

Weekly Macro & Markets View

Highlights and View

- **Credit markets have notably underperformed equities, where several indices have broken to new highs**

Credit fundamentals continue to deteriorate, taking a toll on high yield spreads but the weakness may filter into equities, where levels seem stretched and some caution is warranted.

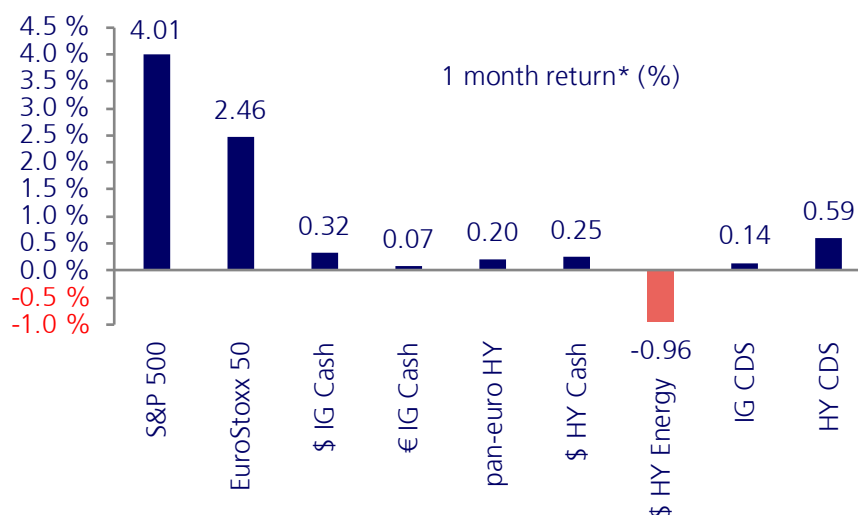
- **China intends to tighten IP protection controls and punishments**

We applaud the announcement as a step forward in the negotiations with the US, assuming it is not purely paying lip-service.

- **Eurozone Flash PMIs show stabilisation in manufacturing, but further declines in services confidence**

The overall Eurozone Composite PMI is consistent with anaemic growth, making the region extremely vulnerable to any further shocks.

Credit sends ominous signals



Source: Bloomberg/ Note: * Excess return for credit cash indices

Credit markets have been notably underperforming equities recently, which was seen again last week when US CCC credit spreads hit 1'000bps on Friday. Indeed, over the last month, when some stock indices hit new records, credit spreads widened, led by US high yield. Credit fundamentals have been weak and worsening for quite some time. With leverage at a record in our estimation, default rates are picking up in US high yield. This was to be expected and is likely to continue given the tightening of credit standards seen in the Fed's bank lending survey, which is one of the best leading indicators for default rates in our view. Leverage is likely to rise even further, as supply has surged this year, with earnings largely flattening out. While central bank support has been a key pillar of strength so far, it remains to be seen how long it keeps a lid on current tight credit spreads. Meanwhile, the picture in equities has also become mixed. Following a strong run in recent weeks, equity markets took a breather last week, with most indices retreating modestly. Having experienced persistent outflows this year, investors have allocated more towards stocks in recent weeks, leading to somewhat stretched levels in the short term. While year-end positioning has the potential to drive markets higher, some caution is warranted given the recent run.

US: Building permits reach a post-recession high

The S&P 500 struggled to keep up the momentum of the past few weeks as trade negotiations dragged on and economic data failed to inspire. While NAHB home builder sentiment ticked down in November, housing data for October show a strong rebound from the weakness the month before. Housing starts grew 3.8% after September's 7.9% drop while building permits rose to the highest level since 2007, indicating a healthy recovery in construction activity. Markit's Manufacturing PMI rose to 52.2 in November from 51.3 in October, indicating that the

manufacturing slump may be behind us for now with production and new orders accelerating. The Services PMI also picked up to 51.6, which lifts the Composite Index to a still modest 51.9. Employment increased marginally as service providers remain hesitant to hire additional workers. Overall, it's good to see some stabilisation but the index levels still point to economic growth slowing down further to below trend levels.

