

# Weekly Macro & Markets View

## Highlights and View

- **Equity markets suffer a relapse**

Following a strong rally in the prior week, investors took flight with funds seeking safe havens. More volatility is expected as managers reposition for the new year.

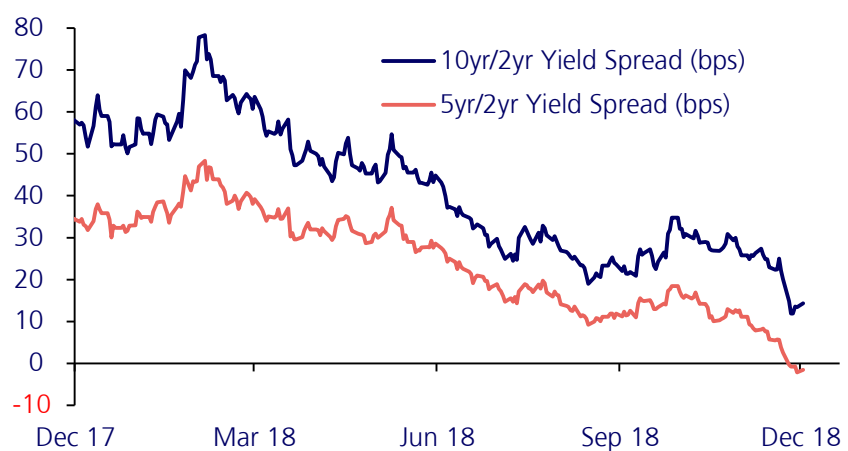
- **Part of the Treasury curve inverts, raising fears about the growth outlook**

While growth is expected to slow in an elongated and late economic cycle, fears of an imminent US recession are overdue.

- **The ISM surveys confirm strong US business activity into year end**

Sentiment is still very upbeat among US businesses and households while the labour market remains solid and inflation expectations are receding.

## Renewed pressure on financial markets as US yield curve inverts



Source: Bloomberg

The Treasury curve inverted last week as the 5yr/2yr and the 5yr/3yr spreads turned negative. An inverted yield curve has been one of the best predictors of US recessions so it's not surprising that it caught investors' attention. In our view, this is unlikely to mark the imminent end to the cycle though. Historically, the curve has inverted well before the onset of recessions, by an average of around five quarters. Other parts of the curve also remain upward sloping, with the 10yr/2yr spread still at 14bps. The economic fundamentals are robust and while US housing and labour market data have weakened, the US consumer is in good shape. What's different this time is that investors are very focused on the slope, but so is the Fed. While a rate hike in December is almost a safe bet, more dovish forward guidance should allow curve flattening to pause.

Equity markets came under renewed pressure last week, with broad-based selling, not helped by the arrest of the Huawei CFO and the yield curve inversion. Following the best week in seven years for the S&P500, last week marked one of the worst of the year, with investors appearing to use the bounce to pull funds out before year end. With active trading days running out, and no sign of a thaw in macro stresses, a 'Santa rally' this year is looking like a wish too much.

## Credit: Spreads gap, while flows erase boost from QE

Credit spreads gapped wider last week as risk aversion took a firm hold. While cash markets generally underperformed CDS once again, even CDS spreads were under notable pressure. Unsurprisingly, the primary markets almost shuddered to a halt, with only a handful of issuers placing deals across the US and Europe in what was one of the lowest volume weeks of the year outside the summer, despite the fact that normally this week tends to see heavy supply ahead of the slowdown after mid-December. The flattening of the US Treasury curve took a toll on US

banks, which saw stock prices decline by around 8% on the KBW bank index. Amid all the mayhem, Monte Dei Paschi's senior rating downgrade to Caa1 from B3 garnered less attention than it normally would. After all, US high yield CCC bonds saw the largest one day drop since 2016. We believe most notably of all, investor outflows from Europe have erased almost all the inflows seen post QE announcement. All in all, multiple headwinds continue to buffet credit markets.

