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Weekly Macro & Markets View

Highlights and View

- **French business sentiment collapses on the protest movement and the ECB ends QE**

  French business confidence should rebound, especially as the government has now changed its policy. The ECB's ending of QE purchases was expected and puts pressure on governments to do more to support the recovery.

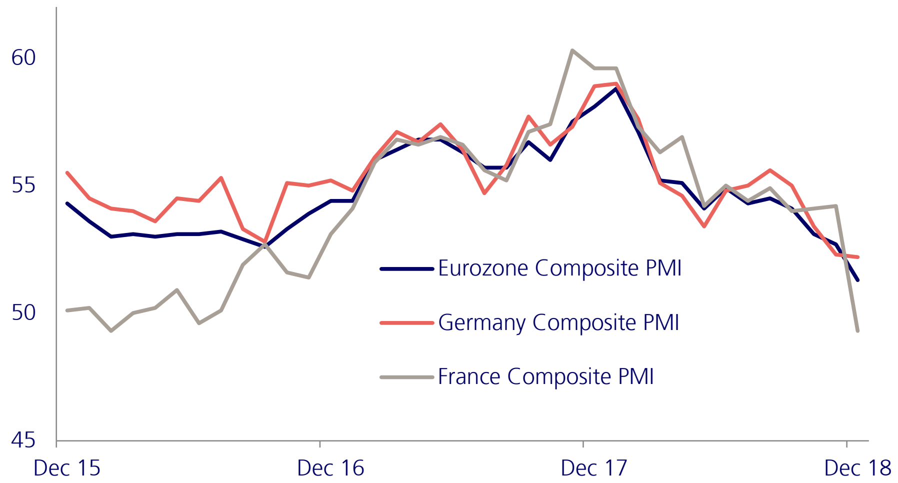
- **Theresa May postpones a critical vote on the Brexit deal and survives a no-confidence vote**

  Major concessions from the EU are unlikely so a no-deal Brexit remains a significant risk, but the ECJ's ruling that the UK could unilaterally revoke the triggering of Art. 50 opens new options.

- **China's economic data for November come in mostly weaker**

  We believe more stimulus measures are in the offing, improving the outlook after Q1.

The ECB ends QE as Eurozone data continue to disappoint



Source: Bloomberg

As expected, the ECB confirmed that it would end its Quantitative Easing (QE) asset purchase programme of government bonds and private sector securities this December, after almost four years of a policy that has expanded its balance sheet by more than 2.5 trillion euros. However, the ECB will keep its balance sheet at around current levels by continuing to reinvest principle and coupon payments from these securities, arguing that this still provides a substantial amount of monetary accommodation. The ECB has also enhanced its forward guidance, saying that it would continue with the reinvestment of these securities "…for an extended period of time past the date when we start raising the key ECB interest rates". ECB President Mario Draghi tried to add a dovish tone to the press conference that followed the monetary policy decision by also saying that while the ECB still viewed the overall risks to growth as "balanced", downside risks had increased.

Indeed, recent Eurozone data have continued to disappoint, with the latest flash composite PMI falling to 51.3 from 52.7, led by a sharp decline in the French survey. However, this survey was conducted in the first two weeks of December, when the 'yellow vest' protests in France were in full swing. Typically this type of event-created disruption to business sentiment unwinds in subsequent months.

Eurozone: French government reverses policy to assuage protesters

French President Emmanuel Macron announced last week a change in policy, confirming the scrapping of the proposed fuel tax hikes that were the catalyst for the protests, as well as announcing tax and spending changes aimed at boosting the take home pay of low-income households. In total, this should amount to around an extra 0.4% of GDP of fiscal expansion next year, compared to prior plans. Along with the extra government spending planned in countries such as Germany, Italy and Spain, the combined government spending should make an important contribution to Eurozone growth next year. In addition, Italy is also showing a greater willingness to compromise on its budget, causing spreads to fall to their lowest levels in almost three months. Overall, despite the weak business confidence data and recent sell-offs in European and global equity markets, the fundamentals still remain supportive for continued economic expansion in the Eurozone next year, albeit at a moderate pace.

