Developed Markets Quarterly Outlook

February 2018

Overview

World Economy: Markets in Retreat?

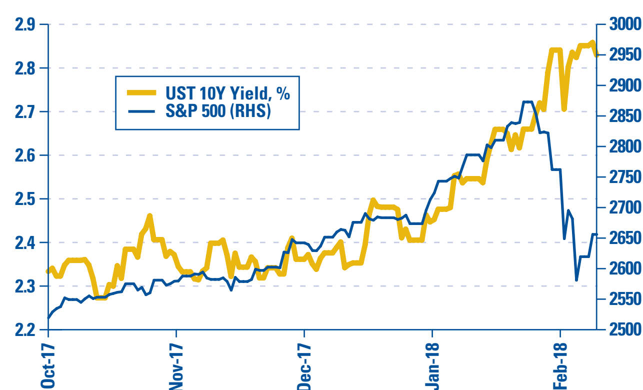
The US economy has continued to perform strongly during the November-January period, lending support to other economies, global growth, an S&P500 gain of 10.0%, a 9.0% gain for developed markets (DM) as a whole and a 12.4% return for emerging markets. The rally that started once markets had digested the shock of China's exchange rate adjustment by February 2016 accelerated once the outlines of the Trump tax cuts became clear, but came to an abrupt halt on February 2nd, when the S&P500 went into sharp reverse and declined as much as 10% over the next week (before rebounding and ending the week just 5.1% down). Over the course of the week, the sell-off engulfed worldwide stock markets, dragging down Japan 5.3%, the UK and the Eurozone 7.1% and emerging markets also 7.1% (led by China's 10% loss). Most notably, volatility, as measured by the VIX, spiked from single digits to 50%, before settling in the 30% range. Other markets, such as the US and European credit, suffered some collateral damage but did not witness a rapid sell-off.

Perhaps more surprising was the market's unabated rise throughout a period of rising long-term yields, which saw the US 10yr yields rise from a low of 2.04% in September 2017 by over 60bps. Only once they had reached the technical resistance level of 2.66%, did the market turn suddenly. This moment coincided with the release of a higher-than-expected wage growth figure in the US (2.9% yoy) as part of the monthly non-farm payroll report. As the sell-off deepened, yields rose further and volatility spiked. This, in turn, prompted the implosion of so-called inverse-volatility products (which bet on volatility remaining low), adding further fuel to the fire.

The argument has been made that the VIX has lost some of its usefulness as a volatility gauge as it has become a traded product itself. But this is true for other financial indicators too, which are nevertheless referenced, and in any case, the pick-up in daily variance can be observed directly in price swings. However, it is worth noting that it did not spread to other market metrics such as the MOVE (rates), the CVIX (currencies) or the OVX (WTI crude). The episode provides some illustration of how the so-called 'volatility paradox' can play out: a long period of low volatility, especially when coupled with extremely low interest rates, can generate a false sense of calmness and lead to a build-up of leverage in areas outside of investors' natural habitat, which can then result in sharp adjustments when triggered by seemingly random shocks.

While the risks are clear, the outlook from here is less so. Some investors worry that the economy has reached full employment and that any stimulus in the form of tax cuts may thus fuel inflation. We attribute a lower probability to such a scenario as we see good structural reasons for wage growth to remain contained. Others are sanguine in the face of the expected extension of the current expansion (now in its 9th year) and regard the recent market decline as a buying opportunity. Still others (including us) see the greatest risk both to and from the long-term rates. On the one hand, this reflects the effect of the Fed's balance sheet reduction, which will boost the annual net Treasury supply to the market by some 60-70%. On the other hand, it reflects the unfunded nature of the administration's fiscal expansion, aggravated by the recent spending deal approved in Congress (worth another $300 bn over two years) as well as the potential for stepped up infrastructure spending.

Chart 1: US Treasury Yields and S&P 500



Source: Bloomberg

Market Strategy

The economy remains in good health for now and earnings expectations are rising. But the paradigm has changed as monetary policy is in reverse, global financial conditions are tightening and volatilities are rising. As such, markets will likely at some point shift from interpreting good economic news as good news for the market (due to higher earnings) and instead view them as bad news (due to higher inflation and/or rates). Against this backdrop, we make the following changes to our allocation:

- We shift the US to *underweight* given high valuations and rising long-term yields.
- We remain *overweight* the Eurozone, but shift Italy to *underweight*. We are wary of political ructions there, but stop short of expecting a systemic shock from them.
- We move Switzerland to *underweight* given the likely lag in economic performance relative to the Eurozone.
- We downgrade Australia to *neutral* on modest growth and expected headwinds for the mining sector.
- We keep our allocation to emerging markets at *neutral* due to less attractive valuations and an environment of rising yields and volatilities.

United States

Underweight (↓)

Strong economic momentum, employment gains and accelerating wage growth have led to tighter financial conditions across the curve and rattled stock markets.

Economic activity remains on a strong footing in the US even as GDP slowed to 2.6% seasonally adjusted annualised rate (saar) in Q4, from 3.2% in Q3, undershooting expectations. But importantly, private consumption was up a strong 3.8% saar and the 14% rise in imports also attested to strong domestic demand. The contribution of net exports was negative as a result and inventories also declined. While household wealth (relative to disposable income) has scaled the pre-financial crisis peak again, the decline in the personal savings rate to 2.8% suggests that consumption will eventually run out of steam. For now, consumer sentiment (Univ of Michigan) remains high at 95.7 in January, but is a tick down from the 95.9 recorded in December.

