Editorial

Growth concerns on the rise

A sigh of relief followed the publication of first quarter GDP data. However since, growth concerns have picked up again on the back of a collection of new economic data but also — and perhaps more importantly — due to continued high uncertainty. The latter stems from concerns over the extent of the slowdown and its consequences in terms of economic risks. It also emanates from escalating tensions between the US and China over trade. The effects of this confrontation already show up in the Chinese data while in the US, mounting anecdotal evidence also point to its detrimental impact on business and the agricultural sector. The Federal Reserve has turned a corner and indicated that rate cuts are coming, much to the joy of the equity market. The ECB has also changed its message: with risks tilted to the downside and inflation going nowhere, it considers more easing is necessary.

New records

While the S&P500 reached new highs, US treasury yields dropped on the back of a revised outlook regarding the path of monetary policy and further declines in the term premium. Based on calculations by the Federal Reserve of New York, this risk premium, which investors are supposed to receive for taking on duration risk, has reached a record low of -90 basis points at the beginning of July. As shown in the charts, the decline of US bond yields has, quite understandably, mimicked the decline of the purchasing managers index (ISM) for the manufacturing sector. The coincidence of a record high stock market and a record low term premium raises a certain discomfort: declining bond yields reflect unease about the economic outlook, so one wonders how long the stock market can stay immune to these concerns. The drop in US yields has been accompanied by a considerable descent into negative territory of Bund yields as well as yields in other eurozone bond markets. Apart from the usual transatlantic correlation, the change in message coming from the ECB has played a key role in explaining such dynamics. Indeed, if we take at face value the ECB president's speech in Sintra towards the end of June, a new cycle of easing is coming.

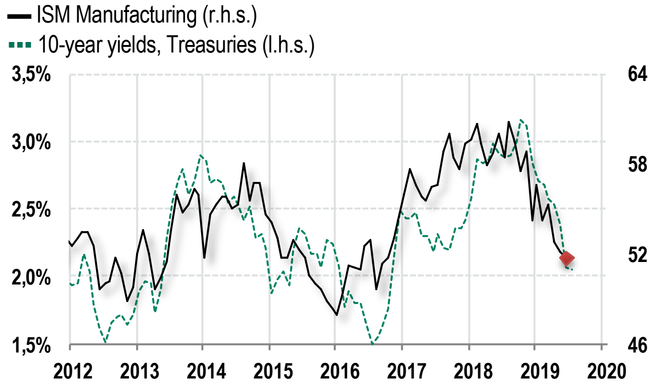
Growing concerns

While a sigh of relief followed the publication of first quarter GDP data, concerns over growth have since picked up again. China continues to slow down and in the eurozone the manufacturing sector, in particular in Germany, remains under pressure, although services are holding up well. While France witnessed some improvements, the picture in the US is mixed. The pace of job creation remains, on the whole, strong but investment activity is weakening. Market based signals (the inversion of certain parts of the yield curve) have raised recession fears, while increasing anecdotal evidence point to the detrimental impact of tariff increases on businesses and the agricultural sector. Although the US entered its 121st month of economic expansion, it appears that euphoria has largely given way to caution.

Tipping point

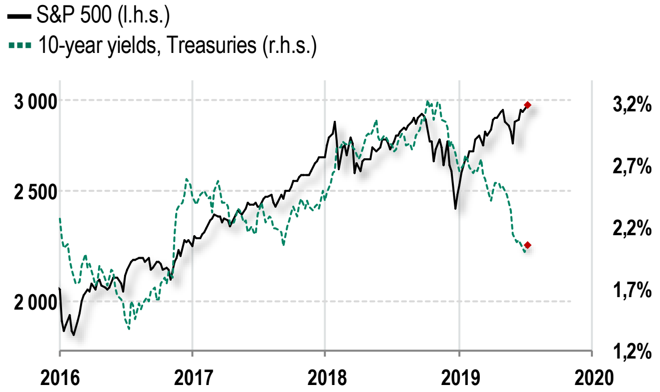
Against this background of increased growth concerns, the key question for the coming months remains whether a tipping point will be reached. Fundamentals (labour market, income growth, corporate profits growth, interest rates) are, on the whole, still satisfactory, but a protracted period of uncertainty could weaken the influence of these fundamentals on growth. This in turn could weigh on confidence and market behaviour and trigger a negative feedback loop. A reduction in uncertainty would obviously provide a boost of confidence and create an uptick in growth. Trade negotiators should keep this in mind when they meet.

1- US Treasury yields vs ISM Manufacturing



Source: Institute for Supply Management, Refinitiv

2- S&P 500 vs US Treasury yields



Source: Refinitiv

William De Vijlder
william.devijlder@bnpparibas.com