

Weekly Macro & Markets View

Highlights and View

- **The ECB extends forward guidance and raises the possibility of restarting QE and cutting rates**

While it is encouraging that the ECB is discussing more QE, the debate within the ECB seems to be at an early stage, suggesting an imminent decision is unlikely and a risk of complacency.

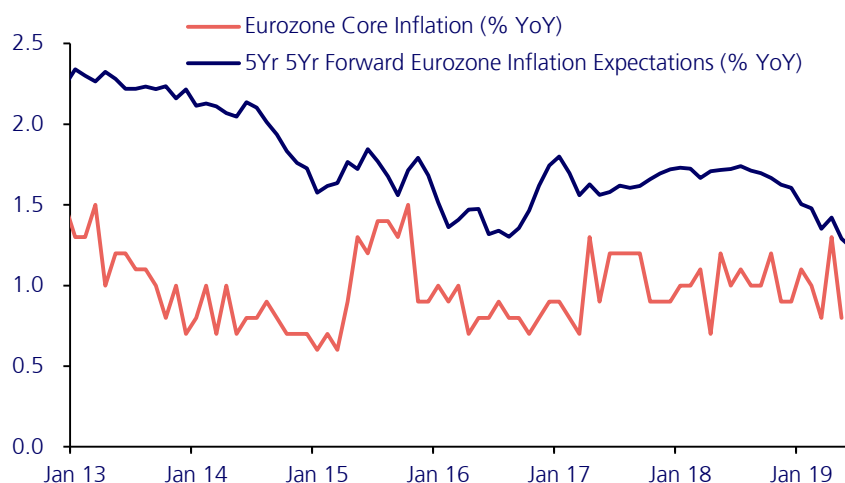
- **The S&P 500 had its best week since last November despite mixed economic data**

The ISM Manufacturing signals further headwinds but investor sentiment was lifted by a solid Non-Manufacturing survey and Trump's announcement to drop planned tariffs on Mexico.

- **Newspaper reports suggest that PM Abe will refrain from postponing the consumption tax hike and from holding combined Upper and Lower House elections**

This is in line with our core scenario that we had expressed in our Topical Thoughts paper.

While the ECB considers restarting QE, it lacks a sense of urgency



Source: Bloomberg

At last week's monetary policy meeting and press conference, ECB President Mario Draghi indicated that the governing council had discussed re-starting QE, as well as cutting interest rates, in order to boost growth and inflation in the Eurozone. Indeed, Draghi said that there was still 'considerable headroom' for more bond purchases. However, his comments also suggested a lack of urgency within the governing council, as he said in referring to the discussion on QE that 'it's a reflection that has just started today in this meeting'. What's more, Draghi said that there was 'no probability of deflation' in the Eurozone at the moment. This seems complacent given that core inflation has averaged just 1% YoY over the past six months and that inflation expectations are also low and falling. In fact, the Eurozone could be just one shock away from deflation. Overall, it appears once again that the ECB is likely to be reactive rather than proactive, especially with a change of leadership coming later this year that could further complicate and slow decision-making. In terms of what the ECB did announce last week, forward guidance on interest rates was extended for six months, with a commitment to keep interest rates at present levels at least through the first half of 2020, and more details on the TLTRO III programme were given (see below). However, neither of these are likely to be game-changers either for the banking sector or the wider economy.

Credit: The ECB's TLTROs likely to end up as a damp squib

Last year we expected that when the current batch of cheap bank loans from the ECB were close to expiry, the ECB would deliver a new round of loans, which would provide meaningful support to the banking sector. Following its initial announcement in March, the ECB released the details of the new so called targeted longer-term refinancing operations (TLTRO) III last week. We had already been disappointed by the initial structure announced in March, and the details announced last week did not cheer us up. Compared to the older loans, the new loans

have shorter tenors, will be issued after around half of the old loans have less than one year to mature (making them ineligible for some regulatory liquidity ratios), and have marginally higher rates with no prepayment allowed. Together with some other details, this makes us think that the new TLTROs will have a much diminished take up and a marginal impact, if any, on earnings and lending. European bank stocks declined after the announcement. Elsewhere, credit markets had a strong tone to them, with primary markets also seeing strong order books.

