ZURICH

Weekly Macro & Markets View

Highlights and View

- **Several Asian Pacific central banks took bold steps to cut rates more than we had expected**

  The regional central banks demonstrated their willingness to act decisively as the global outlook becomes more worrying.

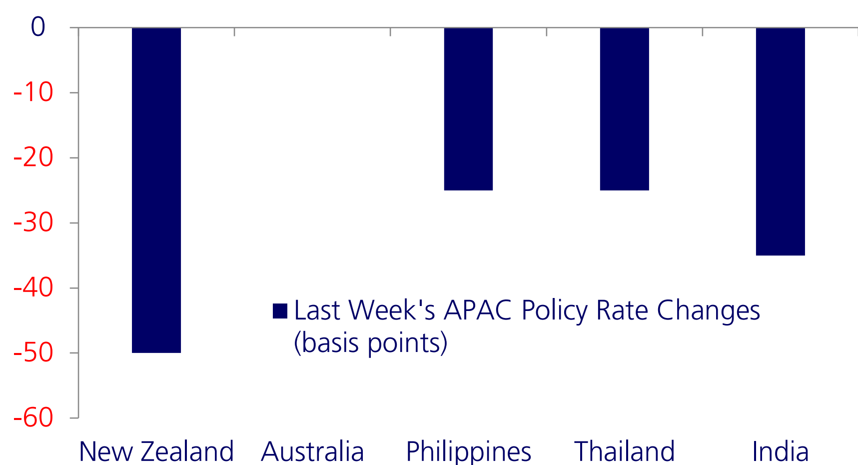
- **Japan's Q2 GDP growth surprises to the upside**

  While this will lift growth forecasts for the full year due to statistical reasons, we suspect that a VAT hike related demand slump in Q4 will spoil the party.

- **In Italy, the Lega party calls for fresh elections**

  Fresh elections, if confirmed, will add to uncertainty and volatility in Italian financial markets, especially as crucial negotiations with the EU over the 2020 budget are coming up.

APAC's dovish central banks take action



Source: Bloomberg

Four out of five APAC central banks announced rate cuts last week, voicing concerns over subdued growth and escalating trade tensions. While we expected most of the moves, the magnitude of some cuts came as a surprise. The Reserve Bank of New Zealand (RBNZ) kicked off the easing series with a larger-than-expected 50bps cut to 1%, followed by an unconventional 35bps cut to 5.4% by the Reserve Bank of India (RBI). Amid India's shattered banking system, a high level of non-performing assets and a credit crunch, it remains to be seen how the cut will transmit through the system. To our surprise, the Bank of Thailand (BoT) cut its policy rate by 25bps to 1.5%, its first cut since 2015. Worries over fragile growth and the strong baht seemed to outweigh the BoT's concerns about financial instability and high credit growth. Following its counterparts, the Bangko Sentral ng Pilipinas (BSP) decided to cut by 25bps to 4.25%, while the Reserve Bank of Australia (RBA) was the only one on hold. Nevertheless, the RBA remained dovish in its statement, affirming that 'it is reasonable to expect an extended period of low interest rates.

We believe this cycle of rate cuts indicates the rising concerns of the regional central banks about spillover effects from trade tensions and the increasing risks of a global economic downturn. We expect most Asian central banks to keep their dovish tilt well into next year.

North Asia: Japan's domestic demand stronger than expected in Q2, while China is locked in an inflation/deflation trap

Japan's annualised sequential growth of 1.8% in Q2 surprised to the upside, while Q1 growth was revised up to a strong 2.8%. Robust private consumption, capex and government spending contributed, while the drag from lower exports was smaller than expected. However, various special factors contributed, including the extended Golden Week holidays and front-loading of consumer durables deliveries before the October VAT hike. Strong consumption is also at odds with tumbling consumer confidence and the weak reading of the Eco Watchers household survey for July. While Q3 growth will benefit from rush demand, the VAT hike will hit the economy in Q4.

In China, a 27% YoY rise in pork prices in July contributed to the CPI's 17-month high of 2.8%, while falling raw material prices pushed producer price changes into negative territory, the first time in three years. We expect this divergence to persist. In Hong Kong, the composite PMI tumbled by more than four points to only 43.8 in July, adding to concerns about a severe growth slowdown.

