Weekly Macro & Markets View

Highlights and View

- **A tumultuous week for the Trump administration spooks investors and drags down Treasury yields**

  While the latest turmoil raises further doubts about Trump's ability to reach his policy objectives, market expectations are now relatively low and could be surprised positively.

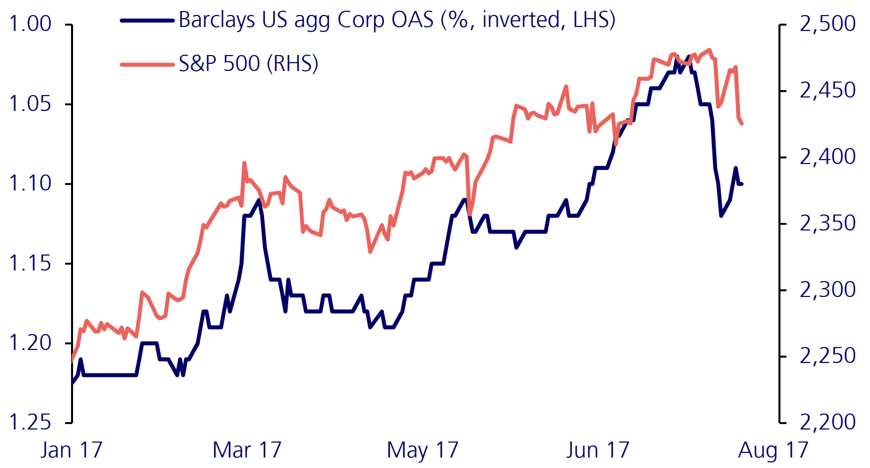
- **Eurozone GDP grew by a solid 0.6% in Q2, lifting the annual rate to 2.2%**

  As expected, hard economic data is catching up with the strong sentiment observed in recent months.

- **Malaysia's GDP jumped to 5.8% YoY in Q2, a nine-quarter high, as consumption and export growth accelerate**

  We expect ongoing strength in domestic demand, thanks to a tightening labour market and a large pipeline of infrastructure projects. Export growth is likely to soften, though.

Market pullback expected to be transitory



Source: Bloomberg

What had looked to be shaping up as a week for a relief rally, with the US having moved away from imminent military action with North Korea, sadly turned sour following the disturbing events in Virginia and Barcelona. Equity and credit markets were off sharply, falling below the prior week's 'fire and fury' tweet-induced lows, while bond yields fell to the bottom end of their recent trading range. Although investors have become unsettled by the events of the past couple of weeks, we do not believe that stocks are poised for a major correction and see the current pullback as transient.

The global economic backdrop continues to be favourable, with data last week pointing to robust activity in the US, Eurozone and Japan, while softer readings from China are largely as expected. With 10yr Treasury and Bund yields falling back to 2.16% and 0.4% respectively, this seems inconsistent with the strong fundamentals. Indeed, the release of Q2 GDP data last week showed the Eurozone growing at 2.2% YoY, while core inflation was confirmed at 1.2% YoY in July. With the concluding earnings season on both sides of the Atlantic supportive of stocks, we think a rebound is likely, although we are concerned by the unpredictability of US political developments and apparent lack of progress on key reforms.

Credit: Outperformance versus equities seen ebbing

Credit markets have underperformed equities during the recent volatility on a beta adjusted basis, which is something that we expect will also occur in future sell-offs. Having led the broader risk markets throughout this cycle, credit spreads are now at levels that don't leave much room for upside. In fact, several credit indices are now close to 2007 levels, especially when adjustments for quality and duration are made. As we had indicated previously, US high yield seems to be displaying some warning signals, with flows yet to gain momentum and ETFs injecting volatility into underlying markets, especially as they are used to hedge oil exposures. However, we aren't forecasting an imminent turn in the credit cycle yet as global economic growth remains healthy and central banks accommodative. That said, we think the days of credit outperforming equities are likely to be over.

