MILLENNIUM GLOBAL

Macro and Currency Outlook

Highlights Q4 2017

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Key Currency Views

- **We stick to our bearish medium-term USD view,** given persistently low inflation in the US, uncertainties about the FOMC's composition in 2018 and a likely modest boost to growth only from fiscal policy next year. Continued upward growth momentum in the rest of advanced economies and the fact that other major central banks are also moving closer to policy normalisation underpin our base case.

- **We see scope for additional EUR gains vs. USD,** based on upside cyclical momentum in the Euro area, an under-priced interest rate outlook by markets and one of the strongest basic balance positions, likely to be further strengthened by the reversal of residents' portfolio outflows associated with QE.

- **We have turned neutral on JPY vs. USD.** Abenomics has already lost momentum as reflected in stalled inflation expectations, a lack of push for new structural reforms and constraints to additional QE and could be further undermined in the aftermath of Oct 22nd elections (in case PM Abe loses his majority). The risk of a regime shift at the BoJ has risen, which, in our view, combines with a strengthening balance of payments position and a cheap valuation to support JPY over the coming months.

- **We retain a bearish outlook for GBP vs. EUR over the medium-term based on cyclical underperformance of the UK economy and continued delays in UK-EU negotiations raising risks of capital flight.** But we acknowledge that the interest rate outlook provides a key support for GBP over the next couple of months. In our view, the BoE's shift towards tightening partly reflects its take on currency weakness doing more harm than good in view of the lack of external rebalancing and imported inflation hitting real incomes.

- **The negative impact of the Chinese real estate downturn on commodity prices should eventually take its toll on AUD in our view, although a soft USD outlook likely limits the extent of AUD/USD decline in Q4.** We continue to look for the RBA to remain on hold, as it waits for wages and income growth to pick up in order for households to be able to sustain a heavy debt burden.

- **We see bigger potential for SEK than NOK to appreciate vs. EUR over the coming months.** Although spare capacity is being absorbed fast in Norway and Norges Bank's medium-term inflation forecast looks too benign, the moderation in housing prices keeps at bay any sense of urgency. In contrast, economic fundamentals are aligned in Sweden for an inflection point in monetary policy with the labour market at full employment, domestic inflation picking up and housing imbalances acute.

- **We believe the market has overreacted to tensions between Poland and the EU, with potential for PLN to rebound vs. EUR.** Meanwhile CZK has yet to discount both domestic cyclical dynamics and the regional environment (e.g. German cycle, start of ECB's exit).

- **A constructive outlook for MXN can be argued based on a combination of real interest rate, BoP dynamics and FX valuation** despite NAFTA renegotiations and the 2018 presidential elections in Mexico.

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US Outlook

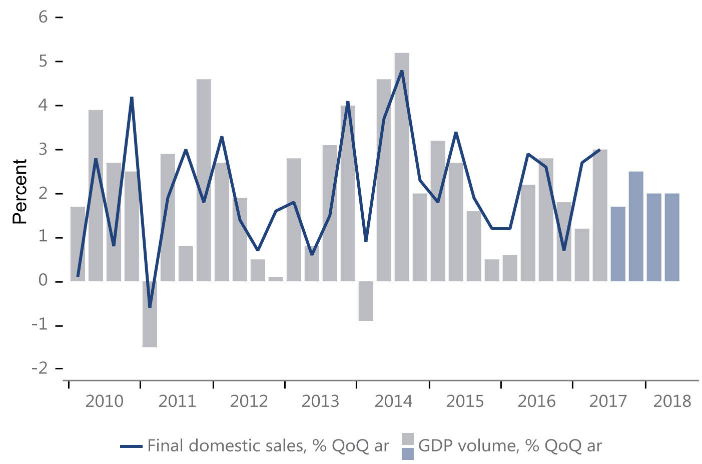
- Q3 US GDP will be hit by hurricanes (likely cutting between 0.7% and 1% off annualised growth) but we see this being recouped in Q4 while activity at the beginning of 2018 could be boosted somewhat as well. All in all GDP growth is expected to remain at potential growth (about 1.7%) into 2018, consistent with some further monetary tightening. OECD and IMF forecasts incorporate modest fiscal easing of 0.6-0.8% in 2018, which could boost GDP growth by 0.3-0.4%.

