July 8, 2019

Weekly Macro & Markets View

Highlights and View

- **Core bond yields slump on dovish ECB nomination and easing expectations**

  It is encouraging that central banks are responding to the global growth slowdown, but a broadening out of the support mechanism is likely to be needed for growth prospects to improve more meaningfully.

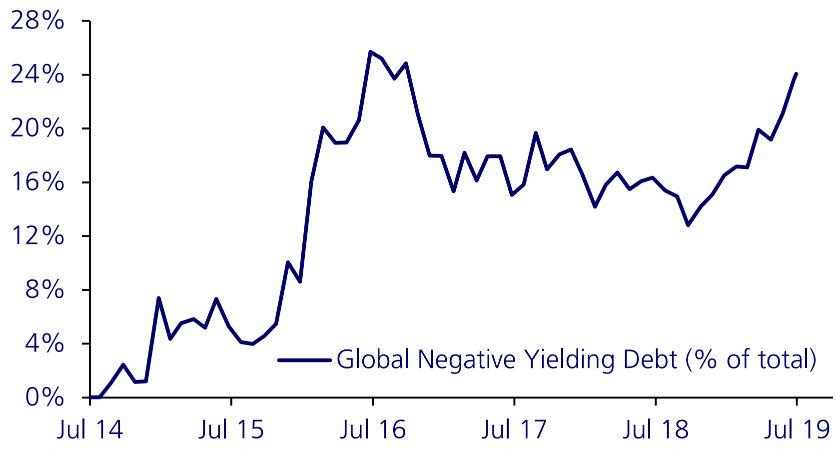
- **US payrolls jump 224k in June vs. consensus expectations of 160k**

  The better than expected jobs report is encouraging, as is the modest rise in the participation rate. However, firms continue to find hiring qualified staff a major problem, which may slow growth ahead.

- **Christine Lagarde, IMF Managing Director, is appointed as the next ECB President**

  Lagarde's appointment was a dovish and positive surprise, she is unlikely to oppose more QE by the ECB, though she will also emphasise the need for fiscal policy to do more.

Negative yielding debt surges on easing expectations



Source: Bloomberg

Global bonds rallied last week as IMF head Christine Lagarde was nominated as the next ECB President. This was a surprise and a dovish development, especially when compared to some of the other candidates that were being touted. Lagarde expressed her support for the ECB when it announced its first QE programme in 2015 and is unlikely to object if, as we expect, the ECB resumes QE asset purchases of government and corporate bonds within the next few months. Peripheral bonds outperformed, with 10yr Italian yield initially falling to the lowest level since 2016, also supported by the news that the European Commission will not launch an Excessive Deficit Procedure against Italy. The Bund curve slumped further into negative territory as the 10yr yield fell below the -0.4% ECB deposit rate on Wednesday. The share of global debt that is negative yielding rose further and is now approaching 25%, close to the levels reached in 2016. The strong US payroll report helped to stabilise yields towards the end of the week. However, with trade uncertainty persisting, the manufacturing cycle still weak and central banks injecting stimulus, it is difficult to see bond yields moving meaningfully higher. For that, a broadening out of the support mechanism will be needed.

Credit: Are buyers in primary about to go on a strike?

The European corporate index yield hit a record low of 0.46% this week, as big parts of sovereign bond curves submerged into the sub-zero territory, with the 10yr Bund yield briefly falling below the -0.40% deposit rate of the ECB. The 'pull of gravity' from negative yields has left credit investors scrambling for paper in the European primary markets. However, last week, issuance was light in Europe and blank in the US, after a few weeks of light primary activity. Furthermore, in Europe, we think investors will soon start questioning the rationale behind receiving a 0.5% coupon, at the late stage of the cycle. CDS indices are also close to hitting resistance in our view, being only a few bps off the cycle lows. With peripheral spreads tightening notably this week after the European commission refrained from disciplinary action on Italy, issuers such as Monte Dei Paschi were able to attract decent demand due to high spreads from the CCC rated issuer. At current valuations, it is not unfathomable that investors go on a buyers strike until yields back up somewhat.

