ZURICH®

Weekly Macro & Markets View

Highlights and View

- **US firms remain very upbeat with the ISM Manufacturing rising to a 14-year high**

  The US economy is in splendid shape, hardly affected by increasing trade tensions with China. However, the labour market indicates that the economy is reaching its capacity limits.

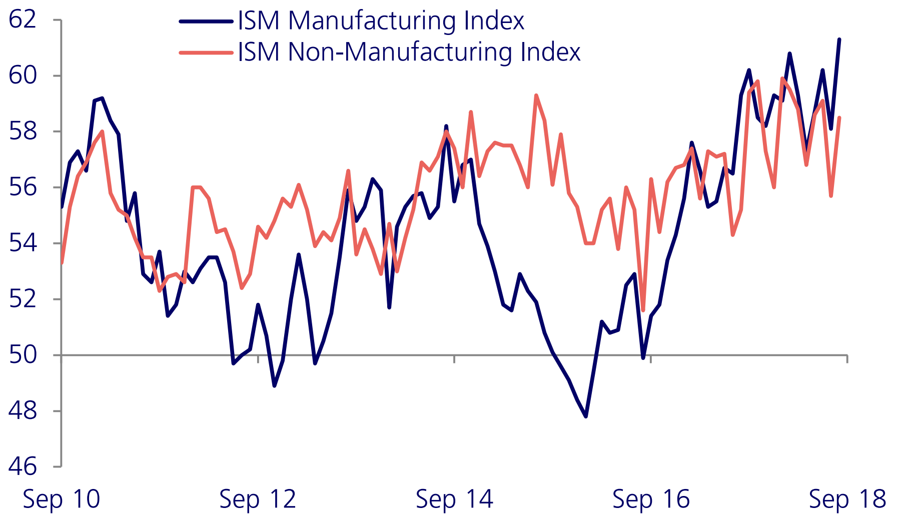
- **Credit remains resilient despite broader risk aversion and a supply deluge**

  A pause in credit's underperformance versus equities was overdue, but multiple headwinds and the current late stage of the cycle imply this pause will be short-lived.

- **Asian PMIs are mixed, with new orders stronger but new export orders sluggish**

  PMIs reveal pockets of weakness, notably in China, but paint a decent picture of demand in the rest of Asia.

US business activity rebounds despite tariff threats



Source: Bloomberg

Global stock markets faced some headwinds last week as the deadline for the comment period regarding another round of tariffs on US imports from China ended, increasing the likelihood of a further escalation in the trade dispute in the coming weeks. While investors worry about the risk of a trade war, US firms remain very upbeat. Business activity rebounded strongly in August after the slowdown in July. The ISM Manufacturing index jumped to 61.3, the highest since 2004. At 65.1, the new orders component indicates that momentum is likely to remain strong in the near term. Services also showed a healthy rebound with the ISM Non-Manufacturing index rising to 58.5 from 55.7 the month before, though levels remain below those at the beginning of the year. 10yr Treasury yields jumped to a four-week high as growth in average hourly earnings accelerated to 2.9% YoY in August from 2.7% in July while consensus was expecting a flat reading. Other labour market data were mostly in line with expectations. 201'000 new payrolls were created in August while the broad underemployment rate fell to 7.4%, the lowest since April 2001, confirming the healthy employment situation in the US. The overall solid set of economic data was only slightly overshadowed by a fall in factory orders in July and a further tick down in vehicle sales to the lowest in a year.

Credit: Underperformance to equities takes a pause

We had suspected that the underperformance of credit vs equities, especially in the US, was due for a pause. Indeed, last week credit was resilient amid weakness in equities, volatility in EM space and heavy supply. This outperformance also came in contrast to adverse technicals, as IG funds suffered outflows in Europe and in the US. Primary markets roared back to life, a seasonal expectation, as the US market recorded its busiest week in 2018 with more than USD 50bn in new bond sales. Activity was boosted by the USD 20bn bond issuance (the second largest deal of the year) from the US health insurer Cigna, to partially fund its USD 67bn acquisition of Express Scripts, announced last March. Pipelines continue to grow in the US and in Europe, fuelled by M&A funding needs, with issuers also expediting deals ahead of the tapering of ECB's purchase programme. Given the headwinds for credit, including supply, we don't see much upside for credit beyond a short pause.

