January 29, 2018

Weekly Macro & Markets View

Highlights and View

- **The ECB says it is monitoring the strengthening euro**

  The central bank may have to use more forceful language if the euro continues to appreciate.

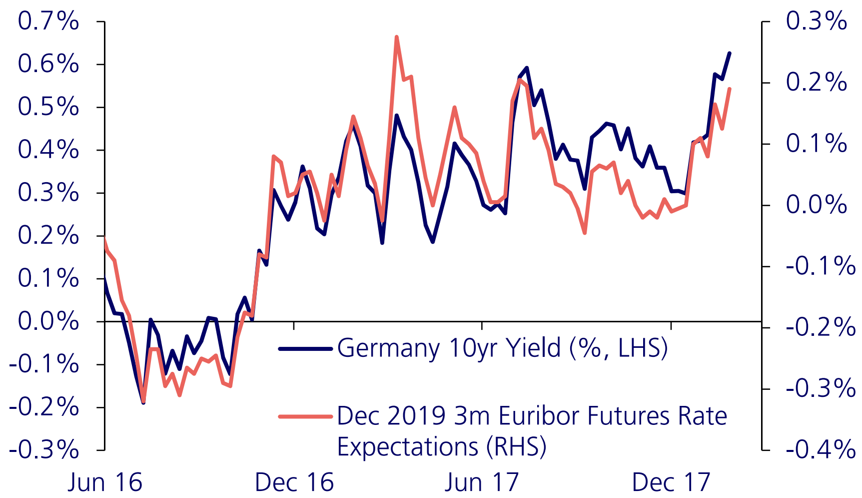
- **The USD continued its slide with the dollar index falling to the lowest in three years**

  The trade-weighted dollar has room to fall further as global monetary policy slowly normalises.

- **January economic indicators for Japan reveal further strength in the manufacturing sector**

  We believe that economic conditions will remain favourable for the time being and that fears of early BoJ tapering are overdone.

ECB President Mario Draghi confirms interest rates to rise in 2019



Source: Bloomberg

In last week's ECB press conference following its monetary policy decision, ECB President Mario Draghi mentioned for the first time a potential date when we might see the first interest rate rise in this cycle. He said he agreed with Bundesbank President Jens Weidmann's recent comment that mid-2019 seemed likely, given currently available information. Markets have already begun to adjust to the reality that the ECB will end QE this year and raise interest rates in 2019, leading Bund yields to move higher in recent weeks. In fact, futures markets are currently pricing in the first ECB rate rise for March 2019. This seems reasonable to us given the current strength of the recovery. Either way, an increase in rates and in particular an eventual end to negative interest rates should be a boost for investor sentiment towards the financial sector. The introductory statement also made reference to the strength of the euro, saying that "the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring". However, in the Q&A, Draghi said that the ECB had not yet completed its analysis on this or decided on the implications for monetary policy. This was not strong enough language to deter euro bulls. The euro appreciated by a cent versus the dollar as Draghi was speaking. If the euro continues to appreciate, we expect the ECB will use more forceful language in an attempt to reverse or at least slow its appreciation.

Eurozone: Composite PMI highest since 2006, with some signs of price pressures building

Data from the Eurozone continue to point to very strong growth momentum. The Eurozone composite PMI hit its highest levels since 2006 and the German ifo survey hit its highest levels on record in January. However, beneath the surface of the reports there were some interesting dynamics taking place. Manufacturing business confidence edged down, while service sector confidence picked up. The decline in manufacturing confidence may be the first sign that the stronger euro is starting to impact exporters, though confidence remains at very strong levels.

Another interesting detail in the surveys was increasing evidence of pricing pressures emerging in both the manufacturing and service sectors. For example, the composite PMI output prices index hit its highest levels since early 2011. We expect growth in the Eurozone to be around 2.8% this year, which is above consensus, and also expect core inflation to gradually edge up during the course of 2018, though it will still remain well below the ECB's target.

