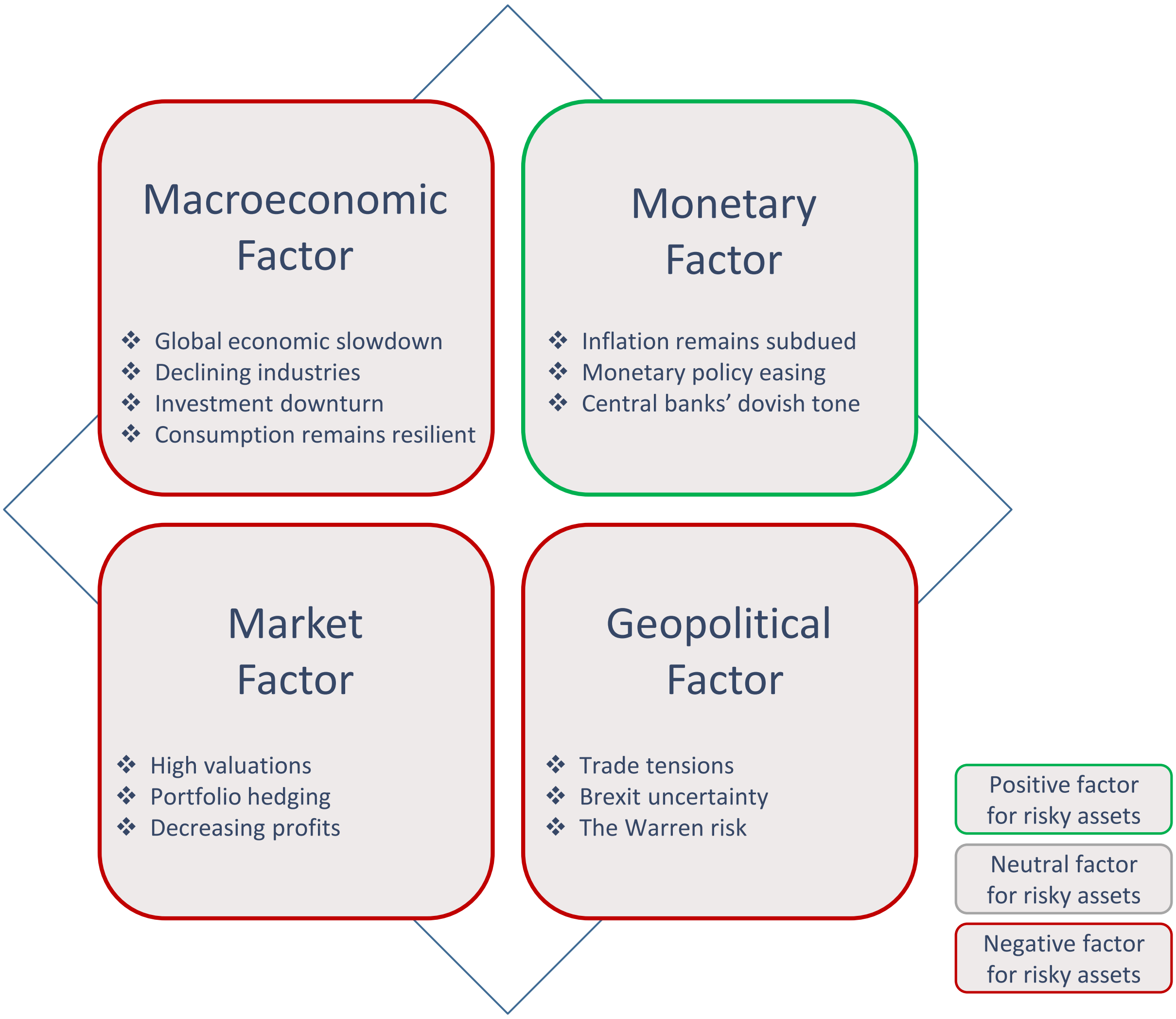
October 2019

T. JOURDE

Can the global economy be revived?

Key Points

- Economic activity is slowing down due to increased uncertainties and slowing trade flows.
- Fears of a deflationary spiral in the euro zone are back.
- Central banks announced new packages of measures to boost inflation and growth.
- Monetary policy needs to be supplemented by fiscal policy (policy mix).