If the current cycle is to sustain its current strength, a greater contribution from other components will thus be required. The actual data suggest that the strong run of equipment spending that characterized 2017 may be coming to an end: both core capital goods orders and shipments softened towards year end. Of course, the planned tax reform may yet give an additional impetus to capital expenditures. Indeed, sentiment surveys point to rising optimism: The ISM non-manufacturing PMI jumped from 56.0 in December to 59.9 in January. The manufacturing PMI slid slightly but remained elevated in January at 59.1.

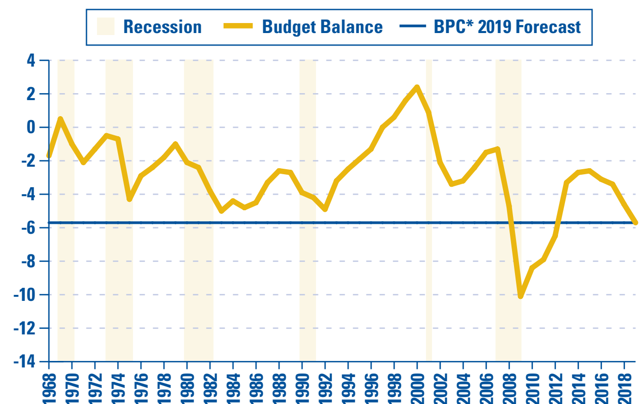
Non-farm payrolls increased 200K in January, up from 160K in December, while the unemployment rate remained steady at 4.1%. But the highlight of the release was the 0.3% mom uptick in average hourly earnings, equivalent to a 2.9% yoy gain, a significant acceleration from the 2.5% trend throughout 2017 and the highest since 2009. However, the data series can be volatile and not all wage metrics confirm the trend. For example, the Atlanta Fed wage growth tracker shows wages decelerating since Q3 2016. The decomposition of the gains and the decline in hours worked also suggest that weather-related factors could have artificially boosted the measure. Yet, the widely-tracked Employment Cost Index (ECI) reinforced the strong message after posting a 2.6% yoy gain in Q4, which matched the post-crisis high in 2015.

Overall price growth has remained subdued so far. Headline CPI closed the year at 2.1% yoy, but the PCE remained around 1.7% yoy and the Fed's favoured metric, the Core PCE, at 1.5% yoy. However, rising oil prices and, to a lesser extent, a weaker US dollar could provide a boost to price growth in 2018. While surveys show long-term inflation expectations anchored at 2.5% yoy, five-year breakeven rates have accelerated sharply recently, from an average of 1.8% in December to above 2% in January.

The Federal Reserve kept rates unchanged as expected (at 1.25-1.50%) at Chair Yellen's final meeting in January. It maintained its cautious approach and stated that "economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate". The committee also upgraded its outlook for inflation, saying it expected year-on-year readings to "move up this year" before stabilising around its 2% goal in the medium term. Recent developments will likely encourage the Fed to proceed with its planned tightening cycle (three hikes in 2018) and market expectations for a March hike have firmed to near certainty following the latest wage release. What is more, market expectations for four rate hikes or more have shifted from 0% in 2017, to 5% at the start of the year and to 25% by end of January.

The frayed relationship between the President and Congress has led to yet another impasse and forced a three-day government shut down in January. The crisis was precipitated by President Trump's removal of the legal protections for the so-called "Dreamers" (800,000 people brought illegally to the US as children), granted by the Obama administration. Senate Democrats agreed to a temporary reopening after Republicans provided assurances that legislation would be introduced to protect the "Dreamers". Lawmakers are now seeking a new funding deal as Republicans look to raise spending limits on defence, while Democrats will only agree if non-defence discretionary spending is also lifted. The Bipartisan Policy Center (BPC), a non-partisan think-tank, predicts that the deficit will rise to 5.7% of GDP in 2019 as a result. Yet, it could rise even further if President Trump's plan for a boost to infrastructure spending advances. This would represent one of the biggest US budget deficits outside of war or recession. Expectations for a rising US deficit have already prompted an increase in monthly debt sales by the US Treasury and further increases throughout the year are likely.

Chart 2: US Budget Balance, % of GDP



*Bipartisan Policy Center

Source: Bloomberg

The combination of a rising fiscal deficit, accelerating wage growth, strong economic momentum and the Federal Reserve's balance sheet reduction has intensified the pressure on long term yields. So far this year, yields on 10-yr US Treasury bonds have climbed 43bps to 2.83%, breaking a technical level at 2.66% and approaching the 3% mark reached during the 2013 taper tantrum. A breakdown of this move reveals both an increase in real yields and a rise in inflation expectations.

Market Strategy: Fundamentals for the US economy remain robust with continuing gains in employment, strong earnings and still-strong forward-looking sentiment indicators. On the rise since February 2016, the equity market rally accelerated in October 2017 as indications of an imminent tax reform deal began to coalesce. However, the market has ignored the build-up of risks - be they related to a potential rise in inflation, the Fed's balance sheet reduction or the coming fiscal expansion - and instead focused on the beneficial effects of the tax reform. The recent sell-off could serve as a useful wake-up call, even if triggered by a data fluke and market technicals (algorithmic trading responding to a rise in volatility). The sell-off was as sharp as 10% at one stage, but a subsequent rebound limited it to 5.1% for the first full week of February. During this period, the VIX volatility measure spiked to 50% - a level last seen during the 2015 Chinese exchange rate adjustment - before settling at 30%. Rates and credit markets experienced increased selling too, but to a lesser extent, in particular as US Treasuries eventually benefited from safe haven inflows.

