November 5, 2018

Weekly Macro & Markets View

Highlights and View

- **October PMIs paint a weaker picture of manufacturing activity in many Asian countries**

  We expect growth to decelerate further in Emerging Asia as confidence weakens and financing conditions tighten.

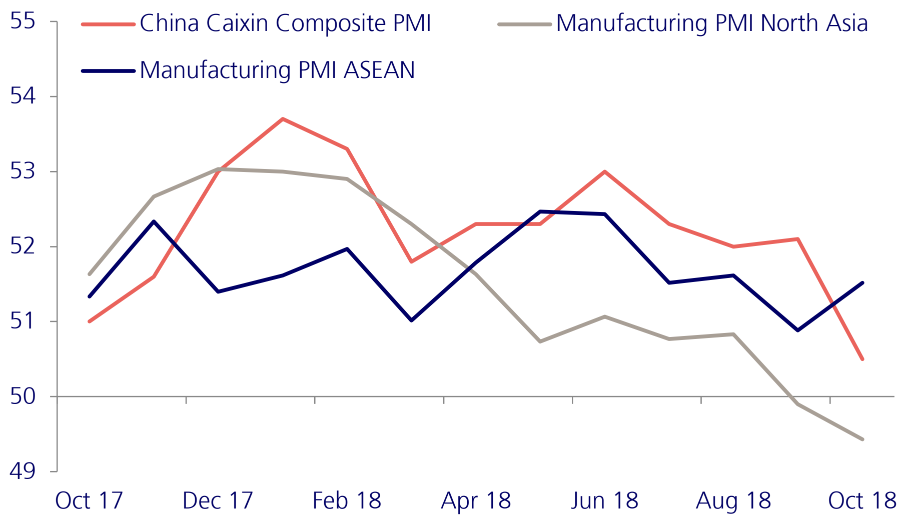
- **Led by EM Asia equities, global equity markets are up week-on-week**

  We think that a stabilisation in EM Asia economic data is needed to trigger a more sustainable turnaround in regional equity markets.

- **US equities rebound on solid earnings and renewed investor optimism**

  With three quarters of companies having reported, Q3 is on the way to beat even the first two quarters of the year with annual earnings growth of 26.5%.

Asian PMIs: No turnaround in business activity yet



Source: Markit; North Asia: avg. Korea, Taiwan, HK PMIs; ASEAN: avg. Indonesia, Malaysia, Thailand, Philipp. Sing., Vietnam

October PMIs paint a deteriorating picture of manufacturing activity in many Asian countries. The Chinese economy is not out of the woods yet: the Caixin composite PMI fell to 50.5, led by the services sector. The official China manufacturing PMI shows that small and medium enterprises continue to suffer from relatively tight lending conditions. We expect the Chinese authorities to react by announcing more fiscal easing: a cut in the car purchase tax is under consideration. In the rest of Asia, the consumer electronics segment is slowing, as evidenced by the sharp fall in the Taiwanese PMI, but relative resilience of other semiconductor exporting countries. Meanwhile, India stands out with its robust PMI, carried by healthy domestic demand following a year of disruptive reforms. Japanese businesses are also upbeat as they forecast stronger investment and benefit from a normalisation effect following the impact of natural disasters in Q3.

Overall, we expect growth to decelerate further in emerging Asia as confidence weakens and financing conditions tighten. EM Asia equity valuations have priced in part of the growth slow down and are now sitting close to crisis levels. However, we think that a stabilisation in Chinese economic data is needed to trigger a sustainable turnaround in regional equity markets.

US: Soaring earnings and a strong labour market

The S&P 500 rebounded with the strongest weekly performance since March, gaining 2.42% as investors shifted their focus back to positive fundamentals. With three-quarters of company reports for Q3 published the average earnings surprise is now 6.74%, lifting annual earnings growth to 26.51%, even higher than the very solid first two quarters of the year. The latest ISM Manufacturing survey signals a continuation of strong business activity despite the headline number ticking down to 57.7 in October from 59.8 the month before and new orders slowing to 57.4 from 61.8. New payrolls rose a solid 250'000 in October although that was partially a payback from the weak (and revised down) number in September. Growth in average hourly earnings accelerated to 3.1% YoY, a post-recession high, reflecting the tighter labour market though the number was helped by base effects. So far, inflation rates remain contained despite accelerating wage growth. PCE Core, rounded up to 2% YoY, just scratched the Fed's target again in September.

