July 22, 2019

Weekly Macro & Markets View

Highlights and View

- **Some short-dated European high yield bonds become negative yielding**

  We think pricing in credit is stretched or even distorted in pockets, as fund flows, passive funds and central bank stimulus deter active investors from positioning against the momentum.

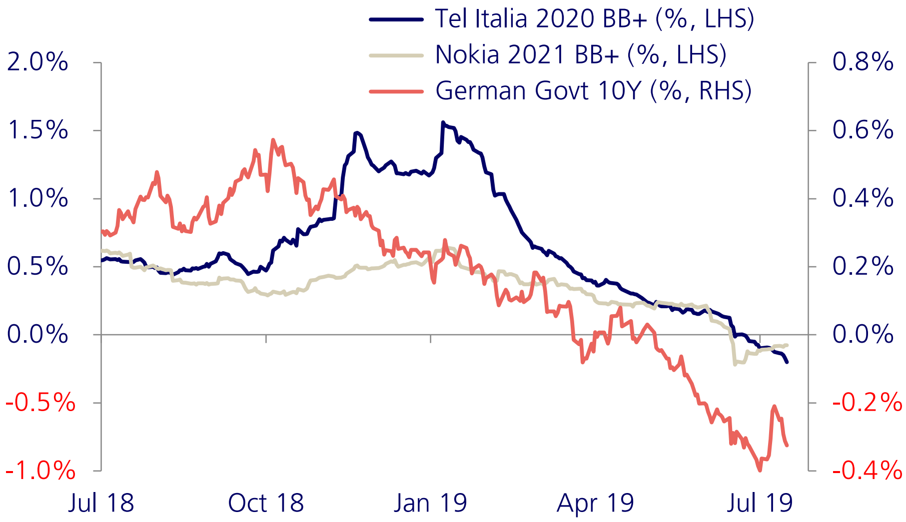
- **The European parliament confirms German Defence Minister Ursula von der Leyen as next EC President**

  Von der Leyen's confirmation ensures that Christine Lagarde will become the next ECB President. Lagarde is expected to support more monetary easing, including restarting QE.

- **The S&P 500 bounces off its all-time high as investors weigh the latest Fed signals and mixed corporate earnings reports**

  Dovish statements by a number of FOMC members are supporting the stock market while investors severely punish companies that fail to meet expectations, as in the case of Netflix

Distortions emerge in credit markets



Source: Bloomberg

Paying more upfront for a bond than its future cashflows doesn’t sound like a good idea, especially if those future cashflows carry default risk. However, this is precisely the case for some short-dated high yield bonds in Europe today that trade at negative yields. Notably, unlike investment grade credit, high yield default rates have historically averaged around 3% to 4%. So, why are credit investors allowing pricing to become stretched in general and distorted in pockets? We think two factors are at work. Firstly, amid heavy inflows, passive index tracking funds are gaining momentum, and it is likely that these are price insensitive. Secondly, the search for yield in an environment where some central banks are setting negative deposit rates is making everything with a spread look attractive, discouraging investors from fighting the central banks. Low yields are taking a toll on global banks, as seen from last week’s earnings reports for US banks. There are some signs that investors are becoming discerning. Some European high yield issuers had to sweeten their deals, while the two times oversubscribed new Monte Dei Paschi Tier 2 bond tumbled within two days to become one of the worst performing bonds this year in European credit. That said, in the short term, credit markets are likely to remain stretched as central banks pump more stimulus.

Eurozone: Von der Leyen is appointed the next EC President, allowing Lagarde to take ECB President role

After being confirmed by a small majority in the European parliament, Ursula von der Leyen was formally appointed as the next European Commission (EC) President last week. This means that the other senior appointments, such as Christine Lagarde’s as the next ECB President, can also go ahead. As Lagarde is seen as dovish, paradoxically her appointment may reduce the pressure on current ECB President Mario Draghi to lock in a dovish policy path before he retires at the end of October. Nevertheless, we expect the ECB will cut its deposit rate by 10bps and also re-start QE within the next few months. It is likely that there will be a modification in the language of the introductory statement at the ECB’s July meeting to prepare the ground for these policy changes. Elsewhere, data in the Eurozone were mixed. The German ZEW investor sentiment survey, which is often a useful leading indicator for the economy, weakened further. Eurozone car sales also fell 6.7% in June, though, after increasing 4.8% and 2.8% in April and May respectively. They are still up slightly in Q2 as a whole.

