July 17, 2017

Weekly Macro & Markets View

Highlights and View

- **China tightens financial sector supervision, while the economy shines**

  Financial deleveraging is a precondition to underpin a more solid medium to long term economic outlook.

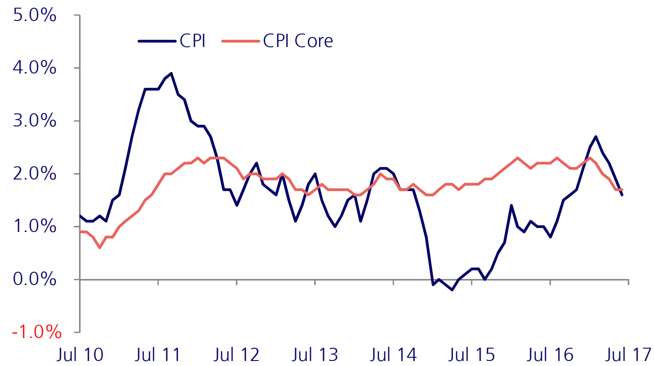
- **The US earnings season kicked off with JP Morgan, Citi and Wells Fargo reporting slightly better than expected results**

  Consensus expects EPS growth of roughly 7% yoy, which looks reasonable given the decent global growth picture.

- **Draghi accepts an invitation to the Jackson Hole central bank symposium in August**

  This could be an opportunity for Draghi to flag up explicitly a forthcoming announcement on QE tapering

A further slowdown in US inflation



Source: Bloomberg

The latest set of inflation data showed a further easing in pricing pressure in the US. Headline CPI inflation was flat in June, lowering the annual rate to 1.6% from 1.9% in May. The key driver of the weakness was once again energy and transportation, but other components added to the slowdown. Core CPI was up by 0.1% MoM, stabilizing the annual rate at 1.7% - the same as last month. Crucially, growth rates in two of core inflation's most important components, owners' equivalent rents and medical care prices, have risen, indicating that core inflation is likely to reaccelerate later this year. The modest inflation data were a drag for Treasury yields, while Janet Yellen reiterated in her semi-annual statement to Congress that the FOMC considers the inflation weakness to be temporary. Her comments indicate that the Fed intends to announce the beginning of its balance sheet reduction at its September meeting. Other data points published last week painted a mixed picture. NFIB small business optimism ticked down slightly, but remains very high. Capital expenditure plans rose to the highest level in a decade which is a promising signal for business investment going forward. On the other hand, the household sector is showing some weakness with retail sales falling 0.2% in June (after -0.1% in May) and the University of Michigan's consumer expectation survey falling to the lowest level since last October.

Eurozone: Hard data move closer in-line with robust business surveys

Industrial production growth accelerated in the Eurozone in May, with gains broad-based across countries and sectors. Output rose 1.3% MoM (4.0% YoY) from 0.3% MoM (1.2% YoY) in April. YoY output growth is now at its highest level since 2011. Gains were broad-based across the large Eurozone economies with Italy, France, Spain and Germany all showing strong output growth. What`s more, capital goods production grew 2.3% MoM (5.5% YoY) in May. This indicates that businesses are now willing to invest. In terms of monetary policy developments, it was announced that ECB president Mario Draghi will be presenting at the annual Jackson Hole central bank symposium on the 24-26 August. This led to speculation that he would use this as an opportunity to explicitly say that the ECB will announce tapering of QE asset purchases from 2018 at the September 7 ECB meeting. This week`s ECB policy meeting could also be an opportunity for Draghi to say that a reduction in QE asset purchases is now being formally discussed.

UK: The labour market defies Brexit uncertainty

The British economy continues to send mixed signals as economic activity has been slowing down significantly, while the labour market remains in a healthy shape. The unemployment rate ticked down to 4.5% in May – the lowest since 1975, indicating a further reduction of slack. Employment has grown by a solid 175'000 in May on a rolling 3-month basis, up from 109'000 in April, while jobless claims have only increased by 5'900. Despite the positive labour market environment, average weekly earnings growth has slowed down to 1.8% in May, down from 2.1% the month before. Wage growth excluding bonuses looks a bit better, accelerating to 2.0% yoy from 1.8% in April. Nevertheless, real wages remain under pressure and continue to be a headwind for consumer spending. While neither gilt yields nor the pound reacted to the solid labour market data, sterling jumped to the highest level since last September against the dollar on weak US inflation data. There were not many other data points except for the latest RICS House Price Balance which points towards a further deceleration of the UK housing market.

China: Economic growth remains robust, while tackling financial risks moves to the forefront

China's 5th National Financial Work Conference (NFWC), held every five years, concluded this weekend. Containing financial risks, deepening financial reforms and a fresh focus on finance to serve the real economy were identified as core tasks. A new committee was established under the State Council that will likely be run under the auspices of the PBoC in order to fill loopholes in supervision between the respective bodies for banks, insurance companies and equity markets. Meanwhile economic data published today were stronger than expected. Real GDP in Q2 remained unchanged at 6.9% YoY, while it accelerated from 5.3% to 6.9% on an annualised sequential basis. June data also came in on the strong side. Industrial production, fixed asset investment, retail sales and property related data accelerated and beat consensus expectations. We believe these dynamics will subside after the 19th Communist Party Congress in October, following the recent financial tightening measures. The policy direction announced at the NFWC confirms our view.

Malaysia: The central bank holds fire but acknowledges stronger growth

As expected, Bank Negara Malaysia maintained its policy rate at 3.00%. The policy statement struck a confident tone as the central bank expected higher growth in 2017. Indeed, hard data continue to surprise to the upside. May exports surged to 32.5% YoY, a 7-year-high, while imports jumped 30.4%. Electronics are leading the recovery, together with other manufacturing segments such as machinery and petroleum products. We think that global demand for semiconductors will hold firm in the month ahead, which should support Malaysian exports further. Given the strength of manufacturing data, the recent plunge of the PMI below 50 is puzzling. We see two potential explanations: businesses have run down their inventories, and strong new export orders have diverged from lacklustre domestic new orders. Overall, we are confident that the cyclical recovery has more to run. Indeed, there are signs that domestic demand is also rebounding. As core inflation slowly rises, the central bank will stay on hold, but we expect it to turn more hawkish in language.

Credit: The diverging fortunes of high yield and investment grade

In a week where risk assets were generally strong, bank stocks were lacklustre on both sides of the Atlantic, after US bank forecasts tempered investor enthusiasm. However, financial credit CDS spreads outperformed bank stocks, catching up somewhat after the recent lag. The short base in CDS seems to be building up, especially in High Yield, as some investors remain concerned around fragility of flows in the US high yield market. In another sign of investor caution, investors have also been recently forcing some high yield issuers to give them better terms. Investment Grade however seems to be in a different world altogether. Not only could 2017 be a year of record inflows, but also issuers such as Nestle, which is increasing leverage, can still successfully place 8 year Euro denominated bonds at less than a 1% yield.

What to Watch

- In the US, the earnings season is gathering pace with more than 70 companies reporting their Q2 results next week.
- ECB monetary policy meeting may see Draghi indicate that the ECB will make a formal announcement on QE tapering later in the year.
- The Bank of Japan is expected to keep monetary policy unchanged when the MPC meets mid-week, but may reduce its inflation forecast. We expect Bank Indonesia to stay also on hold.

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