April 9, 2019

Weekly Macro & Markets View

Highlights and View

- **The ISM Non-Manufacturing survey suffers the biggest drop in almost three years**

  Economic indicators point to decent but slowing growth in the US, while the labour market remains very tight

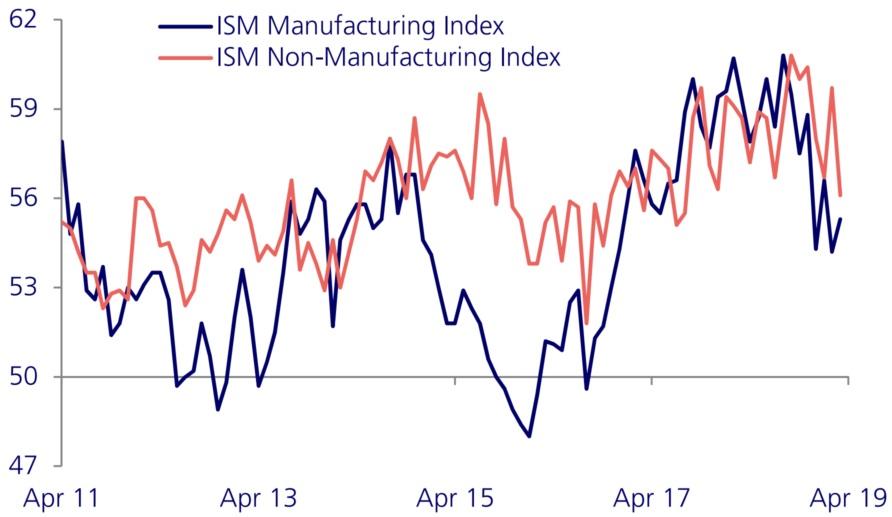
- **UK PMIs diverge as stockpiling lifts manufacturing but services slump**

  Brexit uncertainty is increasingly weighing on the UK economy as the outlook remains clouded and a compromise on the withdrawal agreement seems unlikely in the near term

- **Credit rating downgrades outpace upgrades for US companies in Q1**

  While credit markets have strengthened notably this year, fundamentals remain fragile, as a high proportion of poor quality borrowers with elevated leverage are vulnerable to downside risks

US growth is losing its lustre



Source: Bloomberg

The S&P 500 rose 2.1% last week, fuelled by optimism regarding the ongoing trade negotiations between China and the US as well as the latest batch of economic data. Though not all of it was positive, investors chose to ignore the weaker aspects. The ISM Manufacturing Index rose to 55.3 from 54.2 in March with new orders pointing to a continuation of solid momentum. However, order backlog was weak and new export orders fell to the lowest level since October 2016, indicating that large parts of the world still suffer from weak growth. The ISM Non-Manufacturing Index showed the biggest monthly drop in almost three years, but still points to solid activity in the service sector though both new orders and in particular new export orders weakened. Interestingly, price pressure seems to pick up in both the manufacturing and non-manufacturing sector. Labour market data were taken with some relief as new nonfarm payrolls rebounded to 196,000 in March from last month's slump. At the same time, wage growth eased to 3.2% YoY from 3.4% alleviating potential inflation fears and supporting the Fed's more dovish stance. Consequently, 10yr Treasury yields fell back below 2.5%. Retail sales resumed their weakening trend in February after the distortions in the two months before.

UK: Service sentiment falls to the lowest level since July 2016

The Brexit uncertainty is increasingly taking its toll on the UK economy. At first glance the jump in the Manufacturing PMI from 52.1 to 55.1 in March may look as if the economy is holding up well. However, the pick-up was caused by stockpiling as firms worry about supply chain disruptions after Brexit and try to prepare for it. The slump in the Services PMI to 48.9 shows the real picture of the headwinds that the economy is facing. On the political front, the House of Commons has very narrowly accepted a motion, by just one vote, to avoid leaving the EU without a deal. While this removes some uncertainty on the UK side, the EU will have to agree to another extension to Article 50 which will be debated at the EU summit this week. In a step to seek a cross-party compromise Theresa May met with Jeremy Corbyn, leader of the opposition, to discuss potential solutions but no tangible results have been achieved so far.