- Upside risks to growth in 2018 stem from potentially significant tax cuts (not our base case).

- Home sales have started to decline before the distortions from hurricanes. This likely reflects a combination of factors: a shortage of homes on the market and under construction as well as a delayed reaction to higher mortgage rates. In general, affordability has been hit by higher rates. However, a credit crunch is unlikely to take place as credit standards have continued to ease.

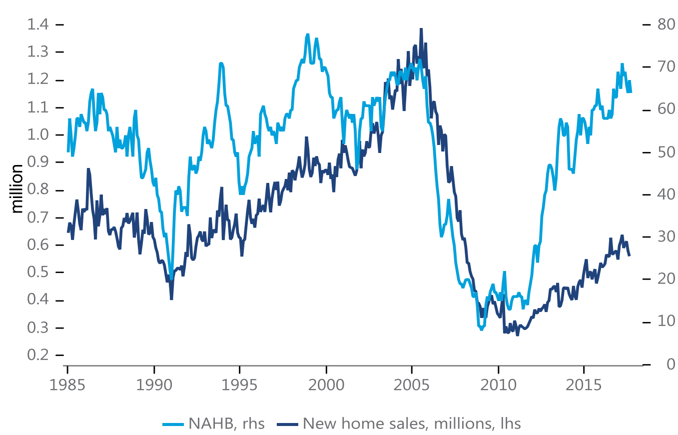
- Key to watch: progress on fiscal policy. Our base case is for patchy progress given time constraints (Obamacare reform and immigration to be dealt with) and Republican divisions (whether a revenue-neutral tax reform is required). Under a base case of modest fiscal expansion, we expect the trend of budget deficit widening to extend in 2018/19. Meanwhile, the USD is expensive vs. other advanced currencies based on our PPP estimates.

GDP growth and forecasts: Q3 GDP to take a hit, Q4 recovery in sight



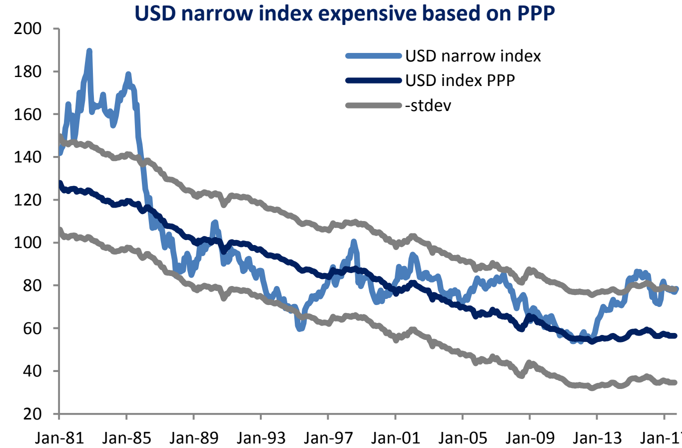
Sources: Macrobond, MGI (forecasts). Data as of 22 September 2017

NAHB sentiment may have peaked, new home sales already softer



Source: Macrobond. Data as of 25 September 2017.

USD narrow index expensive based on PPP



Source: Macrobond, MGI. Data as of 25 September 2017.

Euro Area Outlook

- Growth has been broad-based across sectors and countries, with dispersion of GDP growth across economies falling to a new low. Domestic demand has provided a solid foundation to the recovery. Neither fiscal or monetary policy provides a brake in the near term.

- Consumer confidence reports show household spending has further to run given spending intentions. Meanwhile, the investment outlook has brightened, with some recovery in the business investment ratio to GDP after it collapsed in the wake of the 2008 crisis.

- While there remains a lot of dispersion between countries as regards to the speed of closing the unemployment gap, labour market dynamics have improved further across the region in our view.

