Situation Room

A tale of two 100-year bonds

Credit Analysis

12 August 2019

- **We published the latest Credit Market Strategist on Friday. Click Libor vs. Renminbi or see inside for the key bullets.**

- **A tale of two 100-year bonds**. Slightly less than two years ago the Republic of Austria issued a 2.1% 100-year bond at EUR 99.502. These were then re-opened in June at a price of roughly EUR 155 and a yield of about 1.15%. Today they closed at EUR 189.92, up EUR 2.29 from Friday, for a yield of 0.78%. The duration of these bonds is currently about 56. That highlights the collapse in global yields, which continued today on recession risk arising from the US-China trade war as well as geopolitical risks associated with the developments in Hong Kong. A bit more than two years ago the Republic of Argentina also issued a 7.125% 100-year bond at USD 90. Today they dropped $18.45 to close at $56.38 as Alberto Fernandez won the Argentine primary elections by a much wider margin than predicted (see: Unexpected Argentina election result: investors should brace for impact). Bond spreads exceeds 1,000bps and with single-B ratings, and a somewhat idiosyncratic story, there should be very little overlap with the US IG corporate bond investor base and thus limited contagion risk. In contrast the investor base in the Austrian 100-year should be strongly incentivized to increase exposure to the global IG corporate bond market. – *Hans Mikkelsen*

- **USD>EUR**. With a lack of yield outside the US, and the potential for ECB QE, technicals in the Eurozone bond market have been even stronger than in the US. As a result same-issuer spreads are now notably more attractive in dollars compared to Euros on a fully FX hedged basis. For European issuers dollar spreads are now at the wide end of the historical range compared with euros, while US issuer dollar bond spreads have reached the widest levels to euros since January 2015. That means more demand for USD credit on relative value, and less supply as issuance in EURs is cheaper (US companies in the form of fully-hedged reverse Yankee). – *Yuri Seliger*

- **Daily supply update**. USD IG new issuance continues to be heavy following a $42.9bn week last week, pricing $11.1bn across 9 deals today – including $6.8bn partially going to refinance CP and/or short-term debt. The average new issue concession hovers around 9.5bps today, similar to 9.9bps last week, while the average break performance weakened to 2.4bps tighter today from 4.7bps tighter last week. Note that dealer inventories increased by about $1.5bn today. US equities declined 1.23%, 10-year Treasury yields rallied 9.8bps while CDX IG widened 2.50bps today partially due to overnight developments in Hong Kong. Add heavy supply volumes on top of a weak macro backdrop, liquid secondaries also widened with US banks 2-6bps wider, TMT unchanged to 5bps wider, consumer retail 2bps tighter to 5bps wider, health care 2-6bps wider, and energy 3-6bps wider on the day. – *Yunyi Zhang*

- **Daily foreign demand tracker**. – *Yuri Seliger, Yunyi Zhang*

- **Other reports include:** 1) Week 5 Earnings: EPS beats, but trade war hurting capex, margins, 2) Tighter China financial condition in July underscores the need for further easing, 3) Federal budget deficit higher than expected in July.

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Research Overview — The Situation

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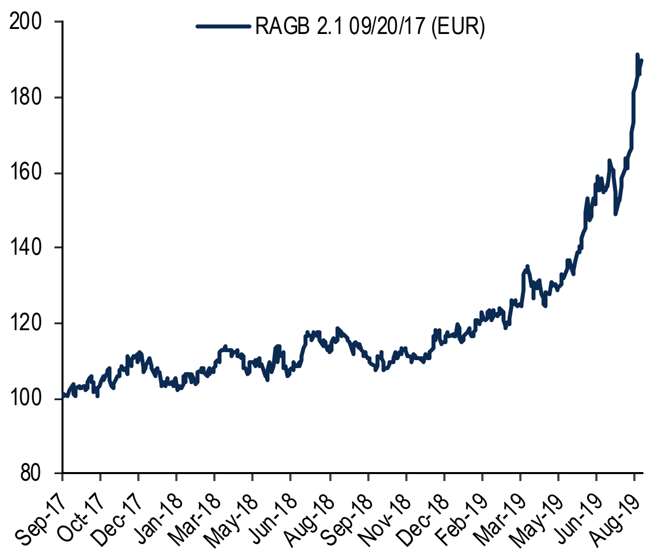
A tale of two 100-year bonds

