MILLENNIUM GLOBAL

Macro and Currency Outlook

Highlights Q2 2018*

* This document contains the views and opinions of our Global Economic Research and Strategy Team (Claire Dissaux, Mattia Taboga and Meena Bassily) as of 19 April 2018 and does not necessarily represent the views and opinions of Millennium or any of its Portfolio Managers.

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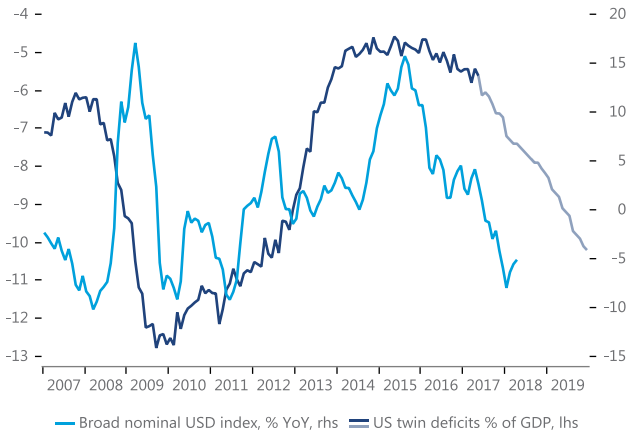
Key Currency Views

- We believe the **trend of medium-term USD weakness** remains intact, on the back of still synchronised global growth, widening twin deficits in the US and steady Fed tightening that feeds into a flattening of the yield curve.
- Upside risks to Euro area's growth outlook have now been removed and **gains in EUR/USD likely capped** as foreign equity inflows may be more limited **in the near term**. But GDP growth, well above potential, and the rapid fall in unemployment suggest dovish market pricing and ECB communication will eventually be challenged. Structural factors point to EUR/USD rising over the long term, including productivity, trends in potential growth and FX valuation.
- A **cheap JPY could benefit** from a negative twist to global risk appetite. In a risk scenario, a slide of Abe's popularity to around 30% is seen as leading to PM Abe's resignation and the end of Abenomics, also boosting JPY. In our base case, we see slower reflation in Japan ahead, which is likely to fail to drive the JPY weaker.
- We look for the BoE to raise interest rates in May on the back of weak supply but the pricing of a November hike is likely to stumble on a final agreement with the EU on a transition deal and slower inflation. We see rising domestic and external **political risks for GBP** (May local elections, Irish border in EU negotiations) as unlikely to be offset by **rate differentials**.
- In Canada, we see BoC on track for 3 rate hikes this year reflecting core inflation at target, with the next one likely in July. **CAD** has scope to gain vs. USD in view of an under-priced interest rate market and cheap CAD valuation on PPP.
- We look for **NOK to benefit** vs. EUR **from** higher **oil prices and** the prospect of **a first rate hike likely in Sep 2018**.
- Inflation disappointment has been a headwind for **SEK** and its valuation is now very attractive but the catalyst for a rebound is missing so far.
- We expect the gap between **emerging markets** (EM) and advanced economies' growth to widen further. Even as the initial impulse from external trade fades, domestic demand should provide a cushion.
- Our EM risk score measure has stabilised at moderately high levels and is consistent with modest trade-weighted EMFX appreciation on average. In particular, the low macro risks of **Mexico, India, South Africa** according to our risk score point to potential for appreciation for MXN, INR and ZAR. In contrast, TRY stands out as most vulnerable in view of too low real rates compared to wide external deficits.
- China's credit tightening remains contained, thereby unlikely to destabilise EM prospects in the near term. The risk of a trade war between the US and **China** would in contrast create important spillovers for other EM Asian economies in particular for those that are more integrated into global value chains than China, e.g. **Korea, Taiwan, Singapore**.
- Political and economic changes in South Africa have opened a new era and those prospects should continue to underpin **ZAR**.
- With improved prospects for NAFTA negotiations, **MXN** should benefit from a lower risk premium and high real rate support at least until market focuses on July 1st presidential elections, in our view.
- For ZAR and MXN risks to our constructive outlook primarily lie in global risk appetite.
- We believe that the growth/inflation mix is more positive than what is priced in local debt and **INR**, despite India's sensitivity to oil prices.

