Market Strategy and Macroeconomics
Investment Management
December 2018

ZURICH®

Economic and market outlook 2019:

Choppy Waters

Source: iStock by Getty Images

Overview

2019 is likely to be the ebb tide of the economic cycle rather than its demise, with slowing global growth, benign inflation and low bond yields. However, the year will host a number of unpredictable but critical political and geopolitical events, creating choppy waters for investors and policymakers to navigate.

The flattening of yield curves, a good but at times flawed predictor of recessions, begs the question of when the expansion will end. We suspect that it is more likely to be in 2020 than 2019, allowing the mature US economy to record its longest cycle on record. That noted, global growth is moderating as financial conditions tighten, and the US economy is expected to slow more abruptly towards the end of the year. With key central banks still missing inflation targets, monetary policies yet to normalise, and growth slowing, the economic environment is more vulnerable to the issues that lie ahead.

From the unfathomable Brexit playbook and the continued prominence of populist ideology, to unconventional US foreign policy and the retirement of Draghi, the highly respected ECB president, uncertainty prevails. There are, however, key issues that will likely define the year ahead. The US-China relationship is one that we feel goes beyond simple tariffs. As China tries to emulate Korea and Japan as one of the few emerging nations able to bridge the middle income trap, the relationship with the US will be pivotal in achieving this. We suspect positions will become more pragmatic by the end of the year, helping global trade and investment as a result, but progress is unlikely to be smooth, with many vested interests at work.

US monetary policy is another defining issue. Despite a still booming economy, the shrinking of the Fed's balance sheet by $50bn per month and an expected ninth rate hike in December are starting to bite. With the interest-rate-sensitive housing and construction markets weakening appreciably, and inflation having only just managed to kiss target before falling back, it seems that time is on the Fed's side. A pause in rate hikes after December would be appropriate, although it appears unlikely just yet.

Despite the challenges, our view of the year is constructive. As pointed out in the Global section from page 4, growth is expected to ease back to around its long-term average and while capacity constraints are becoming more noticeable in developed economies, inflation is not expected to rise meaningfully. Financial conditions continue to tighten globally, however, and along with trade uncertainty it is impacting investment. The US, discussed from page 6, is running into capacity constraints, most notably in qualified labour, which is likely to crimp the pace of expansion. Labour shortages are helping to lift wage growth, but at a modest pace. As noted, the Fed's policy response will be critical.

The Eurozone is never far from the centre of angst, and we delve into the details from page 10. The Italian budget is the current focus, though compromise is likely to win-out in finding a grudging acceptance with the EU. Further elections, however, seem inevitable later in the year given the unstable government construct and the rising popularity of the dominant League party within the coalition. In aggregate, Eurozone growth is expected to be decent and above trend, with the first half of the year likely to experience a bit of a bounce following idiosyncratic issues in the latter part of 2018. Continued loose monetary policy and higher fiscal spending will lend support.

The outlook for Asia, discussed from page 14, remains mixed. The delayed impact from significant policy tightening in a number of countries is likely to take its toll on growth. We are encouraged by developments in China, where a coordinated and targeted approach is being applied to stabilise activity and keep the country on track to double the size of the economy between 2010 and 2020. Supporting evidence is expected through the first half of the year, which will help to boost other emerging market prospects and lift investor sentiment.

More broadly, from an investment perspective, we see mixed fortunes in 2019. Bond yields should remain subdued given easing growth and benign inflation and it is likely that the bulk of the US yield curve will invert in the months ahead. Bunds seem the most vulnerable at current levels, with yields likely to move higher should risk aversion diminish, while periphery spreads will require better news out of Italy to tighten meaningfully. Credit markets are expected to remain under the cosh, with excessive leverage and low interest coverage a risky combination at the late stages of the cycle. More defensive segments, such as ABS and covered bonds should perform relatively better.

Equities remain our favoured asset class following a disappointing 2018. Multiples have compressed appreciably, and some markets, including emerging markets, are looking attractive on a fundamental basis. Performance is likely to be patchy, however, requiring a deft touch to capture returns in an environment where volatility is expected to be high.

Choppy waters indeed, but another year of growth affords further time to bolster a still fragile macro environment before the next recession finally emerges.

Guy Miller
Chief Market Strategist
& Head of Macroeconomics

Contents

Overview 02

Global 04

US 06

UK 08

Eurozone 10

Switzerland 12

Japan and Korea 14

China and Taiwan 16

ASEAN and India 18

Australia 20

Contact 22

Global

Outlook

- Global growth has peaked but the near-term outlook remains constructive, with growth holding up at around trend
- The economic cycle is on its last leg, however, and we anticipate a US recession in 2020, with global consequences
- Inflation is unlikely to become a problem amid benign wage growth and tighter financial conditions

Implications

- Core bond yields are expected to rise, but further upside to yields is limited as inflation is benign and growth is slowing
- Credit spreads are likely to continue widening, with the spread lows seen in early 2018 unlikely to be revisited this cycle
- Favourable conditions for equities in H1, though a worsening backdrop will make the year volatile and divergent

Risks

- A better growth environment leads to complacency and a policy mistake
- An escalation in trade disputes dents confidence and spending, disrupting the global economy
- European bank risks and high corporate leverage remain epicentres of vulnerability in financial markets

Global growth has peaked, but the near term outlook remains positive

Global growth has peaked but remains fairly brisk, tracking at around 3% (at market exchange rates), which is a touch above the longer-term average. Growth is divergent, with many developed markets (DMs) still seeing above trend growth while emerging markets (EMs) have slowed sharply amid currency weakness and tighter financial conditions. We expect global growth to slow further but conditions should remain relatively benign through H1 2019. The US economy is robust and the US consumer, which accounts for a hefty 70% of GDP, is still on a strong footing. The near-term outlook is also favourable for Europe and Japan as financial conditions are still very accommodative and temporary factors that have weighed on activity should wane. China is injecting stimulus and we expect this to stir growth as we enter 2019, stabilising conditions in EMs more broadly. While EMs ex China are likely to see weaker growth, resilience in DMs should offset this.

The cycle has extended, and central banks are continuing to removing stimulus

The cycle has extended, however, with unemployment at multi-decade lows in many DMs and capacity constraints firming. Inflation is not a problem, but central banks are keen to normalise policy before the next downturn. The balance sheet of global central banks has peaked after almost a decade of expansion and a majority of central banks have hiked rates in the past six months (out of a sample of 42), with further rate hikes forthcoming. These headwinds will not reverse and we do not expect global growth to rebound. Instead, we foresee a slip lower over the coming quarters, as central banks continue to tighten policy and as the US economy, in particular, faces increasing headwinds from capacity constraints. Indeed, the volatility in financial markets over the past couple of months, alongside a flatter US yield curve, are consistent with our cycle view that growth has already peaked and the window before the next downturn is limited. We continue to forecast a US recession in 2020, with global consequences.

Missed opportunities to prolong the cycle, with investment now slowing

A sharp upswing in productivity could extend the cycle, but there is little in the data to suggest that this is underway. Output is still rising in line with employment in most regions. Equipment and infrastructure investment, which could boost productivity, appear to be slowing. Indeed, with higher borrowing costs and rising risks around global trade, investment growth is likely to have peaked.

A material pickup in labour market participation could also help to prolong the cycle by relaxing hiring constraints and allowing growth to run further despite record low levels of unemployment. To some extent, this is happening, with rising participation among older workers and further falls in the underemployment rate. This is unlikely to be sizable enough to make a meaningful difference, however. Companies also continue to report that finding suitable labour is one of their most pressing problems, and this is not only a US phenomenon.

With oil prices falling and growth slowing inflation is unlikely to become a problem

We stick to our view that inflation will not become a problem over the course of this cycle. In DMs, wage inflation is gradually picking up but remains very benign compared to historical levels. Oil prices have collapsed and this will help to contain price pressures over the coming months. Central banks are now tightening policy, which will weigh on growth and help to anchor inflation expectations. Indeed, looking beyond the near to medium term, downside risk to inflation still appears to dominate. In our view, this justifies the need for central banks to be cautious when removing stimulus, and why a sharp rise in inflation in core markets remains unlikely.

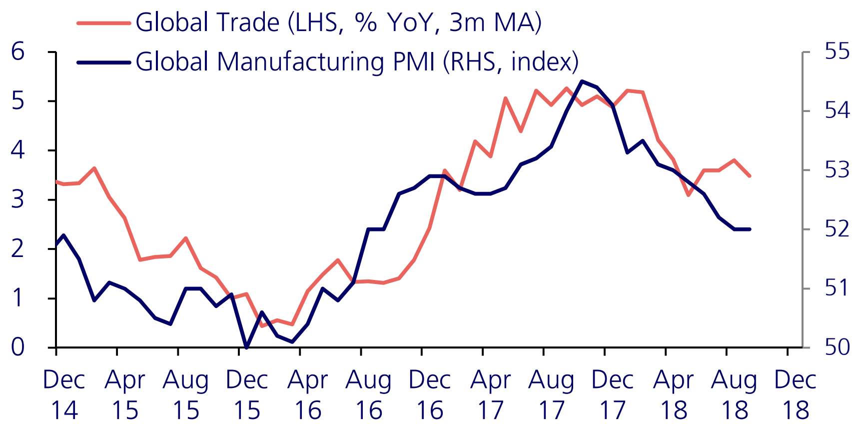
Global trade and politics will weigh on sentiment and activity

The 90 day truce between the US and China agreed to at the G20 meeting will provide breathing space and is a constructive move. It is encouraging that both parties now appear to be focussing on finding a sustainable solution around structural issues such as intellectual property rights and technology transfer. Near-term relief will lend support to the global economy at a critical juncture, but longer-term uncertainty will persist and we expect this to weigh on business confidence and investment over the coming quarters. Stakes are high, and a failure to deliver a longer-lasting solution would have severe consequences for the global economy.

Bond yields should move higher, though upside is limited

Treasury yields reached a seven-year high of 3.24% in November, but have since fallen back to below 3%. Fears of a rapid rise in inflation have not materialised and we maintain our view that yields are capped. There is limited upside to growth, oil prices have plummeted, and the Fed has softened its hawkish tone amid financial market turbulence and a housing market slowdown. Treasury issuance will rise notably in 2019, so supply and demand factors will be less favourable, but real yields have already picked up, helping to compensate for this. Bund yields remain detached from economic fundamentals, with the ECB's rate guidance, concerns around Italy, and slowing Eurozone growth weighing on yields. We still see upside

Global growth has peaked but should stabilise



Source: Markit, CPB, Bloomberg

to Bund yields, but recognise that it is very limited and risk is to the downside.

Italian government bonds spreads are likely to remain in a wide trading range as the dispute between the EU and the Italian government over Italy's spending plans will likely continue for some time. In other periphery markets, spreads should be less volatile and remain around current levels as fundamentals are more supportive and government policy less confrontational versus the EU.

Credit returns will be lacklustre if not negative

Credit investors and issuers have likely kissed tight spreads goodbye for this cycle.

As if 2018 wasn't bad enough for global credit, we expect credit to remain under pressure in 2019. Spreads are expected to generally continue along the widening trend that started in early 2018, when we said that credit spreads were past their bottom. That said, we don't expect a full blown bear market until the latter part of 2019. This implies that a preference for equities over credit on a risk-adjusted basis is likely to have superior returns than an outright underweight in credit versus government bonds, as the latter will be somewhat dampened by carry.

Historically, credit has leading properties for predicting the end of economic cycles and tends to underperform equities notably in the late stage of the cycle. This has been precisely the case in 2018 and was behind our view for favouring equities over credit. We expect this to continue for some time, although we are likely to revisit this later in the year.

Credit underperformance will be driven by weak demand amid poor fundamentals and a slowing economic environment that will possibly see a US recession in 2020. Demand for credit is likely to continue weakening as flows remain under pressure and central banks tighten monetary policy and withdraw the exceptional liquidity provided over the last few years. The primary market is already sputtering, with some deals faring badly as investors become more discerning. The latter is also being seen in more dispersion, as we predicted coming into this year. In fact, a single piece of bad news can send shock waves through credit spreads causing investment grade rated credits to trade like junk, and junk credits to trade like distressed.

Fundamentals are also bad and more focus will be seen on this than in the past. There is no let-up in leverage, with spreads not wide enough to cause managements to change their stance of favouring shareholders at the cost of creditors. Cash repatriation has been a credit negative in our view as cash has mostly gone into the pockets of shareholders rather than for reducing debt. At the same time, European banking sector risks seem to be increasing, not least due to the widening in Italian spreads, while a flattening US yield curve is hampering the outlook for global banks.

Within credit, we believe that US non-financial credit, including high yield and European banks, are best avoided to the extent possible, with ABS, municipals and covered bonds providing a better and safer value proposition.

Equity gains are expected, but volatility and divergence will characterise the year

After a forgettable 2018, the outlook for equity returns remains challenging, although nimble investors are likely to be presented with profitable opportunities. The days of smooth up-tracks for stocks are over, with irregular patterns driven by idiosyncratic factors requiring a proactive approach to capture returns.