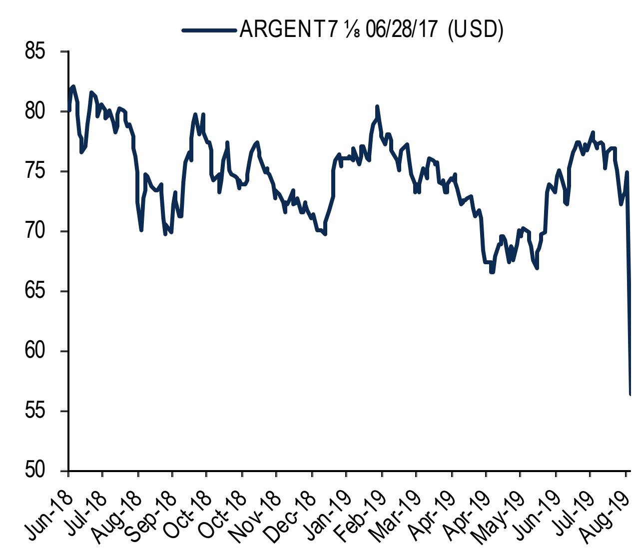
Slightly less than two years ago the Republic of Austria issued a 2.1% 100-year bond at EUR 99.502. These were then re-opened in June at a price of roughly EUR 155 and a yield of about 1.15%. Today they closed at EUR 189.92, up EUR 2.29 from Friday, for a yield of 0.78% (Figure 1). The duration of these bonds is currently about 56. That highlights the collapse in global yields, which continued today on recession risk arising from the US-China trade war as well as geopolitical risks associated with the developments in Hong Kong. A bit more than two years ago the Republic of Argentina also issued a 7.125% 100-year bond at USD 90. Today they dropped $18.45 to close at $56.38 as Alberto Fernandez won the Argentine primary elections by a much wider margin than predicted (see: [Unexpected Argentina election result: investors should brace for impact 12 August 2019]). Bond spreads exceeds 1,000bps and with single-B ratings, and a somewhat idiosyncratic story, there should be very little overlap with the US IG corporate bond investor base and thus limited contagion risk. In contrast the investor base in the Austrian 100-year should be strongly incentivized to increase exposure to the global IG corporate bond market.

Figure 1: Austria 100-year



Source: Bloomberg

Figure 2: Argentina 100-year



Source: Bloomberg

Credit Strategy

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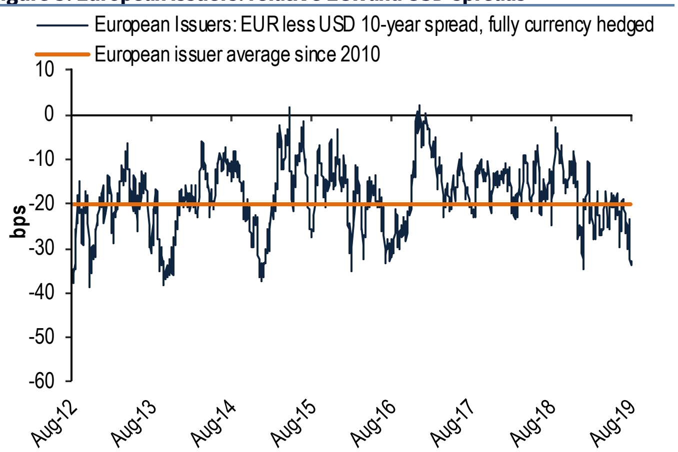
USD>EUR

With a lack of yield outside the US, and the potential for ECB QE, technicals in the Eurozone bond market have been even stronger than in the US. As a result same-issuer spreads are now notably more attractive in dollars compared to Euros on a fully FX hedged basis. For European issuers dollar spreads are now at the wide end of the historical range compared with euros (Figure 3), while US issuer dollar bond spreads have reached the widest levels to euros since January 2015 (Figure 4). That means more demand for USD credit on relative value, and less supply as issuance in EURs is cheaper (US companies in the form of fully-hedged reverse Yankee).

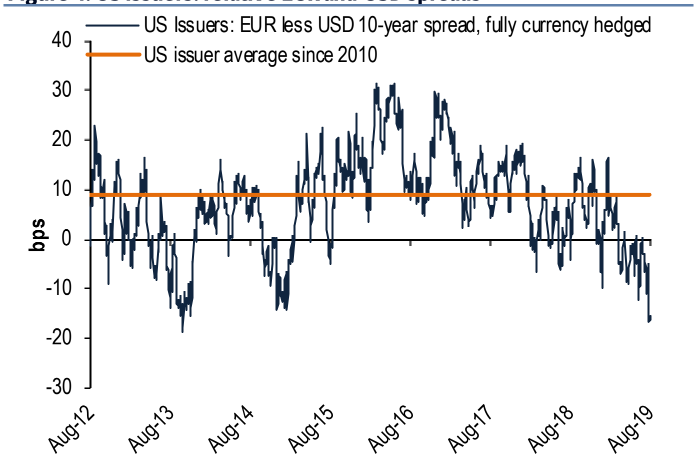
Note that the majority of investors do not fully hedge to maturity, but instead roll short-dated FX forwards. However, issuers without significant business exposure to Europe do tend to fully hedge currency risk in reverse Yankee.

