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Weekly Macro & Markets View

Highlights and View

- **The Turkish Lira tumbles on external financing concerns**

  We believe Turkey is an idiosyncratic risk, with global contagion fears overdone.

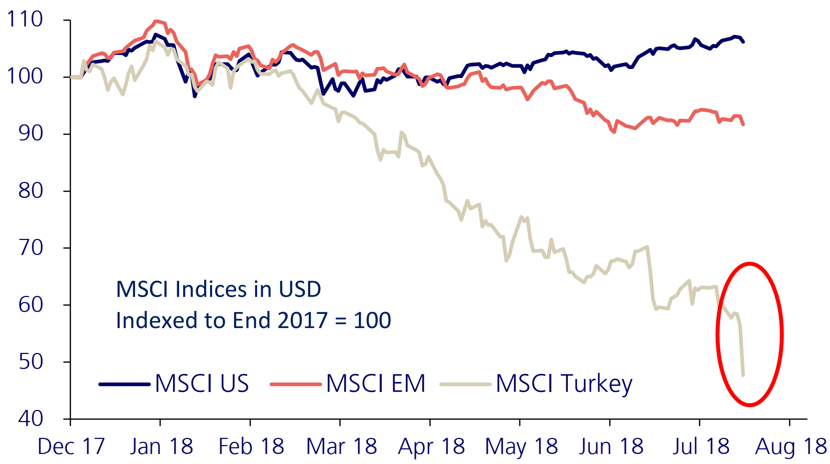
- **European bank credit and equities were significantly hit by concerns around their Turkish exposures**

  Last week's volatility in European bank credit and equities simply confirms that banks remain vulnerable on a number of fronts, although Turkish exposures alone seem unlikely to cause a banking crisis.

- **In Japan, wage growth reached a 21-year high of 3.6% YoY in June**

  While wages are indeed rising due to a tight labour market, summer bonuses distorted wage statistic, with regular wages up only 1.3%.

Fears about Turkey contagion risks seem overdone



Source: MSCI, Bloomberg (EM=Emerging Markets)

While some broad US equity indices marked record highs last week, markets were hit by Friday's steep fall of the Turkish Lira. Emerging market equities started underperforming this spring when investors got concerned about the impact of tighter financial conditions, a rising USD, trade war threats and the economic slowdown in China. Since then, global investors have reduced their exposure to emerging market financial assets. However, there are tentative signs that foreign investor appetite has stabilised, at least for emerging Asian equities. Now Turkey is moving into the limelight. Turkish equities have tumbled 22% in local currency terms or 60% in USD terms year to date. However, we believe Turkish risks are more idiosyncratic, and we point out three factors that make us believe that contagion fears are overdone. 1) Turkey's weight in the MSCI EM Index makes up for only a tiny 0.5%, while the six countries China, Korea, Taiwan, India, South Africa and Brazil contribute 75%. 2) While Turkey is a concern as its external financing requirements are high and rising, economic and financial conditions in only a few other EMs seem really vulnerable. Meanwhile, Turkey's Treasury and Finance Minister, Berat Albayrak, is giving encouraging signs of re-balancing the economy. For us, fiscal discipline and central bank independence need to be granted. 3) Foreign banks' risk exposure to Turkey warrants attention, but seems manageable (see the Credit section below).

Credit: Turkey puts the spotlight back on European banks

We believe that European banks are vulnerable due to their sheer size, interconnectedness, weak profitability and a multitude of other issues. This was again confirmed late last week, when the volatility in the Turkish Lira saw European banks suffering in both credit and equity markets, fuelled by speculation that the ECB is concerned about the Turkish exposures of some banks. Since Thursday close until this morning, the EURO Stoxx Bank index has declined by over 4% while spreads of the European iTraxx CDS indices are wider by 10bps and 22bps for senior and subordinated products respectively. All of this said, despite the over USD 150bn exposure of European banks to Turkey, largely from Spanish, French and Italian banks, we don't think Turkey on its own is likely to cause a banking sector crisis in Europe. The concern of course is if volatility continues to spread to other EM assets, which is not our base case view but warrants close attention. Elsewhere, equities continued to outperform credit last week, while issuance picked up in the US but remained very low in Europe.

