Weekly Update

C0 | EXTERNAL PUBLICATION

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Monetary policy divergence is back – so what?

This week's monetary policy meetings saw the US Federal Reserve (Fed) hike rates by a further 25 basis points (bp) to a 1.75-2% range and the European Central Bank (ECB) opt for no change. But the focus was more on the accompanying statements – and clearly, they were in stark contrast.

In the US, the Federal Open Market Committee (FOMC) now forecasts four rate hikes in total this year instead of three as one member upgraded his projection for 2018in June. This is consistent with the slow rise in core inflation to 1.8% YoY in April and an upward revision to the GDP growth forecast for 2018 (from 2.7% to 2.8%). With the 10-year Treasury yield idle, the 2-10y yield curve continued flattening out, hitting a new low since 2007 at 36bp. Although there is more correlation than causality, an inverted yield curve is frequently seen as a leading indicator of a downturn. This relationship is closely monitored by market participants despite being loose (hit ratio of 60% over the last 60 years) and a time lag that can vary considerably from 11 to 50 months). This suggests that the FOMC may tighten its policy more cautiously from now on. As we forecast the 10-year yield to hover around 3.25% by late 2018, the Fed could hike rates only once more to avoid inverting the yield curve.

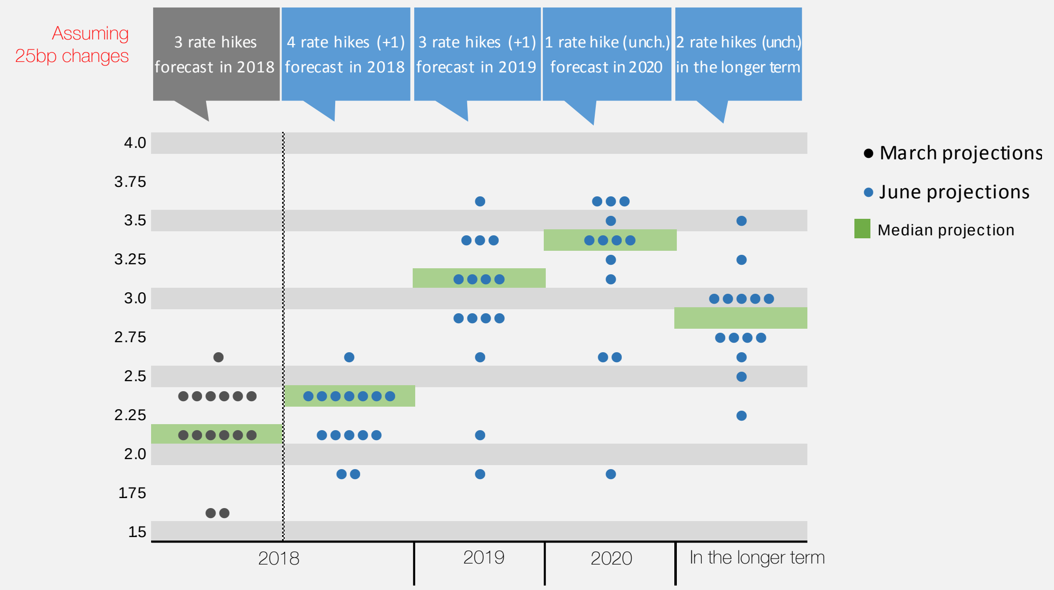
On Thursday, the ECB announced that they would cut monthly asset purchases from €30bn to €15bn in Q4 2018 and then remove the scheme in end December 2018. It could be revived later on although the odds are low and much will depend on the medium-term outlook. Also, the ECB committed not to raise rates before summer 2019 (at least), keeping the deposit and refinancing rates at -0.40% and 0% respectively. The pledge was perceived as very accommodative by the market, pushing bond yields and the euro lower. Indeed, inflation is supported by higher oil prices and a softer euro (1.9% for headline) but does not exceed 1.1% ex volatile items. We expect slight improvement in the second semester as the output gap is closing gradually. This should translate into higher bond yields later this year, but much will depend on growth developments with risks skewed to the downside.

Bottom line. Monetary policy divergence is back. With the 10-year yield gap between US and German government bonds at an all-time high of 260bp, EUR/USD remains under pressure and trades below 1.16. Given we see no catalyst for a rebound in the short run, the cross rate should remain stuck in 1.15-1.20 range. We may downgrade our 6- and 12-month targets (currently at 1.23 and 1.30 respectively) should growth and inflation disappoint. On the fixed-income side, the wide yield gap should cap the US yield curve provided inflation does not flare up. However, short duration and active management will be needed to navigate fixed-income waters in this context.

