CITY OF LONDON
Investment Management Company Limited

Developed Markets Quarterly Outlook

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Overview

World Economy: Peaking or Escaping?

As the 'secular stagnation' narrative has given way to the 'reflation' narrative as the dominant market theme this year, the question arises whether the fairly synchronised upswing that has taken place since mid-2016 represents a mere cyclical peak or whether the global economy has achieved 'escape velocity' and entered a self-sustaining path. The latter is highly pertinent for the appropriate stance of monetary policy and thus the outlook for risk assets.

The global economy has experienced an uptrend in both developed and emerging markets during the past three quarters. In particular, the credit stimulus engineered by Chinese policymakers helped support domestic growth and, with that, contributed meaningfully to global growth. During Q1, Chinese growth perked up to 6.9% yoy as a result, whereas US growth went through a soft patch with a mere 0.7% qoq saar gain. The Eurozone clocked a strong 1.8% yoy expansion. Still within a context of overall strong growth, the situation has since reversed once again, with China seen as decelerating on the back of the recent implementation of credit restrictions, while the US economy is expected to rebound to near 3% in Q2, with subdued inflation.

These developments have brought the extraordinarily accommodative monetary policies of the Fed and the ECB into increased focus. While the Fed has now hiked interest rates three times from the low and expects to implement another two hikes this year, attention has turned to the size of its balance sheet and the prospect for unwinding part of its $4.5 trn size. At the same time, the ECB continues to purchase assets, albeit at a diminishing pace. Its members too are eyeing higher interest rates and debating whether rates should emerge from negative territory before QE ends. If activity is not well enough entrenched, such policy moves could derail the recovery and with it the market rally.

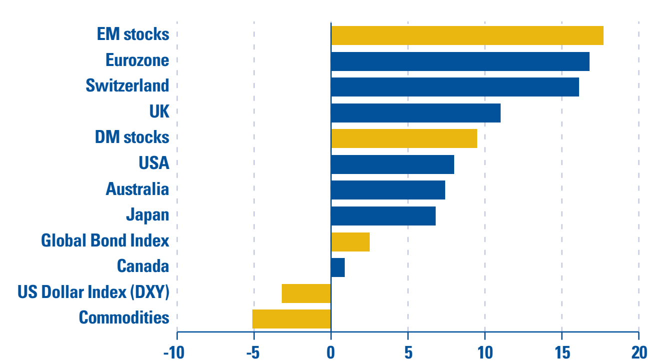
Market participants fear that even in the best of cases, any balance sheet unwind could be detrimental to the market outlook. After all, a recent Fed study estimated that the effect of the entire QE program was to reduce 10-year bond yields by some 120 bps, among other effects. Could the bond market thus be at risk of a large rout? That remains unlikely. For one, the scale of the balance sheet reduction is not going to be as sharp as its build-up and the Fed is likely to end with a balance sheet permanently larger than before the crisis. Second, markets have long anticipated the eventual unwind of the QE program, unlike its start. What is more, the wind-down is sure to be much more gradual, as the balance sheet declines at the rate at which its securities mature, at most. Only the timing of the start of the process is uncertain at this stage. Third, with both interest rates and the size of its balance sheet, the Fed has two policy tools at its disposal. It can use its rate tool to counteract any adverse effect the balance sheet reduction may have. Monetary conditions will be determined by the combination of rates and balance sheet size. Finally, changes in the monetary stance will only be undertaken to the extent that the recovery permits them and the Fed will likely continue to remain deliberately "behind the curve".

To be sure, there are risks and challenges to the global outlook. The recent turn south in commodity prices is one, in particular if it were to continue further. In China, higher funding rates and tighter regulations in the lending and housing sectors could yet mean that the government is overtightening and throttling growth. In the US, the increasing political realism that meets the plans and proposals of the Trump administration risks deterring domestic capital expenditure. Already, the divergence in trends between buoyant 'soft' (survey) and more modest 'hard' (actual production) data is being resolved in favour of the latter. At the same time, strong employment figures still contrast with modest GDP growth - worrisome given the still-low level of interest rates. And finally record high stock prices and high political uncertainty are difficult to reconcile with VIX volatility readings below 10%, the lowest since 1993 (which incidentally, preceded a sharp run in inflation, 325bps worth of Fed hikes and a bond market sell-off)

Market Strategy

There are no significant signs that the global economy risks entering a recession in the near term. The US stockmarket stalled during the past quarter and the USD lost 1.2% in trade-weighted terms. But the economy remains on a cyclical upswing, even if potential growth has been lowered. We retain a small *overweight* to the US and also upgrade the Eurozone to *overweight*, where political obstacles have largely been cleared for the moment and where the recovery is gathering pace. Our key *underweights* remain the UK - on a Brexit-induced slowdown - and Japan, where the recovery remains agonisingly slow.

Chart 1: 2017 YTD Performance, %*



Source: Bloomberg

**All country stock indices are subcomponents of the MSCI All Country World index. Global Bond Index is represented by the J. P. Morgan Global Aggregate Index. Commodities is represented by the Thomson Reuters/Core Commodity index.*

United States

Overweight

Politics remain a high-tension affair but the economy continues its stuttering recovery and the Fed continues its 'rate normalisation'.