Stocks ex US have languished, offering upside potential

Source: Bloomberg

The economic backdrop is expected to be broadly supportive through the first half of the year, although global growth will be on a downward trajectory and earnings growth will have peaked. However, this should not come as a surprise to investors, as equity multiples have compressed appreciably over the past 12 months, reflecting tightening financial conditions and late cycle angst. This comes despite the record margins and substantial earnings growth posted in many regions, suggesting that the peaking of growth has been priced in.

Consequently, there is little evidence of the euphoria that often characterises the final stages of the cycle. On the contrary, the bear market that has embraced some key emerging markets suggests that upside is likely should any positive surprises materialise. On that front we can see two possibilities in the near term. The first is expected to be evidence of a more dovish Federal Reserve in the US, reflecting what we suspect will be growing signs of slowing growth and contained inflation. This should weaken the USD and improve sentiment towards emerging markets. The second stimulant is likely to come from improving Chinese data. This will confirm a stabilisation of growth and remove the perennial threat of a hard landing for the economy. This is particularly significant for stocks in China and its neighbours, but will also provide a fillip to developed equity markets.

Divergences between sectors and geographies should be expected. While valuations are now attractive in many emerging markets, and appear fair to us in both Japan and the Eurozone, the more expensive US market will need to hold in if the others are to prosper. This seems likely, particularly in the first half of the year, with a continuation of stock repurchases, M&A activity and a fading fiscal impulse. However, political and geopolitical issues are likely to provide bouts of volatility, while the second half of the year offers the potentially more unsettling prospect of a substantial slowing in the US economy.

US

Outlook

- The economy remains in good shape but momentum is expected to weaken
- A tight labour market is increasingly becoming a challenge for companies
- Inflation is likely to remain contained as growth is about to soften

Implications

- Bond yields are unlikely to rise much further as the Fed has moved close to its neutral level
- Credit is likely to continue lagging equities, at least in the near term
- Equities remain well supported but will face more headwinds as economic momentum slows

Risks

- The trade war between the US and China escalates further, disrupting growth more than expected
- The Fed sticks to its projected rate path potentially tightening its monetary policy too much
- Equity investors panic as the end of the business cycle gets closer and economic data weaken more than expected

Business sentiment remains very high but capacity is reaching its limits

The US economy enters 2019 in remarkable shape. Should growth continue steadily into the summer it would be the longest expansion since the middle of the 19th century. Business sentiment is very upbeat with the ISM Non-Manufacturing Index hovering close to a 20-year high. New orders indicate that the strong momentum will be carried into the new year. Soaring small business sentiment shows that the positive environment is not restricted to larger companies but reflects the broad-based strength of the US business sector.

However, small business surveys also reveal one of the key challenges that US firms are increasingly facing. The difficulty to fill open positions reached an all-time high in August and has remained there since then. The capacity constraints are also reflected by the fact that the gap between open jobs and unemployed persons has steadily risen over the past few months indicating that the US economy is reaching its growth limits. Naturally, one would expect firms to increase investment trying to circumvent the limited supply of new employees by increasing the productivity of the existing workforce.

Investment spending weakens as trade tensions cloud the outlook

Equipment investment accelerated significantly when the US recovered from the slowdown in 2016 and growth rates remained at elevated levels until the beginning of 2018. Since then, however, growth in equipment investment has slowed over the course of the year and is unlikely to pick up significantly as long as trade tensions are clouding the outlook. To some extent, the slowdown contradicts the bright picture painted by sentiment indicators and is an indication of higher financing costs as well as of higher planning uncertainty given the rising tensions between the US and China. In a world where supply chains reach across many nations, tariffs and non-tariff trade barriers have the potential to significantly increase production costs, limit the access to crucial inputs and make overall production and investment plans more challenging.

Consumers are more cautious regarding the future

While investment is softening, household spending continues to show strength amid one of the strongest labour markets in decades and the fastest wage growth in the current expansion. Personal consumption spending reached an annualised rate of 3.6% in the third quarter, down from 3.8% in Q2. Consumer sentiment remains very high, indicating that household spending will continue to drive GDP growth in the coming months. However, there are some signs of weakening demand beneath the surface, making it likely that momentum is going to slow over the course of the year.

The gap between households' judgement of the current situation and their future expectations as measured by the Conference Board Consumer Confidence Survey rose to the highest level since 2001 over the summer. While this divergence can stay at these elevated levels for some time, it has rarely been higher and is usually a good predictor of a slowdown in consumer spending. Other indicators signal a looming slowdown as well.

Households will become increasingly reluctant to spend

Households continue to consider the current situation to be better than during most of the past two decades, according to the University of Michigan's Consumer Sentiment Indicator. At the same time, however, their perception as to whether or not it is a good time to buy a vehicle has fallen to the lowest level in five years. Even worse, the time to buy a house is considered to be the worst since 2008. Sentiment is dampened by higher house prices and rising mortgage rates.

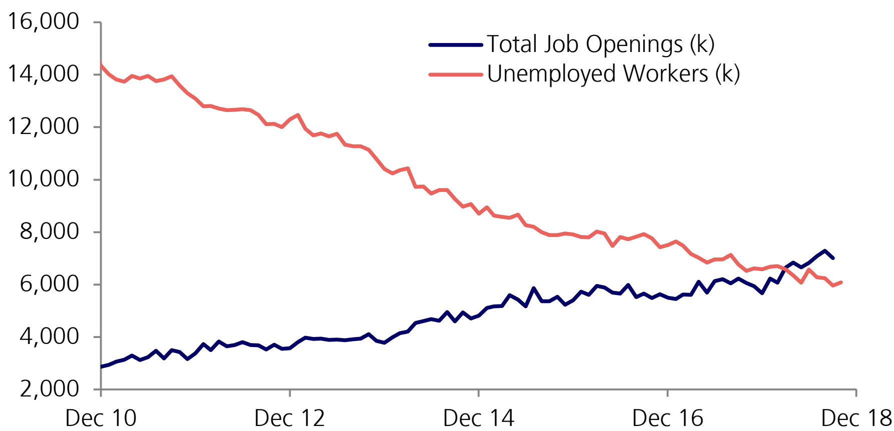
The average rate for a 30-year mortgage rose to almost 5% in November. While still low in a longer-term historical perspective, the significant change is an increasing drag on housing demand. In addition, in an environment with rising mortgage rates refinancing has become unattractive, depriving households of a welcome source of liquidity to finance their consumption. In line with weakening sentiment and increasing costs, both building permits and new home sales have weakened over the course of 2018. Given the Fed's willingness to continue tightening its monetary policy, momentum in the housing market is likely to slow down further.

The Fed seems to be taking a more dovish stance

After having been rangebound for most of the year, 10yr Treasury yields started to rise in late summer 2018 to reach a seven-year high of 3.26% in October before falling back as the stock market correction set in later that month. Higher yields reflect the strong economic environment with higher inflation and accelerating wage growth. In addition, a relatively hawkish Fed has provided further support for higher yields. However, while earlier comments by Fed Chair Jerome Powell have caused uncertainty as to how far the FOMC wants to raise rates to be at a neutral level, the latest signals were more dovish and even opened the possibility that the Fed will soon be willing to pause the hiking cycle until the impact of past hikes become more visible.

In its latest economic projection, the Fed's long-run level for the funds rate is 3%. Including the expected rate hike in December, the Fed funds target range would be between

Qualification mismatch



Source: Bloomberg

2.25% and 2.5% at the end of 2018. The FOMC projects three more rate hikes in 2019 and another one in 2020, which would pushing the target rate above the neutral level.

Given that the labour market is very tight already, the Fed is increasingly focusing on inflation as the second part of its dual mandate. It is true that the headline CPI inflation rate accelerated to 2.9% over the summer before falling back to 2.5% in October, however, prior dollar strength and a steep fall in oil prices are likely to keep a lid on prices in the near future. At the same time, core components remain contained. Core CPI has hovered around 2% for most of the past two years. The October rate was 2.1% YoY and Core PCE just scratched the Fed's target of 2% in summer 2018 without breaking above before falling back to only 1.8% in October. If the housing market continues to soften, shelter costs, an important component of core inflation, are likely to soften further. Finally, households' longer-term inflation expectations remain stuck at the lower end of their recent range, far from signalling a risk of being unanchored.

Wage growth is accelerating

Driven by an ever tighter labour market, wage growth finally picked up in 2018. Average hourly earnings rose 3.1% YoY in October. While wage growth should remain solid in the coming months, the rate of acceleration should not be extrapolated, as the October number was distorted by base effects due to last year's weak growth in the autumn.

Overall, there are no indications that inflation rates are getting out of hand. Clearly, given monetary policy's usual lag, the Fed has to look further out into the future. But given the above mentioned signals of a slowdown in momentum, and the fact that the Fed is just about reaching its inflation target, it seems unlikely that it can follow through on its projected rate path in 2019.

Credit to continue underperforming equities, at least in the short term

US credit spreads are likely to continue widening, despite the substantial widening seen already in 2018. Moreover, we expect credit to continue underperforming equities, at least in the first part of the year. Within credit, we favour ABS and municipals, while risks seem skewed to the downside in non-financials, including high yield. 2019 is also likely to see further dispersion, which should improve alpha opportunities through name selection.

Leverage for US credit continues to rise and there was no respite despite stronger earnings in 2018. In fact, we were somewhat disappointed by repatriated cash being returned to shareholders. Shareholder returns via buybacks, dividends and M&A continue to be the favoured strategies of companies' management. Despite the widening in credit spreads, it seems that the pressure to appease creditors is still not enough to sway management's stance. The flip side of high leverage is the low interest coverage for smaller companies in the high yield market, as these issuers continue to spend most of their income in servicing debt, despite low interest rates that have been locked in over the years. Contrary to what many investors believe, the terming out of debt maturities will not be enough in our view to prevent credits from becoming distressed once companies start seeing an earnings slowdown or cash burn. Rising funding costs are already taking a toll, with energy sector spreads widening as oil prices suffered in the last few months.

US banks are better credits than European banks in our view. That said, it is difficult to get overly excited around further improvement as the credit cycle seems to be in the late stage while the yield curve has flattened aggressively. We prefer US municipals, which have held in despite US tax reform that many expected would lead to a sell off. While we think a rotation amongst investors is likely, any excessive spread widening is likely to be short-lived and used opportunistically by investors given the solid fundamentals of the sector. ABS is also favoured as despite a pickup in delinquencies that will eventually occur, cushions for investors are in place.

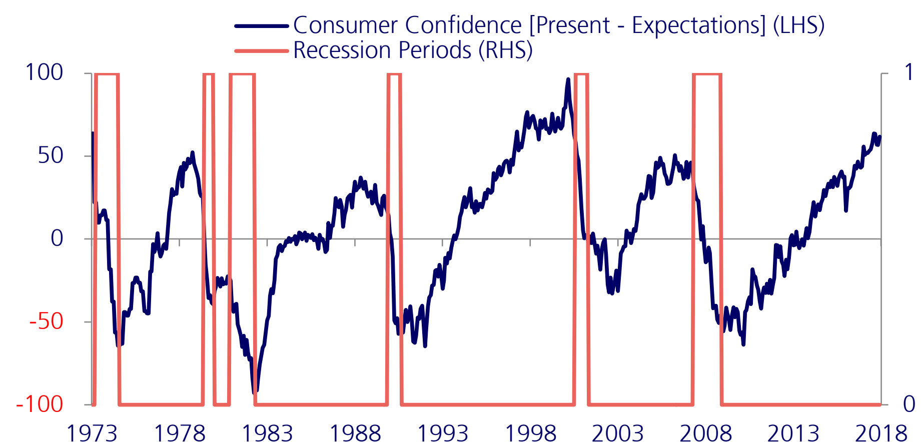
Stock markets will become increasingly nervous as economic momentum slows

Despite the solid economic background and soaring corporate earnings the stock market has faced some significant headwinds since the beginning of 2018. The S&P 500 suffered its worst month in years in October, losing almost 7%, as investors continue to worry about higher yields and an escalation of the trade tensions between the US and China.

Clearly, earnings growth rates of 26% YoY, as reported in the third quarter, are not sustainable and will converge back to more normal levels as the effect of the tax cuts initiated at the beginning of 2018 fade. However, solid sales growth of 8% YoY underline the health of the corporate sector. Economic fundamentals remain supportive for equities, as reflected by strong prints of business and consumer sentiment.

Investors will increasingly price in the end of the cycle and are likely to react very sensitively to weaker economic and earnings data. Nevertheless, given the solid economic background, the potential for a de-escalation in trade tensions, and more dovish signals from the Fed, the equity market remains well supported entering the new year. The expected slowdown in economic momentum will increasingly act as a headwind for risky assets and we are likely to face rising levels of volatility.

