

Weekly Macro & Markets View

Highlights and View

- **There were no new policy announcements by the ECB and President Lagarde downplayed concerns about low inflation**

While the ECB has done a lot in recent months, it may eventually have to do even more to stimulate growth and inflation, especially if the euro continues to strengthen.

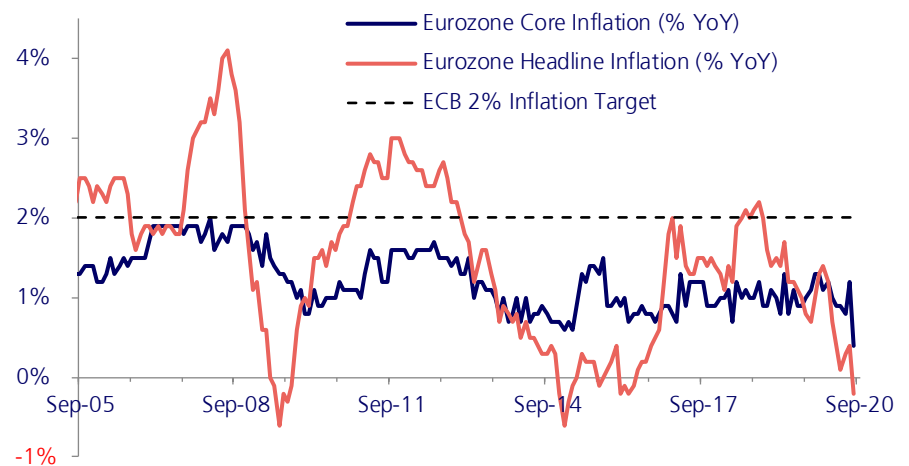
- **The UK government announced its intention to renege on parts of the EU withdrawal agreement causing sterling to suffer**

The controversial bill must still be passed by parliament, but its publication undermines trust and increases the risk of a no-deal outcome.

- **Yoshihide Suga was elected president of Japan's ruling party and will succeed Shinzo Abe as PM**

We do not expect a major change in policy but will watch out for potential snap elections in Q4.

The ECB keeps policy unchanged despite low inflation



Source: Source: Bloomberg (Note: The ECB targets inflation below, but close to, 2%)

Last week's ECB monetary policy meeting and press conference delivered no changes in policy. Indeed, the overall tone was less dovish than some commentators may have expected given how low inflation is currently and given the recent strength of the euro. The ECB President, Christine Lagarde, did not appear too concerned about the current low levels of inflation, arguing that this was due to a number of temporary one-off factors, such as the cut to German VAT in 2020 from July to December, as well as distortions created by the different timing of summer sales this year due to COVID-19 lockdowns. Admittedly, the introductory statement did make reference to the recent strength of the euro, and in answer to questions on this subject, President Lagarde said in the Q&A that the ECB was monitoring it. However, beyond this verbal intervention, it did not appear there was an urgency to act.

The upshot is that for now the ECB appears to be in wait and see mode. However, if inflation continues to remain low, then the ECB may need to consider increasing the size and duration of its EUR 1.35 trillion Pandemic Emergency Purchase Programme (PEPP), which is currently due to end in mid-2021. A further strengthening in the euro over the next few months could be the factor that forces its hand.

UK: No-deal Brexit risk rises as government reneges on former agreements

Sterling suffered its worst weekly setback against the US dollar since March, weakening by 3.6%, and facing similar moves against other major currencies. The UK government's decision to bring forward their Internal Market Bill which intends to override parts of the withdrawal agreement reached with the EU last year raises concerns over the continuation of the trade negotiations with the EU and increases the risk of a no-deal outcome. The bill still has to be passed by the UK parliament, but the fact that the UK government is willing to break international

law by reneging on an agreement reached less than a year ago is worrying and undermines trust. Meanwhile, the economy continues to recover from the COVID-19 shock though at a slighter lower pace. Industrial production increased by 5.2% MoM in July leaving it almost 8% lower than in the same month last year. Monthly GDP rose 6.6% in July following the 8.7% rise in June.

