Developed Markets Quarterly Outlook

CITY OF LONDON
Investment Management Company Limited

February 2019*

Overview

A Monetary Reprieve

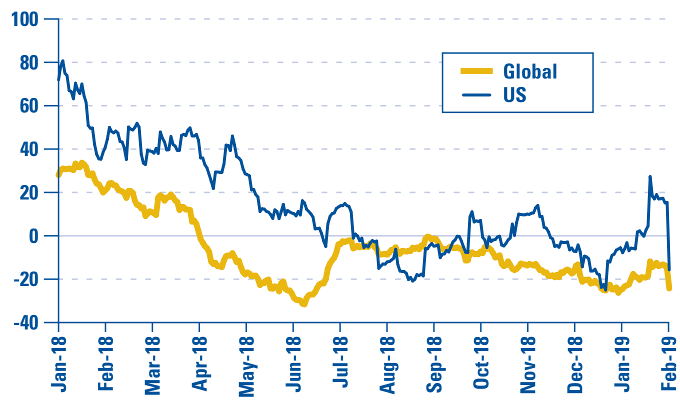
After what had been a disastrous few months for investors in the period up to late December, markets have been on a tear. For a period of about six uninterrupted weeks, risky assets have witnessed a near historic rally. The S&P500 alone rallied by 15% between its nadir in late December and mid-February. This partly reflected a surprise improvement in the US data flow which ran counter to the extreme recession expectations that had prevailed in the market at the time. US PMI bounced back strongly in January and labor market data exceeded expectations. But importantly, the rally benefited from an additional impetus when the Fed signalled a pause in its hiking cycle and allowed for the possibility of altering the course of its balance sheet wind-down should it feel it necessary to do so. The Fed's professed "patience" echoes its view in 2016 when instead of the planned four, it delivered only one rate hike. Just as then, concerns about external risks are rising, in particular with respect to Chinese growth. Indeed, China's PMI has fallen into contractionary territory and is now at a similar level as 2016. While deflation is less of a risk now, worries over trade disputes have filled the space instead.

This represents less of a change in the Fed's "reaction function" (as widely discussed among commentators), but instead a simple U-turn in its view given a previously worsening set of inputs. Perhaps the temporary government shutdown and some technical difficulties in implementing monetary policy under sharply reduced bank reserves may have played some role too.

But on the whole, the Fed is responding to a situation that sees growth revert to trend at the same time as policy rates approach the neutral range of 2.5-3.5%. In this environment and against a backdrop of heightened external risks, a patient and more cautious approach makes imminent sense. Indeed, the Fed could observe a sharp slowdown in the Chinese economy to which the authorities have responded with some stimulative measures, but not in an attempt to reinvigorate growth (given its concerns over excessive debt and capacity) but merely to stabilize it. At the same time, the Eurozone economy is decelerating sharply, while having few policy levers left to counter it and facing a potentially disruptive Brexit process at the same time.

The new environment has affected the monetary policy stance across the world. Partly in response to slower domestic growth, partly in response to the Fed's retreat, central banks in both advanced and emerging economies have shed their hawkish rhetoric and embraced a more cautious outlook.

Chart 1: Citigroup Surprise Indices



Source: Citigroup, Bloomberg

Market Strategy

While the less hawkish monetary stance is to some extent compensated by a duller growth outlook, the effect of looser financial conditions on market sentiment is nevertheless positive. This extends the likely support for risk assets further into the year even as the expansion reaches its last leg and the temporary growth-boosting effects fizzle out.

While valuation continues to argue for maintaining our *overweight* in Europe and *underweight* in the US, recent growth performance suggests the opposite allocation. We shift both to *neutral* to wait for the fog of data to clear. The prospects for emerging markets are not terrible, but on the whole they face the combined headwinds of slower demand in export markets, higher financing costs and ongoing trade tensions. We expect positive returns, but remain *neutral* for now. We summarize our new allocation as follows:

- **Overweight**: Australia, Canada
- **Neutral**: US, Eurozone, Japan, Switzerland and Emerging Markets
- **Underweight**: UK

**The publication reflects asset performance up to January 31, 2019, and macro events and data releases up to February 15, 2019, unless indicated otherwise.*

United States

Neutral (↑)

Robust trend growth and a Fed on pause create a favourable backdrop for risk assets and for US equities in particular.

Markets have been transfixed by the Fed's apparent U-turn at the January FOMC meeting in which it stated that it would "be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate". It also announced that it would be prepared "to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate". This came only six weeks after it had reduced the anticipated number of rate hikes in 2019 from three to two, but had continued to otherwise foresee gradual increases in the federal funds rate and characterized its security purchase program as being on "auto-pilot". While the market had long priced in the absence of any rate hike this year, the move nevertheless came as a surprise and generated a sense that the Fed had over-delivered. In an era of fiat currencies, the (crucial) credibility of central banks is best preserved by avoiding such sudden changes in opinion or U-turns. At best, they suggest that a "Fed Put" remains in place even under Chair Powell and at worst that the Fed abided by President Trump's wishes or changed its reaction function.

