

Weekly Macro & Markets View

Highlights and View

- **The UK Conservative Party loses its absolute majority in parliament**

The election result puts Theresa May's political future at stake and will make Brexit negotiations more complicated. However, the need to look for compromises may reduce the risk of a hard Brexit.

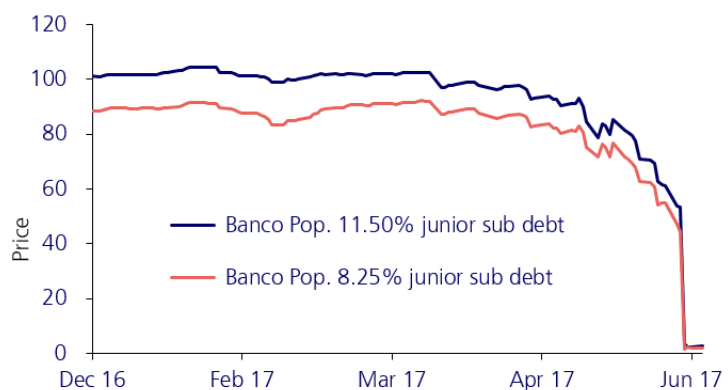
- **The ECB makes modest changes to forward guidance**

Small changes in language by the ECB for now, but QE tapering is coming eventually.

- **Former FBI Director Comey's testimony largely ignored by investors**

Comey's statement did not add a lot of new information with regard to the current investigation into Russia's potential involvement in the US Presidential election.

The very visible hand of loss absorption



Source: Bloomberg

Banco Popular was sold to Santander last week for €1, as policymakers intervened amid a worsening liquidity situation. Importantly for credit investors, junior bonds were wiped out across Tier 1 and Tier 2, along with equity. This should have been a wake-up call for junior debt investors. However, the market reaction was sanguine, with only the junior debt of some smaller Spanish lenders being hit hard. We don't think, however, that this is the last write down of junior bank bonds and investors should price in the peril of write downs and not just coupon skips in these bonds. That said, what concerns us more is what may happen to senior debt in future cases of resolution, as it was spared the guillotine in this case. If there is a thick slice of senior debt, especially the new bail in-able variety, this favourable treatment should not be taken for granted. If the bidder is not as strong, or macroeconomic conditions and credit markets not as benign, resolution may be less favorable and the bail in rules may be brutally used.

More broadly, European CDS rallied late in the week along with peripheral bonds, although cash bonds lagged somewhat. US energy credits were hit by the weakness in oil prices, but this did not spill over more broadly, as investor inflows were decent.

UK: Theresa May's lost gamble

Foreshadowed by a rapidly evaporating lead in the polls in the days before the election, the Conservative Party was not able to achieve the landslide victory it had hoped for, and instead lost its absolute majority in parliament. Sterling sold off as a result of the increased political uncertainty, but ended the week at a relatively modest -1.1% against the dollar. Although the 10yr Treasury/gilt spread widened a few basis points, markets were otherwise mostly unimpressed by the election outcome. The result weakens Theresa May's domestic

standing, as well as her bargaining position with the EU, and puts her political future at stake. The lack of an absolute majority in parliament will complicate matters for whoever is in charge of the Brexit negotiations going forward, but the need to look for a compromise in parliament could actually reduce the risk of a hard Brexit. Theresa May wanted voters to give her a strong mandate for a hard Brexit – she did not get it.

US: ISM Non-Manufacturing signals strong employment situation

It was a relatively quiet week in the US market until the Nasdaq index suffered a sudden intraday drop of more than 3% to end the week with a 1.6% loss. Meanwhile, the broader S&P 500 was down by a more modest 0.3%. Economic data was sparse last week. The ISM Non-Manufacturing Survey indicated a slight loss of momentum in the service sector, falling to 56.9 from 57.5. This is still a solid number, pointing towards a continued expansion. In particular, the employment component is reflecting a benign picture, jumping to 57.8 – the highest level in almost two years and an important signal for the

ongoing strength in the labour market. The healthy employment situation was confirmed by the number of job openings climbing to more than six million – the highest on record. On the political front, former FBI Director Comey's testimony in front of the Senate Intelligence Committee did not add much new substance and was largely ignored by investors.

Eurozone: The ECB makes small changes to its language in its monetary policy meeting

The ECB changed the assessment of risks to growth from 'tilted to the downside' to 'broadly balanced'. They also removed the reference to keeping interest rates at low "or lower" levels. However, in the press conference, Mario Draghi, emphasised that inflation dynamics were still subdued and that the ECB would continue with the QE asset purchase policy, including reinvestment of principal payments from maturing securities. So overall, the tone was still relatively dovish. However, if the Eurozone economy continues to show strong dynamism it will become

increasingly difficult for the ECB to justify such an accommodative stance, which suggests it will taper QE in 2018. Managing this process and the language around it could be challenging and create volatility in Eurozone government bond markets. Eurozone Q1 GDP was revised upward in the second estimate, which was expected given that growth for both France and Italy had been revised higher. The breakdown of the data showed broad-based contribution to growth from consumption, government spending and investment.

Japan: Is Japan's growth really slowing?

The severe downward revisions in Japan's GDP growth for Q1 came as a surprise. Previously recorded as +2.2% on a sequential annualised basis, Japan's economy has grown by only 1%. Both consensus and we believed that the growth rate would have even been revised upwards, as the latest MoF survey showed that capex growth was stronger than expected. We do not believe that growth has already peaked. The revision is due to a change in inventory, which may be temporary and could already have reversed in the current quarter. Looking at the monthly economic

indicators for April and May, we observe a favourable economic environment that does not suggest a slowdown in growth. Japan's composite PMI has risen further by 0.8 points to 53.4 in May, and the Eco Watchers survey has inched higher, with the outlook component coming closer to the 50 line. Wages were up 0.5% YoY in April, following a blip in March, which supports the more favourable consumption outlook. We would also like to point out that Japan's GDP revisions have often been quite volatile over the last three decades.

Australia: Business capex to take over real estate investment

Q1 real GDP rose by 0.3% QoQ to be 1.7% higher YoY, the slowest growth rate in more than seven years. Cyclone Debbie was partly to blame for the negative contributions of dwelling investments and net exports. Coal shipments should normalise in Q2, but housing investment is unlikely to rebound. Indeed, we see the downward trend in building approvals and the recent cooling in Sydney and Melbourne prices as early signs that the housing market is stabilising. Q1 data highlighted another trend, the ongoing weakness in consumption and wages. Wage

growth might be at a turning point, though. The last adjustment to the minimum wage marked, at 3.3% YoY, the largest increase since 2011. Corporate profits, up 30% YoY in Q1, should also spill-over to wages. We note that historically high underemployment should put a lid on the transmission of profits to wages, though. Finally, non-mining capex is rising while mining investment has stopped falling for the first time in years, which is very encouraging. The RBA will likely look through the weak Q1 print and focus on the positive trends. We share this assessment.

What to Watch

- The Fed is expected to raise its target rate by 0.25% while the BoE, the SNB and Bank Indonesia are expected to stay put.
- A broad set of economic data will give an indication regarding current activity in the US, Japan and China.
- Macron is expected to secure an absolute majority in France's lower house elections.

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