Figure 3: European issuers: relative EUR and USD spreads



Note: the chart plots issuer-matched spreads on a fully currency hedged basis. We use maturity matched cross currency basis swaps to fully currency hedge principal and interest rate payments, and forward FX rates to fully hedge the stream of spread payments. We also adjust for the difference in quoting conventions with a 3 to 6M Euribor swap.
Source: BofA Merrill Lynch Global Research, Bloomberg, ICE Data Indices, LLC

Figure 4: US issuers: relative EUR and USD spreads



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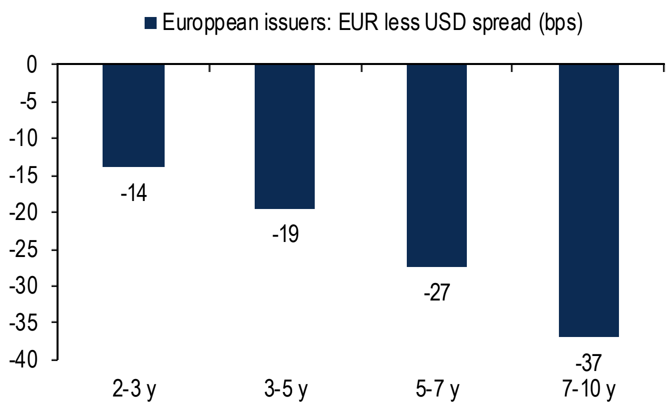
Source: BofA Merrill Lynch Global Research, Bloomberg, ICE Data Indices, LLC

Screening for cross-currency relative value

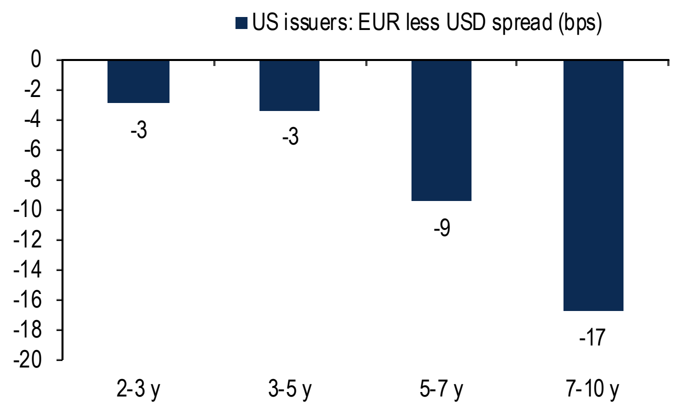
On average USD spreads trade wide to their EUR counterparts on a fully FX hedged basis across the maturity curve, but more so for longer maturities (Figure 5, Figure 6). At the sector level Utilities, Media and Telecom offer the most value to investors in USD relative to EUR (Figure 7). Finally, in Figure 8 and Figure 9 below we highlight bonds trading the at the widest levels in USD relative to a comparable EUR bond for European and US issuers, respectively.

Figure 5: Relative EUR and USD spreads by maturity: European issuers



Note: based on FX hedged spreads, issuer-matched bonds with at most 1yr difference in maturity. We use maturity matched cross currency basis swaps to fully currency hedge principal and interest rate payments, and forward FX rates to fully hedge the stream of spread payments. We also adjust for the difference in quoting conventions with a 3 to 6M Euribor swap.
Source: BofA Merrill Lynch Global Research

Figure 6: Relative EUR and USD spreads by maturity: US issuers



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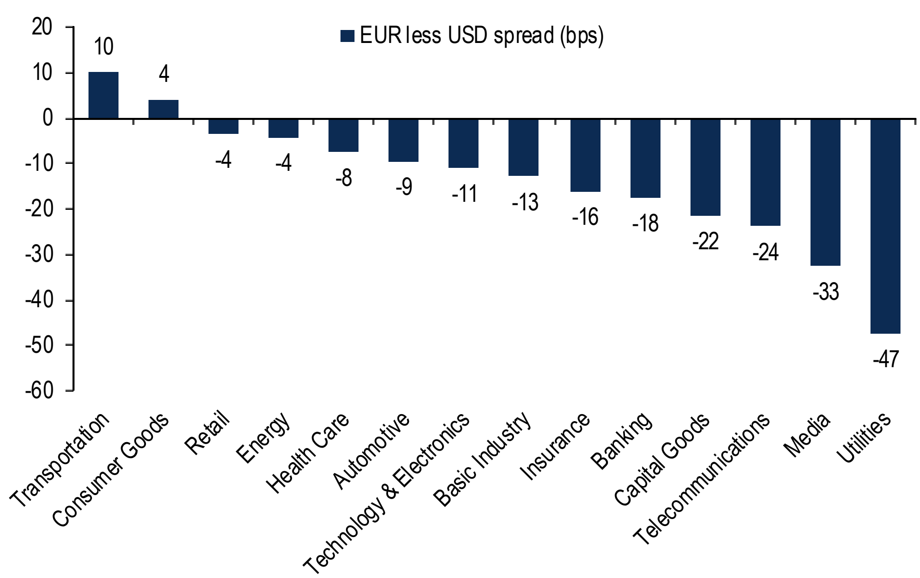
Source: BofA Merrill Lynch Global Research

Figure 7: Relative EUR and USD spreads by Sector



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Source: BofA Merrill Lynch Global Research

