

# Economic and market outlook

Mid year insights 2017: Not the time for complacency



# Overview

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A broad-based and deepening global economic expansion is panning out largely as we had thought. Inflation, however, has been weaker than expected, and with underlying vulnerabilities still evident in most regions, the current cyclical upswing needs to be a catalyst for change rather than a time for relaxation.

Following a robust first half of the year the improving economic environment is likely to continue for some time yet, but we suspect that the pace of improvement will start to slow later this year. Consequently, the sweet spot in which to address the many imbalances and structural issues that linger is now. While many election risks have diminished, the political landscape has been altered and the grievances that have shaped it remain. Excessive debt, stagnating productivity and job insecurity are global issues that must be countered. Idiosyncratic structural reforms are also needed in most regions, if a more robust growth dynamic is to be achieved.

In the Global section, on page 4, we point to the fact that while there is a synchronised global recovery, the cycles themselves are not synchronised, which should help to extend the period of expansion. While the US is in a mature stage, with policy normalisation well underway, the Eurozone is some way behind, while many emerging markets, such as Brazil and Russia are only now entering a growth phase. Inflation remains below policy targets in most parts of the world, however, and we don't see this changing much over the next 12 months. We discuss the US outlook in detail from page 6, where a more hawkish tilt by the Fed has

become evident and the process of exiting QE is expected to begin in October. We see this as necessary, but believe that the number of rate hikes is likely to be less than Fed guidance, given the sensitivity of a highly indebted economy. On the fiscal front, it seems unlikely that the much needed tax reform will impact the economy before next year, though we are hopeful that headway will be made.

Trade is the focus of attention in the UK as the divorce proceedings with the EU commence. On page 8, we determine that it is unlikely that the two-year window to conclude trade negotiations will be met and believe a pragmatic solution needs to be found. This seems increasingly likely given the election outcome and a backing away from 'Hard Brexit'. Growth will be impacted nevertheless, with spending and investment likely to slow.

Eurozone growth has surged and employment is showing strength across the region. On page 10, we look into the drivers of this and go on to assess the political environment, where we see reason for optimism. The mandate that French President, Macron, has for reform is being grasped, with the labour market, taxation and an ideology for a common European budget and defence fund being advocated. While we are sceptical about some initiatives, it is broadly what needs to be tackled during this recovery phase. We continue to point to European bank vulnerability on page 11, where a more comprehensive approach is needed to clean and bolster balance sheets, at a time when capital markets are open and funding is cheap.

In Asia, we are constructive on China and see the growth trajectory easing back only modestly as intended. It is pleasing that shadow banking and

excessive corporate debt are finally being addressed, and on page 16 we look into the actions that are being taken and the risks that are posed. The potentially more durable growth profile that is evolving is supportive of the ASEAN region more generally, and we discuss specific prospects, as well as those for India on pages 18 and 19.

Turning to the financial markets, the outlook is still good and is discussed on page 5 and within regional sections. The economic backdrop is robust, policy initiatives are still supportive in aggregate, and earnings growth is showing more encouraging signs. We continue to believe that a low inflationary environment that is still subject to policy support, along with prevailing high debt levels, will limit a move higher in core government bond yields.

Credit spreads have continued to tighten, while market pricing implies complacency. Leverage has increased, corporate spending has risen, and we believe that equity investors are being favoured over creditors. The combination of better earnings, growing dividends and ongoing share buy-backs should keep momentum strong, although we acknowledge that stocks are also expensive. Late cycle regions and sectors are expected to be favoured, including the Eurozone and emerging markets.

To conclude, the current cyclical recovery in economic growth and robust financial markets is an opportunity for reform, not a time for complacency.



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# Global

## Outlook

- The synchronised global recovery remains on track, but further upside to growth is limited
- Economic cycles are not synchronised, with plenty of spare capacity outside of the US
- Inflation will not drive a global policy tightening as underlying trends remain weak in most regions

## Implications

- Bond yields are too low, but sluggish inflation and policy support should keep them anchored
- Credit is likely to underperform equities as further upside is limited
- Equities are favoured in a maturing cycle, despite valuations being stretched

## Risks

- The better growth environment leading to complacency and a policy mistake
- Fed tightening cycle causing disruption to leveraged corporates globally
- European bank risks still remain an epicentre of vulnerability, while investors seem complacent

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### **The synchronised recovery is expected to continue, but further growth upside is limited**

The global recovery has broadened out across regions, and is also being spurred by stronger trade and investment. World trade is on track to expand at a faster rate than global GDP in 2017, for the first time since 2014. While the first leg up in global growth was driven by the industrial sector recovering from the commodity induced slump, the impulse is now shifting towards services, and robust global new orders and employment show that the recovery retains traction.

We expect global growth to track a bit above its long-term average in 2017, but then slow back towards trend in 2018. While this implies a broadly steady expansion in H2, a reacceleration looks unlikely. The US is in the late stage of an elongated cycle and upside seems limited, particularly as the Fed is keen on normalising policy. China is unlikely to spur growth, given its long-term objectives to slow and rebalance the economy. Japan and the Eurozone are already expanding above potential, making another leg up challenging. This leaves emerging markets, which are now facing increasing headwinds from low commodity prices and a peaking out of trade growth.

### **Investment is strengthening, though challenges remain in place**

Global growth could surprise positively if businesses start to invest. To some extent, this is already happening, with capex spending recovering from its trough. US equipment investment averaged 4.5% QoQ in the past

two quarters (annualised rate), and similar or higher growth rates were achieved in many Asian countries as well as the Eurozone.

While this is encouraging, and in line with data that show that return on capital is holding up, structural headwinds remain. Overcapacity in pockets of the industrial sector, low and falling commodity prices, the emergence of capital light companies, and high corporate debt, suggest investment has limited upside potential.

### **Economic cycles are not synchronised, helping the global cycle to last longer**

While growth is finally broad-based in the global economy, economic cycles are not synchronised. The US, where the unemployment rate has reached a 16-year low, is in the late stage of the cycle. The Eurozone is lagging behind, with spare capacity still available and little risk of overheating. LatAm is early in the cycle, with falling inflation and policy loosening supporting a recovery. Many Asian economies are embarking on structural reform and infrastructure investment programmes, which, together with moderate inflation, mean that their cycles can run further. The fact that cycles are at different stages is encouraging, as large imbalances in the global economy persist, and only a prolonged period with healthy growth and inflation can help address them. It is, however, imperative that policy makers do not become complacent amid better growth, removing stimulus prematurely or pushing back on structural reform. Our call for governments to use fiscal space – when available – to raise investment is also unchanged, as the upturn

is mainly cyclical and productivity growth continues to disappoint.

### **Inflation will not drive policy tightening as trends are still weak in most regions**

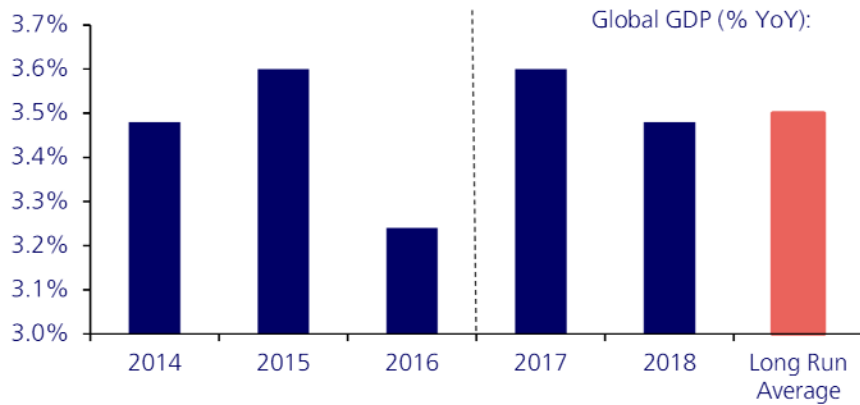
Another key reason why we expect the global cycle to last longer is that inflation is soft in most regions, including in the US, where it has fallen back to well below the Fed's target. Looking at inflation alone, there is clearly no need for central banks to remove stimulus. Consequently, risks around policy normalisation in the US have increased, as the Fed has turned more hawkish, choosing to ignore weak inflation prints. Outside of the US, the better growth picture in Japan and Europe could also lead to complacency, including a premature exit from QE. While not part of the base case, these risks need to be monitored.

### **Bond yields should remain low, though current valuations are stretched**

Core yields have fallen back and the reflation trade triggered by the US election has faded, with long-term inflation expectations falling across regions. The FOMC's median rate forecast and market pricing have diverged, showing a lack of conviction that the Fed will be able to normalise policy over the coming years. A flatter slope is also consistent with a view that the economy is not strong enough to sustain higher rates.

While we maintain our fundamental view that yields are capped due to high debt levels and continued policy support, current levels look stretched. The Fed's rate path is likely to overestimate the degree of tightening, but

## Global growth expected to peak this year



Source: ZIG, Consensus Economics, IMF, Bloomberg; Note: Calculated at PPP weights

market expectations look too benign, with only two further rate hikes priced in by the end 2018. The decline in inflation expectations, both in the US and globally, is also hard to justify, as recent weak inflation prints partly reflected temporary factors. We therefore continue to expect Treasury yields to edge higher, though very modestly so, but a key risk to this view is a further fall in oil prices. Outside of the US, policy distortions persist, preventing yields from rising despite a better economic outlook. That said, we expect the ECB to pre-announce a tapering of QE in the second half of the year, which leaves Bund yields vulnerable to a move higher.

In Europe, political risks have diminished with the election of Emmanuel Macron as French president, helping compress peripheral spreads. Going forward, spreads will be driven by political developments and the outlook for ECB policy. Lingered political risks remain in Italy, where the date and outcome of elections are still uncertain. We also expect ECB monetary policy to be a source of upward pressure on spreads later in 2017 and in 2018, as we expect the ECB to taper and eventually end QE asset purchases in 2018.

### Credit outperformance to ebb

Amid a benign macro environment with abundant liquidity, investors have been engaged in a search for yield that has benefited credit markets. However, we now believe the outperformance of credit within risk assets is likely to ebb. Fundamentals have weakened while rich valuations have skewed the risk reward relationship, leaving favouring equities over credit.

Fundamentals for credit are far weaker than spreads are implying, as is typically the case during the late stages of the credit cycle. Leverage has increased notably in non-financial companies, with a high debt load now offsetting low interest rates to make funding costs a growing concern.

Consequently, a shock in earnings or funding costs could trigger the end of the credit cycle. While current leverage is high, companies are feeling pressured to lever up even more to reward shareholders. At the same time, we also think European banks remain quite leveraged and consequently vulnerable. Recent regulatory actions to deal with problem banks in Italy and Spain have convinced us that in the next downturn, if not before, creditors will bear the cost of recapitalisation of weaker banks in Europe. Lastly, even in some parts of the ABS markets, underlying loan delinquencies are picking up.

While credit fundamentals have worsened, spreads are close to historical lows. At current valuations, further spread tightening potential is limited even if equities rally significantly.

All of this noted, supply/demand technicals are still strong, with potential repatriation of cash in the US providing a further boost. Therefore, while we think credit will underperform equities, we expect it to still outperform government bonds during the next twelve months.

### Maturing cycle favours equities, despite stretched valuations

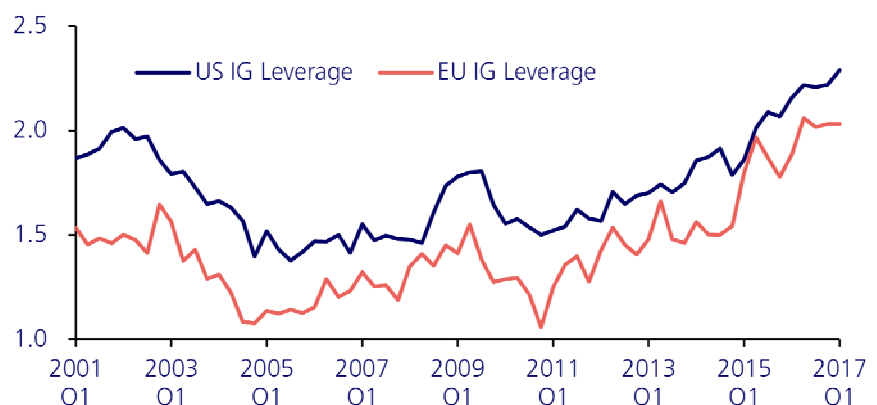
Global equities have had a strong 2017 YTD

and are likely to remain in a bull market for some time yet. The surprise to us has been the lack of volatility, with most markets experiencing an unusually smooth ascendency, despite the risks that have circulated. Indeed it has been EM as well as Eurozone equities that have seen the most significant fund inflows, and have outperformed the global averages. That noted, we still see volatility featuring more in the months ahead, which demands a degree of caution.

Stocks are rich by almost any measure, though there are few signs yet of excessive exuberance on the part of investors. Price-to-EBITDA ratios in some cases are as high as at the peak of the dot-com boom, however, there are a number of reasons to suggest further gains are likely. The global liquidity environment is still favourable, despite Fed tightening. The ECB, BoJ and some other central banks are still providing liquidity. Economic growth is robust, which has translated into earnings in most regions surprising positively. This is especially true in Japan and the Eurozone, while stock repurchases, dividend increases and return on equity should continue to entice yield starved investors to deploy funds. Given our still upbeat economic outlook through this year and into next, we expect the earnings story to remain attractive. Investors are likely to be selective in favouring late cycle, higher beta regions - specifically EM and the Eurozone - subject to the US equity market holding-in as we expect. While these areas have become a consensus trade, the five or six years of relative underperformance implies that momentum is still at an early stage and can drive returns higher.

More generally, with business investment, stock repurchases, and leverage all rising, corporate management is increasingly favouring equity over credit holders. This suggests a relative outperformance for stocks over the coming year as investors increasingly redeploy funds from credit into equities.

