

# Weekly Macro and Markets View

18 March 2024



## Highlights and View

**The ECB unveiled a new operational framework, including the intention to hold a permanent portfolio of securities**

This formalises a new era of central banking with structurally higher liquidity compared to the pre-2008 era, including permanent bond holdings and demand-driven liquidity provision to banks.

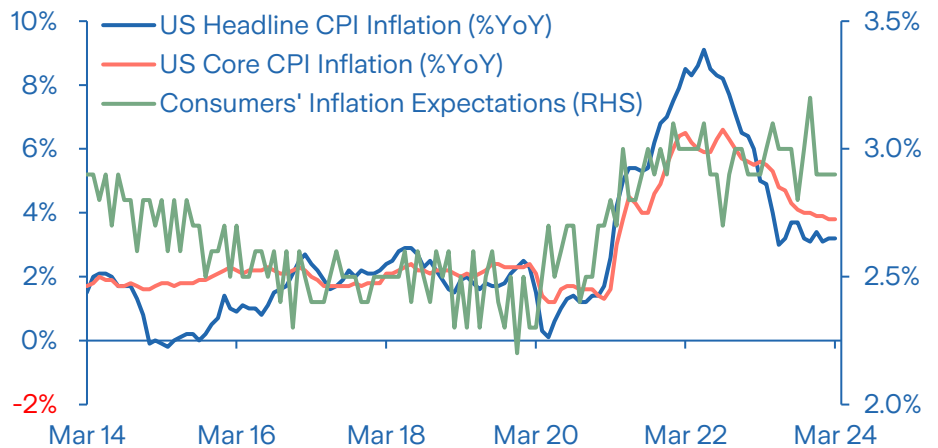
**Japan's 'shunto' wage negotiation outcome seems to have convinced the Bank of Japan to normalise monetary policy**

Wage settlements will continue with smaller companies, with the final wage hikes slightly lower than the ones currently announced, but this will not hold back the BoJ from ending NIRP and YCC.

**China's industrial production and fixed asset investment data for January/February came in stronger than expected**

Retail sales, credit growth and property related data remain weak, which will keep the Government and the PBoC on alert for further stimulus measures.

## US inflation rates remain stubbornly high



Source: Bloomberg

The latest batch of inflation data shows that although price pressure keeps fading slowly, inflation has not been fully vanquished yet. Headline CPI accelerated to 0.4% MoM in February from 0.3% the month before while core inflation stuck at 0.4% MoM. The annual rates for headline and core CPI were 3.2% and 3.8%, both still significantly above the Fed's comfort level. The different components painted a mixed picture. Services inflation remains sticky, with shelter costs still a major driver. Prices for core goods ticked up the first time since May 2023, indicating that the deflation process in goods may come to an end, mitigating the disinflationary forces that helped to keep a lid on overall inflation. A flare-up in price pressure was also visible in producer prices, with headline PPI accelerating to 0.6% MoM from 0.3% in January. Meanwhile, consumers' inflation expectations remain stable but elevated. Consumer sentiment has ticked down marginally in March according to the University of Michigan's latest survey as has the small business optimism index, which is close to the lowest level in more than a decade. Retail sales have not fully recovered from their dip in January. Weighed down by a combination of stubbornly high inflation and soft economic data both the S&P 500 and Nasdaq ended the week slightly lower.

## Bonds

**Government bond yields snap higher on sticky US inflation**

Government bond yields spiked last week as US inflation data surprised to the upside. Just a week ago market pricing implied a near certainty of a Fed rate cut by June, but this has now been dialled back to just above 60%, with a total of 72bps of rate cuts priced for 2024, compared to 150bps in early 2024. Last week's hawkish repricing led to a move higher across the curve, with 2yr and 10yr Treasury yields up close to 25bps. There was significant spillover to other markets, with the 10yr Bund yields up 17bps as ECB rate cut expectations moderated further.

Market expectations for rate cuts look reasonable now, and we anticipate core yields to remain rangebound near term while inflation data will remain a key driver of volatility. Elsewhere, Eurozone sovereign spreads to Germany have narrowed considerably, with the yield difference between Italian BTPs and German Bunds lower than at any time since the ECB began hiking rates in 2022. We believe this move can continue as we head towards ECB policy easing, but a large portion of the likely upside has been realised.

