February 12, 2018

Weekly Macro & Markets View

Highlights and View

- **Global stock markets suffered the worst week since 2011, as short volatility trades collapsed**

  While a correction was overdue, volatility may persist in the short term. Given the supportive fundamental backdrop, however, the equity bull market is unlikely to be over just yet.

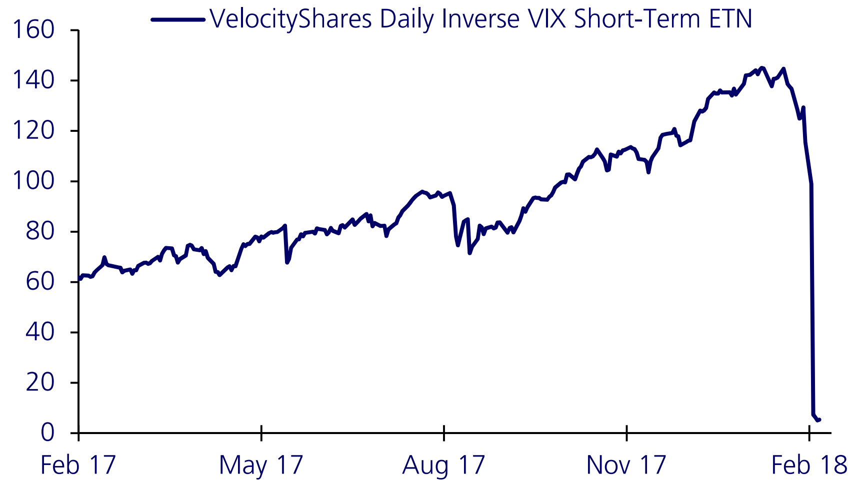
- **US Congress extends government funding after another brief partial government shutdown**

  Government funding has been extended until March, but the debt ceiling has been extended until March 2019, removing a potential disruption until after mid-term elections.

- **Germany's CDU and SPD agree on ministers to form a grand coalition**

  The appointment of an SPD finance minister should facilitate Eurozone reform agreement with the Macron goverment, while also ensuring the SPD party membership approves the grand coalition at their next vote.

Investors need to fasten their seat belts as turbulence jolts markets



Source: Bloomberg

Global stock markets were jolted last week with the S&P 500 index dropping by 4% twice, in the worst week for equities since 2011. It seemed like 'deja vu' from the early days of the credit crisis, when some excessively leveraged credit products returned steep losses to investors. This time, the excesses were in equity volatility, due to leveraged bets that the VIX index, a gauge of US equity volatility, would keep declining into oblivion from its already record low levels. Unsurprisingly, when the VIX rose, the trades started collapsing, rapidly triggering a vicious spiral that spread into stock prices. Notes such as Credit Suisse's exchange trade note (ETN) VelocityShares Daily Inverse VIX Short-Term ETN (ticker XIV) dropped sharply. Rising bond yields did not help, although credit was surprisingly resilient.

At such times, investors need to take a step back and look at the fundamentals, which are still supportive for equities. Furthermore, a correction in equities seemed overdue after such a strong run, and the clean-up of excesses could prove healthy in the longer term. Consequently, while it may take some time for the dust to settle, the bull market for risk assets, particularly equities is unlikely to be over just yet.

US: The US service sector is in splendid shape

The sell-off in equities worsened over the course of last week with the S&P 500 falling another 5.2% after 3.9% the week before. Meanwhile, the fundamental environment remains positive and generally supportive for equities. The ISM Non-Manufacturing rose to 59.9 in January, reaching the highest level since 2005. Strong new orders as well as a jump in the employment component indicate that the momentum in the service industry remains solid. The Q4 earnings season is well under way and points to another positive quarter for US firms. The average earnings surprise stands at 4.8%, after more than two-thirds of companies have reported their numbers. That lifts the annual growth rate to 15.7%, while sales have risen by 8.3% YoY. Somewhat in the background due to the market turmoil, Congress extended government funding until March 23, after another brief government shutdown. In addition, the debt ceiling has been extended until March 2019, removing a potential disruption from the political agenda until after mid-term elections.

