June 4, 2018

Weekly Macro & Markets View

Highlights and View

- **Concerns about fresh elections in Italy unnerve investors, with Italian bond yields spiking**

  While last week's bond market volatility was excessive, investors are likely to require a higher risk premium to invest in Italian government bonds going forward.

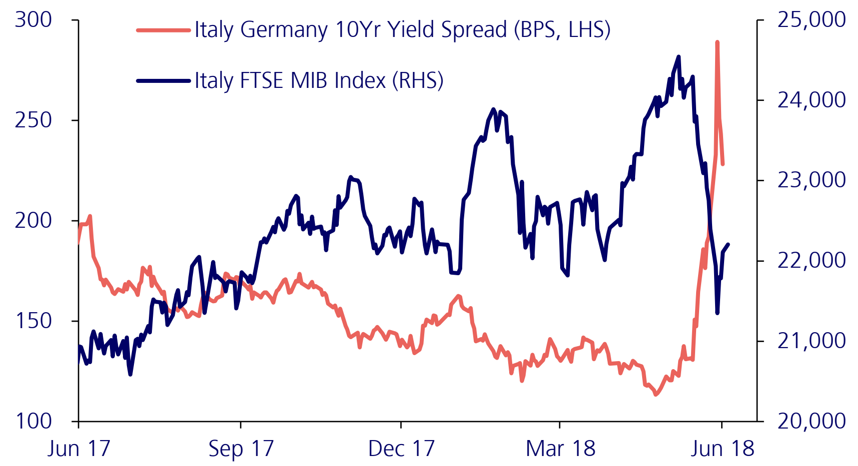
- **European credit, especially bank credit spreads, gapped wider amid investor angst around Italy**

  While spreads are likely to settle down a bit, we think European banks continue to warrant investor attention as they are perhaps the epicentre of weakness in credit markets.

- **The US imposes tariffs on steel and aluminium imports from Canada, Mexico and the EU**

  While the direct economic impact is negligible, retaliatory measures have already been announced and aggressive trade rhetoric increases the risk of a vicious cycle.

Political events in Italy dominate markets as investors reassess risks



Source: Bloomberg

Investors reacted negatively early in the week after Italian President Sergio Mattarella vetoed the 5 Star and Lega's nomination for finance minister on Sunday, May 27 because of his eurosceptic views, raising the risk of fresh elections. Italian 2yr and 10yr yields surged last Monday and Tuesday, with low liquidity exacerbating the moves. Warnings from the Italian central bank governor and the credit rating agency, Moody's, added to the negative mood.

Towards the end of the week, the 5 Star and Lega parties found a less controversial candidate for finance minister in order to still form a coalition. Italian government bond spreads retraced some of their widening from earlier in the week. However, they are unlikely to return to levels we saw earlier this year in our view. Instead, we think that investors will now require a higher risk premium to invest in Italian government bonds. Episodic periods of volatility in Italian asset markets are likely, with autumn a potential flashpoint as Italy must decide on its budget for 2019 then. Political developments also dominated in Spain. Prime Minister Mariano Rajoy lost a no-confidence vote, and was replaced as Prime Minister by Pedro Sanchez from the Socialist Party. However, the new government will have limited manoeuvring room to enact radically different policies given that it has a slim majority in parliament.

Credit: Spreads gap wider as banks get hit

Credit spreads gapped wider on Tuesday last week, with European financials suffering the most, although the rest of the week saw some stabilisation. The vulnerabilities of European banks were at the fore once again, as Italian bank spreads widened by over 50bps in one day. Apart from significant non-performing loans, Italian lenders hold more government debt than Tier 1 capital, a linkage that still remains higher than before the Eurozone crisis. This morning, Unicredit is reportedly wanting a merger with Societe Generale, although it's unclear that this will occur imminently, if it occurs at all. More importantly, however, there were reports that Deutsche Bank's US unit was classified as being troubled by US regulators, followed by a S&P credit rating downgrade. Amid all this, regulators are relaxing regulations, with US regulators now proposing to soften some aspects related to the Volcker rule. We think banks, especially European banks, continue to warrant investor attention as they are perhaps the epicentre of weakness in credit markets.