## Corporate leverage has increased notably



Source: ZIG, Bloomberg; Note: Leverage shown for median Net Debt to EBITDA of corporates (ex. commodity and financial sectors)

## Outlook

- Consumer spending is expected to recover from recent weakness
- Tax reform and fiscal stimulus are delayed and will not have any meaningful impact in the near term
- The Fed continues to normalize monetary policy and will begin reducing its balance sheet later this year

## Implications

- Treasury yields face headwinds from lower inflation but should slowly move higher
- Credit should underperform equities as late stage signals emerge
- Equities are vulnerable to earnings disappointments but sentiment is not overly optimistic

## Risks

- The Fed acts too aggressively, choking off inflation expectations and the economic expansion
- The political turmoil engulfing President Trump triggers market turbulences
- Consumers and firms lose faith regarding the economic outlook and expected fiscal stimulus

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### Consumers are more reluctant, while the investment outlook has improved

After three relatively solid quarters, household spending grew by a more modest 1.1% in Q1, contributing only 0.8 percentage points to the annualized GDP growth rate of 1.4%. Consumption expenditure was dragged down by a big drop in vehicle sales, which seem to have peaked late last year at an annualized number of 18.29 million autos, the highest in more than a decade. Vehicle sales have ticked back up in Q2, in line with other consumer spending metrics like retail sales or personal spending. While we do not expect a significant acceleration of consumption expenditure compared to last year, the outlook for households remains positive. The labour market has tightened further, with the unemployment rate falling to 4.3% in May — the lowest level since 2001. The broader underemployment rate fell to 8.4% and is quickly approaching the last cycle's lows, indicating that there is not much slack left in the labour market. This is confirmed by the NFIB small business survey showing that filling open positions is becoming a major challenge for companies, with the respective index soaring to the highest since autumn 2000.

Despite the increasingly tight labour market, wage growth has still not picked up significantly so far. Annual growth in average hourly earnings stood at 2.5% in May, meaning that real wages have barely grown over the past year. However, employment costs, firms' compensation plans and broader wage trend indicators have started to move higher recently, potentially signalling an acceleration in wage growth going forward.

Higher wages will be crucial to support further consumption growth as the number of people entering the labour market is likely to level off given the stage of the business cycle and the reduced slack in the labour market. Meanwhile, consumer sentiment remains very high and consumer credit has continued to grow, further supporting household spending. However, the credit growth rate has started to slow, in particular for credit cards and auto loans, the latter being in line with the fall in vehicle sales. While overall consumer credit keeps rising, consumer debt to disposable income fell further in Q1, reaching 93% compared to the peak level of 124% in 2007. However, the deleveraging has mostly been on the mortgage side. Excluding mortgages, consumer leverage continues to rise to new highs, in particular if one excludes the highest income brackets. So far, thanks to low interest rates, the debt load has been manageable with the total debt service ratio remaining close to its all-time lows. Nevertheless, while still at low levels, credit card default rates have ticked up further in the last quarter. Should interest rates continue to move higher as expected, higher debt service costs will become a headwind for consumption spending.

While GDP growth in Q1 was dragged down by weak household spending, firms picked up part of the slack. It seems that firms are finally increasing their investment spending as spare capacity is shrinking, business sentiment remains upbeat and return on capital has been on the rise. The outlook for a further pickup in investment is promising as indicated by business surveys like the Philadelphia Fed

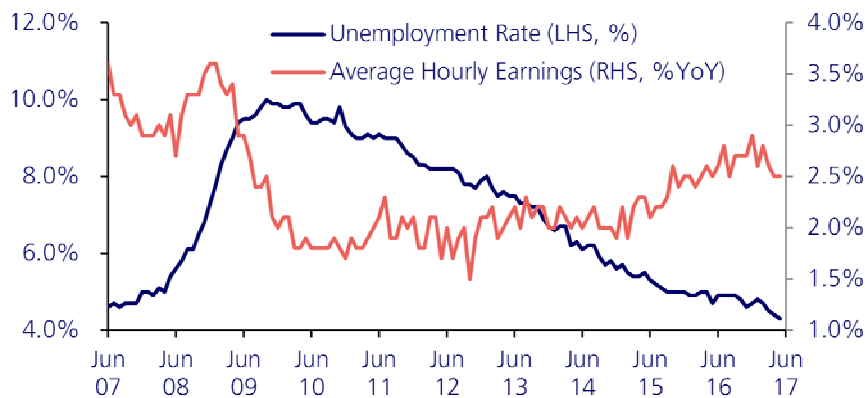
outlook for capital expenditures or the NFIB Small Business Capital Expenditure Plans.

### Fiscal stimulus and tax reform are delayed and will face resistance

Half a year after President Trump has taken office, not much has been achieved regarding the business-friendly policies to stimulate growth announced during the election campaign. Instead, the political focus has been on stricter border control and the repeal of the Affordable Care Act, with the latter potentially having a negative impact on consumer sentiment as millions of Americans risk losing their health insurance.

While still short on details, the Trump administration has presented its tax reform plan, which includes tax cuts for individuals and firms, a repeal of the state and local tax deduction, and the adoption of a territorial tax system that would exempt foreign earnings from US tax. The plan does not endorse the border adjusted tax that is a major part of the House Republicans' blueprint for tax reform, indicating that the Trump administration does not support such a shift. Taking into account that there is also substantial opposition in the Senate, it looks unlikely that the US tax system will switch to a border adjusted tax system. That removes a major upside risk for inflation as taxing imports would have led to an increase in import prices. On the other hand, it removes a major source for paying for the intended tax cuts, making the current plan more difficult to pass through Congress as it would most likely lead to a higher deficit. The administration has stated that most of the

## Modest wage growth despite low unemployment



Source: Bloomberg

fiscal effect of the tax cut would be offset by faster GDP growth, but the predicted growth rates look very optimistic. It is therefore to be expected that the tax proposal will face resistance in Congress and is unlikely to be implemented in its current form. In any case, the tax legislation process is expected to take time and any growth-stimulating effects are not to be expected before 2018.

### Falling inflation expectations are a headwind for yields

Longer-term Treasury yields have fallen to the lowest level since Trump's election victory last November, dragged down by lower long-term inflation expectations. Headline inflation has peaked with the energy base effect reaching its maximum in Q1 and almost disappearing by mid-year. The slowdown in inflation has been relatively broad-based, however. Service inflation fell below 3% in the second quarter despite an ever tighter labour market and was impacted by a significant drop in mobile service costs. We expect inflation to creep higher going forward as the most important components, housing and medical care, continue to grow significantly above 2%. Longer-term inflation expectations were dragged down by the realization that the Trump administration is not following up on the protectionist and inflationary policies announced during the election campaign, as well as by a relatively hawkish Fed. Despite the recent slowdown in inflation and a reduced inflation forecast for the current year, the Fed has hiked rates twice in 2017 and has signalled a further hike later this year. In addition, they have indicated their plans to start reducing the Fed balance sheet relatively soon. Initially, USD 6bn in Treasuries and USD 4bn in MBS will be allowed to run off each month with the caps being increased every three months until they reach USD 30bn for Treasuries and USD 20bn for MBS. The caps lie at the upper end of market expectations and should, in combination with a stabilisation in inflation rates, help to support yields going forward.

### Credit is set to underperform equities

The credit cycle in the US seems to be in its late stages, indicated not only by elevated non-financial corporate leverage, but also by rising delinquencies in some parts of the consumer credit sector. The weakest US companies are quite vulnerable to an unexpected earnings drop or a sudden jump in borrowing costs, as the advantage of low interest rates has been offset by higher debt loads for the median company. It seems to us that a significant part of operating cash flows has been spent on rewarding shareholders and the higher indebtedness has now set in place the seeds of the end of the credit cycle. If the Fed increases rates and reduces its balance sheet too aggressively, it might be the trigger that actually ends the credit cycle. Leverage can improve if companies deploy expected earnings growth towards reducing debt or at least reducing the pace of debt build-up. However, the risks to this are skewed towards the downside. At this stage of the cycle, with credit spreads so low, the temptation for management will clearly be to increase rather than to reduce leverage.

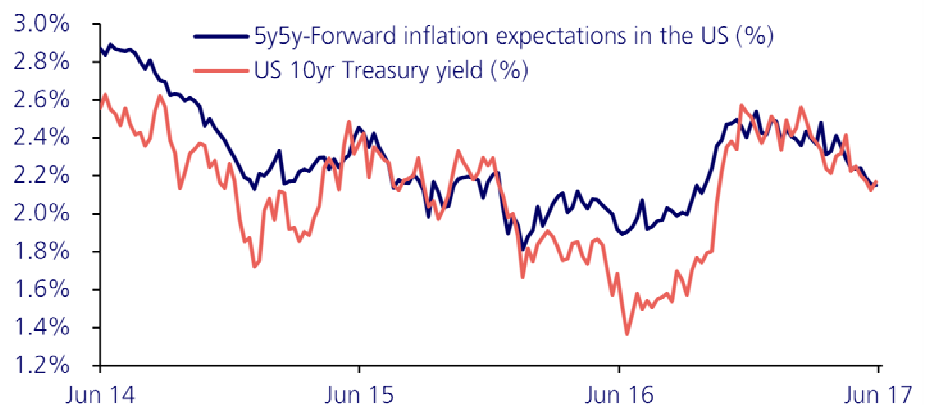
Another late stage signal is the Fed's Senior Loan Officer Survey, which shows tightening in lending standards for some credit sectors.

Empirically, this has been one of the best leading indicators for defaults and delinquencies, and the recent tightening does not bode well for sectors such as auto loans for example. That said, we are comfortable with senior ABS, as investor protections are much better today than they were pre-crisis. Regarding US municipals, we await further details on tax reforms. Linked to the tax reform is also the issue around repatriation of cash by US companies, which can further skew the supply/demand situation in US credit. The currently strong supply/demand technicals are responsible for the current tightness in spreads despite weak fundamentals. This leads us to expect US credit to continue outperforming Treasuries, although we prefer equities to credit within risk assets.

### Equities are expensive but investor sentiment is not euphoric

Despite negative surprises in economic data, the US equity market rose to new highs driven by solid earnings, abundant liquidity and the expectation that the fundamental weakness should prove to be temporary. The rally was led by technology stocks, with the NASDAQ index rising by more than 15% as of mid-June. Financials have shown a relatively modest performance as expectations for a massive deregulation and quickly rising interest rates have been disappointed. On the positive side, industrial sector performance has stabilised since the initial Trump-related euphoria has moderated. The recent pickup in relative performance is a positive signal as the business outlook remains good and the manufacturing sector has recovered from the energy-related weakness. Given the high valuations, the stock market is vulnerable to earnings disappointments as a lot of optimism is already priced in. Nevertheless, profitability remains high, expectations are not excessive and investor sentiment does not seem euphoric, all of which should lend support to the stock market for the time being.

## Inflation expectations are dragging yields down



Source: Bloomberg

## Outlook

- The economy is losing momentum as consumer spending is slowing
- High inflation and weak wage growth are squeezing households' buying power
- Political uncertainty is a headwind for business investment and hiring

## Implications

- Gilt yields are stabilising, but real yields remain deeply in negative territory
- Sterling credit should underperform equities, with risks tilted to the downside
- The UK stock market is expected to lag its global peers, but remains attractive from a yield perspective

## Risks

- Brexit negotiations could turn sour as both parties are unwilling to back off from opposing positions
- The BoE starts to tighten monetary policy despite the weakening economic environment
- A political stalemate or even new elections could create further headwinds for the economy

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### Households increasingly feel their purchasing power shrinking

The British economy initially coped well with the increasing political and economic uncertainty in the aftermath of the Brexit referendum, but more and more, the fallout is becoming visible as growth slows and inflation rises. After a decent fourth quarter in 2016, GDP growth slowed down to a mere 0.2% in Q1 2017. While business investment picked up slightly, household spending grew at the lowest rate in more than two years. Consumer sentiment has suffered somewhat, but remains relatively high compared to where it was a few years ago. However, households are being squeezed by a significant rise in inflation and a slowdown in wage growth. Retail prices were 3.7% higher in May compared to a year ago. On the other hand, average weekly earnings grew only 2.1% - or 1.7% if bonuses are excluded - despite the unemployment rate hitting the lowest level in more than forty years in the second quarter. The employment outlook has not deteriorated materially so far.

Employment has been growing at around 100'000 jobs per month on a three-month rolling basis, while jobless claims have only marginally picked up. However, the labour market is expected to weaken as firms will hold back on hiring in the face of increased business uncertainty. While the global economic background remains supportive, political uncertainty and the unclear future relationship with the EU will be headwinds for the British economy in the coming quarters.

### British voters deny Theresa May a clear mandate for a 'hard Brexit'

With Article 50 triggered, the UK is now on its way to leave the EU by March 2019. Negotiations regarding the exit terms have been initiated. The initial focus will be on EU citizens' rights in the UK and vice versa, the financial settlement with regard to past and potential future liabilities the EU claims the UK has to satisfy, as well as the border between the Republic of Ireland and Northern Ireland. While the UK would like to negotiate exit terms and the future relationship in parallel, the EU insists on first making significant progress regarding the former before moving on to the latter. This will most likely delay the beginning of any meaningful trade talks until at least autumn, possibly even until next year.

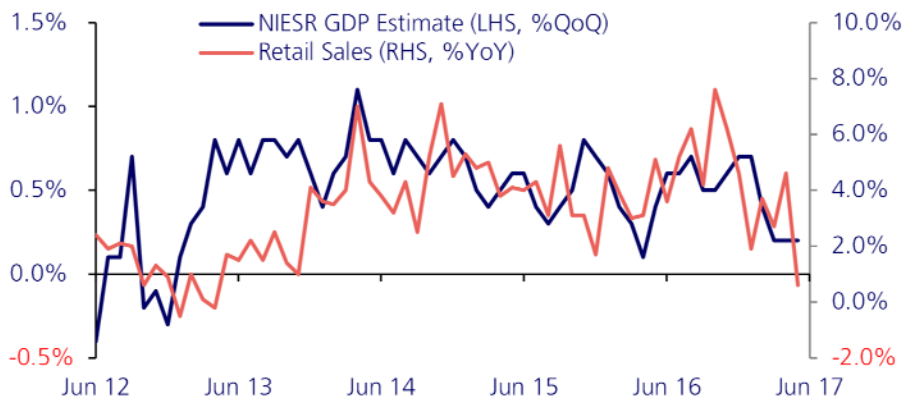
Based on past experience with EU trade negotiations it is therefore unrealistic that the future relationship between the UK and the EU will be defined by the end of the two-year term. Some sort of a transitory solution will therefore be necessary unless the UK wants to risk leaving the EU without an agreement with its most important trading partner. This is even more the case as the British electorate disavowed Theresa May's sought-for mandate for a hard Brexit in June's parliamentary election. With a 20 percentage point lead in the polls, the Conservative Party was expected to increase its majority in Parliament when Theresa May called for early elections. A larger majority would have given her more leeway in the negotiations with the EU with regard to her position within the Conservative Party and across the political landscape.