US Outlook

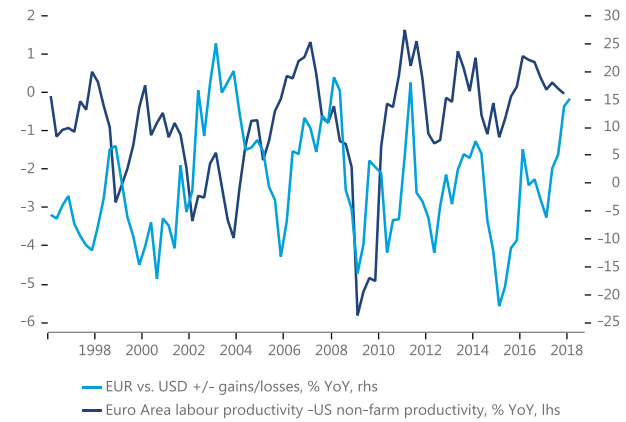
- The policy of the US administration entails a contradiction between cutting taxes to spur domestic demand and targeting a reduction in the trade deficit. The result is widening external deficits that will not be tackled by tariffs in our view.
- Twin deficits are likely to weigh on the USD until the US attractiveness as an investment destination can be restored (e.g. growth potential, carry). With the budget deficit likely to widen to 6% of GDP over the next 2 years, twin deficits are set to grow as the private sector net savings cannot offset the rise in public dis-savings.
- The Fed is torn between the need to accelerate monetary tightening given an increased unemployment undershoot and the willingness to avoid a hard landing given financial imbalances (e.g. keep a steady tightening pace to engineer an orderly market correction). We believe this is why an acceleration in tightening will not be explicit in Fed's communication until the June FOMC meeting.
- The forecast by the FOMC to lift interest rates above neutral by 2020 as required by the unemployment overshoot is set to trigger a correction in asset markets, thereby tightening financial conditions. This tension suggests the USD is unlikely to stage a sustainable rally in case of an acceleration in Fed's tightening.
- Global growth ex-US may have peaked. But improved structural factors (e.g. productivity, investment…) in the Euro area have started to raise neutral rates in the Euro area. This contrasts with a deterioration in structural drivers of the USD (e.g. net international investment position, balance sheets) and is a long term positive for EUR vs. USD.

US twin deficits (% of GDP) forecast to widen, a negative for USD



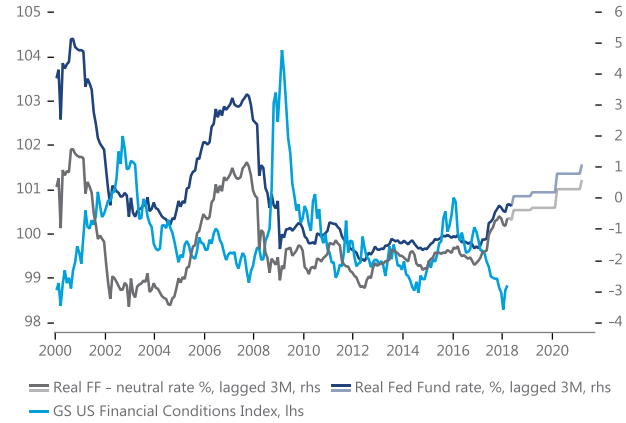
Sources: Macrobond, MGI (forecasts). Data as of 12 April 2018

US no longer has a productivity advantage over the Euro area



Sources: Macrobond, MGI (forecasts). Data as of 12 April 2018.

