Monthly Market Update | August 2019

Running of the Doves

In the World

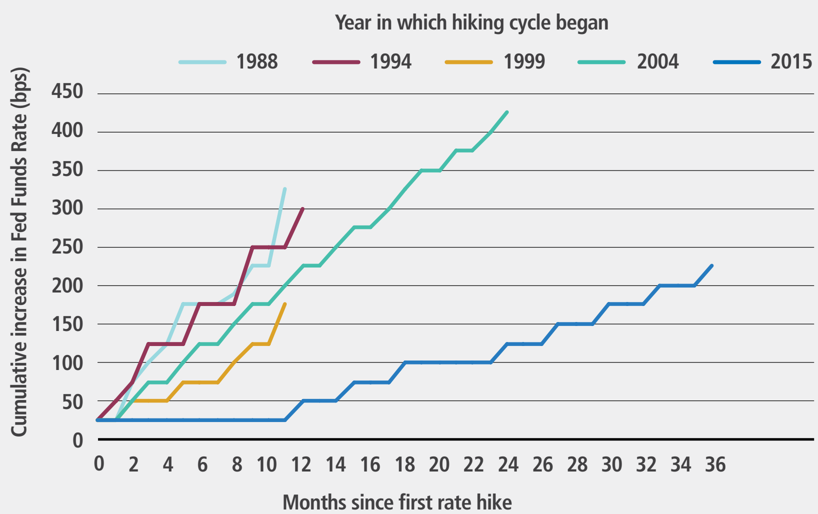
While the bulls ran in Spain, central bank "doves" – headlined by the U.S. Federal Reserve and its highly anticipated rate cut – took the spotlight in July. For the first time since the financial crisis, the Fed cut its policy rate by 25 basis points (ending a three-year hiking cycle that began in December 2015) and announced an earlier-than-expected end to its balance sheet unwind. Although the Fed was aiming to help keep the longest economic expansion in U.S. history on track, Chairman Jerome Powell's press conference took markets by surprise as he shied away from providing specific guidance on further easing and indicated a "mid-cycle adjustment to policy" rather than the start of a protracted easing cycle. While the European Central Bank (ECB) left its policy rate unchanged, President Mario Draghi sent a clear signal of intent to ease further, stating the ECB was "determined to act" to spur inflation and help combat a worsening economic outlook. Elsewhere, the Bank of Japan (BOJ) left rates unchanged, but indicated potential for future support; the Reserve Bank of Australia (RBA) cut rates by 25 bps for the second time this year; and a host of emerging market countries, including South Africa, Malaysia, Turkey, and Russia, all cut rates.

In odd timing for the Fed, U.S. economic data showed some resiliency. Although exports declined and business investment contracted, U.S. Q2 real gross domestic product (GDP) growth was still better than expected at an annualized 2.1%. Albeit slower than the first quarter's 3.1% pace, the Q2 figure was led by robust growth in consumer spending. Retail sales were also stronger than anticipated, core inflation firmed, and U.S. job growth handily beat expectations. In contrast to better trends in U.S. economic data, fundamentals in the eurozone continued to weaken: GDP growth slowed to 0.2% for the second quarter, inflation dropped to 1.1% year-over-year (its lowest this year), and flash manufacturing purchasing managers' indexes (PMIs) fell deeper into contractionary territory. Meanwhile, political developments in Europe featured turnover in key posts: Germany's former defense minister Ursula Von der Leyen became the new president-elect of the European Commission, Christine Lagarde resigned as the head of the IMF to replace Mario Draghi as president of the ECB in September, and Boris Johnson became the new Prime Minister of Great Britain. In Washington, the House passed a budget deal that extended the debt ceiling until after the 2020 elections and increased federal spending in 2020 by about $50 billion.

Market performance was more mixed in July. In the U.S., Chairman Powell's less accommodative-than-expected rhetoric helped send equities lower, the U.S. dollar stronger, and yields at the front-end of the curve higher (despite the 25-bps rate cut). Still, the S&P 500 managed to end the month 1.4% higher. Year-to-date gains crossed over 20%, and the index reached fresh all-time highs, due in part to a strong start to the Q2 earnings season (though many companies guided toward weaker Q3 results given trade tensions and slowing global growth). Outside the U.S., equity gains across developed markets were more modest as stimulus efforts from central banks were dampened by economic data that affirmed slowing growth momentum while emerging market equities fell 1.2% alongside a strengthening U.S. dollar. In Germany, the 10-year bund yield slid 11 bps to -0.44% (an all-time low) as expectations built for a September easing package from the ECB. In response to newly-elected Prime Minister Boris Johnson's pledge to remove the UK from the EU on October 31 with or without a deal, the pound fell 4.2% to a two-year low. Lastly, Brent crude oil prices fell 2.1% as concerns about demand growth outweighed the impact of flaring tensions with Iran in the Gulf and inventory draws in the U.S.

LONG BUT SHALLOW: PUTTING THE RECENT FED HIKING CYCLE IN CONTEXT

The Federal Reserve lowered its target policy rate for the first time in over a decade, ending one of the longest hiking cycles in the past 30 years. While the cumulative increase in the federal funds rate of 225 basis points (bps) was relatively in line with most recent tightening cycles, it took three years to get there. One of the reasons for the longer and shallower cycle may be that the Fed's objectives were different: This cycle was about getting away from the zero-bound – to remove emergency accommodation and have room to cut rates in future economic downturns – as opposed to tightening conditions to slow some type of overheating. The fact that there is less room to reduce rates than in past cycles may also help explain why the Fed focused on the cut as "insurance" to stave off the possibility of returning to zero in the near future; it is also likely the reason the FOMC members were divided, based on their forecasts in June, between leaving the target rate unchanged and cutting it 50 bps by the end of 2019.



