Market Strategy and Macroeconomics
Investment Management
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Economic and market outlook

Mid year update 2018: Shifting Sands

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Overview

Economic conditions are robust and growth is expected to remain above trend, while financial markets are in good shape, with upside for equities. The global landscape has become more fragile, however, as shifting sands are evident. From increasing populism and mounting trade tensions, to the spread of financial tightening, risks have risen.

The US economy is now in its second longest period of expansion while globally, unemployment has been falling with wages starting to move higher. Despite this, the march of populism has quickened its step. Italy has joined the procession with a coalition government formed by extreme right and left wing parties that have little in common other than appealing to some of the insecurities that exist. This shows that political stability and future prosperity are not just about headline economic variables. For society to prosper the disenfranchised need to feel that their voices are being heard and their fears addressed. Unfortunately for Italy and others taking the populist path, the reforms that are needed to improve economic resilience and tackle the imbalances are now less likely to be forthcoming.

The correlation between populism and protectionism has historic precedence. While we continue to believe that a trade war will be avoided, the imposition of tariffs by the US and retaliatory measures by trading partners is disruptive and undermines confidence and investment. We suspect compromises will be agreed, particularly with the US mid-term elections in November appearing on the horizon. Unfortunately, with rising rhetoric, further disruption is possible in the near term.

While strong growth affords some cushion to the political and geopolitical developments, it is a double-edged sword. Above trend global growth has encouraged policymakers to shift in the direction of policy normalisation. A more hawkish Federal Reserve and the rise in the USD has forced the hand of others, notably in many emerging markets, in a bid to stabilise currencies and manage deficits. Since the start of the year over a third of central banks have raised interest rates. Notable exceptions have been the BoJ, which is likely to remain in loosening mode, and the ECB, which has pledged to keep rates on hold until at least September of next year, despite announcing that QE would end in December this year.

While the shifting sands are a concern, we maintain that the economic backdrop is robust and conducive to further gains in equity markets. The US continues to lead the way, and, as we point to in the US section, there are now more job openings being advertised than there are registered unemployed. Wages are picking up and inflation has finally reached the Fed's target. Watch out, however, as we still see a US recession looming in 2020. While the BoJ is failing in its own inflation objective, the labour market is at least robust, with the job to applicant ratio now at a 44-year high. Importantly, as we go on to point out, business investment is surging as labour constraints are encountered.

Europe continues to confound. Brexit remains opaque, with little in terms of concrete UK policy initiative. We point to growing business frustrations and signs of investment being shelved as concerns, while the first fall in London house prices since the financial crisis should not be dismissed. Italy garners much attention in the Eurozone section, and while we go into the details and risks, we also venture that perhaps the political developments will encourage Germany, France and others to step up the reform agenda for the region. Growth is expected to remain above trend for some quarters yet and, encouragingly, wages are rising and business investment is gaining traction.

Emerging markets have been under the cosh and offer varying fortunes. We continue to expect growth in China to moderate in a controlled glide-path. Excessive credit and shadow banking are being addressed, but targeted liquidity will be provided when needed and we believe the political establishment still has the ability to control China's own destiny. This is not the case for many other economies that are vulnerable to USD appreciation and have been forced to follow a tightening path. We believe the era of cheap money is over for Indonesia and India, although we suspect that the Asian region will fare better than some other emerging economies.

From a market perspective, the late stages of the economic cycle favour equities over both corporate credit and government bonds, as discussed in the global and regional sections. We suspect that earnings will continue to surprise to the upside and allow investors to once again focus on the strong fundamentals now that much of the political and geopolitical risks have been priced-in. Valuations have improved at the margin as stock markets have largely moved sideways despite the growth of earnings. Credit investors face the increasing headwinds of ever higher leverage, corporate activity that favours shareholders and, if our forecasts are accurate, rising bond yields. While equities offer further upside, the stage of the cycle and higher macro risks imply increased dispersion of returns between stocks, sectors and geographies.

To conclude, the shifting sands around trade, populism and tightening financial conditions are a concern, but the economic and equity cycles have further to run.

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Global

Outlook

- Peak global growth is expected to be behind us, but the pace of expansion should remain robust
- Tighter financial conditions will act as a headwind to the global economy, with central banks now removing stimulus
- Inflation is rising but should not become a problem during this economic cycle

Implications

- Core bond yields are expected to rise, but further upside to yields is limited
- We are cautious on credit as vulnerabilities have built up and risks are rising
- Robust earnings growth, stock-repurchases and M&A should keep equity investors engaged and the bull market intact

Risks

- The better growth environment leads to complacency and a policy mistake
- An escalation of trade disputes dents confidence and spending and disrupts the global economy
- High corporate leverage and European bank risks act as epicentres of vulnerability in financial markets

Global growth is less synchronised but solid, supported by investment and trade

Global growth has moderated since the turn of the year. The growth upswing has become less synchronised, with solid growth in the US while activity has decelerated in Eurozone and Japan. Conditions in emerging markets have also become more varied, with some signs of a slowdown now emerging in China. The mix of growth is encouraging though, with an ongoing investment recovery and resilient world trade. We are also encouraged by the underlying economic fundamentals, as strong labour markets continue to boost household income and sentiment, particularly in developed markets, and business confidence is elevated amid good earnings. These factors are expected to remain in place and drive growth over the next 6-12 months.

Peak growth is behind us, but headwinds are still relatively modest

We nonetheless expect peak growth to be behind us, and do not foresee a reacceleration to the brisk growth rates seen in 2017 H2, when a synchronised spurt drove global growth well above trend. Headwinds are emerging as a result of policy normalisation, higher oil prices and tighter capacity, all contributing to a less growth friendly environment. On an annual basis, we expect global growth to be steady, tracking at around 3.2% YoY in 2018 (weighted at market exchange rates), modestly below last year's growth but still above a long run average of 2.8%. Beyond mid 2019, however, we expect a slowdown in the global economy, triggered by the US, as capacity constraints and tighter Fed policy start to inhibit growth. The precise timing of the slowdown is of course uncertain but, as we are in the late stage of the cycle, a more cautious medium-term outlook is warranted.

Synchronised removal of stimulus, but not yet the end of easy money

Global central banks are rapidly shifting policy stance. Since the turn of the year, one-third (out of our sample of the major 43 central banks) have raised rates. Developed markets should be able to cope with this tightening as overall conditions remain benign. Outside of the US, policy rates are extremely low and the ECB is additionally committed to leaving rates unchanged at least until mid 2019, while scaling down QE by year end. Liquidity will also continue to be injected into the global economy, as the BoJ is still expanding its balance sheet while the ECB will reinvest maturing securities from its €2.5 trillion bond portfolio for many years to come.

Conditions are becoming less benign for emerging markets, but still manageable

US policy normalisation and the strong dollar are, however, putting pressure on emerging markets. Central banks in Asia and Latam have been forced to tighten policy in order to stabilise currencies and preserve forex reserves, and more rate hikes will be forthcoming. Countries with persistent current account deficits and a large share of dollar denominated debt are more vulnerable, which explains why Turkey and Argentina, among others, have come under pressure. While this will be a headwind to global growth, we see it as a relatively local problem with limited spill-overs to other regions. We therefore do not expect this to disrupt the global economic cycle.

Inflation is not a problem, allowing central banks to be cautious

Another reason for why the near-term outlook is relatively sanguine is that inflation is not a problem. While global slack is being absorbed and many labour markets are tight, wage inflation is still very low. This gives space to central banks to proceed gradually with policy normalisation and even pause if needed. The Fed, which is keen to raise rates, also recognises the need for caution, emphasising that the inflation target is symmetric. This will provide a backstop to the global economy, should conditions deteriorate.

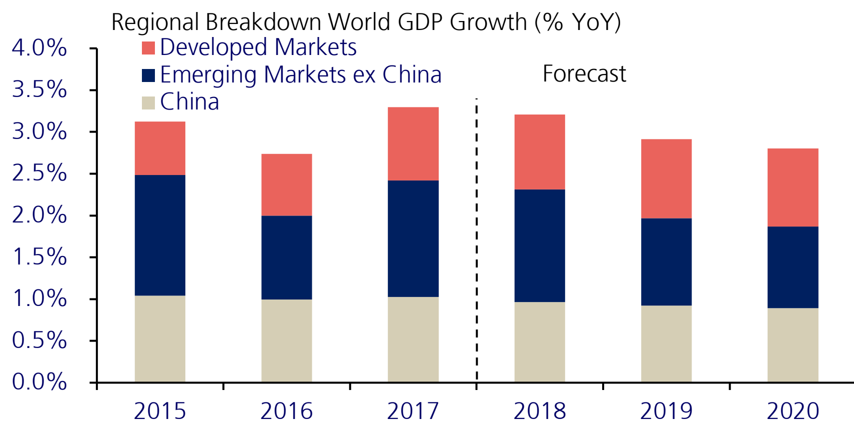
Risks are high, with trade and Eurozone politics at the fore

Risks around the base case are material, with global trade and politics in Italy potential triggers. While stakes are high, we do not expect trade disputes to develop into a trade war where tariffs and trade barriers are jacked up in a vicious circle. Most countries are committed to resolving disputes through the WTO, and recent moves to reform the WTO to better deal with contentious trade questions are encouraging. For now, we are cautiously optimistic that issues around global trade are being brought to the table, though risks are high. Elsewhere, political events in Italy have brought the sustainability of the Eurozone back into the spotlight. We maintain our view that the Eurozone will stay together, but the situation is unstable and progress is urgently needed to accelerate integration towards a fully functioning union.

Bond yields should move higher, though upside is limited

We maintain our view that core government bond yields are in a bottoming process. Looking through recent moves, which were dominated by fears around Italy, Treasury yields have adjusted to a higher range since the turn of the year, with the 10yr yield rising above 3% for the first time since 2013, though this move was quickly reversed. With solid growth and rising inflation, we suspect that the 10yr yield can move a bit higher, but the upside is limited and we consider it a buying opportunity if yields overshoot the 3%

Global growth peaking



Source: ZIG, Consensus Economics, Bloomberg

level. There is limited further upside to growth, inflation is not a problem, the curve is flattening – as should be expected in a late cycle – and the term premium is weighed down by global factors. By contrast, Bund yields remain detached from economic fundamentals, and yields are now lower than at the beginning of the year as safe haven demand has resurfaced due to political risk. While core inflation is still very low in Germany and the Eurozone, headline inflation is rising, labour costs are recovering and growth is above trend. The ECB is also normalising policy. We therefore anticipate Bund yields to rise modestly, but recognise that, for now, a dovish ECB will likely exert downward pressure on European yields.

We expect Eurozone periphery spreads to stay wider and more volatile than they were in 2017, reflecting political risk and the end to the ECB's QE. Italian BTPs are likely to see a wide trading range as the new government spars with the EU to increase government spending. We also expect more differentiation in periphery spreads, depending upon the perceived economic health and political stability.

The heydays of credit are over

The credit spread tights of January are unlikely to be revisited, despite what is still a decent macro environment for stocks. This leads us to be cautious on credit within risk assets and we continue to prefer equities instead, a stance we have had for some time now.

Easy liquidity, low rates and the consequent search for yield has led to some notable vulnerabilities in credit markets. Median leverage among non-financial corporates in both US and Europe is so high that we expect a wave of defaults whenever earnings drop during the next recession. Unfortunately for credit investors, from a short-term perspective, the economics favour leveraging up, which is spurring companies to engage in share buybacks and M&A, notably in the US. European banks are not only exposed to the political risk in Italy, they are also burdened by exposure to EM, bad loans and low profitability. Interlinkages makes the situation worse, as was seen by the notable underperformance of the entire banking sector recently when Italian bond yields spiked. At the same time, in many countries the consumer is also quite leveraged now. Apart from the above fundamental vulnerabilities, episodes of poor liquidity, which can lead to air pockets as seen for example around Italian bonds recently, are another structural vulnerability of the market today that credit investors need to prepare for.

While issuers are vulnerable, risks are now rising. Not only are rates rising, liquidity provision reducing and EM currencies falling, the odds of a trade war, a US recession and, most importantly, political upheaval in Italy have risen. Furthermore, a flattening yield curve makes things worst for the financial sector, while foreboding an end of the cycle in the next couple of years.

Among all this, credit investors are hardly being paid by spreads. High yield spreads, for example, have little room to tighten further, while investors are exposed to significant losses were a recession to occur within the next few years. It doesn't surprise us therefore to see investors shunning deals and flows turning negative for many credit markets. Within credit, we like municipals, ABS and covered bonds, generally at the cost of non-financials, and we dislike European banks the most.

All in all, it's hard to make a positive case for credit. That said, we don't expect spreads to blow out imminently, albeit there are likely to episodes of volatility.

