LOMBARD ODIER
INVESTMENT MANAGERS

Global Perspective

Q2 Outlook: low rates, pro-risk

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April 2019

Executive summary

We continue to envisage a “No Recession Yet Tricky” situation prevailing for the rest of the year. A deeper “search-for-yield” environment is likely to take hold after the Federal Reserve’s clear policy pivot in the first quarter, in our view, and leads us to maintain a pro-risk stance. Dovish central banks should cement the outlook for rates remaining low against a backdrop of stabilising global growth. Chinese indicators are more positive amid the latest bout of fiscal stimulus, and the US and China are expected to resolve parts of the trade dispute. Such developments have the potential to allay the slump in global manufacturing and could lead to worldwide growth steadying in coming weeks. Volatility, however, is likely to persist.

We expect the following key factors to shape the global economy:

- The pivot from the Federal Reserve heralds a significant move towards some form of price-level targeting and cements the case for a low interest rate environment, in our view.
- We continue to believe the European Central Bank (ECB) will not hike in this cycle as its policy reflects the sharp deterioration in Eurozone growth momentum.
- We believe that the Chinese economy has turned a corner amid noteworthy fiscal stimulus. We expect trade tensions will ease (but not disappear) and the most recent data for the country is positive.
- Global manufacturing is decelerating and below trend, and Eurozone economies have slowed markedly. Potential resilience in services and green shoots in China could be supportive, even as multiple risks also threaten the outlook. We continue to see a global recession as unlikely.
- Following the latest 6-month extension to Brexit, we expect continued uncertainty as the deadlock persists.
- Fractured liquidity and the rise of populism could create a strong source of volatility.

Key implications

In light of our search-for-yield outlook, we believe investors should consider the following in the months ahead:

- Emerging market risky assets are expected to outperform developed market assets.
- In fixed income, we prefer corporate credit, especially in the BBB to BB segment.
- Convertible bonds could offer downside protection amid rapid shifts in the policy environment.
- In foreign exchange, a rangebound USD/EUR could contrast with emerging market currencies grinding firmer. With Brexit extended, we are neutral GBP.

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Fed pivot to keep rates low, diverting EM headwinds

Global risk premia normalised in the first quarter of the year amid a remarkable change in tone from the US Federal Reserve. The normalisation followed extreme pressure on risk assets late last year that stemmed from rising fears of a recession and previously hawkish rhetoric from the Fed.

Since then, the US central bank has changed its stance significantly, presaging what we believe will be a move towards some form of price-level targeting and cementing the case for a low real and nominal interest rate environment. The change should divert previous headwinds for emerging market (EM) assets.

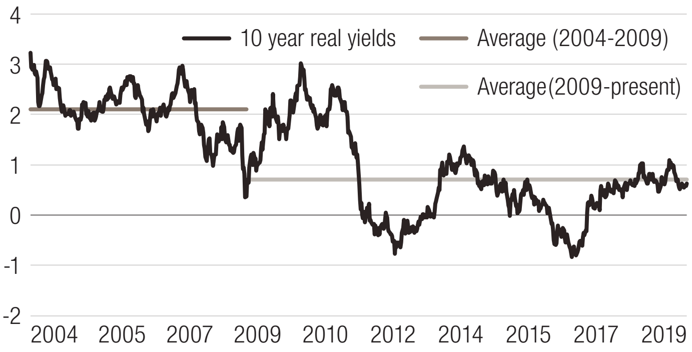
The Fed's sharp pivot in Q1 reflects the central bank embarking on a once-in-a-generation review of its monetary policy framework, we believe. The U-turn was most clearly highlighted by the shift lower in dot plots for 2019: the Fed went from forecasting three rate rises (at its meeting in December 2018), to predicting zero increases (at the March 2019 meeting). This veritable collapse in tightening expectations transpired over a span of just 12 weeks as the Fed shifted towards a more patient stance on removing accommodation. It also led to the widespread perception of hawkish rhetoric at the December meeting representing a "communication mistake."

We believe that generating above-target inflation is becoming a policy goal as the Fed recognises that the neutral real rate has likely fallen and is set to remain below the average seen before the 2008 financial crisis. Recent talk of price-level targeting is one avenue through which such a meaningful shift of the reaction function could occur. More clarity in this regard is likely in coming months, in our view.

This shift in the Fed's reaction function implies that for a given level of macro conditions, US monetary policy is likely to remain easier than what would otherwise be implied by its dual mandate. That mandate specifies the Fed must effectively promote the goals of maximum employment and stable prices.

