ZURICH

Weekly Macro and Markets View

4 July 2022

Highlights and View

US stocks stumble once more and Treasuries rally as attention switches from inflation to growth

We continue to believe that slowing growth and peaking inflation will force a lighter policy touch by the Fed in the latter part of the year.

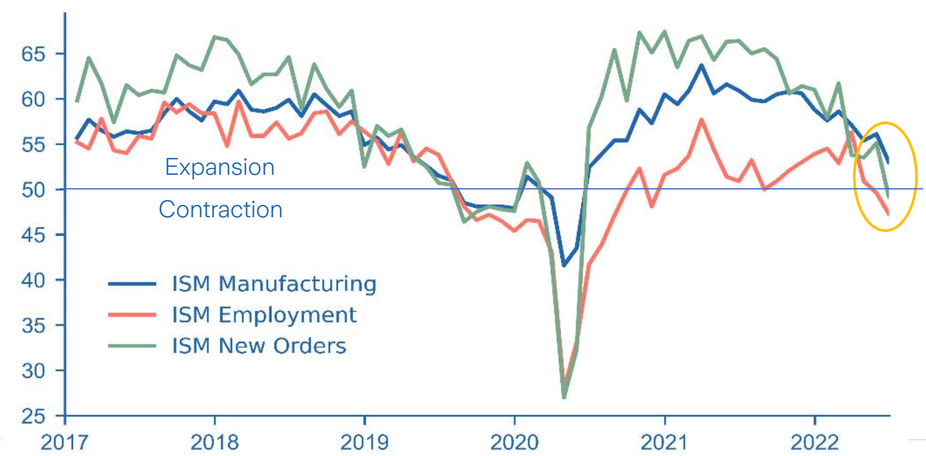
Eurozone inflation hits a further record high of 8.6% in June on rising energy costs while consumer confidence falls even further

Record low unemployment and excess savings built up during the pandemic should help support consumer spending in the face of record inflation, but these effects will not last indefinitely.

The Tankan survey and other May production data reveal that Japan's manufacturing sector continues to suffer

However, we expect a bounce back and want to highlight strong services related data.

US economic data raise the risk of recession, spooking investors



A heavy week for US data turned investor fears towards recession rather than inflation. The S&P 500 once again failed to build on the bounce the prior week, falling 2.2%, while 10yr Treasuries continued their rollercoaster ride with yields hitting 2.8% on Friday from 3.3% on Tuesday. As core PCE inflation slipped for a third consecutive month, to a still elevated 4.7%, concerns mounted around growth. Q1 GDP was revised down a tenth to -1.6% YoY annualised, but the composition surprised. Consumption, the most important element for the US economy, was reduced by 1.3 percentage points to +1.8%, with covid-affected services hit badly. Although this should prove temporary, other data are more troubling. The respected ISM Manufacturing Index showed a marked decline in June to 53 and new orders and employment plunged, with both moving into contractionary territory. Personal income and spending data were also mixed, with income growth outstripping spending, suggesting a more cautious stance by households. Consumers are certainly being squeezed with rising food and energy prices reducing discretionary spending, and the Conference Board's confidence reading fell sharply, the expectations component the worst in almost ten years. While we continue to see a US recession in 2023 risks are closing in, though actual activity levels remain decent for the time being.

Eurozone

The EC's business surveys are more resilient than the PMIs, but inflation spikes further

In the Eurozone, the European Commission's (EC) business and consumer confidence survey released last week was more resilient than the Flash PMI released the week before. Both industrial and services confidence rose, but consumer confidence fell further in June to close to the lows reached during the Covid crisis in 2020. The overall Economic Sentiment Indicator fell modestly to 104 in June from 105 in May, still consistent with a decent pace of growth in Q2. However, the PMIs are probably more useful to understand the direction of travel for the Eurozone economy, and their recent weakness still supports our view of a significant slowdown in growth in H2. Inflation continues to spike higher, up from 8.1% in May to 8.6% YoY in June, adding pressure on households real spending power while the flow of gas from Russia to Europe remains restricted. On a brighter note, unemployment continues to trend lower, moving down from 6.7% in April to 6.6% in May. This should help support consumer spending in the face of record high inflation, but will not last indefinitely.