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US: Consumers are upbeat and increasing spending

While investors focused on the political turmoil engulfing the Trump administration, economic data was mostly positive last week. Consumers had a strong entry into the second half of the year with retail sales growing by 0.6% in July. In addition, last month's growth rate was revised up from -0.2% to 0.3%, underlining the healthy shape of the consumer sector. Households remain upbeat with the University of Michigan Consumer Sentiment Index jumping back to the highest level since January, driven by solid improvement in expectations that signal further growth in consumer spending. Housing data were weaker in July with both building permits and housing starts falling. However, this comes after a strong rebound the month before. The NAHB Housing Market Index rebounded to 68, indicating that the recovery in the housing market will continue. Manufacturing production fell slightly in July, dragged down by weakness in the auto sector where the inventory overhang persists.

UK: A strong labour market despite a slowing economy

Households' purchasing power continues to be squeezed as inflation rates remain significantly above wage growth. Nevertheless, we think the main impact lies behind us as the feedthrough of the steep fall in the pound is slowly fading. The annual CPI inflation rate remained at 2.6% in July, while the MoM rate was -0.1%. The price pressure in the value chain continues to normalise with PPI input prices 6.5% higher than a year ago, down from 10% in June and 20% at the beginning of the year. While inflation rates are stabilising, average weekly earnings accelerated to 2.1% YoY in June from 1.9%. Despite the economic slowdown, the labour market remains strong with the unemployment rate falling to 4.4% —the lowest since 1975. Retail sales grew by 0.5% in July, down from 0.6% in June. While the last two months show a relatively benign picture, the annual growth rate for retail sales reveals the headwinds for consumers, slowing to 1.5% down from 2.8% in June (and 4.4% at the end of last year).

China: Economic growth is starting to slow, in line with our expectations

China's economic indicators for July came in weaker across the board, both in comparison to June, the Q2 average and versus consensus expectations. Supply side measures have played a role on the production and investment side, but we believe that the government's tighter real estate and local government financing policies were the primary driver of the slowdown. We have been expecting this to play out in the second half of the year, and the latest numbers are in line with our expectations. The slowdown in fixed asset investment growth was particularly pronounced and broad based. FAI growth slowed from 8.6% in June to only 6.9% YoY, with manufacturing, property and infrastructure investment all contributing. Real estate investment is slowing as developers are facing a tighter financing environment, while higher mortgage rates and purchase restrictions are hitting demand. However, low inventory levels suggest that the slowdown should be less severe than in previous down cycles. Retail sales growth moderated due to slower auto sales, while online sales growth remains brisk.

Japan: Fastest growing G7 country in Q2

The fact that Japan has been the fastest growing G7 country in Q2 makes a nice headline, but we are aware that later revisions to the 4% annualised sequential growth rate may spoil the party. However, it is remarkable that Japan's economy has now been growing for six quarters in a row, which last happened during the 'Koizumi' boom in 2005/2006. We suspected that growth would be brisk in Q2 following the disappointing growth in Q1, which had been inventory related and was supposed to reverse. This impact has not even fully played out yet, which translates into positive growth expectations for Q3 and should mark the longest expansion phase since the millennium started. We are encouraged that domestic demand has been the driving force, with both private consumption and capital investment growth accelerating more than consensus had expected. The domestic demand deflator rose only 0.4%, suggesting that stronger growth is not yet contributing to a more favourable inflationary environment, which remains a headache for the Bank of Japan.

What to Watch

- The latest PMIs from the US, the Eurozone and Japan are expected to show a continuation of the positive global economic momentum.
- With both Janet Yellen and Mario Draghi speaking in Jackson Hole this week, investors will look for clues as to the Fed's and the ECB's future policy.
- The probability of a rate cut by Bank Indonesia (BI) has increased in the face of slower inflation and growth. Nevertheless, we see a higher chance of BI staying on hold, to minimise the risk of financial instability in the months prior to the Fed and ECB policy announcements.

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