Gap between present situation and expectations at a 17-year high



Source: Bloomberg

UK

Outlook

- Economic sentiment is increasingly burdened by Brexit uncertainty
- Household spending is softening despite a tight labour market with very low unemployment
- Inflation is likely to remain above the BoE's target as sterling remains under pressure

Implications

- Brexit risks continue to weigh on gilt yields as investors are looking for a safe haven
- Credit investors appear complacent in the face of a weak banking sector and binary risks from Brexit
- British equities show attractive valuations but remain vulnerable to political developments

Risks

- Political turmoil and a disorderly Brexit cause major disruptions for the British economy
- Households and firms significantly cut back spending as the economic outlook remains highly uncertain
- The BoE tightens monetary policy to fight high inflation rates choking off economic growth

The UK economy moves from leader to laggard

Although the UK has moved from being one of the fastest growing developed economies a few years ago to one of the laggards, it has nevertheless been holding up reasonably well given the looming uncertainty of splitting away from its largest trading partner. As an open economy Britain has benefitted from a strong global economy not least thanks to a significantly weaker currency. GDP grew at an annual rate of 1.5% in Q3 2018, up from 1.1% in the first quarter. As the global outlook weakens, burdened by tighter financial conditions and rising tensions between the US and its trading partners, and the actual Brexit date moves closer, economic momentum in the UK is likely to soften.

London house prices are falling as Brexit clouds the future of the financial sector

Brexit uncertainty is also leaving traces in the housing market. House prices in London have fallen on an annual basis for the first time since the financial crisis as the outlook for financial services is clouded by an uncertain future and an increasing number of financial firms are moving their offices away from the British capital.

Conditions in the manufacturing sector, as measured by the Markit Manufacturing PMI, slowed sharply in October. The overall index has dropped to 51.1 while new order inflows and employment both declined for the first time since July 2016. The weakness is caused by lower inflows of new work from abroad as well as softer domestic demand. The weakness in new orders was mainly centred on the consumer goods sector, indicating that households are increasingly restricting their spending ahead of Brexit.

The more cautious spending pattern is also leaving traces in the more relevant service sector. The Services PMI dropped to 52.2 in October, the second lowest since July 2016. Again, the weakness was centred around consumer-related sectors such as hotels, restaurants and leisure.

A tight labour market pushes up wages

Households' reluctance to spend comes despite one of the strongest labour markets in decades. The unemployment rate fell to 4.0% in the summer, the lowest level since 1975, before ticking up again in September. The unemployment rate tells us only half of the story, however, as labour market tightness has intensified by a fall in net migration due to the uncertainty of foreign workers' future situation after Brexit. Wage growth further accelerated to 3.2% YoY in September, a post-recession high. Thanks to inflation slowing to 2.4% YoY, the squeeze on households' real purchasing power has finally stopped. It is therefore even more remarkable that consumers remain so reluctant to increase spending.

Inflation is likely to remain above target

Renewed pressure on the pound caused by the political quarrel around the withdrawal agreement with the EU will keep inflation above the BoE's target for the time being, limiting the upside potential for real income gains and household spending. While the Bank of England took the opportunity to hike rates in August 2018, the weakening economic environment and the uncertainty around the actual Brexit process makes it very unlikely that the Bank rate will be increased further before summer 2019. Clearly, the future path of economic activity and monetary policy crucially depends on the outcome of the Brexit process.

The Gordian knot of the Irish border

With most of the open questions regarding the withdrawal agreement like the divorce bill and EU citizens' right in the UK after Brexit and vice versa settled, the question of how to avoid a hard border between Northern Ireland and the Republic of Ireland is proving to be the stumbling block that could still lead to an uncoordinated Brexit.

To avoid both a hard border for goods crossing the land frontier with Ireland and a customs border in the Irish Sea that would separate mainland Britain from Northern Ireland, Theresa May agreed to keep the whole UK in a customs union with the EU during the transition period lasting until the end of 2020 and potentially even longer. This arrangement goes against the interests of many pro-Brexit Tories as it keeps Britain bound too closely to the EU in their view. The Brexiteers have so far been unable to gather enough votes to challenge Theresa May's leadership but they will keep making the prime minister's life difficult.

Fiscal and monetary policy will support the economy after Brexit

While Theresa May has been able to withstand a leadership challenge, her agreement with the EU is facing massive resistance in parliament and caused another wave of ministerial resignations after the announcement. An uncoordinated Brexit would undoubtedly have a significant impact on the British economy in the short term and it's about a lot more than just trade. Agreements covering a wide range of topics including aviation, energy, drugs or financial services could technically cease to be valid after March 29, 2019 if there is no willingness from both the UK and the EU to temporarily extend the cooperation.

While the short-term impact of a disorderly Brexit would be substantial the longer-term effects are less clear and would significantly depend on fiscal and monetary policy reactions. The Bank of England would most

Unemployment falls to the lowest since 1975

Source: Bloomberg

likely cut the Bank rate back to its post-crisis low or even further and could restart or at least signal its willingness to reignite its quantitative easing programme.

Some welcome post-Brexit stimulus for the economy will come from fiscal spending. Chancellor Hammond presented a FY 2019/20 budget that sees more spending, in particular on healthcare, taking advantage of the Office for Budget Responsibilities' positive forecast revisions on growth and receipts. The main impact of the increased spending is back-loaded and will not occur until 2021, however. In case of a disorderly Brexit, fiscal policy support is likely to be ratcheted up, particularly given that the abolition of the withdrawal deal would free some funds that would have been transferred to the EU as part of the divorce agreement.

Treasury-gilt spread climbs to the highest on record

Sterling remains the main pressure valve for the ebb and flow of Brexit uncertainty and expected economic and political disruptions. Should the probability of a disorderly Brexit increase the pound would face increasing pressure even before the actual Brexit date. A weaker currency would help to soften the economic blow but would cause inflation rates to re-accelerate again, squeezing households' purchasing power as it did until recently.

Given the BoE's pessimistic projections for the scenario of a chaotic Brexit, it would very likely look through any currency-induced pickup in inflation and avoid tightening monetary policy. Bond yields already reflect a significant amount of pessimism regarding Brexit. The spread between longer-term Treasuries and gilts rose to the highest on record in November. Further development in bond yields crucially depends on the outcome of the political debate in the UK. If a compromise regarding the withdrawal agreement can be found both sterling and gilt yields would snap back aggressively.

Credit investors seem complacent

Sterling credit investors seems rather complacent in the face of binary risks arising from Brexit, despite a relatively vulnerable banking sector. While we expect spreads to move out globally, sterling credit could uniquely suffer in the event that the Brexit deal is not agreed. Furthermore, we think the credit market, and especially financials, are generally vulnerable even outside of Brexit related concerns. The large size of the British banking sector along with vulnerabilities and exposures to trading as well as to European banks should be on investors' radars. So far, sterling credit spreads have largely moved in line with the rest of the global and European credit spreads.

Going into 2019, even in a benign Brexit scenario, we would expect limited upside for credit given that it's hardly priced in any risks from Brexit, while fundamentals for credit generally remain weak.

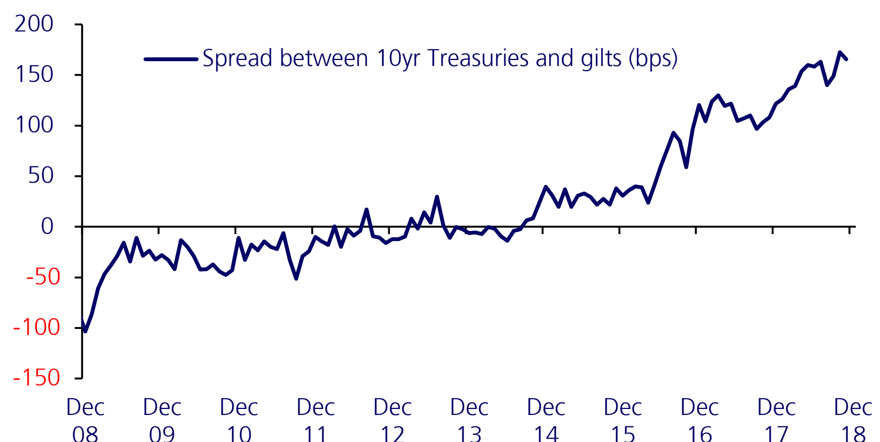
We are more constructive on sterling ABS relative to other credit sectors. Following the expiration of the BoE's liquidity schemes, such as Term Funding scheme (TFS) and Funding for Lending Scheme (FLS), traditional banks and building societies have already increased their issuance of RMBS and credit cards by 50% in 2018. We expect the primary market to remain dynamic, given the many call dates scheduled in 2019 for post-crisis deals. While we think that UK ABS spreads should continue widening, having reached their low point in early 2018, ABS should still outperform other credit sectors. Structural features and credit enhancement of ABS securities, especially of the senior tranches, will provide some cushion against Brexit-driven volatility and weaker macro-economic conditions.

British stocks look attractive but remain susceptible to political developments in the near term

Global stock markets have been volatile for most of 2018 so it is no surprise that the FTSE 100, which mostly represents large, multinational companies, has struggled as well. While smaller cap domestic firms are vulnerable to Brexit-related economic impacts, companies listed in the FTSE 100 earn the lion's share of their profits abroad so a weak currency directly translates into higher earnings in pounds. Despite this, the FTSE 100 has underperformed the MSCI World, although this was mainly due to the US market's strong performance relative to most other regions.

With the estimated price-earnings ratio back at levels last seen in 2013 and an estimated dividend yield of almost 5% British stocks do look attractive, particularly given very low gilt yields. However, near-term performance will be driven by political developments around Brexit with significant volatility to be expected.

The Treasury-gilt spread soars as Brexit looms



Source: Bloomberg

Eurozone

Outlook

- Despite a deceleration in growth and weakening in business confidence the Eurozone is not falling into recession
- We expect Eurozone growth in 2019 to be lower than in 2018, but still slightly above trend.
- The EU-Italy budget stand-off will continue into 2019, with episodic periods of volatility before compromise is found

Implications

- Core bond yields will move modestly higher while Italian bond spreads will stay in a wide trading range
- Credit remains vulnerable, especially as banks are still fragile amid a multitude of risks
- Equities have upside if various risks can be averted

Risks

- An escalation in global trade tensions would be a particular concern
- A further deceleration in emerging market growth would impact the Eurozone's export sector
- Political risks are high with the EU-Italy budget dispute and European elections in May

Settling into a slower pace of growth

We expect Eurozone growth in 2019 to be lower than in 2018, but still slightly above trend. Business confidence has fallen almost continuously since its peak at the beginning of 2018. Growth has also been on a downward track through the course of 2018, but we expect a stabilisation in 2019 with the economy settling into a pace of growth at around 0.3 - 0.4% QoQ in the first half of the year. This contrasts to the 0.7% QoQ pace it was running at in 2017.

The crucial question from an investor perspective is whether this deterioration in growth is just an adjustment to a lower track or whether it represents the beginning of a trend that continues into a recession. We think the former, rather than the latter, especially for the first half of 2019. Once it becomes clear that the recovery will continue in H1, even if at a modest pace, this should give investors more confidence to buy Eurozone assets.

Despite being a large economy in itself, Eurozone activity tends to be particularly sensitive to global growth and trade. Eurozone exports to the rest of the world are 28% of GDP, compared to an equivalent figure of 12% of GDP for the US. Fortunately, external demand should be less of a drag on Eurozone growth in H1 2019 compared to 2018, as China and EMs more generally stabilise following various stimulus policies.

Domestically, fiscal policy will be looser across a number of Eurozone countries in 2019, not just in Italy, which should also support growth. On the monetary side, while the ECB will have ended QE asset purchases, it will continue to keep interest rates low, emphasise forward guidance, and rollover its existing portfolio of assets implying that monetary conditions will still be accommodative.

Falling unemployment and rising wages should continue to support consumer spending. What's more, the recent decline in oil prices, if sustained, will also be a boost for real household incomes and spending.

The upshot is that despite the sharp fall in business confidence that we have seen this year, and some leading indicators that suggest this trend has further to run, we think the recovery in the Eurozone will continue.

Headline inflation to fall sharply, but core to nudge higher

From its current level of around 1%, we expect core inflation to rise modestly. Wage growth is accelerating and the output gap closing, though slower growth in 2019 compared to 2018 could limit the pace of acceleration in wage growth.

In contrast, if oil prices stay around current levels, headline inflation will fall back rapidly in the first half of 2019, due to lower energy inflation.

ECB likely to emphasise forward guidance and liquidity operations for banks

The ECB plans to end QE asset purchases of government and private sector securities in 2018. Since 2015, it will have expanded its balance sheet by around 2.5 trillion euros, buying mainly Eurozone government bonds as well as corporate bonds, covered bonds and asset backed securities.

In 2019, despite ending QE, we expect the ECB to continue with and announce other measures to support the economy. This includes announcing new Targeted Longer-Term Refinancing Operations (TLTROs) to provide liquidity to the banks, as well as emphasising forward guidance on both interest rates and reinvestments of maturing principal and coupon payments from the ECB's stock of securities.

Politics a risk for 2019

The European elections in May will see populist parties trying to gain enough seats to take control of the European parliament, with the ultimate aim of electing their preferred candidate as European Commissioner.

