September 25, 2017

Weekly Macro & Markets View

Highlights and View

- **Theresa May strikes a more conciliatory tone in her speech, seeking a 2-year transition period**

  The speech can be considered as a step away from a hard Brexit, but provides few insights on Britain's future relationship with the EU.

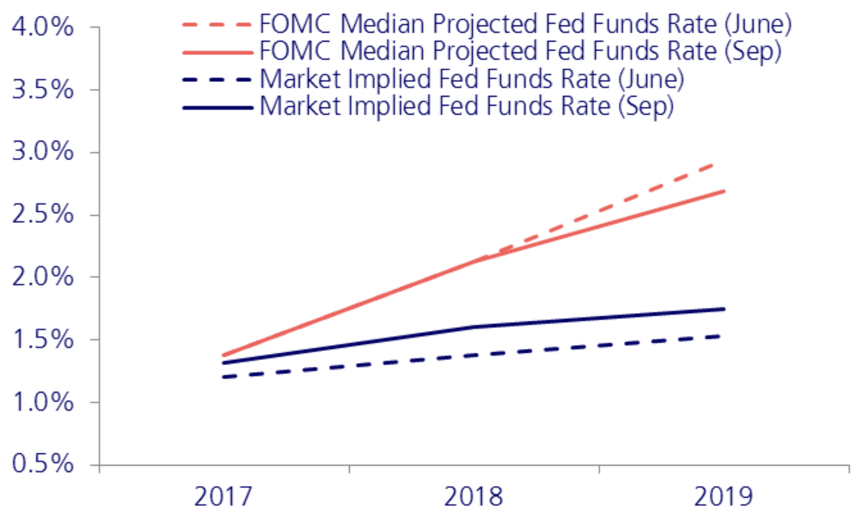
- **Verbal attacks continue between North Korea and the US**

  Despite some missile fatigue among investors, North Korea will continue to dominate headlines.

- **Standard & Poor's downgrades China's sovereign credit rating from AA- to A+**

  S&P should have taken this step much earlier. We believe China's deleveraging process is already proceeding well.

The Fed begins to unwind its crisis-era policy



Source: Bloomberg

The Fed announced it will begin reducing its balance sheet in October. Initially, the decline will be capped at USD 6bn per month for Treasuries and USD 4bn per month for MBS. The caps will gradually rise to a maximum of USD 30bn for Treasuries and USD 20bn for MBS. Both the announcement and the details have been well flagged and did not come as a surprise. As we expected, the Fed also signalled a further rate hike in December, with no change in the number of FOMC members supporting such a step according to the latest dot plot. Reflecting optimism with regard to the economic environment, the Fed raised its GDP forecast for 2017 to 2.4% from 2.2% in June. At the same time, the forecast for Core PCE inflation was lowered to 1.5% in 2017 and 1.9% in 2018, acknowledging that the inflation target will not be reached until 2019. Given these forecasts, economic momentum and inflation would have to fall significantly short of expectations in the next few months to convince the FOMC not to hike in December. Importantly, the Fed also lowered its forecast for the long-term neutral Fed Funds Rate to 2.75% from 3%. At the same time, the market implied path for the Fed Funds Rate has risen, narrowing the gap between the Fed and investors' expectations.

Credit: Rising idiosyncratic risks indicate late cycle risks

Idiosyncratic risks are rising in credit markets, although broader sentiment is still sanguine. Toys"R"Us filed for bankruptcy protection under Chapter 11 last week, in one of the largest bankruptcies in the US retail sector. While one would expect that the retailer's well-known woes would have been priced in, it is notable that the Toys"R"Us 2018 bonds were trading around par at the beginning of September. The bankruptcy of the highly leveraged Toys"R"Us was necessitated by the rapid onset of a self-fulfilling liquidity crunch, a circumstance reminiscent of the situation of some smaller European banks, which had to be dealt with urgently. Unsurprisingly, underwriters are struggling to place highly leveraged deals, high yield is struggling to attract inflows and European banks face capital building and consolidation pressures. While a rise in idiosyncratic risks confirms a late stage of the credit cycle, elevated leverage has sown the seeds of vulnerability and investors should be watchful.

