

Weekly Macro & Markets View

Highlights and View

- **Credit continues to underperform equities amid slow primary markets and outflows**

The divergence between credit and equities is likely to continue as the credit cycle is mature, while TARGET 2 imbalances and banking sector risks focus attention on European politics.

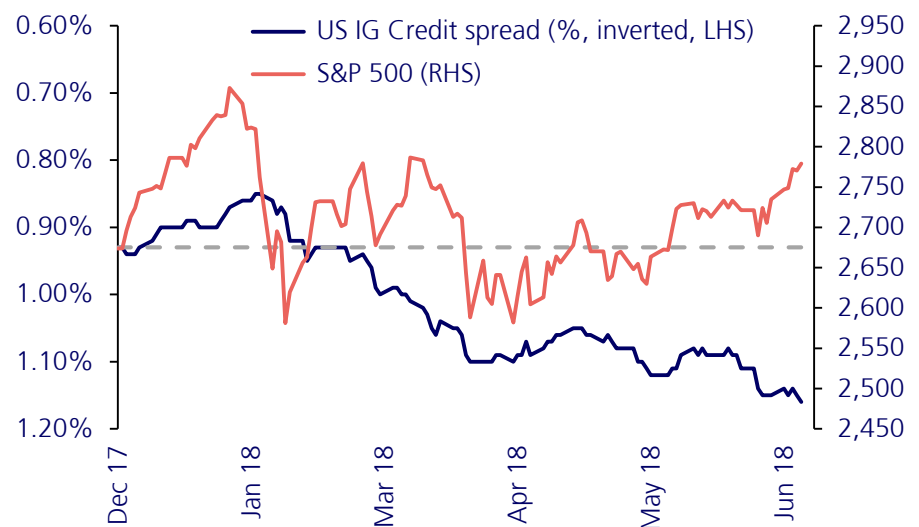
- **ECB Chief Economist, Peter Praet, delivers a wake-up call to investors that QE is coming to an end**

We continue to expect a taper and end to ECB QE in Q4 2018, and Praet's comments support that view.

- **The G7 meeting ends in disarray as President Trump revokes endorsement of the joint statement**

There is still broad commitment to free trade and a willingness to reform and improve the world trading system, which is encouraging, but risks around global trade have risen.

The divergent fortunes of credit and equity



Source: Bloomberg, Barclays US Agg Corp Index OAS

The divergence between credit and equity markets has been quite stark and is likely to continue. Historical patterns suggest that this conveys a simple message: credit is past its prime, as the cycle is mature.

Last week saw a continuation of this divergence as multiple headwinds from European political risk, ECB policy normalisation, jitters in EM debt and higher government bond yields took a toll on credit. Consequently, the primary market in Europe stayed practically shut for a second week, with issuers such as Salt being reportedly forced to pull a large bond deal. Bayer is expected to issue €20bn of bonds to fund its acquisition of Monsanto, but judging by the mood of the primary markets, it is more likely to come in the US than in Europe. Even the US primary market picked up only cautiously after the near shutdown last week. US high yield and EM bond funds suffered heavy outflows amid heightened investor angst.

European political risk is critical for credit, not only due to the vulnerabilities of European banks, but also as the ECB's QE has driven TARGET 2 imbalances to the extremes seen during the peak of the Eurozone crisis. Credit investors will keenly watch the TARGET 2 balance data for May and June to see if Italian banks experienced deposit flight when bank credit was selling off.

Eurozone: ECB Chief Economist gives a clear signal that QE is coming to an end

The ECB's Chief Economist, Peter Praet, said last week that it was time to discuss winding down QE, noting that wage growth was firming and that inflation would gradually pick up. The message was clear and led to a rise in yields in both core and periphery European government bonds. In Italian Prime Minister Giuseppe Conte's maiden speech to parliament he said that he would seek to implement the coalition agreement between the 5 Star Movement and Lega parties. If implemented in full this could lead to an increase in the budget deficit of around six

percentage points of GDP, which would clearly be unsustainable. It will therefore be important to see to what extent these proposals are watered down when the 2019 budget is actually presented to the Italian parliament in the next few months. Finally, data remain mixed. The breakdown of Q1 GDP was encouraging as it showed components of private domestic demand growing at a decent pace. However, industrial production in Germany and France disappointed in April, and German factory orders were also weak.

