MILLENNIUM GLOBAL

Macro and Currency Outlook

Highlights Q1 2018

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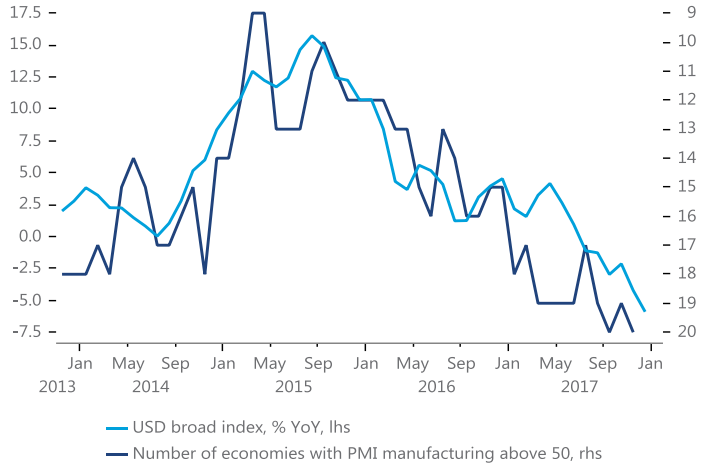
Key Currency Views

- We retain a **bearish view on the broad USD index**, based on continued synchronised global growth and a lack of catalyst to re-price the Fed's interest rate path. Despite a modest boost to growth from the US tax cuts, the implications for the Fed will likely be missing as of Q1 when we expect the bottoming process of inflation to remain slow. With US real bond yields not showing much disconnection with the macro fundamentals, we expect that US twin deficits and subdued real bond yields will remain a drag on the USD.
- **EUR has further upside** vs. USD, amid a self-sustained recovery likely, strong BoP support, and a cheap valuation. Those factors should outweigh the reluctance of the ECB to change its dovish guidance that we expect to remain in place in Q1 2018. Indeed the expansion has further to run in the Euro area than in the US, and so has the re-pricing of monetary policy by the end of 2019 in our view.
- **USD weakness could extend to USD/JPY** amid JPY's massive undervaluation on a trade-weighted basis, improved BoP position and market speculation about adjustments to the yield curve control policy and QQE after the BoJ leadership transition.
- Monetary policy expectations and changes can still provide a big driver of currencies but more in a sporadic way in our view. We see the **support from BoC monetary tightening for CAD as fading**, with a similar pace of rate increase than the Fed and subdued trends in net exports. AUD/USD may initially receive support from a soft USD and the prospect of RBA hiking by Q3 2018 but this should be short-lived and reverse as AUD/USD is vulnerable to a Chinese slowdown driven by the housing sector and to the relative cyclical and monetary policy differential with the US.
- In contrast, we expect **SEK** and **NOK** to be **supported by** the **outlook for monetary policy normalisation** in H2 2018.
- We retain a medium-term **bearish view on GBP but wait for an opportunity to express the view through EUR/GBP as BoE needs to be re-priced first**. While the tail risk of a soft Brexit has risen and that of a cliff-edge disorderly Brexit declined, a "hard Brexit" is still our base case, consistent with a large overshooting of EURGBP PPP. But in the near term markets likely need to bring forward rate hikes from the BoE as the central bank reacts to a tight labour market and the negative impact on domestic demand from Brexit is dwarfed by the supply-side impact.
- In the face of major central banks' tapering but a modest rise in US real yields, **we favour EM reformers, which include INR**, with India's growth prospects and attraction for long term capital bolstered by past structural reforms, **look for opportunities in MXN if NAFTA uncertainties can be lifted** somewhat in view of Mexico's strong fiscal anchor (with a delay of negotiations beyond July 1st elections) **and ZAR** where a political regime change would allow for structural reforms raising potential growth. With signs of inflation rolling over set to restore positive real rates, the attraction of **TRY's cheap valuation** becomes compelling in our view.
- We believe that **CNY TWI strength is at odds with the priority given to financial de-leveraging** and is unlikely to be reproduced in 2018. We believe that given the regional outperformance of CNY in 2017, any CNY TWI weakness amid a housing sector downturn will be more disruptive for commodity currencies such as AUD than currencies of Asian tech economies.

