November 20, 2017

Weekly Macro & Markets View

Highlights and View

- **Equity markets suffer a modest setback after posting substantial gains in recent weeks**

  Following a prolonged rally with exceptionally low volatility, equities succumbed to some profit taking. This is likely to be transitory, as a buy-on-dip mentality prevails and fundamentals remain supportive.

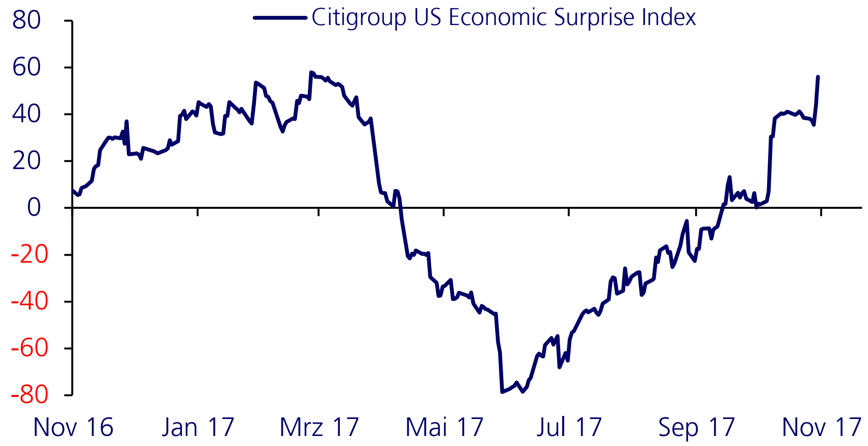
- **Germany's failed coalition talks leaves the country in uncharted territory**

  Political uncertainty will continue for some time, but is unlikely to weigh materially on economic growth.

- **Credit markets show some tentative signs of stabilisation after the recent weakness**

  The stabilisation in credit markets is crucial for the broader risk rally to continue but we don't expect significant upside in credit compared to other risk assets such as equities.

Robust data, led by industrial production and retail sales



Source: Bloomberg

A slew of economic releases continue to paint a very robust picture of the US economy. This supports our view that the Fed will indeed hike rates by a further 25bps in December and is justified in gradually scaling back the size of its balance sheet. Industrial production surprised to the upside, with higher revisions to prior reports, and we suspect that this is likely to remain solid in the months ahead as business sentiment is elevated. A jump in retail sales implies that consumer confidence is also translating into higher spending. Housing data were robust, with home builder optimism rising close to a cycle high, while housing starts and the important forward looking reading of building permits also jumped higher in October. Although continuing jobless claims fell to a cycle low, we are keeping our eye on another modest tick higher in initial jobless claims. We have felt that the strong economic developments would eventually start to nudge inflation higher and there has been some indication of this. Core CPI rose 0.2% in October, taking the YoY rate to 1.8%, while core PPI data also surprised to the upside at 2.4% YoY, though we stress that pricing pressures remain modest at best. From a market perspective, equities were under some pressure, but investors seem to retain a buy-on-dip mentality that is likely to contain downside potential for the time being.

Credit: Signs of stabilisation emerge as ETFs regain some flows

Credit led equities in the recent sell-off and our concern was that if this were to continue, other risk assets including equities could follow. Encouragingly, however, tentative signs of stabilisation emerged late last week. In fact, credit markets started stabilising on Wednesday, despite sharp falls in equities that day, before both markets recovered strongly on Thursday. Notably, US high yield ETF flows recovered somewhat following a relentless streak of heavy outflows. Supply slowed down somewhat with only one jumbo deal that was placed at a concession, while green bond supply continued. Notably, idiosyncratic risk continues to pick up. The US Treasury curve continues to flatten, which is fundamentally negative for credit given low interest coverage for the weakest companies. We believe recent market moves, the flattening of the yield curve, outflows from high yield and rising idiosyncratic risks confirm the late stage of the credit cycle, although a cycle end is not yet imminent.

