February 20, 2017

Weekly Macro & Markets View

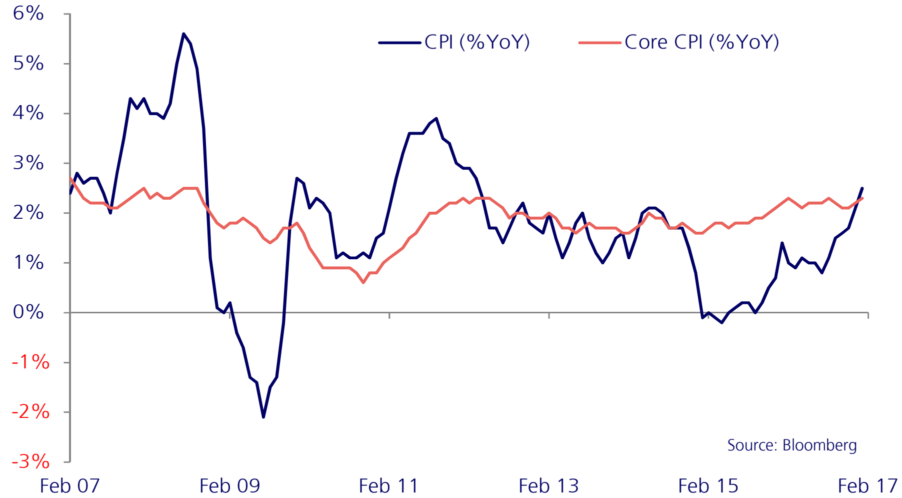
Highlights

- The MSCI All Country World index marks a record high
- China's aggregate financing surges to a record high in January
- Strong inflows into global equities ($18bn), particularly into emerging markets

Our view

- It is encouraging that both developed and emerging markets are contributing
- Strong lending in China is driven by shadow banking products, which is a concern
- Broadening out of inflows are a sign of renewed investor confidence

US headline inflation accelerates to a 5-year high



US small business sentiment ticked up in January to reach a new post-recession high. This bodes well for the employment outlook too, as hiring plans climbed to the highest since 2003. At the same time, filling open positions remains a challenge. The positive sentiment was visible in regional manufacturing surveys as well. The Philadelphia Fed Business Outlook reached the highest level since 1984. However, the upbeat mood was not reflected in hard data, as industrial production fell by 0.3% MoM in January.

CPI inflation picked up significantly last month accelerating to 2.5% YoY. The rise was relatively broad based but the key driver was higher energy prices. Core CPI inflation ticked up to 2.3%. The flip side of higher inflation is lower real wages. Real average weekly earnings fell 0.6% compared to a year ago. Rising prices will be a headwind for household spending going forward, but consumers have not been deterred so far. Retail sales rose 0.4% MoM in January, 0.8% if autos are excluded. Based on the solid economic data, the possibility of a Fed rate hike in March has increased. However, given that wage growth has slowed down recently and the base effects from higher energy prices are expected to fade, the FOMC is more likely to wait until further data confirm that the pick-up in inflation is sustainable. Nevertheless, Janet Yellen kept her options open for the March meeting in her testimony to Congress last week.

UK: Consumers become more reluctant to spend as inflation rises

The Brexit impact is becoming increasingly visible in economic data. Driven by the weaker currency and higher energy prices, CPI inflation accelerated to 1.8% YoY, while retail prices are 2.6% higher than a year ago. Producer input prices climbed a whopping 20.5%, indicating that inflation will accelerate further in the months ahead. Higher prices will be a headwind for consumers. This is increasingly reflected in retail sales, which shrank another 0.2% MoM after falling 2.2% the month before. Including fuel, the annual growth rate is now down to 1.5% compared to its recent peak of 7.2%. Clearly, consumers have been buying ahead of expected price increases. The labour market is still holding up well so far, with jobless claims falling in January and the unemployment rate remaining at 4.8%. However, wage growth has slowed down to 2.6%, indicating that real wages will be squeezed in the months ahead. With the triggering of Article 50 moving closer, both hiring and spending are unlikely to accelerate given the uncertainty around the economic outlook.

