Russell Investments

CHINA
SYNDROME

Global Market Outlook
Q3 update

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Synopsis.

China stimulus, global central bank easing and a China-U.S. trade-war ceasefire could set the scene for a rebound in the global economy later in the year. However, the inversion of the U.S. Treasury yield curve and the downtrend in business confidence indicators keep us cautious at mid-year.

Key market themes

U.S. President Donald Trump's tariff increase on Chinese imports in May triggered the end of this year's equity market recovery. While the stock market has since rebounded, the lasting impact can be seen in falling long-term government bond yields, the inverted U.S. yield curve, the slowdown in global trade and weak global manufacturing surveys. As a result, it now looks increasingly likely that the U.S. Federal Reserve (the Fed) will cut interest rates in both July and September. A combination of Fed easing, China stimulus and trade compromise could make the recent yield-curve inversion a false signal. We will take the inversion much more seriously if it persists for a couple more months. At mid-year, it's a worrying indicator that biases us toward caution.

In Europe, the region's long-anticipated growth rebound remains just that—anticipated. Growth indicators are lackluster. And persistent low inflation has the European Central Bank pushing rate hikes further into the future. Bond market expectations for inflation in five years' time have fallen to a record low of 1.2% as of mid-June. We're not bearish on Europe, but the one-off factors that depressed growth are taking longer to turn around than anticipated. Overall, we see no signs that eurozone equities are either overbought or oversold, while core government bonds look long-term expensive.

The ongoing Brexit uncertainty continues to weigh on the British economy. We think British sterling will remain volatile in the short-term, but a rebound in the currency looks likely if the UK's new prime minister can secure a deal with Europe, or if a second referendum is called.

The escalation of the China-U.S. trade war has put pressure on growth in the Asia-Pacific region, which suggests there will be further Chinese government stimulus measures that should benefit the region. Although the outlook for Australia remains lackluster, there have been a number of positive developments that should help the housing market stabilise, including a rate cut by the Reserve Bank of Australia. While we believe the Australian equity market is fully valued, we see slightly attractive valuations in Japan and Emerging Asia.

We believe the Canadian economy is gradually recovering, but we remain neutral on our outlook for domestic equities. We don't see valuations as compelling yet, and our contrarian sentiment indicators remain far from oversold.

Economic indicators

FISCAL STIMULUS

Fading fiscal stimulus is likely to slow the U.S. economy relative to its breakneck pace from 2018. In addition, the Trump administration's aggressive trade stance with China is exacting a heavy toll on the U.S. and the global economy.

MANUFACTURING CYCLE

Midway through 2019, the U.S. manufacturing cycle remains weak. In addition, the global manufacturing cycle has continued to decelerate, and at mid-year is approaching recessionary levels.

FISCAL EASING

Fiscal easing should provide a decent tailwind, with the European Commission expecting fiscal thrust of 0.4% of GDP (gross domestic product) this year.

TRADE UNCERTAINTY

Trade-war uncertainty is depressing businesses' confidence and international trade. JPMorgan's tracker of global business capital expenditure is signaling negative business investment spending for the second quarter of 2019, after healthy growth through most of 2018.

EXPORTING AND MANUFACTURING

Exports from Asia-Pacific have slowed, while manufacturing activity growth in countries such as South Korea and Taiwan has contracted.

Asset class views

Equities: Broadly neutral to slightly underweight

Our cycle, value and sentiment investment process points to a broadly neutral to slightly underweight view on global equities. We have an underweight preference for U.S. equities, driven by expensive valuation and cycle concerns around the trade-war escalation, fading fiscal stimulus and yield-curve inversion. We're broadly neutral on non-U.S. developed equities. We see valuation in Japan as slightly positive and neutral in Europe. Both should benefit from stimulus in China, which will help bolster export demand.

Fixed income: Universally expensive

We see government bonds as universally expensive, although we believe U.S. Treasuries are closer to fair value than German bunds, Japanese government bonds and UK gilts. High-yield credit is expensive and losing cycle support, which is typical late in the cycle, when profit growth slows and there are concerns about defaults.

Currencies: Preference for Japanese yen

The Japanese yen is our preferred currency as we look toward the third quarter. It's undervalued and has safe-haven appeal if the trade war escalates. The U.S. dollar could weaken once the Fed eases. The main beneficiaries of this would be emerging market currencies. At this juncture, the euro and British sterling appear undervalued.

1.2%

European bond market expectations for inflation in five years' time have fallen to a record low of 1.2% as of mid-June.

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to read the complete 2019 Global Market Outlook – Q3 update.

IMPORTANT INFORMATION

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Keep in mind that, like all investing, multi-asset investing does not assure a profit or protect against loss.

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