May 7, 2018

ZURICH®

Weekly Macro & Markets View

Highlights and View

- **The S&P 500 shows an underwhelming reaction to a very strong US earnings season**

  US economic momentum is slowing from high levels but the environment for stocks remains supportive.

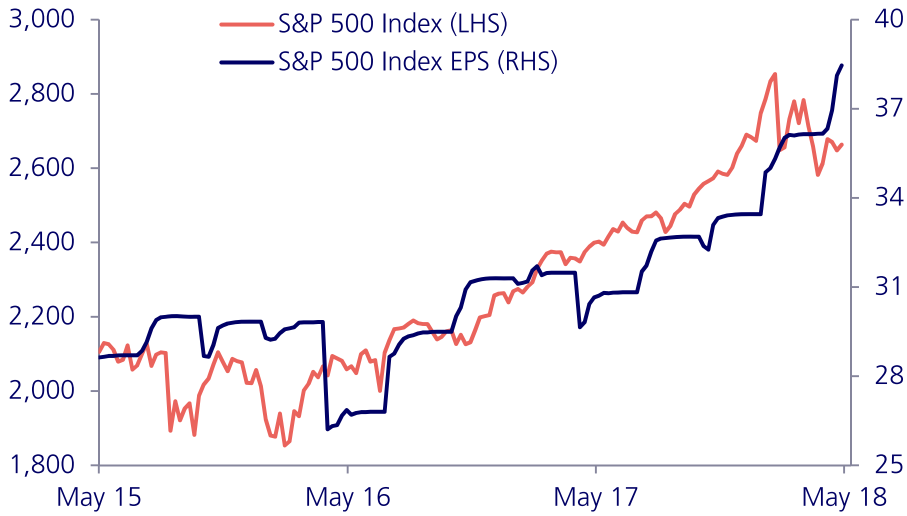
- **No tangible progress was made after two days of trade negotiations between China and the US**

  While we do not expect a full-blown trade war between the US and China tensions are likely to remain high, affecting investor sentiment.

- **EM credit suffers significant volatility as US dollar strengthens further**

  While EM credit volatility should subside as carry trade unwinds abate, such sporadic episodes of volatility are likely to become more frequent as monetary policy normalises further.

Stellar earnings growth fails to impress investors



Source: Bloomberg

US stocks fluctuated before ending the week basically unchanged despite a continuation of a very strong reporting season. With more than 80% of the quarterly results published, the average earnings surprise stands at 6.2%. Annual sales and earnings growth rates reached an impressive 8.4% and 24.5% in Q1. Ignoring the strong reports investors seem to worry that the best times lie behind us. Both the ISM Manufacturing and Non-Manufacturing indices fell 2 points to 57.3 and 56.8 in April, in line with our view that economic momentum is solid but unlikely to pick up significantly going forward. The economic environment remains benign and the latest labour market data confirm the healthy employment situation. The unemployment rate fell to 3.9%, the lowest since December 2000. Despite the ever tighter labour market, growth in average weekly earnings slowed down to 0.1% MoM in April, keeping the annual rate at 2.6%. Finally, PCE Core accelerated to 1.9% YoY in March from 1.6% the month before. However, this was fully priced in already as it was mainly driven by base effects from last year's mobile phone price cuts. The Fed confirmed its current path at last week's meeting where no action was taken, as expected. Despite current investor caution, economic data and corporate earnings continue to point to a positive environment for the stock market.

Credit: EM credit weakness weighs on sentiment

Credit spreads widened last week across the US and Europe as sentiment from weaker credit markets in EM weighed on broader credit, and particularly on European financials. Weakness in EM credit seemed to be driven by the unwinding of crowded positioning in carry trades by leveraged players, triggered by the recent strength in the US dollar. The Argentinian Peso in particular declined sharply, causing the central bank to hike rates very aggressively. Although we don't see the large imbalances that existed during prior crises, corporates in some EM countries have been leveraging up and are vulnerable to US dollar strength and weaker commodity prices. Thankfully, commodity prices and especially oil prices have been holding up better recently than they have done during past episodes of US dollar strength. While we don't think a crisis in EM credit is likely or imminent, we do think that sporadic episodes of volatility are likely to become more frequent, as we enter the late stage of the cycle and monetary policy normalises further.

