February 25, 2019

Weekly Macro & Markets View

Highlights and View

- **Japan's economy is slowing at a rapid pace**

  The broad deceleration gives us reason for concern, and suggests that the economic outlook has started deteriorating even before the consumption tax hike in October.

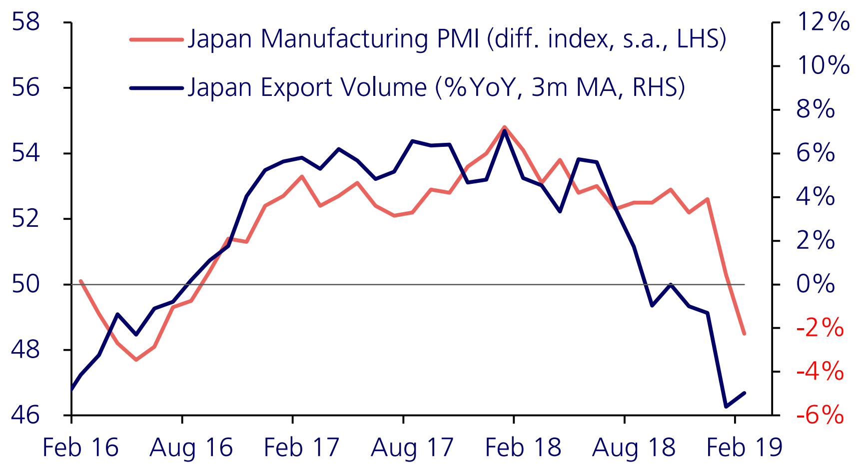
- **Three Tory MPs join the newly formed "Independent Group" in the UK Parliament**

  With no tangible progress on the withdrawal agreement with the EU, patience in parliament is running thin. The defections reduce Theresa May's already slim majority and increase the probability of parliament taking over control of the Brexit process.

- **Eurozone data weaken further, led by Germany**

  Growth prospects are vulnerable and will be dependent on more positive developments in global trade and stronger growth in emerging markets.

Growth slows significantly in Japan



Source: Bloomberg

The latest set of economic data suggest that growth has slowed significantly in the world's third largest economy. The steep drop in the manufacturing PMI in January was confirmed in February, with the PMI falling even further below the 50 line, which in most developed countries indicates contraction rather than growth. The monthly Reuters Tankan paints a similar picture. The manufacturing diffusion index has fallen 10 points in the first two months this year from 23 to 13, while the three-month outlook is also down 10 points. The electric machinery sector was particularly affected, down 18 points, obviously a victim of the deteriorating semiconductor cycle. Even the non-manufacturing sector was hit, with the index falling by 9 points to 22, with all subsectors contributing. We are concerned about these numbers, particularly as they cannot be explained by extraordinary factors like natural disasters or factory closures. Adding to the woes, we note that January export volumes fell at a speed not seen for years, with exports to China and the ASEAN countries hit worst. Optical instruments, transport equipment, general machinery, and iron and steel were the sectors most affected. The latest statistics also reveal that machinery orders fell in Q4 last year, the first drop in six quarters. Even the first retail sales related indicators for January were weak, suggesting that falling consumer confidence is now reflected in real data.

US: Tariff increase delayed as trade negotiations continue

Economic data continue to point to a softer first quarter in the US. Core durable goods orders were basically flat in December after a negative November. Capital goods orders fell by 0.7% MoM after having already weakened 1% the month before. The Philadelphia Fed's business outlook survey in February suffered the biggest monthly fall since 2011, and existing home sales dropped to the lowest levels in more than three years. On a more positive note, a recovery in the NAHB Housing Market Index points to a stabilisation in the real estate market while Markit's Composite PMI rose to a solid 55.8 in February given a stronger service sector, though the manufacturing component declined to 53.7. The stock market continued to climb, supported by optimism regarding the trade negotiations between the US and China and further fuelled by President Trump's announcement that he will delay the tariff increase, as well as an indication in latest Fed minutes that the FOMC would potentially be willing to end the balance sheet reduction in 2019.

