Market Strategy and Macroeconomics
Group Investment Management
December 2017

Economic and market outlook 2018:
High Tide

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Overview

2018 is expected to mark high tide in terms of the global expansion, with all boats being lifted as growth exceeds trend. Robust earnings and still generous liquidity provisioning should sustain investor enthusiasm. The biggest challenge is likely to be central bank policy as the focus shifts to tapering stimulus despite inflation missing targets.

The high water for growth masks the risks that are beneath the surface, notably excessive debt, and a dependency on low interest rates. While we are optimistic for the year ahead, with signs that some structural reforms are being undertaken as we had hoped, central banks face a challenge. Meeting inflation goals while adapting policy and balancing economies that are hooked on debt and rising asset prices will not be easy.

Economic conditions have entered a virtuous cycle that is likely to be sustained, although 2018 is expected to see the rate of growth plateau at a high level. The staggered global recovery, led by the US, is leading to rising business confidence, with job growth showing material improvement in almost all regions. This, in turn, is boosting consumer confidence and spending. Rising consumption is also encouraging business investment and should boost productivity, which is often a necessary condition to justify wage rises. The virtuous circle is now also spilling over into global trade and emerging markets.

What is surprising is just how low inflation remains, with most of the leading central banks continuing to miss their inflation targets by a significant margin, despite the better growth. While maintaining credibility demands that they stick to targets, loose policy jeopardises financial stability, as historically low rates push asset prices to record levels. This is one of the issues that we look at more closely in the Global section. Broadly, we believe that policy will remain favourable, with the BoJ and ECB continuing to expand their balance sheets, albeit at a slowing pace.

The US is one country where we do see inflation becoming more apparent as the year unfolds. Unemployment is at 4.1% and falling, while business and consumer optimism are flirting with record highs. This is usually a potent combination and we think that it will eventually feed through to higher services and wage costs. This will give the Fed cause to continue the policy normalisation process, with three rate hikes in the coming year now likely.

Moving on to Europe, we tackle some of the challenges that the UK faces with regard to Brexit, while the Eurozone section emphasises the positive momentum that has been building. Another year of substantially above-trend growth is anticipated, driven by job gains and a resurgence in business investment. Despite the growth impulse, the ECB is likely to stick to message, with further tapering of QE not expected until the autumn, as inflation continues to miss target. We also see improving prospects for the Swiss economy, though the expansion is likely to remain unbalanced. Although domestic consumption remains sluggish, the strong manufacturing and export sectors are likely to allow a modest adjustment to monetary policy, with an eye firmly on exchange rate stability.

The focus in Asia is on the consolidation of power in the two key countries of Japan and China. The Abe administration has bolstered its position following the general election and is intent on furthering Abenomics; engendering higher growth, productivity and ultimately inflation. Growth is encouraging and we believe that a combination of falling unemployment, now at a 24-year low, rising confidence and capital investment bodes well. China is one economy where we are expecting growth to be marginally lower in 2018, though for good reasons. The enhanced power base that Xi Jinping now has permits the pursuit of the 'New Era' in which China tackles the thorny issues of excess capacity, shadow banking and climate change. To do so will mean a more controlled expansion. While we emphasise once more that no 'hard landing' is likely, the new dynamic will impact the surrounding economies

From a financial market perspective, 2018 can be seen as a year of continuation, with the macro backdrop robust and only modest changes in central bank policies, but we do expect differences in market returns, with equities offering the greatest potential. While we acknowledge that valuations are rich, earnings growth is likely to be strong, allowing stock repurchases and dividend increases to reward investors. Although this supports equity investors, it is to the detriment of credit holders at a time where leverage is high, interest coverage is low and the credit cycle is mature, resulting in credit markets underperforming on a relative basis. Government bonds are unattractive on a fundamental basis, with term premia still distorted by central bank activity. Yields are expected to continue to drift higher, given the growth and firming inflation dynamic, though the weight of outstanding debt will moderate the move. Market volatility may rise in general, as fundamentals start to matter more and central bank tightening gives investors pause for thought.

In summary, 2018 is expected to be a year of robust economic growth and one which favours equities as an asset class.

Guy Miller
Chief Market Strategist
& Head of Macroeconomics

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Global

Outlook

- Global growth is expected to remain strong, reflecting broad-based strength across regions and sectors
- Economic slack is rapidly diminishing, but the global economy is not yet at risk of overheating
- Central banks shift focus towards tapering of stimulus, though removal will be gradual as inflation remains weak

Implications

- Bond yields are likely to be past their lows, but upside is limited
- Credit should continue to underperform equities as the credit cycle advances further
- Equities remain the favoured asset class and are supported by earnings and corporate actions

Risks

- The better growth environment leads to complacency and a policy mistake
- The Fed tightening cycle causes disruption to leveraged corporates globally
- The vulnerability of the European banking system could amplify the effect of unexpected shocks

Global growth surprises on the upside amid broad-based strength

The strengthening in global growth that became evident in early 2017 has proved to be resilient. Global GDP is on course to expand by around 3.8% in 2017 (at PPP weights), up from 3.2% in 2016, and outpacing expectations for the first time since the global financial crisis. Developed markets account for more than half of the growth pickup, led by the Eurozone and Japan, but emerging markets are also contributing, with countries such as Brazil and Russia recovering from deep recessions. The acceleration was initially triggered by the industrial sector, but services have gained pace, and the recovery involves both commodity exporters and importers. The turnaround has also been broad-based across the economy, with consumption and investment growth rising, fiscal spending becoming less of a drag and, with global trade recovering sharply, gains have been spread more broadly.

Conditions are still favourable, and we expect growth to be steady into 2018

Going forward, we expect the global economy to remain solid, with growth broadly flat around its current level, so continuing to track above a long-term average of 3.5%. We have revised up our outlook compared to six months ago, mainly reflecting strength in the Eurozone, but also on the back of solid data in the US and Japan. The latest Eurozone PMIs were stronger than expected, with the forward looking new orders component spiking higher, which is encouraging. Capex plans are elevated across regions, which should help to lock in a stronger expansion. Global trade is firm, currently rising at 5% YoY, and capital goods exporters, e.g. South Korea, Taiwan, Switzerland and Germany, continue to see solid new orders and activity. Elsewhere, household sentiment is supported by strong labour markets in most regions. Although wages lag behind, employment growth is a bigger driver of household earnings and matters more for broader sentiment. Global financial conditions are also favourable, despite the more mature tightening cycle in the US, helped by exceptionally loose monetary policy in Europe and Japan, falling rates in Latin America, and a broadly neutral monetary policy stance in developing Asia. One exception is China, were monetary conditions are tightening and the industrial cycle has lost some momentum, but we do not expect this to be disruptive.

Few signs of overheating, but central banks are becoming more wary

The economic cycles are not synchronised and, outside of the US, there is some economic slack available. As a consequence, signs of overheating in the real economy are relatively rare, with benign inflation in most regions. After a decade of remarkable monetary policies, central banks are becoming more wary about leaving stimulus in place, however, partly for financial stability reasons. We do not expect this to lead to a turnaround in the policy stance over the near term but, over time, it is likely to be reflected in a tightening bias, even with inflation running a bit below target. Indeed, with the Fed now firmly on a tightening path, the BoE reversing the post-Brexit vote cut, the BoC hiking twice over the past year, and the ECB scaling down QE purchases, central banks have switched focus from expansion to the reduction of stimulus.

Low inflation will not last forever, but for now it allows the cycle to persist

Tapering will be very gradual, however, as worries about low inflation still dominate financial stability concerns. Indeed, this is likely to hold back premature tightening as central bank credibility still hinges on moving inflation – and inflation expectation – higher. We anticipate the policy stance to remain very favourable over the near to medium term, underpinning our view that a sharp slowdown is unlikely in 2018.

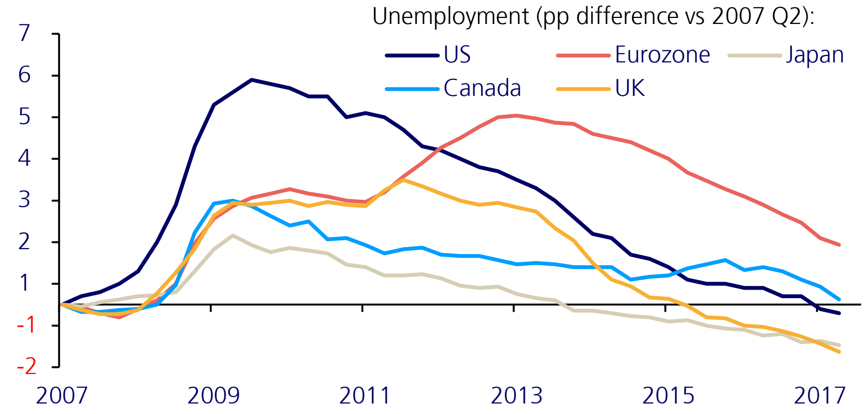
The dependency of policy on inflation generates vulnerabilities in the global economy that are worth watching however. Economic slack is quickly diminishing and, a decade after the great financial crisis, many labour markets are now tight again. With solid growth and difficulties filling open positions, wages are expected to gain more traction over time. Oil prices are up by close to 30% on a year ago. Producer prices are also rising in some regions. We suspect that, as growth has reengaged, inflation will gradually strengthen, with potential for upside surprises over time.

Limited prospects for Treasury yields to rise, but spreads should narrow

Despite strong growth, core bond yields remain rangebound at low levels, failing to move higher in spite of the strong economic data. Looking beyond the stability at the longer end, however, the Treasury curve has flattened sharply over the past quarter, as a more hawkish Fed has been priced in to bond markets. A flattening of the yield curve is a typical late cycle phenomena, but nonetheless warrants monitoring.

Going forward, we only see limited upsides to Treasury yields. This is mainly a result of the extended cycle. Looking beyond the next couple of years, we anticipate a growth slowdown in the US and, with additional headwinds from high debt and unfavourable demographics and productivity developments, we expect the 10yr Treasury yield to remain below 3% over the coming year. Global liquidity provisioning will also limit a further rise in Treasury yields, as the ECB and the BoJ will maintain QE purchases, albeit at a slowing pace. Bund yields are at extreme levels,

A decade after the crisis, many labour markets are tight



Source: Bloomberg

however, far removed from fair value. Over time, we anticipate them to move higher though we recognise that, for now, yields are well anchored by ECB policy. It has to be recognised, however, that as central banks are shifting focus towards tapering, there are prospects for yields to snap higher, particularly if inflation surprises on the upside and inflation expectations rebound from current depressed levels.

Elsewhere, we expect the spread between periphery and core Eurozone government bond yields to widen modestly over the coming year as the ECB scales back its QE purchases. We don't expect this to be disruptive, given the overall favourable financial conditions.

Credit to continue underperforming equities, as the cycle advances further

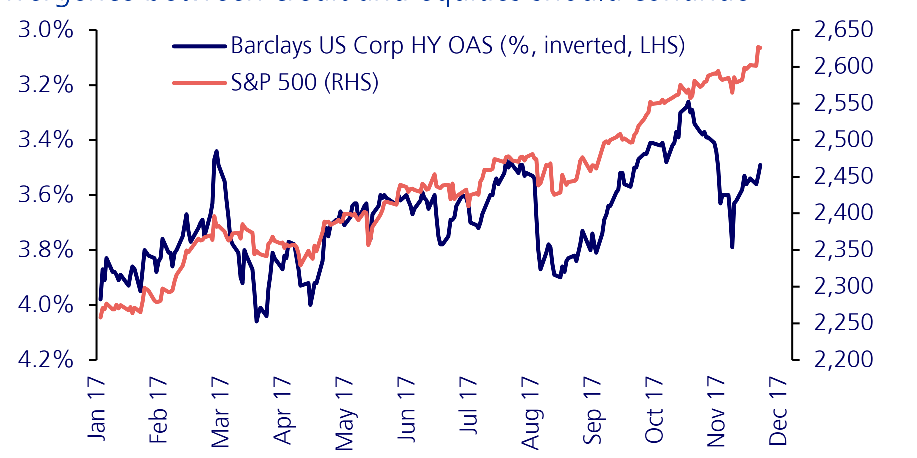
Credit almost always underperforms equities in the late stages of the credit cycle and we see no reason why this time should be different. While credit spreads are likely to tighten marginally during 2018 due to strong supply/demand technicals, we expect credit performance to pale compared to that of equities, continuing the trend that has been in place recently.

