

Weekly Macro & Markets View

Highlights and View

- **OPEC extends output cuts for 9 months, but oil prices drop by 5%**

The OPEC decision underwhelmed investors. US producers will keep up supply pressures, keeping a lid on oil prices. However, broader market impact is likely to stay muted if WTI prices remain above \$40 a barrel.

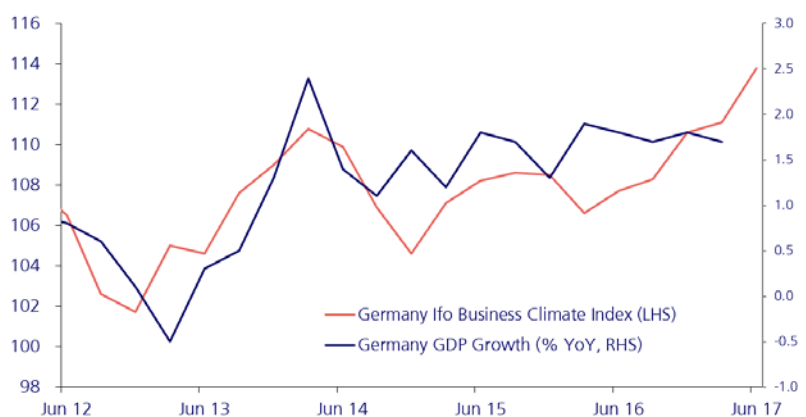
- **Moody's downgrades China's sovereign debt by one notch to A1/stable**

The downgrade should not come as a surprise. While high leverage is a problem, China's authorities are aware of it and are tackling the issue. Foreign debt is not a major issue.

- **The Fed moves closer to reducing its balance sheet with a concrete statement expected later this year**

Gradually increasing caps on the monthly dollar amounts of securities allowed to run off would allow a transparent and predictable path to the Fed's balance sheet reduction.

German business confidence hits highest levels on record



Source: Bloomberg, Note: Ifo Business Climate Index for Q2 2017 is April and May Average

German business confidence, as measured by the Ifo survey of 7'000 companies, hit its highest levels on record in May, driven by robust activity in both current conditions, as reported by companies, and in terms of their expectations of conditions in six months' time. The increase in confidence from already robust levels was broad-based across sectors, including manufacturing, construction, retailing and wholesaling. The breakdown of Q1 GDP growth for Germany also confirmed the broad-based nature of the growth pickup. Overall GDP growth came in at 0.6% QoQ with both net exports and domestic demand contributing to growth. Within domestic demand, business investment and construction were both strong, whilst consumer spending growth was softer, but still positive.

The Eurozone's second-largest economy, France, is also seeing an improvement in its macro outlook with its flash composite PMI increasing to a six-year high in May. Admittedly, given that the overall Eurozone PMI barely changed, this does imply some softening in periphery countries such as Italy or Spain. In addition, given how strong business surveys are, a pullback is possible in the second half of the year. However, from an investment perspective, the better macro outlook is being translated into an improvement in robust corporate earnings growth, with 10 out of 11 sectors in the Euro Stoxx 600 reporting positive earnings growth in Q1 for example. This is a key positive that we expect will continue.

China: Moody's downgrade to A1 focuses on rising leverage

The fact that Moody's downgrading of China's sovereign rating by one notch to A1 had no major impact on China's financial markets clearly shows that China's debt problems are well known by investors. Indeed, we believe that deleveraging efforts by China's government have already become more focused since the latest Politburo meeting with the PBoC and financial regulators in late April. There are only two foreign currency sovereign bonds with a total face value of USD 200mn, and domestic investors would rather focus on

credit ratings by local credit rating agencies. This makes Moody's rating change rather symbolic. However, principally we agree that the debt issued by China's domestic non-financial institutions, mainly SOEs, is problematic, as it could impact China's banks and finally China's government, particularly if China's growth were to slow in the years ahead. On the positive side, the high Chinese household savings ratio of about 40%, high FX reserves and the high reserve ratios of China's financial institutions should be a buffer.

US: Q1 GDP growth revised higher

As expected, and following recent patterns, Q1 GDP growth was revised higher to 1.2% from the initial estimate of 0.7%, driven mainly by an upward revision of consumer spending. The Markit Manufacturing PMI showed a slight loss of momentum in May, which was more than compensated for by a pickup in the services industry. The Composite PMI was lifted to 53.9 in May from 53.2 in April, indicating a reacceleration of the US economy in the second quarter. This confirms the Fed's willingness to look through the recent soft patch as reiterated in its latest minutes. A rate hike at its next meeting in

June is now very likely and the focus will increasingly be on the Fed's plan to reduce its balance sheet. While still short on details, the Fed minutes show a preference for gradually increasing caps on the dollar amounts of Treasury and agency securities that would be allowed to run off each month. Further details should be revealed at the FOMC's June meeting, with the beginning of the balance sheet reduction announced later this year.

