Weekly Update

C0 | EXTERNAL PUBLICATION

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All data taken from Bloomberg (29/11/2018).

Just below

When central bankers talk about the "neutral level" of interest rates, they mean the point at which the cost of borrowing is neither stimulative nor restrictive. What level that might actually be is the subject of much debate and little consensus, despite its key importance for economies. So, when the Chairman of the US Federal Reserve Board (Fed) Jerome Powell observed on Wednesday November 28 that rates were "just below" the neutral range, markets rallied sharply. Did he mean that the Fed would soon halt its regular rate hikes? What does this mean for the US economy?

As Powell observed, the Fed is very close to achieving its dual objectives for the US economy, i.e. full employment and stable inflation. Unemployment at 3.7% is at 49-year lows and core Personal Consumption Expenditure inflation at 1.8% is just below the Fed's definition of stability.

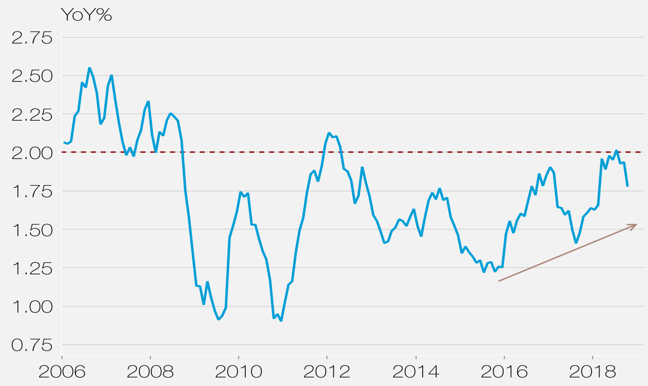
However, as markets have corrected in recent weeks, some signs of weakening economic momentum have emerged. Business confidence measures have eased from recent highs, jobless claims are at their highest level since May while car and home sales data have been weaker than expected. Moreover, high-profile companies such as GM and GE are in the throes of deep restructuring. Finally, the boost to activity from this year's tax cuts will begin to wane as 2019 advances.

In parallel, there has been a clear shift in the way the Fed has articulated its policy stance. After hiking at the September 26 meeting, the Fed governors decided to adjust their statement, removing the previous wording that policy "remained accommodative" – a hint that the neutral level for rates was within reach. However, the Fed's projections continued to call for four more hikes by end-2019, prompting a flurry of Fed-critical tweets from President Trump, who professes a preference for low interest rates.

So, this week's pronouncement from Powell seems designed to clarify the Fed's thinking. The range in estimates for the neutral level varies between economists – for example, the President of the Atlanta Fed Raphael Bostic suggests a range between 2.5% and 3.5%, just above today's rates. This suggests that the end of the rate-hike cycle is in sight. At the same time, Fed chair Powell clearly wants to de-emphasise the neutral level and to increase his flexibility in light of changes in data – he stressed there is "no preset policy path".

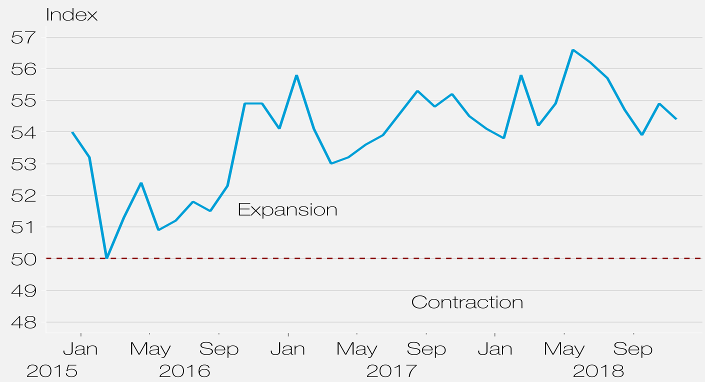
Putting it all together. We maintain our conviction that rates will rise again at the December 18-19 meeting to 2.25-2.5%. For 2019, it now looks likely that rates may only be hiked twice, taking Fed Funds to the middle of Bostic's neutral range. And with monetary policy set to be neither stimulative nor restrictive, we expect another year of decent US growth in 2019.

