Weekly Macro and Markets View

7 November 2022

Highlights and View

The Fed hikes by another 75bps and hints at a higher terminal rate

Although we do expect further rate hikes, we doubt the FOMC's willingness to aggressively tighten its policy when the economy falls into recession, which we think is very likely.

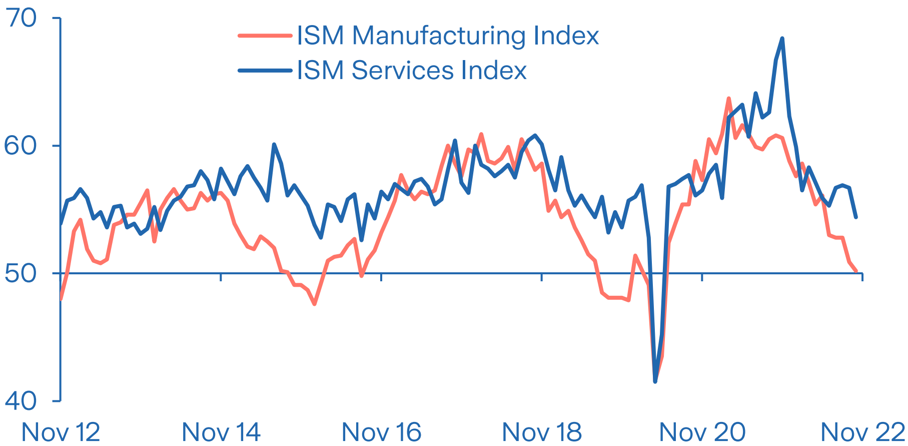
The BoE lifts the Bank Rate by 75bps to 3%, the highest level since 2008

The rate hike was not unanimous, with two members voting for smaller increases. In addition, the BoE pushed back against market expectations regarding the scale of future increases.

Global PMI data indicate slowing growth momentum in October, led by manufacturers with weakness building in Europe and Asia

Employment remains resilient despite slowing growth, with central banks likely to maintain their hawkish bias for now.

The Fed remains hawkish despite further signs of a slowdown



Source: Bloomberg

Last week brought more evidence of a broadening slowdown of the US economy. The ISM Manufacturing Index ticked down to 50.2 in October with new orders signalling continued weakness ahead. Importantly, the price component dipped further to the lowest level since May 2020 indicating that price pressure is continuing to fall rapidly. Services held up a bit better, though still weakened more than consensus expected with the employment component falling to 49.1. The slowdown is also visible in the latest batch of labour market data. Growth in new nonfarm payrolls softened from 315'000 in September to 261'000 in October. At the same time the unemployment rate rose from 3.5% to 3.7%, helped by a small drop in the participation rate. Despite the still relatively tight labour market and elevated inflation rates, wage pressure remains contained with the annual growth rate of average hourly earnings slowing to 4.7% from 5.0%, the lowest since August 2021. As was widely expected, the Fed raised its target rate by another 75bps. While Jerome Powell hinted at the possibility of a slower pace of rate hikes ahead, he also emphasized that the Fed expects the terminal rate to be higher than initially thought. While we expect further rate hikes, we doubt the Fed's willingness and ability to tighten its policy aggressively when the economy falls into a recession, which we think it will.

Markets

A bipolar performance for stocks last week as China bounces while others stumble

Another week of financial market turmoil was driven by hopes of an end to China's zero-Covid policy and dashed hopes of a US policy pivot. After a torrid year so far, the respective 6.4% and 8.7% jumps in the China CSI 300 and Hong Kong's Hang Seng showed the potential of an eventual return to freedom of movement. However, we suspect such optimism is premature and maintain that a dramatic shift in Covid policy is not likely until after the National People's Congress in the spring. Positive moves were in the minority last week for financial assets more generally. Global stocks fell 2% and the US Nasdaq was off a whopping 5.7%, despite bouncing on Friday as Fed policy took centre stage. Government bonds were also under the cosh, with the 2yr Treasury yield hitting a new cycle high of 4.8% before closing the week at 4.66%. Unfortunately, as the Fed pivot remains elusive, we see further downside ahead for stocks. The structural downtrend for global equities remains well established and we expect to see the lower bounds to be tested once more before a more lasting recovery sets in.