US: Consumers and firms remain very upbeat

The S&P 500 managed to climb back into positive territory after a holiday-shortened week in which political turmoil in Italy rattled global markets. 10y Treasury yields briefly fell below 2.80% before rebounding. Meanwhile, US economic momentum remains strong with the ISM Manufacturing index rising back to 58.7 in May and the Conference Board Consumer Confidence survey hovering around its multi-year highs. One reason for the positive mood is the healthy employment situation, which was confirmed again last week. The unemployment rate ticked down to 3.8% in May matching the multi-decade low reached in April 2000. Growth in average hourly earnings re-accelerated to 2.7% YoY from 2.6% in April while 223'000 new payrolls were created, lifting the YTD monthly average to 208'000. Some headwinds for economic sentiment are building as President Trump's decision to impose tariffs on steel and aluminium imports from Canada, Mexico and the EU, and potentially on $50bn worth of imports from China, increases the risk of retaliation and raises domestic costs for households and producers.

Switzerland: Fifteen medals and a boost to GDP

The economy grew at a solid pace in Q1, with GDP up 0.6% QoQ. There was a sizable one-off effect from the winter Olympics, as GDP includes the value added from international sports organisations based in Switzerland (e.g. FIFA, IOC). Stripping out this effect, the economy grew by a more modest 0.4%, below the average quarterly rate of 0.7% in the second half of 2017. The mix was good though, with a boost from equipment and software investment and decent growth in consumption. Construction investment contracted, consistent with our view that the housing market is a headwind to growth. The latest data show slowing momentum, with the KOF leading indicator and the manufacturing PMI moderating in May. Employment growth is still strong though, underpinning the expansion. The sharp appreciation of the franc last week highlights why the SNB is expected to keep its policy in place. Sight deposits edged higher, showing that the SNB was active in forex markets as political events in Italy unfolded.

Japan: A mixed bag

Economic indicators released last week showed a mixed outcome, but still suggest solid growth in Q2. At +0.3% MoM, industrial production was up for the third month in a row in April, though less than expected. Company forecasts for May and June are not really enthusiastic, and expect only a small increase in May followed by a setback in June. Capital goods shipments reached a ten-year high, suggesting strong business investment, in contrast to the somewhat sluggish MoF corporate survey for Q1. A divergence between manufacturing and non-manufacturing sectors is visible in corporate profits, with the former down 8.5% YoY in Q1, while the latter showing an increase of 5%. A sharp drop in profits is noticeable in communication equipment, transport equipment and electrical machinery. On the positive side, retail sales bounced back with a vengeance in April, as consumer confidence recovered and tourist spending contributed positively. Female job creation boosted the labour market, while annualised housing starts surged surprisingly close to the 1mn mark.

ASEAN: Bank Indonesia hikes again; Malaysia commits to a 2.8% fiscal deficit

As expected, Bank Indonesia (BI) Board, led by Governor Perry Warjiyo, delivered a "pre-emptive" 25bps rate hike to strengthen "exchange rate stability against a higher than expected Fed Fund Rate hike". Currency markets responded positively as the IDR moved below 14,000 vs. the USD. We expect BI to hike once more this year, since currency volatility is likely to persist. Local monetary conditions remain relatively benign, however. The recent 50bps hikes barely retrace the 2017 rate cuts. Going forward, we need to watch whether private consumption recovers and which pro-lending macro-prudential measures BI announces.

The Malaysia Finance Minister disclosed his first estimate for the 2018 fiscal deficit, which is to remain at 2.8% of GDP. The replacement of the Goods and Service Tax by the Sales and Service Tax, plus an increase in fuel subsidies will allegedly be offset by cost cuts, higher oil revenues and dividends from government-linked entities. Looking beyond 2018, we think that increasing reliance on oil revenues is risky.

What to Watch

- The ECB is unlikely to announce a decision on QE tapering at this week's meeting, while Italy is likely to dominate the Q&A session.
- Switzerland votes on whether to give the SNB the sole authority of creating money. Polls suggest a large majority is against the proposal.
- In the US, the ISM Non-Manufacturing index is expected to show a continuation of solid momentum in the service sector while the number of job openings measured by the JOLTS survey may have receded from last month's record numbers.
- We will look at Japan's labour survey for April and the Eco Watchers survey for May, and at China's Services Caixin PMI.
- We expect Australia's RBA to stand pat and the Reserve Bank of India to turn from a neutral to a hawkish stance.

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