

Weekly Macro & Markets View

Highlights and View

- **US business activity is soaring with the ISM Non-Manufacturing index rising to a 20-year high**

New orders indicate that the US economy is entering the fourth quarter on solid footing while the employment component signals a continuation of the strong labour market environment.

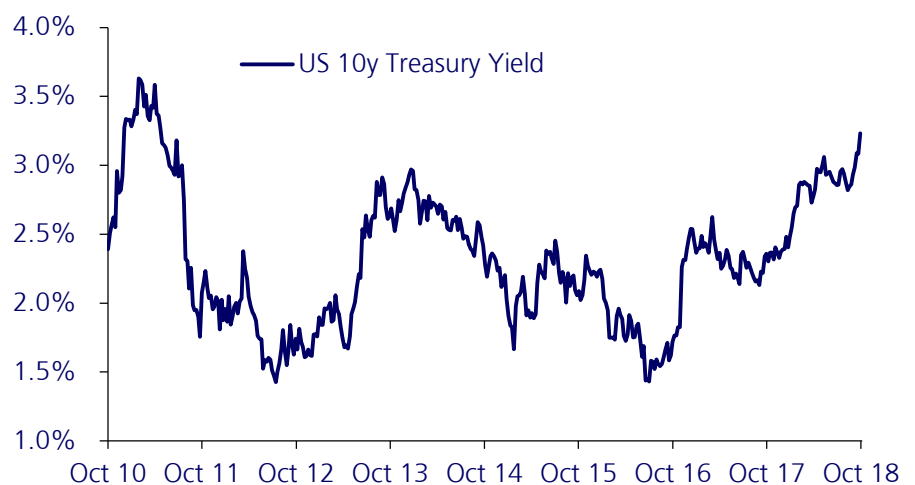
- **Treasury yields snap higher on strong data and hawkish Fed comment**

Further upside to bond yields is likely to be limited, as global growth is already slowing and inflation remains benign.

- **The US Vice President criticises China on a broad range of issues during a speech in Washington**

What may be perceived as part of the mid-term election campaign probably reflects the more deep rooted view of the US administration that trade is not the only concern it has with China and its rising global influence.

10yr Treasury yields reach a seven-year high



Source: Bloomberg

Soaring yields caused some headwinds for the S&P 500, which bounced off its recent high last week despite another set of solid economic data. Although the ISM Manufacturing Index receded slightly from 61.3 to 59.8 in September and the new orders component fell to 61.8 it still indicates a continuation of robust momentum in the fourth quarter. Interestingly, the prices paid component fell to the lowest in almost a year, indicating that price pressure should soften going forward. Business activity is particularly strong in the service sector with the ISM Non-Manufacturing Index rising to 61.6, the highest level in 20 years with both the new orders and employment components ticking up. Strong labour data helped to push yields higher as the unemployment rate fell to 3.7%, the lowest since 1969 (the broader underemployment rate ticked up, however). At 134'000, September's change in nonfarm payrolls was weaker than expected but the prior two months have been revised up significantly, thus keeping the six-month average above 200'000. Despite the ever tighter labour market, growth in average hourly earnings ticked down to 2.8% YoY, helped by base effects due to strong growth a year ago. The opposite effect is expected to lift growth rates next month.

Bonds: A sell-off on strong US data and hawkish Fed comment

Bond markets sold off last week as the US ISM index surged and Fed Chair Powell commented that rates are probably a long way from neutral. The curve bear-steepened, with the 10yr yield spiking to 3.23%, the highest level since 2011. The 5yr5yr forward rate, which has been pinned down by long-term rate expectations, broke out of its narrow trading range. At 3.42%, it is above what would be consistent with the Fed's 3% long-run interest rate projection. Other bond markets followed, despite sluggish data and concerns around Italy. Momentum around the

sell-off is strong and yields could rise further near term. However, as inflation remains benign and with EM and global growth slowing, further upside for bond yields is likely to be limited.