Each point indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year

FOMC members now forecast four rate hikes in total this year

FOMC members' judgment of the appropriate target level for the Federal Funds rate at the end of each year (%)



Source: Chairman's FOMC press conference projection material, 13/06/2018

This week and next

EUROZONE

- In its final estimate, real GDP growth for Q1 2018 was confirmed at 0.4% QoQ and 2.5% YoY. Household spending accelerated to 0.4% QoQ, while private investment rose 0.5% (vs 1.3% in Q4 2017) and exports declined 0.2% QoQ.
- At its 14 June meeting, the European Central Bank kept its main refinancing rate unchanged at 0%. Monthly net asset purchases will be halved to €15bn from September and the scheme will be removed in December.
- Industrial production fell 0.9% MoM in April (Germany: -1%, France: -0.5%, Italy: -1.2%), reflecting softer activity in the eurozone.
- Inflation accelerated from 1.2% to 1.9% YoY in May and the core index ex. volatile items came out at 1.1%.

Next week's key events		Per.	Prev.	Cons.
21 Jun	Consumer confidence	Jun	0.2	--
22 Jun	Manufacturing confidence (PMI)	Jun	55.5	--

UNITED KINGDOM

- The unemployment rate remained unchanged at 4.2% in April while average weekly wages rose 2.5% YoY vs 2.6% in March.
- Industrial output growth was below expectations, decreasing from 2.9% to 1.8% YoY in April, while manufacturing output eased down from 2.9% to 1.4% YoY.
- Inflation remained unchanged at +2.4% YoY in May.
- Retail sales surprised positively, rising 1.3% MoM in May and 3.9% YoY, thus confirming the recovery initiated in November 2017.

Next week's key events		Per.	Prev.	Cons.
20 Jun	CBI Trends total orders	Jun	-3	--
21 Jun	Bank of England rate	N/A	0.5%	0.5%

UNITED STATES

- The NFIB Small business optimism index increased significantly in May, hitting a 34-year high.
- As anticipated, consumer prices increased 0.2% MoM in May. Both headline and core inflation (i.e. excl. food and energy) rose from 2.5% to 2.8% YoY in May, and from 2.1% to 2.2% respectively.
- As widely expected, the FOMC hiked the Fed Funds target rate by 25bp for the second time this year at its 13 June meeting. The Fed turned more hawkish and revised up its rate expectations.
- Advance retail sales rose more than expected (0.8% MoM) in May.

Next week's key events		Per.	Prev.	Cons.
19 Jun	Housing starts (MoM)	Jun	1287k	1312k
20 Jun	Current account balance ($bn)	Q1 18	-128.2	-129.0
21 Jun	Jobless claims	11Jun	222k	--

ASIA & EMERGING COUNTRIES

- In Japan, machinery orders rebounded to 9.6% YoY in April, a record since November 2016. This bodes well for Q2 GDP growth. As a reminder, GDP growth was negative in Q1 for the first time in nine quarters.
- After 5 months of deceleration, growth in Japanese production prices rebounded from 2.1% in April to 2.7% YoY in May.
- China's trade surplus narrowed from $28.8bn to $24.9bn in May, but the trade surplus with the US jumped to $24.6bn.
- Activity softened more than expected in May: retail sales growth slowed from 9.4% YoY to 8.5% and industrial production was down from 7% to 6.8% YoY.
- Chinese inflation remained stable at 1.8% YoY in May.

Next week's key events		Per.	Prev.	Cons.
22 Jun	Japan: Manufacturing confidence	Jun	52.8	--
22 Jun	Japan: Inflation (ex. fresh food)	May	0.7%	--

Sources: Datastream, Bloomberg, 18 June 2018, Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, ECB = European Central Bank

Our 6-month targets for currencies and commodities

	Thursday close	6mth target
EUR/USD	1.16	1.23
GBP/USD	1.33	1.40
EUR/CHF	1.15	1.18
USD/JPY	111	110
Brent	$76.1	$65
Gold	$1306	$1275

Forecast figures are not a reliable indicator of future performance

We have revised our targets for EUR/USD, GBP/USD, EUR/CHF and Brent.

Question time

Past performance should not been seen as a guarantee of future returns.

No Q&A this week.

Market performance

Past performance should not been seen as a guarantee of future returns.

