May 28, 2018

Weekly Macro & Markets View

Highlights and View

- **Eurozone peripheral government bond spreads widen as populist coalition takes control in Italy**

  Episodic periods of market volatility in Italian bond and equity markets are now likely.

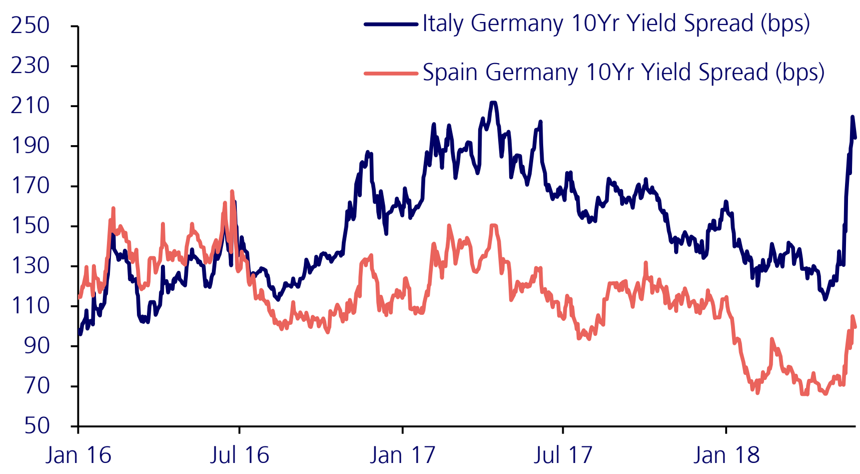
- **Two corporate bond deals in European IG credit were pulled amid weak sentiment**

  Investors are rightly becoming more discerning, as spreads are low, leverage is high and the credit cycle is in its late stage, but we don't see a freeze ahead in primary markets.

- **Export data for South Korea in May as well as for Japan, Taiwan and Thailand in April were brisk**

  This is an important confirmation of our view that the weak global growth environment of Q1 is behind us and that special factors are no longer distorting.

Investors wake up to risks in Italy as populists try to form a government



Source: Bloomberg

Last week, the 5 Star and Lega parties finalised their deal to form a coalition government in Italy. The combined proposal from both parties includes a universal minimum income, a flat tax rate that would probably reduce the overall tax take, and reducing the pension retirement age as well as other items. If all their proposals were implemented in full, it would send Italy's budget deficit well beyond the 3% of GDP limit set in the Stability and Growth pact.

As investors have become more concerned, spreads between Italian and German 10yr government bond yields have increased, from around 120 bps at the end of April to around 200 bps last week. However, in fast moving developments over the weekend, the coalition deal appeared to break down, as Italian President Sergio Mattarella vetoed the coalition's proposed choice of finance minister because of his euro-sceptic views. This led the 5 Star and Lega party leaders to call for fresh elections instead. The President is likely to attempt to form a technocratic government in the meantime. The situation remains fluid and could easily change again quickly. The key conclusion we can make for now is that chances of further market friendly reform of the Italian economy are limited, with episodic periods of volatility in Italian bond and equity markets more likely instead.

Credit: Becoming a buyer's market again

Credit investors showed further signs last week of becoming discerning in the European primary market. Following the poor performance of some acquisition finance deals in the US credit market earlier, last week saw two European deals, namely from Bertelsmann and Whirlpool, being pulled from the European IG primary market. We are not surprised that investors are being more selective at this stage in the credit cycle, when leverage is high and spreads low. In fact, adjusted for leverage, spreads are almost at all-time lows. That said, last week was also generally bad for European credit, as volatility around EM credit gave way to volatility in the periphery, especially Italy. This took a toll on European banks, causing financials to underperform within a weak European credit market. Even in bank stocks, it is notable that European banks have now underperformed US banks by around 10% over the month. While we think spreads will recover somewhat in coming weeks, we think the cycle tights are behind us.