The combination of the sharp fall in prices and upgrades to earnings expectations means that the forward P/E ratio has now fallen from 20 to just above 16, reversing the past four years of run-up on this measure. However, on the basis of actual P/Es the correction is less impressive, reversing only the past few months (the same is true on the basis of book value). Finally, momentum stocks have suffered the least during the sell-off.

In our opinion, the dichotomy between rosy market perceptions and the array of risks present has widened too far. Whether on the basis of dividend yields or earnings yield, the equity market does not appear attractive compared to bonds. In fact, 10yr bonds yield a full percentage more than equities, for the first time since the 2013 taper tantrum. It is true that the stock market has brushed off rising yields for over a year, suggesting that they could rise regardless. But the relationship between equities and long-term rates is not linear: there is a clear point at which the higher cost of funding outpaces the benefit of rising earnings. This time appears closer. We shift our US allocation to *underweight*.

Canada

Overweight

Solid employment and wage growth may prompt the Bank of Canada to continue to raise interest rates in 2018.

Canada reported Q3 GDP at 1.7% qoq saar, normalizing from a very strong Q2 (4.3%). A slowdown in household consumption (4.0% qoq saar), government spending (3.0%) and exports (-10.2%) more than offset the acceleration in fixed investment (3.5%). Real GDP grew 0.4% mom in November (versus no change in October), driven by a strong rebound in the goods sector (0.8% mom vs -0.5% in October) and continued momentum in the services sector (0.3% mom vs 0.2% in October). With a solid manufacturing PMI above 54, GDP is estimated to grow by around 2.0% qoq saar in Q4, resulting in a strong year of 2017 with around 3.0% annual growth.

Consensus expects further normalization of the economy in 2018, with GDP likely to slow to around 2.2%, in line with the average annual growth of 2.4% since 2010. The slowdown is expected to be concentrated in the household sector and residential construction, with private consumption expected to slow to around 2.2% yoy in 2018 (vs estimated 3.0% in 2017). However, consensus expects an acceleration in government spending, fixed investment and exports, with the latter two driven by the strength of the North American economy and a potential acceleration of capital expenditure in the US.

Headline CPI inflation reached 1.9% yoy at the end of last year, in the centre of the central bank's target range of 1-3%. However, consensus expects inflation to quicken to 2.3% in Q3 2018 as the labour market is tightening. Indeed, hourly wage growth reached 2.7% yoy at the end of last year, a sharp rebound from the sub-1% recorded in Q2 last year. The unemployment rate has declined to 5.8%, significantly down from the 7.2% peak registered two years ago. As a result, the Bank of Canada has raised interest rates by 25bps again in January, and consensus expects at least two further hikes in 2018.

Market Strategy: MSCI Canada returned 13.9% in USD terms for the 12 months up to the end of January, underperforming DM equities by 11.9 percentage points. Nevertheless, we remain *overweight* Canadian equities. The trailing P/E ratio is trading at a 14% discount to that of DM equities, close to two standard deviations below the long-term average. Corporate revenues may strengthen on the back of a pickup in global trade and capital expenditures, barring an abrupt collapse of NAFTA negotiations. In addition, a solid labour market indicates that the economy has adjusted to the current level of oil prices. Strong wage gains help address the affordability issue in the housing market, supporting the banking sector.

Switzerland

Underweight (↓)

The Swiss Economy markedly accelerated in Q3 2017 and may continue to do so in 2018. However, its growth and inflation may still lag those of the Eurozone.

Swiss GDP grew 1.1% yoy in Q3 2017, a meaningful acceleration from the average of 0.6% yoy in the previous two quarters. The Q3 rebound was mostly driven by rising industrial production (8.6% yoy) and government spending (1.6% yoy). The recovery may continue into Q4 2017, with consensus expecting 1.7% yoy for the quarter driven by rising exports and fixed investments.

Inflation remains subdued despite accelerating growth. December headline CPI inflation recorded 0.8% yoy. While this represents a marked acceleration from the trough of -1.4% at the end of 2015, inflation remains comfortably within the central bank's target range of 0-2%. Meanwhile, the seasonally-adjusted unemployment rate edged down to 3% in December from 3.3% a year ago, though it remains some distance from the trough of 2.5% in 2008.

Growth and inflation may continue to recover throughout 2018, even though the headline numbers may still lag those of the Eurozone. Consensus expects 1.9% growth this year (vs 1.0% in 2017) and 0.9% inflation (vs 0.7% in 2017), on the back of recovering household consumption and exports. Indeed, Swiss PMI increased to 65.2 at the end of last year, the strongest level since 2010, signalling strong momentum ahead in the manufacturing sector. However, in the Eurozone - Switzerland's largest trading partner - growth and inflation in 2018 are expected to be around 2.2% and 1.5%, respectively.

Similar to the ECB, the Swiss National Bank (SNB) may not raise its deeply-negative interest rate until 2019, as it foresees subdued inflation and remains concerned about the franc's strength. The Swiss franc declined by more than 8% last year, bringing the franc's real effective exchange rate closer to its 10-year average. Still, the central bank may continue to intervene in the currency market to prevent it from strengthening further.

