ZURICH

Weekly Macro and Markets View

7 August 2023

Highlights and View

US business activity continues to moderate, but the labour market remains tight

The ISM manufacturing survey remains in contraction while services show modest growth. In both cases the employment component has weakened substantially.

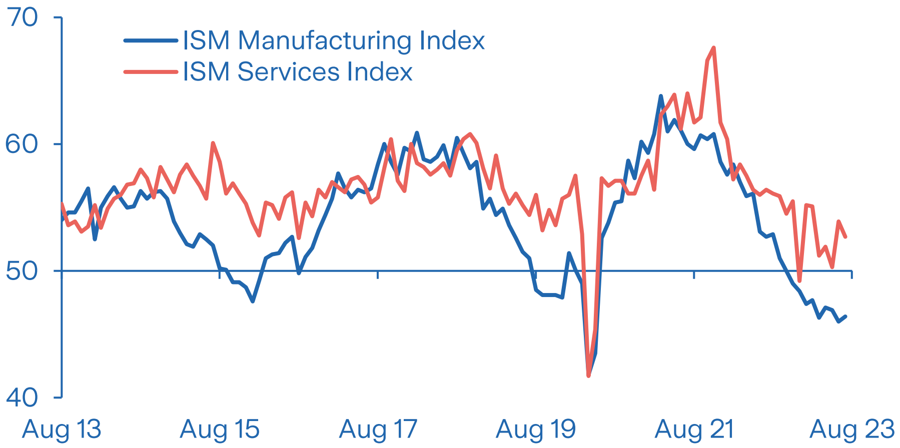
The Bank of England lifts its target rate by 25bps to 5.25%

Given the still elevated levels of inflation and stubbornly high wage growth, a bigger step would have sent a more convincing signal that the BoE wants to get ahead of the curve.

The easing cycle starts in Latin America with Chile and Brazil delivering higher than expected cuts

Early easing and highly discounted valuations should support Latin America's equity market performance.

US business activity moderates



Source: Bloomberg

Last week brought more evidence of a slowing economy with a still tight but cooling labour market. The ISM Manufacturing survey ticked up slightly to 46.4 in July from 46 the month before but remains in contractionary territory for the ninth month in a row. Services are holding up better though the index slowed to 52.7, indicating modest growth. In both cases the employment component has weakened substantially. Meanwhile, employment growth has been holding up with 187'000 new nonfarm payrolls created in July while past figures have once again been revised down. The unemployment rate ticked down to 3.5% though average weekly hours worked declined again simultaneously leaving the aggregate number of hours worked unchanged over the last six months. Growth in average hourly earnings remained at 0.4% MoM, leaving the annual rate at 4.4%, which is still too high for the Fed to feel confident that wage pressure is easing enough. Triggered by Fitch downgrading the US to AA+ from AAA and exacerbated by the Treasury's announcement of higher near-term borrowing needs, bond yields soared with the 10yr Treasury yield briefly rising to 4.2% before falling back. Rising interest rates and mixed corporate earnings results weighed on the stock market with the S&P 500 suffering the worst week since the banking turmoil in March, falling 2.3%.

Eurozone

Data continue to point to a fragmented and vulnerable economic region

Eurozone equities succumbed to global profit taking last week, with the EURO STOXX 50 index down 3% and back within the sideways trading range evident since March. The economy also lacks direction as it dips in and out of recessionary conditions. GDP data for Q2 was better than expected, posting a gain of 0.3% QoQ, after being flat in Q1, although results varied between countries. France bucked its run of poor PMI readings by posting a gain of 0.5% QoQ, with Spain also better, while Germany and Italy disappointed. Once again there is a marked difference between services and manufacturing, the former helped by a strong holiday season, while the latter continues to shrink. As Eurozone growth broadly stagnates, employment remains remarkable, with unemployment at a record low of 6.4%, and coming down across the region. This will keep the ECB vigilant in terms of wage growth, given still troubling inflation readings. CPI for July ticked down to 5.3% YoY from 5.5%, but core inflation remained unchanged at 5.5% YoY, with services ticking higher.

