June 25, 2018

Weekly Macro & Markets View

Highlights and View

- **Eurozone composite PMI rises to 54.8 from 54.1, led by a jump in service sector confidence**

  The survey suggests that Eurozone growth will be above trend, but domestically driven, while the manufacturing sector is weighed down somewhat by tariff concerns.

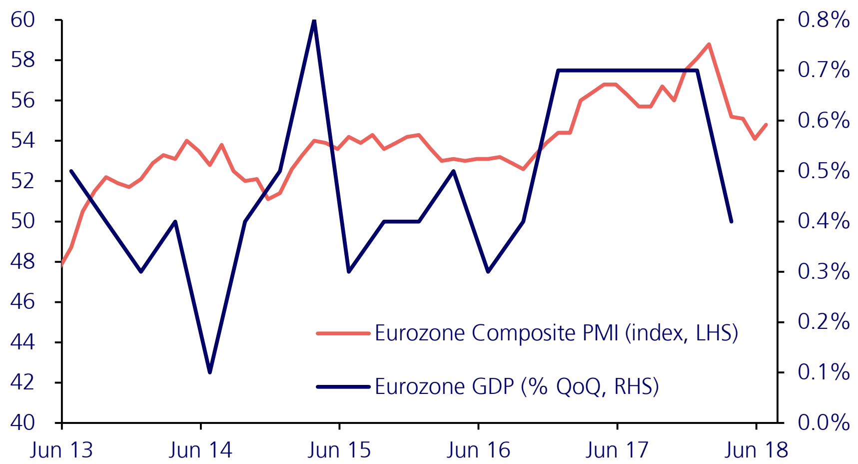
- **China's PBoC cut its RRR by another 50bps, adding CNY 700bn liquidity**

  Both the economic slowdown and signs that the trade dispute with the US might escalate make this step necessary.

- **Credit markets traded with a heavy tone as 'jumbo' M&A led bond deals caused supply indigestion**

  Credit investors should tread with caution. Despite corporate leverage being higher than it was at the depth of last recession, at current low yields M&A and LBOs are likely to continue.

Eurozone data improve as EU summit looms



Source: Bloomberg

The Eurozone composite PMI picked up in June after four consecutive monthly declines, led by a big jump in service sector confidence. This is encouraging. It suggests that despite a slowdown in Q1, the region will grow at an above trend pace this year, led by domestic demand.

Meanwhile, France and Germany have agreed on a proposal to reform the Eurozone, called the "Meseberg Declaration". It will be discussed at the EU summit this week. Though the details are unclear, it includes allowing the European Stability Mechanism (ESM) to provide support to governments without a full bailout programme in place, creating a Eurozone budget and considering a European wide unemployment insurance fund. Giving the ESM greater flexibility would improve responsiveness to shocks. Similarly, a European wide unemployment insurance fund would help create an automatic stabiliser. The rise of populism may have a silver lining if it acts as a catalyst for policymakers to make the Eurozone more resilient. Indeed, Greece exited its bailout with more generous terms than expected last week. Around 100 billion euros of programme loans were extended by ten years in maturity, with the possibility of further debt relief in the future offered as well.

Credit: Heavy tone emerges amid leverage driven supply

Global credit markets traded with a heavy tone last week as investors were in a sombre mood amid leverage driven supply indigestion, volatility in Italian bond spreads, trade rhetoric and continuing outflows. Jumbo acquisition finance deals from Bayer and Walmart hit the market, causing supply indigestion as well as warnings from rating agencies to both issuers on rising leverage. Although the deals were oversubscribed, the broader market suffered indigestion, with another deal pulled from the European high yield market. While secondary market spreads have widened over the last few months, new issues are being priced at even steeper spread discounts. Daimler spreads were wider as the company lowered full year guidance, partly driven by trade tariffs, which, along with continuing tit for tat trade rhetoric, weighed on auto credits. Last but not least, last week's significant sell off in Italian BTPs also weighed on sentiment. Encouragingly, however, Latam credit seems to be tentatively stabilising after a long spate of volatility.

