ZURICH

Weekly Macro & Markets View

Highlights and View

- **Differentiation within the credit market is rising, although risk markets continue to rally broadly**

  Differentiation within the credit market is symptomatic of the late stage of the credit cycle, while the buy on dip mentality should support risk assets, especially equities.

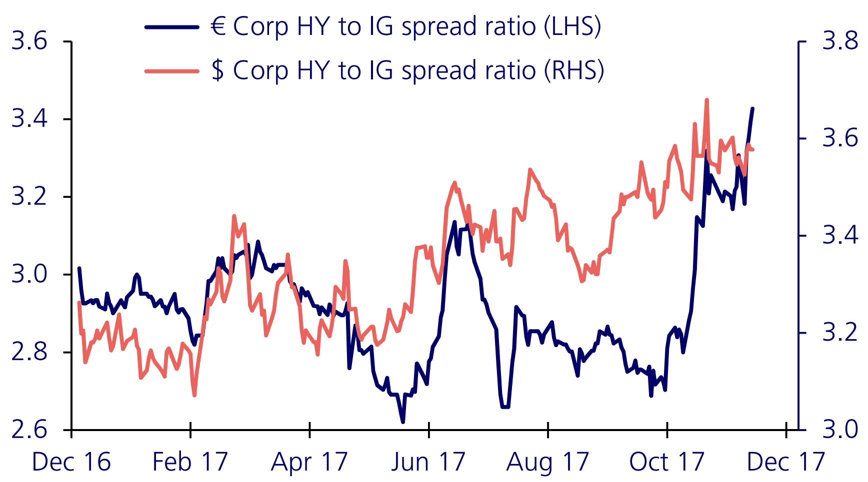
- **US nonfarm payrolls rise by 228'000 in November, the unemployment rate stays at 4.1%**

  The employment situation remains healthy with firms creating jobs at a decent pace. Wage growth is still relatively modest despite the latest pickup to 2.5% YoY in November.

- **The EU agrees to move on to the next phase in Brexit negotiations**

  While it is crucial to define the future relationship between the EU and the UK, negotiations will be complex and time consuming with numerous stumbling blocks along the way.

Differentiation between strong and weak credits is on the rise



Source: Bloomberg

As tailwinds of global quantitative easing are set to start fading, price differentiation between strong and weak credits has risen, even within a strong credit market. This is likely to become even more pronounced during coming months and is reflected in the recent rise of the ratio of spreads of high yield (HY) to those of investment grade (IG) credit indices. This differentiation is typical of the late stage of the credit cycle, as overinvestment in flawed business models, M&A activity and Leverage Buyouts (LBOs) make debt levels overshoot sustainable levels for some companies. This causes investors to shed IG companies that either get downgraded to junk or are at high risk of doing so, as seen over the last few months. In high yield, the spread widening is impacting entire sectors such as retail, pharma and TMT. The recent 50% drop in Steinhoff bonds was another idiosyncratic episode, although it would have been difficult for investors to predict. Despite this rise in differentiation, for broader equity and credit markets the buy on dip mentality continues, as seen last week. Lastly, the long awaited agreement on Basel III was reached, with identified capital shortfalls looking manageable, given the long phase-in period from 2022 to 2027. Whether this will be sufficient or not will be tested in the next downturn.

US: A government shutdown has been averted… for now

Business activity in the US service sector remains strong despite the latest tick down in the ISM Non-Manufacturing Index. The headline number declined to 57.4 from 60.1 and new orders dropped to 58.7 from 62.8, signalling a slowdown from the recent solid trend. Consumer confidence as measured by the University of Michigan Survey also retreated from its recent high, driven by a drop in expectations. Firms added 228'000 new payrolls in November, slightly less than the month before but still showing a healthy pace. While the unemployment rate remained at 4.1%, average hourly earnings grew by 0.2% in November, lifting the annual rate to 2.5%, which is still low given where we are in the business cycle. No major news emerged regarding the tax reform as House and Senate representatives are working to bridge the differences between the two proposals. A government shutdown has been avoided by postponing a decision on the spending authority to December 22nd. As neither party has an interest in a shutdown, a compromise or a renewed postponement before year end seems likely.

