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Market Outlook 2018

What could drive global inflation materially higher this year? Output gaps in the US, Eurozone and Japan are apparently closed, yet there is justifiable scepticism about the extent of persistent inflationary tailwinds. For example, although unemployment in the US has been below 5% since early 2016, growth in payroll wages has been a subdued 2.5%. In the last month this jumped to a cyclical high of 2.9%, but this figure is low in comparison with the previous economic cycle. Meanwhile, continued robust job creation implies that there is still some slack in the US economy, even today.

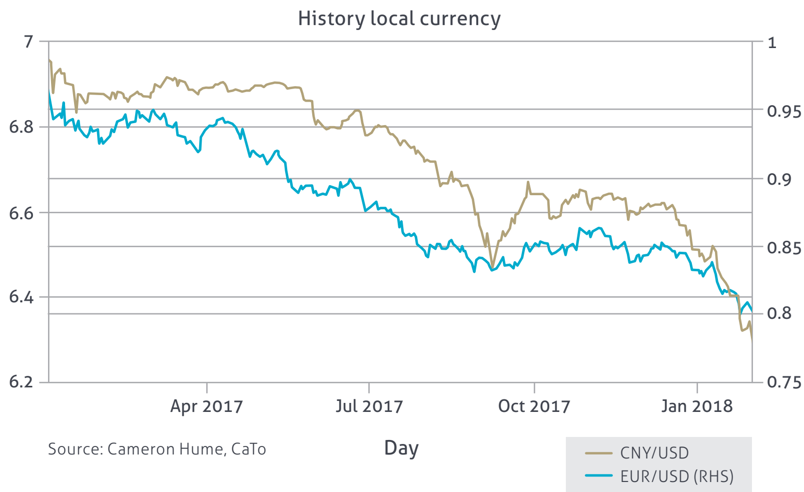
Tentatively, this suggests a 'new normal' has emerged in the US – economic output and employment growth need to run above trend, for many months, in order to generate even incipient signs of underlying inflationary pressures. Yet, wage growth in the Eurozone and Japan remains considerably lower than in the US and surveyed inflation expectations remain well anchored.

Will the recent rise in global equity and commodity prices lift underlying inflation across the US, the Eurozone or Japan? Some scepticism is justified. An immediate question is: what degree of monetary policy tightening is required when inflation is close to target but there are few signs of it accelerating? Irrespective of any policy tightening by the G3 central banks in the year ahead, nominal yields are likely to rise, with real yields following. This illustrates the tension between, on the one hand, a maturing global cyclical upswing and the imminent end to global monetary policy easing, and on the other, those economies, such as the Eurozone, where inflation is currently low, and a premature tightening in financial conditions could make desired policy normalisation very difficult.

In the US, loosening financial conditions through a depreciating US dollar (see Figure 1) are likely to contribute to rising import prices this year and to create pressure for headline CPI; although underlying inflation should remain immune to any sharp pass-through. Conversely, recent material appreciation of the euro will squeeze goods prices across the Eurozone and so constrain headline inflation, and core inflation.

The continued improvement in economic output and employment growth globally gives each of the G3 central banks reason to withdraw exceptional monetary stimulus. Indeed, given both the ECB and the BoJ are tapering bond purchases this year despite inflation remaining low, we can expect further evolving term structure of interest rates, likely flattening yield curves across respective government bond markets. Central banks forecasting inflationary outcomes and tapering bond purchases whilst low inflation persists may have unexpected consequences for long-dated yields. Inflation premia is likely to drop in this scenario, as market participants again question the symmetry of inflation-targeting regimes.

Figure 1: US dollar vs Chinese renminbi and euro



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Market commentary

Upward pressure on global bond yields looks likely to persist globally for now given underlying growth is buoyant, credit spreads remain low and a weak US dollar supports commodity prices and capital allocation away from the US. There are few current indicators that should worry investors about the durability of this phase of the global economic cycle.

Despite the persistence of below target inflation in the US, market expectations continue to reprice the expected path of interest rates higher (see Figure 2). Official projections for the Fed Funds Rate to be close to 3% by end 2019 – implying a further 6 interest rate hikes over that period – still remain at odds with current market pricing for a further 4 hikes only. This expectations gap requires further careful communication and guidance from the Fed over the coming months.

Any prolonged rise in UST yields should be capped however, as payroll wage growth remains low and the boost to incomes from domestic tax cuts is as yet unclear. Alternatively, real yields rising rapidly from here (see Figure 3) could undermine confidence in the durability of the recovery. Whilst the US Treasury yield curve has been flattening through the cycle of increasing Fed Funds Rate, a potential steepening of the yield curve may give market participants cause for concern and undermine risk-based valuations.

Elsewhere, the ECB will end its bond purchase programme later this year and at the same time will face the difficult task of managing market expectations for an imminent exit from negative deposit rates. Ongoing euro appreciation and bond tapering, together with persistently low core inflation and tightening financial conditions, suggest that longer-dated market-based inflation expectations above 2% (see Figure 4) should be capped and eventually fall.

