Weekly Macro and Markets View

31 October 2022

Highlights and View

Rishi Sunak succeeds Liz Truss to become the next UK Prime Minister

Markets welcomed the result with longer-term gilt yields falling back to levels last seen before the announcement of Kwasi Kwarteng's mini budget.

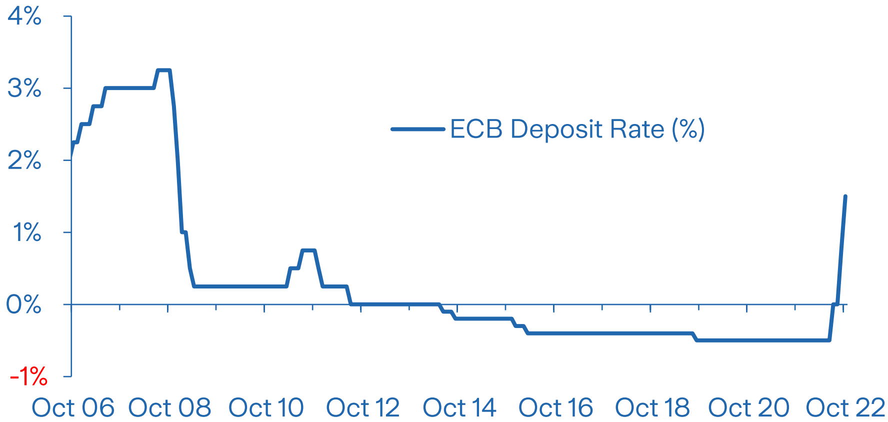
In a very tight second-round presidential election, former President Lula was elected President of Brazil with 50.9% of the vote

Lula will have to reach agreements with the centrist parties to form a governing coalition as the left and centre-left parties will only control 27% of the Lower House. A massive shift in economic policy is unlikely.

Sovereign bond yields fall from recent highs as central banks temper their hawkish positioning and hopes of a coordinated dovish pivot begin to emerge

Bond markets are set to remain volatile near term as elevated inflation will continue to be a key focus for central banks, despite a deteriorating growth outlook.

The ECB raises rates, but sounds less hawkish as recession starts



Source: Bloomberg

The ECB raised interest rates by another 75bps last week, bringing the deposit rate to 1.5%. However, the language used in the press conference and the monetary policy statement was less hawkish than at the previous meeting, suggesting a moderation in the pace or size of rate increases going forward. Instead of referring to several more rate increases to come, the statement simply said that the ECB expects 'to raise interest rates further'. The statement also mentioned that the ECB felt that with this third major policy rate increase, the ECB had 'made substantial progress in withdrawing monetary policy accommodation'. This suggests to us that the ECB will only raise interest rates by 50bps at its December meeting and could thereafter be on hold in 2023 given that the economic outlook is deteriorating.

Indeed, it is likely that the Eurozone has entered recession this quarter. The latest Flash PMI surveys showed a further deterioration with the overall Eurozone Composite PMI falling from 48.1 in September to 47.1 in October, well below the 50-mark separating expansion from contraction. Many forwarding-looking components within the survey were even weaker. For example, the Manufacturing PMI new orders sub-index fell to 37.8 in October. Admittedly, so called 'hard data' such as Eurozone retail sales and industrial production has held up better so far, but we expect this data to also weaken significantly over the next few months.

US

Falling house prices reflect impact of tighter policy

The latest Markit PMIs signal a further deterioration of the economic environment with the Composite PMI falling to 47.3 in October from 49.5 the month before. The move was mostly driven by weakness in the service sector where the PMI survey fell to 46.6. There were also more signs of a softer housing market with house prices falling by 1.3% MoM in August, the biggest monthly drop since March 2009. Although house prices are still 13% higher than a year ago this is down significantly from the peak of 21.3% seen in April this year. Falling house prices will have an impact on consumer sentiment and household spending and eventually on shelter costs and inflation. GDP rebounded in Q3, growing 2.6% at an annualised rate, though most of the rebound was driven by a narrowing trade deficit while the pace of consumer spending slowed markedly. Finally, PCE Core inflation ticked up slightly less than consensus expectations, reaching 5.1% YoY in September from 4.9% the month before with the monthly rate staying at 0.5%.