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## Eurozone

Unconventional policy is now conventional

The ECB released high-level details of their new operational framework last week. They have left themselves plenty of deliberate ambiguity, but the high-level principles are a formalisation of a fundamental change in central banking since the Great Financial Crisis. We see this as a positive for sovereign bonds and the stability of the banking sector within the Eurozone. The ECB has adopted a demand-driven money supply system where banks can access as much liquidity as necessary from various monetary operations. They have also

introduced a permanent security portfolio, which likely means sovereign bonds on the ECB's balance sheet outside of the previous QE holdings. They also refer to climate considerations within their monetary operations, suggesting preferential treatment of 'green' assets without providing specifics. Otherwise, data last week marginally supported the ECB's dovish stance. German wholesale prices fell on the month while Eurozone industrial production fell more than expected in January.

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## Japan

The Bank of Japan to normalise monetary policy tomorrow

Following the strong 'shunto' wage negotiation outcome, as elaborated in our latest 'Weekly' publication, the usually well-informed Nikkei newspaper stated in its Saturday edition that the Bank of Japan will end NIRP (negative interest rate policy) and YCC (yield curve control) policies and raise its benchmark policy rate for the first time in 17 years while maintaining its 2% inflation target. The likely decision comes one month earlier than we had anticipated but had no major market impact today, though Japanese equity indices remain firm. The

BoJ board under Governor Ueda and Deputy Governor Uchida seems to be convinced that the long desired inflation-wage dynamics are now taking hold, allowing the central bank to end its ultra loose monetary policy. However, we do not expect a vigorous policy rate hiking cycle ahead, or any 'dot plot' indications as in the US. Instead, we expect the BoJ to keep 'carefully monitoring' the developments on the wage and price front, with a potential further hike in the policy rate in the offing later this year.

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## LatAm

Despite divergent inflation movements in Chile and Brazil, the market maintains expectations of rate cuts

In February, IPCA inflation in Brazil slowed from 4.51% YoY in January to 4.50%, slightly above market expectations of 4.45%. However, concerns about a potential resurgence of inflation persist. Unanchored inflation expectations for 2024-2025 indicate that inflation is expected to be above the midpoint of the inflation target range ( $3\% \pm 1.5\%$ ) in 2024 - 2025. This expectation will likely influence rate cuts going forward. In Chile, although inflation accelerated from 3.8% YoY in January to 4.5% in February, this can be attributed to

changes in the weights within the CPI basket. However, Chile will continue to be the region with the fastest pace of rate cuts. We anticipate a 100bp cut in the next meeting, in contrast to the 50bp cut by the Central Bank of Brazil. This difference is reflected in the movements of exchange rates, where the Chilean peso has depreciated by approximately ~6.8% so far this year, while the Brazilian real has depreciated by approximately ~2.8%.

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## Covered Bonds

Early signs of lower supply from Eurozone issuers

Covered bond spreads underperformed broader credit and tightened modestly by a few basis point last week. Issuance remained strong with 10 banks raising a total of EUR 7.25bn. Year-to-date, cumulative covered bond issuance remains well above the historical average but is now around 10% lower than in the same period last year. We think that part of the initial strong supply this year was driven by the front-loading of funding plans and that issuance will now abate. Loan growth in the Eurozone remains weak, and European banks are now almost

done with the repayment of the TLTRO to the ECB, with only EUR 150bn of outstanding debt to be repaid over the next three quarters. We also expect more deals to come from non-eurozone lenders, following a recent jumbo offer from Canadian bank Toronto Dominion. With investor demand remaining strong and driven by the high level of yields, these improved technical factors should help covered bonds spreads for Eurozone issuers to outperform unsecured credit spreads in the coming months.

## What to Watch

- In the US, the Fed is widely expected to leave rates unchanged but will give important insights into their predicted path for potential monetary easing in the quarters ahead.
- The SNB is expected to leave rates unchanged in the policy meeting while maintaining a dovish outlook.
- This week's Eurozone data are primarily sentiment indicators. On Thursday we will receive Flash PMI data for major Eurozone economies, and overall EU consumer confidence will be available this week as well. The German-specific ZEW and ifo data will also be released this week.
- China's PBoC, Taiwan's CBC, the Reserve Bank of Australia and Bank Indonesia are expected to keep policy rates unchanged. The Bank of Japan is expected to end NIRP and YCC in its MPC meeting on Tuesday. Japan's March PMIs and foreign trade and CPI data for February will be released. Australia's labour market data, India's Flash PMIs and export data for Malaysia and Singapore are key to watch. Taiwan will report export order and CPI data for February.

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