the tortoise & the hare

Q2 2019 Economic Overview

Economic Overview

Economic conditions in the US are still benign, as GDP expanded by 3.2% year over year as at the end Q1 2019, the highest growth rate since 2015. Unemployment continues to drop, now at 3.6%, and inflation is just below the target rate, at 1.8%. The US Federal Reserve Bank (Fed) has held interest rates at 2.5%, but the market has switched to expecting the Fed to lower rates, leading to 10y yields having dropped to 2%. Both the Euro (-1.1%) and the Yen (-2.7%) weakened against the US Dollar over the last 3 months but the British Pound gained against the Greenback (2.6%).

Growth in the UK picked up in Q1, despite the continuing Brexit saga. Annual GDP increased by 1.8% vs 1.4% in the prior quarter and inflation is at the 2% target, while unemployment is at a 44-year low. The BoE governor signalled that rates could be lowered in the scenario of a “Hard Brexit”. 10y gilts are paying a yield of 0.8%, slightly less than last quarter. The European Central Bank (ECB) maintained a 0% interest rate and German 10y bonds yield a negative 0.3% pa.

Eurozone growth is a meagre 1.2% and unemployment is still at 7.5%, though it continues to drop slowly approaching levels last observed before the Global Financial Crisis.

Japanese growth bounced back, from 0.3% annual GDP growth to 0.9%. Inflation is slightly positive despite the continuation of the expansive monetary policy. China kept growing at the same annual rate of 6.4% as last quarter. Industrial output surprised on the upside, as government growth measures worked in the face of the ongoing trade dispute with the US. However, inflation also picked up, increasing 2.7%, driven by food cost.

Fixed Income

Duration risk paid off in Q2, as the WGBI hedged to USD returned 3.1%. EM FX risk and IG credit risk were also rewarded, as the JPM EMBI Global Diversified index and the Markit iBoxx Liquid IG index increased by 4.1% and 5.4% respectively. Both indices now have double digit gains for the first 6 month of the year. This was good news for model portfolios that are fixed income heavy and include these higher-risk segments.

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However, clients in equity heavy portfolios saw diversification into fixed income impact returns as equity markets continued the Q1 rally.

Equities

In local currency terms, EM and Japan recorded the smallest gains over the last 3 months, while Pacific ex Japan and the US led the pack, with increases of 5.7% and 4.3% respectively. Returns in USD were slightly higher for both the developed world ex the US as well as emerging markets. The S&P 500 has now gained 18.5% year to date, MSCI World ex US 14.6% and MSCI EM 10.6%.

Broadly speaking, our favoured equity premia disappointed. The Russell 1000 Value index outperformed the S&P by 1.7% last quarter but US Small cap underperformed by 2.2%, leaving both tilts trailing the main US market for the current calendar year. In the rest of the developed markets both Value and Small Cap trailed the main markets in Q2 and year to date, in EM the MSCI EM Value came out on top of the main market by 0.4%, while the MSCI EM Small Cap index finished the quarter with 1.6% less return. As in the other regions, the balance for the year so far is negative.

Real Assets and Total Return

Global Real Estate Investment Trusts (REITs) gained 1.6% in Q2, while the broadly diversified Bloomberg Commodity index was down 0.7%, despite a strong increase for the price of gold. Year to date REITs are the only diversifier in higher risk portfolios that could keep up with the run in equities. Commodities are up 5% for the year, though that still adds to the pain given the All Country World index (ACWI) is up 16.2% over the same time period.

Both the Templeton fixed income macro strategy as well as the Credit Suisse Managed Futures index had a good quarter, but again, these diversifiers look disappointing when compared against equities.

Sources

Morningstar for index and foreign exchange data, FT.com for yield data, Yahoo Finance for VIX data, Trading Economics for economic data, all as of 30th June 2019

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Quarterly Indicators

Economic Indicators				
Index	Unemployment rate (%)	Current A/C Balance*	Budget Balance*	Industrial Production (%)**
US	3.6	-2.4	-3.8	2.0
UK	3.8	-3.9	-2.0	-1.0
Eurozone	7.5	3.0	-0.5	-0.4
Japan	2.4	3.5	-3.8	-1.8

* % of GDP 2018 estimate

** change on 1 year ago

Source: Trading Economics (30th June 2019)

GDP annual growth rate (%)			
	2017	2018	Latest quarter
US	2.5	3.0	3.2
UK	1.6	1.4	1.8
Eurozone	2.8	1.2	1.2
Japan	2.4	0.3	0.9

Source: Trading Economics (30th June 2019)

Yields (%) - Government bonds				
	1 month	3 month	2 years	10 years
US	2.2	2.1	1.8	2.0
UK	0.7	0.7	0.6	0.8
Eurozone (DE)	-0.6	-0.5	-0.7	-0.3
Japan	-	-0.1	-0.2	-0.1

Source: FT.com (1st July 2019)

Inflation (%)			
	2017	2018	Latest Months
US	2.1	1.9	1.8
UK	3.0	2.1	2.0
Eurozone	1.4	1.5	1.2
Japan	1.0	0.3	0.7

Source: Trading Economics (30th June 2019)

Foreign exchange	Current Qtr End	Previous Qtr End	Year End		
	30/06/2019	31/03/2019	31/12/2018	Qtr % change*	YTD % change**
USD/JPY	107.7	110.7	109.2	-2.7%	-1.4%
USD/GBP	0.79	0.77	0.79	2.6%	-0.1%
USD/EUR	0.88	0.89	0.88	-1.1%	0.4%
GBP/JPY	137.1	144.2	138.2	-4.9%	-0.8%
GBP/EUR	1.12	1.16	1.11	-3.4%	1.0%
EUR/JPY	122.7	124.3	124.6	-1.3%	-1.5%

Source: Morningstar (30th June 2019)

*Quarter % Change from 31/12/2018 to 31/03/2019

**YTD % Change from 31/12/2018 to 30/06/2019

Volatility Index (%)				
Index	Current	1 year change	52 week high	52 week low
VIX	15.1	-3.0%	36.1	10.9

Source: Yahoo Finance (30th June 2019)