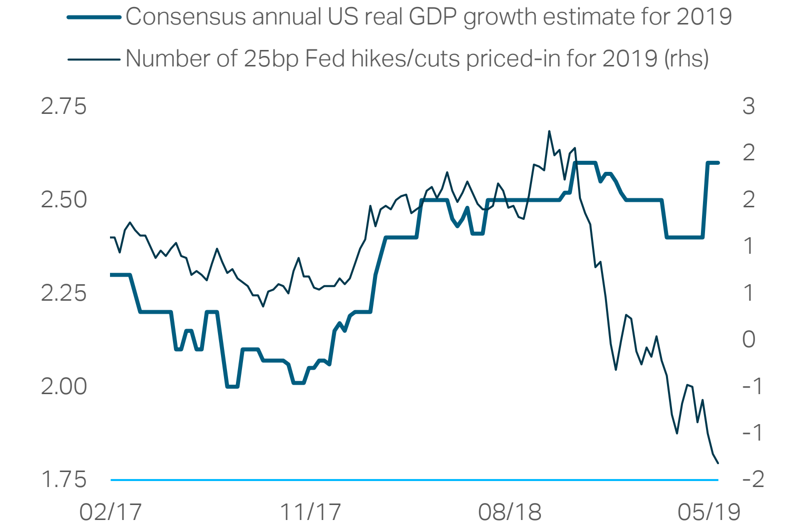
Global Leading Indicators

# WAKE-UP CALL

Konstantinos Venetis / Davide Oneglia

- Trump's tactics turn investor focus from Goldilocks to a slowing world economy
- Macro momentum lacklustre as the US cools, PBoC balance sheet shrinks
- EM green shoots under threat from prolonged trade war, strong dollar
- Equities catching down with bond yields, choppy markets here to stay

**Expectations mismatch**
Percent



# Wake-up call

**Trade war risks have prompted investors to shift their focus from what looks like a Goldilocks market environment to the reality of a world economy that is re-synchronising lower. Global macro momentum is showing signs of stabilisation, but protracted trade tensions translate into higher chances of a growth scare.**

After a powerful rebound from the winter lows, risk assets stumbled in May. Trump's tweets provided the trigger, dashing investor optimism over a swift US-China trade deal at a time when other tailwinds buoying market sentiment were already fading.

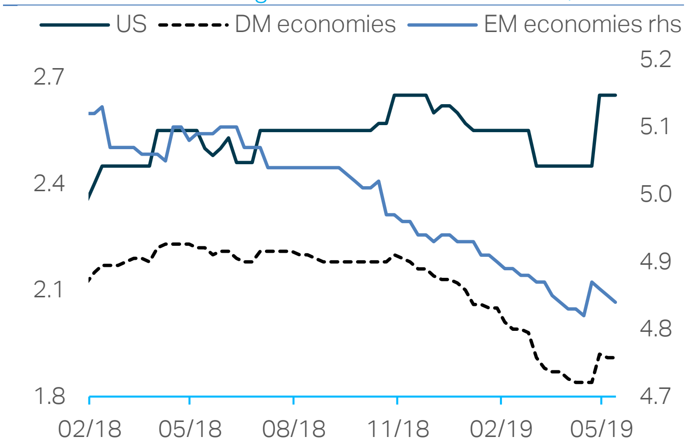
The Fed's dovish about-turn in January worked wonders for financial assets, fuelling rate cut expectations that allowed the market to re-rate. However, in his press conference after the April/May FOMC meeting, Fed Chairman Jay Powell took pains to balance the betting books somewhat. As things stand, the Fed seems happy to stay on the sidelines and wait for solid evidence of a slowdown before acting, i.e. policymakers are showing too much patience at this juncture, preventing them from easing. Green shoots in the world economy are also taking longer to sprout than optimists had been anticipating, dampening expectations of a quick turnaround sponsored by policy loosening in Beijing. Needless to say, the fresh escalation in US-China trade tensions has strengthened the headwinds that global growth must overcome.

Finally, the four-month-long risk rally propelled global stocks to technically extended levels, depressing volatility and setting the stage for a corrective move: if it had not been trade war concerns that shook the market it would have probably been something else. Several market indicators were already sending warning signals. The CRB Metals Index rolled over at the end of March and has now dropped back to its September lows. EM currencies ran out of steam during the second half of Q1. EM equities have been trailing the global aggregate since February while the outperformance of US small-cap equities relative to the S&P 500 hit a wall in March. Global mining stocks started to lag around mid-April, around the same time that copper prices began to decline in tandem with CNY.

The bigger point, however, is that Trump's tactics have prompted investors to shift their attention from what on the surface looks like a benign Goldilocks market environment (dovish central banks, low inflation, strong labour markets, decent profit growth) to the reality of a world economy that is re-synchronising lower. Our Global Leading Indicator remains on the back foot while consensus

**Pricing in the slowdown**

Consensus real GDP growth estimates for 2019, YoY %




Source: Bloomberg, TS Lombard

**Expectations mismatch**

Percent


Source: Bloomberg, TS Lombard

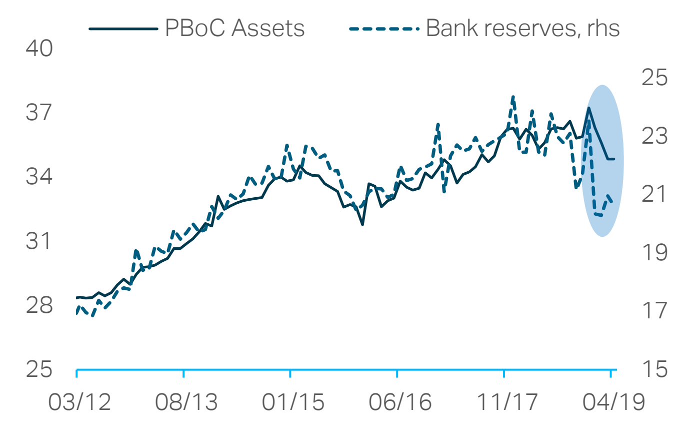
expectations for growth in both DMs and EMs continue to slide and global economic surprise indices have been negative for an extended period.

It was only a matter of time before equities started to "catch down" with falling bond yields, a theme we first highlighted in March. The recent rally in sovereign bonds appears to be predominantly driven by decreasing term premia and lower inflation breakeven rates, not least as oil prices have reversed some of this year's gains. Interestingly, while the drop in nominal US long yields gathered pace, real Treasury 10yr yields had remained in a relatively tight range (around 0.50-0.60%) for the last month. This week, however, they broke decisively through the bottom of that band, consistent with the market moving to discount slower growth ahead.

**Slower US business capex ahead**
Index


Source: Datastream, TS Lombard

**PBoC balance sheet in contraction**
RMB trillion




Source: Bloomberg, TS Lombard

This is not just about the drag from a prolonged trade dispute with China: the US economic slowdown is already underway and has legs, consistent with steady deterioration in our US Leading Indicator and an inverted Treasury curve. My colleague Steve Blitz expects real quarterly GDP of around 1% in Q2 and Q3 following a strong Q1 that was flattered by transitory factors.

Several high-frequency indicators are flashing orange. The Chicago Fed National Activity Index was negative in April for the third consecutive month. Weak durable goods and non-defence capital goods spending points to lower business capex in Q2, in line with the message from the survey data and eroding business profits; prolonged uncertainty from Trump's trade war will only make things worse. Annual growth in railroad container volumes – an indicator of new imports being stockpiled – remains negative, suggesting that the inventory overhang has started to unwind. Loan demand remains listless, with the net percentage of banks reporting stronger demand in the Fed's Senior Loan Officer Survey trending down.

