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ZURICH

Weekly Macro & Markets View

Highlights and View

- **A weaker pound reflects increased Brexit uncertainty and a modest growth outlook**

  Time is running out quickly to secure an agreement with the EU which is likely to come under attack from both pro-EU and pro-Brexit MPs

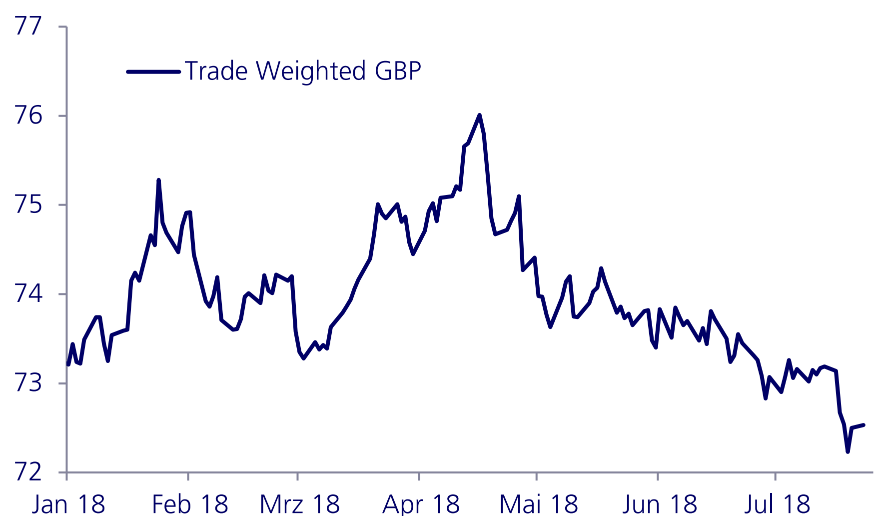
- **Trump criticises China and the Eurozone for manipulating their currencies and the Fed for being too hawkish**

  Except for a slightly weaker USD, markets remain largely unmoved by Trump's comments so far. However, should the verbal attacks be followed by concrete actions, investors will face some turbulences

- **The USDCNY rises above 6.7**

  We do not see currency weakness as a deliberate strategy, but as an effect of softer domestic activity. The Chinese authorities have reacted by loosening economic policies and guidelines on asset management products

Sterling dragged down by political uncertainty and weaker inflation



Source: Bloomberg

Theresa May's fragile position became obvious again last week as several amendments to a crucial part of the Brexit legislation just made it through parliament by a very thin margin. While the situation is settled for now, it is increasingly uncertain whether May will be able to get a majority of the votes to get a final Brexit deal approved as the middle ground that her proposal is treading is likely to draw criticism from both pro-EU and pro-Brexit members of parliament. Sterling faced some headwinds as the parliamentary debate was panning out, not helped by a softer than expected inflation print. Headline CPI was flat MoM keeping the annual rate at 2.4% while Core CPI ticked down to 1.9% YoY from 2.1% the month before. Retail sales were weaker than expected as well, falling 0.6% MoM in June. That comes after two consecutive strong months, however, and still leaves the annual rate at 3.0%, the second highest in more than a year. Taking into account another set of solid labour market data published last week and a reacceleration of input prices, the BoE is likely to remain on track to hike rates at its next meeting. The Monetary Policy Committee has signalled its willingness to raise rates if data confirm its view that Q1's growth weakness was transitory and the window of opportunity for a rate hike before the actual Brexit date early next year is rapidly closing.

Markets: Investors flip-flop, with bonds and stocks struggling for direction

As the dog days of summer set in, with investors increasingly lethargic, US President Trump injected some spice into an otherwise uneventful week for markets. While the Helsinki summit with Russian President Putin captured the headlines, it was comments on his return to Washington that prodded investors out of their summer slumber. Hard talk about imposing tariffs on all Chinese imports, venting frustration about the weakness of both the Chinese and Eurozone currencies, and suggesting that the Fed was being too hawkish, all resulted in a flip-flopping in bond and equity markets, with neither ultimately making much progress. Unfortunately we suspect there will be further unsettling rhetoric around tariffs for investors to deal with, before compromises are found. Looking through the noise, we believe that bond yields will drift higher on the back of the continuation of good economic data, while equities are the favoured asset class. In the case of the latter, the start of the US earnings season bodes well and we suspect another quarter of 20% plus earnings growth will boost investor sentiment.