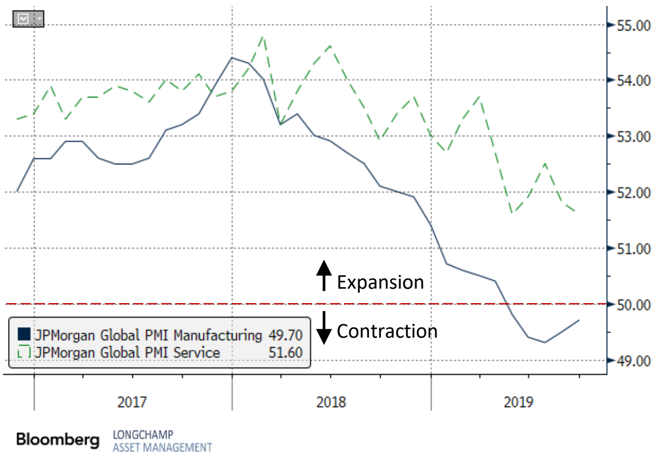


Synchronized economic slowdown

- **The global economy is facing a synchronized slowdown (see Fig. 1) as a result of increased uncertainties and slowing trade flows** (lower external demand).
- The manufacturing sector was the first to be hit and is now showing signs of recession. The service sector is more resilient but not immune to this slowdown (see Fig. 2).
- Under these conditions, central banks are doing their utmost but will not be able to revive the economy without the support of governments.

Fig. 1. GDP growth

Fig. 2. Manufacturing and service PMI



Downturn in international trade

- Trade tensions have severely impacted international trade, which experienced its **sharpest decline since 2009** in the last quarter (see Fig. 3).
- **The most opened and exporting countries, such as Germany and Korea, are likely to be the most severely impacted by the trade downturn**. In contrast, the US economy is more resilient to external shocks and may even benefit from an improvement in its trade balance (see Fig. 4).

Fig. 3. Trade volume and industrial production

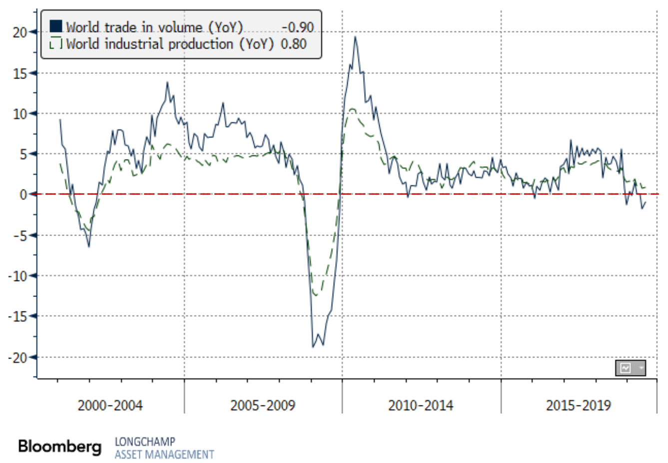
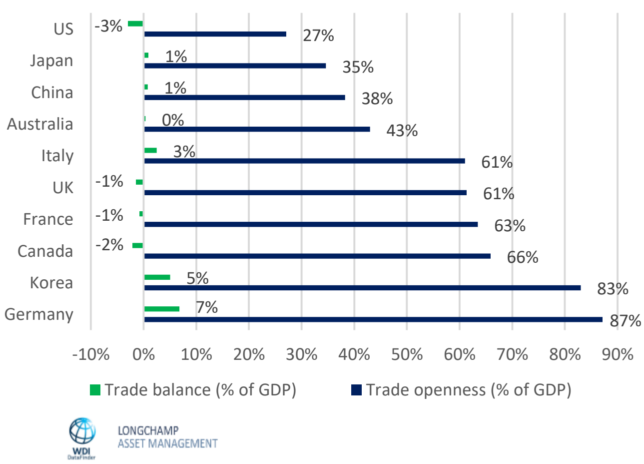


Fig. 4. Trade openness and balance



Avoiding the deflation spiral

- The shortfall in inflation (see Fig. 5) and the decline in inflation expectations (see Fig. 6) raise concerns about the **danger of a deflationary spiral**, especially in the euro area where interest rates have already reached the zero lower bound.

- One of the **key lessons of the Japanese experience** is that timely actions by monetary and fiscal policies are necessary to prevent the anchoring of expectations at a low level and avoid an harmful equilibrium (prolonged period of low inflation and zero interest rates).

