Weekly Macro and Markets View

16 May 2022

Highlights and View

US headline inflation ticks down to 8.3% YoY while core CPI recedes to 6.2% YoY in April

While the slowdown in inflation is reassuring, underlying price pressure remains elevated. Crucially, however, households' inflation expectations remain well anchored.

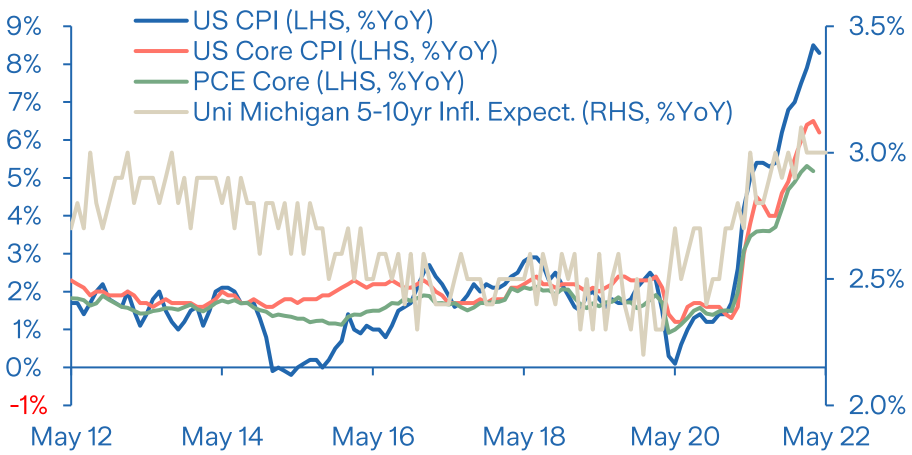
Equities remain under the cosh, with the S&P 500 down for a sixth consecutive week, the worst run since 2011

Now very oversold, signs of tentative equity buying emerged on Friday helped by stabilisation in both bonds and credit, although a sustainable rally will require a better path for inflation and rates.

Key April economic data for China plunge even more than expected

The cost of the zero-Covid policy to the Chinese economy is becoming increasingly apparent, with growth haemorrhaging and inadequate stimulus unable to mitigate the consequences.

Inflation rates show signs of peaking



Source: Bloomberg

The latest batch of price data provided a mixed picture regarding the expected path of inflation in the coming months. Both headline and core CPI inflation fell on an annual basis in April, to 8.3% and 6.2%, compared to 8.5% and 6.5% the month before. While this is reassuring, the monthly pickups were slightly above expectations, a sign that price pressure remains elevated for many components. Some relief can be found in producer prices where monthly pickups fell markedly, leading to lower annual rates for both headline and core PPI. Similarly, import prices were flat in April, helped by a stronger dollar (against consensus expectations of a 0.6% MoM rise). While overall price pressure has abated somewhat, inflation and an uncertain outlook continue to weigh on consumer sentiment with the University of Michigan's survey falling to the lowest in more than a decade. Crucially, however, households' longer-term inflation expectations have remained well anchored at the same level since February despite the surge in prices. Finally, small business optimism remained at relatively subdued levels in April. Price plans ticked down slightly, as did compensation plans, both providing more evidence that price and wage pressures are likely to soften further going forward.

China

Lockdowns take a brutal toll on growth

Another round of grim economic readings shows the massive impact that the Covid lockdowns are having on the Chinese economy, while goods demand from overseas also appears to be softening. Export growth in April plunged to 3.9% YoY from 14.7% in March, as demand for technology products shrank for the first time since Covid hit. Supply disruption likely played a part and certainly contributed to the precipitous fall in industrial production, -2.9% YoY in April from 5.0%, with auto production down a remarkable 32% YoY. With large swathes of the population under lockdown, retail sales also collapsed, falling 11.1% YoY in April, much worse than the -6.6% expected, while the fragile property sector saw new starts down 44% on last year. Given the scale and breadth of the slowdown, and the fact that we don't believe that there will be any relaxation on the principle of zero-Covid, much greater stimulus is urgently needed. While we suspect that we are currently at a maximum pain-point for the economy, the growth target of around 5.5% for this year seems to be slipping away.

