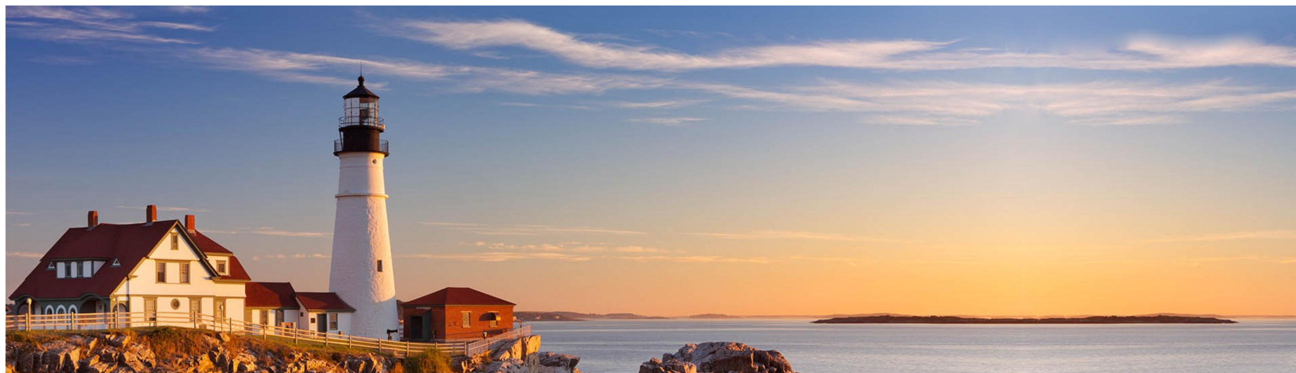
As global momentum stalls, the US remains a beacon of stability

by Mona Mahajan | 21/06/2018



Summary

While the global economy may be stuttering, there's still room for confidence. The second half of 2018 could get a steadying boost from the US economy – and US consumers.

Key takeaways

- Political turmoil and increased trade tensions have exacerbated the global economic slowdown, particularly in Europe and Latin America
- Unlike much of the global economy, the US has demonstrated stellar earnings and economic growth over the first half of 2018
- We expect the US to continue to be a source of stability for the second half of the year, but we will monitor key risks globally: political shifts/geopolitical tensions, rising inflation and tighter monetary policy from central banks

We entered 2018 looking for two key drivers of the US economy: tax reform and global synchronised growth. However, a deeper look at today's economy shows us that while global synchronised growth has faltered, the second half of this year could bring stability.

What's behind stalling growth?

The global growth slowdown began with the slowing of economic momentum indicators. The economic surprise indices, for example, have dropped substantially in both Europe and globally, while we see relative stability in the US. (See Exhibit 1.)

Exhibit 1. Economic surprise indices show European momentum has fallen

Tough trade talk can disproportionately affect Europe and Latin America

Source: Bloomberg. Data as at June 2018.

Economies have been hurt by uncertainty around trade, which impacts the European and Latin American regions disproportionately, as well as stronger currencies for much of last year, which may now have a lag impact on earnings.

The rise of political turmoil and increased trade tensions also exacerbated the economic slowdown:

- In Southern Europe, political instability in Italy and uncertainty around a new anti-euro government caused bond yields to spike. Odds that Spain and Portugal would follow also rose. And finally, concerns that the UK economy may have peaked were stoked by softening data and Brexit concerns.
- In Latin America, recent elections in Venezuela and upcoming elections in Mexico may leave both countries with nonconventional leaders. Argentina is working its way through a currency crisis and a drought that has affected most of its crops. And a Brazilian trucker's strike is threatening to spill over into oil truckers, affecting its largest sector.
- Globally, trade war talks have investors on edge with an on-again, off-again tariff scenario. What began as renegotiations of trade deals with China branched out into tariffs on steel and aluminium from Europe, Canada and Mexico.

However, we have now started to see some stabilization, with easing political strife, diminished trade tension with China and plateauing economic momentum. Notably, a coalition government forming in Italy has supported stability, as has a pause in the rising US dollar, which provides some respite for emerging markets. We believe we could see momentum resume as we enter the second half of the year, particularly if confidence returns to Europe and emerging markets; while we are watching indicators closely, we continue to see 2018 global growth reaching 3.0% – above-potential growth.

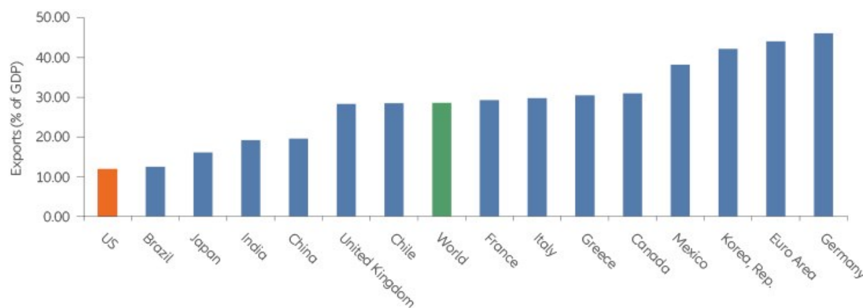
The US continues to chug along

Unlike much of the global economy, the US has demonstrated stellar earnings and economic growth over the first half of this year, despite global tensions. First-quarter earnings for the S&P 500 Index ended with strong 25% year-over-year growth[1], while US GDP growth is expected to be 2.8% in 2018 overall[2], well above potential.

And regardless of the ongoing trade rhetoric, the US remains a relatively closed economy, not as exposed to export demand as most of the world. Only about 12% of GDP comes from exports, versus 29% globally. (See Exhibit 2.)

Exhibit 2. The US economy has relatively robust barriers to trade

Only 12% of US GDP growth comes from exports



Source: World Bank. Data as at June 2018.