Figure 8: Bonds trading the widest in USD vs. EUR: European issuers

Bond			Libor spread (bps)			
USD	EUR	Sector	USD	EUR	EUR spread, FX hedged	EUR less USD, FX hedged
ABIBB 4.7 02/01/36	ABIBB 2 3/4 03/17/36	Food, Bev , & Bottling	179	88	131	-48
BACR 4.61 02/15/23	BACR 1 1/2 04/01/22	Banks/Brokers	161	75	105	-56
BAYNGR 4 1/4 12/15/25	BAYNGR 1 1/2 06/26/26	Basic Materials	159	73	111	-48
BNP 4.705 01/10/25	BNP 1 1/8 11/22/23	Banks/Brokers	129	52	84	-45
BNP 3 3/8 01/09/25	BNP 1 1/8 08/28/24	Banks/Brokers	135	54	88	-47
BNP 3 1/2 11/16/27	BNP 1 1/2 05/23/28	Banks/Brokers	144	58	97	-47
BNP 5.198 01/10/30	BNP 1 3/8 05/28/29	Banks/Brokers	162	69	110	-52

Figure 8: Bonds trading the widest in USD vs. EUR: European issuers

Bond			Libor spread (bps)			
DAIGR 8 1/2 01/18/31	DAIGR 2 02/27/31	Automobiles	164	79	121	-43
DB 3.7 05/30/24	DB 1 1/8 03/17/25	Banks/Brokers	232	148	189	-43
DT 3.6 01/19/27	DT 1 1/8 05/22/26	Telecom	134	39	74	-60
DT 4 3/8 06/21/28	DT 1 1/2 04/03/28	Telecom	139	47	85	-54
DT 8 1/4 06/15/30	DT 2 12/01/29	Telecom	181	60	100	-81
EDF 5.6 01/27/40	EDF 4 1/2 11/12/40	Utilities	208	111	158	-50
ENELIM 4 1/4 09/14/23	ENELIM 5 1/4 05/20/24	Utilities	133	43	76	-57
ENELIM 4 5/8 09/14/25	ENELIM 1 1/2 07/21/25	Utilities	164	49	83	-81
ENELIM 3 5/8 05/25/27	ENELIM 1 1/8 09/16/26	Utilities	187	56	93	-94
ENIIM 4 1/4 05/09/29	ENIIM 3 5/8 01/29/29	Energy	168	71	112	-56
HSBC 4.041 03/13/28	HSBC 2 1/2 03/15/27	Banks/Brokers	160	62	100	-60
ISPIM 3 1/8 07/14/22	ISPIM 1 1/8 03/04/22	Banks/Brokers	169	75	105	-64
NESNVX 3.9 09/24/38	NESNVX 1 3/4 11/02/37	Food, Bev , & Bottling	117	29	61	-56
NWIDE 3.9 07/21/25	NWIDE 1 1/4 03/03/25	Banks/Brokers	123	45	79	-44
ORAFP 8 1/2 03/01/31	ORAFP 1 7/8 09/12/30	Telecom	176	57	97	-79
SOCGEN 4 3/4 09/14/28	SOCGEN 1 3/8 01/13/28	Banks/Brokers	164	79	120	-44
TELEFO 4.103 03/08/27	TELEFO 1.447 01/22/27	Telecom	143	60	97	-46
TELEFO 8 1/4 09/15/30	TELEFO 2.932 10/17/29	Telecom	175	74	116	-59
UCGIM 4 5/8 04/12/27	UCGIM 2 1/8 10/24/26	Banks/Brokers	263	124	167	-96
WPPLN 3 3/4 09/19/24	WPPLN 3 11/20/23	Media & Entertainment	142	40	72	-70

Note: based on FX hedged spreads, issuer-matched bonds with at most 1yr difference in maturity. We use maturity matched cross currency basis swaps to fully currency hedge principal and interest rate payments, and forward FX rates to fully hedge the stream of spread payments. We also adjust for the difference in quoting conventions with a 3 to 6M Euribor swap.
Source: BofA Merrill Lynch Global Research

Figure 9: Bonds trading the widest in USD vs. EUR: US issuers

Bond			Libor spread (bps)			
USD	EUR	Sector	USD	EUR	EUR spread, FX hedged	EUR less USD, FX hedged
AAPL 2.9 09/12/27	AAPL 2 09/17/27	Technology	84	21	56	-28
ABBV 4 1/4 11/14/28	ABBV 2 1/8 11/17/28	Health Care	174	81	122	-52
AMGN 3 1/8 05/01/25	AMGN 2 02/25/26	Health Care	98	41	76	-22
BAC 3.366 01/23/26	BAC 1 3/8 03/26/25	Banks/Brokers	99	39	72	-27
C 3.52 10/27/28	C 1 5/8 03/21/28	Banks/Brokers	128	65	104	-24
EMN 3.6 08/15/22	EMN 1 1/2 05/26/23	Basic Materials	105	34	64	-41
GE 4.65 10/17/21	GE 0.8 01/21/22	Industrial Products	92	39	68	-24
GE 3 3/8 03/11/24	GE 1 1/4 05/26/23	Industrial Products	119	66	98	-21
GE 6.15 08/07/37	GE 2 1/8 05/17/37	Industrial Products	272	188	250	-22
GM 4.15 06/19/23	GM 0.955 09/07/23	Automobiles	154	94	128	-26
GS 2.905 07/24/23	GS 1 3/8 07/26/22	Banks/Brokers	93	37	66	-27
IBM 3.3 05/15/26	IBM 1 1/4 01/29/27	Technology	105	47	84	-21
IBM 3 1/2 05/15/29	IBM 1 1/2 05/23/29	Technology	114	46	84	-30
JNJ 3.55 03/01/36	JNJ 1.65 05/20/35	Health Care	119	28	61	-58
JPM 3.96 01/29/27	JPM 3 02/19/26	Banks/Brokers	108	45	80	-28
JPM 2.95 10/01/26	JPM 1 1/2 10/29/26	Banks/Brokers	105	43	79	-26
JPM 4.005 04/23/29	JPM 2 7/8 05/24/28	Banks/Brokers	116	45	82	-34
JPM 4.203 07/23/29	JPM 1.812 06/12/29	Banks/Brokers	121	61	100	-21
MO 4.4 02/14/26	MO 1.7 06/15/25	Tobacco	163	96	134	-29
T 3.8 03/01/24	T 1.3 09/05/23	Telecom	96	43	74	-22
T 3.6 07/15/25	T 3 1/2 12/17/25	Telecom	122	54	89	-33
T 4.35 03/01/29	T 2.35 09/05/29	Telecom	158	82	125	-33
T 4.3 02/15/30	T 2.6 12/17/29	Telecom	165	90	134	-31
WFC 3 10/23/26	WFC 1 3/8 10/26/26	Banks/Brokers	114	53	90	-24
WFC 3.584 05/22/28	WFC 1 02/02/27	Banks/Brokers	118	56	93	-25