Such a change in Fed reaction function – combined with sluggish global growth and an accommodative stance from the ECB – cement the case for rates remaining low-for-longer, even if inflationary dynamics surface, particularly in the US.

FIG. 1 US 10 YEAR REAL RATES – WE EXPECT THE POST-2008 RANGE TO HOLD



Source: Bloomberg.

US nominal rates are likely to remain between 2.6% and 2.3% for the rest of the year, in our view. We continue to expect a low probability of a US-driven recession, and believe that the inversion of the US Treasury yield curve reflects Fed policy actions since 2008 rather than predicting a recession.[1] If anything, we believe the sizeable easing of financial conditions engineered by the Fed is likely to extend the business cycle. Significant headwinds for emerging markets arose last year from idiosyncratic risks and US policy tightening, particularly for countries with external vulnerabilities. Now, the Fed's pivot substantially reduces pressure on EM central banks to tighten domestic policy in 2019.

As such, we expect no major EM central bank to hike over the next 12 months. This backdrop, together with encouraging signs in Chinese indicators, should be positive for EM asset performance this year, leading us to maintain our pro-risk stance.

We are, however, somewhat perplexed by the resilience of the dollar against emerging market currencies. While dollar strength against the euro is a consequence of potential ECB easing, the argument does not apply to emerging markets. Here, we also note the stability in CNY is becoming more critical for broader EM foreign exchange dynamics relative to the DXY (US dollar index), as the operating framework of CNY is subject to review whilst a US-China trade deal is negotiated.

Overall, we think that the environment has turned positive for EM assets and we believe that USD resilience will give way to gradual EM currency appreciation in coming months.

Accommodative ECB

In line with our non-consensus call, ECB policy has reflected the sharp deterioration in Eurozone growth and kept the central bank firmly rooted in accommodation.[2] Its forward guidance sees rates on hold until the end of the year, and it recently announced another round of Targetted longer-term refinancing operations.

The latest Governing Council meeting showed that the central bank is in wait-and-see mode: President Mario Draghi reiterated that the risks to growth remain to the downside, and the central bank can use all instruments at its disposal, if need be.

We continue to believe the ECB will not hike in this cycle. The bank's discussion of tiering negative interest rates implies that the next step is likely to be further easing, in our view, as inflation remains below-target over the forecast horizon.

1 Please see LOIM paper titled: Predicting a US recession: Has the yield curve lost its relevance?
2 Please see LOIM paper titled: The Eurozone slump: Things are deteriorating quite fast.

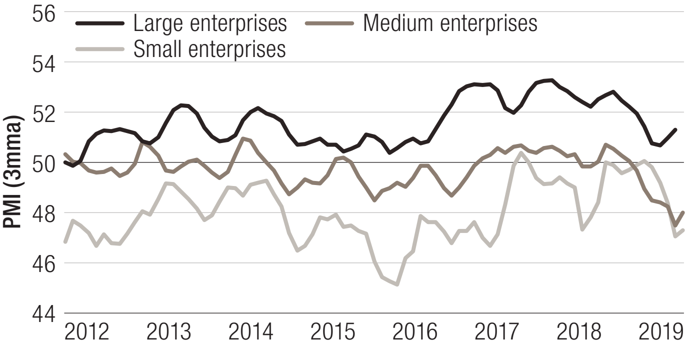
Chinese economy stabilises as trade deal looms

Our out-of-consensus call, foreseeing positive Chinese growth surprises,[3] has begun playing out. Chinese indicators are showing signs of a potential rebound amid the latest bout of fiscal stimulus, though tight credit conditions could be a concern. Developments in the US-China trade negotiations will be key, as will the timing of any accord, and tension could remain unresolved in the longer-term.

At the annual National People's Congress meeting in mid-March, Chinese policymakers said they will provide strong fiscal stimulus in 2019. The stimulus includes a VAT cut worth approximately USD 90 billion, and a significant boost in infrastructure spending through an increased quota for special bond issuance. Such measures should equate to roughly a two percentage point rise in China's so-called "augmented fiscal deficit" this year, and the expansion is beginning to appear in fiscal indicators.

Monetary policy easing is probably ending, although we expect the reserve requirement ratio to be reduced further this year. Real estate policies may be loosened in some cities but probably not nationwide, given high leverage in the sector.