A benign macro-environment and continued liquidity provision will keep a lid on credit spreads in 2018, but we see limited upside in the asset class. Spreads are tight and in various pockets of credit are almost back to 2007 lows. Adjusting for quality, spreads are even tighter than they look on a historical basis. As an example, adjusted for leverage, spreads for non-financial corporates across US and Europe are the tightest that they have ever been per unit of leverage. Within credit, lower quality issuers have also become more dominant and this is likely to continue as M&A and leveraged buyouts gather further momentum. In high yield credit, weaker issuers face an even greater struggle as the share of cash flows that goes towards servicing debt is almost the highest it has ever been for the median company, despite historically low interest rates and credit spreads. While all of this limits the upside for credit investors, a credit bear market is still not imminent just yet. Companies have termed out their debt and benign macroeconomic conditions indicate that earnings and cash flows are likely to remain healthy. That said, the vulnerability of companies to macro risks, or to a deterioration in funding conditions, is high from a creditor perspective. Therefore, we think that policymakers have a very thin margin of error in terms of managing the removal of stimulus that has supported the credit market so far.

Within the credit market, we expect increasing differentiation in 2018 between weaker and stronger companies. While CCCs and the weakest credits have underperformed within high yield on a risk adjusted basis already this year, we think this is likely to become a broader theme next year. Furthermore, the US tax reform proposals could be cash flow negative for the weakest companies, although we see some positives from the reforms, both for earnings and for a reduced need to issue debt due to cash repatriation. We continue to remain concerned around the vulnerability of European banks, and think the ECB is prudent in pushing banks towards drawing a red line below the bad loan exposures. Last but not least, a flatter US yield curve can tighten credit conditions through lower profitability for financials, and warrants monitoring.

All in all, despite a benign macro outlook, at current tight spreads we think credit does not offer compelling value and investors are likely to prefer equities within risk assets.

Divergence between credit and equities should continue



Source: Bloomberg

Equities should do well as fundamentals remain favourable

Prospects for equities are good, most notably in the Eurozone and emerging markets. Global liquidity provisioning continues to provide a positive tailwind, and a robust macro backdrop with an improving earnings outlook offers investors fundamental support. While we see potential for meaningful upside, it is likely to be more nuanced than in 2017 and be accompanied by bouts of volatility, something that has been strangely absent. With fundamentals increasingly taking centre stage and investors likely to be distracted from time to time with speculation about central bank 'exit strategies', the move higher is unlikely to be without wobbles.

As central banks still miss their inflation targets, stimulative policy initiatives are likely to remain, further inflating asset prices. Despite the Fed now reducing its balance sheet, this is at a modest pace and net global stimulus will remain supportive as the Bank of Japan and the ECB are still increasing the amount of liquidity in the system. Until inflation shows a convincing move towards targets, or more emphasis is placed on financial stability through macro-prudential policies, equities should continue to prosper.

Although stocks are richly priced, earnings growth has proven to be better than expected and multiples in many regions have moderated a little. Indeed, with a strong economic backdrop and some signs of pricing power returning, the earnings picture is likely to stay supportive. This is also allowing business leaders to raise dividends and pursue stock buy-backs more aggressively, even in regions such as Europe where this has traditionally been less of a feature. M&A is also rising as the cost of finance remains depressed and confidence in the economic outlook improves. Historically, the current stage of economic cycles typically favours equity investors over government bond and credit holders. Investors have been reluctant buyers of this bull cycle, but this could change as momentum builds.

US

Outlook

- Solid household spending and a pickup in investment are expected to drive economic momentum
- The labour market situation continues to improve and wage growth should accelerate
- The Fed will tighten its monetary policy further as inflation is likely to rise from current levels

Implications

- Treasury yields are expected to rise but they are still held back by the global hunt for yield
- Credit should continue to underperform equities, as risk reward is more asymmetrical
- A moderating earnings outlook limits the upside for stocks, but momentum remains strong

Risks

- Inflation rises sharply forcing the Fed to tighten policy faster than expected
- Consumer sentiment and spending falter as real incomes fail to pick up
- Global or domestic politics catapult financial markets out of the low-volatility environment

The US economy enters 2018 on solid footing

The US economy has shown a significant acceleration over the past two quarters. Annualised GDP growth was 3.3% in the third quarter, after 3.1% in Q2. It was the first time since 2014 that US GDP has grown by at least 3% in two consecutive quarters. Given that the US was hit by two major hurricanes in late summer, growth numbers in Q3 were even more impressive. While consumer spending kept growing at a decent pace, it was mainly the pickup in investment that drove economic growth higher. Equipment investment has accelerated to 10.4% in Q3 after shrinking in the same period a year ago. This reflects the corporate sector's recovery from the energy-driven setback in 2015/2016, as well as a more positive business outlook in general that makes firms more willing to expand their capacities. It is promising that capital goods orders have accelerated over the last few months with the annual rate reaching 10.8% in October, the highest since 2012. Business sentiment in the US remains very upbeat. Both the ISM Manufacturing and Non-Manufacturing indices have recently reached their highest levels in more than a decade, indicating a continuation of the current strong momentum. In particular, new orders signal solid business activity going forward while the employment component is a further indication of a healthy labour market.

An ever tighter labour market should lead to higher wage growth

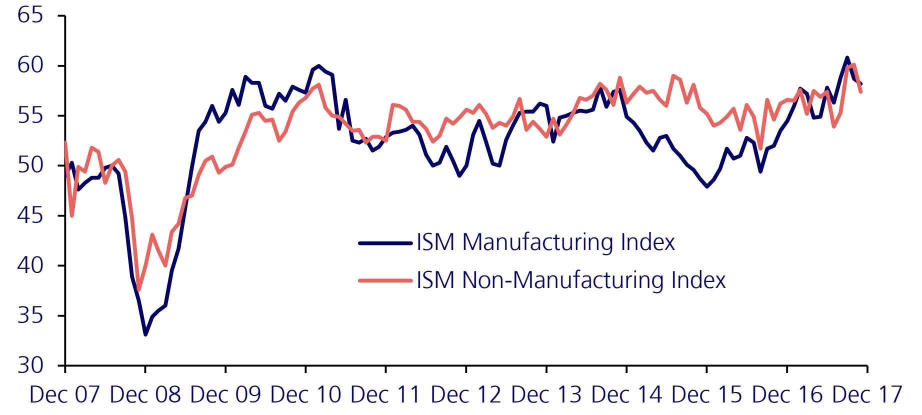
The unemployment rate fell to 4.1% in October, the lowest since 2000, and remained there in November. At the same time the broader underemployment rate stood at 8%, having reached the last business cycle's low in October. The underemployment rate includes persons that are employed part-time for economic reasons and those that are marginally attached to the labour force. As the US economy moves forward in the cycle more people are drawn into the labour market, broadening the basis for continued solid household spending. Although the slack in the labour market has continuously been reduced, wages have so far failed to pick up significantly. Average weekly earnings stood at 2.5% YoY in November, while the broader employment cost index was 2.5% higher at the end of Q3 compared to a year ago. Comparing the current unemployment levels to past cycles and interpreting the pick-up in investment as a signal for tighter capacities, we expect wage growth to accelerate further going forward as filling open positions becomes increasingly difficult for firms. In fact, the corresponding indicator of the NFIB Small Business Optimism Index has recently jumped to the highest level in 17 years and is now close to an all-time high. Wage increases could also be justified by an increase in productivity. Growth in US nonfarm productivity has accelerated to 3% QoQ in the third quarter, lifting the annual rate to 1.5%. While this is still below the long-term average, it is a significant improvement compared to the most recent quarters.

With more people working and wage growth picking up, household spending is expected to keep a healthy pace. Consumer confidence has risen to the highest in more than a decade, helped by a significant improvement in future expectations. Households rarely considered their financial situation to be better during the past four decades than they do now; they expect their incomes to rise and their net debt levels to improve. Accordingly, consumers' intentions to buy big-ticket items has constantly increased over the last few quarters. The corresponding survey levels have rarely been higher than currently, but history shows that sentiment can remain at high levels for an extended period of time. Therefore, while a significant growth acceleration from current levels seems unlikely, we do expect a continuation of the benign growth environment while the broadening of the growth base makes it more sustainable. Some additional stimulus for the economy is likely to come from tax reform, which is intended to lower the tax burden and simplify the tax code.

Investors underestimate the Fed's willingness to hike rates

Despite the strong economic momentum and the ever tighter labour market, core inflation remains relatively modest. While headline CPI inflation stood at 2.0% YoY in October, fuelled by an energy-driven pickup in transportation costs, Core CPI picked up to 1.8% YoY and the Fed's preferred measure has stabilised at 1.4% YoY in October. Part of the weakness in core inflation can be explained by lagging effects of a few one-time events, like the significant price cuts in mobile phone services earlier this year. The latest monthly figures show that some key components of core inflation are slowly beginning to accelerate. However, the annual growth rate in medical care costs has fallen to the lowest in years, dragging down core inflation. Shelter costs are slowly rising but have not significantly picked up steam this year. Nevertheless, with the labour market tightening further and broader unemployment reaching the past cycle's lows, wages are likely to pick up going forward, which should ultimately feed through into higher service inflation. This is also the Fed's view, which keeps signalling a steeper rate path than market participants currently price in. While market expectations regarding the future Fed Funds Rate have slowly moved higher over the course of the year, a significant gap relative to the FOMC's projection remains. We expect this gap to narrow further in the coming months as investors will have to price in more rate hikes in 2018. The market still seems to underestimate the Fed's willingness and ability

Business sentiment reaches the highest level in more than a decade



Source: Bloomberg

to hike rates. Even after four rate hikes, the US economy has shown an impressive growth acceleration, which will encourage the Fed in its view that the current monetary policy is still stimulative. In addition, the Fed itself acknowledges that it won't reach its own inflation target before 2019 while still signalling three rate hikes in 2018. Therefore, inflation would have to fall significantly short of expectations to stop the Fed from lifting rates according to its projection.

On the other hand, the future composition of the Fed is in a state of flux. While the incoming Fed Chair Jerome Powell stands for a continuation of the current policy, several positions are still to be filled, which could have a significant impact on the overall stance of monetary policy. Treasury yields have remained rangebound through most of 2017 despite the strong economic background and the uncertain outlook with regard to the Fed's future composition. Modest inflation helped to keep a lid on interest rates and the global hunt for yield continues to provide an anchor for US yields. While the Fed has started to slowly reduce its balance sheet, central bank liquidity keeps growing globally given the ECB's and the BoJ's continuation of their QE policies. We expect Treasury yields to move higher over the course of the year as inflation is likely to pick up and the outlook for further tapering of global liquidity provisioning should support interest rates. In addition, the term premium, which still stands at very depressed levels, should gradually rise as investors start to price in more uncertainty with regard to the inflation outlook and future central bank policy.

Credit should continue underperforming equities

We see the fundamental backdrop as having weakened for US credit, most notably for non-financial corporates, including high yield. US credit markets have benefitted from the global search for yield, driven by quantitative easing by other central banks, which has now pushed spreads near to the low levels of 2007 with little differentiation between strong and weak credits. At the same time, M&A and share buybacks have elevated leverage as companies used cheap funding to boost share prices. This, along with the fact that a large chunk of recent debt has come from lower quality companies, has caused a decline of aggregate credit quality for US credit. Indeed, spreads per unit of leverage in the US credit market are nearly at all-time low levels. At the same time, given elevated leverage levels, high yield companies are dedicating increasing amounts of their incomes to servicing debt. While US banks have repaired their balance sheets, delinquencies are picking up and lending standards are tightening in some sectors such as credit cards, autos and commercial real estate. Notably, these delinquencies are occurring in a benign macro environment and confirm that the credit cycle is becoming more advanced. We believe the US ABS and the municipal sectors are likely to remain resilient, although there are a number of cross currents in the latter due to US tax reform.

While the fundamental backdrop continues to deteriorate, there are a number of policy changes and related market moves that are likely to be significant for US credit. Having been largely resilient to rate hikes by the Fed so far, spreads may become more volatile as the Fed pares down its balance sheet and the ECB tapers its stimulus provision. The rise in 2yr US Treasury yields that has aggressively flattened the yield curve is another confirmation of the late stage of the cycle and could impact the weakest issuers with floating rate debt or short term refinancing needs.

Lastly, US tax reform is likely to benefit BBB companies the most, but could be cash flow negative for the weakest borrowers due to the threshold on interest rate deductibility. All of these aspects are likely to cause a greater differentiation within the credit markets, which seems to have already begun.

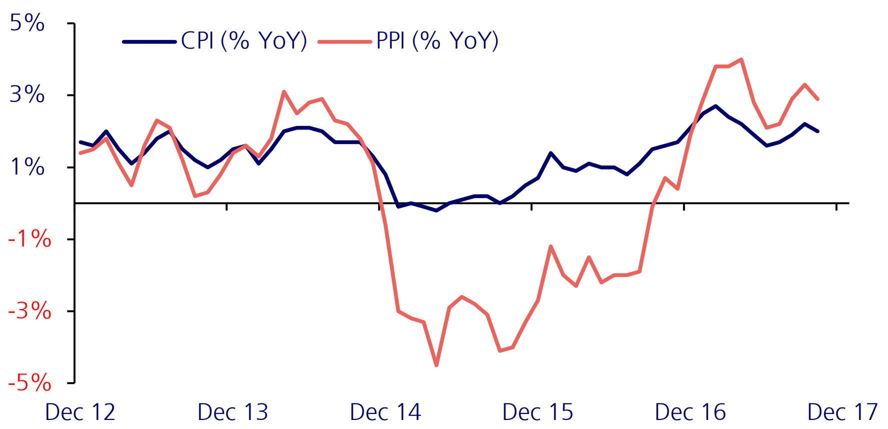
Credit is therefore likely to have limited upside even in a benign macro environment, as rising yields, continued M&A and share buybacks, as well as diminishing global liquidity provision is likely to keep spreads rangebound, even in a positive earnings growth environment. We therefore prefer equities to credit expecting the latter to underperform as is typical of late stages of the cycle. We also think that differentiation within credit, for example between investment grade and high yield, is also likely to rise as investors become more discerning.