After President Trump's first 100 days in office ended without any significant legislative achievement, the Republican party voted 217-213 in favour of a bill that will eradicate large parts of the healthcare reforms enacted by President Obama if approved by the Senate. While the CBO was not given enough time to assess the full effects of the bill before the vote on the floor, one of its provisions would allow states to opt out of covering pre-existing conditions and of providing treatments that were listed as "essential" (e.g. pregnancy, emergency services etc.) in the Affordable Care Act. Members of Congress and their aides would not be affected by the ban under the new bill. What is more, the bill makes big cuts in Medicaid, the program providing health care to the poor. Obamacare expanded Medicaid (and Chip, the children's version of the program), and imposed a tax of 3.8% on the investment incomes of wealthy households and a 0.9% surtax on their ordinary incomes. The House bill eliminates the Obamacare taxes and reverses the Medicaid expansion, potentially excluding 14 million Americans from coverage. The effective tax cut on the wealthy is estimated to result in lost tax revenues of $800-900 bn over a decade but is likely to get stuck at some stage in the legislative process (beginning with the Senate, where Republicans control only 52 of 100 seats). The effective introduction of regressive taxation could cost the Republican Party support in the 2018 midterm elections.

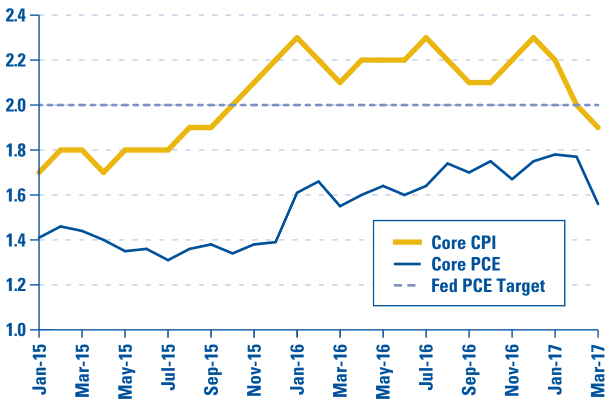
Failure to reform healthcare and free funds has held up the planned tax reforms which Republicans traditionally like to be revenue-neutral over 10 years. Nevertheless, President Trump presented a one-page tax proposal in late April, which was a reprise of the ideas floated earlier. The core of the proposal consists in a reduction of the corporate tax from 35% to 15%. Unlike the Ryan Plan though, which foresaw a reduction to 20% funded by a Border Adjustment Tax, this tax cut is not funded and expected to 'pay for itself' via higher growth. Second, the plan targets the repatriation of the $1.2 trn held abroad by companies by offering a one-time 10% levy. As a nod to the middle class, the plan envisages a reduction in the top marginal tax from 39.6% to 35%, to reduce the number of tax brackets from seven to three and to double the tax-free deductible. But it also is generous to the wealthy with a repeal of the estate tax, an abolition of the Alternative Minimum Tax and the introduction of a Pass-Through Investment Income Tax of 15% which creates an incentive to turn personal income into investment income through the creation of limited liability companies. The Committee for Responsible Federal Budgeting estimated the corporate tax cut to cost $2.2 trn over ten years, out of a total cost of some $7 trn over the same period. In a return of the Reagan-time "Laffer theory", Republicans argue that the boost to growth from the "trickle-down" effect would increase tax collection, even at the lower rates. However, the Joint Committee on Taxation, which makes the relevant assessment for Congress, is likely to take a more conservative view on the growth effect (if any) and it remains far from clear that the proposal would pass in Congress, let alone in the Senate, where it would require near unanimity by the Republicans, given their slim majority.

In early May, Congress agreed a budget for the period up to end-September which saw off many of Trump's signature demands. However, this is likely a tactical retreat only while Republicans focus on healthcare and tax reform plans. A bigger confrontation between parties could yet ensue in October when some key issues such as defence and the border wall may be raised again. As it stands, the interim appropriations increase defence spending by $15 bn (compared to $30 bn demanded by the administration) as well as border security by $1.5 bn, although the funds cannot be used for border wall construction. Conversely, medical research, the departments of Energy and Science, the endowments for Arts and for Humanities as well as the National Parks received funding increases. The EPA did not experience drastic cuts, keeping the overall budget in line with that of the previous administration. Fall negotiations could become more contentious though as President Trump is looking for a $54 bn increase in defence spending as well as cuts elsewhere. Not all Republicans are likely to endorse a widening of the deficit and Democrats thus retain leverage in both the House and the Senate.