Market Strategy: Swiss equities returned 23% in USD terms in the 12 months up to the end of January, slightly underperforming DM equities by 3 percentage points. With its P/E ratio currently at an 11% premium to DM (vs its long-term average of 8%), Swiss equities do not appear cheap. More importantly, Swiss equities are dominated by defensive sectors such as healthcare and consumer staples. These sectors may lag behind DM equities in 2018 as we expect rising inflation, rising bond yields and strong global growth. Therefore, we move Swiss equities from *neutral* to *underweight*.

Eurozone

Overweight

Economic momentum remains strong, inflation absent but Italian and German politics could inject a new source of uncertainty into this becalmed picture.

Political risk continues to be an important factor for the Eurozone. While election results in France and the Netherlands earlier last year yielded the preferred market outcomes, the situation in Germany is more ambiguous. True, Chancellor Angela Merkel will likely soldier on for a fourth term, but her status is diminished given the strong showing of the AfD, the breakdown of talks with the Freedom Party and the difficulties of negotiating a renewed coalition with the SPD (which has yet to be approved by the party membership and has already cost its leader Martin Schulz his leadership). Now, the Italian polls due to be held on March 4 threaten another shock to the stability of the Eurozone. The political landscape in Italy is splintered, opinion polarised and populist, right-wing and eurosceptic parties are set to make strong gains. Most recently, the dominant centre-left Democratic Party (DP) lost its top spot in the polls to the Five-Star Movement (MS5) of Beppe Grillo (sliding to 23% vs MS5 at 28%). In another surprise development, Silvio Berlusconi's Forza Italia has risen above the Northern League (to 17% vs 13%).

With each party holding an approximately equal number of seats, the outcome of the election could well be a hung parliament. The consensus is that in case of gridlock President Sergio Mattarella would simply reappoint DP prime minister Gentiloni. But several other combinations are possible, including a grand left/right coalition (unlikely), a minority government or a Eurosceptic alliance led by one of the populist parties. Ironically, it is Berlusconi's Forza Italia which could now become the moderating force among the radical parties of the right. An alternative scenario could be a fudge, a weak and unstable left/right coalition with shifting alliances. But if efforts to form a government fail following the vote, President Mattarella would be forced to call new elections, prolonging political uncertainty.

Meanwhile, activity retained its momentum even as GDP growth slowed to 0.6% qoq (from 0.7% qoq) in Q4, equivalent to an annual gain of 2.7% yoy, compared to 2.8% yoy in Q3. However, this reading may yet underestimate the true strength of the underlying activity, which PMI readings suggest would be higher. Indeed, the PMI reading for services increased successively throughout the quarter, reaching 57.6 in January, while the manufacturing survey eased off just slightly from the 60.6 high in December, to a still solid 59.6. Similarly, the bellwether German Ifo index stood at an extremely high 117.6 level in January. While industrial production figures are released with a lag, it is worth noting that capacity utilization, an important indicator for the output gap, has continued to rise and reached 84.4% in January. In addition, the strength of consumer confidence, which was close to an all-time high in January, points to a strong underlying trend in consumer spending.

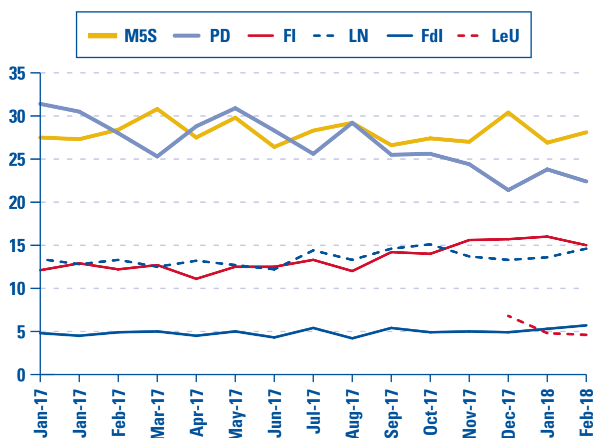
Inflation remains an uneventful series to track, with the December Harmonized Index of Consumer Prices (HICP) nudging down to 1.3% yoy, while core HICP inched up to 1.0% yoy. Nevertheless, core inflation remains steady around a low level. More specifically, core goods inflation has been rising, despite the appreciation of the euro over the past year.

The January ECB meeting passed without a hitch and while many participants expected a shift towards a more hawkish stance (in particular with respect to the ECB's asset purchases), President Draghi maintained as dovish a stance as needed in the short term, while not excluding a hawkish shift in the longer term. Considerations of strong growth and falling unemployment are counterbalanced by an appreciating currency (up 8.6% in nominal effective terms over the past 12 months) and the continuing absence of a sustained upward trend in prices. Thus Draghi did not surprise the market when he said that there were "very few chances at all" of a rate rise in 2018.

Market Strategy: Markets currently underappreciate the risk of a eurosceptic/populist coalition forming the next government in Italy: 10yr Italian bond yields declined from 2.4% in July 2017 to a low of 1.7% by year-end (before settling around 2% amidst a global rise in yields).