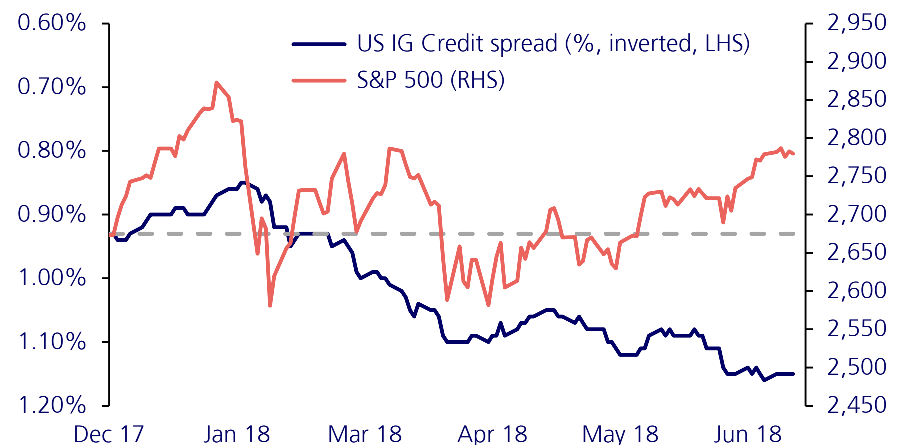
Stocks remain the favoured asset class, with fundamentals robust

Equity markets should benefit from the favourable macro backdrop, keeping profitability high and the bull market on its up-track. This is a powerful mix that we see persisting through the remainder of this year, albeit with some bumps on the way.

Performance in the first half was rather disappointing and showed greater dispersion of returns as well as higher volatility compared with last year. Strong flows in January powered stocks higher, leading to overbought conditions, while an inevitable pullback was driven by a rise in hawkish sentiment around interest rates, geopolitical, and trade tensions. Although US equities have largely developed as we had envisaged, with robust corporate earnings pushing stocks higher, most other regions, including emerging markets and the Eurozone, slipped a little. Dollar strength and political issues in Turkey, Argentina, Brazil and Italy undermined investor confidence

Looking ahead, we continue to favour equities as an asset class, with the bull market expected to remain intact and lifting most regions. Valuations have improved modestly given the strength in earnings and there is little evidence of excessive optimism. Typical late cycle drivers are at work. Strong cash-flows are fuelling stock repurchases and together with rising M&A transactions, shareholders will continue to win out over debt holders. Although financial conditions are tightening, they are not yet at levels that will end the equity cycle. They will, however, act as a headwind for some of the emerging markets, particularly outside of Asia. Japanese and Eurozone equities still offer considerable potential, with accelerating earnings growth and benign rate environments, but Italian politics and potential trade issues for Germany require vigilance. A number of US indices have surged to new highs, which bodes well for the broader market. We suspect that the tech sector will remain in the driving seat for the time being, given earnings, investment and return on equity, which should keep investor confidence high. We do anticipate further bouts of profit taking, however, with stocks being punished should earnings expectations be missed.

Credit should continue to underperform equities



Source: Bloomberg, Barclays US Agg Corporate

US

Outlook

- Economic momentum remains strong, but consumer spending is unlikely to accelerate much
- A positive outlook and tighter labour markets will induce firms to increase investment
- Inflation is creeping higher with the Fed willing to let it overshoot target

Implications

- Bond yields are expected to rise further while the yield slope moves closer to inversion
- Credit is likely to underperform equities, caution is particularly warranted for non-financial corporates
- The environment remains supportive for equities, but turbulences will increase

Risks

- Trade rhetoric and protectionist actions disrupt growth and spook the equity market
- The Fed becomes too hawkish and tightens monetary policy more than the economy can sustain
- Firms refrain from investing as political uncertainty clouds the outlook and financial conditions tighten

Household spending is strong but unlikely to accelerate much

The US economy is now enjoying the second longest expansion since the end of the Second World War and continues to grow at a solid pace although momentum has slowed from an annualised growth rate of 2.9% in Q4 last year to 2.2% in the first quarter of this year. The main reason for the slowdown was a fall in household spending. Personal consumption expenditures grew by only 1.0% in the first quarter, the lowest rate since Q4 2009. While we do expect consumer spending to rebound from the soft patch in Q1, a significant acceleration over the coming 12 months seems unlikely. Consumer confidence has hovered around multi-year highs for more than a year but spending failed to rise accordingly. Vehicle sales seem to have peaked late last year and households' buying intentions for big ticket items are plateauing.

The housing market remains an important pillar of the US economy. Home builder sentiment continues to hover around its post-recession highs indicating that building activity continues to support growth. Nevertheless, both households' intentions to buy a house as well as mortgage applications have weakened. Higher mortgage rates do not seem to have had a major impact on new home sales for now. However, the fact that existing home owners will not be able to refinance their mortgages at lower rates and free up cash will have a dampening effect on consumer spending at the margin.

In addition, growth in consumer credit is slowing, too, as conditions for credit card and auto loans have tightened further in recent months. Nevertheless, the healthy employment situation will continue to support consumer spending as more jobs are being created and wage growth is picking up, although still at a relatively modest pace given the tightness of the labour market.

Filling open positions is becoming increasingly difficult for firms

The unemployment rate fell to 3.8% in May, matching the multi-decade low last seen in April 2000. Growth in average hourly earnings was 2.7% YoY. The broader employment cost index was also 2.7% higher than a year ago in March. This is the highest rate since the end of the financial crisis but still significantly below where it was before the crisis. Given that headline inflation rose to 2.8% YoY in May, real wage growth remains modest. Part of the moderate growth in average hourly earnings can be explained by the fact that a large cohort of elderly workers are retiring. On average, these workers have higher earnings than the ones joining the labour market, so the demographic shift has a dampening effect on average wages. Nevertheless, given the healthy employment situation we expect wages to rise further this year.

Another indicator for the tightness of the labour market is the fact that for the first time on record there are now more open jobs than unemployed workers. This reflects the qualification mismatch mentioned in a number of business surveys and underlines the challenges firms increasingly face when trying to fill open positions. The corresponding component of the NFIB small business survey is close to its all-time high.

Investment is expected to support growth, but trade uncertainty could be a headwind

Firms remain very upbeat and business sentiment indicators are at or close to multi-year highs. Nevertheless, the ISM Manufacturing index has rolled over from its 14-year high reached in February and although the strength of new orders indicates a continuation of solid business activity, the corresponding survey component has receded from the levels seen around the turn of the year. A similar picture can be seen in the service sector where the rebound in sentiment and new orders failed to reach the recent highs.

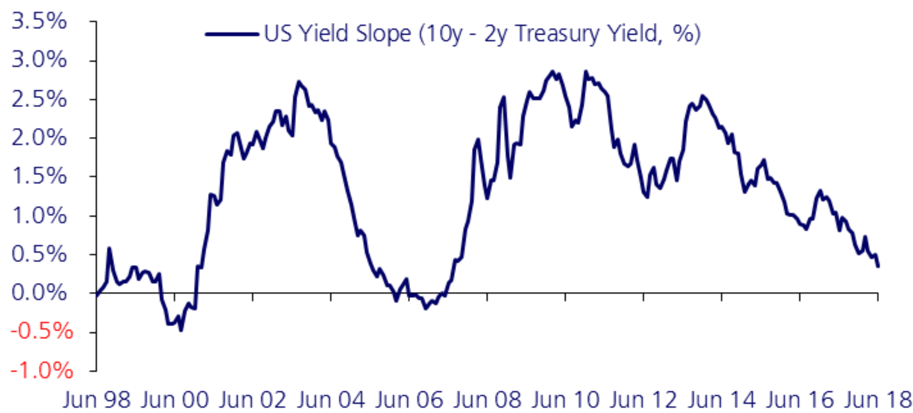
Solid economic growth paired with an ever tighter labour market should induce firms to increase their investment spending. Gross private domestic investment grew at an annualised rate of 7.2% in Q1, which is above the five-year average of 2.8%. Equipment investment accelerated to the highest since 2014 at the end of last year before falling back in Q1. We expect investment to remain supportive for growth but it can only partially compensate a slowdown in consumer spending.

One of the risks facing the economy is rising tensions with trading partners as the Trump administration follows up on its protectionist rhetoric. So far, imposed tariffs and the intensified battle of words around trade have not had any significant effect on domestic economic momentum. However, the risk of increasing trade restrictions and potential retaliation by US trading partners could have a dampening effect on firms' willingness to invest as the uncertainty with regard to future trade relationships and supply chains is increasing. Although we think that a full-blown trade war can be avoided, aggressive rhetoric, arbitrarily imposed tariffs and retaliatory measures by other nations could act as a headwind for domestic investment.

Tariffs have a marginal impact on both import and domestic prices

The tariffs imposed so far will not have a major impact on inflation through higher import prices and domestic price increases. However, should the Trump administration follow up on its threats to impose further tariffs on a broad range of imports this could eventually feed through into higher consumer

US yield curve has flattened significantly



Source: Bloomberg

prices. Headline CPI inflation accelerated to 2.8% YoY in May, the highest in more than six years. While higher energy prices were a significant factor behind the rise in inflation the pickup was broader-based as indicated by Core CPI re-accelerating to 2.2%. The significant pickup since March was caused by last year's aggressive mobile phone price reductions falling out of the annual comparison. Core CPI is now back to where it was through most of 2016. Core PCE, the Fed's preferred inflation measure, has also shown signs of life recently and stood at 1.8% YoY in April. Core inflation is expected to creep higher over the course of the year so the Fed is likely to reach its inflation target relatively soon.

The Fed expects inflation to overshoot its target

With the unemployment rate below the Fed's estimate of the neutral rate and the inflation target within reach, the FOMC will continue to shift from what it considers to be an accommodative monetary policy to a more neutral stance. Having raised interest rates twice this year the Fed signals two more rate hikes in 2018, probably in September and December. With its projections for GDP growth above and the unemployment rate below its longer-term values until 2020, the focus is now on inflation. Interestingly, the FOMC intends to keep interest rates below what it considers to be the neutral rate until well into 2019 despite projecting that inflation will reach the target value this year and is expected to rise above 2% in the coming two years. The Fed is thus underlining that it considers the inflation target to be symmetric.

The slightly accelerated path of expected rate hikes has lifted both short-term and long-term yields. Even if the Fed's intention to accept higher inflation has not significantly impacted investors' inflation expectations, it is likely to increase inflation uncertainty and thus the risk premium in longer-term bonds, putting upwards pressure on yields. However, the yield slope is expected to flatten further with the spread between 10yr and 2yr Treasuries falling to the lowest in June since 2007. Following the recent trend and given the Fed's willingness to continue on its projected rate path, the yield curve would invert over the coming twelve months, which historically was a very good indicator of a looming recession. This would be in line with our view that economic growth is expected to slow down in 2019 as the economy will be hitting its capacity limits and tighter financial conditions will increasingly provide a headwind for growth.

Credit spreads are past their lows

Credit is likely to underperform, especially relative to equities, and in the US is where we have the most conviction on this view.

US companies have seen strong earnings growth and tax reform has boosted it further. However, leverage is higher than during the depths of the 2009 recession, with no signs that managements want to reduce debt. A potential recession in 2019 or 2020 could kick off a wave of downgrades, defaults and restructurings, unless companies deleverage before then, which is highly unlikely. Moreover, monetary policy is advanced in the US and higher interest rates and yields are negative for credit, especially for vulnerable high yield companies that are already struggling to service debt. Furthermore, central banks, including the Fed, are slowly winding down exceptional liquidity provisioning while credit funds are seeing outflows, especially in high yield. As a result, primary markets are sputtering somewhat as investor appetite for risky deals has waned.

Consequently, we are cautious, especially on the US non-financial sector. The financial sector is in better fundamental shape, but it's probably as good as it gets for creditors given a flat yield curve, rising provisions and a watering down of regulation.

We like ABS and municipals. We remain positive on municipals due to their uncorrelated returns, high quality, high recoveries and generally low expected default rates. That said, from a yield perspective, the tax-adjusted value has diminished post tax reform, but we don't expect a materially negative impact on returns as supply has adjusted lower and potential inclusion in HQLA collateral for banks should boost demand. Inflows are positive, in contrast to US high yield for example. Moreover, despite a leveraged consumer and higher delinquencies, we like US ABS. This is because investor protections have ratcheted higher since the financial crisis and the breakeven default rates are much higher than those expected, even for subprime ABS issuers.

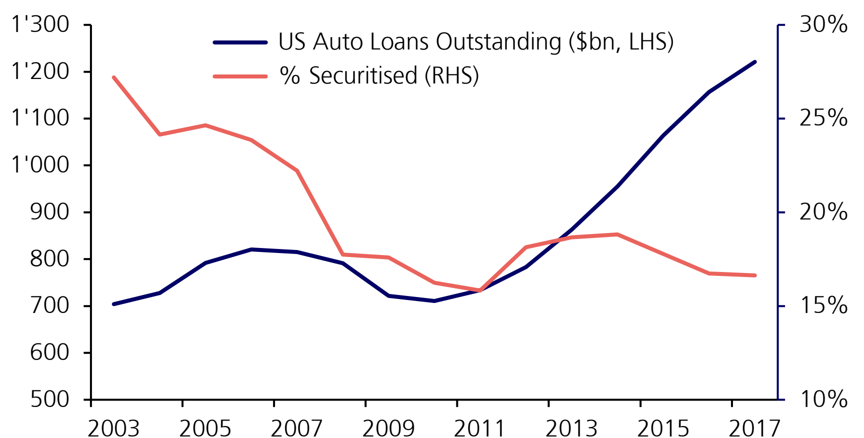
All in all, we remain cautious on US credit relative to equities, but we don't expect an imminent risk of a spread blow out just yet.