Eurozone

Still growing in Q3, but high inflation will weigh in Q4

The first estimate of Eurozone GDP in Q3 showed that the economy was still growing last quarter, at a pace of 0.2% QoQ (2.1% YoY). However, this is a slowdown from growth in Q2 of 0.8% QoQ (4.1% YoY) and we still think that a recession in the Eurozone began in the final quarter of this year. Indeed, the data released last week support this view as the final PMIs for some individual Eurozone countries were particularly weak. For example, Italy saw its Manufacturing PMI fall from 48.3 in September to 46.5 in October. In Germany, factory orders fell 4.0% MoM in September after a 2.0% MoM decline in August. Meanwhile, inflation continues to move higher, negatively impacting households' real spending power. Eurozone CPI inflation rose to 10.7% YoY in October, up from 9.9% in September, though driven mainly by the lagging impact of previous commodity price increases. ECB President Christine Lagarde indicated last week that the ECB intends to continue hiking interest rates given the inflation problem, even if the region is in recession.

Switzerland

The economy is resilient while the SNB suffers a big hit to its balance sheet

The mix between inflation and growth is still a good one in Switzerland, particularly when compared to the situation in the rest of Europe. The Manufacturing PMI edged lower in October, to 54.9, but is still consistent with expansion in the sector. Employment plans are holding up and supply conditions have improved further, with input prices and delivery times marking further declines. CPI inflation fell to 3% YoY in October, down from its peak of 3.5% in August, while core CPI ticked down below 2%. Large energy price hikes will likely cause inflation to reaccelerate in early 2023 but underlying price pressures remain benign. The SNB finally reported a loss of CHF 142bn for the first three quarters of 2022 as its foreign currency positions suffered heavy losses amid rising global interest rates and falling stock prices, amplified by the stronger franc. The loss, which was the biggest in history, did not come as a surprise given the SNB's large exposures and will likely reduce payouts to the federal government and cantons in 2023.

LatAm

Economic activity continues to surprise to the upside, but with a challenging outlook for 2023

In Mexico, preliminary Q3 GDP surprised to the upside, growing 1% QoQ. Both the manufacturing and service sectors were responsible for the better-than-expected results. Furthermore, the Manufacturing PMI remains above 50, while the Non-manufacturing PMI accelerated from 51.1 to 51.8 in October. In Chile, economic activity remained resilient in September, driven mainly by the service sector, growing 0.2%. Nevertheless, the economy contracted by 0.4% on an annual basis. The government announced some aspects of its pension reform plans, an intended overhaul of the current system with an estimated fiscal cost of ~1.5% of GDP. The proposal maintains the practice of private investment managers handling workers' contributions and increases the minimum pension level by 28% to ~USD 260. It also establishes an additional 6% employer contribution to create a collective saving scheme with an individual registry, which would be managed by a new public entity. The proposal will be sent to Congress this week and the discussion thereof will likely be lengthy.

Covered Bonds

Covered bonds : Further supply expected as TLTRO prepayment may spike

In a reversal of fortunes, corporate bonds bounced back last week despite weakness in stocks as well as in CDS. This was to be expected as the differential between bond spreads and CDS spreads was looking stretched. Encouragingly, US High Yield funds saw another solid set of inflows and US Investment Grade primary market oversubscription levels remained healthy. Meanwhile, covered bonds underperformed slightly and issuance was at its lowest level since August with Deutsche Bank being the sole issuer, pricing a EUR 1bn covered bond. We think that last week's ECB decision to tighten financial terms for TLTRO will remove the financial incentive for most banks to keep their current loan amount and expect early prepayments for the current EUR 2.2tn of TLTRO outstanding to start at the end of November. This should give an additional boost to covered bonds issuance as banks will switch to an alternative source of funding but also push the swap spread tighter as large amounts of collateral parked at the ECB will be released.

What to Watch

- In the US, investors will focus on the latest set of inflation data where a slowdown is expected, while the outcome of the midterm elections could also have an impact on investor sentiment.
- In Mexico, the focus will be on the monetary policy meeting, while retail sales will be published in Brazil. Inflation data will be released in several countries in LatAm, with a likely inflation deceleration in Mexico.
- October China inflation data, Taiwan exports, and Japan's Eco Watcher Survey are key data to watch. Malaysia's Q3 GDP and September Industrial Production will also be published.

Disclaimer and cautionary statement

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