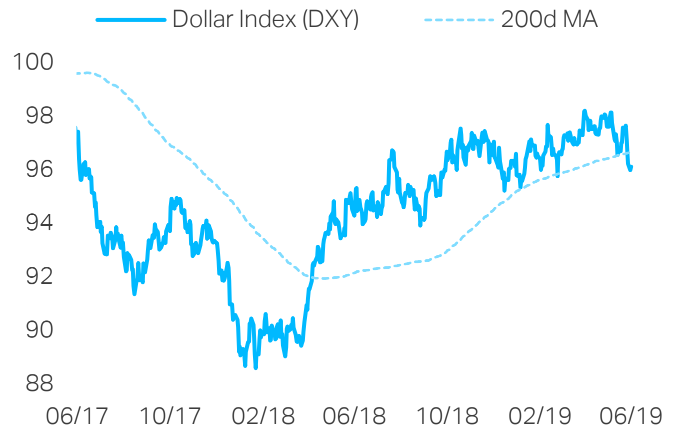
Global Leading Indicators

DOLLAR SMILE

Konstantinos Venetis / Davide Oneglia

- Fed shifts to risk management mode as downside macro risks intensify
- US economic policy turning less dollar-friendly
- Leading indicators sending mixed signals, industrial cycle still in shackles
- The world economy needs a weaker dollar, stable China

Dollar losing its lustre
Index



Source: Bloomberg, TS Lombard

Dollar smile

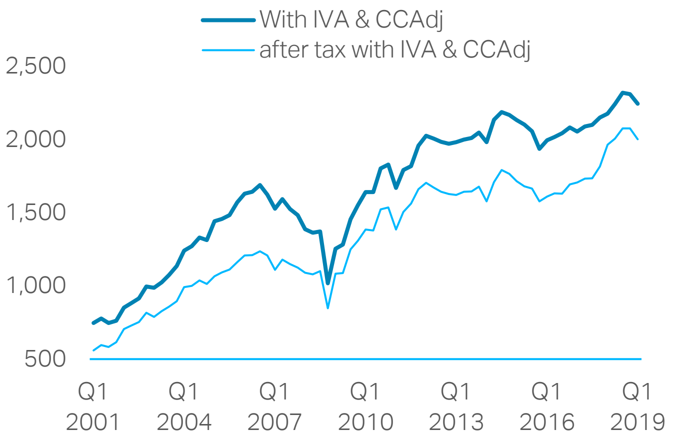
With the Fed in risk management mode and policy around neutral, a rate cut looks imminent. Whether this can shore up inflation when credit demand remains soft is doubtful. Yet the combination of looser US monetary policy and fading fiscal support could mark a turning point for the dollar, helping the world economy find a firmer footing.

Dovish Fed communications took centre stage in June, keeping sovereign yields under pressure and helping risk assets reverse course following May's slide. Fed Chair Powell's remarks in Chicago early in the month opened the door to easier policy. June's FOMC meeting provided confirmation as the Committee's rhetoric switched from a "patient stance" to a readiness to "act as appropriate to sustain the expansion". The Fed effectively eased without cutting, giving a green light for global equities to extend their gains – taking the S&P 500 to new highs and allowing the MSCI World ex US index to recoup two-thirds of May's losses.

It is noteworthy that the Fed is poised to cut rates at a time when, in vice-chair Clarida's words, the "economy is in a good place…with sustained growth, a strong labour market and inflation near the Fed's objective". The change in tone shows a central bank shifting to risk management mode in response to rising uncertainty about the broader macro outlook. Slowing global growth and elevated trade tensions are already weighing on private sector sentiment. US business surveys have been soft (particularly in manufacturing), profits look toppish and capex intentions are rolling over along with current employment, raising a red flag for future hiring plans. Destocking looks set to begin in the coming months following a strong inventory build-up over the last three quarters, weighing on top-line GDP growth – we expect real GDP to expand at an average 1.0% quarterly SAAR in Q2/Q3, consistent with the weakness in our US Leading Indicator. The combination of these factors, together with the lagged impact of last year's monetary tightening and a fading fiscal impulse, threatens to drag already muted inflation expectations even lower, ringing alarm bells in Washington.

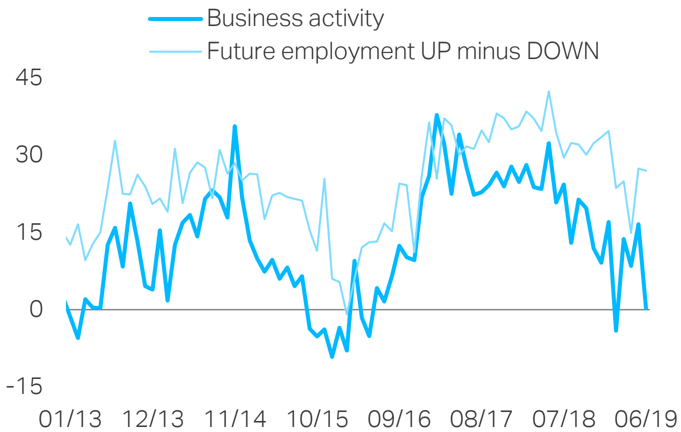
In a recent speech, Fed Board member Lael Brainard noted that "basic principles of risk management in a low neutral-rate environment with compressed conventional policy space would argue for softening the expected path of policy when risks shift to the downside". With the yield curve inverted and the fed funds rate already at the Committee's 2.5% long-run estimate, responding to souring macro momentum would call for looser monetary settings, i.e. taking insurance out against further inflation declines. It would also add credence to Jay Powell's remark that "we certainly don't want to be seen as weak on inflation" and effectively allow the Fed to walk

US profits looking toppish
US corporate profits (US$ bn)



Source: Datastream, TS Lombard

Manufacturing sector under strain
Philadelphia Fed Manufacturing survey, index



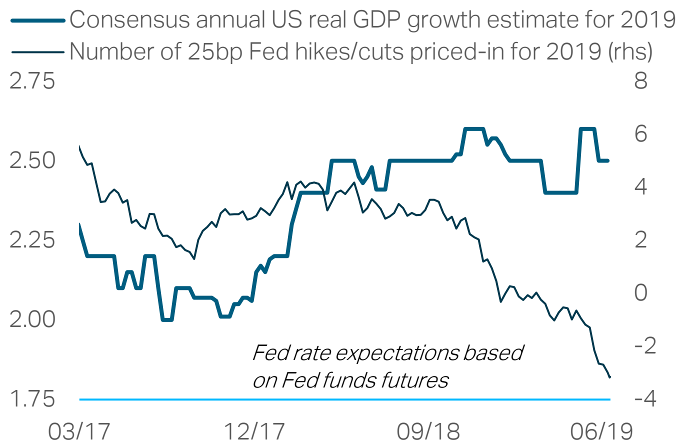
Source: Datastream, TS Lombard

back from December's rate hike – a move that has been viewed as a policy mistake by the market as well as in Fed circles. With the forwards fully discounting a July rate cut, the Fed is unlikely to disappoint.

That said, current market expectations of more than three rate Fed cuts by January 2020 look somewhat excessive. Just like consensus got wrong-footed earlier in the year – expecting not cuts but hikes in 2019 – the pendulum has now swung too far in the opposite direction. The US economy is off the boil but high-frequency indicators are far from signalling a recession and – unlike in 1998, for example, when the Fed ended up cutting rates three times in rapid succession – financial conditions remain very easy. Still, lingering trade war risks are nurturing fears of global recession, driving market participants to a barbell form of 'insurance investing' in anticipation of the Fed's 'insurance cuts'. Bonds and equities have been rising in tandem, propelling risk parity indices to record highs. What is more, June's US equity rally has been led primarily by defensive, low-volatility plays (e.g. utilities), underscoring a strong preference for safety. If a recession is coming, it will probably be one of the most widely anticipated ever.

