

# Weekly Macro & Markets View

## Highlights and View

- **Credit, especially IG corporate bonds, have failed to fully recover since the recent sell off**

While a bear market in credit is not imminent, a multitude of factors, including the latest rise in the LIBOR OIS spread, are converging to suggest that further upside should be limited.

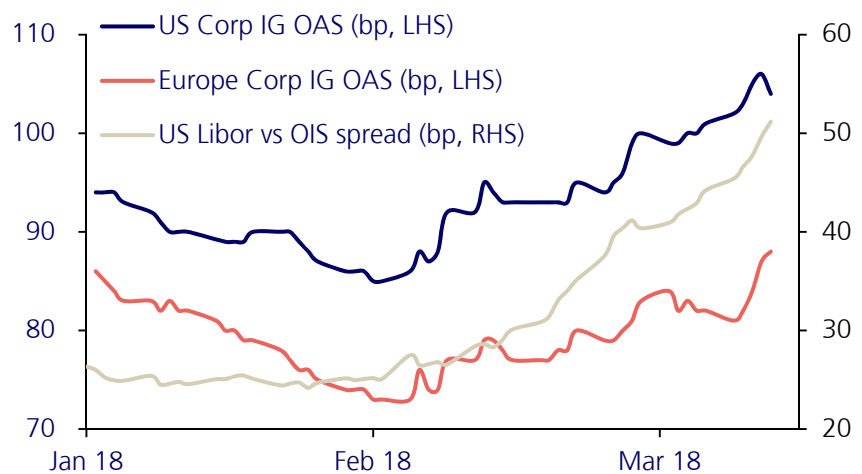
- **US headline inflation ticks up to 2.2% YoY while Core CPI remains at 1.8%**

The monthly rates of both CPI and Core CPI slowed down to 0.2% in February, with some key core components indicating that core inflation is likely to remain contained.

- **Vice Governor Yi Gang has been appointed as China's new PBoC Governor**

We applaud the appointment, as Yi is a well experienced, US-educated expert who will drive forward China's deleveraging process and cautious capital account reform.

## IG corporate bond spreads hit YTD wides



Source: Bloomberg

Credit markets have largely failed to recover from the late January sell-off, especially in investment grade (IG) corporate bonds. While an underperformance versus equities was somewhat expected, given tight spreads and increasing leverage, tentative signs have now emerged that the supply/demand technicals may also be weakening. Recent data suggest that several credit market segments continue to bleed investor flows, leaving the market vulnerable to supply indigestion, as happened last week.

A new contributor to credit weakness gathered momentum recently, which was the widening of the spread between US 3m LIBOR and the Overnight Index Swap (OIS). There are a number of factors behind this, namely heavy US Treasury bill supply, commercial paper supply, high repo rates, potential demand for cash ahead of corporate tax deadlines, some liquidation of short dated corporate and Treasury bonds driven by repatriation etc. Encouragingly, this widening doesn't seem to be driven by banking sector stress. Nevertheless, the LIBOR-OIS spread can be seen as a price for liquidity, and its widening could imply further weakness for credit.

Away from short-term price action, the ECB laid out its 'non-binding' guidance for European banks to tackle new NPLs, which seems as stringent as originally proposed despite opposition.

## US: Consumers are upbeat, but unwilling to spend

As expected, headline CPI inflation slowed down to 0.2% MoM in February, further alleviating investors' fears of an imminent spike in inflation. Despite the slowdown of the monthly rate, the annual rate ticked up to 2.2% from 2.1% while core CPI remained at 1.8% YoY. Although consumer sentiment has further improved, the University of Michigan Index rose to the highest in 14 years, actual spending remained weak with retail sales falling -0.1% in February, the third negative month in a row. While household spending is expected to pick up in the months ahead, the

weak retail sales figures point to a relatively modest first quarter. Small business optimism rose to the highest level since 1983, underlining the very upbeat sentiment among smaller firms fuelled by a positive economic environment, lower taxes and the expected reduction of the regulatory burden. Finally, a fall in building permits, housing starts and the NAHB Home Builders Index all point to a slowdown in the housing market albeit from very solid levels.

