May 4, 2020

Weekly Macro & Markets View

Highlights and View

- **The Eurozone sees record GDP contraction in Q1, while the ECB introduces more generous liquidity operations**

  We anticipate growth will rebound sharply in H2, as easing of lockdown restrictions combines with unprecedented monetary and fiscal stimulus.

- **US GDP fell by an annualised 4.8% in the first quarter, the worst since the financial crisis**

  Personal consumption was particularly badly hit, falling 7.6%. That's the weakest quarter in four decades. Unfortunately, Q2 will probably be even worse.

- **Japan and China released mixed activity and business sentiment data for March/April**

  While Japan's recession is accelerating, China's economic activity is recovering, but remains patchy in our view.

A record contraction in the Eurozone economy

Source: Bloomberg

In Q1 the Eurozone experienced its largest recorded economic contraction ever and there is worse to come for Q2. Eurozone GDP fell by 3.8% QoQ in Q1, with the data currently available showing that the size of a country's contraction closely matches the severity of the respective country's lockdown. Nevertheless, if plans for a gradual easing of restrictions over the next few weeks proceed broadly as planned, we anticipate overall growth will rebound sharply in the second half of the year, though not without long-term consequences in terms of consumer behaviour, the way we work, and monetary and fiscal policy. Meanwhile, the credit rating agency Fitch came out with an impromptu downgrade of Italy's sovereign credit rating last week, pushing it to the lowest rung on the investment-grade ladder, BBB-, with a stable outlook. Italian government bond prices did not move much on the news and in the near term, the rating agencies are unlikely to want to be blamed for precipitating another Eurozone debt crisis by pushing Italy to below investment grade. However, in our view some form of debt mutualisation across the Eurozone will be needed to keep rating agencies and bond investors happier in the longer term. Finally, at the ECB meeting last week the size of asset purchases was kept unchanged but the terms on existing liquidity operations for banks were made more generous and a new liquidity operation with even less conditionality was introduced.

Credit: Supply hits another record, but the ECB disappoints investors

Credit spreads tightened as US investment grade supply set a new monthly record in April, with other credit markets also showing strong activity. Boeing issued USD 25bn debt last week, the largest deal this year. Notably, higher supply amid declining earnings is likely to increase leverage, but it is encouraging that major companies can access liquidity, largely due to the Fed's actions. Judging by price action, however, the ECB disappointed investors as speculation was rife that it would announce acceptance of fallen angel credit – which did not come to fruition. We believe that the ECB is more constrained than the Fed in buying fallen angel debt and is unlikely to do so. Nonetheless, the ECB did announce rate cuts for its existing cheap loans to banks (called the TLTROs) and launch another new more flexible cheap loan program (called PELTROs). Bank lending will be driven by government guarantees, however, as banks have raised loan loss provisions, which we think are likely to rise further. Energy sector spreads tightened sharply, as oil prices rose.

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US: The S&P 500 had its best month since January 1987

With a performance of 12.7% April was the best month for the S&P 500 since January 1987. Entering May, the index failed to hold on to its weekly gains with a 2.8% dip on Friday, ending the week with a small loss of 0.2%. Rising US-China tensions regarding the origins of the COVID-19 pandemic weighed on investors' sentiment. President Trump mentioned tariffs as a potential punishment and the possibility of the US terminating the phase 1 trade deal if China does not live up to its commitments. However, re-imposing tariffs could make a severe recession worse given the state of the economy. GDP fell by an annualised rate of 4.8% in Q1, the worst quarter since Q4 2008. As the lockdown only started to have an impact in the last few weeks of March, it is already clear that Q2 will look much worse. Personal consumption tumbled by 7.6%, a more dramatic fall than in any quarter during the financial crisis and in fact the weakest quarter in four decades. Consumer confidence took a massive hit in April but at least an improvement in expectations provides a silver lining.

