Weekly Macro and Markets View

11 July 2022

Highlights and View

Japan's ruling LDP/Komeito coalition expands its majority in the Upper House

We believe that neither the election's outcome nor former PM Abe's assassination will massively change economic policies in the short term.

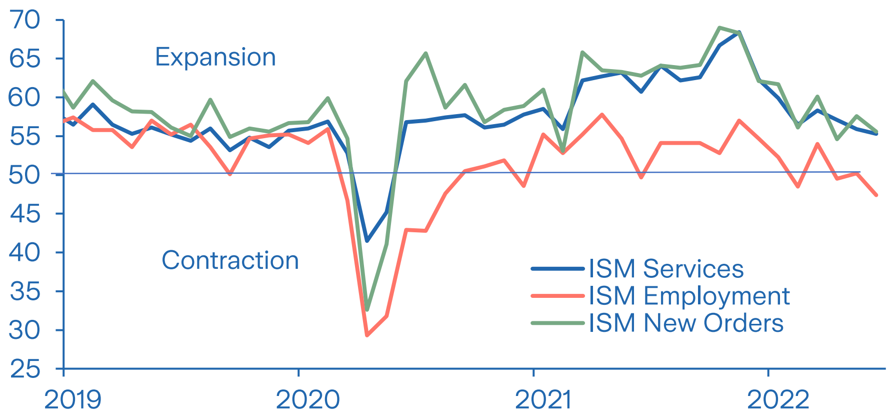
UK Prime Minister Boris Johnson resigns after a number of ministers quit his government

It will likely take at least a few weeks for the Conservative Party to decide on a new leader. Whoever takes over will still face the challenges of dealing with the cost-of-living crisis and Brexit.

Australia's RBA hiked its cash rate by 50bps to 1.35%, while Malaysia's BNM hiked its overnight rate by 25bps to 2.25%

We expect more policy rate hikes by both the RBA and various ASEAN central banks in H2.

ISM services and payroll data point to continued expansion



Source: Bloomberg

The holiday shortened week provided more mixed data and choppy market trading. On balance, however, a decent picture of the US economy remains and points to a further 75bp rate hike at the next FOMC meeting at the end of the month. While the S&P and Dow indices tacked on modest gains over the four trading days, the tech heavy Nasdaq managed a hefty 4.6% jump, despite both 2yr and 10yr Treasuries pushing back above 3%. Equity investors, rightly in our opinion, were encouraged by the economic news, despite another inversion of the yield curve. Factory orders and durable goods data proved to be robust in May, but it was the ISM services and jobs data that were focal points. Though ISM services continued to decline to 55.3 in June, it is still indicative of a healthy expansion. The employment component fell into contractionary territory, however, while new orders also weakened. Following the prior week's manufacturing readings, we believe this to be consistent with our view of still decent but slowing economic activity, with recession more of a concern for next year. This view was bolstered by the robust payroll data, showing a 372k increase in jobs for May, with average hourly earnings remaining elevated at 5.1% YoY. The release of the Fed minutes showed a hawkish committee, noting inflation as being 'much too high', and we maintain that a further 75bp hike is on the cards for July 27.

Japan

Ruling coalition expands majority in Upper House elections

Half of Japan's Upper House is re-elected every six years, with one half scheduled to be re-elected in July 2025, while the next Lower House elections are scheduled for October 2025. In Sunday's Upper House elections, the ruling LDP/Komeito coalition expanded its absolute majority by seven seats to 146 of 248 seats, while the largest opposition party, the CDP, lost six seats and is now represented by 39 seats. Western media are less focused on another important aspect, however. The ruling coalition and two smaller opposition parties have secured the two-thirds majority needed to push for an amendment to Japan's pacifist constitution that would expand the role of Japan's Self-Defence Forces. An additional public voting majority would also be required to do so. The elections were overshadowed by former PM Abe's assassination on Friday. Abe, the leader of the biggest LDP faction, had a major influence on PM Kishida's led government. However, apart from maybe some smaller constituencies, his tragic death did not impact the overall result of the elections.

