ZURICH

Weekly Macro & Markets View

Highlights and View

- **US investment grade credit set a new record with 54 issuers tapping the market in four days**

  Supply is being driven by a desire to refinance expensive debt, rather than an appetite for leverage, leading to an improvement in credit fundamentals that boosts investor demand.

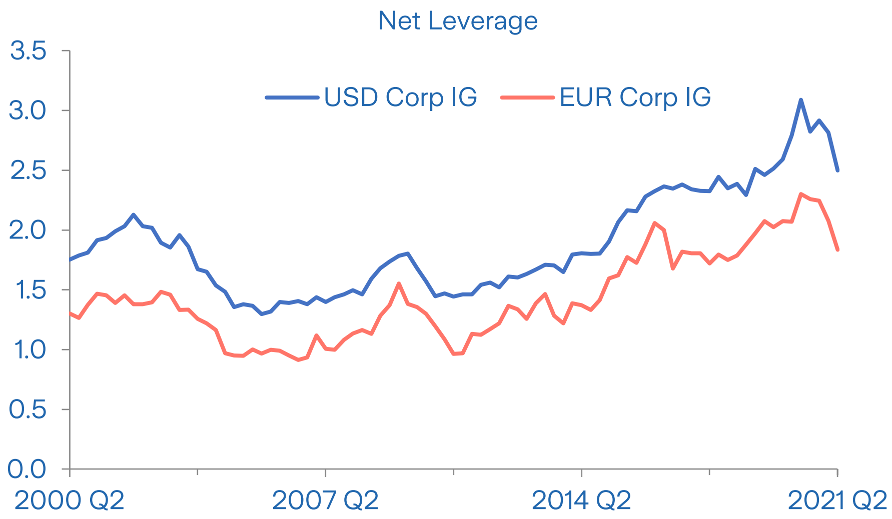
- **The ECB announced that it would moderately lower the pace of PEPP in Q4**

  Despite the moderate reduction in the pace of PEPP, the ECB will still be providing a substantial amount of monetary policy support to the Eurozone economy.

- **The RBA goes ahead with its QE tapering from AUD 5bn to 4bn per week as previously announced**

  The RBA appears more dovish compared to their last meeting, commiting to a 4bn asset purchase per week until Februry 2022 rather than November 2021 as previously stated.

Improving credit fundamentals drive strong demand



Source: ZIG, Bloomberg. Note: Net leverage is median net debt to EBITDA ratio for non-financial issuers.

September typically sees a pickup in primary market activity in credit as we enter the last three busy months of the year, and activity last week did indeed seem to be off to the races. A new record was set for the number of issuers tapping the US credit market. Within four days, 54 companies sold debt with volumes reaching around USD 78bn, over half of the monthly estimates. Europe was strong too, and notably, robust supply met robust demand across both markets. Issuers were able to price deals with still flat to negative new issue concessions amid a healthy oversubscription of deals. The deluge in supply did not cause weakness in secondary markets, which were firm across the board despite weaker stock markets.

Last week confirmed to us not only the strong supply/demand technicals of credit markets in the low yield environment, but also the degree of comfort investors have in improving credit fundamentals. Leverage has declined rapidly while interest coverage has risen as issuers maintain their focus on balance sheets in the improving earnings environment. Indeed, last week's supply was primarily driven by refinancing as issuers seek to lock in low yields and retire expensive debt. That said, with leverage still high and spreads tight, managements need to retain their focus and investors cannot be complacent.

Eurozone: The ECB is set to reduce the pace of PEPP but still keep policy loose

Last week, ECB President Christine Lagarde said that the ECB would conduct its Pandemic Emergency Purchase Programme (PEPP) at 'a moderately lower pace of net purchases … than in the previous two quarters'. While no precise number was given, PEPP was running at a pace of around EUR 80bn per month in Q2 and Q3, and 'moderately lower' probably implies around EUR 70bn a month. In addition to the ongoing Asset Purchase Programme (APP) of around EUR 20bn per month, this is still a substantial amount of monetary support. Indeed, the immediate market reaction to the news was for core government bond yields to fall and periphery spreads to narrow, suggesting a more aggressive reduction in PEPP had been feared by some investors. We expect the ECB to keep policy accommodative and to continue with a substantial amount of asset purchases in 2022. Meanwhile, national industrial production data for July suggest an increase in Eurozone output after falling the previous two months, though anecdotal reports suggest that supply chain problems remain, especially in the auto sector.

