October 30, 2017

Weekly Macro & Markets View

Highlights and View

- **The ECB announces QE will continue well into 2018, albeit at a reduced pace**

  Ongoing stimulus by the ECB will help support the recovery and equities, and could weaken the euro further.

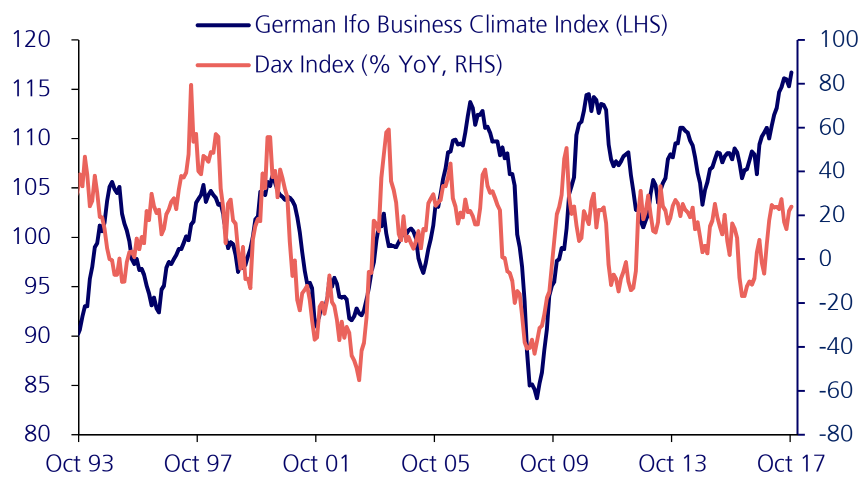
- **US Congress approves the budget resolution as a first step towards the Republicans' tax reform plans**

  The debate will now shift to the details of the tax reform proposal. However, some major obstacles still have to be circumvented, not least the proposed repeal of state and local tax deductions.

- **China's 19th Communist Party Congress concludes with the election of new leadership**

  President Xi Jinping has strengthened his grip on the party, enabling him to focus on central aspects of his 'New Era' thoughts.

The ECB supports recovery as business confidence remain strong



Source: Bloomberg

The ECB announced last week that it would continue QE asset purchases in 2018 at a reduced pace of 30 billion euros a month until September, thereby providing a significant amount of ongoing stimulus to the Eurozone economy next year. This will support growth, inflation, and risk assets in the region, especially equities. Importantly, the ECB has avoided the potential policy mistake of removing stimulus too quickly. Indeed, ECB President Mario Draghi said that there would not be a sudden stop to QE asset purchases after September 2018, suggesting that purchases would continue in the final quarter of 2018, even if at a much reduced pace. What's more, economic data in the Eurozone continue to indicate a robust recovery. The German ifo Business Climate Index hit a new record high in October for example. Admittedly, political risks remain. Last week, the Catalan parliament declared independence, and the Spanish national government triggered Article 155 of the constitution to take over the regional government. In the near term, tensions are likely to increase, with the danger of civil unrest in Catalonia as the national government attempts to exert its authority. The situation is fluid and needs careful monitoring, but we think the dispute will remain a local issue for now and is unlikely to develop in such a way as to derail the Eurozone recovery, or the positive outlook for risk assets in the region.

US: The economy grows steadily despite the hurricanes' impact

GDP grew by a solid 3.0% in the third quarter, according to the first estimate, after 3.1% in Q2. While consumption growth slowed down, both investment and net exports picked up. Capital goods orders grew by 1.3% in September, the same as in August, indicating that the positive environment for business investment will likely continue. New home sales jumped by 18.9% to 667'000 in September, a post-recession high, confirming the positive trend in housing. 10-year Treasury yields rose to the highest level since March on solid data and Congress passing the budget resolution as a first step towards the expected tax cuts. The debate will now move on to the Republicans' tax reform proposal, and while a compromise is likely, working out the details will prove to be challenging. Meanwhile, earnings season continues with a bit more than half of the S&P 500 companies having reported by now. The average surprise is 4.6%, resulting in a blended growth rate of 8.4% compared with the same quarter a year ago.

