Onus placed on monetary policy to avoid recession

Pressure is building on central banks to lower interest rates and help the global economy stave off the threat of recession. The European Central Bank (ECB) failed to deliver a rate cut in July, but the US Federal Reserve (Fed), after much talk, finally 'walked the walk' on the last day of the month and reduced interest rates for the first time since 2008.

It remains to be seen if this is enough to placate investors, who must realise that such stimulus can take six months to work its magic. In the meantime, as companies report their half-year results, we should get a better idea of the real state of play.

Earnings season

Equity markets live and die by company-earnings forecasts and the ability of businesses to live up to their predictions. As the chart below shows, there has been a visible downward pressure on expected earnings in recent weeks, and with companies now reporting their actual earnings for the first half of the year, there is evidence of a marked slowdown in some sectors, such as retail and entertainment.

Chart-1-Aug.PNG

"*Recession is still far from a foregone conclusion, but we're becoming increasingly concerned about the ability of monetary policy to support growth. This makes our strategy of investing in businesses that can deliver in times of high inflation and slower growth even more important.*"
- **Philip Smeaton, Chief Investment Officer**

What does this mean for investors?

Our key concerns are unchanged – the shorter-term risk of recession and the longer-term risk of inflation. We remain focused on good quality companies that have a strong balance sheet, and that are positioned to deliver in both a slower growth economy and a higher-inflation environment over the longer term. Recently, we've seen companies that have delivered results be rewarded by investors, meaning their share price increased as others fell. As a result, we're confident that we have the right investment strategy amid ongoing economic uncertainty.

Investment view: Has Europe backed itself into a corner?

They say the first sign of madness is to do the same thing repeatedly and expect a different result. Far be it for us to criticise the decision makers within the Eurozone, but talk of further interest-rate cuts and a return to quantitative easing is doing more than just raise a few eyebrows.

What is the problem with Europe?

The Eurozone continues to suffer from stubbornly low inflation and sluggish economic growth, despite the ECB's best efforts to get the banking system lending again. Manufacturing is suffering, and Germany has some of the lowest purchasing managers' index scores (a measure that reflects confidence in manufacturing) in the G20. This doesn't just affect the manufacturing companies themselves, but all their suppliers across the Eurozone. With Brexit also clouding the horizon and the prospect of a 'no deal' now the UK's assumed position, policymakers in Europe are under pressure to get the economy moving again.

What are the options?

It seems that rescuing Europe is being placed firmly at the door of the ECB. While they kept interest rates stable in July, they hinted strongly that they would reduce them in September, further pushing them into negative territory. According to the ECB's models, this should result in giving the economy a boost, but the fact that today's rate of -0.3% has not helped suggests they should be thinking laterally for ways to increase demand in European business.

The Sanlam View

We struggle to see how doing more of what has failed will help the European banking system get back to lending. As believers in capitalism, we have concerns that the longer the ECB continues to give handouts to big business without any improvements in the economy, the more Europe's political establishments will struggle to defend the actions to the electorate. As a result of this uncertainty, and the fact their policies don't seem to be helping, we have few investments dependent on the European economy and we don't own any European bank stocks. It's our view that we should never invest where we're not clear on the rationale and outlook for key economic decisions.

Three things we will be looking out for this month

- The arrival of a new prime minister brings the promise of a resolution to Brexit. We will be watching closely as Boris Johnson sets out his stall and begins negotiations with Europe.
- Earnings season continues, and we will be carefully analysing the numbers so that we can make quick and informed decisions should future market volatility yield good opportunities.
- While we're not expecting a global recession, there are several signs that indicate that it is possible. That means watching to what extent the slowdown takes hold and the consequences for corporate earnings.