Solid fundamentals and abundant liquidity support the equity market

Driven by strong economic fundamentals and a lack of alternatives, US stock markets have risen to new record highs in recent months. The market has shown a remarkable resilience to geopolitical events, with investors using the short-lived setbacks to increase their equity exposure. Earnings growth is unlikely to accelerate from current levels and margins are likely to face some headwinds as firms are expected to incur higher wage costs and increased investment spending. Nevertheless, a continuation of the recent earnings trend combined with a further expansion of global liquidity provision and moderate yields should be enough to lift the stock market higher.

Investor sentiment does not look exuberant and the outlook for some fiscal stimulus and the potential for deregulation would further support equities. While the US is not our favourite market we expect it to do reasonably well in a benign macro environment. One of the key risks for financial markets is a sharp pickup in inflation leading to the expectation of tighter central bank policy and significantly higher yields.

Inflation is expected to move higher



Source: Bloomberg

UK

Outlook

- The economy faces further headwinds as Brexit uncertainty burdens consumers and businesses
- Inflation is expected to moderate, mitigating the pressure on households and firms
- The BoE's dovish rate hike makes further tightening in the near term unlikely

Implications

- Gilt yields are expected to rise in line with global yields, but Brexit-related volatility is likely
- Credit has lagged US and European credit, but we don't see much upside
- UK stocks should improve on their recent underperformance as a weak pound supports earnings

Risks

- Brexit negotiations collapse as the gap between positions remains too large to bridge
- The political situation in the UK escalates culminating in new elections
- The BoE continues to tighten its policy despite a slowdown in economic momentum

Real income is falling despite a tight labour market

The British economy has slowed down further over the past two quarters. While annual GDP growth stood at 1.8% at the end of Q1 it fell to 1.5% in Q2 and remained there in Q3, the weakest rate in more than four years. Based on the average quarterly growth rate, the UK has been one of the weakest economies in the OECD in 2017.

A major driver of the economic slowdown is lower consumer spending as households are squeezed by falling real incomes. Fuelled by the significant drop in sterling following the Brexit referendum, inflation accelerated to 3.1% in November, measured by headline CPI. Producer input price inflation has decelerated significantly over the course of the year from 20% YoY in January to 7.3% in November, indicating that the worst is behind us with regards to the currency-induced price push. Nevertheless, consumers' purchasing power continues to be under pressure as wages fail to significantly accelerate despite an ever tighter labour market.

At the surface, the labour market is holding up well, despite the uncertainties around Brexit. The unemployment rate fell to 4.3%, the lowest since 1975. However, this was partially driven by a drop in net migration as fewer EU citizens are coming to Britain in search of jobs given that the outlook for their residency situation after Brexit remains unclear. Beneath the surface, the labour market has been softening with jobless claims ticking up slightly and employment change slowing down and turning negative in September. Therefore, despite the unemployment rate falling to a multi-decade low, annual wage growth still hovers around 2.2%.

Firms and consumers face an uncertain future

Given the uncertain outlook and the pressure on real income, consumer sentiment has continuously fallen over the course of the year. Consumers' more cautious stance is also mirrored in household spending with retail sales growth falling to -0.3% YoY in October.

While consumers are increasingly worried about the economic outlook, business sentiment is holding up relatively well. The Manufacturing PMI stood at 58.2 in November, thus staying in expansionary territory through all of 2017 so far. The expansion is broad-based across sectors and driven by both domestic conditions and new export business. The UK export sector benefits from a weaker currency and strong global growth momentum.

Although sentiment in the manufacturing sector is holding up well, momentum in the service industry is slowing down. The Services PMI fell to 53.8 in November as firms still feel the burden of higher input costs and are reluctant to hire or invest given the uncertainty around Brexit.

However, while overall business confidence points to a continuation of the recent economic momentum, the relative weakness of the consumer sector is also visible in the PMI survey as growth of new orders in consumer goods fell to a seven-month low and business optimism in the sector dropped to the weakest level since the beginning of the year. The flipside of the weaker pound is the ongoing upside pressure on input prices, which remains a concern for many manufacturers and will continue to feed through to consumer prices, although at a slower pace.

The EU agrees to move on to the next phase of Brexit negotiations

With Brexit negotiations so far failing to show any tangible progress with regard to the future relationship between the UK and the EU, the risk is that companies follow households in lowering their expectations about future growth, which could undermine their willingness to spend and invest. Despite the UK government's initial hopes of moving quickly from defining the divorce terms to shaping the future trade relationship, the process remained stuck in the initial phase for an extended period of time.

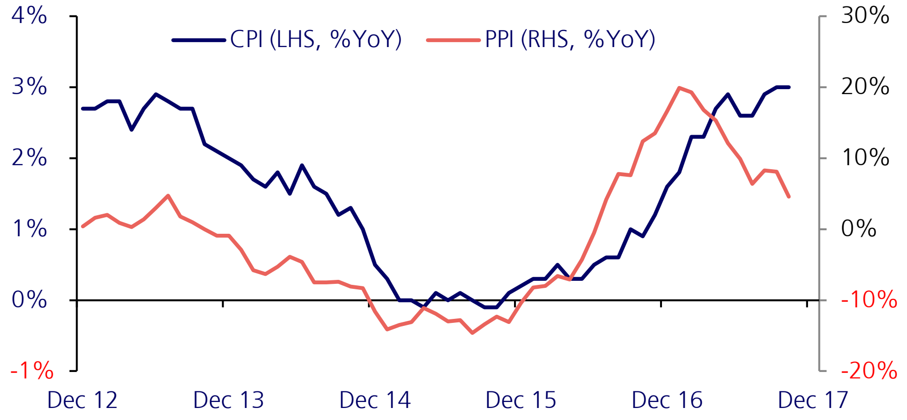
The EU always made it clear that it wants to see sufficient progress on three key topics before moving on to trade talks: EU citizens' rights in the UK and vice versa after Brexit, the border situation between the Republic of Ireland and Northern Ireland, and the financial settlement with regard to past and potential future liabilities the EU claims the UK has to satisfy. The main obstacle to move on to trade talks was considered to be the amount of the divorce bill. However, the other two topics of the divorce prove to be as much of a challenge and still need further refinement. Although a basic agreement on the three divorce topics has recently been announced, a number of questions remain. In particular, it is still not clear how a hard border between the Republic of Ireland and Northern Ireland can be avoided if the UK leaves the customs union and how far the UK will accept the European Court of Justice's jurisdiction with regard to EU citizens living in the UK.

Trade negotiations will be complex and time-consuming

Given the short time horizon until the end of the 2-year period that started with the UK triggering Article 50, it is unrealistic that a final trade agreement will be reached by March 2019. While we still expect some form of a transition period after March 2019, as acknowledged by Theresa May, defining the corresponding terms will not be easy.

First of all, the idea of a transition period is to avoid unnecessary adjustment costs for companies. Therefore, conditions under the

Inflation is expected to fall as currency effects are fading



Source: Bloomberg

transitional deal would have to be close to the existing ones. However, that would mean sticking to the status quo for longer, i.e. paying into the EU budget, applying EU law and accepting the European Court of Justice's jurisdiction – all of which are issues that Brexit supporters want to get rid of as soon as possible. Therefore, the resistance to a transitional period that simply extends the status quo is likely to be significant.

On the other hand, spending a large amount of time on negotiating a transitional deal seems an ineffective way of using the limited time that remains until March 2019. In any case, every month that passes without progress on defining the future relationship between the UK and the EU makes it more difficult to plan ahead. Firms will soon have to start setting up contingency plans, which is likely to be a headwind for economic growth in the UK as investment and hiring are expected to suffer given the uncertain outlook.

The BoE hikes rates for the first time in more than a decade

Unimpressed by the slowdown in economic momentum and despite lowering its growth forecast for 2017 and beyond several times over the past few months, the Bank of England hiked the Bank Rate from 0.25% to 0.5% for the first time in more than ten years at its monetary policy meeting in November. The Monetary Policy Committee (MPC) became increasingly focused on the inflation overshoot in the aftermath of the Brexit referendum. While the MPC initially felt that a lower Bank Rate was necessary to support the UK economy, it now argues that Brexit will reduce the trend growth rate, which makes inflationary pressure more likely going forward.

We expect inflation to fall over the coming quarters as the impact of the weaker pound fades further. After some relatively hawkish statements ahead of the November meeting, the BoE has since taken a more dovish stance and refrained from signalling any further rate hikes in the near future. Acknowledging considerable risks to the economic outlook all MPC members agree that further increases will be limited and gradual. Because the rate hike was well flagged in advance and the likelihood of further hikes is currently limited, both gilt yields and the pound fell markedly after the BoE announcement. The uncertain economic outlook and reduced price pressure ahead are likely to keep the upside potential for gilt yields limited.

Sterling credit has lagged global credit, but we don't see much upside

Sterling credit has lagged most of the global credit markets in 2017 as concerns around Brexit discouraged investors. However, while some of the lag is likely to be reduced, especially if negotiations around Brexit are constructive, we don't expect significant outperformance in credit, especially compared to equities. This is because we can see the tailwinds of strong technicals becoming headwinds late next year, while the credit cycle has matured quite a bit.

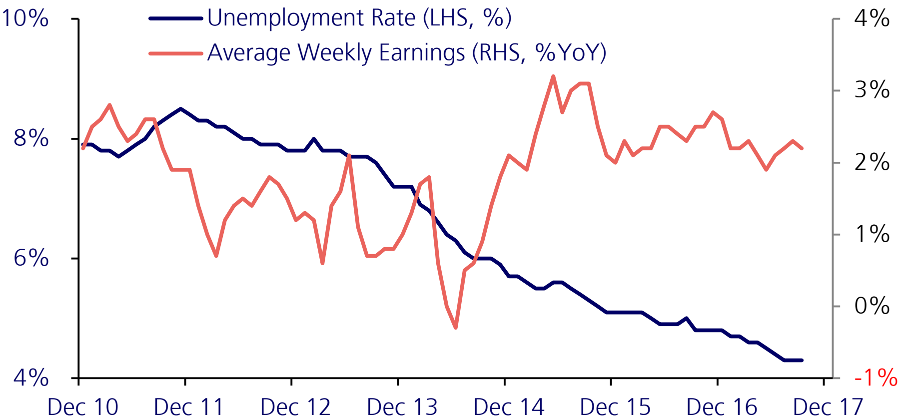
Unlike equities, credit tends to be highly correlated between regions and given the vulnerability of weaker issuers in the global high yield market, as well as in European banks, we believe risks remain to the downside in sterling credit. It also seems that domestic consumer leverage is high in the UK while rising rates and falling real incomes have already squeezed the consumer somewhat. Of course, if there is a hard Brexit, credit will suffer even more, given the vulnerability of financials. It is worth noting that during the days following Brexit, some UK banks saw their credit spreads widen by more than 100bps in a day.

So, all in all, while sterling credit is moderately cheap, the risks from global credit headwinds, as well as a hard Brexit imply that performance is likely to remain lacklustre at best, and we prefer equities within risk assets.

UK stocks have the potential to catch up

The British stock market has been lagging most of its global peers as the uncertainty regarding Brexit is clouding the outlook and dragging down investor sentiment. However, while the domestic situation is a headwind for earnings, firms listed in the FTSE 100 earn more than 70% of their revenues abroad and are thus much less vulnerable to domestic issues than often perceived. The international companies listed in the UK benefit from a benign global growth environment and a weaker currency, which translates directly into higher pound earnings. An escalation of the Brexit negotiations would therefore be beneficial for the large cap indices via a weaker currency. In addition, market sentiment seems too bearish with regard to UK stocks and many investors have an underweight in the UK market, which could trigger a sharp catch-up if part of the position is unwound.