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China: 19th NCCPC concludes with election of new leadership

President Xi's 'New Era' started last week. Consolidating his power, most of the five newly elected members of the Politburo Standing Committee were close companions during his first term. The Congress also elected 204 Central Committee members and 172 alternates. The rule that members retire after reaching the age of 68 was upheld. Interestingly, no younger successor to Xi seems to be in the pipeline, which made some commentators speculate that Xi may remain in power even when his term ends in 2022. The fact that "Xi Jinping's Thoughts" have indeed been enshrined into the party's constitution, as we envisaged last week, brings him to the same ideological level as Mao Zedong and Deng Xiaoping. Overall, we believe that the new leadership will increase its focus on tackling China's income inequality, environment protection, and surging leverage in the financial and corporate sector. The next major events are the Annual Central Economic Work conference in December, where China's policy priorities for next year will be discussed, followed by the NPC in March 2018.

Bonds: Spreads widen on policy divergence

Spreads between Treasury and Bund yields widened last week, as the ECB's decision to keep QE purchases in place for longer was perceived as dovish by markets, while speculation around the next Fed chair and renewed hopes of US tax cuts pushed Treasury yields higher. The 2yr spread, at 235bps, matches the levels reached in the late 1990s, when the 2yr Treasury yield approached 6%. While extended, the spread could widen further, as the ECB is set to keep rates on hold into 2019, while the Fed funds path only implies three rate hikes by end 2019, which is still too dovish in our view. Spreads at the longer end, though not back to post-Trump election levels, are also stretched. In the absence of a breakthrough on US tax reform or decisively stronger inflation data, near term upsides to the 10yr Treasury yield are likely to be limited, given global factors. Event risk is significant, however, with the announcement of the new Fed chair and events in Catalonia at the fore.

Credit: High yield underperforms, market focusses on bank earnings

Credit markets were firm last week, although performance continued to lag that of equities. The 'risk on' sentiment was driven by the ECB being more dovish than expected, as well as by optimism around US tax reforms. Within CDS indices, US indices underperformed amid heavy protection buying as more investors are coming round to the view that spreads are close to a floor. Within cash credit, high yield underperformed despite the strength in oil prices, as funds, including ETFs, suffered outflows again. As we mentioned earlier, it is crucial that flows stabilise in order for the high yield market to hold in at current tight spread levels. Bank earnings from Europe so far were have been mixed so far, with Barclays and Deutsche Bank appearing to lose market share in trading. Notably, the ECB is said to be scrutinising Unicredit's sale of NPLs, with some reports speculating that the average sale price of 13% was artificially boosted. This scrutiny comes at a time when the ECB seeks feedback on harsher NPL provisions and is worth monitoring.

Covered Bonds: It seems like a 'goldilocks scenario'

The recent rally has depressed the premium at which covered bonds trade versus senior bank bonds. Covered bonds, which are guaranteed by the issuing bank, in addition to being secured by collateral, are also unlikely to be 'bailed in' the event of a bank resolution, while legislation is increasingly going in the direction of senior bond 'bail-ins'. Another boost for covered bonds came from the ECB last week, which stated that it will halve its QE programme but reiterated that "the Eurosystem anticipates that the purchase volumes under the three private sectors purchase programmes will remain sizable", which may indicate that most of the volume drop will come from public sector bonds. Monthly net purchases of covered bonds could decline next year, but reinvestment of redemptions will play a larger role and helps CBPP3. As the ECB already holds € 247bn in covered bonds, which is 39% of the eligible European market outstanding, most of the purchases will be sourced via the primary market and should support spreads and new issuance volume.

What to Watch

- The ISM Manufacturing and Non-Manufacturing Surveys, Conference Board Consumer Sentiment and labour market data will show whether the US economy has maintained or even increased momentum after the hurricanes that hit in Q3.
- A broad range of major economic indicators will be published in Japan, while the October PMIs for Asia will give us a glimpse as to whether firm economic conditions in the region will prevail.
- The BoE is expected to hike rates this week, while no action is expected from the Fed or the BoJ.

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