September 17, 2018

Weekly Macro & Markets View

Highlights and View

- **China's economic data paint a mixed picture, with infrastructure spending still falling**

  We believe the economy will stabilise towards year end amid rising local government investment spending.

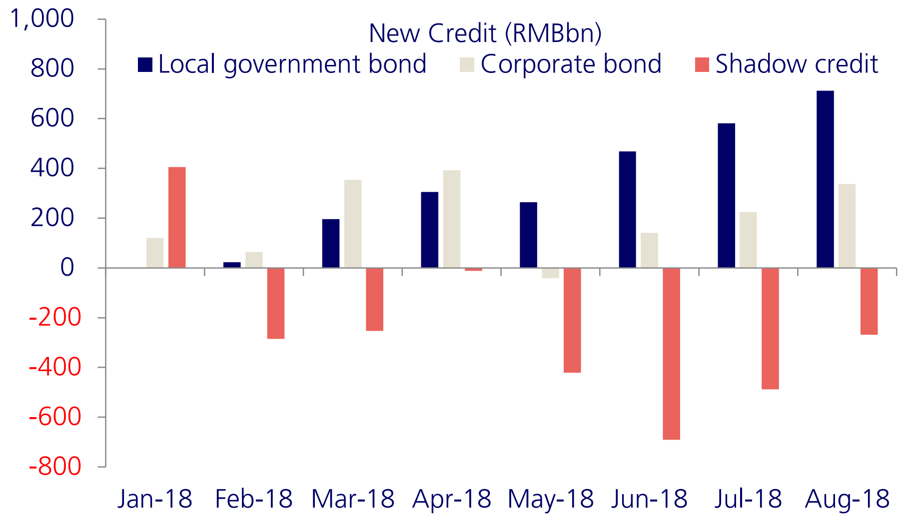
- **Indonesia unveils tariff hikes on selected consumer goods; India loosens external funding rules**

  Both countries are taking encouraging actions to tackle their external deficits. However, EM currency volatility is likely to linger on trade war woes, USD strength and Chinese growth concerns.

- **US firms and households remain very upbeat, and small business optimism climbs to a record high**

  A strong labour market and solid economic momentum are lifting both consumer and business sentiment. However, filling open positions is increasingly difficult as the economy reaches its limits.

China's growth to stabilise towards year end following stimulus measures



Source: JPM, UBS

While US President Trump is proceeding with imposing further tariffs on China, this time on USD 200bn worth of imports, China registered a record high trade surplus with the US in August. This reflects strong US demand, but also some frontloading before harsher tariffs kick in. On the domestic front, China's policy makers are fighting to avoid a further weakening of the economy in the aftermath of overly strong deleveraging measures. The latest economic data paint a mixed picture, but do confirm that the economy is still struggling. Infrastructure investments keep falling, while manufacturing investments remain solid. However, the manufacturing sector continues to suffer from stricter environmental policy restrictions. Fortunately, property investments growth is showing signs of resilience. Retail sales remain lacklustre, barely rising on a real basis, with weak auto sales compensated for by stronger electronic appliance sales. To avoid a more severe deterioration in economic growth and to help exporters amid escalated trade tensions with the US, the VAT rebate for nearly 400 product categories has been expanded by 2ppts to 14.6%, affecting about 14% of exports. Private consumption will get a boost from individual income tax cuts as of October. More importantly, local governments are being urged to speed up their special bond issuance (see chart), while infrastructure spending should benefit from a revival of metropolitan railway projects.

US: Small business optimism reaches an all-time high

The S&P 500 ended the week almost unchanged as investors' focus shifted between trade worries and solid economic data. Small business optimism has never been higher since the surveys were first conducted in 1974. Capital expenditure plans reached a 12-year high in August, indicating that investment growth may pick up in the coming months. On the flip side, difficulty filling open jobs has also reached a new record high, showing the limits for further expansion. Consumer confidence as measured by the University of Michigan's Sentiment Survey has improved in September, climbing back to 100.8 from 96.2, helped by both current conditions and expectations. Despite strong economic momentum, inflation eased in August. Headline CPI slowed to 2.7% from 2.9% while core CPI weakened to 2.2% from 2.4%. Producer prices receded by -0.1% MoM for the first time in more than a year, indicating that price pressure remains muted. Finally, the JOLTS quit rate ticked up to 2.4% in July, the highest since 2001, reflecting increasing optimism among job seekers.

