Monthly Newsletter Savings and Investments

Central banks talk about looser monetary policy

July 2019

Market overview

The second quarter of this year is already behind us. Reversing the weakness in risk assets in May, June's strong performance has made it a good quarter and certainly a good start to the year, almost irrespective of what you were invested in, equities or bonds. Central banks was the main factor that caused upturn in markets in June. Confronted by weaker economic data, risks to the trade outlook and still low inflation, the Federal Reserve (the Fed) and the European Central Bank (ECB) indicated that monetary measures might come in the form of further monetary stimulus. Current market pricing reflects expectations that central bank stimulus will keep the economic expansion going. Whether the stimulus will be enough to extend what is now the longest economic expansion in history, only time will tell. We still maintain our base case scenario that global growth will accelerate in Q3 due to the fiscal and monetary stimulus launched by China, due to increased possibilities of trade agreements and due to the possible additional stimulus from the Fed and ECB. But we have lowered our confidence herein due to the weakened manufacturing sector that we have seen in Europe, the US, and China. On tactical horizon, we chose to keep risk tolerance towards risk assets, such as equities, slightly underweighted. In line, we are closely tracking what is happening in the markets and are ready to make changes in our risk tolerance.

Stock market indexes' performance (until 30 June 2019)

Region	Index	Currency	Performance							
			2019 June	2019 YTD	12 Months	2014	2015	2016	2017	2018
USA	S&P 500	USD	6,9%	17,3%	8,2%	11,4%	-0,7%	9,5%	19,4%	-6,2%
Europe	MSCI EURO	EUR	5,1%	14,2%	0,4%	2,3%	6,1%	1,7%	8,7%	-14,2%
Eastern Europe	MSCI EM Eastern Europe	USD	6,3%	19,6%	16,1%	-40,0%	-8,1%	33,0%	12,9%	-8,3%
Asia	MSCI EM Asia	USD	5,8%	8,6%	-4,5%	2,5%	-11,8%	3,8%	40,1%	-17,3%
Latin America	MSCI EM Latin America	USD	6,0%	10,8%	14,8%	-14,8%	-32,9%	27,9%	20,8%	-9,3%

Major events and expectations

In focus. Manufacturing surveys have weakened around the world, with a quite big decline in the US business surveys and continued weakness in China, Japan and Europe. Germany's manufacturing sector in particular, looks to be struggling. One risk is that this weakness in the manufacturing sector could lead to job cuts and falling consumer confidence. This means rising risk to the employment and consumer outlook, which has probably been a key driver of the shift towards further stimulus from the Fed and ECB.

Faced with greater downside risks to the economic outlook and falling long-term inflation expectations, **the Fed started to use more dovish rhetoric**. The market now expects more than 0.5% worth of rate cuts by the end of this year, this is a sharp contrast to the 0.5% increase in interest rates that was expected for 2019 back in September. Concerned about the downside risks to the economic outlook, **the ECB also talked about looser monetary policy**. ECB president Mario Draghi said that monetary policy would be loosened unless the economy improves, tried to convince markets that the ECB still has plenty of ammunition left if further quantitative easing (QE) is required and that interest rates could fall even further into negative territory if needed**. Christine Lagarde was nominated the next president of the ECB,** a job that will start in November this year. She is seen as looser monetary policy supporter; therefore, an appointment of such a dovish figure could motivate the current president, to accelerate monetary easing sooner rather than later.

The **market's attention** is therefore likely to be focused even more sharply than usual on the **labour market data** in the coming weeks and months. The June **labour market data in US showed much better than expected employment data**. It may have some additional significance due to the uncertainty surrounding the Fed's monetary policy and the July 30-31 policy meeting. Stronger than expected payrolls gain reduces the immediate pressure on the Fed to soften monetary policy. As long as other economic data to be published ahead of the July meeting do not provide evidence of a sharp growth slowdown or the trade negotiations between the US and China collapse, the Fed may leave the nase rate unchanged in July.

