6 June 2019

Periodical

Global Macro Jottings

ECB challenge

The ECB holds its policy meeting and press conference today. It is expected by the financial markets to keep its refi rate on hold, to extend 'forward guidance' on future interest rate moves (i.e. 'lower for longer') and to re-launch its TLTRO programme, which has been described as an 'all-you-can-eat' bank funding vehicle.

This week has seen the DB share price fall to a record low and there remains investor concern about the absence of restructuring and recapitalisation of the Eurozone banking system at a time of weak profitability for the banks. The ECB's Financial Stability Review, published last month, highlights that the return on equity for Eurozone banks stood at around 6% in 2018, broadly unchanged from a year earlier. The cost of equity for most of the largest listed Eurozone banks is estimated to lie in the range of 8-10%. The ECB warns that low economic growth and a low interest rate environment could further dent profitability stemming from the maturity transformation business, not least as retail household deposit interest rates tend to be around zero.

The ECB says subdued bank profitability mainly stems from structural challenges in the form of low-cost efficiency, limited revenue diversification and high stocks of legacy assets in some jurisdictions. A comparison with other major economies reveals that Eurozone banks' creditworthiness lags behind that of their main global competitors. The ECB's own bank lending data shows that lending to corporates remains subdued, especially in Italy and Germany.

The ECB also faces challenges in the form of a downturn in the economic growth cycle. German unemployment is increasing and its export exposure to China has dented activity. When China sneezes, Germany catches a cold. The same applies to other economies, such as South Korea and Australia, that have strong connections to the Chinese market either as a semi-conductor supplier or a raw material supplier.

In addition, the ECB is finding it difficult to persuade investors that the slippage in CPI inflation rates is anything but 'transitory'. Inflation expectations are declining, thus providing the ECB with a Japanese-style risk of mild deflation and associated low economic growth. Now, at a time when the global economic cycle is uncertain and after a period in which the Eurozone upturn in the cycle was short-lived, the ECB is running short of monetary ammunition. The German 10-year bund yield is at a record low which neatly sums up the problems facing the ECB. Given an escalation in the budget dispute between Brussels and Rome, it is unlikely that there is much enthusiasm on the part of the EU to move towards a policy of general fiscal expansion.

Macro

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The IMF's Christine Lagarde back in April described the global economy as being at a 'delicate moment'. So it has proved, especially given the recent escalation in the Sino-US trade dispute, which investors now acknowledge as being part of a longer term, more complex hegemonic struggle between the US and China. The global PMI manufacturing index is at a 7-year low. Both Australia and India have cut rates this week.

Lagarde notes that the US-China tariffs could reduce global GDP 0.5% in 2020 (a loss of USD 455bn), that corporate debt levels have increased to a point where a sudden shift in financial conditions "could trigger disruptive capital flows from emerging markets." The IMF cuts its global GDP growth forecast for 2019 to 3.3%, but looked for a pick-up in growth for the second half of this year with an acceleration in global GDP growth to 3.6% in 2020. In light of recent developments, the IMF might have to consider revising this projection. The downside risks are clear and many market economists are now assigning either a greater probability of a global recession (40%?) or predicting the onset of recession in 2020. The global economy is not just at a 'delicate moment' but also at an important juncture.

The major government bond markets are sending message of 'secular stagnation', and the reduction in libor rates and government bond yields is also sending a message that central banks need to loosen monetary policy. In recent weeks, this has been especially evident in developments in US Treasury yields, where the entire curve is now below the floor of the existing fed funds target range. The US Treasury market is telling the Fed to cut rates. **The FOMC has another policy option in the near term of deferring the scheduled end of the current balance sheet unwind scheduled for September.**

The Fed's estimate of R*, the equilibrium real interest rate, has moved closer to 0.5%. Add in actual inflation of about 1.5% and the neutral nominal rate is about 2.0% (see *Measuring the Natural Rate of Interest*, NY Fed). In this regard, the Fed has a slightly restrictive policy at the moment. To run a 'looser policy' therefore requires the actual fed funds rate to move below 2.00%. Veteran hedge fund manager Stanley Druckenmiller thinks the fed funds rate will be zero in 18 months' time, and Fed Chair Jerome Powell said this week that a return to the zero lower bound was a possibility as **"the next time policy rates hit the ELB - and there will be a next time - it will not be a surprise"** (see *Opening Remarks*, 4 June 2019). The Fed's policy options then turn to the next QE programme, QE4.

Money market investors are unsure about the timing of the next Fed rate cut and think that it could be July (but if not, then September). Equity markets have recovered their poise this week on expectations of a Fed rate cut, but last month was the second worst May for equities since 1962. Equity markets could easily be disappointed if the Fed fails to deliver a policy loosening. The Fed also faces a problem that inflation has persistently undershot its target and that inflation expectations are falling (see the FWISUS55 index on *Bloomberg*). The Fed, like the ECB, is alert to deteriorating inflation and might well respond by cutting rates. In this regard, the next FOMC meeting on 19 June cannot be ruled out. **Tomorrow's US nonfarm payroll report is key in this regard, as a soft report puts a June rate cut firmly on the agenda.**

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Investment Rating Distribution		
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Not Rated	0	0%
Under Review	10	8%
	120	

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Sell	0	0%
Restricted	0	0%
Not Rated	0	0%
Under Review	4	20%
	20	

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