

# Macro Snapshot

## Monetary Policy to the Rescue

Kevin Stirrat

[kevin.stirrat@forsythbarr.co.nz](mailto:kevin.stirrat@forsythbarr.co.nz)

+64 9 368 0069

Corporate earnings follow GDP over the long term. New Zealand's real annualised GDP has averaged +2.62% over the past 30 years, and for the last 10 years the inflation adjusted weighted earnings per share (EPS) for the NZX50 has averaged just over +2.0%. Over the shorter term, the business cycle is often dominated by monetary policy. When interest rates are cut and the money supply is expanded, corporate operating costs fall in-line with debt servicing costs and (usually) lower wage bills. In a weaker economic environment, equity markets can respond more to monetary conditions than underlying growth.

### Global economy settling into a slower pace

Weaker global growth around the world looks to be spreading to the US, partly through the stronger USD and partly through self-inflicted pain. A widening fiscal deficit at the same time the Fed was tightening and reducing its balance sheet, flip-flopping by Fed chair Powell on the likely direction of interest rates, a December rate hike followed by a government shutdown and the ongoing uncertainty around trade with China all seem to be contributing to deteriorating data in the US. Business spending intentions have declined and banks are tightening credit lending standards, both of which point towards more subdued activity during the first two quarters of 2019. Industrial production in the US has slowed at the same time mixed signals are emerging about the strength of the household sector and jobs growth.

Figure 1. US Industrial production (monthly)



Source: Forsyth Barr analysis, Trading Economics

### Central banks responding again

With economic weakness in the EU and China now spreading to the US, central banks have responded as only they know how. The ECB has advised it expects to keep interest rates negative for as long as necessary, the PBoC is boosting liquidity by providing a medium term lending facility at concessionary interest rates for commercial banks, as well as a bank bill swaps program that provides increased liquidity to bank balance sheets, and the Fed has 'paused' as it monitors data.

This monetary support has boosted markets and will likely continue to do so in the near term. Unfortunately, the structural problems causing slowing global growth (over-indebtedness, weak banks and aging work forces) won't be cured by more cheap money.

Financial excesses usually end in recessions. Europe and China have weak banks and deteriorating credit problems. Central banks have put their finger in the dyke again.

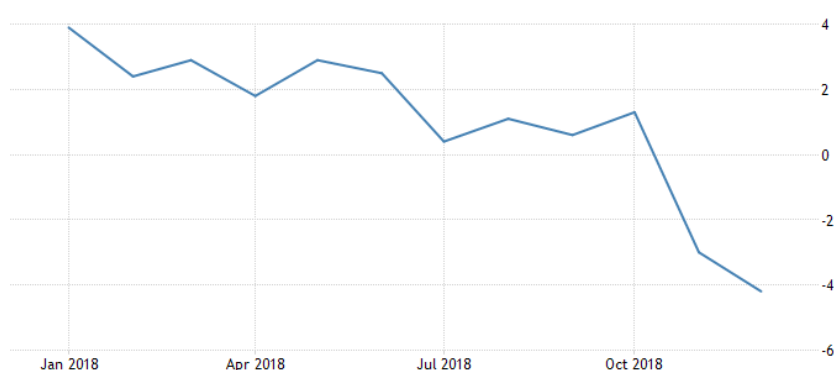
# Weaker Macro Environment

## Trade and industrial production in a funk

### Euro area manufacturing in recession

Global trade has slowed as demand from China weakens. Leading indicators include falling industrial metal prices (copper), subdued bond rates, oil prices (ex-OPEC cuts) and equity markets that remain below the peaks of September 2018. A slower China, as its labour force ages, indicates the commodity super-cycle is over. This is having an impact on exporting nations but also slowing demand for consumer items such as vehicles. Auto production has slumped in Germany, with manufacturing weakness spreading across the EU supply chain. While the EU region narrowly escaped a recession in the last half of 2018, Germany's manufacturing and construction sectors both probably didn't.

**Figure 2. Euro area industrial production (annualised %)**



Source: Forsyth Barr analysis, Trading Economics

### China's industrial inflation falling again

After Beijing's stimulus package in 2017, corporate profits improved in line with industrial prices. Unfortunately, China's PPI has been falling again at the same time the RMB has depreciated. The depreciation of its currency through 2018 seems to have neither boosted China's exports or inflation. At the same time, China's debt to GDP has increased.

**Figure 3. China industrial producer prices**



Source: Forsyth Barr analysis, Trading Economics

This is an extra burden for global businesses that already have to cope with falling demand, increasing protectionism and now industrial deflation being exported out of China again. As inflation falls around the world, this is forcing central banks back into easing modes. This is one main reason why US 10-year bonds remain subdued, even as the Fed reverses its tightening stance. Unfortunately, it looks like China is going to double

down on its policy of capital misallocation. While this may alleviate the impact of slower demand in the short-term, the longer-term consequences will be even more negative for growth.

### What about earnings?

For most of the last decade, FAANG or tech stocks dominated global equity markets and generated the majority of global earnings growth. If tech is running into trouble, or already there, then global equities may face further headwinds. Weakness in the tech sector may explain why US equities ended down for 2018, when earnings for the year were so strong thanks to the Trump tax cuts.

Analysts are turning pessimistic for Q1 and Q2 2019 earnings with expectations for low single digit or even zero growth for the half. This may set up better than expected actual outcomes.

But there seems no doubt that the rebound seen in equities so far this year is due to an easing in central bank sentiment and 'hope' that the trade war between the US and China will get resolved, at least as far as no more tariffs is concerned.

However, if the majority of trading is now undertaken by algorithms and machines, trends will become important to follow. Likewise, more volatility is inevitable.

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