December 16, 2019

Weekly Macro & Markets View

Highlights and View

- **In the UK, the Conservative Party is the clear election winner with the largest majority in more than 30 years**

  The solid majority clears the path for Brexit with parliament expected to pass Johnson's withdrawal agreement before the end of the year.

- **The US suspends new tariffs on imports from China as the two nations agree on a partial trade deal**

  The agreement as well as the partial rollback of tariffs are even more modest than expected but help to remove some near-term uncertainty.

- **China's economic activity data for November came in better than expected**

  However, the road remains bumpy, and more policy support is needed next year.

The US and China agree on a partial trade deal

Source: Bloomberg

The S&P 500 reached a new record high, rising 0.73% last week, lifted by the prospect of a partial agreement between China and the US. Both sides confirmed a limited trade deal that is expected to be signed early next year. While the scope seems even more modest than expected, the suspension of new tariffs on imports from China as well as a partial rollback of tariffs imposed in September remove at least some uncertainty in the short term. As expected, the Fed remains on hold, feeling that it has done enough for now to support the weakening economy with the three rate cuts since July. The median dot now signals no change in rates for all of 2020 although four members do see the need for a rate hike. Interestingly, and somewhat inconsistent, the Fed lowered its estimate for the unemployment rate and expects it to fall below the neutral rate for every year between now and 2022. Despite this, inflation is not expected to rise substantially over the forecast horizon. We continue to believe that growth in 2020 will weaken more than the Fed expects. Most of the burden will weigh on consumers, who have shown some signs of weakness recently. Retail sales growth slowed in November, though this could have been affected by the timing of the Thanksgiving holiday period. This is also true for initial jobless claims, which jumped to the highest level in more than two years due to difficulties with the seasonal adjustment.

UK: Johnson's victory clears the path for Brexit

With a landslide victory Boris Johnson led the Conservative Party to the largest majority since 1987. The pound soared and the FTSE 250, which consists of smaller, more domestically focused companies than the FTSE 100, jumped to a record high as the near-term political uncertainty has been removed. With a solid majority the parliament is expected to pass PM Johnson's withdrawal bill before year end, clearing the path for the UK to leave the EU by the end of January 2020 and to enter the transition period that will last until the end of 2020. In the near term, reduced uncertainty and a clearer Brexit path may help to support growth and activate some pent-up spending demand. However, given that it is very unlikely that the EU and the UK will be able to reach a substantial trade agreement before the end of next year, uncertainty and the risk of a no-deal Brexit will reappear in a few months, weighing on business activity. Fortunately, increased fiscal spending will kick in by then, mitigating the headwinds to growth.

Eurozone: Christine Lagarde kicks off first monetary policy meeting as ECB President

As expected, Lagarde announced a strategic review of monetary policy, the first since 2003. The review will be wide-ranging, including issues such as climate change and inequality, as well as the traditional focus of central banks, inflation. It is expected to be complete by the end of 2020. In the meantime, we suspect the ECB will be cautious in making further changes to monetary policy. With regards to the economic outlook, Lagarde said inflation was not expected to return to target even at the end of the ECB's forecast horizon. This could be interpreted as a dovish comment, because it implies further stimulus is needed. However, she also indicated that some downside risks to the economy had diminished. Last week's data continued a recent theme: improving sentiment surveys, but still weak hard data. The German ZEW sentiment indicator rose to its highest level in almost two years, but Eurozone industrial production fell 0.5% MoM (-2.2% YoY) in October. Meanwhile, equity markets picked up towards the end of the week as the trade deal between the US and China came into focus.

Japan: Deteriorating 'Tankan' for small companies

The Tankan, the quarterly corporate survey conducted by the Bank of Japan, revealed a mixed picture. On the positive side, the non-manufacturing sector seems to be doing better than expected, as the headline index for large companies remained roughly stable with a diffusion index (DI) of 20. The corporate capex outlook for large companies also improved slightly to +6.8%, even though disappointing core machinery orders for October and machine tool orders for November do not confirm this optimistic outlook. Meanwhile, the DI for large manufacturers deteriorated from 5 to 0. Though not in the focus, we are more concerned about the deteriorating outlook for small manufacturing companies, with a DI of -9 and an outlook of -12. Remember that small companies are the backbone of Japan's labour market. Another corporate survey conducted by the MoF revealed a steep drop in Q4, but the outlook for Q1 and Q2 2020 is encouraging. The Composite PMI for December, released today, was stable at 49.8, underpinned by a slight improvement in the service sector.

China: Bumpy, but stabilising

Activity data for November came in better than consensus had expected. Industrial production growth recovered from 4.7% to 6.2% YoY, driven by private companies, while SOEs again experienced slower growth, fully in line with the government's target. Business investment growth increased from 3.7% to 5.2% YoY, supported by higher infrastructure spending and property investment, while manufacturing investment suffered from trade war worries. At first glance, growth in retail sales to a five-month high of 8% is encouraging, however, a surge in pork price inflation due to swine flu fever was behind the surge. Effectively, *real* spending growth was unchanged. Stabilising credit growth, with long-term corporate loans expanding, and stronger import growth suggest a stabilisation or even a slight improvement in China's economic environment. However, the road remains bumpy, as the ups and downs in economic indicators over the last few months confirm. Policy stimulus needs to be forthcoming, certainly a topic that top policymakers discussed during the Central Economic Work Conference last week.

Credit: Firm tone driven by trade and energy

Credit markets were firm last week, although they continued to lag equities, with investor sentiment supported by optimism around a US-China trade deal. US high yield spreads tightened sharply, driven by a significant rally in the energy sector, which saw spreads tighten by around 66bps on the week, driving the sector spreads to tighten finally on the year. The technical picture remains supportive with continuing fund inflows, while supply drops down to a trickle given seasonal factors. European banks' take up of the ECB's new TLTRO program seemed low, at €97.7bn, but we think this program is likely to see a more uniform demand, rather than a front-loaded one, due to the new feature of borrowing limits per operation, hence we wouldn't jump to conclusions yet. European banking sector profitability was again reflected in the lowering of guidance by Credit Suisse and Deutsche Bank. All in all, we expect momentum and liquidity to continue driving credit in coming months, although the pace of spread tightening should slow down.

What to Watch

- In the Eurozone, various business sentiment surveys will be watched closely to assess the extent of any stabilisation in the manufacturing sector.
- The four Asian central banks of Taiwan, Indonesia, Thailand and Sri Lanka will convene this week. We do not expect any changes in their respective policy rates.
- In Asia, various economic data for November will be released, such as export data in Japan, Taiwan, Singapore, Indonesia and Thailand, and industrial production data in Taiwan, Singapore and Thailand. Japan, Hong Kong, Singapore and Malaysia will release CPI data.
- The G3 flash Manufacturing PMI will show whether conditions continue to stabilise in the global economy.

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Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

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