June 18, 2018

Weekly Macro & Markets View

Highlights and View

- **The US-China trade skirmish goes to the next round, while China's deleveraging slows growth**

  Tariffs, reaction and retaliation are a threat to global trade, while China's policy makers are expected to relax tight credit policies to avoid a more severe impact on the economy.

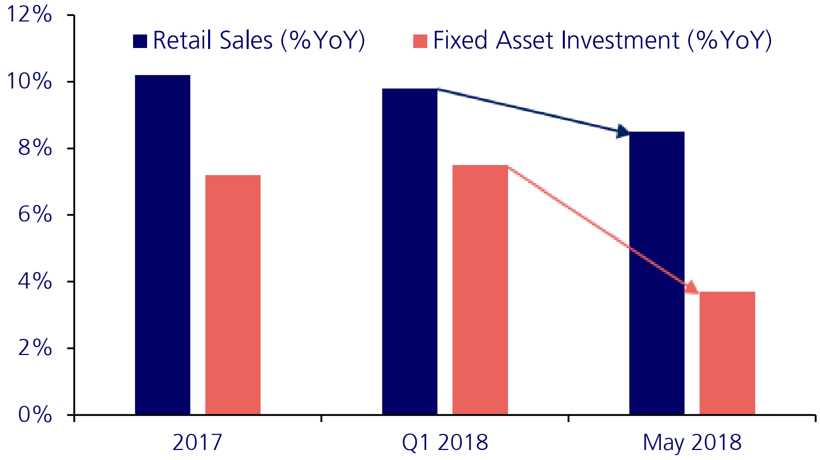
- **As expected, the Fed increased the funds rate to 1.75% - 2%, but signalled two more hikes this year**

  Given the strong momentum, the US economy should be able to cope with two more rate hikes this year. We are less convinced by the longer-term projected rate path, however.

- **The ECB announces it will end QE by year end and commits to leaving rates unchanged for now**

  This was a dovish decision with strengthened forward guidance on rates showing the ECB's commitment to keep policy extremely loose.

US trade issues and deleveraging pose risks for China's economy



Source: Bloomberg

China quickly responded to US President Trump's announcement of a 25% tariff on 1,102 Chinese products worth USD 50bn that contain industrially significant technologies. China now plans to add an additional 25% tariff on 545 agricultural product categories and cars worth USD 34bn, with more commodity and medical equipment related import duties to follow. The US announced that it will pursue additional tariffs once China engages in retaliatory measures, which raises the risk that trade skirmishes could develop into a trade war.

Trump's announcement hits China at a difficult time, as deleveraging measures to reduce domestic financial risks are starting to hit the economy. Indeed, economic indicators for May confirm our expected slowdown is already in full swing, with infrastructure investment, industrial production and retail sales coming in far below consensus expectations. The clampdown on shadow banking products is visible in the latest lending data for May. While aggregate financing more than halved from April to only CNY 761bn in May, new bank loans fell only marginally to CNY 1,150bn. The gap is explained by a sharp reversal in shadow banking lending. We believe the fact that the PBoC did not raise its reverse repo rate following the Fed rate hike last week is an indication that policy fine tuning to avert a more severe slowdown has already set in.

North Korea: Kim Jong Trump

Geopolitical risks around North Korea have receded markedly as US President Donald Trump and North Korea's leader Kim Jong Un seemed to get along well during the much anticipated summit in Singapore last week. We are not too surprised that the joint declaration lacked concrete details. The summit was a first step to build trust and to improve North Korea's relationships with the US and neighbouring countries, but we believe it will be a long and bumpy road ahead. The DPRK has committed to working toward complete denuclearisation, while Trump surprisingly announced a halt to united military drills in South Korea and provide security guarantees to North Korea, but maintaining sanctions for now. South Korea's equity market neglected the outcome, but we believe it will help bring down parts of the risk premium over the medium term, as market participants start to focus on business opportunities for South Korean companies and recognise attractive equity market valuations. However, the geopolitical dimension is certainly more important, not only for financial markets.