Wages fail to pick up despite very low unemployment



Source: Bloomberg

Eurozone

Outlook

- Growth spurt to continue in 2018 as businesses invest more
- Falling unemployment will support consumer spending
- Inflation will remain below the ECB target, but should increase in 2018

Implications

- Core and periphery bond yields will rise, spreads are likely to widen as well
- Credit should underperform equities as investors become more discerning around downside risks
- Equities will benefit from the strong growth environment supporting corporate earnings

Risks

- An unfavourable outcome in the Italian elections
- Global growth slows sharply, led by one of the Eurozone's major trading partners
- The European banking system is vulnerable and could exacerbate any negative shocks from politics or growth

Firing on all cylinders

The Eurozone economy is currently firing on all cylinders. Growth is well above trend, estimated to be around 1% per annum. The latest data available show that in Q3 2017, the Eurozone grew 2.6% YoY, its fastest pace of growth since Q1 2011, with growth broad-based across countries. While modest relative to other regions, especially emerging markets, for the Eurozone such a pace of growth can be characterised as a boom. Indeed, business and consumer confidence are at the highest levels since at least 2011 in many countries and sectors. In Germany, the ifo business climate index is at its highest level on record.

Growth is being supported by a mix of favourable factors. Easy financing conditions, less political uncertainty, still loose monetary policy and an absence of fiscal headwinds are all helping. Strong global growth, especially in emerging markets, is also a tailwind.

Financial conditions remain supportive of further above trend growth well into 2018 in our view. Companies cost of finance in both capital markets and via the banking system has come down in recent years and remains extremely low by historical standards. Monetary policy is also supportive, with the ECB only gradually withdrawing monetary accommodation. From January, the ECB will reduce QE asset purchases to €30bn a month from €60bn in 2017, but this still represents a potent amount of stimulus. Fiscal policy is also no longer a significant headwind to growth, as it had been in the period 2011 to 2014.

Unemployment continues to trend down, now at 8.9% compared to 12% in mid-2013, supporting consumer confidence and spending. Businesses are feeling confident and are now willing to invest more, which is important in terms of ensuring the durability of the recovery. Business investment in machinery and equipment is growing at around 4% on an annual basis, and this pace could accelerate further in 2018. All told, this is a very encouraging growth outlook for the Eurozone, which we expect will continue in the absence of a severe internal or external shock. Indeed, the risks for the Eurozone for once are more external rather than internal.

Back to trend?

One concern, however, is that after a period of well above trend growth an economy will automatically slow down. While mean reversion is a powerful force in economics and financial markets, it does not automatically have to happen this way in the near term. Typically, when an economy grows well above trend financial conditions tighten, ultimately slowing the economy down. This can happen because inflation becomes a problem, and policymakers raise interest rates aggressively in response. The exchange rate may also appreciate substantially, slowing growth down. However, in the absence of a substantial tightening in financial conditions, there is no reason why above trend growth cannot continue for some time, especially if there is a large amount of slack in the economy as there is in the Eurozone currently.

Indeed, this has been the experience of Spain and Ireland, which have grown substantially above trend for a number of years since emerging from the Eurozone debt crisis of 2012/13, and could be a precursor of how the Eurozone overall will grow at least for the next few quarters.

Another trigger that could cause a move from stronger to weaker growth would be a financial market bubble that eventually bursts. However, there are few signs of a bubble in the Eurozone yet. Valuations in equity markets are above long-term averages on some measures, but are not excessive.

Examining the experience and duration of previous boom-like periods can be instructive. The last time the Eurozone was growing this quickly was in 2011. However, the economy only managed to sustain a pace of growth at or above 2.5% YoY for one quarter, before growth quickly fell back. Indeed, by early 2012 the Eurozone was in recession. Clearly this raises concerns that we may be just seeing another short-lived growth spurt. However, the flaring up of the Eurozone debt crisis caused the decline into recession in 2012. Periphery countries have since reformed their economies substantially and brought their public finances under control. For example, Spain's budget deficit as a percentage of GDP has decreased from 9.5% in 2011 to 1.8% in 2017, Italy's from 3.5% to 1.6% and Greece's from 10.2% to 1.6%.This time around risks to growth are predominantly external rather than internal.

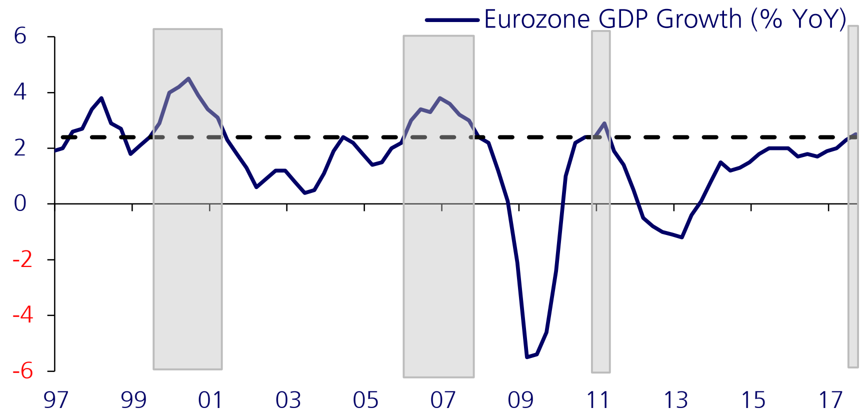
The last time growth was as high as it is currently, apart from the brief period in 2011, was from Q1 2006 to Q3 2007 and before that from Q3 1999 to Q1 2001. So historically, when strong Eurozone growth has ended, it has been because of an external catalyst, typically a global financial market bubble bursting, preceded by very strong growth for around two years beforehand.

This suggests that if history is a guide we are probably less than half way through the current growth spurt. In particular, 2018 should see another year of strong, above trend growth for the Eurozone, though as the year progresses we should become more vigilant of financial market bubbles and economic imbalances building up, either in the Eurozone or elsewhere in the global economy.

Risks remain, but should be manageable

In terms of risks to this upbeat outlook, the key internal risk is political: the forthcoming 2018 Italian elections. General elections must take place at the latest by May 2018, with March the most likely month. The anti-establishment Five Star movement is currently

Chart 1: Eurozone growth enters another "boom" phase



Source: Bloomberg, Shaded area represents period where growth is at or above 2.4% YoY

leading in the polls. However, recent changes to the electoral law in Italy will make it hard for them to gain power. Instead, a centre-right or centre-left coalition government looks to be the most likely outcome. Nevertheless, it will be important to monitor the trend in the polls as we get closer to the election date. A further increase in support for the Five Star Movement could start to worry investors and add an extra risk premia to Italian asset markets in the run up to the election.

As a relatively large open economy, the Eurozone is also vulnerable to a wider slowdown in global growth generated by another major economy such as the US or China. Exports of goods and services are 27% of Eurozone GDP compared to 12% for the US. However, the current strong domestic growth dynamic suggests that the Eurozone would be resilient to a more moderate slowdown in growth in one of its major trading partners

Strong growth points to higher yields and favours equities over bonds

What are the investment implications from another year of well above trend growth? On the fixed income side we expect a gradual increase in bond yields, in both core and periphery markets. Although the ECB has made it clear that it will continue with QE asset purchases through most of 2018, albeit at a reduced pace, there are tentative signs of inflationary pressures emerging that are likely to mean that the ECB will end QE purchases in 2018 and raise rates in 2019.

We expect spreads between periphery and core government bonds to gradually widen in 2018 as investors anticipate the scaling back and eventual end of QE. Uncertainty around the outcome of the Italian elections could be a catalyst for a bigger move wider, but the key reason we expect spreads to widen is simply because of the reduction and eventual end of government bond purchases by the ECB in 2018.

Upside in credit is limited, with more credit differentiation likely

We see limited upside in credit given tight spreads and weaker fundamentals, and we prefer equities to credit within risk assets.

Credit has benefitted significantly from the ECB's QE as well as from the global search for yield. This has, however, led to very tight spreads, despite high leverage in both banks and non-financial issuers. At the same time, within the credit universe there is very little differentiation between weak and strong credits, with the exception of some distressed credits that have a reasonable prospect of defaulting. European high yield credit yields between 2% to 3%, and given historical default rates it is hard to see how investors can breakeven on such low 'all in' yields over the cycle, let alone make a positive return.

Apart from the low levels of yields being paid out, risks are also elevated. High yield has become vulnerable as leverage is high and interest coverage is low despite low interest rates. Notably, European high yield has started underperforming not only investment grade, but also US high yield credit. While high yield is vulnerable, we also remain concerned around European banks. European banks are still very large and leveraged, highly interlinked to sovereigns and to each other, which along with profitability pressures and NPLs can create points of vulnerability. The ECB is nudging banks towards bolstering balance sheets but so far, the response has been slow and reactive.

We believe that European credit markets are likely to encounter greater challenges in 2018, even in good macro conditions. Firstly, the support from global central banks, including the ECB, is likely to wane in 2018, which will remove a key tailwind for credit markets over the last few years. At the same time, differentiation between credits is expected to return to the market, as investors start upgrading portfolios in quality ahead of the credit cycle turn. We believe that the European credit cycle appears to be less mature than the US credit cycle. That said, historically, at least whenever the US credit cycle has turned, the European cycle tended to follow quite quickly due to linkages through funding markets.

All in all, while we are not excited around the prospects of credit market returns in 2018, we don't expect an imminent bear market. That said, we think equities offer a better risk reward than credit on a relative basis.

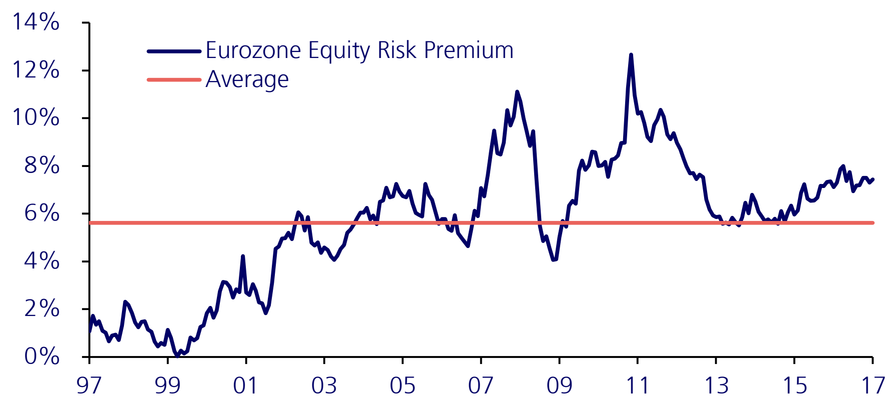
Equities should benefit from earnings growth and multiple expansion

By far the biggest determinant of Eurozone company earnings growth historically has been GDP growth. Therefore, the current strong growth environment should support earnings. Indeed, we expect Eurozone earnings growth in the high single digits or low double digits next year, which is above consensus.

Earnings growth had been volatile in 2016 and 2017, because of the fall and then increase in commodity prices in 2016 and 2017. Lack of clarity around bank earnings, restructurings, exposures to regulatory fines and NPLs has also made it hard for investors to get clarity on the financial sector outlook. As a result, they have attached a higher risk premia to Eurozone equity markets.

We expect 2018 will be a year where Eurozone earnings are less volatile than the last few years, giving investors greater confidence and clarity in Eurozone risk assets, and as a result, allowing them to attach a higher valuation multiple to these assets. Indeed, with many headwinds to earnings diminishing, and underlying economic growth strong, the outlook for Eurozone equities looks positive in 2018 as long as global growth holds up.

Chart 2: Eurozone equities attractive, especially relative to bonds



Source: Bloomberg, Equity Risk premium is defined as earnings yield of Eurozone companies minus real government bond yield

Switzerland

Outlook

- Growth is expected to improve modestly, but remain unbalanced as domestic headwinds persist
- Underlying price pressures are benign, and inflation should stay low following its rapid rise over the past year
- The SNB is expected to implement some changes to monetary policy over the coming year

Implications

- Bond yields should stay rangebound, though they are unlikely to revisit their past lows
- Movements in the franc will be limited by strong fundamental demand and the potential for SNB interventions

Risks

- Record-high forex reserves triggering an unexpected and disruptive change in SNB policy
- The vulnerability of the housing market to a shift in the rate environment
- Inflation rising more rapidly than expected

GDP rebounds in Q3, in line with strong surveys

GDP picked up pace in Q3 when it rose by 0.6% QoQ, which was the fastest rate since the end 2014. For 2017 as a whole, however, we expect GDP to rise by a meagre 1%, which scores it in the bottom rank of the G20 economies. Survey data, by contrast, have been very strong throughout the year. The manufacturing PMI is among the highest globally and the KOF leading indicator, which is a broader measure of activity, is firmly above its long-run average. The divergence between "hard" GDP and "soft" survey data is striking and has persisted throughout 2017, partly reflecting an unbalanced economy in which manufacturers are boosted by strong global demand while the domestic economy lags behind.

GDP growth should improve in 2018, rising modestly above trend

Going forward, we expect domestic demand to gain some momentum. The upswing in global growth has positive spill-over effects on local labour markets and investment, while the weaker franc further boosts exporters and improves competitiveness in services and the retail sector. Upsides are limited, however, and we have pencilled in an expansion of 1.7% in 2018, which implies a sharp rebound compared to 2017 but is marginally below the consensus forecast. This mainly reflects our view that domestic demand will stay sluggish.