Japan: Recession is intensifying

PM Abe extended the nationwide state of emergency today in order to contain new corona infections, which will further dampen the economic outlook. Most of the economic indicators published last week confirmed that the service sector is indeed falling into a tailspin. While department store sales were already down about 10%YoY in March, the latest readings suggest they tumbled by about 80% in April. Labour market conditions are deteriorating as well, which is not yet visible when looking at the unemployment rate, but we note that the job-to-applicant ratio has clearly rolled over from its cycle high at 1.63 six months ago to 1.39 in March. The manufacturing sector seems to be faring better, with industrial production even rising slightly in Q1 versus Q4 last year and with companies forecasting a further improvement for April. This seems too optimistic in our view, as major car manufacturers are already planning a significant production cut. Equities rose 4% until mid-week amid the Bank of Japan expanding QE, but then gave up nearly all gains by Friday. 'Golden Week' holidays will last until Wednesday.

China: A stony recovery path

China's Manufacturing PMIs for April retreated somewhat from March levels, which had indicated a recovery from the mid-February activity trough. While the NBS Manufacturing PMI remained slightly above its 50 'boom/bust' level, the Caixin PMI fell below it again, indicating that manufacturing SMEs are still struggling. Meanwhile, the NBS Non-Manufacturing PMI even rose in April, confirming that the gap between manufacturing and service sector activity is diminishing. Tourist attractions are re-opening, with Beijing's Forbidden City in the headlines, but in a highly controlled manner and with the number of visitors far below pre-crisis levels. We believe China's foreign trade will suffer this quarter following lockdowns in most Western countries. In April, container ship and bulk carrier traffic in Chinese harbours slowed, while the New Export Order PMI tumbled again. We are concerned by US President Trump's recent considerations to impose new tariffs and/or restrict US public pension fund investments into Chinese equities to punish China for the outbreak of the COVID-19 pandemic.

ASEAN: Still at a critical juncture

Despite stringent measures and extensive testing, Singapore saw a spike in COVID-19 infections during the last two weeks with more than 18,000 cases as of May 4 and migrant workers accounting for around 85% of cases. Given poor living conditions and limited healthcare, migrant workers are among the most vulnerable groups not only in Singapore but also in other parts of the world. In Indonesia and the Philippines, despite limited testing, there are still a few hundred new cases reported daily. Meanwhile, March and April economic data show signs of fatigue. Thailand and Vietnam, recognised manufacturing hubs in the region, saw a production dip of around 10% to 11% YoY. Singapore's unemployment rate moved a touch higher to 2.4% in Q1, probably not yet fully reflecting the COVID-19 impact. As retrenchments in the retail and F&B sectors start picking up, Singapore's job data are likely to be much weaker in Q2. While a gradual easing of lockdowns in some countries and a pickup in China's demand might help, we are likely to see a visible recovery only in the second half of the year.

What to Watch

- On Tuesday the German constitutional court will report its verdict on the legality of the ECB's QE programme, but is unlikely to rule against it. Meanwhile, the European Commission will present the latest plans for the European Recovery Fund. The credit rating agency Moody's will report on Friday, we believe it is unlikely to push Italy below investment grade.
- In the US, the ISM Non-Manufacturing Index is likely to show a massive drop as the service sector has been particularly hard hit by the lockdown. Labour market data will be horrible but are lagging in this crisis with more focus on initial jobless claims.
- As Australia's policy rate has already reached its lower bound, we do not expect the RBA to cut further. Malaysia's central bank, however, is likely to deliver another policy rate cut. Key statistics like house prices, building approvals and retail sales will be released for Australia. Foreign trade data for China, Taiwan, Malaysia and the Philippines as well as Q1 GDP data for Hong Kong, Indonesia and the Philippines should be watched. Financial markets will reopen on Wednesday in China and on Thursday in Japan following prolonged holidays. They will be closed on Thursday in Indonesia, Malaysia and Singapore and on Monday and Wednesday in Thailand due to local holidays.

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