February 27, 2017

Weekly Macro & Markets View

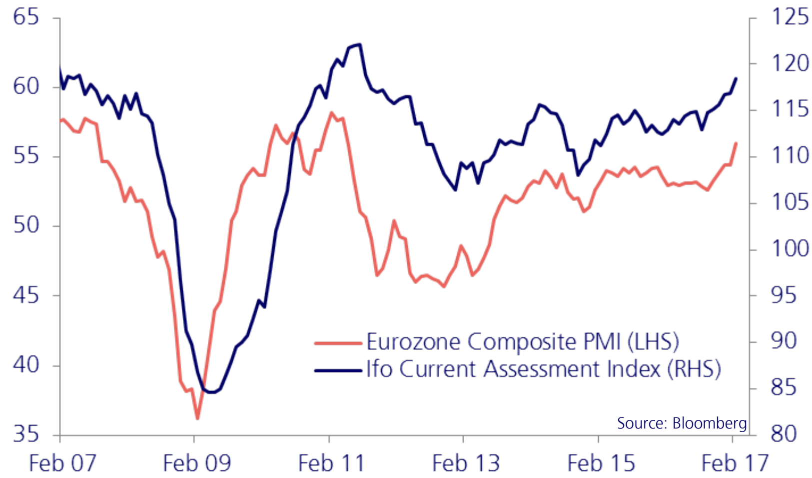
Highlights

- The G3 flash PMIs rise further, led by strong activity in the Eurozone and Japan
- In France, support for far-right candidate Marine Le Pen increases
- January's FOMC minutes do not indicate an imminent rate hike

Our view

- Broad-based strength is expected to boost global growth to above trend in Q1
- The most likely outcome is still a mainstream candidate winning, but the polls are tightening
- While March is not off the table, the Fed is more likely to wait for further data

Eurozone data go from strength to strength, but political uncertainty also intensifies



Last week's Eurozone economic data showed a further improvement and are consistent with growth well above trend in Q1. The flash estimate of the Eurozone composite PMI rose to its highest level since 2011, up to 56.0 in February from 54.4 in January, well above expectations of a slight dip to 54.3. The gain was led by a sharp pickup in service sector confidence. Indeed, the French flash service sector PMI increased to 56.7 from 54.1, suggesting no impact from political uncertainty yet, though manufacturing confidence did fall back a bit. The strength of the Eurozone economy was also confirmed by the Ifo business confidence survey of around 7,000 German businesses. The overall business climate indicator rose 111.0 in February, with companies' assessment of the current business situation reaching its highest level since August 2011. Finally, the second estimate of Q4 German GDP growth was confirmed at 0.4% QoQ, in line with the preliminary estimate. All components of domestic demand, such as government spending, consumer spending, business investment and construction, contributed to growth.

The improved macro data have been reflected in stronger earnings growth and an upward revision to earnings estimates. Overall, the strength of the macro and earnings data suggests upside potential to Eurozone risk assets if political uncertainty is resolved satisfactorily.

Bonds: Core yields slide on political uncertainty

Despite strong macro data and positive inflation surprises in many regions, core yields slid further last week. The 10yr Treasury yield came dangerously close to the lower end of the range that has been holding since the US election, rebounding from 2.31% in Monday's trading. Dwindling hopes of reflationary fiscal and regulatory changes played a role, with some unwinding of extreme short Treasury positions weighing on yields, but political risk in Europe was a dominant factor. Concerns about redenomination risk have returned, visible in the sharp fall in the 2yr Bund yield, which is now trading at -0.94%, almost at par with the Swiss 2yr yield. The 10yr Bund yield has fallen by almost 30bps over the past month, to 0.20%, which is clearly not consistent with strong macro and inflation data.

While we anticipate yields will ultimately rise to reflect the better macro environment, safe haven flows are likely to dominate for now.

US: Markit PMIs indicate a slowdown in economic momentum

While the Markit Flash PMIs remain at decent levels, they signal a slight slowdown in economic momentum at the margin. Weaker business activity growth was mainly driven by the service sector. The Manufacturing PMI ticked down to 54.3 from 55.0 last month, while the Services PMI fell to 53.9 from 55.6. Manufacturers reported that input costs have risen the furthest in two and a half years. As factory prices have barely moved, margins have been further squeezed in February. Rising input costs are expected to remain a challenge in the coming months.

The January FOMC meeting's minutes show that participants expect to hike rates "fairly soon". While not off the table, the language in the minutes and that used by Fed speakers does not indicate a rate increase in March. The market will focus on Janet Yellen's and Stanley Fischer's speeches this week, as they represent the last chance to prepare the market for a rate hike at the next meeting before the self-imposed blackout period begins at the end of the week.

Switzerland: The trade balance surges to new high

The trade balance reached a new record high in January, with a monthly surplus of 4.7bn or, on an annualised basis, 8% of GDP. The nominal balance is boosted by favourable terms of trade effects and is volatile due to one-off factors, but the steady upward trend in the surplus confirms our view that the Swiss franc, on a trade weighted basis, is not substantially overvalued.

That said, the SNB is maintaining its policy of intervening in FX markets to prevent a sharp strengthening of the franc. Sight deposits at the SNB, which proxy forex purchases, rose by 5.5bn in the past two weeks, confirming meaningful interventions. We expect this practice to continue, amid high political uncertainty in the neighbouring economies. While SNB actions should prevent a sharp rise in the EURCHF, we expect pressures on the franc to persist in the run up to the French elections.

Latin America: Central banks take center stage

Declining inflation and weak activity data allowed the Brazilian central bank to proceed with another 75bps rate cut to 12.25%. The surprise was in the tone of the communique that opened the door for even more aggressive cuts and at a faster pace over the course of 2017.

In Colombia, the central bank surprised the market for the third time in a row with a 25bps cut to 7.25% due to weak activity. There will be more and deeper cuts to come as GDP grew at its slowest pace since 2009.

Finally, Banxico introduced a 20bn FX hedge program based on NDF pesos that will not affect its FX reserves. This is good news that will dampen the currency's volatility.

All in all a Latin American central bank hat trick of positive orthodox monetary policy news that will consolidate the positive trend for regional markets.

Credit: Credit markets continue to lag other risky assets

Global credit markets continued to lag equities last week, with European credit underperforming, largely driven by weakness in peripheral companies and banks. Italian and French banks suffered across equities and credit, despite a successful placing of Unicredit's rights issue. Some high-quality European credit sectors, namely covered bonds and agencies, underperformed even more, which is notable and has occurred quite often since late last year.

On the positive side, UK bank earnings were generally better than expected, causing UK bank paper to outperform. Away from financials, Unilever spreads rallied after Kraft Heinz dropped its bid, although spreads did not fully retrace to levels that existed prior to the news of the bid. While leveraged bids are a significant risk for credit given already elevated levels of leverage, we don't expect a deluge of these to be forthcoming.

What to Watch

- Asian PMIs, as well as Japanese industrial production, CPI, employment, and monetary data will be published. We expect Australia's Q4 GDP to confirm that a recession was avoided. India's Q4 GDP will be watched as a first official gauge of the demonetization impact. In Malaysia, we forecast the central bank to stay on hold. In China, the National People's Congress will disclose important economic policy directions and targets.
- Markets will focus on President Trump's joint address to Congress, looking for more details on fiscal policy, tax reforms and other key aspects of future policy. Meanwhile, Yellen's and Fischer's speeches will be watched for clues about an imminent rate hike.
- Eurozone headline inflation likely to edge higher on energy base effects.

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