

Weekly Macro & Markets View

Highlights and View

- **US Thanksgiving week is accompanied by weaker data**

Although initial indications for spending on Black Friday were good, most data points came in weaker than expected, supporting our view of an economy coming off the boil.

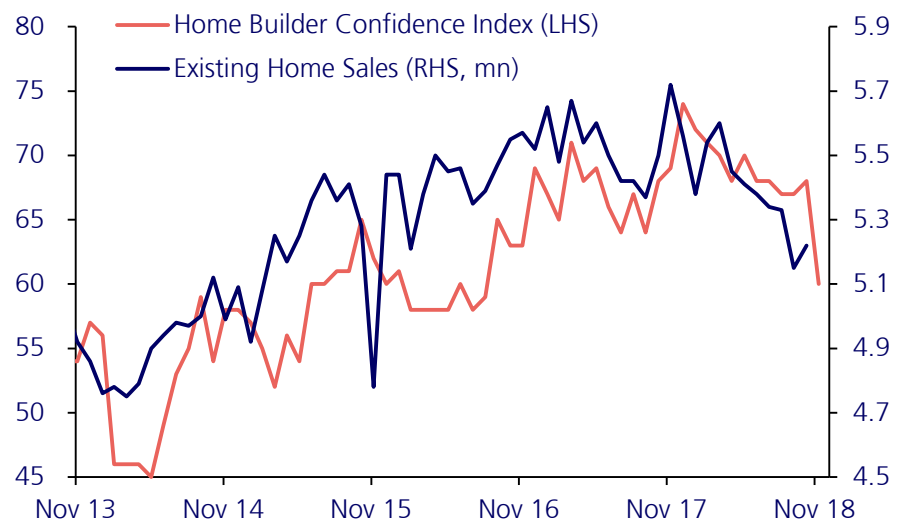
- **The European Council approves EU-UK Withdrawal Agreement**

Whilst the approval removes one potential uncertainty in the Brexit process, the next challenge will be getting the deal approved by the UK parliament, which looks difficult on the first vote.

- **The European Commission recommends opening up an Excessive Deficit Procedure (EDP) against Italy**

In theory an EDP could eventually lead to fines being imposed upon Italy, a more likely outcome is some moderation in spending plans by Italy beforehand.

US economy still strong, but rising rates are biting



Source: Bloomberg

There appeared little to give thanks for in the US investment community last week. Stocks retreated on light volume, with the Dow and S&P 500 indices breaking below October lows, and the tech heavy NASDAQ close to 15% off the summer highs. While we suspect that stocks are nearing the end of a bottoming process, Friday's upcoming US-China trade talks as well as Fed rhetoric will be crucial in determining whether that assessment is correct or not.

Although we continue to believe a December rate hike is in the cards, we would not be surprised if this was accompanied by a more dovish tone. Economic conditions are robust, but last week showed that vulnerabilities are starting to emerge. The volatile durable goods readings largely disappointed, while consumer confidence slipped a tad, but it is housing data that paint a more troubling picture. Housing starts disappointed, with lower revisions to prior data, while existing home sales managed to rise only 1.4% after declining for six consecutive months. The plunge in home builder sentiment, the largest in almost five years, caught the most attention with builders noting that higher interest rates were starting to take their toll. Given the lagged effect of rate hikes and the shrinking of the Fed's balance sheet, we feel that there is reason for the Fed to pause tightening after the December hike as we suspect the economy will see a slowing growth trajectory into next year.

UK: European Council approves Brexit deal, May avoids leadership contest

Sterling bounced back last week against other major currencies as the newsflow on Brexit improved. UK Prime Minister Theresa May's position looks more secure after anti-May conservative MPs fell well short of the number of letters needed to trigger a leadership election, reducing one potential area of uncertainty. May and the EU also finalised the Political Declaration that accompanies the Withdrawal Agreement and sets out in broad terms what the future relationship between the UK and EU will be like. Finally, at the EU summit over the weekend, the European

Council approved the Withdrawal Agreement and Political Declaration on the future of EU-UK relations. However, many hurdles remain before all is said and done. In particular, getting the agreement through the UK parliament on a first vote in December still looks challenging, with the Labour Party and the DUP heavily criticising the agreement so far. As the end of March deadline for Brexit approaches, we expect volatility in the GBP to be high.

