Happy holidays

11 December 2017

DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1. MCI (P) 083/04/2017.
Months in Review

'Sufficient Progress' Made on Phase One of Brexit Talks
FX Street, 08-Nov-17

Trump Announces Jerome Powell as New Fed Chairman
FT, 02-Nov-17

UK could pay £50bn Brexit divorce bill after bowing to EU pressure
Guardian, 29-Nov-17

Draghi pulls off dovish trick with his QE ‘downsize’
FT, 26-Oct-17

German coalition talks collapse after deadlock on migration and energy
The Guardian, 20-Nov-17

US yield curve flattens to 10-year record
FT, 01-Nov-17

Key US consumer inflation rate rises in October
FT, 15-Nov-17

China's central bank warns of 'Minsky moment' as economy powers ahead
Reuters, 19-Oct-17

Bitcoin breaks through the $15,000 mark
BBC, 07-Dec-17

Euro zone growth, eclipsing U.S. economy, set to be best in decade
Reuters, 14-Nov-17

US Senate approves sweeping tax overhaul
FT, 02-Dec-17

Fed's Williams sees calm market reaction to balance sheet unwind
Reuters, 22-Sep-17

Madrid presses constitutional nuclear button
FT, 27-Oct-17

Bank of England takes slow lane after first rate hike since 2007
Reuters, 02-Nov-17

U.S. Economy Notches Solid 3% Growth, Despite Hurricanes
WSJ, 27-Oct-17

China's Communist Party congress - Xi Jinping seeks to cement his power
DW, 16-Oct-17

US stock market hits record high after Trump tax bill success
Guardian, 04-Dec-17
Happy holidays. This is what market sentiment feels like at the moment, with risk assets at or close to multi-year highs. Faster progress on tax reform bills in the US and the EU-UK exit deal provided the last positive catalysts. They add to a favourable backdrop of strong economic growth, increasingly supportive fiscal and regulatory policy, and tightening but still easy monetary policy.

The positive environment should extend in 2018. The global economy should expand at a strong pace, with the US and eurozone growing above potential, and China slowing down but only moderately. Political risk, though still present, shouldn’t escalate. We expect central banks exit from ultra-accommodative monetary policy to continue very gradually. As a result we are generally constructive on risk assets.

What could challenge this positive undertone? A sharp rise in inflation for starters. Despite strong growth and tight (or tightening) labour markets, developed markets inflation remains low, and markets have gotten used to this. There are however increasing signs that inflation will continue rising in 2018. A faster than expected pick-up could surprise markets and lead to a sharp repricing of central bank rate rise expectations, which could be disruptive for risk assets – akin to 2013’s taper tantrum.

Another risk is China growth. Authorities seem to have gotten more comfortable with slightly slower growth, and the central bank is tightening monetary policy. We expect some policy easing in mid-2018 to support growth. But this option may be off the table if inflation is high. Growth would then slow and could weigh on global growth.

In our base case these risks don’t materialise. But they are there. Happy holidays.

David Folkerts-Landau, Group Chief Economist
We expect the robust macro backdrop to continue in 2018, with monetary policy continuing to gradually tighten

Economic outlook

- Global growth to remain robust in 2018, even as momentum slows from highs, China slows down. Forecast 3.8% growth, higher than 2017
- US growth to continue above potential at 2.6% in 2018, up from 2017. Drivers of growth broadening beyond solid consumer spending
- Eurozone cyclically strong, see above consensus growth in 2018 at 2.3%. Main concern is how much longer can above-potential growth last
- EM: cyclical acceleration to continue, growth ticking up to 4.9% in 2018, even as China growth slows slightly

Central bank watch

- Fed: expect rate hike in December, another 4 in 2018
- ECB: slow exit to continue. No new measures until mid-2018; expect QE to end in 2018, first hike in mid-2019
- BoJ: not under pressure to act, no change expected in target short rate or yield curve control policy
- BoE: on hold, risk is additional rate hikes
- PBoC: policy tightening to curb financial risks, followed by some easing in H2-2018 to avoid growth slowdown
- EM: rate hikes starting especially in Asia, CEE – with few exceptions where cuts are still possible

Views on key themes

- Central banks on slow tightening path: led by Fed, followed by ECB but also across EM. Still low inflation means markets not yet fully pricing CBs’ stated plans
- Risk assets: with favourable macro backdrop, rally can last, as long as rates rise is not sharp
- Political risk: to remain prevalent (e.g., Germany, Italy, Catalonia, Brexit, US mid-terms) but little macro impact
- Brexit: increasingly seen as a UK issue. Focus now turns to ability to agree transition deal by Q1-2018
- US tax reform: rising chances of reform. Positive esp. for high tax corporates, but not a major macro impact

Key downside risks to our view

- Sharp rise in rates: taper tantrum-type scenario if inflation rises faster, central banks seen behind curve
- China growth slowdown: high inflation prevents easing of monetary policy to support growth
- DM growth deceleration: rising policy rates interrupt macro momentum, mild recession
- De-globalisation: rise of anti-trade policies exacerbates anaemic global trade and sharply slows growth

Notes: H / M / L indicates estimated probability of risk (High, Medium, Low).
2017 is set to have been a brilliant year for risk assets, with equities and credit rallying while rates remained well bid.