Furthermore, the economic news from China has been uninspiring. Weak PPI inflation and industrial profits continue to weigh on manufacturing investment, which we expect to remain soft in 2019 amid persistent trade frictions. The Li Keqiang Index, which captures high-frequency real activity data such as electricity production and rail freight volumes, is showing signs of a pick-up but remains lacklustre. Declining vehicle purchases – payback from past tax cuts that brought forward auto demand – dragged down retail sales growth to a record low in both real and nominal terms last month. This was despite an improvement in all other major consumption categories thanks to better disposable incomes and access to credit.

Our China team sees the economy stabilising in H2 2019, underpinned by fiscal front-loading that should support an L-shaped recovery, with Beijing tailoring stimulus measures to the severity of trade tensions. Policymakers can also be counted on to introduce more direct public spending (e.g. on infrastructure) if a relapse in private sector confidence ends up clogging the transmission of tax cuts to final demand.

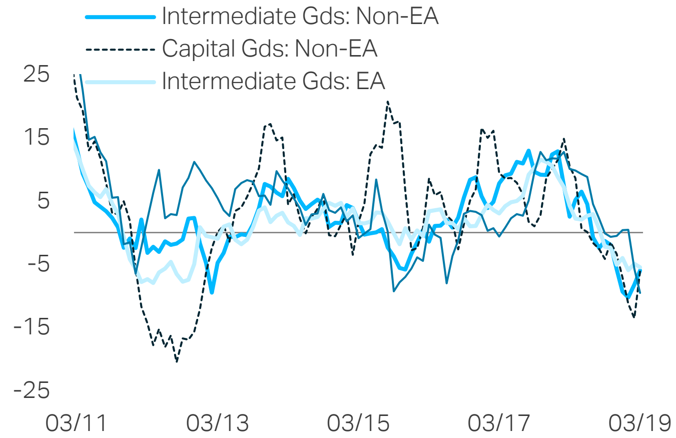
### Chinese money growth stuck in low gear

Percent


Source: Datastream, TS Lombard

### German industry feeling the pain

Manufacturing new orders, vols, sa, YoY% (3m MA)




Source: Destatis, Datastream, TS Lombard

Chinese monetary policy appears to be playing a subordinate role, facilitating the pass-through of targeted fiscal easing rather than powering the stimulus. "Structural deleveraging" remains on the policy agenda. This is consistent with measured credit easing in 2019 – to the disappointment of those expecting a credit blow-out. Beijing's crackdown on off-balance sheet products and non-bank financial institutions has kept a lid on money growth even as Chinese sovereign yields have fallen and the PBoC has been cutting RRR rates. Notably, the central bank's balance sheet has been contracting this year alongside shrinking bank reserves – a reminder that the PBoC faces a struggle to improve liquidity conditions. The message is that policymakers are playing defence, aiming to contain financial risks while managing the transition to slower growth, supporting employment and trying to keep the currency relatively stable.

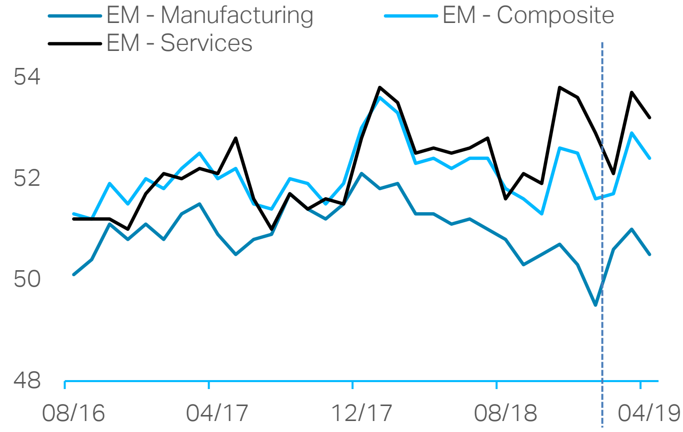
This means that, in its current form, Chinese stimulus is unlikely to lift growth in the rest of the world as it did in 2016/17. What is more, over and above the clouds cast by the trade war, this time round global macro 'initial conditions' are not conducive to a V-shaped reflationary outcome: US rates are higher (especially at the short end); oil prices are no longer depressed; and the dollar remains strong.

Importantly, the dollar's resilience is consequential for world trade from a financial conditions standpoint. Long global supply chains make increasingly heavy demands on working capital, typically financed by dollar borrowing from banks – the counterpart of the prevalence of dollar invoicing. Researchers at the Bank of International Settlements have highlighted that moves in the dollar tend to have a negative relationship with dollar lending. A stronger dollar is associated with tighter funding conditions, hobbling trade.

Together with the downturn in the tech supercycle, this goes some way to explaining why growth in major export-dependent economies has continued to suffer this year. The combination of higher interest rates and a resilient dollar is particularly restrictive for Asian exporters, hurting trade, while a weaker CNY caps competitiveness by buoying their exchange rate baskets. Reliance on import demand from China and other EMs has precipitated a steep decline in German industrial activity

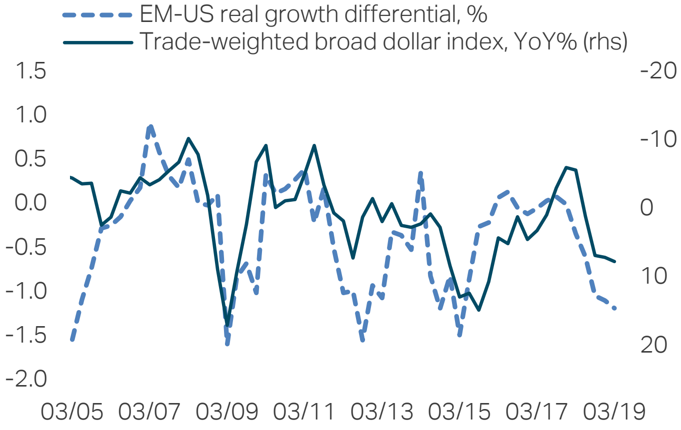
## Rays of hope in EMs

PMI indices




Source: Markit, Datastream. TS Lombard

## EM growth and the dollar joined at the hip




Source: Datastream. TS Lombard

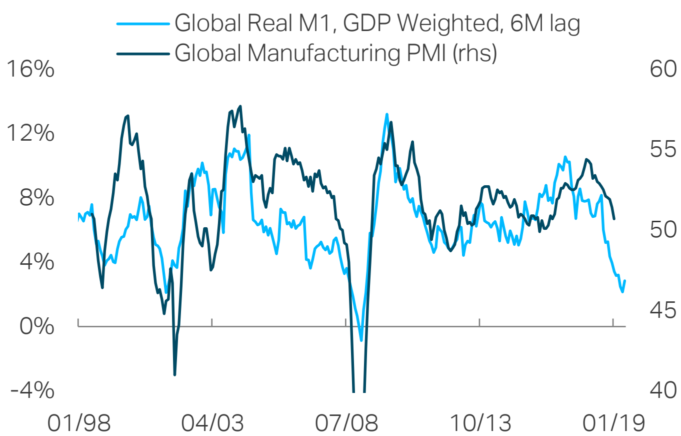
since mid-2018. Manufacturing orders and other leading indicators, including our own, remain deep in contraction territory, although the latest figures suggest the worst could be over.

