ZURICH

Weekly Macro & Markets View

Highlights and View

- **US economic momentum weakens further with the service sector now facing headwinds too**

  While manufacturing remains under pressure cracks are appearing in the non-manufacturing sector as well, with new orders and employment indicating further challenges ahead

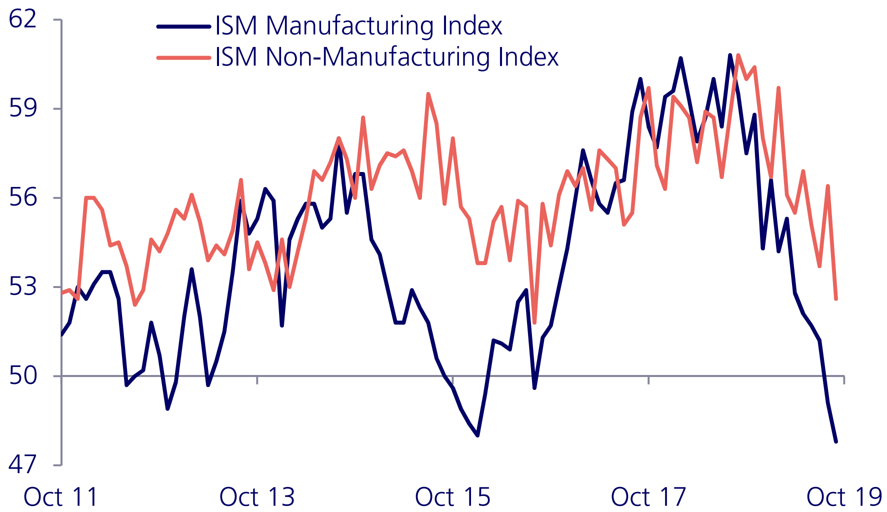
- **A rollercoaster week for stocks as poor US ISM data prompt a sharp fall before bouncing back**

  Disappointing ISM data sparked renewed fears of recession and while this is our base case for 2020, hopes of further Fed easing and trade talks will likely dictate short-term direction

- **Boris Johnson presents his plan to break the Brexit deadlock**

  Johnson softens on his position by proposing a single regulatory zone on the island of Ireland but the short time limit and the Northern Ireland Assembly's factual veto right are unlikely to be accepted by the EU

The US economy loses momentum



Source: Bloomberg

In the end, the S&P 500 lost a modest 0.3% last week after a broad trading range of almost 5%. Investors were torn between further evidence of a slowing economy and hopes for more monetary stimulus and progress in trade negotiations which are planned to restart this week. The ISM Manufacturing index fell to 47.8, the lowest level in a decade, with stalling new export orders underlining the growing headwinds for the manufacturing sector caused by trade uncertainty and a weaker global environment.

While the non-manufacturing sector was holding up relatively well so far, cracks are now appearing, with the ISM Non-Manufacturing weakening to 52.6, the lowest level since 2016. Particularly worrying was the dip in the employment sub-component to a 5-year low, although this has not yet translated into significantly weaker labour market data. The pace of new nonfarm payrolls slowed further to 136'000 in September, with the 6-month moving average at 154'000, which was enough to push down the unemployment rate to 3.5%, the lowest since 1969, reflecting how tight the labour market remains. Despite this, and the fact that the broader underemployment rate fell to a 19-year low, wage growth decelerated markedly to 2.9% YoY, the weakest in more than a year, giving the Fed more room to cut rates further in the months ahead.

Credit: Volatility rises, but search for yield persists

Credit, along with other financial markets, was jolted last week by weaker data, especially out of the US. While credit should be more sensitive to downside economic risks, especially given high leverage, credit investors typically also tend to look through short bursts of volatility which was also evident last week. Initially, credit markets were relatively calm, but later on caught up with the volatility in equity markets. On the week while CDS outperformed equities, cash markets underperformed. High yield was notably weaker, with energy sector spreads widening by over 70bp, despite the fact that major US stock indices had clawed back a significant part of their mid-week losses by Friday. Primary activity was subdued following the September deluge, although primary markets typically tend to slow down amid higher volatility. The impact of easy monetary policy was still evident though, with Monte Dei Paschi's covered bond seeing very strong demand, due to the rarity provided by positive yield in a sector where 97% of bonds trade at sub-zero yields.

