September 3, 2018

Weekly Macro & Markets View

Highlights and View

- **US consumer confidence highest since 2000, while trade agreements prove hit and miss**

  Consumers remain in rude health, which is encouraging for consumption, however, despite mixed progress on a new NAFTA, the real issue is the growing risk of an all-out trade war with China.

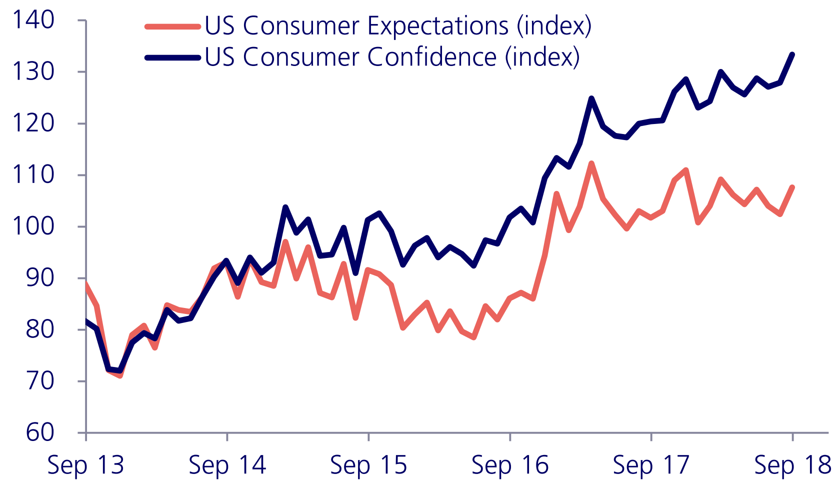
- **German ifo survey substantially beats expectations**

  The large bounce back in the ifo business climate indicator is encouraging and confirms that the Eurozone continues to grow at an above trend pace.

- **Fitch maintains Italy's credit rating, but changes outlook to negative**

  The decision by Fitch highlights the risk of actual rating downgrades if the Italian government adopts an aggressive fiscal loosening.

As good as it gets?



Source: Bloomberg

Today's US Labour Day holiday marks the unofficial end of summer and perhaps gives investors time to digest the plethora of economic data and geopolitical events of last week. US stocks posted new highs, albeit on light summer volumes, helped by a trade agreement with Mexico. However, by the end of the week the lack of a deal with Canada and further talk of imposing the additional tariffs on USD 200bn worth of goods on China led to a modest pullback by Friday's close. Unfortunately, it seems as though the additional tariffs on China are becoming more likely, which would push the current tariff tiffs into a full-blown trade war from our perspective. While we still believe this can be avoided, it is a significant risk for the market and ultimately the global economic outlook.

On that front, US data continue to be remarkably robust, with the latest consumer confidence readings showing that the tight labour market, modest wage gains and an ebullient stock market are all lifting the mood of consumers, with sentiment hitting an 18-year high. It was also important, as shown in the chart, that expectations ticked up after easing back in recent months. Other data were also decent, with a higher revision to 4.2% for Q2 GDP growth, while core PCE inflation inched up to hit the Fed's 2% target YoY. We suspect all of this will push the Fed to hike rates for the eighth time on September 26.

Eurozone: Further evidence that the recovery remains in tact

The German Ifo business climate indicator jumped around two points in August, to 103.8 from 101.7 in July. Business confidence in domestically focused sectors such as construction and services is particularly strong. Although expectations in the manufacturing sector also improved (especially in the auto sector), survey respondents mentioned better trade relations between the EU and US as a reason. This followed EU President Jean-Claude Juncker's visit to Washington to meet with President Trump at the end of July, which resulted in an apparent agreement to reduce tariffs and resolve trade issues. However, trade tensions between the US and EU have resurfaced recently, with President Trump's rhetoric against the EU hardening last week, for example. This suggests confidence in the manufacturing sector could still be volatile and fragile until these issues have been clearly resolved. Nevertheless, other data released last week suggest that above trend growth in the Eurozone continues. For example, lending to non-financial companies grew at healthy 4.1% YoY pace in July.