In the same vein, while global production and trade still lack impetus they seem to be finding a firmer footing. The negative momentum in Asian high-frequency industrial data is showing signs of exhaustion, although elevated inventories still point to a shallow, fragile recovery. Encouragingly, while the global manufacturing PMI index continues to slide, the EM sub-index appears to have made a bottom in January, consistent with the ongoing recovery in shipping rates (e.g. the Baltic Dry Index). What is more, our measure of global real M1 growth – which tends to lead the industrial cycle by a couple of quarters – looks like it is forming a base after last year's collapse.

In addition, the EM services PMI has been trending higher since September, in contrast to sustained weakness in its DM counterpart. Positive divergence in our Global Leading Indicator's EM component tells the same story, potentially foreshadowing real growth outperformance relative to the US. This could, if history is any guide, pave the way for a weaker dollar and alleviate downward pressure on CNY, thereby nurturing a recovery in global manufacturing.

Intensification of the trade war, however, threatens to doom such a positive scenario. Protracted uncertainty will sooner or later erode business confidence, hurting investment, with adverse knock-on effects on private consumption. In other words, the longer the production-exports-capex nexus

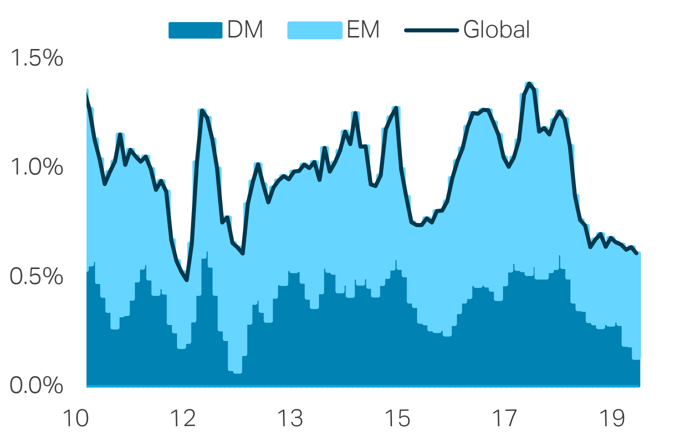
## Money growth forming a base




Source: Datastream, TS Lombard

## EMs cushioning the downside

Global Leading Indicator and components




Source: Datastream, TS Lombard

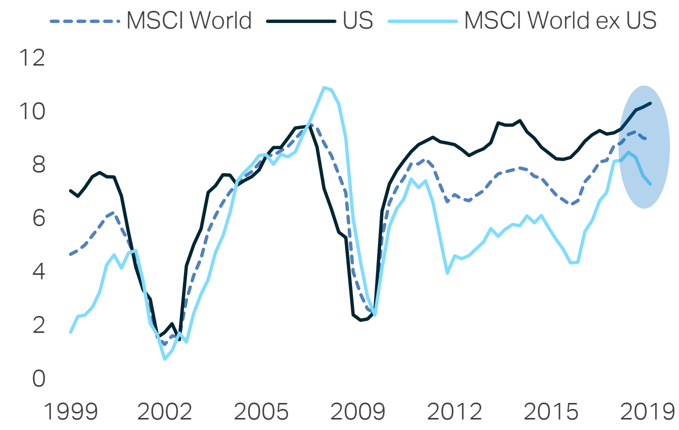
remains in shackles, the greater the likelihood that manufacturing woes contaminate the service sector, raising the risk of a global growth scare that could materialise into something more severe.

To sum up, we view Trump's trade war tweets earlier this month as a wake-up call, prompting equity investors to recalibrate their outlook for global growth and, by extension, business profitability. US corporate earnings beat expectations in Q1, underpinned by healthy revenue growth against a backdrop of solid consumer confidence. Profit margins look toppish, however, particularly in view of sustained dollar strength and soft export orders, and appear poised to revert lower – something that has already happened outside the US – over the coming quarters. Earnings guidance has already started to reflect this prospect, with the ratio of negative vs positive pre-announcements on the rise this year.

This global cycle has stamina but it has entered a vulnerable phase, pointing to choppier markets and a pick-up in volatility for the foreseeable future.

