PIMCO

A Tale of Two Halves

IN THE WORLD

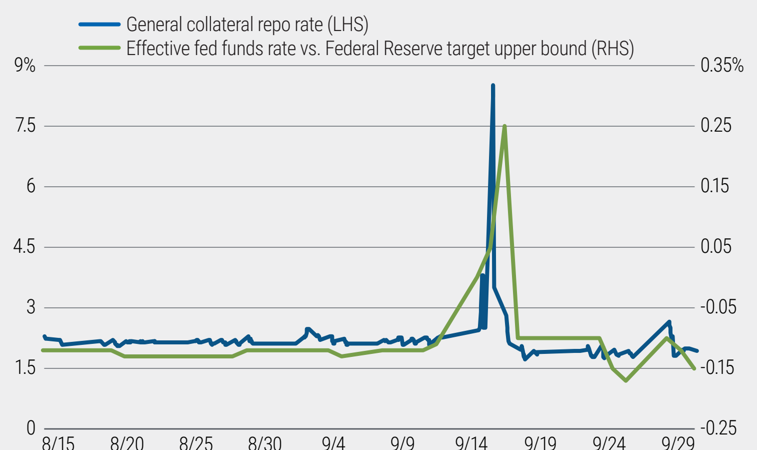
Despite an optimistic start to September, mixed geopolitical developments weighed on investor sentiment over the month. Trade tensions between the U.S. and China eased somewhat as September began: China exempted certain U.S. agricultural products from additional tariffs, and President Donald Trump delayed a scheduled 5% increase in tariffs from October 1 to October 15 so as not to coincide with the People's Republic of China's 70th anniversary celebration. However, political uncertainty rose as U.S. House Speaker Nancy Pelosi launched a formal impeachment inquiry against Trump after a whistleblower's complaint alleged that he had pressured the Ukrainian president to investigate former vice president and Democratic presidential candidate Joe Biden and his son. Developments outside the U.S. were similarly mixed: Odds against a no-deal Brexit appeared to improve as Parliament passed a bill designed to prevent a no-deal exit from the European Union and the U.K. Supreme Court ruled Prime Minister Boris Johnson's suspension of Parliament unlawful. However, political instability remained in Hong Kong, where protests continued; in Spain, which headed for its fourth general election in four years; and in Israel, where Prime Minister Benjamin Netanyahu appeared challenged to form a government following an inconclusive election. Tensions in the Middle East also flared after attacks on two large Saudi oil facilities, temporarily halting nearly 5% of global crude oil output.

Central banks generally maintained more accommodative policy stances as growth concerns lingered. Economic uncertainty also remained elevated. The global manufacturing recession deepened, with a wide swath of countries indicating contractionary levels in their purchasing managers' indexes (PMIs), including many in the eurozone. Softer U.S. job growth, alongside relatively strong retail sales, also painted a mixed picture of the health of the U.S. consumer. Against this uncertain backdrop, the U.S. Federal Reserve (Fed) lowered its target fed funds rate by 25 basis points (bps) in a widely anticipated move. Even so, the division among Federal Open Market Committee (FOMC) members was apparent: Three dissented – though for different reasons – and the "dot plot" revealed that seven members projected another rate cut by the end of this year, while five members preferred to hold rates steady; in addition, five participants went into September's meeting preferring not to cut the benchmark rate at all. In Europe, the European Central Bank (ECB) lowered its deposit rate by 10 bps and announced that its quantitative-easing program would restart later this year despite winding down only last year.

While initially robust, risk appetite waned in the latter part of September. Geopolitical and growth uncertainties eventually weighed on an initial rally in risk assets, a trend evident in equities, credit, and interest rates. A brief surge in short-term rates in U.S. repo (repurchase agreement) markets added to investor anxiety (see chart), as did the attacks on two major Saudi oil facilities, which initially drove up the price for Brent crude oil nearly 15% to $69 per barrel. Global equities (MSCI World Index) gained over 3% in the first part of September, but the rally sputtered in the second half to close up only 2%; U.S. equities (S&P 500 Index) mirrored the pattern as well. In a similar vein, developed market sovereign bond yields generally rose for the first part of the month, headlined by U.S. 10-year yields surging 40 bps before falling back to end 17 bps higher. In addition, the overall gain in U.S. equities masked a notable move: Technical factors drove a dramatic rotation out of momentum and into value stocks, with value (MSCI World Value Index) outperforming growth companies (MSCI World Growth Index) by 3.6% after over a decade of growth-dominated markets.