Meanwhile, the economy disappointed during Q1, with GDP growth recording a mere 0.7% qoq saar on the back of soft consumption (fixed investment was solid and residential investment strong). While this outcome may embody some residual seasonality, it defied the improvement in the data flow, in particular the widely followed surprise indices. Indeed, the outcome came closer to the Atlanta Fed's Nowcast of 0.2% for the quarter than to that of the NY Fed of 2.7%. The difference reflects the fact that the NY Fed forecast includes 'soft' survey data in its analysis, whereas the Atlanta Fed's GDPNow relies on actual production and sales figures only ('hard data'). In other words, heightened expectations that the new administration's policies would meaningfully boost growth have not yet materialised and are vulnerable to a reversal. Some of the factors underlying the Q1 deceleration are likely to be transient, whereas the underlying improvement in labour markets has been persistent, with the latest April non-farm payroll figure clocking 211K (following a weaker 79K in March) and unemployment dipping to a surprising 4.4%. GDP is expected at 2.5-3.0% in Q2 and at an average 2% for the year.

The Employment Cost Index increased 0.8% qoq in Q1, equivalent to 2.4% yoy and finally showing some signs of growth (confirmed by average hourly earnings growth at 2.5% yoy). CPI declined 0.3% mom in March, leading to a drop in the headline rate from 2.7% yoy in February to 2.4% yoy. More importantly, the Core measure fell 0.1% mom in March (the largest such drop since 1982), dragging headline growth to 2.0% yoy, from 2.2-2.3% yoy the months prior. This also resulted in a weakening Core PCE measure, which slowed from 1.8% yoy to 1.6% in March.

Chart 2: US Inflation, % yoy



Source: Bloomberg

Nevertheless, the Fed raised interest rates for the third time in March, lifting them 25bps as expected to 0.75-1.0%. While Fed forecasts point to two additional rate hikes in 2017 (with the next expected in June), markets do not yet fully price this in. But as the policy rate approaches the levels at which the Fed would regard rate normalisation to be "well under way" (understood to be between 1.0% and 1.5%) markets are beginning to speculate about the start of balance sheet normalisation. Assuming a "normal" level of bank reserves of $100 bn, $300 bn in government deposits and currency growth in line with nominal GDP growth starting at the current $1.5 trn, Fed staff recently estimated that the balance sheet could shrink from its current $4.5 trn to $2.5 trn by 2025. Others, like ex-governor Ben Bernanke have argued that bank reserves should be maintained at about $1 trn, implying a steady state balance sheet size of $4 trn. However, former FOMC members (Warsh, Plosser) have warned that maintaining a large balance sheet risks dragging the Fed into conducting "fiscal policy in disguise". Besides the ultimate target size, many related questions emerge in this context, including the start and pace of the reduction, the mix of assets and maturities. Markets assume that the Fed will start off by tapering reinvestments of MBS in late 2017 or early 2018 but that the plan would be set this year, so as to bind the future governor and board, irrespective of its composition.

Market Strategy: US markets took a breather last quarter and performed broadly in line with the market. While the market P/E of 21.3 does not seem particularly high compared to the ACWI's 20.7, the cyclically-adjusted measure (CAPE) is close to 30, similar to the 1929 level and only surpassed during the 1999/2000 bubble. But earnings momentum has continued to improve and even in the face of greater political realism, the US economy is likely to continue to outperform its peers. We retain a small *overweight*.

Canada

Neutral

Economic data is surprising on the upside, but the Bank of Canada remains dovish amid muted inflation.

Canada's economic data has been surprising on the upside in recent months. Q4 GDP grew by an annualised 2.5% qoq against an expected 2.0%, driven by government and residential investment and household consumption. Consumer confidence has been rising since January and is now at its highest since August, while that of corporates has risen to its highest since November 2014. This augurs well for Q2 growth, with full year 2017 output projected to accelerate to 2.3% from 1.4% in 2016.

Despite robust activity, inflationary pressures remain muted. CPI rose by 1.6% yoy in March against 1.3% a year earlier, while core inflation (common measure) was 1.3%. Both are comfortably below the central bank's 2% inflation target. This backdrop supports the Bank of Canada's (BoC) view that a significant amount of slack remains in the economy. Moreover, labour market dynamics are not favourable for consumption, with real wages falling yoy since the start of 2017 and nominal wages rising (1.1% yoy in March) at the slowest pace since 1998. This suggests minimal inflationary pressures for 2017 and maintenance of the BoC's dovish stance.

However, the BoC was more hawkish after it left its key policy rate unchanged at 0.5% at its April meeting. The Bank's GDP growth projection for this year was raised from 2.3% to 2.5% in its Monetary Policy Report and its estimate for potential GDP was reduced, thus bringing forward when it projects the output gap to close to 1H 2018. However, an overall dovish stance remains and, despite double-digit yoy house price rises over the past 10 months (13.5% yoy in March), Governor Poloz said the housing market was not yet a risk to financial stability.

The Q1 trade balance was C$1.1 bn down from C$6.7 bn in Q1 2016 and this is set to aid the improvement in external accounts. Canada's current account deficit is forecast to shrink from -3.3% of GDP to -2.5% this year. Meanwhile while the Canadian dollar has weakened in recent months it remains 10% above its January 2016 trough. This is hampering competitiveness somewhat and is reflected in contracting non-commodity exports, posing a downside risk to external accounts this year.

Market Strategy: Given policy divergence with the Fed, we expect the Canadian dollar to weigh on US dollar returns and this in our view outweighs good fundamentals (e.g. earnings are being revised up, the market's dividend yield exceeds that of DM). We keep our *neutral* weight.

