Weekly Macro and Markets View

10 July 2023

Highlights and View

The ISM Manufacturing survey falls to a post-Covid low, pointing at further headwinds for the US economy

Meanwhile, services recovered in June and the employment situation is still benign despite the weakest growth in new payrolls since December 2020.

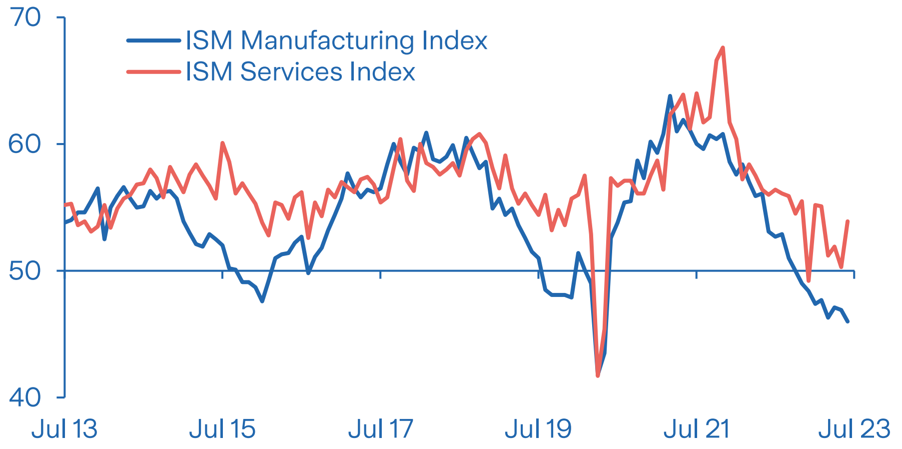
Government bond yields surge as strong US data catalyse a sharp correction

Yields look stretched to the upside given falling inflation, slowing growth and recession risk.

Japan's wage negotiation round marks a 30-year high, with wages up 2.5% YoY

We believe that even real wages will turn positive later this year, which should boost consumer confidence.

US manufacturing under pressure while services remain more resilient



Source: Bloomberg

The ISM Manufacturing survey fell to a post-Covid low in June and has been in contractionary territory for eight months now while new orders have even been receding for ten months. Meanwhile, although having softened recently too, services are more resilient with the ISM Services index reaccelerating to 53.9. Importantly with regard to the inflation outlook, the price component in services fell to a post-Covid low and is now below pre-Covid levels, indicating fading price pressure. A lot of focus was on last week's ADP employment numbers, which showed a massive gain of 497k in June and was far above consensus expectations. However, the perceived strength in the labour market was not confirmed by growth in nonfarm payrolls, which slowed to 209k, the lowest since December 2020. Other labour market indicators also point at a softer employment situation. The number of job openings fell to 9.8mn in May from 10.3mn in April, though the quits rate has picked up again. Initial jobless claims also picked up from 236k to 248k. The unemployment rate ticked down to 3.6%, however, and growth in average hourly earnings remained at 4.4% YoY, still too high for the Fed to be convinced that the labour market has cooled enough. Finally, growth in factory orders was significantly below consensus expectations, remaining at 0.3% MoM in May, with core orders (ex transportation) now falling the fourth month in a row.

Equities

Stocks wilt as interest rate prospects rise

In lacklustre summer trading, with the US closed last Tuesday for Independence Day, equity markets fell back on mixed economic news and fears of tighter policy ahead. The MSCI World Index slipped by 1.4%, broadly representative of most regions, although European indices struggled, with the Euro Stoxx 50 off 3.7%. One poor week following a succession of new 12-month highs on strong momentum does not signal a crack for stocks, however. That noted, we do think that there has been too much complacency as of late, with risk premia likely to rise. Poor European economic data were a reminder of the dangerous cross-currents of a shrinking economy and rising interest rate expectations, as short dated bond yields surged. In the US, it was the much stronger than expected ADP employment reading on Thursday that was a reminder to investors that rate prospects are also rising as growth holds in better than expected. This was underscored by hawkish Fed member commentary by the end of the week. The tug-of-war between rising rates and equity momentum remains too close to call.