FIG. 2 CHINA BUSINESS SURVEYS SHOW GREEN SHOOTS



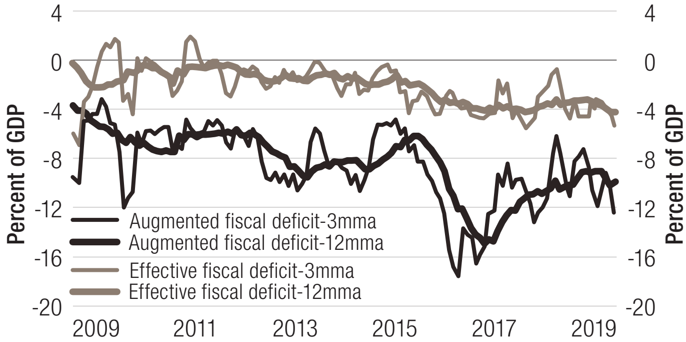
Source: NBS, Bloomberg.

Relative to the past, the government stimulus initiated late last year looks managed compared to the response to previous downturns in 2015, and certainly compared to 2009. How effectively such stimulus will support the real economy remains to be seen, particularly with respect to private companies that still face tight credit conditions, according to various media reports.

Notably, the goal of stimulus is also more modest this time, aiming for 6-plus percent real GDP growth in 2019 compared to 8% growth in 2009 and 7% growth in 2015. And policymakers do not face the equity/FX volatility and capital outflows that were present in 2015, as capital controls seem to be holding up well. In addition, progress on the US-China trade war has also helped soothe sentiment, which had been a major drag on manufacturing for much of 2018.

As this fiscal-led stimulus percolates, both hard and survey data flow is starting to show signs of a rebound in China. For instance, the latest business survey release showed a strong uptick that surpassed the typical rises that accompany the timing of the New Year. Beyond business surveys, indicators are stronger in China than other exporters – this is linked, we believe, to the meaningful stimulus put in the pipeline in Q4 2018.

FIG. 3 FISCAL POLICY IS BEING EASED IN CHINA



Source: Goldman Sachs.

Turning to the US-China trade dispute, news flow has stabilised and there are indications that a deal could prevail in coming months, if not weeks. A flurry of activity recently, accompanied by further negotiations between the delegations, have led to media reports of potential contours for an accord. We continue to believe that the best timing for resolution from the US side is late summer, in order to maximise the impact on the US presidential election year in 2020. Meanwhile for China, removing tariffs appears to be an important objective that will also take time to generate.

Despite the significant de-escalation of risks, some of the more profound issues brought to the surface by trade-induced tensions are likely to remain unresolved, in our view. We see two key sticking points going forward: firstly, emerging signs of Chinese dominance in artificial intelligence over the US, especially with regard to security; secondly, discord on intellectual property rights. We continue to expect a deal focusing mostly on the trade dimension of the conflict, but see the high likelihood of further confrontation after the US presidential elections next year.

Chinese risk asset markets have rightly priced out some of the more extreme, negative scenarios. We now see tangible signs of Chinese data steadying and this will be key to prolonging the rally in the coming months of the year. Continued stabilisation in China's economic growth will be crucial for EM assets more generally, too, as will the dovish central bank backdrop. However, an upswing in idiosyncratic risks in a few central countries, such as Turkey and Brazil, could create wobbles in the broader EM complex as well.

Soft global manufacturing but supportive factors

Ample evidence was delivered in Q1 of a notable softening in global manufacturing. While acknowledging the weakness, we see potential resilience in services and prospective stabilisation in China eventually providing support. We therefore do not expect the slowdown to persist, and consider a global recession unlikely.

Multiple indicators of global growth – such as the volume of international trade, global new manufacturing orders and global composite PMI – were all below long-term averages over the past quarter. This suggests the growth rate has decelerated and is settling slightly below-trend. On a regional basis, all economies have seen a lower growth rate, including China, the Eurozone, the US and EM.

The International Monetary Fund, meanwhile, downgraded its growth projections for the world economy this year to just 3.3% – its weakest prediction since 2009. The fund sees growth recovering in the second half, however, and levelling out at 3.6% next year.

[3] Please see LOIM paper titled: Global Outlook 2019: Managing a 'no recession, yet tricky' scenario.

The manufacturing slowdown has been the main drag on the global economy. The deceleration was evident for most of 2018, but only became a concern when manufacturing PMIs started to settle below long-term averages at the end of 2018. Currently, all manufacturing PMIs that we monitor are under-shooting long-term averages, except for Brazil and India, and suggest below-trend growth in the sector.

