March 25, 2019

Weekly Macro & Markets View

Highlights and View

- **The Fed surprised investors by significantly lowering the projected interest rate path**

  We welcome the Fed's dovish shift and its willingness to pause as there is no urgency to continue tightening and the risks for the economic outlook are to the downside.

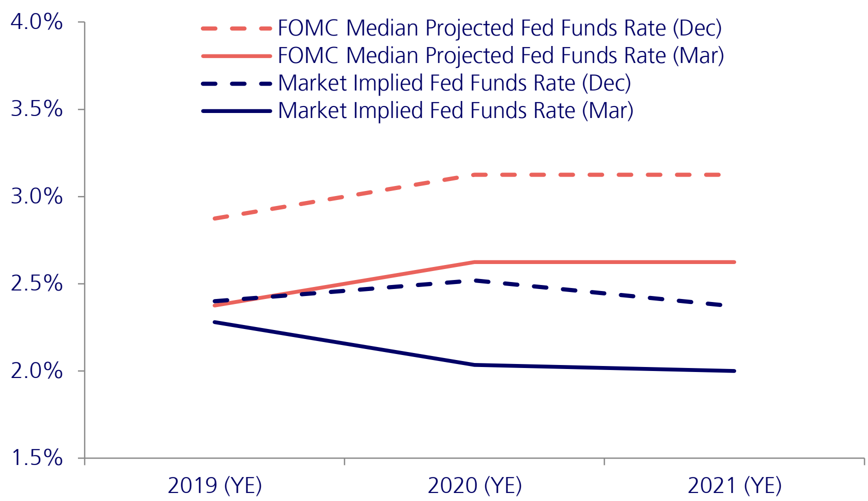
- **Eurozone, especially German, manufacturing confidence slumps, unnerving investors**

  The weakness may eventually spread to the rest of the economy through less hiring and investment, highlighting the need for uncertainties such as the US-China trade dispute and Brexit to be resolved soon.

- **The EU grants the UK a short extension to Art. 50**

  The UK parliament now has an additional two weeks to either agree to May's withdrawal agreement, leave with no deal or ask for a longer extension. The risk of a chaotic Brexit remains significant.

The Fed reaches the end of its policy cycle



Source: Bloomberg

Briefly touching the highest level since last October, the S&P 500 ended the week in negative territory, shedding 0.8% after suffering its worst day since early January on Friday. While removing one of the key risks for 2019 and initially supporting the stock market, the Fed's dovish turnaround raises investors' concerns regarding the economic outlook. As discussed in our topical comment the Fed's pragmatic move is welcome as it vindicates our view that the US economy is facing a significant slowdown. It remains to be seen whether the pragmatic change in policy is enough to reignite growth momentum, but the dovish pivot reduces recessionary risks. Importantly, it takes the pressure off other central banks to tighten their monetary policy, mitigating the headwinds for the global economy. Economic data published in the US last week were mixed and continue to point to a further slowdown in momentum. The NAHB home builder sentiment index remained at 62 in March, indicating that the housing market is stabilising while existing home sales rose strongly in February. The Philadelphia Fed Business Outlook rebounded from its three-year low in March, though the Markit Manufacturing PMI continued its slide, falling to 52.5 in March, the lowest since June 2017.

Eurozone: Investors finally take notice of weak data as manufacturing confidence falls further

Manufacturing confidence, especially in Germany, slumped in March, leading to a sell-off in Eurozone equities. The Eurozone wide flash manufacturing PMI survey fell to 47.6 from 49.3 while Germany's fell to 44.7 from 47.6. Leading indicators within the survey, such as manufacturing new orders, also fell further below 50. In addition, German manufacturing companies also reported much weaker hiring intentions. This is a concern because it presents a mechanism through which weakness in manufacturing can transmit through to the rest of the economy.

Nevertheless, services confidence is still holding up for now and still consistent with trend-like growth. In addition, the flash PMI survey results were worse for Germany and France than for the Eurozone as a whole, suggesting that periphery economies such as Spain, Italy and Ireland were actually more resilient. However, the weak manufacturing PMI data highlight the need for a resolution to the US-China trade dispute and Brexit soon in order to help stabilise confidence and prevent weakness from spreading to the remaining Eurozone economy.