The manufacturing sector is being boosted by the global capex recovery

Strong Eurozone and global demand is boosting the manufacturing sector. The Swiss manufacturing PMI is at a six-year high and all components, including new orders, are firm. Manufacturing activity in Switzerland is closely tuned to the global cycle, so this should not be surprising. Nonetheless, the Swiss PMI is currently running at a higher level than the global PMI, while the opposite was true following the franc appreciation in 2015. This indicates that Swiss exporters have broadly restored competitiveness.

The trade-weighted Swiss franc has depreciated by around 6% over the past four months and the global cycle is firm as we enter 2018. Going forward, this should help underpin firm activity among exporters, though a further acceleration looks unlikely.

Consumption is still feeble, capping growth more broadly

Domestic demand has contributed to the GDP weakness over the past year. This partly reflects sluggish consumption, which has expanded by only 0.7% YTD, and which disproportionally impacts overall growth given a 65% GDP share. Looking forward, there are signs that headwinds to consumption are diminishing: The latest surveys report improving conditions in the retail sector as a result of the weaker franc; Tourism has picked up momentum, spurred by the brisk global cycle and the cheaper currency; The labour market is improving and the unemployment rate is falling (at 3.1% compared to 3.3% in the beginning of the year); Employment surveys, such as the PMI employment index, have improved and Swiss manufacturing firms are now, on balance, expanding their workforce, while shrinking it in the prior two years. Consumer confidence has edged higher and is tracking above its long-term average. Additionally, the net wealth position of the household sector is solid and savings are high, at above 23% of GDP. This underpins our view that the drag from domestic consumption will diminish going forward. However, upsides are limited, given structural headwinds that imply that labour market concerns and cross-border trade will not dissipate.

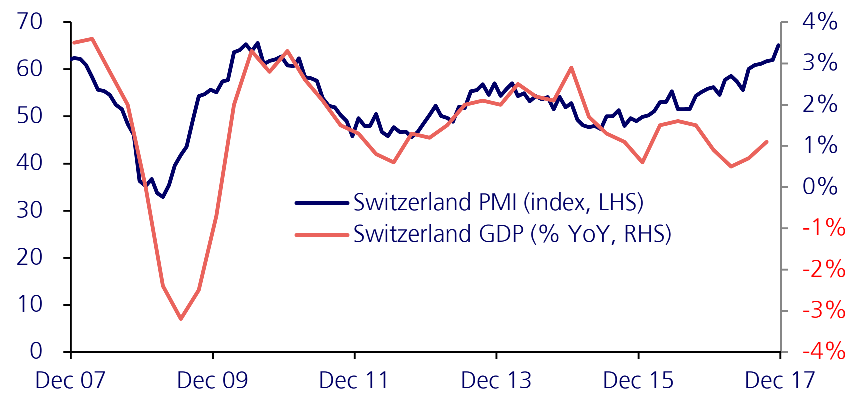
Investment is unlikely to decisively shift growth prospects

Business investment has been sluggish over the past few years, as a result of overcapacity in the manufacturing sector, downbeat sentiment, and intense pressures on profit margins and costs. While there is still overcapacity in some sectors of the economy, surveys indicate a high backlog of new orders while stocks have adjusted downwards. With a weakening franc, diminished concerns around the Eurozone and the global economy, and strong foreign demand for investment and machinery goods, investment trends should improve. Albeit volatile, this was also confirmed by the latest GDP data, which show equipment investment rising by 0.9% QoQ in Q3, following similar growth in H1. This is encouraging, and critical for productivity development, but a modest pickup in investment will not materially change the profile for domestic demand, as its share in GDP is only 15%. A very sharp cyclical upswing in investment also looks unlikely, given persistent headwinds, such as slowing immigration, a trend towards outsourcing, and the emergence of capital light companies in the faster growing sectors of the economy.

A late cycle housing boom is unlikely, despite the negative yield environment

Construction investment was an important growth driver over the 2010-2015 period, when it expanded at a pace of 3% annually. Since then, housing investment slowed, grinding to a halt in 2016, but it has recently picked up again and is currently tracking a bit below 1% YoY. House prices are also edging higher, following a period with price declines in some sections of the market, indicating that the slump is bottoming out. Investor demand is also strong, despite falling rents, as a consequence of the negative yield

The economy is not as weak as GDP suggests



Source: SECO, Bloomberg

environment.

While this is positive, a late cycle housing market boom is unlikely, given weak nominal growth, slowing population growth, falling rents and high debt levels; mortgage debt is above 120% of GDP. The SNB is also concerned about imbalances in the property market and, were there to be a sharp rebound, an adjustment to the countercyclical capital buffer looks likely, capping the expansion. Sluggish construction is therefore likely to continue to weigh on the economy going forward, partly offsetting the strong industrial sector.

Inflation has surged, but underlying trends remain modest

While growth has been weak, inflation has risen faster than expected. This makes Switzerland an exception among the industrialised nations. In our view, this reflects a normalisation from extreme conditions. The sharp rise in inflation over the past year, when CPI inflation accelerated from -1.4% YoY to 0.7%, should therefore not be projected forward. The bulk of the increase reflects base effects from import and oil prices, though services inflation has also edged higher. Wage inflation, however, is weak, tracking below 1% YoY, and this will limit further upsides. We project broadly flat inflation over the coming year, at around 0.7% YoY.

The case for deeply negative rates is diminishing

While the franc is still mildly overvalued vs what we consider fair value against the euro, pressures on the franc have receded. The case for deeply negative rates and large forex interventions has consequently diminished, and the focus is now shifting towards when, and how, the SNB will begin to normalise policy.

In the first stage of normalisation, which arguably is already happening, we expect the expansion of excess reserves to be passively tapered, as forex interventions are scaled back. At a later stage, we also expect the SNB to actively reduce its holdings of foreign currency assets, and raise the policy rate, which remains deeply negative.

The SNB is on hold for now, but 2018 is likely to see some changes to policy

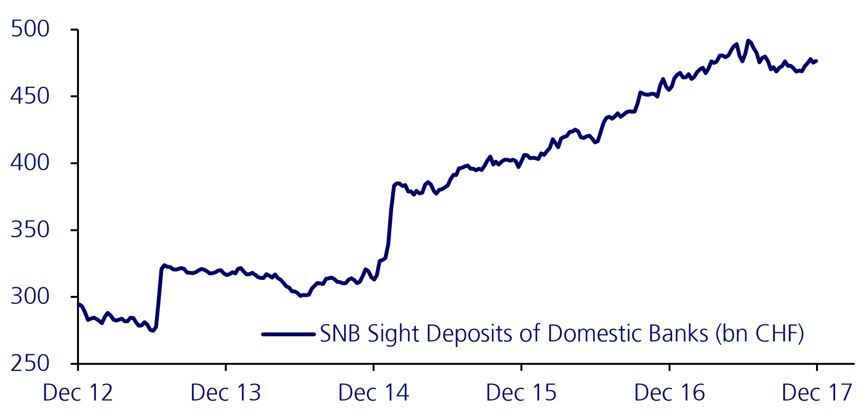
In terms of timing, we expect the SNB to leave policy unchanged in its December meeting, as the economy remains vulnerable and the Eurozone political landscape is still uncertain, with Italian elections in early 2018 at the fore. Looking beyond that, we do not rule out a policy change towards the middle of 2018, likely involving some tentative first steps to reduce the balance sheet, e.g. by tapering reinvestment on the foreign currency bond portfolio. We expect the SNB to proceed more cautiously with rate hikes, with the policy rate likely to be left unchanged well into the second half of 2018. Throughout the process, we expect the SNB to remain focused on exchange rate stability, proceeding very gradually in order to avoid sudden and abrupt changes to the value of the franc.

Given our view that the SNB will very cautiously start to scale back stimulus, we anticipate the EURCHF to remain stable around its current value of 1.17 as we enter 2018. Fundamental demand for the Swiss franc remains strong, given a very large trade surplus, and that limits further depreciation. On the other hand, the potential for renewed forex interventions should limit upsides.

Bond yields should stay low, and remain capped by the low Bund curve

In the absence of a sharp repricing of German bunds, Swiss government bond yields will remain low. The SNB explicitly targets a negative interest rate spread and this policy is expected to stay in place for time being. That said, improvements in the Eurozone mean that we do not expect Swiss yields to revisit the lows from last year, when the whole yield curve was negative. We see the 10yr Swiss Confederation yield fluctuating around zero over the coming year. The short end is likely to be well anchored in the first half of the year, though the 2yr yield should edge higher over time, to reflect changes in the policy environment. The curve is unlikely to steepen significantly, given a lack of supply, particularly for longer maturities.

Excess reserves stabilise as the SNB reduces forex interventions



Source: SNB, Bloomberg

Japan and Korea

Outlook

- Growth is expected to remain brisk, but should slow due to capacity constraints
- Inflation is likely to pick up, but will fail to reach the 2% inflation target in 2018
- The labour market will remain healthy

Implications

- Company earnings are expected to keep growing at a healthy pace
- This should lift the equity market higher, even if valuations stay steady
- The yen has room to weaken due to monetary policy divergences

Risks

- A sudden and severe appreciation in the yen
- The global growth cycle ends earlier than anticipated, negatively impacting exports
- The North Korean crisis takes a turn for the worse, dampening consumer and market sentiment

Political stability enables steady economic policy

The ruling LDP/Komeito government coalition regained its two-thirds 'super majority' during the Lower House snap elections in October 2017. This has increased PM Abe's chance of being re-elected as LDP president in September 2018, despite some credible challengers, making him one of the longest serving prime ministers. This enables a smooth policy environment, which is conducive for the current expansion phase to continue.

We expect above-trend growth to continue in 2018. The current expansion phase is the strongest since 2001, with the economy growing for seven quarters in a row. Even if we were to see one negative quarter during the course of 2018, this would not alter our generally positive stance. We expect the current expansion phase will not only last longer than the "Izanagi boom" from 1965-70, but even the "Izanami boom" from 2002-08, which would be the case if growth were to continue to January 2019. Even though the length of these booms is counted by how many months the coincident indicator rises, it does not give an indication about the strength of the boom phase, and particularly the contribution to household wealth and consumption. However, there is no doubt that the economic expansion since PM Abe took office is impressive and may last well into 2020.

Global trade growth is expected to continue to underpin Japan's exports, though Chinese demand for Japanese machinery and electronics goods may slow somewhat due to tighter credit policies, particularly for infrastructure and property market projects. A revival of the "TPP ex US" deal as well as positive RCEP trade negotiation outcomes may help, though these benefits will only become more visible in the medium to long term.

Our favourable consumption outlook is driven by a firm labour market, growing income and the foreign tourist boom

Consumption growth should be a main pillar for the favourable growth outlook. The labour market is in good health, as the recovery of the job-to-applicant ratio from 0.43 in 2009 to a record high of 1.52 confirms. The unemployment rate has fallen to a 24-year low of 2.8%, while employment growth is mainly driven by rising full-time employment, which differs from previous phases where it was mainly supported by rising part-time employment. This should increase the propensity to spend. Consumer confidence is improving step-by-step, while the household component of the Eco Watchers survey is also encouraging, even though both have not yet reached their pre-financial crisis highs. Of course, consumption may be negatively impacted by weather related factors, as seen in Q3 2017, for example, but this does not negate the positive trend. Another headwind is the lacklustre consumption by pensioners, as this group will grow due to demographic characteristics in Japan.

Furthermore, the impact of the foreign tourist boom on consumption is increasing. This becomes visible when having a closer look at Tokyo department store sales, where tax-free consumption, primarily by Chinese and Korean tourists, has a major impact. Within the last 15 years, the number of foreign tourists to Japan has quintupled, while the number of Chinese visitors has risen more than tenfold, with no end to the boom in sight. The Olympics in 2020 should give another boost.

Positive capital investment outlook

Continuous replacement requirements as well as capacity expansion continue to underpin our strong capital investment outlook. Labour shortages require investment in automation. Even though managers continue to unveil rather conservative capex plans, the strong relationship to earnings suggests that capex will continue to be a growth driver for rising plant and equipment spending. Improvements in corporate governance is forcing the deployment of cash for investment, while the 2020 Olympics will drive investment in Olympic facilities and hotels, though the positive impact may peak in 2018.

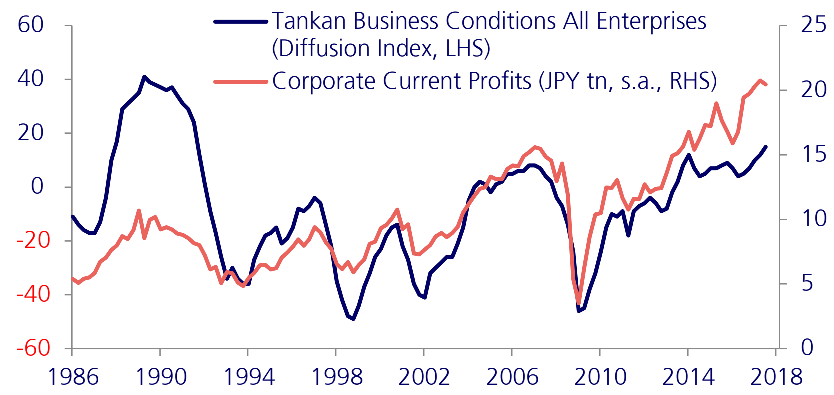
When will inflation reach the 2% target?