Returns* per asset class in 2017

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*Note: (*) Total return accounts for both income (interest or dividends) and capital appreciation. (**) FX, Commodities are spot returns.

Source: Bloomberg Finance LP, Deutsche Bank Research. As of COB, 07 December 2017
Solid global growth outlook continues. 2018 set to post highest growth in the decade, slightly ahead of 2017

Global growth outlook

US: solid growth outlook
- 2%+ growth through end-2018
- Growth drivers broadening as capex and trade pickup
- Deregulation is positive; only a modest boost from tax cuts

Eurozone: strong growth not for long
- Economy much more resilient to political uncertainty than feared
- Expect robust growth in 2018
- But pace unlikely to be sustained for long

UK: weakening economy
- Weak demand, high inflation to persist
- Downside risks to growth if household confidence weakens, Brexit contingency plans are triggered

EM: helped by strong global growth
- Positive outlook for EM as strong DM growth provides export pull
- Asia’s growth cycle most advanced, LatAm playing catch-up
- CEEMEA benefitting from strong growth in Europe

China: moderate slowdown in 2018
- Government appears tolerant of lower growth, policy tightening in H1-2018
- Rising inflation in H1 could trigger faster policy tightening
- Growth to rebound in H2-2018

Japan: growth to slow in 2018
- Five-year economic expansion reaching mature stage
- Domestic demand saturating and expected to slow
- See growth slowing to sub-1%, from nearly 1.5% in 2017

Real GDP growth (%yoy)

- World: 3.8%
- DM: 2.2%
- EM: 4.9%
- US: 2.6%
- Eurozone: 2.3%
- Germany: 2.3%
- France: 2.0%
- Italy: 1.4%
- UK: 1.0%
- Japan: 1.0%
- China: 7.5%
- Brazil: 2.6%
- Russia: 1.9%

Source: Deutsche Bank Research
2018 could be the year of reckoning for inflation and the Phillips curve as inflation at last rises

- Major DMs' core inflation below target despite strong growth
  - US ~0.5pp below target
  - Eurozone higher but below target; Japan falling
- Puzzle of weak inflation but strong growth, tight labour markets has raised questions about the Phillips curve*
  - Rising belief in structural disinflationary forces, including at central banks
- While we sympathise with these arguments, core inflation should move sustainably higher in 2018
  - Labour markets to tighten further
  - Inflation leading indicators supportive (e.g., ISMs, metals prices, US dollar / import prices)

* Core PCE inflation used for US

\* Core inflation below pre-crisis averages

\%y/y

<table>
<thead>
<tr>
<th></th>
<th>Latest</th>
<th>Average (2002-07)</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>1.5</td>
<td>2.0</td>
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<tr>
<td>Euro Area</td>
<td>1.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Japan</td>
<td>0.0</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Note: Data is unemployment rate minus NAIRU. Source: Haver Analytics, BLS, EC Statistical Office, Ministry of Internal Affairs and Communication, Deutsche Bank Research

Labor market set to tighten further

\%yoy

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>2018</th>
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</thead>
<tbody>
<tr>
<td>US</td>
<td>-0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Europe</td>
<td>-0.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.6</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Note: Metals prices lead US and EUR core inflation

\%yoy

- Metals (-20m, ls)
- US core cpi (rs)
- EUR core cpi (rs)

Source: Haver Analytics, BLS, WB, Eurostat, Deutsche Bank Research

Core inflation expected to improve from recent lows

\%yoy

Source: Haver Analytics, Eurostat, BLS, Deutsche Bank Research

Note (*): Phillips curve is the negative relationship between inflation and measures of economic slack, either the output gap or unemployment gap.
US growth should remain solid as the drivers of growth broaden. We expect only a modest boost from tax cuts

- US growth has picked up: back-to-back 3%+ growth in Q2 and Q3
  - We expect 2.8% growth in Q4, lifting 2017 growth to 2.6% (Q4/Q4), strongest since 2014
- Growth drivers have also broadened, as stronger capex, trade have joined resilient consumer spending
- Solid performance should continue into 2018
  - Solid balance sheets, elevated optimism support consumer
  - Capex lifted by firmer energy prices, solid global growth, and elevated business sentiment
  - Financial conditions are at record easy levels
- Modest boost from tax cuts (a few tenths), if they occur
- Potential growth has been subdued but should pick up modestly
  - Some scope for tepid productivity growth to improve

![Growth has picked up in recent quarters](chart1.png)

![And growth drivers have broadened beyond the consumer](chart2.png)

![Financial conditions move to a new high](chart3.png)

![Consumer and business confidence riding high](chart4.png)
US tax reform is progressing faster than markets expected. This is positive for corporates, individuals – but macro impact modest.