Eurozone: Data weaken further, led by Germany

The Eurozone manufacturing PMI is now consistent with contraction in the industrial sector, falling below 50 for the first time since 2013 in February. The weakness is led by Germany, where the index slumped to 47.6, with new orders at their lowest since 2012. France, by contrast, saw a small rebound with new orders ticking up. The divergence between Germany and France is noticeable and partly reflects Germany's larger export dependency. The German ifo survey was also weak, with expectations and current conditions softening further, though the pace of decline slowed. Better signs came from the services PMI, which was stronger than expected. The German GDP breakdown was also modestly positive, as the lack of Q4 growth was partly explained by an inventories drawdown, likely reflecting auto sector issues, with capex and exports rebounding. The ECB minutes recognised persistent and broad-based weakness and, given the asymmetry of risks, it will be critical that it takes appropriate actions going forward.

Bonds: Dovish central banks and poor macro data weigh on bond yields

Bond yields edged down last week, weighed by the Bund market where the 10yr yield struggled to stay above 0.1%, while the 10yr Treasury yield was broadly flat, at 2.67%. Global trade developments will be critical, but for now yields are anchored by dovish central banks and poor macro data, in contrast to a more constructive tone in broader risk markets. US inflation breakevens have rebounded since the turn of the year though, boosted by oil prices and the Fed's pragmatic stance, which is encouraging. By contrast, they remain weak in the Eurozone, where the largest economy is struggling and the ECB has arguably started to withdraw stimulus prematurely. While Fitch left the credit rating for Italy unchanged, growth prospects for Italy are poor. Looking through current weakness, looser financial conditions should help to support the global economy. A more constructive outcome to the US-China trade negotiations also appears to be on the table. We therefore maintain our view that the economic expansion should continue, likely providing a modest upside to yields.

Credit: Strong appetite, but clarity on TLTROs is awaited

Credit markets continued their strong run last week, with strong performance across products, sectors and geographies. So much so, that some parts of credit are beginning to look frothy again, such as the US high yield market, where spreads fell below 400bps. The sentiment in primary is also strong, with some US issuers now issuing at negative discounts, implying that some investors are desperate to catch up with the credit rally. All of this said, there are some crucial policy actions required around European banks. While the EUR 4.5bn fine on UBS is likely to be appealed, it shows that the potential for large fines still remains. At the same time, it looks increasingly likely that the ECB will say something regarding its expiring cheap loans to banks (TLTROs) but different ECB speakers have been sending mixed signals, and we think a further delay or reduction of quantity lent will be negative for banks. More importantly, it could be a policy mistake given that banks are already stressed and expect lending standards to be tightened amid a lacklustre economic environment.

Equities: Stocks ride the momentum wave despite worrying economic data

A ninth consecutive week of gains for the Dow Jones index, with other global stock indices following, is indicative that momentum remains the driving force in markets. Encouraging comments from the US President on the trade negotiations with China helped the bullish mood, which has taken hold as a result of a more dovish shift in policy rhetoric from the leading central banks since the turn of the year. While we suspect that this momentum could last a little longer, we unfortunately seem to have returned to an environment where bad economic news is good for markets. The poor global economic readings last week, that would have unsettled investors a few months ago, were largely overlooked and indeed added to the notion that it would require a more supportive role from monetary policy going forward. While we also applaud the shift to pragmatic policy, we are becoming more cautious on the equity rally. Having completed a V-shaped recovery against a deteriorating macro backdrop, investors may need more than tariff hopes and monetary policy on hold to sustain the bullish sentiment longer term.

What to Watch

- In the US, GDP growth for Q4 will finally be published after the shutdown-induced delay. Among more forward-looking indicators, the ISM Manufacturing Survey will shed light on current business activity and new orders, while the Conference Board's Consumer Confidence measure is expected to tick up.
- US President Trump and North Korean leader Kim will meet for a second summit in Hanoi, Vietnam, this week. The Bank of Korea's MPC will convene this week, with no policy rate changes expected. In Japan, most of the usual monthly data will be published later this week, in addition to the MoF Corporate Survey for Q4. In China, both the NBS and Caixin February PMIs will be released, while elsewhere the focus will be on industrial production and CPI data for various Asian economies.
- Eurozone lending and sentiment data will be watched to assess growth prospects, while CPI data will show whether inflation remains resilient to the growth slowdown.

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