Stock markets are fuelled by solid earnings, but trade frictions are a risk

After a volatile period following the correction in February the stock market has regained its footing. The S&P 500 has recovered a large part of its losses while the NASDAQ and the Russell 2000 small cap index have reached new all-time highs. Companies listed in the S&P 500 reported stellar earnings in the first quarter, surprising already optimistic sales and earnings expectations. Earnings grew by almost 24% compared to the same period last year. A significant part of that was due to the tax cuts imposed by the Trump administration, but sales also grew by a solid 8.2% YoY reflecting the positive economic environment.

While valuations are stretched the fundamental environment for stocks remains positive. Business activity is buoyant and earnings will continue to grow at a solid pace. Nevertheless, we expect more turbulence ahead as tighter financial conditions will increasingly act as a headwind while protectionist rhetoric and related actions are likely to spook investors.

US securitization is more selective than loan underwriting



Source: Federal Reserve Bank of NY, Sifma

UK

Outlook

- The British economy faces further headwinds and growth is expected to remain modest
- Households are reluctant to increase spending and firms refrain from investing as Brexit uncertainty remains
- Inflation has stabilised but is likely to remain above target for the time being

Implications

- Bond yields are expected to recover but the upside is limited
- Credit warrants caution as banks remain vulnerable to risks from Europe as well as Brexit
- Equities are cheap but volatility remains high as the pound continues to fluctuate ahead of Brexit

Risks

- Failing to reach a compromise within the governing party the UK leaves the EU without a deal
- Unbridgeable differences between different factions of the Tory party lead to an open rebellion and new elections
- The economy stalls as consumers and firms refrain from spending given political risks and an uncertain future

The British economy faces further headwinds

Economic growth almost came to a halt in the first quarter as GDP grew by just 0.1% QoQ down from 0.4% in Q4 2017. A significant part of the slowdown was due to unusually bad weather, which is also reflected in a relatively sharp contraction in construction activity. Nevertheless, the headwinds for household spending that dragged down consumer spending in 2017 have not disappeared. Household spending grew only 0.2% QoQ in Q1, the lowest growth rate since Q4 2014.

One of the major headwinds for consumer spending was shrinking purchasing power as inflation has more than offset the rise in wages. Households have adjusted to the squeeze in real incomes by lowering the savings ratio and may continue to do so but the potential and the willingness for further reductions is limited, in particular given that uncertainty with regard to Brexit keeps weighing on consumer sentiment. This is underlined by recent surveys showing that savings intentions have risen to the highest level since the financial crisis. Overall consumer sentiment has stabilised, including households' buying intentions for major items and the perception of their personal financial situation.

Real wages finally start to grow again

Only recently have real wages started to grow again as CPI inflation moderated to 2.4% YoY in May while average weekly earnings grew by 2.8% YoY. This will ease the squeeze on real income growth and should support consumer spending although a strong pickup seems unlikely. Growth in consumer credit slowed sharply in March partially reflecting a tightening in consumer credit conditions. In addition, both mortgage approvals for house purchases and for remortgaging have eased since the beginning of the year, the latter having been a support for consumer spending in recent years.

The relatively subdued environment for household spending is also visible in subdued activity in the housing market. National house price inflation slowed to 3.9% YoY in May, down from a peak of almost 10% in 2014 and about 8% ahead of the Brexit referendum. The fall in house price inflation was particularly sharp in the London region with house prices actually falling in Q1 for the first time since the financial crisis. Given the uncertainty around Brexit, it is unlikely that house prices in London will rise substantially in the near term. Housing investment provided robust support to economic growth in 2017. This is expected to moderate, however, as housing activity is likely to weaken over the course of the year.

Economic growth is expected to remain modest

While households have been squeezed by shrinking real purchasing power the business sector has been holding up reasonably well so far. The PMI Manufacturing index ticked up in May to 54.4 indicating continued expansion. However, looking beneath the surface reveals that the expansion in activity was mainly achieved by firms working through the backlogs of work while at the same time new order inflows saw the weakest increase in almost a year. Given the relatively modest outlook firms seem increasingly reluctant to hire new employees, which is particularly obvious in the consumer sector, again reflecting the pressure on household spending.

The service sector continues to expand at a subdued pace as domestic uncertainty keeps holding back decision making among potential clients. Although the sector recently recovered from the weakness suffered at the end of the first quarter the latest increase in overall new work was still one of the weakest since the summer 2016. Cost pressure from rising wages and higher input cost continues to burden businesses. At the same time, companies report that their pricing power remains limited, which is confirmed by the smallest rise in average selling prices in almost a year.

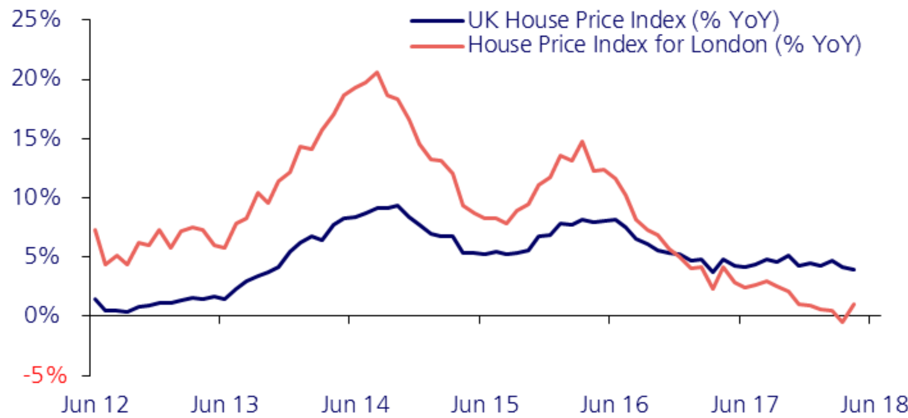
The economic outlook remains modest and despite a tight labour market, firms are unlikely to significantly increase investment given the political uncertainty. In addition, growth contribution from net trade has been relatively disappointing considering the strength of the global expansion and the weak currency. As global growth seems to have peaked and the pound has recovered to levels above those seen through most of 2017 a strong stimulus from trade is unlikely. Finally, not a lot of support is to be expected from the public side either as fiscal consolidation is projected to continue.

Little progress in Brexit negotiations

With Brexit now less than a year away there has been very little progress with regard to the future relationship between the EU and the UK. One of the unresolved stumbling blocks in the negotiations remains the question of how to avoid a hard border between the Republic of Ireland and Northern Ireland. All proposals to solve the issue have so far either been declined by the EU or raised significant resistance within the governing coalition. As the time to negotiate the details of any future agreement is quickly running out, it seems likely that the status quo will be extended after March 2019, potentially including the UK's continued membership in the customs union during a transition period.

Theresa May's latest proposals including a free trade area with the EU for industrial goods and agricultural products was not well

House prices in London are falling



Source: Bloomberg

received by pro-Brexit members of her cabinet. Brexit secretary David Davis and foreign secretary Boris Johnson both resigned from their government posts as May's plan keeps the UK too closely bound to the EU in their view. The resignations lay open the deep rift within May's party and increase the risk of a leadership challenge against the Prime Minister over her Brexit policy.

The BoE refrains from hiking rates but keeps the intention to do so

The ongoing uncertainty around Brexit is also a challenge for the Bank of England's intended path towards a normalisation of its monetary policy. After initially sending strong signals that it would hike rates the BoE refrained from doing so at its meeting in May as GDP growth was weaker than expected in the first quarter and inflation softened more than predicted. Nevertheless, inflation remains above target for the foreseeable future. Renewed sterling weakness as well as a rise in energy prices are expected to keep upwards pressure on inflation. The BoE is keeping a close eye on the tight labour market and expects domestic cost pressure to remain elevated. Accordingly, the decision to keep rates unchanged was not unanimous. The MPC seems intent to raise rates if possible. However, the window of opportunity to do so before renewed tensions arise ahead of the actual Brexit is rapidly closing. It is therefore likely that the BoE will go ahead and hike rates in the coming months if the economy shows signs of rebounding in the second quarter.

While longer-term gilt yields briefly rose to the highest level since the beginning of 2016, supported by a hawkish central bank, they quickly fell back after the BoE's decision not to hike rates. The spread between 10yr Treasuries and gilts has risen to a new record reflecting the diverging outlook on monetary policy. We expect yields to rebound as the economy should recover and the BoE keeps signalling its intention to normalise its policy. The potential for gilt yields to rise seems limited, however, as the economic outlook is unlikely to improve significantly and Brexit related uncertainty will not disappear anytime soon.

Sterling credit vulnerable due to banks

We are generally cautious on global credit, especially relative to equities, which also applies to sterling credit. That said, sterling credit could, in the worst case, be exposed to a double whammy from Brexit if negotiations break down as well as from potential political risk from Europe, especially Italy.

This double whammy is very likely to be transmitted through banks, which we think is the most fragile segment of sterling credit. UK banks are some of the largest in the world, with assets totalling over 400 percent of GDP, and have significant exposure to European risks. Additionally, European banks are also major issuers in sterling. Hence issues in Italy and weakness of European banks will be a core vulnerability of sterling credit, while investors are also exposed to Brexit.

Compared to banks and even corporates, which are quite levered, UK ABS offers better risk reward in our view, especially for credit cards or mortgage related deals. The UK ABS market remains one of the most active in Europe, accounting for around 25% of the distributed volume these past years, across various subsectors. We expect some uptick in ABS issuance for funding purpose, especially from specialised lenders and mid-size banks in the mortgage space after the expiration of the Bank of England's Term Funding Scheme in last February.

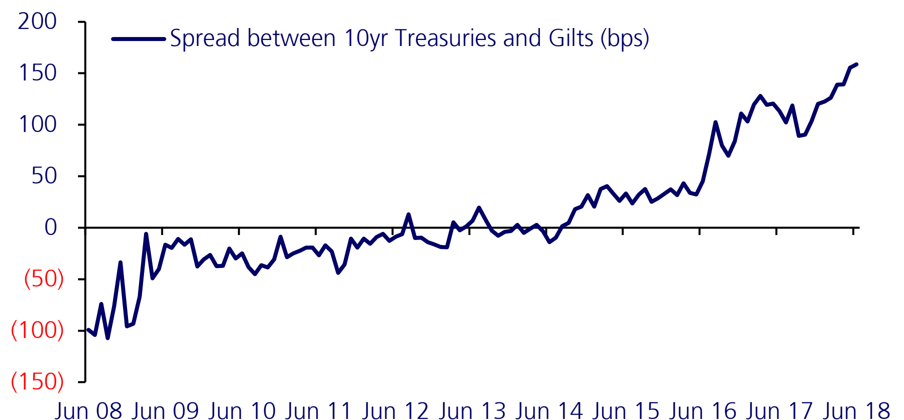
Despite a slowdown in the house prices dynamic and weaker consumer sentiment, underlying loan portfolios' performances remain solid, and better structural features and high excess spread provide sufficient cushion to absorb any potential headwinds coming from Brexit-related uncertainties.

UK equities are cheap but face volatility as the pound fluctuates

UK equities enjoyed a significant rebound in the second quarter fuelled by a weakening pound and rising oil prices. Despite this, the UK stock market remains one of the least loved and most underweight markets. Valuations are relatively cheap but the uncertainty regarding the future relationship of the UK with its most important trading partner continues to loom over British firms.

While it is true that companies listed in the FTSE 100 earn most of their revenue abroad, and thus benefit from a weaker currency, the rapidly approaching Brexit date still keeps investors waiting on the sidelines. Nevertheless, valuations are relatively cheap and the UK stock market provides an attractive dividend yield in a low yield environment. In the longer term, we expect UK stocks to narrow the gap to their international peers but investors will have to face increased volatility as the pound is expected to fluctuate wildly as March 2019 is approaching.

Treasury-Gilt spread soars as Brexit looms



Source: Bloomberg

Eurozone

Outlook

- Despite first half slowdown, strong domestic demand should keep growth above trend in 2018
- The ECB to taper QE in Q4 2018, but commits not to raise rates for more than a year
- Populist parties are likely to continue to do well in elections and polls

Implications

- Episodic periods of volatility in Eurozone government bond markets likely
- We remain cautious on credit, while European banks add significant fragility to the asset class
- In contrast, above-trend growth should support corporate earnings and equity markets

Risks

- A standoff develops between Italy and the EU on government spending plans for 2019
- A further escalation in trade tariffs that would impact the export sector negatively
- The European banking system is vulnerable and could exacerbate any negative shocks from politics or growth

First half slowdown, but recovery is intact

After reaching an intense pace, by Eurozone standards, towards the end of 2017, growth slowed in the first half of 2018. Business confidence in particular declined sharply, albeit from multi-year highs. Nevertheless, the Eurozone economy is still growing well above trend. Provided a full-blown trade war between the US, China and EU can be avoided, and domestically the Italian political situation is not too disruptive, the economy should settle into a decent pace of growth in the second half of 2018. Domestic demand, such as household consumption and investment, is likely to be the key contributor to growth, while the export sector will be less significant in driving growth relative to 2017.