**US profit margins set to revert lower**

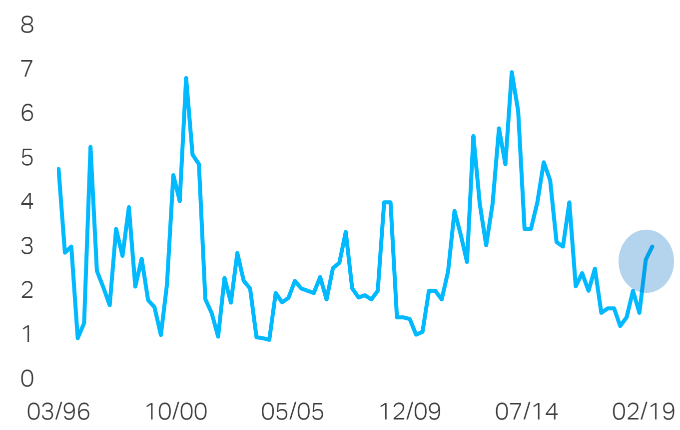
Forward profit margin, percent




Source: Bloomberg, TS Lombard

**Souring earnings guidance**

S&P 500 negative-to-positive preannouncements ratio

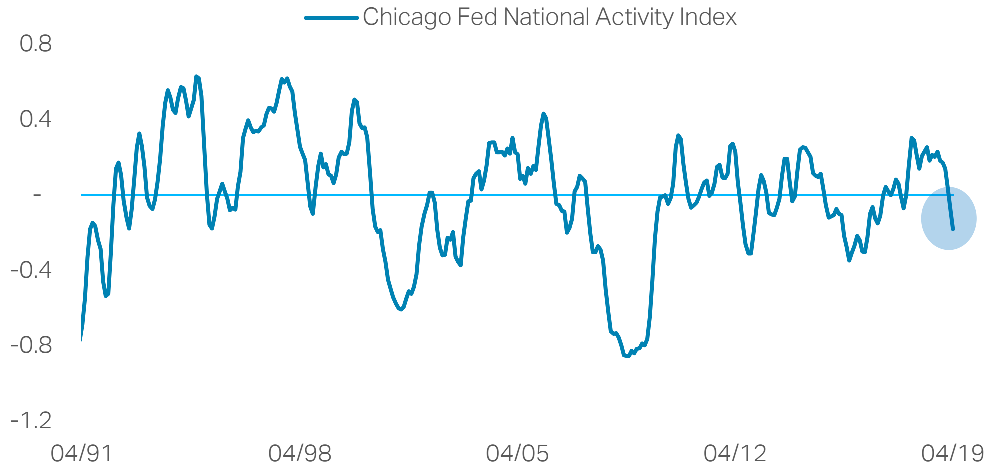



Source: Datastream, TS Lombard

# US – slowdown underway

## Macro momentum on the back foot

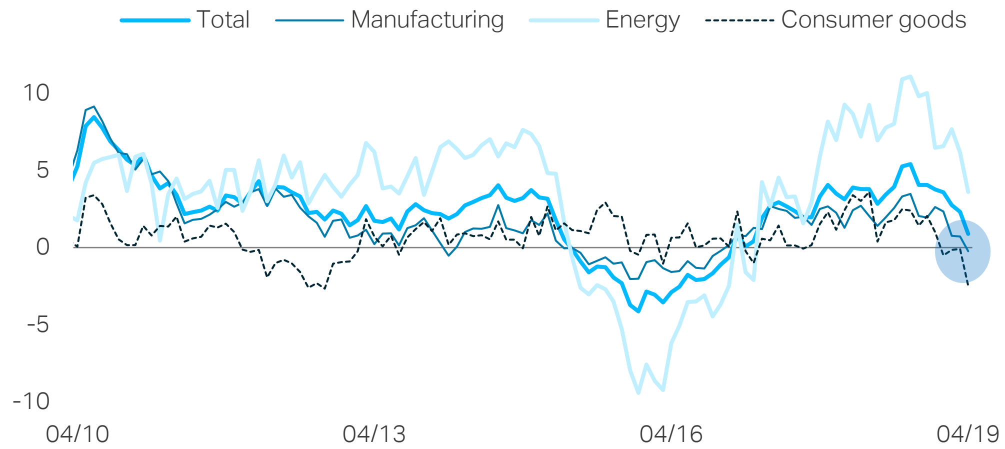
3m MA




Source: Datastream, TS Lombard

## Industrial activity deteriorating

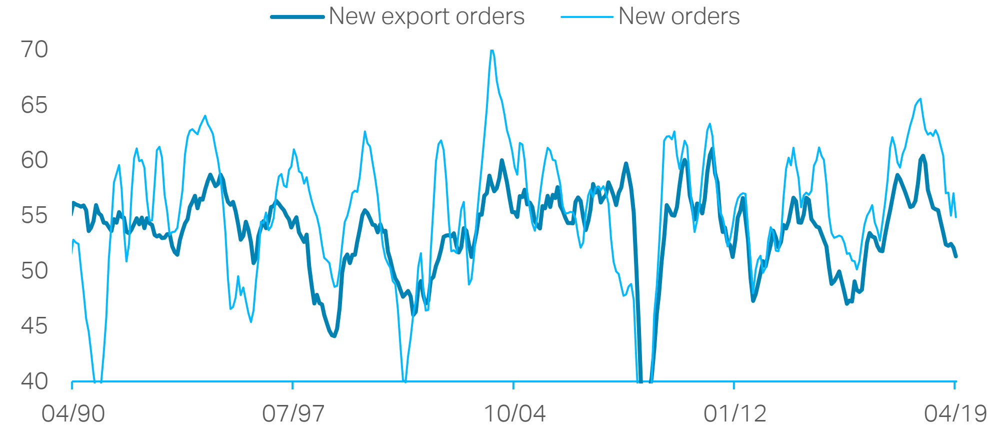
US industrial production, standardised




Source: Datastream, TS Lombard

## Orders still pointing down

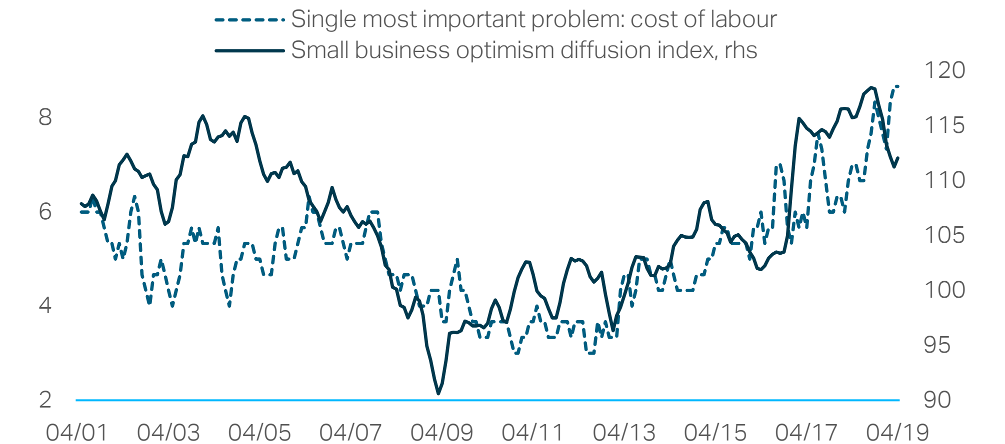
ISM Manufacturing Index




Source: Datastream, TS Lombard

## Tight labour market

NFIB Survey

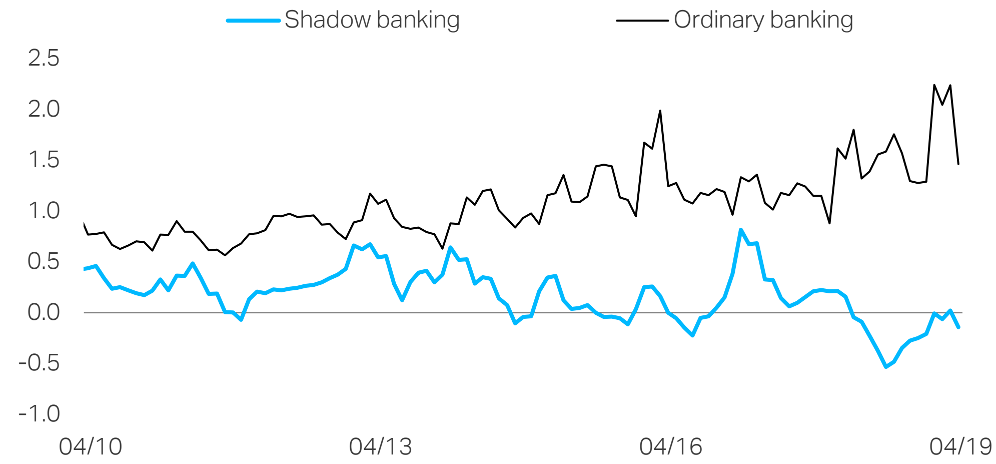



Source: Datastream, TS Lombard

# China – policymakers playing defence

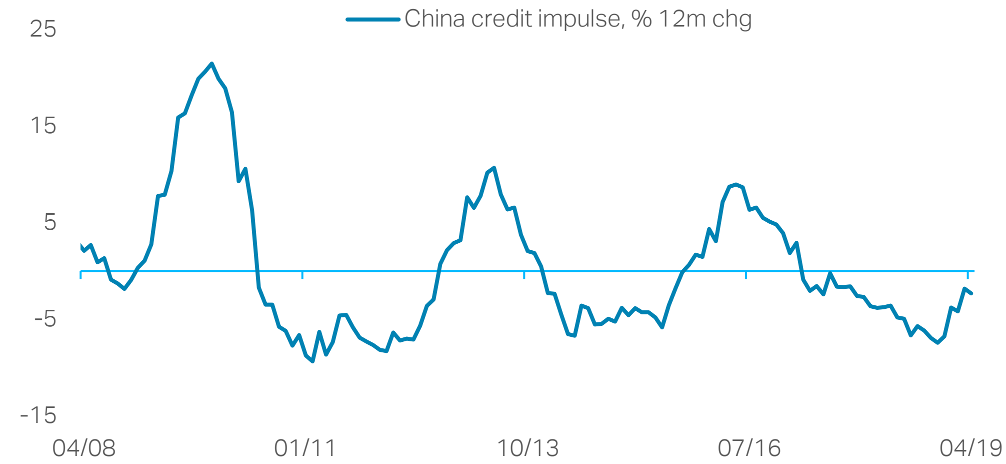
## 'Structural deleveraging' remains on the policy agenda