However, foreshadowed by a rapidly evaporating lead in the polls in the days before the election, the Conservative Party was not able to achieve the landslide victory it had hoped for, and instead lost its absolute majority in parliament. The result weakens Theresa May's domestic standing, as well as her bargaining position with the EU, and puts her political future at stake. The lack of an absolute majority in parliament will complicate matters for whoever is in charge of the Brexit negotiations going forward, but the need to look for a compromise in parliament is expected to reduce the risk of a hard Brexit. In the short run, however, uncertainty has increased.

With the fragile political situation, the unclear outcome of the Brexit negotiations and an already cooling economy, both consumers and firms are likely to become more cautious with regard to spending and hiring. Accelerating inflation and slowing wage growth have put consumers' purchasing power under pressure for some time and are expected to continue doing so. As investment is also expected to remain modest, GDP growth is unlikely to accelerate significantly from current levels. In addition, exports have not been benefitting from a weaker currency. While consumer confidence has been crumbling recently, business sentiment has been holding up relatively well so far. Nevertheless, momentum has been slowing in the past few months, in particular in the service sector. New order growth is weakening and competition for new business is increasing. On the positive side, recent surveys show that cost pressure seems to be moderating somewhat, with the latest survey



## Consumer spending is under pressure



Source: Bloomberg

pointing to the lowest rise in input prices since September 2016. While still significantly higher than a year ago, PPI input prices peaked in the first quarter and are expected to normalise further going forward. As CPI is usually lagging PPI by a few months, we expect inflation to start moderating later this year as well.

### The BoE turns more hawkish

Yields have been trending down since the beginning of the year, briefly touching the lowest level since October in June. Most of the move in interest rates was in line with global markets as the spread between gilts and Treasuries has remained relatively stable over the past six months. Also in line with other regions, longer-term inflation expectations have been falling continuously in recent months. This makes it easier for the Bank of England (BoE) to look through the current spike in inflation, which is driven by the currency weakness following the Brexit referendum. As pointed out above, input prices have already peaked and consumer prices are expected to follow soon. Nevertheless, the BoE has turned more hawkish recently with three out of eight members of the monetary policy committee voting for a rate hike in June. While the BoE will keep a close eye on any potential inflationary spillover from a tight labour market, the slowdown in economic momentum makes it unlikely that it will hike rates anytime soon. Longer-term, however, yields should recover from their recent weakness, as we expect global interest rates to move higher, and spreads between gilts and Treasuries are already close to the highest levels on record and are not expected to widen further.

### UK credit should underperform equities, with risks tilted to the downside

We believe that UK credit is likely to underperform equities, in line with our view for most global credit markets. That said, a lot hinges on how Brexit eventually plays out.

Sterling credit offers both higher yield and spread compared to euro denominated credit, although this comes at the cost of much longer duration. However, in the current 'search for yield' environment, if Brexit shapes up to be of a benign nature and the currency shows signs of stabilisation, investors could be drawn to sterling credit, which in this scenario would outperform euro credit. But the risks are clearly to the downside. Firstly, per unit of duration risk, sterling credit offers less value than global credit and particularly euro credit. In the current environment of tight spreads, elevated corporate leverage, and what seems to be the late stages of the credit cycle, we would be reluctant to chase very long credit spread duration. Secondly, the fortunes of sterling credit may be held hostage to uncertainty and the news flow over the coming months as Brexit negotiations take place.

Last but not least, monetary policy support from both the BoE and the ECB is likely to ebb. We also think that UK banks remain vulnerable to sentiment swings around Brexit negotiations, while spreads between sterling and euro financials are within the narrowest end of the spectrum on a historical basis. In ABS, primary market activity is expected to remain decent and is likely to be less sensitive

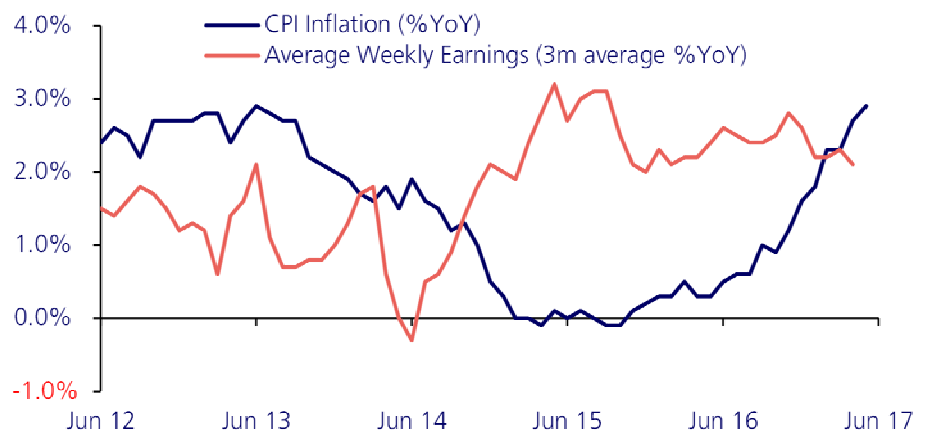
to Brexit talks than the primary market in corporate and financial credit. All in all, our view on sterling credit remains cautious within risk assets, and there could be more downside if Brexit talks become rough.

### UK stocks are lagging, but the dividend yield remains attractive

The FTSE 100 has been lagging most of its global peers since the beginning of the year. The relative underperformance has less to do with Brexit-related worries, but is rather a reflection of sterling strengthening over recent months. As most of the FTSE 100 members' revenues are earned abroad, a stronger currency directly translates into weaker earnings growth in local terms. The view that it was not Brexit holding back UK equities is also supported by the FTSE 250 outperforming its large cap counterpart. As FTSE 250 firms earn more of their earnings domestically, Brexit-related headwinds should lead the FTSE 250 to underperform the FTSE 100, as it did right after the Brexit referendum.

The UK stock market's fate is closely linked to the pound. Recently, however, a gap has been opened as the FTSE 100 has defied the gravitational pull of a stronger currency. It is likely that this gap will close one way or the other. So, while the UK stock market will probably be lagging global equities for some time, valuations are less excessive than in other regions, and the higher dividend yield makes British stocks attractive for global yield hunters.

## Real wages are falling as inflation rises



Source: Bloomberg

# Eurozone

## Outlook

- Strong growth is set to continue in the Eurozone
- There will be further broad-based falls in unemployment
- The ECB is likely to taper QE in 2018

## Implications

- Equities will be supported by earnings growth
- Credit will underperform equities, with banks remaining at risk and support from the ECB diminishing
- Periphery bonds will be supported by lower political risks, but the winding down of QE in 2018 will be a headwind

## Risks

- Italian politics still presents some risks, but they are unlikely to be systemic
- Subdued inflation could still turn into deflation, while the ECB intends to reduce stimulus
- Fragilities in the banking sector become destabilising

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### Strong growth helps reduce unemployment across the Eurozone

Despite elevated political risks, the Eurozone economy has gone from strength to strength in the first half of the year. Business confidence as measured by the Eurozone PMIs is close to its highest level since 2011. German business confidence as measured by the Ifo survey is at its highest level on record.

Although the so called 'hard data' have not been as strong as the survey data, they are still consistent with an above trend pace of growth. For example, Eurozone GDP growth in Q1 was 0.6% QoQ, the strongest quarterly pace in two years. There are also tentative signs that business investment is picking up, an important component of a durable recovery. Unemployment also continues to fall steadily at a pace of just under one percentage point a year. This is another indication that the economy is growing above trend. Indeed, in May, the unemployment rate hit a seven-year low of 9.3%, down from a cycle peak of 12.1% in mid-2013, with an additional 5 million people employed in the Eurozone since the depths of the 2008/09 Global Financial Crisis (GFC). Importantly, the labour market improvement has become more broad-based recently across countries. Whereas previously it had been driven principally by improvements in Germany and Spain, as well as other smaller Eurozone countries, now other core countries such as France and Italy are seeing an improvement in labour market conditions.

### Few signs of inflationary pressures

The Eurozone unemployment rate remains above the Non-Accelerating Inflation Rate of

Unemployment (NAIRU), estimated to be between 8-9%, and there are as yet few signs of inflationary pressures building up. Indeed, after spiking in April due to distortions created by the late timing of Easter this year compared to last year, core inflation moved back to 0.9% in May, essentially unchanged from its levels at the beginning of the year.

The ECB has argued that there is a lot of hidden slack in the labour market, because many jobs that are being created are part-time or temporary jobs and that this has implications for inflation dynamics. These people may prioritise more hours or job security over higher wages in employment negotiations. The upshot is that wage growth has been muted so far and as a result, core inflation is still well below the ECB's target of "close to, but below 2%". However, the silver lining to this weak wage growth and low inflation dynamic is that there is little danger of the Eurozone economy overheating anytime soon, suggesting that the recovery can continue for many quarters or even years, absent a destabilising internal or external shock.

### Political risks have diminished

In this respect, it is also extremely encouraging that political risks have diminished, and in particular that the shock that would have resulted from the election of a non-mainstream, anti-EU/euro party in France was avoided. This was a risk in the first half of the year. Rapidly changing opinion polls over the course of Q1 showed how fluid the election was. In the end, the centrist and

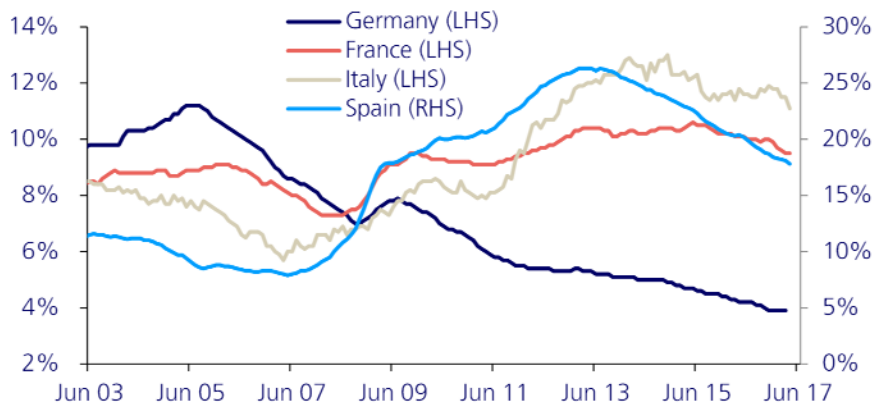
pro-EU candidate, Emmanuel Macron, won the French Presidency in May. Macron then secured a sizeable parliamentary majority in the subsequent legislative elections. His absolute parliamentary majority allows him to legislate proposals more easily and reform the French economy, though the potential for civil unrest and protests against his more market friendly and radical proposals could still be an issue.

Macron's policy proposals include: increasing the flexibility of the 35-hour working week, with employers and managers able to negotiate hours at a company level, deregulation of service sectors such as legal services, reducing corporate tax rates and lowering social charges for companies employing people on low wages. At a European level, he also wants to create a larger common budget and spend more on investment as well as boost defence spending. He has also proposed a Eurozone finance and economy minister who would have power over national budgets and promote harmonisation of corporate tax rates and labour market regulations.

### 'Macron-economics' could help reform France and the Eurozone

Overall, the Macron policy proposals should be stimulative for the French and Eurozone economies. What's more, promoting more market friendly reforms and deregulation will make it easier for Germany to agree to the next steps needed to make the Eurozone a well-functioning currency union, such as automatic fiscal transfers and stabilisers, and common budgets and corporate tax rules.

## Broad-based fall in unemployment rates across the Eurozone



Source: Bloomberg

German politicians have often talked about correct sequencing in completing the single currency project, with other Eurozone countries needing to do more to reform their economies before Germany agrees to automatic fiscal transfers and burden sharing.

### Italian elections are a risk, but majority bonus system is likely to be scrapped

There are still some key political events in the second half of the year and early 2018 to get through, but we do not see them holding the same potential for systemic risk as the French presidential elections did. General elections in Germany take place September 24, with Chancellor Angela Merkel's CDU party currently leading in the polls. However, even if the opposition SPD were to win, this would not be a major issue from an investor perspective as the SPD is also committed to maintaining the integrity of the Eurozone. In fact, the SPD are more willing to consider increased spending at a Eurozone level, fiscal transfers and debt restructuring for Greece.

Italian politics could, in theory, still destabilise the Eurozone. Three of the main five political parties are anti-EU/euro, and the Five Star Movement, Northern League and Brothers of Italy collectively have almost 50% of the vote in opinion polls. However, the bonus system whereby a parliamentary majority is awarded to the party with the most votes looks likely to be scrapped. What's more, the defeat of French far-right politician, Marine Le Pen, who campaigned on an anti-EU/euro agenda makes it likely that non-mainstream parties in Italy will tone down their anti-EU policies.

### Crunch time for the ECB's QE policy

We expect that core government bond yields will drift higher as the Eurozone recovery continues, though low inflation will continue to act as an anchor on yields. The fact that inflation remains low despite the improving economic outlook, suggests the ECB will only gradually remove its extraordinary monetary accommodation (which includes €60 billion of

QE asset purchases a month and negative deposit rates). However, one potential constraint is the ECB's self-imposed 33% issue limit on government bond purchases. If it continues buying at its current pace it will likely hit this limit for German Bunds in 2018. This is another reason why we expect the ECB to announce a reduction in the size of asset purchases in 2018. Uncertainty over the timing and extent of QE tapering could lead to volatility in government bond markets, especially for periphery bonds.

### Credit is vulnerable as bank risk remains and ECB support is likely to wane

We expect European credit markets to underperform equities over the coming year, in line with our view on global credit. While corporate leverage is a risk, we remain particularly concerned around banks.

