ZURICH

Weekly Macro and Markets View

4 December 2023

Highlights and View

Eurozone inflation fell faster than the market had anticipated in November, to 2.4% YoY

We see inflation returning to the ECB's 2% target towards the end of next year, but see upside risks in the coming months as goods and energy prices detract less from annual comparisons.

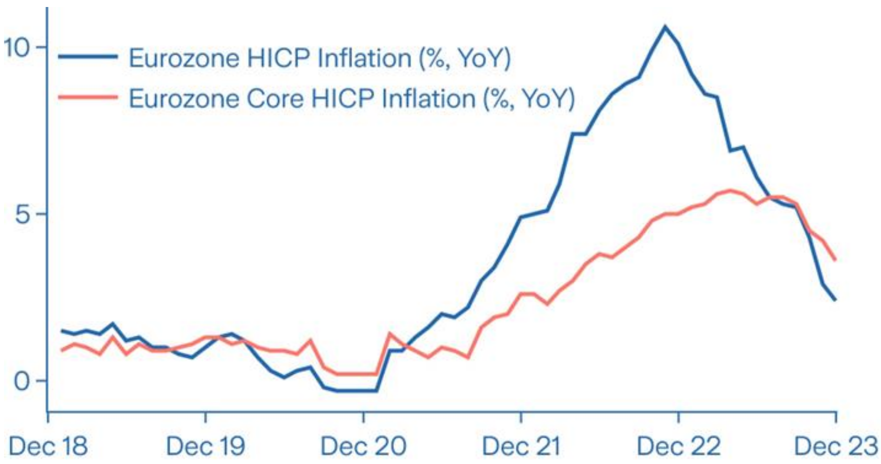
In a surprising twist, Fed Governor Waller sees the possibility of rate cuts in H1 2024

Generally hawkish, Governor Waller's comments are in line with our view that the Fed has done more than enough and is likely to loosen policy in the first half of next year.

Government bond yields slump as inflation falls further and rate cut expectations are brought forward

Better news on inflation now appears to be largely priced, raising the bar for further bond market gains near term.

Eurozone inflation rate falls dramatically



Source: Bloomberg, Eurostat

Eurozone HICP headline inflation fell from 2.9% YoY in October to 2.4% in November. Core inflation, which removes more volatile components such as energy, fell from above 4% YoY to 3.6%. While a slowdown in the rate of inflation was expected, these numbers are considerably below prior published expectations. These figures are unambiguously good news for the ECB as they attempt to bring inflation sustainably back to the 2% level. Services price inflation, which is seen as a better indicator of domestically generated inflation, also fell convincingly in November. Barring any unanticipated shock, we see inflation returning sustainably back to the 2% level by the end of 2024. This is primarily driven by our expectation of weak economic growth and rising unemployment through 2024 and beyond. There remain underlying demographic and trend growth factors in Europe that will likely weigh on inflation as in the 2010s, although uncertainty around the energy and fiscal situations presents upside risks. However, the coming months are unlikely to present a smooth path to 2%. Although we forecast slowing wage growth, the Eurozone labour market remains historically tight and supportive of consumer spending. The main drivers of slowing inflation have been goods and energy prices, where exceptionally high prices in 2022 flatter current year on year inflation. This effect has now mostly played out, shifting the burden of falling inflation towards core prices.

US

More signs of a softer labour market

Last week brought further evidence of a slowing economy and a softer employment situation. The ISM Manufacturing survey remained at 46.7 contrary to consensus expectations of a pickup. While new orders contracted at a slower pace, the falling employment component points at further headwinds in the labour market. Initial jobless claims ticked up to 218k while continuing claims rose substantially to 1.9mn, the highest in two years. Underlining that consumers are becoming more reluctant to spend, personal spending slowed markedly in October to 0.2% MoM from 0.7% MoM. Meanwhile, consumer confidence improved slightly in November as households were a bit less downbeat regarding the future. In a surprising twist, the generally hawkish Fed Governor Christopher Waller noted that he was increasingly confident that policy is currently well positioned to slow the economy and get inflation back to 2%, and he even considered rate cuts in the first half of next year to be a possibility. Treasury yields came under pressure as investors priced in a less hawkish Fed.