Expectations mismatch remains wide

Percent



Source: Bloomberg, TS Lombard

Risk parity boost

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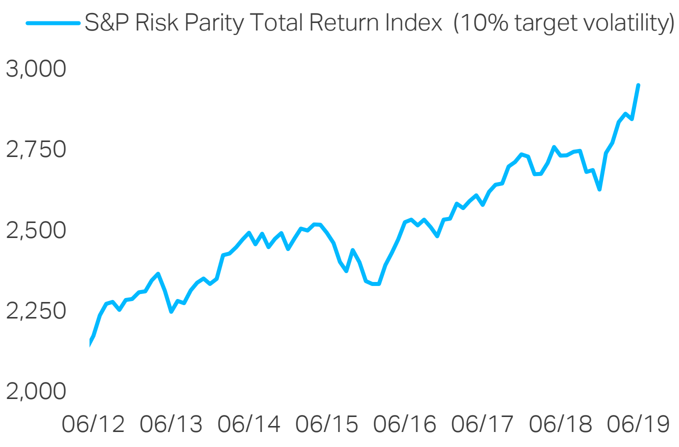

Source: Bloomberg, TS Lombard

The question is whether Fed rate cuts can realistically achieve much for the economy besides potentially giving equities some more room to re-rate. Moving the needle on inflation is difficult given an ageing population and subdued household demand for credit. The Fed's latest Senior Loan Survey confirmed that sluggish loan growth is due to weak demand, not restrictive interest costs. Low yields have boosted financial assets over the last decade but capital spending has underwhelmed. As my colleague Steve Blitz notes "borrowing to spend is the functional root of domestic inflation and, if not for the outsized increase in federal debt, US inflation would probably be even lower".

Perhaps more importantly, looser Fed policy could mean that the days of simultaneous strength in Treasuries and the dollar are numbered. Last month, we wrote that Trump's tweets prompted investors to shift their focus to the reality of a world economy that is re-synchronising lower, marked by faltering US macro outperformance. The prospect of narrowing US growth differentials took some shine off the dollar in May, bringing the broad-based rally that started in Q1 2018 to a halt. This month, dovish Fed rhetoric has nudged the dollar lower against both DM and EM currencies – including the CNY – as investors start coming to terms with what is shaping up to be a less dollar-friendly US policy mix: fiscal easing is set to fade while a softer monetary stance should start eroding (still sizeable) US interest differentials. The breakout of gold prices to the upside of a multi-year range is potentially a confirmatory signal that the dollar cycle is about to turn.

Dollar losing its lustre

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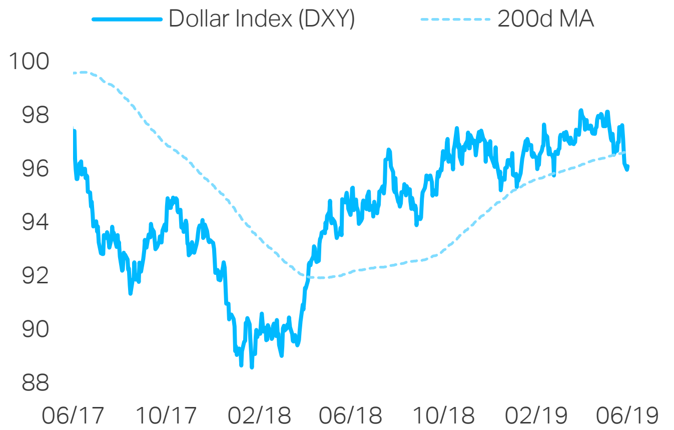
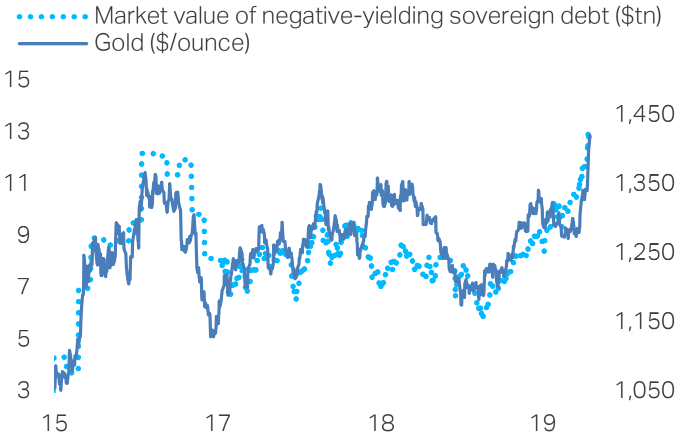


Source: Bloomberg, TS Lombard

Gold breaking higher

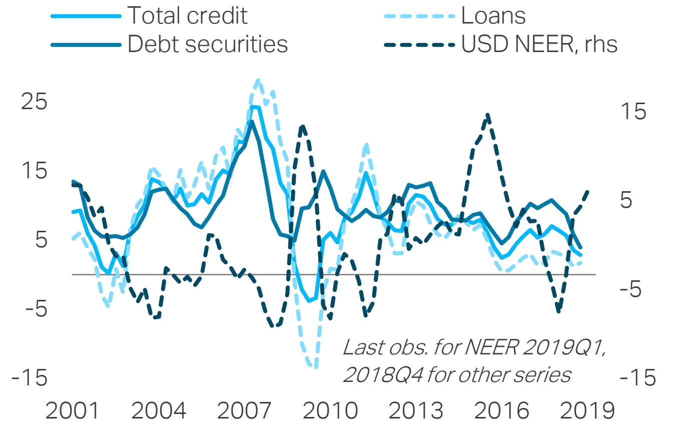


Source: Bloomberg, TS Lombard

While this is still early days, sustained dollar weakness coupled with lower US interest rates is a necessary condition for reflationary impulses to take hold in the rest of the world. The latest BIS quarterly review offers a reminder of US financial conditions' paramount importance for global liquidity and the flow of international credit. Total dollar credit outside the US slowed sharply in 2018 in tandem with substantial dollar appreciation and higher short-term interest rates. Growth in cross-border claims to EMs and offshore centres collapsed, particularly in EM Asia, weighing on global trade, investment and the industrial cycle.

The dollar dictates global credit flows

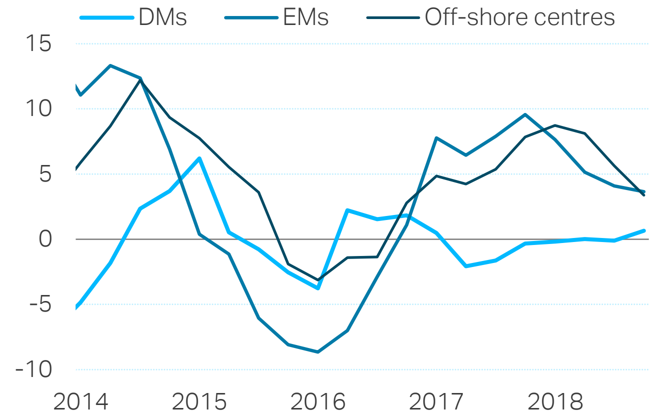
USD credit outside the US, YoY %



Source: BIS, Datastream, TS Lombard

EM & offshore credit nosedived in 2018

Cross-border claims by borrowing region, YoY %



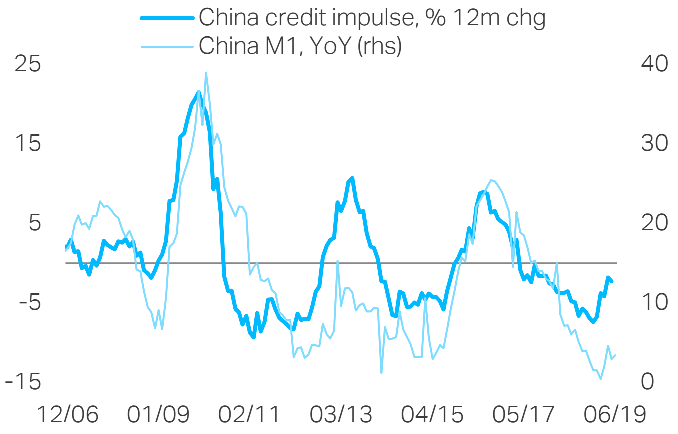
Source: BIS, Datastream, TS Lombard

The other key ingredient required for the global economy to turn the corner is better economic news out of China. Our economists expect infrastructure fixed asset investment to gather pace over the coming quarters as local authorities rush to use annual bond issuance quotas. With local investment accounting for over 90% of total FAI, recent regulatory changes that allow some of the proceeds from such bonds to be used as equity capital should add 1-2ppts to annual infrastructure FAI growth. The authorities are also pulling policy levers to ensure there is a floor under household spending, which should allow retail sales to stabilise. Meanwhile the PBoC is sticking to a 'prudent' monetary stance that is biased towards fixing the country's financial plumbing rather than broad-based easing. Annual total credit growth (including bond issuance) has improved but is struggling to top the 12% rate, confirming our long-standing view that – unlike in 2016/17 – credit stimulus will be relatively slow to come through.