UK: Brexit has been postponed for two weeks

The immediate threat of the UK leaving the European Union without a deal in less than a week has been staved off, but not for long. At last week's summit in Brussels, EU leaders granted the UK some additional time until April 12 to decide to accept the current withdrawal agreement, leave without a deal or ask for a longer extension. Should the UK parliament accept the deal it has rejected twice before the UK would then have time until May 22 to implement the necessary legal formalities. The possibility of a long extension to Art. 50 and growing momentum for a second Brexit referendum increase the chances of May's deal getting a majority in the House of Commons, but the risk of a chaotic Brexit remains significant. Meanwhile, economic data published last week show little signs of the uncertain outlook. The unemployment rate ticked down to 3.9% in January while wage growth was only slightly weaker than the month before. Retail sales grew 0.2% MoM in February following a strong pickup in January.

Switzerland: Low for longer for the Swiss National Bank

The SNB left policy unchanged last week as expected. It was a dovish decision though, with a large downward revision to the inflation outlook. CPI inflation is now expected to average 0.3% in 2019, 0.6% in 2020 and 1.2% in 2021. Compared to one year ago, when the SNB forecasted inflation to rise to 1.9% in 2020, the central bank has shifted stance, recognising that it will fail to reach target over the three year forecast window. In normal times, this would justify further policy accommodation, and it reinforces our view that Swiss rates will stay low for a long time, with a rate hike unlikely this year and next. This has consequences for financial imbalances, and the SNB remains concerned around the housing market as negative rates continue to boost investor demand, but vacancy rates are now edging higher. On a positive note, the real economy is showing resilience, with firm export data and a healthy manufacturing PMI. Some weakness should spill over from the Eurozone, but we maintain our view that the Swiss economy will expand at a modest pace in 2019.

Japan: Land prices keep rising, particularly in commercial metropolitan areas

Japan's Manufacturing PMI for March held steady at 48.9, but we note that the sub-indices for output, new orders and new export orders all deteriorated further, showing that Japan's manufacturing sector remains in a tailspin. This was confirmed by the weak reading of the Reuters Tankan for March, which fell to its lowest level since autumn 2016. Meanwhile, the non-manufacturing sector PMI held steady, with the retail sector performing better than the construction and transport & utility sectors. Export data improved, but we believe that they are distorted due to the Lunar New Year in China. We need to wait for March data to confirm any improvement. Inflation remained flat in February and is expected to fall going forward due to lower energy prices and mobile tariffs. On a positive note, annual land prices were up 1.2% YoY, with commercial land and the metropolitan areas leading. Commercial land prices in central Tokyo were up 8.4% and those in Osaka up 6.4%. Interestingly, land prices in local areas rose only 0.4%, but this was the first rise since the late eighties.

Bonds: The Treasury curve partly inverts on weak macro data and the Fed's policy shift

Global bond yields collapsed last week as the weak manufacturing flash PMIs triggered fears around the global economy. The US yield curve inverted in the 10yr/3m segment, amplifying recession fears and supporting a flight to safety that led to further falls in global yields. The 10yr/3m has, on average, inverted eleven months ahead of a US recession in the last three cycles, so concerns are not unfounded and are likely to persist until global macro data stabilise. The Fed's policy shift also contributed to lower yields, with the Fed funds curve now pricing in one rate cut this year and another one in 2020. Weakness in global data have been centred around the manufacturing cycle and Bunds moved broadly in line with Treasuries last week, with the 10yr turning negative for the first time since 2016. The move in gilt yields outstripped those in other markets, reflecting increased uncertainty around Brexit. Looking forward, we anticipate yields to retrace some of the decline, but this requires a stabilisation in the macro environment that so far has proven elusive.

What to Watch

- In the US, building permits and housing starts will show whether the housing market is stabilising after last year's slowdown while the Conference Board's Consumer Confidence index is likely to show that households' sentiment remains positive.
- Various business surveys and lending data will provide further indications as to the state of the Eurozone recovery.
- In Japan, most of the relevant economic data for February will be published on Friday. Industrial production statistics for February will be released in Taiwan, South Korea, Singapore and Thailand, while China's NBS Manufacturing PMI will be published next Sunday.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL