

Weekly Macro & Markets View

Highlights and View

- **UK PMIs signal a continuation of economic momentum but point to a weakening construction sector**

The combination of relatively modest business activity and increasing price pressures puts the BoE in a dilemma regarding its willingness to hike rates as recently indicated.

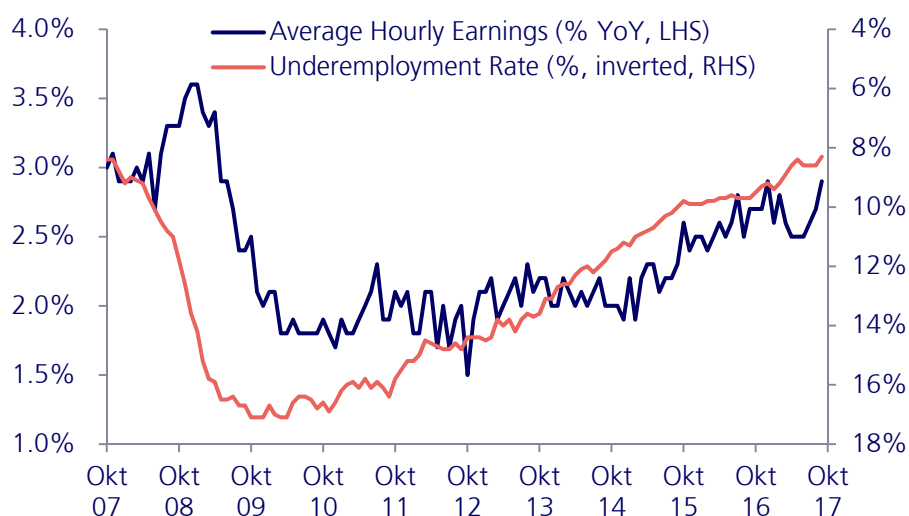
- **China's PBoC cuts its RRR by 0.5 ppts for banks with a 1.5% share of 'inclusive financing' of outstanding loans**

While this step is a boon for banks, it should not be interpreted as a major loosening of monetary policy.

- **Tensions between Catalonia and Spain's central government remain high after last week's referendum**

The situation is fluid and will take time to resolve. Ultimately, an outcome that gives Catalonia more autonomy but not independence still appears the most likely.

Wage growth accelerates to a post-recession high



Source: Bloomberg

US economic data have to be taken with a grain of salt currently, due to the disruptions caused by hurricanes Harvey and Irma, but the latest batch confirmed the solid underlying momentum of the economy. The ISM Manufacturing Index jumped to 60.8 in September, the highest level since 2004. Part of the rise was driven by longer delivery times, which usually point to accelerating business activity but were due to the hurricanes' impact on businesses. Nevertheless, improving new orders, new export orders and employment signal a real acceleration in economic activity. A similar message comes from the service sector with the ISM Non-Manufacturing Survey picking up to 59.8. Again, the survey's subcomponents show that the US economy gained momentum in September. Vehicle sales soared to 18.47 million, the highest since 2005. Further improvement is also visible in the labour market despite the fall in nonfarm payrolls in September, which was caused by the hurricanes. Rightly, investors' focus was on wage growth with average hourly earnings accelerating to 2.9% YoY – a post-recession high. An ever tighter labour market supports wages as filling open positions becomes increasingly challenging. The underemployment rate fell to 8.3% in September, the lowest level since May 2007. Treasury yields initially jumped after the wage numbers were released before falling back on increasing geopolitical tensions.

Bonds: Treasury yields do a round trip

The payroll report triggered a Treasury sell-off, as investors focused on the strong average hourly earnings print. The 10yr Treasury yield spiked higher, testing the 2.40% level, but failed to break through and returned to 2.36% by close, broadly unchanged on the day. Other markets responded similarly, with the 10yr Bund yield failing to rise above 0.5%. The short end of the Treasury curve moved in response to the report though and, with an 80% probability assigned to a December rate hike, this is now arguably seen as a done deal. Beyond this, market pricing

continues to look too dovish in our view, with only two rate hikes fully priced in by end 2019. We anticipate a more hawkish Fed to become priced in over the coming months, which should also be reflected in the long end. That said, the 5Y5Y forward rate is now back at 2.84%, broadly in line with the FOMC's projection for the terminal rate, which now stands at 2.75%. In the absence of a sharp rise in term premia, upsides to Treasury yields appear to be limited.

