Weekly Macro & Markets View

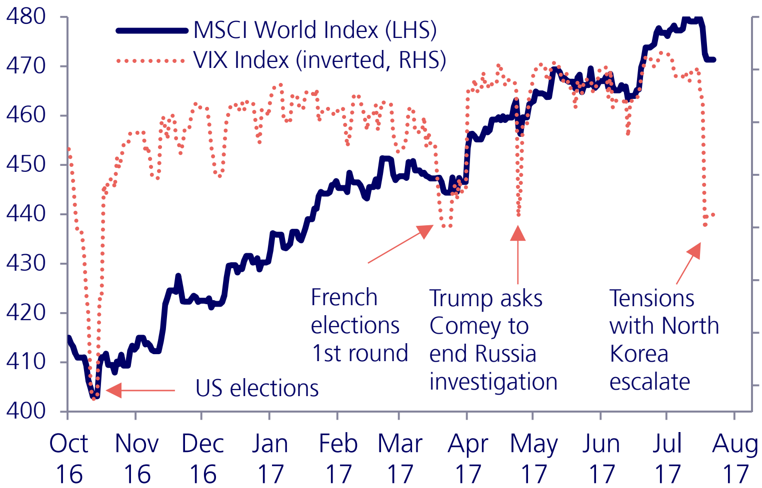
Highlights and View

- **A 'war of words' between the leaders of the US and North Korea spoils market sentiment**
  We believe that a war remains a tail risk, even though its probability has increased, and that markets will return to focusing on favourable economic and earnings prospects.

- **US CPI inflation is slightly reaccelerating but price pressure remains muted**
  Falling producer prices indicate further modest inflation prints ahead, but key core CPI components have started to pick up.

- **Eurozone equity markets are buffeted by geopolitical tensions**
  Solid fundamentals, including corporate earnings, suggest Eurozone equities can bounce back quickly if tensions subside.

The 'fire and fury' market correction is expected to fizzle out



Source: Bloomberg

Long ongoing tensions around North Korea intensified last week. North Korea responded to the latest UN Security Council measures to prohibit the country from exporting certain commodities with a warning that the US would have to pay dearly for the decision. President Trump responded that North Korea would face 'fire and fury' if it threatened the US. The war of words escalated further, with North Korea's leader Kim Jong-un threatening to launch a missile toward the US territory of Guam and turn South Korea's capital Seoul into a 'sea of fire'. This is regrettable, as it seemed the international community was on the right path towards dialogue during a high ranking meeting to commemorate the 50th birthday of ASEAN in Manila just before Trump's remarks. Global markets took note and reacted nervously, not only the two usual suspects South Korea and Japan, which are directly impacted in the event that North Korea were to enter a war. The MSCI World fell 1.9% within four trading days before showing signs of recovering today, Monday, while safe haven assets like gold gained and implied volatility, a measure of risk perception, surged, with the VIX spiking from its record low of 8.87 marked just two weeks ago to above 17. We believe, as long as tensions do not intensify further, that markets' focus should return to the solid global economic and earnings backdrop that was reconfirmed last week by brisk economic data and encouraging earnings reports, particularly in the US.

Eurozone: German industrial production rose sharply in Q2 despite a disappointing June

Production fell 1.1% MoM, leaving YoY output growth running at a 2.4% pace. However, on a QoQ basis German output is still up 1.8% in Q2 versus Q1. In addition, the forward-looking factory orders data were more encouraging in June. More widely in the Eurozone, conditions in Italy appear to be improving quickly with industrial production growth rising to 5.3% YoY in June. What's more, the consumer side of the Eurozone economy is robust, which should be supportive of domestically focused companies' earnings. Retail trade grew 0.5% MoM, 3.1% YoY in June in real terms. Nevertheless, Eurozone equities were under pressure last week, with the Euro Stoxx 50 down almost 3% because of increased geopolitical tensions with North Korea. However, should these tensions reduce, then Eurozone risk assets could bounce back quickly given the still solid fundamentals in the region. Core government bonds benefited from a flight to safety, with German Bund yields down almost 10bps over the course of the week, but Spanish and Italian 10yr bond yields were relatively resilient, ending the week almost unchanged.