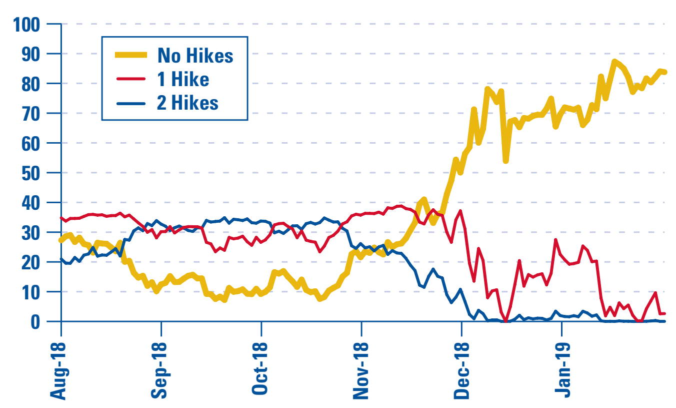
The timing of the decision was certainly odd. Markets had already shed their sense of despair, witnessing a rise of the S&P500 by over 15% from its late-December nadir. On the economic front, the manufacturing PMI (ISM) recorded a strong rebound in January to 56.6 from some of the largest monthly declines in November-December (non-manufacturing at 56.7). Similarly, employment figures have been strong as the economy added some 304K jobs in January even though the unemployment rate ticked up to 4.0% (partly due to the government shutdown). Average hourly earnings increased a solid 3.2% yoy, while the employment cost index hit a new high for the current expansion. As a result, the Citi Economic Surprise Index recorded a surge in late January, moving back into positive territory, following months of a generally disappointing data flow. In turn, this has also pulled up surprises globally (see Chart 1).

Not all of this is rosy though. Notably, consumer confidence has weakened recently, with the Conference Board consumer confidence index declining significantly over the past three months and the University of Michigan sentiment index similarly softer. However, at least part of these declines can be related to the government shutdown in January. As for inflation, it does not argue for a tighter monetary stance, all the more so if the inflation target is to be symmetric (i.e. as tolerant of an overshoot as of an undershoot). Headline CPI declined from a peak of 2.9% yoy in July 2018 to 1.9% yoy by year-end. The overall inflation rate was helped by the decline in energy prices while Core CPI remained more stable, ending the year at 2.2% yoy.

What then to make of the Fed's decisions? Was it simply behind the curve and not aware of the most recent developments? That is unlikely. Economic data alone thus cannot resolve the question as to why the Fed decided to move just now. The explanation more likely lies with two other factors: 1) the difficulties of operating monetary policy under rapidly declining bank reserves and 2) the (re-)emergence of "external risks". Monetary policy recently had to contend with a decline in excess reserves that has outpaced the decline in its security holdings. This has led to a slow drift upwards of the federal funds rate within its target band and to heightened volatility and "dispersion" within. The Fed is also fearful of reducing reserves to a level at which demand for them increases, undermining the stability of short term interest rates. Separately, the Fed has faced a series of external challenges that have emerged recently. They include trade tensions, the threat of a disruptive Brexit and, most importantly, slowing growth in China and Europe. The Fed's preoccupation with these "cross-currents" is evident in the rising number of times it has referred to "external risks" in its minutes. It rose in 2016, particularly when China's manufacturing PMI fell to a similar level as now and Chair Yellen delivered only one rate hike that year, instead of the four announced previously. In addition to these two factors, nominal interest rates have approached the lower bound of the neutral range (2.5-3.5%) and the cumulative tightening based on the "shadow fed funds rate" is already high by historical standards, providing further reason for the Fed to "pause".

The other issue that has preoccupied markets during the past quarter, albeit to a lesser extent, was the US government shutdown, which lasted 35 days and thus became the longest in history. It originated in President Trump's refusal to sign any spending bill that wouldn't include $5.7 bn spending appropriations for building a border wall and was defused only for three weeks when a compromise was reached with House Democrats to temporarily reopen the government without such funding. This means that a renewed shutdown in February remains a possibility. So far, the January shutdown is expected to subtract 0.2-0.3% points from annual GDP growth.

Chart 2: Federal Funds Rate, % Probability



Source: Bloomberg

In sum, the Fed is unlikely to have changed its reaction function but instead is reacting to a change in inputs and the difficulties it encounters in its monetary operations. External factors are not always pertinent to its deliberations, but do come into focus on occasion, when activity is decelerating and the outlook uncertain. Even a response to sagging stock markets – rationalised as 'tightening financial conditions' – would not be novel.

The US economy is on the one hand entering the late-cycle phase of what is becoming its longest expansion in history and on the other hand experiencing the fading effect of the short-lived bump thanks to the 2017 tax cuts. All told, the consensus expectation remains for about-trend growth of 2.5% in 2019, compared to an estimated 2.9% in 2018. This has a clear corollary in earnings prospects as earnings growth has likely peaked. With over two thirds of companies having reported their Q4 results so far, 71% of them beat forecasts as estimates appeared too pessimistic (although beats usually rise as high as 90%). Trade and growth uncertainty will likely exert increased drag on earnings growth in the future, but for now EPS growth remains strong, at 14% yoy.

