January 8, 2018

Weekly Macro & Markets View

Highlights and View

- **Risk assets power to new highs as investors deploy funds at the start of the year**

  Equity and credit markets remain within a bull track, though we continue to believe that the late stage of the cycle will favour equity holders.

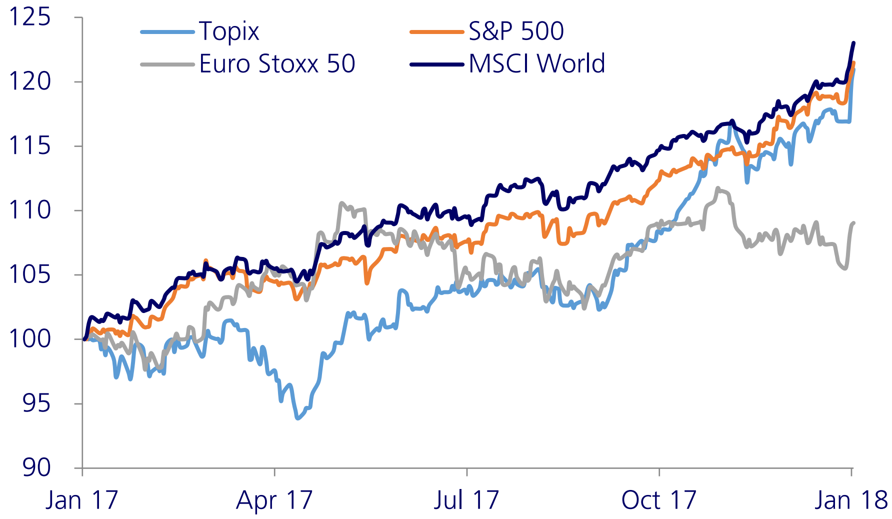
- **US economic data show a continuation of the solid momentum entering 2018**

  Strong manufacturing new orders indicate a positive start to the new year. On the other hand, non-farm payrolls and the service sector are showing signs of deceleration while still at high levels.

- **German retail sales surge while Eurozone inflation remains soft**

  The goldilocks scenario is expected to persist for some time in the Eurozone, however, inflation is likely to rise modestly as significantly above-trend growth reduces spare capacity.

The New Year brings records for stocks while bonds hold in



Source: Bloomberg

Following the most modest of sell-offs in the last few days of 2017, equity investors returned with a vengeance last week, lifting global indices further into record territory. The holiday-shortened week saw money being put back to work, helped by clarity on US tax reform, a continuation of strong economic data, and even some thawing in North/South Korean relations. We had suspected that the strong momentum of last year would continue, though the immediate impact is impressive. Indeed, as we had postured in our January Investment Insights, stocks in Japan have broken out of their long-term trading range and reached levels last seen back in the heydays of 1991. Eurozone equities have also entered the New Year with a bang after relatively lacklustre performance at the back end of last year, though ongoing euro strength needs monitoring. While we continue to believe that both regions will continue to perform well, the jump in stocks more generally is looking extended and we would not be surprised to see some consolidation and profit taking in the weeks ahead.

Despite the move in equities and further strong economic readings, bond yields moved only marginally higher, remaining largely rangebound. Without tangible evidence of a pickup in inflation this pattern is likely to persist. The first auctions of the year in Spain and France were well received, with bid/cover ratios robust and peripheral spreads compressed modestly.

Credit: Firm but lethargic start to the year

Credit markets were firm during the first week of 2018, but continued to underperform the very strong global equity markets, where several equity indices reached new record levels. The tightening bias for credit spreads remains intact, but lethargic, as most credit indices are now at or close to post-financial crisis lows, which naturally limits the room for spreads to tighten further. Dispersion between strong and weak credits is very low as strong demand spurred by QE is overwhelming underlying credit fundamentals. Supply/demand technicals remain strong, with large inflows in high grade funds while high yield funds continue to record outflows, but at a slower pace. The primary market showed an unimpressive start in the US, perhaps affected by the winter storm, but we expect an uptick in issuance this week given the strong pipeline. The tax reform implementation will probably lower the issuance volume in the long run, but growing M&A activity may push financing needs in the coming weeks. In Europe, decent primary activity was mainly driven by financials and covered bonds issuers.