In addition, Italian stocks have been some of the biggest winners during the market upswing in January. Because of the risk of a market-negative outcome, we downgrade Italy to *underweight*. However, while we acknowledge that this bears the potential to spiral into a euro-wide crisis, we also point to the precedent of the Berlusconi governments and the usual uncertainty in Italian politics. With a sufficient number of reformers and steady hands in charge of the European Union, the risk of a system-wide shock is likely to be contained. What is more, the ECB continues to provide monetary support and any withdrawal would only occur on the back of strong activity and would likely boost the euro. We thus remain *overweight* the Eurozone ex-Italy.

Chart 3: Italian Election Voting Intention, Share by Party, %



Source: Wikipedia

United Kingdom

Underweight

> *A recent pick-up in growth eases the central bank's dilemma of having to fight rising inflation in an adverse growth environment.*

The Brexit process continues to be the defining issue for the outlook of the UK economy, in particular as much uncertainty continues to surround the British position and the stability of the country's government.

In September, Prime Minister May asked the EU for a transition arrangement and in February, the EU proposed a draft legal text. Under the proposal, the UK would remain bound throughout the transition by all the EU obligations that currently apply, including financial contributions and the free movement of people. Importantly, it would be barred from acting against the EU's interest and the EU would retain the right to cut the UK off from single market benefits if it violated the agreement.

In December, the government reached an agreement with the EU over the status of Northern Ireland, stating that a future arrangement would avoid a 'hard border' in line with the Good Friday Agreement. However, attempts to translate the deliberately vaguely formulated agreement into a legal text before the March 2018 European Council meeting have exposed the differences in understanding between the two sides again. What is more, it is almost impossible to conclude any deal on the Irish border without setting out the nature of the desired long-term relationship with the EU first or to do so without prejudicing such a debate. Indeed, it appears that parliamentary discourse has recently begun to shift towards an EEA/EFTA-type agreement or a customs union. This would maintain the freedom of movement for goods and capital, but not for people and services. However, despite repeatedly setting out to do so, the government has not yet provided an indication of what kind of trade deal with the EU it aims for. In addition, there have been renewed calls for a confidence vote on Theresa May's party leadership. At this stage, a no-deal crash out, a second referendum or an exit solely on EU terms all remain as possible scenarios.

Meanwhile, activity surprised on the upside as GDP recorded a 0.5% qoq gain in Q4, up from the 0.3% and 0.4% quarterly pace registered in Q2 and Q3 respectively. But due to base effects, the headline rate slid from 1.9% yoy in Q2, to 1.7% in Q3 and 1.5% yoy in Q4. The expenditure breakdown is not available in the initial estimate but the economy likely benefited from the global upswing in demand. However, other activity data have so far painted a more mixed picture. The composite PMI slipped to 53.5 in January, the lowest level since August 2016. Industrial production gained a meek 0.2% mom and 0.4% mom in October and November and likely contracted outright in December in the

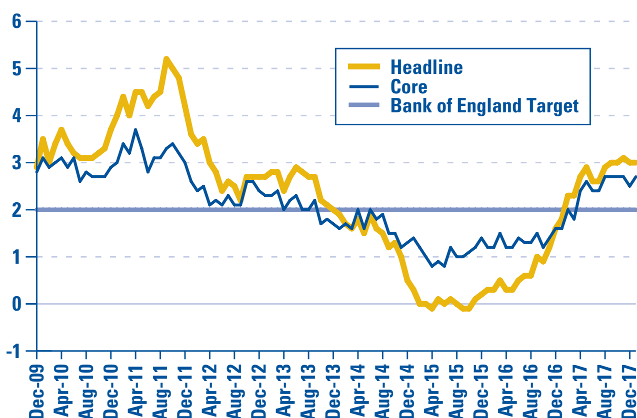
wake of the shutdown of the Forties pipeline. Unemployment has held steady at 4.3% while average earnings growth stabilised at 2.5% at year-end. The BoE recently upgraded its 2018 growth forecast from 1.6% to 1.8%. Nevertheless, consumer confidence remains in the doldrums (albeit somewhat better in January) and is likely set to constrain private consumption growth during 2018.

Inflation nudged down to 3.0% yoy in December but has remained around this mark since mid-2017 and with that, above the BoE's forecast and target. While core goods inflation remained high in response to the currency depreciation, core services inched down recently, allowing core CPI to decline from 2.7% to 2.5% yoy in December. The effect of recent currency appreciation has largely been offset by the rise in international oil prices.

The BoE has stayed on hold after its November "dovish hike", in line with the then-suggested path of "two hikes in the next two years". The incremental progress in the Brexit process, a stronger global economy and the robust Q4 GDP outcome have led markets to price in a 50% chance of a rate hike from the current 0.50% as early as May. However, ongoing uncertainty is likely to prevent the BoE from engaging in a more aggressive tightening cycle, recent hawkish rhetoric notwithstanding.

Market Strategy: The government's inability to formulate a clear Brexit strategy and openly debate its pros and cons is a rising concern. It can only be explained by the Prime Minister's lack of support within her party, itself another source of concern. While the economy has held up recently, the outlook remains highly uncertain. Yet, despite a 1.2% point underperformance during the November-January period, the market's P/E remains a high 21.5. We maintain our *underweight* allocation.

Chart 4: UK Inflation, % yoy



Source: Bloomberg

Japan

Overweight

The economic recovery extends, inflation firms and the external surplus recovers. The BoJ may get closer to a shift in monetary policy, but is not there yet.

