Weekly Macro & Markets View

Highlights and View

- **The Jackson Hole Economic Symposium proves to be a non-event, with central bankers sticking to script**

  With no new policy guidance, we keep to our view of US balance sheet reduction commencing in September, with a rate hike in December, and further ECB tapering to be announced in October.

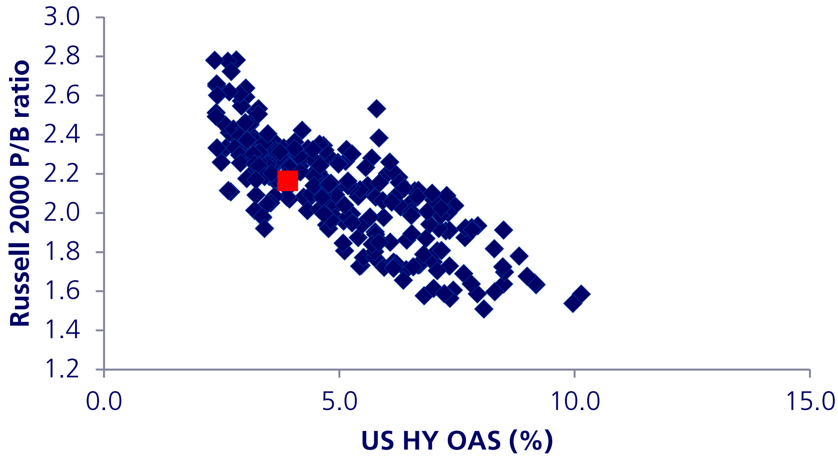
- **The flash PMIs for the G3 economies rebound as data continue to surprise on the upside in the Eurozone and Japan**

  Strong global growth momentum remains in place, despite a tentative slowdown in emerging Asia.

- **Trading volumes in financial markets have been light in August**

  Light volumes mean volatility can spike higher on little new fundamental news, and we would caution against overinterpreting recent equity, currency and bond market moves.

Credit should start underperforming equities



Note : Red dot indicates current level, monthly data is used since 1995

Source: Bloomberg, Barclays

Credit investors lend money to borrowers with the full knowledge that they may never get their money back. This makes them especially alert to significant downside risks such as those arising from a recession, a banking crisis or other such scenarios. This is also the reason why a number of models that aim to predict recessions tend to use credit spreads and spread volatility as one of the key inputs. We believe that we are now in the stage of the business cycle where credit should start underperforming equities on a beta adjusted basis, in both upside and downside scenarios.

Credit spreads are very close to all-time tight levels for many credit indices, which mathematically implies that the upside is limited as spreads cannot go to zero. In contrast, equities do not have such a cap to performance. Moreover, credit fundamentals have deteriorated and we expect spread reaction to downside risks to start becoming elevated. In fact, during the recent risk wobble, credit spreads showed some of this heightened downside sensitivity and US high yield in particular was looking somewhat fragile. Hence, while a credit bear market is not imminent yet, the stage seems to be ripe for credit to start underperforming on a relative basis.

Bonds: Bond markets are too sanguine

Jackson Hole was a non-event for bond markets, as the key speeches by Yellen and Draghi provided no new information with regards to monetary policy. The 10yr Treasury yield slipped back to 2.17%, which is at the lower end of its recent trading range, while Bund yields were broadly unchanged. The biggest move came in the dollar, which weakened further. This helped to push short-term US inflation breakevens marginally higher, but longer-term inflation expectations failed to rise, indicating that investors remain sceptical about the Fed's assessment that recent inflation weakness is temporary. Expectations for the Fed rate path also slipped, with less than a 35% probability assigned to a rate hike this year, and with only one rate hike fully priced in by end 2018. Our view is that pricing has now become even more excessive amid strong economic data, in the US and globally, and central banks' willingness to normalise policy.

US: Service sector activity soars in August

In August, the Markit Composite PMI reached the highest level since May 2015. While the survey shows a slight loss of momentum in the manufacturing sector, services continue to expand at an impressive rate with business volumes and new orders picking up. Input costs are rising and companies are raising their prices on stronger client demand. Accordingly, service inflation is accelerating, which will feed into higher domestic inflation. Overall, activity levels in August suggest that GDP growth is gaining further momentum in the third quarter. Housing data have been softer in July with both new and existing home sales falling. However, the positive trend remains intact and the latest NAHB sentiment survey points to a reacceleration in August.

Eurozone: Macro data remain robust, but Draghi gives little away on QE tapering

The latest Eurozone flash PMI surveys showed a pickup in business confidence, led by the manufacturing sectors in both Germany and France, with strong growth in new orders and new export orders. There was also a pickup in both input and output prices in the Eurozone composite PMI survey, providing evidence that inflation is picking up. However, ECB President Mario Draghi did not say anything further about tapering of QE at the Jackson Hole symposium last week, suggesting a formal announcement is now more likely at the October 26 ECB meeting than September 7 . Political risk may be set to increase in Italy in the months ahead with three right-wing parties, including Silvio Berlusconi`s Forza Italia, looking to form a coalition and discussing the introduction of a parallel currency to the euro. Italian government bonds sold off earlier in the week on the news. However, a formal agreement between the parties has not yet been announced and the situation remains fluid. General elections in Italy must be held by May 2018 at the latest.

Japan: The fastest growing G7 country in Q2

Following the brilliant Q2 GDP growth numbers published last week, it is encouraging to see that growth remains solid in the current quarter. Japan's Manufacturing PMI picked up steam again in August, from 52.1 to 52.8. Most sub-indicators contributed positively, with the output and new order components experiencing a remarkable increase. This is not surprising to us, as strong production plans for August had already suggested that growth would not falter. The Reuters Tankan for August showed a new post-Global Financial Crisis high in the manufacturing diffusion index at 27, while the Non-manufacturing DI fell four points to 29 on a weaker retail component. The outlook for October fell for both components. In the equity space, it is notable that the TSE2 index, representing stocks listed in the second section, marked a record high. However, market capitalisation of these stocks makes up only 1.3% of the market cap of Topix listed stocks. The Topix is still 45% below its all-time high marked in 1989. Finally, BoJ Governor Kuroda's remarks at Jackson Hole suggest that the BoJ will continue its accommodative monetary policy.

Indonesia: Back to monetary easing as growth slows and confidence in financial stability increases

Bank Indonesia (BI) resumed monetary easing for the first time in almost a year. BI had numerous reasons to cut its policy rate by 25bps, bringing it to 4.50%. After a strong run in H1, inflation looks like it is peaking. FX reserves have reached an all-time high, and investor money continues to flow into local sovereign bonds. We thought that the prospects of a busy monetary policy agenda this fall would deter BI from cutting, but the central bank played down the risks around the Fed's policy normalisation. BI might have seized the last occasion to ease, but more rate cuts would be complacent, in our view. The market impact of the Fed's balance sheet normalisation is uncertain, while the trend of slower CPI seen across Asia is in great part driven by lower food prices, and is not structural. We admit that Indonesian consumption and credit growth have softened. We do not see monetary easing as the solution, though, given that loan growth is mainly impaired by asset quality issues. Going forward, BI and other Asian central banks will likely adopt a data-driven stance, while observing the consequences of monetary policy changes in the West.

What to Watch

- Labour market data is expected to show a healthy employment situation, while the ISM Survey will reveal whether momentum in the manufacturing sector has slowed in line with the Markit PMI. PCE Core should have stabilised in July.
- Listing all the economic data that will be published in Japan next week would consume this space, but we will focus particularly on the Q2 MoF survey on company capital spending, sales and profits.

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