At first glance, the decline in business confidence in the Eurozone in the first half of 2018 was both sharp and worrying. The Eurozone composite PMI fell from an 11-year high of around 59 in January to 54 in May, though latest data show the PMI bounced back to around 55 in June. However, this decline needs to be put into perspective. At 54 to 55, the composite PMI is still consistent with well above trend growth in the Eurozone. This view is confirmed by national surveys such as the German ifo and French INSEE business confidence surveys that have also declined, but are still consistent with strong growth. Indeed, the current assessment component of the ifo Business Climate indicator is still close to a post-unification high.

There were also a number of one-off/temporary factors that affected activity in the first half of the year. These included unseasonably bad weather, extra holidays and industrial action in France that is now gradually easing. Our base case remains that Eurozone confidence and growth will stabilise, if not pick up, in the second half of the year.

The ECB announces tapering of QE and no rates increases for more than a year

Nevertheless, the ECB has responded to the slowdown in growth by emphasising the use of forward guidance in its monetary policy. It recently confirmed that it would end it's QE asset purchases this year, with a gradual taper in Q4. It also committed to not raising interest rates until past the summer of 2019. This makes September 2019 the earliest date at which it could raise rates, if it sticks to this commitment. This strong forward guidance should support economic activity, inflation and prevent the euro from strengthening quickly.

Eurozone inflation remains modest currently, with core inflation hovering around 1.0%. There are tentative signs of a pickup in wage growth and other pricing pressure indications that suggest a gradual increase in core inflation over the next few quarters is likely. Nevertheless, erring on the side of caution by keeping monetary policy loose, and by implication the euro weaker than it would otherwise, has been is a sensible strategy by the ECB and should help offset downside risks.

In another positive development, France and Germany have agreed on a joint proposal as to how to reform the Eurozone, called the "Meseberg Declaration". Though the details are as yet unclear, it includes allowing the European Stability Mechanism (ESM) to provide support to Eurozone countries without a full bailout programme in place, creating a Eurozone budget and considering a European wide unemployment insurance fund. Giving the ESM greater flexibility would improve responsiveness to shocks. Similarly, a European wide unemployment insurance fund would help create an automatic stabiliser.

For now, these are policy proposals from France and Germany, rather than an EU-wide agreement. Nevertheless, they demonstrate that the rise of populism may have an unexpected benefit if it acts as a catalyst for mainstream policymakers to make the Eurozone resilient.

Indeed, this may have also been a motivating factor behind the more generous than expected terms offered to Greece in June as it exited its bailout programme. Around 100 billion euros, or 40%, of programme loans were extended by ten years in maturity, with the possibility of further debt relief in the future offered as well.

Investors no longer complacent about political risks

Nevertheless, politics remains a key risk, as populist parties continue to do well in elections and as EU governments disagree about how to deal with the migrant crisis.

In particular, the Italian elections in March saw the 5 Star Movement and Lega Party do better than expected. Investors were initially slow to react, even after the election results were known. However, it eventually became clear that the 5 Star and Lega would join forces to form a coalition government. In their coalition deal, they agreed to pursue their substantial spending promises made during the election campaign. This eventually led to a violent reaction in bond markets, as investors shifted from complacency to fear. For example, in late May moves in yields in Italian government bonds were more violent than during the 2011-13 Eurozone debt crisis, as investors even started to question Italy's commitment to the Eurozone.

These risks need to be put into perspective. We do not think that the new coalition government will seek to leave the euro. Instead, it is more likely to want to spend more in 2019 and 2020 than previous governments had envisaged. This could still put Italy's new government into conflict with the rest of the EU when its budget proposals

Pickup in Eurozone wage growth will support consumer spending

Source: Bloomberg

for 2019 are reviewed by the European Commission in October or later in Q4. This therefore represents a potential flashpoint for more volatility in Italian and wider European asset markets. Various rating agencies are also due to report their views on Italy's sovereign credit rating between July and October, adding to volatility. Eventually, however, a compromise between the EU and Italy still seems the most likely scenario, with the new Italian government unlikely to actually implement all the spending plans outlined in the coalition deal between the 5 Star Movement and Lega. However, the situation will need close monitoring over the next few months to see how far the new government is willing to push its spending agenda.

In our view, a bigger risk for Italy is in the next global economic downturn. Having failed to sufficiently reform its economy or pay down government debt, Italy would be vulnerable to a growing debt burden and rating downgrades, which could also create a vicious circle of higher funding costs and further downgrades.

Finally, nearer term, another key risk is a trade war developing, after the recent tariffs imposed between the US, China and EU. If this develops into a full-blown trade war, or simply escalates further, this could push the Eurozone into a worse growth trajectory than we are currently forecasting as well as impact investor confidence. The Eurozone economy is particularly dependent upon trade. Large exporting economies, such as those of Germany and Italy, would be severely affected, especially if key sectors, such as the German auto sector, were targeted specifically by the US.

Italian government bonds likely to remain volatile and in a wide trading range

Investors in Italian government bonds are likely to continue to demand a higher risk premium going forward than in 2017 and the early part of 2018. Episodic periods of heightened volatility, depending upon the news flow, are probable as well.

More generally, there is likely to be greater differentiation by bond market investors in periphery bond markets depending upon economies' respective fundamentals.

In addition, despite the dovish ECB taper announcement in June, we expect the overall direction for core bond yields will be to move gradually higher as growth stabilises in the second half of the year.

Banks remain the epicentre of weakness in Eurozone credit markets

While globally we are more cautious on credit than on equities, Europe is one market where there is higher than usual risk of a spread blowout, although this is not our base case. European banks are in particular a core vulnerability that amplifies the downward skew of risk reward in credit.

The vulnerabilities in European credit arise from not only elevated leverage in corporate balance sheets as is the case in the US, but more importantly from a fragile banking sector. The recent volatility in Italian assets caused banks to underperform significantly in both credit and equities. This should be unsurprising as not only do banks hold more sovereign bonds than core Tier 1 capital, but also they are not in a position of strength to start with.

While core structural weaknesses that arise from their large size and interlinkages are not easily resolvable, the latest earning reports have also been somewhat disappointing in our view, as most banks are losing market share in trading to US competitors. Moreover, banks such as Deutsche Bank continue to remain under pressure. Most importantly, from a credit investor's perspective the outstanding universe of financial bond indices is becoming more and more populated with easily bailin-able instruments due to the new regulations. Many of these bonds could be written down in the next downturn in our view, irrespective of the seniority of the bonds.

In contrast, we like covered bonds, municipals and ABS. Covered bonds in particular have outperformed other financial debt, a trend that we think is likely to continue for some time. The stronger investor protections and regulatory support make this sector somewhat more resilient to bank stresses, although there will be some negative price impact if bank spreads spike. In European ABS, there is some likelihood that origination picks up again, once QE by the ECB wanes at the end of the year.

All in all, we think risks are skewed to the downside in European credit, especially in banks. Rising political risks, especially in Italy, an end to asset purchases by the ECB and investor outflows are factors that can amplify any shocks that may arise, which investors need to now plan for.

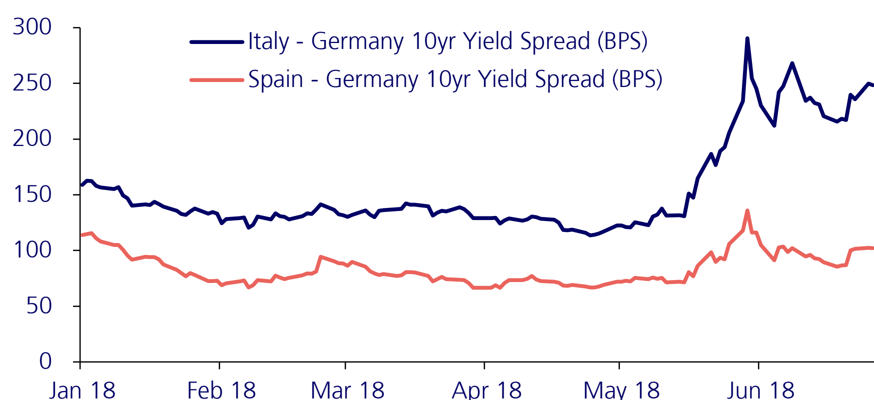
Eurozone equities still have upside

In contrast, the outlook for Eurozone equities is more positive. Despite the first half slowdown in activity, growth is above trend, funding and wage costs are still low and domestic demand strong.

Admittedly, the weaker export sector could weigh on earnings but the weaker euro will be an offset as well. Higher oil prices will also help energy sector earnings.

The upshot is that the outlook for Eurozone company earnings is still positive overall. This has not yet been fully appreciated by investors and analysts in our view. Though currently down year-to-date, there is upside potential to Eurozone equities going forward provided various risks such as a trade war and political uncertainties do not dominate.

Investors become more discerning within periphery bond markets



Source: Bloomberg

Switzerland

Outlook

- Growth is boosted by one-off effects in 2018, the underlying trend remains more modest
- A strong labour market should support domestic demand, though structural headwinds persist
- The SNB is expected to keep rates unchanged in 2018, continuing to taper asset purchases when the opportunity arises

Implications

- Bond yields should rise very modestly, and we believe that they have passed their lows
- The franc is likely to remain rangebound due to strong fundamentals and the potential for SNB interventions

Risks

- An unexpected and disruptive change in SNB policy
- A sudden shift in the rate environment leading to a sharp correction in the property market
- A Eurozone crisis triggering a surge in the franc

Strong Q1 GDP boosted by the Winter Olympics

GDP expanded by 0.6% QoQ in the first quarter, which was stronger than expected. There was, however, a one-off boost from the Winter Olympics, as GDP includes the value added from international sports organisations based in Switzerland (FIFA and the IOC among others). Stripping out this effect, the economy grew by a more modest 0.4%. As we had expected, this was weaker than the very strong growth recorded in the second half of 2017, when the economy expanded by an average quarterly rate of 0.7%. The mix was good though, with solid investment and consumption while government spending, which is volatile, was weak. Construction investment fell, in line with our view that the housing market is now a drag on the economy. Services exports were strong, boosted by licensing income from the Winter Olympics. Goods exports (ex valuables and merchanting) slowed sharply, from a quarterly rate of over 2% in 2017 to 0.8%. This partly reflects temporary factors and adverse weather, but we nonetheless expect export growth to have peaked, in line with global growth.

Underlying growth expected to track at a modest rate of around trend

The leading KOF indicator and the manufacturing PMI have weakened since the turn of the year. The broader KOF measure points to growth in line with the long run trend, following very strong readings in Q4 and Q1. The manufacturing PMI has also dipped, in part reflecting the slowdown in the Eurozone, though it remains at a solid level. Despite this, we have revised up our forecast for 2018 GDP growth to 2%, from 1.8% previously. This is a reflection of the larger than expected boost from the Winter Olympics and additionally the Football World Cup. Underlying 'true' growth is weaker than that, and we expect it to remain around 1.8%. This is in line with its historical average, and well above the growth rates recorded during the past couple of years.

Manufacturing boom set to moderate amid less favourable global conditions

The manufacturing sector has been booming over the past few quarters, benefitting from strong demand from the rest of the world, a revival in global capex spending and an upswing in global trade growth. A favourable currency also stoked export demand, with the EURCHF reaching 1.20 in April for the first time since January 2015. The global backdrop has now moderated. Financial conditions are tightening, weighing on emerging markets in particular, many of which are important export markets for Swiss businesses. Fears around the Eurozone have also resurfaced with political events in Italy, rapidly triggering safe haven flows and a surge in the franc. While some of this should unwind going forward, the political situation remains unstable, and we expect bouts of volatility and periods with upward pressure on the franc over the months ahead.

Confidence is lacklustre as structural headwinds persist

Labour markets have tightened sharply over the past few months as a result of the growth upswing. The unemployment rate has dropped to 2.6%, the lowest level since 2008, in line with surveys that highlight tight capacity. Despite this, job market concerns continue to linger and weigh on consumer confidence, which is still well below prior highs. This is in contrast to the Eurozone and the US, where consumer sentiment is at the highest level since the early 2000s, and underpins our view that structural headwinds persist in the Swiss economy. The real exchange rate is still elevated, at 15% above its level in 2007. Many exporters can cope with this and have adjusted through a combination of efficiency gains, margin compression and cost cuts. Indeed, the currency is broadly at fair value if producer prices are used as a metric. Based on consumer prices, however, the Swiss franc is still 10% overvalued against both the euro and the USD, with prices remaining uncompetitive in the retail and services sectors. Unless the nominal exchange rate weakens sharply, which we do not expect, this is likely to continue to exert downward pressure on Swiss prices and wages. Given these structural headwinds, we do not anticipate a late cycle boom in consumption.

