Weekly Macro & Markets View

Highlights and View

- **Sterling comes under pressure as Brexit negotiations fail to show any tangible progress**

  A transition period after March 2019 still looks like the most likely scenario, but the risk of the UK leaving without a deal has increased.

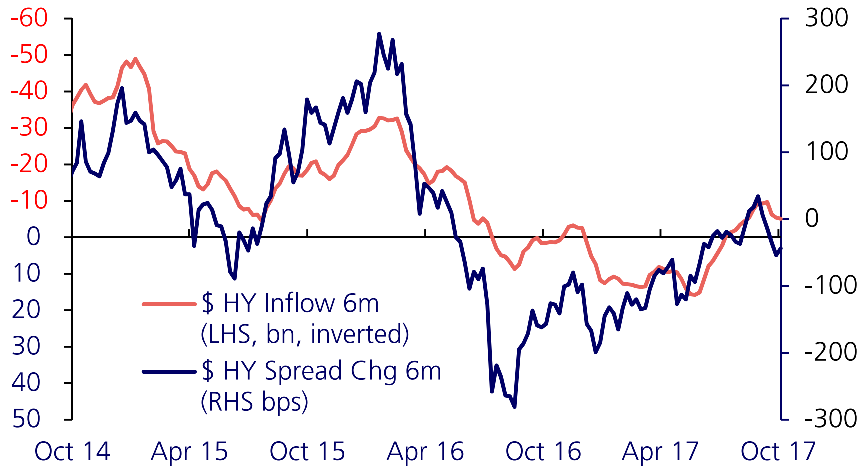
- **Core government bond yields fall back, as the US CPI report delivers yet another soft print for inflation**

  Robust global growth and less accommodative central banks should be reflected in higher bond yields, though upsides will be limited until the pace of inflation quickens.

- **Puerto Rican bonds plummet after US President Trump's comments on debt write-off and ending state aid**

  A bankrupt Puerto Rico is unlikely to impact the broader municipal market, but the final recovery rate for defaulted bonds will be affected by the aftermath of hurricane Maria.

Encouraging inflows into HY, but US banks emit cycle turn signals



Source: Bloomberg

Credit markets generally lead economic cycle turns, and high yield is said to lead within credit. The prospect of realised impairments, as well as the importance of market access for small companies to survive, makes the health of high yield a critical barometer to watch. In this context, we were concerned that the US high yield market was unable to attract inflows this year. As the chart shows, if this were to continue, high yield would be in for a sell off, especially given that spreads are not too far off 2007 lows. Encouragingly, however, inflows have gathered some momentum recently, but it needs to be sustained for the high yield market to remain healthy.

Interestingly, US bank earnings reports emitted some further signals that the credit cycle is maturing fast. Expecting credit card charge offs to climb, JP Morgan and Citigroup both signalled a shift in consumer credit quality, boosting reserves for consumer loan losses by the most in four years. This may be proactively prudent as current losses are small, but it does beg the same question for European banks, where the current stock of non-performing loans total over € 900bn. If the US credit cycle turns, the European credit cycle may not be too far behind, making us more wary of European banks relative to rest of credit.

US: Consumer sentiment soars to the highest since 2004

Small business optimism fell to the lowest level since last November. The subcomponents paint a somewhat mixed picture. Capital expenditure plans have receded from the multi-year high reached the month before while hiring plans have ticked up, indicating that firms still see increased business activity ahead. While the setback can be partially explained by the hurricanes' impact on economic activity, part of it may also have to do with the realisation that the implementation of the business-friendly policies announced by the Trump administration at the beginning of the year will take longer than expected. Headline CPI inflation accelerated to 2.2% YoY in September from 1.9% in August. However, core inflation ticked up by only 0.1% MoM in September, leaving the annual rate at 1.7%. University of Michigan Consumer sentiment soared to the highest level since January 2004 in October, indicating that households remain very upbeat and are likely to continue to spend, in particular given that the labour market remains healthy.