US: The domestic economy shows resilience

The S&P 500 continued its winning streak on Monday, lifting the return for June to 4.89% so far, making up a large part of May's losses. The move higher was helped by President Trump announcing that he would drop plans for tariffs on Mexico as the Mexican government promised steps to curb illegal migration to the US. Meanwhile, economic data remain mixed. The ISM Manufacturing index fell to its lowest level since October 2016, signalling further headwinds for the manufacturing sector though new orders ticked up in May. On the positive side, the

ISM Non-Manufacturing index rose to 56.9, still some way off the highs seen last autumn but nevertheless indicating resilience in the service sector. The employment component rose back from last month's weakness, which is particularly important given the soft payrolls number. Nonfarm payrolls rose a modest 75k in May and the previous two months were revised down by the same amount. Wage growth slowed down to 3.1% YoY despite the underemployment rate falling to the lowest level since December 2000.

Eurozone: The European Commission takes first steps in launching EDP against Italy

The European Commission (EC) took the first steps in launching an Excessive Deficit Procedure (EDP) against Italy last week, when it issued a detailed report on Italy's public finances. This report concluded that Italy's debt to GDP ratio would increase further in 2019 and 2020, in contradiction to the forecast from the Italian government of a gradually declining debt to GDP ratio. The report also concluded that Italy's budget deficit in 2019 and 2020 would be higher than forecast by the Italian government, especially in 2020. While Italy has responded

that revenues will be higher this year and spending lower than previously envisaged, this remains to be seen. BTP-Bund spreads actually narrowed last week, however, as finance minister Giovanni Tria indicated a willingness to compromise and as risk appetite more generally firmed. Nevertheless, the chance of volatility returning to Italian bond and equity markets in the second half of the year is high, as differences between the EC and Italian government are large.

Japan: It now seems likely that the consumption tax hike will not be postponed again

Japan's GDP growth in Q1 was revised up marginally. Notably, the quality of growth has improved slightly as the contribution shifted from inventory build-up to private capex, following the stronger than expected MoF corporate survey. The large decline in imports lifted the contribution from net exports, which makes sense from a statistical point of view, but is certainly not a sign of strong domestic demand. We expect a pullback to only marginal growth in the current quarter. There had been speculation that PM Abe intends to combine Upper and Lower House

elections and postpone the consumption tax hike scheduled for October 1 once again. The press had also made noises about a weaker coincident indicator for March, but the April reading picked up again, which was largely neglected. We stick to our core scenario that the tax hike will go through as scheduled, particularly as the current Diet session will likely not be extended. Meanwhile, Japan's equity market keeps underperforming the MSCI World ex Japan. We are watching the USDJPY rate, as any further yen strength may hit Japanese export related equities.

Asia: Will weak manufacturing conditions spill over to services?

We had noted last week that some of the manufacturing PMIs for May had deteriorated or remained weak for some important countries like China, Korea, Taiwan and most recently even Hong Kong, while those for the ASEAN markets showed a mixed outcome. Last week, China's Caixin services PMI for May fell 1.8 points to 52.7. Even though it remains comfortably above the boom/bust level of 50, we are somewhat concerned that weak conditions in the manufacturing sector are starting to spill over to the service sector. Export data came in slightly better than

expected in May, but we believe that tariff-related frontloading of exports had an impact. Imports fell by 8.5% YoY. Even though the base effect is distorting, it seems domestic demand is slowing. Meanwhile, both Australia's RBA and India's RBI have cut policy rates by 0.25 percentage points, as we had expected in our outlook section last week. The trend towards a more dovish stance by APAC central banks remains intact, even though we believe that Indonesia's BI and Thailand's BoT will keep rates unchanged for the time being.

What to Watch

- In the US, headline inflation is expected to have slowed in May, though core inflation is more likely to have remained at last month's level. Retail sales will give an indication as to whether consumer spending has recovered from its soft patch.
- In China, May statistics for aggregate financing, money supply, CPI, industrial production, fixed asset investment and retail sales need to be watched. In India, inflation, industrial production and trade data will be released, while we will need to keep an eye on employment and consumer confidence data in Australia. Finally, in Japan, the BSI corporate survey for Q2 will give us an indication for the Tankan survey, while core machinery orders for April may show a pullback from strong growth in March.

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