July 26, 2021

Weekly Macro & Markets View

Highlights and View

- **Equity markets and bond yields fell sharply on Monday driven by concerns around the delta variant of Covid-19**

  The recovery of stocks after the S&P 500 hit its 50-day moving average suggests that upward momentum in stocks is likely to continue, while bond yields appear too low given the growth and inflation environment.

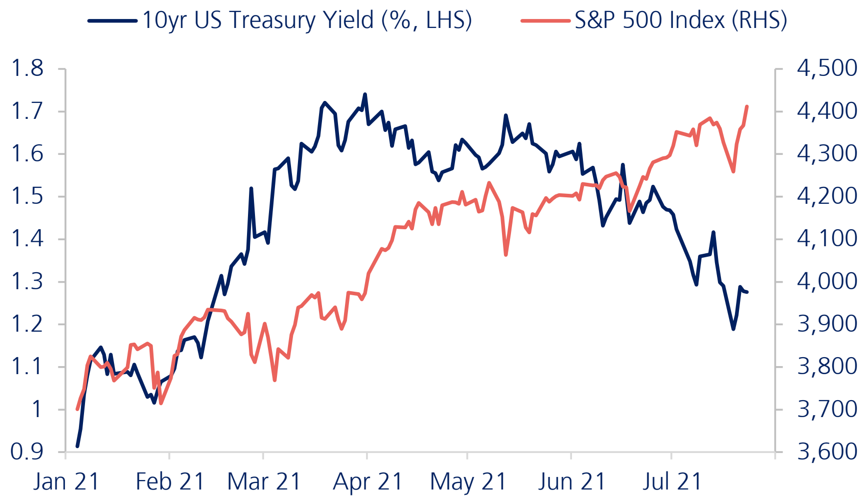
- **Corporate credit is impacted by the volatility in equities and government bonds, but spreads recover after an abrupt widening.**

  With positive Q2 earnings results so far, positive demand/supply technicals and search for yield still in place, credit seems likely to remain well supported.

- **The ECB has made the conditions for when it will consider raising interest rates even more stringent**

  The change to the language in the ECB's forward guidance implies that it may not raise interest rates for the foreseeable future.

Equities pass another 'Buy on Dip' test



Source: Bloomberg

Equities have passed the 'Buy on Dip' test for the sixth time this year. Equity markets suffered sharp falls last Monday, while bond yields fell below important perceived levels as investor sentiment was gripped by renewed restrictions in some countries triggered by concerns around the Delta variant of Covid-19. Value stocks, which benefit from a reopening of economies, underperformed notably, hitting the so called 'value vs growth' strategies, a favoured investment theme this year. US Treasury yields fell sharply after breaching the 200-day moving average, which had been an important perceived support level in the eyes of investors. This also seems a likely contributor to the broader volatility as stop losses could have been triggered in investors' bond positions. Underweighting bonds has also been a popular investment strategy this year given the expected rebound in growth and reopening of economies, fiscal stimulus and rising inflationary pressures. Following the swoon on Monday, however, most markets recovered their poise by late Tuesday, with both stocks and bond yields moving higher. The perception of weakness as a buying opportunity in stocks seems encouraging and is likely to prolong the upward momentum. At the same time, bond yields seem unjustifiably low and likely to pick up over coming months.

Credit: Just a blip and then business as usual

Last Monday, US investment grade (IG) and high yield (HY) index spreads widened by 3bps and 23bps respectively, a move which was abrupt but certainly muted compared to the move in equity and US Treasury markets. European IG and HY index spreads also widened, but even more modestly than US spreads. Market jitters were reflected in fund flow dynamics. US IG corporate bond funds saw the first weekly outflow since November 4, with USD 1.2bn being pulled out for the week ending July 21, according to Refinitiv Lipper data. Despite this, credit markets proved once more to be resilient to bouts of volatility. On Tuesday it was business as usual again, with spreads narrowing and primary issuance reigniting. Refinancing activity continues to drive US HY issuance and new deals continue to be in high demand. Notably, cruise operator Carnival slashed its borrowing costs by selling a USD 2.4bn secured bond with a 4% coupon, the proceeds of which will fund a tender offer to buy back about half of the 11.5% coupon secured debt it issued in April 2020.