Fed fund rate below neutral boosted financial assets, reverse coming

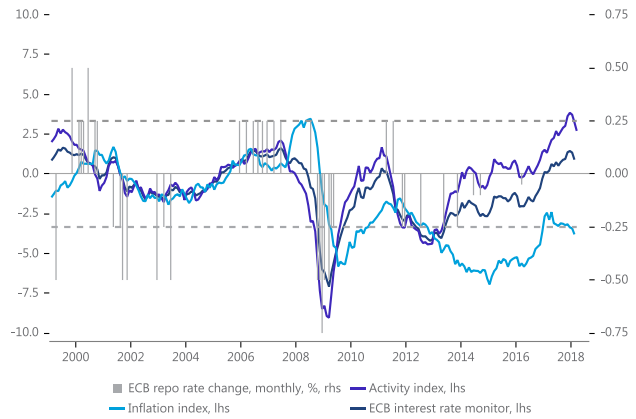


Sources: Macrobond, GS. Data as of 12 April 2018.

Euro Area Outlook

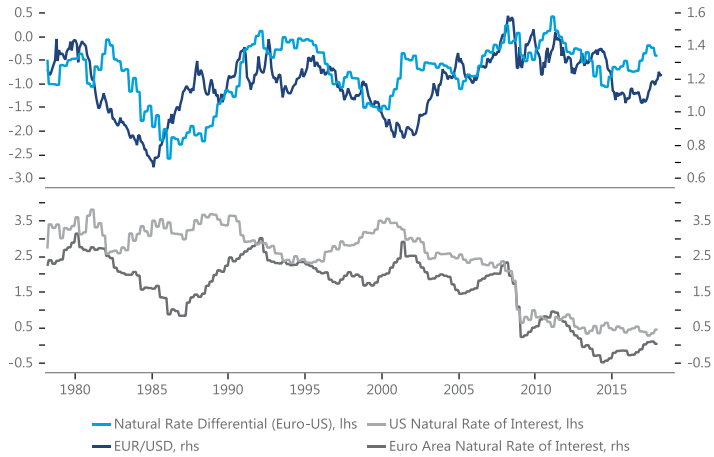
- Despite a loss of momentum in cyclical indicators, our ECB interest rate monitor remains firmly in tightening territory. We still see good breadth to the recovery and the outlook consistent with ECB GDP growth projections (at 2.4% YoY for 2018).
- Continued decline in unemployment, evidence of labour shortages and rising compensation per employee should help underpin a gradual rise in core inflation. On the demand-pull side, price and capacity components of business surveys indicate upward price pressure.
- Dovish market pricing and ECB communication seem likely to be tested by the fast reduction in the unemployment rate, although positive inflation surprises are likely needed for a catalyst. We look for the ECB to wait until June to signal an end to QE in Q4 2018 and link the interest rate guidance to inflation.
- Structural factors point to EUR/USD upside as reflected in a rise in the real neutral rates. Political achievements will take longer to materialise. The June EU summit, when France and Germany are due to present their project of institutional reforms and deeper integration, could be a reminder of the long timeframe required for actual implementation.
- The current account surplus is likely to rise to over 4% of GDP. Weaker cyclical momentum may reduce foreign equity inflows. But the reversal of QE-related resident bond outflows and the increased attraction of FX-hedged returns of Euro area debt for US and Japanese investors due to a rising cost of USD-hedging will be supportive. We also expect central bank reserve allocation to the EUR to increase after falling sharply during the EMU crisis.

Our ECB interest rate monitor still firmly in tightening territory



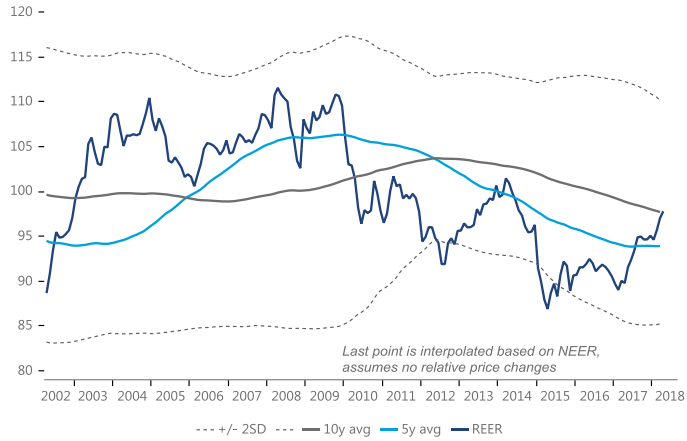
Source: Macrobond. Data as of 12 April 2018.