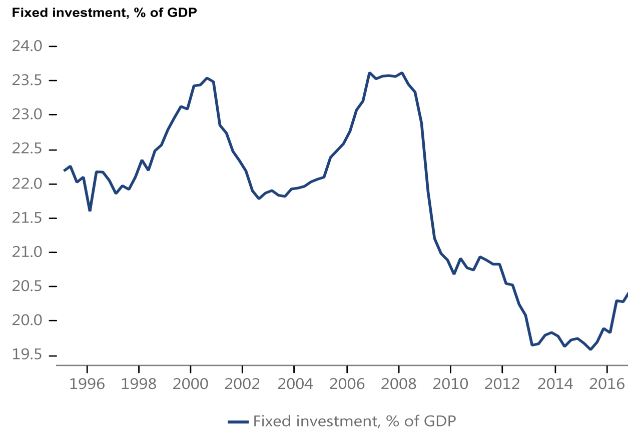
- Business surveys point to faster job creation ahead and labour shortages in some sectors.

- Wage growth has recently accelerated from a low base, amid a tighter labour market.

- Our ECB interest rate monitor calls for the start of monetary policy normalisation, with our activity index having reached a historical high since 1999. We are waiting for the October 26th QE tapering decision and then for new interest rate guidance potentially in Dec 2017.

- While still distant (end of 2019) the end of Draghi's term makes it a consensus decision to plan for QE to end, although it remains unclear how long the tapering will be and whether the end date will be confirmed.

Investment recovery could have a long way to go

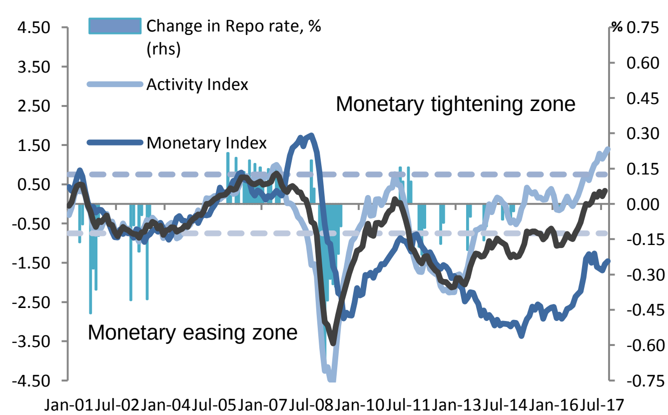


Source: Macrobond. Data as of 19 September 2017.

Hiring intentions point to faster job creation

Source: Data as of 19 September 2017.

ECB rate monitor: economic fundamentals point to higher rates



Sources: Macrobond, MGI. Data as of 22 September 2017.

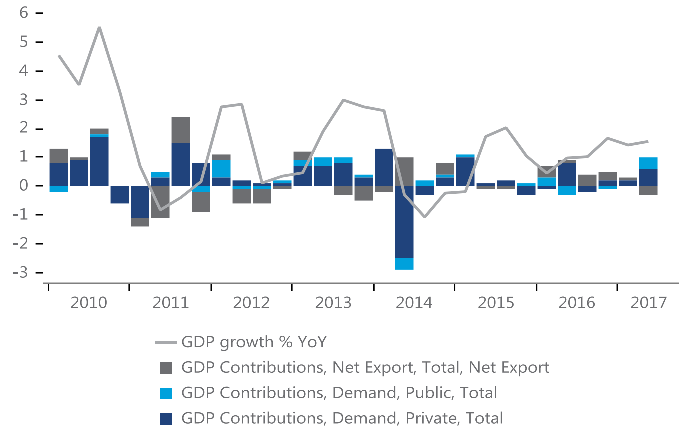
Japan Outlook

- Delays in implementing fiscal stimulus so far mean that there should be no fiscal cliff in H2 2017. Strong consumer confidence, continued growth in employment and a fall in the savings rate all support household spending into Q4. H2 GDP is expected to be softer than H1 as both consumption and investment moderate.
- Maintaining the current regime for monetary policy requires Abe to remain in place and in a majority position; the outcome of Oct 22nd election bears watching.
- Reflationary trends look to have lost momentum with inflation expectations dipping. More broadly, nominal GDP growth has failed to keep pace with volume GDP growth.

