

Weekly Macro & Markets View

Highlights and View

- **Credit markets start very strong, some US high yield sector spreads tighten by nearly 100bps**

Risk reward became more balanced in late December, although to justify continued optimism, dovishness from central banks and a stabilisation in Chinese data is warranted.

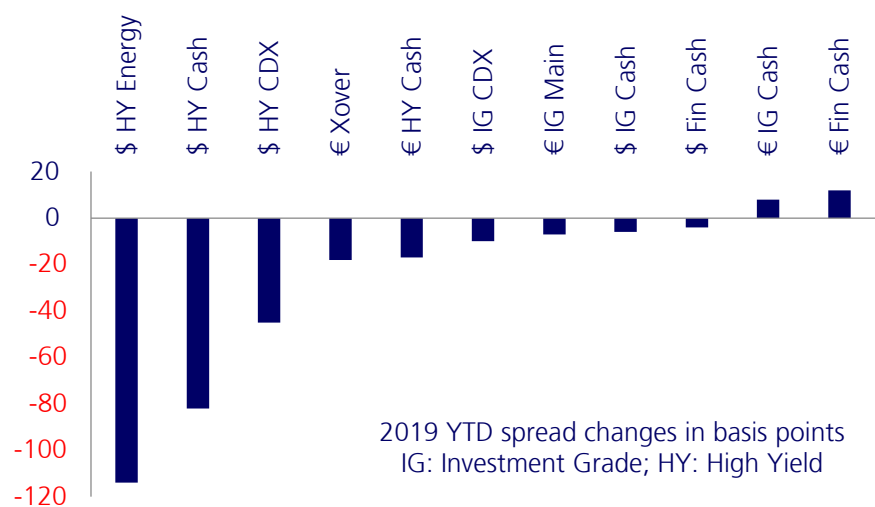
- **The partial government shutdown in the US is now the longest on record**

The political impasse in Washington has entered its fourth week. While the direct economic impact is modest, sentiment will increasingly be weighed down as the stalemate lingers on.

- **Regular wages in Japan mark the strongest increase in more than twenty years**

The firm labour market suggests wage growth will persist, but we believe wages will not consistently rise above the Bank of Japan's 2% inflation target.

Credit: Off to the races again?



Source: Bloomberg

Credit markets tend to lead other financial markets, especially around important market turning points. In this context, the sharp rally seen in credit since late December, outpacing equities, is notable as it departs from the trend seen over the last year when credit lagged other risk assets during risk rallies. Indeed, US high yield may be on track to see the best January in a decade given the nearly 100bps year-to-date spread rally seen in some parts of the market. So the question is, is it a return to the races for credit or simply a sharp dead cat bounce?

We like to think about this question from three perspectives. Firstly, flows are getting more encouraging, at least at the margin. Secondly, primary markets are showing real investor demand as Europe sees record fixed income supply, the US high yield market opens up, and recent new issues outperform. Thirdly, after underperforming for most of 2018, the sharp move in spreads in December created a more balanced risk reward from a valuation perspective. All of this said, more is needed to justify continued optimism. Most importantly, some real dovishness from central banks e.g. a moderation in the pace of balance sheet shrinkage by the Fed would be a game changer, as would signs of improvement in Chinese data.

US: Stock markets lifted by dovish Fed comments

The S&P 500 gained 2.5% while the Russell 2000 won almost 5% last week. Investor sentiment was supported by further comments from FOMC members indicating that the Fed is willing to pause hiking rates and is taking into account financial market developments. Meanwhile, economic data are in line with solid but slowing momentum. NFIB small business optimism ticked down to the lowest since October 2017 but remains far above the post-recession average. The difficulty to fill open jobs has risen further to a new all-time high underlining the tightness of

the labour market. Headline CPI inflation slowed to 1.9% YoY in December, dragged down by a steep fall in energy prices, while the core measure stuck at 2.2%. Initial jobless claims fell back last week despite the ongoing government shutdown that is now the longest ever, showing that the economic impact of the political impasse is modest so far. However, sentiment may be increasingly burdened if the situation does not improve.

