Weekly Macro and Markets View

3 October 2022

Highlights and View

The UK government scraps the announced tax cuts for top earners

While the reaction to immense market pressure is a welcome step more will be needed to regain investors' trust and limit long-term damage to the economy.

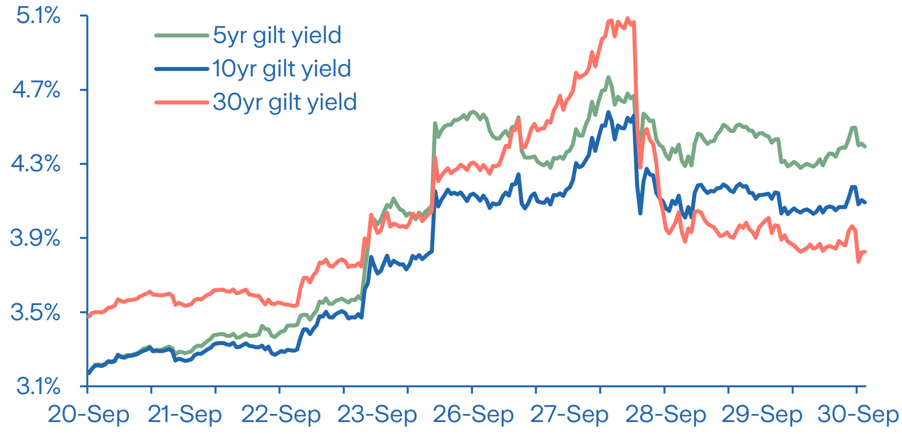
Eurozone inflation hits double-digits for the first time

The rise in inflation increases the chances that the ECB will raise rates by another 75bps at their next monetary policy meeting on October 27, despite a looming recession.

Former President Lula and the incumbent Jair Bolsonaro advance to the second round of the presidential election in Brazil, as Lula leads but with a narrower margin than polls predicted

Despite fundamental differences between the candidates, a massive shift in economic policy is unlikely, and whoever wins in the second round will have to reach agreements with Congress.

The BoE intervenes in gilt markets to avoid a collapse



Source: Bloomberg

Global sentiment was dealt another blow by the latest turmoil in the UK gilt market. Rapidly rising gilt yields, triggered by the announcement of broad-based tax cuts, led to an intervention by the Bank of England (BoE) to avoid a negative chain reaction and the potential default of several UK pension funds. The rout in the gilt market was exacerbated by collateral calls on liability driven investments (LDI) used by the pension funds. With these derivatives moving far out of the money, the imminent risk was that investors would have had to sell liquid assets to meet margin calls, creating significant risks for individual investors and the broader financial market. The BoE's announcement that they will delay the start of quantitative tightening (QT) and instead engage in significant asset purchases to ensure market functioning led to a 100bp decline in 30yr gilt yields. Both sterling and gilt yields stabilised further at the beginning of this week, helped by PM Truss' announcement that the planned tax cut for top earners would be scrapped. This response to immense market pressure is welcome though more will be needed to restore confidence in the government. Many of the fiscal measures included in the mini budget have their merits and could help to support growth in the long run, but the timing is very unfavourable and counterproductive as the BoE must slow down the economy to bring inflation under control.

UK Residential Mortgage Credit

On hold

The turmoil in the UK markets is likely to have long-lasting repercussions in the housing market and for consumers. The share of fixed-rate mortgages stands at 80% of loans outstanding, but it should be noted that fixed terms are generally short in the UK. With more than a third of UK borrowers linked to variable rates or a fixed-rate period ending in 2023, higher mortgage rates are looming for homeowners. Last week's rate volatility caused many UK banks to withdraw their mortgage offers and stop making new loans. The situation is unlikely to turn around quickly given that bank funding from residential mortgage credit is already beginning to suffer. Primary issuance was derailed last week in the UK RMBS (residential mortgage back securities) primary market, with two issuers forced to cancel deals, including one Prime RMBS from Yorkshire Building Society. Spreads of RMBS also suffered, surging by around 60bps to a level of 200bps for non-conforming and buy-to-let deals. While it's not a credit crunch yet, conditions for UK homeowners have tightened markedly.