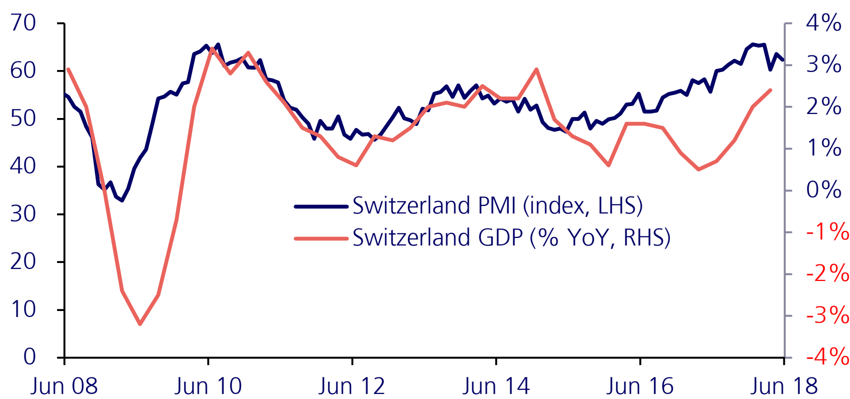
Stronger investment supports growth, but a further acceleration is unlikely

Business investment has staged a rebound in Switzerland. Equipment and software investment expanded by a solid 3.9% QoQ in Q1 (not annualised), and is up almost 5% on a year ago. This is more than double the growth rate of GDP, so investment has finally become a growth driver. This is encouraging, but with a weight of only 15% in GDP compared to 54% for household consumption, the impact on overall growth is still limited and is expected to remain so. There is potential for upside surprises to investment over the coming year, however, which would help to boost productivity and raise growth above trend. This would be a welcome development, given that business investment has been lacklustre over the past decade, lagging behind the expansion in the broader economy.

Construction investment and the housing market are still drags on growth

Construction investment, by contrast, has outpaced GDP growth over the past decade, growing by an annual average of 2.5%, compared to only 1.3% for GDP. Ample liquidity and a search for yield amid low

GDP catches up, but growth likely to have peaked



Source: SECO, Bloomberg

interest rates have helped to spur growth. As we have highlighted before, the pace of growth in construction investment has slowed sharply over the past few years as a reflection of less favourable fundamental drivers, including slowing immigration and increased supply. The SNB's countercyclical policy measures to slow mortgage lending have also contributed to less buoyant demand. While conditions in the housing market appear to have stabilised, construction investment slowed again in Q1, showing that conditions remain fragile. We maintain our view that a late cycle boom in housing and construction is unlikely.

Higher oil prices drive headline inflation higher while the core remains subdued

CPI inflation rose again in May and prices are now up 1% on a year ago, with monthly price increases averaging 0.3% in the past three months. This is a sharp acceleration, mainly reflecting imported goods prices and petroleum prices. With a stronger franc and a stabilisation in oil prices, these effects should wane over the coming months. The underlying trend, by contrast, is weak, with core inflation at only 0.4% YoY. While there are some specific effects holding back inflation, such as administered health care prices, weakness is broader than that. Domestic goods prices in particular are only rising at 0.4% YoY, confirming that a compression of prices persists. We therefore expect inflation to flatten out at around its current level. We have nonetheless an above consensus view on inflation for this year, at 1%, which is also significantly higher than the SNB's forecast of only 0.6%. We do not see inflation as a problem, however, and the overall assessment is that inflation is still far below target and rising inflation is unlikely to drive a policy change from the SNB.

The SNB's policy stance is unlikely to change over the coming year

The SNB has kept its focus on the currency, remaining active in the forex market as necessary. The recent episode of stress related to the Italian political situation highlights that this is the right approach, and we do not expect this to change over the coming year. The prospect for a rate hike remains dependent on ECB policy. The ECB has committed to leaving rates unchanged at least through next summer, and we do not expect the SNB to move ahead of this. We therefore maintain our view that policy rates are likely to be left unchanged at least until 2019 H2. Other elements of the SNB's policy stance are, however, likely to be tweaked. Given strong growth and rising inflation, we expect the SNB to revise up its inflation forecast and adopt a slightly more hawkish tone in its communication. We also expect the central bank will continue tapering excess reserves opportunistically, whenever market conditions allow it to do so. Domestic sight deposits, which peaked in mid-2017, are therefore set to continue declining modestly as the SNB reduces, or even reverses, interventions in forex markets. Importantly, however, forex interventions should remain in the SNB's toolkit for a long time, which allows it to act as a backstop should safe haven flows intensify once again.

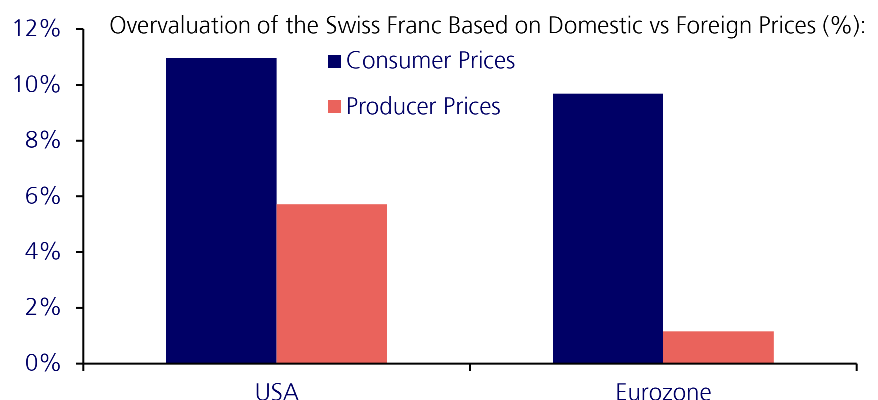
The Swiss franc is expected to remain within its current range

Reflecting our view that the SNB will keep its focus on the currency and only taper excess reserves opportunistically, the Swiss franc is expected to stay rangebound, though within a relatively broad range: A weaker franc presents an opportunity for the SNB to taper forex interventions and excess reserves, which puts a floor under the currency. We therefore do not expect the EURCHF (Swiss francs to the euro) to rise meaningfully above 1.20 over the near to medium term. A much stronger franc, by contrast, poses a risk to the economy and puts downward pressure on inflation and inflation expectations. This should trigger renewed forex interventions, limiting the strength of the currency.

Swiss bond yields are past their lows, but a sharp rise is unlikely

Global and Swiss bond yields are expected to edge higher in the coming quarters, as peak stimulus is behind us and as central banks are gradually normalising policy, with even the ECB planning to end QE before year end. The 10yr Swiss Confederation bond yield should remain mildly positive, though a dip back into negative territory should not be ruled out, given the potential for a flare up in political uncertainty. We continue to expect Swiss yields to lag behind those in other core economies. This reflects the SNB's explicit focus on maintaining a negative interest rate spread vs the Eurozone, and the fact that the SNB should lag behind other central banks in tightening policy. The short end is likely to remain well anchored in 2018, but the 2yr yield should edge higher as we move forward, in anticipation of policy change. There is only limited potential for a steeper slope, as supply/demand conditions remain tight, particularly at the longer end, and as inflation and inflation risk premia are likely to stay low.

Consumer prices are still misaligned



Source: Bloomberg

Note: Shows overvaluation vs fair value based on Purchasing Power Parity

Japan and Korea

Outlook

- Growth outlook remains solid and well-balanced
- The Bank of Japan will maintain its accommodative policy
- The labour market remains firm, with female participation increasing and wage growth inching higher

Implications

- Company earnings should come in stronger than companies predict
- The upward trend in the equity market should remain intact
- The USDJPY should remain rangebound

Risks

- Political turmoil accelerates, with PM Abe losing the election for LDP presidency
- The US imposes high tariffs on imported cars
- Yen strengthening intensifies

Economic expansion hits a bump in the road

In our New Year Outlook edition we expected above-trend growth to continue in 2018 even if we were to see one negative quarter during the course of the year. Indeed, real GDP fell 0.2% on a sequential basis in Q1, ending the longest expansion phase since the late eighties with eight uninterrupted quarters of growth. However, this was mainly due to one-off distortions, like unusually cold weather, and is not the beginning of the end of the current cycle. Even though we may be in a late-cycle expansion phase, this does not preclude a few more quarters of solid growth well into 2020 despite mounting headwinds. These include overtime restrictions scheduled for the start of FY19, the planned consumption tax hike in October 2019 and the negative base effect to growth after the 2020 Tokyo Olympic and Paralympic Games.

We remain optimistic on the consumption outlook

With the unemployment rate at a 26-year low and the job-to-applicant ratio at a 44-year high, the labour market remains in excellent condition. New job offers stood at an average of more than one million in the first four months this year. Female employment has increased substantially. This is conducive to a strong consumption outlook, particularly as real wage growth has started to move into positive territory. High food prices due to heavy snowfall had a negative impact on real income in Q1, but this negative impact is now fading and consumer confidence is creeping up again, albeit at a moderate pace. Combining the increase in the number of employees and the income per worker shows that aggregate wages are rising close to 4%, which shows that consumption is a strong pillar for the favourable macro outlook.

In addition, inbound tourism is hitting record highs, particularly from China and Korea. This is boosting Tokyo department store and electronic retailer sales as well as the accommodation sector, for example, and adds to the favourable consumption outlook.

Solid capital investment and export outlook

High capacity utilisation and the tight labour market are driving forces for a solid capital investment outlook. Labour shortages are a driving force in labour saving capex. For example, there are now more and more automatic check-out machines in many hotels in response to the lack of cheap labour. However, the pace of capital investment is expected to slow as the ratio of capital investment to real GDP is running at peak levels that in previous cycles did not suggest an acceleration. This does not mean that the investment cycle is expected to roll over soon, as capex plans are still too conservative and leave scope to be increased this and next year.

The latest indications about the health of global trade have been encouraging, with exports by several Asian nations starting to pick up again following a lacklustre performance in Q1. As long as global trade is gaining steam again, Japan's export outlook remains solid. However, risks to global trade have been flaring up recently due to the US raising import duties on steel and aluminium and threatening an increase of duties on car imports. Although Japanese car companies produce a large number of cars in the US to meet local demand, this would be a threat for major foreign car producers, with Japan, Germany and Korea at the forefront.

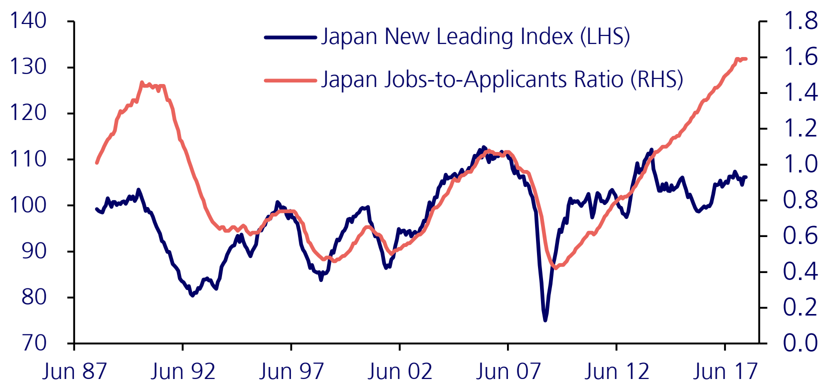
When will inflation reach the 2% target?

As explained in our New Year Outlook, we do not believe that the Bank of Japan's 2% inflation target will be met anytime soon. Indeed, even the BoJ seems to have given up on its target by striking the timeline for reaching it from its Outlook Report at the end of April. The BoJ's price outlook and any policy changes now seem unrelated. The BoJ will maintain its quantitative easing policy as long as its target, the CPI ex fresh food and energy, does not exceed 2% in a stable manner. However, this does not mean that the Bank of Japan will not change monetary policy at all. Indeed, Governor Kuroda, whose term has been extended by five years until 2023, explicitly said that the price outlook and policy changes were not automatically linked. Kuroda believed there was a misconception among market participants, and made clear that deleting the timeline did not signal a change monetary policy at all. However, it seems some kind of tapering may be in the offing, as the BoJ has recently reduced the amount of 5-10yr JGB purchases from JPY 450bn to 430bn per auction. It had reduced purchases to 410bn already in August last year, but raised it back to 450bn early this year. 430bn is still in its target range of about 300-500bn. More important than the technical details, in our opinion, is that the Bank of Japan will maintain its yield-curve-control policy, even though it may lift the 0% target for the 10yr JGB slightly toward the end of this year or early next year. We would also not be surprised if the BoJ were to scale down its effective ETF purchases, unless the equity market were to slide, while still officially maintaining its JPY 6tn purchase target.

Politics will remain a focus in H2

PM Abe remains under pressure ahead of LDP leadership elections in September, following another setback in opinion polls earlier this year, when the Moritomo school scandal erupted again on news that local authorities tried to falsify data linked to the government.

Labour shortage drives jobs-to-applicant ratio to record high



Source: ESRI, Bloomberg

Between summer 1986 and winter 2012, so just before Abe was elected to serve as PM for a second time, the average duration of a PM's term was just one and a half years. It is thus remarkable that PM Abe has been running the country for 5 ½ years, and is striving to do so at least until the Tokyo Olympics in 2020. The drop in public opinion polls, however, remains a risk for him being re-elected as LDP president, and thus continuing to serve as prime minister.

