Market remains cautious

Gerhard Winzer

© (c) iStock

The positive reaction to the agreement between the USA and China on not further escalating the trade conflict for the time being was only short-lived. Risky assets remain under pressure. A number of factors continue to burden the markets.

Trade conflict: agreement still only temporary

President Trump and the Chinese President, Xi Jinping, reached an agreement at the G20 meeting in Buenos Aires not to raise tariffs any further. There will be ongoing negotiations concerning new trade relations for the duration of 90 days. The chances of a definitive agreement are slim, given that the US balance of trade deficit with China will remain big, and the often-criticised practices pursued by China such as forced transfer of know-how and public subsidies will remain in place. Also, the structural ascent of China on an economic, political, and military level means the shift from a unipolar to a multipolar system. China is trying to overcome the attempts at containment from the USA. The two countries are of course rivals.

Weakening growth

Real global economic growth has already fallen from 3.8% (q/q, annualised) in Q3 2017 to 2.8% in Q3 2018. (Source: Bloomberg/Erste AM) Several economic indicators are suggesting that this trend will continue. Of relevance are the following ones:

Flat yield curve in the USA.

The differential between the 10Y and the 3M interest rate in the USA has shrunk significantly (currently 0.49 percentage points). Generally speaking, whenever the rates at the short end of the curve were higher than the ones at the long end ("inverted yield curve") in the past, a recession would follow.

Negative credit impulse in China.

Credit growth in China is falling. If the change in credit volume is below nominal economic growth, the momentum produced by credit is negative. This means that the credit environment is depressing economic activity.

trade conflict

Two political aspects countered these negative factors.

US central bank turning more cautious

In the USA, some central bank members reduced interest hike expectations with their commentary on market prices. At this point, less than a full hike is priced in for 2019 after the generally expected increase of 0.25 percentage points to 2.25-2.50% in December.

At its core, this is all about the question of the neutral key-lending rate. That level has neither a dampening nor supporting effect on the economy. The catch is that this rate cannot be estimated precisely. A political error such as excessive rate hikes that trigger a recession are therefore a substantial risk. Last week, some central bank members pointed out that the lower end of the bandwidth of neutral rate estimates will soon be reached (dovish tone). This is probably based on the assumption that some interest-sensitive sectors such as the private real estate market have shown signs of weakness and market developments such as the flattening of the yield curve (see above), the widening of the credit spreads, and the outperformance by defensive sectors on the equity markets suggest a downturn.

The US central bank can only remain cautious as long as inflation is not rising. In fact, inflation rates will be falling in the coming months due to the fallen oil prices. While the inflation on goods is also receding globally, the increase in wage inflation continues to indicate upside risks in the underlying inflation.

Expansive fiscal policies.

The budget deficits being expanded in particular in the USA and in China. This comes with a mildly supporting effect on global economic growth.

Summary

The suspension of further tariff increases by the USA on Chinese imports, the cautious statements from the US Fed, and the expansive fiscal policies are supporting the economy and the markets. Risks like a further escalation of the trade conflict, a further weakening of global economic growth (especially in China), and drastic rate hikes by the Fed due to higher inflation are dampening the upward potential of risky asset classes.

Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.