Bonds

Government bond yields whipsaw on inflation and recession fears

Volatility in government bond markets remains elevated and is unsettling investors. Last week, a key driver of that volatility was US economic data. After spiking to 3.5% on inflation fears in mid-June, the 10yr Treasury yield slumped to 2.8% early last week on recession worries and following the sharp decline in US manufacturing new orders data. In another whipsaw, yields later rebounded on strong US jobs and services data that sent the 10yr Treasury yield back above 3%, closing the week at 3.08%. Yields also spiked higher on shorter dated Treasuries as the robust jobs report strengthened the likelihood of larger Fed hikes. As a result, the Treasury curve inverted again in the 2/10yr segment, which tends to be a good indicator of recession, albeit with a lag. Looking forward, bond market volatility is set to remain elevated over the coming months given the conflicting forces in the global economy. More convincing evidence that inflation has peaked is likely to be required for that volatility to settle down.

Credit

European High Yield lags notably

US and European spreads narrowed last week, in line with a more positive tone in equity markets. US High Yield (HY) has outperformed US Investment Grade (IG) so far in July, following underperformance in June. HY and IG fund flows have diverged. After three consecutive weeks of outflows, US HY funds saw inflows of USD 889mn last week while US IG funds saw investors pull money for the fifteenth straight week, with outflows of USD 5.79bn, according to Lipper data. In Europe, spreads also closed the week tighter but underperformed the US as concerns around energy security increased. The underperformance was clearly visible in the CDS market, with iTraxx Main closing the week 26bps wide versus CDX IG, a divergence last seen in 2013. Within European credit, HY underperformed IG, reflecting expected downside to economic growth. Decompression of the HY/IG spread ratio, until recently only visible in the US, is now underway in Europe too. Given the challenging macro environment and the unlikelihood of a dovish turn by the ECB, we think that decompression will continue.

Eurozone

Gas supply uncertainty weighs on Eurozone economy

European natural gas futures prices rose by around 25% last week. Uncertainty around supply continues following Russia's decision mid-June to reduce gas flows to Europe by 60% and as supply via the Nord Stream 1 pipeline is completely cut off for a couple of weeks as of today for scheduled maintenance. The news this morning is that Canada will allow the shipping of a turbine that Russia claims is necessary to keep supplying gas as before, but uncertainty and risks for the winter months remain high. In particular, all eyes will be on whether the Nord Stream 1 pipeline is reopened later this month after the scheduled maintenance period comes to an end. Meanwhile, Germany recorded its first monthly trade deficit (instead of the usual surplus) since reunification in 1991 as high commodity prices boosted the value of imports. Germany and the rest of the Eurozone are experiencing a terms of trade shock due to the high cost of commodity prices and weaker euro, though for many emerging market economies the situation is much worse.

LatAm

Energy and food prices are the main drivers of inflation while core inflation accelerates

Inflation remains high and persistent, but June figures did not surprise to the upside. In Brazil, inflation reached 11.9% YoY. While we believe inflation has peaked, high core inflation is still creating pressure for additional policy rate hikes. The recent tax cut approved in Congress will relieve inflation in the short term. However, the higher fiscal uncertainty increases medium-term inflation expectations. The service sector is showing robust growth, with the Service PMI accelerating from 58.6 to 60.8 in June. In Chile, inflation accelerated from 11.5% YoY to 12.5% YoY. We expect inflation will continue to increase and peak in August. The recent currency depreciation should cause higher inflation, pushing for a higher policy rate. We believe the central bank will raise the interest rate by 75-100bps in the next policy meeting. In Mexico, headline and core inflation reached 8% YoY and 7.5% YoY, respectively. Considering the high and persistent core inflation, we expect Banxico to continue hiking rates, and a 75bps hike in August's monetary policy meeting is likely.

What to Watch

- All eyes will be on US inflation readings with the release of the June CPI and PPI. Headline CPI is expected to rise further, from 8.6% YoY to 8.8%, while a third consecutive decline is expected in the core, to 5.7%. In addition, retail sales are expected to rebound from poor readings in May.
- In the Eurozone, industrial production data and the German ZEW survey will give important clues as to the state of the economy.
- In APAC, we believe the Bank of Korea will hike its policy rate by 50bps. China will release June economic indicators as well as Q2 GDP statistics. In Japan, we will focus on the Reuters Tankan for July and June producer prices. Australia will release labour market data for June as well as business and consumer confidence surveys. Q2 GDP data will be released in Singapore, while export data will be reported in Indonesia and the Philippines. Thailand's financial markets will be closed on Wednesday.

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