EURUSD should benefit from recovery in the Euro area neutral rate



Sources: Macrobond, MGI (forecasts). Data as of 12 April 2018.

EUR Real Effective Exchange Rate (REER): valuation attractive still



Source: Macrobond. Data as of 12 April 2018.

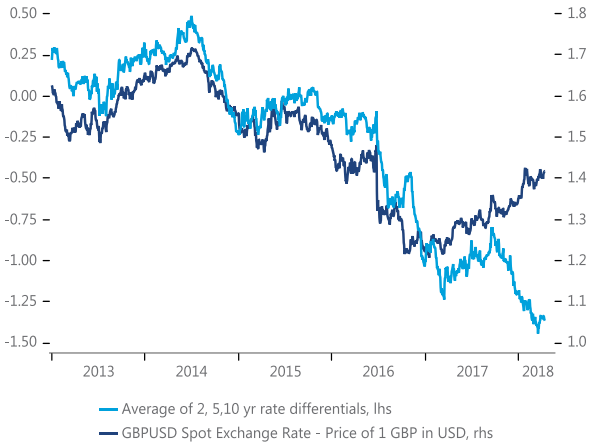
Japan Outlook

- Japan has exited deflation but BoJ's inflation forecasts are likely to be disappointed again and the dynamics between rising inflation expectations, higher wages and rising inflation are not yet in play. In addition, external risks have turned disinflationary as the recent JPY trade-weighed appreciation puts downside risks on inflation.
- The current account surplus has been a rising trend, fuelled by the income balance and is not fully recycled abroad. Net equity outflows are not compensating for reduced debt outflows. While Japanese equity investment abroad has continued, on a net basis, this is mitigated by foreign equity inflows to Japan.
- The new fiscal year may temporarily boost bond outflows from institutional investors and USD/JPY. But we expect a downward bias to remain in place for USD/JPY in the latter part of Q2, amid increased financial market volatility and a lack of new policy initiatives in Japan combining with slower reflation.

Japan: A very strong basic balance surplus (% of GDP) in contrast to a basic balance deficit at the start of Abenomics

Source: Macrobond. Data as of 12 April 2018.

GBP/USD has disconnected from traditional interest rate drivers

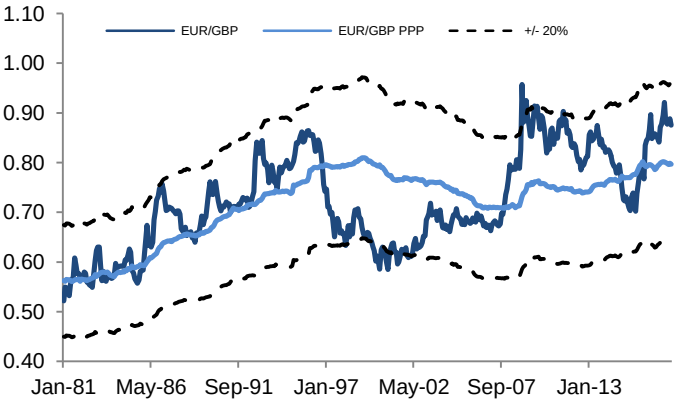


Source: Macrobond. Data as of 12 April 2018

UK Outlook

- Inflation pressures have started to recede and CPI has surprised the BoE on the downside in Q1. With inflation above target, core wage growth rising, and domestically-generated inflation having normalised, a rate hike in May however remains on the cards in our view.
- On REER metrics GBP at about 1 standard deviation is the third cheapest G10 currency while on PPP it is 10% cheap vs. EUR.
- Cyclical underperformance and Brexit risks justify GBP undervaluation. We continue to believe an overshoot is warranted given political risks, which could flare up in Q2.
- The EU council end-June may require to bring clarity on the Irish border issue, which could prove a stumbling point. A leadership contest is also a risk (May local elections in focus).