Credit: The ECB proposals on bad loans could have far reaching implications.

When European banks reported strong results, we felt that the boost to profits from less aggressive provisioning was not prudent, given the large stock of non-performing loans (NPLs) and the low prices at which bad loans are selling in securitisation transactions. It seems that European regulators perhaps felt similarly. The ECB published a draft for consultation last week proposing that, as of next year, new NPLs should be provisioned in full within stipulated time frames. We suspect that similar stringent requirements could be forced on even the existing stock of NPLs,

which would likely require significant capital raising by banks. While the broader credit market took little notice, amid light issuance and political news from Spain, we think this could have far reaching consequences. While the ECB would likely eventually soften its stance somewhat, creditors appear far too sanguine, with some short dated subordinated bonds trading at near zero, if not negative, yields.

Eurozone: The ECB discusses calibration of QE in 2018 and the strength of euro

Last week's release of the ECB September 7 monetary policy meeting minutes showed that the ECB Governing Council discussed a trade-off between the size of monthly QE asset purchases in 2018 and the length of time for which these purchases would be continued. The minutes said that "the benefits from a longer intended purchase horizon, combined with a greater reduction in the pace, were compared with those from a shorter period of purchases and larger monthly volumes". In a speech last week, ECB Executive Board member and chief economist,

Peter Praet, suggested that his preference would be for a longer period of asset purchases, which would imply a lower monthly purchase amount. We expect an announcement at the October 26 ECB meeting, with the balance of probabilities now tilted towards a "lower for longer" type announcement. The ECB minutes also showed that there was discussion and some concern expressed about the recent strength of the euro. After the minutes were released, the euro fell to its lowest level versus the USD since July.

Asia: Manufacturing PMIs tracking at decent levels

The equal-weighted average of Asian PMIs slowed to 51.7 in September from 52 a month ago. Manufacturing activity remains strong, but, in contrast to other regions, has not accelerated. New orders softened and new export orders were roughly stable, with variations between countries. In Korea, the export-orders-to-inventory ratio has sunk below 1, but, in Vietnam, export momentum is strengthening. Across Asia, one commonality is the depletion of inventory levels. This is especially the case in India, where the manufacturing sector is still

adjusting to the Goods and Services Tax. Another common trend is the acceleration of price pressure from raw materials, which is eating into margins. Turning to China, sample differences account for the divergence of a rising official PMI and a decreasing Caixin PMI. According to some manufacturers, environmental inspection policies took a toll on production, which can partly explain the softer Caixin PMI (51 vs. 51.6 in August). Encouragingly, Thailand is finally showing green shoots, while Taiwan is tracking at robust levels.

Japan: A turbulent pre-election phase

Who says Japanese politics are boring? Shortly after PM Abe called snap elections for September 22, new parties began forming, while the main opposition party, the DPJ, is dismantling. Polls are showing wild swings, with the 'Party of Hope', founded by rising star Tokyo Governor Yuriko Koike, challenging PM Abe's goal of achieving a majority of Lower House seats for his ruling coalition. Koike needs to decide by tomorrow whether she will run as a candidate for prime minister. We believe she will stick to her current role. In terms of policy, there are similarities with the

LDP, but Koike wants to abolish the use of nuclear power and does not want to raise the consumption tax in 2019. Meanwhile, a third block has been forming, with the 'Constitutional Democratic Party', the newly founded party of left wing DPJ politicians, joining forces with the Communist Party and the SDP. With nearly one-third of voters still undecided, the next two weeks will be decisive. Our core scenario remains intact: The ruling coalition will win an absolute majority, but will lose its two-thirds majority in the Lower House.

What to Watch

- The Catalan regional parliament meets this week to discuss the referendum result and may declare independence, but such a declaration would not be recognised by the Spanish constitutional court or by international organisations such as the EU.
- Japan will release its latest Eco Watchers Survey, machinery and machine tool orders, and monetary indicators. Aggregate financing in China, September exports in China and Taiwan, and business and consumer confidence in Australia will be in focus.
- In the US, the NFIB Small Business Optimism is expected to show a continuation of small firms' positive mood, while investors' focus will be on inflation numbers with both CPI and PPI expected to climb further.

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