April 23, 2018

Weekly Macro & Markets View

Highlights and View

- **US bank and tech earnings get the season off to a robust start, though forward guidance from banks disappoints**

  While earnings expectations are high and have been boosted by tax reform, we suspect that they will be met, allowing stocks to move higher, but those that miss will be punished.

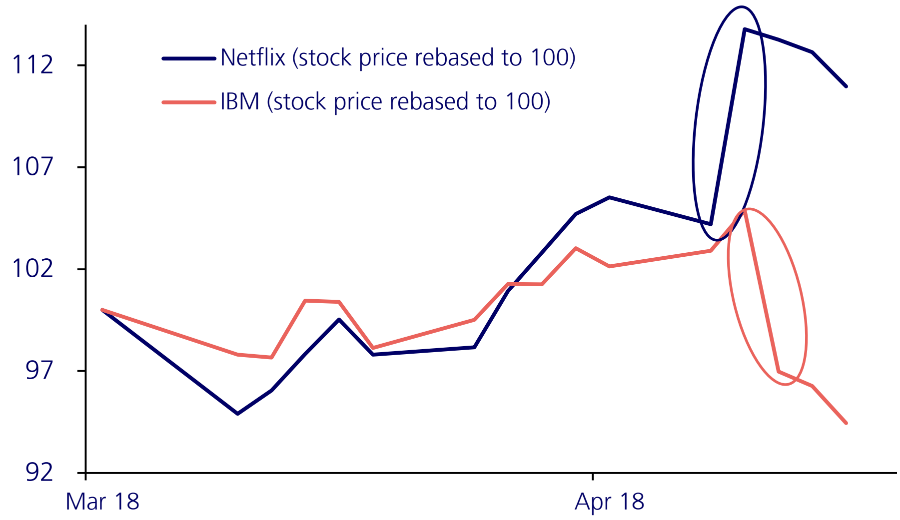
- **China's GDP growth, at 6.8% YoY in Q1, remained strong, unchanged from H2 last year**

  Don't be fooled by this number, as sequential growth and activity indicators suggest that growth is slowing.

- **In Japan, polls show a further deterioration in the approval rating of PM Abe's Cabinet**

  Political turmoil in Japan is expected to persist, however, we do not expect the economy to be affected, as growth should pick up steam again in Q2, following a setback in Q1

Earnings matter!



Source: Bloomberg

After a strong start to the week stocks pared gains, while 10yr Treasury yields broke through their February highs to close at 2.96%. Earnings season kicked off in earnest, with expectations that the quarter could see growth in the region of ~20% on a year on year basis. At this stage in the cycle, we believe that earnings really do matter, and there were some good examples of this last week. Netflix surged 9% following its earnings release, despite high expectations and a stellar performance since the start of the year. Conversely, IBM disappointed, with the stock down 7% on the news. This is a pattern that is likely to become increasingly frequent in a maturing bull market as investors become more discerning, leading to a greater dispersion in terms of returns. We suspect that the earnings season will indeed be robust, but how investors respond will be critical in determining if the broader indices can challenge January highs.

On the economic front data were decent, with retail sales a little better than expected, capacity utilisation rising and jobless claims falling. The Fed's Beige Book gave anecdotal evidence from all 12 districts of an economy running close to full capacity, with signs of upward pressure on wages. While we believe that inflationary pressures remain modest, the direction is higher, which we suspect will help Treasury yields test 3%.

Credit: Surge in supply takes a toll as earnings provide little cheer

Credit markets traded with a soft tone last week, broadly underperforming equities. Investor sentiment was dampened by a surge in supply and government bond yields, with the earnings season showing continued debt build-up by companies. Credit spreads were wider in both derivative and cash markets, with high yield spreads underperforming despite higher oil prices on the week. While it seemed mid-week that inflows were tentatively returning to US high yield market, these hopes were shattered on Thursday when US high yield ETFs suffered substantial outflows. Following their earnings releases, supply from financials such as Morgan Stanley, JP Morgan, Citigroup and Goldman Sachs dominated the US investment grade space, while the various deregulation proposals from the Fed seemed to have had little sustained impact on either equities or credit. Most importantly, although it is still in the early days of the earnings season, there doesn't seem to be any let up in leverage trends so far, despite the very strong earnings growth being reported.

