Tim Toohey, Head of Macro and Strategy
11 November 2019

Reflation: A liquidity driven turning point for the global economic cycle

Entering the final months of 2019 a renewed sense of optimism has crept into global markets. From our perspective, excessive pessimism has dominated markets in recent months, so the market response is thus far best interpreted as a removal of pessimism rather than reflecting excessive optimism.

In this note we:

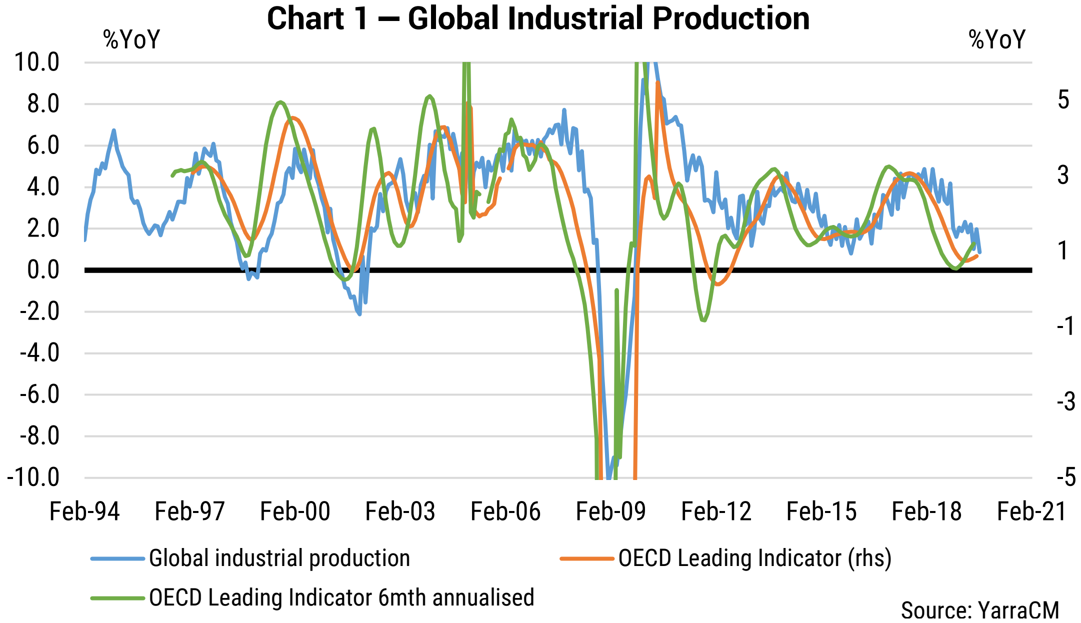
1. Assess the evidence of the global recovery recorded to date;
2. Re-interpret the causal factors behind the recent slowdown; and
3. Illustrate what some of our preferred proprietary leading indicators are suggesting for how the recovery could evolve.

The conclusion is a surprisingly upbeat global growth signal which may highlight some portfolio construction challenges for Australian based investors.

A month is a long time in world of macro-analysis

If you are feeling somewhat discombobulated by financial markets lurching from fears of global recession to talk of recovery in a matter of weeks, spare a thought for interest rate market participants who just last month were looking for further significant rate cuts in the coming months.