European banks are vulnerable, although some capital raising and problem resolution for troubled, smaller banks is on track, largely in line with our expectations. However, this has not been as pre-emptive as we had hoped for. Notably, recent regulatory actions in Italy and Spain to address problem banks have wiped out junior bonds and equity, confirming our cautious stance. While in these cases, senior debt was left untouched

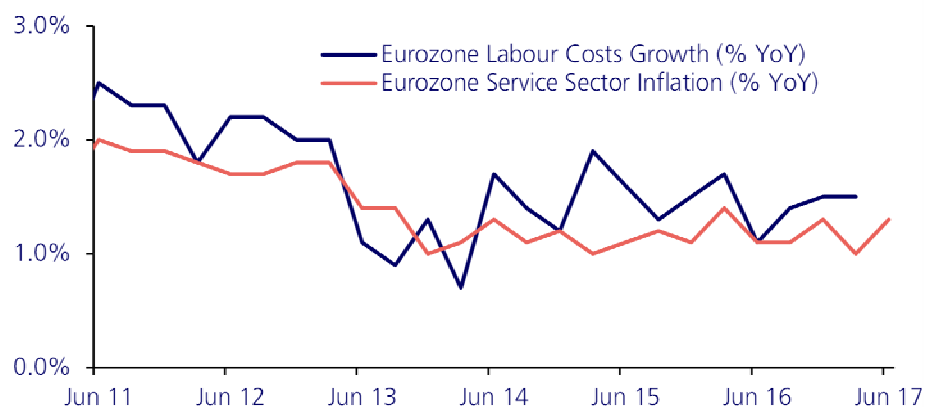
as the signalling effect would have outweighed the benefits, this may not always be the case in future bank clean-ups. Indeed, new types of senior debt, which are junior to current outstanding debt, may well be written down in case the resolution occurs when the buyer is not as strong or economic conditions not as benign. At current spread levels, which are tighter for senior bank debt indices than for industrial debt, we believe the risks of a capital write down are not priced in. We think covered bonds offer much better protection than senior bank bonds for about 40bps lower spreads at an index level, although there are some differences in index composition.

Non-financial credit, while not as worrying as bank debt in Europe, has also seen leverage building up and faces the same late-cycle risks as global credit in general. That said, optimistic earning expectations, if delivered upon, will provide a chance for management to improve balance sheets, as European companies are typically more conservative around leverage than US ones. Overall, tight spreads, weaker fundamentals and the prospect of ECB tapering make us more cautious on credit versus equities.

### Outlook for equities

Above trend growth and reduced political risks should be a positive environment for equities. What's more, Q1 2017 was the second consecutive quarter in which Eurozone companies' YoY earnings growth was positive after four quarters of negative/flat growth. We expect continued positive earnings growth for the rest of 2017 and in 2018. As mentioned earlier, low inflation means the Eurozone is not in danger of overheating anytime soon, suggesting that the recovery could continue for many quarters or even years. Over the past few months, as political risks have diminished, investment flows have returned. We think this trend has further to go given the many years of Eurozone underperformance relative to the US equity market for example.

## Inflation held down by weak wage growth



Source: Bloomberg

# Switzerland

## Outlook

- Growth is expected to remain subdued, with domestic growth drivers notably lacking
- Inflation surprises positively, but further upside is limited
- The SNB is set to keep policy unchanged as the recovery remains fragile

## Implications

- Bond yields are expected to stay negative, but are unlikely to revisit last year's low
- The low yield environment will remain a headwind for the financial sector
- The franc is expected to be range bound, though remains vulnerable to bouts of safe haven demand

## Risks

- Renewed pressure on the franc triggers the SNB to change policy
- High household debt in a deflationary environment
- A sharp deterioration in the labour market as firms come under increasing pressure to cut costs

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### **GDP data likely to underestimate recent growth**

GDP expanded by 0.3% in the first quarter, leaving the annual growth rate at 1.1% YoY. This is weak, and reflects subdued growth in the second half of 2016, when the official GDP data show that the economy all but came to a standstill. The economic surveys, by contrast, have been strong, with both the KOF leading indicator and the manufacturing PMI tracking well above their long-term averages, having recovered steadily from their troughs in 2015. The expansion in the Eurozone, which is the key export destination for Swiss companies, has also been solid, in addition to a firm revival of global trade. Based on this, we estimate that underlying growth is likely to have been a touch stronger in recent quarters than the official GDP data suggest.

### **Economic surveys moderating from a high level**

Economic surveys have weakened more recently, however, reflecting a broad-based slowdown in the domestic economy, though the underlying trend for manufacturing continues to look encouraging. We suspect that growth is likely to have peaked for now, and anticipate weaker underlying dynamics through the rest of the year. We therefore keep our GDP growth forecast of 1.3% unchanged for this year. While this is well below the long-run average of 1.8%, it still represents a decent expansion of the economy, and is in line with what was achieved in 2016. That said, it is also a touch weaker than consensus estimates, reflecting our more benign view on the potential for domestic demand to strengthen meaningfully.

Nominal growth is expected to rebound more sharply, however, as deflationary pressures ease further. This is encouraging and will help stabilise the housing market, which is the sector most vulnerable to persistent deflation.

### **Exports boosted by stronger global demand**

As we had expected, global trade has staged a rebound, helped by the Eurozone recovery but also reflecting stronger dynamics in Asia and a stabilisation in commodity prices. Switzerland has been well positioned to benefit from stronger demand from the rest of the world, with underlying goods exports up 7% compared to a year ago and services exports up 4% over the same time period. Exports have been fuelled by stronger demand from the US and the Eurozone, particularly Germany, as well as a rebound in export values to China and Japan. The broad-based nature of the recovery is encouraging, and we anticipate that this will help underpin the dynamics going forward. This view is also supported by the manufacturing PMI, which remains strong, with new orders at a healthy level. The franc has, however, strengthened against the USD since the beginning of the year while the trade weighted currency is broadly unchanged at a high level, likely tempering a further upside to exports.

### **Consumption will remain sluggish**

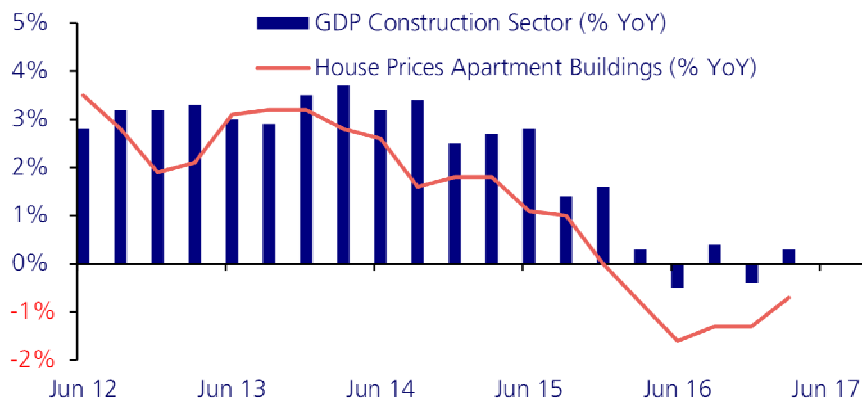
Consumption has been volatile, but the last two quarters taken together show an expansion of 1%, following tepid growth of only 0.2% in the prior two quarters. The firming in consumption is consistent with a broader set of indicators of domestic demand

that have recovered steadily, partly driven by firm car sales but also reflecting stronger demand in the retail and tourism segments. While this is encouraging, the most recent data show that the pace of improvements is slowing, with conditions still remaining below the long-term average. This confirms our view that the currency is still a headwind for the retail sector, given cross-border trade and persistent price pressures, adding to challenges coming from online shopping. The labour market is an additional headwind for consumption. While concerns around job security have diminished, overall sentiment around job prospects is still muted. Further labour market improvements also look unlikely, given high costs and resistance among businesses to take on new staff. We therefore do not expect a further upswing in consumer spending, but conditions should stabilise from now on.

### **Investment rebound likely to be limited**

Equipment investment helped support a rebound in GDP in the first quarter, as it rose by a decent 1.4% on the quarter, linked to stronger global trade and manufacturing dynamics, and boosted by firm R&D spending. This has to be put in perspective, however. The data is volatile, and structural headwinds, including tight margins in both the financial and the manufacturing sectors, are likely to continue to weigh on firms' investment activity. We therefore see limited upside from the investment component going forward. Business investment is also a small component of overall GDP and, unless growth picks up more firmly, it will not decisively change the sluggish growth

## Construction is no longer a driver of growth



Source: SNB, SECO, Bloomberg

pattern.

### Housing market stabilises, but construction set to remain weak

The slowdown in the housing market, and construction in particular, will also remain a headwind to economic activity. Construction investment provided a large boost to GDP growth over the 2010-2015 period, but has slowed sharply since then, contracting by 0.1% over the past year. That said, the slump in the housing market appears to be bottoming out. Construction investment ticked up in the first quarter, and house prices, which are falling in some segments of the market, have also picked up some momentum. From a macro perspective, we expect headwinds to the housing markets to stay in place, reflecting high debt levels, with mortgage debt at over 120% of GDP, slowing population growth, and a persistently subdued nominal growth environment. Partly offsetting this is still brisk demand from institutional investors that still view housing as an attractive investment given the negative bond yields. While this will provide some support, it is unlikely to drive a late cycle-upturn in the housing market.

### Deflationary pressures are starting to diminish

Inflation has rebounded and both headline and core CPI are now tracking above zero for the first time since 2011. The turnaround in inflation mainly reflects base effects from oil and import prices, but underlying price dynamics have also strengthened. Core inflation, which strips out volatile energy and food effects, has risen from -0.3% YoY at the turn of the year to 0.2%, boosted by a steady rise in services inflation, currently tracking at 0.6%, while goods price inflation is still muted. We now expect CPI inflation to average 0.5% this year, still far below the SNB's 2% inflation target, but finally out of deflationary territory. This is slightly higher than the SNB's projection, which reflects our more positive view on services inflation. We

do not expect a steep rise going forward, however, as cost and price pressures are still intense in many sectors of the economy, with wage inflation tracking far below its historical trend.

### SNB expected to be patient and remain on hold

Although growth dynamics have improved, the Swiss economy remains dependent on external demand as domestic growth drivers are notably lacking. Likewise, while inflation has risen meaningfully, it is still very low compared to the 2% target, and the past few months mark the first time in five years that inflation has persistently reached above zero, albeit only modestly so. Against this backdrop of continued vulnerabilities, we anticipate that the SNB will remain focused on the currency, using a combination of forex interventions and a negative interest rate spread versus the Eurozone to prevent the franc from strengthening. Over time, and as the ECB starts to withdraw stimulus, we would expect the SNB to be able to start normalising policy too. However, this is still a long way out, in particular as the ECB is not expected to scale down asset purchases before next year, with Eurozone policy rates likely to remain on hold at least into the second half of 2018. We therefore expect the

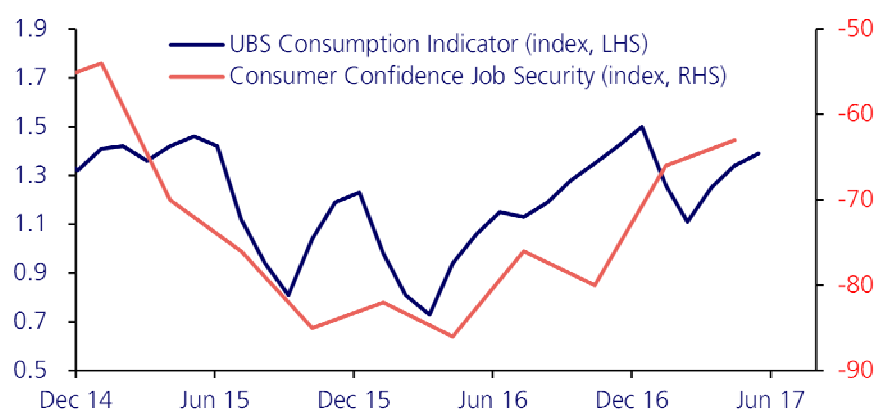
SNB to keep the policy rate unchanged over the coming year. As political risk is still elevated, we also anticipate bouts of safe haven flows to trigger further interventions by the SNB, despite forex reserves now above 110% of GDP.

### Bond yields will stay low, but are unlikely to revisit last year's unprecedented levels

The Swiss yield curve steepened sharply in November last year and yields are now positive beyond the 12yr maturity. The 10yr yield remains negative and has fluctuated in a relatively narrow range between 0% and -0.2% over this period, though it managed to creep above zero on the 10th of March for the first time since September 2015. We do not anticipate this pattern of negative, but broadly stable yields to change during the rest of the year as the short end is anchored in deeply negative territory by policy expectations, and as a negative risk premium continues to weigh on the long end. Looking into 2018, the yield curve should edge up as investors begin to price in that policy rates, both in the Eurozone and Switzerland, will at some point start to rise from their depressed levels. The move will be very tepid, however, particularly as subdued inflation dynamics will temper central banks from acting prematurely.

As we have highlighted before, the catalysts that could trigger a sharper rise in the Swiss yield curve would either be a meaningful rise in Bund yields, or a sharp reversal in safe haven assets. Though this is a risk, it is not part of our baseline, as political risk remains elevated, with underlying issues in the Eurozone still unresolved, and as Bund yields are likely to stay distorted by central bank actions.

## Limited upsides to the labour market and consumption



Source: SECO, UBS, Bloomberg

# Japan

## Outlook

- Private consumption and capex are expected to underpin solid growth
- Monetary policy will remain loose
- Price and wage inflation is expected to creep at a slower speed than envisaged by the Bank of Japan

## Implications

- Japanese equity market outperformance remains highly susceptible to the USDJPY rate
- Company sales and earnings outlook will continue to improve
- Demand/supply conditions are favourable

## Risks

- A bigger than expected economic slowdown in China
- Further yen appreciation
- An escalation of problems in North Korea and a trade war with the US

### Decent growth outlook

Japan's economic growth has been quite solid over the last few quarters. Had there not been a big downward revision to the growth rate in Q1 due to a change in inventory, one could have argued that growth even accelerated. Revisions to GDP statistics have been a common feature in Japan for years, if not decades, and we tend to look through these revisions to gauge the real picture. We appreciate the broadening of growth towards consumption and capex, with both taking the baton from exports, even though the latter are also expected to remain firm, as the synchronised global economic upswing is likely to continue. For the rest of this year and going into next year, overall growth is expected to remain slightly above trend, hovering in the 1% to 1½% range. Assuming that there will be no major disruptions until at least the autumn, the current growth phase will become the second longest post-war expansion.