Switzerland: Solid GDP growth in Q2 as exports surge

The manufacturing PMI rebounded sharply in August, beating expectations by a wide margin. Part of the strength appears to reflect an inventory restocking, so should fade, but solid new orders and employment suggest that underlying conditions remain favourable. This is in line with the latest GDP data that show the economy expanding by 0.7% QoQ in Q2, boosted by exports, while consumption was less upbeat, only up 0.3% QoQ. Large revisions to previous data have tilted the growth profile higher and first quarter growth is now estimated at 1% QoQ while the YoY growth rate is tracking at 3.4%. The key driver behind the acceleration is exports, which are up over 7% compared to a year ago (ex merchanting and valuables), apparently unaffected by trade skirmishes. Given the sharp strengthening of the franc and subdued core inflation, we don't expect the solid GDP data to materially change the SNB's position. We anticipate that the SNB will maintain its dovish stance, intervening in forex markets when required and lagging behind the ECB in its rate hike decision.

Japan: Natural disasters and a capex boom

Following an earthquake, devastating mudslides and a heat wave with record high temperatures above 40C°, Japan was hit by the worst typhoon in 25 years and a strong earthquake in Northern Japan last week. Human casualties, destroyed buildings and infrastructure, the temporary closure of the Kansai airport near Osaka and a major electricity blackout have been widely reported. Supply chain disruptions, flight cancellations, department store closures, trip cancellations by foreign tourists and deteriorating consumer sentiment have all had a negative impact on economic activity. A first rough estimate shows that real annualised GDP growth could be affected by about 0.5 percentage points in Q3, with a risk of even seeing the economy shrink. On a positive note, capex in Q2 was stronger than expected, leading to today's upward revision of GDP growth from 0.5% to 0.7% QoQ. We also note an improvement in the Eco Watchers Survey in August, which suggests that any disaster related setback in economic activity should prove to be temporary, with a recovery expected to become visible in Q4.

Asian PMIs: New orders improve despite geopolitical angst

Asian PMIs were mixed in September. Weak activity in China spilled over to Hong Kong, where the PMI recorded its fifth consecutive month below the 50 mark. The Chinese yuan's depreciation against the Hong Kong dollar pushed businesses to slash prices in order to prop up sales to Chinese visitors.

In Hong Kong and several other countries, businesses reported that geopolitical tensions were taking a toll on export demand. In contrast, domestic demand picked up steam. Indonesia's manufacturing sector registered its strongest gain in new orders since July 2014. In Malaysia, manufacturing conditions improved significantly, partly reflecting front-loading before the Sales and Service Tax takes effect. Growth momentum also accelerated in Japan, led by demand for services.

Overall, PMIs reveal pockets of weakness around China, but paint a decent picture of the rest of Asia. On the inflation front, anecdotal evidence suggests that the past depreciation of local currencies is feeding through to prices.

Australia: GDP growth surprises to the upside

Q2 GDP surprisingly jumped 0.9% QoQ and 3.4% YoY, the fastest pace in almost six years. Private consumption, public demand, and residential property investment all contributed to the strong GDP print. Going forward, we expect growth to slow to a still robust but more sustainable pace. Private consumption growth is likely to moderate as consumers face two headwinds: sluggish wage growth and tighter lending conditions, especially for mortgages. Additionally, cooling residential prices should exert downward pressure on dwelling construction.

We see growth slowing from the stellar Q2 level, but we remain constructive on the Australian economy. On the first hand, an ambitious infrastructure programme is expected to boost investment for a couple of years more. On the other hand, the central bank has signalled that it would leave its policy rate unchanged for longer and the Australian dollar has weakened significantly, which should keep financing conditions accommodative and exports attractive.

What to Watch

- In the US, small business optimism is likely to remain high while inflation is expected to show signs of stabilisation. Finally, retail sales should continue to grow at a steady pace.
- In Japan, we will keep an eye on the widely neglected quarterly BSI corporate survey that precedes the well-known Tankan survey. Australia's labour market data for August are expected to show a recovery from last month's setback, while in China the focus is on credit data and the usual economic activity indicators for August. In India, industrial production data are expected to remain firm, while inflation should soften due to decelerating food inflation.
- The ECB is expected to leave policy unchanged this week, reiterating that QE is on track to end by the end of the year and that rates will be left unchanged until the second half of 2019.

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

ZURICH®