We believe he will be re-elected as long as the Cabinet approval rating does not slip further from current levels. We also believe that PM Abe will try to re-focus the public's attention from domestic politics to the North-Korean issue. Following the meeting between US President Trump and North Korean leader Kim Jong-un in Singapore, PM Abe may also try to arrange a meeting with Kim in order to resolve the long standing hostage issue, which would bring him a step forward in terms of domestic reputation. Alternatively, he could try to play the role of a devil's advocate, which would also be a way to divert attention from the latest domestic scandal. A potential change in the LDP leadership could cause market volatility to rise, as 'Abenomics' would be questioned. However, this is currently not our core, but a risk scenario for H2.

We maintain our constructive view for Japanese equities

At the start of this year it seemed the Topix index would easily break through its 'iron coffin lid' range of 1,750-1,850, levels that we pinpointed in our New Year Outlook, and which served as a strong resistance zone over the last 25 years. But once again, it turned out to be an illusion, and the index fell back 14% from its January high until the end of March, underperforming global equities. Yen strength versus the US dollar once again turned out to be a burden for earnings projections, and sentiment by overseas investors turned sour, resulting in massive foreign selling in Q1. Domestic political turmoil was certainly not helpful either.

However, taking a step back reveals that the upward trend remains intact, with the 200-day moving average still rising, though at a more moderate pace. We believe companies and market participants have become overly cautious about the market outlook by assuming EPS will fall this fiscal year, which we think is too pessimistic. Even when incorporating the higher earnings base due to the impact of the US tax reform, we believe EPS should grow this year, which suggests upside potential for the Topix amid attractive valuations.

While foreigners have been significant sellers of Japanese equities, mainly in the futures market, corporate buybacks, individual domestic investors, investment trusts and the BoJ's ETF buying programme have acted as stabilisers. In aggregate, foreign investors are now running underweight positions in Japanese equities versus their benchmarks, even though they communicate the opposite in regular surveys. This is an environment that should bode well for the market to advance in the second half of 2018.

Well balanced growth outlook for South Korea

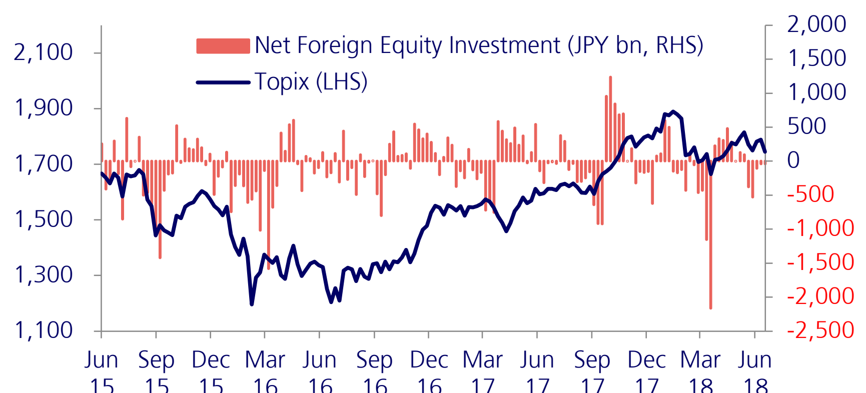
South Korea's growth path has been well balanced. Only net trade was a small drag in the last two quarters. We expect real GDP to grow at last year's pace of around 3% both this year and next. Private consumption remains solid, and capex is mainly driven by strong facility investment in IT and machinery. However, the re-appointed Governor of the Bank of Korea, Lee, has sent out a cautious note about Korea's economy. Some structural issues remain to be tackled, including demographics, slow job growth and high household debt. The government has initiated a supplementary budget focussing on high unemployment among the younger generation, and set up more restrictions for housing loans. Supporting consumption and SMEs remains a prime policy target. Export growth remains strong, but some headwinds have been building due to a new export quota imposed by the US, which will be a burden for the auto and electronics sector. However, South Korea will not be affected by new US tariffs.

We believe monetary policy will remain accommodative, as inflation remains below target, though it is expected to inch higher in H2. However, a policy rate hike in the second half of this year should be no surprise, mainly as a reaction to the latest Fed moves.

Korean stocks are cheap and offer upside potential

We remain constructive toward Korea's equity market. Our argument is quite simple: Korea is the cheapest market in the region. Trading at a discount is nothing new, but we expect the discount to shrink as corporate governance is slowly improving and as the North Korean issue is showing signs of tangible improvement. Should there be a meaningful peace agreement between North Korea on the one side and South Korea and the US on the other side, we believe this could be the beginning of a huge investment led growth phase in North Korea, with South Korean and Chinese companies benefitting the most. Furthermore, as long as the global semiconductor cycle remains intact, the MSCI Korea Index should benefit, as the IT sector has a weight of about 45%.

Foreigners have mixed feelings toward Japanese equities



Source: MoF, TSE, Bloomberg

China and Taiwan

Outlook

- Growth is set to weaken in H2, urging looser policies to support the economy
- Despite some fine tuning, deleveraging to contain risks will remain an overarching policy
- Infrastructure investment will become more targeted

Implications

- China will proceed in upgrading its industrial structure towards higher quality and better environmental standards
- Capital inflows should improve with various schemes to attract foreign capital
- Chinese equities are expected to meander for the time being in both absolute and relative terms

Risks

- An escalation of the deteriorating Sino-US trade relationship
- Policies to de-lever the economy are overdone, hitting growth more severely than intended
- Either escalating *or* sharply falling property prices

Growth is expected to slow in H2

There are some things in China that are not expected to change anytime soon. Firstly, GDP statistics do not mirror the real growth picture, and secondly, the different timing of Lunar New Year causes statistical distortions that are difficult to tackle with seasonal adjustment procedures. It has not been different this year, and it will not change next year. Instead, we rely more on current and leading activity indicators. These indicate that growth has picked up steam recently, mainly based on the fact that authorities have removed pollution controls that had a negative impact on production during the winter heating season. Consequently, state owned enterprises in commodity related industries have experienced a revival.

However, going forward, we expect growth to slow down somewhat in the second half of the year, as the deleveraging process the government has initiated will finally take its toll due to more difficult financing conditions. While deleveraging policies will be in place for the medium term, policy makers will be flexible in implementing them and leave scope for fine tuning depending on the state of the economy. We believe the PBoC will keep liquidity operations flexible by making use of the reserve requirement ratio (RRR) and medium-term lending facility (MLF) in a targeted manner to direct lending into preferred segments of the economy instead of providing broad-based stimulus. Its recent expansion of the MLF collateral framework, for example, is targeting environmental friendly industries and small enterprises. The recent steps taken in that direction were obviously also caused by a number of defaults in the private sector that were not related to deleveraging pressure on SoEs.

Targeted infrastructure investment in line with rebalancing the economy

Overall we believe the reckless injection of funds into infrastructure investment is a thing of the past. Investments will be more targeted in line with central government directives. Infrastructure investment growth has already slowed sharply in the last few years and particularly this year. The government has cut the budget deficit target as well as its railway investment objectives. Even though effective measures tend not to be met exactly, policy direction is clear. Fixed asset investment will be implemented in a more targeted manner, mainly into environmental friendly segments in line with the 'Beautiful China' campaign, into the Belt & Road Initiative and special zones, like the Xiong'an Area and the Yangtze River Economic Zone, as well as into agricultural development projects.

Local governments coming under further scrutiny

Many of the excesses in China's investment binge have been due to overspending by local governments and municipalities, as local politicians were rewarded for growth, which also caused corruption to surge. Following President Xi's anti-corruption campaign and the implementation of new incentives by the Communist Party, excesses seem to have diminished. Off-balance sheet shadow banking activities are shrinking. This is visible in the sharp slowdown in total social financing in May, particularly in the big drop in local government financing vehicle bond financing.

Local authorities were also prone to misusing public private partnerships (PPP). PPPs were intended to alleviate the debt burden of local governments by engaging in shared financing with private partners. However, some local governments have misused these PPPs by falsely labelling debt as equity. This caused the Ministry of Finance to issue restrictions on PPPs late last year. The clean up has caused PPP growth to slow. In March it even dropped. Within six month nearly 1,700 PPPs worth RMB 1.8tn have been cancelled, while more than 2,000 PPPs worth RMB 3.1tn have been ordered to rectify their activities.

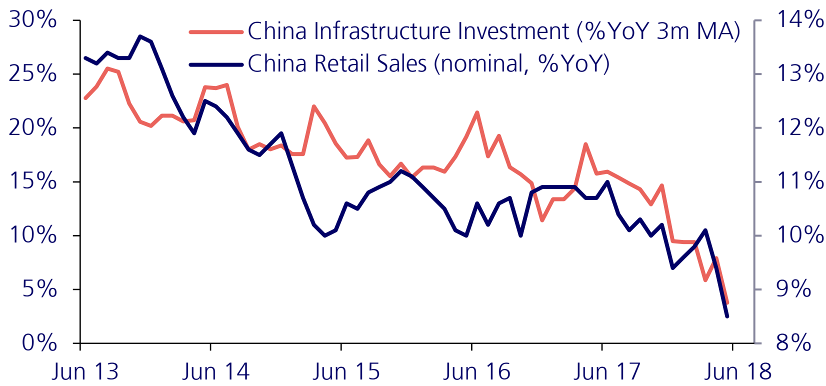
Going forward we believe this clean up should have reduced excesses to a level that allows a more sober way to finance new, productive infrastructure investments.

Brisk outlook for consumption and exports

At this point it may be worth taking a step back to evaluate the impact of the National People's Congress, which concluded in March, on the medium-term outlook for China. The NPC unanimously passed the removal of the two-term limit on the positions of President and Vice President, which gives unlimited power to President Xi. We believe this is a precondition to implementing the necessary changes to China's economic structure and to strengthening its global role, as central and local government official have clear medium- to long-term guidance that is more sustainable.

The restructuring process also involves government entities by merging the Regulatory Commissions for banking and insurance into one unit and by strengthening the position of the People's Bank of China. The PBoC is now the central institution to handle systemic risks, while the Ministry of Finance has also been given more power in terms of macroeconomic regulation. The PBoC's Macro Prudential Assessment framework has been expanded to oversee some of the more risky financial segments like internet and real estate finance that require better supervision in order to avoid financial risks – predominantly the core threat for the country's political leadership.

China's growth is slowing on tighter credit policies



Source: Bloomberg, ZIG

Industrial upgrading, combining the 'Made in China 2025' and the 'Internet+' strategies, will be a topic not only for this and next year, but a target that will be the main focus for the next few years. To achieve this target, China will also need to open up its economy and allow more imports and foreign investment. China will also need to enable more stable capital inflows, in order to relax capital export restrictions that had been implemented when capital flight suddenly accelerated in 2017, depleting some of China's accumulated FX reserves.

Deregulation and opening up the equity market are progressing further

Qualified investors schemes will be enhanced to attract more foreign capital. Opening up the domestic 'A'-share market has just started by adding more than 200 domestic 'A'-shares comprising 2.5% of market cap to the MSCI universe on June 1. Another 2.5% will be added soon on August 1. So far only about 3% of 'A'-share market cap is held by foreigners through qualified investor schemes, including the 'Stock Connect' scheme. A start has been made, with substantially more to follow, even though this is more of a long-term process and not purely a story for our current outlook horizon.

Another financial regulatory change will already have an impact in Q3. The regulator has announced a pilot scheme for listings of Chinese Depositary Receipts (CDRs), the Chinese equivalent to ADRs. It seems likely that this will be comprised of 27 unlisted domestic start-up companies and the five well known off-shore listed Alibaba, Baidu, JD.com, Netease and Tencent. This will enable domestic institutional and individual investors to get access to this promising market segment. Six CDR funds have already been approved. It will also build a bridge to foreign company listings and a potential 'Shanghai-London Connect' scheme later this year.

A more constructive outlook for Chinese equities, unless a trade war emerges

Following a strong start, domestic listed 'A'-shares have suffered this year, losing in the low double-digit percentage range, mainly on concerns about tighter liquidity conditions following the deleveraging efforts by the government, including curtailing shadow banking. Respectively, offshore equities, represented by the MSCI China index, fell only marginally, roughly in line with the MSCI World, but outperforming domestically listed shares. We share market fears about the negative impact of increased trade frictions with the US. However, earnings by those companies exposed to the US only make up a tiny share of aggregate profits. As Chinese equities have corrected in H1, valuations have improved and we are not observing such an overly bullish sentiment as last year and into early this year. We are carefully becoming more constructive towards the market as long as a hefty trade war can be avoided.

Hong Kong: Enjoy it while it lasts

Hong Kong experienced a boom phase in Q1, as GDP grew 2.2% QoQ and was up 4.7% YoY on strong domestic consumption and service exports. Mainland tourism surged both in absolute numbers as well as in spending per head, while domestic retail sales were also strong. However, we do not believe that this favourable trend will persist, as the latest PMI readings suggest at least a slowdown. Risks of a trade war and tighter financial conditions are lingering concerns for the second half and into 2019.

