May 14, 2018

Weekly Macro & Markets View

Highlights and View

- **The victory of the Pakatan Harapan party has brought the first defeat for the Barisan Nasional party since Malaysia's independence**

  We expect volatility in Malaysian financial markets to be short-lived as the new PM clarifies his economic agenda.

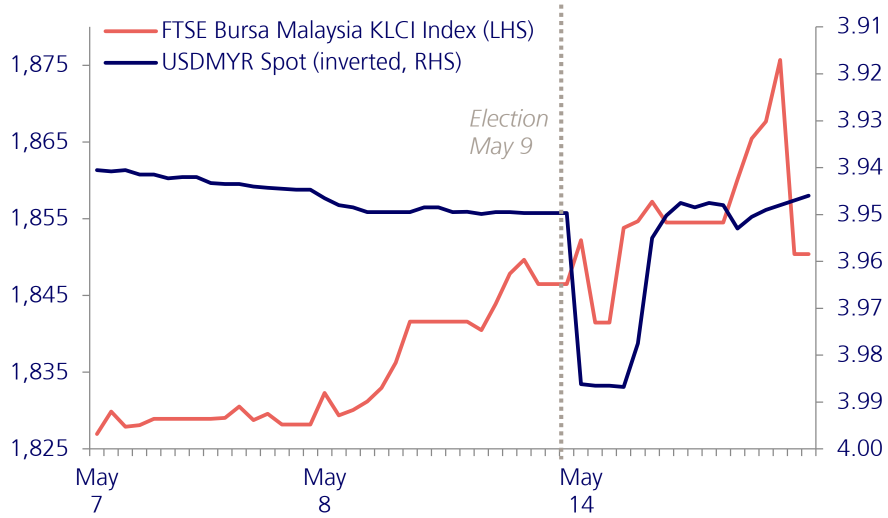
- **S&P 500 increases 2.5% and risk appetite returns to emerging markets despite geopolitical tensions in the Middle East**

  Investors are correctly focusing on the supportive fundamentals of strong earnings and decent economic growth.

- **Donald Trump announces that the US will withdraw from the Iran nuclear deal**

  While the immediate impact has been modest so far, the decision to exit the nuclear agreement is likely to increase tensions in the Middle East.

Malaysia: Investors adjust quickly to surprise election result



Source: Bloomberg; election results available after Wednesday 9 market close; markets reopened on Monday 14; intraday tick = 30 min

The Barisan Nasional party (BN) led by Najib Razak, has lost its first general election since Malaysia's independence in 1957. The opposition party, Pakatan Harapan (PH), led by former Prime Minister (PM) and ex-BN member Mahathir Mohamad, has secured a simple majority in Parliament. In the aftermath of the results, offshore currency and equity markets fell sharply, but recovered after the new PM's first press conference. Foreign investors are concerned about PH's generous fiscal promises, which include the cancellation of the Goods and Service Tax (GST). Removing the GST would deprive Malaysia of ~8% of its fiscal revenues, or 1 to 1.5% of GDP, even after accounting for higher oil revenues. Despite this risk, we remain constructive: PM Mahathir's initial nominations are business- and investor-friendly. The PM also stressed that he would prioritise economic measures in favour of 'Malaysia Incorporated' as well as public debt reduction.

Malaysian voters have sent a strong signal in favour of institutional transparency. Ultimately, this should benefit Malaysia's image among international investors and boost local consumers' morale. In financial markets, we expect short-lived volatility. The recent increase in global risk appetite acts as a tailwind to local markets. Moreover, this week the USD ascent paused and EM equities rebounded sharply following a downside surprise in US inflation.

Markets: Investors finally recognise strong fundamentals

Despite geopolitical tensions in the Middle East, risk appetite was strong last week. The US S&P 500 ended up 2.5% on the week, while the MSCI Emerging Market index was up 1.8%. Investors finally seem to be acknowledging the strong Q1 earnings season in the US, in line with our view that the macro and earnings fundamentals are still supportive of an overweight position in risk assets, especially equities. Whilst a stronger USD remains a risk to emerging markets, in many cases their fundamentals such as current account and fiscal deficits are in better shape than they were when going into the taper tantrum in 2013. For example, in India, the current account deficit has shrunk below 2% of GDP and the fiscal deficit to around 3.2% of GDP. Overall, we expect the risk on environment to persist as the earnings and global growth outlook remain supportive, though we acknowledge the Middle East situation remains a risk. An escalation in tensions could lead to a sharp spike in oil prices, ultimately threatening global growth and risk appetite.