Eurozone: PMIs remain at multi-year highs despite the spread of the Delta variant

The latest PMI data from the Eurozone confirmed that business sentiment remains at multi-year highs, despite the increasing spread of the Delta variant that risks impacting the holiday season. The Eurozone Composite PMI increased by approximately 1 point, to 60.6 in July, a 21-year high. The increase was led by service sector confidence, which jumped around two points to 60.4. The Manufacturing PMI declined somewhat, but from an all-time high in June. Details of the PMI survey were also strong, with hiring intentions remaining well above the 50 expansion/contraction level in both manufacturing and services and new orders were also strong in both sectors. In manufacturing, however, supplier delivery times remained very long and the backlog of work increased, corroborating anecdotal reports that supply bottlenecks and shortages of chips are impacting auto sector production in particular. Nevertheless, overall, the surveys indicate that activity is rebounding quickly in the Eurozone with only a limited impact from the fast-spreading Delta Covid variant so far.

The ECB: Forward guidance changed at first meeting following strategic review

The ECB held its first monetary policy meeting and press conference following the announcement of the results of its strategic review of monetary policy. As expected, forward guidance on when interest rates would eventually be raised was strengthened. The ECB now says that is will now not increase interest rates until inflation is expected to hit its new 2% symmetric inflation target 'well ahead' of its forecast horizon and stay there for the rest of its forecast horizon. This is more dovish than the previous forward guidance, which said that rates would not rise until the ECB expected to meet its inflation target by the end of the forecast horizon. The ECB's forecast horizon is three years and a subsequent clarification by an ECB policymaker indicated that 'well ahead' means around 18 months. Therefore, the ECB would need to forecast inflation hitting 2% within 18 months and staying at or above this level to consider raising rates, according to this new formulation, implying we are unlikely to see any interest rate increases soon by the ECB.

UK: Business activity growth slows from very high levels

The latest batch of PMI data shows that growth in business activity slowed from very strong levels in July with the Composite index falling to 57.7 from 62.2 the month before. The slowdown was visible both in the manufacturing and the service sector. According to the surveys, shortages of raw materials and reduced staff availability are key reasons for the loss of momentum. Employment growth slowed to the weakest since March as companies struggled to fill vacancies and faced an unusually large number of staff departures. Rising costs, including wages, remain a reason for caution among firms. On the other hand, consumer confidence has improved in July to the highest since February 2020, just before the pandemic started to weigh on sentiment. Supported by an improving employment situation and rising wages, retail sales picked up in June. The overall slowdown in growth is not surprising as the immediate effect of reopening the economy is fading. Finally, although still too early to judge, the latest fall in the number of infections despite last week's full reopening is a promising sign.

APAC: Australia Down-Under

With four of the top five notches in the Tokyo Olympic medal ranking taken by APAC countries, the week was slim in terms of economic indicators. Our attention is on the setback in the Australian growth miracle. Preliminary retail sales fell by 1.8% MoM in June, more than expected, while the Services PMI for July tumbled by 12.6 points to 44.2 and the NAB business confidence indicator retreated from its record high of 23.6, marked two months ago, to 10.7 in June. Lockdowns in Melbourne, greater Sydney and Queensland were behind the deterioration in services related consumption. Meanwhile, export related data for June remained brisk in Japan, Taiwan, and Thailand, while South Korea's exports for the first twenty days in July, a leading indicator, also showed resilience. Japan's Services PMI fell 1.6 points to 46.4 in July amid Tokyo's state-of-emergency, while the Manufacturing PMI retreated only slightly to 52.2. Bank Indonesia left policy rates unchanged, as expected, and indicated that it intends to leave monetary policy stable. The surge in Covid infections is a severe burden for the economy.

What to Watch

- In the US, the earnings season is gathering steam while investors will also focus on the latest Fed meeting where more details regarding the tapering path are expected.
- In the Eurozone, various macroeconomic data, including the first estimate of Q2 GDP, will likely confirm that there has been a strong rebound in the economy.
- In APAC, Japan will report the most relevant June economic data on Friday, while China will hold a Politburo meeting and release its NBS PMIs for July. Q2 GDP data will be reported in South Korea, Taiwan, and Hong Kong. South Korea and Thailand will release industrial production data for June and Australia will report inflation data for Q2.
- 2Q GDP and the unemployment rate are the week's key indicators in Mexico, while in Brazil the focus will be on unemployment for May and the fiscal balance for June. In Chile, sectoral figures will be published.

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