- US Congress working towards passing a bill to cut taxes for corporates and households – odds have improved that this will be achieved by year-end
  - House, Senate each passed own version of bill
  - Conference to reconcile differences as next step
  - Final bill to be closer to Senate version, as this is where voting constraints are
  - Expect incremental deficit of $1.4tn over next ten years
- Tax cuts to be positive for corporates, households
  - Corporate: rate cut from 35% to 20% in 2019; upfront expensing of investment; limits on interest deductibility; repatriation tax holiday
  - Households: lower tax rates; eliminate most major deductions, including for state and local taxes; tax cuts expire after 2025
  - Other: small business tax cuts; pivot to a territorial corporate tax system
- Despite the positive impact at micro level, overall macro impact looks to be relatively limited
  - Impact of only a few tenths of 1% of GDP

### Comparison of both bills

<table>
<thead>
<tr>
<th>Corporate</th>
<th>Rate</th>
<th>House bill</th>
<th>Senate bill</th>
</tr>
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<tbody>
<tr>
<td>Tax cut in</td>
<td>2018</td>
<td>20%</td>
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<td>Repatriation</td>
<td></td>
<td>Liquid assets at 14%</td>
<td>Phases out</td>
</tr>
<tr>
<td>Bonus capex depreciation</td>
<td></td>
<td>Expires in 2022</td>
<td>Phases out</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Household</th>
<th>Top rate</th>
<th>House bill</th>
<th>Senate bill</th>
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<tbody>
<tr>
<td>Brackets</td>
<td>39.6%</td>
<td>Four</td>
<td>Seven</td>
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<tr>
<td>Current deductions*</td>
<td>Eliminated</td>
<td>Preserved</td>
<td></td>
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<tr>
<td>Standard deduction</td>
<td>Nearly doubled</td>
<td></td>
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<tr>
<td>Alternative minimum tax</td>
<td>Eliminated</td>
<td>Scaled back but not eliminated</td>
<td></td>
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<tr>
<td>Child tax credit</td>
<td>$1,600 per child</td>
<td>$2,000 per child</td>
<td></td>
</tr>
<tr>
<td>Pass throughs</td>
<td>Top rate 25% with caveats</td>
<td>Deduct 23% of income</td>
<td></td>
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<tr>
<td>State &amp; local deduction</td>
<td>Preserved for property tax up to $10,000</td>
<td></td>
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<tr>
<th>Deficit impact</th>
<th>2018</th>
<th>2018-27 (10 yr)</th>
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<tbody>
<tr>
<td></td>
<td>$32bn / 0.2% of GDP</td>
<td>$1.45tn</td>
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</tbody>
</table>

Note: (*) Deductions for medical expenses, student loans interest rates, personal exemption

Source: US House and US Senate, Deutsche Bank Research
We expect strong growth in the eurozone to continue into 2018, but this pace is unlikely to be sustained for very long

- Eurozone to record strongest growth in a decade in 2017, showing resilience to political uncertainty
  - 2017 GDP growth almost 1pp higher than
  - Unprecedented political uncertainty did not result in material macro impact
  - Domestic demand fuelled by market recovery, capex driven by pent-up demand, exports helped by strong global growth
  - ECB maintained easy, stable financial conditions
- See strong growth in 2018, but slowdown inevitable
  - Initial signs of inflation pick-up as economy grows above potential (e.g., wages, upstream prices rising)
  - Credit dynamics at odds with continued strong domestic demand growth – either spending slows, or bank lending accelerates, or both
  - Gap between very strong manufacturing sector and robust services sector, normally closing with deceleration in manufacturing sector

Eurozone growth came in stronger than expected, with 2017 growth nearly a full pp higher than foreseen a year ago

The credit impulse* suggests a slower level of private domestic demand growth

Note: (*) Credit impulse: Deutsche Bank’s non-consensus view is that it is not credit growth but rather the change in credit growth that is important for domestic demand growth. A slowdown in the pace of deleveraging boosts spending growth, even if credit growth may still be negative
Political uncertainty has retreated, but event risk remains. We don’t expect adverse outcomes and significant macro impact.

**Policy uncertainty has retreated**

**Events**

- **Government formation (ongoing)**
  - Collapse of Jamaica* talks – FDP walked away accusing others of unwillingness to modernise Germany
  - President against new election

- **Catalonia elections (21 Dec)**
  - Central government withdrew Catalonia’s autonomy following independence declaration
  - Social tension subsided
  - Little evidence of macro impact
  - New election in December

- **Parliament elections (TBD, by 20 May)**
  - New electoral law marginally reduced chance of populist Five Star Movement** government
  - Berlusconi’s centre-right Forza Italia, right-wing populist Northern League gaining support

**Deutsche Bank view**

- Political system favours stability
- SPD reconsidering grand coalition with Merkel’s party, or support for minority government
- New government unlikely by year-end
- Separatists likely to keep small majority in election, if united
- Madrid strongly against secession
- Expect compromise resolution that grants region further autonomy, but de-escalation
- Unstable politics, as centrist majority increasingly complex#
- For now, Italy helped by slow ECB exit, growth momentum
- Medium-term, weak governments unable to push reform will hamper growth, feed extremism / populism