Figure 2: US interest rate expectations, 2 years forward

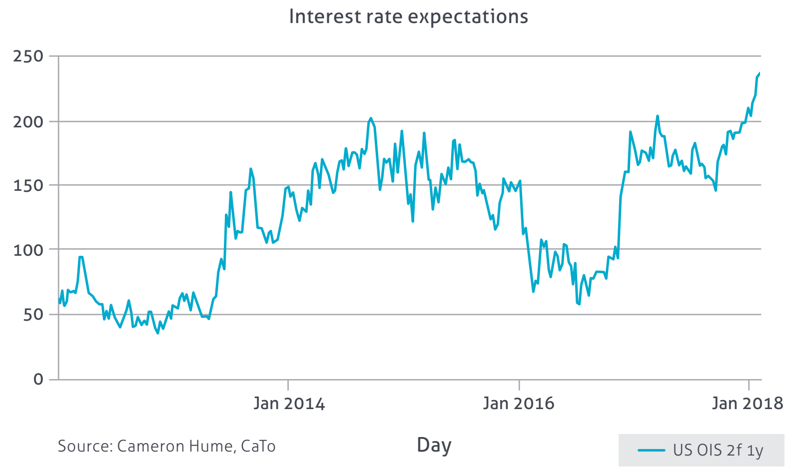
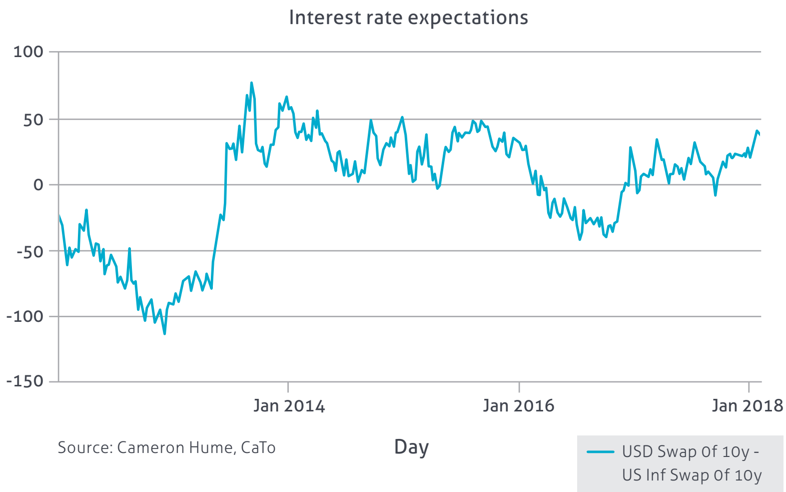


Figure 3: US 10 year real yields

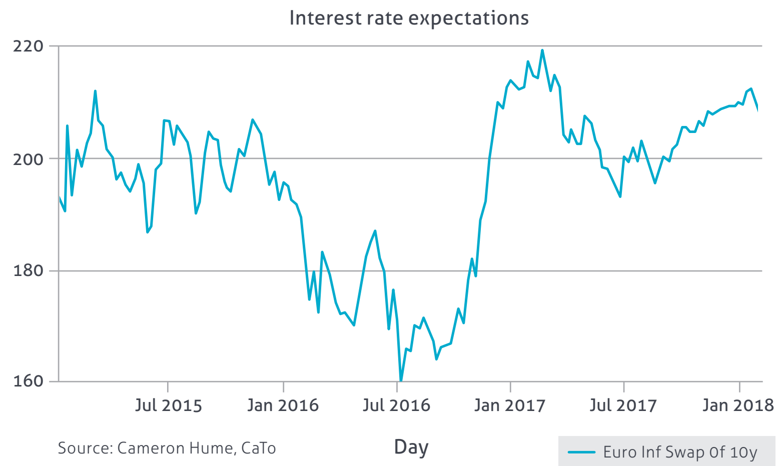


Portfolio commentary

Whilst many of our core investment themes remain largely unchanged from 2017, we have made several adjustments to our strategic exposures over the last few months' economies and look to capitalise on such possibilities.

Broadly, if both nominal and real yields are to rise globally as a result of continued policy tightening in the US then we expect market-based inflation premia will gradually fall in economies experiencing persistently low inflation. Should US dollar weakness persist as a theme this year then, together with rising longer-dated real yields, this may induce unwarranted tightening in interest rate sensitive, open economies. We would expect interest rate expectations to eventually fall in these.

Figure 4: Eurozone 10 year inflation expectations, 10 years forward



Our **Global QE** theme captures expected outcomes from the ongoing tapering of bond purchases by the ECB and BoJ. We anticipate further adjustment to yield curve control from the BoJ, pressuring 10y JGB yields higher and the swap curve there to steepen. However, tapering bond purchases whilst inflation remains low in both the Eurozone and Japan should reduce inflation premia in those markets. Consequently, we expect long-dated government bond yields in Japan and Italy to fall.

Our **Protectionism** theme continues to look for opportunities around persistent bellicose language from the US administration on global trade. Increasing tariffs on imported goods would be negative for the US consumer and so we are short the US dollar versus a basket of Asian currencies. We also currently favour the Norwegian krone versus the Canadian dollar, given protracted NAFTA talks this year and the supportive backdrop for global oil prices.

Global reflation remains elusive and a market expectation rather than a guarantee. The UK has experienced uncomfortably high imported inflation consistently through this cycle, following iterative collapses in the value of Sterling and the current environment is little different. We retain our long-held view that yields in the UK are too low given the supportive economic backdrop and modestly improved Brexit outlook.

Forward guidance has had the desirable effect of **suppressed volatility** across interest rate markets and we expect this to persist somewhat even as bond tapering accelerates this year. Consequently, we continue to favour high quality US CMBS spreads. With the Fed continuing to emphasise that a continuing rise in the Fed Funds Rate remains their central expectation, we are positioned for rising short-dated US swap yields.

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