Still, with quasi-fiscal expansion via local government financing vehicles set to accelerate in H2 2019, China's credit impulse should continue to recover, propping up M1 growth and broader economic activity going into 2020. Our Chinese Leading Indicator has been creeping higher, consistent with easier policy filtering through to the real economy.

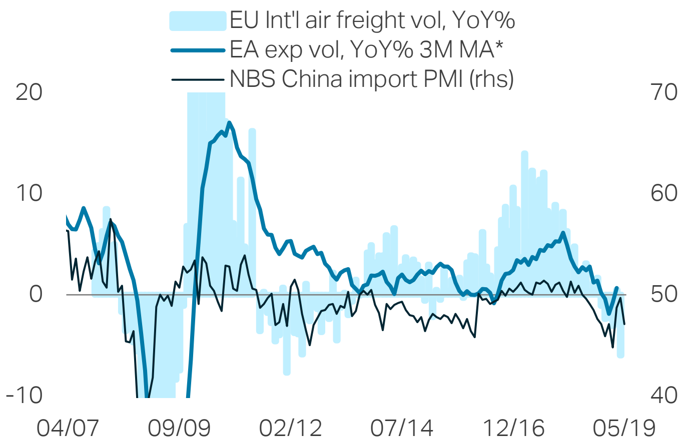
Chinese money & credit on the mend

Percent



Source: Bloomberg, TS Lombard

EA exports lacking impetus

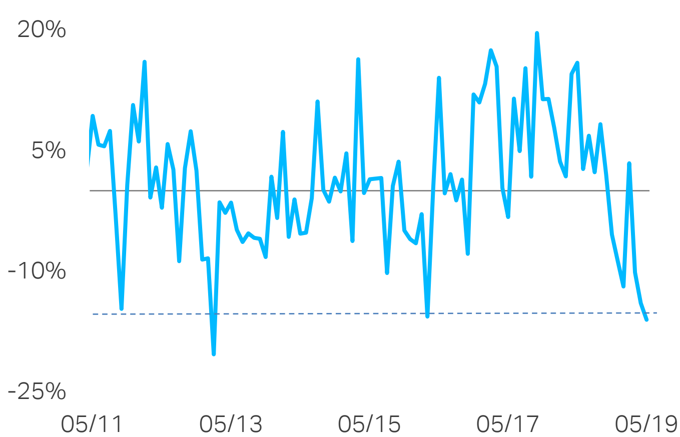


Source: Datastream, TS Lombard

It would be premature, however, to think that the world economy will soon be out of the woods. The high-frequency leading indicators we track continue to send mixed signals, consistent with a bottoming process but also showing little sign of acceleration on the horizon. Our Global Leading Indicator seems to be turning the corner, led by its EM component, pointing to steadier global growth over the coming quarters. The industrial cycle remains under pressure, however, marked by high inventory ratios and a persistent downturn in the tech sector. Our Japan and Korea Leading Indicators remain depressed. Key barometers of Asian manufacturing activity, such as Singapore domestic non-oil exports and Japanese machine tool orders, continue to shrink in YoY terms, although the rate of contraction is at levels which have marked a turning point in the past. Global PMIs remain on the back foot, although positive divergence in the PMI for EM new export orders is encouraging, foreshadowing some stabilisation in Asian export volumes. Still, with electronics new orders showing no evidence of a pick-up, it is hard to envisage a turnaround in world trade any time soon – not least as the official PMI measure for Chinese imports is still pointing down.

Asian exports under pressure

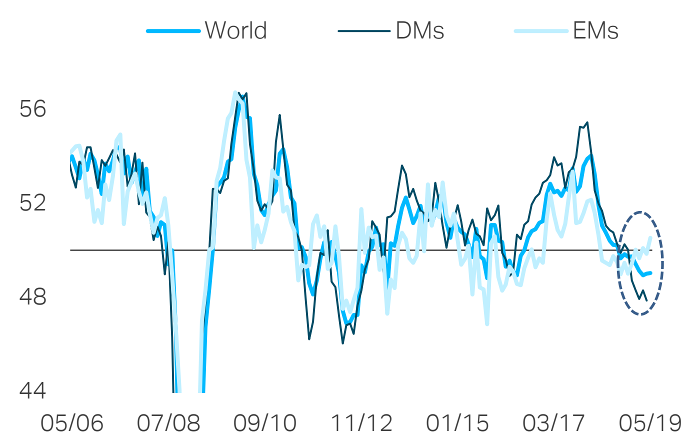
Singapore domestic non-oil exports, YoY



Source: Datastream, TS Lombard

Positive EM divergence

New export orders manufacturing PMIs



Source: Datastream, TS Lombard

Against this backdrop, it is no surprise that export growth in the euro area remains subdued. Escalating trade tensions between the US and China are only making things worse, keeping business sentiment depressed and causing firms to put capex plans on ice. It is telling that air freight volume from Europe – an indicator that tends to track real EA exports well – relapsed in April (down 6% YoY) after a brief recovery during Q1, consistent with soft Chinese manufacturing PMIs. The reversal of strong Brexit-related stockpiling activity in March and the protracted balance-of-payments crisis in Turkey probably magnified the drop. Swedish industrial activity – a reliable leading indicator for European manufacturing – appears to be stabilising but is showing no signs of a turnaround.

The message from market-based indicators is also somewhat mixed. EM equities are outperforming the MSCI World index yet forward earnings expectations continue to slide. Global mining stocks have clawed back most of their spring losses, but the CRB Metals and Raw Industrials indices remain stuck at Q4 2016 levels. Copper prices have rebounded from the June lows in tandem with a stronger CNY, but momentum looks underwhelming.

Metal prices stuck in low gear

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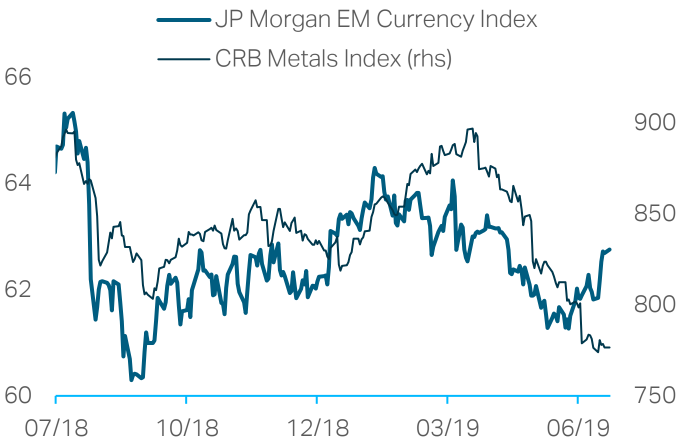
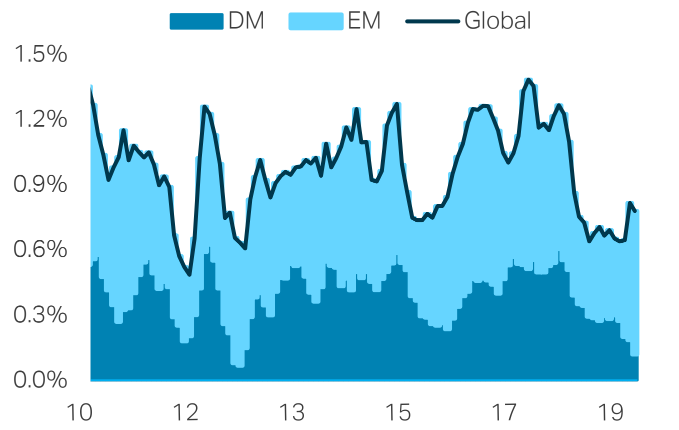


