June 7, 2021

ZURICH

Weekly Macro & Markets View

Highlights and View

- **Australia's GDP returns to the pre-pandemic level in Q1, led by investment**

  We expect the economy will continue to perform well, although the speed of growth should slow from here.

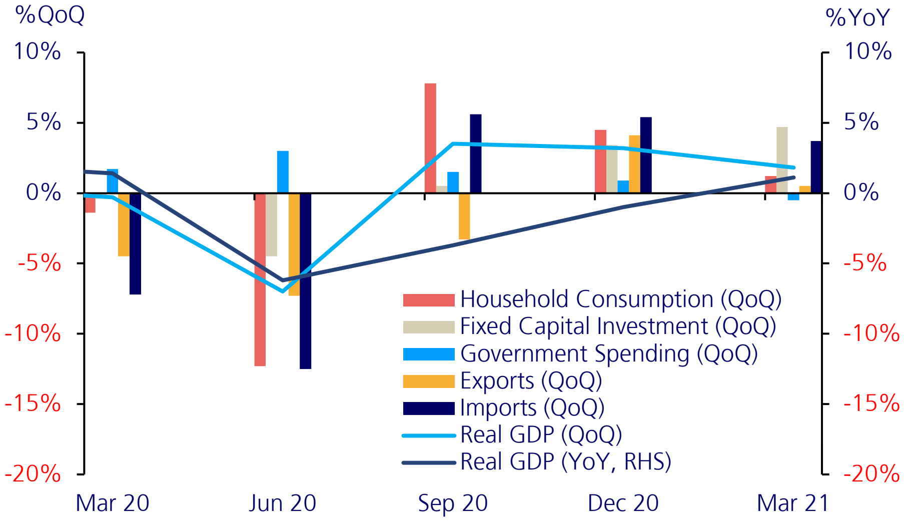
- **The Global Composite PMI rises to a 15-year high, led by a rebound in services activity, with developed markets particularly strong**

  The broadening out of the recovery towards services is encouraging, but slowing growth in emerging markets is concerning and highlights the importance of vaccines.

- **ISM surveys signal strong activity in the US while payrolls rise less than expected**

  Business activity keeps expanding at a solid pace, but firms are still struggling to fill open positions leading to higher wage growth.

Australia's economy is back above its pre-COVID level



Source: Australian Bureau of Statistics, Bloomberg

Australia's recovery from the COVID-19 crisis has been remarkable. With Q1 GDP rising 1.8% QoQ, Australia stands out among a few economies in the developed world that have returned to their pre-COVID levels. Notably, data show a critical shift from a rebound led by pent-up demand last quarter to a recovery driven by investment. While government spending slid on the back of the fiscal tapering, household savings edged down but stayed elevated at 11.6% in Q1. The swift economic recovery, low-interest rates and high household savings are fuelling the housing boom. House prices continue to rise rapidly, up by 9.4% YoY in May. However, the sales to listing ratio has begun to trend down, suggesting that house prices might peak before long. S&P has upgraded Australia's rating outlook from 'negative' to 'stable', driving government bond yields down slightly. The strong economic data and encouraging outlook have reinforced equity investors' confidence. The ASX 200 Index reached a record high in today's morning trade before retracing a little. Surging commodity prices and the economic reopening are underpinning the performance of cyclical stocks, particularly financial and energy related equities. Nevertheless, given Australia's lagging vaccination progress, a resurgence of COVID-19 remains a risk.

US: Strong business activity with decent job gains

The S&P 500 eked out a small gain last week as economic data keep presenting investors with a goldilocks scenario of strong economic growth and decent job gains without forcing the Fed's hand into tightening policy anytime soon. Business activity continues to expand at a solid pace with the ISM Manufacturing and the ISM Services surveys ticking up to 61.2 and 64.0 respectively in May. New orders rose, pointing at an ongoing expansion. Beneath the surface some weak spots are appearing, however. Manufacturing production fell back to the lowest since last June while the employment component softened in both surveys. Reflecting the slightly mixed picture in the labour market nonfarm payrolls rose by 559k in May, less than expected, while the unemployment rate fell to 5.8% from 6.1%. Wage growth accelerated to 2.0% YoY despite the expansion in lower-paid jobs, reflecting companies' continued struggle to fill open positions. Initial jobless claims fell back below 400k for the first time since the recession.