US: More open jobs than unemployed people

The S&P 500 had its best week in two months helped by a mix of positive economic data and weaker than expected inflation. Price pressure broadly moderated in April, mitigating investors' fears that inflation is getting out of hand and forcing the Fed to act more aggressively than intended. PPI input price growth slowed down to 2.6% YoY in April from 3% the month before, with Core PPI falling to 2.3% YoY from 2.7%. While headline CPI has increased by 0.2% MoM, after March's -0.1%, Core CPI just ticked up by 0.1%, both numbers falling short of consensus expectations. The annual rate for CPI inflation has accelerated to 2.5% but Core CPI remained at 2.1%. Both small business optimism and consumer sentiment remain at very high levels and with job openings rising to 6.6 million in March there are now theoretically more open jobs than unemployed people – although a major challenge is the mismatch between open positions and employees' qualifications. Indeed, the latest small business survey confirms that filling open position remains a major challenge for companies.

Italy: 5 Star-Lega coalition government comes into view

At the eleventh hour, and after a threat from Italian President Sergio Matarella to appoint a technocratic government, the Five Star and Lega parties negotiated plans for a coalition government last week and over the weekend. Crucially, Silvio Berlusconi, leader of the Forza Italy party, the Lega party's coalition partner going into the election on March 4, said that he would not stand in the way of a deal between the two parties, even though he did not support such a deal either. This had been a major stumbling block up until now. A Five Star-Lega coalition will pursue higher government spending, which could in turn raise investor concerns around debt sustainability. For instance, one of the first measures they have agreed upon is lowering the pension retirement age, which was raised in 2011 as part of the austerity measures introduced during the Eurozone debt crisis. The 5 star and Lega may also enact their respective flagship policies for a universal minimum income and a flat tax rate, though the details of how this will be implemented or paid for are not yet clear.

UK: The BoE wants to sound hawkish, but the market has its doubts

As expected after the recently published set of slowing inflation rates and weak GDP numbers, the BoE has kept its target rate unchanged at 0.5% despite sending strong signals about hiking rates earlier this year. The decision to keep rates unchanged was not unanimous, however, as two MPC members voted in favour of hiking rates. The BoE lowered both its inflation and GDP forecasts for 2018 but Mark Carney, the BoE's governor, still wanted to send a hawkish message and indicated that a rate hike remains likely by the end of the year.

Although economic data is likely to remain modest for the time being, the MPC seems eager to increase rates and the window of opportunity ahead of the UK leaving the EU in March next year is rapidly closing. The latest batch of data do not bode well in this regard as house prices kept falling in April and the NIESR 3-month rolling estimate of GDP growth remained at a disappointing 0.1% in April, indicating that economic momentum is not picking up after the weak first quarter.

Switzerland: House market imbalances diminish in a better nominal growth environment

The UBS real estate bubble index fell sharply in Q1, to the lowest level since 2015. This reflected stronger nominal growth in the overall economy, making valuations more sustainable. The house-price-to-income and the mortgage-to-income ratios both declined on accelerating household income, real house prices fell as the overall price level rose and construction as a share of GDP slipped as broader activity improved. These are positive developments, reducing risks around the housing market. House prices, however, are high relative to rents, and we do not anticipate nominal growth to accelerate materially from now on. A late cycle housing boom therefore remains unlikely. The unemployment rate dropped further, to 2.7%, which is the lowest level since 2011, in line with surveys that highlight tight capacity. Despite this, the CPI data showed inflation unchanged at 0.8% YoY, with core CPI at 0.5%. While this is stronger than the SNB forecast, domestic inflation is weak and justifies policy remaining dovish.

What to Watch

- In the US, retail sales should hold up reasonably well given high consumer confidence while housing data may see a bit of moderation after a solid start into 2018. In the Eurozone, the ZEW investor sentiment survey is expected to rebound, while German GDP data is likely to confirm that the pace of growth that slowed in Q1, though our view is that the recovery remains intact.
- Japan will release industrial production, machine tool orders, and CPI data, as well as a probably lacklustre Q1 GDP print. In China, industrial production, retail sales, and fixed asset investment data will be published. We will watch exports from Singapore and from Indonesia, as well as Q1 GDP data for Malaysia.
- Bank Indonesia is likely to announce a policy rate hike along with macro-prudential measures to improve currency stability. The Bank of Thailand will probably stand pat.

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