Government Bonds

Yields slump as rate cuts are brought forward

Government bonds rallied strongly last week on further sharp falls in inflation. While Fed speak was mixed, investors focused on remarks that rate cuts could be possible in H1 2024 should inflation continue improve in the months ahead. Fed funds futures shifted to price in over 125bps of rate cuts by the end of 2024, with the probability of a cut in March rising above 50%. As a result, 2yr and 10yr Treasury yields tumbled by 41bps and 27bps respectively, marking the sharpest weekly declines since banking sector issues emerged back in March. European markets saw similar moves, with the first ECB rate cut now priced for H1 2024, while 10yr Bund yields fell 28bps to 2.36%, the lowest since June. The move in yields partly reflected falling inflation break-evens as concerns around persistently high inflation have diminished, but real yields also fell further from October highs. While we agree with the direction of moves, a more benign inflation outlook now appears to be largely priced, raising the bar for further bond market gains near term.

Asian PMIs

A mixed bag with interesting details

Most Manufacturing PMIs gained slightly in November even though there were no huge changes compared to August/ September. Major subcomponents such as output and new orders confirm the trend. We note a deterioration in APAC's major economies Japan, China and Australia, while Malaysia, Taiwan and India experienced the biggest improvement from October to November. Taiwan's seasonally adjusted Manufacturing PMI saw steady gains for four months in a row, up 4.2 points, but still remains below the boom/bust level of 50. The recovery in the global semiconductor cycle is benefitting Taiwan and South Korea, even though their new-export order PMIs still remain below 50. The Philippines experienced the steepest recovery over the last four months, up three points to 57.7, while Vietnam's PMI fell 3.2 points to 47.3, the lowest reading in the pack. China's official NBS PMIs deteriorated for the second month in a row, while the Caixin Manufacturing PMI managed to climb back above the 50 boom/bust line, suggesting that export oriented SMEs are performing better than major SOEs.

Switzerland

Resilient activity, but job growth is slowing

The Manufacturing PMI ticked higher in November, but it remains at a deeply contractionary level and the employment index fell to the weakest level since 2020, indicating that companies are becoming more cautious in their hiring plans. The Services PMI showed a similar development, and we suspect that peak labour market tightness is behind us. That said, the labour market is structurally tight and overall labour market conditions should hold up relatively well, helping to support the consumer in the months ahead. The KOF leading indicator data also improved modestly, consistent with a stabilisation in broader economic activity, following weakness in the first half of the year. Likewise, Q3 GDP data were a touch stronger than we had expected, with growth of 0.3% QoQ. Q2 data were revised down, however, and the economy is now estimated to have shrunk in the second quarter, leaving annual growth at only 0.4% in Q3. We maintain our view of weak growth in the quarters ahead, but a deeper drawdown in economic activity should be avoided.

Chile

Affected by poor performance in mining, economic activity shows weak expansion

The Central Bank of Chile (CBC) published the IMACEC economic activity indicator for October, which showed a drop of -0.1% for the month, after an increase of 0.6% in September. The main detractor was the mining sector, which was partially offset by expansion in the service and trade sectors. In 12 months, economic activity accumulated growth of 0.3%, the same growth as September. Additional data published on sectoral activity for October showed a drop of -4.4 YoY in copper production, an increases of 1.1% YoY in industrial production and 9.5% YoY manufacturing production, and a contraction of -0.9% YoY in commercial activity. Finally, we anticipate that the CBC will continue with the easing cycle, cutting the MPR by 75 basis points in the next meeting. The decision will occur at a point in time when the economy hasn't yet fully recovered, although a rebound is likely from here on. Meanwhile, inflation has continued to decline, and the labour market has remained weak, with the unemployment rate remaining above pre-pandemic levels.

What to Watch

- In the US, investors will focus on the latest batch of labour market data while the ISM Services survey will give important insights into the current state of the service sector.
- In the Eurozone, Spanish and Italian PMIs for November are likely to show a small rebound from low levels. Also due are the Sentix investor confidence survey, the ECB's one and three-year CPI surveys, and German factory orders and industrial production data.
- In APAC, the Bank of Japan will hold its first workshop as part of its broad perspective review of monetary policy over the past 25 years. Japan will release the Reuters Tankan for December as well as the Eco Watchers survey for November and publish the Tokyo CPI for November, October wage data and the first Q3 GDP revision. China will report foreign trade data and the Caixin Services PMI for November. Australia will report Q3 GDP and November export data. We believe Australia's RBA and India's RBI will keep their policy rates stable. November CPI data will be reported in China, Taiwan, South Korea, Thailand and the Philippines.
- In LatAm, inflation data will be published in Chile and Mexico, where we anticipate that inflation will continue to slow.

Disclaimer and cautionary statement

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