### Consumption and capex outlook remains solid

In our Economic and Market Outlook 2017 we said that we were finally expecting a pickup in consumption from low levels, as overall employee compensation will keep improving and the rising savings rate was expected to peak. Indeed, our scenario has unfolded, as consumption is now a major contributor to GDP growth and as monthly indicators like retail and department store sales have picked up. The latter has also benefitted from increasing tourism, as Asian tourists tend to make their purchases at Tokyo's major department and electronic

stores. We expect overseas tourism, particularly from China, Taiwan and Korea to gain even more steam, despite the fact that spending per tourist has levelled out. Overall, consumer confidence has risen steadily from its cycle low three years ago, and there is room to rise further toward the highs of 2006.

We also envisaged that during the course of this year, labour market conditions would improve further and the job-to-applicant ratio could approach levels last seen in the mid-1970s. Indeed, the ratio now stands at 1.49, a 33-year high, after exceeding its 1991 high of 1.44. Labour market shortages are increasing due to the severe demographic situation in Japan. While this should underpin a slow increase in wages, it also results in companies steering corporate capital investment into automation and artificial intelligence as they choose to substitute labour with capital, particularly in the service sector. In the manufacturing sector, capex will be more driven by the replacement of old facilities rather than a fresh investment boom. Unfortunately, corporate capex plans have been somewhat lacklustre recently, as they usually hinge on the earnings outlook. As the yen has not depreciated further, and as the earnings revisions ratio has come off its recent highs, companies remain conservative in their capital investment plans. This, however, is a typical pattern, as Japanese companies tend to increase their capex plans throughout the fiscal year, which started in April. We believe this pattern will hold again this year, and we are confident that capital investment will contribute to growth into early next year. However, from a historical

perspective, the ratio of capex to cash flow remains rather low, and there are no indications of a surge of new investment. Housing investment should benefit from the construction of the athlete's village for the 2020 Tokyo Olympics and new family home construction due to inheritance tax advantages.

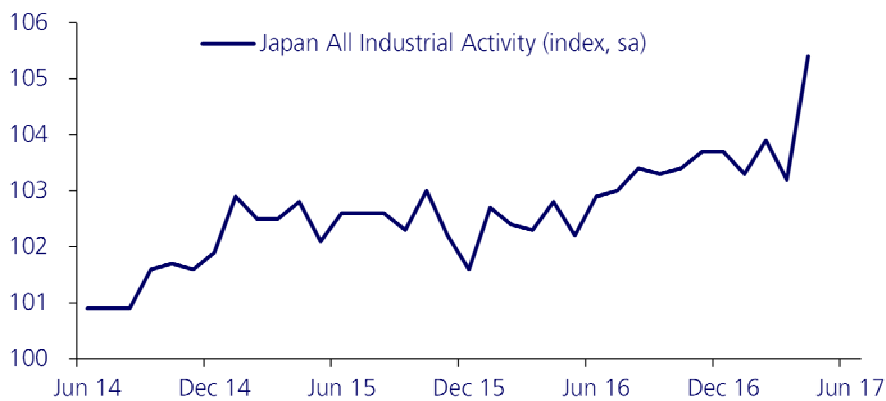
### Fiscal policy is expected to move from expansionary to neutral next year

Japan's fiscal policy stance for last year and this year remains slightly expansionary, considering the supplementary budgets and the decision to delay the consumption tax hike that had been planned for 2017. We are expecting another supplementary budget later this year or even in Q1 next year, but overall the fiscal impulse should be neutral in 2018. Japan's budget deficit is shrinking and may soon be small enough to stabilize the ratio of public debt to GDP. This, however, requires that the planned consumption tax increase from 8% to 10% in 2019 is not postponed again, or even abolished, and that nominal growth remains brisk, which may be considered a contradiction. Fiscal consolidation will re-emerge as a topic next year and beyond considering structural growth in social security spending.

### Monetary policy tightening not yet in the cards

The Bank of Japan has pushed out the timeline for achieving its 2% core CPI target several times. It seems that even some BoJ officials have doubts about achieving this target, but these concerns are not voiced loudly due to credibility reasons. The main

## Proxy for Japan's overall growth is solid



Source: METI, Bloomberg

reason to stick to communicating the target is to drive inflation expectations up, but we do not see any indications yet that this is happening when looking at surveys and market implied measures. What we do see is that producer prices in the service sector are slowly creeping higher, but that is not enough to fuel inflation. It may, however, help to shift inflation expectations, as households tend to forecast higher inflation once they see actual inflation kicking in.

Wage growth remains tepid, despite severe labour shortages in some segments. It is a global phenomenon that wage growth is not in line with tighter labour markets. Obviously globalization, technological progress, flexible employment contracts and the fact that more women are being employed in the less well paid elderly care segments are all contributing to the deteriorating bargaining power of workers and labour unions. Regular cash earnings are running at just about 0.3% YoY, while real wages are not rising at all. Even though wage growth at SMEs is gaining some momentum, it is hard to believe that inflation will pick up towards 2% unless wage growth accelerates above 3%, which seems highly unlikely over the next twelve months.

There has been some speculation recently about when the Bank of Japan will move toward policy normalization or an 'exit' strategy for its current monetary policy following recent remarks by BoJ officials. We do not believe that monetary policy will change significantly over the next twelve months, as the BoJ has established its 'overshooting commitment', which states that there will be no quick policy normalization even if the 2% inflation target were to be achieved. We believe that the BoJ will follow its yield curve control (YCC) policy well beyond 2018. There is, however, a chance that the current target of 'about 0%' may be lifted by 25bps in the first half of next year. At the same time, the BoJ may remove its guidance of JPY 80tn of JGB purchases per year. It is already effectively buying at a pace

clearly below this target. Neither do we see any chance that the negative interest rate policy (NIRP) will be expanded. Indeed, the size of NIRP in Japan is limited anyway, and complaints from financial institutions are well understood by the Bank of Japan. If our scenario is right, the divergences in monetary policy between the Fed, the ECB and the BoJ should indeed result in a weaker yen from its current level of USDJPY 112 and EURJPY 128. A drastic depreciation will, however, be difficult as long as the Trump administration is accusing Japan of unfair currency manipulation.

### Cautiously optimistic outlook for Japanese equities

In the first half of this year, Japanese equities retraced about half of the relative gains versus global equities achieved in the autumn of last year. From a seasonal perspective, the weak market performance at the start of the fiscal year in April was a negative surprise caused by geopolitical events, but the dip turned out to be short lived.

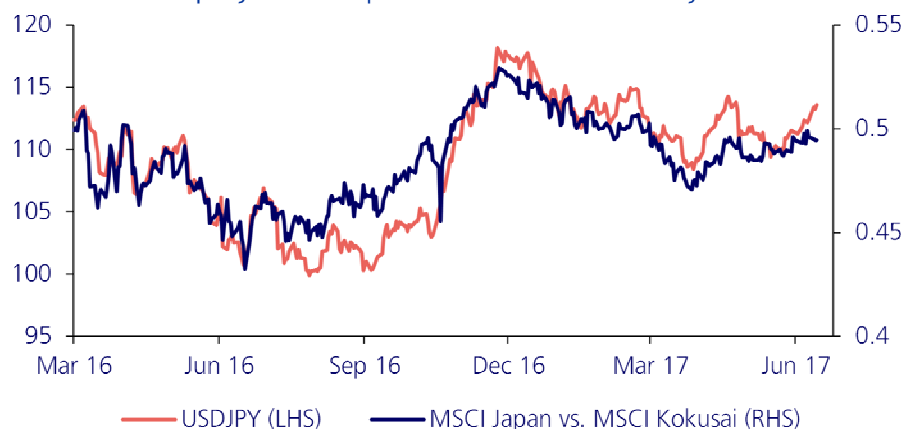
From a fundamental point of view we remain constructive toward Japanese equities, even though the summer months usually tend to be a challenging performance period. Inventory restocking should benefit Japan's

production cycle, which usually coincides with a firm equity market. The earnings outlook is favourable. In FY16, both sales and recurring profits fell slightly, but net earnings showed a handsome gain of more than 12%. The consensus outlook for this year shows a clear turnaround in sales of close to 5% excluding financials and close to 15% for recurring profits. Net income is expected to rise by more than 10%. While company estimates are more conservative, this is in line with their traditional cautious outlook. The earnings revisions trend has stabilized, but we expect it to pick up again. Meanwhile, the recurring profit margin and RoA of large firms have recently risen to new record highs. Corporate governance reform is starting to become visible in higher shareholder payouts.

Valuations on a price/earnings and price-to-book basis look fair, while a dividend yield of 2% is attractive compared to a 10yr JGB yield of zero. Investor positioning is neutral. The latest Merrill Lynch survey shows that global investors state that they have reduced their overweight position in Japanese equities back to neutral, while other surveys even indicate an underweight positioning.

While we are emphasising the positive fundamental picture, it needs to be noted that the Japanese equity market remains highly susceptible to global political risks, as investors tend to sell Japanese equities disproportionately in a risk-off environment. Relative performance strongly correlates with the USDJPY rate. Unless the yen starts to weaken again as we expect, due to different monetary easing cycles in the US, Europe and Japan, it will be challenging for Japanese equities to outperform.

## Relative equity market performance is driven by USDJPY rate



Source: Bloomberg, MSCI

# China

## Outlook

- China's growth is expected to remain solid despite some intentional moderation
- The authorities' focus is rightly shifting toward containing financial risks
- Property market divergences are expected to continue as the market rebalances

## Implications

- Different market index compositions in China will likely lead to significant return divergences
- Higher inclusion of 'A'-shares in MSCI indices will support increased foreign flows over time
- Korea should benefit from cheap valuations and improving return on equity

## Risks

- Capital outflows cannot be brought under control
- Broad-based US trade tariffs
- Reform appetite dwindles following the Communist Party Congress

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### What a difference a year makes

About a year ago, a majority of China observers were warning of a hard landing, as Chinese economic data kept deteriorating. We were more sanguine, acknowledging a slowdown, but not a severe disruptive deterioration of economic conditions. This year, China's economic growth surged above consensus expectations in Q1, leading to broad ranging upgrades of economic growth forecasts for the year. The economic stimulus provided by the government through strong infrastructure investment has had positive second round effects, though we are getting more cautious on the outlook for the rest of the year. We still believe that property and credit tightening measures will take their toll in the second half of this year and into next year, and expect growth to decelerate. However, once again, we do not foresee a hard landing.

### Some headwinds will slow growth

Since China's Communist Party Politburo met with the PBoC and the three major financial regulators in late April to discuss financial risks in the capital markets, a series of measures have been taken to rein in financial risks. Indeed, we believe that restricting speculative activities and reducing financial leverage are needed to address a resurgence in shadow banking activities. But we also believe that the authorities have to find a balance between tackling leverage and avoiding a sudden slowdown in the economy, particularly after the 19th Party Congress in October this year, when major party positions will be reshuffled, including five of the seven Politburo Standing Committee members. We trust that the

government will find the right balance.

It is quite obvious that cyclical growth already peaked in March/April, with the Caixin Manufacturing PMI rolling over and falling below 50, which suggests growth moderation. The same is true for one of our favourite cyclical indicators, the Li Keqiang index, which combines data for electricity production, rail freight volume and bank lending. Following a 'V'-shaped recovery starting in autumn 2015, this indicator has started to roll over as well. Fiscal consolidation, slower investment by SOEs, a slowdown in commodity production and, on the consumer side, a slump in SUV sales, give clear evidence of the impact of tighter policies on cyclical growth.

### Policy tightening in the shadow banking segment was overdue

China's sizeable corporate debt represents a significant burden at a time when the Fed is normalizing its policy. Even if most Chinese debt is denominated in yuan, not in US dollars, the transmission from higher US Fed rates to Chinese debt should occur via capital outflows. Corporate debt accounts for most of the 257% of total non-financial-credit-to-GDP. However, corporate debt is now stabilizing, helped by the economic rebound, which lifted margins and decreased leverage particularly in 'old economy' industrial sectors like energy and mining. Going forward, such a boost to margins is unlikely to persist, especially as producer and commodity prices are rolling over. Deleveraging will now require proactive policy action. We are already seeing the first encouraging steps: in our view, the government will stick to its reduction targets

for coal and steel supply this year, and will probably extend those targets to other areas.

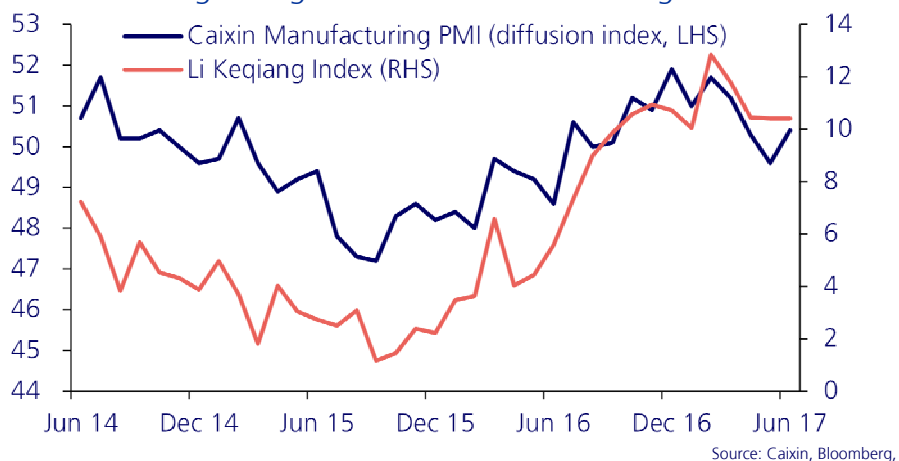
The government is also tackling 'shadow banking' excesses involving small and medium-sized banks that are selling investment funds dominated by wealth management products (WMPs). WMPs stood at RMB 29tn in 2016, following years of double-digit percentage growth. The Chinese authorities are now working with financial institutions to push WMPs back on-balance sheet and post capital against them. Additionally, interbank rates have been hiked, leading to a rise in bond yields and a tightening of lending conditions. There are signs that the infrastructure and real estate sectors are being impacted, but the effect on the rest of the economy is shallow so far.

### Crossing the river by carefully stepping from stone to stone

Looking forward, we think that China will lead a stop-and-go policy, along the lines of Mao Zedong's famous guidance 'cross the river by carefully stepping from stone to stone'. The authorities will tighten to inject liquidity when there are signs that the real economy is slowing. As China tightens, pro-liberalization policies will likely be difficult to push, as they would imply a lift in capital and currency controls. We think that liberalization will occur, but as a second step, after prudential regulation fulfils its required impact. Overall, we interpret these steps by various regulators as necessary coordinated adjustment policies. While opening the capital account remains a longer-term target, short-term regulation will try to avoid capital flight.



