Weekly Macro and Markets View

17 October 2022

Highlights and View

US headline inflation slows to 8.2% YoY, but core CPI reaccelerates to 6.6% YoY

Services inflation keeps pushing up core CPI though many indicators point to a substantial fall in inflation rates in the coming months

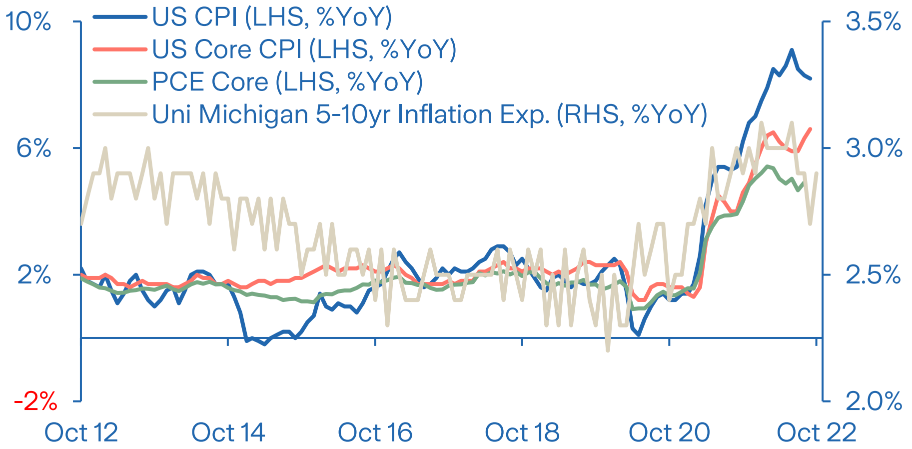
UK PM Liz Truss names Jeremy Hunt as the new Chancellor and scraps her corporate tax plans

The government's announcements brought only short relief to the markets as investors still wait for more details on the longer-term fiscal plans and debt sustainability

China's 20th Communist Party Congress has started with a key address by General Secretary Xi Jinping

Xi warned that China needs to be prepared to be sailing through tough storms, while the focus on high-quality growth dominated the economic outlook

Services keep core inflation at elevated levels in the US



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, University of Michigan, Bloomberg

US monthly rates of 0.4% for headline CPI and 0.6% for core CPI inflation were higher than expected in September, leaving annual rates a tick above consensus expectations at 8.2% and 6.6% respectively. While the deviation from expectations is modest, price pressures remain elevated particularly in services. Rising rents are an important driver of stubbornly high core inflation. However, this mostly represents the lagged impact of higher house prices and delayed rent adjustments within longer-term contracts. Rising vacancies, a slowdown in house prices and lower rent increases for new tenants are all signs of softer core inflation ahead but these will only show up in CPI numbers with a lag.

Although many indicators point to a substantial fall in inflation rates in the coming months, the fact that the Fed remains very focused on current inflation and shows little patience with regards to the usual lag of monetary tightening increases the risk of a policy error significantly. Meanwhile, high inflation and rising rates keep weighing on consumers' sentiment. The University of Michigan's survey shows that households' inflation expectations have risen in October, lifted by a rebound in gasoline prices. Overall consumer sentiment was slightly better than a month ago driven by current conditions, though expectations have deteriorated.

UK

Kwasi Kwarteng resigns from his role as UK Chancellor

Only three weeks after announcing the mini budget with broad-based tax cuts Kwasi Kwarteng had to resign from his role as Chancellor given immense market pressure including massive turmoil in bond and currency markets. Jeremy Hunt was named as Kwarteng's successor. At the same time, PM Truss also scrapped her plan to freeze corporation tax next year, which means corporation tax will rise to 25% from 19%, as had been planned by her predecessor, Boris Johnson. However, despite the PM's U-turn pressure on sterling and gilts subsided only temporarily given the lack of further details regarding the government's fiscal plans. Gilt yields rebounded following the PM's announcement, exacerbated by rising uncertainty given the BoE's announced end of emergency support. While the BoE's monetary response is expected to be less aggressive than initially feared given the reduced fiscal stimulus, volatility in the bond market is likely to remain high until investors get more insights into the government's longer-term fiscal plans and projected debt sustainability.

