September 27, 2021

Weekly Macro & Markets View

Highlights and View

- **Markets started the week on a volatile note but recovered as investors bought the dip**

  It is encouraging to see stocks recovering after hitting technical support levels, with further upside likely in both credit and equities, although the coming days are crucial to confirming the momentum.

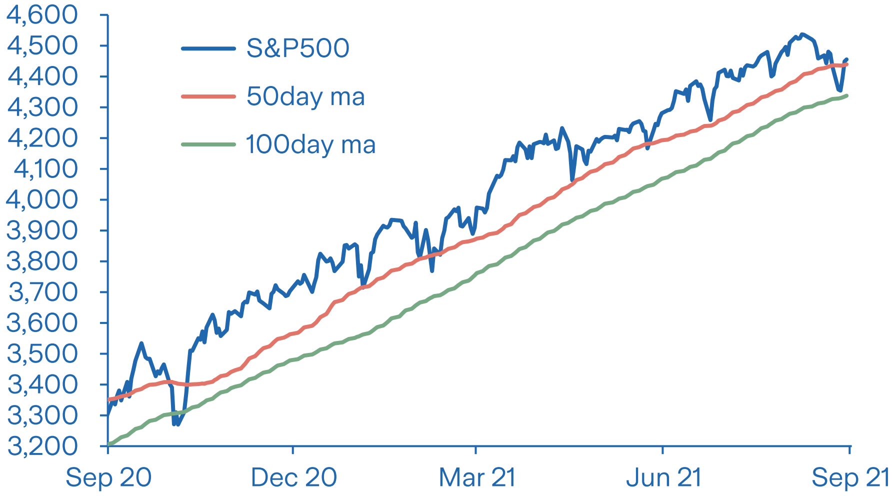
- **The Fed will soon start to taper its asset purchases and signals a rather steep rate hiking path**

  Given strong growth and above-target inflation Fed members are starting to feel some pressure to tighten policy, providing a basis for a hawkish surprise next year.

- **The SPD won the most votes in the German Federal elections, but their lead was not as large as some opinion polls had predicted**

  Weeks of negotiations are likely before a new coalition government emerges in Germany, but the overall market impact is likely to be modest.

Markets brush off angst as investors buy the dip



Source: Bloomberg

Global risk markets were volatile at the beginning of last week but recovered their poise thereafter as investors once again stepped in to buy the dip. Evergrande related concerns led to sharp falls in Asian stocks, engendered by investor angst around the case representing a 'Lehman moment' for China. Our view has been that the systemic fallout from Evergrande is likely to be manageable, although the potential for policy mistakes remains. It seems investors eventually came around to this view with the weakness seen as a buying opportunity. Later in the week, increasingly hawkish guidance coming from central banks appeared to have been priced in. Both the Fed and the BoE gave fair warning of the possibility of rate hikes as soon as next year, while Norway's Norges Bank actually raised rates by 25bp from zero. A subsequent sell-off in government bonds proved beneficial for rate sensitive financials, as well as for credit markets. Notably, credit markets have remained calm throughout the recent volatility around Evergrande, which as a systemic gauge indicator is reassuring. Credit supply was sporadic but well received. It is encouraging to see the S&P 500 bouncing off its 100-day moving average. Further upside ahead seems likely in both credit and equities although the coming days will be important to watch.

US: The Fed has become more hawkish

As expected, the Fed announced that it will soon begin to taper its asset purchases. No details were provided, but Powell said that participants generally view an end to the tapering process around mid 2022. This would indicate a taper pace of USD 15bn per month. The Fed significantly lowered its growth forecast for this year from 7% to 5.9%, which is now almost in line with our own forecast of 5.8%. At the same time, the Fed raised its expectations for core inflation to 3.7% for 2021, which looks more reasonable given the recent spike caused by the reopening of the economy and ongoing supply chain disruptions. The inflation forecast for 2022 was lifted modestly to 2.3% and remains above 2% over the whole horizon, reflecting the Fed's average inflation target. According to the dot plot, the committee is now evenly split on whether the first rate hike should occur next year. The dot plot also implies a rather steep rate path, which seems quite aggressive in our view, but indicates that Fed members are starting to feel some pressure to tighten monetary policy providing the basis for a hawkish surprise next year.

