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ZURICH

Weekly Macro & Markets View

Highlights and View

- **Rising covid cases lead to renewed restrictions in some Eurozone countries, while inflation also spikes**

  A combination of factors, including but not limited to higher Covid cases and rising energy costs is likely to see Eurozone growth slow in Q4

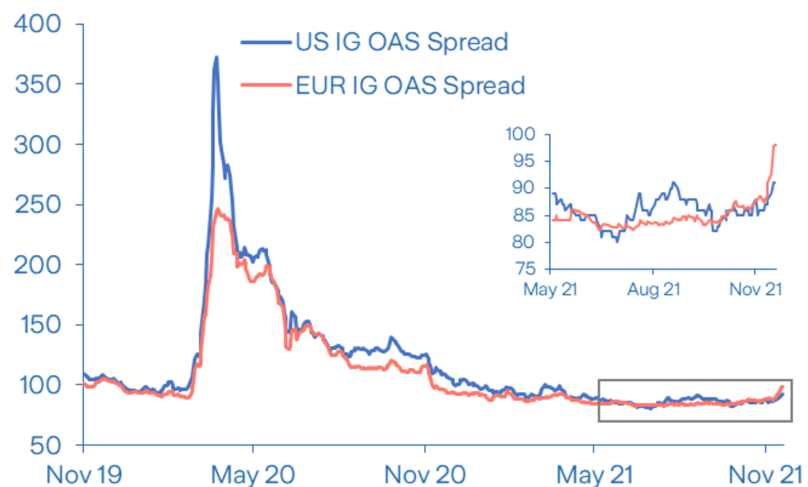
- **US President Biden and China's President Xi discussed various issues in a 3-hour virtual call**

  The meeting was cordial, and contentious issues were discussed behind closed doors, which is a step in the right direction to improve the difficult US-China relationship

- **In Chile, the right-wing candidate Jose Antonio Kast and the left-wing candidate Gabriel Boric will face each other in the second round of Presidential elections**

  Results in the presidential and parliamentary elections, where the centre-right coalition obtained 50% of Senators, are favourable for the market. However, we expect volatility to remain as the result of the second round is still uncertain

Credit softening seems unlikely to last



Source: Bloomberg

Credit markets have entirely missed the risk rally driven by equities since late September. Last week, European Investment grade and CCC rated credits in US High yield came under pressure. Investors have remained on the side-lines due to a number of reasons, most notably due to elevated government bond volatility given concerns around inflation, monetary policy and rising Covid infection rates. Muted demand faced heavy supply in the US, reported broker dealer deleveraging ahead of the year end and higher swap spreads, leading to wider credit spreads.

However, the price action feels worse than it actually is, given investors got accustomed to very low volatility in credit. This is evident from the chart which shows that although on a short-term basis spreads appear to be on a spike, especially in Europe, from a medium-term perspective recent spread movements are quite muted.

We believe the spread widening is technical rather than fundamental. Credit metrics are expected to improve while it seems large CDS hedges are not being put on. Most importantly, the proportional income pick up in credit compared to government bonds is still attractive and should remain so despite central bank tapering. Therefore, while current softness could linger a bit longer, a significant correction in credit seems unlikely.

Eurozone: Restrictions return as Covid cases spike

New covid cases have spiked again in many European countries, leading to a re-introduction of Covid restrictions in some countries, notably Germany, the Netherlands, Ireland and Austria. Restrictions will have some impact on mobility and service sector activity, but the degree of impact should be less pronounced than previous lockdowns/ restrictions. Meanwhile, the second estimate of Eurozone inflation in October confirmed the 13-year high for headline inflation of 4.1%, though driven in large part by record high energy price inflation which contributed around two percentage points to overall inflation. We expect headline inflation will gradually fall in 2022, but it will likely remain well-above the ECB`s target for some time. However, ECB President Christine Lagarde made it clear last week that a rate hike in 2022 was very unlikely, saying that 'we do not see the conditions in place – either at the economy-wide level or at the sectoral level – for inflation rates above our target to become self-sustained' and that 'the conditions to raise rates are very unlikely to be satisfied next year'.

