PIMCO

Monthly Market Update | July 2019

When Bad News is Good News

In the World

Central banks indicated easier policy amid softening economic data and an uncertain trade outlook. The Federal Reserve, the central bank of the United States, dropped the word "patient" from its policy statement and instead signaled that it would act as appropriate to sustain the expansion, which is set to become the longest in U.S. history in July. The U.S. Federal Open Market Committee (FOMC)'s June statement emphasized higher economic uncertainty, which contributed to roughly half of FOMC officials forecasting 50 basis points (bps) in policy rate cuts by December. Even many of those who did not forecast a cut did "agree that the case for additional accommodation has strengthened since the May meeting." Other developed market central banks echoed these sentiments. The European Central Bank (ECB) suggested that additional stimulus in the form of rate cuts or quantitative easing may be required; the Bank of Japan hinted that it may allow 10-year government bond yields to fall below the –0.2% floor; and Australia's central bank cut its overnight lending rate to a record low of 1.25%. Underlying the widespread dovishness were further signs of decelerating growth – notably declining manufacturing PMIs – and ongoing global trade tensions. However, some reprieve occurred at the G20 summit as U.S. President Donald Trump and Chinese President Xi Jinping agreed to proceed with trade negotiations. In a positive surprise, Trump announced he would allow U.S. companies to do some business with China's Huawei Technologies, a previous target of the U.S. administration. Elsewhere, the U.S. "indefinitely suspended" scheduled tariffs on Mexican goods after negotiators reached an agreement on immigration enforcement.

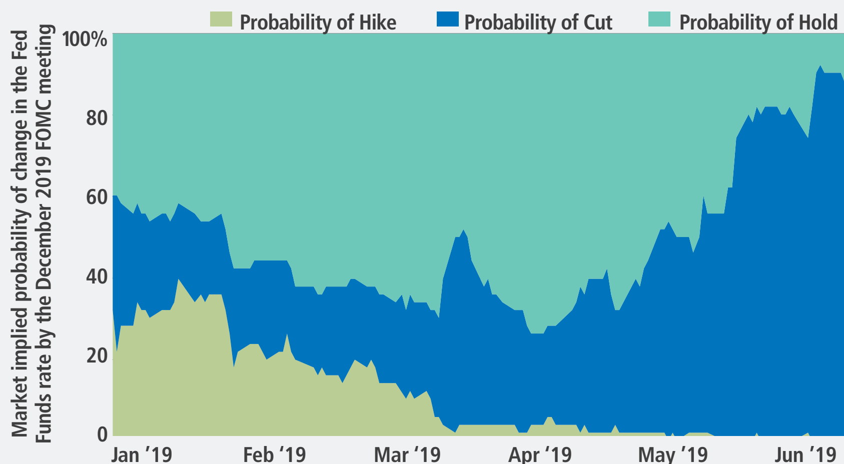
"Safe-haven" and risk assets alike rallied on the heels of increased central bank accommodation globally. The dovish shift from developed market central banks, coupled with more uncertainty over the state of the global economy, sent government bond yields lower: The U.S. 10-year Treasury yield fell below 2% for the first time since 2016, and the German 10-year bund rallied 13 bps to –0.33% (a new low). In fact, the volume of negative-yielding sovereign debt around the globe reached a record of more than $12 trillion. The Fed's dovish rhetoric also sent the U.S. dollar lower against most developed and emerging market currencies, while gold rallied more than 8%, reaching its highest level since 2013. Meanwhile, global stocks bounced back after a volatile May, with the S&P 500 climbing 7% to approach record highs. Credit spreads also tightened, particularly in high yield markets where spreads rallied more than 55 bps.[1] The positive momentum in both risk assets and traditional "safe-haven" assets (including Treasuries and gold), suggested an environment where "bad" news was good news: Negative economic developments were received positively by most markets in anticipation of central bank easing.

Outside of trade, several notable geopolitical developments garnered headlines. Volatile relations between the U.S. and Iran further escalated after two oil tankers in the Gulf of Oman were attacked and Iran shot down a U.S. drone. The U.S. initially threatened to retaliate with a military strike before pulling back and instead imposing additional sanctions. Iran responded by warning it would increase its stockpile of enriched uranium beyond the limit specified in the 2015 nuclear deal if the remaining signatories of the nuclear deal did not assist in easing U.S. sanctions. The escalating tensions managed to push the price of oil 3.2% higher despite data earlier in the month that showed rising inventories in the U.S. and slowing global demand growth. In Hong Kong, hundreds of thousands of citizens flooded the streets to protest a proposed bill that would allow for the extradition of Hong Kong citizens to mainland China. Lastly, in the UK, the 2019 search for Prime Minister Theresa May's successor was underway, with Boris Johnson leading the Conservative Party polls by a wide margin.

