Weekly Macro and Markets View

31 July 2023

Highlights and View

As expected, the Fed and the ECB hike rates by a further 25bps

While inflation at the headline and now core level is falling appreciably, tight labour markets and strong service sectors keep prospects of a pause in rates very much data dependent.

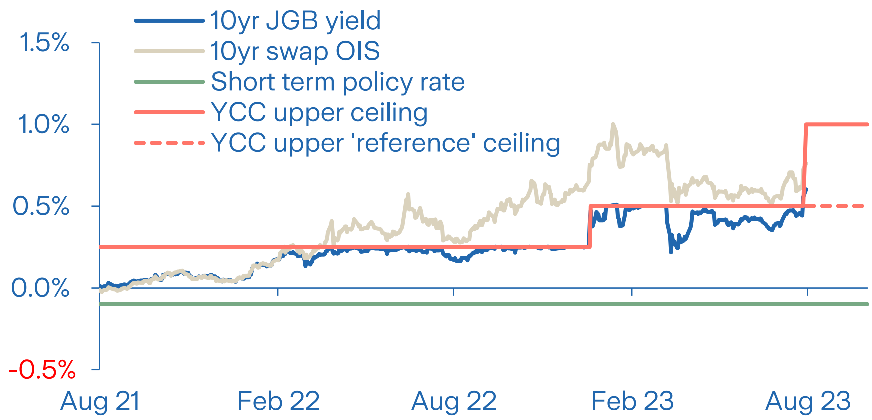
The Bank of Japan leaves key policy rates unchanged, but pledges to make YCC more flexible

While the timing of the announcement came earlier than consensus had expected, the BoJ now has more flexibility in its monetary policy as inflation forecasts have been upgraded.

China's Politburo announces a series of measures to support the ailing economy

We believe quick and targeted policy implementation by various government agencies will be key to reviving the economy.

The Bank of Japan tweaks its YCC policy earlier than expected



Source: Bank of Japan, Bloomberg

The Bank of Japan (BoJ) tweaked its Yield Curve Control (YCC) policy in its Monetary Policy Meeting (MPM) on Friday. Governor Ueda clarified that the BoJ has not changed its policy stance but wanted to enhance its sustainability. The ceiling of the YCC band around the zero 10yr JGB target has been expanded from +/- 50bps to +/- 100bps, while the ceilings of its prior band are now considered 'reference points'. The policy changes allow the BoJ more flexibility in case of future speculative attacks by market participants. The policy change is fully in line with our expectations, though we had been anticipating that the decision would be announced at the September MPM. The BoJ also revised its inflation expectations for FY2023 from 1.8% to 2.5% for core CPI ex fresh food and from 2.5% to 3.2% for new core CPI ex fresh food and energy, with the forecasts for FY2024 and FY2025 roughly unchanged below 2%. Notably, the BoJ mentioned that 'signs of change have been seen in firms' wage and price-setting behaviour'. Coincidently, Tokyo's July core CPI measures came in above market expectations. The 10yr JGB yield rose from 0.44% before the BoJ MPM to 0.6% as of today, while the yen first strengthened into the meeting, but weakened again after the event.

Meanwhile, today's data releases confirm solid consumer activity in June, with confidence even increasing in July, while data for industrial production and housing starts in June disappointed.

China

The Politburo announces a broad set of measures to support the weak economy

China's Politburo convened on Monday, a few days earlier than anticipated, to reveal a series of measures intended to support the ailing economy. Overall, the announcements have to be interpreted as general policy directives, which will then be formulated in detail and implemented by various government agencies. The measures focused on accommodative monetary and expansionary fiscal policy, spurring consumption through targeted policies, supporting the private sector, and easing housing financing restrictions while speeding up the supply of affordable housing and renovating urban villages. We believe the package can re-energise the stumbling economy if it is implemented quickly and efficiently. Investors applauded, with 'H'- and 'A'-shares bouncing nearly 12% and 7% respectively trough to peak within the week. Meanwhile, the NBS Manufacturing PMI for July recovered slightly on stronger domestic demand while the export component continued to deteriorate. Services and construction activity weakened further.