Japan's economy continues to power on, with GDP rising to 2.1% yoy in Q3 from 1.6% yoy in Q2. The quarterly gain was slightly lower than in the previous quarter but it extended the run of consecutive quarterly increases to seven. But since the data are released with a considerable lag, high-frequency data are the more important indicators to watch. While the 4.2% yoy gain in industrial production in December was merely in line with the pick-up observed during the year, the January manufacturing PMI signalled a steady rise in output and new orders, in particular for exports (highest since 2010). The Markit composite PMI stood at a robust, albeit somewhat lower level, of 52.2 in December, following a peak of 53.4 in October. In the January Reuters Tankan survey of large firms, manufacturer sentiment jumped 8 pts to 35, the highest level since January 2007.

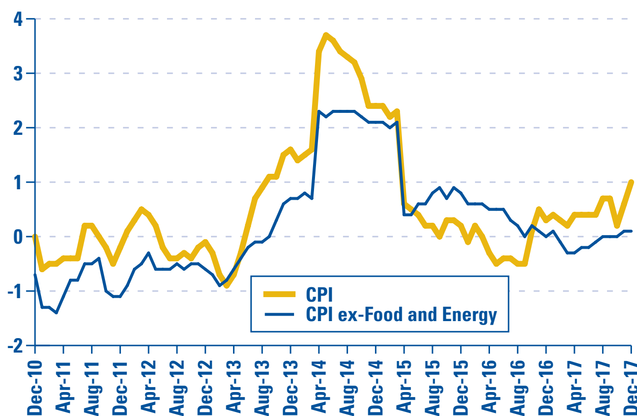
The labour market has remained tight in December: even though the unemployment rate edged up slightly to 2.8%, it remains close to the lowest level since June 1994. Against this backdrop, the outcome of the spring wage negotiations will be critical for the outlook for wage inflation. With inflation expectations firming, these negotiations are expected to deliver a meaningful increase this year.

The nationwide core CPI (excluding fresh food only, the target measure) rose 0.9% yoy in December, unchanged from November, while the BoJ's preferred core measure, which excludes both fresh food and energy, rose 0.3% yoy, also unchanged from the previous month. Headline CPI rose to a full 1.0% yoy in December. By all accounts, inflation remains far from the BoJ's 2% target, but the period of outright deflation appears to have been banished. If wage growth starts to accelerate as expected, core inflation could rise to 1% in H2 2018.

Together with the relative strength of the economy and the global shift towards exiting extreme monetary accommodation, the pick-up in inflation has given rise to expectations that the BoJ might turn more hawkish soon. Indeed, analysts expect a rise in the 10yr yield curve target by 25-50bps by year-end and the BoJ appears to have let 10yr JGBs rise to 0.10% recently. However, Governor Kuroda cautioned in a recent press conference that "the stage for considering the timing and measures of so-called exit has not yet arrived". Governor Kuroda's term is set to expire in April 2018, as will the terms of Deputy Governors Iwata and Nakaso in March, potentially heralding a change in leadership style and

policy. However, consensus expects Kuroda to be reappointed in February, thus ensuring the continuation of a fairly dovish monetary policy thrust.

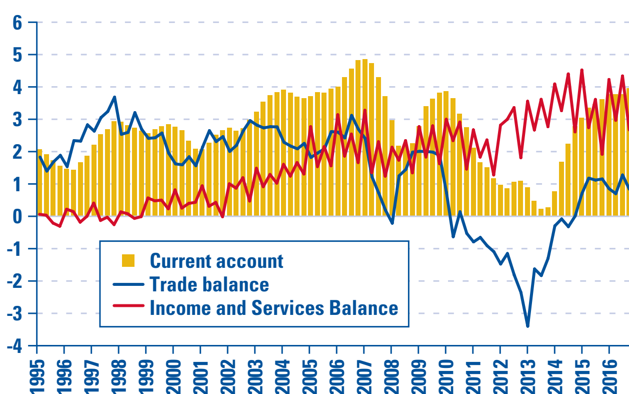
Chart 5: Japanese Inflation, % yoy



Source: Bloomberg

The current account balance has increased notably since 2015, after falling to a surplus of less than 1% of GDP. The trade balance also moved back into surplus after incurring a temporary deficit between 2011 and 2015 and putting downward pressure on the yen. However, given the robustness of domestic demand, the trade surplus started to shrink again in 2017. Yet, this has been offset by a rise in the income and services balance, which stabilized the current account surplus around 4% of GDP. While export growth is set to benefit from stronger global demand, this will likely be roughly balanced by rising imports due to a higher oil bill and keep the current account surplus near current levels.

Chart 6: Japanese Current Account Balance, % yoy



Source: Bloomberg

Market Strategy: Japan's market underperformed slightly during the past three months, but it's P/E of 14.9 remains half a standard deviation below its historical 12% discount. Given the ongoing efforts to reflate the economy under a stable political stewardship, we retain our *overweight* allocation.

Australia

Neutral (↓)

Headwinds remain for the Australian consumer, housing and mining sectors, despite a gradual recovery.

The Australian economy grew by 2.8% yoy in Q3 2017, a meaningful recovery from the sub-2% growth in H1 2017. The growth rebound was driven by rising machinery and equipment investments (2.6% yoy), construction (5.1% yoy) and exports (6.4% yoy). Private consumption remains more subdued, however, with only 2.2% yoy growth.