Italy: Fitch maintains Italy's BBB rating, but changes outlook to negative

On Friday, after markets closed, credit rating agency Fitch issued its latest assessment of Italian sovereign debt, keeping its rating at BBB, but changing the outlook from stable to negative. A rating downgrade could therefore come later this year or next year. A lot will depend on the 2019 budget. Whilst markets and investors are expecting some fiscal slippage, anything too aggressive (i.e. towards a 3% of GDP budget deficit) would probably generate a further negative reaction from both bond markets and credit rating agencies. More generally, Italy remains vulnerable in the next global economic downturn, given its weak starting point in terms of debt levels. This also increases the urgency to make the Eurozone more resilient to future shocks. Comments this week from German deputy finance minister, Jorg Kukies, were broadly encouraging. While the idea of a separate Eurozone wide budget was de-emphasised, instruments that would act as automatic fiscal stabilizers, such as a Eurozone wide unemployment insurance scheme, were considered important.

Japan: Weather woes impact July data

July activity was weak, partly impacted by extreme weather conditions. Torrential rains forced some factories to shut down, leading to a small decrease in industrial production. Manufacturing activity is likely to pick up in August, according to company surveys. Weather headwinds pushed consumers to stay at home. As a result, retail sales ex food and energy were sluggish. We will monitor consumption data for a recovery as we expect the rise in real income to boost retail sales at some point. Indeed, ongoing strength in employment growth and a tightening labour market represent tailwinds for consumers' income growth.

Consumer prices regained some strength as the Tokyo CPI ex fresh food and energy ticked up to 0.6% YoY, partly helped by a surge in hotel charges. This is encouraging although unlikely to change the stance of the Bank of Japan. The central bank will probably keep yield curve controls in place at least until spring 2020, when the impact of the VAT hike has been evaluated.

China: PMI activity to disappoint before policy stimuli take effect

China's Caixin manufacturing PMI ticked down to 50.6, a 14-month low. Robust output growth was not enough to offset the sharp fall in new orders. Downbeat manufacturers blamed softer domestic demand for this fall. In contrast to China, other Asian PMIs reveal a marked improvement in local demand. This tells us that Chinese economic weakness has not spread through the region yet. We expect Chinese activity to bottom out towards the end of this year / early next year, helped by synchronised easing on the monetary, regulatory, and fiscal fronts. In a recent announcement, policy makers agreed to cut personal income tax for low to medium wage earners, which should boost private consumption with a lag of a few months.

In the short-term, Chinese data will probably weigh on investor appetite for EM markets. Investors need to see economic data turn around to regain confidence. We think that total social financing, a measure of credit growth, has to be scrutinised as a sign of activity stabilisation.

Credit: Time to pause on pace of underperformance vs equities

In a week where US equity indices broke new records, global credit markets continued to be buffeted by headwinds. Credit markets were weak across the board, with Europe marginally underperforming the US. European banks were again under pressure, with spreads wider and stocks down significantly, weighed upon by concerns around Italy and EMs. Italian yields were wider as investor sentiment remains rather jittery regarding the upcoming budget, while EM currencies continued to plunge. The Argentinian peso plummeted to new lows, while the Turkish lira also weakened sharply, giving up a lot of the recent gains. Appetite for primary deals was strong, however, especially in Europe, where Siemens and Michelin led a surge in activity, although the US market was quiet. Looking ahead, we think credit seems likely to continue underperforming equities, especially in the US. However, that said, the pace of outperformance of US equities could moderate given the recent strong run and risks from seasonal patterns, trade rhetoric and the Italian budget.

What to Watch

- In a holiday-shortened week in the US, most attention will be on the ISM readings for August, which are expected to remain at robust levels, as well as Friday's monthly labour market data. The unemployment rate is expected to remain at 3.9%, with a small pickup in payrolls to 191k. An announcement is also expected as to whether the US will impose tariffs on USD 200bn of Chinese imports.
- Eurozone final PMIs and Q2 GDP breakdown are likely to confirm that the recovery continues, but that Italy remains a weak link.
- Swiss Q2 GDP and PMI data are expected to show robust, but slowing, growth.
- Chinese exports and money supply, Australia's Q2 GDP, and the rest of the Asian PMIs will be released. We expect the central banks of Australia and Malaysia to hold rates.

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Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

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