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# GLOBAL ECONOMIC AND EQUITY REFLATION, CENTRAL BANKS LESS DOVISH THAN EXPECTED

Global Investment Committee Outlook

## Global Growth Should Continue Firm

The most important factor in the coming two quarters is that we still do not foresee geopolitical risk impacting markets much despite the numerous serious issues present. Given such, and coupled with our view that animal spirits and wealth effects will take strong hold of both the individual and corporate sectors, we believe that the G-3 economies should perform even better than consensus expectations, but for China to grow a bit slower than expected due to the deleveraging, anti-pollution and other campaigns of restraint following President Xi's consolidation of power. Global growth should be counterbalanced in this way, leading to safer conditions. We expect central banks to reduce their accommodation somewhat faster than consensus expectations, bond yields to rise, the USD to moderately strengthen and equity markets to rise quite a bit further. The resulting global investment stance, thus, is nearly the same as in September, but with mildly more reflationary characteristics.

Equity markets mostly exceeded our moderately bullish targets in September, with the SPX well above our end-December target of 2516, TOPIX 4% higher than our 1715 target and the Hang Seng also above our bullish target. The Eurostoxx Index, however, was below our target. Our G-3 bond yield targets for end-December were accurate in the US and Japan, but above target for the Eurozone. Our September forecast of a 1.3% decline in USD-based global bond returns through December looks right on target, however. As for currencies, our Yen and EUR targets for December turned out to be very accurate.

Our call in September that a major portion of Trump's tax plan with Congressional Republican leaders would occur in the 4Q17 (or soon thereafter) was correct and we expect success in passing an infrastructure bill soon, as well. Also, as we predicted in September, global economic has been sturdy, and even stronger than expected, especially in Europe and Japan. Looking forward, US GDP, at a 2.7% Half on Half Seasonally Adjusted Annualized Rate (HoH SAAR) in the 1H18, should exceed consensus expectations of 2.2%, with the same rate in the 2H18, as well. Growth should come from increased personal consumption, fixed asset investment, government spending and inventories, while net trade will likely be a negative factor. Meanwhile, Japan's and the Eurozone's GDP will likely grow at 2.4% and 1.8%, respectively on a HoH SAAR basis in the 1H18 and 2.4% and 1.4%, respectively, in the 2H, both approximately exceeding consensus by about 0.4% in both periods. These results should re-assure risk markets and corporate profit estimates should continue to show sturdy growth for CY18. Lastly, China's official GDP should be 5.8% HoH SAAR in both periods, vs. consensus of 6.5%, but this still translates to 6.2% YoY growth in the 1H18 and 6.0% in the 2H18, which is within the tolerance range of Chinese officialdom. Here too, personal consumption will likely lead the way, while fiscal stimulus will continue to provide much less support. Also slowing growth will be pollution related industrial cutbacks, capacity reduction in major industrial sectors, a crackdown on high personal mortgage and corporate leverage, a slowdown in cellphone production, tight controls over real estate, and overall tighter financial system regulation.

As for geopolitical issues, we still believe, as have markets so far, that such will be handled without crisis due to the strong economic incentives of all major players, although the situations in North Korea and the Middle East remain at very dangerous levels.

## Central Banks: Less Dovish than Expected

Since March, we expected Fed to hike three times in CY17 and to start balance sheet reduction by year-end, which was a much more hawkish view than consensus for most of the year, but turned out to be accurate. **We now expect 25 bps hikes in each quarter of 2018**, which is well above what fixed income markets and economists expect. For this call, it is noteworthy that two hawks are replacing two doves as FOMC voters in 2018. The ECB and BOJ have remained very dovish, as we have long predicted (along with consensus), but we expect them to be significantly less dovish in 2018 than the market expects. The ECB will start QE tapering in January, as expected, but its rhetoric will likely be much less dovish and it should indicate in the 3Q that it will hike rates by year-end, whereas the market only expects this to happen in 2019. Meanwhile, we expect the BOJ to hike its 10-year JGB target by 20 bps in the 2Q18 and 10 bps more in the 4Q, while also tapering its ETF purchases in the 1H18. As for inflation, we expect the US Core CPI to be 2.4% YoY in June, and as we expect the Brent oil price to be $66 then, we expect the headline CPI to be 2.9% YoY. Despite the mildly stronger USD since our September meeting, Brent oil moved up from $57 to above our $61 target for December, and we expect similar dynamic in the 1Q18 and 2Q18. Overall commodity prices should also move mildly upward, except gold, as despite somewhat disappointing Chinese economic growth, G-3 growth should keep global commodity demand quite firm.

## Rising USD and G-3 Bond Yields

Given our scenario, we expect G-3 bond yields to continue rising gradually in the next few quarters. For US 10Y Treasuries, our target for March-end is 2.55%, while those for 10Y JGBs and German Bunds are 0.10% and 0.45%, respectively. These are not major changes from current levels, but we expect more substantive increases through June, at 2.70%, 0.3% and 0.6%, respectively. This implies (coupled with our forex targets) that including coupon income, the Citigroup WGBI (index of global bonds) should produce a -1.7% unannualized return from our base date of December 15th through March in USD terms, -3.0% through June and -5.1% through December 2018. Thus, we continue to **maintain an underweight stance on global bonds for USD-based investors.** The WGBI index in Yen terms should be -0.3% through March and -1.2% through December 2018. As for JGBs, we target the 10Y to have a -0.5% total unannualized return in Yen terms through March, with -3.4% through December 2018, so within bonds, we clearly prefer overseas bonds for Yen-based investors.