EUR/GBP more than 10% expensive on PPP, further overshoot warranted in our view

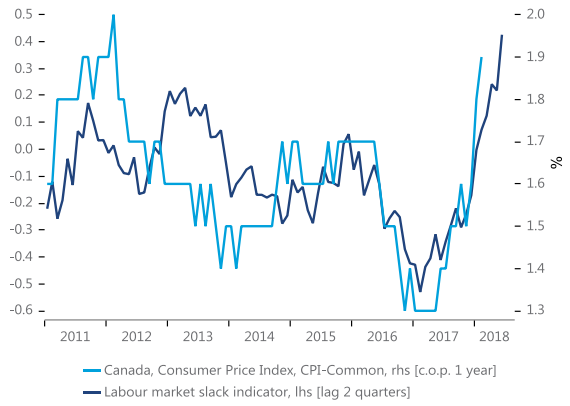


Sources: MGI, Macrobond. Data as of 12 April 2018

Canada Outlook

- With core inflation having risen to target and wage inflation picking up, the outlook for further rate normalisation is well on track in our view, with 2 more hikes likely in 2018.
- Given inflation prospects and our view of a benign NAFTA outcome, we look for the BoC to deliver the next rate hike by July.
- Our view on CAD vs. USD is constructive, reflecting in particular its discount to terms of trade and interest rate differentials, as captured by our short-term fair value model.

Canada: Our labour slack indicator points to inflation at target

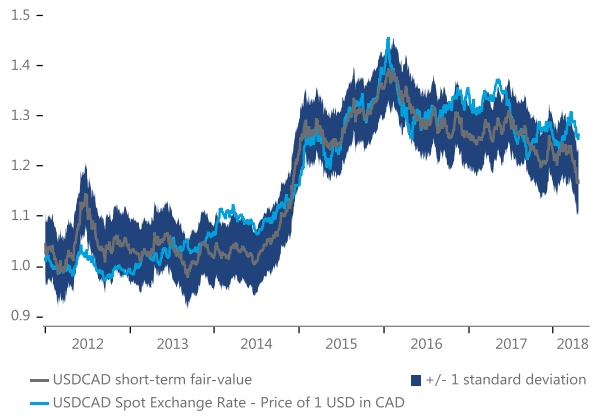


Sources: MGI, Macrobond. Data as of 12 April 2018.

Australia Outlook

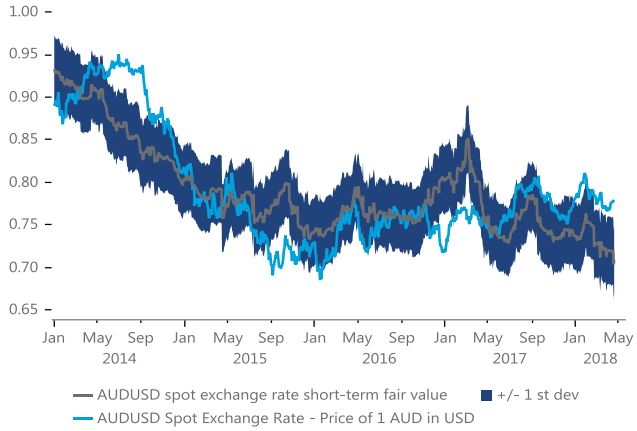
- Consistent with the remaining slack in the labour market, most wage indicators suggest underlying pay growth hovering around 2% YoY. While locally some areas are reporting greater pressures, we doubt that at an aggregate level, pay rises will be sufficient to deliver a change in tone by the RBA in Q2.
- As a result underlying inflation should remain well-behaved and below RBA's target range.
- We expect a rate rise towards the latter part of the year however, as RBA's reaction function tilts more towards the improved macro backdrop and financial stability risks.
- Our short-term fair value, which includes interest rate differentials and terms of trade, points to AUDUSD in a 0.70- 0.75 range.
- Based on our PPP metric, we see a similar valuation gap, with fair value currently around 0.72 for AUD/USD.
- We believe that with the Chinese credit tightening this year, its impact on investment and commodity prices, as well as the erosion of interest rate spreads, will take its toll on AUD vs. USD.

