July 30, 2018

Weekly Macro & Markets View

Highlights and View

- **The US economy grew at an annualised rate of 4.1% in Q2, the fastest since 2014**

  A rebound in household spending lifted GDP growth while investment provided some headwind. The latest PMIs signal a continuation of strong momentum.

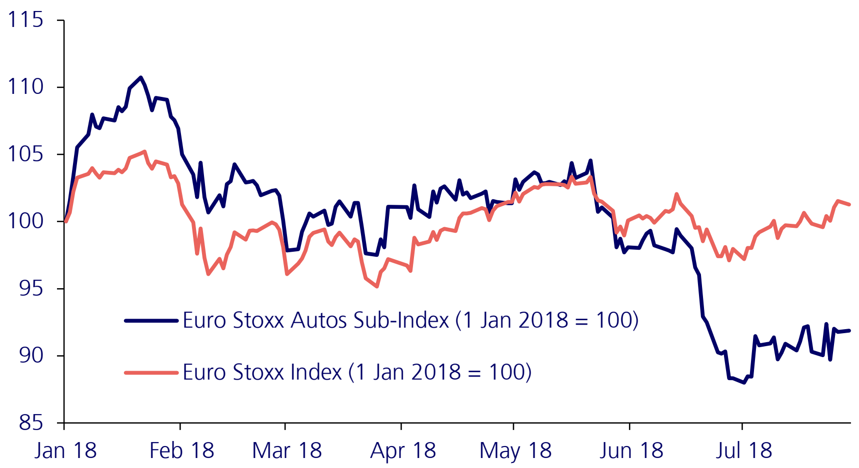
- **US and EU make a joint statement on trade, pledging to work together to reduce tariffs**

  The joint declaration is encouraging, reducing risks of a trade war between the US and EU. Tensions between the US and China will probably remain for some time before an eventual agreement.

- **China's State Council announces a series of policy loosening measures to keep economic growth on track**

  While this should help the economy overall and improve liquidity, the broader goal of deleveraging will be maintained.

European autos benefit from US and EU trade truce



Source: Bloomberg

Last week, US President Donald Trump and European Commission President Jean-Claude Juncker, pledged "…to work together towards zero tariffs, zero non-tariff barriers and zero subsidies on non-auto industrial goods". The EU also committed to buy more liquefied natural gas and soybeans from the US. The two also pledged to join forces to reform the WTO and address unfair trade practices and intellectual property theft. While short on specifics, this declaration was encouraging. The threat of US tariffs on EU autos has receded, helping the sector last week, though it is still down sharply since the beginning of the year. Our base case view remains that a global trade war will also be avoided, and last week's developments support this view. Nevertheless, risks remain with the focus now shifting to trade relations between the US and China, where the threat of further tariffs is still present. While we think there will eventually be a compromise between these two countries as well, it could be harder to achieve.

Last week also saw further evidence that the Eurozone recovery remains intact. The German ifo survey was broadly stable in July, while Eurozone lending to non-financial companies picked up to 4.1% YoY in June from 3.7% YoY in May. The ECB's quarterly lending survey also confirmed that credit standards continued to be supportive of growth.

US: Consumer spending rebounds after disappointing Q1

The reporting season for Q2 earnings is in full swing now with slightly more than half of the S&P 500 companies having published their numbers. So far, the average earnings surprise stands at 5.1%, leading to an annual growth rate of 24%. Part of this is due to the tax cuts imposed by the Trump administration but solid sales growth helps a lot, too. The first GDP estimate for Q2 shows that the US economy grew at the fastest pace in almost four years, fuelled by a rebound in consumer spending after a disappointing first quarter. On the other hand, equipment investment growth slowed down to the lowest since Q4 2016. Overall, private domestic investment even fell by 0.5% QoQ, dragged down by inventory destocking. July's Markit PMIs show that business activity remains strong, although price pressure and difficulties in filling open positions remain an issue, as well as worries regarding an escalation of the trade disputes with China and other regions.

