July 16, 2018

Weekly Macro & Markets View

Highlights and View

- **The Trump administration proposes tariffs on an additional USD 200bn in imports from China**

  While the pre-announced step raises the stakes in the ongoing trade dispute, the lack of a retaliatory response so far indicates that China may try to avoid a further escalation for the time being.

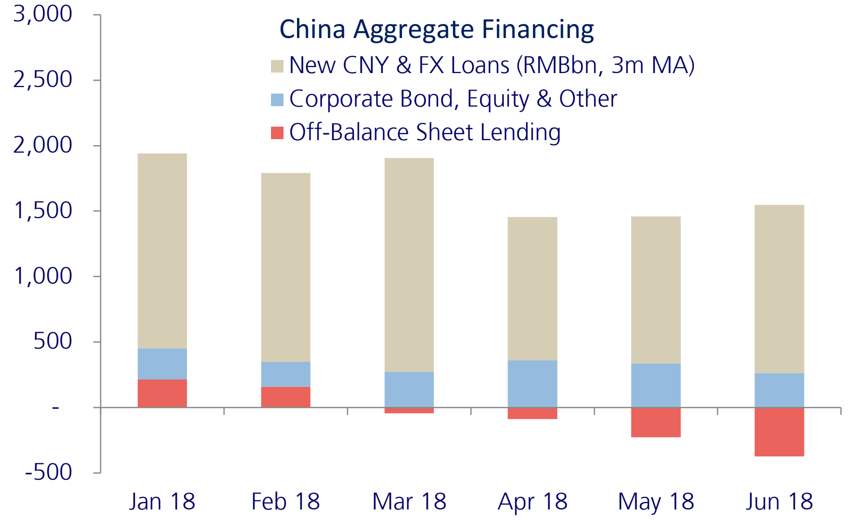
- **The latest economic data confirm that China's economy continues to slow**

  We believe that both monetary and fiscal policy will be loosened without giving up on the structural deleveraging process.

- **Brexit secretary Davis and foreign secretary Johnson resign after May's Brexit proposal**

  The proposal seeks a closer relationship with the EU than Brexit supporters like. It's unlikely that the EU will accept it as it stands, but it finally provides a basis for negotiations.

China's economic growth continues to decelerate



Source: Bloomberg

China's GDP statistics do not reflect reality, in our view. How can it be that growth accelerated from 5.7% in Q1 to 7.4% on an annualised sequential basis, when the monthly indicators are clearly showing a downturn in economic activity in Q2? However, the fact that the YoY rate nudged down from 6.8% to 6.7% may be a symbolic recognition of the slowdown and may give authorities a reason to be more flexible when incorporating China's deleveraging policy. We expect more cuts in the reserve requirement ratio and overall looser monetary and fiscal policies to some extent, without giving up on the longer-term structural deleveraging target. The latest data from the monetary front confirm that shadow banking activities were indeed tackled again in June, as aggregate lending was significantly below regular bank lending for the second month in a row.

Infrastructure investment growth slowed further in June, reflecting a tougher stance on SOE investment, which fell to a record low. Fortunately, manufacturing investment is picking up again, particularly in the high-tech space, in line with government directives. Industrial production growth slowed once more, but we note that there were less working days. Retail sales growth picked up again due to the different timing of the Qingming Festival. As service consumption remains strong, we think private consumption remains solid.

US: Investors shrug off the latest tariff threat

The S&P climbed higher and the NASDAQ reached a new all-time high last week despite a brief setback from the Trump administration's proposal to impose tariffs on an additional USD 200bn in imports from China. The tariffs would take effect in September at the earliest but could burden investor sentiment. So far, China has not explicitly announced how it intends to potentially retaliate, indicating that the Chinese government is trying to avoid a further escalation for the time being. Small business sentiment ticked down in June but remains close to the multi-decade high reached last month. Inflation accelerated further in June with headline CPI reaching 2.9% YoY while Core CPI ticked up to 2.3% from 2.2% the month before. The JOLTS quit rate rose to a 17-year high in May underlining the healthy employment situation. With the solid economic background in mind investors will focus on the Q2 earnings season, which will be gathering steam over the coming weeks. Stocks of JP Morgan, Citi and Wells Fargo fell against the market trend after releasing a mixed set of results.