US inflation close to the Fed's 2% objective
Core Personal Consumption Expenditures



Sources: SGPB, Macrobond, BEA, October 2018

Recent weakening in business confidence
US Composite PMI index



Sources: SGPB, Macrobond, IHS Markit, November 2018

This week and next

EUROZONE

- November economic sentiment dropped less than expected, from 109.7 in October to 109.5, as industrial sentiment improved for the first time since April from 3.0 to 3.4. The business climate index rose to 1.09 in November, up from 1.01 and beat expectations for 0.96.
- Consumer confidence fell to -3.9 in November, from -2.7 a month ago, confirming the flash estimate released earlier this month.
- The M3-money supply annual growth rate unexpectedly increased to a three-month high in October at 3.9% YoY, up from 3.5%.
- Headline inflation decelerated from 2.2% YoY to 2.0% in November, mostly due to the drop in oil prices. The core measure (excl. food and energy) also slowed from 1.2% YoY to 1.1% missing expectations.

Next week's key events		Per.	Prev.	Cons.
4 Dec	Producer prices YoY	Oct	4.5%	4.5%
7 Dec	GDP YoY (second release)	Q3	2.2%	1.7%

UNITED KINGDOM

- GfK consumer confidence fell from -10 to -13 in November, a 11-month low ahead of the UK exit from the European Union in March next year.
- The number of mortgage approvals picked up to a nine-month high at 67.1K in October from 65.7K in September. Consumer credit, which includes borrowing, using credit cards, personal loans and overdrafts, slowed down from 7.9% YoY to 7.5% in October, its weakest growth since May 2015.
- The CBI Distributive Trades survey on sales volumes rose from 5 to 19 in November, helped by a retail sales pick-up ahead of Christmas.

Next week's key events		Per.	Prev.	Cons.
3 Dec	Manufacturing PMI	Nov	51.1	51.5
7 Nov	Halifax house prices MoM	Nov	0.7%	0.5%

UNITED STATES

- The consumer confidence index fell to 135.7 in November but remained strong as the October reading of 137.9 was an 18-year high.
- Gross domestic product (GDP) rose 3.5% YoY in Q3 according to the second release – unchanged from the previous estimate. US economic growth was still above its 2% estimated potential.
- Consumption expenditure, which accounts for more than two thirds of the US economic activity rebounded from 0.2% MoM to 0.6% in October, a 7-month high.
- Initial jobless claims jumped by 10K to 234k in the week ending November 24, the highest level since May.

Next week's key events		Per.	Prev.	Cons.
3 Dec	ISM manufacturing PMI	Nov	57.7	57.8
7 Dec	Unemployment rate	Nov	3.7%	3.7%

ASIA & EMERGING COUNTRIES

- Japanese manufacturing PMI declined from 52.9 – a six-month high – to 51.8 in November. Conversely, retail sales rose 3.5% YoY in October, the fastest pace this year, following a 2.2% rise in September. The unemployment rate missed expectations of no-change, edging higher from 2.3% to 2.4% in October.
- In China, the manufacturing PMI index fell 0.2 pp in November and hit the 50-threshold, the dividing line between expansion and contraction in output.
- Chinese industrial production jumped 1.0% MoM in October after a 2.7% decline in September. The YoY rebound printed at 10.7%, the fastest since February 2012.

Next week's key events		Per.	Prev.	Cons.
3 Dec	Japan: Business capex YoY	Q3	12.8%	--
8 Dec	China: Trade balance ($bn)	Nov	34	34

Sources: Datastream, Bloomberg, 30 November 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 3-month targets for currencies and commodities

	Thursday close	3mth target
EUR/USD	1.14	1.15
GBP/USD	1.28	1.32
EUR/CHF	1.13	1.15
USD/JPY	113	110
Brent	$59.6	$70
Gold	$1227	$1220

Forecast figures are not a reliable indicator of future performance.

Question time

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

RUSSIAN ROUBLE: CAUGHT BETWEEN STRONG FUNDAMENTALS AND THE THREAT OF NEW SANCTIONS

In this week's Q&A, we look at how the Russian rouble is caught between strong fundamentals and the threat of new sanctions.