US-China trade war cease-fire reduces. At the G20 summit at the end of June, Donald Trump and Xi Jinping agreed to a truce in the US-China trade war and trade negotiations will restart. The US will not put new tariffs on Chinese imports. The outcome was in line with our expectations and means that one of the major downside risks to the global economy has been avoided for now. Although today's agreement means that there is a chance for the US and China to reach a deal, there is still a significant risk that the trade war will escalate. The US is still demanding major changes to Chinese trade and industrial policy. China is unlikely to agree unless the US is also prepared to make concessions, including a roll back of existing tariffs. Worries over trade war escalation will continue to impact financial markets and an escalation remains one of the major downside risks.

In the UK news about next prime minister dominates. The polls and odds suggest that Boris Johnson is a strong favourite to be the next prime minister. Whoever is prime minister, parliament is still likely to prevent a no deal Brexit, unless a general election or referendum takes place and provides a strong mandate from the population for such an outcome. At the moment, polls suggest only about 30% of UK voters want to leave the European Union without a deal. How the new prime minister hopes to unite the Conservative Party and solve the Brexit issue remains to be seen.

2019 Q2 earnings season is starting soon. Analysts talk about **not so promising** results and that it might be the worst quarter in 3 years. In the US 1% year-over-year decline in aggregate earnings per share is expected. But this shouldn't come as a surprise to market participants as companies have already been issuing negative earnings guidance. **What is driving slowdown in earnings?** Slowing economic growth probably is the main reason. But also other factors such as increasing input costs (labor cost), trade wars and tariff uncertainty leads to slowing earnings growth. From next week investors will start to put more focus on earnings season.

To **summarize**, recently there was a period when **bad economic news was good news for markets**. Market has been willing to ignore the bad economic news in the **hope that central bank stimulus will help avoid downturns in economy**. If economic data remains weak, delivery of the hoped for stimulus seems highly likely. Whether the stimulus will be enough to extend what is now the longest economic expansion in history, only time will tell.

We currently see the gains in equities and the valuations as unsustainable unless we see a firm acceleration in growth over Q3 2019. While we wait to see whether growth reaccelerates or slows further, investors may want to hold only a neutral allocation to risk assets and avoid overweight to higher risk. On tactical horizon, we chose to keep **risk tolerance** towards risk assets, such as equities, **slightly underweighted**. However, we still maintain our base case scenario that global growth will accelerate in Q3 due to the fiscal and monetary stimulus launched by China and due to the possible Fed and ECB stimulus. But we have lowered our confidence herein due to the weakened manufacturing sector that we have seen in Europe, the US, and China.

Glossary

Terms used	Explanation
Fiscal policy	Fiscal policy relates to government spending and tax collection. Fiscal policy refers to the use of the government budget to influence economic activity. For example, when economic growth is slowing down, the government can step in and increase its spending to stimulate demand and economic growth. Or it can lower taxes to increase disposable income for people and businesses.
Gross Domestic Product (GDP)	The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.
Investment grade bonds, **high yield bonds**	Investment grade bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively low risk of default. High yield bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively higher risk of default than investment grade bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Two main credit rating agencies Standard & Poor's (S&P) and Moody's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. S&P designations of 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as high yield or "junk bonds".
Monetary policy	Monetary policy is the process by which the monetary authority (usually the central bank) of a country controls the supply of money (the size and rate of growth of the money supply), for the purpose of promoting economic growth and stability. For example, if the money supply grows too fast, the rate of inflation will increase and the economy will "overheat". If the growth of the money supply is slowed too much, then economic growth may also slow. The main tools to control money supply include open market operations (buying or selling assets), changing interest rates and changing reserve requirements for commercial banks.

Purchasing managers' indexes (PMIs)	An indicator of the economic health of the manufacturing sector. The PMI indexes are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change.
Yield	The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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