[1] Barclays Global Agg High Yield Index

READY, SET...CUT?

In light of greater uncertainty in the economic outlook, the U.S. Federal Open Markets Committee (FOMC) took a more accommodative stance at its June meeting and indicated a willingness to act – a notable shift from May, when Chairman Jerome Powell declined to discuss the economic conditions that would warrant rate cuts, and instead emphasized a solid economic outlook. In fact, roughly half of FOMC members are now expecting 50 basis points (bps) in rate cuts by year-end. The shift has led the market to fully price in Fed easing by the end of the year, with expectations for the number of rate cuts also rising – with more than a 50% probability of three cuts or more. This stands in stark contrast to the beginning of 2019 when markets predicted the policy rate would remain largely unchanged. Recent accommodative stances from central banks globally, along with rising uncertainty about growth outlooks, have contributed to a significant move lower in global yields this year: U.S., German and UK 10-year government bond yields have rallied 68, 57, and 44 bps, respectively.



Source: PIMCO, Bloomberg. As of 30 June 2019.

Market snapshot

To view detailed on each asset class, visit pimco.com/monthly-market-update.

BONDS	U.S.				U.K.				EUROZONE				JAPAN				BRAZIL			
	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018
	Level	Change (bps)			Level	Change (bps)			Level	Change (bps)			Level	Change (bps)			Level	Change (bps)		
Target Rate*	2.50				0.75				-0.40				-0.10				6.50			
2 YR	1.75	-17	-73	+60	0.62	+2	-13	+31	-0.75	-9	-14	+2	-0.22	-5	-8	-1	6.06	-69	-130	-69
5 YR	1.77	-14	-74	+30	0.63	-1	-27	+18	-0.66	-8	-35	-11	-0.26	-6	-11	-4	7.03	-97	-182	-120
10 YR	2.01	-12	-68	+28	0.83	-5	-44	+9	-0.33	-13	-57	-19	-0.16	-6	-16	-5				
30 YR	2.53	-4	-49	+27	1.47	+0	-35	+6	0.27	-16	-61	-39	0.36	-10	-36	-9				
5 YR ILBs	0.23	-11	-77	+71	-2.54	+9	-31	-9	1.26	+5	-21	-24					2.45	-40	-59	-85
10 YR Muni[a]	1.62	-3	-70	+31																
CURRENCIES	USD**				GBP/USD				EUR/USD				USD/JPY				USD/BRL			
	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	96.13	-1.7%	0.0%	4.4%	1.27	0.5%	-0.5%	-5.6%	1.14	1.8%	-0.8%	-4.5%	107.89	0.4%	1.6%	2.8%	3.85	1.9%	0.6%	-14.6%
EQUITIES	S&P 500				FTSE 100				EURO STOXX 50				NIKKEI				BOVESPA			
	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018	June '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	2,942	7.0%	18.5%	-4.4%	7,426	4.0%	13.1%	-8.7%	3,474	6.0%	18.3%	-12.0%	21,276	3.5%	7.3%	-10.7%	100,967	4.1%	14.9%	15.0%

SECTOR SPREADS***				
	June '19	MTD	YTD	2018
	Level	Change (bps)		
MBS[b]	46	+1	+10	+11
IG[c]	109	-11	-32	+54
HIGH YIELD[d]	422	-58	-123	+206
EM EXTERNAL[e]	366	-27	-69	+124

COMMODITIES				
	June '19	MTD	YTD	2018
	Level	Change		
Oil	$58	9.3%	28.8%	-24.8%
Gold	$1,414	8.3%	10.3%	-2.1%
Copper	$271	2.5%	2.8%	-20.3%
Grains[f]	$31	0.1%	0.9%	-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 moves sideways.** With growth likely to continue slowing through the year and inflation remaining below target, the Fed has adopted a more dovish stance and looks likely to cut rates by 50 basis points (bps) by year-end 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 a lower-probability event. **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. **With core CPI inflation expected to dip into negative territory** (due to temporary factors), we expect the Bank of Japan to keep its targets for short rates and the 10-year yield unchanged this year.

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. Yuan stability is well-anchored with a patient Fed and the understanding that this needs to be a component of the China–U.S. trade deal.

P I M C O

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