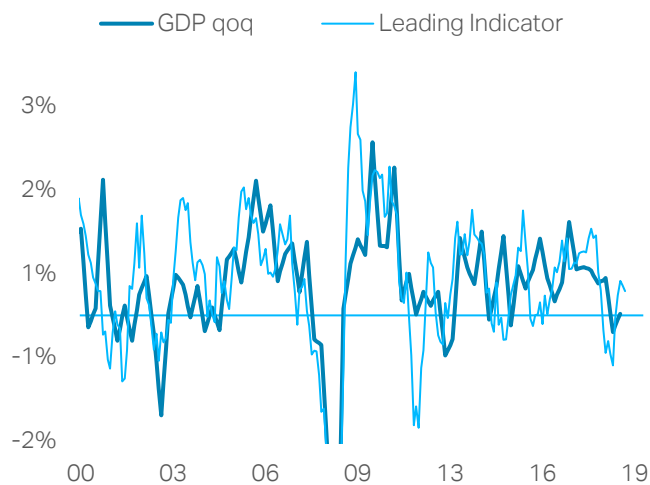
United Kingdom



Source: TS Lombard

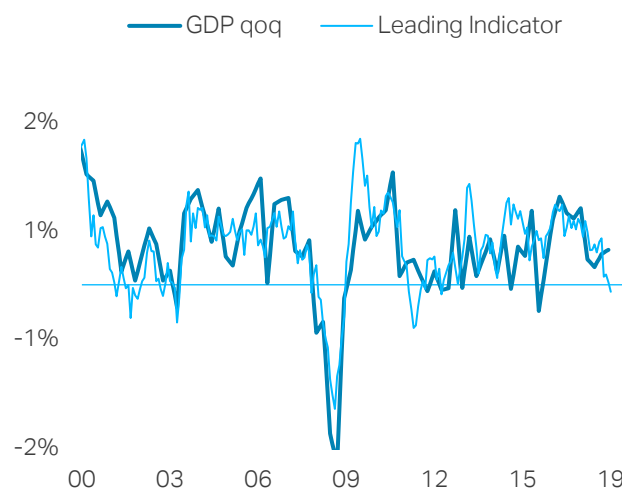
Appendix: TS Lombard Leading Indicators (cont.)

