Weekly Macro and Markets View

25 July 2022

Highlights and View

The ECB raises policy rates by 50bps, thereby exiting negative interest rates

After indicating previously a 25bp hike was coming, the ECB's decision to hike by 50bps instead is justified given high inflation.

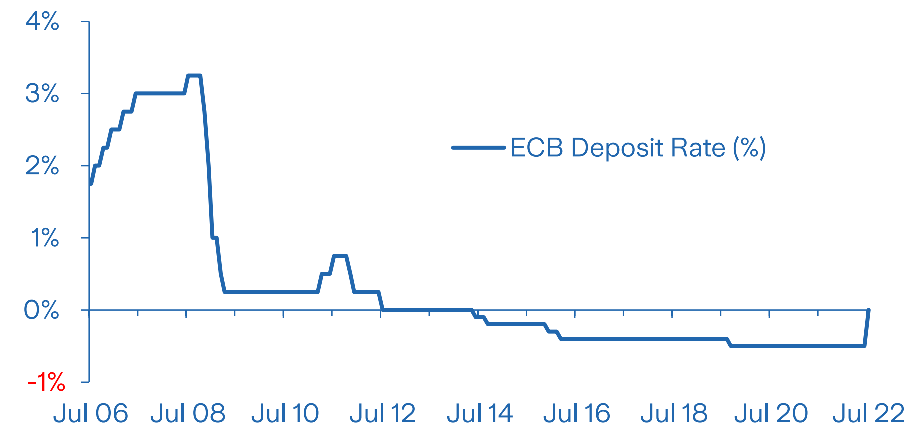
In Australia, the RBA minutes for July were more hawkish than market expectations, with a 50bp hike for August highly likely

Managing inflation risks remains a high priority for the RBA. The central bank will continue aggressively tightening monetary policy to slow domestic demand.

The S&P 500 has now recovered more than 10% from its recent low, reaching critical near-term levels

The tug of war between a softer growth outlook and reduced inflationary pressure is likely to keep investors on their toes.

The ECB exits negative interest rates



Source: Bloomberg

The ECB raised policy rates by a larger than expected 50bps last week, thereby exiting negative interest rates. We welcome this development as we have long argued that negative interest rates distort the financial system. It also gave details of its Transmission Protection Instrument (TPI) designed to contain periphery government bond spread widening. Importantly, it said the instrument would not be limited in size ex-ante, which is encouraging as it makes the TPI more credible. The announcement was timely as Italian Prime Minister Mario Draghi finally resigned last week. Elections have been called for September 25. Italian government bond spreads have widened recently and are likely to remain volatile, at least until a new coalition government is in place. However, we do not anticipate the TPI being used yet. Meanwhile, economic data in the Eurozone continue to deteriorate. The Flash Eurozone Composite PMI fell 2.6 points to 49.4 in July, with forward-looking indicators such as new orders particularly weak. Admittedly, the survey was conducted when uncertainty over the natural gas supply was acute, with the Nord Stream 1 pipeline shut. It has since been re-opened though it is running well below full capacity. Overall, the PMI survey supports our view that the Eurozone is unfortunately heading into recession, with the risk increasing that it will be later this year rather than in 2023, though a lot will depend upon how the geopolitical situation evolves.

US

A broad slowdown in activity

There were further signs of a broad-based slowdown in the economy last week with a particular focus on the housing market. The NAHB home builder market index fell by 12 points in July, the biggest drop on record except for the pandemic-induced stall in April 2020. This emphasises the amount of tightening caused by the steep rise in mortgage rates. A softer housing market was also reflected in weaker building permits, housing starts and existing home sales. The weakness was not limited to housing, however. The Philadelphia Fed's business outlook survey fell to a post-pandemic low. Meanwhile, initial jobless claims keep rising, reaching 251'000 last week, the highest level in eight months. Finally, the Markit Composite PMI dipped into contractionary territory for the first time since June 2020, falling to 47.5 in July, weighed down by weaker service activity. While activity contracted, new orders ticked up modestly and average prices charged rose at the slowest pace since March 2021, held back by greater competition and softer demand conditions.