China: Mixed data with exports being a bright spot

Exports were surprisingly strong in August, up by 25.6% YoY, beating consensus expectations by a wide margin. We suspect supply disruptions concentrated in ASEAN led to a redirection of trade towards China, lifting China's exports. August CPI and PPI are showing a widening divergence. CPI drifted lower, from 1% to 0.8% YoY, while PPI showed the largest rise since August 2008. The PPI surge is likely linked to transportation bottlenecks due to Covid and ongoing curbs of highly polluting raw material output to ensure blue skies for Beijing's Winter Olympics. Meanwhile, China's money and credit data only improved a little in August. While total social financing growth rose on a month-on-month basis in August, it slowed from 10.7% to 10.3% YoY. New bank loan growth softened from 12.3% to 12.1% YoY. The PBoC has announced another RMB 300bn re-lending quota for local banks amid slowing credit growth.

Brazil: Local uncertainty continues to impact financial markets

In a volatile week, the equity market fell 2.3% and the BRL depreciated 1%. After a large street demonstration in favour of the government, President Bolsonaro delivered a heated speech against the judicial system, mainly targeting one of the ministers of the Supreme Court. Bolsonaro's statement generated criticism from several authorities and negatively impacted the value of local assets. Two days later, Bolsonaro walked back his remarks, issuing an official statement in which he noted that it was never his intention to attack other branches of government. The statement indicated his respect for the institutions and his willingness to interact with other authorities to maintain harmony and independence. Headline inflation in August increased 0.87%, above market expectations, reaching 9.7% YoY, and core inflation continues to accelerate. The inflationary surprise was generalised, highlighting the prices of core services, fuel, food, and vehicles (new and used). We estimate that inflation will continue to accelerate in September.

LatAm: Inflation pressures should remain throughout 2021

In Chile, headline inflation rose 0.4% in August, exceeding market expectations, reaching 4.8% YoY, above the central bank's target. The recovery in service prices, which we expect to continue as the economy reopens, is the main reason for the increase in monthly inflation. However, the consumption that is being driven by withdrawals from pension funds and fiscal stimulus will also continue to pressure prices in the short term. Core inflation continued to accelerate, reaching 3.8% YoY. The uncertainty regarding the approval of a fourth withdrawal from pension funds remains, where the vote in Congress is still uncertain. In Mexico, inflation decelerated from 5.81 to 5.59% in August, driven by lower prices for liquified gas as the government implemented a policy of maximum prices. Core inflation accelerated further, reaching 4.78% YoY, and we expect it to maintain an upward trend as supply shocks and the economic recovery continue. Industrial production grew 1.1% MoM in July, above market expectations, mainly explained by growth in manufacturing and utilities.

Covered Bonds: The surge in issuance volume is likely to be transient

Activity in the European primary market was particularly strong for covered bonds, which saw over EUR 10bn in supply, the largest weekly volume for 2021 thus far and the highest since January 2020. The European Banking Authority (EBA) recently released its analysis of European banks' funding plans for the next three years. Most banks expect to increase their market-based funding to replace part of the cheap central bank liquidity but also to fund higher loan volumes and compensate for lower deposit growth in the future. But we don't expect this move to materialise this year. When analysing last week's volume, most of the covered bonds were issued by non-eurozone banks, with Canadian banks selling half of the weekly volume. While it is encouraging to see some large European banks coming back to the market, especially with long-dated 20yr bonds, we don't expect a surge in supply soon. Due to the positive supply/demand dynamics, spreads will probably remain supported by ECB purchases with the recent reduction in PEPP purchases likely to predominantly affect government bonds.

What to Watch

- US Small Business Optimism and the University of Michigan sentiment readings will give some insight into future spending and investment plans. Most attention will be on the CPI release for August, with expectations for still elevated inflation prints. Any upside surprise will bring forward expectations of Fed tapering.
- Eurozone-wide industrial production data for July is expected to show a pickup, after output fell the previous two months.
- China's activity data are key to watch. Indonesia's exports might show signs of moderation while Singapore's exports will provide further insights into ongoing supply bottlenecks in ASEAN due to Covid. Employment data for Australia, South Korea and Hong Kong will be released.

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