UK Outlook

- The BoE has delivered an unexpected turn by signalling readiness to hike rates as soon as November. Communication from the BoE has been somewhat erratic recently but overall the desire to tighten policy finds some macro backing.
- We now expect the BoE to deliver a 25bp rate hike in November, followed by two more in 2018, provided wage growth picks up a touch and the government secures a long transition agreement for Brexit.
- Potential growth seems to have taken a step back since the EU referendum, with immigration down 25% and productivity averaging only about 0.5% YoY. Assuming these trends persist, this would suggest potential growth of just above 1% YoY.

Domestic demand-led growth in Japan: sustained but with slower momentum into H2

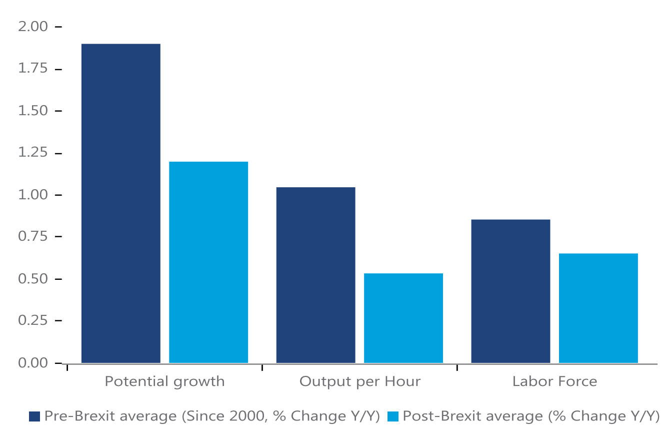


Source: Macrobond. Data as of 12 September 2017.

GBP rate support improved materially

Source: Macrobond. Data as of 4 October 2017.

Some of the downshift in potential growth likely due to Brexit



Source: Macrobond, MGI. Data as September 20th, 2017.

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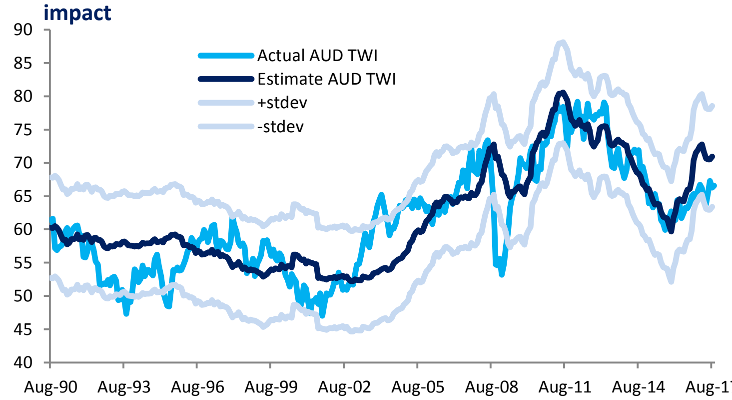
Australia Outlook

- While AUD has managed to disconnect somewhat from lower commodity prices at the end of Q3 2017, this mainly reflects the impact from a weak USD and support from interest rate differentials.
- Meanwhile, we expect a resumption of credit tightening in China after the October Party conference to intensify the downward trend in real estate investment and commodities.
- The RBA is waiting for an erosion of labour market slack and a pick-up in household income in order to be able to tighten monetary policy and deal with housing sector imbalances, which have so far been tackled by macro-prudential tightening.