Source: Bloomberg, TS Lombard

EMs still in the driver's seat

Global Leading Indicator and components



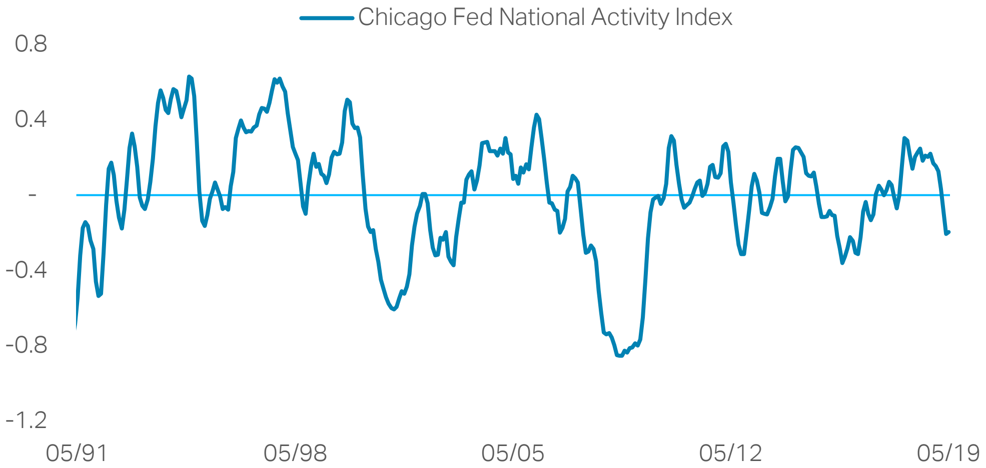
Source: Datastream, TS Lombard

Looking out beyond the near term – and putting trade war considerations to one side – the combination of progressively less restrictive global liquidity conditions and better Chinese macro momentum paints a positive global macro scenario that could rekindle the global commodity cycle. This would (1) allow inflationary pressures to bottom out and (2) nudge bond yields higher, taking some air out of the crowded 'long US Treasuries' trade. Incidentally, with the inverted US curve having rendered the FX- hedging of US bond positions unattractive for foreign investors, the pressure to unwind unhedged dollar exposures would increase in such circumstances, potentially dealing another blow to the dollar. Inflation expectations could also get reignited via the supply side, e.g. a 'tanker war' flare-up in the Gulf region that would inject a premium into the oil curve, pushing bond yields up and turning the global macro playbook upside down.

To sum up, the global cycle remains in a vulnerable phase. Fed easing should support stock market multiples, but the key question for equity investors is what happens to earnings as the US economy recouples lower with the rest of the world. With margins coming under threat, and absent a US-China trade deal, it looks like all that is left to extend the earnings cycle and underpin equity prices is a softer dollar. Whether the combination of Fed rate cuts and a fading fiscal sugar high can do the trick remains to be seen.

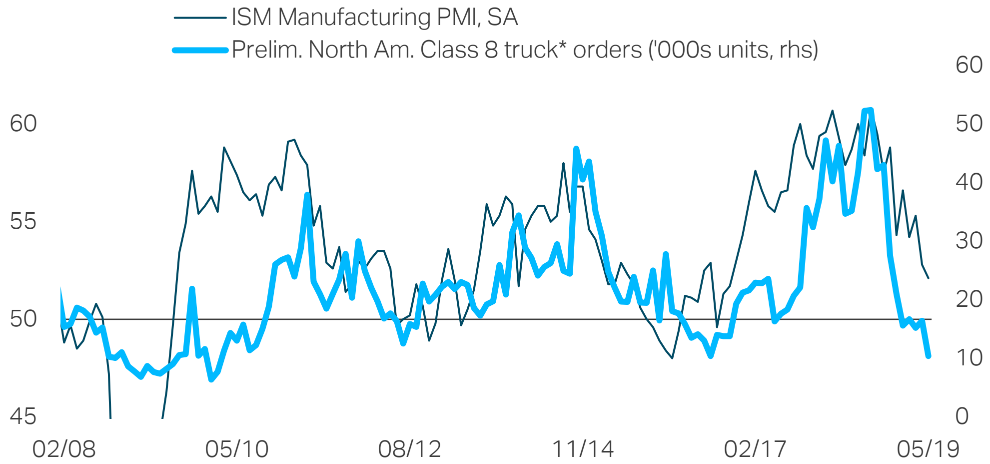
US – downside risks intensifying

Macro momentum pointing down
3m MA



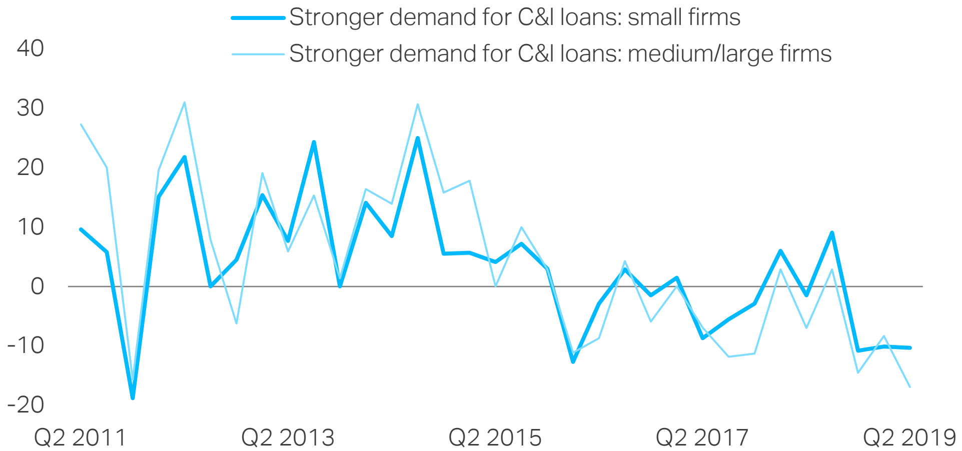
Source: Datastream, TS Lombard

Heavy truck orders remain under pressure



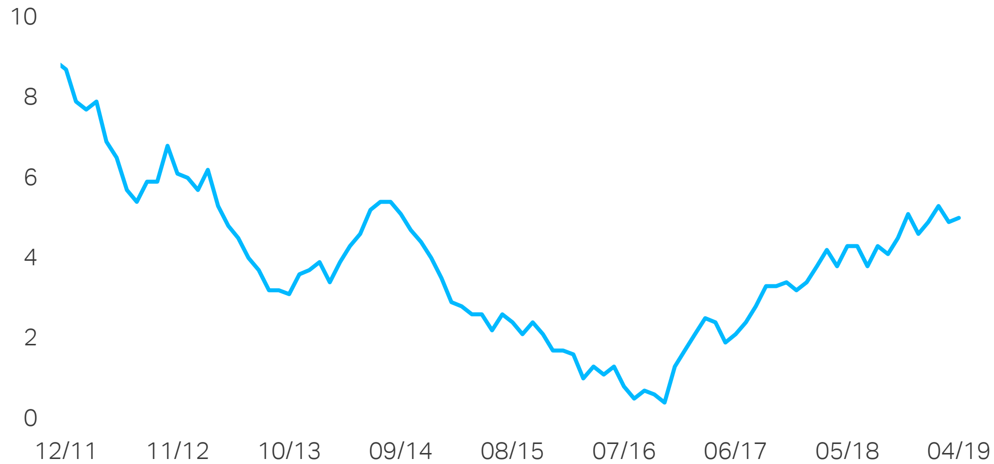
Source: Datastream, TS Lombard

Sluggish demand for credit
Fed Senior Loan Survey



Source: Datastream, TS Lombard

Inventory overhang to weigh on growth in H2 2019
US manufacturing & trade inventories, YoY %