Although we expect populist parties to gain more seats in the European elections than they currently have, we do not think they will get an absolute majority. Rather, centrist and pro-EU parties will be likely to hold a majority. It will also be difficult for populist parties from many different countries and with different agendas to unite behind a common platform.

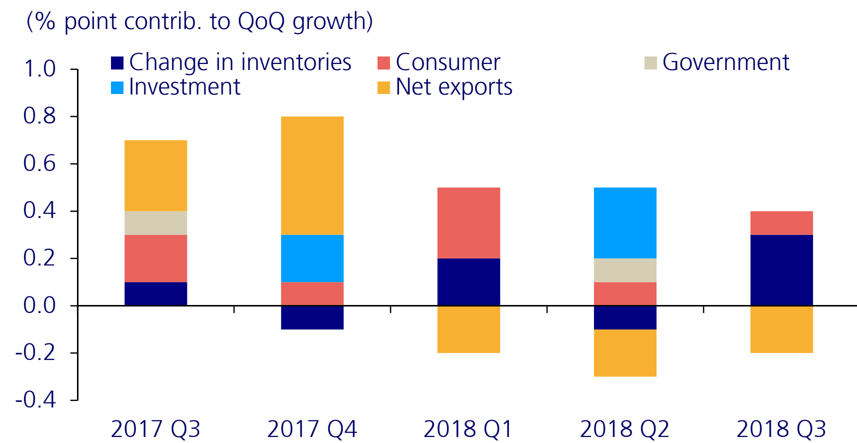
Support for the EU has increased in 2018 according to the Eurobarometer survey. What's more, in recent German regional elections, whilst the CDU and SPD both lost support, the Green Party did much better than expected showing that many votes transferred to the Greens rather than just to more extreme populist parties.

Annegret Kramp-Karrenbauer will have increasing influence over German government policy after having been elected CDU leader and as Angela Merkel gradually cedes power after 13 years as Chancellor. However, we do not expect a dramatic change in policy with respect to the rest of the Eurozone.

Core bond yields to move up

We expect core Eurozone government bond yields to move gradually higher during the course of 2019. Yields are being partly suppressed currently by safe-haven demand, but as investors' worst fears fail to materialise, we think some of this demand will diminish. However, any moves higher in core yields will be limited by still low inflation, likely dovish forward guidance on interest rates by the ECB and the continued reinvestments of maturing assets on its balance sheet.

Trade a drag on Eurozone in 2018 (contributions to QoQ growth)



Source: Eurostat

Investors will demand a substantial risk premium to buy Italy`s debt

Spreads in Italy are likely to remain in a wide trading range as the dispute between the EU and the Italian government over its spending plans will run on for some time. Recently, the Italian government has shown a greater willingness to compromise, which is encouraging, but there are likely to be many twists and turns before an agreement is reached. If and when this happens, both Italian and wider Eurozone risk assets could enjoy a re-rating.

Nevertheless, damage has already been done to Italian business confidence and economic activity by the uncertainty regarding the 2019 budget and accompanying tightening in financial conditions. This suggests growth in Italy will fall well short of the government's forecasts of 1.5%. We think it is more likely to be half of this and it could even be mildly negative in 2019.

Indeed, things may have to get worse before they get better in Italy. Further market pressure and/or evidence of negative impacts on the Italian economy may be necessary for the government to adjust its spending plans.

The longer-term issue is that Italy remains extremely vulnerable whenever the next global or Eurozone recession does materialise, because of its starting point of high government debt levels and weak trend growth.

European credit, especially banks, remains vulnerable

European credit was hit hard in 2018, with spreads widening more than in other markets. Some high yield indices for example have seen spreads widen by almost 200bps, while financial indices have seen spreads widen by around 70bps. We expect European credit to remain under pressure in 2019 as banks remain vulnerable, and a global growth slowdown and higher Italian government bond yields keep risks elevated.

Furthermore, support from the ECB's QE will not be present in 2019 to counter pressure from investor outflows. Fundamentals in European credit, particularly for banks, have been worsening and some vulnerabilities that we have been flagging came into the spotlight in 2018 as the cover of easy liquidity was lifted by central banks.

Bank profitability remains poor while exposure to emerging markets and wider Italian spreads puts investor focus back on sovereign-bank linkages, often referred to as the 'doom loop'. This will continue to be an issue, especially as Italian bond spreads are likely to remain elevated in 2019. Banks continue to warrant caution due to their fragilities and as the next downturn comes closer, the risk of a banking crisis is likely to slowly rise. Furthermore, a new type of bail-in-able senior debt is increasingly becoming a part of issuance and unsuspecting investors may suffer unexpected losses if a bank has to be resolved. We expect the ECB to take a benign approach towards extending TLTROs as banks would get some relief from continued cheap funding. Supply/demand technicals have faced significant pressures that we think will persist. Investor outflows have been somewhat broad-based in Europe and this is at risk of continuing in 2019.

While banks warrant caution, non-financial leverage is also running high, although less so than in the US. Covered bonds and ABS remain favoured and are likely to outperform other sectors in a spread widening environment.

Eurozone equities to benefit as some risks reduce in 2019

Eurozone equities have struggled in 2018, despite decent earnings growth. By country, performance has varied through the course of this year. Italy did very well up to and including the May election, but then performed badly as the anti-establishment coalition government was formed and presented its aggressive spending plans. This was also a drag on the wider banking sector equity market performance in the Eurozone.

The auto sector has also suffered a substantial de-rating this year due to temporary and structural factors. The temporary factor has been the change to a new emission standard in Germany affecting demand for and production of diesel cars. This effect should unwind over the next few months, leading to a rebound in production.

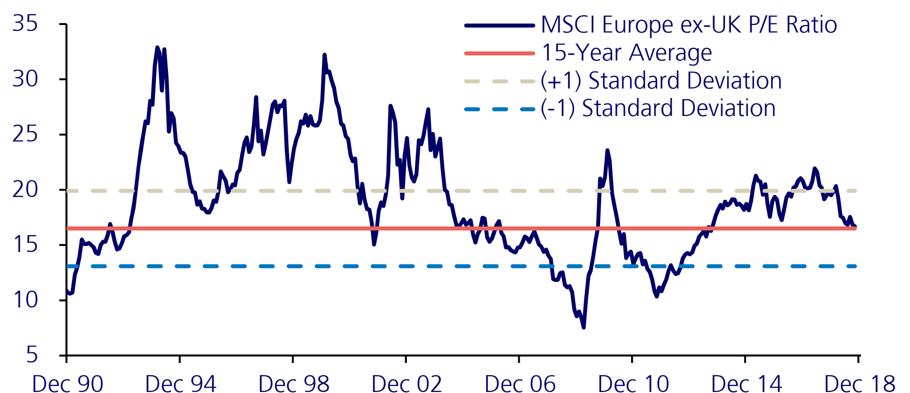
The more worrying structural factor is the difficulty the sector is facing globally to adjust to the rise of electric vehicles and changes in consumer behaviour. Given the long lead times in investment and production, and the high cost of developing new cars, this is creating severe challenges and will weigh on earnings growth for some time.

Given the headwinds of a trade dispute and EM slowdown, disruptions in the auto sector, as well as the Italy-EU budget stand-off, Eurozone equities have actually been quite resilient in 2018, down only 7% year-to-date on a total return basis (as of November30), though this is of limited comfort to investors.

More importantly, we expect at least some of these headwinds to wane during the course of 2019, which should reduce the risk premium attached to Eurozone risk assets and allow them to achieve a higher rating.

However, volatility and event risks are likely to remain high. This suggests a tactical, selective and nimble approach will be needed in order to generate positive returns in Eurozone equity markets in 2019, rather than a simple buy and hold strategy, especially if we are right that towards the end of 2019 and in 2020 the global economy does enter a more pronounced slowdown.

European equity market valuations improve



Source: Thomson Reuters Datastream

Switzerland

Outlook

- Growth is expected to slow in 2019, led by a weaker global cycle
- Domestic consumption will not provide an offset to weaker external demand, as structural headwinds persist
- The SNB is expected to lag the ECB, leaving rates unchanged at least until the second half of the year

Implications

- Bond yields should rise only very modestly, but 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
- An escalation of the bilateral US-China trade dispute into a global trade war
- A Eurozone crisis triggering a surge in the franc

Growth normalising after booming conditions

Growth was running hot in the first half of 2018 when GDP expanded by over 3% YoY, well above its long-run average and one of the highest among developed markets. Special factors, including the Winter Olympics and the football World Cup, which boost Swiss GDP through licensing fees to international sports organisations based in Switzerland, were partly responsible for the strong GDP data. Underlying growth was also firm, however, as the manufacturing sector enjoyed an export led boom, with positive spillover effects for the labour market and the broader economy. Growth has now peaked and economic activity is rapidly normalising. We expect GDP growth to fall back to 1.5% in 2019, down from a projected 2.6% in 2018. This is a bit below consensus expectations, reflecting our less upbeat view on the global economy and our long-held view that domestic demand will remain sluggish in Switzerland, lacking impetus to offset external weakness.

Q3 GDP shows growth slowing materially, in line with global demand

The latest GDP report shows growth slowing sharply into negative territory in Q3, at -0.2% QoQ, with the annual growth rate falling back to 2.4%. This was much weaker than expected but broadly in line with the manufacturing PMI, which peaked at an eight-year high in August and has since fallen sharply. Much of the weakness is related to the external environment, with slowing emerging market and China growth, weaker conditions in the Eurozone and risks to global trade. For the Q3 GDP data, one-off factors that have weighed on the German auto sector also appear to have spilled over to Switzerland, showing the importance of supply chain linkages. A stronger franc has also weighed on growth. While some of these effects should stabilise going forward, it is clear that global growth has peaked and we expect conditions in the industrial sector to normalise going forward. The manufacturing sector, which boosted growth in 2017 and the first half of 2018, is therefore expected to be a drag on the economy over the coming quarters.

The Swiss consumer will not provide an offset to weaker external demand

Domestic demand is unlikely to provide a meaningful offset to external weakness. Consumer sentiment is disproportionally affected by labour market conditions. While businesses are still hiring, the pace of employment growth has peaked and we expect this to weigh on sentiment and spending going forward. Measures of consumer sentiment, which peaked in early 2018, have declined and remain below their historical averages. Private consumption, which has been lacklustre over the past year despite strong overall growth, is therefore unlikely to pick up materially. Structural headwinds that are impacting the retail sector also appear to be intensifying, which is a concern to us. Retail sales volumes contracted by 2.5% in the first three quarters of the year and are down by over 7% since the end of 2014. While producer prices have largely adjusted to a stronger franc, consumer prices have clearly not. We expect this to continue to weigh on the retail sector, with growth unlikely to pick up materially. We maintain our forecast of sluggish consumption growth in 2019, at an annual pace of around 1.5%.

The housing market is normalising, but imbalances persist

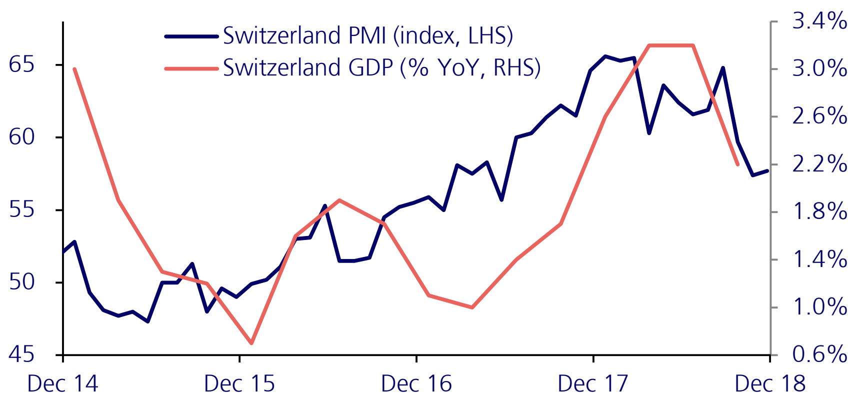
The latest housing market data show that imbalances are diminishing. The UBS real estate bubble index indicates that the Swiss housing market is out of the 'risk' zone for the first time since mid-2012. This may sound encouraging and reflects the stronger nominal growth environment, with both consumer prices and wages rising at a faster pace than house prices in 2018, however, looking through the headline, signs of weakness are emerging. Rents are falling and there is a notable divergence between prices of owner occupied homes, which rose by 0.4% QoQ in Q3, and rents, which contracted by 0.6%. The fundamental drivers are becoming less favourable, with slowing immigration and rising supply. So far, this has mainly spilled over to softer rents while prices have been resilient. With rates still very low and investor demand strong, this is not surprising, but it reinforces our view that a late cycle boom in housing is unlikely.

Construction investment has slowed, and the latest data show that growth stalled in Q3, taking the YoY expansion to 0.7%. This compares to annual growth of 2.5% over the past 10 years. Given soft rental growth and less favourable fundamentals, we have not changed our view that construction will not be a growth driver in 2019.

