Weekly Macro and Markets View

24 July 2023

Highlights and View

Better than expected US bank earnings drive US bank stock indices higher by over 6%

The results confirm our view that while a systemic bank crisis seems unlikely, credit conditions should remain tight for some time and will likely weigh on economic growth.

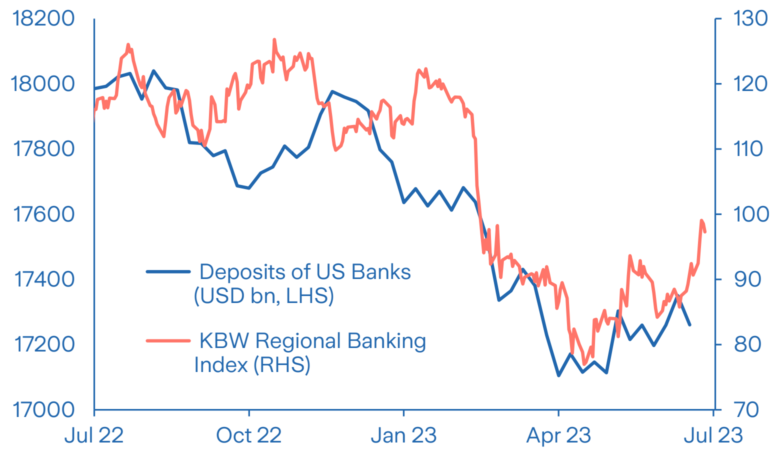
UK CPI inflation surprises positively for the first time this year

The decline in both the core and headline reading is welcome, but the still elevated level is likely to keep the BoE in hawkish mode.

The Spanish election has an inconclusive result, with the opposition Popular Party falling short of a majority

The result was at odds with the polls that had the PP, combined with the right-wing populist VOX party, on track for a majority. The outcome has created a period of uncertainty with a new election likely before year end.

US Bank earnings buoy sentiment



Source: Bloomberg

The much awaited US Bank earnings for Q2 boosted investor sentiment strongly last week, driving the KBW Bank index and the KBW regional bank index up by around 6.5% and 7.3% respectively. Financial credit spreads outperformed non-financial spreads but not to the same degree as was seen in stocks. While several regional banks have yet to report, results have on average been better than expected. However, we believe going forward margins are at risk of coming under increasing pressure, not only from an expectation that interest rates are likely to peak but also from the pressure on banks to pass on higher rates to depositors and savers. At the same time, while loan losses and provisions appear manageable for the moment, a recession such as the one we expect can change the outlook meaningfully. Deposits seem to be tentatively stabilising, but as the chart shows it is a stabilisation as opposed to a rebound. We believe a rebound in deposits is likely to require both a greater pass through of higher interest rates as well as a clear diminishing of recession prospects. Last but not least, the pace of losses on commercial real estate exposures is uncertain and could impact some small banks. All in all, the results confirm our view that a systemic bank crisis is likely to be avoided but credit conditions should remain tight for some time as pressures remain from a fear of deposit flight and deteriorating fundamentals.

UK

Finally some positive news on inflation as both headline and core CPI ease

Attention was on the UK inflation readings, having continually disappointed this year. In a welcome change, the headline reading declined sharply from 8.7% YoY to 7.9% YoY, largely as a result of base effects around fuel and energy costs. More encouragingly, the core reading, stripping out the volatile food and energy components, also fell. The 6.9% YoY was down two tenths from last month as industrial goods prices slumped. There was also some better news on the services part of the economy as well, as prices have started to ease. Despite the better readings, actual levels are still extended and the highest amongst the G7. With wages still rising 7.3% YoY and consumer spending holding up in June, we suspect the BoE will be bold at the next meeting with another 50bps in tightening, despite market expectations easing back. The inflation reading also helped the beleaguered gilt market. 10yr yields hit a post financial crisis high of 4.66% the prior week, but fell back to close at 4.28% on Friday, in line with our view that yields had become stretched and poised for a pullback.