Switzerland

Neutral

The improved economic backdrop and return of inflation could lead to reduced monetary accommodation.

Economic conditions in Switzerland have improved to date. The KOF Leading Economic Indicator rose to 107.2 (a level of 100 is consistent with the long-term average), its highest level since 2013, and the KOF Business Situation indicator posted a broad based improvement to rise to 12.8 in March from 9.3 in December. Manufacturing PMI has also risen and remained convincingly in expansionary territory (above 50), at 57.4 in April. Retail sales expanded by 2.1% yoy in March, the fastest pace of growth since 2014 and accelerating from a 0.7% rise in February. This bodes well for H1 activity. GDP growth for full-year 2017 is forecast to rise to 1.5% and to 1.9% in 2018, from 1.3% in 2016.

The improved backdrop is reflected to some extent in the return of inflation. Headline CPI rose by 0.6% yoy in March, a five-year high and up from deflation of -0.9% a year earlier. Over the same period, core CPI rose from -0.5% yoy to 0.1%. Although inflationary pressures are minimal, the move away from deflation amid accelerating activity suggests that the Swiss National Bank's (SNB) ultra-loose policy stance could be tightened.

Switzerland continues to have a large current account surplus (10.8% of GDP in 2016). Recycling of this surplus has been insufficient to produce outflows to weaken the franc. Unhedged private capital outflows were only 1.5% of GDP in 2016, which is partly due to a poor yield pick-up in the Eurozone for Swiss investors. The SNB has intervened heavily in the currency market ytd. In Q1, it sold CHF 33bn, double the amount it sold after last June's Brexit vote. Recent intervention was partly aimed at countering safe haven flows caused by European election risk, but the Dutch and French elections avoided the adverse outcome and franc demand may now dissipate somewhat.

There are several reasons for the SNB to reduce its monetary accommodation and FX intervention including: 1) an improving domestic economic backdrop; 2) reduced political risk in Europe; 3) better prospects for the Euro Area economy and the potential end of ECB easing; 4) the SNB's large balance sheet (117% of GDP) and exposure to foreign assets (93% of the SNB's assets are foreign currency denominated) and 5) the risk of being labelled a 'currency manipulator' by the US.

Market Strategy: Switzerland's P/E is at a 12% premium to DM, above its long-term average of 8%. The improved economic backdrop is therefore somewhat priced in, so we stay *neutral*.

Eurozone

Overweight (↑)

Political risks recede, while the economy continues to recover, shifting the locus of the reflation narrative.

After several contenders in the French presidential election, failed to make it through the first round of voting, Emmanuel Macron, head of his newly created party "En Marche", achieved a decisive victory in the second round vote on May 6 with 66.1% of the vote, defeating far-right candidate Marine LePen of the Front National. The outcome came as a relief to markets as a Marine LePen, aside from illiberal and populist policies, had threatened to pursue France's exit from the EU. Macron is to be France's youngest-ever President at 39, has never held elected office before (he resigned as President Hollande's Minister for the Economy just a year ago) and ran his campaign on a strongly pro-European, centrist platform. The victory had been well discounted as French stockmarkets and the euro moved higher after the first round but gained little after the second round.

Yet, the key to Macron's ability to implement his reform plans will be the outcome of the parliamentary elections due in June. En Marche (now renamed "La Republique en Marche") does not currently hold any seats but polls suggest that it could win as many as 250-290 seats in the 577-strong parliament. However, without a majority in parliament Macron could see his policy plans frustrated. Polls indicate that 61% of voters did not want him to have an absolute majority. Indeed his election has as much to do with the rejection of LePen and many voters abstained or voted invalid in protest at their choice. The legislative election will be held on June 11, while every candidate who achieves at least 12.5% will automatically move into the run-off due on June 18 if no candidate achieves an outright majority. Periods of 'cohabitations' when the president does not have a majority backing in parliament and chooses a Prime Minister from the opposition occurred three times during the Fifth Republic: in 1986-1988 and 1993-1995 under Mitterrand and in 1997-2002 under Chirac). The most likely outcome is not a 'cohabitation' though, but the formation of a cross-party coalition across the centre. This would be an unprecedented political constellation and could imply a high degree of political uncertainty. For its part, the Front National, which currently has only two seats in the Assemblée, hopes to become the main opposition party, although that is unlikely.

Elsewhere in Europe, this leaves the German election in October 2017 and the Italian election by April 2018 on the horizon. While the poll standing of the AfD in Germany has been receding, the Five-Star movement in Italy remains strong and the banking system difficulties unresolved.

The euro area has been one on the bright spots in the global economy in Q1 as activity remained robust: GDP expanded by 0.5% qoq, equivalent to 1.8% annualised and 1.7% yoy (flash estimate). The 1.8% rate compares to just 0.7% in the US during the same period. The outturn extends the above-trend pace in place since mid-2013. Other indicators also point to robust activity: PMI readings were strong both across sectors in April (57.9 in manufacturing and 56.4 in services) and across countries. It should be noted though, that industrial production has not yet followed suit, contracting 0.3% mom in April, for 1.1% yoy increase. At the same time, consumer spending remained resilient, with retail sales inching up 0.3% mom in April (for a 1.1% qoq increase) even though real disposable income slowed as inflation picked up.