Government Bonds

Markets set to remain volatile

Political turmoil in the UK and the surprisingly strong US CPI print led sovereign bond yields higher last week, with the 10yr yield ending the week above 4% in both the US and the UK. Pricing was extremely volatile as political events unfolded, with gilt yields approaching their September highs mid-week as the BoE confirmed that the temporary gilt backstop would end as planned. As political pressures rose, the appointment of a new chancellor on Friday helped to ease market concerns, with the 10yr gilt yield initially falling back below 4%, before rebounding given a lack of further details on fiscal plans. In the US, the CPI release triggered large swings on the day, with the 2yr Treasury yield rising by 17bps on a more hawkish Fed outlook, while the 10yr yield surged by 24bps before edging lower, ending the day 5bps higher. We expect bond market volatility to persist. While the fiscal U-turn in the UK has eased near term concerns, the BoE ended the gilt backstop on Friday and the inflation backdrop remains challenging, both in the UK and globally.

Credit

IG spreads touch YTD wides

Last week credit performed poorly, especially in IG. Notably, IG spreads touched YTD wides (165bp for USD IG and 234bp for EUR IG), while HY spreads stayed below their early July peak. Risk-off sentiment was reflected in issuance activity, or lack thereof. The only USD IG issuer of the week was Morgan Stanley, which announced a deal on Friday after reporting earnings. In USD HY, where three issuers came forward, the need to sweeten deal terms was clear for movie theatre company AMC Entertainment, which had to increase the yield of its B-rated deal to 15%. Outflows were registered across the board according to EPFR and Refinitiv Lipper data. European IG and HY funds suffered outflows which were smaller than the prior week but still significant. Outflows also continued from US IG funds and resumed from US HY funds. We believe that amid tightening financial conditions, growth headwinds and continuing volatility in rates, credit remains vulnerable, especially global HY, where prices don't reflect the extent of the challenges and where HY/IG spread decompression is to be expected.

Japan

Household sentiment is improving, but inflation is a concern

The October Reuters Tankan and September Eco Watchers Survey focused on current consumer and business sentiment and the outlook for the next few months. Following a 'V'-shaped recovery in the manufacturing industries, particularly autos, current conditions and the outlook are deteriorating, especially for material and machinery related sectors. In contrast, household sentiment is improving on subsiding Covid-infections and expectations for travel discounts, while retailers are looking forward to an increase in inbound tourist spending. However, some retailers remain cautious, as increasing consumer price inflation is putting a lid on consumer spending appetite.

Meanwhile machinery orders for August confirm the extremely volatile order pattern for specific sectors. To us, the core message from the data is that foreign orders have continued to fall for a fourth month in a row, confirming what we have observed in other countries in the region, particularly Taiwan and Korea.

China

Xi Jinping's opening address dominated the start of the 20th CPC

China's 20th Communist Party Congress (CPC) started with a two-hour long speech by General Secretary Xi Jinping, in which he gave a review of the achievements over the last five years and then highlighted policy priorities for the future. National security, social stability and high-quality economic growth featured prominently in his speech. There were no indications that the nation's zero-Covid policy would end soon, instead the success of this policy has been highlighted not only during Xi's address, but also in the media just before the congress. Military strength was another focus. The goal of a peaceful re-unification with Taiwan was followed by a remark that military options remained open, which was applauded by the delegates. Economic data reported last week included September credit data. Infrastructure related lending by policy banks remained strong, while loans to households were still subdued. Headline CPI inflation rose to 2.8% YoY, but core inflation fell to an 18-month low and producer price inflation continued to retreat to only 0.9% YoY.

What to Watch

- In the UK, inflation rates are expected to remain elevated while consumer sentiment and retail sales will likely remain under pressure.
- In the Eurozone, an EU summit will discuss the energy crisis, while Italy`s new coalition government is expected to unveil its ministerial appointments. Various business confidence and economic data will also be released.
- In APAC, our focus will be on China. The 20th Communist Party Congress is likely to end on Friday, but the focus will be on the following first plenary session next weekend, in which the Politburos' new Standing Committee members will be revealed. Q3 GDP and various important economic data for September will be reported on Tuesday. September export data will be reported in Japan, China, Taiwan, and some ASEAN countries. Bank Indonesia is likely to lift its policy rate by at least 25bps. Australia will report labour market data for September and business confidence for Q3.

Disclaimer and cautionary statement

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