Investment has caught up, and a further upswing is unlikely

Business investment has boosted growth in 2018, with equipment and software investment tracking at an annualised rate of almost 5% in the first half of the year. The investment to GDP ratio, which slumped following the financial crisis, has picked up and the ratio, now at 16%, is at a multi-decade high. Though capacity is tight in the industrial sector, growth is slowing and there is uncertainty around the prospects for global trade. While investment should continue to rise at a decent pace, a further pickup in growth looks unlikely. Indeed, the latest Q3 GDP report show the annual growth rate slowing sharply to only 1.1%. Compared to 2018, we see slightly slower investment growth in 2019.

The export led growth boom is over



Source: SECO, Bloomberg

CPI inflation will remain low, as consumer prices are still misaligned

Headline CPI inflation has risen rapidly since the beginning of the year and is now tracking at around 1% YoY. This has mainly reflected higher oil and import prices (partly a lagged effect from a weaker franc earlier this year) and core inflation remains subdued, at only 0.5%. Weakness is broad-based, with both services and domestic goods price inflation still very low, at below 0.5% YoY. Swiss inflation has persistently undershot inflation elsewhere, which has helped to reduce the real exchange rate and restore competitiveness. While producer prices have largely adjusted to the higher value of the Swiss franc, consumer prices are still misaligned. Indeed, based on consumer prices alone, the franc is still overvalued relative to both the euro and the dollar, at around 10%. This is the key reason why we expect wages and prices to remain under pressure going forward, with inflation unlikely to rise materially from current levels. We expect CPI inflation to average 1.2% in 2019, a touch above the 2018 forecast of 1%, and a bit above the SNB projection.

The SNB is expected to stay put, and the window for rate hikes is shrinking rapidly

As we had expected, the SNB left policy unchanged in 2018, with negative rates and forex interventions still in place. As we highlighted at the beginning of the year, the SNB appears to be tapering its balance sheet opportunistically, reducing forex reserves whenever pressure on the franc eases, and vice versa. This has left sight deposits, which proxies forex interventions, broadly unchanged on the year, after peaking in mid-2017. We expect the SNB to stick with this policy in 2019, which should leave the franc within a fairly tight range against the euro, with the EURCHF likely to stay somewhat overvalued relative to a fair value estimated of around 1.20.

The bar for the SNB to intervene in forex markets has, however, risen. The export sector has enjoyed strong growth, making it more difficult to justify currency manipulations. Moreover, the US Department of the Treasury (UST) is monitoring Switzerland as a potential currency manipulator. In fact, the main reason why Switzerland has not yet been named a currency manipulator is its size – the bilateral trade surplus vs the US is below the USD 20bn threshold which the US Treasury uses as one of its key indicators. The trailing 4Q surplus is USD 17bn though, and could easily tick up further. While we do not expect this to force a change in SNB policy, we suspect it will restrain interventions.

We also maintain our view that the SNB will lag the ECB in its rate decision, and leave rates unchanged at least until the second half of the year. With the window for rate hikes now rapidly shrinking, it is likely that the SNB will be able to raise rates only once, or at most twice, before the end of the cycle. Unfortunately, this means that rates are likely to still be negative when we enter the next downturn, highlighting vulnerabilities to the broader economy.

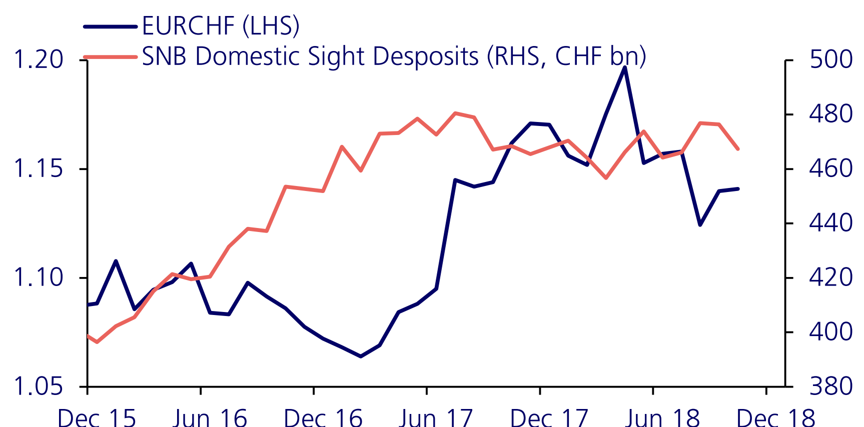
Despite the prospect of entering the next downturn with negative rates, we do not expect the SNB to follow the paths of Norway and the Czech Republic, which have started their tightening cycles before the ECB, or Sweden, which is signalling a rate hike by the end of 2018. The key reason for this is the franc's status as a safe haven currency; the franc has appreciated by an order of magnitude more than the other European currencies since the Eurozone crisis. In our view, the SNB's policy choice is therefore not directly comparable with those of other smaller European 'satellite' states.

Bond yields are past their lows, but the move up will be limited

We have left our bond yield forecasts unchanged, with very limited upsides for yields over the next 12 months. The cycle is at a late stage and underlying structural issues remain in the Eurozone. The Swiss bond market remains tight, with government debt projected to fall further in 2019, to below 40% of GDP. Additionally, while the ECB will end QE, reinvestment needs will be large, helping to contain Bund yields. This serves as an anchor for yields in Switzerland.

Yields at the short end should rise very modestly, however, as we get closer to a potential rate hike. Once again, given our view of at most two rate hikes over the next few years, upsides to policy rates and the shorter end of the curve are also limited.

The SNB has paused, but is unlikely to abandon, forex interventions



Source: Bloomberg

Japan and Korea

Outlook

- The consumption tax hike from 8% to 10% in October will impact the growth pattern in the second half of 2019
- Capex will remain the main growth driver in 2019
- Core inflation is expected to pick up, but not come close to the Bank of Japan's 2% target

Implications

- Growth should come in slightly above trend
- The Bank of Japan is expected to stay put, with a tightening in monetary policy only expected for 2020
- Foreign selling of Japanese equities is likely to subside, while corporate buybacks should be supportive

Risks

- The ruling parties suffer a blow in Upper House elections
- Japan comes under scrutiny by the US administration, which could impose tariffs on Japanese auto imports
- The yen strengthens significantly, while in Korea the downturn in computer memory prices accelerates

While 2018 could be labelled as the year of severe weather conditions and natural disasters that led to a contraction of GDP in Q1 and Q3, we believe 2019 will be mainly impacted by the consumption tax hike and the indirect impact of the US-China trade dispute, which seem to be escalating from a series of skirmishes. As China and the US are Japan's major trading partners, there is a risk that Japan's foreign trade will be negatively impacted, notwithstanding the fact that Japan's export/GDP ratio is rather low.

Consumption tax hike will distort Japan's growth path

While consumption should benefit from increasing labour income amid rising wages in 2019, the planned consumption tax hike will lead to a rather volatile consumption pattern. The government has made clear that the next consumption tax hike from 8% to 10% on October 1st will not be postponed again, unless a global financial crisis erupts in 2019. We do not expect that the impact of the future consumption tax hike will be similar in size to the 2014 tax hike from 5% to 8%. Firstly, the hike is incrementally smaller than the previous one, and secondly we have to account for various countermeasures to alleviate the impact for consumers.

These include an exemption for food (but not alcohol and restaurants) and newspaper subscriptions from the tax hike, which will benefit low-income earners. These categories tend to have a bigger impact on the perception of inflation that other product categories. Furthermore, a point reward system will be introduced at small and medium-sized retailers, which equates to 2% of the purchases if cashless payments are used. We have some doubts about this system as it seems rather complicated for retailers and consumers. We do not believe that it positively impacts the perception of higher prices. In addition, some tax relief measures for autos, home purchases and renovations will be implemented. Finally, the government will introduce free day care and preschool education, which in itself should compensate for roughly one quarter of the overall additional tax burden. Taking all the counter-measures into consideration, we believe the drop in consumption after the tax hike will be less than half as big as the one in 2014. We also have to incorporate the usual front-loading of consumption in Q3, which will artificially lift GDP growth, before the drag becomes effective.

Structural capex needs will prevail

Capital spending may once again be the saviour of economic activity in 2019, as it has been in 2018, though the pace of investment is expected to slow somewhat as the capex-to-GDP ratio is already at a 25-year high and should peak soon. A solid profit outlook should underpin another year of rising capital investment. But more importantly, one has to remember that one of the strong drivers for capex is Japan's severe labour shortage. Investments into information and communication technologies are required in order to increase the productivity of the labour pool. This phenomenon has secular characteristics, which will underpin capex in the longer term. However, cyclical capital investment will lose steam, and investments for the Tokyo Olympics in 2020 are expected to taper off already in 2019. This may not be fully compensated for by increasing public spending into the ageing segments of Japan's infrastructure such as roads and tunnels.

We see public spending having a neutral impact on growth next year, even though the supplementary budgets and the 2019 budget, once passed, may surprise to the upside, particularly as the Upper House elections in July argue for a positive fiscal stimulus.

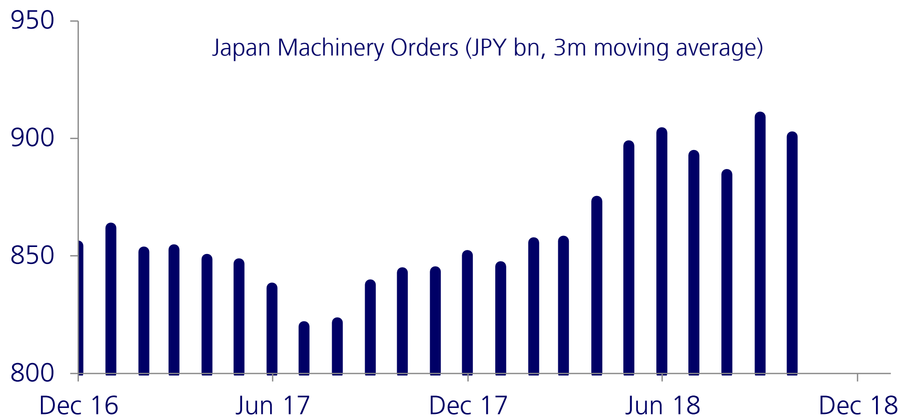
The outlook for exports is uncertain, but not as grim as some observers believe

As growth is expected to slow in Japan's main trading partners, Japanese exports will be affected negatively. This is particularly true for exports to China. Were the trade issues between the US and China to escalate, Japanese exports would suffer to some extent, though the negative impact in 2018 seems to have been negligible. On the positive side, trade deals such as TPP-11, RCEP and the Japan-EU Economic Partnership Agreement should support foreign trade, while Japan-China relations have also improved following PM Abe's visit to China in autumn 2018. It also seems unlikely that Japan's auto sector will be subject to direct US tariffs, even when the current bilateral agreement ends. The US recognises that Japanese auto manufacturers have heavily invested in US factories, with a positive impact on US employment.

Difficult inflation outlook, but the Bank of Japan is expected to stay put in 2019

We believe it is too early to expect inflation to significantly gain steam in 2019. The headwind is coming from the previously mentioned government plan to offer free-of-charge education and to cut mobile phone charges, though details of the latter have not yet been published. Even if mobile phone operators charge more for the mobile phones, this move would not compensate for the cut in mobile phone service charges. Core CPI, excluding fresh food and energy, is expected to crawl higher from 0.4% currently to just below 1% towards the end of 2019 when adjusted for the special factors mentioned before. Interestingly, the tight labour market has not yet shown an overly inflationary impact on wages in the service sector, even though overall wages are creeping higher.

Robust machinery orders point to ongoing capex strength



Source: Bloomberg

Amid our inflationary outlook it is hard to believe that the Bank of Japan (BoJ) will move its 10-year rate target up by 25bps or its short-rate target back to zero. Despite speculations that will certainly pop up again during the course of 2019, we believe monetary policy will remain anchored as long as inflation does not move higher on a sustainable basis. In its forward guidance given in July 2018 the BoJ made clear that it wants to evaluate the impact of the consumption tax hike on prices and inflation expectations. We believe a marked change in monetary policy will only become a topic in Q2/Q3 2020, unless a major financial crisis spoils the party. We also believe that the Bank of Japan will look through temporarily rising inflation rates due to base effects in the spring next year. In case the BoJ deems it necessary to change any policy settings, a further band widening for the 10yr yield from the current +/- 20 bps may be considered.

Foreign selling should subside

In last year's New Year outlook we wrote that we expect the Topix to move above the range of 1'750-1'850 that had been an 'iron coffin lid' since the early 1990s. Indeed, the market seemed to have listened and held above that level throughout January, reaching a 27-year high. However, the break was not convincing, and in line with other global indices the Topix quickly retreated, falling back below 1,600 in October. Foreign investors lost conviction, selling a record JPY 11tn YTD in 2018. This came as a surprise, as most major global investment banks highlighted Japan as one of their favourite markets for the year. Fortunately, apart from crossholding unwinding by domestic financials, domestic buying is holding up well on support from domestic individuals, corporations and trust banks including the BoJ ETF buying programme. We expect this to continue. Furthermore, many companies have increased their share buyback budgets. Once they start to fill the gap to their targets, and foreign selling subsides, demand-supply conditions should improve despite higher equity financing supply.