SPIKED SEPTEMBER

Overnight rates for repos (or repurchase agreements, which are very short-term secured loans) surged on September 17, reaching nearly 9% from 2.52% the prior day and raising concern of a larger systemic issue. The spike, however, was due to a number of idiosyncratic factors that drove a mismatch in the supply and demand for cash, including the deadline for U.S. corporate tax payments and an increase in the U.S. Treasury general account. When repo rates rose, the subsequent flow of capital to the repo market then put upward pressure on the effective U.S. fed funds rate, which finished at 2.30% that day, 5 basis points (bps) above the Federal Reserve's target range at the time of 2.00%–2.25%. To bring the funds rate back to normal, the New York Fed conducted its first overnight system repo in a decade, injecting billions of dollars in liquidity, and continued with these operations throughout the month. It will likely do so through early November (with a more permanent solution expected at the next Federal Open Market Committee meeting).



Source: Bloomberg as of September 30, 2019

Market snapshot

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

Bonds	U.S.				U.K.				Eurozone				Japan				Canada			
	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018
	Level	Change (bps)			Level	Change (bps)			Level	Change (bps)			Level	Change (bps)			Level	Change (bps)		
Target Rate*	2.00				0.75				-0.50				-0.10				1.75			
2 YR	1.62	+12	-87	+60	0.37	-3	-38	+31	-0.77	+16	-16	+2	-0.32	-2	-17	-1	1.58	+23	-28	+18
5 YR	1.54	+16	-97	+30	0.29	-5	-62	+18	-0.77	+15	-46	-11	-0.36	-1	-21	-4	1.40	+21	-49	+2
10 YR	1.66	+17	-102	+28	0.49	+1	-79	+9	-0.57	+13	-81	-19	-0.21	+6	-22	-5	1.36	+20	-61	-8
30 YR	2.11	+15	-90	+27	0.97	-4	-85	+6	-0.07	+11	-94	-39	0.37	+22	-35	-9	1.53	+10	-66	-8
5 YR ILBs	0.21	+16	-79	+71	-3.05	-8	-82	-9	1.04	-6	-43	-24					0.22	+18	-43	+40
10 YR Muni[a]	1.47	+20	-85	+31													2.24	+16	-80	+17

Currencies	USD**				GBP/USD				EUR/USD				USD/JPY				USD/CAD			
	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	99.38	0.5%	3.3%	4.4%	1.23	1.1%	-3.6%	-5.6%	1.09	-0.8%	-5.0%	-4.5%	108.07	-1.7%	1.4%	2.8%	1.32	0.5%	3.0%	-7.8%

Equities	S&P 500				FTSE 100				EURO STOXX 50				NIKKEI				SPTSX			
	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018	Sep '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	2,977	1.9%	20.6%	-4.4%	7,408	3.0%	14.3%	-8.7%	3,569	4.3%	21.9%	-12.0%	21,756	5.7%	10.4%	-10.7%	16,659	1.6%	18.4%	-9.6%

Sector Spreads***

	Sep '19	MTD	YTD	2018
	Level	Change (bps)		
MBS[b]	46	-1	+11	+11
IG[c]	108	-3	-33	+54
HIGH YIELD[d]	465	-19	-80	+206
EM External[e]	338	-23	-97	+124

Commodities

	Sep '19	MTD	YTD	2018
	Level	Change		
Oil	$54	-1.9%	19.1%	-24.8%
Gold	$1,466	-3.8%	14.4%	-2.1%
Copper	$258	1.8%	-2.0%	-20.3%
Grains[f]	$28	5.1%	-6.1%	-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. We expect the Federal Reserve to support growth by cutting rates further over the next few quarters.

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. I**nflation 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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