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US: Data surprise positively once again, with retail sales powering ahead

Another week and another round of strong US data that has become a feature since the Delta weakened numbers of early autumn. This helped to maintain momentum in stocks, with the S&P500 up on the week and the tech-heavy NASDAQ closing at a new record on Friday, though the Dow slipped back modestly. While industrial production proved to be better than expected, and both the Philly Fed and Empire manufacturing readings also surprised positively, retail sales were particularly robust. Up 1.7% MoM in October, almost all categories were strong with the exception of small declines in clothing and healthcare. Following the generous stimulus programmes, and with a resurgent jobs market, consumer balance sheets are in rude health. This bodes well for a robust holiday shopping period, with initial indications suggesting an early start this year. As the Fed begins its tapering of asset purchase by USD15bn in both November and December, we suspect and hope that this pace will be increased thereafter. Given the strength of the US economy and elevated inflation, asset purchases are no longer required.

UK: Higher than expected inflation increase chances of rate rise

CPI inflation increased to 4.2% YoY in October from 3.1% in September, well-above expectations of an increase to 3.9% YoY. The main driver was energy prices, reflected in the housing component, as well as transport. The high inflation print is likely to increase pressure on the Bank of England to raise interest rates sooner rather than later, especially as other economic data are consistent with the economy continuing its recovery path. The labour market is showing resilience, with three-month average weekly earnings growth falling to 5.8% YoY in September from 7.2% in August, partly due to the unwinding of furlough schemes and still at a strong pace, while the unemployment rate in the three months to September fell to 4.3% from 4.5% in August. Other data released last week also confirmed that the UK economy is gradually healing. Retail sales excluding auto fuel were up 1.6% MoM in October, with retailers reporting an early and healthy start to the festive shopping season.

Japan: Even after drilling down from the huge headline numbers, the fiscal package gives an impressive boost to the economy

PM Kishida's economic JPY 78.9 trn package appears to be huge. The public fiscal contribution adds up to JPY 55.7 trn, more than 10% of GDP, which is the biggest ever. However, that is the baseline from where we need to drill down to the real economic impact. Even the 'real water' (真水) impact appears to be massive, but we need to be careful by excluding funds from previous packages and emergency budget reserves booked under the FY22 initial budget. To calculate the real impact on growth, we need to wait for the supplementary budget details revealed later this week, but estimates show that the boost to growth next calendar year is likely to be in the range of 1.5% to 1.7% of GDP. This is still a remarkable support to growth in 2022. PM Kishida emphasised that now is not the time to discuss fiscal austerity, but rather to tackle the burden caused by Covid, which seems to be the right approach. However, we have some concerns that the 'fiscal cliff' has just been postponed to after the July Upper House elections.

Australia: Q3 wage increases underpin the RBA's dovish stance – for now

Q3 wage growth, at 0.6% QoQ and 2.2% YoY, matched the pre-Covid level and was fully in line with market expectations and the RBA's target range. However, only 20% of employees received a wage increase as Covid related pay freezes have been maintained. We believe that this impact has somehow artificially kept overall wage increases low. As labour market conditions are normalising, it is likely that wage increases should gain some momentum. The bond market concurs and is pricing in a policy rate hike by the RBA already next summer, while the RBA maintains its dovish stance and does not see any pressure for a hike before 2024. Governor Lowe sounds very relaxed about the RBA's CPI and wage inflation outlook. He described the probability of wage increases above 3% as "very, very low … close to zero", and is not likely to follow the somewhat more hawkish stance of other major central banks. We think the truth may be somewhere in the middle between the hawkish market view and the dovish stance by the RBA and believe a policy rate hike in 2023 has a higher probability.

What to Watch

- The G3 flash PMIs will indicate if global growth continued to pick up in November
- Focus in the US will be on the Fed's favoured PCE inflation readings for October, with headline and core numbers expected to jump to 5.1% and 4.1% YoY respectively.
- In the Eurozone, various business surveys are likely to show if there is already an impact from rising Covid cases on sentiment and activity.
- In APAC, we expect both the Bank of Korea and the Reserve Bank of New Zealand to lift their policy rates by 25 bps. Japan and Australia will release their November PMIs. Tokyo will report CPI data for November and department store sales for October. Q3 capex and October retail sales data will be released in Australia. Japan's markets will be closed on Tuesday, India's on Friday.

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