“As Good As It Gets”

The word “peaking” rapidly became the buzz phrase of our investment policy discussions in April, with a number of leading indicators struggling to keep momentum for the first time in months. Could it be time to adopt a more cautious tone on the outlook for the global economy?

Since its trough in the spring of 2016, the global economy has accelerated meaningfully, driven by looser global financial conditions, the stabilization in commodity prices, and the delayed impact of Chinese stimulus measures taken early last year. As the impact of stimulus in both China and the developed world starts to fade and demand moderates, due to commodity prices eroding consumer purchasing power, the momentum in global growth could start to slow. There are some early signs this has started.

“Global PMI data seems to have reached a peak,” said Portfolio Manager and Head of International Fixed Income Arif Husain. “Much of what has lifted the global economy is down to China. If that stops or diminishes, it’s difficult to see where the next catalyst for a rise in growth expectations can come from.”

–Arif Husain, Portfolio Manager and Head of International Fixed Income

shifted toward monetary tightening. At the same time, authorities have introduced measures to cool the property market. The confluence of these factors should eventually have an effect on growth.

Even so, the global investment team noted that the current mood in markets is one of optimism for global growth. This is based mainly on the back of so-called soft data, such as surveys and confidence indicators, reaching high levels. So far, however, real evidence through hard data has failed to impress as much. Could it be that the market is expecting too much from the new Trump administration?

“For failure to deliver on tax cuts and other preelection policies will dent confidence

“For now, growth in China continues to hold up well. But the central bank has
and possibly cap real economic growth,” said Mr. Husain. “Unless we see a comprehensive reform agenda, there’s a risk that pessimism takes over, causing interest rates in core markets to decline. This is why long-dated bonds in the U.S. look attractive right now, in my opinion,” added Mr. Husain.

When assessing the potential implications of slower growth, the team also focused on sectors and companies. They noted that with the exception of banking, most equity sectors that initially rallied after the U.S. election have now witnessed a substantial retracement. This contrasts with credit markets, where spreads have continued to grind tighter with little divergence among industries. If the global economy has indeed reached an inflection point and momentum starts to turn down, it’s unlikely this trend can continue.

“U.S. automakers seem to be the most vulnerable to a slower growth scenario at this point in the cycle,” said Mr. Husain. Commodity-related companies as well as infrastructure names could also come under pressure in such a climate, while other companies, such as pharmaceuticals, could benefit from a standstill, he added.

Interestingly, the team noted that a lack of growth momentum may not impact European bonds to the same extent as other countries and regions due to the divergence between soft and hard data there not being as large. While growth disappointment would certainly lead to an underperformance of periphery sovereign bonds and corporate bonds in the short term, that underperformance is also more likely to be contained as it may force the hand of the European Central Bank to lengthen its bond buying program.

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~Arif Husain, Portfolio Manager and Head of International Fixed Income

Past performance is not a reliable indicator of future performance.
Sources: National Federation of Industrial Business and T. Rowe Price.

FIGURE 1: Has small business optimism already peaked in the U.S.?
As of March 31, 2017

![Graph showing NFIB U.S. Small Business Optimism Index from 1991 to 2017.]

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Sources: National Federation of Industrial Business and T. Rowe Price.
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