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Eurozone: Services confidence and retail sales hold up, but manufacturing slump continues

Service sector confidence in the Eurozone rose in March in many countries, according to the final PMI survey. This led to the overall Eurozone composite PMI being revised up to 51.6 from 51.3 on the flash estimate, consistent with modest growth in the Eurozone. Eurozone retail sales were also strong in January and February. However, manufacturing confidence remained weak, especially in Germany. In fact, the final German manufacturing PMI was even weaker than the flash estimate, falling to 44.1 in March from 47.6 in February. Forward-looking components such as new orders were also very soft, especially for capital goods. This suggests that globally companies are still holding back from investing until they get greater clarity on the trade dispute between the US and China. In addition, the ongoing uncertainty around Brexit is also likely weighing on German business sentiment and activity, as the UK is one of its largest export markets. However, Eurozone equities continued to do well last week, buoyed by tentative signs of stabilisation in EM data and signs of progress in US-China trade talks.

Switzerland: Regulator issues warning about the Swiss real estate market

The Swiss regulator, along with the SNB and the IMF, has warned about risks in the real estate market, particularly for the residential investment property segment. Vacancy rates are rising and rents are stagnating but new supply remains strong, spurred by a search for yield. The finance department has also initiated a consultation on capital requirements, including adjusting risk weights for residential investment property with a high loan to value ratio. With bond yields likely to remain negative for a long time, we are not surprised by these steps, and regulatory measures to increase resilience should not be ruled out. Elsewhere, Swiss activity has held up well, given the slowdown in the Eurozone, but the latest manufacturing PMI fell sharply. It remains above 50 though, so is still consistent with expansion. The leading KOF indicator also rebounded in March, with most sectors participating positively. For now, we therefore stick to our view of a modest expansion this year, helped by resilient exports.

Covered Bonds: EU harmonisation should further boost the market

The EU covered bonds harmonisation draft texts have now reached their final stages and are expected to be voted by the European parliament shortly. This will establish a common baseline through the EU and set out the rules for a 'European Covered Bond' label. The Directive will set mandatory features including the quality of the underlying assets, liquidity buffers, coverage ratios and transparency requirements. By raising the overall legislative standards, we think this new law will broaden the investor base and help less developed markets to expand. With 5yr core covered bonds yielding 0%, we expect more banks to take advantage of this to fulfil their long term funding needs. Covered bond supply remains robust, attracting large order books and minimal new issue concessions. Moreover, the new cheap loans for banks from the ECB, with a shortened 2 year maturity, are unlikely to compete with covered bond as a funding source. Secondary spread tightening is likely to remain limited, but covered bonds should add resilience to investor portfolios.

Credit: Strength continues despite fragile fundamentals

Credit markets remained strong last week, as investors continued their scramble to catch up with the rally, pressured by solid inflows and working down of large cash piles left at the end of 2018. This has been the theme so far this year, explaining outperformance of credit versus equities, amid a number of signs of investor 'desperation' emerging. While accepting new issues at negative discounts in the US is one such sign, others are the 10 times oversubscribed order book for Holcim's subordinated bond in Europe, and strong demand also been seen for subordinated bank bonds. Issuers are taking advantage of the low financing costs, with overall supply running notably higher than 2018 levels. While the strength is likely to last a bit longer, we don't think there is much more room for spreads to tighten, while fundamentals remain fragile. Ratings are already deteriorating, with S&P reporting a strong pace of downgrades versus upgrades in Q1 for US companies. Given elevated corporate leverage and high proportion of poor quality borrowers, investors will be prudent to assess the cycle turn risks at current spreads.

What to Watch

- At the ECB meeting this week, President Draghi may be asked for more detail on TLTRO3 and potential tiering of interest rates.
- In Japan, the main focus will be on core machinery orders in February.
- In Australia, we will watch April's Westpac Consumer Confidence index.
- Singapore's MAS will release its semi-annual Monetary Policy Statement on Friday.
- Export data will be published in China, Taiwan and the Philippines, while March CPI data will be released in China, Taiwan and India.
- India's general elections will start on Thursday and last until May 19.

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