What does drive the US economy is the consumer, as consumption makes up about 70% of GDP.[3] Consumer confidence is a key indicator for the health of equity markets; there is a 0.97 correlation between consumer confidence and performance of the S&P 500 Index. Consumer confidence continues to remain solid in the US. (See Exhibit 3.)

Exhibit 3. US equities and consumer confidence have an uncanny relationship

A healthy consumer often points to a healthy economy

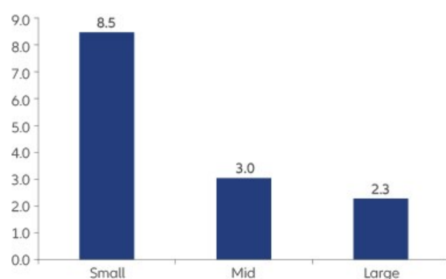
Source: FactSet. Data as at June 2018.

What's been working so far? US-focused assets

Generally, we have seen US-centric assets perform well this year. US small-cap holdings, for example, have outperformed; these companies are domestically oriented, have less exposure to global trade tensions and can benefit from US tax reform. (See Exhibit 4.) Furthermore, technology and consumer discretionary companies have also been the top-performing sectors in the S&P 500 this year.[4]

Exhibit 4. Small caps are real standouts

Year-to-date S&P 500 Index performance by size as of June 2018



Source: Bloomberg. Data as at June 2018.

The US dollar has been strengthening, up 10% from recent trough to peak[5], which has hurt emerging-market equity and debt. More recently, we have seen the dollar stabilise; this may continue in the second half of the year as global economies is become more stable as well. The ECB is also in focus as it begins to wind down its bond-buying program.

Finally, oil prices, which have been rising for much of the year (up 35% over the last 12 months), are also pausing, offering some relief to oil importers.[6] This may provide further respite to US consumers at the pump as we head into the summer driving season.

Risks to consider

As we look to the second half of the year, we believe investors should remain vigilant as volatility will likely remain elevated. There are certain risks that may derail the generally sanguine US outlook:

- **Politics and geopolitics spill onto confidence:** we think ongoing negotiations around trade and tariffs, as well as political headlines like November's US mid-term elections, could weigh on investors and equity markets. If these issues escalate and create prolonged market uncertainty, we may start to see US consumers and businesses begin to lose confidence and slow spending and investment.
- **Inflation rises above expectations:** while inflation has been gradually rising, we have not yet seen inflation figures meet or exceed the Fed's 2% target. Nonetheless, we see several ingredients for inflation in place: solid economic growth, late-cycle fiscal stimulus, tight labour markets and rising commodity prices. If inflation does start rising more rapidly and investors expect the Fed's tightening to accelerate, we believe they would become incrementally more risk-averse.
- **Global central banks start tightening:** while the Fed's normalization is well communicated, there is more uncertainty around the paths of other major central banks, notably the ECB. While some investors previously believed the ECB would extend the timeline of its tightening process, given political and economic uncertainty in the euro zone, the ECB's most recent communications called for an end to its quantitative-easing program this year – but no rate hikes until at least the summer of 2019. This has implications not only for currencies, but also for equity markets that have relied on global central-bank liquidity for years.

Five to watch

Here are five key themes that will likely power markets in the months ahead.

1 Growth and small caps are in the sweet spot

Within the US equities universe, growth and small-cap stocks have outperformed; we believe both these areas have legs as the US continues to outperform. Our conviction lies in the long-term story of "winners from disruption", particularly in the technology, health care and discretionary sectors.

2 Value may take the lead

Over this cycle, we believe value sectors may show signs of market leadership; we have already seen energy perform well and believe financials can do the same. With recession unlikely in the US over the next 12 to 18 months, it remains early for a rotation into highly defensive sectors like consumer staples and utilities.

3 Fixed on short duration

Within the fixed-income universe, we continue to favour shorter-duration strategies, and we still find selective higher-yielding fixed-income securities to be attractive given that we do not see a rise in defaults on the horizon. We also continue to favour a convertibles strategy, which has potential upside from equities as well.

4 Choosy on international

We remain selective in international exposure. With softness in Europe and some rollover in emerging

markets, we continue to look to Asia as a source of growth – and in certain cases income and yield. We favour China, where long-term domestic demand remains attractive.

5 Alternatives are more than just an idea

As we get further along this cycle, we also believe investors should gradually increase their allocations to alternative strategies – such as absolute return, private credit and infrastructure equity – which are generally uncorrelated to equity markets over time.

[1.] *FactSet as at June 2018.*
[2.] *Bloomberg as at June 2018.*
[3.] *Federal Reserve Bank of St. Louis as at first-quarter 2018.*
[4.] *Bloomberg as at June 2018.*
[5.] *Bloomberg as at June 2018.*
[6.] *Bloomberg, crude oil futures as at June 2018.*

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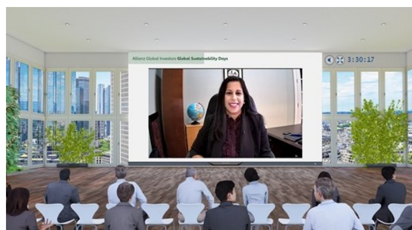

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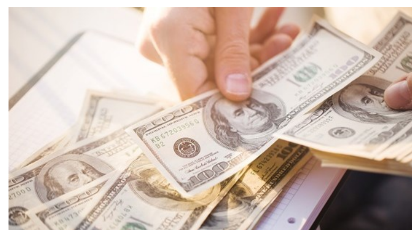

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Mona is the US investment strategist and a director with Allianz Global Investors, which she joined in 2017. As a member of the Global Economics and Strategy team, she is responsible for providing US retail and institutional clients with differentiated investment thought leadership.

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