US

The Fed hikes, probably for the last time in this cycle

As was widely expected, the Fed hiked rates by another 25bps to a range of 5.25% to 5.5% in July, the highest in 22 years. Fed Chair Jerome Powell emphasised that the next policy steps will be data-dependent, though given our growth outlook we don't expect any further rate hikes in the current cycle. Both the employment cost index for Q2 as well as PCE Core inflation in June receded more than consensus expected, helping to sooth the FOMC's worries. The first estimate for Q2 GDP shows that the economy was growing by 2.4% QoQ between April and June despite a marked slowdown in consumer spending. Meanwhile, the latest batch of PMI data shows that the economy continues to cool down with manufacturing still in contraction and service activity slowing down to 52.4 in July from 54.4 the month before. On the other hand, consumer sentiment picked up to the highest in two years in July helped by a healthy labour market and falling inflation. Investors welcomed the looming end of the hiking cycle lifting the S&P 500 to the highest level since March 2022.

Eurozone

The ECB takes centre stage amid another round of weak data

Despite the summer sun, economic readings last week continued to paint a gloomy picture of the Eurozone, not helped by a much anticipated 25bp rate hike by the ECB. Provisional PMI readings for the region were grim, with the manufacturing index falling to 42.7 and Germany particularly weak at 38.8. Services were better but still in decline, falling below expectations to 51.1, and it was France that stood out on this measure, with a contractionary reading of 47.4. With confidence levels in decline, despite unemployment at record lows, the region remains vulnerable. The ECB press conference offered some hope in terms of rate projections as President Lagarde would not pre-commit to further hikes and emphasised the data dependency of future decisions. This was enough to encourage equity investors, with the EURO STOXX 50 equity index breaking above the tight trading range it has been in since April, posting a gain of 1.7% on the week.

Australia

Inflation surprises to the downside

Q2 inflation came in at 0.8% QoQ and 6% YoY, lower than consensus expectations of 1% QoQ and 6.2% YoY. The softer inflation print drove bond yields lower last week, with market pricing now implying fewer rate hikes in the second half of the year. The ASX200 Index also regained some momentum amid hopes that the RBA will not need to hike rates aggressively. While we envisage the RBA pausing this week, one or two more rate hikes are still likely in H2. A tight labour market, coupled with rising rents, suggests that inflationary pressure will probably persist. Additionally, demand continues to hold up, with retail sales showing a flat overall trend at 2.3% YoY despite a MoM decline. That said, some cracks are starting to emerge, with the Flash Services PMI falling below 50 in July, while the Manufacturing PMI also showed similar weakness.

Credit

Another weak report for European credit conditions

The release of the latest ECB Bank Lending Survey confirmed a further deterioration in credit conditions. Despite a slight improvement from the previous quarter, the net balance of banks reporting tighter standards remained positive, at +14% for corporates and at +18% for consumers. The main negative news came from very weak demand for loans to corporations and households, which remained at low levels below banks' expectations. European Banks reported that an increased perception of risk related to the economic outlook and the higher cost of funding were among the factors contributing to the tightening, underlying that the transmission of the ECB's restrictive policy to the economy through the banking sector is working well. We believe that high interest rates and tighter credit conditions should push corporate default rates higher. Given current tight credit spreads, this confirms our view that the upside in credit remains limited, particularly if a recession or an economic slowdown materialises in the coming months.

What to Watch

- In the US, the ISM surveys for July as well as the latest batch of labour market data will give crucial insights into the current state of the economy.
- In a light data week for the Eurozone, attention will be on the CPI inflation readings, where the headline is expected to moderate to 5.3% YoY from 5.5%, and the core to 5.4% from 5.5%.
- In APAC, the Reserve Bank of Australia and the Bank of Thailand are expected to keep their policy rates unchanged. July CPI data in South Korea, Indonesia and the Philippines are likely to reveal that headline inflation is cooling further. Japan will report labour market data for July, while in China the focus will be on July PMIs. Australia will report July house prices, June building approvals and July export data. South Korea will release July export data, while Hong Kong will report June retail sales data. On Tuesday, markets will be closed in Thailand due to a national holiday.

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Zurich Insurance Company Ltd

Investment Management
Mythenquai 2
8002 Zurich

173008049 01/22) TCL