WEEKLY UPDATE

(Not-so-soft) Kashmir

Tensions over the disputed Kashmir province have long simmered between India and Pakistan. This week they boiled over. In retaliation to a mid-February suicide bombing attack by Pakistan-based terrorists, India carried out an airstrike on one of their training camps, prompting the first aerial combat between the neighbours since 1971. Given that both countries hold large nuclear arsenals, this conflict has rattled nerves across the world.

These tensions come just as India's general elections in April and May begin to loom. Incumbent Prime Minister Narendra Modi is under popular pressure to adopt a firm line with Pakistan, adding to the risks of a misstep and further escalation. In this context, the offer by his counterpart Imran Khan to release an Indian pilot captured during the dogfight is a welcome move. Why might Pakistan want to diffuse tensions?

Pakistan's role as a base for terrorist groups, such as the one which launched February's attack, has been a source of concern for its allies, in particular for China. **Pakistan is one of the largest beneficiaries of the Belt and Road Initiative** (BRI) via the $62bn China-Pakistan Economic Corridor plan, involving expansion of a major port, rail and road links and new power plants. With BRI projects being mooted as targets by Pakistan-based terrorist groups, in reaction to China's treatment of its Muslim minorities, Mr Khan can ill afford to alienate his key ally by military action in defence of terrorists.

The tensions come at a time of slowing growth in India. GDP increased 6.6% QoQ annualised in Q4 2018 after 8.0% and 7.0% in the two previous quarters. Growth has been hit by last summer's spike in oil prices and by shrinkage in shadow banking. Since then however, oil prices have corrected and mainstream banks have increased lending. Also, the Reserve Bank of India cut rates unexpectedly on February 7 on the back of recent weakness in inflation. In addition, fiscal policy will remain supportive – the recent pre-election budget outlined an increase in the deficit to 3.4% of GDP, with populist measures such as cash handouts to India's 120 million small farmers.

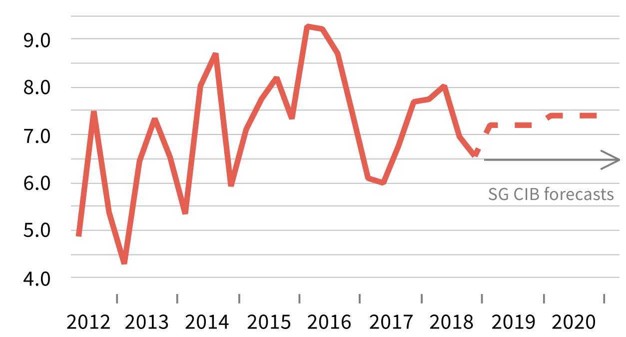
There are now signs that these measures have begun to ease the headwinds – the February manufacturing Purchasing Managers Index jumped to 54.3, while the new order component hit the highest level since October 2016. For the fiscal year to March 2019, **our economists are expecting growth to hit 7.2%,** and 7.4% the following year.

Mr Modi came to power on a platform to reform India's economy. Despite some disappointments, his government has made progress in key areas – 2016's demonetisation to clamp down on the informal economy by replacing certain banknotes and 2017's introduction of the Goods and Sales Tax to create a single market between states should prove lasting legacies.

Bottom line. Reform measures have improved India's longer-term prospects. And the domestic focus of its economy makes it less vulnerable to trade war tensions. However, the risk of conflict with Pakistan and demanding valuations – the Nifty 50 index trades at 20.4 times 2019 earnings – should keep a cap on equity market performance for now.

Growth eased in H2 2018 but should rebound

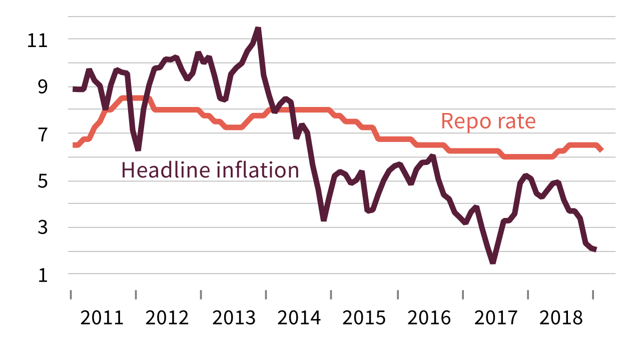
India Gross Domestic Product (QoQ% annualised)



Sources: Macrobond, Indian Ministry of Statistics, 28/02/2019

Slower inflation bodes well for RBI to cut rates

Inflation (%YoY) and Repo rate (%)



Sources: Macrobond, Reserve Bank of India, Ministry of Statistics, 28/02/2019

OUR MACRO-COMMENTS

This week and next

EUROZONE

- Eurozone economic confidence slipped for the eighth consecutive month to a new two-year low at 106.1 points in February, down from 106.3 in January. Business sentiment was more downbeat in terms of inventories, order books and production expectations.
- As expected, preliminary figures indicated that German headline inflation was unchanged for the third month in a row, at 1.7% YoY in February.
- According to INSEE, France's quarterly economic growth met expectations of 0.3% in Q42018. Foreign trade balance contributed 0.3 point to GDP growth, while changes in inventories detracted -0.2 point.