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UK: Davis and Johnson resign after May's Brexit proposal

The government published its long-announced "white paper" on the future UK-EU relationship, although the crucial points had already been revealed last week in Theresa May's Chequers speech. The latest proposals, including a free trade area with the EU for industrial goods and agricultural products, were not well received by pro-Brexit members of her cabinet. Brexit secretary David Davis and foreign secretary Boris Johnson both resigned from their government posts as May's plan keeps the UK too closely bound to the EU in their view. The EU is unlikely to accept the proposal in its current form, but it finally provides a concrete starting point for negotiations, although time is running short to find a compromise. The pound weakened against the dollar as political risks remain elevated and the economic outlook is modest. Nevertheless, the newly published monthly GDP figure shows that growth picked up further in May, recovering from the first quarter's weak spot.

Eurozone: Eurozone industrial production bounces back

Industrial production rose 1.3% MoM in May, ending a run of weak data since the start of the year and bringing the year-on-year rate of output growth to a respectable 2.4% YoY. The gain in production in May was broad-based across categories and countries and is further evidence that activity is stabilising in the Eurozone. However, the manufacturing and export sectors are vulnerable to a further escalation of trade tariffs, and overall we expect domestic demand to be the key driver of growth this year in the Eurozone. Elsewhere, the ECB minutes of the June monetary policy meeting suggest it is increasingly confident that inflation will return towards target over the medium term. The minutes also showed that the June decisions to taper QE purchases and to commit to not raise interest rates for more than a year were unanimous. The minutes also made reference to the fact that the reinvestment of maturing securities meant that that the ECB would remain a significant presence in asset markets, and thus that monetary policy was still accommodative.

Japan: Both households and corporates are cautious

Japan's June 'Economy Watchers Survey' current conditions index is down nearly six points in the first half of the calendar year, which is disappointing. Even though it recovered in June to 48.1, the household component remains lacklustre, while the corporate component fell for the second month in a row. Both the manufacturing as well as the service related indices declined. Increasing labour costs amid labour shortages as well as the impact of higher oil prices have been indicated as reasons. We believe the recent weakening of the yen should help corporate management to become more optimistic. While the latest Tankan survey reveals that enterprises expect the USDJPY at 107.26 for this fiscal year, last week's surge toward 112.80 should help to alleviate some of the earnings concerns. We also note that core machinery orders remain brisk, even though they were down from the ten-year high marked last month. The trend is clearly up, confirming our optimistic capex outlook. Equity investors seem to agree. Japanese equities have rallied over the last three trading days.

Credit: Firm but lagging stocks, while US bank earnings are mixed

Credit markets were firm last week but lagged stocks in the recovery. Interestingly, credit has developed a tendency lately to be dragged down when stocks are weak, but the recovery when stocks recover is somewhat half-hearted. Primary markets remained quiet despite the risk-on sentiment, partly because of the US earnings season. Regarding the earning season, the three major US banks that reported earnings, namely JP Morgan, Citi and Wells Fargo, recorded better than expected earnings but got a cold reception from the stock market. While banks face an uphill battle from a flat yield curve and a maturing credit cycle, trading results and investment banking revenues are expected to provide some offset. Although it's still early, capital market revenues for the last quarter appear somewhat soft so far, which perhaps forebodes even worse outcomes for European banks that have been losing market share to US banks. That said, Deutsche Bank pre-announced better than expected earnings this morning, surprising most market participants.

What to Watch

- While some economic data including retail sales, industrial production and housing starts will be published, investors will focus on Q2 earnings releases with more than 60 S&P 500 companies reporting this week.
- The ECB meeting is unlikely to see any policy changes announced. However, in the press conference ECB President Mario Draghi may be asked to clarify when it is expecting to raise interest rates in 2019.
- In Asia, June export related data will be released in Japan, Taiwan, Singapore, Indonesia and Thailand. We will also keep an eye on June CPI data in Japan and Malaysia, as well as labour market data in Australia. We believe Bank Indonesia will stand pat, with a small risk of a third successive rate hike in case the IDR weakens again.

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