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Weekly Macro and Markets View

6 March 2023

Highlights and View

China's NPC starts with the Government Work Report by outgoing Premier Li Keqiang

Economic targets have been set rather cautiously, leaving space to surprise to the upside.

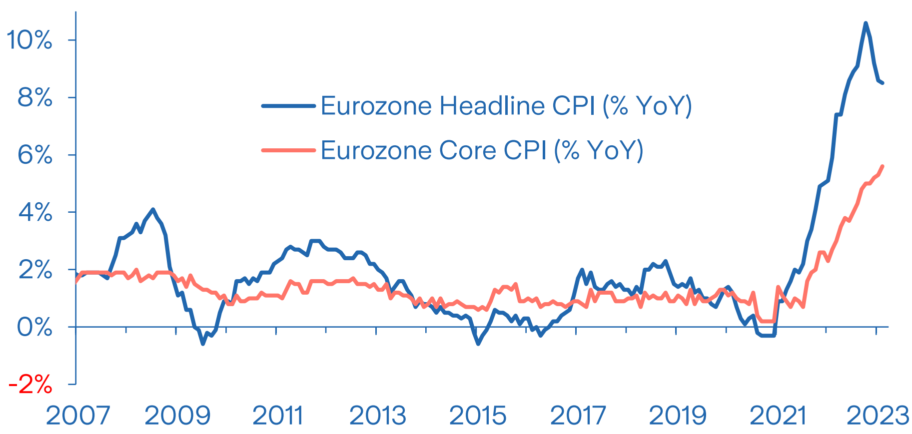
UK Prime Minister Rishi Sunak secures the 'Windsor Framework', an agreement with the EU to reform the Northern Ireland Protocol

The deal with the EU is an encouraging step forward, but it will require a sign-off in the UK parliament before it can be confirmed.

The latest PMI surveys in Asia suggest a tentative recovery in regional manufacturing and trade

New export orders, while still in contractionary territory, improved notably, signalling an impending rebound of Asian exports after a period of a sharp declines.

Sticky core inflation will worry the ECB and lead to higher policy rates



Source: Bloomberg

Eurozone headline inflation fell from 8.6% in January to 8.5% YoY in February, continuing its series of monthly declines that began late last year, but worryingly for the ECB, core inflation ticked up further from 5.3% to 5.6%. While there may have been statistical distortions that led to the jump in core inflation in February, and more favourable base effects could even see core inflation falling back somewhat in subsequent months, the underlying message is that core inflation is sticky, as we have been arguing for some time. Indeed, it is well above the ECB's inflation target of '2% over the medium term'.

The upshot is that we now expect the ECB will hike interest rates by another 50bps both at its March and May meetings, bringing the deposit rate to 3.5% and may even hike rates further after that. Financial markets have also moved to price in a higher terminal policy rate, and Eurozone government bonds sold off last week as well, with 10yr German government Bund yields up almost 20bps. However, the risk is that in the course of trying to deal with inflation, the ECB chokes off the economic recovery and destabilizes periphery bond markets, even though periphery spreads have been well behaved so far. Finally, Irish GDP growth in Q4 was revised down significantly, from 3.5% QoQ to just 0.3% QoQ, which means that the Eurozone economy may have contracted in the final quarter of 2022 after all. We will know more when the third estimate of Eurozone Q4 GDP is released later this week.

US

Good news is again good news for stocks

In aggregate, US economic data were a tad more positive last week, though again highlighting a bifurcated economy. The ISM series showed the manufacturing sector still in contraction (below 50) at 47.7, with prices paid rising and employment weakening, though new orders jumped from 42.5 to a still contractionary 47.0. This contrasts sharply with ISM services, which surprised to the upside at 55.1, with new orders booming and rising further to 62.6. With excess savings still high and another week of very benign initial jobless claims, consumers have both the means and will to spend. This is a challenge for the Fed, not helped by unit labour costs last week that showed a jump in Q4. Consumer confidence weakened in February, with expectations of future conditions down sharply, while home prices fell for a sixth consecutive month, though prices are still up 4.7% YoY versus the peak of 21.3% YoY this time last year. Equity investors seemed less concerned about the impact on rates as stocks marched higher, with the Nasdaq index rebounding 2.6% following a difficult few weeks.