While the stance of foreign investors was obviously too euphoric a year ago, current scepticism, if not even pessimism, seems overdone to us. Though we agree that Japan is a cyclical equity market that is suffering from a slowdown in global economic and trade growth, we believe that growth, though subdued, will remain at or above trend in many major countries, which should support the cyclical aspect of Japanese equities. Taking into account that valuations are now attractive and that we do not envisage a slowdown in structural reforms, the appetite of foreigners for Japanese equities should recover. Summing it up, our stance towards Japan for 2019 is cautiously optimistic.

Headwinds for South Korea's growth outlook

South Korea's economic environment will be challenging in 2019. We expect growth to slow further from 3.1% in 2017 and 2.8% in 2018 to only 2.5% in 2019. Private consumption growth has picked up due to a temporary cut in the consumption tax on autos, but we do not think that the positive momentum will prevail. Weaker labour-intensive construction activity and the negative impact of corporate restructuring in core industries like autos and shipbuilding will take their toll. The minimum wage hikes of 16.4% in 2018 and 10.9% in 2019 will benefit low-income employees that have a higher propensity to consume, but it will be negative for those that are affected by hiring freezes or are laid off by SMEs who cannot afford to pay higher wages.

Construction has already started to weaken, and this trend is expected to continue in 2019 amid weak orders. Following a strong surge that lasted into Q1 2018, capex has started to contract, which should last well into 2019. As a major export driven country, slower global trade growth, a weakening computer chip memory cycle and the negative impact of rising indirect trade sanctions will dampen the outlook for Korean exporters. Fiscal policy will need to be counteractive and is expected to remain accommodative, but it will not be able to fend off the headwinds to growth.

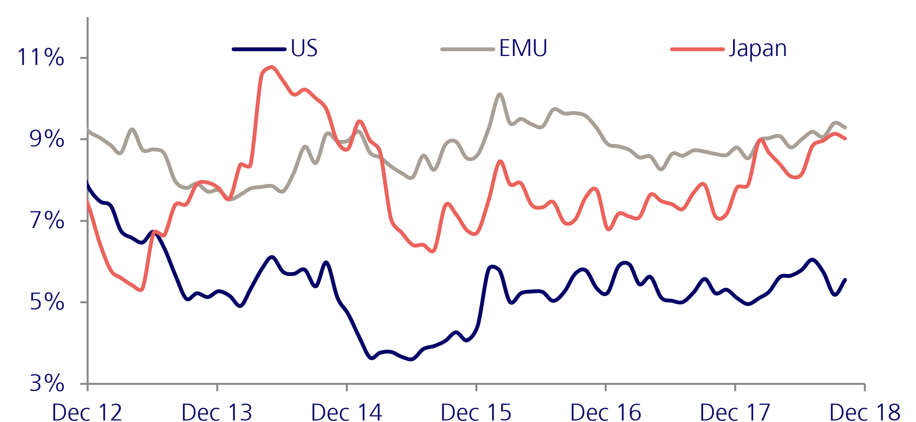
The Bank of Korea will find it difficult to raise its policy again after the November hike of 25bps. High household debt certainly calls for another hike, but it will be a difficult call amid a deteriorating economic environment and core inflation not moving to the target band in H1.

We remain constructive on the Korean equity market

Korean equities took a beating in 2018. In 2019, much will depend on how steep the drop in DRAM and NAND flash memory prices will be, as this has a direct impact on the two heavyweights in the MSCI Korea, Samsung Electronix and SK Hynix, which currently make up 36% of the index. Excluding the memory stocks, the IT sector is expected to do well when it comes to companies active in the OLED, optical component and electric vehicle battery business.

The Korean equity market is cheap on traditional valuation metrics, and on a PB/RoE basis it is by far the cheapest market in Asia. As we are warming up to emerging markets relative to developed markets, Korea as a heavyweight should benefit. Upside potential could kick in if investors start to discount the medium to longer-term impact for South Korean companies benefitting from North Korea as a cheap production base, while the increase in the weight of China's 'A'-shares in the MSCI EM index is a risk, as investors may sell parts of their Korean holdings to free up space in their EM portfolios.

Japan's equity risk premium has become more attractive



Source: Thomson Reuters Datastream

China and Taiwan

Outlook

- Growth will slow, but not collapse, in 2019 as US tariffs will be a drag on exports
- Service consumption will remain strong, while weaker goods consumption is expected to recover on tax cuts
- Infrastructure investment should recover, while housing and parts of manufacturing investment will slow

Implications

- China's stimulatory measures will broaden in order to avoid a more severe economic deterioration
- The environment for foreign companies to invest in China will improve
- Chinese equities are expected to outperform global equities in 2019 following a dreadful 2018 performance

Risks

- The conflict between the US and China escalates again following the latest truce
- The balance between deleveraging and adding stimulus cannot be maintained
- Capital flight will accelerate again despite counter measures

Growth is expected to slow in 2019, but no hard landing is envisaged

China is currently caught in a trap. On the one hand, China needs to delever in order to improve, or at least stabilise, critical debt ratios of its state owned companies (SoEs) and local governments. On the other side it needs to stimulate an economy that is challenged on various fronts. These include the dispute with the US that goes far beyond just trade, the difficulties small - and medium-sized private companies (SMEs) have accessing credit, and a slowdown in private goods consumption.

For some time we have forecast real GDP growth slowing from 6.5% to 6.2% in 2019. Over the last few months, consensus has scaled down forecasts to the same level. While we are well aware of the statistical issues with Chinese GDP data, we expect the government to target a range of 6 – 6.5% rather than a specific number for 2019. The decision will be made during the Economic Work Conference in December 2018, but will most likely only be announced during the National People's Congress in spring 2019. Reaching this target range still matches the overall goal of doubling GDP within the 10 year time frame to 2020, but it also takes into account the more difficult global environment. For our assessment of effective growth we will continue to refer to alternative activity measures and regular monthly economic indicators.

Differentiated assessment required for our consumption outlook

Consumption remains the biggest contributor to GDP growth, followed by investment, while net exports have been a drag on growth in 2018. However, when it comes to consumption, we have to distinguish between goods consumption, as reflected in monthly retail sales, and services consumption. Retail sales data include government consumption and online sales. The latter is rising at a pace a bit below 30% YoY. To add some colour, the latest 'Singles Day' sales, on November 11, which are comparable to the Western 'Cyber Monday', set another record at USD 31bn. Auto sales have recently fallen on a YoY basis and have been a major drag for retail sales, together with housing related categories like furniture, decoration and home electronics. The authorities are tackling the weak spots in consumption, for example by planning to halve the car purchase tax and to promote old car disposal, a measure that has proven to be successful in Germany. These measures are expected to stabilise auto sales.

To spur consumption, the government has taken a series of measures that will be implemented in steps. The tax-free thresholds have been raised, while tax brackets for lower-income groups have been expanded. In addition, various deduction schemes will be implemented on January 1, 2019. These include deductions for housing rent and loan interest, education, elderly care and treatment of critical illness. These benefits will enable stronger consumption even if loopholes to evade paying taxes and social security compensation are closed.

Last but not least, we expect service consumption to remain strong and to continue to grow in the lower double-digit percentage range. Expenditure for medical purposes, education as well as culture and leisure continue to grow at a faster pace than expenditure on goods, something which is easily neglected when purely looking at the monthly nominal retail sales statistics.

Recovery in infrastructure investment expected, but manufacturing and housing investment growth likely to slow

We expect manufacturing investment growth to slow. Lower producer price inflation will eat into industrial profit growth and some production facilities may be moved abroad to avoid US tariffs. However, investment into the high technology space should remain firm as per China's strategic targets.

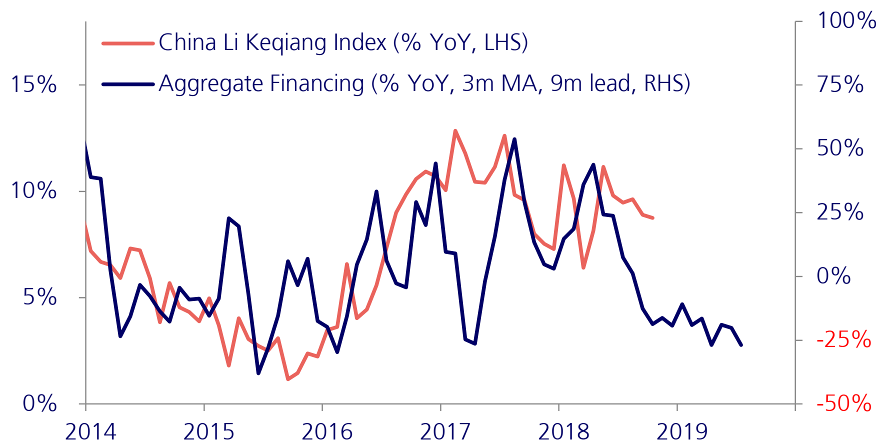
Infrastructure investments decelerated in 2018, in line with tighter credit conditions following deleveraging policies. As local governments were allowed to issue more special bonds late in 2018, infrastructure investment picked up some steam. This momentum should prevail in 2019, though not come close to previous high growth rates, supported by improving credit conditions. Some specific investments in core metropolitan areas should benefit most.

We do not expect housing investment in 2019 to continue at the strong pace seen in 2018. Land purchases by developers should slow down from the strong pace in 2018 as financing conditions will deteriorate amid a high share of debt maturing in 2019, which should curtail housing investment. Weaker construction trends are likely to continue, along with weaker home sales. Shantytown redevelopment is likely to continue, but at a somewhat more moderate pace than in 2018. We will carefully monitor whether the weakening momentum in house prices continues into 2019, a scenario that is not unrealistic.

Trade issues remain in focus for 2019

US tariffs did not have a major impact on China's exports in 2018, mainly because exports were front loaded to avoid tariffs before they were initiated on USD 50bn in July/August, then on an additional USD 200bn in September. The real negative impact of these tariffs will only be felt in 2019. However, it may not be as severe as some economists have estimated following the truce between US President Trump and China's President Xi at the G20 summit in Buenos Aires on December 1.

Chinese activity expected to deteriorate before stabilising in H2 '19



Source: Bloomberg, ZIG

Trump postponed the planned increase in tariffs from 10% to 25% on USD 200bn worth of imports from the start of 2019 to April 1, and did not refer to his threat to impose additional tariffs for the remainder of about USD 267bn of Chinese imports that have not been subject to tariffs yet. It is now on China to come up with measures to address broader US concerns about issues that go far beyond trade, including intellectual property and cyber misuse, forced technology transfer, non-tariff barriers and geopolitical aspects.

Were China to address these basic points of criticism and mistrust from the US in a convincing manner, the drag on GDP growth from net exports would be significantly lower than 100bps. We also need to take into consideration the positive impact of domestic counter measures to stimulate the economy. This would further strengthen our conviction that a hard landing scenario can be avoided.

Controlled yuan depreciation may be in the offing

We do not expect China's administration to use its currency as a weapon to compensate for higher US tariffs. This does not exclude gradual depreciation of the USDCNY to move above the psychologically relevant level of 7, particularly as China wants to avoid being susceptible to currency speculators who may assume that the PBoC will defend this level. However, we do not envisage a strong depreciation as this may awaken the ghost of capital flight. With this in mind, China will continue to encourage capital inflows and to manage the currency carefully. Authorities may also keep an eye on the current account balance that is at risk of falling into deficit territory for the first time in 24 years.

Constructive outlook for Chinese equities

Following a dismal performance in 2018 we are taking a more constructive view towards Chinese equities in 2019. A lot of bad news has already been discounted, suggesting equities are now cheap by the usual metrics. Policy stimulus, better liquidity provisioning and hopes that the worst will be avoided in the US-China trade conflict are helping to ignite animal spirits amongst both local and overseas investors. When it comes to the MSCI China, where major internet companies listed abroad represent an index heavyweight, the concerns we had at the beginning of 2018 are subsiding following the major correction in internet related stock prices and a more realistic, less euphoric investor view.

Double whammy from China slowdown and higher US rates to hit Hong Kong

GDP growth in Hong Kong is likely to slow significantly in 2019. The direct and indirect negative impact of China's trade tensions with the US will impact Hong Kong, despite the recent truce agreed at the G20 summit in Buenos Aires. China's slowdown in Q1 will not leave Hong Kong unaffected either, nor will higher real rates. We believe the Hong Kong Monetary Authority will allow the HIBOR to move higher to defend the USDHKD peg, which will have an impact on Hong Kong's property market. The Centaline leading property index has already topped out and has corrected by 6% from its record high marked in August. Even though we do not expect a steep property market correction, we think there is more downside ahead in 2019. However, pressures should recede in the second half of 2019 as China's economy is expected to recover. While the new Hong Kong-Zhuhai-Macau bridge and the new Guangzhou-Shenzen-Hong Kong high-speed railway are already showing a positive effect on Mainland tourism in Hong Kong and Macau, the expected slowdown in China's economy, yuan depreciation and the VIP smoking ban in Macau casinos should negatively impact tourist spending in Hong Kong and Macau, in line with pessimistic indications by casino operators in Macau.

