May 2, 2017

Weekly Macro & Markets View

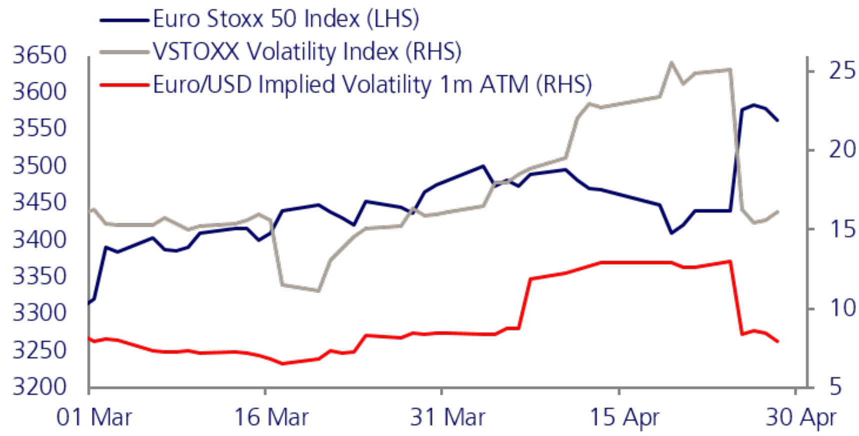
Highlights

- Sharp fall in implied volatility
- The White House unveils its tax reform plans, including tax cuts for firms and individuals
- The US House and Senate negotiators reach a deal to avoid a government shutdown

Our view

- The move reflects the reality that tail risks have reduced
- Trump's tax proposal lacks any details and will face a long period of negotiation with Congress
- The agreed spending bill rejects many of Trump's priorities, such as funds to build the Mexican border wall

French election relief rally leads to collapse in implied volatility



Source: Bloomberg

Last week saw a relief rally in global equity markets after Emmanuel Macron won the first round of the French presidential elections. The Euro Stoxx 50 was up around 4% Monday, April 28, and implied volatility (derived from option market pricing) collapsed in currency, equity and bond markets. The second round vote takes place on May 7, and though the opinion polls have narrowed a little, Macron is the clear favourite to win.

Business surveys in the Eurozone are still robust. The German Ifo index hit a new multi-year high in April, buoyed by better current conditions in key sectors of the economy. For the Eurozone as a whole, the European Commission business and consumer sentiment surveys reached their highest levels since 2007. While so called hard data, such as industrial production and retail sales, have not yet picked up as much, the continued strength of the surveys suggests that it will. Inflation is also showing some signs of picking up, though the late timing of Easter this year may be skewing the numbers somewhat.

At its monetary policy meeting, the ECB recognised the improvement in the data, but ECB President Mario Draghi was still relatively dovish and the reference to interest rates staying "at present or lower levels" was kept in the introductory statement. However, assuming there are no negative political developments, the ECB will soon to have to change its language, and this will likely put upward pressure on Eurozone government bond yields in particular. Risk assets in the region should benefit from the improving macro and earnings outlook.

US: Investors unimpressed by Trump's tax proposal and soft GDP numbers

A few days before reaching his first 100 days in office, President Trump presented his tax reform plan. Key elements are the reduction of the corporate tax rate to 15%, the switch to a territorial tax system with a one-time tax on non-repatriated foreign earnings, tax cuts for individuals and the repeal of state and local tax deductions, which would mainly hit individuals in high-tax states. Importantly, the plan does not endorse a border adjusted tax nor does it address interest deductibility or capex expensing, which implies that the White House is not supportive of the proposals presented in the House Republican tax plan. Markets were not overly impressed as the proposal is very much in line with Trump's campaign promises but lacks any further details. Investors were equally unimpressed by the soft Q1 GDP growth number (+0.7%) as it follows the pattern of unusually weak first quarters, most likely due to inaccurate seasonal adjustments. On the positive side, investment in equipment has shown a solid pickup, indicating firms' increasing willingness to spend.

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China: Focus on financial risks

China's Communist Party Politburo met with the PBoC and the three major financial regulatory commissions to discuss financial risks in the capital markets. The importance of this topic is reflected by the fact that President Xi held a rare speech on this topic, focussing on six key tasks. The politburo is concerned about financial turbulence in the next few months before the 19th Party Congress later this year. We believe the series of measures already taken this year will increase in speed and intensity. Restricting speculative measures and reducing financial leverage are urgently needed to address a resurgence in shadow banking activities. The authorities involved will need to find a balance between tackling renewed leverage and avoiding a sudden slowdown in the economy and financial markets, a phenomenon that has occurred in prior instances of tighter regulation. Overall, we believe monetary policy will remain neutral, though a specific tightening in certain areas seems proper and unavoidable to us. Credit and property sector tightening will slow China's growth momentum this year.

Japan: The Bank of Japan gives no hint as to an 'exit strategy'

Japan's regular economic data bonanza at the end of each month revealed a mixed picture. Industrial production fell more than expected in March on a sequential basis, but company forecasts for the following two months are much stronger than usual at this time of the year. Stronger retail sales are encouraging, but more positive data surprises are needed before suggesting that consumption will finally gain steam. Labour market conditions remain firm, with the job-to-applicant ratio just marginally below the record high marked back in 1990, which is remarkable. However, labour market strength is not yet reflected in higher inflation. The Bank of Japan left its monetary policy unchanged as expected, but raised its growth forecast. The 2% inflation target should be achieved only after FY2018, but BoJ Governor Kuroda emphasized the fact that wage growth at SMEs is picking up. Kuroda also mentioned that talk about an 'exit strategy' to its current JGB buying programme seems premature. This confirms our belief that recent yen strength was overdone.

Brazil: Reforms — blood, sweat and tears?

Strikes to protest labour and pension reforms have led to disruptions, but have not been overwhelming enough to seriously endanger the reform process. With the debt-to-GDP ratio reaching 71.6%, its worst since September 2002, the fiscal reforms currently being discussed in Congress take on another dimension amidst social protests.

The fiscal deficit remains awash in red ink due to weak fiscal revenues, so spending cuts will have to be honoured by the government. A critical vote this week in Congress on tightening social security benefits will be carefully scrutinized by investors. A large, deep and permanent structural fiscal adjustment remains front and centre on the policy agenda in order to restore both domestic and external balances.

Credit: Pockets of froth may be emerging, while banks report strong earnings

The rally following the first-round French election results has catapulted a few pockets of the credit market to somewhat frothy valuations, in our view. Most CDS indices are near their tight post-crisis levels, with the Senior Financial Index, for example, ending the week at 74bps, down from levels of around 110bps in November. Global bank earnings were robust, although it should be noted that Q1 2016 is a weak quarter to compare against. Beneath the surface of strong bank earnings, three trends were notable. While trading revenues were strong, Deutsche Bank and Barclays fared poorly, reinforcing concerns around loss of market share. Consumer driven revenues in US banks were weaker, in line with the tighter lending standards and higher delinquencies in some pockets. Banks exposed to EMs benefitted from better margins and asset quality, as seen in Santander and Standard Chartered results.

What to Watch

- No action is expected from the Fed while nonfarm payrolls should have recovered from last month's drop.
- The sole debate between the two French presidential candidates, scheduled for Wednesday, May 3, will be an important test before the election on May 7. Eurozone Q1 GDP data are likely to confirm the continued recovery, though it may not match the strength of recent business surveys.
- Asian PMIs will allow us to check the pulse of the manufacturing recovery.
- Tomorrow, Wednesday, capital markets will be closed in Hong Kong due to Buddha's birthday.

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