Japan: Economic growth remains brisk, though momentum is slowing

In a somewhat lacklustre week, Japanese stocks posted modest gains as the USDJPY hovered in the 111-112 range. Economic data were mixed. The Manufacturing PMI dropped 0.7 points to 52 in May, with all components showing a modest deterioration and tentative signs of a slowdown, though economic activity remains brisk overall. The Reuters Tankan for May confirms the mixed picture, with a slight decline in the manufacturing diffusion index, while the non-manufacturing index moved back to record-high territory, supported by the strong retail

component. However, we note an 8 point decline in the outlook component. Trade statistics for April show that export volumes fell for the second month in a row, suggesting that the surge in February was a one-off. The fact that CPI ex fresh food moved to a two-year high of 0.3% YoY in April makes for a nice headline, but masks that most other inflation measures are still hovering at or slightly above zero. We believe inflation could edge a bit higher, but it will be difficult for it to move towards the BoJ's 2% target.

Bonds: Markets take little notice of Fed's intention to reduce its balance sheet

Treasury yields were flat last week, with average daily moves of less than 2bps in the 10yr, and with an intraday range of only 7bps, between 2.22% to 2.30%, for the 10yr. The Fed minutes, which confirmed plans to hike rates in June and laid out an approach for scaling down the balance sheet, were taken in a dovish way by the market, failing to lift risk premia and resulting in a further fall in inflation breakevens. Despite strong Eurozone data, Bund yields also edged down, though they remained within their recent trading range. Gilt yields, by contrast, slipped further

on the softer than expected GDP report, which made it more likely that the BoE will need to revise down its upbeat growth forecast. The GDP deflator also edged down, highlighting weakness in the domestic pricing environment. The 10yr gilt yield ended the week at 1.01%, which is the lowest level since October last year, and down 8bps compared to a week ago.

Credit: Underlying the calm, watch out for leverage trends

Credit spreads were firm in CDS markets, but largely unchanged in cash as investor activity was largely muted in a holiday shortened week, which was also reflected in the primary market. However, underlying the calm price action at the headline level, volatility picked up in the energy and retail sectors. US high yield energy bonds gave up some of their recent gains after the OPEC supply cuts underwhelmed investors, causing oil prices to drop by 5%. US retailers were generally better bid, with the exception of Staples, which was said to reject a bid by Cerebrus.

What concerns us generally is that given tight spreads across rating buckets, the economics seem to be tilting in favour of leveraging up for companies, and more leveraged bids are likely to be forthcoming. While not an imminent spread driver, this is something credit investors need to have at the top of their radar screens.

What to Watch

- In the US, the focus will be on the labour market data and the ISM Manufacturing Survey, while the Conference Board Consumer Confidence Index will give an indication as to current household sentiment.
- Final Eurozone PMIs with a full breakdown by country will be important to watch, especially for the periphery economies.
- In Asia, the focus will be on the Japanese PMIs for May, as well as April statistics. We will also keep an eye on the Q1 MoF capex survey in Japan and May exports in Korea.
- *Due to a holiday, the next 'Weekly Macro & Markets View' will be published on Tuesday, June 6.*

Disclaimer and cautionary statement

This publication has been prepared by Zurich Insurance Group Ltd and the opinions expressed therein are those of Zurich Insurance Group Ltd as of the date of writing and are subject to change without notice.

This publication has been produced solely for informational purposes. The analysis contained and opinions expressed herein are based on numerous assumptions. Different assumptions could result in materially different conclusions. All information contained in this publication have been compiled and obtained from sources believed to be reliable and credible but no representation or warranty, express or implied, is made by Zurich Insurance Group Ltd or any of its subsidiaries (the 'Group') as to their accuracy or completeness. Opinions expressed and analyses contained herein might differ from or be contrary to those expressed by other Group functions or contained in other documents of the Group, as a result of using different assumptions and/or criteria. This publication is not intended to be legal, underwriting, financial investment or any other type of professional advice. Persons requiring advice should consult an independent adviser. The Group disclaims any and all liability whatsoever resulting from the use of or reliance upon this publication. Certain statements in this publication are forward-looking statements, including, but not limited to, statements that are predictions of or indicate future events, trends, plans, developments or objectives. Undue reliance should not be placed on such statements because, by their nature, they are subject to known and unknown risks and uncertainties and can be affected by other factors that could cause actual results, developments and plans and objectives to differ materially from those expressed or implied in the forward-looking statements.

The subject matter of this publication is also not tied to any specific insurance product nor will it ensure coverage under any insurance policy. This publication may not be reproduced either in whole, or in part, without prior written permission of Zurich Insurance Group Ltd, Mythenquai 2, 8002 Zurich, Switzerland. Zurich Insurance Group Ltd expressly prohibits the distribution of this publication to third parties for any reason. Neither Zurich Insurance Group Ltd nor any of its subsidiaries accept liability for any loss arising from the use or distribution of this publication. This publication is for distribution only under such circumstances as may be permitted by applicable law and regulations. This publication does not constitute an offer or an invitation for the sale or purchase of securities in any jurisdiction.