The House View

Snapshot

Macro views

World

- We expect global growth to accelerate to +3.8% in 2018, marginally faster than 2017 which was the fastest in a decade, with the improvement led by the US and emerging markets. Relative to consensus, we are most bearish on the UK and Japan. We expect the Eurozone to continue growing above potential, but do not anticipate any further acceleration. In China, we expect growth to slow, and are more worried about inflation and financial risks than consensus.
- This remains a very robust and broad-based economic backdrop. However, 2018 should mark the peak of the current cyclical expansion, and growth should decelerate from 2019.

United States

- Growth to accelerate in 2018 to +2.7%, the fastest pace since 2015, boosted around 0.3-0.4pp by Trump's tax reform. We note upside risks to this estimate given the potential for increased fiscal spending if Congress ends up raising its spending caps in the FY2018 budget.
- Growth momentum remains very strong, with firms continuing to expand their capital expenditure and consumer spending accelerating impressively. A potential headwind to this outlook is in housing, where activity remains tepid and the new tax reform's provisions could further weigh on the sector.
- By several measures (e.g., ISM prices paid index, unemployment rate, gauges of underlying prices) inflation should accelerate in Q2-2018 after disappointing in 2017. We see core PCE inflation at +1.9% by the fourth quarter, at +2.2% by end-2019, above the Fed's +2.0% target for the first time since 2006.
- Dollar weakness (7% depreciation on a trade-weighted basis in 2017) should add a few tenths of a percentage point to both inflation and growth.

Eurozone

- Eurozone growth has risen to the fastest pace in a decade. We forecast +2.3% growth for 2018, in line with consensus. We expect growth to decelerate in the second half of the year as tailwinds fade.
- Indeed the current pace of growth is far above our estimate of potential growth, which is around +1.0%. Cyclical momentum will naturally decline as output gaps close; financial conditions will tighten as the ECB exits its accommodative policy stance; and the boost from net exports will fade as Asia, and especially China, decelerate. A strong euro will also act as a drag on growth, albeit with a lag.
- The political agenda remains busy, with Germany's government formation, Brexit negotiations, the Italian election and the debate on EU reform. On all fronts, though, our baseline scenario is for little fundamental change or macro impact.

China

- China's economy to continue decelerating in 2018. We forecast +6.3% growth vs. +6.9% for 2017. We see risks balanced on both sides. Fiscal and monetary policies will remain tight and investment will continue to slow. This will be partially balanced by strong wage growth and consumer spending.
- Assuming growth decelerates as we expect, PBoC should ease monetary policy in H2 (we see two RRR cuts) as stimulus. Our base case is for policymakers to mitigate the extent of any slowdown, avoiding a sharp deceleration.
- We see two major risks to our base case. The first is inflation: core inflation reached a 6-year high in 2017 and could rise further this quarter; this could prompt PBoC to raise rates (in the past we have seen hikes when CPI reached +3.0%). The second is financial stability on the back of high leverage in the financial sector. The system has grown more complex, credit quality has deteriorated, and IMF stress tests showed potential capital shortfalls at a significant number of large- and mid-sized banks.

Emerging Markets

- EM growth to remain broadly positive in 2018, but regional cycles becoming more differentiated: Latin America in a more favourable cyclical position than most of EM Asia and, to a lesser extent, CEEMEA.
- The geo/political calendar presents idiosyncratic risk in many major EMs: general elections in Mexico, Brazil, Russia; regional elections in India, Indonesia; volatility in South Korea, South Africa, Turkey.
- These fundamentals should support continued portfolio flows into EM and help the macro picture. Historically, Fed rate hikes have not interrupted EM flows unless long-end rates also increased.

Monetary Policy

- Fed: expect 4 rate hikes in 2018, more than FOMC guidance (3) and than market pricing (2.5).
- ECB: expect QE to terminate at end-2018, first hike in mid-2019, broadly in line with market pricing.
- BoJ: Kuroda to be reappointed, monetary policy broadly unchanged, but net QQE purchases to slow.
- BoE: on hold until 2019 due to Brexit uncertainty, slow growth. Risks skewed to earlier rate hikes.
- PBoC: policy steady through H1-2018, followed by 100 bps of RRR cuts as growth slows in H2. Risk of policy tightening if inflation surprises to the upside.
- EM: regional divergence – tightening in Asia contrasts with room for rate cuts in LatAm.

