

Weekly Macro & Markets View

Highlights and View

- **The Fed's latest lending standard survey shows a tightening in credit standards**

This is an ominous sign in the late stage of the credit cycle, although it may be too early to jump to conclusions and further data points are awaited to confirm the tightening.

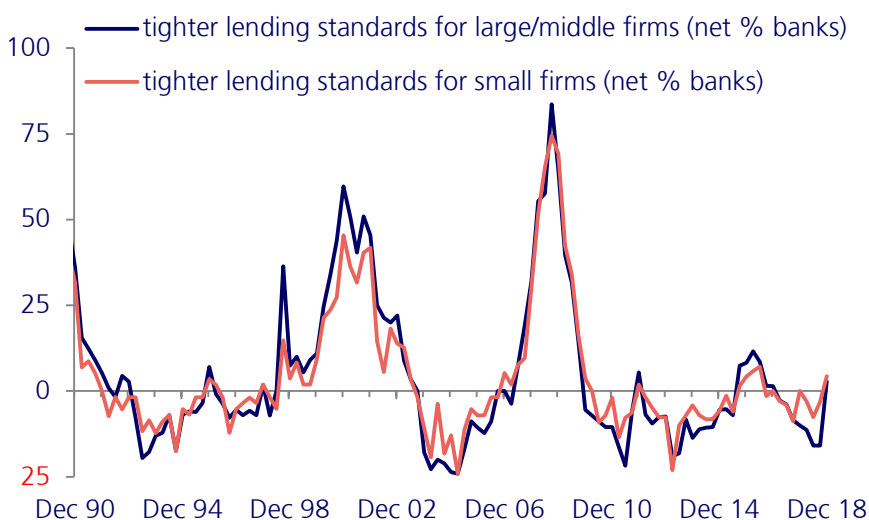
- **European Commission cuts its 2019 growth forecasts for the Eurozone and Italy**

While the forecast reductions should not be a surprise to investors, they have put attention back on to Italy's precarious fiscal position, putting pressure on the government not to do anything more to unnerve investors.

- **APAC central banks are taking a more dovish stance, with the RBI even cutting its policy rate**

The dovish tilt will be maintained amid a more challenging global economic environment and reduced inflation fears.

Ominous signs from credit standards



Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices; Notes: Domestic banks, NSA, lending and demand in the last three months. Small firms have annual sales below \$50 million.

While credit markets have been seeing a ferocious rally, which we think is likely to continue in the short term, there are further signals emerging that suggest the credit cycle is maturing rapidly. The Fed's latest Senior Loan Officer Opinion Survey (SLOOS) is quite significant in this regard. The lending standards are one of the more reliable leading indicators for credit markets and often forebode a weakening in economic activity. The latest SLOOS has shown a tightening in lending standards for both large and small firms, in addition to continued tightening in other sectors such as commercial real estate and credit cards. While one possible explanation is the influence of volatility in credit and loan markets during Q4 2018, the next few data points are critical in confirming whether or not this is a one-off. Even before the latest uptick, we were concerned about small firms, which saw harsher standards than large firms. While it's not our conclusion that the end of the cycle is imminent, this certainly raises room for caution. However, the short-term mood in broader credit remains upbeat, as inflows continue and primary markets are drawing strong demand from investors. While CDS indices had led the way in the rally, they took a pause and passed the baton on to cash credit, which rallied significantly over the week.

Italy: Italian spreads widen as EU revises down growth forecasts substantially

The European Commission revised its 2019 growth forecast for the Eurozone down substantially, from 1.9% to 1.3%, and for Italy in particular, from 1.2% to just 0.2%. This unnerved bond investors, with spreads widening between Italy and Germany to their highest levels this year. Eurozone equity markets sold off on the announcement last week as well. Italy is already in technical recession, having seen two quarters of negative growth in 2018 H2, and the latest data suggest the contraction will drag on at least into early this year. The composite PMI

for Italy declined from 50.0 to 48.8 in January, in sharp contrast to Spain for example, which saw an increase to 54.5 from 53.4. While episodic periods of volatility in Italian bond and equity markets are to be expected, the danger is that a prolonged recession will tip Italy into a more severe fiscal and bond market crisis. The situation therefore requires careful monitoring. However, the weak data will also put pressure on the government not to unnerve bond investors further by engaging in continued aggressive fiscal spending or other unorthodox policies.