The Bank of Japan has so far failed to achieve its 2% inflation target, based on the new core CPI definition excluding fresh food and energy, which is still hovering just above zero. BoJ Governor Kuroda claims his target, which has been postponed several times, has mainly failed to be achieved due to the negative indirect impact of falling oil prices in 2014 and 2015. However, he claims that the target itself will be maintained, as inflationary pressure will kick in with a delay, and because inflation expectations need to be maintained.

We do not expect that the new core CPI measure will even reach 1% in 2018, despite the economy growing above trend. Corporate pricing power is not yet sufficient to raise prices steadily, particularly considering the limited spending ability of pensioners. Certainly, there are sectors with severe labour shortages, as in the construction industry or in parts of the service sector. However, companies tend to replace workers with automated systems or even robots, which will put a constraint on higher salary requests.

There are hopes that the government will declare an end to deflation well before the Bank of Japan. This may indeed become a topic closer to the LDP presidential election later in 2018, but it is too early to think about such a statement now. The government has been pushing corporations for years to raise wages in order to end deflation. This plea would not sound convincing if an end to deflation were to be trumpeted.

Favourable business conditions are driving profits



Source: BoJ, MoF, Bloomberg

As for the Bank of Japan, we will keep a close eye on whether Governor Kuroda will be replaced in April, and if so, by whom. Kuroda's two deputies, Iwata and Nakaso, are also scheduled to be replaced in March. Consensus is betting on another term for Kuroda himself, while probabilities have recently decreased for other potential candidates, including an even more radical dove.

In mid-October, the government will need to make a final decision on whether the consumption tax will be raised again on October 1st in 2019, this time from 8% to 10%. We believe that the decision will not be revoked again, particularly as some food items will be exempted, and as a major part of the additional tax income will be used to finance free child care programmes. While this step will have a deflationary impact, the consumption tax hike will raise inflation, albeit temporarily.

The equity market has more upside potential

2017 was an interesting and at the same time challenging year for the Japanese equity market. Decent double-digit percentage gains, a 25-year high for the two major indices, the Topix and Nikkei 225, as well as a record sequence of daily gains have been making headlines. Whereas the BoJ's ETF buying supported the market throughout the year, it was foreigners who suddenly rediscovered their appetite for Japanese equities during autumn that gave an additional boost. It is also worth noting that the strong correlation between the USDJPY and the relative performance of the MSCI Japan index versus the world weakened significantly in Q4. It remains to be seen whether that is just a temporary phenomenon, or whether foreign investors have realised that the strong correlation is not a given, and the market will finally decouple from the currency.

The market will first have to digest the latest surge, which may result in a slow start to the year, but we believe that the 'iron coffin lid' on the Topix range of 1,750–1,850, could finally be broken to the upside in a more convincing manner. Once that happens, foreign investors would pay even more attention, and could give another boost to the market. There is room to the upside before foreigners become euphoric, which would be a signal to become more cautious. Valuations are still reasonable to cheap, while corporate governance is improving, which also supports our view that there may be more upside. The main risk for this rather rosy scenario is a decisively stronger yen caused by a perception change in monetary policy by the Fed and the BoJ, which would lead to a narrowing of the long-term yield gap. Another risk is a deterioration of the North Korean issue, as investors are highly susceptible to this crisis. Foreign investors tend to quickly liquidate positions in Japan's highly liquid market whenever a global crisis emerges, while domestic investors are extremely nervous when North Korea threatens to launch a rocket.

Export performance expected to remain solid in South Korea

Referring to Korea, it is surprising that the North Korean crisis hasn't had a more negative impact on South Korea's economy. Indeed, both business as well as consumer sentiment has recovered nicely throughout the year, and even China's boycott against South Korea's tourism industry, following the installation of an American anti-missile system, was less of a drag than previously anticipated. We don't expect this drag to continue, as the economic relationship between both countries is normalising.

Will the 'iron coffin lid' be broken in 2018?

Source: Bloomberg

South Korea has benefitted from a surge in exports, as global trade growth resumed and demand for South Korean technology has been brisk. As our global trade outlook remains benign, we believe that Korea's exports will continue to be a solid contributor to growth in 2018. Even though only some parts of the manufacturing sector are the beneficiaries of the export boom, there may be some trickle through effects on private consumption. A major problem remains South Korea's high household debt, which is now being tackled by the authorities through macroprudential tightening.

Another problem is the huge difference in productivity between the well-known major conglomerates, the 'chaebols', and SMEs. The government is trying to make the latter more attractive for workers by raising the minimum wage by 16.4% in 2018 and by implementing tax incentives to improve employment conditions. However, we doubt whether these measures will help to tackle the principle problems, as they are not enhancing productivity. At the same time measures will be taken to slow the intrusion of the big chaebols, into the service sector.

The Bank of Korea has already given hints that it may increase policy rates by more than the 25bps hike to 1.5% initiated at the end of November 2017. Economic conditions have certainly improved enough to hike again, but we believe that inflation should be contained and stay within the BoK's tolerance zone, particularly as the output gap has not yet closed.

South Korea's equity market is expected to continues to perform well

We expect another decent year for Korean equities. Much depends on the performance of Samsung Electronics, which dominates the MSCI Korea with an index weight of one third. South Korea is the cheapest Asian equity market on a PB/RoE screen. We expect chaebols to care more about shareholder interests, but that process will take more time.

China and Taiwan

Outlook

- Economic momentum is slowing, but economic conditions remain robust overall
- Innovation, the vibrant service sector and private consumption remain driving forces of China's economic dynamism
- The deleveraging cycle is necessary, but will curtail growth

Implications

- Chinese equities will be led by the new, mostly internet-related companies
- Companies need to deliver the high earnings growth that is discounted by high valuations
- The RMB is expected to depreciate, though not dramatically

Risks

- The pace of deleveraging is more disruptive than desired by policy makers
- Renewed conflicts with the US in economic and security related topics are not likely, but certainly a risk
- The internet stock frenzy experiences a sharp setback, resulting in an overall loss of confidence in Chinese stocks

The 19th Communist Party Congress has set the tone for the medium to longer term outlook

China is on track to shift its focus to quality instead of quantity when it comes to economic growth. While the previous target to double China's GDP by 2020 was not officially reconfirmed during the latest Communist Party Congress, it has not been cancelled, which suggests that a 6½% growth pace remains likely for the next two years. However, we also note that an official stated in a well-respected newspaper that GDP growth of around 6.3% over the next three years would be enough to achieve the Communist Party's growth target. It is obvious that purely chasing a specific growth target by any means has become less of a focus than before. This means that a slower pace of growth is likely to be tolerated as long as the drift towards a cleaner environment, higher income equality and reduced poverty is maintained. However, whenever the economy is on the brink of slowing too sharply, we believe that adequate policy measures will be taken to avoid a downward spiral, as the government has enough room to employ fiscal, monetary and macroprudential measures to fight back.

China's authorities are determined to avoid a middle income trap by all means in order to achieve their longer-term ambition, which is to become the biggest global economy, even though it will never be formulated that transparently. Roughly in line with consensus, we have pencilled in a growth rate of 6.4% for 2018, down from our estimate of 6.8% for 2017. However, we continue to warn against misinterpreting growth forecasts to the last decimal point, as there are still some doubts about the quality of GDP statistics in China, which do not yet completely adhere to international standards. We continue to prefer alternative leading indicators to get a glimpse of the true pace of growth, even though we recognise that some of them do not fully capture the vibrant tertiary industries. What is clear to us is that China seems likely to remain in a 'goldilocks' growth range next year – not too hot, but not too cold either.

A year ago, we had been predicting a slowdown over the course of 2017, which has now finally materialised in Q4, maybe not by coincidence following the Party Congress. Fixed asset investment growth is faltering, as are nationwide property sales. Some growth proxy measures are also rolling over, even though PMIs remain robust both in the manufacturing and service related industries.

Property slowdown is finally underway, though we do not expect a bust cycle due to low inventories

The property sector is expected to become a drag next year. As property prices are not rising any longer, there will be less pressure for potential buyers to rush into the market. As household leverage has been rising and credit policies have become tighter, headwinds will increase. Throw in the fading impact of shanty-town subsidies and it becomes clear that the property boom in many segments is over for now. Fortunately, no significant downturn or crash, comparable to the circumstances that prevailed four years ago, is predicted, as inventory has come down and construction growth has slowed.

The other major factor that will contribute to slower growth is supply-side reform. The process of excess capacity reductions is already in full swing, particularly in the mining and heavy industries. Stricter environmental regulations are finally no longer nice talk, but are getting implemented. This does not only put a lid on growth, but has become a drag. SOE reform is another driver to consolidate industries, which will have a short-term negative impact on investment and production next year, but at the same time should also improve the earnings outlook. The swing in producer prices has already contributed to a remarkable increase in industrial profits over the last two years.

Brisk outlook for consumption and exports

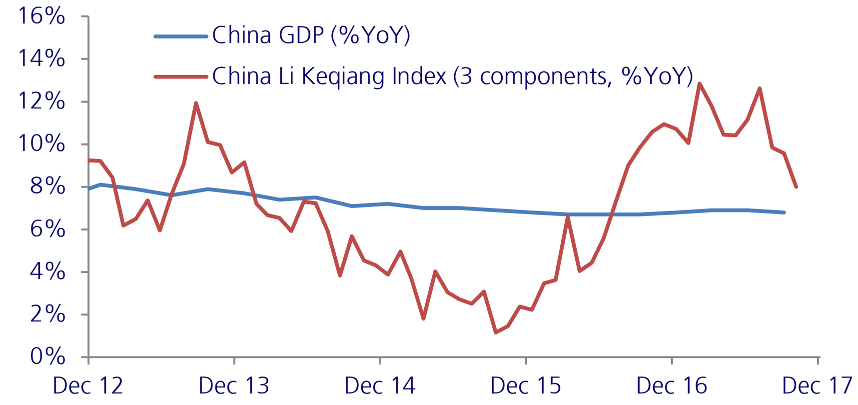
Consumption will remain a bright spot next year. Income and employment growth remain intact, and consumer credit is now more easily available than before. With the property boom deflating, demand for luxury goods is expected to slow, while online shopping will continue to boom, as the latest surge during the 'singles' day as well as 'Black Friday' confirms. As online shopping is not part of retail sales calculations, we would not be surprised if YoY retail sales growth were to fall below the 10% mark.

As our global trade outlook is positive, we also believe Chinese exports will do well, though CNY appreciation will be a drag. A trade war with the US looks less likely than a year ago, however, there will be segments where friction will pop up from time to time. Slower domestic investment growth is expected to hamper import growth, which should be a boon to net export growth in 2018.

CPI inflation up, PPI inflation down

Rising input costs in 2017, following the surge in some commodity prices, should find their way through the value chain, leading to a pickup in consumer price inflation. Power tariffs are also expected to be lifted higher. We have pencilled in a rise from 1.7% YoY in 2017 to an average 2.3% in 2018. Only if services prices in areas like healthcare and education were to accelerate further would our benign inflation outlook be at risk, something we will monitor carefully. On the producer side we expect PPI inflation to decelerate from the current level of around 7%. The still benign inflation outlook argues for stable policy rates next year, even though

China's growth is slowing on tighter credit policies



Source: Bloomberg Li Keqiang Index: Bank loans (40%), Electricity production (40%), Rail freight volume (20%)

the Fed will continue to hike. Monetary policy will continue to be 'prudent', combined with regulatory tightening and the move toward deleveraging. Aggregate financing is expected to grow at a slightly slower pace than in 2017, particularly as shadow banking will suffer from increased supervision.

Will the stock market rally go on?

The MSCI China index has rallied more than 50% in 2017, with its top performer, a major property developer, up six-fold. However, the rally was mainly driven by major internet stocks, many of them US-listed ADRs that make up more than 40% of the index, including the two heavyweights Alibaba and Tencent. Both stocks more than doubled. Hong Kong listed 'H'-shares and domestic 'A'-shares benefited less from the internet boom, but were still up by about 25%.

Considering that the MSCI China index ex the big internet stocks is still cheap, we think the index has more upside in 2018. The major internet stocks, even if they seem expensive based on their PEG-ratio, may benefit if foreign investors buy China and emerging market funds, as they will automatically also invest in these heavyweights. Overall we believe there is more upside for emerging markets, and China, as the major component of these indices, will benefit. We also see strong southbound flows from Mainland investors into many of the Hong Kong listed stocks in the MSCI China. However, should there be a pullback in the internet stocks, 2018 may be more volatile than 2017.