Market Strategy: The sell-off during late 2018 was savage and created enough of a risk premium to sustain the strong subsequent rally. Thus, the November-January quarter was essentially a wash for the US market as the dip and rebound combined for a 0.2% gain over the period. While quarterly earnings growth has turned negative and could give rise to a technical "earnings recession" in Q1, annual earnings growth remains sufficiently high to outpace that elsewhere, in particular in Europe. The Fed pause will likely give equity markets an extended lease of life as robust growth and a patient Fed present a favourable mix for risk assets. As a result, we cut the underweight to the US and move our allocation to *neutral* for now.

Canada

Overweight

Solid US demand and recovering oil prices continue to support Canadian equities. But housing remains a drag on growth.

The Canadian economy was set to moderate in Q4 due to lower oil prices, weaker external demand and elevated trade tensions. November GDP shrank by 0.1% mom after 0.3% growth in October, with the annualised rate growing below 2%. Both Manufacturing PMIs and the CFIB Small Business Sentiment continue their downward trends, signalling near-term weakness in economic activity. Consensus expects GDP to moderate from 2.0% qoq saar in Q3 to 1.2% in Q4. Q1 growth may slide further as unprecedented oil production cuts in Alberta started in January.

Looking ahead, however, some supportive forces have emerged. First, oil prices quickly recovered in January on the back of a broad-based rally in risky assets. Second, Alberta production cuts and U.S. sanctions on Venezuela's state oil company have significantly tightened the spread between the Canadian WCS and the US WTI, boosting Canadian oil producers' profit margins. Third, US PMIs and ISM rebounded in January – in contrast to the decline for the rest of DMs - signalling a still-solid US economy and healthy US demand for Canadian goods. Finally, the labour market continues to strengthen, with the unemployment rate hitting 5.6% in December, the lowest in more than 40 years. Consumer Confidence rebounded to 54 in January from 52, close to its long-term average. All point to the resilience of the Canadian economy despite the sharp oil price fall in Q4.

Housing activity remains a drag on domestic demand, as existing home sales contracted by 2.5% mom or 19% yoy in December. The average sale price declined by 5% in 2018. Housing starts rebounded less than expected in November to 224K units, followed by a weaker 213K in December.

A dovish Fed gives room for the Bank of Canada (BoC) to adjust its monetary policy. Both headline and core inflation stabilised around 2%. Also, the 10-year breakeven inflation rate reached 1.5% in January, significantly lower than the 1.8% observed as recently as October. Therefore, the BoC may slow the pace of tightening this year, having increased the policy rate by 125bps since mid-2017. Consensus expects two rate hikes from the BoC this year, and the risk is tilted towards fewer hikes.

Market Strategy: MSCI Canada returned 3.9% in USD terms between November and January, outperforming both MSCI ACWI and MSCI World. Valuations are unchallenging, with the trailing P/E at a 7% discount to DM compared to a long-term average of 2%. We maintain our *overweight* allocation on the back of solid US demand, recovering oil prices and less tightening bias of the central bank.

Switzerland

Neutral

Swiss equities appear quite resilient against the Eurozone growth slowdown.

The Swiss economy is set to recover to 0.5% qoq growth in Q4 from a 0.2% contraction in Q3. That said, the downward trend remains in place given disappointing growth in the Eurozone. The Swiss KOF Economic Barometer slid to 95.0 in January, in sharp contrast to a strong level of 106.5 twelve months ago. Adverse developments are broad-based, affecting both the manufacturing and the service industry, a trend also confirmed by the latest PMI data. Consensus expects 1.6% growth in 2019, a large step down from the 2.6% in 2018. Private investment is likely to decelerate due to weak external demand, a stagnating housing market and tepid credit growth. For instance, M3 supply grew by 3.1% yoy in December, slower than the post-GFC average of 5%. Housing prices grounded to a halt in 2018, having increased by 1% and 3% in 2016 and 2017, respectively.

Private consumption may be the brighter spot of the economy on the back of a strong labour market and low inflation. The unemployment rate remains at 2.4%, the lowest since the Global Financial Crisis. The Swiss Consumer Confidence Index continued to improve in Q1 as consumers expect further improvements in the employment rate, household budgets and the savings rate.

Meanwhile, headline inflation edged down to a mere 0.7% yoy in December, further away from the Swiss National Bank's (SNB's) 2% inflation target. Therefore, the SNB remains comfortable with its dovish stance. It maintained the deposit rate at -0.75% in December - no change since 2015 - and expected inflation to weaken further this year. We are unlikely to see any policy rate changes in Switzerland until the ECB adjusts its policy rate, as the Swiss franc is considered "highly valued". Consensus expects a rate hike in H2 2019 when the ECB might increase its own policy rate. However, the recent deterioration in the growth outlook for the Eurozone (notably Germany and Italy) has raised doubts about the ECB's willingness to hike rates this year, which in turn increases the chance that the SNB remains on hold this year.

Market Strategy: MSCI Switzerland returned 0.7% in USD terms from November to January, in line with MSCI World and moderately underperforming MSCI ACWI by 1.1% points. Valuations are not compelling, with the Swiss equity's P/E premium over DM at 30% compared to a five-year average of 14%. That said, the defensive tilt of MSCI Switzerland (heavily weighted by healthcare and consumer staples) and the Swiss Franc indicate some benefit of holding Swiss assets against the background of slowing global manufacturing and investment activities. Hence we remain *neutral* on Swiss equities.