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## Eurozone: ECB focus shifts to raising interest rates in 2019, but emphasises the need for prudence

Last week, ECB President Draghi discussed the prospect of interest rates rises in 2019. He emphasised that adjustments to monetary policy will remain “predictable” and proceed at “a measured pace” and that the ECB will be “prudent”. Nevertheless, it means that absent a major shock, winding down QE in 2018 is now a foregone conclusion for the ECB. Indeed, we continue to expect a taper of asset purchases in the final quarter of 2018, from the current monthly pace of 30bn euros a month down to zero. In Italy, the political situation remains extremely fluid,

with little clarity yet on the eventual coalition that is likely to govern. So far, the Northern League leader Matteo Salvini has ruled out an alliance with the PD, but not with the 5 Star Movement. It will likely take weeks before a government emerges, with Italian government bonds vulnerable, particularly if there are signs that the new government will allow the budget deficit to increase. Finally, January industrial production data showed Eurozone output continued to grow at a decent pace once weather-related distortions due to energy were taken into account.

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## Japan: PM Abe and Finance Minister Aso under further pressure from the ‘Moritomo’ scandal

New details of the ‘Moritomo’ scandal have pushed the start of Japan’s ‘sakura’ cherry blossom season to second rank in domestic TV news. It was revealed that documents had been falsified in order to hide the involvement of government officials in last year’s private school funding scheme. Furthermore, a contractor said it falsified a report about buried waste on behalf of a government request. A local official committed suicide, while the head of the National Tax Agency stepped down and will be summoned in parliament to give testimony. Public approval

ratings for the Cabinet have dropped significantly, and opposition parties have called for both finance minister Aso and PM Abe to step down, which they have refused to do. We are concerned about pressure on Abe from within the ruling LDP, which is split into various powerful factions. We believe as long as combined public support for the Cabinet and the LDP, dubbed as the ‘Aoki’ ratio, currently above 60%, remains above 50%, PM Abe will be able to stay in office. His firm stance on North Korea may also help him.

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## China: NPC confirms major overhaul of State Council, streamlining China’s administration

The NPC, China’s National People’s Congress, is now coming to an end. Following the unanimously approved removal of time restrictions on President Xi’s regime, the focus moved to the State Council restructuring plan, which will streamline departments to improve efficiency. Among the 26 ministries and commissions the focus will be on the CBIRC, China’s new banking and insurance regulator, and the PBoC, which now will oversee macro prudential measures. National and local tax collection as well as the national health insurance will be consolidated, while the

National Audit Office will have an expanded supervisory role. Today, the NPC approved out-going PBoC Governor Zhou’s successor. To the surprise of many, Yi Gang, Zhou’s protégé and vice governor, will take over. We applaud the nomination, as Yi is a US-educated, reform minded central banker with a strong academic background. Yi is also a proponent of financial deleveraging and cautious capital account liberalisation. As widely expected, Liu He, a close ally of President Xi, has been appointed as Vice Premier, while Liu Kun will head the Finance Ministry.

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## Global Trade: Still going strong, but risks have increased

Last week’s headlines were dominated by Trump’s decision to impose tariffs on steel and aluminium imports to the US. Less attention was paid to the CPTPP (Comprehensive and Progressive Agreement for Trans-Pacific Partnership) that was signed by 11 Asia-Pacific states the prior week. It will come into effect once it is ratified by at least of 6 of the 11 countries and will deepen trade in a region that accounts for almost 15% of world GDP. When the US abandoned the TPP one year ago, it was widely expected that the agreement would not see the light of day.

Instead, negotiations accelerated, confirming strong commitment to trade in the region. The EU is also pushing the trade agenda, having concluded negotiations with Canada, Japan, Vietnam and Singapore, and is now launching new initiatives with Mercosur and Mexico. While risks around global trade are material, we maintain our view that a negative spiral of tariffs and protectionism is unlikely. The pending NAFTA negotiations and Section 301 investigation into China’s practises on intellectual property and technology transfers, will be decisive.

### What to Watch

- While a rate hike at this week’s FOMC meeting is fully price in, investors will focus on any signs that the Fed intends to step up the pace of its policy tightening.
- No major changes in monetary policy are expected when the Bank of England, Taiwan’s CBC and Indonesia’s BI hold their policy meetings this week.
- First steps in reforming the Eurozone to make it more resilient to future shocks will be discussed at the EU Summit.

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