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UK: Time to move on with Brexit negotiations

The EU agreed to proceed to the next phase in Brexit negotiations after a basic agreement on three key issues was reached. It is crucial to quickly move on to define the UK's future relationship with the EU as firms need to plan ahead with regard to hiring and investment. Nevertheless, trade negotiations will be complex and cumbersome. Some key questions, like the European Court of Justice's jurisdiction with regard to EU citizens in the UK and how to avoid a hard border between the Republic of Ireland and Northern Ireland, remain unresolved. Despite the decision to move on, the pound weakened, helping the FTSE 100 to reach its best weekly performance since the beginning of October. The Services PMI weakened to 53.8 in November, from 55.6 in October, showing a renewed loss of momentum after a brief pickup in autumn. Firms are still burdened by higher input costs and job creation remains subdued. Industrial production stagnated in October while the trade deficit has slightly increased.

Eurozone: The growth boom continues

The second Eurozone Q3 GDP estimate confirmed the broad-based nature of growth by sector and country. Quarterly growth came in unchanged at 0.6% QoQ, but annual growth was revised up a tenth of a percentage point to 2.6% YoY, from 2.5% in the first estimate. The details of the report were encouraging, with a strong contribution to growth from investment for the second quarter running, as well as a continued contribution from household expenditure. Last week also saw the EU unveil proposals for reforming the Eurozone. Proposals include converting the European Stability Mechanism (ESM) fund into a European Monetary Fund, enshrining the "Fiscal Compact" agreed by member states in 2012 into EU laws and establishing a European Minister of Economy and Finance. The European Monetary Fund would have faster decision-making powers for specific urgent situations, and a more direct involvement in the management of financial assistance programmes. If adopted, these proposals would be an encouraging development in making the Eurozone more resilient in the face of future shocks.

Japan: Encouraging economic data

Following some disappointing economic data, which we believe have been distorted due to various one-offs, last week's data were more encouraging. GDP growth in Q3 was revised up more than expected, from 1.4% to 2.5% on a sequential annualised basis, following a significant upward revision in capital spending. A stronger inventory build-up also contributed, though this positive impact may be reversed soon. As we had suspected, household activity rebounded nicely in November from weakness in October, which had been caused by bad weather conditions. The Eco Watchers Survey spiked by nearly 3 points to 55.1. While the perception of future conditions deteriorated, the level remains solid. Regular wage growth remains firm, up 0.7% YoY in October, which may contribute to rising inflation expectations. Finally, both the Reuters Tankan for December and today's MoF's Q4 BSI business conditions indicator remain at solid levels, confirming our view that the Q4 Tankan survey, which will be released on Friday, should show a decent outcome.

Australia: GDP and the dichotomy between households and businesses

GDP expanded by 0.6% QoQ and was up 2.8% YoY in Q3. Household consumption rose by a modest 0.1% QoQ to be 2.2% higher YoY, while dwelling investment subtracted decimal points from quarterly growth. Business investment registered strong growth, offsetting the weakness in other components. Investment is partly driven by ongoing infrastructure projects, and partly by the tertiary sector, which is encouraging. High-frequency indicators have been painting a similar picture. Corporate animal spirits are on the rise, but households continue to suffer from tepid wage growth and high levels of debt. Going forward, we think that the labour market will tighten further and push the underemployment rate down. Business surveys argue for a rebound in wages, but we see this process as gradual, given the existing slack in employment. Overall, the Australian economy should be resilient as long as the RBA patiently maintains its hold on the policy rate and waits for signs of life in wages.

What to Watch

- The Fed is widely expected to raise interest rates this week, while the ECB, BoE and SNB are not likely to announce any major changes to policy. However, language will still be important to watch.
- It will be formally agreed at the EU summit this week that next stage of Brexit negotiations on trade can begin.
- Inflation in the US is expected to pick up in November while small business optimism is likely to remain high.
- Japan's Tankan survey for Q4 will be released on Friday, the day after the December Manufacturing PMI. It's also a big week for China data releases, with most of the important November data out this week. We will also keep an eye on October industrial production data in Malaysia and India, and Philippine export data.

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