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Key downside risks

- Higher than expected inflation prompts fast monetary policy tightening, disrupts markets
- Market correction: a global equity correction weighs on sentiment and wealth, triggers a recession
- Financial stability: tighter policy or slower growth causes financial sector instability especially where leverage is high
- China slowdown: higher inflation, a policy mistake, or financial stress leads to a marked deceleration in growth, with global ramifications though trade and financial channels

Key themes

- Cyclical recovery reaches its peak: most countries' economic growth will plateau or decelerate in 2018, LatAm being a key exception. We forecast slower growth in the UK, Japan, China, and the rest of EM Asia in 2018, and in the US and the Eurozone in 2019. As such 2018 should mark the peak of the current cyclical expansion, and growth should decelerate from 2019.
- Steady inflationary pressures: we expect inflation to start picking up more noticeably this year, as output gaps continue to close. Leading indicators suggest inflation will rise more noticeably from Q2 in the US; we expect similar dynamics in Europe. In EM, energy and food prices may accelerate, partially attributable to positive base effects, putting upward pressure on gauges of headline inflation.
- The end of QE: 2018 (almost) the last year of QE (BoJ may continue QQE in 2019). We expect ECB purchases to end in Q4; the BoJ's volume of purchases has slowed amid its YCC framework; the Fed will continue to let its balance sheet runoff accelerate. The end of QE will need to be watched carefully, given the program's earlier impact on term premia and risk assets.
- US government shutdown: modest negative for growth but should not derail Fed hiking plans. Based on prior episodes, a two-week shutdown could take 0.25-0.5pp from annualised quarterly growth.

Market views

Equities

- Constructive US equities despite record levels. Corporate tax reform fully priced in at the index level, but strong US macro backdrop should support equities. We target the S&P500 at 3,000 for end-2018.
- Neutral European equities, targeting the Euro Stoxx 600 at 395 for end-2018. PMIs and growth should plateau this year, and the euro's strength will continue to weigh on exporters' profits.

Rates

- Strategically bearish in US and Europe. Despite recent sell-off, the market is still pricing low inflation and little further tightening ("Fed is nearly done") – at odds with our inflation and central bank views.

FX

- Bearish dollar: currency reached a medium-term peak. As in 2004-06, the dollar can weaken despite favourable rate differentials: wider twin deficit, record-high US asset valuations negative for inflows.
- Bullish euro: flipside of our bearish dollar view; target 1.30 vs. dollar this year. ECB expectations have more room to reprice and the positive basic balance will keep flows highly supportive.
- Bearish yen, but risks are balanced and prefer to buy volatility than take a positional view.

Credit

- Constructive credit short-term, as fundamental and policy support remain steady for now. As end of QE approaches in Europe and growth levels off, we expect credit to be pressured.

EM

- Positive macro backdrop of strong growth, rising but not yet high DM inflation, still low vol to continue supporting EM inflows and in turn asset valuations – even if performance should moderate after a stellar 2017. Returns to be tilted toward EM FX – we are long EM FX vs. USD.
- However, risks remain higher than in 2017, given reduced central bank support, China's deceleration, and potentially stretched valuations.

Commodities

- Negative on oil, positive on metals. Global growth points to continued commodity demand, but we expect oil prices to decline modestly from current levels as US supply rebounds.
- The supply outlook is more nuanced for metals, as reforms, disruption, and slow supply growth, mean that robust industrial activity should support prices.

Key macro and markets forecasts

GDP growth (%)

	2016	2017	2018F	2019F
Global	3.2	3.8	3.9	3.8
US	1.5	2.3	2.7	2.2
Eurozone	1.8	2.3	2.3	1.7
Germany	1.9	2.3	2.3	1.8
Japan	0.9	1.8	1.2	0.8
UK	1.9	1.6	1.0	1.4
China	6.7	6.9	6.3	6.3

Central Bank policy rate (%)

	Current	Q4-18F	Q4-19F	Q4-20F
US	1.38	2.38	3.13	2.63
Eurozone	0.00	0.00	0.50	0.75
Japan	-0.10	-0.10	-0.10	-0.10
UK	0.50	0.50	0.75	
China	1.50	1.50	1.50	1.50

Key market metrics

	Current	Q4-18F	Q4-19F	Q4-20F
US 10Y yield (%)	2.65	2.95	2.96	2.96
EUR 10Y yield (%)	0.57	0.85		
EUR/USD	1.223	1.28	1.35	1.40
USD/JPY	111.2	120	110	100
GBP/USD	1.394	1.38	1.42	1.47
S&P 500	2,818	3,000		
Stoxx 600	402	395		
Oil WTI (USD/bbl)	63.7	54	56	
Oil Brent (USD/bbl)	69.1	60	62	

Current prices as of 22-Jan-2018

Recent publications

- The House View: Happy holidays, 11-Dec-2017
- The House View: Back to school, 17-Sep-2017
- The House View: Taking a step back, 25-Jul-2017

Appendix 1

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