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Japan: No 'Abexit' expected

It now seems highly likely that PM Shinzo Abe will win the LDP Presidential election in September. As with last year, Abe seems once again to have survived the so-called 'Morikake' school financing scandal, recovering in the polls as the signing of the free trade agreement between Japan and the EU helped him to gain positive recognition. Furthermore, one of Abe's competitors in the LDP presidency race, Fumio Kishida, Chairman of the LDP Policy Research Council, has announced his withdrawal from the race and is now supporting Abe. This means that four of the five major LDP factions will back Abe in the Diet vote, which makes up for half of all votes. Candidate Shigeru Ishiba, former Defence Minister, will need to find support among the 'rank and file' LDP members, who make up the other half of the votes. We believe this will be difficult, in particular as Seiko Noda, Communications Minister, may gain enough votes to spoil the party for Ishida. Unless a new scandal erupts, PM Abe is set to win the election and stay in office for the next three years, which should keep 'Abenomics' on track.

China: Changing track, not direction

Following the slump in certain segments of China's economy and fears of an escalating trade dispute with the US, China's Cabinet Office responded with a broad range of policy loosening measures. Indeed, the government has pulled out all the available stops. It was made clear that fiscal policy needs to be more proactive. RMB 65bn in corporate tax cuts and a faster pace of local government bonds issuance to support infrastructure spending have been announced. On the monetary front, the PBoC increased its medium-term lending facility (MLF) to encourage more lending to small- and mid-sized companies and to buy high yielding corporate bonds. The speed of shadow credit unwinding will be lowered by less restrictive guidance on financial institution's asset management products (AMPs) and by allowing fund management companies to invest in non-standardised products. We would like to stress that all these measures should not be interpreted as giving up on the overall deleveraging process. Instead, reins have just been loosened to support the ailing economy. Reckless stimulus is a thing of the past.

Asia: Semiconductor shipments slow

In Asia, semiconductor shipments have slowed markedly. Taiwanese export orders contracted in June, while electronic exports from Singapore registered their seventh consecutive month of YoY decline. Inventory-to-shipment ratios have increased in the region as supply has caught up with demand for chips and other electronic products. In contrast, Korean exports have held up well. This divergence in export performance is probably related to regional product specialisation, with Taiwan and Singapore more exposed to weaker smartphone sales. Encouragingly, other export categories have thrived, partly offsetting the weakness in electronics.

On the financial market front, a tactical rebound is underway in many EM equity markets, although onshore Chinese stocks remain under pressure. Foreign equity outflows have moderated and investor sentiment stabilised. A rebound in local currencies would represent a significant tailwind for domestic equities, but has not materialised yet.

Credit: Flows remain light for investment grade new issuance

Primary markets have already entered the summer slowdown, with weekly volumes of only EUR 5bn in Europe and below USD10bn in the US. Markets participants anticipate a busy September as some issuers may rush to get deals done before the ECB halves its asset purchase program. Companies also continue to be active in the M&A space. BP agreed to buy most of BHP Billiton's US onshore assets for USD10.5bn in cash, and Saudi Aramco is said to consider raising cash through a large bond sale, shifting from the planned IPO, to finance the acquisition of petrochemical Sabic. European banks have started to report their Q2 earnings, which have been mixed. While Deutsche Bank reported a net income of EUR 401mn, twice the consensus expectation, the quality of the result was poor, with non-recurring positive items and a decrease in litigation costs. Sales and trading revenues suffered and confirmed weakening market share, with a plunge of -17% YoY for fixed income, in contrast with the good performance reported by US banks.

What to Watch

- We expect no change from the US Federal Reserve. In contrast, the central banks of England and India will probably hike their respective policy rates. The BoJ is unlikely to make major changes, but will probably tweak its policy to reduce negative side effects for banks.
- A broad set of economic data will give an indication regarding current activity in the US, Japan and China. The ISM indices are expected to soften but remain at very high levels while US labour market data should keep signalling a healthy employment situation.
- The Eurozone Q2 GDP report is expected to confirm that the region's recovery remains intact despite a sharp fall in business confidence in the first half of the year.
- Asian PMIs and exports from Korea, Thailand, and Malaysia will be in focus. Japan job and industrial production data will be released.

Disclaimer and cautionary statement

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