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Weekly Macro & Markets View

Highlights

- Manufacturing PMIs for the G3 countries rise further, beating expectations in the US and Eurozone
- After several attempts, the Dow Jones rises above the psychologically important level of 20'000
- As expected, the UK Supreme Court confirms the High Court's ruling that parliament has to vote on Brexit

Our view

- Global growth has risen above trend, with stronger investment spending helping to sustain the recovery
- Sentiment remains upbeat, but expectations are high and political risks will increase
- The court's ruling risks delaying the Brexit process as parliament may seek more influence on negotiations

Eurozone bond spreads widen on political and monetary policy uncertainty

Source: Bloomberg

Last week, the Italian constitutional court announced only a few changes to recent electoral law legislation. This should allow early elections to take place this year, though no date has yet been set. Both houses of parliament will follow a proportional representation system, with the lower house also allocating a substantial number of bonus seats to any party or coalition winning at least 40% of the vote. With the PD and 5-Star movement both polling around 30%, the chances of reaching this 40% threshold are low for now. However, the risk is that Italy ends up with a weak or unstable coalition government that is unable to do much to reform the economy further.

In France, support for the far right National Front party looks solid in the first round of the April Presidential elections at just above 25%. While it is unlikely that the National Front would actually win in the second round run-off, it is not impossible, suggesting investors will require a higher risk premium until the election uncertainty is over.

Recent data such as the flash Eurozone PMIs and German Ifo survey continue to indicate a robust pace of growth, but this could unnerve bond investors as they question for how long and at what pace the ECB will continue buying government bonds. The expectations component of the Ifo survey did fall back a bit, a possible indication that political uncertainty and concerns about US trade policy are impacting business confidence.

US: GDP growth slows in Q4, dragged down by net trade

The US stock market had another decent week, with the S&P 500 reaching a new all-time high and the Dow Jones finally breaking through the psychologically important level of 20'000. While sentiment in the stock market remains upbeat, fundamentals have been sending mixed signals. The earnings season is well ahead with blended annual profit growth standing at 4.4% after roughly one-third of the companies in the S&P 500 having reported their 2016 Q4 numbers. This is only a slight acceleration relative to Q3. GDP growth slowed to 1.9% in Q4 after 3.5% in Q3.

While consumer spending was a bit weaker, investment increased significantly, but net trade was a major drag. Both the Markit Manufacturing and the Services PMI point towards an acceleration of business activity in the current quarter, each climbing to 55.1 in January. Some weakness can be spotted in the housing market, though. Both existing and new home sales fell last month. While part of this can be explained by supply problems, higher mortgage rates are likely to cause some headwinds for real estate, too.

Switzerland: The recovery remains on track

Solid macro data confirm that the recovery remains on track, and it is encouraging that consumption is finally showing some life. While the KOF leading indicator ticked down in January, it stayed above its historical average, consistent with a healthy pace of expansion. The recovery is broadening out, with the UBS consumption index at a two-year high in January, boosted by strong car sales. Although volatile, export volumes recorded a solid 10% expansion in December, likely supported by a favourable exchange rate vs the dollar. Since then, the franc has strengthened and last week saw a sharp rally in the franc, with the EURCHF falling below the 1.07 level. We do not see this as a break in the trend, as it likely reflected news around the Actelion takeover. SNB deposit data also edged up, indicating that the SNB intervened in FX markets to cap the move.

Asia: Mixed Data

Japan's export data for December were encouraging, as export volumes were up 8.4% YoY, driven by exports to Asia, particularly China. Export values got a boost from the weaker yen. Korean exports surprised to the upside, surging 25% YoY in the first twenty days of January. However, we are not overly excited about these numbers, as working-day adjustments show that exports rose 'only' 8.3% YoY per day. Even this number may be distorted due to higher deliveries before the Chinese Lunar New Year kicked in at the end of this month. Overall, Korea experienced a broad-based slowdown in growth in Q4. Real GDP was up 1.6% on an annualised sequential basis, or 2.3% YoY, down from Q3. Going forward, we believe domestic demand will remain poor. In contrast, Taiwan's GDP growth recovered in Q4, although it was from a disappointingly low base. Growth was driven by stronger investment and improving external demand. Finally, a glimpse at Macau gives us a read-through to China's private expenditures during the Lunar New Year holidays. Hotels were fully booked earlier than usual.

Bonds: Inflation and political risk dominate bond markets

Despite fairly large intra-week swings in yields, the weekly net moves were small, with a 2bps backup in the 10yr Treasury yield, which ended the week at 2.48%, following a two-day stint above 2.50%, and a 4bps rise in the 10yr Bund yield. The latter was driven by inflation expectations, which continue to grind higher amid strong macro data and rising inflation. There is room for core yields to rise modestly from here, particularly as inflation prints are likely to be strong in Q1, though the unpredictable political environment will also be supportive to core bonds. Elsewhere, peripheral spreads widened, as the Constitutional court ruling opened up the possibility for Italian elections later this year, while uncertainty around the French election demands a higher risk premium. We see potential for further widening in peripheral spreads over the coming months, though the ECB's QE purchases remain a backstop.

Credit: Surging supply takes a breather

Cash credit spreads finally caught a modest bid as the heavy supply of last few weeks took a breather. Cash credit spreads tightened across the board by 2-3bps, outperforming CDS indices. Despite a quieter week, supply has been very strong in January across both the US and Europe, with the former nearing record levels. While European banks issuing in US dollars to meet regulatory requirements is partly responsible for the surge, this is not the only driver and it is reported that the pipeline should be busy during the coming weeks. Indeed, M&A activity continues on both sides of the Atlantic and the latest around Intesa bidding for Generali is being closely watched. This morning, European banks are weaker in both equity and credit markets, driven by Italian banks after it was reported that Unicredit has brought forward a board meeting and the ECB is still somewhat concerned around addressing credit quality issues at the bank.

What to Watch

- Economic data from the US will give us further clues about sentiment in the household sector. The ISM indicators are expected to indicate solid business activity in January while the labour market data should continue to be robust.
- Asian PMIs for January and the usual month-end economic data bonanza in Japan will be in focus.
- No action is expected from the Fed and the BoE at their meetings next week.

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