Eurozone: Headline inflation hits 2% for the first time since 2018

Headline inflation hit the ECB's 2% ceiling target in May for the first time since 2018. However, the ECB is unlikely to tighten monetary policy any time soon in our view. In fact, we expect that at this Thursday's monetary policy meeting and press conference ECB President Christine Lagarde will say that it plans to continue its faster pace of asset purchases under PEPP from Q2 into Q3. Indeed, at a speech last week, Lagarde said that even though "the intrinsic fragility of the euro area has now declined" thanks to the Next Gen EU program, strong policy support was still needed to ensure the recovery. We agree. While headline inflation hit 2% in May, this was mainly due to base effects because of much higher energy prices this year compared to the same time last year. Underlying or core inflation remained subdued at just 0.9% in May. On a more positive note, the final Eurozone PMI survey for May was even stronger than the preliminary estimate suggested. Both the manufacturing and services indices were revised up, with strong numbers across both periphery and core economies.

APAC PMIs: Overall somewhat lacklustre, despite some bright spots

While Asian PMIs remained solid, they pale in comparison to those of the US and Europe. Only Taiwan's Manufacturing PMI remained above 60, while in Europe, Switzerland's Manufacturing PMI, for example, approached 70. This observation is also reflected in leading indicators like the new orders minus inventories index or the new export orders PMI. While these indicators surged to record highs in major developed countries, they remained rangebound for Asia ex Japan. Supply chain bottlenecks and the difficult pandemic situation in many Asian countries are likely to have contributed negatively. Almost all countries experienced a surge in the input price components, reflecting the knock-on effect of global supply constraints. Given current lockdowns, India's manufacturing sector held up better than the service sector, with the Services PMI contracting sharply from 54 to 46.4. Australia's Manufacturing PMI remained strong at 61.8, but its new export order PMI fell ten points below the 50 mark. China's SMEs are facing tougher circumstances than the major state-owned companies.

LatAm: Expectations continue to improve after positive surprises in economic activity

The economic recovery in LatAm proved to be resilient during Q1 despite the worsening pandemic with the service sector also improving. Brazil's economic activity is recovering faster than expected. Q1 GDP increased by 1.2% QoQ, above market expectations. The main positive contribution came from the increase in fixed capital formation, while private and government consumption fell. Q1 economic activity and better economic indicators in Q2 have led to a rise in market expectations for GDP growth during 2021. Service and Manufacturing PMIs improved in May. However, industrial production contracted for the third consecutive month, falling 1.3% MoM in April. The disruption in supply chains could be one of the main reasons for its fall. In Mexico, the economic situation is also improving. The central bank raised its annual GDP forecast for 2021 from 4.8% to 6.0% and reduced its estimate for 2022 from 3.3% to 3.0%. Banxico also revised up inflation for this year to 4.8% due to transitory shocks.

Covered Bonds: Spreads to remain supported by strong demand and muted supply

We expect the imbalance between low supply and strong demand in the European covered bond market to remain in place for the next few quarters and consequently, covered bond spreads should remain supported. The recent increase in European yields and the steepening of the curve have pushed more covered bonds yields back into positive territory, keeping investor appetite strong. But supply remains depressed as banks are still flush with cheap ECB funding and continue to focus on loss-absorbing debt issuance rather than on covered bonds. The latest dashboard from Single Resolution Board confirmed that many banks are about to close their MREL shortfall after the recent robust issuance of senior non-preferred debt. Supply of covered bonds remains far below that seen in previous years and stands around 33% lower than the same period last year, with the recent activity mostly driven by issuers outside the Eurozone. Furthermore, as the ECB continues to be a strong buyer, with purchases of at least EUR 30bn of covered bonds anticipated during 2021, we expect the imbalance between supply and demand to persist.

What to Watch

- In the US, investors will focus on inflation numbers. A further acceleration is expected. Small business optimism will reveal whether the labour market bottlenecks have started to moderate.
- The highlight in the Eurozone this week will be the ECB monetary policy meeting and press conference, where we expect the ECB will extend its more aggressive pace of assets purchases into Q3
- In APAC, China will release aggregate financing, M2, CPI and PPI data for May. Japan's first revision of Q1 GDP is expected to be minor. In Australia, NAB Business Confidence for May and Westpac Consumer Confidence for June are core indicators to watch. Malaysia's and India's industrial production as well as China's, Taiwan's and the Philippines' export data will also be in focus.
- Inflation for several LatAm countries will be published this week. The Central Bank of Chile is expected to remain on hold, but the focus will be on the wording and forward guidance. In Brazil, retail sales will be released.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001566 (01/16) TCL

ZURICH®