Fig. 5. Consumer price indices (yoy)

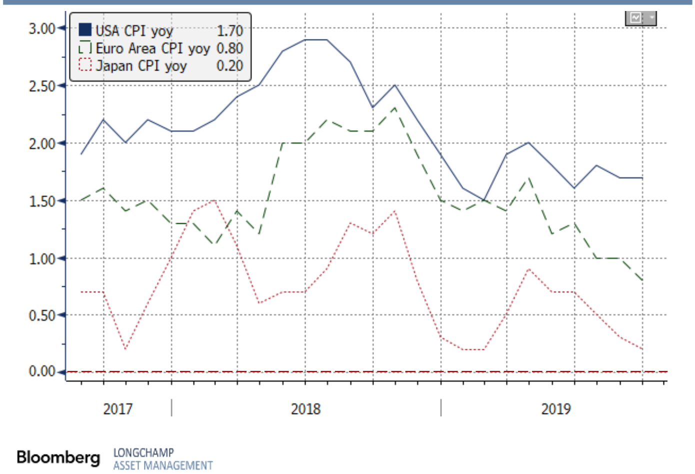
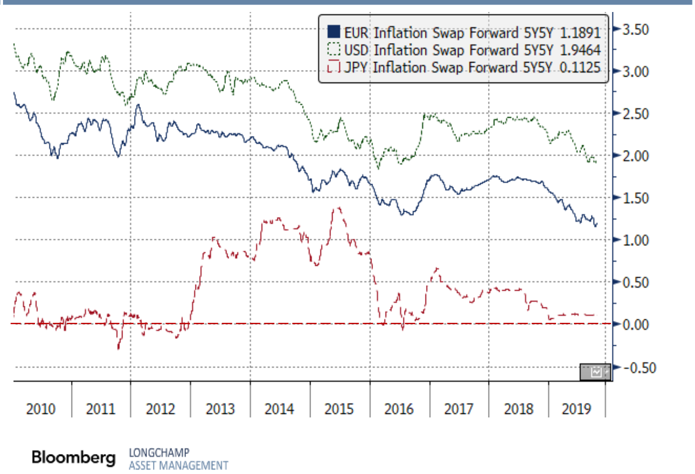


Fig. 6. Inflation expectations



Central banks at work

- The Fed reduced its target rate twice in recent months (see Fig. 7). Moreover, the Fed announced that it will **resume the expansion of its balance sheet (see Fig. 8) to ease upward pressure on short-term interest rates** (purchase of Treasury bills - $60 billion per month).

- **The ECB adopted a new package of measures to revive inflation and growth**, including (i) a 10 bps reduction in deposit rates (see Fig. 7), (ii) a system to offset the adverse impact on banks (tiering), (iii) more favorable conditions for TLTRO, and (iv) a restart of asset purchases (€20 billion per month from November 2019).

Fig. 7. Fed target and ECB deposit rates

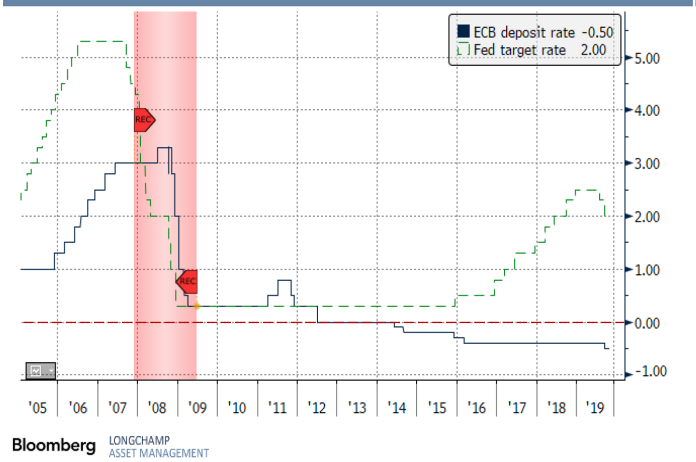
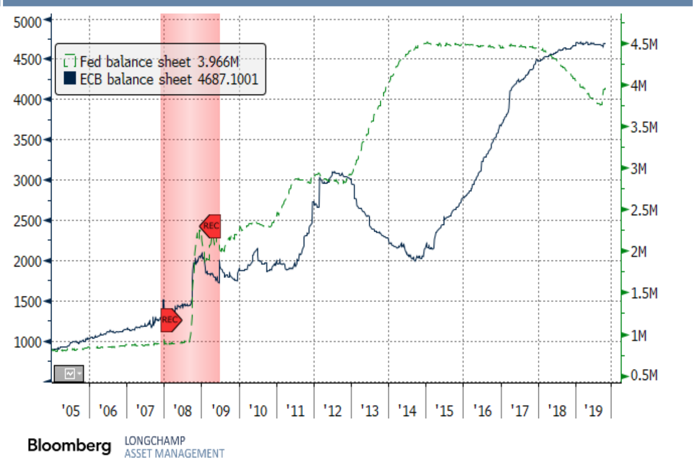


