# Weekly Macro & Markets View

## Highlights and View

- **North Korea warns that it will take measures causing "greatest pain" to the US if the UN Security Council approves new sanctions today**

  Risks around the North Korean issue are not expected to abate soon.

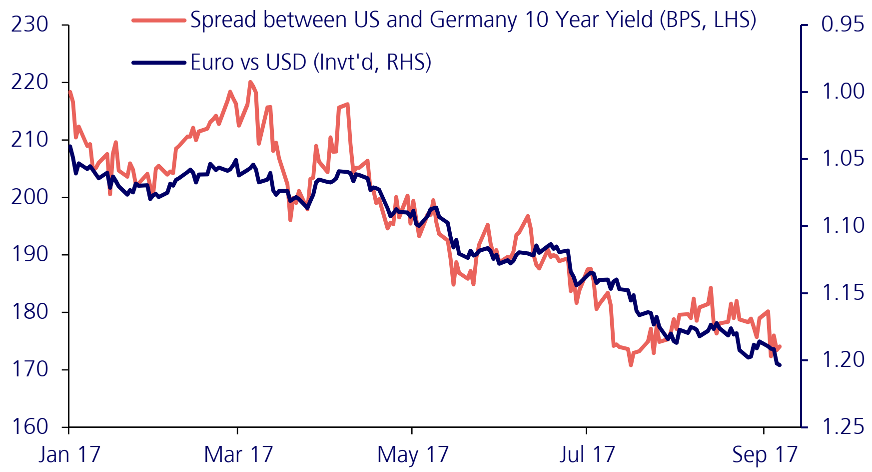
- **Less than two weeks after Hurricane Harvey, Irma devastated parts of the Caribbean before hitting the US**

  While raging with deadly fury and leaving a trail of destruction, Irma's economic impact seems less grave than initially feared.

- **US Congress suspends the debt limit as part of a bill providing funds for Hurricane Harvey victims**

  Suspending the debt limit until December removes a near-term political risk in the US and clears the way for Congress to focus on other issues, including a tax reform bill.

## ECB says it will announce decision on 2018 QE at October meeting




Source: Bloomberg

At last week's ECB monetary policy meeting and press conference ECB President Mario Draghi revealed that the bank was likely to announce a decision on the "calibration" of its policy instruments for 2018 (i.e. the size of QE asset purchases) at its October 26 meeting. We expect that there will be a gradual reduction in the size of monthly purchases and eventual an end to QE in 2018. This should cause gradual upward pressure on core and periphery bond yields.

Regarding the recent strength of the euro, the ECB introductory statement said "the recent volatility in the exchange rate represents a source of uncertainty" with "possible implications for the medium-term outlook for price stability". Moreover, Draghi said that whereas only a few governing council members had expressed concern about the strength of the euro at the previous meeting, most members expressed concern at this meeting. However, the latest ECB staff forecasts show the estimated impact is relatively modest, and is expected to reduce inflation by only 0.1 of a percentage point in 2018 and 2019. Draghi also said that he doesn't comment on specific levels of the exchange rate. The upshot was that Draghi's comments were not seen as a firm enough attempt to quash euro strength, though long euro positioning remains extreme and could still be due a reversal.

## US: Irma hits Florida, while a political storm has been avoided

While hurricanes Harvey and Irma will leave their mark in Q3 economic growth, the underlying momentum remains strong as indicated by the latest ISM Non-Manufacturing Survey. The headline figure rose to 55.3 with business activity accelerating to 57.5 and new orders rising to 57.1, both reflecting a healthy environment for the service industry. Prices paid rose to the highest level since January, signalling increasing price pressure in the pipeline. Initial jobless claims jumped to the highest level in more than two years, driven by a spike in claims in Texas, reflecting the impact of Hurricane Harvey. A political storm has been avoided in Washington for the time being with the debt limit suspended until mid-December after President Trump struck a deal with the Democrats. Given that the Treasury will have renewed access to a number of extraordinary measures, the "hard" limit will not be reached until spring 2018. This removes a near-term political risk and a potential headwind for financial markets.



