July 2, 2018

Weekly Macro & Markets View

Highlights and View

- **Foreign investors are shunning emerging markets**

  Stagflationary fears may intensify over the summer, but we believe investor concerns are overdone in the medium term.

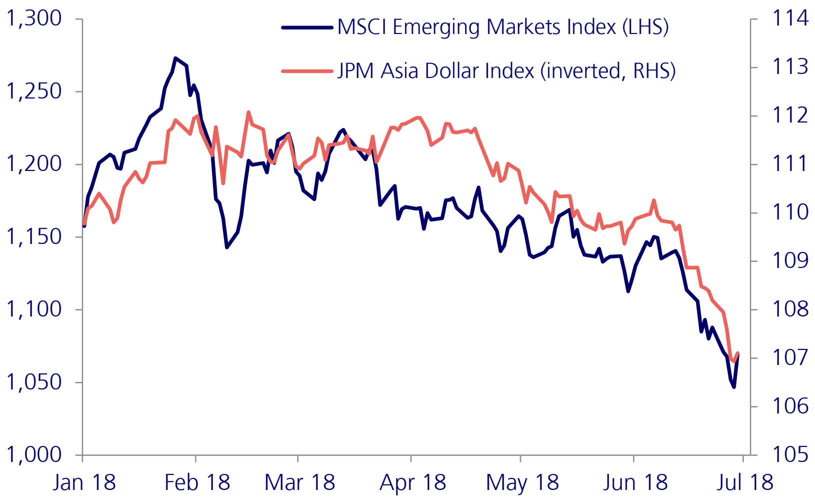
- **EU leaders reach a deal on how to manage the migrant crisis**

  The deal shows that there is still willingness to compromise in the EU, which is encouraging. Nevertheless, political risks remain high.

- **The primary market in credit almost ground to a halt, with low volumes and pulled deals**

  While not our base case, prolonged primary market activity shutdown is a key risk that warrants investor attention as it is crucial that companies retain continued access to funding.

Investors lose confidence in emerging market assets



Source: JP Morgan, MSCI, Bloomberg

Weakness in emerging market financial assets has accelerated over the last few weeks. In June, EM equities lost about 5%, while developed market equities were roughly unchanged despite recent weakness. EM bond markets have suffered as well, with the EMBI spread rising about 100bps this year. Within the equity space, Asian markets, Brazil, Turkey and Russia have been hurt the most. Emerging currencies have not been left unharmed, with the JPM Asia Currency Index losing nearly 5% in Q2. Following strong inflows in Q1, global EM funds have suffered eight weeks of outflows.

Three factors are behind this market weakness. Firstly, the continuous Fed policy rate hikes led the USD to appreciate, causing tighter financial conditions for emerging markets. Secondly, with the first round of reciprocal tariffs between the US and China taking effect this Friday, fears of a trade war have intensified. Finally, China's weaker economic indicators for May have caused fears that Asia's biggest economy is on the brink of a more severe slowdown. After all, China makes up 42% of the JPM Asia Currency Index and, together with Hong Kong, about a third of the MSCI EM Index. We believe that even though investors may remain jittery over the next few weeks, fears are overdone. Many EM equity markets are now showing reasonable valuations and are fundamentally in better shape than in previous cyclical downswings.

Indonesia: Bank Indonesia hikes for the third time and by 50bps

Bank Indonesia (BI) hiked for the third time this year by 50bps, twice as much as the prior hikes. The 7-day reverse repo rate now stands at 5.25%, and BI has turned more hawkish, deleting the words "measured way" to qualify its stance. The central bank quoted a "more aggressive" Fed and changing monetary policies in Europe and China as sources of uncertainty for emerging markets. The reaction of the rupiah was muted, as it continued to trade above 14,000 IDR/USD. We deduce that further rate hikes will be necessary to defend the currency. Indeed, the trade deficit has deteriorated this year and portfolio outflows have persisted. On the bright side, stronger imports reflect robust growth in domestic investment and consumption. In the run-up to 2019 general elections, fiscal policy is likely to remain accommodative and should stimulate domestic demand. BI has also relaxed the loan-to-value ratio for mortgages, but it remains to be seen whether this cushions the impact of tighter monetary policy on credit growth.