Inflation and wage growth remain weak due to elevated unemployment. The labour market is still adjusting to weaker commodity prices, with the unemployment rate at 5.6% at the end of 2017, some distance from the trough of 4.2% in 2008. Wage growth (seasonally adjusted, excluding bonuses) has reached an all-time low of 2% at the end of 2017, versus a long-term average of 3.2%. Weak wage growth has led to weak CPI inflation, which was at 1.9% yoy in December, versus the central bank's target of 2-3%. The Reserve Bank of Australia is thus expected to remain on hold for most of 2018.

The Australian economy is likely to continue to recover in 2018, with consensus expecting 2.6-2.9% growth, slightly below its long-term average. The gradual recovery would probably be driven by stronger exports and rising capital expenditures in the non-mining manufacturing sector.

However, headwinds remain for the consumer, housing and mining sectors. Household debt (including mortgages, auto loans and credit card debt) has risen to 200% of GDP as of Q3 2017, double the level in the year 2000. Meanwhile, housing prices have risen substantially over the past five years, with an average annual rise of 8%. High consumer debt, elevated housing prices and weak wage growth are weighing on real disposable income and consumption. Banks are tightening lending conditions against the deteriorating credit profiles of consumers. Coupled with recently implemented property purchase taxes on foreign buyers, housing prices and residential construction may slow in 2018. In addition, miners may lag behind their global peers as iron ore – Australia's major mining export – may continue to see price underperformance due to Chinese environmental campaigns to slash its steel production.

Market Strategy: Australian equities returned 18.4% for the 12 months up to end of January, underperforming DM equities by 7.4 percentage points. Its P/E is trading at a 20% discount to DM, two standard deviations below its long-term average. However, headwinds facing the consumer, banking and mining sector, as well as the Chinese investment slowdown, have made us more cautious. We move our view on Australian equities from *overweight* to *neutral*. ◆

The information contained herein is obtained from sources believed by City of London Investment Management Company Limited to be accurate and reliable. No responsibility can be accepted under any circumstances for errors of fact or omission. Any forward looking statements or forecasts are based on assumptions and actual results may vary from any such statements or forecasts.

KEY ECONOMIC AND FINANCIAL INDICATORS *(All data shown are as at end-January 2018 unless otherwise stated)*

	Macroeconomic Data													Market Performance				Forecast	
		% change on year ago				Latest 12 months													
	Developed Market	Annual GDP Growth	Quarterly GDP Growth QoQ*	Industrial Production Growth	Consumer Price Index	Budget Balance % of GDP 2018F**	Trade Balance	Current Account Balance	Foreign Reserves 2017 Latest	Foreign Reserves 2016 Year Ago	Currency vs $ 2018 Latest	Currency vs $ 2017 Year ago	Short-Term Interest Rates	Sovereign Rating S&P	% MSCI ACWI Net***	Stock Market Index (MSCI ACWI Net) US$	Change since 12/31/17 US$	Change since 12/31/17 Local	2017 P/E Forecast	3 month Currency vs $ +/-
		%	%	%	%		$ Bns	$ Bns	$ Bns	$ Bns			%		Jan. 31, 2018	Jan. 31, 2018	%	%		
Overweight	CANADA	3.5	1.7	5.2	1.9	-0.8	-16.0	-46.1	76.65	72.95	1.25	1.31	1.63	AAA	2.99	5586.97	0.92	-1.18	15.3	-
Overweight	JAPAN	2.1	2.4	4.2	1.0	-4.5	26.8	198.5	1202.61	1158.28	110.00	112.07	-0.12	A+	7.81	6838.90	4.58	1.34	15.2	-
Overweight	AUSTRIA	2.8	2.8	3.4	2.2	-0.8	-2.9	8.6	6.81	9.72	1.24	1.07	-0.33	AA+	0.09	4475.24	10.86	6.86	12.4	-
Overweight	BELGIUM	1.9	2.0	6.2	1.7	-2.0	-3.3	-3.9	9.54	8.32	1.24	1.07	-0.33	AA	0.36	11754.69	5.42	1.61	18.5	-
Overweight	FINLAND	3.0	1.6	3.4	0.5	-1.2	-3.0	1.4	6.37	6.50	1.24	1.07	0.14	AA+	0.31	1069.39	6.85	3.00	16.7	-
Overweight	FRANCE	2.4	2.4	2.5	1.4	-2.8	-70.9	-24.6	37.74	39.19	1.24	1.07	2.00	AA	3.55	6841.68	7.02	3.16	15.6	-
Overweight	GERMANY	2.8	3.2	5.7	1.6	0.8	276.6	284.5	37.44	36.89	1.24	1.07	0.18	AAA	3.25	6863.16	5.93	2.11	14.0	-
Overweight	IRELAND	10.5	16.8	3.0	0.4	-0.2	51.0	68.2	1.03	1.02	1.24	1.07	-0.39	A+	0.16	406.89	2.60	-1.11	16.3	-
Overweight	NETHERLANDS	3.0	1.6	4.4	1.3	0.5	67.1	73.1	5.05	5.88	1.24	1.07	-0.33	AAA	1.18	16452.49	6.34	2.89	16.5	-
Overweight	PORTUGAL	2.5	2.0	1.3	1.5	-1.4	-15.6	1.1	8.73	9.55	1.24	1.07	-0.33	BBB-	0.05	160.99	4.47	0.70	17.2	-
Overweight	SPAIN	3.1	2.8	4.7	0.5	-2.5	-27.9	-3.8	51.70	46.95	1.24	1.07	-0.33	BBB+	1.09	3766.26	8.93	5.00	13.5	-
Neutral	AUSTRALIA	2.8	2.4	0.4	1.9	-1.5	12.4	-22.3	58.74	47.64	0.79	0.76	1.90	AAA	2.22	4009.66	2.95	-0.55	16.1	-
Neutral	DENMARK	1.4	-2.0	-1.2	1.0	-0.8	9.8	26.4	68.70	60.32	6.00	6.93	-0.65	AAA	0.59	27161.23	3.12	-0.64	18.2	-
Neutral	HONG KONG	3.6	2.0	0.3	1.7	1.2	-61.9	37.5	421.92	384.93	7.82	7.76	0.01	AA+	1.16	70321.60	4.65	4.70	17.2	+
Neutral	ISRAEL	3.0	3.4	1.6	0.4	-2.7	-15.0	36.3	111.49	94.28	3.45	3.74	0.10	A+	0.15	138.94	4.26	3.23	11.2	+
Neutral	NEW ZEALAND	2.7	2.4	8.6	1.6	1.0	-2.0	-5.2	21.13	16.26	0.73	0.73	1.85	AA	0.06	518.62	3.71	-0.34	24.6	+
Neutral	NORWAY	3.5	2.4	2.3	1.6	4.5	19.4	20.9	62.63	59.14	7.79	8.27	0.84	AAA	0.22	9086.41	5.96	-0.56	14.9	+
Neutral	SINGAPORE	3.1	2.8	-3.9	0.4	0.5	75.7	57.5	277.39	245.56	1.32	1.41	1.06	AAA	0.43	1280.06	6.40	4.26	14.4	+
Neutral	SWEDEN	1.7	3.2	6.5	1.7	0.8	-0.5	21.2	53.46	51.57	7.93	8.85	-0.46	AAA	0.89	24432.41	6.13	1.81	16.3	+
U/W	UNITED STATES	4.4	2.6	3.6	2.1	-3.7	-558.2	-450.7	42.76	39.02	1.00	1.00	1.91	AA+	52.23	7412.43	5.71	5.71	18.6	uc
U/W	ITALY	1.7	1.4	2.2	0.8	-1.9	54.3	56.4	37.55	34.08	1.24	1.07	1.21	BBB	0.81	919.22	11.64	7.62	13.0	-
U/W	SWITZERLAND	1.1	2.4	8.6	0.8	0.4	35.6	66.5	749.75	636.37	0.94	0.99	-0.85	AAA	2.60	12466.86	4.28	-0.53	17.4	-
U/W	UK	1.5	2.0	2.5	3.0	-2.2	-36.4	-119.4	120.44	106.54	1.40	1.25	0.61	AA	5.68	6808.16	3.04	-1.98	14.5	-

