July 9, 2018

Weekly Macro & Markets View

Highlights and View

- **The first round of trade tariffs between the US and China is now in place**

  So far the impact is manageable, but we are concerned about the US threat to impose 25% tariffs on all imports from China

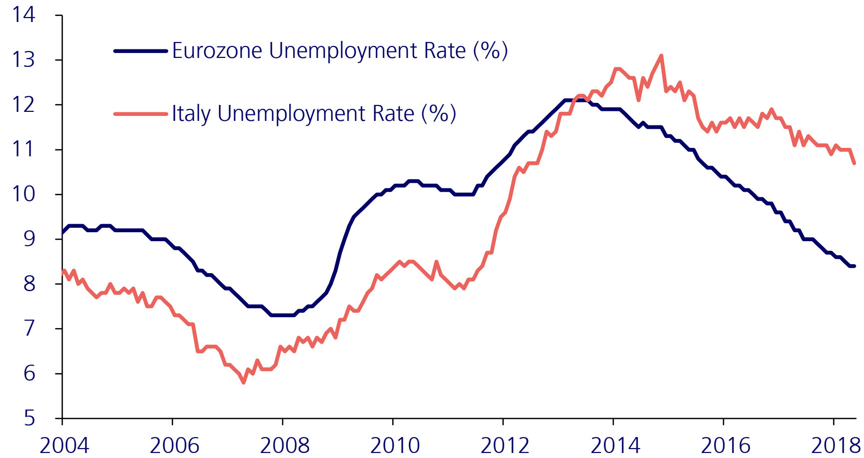
- **US payrolls rise a higher than expected 213k, and unemployment ticks back up to 4%**

  Another round of strong jobs data, with the unemployment rate up on the back of a jump in the participation rate, though wage growth remains subdued.

- **The new Italian government adopts the Dignity Act, focused on labour market reform**

  The reform makes the Italian labour market less flexible, but investors are more focused on the 2019 budget.

Italian government approves the Dignity Act, its first decree since taking power



Source: Bloomberg

For employees on open-ended contracts, Italian companies will now need to give 36 months' pay as compensation, instead of the previous 24 months, if they are unjustifiably dismissed. The Dignity Act also makes it harder to extend the duration of temporary work contracts. The reform is likely to add to labour market rigidities. However, Italian equity and bond markets were stable last week. The budget plan for 2019 is the key issue investors are focused on. On a recent research trip to Italy, we found that analysts expected only a subset of the coalition deal proposals to make it into the 2019 budget, with a focus on pension reform and abolishing a planned VAT hike. Plans for a universal basic income (UBI) and tax cuts are expected to be phased in over a number of years. Italian economic data have been resilient so far given the increased uncertainty over policy and recent financial market volatility. The composite PMI for Italy came in at 53.9 in June vs 52.9 in May. The Italian unemployment rate also fell to 10.7% in May from 11.0% in April, though it can be a volatile series. In the wider Eurozone, there are further signs of stabilisation in business confidence and activity. Both German factory orders and industrial production rebounded in May, and Eurozone unemployment continues to trend down, suggesting that the recovery remains intact for now.

US: Strong economic data lifts investor sentiment

In the holiday-shortened week investors looked through the obvious trade issues and embraced a range of strong economic data, pushing stocks higher. The Russell small cap index led the charge, rising by more than 3%, with the tech-heavy NASDAQ not far behind. While we remain concerned about the potential for an escalation in the tariff tiffs, much has now been priced in and we suspect investors will increasingly be guided by fundamentals, particularly as earnings season gets underway in earnest next week. On the macro front, data were strong last week.

Payroll growth was impressive and it was encouraging that the labour force grew by around 600k, as more people made themselves available for work. Importantly, both the ISM manufacturing and non-manufacturing surveys ticked higher from already elevated levels, indicating further growth ahead. With car sales strong and factory orders rising, the US economy is in very good shape, though it is not immune to a trade war.

