October 29, 2018

Weekly Macro & Markets View

Highlights and View

- **US stock markets suffered another setback as investors worry about the growth outlook**

  Investors ignore strong earnings figures and a pickup in US business activity. Longer-term risks should not be underestimated, but markets look oversold now as investors seem too pessimistic on the outlook.

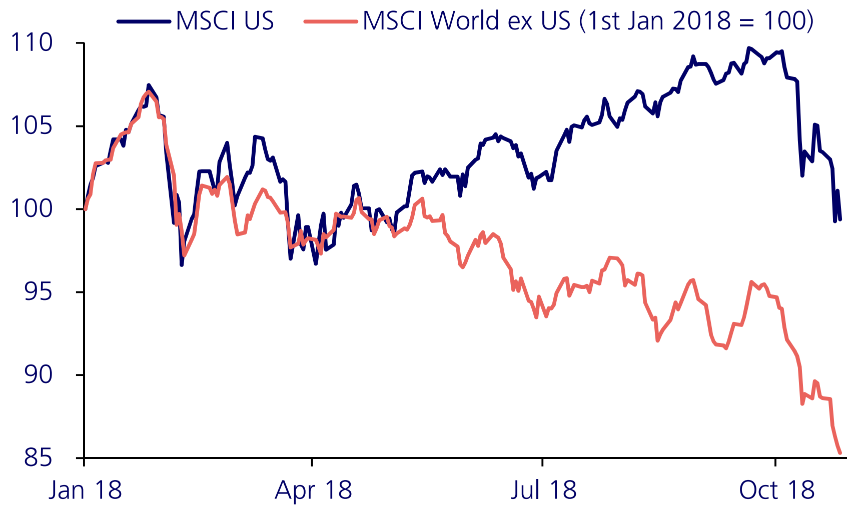
- **Credit spreads widen as the primary market slows, with Italian banks on the ECB's radar**

  While the significant volatility in stocks is to blame for wider spreads and slow primary market activity, we continue to see little upside in credit and remain cautious on European banks.

- **The Eurozone flash composite PMI falls more sharply than expected**

  The decline in the key barometer of Eurozone activity is a concern, though other data suggest that overall the economy is growing at a slightly above trend pace.

The stock market roller coaster continues



Source: Bloomberg

Stock markets had another rough week with the S&P 500 shedding 3.9%, extending the peak-to-trough drawdown in the current correction to 10.6%. The MSCI World ex US fell by a similar amount last week. The equity sell-off is driven by investors' worries about the global economy and geopolitical risks as both domestic economic conditions and the earnings situation in the US remain splendid. With almost half of the S&P 500 companies having reported their Q3 numbers, the average earnings surprise stands at 6.2%, better than Q2, and pushing annual earnings growth to 23.7% while sales growth is an impressive 8.8% YoY. Meanwhile, the economic environment remains very positive. GDP grew by an annualised 3.5% in Q3, slightly faster than expected thanks to an acceleration of personal consumption. Business activity, as measured by the Markit PMI, has picked up in October with the Manufacturing PMI ticking up to 55.9 from 55.6 and the Services PMI rising to 54.7 from 53.5. Strong new orders are a key driver of growth, particularly in the service sector. At the same time, firms continue to struggle with tight labour markets and rising input costs partially caused by the trade tariffs. A weak spot in the economic data set remains the housing sector with new home sales falling by 5.5% in September to 553'000, the lowest level since December 2016.

Credit: Spreads widen as primary market sputters and ECB watches Italian banks

Credit markets were fairly volatile last week, as could be expected in a week where equities declined significantly. Cash markets underperformed CDS notably, with both corporates and financial credit spreads widening significantly. Interestingly, high yield markets, which had been resilient for quite a while, especially in the US, have recently come under pressure and this was indeed the case last week as well. Amid earnings releases and a risk-off sentiment, the primary market almost shuddered to a halt, even in the US, where supply was the lowest since the summer. US IG fund flows took a hit, which is worth monitoring as this was one sector bucking the trend of outflows seen elsewhere. On the earnings front, US earnings seem decent, but European bank earnings are somewhat mixed. Deutsche Bank reported disappointing results, while the beats at some others were driven by non-repeatable factors. What concerns us most, however, is that the ECB is reported to be continuously monitoring the liquidity levels at major Italian lenders.