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Eurozone: Industrial production disappoints in July, with Italy particularly weak

Eurozone industrial output fell 0.8% MoM, bringing the YoY rate of output growth close to zero. However, most of the monthly decline was concentrated in one sector and the data can be volatile over the summer months. We expect Eurozone output to rebound in the next few months. More worrying was the industrial production data from Italy, which showed a decline of 1.8% MoM, and where the decline was broad-based across sectors rather than concentrated in one sector. Business confidence in Italy has also fallen sharply in recent months suggesting growth could be flat in Q3. At the ECB meeting this week, President Mario Draghi confirmed the plan to taper and end QE in Q4 this year. Draghi also said that the ECB governing council had not discussed reinvestment policy for next year, but that the capital key was likely to be a guiding principle. On Italy, Draghi said that so far there had not been contagion to other bond markets, and he did not give any indication that the ECB would buy more BTPs simply to keep yields lower.

Japan: Capex remains the driving force

Following the upward revision of Japan's GDP growth in Q2 due to stronger than expected capital investments, there were more signs of solid capex growth last week. Machinery orders got another boost in July. While non-manufacturing orders remain solid, manufacturing orders have picked up steam in the last two years, reflecting a structural shift towards labour-substituting equipment. Machine tool orders for August remained brisk as well, even though they have retreated from their record high levels marked in March. We also note that firms across all industries have raised their capex plans to nearly 10% for this fiscal year, as the Q3 Business Outlook Survey reveals. Finally, both the Eco Watchers Survey for August and the Reuters Tankan for September have been strong, though we would caution against reading too much into these as the surveys were taken before the natural disasters two weeks ago. The focus this week is on the LDP leadership election. The latest polls confirm what we expected already for some time: PM Abe is expected to win against his competitor, former Defence Minister Ishiba.

Bonds: Government bonds sell off as wage inflation shows signs of life

Last week saw core bond yields drifting higher in the US and Europe, with the 10yr Treasury yield attempting, but failing, to break above 3%. Wage inflation has surprised positively in the US and the UK, and this appears to have helped to stir the sell-off. As expected, the ECB and the BoE left policy unchanged and the ECB is on track to end QE by year end. Reinvestments will remain large though, capping core European yields. The short end is also anchored by the ECB's plan to leave rates unchanged until at least 2019 H2. This is in contrast to the US, where the 2yr yield resumed its upward track last week, rising to 2.77%. This implies almost four rate hikes by end 2019, which is still dovish vs the Fed's own projection. With rising US rates, EMs will probably remain under pressure, and last week saw both Turkey and Russia hiking rates. With slowing EM and global growth, well-anchored European yields and a late US economic cycle, we suspect that it will remain difficult for the 10yr Treasury yield to rise sustainably above 3%.

Credit: Firm, but the pace of outperformance moderates

Credit markets were firm last week, led by US high yield and European financials. That said, outperformance to equities moderated somewhat from the previous week. US high yield has been one of the best performing sectors in credit this year, with spreads tighter on the year despite poor fundamentals and relentless outflows, which we think is untenable in the medium term. European financials were boosted by better sentiment in Italian assets at the beginning of the week while stability in EMs also helped later in the week. Turkish financial credit tightened by around 100bps after the central bank delivered a higher than expected rate increase, which stabilised EM assets, along with news that the US was reaching out again to China on talks regarding trade. Encouragingly, Italian banks have continued to reduce NPLs aggressively, while the deadline for government guarantee on senior tranches of securitization has been extended. Interestingly, Brexit risk is now increasingly being priced in sterling credit, which is likely to continue.

What to Watch

- Global Flash PMIs are likely to confirm that growth in developed markets remains strong.
- The SNB is expected to leave policy unchanged despite strong growth, as the franc has appreciated markedly and inflation remains subdued.
- We do not expect a major change in monetary policy when the Bank of Japan's MPC convenes this week. We see a high chance that the Bank of Thailand will delay its first rate hike until after September, although the conditions for policy normalisation are present. As data releases are concerned, the focus will be on August export data in Japan, Taiwan and Thailand.

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