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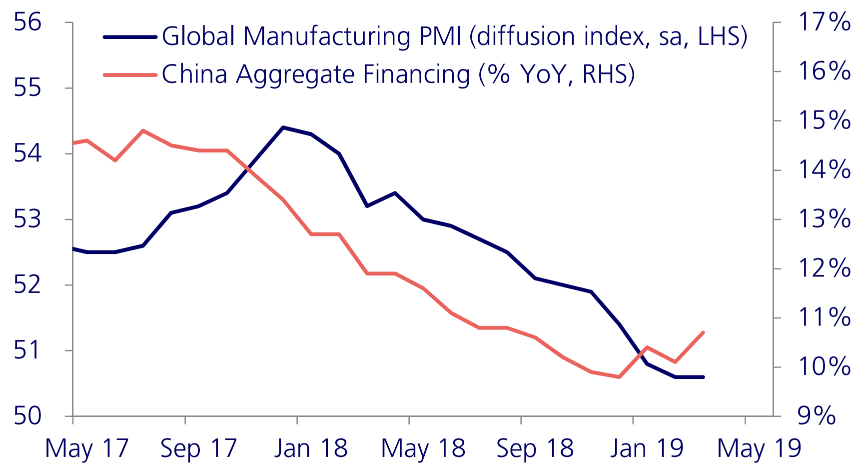
Monthly Investment Insights

Will China's stimulus lead a global economic recovery?



Source: Bloomberg

Most equity markets are turning a blind eye to still dismal economic conditions in manufacturing industries and focusing on the favourable earnings season instead. Q1 earnings for the US are coming in better, with the positive surprise rate even higher than the market has become accustomed to, pushing some benchmark US indices to record highs. In Europe, companies with strong earnings and guidance have clearly outperformed. Meanwhile, global manufacturing conditions remain poor with the global manufacturing PMI falling from a cycle high of 54.4 in early 2018 to 50.6 now, only slightly above the 'boom and bust' line of 50 that distinguishes between growth and contraction. Manufacturing conditions continue to be particularly grim in the Eurozone, Japan, Korea and Taiwan, with PMI readings in the mid to upper forties range.

However, we are starting to see light at the end of the tunnel. The trade truce between the US and China looks likely to end in a mutual agreement on various lingering issues between both countries, including protecting intellectual property rights and more imports of US goods to China. The US threat of higher trade tariffs seems unlikely to be pushed through, while existing tariffs may be reduced over time in a 'trust but verify' scheme. As for the semiconductor cycle, there are tentative signs that it may bottom out sooner or later this year. However, we put a strong emphasis on signs that China's government is pushing ahead with a series of stimulus measures on the fiscal, monetary and regulatory front. Tax cuts and measures to lower the social contribution burden were implemented on April 1 while aggregate credit supply surged in the first quarter of this year, with the focus on supporting small to mid-sized private companies. Both versions of China's manufacturing PMI have climbed back above 50, while several economic indicators experienced a turnaround in March, coming in better than consensus had expected. While GDP growth has decelerated on a sequential basis, it surprised on the upside in YoY terms. We appreciate the willingness of China's authorities to stabilise growth without neglecting policies to curb lending excesses, as discussed during the latest Politburo meeting.

Taking stock of the latest positive developments, an at least moderate global economic recovery in the manufacturing sector should add to already solid conditions in services related industries. There are green shoots in a still fragile economic environment.

Market Assessment

Key developments

- China's stimulus measures are starting to pay off and should help to stabilise the global economy
- Following the Fed, other central banks have started shifting towards a more dovish stance
- Major US equity market indices have marked fresh record highs, following a 'V'-shaped recovery

Zurich's view

Strong momentum in many developed and emerging equity markets in Q1 has carried over into April, with both the S&P 500 and Nasdaq Composite marking fresh record highs.

Dovish central banks, led by the Fed, China's stimuli, hopes of a resolution in the US-China trade dispute and a strong US earnings season are all reasons that more funds are being shifted from the sidelines to be deployed into risky assets. However, some sentiment surveys suggest that investors are now overly optimistic towards risk assets, following the extreme pessimism at the end of last year. Meanwhile, bond markets are showing a more mixed performance, as there was no follow through in yields rising, inflation remains soft, and central banks are unable to raise rates further.

We believe in such an environment it makes sense to take a neutral stance, as the current scenario still favours a balanced view towards both opportunities and risks.

Credit markets have rallied aggressively since the start of the year and have now reached levels at which it is difficult to see much further upside. At the same time fundamentals remain weak, as evidenced by elevated leverage, rating downgrades outpacing upgrades, and other signs of a maturing credit cycle.

