The shifting sands of global cyclical momentum

By Richard Thies

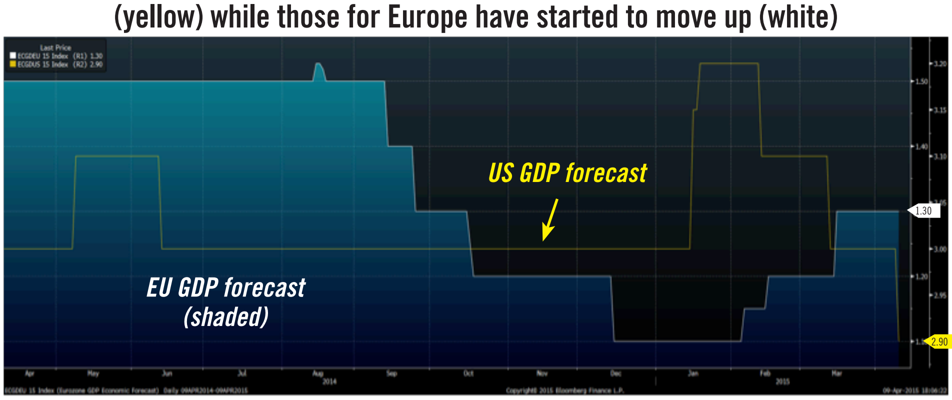
An exciting first quarter of the year crystallized some recent themes and brought a few important new developments to the forefront of investors' attention. In our view, three of these developments explain a majority of the recent gyrations in asset markets. Namely, the quarter brought a significant shift in the composition of global growth momentum that caught many off guard. Secondly, the now-familiar ascent of the US dollar during the quarter sent more ripples across the global economy as well as the equity and credit markets. Finally, rapidly falling sovereign yields, particularly in Europe, continue to have far-reaching consequences across all asset classes.

US vs. Europe

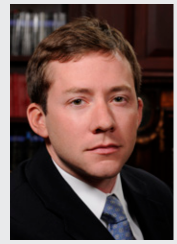
Arguably the most important new development of the first quarter from an allocation perspective was the shifting economic momentum displayed by developed market economies. The consensus during 2014 was that the US economy was great and everything else, especially Europe, was awful—a consensus supported by the performance of US assets. However, as we discussed at length in our [last quarterly commentary](), investors were exaggerating both the dire state of the European economy and simultaneously understating the potential for a positive surprise from the European Central Bank (ECB) in response to it. The evidence from the first quarter suggested economists were caught off guard by the performances of the respective economies (Exhibit 1) just as investors were surprised by the strength of the ECB's quantitative easing program, judging from recent relative equity price performances.

Let's focus on the differing cyclical behaviors of the eurozone and the US in recent months because those are the most interesting, as Japanese economic momentum stayed relatively steady and the emerging market economies continued to slow during the quarter. First, the US economy was a disappointment in the first quarter, likely growing less than 1.50% quarter over quarter and a far cry from consensus' expectation of a 3% quarterly expansion. For the second year in a row, the blame is falling on another brutal winter. That's undoubtedly

Exhibit 1: US GDP forecasts for 2015 have trended down throughout the year (yellow) while those for Europe have started to move up (white)



Source: Bloomberg



About the Author

Richard Thies is an assistant portfolio manager. He provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. Also, at the request of portfolio managers and analysts, he provides in-depth analysis of specific events and potential scenarios at the region, country and sector levels.