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US: The economy lost some momentum in Q4 2017

GDP growth slowed down to 2.6% in Q4 according to the first estimate. While consumer spending reaccelerated to a solid 3.8%, net trade and inventories acted as a drag. Equipment investment growth rose to 11.4%, reflecting the positive business outlook and shrinking capacities. The latest Markit PMIs are signalling a continuation of the current momentum. Although the Composite PMI fell to an eight-month low, manufacturing picked up and new orders point to a solid business outlook. Meanwhile, the stock market enjoyed another positive week while the earnings season is gaining traction. With roughly one quarter of S&P 500 companies having reported so far, the average earnings surprise lies at 2.2%, somewhat lower than in recent quarters, but sales growth looks set to have accelerated and is currently standing at 8% YoY. The rise in yields has also gained momentum on higher inflation expectations and in anticipation of hawkish Fed comments.

Japan: Strong indicators confirm strength in the manufacturing industries

The latest economic indicators for the manufacturing sector are very encouraging. The Manufacturing PMI for January climbed to a four-year high, despite a small pullback in the new order component. Meanwhile, the manufacturing diffusion index of the Reuters Tankan spiked to a ten-year high, with the outlook showing no signs of deterioration, while the non-manufacturing DI remained at a high level. Solid export volume growth in December confirms that the expansion cycle remains intact. The equity market suffered from a stronger JPY vs. the USD last week, as speculation about early tapering by the Bank of Japan spoilt the positive mood among foreign investors. We believe these concerns are unfounded. Firstly, a corresponding comment by Governor Kuroda at the WEF in Davos was taken out of context. Secondly, the latest core CPI data for December and January do not reveal any acceleration, and even if the 2% inflation target were to be achieved earlier than envisaged, the BoJ will maintain its monetary policy stance for some time.

Malaysia: Bank Negara Malaysia hikes to pre-empt macro prudential risks

Bank Negara Malaysia (BNM) raised its policy rate by 25bps to 3.25%. The central bank expects the synchronised recovery to continue to benefit Malaysia in 2018 and flagged high oil prices as an inflationary risk. BNM also intended to "prevent the build-up of risks that could arise from interest rates being too low for a prolonged period of time". Indeed, real rates have been in negative territory while the output gap has been closing. We therefore think that BNM has hiked at the right moment. We are still bullish on domestic growth, which should be fuelled by infrastructure investment and consumption. In H2 this year, however, the bulk of the pre-election cash handouts will have been awarded, which could lead to a slowdown in consumption. Fuel prices could also eat into household finances, although we think that the government will intervene at some point. Finally, structural imbalances remain as household-debt-to-GDP is still ~85%. Therefore, we see BNM on hold in 2018, but attentive to economic and macro-prudential data.

Credit: The search for yield continues, but price upside seems limited

A robust search for yield in credit last week was fuelled by low supply, which is lower by 15% to 20% from the comparable period last year. This is reflected in the notable oversubscription of new deals. Following the heavy oversubscription for subordinated paper from Monte Dei Paschi, some other banks such as IKB, one of the first victims of the financial crisis, issued subordinated debt that was eagerly lapped up by investors. Even the US sub-prime auto space is seeing deals oversubscribed by over five times, regardless of tight spreads and rising delinquencies. However, despite the strong search for yield, price upside seems more limited. European high yield indices today provide investors an all in yield of around 3.25%, while European stock indices have a dividend yield of 3.17%. As defaults are likely to eat into the 3.25% yield on a buy and hold basis, without the upside of equities, it is unsurprising that high yield fund flows are becoming jitterier. It is likely that credit will continue to lag equities in the near term.

What to Watch

- Both consumer and business sentiment in the US are expected to stabilise at a high level while labour market data should confirm a continuation of the healthy employment situation. No action is expected from the Fed.
- Eurozone Q4 GDP is likely to confirm that the recovery remains on track whilst inflation is also expected to pick up slightly.
- Asia January PMIs should point toward ongoing strength in manufacturing. In Japan, industrial production and employment data will be released. Hong Kong retail sales and South Korea exports will also be published.

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