October 15, 2018

Weekly Macro & Markets View

Highlights and View

- **The S&P 500 suffers its worst week since March as investors fear rising yields and geopolitical risks**

  Rising volatility is not unusual in a mature bull market, but fundamentals remain strong in the US and solid earnings should help to support equities.

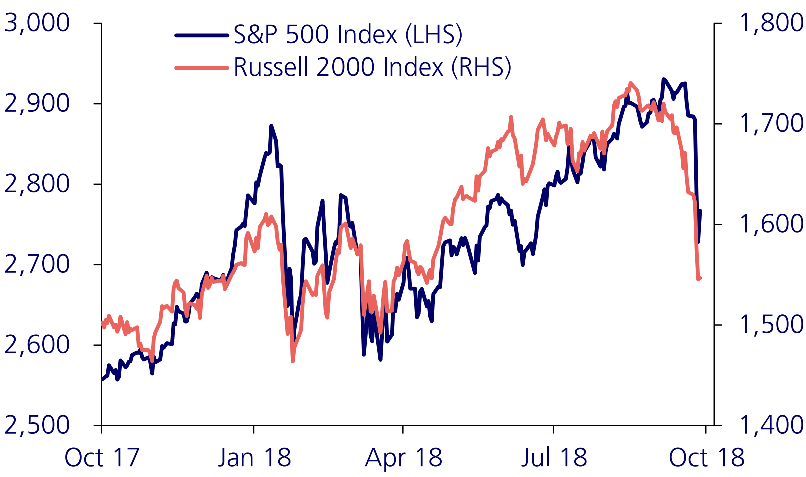
- **In Bavarian state elections, both the CSU and SPD did badly, while support for the Greens surged**

  The coalition government has been weakened, but we expect it will remain in power for now. State elections in Hesse in two weeks' time will also be crucial.

- **US high yield funds experienced heavy outflows driven by investor anxiety as total returns were hit by both higher yields and spreads**

  We believe investor angst is overdue. US high yield is one of the richest parts of the credit markets and spreads are not adequately reflecting the vulnerability of leveraged corporates to rate rises.

Investors are heading for the exit



Source: Bloomberg

The US stock market suffered the worst week since March, with the S&P 500 losing 4.10% despite a rebound on Friday. Cyclical and small cap stocks were hit even harder, and the Russell 2000 index is now down by more than 11% from its peak reached in August. Markets are expected to become more volatile as the business cycle matures and monetary policy tightens. However, economic fundamentals remain very strong in the US and investors will shift their focus to the current earnings season, which has started on a positive note with a number of major banks reporting solid earnings. Given that worries on tighter monetary policy and higher yields are one reason for the recent stock market correction it was important to see that inflation softened in September. Headline CPI inflation slowed to 2.3% YoY from 2.7% while Core CPI remained at 2.2% YoY; both numbers were below consensus estimates. Small business optimism has receded slightly from its all-time high in September but keeps signalling very upbeat firms. However, the difficulty to fill open positions is still at a record high and capital expenditure plans have ticked down. Consumers remain very optimistic as well, with the University of Michigan’s sentiment index hovering close to its post-recession high. Interestingly, households’ longer-term inflation expectations have ticked down to match the all-time low reached in December 2016.

Credit: Spreads undermined by outflows and equity fall

Credit spreads widened significantly last week following the sharp declines in US stocks. Financials, subordinated and high yield bonds underperformed the rest of the credit market. While we have been mentioning that US high yield looks rich, last week investors became anxious as total return was impacted by the recent yield increase. Lipper reported that US high yield bond funds suffered their biggest outflow since Feb 2018 and the 4th biggest weekly outflow of all time, at -$4.9bn. Furthermore, European banks continue to remain vulnerable to the situation in Italy. Last week, European banking supervisors stepped up their monitoring of liquidity levels at Italian banks after the sharp increase in BTP’s yields. Italian banks and insurers were also under scrutiny given their commitment to the construction sector as three of the top six Italian builders are now either insolvent or negotiating with creditors. While credit spreads may stabilise somewhat in the near term, longer-term credit underperformance will likely continue as the asset class gets buffeted by multiple headwinds.