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Notes: (*) Jamaica coalition describes coalition among the Christian Democratic Union / Christian Social Union, Free Democratic Party and Green Party. (**) SSM. (#) According to opinion polls
Brexit will continue to draw attention in Europe, though increasingly this is seen as a UK not EU risk

- Brexit talks finally making some progress
  - Sufficient progress* likely by 14-Dec EU Council
  - Means negotiations move from just exit talks to negotiation of future relationship
- Securing a transition deal** soon is key for the UK
  - No time to negotiate future state by Mar-2019#
  - Lack of clarity by Mar-2018 (12 months before Brexit) likely to trigger contingency plans – hurting the economy
- Securing a transition deal a tall order, given UK’s target end-state relation with EU still unclear
  - From EU standpoint, only two options available, EEA membership or free trade agreement
  - Trade-off for UK: EEA and single market access vs. autonomy under free trade agreement
  - Tightrope for UK government, to keep Brexiters on board while not antagonising EU
- Brexit to remain in focus in 2018, but increasingly seen as a risk to the UK not the EU
  - UK more negatively impact without a transition, at least in the short- to medium-term

### December’s EU Council only the end of the beginning of Brexit negotiations

<table>
<thead>
<tr>
<th>Divorce</th>
<th>Future relationship and transition</th>
<th>Ratification</th>
</tr>
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<tbody>
<tr>
<td>15-Dec EU27 to decide on sufficient progress*</td>
<td>23-Mar UK needs transitional deal</td>
<td>19-Oct UK / EU deal to parliaments for approval</td>
</tr>
<tr>
<td>29-Mar Brexit day</td>
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</tbody>
</table>

### Possible Brexit outcomes

<table>
<thead>
<tr>
<th>Crash Brexit</th>
<th>Deal Description</th>
<th>How do we get there</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU exit in 2019, no transitional or future agreement in place</td>
<td>Weak UK government unable to compromise</td>
<td></td>
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<tr>
<td>Talks fail, time runs out</td>
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<tr>
<td>Free-trade deal</td>
<td>Satisfies UK’s “clean Brexit” constraints</td>
<td></td>
</tr>
<tr>
<td>W/ transitional deal</td>
<td>UK government willing and able to compromise – some signs</td>
<td></td>
</tr>
<tr>
<td>EEA-type agreement</td>
<td>But fragile government makes for difficult reconciliation of Brexit and pro-EU camps</td>
<td></td>
</tr>
<tr>
<td>W/ transitional deal</td>
<td></td>
<td></td>
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</tbody>
</table>

Notes: (*) EU demands that sufficient progress be made on exit “divorce” talks before engaging negotiations on the future UK / EU relationship. (**) Transitional deal to bridge period between EU exit and future agreement kicking in. (#) 29-Mar-2019 set as Brexit day
In China, growth is set to slow moderately due to fiscal and monetary policy tightening. Watch inflation and interest rate risks

- China’s growth is expected to slow in 2018, after the strong performance so far in 2017
  - Investment slowed down, property sales growth turned negative in October
- The slowdown is driven by policies
  - Government is likely to tolerate slower growth to make room for deleveraging, following the policy message from the 19th CPC Party Congress
  - Monetary, fiscal, and property market policies may be tightened further
- Risks may stem from inflation and interest rates in the next 6 months…
  - Inflation is expected to pick up in early 2018
  - Interest rates are on the rise amid tightening financial sector regulations
- …but overall, risks should be manageable. We do not expect a hard landing
  - We expect the government to loosen policy on the property sector some time in H1. Investment will likely rebound in H2 2018

China growth to slow in the near term, rebound in H2 2018

CPI inflation is expected to rise in early 2018
EM will continue to benefit from robust growth in advanced economies. EM specifics to play an important role in 2018

- EM growth outlook remains positive in 2018, helped by synchronised global growth
  - Expect slightly higher and less disperse growth across EM and DM
  - Typically accompanied by acceleration in investment, pick-up in portfolio inflows, FX appreciation and reduced policy divergence
- Asia growth cycle most advanced
  - Inflation pressures building as output gaps are closed
  - Monetary policy tightening, but offset by easing of fiscal policy, with China the notable exception
- Latin America cycle lagging, but expect growth to double in the region (from a low base)
- In some limited cases low inflation should allow central banks to cut rates against rising growth – e.g., Brazil, Russia
- Country specifics, including a heavy political calendar, should play a bigger role in 2018

![Graph showing EM growth premium to DM rising but still much lower than pre-crisis](source: Haver Analytics, IMF WEO, Deutsche Bank Research)

![Positive growth outlook for EM in 2018. LatAm to pick-up pace](source: Deutsche Bank Research)
The Fed and ECB continue on their exit path – while BoE and BoJ are likely to remain on hold