RMB trn




Source: CEIC, TS Lombard

## Credit still subdued




Source: Bloomberg, TS Lombard

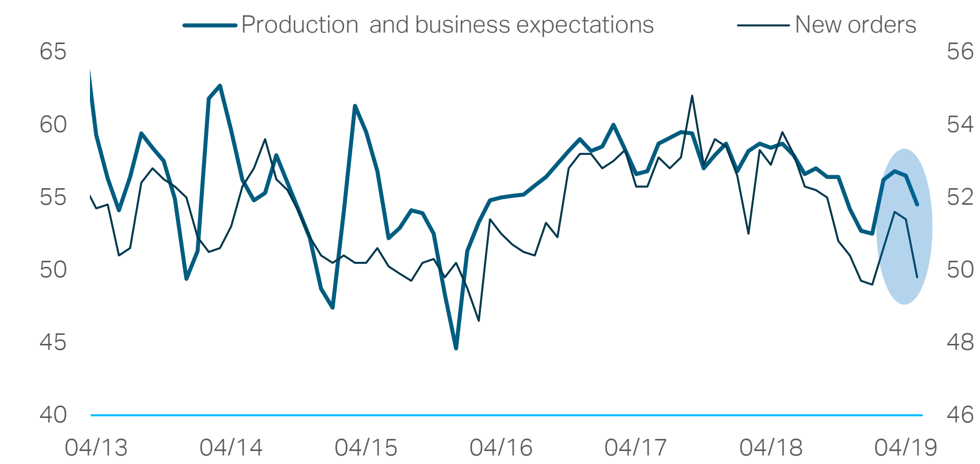
## Real activity lacking impetus

Index


Source: CEIC, TS Lombard

## Fragile manufacturing sector

PMI indices

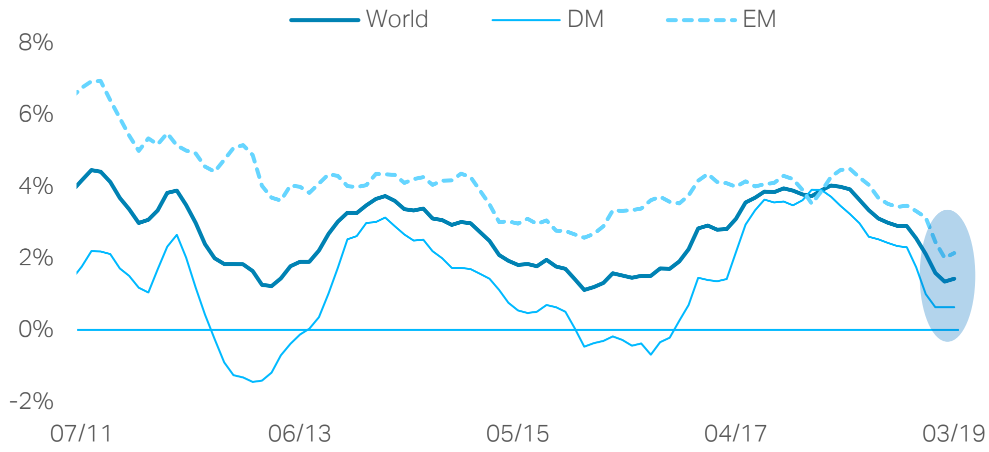



Source: CEIC, TS Lombard

# Industrial cycle – looking for the bottom

## Signs of stabilisation

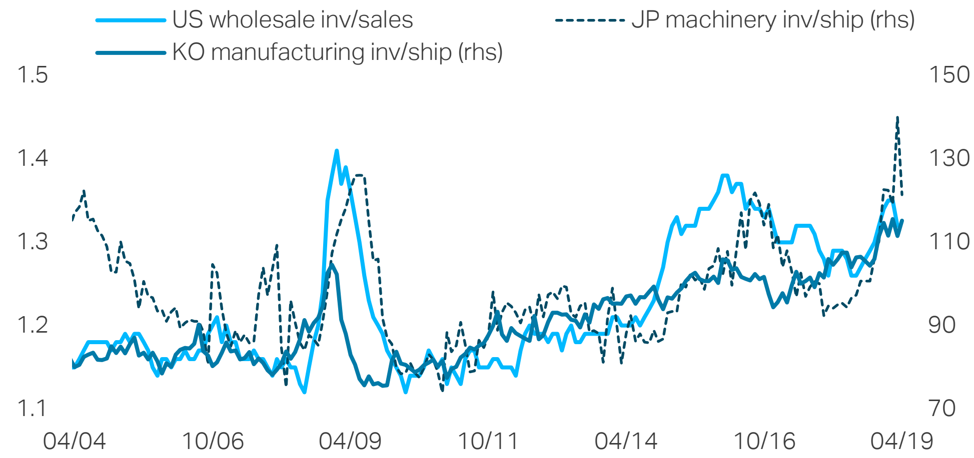
Industrial production, 3m/3m %




Source: Datastream, TS Lombard

## Inventory glut keeping a lid on output

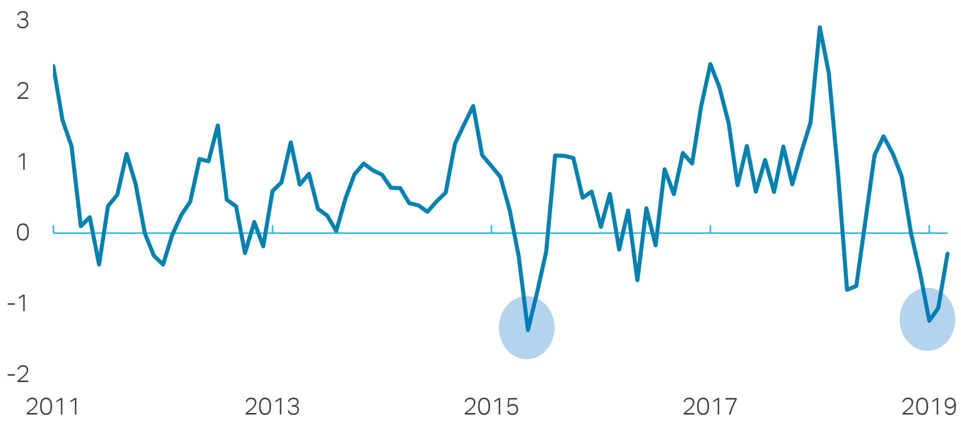
Index




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

