Weekly Macro & Markets View

Highlights and View

- **The Global Manufacturing PMI was flat in January, still consistent with growth firmly above trend**

  The global expansion remains strong and improving activity and new orders in Asia suggest growth will hold up.

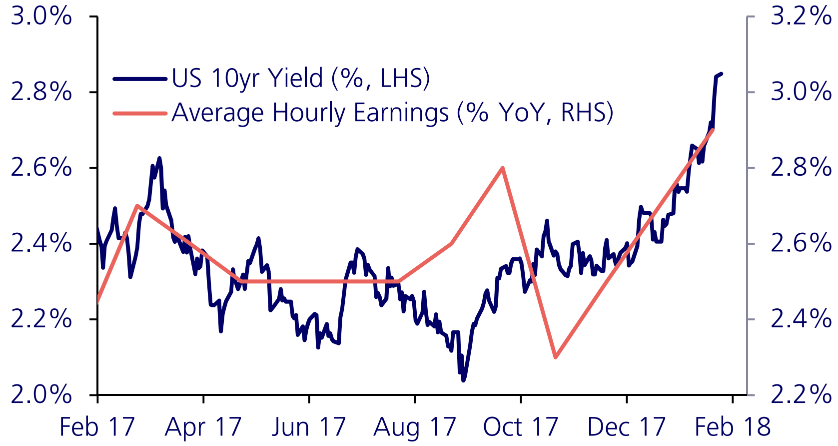
- **Core bond yields rise further amid firm growth, policy normalisation, and stronger inflation data**

  Headwinds to higher yields are still in place and a pause looks likely following the sharp sell-off, though conditions are likely to remain volatile as policy normalisation is increasingly priced in.

- **US wage growth accelerates to a post-recession high while unemployment remains at 4.1%**

  The pickup in average hourly earnings growth to 2.9% YoY will help support household spending. However, the impact is somewhat muted by a drop in weekly hours worked.

Stronger US wage growth accelerates the bond sell-off



Source: Bloomberg

Core yields spiked higher last week and are now trading well above their recent ranges. The 10yr Treasury yield rose to 2.84%, which is the highest level since January 2014 when it turned out to be a buying opportunity. The latest leg up was driven by the long end, in response to stronger average hourly earnings, but bond risk premia have also risen amid higher volatility. The yield curve has steepened sharply, offsetting the flattening move that occurred in Q4.

Core yields appear to be finding a new trading range, but the sell-off may have gone too far too quickly. While bond yields at these levels are clearly justified by strong fundamentals, the 5yr5yr Treasury forward rate rose to 3.14%, which is significantly above the Fed's 2.8% terminal rate. It appears that investors are now rapidly pricing out fundamental factors that should continue to weigh on yields, including high debt and weak demographics. The global search for yield also remains a headwind as liquidity continues to be injected by central banks globally, and the lack of inflation in other regions means that they will be very cautious in removing stimulus. While this leads us to believe that the bond sell-off is likely to pause, conditions will be more volatile in 2018 as policy normalisation continues to be priced in.

Credit: Investors seem to expect the risk-off tone to be transient

Despite both equities and government bonds selling off aggressively last week, the reaction in credit markets was more muted. It seems that credit investors view the current pull back in equities as rather short-lived, which is deterring them from liquidating cash positions, although derivative indices underperformed cash within credit. If the current equity sell-off were to gather significant momentum, credit is likely to have a more non-linear reaction to the downside than it has had so far, while cash spreads would be at risk of gapping out. Higher yields are fundamentally negative for credit given the already low interest coverage ratios of weaker companies, while high yield outflows are continuing, leaving issuers vulnerable to higher refinancing costs. That said, in a typical late cycle sign, investors still seem increasingly open to higher risk securities. In fact, last week investors lapped up a CCC+ rated € Toggle PIK note to fund a leveraged acquisition of a French packaging company, Albea, which will pay cash only if the company effectively 'can afford to pay'.

