FUNDING YOUR TOMORROW

THE MACRO FIVE-PAGER
MACROECONOMIC MOMENTUM
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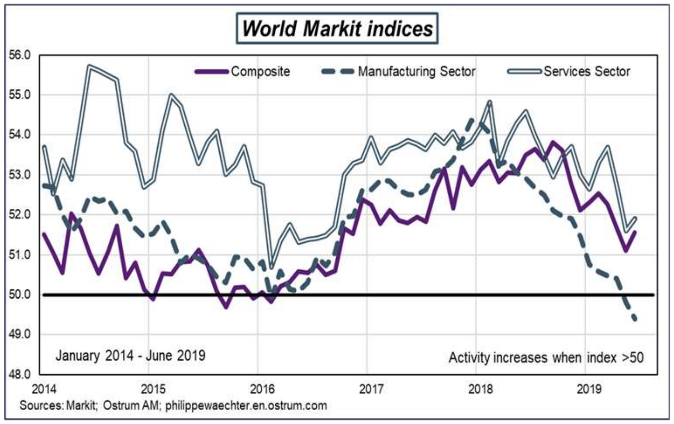
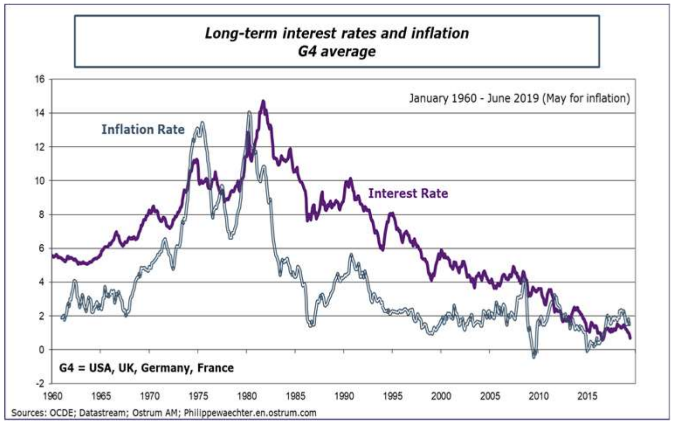
SYNTHESIS

- The world economy's slightly chaotic showings reflect the likely end to a world balance dominated by the US, as well as the hunt for a new world order. This multi-faceted balance would include the US, China and Europe.
- This quest for a new equilibrium can be witnessed first and foremost in the current less coordinated and cooperative context, where each country seeks to get the most out of a situation where the rules are changing. Border tariffs are just one example of this.
- In the short term, this leads to uncertainty that drags down economic activity, as well as investment. Growth is slightly more sluggish across the board, while inflation remains contained and is still a far cry from the central bank's target, especially in the euro area.
- There is a tendency towards continued accommodative monetary policy. Going too fast when all the risks for the economy have not fully emerged means taking the risk of having an insufficient impact and running out of options when the situation becomes more tricky.
- This would be the case for the US, where interest rate cuts being made too quickly would mean a fresh surge in liquidity, promoting more real estate lending and corporate credit from non-banking institutions, so excesses already seen would become even more severe. This would also heighten risks on these markets and curb the Fed's ability to act in the event of a future crisis.
- Another key point is that long-term rates are set to remain very low for a very long time, until such times as this new world balance emerges: this will force the financial sector to reinvent itself.





MACROECONOMY – SHORT-TERM MOMENTUM AND OUTLOOK

- **World economic signals still point to the risk of a further slowdown**.
  The world trade profile has changed since the start of 2018 with the US administration's tariff steps.
  Trade has stagnated since then, having traditionally been a strong source of economic impetus.
  This has led to a severe slowdown in manufacturing, and the Markit world composite indicator points to a contraction in the sector in May and a further downturn in June. This trend can be witnessed across all parts of the world, in both developed and emerging markets.
  Meanwhile the US and China are locked in a battle of economic, technological and political wills, and we would be very much mistaken to think that an agreement between the two countries is an option. A new world order must be forged and Europe will also need to find its role in this new landscape. It would be delusional to think that this situation will ease up soon: we should expect economic shocks and volatile growth.

