April 29, 2019

Weekly Macro & Markets View

Highlights and View

- **US equity markets hit fresh record highs on better than expected earnings and GDP**

  The momentum in US equity markets is impressive, however, there are some signs of investor complacency building and the stronger USD is creating problems for some emerging markets.

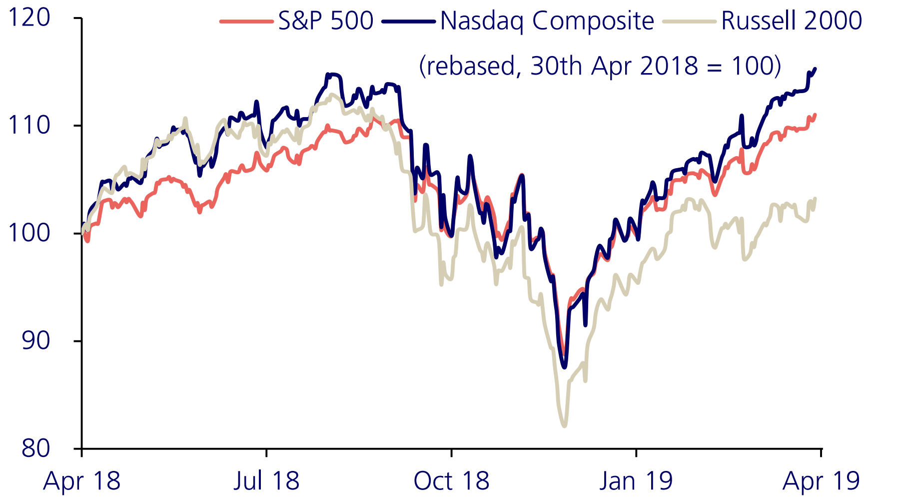
- **Economic data confirm that Asian economies remain in the doldrums**

  Hopes for a recovery are shifting to the second half of the year, when stronger Chinese demand should show an impact.

- **In Spain, the Socialist Party is well supported in the general elections, but remains short of an absolute majority in parliament**

  It may take weeks if not months to form a coalition government led by the Socialists, but this is unlikely to have much of an impact on either Spanish equity or bond markets.

As some US indices hit record highs, investor complacency emerges



Source: Bloomberg

US equity markets hit record highs last week, propelled by stronger than expected earnings and Q1 GDP. With more than three quarters of S&P 500 companies having reported Q1 earnings, EPS growth is running at 5% YoY, better than expected, especially as some analysts had forecast an earnings recession. All sectors except commodities have seen positive earnings growth. Revenue has also come in better than expected, with more than half of companies beating sales estimates. However, analysts' estimates for both earnings and sales were revised down aggressively earlier in the year and both earnings and sales outturns typically beat analysts' forecasts. Furthermore, not all US equity markets have marched back to old highs. The Russell 2000 small-cap index is clearly lagging the S&P 500 and Nasdaq. Outside of the US, other developed equity markets were mostly rangebound last week. Meanwhile, the stronger dollar dented EM equities. The USD Index hits its highest level since mid-2017 and almost all emerging markets currencies weakened versus the USD. The Argentine peso sunk to a record low amid a crisis of confidence and fears that President Macri could lose the upcoming election. The Turkish lira also weakened after the central bank removed a reference to possible future monetary tightening. Some US measures of investor positioning are also starting to show complacency, with net shorts on the VIX Volatility index at all-time highs.

US: Temporary effects boost US GDP in the first quarter

US GDP was stronger than expected in Q1, rising by 3.2% QoQ (annualised) compared to 2.2% in Q4. The underlying details were softer though, as the upside mainly reflected a build-up in inventories and strong net trade, which are unlikely to be sustained. By contrast, domestic demand was weak as both consumption and equipment investment growth slowed, residential investment continued to decline, and the government shutdown weighed on federal government spending. Price news was also soft, with both the GDP and the consumption deflators surprising on the downside, reinforcing expectations of a dovish Fed. Looking forward, it is encouraging that new home sales rose further in March, suggesting that the housing slump is waning. The University of Michigan survey of consumer expectations also confirmed a rebound in sentiment following Q1 weakness, which should be positive for consumption. For now, the US economy looks set to continue to expand, helped by a dovish Fed, but a further acceleration is unlikely.