US: The service sector keeps a healthy pace

A decent start followed by a weaker second half left the S&P 500 basically unchanged over the course of last week. Investors were spooked by further signs of weakening economic momentum outside of the US and indications that the trade negotiations between China and the US seem to face some headwinds. Meanwhile, the US economy still enjoys a solid pace as confirmed by the latest ISM Non-Manufacturing survey. Although it receded to 56.7 in January from 58.0 the month before, both the headline number and new orders keep signalling a continuation of

strong business activity in the service sector. New export orders fell to the lowest in two years, however, reflecting weaker business activity in the rest of the world. Some caution is also visible among households, with consumer debt rising by the slowest pace in three months. As expected, initial jobless claims fell back from their recent shutdown-induced spike, though not yet to the levels seen before the shutdown.

Eurozone: German headline industrial data remains weak, with some bright spots

Industrial production in December fell 0.4% MoM (3.9% YoY) in December, while headline factory orders were also weak. Industrial production in Q4 was lower than in Q3, implying downside risks to the official 2018 Q4 German GDP data to be released this week. However, there were some bright points in the detail of the industrial production and factory orders reports. For example, the factory orders data showed that auto orders are rebounding sharply after disruption caused by new diesel emissions standards in Q3 last year, which severely

impacted orders and production. 3m/3m auto orders grew 10.2% in December, suggesting the impact from this disruption is at least fading. Nevertheless, broader conditions and sentiment in the German manufacturing sector remain weak, implying continued downside risks for the economy in H1. This underlines the importance of progress in trade deal talks between China and the US and Brexit amongst other things in order to stabilise sentiment.

APAC: Central banks are turning more dovish

Due to the Lunar New Year, it would have been a quiet week, however, APAC central banks kept us busy, with turnarounds towards a dovish tilt. Australia's RBA kept its policy rate unchanged, as expected, but lowered its GDP growth forecast for this year from 3.5% to 3%, and its inflation forecast by 0.25 bps to 2%. While the weak global economic environment and falling house prices were acknowledged, the strong labour market is the main reason for an overall balanced RBA stance. India's RBI cut of its policy rate by 25 bps to 6.25% came as a surprise to us, even

though we had expected a move towards a neutral stance from "calibrated tightening". In RBI Governor Das's first policy meeting, the MPC voted 4:2 for the rate cut and reduced its inflation forecast substantially. Thailand's BoT kept its policy rate unchanged. While the downside risks to growth and inflation were acknowledged, two out of six attending MPC members voted for a rate hike. Philippine's BSP kept its policy rate unchanged, but the tightening tilt seems to have changed towards a more neutral stance, as inflation fears subside.

Covered Bonds: ECB indecision regarding the future of TLTRO boosts primary markets

We feel that the ECB needs to proactively tackle the end of its long-term cheap funding operations, technically known as TLTRO. President Draghi appeared reluctant in January to discuss new operations and renew fresh funding for banks. We think that not extending these schemes could turn out to be a policy error and hamper European banks' profitability. Many banks have already warned the ECB about the risk of a sharp increase in their cost of funding. A side effect of this uncertainty was the deluge of covered bonds in the primary market, with the €40bn

monthly volume marking the highest January of the last eight years. For instance, Deutsche Bank anticipates issuing as much as €6bn in covered bonds this year to replace TLTRO funds. We remain constructive on covered bonds and think they are good value fundamentally. Real money investors, including bank treasuries chasing HQLA (High Quality Liquid Assets) eligible bonds, have stepped in and replaced the ECB bid. We think that reinvestment of the redemptions of the ECB holdings will remain a strong support.

What to Watch

- In the US, small business optimism is expected to remain solid while inflation is likely to have weakened on an annual basis. Retail sales will provide insights into households' purchasing behaviour in the last month of 2018.
- Given the weak headline industrial production data, there are downside risks to the first estimate of German Q4 GDP to be released this week.
- In Japan, Malaysia and Taiwan, statistics for Q4 GDP growth will be released. In China, the focus will be on aggregate financing, exports, CPI and PPI data for January. Don't be surprised if lending has soared in China, a usual phenomenon in January. Taiwan's and Indonesia's export performance in January is also worth watching. Japan's financial markets are closed today due to a public holiday.

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