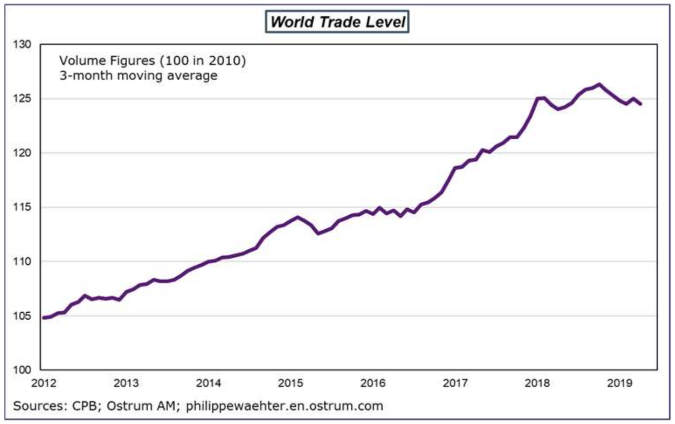
- **The US economy is slowing in 2019.** This is symptomatic of the end to the White House's 2018 fiscal stimulus policies, which had a major impact. The US economy is now close to its potential growth rate and could slow further over the months ahead as companies are shying away from investment, while the country's trade policy is hampering both the manufacturing sector and consumers, who are paying the price for higher border taxes. Real estate is also slowing and no longer acts as a key driver. The decrease in all interest rates across all maturities is indicative of an unwillingness to take risks on the future, as all parties sit tight in a damaging strategy for the economy. The inverted yield curve is a perfect illustration of these negative expectations.

- **The Chinese economy is hindered by the international context, as well as by a vast domestic adjustment**
  China is specifically targeted by US measures as the country is quicker at implementing the innovations (5G) that will dictate tomorrow's type of economy. Industrial activity is hit by this situation as exports have slowed considerably. Meanwhile the domestic economy is also still undergoing the transition towards a services-led economy, with major changes for the industrial sector which still carries hefty debt. Consumers are also more cautious.

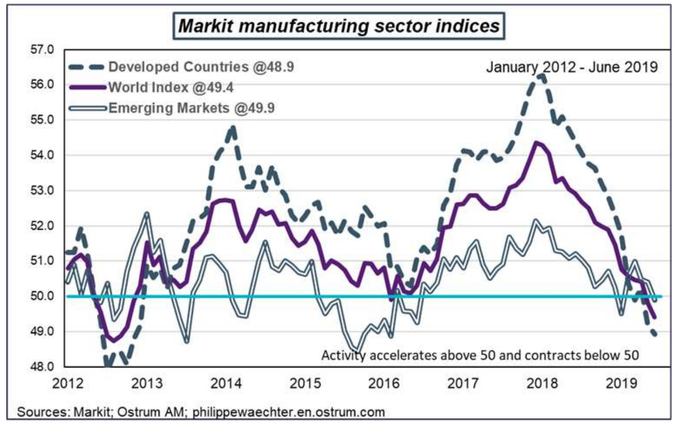
- **Looking to Europe, the euro area is losing steam and the UK is suffering a severe slowdown**
  The downturn in the euro area economy reveals a real slowdown in Germany, which is not offset by other countries in the area. Germany is hit as its economy is very open to world trade, with exports equating to close to half of GDP, so the deterioration in world trade has a damaging effect for the country's growth. This adjustment in Germany should dampen the labor market and prompt the government to take a more active approach to diminish the risks on growth. The industrial segment of the Spanish economy is also slowing and growth is set to deteriorate. Meanwhile growth in Italy remains very weak. The good news is that VAT revenue generated by a new set-up helps reduce the country's risk of budget sanctions.
  Government measures taken in France in December 2018 (in-work benefit, a tax-free benefit and a decrease in residence tax) are set to rein in the effects of world trade on growth, curbing the risks on economic activity.
  In the UK, massive inventory build-ups ahead of the initially slated Brexit date on March 29 are now creating sluggish economic conditions as stocks need to be run down, and no-one knows exactly when the UK will actually leave the EU. The months ahead are set to be particularly tough in the UK as a result of the unstable political situation.

