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Weekly Macro and Markets View

31 January 2022

Highlights and View

The S&P 500 ends a very volatile week in positive territory

Although markets may remain choppy in the coming weeks current investor pessimism seems overdone.

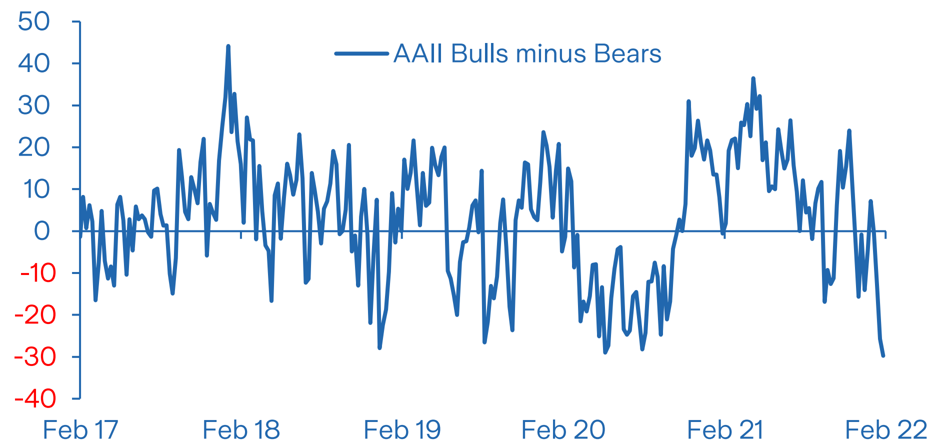
Jerome Powell signals that the rate-hike cycle will begin in March

While Powell may have sounded more hawkish than investors hoped for it is unlikely that the Fed will raise rates at every meeting this year as some investors fear.

In Italy, incumbent President Sergio Mattarella was re-elected for another seven-year term

Mattarella's re-election as President should reassure investors as it implies that Mario Draghi will likely remain as Prime Minister until parliamentary elections in 2023.

Investor sentiment falls to the lowest in years



Source: Bloomberg

Stock markets had another rollercoaster week with the S&P 500 going through a more than 2.5% move within every single day before closing the week with a 0.8% gain on Friday. Investors have turned very cautious recently, focussing on the possibility that the Fed will tighten policy too much. Although Jerome Powell simply reiterated the FOMC's current stance, investors seemed disappointed that he did not sound more dovish following the recent stock market correction. However, given that the Fed is behind the curve and markets have priced in more than four rate hikes until the end of the year, it would be wrong in our view if Powell undermined the projected tightening path by sounding too dovish at this point. The economy is strong enough to cope with a few rate hikes and investors are likely to digest the related rise in real yields given that there are still few attractive alternatives. The fact that Powell didn't exclude a potential rate hike at every single meeting in 2022 doesn't mean that the Fed will actually raise rates seven times this year. In fact, we think this is rather unlikely given our expectation that growth will slow and inflation rates will fall markedly over the course of the year. Meanwhile, the latest batch of economic data and reported earnings were mixed and reflect the transitory impact of Omicron and ongoing supply chain disruptions.

Eurozone

Country-level Q4 GDP data confirms end of year slowdown

Last week saw the release of the first estimates of 2021 Q4 GDP for some of the major Eurozone economies. The Eurozone wide estimate will be released this week. Germany saw its economy contracting by a more than expected 0.7% QoQ in Q4. However, France and Spain saw growth of 0.7% and 2.0% QoQ respectively. The differences are mainly due to the different timing of Covid waves and differences in the severity of the associated lockdowns. The upshot overall is that Eurozone growth slowed around the turn of the year after the blistering pace of growth set mid year, as we have been warning for some time. However, looking further ahead the signs for the rest of this year are still encouraging. Admittedly, the Flash Composite PMI fell further in January, but this was mainly due to a decline in services confidence, which we expect will reverse once the latest Covid wave dies down. Manufacturing confidence remains resilient, with increasing signs that supply-chain disruptions are easing. For example, the Manufacturing PMI for Germany jumped around three points in January.