April in particular provided an upside surprise as Core inflation jumped to 1.2% yoy from the 0.7% yoy it had slid to in March. This was primarily driven by a rise in service inflation as goods price inflation remained stable. However, the timing of Easter likely affected the distribution of price increases relative to last year and the average of the two months appears closer in line with the 0.9% yoy recorded in February. This effect will likely fade in May and Core CPI settle around the 1% yoy mark, rising gradually through year-end. The headline rate mirrored these developments, rising to 1.9% yoy in April, after dipping to 1.5% in March, from 2.0% yoy in February. As the effect of the energy price rise fades, headline CPI is likely to converge with core inflation as the year progresses, to 1.2-1.3%.

The ECB remained on the sidelines in May, awaiting the June meeting when new staff projections will be available. While the ECB deemed that growth risks have "further diminished" and that "inflation pressures remain subdued" it did not meaningfully shift its rhetoric or comment on plans to exit its QE program. Observers have debated the merits of abandoning the negative interest rate policy before the end of QE, given its negative effect on banks, insurers and savers after some policymakers were said to have expressed a preference for such a move. This would be in conflict with the ECB's current forward guidance which states that QE will remain in place until December (or longer) and that rates would remain "at current or lower levels [...] well past the horizon of our net asset purchases". This implies rate hikes not before mid-2018 although the discussion could also imply that the tapering process could take much longer.

Market Strategy: Europe's economy has seen its greatest populist threats in France and the Netherlands banished for now and elections in Germany look set to achieve a similar result. With a P/E of 23.1, the Eurozone valuations remain near their usual premium while the recovery is gathering increasing momentum. We add the Eurozone to our *overweights.*

United Kingdom

Underweight

The Brexit project continues to divert the country from other tasks and instead plunges it into early elections. Meanwhile, activity has begun to soften.

PM May triggered Article 50 on March 29 and thereby started the mandated two-year process of negotiating the UK's exit from the European Union. Despite a more cordial tone adopted in the letter, relations with the EU have since been fraught, with important disagreements already emerging over the financial settlement (estimates over the UK's 'exit bill' range from 50-100 bn), future border arrangements and the status of EU and UK citizens. Importantly, the UK government hopes to conduct negotiations over a future trade agreement concurrently, whereas the EU insisted on a sequential process that would require "sufficient progress" on the above issues before trade negotiations could be launched. In turn, the UK has tried to link its cooperation on defence and security to any future trade agreement.

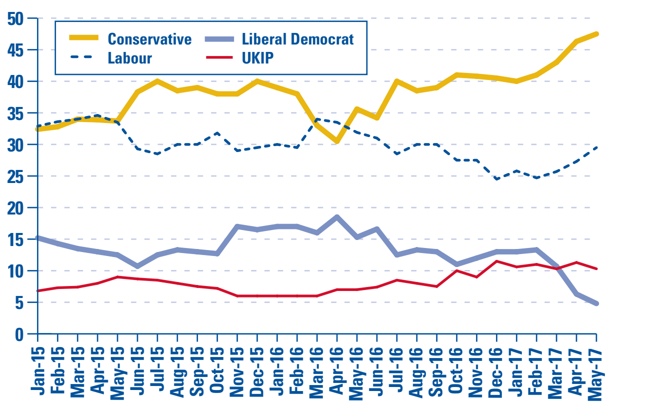
Despite repeated assurances to the contrary, PM Theresa May subsequently called a snap election for June 8, 2017. Parliament gave its consent, overturning the Fixed Term Parliament Act with a 2/3 majority with the help of the Labour party (as allowed under the FTPA). The Conservative party currently enjoys a 13-21% point lead in the opinion polls over its nearest rival, Labour, and if it wins a larger parliamentary majority, this could allow PM May to act with greater freedom in the Brexit negotiations. Similarly, the election timetable (previously the next election was planned for 2020, one year after the scheduled conclusion of the exit talks) no longer represents a potential constraint for the negotiations should they extend beyond the initial timeframe. That being said, it is still not clear where PM May stands on the many complex issues and trade-offs the country will have to face and how a larger majority would affect her stance (e.g. shift towards prioritising trade over immigration).

Labour appears divided and under poor leadership, scoring a mere 25% in polls taken immediately after the election announcement, while the Conservatives hold near near 45% and the Liberal Democrats near 11%. The Liberal Democrats will likely target Conservative-held seats in areas where support for "Remain" in the referendum was high. Yet, even if successful, if the current polling figures translate into the actual election outcome, it could mean a majority of over 100 seats for the Conservatives.

Meanwhile, growth slowed sharply, as Q1 GDP decelerated from 0.7% qoq in Q4 to 0.3% qoq, underperforming the market's and the Bank of England's expectations. While base effects meant that the headline rate moved up from 1.9% yoy in Q4 to 2.1% yoy, softness in activity has been evident in other data too. Retails sales fell by a sharp 1.8% mom in March (making for the largest quarterly decline since 2010 in Q1), consumer confidence continued to decline in April, house prices dropped for two consecutive months in April according to the Nationwide index and the manufacturing PMI has slid all year so far, even though it remains in expansionary territory.