- **Limited risks on inflation beyond oil price-related risks**

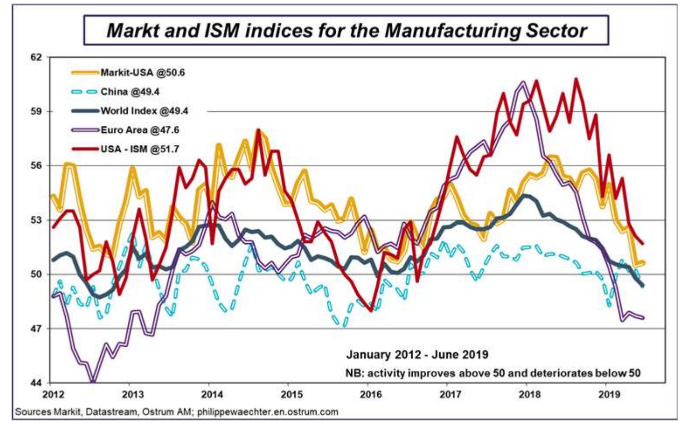
EXPLANATORY CHARTS - MACROECONOMY



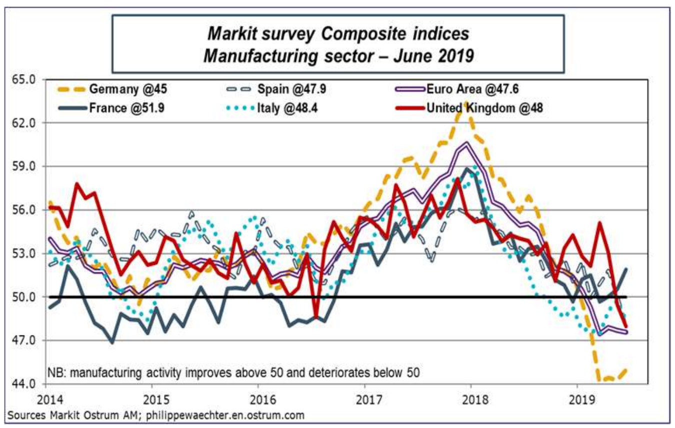
The change in pace from the start of 2018 is clear from this chart. The disruption in trade reflects the US border tariff policy, pointing to a less cooperative and coordinated world, which will lead to slower global growth for the long term.



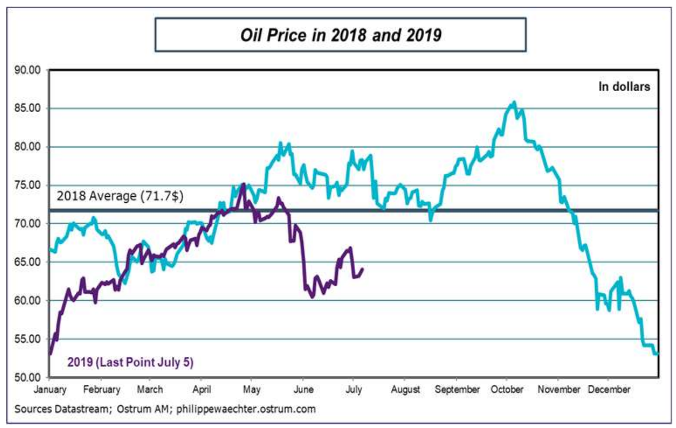
The world economy as a whole is hit by this shift in trade trends. The world indicator fell below the 50 mark in May and June 2019, but we can also see that developed markets are broadly below the threshold and emerging markets have just reached it.



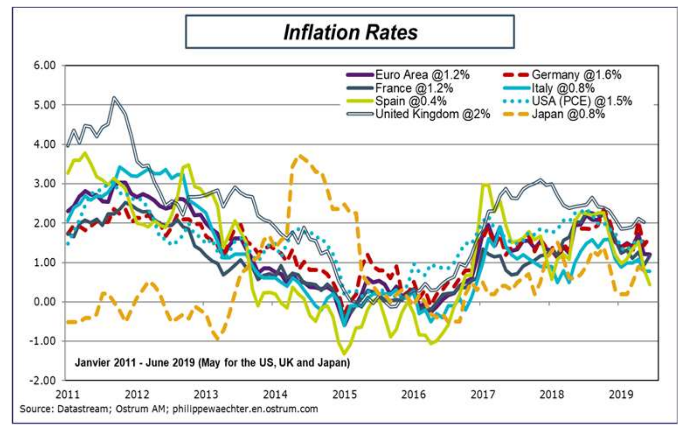
The US economy is slowing fast (yellow and red lines on chart) as the effects of 2018 fiscal measures fade out. Both indices are just slightly above the 50 mark and below their historical average. China is seeing a moderate contraction while the euro area is slowing fast.



Trends in the euro area are dictated by German performances. Italy and Spain are contracting, while the situation is improving in France due to government efforts to shore up the domestic market. However, inventory build-ups in the UK are now being run down, pointing to a drastic downturn in economic activity.



Oil prices remain slightly short of figures seen last year, meaning that energy's contribution to inflation will be virtually neutral. Oil prices are now more dependent on US production than Saudi Arabia's output. Short-term risks come from US/Iran tension, with questions over security in the Strait of Ormuz.