*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 a 12.2% weighting in the MSCI ACWI as at 31 January 2018. The CLIM weighting for global emerging markets for the period February to April 2018 is 12.2%; the weighting for developed markets is 87.8%.*

†Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results.

Source: Bloomberg, City of London Investment Management

CITY OF LONDON
Investment Management Company Limited

Contacts

Macroeconomic Analysis

Michael Hart, London Office
Phone: 011 44 207 711 1558
E-Mail: michael.hart@citlon.co.uk

Lyndon Barreto, CFA, London Office
Phone: 011 44 207 711 1551
E-Mail: lyndon.barreto@citlon.co.uk

Mike Liu, CFA, London Office
Phone: 011 44 207 860 8318
E-Mail: mike.liu@citlon.co.uk

London Office

77 Gracechurch Street
London EC3V 0AS
United Kingdom
Phone: 011 44 20 7711 0771
Fax: 011 44 20 7711 0772
E-Mail: info@citlon.co.uk

Philadelphia Office

The Barn, 1125 Airport Road
Coatesville, PA 19320
United States
Phone: 610 380 2110
Fax: 610 380 2116
E-Mail: info@citlon.com

Seattle Office

Plaza Center
10900 NE 8th Street, Suite 1519
Bellevue, WA 98004
United States
Phone: 610 380 2110

Singapore Office

20 Collyer Quay
10-04
Singapore 049319
Phone: 011 65 6236 9136
Fax: 011 65 6532 3997

Dubai Office

Unit 2, 2nd Floor
The Gate Village Building 1
Dubai International Financial Centre
P.O. Box 506695, Dubai, United Arab Emirates
Phone: 011 971 4 249 8402
Fax: 011 971 4 437 0510

Website

www.citlon.com
www.citlon.co.uk

Important Notice

City of London Investment Management Company Limited is authorised and regulated in the UK by the Financial Conduct Authority, registered as an Investment Advisor with the United States Securities and Exchange Commission and regulated by the Dubai Financial Services Authority.

While City of London Investment Management Company Limited has used reasonable care to obtain information from reliable sources, no representations or warranties are made as to the accuracy, reliability or completeness of third party information presented herein. No responsibility can be accepted under any circumstances for errors of fact or omission. Some of the information in this document may contain projections or other forward looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions as of the date of this document which could change without notice and actual events or results may differ.

This document does not constitute an offer to sell or the solicitation of an offer to buy any securities. Nothing herein should be construed as investment advice to buy or sell any securities. Past performance is not a guide to future results. The value of an investment and any income from it can go down as well as up and investors may not get back the original amount invested.