US Outlook

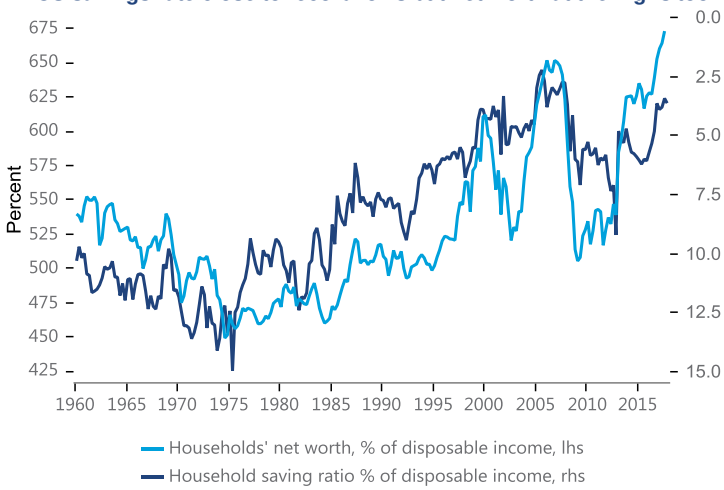
- We look for the Fed to raise interest rates at its March meeting, also as a way to keep the option to raise rates four times in 2018 if inflationary pressures rise more than expected. Although the FOMC's median path for interest rates is not discounted yet by markets, the catalyst of higher inflation is needed in our view to re-price the Fed's rate path and will likely be missing still in Q1.
- We are sympathetic to market under-pricing in 2018-19 in view of signs of late cycle (e.g. cycle high for corporate debt to GDP, peaking corporate profits, near record low household savings, euphoric consumer confidence) and structural factors behind persistently low inflation.
- Consumer spending is expected to soften somewhat in 2018 as the impact of higher inflation, in particular higher oil prices kicks in. But steady labour market income growth should limit any downside in our view.
- The tax cuts will contribute to wider budget deficits. The combination of subdued real rates and widening twin deficits will likely act as a strong headwind for the USD. In addition, the cuts may raise GDP growth by 0.4% in 2018 according to the Tax Foundation model, with the positive impact fading over the next 10 years and then reversing amid higher bond yields. (The model estimates are at the higher end of similar models by other think-tanks).
- In a synchronised global growth environment the USD has been and should stay less sensitive to rate differentials.

Synchronised global growth makes it less attractive



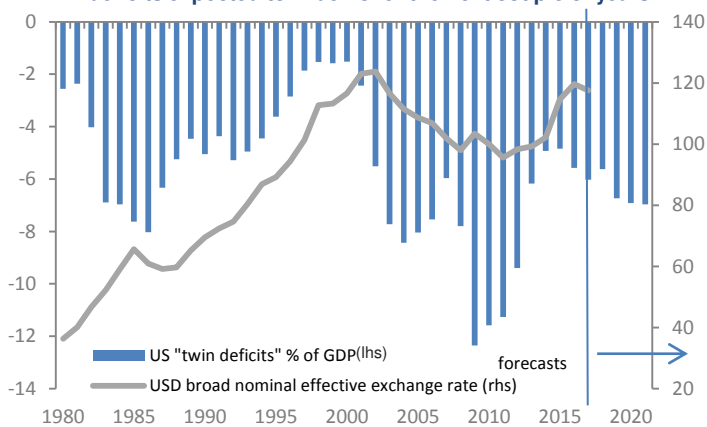
Source: Macrobond, Federal Reserve, MGI (calculations. Data as of 19 December 2017).

US savings rate close to record lows but net worth at the highs too



Source: Macrobond. Data as of 15 December 2017.

Twin deficits expected to widen over the next couple of years



Source: Macrobond. Data as of 5 December 2017.