CAD cheap vs. USD on our short-term fair value model



Sources: MGI, Macrobond. Data as of 19 April 2018

AUD expensive vs. USD based on our short term fair value model

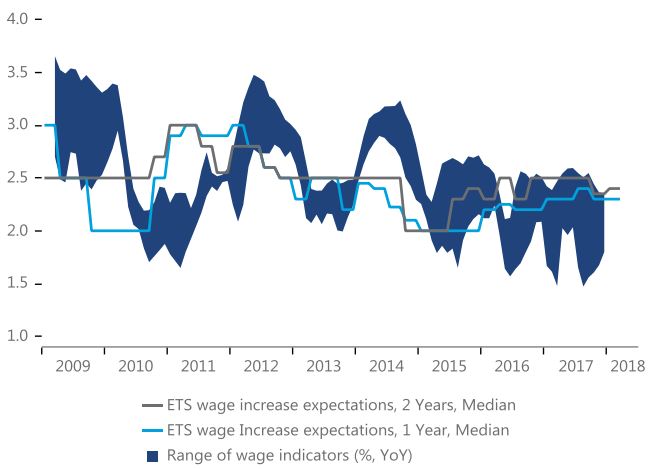


Sources: MGI, Macrobond. Data as of 19 April 2018

Sweden Outlook

- The closely watched core CPI service inflation has been trending lower, resulting in a material undershoot of Riksbank's forecasts for CPIF in Q1.
- Wage surveys point to only a moderate uptick in wage inflation ahead. But we view the recent wage negotiations in the German industrial sector as providing a positive impulse for Swedish unit wage costs.
- We now expect the Riksbank to hike rates in October
- SEK vs. EUR seems to be discounting a lot of the bad news with the rate market under-priced in our view but a catalyst – higher wages and inflation – is still missing.

Sweden: Wage growth continues to move sideways

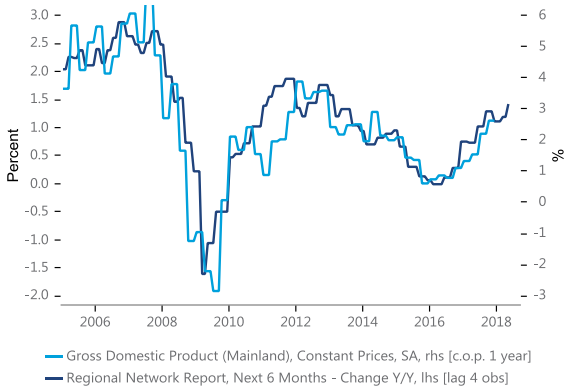


Source: Macrobond. Data as of 12 April 2018.