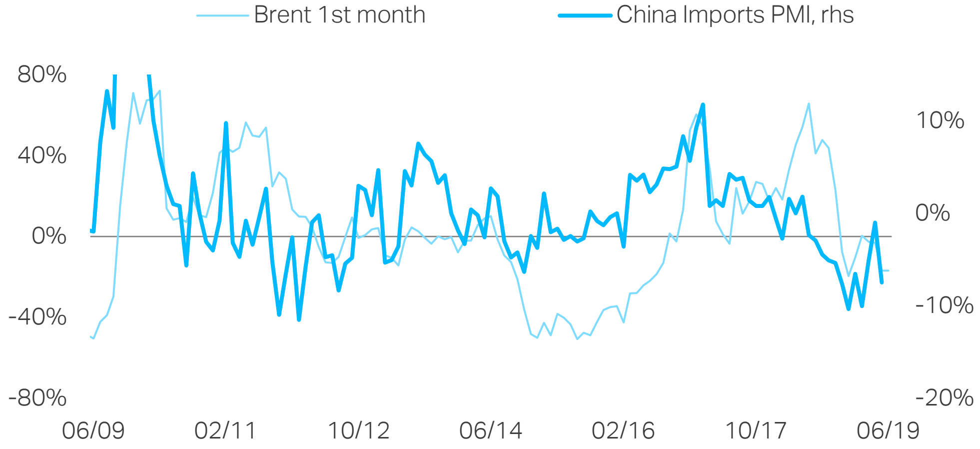


Source: Bloomberg, TS Lombard

China – fragile improvement

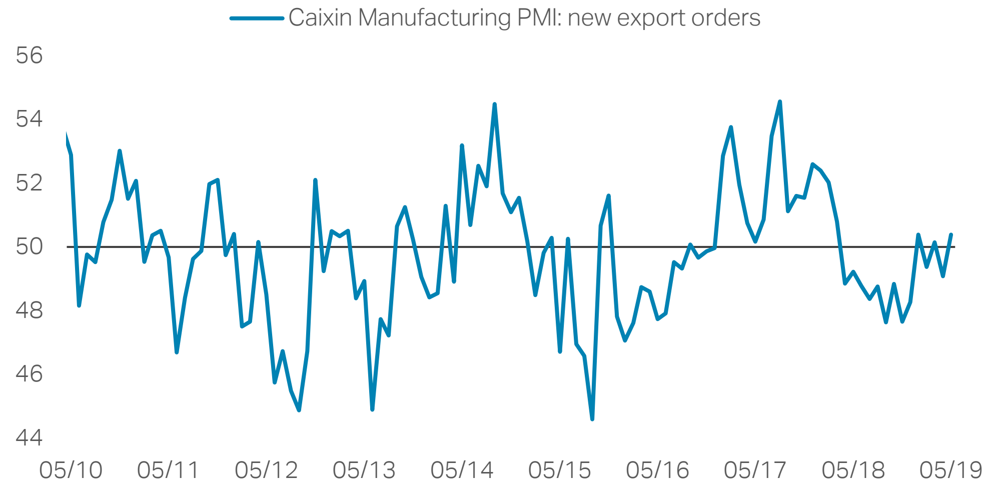
Weak China trade a warning sign for oil

YoY



Source: Bloomberg, TS Lombard

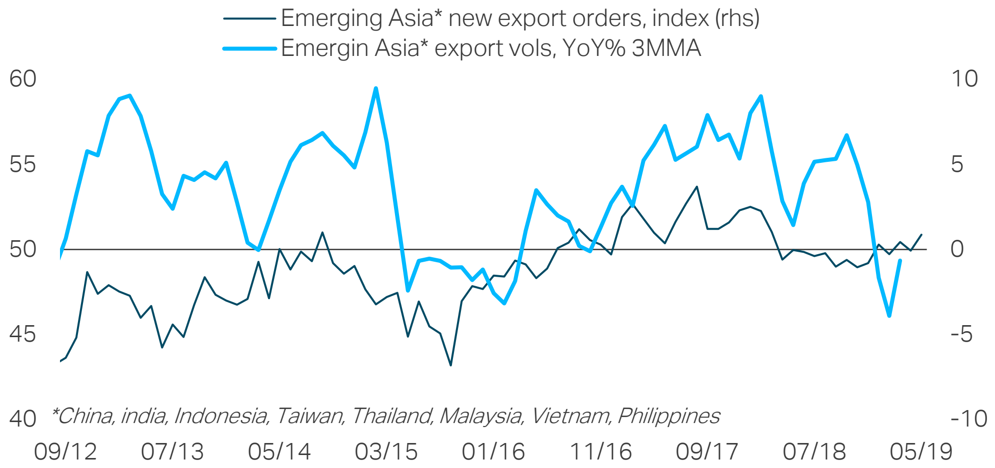
Chinese new export orders stabilise



Source: IHS Markit, Datastream, TS Lombard

Steadying Chinese orders to lift the rest of Asia

GDP-weighted indices

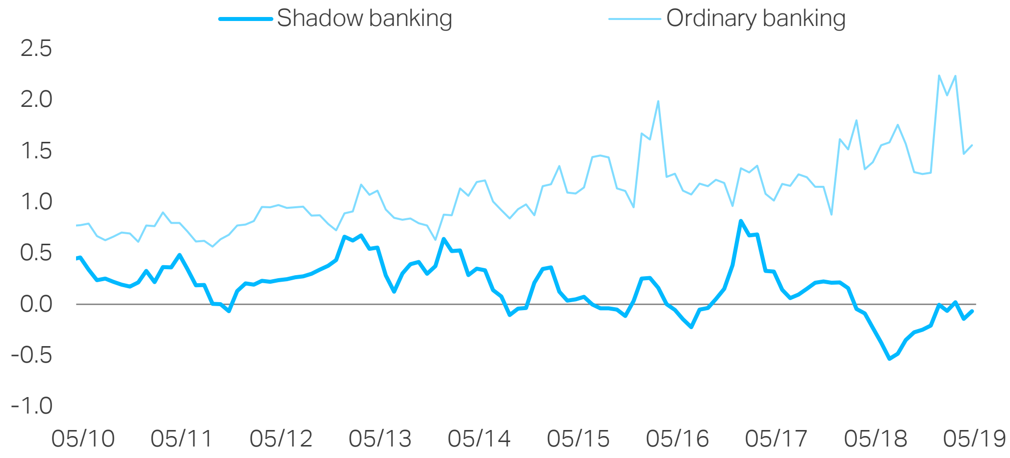


*China, india, Indonesia, Taiwan, Thailand, Malaysia, Vietnam, Philippines

Source: IHS Markit, Datastream, TS Lombard calculations

Structural deleveraging is a medium-term target

New increases in Total Social Financing, RMB trn

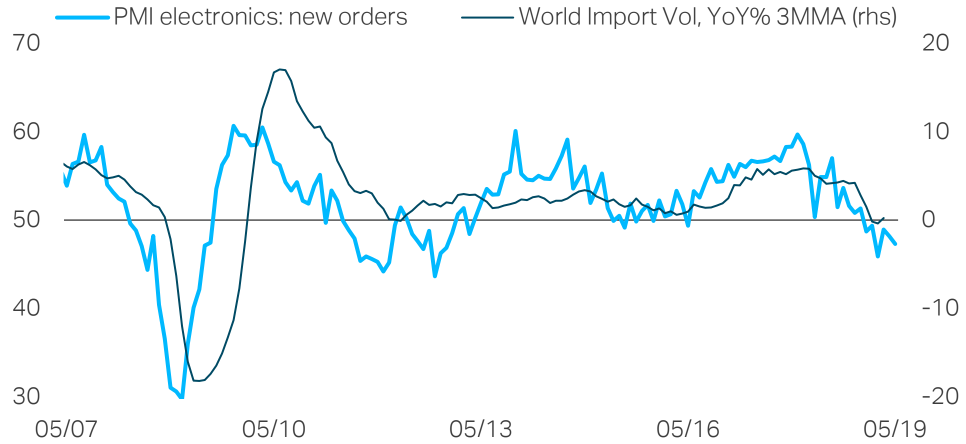