## Global trade momentum steadying

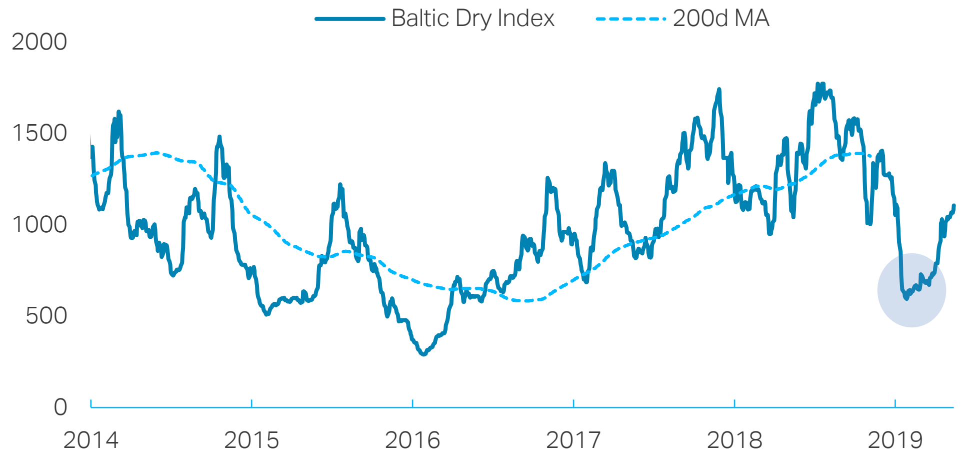
World trade volume index, 3m/3m %




Source: CPB, Datastream, TS Lombard

## Shipping rates in recovery mode

Index

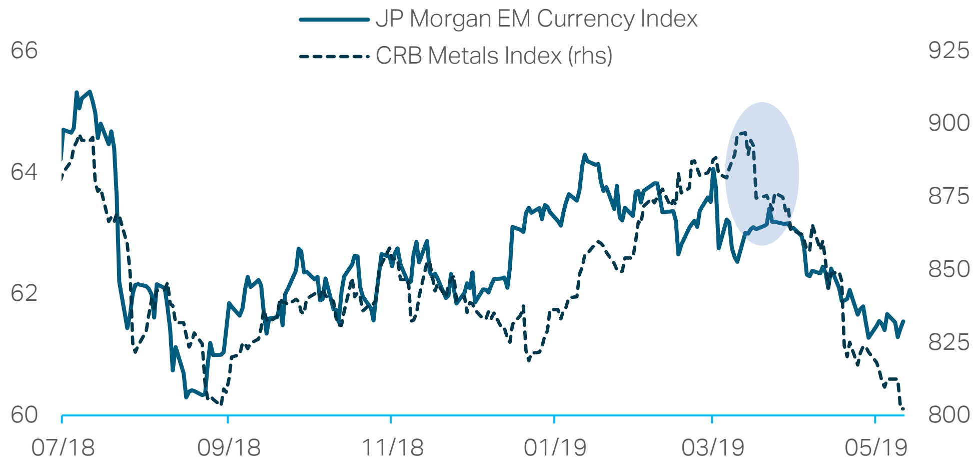



Source: Datastream, TS Lombard

# Cyclical market indicators were flashing orange ahead of May's stock market correction

## Warnings signals from growth-sensitive assets

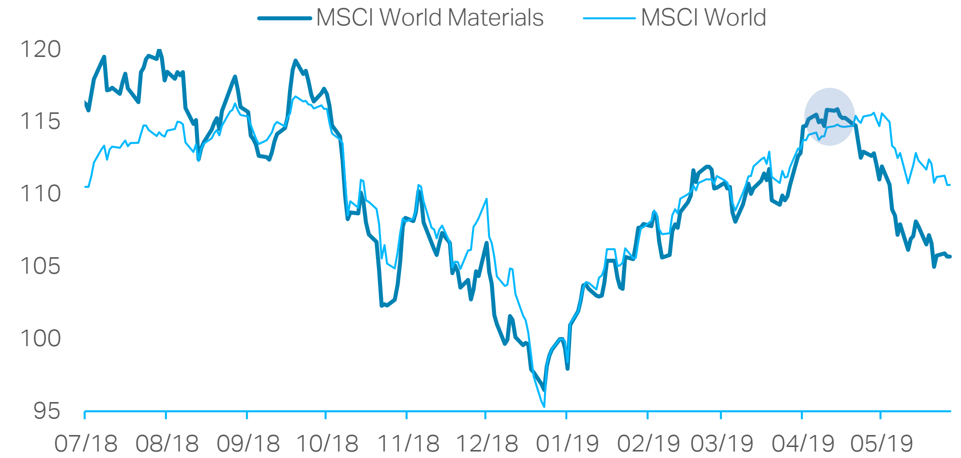
Index




Source: CPB, Datastream, TS Lombard

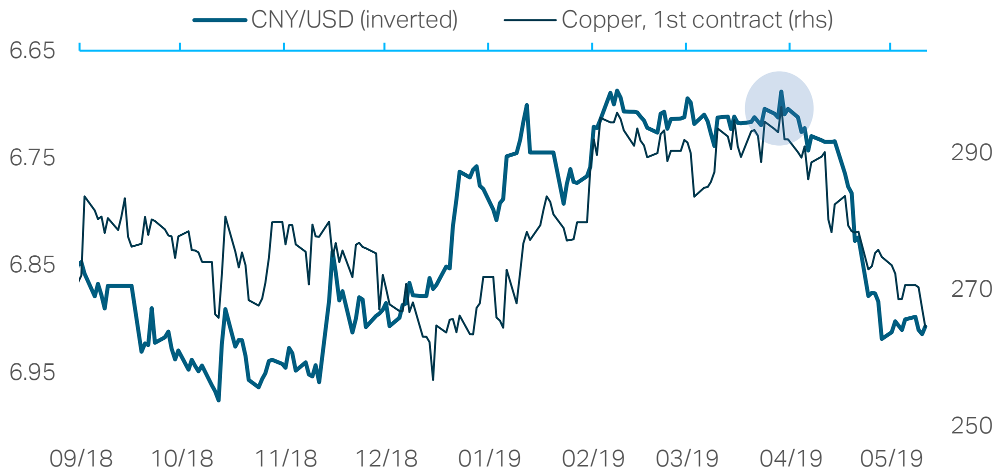
## Global materials stocks underperforming

Rebased indices (100 = 3/1/19)




