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Woodhall's Wrap

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Markets take stock

US Fed on hold for 2019
Global recession fears spooked markets
RBA acknowledges rates may go down in Australia

The Big Picture

After two very strong months on global stock markets, which completed the recovery from the end-of-2018 rout, markets were relatively flat in March. That behaviour was inevitable but the narrative surrounding the end of the recovery was an over-reaction, in our opinion.

The US Fed last raised rates in December and then forecast two more hikes for 2019. At the March meeting, the Fed signalled no more hikes in 2019 and the markets started pricing in the possibility of cuts. There was heightened talk about a global slow-down causing this change in stance.

Possibly precipitated by the Fed policy, 'the yield curve became inverted' on March 23rd. Usually, the short-term interest rate – such as the 90-day-bill rate – is below the rate at the long end – say the 10-year bond rate. When the short rate is above the long rate, the so-called yield curve is said to be inverted.

Inverted yield curves are rare and are often associated with an impending recession. The last time the US yield curve was inverted was in mid-2006 before the GFC but we think the 2019 version is different.

An inverted yield curve is usually caused by the central bank jacking up its short-term rate while the long end moves less because it is tied to inflation expectations. That's what happened in 2006 but not in 2019.

The current Fed rate is about half of what it was in 2006. This time, it was the long end which fell on the news that the Fed had stopped hiking as inflation was not a current issue!

No one is suggesting that there is a causal link between inversion and recession. Rather, both are usually caused by common factors. At the end of March, the final estimate for US economic growth in 2018 came in at 2.9% which is way above even moderate levels.

At home, our central bank, the RBA, kept rates on hold. But the economic growth figure for Q4 came in at only +0.2% only days later. The RBA's expectation was for +0.6% for Q4 and 3.0% for 2019. The market too predicted +0.6% for Q4 a few days before the data release but cut that forecast to +0.3% the day before. Governor Lowe stated that "it's hard to see a case for a rate hike this year".

The situation was not helped when the US jobs data was particularly soft. Only 20,000 new jobs were reported in the month of February but that month's

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employment was affected by the partial government shutdown caused by Congress' failure to agree on spending. The jobs' report was delayed in its release because the data collection agency was also affected by the shutdown. This data read might well be revised upwards. The new reported unemployment rate was down to 3.8% from 4.0% and wages growth came in at 4.3% which is the highest since the GFC. We are not in the naysayer's camp.

Naturally China played a big role in shaping the broader views of economic prospects. The official China growth forecast for 2019 came in at 6.0% to 6.5%, a fraction down on the 2018 outcome. But it did cut its (GST-equivalent) value added tax (VAT) rate to 13% from 16% in an attempt to stimulate the economy.

The China-US trade talks resumed at the end of March. There appears to be widespread hope of some sort of resolution to the impasse – but just not yet.

The Brexit negotiations are now outdoing even the best of the Monte Python sketches. The UK PM took the same bill back for a third vote after it had failed twice. She had offered to stand aside if it that last vote had been successful and stay if it failed!

We still think the fundamentals of the ASX 200 and Wall Street are strong but all eyes will be on the latter's Q1 reporting season that starts in a couple of weeks.

Asset Classes

Australian Equities

The ASX 200 only climbed +0.2% in March after two great months (+3.9% and +5.2%). Energy (-4.7%) and Financials (-2.8%) pulled the March gains back. Property led the way with a +6.0% gain.

We have this market about fairly-priced at the moment. With the next reporting season four months away, the market will be more reliant on the macro and political picture than company news.

The Federal Budget due on April 2nd could well provide some fiscal stimulus that will help the economy and the market. With the general election possibly on May 11th, the government may will wish to announce some electoral sweeteners to kick off the full election campaign.

Foreign Equities

The S&P 500 posted a gain of +1.8% in March making it three strong months in a row – and the best opening quarter since 1998! We have that market too about fairly priced but their next (quarterly) reporting season is only two weeks away.

With some investors and commentators focusing on a possible recession in the US, the company outlook statements will be key to the medium-term future of Wall Street.

