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Weekly Macro & Markets View

Highlights and View

- **G20 ends with US-China resuming trade talks, while the Mercosur and EU regions strike historic deal**

  We see protracted and difficult negotiations ahead around intellectual property and corporate embargos, but the EU-Mercosur deal is significant, showing that global trade is not dead.

- **US Q1 GDP confirmed at 3.1% YoY annualized, though consumer confidence plunged in June**

  The sharp fall in consumer confidence for both present situation and expectations is a concern. Personal income and spending are holding up well, while inflation remains weak.

- **German ifo business climate indicator and EC economic sentiment indicator decline in June**

  The further decline in key Eurozone confidence indicators is a worrying development, which highlights downside risks to growth unless policy improves soon.

No surprises at G20 as Trump and Xi agree to restart trade negotiations

Source: Bloomberg

As expected, a cordial meeting between Presidents Trump and Xi opened the way for what we suspect will still be protracted and challenging trade and industry negotiations. Although the outcome had been anticipated in the financial markets, it is a move forward in the frayed relationship between the economic superpowers and further tariff hikes were put on hold. Few details were forthcoming, although it appears that a modest easing in export restrictions on Huawei may be accepted, while the broader US embargos on technology companies would only be addressed towards the end of trade negotiations. We suspect that this will remain a key sticking point and could once again prove to be a deal breaker. In the meantime, the meeting removes an immediate risk for investors.

Although there were few tangible outcomes from the G20 meeting, the agreement between the EU and Mercosur – the trading block formed by Brazil, Argentina, Paraguay and Uruguay – was significant both in terms of its scale and the fact that it came after 20 years of negotiation. EU estimates suggest that it will erase €4bn in annual export duties. This follows the EU's free trade agreement with Japan back in January and shows that despite the attention the US-China conflict is receiving, other important trade deals are being struck — something the UK should be considering carefully. Protectionism is not going unchallenged.

Eurozone: The continued deterioration in business confidence is a concern

Last week's Eurozone data suggest that the economy is far from being on the mend. The German ifo business climate survey declined to 97.4 in June from 97.9 in May, driven by a sharp fall in the business expectations component. This is a concern because the expectations component is a useful leading indicator for business investment. Separately, the European Commission (EC) business and consumer confidence survey fell to its lowest level in almost three years in June, driven by a sharp decline in manufacturing confidence, and a modest fall in services as well. The EC survey had declined for 11 consecutive months, before rebounding in May, so this fall back in June is a setback. While consumer sentiment has held up better so far, the continued deterioration in business confidence is a worrying development that suggests that unless there is a substantial boost from monetary and fiscal policy and an improvement in trade relations and uncertainty soon, the Eurozone region will continue to experience modest growth at best with increasing downside risks and vulnerability to shocks.

Switzerland: Negotiations with the EU come to a deadlock

Talks on the Framework Agreement, that aims to replace 100+ separate treaties governing the EU-Swiss relationship with a unified umbrella framework, have come to a deadlock. As a result, the European Commission has followed through with its threat not to extend the recognition of Switzerland as an equivalent financial market to the EU, meaning that Swiss and EU investors can no longer trade freely across each other's borders. As a countermove, the Swiss government banned trading of Swiss equities from within the EU. This creates a loophole, as EU traders are then allowed to go back to Switzerland to trade, as regulation permits this when there is no other choice. These tit-for-tat actions were expected, as the EU had only given Switzerland a temporary extension to the equivalence status and Switzerland had already signalled that it would put counter-measures in place. While it appears that the impact can be managed near term, by rerouting trades via Switzerland, this is not a constructive outcome and it could have longer-term implications for both parties.

Asia: The overall picture is gloomy

June manufacturing data paint a gloomy picture of the region. While the PMIs of the Philippines and Vietnam display a modest improvement, Taiwan, Korea and Malaysia showed firm declines. Particularly Taiwan's PMI, which fell from 48.4 to 45.5. Korea's exports also fell by 13.5% YoY, compared to 9.4% in May. China's Caixin manufacturing PMI also moved below 50 to 49.4. New export orders for Asia ex Japan and China also slumped, following some improvement in the previous month. As we have expected, trade disruption continues to weigh on the region, amplified by the weak semiconductor cycle. One bright spot is Vietnam, the biggest gainer from US-China trade tensions as an alternative supplier for many US importers. Vietnam's exports increased strongly by 8.5% in June and its PMI reading improved by 0.5 to 52.5. Nevertheless, this has not gone unnoticed by the US. Consequently, Vietnam is vulnerable to increased tariffs by the US.

Japan: The manufacturing index slumps, while domestic demand remains resilient

The BoJ Tankan survey showed a slump from 12 in Q1 to 7 in Q2 for large manufacturing firms, likely discouraged by the US-China trade dispute, China's weak data and a late technology cycle. On the brighter side, the Tankan non-manufacturing index surprisingly bounced back from 21 in Q1 to 23 in Q2. Retail sales also improved by 0.3% in May, a rebound from a 0.1% fall in April. The biggest contributor was motor vehicle sales, which increase by 3.5% MoM. We expect that the strong growth in consumption will continue before the tax hike. Industrial production rose by 2.3% MoM, well above market expectations of a 0.6% gain. We predict June might experience a slight decline as a correction for a strong May figure. The June composite PMI stabilized, but remains below 50. Looking forward, businesses have revised up their capex plans from 1.2% to 7.4%, which will give a push to the economy if it is realized. Overall, the road to recovery is somewhat bumpy and dependent on the momentum of the global economy.

Credit: Marching towards cycle tights

Credit markets took a brief breather mid-week, but then resumed their march towards cycle tights, and have opened tighter again this morning after the G20 meeting. At current tight spread levels, given fragile fundamentals and a deteriorating macro backdrop, further upside seems limited. However, investor demand is strong due to impending stimulus from central banks and negative yields in parts of the global fixed income universe. In Europe, credit inflows have been strong recently while the primary market also remains strong. In contrast however, the US primary market remains lacklustre, while US high yield has lagged recently. The Fed's Comprehensive Capital Analysis and Review (CCAR) was largely uneventful, with all US banks and US entities of foreign banks passing the stress tests, resulting in announcements of $130bn share buybacks and 16% dividend increases for US banks. While the results confirm our view that US banks have strong balance sheets, we believe that given the late stage of the cycle, it would be more prudent for banks to retain capital rather than return it to shareholders.

What to Watch

- A holiday shortened week in the US will see the all-important employment reports on Friday, where payrolls are expected to rebound from the surprisingly weak 75k reading last month, while both the ISM manufacturing and non-manufacturing reports need watching for signs of further weakening.
- In the Eurozone, lending data, the final PMIs and German factory orders will give further indications as to the state of the economy, with downside risks to these indicators.
- The Reserve Bank of Australia (RBA) will meet this week. Given the dovish tone that has been set by the RBA earlier, the market is expecting another rate cut. However, we believe the rate cut is more likely to come in August once Q2 data has been released.

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