UK: Manufacturing feels the chill of Brexit

Brexit uncertainty is increasingly taking its toll on the British manufacturing sector. The Markit Manufacturing PMI dropped to 51.1, the biggest fall since the Brexit referendum, with new order inflows and employment both declining for the first time since July 2016. The weakness is centred on the consumer sector, indicating that households are increasingly holding back their spending. A welcome post-Brexit stimulus for the economy will come from fiscal spending. Chancellor Hammond presented the FY 2019/20 budget, which sees more spending, in particular on healthcare, taking advantage of the Office for Budget Responsibilities' positive forecast revisions on growth and receipts. However, the main impact of the increased spending is back-loaded and will not occur until 2021. Finally, as was widely expected, the BoE unanimously voted to leave the Bank Rate unchanged at 0.75% at its meeting last week. There were no changes to the BoE's growth forecasts.

Eurozone: Eurozone Q3 GDP growth disappoints, dragged down by Italy and Germany

The first estimate of Eurozone Q3 GDP growth came in worse than expected, at 0.2% QoQ (1.7% YoY), dragged down by weak growth in Italy and probably Germany as well. However, by country, most of readings released so far were decent. For example, GDP growth in France, Spain and Belgium was 0.4% QoQ, 0.6% QoQ and 0.4% QoQ respectively, still above trend. However, there was zero growth in Italy in Q3, bringing the YoY rate of GDP growth to only 0.8% YoY, and highlighting its vulnerability given its recent tightening in financial conditions. In addition, although Germany's official figures have not yet been released, it is likely that growth here was weak as well, though for one-off reasons to do with the move to a new emissions standard for car production, which is likely to have affected industrial production in Q3. Overall, the Eurozone Q3 GDP data were was not as bad as the headlines suggest, but the situation in Italy is a concern. Various comments from ECB policymakers last week suggest that the central bank is still on track to end QE this year despite the softer data.

Switzerland: Weaker external demand takes a toll on growth

Swiss activity decelerated sharply in October, led by weaker external demand. The manufacturing PMI fell to the lowest level since mid-2017 as both output and employment growth fell. The backlog of new orders was unchanged at a solid level, though, and part of the decline reflected weaker price dynamics, led by lower commodity prices. Our takeaway is that while conditions have moderated, activity remains decent. The UBS real estate bubble index has also fallen to the lowest level since 2014. The index captures imbalances in the housing market and has now exited the 'risk' zone, as house prices have moderated relative to household income and consumer prices. House prices are still rising sharply relative to rents, however, and the divergence appears to have accelerated in Q3 when prices on owner occupied homes rose by 0.4% QoQ while rents fell by 0.6%. In our view, the housing market remains vulnerable and we believe that the SNB will continue to keep a close eye on this segment of the economy.

Credit: Tighter spreads, but signs emerge of waning investor demand

Credit spreads tightened last week as risk appetite rose, although we find it more concerning that real investor demand seems to be showing signs of fatigue. While CDS spreads and major equity indices recovered, despite a small setback on Friday after US payrolls, cash credit lagged, especially in the US. US IG mutual funds saw the largest weekly outflow since December 2015. This is somewhat concerning, as US IG was the one sector that had been bucking the trend of outflows seen in most credit sectors. At the same time, the primary market is also showing signs of stress. Not only has the European primary market seen a number of deals being pulled, this is also now the case in the US high yield primary market as higher Treasury yields, wider spreads and lower energy prices take a toll on investor sentiment, leading to one of the lowest monthly volumes since 2008. European bank results remain mixed, confirming our fear that European banks continue to lose market share in trading activity to their American peers. EBA stress tests were not surprising and hence unlikely to move the market.

What to Watch

- In the US, investors will focus on the mid-term elections where polls show that the Republicans are likely to keep their majority in the Senate while losing it in the House of Representatives. No action is expected from the Fed.
- In the Eurozone, industrial production data for various countries should give more indications as to the state of the recovery.
- In China, we will watch trade, money supply, and CPI data. We expect the central banks of Australia and Malaysia to stand pat.

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