Eurozone: Industrial production bounces back but underlying trend is still soft

Eurozone industrial production bounced back in August by 1% MoM, after consecutive monthly falls of 0.7% in June and July. However, the annual rate of output growth remains soft, at 0.9% YoY, with growth in the Eurozone still mainly driven by the domestic/services sector. Meanwhile, the Italian parliament approved the government's 2.4% budget deficit target for 2019, despite an independent fiscal audit committee that reports to parliament saying the deficit target was based on unrealistic growth assumptions. This week the government will formally send its 2019 budget to the European Commission (EC) for review. The EC is likely to reject the budget plans, but the Italian government can still go ahead with approving it in parliament by the end of the year. In this scenario the EC would eventually open a formal Excessive Deficit Procedure against Italy, which could lead to fines being imposed. However, the whole process would take a long time and market pressures could become more intense well before, forcing a change in policy by the Italian government.

Japan: Natural disasters have had an impact on economic data

We suspected that some of the economic indicators for September would be impacted by a series of natural disasters, and indeed that is what the Eco Watchers Survey for September reflected. While roughly flat from August, at 48.6 it came in better than consensus had expected. Digging deeper, it is interesting to note that the diffusion index for regions most affected by disasters fell. Following a strong earthquake, Hokkaido's index fell 11.8 points, while Kansai's index dropped 0.8 points following the flooding of its international airport after the strongest typhoon in 25 years. The household retail index improved following strong demand for emergency goods before the typhoon, but also on pre-emptive buying of tobacco products ahead of price hikes. Meanwhile, core machinery orders surged further in August, rising 6.8% MoM and 12.6% YoY to a ten-year high. Special orders in the category 'transportation and postal activities', up nearly 65%, and in 'iron and steel', up 85%, may have distorted to the upside. Finally, corporate goods prices rose more than expected by 0.3% MoM on higher energy prices.

Singapore: Cautious and gradual policy normalisation

The Monetary Authority of Singapore (MAS) has tightened policy for the second time this year by hiking the slope of the policy band that guides the fluctuation of the Singaporean Dollar (SGD) vs. a basket of currencies. Unlike other Asian central banks, the MAS was not forced to follow the US Fed. The "modest and gradual" appreciation of the SGD policy band follows a broad pickup in domestic growth and core inflation. The labour market has been boosted by job creation in the services sector, notably finance and insurance, while wage growth has risen. The semiconductor industry, which has powered ahead since 2016, is now slowing, but the pharmaceutical and petrochemical sectors have taken over. Going forward, business confidence indicators are ebbing, which points towards slower growth. Singapore stands at the core of the Asian trade value chain and is therefore exposed to the trade conflict between the US and China. Consequently, we expect the MAS to cautiously assess the impact of the first trade tariffs before engaging in further policy normalisation.

Global: Growth is still holding up

The IMF cut its global growth forecast in last week's WEO. We were not surprised by this, given how strong their numbers had been. The IMF still expects flat growth in 2019 compared to 2018, however, at 3.7%. This looks too optimistic in a mature cycle, and we expect growth to slow in 2019. Near term, activity should hold up though as conditions remain favourable in developing markets. Recent data support this view, with strong momentum in the US and growth in the Eurozone and Japan still above trend. The PMIs also show divergence within emerging markets, with softer manufacturing activity but still healthy domestic demand. A broad based collapse in emerging market activity therefore remains unlikely, though localised pressure should be expected. That said, risks are high, with market turbulence, Fed policy normalisation and China stabilisation at the fore.

What to Watch

- Retail sales in the US are likely to show continued strength in household spending while housing data are expected to show further weakness.
- Italy will formally submit its 2019 budget to the European Commission for review this week, while this week's EU summit will be crucial to see if a transition deal on Brexit can be agreed soon.
- In Japan, export and CPI data will be in focus. China's most important economic data for September will be published, in addition to Q3 GDP data, which are expected to weaken compared to Q2. Export data for Singapore, Indonesia and India as well as Australian labour market data complete our focus. Finally, we expect the Bank of Korea to hike policy rates in November, but there is a chance that they will take this step already next week.

Disclaimer and cautionary statement

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