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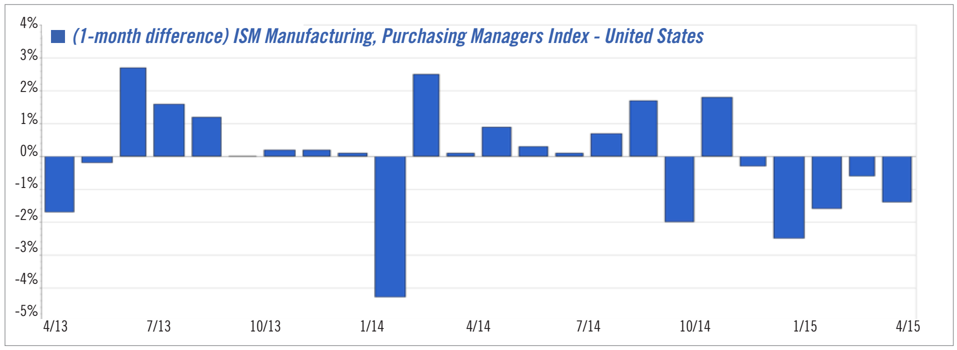
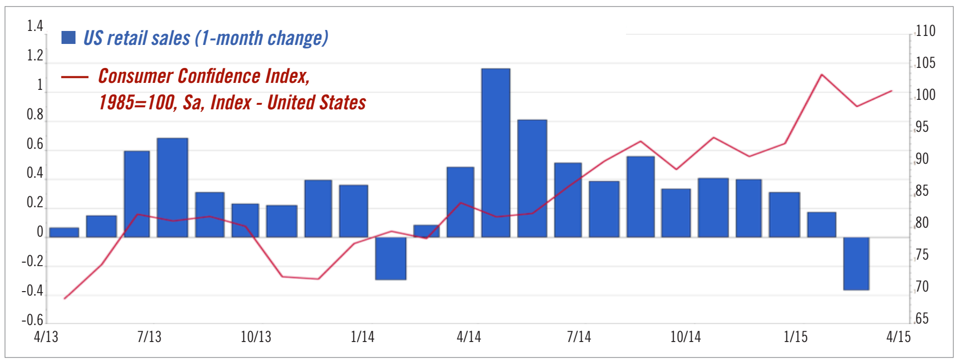
Exhibit 2: US Manufacturing PMI feeling effects of dollar long before the weather started to affect activity (m/m change in PMI)



Source: Factset

Exhibit 3: US retail sales, excluding the effect of lower gasoline sales (blue), has been losing momentum inexplicably, despite quickly improving confidence indicators (red)



Source: Factset

Exhibit 4: European consumer confidence has moved higher in recent months as have actual sales volumes

Source: Bloomberg

part of the story but consider two additional realities. The parts of the US economy that are sensitive to dollar strength are relatively few, but those that are affected by dollar strength started deteriorating long before the weather turned south, a reflection of declining competitiveness (Exhibit 2). Further, consumer spending, the engine of expected incremental growth in 2015, has not only failed to materialize, it has deteriorated since the oil price began to fall last summer (Exhibit 3).

Consumer spending will likely bounce back in the coming quarters given the supportive backdrop. Our view is that consumers take a long time to adjust to new realities and expectations for an immediate increase in spending of the gas “tax cut” was unrealistic, but it should come soon. We also expect the US manufacturing and industrial sector to continue to underperform globally. Overall, that leaves us expecting a small recovery in consumer spending, continued weakness in investment and the manufacturing sector, and no notable change in the fiscal impulse. We are of the view that this year’s US growth expectations are still too high.

On the other side of the Atlantic, cyclical data has been clearly improving, albeit off a depressed base. In contrast to their American counterparts, European consumers appear to be spending their oil price windfall. Europe has seen the biggest change to the consumption environment in recent months, with consumers aided by improving job prospects, lower energy bills, thawing bank credit and less deflationary fears. Retail spending has followed confidence higher and is currently growing 3% year over year in volume terms, the same level as in the US. We rely heavily on inflection changes in our investment philosophy and use the same approach to interpreting macro changes. As such, we view Europe’s recent ascent to a 3% growth rate as more important than the 3% US growth rate, which has been steady since 2012 (Exhibit 4).

Outside of the European consumer, there are the better-known phenomena that the weak euro is having a powerful effect on Europe's relatively more open economy. Manufacturing surveys look good and the sector is starting to contribute more to growth, though investment is languishing, similar to other developed peer economies. Finally, the biggest change is that the fiscal spending will be even more supportive this year after several years of below-trend growth (Exhibit 5). With everything moving in the right direction, the ECB's quantitative easing program comes along at a perfect time. We remain confident that the program will work, both for asset markets and the real economy. Further, we still believe the "peak deflationists" unfairly punished the European economy for the massive contraction in the ECB's balance sheet in 2014, which any economy would struggle to overcome.