Eurozone: Business surveys remain robust

The flash Eurozone PMIs confirmed the continued strength of the economy, which should be supportive for corporate earnings growth and regional equity markets and put gradual upward pressure on bond yields. The flash composite PMI came in at 56.7 in September, up from 55.7 in August, with both services and manufacturing confidence picking up. In particular, the German manufacturing PMI rose above 60 for the first time since 2011. The dynamism of the Eurozone economy seems to be transferring though to wage growth, though the pickup so far is modest and the series volatile. Eurozone wage growth rose to 2.0% YoY in Q2, from 1.3% YoY in Q1, and 1.6% YoY in Q4 2016. Meanwhile, tensions in Catalonia continue to rise, with the central government sending national police to arrest local officials involved in organising the independence referendum, and to seize ballot papers and boxes. We think it is very unlikely that Catalonia would actually secede from the rest of the Spain, but tensions are likely to remain high in the near term.

Germany: Elections results will lead to period of coalition building

As expected, Chancellor Angela Merkel's CDU party won the most number of seats in the German elections, meaning she will remain as Chancellor for a historic fourth term. However, the 33% share of the vote won by the CDU/CSU coalition was lower than recent polls had been suggesting, and well below the 41.5% obtained in the previous election. What's more, the strong support for the far-right, anti-euro and anti-immigration AfD party, which won 12.6% of the vote and enters parliament for the first time, could raise investor concerns. (Notably, the euro is a little weaker against the US dollar this morning.) It is very unlikely that the AfD will be part of a coalition government, which will instead most likely be a so-called "Jamaica coalition" (i.e. the CDU/CSU, FDP and Greens, whose parties' colours are collectively the colours of the Jamaican flag). Another possibility is a CDU/CSU and SPD grand coalition, though the SPD have so far ruled this out and said they will go into opposition. Either way, the new German government will still be very much pro-euro.

Japan: Welcome 'Abelection'

What was leaked to the media last weekend was officially announced today: PM Abe is calling for parliamentary snap elections on October 22, following the dissolution of the Lower House this Thursday. Abe is taking advantage of a recovery in the polls for his party, the LDP, while the opposition is still in disarray, even though there is a risk of losing the coalition's two-thirds majority. Meanwhile, Tokyo Governor Koike announced today that she will lead the new 'Party of Hope' with candidates across the country. Surprisingly, Abe will go ahead with his plan to raise the consumption tax again in October 2019, from 8% to 10%. We thought that he would postpone this step once again, in order to not put the economic recovery at risk. To partially compensate for the fiscal drag, Abe announced a two trillion yen stimulus package and intensive investment until 2020. We need to wait for further details, particularly the 'mamizu' part of the package that will effectively give a direct boost to the economy. A portion of the additional tax revenue will be used finance free pre-school education.

Asia: Four central bank meetings, one unexpected rate cut

We did not expect any changes in monetary policy when the monetary policy councils of four Asian central banks convened last week, but, surprisingly, Bank Indonesia (BI) announced another 25bps policy rate cut on Friday evening. While we understand that weak inflation and soft domestic demand support the move, we remain sceptical with regard to BI's intention to push for more banking intermediation, which in our view does not depend too much on lower interest rates. We expect BI to stand pat for the rest of the year and into next, even though there may be scope for another cut if loan growth remains tepid. The Bank of Japan maintained its monetary policy stance, but it was surprising that one of the two new board members, Kataoka, dissented, believing that the yield curve control policy is insufficient to achieve the 2% CPI target. Taiwan's CBC stayed on hold for the fifth consecutive meeting, and we believe that the outlook remains balanced. In the Philippines, the Bangko Sentral ng Pilipinas left monetary policy unchanged, reiterating that its current policy remains appropriate.

What to Watch

- In Japan and South Korea, numerous relevant economic indicators will be published this week, followed by Japan's quarterly Tankan on Monday next week. China will release both the NBS and the Caixin Manufacturing PMI for September.
- US Core PCE inflation should stabilise in line with other inflation measures, while consumer sentiment is expected to remain high.

Disclaimer and cautionary statement

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