November 13, 2017

# Weekly Macro & Markets View

## Highlights and View

- **The US Senate releases its version of the tax reform proposal, deviating from the House on several points**

  The two proposals go in the same direction with regard to corporate taxes so a compromise is likely, while the differences look somewhat more challenging regarding individuals.

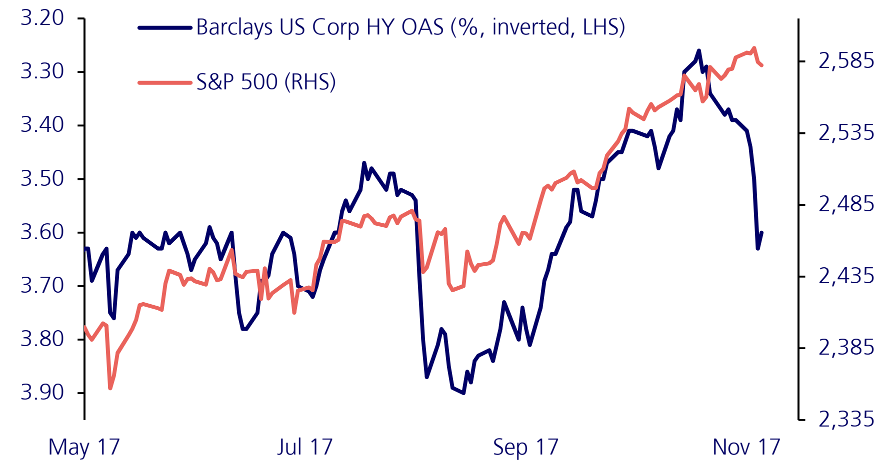
- **High yield market sells off aggressively, underperforming equities**

  Credit should continue to underperform equities given the late stage of the credit cycle, with US high yield outflows warranting close observation.

- **Eleven nations decide on TPP framwork without the US at the APEC meeting in Da Nang, Vietnam**

  We applaud the progress, which should boost global trade, though more time is needed as the devil lies in the details.

## High yield ETFs drive junk bond sell-off




Source: Bloomberg

Credit notably underperformed other risk assets last week, led by high yield markets. We believe that the US high yield market is a core area of vulnerability within credit today given tight spreads, high leverage and a failure to attract sustained investor flows this year. Some market participants described last week's volatility as being reminiscent of that seen in Q1 2016, with bond prices gapping down and apparent forced liquidations. This was triggered by the two standard deviation, single day outflow from US high yield ETFs that occurred on Thursday, leading ETFs to trade at a discount to the underlying asset value. While investment grade credit also underperformed equities, this was driven by supply indigestion rather than outflows. Credit supply reached $47bn in the US and nearly €27bn in Europe last week. Moreover, while Oracle, Apple, Johnson & Johnson, UPS and BASF priced jumbo deals, some of these were priced at hefty discounts while others subsequently weakened, and some high yield deals were pulled.

We believe that underperformance of credit within risk assets should be expected given tight spreads and the late stage of the cycle. That said, outflows in US high yield warrant close observation as they can quickly morph from a technical to a fundamental concern for weak issuers.

## US: Differences between the Senate and House tax proposals look bridgeable

Economic data were sparse last week. Job openings held steady near record highs in September, with the quit rate ticking up to 2.2% from 2.1%. Consumer confidence receded from its recent decade high, but remains very strong according to the University of Michigan Consumer Sentiment Indicator. Investors' focus was on the Senate's tax bill draft, which deviates from the House version on several points. While the Senate also proposes cutting corporate tax rates to 20%, it would delay the cuts until Jan. 2019 (vs. Jan. 2018 in the House's version).

