By John Vail,
Chief Global Strategist

HOUSE VIEW THROUGH JUNE 2019: GLOBAL ECONOMIC REBOUND AND EQUITY REFLATION

Global Growth Should Rebound

Our updated house view is that the G-3 and Chinese economies will rebound through June 2019 approximately in line with consensus expectations, after the global 1Q deceleration, while we expect central banks to reduce their accommodation similarly to consensus expectations. With such as the backdrop, we expect bond yields to rise mildly, the USD to be relatively flat and equity markets to rise quite a bit further, especially as we forecast that geopolitical risks will remain under control.

MSCI World rose 0.4% from our last meeting in early-March through June 8th, less than we expected (although are targets were for end-June, which could well still be met), yet somewhat justifying our bullish stance at the time, at least relative to bonds. The major reason why both asset classes were subdued in USD terms was the strength of the USD. The SPX rose slightly, but is lower than our June-end target, while TOPIX rose nicely in USD terms, but also below our target. It was MSCI Europe and MSCI Pacific ex Japan that disappointed the most vs. our expectations, primarily because we did not foresee the Italian tumult and ultra-aggressive US trade policy, respectively. G-3 bond yields are mildly below our targets for end-June, except for Japan, which remains consistent with our flat target. Our March forecast of 0.2% USD-based global bond return through June is likely too high due to the stronger USD pushing down the value of overseas bonds. Indeed, Euro was much weaker than we expected, greatly due to the Italian tumult, while the Yen is 110 vs. our 107 forecast.

G-3 economic growth decelerated significantly in the 1Q for Japan and Europe, but remained quite sturdy for the U.S. and China. Our forecasts in March for firm economic growth in the 2Q-3Q period, around the consensus forecast at that time, looks correct now, although of course, with a lower 1Q base for Japan and Europe. Looking forward, U.S. GDP, at a 3.1% Half on Half Seasonally Adjusted Annualized Rate (HoH SAAR) in 2H18 and a 2.3% rate in 1H19, should match consensus expectations. Growth should come from increased personal consumption, fixed asset investment, government spending and inventories, while net trade will likely be a negative factor. Meanwhile, the Eurozone's and Japan's GDP will likely grow at 2.2% and 1.8%, respectively, on a HoH SAAR basis in 2H18 and 2.0% and 1.8%, respectively, in 1H19, both approximating consensus expectations. These results should re-assure risk markets and corporate profit estimates should continue to show sturdy growth well into 2019. Lastly, China's official GDP should be approximately 6.5% HoH SAAR in both periods. Here too, personal consumption will likely lead the way, while fiscal stimulus will continue to provide much less support.

As for geopolitical issues, we still believe that such will be handled without crisis due to the strong economic incentives of all major players, but there are many situations that bear close monitoring. Although we did not forecast the Italy's disruption, it may turn out to be of only moderate importance, while the bigger issues of North Korea, the Middle East and BREXIT did, indeed, not become problematic for markets. Trade disputes were more serious than we expected, but we continue to believe that they will be settled relatively soon, especially as Trump desires a positive economy and stock market leading up to the November elections.

Central Banks: Remaining Relatively Dovish Despite Reflation

We maintain our Fed call for hikes in June, September and March, while adding one in our new June 2019 forecast period, as well. This is a bit more aggressive than fixed income markets expect, but approximates the consensus of major street economists. As we expected, the ECB and BOJ remained very dovish and we still expect the former to end QE in December, with rate hikes starting in 2Q19. Meanwhile, we continue to expect the BOJ to maintain its 10-year JGB target until a 1Q19 hike of 20 bps. As for inflation, we expect U.S. Core CPI to be 2.1% YoY in December, and as we expect the Brent oil price to be $75 then, we expect the headline CPI to be 2.6% YoY. Overall commodity prices should also move mildly upward, with oil essentially flat, as global growth should keep global commodity demand quite firm, thus more than offsetting the effect of higher interest rates.

Flat USD and Mildly Rising 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 end-September is 3.00%, while those for 10Y JGBs and German Bunds are 0.05% and 0.45%, respectively. In December, we expect 3.05%, 0.10% and 0.50%, respectively. This implies (coupled with our forex targets) that including coupon income, the Citigroup WGBI (index of global bonds) should produce a -0.4% unannualized return from our base date of June 8th through September in USD terms, and -1.3% through December 2018. Thus, **we continue to maintain an unenthusiastic stance on global bonds** for USD-based investors. The WGBI index in Yen terms should be -0.2% and -0.6%, respectively, and as for JGBs, we target the 10Y to have a

-0.2% total unannualized return in Yen terms through September and -0.6% through December 2018.