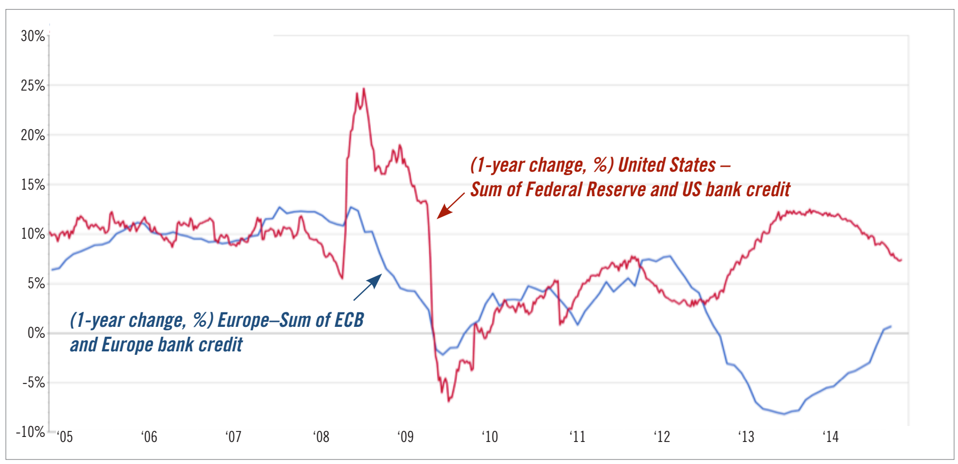
Why do these recent changes matter?

As noted previously, incremental changes to long-term trends are important, so it goes without saying that we find the recent economic improvements in Europe significant. In addition, the following three points give us confidence that this trend should not be ignored. First, the behavior of key leading indicators suggests the divergence from below-trend growth will continue. Manufacturing surveys in Europe are being consistently led by orders ahead of production and the currency dynamics support that continuing. We also believe that European exporters will be much more aggressive in using this supportive backdrop to secure market share than their Japanese counterparts did (or didn't, in most cases). The ECB balance sheet isn't the only thing growing in Europe, as commercial banks are starting to lend. The combination of the two (central bank plus commercial bank credit) is diverging massively between the US and Europe and we anticipate that to get more extreme, directly affecting economic growth (Exhibit 6).

Exhibit 5: Government consumption drag has been significant relative to history in Europe (y/y growth rate of government consumption)

Source: Bloomberg

Exhibit 6: Total credit growth (central bank plus commercial banks) suggests diverging trends in the EU and US, with much more divergence to come (blue is Europe, red is US)



Source: Factset

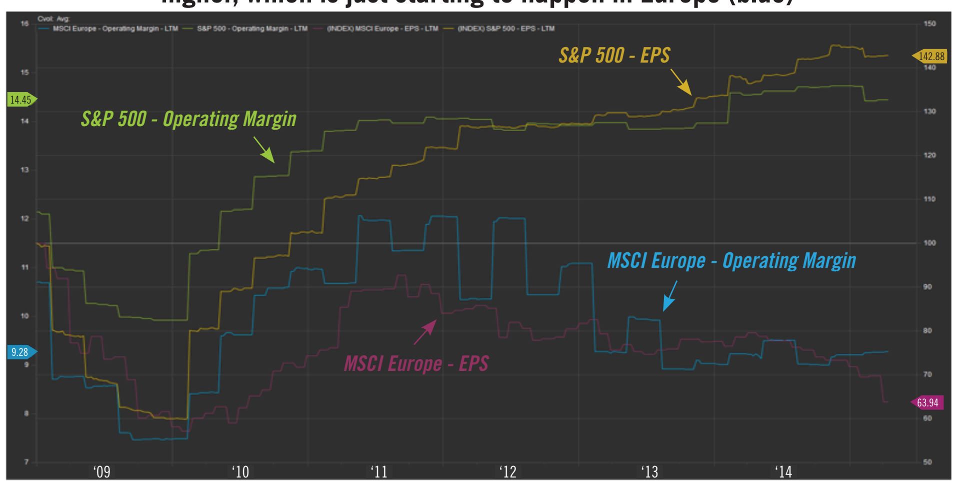
Heading into the year, European equities traded at a substantial discount to their US peers, a disparity that has now closed. On a trailing basis, Europe is actually at an 11% premium to the US, but at what is most likely trough earnings (Exhibits 7 & 8). While deficient economic growth has certainly weighed on European earnings over the past several years, a bigger difference is that European corporates haven't benefited from margin expansion as much as American companies, with operating margins nearly as bad as they were in 2009. Going forward, we expect this trend to reverse somewhat. With the health of the financial system finally improving, European corporates can reduce debt cost and restructure balance sheets in a similar vein as the Americans have done since the financial crisis. The expected wage increases in the US in 2015 and beyond will likely chill margins, a development unlikely to present itself in Europe outside of Germany. Currency dynamics have long been working against European companies and working for US margins, a situation that is clearly reversing itself as suggested by the US trend in first quarter early earnings reports and pre-announcements.

