June 17, 2019

Weekly Macro & Markets View

Highlights and View

- **Most economic activity data for May confirm China's slowdown**

  We expect further stimulus measures to counter the negative impact of higher US tariffs, tech restrictions and the global trade slowdown.

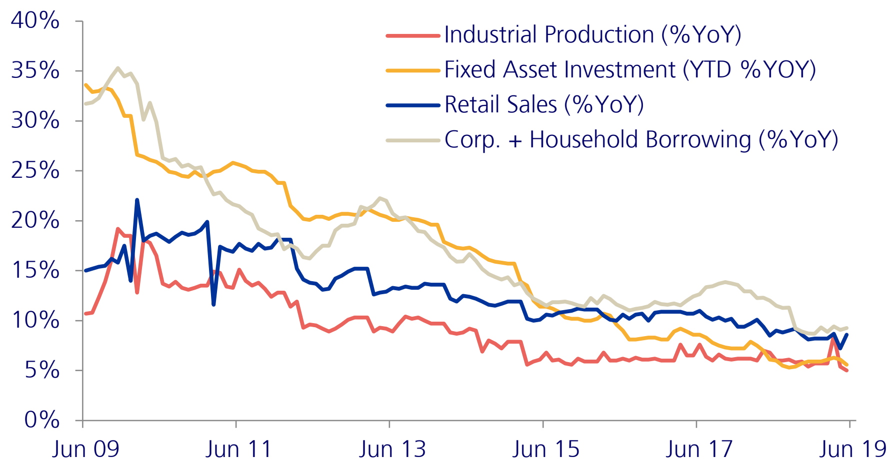
- **Credit issuance surges in Europe but demand in the US is showing signs of fatigue**

  With weak fundamentals and tight spreads, strong supply/demand technicals are the key support for credit and while last week confirms strength in Europe, fatigue in US is a worrying sign.

- **Boris Johnson is leading the race to become Britain's next Prime Minister**

  Having already secured more than a third of the votes, he is very likely to be one of the final two candidates. Sterling was basically unchanged following the vote.

China's slowdown requires more stimulus



Source: NBS, PBoC, Bloomberg

Industrial production growth slowed to a 17-year low of only +5% YoY in May, while fixed asset investment growth continued to decelerate, down 1.4 percentage points to only 4.3% YoY. The front-loading spending spree earlier this year seems to be fizzling out, as infrastructure spending slowed. Private manufacturing investment growth slowed as well, while property investment moderated, though it remains rather resilient. The slump in imports, down 8.5% YoY in May, led by a 27% drop in imports from the US, also shows evidence of weak domestic demand. On a positive note, retail sales growth rebounded to 8.6% YoY, with solid growth in categories like cosmetics, clothing, home appliances and liquor. Even auto sales were up slightly following a decline that lasted for twelve months. Consumer prices rose on higher food inflation, but core inflation declined to a three-year low, while producer price inflation softened. President Xi Jinping sees China on a 'new Long March' to tackle major challenges, while PBoC Governor Yi Gang and Vice Premier Liu He said there is enough room for further stimulus, as local media are trumpeting a tougher stance towards the US. The PBoC announced an increase in special financing vehicles and liquidity to medium-sized and small banks, while other regulators jointly allowed local governments to use special bond proceeds as capital for some infrastructure projects. China seems to be preparing to tackle an uphill struggle.

Credit: European supply surges but US technicals seem to weaken

Supply rose sharply in European credit last week as pent up demand from investors was unlocked amid an improving risk tone, while issuers that had been on the sidelines during May rushed to lock in low yields ahead of the holiday season. Financials were the largest issuers, issuing senior non-preferred bonds, as well as covered bonds, several of which were printed around 0.1% yield, the upper range of TLTRO III rates announced by the ECB a week ago. Sovereign issuance was also strong and overall the subscription levels were quite robust. US credit, though, saw somewhat weaker technicals, with some deals not being well received and anecdotal reports of some issuers pulling deals. The energy sector's underperformance on the back of a volatile oil price recently has also hit performance of US credit markets on a relative basis. While last week's supply picture suggests European supply/demand technicals are currently solid, the US could be approaching fatigue, which should be closely monitored by investors looking to anticipate a turn in the credit cycle.

