

Central banks to the rescue? Don't count on it.

Weekly Market Compass: Economic data has been worsening, but there may be holes in the traditional central bank 'safety net'

Nov 26, 2018 | Kristina Hooper, Chief Global Market Strategist

Stocks continued to slide last week, and most major indices are negative for the year-to-date period – some having posted double-digit losses. As I noted in **my commentary last week**, there are hints of an economic slowdown appearing. In this environment, expectations are increasing that central banks may loosen their monetary policy in response, but I'm not sure that central banks will come to the rescue this time. In fact, I believe central banks are more likely to be a risk factor going forward.

Signs of an economic slowdown

As I gauge the health of the economy, one obvious sign of a slowdown is, of course, the current pullback in stocks. In addition, investors have flocked to Treasuries – which I view as a more accurate gauge of fear than the VIX – with the yield on the 10-year US Treasury falling to 3.045% at the end of last week.¹ Speculative-grade debt has been coming under pressure, with the Bloomberg Barclays CCC Index falling more than 5% in the last two months.¹ And, the price of oil has fallen precipitously in the course of just two months, raising concerns that the global economy is slowing.

While it's still not clear that something wicked is coming our way, it is safe to say that many investors are on recession watch – or at least “slowdown watch.” One sign of growing US economic weakness emerged last week in the form of durable goods orders, which fell 4.4%.² Now, one data point does not a slowdown make, but we need to be following the data closely, especially given that both the Atlanta Fed GDPNow Indicator and the NY Fed Nowcast are forecasting much slower growth of 2.5% for the fourth quarter.³

We are also seeing signs of a slowdown elsewhere:

- There is clearly an economic slowdown underway in the eurozone. The most recent evidence of this comes from the Eurozone Purchasing Managers' Index (PMI) for November, which fell to its lowest level in four years.⁴
- Some Asian economies are showing signs of slackening. One example is South Korea, where job growth has slowed significantly and is expected to worsen in January, when the minimum wage is slated to rise 11%.⁵
- The State Bank of India's Composite Leading Indicator has been showing a marginal declining trend. And the Organization for Economic Cooperation and Development (OECD) released its forecast for growth for India in 2019, expecting it to slow somewhat to a still-strong 7.5%.⁶

In addition to all of this, last week saw the US government release a report on climate change that projects devastating results for the economy in the coming decades. The Bank of Italy has raised serious concerns about the impact of rising bond yields (although that has had a positive impact on encouraging the Italian government to lower its projected spending for 2019). In addition, French President Emmanuel Macron has come under extreme political pressure because of a gas tax that has enraged many French citizens, leading to major protests.

Yet, central banks may stay the course

In a world of central bank near-omnipotence, bad news can bring about good news. In other words, the conventional assumption is that enough bad data will mean looser monetary policy. Expectations are already increasing that the US Federal Reserve (Fed) will take its foot off the accelerator next year. And it's not just the Fed. The Financial Times reported that European business leaders met privately with European Central Bank (ECB) officials last week to discuss their concerns about the health of the economy. One can only assume they met with the ECB because they want the central bank to remain very accommodative.

However, I believe this conventional assumption - which has worked in the past - may not work going forward. After all, headline inflation may be easing because of the meteoric drop in oil prices, but the Fed cares about core inflation - which excludes energy and food prices. A critical influencer of core inflation is wage growth. If we continue to see the kind of wage growth we saw in the October US jobs report, with average hourly earnings growing more than 3% year over year,⁷ the Fed may not have the flexibility to hit the "pause button" on tightening. And while I expect the ECB to continue to be very supportive in coming months - and possibly even extend tapering - that may only be temporary as ECB President Mario Draghi's term ends in October 2019. If he is replaced by a more hawkish ECB head, this situation could easily change.

Bottom line: We can't assume that central banks will continue to play the role they have played in the last decade as a powerful safety net. In fact, central banks are more likely to be a risk factor going forward. Given the current economic turmoil, and without a central bank safety net to count on, I expect more volatility. In this environment, I believe company fundamentals will be a bigger driver of stock performance than they were in the last decade, when developed central banks were providing a cushy safety net for all risk assets.

While there has been a lot of gloom and doom in the air, I still expect stocks to experience a modest rebound, finishing the year at least slightly higher than where we are today.

What to watch this week

This should be a very important week for news flow:

- **G20 summit.** All eyes will be on the Xi Jinping-Donald Trump meeting on the sidelines of the G20 summit. Expectations are high that the trade situation will improve as a result of this tete-a-tete. However, I remain very skeptical, as the Chinese and US presidents remain far apart on the issue of trade. If the two leaders are able to reach even just a détente, I expect a very significant stock market rally.
- **Brexit.** This past weekend, British Prime Minister Theresa May accomplished the easy part of her Brexit task - winning European Union approval for her plan. However, the more difficult task will be securing the approval of Parliament - and that seems very iffy at this juncture. I expect British currency and stocks to fluctuate as the situation develops.
- **Possible US government shutdown.** Since last week's commentary, the likelihood of a shutdown has increased as Trump seems willing to allow a shutdown as he tries to secure funding for his border wall. Investors must keep in mind that 75% of government spending is already funded through October 2019; however, investors seem to be walking on eggshells right now, so this shutdown could cause some volatility for US stocks.
- **Possible increase in aggression between Russia and Ukraine.** This past weekend saw Russia seize three Ukrainian naval ships. The United Nations Security Council will be holding an emergency meeting, and there is the potential that tensions escalate further.

- **Thursday's release of FOMC minutes.** The Federal Open Market Committee (FOMC) minutes will give us an opportunity to better understand the state of mind of Fed participants – at least as recently as several weeks ago when they met. This is important because we may get clues as to whether their views have changed about tightening in 2019.
- **Fed talk.** We will also want to pay attention to any comments by FOMC participants this week as we near the next Fed meeting on Dec. 18-19 – especially Fed Chair Jay Powell's speech scheduled for Wednesday. We will want to see if Powell echoes recent comments by other Fed participants, who seem to be taking a more dovish stance.

Source

¹Bloomberg, L.P., as of Nov. 23, 2018

²US Census Bureau, as of Nov. 21, 2018

³Federal Reserve Bank of Atlanta, as of Nov. 21, 2018, and Federal Reserve Bank of New York, as of Nov. 23, 2018

⁴IHS Markit, as of Nov. 23, 2018

⁵Reuters, "Moonwalking: South Korea's wage, hours policies backfire for jobless, low income workers," July 17, 2018

⁶OECD, as of November 2018

⁷US Bureau of Labor Statistics, as of Nov. 2, 2018

Important information

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

The Bloomberg Barclays CCC Index is an unmanaged index considered representative of US corporate bonds rated CCC.

The Federal Reserve Bank of Atlanta's GDPNow forecasting model provides a "nowcast" of the official GDP estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the US Bureau of Economic Analysis.

The Federal Reserve Bank of New York's Nowcast model of GDP growth incorporates a wide range of macroeconomic data as it becomes available. The aim is to read the real-time flow of information and evaluate its effects on current economic conditions.

The composite leading indicator (CLI) is designed to provide early signals of turning points in business cycles.

The IHS Markit Eurozone Composite PMI® (Purchasing Managers' Index®) is an indicator of the overall health of the eurozone economy. The monthly data are derived from surveys of senior executives at private sector companies.

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