	Key developments	Zurich's view
Global	• Global macro data show signs of stabilisation, but manufacturing and trade activity remain vulnerable to a worsening in sentiment • Services activity remains solid, helping to maintain strong labour markets and sound consumer sentiment • Central banks turn more dovish amid weak inflation and slowing growth, but so far refrain from outright rate cuts	The G3 flash PMIs stabilised in April, after slumping in prior months. There are also firmer signs of a turnaround in China, where data confirm stronger manufacturing activity and a pickup in credit growth. While this is positive, the global cycle remains fragile, with major economies still in industrial recession. Global trade has also failed to strengthen, and weak leading trade data from Asia indicate that an imminent rebound is unlikely. The silver lining is that inflation is not a problem, despite very tight labour markets, allowing central banks to turn more dovish. Favourable financial conditions should help to underpin the global expansion but risks are high, with sentiment and business spending dependent on progress in US-China trade negotiations.
US	• GDP surprises on the upside in Q1, but this partly reflects a temporary boost from net trade and inventories, while domestic demand growth weakens and the ISM Manufacturing index falls to the lowest since 2016 • The Fed is expected to maintain its dovish stance as inflation slips further below target • Q1 earnings season is better than expected, as an earnings recession is avoided	The economy expanded at a solid pace in the first quarter, with GDP up 3.2% QoQ (annualised), helped by strong net trade and an inventories build-up. Domestic demand growth slowed notably, however, led by weak consumption and investment spending, suggesting that GDP growth will fall back in Q2. That said, the expansion should continue as the labour market remains strong and consumer sentiment has rebounded, while the housing market is benefitting from a dovish Fed. With more than three quarters of S&P 500 companies having reported so far, the US Q1 earnings season has also come in better than expected. In particular, most companies are seeing positive YoY earnings growth, dispelling fears of an earnings recession for now.
UK	• Brexit is postponed again, until the end of October, as Parliament asserts its authority on the process • Negotiations between the government and the Labour party continue, with the extent of a customs union a key area of contention • Service sector confidence slumps on uncertainty created by Brexit, while GBP also trades lower	The Brexit saga continues, with an extension to Article 50 accorded by the EU until the end of October, as the UK government was unable to get Parliament to accept the Withdrawal Agreement. Although Parliament did narrowly accept a motion to avoid leaving the EU without a deal. Negotiations between the Labour Party and the government regarding the way forward continue, but the uncertainty is affecting activity, with service sector confidence slumping in March. However, unemployment remains low, and the economy continues to grow for now. Paradoxically, equity markets have benefited from the weak pound, as many larger companies make the majority of their revenue abroad. Higher commodity prices have also helped miners and oil companies in particular.
Eurozone	• Eurozone manufacturing remains in the doldrums despite better data from China • However, resilient service sector confidence suggests trend-like growth is still likely • The ECB hints at more support for banks, but details are lacking so far	Eurozone, and especially German, manufacturing remains in a severe slump, with business confidence still at extremely depressed levels. In time, we expect conditions to stabilise as stimulus from China feeds through, but there could be a long lag, and an increase in trade tensions between the US and EU would be one risk to this view. Eurozone equity markets continue to climb higher, however, on the view that a trade deal will be agreed between the US and China and that the manufacturing slump in the Eurozone is transitory. Finally, the ECB has yet to release details on the pricing of its new TLTRO3 programme that starts in September, but has hinted that it is looking for ways to support bank profitability, though the programme is unlikely to be a game-changer in our view.
Switzerland	• Data show signs of stabilisation after a slowdown in previous quarters, and we continue to expect the economy to expand at a moderate pace in 2019 • The regulator flags risks in the housing market, as supply remains strong and mortgage lending reaccelerates; measures to increase resilience look likely • The SNB leaves policy unchanged, with rates set to remain stable for the foreseeable future	Activity has slowed compared to mid-2018 but recent data show signs of stabilisation. The KOF indicator has rebounded from its recent low and the SNB's report on business cycle signals was moderately positive, as companies continue to see healthy demand and plan to invest and hire more staff. By contrast, the manufacturing PMI has weakened further. One area of concern is the housing market, in particular the residential investment property segment where supply is strong despite rising vacancy rates and falling prices. Mortgage lending has also reaccelerated after a slowdown in previous years. The regulator issued a warning regarding real estate risks, and measures to increase resilience should not be ruled out.

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Japan	• Japan's economy is hovering around standstill • Small manufacturing companies are bearing the brunt of the burden • Japanese equities keep underperforming, but continue to stabilise against Chinese equities	Japan's economy remains in the doldrums, with most of the latest economic indicators showing no meaningful turnaround in economic activity. The latest Tankan survey revealed that smaller manufacturing companies are getting hit in particular, while conditions in the non-manufacturing sector are more stable. Core machinery orders as well as machine tool orders are suffering from reduced Chinese demand, while industrial production keeps falling. Private consumption also remains lacklustre, with consumer confidence down for 16 months in a row. The extended Golden Week holidays and the start of the new 'Reiwa' era under Emperor Naruhito may bring some relief, but we have doubts about its sustainability, particularly as the next consumption tax hike is coming closer.
China	• China's economy is showing signs of a turnaround as stimulus is kicking in, even though PMIs for April were softer than expected • The government continues to strike a balance between stimulating the economy and avoiding speculation • Chinese equities have corrected, which so far looks healthy rather than dangerous	China's authorities have taken measures to stimulate the ailing economy on the fiscal, monetary and regulatory front. A month ago, tax reductions were implemented, while aggregate financing in March was even stronger than optimists had expected. Lending is targeted towards small- to medium-sized private companies. However, the Politburo has made clear that it will not negate the need for deleveraging whenever there are risks to a solid medium-term growth path. GDP growth of +6.4% YoY was stronger than anticipated, but was slower on a sequential basis, as expected. Chinese equities experienced a pullback in the second half of April, which looks more like a breather than the start of a major correction. The CNY has moved sideways for the second month in a row.
Australia	• The RBA is likely to shift to a more dovish stance following a weak Q1 inflation print • Labour market conditions stay firm, while the housing market remains in the doldrums • The race between the ruling Liberal Party and the opposition Labor Party now seems evenly balanced	We believe the lower than expected inflation print for Q1, along with an unchanged CPI on a sequential basis and down from 1.8% YoY in Q4 to only 1.3%, will make it easier for the RBA to cut policy rates soon. Underlying inflation is weak, house prices keep falling and building approvals are expected to soften again. Even the persistently strong labour market should not be an impediment to loosen the reins. Australian equities have made up the losses suffered in Q4 last year and have marked a 12-year high. However, on a relative basis versus the world, the MSCI Australia keeps meandering within the same range since the middle of last year. On the political front election chances for the ruling conservative Liberal Party and the centre-left opposition Labor Party suddenly appear more balanced, while previous polls had suggested a change in government.

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