Eurozone: Fundamentals are sound despite the turmoil in financial markets

Despite the turmoil in equity markets last week, the macro data continue to highlight the robust nature of the Eurozone recovery, which we believe will support corporate earnings growth and Eurozone equity markets over the course of the year. The Services PMI for the Eurozone rose to 58.0 in January, its highest level since 2007, from 56.6 in December. The strength in the survey was broad-based across countries, with the Italian and Spanish Services PMIs both jumping more than 2 points. The so-called hard data, such as industrial production were also strong. Spanish industrial production grew 6.1% YoY in December, while German industrial production grew 6.5% YoY. Wage growth is also accelerating, albeit gradually and from a low base, as the latest settlement between IG Metall and German employers showed. Finally, the formation of a grand coalition in Germany took an important step forward with the main cabinet appointments agreed, including an SPD finance minister. This should help ease the way forward for France and Germany to agree on reforms to the Eurozone to make it more resilient to future shocks.

UK: The BoE sends out a hawkish signal

While the manufacturing sector is holding up reasonably well thanks to the strong global growth picture, the more domestically focused service industry is increasingly feeling the headwinds caused by Brexit-related uncertainty. Business activity in the service sector, as measured by the Services PMI, fell to 53.0 in January, the lowest since September 2016. On the positive side, service providers increased the rate of job creation despite the more modest outlook and inflationary pressure has eased further, although from an elevated level. Inflation was also the BoE's focus at its meeting last week. Emboldened by a decent outlook, the BoE signalled that a rate hike could come earlier than expected. With the UK benefitting from a strong global background, another rate hike this year looks likely. However, disruptions around Brexit negotiations with the EU could still be a drag on both business and consumer sentiment, potentially limiting the BoE's willingness to tighten its monetary policy.

Switzerland: A surge in suppliers' delivery times confirms booming conditions and stretched capacity

The manufacturing PMI was unchanged in January, at a very high level, and the components indicate stretched capacity. Suppliers' delivery times surged to a level that exceeds previous cycle highs and input prices picked up momentum. Businesses are reportedly running down inventories to meet strong new orders, indicating further strength going forward. The expansion also continues to broaden out, as improved job security helps to strengthen consumer confidence. Retail sales are still weak, but the latest data show a rebound towards the end of last year, and we anticipate the consumption recovery will continue. Despite strong data, we maintain our view that the economy remains vulnerable, as domestic demand, although recovering, is still sluggish. Inflation is also tracking at less than half of the SNB's target. We therefore expect the SNB to keep its focus on the currency, maintaining forex interventions to prevent a further strengthening of the franc and keeping rates on hold well into 2019.

China: Structural reforms are starting to bear fruit

China's State Administration of Foreign Exchange (SAFE) emphasised the importance of liberalising capital accounts in 'two directions' during its Annual Work Conference last week. Indeed, following a step up in capital control regulations, the CNY has gained close to 10% vs. the USD and ~2.2% on a trade-weighted basis since early 2017. Broader USD weakness has played a major role in the CNY appreciation, but we think that solid economic activity, as well as expectations of higher local rates have also supported the Chinese currency. Going forward, we foresee an ongoing focus on deleveraging and financial regulations, which should deliver upward pressure on local rates. Regulators have so far succeeded in reigning in wealth management product growth, to +2% YoY in 2017 (RMB 29.5trn) from +24% in 2016 and an average of +50% YoY in 2011-15. Given these fundamental drivers, the Chinese authorities are now more comfortable with relaxing capital controls. Finally, expected progress on opening up China's bond market should mark another step toward financial liberalisation.

What to Watch

- Investors will be very focused on US inflation numbers this week as a strong acceleration could stoke fears and put bond prices under renewed pressure. Retail sales and consumer sentiment will give further hints on the current trend in household spending.
- Following strong monthly PMIs, we expect solid hard data in Asia. Q4 GDP figures for Japan, Singapore, and Malaysia will be released, as well as Singaporean exports and Japanese industrial production. We expect the central banks of Indonesia and Thailand to stand pat.

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Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

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