Perhaps most important, the incredibly weak earnings trend displayed since the financial crisis reflects, in simple terms, a reality of the post-crisis world that looks like it is about to change. European earnings, margins, and sales used to correlate strongly with those in the US as both shared developed economy status in a steady global growth environment. The weakness of European earnings since that time is a clear illustration of the growth the global economy has been missing. Its recovery will likely push global growth above trend meaningfully (assuming no pitfalls elsewhere), which should have a big effect on how investors view asset markets.

Exhibit 7: Trailing 12-month P/E for Europe (blue) and the US (green)

Source: Bloomberg

Exhibit 8: But the US has seen large operating margin expansion push earnings higher, which is just starting to happen in Europe (blue)



Source: Bloomberg

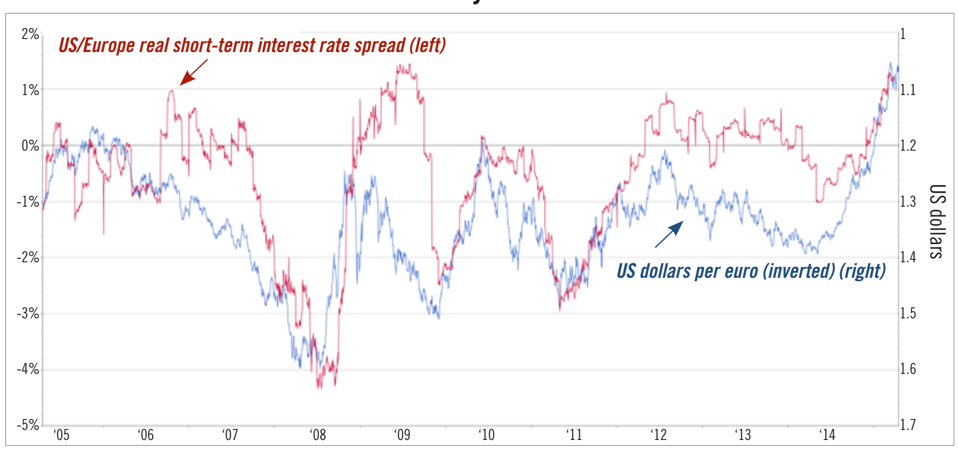
We'd be remise not to end this discussion of the changing dynamics in the US and Europe with what we suspect is an important disclaimer. We recognize the long-term structural advantages the US economy and its corporate sector have over the European equivalents (so please don't question our patriotism!), including: demographics, more centralized decision-making, significantly less leverage in the financial sector, a healthier public debt outlook, friendlier immigration policies, and the intangible superior history of innovation. Recognizing those, it's not clear to us that markets react to the long-term changes as much as to the shifting sands of cyclical changes, allowing the short-term to infect views on the long-term. If European momentum continues to improve as we expect, we wouldn't be surprised if the long-term structural view starts to shift as well.

We leave this discussion with one example that, to us, perfectly illustrates this phenomenon. Long-term interest rate swaps should be something of a proxy for the market's view on potential growth rates. For example, a country with a higher potential growth rate will theoretically require a higher policy rate in the future to bring inflation to target, meaning the long-term policy swap rate will be higher. In reality, however, the long-term assumptions are deeply affected by what's happening today. While one would think the eurozone's flaws were easy to spot even before the crisis, the difference between long-term interest rate expectations in the US and Europe typically tracks the difference in realized GDP growth, not investors' prognostications about the long-term potential of the two continental economies. In sum, we don't understate the ability of the cyclical to change views on structural realities, no matter how wrong they may ultimately be (Exhibit 9).

Exhibit 9: Long-term interest rate differentials between the US and Europe (yellow) follow cyclical changes despite being an indicator of structural differences (green—spread between US and EU GDP growth)

Source: Bloomberg

Exhibit 10: The Euro/Dollar relationship is underpinned by real short-term yield differentials



Source: Factset

The tired dollar

Given how much ink we (and others) have spilled on the dollar's meteoric rise, we briefly considered sparing you from more discussion of it in this quarterly commentary. Instead, we will focus on one element of the conversation. Namely, that the dollar's rapid appreciation has gone from broad-based in the second half of 2014 to a bit more selective in the past quarter, becoming less a 'dollar strength' story as more a 'euro weakness' one. With that in mind, we want to highlight that for all the hyperbole, punditry and one-sided positioning of this trade, it remains almost entirely supported by fundamentals. The spread between real short-term yields in Europe and real short-term yields in the US has long been the underpinning of the currency relationship, with some variations due to central bank balance sheet size (Exhibit 10).