Eurozone: Mixed data leave equities rangebound

Last week's Eurozone Flash PMIs were a mixed bag. There were further tentative signs of stabilisation in manufacturing confidence, albeit at very weak levels. The Eurozone Manufacturing PMI increased for a second month, to 46.6 in November from 45.9 in October and 45.7 in September. The forward-looking manufacturing new orders minus stock of finished goods indicator also increased for a second month. However, service sector confidence deteriorated and hiring intentions in both the manufacturing and service sectors remain weak. Indeed, the

overall Eurozone Composite PMI declined to 50.3 in November from 50.6 in October. This is consistent with only modest growth in Q4 and makes the region vulnerable to possible shocks in 2020, such as a further slowdown in the world economy. Eurozone equity markets were rangebound last week on soft economic data and continued uncertainty regarding a Phase 1 US-China trade deal, but an earnings season that has been slightly better than expected. Eurozone companies grew earnings by around 2% YoY in Q3.

Japan/Asia: Data confirm sluggish growth, with export performance stabilising

Japan's Manufacturing PMI for November crept up marginally to 48.6, the first increase in four months. Both the output and new order sub-indices rose 0.8ppts to 48.8 and 45.9 respectively, while the employment index was up as well. The Services PMI recovered from 49.7 to 50.4. Tokyo department store sales had risen 20.7% YoY on rush buying before the consumption tax hike, so the 19% drop in October should not be a surprise. Asian exports showed a mixed picture, with some stabilisation visible in Taiwan and South Korea. In Japan, exports dropped 9.2% YoY

both due to falling prices and volumes. Strong auto sales to the EU could not offset weak exports to the US, while high tech related goods exports experience a slight recovery. Based on data for the first 20 days, we believe that South Korean exports will be down about 10% YoY in November but seem to be stabilising on a sequential basis. Petroleum and auto exports are doing better than semiconductor exports. In the ASEAN region we note weak exports from Singapore to China and softer gold exports from Thailand following a boom.

Australia: The unemployment rate edges higher

The Reserve Bank of Australia released its November meeting minutes, noting that 'a gentle turning point had been reached' given a slight pickup in GDP growth in 2019 compared to H2 2018. The RBA's MPC members also discussed potential rate cuts, acknowledging 'the negative effects of lower interest rates on savers and confidence'. Meanwhile, the central bank sounded quite positive on employment growth and expected a steady unemployment rate of 5.25%. However, October labour data came in with the largest employment decline in three years

by 19k, significantly weaker than consensus had expected. Although the participation rate edged lower, it was not enough to mask falling employment, driving the unemployment rate up from 5.2% to 5.3%. This puts a lid on wage growth, particularly when businesses are cautious to expand their workforce amid slow economic activity and a gloomy growth outlook. Hence, we expect further monetary and fiscal easing to support growth and help to narrow the employment gap.

Bonds: Yields stable for now

Bond yields are range trading, rising and falling in line with perceived prospects of a breakthrough in US-China trade negotiations. Last week, a near-term agreement looked less likely, leading yields down. The US 10yr yield fell back to 1.75% before edging higher on Friday as US macro data improved, with both sentiment and activity surprising on the upside. With the short end currently anchored by stable policy expectations, this has resulted in significant curve flattening, with the 2yr/10yr Treasury spread falling from 27bps just two weeks ago to 14bps on Friday.

Elsewhere, yields were broadly unchanged on the week. ECB President Lagarde delivered her first policy related speech, highlighting the need for fiscal action in the region. There was little news in the message and bond markets failed to respond, with inflation expectations remaining at a depressed level. Looking forward, we see limited upside to bond yields from here, given that both growth and inflation remain weak and that prospects for a comprehensive US-China trade agreement still look uncertain.

What to Watch

- We do not expect any policy rate changes when the Bank of Korea's MPC convenes on Friday. In Japan, we will see the usual end-of-the-month economic data festival. Industrial production for October will be published in Taiwan, South Korea, Thailand and Singapore, along with South Korean November exports and Q3 GDP in Taiwan and India. On Saturday, China's NBS Manufacturing PMI for November will be released.
- In the Eurozone, business confidence and other macro data are likely to confirm an economy that is growing at a sub-trend pace.

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