China: Weak economic data urge more stimulus decisions at the Economic Work Conference

China's economic conditions continued to deteriorate in November. Domestic demand momentum faltered as nominal retail sales growth, at 8.1% YoY, marked the lowest rate since 2003 and was much weaker than consensus had expected. The main impact came once again from weak auto sales, down 10% YoY. Industrial production was also weaker than expected, up only 5.4% YoY, a ten-year low, while export growth decelerated. On a more positive note, both manufacturing and property investment growth have been more resilient, and infrastructure investment is faring better than in Q3, showing positive growth for the second month in a row. Infrastructure project approvals are now accelerating, which gives us some hope for next year. Aggregate financing improved in November from the dismal reading in October, but that is mainly due to seasonal reasons. On a YoY basis lending remains tepid. We believe the weak data set for November will urge further discussion of economic stimulus at this week's important Economic Work Conference.

Japan: Q4 data suggest that our anticipated economic recovery is in full swing

Plenty of economic data were published last week. Digging through the details, our key interpretation is that the economic contraction that followed a series of natural disasters was worse than previously envisaged, with GDP down -2.5% on an annualised sequential basis in Q3, but Q4 is already showing evidence of our expected recovery scenario. The Tankan, a quarterly corporate survey, showed that conditions in the manufacturing industries are holding up well for both small and large companies, even though the outlook is less positive. Conditions for the non-manufacturing sector even improved, and capex plans are improving as well. The BSI quarterly industry survey conveys a similar message. Focussing on the monthly indicators we note: a slight improvement in the PMI Manufacturing diffusion index for December; a swing in core machinery orders in October from negative to positive growth rates, both on a MoM and YoY basis; a better than expected move of the Eco Watchers survey in November, from below to above the segregation line of 50; and a recovery in inbound tourism.

India: Higher political uncertainty in the run-up to the 2019 general elections

It has been a busy political month for India. The BJP lost five state elections to Congress and to regional parties, including in the BJP's strongholds of Madhya Pradesh, Rajasthan and Chhattisgarh. These defeats will probably push the ruling party to grant additional benefits to voters to prepare for the 2019 general elections. Meanwhile, Governor Patel resigned from the Reserve Bank of India (RBI) following long-standing disagreements with the government on liquidity injections into non-bank financial companies, the use of the RBI's excess reserves, and the Prompt Correction Action framework for banks. Dr Patel's successor, Shaktikanta Das, a former economic affairs secretary, is likely to stick to the inflation-targeting mandate but to look at growth as another major objective of monetary policy. The RBI's stance will probably change from 'calibrated tightening' to 'neutral', although one more rate hike is likely next year as global monetary tightening bites. Resumed negotiations between the RBI and the government will certainly lead to pro-growth policies.

Bonds: Global growth concerns support core bonds

Friday's weak data from China and Europe led core yields lower, after having edged higher through the week. The 10yr US Treasury yield closed at 2.89% as inflation breakevens fell further, despite some stabilisation in the oil price, and Bund yields dipped on the soft flash PMIs. The ECB confirmed that it will end QE purchases in December, but ECB President Draghi was cautious on the near-term outlook and there was no mention of any 'operation twist' that would steer reinvestment towards longer maturity bonds. This helped to steepen the Bund curve, with a rebound in the 30yr Bund yield of 6bps. The Treasury curve steepened, with the 10/2yr spread up from 11bps to 16bps and the 5/2yr spread, which turned negative two weeks ago, moved back towards zero. This is positive but partly reflects more dovish central bank pricing, with less than two rate hikes by end of 2019 now fully priced in. We suspects that yields have overshot on the downside, but a stabilisation in macro data is likely needed to trigger a sustainable rebound.

What to Watch

- In the US, the Fed is expected to hike rates by 25bp while sending a more dovish message regarding its projected rate path. Housing market data should have stabilised while core PCE is expected to pick up slightly.
- The German ifo survey will be closely watched to gauge the state of the recovery in the Eurozone.
- The central bank monetary councils of Japan, Taiwan, Indonesia and Thailand will convene this week.
- Export, industrial production and CPI data will be the major focus during the next two weeks in Asia. In Australia, we will watch labour market data for November. Please note that regular trading at many Asian stock exchanges will be maintained with the exception of one or two days around Christmas in Hong Kong, South Korea, Malaysia and Indonesia, and the Emperor's birthday in Japan.

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