December 18, 2017

ZURICH

Weekly Macro & Markets View

Highlights and View

- **Eurozone business confidence increases further in December**

  The Eurozone economy is now in a boom phase that should continue into 2018 and will support corporate earnings growth in the region.

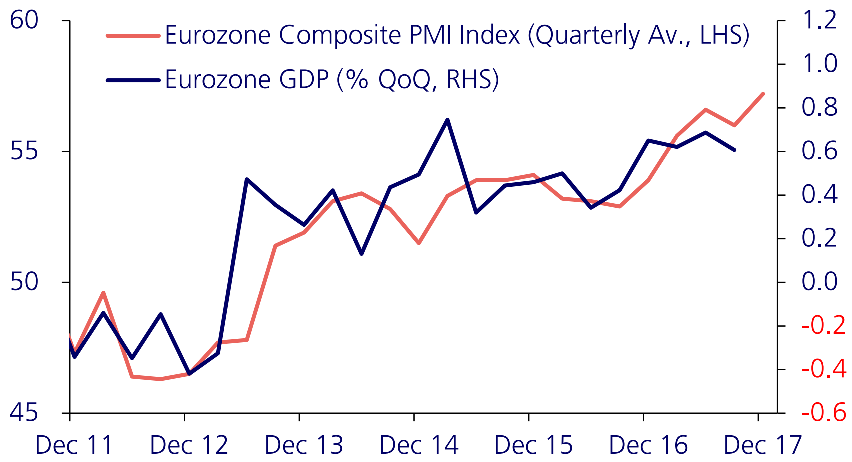
- **The US stock market hits another record high on renewed tax reform optimism**

  It looks very likely now that the tax bill will be passed before Christmas, including cutting the corporate tax rate to 21% beginning in 2018.

- **Walt Disney agrees to buy part of 21st Century Fox for $52.4bn in stock, as M&A activity continues**

  While this deal was not too adverse for Disney's creditworthiness, current easy financing conditions are conducive for M&A and LBOs activity to pick up, favouring shareholders over creditors.

Eurozone enters boom territory



Source: Bloomberg

Last week saw another raft of exceptionally strong data from the Eurozone. The flash composite PMI hit 58.0 in December, up from 57.5 in November. The manufacturing PMI for December was 60.6, the highest on record since the survey began in 1997. The quarterly average of the PMIs suggests GDP growth will be even higher in Q4 than the strong rate of Q3. Forward-looking components within the series, such as new orders, also rose in December, suggesting that although Eurozone growth is booming, it has not yet peaked. These boom-like economic conditions should support corporate earnings growth in the Eurozone in 2018 and in time lead to higher bond yields.

After the ECB monetary policy meeting last week, ECB President Mario Draghi said that the strengthening economic conditions gave him greater confidence that inflation would return to target over the medium term. QE asset purchases are scheduled to be reduced to €30bn a month from January and to continue until September 2018. However, Draghi was non-committal on what would happen thereafter. Whereas he has previously said that there would not be a sudden stop to asset purchases, he now says that the ECB governing council did not discuss what would happen after September. This suggests that if strong economic conditions continue it could eventually lead the ECB to take a less dovish stance than it has to date.

US: The Fed hikes rates and raises its growth forecast

The S&P 500 hit another record high on Friday as the tax bill is now very likely to be passed before Christmas, including cutting the corporate tax rate to 21% effective from 2018. Small business optimism soared to the highest level since 1983 in November, confirming the continuation of strong business activity and a positive outlook. Hiring plans have even jumped to the highest on record, boding well for the employment situation. Inflation is on the rise as well, with headline CPI accelerating to 2.2% YoY in November from 2.0%. Core CPI slowed down to 1.7% YoY from 1.8% in October. However, the acceleration of producer price inflation to 3.1% YoY, the highest in almost six years, indicates that more price pressure is feeding through the value chain. As was widely expected, the Fed increased its target rate by 0.25% to 1.25%-1.5%. At the same time, the FOMC significantly raised its growth forecast for 2018 and beyond while keeping their above-market rate projection for the years ahead. The move underlines that the Fed feels increasingly able to hike rates as planned without impairing growth.