US

The S&P 500 Index falls to a new post-pandemic low

The S&P 500 broke below June's low last week, falling to the lowest level since November 2020. The bond market turbulence in the UK and a number of hawkish Fed comments weighed on investor sentiment. The latest batch of economic data was mixed, but market projections for the expected year-end level of fed funds were only marginally lower. Durable goods orders ticked down in August though slightly less than expected. Reflecting the impact of tighter policy on the real estate market, house prices fell on a monthly basis for the first time in more than a decade. Core PCE inflation ticked up slightly more than expected in August, lifting the annual rate to 4.9% from 4.7%. However, given that most of the price data were already known this didn't have a major impact on markets. Initial jobless claims fell back below 200'000 indicating that the labour market remains very tight for now. Finally, consumer confidence improved in September helped by both the present situation and households' expectations.

Eurozone

Inflation hits 10%, sentiment indicators continue to deteriorate

The economic data and surveys continue to deteriorate in the Eurozone, pointing towards an imminent recession. The European Commission's Economic Sentiment Indicator fell to 93.7 in September, from 97.3 in August, and is now consistent with a contracting economy. The decline was driven by large falls in services and consumer confidence. In Germany, the ifo Business Climate Indicator also fell sharply due to large declines in both the expectations and current conditions components of the survey. Meanwhile, inflation continues to increase, reaching 10% in September (the first time ever in double-digits for the Eurozone), driven by higher energy prices and rising core inflation. Meanwhile, Germany has announced a EUR 200bn support package for households and companies to offset the impact of high energy prices. While the package will help, it will not be able to prevent a deep recession over the winter months. Some other European countries also expressed disappointment that the stimulus was not coordinated at an EU level.

Asia

China's PMI data are mixed ahead of the national congress, Japan's industrial production shows strong growth

In China, growth remains heavily impacted by the ongoing disruptions from Covid. The official Manufacturing PMI of 50.1 for September was slightly ahead of market expectations. However, the Caixin Manufacturing PMI, more reflective of smaller companies, fell from 49.5to 48.1. China's Non-manufacturing PMI of 50.6 for September was lower than the market forecast of 52.4. Demand for Chinese exports is falling, with new export orders in the official PMI falling to 47, the lowest in four months.

In Japan, the economy continues to recover from the impact of Covid. Industrial Production increased by 2.7% MoM in August, and retail sales increased by 1.4% MoM, exceeding market expectations. Despite positive momentum in the economy, PM Fumio Kishida continues to plan a stimulus package, which economists have warned is oversized and unnecessary. Kishida's planned stimulus would focus on easing cost-of-living pressures arising from the recent increase in food and energy prices.

Credit

Volatility returns after a long spell of resilience

Credit resilience was shaken last week as investor sentiment was hit by multiple factors such as turmoil in UK markets following the new government's mini budget, the alleged sabotage to gas pipelines in Europe and Russia's annexation of occupied territory in Ukraine. Spreads widened across the board with US IG widening by 7bps on Tuesday alone and by 13bps on the week. US HY outperformed in relative terms seeing spreads widen by 10bps on Tuesday and 40bps on the week. European credit fared no better, with EUR IG and HY spreads closing the week 21bps and 63bps wider respectively, and GBP IG spreads widening 29bps on the week. Fund flows reflected market sentiment, with outflows of roughly USD 10bn and 3bn from US IG and US HY respectively. European funds also suffered outflows, totalling USD 6bn and USD 929mn from IG and HY funds, respectively. With EUR IG spreads reaching 225bps (versus 247bps in March 2020), we believe that a lot is priced in. This cannot be said for US IG and global HY, however, where spreads are still far below crisis spread levels.

What to Watch

- In the US, the ISM surveys are expected to reflect a modest slowdown in activity while the latest set of labour market data will give indications as to whether tighter financial conditions are having the desired impact on the employment situation.
- In APAC, we expect the RBA and RBNZ to increase interest rates by 50bps to 2.85% and 3.50%, respectively. In Japan, the Tokyo CPI for September will be monitored closely for any increases in inflationary pressures in the economy. In Korea, the YoY CPI for September will be released and is expected to remain at 5.7%.
- Inflation is expected to continue accelerating in Mexico, while in Chile, prices will likely start to decelerate. Several economic activity indicators will be published in Brazil and Mexico, potentially indicating decreases in the industrial sector and domestic demand.

Disclaimer and cautionary statement

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