Chart 1 — Global Industrial Production



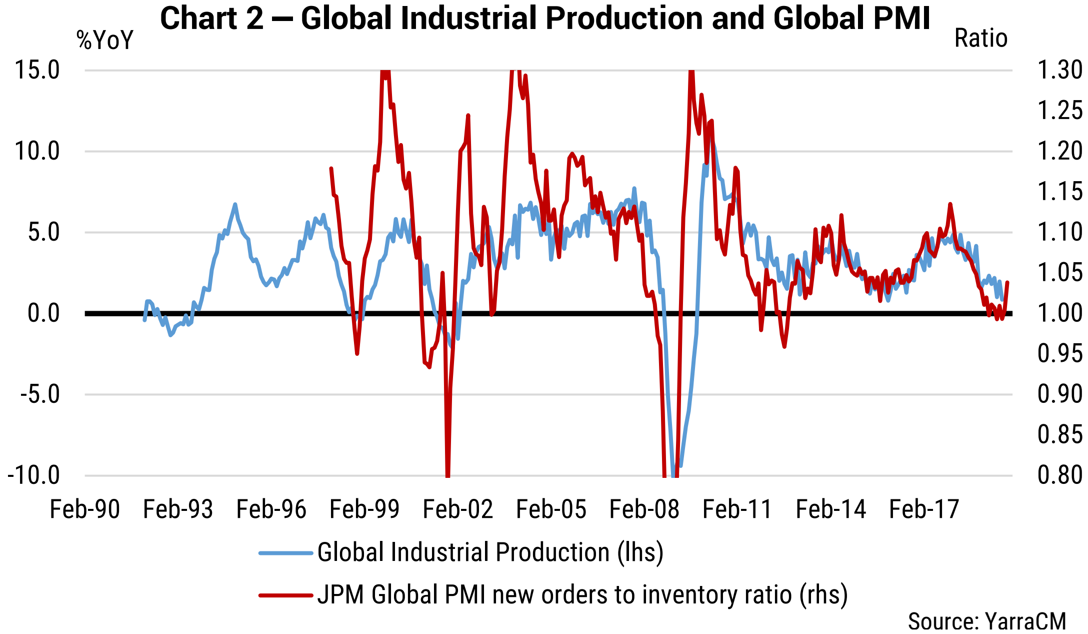
Source: YarraCM

Interest rate curves in the world's major markets now reflect only a modest chance of further easing by mid-2020. Just last month interest rate markets implied the Federal Reserve was on course to ease a further 50bps by April 2020. Now, a more sensible degree of implied easing is embedded, with only a 50% chance of a single cut implied and the odds of that occurring appear to be slipping by the day. Moreover, the US yield curve has steepened materially in the past month leaving fears of an impending recession in its wake.

That equity markets have smoothly navigated this quite sharp re-pricing in interest rate markets is both encouraging and instructive. Equity markets are now rewarding the expression of cyclical global growth rather than discounting in perpetually lower bond yields. While signs of a turning point in the OECD leading indicator have been evident for a couple of months (refer Chart 1, previous page), the inclusion of equities as part of the leading indicator complicated the signal when equity market gains were reflecting lower bond yields rather than an improving economic outlook.

The improved mood music around the US-China trade deal has clearly contributed to this shift, yet to conclude that nothing else has changed in recent weeks is to sell the story short. Real economy data points of modest improvement have continued to accumulate over the past two months, including closely watched data points such as the new orders to inventory ratio in global business surveys (refer Chart 2). At the very least, markets can take heart that the global inventory cycle has turned.