UK: Solid business activity and rising input costs

The latest set of PMIs show that growth momentum has slowed further in September with the Composite PMI receding to 54.1 from 54.8. New orders also fell slightly but keep signalling solid business activity as we enter the fourth quarter. The slowdown was more pronounced in manufacturing as ongoing supply-chain disruptions weigh on activity. Reassuringly, job creation continues at a solid pace in the service sector, though employment growth slowed sharply at manufacturers given shortages of available staff and signs of moderating demand.

Meanwhile, inflationary pressures show few signs of abating, with input costs rising sharply driven by higher wage costs, the effects of severe supply-chain disruptions on raw material prices and increased transportation costs. Companies raised their own selling prices at the strongest pace on record. Putting an emphasis on rising inflation, the BoE confirmed its more hawkish outlook at its latest meeting making a rate hike in the first half of 2022 increasingly likely.

Eurozone: Weeks of negotiation expected to form a new government in Germany

The German federal elections saw the SPD gaining the most votes (around 27.5%) only slightly ahead of the CDU/CSU (24.1%), and with a smaller lead than many opinion polls had been predicting in the run-up to the election. The upshot is that both the SPD and CDU/CSU will try to form a coalition government with the Greens and FDP, but negotiations will be complex and could take weeks if not months. With the Greens and FDP effectively acting as kingmakers, support for environmentally friendly policies can be expected to increase while the FDP will likely push for fiscal conservatism as the price of its support for a coalition. Meanwhile, the Flash Eurozone PMI fell more than expected to 56.1 in September from 59.0 in August. The survey and anecdotal reports suggest that bottlenecks in the manufacturing supply chain are far from being resolved. The German ifo Business climate survey confirmed a similar picture. On the more positive side, consumer confidence in the Eurozone remains at high levels and unemployment continues to fall, which should support household consumption over the next few quarters.

Asia: Painting a mixed picture

Several Asian central banks including the Bank of Japan, Taiwan's CBC, Bank Indonesia and Philippines's BSP kept policy rates unchanged as expected. Meanwhile, it seems likely that the Bank of Korea and the Reserve Bank of New Zealand will raise their policy rates in Q4. In China, the probability that the government will handle the credit problems around major property company Evergrande in a careful manner has increased, calming global investor concerns. Regional export performance remains brisk, as South Korea's September exports for the first twenty days, Taiwan's August export orders and China's industrial sales for exports suggest, while supply bottlenecks have severely hit industrial production in Malaysia, Thailand and Vietnam, which are major hubs within the Asian electronics supply chain. Meanwhile, Japan's service sector is showing signs of recovery based on the September Services PMI, while the Manufacturing PMI deteriorated further following supply chain issues in the auto sector, though it remains above 50. Australia's September Composite PMI improved.

Bonds: Yields snap higher as central banks signal a hawkish stance

Bond yields rose last week on hawkish signalling from the Fed and the BoE. The 10yr US Treasury yield broke out of a narrow range and closed the week at 1.45%, up from 1.36% the prior Friday. The move was partly driven by the short end, where a steeper hiking path is now priced in, while the longer end was relatively resilient with the 5yr/5yr forward rate still well below the Fed's terminal rate projection of 2.5%. Inflation expectations were benign, and the move was primarily driven by a rise in real yields, which nonetheless remain deeply negative. Gilt yields spiked higher as gas prices surged and the BoE confirmed a more hawkish outlook, with one more member voting to stop QE. Market pricing now implies a relatively steep BoE hiking path, with almost two hikes priced in a year from now, while the Fed funds rate implies a shallower path and continues to lag the Fed's own median rate projection. Elsewhere in Europe, yields rose, with the German election adding momentum. While we maintain our view that there is further upside to yields, a more reasonable policy outlook is now priced in.

What to Watch

- In the US, consumer sentiment and personal spending will provide insights into the current state of private households. The ISM Manufacturing Index is expected to reflect solid activity.
- The European Council's business and consumer confidence survey is likely to show a fall in the Eurozone while inflation may have moved even higher in August.
- In Japan, the next LDP leader will be elected on Wednesday while the Q3 corporate Tankan Survey and a series of economic indicators for August will be reported. China will release its September PMIs. We believe the Bank of Thailand will keep its policy rate unchanged. China's Labour Day holidays will start on Friday. Hong Kong's financial markets will be closed on Friday.
- We expect Banxico to raise the policy rate by 25bps in Mexico, while monthly economic activity and unemployment data will be released. Monthly economic activity should remain solid in Chile. Brazil's monetary policy meeting minutes and Q3 inflation report will be printed.

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