February 19, 2018

Weekly Macro & Markets View

Highlights and View

- **Inflation is showing broad-based acceleration in the US, producer prices signal further pressure**

  Headline and core CPI rose at the fastest rate in years in January. While inflation is an underestimated risk in the US, we caution against simply extrapolating the recent pickup

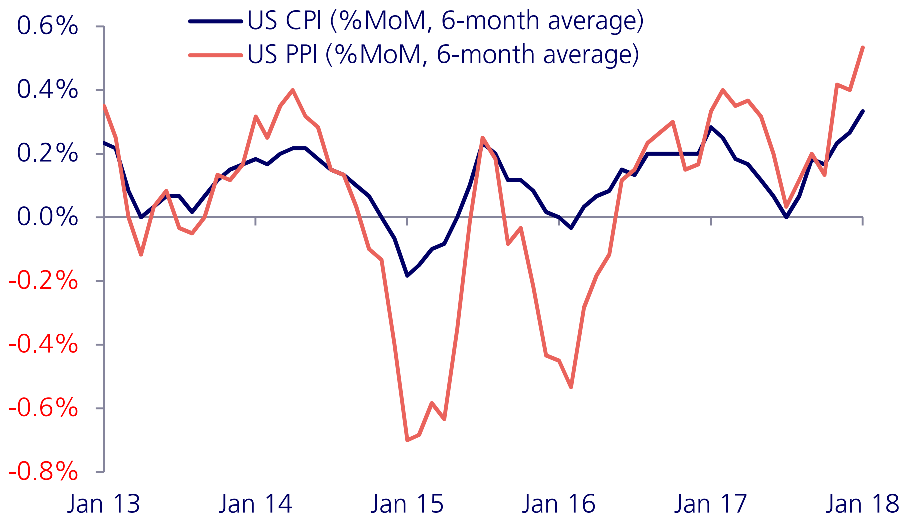
- **Equity markets rebound with the S&P500 up ~6% from its February low, despite bond yields continuing to creep higher**

  Given that fundamentals remain supportive for equities, the recent sell-off seemed excessive and exacerbated by technical factors

- **Japan's government retains BoJ Governor Kuroda and nominates Professor Wakatabe and BoJ executive Amamiya as deputies**

  We believe Wakatabe's nomination tilts the BoJ policy board towards a more reflationist stance, even though he will vote in line with Kuroda

The S&P 500 rebounds despite accelerating inflation



Source: Bloomberg

The S&P 500 has shown an impressive rebound from its recent selloff of ~12% from peak to trough, gaining 4.3% last week, the best weekly performance in more than five years. The strong performance was achieved despite an above-consensus inflation number published last week, indicating that inflation fears are unlikely to have been the main reason for the latest stock market correction. Headline CPI inflation was 0.5% MoM in January, accelerating from an upwards revised 0.2% the month before. Producer prices also accelerated to 2.7% YoY after 2.6% in December. We do expect inflation to rise this year, but we caution against simply extrapolating the recent acceleration. Overall, economic data published last week were mixed. Small business optimism rose back close to the multi-decade high reached last November, with most of the sub-components improving. Consumers were also more upbeat on both current conditions and future expectations. This is crucial as retail sales have been rather disappointing, falling 0.3% MoM in January and revised to 0% from 0.4% MoM in December. The implied slowdown in GDP momentum around year-end was further accentuated by industrial production falling by 0.1% in January and being revised down to 0.4% from 0.9% MoM in December. Despite the current softness, we do expect a reacceleration of economic momentum in the coming months as tax benefits and fiscal stimulus kick in.

Earnings: Solid corporate earnings in the US and the Eurozone

Roughly 80% of S&P 500 companies have reported Q4 numbers by now, painting a very benign picture of the US business environment. Earnings growth has reaccelerated to 15.2% YoY, while sales growth has picked up to 8.1%. The positive development was broad based but led by energy, basic materials and technology. Given that both the global and domestic growth environments remain strong and corporate tax cuts will kick in this year, we expect the solid earnings momentum to continue for the foreseeable future.

In the Eurozone, although fewer companies have reported so far (28 out of 50), the Q4 earnings season also seems to be shaping up well. Earnings growth on a YoY basis for the Euro Stoxx 50 has come in 6% better than expected, with overall earnings growth running at 11% YoY. Indeed, we expect earnings growth in 2018 in the Eurozone to beat consensus expectations because of strong economic growth and companies' increased pricing power (see our recent publication, Topical Thoughts: The Outlook for Eurozone Earnings).