UK: The British parliament wants a veto on the final Brexit deal

The EU formally agreed to move on to trade talks with the UK at its summit last week. While an agreement on the three key divorce topics was announced, many open questions remain, not least how to avoid a hard border between the Republic of Ireland and Northern Ireland if the UK does not remain in the customs union. Theresa May faced another setback at home as the parliament voted to have a veto right with regard to the final deal with the EU. Meanwhile, households' real incomes remain under pressure as inflation reaccelerated to 3.1% YoY in November while weekly earnings grew at only 2.5% YoY in October. The labour market looks healthy at the surface, with the unemployment rate remaining at 4.3% in October. However, jobless claims have ticked up in the past two months while the fall in employment has accelerated. Nevertheless, retail sales have rebounded from their recent multi-year low, growing 1.1% MoM in November. As expected, the BoE voted unanimously to keep monetary policy unchanged.

Switzerland: The SNB leaves policy unchanged amid a more upbeat outlook

The SNB left policy unchanged in last week's policy meeting, as expected. The policy statement was left broadly unchanged, reiterating that while the overvaluation of the Swiss franc had continued to decrease, the franc remains highly valued. It also highlighted that the depreciation of the Swiss franc has been driven by reduced safe haven demand, and that this development is still fragile. The inflation forecast was revised up but, at only 0.5% in 2017 and 0.7% in 2018, this clearly does not justify an imminent change in policy. We stick to our view, however, that the SNB is set to make some changes to its policy next year, likely reducing forex purchases further, and possibly also reducing the scope of the negative deposit rates on excess reserves. The negative policy rate is expected to be left unchanged, at least well into the second half of 2018, given the ECB's expansionary policy. A stable currency is a top priority for the central bank, which underpins our view that the SNB will proceed very cautiously.

Japan: Tankan business conditions at a 26-year high

Japan's Tankan, the quarterly corporate survey that covers more than 10,000 companies, revealed a further solid, though not spectacular, improvement in business conditions. The diffusion index that covers all firm sizes and industries rose another point to 16 in Q4, marking a 26-year high. The headline index for large manufacturing companies improved three points to 25, while small companies are also doing well. This is encouraging as this category tends to hover just above zero or be in negative territory. Firm manufacturing conditions have also been confirmed by a strong showing of the Manufacturing PMI in December. A new cycle high was marked at 54.2. Capacity shortages are increasing, which is visible in the labour market where staff shortages have not been as severe since the early nineties last century. Shortages finally seem to be becoming visible in some price pressure. While the input price component jumped five points to 24, output prices also crept higher to 1, a nine-year high. Overall, these data point to solid growth for 2018, in line with our expectations.

China: Mixed economic data, a small rate hike, and the Politburo meeting

Following the Fed's 25bps rate hike, the PBoC shifted its 7-day and 28-day repo rate as well as its mid-term lending facility rate up by 5bps, catching up with the recent rise in interbank rates. We believe this was a symbolic move within the PBoC's new monetary policy framework, and not responsible for some minor equity market wobbles on that day, as some commentators alluded to. Economic data for November were roughly in line with consensus expectations. Fixed asset investment growth benefitted from strong infrastructure spending, while property investment was a drag, despite some more upbeat data on floor space growth. Industrial production continues to suffer from pollution control measures in the mining industries in the northeast of China. Retail sales growth bounced back, but the online 'single' day sales on 11.11 were only visible in strong mobile phone and cosmetic sales, rather than a broad acceleration in overall online sales. Finally, the Politburo meeting confirmed that reducing financial risks, poverty and pollution while maintaining steady growth will remain centre stage.

What to Watch

- Regional elections will be held in Catalonia on December 21, with polls too close to call as to whether pro-independence parties will gain a majority. Either way, tensions appear to be de-escalating with both sides focusing on the need for dialogue to resolve the crisis.
- The monetary policy boards of Sweden's Riksbank, the Bank of Japan, Taiwan's Central Bank of China, and the Bank of Thailand will convene this week. We do not expect any policy rate changes.
- We would like to wish all our readers a joyous festive season and a Happy New Year. There will be no Weekly published until January 8, but our Economic and Market Outlook 2018 should keep you going in the meantime. Economic and Market Outlook 2018

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