March 18, 2019

Weekly Macro & Markets View

Highlights and View

- **The UK parliament rejects Theresa May's withdrawal agreement again and will seek an extension to Art. 50 to avoid a no-deal Brexit**

  The pound strengthened as the risk of a hard Brexit has fallen, but the way forward remains unclear even if the EU agrees to an extension.

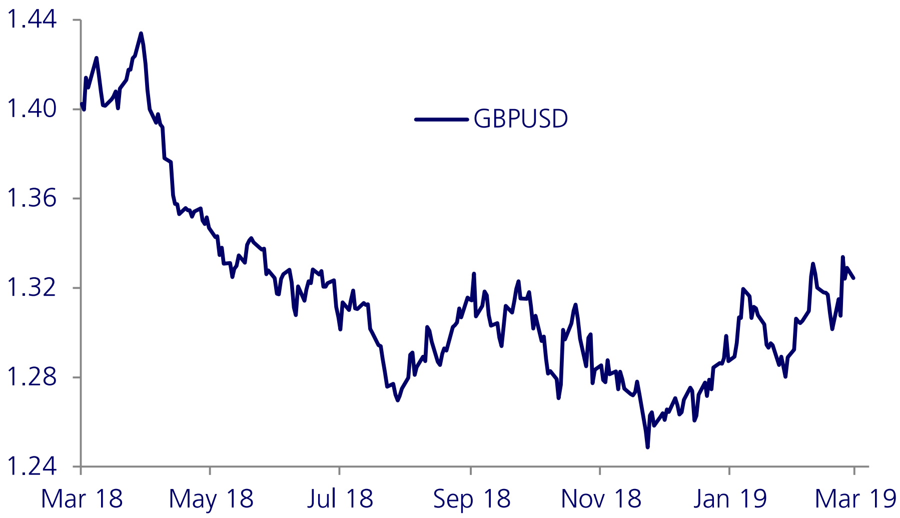
- **Japan's latest economic data continue to disappoint while the BoJ stays on hold**

  We expect Japan's economy will avoid negative growth in Q1 only by a slim margin.

- **China's manufacturing sector remains in the doldrums**

  Policy support will help, but we expect only a modest recovery in the second half of the year.

Third time lucky? Theresa May's Brexit proposal may get another chance



Source: Bloomberg

With the Brexit date less than two weeks away it is still unclear where Britain is heading regarding its relationship with the EU. In a series of votes the UK parliament has shown again what it does not want without much progress on the road ahead. Theresa May's withdrawal agreement was rejected a second time by a wide though slightly smaller margin than the first time. The parliament then voted with a relatively small majority to reject leaving the EU with no deal and finally passed a motion to request for an Art. 50 extension. The pound strengthened over the course of the week, briefly touching the highest level since June last year as the risk of a no-deal Brexit has fallen. The EU has signalled its willingness to agree to an extension of Art. 50 but will want to know the purpose as the length of the extension will depend on the objective. The UK parliament may vote once more on May's withdrawal agreement this week. Should it pass, Art. 50 will be extended until the end of June to allow time for the necessary legislation. Should it be rejected, a much longer extension is on the cards. Given this, some of the Brexit supporters may change their minds to avoid the possibility of a softer Brexit, or no Brexit at all, evolving during the extension period. Therefore, while still facing major opposition, Theresa May's withdrawal agreement may still rise from the dead after all.

US: Stocks rebound despite mixed economic data

With a performance of 2.9% the S&P 500 ended its best week this year and more than recovered from its dip the week before. The solid performance came despite a mixed set of economic data and the announcement that the meeting between presidents Trump and Xi will not take place in March as initially expected. Retail sales recovered in January after suffering the worst monthly decline in a decade in December, with numbers even revised down. A pickup in the University of Michigan's consumer sentiment index shows that households are still in an upbeat mood.

On the other hand, industrial production remained modest in February, growing just 0.1% after January's decline and new home sales suffered a setback as well. Small businesses remain only cautiously optimistic with the NFIB's survey sticking close to its two-and-a-half year low. While households' inflation expectations have ticked up in March, actual CPI headline and core inflation rates have softened to 1.5% and 2.1% YoY in February, respectively.