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## US: Business activity remains very strong

In a choppy week for markets, investors chose to ignore the latest batch of solid economic data. The ISM Manufacturing index rose to 59.3 in November from 57.7, with new orders soaring to 62.1 from 57.4, indicating a continuation of solid business activity. The strong momentum was confirmed in the service sector as well with the ISM Non-Manufacturing ticking up to 60.7 from 60.3 with new orders rising to 62.5 from 61.5. The University of Michigan's consumer sentiment indicator underlines households' upbeat mood with the index sticking close to its post-

recession high. One reason for the positive mood remains the labour market. The unemployment rate stuck at 3.7% while 155'000 new payrolls were created. Importantly, households' longer-term inflation expectations fell back to the lower end of the recent range, further reducing any urgency the Fed may have felt in tightening its monetary policy and increasing the likelihood of a pause in its hiking cycle next year.

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## Eurozone: Data show tentative signs of stabilisation but are still fragile

German factory orders increased for a third consecutive month, with auto orders in particular recovering. This is a tentative sign that conditions are stabilising in this sector. The Eurozone final PMIs were also revised modestly higher, compared to the flash estimate. However, the detail of the survey shows that Italy continues to be weak, with the manufacturing survey falling further below 50. Last week, Italian government ministers, including Prime Minister Giuseppe Conte, indicated that they were prepared to make concessions on the deficit target for

next year. Unfortunately, damage has clearly already been done to the economy and weak growth will make the deficit larger than it would otherwise have been. In France, the government has had to scrap planned fuel tax hikes due to wide-scale protests, though the continued protests over the weekend suggest a more fundamental malaise and that protests could continue despite the abandonment of the fuel tax increase.

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## Asian PMIs: Soggy manufacturing activity in Northern Asia

November PMIs show that services activity is holding up in Asia, especially in China where the Caixin services index recorded its highest score since June. However, manufacturing activity has deteriorated in China and in Northern Asia. The Caixin manufacturing PMI ticked up modestly, just above 50, but China's official manufacturing PMI fell to a 28-month low of 50.0 as conditions for small companies tightened further. Aggregate financing, a leading indicator for growth, indicates that Chinese manufacturing is unlikely to recover before the second half of 2019. Weak

Chinese demand is impacting Hong Kong, Taiwan, and South Korea, as their respective PMIs stood in contraction territory with the leading new-orders-to-inventory ratio below 1. Anecdotally, Korean businesses reported weaker international demand, especially for automobiles. Meanwhile, ASEAN activity was mixed, and India's PMI surged, mirroring the recovery in some emerging markets ex-Asia. Overall, the short-term outlook for Asian manufacturing activity is negative and coincides with the slowdown in global growth.

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## Australia: Growth to slow further from Q2 peak

As expected, GDP growth slowed from the exceptionally strong Q2 pace to reach 2.8% YoY in Q3. Public demand boosted growth and is expected to continue to do so in 2019, thanks to a strong pipeline of infrastructure projects and to a step-up in fiscal spending. Meanwhile, the outlook for private demand is less upbeat. Household income is rising at too slow a pace to compensate for other headwinds such as the slump in housing prices and tighter lending conditions. Increased scrutiny from regulators on banking processes have led banks to become less

willing to lend. This has affected mortgage growth and lending to developers. So far, these weak areas have been offset by strong export growth and solid business investment. However, terms of trade are showing signs of peaking and investment has hit a soft patch. Overall, growth is likely to slow in 2019, but will be cushioned by the central bank decision to delay any hike until the end of next year and by increased fiscal spending.

## What to Watch

- In the UK, the parliament will vote on Theresa May's withdrawal agreement with the EU. It is unlikely that the deal will be approved.
- The ECB is expected to confirm it will end QE asset purchases this year, despite the soft tone to recent data, while the EU summit will discuss the latest Eurozone reform proposals and Brexit.
- The Philippine central bank's MPC is expected to stay pat on Thursday. In China most of the relevant economic indicators for November will be released. Following Japan's dismal downward revision for Q3 GDP growth this morning, the focus will move to the BSI industry survey and the Tankan corporate survey for Q4. In Australia, we will keep an eye on Q3 house prices, NAB business conditions and Westpac's consumer confidence for December.
- The Swiss National Bank is expected to leave policy unchanged in this week's policy meeting.

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