Eurozone

Neutral (↓)

Economic activity is once again decelerating sharply, prompting a shift in tone from the ECB and putting any tightening on hold.

Given some incipient signs of recovery, the Eurozone was expected to play its part in delivering a synchronized global recovery in 2018. Yet, ultimately this did not come to pass as the economy failed to achieve the fabled 'escape velocity' and instead a worrisome deceleration had taken hold by year-end. GDP gained only a meek 0.2% qoq in the final quarter of the year, equivalent to 1.2% yoy and down from 1.6% in Q3. Economic activity had been increasingly held back by weakness in the German economy, which had suffered a series of one-off shocks, first the passage to a new car emissions regime which temporarily slowed auto production, and later the low water level in the Rhine, which affected transportation of raw materials and parts in the chemical sector in particular. Italy entered a technical recession in Q4, while French activity rose broadly in line with the region and Spain outpaced it significantly.

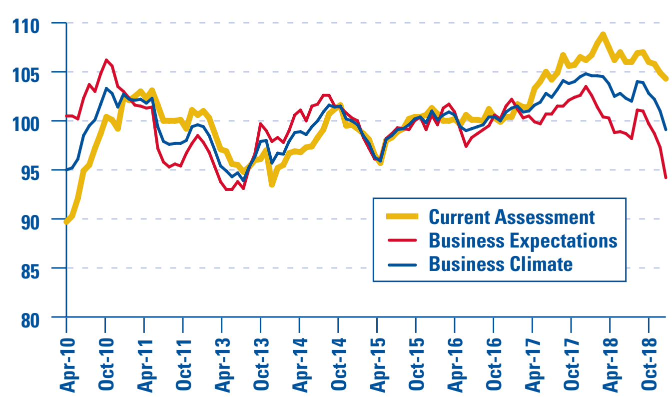
While some rebound is likely in both Germany and France (where the "yellow vest" protests had also disrupted activity in November and December), high frequency indicators suggest that the slowdown may persist beyond the temporary shocks. In Germany, the IFO index continued its precipitous decline across all components in January (see Chart 3), while the Eurozone PMI fell 0.4 points to 50.7, barely in expansionary territory. This follows on the heels of a 3.0% yoy contraction in industrial production in November and an additional 4.2% yoy decline in December. This situation is paralleled in the consumer confidence readings, which remain above their long run average but have seen their level decline over the past year. One bright spot of the economy is the labor market, which reported a 0.7% point decline in the unemployment rate over a year ago in December (to 7.9%). At the same time, companies report high and rising labor shortages in both the manufacturing and services sector.

These shortages have contributed to rising wage gains but have failed to feed into higher headline inflation. Indeed, the HICP ended 2018 at 1.6% yoy and has since declined to 1.4% yoy, while Core HICP has remained fairly stable in a 1.0-1.2% yoy range over the past eight months. At present, there is no indication that inflation would move significantly higher in the year ahead, all the more so in an environment of decelerating final demand. Indeed, inflation expectations have again collapsed: 10-year breakevens are as low as 0.6% for Italy, but the development is uniform across countries, with inflation expectations for Spain, Germany and France all having declined to around 1%.

As a result, the ECB's decision to leave rates and its forward guidance unchanged at the January meeting are unsurprising. The Council did however move to describe risks to growth as being "on the downside", although it judged the risk of recession as "low". Markets espouse an even more pessimistic view than the ECB and currently don't price a rate hike until 2021. Another issue the ECB has yet to address is whether to offer new LTRO/TLTRO facilities to banks once the current ones will have a maturity of less than one year from June. This could be done either to provide liquidity, to support the financial sector in an environment of persistently low interest rates or in order to bolster growth. It is widely expected that the facilities will be renewed, albeit perhaps for a shorter tenor of only two years.

Trade negotiations with the US have stalled, having remained in limbo following the Trump-Juncker ceasefire concluded last July. Yet, the US is set to publish its Section 232 investigation into tariffs on car imports in February, while tariffs on steel and aluminium remain in place. The EU has stated that it won't conclude any agreement on anything else until these tariffs have been removed and that it would suspend negotiations altogether should tariffs on cars and car parts be introduced. The US may ultimately yield to a large extent to the EU in exchange for some small 'wins' as it seeks its support in putting pressure on China.

Chart 3: German IFO Index



Source: IFO Institute, Bloomberg

Market Strategy: The Eurozone gained 0.5% during November-January, underperforming the MSCI ACWI by 1.3% points. As in the previous quarter, underperformance was broad-based, ranging from core to periphery markets, with the exception of Spain, where growth remains strong and the market outperformed by 2.6% points. On the whole though, prospects for the Eurozone have dimmed considerably as the German economy has weakened, even inviting expectations of a potential fiscal stimulus. What is more, politics remain a persistent flashpoint, albeit in a generalized way rather than in the form of a virulent crisis. But by providing an unstable backdrop, the current political landscape could yet provide the fodder for a crisis to erupt. Most recently, Spain appeared poised for early elections (April) which bears the risk of bringing yet another right-wing party in Europe to power (Vox). We thus shift our *overweight* allocation to *neutral*.

United Kingdom

Underweight

The economy is beginning to show the effects of prolonged Brexit uncertainty as the government runs down the clock. Meanwhile, the BoE sends a more dovish signal.