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US: Rate cut still likely despite rebound in payrolls

A holiday-shortened week ended on a positive note. Payroll data for June jumped by 224k, from the prior month's worryingly low 72k reading, though wage growth remained subdued at 3.1% YoY. Interestingly, the stock market hit a record high on Wednesday, following weakening ISM manufacturing and service data, with new order readings for both series down sharply, as investors raised expectations of rate cuts. The payroll data seemed to dampen this enthusiasm a little, with stocks and bonds giving up some of the week's gains on Friday. While payrolls tend to be volatile and subject to revisions, the robust reading may give the Fed pause for thought. We suspect, however, that with the economy coming off the boil, inflation expectations in decline and trade uncertainties impacting business investment, a rate cut at the end of the month still seems likely. Unfortunately, we are back in an environment where bad news is taken as good for liquidity provisioning, while fundamental drivers of markets, such as growth and earnings expectations, are pushed aside.

Eurozone: Manufacturing remains the weakest link, Italy avoids EDP

Data last week from the Eurozone were in line with an economy that is still growing at a modest but trend like pace for now, though with continued and severe weakness in the manufacturing sector that could eventually spread out to the rest of the economy. The Eurozone manufacturing PMI remained below 50 for a fifth consecutive month, with sector employment declining in Germany, Italy and Spain according to the survey. However, the Eurozone services PMI was more robust, staying above 50, and the latest bank lending data also indicate that overall the economy continues to grow. Meanwhile, Italy managed to avoid the launching of an Excessive Deficit Procedure (EDP) against it by the European Commission last week, which helped further support demand for Italian government bonds. The government reduced its budget deficit target for 2019 to 2.04% from 2.4%. However, medium-term risks for the Italian economy remain high, and the 2020 budget could be another source of disagreement between the EC and Italian government within the next few months.

Japan-Korea: The dispute between Japan and South Korea intensifies

Japan has imposed tight technology-related export controls on South Korea following an escalation in the long standing wartime labour dispute. South Korean courts had ordered Japanese firms to pay compensation for maintaining labour camps during the 1910-1945 occupation of the Korean Peninsula. Lawyers then seized Japanese firm's assets through local courts and are threatening to sell them. Japan, which had settled all compensation issues under a 1965 bilateral agreement, argues that the recent measures have not been in retaliation, but out of security risk concerns, while South Korea has threatened to take Japan to the WTO. South Korean Samsung and SK Hynix will face sourcing problems of special semiconductor materials once inventory is depleted, which is estimated at about 30 days. China and Vietnam could be major victims of memory chips shortages, while Japan's producers of semiconductor materials have been surprised by the governments' action. Japanese electronics companies reliant on Korea's semiconductors will also be negatively affected.

Asia: Weak data persist

Japan's consumer confidence index fell 19 months in a row to 38.7, while the June services PMI showed a marginal improvement to 51.9. May marked a record trade surplus for Australia at AUD 5.745bn, primarily driven by rising iron ore prices. House prices fell slightly by 0.1% MoM, signalling a stabilisation in the housing market. The Reserve Bank of Australia (RBA) cut its policy rate by another 25bps to 1%, following its June cut. Malaysia's export growth remains resilient at 2.5% YoY, mainly supported by a rise in palm oil exports. Nevertheless, the deteriorating manufacturing PMI as well as new export orders for Malaysia imply softer export data further ahead. India's services PMI declined to 49.6, the weakest since May last year. India's 2019 annual budget has pledged USD 1.44 trillion in infrastructure investment over the next five years. Furthermore, the corporate tax will be cut from 30% to 25%, aiming to support businesses.

What to Watch

- Given the high expectations of a US rate cut on July 31, attention will be on the release of the Fed minutes, as well as Fed Chair Powell's testimonies to the House Financial Services Committee and the Senate Banking Committee next week.
- The MPC of Bank Negara Malaysia (BNM) will convene this Tuesday. Given current economic data, there is no urgency for a rate cut this month. Thus, we expect BNM to maintain its policy rate at 3%. Export data will be released in China, Taiwan and the Philippines. In Australia, we will watch business confidence for June and consumer confidence for July.

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