Source: CEIC, TS Lombard

Industrial cycle – ongoing struggle

The tech cycle continues to weigh on global trade

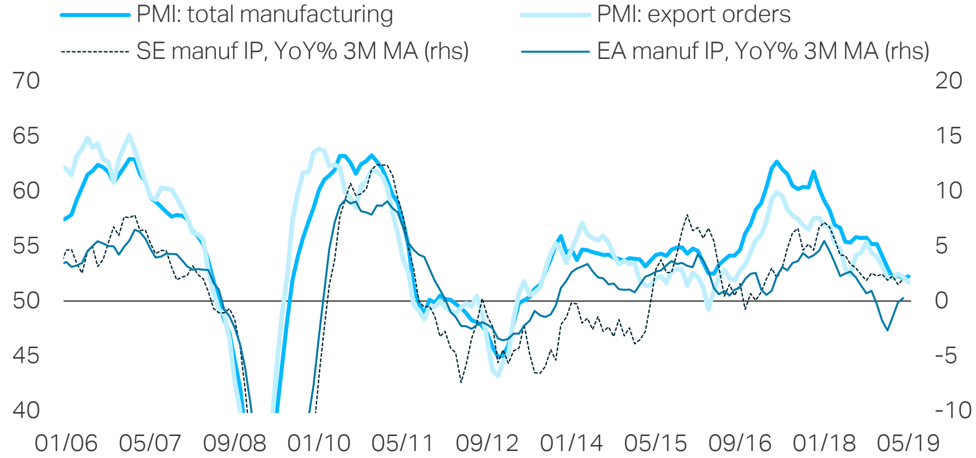
Indices



Source: IHS Markit, CPB, Datastream, TS Lombard

Swedish PMIs argue for prolonged stagnation

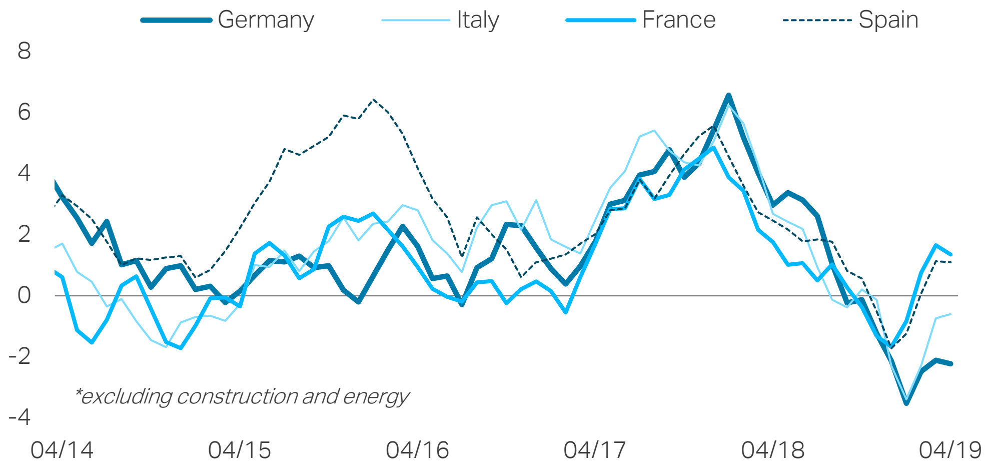
PMIs and volume indices



Source: Datastream, TS Lombard

A two-speed Euro Area

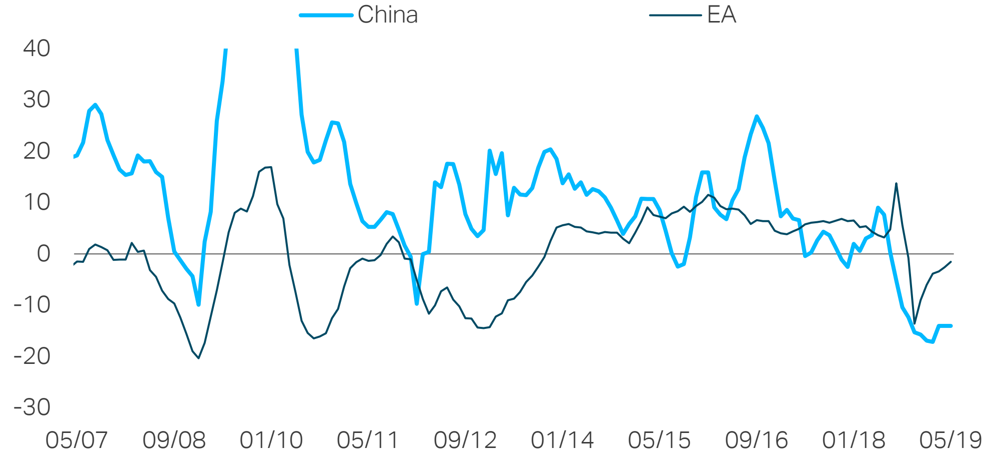
Industrial production*, volume indices, SA, YoY% 3M MA



Source: National sources, Datastream, TS Lombard calculations

Auto sector still in the doldrums

New passenger car sales, YoY% 3M MA



Source: Datastream, TS Lombard

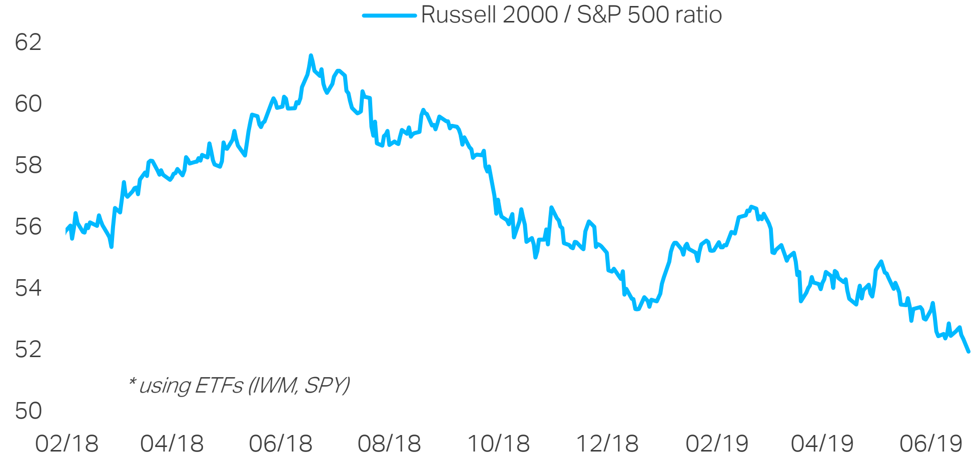
Market-based indicators sending mixed signals