Note: based on FX hedged spreads, issuer-matched bonds with at most 1yr difference in maturity. We use maturity matched cross currency basis swaps to fully currency hedge principal and interest rate payments, and forward FX rates to fully hedge the stream of spread payments. We also adjust for the difference in quoting conventions with a 3 to 6M Euribor swap.
Source: BofA Merrill Lynch Global Research

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Daily supply update

USD IG new issuance continues to be heavy following a $42.9bn week last week, pricing $11.1bn across 9 deals today – including $6.8bn partially going to refinance CP and/or short-term debt (Figure 10). The average new issue concession hovers around 9.5bps today, similar to 9.9bps last week, while the average break performance weakened to 2.4bps tighter today from 4.7bps tighter last week. Note that dealer inventories increased by about $1.5bn today. US equities declined 1.23%, 10-year Treasury yields rallied 9.8bps while CDX IG widened 2.50bps today partially due to overnight developments in Hong Kong. Add heavy supply volumes on top of a weak macro backdrop, liquid secondaries also widened with US banks 2-6bps wider, TMT unchanged to 5bps wider, consumer retail 2bps tighter to 5bps wider, health care 2-6bps wider, and energy 3-6bps wider on the day.

Figure 10: Recent new issue pricing and new issue concessions

Date	Ticker	Name	Tenor	Size ($mm)	Moody's/S&P Rating	Coupon (%)	Px Spread (bps)	New Issue Conc. (bps)	* Break performance	Current spread (bps)
2019-08-12	CNP	CenterPoint Energy Inc	5	$500	Baa2/BBB	2.5	105	14	-3	102
2019-08-12	CNP	CenterPoint Energy Inc	11	$400	Baa2/BBB	2.95	135	1	-2	133
2019-08-12	CNP	CenterPoint Energy Inc	30	$300	Baa2/BBB	3.7	163	n.a.	-1	162
2019-08-12	DAIGR	Daimler Finance North America LLC	3	$1,500	A2/A	FRN	3mL+90	n.a.	n.a.	n.a.
2019-08-12	DAIGR	Daimler Finance North America LLC	3	$1,250	A2/A	2.55	105	n.a.	-2	103
2019-08-12	DAIGR	Daimler Finance North America LLC	5	$750	A2/A	2.7	125	n.a.	-3	122
2019-08-12	DAIGR	Daimler Finance North America LLC	10	$500	A2/A	3.1	150	29	-6	144
2019-08-12	DUK	Duke Energy Carolinas LLC	10	$450	Aa2/A	2.45	82	6	n.a.	n.a.
2019-08-12	DUK	Duke Energy Carolinas LLC	30	$350	Aa2/A	3.2	110	2	-2	108
2019-08-12	EVRG	Westar Energy Inc	30	$300	A2/A	3.25	117	13	n.a.	n.a.
2019-08-12	LNC	Lincoln National Corp	10	$500	Baa1/A-	3.05	142	8	n.a.	n.a.
2019-08-12	OKE	ONEOK Inc	5	$500	Baa3/BBB	2.75	130	10	n.a.	n.a.
2019-08-12	OKE	ONEOK Inc	10	$750	Baa3/BBB	3.4	180	14	n.a.	n.a.
2019-08-12	OKE	ONEOK Inc	30	$750	Baa3/BBB	4.45	235	12	n.a.	n.a.
2019-08-12	PNW	Arizona Public Service Co	10	$300	A2/A-	2.6	98	4	n.a.	n.a.
2019-08-12	SHW	Sherwin-Williams Co/The	10	$800	Baa3/BBB	2.95	135	-1	+1	136
2019-08-12	SHW	Sherwin-Williams Co/The	30	$550	Baa3/BBB	3.8	170	7	+1	171
2019-08-12	VTR	Ventas Realty LP	10	$650	Baa1/BBB+	3	140	14	n.a.	n.a.

