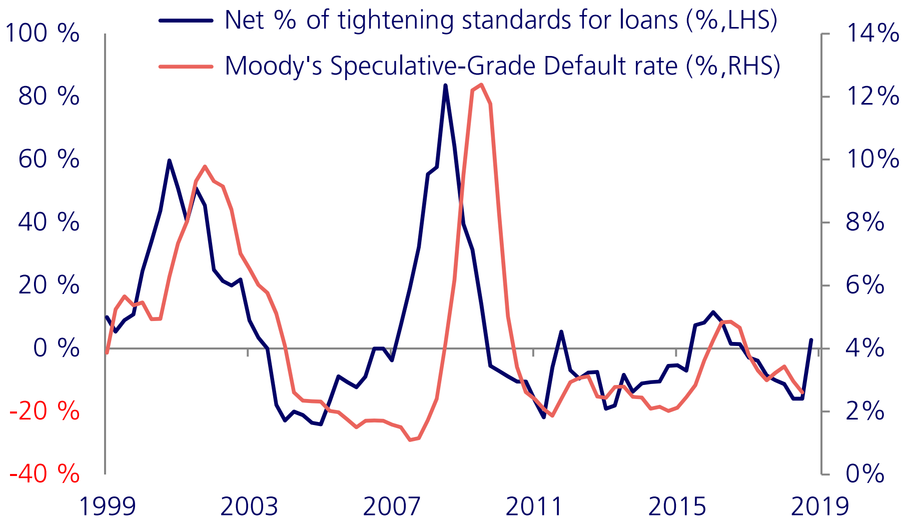
April 2, 2019

Monthly Investment Insights

Credit is the canary in the coalmine - investors watch out



Source: Moody's, US Federal Reserve

Credit markets tend to lead other markets, so much so that credit performance is often a leading indicator in many predictive models. For example, as we had highlighted during 2018, US credit spreads widened steadily throughout the year with half-hearted rallies and aggressive sell-offs, culminating with US equities selling off sharply in the closing months of the year. Similarly, at the beginning of 2019, the rally in credit was intense following the brutal sell off in December 2018. US high yield credit spreads rallied by almost 80bps in the first half of January, marking the best periodic return since 2009—which made us feel that the behaviour was different than in 2018 and that the rally was likely to have some legs. Indeed, this was followed by significant strength in equities, with Q1 2019 seeing double-digit gains for most stock indices. Given this, the critical question is: What will be the next signal from credit?

Currently, credit markets are showing strong investor demand. The recent rally in risk assets is largely driven by the dovish pivot being adopted by central banks to fend off weak growth. It seems that credit investors have largely priced in the view that this will be enough to elongate the cycle, an assessment we are somewhat sceptical of.

In our opinion, credit markets are at an important turning point and are likely to falter in the medium term. Should that happen it forebodes a dim outlook for other assets. The recent rally has taken credit markets closer to valuations that we consider to be somewhat extreme in risk/reward. As an example, the spread differential between US high yield and investment grade indices is only 100bps above the cycle lows. At the same time, the downside, e.g. if a recession were to occur, could see this spread differential widen by 500bps or even more. This is occurring with a background in which several warning signs are flashing amid fragile fundamentals. Corporate leverage is at a record level outside of a recession in our estimation, while European banks are vulnerable. The lending standards survey of loan officers by the US Fed showed tighter standards in Q4, and the chart above shows clearly how tightening standards lead default rates. Even in Europe, the lending standards are expected to tighten according to the ECB survey. Furthermore, macro-economic data continue to remain weak, and trade continues to weaken globally with central banks having to cut their economic forecasts. Credit investors seem to have moved too quickly from excessive pessimism to over-optimism and this could easily fade in coming months.

Market Assessment

Key developments

- A dovish tilt by central banks boosts investor sentiment
- It remains to be seen whether this will elongate the cycle amid recent weakness in macro and trade data
- Financial markets, especially credit and equities, seem to have moved from pricing in excessive pessimism to pricing in over-optimism

Zurich's view

Risk assets continued to rally last month, amid a dovish pivot by central banks. In its latest meeting the Fed, the world's most important central bank, downgraded its growth and inflation forecasts while also reducing the expected number of rate hikes. Even the ECB downgraded its growth forecasts and announced new long-term bank loans to replace current cheap ones. We are sceptical, however, about the efficacy of the new loans.

In the short term, the strength in equities and credit may persist for some time due to momentum and some technical levels having been breached in equities, which some market commentators view as a bullish sign. Furthermore, weak data and dovish central banks have pushed 10yr Bund yields back to negative levels for the first time since 2016. We think bonds are expensive, but lack a catalyst for an imminent sell-off.

From a medium-term perspective, however, the risk rally buoyed by central bank dovishness is ignoring the reasons behind this dovishness. Flattening yield curves, tightening lending standards and weakening data are foreboding risks to the cycle. We think the excessive pessimism of late 2018 has given way to over-optimism today.