US

The start of earnings season shows mixed fortunes

US stocks continued to grind higher last week, with the Dow up 2%, posting 10 consecutive up sessions to hit a 17-month high. Broader indices lagged as earnings season got into full swing. Banks posted good numbers with both Morgan Stanley and Bank of America beating expectations, but some favoured names struggled. Tesla was down over 7% on the week on disappointing earnings and shrinking margins while Netflix fell sharply on a revenue miss and lowered guidance. That noted, stock momentum remains impressive, though earnings are likely to fall for the third consecutive quarter. Data continued to show a bifurcated economy. Industrial production and capacity utilisation were weak in June, but core retail sales surprised positively with revisions to prior data. Initial jobless claims were better than expected at 228k, with the four-week average continuing to decline. Housing activity remains lacklustre with permits and starts down, though homebuilder sentiment continues to tick higher. We see a further 25bp Fed hike this week as almost a given.

Japan

Leading surveys reveal manufacturing weakness

Both today's July Flash PMI release and last week's July Reuters Tankan report reveal that services activity remains strong while weakness is emerging in Japan's manufacturing sector. The Reuters Manufacturing diffusion index weakened for the first time this year from 8 to 3, with the outlook component falling six points. Meanwhile, the Manufacturing PMI, at 49.4, softened again and remained below the boom/bust line of 50, with the new order index falling 1.3 points. However, the new export order index rose 2.6 points, even though it remained below 50. Japan's trade balance swung to a surplus for the first time in 23 months on a lower energy import bill and improving export volumes, particularly for vehicle exports. However, we note a significant drop in semiconductor machinery equipment exports to China, in line with sanctions. At 3.3% YoY, Japan's headline June CPI came in above that of the US for the first time in eight years while the various core measures were reported in line with expectations.

ASEAN

Trade weakness remains a headwind to growth

ASEAN continues to grapple with the headwinds of the global trade downturn, with Singapore's non-oil domestic exports down by 15.5%, Malaysia's exports declining by 14.1%, and Indonesia's exports falling by 21.2% on a YoY basis in June. However, there was a glimmer of hope in the tech sector, with tech exports in Malaysia and Singapore showing a MoM improvement of 5.6% and 13.6%, respectively. Singapore's exports to China demonstrated strength, but exports to developed markets remained choppy.

Having said that, leading indicators such as PMI new export orders across ASEAN continued to be fragile, suggesting ongoing uncertainty around the trajectory of trade. Meanwhile, YoY imports across Singapore, Malaysia and Indonesia stayed in contraction, indicating weak domestic demand. Overall, we expect trade weakness will continue to drag on growth in the region in the near term.

UK RMBS

Higher rents to partly offset interest costs for landlords

UK rents for private tenants experienced the largest increase since 2016, with the Office for National Statistics reporting a 5.1% annual jump for the whole stock of rented properties. The increase is even more dramatic for newly let properties, with various providers reporting annual rent inflation above 10%. Rising mortgage costs have shut out first time buyers from the property market, which has contributed to the robust rental demand. The privately rented sector is an important part of the UK housing market and represents close to a fifth of the overall mortgage market. The recent rental increase should therefore help mitigate the impact of higher mortgage rates for the landlords and should support RMBS (residential mortgage backed securities). We also think this should alleviate pressure on house prices as most landlords who let out properties tend to use leverage to boost their return. However, given the improvement in rental yields along with the substantial home price appreciation over last few years, landlords will likely avoid forced sales despite an increase in mortgage payments.

What to Watch

- All attention globally will be on the Fed meeting Wednesday, where a 25bp rise is expecting following the pause last month.
- In the Eurozone, a further 25bp hike is also expected from the ECB, while PMI data will be scrutinised for signs of stabilisation in what has been a clearly weakening trend.
- In APAC, the focus will be on the Bank of Japan's monetary policy meetings on Thursday and Friday, when the MPM board will likely decide whether to tweak YCC and announce new inflation targets. Bank Indonesia is expected to keep its policy rate unchanged on Tuesday.
- In Chile, investors will focus on the upcoming Central Bank meeting on July 28. The market is expecting the start of the easing cycle with a 75bp cut to 10.25%.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd

Investment Management
Mythenquai 2
8002 Zurich

173008049 01/22) TCL

ZURICH®