May 22, 2017

Weekly Macro & Markets View

Highlights and View

- **Political scandal involving the interim president wreaks havoc on Brazilian assets**

  The outlook for necessary fiscal reforms is now clouded and certainly delayed. Still, the macro backdrop is less vulnerable and healthier than it was during the past two years

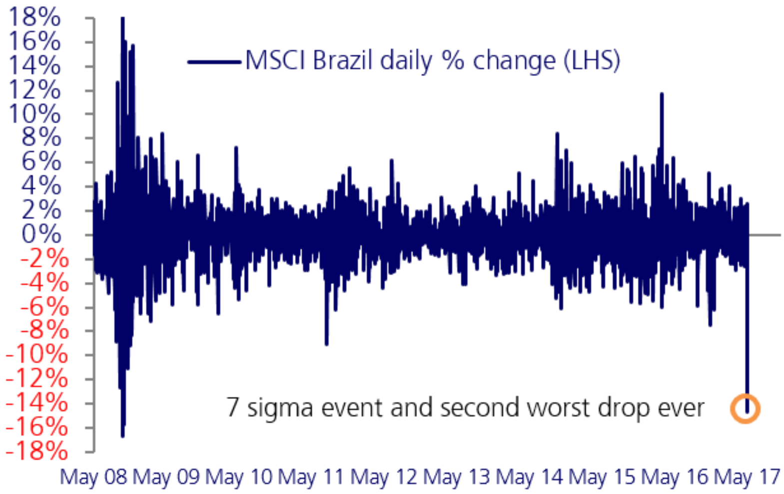
- **The political turmoil engulfing the Trump administration hits global stock markets**

  Pressure on President Trump is rising, increasing the risk of further distracting the administration from its policy agenda

- **US manufacturing data underlines the sector's renewed strength**

  Manufacturing production grew a solid 1% in April, while the rebound of the Philadelphia Fed's Business Outlook survey signals a continuation of the solid momentum

Brazilian markets suffer a Maracanazo



Source: Bloomberg

The seven sigma fallout that the Brazilian market experienced in a single day last week is an echo of the country's historical soccer debacles. Both were bitterly unexpected. A corruption probe is once again rocking the political boat and creating instability, as a potential impeachment of President Temer could harm the pace of reforms.

The impeachment of President Rousseff is too fresh in the minds of investors, and the prospect of a political vacuum in the midst of critical votes on fiscal reforms has taken market participants off guard. The steep decline in the equity market, the worst one-day sell-off in the currency market since the devaluation of the late 90s, a steeper yield curve and a widening of credit spreads are all testimony to the element of surprise but also the classic reaction of sell first and ask questions later.

The dust will need to settle, but the macro backdrop is quite different than it has been during the past two years with inflation now below target for the first time in seven years, a stronger external balance, and a central bank that still has room to ease. Nevertheless, the outlook for reforms has weakened with the risk of dilution, delay or cancellation that would derail the attempt to fix the fiscal deficit. Political turmoil and the fiscal Achilles heel remain centre stage.

US: Mounting pressure on the Trump administration

Growing concerns over the political turmoil building around the Trump administration led the S&P 500 to suffer its biggest daily drop since last September. Most of the loss was recouped by the end of the week, but the situation remains fragile. While the appointment of Ex-FBI Director Robert Mueller as special counsel has removed some of the immediate pressure, the investigation weighs on the Trump administration and increases the risk of further delays in key policy areas. While politics took centre stage last week, economic data were tilted to the positive side. Both housing starts and building permits dropped in April, but home builder sentiment climbed back close to a 12-year high. Industrial production grew by a solid 1% in April and capacity utilization rose to the highest level in almost two years, increasing the likelihood of a further pickup in investment. Finally, jobless claims underlined the labour market's current strength and the Philadelphia Fed's Business Outlook rebounded to the second-highest level in 24 years.

msme@zurich.com

Eurozone: the ECB gets closer to a change of language in its forward guidance

Accounts of the most recent ECB monetary policy meeting released last week indicated that there is a general consensus that risks to the Eurozone outlook have diminished and that this should be recognised by the ECB, especially in terms of its forward guidance, though there is still a lively debate within the ECB about the implications for monetary policy. At a minimum, it looks likely that the ECB will drop the reference to interest rates staying at present "or lower levels" at its June 8 meeting.