Next week's key events		Per.	Prev.	Cons.
04 Mar	Sentix Index	Mar	-3.7	-3.1
05 Mar	PMI composite	Feb	51.4	51.4
07 Mar	ECB refinancing rate	Mar	0.0%	0.0%

UNITED KINGDOM

- GfK Consumer confidence bounced back by one point in February to -13. The index remains well below the level reached before the Brexit Referendum in June 2016.
- The number of mortgages issued for house purchases rose to 40'634 in January, the highest since September 2017. Consumer credit growth picked up by 4.6% YoY.
- Nationwide's house price index remains sluggish, up 0.4 % YoY in February, a small improvement from January's 0.1%. Brexit uncertainty continues to weigh on the economy.

Next week's key events		**Per.**	**Prev.**	**Cons.**
05 Mar	CIPS Service PMI	Feb	50.1	50.1
05 Mar	BRC retail sales YoY	Feb	1.8%	--

UNITED STATES

- GDP surprised to the upside at 2.6% YoY in Q4 2018, down from 3.4% in Q3 but above expectations thanks to higher investment. The Federal Reserve's cautious approach to future interest rate hikes suggested growth may remain stronger for longer than expected.
- According to preliminary figures, core personal consumption expenditure (PCE) prices increased slightly to 1.7% YoY in Q4, from 1.6% in the previous quarter.
- Chicago PMI bounced back significantly in February, printing at 64.7, vs 56.7 the previous month, beating expectations of 57.5.

Next week's key events		Per.	Prev.	Cons.
05 Mar	ISM Non-manufacturing	Feb	56.7	57.1
06 Mar	International trade bal. ($bn)	Dec	-49.3	-51.3
07 Mar	Initial jobless claims	Mar 2	225k	--

ASIA & EMERGING COUNTRIES

- China's official Manufacturing PMI contracted to 49.2 in February, from 49.5 in January – the lowest since February 2016.
- Japan's industrial output fell unexpectedly by -3.7% MoM in January, for the third month in a row and below market expectations of -2.5%, reflecting slowing demand in China.
- In Japan, retail sales growth slowed to 0.6% YoY in January, down from 1.3%, missing the market consensus of 1.4%.

Next week's key events		Per.	Prev.	Cons.
05 Mar	Japan: Services PMI	Feb	51.6	--
08 Mar	Japan: GDP QoQ	Q4 A	0.3%	--
08 Mar	China: trade balance (CNYbn)	Feb	271.16	--

Sources: DataStream, Bloomberg, 1 March 2019
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	1.13
GBP/USD	1.33	1.30
EUR/CHF	1.14	1.13
USD/JPY	111.4	112
Brent	$66.0	$68
Gold (oz.)	$1316	$1250

Changes made to our 3-month targets this week.

Forecast figures are not a reliable indicator of future performance.

THIS WEEK'S Q&A

A look at banks' recent crash test

This week we look at how the financial solidity of banks is measured. We conclude that the measures and rules implemented by regulator and the Bank of Settlements have significantly strengthened the solidity of the European banking system but have also weighed heavily on banks' profitability within a context of moderate growth and very low interest rates.

How is a bank's financial solidity measured?

By assessing their solvency, liquidity and leverage.

Which is the most important measure?

The most important criterion is solvency because it determines a bank's resilience to economic and financial shocks.

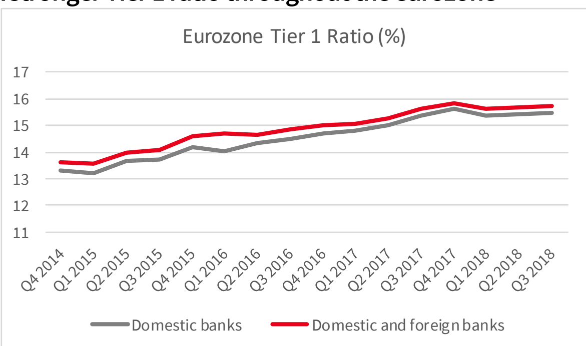
The regulator also introduced provisions around banks' liquidity to ensure they are able to withstand difficulties arising from tensions in the money market, such as those observed during the 2007-2009 crisis.

After that crisis, the Bank for International Settlements (BIS) adopted new rules (Basel III) in 2010 governing banks' capital levels, establishing a minimum level of regulatory capital (commonly referred to as Tier 1 and Tier 2 capital) that they must hold in relation to their risk-weighted assets.

What was the end result ?

This led to a significant strengthening of the solidity of the European banking system, but it also weighed heavily on its profitability in a context of moderate growth and very low interest rates.

A stronger Tier 1 ratio throughout the eurozone



Source: Datastream, European Central Bank, data as of Q3-2018

What are the results of the latest stress test on French banks?