Fig. 8. Fed and ECB balance sheets



Need for fiscal stimulus in the euro area

- Monetary policy easing has probably reached its limits of effectiveness and should be supplemented by fiscal policy (policy mix).
- **The ECB has created a low interest rate environment allowing governments to pursue fiscal measures, while keeping public debt stable**. This is notably true in countries where growth is higher than interest rates and debt levels are low (e.g., Germany, Netherlands, Finland, Ireland and Austria; see Fig. 9 & 10).
- Such policy would boost domestic demand throughout the region and help to stop the synchronized slowdown in the global economy.

Fig. 9. Government budget and GDP growth

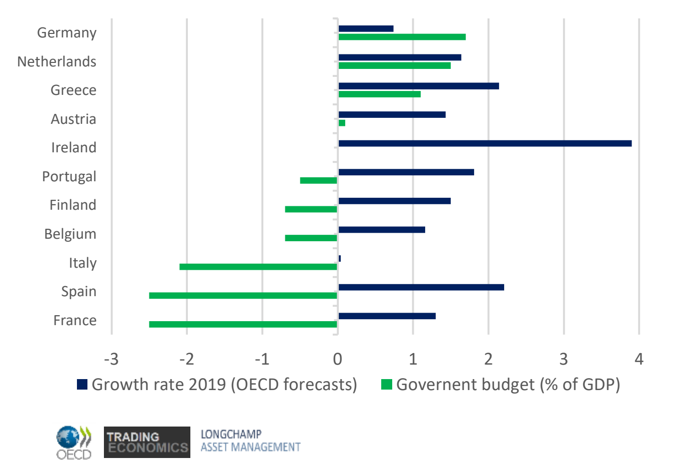
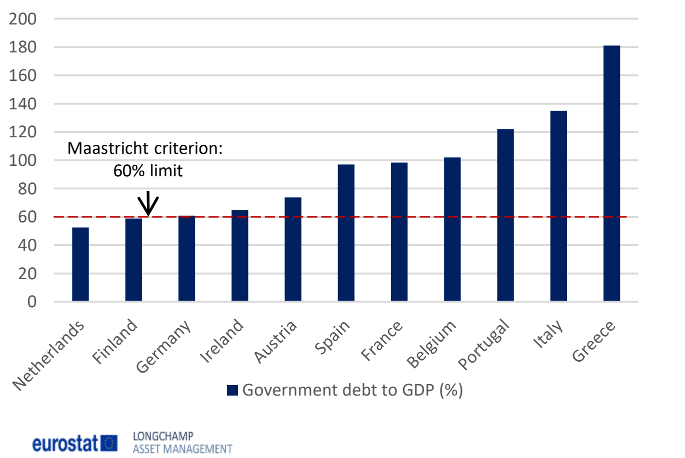


Fig. 10. Public debt (% of GDP)



Chinese economic activity and financial stability

- The stimulus package (mainly focused on the private sector) and the monetary policy easing have a high cost on financial stability (Fig. 12) and limited efficiency (the GDP growth slowed to +6% yoy in the third quarter; see Fig. 11).
- This highlights the strength of the slowdown drivers in China, including uncertainties, the downturn in the international trade, and the transition to a service-oriented economy. In this context, **a rebound in public investment will be necessary to prevent further economic slowdown.**