Bonds

Government bond yields surge on strong US data

In a dramatic week for bond markets, yields surged, with Thursday's strong US ADP and ISM Services data being the catalysts for the sell-off. Critical levels were breached, as the US 2yr yield rose above 5% intraday on Thursday, though it edged lower on Friday on the softer US payroll data. Though rates rose, the sell-off was led by the long end of the curve. The 10yr Treasury yield surged by 22bps to breach 4%, with similar moves in Bund and gilt yields. Treasury and Bund yields are now back at levels last reached in early March, prior to bank stresses, while gilt yields have risen to the highest level since 2008. Bond markets now appear to largely have priced out recession risk, despite sharply slowing growth in Europe, deflationary pressures in China, and a global manufacturing sector that is in contraction. While bond market pricing will remain volatile and data dependent for the time being, we see limited further upside to yields given headwinds to growth and activity.

Australia

The RBA pauses, yet remains hawkish

The Reserve Bank of Australia (RBA) maintained its cash rate at 4.1% last week, in line with our expectations. In May, the surprising decline in the monthly inflation rate from 6.8% to 5.6% YoY reduced the urgency for another rate hike. However, the RBA maintained its hawkish tone, stating that 'some further tightening of monetary policy may be required to ensure that inflation returns to target'. We expect the RBA to deliver one to two more rate hikes in H2, depending on the inflation trajectory. Meanwhile, house prices continued to rise for the fourth consecutive month in June. Home loans grew 4.8% MoM, but remain down 20.5% YoY. Building approvals rose by 20.6% MoM in May, signalling some easing of housing supply constraints, yet the number of approvals remained well below the 10-year average. Despite positive momentum in the housing market, challenges persist given the RBA's impending rate hikes and the delayed impact of past rate hikes. Our upcoming Topical Paper will offer in-depth analysis of the key drivers in the housing market.

Northern Asia

Japan's wages are rising while Taiwan's exports continue to suffer

Japan's household survey and the labour report for May are sending completely different messages. The former shows real disposable income tumbling 7.4% YoY, while the latter shows nominal wages rising 2.5% YoY, with real wage changes improving two percentage points to -1.2% YoY. As the sample base of the household survey is small, we tend to prefer the labour report. Furthermore, the final outcome of the 'shunto' wage negotiations between employers and trade unions reveals headline wage growth of 3.58%, the highest since the early 1990s, with a base pay rise of 2.12%. We believe that even real wages will turn positive later this year. Meanwhile, China's Caixin Services PMI contracted 3.2 points to 53.9 in June, while South Korea's and Taiwan's June PMIs disappointed at 47.8 and 44.8, respectively. China's June CPI fell to zero, while PPI deflation intensified to -5.4% YoY. Taiwan's June exports continued to tumble both for tech (-17.3% YoY) and non-tech goods (-34.2% YoY).

Credit

Higher delinquencies in US ABS forebode more pain to come

Delinquency rates for US consumer debt have trended higher since the historical lows during the pandemic and are now close to or above pre-Covid levels. Deterioration is particularly noticeable amongst the weakest borrowers, as seen in the performance of Subprime Auto ABS deals. However, the roll rate from delinquencies to defaults is low as most consumers are doing their best to avoid default, not wanting to lose their cars. This situation has been manageable for borrowers due to the strong labour market, while loss rates have been helped by elevated used car prices, which boosted recovery levels for repossessed cars. But we expect these trends to reverse as real income remains under pressure and recession looms. Another headwind for US households will be the end of the forbearance plan for student loans and the recent US Supreme Court ruling against Biden's forgiveness plan. The outlook for consumer credit looks weak given debt service costs and the likelihood of recession, but senior ABS tranches should be protected from losses.

What to Watch

- In the US, investors will focus on the latest batch of inflation data where both headline and core CPI are expected to have weakened further while consumer sentiment will give insights into the current mood of households.
- Data on industrial production and the Sentix and ZEW surveys are expected to point to continued weak economic activity and sentiment in the Eurozone.
- In APAC, the Bank of Korea is expected to keep its policy rate at 3.50% while maintaining a hawkish tone. Australia will release business and consumer confidence reports as well as household spending data for June. Japan will publish May machinery orders and June producer price data. Singapore will publish Q2 GDP data, and India will release May industrial production as well as export and CPI data for June. Our focus will be on China's monetary data, CPI, PPI and foreign trade statistics for June.

Disclaimer and cautionary statement

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