Regarding forex, Fed policy will tighten faster than that for the BOJ and ECB, but global worries about U.S. budget deficits should restrain USD enthusiasm, so we expect the Yen and Euro to be basically flat through June 2019, with the EUR slightly declining towards the end of this period. One additional positive factor for the USD for the last three months has been the major decline in the U.S. trade deficit, as imports have been sluggish. However, it is likely that it will widen in the 2H18 due to strong personal consumption. This would be USD bearish, but if the widening is very marginal, such would actually be a positive factor for the USD.

Still Positive on Global Equities

Our new scenario continues to be bullish on equities (as it has for virtually the entire period since the Global Financial Crisis), as economic growth should propel earnings growth, while mildly rising interest rates should not curtail valuations much. Aggregating our national forecasts from our base date of June 8th, we forecast that the MSCI World Total Return Index will increase 2.5% (unannualized) through September in USD terms, 5.2% through December and 6.8% through March 2019. **Clearly, this suggests a positive stance on global equities for USD-based investors (and Yen-based investors, as well).**

In the U.S., strong global economic growth, coupled with deregulation and accelerated share buybacks should easily offset the headwinds from mildly higher interest rates, so the equity backdrop is quite strong, especially as SPX CY18 EPS estimate has risen by another 2% since our meeting and the PER based on such is at a fairly reasonable 17.5 times. Given all of this, we expect the SPX to hit 2821 (2.1% total unannualized return from our base date) at end-September and 2878 at year-end (4.6% return), clearly reasonably high returns on an annualized basis.

European equities have been quite disappointing recently, especially in USD terms, and some European macro economic data is still showing signs of deceleration, but GDP should be reasonably solid going forward, especially by mature-country standards. Political risk continues to haunt the market, as does the credit quality for major parts of the German banking system. Continued low interest rates and strong earnings growth from global economic growth, however, should help its equity market rebound. Notably, mildly rising commodity prices, to which UK and European corporations are highly geared via multinational companies, should also boost corporate earnings. The European PER on 2018 EPS is quite reasonable and will likely rise somewhat, so we see the Euro Stoxx rising to 398 and the FTSE to 7780 at end-September, and to 409 and 7950 through December, which translates to 3.8% and 7.5% unannualized MSCI Europe returns in USD terms for those periods. On the political front, fears of an Italian crisis have greatly decreased in recent days, but BREXIT will likely remain a moderate headwind. Although it is not our expectation, there is the possibility of increasingly damaging trade spats with the U.S., as Europe seems completely unwilling to deal with the Trump Administration.

Japanese equities have not only risen in Yen terms since our March base date, but also +2.5% in USD terms. Part of this was due increased equity investor confidence due to a weaker Yen. 1Q EPS results were especially good due to a declining US tax rate and EPS growth ahead continues upward. Japan has high operational gearing to strong global economic growth and corporate governance continues to improve (despite a few hiccups), so we expect TOPIX at end-September to be 1829, with 1876 through December for a total return of 3.2% and 6.3% in USD terms, respectively (virtually the same in Yen terms, as well). The reasonable equity valuation, at 15.0 times CY18 EPS, is also factor in our positive outlook.

As for the Developed Pacific-ex Japan MSCI, we expect Hong Kong and Australian equities to perform very well, leading to a 3.3% unannualized return in USD terms through September and 7.3% through December. Strong global growth, reasonable equity valuations, decent earnings growth and continued low global interest rates all play major roles in these expected returns. Once again, the major risk is trade disputes, particularly between the U.S. and China, but we believe the worst has likely passed. That said, it will continue to be a worrisome issue at times and it is partly linked at how well North Korean denuclearization proceeds.

Investment Strategy Concluding View

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. Thus, similar to our meetings of the last year, this justifies a **positive stance on global equities, particularly in Japan, Europe and the Asia Pacific**. Meanwhile, global bond yields should rise somewhat, so we **maintain an unenthusiastic stance on global bond returns**.

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