For journalists and media representatives only

Why is the global economy vulnerable to a deflationary shock?

By Ariel Bezalel, Head of Strategy, Fixed Income

Ariel Bezalel, Head of Strategy, Fixed Income, discusses the factors driving the rallies in stock and bond markets year to date and why he believes the global economy is vulnerable to a deflationary shock.

There is a striking disparity between the signals given by both stock and bond markets year to date. Both have rallied – stock markets have retraced much of Q4's losses, while government bond markets have benefited from lower yields. But economic fundamentals paint a subdued global outlook. China's economy has continued to slow down overall, despite an inconclusive bounce back in March's PMI's. Countries around China have been weak for quite a while, with Taiwan, South Korea and Singapore exports all seeing somewhat lower exports year-on-year. Economic activity is sluggish across Europe with many countries in a technical PMI-recession where readings are below 50 (led by Germany and Sweden which are correlated to China's growth).

It is worth taking a closer look at the stock market rally. Cyclical sectors such as energy, industrials, materials and financials have all underperformed, which suggest they are mirroring the macro concerns signalled by the bond markets. Oil and iron ore prices have been strong this year, but they seem to be driven by supply rather than demand. Given the vast amount of share buybacks within the US stock markets, it will be interesting to see if volatility spikes during April when many companies are in their blackout period.

Weaker inflation data, slowing M1 money supply growth, and flattening or inverting yield curves are now global headaches for central banks, with Canada, Australia, New Zealand and Germany joining the US in indicating either pauses to interest rate hikes or interest rate cuts. In March, Germany even issued a negatively yielding 10-year Bund for the first time.

While the perennial debate continues about how accurate the yield curve is for predicting (or even causing) recessions, its past success rate means investors ignore it at their peril. Historically, the flattening/inverting of the yield curve has led to a recession 85% of the time; then-Fed Chairman Alan Greenspan dismissed the flattening yield curve in 2005 and future Chairman Ben Bernanke infamously blamed it on a "global savings glut". At a minimum, we believe it reflects just how late cycle many developed market economies are. The late stage of the US economic cycle underpins what will become the longest bull market in post-war history come July, which by itself warrants caution and is a strong signal to consider de-risking as an appropriate strategy.

Structurally, we believe the world is vulnerable to a deflationary shock. We continue to position the portfolio defensively for a further slowdown in growth, with the view that the global economy is going to struggle under the weight of too much debt and a deteriorating demographic profile, especially in the developed world. We have long believed that increasing concerns over a global slowdown will inevitably bring quantitative tightening to an end in the US and that rate cuts could well be on the agenda come the second half of 2019. Meanwhile, in Australia, the housing market slump continues to reveal concerning parallels to the Irish housing market crash in 2009, with a banking sector that is heavily reliant on foreign creditors and high levels of household debt. We therefore continue to maintain a barbell approach that balances AAA-rated US and Australian government bonds with a selection of high-yielding, short duration investments.