The putative end to the UK's EU membership is approaching fast, yet the government appears no closer to achieving a universally acceptable solution. In January, the British Parliament overwhelmingly rejected Theresa May's painfully negotiated Withdrawal Agreement in a 432-to-202 vote. The rejection was mostly driven by the refusal to accept the "Irish backstop" provision during the transition period for fear that it could pave the way for an eventual customs union arrangement with the EU. Westminster MPs will get another chance to vote on a potentially revised agreement on February 27 or may vote to extend negotiations, a step that would be legally binding on the government (MPs have previously voted against it but could change their minds as the deadline approaches). The House of Commons also voted in favour of two other amendments in January, one rejecting leaving the EU without a Withdrawal Agreement in place and the other, supporting the current agreement subject to the Irish backstop being removed from it and being replaced by "alternative arrangements" (these amendments were not legally binding though).

The Prime Minister has been accused of "running down the clock", that is, wanting to present MPs with the stark choice between the agreement she fashioned and a no-deal Brexit shortly before the deadline. However, it appears more likely that Theresa May will either seek an extension to the Article 50 deadline herself or present MPs with a choice between opting for the proposed agreement and a lengthy extension of up to one year (the choice would depend on the state of negotiations). The latter option would presumably be viewed as potentially derailing the process altogether and is thus likely to be shunned by MPs.

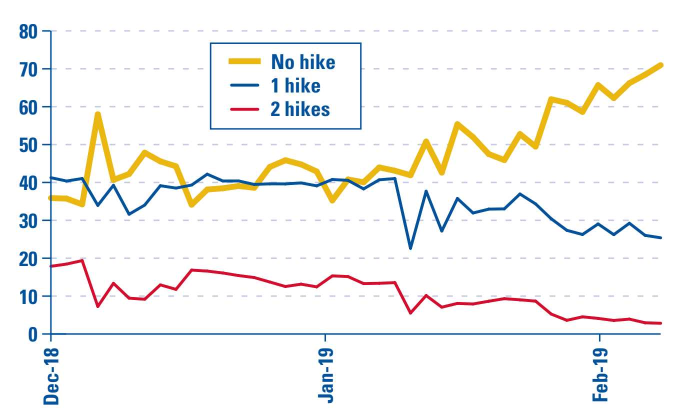
The economy has finally shown evidence of the effect prolonged Brexit uncertainty can have as monthly GDP contracted 0.4% mom in December. This translated into a sharp decline in quarterly growth to 0.2% qoq (from 0.6% qoq in Q3) and to growth of only 1.4% for the year, the lowest since 2009. Household spending was still the main driver of growth, but was offset by falling investment (for the fourth consecutive quarter) and a negative contribution from net trade. Exports declined by a full 0.9% yoy, while imports rose by 1.7% yoy during the quarter, illustrating that companies have not been able to take advantage of sterling's weakness.

Already ahead of the GDP release, the BoE had lowered its outlook for growth in 2019 by 50bps to 1.2% and by 20bps to 1.5% for 2020. Despite the large growth downgrade, the BoE expects inflation to run above target in the second and third years of its forecast, while coming in at just 1.9% in 2019, down from a previous expectation of 2.2%. CPI had declined throughout 2018 and registered a mere 1.8% yoy gain in January, whereas private sector wage gains (weekly earnings) have accelerated steadily to a pace in excess of 3% yoy most recently. The forecast revisions have dovish implications for the near term but keep the tightening bias for the subsequent years firmly in place. While the BoE expects one rate hike per year for the next three years, markets are much more pessimistic and foresee no more than one hike in three years. Of course, the BoE forecast is based on a Brexit deal being struck and as such may not come to pass. The market-implied probability of tightening this year fell from 45% to 35% following the latest activity data releases.

Another focal point in light of recent readings is the spring budget statement due on March 13. While the Chancellor has insisted that this would not be a significant "fiscal event", market participants are increasingly looking for stimulative measures.

Market Strategy: The UK market underperformed 0.5% points during the November-to-January period as the changing prospects of Brexit whipsawed investors. At present, there seems little consensus within parliament to support either the 'soft Brexit' solution proposed by Theresa May or the 'Irish Backstop'. Yet, at the same time resistance against a 'No Deal' crash-out appears to be building. While an extension request appears the most likely outcome against this backdrop, resolution will likely have to await a moment ever closer to the deadline. This can make for more market volatility and, ultimately, underperformance. In these circumstances, even accelerated exchange rate depreciation would not be enough to support the corporate outlook. The UK's trailing P/E of 15.8 is somewhat cheap historically, but remains higher than that of the Eurozone of 13.8. We maintain our *underweight* allocation.

