August 27, 2018

Weekly Macro & Markets View

Highlights and View

- **Despite stellar Q2 earnings, corporate leverage remains high**

  It is typical in the late stage of the credit cycle for corporate managements to favour shareholders over creditors, which should cause stocks to keep outperforming credit.

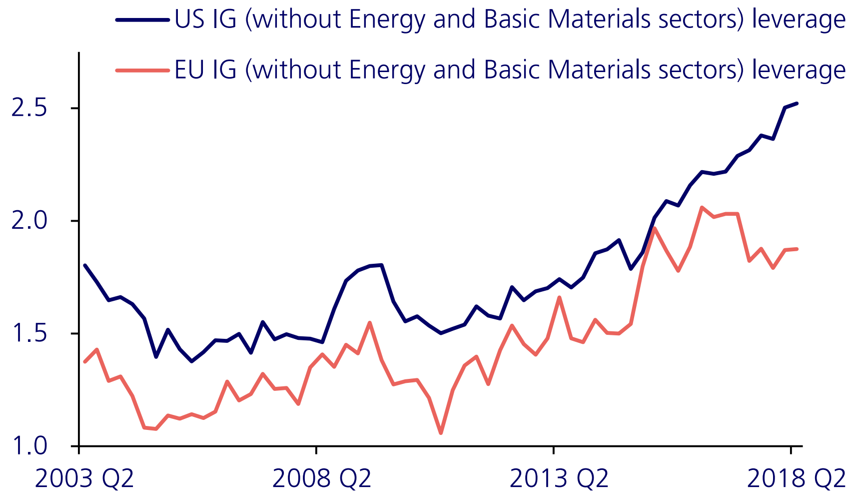
- **Mr Morrison replaces Mr Turnbull as leader of the Liberal Party and Australia's prime minister**

  Although socially conservative, Mr Morrison is likely to seek continuity on the economic front. With the federal elections looming, the Liberal Party needs to re-build its cohesion.

- **China's PBoC re-introduced the 'counter-cyclical' factor when fixing the CNY's daily mid-point**

  The factor gives the PBoC discretion to move the CNY into a direction that it believes is fundamentally appropriate. We doubt that it will accept a huge reduction of its FX reserves to defend its currency vs. the USD.

Shareholders cream the earnings, leaving creditors behind



Source: Bloomberg (Note:Leverage is median Net Debt to EBITDA ratio)

As the curtain draws on the Q2 earnings season, credit investors should take a step back to ponder, in our view. It has been a stellar Q2 reporting season, particularly in the US, with S&P500 company earnings rising by over 25% and sales by nearly 10%. However, what do those strong earnings imply for creditors? Unfortunately, cash is not being saved for a rainy day – which is what creditors should look for. In fact, corporate leverage continues to rise unabatedly, especially in the US, as companies take even more debt than earnings have risen by. Even in Europe, where leverage is more conservative, it is still higher than it has been at the depths of previous recessions. Furthermore, some of the cash which was parked abroad by US companies is being returned to shareholders. Consequently, in a low yield environment, equities are offering around a 4% yield on dividends and buybacks, with added upside potential. All of this argues for continued outperformance of equities over credit. Indeed, over the last twelve months the ratio of total performance of US equities to excess returns on credit indices over government bonds was around 19:1 in the US, while year to date this has become even more skewed. This appears set to continue, as is typical during the late stage of the credit cycle when only a recession typically reinforces the value of cash conservation.

Covered Bonds: Covered bonds outshine underperforming European bank bonds

We remain constructive on covered bonds and believe they offer a safe haven within the financial universe, given the vulnerabilities in European bank credit. Apart from better fundamentals, we expect supply to remain limited as European banks will allocate part of their funding to the new "non-preferred" bonds they need for MREL requirements, as covered bonds remain immune to bail-in risk and hence ineligible for MREL. This limited supply and the reinvestment by the ECB should support the spread for covered bonds.

On the regulatory front, the ECON committee has published its draft report and the covered bond directive is still scheduled to be adopted in 2019 Q1. We view this directive, with its goals of greater harmonisation and softer requirements, as an additional tailwind for the already strong and investor-friendly framework. We are also encouraged by the potential emergence of covered bond-like structures, backed by loans granted to SMEs, based on the recommendation issued by the EBA for the creation of European Secured Notes (ESN).