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US: Inflation reaches the Fed's target for the first time since 2012

Trade worries continue to weigh on investors' minds as the next wave of potential tariffs could be imposed in the coming weeks. At the same time, fundamentals remain supportive for equities as economic momentum is strong and earnings are expected to grow at a solid pace. Financials helped to lift market sentiment as numerous banks announced higher dividends and stock buybacks following the release of the latest Fed stress test. Households remain upbeat, as revealed by the Conference Board consumer sentiment survey. The index has ticked down slightly, however, caused by expectations softening to the lowest since last December. Consumer spending is still expected to rebound from its weakness in Q1, which is shown to have been even more pronounced with the second revision of GDP, indicating an annualised growth rate of 2% for the economy and just 0.9% for consumption expenditure. As expected, core inflation continues to move higher with PCE Core being rounded up to 2% YoY in May, technically reaching the Fed's target for the first time since 2012.

Eurozone: After intense negotiations, EU leaders reach a deal regarding the migrant crisis

The deal focuses on the establishment of control centres, but is short on details and could still unravel. Chancellor Angela Merkel's government coalition in Germany is particularly fragile because of disagreements over how to deal with migration. Nevertheless, it was encouraging that at the EU level, leaders showed willingness to compromise. Separately, last week's data showed further evidence of stabilisation in Eurozone business confidence and activity. The expectations component of the German Ifo survey did not fall for the first time since November. The current conditions component, although it did decline in June, was still at a higher level than its recent peaks in 2007 and 2011. ECB data showed that lending to Eurozone non-financial companies increased to 3.6% YoY in May from 3.3% YoY in April. Finally, deals were agreed upon in both Germany and Spain last week that point to an acceleration in negotiated wage growth in 2019 compared to 2018. This will support consumer spending going forward.

Japan: Tankan not as bad as headline figure might suggest

Many commentators have put a negative spin on Japan's economic outlook following today's publication of the Tankan headline index for large manufacturers, which saw its second drop in a row, falling from 24 in Q1 to 21 in Q2. We are less concerned for three reasons: Firstly, the often neglected but really important non-manufacturing diffusion index was up one point to 24, just marginally below the 26-year high marked in Q4 2015. Secondly, capital spending plans have improved notably, with capex expected to rise 13.6% YoY versus the 2.3% rise in the prior survey, which is notable and comprehensible amid severe capacity constraints. Thirdly, economic indicators for May such as industrial production, housing starts and the labour market are encouraging. We agree with the government's assessment that output is "picking up slowly", suggesting that economic weakness in Q1 was indeed just a blip, as expected. However, we need to keep an eye on profits. Companies expect recurring profits to drop by 5.1% this fiscal year, which we think is too pessimistic, unless the yen strengthens significantly from here.

Credit: Worryingly, the primary market sputters again

Credit markets were fairly volatile last week, with primary market almost grinding to a halt once again. Spreads widened for most of the week, with a brief respite on Friday, which could be short-lived though, judging by the weak open today. Importantly, however, it is the primary market that worries us. Primary markets are the life blood of credit markets and it is essential that companies have continuous access to funding. Not only is it more expensive to issue right now, but some companies are not getting deals placed at all. The European high yield market has now seen the tenth bond deal being postponed. The Fed's stress tests were passed by all banks except Deutsche Bank's US unit, which failed the qualitative assessment, with some harsh criticism of risk management in our view. With European bank spreads wider and the US primary market also recording the lowest supply this year, a rather sombre mood prevailed in credit markets, with some rare exceptions such as GE, which saw better sentiment on the back of news of a spin-off of its healthcare unit and offloading of its stake in Baker Hughes.

What to Watch

- The global PMIs are expected to show resilient growth, but with a more mixed performance amid policy tightening and trade concerns.
- In the US, both the ISM Manufacturing and Non-Manufacturing indices are expected to soften, but keep signalling strong business activity. Meanwhile, labour market data are likely to show a continuation of the healthy employment situation.
- In Asia, apart from the PMIs, our focus will be on Japan wages, Hong Kong retail sales and Malaysian exports for May. Several countries will publish CPI data for June. In Australia, we expect the RBA to keep its policy rate stable at 1.5%

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