July 3, 2017

Weekly Macro & Markets View

Highlights and View

- **Hawkish rhetoric from major central banks triggers a global bond sell-off**

  The rebound in bond yields was overdue, but for yields to rise sustainably higher from current levels, stronger inflation prints and economic data will be needed.

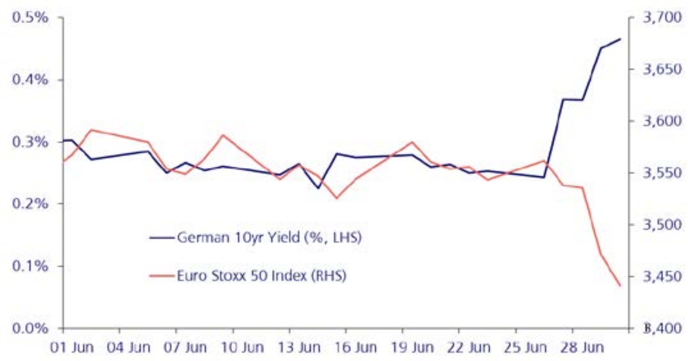
- **Global stock markets stumble, as technology sector rout continues**

  Despite the tech and bond move, stocks have held up reasonably well, and we are encouraged by sector rotation, which suggests money is remaining within the asset class.

- **All US banks passed the Fed's stress test and will return more than expected to shareholders**

  We believe US bank fundamentals are strong, and the credible Fed stress tests reinforce this, although higher than expected shareholder payouts are positive for equities, not credit.

Investors get a wake-up call as Draghi says ECB will reduce QE



Source: Bloomberg

Last week, in a speech entitled 'Accompanying the economic recovery', ECB President Mario Draghi indicated that the ECB was planning to reduce the size of its monthly QE asset purchases in 2018, which are currently running at 60 billion euros a month, for the rest of this year at least. Draghi said that as the economy continues to recover, 'a constant policy stance will become more accommodative' and the ECB can 'accompany the recovery by adjusting the parameters of its policy instruments'. The reaction in bond and other asset markets suggests that investors were not fully prepared for this. German 10yr Bund yields moved up around 20bps and the Eurostoxx 50 index was down almost 3% over the course of the week. The euro was also stronger against the USD. Clearly, Draghi's speech came as somewhat of a wake-up call for investors.

However, the moves in equity markets could be an overreaction in our view. Economic data indicate that the Eurozone recovery remains extremely solid and is broadening out. This should be supportive for corporate earnings. Lending growth to households picked up in May, while consumer confidence in the Eurozone is at 16-year high. Admittedly, the Eurozone services PMI fell back in June, but it remains strong and the overall composite PMI is still consistent with above trend growth in Q2.

Bonds: Hawkish central banks trigger bond sell-off

Coordinated hawkish rhetoric from central banks drove last week's bond sell-off, but a rebound in oil prices and better US data supported the move. Policy divergence diminished as the ECB, the BoE and the BoC signalled a shift towards less accommodative policy. Yields snapped higher globally, with the UK and Germany seeing the sharpest sell-offs, taking gilt and Bund yields 23bps and 21bps higher on the week respectively. Treasuries outperformed, but this meant a solid 16bps rise in the 10yr yield, despite another soft inflation print.

The rebound largely reflected higher real yields as inflation breakevens lagged, with market participants still unconvinced that central banks will achieve their inflation targets. The sell-off removed the worst excesses in bond markets, so it was overdue in our view. For yields to rise sustainably from current levels, we suspect that stronger economic data, particularly in the US where data surprises remain negative, and stronger inflation prints will be required.

msme@zurich.com

US: Stocks wobble, while economic data stabilise

The end of the first half of the year was marked by a choppy week of trading that saw equities marginally weaker as the technology sector remained under pressure, while Treasury yields surged. The end of a quarter, however, is often distorted by portfolio adjustments and we will need to see how the coming week progresses before reading too much into the moves. Certainly the economic data were a bit better. GDP in Q1 was revised up, to 1.4% QoQ annualised, for the 'right' reasons. Consumption and exports were stronger, with only a modest downward adjustment to business investment to a still stellar 10.4%. Consumer confidence was also robust, while the Fed's favoured core PCE inflation measure ticked lower to 1.4% YoY. We suspect that economic data are in the process of stabilising following another soft patch that saw the Citigroup economic surprise indicator plummet to its lowest in six years. With inflation falling further from the target, a turnaround will be critical for the Fed to maintain credibility and for bond yields to sustain their recent move higher.

Japan: Political turmoil overshadows favourable Tankan survey

PM Abe's LDP suffered a severe defeat in the Tokyo Metropolitan Assembly election over the weekend. The coalition around Governor Yuriko Koike (Tokyoites First, Komeito and others) won 79 out of 127 seats, while the LDP posted a record low of only 23 seats, losing 34. As the outcome was worse than expected for the LDP, this is certainly a blow to PM Abe, which may foster factional fights within the party. PM Abe will probably reshuffle his cabinet, focussing on pro-reform issues. We do not believe that opposition parties will benefit on a national level, as local aspects have dominated the Tokyo election, and Koike has made it clear that she does not intend to expand her grip on a national level. Focussing on economic data, today's quarterly Tankan release improved in all components and came in slightly better than consensus had expected, with the headline reading reaching post-financial crisis highs. The labour market remains tight, while there are no signs of higher inflation.

China: PMIs are rebounding

The Caixin Manufacturing PMI for June, reported today, confirmed last week's rebound in the official NBS PMIs. At 50.4, the index bounced back above the critical 50 line. This does not imply that China's growth is off to the races again, however. Indeed, we continue to believe that China's economic growth momentum will slow into the second half of this year and into next year, following slower credit growth and tighter monetary policy. Still, the latest data are encouraging in that hard landing fears voiced by some observers will certainly subside. The latest data should encourage China's authorities to focus on implementing further reform steps, including accelerating capacity adjustment in the 'old', commodity and heavy industry-related segments of the economy, while carefully steering the impact on the labour market.

Credit: European financials see divergence between equity and CDS

European financial CDS notably underperformed equities last week, as the positive spillover from the clean-up of two small Italian banks was rather short-lived. European sub-financial CDS spreads widened continuously from the Monday morning open, despite a nearly 2.5 % gain in European bank stocks, as investor positioning seems more balanced now in CDS. From a big picture perspective, the European banking sector is witnessing a much warranted clean-up, with Spain having just completed legislation around new bail-in-able senior debt, while Italy is also reportedly accelerating this process. Investors will likely see more bail-ins, but recently announced changes in CDS indices should also boost investor protection. In contrast to CDS, cash markets were boosted by higher oil prices and higher yields. The releveraging theme continues to gain momentum, however, with Nestle slated to buy back its stock.

What to Watch

- US ISM data will be important to gauge whether the recent economic soft patch was indeed transitory, while the attention on Friday will be on nonfarm payrolls and average hourly earnings after poor readings last month.
- We expect the central banks of Australia and Thailand to stand pat.

173001566 (01/16) TCL

ZURICH®