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Weekly Macro & Markets View

Highlights and View

- **The US government began a partial shutdown on Saturday as Congress failed to extend government funding**

  Given the solid economic momentum, the impact on both the economy and financial markets should be limited if the stand-off is resolved within a reasonable time.

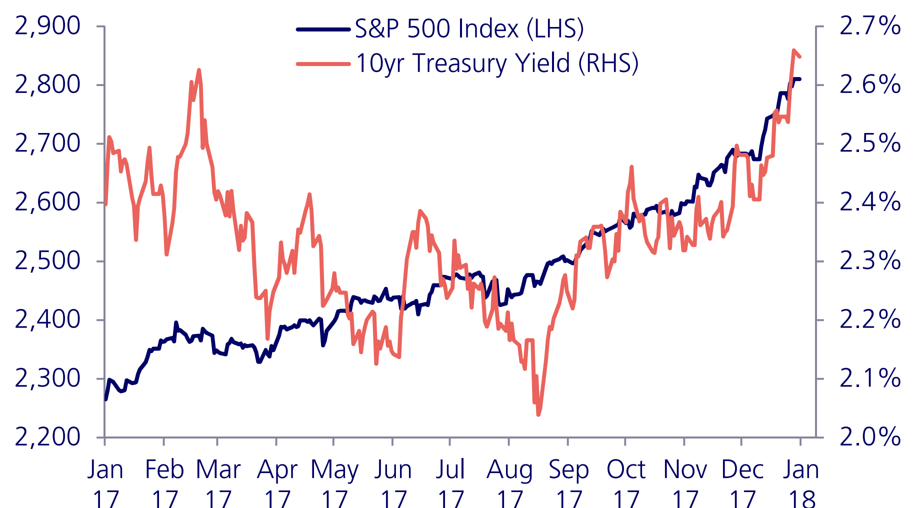
- **In China GDP growth was up 6.8% YoY in Q4 and 6.9% in 2017, stronger than expected**

  While IT related service sector activity remains strong, there is no doubt that economic growth is slowing overall.

- **Germany's SPD voted narrowly to start detailed negotiations with the CDU/CSU to form another grand coalition**

  The final deal must still be accepted by the 450,000 SPD members, so some risk to the formation of another grand coalition in Germany remains.

Investors look through the US government shutdown



Source: Bloomberg

The US government began a partial shutdown on Saturday as Congress failed to extend government funding, which ended on Friday at midnight. Given the solid economic momentum, the impact on the economy should be limited if the stand-off is resolved within a reasonable time. The October 2013 shutdown lasted 16 days but GDP growth in that quarter still was a healthy 4%. Investors looked through the shutdown, with the S&P 500 rising to new records and now showing the longest period ever without a 5% correction. Treasury yields joined the race with the 10yr yield rising to 2.67%, the highest level in more than three years.

While markets race ahead, the economy is losing some steam at the margin. Several regional manufacturing indicators softened as did the NAHB Housing Market Index. Building permits were flat in December (-0.1% MoM) while housing starts fell by 8.2% to 1.2 million units. Industrial production accelerated in December, but that was mainly driven by higher utility output. Manufacturing production slowed to a mere 0.1%. Consumer confidence weakened further from recent highs, with inflation expectations picking up. Initial jobless claims ceased the recent trend higher and fell back to the lowest level since 1973 reflecting the healthy employment situation. All in all, last week's economic data confirm our view that economic momentum in the US remains solid but is unlikely to accelerate much from current levels.

China: Growth is not as brisk as GDP statistics might suggest

Last week we wrote that one should not be misled by likely strong Q4 GDP statistics. Growth of 6.8% YoY in Q4 and even 6.9% YoY in 2017, which was higher than the prior year and above the government's target of 6.5%, may make a nice headline, but scratching below the surface reveals a more sanguine picture indeed. Firstly, while still brisk, growth slowed from 7.4% to 6.6% on a sequential, seasonally adjusted basis. Secondly, current activity indicators already show a clear slowdown in growth. Tumbling import growth in December was the most obvious, followed by weaker retail sales growth. Industrial production growth remained stable, but looking at the output of individual products again reveals a slowdown. Construction is another sector that is slowing. Meanwhile, service sector activity remains strong, particularly in the IT sector, which surged 33% YoY in Q4. The shift towards new innovative segments of the economy is certainly positive, and in addition, China will also benefit from strong global trade. However, an overall slowdown seems inevitable to us.

