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Market and fundamentals

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Weak growth

Real global economic growth was surprisingly weak in Q1. The preliminary estimate for the annualised growth rate of Q4 2014 to Q1 2015 is only 1.5%. This is mainly due to disappointingly weak growth of the GDP in the USA (+0.2%), in China (+5.3%), in the UK (+1.2%), and in Japan (+1.5%; estimate). Brazil (-2.4%) and Russia (-11.5%) have even shrunk (both figures are preliminary estimates). In line with this situation, the data surprises have been largely negative, and the trend of downward revisions for economic growth has continued.

Decline in potential growth

In this environment of overall demand weakness, the growth rate of potential production (i.e. supply) has fallen as well. The concept of potential growth is defined as the overall production output of an economy when both factors, capital and labour, are being utilised at optimal rates, i.e. without pressure from inflation or deflation, bearing in mind productivity. For the industrialised countries, the IMF estimates a decline in annual potential growth from 2.2% in 2001 to 2007 to 1.3% in 2008 to 2015. By comparison, the emerging countries are expected to incur a decline in economic growth from 6.7% to 6.3%. The decline in potential growth is due to the fall in the growth rates of investments, of the labour force, and of productivity in many countries.

Negative output gap

Unforeseen events such as the Great Recession in 2008/2009 may cause actual growth to deviate from optimal economic growth. This situation is called a negative output gap. Since wages and prices react with a time lag to shocks, the gap closes only slowly. In fact, the IMF estimates an output gap of -1.9% of potential production for the industrialised countries in 2014. This implies that inflation pressure will remain low. In March global inflation amounted to only 1.3% y/y.

Expansive central banks

When both supply and demand disappoint, this means that the monetary policy can remain loose for longer (no immediate interest rate hike) and that the neutral interest rate level is lower (fewer interest rate hikes). Indeed, the central banks have cut their interest rates in the past months. They have dialled down the expectations for interest rate hikes (Fed), launched (ECB) or expanded (Riksbank) a bond purchase programme, cut the key-lending rates below zero (Switzerland, Denmark, Sweden, Eurozone) and cut the minimum reserve requirements of commercial banks with the central bank (China). This environment supports the yields of all asset classes. That being said, the falling earnings growth has become increasingly challenging for risky assets.

Improvement in Q2

At this point the question of whether we will experience an improvement in demand and/or supply is crucial. At the moment there are no signs that would indicate an improvement in potential growth. The indicators of labour productivity for Q1 suggest lower growth rates. On the demand side, there are indicators suggesting a moderate acceleration of economic growth in Q2, the crucial argument being that the leading indicators of OECD and the purchasing managers indices failed to predict the demand weakness in Q1. This “error” might be closed from the “right” side. Or put differently: the leading indicators seem to be saying that the weak economic growth in Q1 was a growth dent.

Base scenario

This is the base scenario for Q2: persistently weak potential growth, moderate increase in economic growth, stable inflation, high surplus liquidity due to the lacklustre investment activity, and high demand for bonds from central banks in Japan and the Eurozone. This means that economic growth will remain weak enough for inflation pressure to remain low and the monetary policies to remain expansive, but strong enough to support earnings growth.

Lots of movement on the markets

How does this match up with the recent movements in the market? The big trends in the past months – appreciation of the US dollar, flattening of yield curves, and outperformance of equities in the Eurozone – have reversed in recent days or weeks. The common denominator was the “expensive” valuation and the fact that the positioning of the market participants was asymmetrical (US dollar appreciation). This is among other things due to the very expansive central bank policies (mini boom/bust cycles).

Expensive valuation

As a matter of fact, the real effective US dollar is clearly above its long-term average. At the same time the expectations of interest rate hikes in the USA have fallen while the balance of trade deficit has increased. The 10Y real yield in Germany reached -1.37% in April (currently: -0.96%), and the yield differential between short and long-term government bonds has declined noticeably in spite of the accelerating economic growth. Eurozone equities continued to record weak earnings growth in Q1. In this environment it does not take much to set off a pronounced reversal.

Focus

Investors are currently focusing on two issues: 1) when, how fast, and to what extent the US Fed will increase the Fed funds rate will depend mainly on wage growth, which has recently accelerated a bit; and 2) the European Central Bank will be successful with its reflationary policy especially if it manages to keep nominal yields low and the euro weak, and to move inflation expectations towards ECB target.

Conclusion: the environment does not support a sustainable depreciation of the US dollar; it does not suggest sustainable yield increases in the Eurozone but is supportive to Eurozone equities.

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