Currency is expected to depreciate somewhat

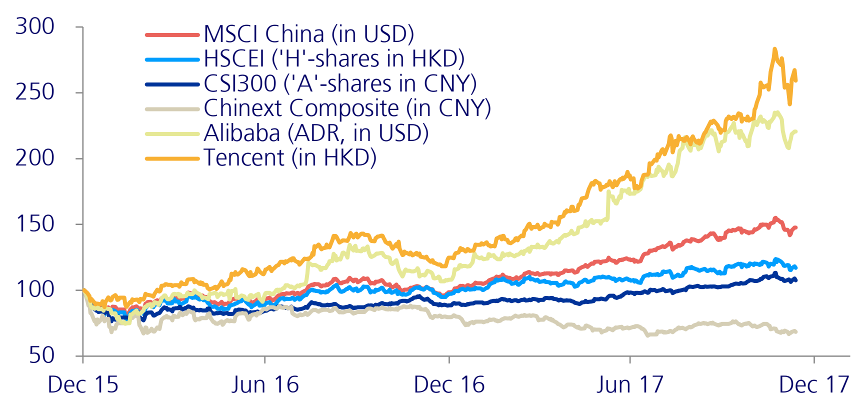
As far as China's currency is concerned, we expect a soft depreciation trend, as heavy capital flight has subsided following the implementation of stricter rules. This should help export competitiveness. A strong depreciation, however, is not expected, as this could trigger accusations of currency manipulation from the US administration. The PBoC wants to avoid a one-way bet against the currency, which should make the trend somewhat volatile. However, we do not expect huge swings in the currency as seen in 2017, and also do not envisage a broadening of the CNY band.

Headwinds and tailwinds for Hong Kong's economy

Hong Kong's economic growth has come in stronger in 2017 than consensus had expected. Buoyant global trade has certainly helped net exports, while retail sales have also picked up nicely, partly as Mainland tourists have started to open their purses again. We expect export growth to hold up well as long as China's domestic economy does not fall into a tailspin. Tailwinds will also come from the rather expansive budget. According to Chief Executive Lam's policy address, spending on research and development will double, while profit taxes will be cut substantially for the first HKD 2mn. In addition, the middle class will be able to use new schemes to buy homes.

Risks are evident in the property market. House prices have continued to rise substantially over the last two years, but there are now signs that property prices may start to roll over. Indeed, property transaction volumes have slumped since the HKMA implemented tightening measures, which was followed by softer home prices. As Hong Kong rates follow the Fed policy rate hikes due to the peg, and as land supply will slowly increase, there will be headwinds in the property market. We would not be surprised to see prices roll over and start falling in 2018.

Internet stocks are driving MSCI China index performance



Source: Bloomberg; Indexed to 1. Jan. 2016 = 100

Taiwan benefits from the strong tech cycle and infrastructure spending

Taiwan is benefitting from the global tech cycle, but we note that exports have also shifted towards commodity related products. In the tech space, sales of Apple's iPhone 8 were somewhat disappointing, but it seems that strong sales of the iPhone X should help Taiwan's tech exports to remain brisk in H1 2018.

Public infrastructure spending should be a second pillar of growth in 2018, while higher disposable income is expected to underpin a pickup in private consumption. The government will raise wages for public sector employees, the minimum wage will be increased and private companies are already in the process of following suit. This contributes to rising consumer confidence and should bode well for private consumption in 2018.

As for monetary policy, we believe Taiwan's CBC will follow the Bank of Korea's normalisation with a lag, suggesting a policy rate hike by 12.5bps in the first half of 2018, followed by another hike in H2. Taiwan real interest rates are still positive, whereas South Korea's remain negative, despite the latest policy rate hike.

ASEAN and India

Outlook

- Asian trade growth is likely to moderate slightly as China switches to a less import-intensive growth model
- Fiscal spending should boost domestic consumption as several countries enter election and pre-election periods
- 2018 is expected to see India recover from the impact of major reforms undertaken in 2017

Implications

- We see decent upside for ASEAN and Indian equities in 2018
- Foreign investors have capacity to increase their exposures to the region
- We turn more cautious on local sovereign bonds as their yields are at historical lows and as the Fed normalises its policy

Risks

- The moderation in the tech cycle is more severe than expected and leads to a correction in equity markets
- A potential correction in foreign financial markets as the cycle matures in other regions
- The US Fed or the Chinese regulatory authorities commit a policy mistake

Asian trade growth to soften slightly

In 2017, an upcycle in electronics and a global economic recovery have boosted Asian trade to levels unseen since 2014. Going forward, a clearer shift from China to less investment-intensive growth should prompt trade momentum to slow. The strong ratio of global semiconductor orders to inventories keeps us optimistic, though. As for China, we recognise that the domestic property market boom is unlikely to be repeated in 2018. Nevertheless, a more prosperous Chinese middle class and increasing disbursement of social benefits will continue to support discretionary spending, translating into goods and services (tourism) imports from ASEAN. Finally, ongoing innovation in the internet and technology space should nurture the tech cycle.

Diverging monetary stances

We expect the Fed to deliver three rate hikes in 2018 and see the US dollar appreciate slightly before rolling over sometime in 2018. Asian financial conditions will tighten somewhat, but healthier current accounts and increased foreign reserves should cushion the impact of higher global rates. Asian central banks are therefore unlikely to follow the Fed's pace, but should adopt neutral to tightening stances. In Malaysia, where growth has become entrenched and core inflation has picked up, the central bank has room for one rate hike in 2018. Domestic oriented India and Indonesia are experiencing transient economic shocks following a series of structural reforms. Both central banks will favour an 'on hold' strategy unless growth fails to rebound.

Our view on central bank action assumes a modest uptick in regional inflation. Indeed, the extremely benign conditions for food inflation are unlikely to continue in 2018, and a key source of uncertainty is the direction of global oil prices.

India to recover from reform disruption

We expect the economic disruption from reforms to fade in 2018, leading to a rebound in real GDP growth to ~7.4% YoY, while CPI should edge up to ~4%. India underwent three ambitious reforms this year. The economic situation has normalised post demonetisation, but has been affected by the more recent introduction of the Goods and Service Tax (GST). Consumer confidence, the retail trade, and manufacturing have been severely hit. Anecdotal evidence suggests that two main drivers are at play: mistrust in the system of input tax credits (aimed at avoiding double taxation), and the reluctance of many businesses to move from informal to tax-compliant transactions. In our view, the situation should improve thanks to the flexible attitude of the government and to recent measures to simplify and reduce tax rates.

Boosting tax revenues was one of the objectives of the demonetisation operation. As cash was deposited in banks, suspicious accounts were flagged and investigated. Other operations by the tax authorities include digitalising and connecting data around individual identity and financial transactions. Overall, the recent reforms go in the right direction, even if it is too early to assess their financial success.

Non-performing assets have reached 20% of public bank balance sheets and have been another policy battlefield. The government has announced a comprehensive recapitalisation plan for public sector banks in the amount of INR 2.11tn or 1.3% of GDP, over two years. In our view, this should, over time, help to revive private investment.

A few risks threaten our 'growth revival' scenario. The central government and the states have limited fiscal space in the short term as tax collection enhancement policies should be effective with a lag. A hypothetical further increase in global oil prices would weigh on the ´double deficit´. The third risk is political. A series of state elections in 2018 will precede the general elections in 2019. At stake are additional parliamentary seats for the BJP coalition and the elections will also be a gauge of President Modi's popularity. Modi needs to secure a second five-year mandate to push his reform agenda.

Indonesia, a much needed rebound in consumption

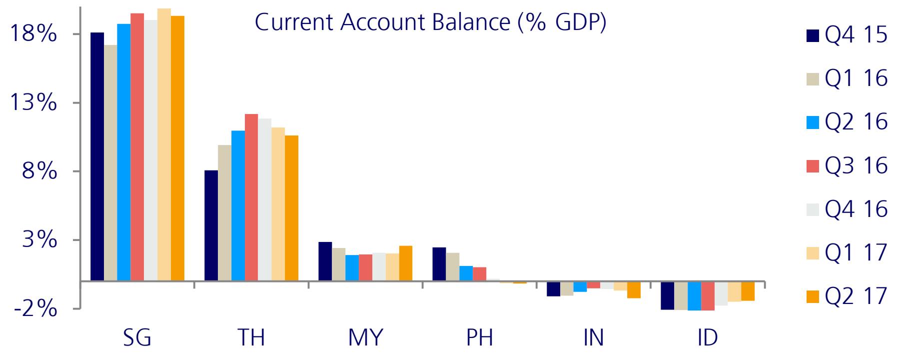
We see Indonesia GDP growth gaining a few decimal points in 2018 to average 5.3% to 5.5% YoY. CPI should stay contained at ~ 4% YoY.

In 2017, consumption has surprised to the downside. A combination of energy subsidy removal and a downward revision of the minimum wage (now indexed to GDP growth) has weighed on the purchasing power of low to middle-income households. Additionally, in the wake of the 2016-17 tax amnesty operation, more SMEs have to comply with VAT payment, while spending by high-income households has come under increased scrutiny by the tax authorities.

The burden on low to middle class households should lift somewhat in 2018. Indeed, the 2018 budget has allocated increased funding to education, health, and housing affordability. This justifies our view of a modest recovery in domestic consumption next year.

The expenditure target for infrastructure has also been raised. Several thousand kilometres of toll roads and bridges are planned, with the trans-Java highway expected to be complete by 2019. This should help GDP growth in 2018 and especially in 2019, when the roads come into use. There are downside risks to the execution of the budget. The budget deficit target of 2.2% to GDP for 2018 seems ambitious to us. Fiscal slippage is likely if energy prices stay or rise above current levels.

Current accounts see positive balances or contained deficits



Source: Bloomberg

To minimise the budget deficit, the government has engaged in a tax revenue hunt since 2016. A big step for tax compliance would be achieved if the automatic exchange of information with Singapore (the main offshore centre for Indonesian wealth) goes live in 2018, as hoped.

Another driver contributes to our positive stance on Indonesia in 2018. Private investment is showing signs of life, partly helped by higher commodity prices, and partly by stronger growth of foreign direct investment (FDI) in Indonesia, especially from China. FDI growth should be sustained in 2018. Indeed, an attractive domestic market and ongoing progress in the ease of doing business are compelling arguments for foreign investors.

The structural reforms undertaken by Jokowi's administration have started to bear fruit, but much remains to be done, especially on the issues of decentralisation, fighting corruption, and stimulating private investment. A second presidential mandate in 2019 is therefore much needed. Jokowi's popularity is strong, and the 2018 regional elections should help us to better assess his chance of being re-elected in 2019.

Malaysia is on a cyclical upswing

GDP growth is likely to moderate to a still solid rate of 5% YoY, while CPI should hover around 3% to 3.5% in 2018.

Growth significantly accelerated in 2017 and has spread across sectors. The Malaysian contribution to the global trade value chain has certainly helped. In 2018, export spillover should diminish slightly as global trade momentum softens. Growth in investment and private consumption should continue to boost economic activity, though.

We note that household confidence has remained fragile. Malaysians are concerned about the state of their personal finances. The recent removal of energy subsidies has triggered a surge in transport prices, which has eroded household purchasing power. We estimate that real wage growth is tracking at 2.5% to 3% YoY in September 2017, an improvement from 2016.

In 2018, two drivers should relieve household finances. First, the labour market should tighten further, helping wage growth. In parallel, the government is considering an increase in the minimum wage. The second driver is fiscal. In the 2018 budget, income tax cuts for middle-income households, incentives for housing affordability, and a package for SMEs are among the most prominent initiatives.

The 2018 budget can be considered as voter-friendly. Indeed, general elections have to be called before August 2018. Market volatility will probably rise around the election date, but is unlikely to last. The re-election of Prime Minister Najib is highly probable, although the opposition is stronger than in the last elections, which introduces higher uncertainty.

On the investment side, ongoing infrastructure spending should contribute to GDP growth in 2018. The East Coast rail link, which will connect the east coast with the Klang Valley Port, will cover hundreds of kilometres. We have some reservations about the economic multipliers of some of these projects, though. The construction phase mainly benefits non-local workers. Additionally, Chinese companies are key users of the finalised infrastructure (Kuantan port). The Malaysian government often foregoes tax income to incentivise foreign investment. Finally, the long-term impact on domestic employment growth, innovation, and skill upgrade is uncertain. In the long term, these projects, at least 50% of which were financed by Chinese SoEs, will weigh on Malaysia's already large (15-20% of GDP) contingent liabilities.

Financial markets

With three Fed rate hikes on the cards in 2018, we are turning more cautious on Asian sovereign bonds. Spreads to US Treasuries have contracted to historical lows and global investor positioning has increased considerably. Asian currency volatility should slightly increase but should remain capped by solid FX reserves. Finally, in countries such as Indonesia and Malaysia, domestic institutional investors are mandated to hold a certain share of local sovereign bonds, which should provide a safety net for local assets.

