

Weekly Macro & Markets View

Highlights and View

- **In China, property and infrastructure investment ticked down, but retail sales and manufacturing were steady**

Tighter interbank liquidity conditions should impact the real economy further. Yet, we think that liquidity will be punctually injected to prevent a sharp slowdown.

- **Macron's party wins a substantial majority in the French parliamentary elections**

A majority will make it easier for Macron to push through much needed reforms to the French economy.

- **Amazon's \$13.7bn cash offer for Whole Foods Market is perceived as a game changer for the sector**

Investors should expect more forays by technology companies into other markets, which suggests brighter prospects for equities than for credit markets.

Weak inflation and a hawkish Fed put Treasury yields under pressure



Source: Bloomberg

Longer-term Treasury yields briefly touched their lowest level since last November on soft inflation data and falling retail sales. CPI inflation fell 0.1% in May, lowering the annual rate to 1.9%, down from 2.2% last month. Core CPI grew by 0.1% in May, leading to an annual rate of 1.7%, after 1.9% in April. As the inflation rate has trended lower for three months in a row, investors have started questioning whether the Fed will be able to reach its inflation target at all. This is reflected in longer-term inflation expectations continuing to slide, reaching the lowest level since last October.

While the latest drop in yields seems exaggerated, the Fed has turned relatively hawkish recently, putting further pressure on inflation expectations. As expected, the FOMC increased its target rate to a range of 1%-1.25% at its meeting last week. In addition, they presented their plans to start reducing the Fed balance sheet, a process they indicated they want to start relatively soon. Initially, \$6bn in Treasuries and \$4bn in MBS will be allowed to run off each month, with the caps being increased every three months until they reach \$30bn for Treasuries and \$20bn for MBS. The caps lie at the upper end of market expectations and should, in combination with a stabilisation in inflation rates, help to support yields going forward.

Eurozone: ECB policymaker comments on when QE policy changes likely

ECB Vice President Vitor Constancio's comments last week suggest that the ECB will explain at either the September 7 or October 26 governing council meeting what it intends to do about QE asset purchases in 2018. We expect a reduction in the size of monthly asset purchases and an eventual end to the programme in 2018. Constancio said that "before December we will have to say something about the future" of quantitative easing, adding that "it could be very well in autumn, but certainly before the end of the year".

Ending the unprecedented monetary support provided by the ECB is unlikely to be a smooth process and could create volatility in Eurozone government bond markets. Data flow was relatively light last week. The German ZEW current conditions index continued to be very strong, though the forward-looking expectations index was softer and fell back a little. Overall, industrial production in the Eurozone continues to grow, though still not at the pace that the robust business surveys would suggest.

UK: A hawkish BoE supports gilt yields and the pound

The BoE caught markets by surprise with a relatively hawkish message. Three of the eight members of the Monetary Policy Committee voted for a rate hike after only one such vote last time. Gilt yields jumped and the pound strengthened after the announcement. The BoE put its focus on the accelerating inflation rates while seemingly ignoring the significant economic slowdown. Data published last week showed that CPI inflation reached 2.9% in May, up from 2.7% the month before. Retail prices even rose by 3.7% compared to a year ago. Meanwhile, average weekly earnings

grew by only 2.1% YoY, or only 1.7% excluding bonuses, squeezing consumers' real purchasing power. Accordingly, household spending will remain under pressure. This was confirmed by the latest retail sales figures, which showed a drop of 1.6% in May, pushing down the annual rate to 0.6%, the lowest since 2013. Despite modest wage growth, the labour market shows few signs of weakness so far. The unemployment rate remained at 4.6% in April.

Switzerland: The SNB stands ready to act... but not on interest rates

As expected, the SNB left policy unchanged last week. Despite their cautiously optimistic tone, they pointed to downside risks and lowered the inflation forecast, taking a slightly more dovish than expected tone. More interesting was the financial stability report, which emphasised that house market imbalances have not fallen and that the SNB stands ready to use countercyclical measures if needed. One area of concern is domestically focused banks, which have raised mortgage lending strongly to compensate for falling interest rate margins.

Residential investment property was also singled out, as the negative interest rate environment boosts demand despite low yields, whilst construction activity in the segment remains strong. We do not expect the SNB to act immediately, but a tightening in their countercyclical policy should not be ruled out, especially as rates will stay negative for longer.

Japan: Talk of ending monetary easing is premature

The BoJ left its short-term rate and 10yr JGB yield unchanged at 0.1% and 0% respectively and maintained the rhythm of ETF and REIT purchases. As we expected, there was no mention of a potential end to monetary easing, and the soft guidance of JPY 80tn JGB purchases was reiterated. We think that the BoJ will maintain the status quo as long as inflation significantly undershoots its 2% target. At 0% YoY, core CPI excluding fresh food and energy remains far below target. The BoJ is also focused on driving inflation expectations, hence its reluctance to "confuse

the markets" by talking about an end to easing. Going forward, we believe the BoJ will continue to emphasise its yield target. In our view, the BoJ is following a "wait and see" strategy and will let the Fed and potentially the ECB normalise first, with the hope that higher interest rate differentials will weaken the JPY. We are quite critical of this passive stance. Finally, the end of Governor Kuroda's mandate in April 2018 introduces some uncertainty since other committee members have been more outspoken about ending easing.

Credit: European CDS indices inch towards cycle tights

Credit markets outperformed other risk assets last week. Notably, European CDS indices inched towards cycle tights, as some hedges around Italian elections seemed to have been taken off. Strong supply/demand technicals were supported by inflows across investment grade and high yield, while the weekly supply volumes were among the lowest in 2017.

Within the broad-based rally, however, the energy and grocery companies in the US saw spreads widen. While oil prices weighed on energy names, the grocers were volatile even

before the bid for Whole Foods by Amazon, which added momentum to the spread widening.

The aftermath of the Banco Popular resolution led to substantial volatility in smaller Spanish banks and the imposition of a short sale ban on shares of a small lender. Encouragingly, however, RBS was upgraded by Moody's to Investment Grade while Italy seems to be coming closer to a solution for two smaller Venetian lenders that is likely to involve subordinated bondholders.

What to Watch

- The flash PMIs are expected to show continued growth among the G3 economies.
- US Bank stress test results to be released in two stages, with Dodd Frank Stress Test (DFAST) results on Thursday, June 22, and the Comprehensive Capital Analysis and Review (CCAR) results on Wednesday, June 28.

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