Chart 2 — Global Industrial Production and Global PMI



Source: YarraCM

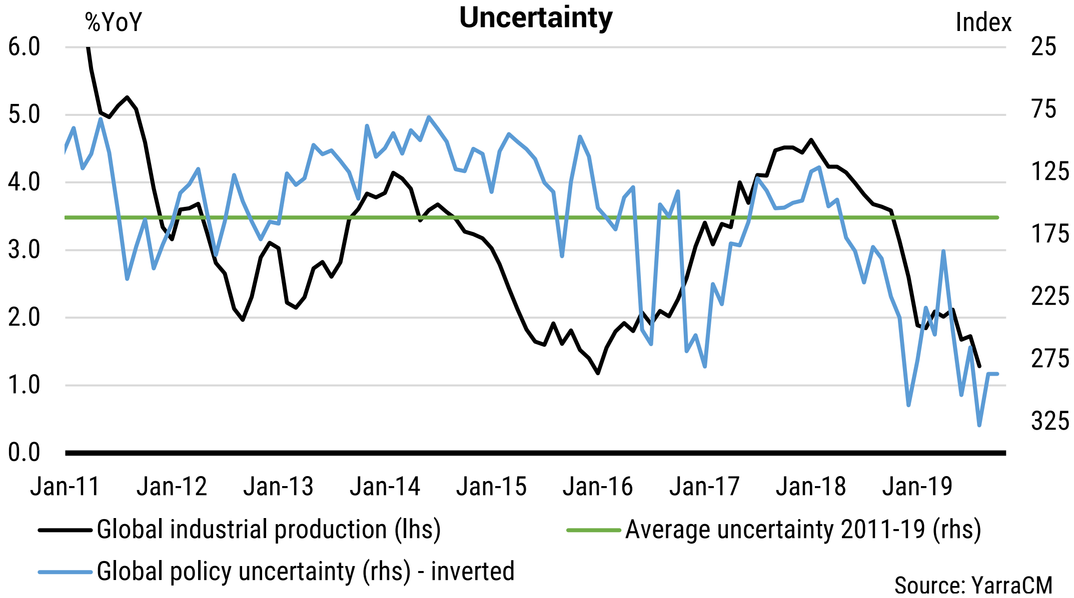
Despite these positive signs, doubts over the durability of any recovery clearly remain. How can you be confident that the initial signs of recovery can be sustained?

Listen to Vince Lombardi

If your frame of reference for the economic slowdown was principally the disruption caused by the US-China trade dispute and Brexit concerns, then Chart 3 (next page) provides a degree of confirmation. Recent historically high readings of global policy uncertainty (approximated by news counts in leading media outlets on words relating to economic policy uncertainty) coincided with the sharp slowing of global industrial production from the start of 2018 and declines in business surveys. Indeed, many of the world's central banks, including the RBA, have directly referenced 'high levels of policy uncertainty' as a reason for easing policy in recent months.

Should concerns over the trade dispute partly diffuse and uncertainty levels abate, then it is reasonable to expect industrial demand growth to accelerate in tandem. Uncertainty levels in the post-GFC period have on average been more elevated than prior to the crisis, yet a mere return to the average that pertained since 2011 would be consistent with a recovery in global industrial production growth from the relatively anaemic 1.3%yoy currently to a respectable 3-3.5%yoy over the next 12 months.

Chart 3 – Global Industrial Production and Global Policy Uncertainty



Source: YarraCM

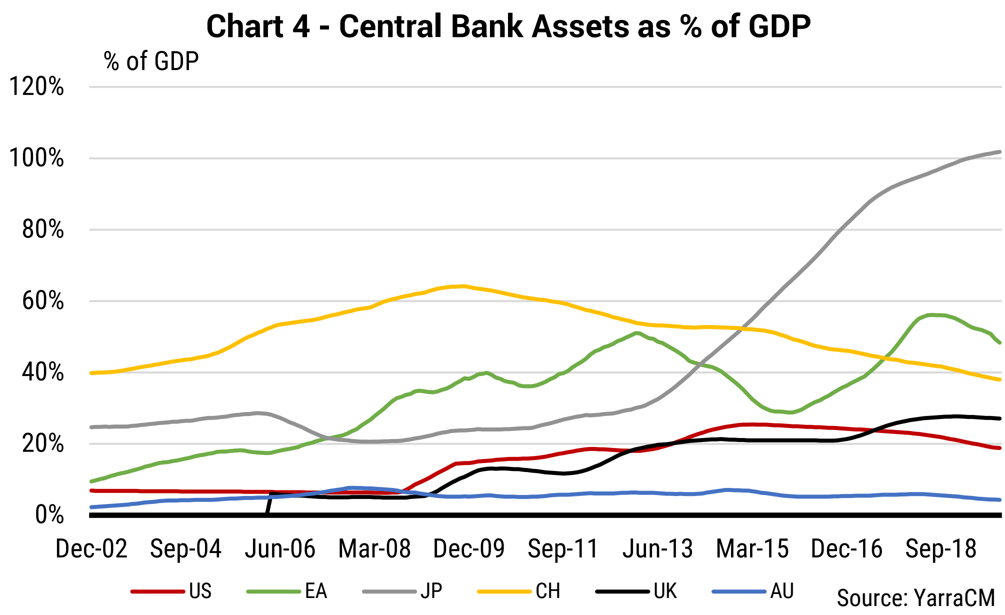
However, merely hoping that uncertainty declines is an unsatisfactory basis for tactical asset positioning. At best, shifts in measures of uncertainty will merely move in concert with asset prices. They will not lead them. Moreover, basing investment decisions around uncertain policies and election outcomes in major global economies in the coming year is a strategy fraught with danger. As Vince Lombardi, perhaps the greatest NFL coach, first opined in the 1960s, hope is not a strategy.