<table>
<thead>
<tr>
<th>Macro backdrop</th>
<th>Federal Reserve</th>
<th>European Central Bank</th>
<th>Bank of England</th>
<th>Bank of Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strong macro backdrop, growth above trend</td>
<td>GDP growth strong, above-trend, rising</td>
<td>Economy slowing. Weak pound hurts households but doesn’t help exports</td>
<td>Economy slowing down into 2018</td>
<td></td>
</tr>
<tr>
<td>At full employment</td>
<td>Indications of upstream price pressure emerging</td>
<td>Close to full employment</td>
<td>Inflation to peak below 1%</td>
<td></td>
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<tr>
<td>Inflation has been low</td>
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| Key challenge                  |                                                             |                                                             |                          |
| Soft inflation casts doubt over Fed’s rate guidance | Gaps in data say growth unlikely to stay so fast   | Conflicting goals: high inflation, weak sterling warrant higher rates, but this threatens growth | Inflation, wage growth not rising despite near full-employment and massive BoJ stimulus |
| Market reluctant to price normalisation beyond next hike (i.e., terminal rate pricing is low) | Market confidence in inflation normalisation remains low | Brexit uncertainty       | Sustainability of Yield Curve Control* |

| Policy stance                  |                                                             |                                                             |                          |
| Sticking to gradual exit       | Strength of economic recovery allows gradual exit from QE | On hold, as weak growth prevents further hikes              | On hold, no changes in target yields on YCC |
| Would like to see convincing evidence of firmer inflation to continue rate hikes | Slow, gradual exit warranted by inflation | But risk of tightening if Brexit transition agreed early | Priority in sustaining over fine-tuning YCC |

| What we expect                 |                                                             |                                                             |                          |
| Dec-17: rate hike               | QE continuing at E30bn/pm until Sep-18                      | No policy change through 2018                               | Expect Kuroda to be reappointed – meaning status quo for policy |
| 2018: four hikes, with inflation being key | End-18: QE finishes                                      | Risk is of more tightening                                  |                          |
| Ongoing balance sheet unwind in background | Mid-19: first policy rate hike (refi & depo rate) |                                                             |                          |

Note: (*) BoJ introduced YCC in Sep-2016. Rather than maintaining a commitment to a JPY amount of QE purchases, the BoJ started targeting a 10-year yield around zero. The policy has a countercyclical nature: the more inflation normalises and yields rise, the more bonds the BoJ will purchase, thus easing when not needed; the opposite also holds true.
Fed to raise rates in December. Four more increases expected in 2018 as officials grapple with the causes of recent low inflation

- Fed policy decisions are being made in the presence of strong countervailing forces
  - On the hawkish side are solid growth, a tight labour market, and loose financial conditions
  - On the dovish side are softer inflation and a belief the neutral fed funds rate (r-star*) is low
- We expect the Fed to raise rates again in December
  - Fed communications have signaled a hike and market is nearly fully pricing the move
- In 2018, we see four rate hikes – the first in March – but inflation developments will be crucial
  - Fed is having an open debate about the sources of low inflation – temporary factors versus structural disinflationary forces (e.g., innovation)
  - We expect more convincing signs inflation is rising, pushing Fed to hike more aggressively
- We expect three hikes in 2019, pushing the fed funds rate above 3%, with unemployment near 3.5% and inflation slightly above target
- Alternatives to 2% inflation target being discussed, as a low r-star means monetary policy will be more frequently restrained by near-zero rates in the future

**DB fed funds rate projections above the Fed, well above market**

<table>
<thead>
<tr>
<th>%</th>
<th>Sep FOMC projections</th>
<th>Sep FOMC medians</th>
<th>Market pricing (latest)</th>
<th>DB forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
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<tr>
<td>1.0</td>
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<td>4.0</td>
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</table>

Source: FRB, Deutsche Bank Research

**Policy framework options: Impact on Fed policy outlook**

<table>
<thead>
<tr>
<th>Framework option</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher inflation rate target</td>
<td>Fed raises inflation rate target from 2% to, say, 3 or 4%</td>
</tr>
<tr>
<td>Price level target</td>
<td>Fed targets price level instead of inflation rate</td>
</tr>
<tr>
<td>Nominal GDP target</td>
<td>Fed targets nominal GDP growth or level</td>
</tr>
<tr>
<td>Temporary approaches</td>
<td>Switches frameworks (e.g., to price level targeting) when fed funds rate is at zero lower bound but otherwise unchanged</td>
</tr>
<tr>
<td>Enhanced forward guidance</td>
<td>Calendar / outcome-based guidance when policy rate at ZLB</td>
</tr>
</tbody>
</table>

Note (*): The neutral fed funds rate (“r-star”) is the level of the real fed funds rate that keeps output at potential and inflation at target. Rates below r-star are accommodative while rates above r-star are restrictive.
With the ECB embarked on a slow exit, little is expected before mid-2018. We expect the first hike a year later, earlier than market expectations.