Norway Outlook

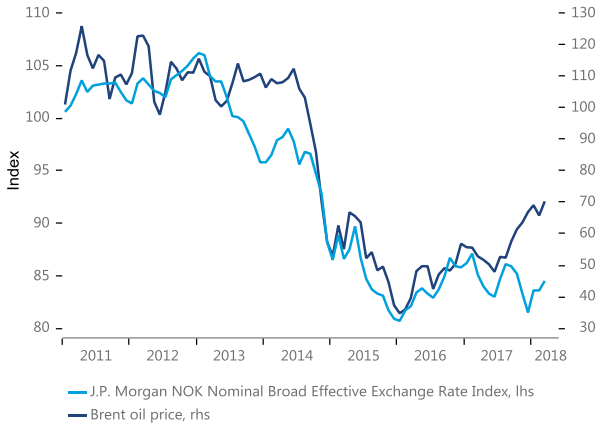
- The Norges Bank Regional survey points to an acceleration of GDP growth to 3%, which would be above the central bank's revised GDP growth of 2.8% for 2018.
- The fast recovery in the oil sector which is now only slightly underperforming should give further comfort to Norges Bank.
- The housing market has given signs of stabilisation. With the household sector overextended and the macro backdrop normalising, there is less and less of a case for monetary policy not to lean against the wind.
- We now expect a rate hike in Sep 2018.
- It can not be ruled out that the central bank steepens its interest rate path further in its June MPR (monetary policy report), hence injecting some premium of a second interest rate rise by December. In addition, NOK continues to remain cheap to oil and interest rate differentials, also making the case for a bullish view.

Norway: broader-based and stronger growth



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

NOK trade-weighted exchange rate at a discount vs. oil prices

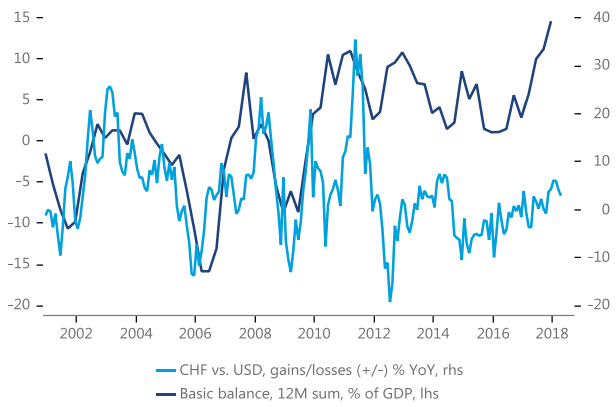


Source: Macrobond. Data as of 12 April 2018.

Swiss Outlook

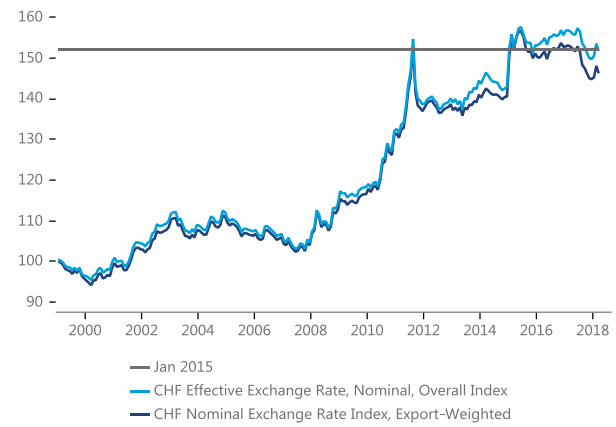
- CHF benefits from the one of the strongest basic balance surplus, set to act as a cushion at times of global risk aversion.
- In contrast, in case of strong global risk appetite, large residents' capital outflows abroad and a reduction by corporates in hedging ratios are required to sustainably weaken CHF on a trade-weighted basis.
- On the domestic front, solid domestic demand-driven growth and slowly rising inflation, open up the possibility for policy normalisation. SNB's forecast for inflation shows price stability by 2020.
- A sharp weakening of CHF could bring forward the start of SNB normalisation in our view, even before the ECB starts raising rates (likely by mid-2019).

CHF: A strong basis surplus to limit depreciation



Source: Macrobond. Data as of 12 April 2018.

CHF trade-weighted exchange rate less expensive not cheap



Source: Macrobond. Data as of 19 April 2018.

China Outlook

- The *threat* of a trade war with the US might explain why CNY policy remained for a strong currency in Q1. The *materialisation* of a trade war does however create downside risks for CNY in our view.
- The US trade deficit with China is concentrated in the electronic/computer sector followed by textile. US tariffs on this sector would increase the macro impact on China.
- Our basic balance proxy (using net FDI and the trade balance) shows flows for CNY are roughly balanced, e.g. capital outflows have been tamed. In turn, authorities to engineer moderate currency depreciation without destabilising residents' expectations.
- We expect moderate depreciation of CNY vs. USD as interest rate differentials narrow further.

