January 15, 2018

Weekly Macro & Markets View

Highlights and View

- **Government bond yields rise sharply on stronger US inflation and speculation about more hawkish central bank actions**

  Core bond yields have bottomed, but upsides are limited. The global search for yield persists while central banks only cautiously scale down stimulus, with net liquidity remaining positive.

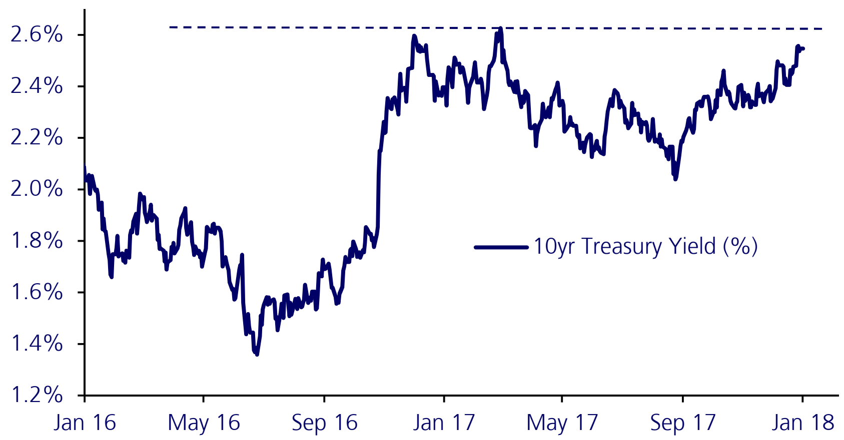
- **Credit-fuelled US consumer spending slowed down in December**

  A surge in consumer credit fuelled strong spending late last year. However, the strong momentum is unlikely to be sustained through all of 2018.

- **A less dovish ECB leads to rising bond yields**

  It was to be expected that the ECB would gradually change language given the strength of the economic data, but it will still reduce monetary accommodation only gradually.

Core goverment bonds sell off, but yields remain capped



Source: Bloomberg

Four factors conspired to create last week's global core bond sell-off: A stronger than expected US core CPI print, a hawkish set of ECB minutes, rumours that China will be buying fewer Treasuries, and speculation that the BoJ is scaling down QE. The 10yr US Treasury yield touched 2.59% intraday following the CPI print, but failed to break the resistance level at 2.64% and closed the week at a more modest 2.55%, with very strong demand at the 30yr auction. Bund yields also spiked, with the 10yr now at 0.57%, compared to 0.3% one month ago.

Last week was different in that bond yields finally moved in response to news, confirming that bond investors are becoming nervous. Self-correcting mechanisms remain in place, however, and we believe that upsides to yields are capped. The BoJ and the ECB will continue to inject liquidity as inflation is still lacking. Demand for US Treasuries should stay healthy given a global search for yield. US inflation is set to rise this year and the increase in the core CPI print was encouraging. However, other inflation data have been softer and a spike higher in inflation is unlikely given global disinflationary factors and headwinds from non-cyclical inflation components. While bond yields have bottomed, this suggests that last week did not mark the beginning of a bond bear market.

Credit: Underperformance to equities continues

Despite a strong 'risk on' tone in financial markets, credit continues to underperform equities. Last week, this underperformance gathered further momentum, with bond yield volatility, heavy supply and fragile high yield flows weighing on investor sentiment. US high yield underperformed last week despite higher oil prices. Higher Treasury bond yields were blamed for ETF outflows, dashing hopes of stabilisation stoked by inflows since the beginning of the year. Notably, however, the search for yield continues to remain strong despite little room for spreads to tighten further. While Tencent's new debt deal attracted around $40bn orders for $5bn debt, Monte dei Paschi di Siena's 5.375% subordinated debt offering was also more than three times oversubscribed. Notably, the Monte dei Paschi deal came about a year after the bank imposed losses on previous subordinated note holders. Given potential upside and even reasonable dividend yields compared to credit market yields, equities could continue to outperform credit.