Chart 4: BoE Base Rate in 2019, % Probability



Source: Bloomberg

Japan

Neutral (↓)

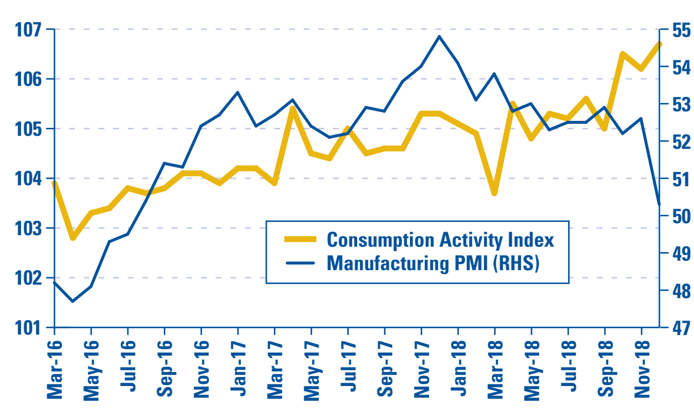
Activity bounced back less than expected in Q4 and faces significant headwinds, while the inflation target remains ever so elusive.

In a move apparently running counter to the current shift in stance by global central banks, the BoJ recently announced that it would cut back its bond purchases in order to limit further flattening of the Japanese yield curve. Yet, despite the attention the move grabbed, market fallout was limited as it was clearly not intended to signal the onset of a new-found hawkish stance. Indeed, the BoJ kept its interest rates firmly on hold at its January meeting and lowered its expectations for inflation once again. The central bank sharply revised its forecast for Core CPI from a 1.5-1.7% range to 1.0-1.3% for 2019, further yet from its 2% target. Although the revision owed primarily to lower oil prices, a pattern is quite apparent from successive revisions. CPI dropped to a mere 0.3% yoy in December, while the politically sensitive average wage growth picked up to 1.8% by year-end, leaving real wage growth for the year at about 1%.

Following a GDP contraction of 2.6% qoq in Q2 due to a series of natural disasters, a strong rebound of equivalent size had been expected for the final quarter of the year. Yet, it turned out differently and activity expanded a mere 1.4% qoq in Q4. There was a noticeable jump in capital expenditures from the previous quarter's sharp decline, but net exports and an inventory drawdown subtracted from growth. GDP growth of 0.7% in 2018 is expected to weaken further in 2019 as the October VAT hike kicks in, with a mere 0.6% gain anticipated for the year.

More recent data releases have been downbeat as well. The January PMI fell 2.6 points to just 50, its slowest level since August 2016. The drop extends the softening underway since early 2018 and is broad-based, encompassing both new orders and export orders. The services sector has held up better though and even rose in January, recording 51.6, on the back of firm domestic consumption.

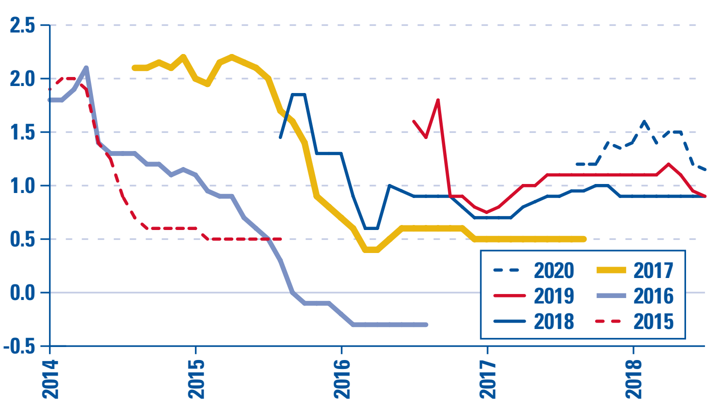
Chart 5: Japanese Activity Indicators



Source: BoJ, Nikkei, Bloomberg

The external sector has clearly begun to experience the effects of the regional slowdown as exports shrank at their fastest pace in two years in December. The 3.8% yoy drop owed primarily to a 7% decline in shipments to China, Japan's largest market in the region, an 11.6% decline to South Korea and a 17.3% decline to Hong Kong. Meanwhile, exports to Japan's largest global market, the US, increased by 1.6% yoy. The decline in exports was concentrated in the semiconductor and communications sectors and a direct reflection of the Sino-American trade dispute. Meanwhile, imports rose by 2% yoy, leaving the trade balance in deficit of $505 mn for December. For the year as a whole, the trade balance shifted from a JPY2.9 trillion (0.5% of GDP) surplus in 2017 to a to JPY1.2 trillion (0.2% of GDP) deficit in 2018, the first full-year deficit in three years. For the balance of payments, the decline in the trade surplus meant that the current account surplus shrank from 4.0% of GDP in 2017 to 3.5% of GDP in 2018. The income balance benefited from yen weakness and profit repatriation and turned in a surplus, while the services deficit narrowed to near-balance. In 2019, the external balance is set to benefit from the completion of the inventory adjustment and the fading effect of high energy prices on import values. On the other hand, imports could once again surge pre-emptively ahead of the planned rise in VAT in October. On balance, a similar outcome is expected for the year as in 2018.

Chart 6: BoJ Core Inflation Forecasts, %



Source: BoJ, Bloomberg

Market Strategy: The Japanese market lost 0.6% during our previous quarter, an underperformance of 2.4% points relative to the MSCI ACWI. The economic outlook has once again deteriorated and the BoJ is writing both inflation and growth forecasts down. What is more, the planned VAT hike in Q3 holds more downside in store. This outweighs Japan's attractive valuation as its P/E of 13.4 remains two standard deviations below its long-run average. We shift our temporary *overweight* allocation back to *neutral*.