Source: CPB, Datastream, TS Lombard

## Copper down in tandem with CNY

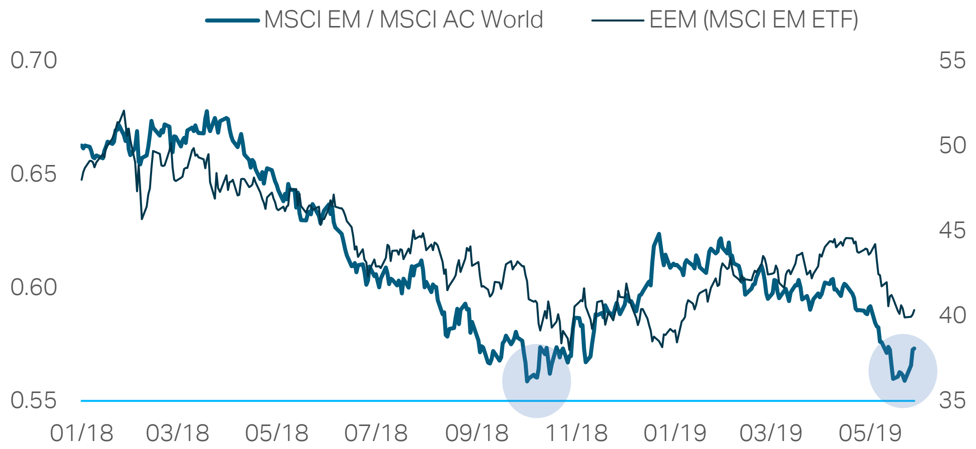



Source: Datastream, TS Lombard

## EM equities' relative performance hovering at the 2018 lows

Ratio

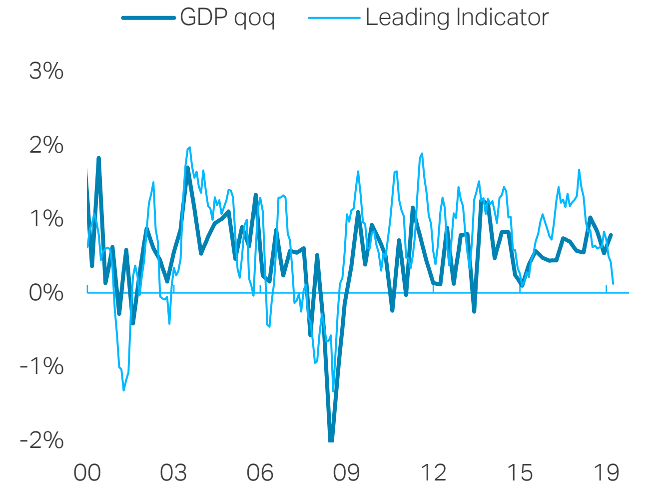
US$




Source: IHS Markit, Datastream, TS Lombard

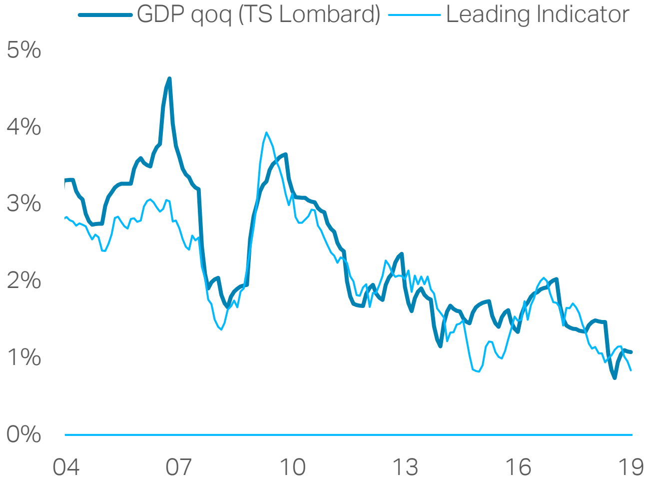
# Appendix: TS Lombard Leading Indicators

## United States



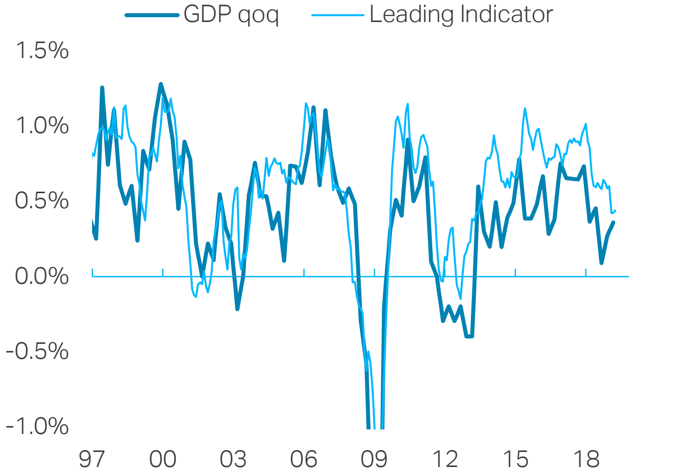

Source: TS Lombard

## China



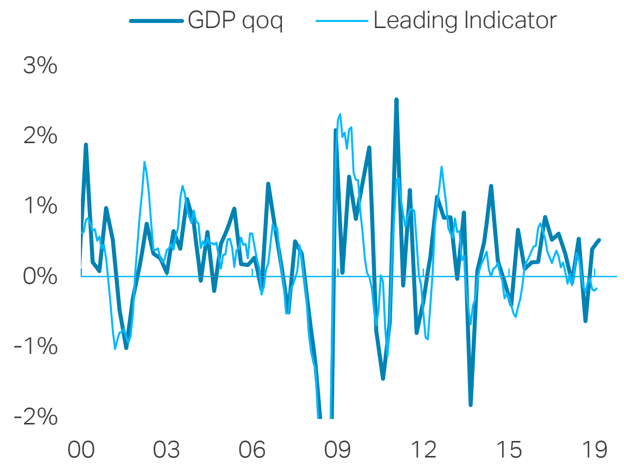

Source: TS Lombard

## Euro area



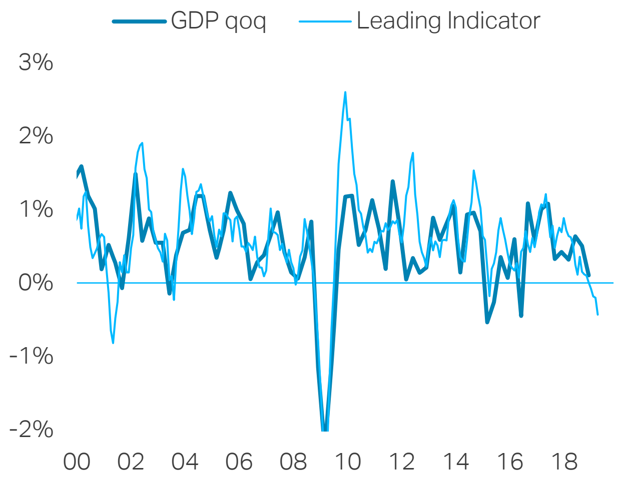

Source: TS Lombard

## Japan



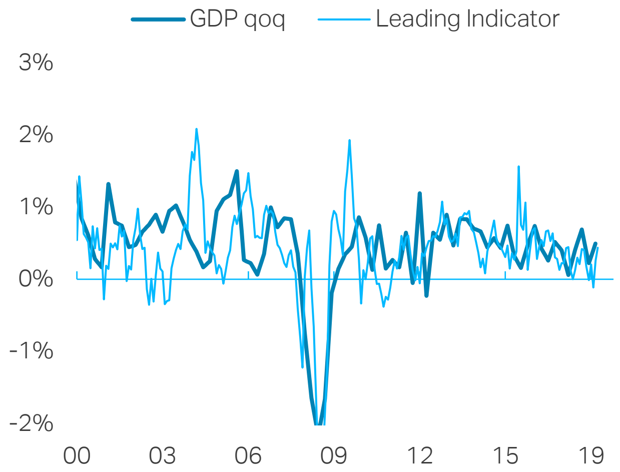

Source: TS Lombard

## Canada




Source: TS Lombard

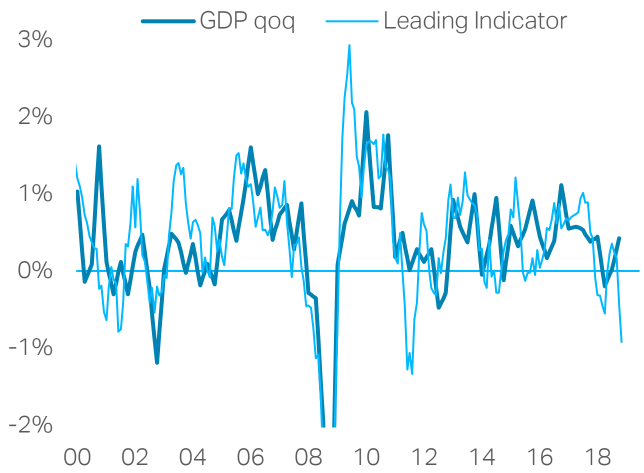
## United Kingdom




Source: TS Lombard

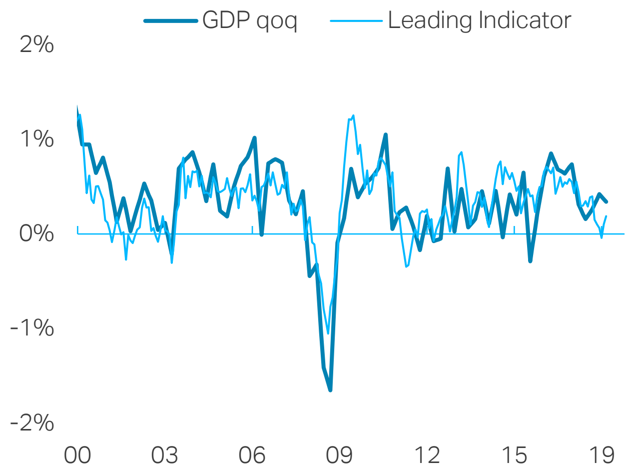
# Appendix: TS Lombard Leading Indicators (cont.)