Eurozone: Industrial production declines sharply, though partly because of temporary factors

Industrial production data from the key Eurozone economies made for grim reading. French output declined sharply in November, by 1.3% MoM (to -2.1% YoY), with declines across a broad range of sectors, but this was in part due to the yellow vests protests. As the protests continued in December output could be weak then as well, but may rebound early in 2019 since the protests have been smaller and less disruptive so far this year. German industrial production fell 1.9% MoM in November (to -4.7% YoY), with declines broad-based across sectors. Temporary factors

were also partly to blame, with many workers taking an extra bridge day holiday in November, according to the German statistics office. Nevertheless, the data are weak and highlight the danger of prolonged weakness in emerging markets as well as idiosyncratic domestic factors eventually infecting the wider Eurozone economy. On a more positive front, unemployment continues to fall, while the latest ECB minutes showed a shift in tone, recognising the weak data and discussing extra support, such as more liquidity operations for banks.

Switzerland: The SNB posts a loss in 2018

The SNB announced an expected loss of CHF 15bn for 2018. The details are not yet available, but the trade-weighted franc strengthened by around 4% in 2018, suggesting sizable exchange rate related losses while risk assets also sold off. It highlights the vulnerability of the SNB's balance sheet, both because of the huge forex position, at over 110% of GDP, but also due to large holdings of risk assets, with credit and equities accounting for one third of the portfolio. While reserves are large and will be a buffer to further drawdowns, the

potential for large losses makes the SNB vulnerable to political pressure. Despite this, we expect the SNB to retain forex interventions as part of its tool kit over the coming years, though the hurdle for further interventions will be large. The balance sheet will, however, stay bloated, and will constrain policy actions once the next global downturn hits. Many central banks face this problem, but the size and the composition of the SNB's balance sheet highlight the issues at stake.

Japan: Biggest wage rise in more than twenty years

Japan's wages were up 2% in November, more than consensus had expected, with higher special wages contributing significantly, even though the impact of winter bonuses will only become visible when data for December are released in a month's time. However, even regular wage growth was firm and at 1.6% showed the strongest YoY increase in more than twenty years. Sample changes are still distorting, but wage acceleration is visible even when looking at the old sample. Is wage growth off to the

paces? We do not believe that regular wages will rise significantly above 2% going forward.

Consumer confidence, the Eco Watchers Survey and the Household Survey all revealed a more pessimistic stance amongst consumers. Considering some special factors this is unlikely to become a trend, but it needs to be monitored. On the political front we are encouraged by PM Abe's effort to improve relations with China, Russia and even North Korea, amid speculation that he might meet leader Kim later this year.

China: Producer price deflation ahead again?

Both CPI and PPI inflation data for December came in weaker than consensus had anticipated, not at least because the impact of falling energy prices may have been underestimated. Non-food inflation fell to a two-year low of 1.7% YoY. What is more interesting is the fact that producer price inflation fell significantly more than estimated, from 2.7% YoY in November to only 0.9%, also a two-year low. PPI also fell significantly by 1% in MoM terms. In addition to lower oil prices, declining prices for consumer and industrial input goods also contributed.

Output prices actually declined in more than half of the 30 industries reported. Even if prices were to remain stable from here, negative PPI inflation prints in YoY terms are highly likely later this year. This suggests that industrial profits will be impacted negatively and that the government will need to add more stimulus, including further RRR cuts and potentially even a policy rate cut in addition to removing some restrictions in the property sector.

What to Watch

- The UK parliament is set to vote on Theresa May's Brexit deal. If the deal is voted down as expected, the government will have to present a plan B within three days of the vote.
- One implication of the shutdown in the US is that some economic data will be delayed, but we should get news on the housing market as well as the University of Michigan's Consumer Sentiment Survey and industrial production data.
- In Asia, we believe Bank Indonesia will keep its policy rate unchanged amid a stabilisation of the IDR. Following China's release of weak December export data this morning, Singapore, Indonesia and India will follow up, while inflation data will be reported in Japan, Australia and India.

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