In spite of the failing Brexit negotiations, the London FTSE posted strong March (+2.9%) gains but the German DAX struggled with a +0.1% gain on a slowing economy.

Bonds and Interest Rates

The CME Fedwatch tool for pricing possible rate changes in the US is now set at about 34% for no change in 2019 and 41% for one cut, 20% for two cuts and 5% for three! There is even a slight chance (0.6%) given to their being four cuts in the rest of this year! This distribution represents a massive change in expectations from that in February.

The RBA was on hold in March but we think it is likely to cut a couple of times in 2019. With the Budget in April and the election in May, it might be forced to wait until June for the first cut with the second in rapid succession.

The ECB has pushed back its plan for a rate rise.

Other Assets

The price changes for the major commodities were quite mixed: oil was up 3% while copper was down by a similar amount. Iron ore was flat and gold was down nearly 2%.

Regional Analysis

Australia

The jobs report in March revealed a modest jobs' gain of +4,600 but there were +20,600 new jobs in the 'official trend data'. The unemployment rate did fall from 5.0% to 4.9% but the trend rate was flat at 5.0%.

The Q4 GDP read came in at +0.2% making for a second half of the year at +1.0%. However, a strong

start to 2018 produced an acceptable +2.3% for the year. 2019 could be a different story.

Westpac's consumer sentiment read dropped sharply below the 100 level to 98.8 from 103.8.

If the RBA does cut twice this year and the April Budget produces a reasonable fiscal boost, there is no need for any talk of recession at home. However, if both monetary and fiscal policy fail to accommodate the current situation, our economic prospects are not strong.

China

The People's Congress published an economic growth forecast range of 6% to 6.5% for 2019. The Congress usually gets what it wants!

It is planning to promote growth through a cut in indirect taxes and infrastructure spending. China's trade data were again out of line with expectations but quite likely due to the change in patterns due to both new and possible tariffs and the trade negotiations.

China's increase in soybeans and auto imports from the US helped produce the biggest cut in the US trade deficit for 10 months. Some changes in trade are underway. The trade talks with the US resumed at the end of March.

The manufacturing PMI (Purchasing Manager's Index) jumped 1.3 pts to 50.5 after three months operating below the 50 mark that separates growth from contraction.

US

Delayed US growth data produced a first revision for the previous Q4 release to 2.6% at the start of March but this was brought back to 2.2% for the final Q4 read at the end of March. The figure for 2018 as a whole was 2.9%, just below Trump's forecast of 3%. The Fed chair, Jerome Powell now predicts 2.1% for 2019 from his December forecast for 2019 of 2.3%.

US core inflation was +0.1% for the month and 2.1% for the year – just on the Fed's target. The broader inflation read that does not exclude highly variable components came in at +0.2% for the month and +1.5% for the year. US inflation is not an issue and the Fed has stated that it would even be happy if inflation did come in a little higher before it felt the need to hike rates.

The Mueller report concluded that Trump did nothing illegal in the widely-discussed Russian conspiracy theory. He cannot be impeached on that but the Democrats are still looking for angles to discredit the president.

US retail sales came in at 2.3% for the year. All in all – when data glitches are accounted for – the US economy is not heading for recession in 2019 – in our opinion!

Europe

Unlike in the US, European growth is slowing and it needs some stimulus – as does Australia – to avoid a bleaker future. Some of the growth problems emanate from Trump's tariffs on German cars. It is not just China that is in the cross-hairs.

The Brexit saga should have ended by now. It was all due to be resolved by last Friday, March 29th but a short extension to April 12th was granted. The UK PM continues to try to get a resolution but it is almost impossible. A number of choices were put before parliament but all were rejected!

A major stumbling block is the treatment of the Eire – Northern Ireland border as the southern Republic will stay in the EU. Moreover, May's government relies on the support of the Northern Ireland conservatives in her coalition majority. After decades (and centuries) of disharmony that was resolved at the Good Friday (1998) Agreement no one wants to return to the bad old days of disunity in Ireland.

Rest of the World

Turkey continues to be embroiled in economic and political crises. In the last week of March, the swap rate for the lira (an interest rate for borrowing the currency overnight) touched 1,000%. At least our economic problems are manageable!