- ECB exit measures in October a market non-event
  - Reduction of QE purchases, extension to Sep-2018; stick to open-ended commitment to QE
- Little reason for ECB to act before mid-2018
  - Little / no inflation pressure through 2018
  - Current guidance buys time through Q1/2-2018
  - Expect QE to end in Q4-2018, first hike mid-2019
- Market taking a more dovish view, with a first hike only in 2020. This appears too complacent
  - Evidence of turning point in inflation cycle beginning to build
  - Taylor Rule\(^*\) suggests unconventional monetary policy ought to end before 2018
  - ECB to tighten monetary policy more, to compensate for easing of fiscal stance when GDP growth is strong, output gap is closed
- Still low inflation, upcoming Italian election mean repricing of ECB hikes is unlikely before H2-2018
- Change in composition of ECB board makes current framework / guidance somewhat less relevant
  - 5 out of 6 board members to be replaced by end-2020, including Draghi at end-2019

### Eurozone core inflation to gradually accelerate

![Graph showing ECB expectation, Actual, and DB forecast for Eurozone core HICP inflation, %yoy from 2014 to 2019.](source: ECB, Haver Analytics, Deutsche Bank Research)

### Market pricing a slower ECB cycle than we expect

![Graph showing ECB policy rate, bp from 2018 to 2021.](source: Bloomberg Finance LP, Deutsche Bank Research)

Note: (*\) 3m Eonia minus spot
Note: (#) A Taylor rule infers the policy rate that should be set by the Central Bank given the current state of the economy and inflation.
### Summary of market views

<table>
<thead>
<tr>
<th>Asset class</th>
<th>View</th>
<th>Rationale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Markets</td>
<td>Supportive backdrop for risk</td>
<td>Positive context set to continue, allowing for continued strong performance for risk assets. On current expectations, monetary policy tightening to be benign, not disruptive for risk</td>
</tr>
<tr>
<td>Equities</td>
<td>US: bullish view</td>
<td>S&amp;P surpassed year-end target. See upside to 2,850 by end-2018 on strong earnings growth. Additional upside from tax reform, end-2018 target of 3,000</td>
</tr>
<tr>
<td></td>
<td>Europe: cautious view</td>
<td>Goldilocks backdrop of accelerating growth and falling real bond yields fading. End-2018 target of 395, but risk of ~5% pullback by Q2-2018</td>
</tr>
<tr>
<td>Rates</td>
<td>Strategically bearish</td>
<td>Rising US inflation as well as fiscal and regulatory easing will support further Fed tightening. Target 3% for US 10y yield in 2018. ECB to hike rates earlier than currently priced</td>
</tr>
<tr>
<td>FX</td>
<td>Broad USD downside</td>
<td>USD multi-year upcycle ended this year. Tactical dollar bounce since September likely over, and structural downside risks dominate into 2018. Little upside from tax reform, as this is mostly priced in</td>
</tr>
<tr>
<td></td>
<td>EUR positive</td>
<td>Target 1.20 for end-2018, but risk is of an overshoot above this target</td>
</tr>
<tr>
<td>Credit</td>
<td>Constructive short-term</td>
<td>Scope for further spread tightening in Q1 especially in Europe as recent widening attracts investors back into the asset class</td>
</tr>
<tr>
<td>EM</td>
<td>Positive short-term, more cautious thereafter</td>
<td>EM assets to continue benefitting from positive backdrop for risk. Portfolio inflows to remain supportive. Turning more cautious later as DM monetary tightening poses headwinds</td>
</tr>
<tr>
<td>Oil</td>
<td>Short-term risk</td>
<td>Risk for downside during Q1-2018 as US supply optimism rebuilds. Medium term constructive as demand growth absorbs OPEC spare in 2019</td>
</tr>
</tbody>
</table>
Markets are benefiting from a supportive macro backdrop; this context is set to continue, but there are risks

- Risk assets continue to perform strongly
  - US equities record highs, strong rally in Europe
  - Credit spreads at or close to multi-year tights
- The macro backdrop is supportive
  - Strong cyclical growth, easing fiscal policy, end of regulatory drive
  - Tightening monetary policy, but only gradually and from ultra accommodative levels – financial conditions still strongly supportive
- Positive context set to continue, allowing for continued strong performance for risk assets
  - On current expectations, monetary policy tightening to be benign, not disruptive for risk
- Markets not shielded from a correction, e.g.,
  - Sharp and disorderly repricing up of rates, ala 2013’s taper tantrum – triggered by faster than expected rise in inflation
  - Sharper growth slowdown in China, if sticky inflation prevents easing of monetary policy

Supportive macro backdrop for markets

- Growth
  - Strong global growth, 2017-18 to post highest growth of decade
  - Momentum coming off highs
- Fiscal stance
  - Fiscal easing – e.g., US tax reform, fiscal relaxation in Europe
- Regulatory stance
  - Past peak regulatory tightening
  - Trend toward regulatory easing especially in the US
- Monetary stance
  - Gradual tightening continues
  - Overall stance still very accommodative