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US: CPI inflation picks up, but remains modest

As inflation has slowed down markedly over recent months, last week's economic focus was on inflation data. Headline CPI inflation accelerated slightly in July, both on a monthly and on an annual basis, reaching 0.1% and 1.7% respectively, after 0.0% and 1.6% in June. Core CPI remained at 1.7% YoY. The latest inflation data confirm that pricing pressure remains modest and producer prices measured by PPI were actually falling in July, dragging the annual rate back below 2%. While solid increases in key core CPI components, like medical services and owners' equivalent rent, point to stronger Core CPI measures later this year, the acceleration is likely to remain muted. Other than inflation data, JOLTS Job Openings reached 6.2 million, the highest on record (since 2001). Ongoing labour market strength was also confirmed by the NFIB Small Business Optimism's Job Openings Hard to Fill measure, which came within one point of an all-time high as well (going back to 1973), underlining firms' increasing difficulties in finding qualified personnel.

Switzerland: The fortunes of the franc are still tied to the euro

The Swiss franc appreciated against the euro last week, reflecting the global risk-off trade. Despite the latest geopolitically driven move, the currency is still 1.14 francs per euro (EURCHF), compared to 1.10 in end June, implying a 4% depreciation of the franc to the lowest level since January 2015. The shift mainly reflects euro strength, which in fact has left the franc significantly stronger against the dollar. There is also some evidence that the SNB has amplified the franc depreciation against the euro, as sight deposit data, which proxy forex interventions, rose significantly in prior weeks. In our view, the SNB is likely to have acted to stave off a further strengthening of the franc against the dollar. With euro strength looking excessive near term, and with limits as to how much the SNB is prepared to intervene in forex markets, we do not rule out a stronger Swiss franc against the euro, particularly if geopolitical concerns remain.

Asia: Domestic demand needs to take over trade growth

Although still brisk, Asian export growth is decelerating. The latest trade data from Taiwan and Malaysia show that electronics shipments are increasing at a slower pace, which is not surprising after their stellar run in H1. We were hoping for domestic demand to take over from trade, and this has occurred in some Asian countries. In Hong Kong, Q2 GDP grew by an impressive 3.8% YoY. While net exports weighed on growth, investment and consumption pushed GDP higher. The government's generous fiscal package, the tightening of the labour market, and the positive wealth effect from higher property prices helped. The HK property market has been buoyant thanks to low HIBOR rates, but this could change in 2018, as the Fed normalises its monetary policy. In contrast, Indonesia is experiencing an economic soft patch. GDP growth was stuck at 5.0% YoY in Q2, below potential. Investment shows signs of rebounding, but private consumption was dragged by higher inflation in H1. Going forward, we expect a recovery in consumption, but are slightly preoccupied by the slowdown in reform momentum.

Credit: Shaken from complacency

Credit markets saw the return of volatility after quite some time, with High Yield cash credit spreads widening by around 40bps on the week. While high yield spreads have become too tight, flows are also not yet seeing a firm footing, especially in the US, with the latest data indicating another week of outflows. Investment grade did not fare much better in secondary markets despite continued strong inflows. However, in what is perhaps still an indication of strong technical demand, primary markets absorbed a multi-tranche jumbo deal from BAT while Tesla managed to place a $1.8bn debt issue amid risk aversion and despite its not so pristine creditworthiness. Last but not least, bank results have generally beaten expectations in both the US and Europe, but it seems investors are not particularly impressed by provision releases, with both stock and credit underperforming over the last few weeks.

What to Watch

- China will report July data for industrial production, fixed asset investment and retail sales, while Japan's export data will also be in focus. Malaysia and the Philippines will report GDP data for Q2.
- Inflation is expected to stabilise in the UK as the effects of a weak currency slowly wear off. Both labour market data and retail sales should reflect the continued slowdown in economic growth.
- Eurozone industrial production, GDP and CPI data should indicate that the recovery remains on track, with upside risks to both GDP and CPI data.

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