Euro Area Outlook

- Looking to the Euro Area, our ECB interest rate monitor highlights that the growth/inflation mix makes the case for a start of normalisation of monetary policy. While an actual rate hike (first returning the depo rate to zero possibly in Q4 2018/Q1 2019 followed by policy rate hikes in 2019) is a long time away, we believe a change in the rate guidance to reflect improved economic conditions could be discussed by mid-2018 in view of a fast reduction of the output gap and of unemployment.
- Strong cyclical momentum, a still low inflation and interest rate environment and benign valuations continue to support Euro area equities into 2018 in our view, in turn feeding into a rise in unhedged equity flows that should support EUR.
- Although ECB forecasts for wage increases remain optimistic, the sharp fall in unemployment, which is set to drop below NAIRU in Q3 2018 in our view, and indications of labour shortages across surveys suggest that the gradual rise in wages will continue. In turn, this should underpin a gradual rise in core inflation, especially services. Base effects from oil prices and the currency will however depress somewhat headline inflation in Q1 2018.
- The current account surplus is expected to remain elevated at close to 3% of GDP in 2018, providing additional support to EUR strength.
- Italian elections due to take place on Mar 4th are not expected to create systemic risk for the Euro area but to prolong the chronic issues of the economy of low growth, high debt burden and slow reforms.

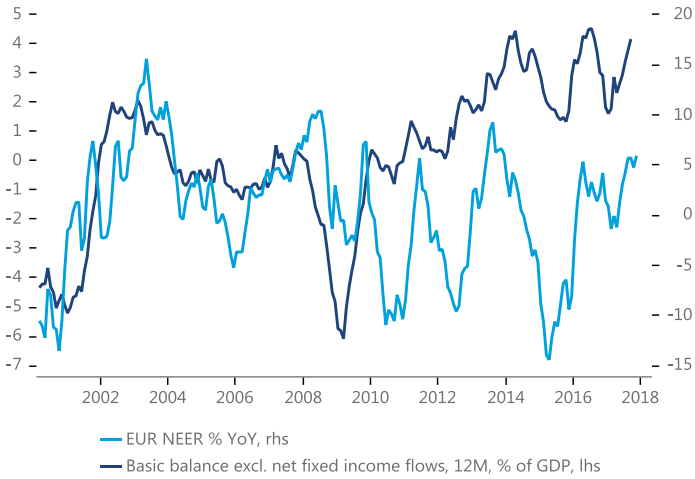
EUR/USD and relative term premium (Bp)

Sourcea: Macrobond. Data as of 21 December 2017. Relationship illustrated in Monetary policy, exchange rate and capital flows, B. Coeure, 3 November 2017

Compensation per employee, ECB forecasts and actual, % YoY

Sourcea: Macrobond, ECB forecasts (annual average for 2018 and 2019). Data as of 13 December 2017.

BBoP position still supportive of EUR nominal effective exchange rate (NEER)



Source: Macrobond. Data as of 14 December 2017.

Japan Outlook

- Despite growth above potential and a tight labour market, we see only slow progress on wages. Companies instead resort to labour-saving investment or robotisation. No major economic policy initiatives from PM Abe are expected in Q1. Hence Abenomics is no longer as powerful in driving real rates lower. Core inflation is likely to be driven by JPY and oil prices, which should take it towards 1% in 2018. 1% could be enough to trigger a change in BoJ communication in our view.
- BoJ communication could shift in Q2 after the leadership transition (Mar/Apr). BoJ cannot continue forever with the current QQE (it owns 40% of JGBs). Side-effects from a flat yield curve and negative rates for the banks are likely to offset economic benefits when growth is above trend and deflation defeated.
- JPY is one of the cheapest currency on both PPP and historical REER. A strengthening BoP also provides fundamental support to JPY.