US: The Fed raises rates and signals two more hikes this year

The S&P 500 finished the week basically unchanged and 10yr Treasury yields briefly dipped back below 2.9% as the US announced another round of tariffs on Chinese imports, which was immediately followed by a reciprocal statement from China. Yields initially jumped after the Fed published its slightly more hawkish projections. It hiked rates as expected but is now signalling two more rate hikes this year, most likely in September and December. The FOMC also raised its inflation forecast, expecting to reach the inflation target already this year. Economic data published last week signal a continuation of the strong momentum. Both small business optimism as well as the University of Michigan's consumer sentiment index rose although the latter remains below the highs seen earlier this year. Reflecting the consumers' positive mood, retail sales grew by 0.8% MoM in May, the highest rate so far this year. Inflation accelerated in May as expected, with headline CPI rising to 2.8% YoY and Core CPI ticking up to 2.1% YoY.

Eurozone: Dovish ECB announces the end of QE while strengthening guidance on rates

The ECB delivered a dovish tapering of stimulus, committing to hold rates unchanged at least through the summer of 2019 while phasing out QE by year end, subject to incoming data. A tapering announcement was not expected for this meeting, but enhanced forward guidance on rates prevented a tightening of financial conditions; Bund yields fell, the euro weakened and stocks rallied. With this decision, the ECB is moving towards policy normalisation but at a glacial pace. Reinvestment flows will be large and forward guidance has been strengthened, showing a commitment to keep policy extremely loose. We agree with this approach, as underlying inflation is still weak and growth is slowing, albeit from a high level, with politics also weighing on sentiment. Meanwhile political infighting between the German CDU and its Bavarian sister party about migration issues has escalated, putting Merkel's government at risk, even though a last minute compromise is being negotiated.

UK: Household spending strengthens after Q1's soft patch

With Brexit rapidly approaching Theresa May has so far been able to avoid an open rebellion within her own party. Pro-EU rebels refrained from voting against May last week, but the situation remains fluid and the compromises came at the price of a still undefined future relationship. Meanwhile, the economy seems to be recovering from the weather-distorted first quarter. Retail sales rose by 1.3% MoM in May lifting the annual rate to 4.4%, the highest in more than a year. Accordingly, the rolling 3-month NIESR GDP estimate shows a pickup from 0.0% in April to 0.2% in May. Consumption is helped by a healthy employment situation. The unemployment rate remained at 4.2% in April, but weekly earnings growth ticked down to 2.8% YoY from 2.9% the month before. Headline CPI inflation was 2.4% YoY while Core CPI was 2.1%, both unchanged from a month earlier. A pickup in input prices indicates that there is still price pressure in the pipeline, further exacerbated by the renewed weakness in the pound.

Credit: A thaw in primary markets brings some relief

The smooth functioning of primary markets is critical in our view for the fundamental health of credit markets. The recent freeze, especially in Europe was concerning, but we expected a thaw soon. Encouragingly, the primary market has now opened up, with a number of deals being heavily oversubscribed. The relief has also filtered into secondary markets, causing spreads to tighten despite a more sombre mood in equities, and giving credit the opportunity to outperform equities after a while. All of this said, we wouldn't cheer too much. Firstly, issuers are paying a big price in terms of new issue concessions. Secondly, risks are rising according to some market indicators. The rate rise by the Fed caused the US Treasury curve to flatten to levels not seen since 2007, while EM credit continues to be under pressure due to a stronger dollar. The flattening of the curve caused bank stocks to decline across the US and Europe, with the latter now being in bear market territory versus its highs in January.

What to Watch

- We expect the G3 PMIs to be broadly stable, consistent with solid global growth.
- We do not expect any changes in monetary policy when the central banks' MPCs of Taiwan's CBC and Thailand's BoT meet this week, while there is a chance that the Philippines's BSP may raise its policy rate by 25bps to defend its currency.
- In Japan we will watch May data for exports, CPI and department store sales, while in the rest of APAC the focus will be on Australia's house price index in Q1and May export data in Taiwan, Singapore and Thailand.

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