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Credit: Substantial outflows cause credit to underperform other risky assets

Massive outflows from high yield and investment grade mutual funds and ETFs prevented credit markets from benefitting from the better tone in equity markets and lack of new issuance. Cash spreads have been stable for investment grade rated issuers and ended the week almost unchanged, although subordinated and high yield bonds experienced more volatility. US and European primary markets both had the lowest weekly volume since last summer and there have been signs of investors becoming more selective, with half of the €4.1bn European bonds sale coming from covered bonds issuers. Derivatives indices remained more volatile and underperformed cash within credit. Investors remain reluctant to sell corporate bonds, especially in Europe, as liquidity remains poor with the ECB keeping its private sector bond purchase at elevated levels. Despite US equity markets being back in positive territory YTD, synthetic credit indices remained slightly wider compared to end of last year. It seems likely that credit will continue to lag equities in the near term.

Eurozone: Broad-based and robust recovery continues

As risk appetite returned to Eurozone equity markets last week, the second estimate of Eurozone Q4 GDP showed continued broad-based momentum in economic growth across the region, with overall growth confirmed at 0.6% QoQ (2.7% YoY). This highlights that economic fundamentals remain supportive for risk assets in the region. This was also confirmed by the latest monthly Eurozone industrial production data for December, which saw industrial production growth of 0.4% MoM (5.2% YoY). By country output grew 6.8% YoY in Germany, 6.5% YoY in Spain, 4.6% YoY in France and 4.9% YoY in Italy, demonstrating the broad-based nature of the recovery. There was also a very sharp fall in unemployment in France in the final quarter of 2017. The unemployment rate fell from 9.6% in Q3 to 8.9% in Q4 on the ILO measure, a record fall, and is likely to lead to a downward revision to the overall Eurozone unemployment rate for December. Rapidly falling unemployment will help support domestic demand and by implication domestically focused companies in the Eurozone.

Japan: New BoJ nominations are tilted toward keeping reflationary policy stance

The government announced it will advise that the Diet retains BoJ Governor Kuroda after his current term expires in April, while it submitted two nominations for the new deputy governors. We expect the Diet to approve the nominations of BoJ Executive Director Amamiya and Professor Wakatabe to replace deputy governors Nakaso and Iwata when their respective terms end in March. Even if Wakatabe's nomination comes as a surprise, we do not see it as a game changer. Wakatabe has a more reflationist agenda and believes that more monetary easing is necessary to offset the impact from next year's consumption tax hike. However, it is likely that, as a deputy, he will vote in line with Kuroda. Even if he shares some views with reflationist policy board members Harada and Kataoka, the latter frequently voting against his colleagues in favour of more aggressive stimulus, we doubt that Wakatabe's line of thinking will be reflected in his voting behaviour. However, the government, through Wakatabe's nomination, may want to avoid any pre-emptive attempts toward policy normalisation.

ASEAN: Investment holding up and central banks on hold

In Malaysia, GDP growth reached 5.9% YoY in Q4, concluding an outstanding year on both domestic and export fronts. We are now detecting early signs of exhaustion in demand for Asia electronic products, which should weigh on Malaysia exports, however, we expect pre-election cash handouts, as well as the start of new infrastructure projects, to boost Malaysia domestic demand. In Indonesia, Q4 GDP ticked up to 5.19% YoY, thanks to a rebound in investment. Looking at the growth in capital goods imports, we see this recovery as sustainable. Private consumption has disappointed so far, but is likely to improve thanks to more targeted fiscal spending. In ASEAN, the last dovish central banks have turned neutral, and some, like Bangko Sentral ng Pilipinas will probably hike this year. Indeed, output gaps in ASEAN are closing. The prospect of tighter monetary policy in the West also puts pressure on ASEAN central banks, although sovereign spreads to US Treasuries have so far compressed, indicating that investors continue to favour local assets.

What to Watch

- PMIs will be published in Japan and in the US, and should be consistent with solid activity momentum.
- Business surveys such as the German ifo and Eurozone wide flash PMIs may soften a little, but should still be close to multi-year highs and consistent with robust growth.
- US markets will be closed on Monday due to President's Day. China's markets will be closed for the first three days, Taiwan's for two days and Hong Kong on Monday due to Lunar New Year celebrations.

Disclaimer and cautionary statement

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