Malaysia and Indonesia

GDP accelerates on improving domestic demand

In a surprise move, Bank Negara Malaysia (BNM) raised the overnight policy rate by 25bps to 2.0%, despite the earlier narrative that core inflation was still manageable. Q1 GDP was a beat at 5% growth YoY, vs expectations of 4%, lead by a revival in the services sector in tandem with increased social and leisure activities. We believe this prompted BNM to bring the rate hike schedule forward, marking the first increase since January 2018. BNM's monetary policy statement has turned slightly hawkish on the domestic economy.

Indonesia also reported a similar Q1 GDP growth of 5% as the relaxation of pandemic curbs drove a pickup in household consumption. April headline and core inflation rose to five and two-year highs respectively as the price of food and energy picked up. Given that domestic demand is back above pre-pandemic levels and inflation is approaching the upper end of BI's target range (2%-4%) expectations are for Bank Indonesia (BI) to deliver its first 25bp rate hike during the upcoming meeting on May 24.

LatAm

Positive momentum in the Brazilian economy despite high inflation and interest rates

In Brazil, recent activity data have shown resilience, surprising to the upside. Core retail sales grew 1.0% MoM in March, while the broader indicator rose 0.7% MoM. Furthermore, the service sector showed a robust and broad-based performance, growing 1.7% MoM. The highest contribution came from transportation with a surge of 2.7% MoM and information and communication, which increased by 1.6% MoM. Despite the current good economic performance, we expect the tight monetary policy and the global deceleration to start impacting economic growth in the coming quarters. Inflation surprised to the upside for a third consecutive month in April, mainly explained by food prices and transportation. Headline inflation appears widespread as most categories accelerated, reaching 12.1% YoY. Core inflation also accelerated, reaching 9.7%, its highest level since 2003. In Mexico, the central bank hiked the policy rate by 50bps to 7.0%, as expected, with one board member voting for a 75bp hike. Banxico also revised its inflation forecast to the upside for 2022.

Covered Bonds

Spreads remain supported despite broader weakness

Activity in the primary market for covered bonds remains robust as investors seek high quality assets amid the broader volatility in equity and credit markets. YTD issuance volume is now close to the whole of 2021 and nearly three times the amount raised by this time last year. Heavy issuance volumes had so far been absorbed by the market quite easily, and covered bonds spreads have outperformed other credit sectors over the past weeks. Given the rise in government yields, the covered bond universe has moved from 95% negatively yielding bonds to all bonds having a positive yield. It is reassuring to see issuers able to sell long dated tenors above 10 years with decent subscription levels, despite generally weaker risk sentiment. Supply demand technicals should benefit not only from the reinvestments of the ECB, which total EUR 20bn cash until the year end, but also a deceleration in issuance given lower funding needs and slower TLTRO repayments as the ECB raises rates. Consequently, we believe covered bond spreads should remain supported in the coming months.

Credit

Volatile yet calmer than stocks

Credit markets remained volatile last week with cash spreads underperforming derivatives and High Yield underperforming Investment Grade. Investor pessimism continued with outflows gathering further momentum and US Investment Grade credit seeing the fourth largest outflow on record and the biggest outflow since April 2020. Supply was also relatively subdued while new issue concessions remained elevated, although there are some signs of pent-up demand emerging in deal oversubscription levels. However, what has been most interesting over the last few days is that spread widening seems to be facing some resistance despite continued risk aversion in stocks. This was also the case in government bonds, where yields fell on the week while stock markets were negatively impacted by the stronger than expected US inflation print. While we think equities and credit appear oversold given our fundamental views, the tentative stabilisation in fixed income markets last week could be an early indication that sentiment has become too pessimistic.

What to Watch

- In the US, retail sales will provide insights into the current state of households while the latest batch of housing data is expected to show a softening in housing activity.
- This week will be a busy one for ECB speeches. Eurozone consumer confidence and GDP data will also released.
- In Japan, Q1 GDP will be released, where a contraction of 1.8% QoQ is expected, while CPI for April is likely to rise to 2.5% YoY at the headline level.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd

Investment Management
Mythenquai 2
8002 Zurich

173008049 01/22) TCL

ZURICH®