In terms of data, the German ZEW expectations survey edged up to its highest level since August 2015. The second estimate of Q1 Eurozone GDP was confirmed at 0.5% QoQ, in line with expectations. While the detailed sector breakdown is not yet available, it is likely that household spending, investment and net trade will have contributed to growth. Releases by country showed that amongst the large economies Spain continued to outperform in Q1 (+0.8% QoQ), followed by Germany (+0.6%), and France (+0.3%), whilst growth in Italy remains soft for now (+0.2%).

Japan: Firm earnings reports, but the outlook seems too conservative

The earnings report season for the fiscal year 2016 that ended in March this year showed a favourable outcome, with positive earnings surprises clearly outpacing negative ones. Despite sales falling by 2% YoY and recurring profits up a paltry 1%, net profits surged 14%, clearly above consensus estimates. Reported earnings have surprised consensus estimates positively for four quarters in a row, though momentum is now slowing as analysts are adapting to reality. Companies estimate that sales will rise 3% in the current fiscal year per end of March 2018, with recurring profits up 6% and net profits up 4%. Guidance is once again far below consensus estimates (recurring profits up 12%, net profits up 9%). However, this gap is fully in line with the pattern seen in previous years, as Japanese companies tend to be very conservative. We are encouraged by the positive swing in top-line growth. Forex assumptions are conservative, particularly versus the euro, giving some leeway for positive earnings surprises going forward. Based on various valuation metrics, Japanese shares appear attractively valued.

Bonds: The Trump trade is fading

Core yields fell last week, led by a politically driven Treasury rally, with the 10yr Treasury yield down 9bps and the Treasury/Bund spread narrowing by 7bps. Many of the prices that moved after the US election reversed further last week. Inflation expectations slipped, with the 5Y5Y inflation forward at 2.22%, down from 2.42% in the beginning of the year and 2.30% a week ago. The yield curve flattened further, to below its pre-election level, and market pricing is no longer consistent with the Fed's 3% terminal rate, with the 5Y5Y interest rate forward at only 2.75%, compared to 2.86% a week ago. By contrast, the short end of the yield curve remains anchored, with a June rate hike almost fully priced in. As the underlying fundamentals remain robust, with the US economy operating at almost full capacity and a Fed keen to stop its reinvestment policy, a 10yr Treasury yield at 2.25% look stretched.

Credit: After the capitulation, comes the wobble

Following the capitulation of under-weight positions recently, the spread rally became a bit unhinged this week, with most cash credit spreads ending the week wider. European bank paper, especially subordinated paper issued by Spanish banks, was hit hard, as was paper from some US banks that were potential beneficiaries of expected deregulation by the Trump administration. However, despite the volatility, we think supply/demand technicals remain strong in credit. Inflows into investment grade remain robust, although US high yield is struggling to re-attract flows. Evidence of strong demand was displayed in the jumbo $11bn Qualcomm deal, which was around four times oversubscribed, with little new issue premium. There were also some signs of progress for troubled banks, namely Monte Dei Paschi and Banco Popular, although we think the approach is more reactive and piecemeal than we would ideally like.

What to Watch

- The G3 flash PMIs are likely to show continued growth, though a further upswing is unlikely.
- No major surprises are expected from the Fed minutes, while the first revision of Q1 GDP data for the US should show a more benign picture of the economic situation.
- At the upcoming OPEC meeting in Vienna, we expect at least an extension of oil output cuts in a bid to try and normalize inventories.

173001566 (01/16) TCL

ZURICH®