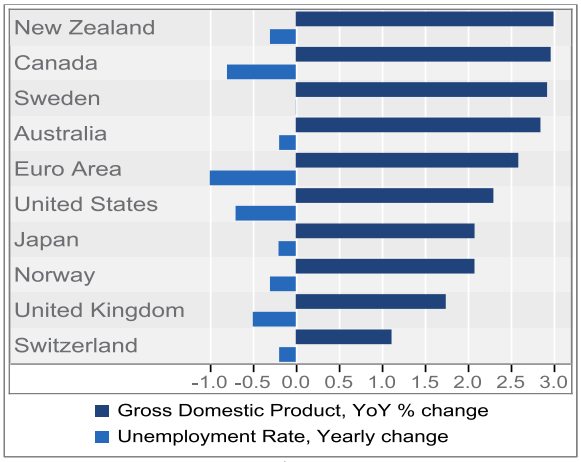
UK Outlook

- UK's growth underwhelms vs. peers but the decline in unemployment rate has been one of the fastest. Given a recovery in yearly domestic inflation and wages, supply-side weakness will likely trigger further BoE tightening: we see 2 hikes in 2018, with the first one in May.
- Brexit negotiations on a transition agreement will fail to fully remove business uncertainty over the next couple of quarters in our view, in turn dampening investment in 2018.
- We retain a medium-term bearish view on GBP with a "hard Brexit" as our base case that should justify an overshoot from PPP valuation vs. EUR (to around 0.93), but wait for an opportunity to express the view through EUR/GBP as BoE needs to be re-priced first.

JPY very cheap based on real effective exchange rate (REER) – z-score

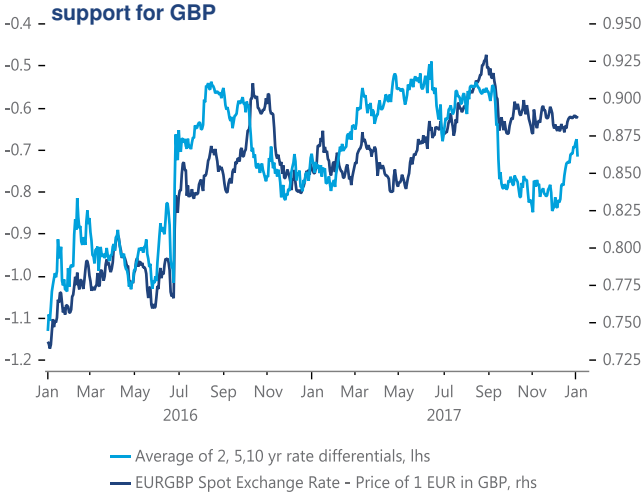
Source: Macrobond..Data as of 21 December 2017.

UK: A tale of weak supply, a medium-term negative for GBP - Q3 GDP YoY and unemployment rate across economies



Source: Macrobond. Data as December 20th, 2017.

UK Interest rate differentials vs. EUR: A temporary support for GBP



Source: Macrobond. Data as December 20th, 2017.

Canada Outlook

- After a remarkable start of the year, economic growth moderated in H2 2017 and returned to a more sustainable path, on the back of slower consumer trends and the stronger CAD subduing external demand. However GDP growth seems set to remain above potential, keeping the BoC on a tightening path.
- Wage growth is giving further signs of normalisation, with the headline hourly earnings moving closer to 3% YoY.
- We now see about a 30% chance of a hike in January and 70% chance of a hike in March/April from the BoC. Private sector leverage, including household debt, has been increasing at the fastest pace in DM and is currently the third highest in DM as a % of GDP pointing to a cautious approach by BoC.