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US: Manufacturing sentiment takes a hit

Stock markets ended the week in negative territory as fears regarding an escalation of trade tensions continue to weigh on investor sentiment. Despite these worries, the NASDAQ hit a new all-time high before falling back, indicating that underneath the surface fundamentals remain strong and have the potential to lift equity markets higher. However, the latest business sentiment indicators show a deterioration with the Markit Manufacturing PMI softening to 54.6 in June down from 56.4 while the Services PMI ticked down to 56.5 from 56.8. The more cautious outlook for manufacturing was confirmed by the Philadelphia Fed business outlook survey dropping to 19.9 in June, the lowest since November 2016. Mixed signals came from the housing market with housing starts continuing their positive trend and reaching a post-recession high in May. On the other hand, building permits dropped to the lowest since last September. Although the latest drop may overstate the slowdown in housing, June's NAHB housing market index is levelling off as well, receding back towards the average value of the last 18 months.

UK: Rebellion postponed

The FTSE 100 was up for the first time in five weeks, outperforming most of its global peers, helped by rising oil prices and the fact that Prime Minister Theresa May managed to avoid defeat in parliament over the crucial Brexit bill, which will transfer EU regulations into UK law. So an open rebellion has been avoided this week, but the tensions are likely to resurface again soon and both the pound as well as the stock market will face further turbulence. As expected, the Bank of England decided to leave rates unchanged but interestingly the BoE's chief economist, Andy Haldane, has now joined the ranks of those voting for a hike, leading to a slimmer majority of 6-3 for the status quo. The minutes show that the BoE feels confident with its view that the economy is recovering from a transitory soft patch in Q1. If economic data continue to point towards a rebound a BoE rate hike within the coming months is still on the cards.

Switzerland: Dovish SNB leaves policy unchanged and highlights downside risks to the outlook

The SNB left policy unchanged, reiterating that the currency is highly valued and that negative interest rates and the SNB's willingness to intervene in the forex market remain essential. While this was in line with expectations, the decision was more dovish than anticipated. The inflation forecast was revised up in 2018 but the longer-term profile was reduced due to a more muted Eurozone outlook. Downside risks from protectionism and Italian politics were highlighted. The SNB also emphasised that imbalances in the housing and the mortgage markets have worsened, as domestically focused banks continue to offset declining margins with strong mortgage lending and increased risk taking, with a worsening in affordability measures. With the negative interest rate environment set to remain for the foreseeable future, imbalances in the housing market are unlikely to reduce. Given this, changes to the countercyclical capital buffer and other measures to reduce financial stability risk look increasingly likely in our view.

Asia: Another RRR cut in China and solid data in Japan

Following weak economic indicators for May, the PBoC has announced another cut in the Reserve Requirement Ratio (RRR) of 50bps effective July 5, which is expected to inject RMB 700bn of liquidity into the economy. RMB 500bn are targeted towards twelve major banks to fund debt-to-equity swap programs, part of the deleveraging process, while RMB 200bn are targeted at small banks to support small companies. We believe that the slowdown in economic growth, but also the threat of further escalations in the trade dispute with the US makes a more expansionary monetary policy stance inevitable. The US has not only threatened to add another 10% of tariffs to imports of Chinese goods worth USD 200bn, but is also preparing to increase scrutiny on China's investments in US technology companies under an emergency law. Meanwhile, economic data show that Japan's economy is on track to bounce back from the slump in Q1. The Manufacturing PMI as well as the Reuters Tankan for June show that the manufacturing sector is recovering, while external demand remains healthy.

What to Watch

- The EU summit will focus on reforming the Eurozone, Brexit and the immigration crisis. Chances of final agreements look slim, but some progress may be made. Investors will also look for further signs of stabilisation in Eurozone business confidence data.
- In the US, the Conference Board Consumer Confidence Survey is likely to show that households remain upbeat while PCE Core is expected to have ticked up in May.
- Bank Indonesia will probably hike for a third time this year to fight rupiah weakness.
- Asian June PMIs will be released, as well as export data from Korea and Hong Kong and industrial production data from Singapore. In Japan the Tankan survey for Q2, retail sales, industrial production and job data for May will be in focus.

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