Weekly Macro & Markets View

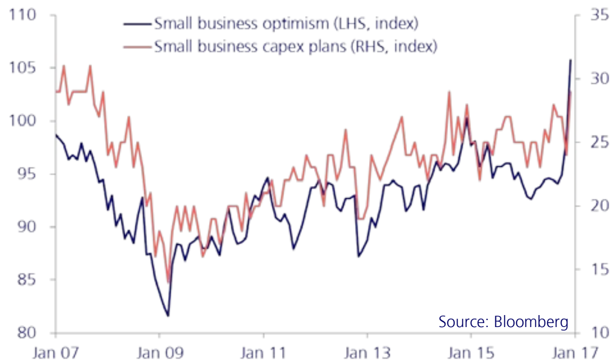
Highlights

- US small business optimism soars while consumer confidence remains high
- The Central Bank of Brazil delivers a larger than expected 75bps rate cut
- DBRS downgrades Italian debt to BBB-

Our view

- US firms are expected to increase investing, which is crucial to the current growth momentum
- The Brazilian central bank's rate campaign will likely be more aggressive than initially anticipated
- The downgrade increases bank funding costs only marginally, but is a negative signal

US small business optimism jumps to its highest level in more than a decade



Most of the data published last week confirmed the stronger momentum of the US economy. In particular, small business optimism showed the biggest monthly jump on record to reach the highest level since 2004. Rising optimism among small firms is crucial as they represent roughly 80% of the labour market in the US. Part of the better sentiment can be attributed to rising optimism in the aftermath of the election. Given that most of the expected improvements with regard to taxes, regulation and fiscal spending will not come through quickly, business sentiment is expected to fall back somewhat in the coming months. Nevertheless, the rising optimism can ignite a virtuous cycle. Importantly, small firms' capex spending plans also picked up, indicating that companies are increasingly willing to invest.

Stronger investment is needed to lift US growth this year. We expect household spending to remain solid, but a significant acceleration from already strong levels is unlikely. This was confirmed by the slightly disappointing retail sales numbers last week. While headline retail sales grew by 0.6% in December, mainly driven by strong auto sales, the retail sales control group, which feeds into the GDP numbers, picked up by only 0.2% after a flat November. However, consumer confidence remains high and the employment outlook is healthy, which will support household spending in the coming months. The latest University of Michigan report shows that consumers' longer-term inflation expectations have rebounded from the all-time low reached in December. This is crucial on the path to further rate hikes as the Fed wants to avoid de-anchoring inflation expectations by all means.

Eurozone: Italy loses its last remaining A rating

DBRS, the rating agency, downgraded Italy's sovereign credit rating to BBB- from A-, citing political uncertainty likely to impede further reform as well as fragilities in the banking sector. As a result, the ECB will apply higher haricuts when Italian debt is presented as collateral by banks, but the impact on bank funding costs from the downgrade should be manageable. Separately, Unicredit got approval from investors during its EGM for a EUR 13bn rights offer that should start before mid-March. However, Unicredit warned in a statement it may not be able to pay coupons on contingent convertible bonds if this capital increase falls short. Also in Italy, the constitutional court ruled that the most significant part of the 2015 electoral reform law does not need to be presented to a referendum. This reduces slightly the chances of snap elections, though there is still a strong likelihood that elections will be called later in 2017. On the data front, the hard data are now catching up with the buoyant business confidence surveys. Eurozone industrial production rose 1.5% MoM in November, with Spain, France and Italy all recording decent output growth.

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China: From deflation to inflation

While the CPI for December, at +2.1% YoY, benefitted from a slowdown in food inflation, the focus was very much on stronger PPI inflation, up 5.5% YoY. This marked a five-year high and is up significantly from the close to -6% deflationary territory seen in the second half of 2015. Rising commodity prices, the weaker RMB and some success in cutting overcapacity, particularly at smaller steel mills, are the main reason behind the bigger than expected surge in producer prices. Credit data for December came in much stronger than anticipated. A surge in corporate loans was in stark contrast to lower mortgage loans following the slowdown in the property market. Strong infrastructure loans by policy banks show that the government is determined to support growth. We would not read too much into the rather weak export statistics in December, as the base effect is partly contributing. RMB depreciation has boosted export volumes in local currency terms. Looking ahead, US trade policy toward China will be crucial. Risks have certainly increased.

Emerging Markets: Relief for asset prices

Emerging Market (EM) equities are recovering from the shock of the US elections. The MSCI EM has bottomed out and foreign inflows into EM equity funds have staged a timid come back. EEMEA, LatAm and select Asian assets, including bonds, are attracting the bulk of inflows. Looser financial conditions have acted as a primary driver for the EM asset price recovery. US Treasury yields are now more rangebound, which has helped EM currencies to stabilise. Positive momentum in commodity prices is supportive. Economically, trade activity continues to improve, with Australia registering its first positive monthly trade balance in more than two years, and Malaysia finally joining the export rebound. Strong global PMI new orders lead us to expect a continuation of this trend in the coming months. Going forward, those tailwinds could outweigh the increase in political risks, helping under-owned EM markets.

Brazil: The central bank goes pedal to the metal

Weak economic data, combined with inflation falling back within the central bank's target range for the first time in more than two years, opened the door for the monetary authority to accelerate the pace of its rate cuts. Having regained its credibility over the past few months, it delivered a 75bps rate cut last week. Both equities and fixed income reacted positively, and we expect more positive earnings revision from here. The rate campaign will be more aggressive than initially expected and inflation could very well fall below 5% and be lower than in Mexico this year. We expect another 250bps of easing over the course of the year. Despite weak GDP data, we kept our tilt towards modest GDP growth for 2017 while consensus has drifted back towards no growth. We believe that the street will have to readjust towards more plausible positive growth.

Commodities: Copper prices are supported by supply disruptions

Copper prices have rallied since the start of the year, supported by worries about supply disruptions in Indonesia and Chile. Indonesia halted exports of minerals in 2014, although copper had been exempt from the ban. The exemption was due to expire last Wednesday and the current failure of the government and producers to quickly reach a new agreement could disrupt copper shipments. The risk of strikes at the Escondida mine in Chile also added to supply worries. Other ferrous metals were also well bid, helped by the weaker dollar, while gold continued to reverse its post-election losses on uncertainty surrounding the Trump presidency. US oil inventories rose last week more than expected, underscoring the challenges to OPEC's attempt to rebalance the market, just as the EIA increased its 2017 US oil production forecast on expectations of stronger shale output.

What to Watch

- Politics is expected to take a hold of markets, as investors focus on Trump's initial policy steps after he takes office on January 20th.
- Theresa May will offer more details regarding her Brexit plans in a speech on Tuesday. The pound has continued its slide as investors worry about the risk of a hard Brexit.
- The ECB is likely to emphasise the need for continued asset purchases despite the improved macro outlook.
- China's President Xi Jinping will attend the World Economic Forum in Davos, and Chinese GDP for Q4 and 2016, as well as major economic indicators for December, will be released.

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