Dialling down expectations

Source: Bloomberg, TS Lombard

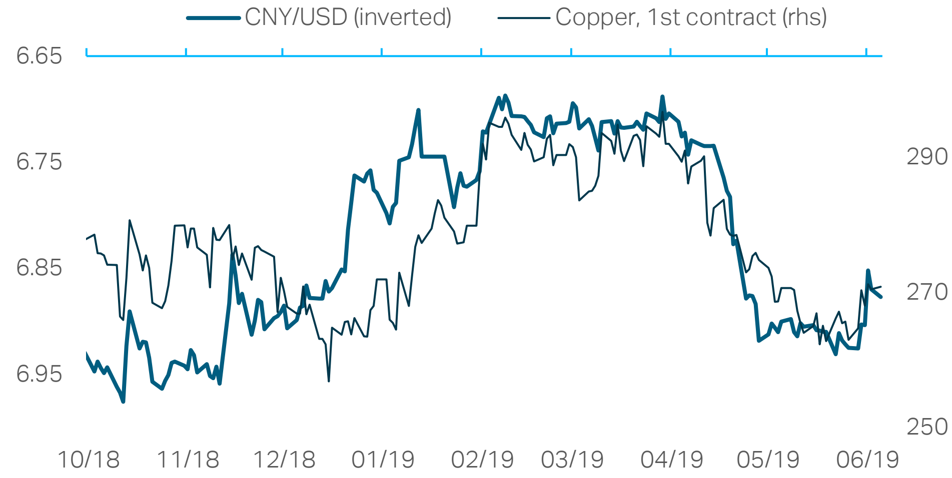
US small-caps on the back foot

Ratio*



Source: Bloomberg, TS Lombard

Copper steadying in tandem with CNY



Source: Bloomberg, TS Lombard

EM FX carry catching a bid

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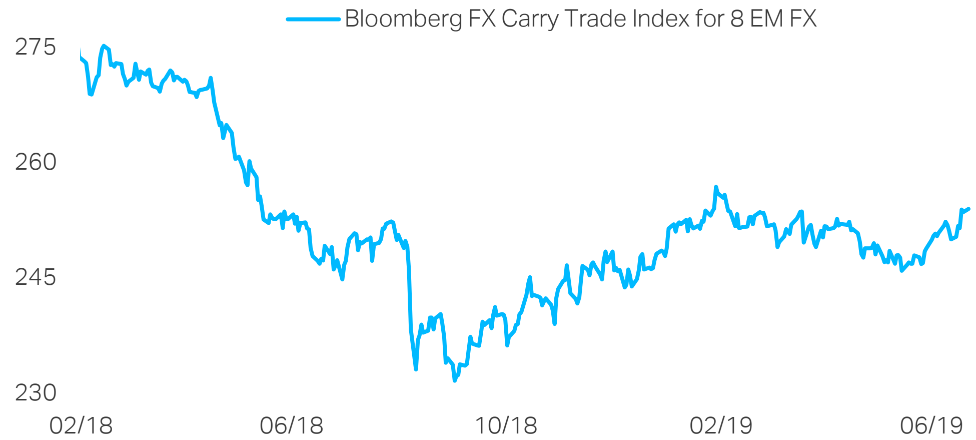
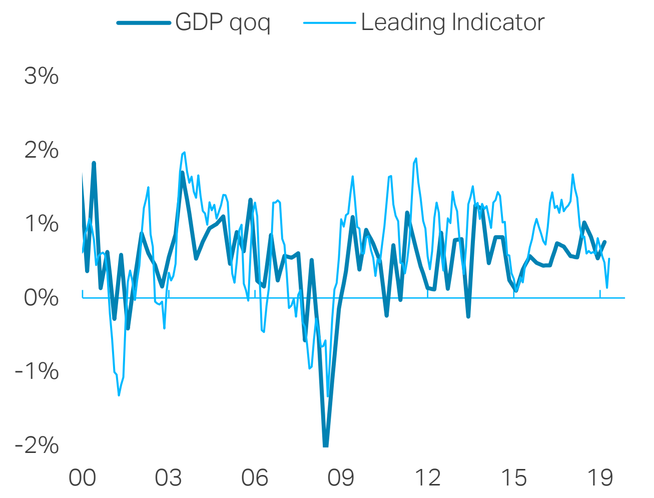


Source: Bloomberg, TS Lombard

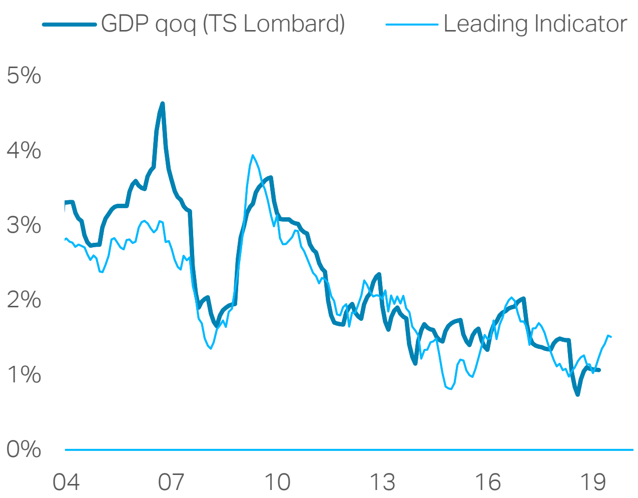
Appendix: TS Lombard Leading Indicators

United States



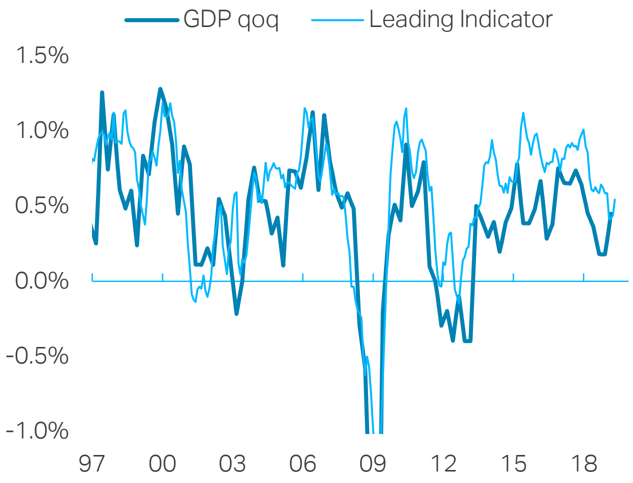
Source: TS Lombard

China



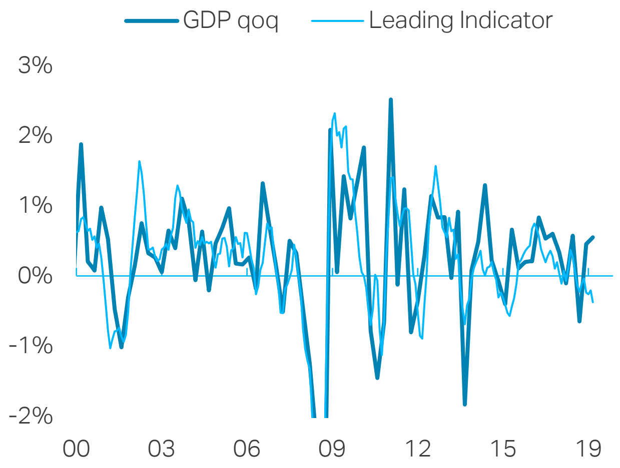
Source: TS Lombard

Euro area



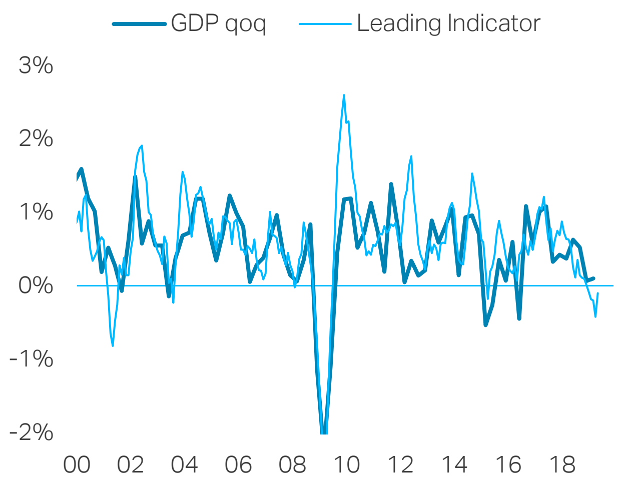
Source: TS Lombard

Japan



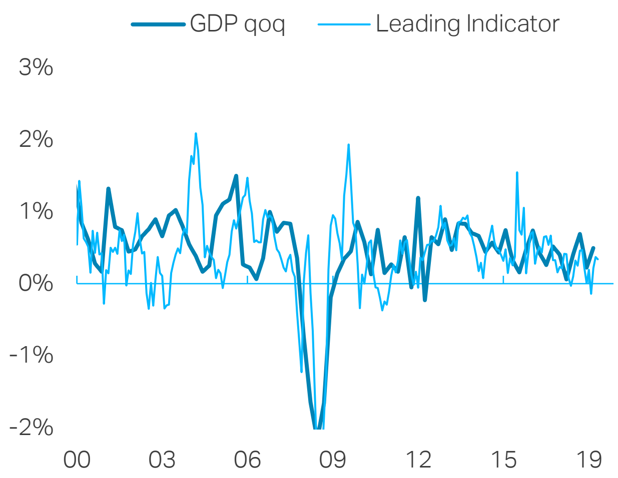
Source: TS Lombard

Canada



Source: TS Lombard

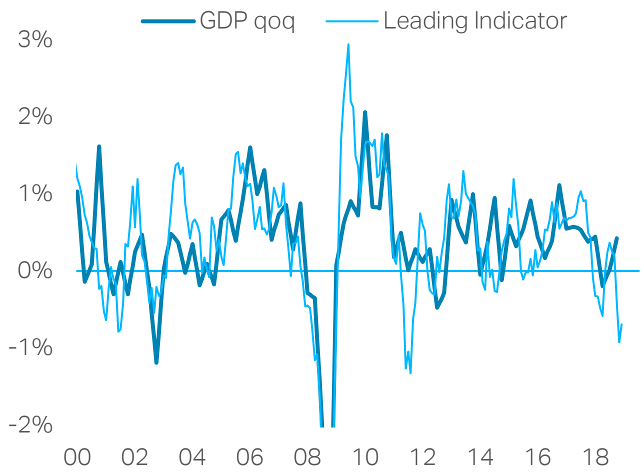
United Kingdom



Source: TS Lombard

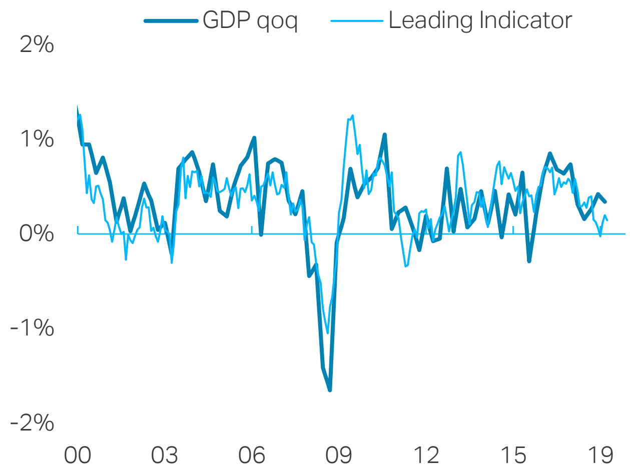
Appendix: TS Lombard Leading Indicators (cont.)