* We define the break performance as the difference between the new issue spread and the initial secondary market spread on the first day of trading.
Source: BofA Merrill Lynch Global Research

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Previously published here
Credit Market Strategist: Libor vs. Renminbi 09 August 2019

Credit Market Strategist: Libor vs. Renminbi

- **Libor vs. Renminbi**. Corporate credit spreads continue to be driven by the two big longer term stories: 1) monetary policy easing (lower Libor) asserts tightening pressure while 2) US-China trade dispute (weaker CNY) adds widening pressure. Of course these two are interrelated but the former creates very favorable technicals for US IG credit and the latter increases uncertainties that weigh on economic growth and raises recession risk. While we continue to think the interplay and tradeoffs between these two are consistent with meaningful spread tightening for US IG, obviously US HY would be better off in an environment of higher growth and less monetary policy accommodation. This because the proportion of credit spreads compensating for default losses is much higher than in IG. Hence the recent outperformance of IG over HY on a risk-adjusted basis.

- **You're gonna need a bigger allocation to corporates**. This week showed that sometimes there is just too much volatility for IG - particularly on Wednesday the ranges for interest rates and credit spreads were very wide. We continue to expect that a wall on money (foreign as well as domestic moving out the curve) will flow into the US IG corporate bond market. However, current elevated volatility levels, especially on the rates side, slow/delay that process. But the fact that IG credit has outperformed and is currently about 17bps rich to equity and rates vol suggests these flows are already having an influence. Despite relative richness we consider current spread levels an attractive buying opportunity. Fool me once, fool me twice. IG credit investors should increasingly discount rates and equity vol related to the US-China trade dispute.

- **Trade vs. Brexit**. For US IG credit up until this point the situation reminds us a lot about the aftermath of the UK's Brexit vote in the summer of 2016. We count 19 macro selloffs over the past decade with a median IG spread widening of 19% and 28 business days to reach the wides. The Brexit episode was comparatively shallow and short lived, as following the no vote IG spreads reached peak widening of +10bps in two business days and subsequently retraced all of that in 11 days. US IG fixed income currently pays 90% (vs. 83% max post Brexit) of all global IG yield. We suggest there will be a time where things stabilize a bit and a big fight for US corporate bonds ensues because there are few other places to go.

- **July Senior Loan Officer Survey: still easing standards**.

- **Preliminary 2Q HG fundamentals**. Gross leverage for US non-Financial non-Utility IG issuers increased to 2.61x in 2Q from 2.54x in 1Q-19.

- **It's different this time**. The IG index spread widening since last Thursday on the back of escalating trade tensions led to an outsized increase in issuer spread dispersion - unlike in other recent selloffs.

- **Fund flows: Outflows from bonds and stocks**. $1.86bn IG fund/ETF inflow.

- **Supply: Supply to remain heavy**. $41.3bn this week. Expect $30-40bn next week.

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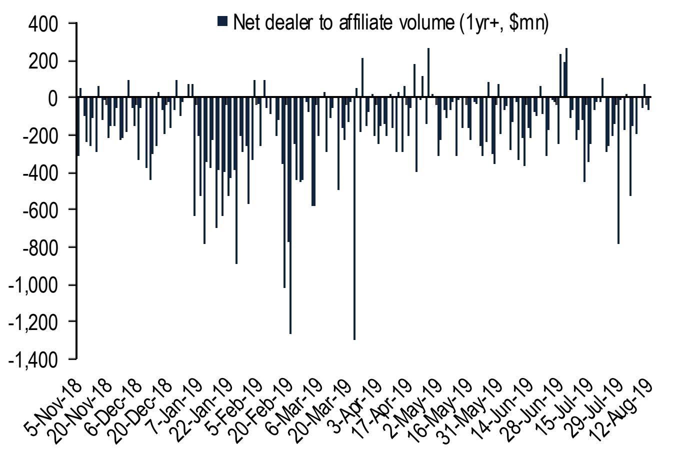
Daily foreign demand tracker

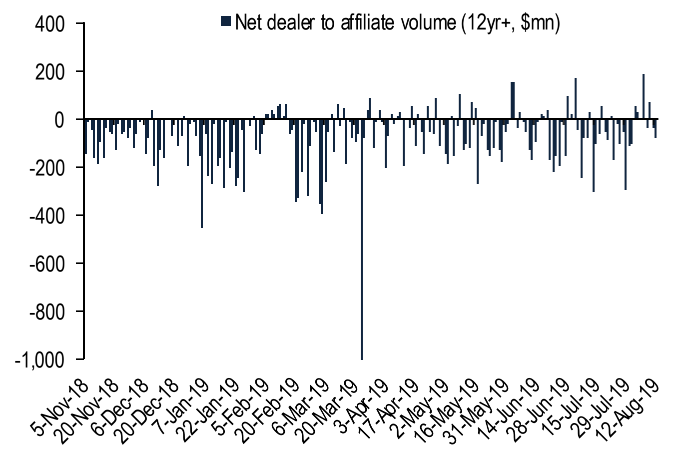
We believe net dealer-to-affiliate volumes from Trace are correlated with foreign buying of US HG corporate bonds - i.e., negative numbers mean foreign investor buying (US dealers taking down inventory in favor of foreign affiliates). For supporting material see our "primer" on tracking foreign inflows (See: Credit Market Strategist: One year round-trip in spreads 15 July 2016). Figure 11 shows the overall daily dealer-to-affiliate volumes while Figure 12, Figure 13 and Figure 14 show subsets of this data. In particular Figure 12 shows net dealer-to-affiliate volumes for longer maturity (12+ years) bonds, Figure 13 displays volumes reported to Trace before 8am NY time (biased toward Asian buying) and Figure 14shows the subset of net trades reported between 8am and noon (biased toward European buying). Figure 11 and Figure 12 include data from today, whereas Figure 13 and Figure 14 run through the previous business day.

