Weekly Macro and Markets View

12 June 2023

Highlights and View

In the US, the ISM Services Index falls to 50.3 in May, indicating a slowdown in service activity

Following the contraction in manufacturing, the service sector is now also facing increasing headwinds with most components of the survey deteriorating.

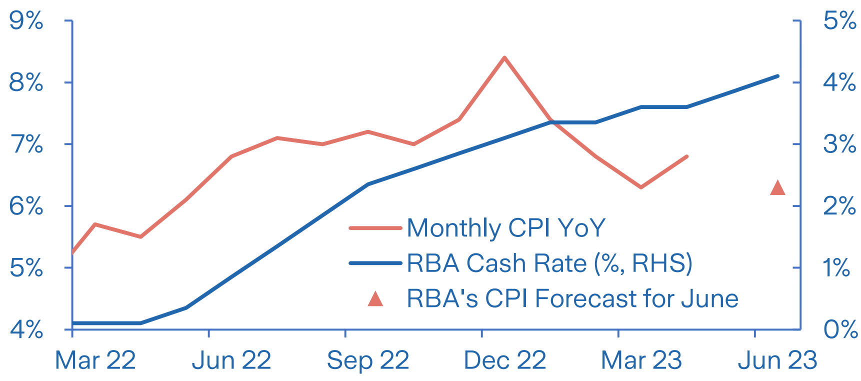
Revised GDP data show that the Eurozone entered a technical recession in Q1, contracting for two consecutive quarters

The data confirm our view of weak and fragile growth in the Eurozone, with domestic demand notably downbeat.

The downward surprise in LatAm inflation provides more evidence that the downward trajectory of inflation is in tact

Easing inflation is paving the way for central banks to cut rates in the coming months, boosting the local equity and fixed income markets.

A surprise rate hike by the RBA as inflation overshoots



Source: Bloomberg, RBA

The Reserve Bank of Australia (RBA) unexpectedly increased its cash rate by 25bps to 4.1%, following recent developments including the unexpected acceleration in the April CPI, hikes in minimum and award wages, and a notable rise in unit labour costs against the backdrop of falling productivity. Governor Lowe once more underscored the 'narrow path' between controlling inflation and preserving jobs, reiterating that 'the desire to preserve the gains in the labour market does not mean that the board will tolerate higher inflation'. This stance highlights a more hawkish shift in the RBA's narratives, suggesting the central bank will likely uphold its tightening bias and remain responsive to inflation data.

Meanwhile, Q1 GDP eased to 0.2% QoQ and 2.3% YoY, down from 0.5% QoQ and 2.7% YoY in Q4 2022, led by lacklustre household consumption and a pronounced decline in housing activity. On a positive note, solid public and business investments compensated for some consumer sector weaknesses. Both household disposable income and the saving rate dipped further. Given the looming interest rate hikes, we expect that growth will likely continue to stagnate.

US

Service activity slows markedly

Following the contraction in manufacturing, services are now also showing signs of slowing down, with the ISM Services Index falling from 51.9 in April to 50.3 in May. The service activity component dropped to the lowest level since 2009, excluding the Covid-related dip in spring 2020, while employment has been contracting slightly according to the survey. On a positive note, the service price component receded to the lowest since May 2020 signaling reduced price pressure. Factory orders were weaker than consensus expected in April with core orders falling for the third month in a row. Further indications of a deteriorating growth environment came from initial jobless claims which shot up to 261'000 last week, the highest number since October 2021, although the figure could have been distorted by the Memorial Day holiday. Markets shrugged off the negative news on the economy, with the S&P 500 rising modestly last week and both short and longer-term yields moving higher ahead of this week's Fed meeting.