Russian financial and economic metrics are supportive for the rouble. Long-term fundamentals are sound, with low public debt, balanced budget, and positive current account, and several adjustments to monetary policy are helping mitigate the impact of American sanctions.

The pulse of the Russian economy remains robust, though signs of weakness are gradually emerging. This is reflected in slowing business investment. Also, January's planned VAT increase may curtail consumer spending next year, after a temporary boost in Q4. And while weaker oil prices have recently eroded support for the rouble, we expect a recovery in Brent next year back to $70-$75 per barrel.

However, politics should hang over the currency throughout 2019, with heightening tensions in our view. The rouble was recently bolstered by news of talks – since cancelled – between Presidents Putin and Trump at this week-end's G20. They were due to discuss the Intermediate-range Nuclear Forces (INF) Treaty, a key nuclear arms control agreement, in an attempt to restore their stalled relationship.

Nevertheless, a sustainable detente seems remote for several reasons:

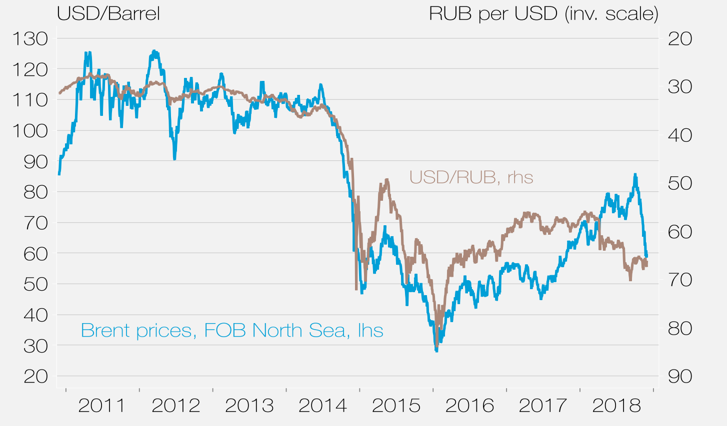
1. Fresh American sanctions against Russia are highly likely now that the Democrats are back in control of the House of Representatives. Whether the sanctions apply to specific individuals or entities, the banking system and/or public debt (far more impactful) will be decisive for the rouble. However, potential gridlock in Congress means sanctions might end up less severe than expected.
2. Tensions around the strait connecting the Sea of Azov with the Black Sea could lead to additional sanctions. Since the annexation of Crimea, Russia has claimed control of the strait, which Ukraine disputes. Ukraine might also seek to add to international pressure on Russia and/or obtain stronger military support. These measures could help rally support for the government in Kiev ahead of March 2019's presidential election. In any case, further sanctions on Russia seem likely whatever happens in Ukraine.
3. Following several INF violations by Russia, we anticipate that the US will terminate the Treaty, as already announced by the White House. In addition, China – which is not an INF signatory – has been building an arsenal of arms forbidden by the Treaty. This could signal a renewed arms race as the US reacts to the perceived Chinese challenge to its supremacy.
4. The US is striving to extend its sphere of influence to Poland and some former Soviet states, provoking strong reactions from Russia.

Aside from politics, we do not expect monetary policy to be a decisive factor for now. A rate hike seems unlikely in the near future despite the risk of higher inflation after January's VAT increase.

Our tactical models currently suggest limited arbitrage opportunities in the rouble. We expect the USDRUB exchange rate to remain around 67 in coming weeks, as the macroeconomic pulse starts to weaken and political issues take their toll.