Macro momentum remains robust across regions

Source: Haver Analytics, Bloomberg Finance LP, Deutsche Bank Research
We are bullish US equities, where we expect the rally to extend. Further upside potential if US tax reforms passes

- S&P500 rallied close to 20% this year
  - Strong earnings the primary driver, some multiple expansion too
  - Little impact from strong dollar
  - Additional boost from tax reform hopes
- We are bullish in 2018
  - Target 2,850 (+8% from current levels)
  - Expect continued strong EPS growth in 2018 – supported by continued strong US and global growth, small dollar boost

- Tax reform could provide additional upside
  - 2018 year-end target of 3,000
  - Stronger EPS growth – commensurably above trend
  - Multiple should compress as markets look through above-normal earnings
  - Further scope for outperformance for high tax companies – 5pp outperformance so far vs. low tax firms is low given EPS sensitivity to tax cut

Source: Bloomberg Finance LP, Deutsche Bank Research
In Europe, our equities outlook is more cautious as some of the drivers that have provided support fade

- European equities benefitted from Goldilocks conditions of rising growth, falling real bond yields
  - These tailwinds are turning
- We see some but limited upside into end-2018 – muted EPS growth, no multiple expansion
  - End-2018 target of 395
  - EPS weighed by euro appreciation

- Tactically neutral, but some downside by Q2-2018
- Overweight defensives, underweight cycicals, underweight resources
  - Our PMI momentum framework points to 8% downside for cycicals vs defensives by Q2, with relative Shiller P/E already at a 30-year high
  - Favourite defensives: pharma, food & bev, telecoms
  - Underweight autos, tech, luxury goods

Fair value multiple moving lower to 15.1 at end-18

Goldilocks – strong growth, low yields

Source: Haver Analytics, Bloomberg Finance LP, Deutsche Bank Research
We are strategically bearish core rates. We expect more monetary policy tightening than the market prices

- Supportive macro backdrop...
  - Strong global growth, easing fiscal stance
  - Low but gradually rising inflation
- ...should allow Fed, ECB to continue gradually tightening monetary policy
  - Fed to hike in December, and another four times in 2018
  - ECB to announce mid-year the end of QE around end-2018

- Market is however taking a more dovish view on the monetary policy path
  - US: Dec-2017 hike fully priced, but only 2 hikes priced for 2018 vs. our expectation of 4 hikes
  - Europe: market extrapolating from Fed precedent, expecting first hike a year after end of QE – we expect the ECB to be more hawkish
  - Significant repricing unlikely in Q1-2018
- Risk is sharp and sudden repricing of central bank tightening, e.g., if inflation surprises to the upside

Expect core rates to rise steadily through 2018

![Graph showing US 10Y vs. EU 10Y core rates from 2013 to 2018 with DB forecasts.](image)

Source: Bloomberg Finance LP, Deutsche Bank Research

Eurozone inflation expectations slowly but steadily rising

![Graph showing 5y5y inflation expectations from Jan-16 to Oct-17 with US and Eurozone data.](image)

Note: Market-based (inflation swaps) Source: Bloomberg Finance LP, Deutsche Bank Research
In FX, we see the tactical dollar bounce as likely over and structural downside risks dominate

- Multi-year dollar upcycle interrupted this year
- Broad dollar troughed in mid-September and bounced until early November
  - 4% bounce against majors into mid-November
  - Supported by revived hopes for meaningful tax reform in the US, speculation over a hawkish replacement for Janet Yellen at Fed
- Tactical bounce is likely over now
- Structural downside risks dominate into 2018
  - Tax reform to deliver unfunded tax cuts of $1.5trn at best, and Fed terminal rate pricing now reflecting it more fairly
  - Structural euro upside on robust eurozone growth, receding political risk, and increasingly hawkish risks to ECB forward guidance
- Overvaluation to weigh on broad dollar, not just vs. euro
As for the euro, despite the large move this year we see risks of a drift above our 1.20 target vs. the dollar next year

- EURUSD already above our year-end target of 1.17 and could squeeze higher
  - German political uncertainty could be positive if Grand Coalition emerges
  - Growth momentum exceptionally strong
- 14% move this year largest since 2014, but not extreme and less pronounced on a trade-weighted basis (+9%)

- We target 1.20 for end-2018 but EURUSD is more likely to overshoot than to reverse lower
  - Currency only just approaching fair value
  - Global real money still structurally underweight, generating demand for euro assets
  - Few signs of stronger euro weighing on growth
  - First ECB rate hike priced very dovishly for 2020, and a repricing of the front-end would be more bullish than QE taper

---

![Annual ranges in EURUSD since 1976: this year is not extreme](source)

![Beta of EURUSD to 1% change in Eurozone swap yields by tenor](source)
Oil has recovered strongly from its mid-year slump. We are now tactically negative on US supply