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US: Core inflation is creeping higher

The S&P 500 ended a winning streak of five positive weeks in a row, losing -0.25% last week. While the market was up for most of the week, it sold off on Friday as increasing tensions around Turkey weighed on investor sentiment. The earnings season is nearing its end with the average earnings surprise at 5.5%, leading to an annual earnings growth rate of 25.6%, helped by sales growth of 10.1% YoY. There was not a lot of economic data to focus on last week. Headline CPI rose 0.2% MoM, which kept the annual rate at 2.9%, in line with expectations. Producer prices were flat in July leading to a tick down in the annual rate to 3.3% from 3.4%. Core CPI inflation accelerated to 2.4% YoY from 2.3% with most components supporting the rise, indicating that PCE Core is soon likely to move back towards the Fed's 2% target. The number of job openings remained basically unchanged in June at 6.7 million while the quits rate stuck at 2.3%, the last cycle's peak.

Eurozone: Earnings are holding up well despite soft industrial production

The industrial production of some large Eurozone countries disappointed in June. For example, output in Germany fell 0.9% MoM after a 2.4% MoM gain in May, bringing the YoY rate of production growth to 2.5%. German factory orders were also weak in June, with foreign orders leading the decline. This highlights the vulnerability of the industrial/export sector given the slowdown in key emerging markets such as China over the past few months, as well as tariff concerns. However, overall the Eurozone economy remains in good shape, with domestic demand strong and still driving growth. Indeed, the Eurozone earnings season has been encouraging. Around three quarters of companies have reported so far and earnings growth is currently running at around 9% YoY, with around 55% of companies beating sales and earnings estimates. All sectors except healthcare have seen positive YoY earnings growth.

Switzerland: Sentiment takes a hit, but fundamentals remain robust

Sentiment has weakened notably, both among consumers and investors, likely reflecting recent trade disputes, which pose a threat to small open economies such as Switzerland's should they escalate further. Consumer sentiment has fallen to the lowest level since early 2017, though the perception of job security, which is key for the domestic economy, is still strong. Economic activity is also holding up well, with the manufacturing PMI well above its long-run average in July, boosted by inventory restocking and strong factory output. Export data are brisk, with no signs of a slowdown so far. The stronger growth environment was also mirrored in the UBS real estate bubble index for Q2, which shows that imbalances in the housing market are receding, mainly reflecting rising household income. The Swiss franc has, however, come under pressure again, with concerns around Turkey triggering a sharp strengthening vs the euro over the past week. For now, the economy should be able to sustain this, but sentiment is vulnerable.

Japan: Consumer sentiment hit by severe weather conditions despite strong summer bonuses

Following a mostly weather related shrinkage in Q1, Japan's economy recovered in Q2, up 1.9% on a sequential annualised basis, or 1% YoY, which exceeded consensus expectations. Strong private consumption and capital investment were the main pillars of growth, while net exports were a minor drag. However, consumption may take a beating in Q3, again impacted by severe weather conditions. Following torrential rain in central Japan, with human casualties and disruptions to the supply chain, consumers suffered from a severe heat wave that culminated in record high temperatures above 40°C. Higher vegetable prices and a low propensity to spend (apart for air conditioners) already had an impact in the Eco Watchers survey, which fell 1.5 points to 46.6 in July and is down 7.3 points since the start of the year. We believe this setback to be temporary, as real income growth, up 3.8% YoY in Q2, is strong. Wage growth surged to a headline-grabbing 21-year high in June, up 3.6% YoY, but we caution that summer bonuses had a major impact, while basic wage growth remained stable at 1.3%.

What to Watch

- In the US, retail sales are expected to slow down after a strong rise the month before while both consumer confidence and small business optimism are likely to remain high. Building permits and housing starts should recover in July from a slump observed in June.
- Eurozone wide industrial production for June should confirm the decline seen in national data, but other data should indicate that the recovery remains intact.
- Bank Indonesia's MPC will convene on Wednesday. We believe the policy rate will remain unchanged at 5.25%. Q2 GDP statistics will be published in Taiwan, Malaysia and Singapore, while July export data will be released in Japan, Indonesia, Thailand and Singapore. In China, we will monitor July data for aggregate financing, industrial production, fixed asset investments and retail sales, while in Australia, the focus is on labour market and confidence data.

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