US: Rising headwinds for the service sector

After a tumultuous start, with the worst daily performance since last December, the S&P 500 almost fully recovered and ended last week with a small loss of 0.5%. Nevertheless, markets remain fragile as the re-escalation of the trade dispute between the US and China continues to weigh on investors' sentiment. Meanwhile, economic fundamentals have further deteriorated. The ISM Non-Manufacturing index fell to 53.7 in July, the lowest level since 2016, indicating that manufacturing headwinds are more and more spilling over to the service sector. Total job openings ticked down marginally in June but are still at very high levels. The quits rate remained at its post-recession high while initial jobless claims ticked down to 209'000, all confirming that the labour market remains healthy. Headline producer prices were stuck at 1.7% YoY and core price development was unexpectedly weak, showing that inflation pressure remains muted, leaving the door open for further Fed rate cuts next month.

Eurozone: Italian bond yields spike higher on politics, data remain soft

Data remained soft in the Eurozone last week, especially in the manufacturing sector, and financial markets were volatile. German industrial production declined by 1.5% MoM in June, bringing the rate of output growth down to -5.2% YoY. This increases the risk that German Q2 GDP growth will be negative (data will be released on 14 August). The debate about whether Germany should engage in more fiscal stimulus was rekindled last week but unfortunately a sense of urgency still seems to be lacking on the part of policymakers. Meanwhile, in Italy political uncertainty has increased with the Lega party calling for fresh elections that, if confirmed, could take place in October, just ahead of crucial negotiations with the EU over the 2020 budget. Investors reacted negatively to the increased uncertainty with Italian government bond yields spiking higher and the stock market down 2.5% on Friday. This underperformance could persist over the next few weeks if fresh elections do take place.

Switzerland: Slowing activity and a strong franc pose a dilemma

The manufacturing PMI slumped in July, down from 47.5 to 44.7, which is the weakest level since 2009 and consistent with a deep industrial contraction. The signal was mixed though, as the new orders component collapsed while employment growth edged higher. The KOF leading indicator also improved, both reflecting the manufacturing sector and the broader economy. It is clear that growth has slowed sharply, mainly as a result of the Eurozone slowdown and a sudden stop in global trade, but we suspect that underlying growth is holding up slightly better than some of the survey data suggest. Forex reserves rose in July, indicating currency interventions by the SNB. Despite this, the franc has strengthened, particularly against the euro, on ECB stimulus expectations. With a balance sheet at 120% of GDP and a deeply negative policy rate, the SNB has limited space to inject further stimulus or stabilise the currency, which could become an issue if the global slowdown turns more sinister.

Credit: Notable underperformance versus equities

We have been of the view that upside in credit is limited at current levels and it should start underperforming equities at some point. While risk assets were generally volatile last week, underperformance of credit during both the equity sell off and the recovery was notable, particularly in the US markets. While the S&P 500 ended the week little changed, credit spreads were notably wider. The US high yield energy sector, which led the broader rally in January, saw spreads widen by 65bps on the week, and has now given up the spread tightening for the year. Bloomberg Barclays High Yield Index spreads widened by 40bps on Monday alone, with a lacklustre recovery in the following days. While investment grade credit is generally benefiting from decent inflows, US high yield suffered significant outflows last week. All of this said, there does seem to be cash on the sidelines with many investors still retaining a buy on dip mentality. This is evident from strong demand in the US new issue market, albeit at higher new issue concessions. All in all, the coming weeks will be a crucial indicator as to whether a turn in credit spreads is imminent.

What to Watch

- In Asia, this week's focus will be on China's July data for industrial production, fixed asset investment, aggregate financing, and retail sales. We expect Indonesia's exports will have remained weak in July, while Singapore's exports probably bounced back slightly. Malaysia's GDP Q2 growth is expected to be roughly in line with Q1, while Hong Kong has probably fallen into recession. Australia will release business and consumer confidence data, Q2 wages and July labour market data.
- In the US, small business optimism is expected to remain high while inflation data are likely to show only modest price pressure. Housing market data are expected to have stabilised in July.
- Eurozone June industrial production and German Q2 GDP data are likely to highlight the ongoing weakness in the manufacturing sector.

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