The consumption slowdown reflects the reduction in purchasing power which resulted from the 15% sterling depreciation in the wake of the Brexit referendum. At the same time, slowing employment growth, soft nominal wage growth and rising inflation further weigh on real household incomes. After a sharp rise in the preceding months, headline CPI held steady at 2.3% yoy in March, while Core inflation slid from 2.0% yoy to 1.8% yoy. However, temporary working day effects suggests that price growth will again pick up in April and the BoE be forced to revise its 2.4% inflation forecast for the year in its next Inflation Report.

Chart 3: UK Political Party Support, %



Source: Bloomberg, City of London Investment Management

The BoE cut interest rates last August in order to mitigate an expected downturn. While the feared recession has been averted, consumption remains in the doldrums and the MPC faces further uncertainty over the outlook given the imminent elections. Growth could well undershoot its 2.0% forecast this year but the rise inflation (coupled with a likely upwards revision of its forecast) could prompt more hawkish rhetoric from some MP members. However, the majority is likely to want to retain a cautious stance and wait to see how consumer spending unfolds, leaving rates on hold for the remainder of this year.

Market Strategy: While the imminent election provides an opportunity for the government to achieve a less disruptive 'Brexit' outcome and is thus market-supportive, knowledge of such modalities remains two years away. On the other hand, consumption is beginning to experience increasing headwinds from rising inflation and weaker sterling, weighing on activity. The UK market remains expensive and has performed in line with the broader market. We retain our *underweight*.

Japan

Underweight

Activity continues to strengthen and inflation is gradually rising. The BoJ may have to review its long term yield target soon.

Having ended the year on a soft note, activity has gained momentum since. Japan faces a benign combination of firm external demand, domestic fiscal stimulus and strong corporate profits. Trade data show a continuing gain in exports and earning reports from large corporates are positive. While real exports declined in March, they increased 12.4% qoq in Q1, after a 10.3% gain in Q4 2016. Both the Tankan business survey and the Shoko Chukin small business survey indicators continued to rise and labour market indicators are strong as a result. While PMI readings have been mixed, the latest data point to steady growth, with the April composite PMI at 52.6 and both the services and manufacturing components above the 52 level. Industrial production recorded a 2.1% mom dip in March, down from a 3.2% gain the month prior, for a 0.3% quarterly decline after a 0.7% increase in Q4. Yet, labour market indicators remain strong, with the unemployment rate unchanged at 2.8% in March, the lowest since June 1994. But tightening labour market conditions have so far failed to push wage up much. March wage data was weak, recording a 0.4% yoy decline, the first in almost one year and down from an average 0.4% yoy pace. Only part-time hourly wages have shown a sustained upward trend, but remain below their 2009 peak (the spring wage negotiations did not result in significant gains either).

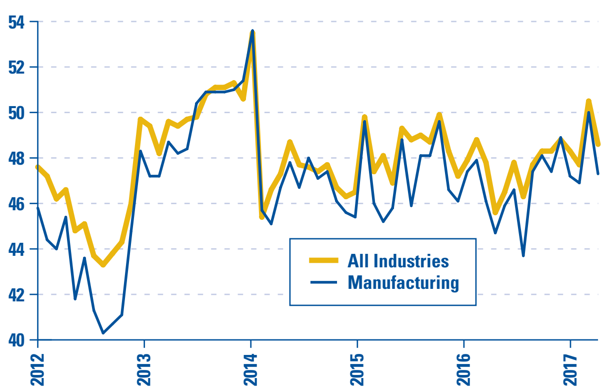
As a result, consumer prices have remained weak as core CPI (ex. fresh food and energy) declined 0.1% yoy in March, down from a 0.1% rise in February. The headline figure also remained stuck at a low 0.2% yoy. The March weakness largely reflected special factors, but consumption has remained soft and retailers cautious, which will likely keep the trend subdued. Nevertheless, inflation readings likely bottomed that month and the rise in oil prices as well as the 10% JPY depreciation in trade-weighted terms will likely begin to feed into prices. The BoJ has stayed on the sidelines so far, but in its Outlook Report, it revised down the FY2017 inflation forecast from 1.5% yoy to 1.4%, leaving the FY2018 forecast unchanged at 1.7% yoy. Indeed, inflation expectations range from 0.5% to 1.0% depending on the measure (market rates and various surveys).