Switzerland

Countercyclical capital buffer is reactivated as imbalances in the real estate market build

Given strong house price inflation and mortgage lending, last week's decision to reactivate the Swiss countercyclical capital buffer did not come as a surprise. The buffer now requires banks to hold additional capital at 2.5% of relevant exposures to Swiss residential property — compared to 2% before the Covid crisis. This should help contain a further build-up in imbalances and appears appropriate given the ongoing search for yield environment. Elsewhere, macro data are strong, indicating stable growth at well above trend, with both domestic spending and external demand contributing. By contrast, inflation is relatively benign, with the core CPI measure still below the 1% handle. With a strong currency and more favourable energy base effects, upward price pressure should ease going forward. We expect the SNB to leave its monetary policy stance unchanged beyond the coming year, and market pricing, which now implies over one 25bps rate hike in the next 12 months, appears too hawkish.

Japan & China

Cracks in the services sector

China's Manufacturing PMIs for January reveal intensifying weakness amongst SMEs, while larger companies are faring better. The NBS PMI fell to 50.1, and the Caixin PMI slid to 49.1. Ongoing Covid related mobility restrictions and the slowing property market are negatively impacting the services and the construction sector, with the Non-Manufacturing PMI falling to 51.1.

Meanwhile, Japan's Manufacturing PMI for January edged up to 54.6, a four-year high, supported by the robust auto sector, while the Services PMI tumbled by 5½ points to 46.6 amid surging Omicron infections. Major prefectures are now under a quasi state of emergency. Japan's economic growth faltered in December, as revealed by data for industrial production and retail sales that were released today. While auto sales were brisk, food and beverage sales fell markedly, while consumer confidence for January showed the expected setback amid Omicron concerns. The Topix Index fell by more than 10% from its intra-day high in January but now appears to be stabilising.

US Structured Credit

A safe haven in the broader turmoil

US ABS and CLO tranches have emerged as outliers amid the broader market turmoil in 2022 that has negatively impacted stocks, credit and government bonds. While performance is positive on a YTD basis, some softening occurred last week driven by stronger supply. Structured credit continues to benefit from strong fundamentals, but the recent outperformance has been mostly driven by the perceived hawkishness of the Fed. Structured credit bonds benefit from their short duration given their floating-rate based coupons, attracting investors looking to partially hedge their interest rate sensitivity. US leveraged loans were also boosted by the more hawkish tone from the Fed, ending January on a positive note . Inflows into US loan funds reached USD 2bn last week, the second largest inflow on record. We expect this renewed investor appetite to persist over the coming months as floaters should benefit from rising rates. Strong demand, plus strong underlying fundamentals amid the economic recovery, should help US ABS and CLO tranches to outperform the rest of the credit market.

Credit

Cracks emerging as gap risks rise further

Credit markets showed initial indications of gapping down despite tentative signs of stabilisation emerging in stocks towards the end of the week. Indeed, US credit spreads widened even on Friday, despite a bounce in US stocks. High yield spreads widened notably last week, with overall yield levels jumping above 5% in the US, causing sizeable outflows for the third week in a row. Notable outflows were also seen in US investment grade, European investment grade and European high yield credit. Primary issuance largely shuddered to a halt, with downbeat investor sentiment already evident in the sizeable new issue concessions that we highlighted previously. However, despite the recent weakness, while stocks appear oversold on some metrics, credit spreads still look expensive on a historical basis. Hence, the risk reward seems skewed more to the downside in credit than in stocks. We believe that were the stock market volatility to resume after the nascent stabilisation seen last week, credit spread widening would be at risk of becoming more non-linear.

What to Watch

- In the US, the ISM surveys will reveal the ongoing impact of the Omicron wave on business activity while the latest batch of labour market data will provide important insights into the current employment situation.
- In additon to the release of the first Q4 GDP and inflation estimates for the Eurozone, the ECB will meet to decide monetary policy, though no significant policy announcements are expected.
- We do not expect any policy rate change when the Reserve Bank of Australia convenes on Tuesday, but we will watch Governor Lowe's speech on Wednesday and the RBA's statement on monetary policy on Friday. Australia's December exports, retail sales and building approvals as well as January house prices and Q4 business confidence will also be in focus. India's Union Budget will be announced on Tuesday. Various financial markets will be closed for a day or even for the whole week due to the Lunar New Year.

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