July 24, 2017

Weekly Macro & Markets View

Highlights and View

- **The synchronised cyclical recovery remains intact, supported by a pick-up of investment globally.**

  The global cyclical recovery will likely run further, as it is backed by the drivers of investment and consumption. As monetary policy normalises, an acceleration in growth is unlikely, though.

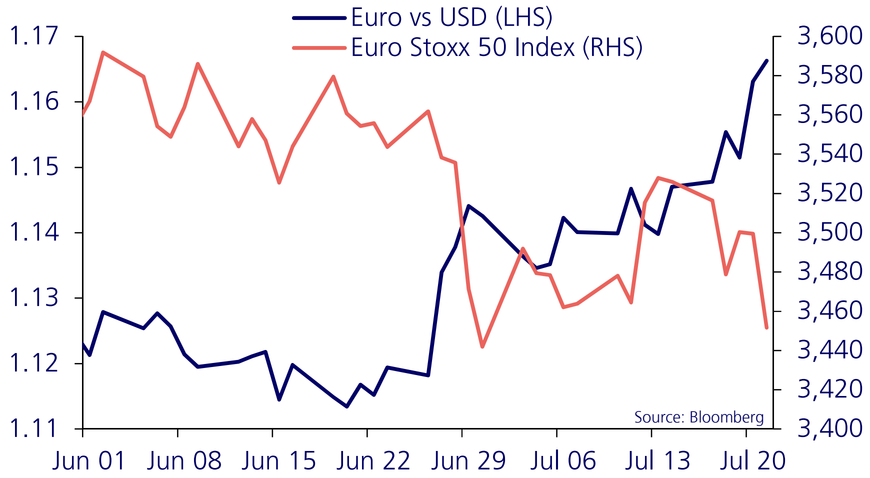
- **Republicans fail to gather enough votes in the Senate to replace Obamacare.**

  The failed efforts to replace Obamacare raises concerns about the Trump administration's ability to implement other key policy initiatives including tax reform and infrastructure spending.

- **No joint statement issued after the Sino-US Comprehensive Economic Dialogue last week.**

  Obviously, the honeymoon between President Trump and President Xi is over, as there is no progress on the North Korean problem. However, a trade war still seems unlikely.

ECB still on course to announce tapering of QE



At the ECB monetary policy meeting and press conference last week, ECB President, Mario Draghi, noted that the recovery is broadening and strengthening and that he expects inflation will gradually pickup as a result. However, Draghi was vague on the specific date of when the ECB will review and make an announcement on the size of monthly QE asset purchases in 2018. He referred to the autumn, which could indicate an announcement at either the September 7 or October 26 meeting.

When asked whether the ECB was concerned about the recent strength of the euro, he noted that it was discussed but that overall financial conditions were generally still supportive. The fact that Draghi did not express more concern helped push the euro to its highest levels in two years against the USD. Unfortunately, the euro's strength led to a decline in Eurozone equities as a stronger currency squeezes exporters' margins. Underlying economic conditions in the Eurozone are still robust, and this should help support domestic earnings. For example, the latest ECB bank lending survey showed a further loosening in credit standards in loans to enterprises and for mortgages, and an increase in demand for loans. However, for now investors are focusing more on the negative impact on Eurozone exporters' earnings from the stronger euro, which could continue for a while.

UK: Inflation is receding

Headline CPI inflation was flat in June, helped by the recent drop in energy prices, lowering the annual rate to 2.6% from 2.9% in May. The retail price index crept higher in June, albeit at a slower pace than a month ago – to 3.5% YoY from 3.7%. While the slowdown in inflation reduces the pressure on households, consumers' purchasing power continues to be squeezed as real wage growth remains negative. The impact of the weaker pound on prices is fading, though. PPI input prices were 9.9% higher than a year ago, down from 20% at the beginning of the year. The latest set of inflation data should help to alleviate the BoE's more hawkish members' fears, reducing the likelihood of an imminent rate hike. Accordingly, the pound weakened and short-term gilt yields fell after the data was released. On the positive side, after having fallen to the slowest pace in four years, retail sales growth has reaccelerated in June, supported by unusually warm weather. Nevertheless, with the real income squeeze and Brexit uncertainty still present, headwinds for UK consumers remain.