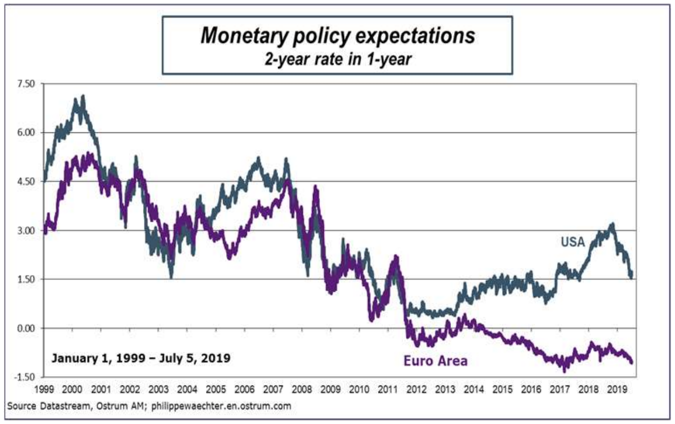


Inflation is relatively stable and oil prices are the only cause of volatility.
I definitely do not think that there will be a surge in inflation, even for core figures. Wage pressure is restricted, particularly for intermediate jobs (50-60% of jobs). There is little risk of nominal adjustment for companies.

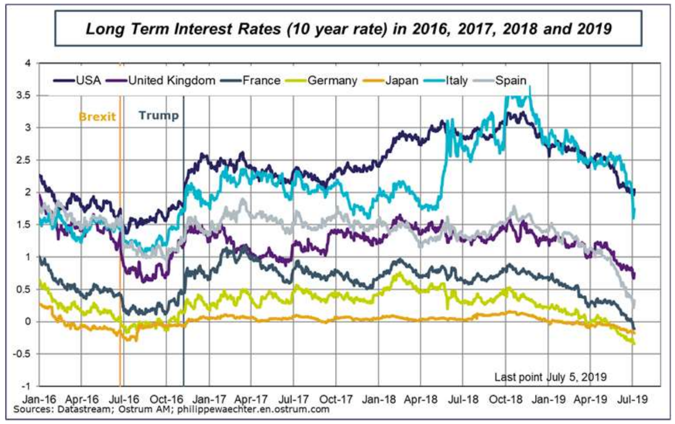
MONETARY POLICY AND FINANCIAL MARKETS

- With growth now more lackluster and inflation around or below the central banks' target (2%), **these banks have no reason to adopt restrictive policies.**
  Yet for such times as macroeconomic risks remain unclear, they do not need to take a more accommodative approach either.
- The ECB mentioned moves to cut back interest rates, adjust its deposit facility rate and resume asset purchase programs. This would rejig the financial balance, but we should expect only a **slight macroeconomic impact**. We had seen a real change in behavior when the refinancing rate was cut to 0%, but I am not convinced that there will be much impact if it is reduced further to -0.25%. A resumption in the QE program does not seem necessary at this point, as interest rates are already very low across all countries in the area, apart from Italy for country-specific reasons. Real rates are already negative everywhere and **financial repression** is under way.
  Another point is that the ECB cannot act alone and there is no Europe-wide fiscal policy: instruments as well as targets (on growth and inflation for example) are required for policy to be effective, and at this stage the ECB has only one instrument, i.e. monetary policy. The chances of success are also slim when we consider the unsteady and uncooperative international context.
  Adding to this, **can the ECB really swiftly change policy when Christine Lagarde will only arrive on November 1?** Can she be hemmed in before she has even taken over at the helm?
- **The Fed is expected to have to cut back its key Fed funds rate** by 50bps at its late-July meeting, but this would not be a wise move for two reasons.
  On the one hand, current economic conditions are too robust to warrant a change in monetary policy. In the past, banks have eased monetary policy when **economic conditions were much worse than they are now,** bar the summer of 2007 due to liquidity reasons, which we are not seeing at this stage.
  On the other hand, a rate cut in July would substantiate **pressure from the White House**. The Fed Chair Jay Powell does not seem to be in favor of a rate cut, so if the Fed ends up reducing rates at its next meeting on July 30 and 31, this would mean that the Chair is in the minority, raising questions on the bank's independence and credibility.
  This is a serious risk for the most powerful bank in the world.
  There will probably be a rate cut later in the year, but it is too soon to expect one as early as July.
- **Inversion of the US yield curve very probably predicts a recession in 2020,** and we have seen this trend in the past in the US. When all yields move below the Fed funds rate, we can conclude that investors' expectations are low, and they drastically cut back risk by investing in risk-free bonds. This is a negative signal that can point to a severe downturn in the US economy.
  Cutting interest rates to curb financial risk is not the right answer, as a surge in liquidity would fuel lending and push up risk on both real estate and corporates. Therefore it is too early for this, a bolstering of the prudential regulation is necessary first.
- The yield curve is negative in the euro area and all maturities apart from the 30-year are below the refinancing rate. However, this does not have the same implications as in the US, **and a rate cut from the ECB could shift the entire yield curve down.**

