Weekly Macro & Markets View

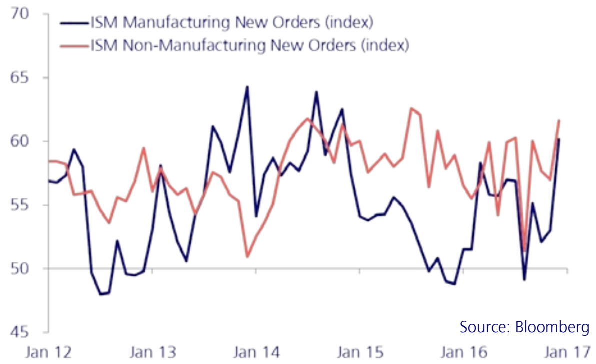
Highlights

- The global PMI rose further in December, with almost all regions recording stronger activity
- A liquidity squeeze boosted the RMB against the USD in the new year
- Sir Ivan Rogers, the UK's ambassador to the EU, quit his job, criticizing the government's approach to Brexit

Our view

- Global new orders have not peaked yet and the upswing in the global cycle is expected to run further
- The RMB should continue to depreciate slowly, as a result of the Chinese 'flex-policy'
- The criticism raises doubts about May's Brexit strategy and increases pressure to come up with a plan

A positive start to the new year in the US



Financial markets entered the new year on a positive note with the S&P 500 gaining 1.7% in a shortened trading week. Solid economic data in the US and globally helped to set the scene for the optimistic background. In line with the regional sentiment indicators, the ISM Manufacturing index picked up to the highest level in two years. Strong new orders point towards a continuation of the positive trend while the jump in input prices indicates that there is increased pricing pressure in the pipeline. The renewed strength in the manufacturing sector was echoed by another solid print of the ISM Non-Manufacturing Survey. The service sector continues to be in a good shape with new orders picking up to the highest in more than a year. However, there were some weaker spots as well, with both new export orders and employment receding.

The improving economic environment was reflected in the Fed minutes published last week. Most FOMC members feel comfortable with the current state of the labour market and the focus lies on reaching the inflation target. The future rate path depends crucially on the Trump administration's policy with regard to taxes, fiscal spending and tariffs, all of which have the potential to fuel inflation and may lead the Fed to tighten more aggressively than expected. The latest labour market data confirm the healthy employment situation despite a slightly higher unemployment rate. Wage growth accelerated to 2.9% YoY underlining the growing tightness of the labour market. Higher wages are supportive for household spending, reflected by a strong pickup in auto sales in December. However, rising wage costs will act as a headwind for firms' margins going forward.

Credit: Spreads tighten, particularly in financial CDS, while issuance surges

Credit markets started the new year on a firm footing, with European financial CDS outperforming. Issuance surged, most notably from European banks. Several French, UK and Swiss banks issued debt, mostly senior debt compliant with MREL (minimum requirements on own funds and eligible liabilities), the new regulation on loss absorbing liabilities. In Financial CDS, the positive tone from late last year continued, with CDS index spreads tightening by 7bps on the week and by 25bps from levels in November. Italy's decision to set up a €20bn fund for addressing banking sector concerns, along with a precautionary recapitalisation of Monte Dei Paschi are being viewed positively, as are Deutsche Bank and Credit Suisse's settlements of the mortgage mis-selling fines by the US DoJ. While European banks issues are not resolved yet, in the short term sentiment is likely to remain positive.

msme@zurich.com

Eurozone: Further confirmation of cyclical pickup

The final estimate of the Eurozone composite PMI was revised up compared to the initial estimate as service sector confidence was stronger than initially reported. The detail of the survey showed impressive strength in the forward-looking new orders sub-index, especially in manufacturing. Monthly output data such as German industrial production has also confirmed the improved outlook. Admittedly, German factory orders fell in November, but the data are volatile and the trend over the past few months has been for a sharp pickup in orders. Overall, the data are consistent with an above trend pace of Eurozone growth at the end of the year and we expect this momentum to continue into Q1. However, political and banking risks could return later in the year and affect business sentiment and investment. On the inflation front, there was a sharp pick up in headline inflation to 1.1% in December from 0.6% in November, which was to be expected given higher oil prices. Core inflation also ticked up modestly to 0.9% from 0.8%, but remains well below the ECB's 2% target.

China: The RMB 'flex policy'

The offshore RMB (CNH) surged to 6.84 from 6.98 against the USD in the new year. Onshore, the CNY followed to a smaller extent. A liquidity squeeze triggered the move, as CNH deposits keep melting. A PBoC intervention against speculators cannot be ruled out. Barring this move, the RMB will, in our view, continue to weaken against the USD. We do not expect a strong devaluation though, as Beijing has committed to stability. Meanwhile, the RMB basket was extended by 11 currencies to reflect trade reality. This highlights China's will to liberalise markets while keeping some guidance by limiting the pass-through of the stronger USD to the CNY. Tight controls will also apply to capital outflows. We think that China will address its double mandate of economic stability and financial risk management. A major risk is the diplomatic relation to the US following the 'trade hawkish' nominations of President-elect Trump.

Asia: Manufacturers grow more confident

Manufacturing activity has gathered pace in Asia, as the region's average Manufacturing PMI rose to 51.8 from 51.5 in December. Australia, Taiwan, China and Japan posted especially strong PMIs, while the PMIs of Thailand and Korea improved notably. Solid international demand from China, Asia and Europe boosted new export orders. Trade value also benefitted from higher commodity prices. The recovery appears sustainable to us, supported by strong new orders, notably from the West and China. In China, large companies continue to outperform SMEs, but SOE reforms are progressing, which should address the gap. With economic conditions seemly lifting, we are cautiously watching the developments around protectionist policies. Finally, prices of raw materials have reached record highs, but output prices only increased in few countries. If business confidence persists, final prices should slowly pick up.

LatAm: Resurgent Argentina, trade-punched Mexico

Argentina started the year off with a bang, scrapping the 120-day minimum holding period FX rule. The lifting of all restrictions on portfolio inflows bodes well for the re-categorization of Argentina within Emerging Markets indices. A jumbo bond issue is already scheduled for later this month. A very successful tax amnesty repatriation, the implementation of the seven-day repo mechanism introduced by the Central Bank as part of its inflation targeting regime, the deregulation of checking account deposits and various announced sector reforms were all cheered by investors.

Despite decent macro data, Mexico was in the spotlight due to the negative Trump trade rhetoric threatening to penalize automakers investing in Mexico. Ford cancelled a planned investment and the currency came under pressure, triggering FX intervention for the first time in a year. Banxico will remain vigilant.

What to Watch

- China will release important trade, inflation and money supply data. In Japan, we will be watching trade data, the results of the Eco Watcher's survey and machine orders.
- In the US, both small business optimism and the University of Michigan consumer confidence survey are expected to remain high while retail sales should have picked up, fuelled by positive sentiment and a pickup in wages.
- Eurozone industrial production data should confirm that the pace of growth has improved, while the rating agency DBRS is expected to confirm Italy's A- rating this week.

173001566 (01/16) TCL

ZURICH®