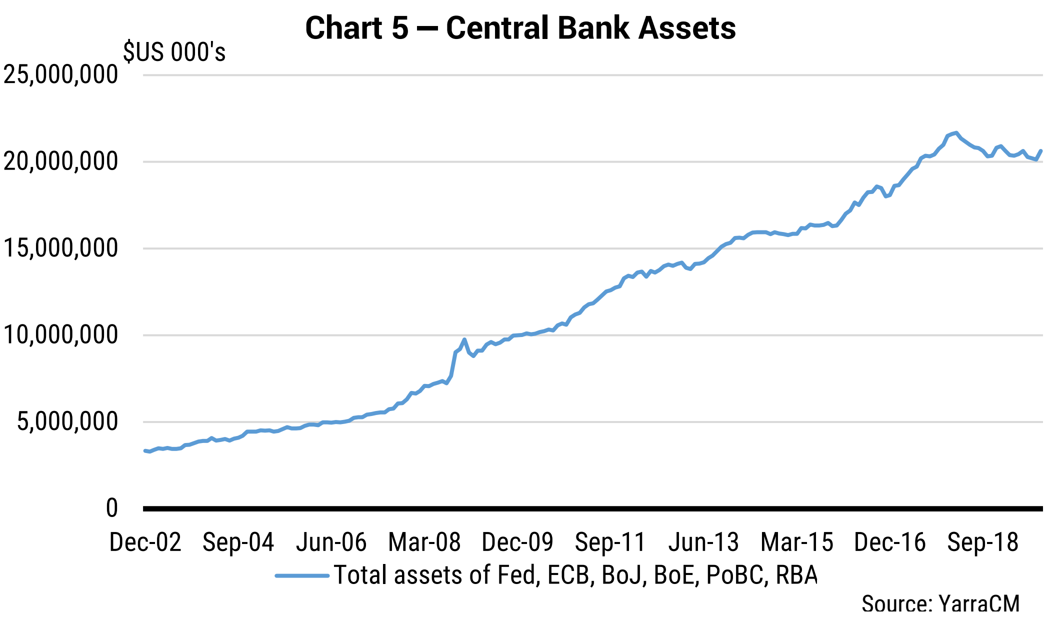
Liquidity matters

A more satisfying frame of reference for understanding the slowdown and the prospect for recovery is provided by thinking through the importance of central bank liquidity provision and its role in determining both the shape and duration of the current economic and asset price cycle.