Eurozone: Trend of weaker Eurozone data continues

There were some disappointing data from the Eurozone last week, with the flash composite PMI falling further and weakness spreading from manufacturing to services. While the survey is consistent with the Eurozone growing at a trend-like pace, other data such as lending growth, consumer confidence and national business confidence surveys have been more resilient recently. For example, last week's French national business confidence survey, measured by the national statistics office, INSEE, increased in November. So overall the Eurozone is likely still growing at a

slightly above trend pace. Nevertheless, growth has clearly weakened substantially since the beginning of the year, and the more moderate pace of growth makes the region vulnerable, for example, to a further escalation in trade tensions or a worsening in the situation in Italy. We still expect the ECB to end QE this year, but it is more likely to embrace other measures in 2019 to support the economy, such as providing further liquidity to banks as well as continuing to emphasise forward guidance.

Italy: The European Commission takes next steps in launching EDP against Italy

The European Commission made a recommendation that an Excessive Deficit Procedure (EDP) be launched against Italy last week. This could ultimately lead to fines being imposed. The recommendation for an EDP now needs to be formally approved by the European Council, which is likely to happen in December or early next year. However, there are many steps in the EDP and no country has ever been fined yet. Ultimately, we expect that a compromise between Italy and the EU is the most likely outcome. Indeed, last week there were media reports that the Italian

government is prepared to show some flexibility on its spending plans for 2019, and in particular on when various measures such as pension reform and income support would be introduced. This led to a narrowing in Italian to German government bond spreads later in the week. The initial take up of Italian government bonds issued to the retail sector was also disappointing, adding pressure on the government to change course. However, more pressure may be required before an eventual compromise is agreed with the EU.

Bonds: Resistance to higher core bond yields

Treasury yields were broadly flat last week, with the 10yr closing at 3.04%. Fed rate expectations ticked down as data confirmed housing weakness, with only two rate hikes fully priced in by end 2020, compared to five for the Fed's dot plot. Real yields have ticked down, failing to break above prior levels, and forward rate expectations have slipped back to their longer-term range. Inflation breakevens have plunged, led by oil prices but also reflecting recent benign inflation prints. The Fed has shifted its rhetoric, recognising weakness in the global economy and playing

down that rates are a long way from neutral. This should help to stabilise sentiment and indicates that Treasury yields may have peaked. This week's US-China meeting will be important, however, and a favourable outcome would move yields higher. Elsewhere, concerns around Italy and weak data have weighed on Bund yields. As the ECB ends QE and moves closer to a rate hike, yields should respond. However, headwinds to higher yields are large, given risks around Italy and tight supply and demand conditions.

Credit: Covered bonds are an oasis of calm in the credit market

Despite renewed volatility and widening moves for IG and HY credit spreads, covered bonds remained notably stable last week and continue to outperform other credit sectors. In contrast to the lack of non-financial issuance last week in Europe, the primary market also remains dynamic for covered bond issuers. YTD volume has already exceeded last year's, ending three consecutive years of decreasing issuance and pushing net issuance back into positive territory. The gradual reduction of ECB purchases, especially in the primary market, has pushed the new

issue spread concession higher and improved investors' return. Given the need for TLTRO refinancing and for more long-dated funding to comply with the new NSFR (net stable funding ratio) liquidity ratio, we expect European banks to issue more covered bonds in the coming quarters. This will be one of the few alternatives for European banks to compensate higher funding costs after their credit spread widening and the introduction of new, more expensive bail-in-able liabilities.

What to Watch

- US President Trump and China's President Xi are expected to discuss bilateral relations and trade issues during the G20 meeting in Buenos Aires starting on Friday. We believe the outcome is open. Trade teams have already met and prepared the meeting, but deeply rooted concerns by the US administration may be an impediment for a deal.
- In Japan, the Manufacturing PMI and Tokyo's CPI for November will be released in addition to the usual set of economic indicators for October. Industrial production data for October will be published in Korea, Thailand and Singapore, as well as Q3 GDP data for Taiwan and India.
- In the Eurozone, ECB bank lending data and the final PMIs will be important to gauge the strength of the recovery.

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