US: The NASDAQ reaches a new all-time high

In a week with little economic data, the US stock market continued its way up, with the S&P 500 rising to the highest level since March and the NASDAQ index even reaching a new all-time high. The ISM Non-Manufacturing index rebounded to 58.6 in May from last month's dip with new orders ticking up to 60.5 after 60 in April, confirming the ISM Manufacturing's solid print and indicating that the strong economic momentum remains intact. The employment component did not rise in proportion to the overall index, however, and was the second

weakest since last summer. Job openings rose to 6.7 million in April, further expanding the gap between available jobs and the number of unemployed workers. Finally, growth in consumer credit continued to soften with a plus of USD 9.3bn in April, one of the lowest increases in recent years. As credit conditions are expected to tighten further going forward, a significant pickup and a related boost for household spending is thus rather unlikely.

Japan: Growth is picking up again this quarter following a soft patch in Q1

Hopes that Japan's GDP data for Q1 would be revised up were unrealistic, as stronger capex data were offset by a downward revision of consumption and inventory. However, we note that Q4 growth was revised up. We look through the soft patch in Q1 and focus on how the economy is developing in the current quarter. The BoJ's consumption activity indicator, a better gauge for consumption than the household survey, surged by 2.4% MoM in April, while capital goods shipments reached a ten-year high in April. Core machinery orders for April, released today,

surged by 10.1% MoM in April, far better than consensus estimates. Non-manufacturing orders also edged up, though at a much slower pace. Finally, foreign orders picked up nicely, following two weak months. The indicator that spoils the party is the Eco Watchers Survey, where both the household and the corporate diffusion indices slumped. The decline visible in supermarkets and restaurants may be a distortion following the Golden Week holidays, but the drop in the manufacturing component is in contrast to corporate production forecasts.

Asia: Idiosyncratic trends in PMIs

Three trends are visible across Asian PMIs in May: new export orders have ticked up, businesses are optimistic about the next 12 months, and input costs from raw materials and wages have jumped, in some cases leading to output price hikes. In parallel, many idiosyncratic drivers are at play. In China, large SOEs are confident, in contrast to pessimistic SMEs. Strong momentum is visible in China services sectors, especially transport, internet, and software. In Australia, a large infrastructure pipeline is boosting demand. In Malaysia, activity fell sharply but businesses

have high hopes for the new government's policies. Taiwan and Hong Kong have turned increasingly pessimistic. Hong Kong PMI plunged to 47.8 as export orders from mainland China fell sharply in May, and manufacturers reported tougher competition from e-commerce. Overall, Asian PMIs paint a decent picture of activity in the region, although the weakness in Northern Asia has to be monitored. Inflationary pressures are clearly accelerating in the region.

World Trade: The G7 trade meeting ends in disarray but trade data show resilience

The G7 meeting ended in disarray as President Trump revoked his endorsement of the joint statement. While disappointing, the meeting was expected to be fractious and there was little hope of a breakthrough. The risk of escalating trade disputes has risen, but we highlight that there is still strong commitment to free trade, with broad commitment to working through the WTO to tackle disputes. The trade system is not perfect though and we were encouraged that the communique stated the need to reform elements of the WTO and develop and enforce new rules, in

particular around intellectual property rights. Elsewhere, data show that trade has rebounded after a weak Q1. Asian trade tends to lead world trade, and export values in northern Asia rose at double-digit rates in May. Demand was broad-based and intra-Asia trade was firm, with mechanical and electrical goods, semi-conductors and petrochemicals leading the rebound. Although not as strong as in 2017, the Asian trade revival signals robust world trade.

What to Watch

- The ECB is likely to say that it discussed tapering QE, though an actual decision announcement is only likely at the July meeting.
- Both the NFIB small business optimism index and the University of Michigan sentiment survey are expected to reveal upbeat firms and households, likely to be reflected in a pickup in retail sales. Inflation is expected to have accelerated in May.
- Japan's industrial production, exports and PPI will be in focus. China's money supply, industrial production, retail sales and fixed asset investment will be released.
- President Trump meets North Korea's leader, Kim Jong Un, for a historic summit in Singapore.

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