US: The S&P 500 suffers the worst week in more than two years

Driven by worries about quickly rising yields and a number of disappointing company earnings reports, the S&P 500 fell by 3.85% last week, experiencing the worst week since January 2016. Nevertheless, fundamentals remain supportive for stocks. With half of the companies having reported Q4 earnings so far, the annual growth rate was 14.8% for earnings and 9.6% for sales, the latter representing a sold pickup from recent quarters. Economic data were holding up well, too. The ISM Manufacturing Index ticked down slightly to 59.1 in January, from 59.3 the month before. New orders are still at a very solid 65.4, receding from last month's 14-year high. The highest reading on paid prices since 2011 stoked inflation fears as did the pickup in average hourly earnings to 2.9% YoY. Firms added a solid 200'000 new payrolls in January while the unemployment rate remained at 4.1%. Both bond and stock investors have been shaken from their recent complacency, indicating that volatility will be higher in 2018 than it was last year.

Eurozone: Business surveys dip in January, but remain exceptionally strong

The first estimate of Eurozone 2017 Q4 GDP showed that the economy grew 0.6% QoQ (2.7% YoY), slightly slower than the pace set in Q3 of 0.7% QoQ (2.8% YoY). However, GDP data was recently revised higher in subsequent estimates and we expect this to be the case for Q4 as well. Despite some moderation in January, most business surveys are at exceptionally strong levels. For example, the final estimate of the Eurozone Manufacturing PMI dropped one point to 59.6 in January, but is still extremely strong. The European Commission Economic Sentiment Indicator weakened slightly, to 114.7 in January from 115.3 in December, but remains close to a 17-year high. Various ECB policymakers suggested last week that a short taper of ECB asset purchases after September would be appropriate. This is in line with our base case that QE asset purchases will end in 2018, with a short taper in Q4. Indeed, last week's sell-off in bond markets should convince the ECB that it would be better to end QE gradually rather than with a sudden stop.

Japan: The Bank of Japan is acting strongly

The Bank of Japan needed to set a signal – and it did. Following a misinterpretation of Governor Kuroda's remarks at the WEF, market participants believed that the BoJ was closer to removing stimulus, particularly as the BoJ had cut the amount of JGBs at its regular bond auction early this year. On Friday, the BoJ offered to buy an unlimited amount of JGBs at an extraordinary fixed-rate auction, in addition to raising the amount of JGBs in the 5-10 year bracket at its regular auction. The market understood the message: the 10yr JGB yield fell back below 0.1%, while the yen weakened. Industrial production for December was strong, significantly exceeding consensus expectations. While companies expect a strong pullback for January, the outlook for February is encouraging. Retail sales were also brisk, while consumer confidence remained firm, and the job-to-applicant ratio surged to a record high. Finally, Japan's PMI Services recovered 0.8 points to 51.9, as reported today. Today's equity market reaction, with the Topix down 2.2%, is characteristic for a high-beta market: Investors tend to overreact during high volatility phases.

China: The service sector remains China's driving force for growth

It is not unusual for the two different sets of PMIs in China to paint slightly different pictures. While the NBS Manufacturing PMI fell from 51.6 to 51.3 in January, with all subcomponents contributing, the Caixin Manufacturing PMI remained stable at 51.5. The former tends to be more focussed on SOEs, and reflects the impact of pollution related factory shutdowns to a greater extent. We note that consumption, service and internet related segments of the economy continue to shine, as the strong reading of the NBS Non-Manufacturing PMI and the Caixin Services PMI confirm. China now enters a foggy period for economic statistics due to timing distortions related to the Lunar New Year. Elsewhere, we note stronger readings of Korea's and Taiwan's Manufacturing PMIs, with the semiconductor market being the biggest positive contributor. In Korea, industrial production fell 6% YoY in December, caused by a 25% plunge in auto output due to strikes. These kind of production setbacks tend to be reversed in due course. We also note that Korean export data for January remained firm.

What to Watch

- In the US, the ISM Non-Manufacturing is expected to show decent momentum in the service sector, while the Eurozone Services PMI is expected to confirm that the region is still growing at very robust pace.
- The central banks of Australia, India and the Philippines are expected to stand pat when their MPCs meet this week. Amongst economic indicators, we will focus on Japan's Eco Watcher survey and wage data as well as export and CPI data in China, Taiwan, Malaysia and the Philippines.