March 6, 2017

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Weekly Macro & Markets View

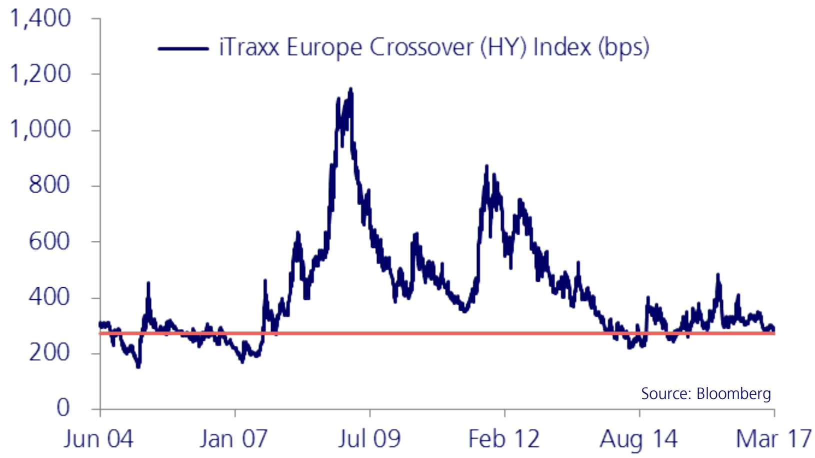
Highlights

- Fed Chair Yellen signals the FOMC's willingness to hike rates next week
- China sets a target growth rate of 'around 6.5%' or more down from '6.5% to 7.0%' as the NPC opens
- North Korea fires four ballistic missiles into the Sea of Japan, two weeks after China bans their coal import

Our view

- Solid economic data support a rate hike, which is now priced in by investors
- China's gradual shift from quantitative targets to sustainable growth policies is encouraging
- With the US reviewing its geopolitical strategy, American cooperation with China on N. Korea would be positive

Credit: It feels like 2006



After lagging equities and other risk assets for most of the year, credit spreads caught a sharp bid last week. It is worth noting that the strong performance in credit occurred amid decent supply and despite lacklustre performance by global equities. Continuing strong momentum in flows, along with sharp peripheral spread tightening, supported credit investor sentiment while causing some short covering. A rally in bank credit and equities helped, as higher yields and signs of pre-emptive actions to deleverage and boost capital emerged from Deutsche Bank and Sabadell. Notably, however, the 2s/10s yield curve, which is a key driver of profits from lending, has not steepened much since December, either in US or Europe. This, together with tighter lending standards, suggests that the enthusiasm of bank investors to higher yields may be worth tempering a bit.

With last week's rally, spreads of several high yield indices and some US investment grade indices, have reached 2006 spread levels. As an example, the iTraxx Crossover index currently trades around 280bps. While strong technicals could certainly extend the rally to the 150bps to 200bps region, it is worth noting that 200bps is generically considered to simply be the compensation for default rates, apart from being the level in mid-2007.

Bonds: Large swings in yields with a rebound from recent lows

Treasuries sold off last week, with a sharp rebound in yields from the lower end of the trading range to the upper end. The move reflected a continuation of firm macro data, coupled with clear signals from the Fed that a March rate hike is on the cards. Following Yellen's speech, a hike is now almost fully priced in, with the 2yr yield surging 16bps to 1.31% last week. Market pricing is still notably dovish, however, with only six hikes priced in by end 2019 compared to nine hikes in the Fed's SEP median forecast. The 10yr yield also failed to break above 2.50%, with extreme short positions continuing to weigh on yields. European core yields also rebounded, with the 10yr Bund yield up 15bps from its recent low of 0.19%, led by the short end. We anticipate bond markets to remain volatile and sensitive to the news flow in the run up to the French election, as uncertainty around the eventual outcome remains high.

US: The Fed signals a rate hike on strong economic data

Last week saw a steady flow of relatively hawkish comments from several Fed members, culminating in Fed Chair Yellen on Friday basically announcing a rate hike for the upcoming meeting on March 15. Supported by a stream of solid economic data and rising inflation, the FOMC seems to feel confident enough to hike rates for the second time in three months. Last week's data certainly did not speak against a rate hike next week, although the Fed's preferred inflation measure remained at 1.7% YoY in January. Both the ISM Manufacturing and Non-Manufacturing came in higher than expected, indicating a continuation of the recent strong momentum. Consumer sentiment also picked up in February, helped by a better current environment and improving expectations. Nevertheless, households preferred to save some of their earnings as personal spending increased less than personal income. Initial jobless claims dropped to 223'000, a new four-decade low, signalling a continuation of the strong employment situation.

Eurozone: Headline inflation hits highest level in four years

The Eurozone composite PMI was confirmed at 56.0 in February, its highest level since 2011, with the latest increase in business confidence led by a tick higher in services confidence across the region. The unemployment rate was 9.6% in January, two-and-a-half points lower than its mid-2013 peak. Meanwhile, headline inflation continues to increase, driven mainly by base effects from higher energy prices. In the Eurozone as a whole, headline inflation hit 2% in February. In Germany it reached 2.2%, crossing the ECB 2% ceiling for the first time since mid-2012. However, core inflation in the Eurozone remains low, stuck at 0.9%, and the boost to headline inflation will start to fade in the coming months assuming no further increases in oil prices from here. Therefore, despite the strength of the business surveys and pickup in headline inflation, the ECB is likely to continue with its QE asset purchases for now. Indeed, with political uncertainty running high ahead of the French elections the ECB is unlikely to want to do anything that could destabilise investor confidence at this time.

Japan: Strong economic momentum

Business confidence remains robust, as evidenced by the Japanese PMI, up for the fourth month in a row. Businesses, especially manufacturers, have enjoyed a record high rebound in profits. This has triggered a sequential pickup in private investment, which we see as very positive. Corporates' hiring intentions are also firming up, but so far this has not translated into faster wage growth. As a result, household consumption has failed to rebound. However, the labour market has continued to tighten, supported by the creation of 'regular' jobs. A firmer labour market and a recovery in economic activity should put some upward pressure on wages. Core inflation ex-fresh food and energy has modestly edged above 0% to 0.1% YoY, which does not signal any sincere rebound yet. As for equity markets, they should benefit further from the earnings turnaround. A weak yen is as another precondition of better equity performance and would also help to revive inflation.

Asia: Economic growth in the times of tighter Fed rates

Asian manufacturing PMIs improved to an average of 52.3 from 51.4, masking discrepancies between strong Chinese, Japanese and Australian prints and the rest of Asia. Australian business confidence is running at a multi-year high following higher profits. Solid Chinese new orders and rising global shipment-to-inventory ratios augur well for tech exports. Yet, we remain cautious as momentum has slowed recently.

In China, the National People's Congress set a 3.0% fiscal deficit target for 2017, unchanged from 2016. Ambitious reduction targets for domestic coal and steel supplies have been reiterated. Overall, this policy mix should be favourable to commodity exporters. The impact of a cooling property market on Chinese imports is more uncertain.

Turning to financial markets, Asian assets should be more resilient to higher US rates since current account positions have improved recently. The balance between economic recovery and tightening financial conditions remains a delicate one, though.

What to Watch

- The ECB is unlikely to announce any changes to its QE policy despite the increase in headline inflation.
- Investors will focus on US labour market data, which are expected to confirm a continuation of the positive employment environment.
- Chinese trade, inflation, and money supply data will be published. In Australia, we expect the central bank to stand pat.

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