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Eurozone: The stalemate between Spain and Catalonia continues

Tensions remain high between the regional government of Catalonia and the central government of Spain after a request by the Spanish Prime Minister, Mariano Rajoy, to the Catalan government to clarify whether it is declaring independence or not. The Spanish government is threatening to trigger "article 155" of the constitution, which would allow it to take over the regional government and its administration if the Catalan government does formally declare independence. Fresh regional elections could follow soon thereafter. The situation is likely to remain tense and difficult for some time, and could create some volatility in local markets, but is unlikely to derail the Eurozone economic recovery in our view. An eventual solution to the crisis could involve giving Catalonia more autonomy, but not full independence. Data continue to indicate that growth in the Eurozone remains robust. In August, industrial production grew at close to its fastest pace on a YoY basis since 2011, with output up 1.4% MoM, 3.8% YoY.

Asia: Data confirm brisk economic trend

Japan's Eco Watchers Survey diffusion index for September surpassed the 50 line for the first time this year, rising 1.6 points to 51.3. The improvement was mainly driven by the strong retail component, while activity in the non-manufacturing industries remains healthy. Firm and stronger than expected core machinery orders for August suggest that capex will be strong in Q3, as we had expected. In Taiwan, exports surged 28.1% YoY in September, with machinery exports up 56.5%. We have to caution against any exuberant expectations about the export boom accelerating, as these statistics are highly distorted due to seasonal factors, like the timing of the Mid-Autumn festival, and the fact that no calendar day adjustment is incorporated. However, even though we expect export growth to slow, technology exports should remain brisk. Meanwhile, China's export growth in September, 8.1% YoY, was not as good as expected, and we believe that the stronger CNY will contribute to slower export growth going forward. However, strong import growth suggests that domestic demand remains solid.

Malaysia and Singapore: From export growth to domestic demand

Strong global demand continues to fuel Malaysia's manufacturing activity. Both exports and industrial production strengthened in August to 21.5% YoY and 6.8% YoY, respectively. Malaysia has climbed the manufacturing value chain in the last years, and is thus benefiting from the ongoing upcycle in semiconductors. Commodity exports are also doing well, thanks to solid Chinese demand for natural gas. Given the broad-based nature of global demand, we expect solid growth for Asian trade in the near future. In Malaysia, fiscal policy has also helped the economy: cash hand-outs and infrastructure projects are starting to positively affect consumer spending and investment. In Singapore too, export-driven industries are buoyant, pushing Q3 real GDP to a three-year record of 4.6%. There are green shoots in the very weak Singaporean labour market, and retail sales are likely bottoming, but the recovery is less pronounced than in Malaysia. Going forward, both countries will need to see income growth edge higher to overcome their respective debt hurdles.

Hong Kong: First policy address by Chief Executive Carrie Lam indicates a fiscal policy boost

Following her first 100 days in office, Carrie Lam responded to falling popularity polls and public concerns about Hong Kong's legal system in her policy address to the Legislative Council. Her speech focussed on alleviating pressure on public and small enterprises. One major theme was enabling home ownership for middle-class families and increasing housing supply, helping tackle the overheated property market that is highly impacted by mainland demand. A series of other measures focussed on social welfare subsidies to low-income families, raising expenditures on education, improving the healthcare system and increasing spending for new rail and road infrastructure projects. Another topic was support for SMEs and start-ups. A two-tier corporate profit tax was announced, halving the tax rate on the first HKD 2mn in profits, while raising R&D spending to improve Hong Kong's global competitiveness. Coordination with mainland China's Greater Bay Area policy was another subject. The rather aggressive fiscal policy boost can be financed by Hong Kong's vast fiscal reserves, so we do not expect a budget deficit next year.

What to Watch

- EU leaders will meet this week at a summit that was initially planned to be the beginning of the trade talks with the UK. However, lack of progress in Brexit negotiations makes this unlikely.
- China's 19th National Congress of the Communist Party will convene on Wednesday and last until next week. The focus will be on electing China's new leadership and the policy outlook for the next five years. We will also keep an eye on China's GDP growth statistics for Q3 and major economic indicators for September, published on Thursday. No policy change is expected when the MPCs of the Bank of Korea and Bank Indonesia convene on Thursday.
- The US earnings season has started with mixed results for banks and is now ramping up with 58 S&P 500 firms reporting this week.

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