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Constructive central banks

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Risky asset classes such as equities have recorded price increases at the beginning of the year. The core question for the investor is whether this recovery after the sharp decline in Q4 is sustainable or not.

Growth weakening

central banks

Chart 1: falling economic indicators

The global economic cycle is currently on the decline. Real global economic growth has been on the fall since Q4 2017. GDP growth has reached trend growth levels. Remarkably, the goods sector is particularly sensitive to the downturn. In many countries, industrial production was falling significantly at the end of 2018. The majority of survey-based leading indicators (purchasing managers' indices, OECD leading indicators – see chart 1) suggest further decline in growth. Is this development

only a form of normalisation after a phase of unsustainably high growth rates, or has the risk of recession actually increased?

Weakly positive signals

central banks

Chart 2: no further Fed funds rate hikes

Not all economic indicators are facing south. There are a number of signals that suggest the stabilisation of economic growth, albeit at low levels. As far as the purchasing managers' index for January is concerned, two important sub-categories have increased, i.e. new orders in the USA and imports in China. In Germany, the number of spin-offs of capital goods in December increased relative to the previous months. Also, credit growth stopped falling in China in the month of December (m/m). This

environment suggests an imminent end of shrinking industrial production.

Monetary policy supports financial market

The monetary policy is lending strong support to the markets yet again:

- The US Fed has given up its tendency towards further interest rate hikes. As a result, the worries of the economy and the markets over excessively high interest rates have therefore disappeared (for now). The future interest rate hikes priced into the market for the coming 12M have reversed from 0.8 percentage points in September to currently a slight cut (see chart 2). Also, the US Fed has signalled its intention of ending the process of shrinking the balance sheet sooner than generally expected (i.e. more liquidity).
- The ECB has mentioned downside risks to the economy (i.e. recession risks). This makes a soon reversal of the currently very expansionary monetary policy even less likely.
- In China, the reserve requirement ratio has been cut repeatedly (i.e. more and cheaper liquidity for banks). The growth rate of the central bank balance sheet increased in December after a downward trend throughout the year.

Summary

The main motive cited for abandoning the gradual tightening of the monetary framework is the deterioration of the financial environment (i.e. falling share prices, higher credit spreads). This does not mean that falling share prices are to be avoided per se. Rather, this is about putting a halt to the negative feedback from the deteriorating financial environment to the economy. And it seems to be successful for the time being. A (possible) end to the weakening growth rate in the first half of the year combined with a still expansive stance by the central banks supports (for now) risky asset classes (equities, emerging markets). This would also require the leading indicators for economic growth to stop falling soon.

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