- We are tactically negative on a second emerging wave of supply-positive data emerging from the US:
  - Rig counts responding to higher WTI price
  - Rig productivity rising as frac capacity delivered
  - Monthly and weekly production data now agree, removing a key uncertainty
- Global supply-demand balance surplus of +500 kb/d in Q1-18 also likely to be a short-term negative
- Slower inventory draws over the next 12 months suggest stable prices with risk of downside drift
- Medium term we are constructive on the commodity; recent pre-FID project breakevens indicate USD 65/bbl is still relevant as a marginal cost of supply, and therefore an equilibrium price level
- Likelihood of sizeable deficit emerges in 2020 (-750 kb/d) after US supply growth and OPEC spare capacity are both absorbed by steady demand growth
- Possible overshoot of USD 65/bbl equilibrium in 2020

---

![Graph: US oil rig count in a rebuilding phase, signaling stronger growth](source)

![Graph: OECD inventory surplus reduction to follow slower path](source)

![Graph: Global supply demand deficit emerging in 2020](source)
## DB forecasts

<table>
<thead>
<tr>
<th>GDP growth (%)</th>
<th>2016</th>
<th>2017</th>
<th>2018F</th>
<th>2019F</th>
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<tr>
<td>Global</td>
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<td>3.7</td>
<td>3.8</td>
<td>3.7</td>
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<td>US</td>
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<td>2.3</td>
<td>2.6</td>
<td>2.2</td>
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<tr>
<td>Eurozone</td>
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<td>2.3</td>
<td>2.3</td>
<td>1.7</td>
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<tr>
<td>Germany</td>
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<td>2.3</td>
<td>2.3</td>
<td>1.8</td>
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<td>1.4</td>
<td>1.0</td>
</tr>
<tr>
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<td>3.1</td>
<td>2.9</td>
<td>2.3</td>
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<tr>
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<td>1.5</td>
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<td>0.8</td>
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<tr>
<td>UK</td>
<td>1.8</td>
<td>1.6</td>
<td>1.0</td>
<td>1.4</td>
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<tr>
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<td>6.8</td>
<td>6.3</td>
<td>6.3</td>
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<table>
<thead>
<tr>
<th>CPI inflation, YoY (%)</th>
<th>2016</th>
<th>2017</th>
<th>2018F</th>
<th>2019F</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>1.3</td>
<td>2.1</td>
<td>2.1</td>
<td>2.2</td>
</tr>
<tr>
<td>Eurozone</td>
<td>0.2</td>
<td>1.5</td>
<td>1.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.1</td>
<td>0.3</td>
<td>0.4</td>
<td>0.8</td>
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<tr>
<td>UK</td>
<td>0.6</td>
<td>2.6</td>
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<tr>
<td>China</td>
<td>2.0</td>
<td>1.7</td>
<td>2.7</td>
<td>2.4</td>
</tr>
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<table>
<thead>
<tr>
<th>Central Bank policy rate (%) Current</th>
<th>Q4-18F</th>
<th>Q4-19F</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>1.125</td>
<td>2.375</td>
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<tr>
<td>Eurozone</td>
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<tr>
<td>Japan</td>
<td>-0.10</td>
<td>-0.10</td>
</tr>
<tr>
<td>UK</td>
<td>0.50</td>
<td>0.50</td>
</tr>
<tr>
<td>China</td>
<td>1.50</td>
<td>1.50</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Key market metrics</th>
<th>Current</th>
<th>Q4-18F</th>
<th>Q4-19F</th>
</tr>
</thead>
<tbody>
<tr>
<td>US 10Y yield (%)</td>
<td>2.38</td>
<td>2.95</td>
<td>2.96</td>
</tr>
<tr>
<td>EUR 10Y yield (%)</td>
<td>0.31</td>
<td>0.90</td>
<td></td>
</tr>
<tr>
<td>EUR/USD</td>
<td>1.177</td>
<td>1.20</td>
<td>1.20</td>
</tr>
<tr>
<td>USD/JPY</td>
<td>113</td>
<td>120</td>
<td>110</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>2,652</td>
<td>2,850</td>
<td></td>
</tr>
<tr>
<td>Stoxx 600</td>
<td>389</td>
<td>395</td>
<td></td>
</tr>
<tr>
<td>Oil WTI (USD/bbl)</td>
<td>57.4</td>
<td>52.0</td>
<td>53.0</td>
</tr>
<tr>
<td>Oil Brent (USD/bbl)</td>
<td>63.4</td>
<td>55.0</td>
<td>56.0</td>
</tr>
</tbody>
</table>

* CPI (%) forecasts are period averages

CEEMEA: Czech Rep., Israel, Egypt, Hungary, Kazakhstan, Nigeria, Poland, Romania, Russia, Saudi Arabia, South Africa, Turkey, UAE and Ukraine

LATAM: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela

ASIA: China, HK, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Sri Lanka, Taiwan, Thailand, Vietnam

DM: Australia, Canada, Denmark, Eurozone, Japan, New Zealand, Norway, Sweden, Switzerland, UK, US

Source: Deutsche Bank Research

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