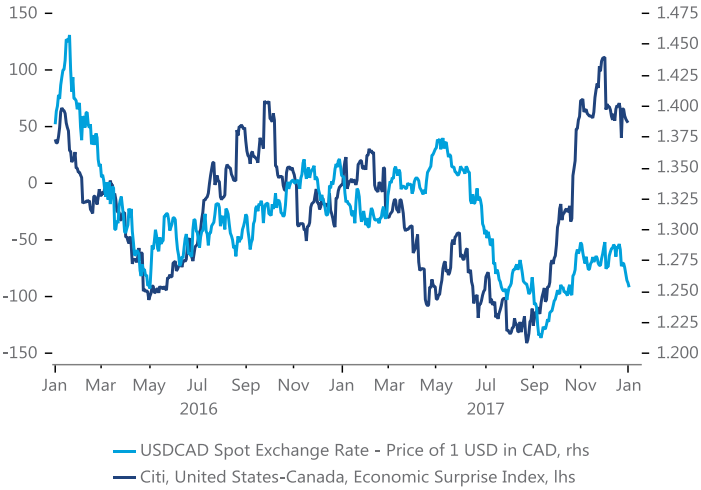
Australia Outlook

- Labour market dynamics in Australia have improved, with strong job creation in 2017 and a decline in the unemployment rate.
- The rise in household debt to income has continued unabated, while real housing prices have increased further. Risks to financial stability remain elevated over the medium term.
- Given our view on US and RBA monetary policy in 2018, we expect the real interest rate differentials between Australia and the US to fall further. While AUD/USD's sensitivity to short term rates has declined, likely reflecting Australia's reduced current account deficit, longer bond yields still matter.
- Financial de-leveraging and credit tightening in China are likely to put downward pressures on metal prices, hitting Australia's terms of trade.

CAD: Household consumption set to reconnect with surveys

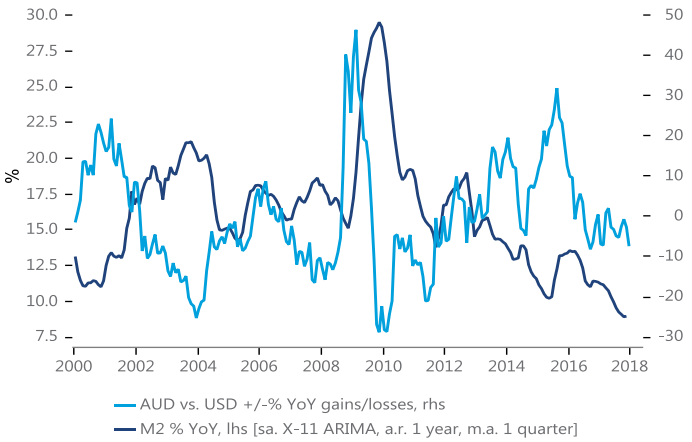
Source: Macrobond. Data as December 20th, 2017.

Economic surprises have been moving against CAD



Source: Macrobond. Data as December 20th, 2017.

Chinese monetary aggregate slowdown points to downside risks for AUD/USD



Sources: Macrobond., GS Data as of 22 December 2017.

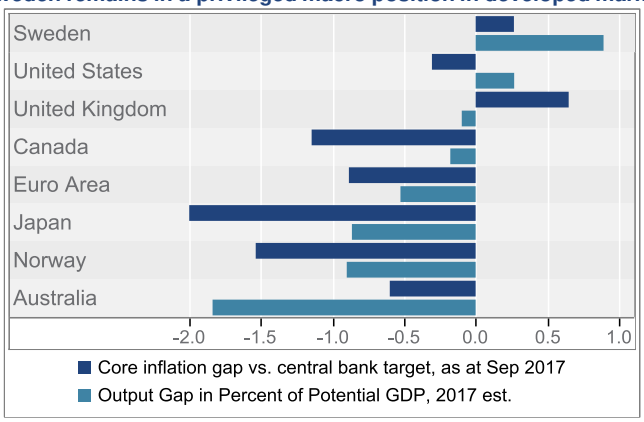
Scandinavian Outlook

- In Sweden, two back-to-back sequential declines in house prices have gathered market attention of a possible correction in the housing market, amid stretched valuations and the recent build-up in credit.
- We share the Riksbanks' view that the recent softening in the housing market is not so far concerning and should carry limited policy implications. For one, macroprudential tightening and the nearing of the end of QE were deemed to soften housing trends. Secondly, indicators have been mixed with some pointing to some stabilisation in price dynamics.
- While disappointing inflation prints and housing concerns have weighed on SEK in Q4, we view macro conditions as little changed from our previous assessment. Provided our view on the housing market is vindicated, this should carry little spillovers to the consumer outlook (i.e. via wealth effects and consumer confidence). Unless SEK rallies materially, we believe this keeps the central bank on track to deliver a first rate hike in H2 2018.
- NOK's major underperformance in Q4 2017 contrasts with positive macro developments and higher oil prices. We believe that housing sector concerns are overblown, as the rebound in real wages keeps household spending resilient to diminishing wealth effects.
- The Norges Bank acknowledged faster absorption of spare capacity at its December policy meeting, by revising upwards its estimate of the output gap (40-50 bp narrower output gap in the next two years). As a result, underlying inflation is now seen as moving closer to target, hovering around 2% over the forecast horizon.

