

# Weekly Macro & Markets View

## Highlights and View

- **The Republicans' tax reform proposal includes corporate tax cuts and a territorial tax system**

The proposal provides a welcome simplification of the current tax system. It would benefit shareholders and support growth, but it is unlikely to pass Congress in its current form.

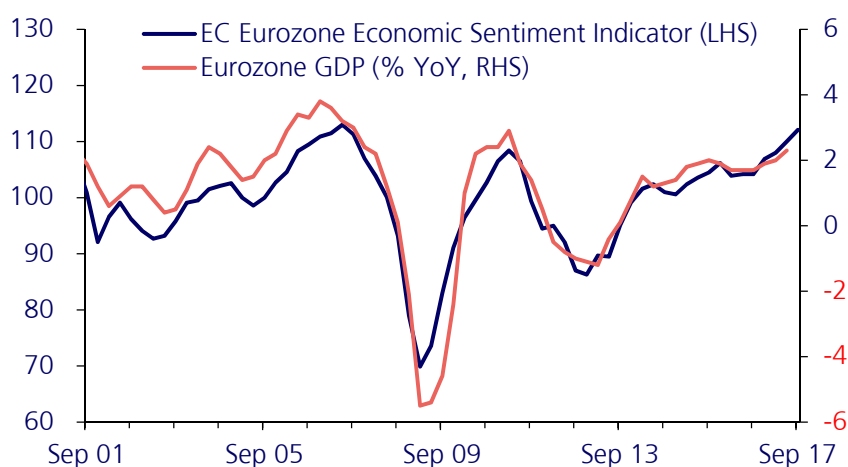
- **Japan's Tankan survey shows a strong reading**

We are particularly encouraged by the strong outcome for small companies and large export-related manufacturing firms.

- **Spanish police and Catalan independence supporters clash as referendum goes ahead**

Tensions between Catalonia and the central government will remain high, however, we do not see these tensions widening to the rest of the Eurozone or derailing the Eurozone recovery.

## Eurozone business confidence at the highest level since 2007



Source: Bloomberg

Business sentiment surveys continue to point to a strong growth dynamic in the Eurozone that is broadening out and has the potential to become self-reinforcing, as long as there are no internal or external shocks. In particular, the European Commission's September business and consumer sentiment survey hit its highest level since 2007, pointing to another above trend GDP print for Q3. Admittedly, the German Ifo Business Climate indicator did slip back a bit in September, but it remains close to its highest levels on record. What's more, national business confidence surveys for other major Eurozone economies continue to move higher. In particular, business confidence in Italy hit its highest level since 2007 in September, which is encouraging given that Italy had previously been lagging in this recovery. There are also signs that business investment in the Eurozone is picking up, which is important in terms of making the recovery more durable. Robust growth in the Eurozone should help companies grow their profits, despite the stronger euro, thus supporting the region's equity markets. It will also make the ECB more confident in reducing QE asset purchases next year, although still low inflation means the bank will proceed slowly.

## Eurozone: Risks to the outlook remain

Currently, the biggest risks to the Eurozone are political rather than economic. Tensions between Catalonia and the Spanish central government look likely to continue following Sunday's referendum and ensuing violence between national police and civilians. In Germany, Chancellor Angela Merkel's room to manoeuvre in terms of agreeing to reforms in the Eurozone may be more limited following elections that will require her to form a coalition government, most likely with the FDP and Greens. In Italy, elections must take place by May 2018 at the latest, with the anti-

establishment Five Star Movement and the PD very close in latest opinion polls. However, even on the political front, it is not all bad news. For example, French President Emmanuel Macron last week proposed a series of reforms to improve the Eurozone, receiving a positive response from Angela Merkel. The Five Star Movement has recently toned down their anti-euro rhetoric. Overall, while various political events will need careful monitoring, we expect the Eurozone recovery to continue, which is also important from the perspective of the global economy.