Figure 11: Net dealer buying from affiliate (1yr+)



Note: Net dealer-to-affiliate volumes are correlated with foreign buying/selling. Negative numbers indicate foreign buying.
Source: Bloomberg, TRACE

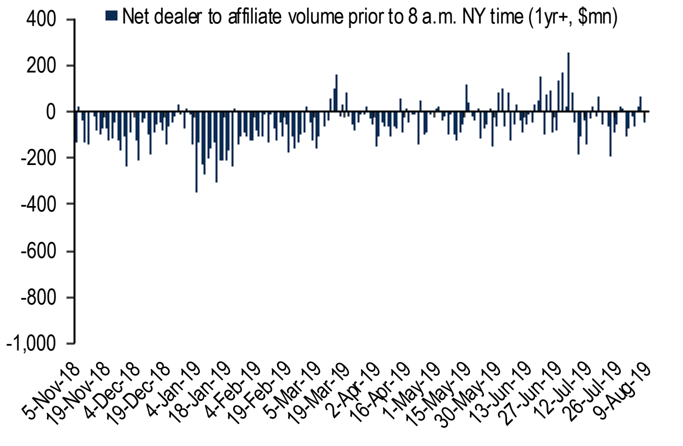
Figure 12: Net dealer buying from affiliate (12yr+)



Note: Net dealer-to-affiliate volumes are correlated with foreign buying/selling. Negative numbers indicate foreign buying.
Source: Bloomberg, TRACE

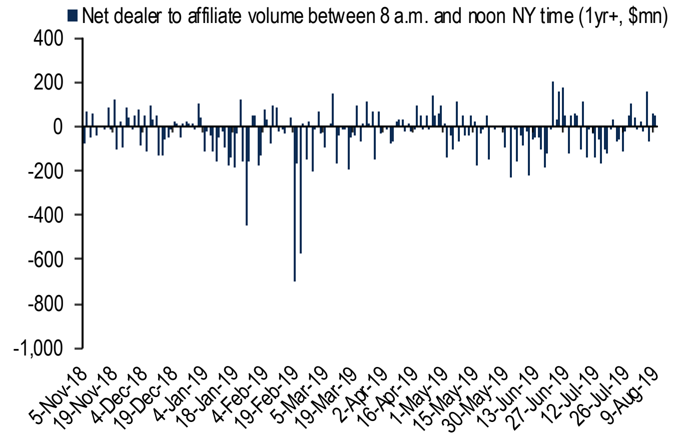
Bank of America Merrill Lynch

Figure 13: Net dealer-to-affiliate trading volumes before 8 a.m. NY time



Note: Morning share of daily trading volume is correlated with secondary market activity of foreign investors due to different time zones.
Source: BofA Merrill Lynch Global Research, TRACE

Figure 14: Net dealer-to-affiliate trading volumes 8 a.m. - noon NY time



Note: Morning share of daily trading volume is correlated with secondary market activity of foreign investors due to different time zones.
Source: BofA Merrill Lynch Global Research, TRACE

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Earnings Tracker: Week 5: EPS beats, but trade war hurting capex, margins 12 August 2019

Week 5 Earnings: EPS beats, but trade war hurting capex, margins

Tracking a 2% beat after last big week of earnings season

Following Week 5, 451 companies (93% of S&P 500 earnings) have reported. Bottom-up 2Q EPS rose to $41.26 from $41.17, led by beats in Health Care and Insurance. EPS is +0.6% YoY, a 2% beat vs. analysts' expectations at the start of July (and a >3% beat when excluding Boeing's charge). Sales have beaten by 1%, +4% YoY (where FX was a 2ppt hit). 39% of companies beat on both EPS and sales, slightly above the long-term average (since 2000) of 35%. Health Care and Tech have seen the most beats (66% and 50%), while just 7% of Materials beat on both. The remainder of reporting will be spread out between now and late Sept., with chiefly the Retails left to report. Our analysts expect weakness to continue for department stores, which begin reporting next week.

Bigger reward for beats, less punishment for misses

Beats have outperformed by 2.2ppt in the one-day post results (vs. 1.6ppt historical avg.), while misses have underperformed by just 1.2ppt (vs. -2.4ppt on avg.)-where investors may have cared more about forward guidance. Beats have been rewarded most in Materials & Energy (which has seen some of the weakest results), while misses have been punished most in Health Care (where beats have been most prevalent).