SEK: Despite concerns, we retain a soft landing view rooted in positive macro backdrop

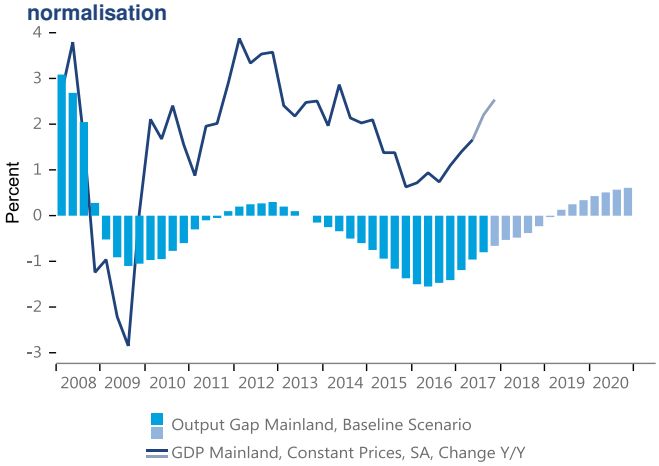
Source: Macrobond. Data as December 20th, 2017. Housing market macro backdrop based on standardised labour market signals, credit impulse and mortgage rates.

Sweden remains in a privileged macro position in developed markets



Source: Macrobond. Data as December 20th, 2017.

NOK: A faster absorption of spare capacity bodes well for policy normalisation



Source: Macrobond. Data as December 20th, 2017.

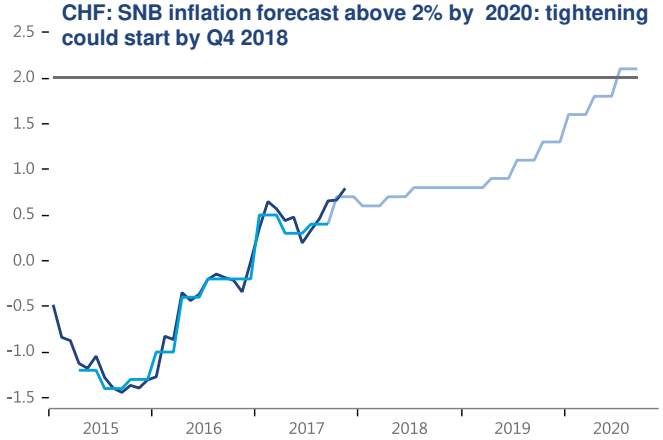
Swiss Outlook

- In a positive global risk environment, Swiss residents' outflows drive CHF TWI depreciation but in our view this should be mitigated by the still huge current account surplus and the strength of the real economy, likely to point to some policy normalisation by Q4 2018.
- Growth has become broader-based and has momentum, which points to gradually rising inflation. SNB forecasts CPI above 2% by 2020.
- Using SNB index, CHF real effective exchange rate is back to the same level as just before the removal of the floor (15 Jan 2015). While still overvalued, the level of CHF exchange rate vs. EUR should make SNB more comfortable hiking interest rates in our view after ECB ends QE.

China Outlook

- In China, housing sector activity and prices are likely to weaken further into Q1 2018, following earlier property tightening measures in lower tier cities.
- Financial de-leveraging is a policy priority and although the authorities wish to preserve credit to the real economy, the spillover is inevitable in our view, with banks balance sheet adjustment resulting in the sale of government bonds.
- FX policy lacks clarity and contradictions are unresolved in our view: authorities seem to value maintaining FX reserves above USD 3 trillion and keeping CNY broader stable but the potential implications for higher interest rates and capital controls may conflict with the needs of the real economy and the strategic aim to make RMB more international.
- CNY looks expensive and USD/CNY has gone ahead of rate differential with the US.