In some countries and especially in Europe, manufacturing PMIs are beneath the 50 threshold, suggesting a contraction in manufacturing activity. Such contraction likely results from slower demand from China as its economy slowed meaningfully in 2018, and greater caution by producers due to uncertainty arising from the US-China trade dispute.

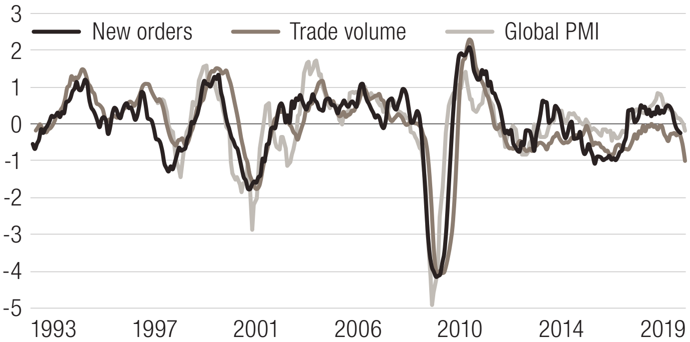
On the flip side, weakness in manufacturing contrasts with continued strength in the service sector. The service sector has indeed slowed in recent months – somewhat in line with the global slowdown and also at a below-trend rate – but remains in positive territory. Since about two-thirds of the global economy is based on services, the resilience in the sector is keeping overall growth positive, albeit weak.

The main question for the outlook is whether services manage to hold up until manufacturing stabilises and improves, or whether the weakness broadens to services and pushes the economy into contraction territory. We note that these opposing outcomes would drive vastly different market reactions. Forward-looking data in manufacturing surveys point to continued weakness, while data services surveys point to on-going robustness – this suggests a potential for divergence to persist in coming months.

Moreover, we are confident that falls in Chinese growth likely bottomed out in early 2019 and should start to show signs of improvement in the coming months, supported by numerous stimulus measures announced recently. Already, the most recent PMI numbers suggest a tentative improvement in manufacturing.

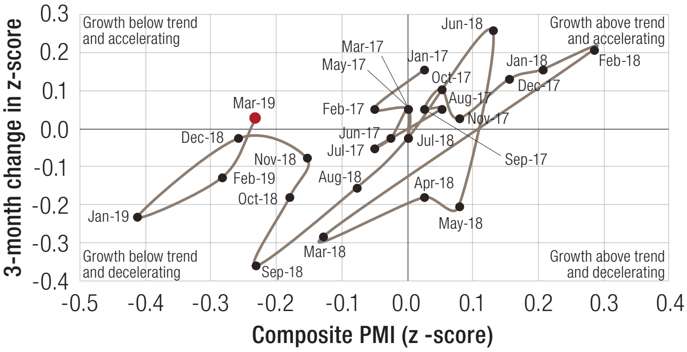
Stabilisation of the Chinese economy would likely provide some support for other Asian economies and the global economy, preventing further growth deterioration. This means that the pessimistic economic view – ie that the global slowdown will continue and that a global recession is close – is very unlikely, in our view. In addition, we highlight that Chinese manufacturing PMI leads its German counterpart by about two to three months, suggesting improvement in China could feed through to the Eurozone in coming months.

FIG. 4 GLOBAL MANUFACTURING GROWTH IS UNDER PRESSURE (Z-SCORE)



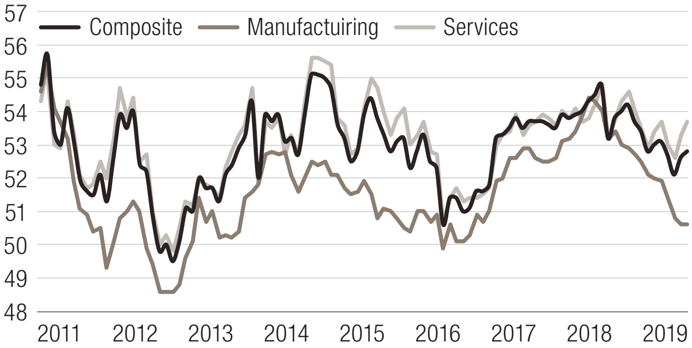
Source: Markit, Bloomberg, Datastream, CPB, LOIM.
Note: The new orders series is based manufacturing orders of the US, Japan, Germany, Korea, Taiwan and Canada. The PMI series has been adjusted so that 50=0. The trade series is expressed in 3mma.

