

Summer of Discontent

IN THE WORLD

The U.S.–China trade war escalated to new heights, weighing on risk-asset performance and sending global rates sharply lower.

After little materialized from the Shanghai trade talks at the end of July, President Donald Trump announced tariffs of 10% on an additional \$300 billion of Chinese goods. Shortly after, Chinese policymakers allowed the yuan to sink below 7 against the U.S. dollar for the first time since the global financial crisis, an apparent countermeasure to blunt the effect of the increased tariffs, which then prompted the U.S. Treasury to formally label China a “currency manipulator.” Tensions continued to build, with China adding more tariffs on U.S. goods. The trade developments, coupled with enduring global growth concerns, triggered a “risk-off” reaction across markets: Global stocks fell 2% (MSCI World Index), credit spreads widened, inflation expectations dropped considerably, and 30-year sovereign bond yields from the U.S. to the U.K. to Germany fell by a startling 30–60 basis points (bps). In fact, the move in global yields led to a number of records: Germany issued negative-yielding 30-year bonds for the first time, while U.S. and U.K. 30-year yields likewise fell to all-time lows. In the U.S., the yield curve inverted between two- and 10-year Treasury yields for the first time since 2006.

Against a backdrop of slowing economic activity, central banks committed to easier policy stances.

Evidence of a global manufacturing recession continued to mount in August: Flash purchasing managers’ indexes (PMI) showed slowing in U.S. manufacturing, while those in Germany, Japan, and 10 other countries in the G-20 were in contractionary territory. Data also showed signs of decelerating momentum in the U.S. labor market. Preliminary benchmark revisions from the Bureau of Labor Statistics suggested that the monthly pace of payroll gains was closer to 120,000 (versus the roughly 225,000 pace this time last year), just slightly above the level needed to keep the unemployment rate steady. Importantly, these slower payroll gains have coincided with fewer weekly labor hours – a trend that, if continued, could

eventually hurt consumption (the largest driver of growth in the U.S. economy). Amid the heightened economic uncertainty, central bankers gathered in Jackson Hole for the annual Economic Policy Symposium to discuss the future path of monetary policy. Federal Reserve Chairman Jerome Powell’s remarks broke little ground, suggesting what the market already expected – a 25-bp rate cut in September – but stopping short of outlining further easing. Meanwhile, expectations continued to build for an easing package from the European Central Bank (ECB) in September, and a number of other central banks cut their benchmark interest rates, including New Zealand, Mexico, India, and Thailand.

Outside of trade tensions, electoral developments in Europe and Argentina garnered attention.

In the U.K., Queen Elizabeth II granted Prime Minister Boris Johnson’s request for a suspension of Parliament in September. The request was viewed as an attempt to limit Parliament’s ability to challenge a plan to remove the U.K. from the European Union with or without a deal on the 31 October deadline. Elsewhere in Europe, the Italian government coalition between the far-right League Party and the anti-establishment Five Star Movement collapsed due to ideological differences, though a new coalition appeared to have formed between Five Star and the center-left Democratic Party under the leadership of Prime Minister Giuseppe Conte. That averted the need for snap elections that would have likely favored the League Party and investors responded favorably on expectations of less antagonism with Brussels. As a result, the Italian 10-year government bond yield fell below 1% for the first time in history. In emerging markets, there was a surprise outcome in the PASO (a key national primary) in Argentina – the lead-up to the presidential election in October – as current President Mauricio Macri lagged Peronist candidate Alberto Fernández by a much wider margin than anticipated. With Fernández now a clear favorite to win October’s presidential election, Argentine assets weakened considerably amid uncertainty over how a Fernández administration would handle the country’s debt obligations and Argentina’s critical financing program with the IMF.

RALLY OR RECOVERY?

