September 2, 2019

Weekly Macro & Markets View

Highlights and View

- **The Five Star Movement and PD agree to a new coalition government in Italy**

  Investors have reacted positively to the new coalition government, but Italy's medium-term economic challenges remain severe.

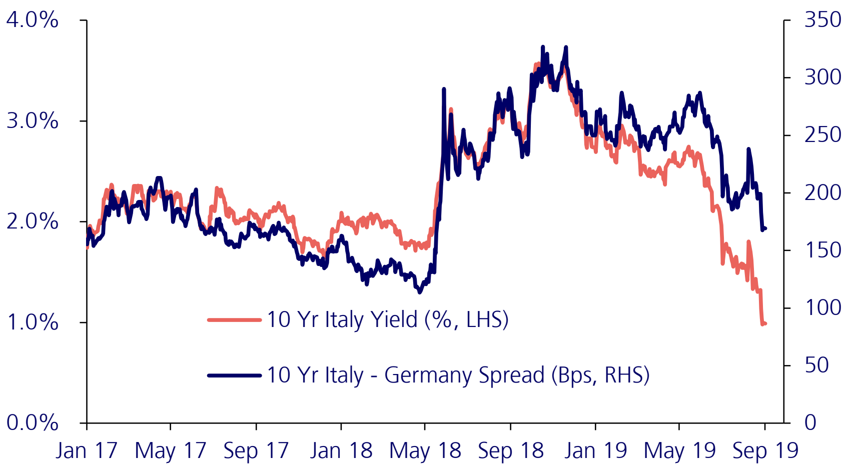
- **The UK Prime Minister prorogues parliament for longer than usual**

  The decision leaves very little time for 'remainers' to organise a stop or delay to Brexit and also risks provoking a constitutional crisis or fresh elections.

- **Stocks rebound on conciliatory language from the Chinese regarding tariffs and rising hopes of Fed and ECB action**

  Having become somewhat oversold in the short term, the rebound in equities is encouraging and we suspect could run further should constructive dialogue continue on the US-China trade front.

Investors welcome new Italian government, but risks remain high



Source: Bloomberg

Italy has a new government after the PD and Five Star Movement agreed to form a coalition. The deal still needs to be approved in an online poll of Five Star Movement members this week, but is expected to pass. Investors reacted positively as this creates less uncertainty compared to the alternative of fresh elections. 10yr Italian government bond yields fell to their lowest levels on record, and the spread between Italian and German government bonds hit the lowest level since May 2018. The FTSE MIB was also up 4% on the week. This new government is likely to be less confrontational vis-à-vis the European Commission in negotiating Italy's 2020 budget than the previous coalition government. However, the coalition may be unstable and could easily fall apart over the next few months, leading to fresh elections anyway. In addition, Italy's economic challenges remain severe, especially if the Eurozone and global economy continue to slow as we expect.

Indeed, data in the Eurozone remain weak. The German ifo Business Climate Indicator for August fell to its lowest level since 2012 and shows services confidence now also deteriorating rapidly. Admittedly, lending in the Eurozone is holding up for now, as seen in the ECB's latest data, but the risk of a recession in the next few quarters is high unless there is a significant change in monetary and fiscal policy and improvement in global trade tensions and uncertainty.

UK: Boris Johnson prorogues parliament, Brexit process enters a crucial week

UK Prime Minister Boris Johnson's decision to prorogue parliament, approved by the Queen, will accelerate the Brexit process one way or the other and could also provoke a constitutional crisis. Parliament will now be out of session from September 9 to mid-October, leaving very little time for 'remainers' to stop Brexit, which is scheduled to happen at the end of October. This week they will attempt to pass legislation in parliament to delay Brexit and if this fails then they could hold a vote of no confidence in the government, which if passed could lead to fresh elections. The EU is likely to see how this week plays out in parliament before making any concessions, though both President Emmanuel Macron and Chancellor Angela Merkel have indicated verbally at least some flexibility recently. A hard Brexit and/or constitutional crisis in the UK remain significant risks, though a last minute compromise between the UK and EU on Brexit still seems the most likely outcome. While the GBP and the UK stock market are already lagging global markets, a hard Brexit is not fully priced into asset markets.

