September 18, 2017

Weekly Macro & Markets View

Highlights and View

- **Equity markets rebound and bond yields jump**

  As expected, the sell-off in stocks and safe haven asset rally has reversed. The move should continue as sentiment turns more optimistic and the macro backdrop remains favourable.

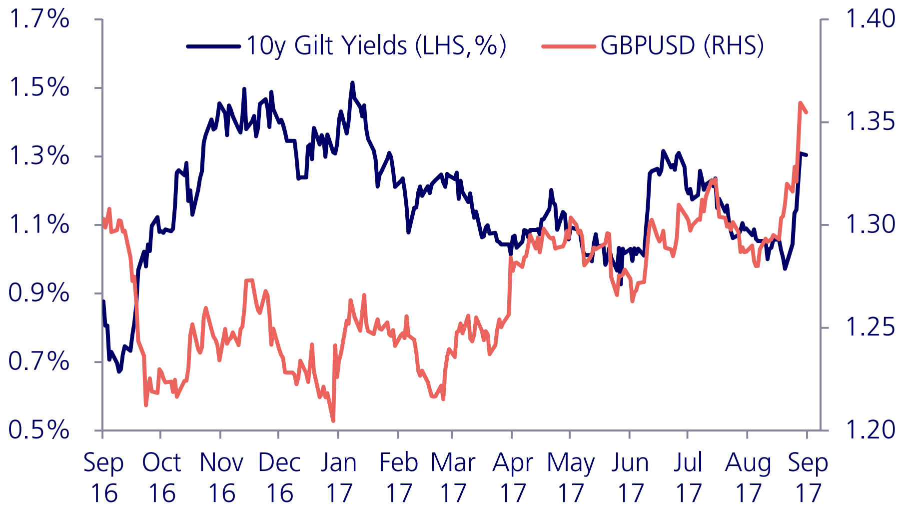
- **Credit markets continue to see a supply surge, particularly in the long end**

  Demand remains strong in credit markets, judging by oversubscription of new issues. While this will continue to support the primary market, upside in the secondary market is limited due to tight spread levels.

- **Japanese media reports that PM Abe may call snap elections for end of October**

  PM Abe is benefitting from an LPD revival in the polls and opposition parties in disarray, though there are risks that the leading coalition may lose its two-thirds majority.

Gilt yields rise as the BoE turns more hawkish



Source: Bloomberg

Global bond yields rebounded as investors' nerves calmed down, and even North Korea's latest missile test was shrugged off by the markets. In an environment of rising yields, gilt yields received some extra support from higher inflation rates and a relatively hawkish BoE. Headline CPI inflation reaccelerated to 0.6% MoM in August, lifting the annual rate to 2.9% from 2.6% in July. PPI input prices were up 7.6% YoY, an acceleration from last month but still significantly below the levels at the beginning of the year. Based on the PPI trend and the recent strength of the pound, we expect inflation rates to moderate in the coming months. Nevertheless, the squeeze on consumers' purchasing power continues as growth in average weekly earnings remained at 2.1% in July, regardless of the fall in the unemployment rate to 4.3%. Despite the modest growth outlook, uncertainties around Brexit, and the recent pickup in sterling, the BoE is increasingly worried about high inflation rates. According to the latest minutes, a majority of the MPC members seem willing to hike rates in the coming months if the economy develops in line with the BoE's projection. While the focus on high inflation rates increases the likelihood of a rate hike, it is far from certain as we expect growth to remain modest and the outlook clouded by the lack of progress in the Brexit negotiations.

US: Inflation reaccelerates

With the debt limit pushed back and Hurricane Irma causing less havoc than initially feared, higher inflation rates added further momentum to already climbing Treasury yields. In August, headline CPI inflation rose a solid 0.4%, lifting the annual rate to 1.9% while Core CPI remained at 1.7% YoY. Although core goods prices kept falling, core services rose, driven by shelter and medical care. Retail sales weakened in August, falling 0.2% MoM, partially distorted by the impact of hurricanes Harvey and Irma. NFIB Small Business Optimism ticked up to 105.3 from 105.2, still hovering around the current cycle's high of 105.9, reached in January. Importantly, capital expenditure plans soared to the highest level since 2006, indicating that business investment will further accelerate going forward. Consumers became slightly more cautious according to the University of Michigan Sentiment Indicator, but remain very upbeat overall. Finally, job openings reached another record high in July, climbing to 6.17 million.

