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Weekly Macro & Markets View

Highlights and View

- **Global stocks rebound from oversold conditions after a torrid end to 2018**

  Markets were poised to rebound and now look attractive on many valuation measures. Volatility is likely to remain high with better economic data and news required to maintain the rally.

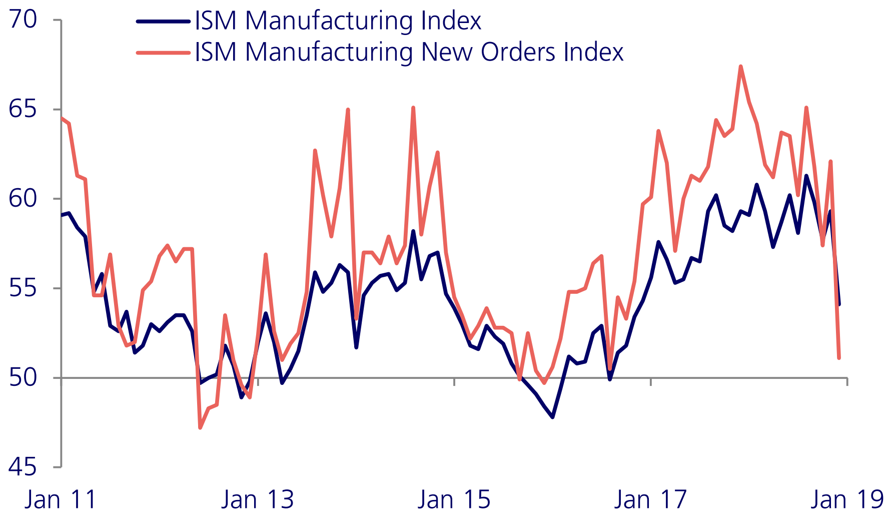
- **The US ISM Manufacturing index suffers the biggest monthly decline in a decade**

  The trade war with China, falling oil prices and a slowdown in global growth weigh on business sentiment, though positive signs from the trade talks could trigger a rebound.

- **China's PBoC announced an RRR cut, while President Xi urges reunification with Taiwan**

  We believe more stimulus measures are ahead as conditions in the manufacturing sector keep deteriorating. Political concerns will prevail throughout 2019.

US manufacturing new orders collapse



Source: Bloomberg

The S&P 500 had a volatile start into the new year, with sizeable moves in both directions, but has now recovered roughly half of the losses suffered in the worst December since 1931. Investors are encouraged by positive signals from US-China trade talks and Fed Chair Powell's indication that the FOMC would be willing to pause after unanimously voting to hike rates in December and lowering the median projection for 2019 from three hikes to two. It is reassuring that Powell wants to keep an eye on financial markets as the Fed remains one of the key risks for both markets and the economy. Nevertheless, a pause or even the end of the hiking cycle are far from certain. The biggest monthly fall in the ISM Manufacturing index in a decade and new orders almost coming to a halt in December do not bode well for business activity in the US and are in line with our view of a marked growth slowdown in 2019. The same is true for the Conference Board Consumer Confidence index where the divergence between the positive current assessment and weaker future expectations has further increased. On the other hand, the service sector remains in a better shape, with the ISM Non-Manufacturing index remaining strong and new orders actually picking up. New payrolls jumped by 312'000 in December while growth in average hourly earnings reaccelerated to 3.2% YoY. The unemployment rate rose to 3.9% from 3.7% but that was entirely due to a higher participation rate as people flock back to a solid labour market.

Credit: No longer a cheap short

Credit markets saw 2018 end with spreads spiking to new highs for the year amid low liquidity and heavy investor outflows. Notably, unlike US equities, global credit spreads had been steadily widening for a good part of 2018. CDS index spreads widened by around 50bps for Investment grade (IG) and 125bps for High Yield (HY) during 2018, while the performance in cash was even more dismal with spreads widening by around 60bps in IG and by around 200bps in HY. The key question is whether 2019 is set to see a repetition of the secular spread widening trend seen in 2018. While we think there is significant room for spreads to widen once the cycle turns, we don't believe we are at such a turn imminently. Furthermore, a number of markets seem oversold in the short term and credit is no longer a cheap short at current spread levels. Hence a relief rally is likely to occur. Even the primary market seems to be slowly regaining momentum, albeit with new issue concessions that are painful for issuers. Idiosyncratic risks continue to rise, however, amid speculation of a PG&E bankruptcy filing and a liquidation of Sears.