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Credit: Underperformance continues as headwinds gather momentum

Credit markets traded with a weak tone last week. Cash and derivatives both suffered a leg down, with Europe underperforming the US in IG, although the picture reversed in HY as oil prices declined. More notably, credit continued to lag equities as headwinds are gaining momentum. Firstly, worries around China and commodities re-emerged. Although EM credit has been more stable than currency and commodities, the weakening in the Chinese Yuan and slowing economic activity in China along with lower commodity prices are reminding investors of 2015. Secondly the rhetoric on trade is not helping either. Thirdly, flows continue to be lacklustre in most parts of credit, with the sole exception of US IG. Last but not least, European financials remain under pressure, as concerns around Italy and Brexit persist, while good US bank results are not seen as boosting prospects for their European counterparts. All in all, another week of continuing lacklustre performance that we expect is likely to continue over the coming months.

US: Initial jobless claims fall to the lowest since December 1969

The S&P 500 closed Friday almost exactly at the same level as a week before, with an intra-week trading range of less than a percentage point. While it is still early days, the Q2 earnings season is off to a good start with an average earnings surprise of 4.9%, which would lead to an annual rate of 22.5% for the S&P 500 index. Economic data was more mixed with retail sales growing 0.5% MoM in June, down from 1.3% in May. Industrial production rebounded in June, leaving the 2-month average rate roughly unchanged. June's housing starts fell the most since November 2016 and building permits receded for the third month in a row, indicating some adverse effects of higher mortgage rates. NAHB home builder sentiment remained at 68 in July, the same as the month before, pointing towards a stabilisation in the housing market. Underlining the healthy employment situation, initial jobless claims dropped to 207'000, the lowest since December 1969.

Eurozone: Italian government reaffirms commitment to the euro

Last week, Italian Prime Minster Giuseppe Conte said that the "euro was irreversible". He also emphasised the government`s commitment to fiscal discipline. Separately, Northern League leader and Interior Minister, Matteo Salvini, said that he had changed his view compared to a statement he made in 2016 when he said that a "Northern League government would get rid of the euro and move back to a national currency". He said that while he still thought the euro was a wrong idea, "since now it is here, we have to improve its conditions." While these statements are reassuring, the near-term test for the new government will be the 2019 budget presented this autumn. There was little data from the Eurozone last week. Core inflation in June was revised down slightly on the second estimate to 0.9% YoY from 1.0% YoY, but headline inflation was left unrevised at 2%, its highest level since early 2017 due to high oil prices.

Asia: Bank Indonesia pauses, while Asian currencies remain under pressure

Bank Indonesia (BI) chose to hold fire after hiking the repo rate by 100bps this year. BI sounded more pessimistic on global growth, and flagged monetary tightening in the US as a major headwind for emerging markets. To address external pressures, the central bank said that it would work with the government "to reduce the current account deficit (CAD)". To us, this means that BI is likely to tolerate some weakness in the rupiah in order to rein in the CAD. This should impact economic growth going forward, despite signs that consumption and investment have been robust in Q2. The Indonesian rupiah and other Asian currencies weakened further last week, led by the USDCNY cross, which passed the 6.7 threshold. Ongoing concerns on softer Chinese data, trade tariffs, and tightening by the US Fed continue to weigh on sentiment. Nevertheless, we detect some signs of stabilisation in Asian credit, which has led equity markets this year. Encouragingly, some sovereign bond markets have also seen foreign inflows return.

What to Watch

- The PMIs for the US, Japan and the Eurozone will indicate whether the recent slowdown continues over the summer, while Q2 GDP for the US is likely to show a solid growth acceleration.
- ECB President, Mario Draghi, will be pressed to clarify the ECB`s position on the timing of an eventual increase in rates in 2019 at the monetary policy meeting and press conference. Business confidence surveys will show how robust activity was early in Q3.
- The Tokyo CPI in Japan and the headline CPI in Australia will be in focus. South Korea's Q2 GDP and Hong Kong exports data for June will be released.

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