Credit: Bond yields take the baton for battering from Italian yields

Credit markets suffered last week, along with most risk assets as bond yields rose sharply, just when spreads on Italian government bonds were stabilising at the margin. Credit investors preferred putting on CDS hedges rather than selling cash bonds, which explained the notable underperformance of CDS. Interestingly, cash credit was rather resilient despite heavy supply, especially in the US, which saw one of the busiest weeks of the year, dominated by the USD 27bn Comcast debt that attracted USD 85bn in orders. Resilience of the cash market can be

partly attributed to flows, which were shifting from US Treasury and money market funds to both investment grade and high yield funds. That said, the flow picture in European credit was pretty dismal. Our view remains that given the mounting headwinds, the drivers will keep changing but the direction will remain one that keeps pressure on credit spreads to widen, and it is therefore rather likely that cash credit will not retain its resilience for long.

Eurozone: The dispute between Italy and the EU over deficit targets intensifies

Last week, Italy's government gave more detail on its budget deficit targets and GDP growth forecasts for the next three years. It is still targeting a 2.4% budget deficit for 2019, but has revised down its target for 2020 to 2.1% and to 1.8% for 2021. However, this is unlikely to be enough to satisfy the European Commission or rating agencies, especially as the targets are based on optimistic GDP growth assumptions. Indeed, the European Commission has said it has "serious concern" around Italy's spending plans and fiscal targets. Italian government bond spreads

remained at the high end of recent ranges last week and Italian equity markets were under pressure, with the FTSE MIB down around 5%. Financial markets are likely to continue to apply pressure until Italy adopts less aggressive fiscal targets. In terms of data, the final Eurozone PMI surveys confirmed that manufacturing sector confidence is soft, but services confidence more resilient. However, overall, the composite PMI is still consistent with above trend growth in the Eurozone.

Asian PMIs: Export demand slows

Asian PMIs reveal a slowdown of manufacturing activity in the region, mainly driven by softer foreign demand. The new export order indices of the China Caixin and Taiwan manufacturing PMIs both reached their lowest levels since February 2016. According to some manufacturers, orders from Europe, the US, and China have weakened. The Hong Kong PMI reinforces this message, as it shows a marked fall in new business from China. The Chinese authorities have stepped up policy easing this year and the PBoC announced a 100bps cut in the

bank's reserve requirement ratio (RRR) on Sunday. However, it will take time for policy loosening to impact the Chinese economy. On the positive side, domestic demand is proving resilient in many economies such as India and Australia where large infrastructure projects are boosting growth. Malaysian business confidence remains solid as well, despite the recent introduction of the Sales and Services Tax. Overall, Asian PMIs show that growth remains desynchronised, which does not argue for a recovery of emerging Asian markets just yet.

Korea: Solid economic activity data and rising inflation suggest a policy rate hike is in the offing

At a first glance, Korea's export contraction of 8.2% YoY in September looks shocking, but this statistic is highly distorted by the fact that the Chuseok Harvest Moon holidays occurred late September this year, compared to early October last year. On a working day adjusted basis exports even accelerated to 10.6% YoY, driven by strong semiconductor and petrochemical exports. Industrial production in August was stronger than consensus had expected, as automobile production recovered from interruptions during the wage negotiation period, while temporary tax cuts

also helped. CPI inflation rose more than expected following higher agricultural prices due to severe weather conditions. At 1.9%, consumer price inflation is already close to the Bank of Korea's target of 2%, while core inflation is also creeping higher. Rising property prices in the greater Seoul area are giving another warning signal. Both economic activity and inflation data make us believe that the BoK is moving closer to a 25bps policy rate hike, probably in November.

What to Watch

- In the US, investors will focus on the latest set of inflation data and the University of Michigan's consumer sentiment survey.
- Bavaria holds state elections this week, which will be an important test of support for the CSU and by implication for the ruling coalition government in Germany.
- Singapore's MAS will hold its policy meeting on Friday. In China, we expect September lending data to show a shrinking gap between aggregate financing and new bank loans, while provincial bond issuance should continue to grow. We will also watch export data in China, Taiwan and the Philippines, industrial production statistics in Malaysia and India as well as GDP growth in Singapore in Q3. In Australia, the focus is on consumer and business confidence data.

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