Eurozone Data: No sign yet of a rebound in manufacturing confidence

Despite the stronger data coming out of China over the past few weeks, manufacturing confidence in the Eurozone remains in the doldrums. The latest evidence of this was the German ifo survey in which the overall business climate index fell further in April, bringing manufacturing confidence to its lowest levels since 2012. Manufacturing confidence declined in France as well, to its lowest levels since June 2015, despite a small improvement in overall business confidence. In time, we would expect manufacturing confidence to stabilise, but the data highlight the lag time between Chinese stimulus and its impact on the Eurozone.

Meanwhile, the ECB still seems undecided about how much extra support to provide to banks. ECB Executive Board member Benoit Coeure said last week 'at the current juncture, I do not see the monetary policy argument for tiering'. Despite the fresh record highs set in the US, Eurozone equity markets were mostly rangebound last week as the soft Eurozone data dented investor hopes of a quick rebound in activity.

Eurozone Politics: Macron announces more reforms in France, while the Socialist Party does well in Spanish elections

French President Emmanuel Macron announced a series of reforms last week in a further attempt to placate the 'yellow vest' protest movement. The reforms included gradually re-indexing pensions to inflation, income tax cuts, and a degree of proportional representation in parliament. However, he also vowed to continue with reforming the French economy. He also said he would maintain the unpopular abolition of the wealth tax for now. Overall, the measures may placate some opponents, but the protests are likely to continue to rumble on, and could easily flare up in intensity over the next few months.

In Spain, the general elections saw a strong increase in support for the incumbent Socialist Party while the right wing PP in particular lost a lot of support. However, the Socialists are still well short of enough seats for a majority and will need to form a coalition to govern. Weeks or months of negotiations are likely, but we do not expect a negative reaction from either Spanish equity markets or government bonds.

Japan: The BoJ stands pat as the economy continues to struggle

The Bank of Japan left monetary policy unchanged, as expected. Indeed, rate targets will remain unchanged at least until spring 2020, while it is highly likely that forward guidance will be extended even further. Governor Kuroda sounded dovish at his press conference and no BoJ board member expects the 2% inflation target to be reached by fiscal year 2021. Meanwhile, economic indicators released for March have been mixed. Industrial production dropped again, bringing the fall in Q1 to 2.6% QoQ following a rise of 1.4% in Q4. Corporate production plans suggest a recovery in April and May, but these forecasts often tend to be too optimistic. We are concerned as the inventory-to-shipments ratio rose again to nearly a ten-year high. Retail sales are picking up some steam, supported by record high tax-free sales by foreign tourists, mainly from Asia. Housing starts surged 10% YoY in March and came close to 1mn units on an annualised basis. Tokyo's CPI picked up stronger than expected, but was mainly driven by higher travel-related items ahead of the extended 'Golden Week' holidays.

Asia: Data keep disappointing; hopes for a recovery shift to the second half of this year

We are carefully keeping watch for any sign of a rebound in activity in the Asian region, but the latest economic statistics are not really encouraging. Korea's economy contracted in Q1 by 0.3% QoQ, while its YoY rate fell from 3.1% to only 1.8%. This was far weaker than consensus had expected. Even April statistics keep disappointing, as Korea's exports in the first twenty days were down 8.7% YoY, again hit by weak semiconductor exports, while mobile phone exports did much better. In Taiwan, both industrial production, down nearly 10% YoY in March, and export orders, down 9%, came in much weaker than expected. Thailand's March exports were weak as well, down nearly 5% YoY. An increase in demand from China will obviously take longer than many observers had assumed. The only glimpse of hope comes from a small recovery in port throughput in Hong Kong and Singapore. Summarising, conditions remain difficult, but we believe a recovery will become visible in the second half of the year.

What to Watch

- In Japan, Golden Week holidays have been extended until May 6, as Japan's new emperor, Naruhito, will open the new era of 'Reiwa', or 'beautiful harmony', on May 1.
- In APAC, a series of economic indicators for March, April and Q1 will be published this week, including April Manufacturing PMIs for China and Australia, Australian house prices for April, and retail sales and exports for March and Q1 GDP in Hong Kong.
- In the US, the Federal Reserve is expected to remain dovish at its monetary policy meeting this week, especially given recent weak inflation data.
- The first estimate of Eurozone Q1 GDP is likely to show trend-like growth in the region at best.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

ZURICH®