If inflation does indeed rise, the BoJ "Yield Curve Control" policy will come under increasing scrutiny, especially as central banks elsewhere plan or proceed with their exits from highly accommodative monetary conditions. The BoJ gauges the degree of monetary accommodation as the deviation of the real interest rate from the natural rate. It currently estimates to be currently near 0% and the real interest rate is up to 1% negative. The BoJ regards this degree of monetary accommodation as appropriate given current economic conditions. But if inflation rises as anticipated, the real interest rate will decline further and monetary policy will thus become more accommodative, all else equal. The question is whether the BoJ should raise its 10yr yield target of 0% at that point. This situation is different from the sequencing issue the ECB faces as the BoJ's asset purchases are a direct function of the targeted long term yield level. The longer the BoJ keeps its target yield fixed at 0% in an environment of rising inflation, the sharper the subsequent adjustment is likely to be. If markets conclude that yields needed to be higher, the BoJ would be forced to step up its asset purchases to defend its target, adding to the risk of large losses if it has to give up eventually. A corollary would also be a potential jump in the exchange rate once the target is abandoned. On the other hand, if the BoJ moves too early, it risks chocking off the recovery once more. A middle of the road choice would be to raise the yield target, but by an amount smaller than the rise in inflation expectations (and hence the drop in real yields).

Maintaining its 0% target for longer has the advantage of allowing inflation to reach the official 2% earlier. At current exchange rate levels, the BoJ will likely be inclined to keep the target unchanged throughout the year. But should the yen weakened sharply, an adjustment could already take place in 2017. Indeed, the BoJ may soon start to provide guidance as to the conditions under which it would consider changing its target.

Market Strategy: Despite the ongoing economic recovery and incremental reflation, the Japanese economy lags other DM economies more advanced in the cycle. It thus continues to underperform, shedding 3.3% during the past quarter, relative to the MSCI ACWI. As a potential target of trade sanctions by the US, we retain our *underweight* allocation.

Chart 4 Japanese Small Business Sentiment



Source: Bloomberg

Australia

Neutral (↓)

Economic conditions are stable in Australia and this is expected to remain as the RBA stays on hold.

Australia's economy is forecast to grow by 2.5% this year, matching last year's outturn. Q4 GDP grew by 1.1% qoq, up from a contraction of -0.5% in Q3. Investment rose by 1.6% and could rise further as NAB Business Confidence in April rose to its highest level since 2010. Household consumption recovered from a slowdown in Q2 and Q3 2016, aided by a reduction in savings to a multi-year low amid a 0.5% qoq fall in nominal household income. However, consumer confidence fell to its lowest level since 2012 in April and suggests that household consumption could fall back in 1H.

The labour market has also softened over the past six months, with unemployment rising from 5.6% in October to 5.9% in March. Real wage growth has fallen from 1.1% in Q2 2016 to 0.4% in Q4 and could turn negative this year amid rising inflation and stagnant nominal wages. The detrimental impact on household consumption (57% of GDP) is likely to keep the Reserve Bank of Australia's (RBA) on hold. The Bank stated in May that it expects slow wage growth to continue "for a while yet".

Meanwhile, supply disruptions due to Cyclone Debbie led to a near doubling of coal prices and supporting an 8.2% qoq rise in Australia's terms of trade in Q1. Conversely, iron ore prices have been falling amid slowing demand from China, but this is likely to be outweighed by rising coal prices in Q2 and result in a continued rise in the terms of trade. However, some of the major coal ports in Queensland are likely to be closed for most of Q2 and net trade may be a drag on GDP.

Inflation moved back into the RBA's 2-3% target range for the first time since Q3 2014, with CPI rising by 2.1% yoy in Q1. However, core inflation remained below 2% and suggests underlying inflationary pressures are under control. The central bank left its key policy rate at 1.5% at its policy meeting in May, stating that it expects inflation to rise only gradually. At the same time, the regulatory clampdown on interest-only loans has led to a welcome tightening of conditions in the housing market, somewhat negating the need for a rise in the RBA's cash rate.

Market Strategy: Australia's market marginally underperformed DM over the past three months, but its trailing and forward P/E remain above its long-term average. We view the current stability of Australia's economy as vulnerable to a slowdown in China and this could act as a drag on growth in 2H. As a result, we downgrade our exposure from *overweight* to *neutral.* ◆

Michael Hart & Lyndon Barreto, CFA, May 2017

KEY ECONOMIC AND FINANCIAL INDICATORS *(All data shown are as at end-April 2017 unless otherwise stated)*