## Germany



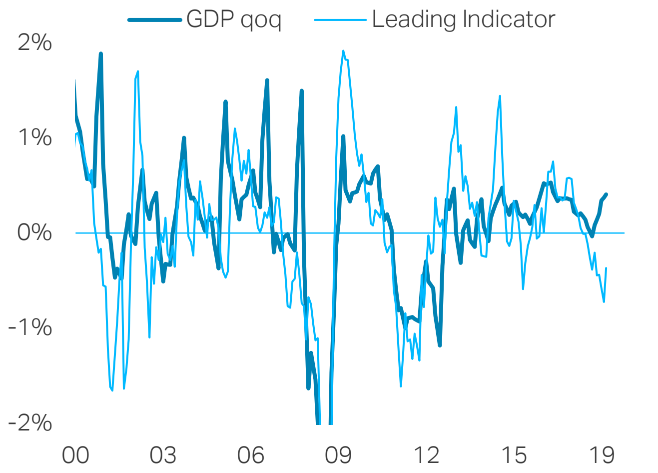

Source: TS Lombard

## France



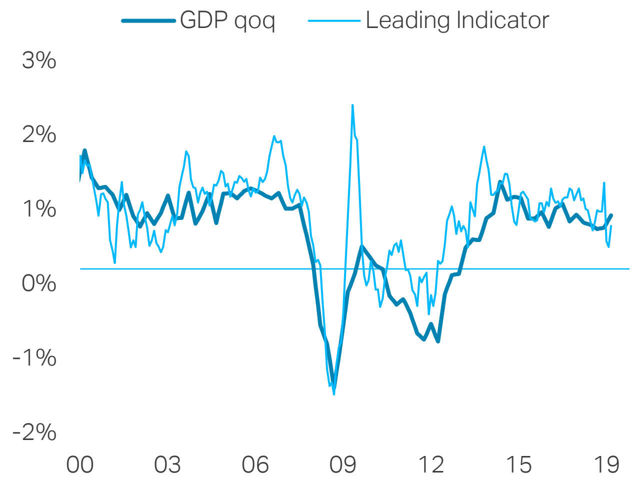

Source: TS Lombard

## Italy



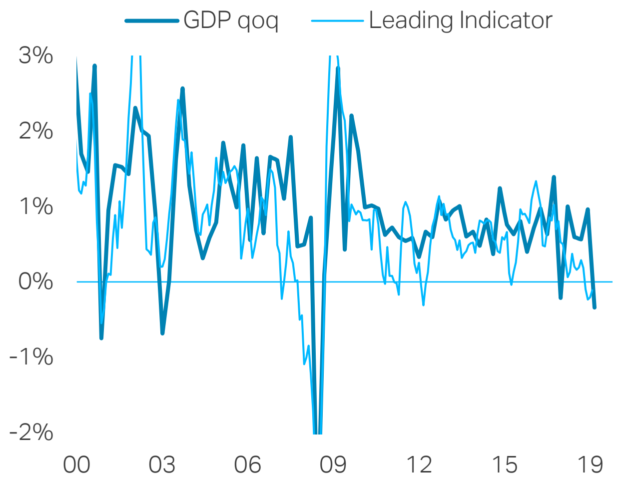

Source: TS Lombard

## Spain



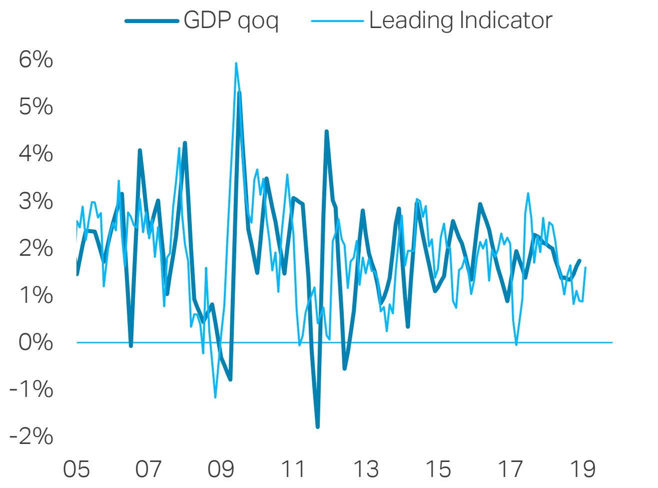

Source: TS Lombard

## Korea




Source: TS Lombard

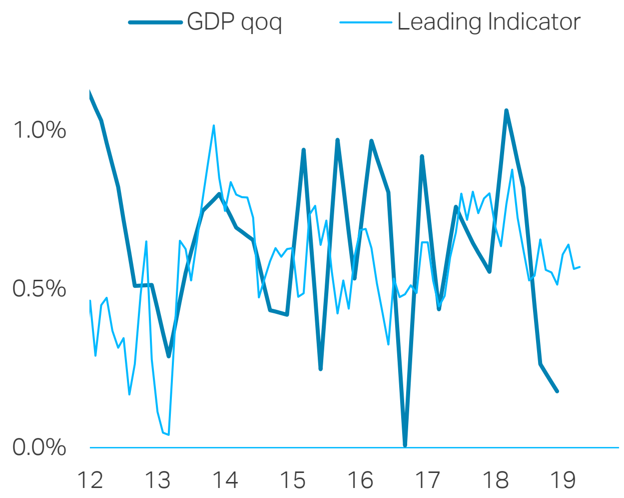
## India




Source: TS Lombard

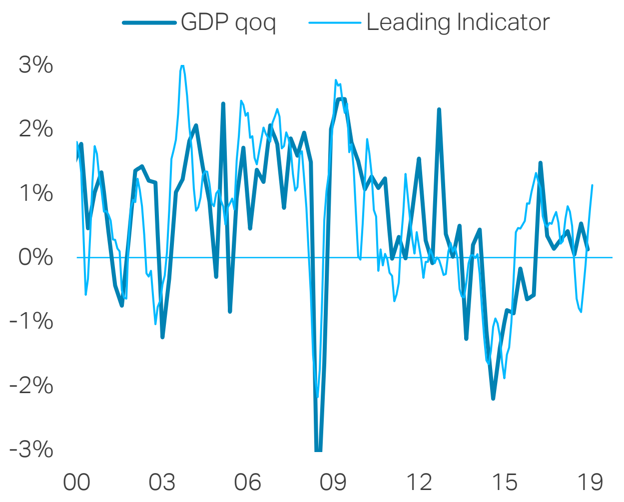
# Appendix: TS Lombard Leading Indicators (cont.)

## Australia



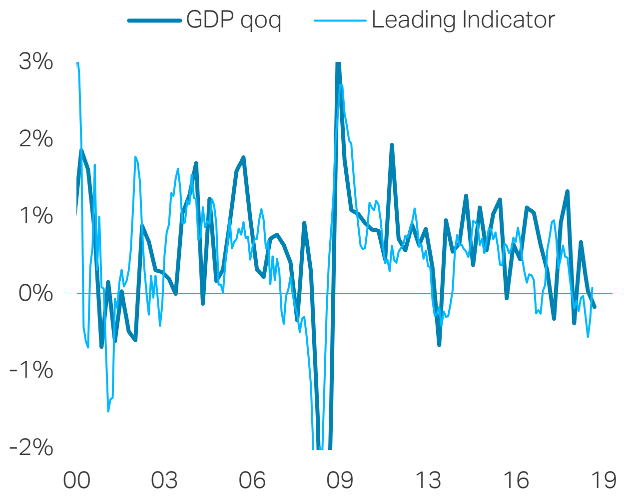

Source: TS Lombard

## 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