Fig. 11. GDP growth

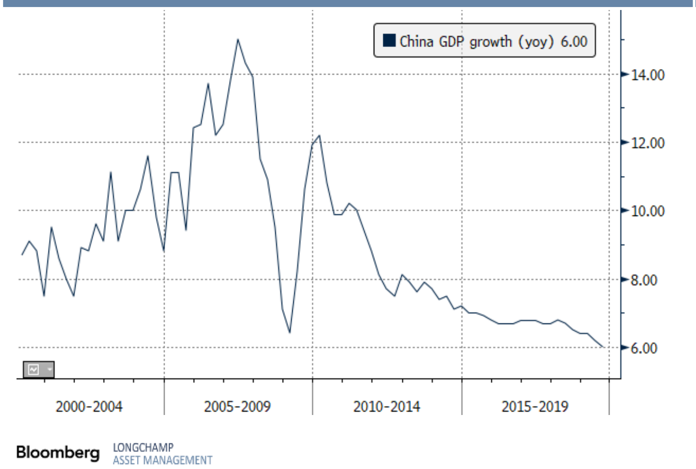
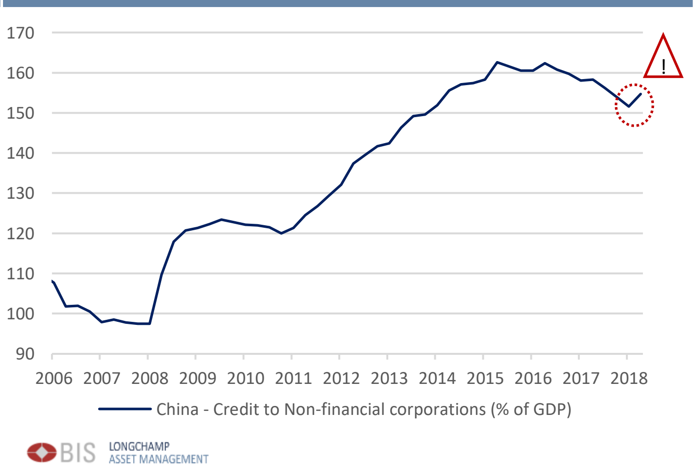


Fig. 12. Corporate debt (% of GDP)



Elisabeth Warren's political rise

- In recent months, **E. Warren has gained popularity** according to surveys (see Fig. 13) and prediction markets. In addition, polls show that E. Warren would win against D. Trump in the general election (see Fig. 14).

- E. Warren's agenda includes an increase in corporate and high-income taxes, a doubling of the minimum wage, the regulation of GAFAM, the re-introduction of the Glass Steagall Act and the prohibition of fracking. **This program would have a negative impact on the firm's profits**.

- Hence, we believe that **the prospect of her victory could lead to a significant market correction**.

Fig. 13. Democratic nomination (polls)

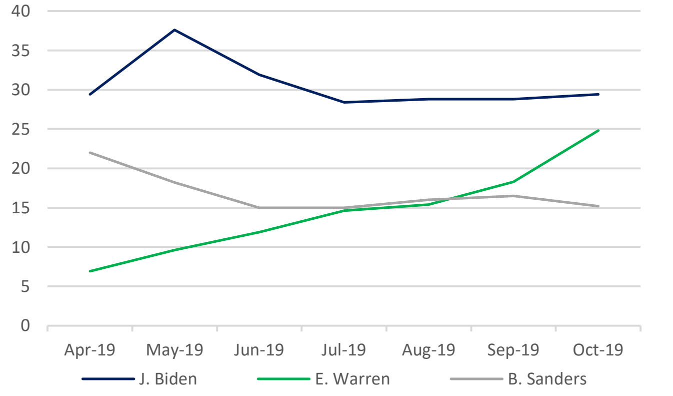


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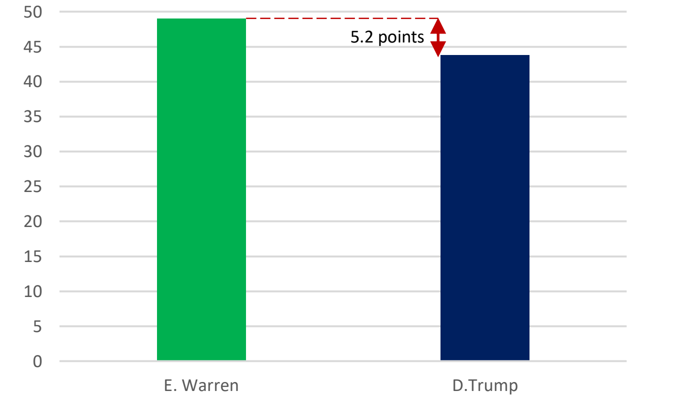
Fig. 14. General election: Trump vs. Warren (polls)



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Market fundamentals and investor sentiment

- **Stock market valuation exceeds their long-term average in most countries** (see Fig. 15). The incentive to buy stocks in such a situation is low.

- Over the past few months, investors have also purchased put options to protect their portfolios. As a result, **the put/call ratio based on the S&P500 index recently reached a 10-year high** (see Fig. 16). This is a sign that investors are increasingly aware of the economic and geopolitical risks.