Canada Outlook

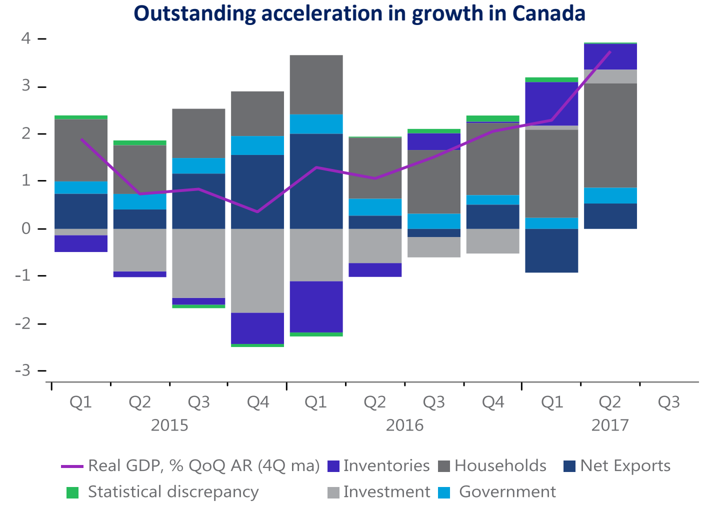
- Growth in H1 2017 has been remarkable and posted the strongest expansion in G10, with Q2 GDP up 4.3% YoY. Growth drivers, whilst still hinging on strong consumer spending, are broadening, with a trend improvement in the net trade position and a gradual pick-up in business investment.
- By moving ahead of nominal pressures, the BoC seems likely to tolerate a more gradual return of inflation to target.
- With our base-line of a further rate rise in Q4 not fully priced, residual rate support can help CAD deliver some further gains. Furthermore, while we expect the pace of tightening to slow as nominal rates surpass the US's, we also expect the BoC to continue to point to the likely need for further policy tightening into 2018, keeping the forward curve supported, although we expect the pace of rate hikes to slow; pencilling in only two more in 2018, most likely in April and October.

AUD: USD weakness and rate differentials help offset commodity impact



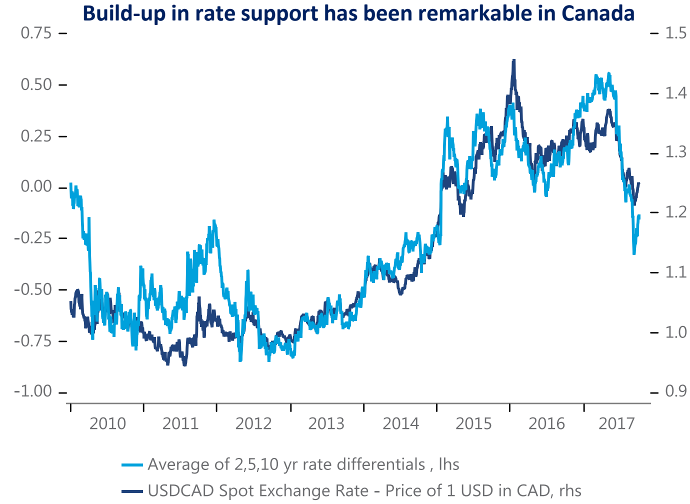
Sources: Millennium Global, Macrobond. Data as of 18 September 2017.

Outstanding acceleration in growth in Canada



Source: Macrobond. Data as September 20th, 2017.

Build-up in rate support has been remarkable in Canada

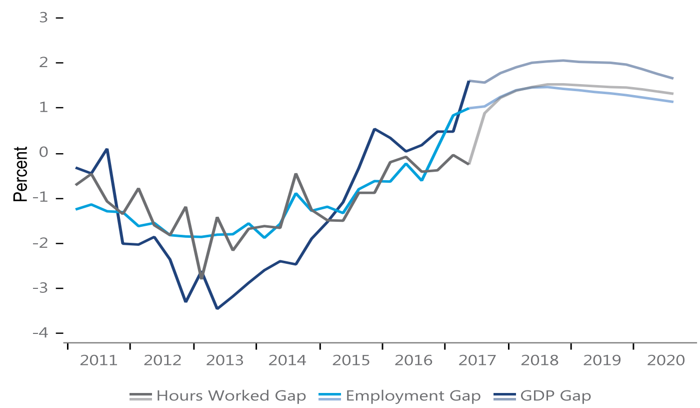


Source: Macrobond. Data as of 20 September 2017.