Eurozone: Industrial output rebounds in January, but Germany is still struggling

The Euro Stoxx had a good week, up around 3% on the view that a US-China trade deal will be struck soon and data will improve. Indeed, Eurozone industrial output picked up in January by 1.4% MoM, bringing the YoY rate of output growth to -1.1% YoY, an improvement over December's -4.2% YoY. By country, most major economies saw positive MoM output growth in January, France (+1.3%), Spain (+3.6%) and Italy (+1.7%). However, production in Germany fell 0.8% MoM. Admittedly, December German industrial production was revised up, but overall the country's manufacturing sector is still struggling. Generally, given how volatile month-to-month industrial production figures can be, we would put more weight on the PMI surveys and other business confidence data to gauge the health of the sector. Manufacturing confidence picked up a bit in France recently, but in Germany it remains extremely weak. This week's flash PMI survey will be important to see if there is evidence of the PMI stabilising, or at least leading indicators within the survey, such as new orders bottoming out.

Japan: The BoJ maintains its accommodative stance while economic indicators continue to deteriorate

The Bank of Japan maintained its monetary policy stance as expected. Governor Kuroda sounded quite relaxed about the economic outlook, even though he referred to some risks for exports and industrial production. We are more concerned as the latest economic indicators again came in worse than expected. Manufacturing orders fell to a nine-month low in January, while non-manufacturing orders dropped significantly, maintaining their recent volatile path. Machine tool orders continued to tumble, which does not augur well for capital investment prospects. The quarterly Business Sentiment Survey conducted by the MoF was weak as usual in Q1. We note that the index fell 7.3% for large manufacturers and 22.9% for small manufacturers, even though we are aware that this index tends to improve over the following quarters. February exports reported today recovered from their slump last month. However, real exports in January/February were 3.5% below their Q4 average. Taking it all together, it seems likely that GDP will only grow marginally in Q1.

China: Weak growth should stabilise amid fiscal and monetary policy support

In order to eliminate statistical distortions due to the different timing of Chinese New Year some economic indicators tend to be published only on a combined two-month basis for January and February. The equivalent of industrial production shows that growth, at 5.4%, has never been as slow in the last nine years. Fixed asset investment statistics are a mixed bag, with manufacturing investment up a disappointing 5.9%. Within infrastructure investments, only railway and highways show strong double-digit percentage growth. Real estate investment growth accelerated, but property sales rose only slightly, while floor space sales even contracted. Strong property investment obviously only benefitted from projects started, which does not look sustainable. Nominal retail sales recovered in some categories, while others experienced a significant deterioration, including clothing, furniture and home appliances. Auto sales continued to contract, though less than in Q4. Our view remains unchanged: significant weakness will be followed by a stabilisation in Q2 and a modest recovery in the second half of the year.

Credit: US municipals see no disruption to risk appetite from the tax reform

There is increasing evidence to support our long-held view that fears around the impact of the US tax reform on municipal bonds seem overblown. US municipal bonds have already outperformed Treasuries strongly in 2019, by around 0.8%. The ratio of municipal bond yields to those of Treasury bond yields has now fallen below 80%, close to multi-year lows. This good performance is likely to persist, especially given the strong supply/demand technicals. According to the last quarterly Fed flow of funds, the size of the municipal market decreased by $58bn in 2018 due to lower issuance. And despite the negative impact of the tax reform for some investors, there was no major disruption in the holdings breakdown. Banks have gradually lowered their exposure, but at a slower pace than some analysts feared given their lower tax rate. Other investors, like property & casualty and life insurers or mutual funds, have stepped in and increased their holdings. We expect these trends in investor type rotation to remain contained and the risk of spread widening from large liquidations will likely remain limited.

What to Watch

- PMIs for the US, Japan and the Eurozone will indicate whether global growth has stabilised at the end of the first quarter.
- No action is expected from the Fed, but investors will focus on more hints regarding the end of the balance sheet reduction as well as indications as to whether the FOMC wants to increase rates further later this year.
- The Swiss National Bank is expected to keep policy unchanged in this week's meeting.
- Several Asian central bank meetings will be in focus. We expect monetary policy to remain on hold in Taiwan, Indonesia, Thailand, the Philippines and Pakistan. With the exception of Thailand, the tone of most of these central banks is tilted towards dovish. In Australia, house prices for Q4 and labour market data for February should be watched.

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