Japan

The Tankan and other economic indicators for May reveal a mixed picture

The key message from the Tankan, the Bank of Japan's quarterly corporate survey, is that conditions in the manufacturing sector are still deteriorating in the aftermath of supply chain disruptions, while the services sector is recovering following a normalisation on the Covid front. We also want to highlight that corporate capex plans were unusually strong. Indeed, the 18.6% YoY surge in fixed asset investment plans by large corporations was the second biggest since data have become available, close to the record high marked during the bubble in the eighties of the last century. Even though plans tend to be more optimistic than the real outcome, it is encouraging. Meanwhile, industrial production plunged by a surprisingly sharp 7.2% MoM, but corporate forecasts suggest a 'V'-shaped recovery in June. May retail sales continued to grow, though with declining momentum, and the further deterioration of consumer confidence is a warning signal. The USDJPY set a new 23-year high of 137 but seems ripe for a short-term correction.

China

Asian PMIs are retreating, while China's PMIs are bouncing back

June manufacturing PMIs slightly contracted across most Asian countries but remained in expansionary territory above 50, with the exception of Taiwan, which saw a marginal deterioration to 49.8, while Malaysia's PMI improved slightly to 50.4. The most impressive move was reported in Mainland China, where the Caixin Manufacturing PMI rose 2.6 points to 51.7 and confirms that particularly smaller industrial companies in the coastal regions are experiencing a swift recovery following less restrictions on the Covid policy front and improvements in the supply chain. However, even that better than expected recovery pales to the one seen in services related industries, with the official NBS Non-Manufacturing PMI spiking nearly seven points to 54.7. The Caixin Services PMI will be released tomorrow, and we are expecting an even more spectacular recovery. It is too early to tell whether this reflects just a short-term spike or a longer lasting recovery. The recent easing in Covid controls is encouraging as quarantine periods have been shortened.

Chile

Currency depreciation complicates the outlook for the central bank

The labour market is losing momentum, with a reduction in the pace of job creation. The unemployment rate increased from 7.7% to 7.8%, while the participation rate reached 59.8%, its highest level since April 2020 but still below the pre-pandemic level of 62%. Economic activity fell 0.1% MoM in May. The mining sector increased by 5.1% MoM, but the non-mining sector showed a sharp decline of 0.9% MoM, confirming that the economy is decelerating. The commerce sector contracted by 2.3% MoM, suggesting that consumption is finally starting to normalize. The Chilean peso has continued its negative trend and was the worst-performing EM currency in June. Despite the additional inflation pressure, we do not expect the central bank to intervene in the FX market. However, further hikes in the policy rate are likely. The government announced the tax reform bill, which is expected to increase tax revenues by 4.1% of GDP in four years. The proposal includes an increase in tax rates for higher income brackets, a new wealth tax, a reduction in tax exemption, and a new mining royalty.

Covered Bonds

Technical strength to offset end of ECB purchases

Covered bonds spreads widened modestly last week but continue to outperform the rest of the credit market. Despite the end of ECB net purchases, we expect this outperformance to last during coming months as technical support should be stronger after the summer. Activity for covered bonds issuance has slowed recently and it seems the primary market is now taking a much-needed pause after the most active second quarter of the post-crisis period. YTD supply is at its highest level since 2011, well over double the amount seen during the first half of last year. Many banks are now almost done issuing their secured funding for the year, and we expect issuance to slow down in the coming months. This should boost activity in the secondary market and support covered bond spreads. Net purchases from the ECB came to an end last week but redemption reinvestments should continue with more than EUR 16bn scheduled for the next six months.

What to Watch

- Attention in the US will be on the key ISM services release after poor consumption data last week, while the all-important jobs data are expected to remain robust with unemployment stable at 3.6% and earnings easing.
- The final PMIs for Eurozone as well as various industrial sector data will be released.
- In APAC, we expect another 50bp hike in the cash rate by Australia's RBA as well as a 25bp policy rate hike by Malaysia's BNM. In Japan, our focus will be on the June Eco Watcher survey and the final outcome of the 'shunto' wage negotiations. In Australia, foreign trade data, building permits and house financing data for May will be released. Taiwan will report June export data. Various countries will publish June CPI data.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd

Investment Management
Mythenquai 2
8002 Zurich

173008049 01/22) TCL