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## Markets: So much for efficient markets!

Investors appeared to be more schizophrenic than usual last week, as various asset classes represented risks and economic data releases with markedly different pricing. North Korea's latest bomb test led to a flight to the traditional safe havens early in the week. Core government bonds surged, with 10yr Treasury yields breaking below the 2.1% technical support level. Gold rallied and the yen jumped, although, unusually in a risk-off period, the euro was favoured over the dollar. However, equities subsequently rebounded, with the higher beta DAX and Euro Stoxx 50 indices actually closing up on the week. Somewhat surprisingly, safe havens also continued to perform well, pushing bond yields even lower. With global economic data robust, we believe that equities are likely to see further upside, with any setbacks on geopolitics proving transient. Bond yields clearly do not equate with economic activity and last week's fall is interpreted as being aberrant and likely to unwind fairly briskly.

## Bonds: Treasuries yields break through technical support level

Core yields plummeted last week on concerns around North Korea and hurricane Irma, and on a dovish tone from the ECB. The 10yr Treasury yield broke through the 2.10% technical support level, and touched an intraday low of 2.01% on Friday, before rebounding. Bunds rallied after the ECB's press conference, which had a dovish tilt, with downward revisions to the inflation projection despite stronger growth. While global yields have dropped, inflation expectation are stable, confirming that concern around inflation is not the main driver of last week's rally. The slope of the Treasury curve has fallen further, particularly at the short end, and the 2yr yield and the Fed target rate have essentially converged, with only one additional rate hike fully priced in by the end of 2019. This is excessive, given a Fed that not only wants, but also should be able to normalise policy further. We therefore stick to our view that yields are likely to rebound, though geopolitical concerns will remain a headwind.

## Credit: Supply surge leads to underperformance

Supply surged in credit markets, as expected, during the first busy week after the summer lull. The price action and demand dynamics in the first week of September are usually good leading indicators for the rest of the year. Evidently, there seems to be strong demand for new issues, if one were to look at the oversubscription levels of new deals. Moreover, the very fact that US and European credit supply surged to around $40bn and €20bn should indicate that primary demand remains healthy. However, there was notable weakness spilling over into the secondary markets, with cash underperforming CDS indices. Part of the weakness could be attributed to the heightened risk aversion from geopolitical events and hurricanes, which was also reflected in the sharp fall in government bond yields. However, we are not fully convinced yet and given the weakness seen recently in flows, it remains to be seen whether investor appetite will remain strong given tight spread levels.

## Japan: Pushed from the Q2 growth throne

As we had suspected, Japan had just two weeks to enjoy being the fastest growing G7 economy in Q2. The sequential annualised growth rate was revised down from 4% to 2.5%, a fall that was steeper than consensus had expected and below the US growth rate of 3%. The downward revision of private corporate investment was the main contributor, however, we note that machinery orders for July and machine tool orders for August, reported today, were brisk. On the labour market front, wages fell 0.3% YoY in July versus an expected rise of 0.5% by consensus. At first glance, this suggests deflation, but one has to dig deeper to understand that the sole contributor was a lower summer bonus, while regular wage growth came in at a stable growth rate of 0.5%. This is certainly no reason for concern. Finally, the Eco Watchers Survey current conditions index was unchanged in August. The household sub-index fell, while manufacturing conditions improved. The outlook component, which is based on a two to three month perspective, marked a new high for the year, supported by both households and businesses, which is encouraging.

## What to Watch

- No change is expected from either the BoE or the SNB, both of which hold meetings this week
- US inflation rates are expected to have accelerated in August, while consumer and small business sentiment are likely to remain at high levels.
- Most of the important economic indicators for August will be released in China, including aggregate financing, industrial production, fixed asset investment and retail sales.
- In Japan, we will keep an eye on the MoF BSI business conditions survey for Q3, which is preceding the more well-known BoJ Tankan survey.

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