US: Retail sales rebound

Economic data published last week were tilted to the positive side, helping the S&P 500 to eke out a small gain of 0.47%. Small business optimism ticked up in May, confirming earlier signals that the domestic economy is holding up well despite the global slowdown and the escalation of the US-China trade dispute. Particularly, hiring and compensation plans have improved, signalling a continuation of the healthy employment situation. Retail sales growth accelerated, even from revised up levels the month before, while consumer sentiment stayed close to its multi-year highs, both indicating that household spending keeps supporting the economy. Inflation figures sent some mixed signals as both headline and core CPI inflation decelerated in May, but core producer prices are pointing towards a slight reacceleration going forward. The Fed will have to tread carefully this week as markets have priced in aggressive rate cuts in the next few months while economic data do not (yet) call for urgent monetary easing.

Eurozone: ECB policymakers attempt to explain its reaction function in more detail

Following the June 6 monetary policy meeting at which the Governing Council (GC) had discussed restarting QE and cutting interest rates to support growth and inflation in the Eurozone, ECB policymakers made various comments explaining in more detail the ECB's likely reaction function going forward. The general message was that the ECB was not ready to act yet, but that if economic conditions were to deteriorate further then it would consider using these tools. For example, Finnish central bank governor and ECB GC member Olli Rehn said that 'in case of a further weakening of economic activity and a materialisation of adverse contingencies, the Governing Council is determined to act and stands ready to adjust all of its instruments, as appropriate'. However, the danger in waiting for economic conditions to deteriorate further before acting is that low inflation expectations become entrenched in the economic system and harder to dislodge. In terms of data last week, Eurozone industrial production fell for two months in a row, confirming the weakness of the industrial sector.

UK: Boris takes the lead

Boris Johnson emerged as the clear leader in the race to become Britain's next Prime Minister after the first round of voting by Conservative members of parliament. Johnson won 114 votes out of a total of 313, followed by Jeremy Hunt with 43 votes and Michael Gove with 37 votes. Andrea Leadsom, Mark Harper and Esther McVey did not win the necessary number of votes and drop out of the leadership contest while Matt Hancock withdrew his candidacy. Given that Johnson already secured more than a third of the votes in the first round, it is very likely that he will be one of the two remaining candidates from which the Tory party's grassroots members will choose their future party leader and Prime Minister. Sterling was basically unchanged following the vote indicating that markets have already priced in a significant risk of a no-deal Brexit, which Johnson is not ruling out as a potential outcome. Meanwhile, the economy faces further headwinds with industrial production shrinking in April, pushing the annual growth rate to -1.0%.

Switzerland: The SNB leaves policy unchanged but introduces a new policy rate to replace the old Libor range

The SNB left policy unchanged last week, as expected, reiterating that it will remain active in forex markets. The monetary policy briefing was dovish, emphasising that downside risks to growth have increased over the past quarter, reflecting trade and geopolitical risk. The SNB also introduced a new policy rate that will be used to communicate monetary policy decisions from now on, replacing the target range for the three-month Libor. The SNB rate is at present set to equal the interest rate paid on sight deposits held at the SNB, -0.75%. The annual Financial Stability Report drew attention to a further build-up in risks in the residential investment segment, due to rising vacancy rates and affordability risks. The SNB supports the proposal to raise capital requirements for high LTV loans in this segment, with stricter measures set to take effect in early 2020. With negative rates expected to remain in place over the next few years, with little hopes of a rate hike, we agree that is prudent to tighten standards.

What to Watch

- The Fed is expected to reiterate its willingness to react to a potential slowdown if necessary, but is unlikely to take action at its meeting this week.
- In the Eurozone, the ZEW survey and the flash PMIs surveys will be an important gauge as to the pace of growth.
- The monetary policy boards of the central banks in Japan, Taiwan, Indonesia and the Philippines will convene. We expect no change in policy rates among the former three, but a 25bps cut in the Philippines. Bank Indonesia might shift to a more dovish stance.
- Export related data for May will be published in Japan, Taiwan, Singapore and Thailand, and for the first twenty days in June in Korea. In Japan, May CPI and department store sales data will be released. Japan and Australia will publish June Manufacturing PMIs on Friday.

Disclaimer and cautionary statement

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