FIG. 5 WHERE ARE WE IN THE CYCLE?



Source: Markit, LOIM calculations.

FIG. 6 GLOBAL PMI: MANUFACTURING VERSUS NON-MANUFACTURING



Source: Markit.

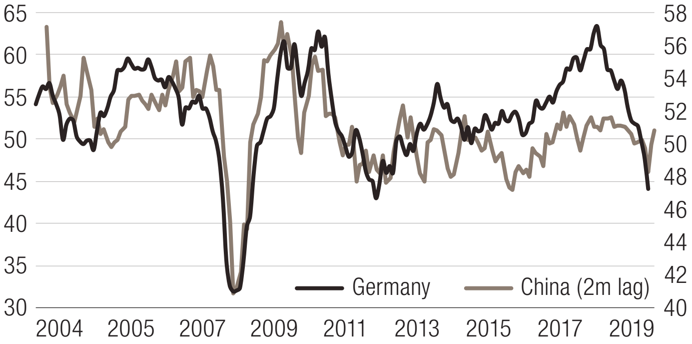
The Eurozone case

The economies of Eurozone countries have slowed sharply over the past year. Amid the deterioration, however, we highlight robustness in domestic demand and labour markets, for instance, as well as ripple effects from a potential rebound in China. Nevertheless, multiple risks also threaten the outlook.

The Eurozone GDP growth rate was well above-potential at almost 3% at the end of 2017, but has fallen to about 1% currently, and continues to lose steam. Most of the decline can be viewed as a necessary normalisation back in line with longer-term trends as it was unlikely that the Eurozone could sustain growth well above-potential for a prolonged period. As such, a return to growth of about 1.5% was expected, and is in line with our view of where Eurozone potential growth should be.

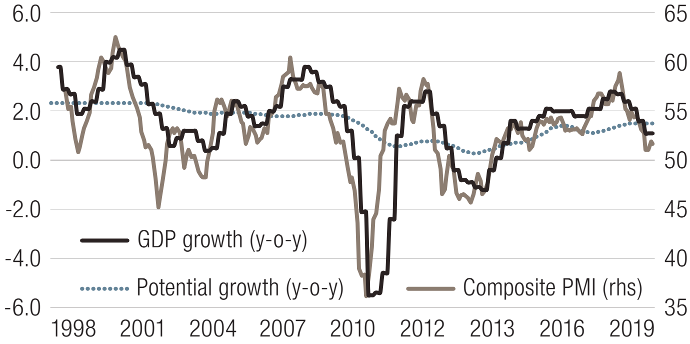
Nevertheless, by the end of 2018 it became clear that the slowdown was more meaningful than a simple normalisation. Headline PMIs have continued to moderate in the Eurozone to 51.3 in March, a level that would be consistent with growth of close to 0.5% y-o-y in Q1.

FIG. 7 CHINESE ECONOMIC ACTIVITY LEADS GERMAN ACTIVITY



Source: Markit.

FIG. 8 SHARP DETERIORATION IN EUROZONE GROWTH DYNAMICS



Source: Eurostat, European Commission, Markit, LOIM.

As witnessed at the global level, the slowdown in Europe was primarily driven by a moderation in manufacturing activity. At the end of 2018, industrial production declined in all major Eurozone countries (Germany, France, Italy and Spain) and manufacturing PMIs dipped below the 50 threshold. The latest manufacturing PMI numbers for the Eurozone and Germany suggest that growth in the sector remains well below long-term average and continues to deteriorate, while there are some signs of stabilisation in France and Italy.

At the same time, while service PMI indicators show activity moderating in the sector, they remain strong enough to maintain the overall economy in growth territory. Moreover, the most recent releases for some countries have shown tentative signs of recovery. The continued resilience of the service sector is also reflected in robust domestic demand in Europe, as seen in the on-going strength of retail sales.

Domestic demand is being supported by continued vigour in consumer confidence, likely helped by on-going improvement in the labour market. The pan-Eurozone unemployment rate has consistently declined over the past five years to reach 7.9%, for instance. However, below-potential growth in recent months could stall the stonger labour market, and eventually erode consumer confidence.

As previously mentioned, a pickup in activity in China and the rest of Asia would be benefit European manufacturers and could signal some improvement in the European manufacturing sector, if sustained. We note that nascent signs of such a Chinese rebound have appeared in recent indicators.

