

# Weekly Macro & Markets View

## Highlights and View

- **Chinese aggregate financing growth ticks down, while local government bond issuance and bank lending remain solid**

Credit and investment data show tentative signs of stabilisation, though not enough to prevent the Chinese authorities from easing policy further.

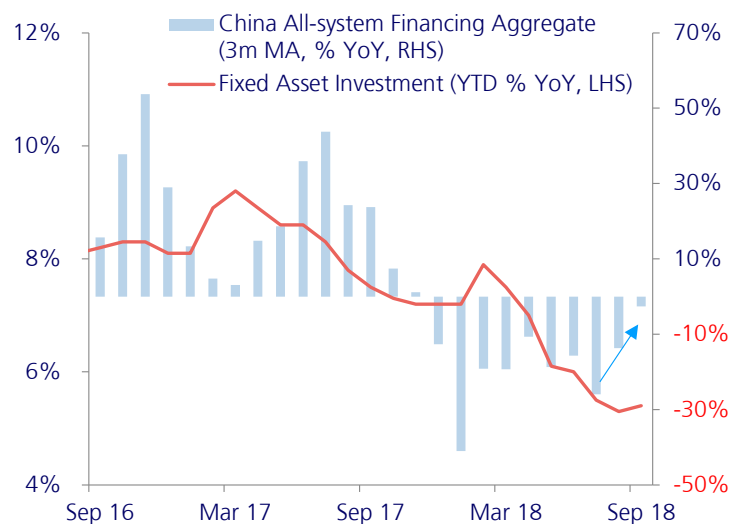
- **Last week's EU summit has passed without a divorce agreement between the EU and the UK**

While an agreement between the UK and the EU still seems likely, the necessary compromises increase the risk of the deal being rejected in the British parliament.

- **Moody's cuts Italy's credit rating one notch, but changes outlook to stable from negative**

The downgrade was widely expected. The change in outlook to stable from negative is a relief, but Italy's long-term economic challenges and vulnerabilities remain substantial.

## Mixed data from China suggest that policy will be loosened further



Source: Bloomberg

The slowdown of GDP growth, to 6.5% YoY in Q3 from 6.7% in Q2, is consistent with the picture painted by high frequency indicators. Noticeably, the auto sector has weakened sharply. This could be linked to supply side effects, as the incentive programme to purchase electric vehicles is being phased out. Outside of autos other manufacturing sectors such as machinery and electronic products are performing well. Importantly, the growth in total social financing (TSF), which measures the credit impulse in the Chinese economy and leads data by several months, is sending mixed signals. Total outstanding TSF growth ticked down 20bps to 10.6% YoY, dragged by ongoing contraction in shadow banking. However, the improvements in bank lending and local government bond issuance suggest that the slump in infrastructure investment will level off in the next few months. Overall, we cannot call for a clear turnaround in economic data yet and think that the Chinese authorities, who have recently announced a rebate on export taxes, will loosen policy further. Remarkably, the 3m SHIBOR rate has fallen to its lowest level in two years. The PBoC has so far been able to lean against the global monetary tightening trend but could hit the limits of policy easing were capital outflow pressures to resurface.

## US: First reports point to another solid earnings quarter

The stock market remains fragile despite showing signs of stabilisation. The S&P 500 edged up slightly last week while the Russell 2000 suffered its fifth weekly loss in a row with a performance of -0.30%. Though still early with only 85 S&P 500 companies having reported so far, the earnings season is gaining traction and points towards another solid quarter. The average earnings surprise is 4.6 percentage points so far, leading to an annual earnings growth rate of 21.3%. Economic data were mixed last week with headline retail sales weaker than expected but the

crucial components that feed into GDP accelerated in September. Both building permits and housing starts fell in September reflecting the ongoing weakness in the housing market. However, the NAHB Home Builder Market Index ticked up in October from its recent 12-month low, signalling a stabilisation in the housing market. The JOLTS report revealed that the number of job openings was rising further to 7.1 million while the quits rate stuck at its 17-year high of 2.4% in August.

