# Is this the calm before the storm?

Since the Federal Reserve (Fed) paused interest rate hikes, markets have been taking a 'wait-and-see' approach, leading to a recovery in equity valuations and a period of relative calm. But with inflation pressures still evident in both the US and UK, and the outlook for growth looking uncertain, our focus is on three potential scenarios as the year progresses.

## Scenario 1: Inflation forces interest rate hikes

Unemployment is still very low both here and in the US. Alongside productivity improvements and population growth, this is contributing to above-inflation wage growth, and the risk of rising inflation. So, while the Fed has said it will listen to markets before increasing interest rates further, the reality is that they could be forced into hikes just to control inflation. Should this happen, financial markets could react with shock – especially since they are pricing in an interest rate cut.

## Scenario 2: We're heading towards a meaningful economic slowdown

The fact that markets reacted so dramatically to interest rate rises last year implies that businesses are unable to easily absorb an increase in the cost of borrowing. If this is true, they are unlikely to invest in growth, as this usually means taking on more credit. We must acknowledge that the Fed may have tightened monetary policy too far and too quickly, and other political uncertainties, such as the trade war, could mean we are facing a significant economic slowdown by 2020.

## Scenario 3: A continuation of the status quo

Of course, the actual outcome could be somewhere in the middle, where we find that the interest rate hikes, to date, have managed to slow growth in a controlled fashion, while keeping inflation subdued. But history suggests this scenario is unlikely.

## What does this mean for investors?

While we could experience relative calm for a few months yet, we think a version of scenario 1 will manifest itself, and we're therefore continuing to take a prudent approach on behalf of our investors. Our focus on valuation means our portfolios continue to be positioned defensively in anticipation of slower growth and subdued equity markets, as well as higher bond yields driven by inflation pressures.

*"The evidence points towards a moderation of economic growth as global labour markets remain tight, and production nears capacity. This means that above-trend growth risks generating inflation."* - **Philip Smeaton, Chief Investment Officer**

## Investment view: What does the car industry tell us about the future of the economy?

Last year was not a great year for the global automotive industry. Buoyant sales and high margins came to an end as car sales in China fell for the first time in 20 years**[i]**, the US reported only 0.3% growth**[ii]** and the UK saw the biggest drop in sales since the financial

crisis**[iii]**.

Traditionally, car sales were the economy's equivalent of the miners' canary – the first warning sign of trouble ahead. So, should we be concerned? What are the key factors affecting the automotive industry, and could these also impact other sectors?

## Political uncertainty

The repercussions of the US/China trade war have been felt across the global car industry. Germany has blamed it for a significant decline in car sales, and that's before the US imposes tariffs specifically on European car imports. As new cars are usually made to order, and are a significant spend for most people, it's unsurprising that tariffs had an immediate impact on this market. For other sectors, where products were already in production, the pain of these tariffs could be yet to come.

## Climate change

The world is finally waking up to climate change, and the car industry is feeling the full force of this shift in consumer and political sentiment. Diesel cars practically became an archenemy overnight, and petrol cars won't be far behind, as the world becomes less dependent on fossil fuels. Car manufacturers have been forced to invest vast sums of money in developing cleaner technology, knowing that their business will become obsolete if they fail to keep up. Businesses across other sectors should take heed, as consumer behaviours can change very quickly in the face of environmental conscience.

## Technology

The global economy is in the grip of a technological revolution. While the effect of this megatrend is hard to predict for some sectors, the promise of self-drive, 'summon-able' cars is no longer science fiction, and it's weighing heavily on the balance sheets of car manufacturers today. The race is on to be at the forefront of personal transport, and it's not just the car industry that is investing billions of pounds in this technology. Competition is high, and there will undoubtedly be casualties as a result.

## The Sanlam view

Given that the automotive industry sits at the forefront of significant macroeconomic challenges, investors should be drawing parallels with other sectors and extrapolating future effects on these businesses.

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**[i] https://edition.cnn.com/2019/02/18/business/china-slowdown-auto-sales/index.html < https://edition.cnn.com/2019/02/18/business/china-slowdown-auto-sales/index.html>**
**[ii] https://www.marklines.com/en/statistics/flash_sales/salesfig_usa_2018 < https://www.marklines.com/en/statistics/flash_sales/salesfig_usa_2018>**
**[iii] https://www.bbc.co.uk/news/business-46774053 < https://www.bbc.co.uk/news/business-46774053>**