Eurozone: ZEW surveys falls to lowest levels since 2012

The German ZEW expectations index fell in April to -8.2, its lowest level since late 2012. Given recent stock market volatility, soft macro data, and concerns around trade tariffs, the fact that this survey of 350 analysts and investors shows that they have become less optimistic should not have been completely unexpected. The survey is at levels from which it has previously rebounded in subsequent months. Indeed, our base case is that an actual trade war will not materialise, while Eurozone macro data should stabilise soon. Meanwhile, the second estimate of Eurozone inflation in March confirmed the still subdued inflation picture. Core inflation was unchanged from its initial estimate of 1.0%, and headline inflation was revised down slightly to 1.3% from an initial estimate of 1.4%. We expect inflation to rise, but the increase in core inflation in particular is likely to be gradual. Wage growth is picking up, but the acceleration is modest. For example, in Germany, recent wage deals for the public sector imply wage growth of around 2.9% in 2018, after growth of 2.6% in 2017.

UK: Weak data and Carney comments reduce the chances of a May rate hike

Inflation fell unexpectedly in March to 2.3% YoY on the CPI measure, compared to 2.4% in February and expectations for an increase to 2.5% YoY, with the statistics office saying that increases in clothes prices were lower than usual for this time of year. Wage growth also disappointed in February, coming in at 2.8% on the 3m YoY measure, compared to consensus expectations of 3.0%. Retail sales were also weaker than expected in March. Bank of England Governor Marc Carney, recognised the recent softness in the data last week saying that policymakers will make their decision about interest rates at the May 10 meeting "conscious that there are other meetings" at which they could act later this year. This was a big hint that a May rate rise is no longer as strong a possibility as it looked a few weeks ago. The pound was quick to react to his comments, falling from a recent high of 1.44 versus the USD to around 1.40. Going forward, sterling also remains vulnerable should Brexit negotiations prove more difficult than currently expected.

China: Growth is less robust than the GDP growth rate of 6.8% YoY in Q1 suggests

Even though China's real GDP growth in Q1, at +6.8% YoY, exceeded the government's annual growth target of 6.5% for 2018, sequential growth softened from 6.6% in Q4 to 5.7% on a seasonally annualised basis. Principally, we do not focus too much on China's GDP statistics but prefer to watch current activity indicators. Even though these are distorted due to problematic adjustments for the varying date of Lunar New Year, we believe economic growth has started to roll over. Infrastructure spending is suffering due to tighter deleveraging policies affecting local governments. As the Caixin PMI output index suggests, companies have started to suffer under tighter financing conditions, which may have been one reason why the PBoC cut its Reserve Requirement Ratio (RRR) by 100bps to support lending to small firms. On the positive side, SOEs are now benefitting from a loosening of factory closures due to pollution reduction measures, while the property sector, services and private consumption are still supporting growth. Indeed, nominal retail sales growth in March recovered to 10.1% from a prior reading of 9.4% YoY.

Japan: Political headwinds for PM Abe

Japan's domestic political situation is still in disarray. Polls published over the weekend show a further deterioration of the Cabinet approval rating, even though the rating for the ruling LDP has not been much affected. In addition to the Moritomo scandal, Finance Minister Aso is coming under further scrutiny due to a sexual harassment incident affecting a vice minister he has appointed. These issues are an impediment for Abe in the upcoming LDP leadership election, as his competitors Kishida and Ishiba seem to be joining forces, and there are rumours about potential national snap elections. PM Abe's summit with US President Trump did not help either, as the body language showed that bilateral problems, particularly on trade issues, persist despite positive comments from both sides. However, the fact that Abe succeeded in convincing Trump that the abductee issue needs to be discussed at the US / North Korea summit may create some support domestically. On the economic front, despite today's rather favourable Manufacturing PMI reading, there remains a risk that the economy shrunk in Q1, albeit marginally.

What to Watch

- No major policy announcements are expected at the ECB or BoJ monetary policy meetings this week. We will watch the BoJ's quarterly economic outlook, although we expect the inflation outlook and thus monetary policy to remain unchanged.
- The G3 flash PMIs as well as the German ifo are expected to show growth stabilising in April after having weakened in the first quarter. A plethora of US data will need to be digested including consumer confidence, durable goods orders and housing data, but corporate earnings will likely have a greater market impact.
- Major economic indicators will be published in Asia, with the focus on Japan's March labour market data, industrial production, retail sales and housing starts, as well as industrial production in Taiwan, Singapore and Thailand and Q1 GDP growth in Korea and Taiwan. On Friday, the Inter-Korean summit will be watched closely.

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