Defending the HKD to keep it within its trading band versus the USD will force Hong Kong's monetary authority to push up the HIBOR further. We believe the HKMA will be able to defend the peg, but liquidity conditions are expected to deteriorate, which should also negatively impact the still resilient property market. Southbound flows have surged over the last two years but have now started to moderate, which, at the margin, should also impact liquidity conditions.

Taiwan's economy is benefitting from favourable external and domestic conditions, with some risks looming

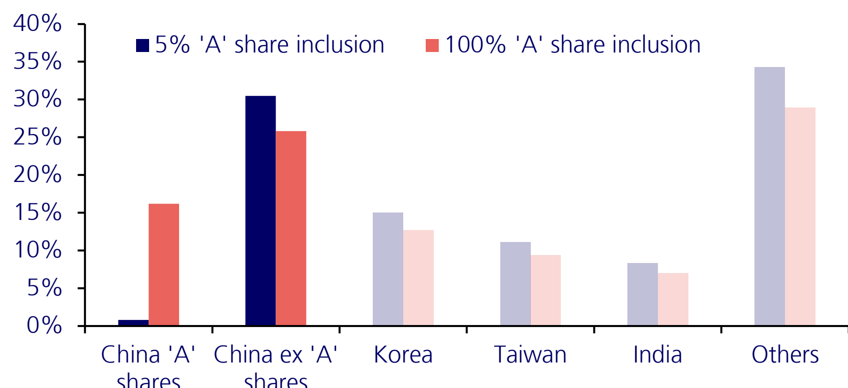
Taiwan's economy remains in rather good shape, with both the external sector and domestic demand contributing. Even though the Manufacturing PMI has fallen 3½ points from its January high, at 53.4 it remains clearly above the boom/bust line of 50. Current economic indicators for April/May, like industrial production and exports, have come in stronger than consensus had expected.

The domestic economy is expected to remain firm, with higher household income translating into firm consumption. An improvement in Taiwan's property prices is certainly helping consumer confidence. Taiwan's central bank, the CBC, is expected to remain on hold for the time being. A small hike in the policy rate after the local elections later this year would be rather symbolic.

An escalation in the trade dispute between China and the US would hit Taiwan's export industries significantly, as the share of Taiwan-made components in Mainland China's exports to the US is high. In this negative scenario it is obvious that the CBC would stick to its current supportive monetary policy.

Taiwan's equity market has held up quite well so far this year, while stocks remain attractively valued. We see some risks if the global semiconductor-cycle were to weaken, which would hit Taiwan's equity market, with the information technology sector making up more than 60% of the market cap of the MSCI Taiwan.

China's weight in the MSCI EM will increase over time



Source: Bloomberg, Credit Suisse

ASEAN and India

Outlook

- Many Asian central banks have entered a tightening cycle to defend local exchange rate stability
- Infrastructure spending is likely to support domestic demand, but headwinds to private consumption have increased
- On the bright side, ASEAN can rely on China as a solid trade partner and investor

Implications

- We expect bouts of volatility in local currency and rate markets
- ASEAN and Indian equities will probably deliver disparate performances
- We do not foresee a repetition of the 2013 "taper tantrum", as economic fundamentals are much stronger today

Risks

- The US dollar appreciates sustainably and financial conditions tighten more severely than expected
- Domestic central banks hike too aggressively and harm domestic demand
- Global growth decelerates sharply, impacting Asia's manufacturing exports

Domestic demand to offset negative net exports in ASEAN

Export growth has been volatile but resilient overall in H1 2018. Going forward, high inventory-to-shipment ratios signal softening in the electronic and semiconductor cycle, although demand for machinery exports has picked up. We expect net exports to subtract from growth, as most ASEAN countries are net oil importers. In contrast, domestic demand, driven by public infrastructure spending, is likely to compensate for the drop in net exports. The outlook for private consumption is more uncertain as financial conditions tighten.

The tightening cycle has started

Monetary policy normalisation in the US has pushed US Treasury (UST) yields higher and has recently impacted the US dollar. The US dollar is likely to appreciate further vs EM Asian currencies, forcing the local central banks to adjust policy rates in order to contain portfolio outflows and/or pre-empt the inflationary impact of weaker domestic currencies. We identify three categories of countries with regard to financial vulnerability.

India and Indonesia are vulnerable because of their respective twin deficits. In India, a weaker rupee combined with elevated oil prices will push CPI above the central bank's target and drive a wider current account deficit (CAD) from -2.0% today to around -2.5% of GDP. In Indonesia, inflation is tracking well below Bank Indonesia's target, but higher FX-adjusted prices will weigh on the fiscal deficit and, to a lesser extent, on the CAD. Both countries are net international debtors, with Indonesia especially exposed due to the large foreign ownership (38%) of local sovereign bonds. We expect the respective central banks to hike in 2018. Liquidity crises are highly unlikely, but tighter local rates represent headwinds for domestic consumption in both countries.

Malaysia carries the highest gross-external-debt-to-GDP ratio, but its net external debt is marginal. Furthermore, its current account surplus benefits from higher oil prices. The new government's policies are likely to lead to more volatile fiscal revenues, however. New policy announcements will probably trigger portfolio outflows, especially if international credit rating agencies change their assessment. Despite this likely episode of portfolio flow volatility, growth should remain unscathed in Malaysia. The Philippines is a marginal international net debtor. Its current account is turning negative and inflation is likely to rise above the central bank's target, probably leading to a rate hike. However, we do not expect monetary tightening to derail the country's solid growth trajectory.

Vietnam and Thailand are in strong shape, thanks to their respective current account surpluses and low external-debt-to-GDP ratios. In both countries, inflation will probably tick up, albeit from modest levels.

In comparison to 2013 pre-taper tantrum conditions, ASEAN exhibits solid fundamentals. Additionally, China's role as an investor and trade partner for ASEAN is more prominent today. The Chinese authorities have launched ambitious reforms to tackle domestic leverage and shadow banking lending, but have recently delayed the implementation deadlines for these reforms to 2019–2020. In the medium term, China's stronger focus on preserving growth will be supportive for ASEAN.

India: External headwinds to cyclical rebound

Growth is rebounding in India, led by favourable base effects and the normalisation of economic activity following the Goods and Service Tax (GST) disruptions last year. Vehicle sales are tracking higher, signalling healthy growth of rural and urban consumption. Fixed asset investment has recovered thanks to an acceleration in the realisation of public transport infrastructure projects.

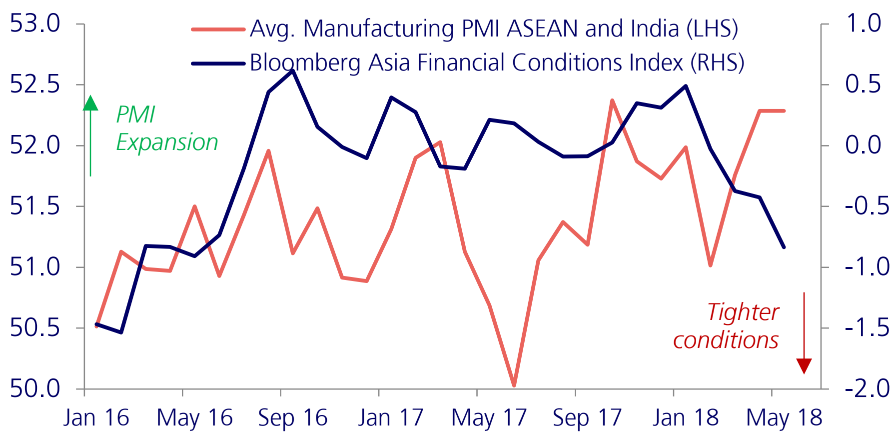
Inflation will probably rise from 4.6% currently to slightly above 5% YoY. Because of excise taxes, consumers and businesses are bearing the brunt of oil price increases. Additionally, the government will implement a series of inflationary policies this year, such as hiking agriculture minimum support prices.

As discussed above, the current account deficit will deteriorate. The trajectory of the fiscal deficit is uncertain. Generous fiscal expenditures, such as a new national health scheme, will be partly offset by larger tax collections. Additionally, we suspect that the government could put some infrastructure projects on hold for a few months in order to honour its budget target.

Taking a step back, Indian structural reforms have made good progress. GST monthly collections have outpaced the government's INR 1tn target in April 2018. The Reserve Bank of India (RBI) has stiffened rules for non-performing asset disclosure and restructuring, and the clean-up of public banks' balance sheets is moving ahead.

We are turning more cautious on India's short-term prospects. Monetary conditions are likely to tighten somewhat, and oil prices and global market volatility are headwinds for domestic consumption. However, we believe that India is presently better equipped to face those hurdles than in 2013; foreign currency reserves, for instance, have climbed from five months of imports in 2013 to eight months as of now. We are also constructive on the country's structural growth improvements. Of course, political risks persist: the opposition is teaming up against the BJP in the run-up to the Lok Sabha elections, scheduled for April 2019. A BJP defeat would lead to a pause in structural reforms, but does not constitute our base case scenario.

Solid economic activity despite tighter financing conditions



Source: Bloomberg

Indonesia: Rougher times ahead

Indonesia 2yr sovereign yield has climbed to 6.7% as we write, a sign that the era of cheap and easy funding is over. We think that Bank Indonesia (BI) will prioritise exchange rate stability and will probably deliver another rate hike this year.

As regional and general elections approach, the government has committed to maintaining the stability of prices for subsidised fuel and electricity and to controlling prices for non-subsidised fuels. This implies a deterioration of the fiscal deficit, from -2.6% last year. As the government is legally bound by a limit of 3%, expenses might need to be reduced elsewhere in order to compensate for higher fuel subsidies.

Notwithstanding a short-lived jump in private consumption, under the effect of pre-election spending, we are concerned about the economic effects of tighter monetary policy and limited fiscal space. In recent years, growth has been powered by public infrastructure investment. In 2017, 150km of toll roads were completed. In 2018, another 175km are targeted. The government has also made progress on harbour and power plant capacity construction. Private consumption has been tepid, however. In 2018-2019, tighter financial conditions represent additional hurdles for consumption. We suspect that the government will reprioritize and delay some infrastructure projects to focus on supporting the consumer.

Despite our concerns on growth, we do not expect any liquidity crunch for Indonesia. Indeed, most external metrics have improved compared to Q1 2013 (the period preceding the taper tantrum). Additionally, Indonesia has placed around half of its 2018 sovereign bond issuance. We also think that creditors from China and Japan would help in case of severe liquidity need.

Finally, the government's ongoing focus on improving the country's business environment is encouraging for long-term investors. The latest regulations will streamline administrative processes and increase tax advantages for R&D investment. Year-to-date, FDI is up 10% YoY and are expected to offset a large share of the current account deficit.

Malaysia: Upside to consumption with likely fiscal slippage

As we write, Malaysia's new government, led by Prime Minister Mahathir Mohamad, has been in power for 25 days, and has only disclosed a small portion of its reform agenda.

From what we have learned so far, and building on the Pakatan Harapan party's election manifesto, new policies are likely to boost private consumption. Consumer confidence has been on the mend year-to-date, and real wages have edged higher. Reforms like the repealing of the Good and Services Tax (GST) and the instauration of fuel subsidies will shift cost burdens from consumers to producers. Additionally, the government has promised to raise the minimum wage. Private consumption growth is likely to compensate for the slowdown in manufacturing activity. Indeed, manufacturing export growth has decelerated in the last few months.

The prospects for inflation are more blurry. We expect core inflation growth to tick up, but headline inflation will be negatively impacted by the replacement of the GST by the Sales and Service Tax (SST).

The finance minister has announced a revenue shortfall of ~MYR 21bn for 2018, to be offset by cost cutting in public administrations, higher oil prices, and dividends from government-linked companies. If the government's 2.8% fiscal deficit target seems achievable for 2018, we think that the reliance on volatile oil revenues is negative for the fiscal balance in the coming years. As we have written above, Malaysian finances are cushioned by a comfortable current account surplus and the country benefits from net oil exports. However, with a 42% ratio of foreign ownership in local sovereign bonds (MGS), Malaysia is likely to suffer episodes of portfolio outflows.

Finally, the government is focused on trimming total debt and commitments, which, including government guarantees to entities deemed insolvent, amount to 80% of GDP. This entails renegotiating the terms of existing infrastructure projects such as the East Coast Rail Link, mostly financed by Chinese lending. We mainly view the infrastructure pipeline review positively, as not all projects make business and financial sense for Malaysia. We also expect the government's push for higher transparency in the public and business spheres to improve Malaysia's business and investment environment.

Asian Financial Markets

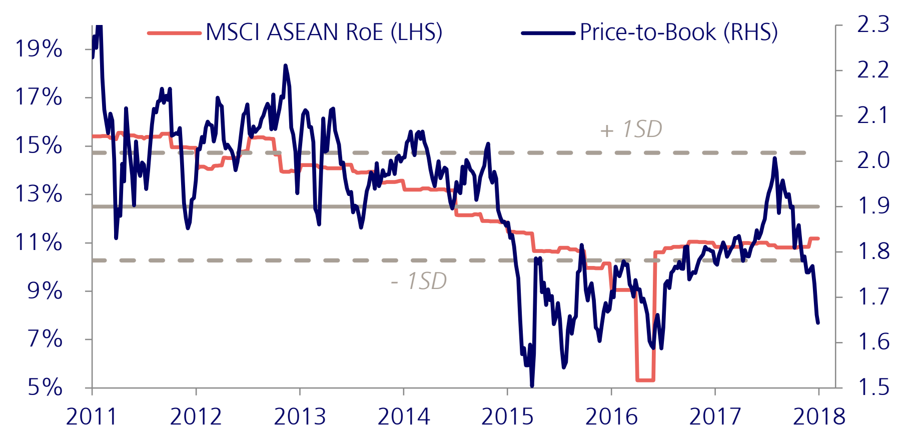
2018 will probably be characterised by ongoing volatility in EM Asia currency markets and upward pressure on local rates, as domestic central banks follow the US Fed's lead.