Source: Bloomberg. As of 31 July 2019.

Market snapshot

To view detailed on each asset class, visit pimco.com/monthly-market-update.

BONDS	U.S.				U.K.				EUROZONE				JAPAN				CANADA			
	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018
	Level	Change (bps)			Level	Change (bps)			Level	Change (bps)			Level	Change (bps)			Level	Change (bps)		
Target Rate*	2.25				0.75				-0.40				-0.10				1.75			
2 YR	1.87	+12	-62	+60	0.44	-18	-32	+31	-0.78	-3	-17	+2	-0.20	+2	-6	-1	1.54	+7	-32	+18
5 YR	1.83	+6	-68	+30	0.38	-25	-52	+18	-0.72	-5	-40	-11	-0.24	+2	-9	-4	1.45	+6	-44	+2
10 YR	2.01	+1	-67	+28	0.61	-22	-67	+9	-0.44	-11	-68	-19	-0.15	+1	-16	-5	1.48	+1	-49	-8
30 YR	2.52	-0	-49	+27	1.32	-16	-50	+6	0.12	-14	-75	-39	0.35	-1	-37	-9	1.70	+1	-49	-8
5 YR ILBs	0.29	+6	-71	+71	-2.94	-40	-70	-9	1.33	+7	-14	-24					0.17	+11	-48	+40
10 YR Muni[a]	1.54	-9	-78	+31													2.33	-0	-70	+17

CURRENCIES	USD**				GBP/USD				EUR/USD				USD/JPY				USD/CAD			
	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	98.52	2.5%	2.4%	4.4%	1.22	-4.2%	-4.7%	-5.6%	1.11	-2.6%	-3.4%	-4.5%	108.78	-0.8%	0.8%	2.8%	1.32	-0.7%	3.4%	-7.8%

EQUITIES	2.5%				FTSE 100				EURO STOXX 50				NIKKEI				SPTSX			
	2.4%	MTD	YTD	2018	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018	July '19	MTD	YTD	2018
	4.4%	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	2,980	1.4%	20.2%	-4.4%	7,587	2.2%	15.7%	-8.7%	3,467	-0.1%	18.2%	-12.0%	21,522	1.2%	8.5%	-10.7%	16,407	0.3%	16.1%	-9.6%

SECTOR SPREADS***	July '19	MTD	YTD	2018
	Level	Change (bps)		
MBS[b]	38	-8	+3	+11
IG[c]	101	-8	-40	+54
HIGH YIELD[d]	420	-2	-125	+206
EM EXTERNAL[e]	333	-33	-102	+124

COMMODITIES	July '19	MTD	YTD	2018
	Level	Change		
Oil	$59	0.2%	29.0%	-24.8%
Gold	$1,426	0.9%	11.3%	-2.1%
Copper	$267	-1.5%	1.3%	-20.3%
Grains[f]	$29	-5.8%	-5.0%	-7.4%

*Central Bank Policy Rate
**U.S. Dollar Index (DXY)
***Sector spreads to like-duration government bonds

Source: Bloomberg

[a]Thomson Municipal Market Data (MMD) AAA Curve, [b]Barclays Global Agg MBS Index, [c]Bloomberg Barclays Global Agg Credit Average OAS, [d]Barclays Global Agg High Yield Index, [e]JPMorgan Emerging Markets Bond Index, [f]Dow Jones – UBS Grains Subindex

Outlook

Based on PIMCO's cyclical outlook from March 2019.

In the U.S., we continue to expect growth to slow to 2%–2.5% in 2019 from nearly 3% last year. Factors contributing to the deceleration include fading fiscal stimulus, the lagged effect of tighter monetary policy over the past few years, and headwinds from the China/global slowdown. **Headline inflation is likely to remain in the 1.5%–2% range this year, while core CPI moves sideways.** With growth likely to continue slowing through the year and inflation remaining below target, the Fed has adopted a more dovish stance and looks likely to cut rates by 50 basis points (bps) by year-end 2019.

For the eurozone, we expect growth to slow to a trend-like pace of 0.75%–1.25% in 2019 from close to 2% in 2018, as weak global trade exerts significant downward pressure on the economy and some countries experience a recession. An improvement in global trade conditions would contribute to a gradual reacceleration. Reflecting firmer wage growth, **we expect a modest pickup in core inflation, which has been stuck at 1% for some time.** Mirroring the dovish shift by many central banks, the European Central Bank (ECB) has also taken an accommodative tone with some potential for more easing policies in 2019..

In the U.K., we expect real growth in the range of 1%–1.5% in 2019, modestly below trend, and we continue to think that a chaotic no-deal Brexit is a lower-probability event. We see core **CPI inflation stable at or close to the 2% target** as import price pressures have faded and domestic price pressures remain subdued.

Japan's GDP growth is expected to be modest at 0.5%–1% in 2019, broadly unchanged from 0.7% in 2018. **With core CPI inflation expected to dip into negative territory** (due to temporary factors), we expect the Bank of Japan to keep its targets for short rates and the 10-year yield unchanged this year.

In China, we see growth slowing in 2019 to the middle of a 5.5%–6.5% range from 6.6% in 2018, stabilizing somewhat in the second half of the year as fiscal and monetary stimulus find some traction. . We expect fiscal stimulus of 1.5% to 2% of GDP. **Inflation remains benign at 1.5%-2.5% in our forecast,** and we may see additional stimulus if credit conditions deteriorate more. Yuan stability is well-anchored with a patient Fed and the understanding that this needs to be a component of the China–U.S. trade deal.

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