THE JOLLY BANKER Woody Guthrie, 1940

July saw a continuation of the momentum in macro data and price action observed over the past few months. Economic growth is showing signs of fragile stabilisation, albeit with large divergences within and across regions. Disinflation, however, is more worrisome and has taken centre stage in central bankers' minds as they now focus on trying to revive tepid growth and extend the economic cycle for as long as possible. Our assessment looks at the world from three different dimensions: macro, sentiment, and valuation. Equally important over the long run, it seems like the recent past has been all about monetary policy as a tool to push the next recession out further, and financial assets reaching new highs as investors thrive, listening to The Jolly Banker.

WHAT'S NEXT?

Macro: Headwinds fought by the jolly bankers

Without a shadow of a doubt, global economic growth has taken a hit from largely above-potential levels observed in October last year. Since early 2019, our proprietary Growth Nowcaster has indicated a continuous decline, with a stabilisation around potential in March. Fast forward to July, the global level of growth has remained in check with divergences growing in the developed world. The Eurozone, Canada and UK have been showing continued signs of deceleration whereas the US economy has remained stable. It thus came as no surprise that the ECB recently ramped up its accommodative rhetoric to address this worrying situation. On average, the largest detractor remains production expectations, as uncertainty coming from trade tensions weighs on corporate optimism and investment.

No signs of improvement in inflation appeared on the horizon in July. Diffusion indices of our Inflation Nowcaster –indicating the dynamic of underlying data – dropped 10% to showcase a 60% deterioration in underlying data. This illustrates the negative inflation momentum most central bankers have acknowledged in recent declarations, and has been an important trigger behind their bid to tackle cross currents from the trade war and late cycle apathy. Inflation expectations have been the main drag globally while wage growth has been the main detractor in the US in spite of relatively strong job data abroad: the Phillips curve has not been repaired yet.

Central banks have therefore reacted firmly to stem economic decay and disinflationary forces. Response times were swift in turning less accommodative / hawkish stances back into supportive, easy monetary policies. In July alone, policy makers from Europe, Japan, Turkey, South Africa, Korea and the US all moved toward ample monetary support. This has been by far the most important factor in financial asset performance this year, and will continue to be until the next inflection point if, and when, macro fundamentals materially improve.

Sentiment: Legitimate complacency?

Optimism seemed to be everywhere up until the very last day of July, when the Fed delivered a somewhat "disappointing cut". Broad measures of market sentiment had been pointing toward a low level of risk aversion and our Market Stress Nowcaster was no exception. The indicator fell back to low levels after a brief pick-up in May: credit spreads kept on tightening in all credit segments, volatility measures receded and liquidity improved as a result of CB easing. So far so good, but one could argue that sentiment was artificially maintained at very high levels by the jolly bankers. Indeed, under normal circumstances (traditional cycle and non-almighty policy makers) decelerating growth and heightened geopolitical tensions would weigh on sentiment, not buoy it.

This is what we have been calling the "bad is good" situation for some time, where complacency becomes "legitimate" as long as the "central bank put" remains alive. Pragmatism remains key in this environment and it required effort not to reduce market exposure at a time when numerous assets have become substantially more expensive. In the meantime, headline risk remained elevated and resurfaced violently late last week on the back of hardening rhetoric between the US and China. The new threat of a 10% tariff on USD 300 Bn of Chinese goods and potential retaliation fears hammered risky assets and complacency in one go.

Finally, "smart money" (CTA and Macro managers) has increased exposure to risky assets recently so the participation in the last leg of the rally has increased. Positioning in growth assets is not "light" any more and could soon become a source of concern as it is now hovering around October 2018 levels: high by historical standards but not yet extreme.

Valuation: Rich, but does it really matter?

This is the usual consequence of monetary policy accommodation: it creates richness – if not bubbles -- and exuberance across asset classes. In fact, most risk premia are now flashing red when it comes to valuations. However, relative valuations paint an interesting picture: risky assets (equities and credit) are cheap relative to hedging assets (government and inflation linked bonds, precious metals). As a result, even if it is too early to call for a valuation crush, the expensiveness of hedging assets driven by the jolly bankers could have unpleasant consequences: correlation distortions and diminished protection if, and when, risk appetite reverses.

Markets are currently dismissing the overall valuation factor for a good (or bad) reason. The outcome of such widespread expensiveness does not necessarily have to end in a drama in all risk premia but it would be naive to consider a broad-based multiple expansion as a sustainable environment. Stock valuations have a chance to cool down with a surge in earnings expansion, and credit spreads can keep on tightening as long as recession risk remains muted on the back of central bank action. Nevertheless, certain segments of the fixed income space seem materially over-priced, such as investment grade or government bonds.

Cross asset allocation: Reduced beta, increased carry

The current environment does not require a material and durable risk reduction, yet taking profit from large overweights made sense. As a result, beta reduction can be compensated by relative value opportunities, and our current preference is for credit carry, with a large long/short position in high yield against investment grade. Given the very low level of volatility, we have implemented a number of optional hedging strategies on equity indices to protect in case of an unexpected market shock.

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IMPORTANT INFORMATION

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