Additionally, the Senate wants to tax US companies' accumulated foreign cash earnings at 10% vs. 14% proposed by the House. Major differences also appear with regard to individuals. Whereas the Senate wants to fully repeal state and local tax deductions, the House proposes a 10'000 USD threshold. Despite the differences, a compromise looks likely, particularly on corporate taxes where both the Senate and the House are aiming for a reduction. Their divergence on the individual side makes an agreement before Thanksgiving challenging.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## Eurozone: Sicilian regional elections could encourage a centre-right coalition at the national level

Regional elections in Sicily held on November 5, in which a centre-right coalition defeated the Five Star Movement and the PD, could be a precursor of what to expect for Italy as a whole next year when it goes to the polls. General elections must be held by May 2018 at the latest. Recent changes to the electoral law make it harder for non-mainstream parties such as the Five Star Movement to gain power. The centre-right coalition in Sicily consists of Silvio Berlusconi's Forza Italia, the Northern League and the Brothers of Italy parties. The fact that they won the Sicilian regional elections could encourage these parties to form a coalition at the national level, with a good chance of getting the most number of seats and possibly an absolute majority in parliament if they do so. This could create some tension at a Eurozone level, vis-à-vis Germany and France in particular, as these centre-right parties are arguably less focused on reform and less pro euro than the current administration. Periphery bond markets could also be impacted negatively by the increased political uncertainty around the time of the elections.

## Asia/Japan: Relations get a boost, while Japan's favourable economic and earnings environment continues

US President Trump's visit to Japan, South Korea, China, Vietnam and the Philippines improved the administration's relationship with Asian nations. However, his comments on North Korea were too ambiguous to make any judgement on how the conflict will evolve. The US and China signed business deals worth more than USD 250bn, particularly in the energy space, though it will take time to fill the agreements with substance. Meanwhile, a 'TPP-ex-US' framework deal was concluded during the APEC meeting in Vietnam, which is progress and needs to be applauded, though it will take time until the final agreement becomes effective. Moving to economic indicators, we note a significant improvement in Japan's October Eco Watchers survey both in the household, corporate and employment components, which is confirmed by the strong PMI Services reading and an uptick in regular wage growth. The favourable picture goes hand in hand with an encouraging earnings season, with 80% of all companies having reported FY17 Q2 earnings, clearly outpacing consensus expectations.

## Asian Central Banks: Diverging stances

Last week the central banks of Malaysia (BNM), the Philippines (BSP), Thailand (BoT), and Australia (RBA) left their respective policy rates unchanged, but adopted divergent stances. Indeed, the global cyclical recovery has not benefited Asian countries equally. On the more hawkish side, BNM has acknowledged that growth has become "entrenched" in Malaysia, leading to upside risks to core inflation. To tighten monetary conditions, BNM is likely to allow a gradual appreciation of the local currency while delivering one rate hike next year. In the Philippines, like in the rest of Asia, headline CPI has been dragged by food disinflation and has remained within the 2-4% BSP target. Next year, however, food and fuel inflation could surprise on the upside, leading BSP to hike. In Thailand, a combination of low inflation and nascent economic recovery should leave the BoT on hold. As for the RBA in Australia, it remains concerned about the combination of weak wage growth and high household debt and should therefore stand pat.

## Bonds: Treasury yield curve flattest since 2007

Core bond yields snapped higher last week, but failed to break out from recent trading levels. There was no single trigger behind the move, but a 10% oil price rise over the past month, progress on US tax reform, and strong economic data all justify higher yields. The 10yr Treasury yield breached 2.40% on Friday, but failed to close above that level. The 2yr yield continued its steady grind higher, reaching 1.65% last week, and is now up by close to 40bps since mid-September. A Fed rate hike in December is almost fully priced in, with two additional hikes implied by end 2019. The breakout at the short end has not been passed on to the long end, which remains anchored by low, but stable inflation expectations and a depressed term premium. The 10yr/2yr Treasury slope consequently fell to its lowest level since 2007 last week. Curve flattening is not uncommon at this stage of the cycle, but the slope warrants monitoring and further flattening would be a cause for concern, particularly for global central banks.

## What to Watch

- The NFIB Small Business Sentiment Index will show whether small firms in the US continue to be optimistic into year's end, while PPI and CPI are expected to have slowed down from hurricane-induced spikes.
- Most of China's major economic indicators for October will be published, while October export data in Singapore and Indonesia are expected to come in favourably. Underwhelming GDP growth and contained inflation could spur Bank Indonesia to cut once more.
- In the UK, inflation is expected to remain high, further squeezing households' real incomes, while the labour market will probably still show only few signs of weakness.
- In the Eurozone, data such as industrial production, the second estimate of Q3 GDP and the German ZEW survey should provide more evidence of the strength of the recovery

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