Eurozone: Mixed data, but overall outlook is still for above trend growth

After having appeared to have stabilised in April, the Eurozone flash composite PMI fell by a further point in May. Temporary factors may have been partly to blame. The French services PMI fell three points for example, probably due to the ongoing strikes in the transport sector. However, latest developments suggest these strikes could soon wind down. The French manufacturing PMI, less affected by the transport strikes, actually increased in May. German manufacturing confidence fell, potentially impacted by capacity constraints and ongoing concerns around tariffs. The overall German ifo survey across four sectors and 7,000 companies was unchanged in May compared to April and still at a robust level in terms of current activity. Finally, the breakdown of German Q1 GDP was encouraging in that all components of private domestic demand were strong, especially business investment. Overall, despite some mixed data, the Eurozone recovery appears on track, even if the pace of growth has slowed from the very strong pace it was setting at the beginning of the year.

US: PMIs signal a continuation of solid economic momentum

The S&P 500 ended the week in positive territory unlike most of the other stock markets around the globe. Geopolitics provided a bit of a headwind as President Trump announced his intention to cancel the planned meeting with North Korea's leader Kim Jong Un, which was then put back on schedule over the weekend. Meanwhile, the latest set of Markit PMIs indicates a continuation of strong economic momentum in the US. The Manufacturing PMI ticked up slightly to 56.6 in May from 56.5 in April. The Services PMI rose to 55.7 from 54.6, lifting the composite PMI to 55.7. New home sales fell slightly in April but remain in an upwards trend. Going forward, we would expect more of a negative impact from rising mortgage rates, however. The latest Fed minutes show that the focus has shifted from reaching the inflation target to how sustainable the recent acceleration in inflation is. While a rate hike in June is almost certain, FOMC members remain split on how fast monetary policy should be tightened afterwards.

Japan: Economic recovery is in the offing

Following the dismal economic performance in Q1, with real GDP falling by 0.6% on a sequential annualised basis and ending the longest growth phase since the late eighties, economic conditions have started to improve again. As seen in South Korea, Taiwan, Singapore and Thailand, both export and import volume growth in Japan started to accelerate again in April. Export values moved to the highest level this year, partly reflecting higher prices. While the Manufacturing PMI dropped to 52.5, the lowest level since August last year, the new-export-order PMI inched higher. We are particularly impressed by the latest Reuters Tankan for May. The manufacturing component turned up slightly again to 22, following several months of deterioration, while the outlook improved even more to 27. The major positive element, however, has been the non-manufacturing diffusion index, which moved up three points to 39, a record high level, with both real estate and services contributing. Finally, Tokyo department store sales were up nearly 2% YoY, benefitting from higher spending by mostly Asian tourists.

Bonds: Core bonds rally on Italian politics

Events in Italy triggered a rally in core bonds, with the 10yr Bund yield recording the largest weekly decline since 2012, after the Italian president asked the 5 star/Lega prime minister nominee to form a government. Events are fluid, but the 10yr Bund yield fell to 0.41% as a safe haven flow intensified, with other safe haven assets such as the Swiss franc surging. Bund yields are now lower than they were at the beginning of the year, despite a solid expansion and some stabilisation in the data. Gilts also rallied as Q1 GDP surprised on the downside, in contrast to BoE expectations, with a rate hike being pushed further out. Oil prices declined by almost 5% on the week, further weighing on inflation breakevens. Treasuries initially resisted the rally, but Friday saw a sharp decline in Treasury yields that took the 10yr to 2.93%, down from the recent peak of 3.11%, also helped by a dovish set of Fed minutes. Fundamentals justify higher core yields, but the near-term outlook depends on politics.

What to Watch

- Most of the relevant economic indicators for April will be published in Japan. In addition, we will watch the Q1 Corporate Survey by the MoF, a precursor to the Tankan. In China, both the NBS and the Caixin Manufacturing PMIs for May will be released. April industrial production data for Korea and Thailand as well as Q1 GDP data for India will also be in focus.
- A 2.5% portion of China's MSCI A-share index will be included in the MSCI Emerging Market index on Friday, bringing its initial weight to 0.4%.
- In the US, consumer confidence indicators and the ISM Manufacturing survey should reveal that sentiment remains very positive while labour market data are expected to reflect a continued healthy employment situation.

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