Japan: New LDP President Yoshihide Suga will be appointed Japan's new Prime Minister on Wednesday

As expected, Chief Cabinet Secretary Yoshihide Suga has been elected president of the LDP, the current ruling party, receiving 377 out of 535 votes against his two contenders. Suga will become Japan's next Prime Minister on Wednesday, succeeding Shinzo Abe, who has resigned due to health reasons (see our latest Topical Thoughts paper, ['Abenomics' has NOT resigned](#)). We expect policy continuation but will watch for potential snap elections in Q4. New Cabinet ministers will be appointed later today. On the economic front we note an improvement in

the September Reuters Tankan in both the manufacturing as well as non-manufacturing components. However, both diffusion indices remain in deeply negative territory. Based on the Business Outlook Survey for Q3, conducted by the Cabinet Office, the All Industry index surged from -47.6 to +2. However, this V-shaped recovery is misleading and indeed does not suggest a major improvement. Digging into the details of the sales, profit and capex outlook reveals a deeply negative assessment of business conditions and at the least a cautious outlook.

China: Strong credit impulse continues to support growth

China's aggregate financing surged in August, up 13.3% YoY, accelerating for a sixth month in a row. Strong local bond financing was the driving force, but we note that bank lending, direct corporate financing and a slower contraction in shadow bank financing were also contributing positively to the latest credit boost. Local governments will fill the remaining issuance quota by the end of October, with the credit impulse expected to stabilise for the rest of the year. The better than expected credit data confirm our above-consensus GDP growth forecast for this year.

Meanwhile, export growth, at +9.2% YoY, was stronger than expected. The growth contribution of non COVID-19 related exports has risen to 80%, whereas COVID-19 related medical and IT exports have been the driving forces over the prior four months. Import growth also remains brisk. On the price front, both consumer price inflation as well as producer price deflation are easing. In terms of equity markets, China's 'hot' ChiNext tech-heavy venture board has cooled off somewhat, as authorities criticised speculative elements.

Indonesia: New lockdown measures in Jakarta take markets by surprise

As new COVID-19 cases continue to surge, the capital city of Jakarta announced large-scale social distancing measures valid as of today, Monday. Home office is compulsory, and many public and private buildings will be closed except for some essential sectors. Public transport will be reduced. Jakarta and its satellite cities generate about one quarter of Indonesia's GDP. The decision, which was obviously not coordinated with the central government, took people and capital markets by surprise with the MSCI Indonesia tumbling 6.1% and the Jakarta Composite Index down

5% on Thursday. Panic selling continued into Friday morning before a recovery set in. Bank Indonesia's policy board, which will convene on Thursday, faces a dilemma as the expected slump in domestic demand needs policy support, while the weakening rupiah does not allow for a rate cut. BI's actions will also be closely monitored with respect to possible closer monetary policy involvement by the Ministry of Finance. Foreign investors, who had just started to become more interested in Indonesian equities, are likely to take a wait-and-see attitude for now.

Covered Bonds: Strength driven by low supply and strong demand

Covered bonds continue to outperform with spreads having fully retraced the COVID-19 driven widening. Indeed, covered bonds are the only credit sector with spreads now tighter for the year. Investor demand remains strong despite yields reaching an all-time low and over 95% of covered bonds trading at negative yields. The ECB purchases also continue to be supportive, with gross purchases remaining at elevated levels, although redemptions offset some of it. The ECB now holds more than EUR 288bn covered bonds, representing more than a

third of the euro benchmark market. At the same time, supply remains muted. Following six blank weeks during the summer, issuers are back in the primary market but volumes remain low. Banks are flush with central bank liquidity and cumulative covered bonds issuance is 36% lower than in 2019 – in stark contrast to corporate bonds. Given that the ECB will take a while to reach its inflation target, we think liquidity provision to banks will remain abundant and hence the technical squeeze in the covered bond market is likely to persist.

What to Watch

- In the US, retail sales, industrial production and housing data are expected to show a continuation of the recovery, though at a slower pace, while investors will focus on the Fed's latest projection and forward guidance.
- In Asia Pacific, we believe the monetary policy committees of the Bank of Japan, Taiwan's CBC and Bank Indonesia will leave policy rates unchanged. The BoJ may raise its assessment of the economy, while BI will be mired between disinflationary tendencies, a weakening currency and the economic impact of the latest partial lockdown measures. Major economic indicators for August are expected to show a further improvement of economic activity in China. Export data for August will be published in Japan, Singapore and Indonesia. In Australia, it will be interesting to see whether the lockdown in Victoria had a negative impact on Australia's labour market in August.

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