MORNING NEWSLETTER

# December 2018

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01

## US – monetary policy - From ‘a long way from’ to ‘just below’ neutral

We have seen quite a sudden reversal in the outlook for Federal Reserve monetary policy. From September until early October, strong US economic data, rising oil prices and communications from most Fed members - culminating in Jerome Powell's 'long way from neutral' statement - contributed to raising market expectations of continued rate hikes in 2019.

However, expectations were scaled back in November. Market volatility, lingering concerns around global growth, the fall in oil prices and consistently below-expectation US inflation data challenged the relevance of tightening US credit conditions, despite the context of resilient US economic growth.

These developments appear to have shifted the Fed's assessment of the situation, with several Fed members starting to send more accommodative messages. Powell declared on 28 November that interest rates were 'just below' the neutral level. It is hard to tell whether the Fed simply blinked in the face of the equity market correction, or whether there were more fundamental reasons behind this apparent U-turn, such as the reduced chances of another fiscal stimulus next year, stubbornly anchored inflation rates and softer activity in some cyclical and rate-sensitive sectors. The outlook for Fed rates is now less straightforward than it was two months ago.

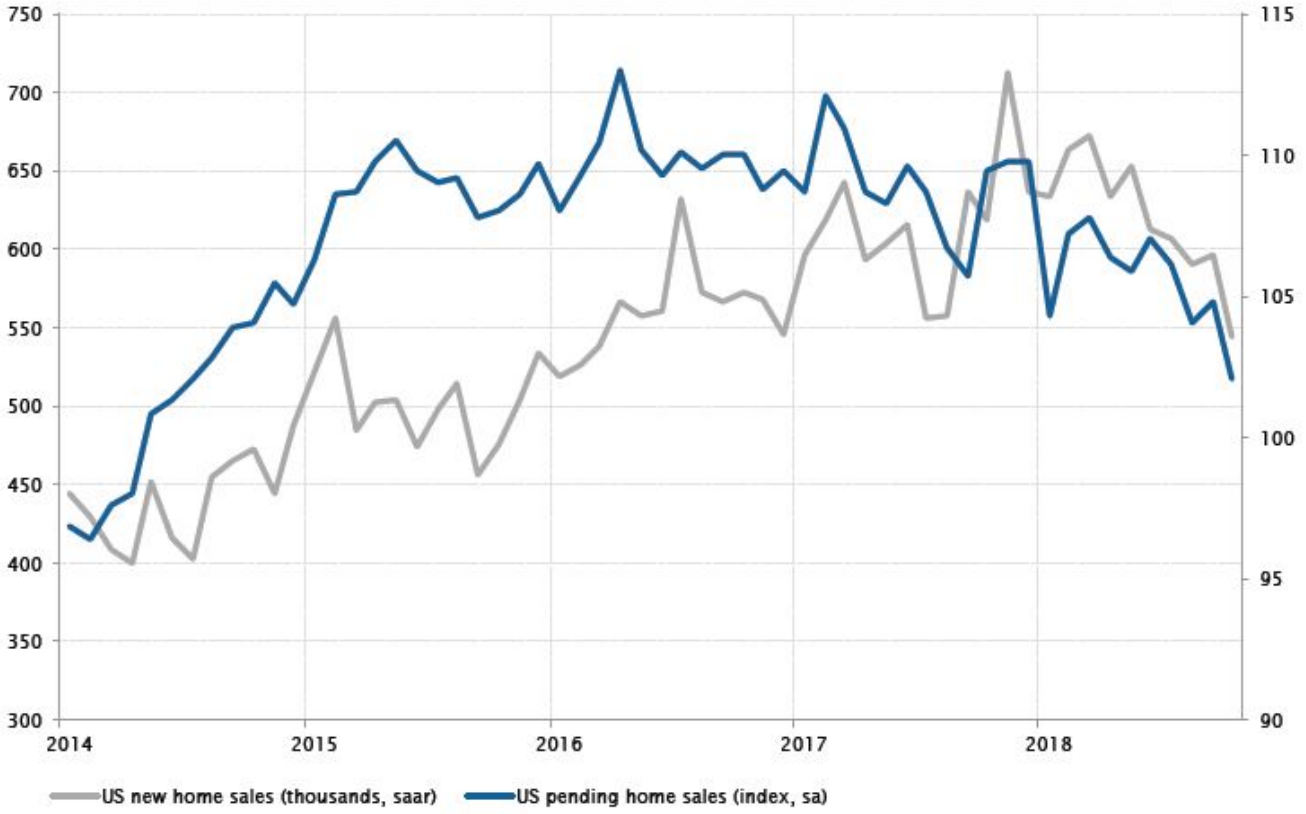
Fed rate hike expectations went up, then down in November

Sources : Bloomberg, SYZ Asset Management. Data as at : 01 December 2018




US home sales are declining

Sources : Bloomberg, SYZ Asset Management. Data as at : 30 November 2018




02

## US – Softness in the housing market

US new home sales surprised to the downside in October, dropping by 8.9% month-on-month (MoM), to the lowest level in more than two and a half years. Data is softening since the end of last year, with October figures representing the largest monthly decline in 2018. In parallel, pending home sales fell by 2.6% MoM, reaching a four-year low. This also suggests the US housing market is deteriorating.