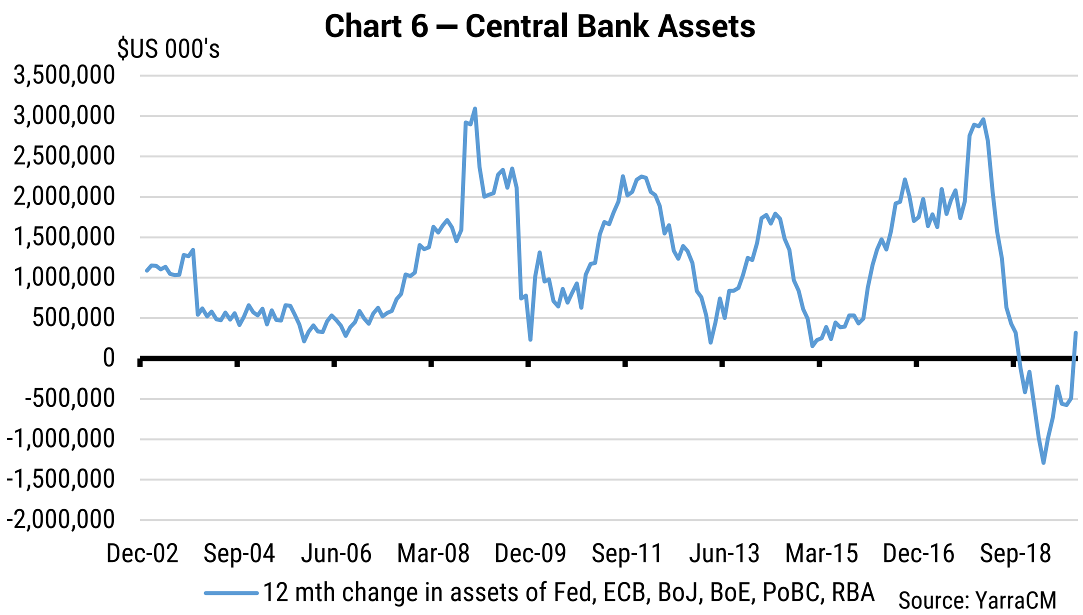
Each of the major central banks that have experimented with quantitative easing have had their own journey of expanding and contracting their balance sheets as deemed appropriate for their own economies (Chart 4, next page). The Fed's attempts at quantitative tightening have now been abandoned and November marks an important transition point for the global economy: the Euro Area now concedes that the cycle had proved much more challenging than they expected, with the ECB ushering in a new era of balance sheet expansion.

For financial markets, though, we contend it is not so much the individual journeys of each central bank that matter, but the aggregate picture of central bank balance sheets. Chart 5 (next page) converts the world's major central banks asset purchases into US$ terms, and makes clear that the remarkable quadrupling of central bank assets from 2005 (US$5 trillion) to 2018 (US$22 trillion) ended abruptly in 1Q2018.