China: Renewed fears of an escalation in the trade dispute with the US

Following weeks of CNY depreciation and falling domestic 'A'-shares and Hong Kong listed 'H'-shares, markets started to stabilise and reverse today. Fears about an escalation of the trade dispute between the US and China, as well as concerns about a sharp slowdown of economic growth are obvious reasons for the sell-off in China's currency and equities. As the first batch of tariffs comprising USD 34bn exports on each side became effective last Friday, the second batch of USD 16bn will follow in two weeks. Both together will have a rather small impact on overall growth, however, we are concerned about US President Trump's threat to impose 25% tariffs on all US imports from China, comprising USD 500bn, which could knock off about one percentage point of growth in China. Meanwhile, the equity market is also suffering from stock-backed loan financing. Even though the market value of shares pledged as collateral makes up for less than 3% of the total value, concerns about some SMEs with higher ratios will remain a burden for the market until the deleveraging process is relaxed somewhat.

Asian PMIs: Soft picture for exports, but robust domestic demand

June PMIs showed a marked decline in new export orders for key trading countries such as China and Japan. Japanese new export orders fell below 50 for the first time since August 2016, as companies reported weaker demand from North America and China. However, export orders from Korea and Taiwan jumped, which probably coincides with a revival in tech exports. In contrast to overseas demand, domestic demand was robust in Asia, especially in Vietnam and Singapore, as well as India, where a powerful cyclical recovery is occurring. Manufacturing activity is weaker in Malaysia and Indonesia. The services sector is experiencing strong growth across countries, especially in Australia where the services activity index has reached an all-time high. Finally, input costs of metals, energy, and other raw materials rose sharply in all countries. This suggests that headline inflationary pressures are building up in the region.

Bonds: Politics and trade anchor core yields at low levels, despite solid economic momentum

Core yields edged down last week despite positive data surprises as politics and trade continue to dominate investor sentiment. The US ISM survey surprised on the upside, confirming strong momentum in the economy. The payroll data were solid but investors focused on hourly earnings, which were a tad weaker than expected, helping to push yields lower. The Fed minutes contained little news but Fed pricing has turned dovish, with three rate hikes priced in by end 2019 vs the Fed's median dot plot of five hikes. Bund yields were broadly flat last week, with the 10yr falling to only 0.29% on Friday, despite data indicating that Q1 weakness was temporary and the ECB signalling that pricing of the first rate hike is too dovish. Both the Treasury and the Bund curve flattened further. While this should be expected at this stage of the cycle, the level of yields is not justified by economic fundamentals. Near-term dynamics, however, will continue to be dominated by politics, with trade a key risk.

Credit: Rise in Italian Target 2 imbalances is worrying

Credit markets saw better sentiment emerge last week, although the mood in primary markets continued to remain somewhat cautious. While the US primary market was quiet amid a holiday-shortened week, the European primary market saw a modest pickup in activity. Deutsche Bank stock was boosted by speculation that JP Morgan and ICBC of China were interested in a stake, although JP Morgan denied this and ICBC declined to comment. Most importantly, we were eagerly awaiting Target 2 balances from the Bank of Italy to watch for any signs of deposit outflows from Italian banks. In May and June, the Italian Target 2 imbalances increased by €55bn, significantly more than previous two month average delta, to reach –€481 billion, while German imbalances moved in the opposite direction. This is a crucial indicator to watch for credit investors going forward. While Italian banks are reducing NPLs through sales and securitizations, deposit flight is still a risk if political sentiment deteriorates in coming months.

What to Watch

- A light week for US economic data, with consumer sentiment and CPI inflation readings most notable. More importantly, earnings season gets underway with many of the investment banks reporting for Q2, which will set the tone for investors and markets.
- Chinese data will be in focus, including money supply, industrial production, exports, investment, CPI, and retail sales for June, as well as Q2 GDP. In Japan, industrial production, core machine orders, and PPI will be released. Both the Malaysian and Korean central banks are expected to stand pat.
- The ZEW survey and Eurozone industrial production data should confirm the stabilisation in sentiment and activity in the Eurozone.

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