Eurozone: Revisions to PMI survey give further cause for concern

The final composite PMI for the Eurozone was revised down compared to the flash estimate, which was already weak. The PMI came in at 50.1 in September, revised down from the flash estimate of 50.4, and from 51.9 in August, driven by weaker services confidence than originally thought. At these levels, business confidence is barely consistent with any growth at all in the region. Forward-looking indicators within the survey such as new orders and employment hiring intentions were soft and there is increasing evidence that weakness in the manufacturing sector is transmitting to the service sector. Meanwhile, Italy has announced its fiscal targets for the next three years, targeting an unchanged budget deficit of 2.2% of GDP in 2020, without the scheduled VAT tax rise, or a substantial reduction in the structural deficit. However, a stand-off with the European Commission is unlikely given the more conciliatory tone of this new government coalition compared to the previous one. Eurozone equities were under pressure last week, on the weak macro data coming out from both the region and in the US.

Switzerland: Swiss franc dips as data weaken further

Leading indicators have deteriorated and the manufacturing PMI fell back to a cycle low in September. The employment component is below 50, meaning that businesses plan to shrink, rather than expand, the workforce. The SNB's business cycle signals indicate that weakness above all reflects a sharp deterioration in exports to Germany while demand from other regions is holding up better. Within manufacturing, conditions are mixed, with the pharmaceuticals industry doing well while suppliers to the auto industry and producers of machinery face challenging conditions. So far, domestic demand has been resilient, and we maintain our view that the expansion will continue, albeit at a sluggish pace.

The franc weakened last week along with some other European currencies. This appears to have reflected underlying data weakness, though SNB actions may also have contributed, with sight deposits edging higher on the week. We expect demand for the Swiss franc to remain solid, with forex interventions set to continue.

North Asia: Japan's consumption tax hike and Tankan business survey in focus

The economic impact of the consumption tax hike from 8% to 10%, effective as of Tuesday last week, will be less severe than the three percentage point hike in 2014. The labour market and personal income levels are in better shape than five years ago, and a series of measures have been taken to cushion the negative impact on households. Free pre-school education, levies for food and non-alcoholic beverages as well as rewards for cashless payments until summer next year have been introduced. However, these measures have not helped consumer sentiment, which has fallen for 16 months in a row to a level below that seen after the 2014 consumption tax hike. In particular, elderly household sentiment has tumbled. Retail sales have improved in August, mainly due to tax frontloading demand.

Meanwhile the latest quarterly Reuters Tankan business sentiment indices fell less than expected, but the outlook remains cautious, particularly for smaller companies. Finally, industrial production in August fell more than expected.

ASEAN: Will the improvement in manufacturing PMIs sustain?

The headline manufacturing PMIs for Asia came in relatively better than expected in September. Australia stands out with the most robust reading, rising from 53.1 to 54.7, which is worth noting considering the deterioration in most developed markets. China and Taiwan experienced a robust improvement, with Taiwan's reading hitting the 50 line after twelve consecutive months under water. However, a few bright spots do not mask the prevalent weaknesses. The ASEAN aggregated manufacturing PMI, while picking up slightly to 49.1, is still hovering below 50, mainly led by Malaysia and Indonesia. Despite improving headline readings, the new export order component for most countries remains below 50, driven by the negative impact from trade tensions. Japan, South Korea and Singapore, closely tied to the global supply chain, also saw their manufacturing PMIs dipping further into contractionary territory. Australia's and India's central banks have cut their policy rates by 25 bps to 0.75% and 5.15% respectively, in an attempt to provide further support to their economies.

What to Watch

- China's markets will re-open on Tuesday, following the 'Golden Week' National Day celebrations, while Hong Kong's will be closed on Monday for the Chung Yeung Festival.
- Chinese and US delegates will meet in the US for a new round of high-level trade talks. In Japan, we will focus on August machinery orders and household spending data, while Australia will release business and consumer confidence surveys. Malaysia will announce its 2020 budget next week while the Monetary Authority of Singapore (MAS) is expected to reduce its NEERSGD slope by 50 bps. Industrial production data will be reported in India and Malaysia.
- In the US, investors will focus on inflation numbers and the Fed minutes, while small business optimism is expected to have ticked down in September.

Disclaimer and cautionary statement

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