US: A surge in credit fuels consumer spending

Consumers continued their shopping spree in December although at a slower pace with retail sales growing only 0.4% MoM after 0.9% in November. November's spending was supported by the biggest jump in consumer credit in 16 years while the savings ratio stood at 2.9%, the lowest since 2007, indicating that the strong momentum in consumer spending may not be very sustainable. NFIB small business optimism fell back to 104.9 in December from its recent multi-decade high. Meanwhile, compensation plans rose to the highest level since 2000, signalling a pickup in wage growth. That could add to the slowly increasing price pressure reflected in the latest CPI data. While the monthly CPI inflation rate slowed down to 0.1% in December, core CPI accelerated to 0.3% MoM, lifting the annual rate to 1.8%. An important driver of higher core inflation was a pickup in medical care costs, which represent a significant component in the Fed's preferred inflation measure. While we expect inflation to accelerate in 2018, a drop in PPI in December indicates that the risk for a near-term spike remains modest.

Eurozone: ECB minutes show policymakers increasingly confident in economic outlook

The release of the ECB minutes from the December 14 meeting attracted a lot of investor attention. Policymakers noted that the outlook for growth was "very positive", and that the output gap would close in the "near future", earlier than previously expected, which would allow inflation to pick up. As a result, ECB policymakers felt that "communication should be adjusted gradually over time to avoid sudden and unwarranted movements in financial conditions." Eurozone government bond markets sold off on the release of the minutes. Data in the Eurozone remain strong, with the EC Economic Sentiment indicator hitting a fresh record high in December and the unemployment rate ticking down further. We still expect the ECB to proceed gradually in removing monetary accommodation, with asset purchases continuing through most of this year and the ECB only raising interest rates in 2019. Elsewhere, Germany moved further towards a grand coalition government, with a preliminary deal having been agreed between the CDU, CSU and SPD, though it still needs to be signed off on by the SPD membership.

China: Import growth tumbles

Export volumes pulled back on a sequential basis in December. However, exports remain brisk, up 10.9% YoY, underpinned by strong global trade growth. We have some concerns about slow import growth, which was far below expectations, up only 4.5% YoY from a prior reading of 17.6%, implying that import volumes fell 6.8% MoM. Industrial commodities experienced a sharp drop, and, apart from the US, all major regions were affected. This suggests that domestic investment and consumption have started to slow materially. We are not surprised as the tighter policy framework and closures of factories to reduce pollution were bound to become visible in weaker statistics. Tighter credit policies are also reflected in a slowdown in aggregate financing, new bank loans and money supply, which exceeded consensus expectations. A potential positive surprise in Q4 GDP data should not be misinterpreted, as slower import growth has a positive impact on GDP statistics. Should the domestic economic slowdown accelerate, we believe that monetary policy will be handled flexibly to counter any significant slowdown.

Japan: Consumers less upbeat

Japan's Eco Watcher Survey took a beating in December, as both the current conditions and outlook diffusion indices came in weaker than expected while November statistics were revised down. However, we do not believe that this slowdown marks a significant turnaround in economic activity, but rather a pullback from high levels. Consumer confidence remains brisk, and the manufacturing subcomponent, which makes up about 10% of the Eco Watchers survey, even rose by 2.1 points to 56.9, the highest level for four years. Wage growth spiked in December, up 0.9% YoY, but we avoid being thrilled by this headline number, preferring to look at the regular wage component, which was up only 0.4% YoY, roughly in line with the average rise seen over the last few months. Real wage growth remains close to zero. We note an uptick in overtime hours worked and also a slow continuation in rising inflationary expectations by households. Meanwhile, the equity market remains firm, with the Topix hovering at its 26-year high, so far neglecting a stronger yen. We need to keep an eye on the USDJPY 110 level.

What to Watch

- In Germany, the SPD will meet at a party conference on January 21 to decide whether to authorise the tentatively agreed upon coalition deal and join another grand coalition government. While it should pass, there are some risks given that many SPD members are still opposed to another grand coalition.
- The monetary policy councils of the Bank of Korea and Bank Indonesia will convene on Thursday. We do not expect any changes to policy rates.
- The remainder of China's economic statistics for December will be released on Thursday, in addition to Q4 GDP statistics. We will also watch export data for December from Singapore, Indonesia and India.

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