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Eurozone: Tensions between the central and Catalonian government increase in Spain

Political tensions in Spain are increasing with a referendum scheduled by the Catalonian government for the 1st of October that has already been declared invalid by the central government and suspended by the constitutional court, but may still go ahead. Spanish to German 10yr bond yield spreads have widened by around 15bps since mid-August, and could widen further around the time of the vote. However, even if the vote does take place and the result is in favour of independence, it will not be legally binding and is unlikely to be recognised by the central government, constitutional court or EU. This suggests that the amount of political risk that will be priced in by investors will be limited.

In terms of data, Eurozone industrial production rose 0.1% MoM and 3.2% YoY, with a broad-based contribution to output growth by country. Italy, in particular, is seeing a pickup in industrial production and business confidence, despite the stronger euro.

Switzerland: SNB leaves policy unchanged, reiterating concerns about the housing market

As expected, the SNB left policy unchanged in last week's policy meeting. While welcoming a weaker franc, they reiterated that the currency is highly valued and kept the inflation projection broadly unchanged, at a meagre 0.4% this year and next. Concerns about housing imbalances persist, in particular strong investor demand in the residential property segment, and it was noted that house prices are rising again. With little prospects for rates to rise any time soon, an adjustment to the capital buffer should not be ruled out. Q2 GDP growth was in line with our view but, at only 0.3% QoQ, it was well below market expectations of 0.5%. The annual growth rate has fallen sharply, from 2% one year ago, to only 0.3% currently, while surveys have moved in the opposite direction. We anticipate the discrepancy between hard and soft data to persist, due to sluggish domestic demand, which continues to weigh on the export led expansion.

Japan: Capex plans are encouraging

The business outlook survey, conducted by the Ministry of Finance and the Cabinet Office, published at the start of each quarter, often gives valuable insights into the state of Japan's corporate environment. The business sentiment index (BSI) for large firms recovered to 5.1 in Q3 from -2 in Q2, and expectations for the next two quarters, at 7.5 and 5.6, are encouraging. We note that 15 out of 18 manufacturing sectors expect an improvement in economic conditions. While an improvement is also visible for small firms, the index remains in negative territory, with a blip into positive territory expected for next quarter. Capex plans are slightly more positive for manufacturers, while non-manufacturers are turning somewhat more cautious. Across all industries, sales and profit expectation for this fiscal year remain roughly unchanged, which tends to be the typical seasonal pattern. Meanwhile, the Reuters Tankan for September seems to be peaking near post-global financial crisis highs for manufacturers, while non-manufacturers became more optimistic again, following a blip down last month.

China: Growth slowdown is in line with our expectations

Most economic indicators for August came in weaker than consensus had expected. Fixed asset investment growth moderated, particularly in the infrastructure segment, as fiscal support waned and financing for local governments tightened. Manufacturing investment suffered from tighter environmental inspections and restrictions. This impact is also visible in the slowdown of industrial production, where even mining production contracted. Nominal retail sales growth also decelerated, with autos, fuel, furniture and household electronics a drag, while online sales growth, with a share of nearly 14% of total sales, remained brisk. Property sales and investment growth was solid. The slowdown is fully in line with our expectations voiced earlier this year, namely that a growth slowdown had to be expected following credit tightening. Deleveraging the economy is an overarching target, and looser policy would only become visible if growth were to experience a sharper slowdown than what China is experiencing currently. Meanwhile, property price growth is decelerating across 70 major cities, as data published today reveal.

What to Watch

- In the US the focus will be on the Fed, which is expected to announce the beginning of its balance sheet reduction while keeping open the option for another rate hike later this year.
- We do not expect any changes in policy rates when the central banks of Japan, Taiwan, Indonesia and the Philippines convene this week.
- Angela Merkel is on track to win a fourth term as Chancellor, as Germany holds parliamentary elections on September 24. The main focus will be on whether her CDU party continues in a grand coalition government with the SPD, or forms a coalition with other parties.

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