A rather bleak outlook for Taiwan's growth and equities

No other country is more exposed to the well-being of China's economy, and the trade conflict with the US clearly shows the vulnerabilities of Taiwan's supply chain. We expect GDP growth to slow further next year, as the rather steep deterioration in Taiwan's Manufacturing PMI and its new order and export components are already indicating. Exports will suffer from the US-China trade conflict, while slowing global trade growth and a weakening semiconductor cycle will add to the deteriorating outlook, particularly in the tech sector. There are also concerns around iPhone suppliers.

Inflation is expected to remain subdued, as the effect from the cigarette tax hike fades. The CBC, Taiwan's central bank, may marginally lift its policy rate in the second half of 2019, however, with a limited impact on short-term rates.

Despite our favourable outlook for emerging market equities, we remain cautious on Taiwan equities, as the underperformance versus Asian peers may need time to subside.

In politics, the presidential election in January 2020 will move into focus. The Democratic Progressive Party (DPP), which ousted the then ruling China-friendly Kuomintang (KMT) by a wide margin in 2016, suffered a strong setback in local elections in November 2018, with KMT candidates winning 48.8% of the overall vote versus only 39.2% for the DPP. President Tsai resigned as the head of the DPP, but will likely seek a second term as president in 2020. Though specific local topics played a role in the local election, Taiwan's stance toward Mainland China and the US will remain a major focus in 2019.

China's equity market underperformance is ebbing

Source: Bloomberg

ASEAN and India

Outlook

- Asian central banks have front-loaded the bulk of their rate hikes, with only modest tightening expected in 2019
- Past monetary tightening and stricter fiscal conditions will weigh on growth in 2019
- Several countries are holding key elections, which will impact consumption, inflation and sentiment

Implications

- External headwinds will weigh on Asian currencies in the short term, before lifting as the Fed pauses in 2019
- Cheap valuations have made some Asian equity markets attractive
- A positive trigger, such as USD weakness, is needed to lure investors back to Asian equities

Risks

- The US Fed delivers more than our expected two rate hikes in 2019 or pauses earlier than expected
- In Asia, areas of high leverage, notably mortgage debt, come under severe pressure
- China's policy easing fails and triggers another episode of risk aversion towards emerging markets

Tighter financial conditions to weigh on ASEAN growth

In 2019, the G3's aggregate central bank balance sheets will contract further, led by the Fed in the US. We foresee the Fed hiking twice next year, and then pausing as domestic data soften, ultimately pushing the US into recession in 2020. For Asia, this will translate into tighter financial conditions in H1, followed by relief as US Treasury yields and the USD peak. This sequence would be affected if the Fed decides to pause earlier.

The most vulnerable Asian economies have already caught up with the Fed and front-loaded the bulk of their rate hikes in 2018. Indonesia, exposed because of its current account deficit and its reliance on volatile portfolio flows, has seen its policy rate rise by 175bps. As a result, Indonesian growth should slow in 2019. In the Philippines, following a 175bps tightening and rice supply reforms, inflation has probably peaked, but a widening current account deficit will warrant at least one more rate hike. In India, the inflation-targeting central bank has raised the repo rate by 50bps and is likely to hike once more as food inflation rebounds.

Thailand enjoys a current account surplus and has been able to afford standing pat in 2018 but will probably hike once in 2019. In Malaysia, the central bank is expected to be on hold, but fiscal policy will become less accommodative towards the end of 2019. Indeed, Malaysia's external debt metrics rank among the poorest in the region, and the government is under pressure to trim the budget deficit.

In many ASEAN economies, years of easy liquidity have driven leverage up significantly. Thailand and Malaysia have the highest levels of household debt and interest payment to GDP, and would come under stress in case of a global downturn. Reassuringly, most ASEAN governments, led by Singapore, have stepped up their prudential mortgage regulations. More generally, ASEAN countries have reacted swiftly to adapt to a new global monetary regime. Outside of the Philippines, most countries are targeting fiscal consolidation. Indonesia offers a good example of coordinated policy action, encompassing financial market reforms, import duties, and monetary tightening. Overall, our base case is for regional growth to slow, but for a systemic regional crisis to be avoided.

China's easy money will not help ASEAN

Liquidity conditions have eased in China, which will support domestic demand. As a consequence, some ASEAN economies like Thailand will probably see a positive impact on tourist arrivals. However, the positive spillover to the region will be limited by stricter controls of portfolio and FDI outflows coming out of China. Indeed, China's policy easing leans against the global tightening wave, which will probably force the authorities to control money outflows. In H1 2018, Chinese investment in East Asia had already melted by half and construction funding in the region has also fallen (YoY annualised basis).

Trade: No sign of relocation to ASEAN yet

Any escalation in the US-China trade war would impact ASEAN negatively, given tight linkages in the regional value chain. For instance, electronic manufacturing involves complex trade flows between Singapore, Malaysia, Thailand, China, and Northern Asia. Admittedly, relocation outside of China could benefit ASEAN. However, surveys suggest that companies have not yet decided to relocate. In contrast, the entry into force of the Trans-Pacific Partnership (TPP) next year will reduce non-tariff barriers and partly offset the negative effects of the trade war, especially for Singapore, Malaysia, and Vietnam, which export the most to their fellow TPP members. Overall, the slowdown in global growth will be the dominant driver, leading to weaker exports.

A busy political season

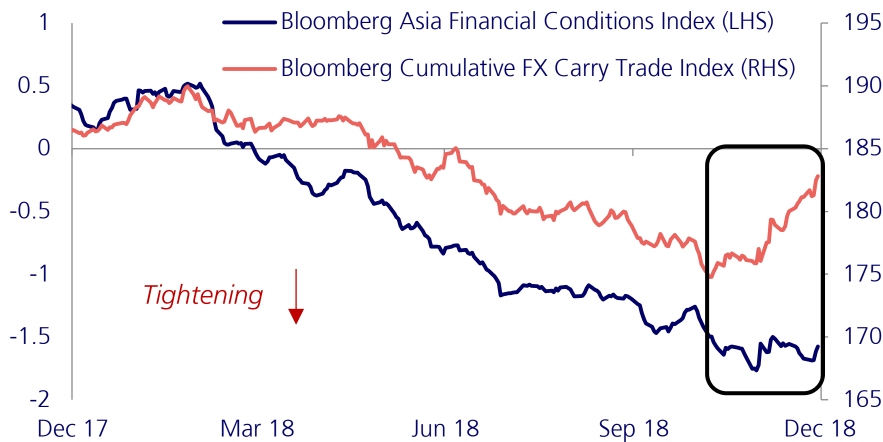
Thailand legislative elections will occur between February and May 2019. In Q2 2019, India will hold general elections, Indonesia legislative and presidential elections, and the Philippines mid-term elections. Companies typically delay major investment plans in the months prior to an election. Meanwhile, fiscal spending usually aims at improving people's purchasing power. In Indonesia's case, the government has held fuel prices steady since March 2018, pushing the cost of subsidies close to 1% of GDP in 2018, the brunt of which has been financed by local SoEs. Given their heavy cost for Indonesian corporates, we expect subsidies to be trimmed after the general elections. This will slow private consumption and push inflation up after the elections.

In other ASEAN countries, we see headline inflation ticking up as well as subsidies being rationalised. Outside of the Philippines, food inflation is also likely to edge up from historically low levels, potentially aggravated by El Niño effects. Oil prices are a game changer: were they to stay at or below the current level of ~60 USD a barrel, they would cap headline inflation in the region.

Asian currencies

The headwinds that led Asian currencies to tumble in 2018 will probably linger in H1 next year. Ongoing divergence of monetary policy in the US and China will weigh on the Chinese yuan, and anchor other Asian currencies. The case for a reversal in US dollar strength in H2 is growing as the US economy slows and the Fed pauses. By then, many Asian currencies will be trading below fair value, ready for a rebound. This could support a recovery in Asian equity markets.

Asian financial conditions have stopped deteriorating



Source: Bloomberg

Cheap equity valuations create tactical opportunities in some countries

Asian equities experienced a severe downturn in 2018. Single-digit earnings growth has been largely offset by a large contraction in valuations and by a fall in local currencies. The correction in valuations is rightfully pricing in a slowdown in earnings growth in 2019. Cheaper valuations are attractive, but an additional trigger is needed to lure investors back to Asian equities. The most likely trigger, in our view, is a reversal of USD strength, which is likely, at least in part, next year. A US-China trade deal would also help, but the uncertainty around that outcome is great. Within ASEAN, equity performance will diverge between countries. In Indonesia, valuations have come down to their long-term average and earnings revisions are turning around, which is constructive for equities. In Singapore, valuations are approaching crisis levels and earnings revisions are tentatively stabilising. In the rest of ASEAN and in India, valuations remain rich and earnings forecasts are likely to be revised downward.

India: Turbulent global backdrop raises the stakes for elections

Growth will moderate in 2019 after a stellar 2018. First, the positive base effects from the Goods and Service Tax (GST) normalisation will fade. Second, monthly consumption indicators such as two-wheeler and car sales are already softening. Third, global monetary tightening has exposed the vulnerabilities of India's shadow banking sector, which will tighten credit access for housing, consumer, and SME loans.

However, we see a potential game changer for India. Oil prices have corrected by 30% from their 2018 peak. Were oil prices to stay contained, India's balance of payments would swing out of deficit. Lower oil prices would also be passed on to consumers and ease the urgency of the Reserve Bank of India (RBI) to raise rates.

We still expect one rate hike by the RBI in 2019, as food inflation ticks up. On the fiscal side, there is little margin to expand spending Overall, the policy backdrop is turning less accommodative, notwithstanding a sustainable weakness in oil prices.

Q2 2019 general elections could make or break investors' confidence. The current government has achieved significant reform milestones with the bankruptcy code and the GST. Were the 'old regime' of a fragmented government to return, reform implementation would stall and investor sentiment would be severely hit.

Indonesia: Slower growth post-elections

Indonesia has tightened its monetary policy in 2018, translating into a ~25bps rate increase for investment loans. Meanwhile, the 2019 fiscal impulse will be negative. We expect domestic demand to cool, but only gradually. Indeed, fuel and utility prices continue to be artificially depressed by the government. We expect subsidies to be rolled back after the April elections, which will weigh on consumption and give a boost to inflation. Similarly, the pause in new infrastructure projects will weigh on imports, but only in late 2019. Despite a fall in the number of new projects in the pipeline, many infrastructure ventures will only be completed in 2020, leading to ongoing imports of machinery and raw materials. Overall, we expect the current account deficit's reduction to be lengthy and non-linear.

To address its dependency on external funding, a more sustainable strategy for Indonesia is to push structural reforms forward and stimulate investment in local manufacturing. After a dormant year marked by little reform progress on that front, the government has just announced its 16th economic package, aimed at expanding the manufacturing tax holiday and opening more sectors to foreign direct investment (FDI). Reviving FDI growth, which has slowed in 2018, is essential. The April elections will be equally critical as investors clearly favour policy continuity, and would be spooked by an alternative outcome. President Jokowi is leading in the polls, but anecdotal evidence suggests that some of his policies are encountering severe criticism.

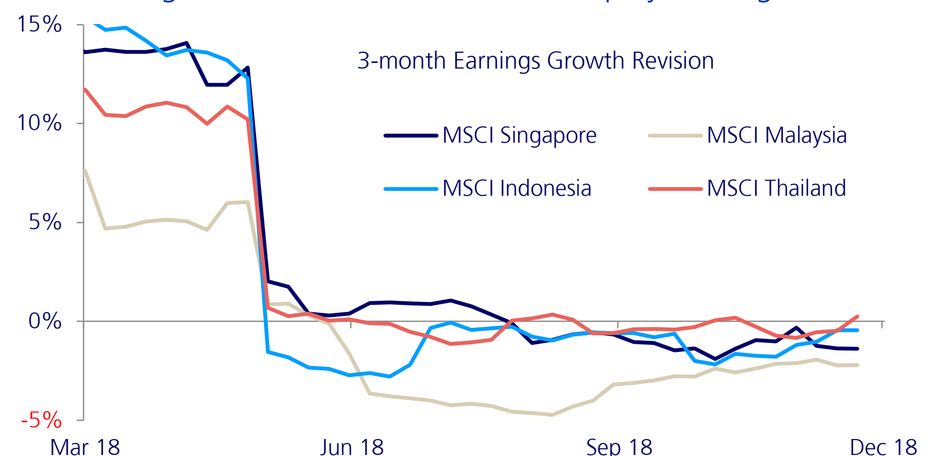
Malaysia: Deleveraging, beneficial in the long-term, bumpy in the short-term

Malaysian growth will cool from the very strong 2018 levels. We expect slower global demand to weigh on Malaysian exports of electronics and commodities, especially towards H2 2019. On the domestic front, the cancellation of several billion Malaysian Ringgit in infrastructure projects, among which is the emblematic East Coast Rail Link, is another drag on growth. We also note that FDI from China to Malaysia is falling sharply, as Malaysia has become more selective about the nature and financing of construction projects.