China

The government sets modest economic targets for 2023 as the NPC convenes

China's National People's Congress (NPC) started with the Government Work Report (GWR) by outgoing Premier Li Keqiang. It should be no surprise that the report was 80% backward looking, while forward looking policies apparently expressed the targets of the new government, which will be officially nominated later this week on Sunday. The economic growth target for this year was set at 'around 5%', lower than consensus had expected and also lower than the GDP-weighted average of provincial growth targets. We suspect that the new government has learned from last year's failure to meet the growth target and prefers to keep all options open to surprise on the upside this year. Fiscal policy and labour market targets were slightly higher than a year ago, but lower than the actual outcome last year. We note that the modernisation of the industrial system as well as digitalisation are key focal points of the GWR. Attracting new foreign direct investment seems challenging amid the regional diversification tendencies of foreign companies.

Japan

Strong retail sales meet weak industrial production

From a political perspective, the landmark deal on the long-lasting wartime labour dispute between South Korea and Japan deserves to be highlighted before focusing on the economy. According to the quarterly MoF Survey, ordinary profit growth plunged from 18.3% to -2.8% YoY in Q4 last year. Though this sounds dramatic, we note that actual profits remained just marginally below the record high marked in Q3. Higher wages and the fact that firms have not fully passed on higher input costs to their customers have caused lower, but still high profit margins, while capex spending remains brisk. Meanwhile, industrial production fell 4.6% MoM in January, likely impacted by the Lunar New Year effect. Forecasts for February suggest a modest recovery. January retail sales were brisk, up nearly 2% MoM, reaching the highest level since September 2019, when front loaded demand surged ahead of the consumption tax hike. However, consumer confidence remained soft in February, negatively impacted by high inflation.

Bonds

Government bonds sell-off on strong inflation and economic activity

The global sell-off in government bonds gained momentum last week, led by strong data on both inflation and economic activity. Eurozone core CPI surprised on the upside, triggering a sharp repricing of the ECB rate outlook, with the 2yr Bund yield jumping almost 20bps to 3.2% following a similar move in the prior week. The 10yr Bund yield followed, up 18bps to 2.71%. The move higher in the long end reflected higher inflation expectations, with a surge in the 5yr5yr Eurozone forward inflation swap to its highest level since 2012. This raises fears around the de-anchoring of inflation expectations and will not be taken lightly by the ECB. Treasuries were volatile, with the 10yr yield closing flat at 3.95% on the week after an intraday high of 4.09% on Thursday. Central banks will step up their hawkish guidance given resilient economic activity and labour markets, with bond markets set to remain volatile until there is more evidence that policy tightening is having a broader impact on the economies. This week's US payroll data will be critical, along with next week US CPI print.

Structured Credit

Higher yields are beginning to bite

Tighter central bank policy and higher government yields are beginning to have a strong negative impact on funding costs for both companies and households. The latest data from the Fed show that interest rates on credit cards are now at record highs above 20%. We expect higher funding costs to push defaults higher, especially amongst the weakest borrowers as unemployment is expected to pick up later this year. Subprime Auto ABS delinquencies have increased and are now above pre-pandemic levels. Higher rates are also impacting the real estate market and making refinancing more difficult. Blackstone defaulted last week on a Finnish CMBS after a maturity extension request was rejected by bondholders. That followed other defaults in the US on loans backed by office properties. With growing pressure from the higher cost of funding amid declining income, we expect delinquencies and defaults in CMBS to continue rising. However, while loan provisions should eventually rise, high excess spreads and appropriate subordination should protect senior ABS bondholders from default risk.

What to Watch

- Most attention next week will be on the US labour market data, where payrolls are expected to ease back to 215k in Feb from the stellar 517k in Jan, while unemployment is likely to remain unchanged at 3.4%, with average hourly earnings up 0.3%.
- In Europe, the third estimate of Eurozone Q4 GDP is likely to be revised down into negative territory given the large downward revision to growth in Ireland in Q4 that has already been announced.
- In APAC, we believe the RBA is likely to raise its cash rate by 25bps while Bank Negara Malaysia will keep its monetary policy unchanged. In Japan, we expect the first revision of Q4 GDP data to be modest, while producer prices have likely peaked in February. China and Taiwan will report export and inflation data for February. South Korea, Thailand and the Philippines will report February CPI data. Q4 GDP data will be released in South Korea. Thai markets will be closed on Tuesday, India's on Wednesday.
- Inflation figures for February, which will be a key inputs for monetary policy guidance for the coming months, will be published in several countries in LatAm.

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