Weekly Macro & Markets View

Highlights and View

- **The G3 manufacturing PMIs fall on softer activity in the US and Japan, while Eurozone data stay strong**

  The global macro backdrop remains good, though a further acceleration from here is unlikely.

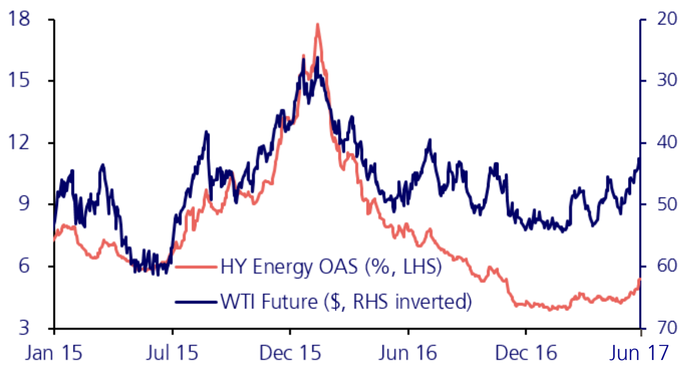
- **MSCI decides to include a portion of China's domestically listed 'A'-shares to its universe**

  MSCI's careful decision is a step in the right direction to full inclusion in the years ahead, which should reward further moves by China's government toward opening its capital markets.

- **As expected, Banxico hiked 25bps to 7%, but stated that tightening might be over**

  The message that Banxico might be done and decouple from the Fed hiking campaign was a surprise, and it is premature to expect rate cuts any time soon. The central bank will remain cautious and stay put for the rest of 2017.

High yield credit suffers a jolt on oil price jitters



Source: Barclays, Bloomberg

It seemed like early 2016 as weakness in oil prices caused some US high yield energy bonds to drop by 5 to 10 points last week. The catalyst was the heavy selling reported out of US high yield ETFs, which were used as the hedge of choice due to their energy exposure being around 13%, much higher than that of equity indices and even marginally more than that of CDS indices. While the ETF selling may have catalysed a repricing, we have been of the view that energy sector pricing had seemingly overshot the bounce in oil prices since early 2016. We think that despite the recent correction, energy credit will have significant further downside should oil prices drop below $40/barrel.

Spreads gapped out, while equities surged as leveraged buy-outs were reported to be in the offing for Staples, CA Inc and Nordstrom. We think that leverage is likely to rise further as the incentives from current low spreads seem compelling.

Lastly, over the weekend, the Italian government allocated € 17bn for the orderly transfer and split of the two Italian Veneto banks. Intesa will receive funds and guarantees from the government for taking over the good assets of the two banks. The wipeout of equity and junior debt confirms our view that private investors will continue to bear the cost of future European bank recapitalisations.

Bonds: Core bond yields fail to rebound amid falling oil prices

We had expected core yields to back up modestly, as the latest leg appeared overdone. Instead, yields have edged down further, with the 10yr Treasury yield ending the week at 2.14%, despite US unemployment at a 16-year low and a decent macro backdrop. Inflation weakness is the main culprit for lower yields, as de-anchored inflation expectations are falling in line with oil prices. It was therefore encouraging that Friday's oil price stabilisation helped stage a rebound, with the 5Y5Y inflation swap ending the week a touch higher. Despite this, the slope of the Treasury curve fell further and the 10/2yr spread now matches last summer's levels, when the Brexit vote triggered excessive pricing. Pricing at the short end also looks stretched, with only two rate hikes priced in by end 2019, rejecting the hawkish message of June's FOMC meeting. While prospects clearly hinge on oil price developments, bond market pricing continues to look excessive, both at the short and the long end.

msme@zurich.com

Eurozone: Energy stocks under pressure on low oil prices

Although the energy sector only represents around 5% of the overall Eurozone equity market, its earnings are particularly volatile and sensitive to changes in oil prices. What's more, when oil prices are weak, we typically see lower bond yields, which tend to be seen as negative by investors for bank earnings because of the implications for net interest margin. However, lower oil prices also have a positive flipside in that they support consumers' real income, thereby helping economic activity in other sectors of the economy. Nevertheless, in the short term, for the Eurozone equity market to do better it will probably require oil prices to at least stabilise.

In terms of data, French business confidence as measured by INSEE climbed to its highest level since 2011. The flash Eurozone services PMI declined, but manufacturing confidence increased and the forward-looking new orders index in both sectors was strong.