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US: The US earnings season is picking up steam

The S&P 500 failed to stay above 3'000 and shed 1.2% last week as investors focused on dovish Fed signals and mixed corporate earnings reports. While it is still early, the overall beat/miss ratio is roughly in line with recent historical averages, but some stocks were heavily punished after missing their targets. Netflix, for example, dropped more than 15% last week as the company lost customers in the US and reported slower growth in other regions of the world. Meanwhile, economic data were more on the positive side last week. Retail sales grew at a solid pace in June while some of the regional business indicators signal a pickup in activity. On the other hand, developments in the housing market do not look promising. Housing starts fell for the second month in a row while building permits fell by more than 6%, the biggest fall since Q1 2016. Finally, the University of Michigan's consumer sentiment survey stayed at elevated levels in July with longer-term inflation expectations rebounding to the upper end of the recent range.

UK: MPs take back control

At least 30 Conservative MPs voted against the government and helped pass measures to prevent Theresa May's successor from closing down parliament in order to force through a no-deal Brexit. Sterling recovered somewhat after the vote as it reduces the risk of a hard Brexit. On the other hand, the MP's move to take back control increases the likelihood of new elections, particularly if Boris Johnson will succeed May as the Prime Minister, as he declined ruling out the possibility of suspending parliament. Johnson could try to win back voters from the Brexit party with his combative rhetoric, aiming for a strong Brexit mandate and a bigger majority in parliament. Sterling is likely to remain volatile in the coming weeks as investors try to quantify the probabilities of the different scenarios. Meanwhile, the economy is showing a few signs of relief after the recent weakness. Retail sales rebounded strongly in June while wage growth accelerated to the highest since 2008 as the labour market remains tight.

Japan: The coalition wins Upper House elections, but fails to gain a two-thirds supermajority

Japan's Upper House elections showed a low voter turnout of only 48.8%. PM Abe's ruling LDP and coalition partner Komeito will have an Upper House majority of 141 seats versus the opposition's 104 seats. Only half of the seats have been contested, of which the ruling coalition won 71 versus the opposition's 53 seats. What is more important is the fact that the coalition failed to secure its two-thirds majority, which is necessary to push through constitutional reforms, one of PM Abe's main political targets. It will now be difficult to change the war-renouncing Article 9 to formalise the legal status of the Self-Defense Forces, as Abe will have to rely on cooperation with the opposition DPP. Meanwhile, exports recovered in June, but were unable to make up for the plunge in May. Export volumes were still down 5.5% in YoY terms, dragged down by semiconductor related exports, while auto exports turned marginally positive. Import volumes remained weak. The Reuters Tankan for June revealed further weakness in the manufacturing sector, as the index fell to a three-year low, while the non-manufacturing index remained firm.

Asia: Will dovish central banks save the day?

Bank Indonesia (BI) and the Bank of Korea (BoK) cut their policy rates by 25bps to 5.75% and 1.5% respectively. Both cuts were in line with our expectations. As BI hinted at further easing, we expect another 50bps in cuts this year. Note that the existing high level of external debt and sticky current account deficit will put a lid on how much BI can loosen. For Korea, the reasons are not new. Highly correlated to global trade, Korea is suffering from lacklustre global demand and the weak semiconductor cycle. In addition, the trade conflict with Japan comes at a bad time. Japan's restrictions on sales of certain semiconductor input materials to Korea will likely hurt major Korean electronics manufacturers and eventually weigh on exports. With all this bad news, Korea is the second worst performing major Asian stock market this year, up a meagre 2.6%, with only Malaysia performing even worse. Meanwhile, trade data for India, Singapore and Indonesia remain lacklustre. To curb the negative momentum, accommodative policies seem to be a card to play for many regional central banks further ahead.

What to Watch

- Investors will closely watch the publication of PMIs in the US, the Eurozone and Japan for signs of a stabilisation in global business activity.
- The ECB is expected to change the language in its introductory statement at this week's monetary policy meeting to prepare the ground for the announcement of a rate cut and re-starting of QE at the September meeting. There is even a chance that it will announce an easing of policy at this week's meeting.
- In the UK, the new leader of the Conservative Party and next Prime Minister will be announced, with Boris Johnson expected to be the winner of the postal ballot among the party's grassroots members.
- Australia's PMIs as well as Taiwan's and Singapore's industrial production data are expected to remain soft. Korea's Q2 GDP growth may pick up somewhat following its weak performance in Q1. Tokyo's CPI for July is expected to be in line with consensus expectations.

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