April 30, 2018

Weekly Macro & Markets View

Highlights and View

- **US GDP growth in Q1 surpasses expectations at 2.3% QoQ annualised**

  Although a softer patch appears to have been encountered in the first quarter once again, the growth dynamic remains robust, and, with a rise in the employment cost index to 0.8% QoQ, will encourage the Fed to maintain its rate hiking trajectory.

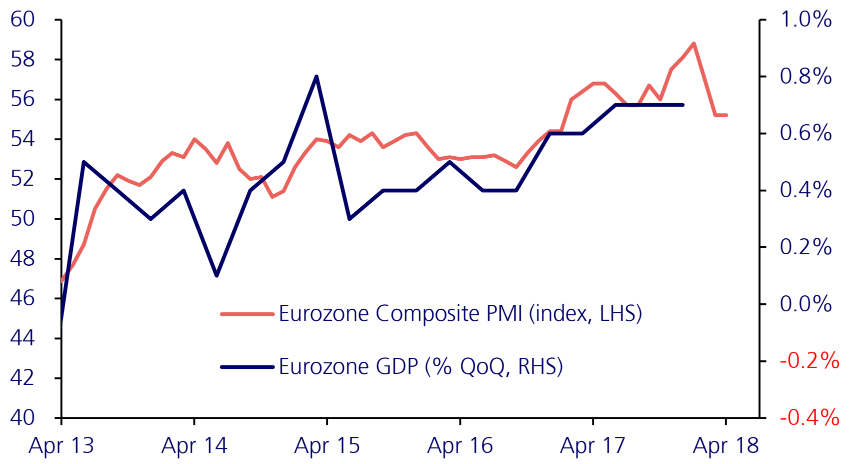
- **The Eurozone April flash composite PMI comes in unchanged from March at 55.2**

  The stabilisation in Eurozone business confidence is a welcome development and combined with other data suggests continued above trend growth despite a soft Q1.

- **The 10yr Treasury yield rises above 3% but fails to hold in at the higher level**

  We suspect the 3% level will be tested again, though headwinds to higher yields persist globally.

Eurozone business confidence stabilises



Source: Bloomberg

After a run of disappointing data, there are signs that Eurozone business confidence and economic growth are stabilising. For example, after having declined by around 3.5 points from its 11-year high in January, the Eurozone flash composite PMI survey for April came in unchanged from March, at 55.2. What's more, this is still consistent with the well above trend pace of growth in the Eurozone at the beginning of the second quarter. The latest ECB bank lending survey was also encouraging. The survey showed an easing of credit standards for loans to enterprises in Q1. This survey is typically a useful leading indicator and suggests that underlying economic activity in the region remains strong. Therefore, despite a weaker than expected start to the year, the recovery appears intact.

At last week's ECB meeting and press conference, President Mario Draghi recognised that economic data had moderated in recent months, but he indicated that his base case was also that the recovery would continue. Nevertheless, his commentary was somewhat on the dovish side, causing the euro to weaken against the USD. We still expect the ECB to end QE this year, with a taper of asset purchases in the final quarter of 2018. However, so as to give itself more time to monitor incoming data, the ECB may wait as long as possible before announcing its decision on QE.

US: Investors demand perfection

With 10yr Treasury yields breaching 3% and Caterpillar talking about 'peak' earnings in Q1, investors took pause for thought in what turned out to be another choppy week for stocks. Despite posting robust numbers and giving decent projections the plunge in Caterpillar's stock showed that investors are a demanding bunch currently, and need to believe further growth lies ahead given the valuation the market is trading on. That noted, we remain optimistic for the remainder of the earnings season and see upside potential for stocks despite the high expectations. We also take heart from economic activity picking up from another relatively soft Q1. The first estimate of GDP at 2.3% QoQ annualised was down from Q4, but a little ahead of expectations. A raft of more up-to-date data, from housing, consumer confidence and PMI indicators, to initial jobless claims falling to a 49-year low, suggest a robust economy that is not quite yet at the end of the cycle.