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## Eurozone: Moody's cut Italy's credit rating to Baa3, but with a stable outlook

After markets closed on Friday, Moody's, the credit rating agency, announced it was cutting Italy's sovereign credit rating from Baa2 to Baa3, the lowest rating on the investment grade scale. Moody's cited much higher planned budget deficits for the next three years that will keep Italy's debt to GDP ratio high and make it vulnerable to internal or external shocks as the reasons for the downgrade. However, crucially, Moody's changed Italy's outlook from negative to stable, suggesting a further downgrade into high yield or so called "junk" status is not

imminent. Indeed, the early market reaction this Monday morning with spreads narrowing suggests investor relief, with more focus on the change in the outlook to stable from negative than on the actual downgrade itself. The downgrade was widely expected, and arguably already priced in. We expect Italian government bond spreads to remain volatile over the next few weeks, buffeted by both positive and negative news flow. We would also highlight that lack of fiscal consolidation and reform make Italy extremely vulnerable in the next downturn.

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## UK: Wages grow at the fastest rate in almost a decade

The long expected EU summit came and went without an agreement between the EU and the UK on the Brexit divorce terms. A major obstacle remains the challenge to avoid a hard border between Northern Ireland and the Republic of Ireland. While comments from both sides continue to signal optimism regarding an agreement and even a potential extension of the transition period, time is running out and the risk of a hard Brexit is increasing. Meanwhile, the unemployment rate stayed at 4% in August despite employment actually falling slightly on a

three-month rolling basis. The consistently low unemployment rate is supporting wages with average weekly earnings growth accelerating to 2.7% YoY. Excluding volatile bonus payments, wages rose by 3.1% YoY, the highest rate since January 2009. While accelerating wage growth may increasingly attract the BoE's attention, the latest inflation data should help to lower anxiety. Headline CPI slowed down to 2.4% YoY in September from 2.7% in August while Core CPI ticked down to 1.9% from 2.1%.

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## Bonds: Resilient yields despite broader financial fragility

Treasury yields ticked up again last week, with the 10yr yield ending the week at 3.19%. The move was once again led by higher real yields. On a core CPI basis, the 10yr real yield is now sitting just above 1%. While still low relative to history, it has failed to sustainably break above this level since 2011. Despite the raising yields the yield curve flattened very modestly as the 2yr yield rose further, to 2.90%. The flattening trend is likely to continue, as market pricing still lags the Fed while further upside to longer-term yields appears limited. Outside of the US, core yields

declined but failed to revisit recent lows. In Europe, Italy BTP/Bund spreads spiked higher as the EU indicated it would reject Italy's budget, though a more conciliatory tone on Friday led to a narrowing in spreads. We expect volatility to persist, though overall investors are likely to continue to require a substantial risk premium to buy BTPs.

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## Credit: After sovereign, Italian financials will come under rating agencies review

Credit spreads widened only modestly this week as equity markets stabilised. The European banking sector exhibited wider performance dispersion given various news flows. Moody's took positive rating actions on six Portuguese banks, following the recent upgrade of Portugal's rating. Italian banks are now at risk to go through an opposite move after the cut of the Italian sovereign rating to Baa3 by Moody's on Friday. A lower sovereign ceiling may impact both covered and senior bond credit ratings for Italian banks, probably as early as this week. Spanish banks were the

worst performers on Thursday following the decision from the Spanish Supreme Court that banks, and not customers, must pay documentation mortgage tax. On Friday, Spanish Banco de Credito Social Cooperativo delayed a planned Tier 2 deal due to "the deterioration in market conditions and adverse impact on T2 pricing in Spain". This was the third bond pulled out this week and adequately illustrates that more caution and name differentiation is being exercised credit investors.

### What to Watch

- The ECB meeting this Thursday may reveal more details regarding its reinvestment policy for 2019, while S&P reports its view on Italy's credit rating at the end of this week.
- The G3 flash manufacturing PMIs are expected to stabilise, though risks have tilted to the downside.
- In the US, GDP growth is expected to have slowed in Q3 but should remain significantly above trend.
- In a tight call, Bank Indonesia is likely to deliver one more hike, although the risk that the central bank stands pat is high.

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