## Signs of growth slowdown following boom



For the time being, liberalization measures will focus on attracting foreign capital.

### Bifurcated property market

We believe that China's bifurcated property market developments will continue. Tightening measures are already showing some impact in the overheated tier-1 segment, comprised of major cities like Beijing, Shanghai and Shenzhen, and some cities in the tier-2 segment, while we expect property prices to rise further in smaller tier-3 and tier-4 cities. Authorities keep implementing targeted regulatory measures to cool down overheated segments, including home purchase restrictions. Mortgage loan financing has increased substantially in China over the last few years, whereas it used to be a tradition to buy homes financed by cash. Only recently have higher mortgage rates and some window-guidance by regulators shown some impact. We believe the environment for the bank mortgage business will become tighter into next year, when we expect the property cycle to mature.

### Hong Kong, Taiwan and Korea will benefit from the global trade recovery

Hong Kong should benefit from the favourable global trade outlook, which should more than make up for our projected soft slowdown in China's economy. The turnaround in global trade volume via Hong Kong is essential and has an indirect impact on domestic consumer sentiment as well. Tourism spending from Mainland China is slowly improving again following a severe setback last year, as measured by the number of tourists and the jewellery/watches component of retail sales. Hong Kong has to compete with other Asian and global shopping and entertainment destinations. We see Hong Kong's still booming property market, which remains fuelled by Mainland demand, as the biggest risk to our benign forecast. Were China's growth to slow more and/or were the Fed to hike by more than we anticipate, the Hong Kong Monetary

Authority would probably increase rates in order to defend the USDHKD peg. Even though Mainland property demand at times tends to show a low price elasticity, we think that domestic affordability will decrease further. We also know that Hong Kong property prices have seen wild swings in both directions in the past, and that they are not immune to a fall following a long period of exuberance.

Taiwan's economy should benefit from the global trade recovery, and it seems likely that the CBC will start to hike rates during the course of next year. At 1.375%, the discount rate is now hovering close to its lows following the Lehman crisis. Some question marks remain on Taiwan's fiscal side, as it is not clear to what extent fiscal policy will be tightened to finance the eight-year infrastructure program, which still has to clear more parliamentary hurdles. We believe that the overall impulse should be positive as Taiwan's productivity will be enhanced.

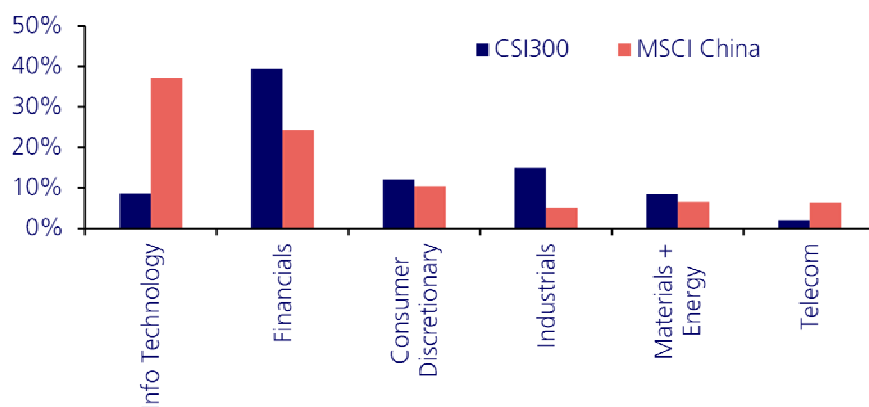
Korea is also a beneficiary of the global trade recovery. We expect export volumes to recover well into next year. This should at some point spill over into domestic capex and household consumption, which are still lagging. Fortunately, household debt growth

has started to decelerate following macro-prudential measures, but household debt remains the Damocles sword for Korea's economy. Households need to de-lever their balance sheets more radically. Construction has been firm, but growth should moderate into next year. On the other hand, corporate facility investment should improve following the big setback last year, as the export recovery helps improving capacity utilization. While we do not expect a major fiscal boost, we think it is too early to speculate about the Bank of Korea hiking policy rates this year.

### Watch out for discrepancies in China equity indices

Forecasting China's equity market very much depends on which index one is referring to. 'A'-shares traded in Shanghai and Shenzhen (CSI300 index) are the playing field for domestic investors, while 'H'-shares are those listed in Hong Kong (HSCEI index) and available to global investors. The 'A'-share segment has opened up to international investors to some extent through various 'connect' schemes, though foreigners remain marginal players for now. We are focused on the MSCI China index, which is primarily dominated by internet related shares, many of them US-listed ADRs, followed by banks and insurance companies. IT, finance, and internet related shares in the consumer discretionary sector make up about two-thirds of MSCI China's capitalisation. It thus requires sector and company analysis to forecast this index. While we acknowledge that internet related shares are representatives of some parts of the much celebrated 'new' China, these segments are also vulnerable to hype. On a relative valuation basis MSCI Korea still looks attractive, despite its 50% surge since its cyclical low in August 2015, as ROE is expected to improve further. However, the index composition also needs special attention, as a single tech company, Samsung Electronics, represents one-third of the index's market capitalisation.

## Major China indices' sector weights (%)



# ASEAN and India

## Outlook

- The cyclical recovery has further to go, helped by a synchronized pickup in domestic infrastructure investment
- We expect stronger growth in Malaysia and in Indonesia and a 'V-shape' recovery in India
- ASEAN's dependency on China as a trade partner and a source of funding will likely increase

## Implications

- Benign financial conditions, improving investor sentiment, and recovering earnings should benefit Asian equities
- We see earnings rebounding further on the back of better margins, increased asset turnover, and lower leverage
- In fixed income, high-yielders should outperform and low-yielders could be pressured by further Fed hikes in 2018

## Risks

- Fiscal conditions tighten in China as the Fed normalizes its policy, disrupting other Asian economies
- The cyclical recovery in trade fades and exports growth collapses
- The domestic governments in ASEAN and in India fail to implement their structural reform agendas

### More room for export growth

Global trade rebounded in H2 2016, benefitting Northern Asia and ASEAN. Semiconductors and tech products have been the key drivers of trade growth. A combination of growing global demand and depleted inventories has boosted export volumes and prices. Recently, however, momentum seems to have run out of steam. We think that export growth will slow, but not collapse, as technological innovation and end market demand continue to be strong.

Demand for tech and commodities has been led by China, with the US, Europe and Japan also contributing. A significant slowdown in China's growth would certainly affect ASEAN, but this is not our base case. We see China executing its reforms in a non-disruptive way. We acknowledge China's significant deleveraging challenge, though, as the Fed normalization spurs capital outflow pressures.

### Global and local investment should help

Developed markets are experiencing a rebound in capex as global machinery orders pick up, mostly from the US and Japan. Asia's supply chain should benefit from this trend, although the duration of this recovery is difficult to assess. Domestically, we think that investment has bottomed thanks to the execution of vast infrastructure programmes at the heart of the political agenda in the Philippines, Indonesia, Malaysia, and Thailand. Governments will likely use the additional fiscal revenues generated by stronger economic growth to fund infrastructure investment. In parallel, financial support from China will likely increase. In Q1, Malaysia and

Indonesia received ~USD 1bn each of net foreign direct investments (FDIs) from China. We do not expect the recent tightening of Chinese capital outflow regulations to impact FDIs, as those do not qualify as 'speculative' flows. The structural reforms led by China actually play in favour of ASEAN: the authorities are eager to export excess manufacturing capacity from China to the rest of Asia, by incentivizing Chinese companies to take on large projects abroad.

### Agricultural production recovers

Turning to the second pillar of the recent export boom, commodities, we see a more uncertain outlook. Apart from Indonesian coal, the main commodities produced in ASEAN are driven by global supply and demand forces, and are less reliant on China. Production volumes normalized in H1 following the severe weather disruptions of 2016, translating into higher farm incomes and leading to a multiplier effect on consumption. Going forward, commodity prices will likely soften further but future production volumes should benefit from benign weather conditions. As the only net oil exporter in the region, Malaysia should see terms of trade weaken.

### Building up the FX reserves buffer

Trade windfalls have pushed FX reserves up across ASEAN. Indonesia has experienced strong growth, bringing FX reserves to an all-time high. The recovery in foreign portfolio inflows to EM bond and equity markets has also helped. Higher FX reserves provide a cushion to the ASEAN central banks as the Fed normalizes its policy.

### Most central banks to remain on hold

ASEAN central banks have turned more positive on growth and more vigilant on inflation. Looking through headline inflation base effects, core inflation has significantly picked up in the Philippines and Malaysia. We estimate that the output gap is marginally positive in the former and closing in the latter. Over the coming 12 months we expect a rate hike in the Philippines and a move towards hawkish rhetoric in Malaysia. The other central banks in the region will likely stay on hold.

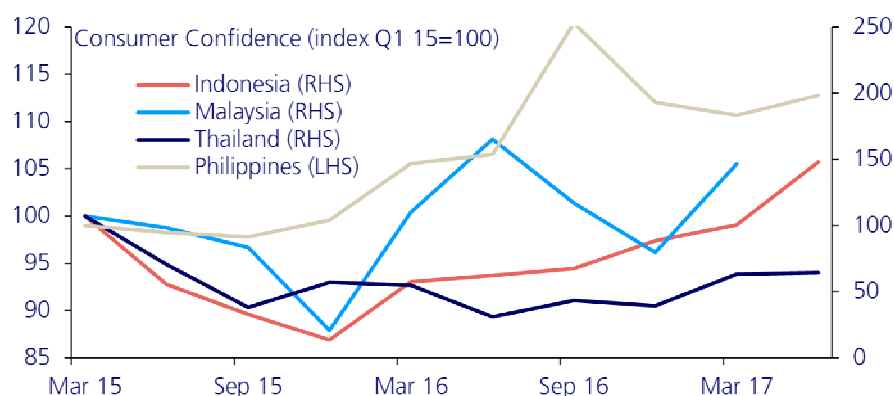
### Neutral financial conditions for fixed income

Abundant liquidity, a weaker dollar, and contained G3 bond yields have played in favour of Asian fixed income assets. In the year to come, liquidity conditions should remain benign for high-yielders such as Indonesian sovereigns. Low-yielders could be more challenged if the Fed proceeds with its hiking schedule in 2018 (which is not yet priced in by the market). We think that, absent short-term fluctuations, the DXY has rolled over, though. This should help, as should solid demand from China.

### More tailwinds for Asian equities

Asian equities will continue benefitting from attractive valuations compared to historical average valuations, and the valuations of developed markets. Global funds have raised their exposure to EM Asia but remain under the benchmark's weights. To these supportive conditions, we add fundamental drivers: earnings growth for EM Asia equities

## ASEAN consumers are growing more confident



Source: Thomson Reuters Datastream, Bloomberg (Q2 17 cut as of May 17 except for Malaysia where n/a)

bottomed in Q1 after years of weak performance. Better forecasts are being confirmed by actual improvements in trailing earnings and RoEs. RoE increases are being driven by a healthy combination of better operating margins, higher asset turnover, and lower leverage. Among ASEAN equity markets, we like Singapore where earnings are bottoming and where valuations remain cheap. Malaysia should benefit further from stronger economic growth. In Indonesia, earnings growth is healthy, but positioning is heavy. A positive catalyst, probably a pickup in infrastructure spending, would help. Indian earnings have been impacted by the demonetization shock and by the ongoing drag of non-performing assets (NPAs), leading to expensive valuations. The economy should rebound in H2 and earnings should follow by the end of the year and into next year.

### India is on track for a solid rebound in H2

The demonetization operation knocked a few decimals off Q1 GDP growth, but high-frequency indicators are already pointing toward a sharp recovery in both rural and urban demand. Demonetization has pushed lending rates lower, which is likely to boost consumer lending. India is also reaping the benefits of its consistent fiscal focus on pro-rural and social spending. The BJP has gained political clout following its landslide victory in Uttar Pradesh, and reforms have sustained a good rhythm. The government has recently issued an ordinance that authorises the RBI to initiate and manage insolvency processes and recapitalize banks. If the bill is approved by the Senate this summer, it will represent a major step forward, as NPAs have long stood in the way of private investment. We applaud these reforms, but remain cautious on their execution. Looking forward, reforms are yet to be passed, especially to tackle the structural downtrend in formal employment. Turning to monetary policy, the RBI's 4% CPI target seems achievable. Although we see a risk of one more rate cut this summer, this is not our base case. Credit has already

cheaped, and NPAs, not high rates, are the main obstacle to loan growth.

### Indonesia should shake off Q1 weakness

Following a busy 2016 marked by the push for structural reforms and by a jump up of 15 places in the last Ease of Doing Business survey, 2017 seems to have started on a softer tone. Yet, the government has been focusing on the implementation phase of reforms: like capitalizing on the tax amnesty success and increasing the efficiency of the collection processes. The initial data are promising: tax revenues are up 16% YoY in Q1 (vs. -12% in Q4 16). Infrastructure spending, the other priority of the administration, should gain traction this year following a weak Q1. We also see confidence recovering, which augurs well for consumption. Loan growth has failed to accelerate, though. We think that some progress on NPA regulation this year should help. We see Indonesia continuing to attract FDIs from Japan and China, thanks to the large potential of its domestic market. Political risks remain acute following Jakarta's election, but we do not expect the upcoming gubernatorial elections to derail reforms. Indeed, President Jokowi still benefits from strong popular and political support.

