

Weekly Macro & Markets View

Highlights and View

- **China's economic downturn is gathering steam**

Targeted policy loosening is setting the stage for a turnaround later this year.

- **US households consider it to be the worst time to buy a house since 2008**

The University of Michigan's consumer confidence survey reveals that households have become increasingly reluctant to buy major household items, vehicles or houses.

- **Bank Indonesia and the Central Bank of Argentina raised policy rates against expectations**

Both banks responded quickly to the Turkish currency crisis last week in order to defend their currencies. We believe only a few EM countries are vulnerable from an external financing perspective.

China slowdown intensifies, but light at the end of the tunnel



Source: Bloomberg

Economic statistics for July confirmed that China's economic slowdown continues. Data came in even weaker than consensus had expected, with industrial production up a tepid 6% YoY, and nominal retail sales up only 8.8% YoY, a 15-year low, driven by weaker electronics sales. The major drag came from fixed asset investments, particularly infrastructure investment growth, which hit a record low. On a smoothed basis, infrastructure investment even contracted, as the chart shows. However, it has to be noted that manufacturing and real estate investment growth have started to pick up again and that home sales remain brisk, up 24.8% YoY, while new floor space under construction surged 36% YoY. Weak infrastructure spending is a result of over-tightening following the deleveraging process that was initiated by the government as a medium to long-term policy target. We believe that while risk-reduction policies will remain in place, there is some leeway around them, and policy fine tuning has already started, with further stimulus measures on the monetary, fiscal and regulatory front in the offing. Indeed, fiscal spending is likely to increase substantially in the next few months, with urban rail transportation projects at the forefront. While the current drag on the economy may persist through this quarter, we believe the economy will turn around in Q4 and into next year, although accelerating trade disputes with the US remain a risk.

Credit: The nascent bounce appears to be stalling

The recent bounce in credit markets appears to be stalling. This bounce, which occurred after the almost relentless spread widening of last few months, is under threat despite US equities being particularly resilient and hovering around all-time highs. European credit markets were weak amid a lifeless primary market, with the culprit being weakness in corporates rather than financials. A bridge collapse in Italy caused Atlantia spreads to spike while commodity credits were weak, as copper declined by around 4% following investor concerns around Chinese

growth, which also caused Chinese equities to underperform significantly. As expected, financial credit stabilised somewhat after the Turkey related jitters of the previous week, although late on Friday both Moody's and S&P downgraded Turkish debt. Flows were also almost universally negative for various credit sectors, with the usual exception of US investment grade, where inflows were also weaker than before. All in all, credit's lag to equities looks set to continue.

US: Small business optimism reaches a multi-decade high

Small business optimism has reached a new cycle high, climbing to 107.9 in July. Most of the subcomponents reflect a healthy state of the broader economy. However, driven by an ever tighter labour market, difficulty filling open positions has risen to the highest on record and is a significant challenge for businesses, creating a headwind for a further expansion in a number of sectors. Meanwhile, the University of Michigan's consumer confidence index ticked down to the lowest in almost a year, with households more reluctant to buy big ticket items. The more cautious

mood was not reflected in retail sales, which rebounded in July after a slowdown in June. Housing data was mixed with housing starts failing to significantly improve in July after the steep fall the month before. Building permits did increase but August's NAHB home builders' index ticked down to the lowest since September last year, indicating that the housing market is unlikely to re-accelerate much in the near term.

Eurozone: Italian bond spreads move back close to recent highs

Eurozone Q2 GDP growth was revised up to 0.4% QoQ from an initial estimate of 0.3% QoQ, with German growth in particular revised higher. The ZEW investor expectations survey also increased in August for the first time since January. This suggests underlying economic momentum in the region is still strong. However, internal and external risks remain this year. The biggest external risk to the Eurozone is the ongoing trade dispute between the US and China. The news that the two parties are resuming negotiations is encouraging. The biggest internal risk remains

the upcoming Italian budget for 2019. Spreads between Italian and German government bonds have widened in recent weeks and are back close to late May highs. We think it is unlikely that the Italian government will enact all the spending proposals contained in the original 5 Star Movement and Lega Party coalition deal in the 2019 budget, but there is likely to be some fiscal slippage. Spreads are likely to stay volatile and in a wide trading range for the next few months until investors have greater clarity on the Italian government's plans.

UK: Unemployment rate falls to a 43-year low

The unemployment rate fell to 4% in June, the lowest level since 1975, although the latest drop was mainly driven by a falling participation rate. The number of employed persons actually fell in June. Wage growth continued to decelerate, with growth in core wages (ex bonuses) ticking down to 2.7% YoY from 2.8%. Annual headline CPI inflation accelerated to 2.5% in July despite a flat MoM reading. Core CPI remained at 1.9% YoY, down from 2.7% at the beginning of the year and the lowest level so far this year. Input prices continued to move higher, reaching

10.9% YoY after slowing down to 3.9% earlier this year, indicating that inflation is likely to remain above the BoE's target for the time being. Currency weakness is a key driver of higher input costs as sterling has fallen back to the lowest level in more than a year. While distorted by the football World Cup and unusually hot weather, the rebound in retail sales by 0.9% in July is a positive signal that the UK economy is holding up reasonably well entering the third quarter despite rising Brexit uncertainty.

Indonesia: Coordinated policy measures are taken as EM volatility increases

Bank Indonesia (BI) raised its policy rate to 5.50%, taking the cumulative hikes to 125bps this year. BI reiterated its focus on maintaining "macroeconomic and financial system stability" and defending the currency. The rupiah weakened further against the US dollar last week, mirroring the weakness in other EM currencies. The softness in the rupiah also reflects a deteriorating current account deficit. Indeed, vigorous domestic demand has boosted imports. To rein in imports, the government has announced that it would delay second-priority infrastructure

projects, impose restrictions on 500 imported products, and promote the use of biodiesel. Policymakers' actions are coordinated, which is positive. That said, we are wary of the potential unintended impact of some measures on the ease of doing business, and possibly, inflation. In its 2019 draft budget, the government also shifted its focus away from investment to social spending. We view this shift as sensible: the main transportation projects will be completed, but the rest of the pipeline will be put on hold to adjust to tighter financing conditions.

What to Watch

- We expect the G3 flash PMIs to show that momentum is holding up in the major economies, as they have been less impacted than emerging markets by recent market pressure.
- In Asia, CPI data for July will be released in Japan, Hong Kong, Singapore and Malaysia. Industrial production in Singapore and exports in Thailand round out a relatively calm week in terms of Asian economic data.
- In the Eurozone, various business confidence surveys will be released during the week that should confirm that economic activity remains strong.

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