Japan

The BoJ remains on hold while the government announces a fiscal stimulus package

The Bank of Japan left all monetary policy parameters unchanged but revised up its inflation forecast for this and the following two fiscal years while cutting its growth forecast for this and next fiscal year. Meanwhile, the government announced a fiscal stimulus package totalling JPY 39tn, of which JPY 29tn is central government spending financed by a supplementary budget. The package is expected to boost GDP growth by up to 1%. A series of economic indicators have been released for September. Industrial production declined for the first time in four months, led by the auto and machinery sectors. We note that the October forecast anticipates a further decline. Retail sales picked up steam in September, though the increase was less encouraging on a real, price-adjusted basis. Consumer confidence fell slightly in October, while September housing starts rose less than expected. Japanese equities are recovering from their latest correction but have underperformed global equities in October.

LatAm

Lula is elected President in Brazil and the economic slowdown in Chile continues

In a very tight second-round presidential election, Lula was elected President of Brazil with 50.9% of the vote against incumbent President Bolsonaro's 49.1%. Lula will have to be pragmatic and reach agreements with the centrist parties to form a governing coalition. The political left in the Lower House will be around 120 seats short of the votes needed for a simple majority and only control 17% of the elected Senate. In a positive signal for markets, the fiscal anchor, a key component for fiscal credibility, will likely remain in place. The Central Bank of Brazil kept the Selic rate at 13.75%. The statement pointed out that economic growth has moderated while inflation remains high despite the recent drop. In Chile, the labour market continues to deteriorate while retail sales fell 2.2% MoM in September, confirming that private consumption is coming down. In Mexico, monthly economic activity surprised to the upside, proving not only the strength of the service sector but also the resilience of industrial production.

Credit

Corporate Bonds lag everything else

Most financial assets, including credit derivative indices, rallied last week due to hopes of more dovish central banks, but corporate bonds lagged behind. It seems likely that this is a short-term dislocation that should correct as the basis between cash credit and derivatives now appears excessive. Notably, some encouraging signs could be seen in primary markets and flows. The primary market was active in Investment Grade credit, with healthy oversubscription levels. While High Yield markets continue to see a lack of supply, spreads rallied, partly supported by strong inflows into US High Yield funds. The gloomy outlook for the European economy was visible in the ECB's lending standards survey. Lending standards tightened while demand weakened across the board, but the tightening was most pronounced for mortgage lending, where the degree of tightening exceeded that seen during the Covid crisis. We think lending standards will be a contrarian signal when they peak as European credit spreads have already widened notably.

Structured Credit

Monetary policy starts weighing on the cost of credit

The higher cost of funding for banks is now starting to impact households. Mortgages were the first credit product to take the hit from higher yields and the 30-year fixed rate has now surpassed 7% in the US, more than doubling in the last twelve months. Other consumer loans, such as credit card and auto loans, which lagged the initial impact of hawkish central banks, are now facilitating some transmission of tighter monetary policy to consumers as the latest consumer credit data from the Fed showed. The rate for credit card assessed accounts has reached an all-time high of 18.57%, although on a relative basis this increase is far more subdued than that seen in mortgages. We believe that these higher rates should, at the margin, make existing debt more difficult to refinance and push delinquencies and defaults higher, but we expect these to be manageable for banks. Most importantly, we don't expect a credit crunch such as was seen in 2008 given low unemployment. Given the cushion of wide excess spreads, ABS senior tranches should easily be able to withstand the current deterioration.

What to Watch

- In the US, all eyes will be on the Fed, which is expected to deliver another 75bp hike. In addition, the ISM surveys as well as the latest batch of labour market data are likely to show a further slowdown in economic activity.
- In the Eurozone, Q3 GDP data should show that the region grew last quarter, but we still think a recession began in Q4. Meanwhile, CPI data are likely to show inflation above 10% in October.
- In Switzerland, consumer sentiment, CPI and PMI data will reveal whether the growth and inflation outlooks remain relatively favourable.
- We expect the RBA to hike its cash rate by 'only' 25bps to 2.85% despite higher than expected inflation in Q3. Australia will also report data on house prices, retail sales, building approvals and private sector lending. Malaysia's BNM is set to hike its policy rate by 25bps to 2.75%. South Korea and the Philippines will release export data, while CPI prints will be reported across the region.

Disclaimer and cautionary statement

Zurich Insurance Company Ltd

Investment Management
Mythenquai 2
8002 Zurich

173008049 01/22) TCL