Fig. 15. Equity valuation (Z-score)

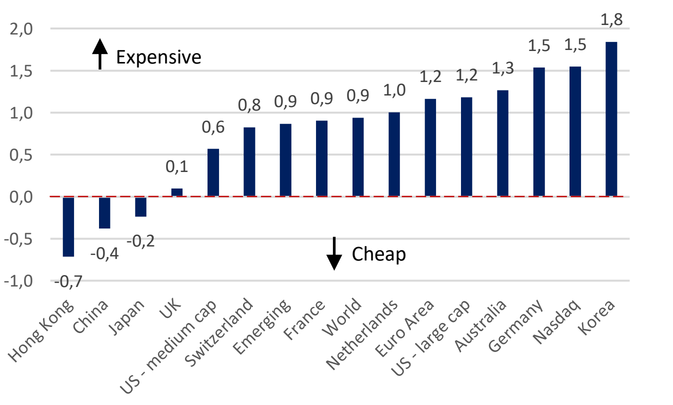

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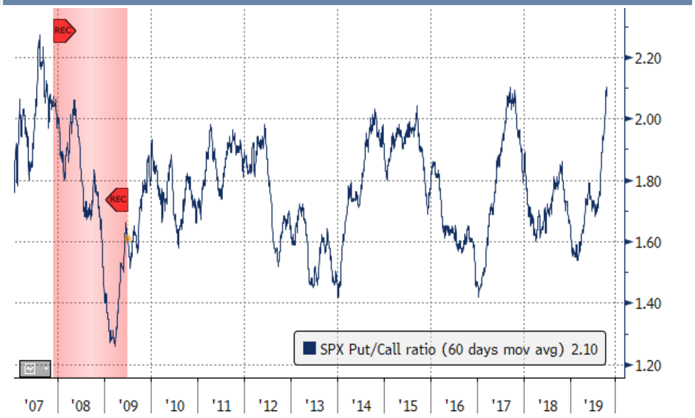
Fig. 16. Put/call ratio (S&P 500)



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Asset allocation

- **Stock markets have recently been buoyed** by: (i) expectations of a partial trade agreement between China and the United States; (ii) hopes of a Brexit with agreement and (iii) monetary policy easing.

- However, optimism about the early resolution of these conflicts is likely to be short-lived. In addition, **the deterioration of the economic activity is set to continue** and fiscal stimulus should be insufficient to revitalize the economy (estimated at +0.3% in 2020 in the euro area).

- Therefore, we continue to **recommend a prudent asset allocation**. Regarding the equity class, we propose to **overweight low volatility and defensive stocks**, which tend to outperform during turbulent times.

- We also expect **a continued decline of sovereign yields** due to the ongoing economic slowdown and monetary policy easing. In particular, we **overweight US Treasury bonds**, which offer more attractive interest rates than European bonds. In addition, we **keep our exposure on Italian bonds,** as the political situation keeps improving (the coalition between the Democratic Party and the M5S has won the confidence of the Senate).

- We keep our **EURUSD long position**, as (i) the Fed has more leeway than the ECB to reduce the rates and (ii) currency valuation models indicate that the dollar is overpriced. We also maintain a **short position on the GBPUSD,** as a long-term insurance against a deterioration in the UK economic activity. We also remain **exposed to the yen**, which is a safe haven currency.

- Finally, our **position on silver** has performed well in recent months. In fact, demand for silver increased amid (i) uncertainty, (ii) low interest rates, and (iii) cheap price compared to gold.

Key Trades - as of October 18, 2019

Asset class	Key trades	Direction	Returns	Start date	P&L LtD (local/hedged)	P&L LtD (in euro)	P&L MtD (local)
Equity	Low volatility factor	Long	%	June-19	3,3%	4,6%	0,3%
	Defensive vs Cyclical	Relative value	%	May-19	-3,5%	-3,6%	-0,7%
Bond	US Linkers	Long	Bps	January-19	-60,6	-60,6	-2,1
	Italy	Long	Bps	September-18	-238,5	-238,5	10,5
FX	EURUSD	Long	%	April-18	-0,3%	-0,3%	2,5%
	GBPUSD	Short	%	August-19	-7,5%	-7,5%	-5,7%
	USDJPY	Short	%	January-18	0,9%	0,9%	-0,3%
Commodities	Silver	Long	%	October-18	23,2%	24,7%	3,3%

Contacts

Sarah ALFANDARI, Sales

Sebastien CABROL, Portfolio Manager, Head of Research

Tristan JOURDE, Economist, PhD Candidate

Longchamp Asset Management

30 rue Galilée
75116 Paris
France
www.longchamp-am.com

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