October 26, 2020

Weekly Macro & Markets View

Highlights and View

- **The Eurozone Services PMI fell further below 50 in October as lockdown restrictions increased**

  With virus cases continuing to surge, downside risks to Eurozone growth in Q4 are growing, but it is important to bear in mind that there is now a substantial amount of policy support that will help in the medium term.

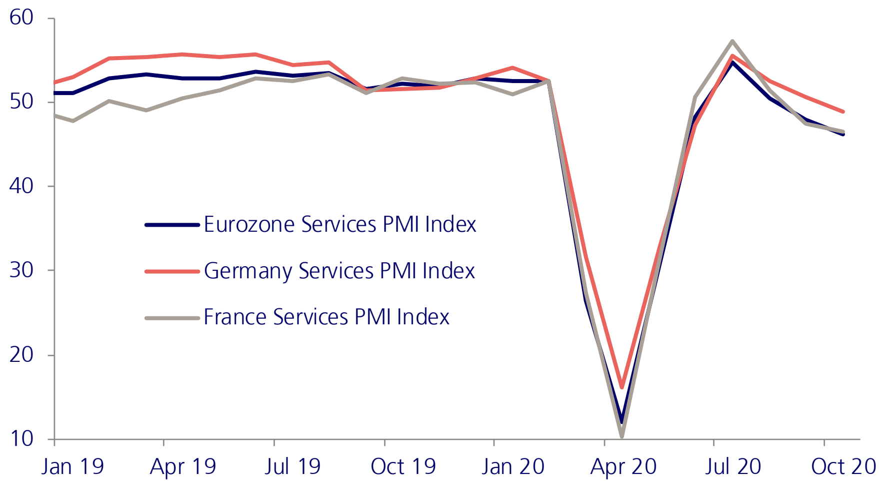
- **Markit's US Composite PMI rises to the highest level since February**

  The reacceleration in COVID-19 cases may provide headwinds to the economy in the coming weeks, but it is reassuring that activity picked up significantly in the service sector entering Q4.

- **Surging infection rates weigh on government bond yields in Europe while the US sees higher yields on stimulus hopes**

  Spreads look stretched in a global search for yield, with elevated virus vulnerabilities in all regions.

Eurozone service confidence buckles as virus surge continues



Source: Bloomberg

Service sector confidence in the Eurozone is weakening as the second virus wave shows no sign of abating, resulting in further lockdown restrictions. While the overall Eurozone Composite PMI was only modestly lower than the flash estimate at 49.4 in October versus 50.4 in September, services confidence fell almost two points to 46.2 from 48.0, well below the 50 mark dividing contraction from expansion. What's more, forward-looking subcomponents in the service sector survey, such as new business activity, declined even further, to 44.9 from 48.1 September. Lockdown restrictions continue to be tightened with Italy and Spain announcing further restrictions over the weekend (including a nationwide curfew in Spain), while last week France extended curfew measures to cover almost two-thirds of the population and other countries also announced tighter restrictions. The upshot is that downside risks for activity in the region in Q4 have increased substantially. However, it is still important to put these risks into perspective. We do not expect the record 12% fall in GDP experienced in Q2 and it is also important to bear in mind that there is now a substantial amount of policy support in place to support the economy on both the fiscal and monetary side. The Euro Stoxx 50 Index was down around 1.5% last week and the increasing numbers of new virus cases and lockdown measures could lead to some near-term volatility in local risk assets until the virus situation improves.

UK: Consumer sentiment takes a hit as infection rates reaccelerate

The economic recovery continued in October but has now lost momentum compared to a month ago, as indicated by the latest PMI surveys. The slowdown was particularly pronounced in the service sector with the respective PMI level falling to 52.3 from 56.1 in September. The latest hit to the service sector was mainly due to the new lockdown measures, which caused a major setback for the travel, leisure and hospitality industries. Manufacturing has fared better, partially helped by stock building ahead of the looming end of the Brexit transition period.

Weighed down by the deteriorating situation around COVID-19, consumer sentiment fell back to the lowest level since May, not helped by an uncertain job market outlook. The risks to the labour market have been somewhat mitigated by Chancellor Sunak's announcement of a significant expansion in job support, increasing the generosity of the new wage subsidy program that will replace the existing furlough scheme in November.