Eurozone: Broad-based growth continues in the Eurozone with Germany leading the way

Q3 GDP data from the Eurozone confirmed the strength of the recovery. The country breakdown available in the second estimate revealed that Germany grew 0.8% QoQ, well above expectations for 0.6% QoQ growth. Growth also accelerated in Italy to 0.5% QoQ from 0.3%. However, growth slowed modestly in France to 0.5% from 0.6% and in Spain to 0.8% from 0.9%. Nevertheless, overall these are strong growth numbers that should support corporate earnings in the region and equity markets. The strong GDP outturn for Germany led the euro to strengthen against the USD. It increased a cent and a half on the day the data were released last week. However, political events over the weekend then led to some weakness in the single currency. Germany's political parties were unable to arrive at a deal to form a coalition, despite weeks of negotiation. This leaves the possibility of either a minority government, or another grand coalition, or fresh elections. Though this political uncertainty could impact markets in the short term, by itself it is unlikely to have a meaningful impact on growth in our view.

Japan: Economy grows for the seventh quarter in a row, despite a setback in private consumption

Japan's economy grew for seven quarters in a row in Q3, the longest growth phase since 2001. Real GDP was up 1.4% on an annualised sequential basis, or 1.7% YoY. Net exports and inventories were the main drivers, while public demand shrunk following a strong Q2 and private consumption contributed negatively. At first this looks disappointing. However, we believe that this was more a blip than the start of households stepping back. The typhoon season certainly had a temporary negative impact. Overall employee compensation is still growing and both consumer confidence and the household component of the Eco Watchers survey spiked higher in October, which is encouraging. We also note that disinflation seems to have subsided as the domestic demand deflator was up 0.5% YoY. Not surprisingly, there is some speculation that the government may soon declare an end to deflation. In the equity market, the Topix fell 5.7%from its 26-year high last week before recovering on Thursday and Friday. We believe foreign investment will continue, though the stronger JPY versus the USD needs monitoring.

China: Weaker economic indicators no reason to worry

Economic activity in October moderated as expected, but several temporary factors played a role. Industrial production was affected by October having fewer working days than last year. Tougher pollution controls, in line with 'new era' policies, also had a negative impact. Fixed asset investment growth fell to 3% YoY, or 7.3% YTD, and was negative on a real basis, the lowest rate seen in more than ten years. Infrastructure, manufacturing and real estate investment softened. Total floor space sold shrunk by 6% YoY. However, land purchases by developers accelerated, which should help stabilise real estate investment in 2018. Nominal retail sales growth was far weaker than expected, particularly in housing related items, while auto sales growth moderated as well. Online sales growth remained strong at 28.8%YoY. We believe that buying was postponed to November, as the 'Singles Day' shopping spree on 11.11 was overwhelming, and we expect that 'Black Friday' sales will be strong this week. Credit growth has slowed due to higher market rates and regulatory tightening, though loans to firms have been solid.

ASEAN: Bank Indonesia holds for now

The combination of underwhelming growth, low inflation, and a narrower current account deficit, which has already triggered two prior consecutive rate cuts by Bank Indonesia (BI), did not justify a third rate cut this time. The BI committee appeared satisfied by the level of economic activity, revising its GDP growth forecast down to 5.1%YoY in 2017, while expecting an improvement to 5.1%-5.5% in 2018. The composition of growth, marked by an improvement in private investment and public spending, is indeed encouraging. The recent increase in palm oil and coal exports has also helped. Additionally, the 2018 budget dedicates more resources to social spending and poverty alleviation, which should give a push to consumption. We note, however, that household spending remains muted. Bank lending, a leading economic indicator, has failed to pick up significantly. Considering these dynamics, we think that BI has room to ease further. The central bank is probably waiting to assess the inflationary impact of the upcoming upward revisions to electricity tariffs before changing its policy.

What to Watch

- We expect the G3 manufacturing PMIs to show continued brisk activity in the major economies.
- In the UK, all eyes will be on the Chancellor, Philipp Hammond, as he delivers the budget this week.
- Nothing surprising is expected in the release of the Fed minutes from its November meeting. Attention will be on existing home sales and durable goods orders, while we would like to see initial jobless claims moderate from recent gains.

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