Bonds: A brief visit above 3%

Bond yields spiked higher last week, with the 10yr Treasury yield closing above 3% for the first time since end 2013. There was not a single trigger behind the move but pricing had become stretched. As sentiment around trade and geopolitics improved, yields corrected, also helped by higher oil prices, rising inflation breakevens and a tentative stabilisation in economic data. Bunds participated in the sell-off but yields failed to break above the February high. A dovish ECB press conference and reduced likelihood of a BoE rate hike in May pushed global yields down towards the end of the week. We suspect the 3% level can be tested again, following Friday's upside surprise to the US employment cost index, which recorded a 9-year high for the annual rate. Next week's core PCE release will be critical, and expectations are that it approaches 2% for the first time since 2012.

Japan: Policy stays accommodative as the economy experiences a temporary soft patch

The Bank of Japan (BoJ) left its monetary policy unchanged. Additionally, in its quarterly Outlook, the central bank dropped the reference to the date when the 2% inflation target was likely to be reached ("around fiscal 2019"). At 1.8%, CPI projections for 2020 are also tracking below target. By retaining a dovish tone, we think that the BoJ seeks to guide inflationary expectations higher. Indeed, despite a steady rise in 2017, inflation remains far below the BoJ's 2% target. Currency markets appear to reflect this policy stance, with the yen weakening against the US dollar.

As for real activity, it slowed in Q1 but is likely to pick up steam in Q2. Industrial production dropped 1.4% QoQ in Q1 as the inventory-to-shipments ratio jumped, especially for communication and electronic devices. Real retail sales also softened in Q1, because of temporary factors. We remain constructive for the rest of 2018: the labour market continues to tighten at a fast pace, business confidence is high, and a weaker yen should help.

Asia: USD jump creates turbulence in Asian markets

The US dollar index surged ~1.2% last week to reach its 200-day moving average. The move occurred against developed and emerging market currencies as US Treasury (UST) yields momentarily breached the psychologically significant 3% threshold. In emerging Asia, sovereign spreads to UST widened, led by India and Indonesia, while foreign outflows from equities resumed. Going forward, more episodes of volatility spikes are likely as global central banks slowly follow the Fed's lead. Last week, Bank Indonesia intervened in FX markets again to support the rupiah and declared that it would consider a policy rate hike if needed. This statement represents a significant hawkish shift.

In the medium term, we expect economic activity to recover in emerging Asia and to outweigh tighter financial conditions. The main downside risk to this base case is a recoupling of the US dollar with rising UST yields, which would lead emerging markets to underperform other financial markets.

Credit: Are investors losing the will to fund leverage?

Beneath the surface of small index moves, we think one of the most significant developments occurring almost by stealth is the change in appetite of credit investors to fund leverage and M&A. While until recently, every new issue saw strong demand, investors have now started becoming more discerning, as seen in the latest Bacardi deal but also in previous ones for example from Campbell Soup. This to us implies that credit returns should continue to lag those of equities in the near to medium term. Last week, where equities were relatively flat and performed in line with CDS, cash credit spreads widened. While higher yields were a factor, as 10yr US Treasury yields hovered around the 3% level, several credit markets also saw significant outflows, impacting sentiment negatively. Last but not least, earnings from European banks were generally weak, trailing US peers in trading, although significant US corporate debt issuers reported better numbers but mixed outlooks. All in all, we see headwinds gaining momentum for credit despite equity tailwinds.

What to Watch

- The first estimate of Q1 Eurozone GDP growth is likely to show a slowdown in the pace of growth compared to Q4, but our view is that the Eurozone recovery remains intact.
- Attention will turn to the US core PCE inflation reading on Monday that is expected to hit 2% for the first time in four years, though we suspect that this may be a little aggressive. Wednesday sees the FOMC meeting, where no change in rates is expected.
- Asian PMIs will be released, as well as export data for Taiwan and Korea. We will be watching for signs of a rebound in manufacturing activity after a soft patch in Q1. In Australia, the central bank is expected to stand pat.

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