US: Divergence between manufacturing and services

Economic momentum remained very solid in the final month of last year. The ISM Manufacturing reaccelerated to 59.7 in December from 58.2 in November. In particular, new orders soared to the highest level since 2004, indicating a very strong start to the new year. A slightly different message came from the service sector with the ISM Non-Manufacturing receding to 55.9 from 57.4. Both the backlog of orders as well as new orders fell, with the latter dropping to the lowest level since August 2016. Whether this is just a one-off remains to be seen, but it is unlikely that the strong economic momentum will be in place for the whole of 2018. New payrolls have also shown a loss of momentum, slowing down to 148'000 in December from 252'000 in November. The unemployment rate remained at 4.1% while average hourly earnings accelerated to 0.3% MoM, slightly lifting the annual rate to 2.5% from 2.4% in November. No surprises came from the FOMC minutes. A lot of focus was put on below-target inflation, but the Fed feels comfortable with its projected rate path for 2018.

UK: Service sector new orders the lowest since August 2016

Business activity was holding up reasonably well at the end of 2017. The Composite PMI remained basically flat at 54.9 in December, after 54.8 the month before, ending the year at almost exactly the average level reached over the course of 2017. Manufacturing remained solid, although the corresponding PMI dropped to 56.3 from 58.2. Interestingly, the main growth dynamic came from the intermediate and investment good sectors, benefitting from a solid increase in new export sales, while growth slowed further in the consumer goods sector. The service sector was also holding up relatively well, with the Services PMI ticking up to 54.2 in December from 53.8 in November. However, new orders growth fell to the lowest level since August 2016 and the rate of job creation slipped to a nine-month low. Brexit-related uncertainty is expected to remain a headwind for domestic business in 2018 as negotiations with the EU are unlikely to provide a lot of clarity regarding the future trade relationship any time soon.

Asia: PMIs continue to indicate healthy growth despite some pitfalls

Asian Manufacturing PMIs for December still paint a rosy picture of the industrial parts of the Asian economies, even though they pale compared to those published for the Eurozone and the US. Taiwan leads the pack with another increase to 56.6, which is important considering its position in the global electronics chain. Japan also shines with its PMI at 54, the highest in nearly four years, with new export orders surging. The trophy for strongest surge goes to India this month, with its PMI up 2.1 points to 54.7. Among the somewhat disappointing PMIs are those of Korea, Indonesia and Malaysia, with all of them falling back below the 'boom or bust' line of 50, though only marginally. We believe that there are some distortions in Korea due to fewer working days and strikes in the auto sector, while the semiconductor sector is still doing very well. In Indonesia, all five components fell back into contractionary territory, with subdued demand and raw material shortages having been indicated as the prime reasons. Overall, we also note a slight uptick in input and output prices.

China: Growth remains firm despite tightening

China's PMIs for December came in better than expected, considering policy tightening. The Caixin Manufacturing PMI rose to 51.5, with production rising and inventories falling. New orders and new export orders also contributed positively. Meanwhile, the NBS Manufacturing PMI eased slightly, reversing its rise in November. Large companies fared better than SMEs. Even though the NBS and the Caixin Manufacturing PMIs paint a slightly different picture, which is not uncommon, we note that new export orders are up in both surveys. We are encouraged by the strong readings of the NBS Non-Manufacturing PMI and the Caixin Services PMI, both came in much stronger than consensus had expected. Favourable conditions are particularly visible in internet, banking and construction. The PBoC announced a temporary monetary easing step for Chinese New Year from February 15th, reducing the reserve requirement ratio (RRR) by up to 2% for a period of 30 days for some large banks. We interpret this step positively as it shows that Chinese policy makers will act flexibly within overall tighter policies.

What to Watch

- In the US, CPI and PPI will show the degree of price pressure, while retail sales are expected to reveal decent spending in December. Small business optimism is likely to remain high.
- Among the Asian economic indicators, we will have a closer look at wages in Japan, exports in China and Taiwan, industrial production in Malaysia and India, and inflation data in China and India. China is likely to also publish lending and monetary aggregate data for December.
- Eurozone retail sales and industrial production data are likely to show further improvement as are confidence readings for December. We suspect that unemployment could also tick lower from the current 8.8% level given the momentum in economic activity.

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