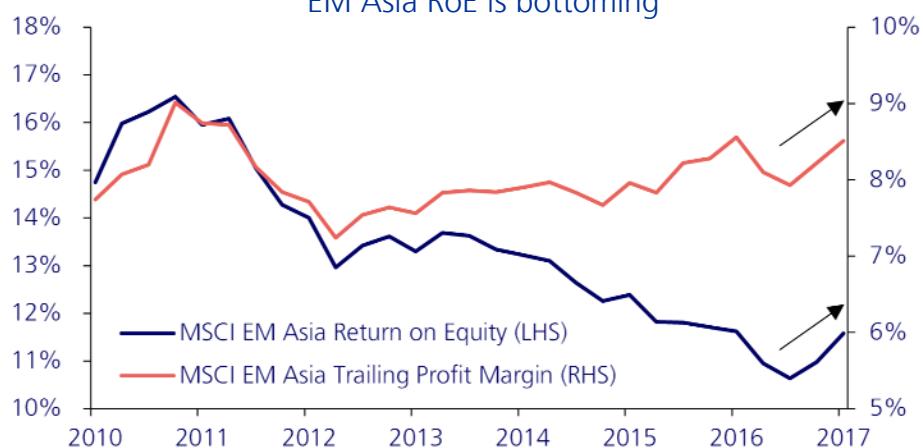
## Malaysia: On a cyclical upswing

Malaysia is experiencing a strong cyclical rebound in commodities (palm oil, LNG) and electronics exports. Those have boosted fiscal revenues, farm incomes, and manufacturing employment. As discussed earlier, we think that this momentum has further to go, mainly on the manufacturing front. Our confidence in growth sustainability mostly relies on the positive turn that we are witnessing in domestic demand. First, consumption growth is accelerating and household balance sheets are deleveraging. Second, spending on infrastructure is gaining traction, and ~MYR 400bn (~30% of GDP) of infrastructure projects are in the pipeline for the next ten years. Funding from China will probably increase. On the FX side, the recent liberalization of onshore hedging should help the MYR retrace its post-US election losses. FX reserves have also moved up, but more upside is needed to improve the external debt coverage. On the political front, the next general election will probably be called soon, and Prime Minister Najib is well positioned to win another mandate.

### Singapore, the Philippines, and Thailand

Singapore's economy is highly exposed to cyclical growth, which, in our base case, should continue. The city-state's households are struggling with a weakening labour market, though. A positive shock could, in our view, come from further alleviation of mortgage rules. The Philippines will likely retain its status as the star economy in ASEAN as domestic demand shows no sign of faltering. President Duterte's approval ratings are high, despite some controversial policies. The government is focused on helping the more modest households, which is positive for growth. In Thailand, the royal succession has run smoothly, but political tensions could resurface when the general election is called sometime in 2018. We remain cautious in our outlook, but acknowledge the progress realized on infrastructure spending, as well as the recovery in consumer confidence.

## EM Asia RoE is bottoming



Source: Bloomberg

# Australia

## Outlook

- Mining prices and terms of trade are unlikely to maintain the high levels seen in H1 2017
- Residential price growth is moderating as macro-prudential regulations start to bite
- Business investment, including mining investment, and wage growth are recovering nonetheless

## Implications

- Modest supply of sovereign bonds and weak inflationary forces should keep a lid on yields
- Lower terms of trade and a smaller differential with US rates should put a cap on the AUD
- Earnings growth is likely to moderate towards the end of the year and into next

## Risks

- Wage growth fails to rebound, squeezing household income further
- Property markets cool faster than expected
- China commits a policy mistake in deleveraging

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### Less iron ore demand from China

Iron ore prices have surged since 2016 before coming down sharply a few months ago, and Chinese inventories have been filling up. Because resources account for 65% of Australia's exports, the recent rise in commodity prices has boosted terms of trade and national income. At ~30%, iron ore constitutes the lion's share of resource exports, before metallurgical coal (~15%), and LNG (~10%). We have turned less positive on iron ore as the drivers that triggered higher prices seem to be fading. China, which accounts for more than 60% of global iron ore imports, has refilled its inventories. Additionally, China's domestic investments in infrastructure and real estate are unlikely to accelerate in 2018, which should put a lid on the imports of iron ore. We have identified several upside risks for iron ore prices though. China remains committed to cutting domestic supply and is unlikely to tighten monetary policy to the point of triggering a sharp slowdown in its economy. Also, we see fiscal investment rebounding in ASEAN, where governments are undertaking multi-year infrastructure projects.

### Mining capex is stabilising

As for coal, Cyclone Debbie is likely to reduce export volumes by ~10% in 2017. Prices should come down progressively as new contracts are signed. The prospects for LNG shipments are good: Australia is ramping up LNG production to reach 20% of global capacity. LNG prices track oil prices with a lag and should therefore erode slightly in the coming months. We see a slightly positive trade balance for Australia in 2017 and H1

2018, given the outlook for commodity exports.

In Q1, mining capex registered its first gain in three years. Exploration expenses from the mining companies have also ticked up. It is too early to conclude that we are witnessing the beginning of a mining investment upcycle. The fact that metal prices have rolled over does not support this scenario, but we will nevertheless be watching future investment data to determine whether the trend is sustained.

### Stronger business and infrastructure investment

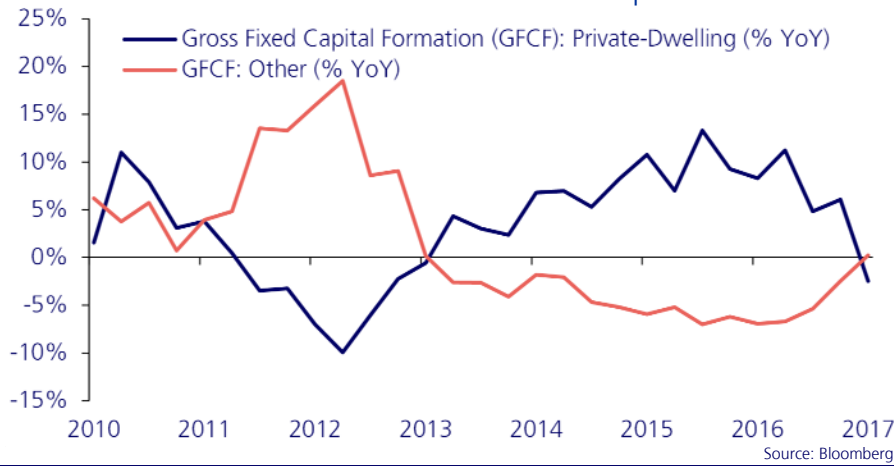
The services economy accounts for 70% of Australia's GDP, dwarfing the mining sector. Growth in services exports has been solid and is expected to strengthen further. Indeed, Australia possesses the skills and resources needed to address the booming structural demand for health, education, and tourism services. The demand from China should grow further, despite the recent political noise around anti-immigration policies. In addition, investment intentions in the non-mining sector are on the rise. This tells us that we might be at a turning point for business investment. 2018 will also see an acceleration in infrastructure spending: from ~AUD 5bn in 2017 to ~10bn in 2018, for a total spending plan of ~75bn spread over the next ten years. Overall, business confidence is tracking at historically high levels, capacity utilization is edging up, and intentions to hire are on the rise. Hard data has lagged soft data, especially when it comes to employment, but we think that is about to change.

### The labour market is tightening

The unemployment rate has stagnated between 5.5% and 6% for years, but job creation has picked up speed recently. Full-time job growth is tracking at ~37k a month in 2017. Forward-looking indicators such as job openings and business sentiment are pointing towards further employment growth. We note that the mining states of Queensland and Western Australia, which have suffered from the highest unemployment rates in the country, are experiencing positive job growth again. If we link the rebound in employment in the mining states to the stabilization of mining investment, we can deduce that mining investment has troughed. It is too early to call for a mining upcycle, but the negative contribution of mining investment to economic growth has likely come to an end.

The labour market is gaining some strength, but why is wage growth not accelerating? We have identified three obstacles to faster wage growth. First, the recent increase in national income has been transferred to shareholders, not to employees. In Q1 corporate profits were 40% higher YoY, with mining profits up 113%, and non-mining profits up 17%. At the same time, wages and salaries rose by a meagre 0.9% YoY. Second, there remains plenty of slack in the labour market. The number of hours worked stands at a multi-year low, although it has been increasing recently. According to the ABS, 30% of part-time employees are underemployed. The third argument regarding stagnant wage growth is, in our view, that the recent economic improvements

## Non-residential investment to take up the baton



are taking time to translate into full-time job creation and into wage increases. We are likely to have seen the lows of wage growth, though: the recent 3.3% YoY increase in the minimum wage is encouraging. Besides, the business sentiment indicators relative to wages and employment are in expansionary territory. We caution that any pickup in wage growth would occur progressively, given the existing slack. The labour market is also facing a downside risk related to the cooling of the property market.

### Towards slower property price growth

Forward-looking indicators, such as the number of building approvals, are on a decreasing trend. Recently, housing price growth in Melbourne and Sydney, the two hottest segments in Australia's property market, has slightly slowed. However, housing market resilience has repeatedly surprised. In 2015–16 prices looked like they were rolling over, but rebounded strongly in H2 2016.

What is different this time? The surge in residential prices that occurred in H2 2016 was the result of further monetary easing by the central bank (RBA). Today, the central bank's strategy has changed: its primary concern has shifted to containing the level of household debt, which is approaching ~190% of household disposable income. More policy rate cuts appear unlikely.

Additionally, a new round of tightening measures for mortgages will probably impact the residential market. The share of new loans that a bank can dedicate to interest-only mortgages is now limited to 30% of total new loans. Currently, the big Australian banks have allocated ~40% of their mortgage book to interest-only loans. The federal budget has also adopted a punitive stance towards foreign speculative investment in Australian real estate. More measures regarding additional capital to be posted by banks against mortgages are also

in the making. The most constraining factor for real estate investment is, in our view, the recent increase in variable mortgage rates. YTD, the four main Australian banks have hiked investor mortgages by ~25bps and the interest-only share of owner-occupied loans by ~18bps. For Australian households holding a mortgage, this is equivalent to a rate hike of 12-15bps. Based on sensitivity computations by the RBA, we estimate that a 12-15bps mortgage rate hike could shave 5bps off consumption growth.

We should refrain from excessive pessimism though. Residential prices are growing and demand is still very strong, especially in Sydney and Melbourne (although the growth of Chinese demand is showing signs of decelerating). We do not see prices collapsing, but rather growth decelerating. On the prudential side, we must highlight that households, which hold mortgages, also have high levels of cash balances in offset accounts which are equivalent to ~2½ years of scheduled repayments. The capital ratios of large banks have also been boosted to comply with international regulatory standards. When it comes to the housing market, the main risk is economic, not prudential.

## Bringing it altogether

To summarise, we see the contribution of residential investments to growth fading, but being replaced by business investment. The RBA is unlikely to cut rates further, but the current level of interest rates (outside of mortgage rates) will stay low if, as we predict, the RBA stands pat. The consumer is in a challenging position, and faces the negative effects of tighter mortgage rates and higher cost-push inflation. It is critical that wage growth rebounds, and we think this will be the case.

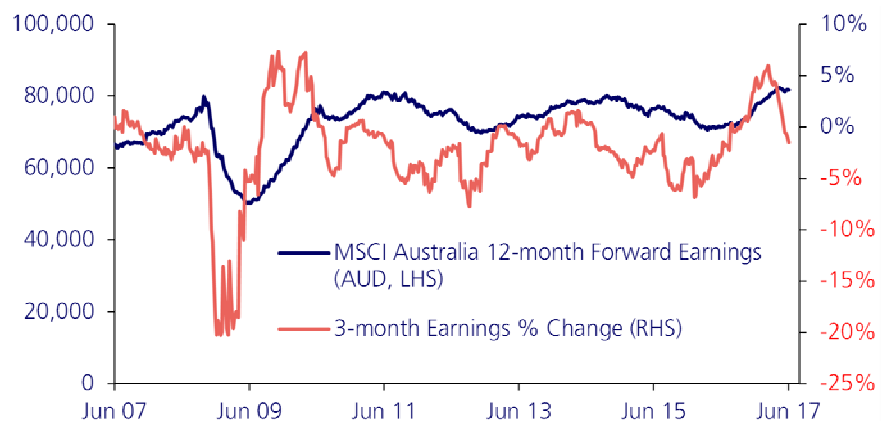
## Our view of financial markets

Looking at Australian sovereign bonds, the smaller supply in 2017–18 should contain yields. An upside surprise could come from a sudden surge in economic growth and inflation, if, for example, investment rebounds strongly and the labour market tightens faster than expected.

The AUD should experience several headwinds: a diminishing interest rate differential with the US and unexciting prospects for base metal prices. We do not see much downside for the AUD, though, given that the factors cited above have already been partially priced in.

We are turning more cautious on equities. The large turnaround in mining margins is already behind us, and, given the current level of commodity prices, there is little upside left. A positive surprise would come from a potential acceleration in global fiscal policy, which would generate stronger demand for Australian mining exports. Apart from materials (~15%), financial stocks have a large share in the MSCI Australia index (~42%). The following headwinds will likely weigh on the profitability of the main Australian banks: a new levy of 6bps on banks liabilities and stricter regulatory frameworks around mortgage lending. This justifies our moderate expectations on earnings growth for the MSCI Australia.

## Earnings upgrades have stalled



## Outlook

- The region returns to growth, but it is vulnerable ahead of a heavy political agenda
- Mexico's fiscal and monetary tightening will impede growth
- Chile is at the crossroads after years of sluggish economic growth

## Implications

- NAFTA renegotiation will be critical for Mexico in the midst of a slowing economy
- The Chilean economy needs a positive shock from the November presidential elections
- Argentina's economy is likely to bounce ahead of the important mid-term elections

## Risks

- For Mexico, a less beneficial NAFTA renegotiation proposed by the new US administration
- For Argentina, failure of the ruling party to win the elections
- For the region, growth requires structural reforms and better political choices

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### Mexico: Much ado about nothing?

Following US President Donald Trump's victory, the US economy has been characterised by a big boost in confidence indices, but lacklustre hard economic data. In Mexico, we witnessed exactly the opposite, with a dramatic plunge in confidence indices while hard economic data demonstrated amazing resilience despite the US trade rhetoric.

Still, we expect the economy to lose some of its dynamism, as it has to face the combination of restrictive fiscal policy and monetary tightening to anchor inflation expectations. We remain cautious and project growth of 1.7% in GDP for 2017, with a better pace the following year.

Faced with a potential rating downgrade, the government is tightening the fiscal belt by cutting spending, with the goal of generating a primary fiscal surplus for the first time in a decade. We believe that the current credit rating will be maintained, but it should be kept under scrutiny in light of the upcoming presidential election that could impact fiscal spending.

The central bank has more than doubled its reference rate since December 2015 to counteract the currency weakness. Inflation is now the highest in the region due to the combination of energy price liberalisation and the currency pass-through effect. Still, the currency has recouped all its post US elections losses thanks to Banxico's swap program, as well as a higher reference rate that makes shorting a more expensive proposition. We

think that inflation is about to peak and should err towards the 5% mark by the end of the year. The central bank is apparently done with its hiking campaign, with its reference rate at 7% and a clear statement that this level is consistent with a convergence of inflation towards 3%. Still, Banxico will remain vigilant and stay put before embarking in the easing direction, mainly to preserve the stabilisation of inflation expectations and because of political volatility in coming months, as well as a Fed that is not finished in hiking rates.