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## US: Yellen warns against moving too gradually

The S&P 500 finished last week on a positive note, adding an eighth positive quarter in a row. Investor sentiment was lifted by the Republicans' tax proposal, which includes a reduction of the corporate tax rate to 20% from 35%, the transformation to a territorial-based system, elimination of the estate tax and fewer tax brackets for individuals. While the proposal has the potential to support economic growth and would be positive for shareholders, it does not give any details as to how the plan would be financed. It is

therefore unlikely that the proposal will pass Congress in its current form.

In addition to renewed optimism on tax reform, Treasury yields received additional support from Janet Yellen's warning of moving too gradually. PCE Core inflation came in slightly below consensus at 1.3% after 1.4% in July. Nevertheless, given the Fed Chair's comments and the FOMC's lowered inflation projection, this latest data point will not be enough to stop the Fed from hiking in December.

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## Japan: Solid Tankan suggests brisk growth in the manufacturing sector

The Bank of Japan's quarterly corporate business confidence survey, the 'Tankan', revealed an upbeat mood for large manufacturing companies, with the headline index jumping five points to 22, close to its pre global financial crisis highs marked in 2006/2007. This was even better than consensus had expected. Industries benefitting from strong exports were leading the pack. Digging a bit deeper, we are encouraged by the improvement for small companies, both in the manufacturing and the non-manufacturing segments. Investment

plans have improved further for all companies, even though large manufacturers have become a bit more cautious. Labour shortages have increased further.

In the political arena, Japan's main opposition party, the DPJ, seems to be dissolving, with many candidates now joining the new 'Party of Hope', posing a risk to the PM Abe led LDP/Komeito coalition. However, we still expect Abe's LDP to achieve its minimum goal of a single party majority, while the coalition's two-thirds majority clearly seems at risk.

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## Switzerland: Manufacturing activity surges, but growth remains unbalanced

Economic surveys point to stronger activity in September, as the manufacturing PMI rose to the highest level since 2010, led by higher new orders and a run down in stocks. The broader KOF indicator also rose and remains above its long-run trend, supported by a pickup in activity in tourism and manufacturing. Consumption, construction and financial sector dynamics were weaker, holding back the overall pace of expansion. Growth in the Swiss economy is notably unbalanced, as the export driven sector benefits from strong external demand while

services struggle, with labour market concerns a headwind. This was highlighted by the UBS consumption indicator, which rose in August, but subdued employment growth indicates that strength is likely to be temporary. Retail sales data were also sluggish, showing no expansion on a year ago. This weakness underpins our view that the SNB is unlikely to change policy this year, remaining active in the forex market when needed.

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## Credit: US tax reforms unlikely to dent municipal bond performance

The US tax reform proposals, which have been the single biggest concern for municipal bond investors this year, are unlikely to prove disruptive in our view. We don't believe tax exemption will be put at risk given the importance of the municipal bond market for infrastructure investment at the state and local levels. Moreover, the marginal negative impact from lower tax rates and brackets for households, which will reduce the attractiveness of municipal bonds, appears to be largely priced in.

The market reaction this week after the release of the tax reform proposals was in line with our view. Municipal bonds held in quite well despite heavy supply and some sharp moves in US Treasury yields. On the single issuer front, Puerto Rico bonds continued to sell-off following Hurricane Maria. Despite being now eligible for federal emergency supply and aid, severe damage to infrastructure and a weaker economic outlook are likely to affect final bondholders' recoveries.

### What to Watch

- With regard to the current momentum of the US economy, the focus will be on the ISM surveys this week as the labour market data will suffer from hurricane-related distortions.
- The Eurozone final PMIs should confirm robust growth outlook for the region.
- Following the release of several Asian September PMIs announced today, we will watch the remaining ones to be published this week, including Japan's Non-Manufacturing PMI, China's Caixin Services PMI and Hong Kong's Composite PMI.
- Markets in China and Korea will be closed this week due to the mid-autumn moon festival and national days. Markets in Hong Kong are closed on Monday and Thursday, while Taiwan's markets are closed only on Thursday.

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