June 24, 2019

Weekly Macro & Markets View

Highlights and View

- **ECB President Mario Draghi indicates more monetary easing, including restarting QE, is likely**

  More ECB stimulus will help, but a fiscal boost and reduction in trade tensions are also needed to improve economic conditions in the Eurozone.

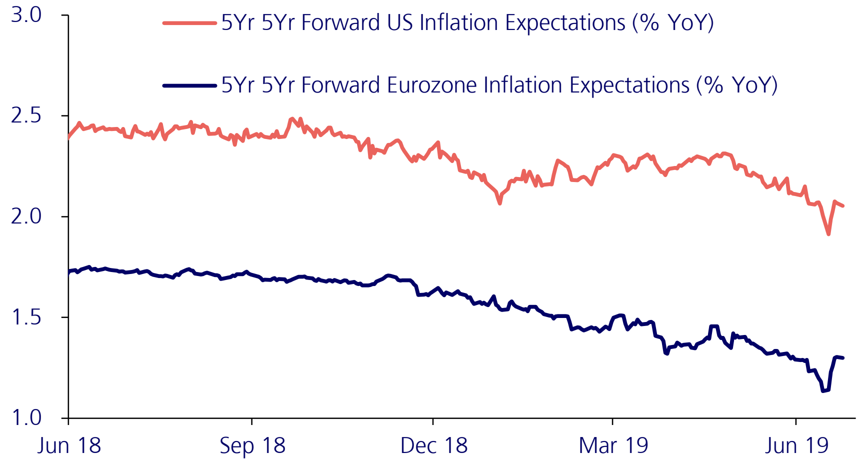
- **The S&P 500 reaches an all-time high as the Fed signals its willingness to cut rates**

  The Fed's more cautious stance is welcome though it is unlikely to be enough to avoid the expected slowdown in economic momentum.

- **The G3 flash PMIs slip further in June, with weakness in the global economy persisting**

  The global monetary policy cycle has turned in response to weak macro data and persistent uncertainty, which should help to stabilise economic conditions.

The world's major central banks signal easing ahead



Source: Bloomberg

Last week the Fed and the ECB signalled that they were preparing to inject more monetary stimulus into the global economy. Whereas the ECB Governing Council (GC) had previously argued that a further deterioration in the economic outlook would be necessary to justify more stimulus, ECB President Mario Draghi said last week that simply an absence of improvement would justify more action. Additional stimulus could come in the form of cutting interest rates, restarting QE asset purchases and enhanced forward guidance. With respect to cutting interest rates he said, 'Further cuts in policy interest rates and mitigating measures to contain side effects remain part of our tool kit'. This was a reference to tiering interest rates to make it less expensive for banks with excess reserves held at the ECB. Regarding asset purchases, Draghi hinted that the ECB would reconsider its 33% issue limit on bonds purchases. This would be important in terms of giving extra QE more credibility and firepower. We now expect that within the next few months the ECB will restart QE asset purchases of both government and corporate bonds and cut the deposit rate by 10bps, bringing it to -50 bps. It may also introduce a tiered interest rate system for excess reserves and adjust its forward guidance. Inflation expectations bounced higher after Draghi's speech, but an improvement in trade tensions and a large fiscal boost are needed to substantially improve the Eurozone outlook in our view.

US: The Fed signals its willingness to cut rates

The S&P 500 rose to an all-time high last week after the Fed signalled its willingness to cut rates and end its balance sheet reduction earlier than expected. Worries around global trade and weaker inflation expectations led a number of FOMC members to shift to a more dovish stance. We expect the Fed to cut rates in the coming months to mitigate the expected slowdown. Though the domestic economy and the labour market remain resilient, signs of a loss in momentum are increasing. The Markit Manufacturing PMI fell to 50.1, close to indicating a contraction in the manufacturing sector and the lowest level since 2009. The Services PMI fared little better, ticking down to 50.7 from 50.9. Regional activity indicators confirm the weakening momentum, with the Philly Fed's business outlook showing that new orders and shipments have slipped while the Empire Manufacturing Index suffered its biggest monthly decline on record to the lowest level since 2016. The Fed's more cautious stance is therefore welcome, though even a rate cut or two is unlikely to be enough to avoid the slowdown.