For a foreign investor in EM Asia equity markets, local currency volatility makes equity returns less attractive. This partly accounts for the sizeable foreign outflows experienced by Asian equities between February and June 2018. We think that outflows have been too severe for some markets. In Indonesia and the Philippines, valuations have cheapened to crisis levels and have become more attractive.

In Malaysia, the decrease in policy uncertainty as the government progresses in its 100-day reform timeline probably represents a tailwind for equities. Sector rotation is also likely, with construction companies likely to be impacted by the review of infrastructure projects, but consumption companies standing to benefit from pro-consumer policies.

Singapore equity valuations stand at relatively cheap levels, and should benefit from better macroeconomic dynamics.

ASEAN valuations have cheapened below 1 standard deviation



Source: Bloomberg

Australia

Outlook

- Growth is likely to rise to 2.8% YoY in 2018, spurred by exports and investment
- We expect activity to slow in 2019, as cyclical drivers weaken
- Households will probably experience a soft deleveraging, facilitated by accommodative monetary conditions

Implications

- Easy financing conditions are supportive for equities
- Banking stocks are expected to suffer from slowing credit growth
- Sovereign yields are likely to follow US Treasury yields higher, although the yield differential should remain negative

Risks

- Household finances fail to improve, dragging down growth for longer than expected
- An external economic shock destabilises highly leveraged households
- The central bank delivers a premature rate hike

We expect strong growth for 2018 at ~2.8% YoY and softer growth of ~2.5% in 2019 as the positive contributions from investment and exports fade. We think that corporates will share some of the national income pie with employees, helping consumption. We acknowledge considerable uncertainty around the pace of wage acceleration. Monetary conditions will remain accommodative until wage growth picks up. Fiscal conditions are expected to be less tight than forecasted by the federal budget. Our base case argues for a soft deleveraging, recognising that households have become vulnerable to a potential macro-economic shock. We foresee increased headwinds in 2019–2020, with an expected mild recession in the United States having an impact.

Mining: Full production capacity reached in 2018

In 2016–17, resources and energy constituted 68% of Australia's goods exports, boosting the trade balance and fiscal revenues. The positive contribution from net exports is likely to diminish in 2018–19. Indeed, iron ore export value will probably post slightly negative growth as iron ore's main market, China, has tightened financing for infrastructure and property investment. Additionally, Chinese iron ore inventories are high, which has led to a decoupling between steel and iron ore prices. As for LNG, prices will probably track Brent prices higher. LNG export volumes should rise until end-2018, when full production capacity will have been reached.

No large brownfield projects are scheduled after 2018, and a survey of mining companies points towards a sharp fall in investment intentions for 2019. The mining sector employs a meagre 1.8% of the workforce, and this figure is likely to stagnate.

Solid non-mining investment until 2019

In contrast to mining, non-mining investment is expected to post solid growth in 2018–19, helped by a growing pipeline of infrastructure projects. However, we expect volatility in quarterly investment growth. Non-residential building approvals, a leading indicator for construction capex, have fallen back to 2016 levels. Approvals for office buildings have come down slightly, which may be a side effect of the slowdown in residential approvals. After 2018, capex prospects appear less rosy, as companies' spending intentions turn south.

No convincing rebound in consumption

Despite some signs of life in household goods sales and restaurant spending, total retail sales have continued to weaken. Consumer confidence has moved sideways, signalling poor prospects for retail sales in the next few months. Two drivers have weighed on consumer spending: subdued wage growth (expected to lift slightly in the coming year) and stiffer credit conditions (likely to tighten further).

Underemployment to erode gradually

Green shoots are visible in wage data. The wage price index has rebounded from its all-time low of 1.9% YoY to stabilise at 2.1% YoY. Meanwhile, the Fair Work Commission has announced a 3.5% increase in the minimum wage. Nevertheless, the current pace of wage increases is insufficient: real wage growth stands barely above 0. The fall of the saving rate to ~2%, an 11-year low, speaks to households' struggle.

We suspect that employers are in a better position than employees when it comes to wage negotiation. Indeed, in Q1 2018, the share of total factor income going to corporate profits rose to ~28%, which is 2% below all-time highs, while the wages portion fell to ~52%. The labour force supply crept higher in the last year, which has probably weighed on employees' negotiation power. Labour force participation now stands at 65.6%, just 0.1% shy of the record high, and we see limited upside from here. Additionally, leading indicators such as job vacancies and business surveys signal slower but decent employment gains going forward. The total underemployment rate (unemployment + underemployment) would need to decrease by at least 50bps to ~13.5% to push wage growth to 2.5% YoY. We think that such a move is achievable in 2018–19, assuming further gains in full-time employment and a stable participation rate.

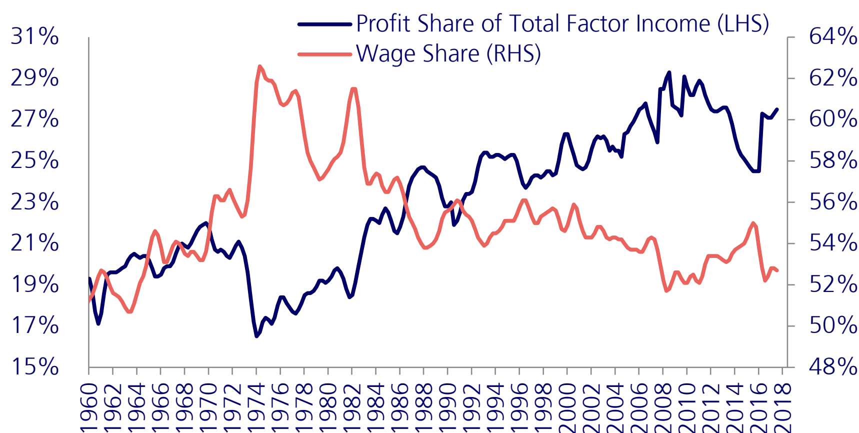
There are downside risks to this view. In the past, we have been negatively surprised by the slow pace of the labour market tightening and by the persistence of the gap between profits and wage growth. The recent gains in labour supply have been dominated by female workers, a phenomenon also visible in other countries. This change in social patterns introduces uncertainty around the scenario of a tighter labour market leading to faster wage growth.

Household balance sheet pressures are manageable

We are constructive on wage growth, but more negative on the consequences of elevated household debt. Household debt has reached the saturation level of 190% of income. This ratio marginally decreases when accounting for offset accounts.

So far, lending books have displayed little signs of stress, and average mortgage prepayments amount to a comfortable 32-month buffer. Low interest rates represent a major tailwind: mortgage interest payments only account for ~9% of household income. In the coming year, mortgage rates are unlikely to climb, but many borrowers have been forced to switch from interest-only loans to principal-and-interest loans, and will therefore see significant increases in liabilities.

Wage share of income close to all-time lows



Source: Thomson Reuters Datastream

As households focus on mortgage payments, consumption is likely to suffer. We also expect a modest increase in total mortgage arrears from low levels (currently, arrears account for 0.8% of domestic mortgage books).

Mortgage lending growth to fall

In parallel, new macro-prudential regulations, influenced by the findings of the banking royal commission, are likely to weigh on new mortgage disbursements. Following a rapid fall in interest-only lending, the Australian Prudential Regulation Authority (APRA) has removed the cap on interest-only mortgages, but is preparing additional regulations. Domestic banks have been asked to look into limits for debt-to-income levels for individual borrowers. The impact on lending growth will be negative, since very high debt-to-income lending (6x) currently accounts for ~30% of new lending. Additionally, banking due diligence processes and inquiries into borrowers' financial situations will come under higher scrutiny.

The CoreLogic 8-city average dwelling price for Australia was down 1.1% YoY in May, due to slower growth in Melbourne and negative growth in Sydney. Sydney housing prices have fallen by 4% since their 2017 peak, but remain 66% above their mid-2012 trough. Going forward, leading indicators such as housing sales and building approvals, on top of tighter lending conditions, point to modest falls. We expect a gradual cooling in the housing market, not a hard landing. Indeed, monetary conditions are likely to remain accommodative in the coming year.

We acknowledge that household finances have become vulnerable and could come under severe stress in the event of external economic shock. The housing debt-to-asset ratio now stands at ~29%, but is likely to tick up as housing valuations soften.

Negative fiscal impulse, for now

The federal budget forecasts the fiscal balance to turn positive in 2019–20. As a consequence, the structural fiscal impulse to GDP is projected to be negative in the next couple of years. A series of income tax cuts have been announced, but will probably account for a modest ~0.2% share of GDP in 2019–20, before rising to a more significant ~0.8% of GDP in 2022–23.

We do not expect any significant fiscal measure to be announced before the federal elections in April–May 2019. Indeed, public opinion significantly favours fiscal conservatism. After the elections, we suspect that fiscal spending will have to be more generous than projected. Indeed, the income situation of households is critical. On the bright side, Australia's fiscal situation is relatively comfortable. At 1%, the current fiscal deficit is contained, and the contingency reserve adds a buffer of ~1.2% of GDP. Additionally, Australia's net government debt is only 19%, below the debt levels of most AAA-rated peers.

The RBA is patiently waiting for higher wage growth

The Reserve Bank of Australia (RBA) has remained its upbeat self when it comes to real growth projections. However, the tone of its recent statements has become stern with regard to the household situation. The central bank's primary focus is now on wage growth, as it is looking for a genuine increase to justify a policy rate hike. The RBA estimates that underlying inflation will rise above 2% YoY only in June 2020 and the unemployment rate will remain above its 5% NAIRU estimate throughout 2020. This sends a clear message: the RBA will continue to stand pat.

Some analysts have suggested that policy rate cuts would be considered to address the fall in residential prices. We do not subscribe to this view. The RBA has actively assigned to APRA the mission of regulating the mortgage market and is likely to interpret the gradual cooling of the housing market and the moderation in mortgage growth as actual successes. Additionally, in the event of severe stress in the housing market, we think that the first countermeasure would be to unwind some of the macro-prudential regulations, rather than cutting the policy rate. Indeed, the RBA wants income growth, not credit growth, to support demand.

As written above, we expect wage growth to rise toward 2.5% YoY in 2018–19, leading to a policy rate hike sometime in H1 2019. We acknowledge the risk of the first rate hike being delayed. Indeed, there is considerable uncertainty around the pace at which the labour market will tighten.

Australian financial markets

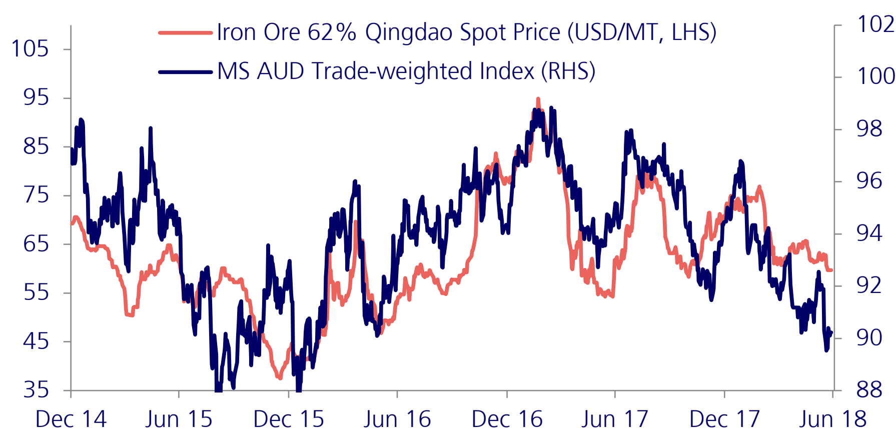
Robust business confidence and accommodative financing conditions argue for decent growth in Australian equity earnings, perhaps in the high single digits. Spot commodity prices remain high, which can spur materials and energy stocks in the short term.

We do not see any large upside potential for Australian equities, however. At +1 standard deviation, PE and PB valuations are not particularly attractive. Banking, the largest sector in the ASX200, will likely face the headwinds of lower net interest margins and slower credit growth.

Domestic sovereign yields are likely to follow US Treasury (UST) yields higher, although the 10yr interest rate differential to UST is likely to stay negative until the RBA shifts to a more hawkish tone.

Negative interest rate differentials with the US will continue to put downside pressure on the Australian dollar, although stable iron ore prices will probably put a floor on the currency. As a result, the Australian dollar is likely to be rangebound.

The trade-weighted AUD has cheapened



Source: Bloomberg

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