Eurozone: Further confirmation of stabilisation in activity

Eurozone GDP growth fell to 0.4% QoQ in Q1 from 0.7% QoQ in Q4. However, other data released last week suggest the worst of the slowdown is over and that growth should at least stabilise, if not pick up in Q2. The latest bank lending statistics from the ECB showed a pick-up in lending growth to households and non-financial companies in March compared to February, confirming the encouraging ECB Q1 lending survey released the week before which showed a continued easing in credit standards and strong loan demand. The final Eurozone composite PMI for April came in at 55.1, consistent with a well-above trend pace of growth in the Eurozone. Admittedly, core inflation fell more than expected in April, to 0.7% YoY from 1.0% in March. However, this was due to the different timing of Easter this year compared to last year, artificially depressing the services component of inflation. Core inflation should rebound in May, though it will still remain well-below the ECB`s target.

Italy: Political impasse continues with increasing chances of early elections

The political impasse in Italy continues. More than two months after elections were held there is still no sign of a new government. Negotiations between the 5-Star Movement and PD ended last week, as the PD at a party conference decided to refuse to enter into government with the 5-Star. Latest developments suggest that the 5-Star and Lega party are still looking at ways to form a government, despite the breakdown of their own talks a few weeks ago. Italian President, Sergio Mattarella, is also likely to attempt to pursue a technocratic government as a last ditch option if talks between the various parties fail. However, there are also increasing chances of early elections being held, possibly this autumn or early next year. For now, sovereign bond investors appear sanguine about the ongoing political saga, but the chances of further economic reform in Italy are now low. In time, we think bond investors could become more worried about these developments, and Italian government bond yields increase versus other Eurozone government bonds, where medium-term political and economic risks are lower.

Switzerland: The economy rebounds but households become more downbeat, with job security a concern

The economy appears to be gaining momentum after a soft patch in the first quarter. The manufacturing PMI rebounded in April on broad-based strength and capacity constraints are becoming more evident, with suppliers delivery times and input prices at cycle highs. The KOF leading indicator also edged higher, with improving dynamics in most sectors. While the broader economy continues to expand at a decent pace, weakness in the consumer segment persists. Consumer confidence ticked down in April and appears to be peaking at a modest level, with job security a concern. Retail sales are weak, with a 5% decline on a year ago in the ex-fuel ex-food segment. We maintain a below consensus view on the Swiss economy, mainly reflecting persistent headwinds in the domestic economy, in line with the latest data. A weaker Swiss franc will, however, help to boost activity and sentiment, and we expect this to be visible in the data in the months ahead.

Asian PMIs: Weaker exports, but solid domestic demand

April PMIs paint a mixed picture of private sector activity in the region. The large economies of India and Japan saw improvements in domestic demand for manufacturing and services. The Caixin composite PMI ticked up to 52.3, boosted by robust services activity in China. One feature was shared by most Asian economies, though: export orders for manufacturing goods were substantially weaker. Chinese, Malaysian, Korean, and Australian new export orders fell below the 50 mark. Korean firms blamed ongoing restructuring in the car industry and a calm period in-between tech model launches. Ongoing softness in export demand warrants careful monitoring, although we are not too preoccupied yet. On the bright side, domestic consumption and investment growth have gathered pace in many Asian countries, supported by generous fiscal spending. Overall, as global monetary conditions tighten further, Asian economic activity appears resilient so far.

What to Watch

- In the US, the focus will be on inflation data where CPI is likely to have accelerated in April after a monthly drop in March. Both small business optimism and consumer sentiment are expected to remain high.
- Chinese and Filipino exports will be released, as well as Hong Kong Q1 GDP. We will watch China money supply and CPI data. Japanese wages statistics and the Eco Watcher survey will be published.
- The Australian government will propose major tax reforms in the next federal budget. In Malaysia, the central bank will likely stand pat, and general elections will be held.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

ZURICH®