Japan: Bank of Japan postpones inflation target again

The Bank of Japan left monetary policy settings unchanged at its latest MPC meeting. However, the board members upgraded their growth assessment, with the median GDP growth forecast revised up from 1.6% to 1.8% this fiscal year and from 1.3% to 1.4% for next year. What is more important is the downward revision of the BoJ's inflation forecast. CPI ex fresh food is expected to show a reading of only 1.1% this fiscal year, down from the prior forecast of 1.4%, and to 1.5% next year. The timeframe for reaching its 2% inflation target was pushed back for the sixth time to the end of FY 2019, which effectively means early 2020. Though we often commented that the BoJ's inflation target was unrealistic, we note that wage growth seems to be gaining some steam. Despite being revised downwards, regular wages were up 0.7% in May. Finally, as of today, two new BoJ board members, Kataoka and Suzuki, will take over the baton from Kiuchi and Sato, the two hawks who frequently dissented from the majority view. This will make it easier for Governor Kuroda to push his policy.

Australia: The RBA needs to see firmer wage growth before it considers hiking

The RBA released the minutes of its July meeting, which boosted the AUD close to 0.80 vs. the USD, above the upper bound of the 0.71-0.78 two-year trading range. Investors were spooked by the discussion around the neutral policy rate, which the Board members estimated at 3.5%, 2 percentage points above the current rate. The central bank is also turning more confident on the economy, and so are we. So far, corporates have benefited the most from the cyclical recovery, but there are now signs that the situation of households is also improving. Full-time job creation has gathered speed, and is tracking at 28k per month in 2017 vs. -5k in 2016. A spill-over to wage growth will likely take some time to materialise, though. According to the Australian Bureau of Statistics, 30% of part-time workers would like to work more, which shows ongoing slack in the labour market. Consumers are also facing the headwinds of tighter mortgage rates and higher headline inflation. For these reasons, the RBA will likely stay on hold for now, and watch for a clear lift in wage growth.

Asian: Asian equities are riding the tech wave

Technology stocks keep pushing the MSCI Asia higher: the IT sector has the largest weight in the index and is up 38.2% year-to-date. The rally has been backed by strong fundamentals, as Asian exports of semiconductors and other electronic components are still registering double-digit growth rates. Last week, strong export data for Taiwan, Korea, Singapore and Thailand confirmed the attractive backdrop. Northern Asian equity markets, which are more geared towards IT, have outperformed ASEAN. The MSCI China index has jumped 31.7% year-to-date, and we would not be surprised if its steep outperformance versus the world were to pause at this stage. In the tech space, the MSCI China is more geared toward pure internet stocks, while other North-Asian markets, like Taiwan and Korea, offer an exposure to traditional tech at more attractive valuations. In general, we see ongoing positive drivers for equity markets in EM Asia such as a weakening US dollar, attractive valuations, and an ongoing improvement in Asian corporate earnings.

Credit: Strong technicals underpin outperformance versus equities

Credit remained firm and continued to outperform equities, especially in Europe and in the banking sector across Europe and the US. This outperformance of financials for a second week in a row occurred despite a notable deluge of US financial debt issuance following earnings. Top money centre US banks were reported to issue a total of $31bn in debt, with Bank of America and Morgan Stanley issuing around $7bn each. While bank stocks have been soggy due to the notable transience of higher net interest margins in the US earning reports, credit has been underpinned by strong technicals. Encouragingly, even High Yield has begun to tentatively experience some inflows, although a lot of it is in 'hot money' ETFs. With the summer lull approaching, barring exceptionally high post earnings US corporate issuance, technicals are likely to remain strong, but tensions in short term money markets are worth watching.

What to Watch

- No action is expected from the Fed this week, but the FOMC is likely to give more hints on the planned balance sheet reduction. Markit PMIs will give an indication of the current economic momentum in the US, while GDP numbers are expected to show that growth has rebounded in the second quarter.
- Eurozone lending and business confidence data should indicate that growth remains robust.
- In Japan, inflation data for June/July, labour market data and retail sales for June, as well as the Shoko-Chukin survey for July will be in focus. We will also watch out for Q2 GDP and industrial production data for June in both Korea and Taiwan.

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