The Month of May or May Not

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Markets saw a couple surprises in the last few weeks. First, the minutes of the April Federal Open Market Committee (FOMC) meeting sent a clear message that financial markets are underestimating the chances of another rate hike in June. The minutes showed a few members were comfortable raising rates at the April meeting and most members thought it would be appropriate to do so in June if we get more evidence of a spring growth rebound. We have been flagging the risk of a summer rate hike for a while, consistent with our forecast of stronger US growth in the remaining three quarters of the year.

The second story is the continued rise in oil prices. The International Energy Agency confirmed in its latest oil market outlook that it expects supply to decline in the second half of the year, mainly as a result of lower US production. The bigger surprise was an upward revision to demand expectations, mainly from India, China, and, surprisingly, Russia. That was enough to offset two ineffectual Organization of the Petroleum Exporting Countries (OPEC) meetings and push oil prices back to $50 per barrel at the end of May, a nearly 90% increase since the trough in mid-February. While that sounds like a bullish signal, other industrial commodity prices softened in May and are flat for the year, suggesting no sign of a broader improvement in industrial activity.

Market recap

Equity markets eked out another small gain in May. Yet the performance came exclusively from developed markets, especially the US and Europe, suggesting investors aren't too concerned about the impact of higher US rates. The decline in emerging market stocks despite the surge in oil prices was even more surprising. It seems we are seeing the disconnect between rising oil prices driven more by changing supply expectations and falling industrial metals prices that are a symptom of weak global growth.

The US dollar posted solid gains against all major currencies, emerging or developed, in May. Only the British pound was able to keep pace, suggesting that investors are less concerned about "Brexit" risk. US bonds trended mainly sideways. Benchmark 10-year Treasury yields were virtually unchanged, and corporate bond indexes were mainly flat in May. Local currency emerging market sovereigns gave back some of the strong performance in the past few months, mirroring the losses we saw in emerging market stocks.

Cautious optimism in the Americas

Most economists expect the weak US growth trend in the six months through March was merely temporary. True, we are not seeing much evidence of a recovery in business activity, but consumer and housing fundamentals continued to improve in May, pointing to a reacceleration in the coming quarters. Meanwhile, the increase in oil prices is reversing the negative contribution from the energy component in headline inflation indexes – the main reason why US inflation rates were stuck around 0% last year. Core inflation is already running above 2%, showing the way inflation trends are going. The Atlanta Fed's GDP "nowcasting" model is showing first-quarter GDP growth of 2.9% with the information we have so far. So, unless we see a significant change in the economic news flow, the Fed is on track for a second rate hike in June or July.

The political crisis in Brazil seems to be moving in the right direction. Congress started the impeachment process against President Rousseff, which forced her to resign temporarily and hand power to her vice president. However, Michel Temer is also facing corruption allegations and one of his cabinet choices already had to resign. His economic agenda has impressed, but he has to prove he can get reforms passed in Congress before convincing still-nervous investors that Brazil can indeed turn its economic crisis around.

Meanwhile, Mexico is showing signs of improving fundamentals. The economy grew at an annualized rate of 3.3% in the first quarter, the fastest pace in two years. The recent surge in retail sales suggests much of the growth acceleration stemmed from domestic consumption. One of its drivers is the steady decline in the country's unemployment rate, which has fallen below 4% for the first time since the Great Recession.

Politics dominate in Europe

If it wasn't for a volatile political climate, things in Europe would actually look quite good. The eurozone posted a 2.1% annualized growth rate in the first quarter, the second-best result in the past five years. And purchasing managers indexes show that growth trend continued through the first two months of the second quarter. Especially encouraging is the improvement in growth conditions in Germany, which is benefitting from strong domestic wage growth, rising housing values, and a resurgence in business investment.

In the UK, the Brexit debate dominates the coverage. The "remain" camp has been consistently in the lead. Yet polls show the "leave" camp has managed to close the gap again. Markets have largely priced out Brexit risk, as the sterling rally in the past few weeks demonstrates. We agree, expecting voters will choose the status quo over an uncertain future outside of the European Union.

There is more political risk in the eurozone. Austria nearly elected a right-wing, anti-immigrant president. The Greece debt crisis resurfaced, with more demands for outright debt relief by the International Monetary Fund countered by the EU with a further repayment extension and demands for more fiscal tightening.

Lacking support among the other EU members, the Tsipras government has largely chosen compliance over resistance. That could change next month if elections in Spain bring to power a coalition that includes the left-wing, anti-austerity Podemos party.

Stimulus measures dominate in Asia

While the US is on track for a growth reacceleration and a more solid growth trend is emerging in Europe, Japan continues to face recession and deflation threats. The economy posted surprisingly stronger GDP growth in the first quarter after contracting in the last quarter of 2015. However, purchasing managers indexes show both the manufacturing and service sectors slipped back into recession territory in March and deteriorated further in the subsequent two months. The fact that inflation fell back below 0% in April in spite of the strong rebound in oil prices only increases the pressure on the Bank of Japan and the Abe government to step up stimulus measures and pull the economy out of this slump.

China's macroeconomic prospects continue to look mixed. On the one hand, the underlying trend in credit supply continues to point higher, suggesting monetary stimulus is still increasing. In addition, a wider fiscal deficit and evidence of strong growth in public fixed investment projects highlight the increasing role of fiscal policy in the government's stimulus strategy. However, purchasing managers indexes continued to erode through April, pointing to stagnating growth momentum. The best economic indicator supporting the reacceleration thesis is the National Bureau of Statistics' leading index, which has improved four months in a row since bottoming last November, rising to the highest level since the end of 2014. We may need more patience, but the first green shoots are there in China.