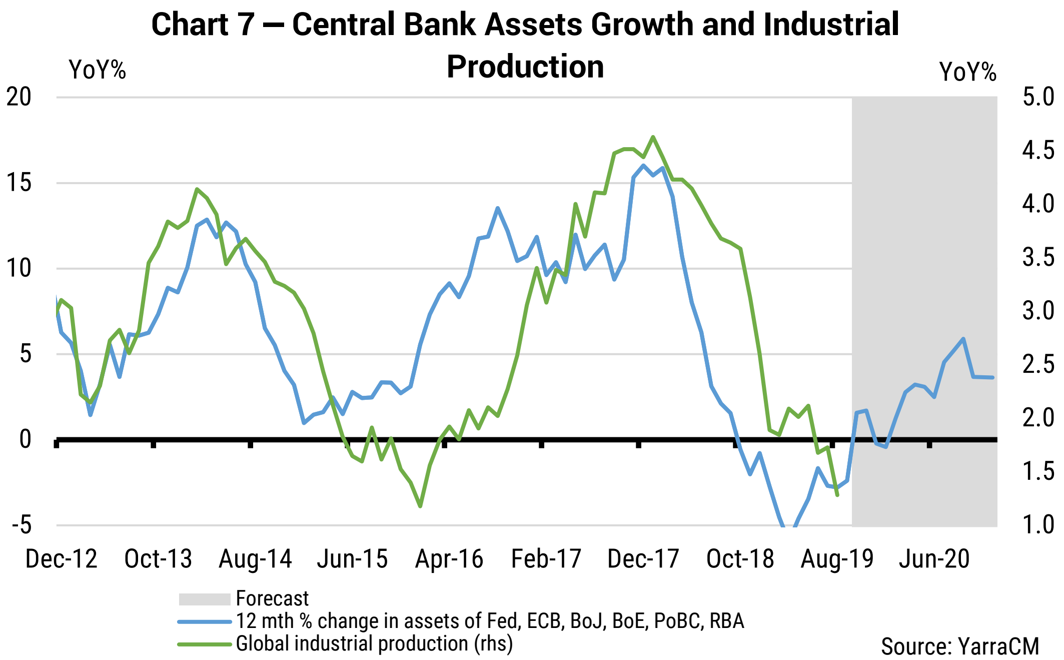




The contraction in US$ liquidity via changes in central bank balance sheet has been unprecedented in the modern era. As Chart 6 (next page) shows, the world has moved from a record level and pace of US$ liquidity provision to an outright contraction in a very short period of time.



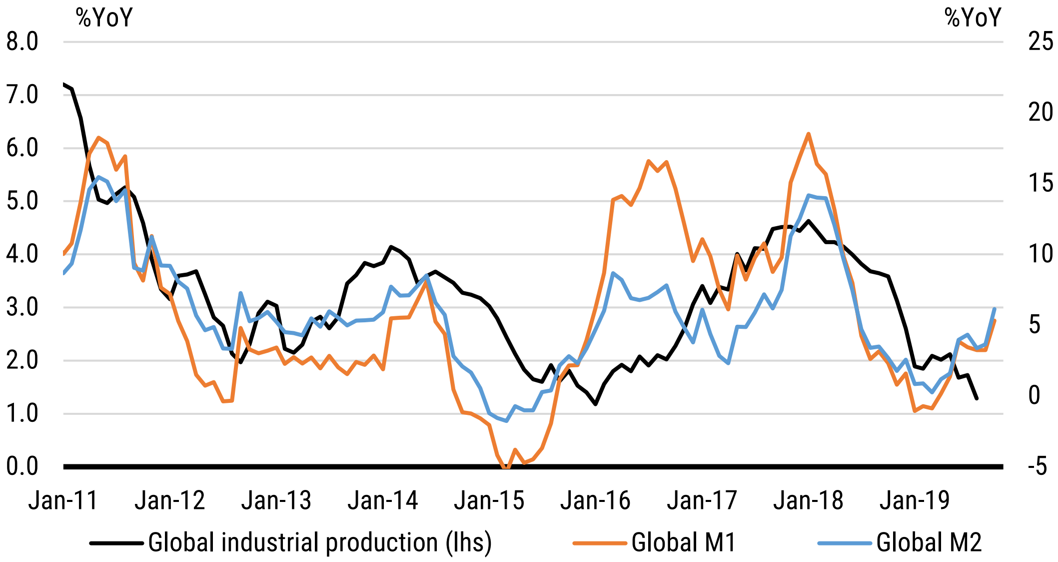
It would be naïve to have expected that such a sharp shift US$ liquidity would not have financial market and real economy impacts. Indeed, we believe Chart 7 is key to understanding the causal factor behind the global economic cycle in the post-GFC period. Ebbs and flows in the pace of expansion of central bank derived US$ liquidity have consistently led the global industrial cycle and shaped the trajectory of asset returns in the post-crisis period.



It is therefore of note that the ECB's planned €20bn of monthly asset purchases from November 2019 and the BoJ continuing on its current trajectory would be sufficient to underwrite a material increase in the pace of US$ liquidity provision by central banks in the coming months.

Indeed, even with the conservative assumptions that the PBoC contracts its balance sheet, BoE assets remain unchanged and Australia does not embark on its own QE experiment, US$ liquidity growth will still be sufficient to suggest global industrial demand will accelerate towards 3%yoy through 2H2020.