	Key developments	Zurich's view
Global	• Global macro data fail to stabilise, led by weakness in manufacturing while services remain resilient • Inflation is benign globally, which allows central banks to respond to the slowdown in growth • Policy support should help to stabilise the global economy, but downside risk has increased	The G3 flash manufacturing PMIs were weaker than expected in March, with the Eurozone slipping further into industrial recession. Services activity, by contrast, remains resilient, helped by firm labour markets. Looking forward, it will be critical that central banks act decisively to provide a backstop to the global economy. The Fed has already shifted policy, abandoning aggressive rate hikes in an effort to stoke the slowdown. This has allowed other central banks to turn more dovish, but most central banks are still refraining from cutting rates. We maintain our view that a stabilisation in the global economy is likely, but downside risk has increased, and the outlook is once again critically dependent on policy support.
US	• The ISM Manufacturing index falls to the lowest since November 2016 • New payrolls slump to only 20'000 in February though the figure was probably distorted • The Fed surprises investors by significantly lowering the projected interest rate path	Economic data continue to deteriorate from strong levels with the Citi Economic Surprise Index falling to the lowest level since August 2017 in March. Both business and consumer sentiment indicators have receded from their high levels while manufacturing, housing and payrolls also show weakness, though the latter has probably been distorted by a number of factors. The Fed reacted to the worsening outlook by signalling no rate hikes in 2019. We welcome the Fed's dovish shift and its willingness to pause as there is no urgency to continue tightening and the risks for the economic outlook are to the downside. It remains to be seen whether the pragmatic change in policy is enough to reignite growth momentum, but the dovish pivot reduces recessionary risks.
UK	• Brexit has been postponed until mid-April as the EU agrees to an extension of Art. 50 • Economic data have been surprising to the upside though the Composite PMI signals modest growth ahead • The unemployment rate falls to the lowest level since 1975	The immediate threat of the UK leaving the EU without a deal has been staved off, but not for long. EU leaders have granted the UK additional time to decide whether to accept the current withdrawal agreement, leave without a deal or ask for a longer extension. Should the UK parliament accept the deal it has rejected twice before, the UK would have until May 22 to implement the necessary legal formalities. Sterling briefly rose to the highest level against the dollar since June 2018 as investors saw the risk of a hard Brexit reduced. Meanwhile, last week's data show little signs of the uncertain outlook. Unemployment ticked down to 3.9% in January while wage growth was only slightly weaker than the month before. Retail sales grew 0.2% MoM in February following a strong pickup in January.
Eurozone	• Manufacturing, especially in Germany, remains in the doldrums • The ECB announces a new liquidity operation and low rates for longer, but the announcements underwhelm • Eurozone equities largely look through weak data on hopes of China stimulus and a US-China trade deal	The March German manufacturing PMI fell to its lowest levels since early 2012, with both hiring intentions and new orders declining sharply, while the Eurozone manufacturing PMI was also weak. Risks are high and a stabilisation in the data may not come as early as investors currently seem to expect. Any more negative news risks catalysing a feedback loop between weakness in the manufacturing sector and the rest of the economy through less hiring and investment. The ECB announced that it did not intend to raise rates at all this year and that it would begin a new round of liquidity operations for banks instead. However, markets had already priced out the chance of a rate increase this year, and the new liquidity operations (TLTRO3) may not be as generous as the current one.
Switzerland	• Manufacturing and export activity is resilient, despite a sharp slowdown in the Eurozone • Inflation will remain weak, tracking well below target for the foreseeable future • The SNB is expected to leave rates on hold at least until 2021, while remaining active in the forex market	The SNB left policy unchanged in the March meeting. The inflation projection was cut and inflation is now projected to track far below target throughout the forecast horizon. This confirms our view that the SNB is unlikely to move ahead of the ECB and we expect rates to be on hold at least until 2021. Macro data are decent, with both the manufacturing PMI and exports indicating that growth held up well in February, and the labour market is firm, which will support sentiment. While some weakness in the Eurozone should spill over to Switzerland, we maintain our view that the economy should continue to expand in 2019. Bond yields have fallen sharply into deeply negative territory. We suspect the latest move is overdone, but Swiss yields will remain very low for a long time.

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Japan	• Japan's manufacturing sector is suffering from weaker global demand, particularly from China • Land prices keep rising, with strong momentum in metropolitan areas and in the commercial segment • Japanese equities keep trending lower vs. global equities	Japan's economic growth momentum slowed significantly in Q1, and by a faster pace than we had envisaged. The deterioration of conditions in the manufacturing sector is the driving force, while the non-manufacturing sector remains more resilient. Major components of the manufacturing PMIs and the Reuters Tankan for March continue to creep lower. Meanwhile, the Bank of Japan sticks to its loose monetary policy, while the JGB 10yr yield has fallen back below zero for the first time since 2016. Equities have meandered, but have recently taken a beating on strong foreign selling. On a positive note, land prices were up 1.2% YoY last year, with central Tokyo prices up 8.4%, while local area land prices lagged with a rise of 0.4%, the first rise since the late eighties.
China	• Growth momentum continues to deteriorate, with a recovery expected in H2 • Financing conditions for private small firms seem to be improving • Chinese equities have rallied, but a pause looks likely	As we had anticipated, growth momentum continues to deteriorate, particularly in the manufacturing sector. Combined data for January/February have been particularly disappointing for industrial production as well as manufacturing and infrastructure fixed investment. Real estate related data have been mixed. Retail sales, particularly auto sales, remain lacklustre, with growth now at a fifteen-year low. We maintain our outlook for a modest recovery in economic activity in the second half of the year. There are some early indications that small business confidence is starting to improve, following support by the government. Tax and fee reductions, as announced at the National People's Congress, will take effect on April 1 and May 1 and should induce a consumption recovery.
Australia	• Falling house prices have a negative impact on building approvals and the construction sector • The labour market remains strong, while wage growth is moderate and inflation below target • The RBA is expected to shift towards a dovish tilt, while fiscal policy will become more expansionary	Australia's economy is mired between a strong labour market, a mixed investment outlook and a weak housing market. House prices continue to fall, hitting the construction sector and building permits. We suspect that at some point consumer sentiment will be affected negatively, which would shift the RBA's neutral tilt towards dovish, with one policy rate cut likely. It appears unlikely that core inflation will move towards the middle of the RBA's inflation target anytime soon, which also argues for a rate cut. We expect a substantial fiscal boost in the budget, which will be announced on April 2. Australian equities meandered last month both on an absolute and relative basis.

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