UK

Headline inflation surges while core prices moderate further

Headline inflation accelerated to an annual rate of 9.4% in June with food and energy the major drivers. Price pressure continues to shift from goods to services as spending patterns have changed in the aftermath of the pandemic. Annual core inflation slowed the second month in a row to 5.8% from 5.9%. Going forward headline inflation will remain dominated by energy costs and Ofgem's expected price adjustment following the recent surge in electricity and natural gas prices. Core components are likely to moderate further in the coming months as the real income squeeze and a deteriorating outlook will weigh on consumer spending. In July, consumer confidence remained at the record low it reached in June with retail sales falling 0.1% MoM following a 0.8% dip in May. Despite the sobering news on inflation and consumer spending, business activity has held up relatively well in July. The Manufacturing PMI and the Services PMI fell only modestly to 52.2 and 53.3 respectively but keep signaling an expanding economy. Finally, the unemployment rate remained at 3.8% in May.

Japan

New Covid cases surge to a record high, while the Bank of Japan stays pat

The fact that the Bank of Japan did not change its monetary policy stance was well anticipated by us and the consensus. However, it is worth noting that the BoJ cut its GDP growth target for the current fiscal year by 50bps to 2.4%, while revising its forecast up slightly for the two following fiscal years. The BoJ's growth forecast is still above consensus expectations for all three years. In parallel, the BoJ shifted its inflation forecast up for this and the next two years, but, with a core CPI (excl. fresh food) forecast of 2.3% for the current year, it is only matching its 2% inflation target this fiscal year, while remaining below its target in FY 2023 and FY 2024. Meanwhile, the Manufacturing PMI fell again by half a point to 52.2 in July, with the output index even tumbling below the 50 mark to 49.5, suggesting contraction in industrial production. The Services PMI fell 2.8 points to 51.2, partially reflecting the surge in Covid infections to a record high. Indeed, new Covid cases were nearly twice as high as the previous record marked in February.

ASEAN

Food prices push up Malaysia's inflation; Bank Indonesia holds policy rate yet again

Malaysia's headline inflation spiked to 3.4%, while core inflation rose to a six-year high of 3% and food inflation recorded a new decade high of 6.1% in June. This brings H1 average headline inflation to 2.5% and core inflation to 2.2%, still well within Bank Negara Malaysia's forecast range. As a net food-importer, depreciation of MYR/USD close to a five-year low is partially responsible for the spike in food inflation. The continuous upward trend in core inflation indicates underlying price pressures from surging domestic demand. We therefore expect BNM to consider another rate hike in September. Bank Indonesia kept its policy rate at 3.5% in July, despite headline inflation breaching its 2-4% target in June. The governor stated that although the policy rate will be kept on hold, BI will strengthen market operations by selling more government bonds and raising money market interest rates. We think the aggressive rate hikes by the Fed and the ECB may further weigh on the rupiah in coming months, adding more pressure on the BI to hike.

Credit

Spreads tighten but outflows persist

Sentiment in credit markets was positive last week, in line with the tone in equities. Spreads tightened across the board and issuers took advantage of the calm to issue new debt, with US IG bond sales exceeding USD 45bn, the largest since mid-April, mostly driven by US banks. Despite these encouraging signs, fund flows didn't reverse, with both US IG and US HY funds suffering further outflows. Moreover, in US HY, while the rally helped Cornerstone Building Brands conclude its deal, other deals, such as the one funding the buyout of Citrix Systems, were postponed until after the US Labor Day holiday in the hope of better market conditions. The IG/HY spread decompression, which has been visible since April in the US market and since June in the European market, paused during last week's rally. However, we expect the decompression trend to continue as the macro and micro backdrop remains challenging, especially for low-quality HY issuers. In fact, decompression within the US HY market did not pause, with CCC-rated bonds underperforming BB- and B-rated.

What to Watch

- In the US, the Fed is expected to lift the fed funds target rate by another 75bps.
- Economic data coming out of the Eurozone will indicate the state of growth and inflation in the region.
- In APAC, the focus will be on Japan's series of June/July economic indicators published on Friday. China's NBS PMIs for July will be released on Sunday. In Australia, we will watch Q2 inflation data and June retail sales statistics. Taiwan and South Korea will publish Q2 GDP data while South Korea, Singapore and Thailand will release June industrial production statistics.
- In Mexico, GDP for Q2 will likely remain robust, while in Brazil, the focus will be on the unemployment rate and the fiscal outcome.
- *Please note that no 'Weekly' will be published next week due to Swiss National Day holidays.*

Disclaimer and cautionary statement

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