Australia

Overweight

Chinese stimulus and a dovish Fed continue to support the Australian economy and equities. Declining housing prices remain a headwind.

Consensus expects GDP to marginally recover in Q4 to about 2.9% yoy from 2.8% in Q3, as exports pick up due to rising iron ore prices and private consumption may accelerate marginally given lower inflation. Consensus expects the full-year GDP to accelerate to above 3% in 2018 from 2.4% in 2017 when trade disruptions in the commodity sector hit exports.

Higher-frequency indicators weakened recently, in line with the synchronised growth slowdown witnessed elsewhere in Q4. Manufacturing PMI plunged to 50 in December – in contrast to the above-60 readings in Q1, before recovering marginally to 52.5 in January. Both NAB Business Conditions and Business Confidence continued their decline in December. Business confidence remains weakest in finance, business and property services. Indeed, the declining housing market seems to be the primary driver behind tepid domestic demand. House prices dropped the most in a single quarter in Q4 since 2008, resulting in a 5% contraction for 2018. Sydney and Melbourne have seen their house prices falling by 11% and 7%, respectively, since the 2017 peak. Also, building approvals plunged by almost a third in December compared to a year ago. Declining housing prices have weighed on household balance sheets, contributing to a decline in consumer confidence and the savings ratio. Consensus expects a further contraction in house prices and housing investment in 2019 until housing valuations come back to a more reasonable level. Overall, consensus expects GDP growth to moderate to 2.7% in 2019.

External demand and the resource sector may come to the rescue in 2019, however. While the global trade slowdown has not bottomed yet, Australian exports are already picking up on the back of the Chinese stimulus, rising iron ore prices and the successful commissioning of LNG projects. Past depreciation in the Aussie dollar has also contributed to a recovery in the terms of trade, supporting net exports. Indeed, the mining industry expects much more favourable business conditions in 2019 than other industries do.

Market Strategy: MSCI Australia returned 4.4% in USD terms between November and January, outperforming both MSCI ACWI and MSCI World. Valuations are unchallenging, with the trailing P/E at a 4% discount to DM compared to a long-term average of 6%. We maintain our *overweight* allocation on the back of the Chinese investment stimulus and rising commodity prices. Also, AUDUSD may be supported by a dovish Fed, as the interest rate gap between the two countries is likely to expand at a slower pace in 2019 than last year. ◆

KEY ECONOMIC AND FINANCIAL INDICATORS *(All data shown are as at end-January 2019 unless otherwise stated)*

