

Markets Tariff-ied

In the World

An unanticipated escalation in global trade tensions precipitated a sell-off across risk assets. After the latest round of trade talks with China hit an impasse, President Trump announced an increase in tariffs from 10% to 25% on \$200 billion in Chinese goods; he also signed an executive order barring U.S. companies from conducting business with the controversial Chinese telecommunications company Huawei, among others. China retaliated by hiking tariffs on \$60 billion in U.S. goods and threatening to tax rare earth metals, a move that could stunt U.S. technology growth. The global trade war then opened on a new front after the U.S. administration surprised markets by announcing it would impose a 5% tariff on all Mexican imports – set to rise by 5% each month, up to 25% – unless Mexico helped stem the flow of illegal immigration into the U.S. Risk assets globally reversed course as developed market equities¹ fell 5.8%, marking their first negative month this year, while emerging market (EM) equities² fell 7.3% on the month as dollar strength exacerbated the trade concerns. Not surprisingly, the Chinese yuan and Mexican peso were the worst-performing EM currencies against the U.S. dollar in the month. Credit markets weren't immune to the pullback in risk appetite either: Spreads broadly widened, with high yield spreads³ 62 basis points (bps) wider. As risk assets sold off, bond yields fell sharply across the yield curve, leaving U.S. 10-year yields 38 bps lower at 2.12%, their lowest level since 2017. The front end of the yield curve also inverted for the second time this year as the spread between three-month and 10-year yields turned negative.

Signs of decelerating global growth also weighed on market sentiment. Manufacturing metrics in particular dipped lower across regions as purchasing managers' indexes (PMIs) in Japan, Europe, and China fell below 50 (the level separating contractionary activity from

expansionary), while the U.S. index – though still above 50 – fell over two points to its lowest level in nearly a decade. Other economic data in China also pointed to weakness despite recent stimulus measures, highlighted by slowing retail sales and a larger-than-expected decline in industrial production. With global inflation pressures still subdued, central banks remained supportive: New Zealand's central bank became the latest developed economy to ease policy, cutting rates to a record low of 1.5%, in light of unexpected weakness in inflation. Even Federal Reserve members suggested that rates could be lowered if data were to show persistently below-target inflation or materially weaker global conditions.

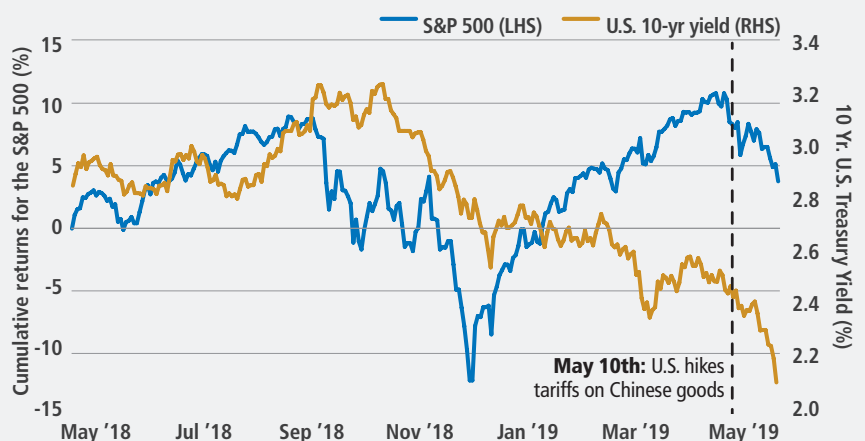
Outside of trade, May featured a number of election-related headlines.

In the U.K., Prime Minister Theresa May announced that she would step down after political pressure arising from her failure to pass a Brexit deal. Meanwhile, a number of incumbents will remain in office: Australian Prime Minister Scott Morrison secured a third term for his center-right government in a surprise victory, and India's Prime Minister Narendra Modi handily won his re-election. The European Parliament elections revealed few surprises, with populist and eurosceptic parties picking up support broadly in line with predictions, though remaining well below 50% and thus limited in their power. The Brexit Party in the U.K. finished first, with 31% of the vote; Deputy Prime Minister Matteo Salvini's League Party solidified its power in Italy, while its coalition partner, the Five-Star Movement, saw its popularity wane; and Marine Le Pen's National Rally Party finished ahead of President Emmanuel Macron's pro-EU party in France. In the U.S., the Trump administration delayed tougher sanctions on Iran's petrochemical sector in hopes of easing growing tensions between the two countries after the U.S. accused Iran of attacking Saudi Arabian oil tankers.

¹MSCI World Index ²MSCI EM Index ³Barclays Global Agg High Yield Index.

