PIMCO

Beneath the Surface

IN THE WORLD

A reprieve in trade tensions between the U.S. and China bolstered investor confidence in October even as political uncertainty increased around the globe. Washington and Beijing announced details of a potential deal – coined as "phase one" – for the U.S. to forego the next round of scheduled tariffs in exchange for increased agricultural purchases by China. While President Donald Trump described the interim agreement as "substantial" and negotiations indicated a desire to limit further escalations, the details fell short of addressing underlying structural issues between both administrations. Meanwhile, impeachment proceedings against Trump advanced as the House of Representatives passed a resolution on 31 October that formally laid out its plan for the investigation. Across the Atlantic, the Brexit deadline was postponed to the end of January, with Prime Minister Boris Johnson calling for a general election in December in an attempt to solidify support for his proposed withdrawal agreement. Elsewhere, major political demonstrations continued in Hong Kong and began in a number of countries – including Iraq, Chile, Spain, Ecuador, and Lebanon – stemming from grievances that included sovereignty, corruption, and the increased cost of living.

Central banks maintained accommodative policy as concerns grew amid generally weaker data. Despite better-than-expected U.S. Q3 real GDP growth of 1.9% annualized, strong consumer spending and faltering business investment painted a more mixed picture of the U.S economy. In particular, while the U.S. jobless rate reached a half-century low of 3.5%, the ISM purchasing managers' index (PMI) contracted in September to its weakest level since June 2009, and the Chicago PMI fell to its lowest level since December 2015. The PMI trend was similar in the eurozone and Japan, reflecting a deepening global manufacturing recession. The IMF again downgraded its estimate for 2019 global growth to 3.0%, representing the lowest rate of expansion since the financial crisis. Against this backdrop, the Federal Reserve lowered its target fed funds rate by 25 basis points (bps) again in a widely anticipated move, although Chairman Jerome Powell indicated that any future cuts would be reliant on a material deterioration in the economy. Elsewhere, the European Central Bank and the Bank of Japan left rates unchanged, with the former emphasizing stimulus measures announced last month and the latter slightly tweaking its guidance to allow for rate cuts in the future.

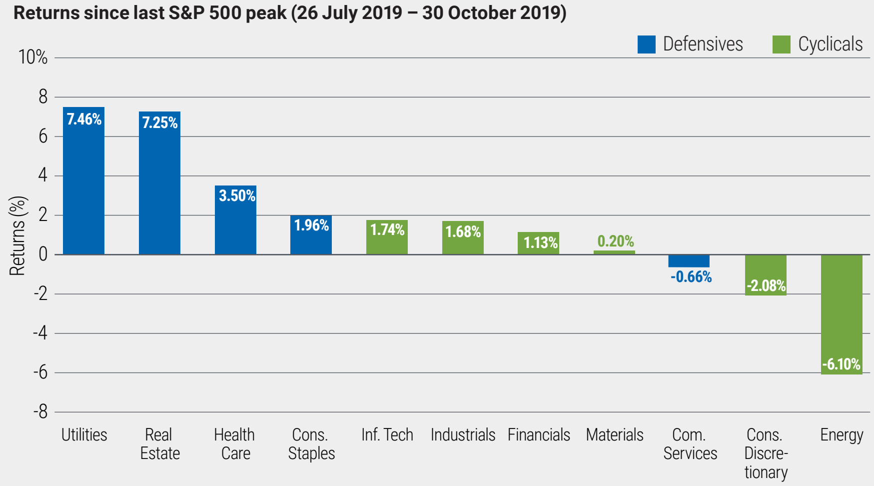
The renewed optimism about U.S.–China trade generally outweighed concerns over softer economic data and provided a boost to risk assets. Global equities posted strong returns in October – both in developed markets (+2.5%) and emerging markets (+4.2%) – on improved U.S.–China trade sentiment, positive Brexit developments, and continued accommodation by central banks. The S&P 500 set all-time highs and ended the month 2.2% higher, though the move appeared driven by more defensive sectors (see chart). The U.S. equity return also lagged other developed markets as the U.S. dollar weakened (–2.0% based on DXY). In a reversal of the recent trends where equities and bonds rallied in tandem, government bond yields across major developed economies broadly rose: The 10-year German yield rose 16 bps, the U.K. 10-year rose 14 bps, and the U.S. 10-year 3 bps. Meanwhile, credit markets were mixed over the month: Investment grade bond spreads tightened modestly, while high yield spreads appeared to price in the weaker fundamental data and widened.

UNDER THE HOOD

U.S. equity markets hit record highs in October, surpassing the prior peak in July, as investor confidence rose on indications of progress in U.S.–China trade talks and interest rate cuts by the Federal Reserve. While the peak-to-peak story struck an optimistic tone, not all sectors participated in these fresh gains: Cyclical sectors that had led the rally through July, including financial and consumer discretionary stocks (i.e., sectors with more exposure to the business cycle) have generally lagged since then, displaced by defensive sectors like utilities and real estate – a cohort that tends to outperform in more adverse economic environments. Investors' shift to defense may indicate a sense of unease beneath the recent market rally, particularly given weaker trends in manufacturing data, business sentiment, and private investment overall.

Source: Bloomberg as of 30 October 2019

Returns since last S&P 500 peak (26 July 2019 – 30 October 2019)



Market snapshot

TO VIEW DETAILS ON EACH ASSET CLASS, VISIT PIMCO.COM/MONTHLY-MARKET-UPDATE.