Germany



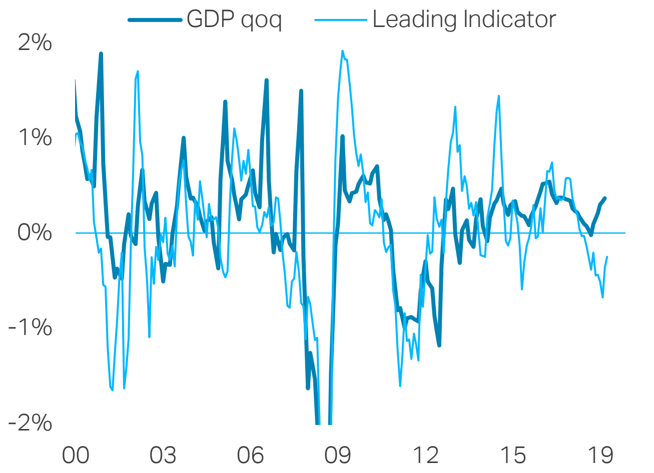
Source: TS Lombard

France



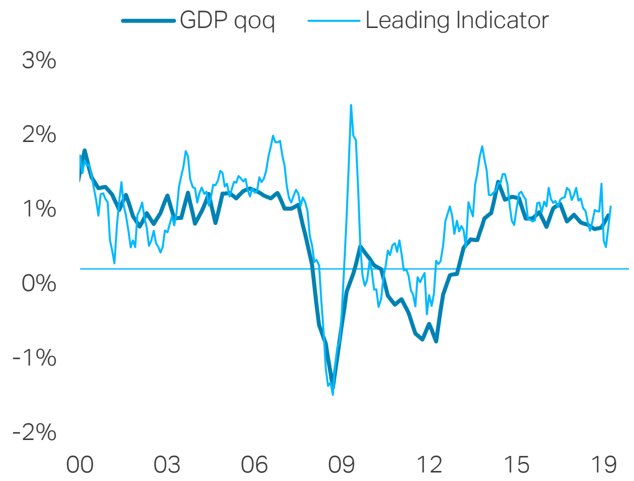
Source: TS Lombard

Italy



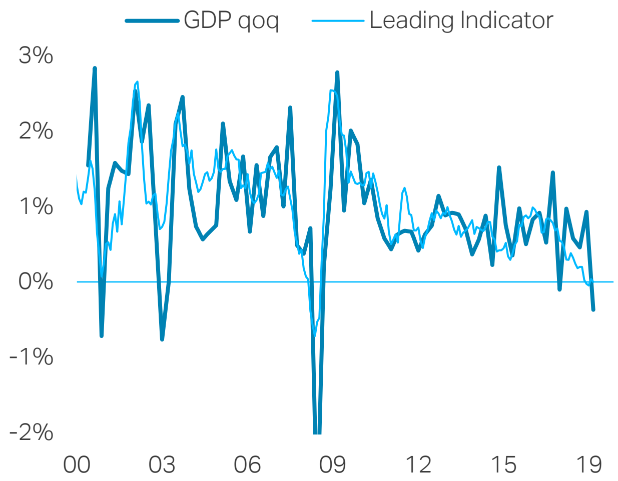
Source: TS Lombard

Spain



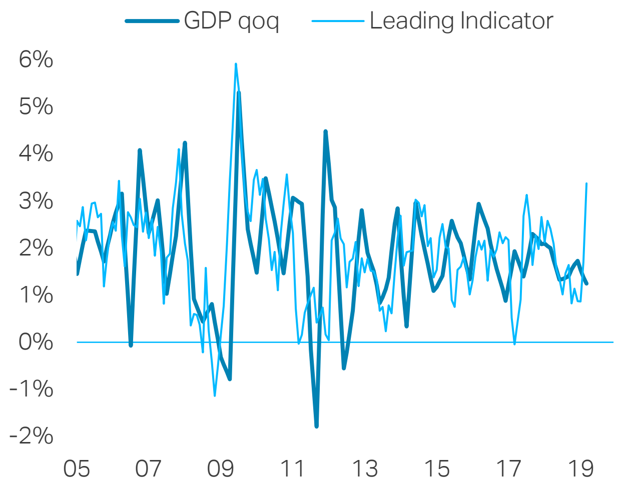
Source: TS Lombard

Korea



Source: TS Lombard

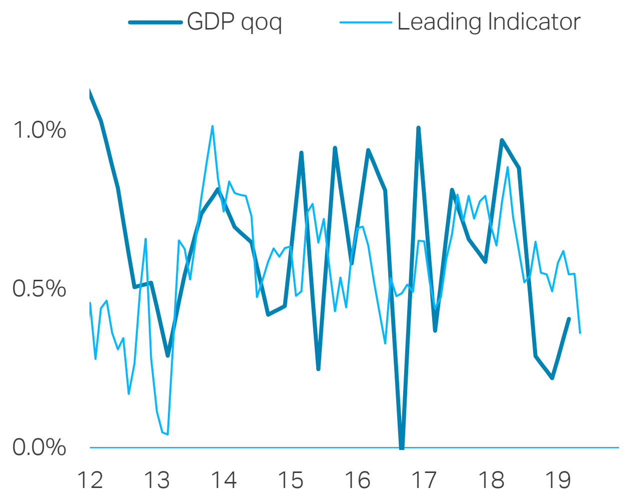
India



Source: TS Lombard

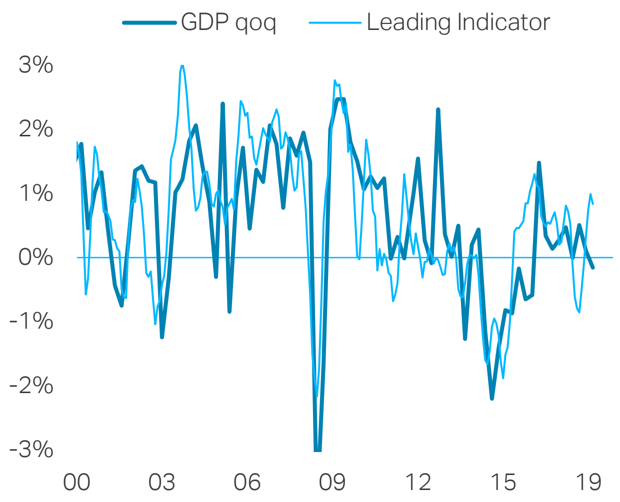
Appendix: TS Lombard Leading Indicators (cont.)

Australia



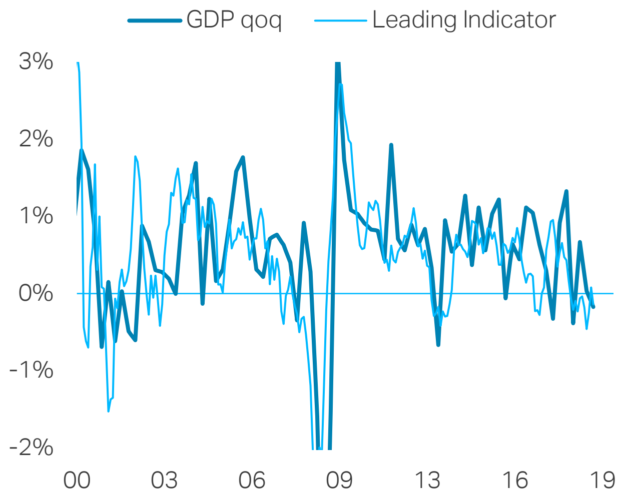
Source: TS Lombard

Brazil



Source: TS Lombard

Mexico



Source: TS Lombard

A note explaining the methodology and construction of our Leading Indicators can be found here.

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