TOGETHER AGAIN ... AND HEADED DOWN

U.S. equities tumbled in May, marking the first monthly decline of 2019 and a reversal of the robust risk appetite that had underpinned impressive gains in equities through April. A repricing of global trade tensions and lingering growth concerns dragged risk assets into the red, with the S&P 500 dropping 6.4% in the month. Consistent with traditional "risk-off" behavior, bonds rallied as global rates fell dramatically: The 10-year U.S. Treasury yield declined 38 bps to 2.12% (notably below the Federal Reserve's current policy range of 2.25%–2.50%). That is the lowest level since 2017 and more than 100 bps below the 2018 high reached last November. The unusually large move lower in yields is partly due to investors' rising expectations for interest rate cuts by the Fed, which increased to three by the end of this year. As a result, the U.S. yield curve inverted again (typically seen as a precursor to recession), adding to fears of deteriorating economic conditions.



Source: Bloomberg. As of 31 May 2019.

Market snapshot

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

BONDS	U.S.				U.K.				EUROZONE				JAPAN				BRAZIL			
	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018	May '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	1.92	-34	-57	+60	0.60	-16	-15	+31	-0.66	-8	-5	+2	-0.17	-2	-3	-1	6.75	-62	-61	-69
5 YR	1.91	-37	-60	+30	0.64	-27	-27	+18	-0.58	-17	-27	-11	-0.19	-3	-5	-4	8.00	-58	-85	-120
10 YR	2.12	-38	-56	+28	0.89	-30	-39	+9	-0.20	-22	-44	-19	-0.09	-5	-10	-5				
30 YR	2.57	-36	-45	+27	1.47	-22	-35	+6	0.43	-23	-45	-39	0.46	-11	-26	-9				
5 YR ILBs	0.34	-9	-66	+71	-2.64	-37	-40	-9	1.20	-12	-27	-24					2.85	+6	-19	-85
10 YR Muni ^a	1.66	-24	-66	+31																
CURRENCIES	USD**				GBP/USD				EUR/USD				USD/JPY				USD/BRL			
	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	97.75	0.3%	1.6%	4.4%	1.26	-3.1%	-1.0%	-5.6%	1.12	-0.4%	-2.6%	-4.5%	108.28	2.9%	1.2%	2.8%	3.92	-0.1%	-1.2%	-14.6%
EQUITIES	S&P 500				FTSE 100				EURO STOXX 50				NIKKEI				BOVESPA			
	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018	May '19	MTD	YTD	2018
	Level	Change			Level	Change			Level	Change			Level	Change			Level	Change		
	2,752	-6.4%	10.7%	-4.4%	7,162	-2.9%	8.8%	-8.7%	3,280	-5.5%	11.6%	-12.0%	20,601	-7.4%	3.7%	-10.7%	97,030	0.7%	10.4%	15.0%

SECTOR SPREADS***				
	May '19	MTD	YTD	2018
	Level	Change (bps)		
MBS ^b	44	+3	+9	+11
IG ^c	120	+15	-21	+54
HIGH YIELD ^d	480	+62	-66	+206
EM EXTERNAL ^e	393	+28	-42	+124

COMMODITIES				
	May '19	MTD	YTD	2018
	Level	Change		
Oil	\$54	-16.3%	17.8%	-24.8%
Gold	\$1,306	1.6%	1.9%	-2.1%
Copper	\$264	-9.0%	0.3%	-20.3%
Grains ^f	\$30	12.2%	0.8%	-7.4%

*Central Bank Policy Rate

**U.S. Dollar Index (DXY)

***Sector spreads to like-duration government bonds

Source: Bloomberg

^aThomson Municipal Market Data (MMD) AAA Curve, ^bBarclays Global Agg MBS Index, ^cBloomberg Barclays Global Agg Credit Average OAS, ^dBarclays Global Agg High Yield Index, ^eJPMorgan Emerging Markets Bond Index, ^fDow 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. We estimate that China's easing will not filter through to U.S. growth until late 2019 or early 2020. **Headline inflation looks set to drop to 1.5%–2% this year, while core CPI moves sideways.** With growth slowing and inflation remaining below target, the Fed is likely to keep rates unchanged in 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 Italy slipped into recession. An improvement in global trade conditions through this year should contribute to a gradual reacceleration. Reflecting firmer wage growth, **we expect a moderate pickup in core inflation, which has been stuck at 1% for some time.** In line with the European Central Bank's (ECB) forward guidance, we expect policy rates to remain unchanged this year.

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 low-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. In the event of a soft Brexit by midyear, a rate hike by the Bank of England in the second half of the year would appear likely.

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) around the middle of the year, 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, but stabilizing in the second half of the year as fiscal and monetary stimulus find some traction and a likely trade deal between the U.S. and China supports confidence. We expect fiscal stimulus of 1.5% to 2% of GDP. **Inflation remains benign at 1.5%–2.5% in our forecast,** and we look for another rate cut by the People's Bank of China in addition to more reductions in banks' reserve requirement ratios. 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.

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