With the trend in the US data currently disappointing, we are not in the camp that short-term US yields and the US dollar are set for a sharp rise. However, we see a few ways that the spread could widen further and bring the euro down even more. First, assuming the Federal Reserve does hike interest rates by the end of this year and there is little economic effect, the market could quickly reconsider the pace of the tightening cycle and push the two-year yield higher.

Secondly, with many European two-year yields already below the -20 basis points limit for ECB purchases, it is uncertain how much lower they can fall. However, given the behavior of bonds in Europe and very low new supply of short-term government bonds, it wouldn't surprise us if they fell further. While we expect inflation to rise faster over the coming 18 months in the eurozone and in the US, there is little chance higher inflation brings yields higher in Europe as it will in the US, meaning the real yield spread would drive the euro lower. We maintain our view that the dollar strength is at risk in the very short term given the poor US data, how one-dimensional the strength has become, and how crowded the trade is. Longer term, however, we believe the trend gets even more extreme.

A final note on the tired dollar is one that brings us some dismay. In recent research, the Federal Reserve suggested that the real appreciation of the dollar is roughly equivalent to tightening financial conditions by between 1.00% and 1.50%. With that in mind, we thought the dollar's strength would have something of a self-limiting effect, where its strength tightened conditions and gave the Fed some additional breathing room. A private meeting last month with a recent FOMC voting member suggested that was anything but the case, citing the committee's strong desire not to give any impression that they are managing policy to the exchange rate. We find this both surprising and discouraging, and it further suggests a runway for medium-term dollar strength.

Searching (and finding) yield

Our third and final theme affecting asset markets in the first quarter was another very well-discussed one, namely the further fall in US long duration bond yields. While no sell-off in US Treasurys would be expected in light of the poor US data, there was some relatively hawkish commentary with the Fed indicating it clearly still plans to raise rates, and the improved global cyclical data usually moves US yields higher. All the same, commentary throughout the period again consistently expressed consternation about the low level of yields and surprise that they haven't risen in response to the Fed's tightening ambitions. We challenge the conventional wisdom that yields are low by asking, "in relation to what?"

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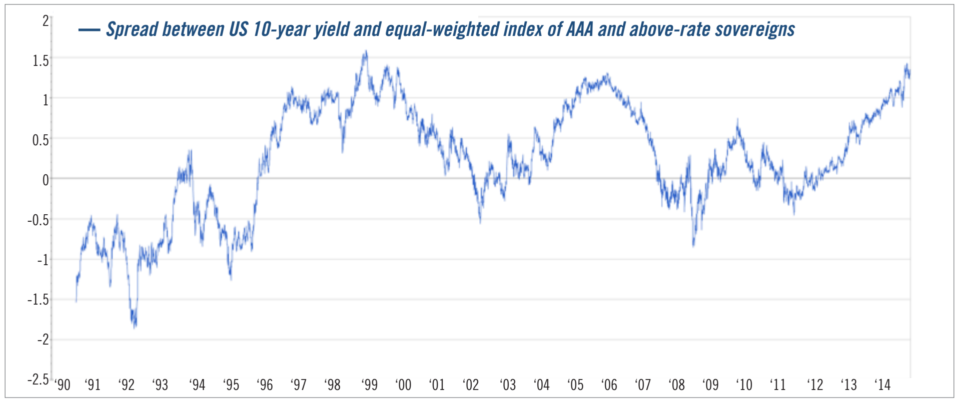
We can think of a few simple ways to answer this question. First, nominal yields are certainly 'low' with regard to historical levels, which doesn't tell you anything useful. On a real basis, using the Fed's five-year breakeven inflation measure, real yields are around zero—right where they've been for most of the post-crisis period. While historical comparisons don't tell you much about the intrinsic value of bonds, term premium should (shows value of a long bond versus the return of rolling over shorter duration bonds), and on this score bond yields look low with term premia slightly negative.

However, term premia have been much more negative in the past and it's not clear that even a term premium model is perfect anymore. Preferences vary significantly among investors and rolling over shorter-duration bonds instead of buying a long bond are not, in reality, perfect substitutes, when some buyers, such as pension funds, have a preference for longer duration maturities. Alternatively, a final measure shows that yields are quite high. Given that about 40% of US bond holders reside outside of the country, the incremental buyers look at whether yields are high or low in relation to their other options. On this, yields are unequivocally high and are at a point that has historically brought resistance (Exhibit 11). Maybe this time is different?

Exhibit 11: US 10-year yields look precariously high when compared to an equal-weighted spread of AA-rated and above sovereign alternatives



Source: Factset