US: PMIs indicate a solid start into Q4

The S&P 500 ended last week slightly lower, losing half a percent, while the Nasdaq 100 shed 1.4%. The realisation that more fiscal stimulus ahead of the election is very unlikely as well as a significant reacceleration in new COVID-19 infections weighed on investors' sentiment. The Q3 earnings season is now well under way with roughly a quarter of the S&P 500 companies having reported. The beat/miss-ratio is above historical levels and the average earnings surprise currently stands at a solid 18%, though lower and less of a market driver than in Q2. Economic data continue to paint a decent picture of the current environment. Markit's Composite PMI rose to 55.5 in October from 54.3 the month before, the highest level since February 2019. It was the service sector in particular that recorded a marked acceleration in activity, entering the fourth quarter on a solid footing. Strength remains visible in the housing sector as well, with building permits, housing starts and existing home sales growing in September and the NAHB Home Builder Index setting a new record in October.

Japan: PMIs reveal a mixed picture, while PM Suga strengthens ties with ASEAN

Japan's Manufacturing PMI improved for the fifth month in a row, though only marginally by 0.3 points to 48, still below the 'boom/bust' line of 50 and below the PMIs of its developed peers. While the output component improved as well, we focus on strong new export orders, which surged by 2.2 points to 49.5, a two-year high, partly reflecting the revival of auto exports. On the other hand, the slower rise in the new orders component of 0.5 points to 45.8 suggests that domestic demand is recovering at a far slower pace. We suspect that it is the lagging capex element that remains a drag. The Services PMI fell 0.3 points to 46.6, however, it must be noted that the prior reading was revised up by 1.3 points. Turning to politics, PM Suga choose Vietnam and Indonesia as his first foreign country visit destinations, showing how important ASEAN has become for Japan. China is also fostering ties with ASEAN. Meanwhile, Suga's cabinet approval rating has started to fall, following the usual pattern once the initial euphoria for a new prime minister starts to fade.

Australia: More monetary stimulus to come amid a faltering recovery

While the Flash PMIs for October suggested the economic recovery remains intact, other indicators implied that the pace of the rebound is faltering. The weekly job survey ending October 3 as well as September preliminary retail sales point to modest contractions on a MoM basis, not only in Victoria, where restrictions have not yet been fully lifted, but also in the rest of the country. This implies a natural trajectory towards normalisation, and Victoria's pent-up demand might provide a short-lived boost in Q4. Policy support remains the key 'bridge to the recovery'. The RBA has signalled it will lower its cash rate and the yield target for 3yr government bonds from 25bps to close to zero. An extension of Quantitative Easing (QE) beyond the three-year tenure is possible given that Australia's yield curve is steeper than its peers, putting upward pressure on the currency. Meanwhile, the MSCI Australia Index enjoyed a winning streak, up by about 7% since early October given the significant fiscal stimulus unveiled in the 2020-21 Budget and the RBA's indication of further rate cuts and potential QE.

Bonds: A global search for yield should cap divergence

Last week saw diverging trends in bond markets, with Treasury yields at the highest level since early June while Bund yields fell to a low since March. Prospects for additional stimulus before the US election and a democratic sweep moved US yields higher, while European yields fell as infections surged. Investors were attracted by the higher yields offered by the EU's first sale of COVID-19 bonds and Italy's sale of 30yr bonds — both of which were heavily oversubscribed. Given the global search for yield and with infection rates rising more broadly, spreads between Treasury and Bund yields look stretched. Prospects for Treasury yields to move higher are limited, given high debt levels and ongoing policy support. The more constructive policy backdrop in the EU is also not reflected in Bund yields close to record lows. On that note, Italy got some good news from the S&P ratings agency, which reaffirmed Italy's BBB rating and lifted its outlook to 'stable' from 'negative', highlighting the substantial European policy response that offsets downside risks from the virus.

What to Watch

- In the US, the earnings season is reaching its peak with most of the big tech names reporting their Q3 numbers. Consumer confidence will shed some light on households' current sentiment.
- The ECB will meet to decide monetary policy and is expected to hint strongly that further increases to the PEPP to be announced in December. Meanwhile, the first estimate of Eurozone Q3 GDP is likely to show a strong bounce back. However, this is already rear-view mirror data, as investors focus increasingly on the virus situation and lockdown measures in Q4.
- The 14th five-year plan will be centre stage at China's fifth plenary session of the 19th party congress. The Bank of Japan's MPM meeting, Japan's September economic indicators, China's October NBS PMIs and Q3 GDP data for Taiwan, South Korea and Hong Kong will be in focus. In Australia, the focus will be on inflation, housing and business confidence data.
- We believe the Central Bank of Brazil will keep the policy rate unchanged at 2.0%. In Mexico, the focus will be on GDP for Q3.

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