Bonds: Core bonds rally as sentiment plummets

Bond markets ended 2018 on a strong note as the collapse in sentiment lent support to safer assets. German Bunds were one of the few asset classes that posted a positive yearly return and Treasuries saw a sharp year-end rally, with the 10yr yield ending 2018 at 2.68%, down from over 3.2% in November. Revised expectations around Fed tightening contributed to the move, with market pricing now implying rates on hold in 2019 and a rate cut in 2020. While slowing growth and an extended economic cycle underpin our view that core yields are capped, the recent move appears overdone. Fears of a US recession are unlikely to materialise near term, with macro fundamentals remaining intact. Inflation is not a problem and the Fed has already signalled a more dovish stance. The global growth impulse is also likely to improve, in part reflecting further China stimulus. With this in mind, bond yields are unlikely to revisit recent lows, though any upside remains modest.

Eurozone: Services PMIs dragged down by France, manufacturing continues to struggle

The Eurozone services PMI fell more than two points, to 51.2 in December from 53.4 in November, led by a sharp decline in France, where it collapsed six points to below 50, because of the 'gilets jaunes' protests. While the protests have continued, the numbers involved have fallen recently and we expect French service sector confidence to bounce back over the next few months. In Italy, both services and manufacturing confidence picked up slightly, albeit from very weak levels, and are still consistent with a stagnating economy. Overall, the Eurozone economy remains in a weak spot, buffeted by external factors such as the ongoing trade dispute and China slowdown, as well as idiosyncratic domestic factors in Italy, France and Germany. Whilst domestic demand should be resilient enough to maintain the recovery, there is a danger that eventually these factors accumulate to such an extent that they extinguish it. This is certainly not our base case, but it is a risk that needs monitoring carefully over the next few months.

Japan: Rollercoaster start to 2019 for Japanese equities

Japan's equity market had a rollercoaster start to 2019. Following the traditional New Year holidays, the Topix fell 1.5% last Friday only to recover 3.2% in the first two trading days this week, reflecting the change in investor mood in the US and the flash crash of the USDJPY on January 3. 2018 was heavily impacted by strong foreign investor selling. Economic data published at the year's end for November and December were mixed. The Services PMI inched lower by 1.3 points to 51 and retail sales data for November came in weaker than expected, which is also reflected in the weak consumer confidence for December published this morning. Industrial production was also weaker in November. However, this partly reflected the strong pickup seen in October and the setback was not as bad as consensus had anticipated. On the political agenda the focus will move to PM Abe's meeting with Russian President Putin later this month, which might bring a resolution to the conflict about the Kuril Islands and finally enable a peace treaty.

China: PBoC announces RRR cut of 100bps following weaker economic data

China's central bank has decided to lower the Reserve Requirement Ratio (RRR) for major banks by a total of 100 bps in two steps in January, after both the NBS and Caixin manufacturing PMIs fell below the 50 line in December and industrial profits fell 1.8% YoY in November. We believe more stimulus measures will be necessary as economic conditions, particularly in the manufacturing sector, are expected to deteriorate further in Q1. However, we also note that both the NBS Non-Manufacturing and the Caixin Services PMI inched higher and were stronger than consensus had expected. On the political front President Xi said that Taiwan's reunification with the Mainland is unavoidable and that the military needs to be ready for war, which raised eyebrows among global observers and caused a strong rebuttal from Taiwan's President Tsai. Meanwhile, hopes are rising that mid-level US-China trade talks will bring progress towards a solution.

What to Watch

- Investors will scan the Fed minutes for a dovish message while US inflation is expected to have slowed in December.
- In Japan, we will focus on wage data for November and the December Eco Watchers Survey. In China, December aggregate financing is expected to be lower than in the prior month, while PPI inflation is expected to fall significantly. November industrial production data for Malaysia and India will be released as well.

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

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