Interest rates

Interest rates	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-36 bp	-1 bp	→	0 bp	-2 bp	-1 bp
3mth Euribor (EUR)	-32 bp	0 bp	→	1 bp	1 bp	1 bp
3mth Libor (USD)	233 bp	1 bp	→	19 bp	64 bp	108 bp
3mth Libor (GBP)	63 bp	0 bp	→	2 bp	11 bp	34 bp
10-year US Treasury bond	295 bp	2 bp	↑	13 bp	53 bp	81 bp
10-year German bond	43 bp	-6 bp	↓	-16 bp	1 bp	20 bp
10-year French bond	71 bp	-13 bp	↓	-1 bp	4 bp	13 bp
10-year UK bond	138 bp	-8 bp	↓	-7 bp	16 bp	52 bp

Credit

Credit	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0.4%	↑	-0.4 %	-0.6 %	0.3 %
BAML EURO Corp HY	0.2%	↑	-0.6 %	-0.6 %	1.8 %
BAML GBP Corp IG	0.9%	↑	0.1 %	-1.3 %	-1.0 %
BAML US IG	0.0%	→	-0.8 %	-3.2 %	-1.2 %
BAML US HY	0.4%	↑	1.2 %	0.7 %	2.9 %
JPM Global EM Sov. Plus	-0.9%	↓	-4.4 %	-5.9 %	-2.6 %

Exchange rates

Exchange rates	Last	1wk		3mth	YTD	12mth
EUR/USD	1.16	-1.9 %	↓	-6.5 %	-3.7 %	3.1%
EUR/CHF	1.15	-0.3 %	↓	-1.3 %	-1.4 %	5.9%
GBP/USD	1.33	-1.2 %	↓	-5.0 %	-1.8 %	4.0%
USD/JPY	111	0.8 %	↑	4.0 %	-1.8 %	1.0%
USD/BRL	3.81	-2.6 %	↓	16.7 %	14.9 %	16.2%
USD/CNY	6.40	0.2 %	↑	1.3 %	-1.6 %	-5.7%
USD/RUB	62.6	0.3 %	↑	9.4 %	8.5 %	9.0%

Government bonds*

Government bonds*	1wk		3mth	YTD	12mth
United States (3-7yr)	-0.1 %	↓	-0.2 %	-1.5 %	-2.2 %
United Kingdom (3-7yr)	0.3 %	↑	0.5 %	-0.4 %	-1.6 %
Germany (3-7yr)	0.3 %	↑	0.8 %	0.3 %	-0.6 %
Japan (3-7yr)	0.0 %	→	0.0 %	0.0 %	0.1 %

Equities*

Equities*	Last	1wk		3mth	YTD	12mth
MSCI AC World	520	0.0 %	→	0.3 %	2.6 %	13.7 %
Eurostoxx 50	3 527	2.1 %	↑	6.8 %	3.6 %	3.0 %
DAX	13 107	2.3 %	↑	7.1 %	1.5 %	2.4 %
CAC 40	5 528	1.7 %	↑	8.4 %	6.9 %	8.9 %
S&P 500	2 782	0.5 %	↑	1.7 %	5.0 %	16.4 %
FTSE 100	7 766	0.9 %	↑	10.3 %	3.3 %	8.2 %
SMI	8 691	1.7 %	↑	0.6 %	-4.3 %	1.6 %
Topix	1 784	-0.3 %	↓	3.4 %	-0.8 %	14.5 %
IBOV Brazil	71 421	-3.3 %	↓	-17.0 %	-6.5 %	15.3 %
MICEX Russia *	2 253	-2.7 %	↓	-1.0 %	6.8 %	22.6 %
MSCI EM	1 126	-2.0 %	↓	-7.0 %	-1.9 %	14.0 %
SENSEX 30 India	35 600	0.5 %	↑	5.7 %	5.9 %	15.8 %
Hang Seng (H-K)	30 440	-3.3 %	↓	-2.0 %	3.3 %	22.4 %
Shanghaï Composite	3 044	-2.1 %	↓	-7.5 %	-8.0 %	-2.8 %

Commodities

Commodities	Last	1wk		3mth	YTD	12mth
Brent	$76	-1.3 %	↓	17.5 %	14.2 %	62.1 %
Gold	$1 306	0.6 %	↑	-1.5 %	0.2 %	2.3 %
Silver	$17.2	2.1 %	↑	4.0 %	1.3 %	0.3 %

Source: Datastream, on 15/06/2018. 1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7 year returns. Figures are rounded.

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