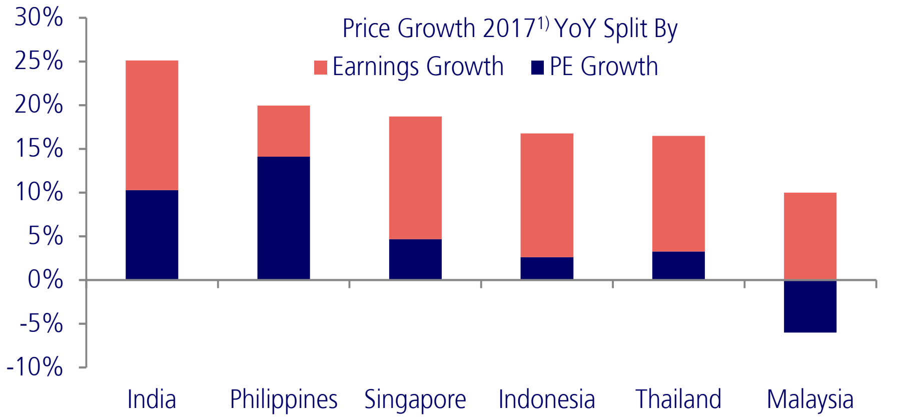
ASEAN equities performed decently in 2017, thanks mostly to a rebound in margins and earnings. Price gains have paled in comparison to those of Northern Asia though. As a result, valuations have remained at or slightly below their seven-year average, with Indian and Indonesian valuation premiums standing out as exceptions. Reasonable valuations and a light positioning of global funds create favourable conditions for regional equities.

We expect mid-teen earnings growth in 2018. Indeed, accommodative fiscal conditions should support economic activity. Several countries are entering election and pre-election phases, which is usually associated with generous consumption incentives. Finally, we see an upside risk for investment growth, as ASEAN catches up with Northern Asia.

Within the region, Singaporean equities should benefit from the transmission of Fed rate hikes to local bank margins. Indian equities should also perform well as the economy rebounds.

In case there were a global pullback, Asian markets would be affected, even if valuations are not stretched. Another, less prominent risk is a sustained rise of energy prices, which would harm Asian consumer-heavy equities.

Performance has relied on earnings growth in most equity markets



Source: Bloomberg (MSCI indices), ZIG analysis; 1) As of December 11, 2017

Australia

Outlook

- Animal spirits will likely boost non-mining business investment further
- The property market is heading towards a soft landing as policy normalisation lags
- Consumption is the missing ingredient in the recovery, but a gradual pickup in wage growth will help

Implications

- The turnaround in corporate earnings is unlikely to repeat itself, but earnings should benefit from the economic recovery
- Budget consolidation is likely to keep a cap on sovereign yields
- Monetary policy divergence is expected to put pressure on the AUDUSD

Risks

- Sudden risk aversion from households leads to a consumption crunch
- Chinese capital outflows from Australia trigger a fall in property prices
- A jump in global market volatility spills over to domestic markets

New drivers of growth

Bottoming business investment, ongoing infrastructure spending, and, to a lesser extent, positive net exports should push real GDP growth higher to 2.8% YoY in 2018. As wage growth recovers slightly, so should household consumption, while CPI is likely to hover around 2.5%. Consumption accounts for 60% of Australia GDP and has so far been the missing element in Australia recovery. It is critical that wage growth picks up this year.

In 2017, strong export volumes and higher terms of trade contributed to a positive trade balance. In 2018, export volumes of iron ore and metallurgical coal, which represent half of Australia's resources exports, should grow further.

Commodity exports hinge on China

The outlook for prices is uncertain, however, and will depend on the policy choices of the main consumer of Australia's commodity exports, China. Volatility in prices is probable as China enforces environmental curtailment of domestic supply, with steel production expected to moderate, weighing on prices.

There are, however, demand factors likely to partly offset this moderation: the Belt and Road Initiative should support the demand for iron ore and coal from Australia, although we suspect it represents only a fraction of China's domestic demand. Outside of China, demand from EM Asia, where large infrastructure projects are ongoing, should help a little.

As for LNG, the government estimates exports are likely to add ~1/3 of a percentage point to annual GDP growth over the next two years as production ramps up.

Mining capex stable at worst

As our base scenario does not assume a sustainable increase in iron ore and coal prices, it is unlikely that we will witness a renaissance of mining investment. Mining companies have, indeed, used 2017 earnings to pay back debt and distribute dividends, but have not announced any major capex projects. Were commodity price growth to surprise to the upside in 2018, this scenario would have to be revised, however. Mining investment as a share of GDP looks like it has stopped falling, at least. For some metals – nickel, cobalt, zinc and gold – exploration expenses have increased significantly, but they represent a modest weight of Australian resource production.

Animal spirits boost non-mining capex

Months of strong corporate optimism have finally revived non-mining capex. Indicators such as private non-residential investment and non-residential building approvals are pointing towards a steady positive trend in business investment. Meanwhile, NAB business confidence and conditions are tracking at historically high levels post 2008, while capacity utilisation has climbed to 82%, indicating that animal spirits should hold steady in 2018. Services, such as health, information, and media, have gained a larger share of non-mining business investment. In parallel, public engineering is recording double-digit growth rates thanks to the strong pipeline of infrastructure projects. Private companies are also involved in infrastructure projects, and therefore pushed to invest in machinery and other capex. In 2018, several billion in infrastructure spending (mainly transport) should represent a significant source of demand.

Underemployment trending lower

Labour market conditions improved markedly in 2017. The unemployment rate fell to 5.4% in October (still 40bps above the NAIRU estimate by the central bank). The participation rate has risen to ~65% YTD, and full-time employment has added close to 240k jobs. With the broader underemployment measure tracking at ~14%, more is needed to absorb labour capacity, however.

In line with our bullish expectations on business investment, we foresee a fall in the underemployment rate in 2018. This should gradually help wage growth to bottom out.

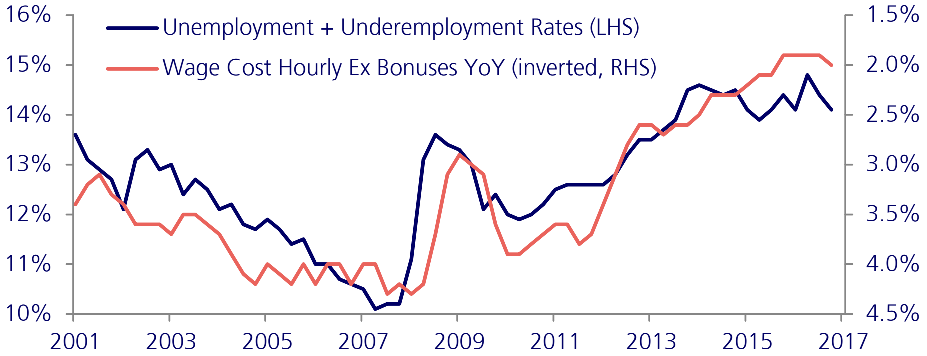
We are indeed encouraged by the strength of various leading indicators. Online vacancies posted on the SEEK online job board have grown at a higher pace recently. Additionally, we find that job openings are experiencing double-digit growth across states. This is positive considering the current geographical disparities in the labour market, with the unemployment rate in New South Wales much lower than in the other states. Vacancies in trade and services, information and technology, healthcare, and real estate have increased. We also observe strong growth in mining employment, even if from a low base. Interestingly, salaries advertised in real estate and property, the sector which created the most job openings in Q3 2017 according to SEEK, are increasing.

Households still under pressure

Contrasting with strengthening corporate confidence, the consumer mood has stabilised at the level where the number of pessimists slightly outweighs the number of optimists. The household savings rate has declined further, close to 3%. Recently, retail sales volumes have recovered somewhat and service consumption has increased. For a rebound in consumption to occur, a positive shock to income growth is needed, however. We do expect wage growth to tick up in 2018, but the process will be slow.

On the positive side, macro-prudential indicators on household balance sheets remain healthy. The proportion of major bank customers who are ahead of their monthly minimum mortgage repayments is around 70% in H2 2017. Additionally, the RBA is

A decrease in underemployment should translate into wage growth



Source: Bloomberg

likely to lag the global monetary normalisation cycle, which should keep debt serviceability levels tolerable.

On the fiscal side, the government has announced its intention to implement income tax cuts for middle-income households. No further details have been published yet, making it is too early to assess the impact of this potential tax relief.

The property market heads towards a soft landing

There are signs that the historically hottest segments of the property market are turning less hot, especially in Sydney where price growth has slowed. Leading indicators confirm this trend. Total private residential investment is now decreasing, while clearance rates at auctions in Sydney and Melbourne are turning south. Real estate investors retain a positive stance, however, which tells us that a hard landing in property prices is unlikely.

These conflicting signals can be partly explained by the recent introduction of macro-prudential regulatory constraints on mortgage lending. Regulations have targeted interest-only and investor mortgages, with the former capped at 10% of total new mortgage lending and the latter at 30%. Lending rates for these two categories of mortgages have increased year-to-date, while a rotation from these types of loans to owner-occupier loans has occurred, leaving the total value of mortgage approvals roughly stable in 2017. Owner-occupiers have clearly benefitted from the new rules, since effective lending rates have actually decreased year-to-date, as a result of banks offering discounts. Additionally, in some states, first home buyers are entitled to fiscal incentives. Ongoing benign financing conditions for owner-occupier and principal-and-interest borrowers argue in favour of a soft rather than hard landing in property prices.

We are more concerned about the prospects of foreign (mainly Chinese) investment in Australia's domestic real estate. Some Chinese property brokers in Australia have reported declines in transactions lately. The latest NAB residential survey confirms the decline in foreign investor participation in new property markets, to 9.5% in Q3 2017, from 11.6% in Q2, the lowest share in five years. The fall is especially stark in Victoria (to 14.4% from 20.8%) and New South Wales (to 7.8% from 12.0%). We were sceptical that the recent introduction of a foreign buyer tax on top of the exiting stamp duty (the total amounts to ~15%) would be effective, as the Australian penalty remains below those enforced by other countries. At this stage, it is too early to believe that Chinese appetite for Australian property investment will dwindle, but it is necessary to monitor flows.

Lately, we have observed a clear pickup in rents in New South Wales and Victoria. A continuation of this trend would be a mixed blessing: on the one hand, higher rental yields could provide a cushion to property owners against future rate hikes, on the other hand, higher rents would impact the disposable income of tenants negatively, in a context of already lacklustre income growth.

The RBA is keeping an eye on wages

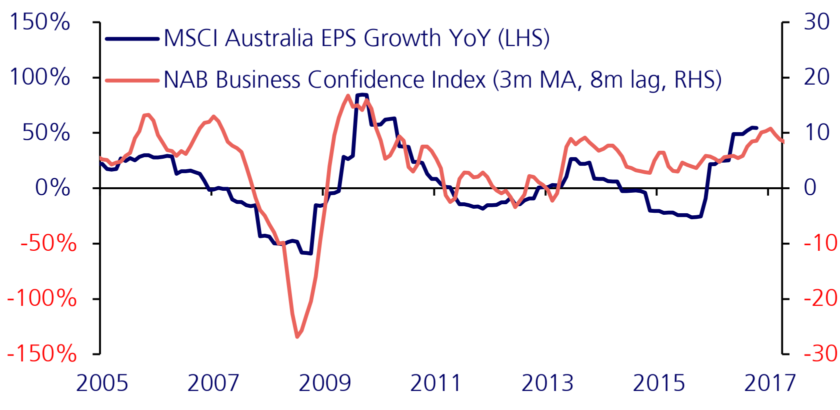
The central bank is keeping an eye on wage growth, as the latter has weighed the most on core inflation weakness, together with low rental growth. The RBA targets a band of 2% to 3% for CPI, and forecasts that core inflation will reach 2% only in Q2 2019. Additionally, the RBA governor has stressed the following two objectives: supporting households economically while containing debt levels. Given the RBA's CPI forecasts and objectives, we think that there is a decent chance of a rate hike occurring in late 2018 or early 2019. Indeed, the labour market is tightening at a strong pace, and capex is rising, which should feed into wage growth by the end of 2018. Additionally, the global recovery could trigger a rebound in Australia's tradable inflation in 2018. This scenario would be put at risk were housing price growth to turn negative in 2018.

Financial markets

Ongoing fiscal consolidation and a moderate increase in inflation should support local sovereigns, although, currently, the 10yr spread to US Treasuries seems excessively low to us. The trajectory of the AUD will depend on the move in terms of trade and, therefore, on Chinese demand for Australian exports.

The turnaround in mining sector margins witnessed in 2017 is unlikely to be repeated in 2018, which, given the weight of the materials sector in Australian equities, points towards lower aggregate earnings growth in 2018, likely around 5% to 10%. As for banking stocks, they will face the headwind of slower lending growth. Overall, we are positive on the reasonable valuations and strong business sentiment, which has historically correlated with good earnings growth.

Strong business confidence usually leads solid EPS growth



Source: Bloomberg

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