CHF: SNB inflation forecast above 2% by 2020: tightening could start by Q4 2018

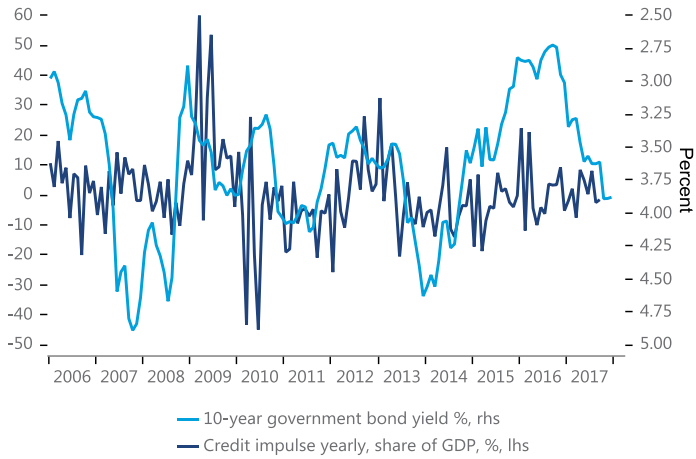


Source: Macrobond. Data as December 20th, 2017.

Chinese home sales have slowed down, housing starts to follow

Source: Macrobond.. Data as of 22 December 2017.

CNY: Credit tightening underway amid higher bond yields



Source: Macrobond. Note: diffusion index=number of cities where prices rise-number if cities where prices fall. Data as of 21 December 2017.

EM Outlook

- **South Africa:** In addition to a potential political regime shift post-Zuma, positive tailwinds for ZAR include its cheap valuation (REER, PPP) and overall small imbalances (significant external rebalancing has occurred, pace of public debt increase more than the level is an issue).
- **Turkey:** TRY benefits from attractive valuations and a very high carry to volatility ratio. While economic fundamentals are weak, we believe that signs of a peak in inflation (at 13% YoY) and in the current account deficit (at 4.7% of GDP) provide support in addition to still modest market positioning.
- **Czech Republic:** The CNB aim for a neutral policy stance in the forecast horizon (two years), which in their definition suggests 3m PRIBOR should be at 3.00%, or the repo rate at 2.80%. We expect a hike in Feb, then one hike per quarter more than priced by the market in 2018. A 1% move in EURCZK equates to around 20-25bp of hikes.
- **Russia:** In Russia, both nominal and real rates remain supportive of RUB, although the pace of disinflation is set to slow throughout 2018 amid domestic demand recovery. Positive seasonal factors in Q1 should boost the current account, offering a cushion against political risks (US Treasury report in Q1 and March 2018 presidential elections). We observe a recent mispricing of RUB to oil which makes tactical long RUB positions vs. USD attractive.
- **Mexico:** NAFTA negotiations are likely to drag beyond the Mexican July 1st election. While a political risk premium in MXN will be justified throughout the year, the tight monetary policy stance, strong fiscal anchor and cheap MXN valuation on a real effective basis point to a potential rebound in case the risks of ending NAFTA were to be removed.

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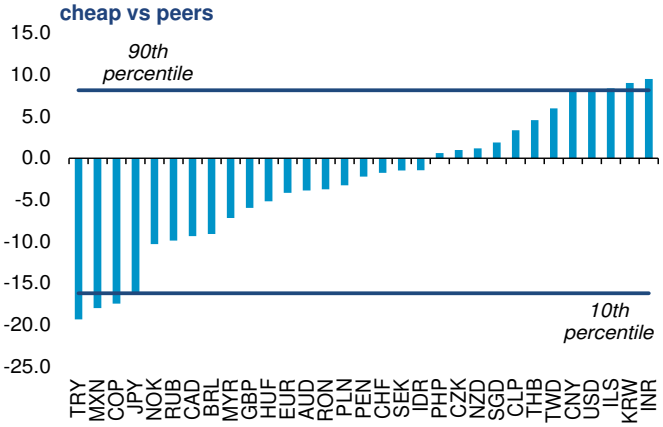
TRY: REER % deviation from 10y average shows TRY as cheap vs peers



Sources: Macrobond, MGI. Data as of 2 January 2018.

RUB has underperformed the recent rise in oil prices

Source: Bloomberg. Data as of 2 January 2018.

USD/MXN likely to be driven lower by relative real rate differentials

Source: Macrobond. Data as of 10 January 2018