Bonds	U.S.				U.K.				Eurozone				Japan				Canada			
	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018
	Level	Change (bps)			Level	Change (bps)			Level	Change (bps)			Level	Change (bps)			Level	Change (bps)		
Target Rate*	1.75				0.75				-0.50				-0.10				1.75			
2 YR	1.52	-10	-96	+60	0.50	+13	-25	+31	-0.66	+11	-5	+2	-0.23	+9	-9	-1	1.52	-6	-35	+18
5 YR	1.52	-2	-99	+30	0.44	+15	-47	+18	-0.63	+15	-31	-11	-0.26	+9	-12	-4	1.42	+2	-47	+2
10 YR	1.69	+3	-99	+28	0.63	+14	-65	+9	-0.41	+16	-65	-19	-0.13	+8	-14	-5	1.41	+5	-56	-8
30 YR	2.18	+7	-84	+27	1.14	+16	-69	+6	0.11	+18	-77	-39	0.39	+2	-33	-9	1.57	+5	-61	-8
5 YR ILBs	0.07	-14	-93	+71	-2.47	+58	-23	-9	1.12	+7	-35	-24					0.21	-1	-43	+40
10 YR Muni[a]	1.48	+1	-83	+31													2.28	+4	-75	+17

Currencies	USD**				GBP/USD				EUR/USD				USD/JPY				USD/CAD			
	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	97.35	-2.0%	1.2%	4.4%	1.29	5.3%	1.5%	-5.6%	1.12	2.3%	-2.7%	-4.5%	108.03	0.0%	1.5%	2.8%	1.32	0.6%	3.6%	-7.8%

Equities	S&P 500				FTSE 100				EURO STOXX 50				NIKKEI				SPTSX			
	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018	Oct '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	3,038	2.2%	23.2%	-4.4%	7,248	-1.9%	12.1%	-8.7%	3,604	1.1%	23.2%	-12.0%	22,927	5.4%	16.3%	-10.7%	16,483	-0.9%	17.3%	-9.6%

Sector Spreads***

	Oct '19	MTD	YTD	2018
	Level	Change (bps)		
MBS[b]	49	+3	+13	+11
IG[c]	104	-4	-37	+54
HIGH YIELD[d]	479	+14	-66	+206
EM External[e]	323	-15	-112	+124

Commodities

	Oct '19	MTD	YTD	2018
	Level	Change		
Oil	$54	0.2%	19.3%	-24.8%
Gold	$1,515	3.3%	18.2%	-2.1%
Copper	$264	2.3%	0.3%	-20.3%
Grains[f]	$29	1.2%	-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 SEPTEMBER 2019.

We believe the global economy is about to enter a low-growth "window of weakness" as ongoing trade tensions and heightened political uncertainty continue to act as a drag on global trade, manufacturing activity, and business investment. In our baseline forecast, the low-growth period of vulnerability – with trade, monetary, and fiscal policy acting as swing factors – gives way to a moderate recovery in U.S. and global growth in the course of 2020.

In the U.S., we continue to expect growth to slow to 1.25%–1.75% in 2020 from a peak of 3.2% in the second quarter of 2018. Slower global growth and elevated trade tensions are expected to depress investment and export growth, while slower business output and lower profit growth slow labor markets, weighing on consumption. **Core inflation is likely to firm somewhat to the 2.25%–2.75% range due to the recent tariffs on Chinese goods,** though it is likely to moderate in later 2020. After cutting rates three times in as many meetings, the Federal Reserve has indicated that it may moderate or pause this cycle. Still, we believe more accommodation may be needed in the quarters ahead.

For the eurozone, we see the continuation of a 1% growth, 1% inflation economy. Ongoing trade tensions are expected to exert a significant drag on growth, somewhat offset by supportive domestic conditions, including easy financial conditions, modest fiscal stimulus, and remaining pent-up demand. **Core inflation could rise a bit over the next year in response to rising wages,** but weak growth suggests that margin pressure on businesses will continue, limiting the pass-through of higher labor costs. While the European Central Bank may cut the policy rate a little further, we expect the focus to remain on forward guidance, targeted longer-term refinancing operations (TLTROs), and asset purchases.

In the U.K., we expect real growth in the range of 0.75%–1.25% in 2020, modestly below trend. We anticipate an orderly Brexit, either through an amended withdrawal agreement or a relatively orderly no-deal exit. However, we see headwinds from weak global trade, Brexit-related uncertainty, and possible disturbances in the event of a no-deal exit weighing on growth. **We expect core CPI inflation to remain stable at or close to the 2% target.** While wage growth has picked up, we think firms are likely to absorb higher labor costs. The Bank of England will likely keep its policy rate unchanged at 0.75%, but we expect a cut in the event of a no-deal exit.

Japan's GDP growth is expected to slow to a 0.25%–0.75% range in 2020 from an estimated 1.1% this year. Although we expect domestic demand to remain resilient thanks to a tight labor market and anticipated fiscal accommodation, the balance of risk remains on the downside due to external factors. **Core inflation is expected to remain low at 0.5%–1%, with most of the impact from the consumption tax hike offset** by lower mobile phone charges and free nursery education. The hurdle for deeper negative interest rates remains high, but there is clear appetite for fiscal stimulus from both the Bank of Japan and the government.

In China, we see growth slowing in 2020 to a 5.0%–6.0% range from an estimated 6.1% in 2019 due to the trade conflict, rising unemployment, weakening consumption, and sluggish business investment. We expect fiscal stimulus of around 1% of GDP, likely front-loaded in the first quarter of 2020. **Inflation should remain benign at 1.5%–2.5%,** and we expect the People's Bank of China to cut rates by 50 basis points, in addition to reductions in bank reserve requirement ratios. We also expect further moderate yuan depreciation against the U.S. dollar to cushion the trade war's impact on manufacturing.

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