August’s escalating trade conflict spurred a “risk-off” market reaction – the S&P 500 fell 1.6%, U.S. credit spreads widened 11 basis points (bps), and the U.S. 10-year Treasury yield fell more than 50 bps – putting a small dent in what has been a notably positive year for risk assets. While the S&P 500 is still up more than 18% year-to-date, in the context of the 14% drawdown that began last September and continued through year-end 2018, it may be more accurate to think about 2019 as a risk-asset recovery than a risk-asset rally. Over the full period that includes the fourth-quarter drawdown, equities are about flat (up just 1.8%). What’s perhaps more concerning has been the unusually large move in interest rates over this time period. The U.S. 10-year yield has fallen nearly 160 bps, while at the same time, credit spreads have widened only 12 bps. This relatively modest widening in credit spreads is unusual, especially as growth outlooks have clearly worsened and central banks around the world have stepped in to provide support.

Source: Bloomberg as of 31 August 2019.

Equities represented by S&P 500. Credit spreads represented by Bloomberg Barclays U.S. Credit Index.

Past performance is not a guarantee or a reliable indicator of future results.

	Q4 equity drawdown 9/20/18–12/31/18	Year-to-date 12/31/18–8/31/19	Cumulative performance 9/20/18–8/31/19
U.S. equities: Return (%)	-14.0%	18.3%	1.8%
U.S. credit spreads: Change in spread (bps)	42 bps	-29 bps	13 bps
U.S. rates: Change in 10-yr U.S. Treasury yield (bps)	-38 bps	-119 bps	-157 bps

Market snapshot

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

Bonds	U.S.				U.K.				Eurozone				Japan				Canada			
	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018	Aug '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	1.50	-37	-98	+60	0.40	-4	-35	+31	-0.93	-15	-32	+2	-0.30	-9	-16	-1	1.351	-19	-50.9	17.5
5 YR	1.39	-44	-112	+30	0.33	-5	-57	+18	-0.92	-21	-61	-11	-0.35	-11	-20	-4	1.187	-25.9	-69.8	2.2
10 YR	1.50	-52	-119	+28	0.48	-13	-80	+9	-0.70	-26	-94	-19	-0.27	-12	-27	-5	1.161	-31.4	-80.4	-7.6
30 YR	1.96	-56	-105	+27	1.02	-30	-80	+6	-0.18	-30	-105	-39	0.16	-20	-56	-9	1.426	-26.9	-75.6	-8.2
5 YR ILBs	0.05	-23	-95	+71	-2.97	-3	-74	-9	1.10	-23	-37	-24					0.036	-13.4	-60.9	39.9
10 YR Muni ^a	1.27	-27	-105	+31													2.078	-25.5	-95.2	16.7
Currencies	USD**				GBP/USD				EUR/USD				USD/JPY				USD/CAD			
	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	98.92	0.4%	2.9%	4.4%	1.22	0.0%	-4.7%	-5.6%	1.10	-0.8%	-4.2%	-4.5%	106.26	2.4%	3.2%	2.8%	1.33	-0.9%	2.4%	-7.8%
Equities	S&P 500				FTSE 100				EURO STOXX 50				NIKKEI				SPTSX			
	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018	Aug '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	2,926	-1.6%	18.3%	-4.4%	7,207	-4.1%	11.0%	-8.7%	3,427	-1.1%	16.9%	-12.0%	20,704	-3.7%	4.4%	-10.7%	16,442	0.4%	16.5%	-9.6%

Sector Spreads***

	Aug '19	MTD	YTD	2018
	Level	Change (bps)		
MBS ^b	47	+9	+12	+11
IG ^c	111	+10	-30	+54
HIGH YIELD ^d	484	+64	-61	+206
EM External ^e	361	+28	-74	+124

Commodities

	Aug '19	MTD	YTD	2018
	Level	Change		
Oil	\$55	-5.9%	21.3%	-24.8%
Gold	\$1,523	6.8%	18.9%	-2.1%
Copper	\$253	-5.0%	-3.7%	-20.3%
Grains ^f	\$27	-6.0%	-10.7%	-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 is likely to accelerate somewhat as corporations pass on higher import tariff costs.** With growth likely to continue slowing and higher downside risks from recent U.S. trade policies, the Fed has adopted a more dovish stance and looks likely to cut rates further in 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 relatively less likely than other scenarios. **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. **Core CPI inflation is expected to dip into negative territory** (due to temporary factors).

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.

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