	Developed Market	Macroeconomic Data: % change on year ago: Annual GDP Growth	Quarterly GDP Growth QoQ*	Industrial Production Growth	Consumer Price Index	Latest 12 months: Budget Balance % of GDP 2019F**	Trade Balance	Current Account Balance	Foreign Reserves 2019 Latest	Foreign Reserves 2018 Year Ago	Currency vs $ 2019 Latest	Currency vs $ 2018 Year ago	Short-Term Interest Rates	Sovereign Rating S&P	Market Performance: % MSCI ACWI Net***	Stock Market Index (MSCI ACWI Net) US$	Change since 12/31/18 US$	Change since 12/31/18 Local	Forecast: 2019 P/E Forecast	3 month Currency vs $ +/-
		%	%	%	%		$ Bns	$ Bns	$ Bns	$ Bns			%		Jan. 31, 2019	Jan. 31, 2019	%	%		
O/W	CANADA	1.7	2.0	2.7	2.0	-0.8	-17.0	-47.1	76.91	76.50	1.33	1.26	1.82	AAA	3.08	5181.11	13.03	8.69	10.0	+
O/W	AUSTRALIA	2.8	1.2	3.1	1.8	-0.3	16.2	-37.0	35.97	44.69	0.71	0.79	1.85	AAA	2.11	3520.35	7.21	3.51	14.8	+
Neutral	AUSTRIA	2.3	0.8	1.0	1.9	-0.2	-5.6	11.5	8.41	6.81	1.13	1.24	-0.31	AA+	0.07	3461.83	8.91	8.50	13.5	+
Neutral	BELGIUM	1.2	1.2	2.4	2.0	-1.3	-4.8	1.8	10.16	9.54	1.13	1.24	-0.31	AA	0.30	8818.00	9.84	9.43	15.6	+
Neutral	DENMARK	2.3	2.8	16.7	1.3	-0.2	6.3	20.9	65.57	70.05	6.59	6.00	-0.65	AAA	0.52	23042.13	3.44	3.11	16.7	+
Neutral	FINLAND	2.5	1.6	2.8	1.1	-0.5	-3.1	-3.8	6.10	6.37	1.13	1.24	0.22	AA+	0.32	1046.34	8.26	7.86	18.2	+
Neutral	FRANCE	0.9	1.2	-1.4	1.2	-3.2	-70.7	-16.8	48.53	37.74	1.13	1.24	2.00	AA	3.35	5903.45	5.85	5.45	15.2	+
Neutral	GERMANY	0.6	0.0	-4.0	1.4	0.9	269.3	294.2	36.41	37.44	1.13	1.24	0.14	AAA	2.68	5376.65	6.63	6.23	13.8	+
Neutral	HONG KONG	2.9	0.4	1.2	2.5	1.8	-71.7	41.5	423.05	421.92	7.85	7.82	1.55	AA+	1.20	66742.70	7.76	7.98	15.0	+
Neutral	IRELAND	4.9	3.6	-17.8	0.7	0.0	59.9	47.8	0.98	0.96	1.13	1.24	-0.36	A+	0.16	311.59	5.19	4.79	15.8	+
Neutral	ISRAEL	2.7	3.1	3.6	1.2	-3.2	-22.4	30.0	116.42	116.10	3.62	3.51	0.25	AA-	0.17	141.17	12.08	10.50	16.9	-
Neutral	ITALY	0.1	-0.9	-5.5	0.9	-2.6	46.7	52.7	39.22	37.63	1.13	1.24	1.26	BBB	0.70	735.07	8.55	8.14	12.0	+
Neutral	JAPAN	0.0	1.4	-1.9	0.3	-3.6	-10.5	174.0	1216.66	1205.29	110.62	106.57	-0.16	A+	7.51	6044.49	6.10	5.24	18.9	+
Neutral	NETHERLANDS	2.0	2.0	-4.2	2.2	1.0	62.6	81.8	4.74	5.05	1.13	1.24	-0.31	AAA	1.05	14419.27	7.26	6.90	15.3	+
Neutral	NEW ZEALAND	2.6	1.2	7.3	1.9	0.9	-3.9	-7.1	16.06	19.33	0.69	0.74	1.75	AA	0.07	508.14	5.81	2.29	12.3	+
Neutral	NORWAY	1.8	3.6	2.5	3.1	5.2	34.6	34.0	55.49	62.98	8.59	7.78	1.28	AAA	0.22	8339.84	6.44	3.54	25.4	+
Neutral	PORTUGAL	1.7	1.6	-0.3	0.5	-0.6	-20.1	-1.3	7.76	8.73	1.13	1.24	-0.31	BBB-	0.05	143.84	4.99	4.60	15.6	+
Neutral	SINGAPORE	1.9	1.4	2.7	0.5	-0.4	94.5	63.8	285.35	277.81	1.35	1.31	1.88	AAA	0.41	1152.75	5.77	4.35	13.1	-
Neutral	SPAIN	2.4	2.8	-4.2	1.0	-2.2	-50.5	-4.7	52.51	52.24	1.13	1.24	-0.31	A-	0.94	3087.66	6.55	6.15	16.9	+
Neutral	SWEDEN	1.6	-0.8	2.6	1.9	0.8	-3.7	11.9	52.13	54.38	9.33	7.98	-0.06	AAA	0.82	21014.72	5.74	7.91	16.9	+
Neutral	SWITZERLAND	2.2	-0.8	1.4	0.6	0.5	32.9	70.1	738.43	762.19	1.00	0.93	-0.85	AAA	2.62	11540.78	6.17	6.85	18.2	+
Neutral	UNITED STATES	3.0	3.4	3.8	1.6	-4.5	-604.2	-466.9	41.08	42.57	1.00	1.00	2.56	AA+	54.53	7203.50	8.18	8.18	13.5	+
U/W	UK	1.3	0.8	-0.9	1.8	-1.6	-42.6	-107.1	141.78	125.46	1.30	1.40	0.78	AA	5.17	6073.86	7.09	3.68	11.0	+

*Note: S&P credit rating shown is long-term foreign currency rating. * % change in GDP on previous quarter, annual rate. **Bloomberg consensus forecast. ***MSCI All Country World Index Daily Total Return Net. Global emerging markets had an 11.9% weighting in the MSCI ACWI as at 31 January 2019. The CLIM weighting for global emerging markets for the period February to April 2019 is 11.9%; the weighting for developed markets is 88.1%.*

†Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results.

Source: Bloomberg, City of London Investment Management

CITY OF LONDON
Investment Management Company Limited

Contacts

Macroeconomic Analysis

Michael Hart, London Office
Phone: 011 44 207 711 1558
E-Mail: michael.hart@citlon.co.uk

Lyndon Barreto, CFA, London Office
Phone: 011 44 207 711 1551
E-Mail: lyndon.barreto@citlon.co.uk

Mike Liu, CFA, London Office
Phone: 011 44 207 860 8318
E-Mail: mike.liu@citlon.co.uk

London Office
77 Gracechurch Street
London EC3V 0AS
United Kingdom
Phone: 011 44 20 7711 0771
Fax: 011 44 20 7711 0772
E-Mail: info@citlon.co.uk

Philadelphia Office
The Barn, 1125 Airport Road
Coatesville, PA 19320
United States
Phone: 610 380 2110
Fax: 610 380 2116
E-Mail: info@citlon.com

Seattle Office
Plaza Center
10900 NE 8th Street, Suite 1414
Bellevue, WA 98004
United States
Phone: 206 830 9986

Singapore Office
20 Collyer Quay
10-04
Singapore 049319
Phone: 011 65 6236 9136
Fax: 011 65 6532 3997

Dubai Office
Unit 2, 2nd Floor
The Gate Village Building 1
Dubai International Financial Centre
P.O. Box 506695, Dubai, United Arab Emirates
Phone: 011 971 4 249 8402
Fax: 011 971 4 437 0510

Website
www.citlon.com