Eurozone

After a technical recession in Q1, growth is set to remain weak and fragile

Q1 GDP growth was revised down from +0.1% to -0.1% QoQ following a similar decline in Q4 2022. This means that the region was in a technical recession (defined as two consecutive quarters with negative growth) during the winter, with domestic demand notably soft at -0.8% QoQ. Looking forward, activity is set to remain weak and fragile and the latest data confirm a weak start to Q2. German factory orders failed to rebound in April and have fallen by 7% in the past three months. Eurozone retail sales disappointed, flat on the month and down by 2.5% YoY. The Services PMI was also weaker than expected in May, marking the first decline since November and indicating that services momentum may be beginning to soften. Producer prices have finally slumped, down by -3.2% MoM in April. This left the annual rate at 1% vs. the peak of 43% in August, marking a dramatic improvement in the pricing environment. With labour markets remaining tight and wages still brisk, the ECB is unlikely to pause in this week's policy meeting, however. We expect a 25bp rate hike, with guidance to remain hawkish.

North Asia

Mixed data in Japan while China's exports slump and PPI deflation intensifies

Japan's already strong GDP growth in Q1 was significantly revised upwards from 1.6% to 2.7% in sequential annualised terms. However, we believe the main driver, a higher inventory build-up, will reverse in Q2. Meanwhile, the Eco Watchers Survey DI improved for a fourth month in a row, driven by the corporate manufacturing DI, while the household DI was unchanged. This is in line with the weaker household survey for April as reduced public travel subsidies took their toll. Basic wages rose 1.1% YoY in April. While the latest round of 'shunto' wage negotiations were somewhat disappointing, we still expect a significant positive impact on wages to become visible in July. China's May exports slumped 8% MoM and 7.5% YoY on weaker exports to the US, Japan and ASEAN, which makes us believe that MLF policy rates may be cut as early as this Thursday to spur the economy. China's CPI came in at only 0.2% YoY amid weak aggregate demand, with core inflation at 0.6% while producer price inflation dropped to a seven-year low of -4.6% YoY amid falling commodity prices.

LatAm

Another downward surprise in inflation opens the door to an early start in the easing monetary cycle

In Chile, monthly inflation reached 0.1%, below market expectations. The annual headline and ex-volatile inflation continue to decelerate, reaching 8.7% and 9.9% respectively and providing more evidence that the downward trajectory of inflation is in place amid a slowing down in economic activity. We expect the Central Bank of Chile to start cutting rates in Q3 2023, leading the monetary easing cycle in LatAm. In Brazil, monthly inflation reached 0.2%, with annual inflation falling from 4.2% to 3.9%, consolidating within the target band. The negative prints in fuels and fresh food prices explained the downward monthly surprise. The inflation breakdown is also looking better. Core inflation has been decelerating for eleven consecutive months, reaching 6.7%, increasing the odds for an early start of the monetary easing cycle. In Mexico, headline inflation was also surprising to the downside, with negative monthly inflation in May, while annual inflation reached 5.8%. The latest figures confirm the disinflation process but will not impact the monetary policy decision in the short term.

Credit

Covered bonds: A comeback for Italian banks

Covered bonds contributed a major part of the credit market supply last week, with eleven banks selling close to EUR 10bn debt. While two UK banks came to the market following the renewal of Prime RMBS issuance in May, the bulk of the supply was driven by Italian banks that had been absent from the market for the last twelve months. Italian issuers were locked out of the market awaiting the adoption of the Covered Bond Directive by the regulator. Unicredit opened the market last Tuesday, gathering EUR 4.8bn of orders for its EUR 3bn deal in two tranches. Given that Italian banks had been major beneficiaries of the ECB's cheap loan program, the TLTRO, they are likely to be more active in the coming weeks ahead of the TLTRO repayments. Despite the supply this year being well above the same period last year, covered bond spreads have now almost retraced the widening of the first quarter and are back to the level of early January. Looking ahead, we expect covered bonds to outperform other parts of the credit market due to their safe haven nature.

What to Watch

- In the US, the Fed is expected to keep rates unchanged while CPI and PPI data are likely to reflect a further reduction in price pressure.
- The ECB is expected to hike rates by 25bps in this week's policy meeting.
- In APAC, we expect both the Bank of Japan and Taiwan's CBC to keep monetary policy unchanged. Japan's May export data are likely to be soft. Australia's employment data will show whether the job market is still loosening, which has important implications for the inflation outlook. Consumer and business confidence data will also be reported. China will report most of its major economic data for May. Indonesia and Singapore will release May export data.

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