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Summary

The global economy is entering another manufacturing-led cyclical slowdown. These slowdowns are regular events triggered by shocks to final demand. They lead to temporary slowdowns in production and hiring as companies adjust their production levels to bring excess inventories back to levels consistent with observed demand. We do not think this inventory cycle will change the broader global macroeconomic backdrop, which remains one of weak demand in the HIDCs (Heavily Indebted Developed Countries). So far the effect of the slowdown in manufacturing on HIDC equity markets has been modest, partly because of expectations of further support from monetary authorities and partly due to the absence of clear and present tail risks. While fixed income tends to perform strongly during manufacturing downturns these events also provide good value opportunities to scale into currency and equity positions, in our view.

Global

The recent rush of weaker US and European data continued in the past week. Notable disappointments relative to expectations in the US included ADP private payrolls, softer Markit PMI mom, big drops in Chicago, Kansas, Milwaukee, and Dallas manufacturing surveys, and softness in the employment and construction components of ISM. The Fed yesterday responded to the recent disappointments by maintaining the current elevated rate of bond purchases (Quantitative Easing). This is likely to continue until the Fed sees material improvements in the labour market and signs of rising inflation. So far, unemployment rates have been trending down mainly due to lower participation rates, while inflation has in the wrong direction, namely down. The core personal consumption expenditure price index, which is favoured by the Fed over CPI, is now just 1.1%, down from 1.9% in early 2012.

In Japan, Industrial Production slowed significantly (0.2% versus 0.4% expected and 0.6% last), while retail sales and construction spending were also soft.

In Europe, Germany's economy in particular has shown recent weakness, though this morning's PMI print was stronger than expected. The EUR has appreciated (as unrealistic hopes of a strong US growth performance, which had been priced into the US dollar are being squeezed out). Both these factors have fed expectations that the ECB may now cut rates by 25bps to 50bps. In Southern Europe, however, the news is now relatively less discouraging. In Italy, Enrico Letta formed a government. Portugal had strong Industrial Production data. Spain recorded stronger housing numbers, while GDP was in line with expectations.

Still, against the broader backdrop of weaker cyclical indicators, commodities dropped 1.4% over the past week, though this aggregate decline masked both strong rises in precious metals and soft commodities and declines in the more cyclically sensitive sectors, such as oil (-1.7%), gasoil (-2%), aluminium (-3.8%), and copper (-2.6%). S&P500 dropped 13bps and Nikkei fell 1.1%, while VIX rose 6.4%. US 10 year treasury bonds rallied to 1.64% yield, while 10 year Italy rallied 19bps to reach 3.87% yield. EURUSD rallied 1.1%, while USDJPY dropped more than 2%.

Emerging Market currencies performed strongly with a 41bps rally across the main crosses. Emerging Markets stocks rose 1.2%, while dollar denominated sovereign credit rallied 69bps and corporates rallied 48bps.

Latin America

Mexico: Mexico's central bank left rates unchanged at 4%, but central bank governor Agustin Carstens hinted that the central bank could cut rates again if inflation drops below 4% in H2 2013. Mexico also recorded a much stronger than expected trade surplus. Tensions between government and opposition groups intensified in Venezuela following a recent disputed election.

Colombia: Colombia's central bank left rates unchanged at 3.25% and stepped back from announcing further measures to stem currency appreciation pressures.

Argentina: Argentina's parallel exchange rate widened to 9.43 pesos per dollar, a new low.

Brazil: Brazilian IGP-M inflation came at just +0.15%, the low end of expectations, while President Dilma Rousseff re-stated her commitment to keeping inflation under control.

Continued overleaf

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Asia

India: India's government reduced taxes significantly for foreign investors in the domestic bond market against the backdrop of announcements of major new FDI flows to the country.

China: The official fix for CNY, China's currency, reached a new strong point against the dollar at 6.2082. China's two main manufacturing indices (official and HSBC) both came broadly in line with expectations in April. Both pointed to a slower rate of expansion than last month, consistent with softer manufacturing prints elsewhere.

South Korea: South Korean inflation was softer than expected (-0.1% vs 0.2% expected), while exports were twice as strong as anticipated (0.4% vs 0.2% expected). Despite softer Industrial Production, Q1 GDP was much stronger than expected at 0.9% qoq. The trade balance in Indonesia strengthened following lower than expected imports, but S&P, the ratings agency, revised the outlook to stable from positive. April's PMI rose marginally to 51.7 from 51.3 in March.

Philippines: Government debt was raised to investment grade by S&P, and the central bank cut the Special Deposit Account rate by 50bps to 2%.

Singapore: Industrial Production rose 6% mom in April.

Eastern Europe, Africa, and Middle East

Slovenia: The government abandoned an attempt to issue bonds following a downgrade of the sovereign by a ratings agency. The difference in ratings by S&P and Moody's is now 4 notches. Turkey's trade deficit widened to $7.4bn versus $8.3bn expected, while PMI slowed to 51.3 in April from 52.3 in March.

Hungary: PMI declined to 51.7 in April as the central bank disclosed further details about new measures under consideration to support small and medium sized enterprises.

South Africa: South Africa's trade balance was significantly stronger than expected at -$7.7bn versus -$8.5bn expected.

Ukraine: The government submitted a bill to the parliament to allow privatisation of Naftogaz, the national gas company. Serbia's central bank allegedly bought EURs to stem appreciation of the Serbian Dinar. Russia changed the rules for the reserve fund in the face of falling oil prices, which means that the reserve fund will accumulate less revenue, but also that the government will issue less debt.

Czech Republic: PMI rose from 49.1 in March to 49.5 in April.

Russia: PMI softened marginally from 50.8 in March to 50.6 in April.

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