Plunging oil prices have put pressure on the rouble

Latest indicators



Sources: SGPB, Macrobond, data as of 29/11/2018

Market performance

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

Interest rates

Interest rates	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-36 bp	0 bp	→	0 bp	-2 bp	-6 bp
3mth Euribor (EUR)	-32 bp	0 bp	→	0 bp	1 bp	1 bp
3mth Libor (USD)	274 bp	5 bp	↑	43 bp	104 bp	126 bp
3mth Libor (GBP)	90 bp	0 bp	→	9 bp	38 bp	38 bp
10-year US Treasury bond	304 bp	-3 bp	↓	rke	62 bp	66 bp
10-year German bond	32 bp	-5 bp	↓	-9 bp	-10 bp	-6 bp
10-year French bond	70 bp	-5 bp	↓	-5 bp	-9 bp	-2 bp
10-year UK bond	137 bp	-6 bp	↓	-12 bp	18 bp	3 bp

Credit

Credit	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0.1%	↑	-0.9 %	-1.3 %	-1.6 %
BAML EURO Corp HY	-0.3%	↓	-3.1 %	-3.2 %	-3.3 %
BAML GBP Corp IG	0.1%	→	-1.8 %	-3.0 %	-1.5 %
BAML US IG	-0.1%	↓	-1.8 %	-3.7 %	-2.9 %
BAML US HY	0.3%	↑	-2.0 %	-0.1 %	0.2 %
JPM Global EM Sov. Plus	0.2%	↑	-1.5 %	-6.8 %	-5.9 %

Exchange rates

Exchange rates	Last	1wk		3mth	YTD	12mth
EUR/USD	1.14	-0.1 %	↓	-2.7 %	-5.1 %	-3.8%
EUR/CHF	1.13	0.0 %	→	-0.1 %	-3.1 %	-2.7%
GBP/USD	1.28	-0.6 %	↓	-1.8 %	-5.3 %	-4.6%
USD/JPY	113	0.5 %	↑	1.6 %	0.7 %	1.4%
USD/BRL	3.85	1.3 %	↑	-6.2 %	16.3 %	18.7%
USD/CNY	6.94	0.2 %	↑	1.8 %	6.7 %	5.0%
USD/RUB	66.2	0.9 %	↑	-2.6 %	14.9 %	13.0%

Government bonds*

Government bonds*	1wk		3mth	YTD	12mth
United States (3-7yr)	0.2 %	↑	0.3 %	-0.4 %	-0.4 %
United Kingdom (3-7yr)	0.3 %	↑	1.0 %	0.6 %	1.0 %
Germany (3-7yr)	0.2 %	↑	0.3 %	0.8 %	0.3 %
Japan (3-7yr)	0.0 %	→	0.2 %	0.0 %	0.0 %

Equities*

Equities*	Last	1wk		3mth	YTD	12mth
MSCI AC World	490	2.6 %	↑	-6.6 %	-2.3 %	-0.4 %
Eurostoxx 50	3,174	1.6 %	↑	-7.9 %	-6.3 %	-8.4 %
DAX	11,298	1.4 %	↑	-10.1 %	-12.5 %	-13.5 %
CAC 40	5,006	1.4 %	↑	-8.8 %	-2.9 %	-4.2 %
S&P 500	2,738	3.4 %	↑	-5.6 %	4.2 %	6.3 %
FTSE 100	7,039	1.2 %	↑	-6.1 %	-4.6 %	-0.7 %
SMI	9,016	2.7 %	↑	-0.7 %	-0.6 %	0.3 %
Topix	1,659	1.9 %	↑	-3.8 %	-6.9 %	-5.1 %
IBOV Brazil	89,710	2.6 %	↑	14.4 %	17.4 %	23.4 %
MICEX Russia *	2,399	1.2 %	↑	2.1 %	13.7 %	12.9 %
MSCI EM	998	2.3 %	↑	-6.3 %	-11.6 %	-10.1 %
SENSEX 30 India	36,170	3.4 %	↑	-6.3 %	8.3 %	9.0 %
Hang Seng (H-K)	26,451	1.7 %	↑	-6.2 %	-8.5 %	-7.5 %
Shanghaï Composite	2,567	-2.9 %	↓	-7.3 %	-22.4 %	-23.1 %

Commodities

Commodities	Last	1wk		3mth	YTD	12mth
Brent	$60	-5.1 %	↓	-22.2 %	-10.5 %	-5.9 %
Gold	$1,227	0.0 %	→	2.0 %	-5.8 %	-4.4 %
Silver	$14.4	-1.2 %	↓	-2.6 %	-15.6 %	-13.6 %

Source: DataStream, on 29/11/2018. 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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