Eurozone: Growth revised down as political uncertainty increases

GDP growth in Q4 was revised down slightly to 0.4% QoQ (1.7% YoY), compared to the initial estimate of 0.5% QoQ (1.8% YoY). What's more, political uncertainty may be starting to impact business activity in the Eurozone. The February ZEW expectations survey for Germany came in below expectations, though it was still consistent with a decent pace of growth. Industrial production in the Eurozone also disappointed for December, though at the country level output growth in Italy was strong. However, it is too early to say for definite that political uncertainty is impacting activity. The next few weeks' data should give us more clues as to whether this is the case. On the political front, the chances of early general elections in Italy have receded with Matteo Renzi, former Italian Prime Minister, resigning from the leadership of the PD party last week and standing for re-election. However, political uncertainty and risks in France have increased over the past few weeks. Finally, the ECB minutes were dovish and emphasised that it will continue with QE and look through the recent spike in headline inflation generated by higher energy prices.

Japan: Improving earnings momentum

Earnings reports for FYQ3 (October-December 2016) have come in better than consensus had expected. This is encouraging, as analysts had already revised up their earnings forecasts considerably, confirmed by the rising earnings revision ratio. Indeed, the difference between positive and negative earnings surprises stood at 35%, a multi-year high. Net profits of all companies listed on the first section of the Tokyo Stock Exchange were up 20% YoY, much better than the 4% YoY rate that consensus had expected and the 2% rate in the prior quarter. Full year guidance has also been encouraging, with 260 companies lifting full year guidance compared to 102 companies showing downward revisions. All sectors contributed, with a particularly strong contribution by the auto, transportation, materials and financial sectors. Financial problems reported by Toshiba last week were more of an idiosyncratic nature and should not have a major impact on the Japanese equity market. Toshiba has a weight of only 0.2% in the MSCI Japan.

China: Aggregate financing balloons to a record high

China's new 'Total Social Financing' showed a record high of RMB 3.74tn in January on a surge in shadow banking lending, far higher than expected. Bank lending tends to surge at the start of the calendar year, as banks quickly start filling their quotas, but window guidance by the PBoC was probably the main reason why pure bank lending came in below consensus expectations. Financial institutions traditionally tend to circumvent tighter lending controls by the government by moving to shadow banking, which is a concern to us. On the positive side, strong credit demand shows that economic growth remains resilient, particularly due to strong infrastructure investment and healthy mortgage lending. We believe that the PBoC will continue to tighten monetary policy further, though gradually, not least because stronger than expected producer price inflation, up 6.9% YoY in January, needs to be curbed. However, the PBOC will try to avoid any drastic deleveraging and keep to its prudent approach.

Singapore: Better data, but persistent challenges

Economic data continue to beat expectations, lifted by recovering exports. We expect the strong momentum in trade volumes and prices to last, as demand from China and the US remains robust. Electronic and petro-chemical products are leading. As a result, Q4 GDP was revised up by 1.1pps to 2.9% YoY. Manufacturing and export-related services are outperforming, masking lacklustre domestic demand. Private consumption stands at a multi-year low, dragged by a weakening labour market, and private investment is lagging. A shift away from fiscal orthodoxy for 2017 would be welcome, in our view. Turning to the equity market, banks, which account for the lion's share of the STI index, have posted disappointing earnings. Credit costs have risen as more provisions have been booked for bad loans to the oil and gas sector. 2017 will likely see an easing in credit costs, except for OCBC. The rise in US-linked domestic rates combined with a bottoming-out of lending growth should also support banking margins. Strengthening oil prices and stability in China are two major conditions for the STI's continued performance.

What to Watch

- Manufacturing PMIs and some Service PMIs for February will be published in the US, the Eurozone and Japan. We do not expect major changes from the January levels, as most economies are holding up well, though the Eurozone data will be worth watching closely for any signs of weakness due to political uncertainty.
- The Eurogroup meeting of finance ministers is unlikely to agree a deal on Greece, though there is still some time before Greece`s large debt repayments come due in July.

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