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Eurozone: The flash PMI suggests that the economy is slowing towards the end of year

The Eurozone flash composite PMI fell to 52.7 in October from 54.1 in September, dragged down by weaker readings in manufacturing and services, and consistent with growth only in line with trend. The decline in services confidence was particularly disappointing as the service sector had been more resilient up until now this year. However, other data such as consumer confidence, the ECB lending survey and actual lending data have been more robust. The latest ECB lending survey shows that credit standards continue to be eased and loan demand is strong. The latest actual lending data showed a pickup in the growth of non-financial corporations, to 4.3% YoY in September from 4.1% in August. Therefore, overall, the data indicate that the Eurozone is probably still growing at a slightly above trend pace in the final quarter of the year, even if the pace of growth has moderated. Nevertheless, slower growth does make the region more vulnerable, should an internal or external shock emerge.

Italy: No downgrade from S&P, but the ECB remains set to end QE this year

Italian bond spreads remained stable last week, despite the wider sell-off in risk assets. After markets closed at the end of the week S&P left Italy's credit rating unchanged at BBB, though it lowered its outlook to negative from stable. There was a small shift in rhetoric, with the Italian Prime Minister, Giuseppe Conte, and Finance Minister, Giovanni Tria, talking about the 2.4% deficit for 2019 being a ceiling rather than a target and their willingness to have a dialogue with the European Commission (EC). At the ECB meeting and press conference President Mario Draghi recognised the recent weaker data, but said that the ECB's view was that the economic recovery in the Eurozone continues. Therefore, QE asset purchases are still likely to end this year. With regards to Italy, Draghi noted that it was for the EC to enforce the Stability and Growth Pact, not the ECB, but he was hopeful that eventually there would be a compromise agreement between Italy and the EC. We also think a compromise is the most likely outcome, but beforehand more market pressure could be needed.

Japan: Abe's first official visit to China marks a symbolic milestone

China's President Xi Jinping rolled out the red carpet for Japanese Prime Minister (PM) Shinzo Abe. It was PM Abe's first official visit to China since his election in 2012. A series of bilateral business agreements were signed, but the most notable achievement of the visit was the willingness expressed by both countries to work on improving their relation. Major geopolitical and historical issues still stand in the way of a full reconciliation. Additionally, Japan shares stronger diplomatic ties with the US and its allies, which represent a counter power in the South China Sea region. On the economic front, the pickup of the Japanese manufacturing PMI from 52.5 to 53.1 suggests that growth will recover in Q4 following a third quarter distorted by natural disasters. Encouragingly, the PMI new export orders index rebounded above 50. Meanwhile, both the PMI output price index and the Tokyo CPI point toward sustained inflationary pressures. Outside of energy and food these pressures remain contained, though.

Indonesia: Bank Indonesia pauses as focus shifts towards non-monetary policies

Bank Indonesia (BI) left the policy rate on hold at 5.75% at its October meeting. Despite ongoing portfolio outflows and the weak rupiah, the central bank chose to pause. We see two reasons for this decision. On the first hand, BI is now sharing the policy burden with the government who has implemented several measures to restrict import growth. BI said that it expected the current account to improve further as a consequence of concerted policy efforts. From November on, BI is also testing a new currency hedging tool aimed at avoiding the conversion to USD. On the second hand, BI has turned more cautious on domestic growth: it downgraded its forecast for 2018 GDP growth to the bottom of the 5.0% - 5.4% range. Like BI, we expect the current account deficit to diminish, probably towards 2019. The measures to substitute crude oil imports and to delay some infrastructure projects should be quite effective. In the meantime, local financial markets remain under pressure and we expect BI to deliver at least one more rate hike in 2018-19.

What to Watch

- In Japan, the central bank is expected to stand pat. In Malaysia, the 2019 budget is likely to focus on more restrictive initiatives than in 2018. The release of Asian PMIs and South Korean export data will give the pulse of regional manufacturing activity. Q3 GDP growth will be published in Taiwan and Indonesia, with the latter expected to slow from Q2.
- In the US, the ISM Manufacturing index is expected to keep signalling strong activity while labour market data are likely to show a continuation of tight conditions.
- The first estimate of Eurozone Q3 GDP should indicate that the economy continued to grow at an above trend pace, though there are downside risks.

Disclaimer and cautionary statement

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