INVESTMENT POLICY NOTES

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In 2018 there was no place to hide in financial markets, but in the first quarter of this year a much better environment took hold. The turnaround is surprising in some ways. The fundamentals of most economies have not changed much. Growth has been slowing everywhere, but this was not unexpected. Given the length of the expansion, now a record 37 quarters in the US, a slowdown was inevitable. But for financial markets liquidity was the critical factor. After 10 years of central banks adding liquidity to the system, this reversed last year led by the US and China. Markets foundered, but when the Fed made a complete reversal of policy in January, and China announced a new stimulus package, the market rallied hard. The market reaction suggests they have repriced growth, but that growth has not come through yet. If there is one message that investors should take away it is that when the world's monetary base contracts trouble follows.

While liquidity conditions remain benign it will still require fundamentals to do well for asset prices to rise from here. The outlook for the US economy is still positive, but the growth is more moderate than before. Two areas look likely to do well are the consumer and housing. Mortgage activity and construction should pick up, as affordability is good. A further positive is inflation is not a problem. There is some wage inflation, but it is modest. Globalisation and automation/robotics remain powerful forces on labour's ability to bargain. A boost to the stock market could come from the dollar falling. On a PPP basis the dollar is expensive, but it enjoys a yield premium and the relative strength of the US economy. The principal concern in the US is debt. The US government deficit is projected to reach $1.4 trillion this year. Corporate debt has ballooned and much of it has been deployed in financial engineering, not invested in productive assets. For example in Q4 2018 there was a record $225 billion of share buy backs. But total US leverage is not so bad because household leverage has declined.

Europe is much more vulnerable to world trade and global growth declining. If President Trump introduces tariffs on the auto sector this would be significant. For Germany in particular the auto sector is an important part of the economy. Car production already faces a weak environment as it is in the middle of a big technological shift, and sales in China slow as capacity has been reached, and demand there now enters a replacement cycle phase. Europe's domestic demand remains sluggish, and this is being worsened by the recent rise in oil prices. The ECB are at the limits of what they can do with monetary policy. In theory Europe should undertake a fiscal stimulus, but it is constrained by fiscal rules on this. Indeed the German Finance minister has just said that weak growth limits the ability to make fiscal packages. If Germany slips into recession then this thinking may start to change. To reinvigorate Europe probably requires massive fiscal stimulus by a tax cut and infrastructure packages. For now there is little appetite for this.

China has also slowed, but it should pick up in the second half. China's slowdown is different from its previous ones which centred on its industrial economy. This time the slow down relates more to the consumer credit. The export numbers have also fallen, but this may be due to buyers building inventory ahead of US tariff imposition. Nonetheless China is ramping up stimulus and the results should be seen in the second half. It will mean that leverage will rise again in China, which may become a problem in the future, but is not a concern for now. A recovery in China will help the emerging markets where investors are massively underweight, but they are unlikely to rebalance until the dollar weakens.

There is a calmer mood in the market compared to the end of last year. It has been created by the Fed stepping back from raising rates, China's stimulus, and a brighter outlook on the US-China trade talks. Against that must be weighed the fact that global growth is slowing, Europe is on the brink of recession and US government borrowing is far too high for this stage of the cycle. A big unknown swing factor is the oil price which has been rising recently. If this continues it could upset the better sentiment. But the combination of the world's two major economies looking set for steady growth this year, and no sign of inflation, provides a good background for equities.