China

July PMIs paint a mixed picture, while policy support is on its way

As is often the case, China's NBS and Caixin PMIs for July revealed different messages, which can be clarified to some extent by digging deeper into the statistics and definitions. While the PMIs published by the National Bureau of Statistics (NBS) focus on the bigger industrial companies, many of them state-owned enterprises (SOEs), the PMIs published by the news agency Caixin focus more on the light manufacturing companies on China's Eastern coast. Furthermore, the NBS and the Caixin PMIs have different sample sizes and survey dates within a month. The Caixin Manufacturing PMI fell 1.3 points below the boom/bust line of 50 to 49.2, reflecting weakness in China's export related industries, while the NBS Manufacturing PMI improved slightly to 49.3 on solid infrastructure spending and the strong domestic auto sector. Meanwhile, the NBS Non-Manufacturing PMI fell 1.7 points to 51.5 on further weakness in construction and services activity. Amid steps announced to implement policy guidance from the Politburo, we believe China's PMIs will slowly improve in the second half of the year.

APAC

Focus on a big PMI spectrum, the RBA and the BoT

It is worth noting the significant difference in PMI readings in the Asia-Pacific region for July. Domestic oriented economies are shining, with India's Manufacturing PMI at a solid 57.7 and its Services PMI at a 13-year high of 62.3, while Indonesia's Manufacturing PMI at 53.3 and the Philippines at 51.9 continue to hover in the expansionary 50-55 range. This is in stark contrast to Taiwan's Manufacturing PMI of 44.1, down 0.7 points from June and not too far away from its Covid lows. A soft new-export-order component is contributing to the weak reading. Meanwhile, Australia's RBA left its policy rate unchanged at 4.1%. We suspect that rising unit labour costs will keep services inflation elevated, which is in line with the RBA's remark that some further monetary tightening may be needed. However, the deteriorating growth outlook will not go unnoticed. A wait-and-see attitude seems likely for now. The Bank of Thailand lifted its policy rate by 25bps to 2.25%, likely ending its tightening cycle. The vote to elect the prime minister in parliament has been postponed again.

LatAm

The time has come, and early easing has begun

Chile and Brazil delivered much-awaited initial rate cuts last week. In the case of Chile, the 100bp reduction to 10.25% was larger than the market's 75bp expectation while in Brazil, the 50bp cut was also above the 25bps expected by consensus, leaving the SELIC rate at 13.25%. The magnitude of the cuts should be similar in other upcoming meetings, and the market expects cuts of 400-500bps for each economy during the next 12 months. We believe this should support equity performance not only from a valuation rerating perspective but also better earnings prospects as the economies benefit from lower rates. Mexico's Q2 earnings season finished with positive results. Roughly 50% of companies reported in line with estimates and close to 25% were above expectations. The highlight of the season was several upward revisions to earnings guidance, following better demand dynamics, positive margin expansion on lower commodity prices, and FX appreciation. We expect upward revisions to earnings estimates to support valuation and performance going forward.

Credit

The Fed's survey confirms tighter credit conditions

In line with the ECB last week, the Fed's Senior Loan Officer Survey confirmed that credit conditions remained hawkish. The net percentage of banks reporting tighter lending standards for corporate loans rose from 46% to 50.8%, but credit card and other consumer loans were also subject to tighter conditions. Loan demand was also reported weaker and is now close to levels experienced during prior recessionary periods. Increased cost of funding and deposit outflows were among the reasons quoted by banks to explain their current stance. We think that the release of the proposed regulatory changes linked to the implementation of the final Basel rules will also limit balance sheet expansion. As credit conditions have been a reliable leading indicator for corporate default rate dynamics in previous cycles, we think that bankruptcies and delinquencies will resume their rising trend and should add pressure to move credit spreads higher from their current tight levels.

What to Watch

- In the US, investors will focus on the latest batch of inflation numbers while consumer sentiment will give insights into the current state of US households.
- In APAC, India's RBI is expected to leave policy rates unchanged. Japan will release the Eco Watchers survey and producer prices for July as well as the household survey and wage data for June. Australia will publish consumer and business confidence data. China's July data for exports, inflation, credit and money supply will be in focus. In Taiwan, we will watch exports and CPI data for July. Indonesia and the Philippines will report Q2 GDP data. Markets will be closed on Monday in Australia, on Wednesday in Singapore, and on Friday in Japan due to public holidays.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd

Investment Management
Mythenquai 2
8002 Zurich

173008049 01/22) TCL