US: The S&P 500 reaches a new all-time high

The S&P 500 rose to a new record high last week as worries regarding a potential escalation in the trade dispute with China shifted to the background. Instead, investors felt reassured by Jerome Powell's statements in Jackson Hole, signalling a continuation of the Fed's gradual tightening of its monetary policy. Economic data were mixed as house prices grew at a slower pace in June and sales of both existing and new homes fell in July. Meanwhile, despite slowing down, business activity remained solid in August. The Markit Manufacturing PMI fell to 54.5 from 55.3 while the Services PMI receded to 55.2 from 56.0. Overall, new orders grew at the slowest pace since December 2017 while staffing levels increased at the softest pace for over a year. On a positive note, the surveys show that inflationary pressure moderated in August. Finally, core durable goods orders rose a mere 0.2% MoM in July following two months of modest growth.

Eurozone: Overall PMI holds up, but there are signs of weakness in the periphery

The Eurozone flash composite PMI was virtually unchanged in August, coming in at 54.4 from 54.3 in July. Stronger service sector confidence was offset by slightly weaker manufacturing confidence, with the overall index still consistent with above trend growth continuing in Q3. However, the flash release only covers Germany, France and the Eurozone as a whole. The complete survey will be released next week. Both Germany and France saw stronger composite PMI outturns in August, even though the Eurozone wide indicator was virtually unchanged. This suggests that other economies, probably Italy and Spain, saw a fall in business confidence. This could be of particular concern for Italy, as growth is already weak there, and will need monitoring going forward. Nevertheless, the overall survey is encouraging as it suggests that strong growth in the Eurozone will continue in Q3, which should be supportive of corporate earnings and risk assets in the region, especially equities.

Asia: Promising export performance

Global trade tensions have not yet had an impact on the export performance of major Asian export nations. Korea's exports in the first twenty days of August accelerated to 14.9% YoY, driven by strong exports of petrochemical products (+53.2%), semiconductors (+39.1%) and autos (+23%), with exports to China, Japan and Vietnam particularly solid. These are encouraging numbers, even though growth will level out for the rest of the year due to a base effect. The same is true for Taiwan, where July exports surprised to the upside, up 8% YoY. Electronic and information & communication products, which make up more than half of all exports, as well as machinery and base metal exports were brisk. Thailand rounded out the favourable Asian export performance, with exports up 8.3% YoY in July. Most product categories performed well. We are particularly encouraged by the solid industrial/electronics export performance in the region, while we will closely monitor how the US-China trade dispute develops over the next few months.

Bonds: Yield curve flattening signals that this cycle will not last forever

The major story in bond markets last week was the continued flattening of the yield curve. In the US, the 10/2yr and the 30/2yr spreads fell to 19bps and 34bps respectively, both cycle lows. Recent flattening reflected lower yields at the longer end, while the short end has been steady. The 2yr yield edged down in August as the Fed reiterated its gradual policy approach, while the 10yr yield fell more markedly and is currently only at 2.81% despite data showing large short positions among investors. The curve will invert in a few months if the flattening continues at a similar pace, and this has historically been a good predictor of recessions. There is, however, typically a lag between curve inversion and recession. For example, the 10/2yr spread first turned negative in Dec 2005 and the US economy did not enter a recession for another two years. The flattening curve therefore appears consistent with our view that the US economy is in the late stage of the cycle, with significant recession risk over the next couple of years, though near-term recession risk remains low.

What to Watch

- The Bank of Korea is expected to remain pat when its MPB convenes on Friday.
- In Japan, most of the relevant economic data for July as well as Tokyo's CPI for August will be released at the end of the week. In China, the official NBS PMIs for August will be in focus, while industrial production data for July will be released in South Korea and Thailand. Finally, building approvals for July as well as capex data for Q2 will be published in Australia.
- Consumer confidence in the US is likely to remain high in August while PCE Core inflation is expected to have climbed back to 2% in July. No major revisions are expected for the second quarter's GDP.
- In the Eurozone, lending data, the European Commission business and consumer confidence survey, and the German ifo survey should confirm that above trend growth continues.

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Investment Management
Mythenquai 2
8002 Zurich

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