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Eurozone: The ECB expresses concerns about the strength of the euro

Various ECB policymakers tried their best last week to push back on the hawkish interpretation by investors of the ECB minutes released the week before. In an interview with La Repubblica, ECB Vice-President Vitor Constancio said, "inflation is weak and will remain so for some time in all the developed countries". He also indicated that it was unlikely that the ECB's forward guidance would change at this week's meeting, with changes more likely at the March meeting instead. Constancio referred to the recent strength of the euro, saying that he is "concerned about sudden movements, which don't reflect changes in fundamentals". From an investor perspective, Eurozone equity markets have been more resilient to a stronger euro so far this year than in 2017. However, the ECB is concerned that a stronger currency could impact inflation and inflation expectations, making it harder for inflation to move back to target. It is likely that ECB President Mario Draghi will also express concern about the strength of the euro at the ECB meeting and press conference this Thursday.

UK: Inflation slows, but pressure on households remains

While British households remain squeezed by shrinking real incomes, the pressure is likely to moderate as the currency-induced acceleration in inflation is slowly fading. Although headline CPI rose by 0.4% MoM in December, the annual inflation rate ticked down to 3.0% from 3.1% the month before. Core CPI slowed down to 2.5% YoY from 2.7% in November. We expect inflation to moderate further over the course of the year. Input price pressure is diminishing with PPI falling to 4.9% YoY, the lowest since July 2016 and significantly below the peak reached in early 2017. While households will welcome the reduced pressure on their purchasing power, the trend in consumer spending remains negative. After the short-lived pickup in November, retail sales dropped by 1.6% MoM in December, matching the multiyear low reached in June 2016 in the aftermath of the Brexit referendum. The annual rate (excluding fuel) stood at a modest 1.3%, confirming that households remain reluctant to spend.

Asia: BI keeps the repo rate at 4.25%, but announces monetary policy tweaks

Bank Indonesia left its policy rate unchanged, but announced adjustments to bank reserve requirements. The decision came amid a recovery in investment and exports, but ongoing sluggishness in consumption and credit growth. The BI Assistant Governor declared that the "window to lower policy rate is closing". Indeed, policy normalisation by the Fed and the threat of higher for longer oil prices argue for BI to stay on hold. We think, however, that the central bank will retain a 'wait and see' strategy, and could revise its neutral position if consumption fails to rebound. BI's dovish tilt, as well as regular sovereign rating upgrades have led foreigners to invest massively in IndoGBs, pushing the offshore ownership ratio to a record 41%. Foreign investors have also favoured other EM Asia sovereigns, as local currencies have been appreciating against the USD. Going forward, we are confident that Indonesia and most EM Asia countries will continue to grow at a good pace and are building sufficient external buffers to sustain policy normalisation by foreign central banks.

Credit: US municipal bonds buck the trend, but not for long

Following a strong performance in 2017, long-dated US municipals had a weak start to the year in contrast to the strength seen across most credit markets and also underperformed Treasuries. We don't expect this weakness to persist, although the government shutdown may prolong the weakness somewhat. US Tax reform is likely to prove transformational for the municipal market's structure and composition, but the overall spread impact should be limited. Some state and local authorities with higher tax rates would likely face headwinds due to local tax repeals that worsen budgetary imbalances, while smaller deductions heighten the risk of demographic shifts. A lower corporate tax rate would dampen demand from institutional investors, namely banks and insurance companies, but demand from retail investors should remain strong as demonstrated by recent steady inflows in municipal bond funds. This, along with lower than expected supply due to pre-funding in 2017 by many issuers, should continue to support the supply-demand technicals of the market.

What to Watch

- The ECB meeting and press conference this Thursday could see a comment on the recent strength of the euro. We expect the Bank of Japan to stand pat. In Malaysia, there is a high chance of the central bank delivering a 25bps hike.
- Flash PMIs for the G3 economies and Asian export data will shed further light on the global expansion. Both the PMIs and the export data are expected to moderate somewhat, but still be consistent with solid global growth.
- First estimates for both US and UK Q4 GDP will be published this week. While growth in the US is expected to have been solid, the British economy will continue to feel Brexit-related headwinds.
- The WEF meeting in Davos will be in the headlines this week, with Prime Minister Modi delivering the opening speech on Tuesday followed by Macron on Wednesday, May on Thursday, and Donald Trump closing on Friday.

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