Germany



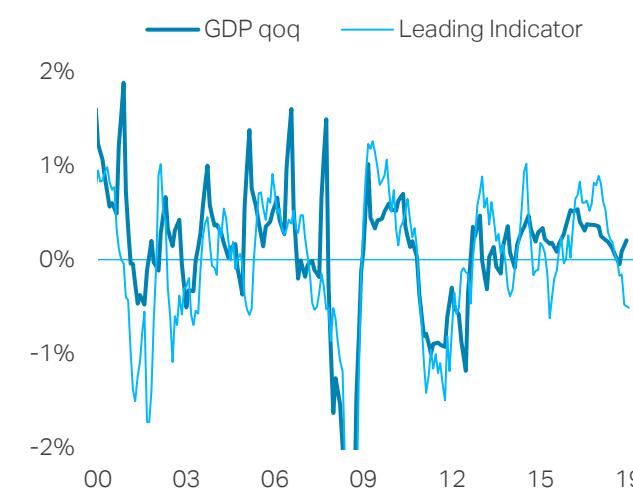
Source: TS Lombard

France



Source: TS Lombard

Italy



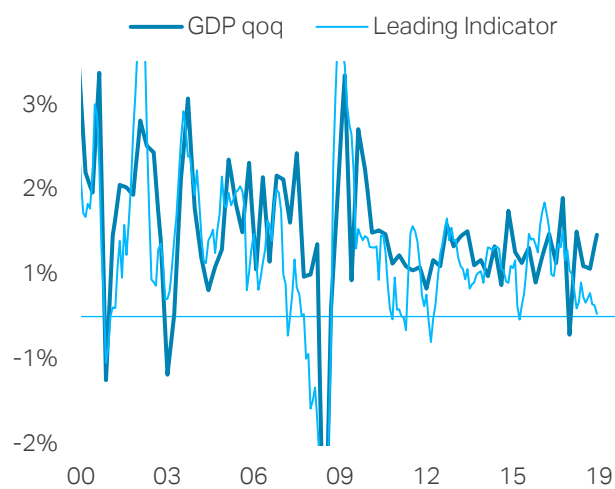
Source: TS Lombard

Spain



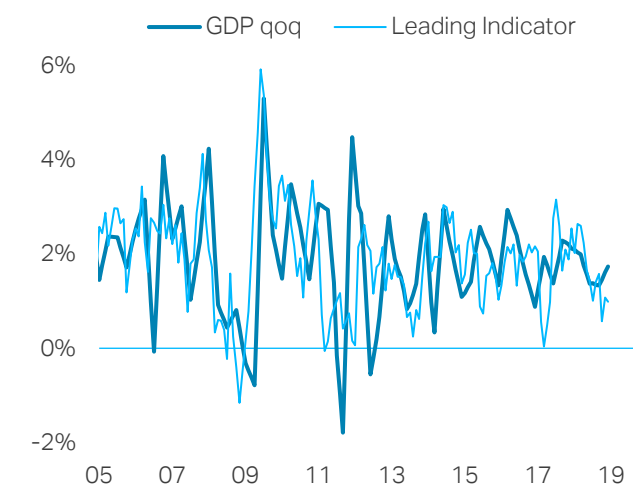
Source: TS Lombard

Korea



Source: TS Lombard

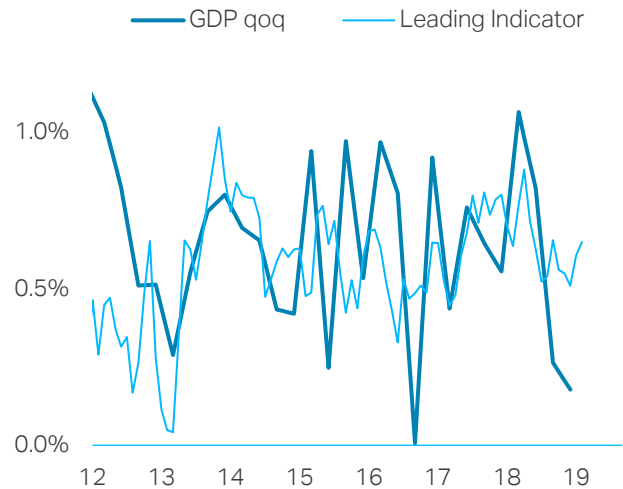
India



Source: TS Lombard

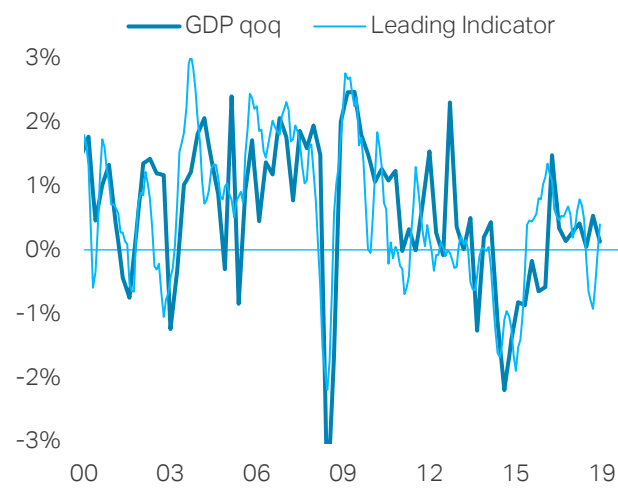
Appendix: TS Lombard Leading Indicators (cont.)

Australia



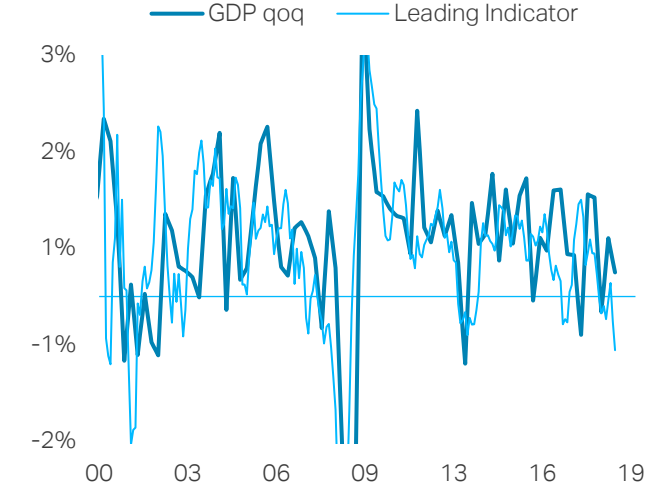
Source: TS Lombard

Brazil



Source: TS Lombard

Mexico



Source: TS Lombard

A note explaining the methodology and construction of our Leading Indicators can be [found here](#).

Authors



**Konstantinos
Venetis**
Senior Economist



Davide Oneglia
Economist