Domestic demand has been brisk thanks to a strong labour market, booming remittances in local currency terms, and a decent credit impulse. Still, the service economy should cool off and we are witnessing a rebalancing towards manufacturing. The non-oil trade surplus keeps climbing and fears about US trade policy have dissipated somewhat, at least for now.

The NAFTA discussions will be initiated in August and should give a better picture of the potential impact it could have on the structure of the economy. We think that common sense will prevail but concessions will have to be made. The risk is that the failure to pass domestic reforms in the US could trigger a more aggressive tone towards external factors that negatively impact the US economy.

Gubernatorial elections were won by the incumbent party, but it was also a prelude to an open race for the 2018 presidential election that could see rising political risk and a move away from pro-business parties. We

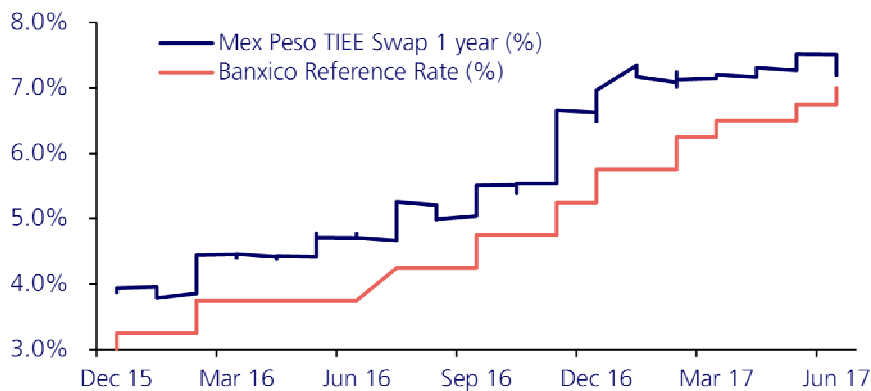
believe that this might be the most underappreciated risk for Mexico as Lopez Obrador and his new party challenged the PRI with a tight race in the important contest for Mexico City. July 2018 is not far away and it appears that it will be a quite open race as of now.

### The Andean region: Economies have bottomed, but growth will be lacklustre while monetary easing is making up for restrictive fiscal policies

Chile has been stuck in a slow growth channel over the past few years due to widespread pessimism and dissatisfaction with the reform agenda. We believe that the country is at a crossroads and that an improvement is overdue based on the better political prospects of the upcoming presidential election in November. At this stage, the race is quite open but the primaries in July will give a better picture of the candidate's chances.

Impacted by a long strike at Chile's largest copper mine and forest fires, the economy barely avoided a contraction in the first quarter. Growth will be stuck below 2% again in 2017, which remains a far cry from the above 4% average growth rate of the last ten years. Inflation has declined below the 3% mark for the first time in three years, and the central bank has frontloaded its rate cuts ahead of the elections to reignite growth. The monetary authority stated that its reference rate will remain low for longer and that monetary policy is now a quite expansive one with negative real rates. It is not a luxury, however, considering that the economy had

## Banxico anchored inflation expectations



Source: Bloomberg

its weakest GDP print since 2009 and there is fiscal contraction as the government reigns in real public spending to 2.7% in real terms, which is the lowest level since 2003.

The Peruvian economy has surprisingly fallen from its perch, with economic activity contracting for the first time since 2009. A bribery scandal and a strong El Niño have damaged the economy and a fiscal stimulus package has been put in place. The central bank recently joined the trend of monetary easing as inflation receded. Serial resignations in the government are putting the reform agenda at risk.

In Colombia, the economic adjustment is also behind us, but at a cost as the economy had also its lowest GDP print since 2009. Lower taxes should allow the economy to bounce in the second part of the year and aggressive rate cuts by the central bank will also play its part in a modest recovery.

In Venezuela, the economic depression has taken a turn for the worse and the daily reality resembles a civil war due to a political impasse. FX reserves have dwindled and a credit event is a real possibility over the next twelve months. Eventually, great opportunities will arise as we get closer to the end-game, with a positive resolution, but there is no visibility regarding the timing of it.

### Argentina: An orchestrated economic bounce to gain political clout

High expectations have made way for more realism as the transition to a new policy framework faces obstacles and won't happen overnight. The economy is recovering and we expect a gradual bounce towards 3% ahead of the mid-term elections in October. Clearly the fiscal adjustment has been softened and pushed out to 2018, while monetary easing has been put on hold, with temporary rate hikes to anchor inflation expectations. We expect inflation to overshoot the 17% target and end the year at around 22%. The central

bank should ease again in the second part of 2017. The currency has become expensive, but it has helped to reduce inflation. The central bank announced its objective to build up FX reserves towards 15% of GDP over the next two years.

Argentina is certainly back on the stage in terms of market representativeness with debt issues raising its profile in the bond markets, despite the fact that the graduation towards emerging markets status was not granted.

The upcoming elections will be key for the government and it should benefit from a fragmentation of the opposition, but we expect the results to be a ratification of the 2015 election.

### Growth is back in the region, but it is far from robust and has a heavy political agenda ahead

The main message from Latin America, including Brazil, is that the economies have turned the corner and will finally deliver positive growth, albeit muted. In 2018, growth should accelerate further. Disinflationary pressures will persist in the second part of the year, allowing monetary easing to compensate for a more restrictive fiscal stance in 2017.

The regional cyclical improvement is welcome, but its sustainability is questionable beyond 2018 due to a heavy political calendar that will dictate the reforms. The election agenda is heavy with elections taking place in all countries throughout the region in the coming months, starting with the legislature in Argentina in October and then the presidential election in Chile in November. This will be followed in 2018 by elections in Colombia in March and May, then the Mexican presidential election in July, and will culminate with legislative elections in Peru and a presidential election in Brazil in October 2018.

Latin America will remain a relevant contributor to the delta of global growth for 2017, but it remains a modest expansion. It is a bit of a concern considering the current synchronised global recovery and indicates how relevant the domestic political decisions to cement a sustainable growth path have become.

## Chile in the doldrums and flirted with recession



Source: Bloomberg

# Brazil

## Outlook

- Recovery is underway, but reform is slow as political roadblocks still abound
- The inflation outlook remains benign as there is a great deal of slack in the economy
- Political instability is here to stay ahead of the October 2018 elections

## Implications

- Constraints on consumption will prevent a sharp rebound in economic growth
- Credible inflation fighting by the Central Bank is now allowing further rate cuts
- International investors are likely to remain cautious given the political risks

## Risks

- Renewed political turbulence could derail the incipient economic recovery
- Fiscal sustainability concerns could re-emerge if the reform process is postponed
- The economic recovery could disappoint and plateau below 1% for an extended period

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### **Green shoots abound and the economy has turned the corner but at a tortoise pace**

Green shoots abound with the first quarter marking an inflection point. Recovery is underway, but it will remain fragile and prone to shocks. After a severe recession and a loss of close to 10% of GDP over the past three years, a strong recovery cannot be expected due to the numerous structural issues that need to be resolved.

Confidence indices have improved markedly and the PMI composite crossed the line of expansion for two months in a row, which has not occurred since early 2015. Retail sales seem to have found a bottom, with the first rise on a yearly basis in two years.

Rising unemployment should peak in the second quarter of 2017, but job creation is now back in positive territory. Consumption will remain weak due to a combination of a poor labour market, lack of credit availability and the deleveraging process. Still, the lower inflation rate should be good news for the consumer and could allow wages to be positive in real terms.

Investment pickup will be key and the negative output gap will offer strong operating leverage to companies. The high level of idle capacity should allow the economy to grow with minimal inflationary pressures. The inventory cycle should also be helped by a positive contribution from exports, with the commodity complex having stabilised.

The external adjustment is complete as imports have collapsed and terms of trade have improved. The current account deficit should remain around 1% of GDP and FDI is cruising at around 4% of GDP. This should keep the currency stable, which is also a positive on the inflation front.

Monetary policy easing is certainly welcomed but it has to be considered in the context of a necessary fiscal tightening, which is a common theme across the region. There is a structural need to adjust fiscal issues and a cyclical need to give oxygen to the economy through rate cuts. Despite the political noise and the subsequent delay and dilution of the social and pension reforms, the fiscal spending cap remains an important anchor on the expenditures front. Still, the long-term degradation of fiscal metrics has not been addressed and this will make Brazilian assets prone to bouts of volatility if reforms are impacted and delayed.

We are more positive on the growth front than consensus due to the high levels of slack and operating leverage that should benefit from aggressive monetary easing. We are expecting 0.9% GDP growth in 2017 mainly through the rebuilding of inventories, while consensus is hovering at 0.4%. We are cognizant that the risk of a relapse into recession is real as uncertainty around reforms could mute investment growth.

### **Strong and entrenched disinflation will allow the central bank to stay aggressive in its monetary easing campaign**

Inflation has collapsed, reaching a decade low

of 3.6%, which is way below the central bank target. The central bank target of 4.5% has not been reached since 2010 and was breached on the downside. It has allowed the central bank to keep cutting its reference rate aggressively both in size and speed. The currency is not a concern anymore as the balance of payments is healthy and backed up by strong FDI. Additionally, the BRL is navigating in fair value territory and still benefits from a decent carry cushion.

We expect the economic rebound to be non-inflationary, with operating leverage due to a deep negative output gap that reaches close to 3% of GDP. This should be a comfortable situation for the central bank to cut interest rate despite the political noise and the risk that reforms could be diluted or simply postponed indefinitely. We project that the inflation rate should end 2017 below the central bank target of 4.5%, which is less sanguine than the consensus standing at 3.6%.

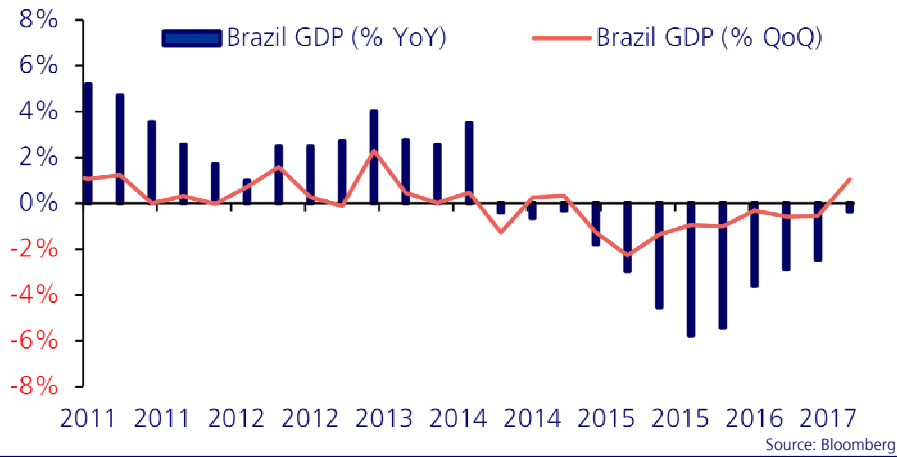
We expect the reference rate to reach 8.75% by the end of the year, which will amount to a 500bps cut from the end of 2016.

### **The political arena will remain key to watch ahead of the presidential election in 2018**

The risk of President Temer also being impeached triggered a sharp sell-off in all Brazilian asset classes, with the currency suffering its worst daily depreciation since the floating of the currency. Despite the fact that reforms are delayed and potentially diluted, one should remember that the cap on fiscal



## The worst is over for the Brazilian economy



spending was passed and is a safeguard against a further deterioration of the deficit. So far we can say that the political uncertainty is changing the speed but not the direction of the fiscal adjustment.

be held in 2018 and the window of opportunity to implement crucial social and fiscal reforms is shrinking, which will expose macro vulnerabilities once the election nears.

If the president is ultimately impeached, it will require a fast election by the members of the legislature, given there is currently no vice president to take over the reign. Although it is not our base case, there is a real probability that it could occur. Either way, the damage is done as some members of the coalition have left and the timing of next year's elections might be earlier than expected. Clearly, the population has had enough and that might render the political chessboard quite open for the 2018 presidential elections.

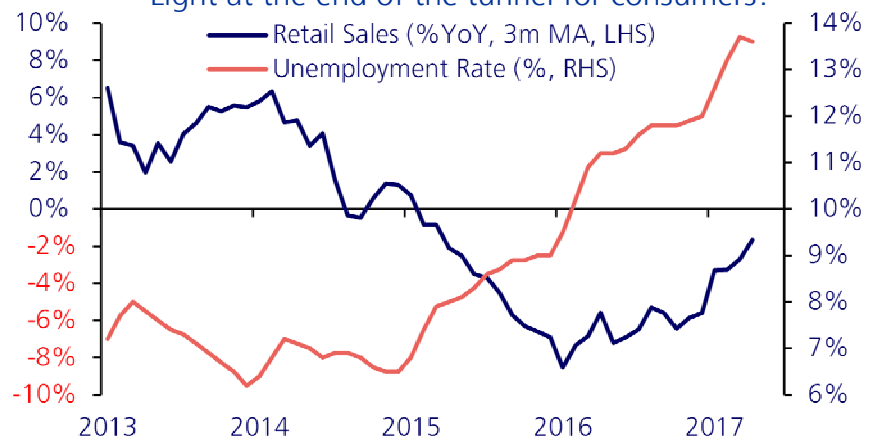
### Assessment: coming from a low base, the economic recovery is on its way, but it will unfold at a slow pace

Lower inflation and the return to positive growth are welcomed developments in Brazil after a long and deep recession. Monetary loosening is the fuel of the economic growth, and the central bank has largely regained its credibility, which should allow it to remain aggressive in its monetary easing campaign as the output gap remains large. Despite a strong bounce of 4% from the bottom, GDP growth will remain below the 1% level as renewed political uncertainty will dent the recent bounce in optimism.

The equity market is trading at a P/E of 11 and a price-to-book of 1.5, with a decent earnings recovery. The problem, however, is that investors will be reluctant to commit funds given the political risks that have re-emerged. The fixed income market will remain attractive in the current environment, while the currency should remain stable to slightly depreciating.

The political situation remains fragile and the reform agenda vulnerable to the resurgence of political turmoil. Presidential elections will

## Light at the end of the tunnel for consumers?



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