Weekly Macro & Markets View

Highlights and View

- **The S&P 500 extends its gains after the US midterm elections bring no major surprise**

  Historically, a split parliament is not necessarily negative for financial markets, though further fiscal stimulus and business-friendly policies will be more difficult to get through Congress.

- **The credit market recovery was rather lethargic last week, notably lagging equities**

  Given the late stage of the cycle, we expect market drawdowns to be larger and recoveries to be lethargic, as multiple headwinds and tight spreads should continue to deter investors.

- **Overall Eurozone composite PMI is revised up, but Italy's indicator falls sharply**

  The fall in the Italian composite PMI to below 50 is worrying, and suggests the government's growth forecast for next year is extremely optimistic.

A solid rebound

Source: Bloomberg

The US stock market enjoyed another positive week with the S&P 500 rising 2.1%, pushing its performance since the low on October 29th to 6.8%. Another set of strong earnings data helped to lift sentiment and while the outcome of the midterm elections resulted in no major surprises, with the Democrats winning a majority in the House of Representatives while the Republicans bettered their position in the Senate, investors were relieved to have one uncertainty less to account for. Economic fundamentals remain supportive for equities, as reflected by another strong print of the ISM Non-Manufacturing Survey. The index ticked down from its two-decade high to a still impressive 60.3 in October from 61.6 the month before, but new orders were almost unchanged at 61.5, signalling a continuation of strong business activity in the fourth quarter. Households remain very upbeat as well, with the University of Michigan's consumer sentiment indicator staying close to its post-recession high in November. No surprise came out of last week's Fed meeting. The FOMC kept its policy unchanged and acknowledged some weakness in investment but pointed towards the strength in consumer spending. Overall, risks to the outlook are considered to be balanced and the Fed remains on track for a rate hike in December.

Credit: A lethargic rebound, lagging equities

Credit markets rebounded in a rather lethargic manner last week, lagging equities. It has been our view that in the late stage of the cycle, credit should underperform equities and such price behaviour as seen last week is to be expected. Two areas of notable weakness in credit last week were European financials and energy, the latter weighed down by weaker oil prices. European financials were impacted by mixed bank earnings reports, while wider peripheral spreads were also a drag on investor sentiment. Unicredit earnings took a hit from a substantial charge to revalue its holding in Turkey based Yapi Kredi Bankasi. Notably, Unicredit's stock has declined by over 25% since the beginning of the year while its senior CDS spread has tripled. Italian banks warrant close monitoring, although we are somewhat comforted by the fact that despite volatility in Italian bond yields, Target 2 imbalances are not indicating deposit flight. Elsewhere, it was encouraging to see primary markets gaining some momentum and new issue premiums declining, amid some inflows.

Eurozone: Final PMIs are revised up for the region as a whole, but are very weak for Italy

The final October PMIs in the Eurozone were a mixed bag. The overall Eurozone composite PMI was revised up from the flash estimate of 52.7 to 53.1, consistent with a slightly above trend pace of growth in the region overall. However, the survey for Italy was extremely weak. The Italian services PMI fell by around 4 points to 49.2, the same level as the Italian manufacturing PMI. Recent financial market volatility and budget uncertainty in Italy is clearly already having an impact on business confidence and activity, suggesting that the government's growth forecast of 1.5% for next year is extremely optimistic. However, elsewhere in the Eurozone other data were generally more encouraging. German industrial production stabilised in September, as the auto industry seems to be gradually adapting to new emission standards for production. This trend should help boost German GDP growth in Q4, after what could be a flat or even negative outturn for Q3 when the first estimate is released later this week.

Asian Trade: Export data surprise positively

Exports from Korea and Taiwan, two bellwethers of regional trade, rebounded in October. Semiconductors and electronics exports increased at a slower pace, partly driven by weaker prices, but shipments of base metals, rubber and petrochemicals gathered steam. This suggests that the slowdown in Asian trade is stabilising. Commodity imports have been robust, notably in China, indicating that fixed asset investment is recovering as monetary and fiscal stimuli start to bear fruit. Chinese exports surprised with a double-digit growth print in October, led by improved exports to emerging markets. Export growth to the US softened only slightly, shrugging off the 10% tariffs imposed by the US on USD 200bn of Chinese goods at the end of September. Curiously, Chinese exports are diverging from downbeat PMI surveys. One explanation for this discrepancy could be that manufacturers' sentiment has deteriorated even though exports are holding up. Another explanation could be that Chinese exporters are front-loading shipments as they expects tariffs to be hiked to 25% in January.

Malaysia: A middle way between austerity and stimulus

Malaysia's 2018 budget deficit was revised higher to 3.7% of GDP vs. the initial estimate of 2.8%. This was not a surprise, since the government had been communicating the likelihood of an increase in the deficit prior to the official Budget presentation, linking it to the disclosure of off-balance sheet spending by the prior government. More surprising was the modest path to future budget consolidation: 3.4% in 2019, 3% in 2020, and 2.8% in 2021. In 2019, the deficit is mostly driven by tax refunds, and will be covered by a large dividend from Petronas.

Looking through these one-off items, we think that more restrictive measures will be needed. Indeed, the new taxes on gambling, sugar, and property will not offset the loss of revenues brought by the cancellation of the Goods and Service Tax. As a result, the budget is likely to deliver a small boost to private consumption next year. Meanwhile, public investment will slow due to the cancellation of several infrastructure projects. Overall, Malaysia can afford, for now, to continue following an intermediary path between fiscal austerity and stimulus.

Bonds: Yields rise and fall with broader sentiment

Treasury yields moved with broader risk markets last week, with the 10yr yield edging down to 3.18% as the equity rally faded on Friday. As expected, with strong data and inflation close to target, the Fed did not signal any change to its view in the FOMC meeting. The 2yr yield rose further, but there is still a large gap between the Fed's dot plot and the Fed Funds futures, with further rate rises likely to be priced in. Unless the outlook worsens materially, this limits the potential for yields to fall, but we also maintain our view that yields are likely to be capped. Treasury Bund spreads have extended to an all-time high of 280bps (vs a historical average of around 50bps), and downward pressure on Bund yields is likely to persist given risks around Brexit and Italy. Inflation breakevens have slumped with oil prices, putting upward pressure on real yields. With mortgage rates rapidly normalising, the US housing market is also coming under some pressure, taking the edge off growth.

What to Watch

- In the US, core inflation is expected to remain stable while retail sales should have picked up in October.
- The first estimate of German Q3 GDP may show flat or negative growth, but this is mainly due to problems in auto production, which now appear to be diminishing.
- China's money supply, industrial production, retail sales, and fixed asset investment data will be in focus. We will watch Indonesia's trade balance for signs of further improvement. Japanese and Malaysian GDP data will be released. The central banks of Thailand and the Philippines are likely to stand pat.

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