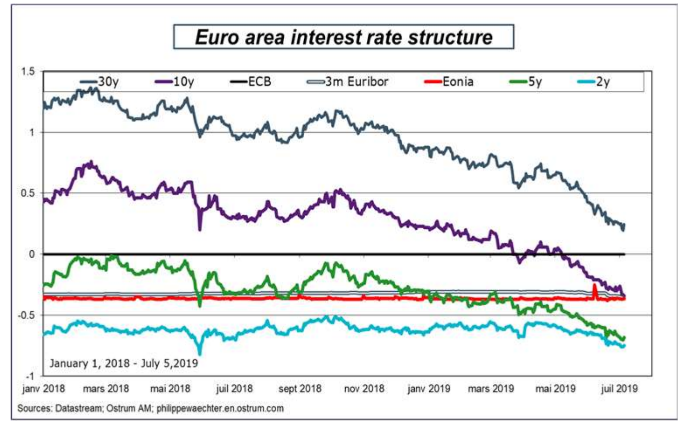
EXPLANATORY CHARTS – MONETARY POLICY AND FINANCIAL MARKETS



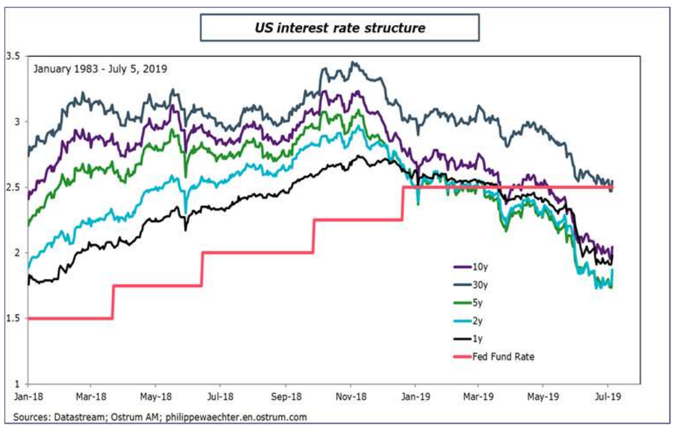
Monetary policy projections from the Fed and ECB stopped moving apart at the start of 2019 when the Fed changed its strategy. Projections are now for a drop in the US and a stable or further downward trend for the euro area.



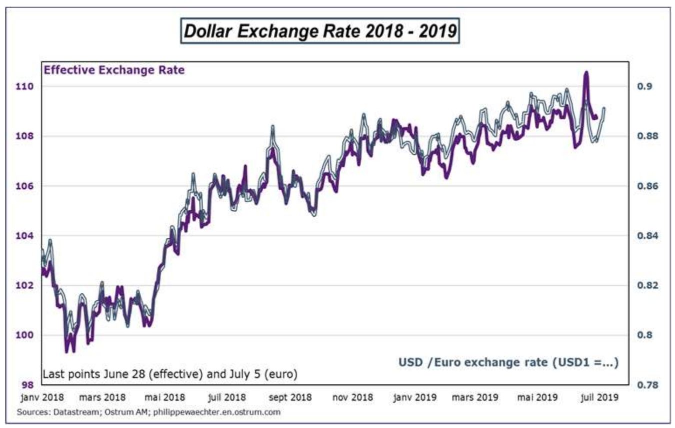
This chart clearly shows risk aversion, with all rates plummeting. The German yield is most definitely negative, while the French figure stands at 0% and rates in peripheral markets are low enough to no longer be a constraint. The Italian yield has dropped sharply as a result of a decrease in budget risks.



The drop in yields across all maturities is impressive. Only the 30-year is still slightly positive.
The risk is that a rate cut from the ECB could be seen as a way to go lower across all maturities.



Inversion of the US yield curve is always a warning sign for a recession. In the fall, inversion reflected the impact of a hike in Fed Funds and gradual compression of spreads, but the curve is now inverted as pessimism has driven down long-term rates, making for a very different outlook.



The dollar is on an upward trend, but this does not reflect the difference in growth or interest rates. The currency has not gained much when we compare with US fundamentals.
Elsewhere on the forex market, sterling has declined due to uncertainty over Brexit.

The US market is particularly robust and stood at a high at the end of 1H. The European market as reflected by the CAC 40 is relatively stable - setting aside fluctuations - while the Japanese market declined and the UK market lacks direction.

ADDITIONAL NOTES

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