Simultaneously, however, multiple risks loom on the horizon for the Eurozone economy. First, Brexit remains far from resolved. Second, public discontent in France endures and is taking its toll on economic data. Third, the European elections are just around the corner and potential gains by Eurosceptic groups could potentially influence policies. Fourth, the risk posed by a China-US trade agreement – which would likely displace demand from China towards the US – and the threat of US tariffs on car imports could make European manufacturers cautious.

Brexit extension prolongs uncertainty

Once again kicking the can down the road, EU leaders agreed at their latest summit to extend by 6-months the deadline for the UK leaving the EU. The new Brexit deadline of 31 October could become a slow-burn, Halloween horror story as the process drags on, we believe. We expect continued uncertainty as the deadlock persists.

The extension aims to enable Prime Minister Theresa May and the British Parliament to find common ground and pass the Withdrawal Agreement. The length of the extension is a compromise between May's request and French President Emmanuel Macron's preference, but shorter than what other EU leaders sought. The extension is also flexible, with a review on 30 June, meaning that the UK could leave the EU as soon as it approves the Withdrawal Agreement. Still, the UK will need to participate in the European parliamentary elections at the end of May.

The likelihood of a no deal Brexit has diminished dramatically in the short-term, we believe. The EU and Germany have clearly said they want to avoid no deal, while the UK parliament also voted to prevent no deal. That said, the risk of no deal could rise again in future, especially if a new UK PM takes office.

Still, the delay does not remove uncertainty. Negotiations are ongoing between May and the opposition leader, Jeremy Corbyn, to find common ground to pass the Withdrawal Agreement. With the deadline again postponed, there is less of a hurry to reach a compromise.

In our view, the Brexit deadlock is likely to continue. We still believe that a public vote may be the only solution, however, we think a general election is more likely. One reason politicians prefer a general election is that it avoids further fracturing their own parties along the Remain-Leave axis. Such fracture typically involves additional members defecting from their parties, and potentially leads to the disintegration of the traditional parties.[4]

With uncertainty likely to linger for some time, we are neutral on GBP and look for more clarity before re-engaging. We expect the Bank of England to remain on hold during the protracted process.

4 For further discussion of the issue, please see LOIM paper titled: Brexit uncertainty and tail risks.

Risks from liquidity and populism

Should another search-for-yield environment take hold in coming weeks, we highlight two important paradigm shifts could create a strong source of volatility for markets.

Firstly, fractured liquidity due to increased regulation has seriously impaired the ability of broker/dealers to provide secondary market liquidity. This is particularly relevant in fixed income markets. The December sell-off provided strong evidence of this dynamic when volumes collapsed across the board, sparking disproportionately volatile moves in fixed income and equity prices.

We think such liquidity-exacerbated moves are likely to become more common in markets as susceptibility to large swings has increased. Therefore, we continue to recommend low-turnover portfolio construction with a strong emphasis on quality.

Secondly, the rise of populism remains unabated in the developed world. We believe that it is now also a political imperative for central banks to avoid a recession as another serious economic downturn would only further strengthen populist forces.

Within this context, we think that the Fed's regime shift is the correct response, and the objective of generating inflation in a very high debt world continues to gather urgency. We will be developing this theme further in coming weeks.

Investing in a low rate environment

Overall, we expect a search-for-yield environment to take hold, buoyed by dovish central banks, and the potential for green shoots of recovery in China to turn the tide in global manufacturing. This environment of continued low rates in the coming months is likely to support risky assets, we believe, but we caution that the ride might not be smooth and markets could experience volatility.

In this search-for-yield environment, we believe investors should consider the following:

- We expect **emerging market risky assets to outperform** developed market assets as headwinds recede and a search-for-yield environment takes hold.
- In fixed income, we emphasize a **focus on quality**. We prefer corporate credit to give investors a better balance between duration and credit risk, especially in the BBB to BB rated segment. We expect US 10 year Treasury yields to remain below 2.65%.
- We recommend **exposure to convertible bonds given their embedded downside protection**, which is valuable in a world where the policy environment shifts rapidly. Convertibles offer an asymmetric return profile that enables investors to capture the upside in equities, but also limits the downside risk due to the bond element.
- In foreign exchange markets, we expect the dollar to remain rangebound against the euro. **Emerging market currencies could start appreciating** slowly, however, as global growth, led by China, stabilises.