Scandinavian Outlook

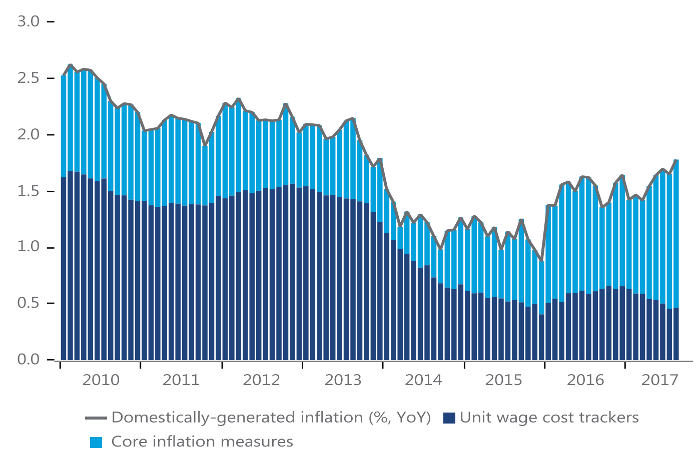
- In Sweden the Riksbank revised its view of the output gap, extending it further into positive territory by 0.5% points, reflecting stronger growth this year.
- CPIF ex-energy is now in line with the inflation target, underscoring the improvement in domestic price pressures. This is also evident in services inflation which has shifted a gear and printed 3.2% YoY in August. Our proxy of domestically-generated inflation, which has been inching steadily higher since the turn of the year, is currently signalling normalisation in underlying price pressures after the downshift that started in 2014.
- To be sure, the Riksbank continues to see risks that currency strength could derail progress made towards the achievement of the inflation target, which justifies micro-managing currency moves. We are sympathetic with this position, however, as inflation continues to hover around target and the output gap firms into positive territory, moderate TWI appreciation should be increasingly seen as a macro-stabilising force rather than a risk for the inflation outlook, which should underpin SEK gains over the medium term in our view.
- In Norway FX pass-through would suggest a snapback is not likely in the next few months but upside risks could materialise afterwards, supporting our view that the Norges Banks's medium-inflation forecast looks too benign. The central bank has moved closer to this view by upgrading its inflation outlook in the past two monetary policy reviews, with the September 2018 forecasts being upgraded by 0.1% despite disappointing spot inflation.
- Nonetheless NOK remains attractive in light of policy guidance which remains dovish vs. our expectation as well as relative cheapness vs. market and on fundamental metrics.

Riksbank revised its view of the output gap to reflect stronger growth..



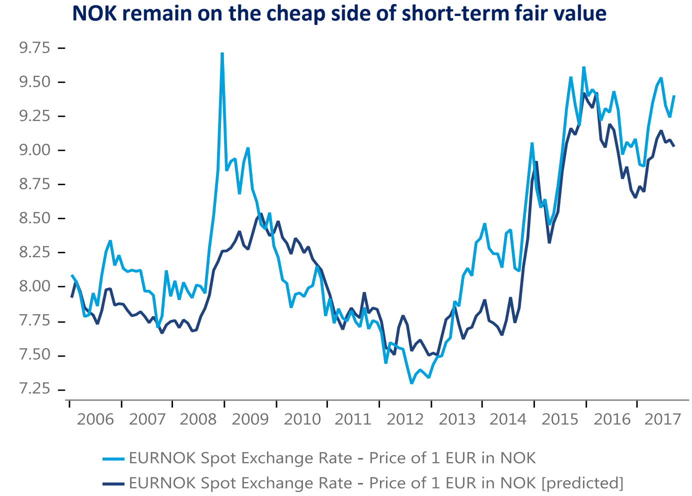
Source: Macrobond. Data as September 20th, 2017.

.. As domestic inflation in Sweden gives signs of a turn



Source: Macrobond, MGI. Data as September 20th, 2017.

NOK remain on the cheap side of short-term fair value



Source: Macrobond. MGI. Data as September 20th, 2017.

Czech Rep and Poland Outlooks

- Czech growth has been driven by an acceleration in private sector demand. Despite an initial rate hike in August and some currency appreciation, broad monetary conditions remain too loose for an economy that is running well above potential.
- In particular, there remains scope for CZK to gain in real effective terms in view of the strength of the regional cycle.
- PLN looks too weak compared to the strength of both domestic and regional growth, all the more so as faster growth has come with better macro stability as reflected in narrower twin deficits. Despite some loss of momentum, GDP growth is likely remain well above potential.
- We believe PLN has overreacted to tensions with the EU over the judiciary reform. While the conflict has yet to be resolved, we doubt it will ever lead to EU sanctions.

Czech business and consumer confidence still rising

Source: Macrobond. Data as of 26 September 2017.

PLN vs. EUR has failed to benefit from the strong regional cycle

Source: Macrobond. Data as of 26 September 2017.

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