	Developed Market	Annual GDP Growth	Quarterly GDP Growth QoQ*	Industrial Production Growth	Consumer Price Index	Budget Balance % of GDP 2017F**	Trade Balance	Current Account Balance	Foreign Reserves 2017 Latest	Foreign Reserves 2016 Year Ago	Currency vs $ 2017 Latest	Currency vs $ 2016 Year ago	Short-Term Interest Rates	Sovereign Rating S&P	% MSCI ACWI Net***	Stock Market Index (MSCI ACWI Net) US$	Change since 12/31/16 US$	Change since 12/31/16 Local	2017 P/E Forecast	3 month Currency vs $ +/-
		Macroeconomic Data													Market Performance				Forecast	
		% change on year ago				Latest 12 months														
		%	%	%	%		$ Bns	$ Bns	$ Bns	$ Bns			%		Apr. 28, 2017	Apr. 28, 2017	%	%		
Overweight	UNITED STATES	4.0	0.7	1.5	2.4	-3.2	-503.3	-481.2	40.11	41.49	1.00	1.00	1.17	AA+	52.98	6202.36	7.19	7.19	18.7	uc
	AUSTRIA	2.0	2.0	3.1	2.0	-1.3	-6.4	6.8	9.84	10.25	1.09	1.15	-0.33	AA+	0.07	3047.09	19.50	15.74	12.3	-
	BELGIUM	1.5	2.0	4.0	2.3	-2.4	-0.3	-1.9	8.88	8.59	1.09	1.15	-0.33	AA	0.38	10210.29	8.56	5.15	19.8	-
	FRANCE	0.8	1.2	-0.7	1.2	-3.1	-61.3	-27.4	37.57	39.47	1.09	1.15	2.00	AA	3.44	5611.82	13.02	9.47	15.9	-
	GERMANY	1.7	1.6	2.3	2.0	0.4	280.3	286.7	37.07	36.39	1.09	1.15	0.22	AAA	3.14	5662.55	11.61	8.10	14.0	-
	IRELAND	7.2	10.0	-9.9	0.7	-0.6	52.8	47.7	1.03	1.02	1.09	1.15	-0.31	A+	0.15	360.58	7.42	4.04	17.9	-
	ITALY	1.0	0.7	1.9	1.8	-2.4	54.0	46.8	34.81	35.06	1.09	1.15	1.14	BBB-	0.71	695.67	8.52	5.11	14.0	-
	NETHERLANDS	2.5	2.4	5.0	1.1	-0.7	60.1	58.7	6.22	7.31	1.09	1.15	-0.33	AAA	1.15	13573.23	15.98	12.64	16.9	-
	PORTUGAL	2.0	2.4	1.9	1.4	-2.5	-12.2	2.4	11.27	4.74	1.09	1.15	-0.33	BB+	0.05	134.98	8.45	5.05	16.9	-
	SPAIN	3.0	3.2	-1.7	2.6	-3.5	-15.2	-3.5	47.64	39.38	1.09	1.15	-0.33	BBB+	1.13	3265.18	19.98	16.21	14.7	-
Neutral	AUSTRALIA	2.4	4.4	1.6	2.1	-2.0	-1.9	-33.7	53.43	41.19	0.75	0.75	2.00	AAA	2.43	3578.48	10.20	6.70	16.4	-
	CANADA	2.5	2.6	12.6	1.6	-1.5	-17.8	-51.7	72.73	71.80	1.37	1.27	0.93	AAA	3.09	4785.34	0.33	2.30	16.4	-
	DENMARK	2.3	2.0	2.1	1.0	-1.8	9.6	24.9	61.42	57.42	6.81	6.46	-0.65	AAA	0.57	22353.22	14.31	10.74	18.3	-
	FINLAND	1.2	0.4	0.1	0.8	-2.6	-3.4	-2.3	6.42	6.02	1.09	1.15	0.15	AA+	0.32	931.47	14.01	10.43	19.1	-
	HONG KONG	3.1	4.8	-0.8	0.5	1.2	-56.1	28.8	390.34	359.82	7.78	7.76	0.01	AAA	1.16	57687.23	16.90	17.24	16.5	-
	ISRAEL	4.9	6.2	0.3	0.9	-2.7	-12.9	36.8	102.11	93.48	3.62	3.77	0.10	A+	0.22	138.56	6.12	3.73	10.8	-
	NEW ZEALAND	2.7	1.6	1.9	2.2	0.2	-2.7	-5.1	17.16	14.98	0.69	0.69	1.90	AA	0.05	460.48	2.85	4.46	21.6	-
	NORWAY	1.9	1.2	-1.4	2.4	4.2	20.6	18.1	58.07	60.59	8.60	8.09	0.94	AAA	0.20	6774.42	1.33	0.84	14.0	-
	SINGAPORE	2.5	-1.9	10.2	0.7	0.6	77.2	56.8	251.20	241.73	1.39	1.35	0.94	AAA	0.43	1009.89	13.80	10.14	14.2	-
	SWEDEN	1.3	4.0	4.1	1.3	0.2	-1.7	23.7	50.73	52.03	8.82	8.02	-0.48	AAA	0.96	21843.27	14.41	11.52	17.1	-
	SWITZERLAND	1.0	0.4	-1.2	0.6	0.0	39.2	70.5	665.55	571.28	0.99	0.95	-0.91	AAA	2.87	10937.31	12.08	9.77	18.3	-
U/W	JAPAN	1.6	1.2	3.3	0.2	-5.0	37.6	187.8	1169.42	1201.72	112.13	106.31	-0.09	A+	7.59	5569.00	5.59	0.91	13.9	-
	UK	2.1	1.2	2.8	2.3	-3.1	-51.4	-113.1	112.52	107.74	1.29	1.46	0.34	AA	5.84	5792.53	7.22	2.41	14.8	-

*Note: S&P credit rating shown is long-term foreign currency rating. * % change in GDP on previous quarter, annual rate. **Bloomberg consensus forecast. ***MSCI All Country World Index Daily Total Return Net. Global emerging markets had an 11.1% weighting in the MSCI ACWI as at 28 April 2017. The CLIM weighting for global emerging markets for the period May to July 2017 is 11.1%; the weighting for developed markets is 88.9%.*

Source: Bloomberg, City of London Investment Management

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