On 2 November 2018, the European Banking Authority (EBA) published the results of the stress tests on European banks, which it oversees jointly with the European Central Bank (ECB). A panel of 48 banks (including France's six largest banking groups), representing around 70% of the European Union's total banking sector assets, took part.

What was the EBA's objective ?

The aim of the exercise was to assess whether the banks had enough capital to deal with shocks or adverse scenarios and remain solvent. It took into account losses linked to credit, market and operational risks and computed the Common Equity Tier 1 (CET1) in a worst-case scenario. All six French banks met the minimum capital threshold required by the prudential authorities, reflecting the solidity of the French banking system.

MARKET PERFORMANCE

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

Interest rates	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-37 bp	1 bp	→	-2 bp	-1 bp	-1 bp
3mth Euribor (EUR)	-31 bp	0 bp	→	1 bp	0 bp	2 bp
3mth Libor (USD)	262 bp	-4 bp	↓	-12 bp	-19 bp	60 bp
3mth Libor (GBP)	85 bp	-1 bp	↓	-4 bp	-6 bp	27 bp
10-year US Treasury bond	271 bp	2 bp	↑	-30 bp	2 bp	-16 bp
10-year German bond	19 bp	6 bp	↑	-12 bp	-6 bp	-48 bp
10-year French bond	58 bp	3 bp	↑	-11 bp	-13 bp	-35 bp
10-year UK bond	130 bp	10 bp	↑	-6 bp	4 bp	-20 bp

Credit	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0,1%	→	1,9 %	1,7 %	0,9 %
BAML EURO Corp HY	0,8%	↑	3,7 %	4,1 %	0,7 %
BAML GBP Corp IG	-0,3%	↓	3,4 %	2,2 %	1,8 %
BAML US IG	0,1%	↑	4,0 %	2,5 %	2,6 %
BAML US HY	0,5%	↑	4,0 %	6,4 %	4,3 %
BAML Global EM Sov. External Plus	0,7%	↑	6,5 %	5,0 %	1,1 %

Exchange rates	Last	1wk		3mth	YTD	12mth
EUR/USD	1,14	0,3 %	↑	0,5 %	-0,9 %	-6,8%
EUR/CHF	1,14	0,0 %	→	0,4 %	0,8 %	-1,4%
GBP/USD	1,33	1,6 %	↑	4,0 %	3,9 %	-3,6%
USD/JPY	111,4	0,6 %	↑	-1,8 %	1,7 %	4,4%
USD/BRL	3,75	-0,5 %	↓	-3,0 %	-3,3 %	15,6%
USD/CNY	6,69	-0,4 %	↓	-3,8 %	-2,7 %	5,7%
USD/RUB	66,0	0,5 %	↑	-1,7 %	-5,4 %	17,1%

Government bonds*	1wk		3mth	YTD	12mth
United States (3-7yr)	0,0 %	→	2,2 %	0,4 %	3,4 %
United Kingdom (3-7yr)	-0,4 %	↓	0,2 %	-0,1 %	1,8 %
Germany (3-7yr)	-0,2 %	↓	0,2 %	0,0 %	1,6 %
Japan (3-7yr)	-0,1 %	→	0,2 %	0,1 %	0,2 %

Equities*	Last	1wk		3mth	YTD	12mth
MSCI AC World	503	0,4 %	↑	3,1 %	10,9 %	-0,3 %
Eurostoxx 50	3 298	1,1 %	↑	4,5 %	10,3 %	-0,6 %
DAX	11 516	0,8 %	↑	2,3 %	9,1 %	-7,4 %
CAC 40	5 241	0,9 %	↑	5,1 %	10,8 %	1,8 %
S&P 500	2 784	0,4 %	↑	1,4 %	11,5 %	4,7 %
FTSE 100	7 075	-1,1 %	↓	2,3 %	6,0 %	2,2 %
SMI	9 389	0,6 %	↑	3,9 %	11,4 %	9,1 %
Topix	1 608	-0,3 %	↓	-3,4 %	7,7 %	-7,1 %
IBOV Brazil	95 584	-1,4 %	↓	6,8 %	8,8 %	12,0 %
MICEX Russia *	2 485	0,6 %	↑	3,9 %	5,4 %	8,2 %
MSCI EM	1 051	0,1 %	→	6,2 %	9,0 %	-9,5 %
SENSEX 30 India	35 867	0,0 %	→	-0,8 %	-0,5 %	6,3 %
Hang Seng (H-K)	28 633	0,0 %	→	8,3 %	11,1 %	-3,8 %
Shanghaï Composite	2 941	6,9 %	↑	13,6 %	17,9 %	-9,8 %

Commodities	Last	1wk		3mth	YTD	12mth
Brent	$66,0	-1,7 %	↓	12,4 %	24,3 %	0,5 %
Gold	$1 316	-1,2 %	↓	7,9 %	2,7 %	-0,3 %
Copper	$6 556	2,5 %	↑	5,3 %	10,2 %	-4,9 %

Source: DataStream, on 28 February 2019.

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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