China: 'A'-share inclusion into the MSCI universe is a step in the right direction

Following several rounds of consultation, MSCI, the index provider, has finally decided to include a portion of China's domestically traded 'A'-shares in its global universe. 5% of the 222 'A'-shares' market capitalisation will be included by August next year at the latest. This makes up about 0.7% of the MSCI Emerging Market index, in addition to China's current weight of 28.6% of Hong Kong listed 'H'-shares and US listed, mostly Internet related, ADRs. Full inclusion will depend on improvements of Chinese capital market accessibility over the next few years.

Finally, China's weight in the MSCI EM index could be bigger than 40%, reflecting the fact that China's domestic market is the second biggest equity market in the world behind the US. Market reaction was muted, which should not be a surprise. We applaud MSCI's decision, as it will attract more interest by foreign investors and should contribute to making this segment, which is now driven by speculative retail investors, more professional.

Asia: Trade still flowing

Asian trade is still flowing. The combined container throughput of the top seven global harbours was up 9.8% YoY in May (on a three-month moving average basis). Admittedly, export momentum moderated in Q2. Exports of mobile phone pieces have slowed and commodity prices have decreased, which has weighed on export values. Shipments of semi-conductors and machinery have maintained a strong growth rate, though. We think that the ongoing export strength is being fuelled by a global capex upcycle. A migration to new memory drives for personal computers is ongoing, and, in Asia especially, several public infrastructure investment projects have been launched. Going forward, trade growth should maintain a decent pace as global demand remains solid. A sharp slowdown in Chinese infrastructure and property investment, however, would threaten the good health of Asian trade. But we do not foresee a severe drop in Chinese demand: the Chinese authorities are tightening interbank liquidity in a progressive manner and are careful not to harm the real economy.

LatAm: Argentina issues a century bond in a market very hungry for yield

Argentina, a country that has spent a third of the past 200 years in default and has defaulted three times in the past 23 years, has just issued a 100-year bond below par, with a clearing yield of 7.92% for a total amount of USD 2.75bn. Paradoxically, it occurred the same week that MSCI rejected the country's bid to be reclassified in equity indices from frontier to emerging markets. But don't cry for Argentina —investors snapped up the paper issued only 14 months after exiting default, bidding more than three times the amount offered. It now joins the club of super-long emerging markets bonds and will vie with Mexico 2110 and Petrobras 2115 bonds. It is another savvy financial marketing tool from the administration of a country that has defaulted eight times since its independence.

What to Watch

- US consumer confidence is expected to remain at elevated levels, while PCE Core will likely reflect the slowdown in inflation that was visible in CPI data. Finally, capital goods shipments will give an indication with regard to the trend in business investment.
- In the Eurozone, bank lending data and various business confidence surveys should confirm that growth remains strong.
- By Monday next week, most of the Asian PMIs as well as Japan's economic data for May/June will be published, which will give us insights into whether growth momentum is slowing.

Disclaimer and cautionary statement

This publication has been prepared by Zurich Insurance Group Ltd and the opinions expressed therein are those of Zurich Insurance Group Ltd as of the date of writing and are subject to change without notice.

This publication has been produced solely for informational purposes. The analysis contained and opinions expressed herein are based on numerous assumptions. Different assumptions could result in materially different conclusions. All information contained in this publication have been compiled and obtained from sources believed to be reliable and credible but no representation or warranty, express or implied, is made by Zurich Insurance Group Ltd or any of its subsidiaries (the 'Group') as to their accuracy or completeness. Opinions expressed and analyses contained herein might differ from or be contrary to those expressed by other Group functions or contained in other documents of the Group, as a result of using different assumptions and/or criteria. This publication is not intended to be legal, underwriting, financial investment or any other type of professional advice. Persons requiring advice should consult an independent adviser. The Group disclaims any and all liability whatsoever resulting from the use of or reliance upon this publication. Certain statements in this publication are forward-looking statements, including, but not limited to, statements that are predictions of or indicate future events, trends, plans, developments or objectives. Undue reliance should not be placed on such statements because, by their nature, they are subject to known and unknown risks and uncertainties and can be affected by other factors that could cause actual results, developments and plans and objectives to differ materially from those expressed or implied in the forward-looking statements.

The subject matter of this publication is also not tied to any specific insurance product nor will it ensure coverage under any insurance policy. This publication may not be reproduced either in whole, or in part, without prior written permission of Zurich Insurance Group Ltd, Mythenquai 2, 8002 Zurich, Switzerland. Zurich Insurance Group Ltd expressly prohibits the distribution of this publication to third parties for any reason. Neither Zurich Insurance Group Ltd nor any of its subsidiaries accept liability for any loss arising from the use or distribution of this publication. This publication is for distribution only under such circumstances as may be permitted by applicable law and regulations. This publication does not constitute an offer or an invitation for the sale or purchase of securities in any jurisdiction.

173001566 (01/16) TCL

ZURICH®