Regarding forex, from the 112 level at our September meeting, the Yen is now 113 compared to our December-end forecast of 114, while from the 1.19 base level, the EUR is 1.18, equaling our forecast. Clearly, confidence in Europe has improved due to confirmation of the strong macro data and improved political prospects. Because Fed policy will tighten faster than BOJ policy and we expect some US legislative success on infrastructure spending, we expect the Yen to weaken to 115:USD at end-March and end-June, with 118 at year-end. For the EUR, we expect it to be 1.16, 1.15 and 1.15, respectively vs. the USD for those time periods. In sum, we think that the US strong macro characteristics, coupled with a new hawkish tilt to the FOMC voting members, will moderately outweigh, in the eyes of the forex market, the macro improvements and less dovish central bank trends in Japan and Europe. Interest rate differentials, especially on the short end of the curve, will become quite compelling, indeed.

## Still Overweight Global Equities

Our September meeting's MSCI World Index target for end-December was too conservative at a 1.4% unannualized return, with even the 7.3% targeted return through June now looking conservative. Our new scenario is even more bullish, as economic growth should propel earnings growth, while rising interest rates should not curtail valuations much. Aggregating our national forecasts from our base date of December 15th, we forecast that the MSCI World Total Return Index will increase 5.6% (unannualized) through March in USD terms (7.1% in Yen terms), 9.2% through June (10.8% in Yen terms) and 12.9% through December 2018 (17.6% in Yen terms). **Clearly, this suggests a continued overweight stance on global equities for USD- based investors (and Yen-based investors, as well).**

In the US, global economic growth, coupled with deregulation and accelerated share buybacks (due to the tax break on the repatriation of foreign profits) should easily offset the headwinds from a mildly stronger USD and higher interest rates, such that CY18 earnings should be quite strong. Currently, because the tax cuts are not fully approved, analysts have not fully adjusting their EPS forecasts for such, but this **is likely a major anomaly that makes the market much less expensive than it appears.** Indeed, we estimate that the market is trading on about 16.9 times CY18 EPS (and even less if buybacks are greater than expected). In sum, these factors should send the SPX to 2841 (7.4% total unannualized return from our base date) at end-March, 2941 at end-June 2018 (11.6% total return) and 2994 at year-end (14.6% return). While these forecasts might seem overly optimistic, they are much lower than 2017 returns and are merely growing with tax-cut-boosted consensus earnings forecasts. Comparatively, these are stronger returns than its peers and, thus, **justifies a continued overweight US stance.**

**As mentioned earlier, European equities** did not rise as much as we forecasted in September. Given the shockingly good economic data and yet continued low interest rates, coupled with a stable EUR, the flattish return may be related to equity investors re-allocating funds to the US and Japan (both of which are returning double digit in USD terms so far in the 4Q). European valuations were also a bit on the high side back in September. Looking forward, we expect European equities to perform moderately well, with EuroStoxx rising to 399 and the FTSE to 7680 at end-March, and to 408 and 7850 through June, which translates to 1.9% and 3.9% unannualized MSCI Europe returns in USD terms for those periods. Consumer confidence has risen, fears of a banking crisis have greatly diminished and global growth should cause consensus profit estimates to rise. BREXIT will remain a difficult issue, but should not affects the markets too much. Meanwhile, the Italian election in March is too difficult to gauge yet, but certainly adds some uncertainty. Notably, rising commodity prices, to which UK and European corporations are highly geared, should also boost corporate earnings. As for valuations, they have moderated to a reasonable degree and we think they can be sustained despite a less dovish ECB stance ahead. In sum, **we are positive but will switch to a slightly underweight stance on the region.**

In our last reporting period, **Japanese equities performed very well in both local currency terms and USD terms, outperforming the MSCI World Index.** Part of this is due to Abe's election landslide, but even more so to a 3QCY earnings season that surged far above consensus. Japan has high operational gearing to global growth, which has clearly surged as well. Given that we expect global economic growth to run even faster than the currently strong consensus, it is not surprise that we are positive on Japan. We expect TOPIX at end-March to hit 1867, with 1923 through June for a total return of 2.0% and 5.5% in USD terms respectively (3.5% and 7.1% in Yen terms). These are relatively moderate gains in the short run (although our target of 2016 for year-end is more impressive), as our Japan team is somewhat concerned about sentiment leading up to the decision later this year to hike VAT hike in late 2019, but most other metrics, especially strong corporate profits and relatively low equity valuations imply a very positive outlook. However, as its USD-termed equity returns are somewhat lower than some of its peers, **we will retain a slight underweight stance.**

**As for the Developed Pacific-ex Japan region,** we expect Hong Kong and Australian equities to perform very well, leading to a 6.1% unannualized return in USD terms through March and 11.8% through June. Rising commodity prices and increased comfort that Chinese economic growth is emphasizing quality over quantity will play major roles in these returns. Thus, we **will shift from an underweight stance to an overweight one on the region.**

Lastly, besides all the geopolitical risks, protectionist actions by the US will need to be watched very carefully. Of course, neither Trump nor Chinese officials wish to cause a crisis, and will attempt to avoid such as they have done so far, but emotions are running high and accidents could occur.

## Investment Strategy Concluding View

Global equities returned 5.1% vs. Global bond's -0.3% in unannualized USD terms in the prior quarterly reporting period through December 15th. Looking forward, there is no doubt that geopolitical tail risks remain quite large, but the Global Investment Committee remains upbeat because the net impulses for global economic growth and corporate profits continue to improve. Similar to our last few meetings, this justifies **an overweight stance on global equities, particularly for the US.** Meanwhile, global bond yields should rise somewhat, so we **maintain an underweight stance on global bonds, with an overweight stance on USD cash** for USD-based clients. For Yen-based clients, Yen cash looks more attractive than both JGBs and global bonds.

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