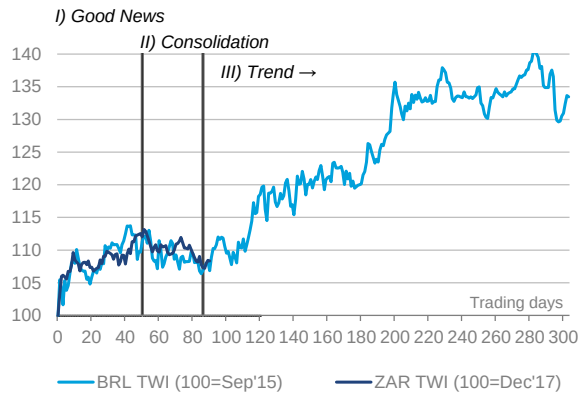
CNY vs. USD: Too strong vs. interest rate differentials

Source: Macrobond. Data as of 19 April 2018

EM Outlook

- **South Africa:** We look for a virtuous cycle of: political transition/reform, improved consumer/ business sentiment, ZAR strength, lower inflation/ rate cuts, portfolio inflows and ZAR strength. We see early evidence of this.
- ZAR real effective exchange rate (REER) is marginally above its 10-year average while the terms of trade suggest richer valuations. However overshoot is highly possible.
- As a framework we look to the path of BRL following the Dilma impeachment process that catalysed political change in late 2015.
- **Mexico:** We hold a constructive view on MXN vs. USD, illustrated by MXN underpricing the macro fundamentals as measured by our risk score. Banxico has been pre-emptive, raising real policy rates to the highest level since 2009. Meanwhile, inflation is on a downward trend. We expect this to allow Banxico to stay on hold in Q2, in turn supporting bonds and MXN. NAFTA negotiations have also made progress.
- While AMLO running ahead in polls highlights the binary risks of the July 1st presidential election, we believe it is only closer to the election that polls become informative.
- **India:** INR should benefit from a positive growth/inflation mix and a strong external liquidity position in particular as captured by our India's risk score measuring macro risks.
- Rising investment suggests that the inflationary impact of growth acceleration will be limited. We see RBI on hold over Q2. Increased quotas for foreign investment in FY18/19 should pave the way return of foreign bond inflows while modest credit demand should leave banks' demand for government bonds supported.
- Risks to monitor include that of fiscal slippage ahead of local elections in H2 and oil prices.

BRL path in 2015 as a guide for ZAR in 2018 suggests a trend is in waiting

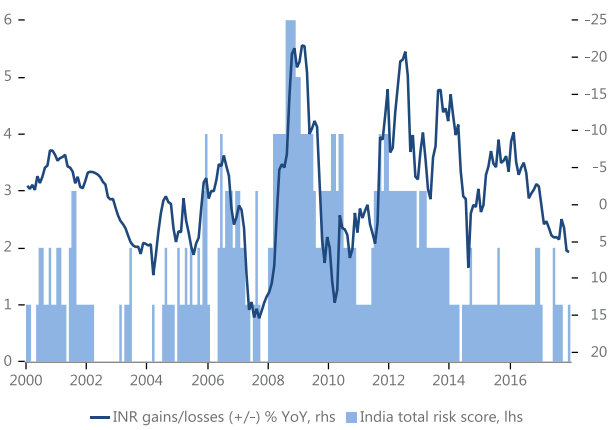


Source: Macrobond. Data as of 19 April 2018

Mexico risk score points to potential MXN gains vs. USD

Sources: MGI, Macrobond. Data as of 19 April 2018

India's total risk score points to potential INR appreciation



Sources: MGI, Macrobond. Data as of 10 January 2018

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