Chart 8 — Global Money Supply and Industrial Production



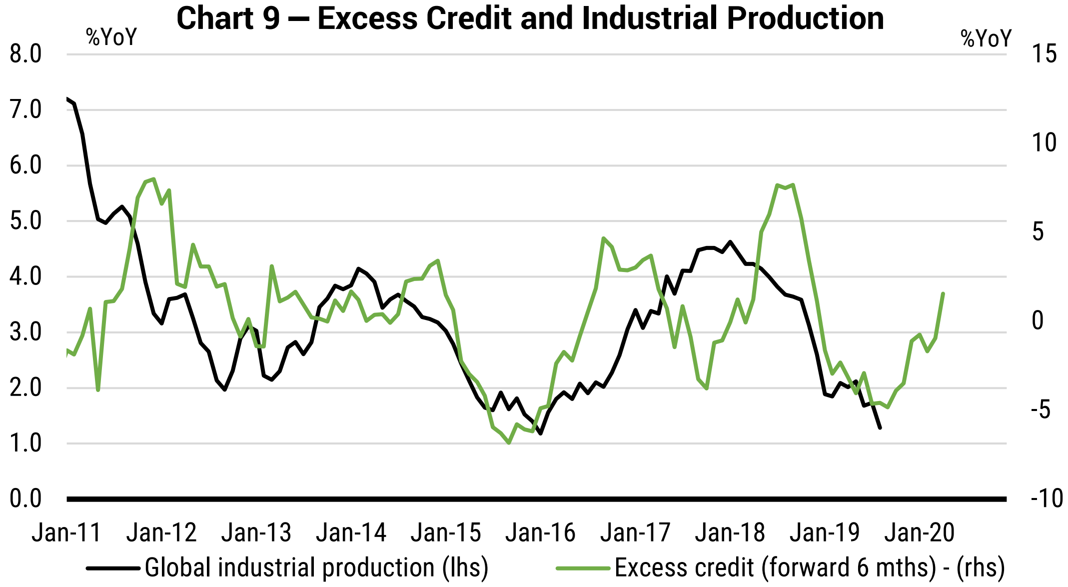
Source: YarraCM

The encouraging news is that even before this recent tilt by central banks, credit growth via the more traditional bank sector has already been expanding at a far healthier pace. Our measures of global money supply growth suggest that both M1 and M2 measures of money supply growth are already expanding at 5-6%yoy, the fastest growth since mid-2018 and materially higher than the 1-1.5%yoy recorded at the start of the calendar year.

Why does this matter? Because history has proven that once credit growth exceeds the current pace of nominal economic growth - which we denote as “excess credit” - a recovery in economic growth reliably materialises within a 6-month timeframe. Indeed, we believe this is one of the longest leading and most reliable guides to the outlook for the industrial cycle.

It is worth noting that October 2019 marked the first month since 2017 that the US, China, Japan, the Euro Area, and the UK all moved into excess credit growth. Chart 9 (next page) suggests that the turning point for the industrial cycle has not only likely been reached, it suggests a relatively robust recovery lies ahead.

Chart 9 — Excess Credit and Industrial Production



Source: YarraCM

Hope may not be a strategy, but following the shifts in global liquidity most certainly is.

Implications for Australian investors

What does this mean for Australia?

For a nation that remains at pointy end of shifts in the global economic cycle, the A$ is likely to be one of the prime expressions of improved global industrial growth. Not only could a more positive global industrial cycle prompt a shift from defensives to global cyclicals and value sectors, but it should also prompt a reassessment of companies with US$ earnings.

Few of us can remember the last time Australia managed to run Federal Budget and Current Account surpluses in tandem, let alone when this has occurred at the trough of the global industrial cycle. Yet that is exactly where Australia finds itself at the end of 2019. If there is to be a surprise for local managers it is that the A$ appreciates at an uncomfortable pace in coming months, even as geopolitical uncertainty remains high into the US election year and as the threat of RBA embarking on its own QE journey looms in the background.

In short, prior reflation periods suggest the best exposures include:

- Long equities in general and EM equities in particular
- Long base metal commodities v short gold
- Long A$, KRW, CNH and NZ$ v US$, JPY, and CHF
- Short DM bonds and steeper yield curves

While the amplitude and duration of the reflationary impulse is likely to be shallower and shorter than prior cycles, given our understanding of current positioning amongst global investors, it is a thematic that will prove difficult for investors to ignore.