July 12, 2021

Weekly Macro & Markets View

Highlights and View

- **Bond yields slump to multi-month lows as credit holds firm and stocks hit record levels**

  Numerous factors conspired to the swoon in yields. We believe this is overdone and see yields resuming a modest up-track. Credit and stock fundamentals remain strong, with further gains likely.

- **The ECB has reformulated its inflation objective as part of its review of monetary policy**

  The review confirms a lot of changes to monetary policy that have effectively already happened but it still underscores that the ECB is likely to remain dovish and keep monetary policy supportive.

- **China's State Council has guided the PBoC to cut the RRR by 50bps**

  We do not interpret this as an emergency move amid slower growth and a contracting credit impulse, but rather as a measure to help SMEs and to overcome temporary liquidity constraints.

Government bond yields slump and curves flatten as infections rise

Source: Bloomberg

In a dramatic week in government bond markets, yields fell to levels last seen in February. The bond leg of the reflation trade, which hinges on growth and inflation rising above last decade's anaemic levels, sizzled out. In the Treasury market the 10yr yield closed at 1.29% on Thursday, down 45bps from the March peak and largely reflecting lower inflation expectations. The 5yr5yr forward inflation swap rate has fallen by 35bps since May, indicating a lack of faith in the Fed's reinforced 2% target. The Treasury curve flattened, with the 2/10 yield spread down by close to 45bps from peak. The 5yr5yr forward rate, which is an assessment of where the market prices the longer-term 'terminal' rate, fell to 2%, down from 2.5% a few months ago. Despite the spread of the delta variant, this sudden shift in growth and inflation expectations is hard to justify given strong macro data, rising vaccinations and a constructive policy backdrop. Indeed, while last week's US data showed slowing momentum in the service sector, the pace of expansion remains very high and the number of job openings in the economy rose to the highest on record. Though the signals that come out of the Treasury bond market should be taken seriously, we suspect the fall in yields has been overdone, potentially amplified by very tight demand/supply conditions in the Treasury market and a covering of short positions by investors, and we expect the up-track will be resumed.

Equities: New records amidst cross-currents in sentiment

In a week dominated by the moves in bond markets and speculation on the drivers, equity investors stuck to plan and bought into any wobbles. The MSCI World Equity Index, led by US stocks, closed the week at a record level, having come under some pressure mid week. Although investors are sticking to the asset class, the move last week belies further churning between and within markets. US tech was back in favour, while small caps struggled, and financials were also shunned as bond yields fell and curves flattened. Asian stocks were under particular pressure as the Delta virus variant took hold in a region still struggling to mass vaccinate. A number of European markets also struggled on fears of further lockdowns as well as heavy banking exposures in some markets. With the earnings season now upon us, we remain sanguine on the prospects for stocks. Earnings expectations are likely to be bettered once again and we see upside potential for future estimates. With policy remaining supportive, buying on dips still evident and fundamentals improving, upside for stocks remains.

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Credit: Retaining composure amid broader yield driven jitters

Credit markets were calm last week despite the broader jitters caused by the sharp move down in bond yields. That said, US investment grade did show some angst with spreads widening by around 3bps at an index level, which is not a big move but one that has not been seen in a while. European credit ended the week with spreads unchanged while even high yield was barely wider in beta-adjusted terms compared to the volatility seen in stock and bond markets. Even the lowest rated segments of high yield showed resilience as companies keep improving their debt profiles by replacing high coupon debt with lower yielding debt. Indeed, Carnival Cruises launched a partial tender offer for an 11.5% coupon secured bond, which was issued at the height of the pandemic-driven angst in 2020. Structured credit markets also fared well, with latest Fed data showing a surge in US consumer credit extended in May. All in all, the strong technical dynamic is still intact, and there are signs that credit investors believe that the latest dip in yields is not a sign of the credit cycle turning anytime soon.

Eurozone: The ECB changes the formulation of its inflation objective

The ECB announced the conclusion of its strategic review of monetary policy last week. The main outcomes were: 1) A simplified symmetric inflation target of 2% over the medium term, 2) a commitment to be aggressive in responding when inflation falls below 2% and to look through temporary deviations above 2%, 3) the inclusion of consumer housing costs when thinking about inflation, and 4) an increased commitment to consider the environment e.g. by tilting asset purchases towards low carbon emitting assets. In abandoning the "below, but close to, 2% over the medium term" formulation of the inflation target, the ECB recognises that deflation is currently as likely to be a problem as too high inflation and a bigger concern if it becomes entrenched. However, the market reaction was relatively muted and in practical terms not much seems to have changed. Nevertheless, ECB President Christine Lagarde indicated that the review would have implications for monetary policy, in particular forward guidance.

Japan: An Olympics without public spectators

Due to rising Covid infections, Japan's authorities have re-imposed the state of emergency for Tokyo until August 22 and have decided that no spectators will be allowed at the Olympic Games in Tokyo. We believe the decision is to a good extent politically motivated. During the Tokyo Metropolitan Assembly Election, the ruling LDP gained less seats than expected. Nationwide snap elections are likely to be held in September or October, and the LDP does not want to risk angering a public that has serious concerns about the negative impact of a potential Olympic 'super spreader' event. Foreign athletes, officials and media representatives will have to adhere to strict quarantine and 'playbook' measures to avoid contact with the public. The new state of emergency in Tokyo and quasi measures in neighbouring prefectures do not bode well for consumer activity, which has just recovered steeply as evident in the latest Eco Watchers Survey. However, on a positive note, we are encouraged that new fiscal stimulus measures are likely to be bigger than previously expected.

China: Stable credit growth, lower inflation and a RRR cut

Following a decision by the State Council, the PBoC announced a 50bps RRR cut to 12%, bringing the weighted average deposit reserve ratio of financial institutions to 8.9%. We do not concur with comments describing the move as an emergency measure amid a slowing economy and a contracting credit impulse. We rather interpret the move as a targeted stimulus to bridge corporate financing needs, enable smooth local government bond issuance and support ailing SMEs, while deleveraging policies are likely to prevail. Credit data for June show that aggregate financing growth stalled at 11% YoY in June, lower than the recent peak of 13.3% in February. Producer price inflation may have already peaked, down 0.2 percentage points to 8.8% YoY, while consumer price inflation fell to only 1.1%, dragged down by persistent pork price deflation. Meanwhile, the government is tightening its control over major internet companies. Enterprises with overseas listings have to undergo an intense cybersecurity review.

What to Watch

- In the Eurozone, national data already released suggest that Eurozone wide industrial production will show a fall in May due to supply constraints. However, the recovery overall remains strong.
- In APAC, we expect the Bank of Japan and the Bank of Korea to keep policy rates unchanged. The BoJ is likely to outline details about its 'climate change' fund provisions. In Japan, our focus will be on the Reuters Tankan Survey for July. China will release its most relevant June data as well as GDP statistics for Q2. In Australia, we will focus on June labour statistics as well as business and consumer sentiment data. Export data for June will be released in Indonesia and Singapore.
- In Chile, we expect the Central Bank to start the normalisation cycle by hiking the monetary policy rate by 25bps. Monthly activity for May will be released in Brazil, while in Mexico the focus will be on May industrial production.

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