We see further downside risk for 2020 estimates

Consensus now expects 2019 EPS of $165 (in line with our est.), with EPS expected to fall 2% YoY in 3Q and grow 5% YoY in 4Q. We see more risk to 2020 estimates, where analysts expect 10% growth (vs. our +6%), and ests. have fallen just 1% since the start of July. Commentary on earnings calls has been mixed: mentions of "better"/"stronger" vs. "worse"/"weaker" are tracking similar to in 1Q and in-line with avg., but mentions of optimism are just above 1Q's record lows. The earnings guidance ratio is tracking in-line with its long-term average, where guidance has been strongest within Real Estate & Health Care and weakest within Tech & Discretionary. Given that the recently-announced 10% tariffs will hit consumer goods, we see further risks in Discretionary.

Trade war showing up in earnings call transcripts

With re-escalation of trade tensions, for the ~100 companies that discussed China growth trends on earnings calls, nearly half of the mentions were negative (vs. <30% of mentions being negative last quarter). And ~15% of total reported S&P 500 companies have cited negative impacts from tariffs, compared to only ~10% in recent quarters. Negative impacts remain most concentrated in Industrials, Tech, and Materials.

Capex growth remains anemic

S&P 500 capex growth is tracking +3% YoY in 2Q, on-par with 1Q's rate (lowest since 2Q17). Our three-month ratio of above- vs. below-consensus capex guidance is tracking at 1.5x in August (same as in July), a hair above the 1.4x average. With no trade truce in sight and macro data (particularly in manufacturing/industrials) continuing to surprise to the downside, the uncertainty overhang may continue to impact business spending.

Tariffs, wages impacting margins

S&P 500 non-Financial net margins are coming in at 10.9%, 60bp below year-ago levels. Margins have compressed most within Materials, Tech, Industrials and Discretionary-all sectors which are either trade-exposed, or among the most labor-intensive sectors. Our Corporate Misery Indicator has also continued to suggest increased risks to margins.

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China Economic Watch: Tighter financial condition in July underscores the need for further easing 12 August 2019

Tighter China financial condition in July underscores the need for further easing

Figure 15: Announced: Monday, 12 August 2019

July 2019	New Loans	Outstanding loans	TSF*	Outstanding TSF*	M0	M1	M2
	RMB bn	% yoy	RMB bn	% yoy	% yoy	% yoy	% yoy
Actual	1,060	12.6	1,010	10.7	4.5	3.1	8.1
Previous	1,664	13.0	2,263	10.9	4.3	4.4	8.5
Consensus	1,275		1,625		4.4	4.7	8.4
BofAMLe	1,300	12.8	1,650	11.1			8.4

Source: PBoC, BofA Merrill Lynch Global Research.

BofAML China FCI tightened in July

The BofAML China Financial Condition Indicator (FCI) tightened to 101.3 in July from 100.2 in June. The tighter financial condition is broad based, driven by slower depreciation of CNY NEER (at 1.2% yoy, vs. 4.2%), lower growth of TSF (total social financing, at 8.9% yoy, vs. 9.2%, under the old definition), as well as higher nominal interest rates (average of 7d repo and 10yr treasury yield at 2.92%, vs. 2.89%).

Growth of TSF, M2 and loan all slowed down

July money and credit growth surprised on the downside. In particular, new TSF decreased to RMB1,010bn from RMB2,263bn in June, while new loans fell to RMB1,060bn from RMB1,664bn. Growth of outstanding TSF moderated to 10.7% yoy in July from 10.9% in June, while that of RMB loans also eased to 12.6% from 13.0%. M2 growth declined more than market expected to 8.1% from 8.5%.

TSF growth dragged down by lower short term bank loans

The slower total social financing (TSF) growth was primarily driven by lower new bank loans, even though corporate and local government special bond issuance was higher. Meanwhile, off-balance lending activities (in particular, non-discounted bankers' acceptance, BA) continued to drag.

The decrease in new RMB loan issuance was attributed to a significant drop in new short-term (ST) loans to both households and corporates. Meanwhile, new medium-to-long-term (MLT) loans to both corporates and households decreased slightly.

Still tight FCI calls for further monetary easing

In our view, the tight financial condition in July (financial conditions index, FCI) underscores the need for the PBoC to lean towards further easing. With stiffer headwinds from escalated US-China trade tension as well as sluggish investment demand, we believe more easing, esp. in monetary policy, is warranted. July data confirmed our view that short-term funding demand remains very weak. However, in contrast to mini cycles in the past, financial condition has barely turned more accommodative in the last 13 months.

Now with the exchange rate breaking away from previous constraints, we believe the central bank should and will consider benchmark interest rate cuts while injecting more liquidity into the system. We expect financial conditions to ease over time in 2H19 to help stabilize growth.

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Federal budget deficit higher than expected in July

The federal government ran a deficit of $119.7bn in July, up from a deficit of $77bn in the prior year. Revenues rose 11.6% year over year to $251.3bn in July, and outlays rose 22.8% year over year to $371.0bn in July. As of July, year-to-date revenues were up 3.4%, while outlays rose 8%.

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