The Latest View from 35,000 Feet

Global Investment Climate Remains Challenging

Dr. Win Thin
Global Head of Currency Strategy
212-493-8867
win.thin@bbh.com
US Economic Outlook
US Midterm Elections Went Largely as Expected

No Real Shockers

1. The Democrats won control of the House while Republicans kept control of the Senate

2. While the final tallies are still to be determined, this was the outcome that markets had priced in and is also the outcome that we think is best for markets

3. The legislative branch will now fulfill one of its most important functions, which is to provide checks and balances on the executive branch

4. The current US fiscal stance and macro outlook remain intact and the Fed will feel comfortable tightening rates further as wage and price pressures continue rising

5. While the knee-jerk reaction is to push US yields down and sell the dollar, we think the previous drivers will re-assert themselves

6. US rates should ultimately resume their climb

7. We see no change to Trump’s approach to trade relations and that means continued tensions with China ahead

8. Trump’s economic team is expected to remain largely intact; status quo will prevail

9. Dollar rally likely to continue well into 2019; 2020 becomes problematic
1. The Fed meets December 19 and is likely to hike the Fed Funds rate 25 bp
2. This will be the ninth hike of this tightening cycle
3. The Fed intends to hike rates three times in 2019 and one time in 2020
4. We do not expect any significant change to the Dot Plots at the December meeting
5. Starting in 2019, every meeting becomes live with press conferences to follow
FOMC Outlook
Where will this Fed current tightening cycle end?

1. Market is pricing in 3.0% terminal rate, right at the Fed’s current long-term neutral Fed Funds rates of 3.0%
2. Recent Fed comments suggest a potential move to restrictive policy
3. In the 2004-2006 tightening cycle, the terminal rate was 5.25%
4. In the 1999-2000 tightening cycle, the terminal rate was 6.50%
5. In the 1988-1989 tightening cycle, the terminal rate was near 10.00%
6. In the 1983-1984 tightening cycle, the terminal rate was near 11.50%
7. In the 1980-1981 tightening cycle, the terminal rate was near 20.00%

Source: Bloomberg
US Fiscal Outlook

Trying Times Ahead

1. The FY2018 budget deficit widened to -3.8% of GDP despite robust GDP growth
2. CBO estimates the budget deficit will widen to -4.6% of GDP in both FY2019 and 2020, -4.9% in FY2021
3. CBO forecasts GDP growth of 2.9% in 2019, 2.0% in 2020, and 1.5% in 2021
4. Next US recession will be a fiscal nightmare
5. Past US experiences suggest the deficit could widen to -8% of GDP in FY2021 if there is a recession

Source: Bloomberg
Global Economic Outlook
Global Liquidity Backdrop
The Fed Was Not Alone

1. Central bank balance sheets saw unprecedented growth after the Great Financial Crisis
2. Fed’s balance sheet peaked in 2014 and started shrinking in Q3 2017
3. ECB’s EUR4.6 trln balance sheet won’t peak until the end of December
4. ECB has not announced when it will start shrinking its balance sheet
5. BOJ’s JPY552 trln balance sheet is still growing
6. BOJ is likely to be the last major central bank to exit QE

Central Bank Balance Sheets, Jan 2007 = 100

Source: Bloomberg
Global Rising Rate Environment

Rates are going up

1. The Fed, BOE, BOC, and Norges Bank have already started hiking
2. ECB will end QE in December and hike rates after summer 2019
3. Riksbank has signaled first hike in December or February
4. RBA and RBNZ likely to hike Q4 2019
5. In Emerging Asia, tightening began in India, Indonesia, Korea, Malaysia, Philippines, and Singapore
6. In EMEA, tightening began in Czech Republic, Russia, and Turkey; South Africa and Israel likely to begin in Q4
7. In Latin America, tightening began in Argentina, Chile, and Mexico; Peru likely to hike in Q4, Brazil and Colombia likely in Q1 2019

Source: Bloomberg
Are Markets Underestimating Inflation Risks?
Benign Global Inflation Outlook May Be Tested

1. IMF forecasts inflation in the Developed Market Economies for 2018 and 2019 at 2.0% and 1.9%, respectively
2. IMF forecasts inflation in the Emerging Market Economies for 2018 and 2019 at 5.0% and 5.2%, respectively
3. US labor market is already tight and getting tighter
4. Higher oil and energy prices suggest upside risks to headline inflation globally
5. Tariffs pose upside risks to US inflation, though extent of pass-through to consumers is still unknown

Source: Bloomberg
1. The eurozone economy is slowing even as the ECB is set to curtail stimulus

2. QE is slated to end after December while the first hike is planned after summer 2019

3. Italy and the EU are headed for deeper conflict regarding the 2019 draft budget

4. Italy is slowing even as it uses optimistic growth forecasts in its budget calculations

5. Due to concerns about peripheral banks, the ECB is reportedly considering another Targeted Longer-Term Refinancing Operation (TLTRO)

Source: Bloomberg
UK Outlook
Brexit Uncertainty Persists

1. The BOE has already started hiking but pace will remain modest

2. Short sterling futures now show next hikes are priced in for March 2019 and then March 2020

3. This compares to June 2019 and June 2020 last month

4. A Brexit deal would not mean that the BOE suddenly turns more hawkish

5. General election not due until 2022 but political risk high as Prime Minister May vulnerable

6. A Labour government would not be taken well by markets

Source: Bloomberg
Japan Outlook
Policymakers to Remain Cautious

1. Abenomics began upon his election victory in 2013
2. BOJ Governor Kuroda was tasked with bringing inflation up to 2% target
3. Inflation is rising but the pace is slow
4. Labor market is tight but wage pressures lower than anticipated
5. BOJ recently pushed out timing for meeting its inflation target until FY2021
6. No hint of exiting unconventional policy anytime soon

Source: Bloomberg
EM Growth Rolling Over?

Signs Of Potential Slowing Ahead

• The IMF sees EM growth of 4.7% in both 2018 and 2019, down from 4.9% and 5.1% previously

• This may still be too optimistic

• Composite EM PMI was 51.4 in October, lowest since July 2017

• Emerging Asia is forecast to grow 6.5% in 2018 and 6.3% 2019

• Emerging Europe is forecast to grow 3.8% in 2018 and 2.0% in 2019

• Latin America is forecast to grow 1.2% in 2018 and 2.2% in 2019

• Sub-Saharan Africa is forecast to grow 3.1% in 2018 and 3.8% in 2019

No assurance target will be attained.
China Slowdown Continues

Signs Of Potential Slowing Ahead

• The IMF sees China growth of 6.6% in 2018 and 6.2% in 2019, down from 6.9% in 2017

• We see downside risks as trade war with US drags on

• We do not think China will intentionally weaken the yuan

• Economic data is not reliable

• Rather, gauge the depth of economic slowdown by the policy response

• PBOC has cut reserve requirements several times this year

• Income tax and auto sales tax have been cut and may be cut again

No assurance target will be attained.

Source: Bloomberg
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