Bonds: Dovish central banks help to stabilise yields, at least for now

Central banks dominated the news flow last week and helped to drive a further leg down in yields. The Fed's dot plot was more dovish than expected and led to a repricing of policy expectations, with a Fed rate cut now fully expected for July and the Fed Funds rate consistent with four rate cuts by the end of 2020. While the 2yr yield fell further, to 1.77%, the latest actions appear to have put a floor, at least temporarily, under the 10yr Treasury yield, which closed the week at 2.05%, and triggered a steepening of the 10/2 slope. Global inflation expectations also rebounded, which is encouraging, though the latest move up was also influenced by a spike in oil prices. In Europe, expectations of an ECB rate cut compressed yields at the short end of the curve, while the 10yr Bund yield appeared to find some stability at around -0.3%. While central bank actions should help to stabilise economic conditions, persistent uncertainty around global trade and geopolitical tensions will remain and are likely to keep bond yields low for now.

Credit: European credit yields fall to record low of 0.55%

Credit market's outperformance versus equities accelerated last week, as both the Fed and the ECB hinted at further stimulus in coming months. The 40bps to 50bps spread tightening seen in high yield indices suggested capitulation by some bearish investors, with some brokers also changing their stance. While US primary markets saw mixed sentiment continuing from last week, European primary markets saw substantial demand. For example, Heidelberg Cement was able to tighten pricing by 35bps for a €750m bond, after building an over €5bn order book, while the Greek bank Piraeus successfully issued a CCC rated subordinated bond. However, with the spreads of many credit indices close to cycle tights, most of the positive news is priced in already, leaving little further upside for investors. Slowing growth and increased uncertainty, the drivers of monetary stimulus, don't appear to be priced in. That said, it seems premature to underweight credit, as the pull of gravity from negative yielding bonds has become stronger, skewing the supply/demand technicals in the opposite direction of fundamentals.

Asset Backed Securities: European ABS continues to be resilient

ABS performance has been strong since the beginning of 2019, with spreads stable even during times of higher volatility. With the new STS (Simple, Transparent and Standard) framework now in place, we continue to expect a rebound in primary market activity and out-performance of ABS versus other credit sectors. The Global ABS conference in Barcelona confirmed cautious investor optimism. After a pause for the conference, supply picked up last week. The flow of UK deals continues as issuers rush to issue given the increased uncertainty and the risk of a no-deal Brexit, but some Spanish and Italian issuers are also joining a robust pipeline. Italian banks continue to sell Non-performing Loans and the extension for another two years of the renewed government scheme (GACS) should support a steady momentum and help Italian banks cope with still elevated NPL stock. Despite house prices slowing down in most European countries, RMBS performance remains strong as household affordability is supported by strong labour markets and a low rate environment.

Asia: Weak data is prevailing across Asia while major central banks stay on hold

Major Asian central banks stayed on hold last week, an outcome we were expecting for Japan, Taiwan and Indonesia. While we had expected another 25bps cut in the Philippines, we believe it is just a matter of time as the narrative is rather dovish. Most economic indicators were disappointing across the region. In Japan, the Reuters Tankan survey for June showed a significant decline in the condition and outlook indices, both in the manufacturing and non-manufacturing industries, while the manufacturing PMI for June fell another 0.3 points to 49.5, with the two order related sub-indicators falling more sharply. Export volume also fell 3.8% MoM and 9% YoY in May, adding to the rather gloomy picture. Other export related indicators continued to be weak across the region, as was highlighted by the worse than expected May electronic exports in Singapore, down a hefty 31.4% YoY. In Australia, house prices continued to fall, down another 3% QoQ and 7.4% YoY, a record decline. Meanwhile, the US Treasury added Malaysia, Singapore and Vietnam to its expanded list of 'currency manipulators'.

What to Watch

- In the Eurozone, various national business confidence and inflation data are likely to confirm a mixed picture in terms of economic activity.
- In Japan, the usual month-end data bonanza is around the corner: Retail sales, labour data, industrial production, housing starts, and construction orders for May and the Tokyo CPI for June will all be published. Industrial production data for May will be released in Taiwan, South Korea and Thailand, as well as export data in Hong Kong and Indonesia. We expect the Bank of Thailand to stay on hold, when its monetary policy council convenes on Wednesday.
- Presidents Trump and Xi will meet at this week's G20 summit, potentially agreeing to a path forward for negotiations and moderating trade tensions near term.

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Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

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