In contrast, we see private consumption holding up, thanks to the recent cut in indirect taxes and to a 10-22% boost in the minimum wage. Fiscal policy is targeting a middle way between generous and conservative. Indeed, the government is pursuing fiscal consolidation in the medium term. It has scaled down cash handouts and will re-introduce floating fuel prices with targeted subsidies, which should push CPI higher from the current weak levels.

The government is prioritising governance transparency and public debt reduction, which should benefit Malaysia in the long term. The short-term path to deleveraging is likely to be bumpy, though. Under increased scrutiny of the rating agencies, the government will probably need to tighten fiscal policy further.

Tentative signs of stabilisation for ASEAN equity earnings revisions



Source: Thomson Reuters Datastream

Australia

Outlook

- Growth is likely to slow from very strong 2018 levels as cyclical drivers weaken
- The housing downturn will spill over to consumption and investment, but policy action will prevent a hard landing
- As the federal election approaches, growing uncertainty will harm sentiment towards the housing and financial markets

Implications

- Slower growth and tighter lending conditions will weigh on equities
- Financial stocks have priced in many headwinds already and would rebound should the Coalition remain in power
- The sovereign interest rate spread to US Treasuries should remain negative in H1 and weigh on the AUD

Risks

- An external economic shock destabilises highly leveraged households
- Wage growth increases significantly
- The government delivers a larger fiscal boost than expected or the RBA cuts rates

We are turning more cautious on Australia's economic outlook

In Q2 2018, Australia registered it highest YoY growth rate in four years, thanks to a large construction pipeline, strong employment growth, and booming commodity exports. Going forward, we expect growth to slow markedly. Commodity exports will soften, and cooling property markets will weigh on private consumption and on investment. Tighter lending conditions will be partly offset by generous fiscal spending though, and a hard landing will be avoided.

Housing woes to persist in 2019

The 2012-2017 housing boom that saw Sydney and Melbourne residential prices climb by 75% and 60% respectively came to an end in 2018, with prices correcting by 8% in Sydney and 5% in Melbourne. We expect prices to continue falling in 2019. Indeed, leading indicators point towards softening demand, and we see three major headwinds persisting in 2019.

First, housing supply has caught up with demand, and a large building pipeline will strengthen this imbalance.

Second, Chinese investment in Australian real estate has slumped and is unlikely to recover anytime soon. Indeed, the Chinese government is expected to maintain tight controls on capital outflows. Meanwhile, in Australia, stamp duties and regulations on foreign ownership have made the residential property market less attractive for foreign investors.

The third and most important factor is the tightening of lending conditions. Following its public inquiry into banks' lending practices, the Royal Commission is expected to recommend a stricter due diligence process for borrowers. In parallel, the macro prudential authorities are focusing on limiting debt-to-income levels from prior extremes. Finally, in the run-up to the 2019 federal election, the Labor party has pledged to abolish two major tax incentives for property investors, the 50% discount on capital gain taxes and the 'negative gearing'. The negative gearing allows investors to offset negative cash-flows from investment properties against their income tax liability. These changes would not apply to existing borrowers, but would be a strong blow to new lending.

Why housing matters for the rest of the economy

So far, the adjustment in residential prices has been healthy and focused on the more speculative segments of the market. However, there are early signs that non-speculative demand is peaking, with tighter lending standards likely to weigh further on credit demand. A credit crisis is not our base case: non-performing loans and arrears remain low and we expect the government, the central bank, and the regulators to work together to avoid a severe credit crunch, especially in an election year.

The most likely scenario is that the housing downturn will shave a few basis points off domestic demand. Indeed, housing assets represent close to half of total households' assets, and a negative wealth effect is probable although difficult to measure. In the past five years, housing has also boosted employment and investment.

Slower investment growth in 2019

We expect residential investment to decrease with some negative spillover to other sectors. Within the non-residential property sector, demand for offices is holding up and vacancy rates are close to record lows in Sydney and Melbourne. Hotel demand is equally robust, but retail investment is weakening sharply. Additionally, property developers are becoming less confident, with recent surveys signalling difficulties to obtain capital and reporting rising debt funding costs. We read these as red flags in the otherwise robust commercial property market.

A strong pipeline of infrastructure projects will partly offset those negatives. Overall, total investment growth is likely to remain positive albeit lower than in 2018.

The consumer's situation remains fragile

In 2018, the consumer's situation has improved marginally, thanks to robust employment growth and a few basis points increase in wage growth. However, this represents a meagre improvement in an environment of tighter lending conditions. Additionally, the saving rate has decreased and stands close to a record low, which leaves households with only a small financial buffer.

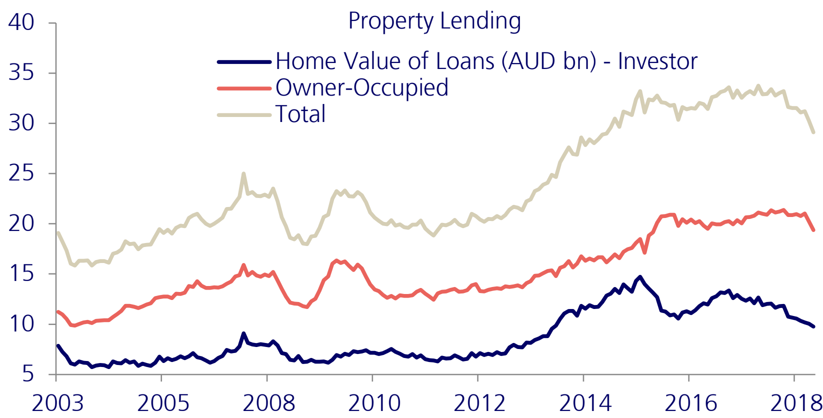
Going forward, it is essential that wage growth picks up. Alas, the pace of wage increases has been very slow and the expectations for long-term wage growth from unions and analysts are stuck at 2.5% YoY. Solid employment growth has been a comfort in 2018 but, here again, leading indicators are weakening.

Commodities: Export growth softens

The completion of two final LNG projects in 2019 will underpin strong export volume. There is more uncertainty around LNG export prices, given the recent volatility in global oil prices.

As for iron ore, we expect prices to track Chinese metal prices lower. China has started to destock the metal inventories it has accumulated since 2015, which should weigh on Australian exports of iron ore. Additionally, we do not expect China's policy stimulus to trigger a strong revival in metal demand.

Property lending has peaked



Source: Bloomberg

The Australian dollar's weakness is likely to persist in H1 2019, which should support exports somewhat. Overall, our base case is for export growth to slow from very strong 2018 levels.

Policy: Fiscal spending to the rescue

The Reserve Bank of Australia (RBA) retains its upbeat economic assessment, but has become more cautious on the outlook for consumption and inflation. Indeed, wage growth remains tepid, CPI is below the central bank's 2-3% target, and inflation expectations have been flat for a year. Therefore, the RBA is unlikely to hike before the end of 2019, possibly delaying tightening until 2020. Independent of the central bank's decision, as we have written above, lending conditions are tightening as a result of stricter lending regulations and also as a consequence of rising funding costs. Banks have passed on part of the recent increase in money rates to consumers by increasing lending rates. Loans are likely to be re-priced higher in 2019.

As economic headwinds have increased and with the federal election approaching (likely to be called in May 2019), the current government has adopted a more generous fiscal stance. Australia stands in a comfortable fiscal position thanks to solid nominal growth and the elevated commodity prices in 2017 and 2018. The government is about to announce the smallest fiscal deficit since the global financial crisis and is on track to reach a budget surplus in 2019/20. Going forward, we expect a step-up in fiscal spending: the government plans to accelerate the timeline for SME tax cuts and is considering a fiscal package to prop up SME funding. On top of these measures, we think that a fiscal boost for households is likely and necessary.

The federal election: Downside risks for property and financial markets

As the federal election approaches, political uncertainty is increasing.

Some of the campaign pledges and political statements of both parties are introducing downside risks to growth. The current government is considering a ~15% cut in the quota for permanent immigration visas. The rhetoric, more than the cut itself, represents a downside risk for one of Australia's main growth engines. Meanwhile, diplomatic relations with China have deteriorated during the past year. On immigration and on the relationship with China, our base case argues for a pragmatic approach, given the economic importance of these two issues.

A Labor victory at the next federal election would be negative for the housing market, given the party's plan to slash property tax benefits. The Labor party also promised to remove cash refunds on imputation credits for equity dividends and is supportive of a severe approach towards the banking sector's misdeeds in the wake of the Royal Commission's recommendations, which are to be published next year. A Labor victory would be negative for Australian equities.

Financial markets

As we write, Australian equity valuations have cheapened below their long-term average, but earnings revisions have turned negative and, given our cautious economic outlook, we see limited upside for equity prices.

Financial stocks, which account for the largest share of the ASX 200 index, have seen a steep fall in valuations, and we suspect that a lot of the bad news around tighter regulations, political scrutiny, and lower lending growth are priced in. This could translate into a short-term tactical rebound for financial stocks, especially in the event that the Coalition gets re-elected.

Financial equity valuations have fallen below their 10-year average

Source: Bloomberg

Turning to currency markets, softer base metal prices and persistent US dollar strength in H1 2019 will cap the price upside for the Australian dollar. Later next year, US dollar strength is likely to reverse somewhat, pushing the Australian dollar higher. Were the US Fed to pause earlier than H2, the Australian dollar would appreciate sooner in 2019.

Contact

Guy Miller
Chief Market Strategist
Head of Macroeconomics

guy.miller@zurich.com
+41 44 625 28 85

Julien Seetharamdoo
Head of European Market Strategy

julien.seetharamdoo@zurich.com
+41 44 625 39 53

Aurélie Barthère
Market Analyst Asia-Pacific

aurelie.barthere@zurich.com
+41 44 625 32 27

Puneet Sharma
Head of Credit Strategy

puneet.sharma@zurich.com
+41 44 625 30 04

Charlotta Groth
Global Macroeconomist

charlotta.groth@zurich.com
+41 44 625 25 40

Thomas Liebi
Head of US and UK Market Strategy

thomas.liebi@zurich.com
+41 44 625 25 47

Håkan Hedström
Head of Asian Market Strategy

hokan.hedstroem@zurich.com
+41 44 625 31 93

Disclaimer and cautionary statement

This publication has been prepared by Zurich Insurance Group Ltd and the opinions expressed therein are those of Zurich Insurance Group Ltd as of the date of writing and are subject to change without notice.

This publication has been produced solely for informational purposes. The analysis contained and opinions expressed herein are based on numerous assumptions concerning anticipated results that are inherently subject to significant economic, competitive, and other uncertainties and contingencies. Different assumptions could result in materially different conclusions. All information contained in this publication have been compiled and obtained from sources believed to be reliable and credible but no representation or warranty, express or implied, is made by Zurich Insurance Group Ltd or any of its subsidiaries (the 'Group') as to their accuracy or completeness.

Opinions expressed and analyses contained herein might differ from or be contrary to those expressed by other Group functions or contained in other documents of the Group, as a result of using different assumptions and/or criteria.

The Group may buy, sell, cover or otherwise change the nature, form or amount of its investments, including any investments identified in this publication, without further notice for any reason.

This publication is not intended to be legal, underwriting, financial investment or any other type of professional advice. No content in this publication constitutes a recommendation that any particular investment, security, transaction or investment strategy is suitable for any specific person. The content in this publication is not designed to meet any one's personal situation. The Group hereby disclaims any duty to update any information in this publication.

Persons requiring advice should consult an independent adviser (the Group does not provide investment or personalized advice).

The Group disclaims any and all liability whatsoever resulting from the use of or reliance upon this publication. Certain statements in this publication are forward-looking statements, including, but not limited to, statements that are predictions of or indicate future events, trends, plans, developments or objectives. Undue reliance should not be placed on such statements because, by their nature, they are subject to known and unknown risks and uncertainties and can be affected by other factors that could cause actual results, developments and plans and objectives to differ materially from those expressed or implied in the forward-looking statements.

The subject matter of this publication is also not tied to any specific insurance product nor will it ensure coverage under any insurance policy.

This publication may not be reproduced either in whole, or in part, without prior written permission of Zurich Insurance Group Ltd, Mythenquai 2, 8002 Zurich, Switzerland. Zurich Insurance Group Ltd expressly prohibits the distribution of this publication to third parties for any reason. Neither Zurich Insurance Group Ltd nor any of its subsidiaries accept liability for any loss arising from the use or distribution of publication. This publication is for distribution only under such circumstances as may be permitted by applicable law and regulations. This publication does not constitute an offer or an invitation for the sale or purchase of securities in any jurisdiction.

Zurich Insurance Company Ltd
Investment Management
Mythenquai 2
8002 Zurich

173001631 (01/16) TCL

ZURICH®