US: Robust spending and benign inflation help stocks to the top of the range

With today's US Labour Day holiday marking the unofficial end to the summer season, investors have time to ponder the market. August was a relatively volatile month for stocks, with the S&P 500 trading in a 3.5% range. As we now test the upper end, it seems that positive surprises will be required for a break higher. Economic data, at the margin, were good last week, with consumer spending robust and confidence in the present situation ticking up, although it is worth noting that consumer expectations on future conditions fell appreciably.

Manufacturing data were also decent, with the Richmond Fed Index moving back into positive territory and the Chicago PMI breaking above 50. Inflation continued to prove benign, however, with the Fed's favoured core PCE reading still well below target at 1.6%, supporting our view that a further rate cut will indeed be forthcoming at the September 18 FOMC meeting. Our downbeat growth forecast remains in place, despite last week's data, but better trade news could push stocks out of their range given light positioning.

North Asia: Manufacturing PMIs send mixed signals

China and Korea experienced a robust rebound in manufacturing PMIs this month, recovering from a July low, while Japan and Taiwan's figures continued to be sluggish. Except for China's Caixin manufacturing PMI, which moved above 50 signalling a mild expansion, most other PMIs hovered below 50, indicating a contraction in manufacturing activity. We expect the volatility in PMI readings to persist amid trade tensions and risks of a global downturn. Meanwhile, the Bank of Korea kept its policy rate unchanged at 1.5% last week but affirmed its willingness to support the economy if it deteriorates further. Japan's consumer confidence index fell to 37.1 in August, the lowest level since 2014, while the July preliminary figure for industrial production rebounded by 1.3% MoM. However, forecasts for August and September stayed subdued. Along the same lines, retail sales dropped by 2% YoY after ticking up last month, dragged by a 9% decline in household appliance consumption. Nevertheless, we expect a rebound in retail sales in August ahead of the tax hike that will soon come into effect in October.

Australia/ ASEAN: Weaknesses prevail

After pointing to a stabilisation in June, July manufacturing PMIs weakened again for Indonesia, the Philippines and Thailand, with Indonesia's figure dipping further into contractionary territory from 49.6 to 49. Although Australia's manufacturing PMI is still above 50, it dropped from 51.6 to 50.9. Meanwhile, supply-side data in the Australian housing market painted quite a grim picture despite some optimism over a further uptrend in house prices. July building approvals collapsed by 28.5% YoY, while Q2 construction and private building capex fell by 3.8% and 3.3% QoQ respectively. Supply falling short of demand might be visible next year, supporting a further improvement in house prices, but for now subdued growth, rising unemployment and high household debt burden still dampen market enthusiasm for real estate. On a brighter note, Singapore's July industrial production increased by 3.6%, with electronics outputs up by 22.1% MoM. We expect data to be volatile, as the electronics sector remains fragile given the current global trade uncertainties.

Covered Bonds: Almost the entire market submerges below zero yield

Dovish central banks have caused negative yields to now dominate the entire covered bond space, with 95% of bonds yielding below 0% and 65% even below the ECB's deposit rate of -0.40%. This is despite many issuers having turned to longer tenors during the first half of 2019 to avoid negative yield for investors. The primary market has now slowly reopened after a four-week summer break and two German banks were able to attract strong investor demand despite pricing at the lowest yield ever seen on the market, close to -0.60% for three to four year maturity. However, we expect supply to continue despite these yields, driven by reinvestment and potential QE from the ECB. The last EBA report on bank funding plans highlighted that market-based funding should play a central role over the next three years given expected asset growth. We think that banks are likely to continue to favour covered bonds to benefit from cheap funding. The ECB's 2018 annual statistics also indicate a turning point for the sector as the covered bond market grew by 4.7% YoY, the first increase in six years.

What to Watch

- The global PMIs will be closely watched for clues on whether the manufacturing slowdown may be starting to bottom out.
- Attention in the US will be on the ISM manufacturing and non-manufacturing data and final PMI readings, following the weak preliminary results of the latter series.
- In the Eurozone the final PMIs, the breakdown of Q2 Eurozone GDP, and German industrial production and factory orders data will likely highlight the fragile state of the Eurozone economy.
- Trade data for Malaysia and China will be released this week. We predict a further contraction in exports given the gloomy outlook on US-China trade issues. The Reserve Bank of Australia will probably keep rates unchanged but remain dovish. August CPIs figures are expected to be soft for most countries.

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