The downward trend in home sales is evidence higher interest rates have penalised the real estate market. Despite slowing, house price growth also continues to outstrip wage growth, weighing on demand. In this context, the US housing market slowdown is expected to continue into 2019.

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## Japan – QE continues in Japan

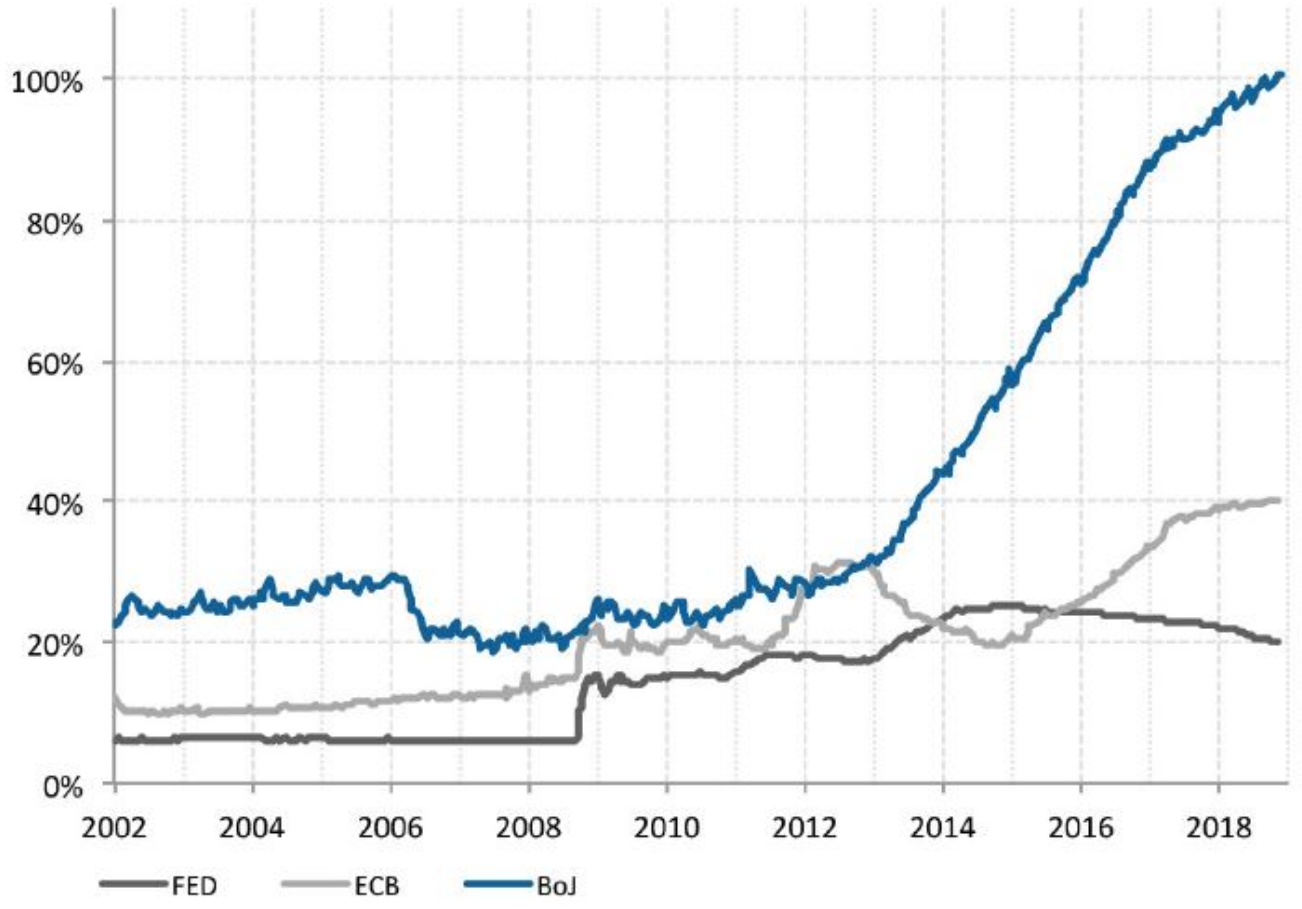
The Bank of Japan's (BoJ) balance sheet now represents more than 100% of Japan's GDP. While this is more symbolic than meaningful, and was expected to happen sooner or later, it is still staggering. Admittedly, this has been the case in Switzerland for a while, but the amounts at stake and the composition of the asset purchases are quite different in Japan.

Interestingly, the ongoing increase in the BoJ's balance sheet, fuelled by Japan Government Bond (JGB) purchases, is now at odds with the dynamics in the US and Europe. The Federal Reserve's balance is just below 20% of US GDP, as the central bank reduces its holdings at a pace of $50bn per month, tightening US dollar financing conditions. The ECB is less advanced in its monetary policy normalisation, but will in all likelihood stop growing its balance sheet by year-end.

The BoJ is the last large central bank to have to manage the exit from the quantitative easing era. It is already heading in this direction, by reducing long bond purchases and widening the band for the 10-year rate. However, the central bank now holds half of all JGBs outstanding - about $500bn - and is the second largest public issuer in the world, after the US. These are staggering numbers.

The BoJ now holds more assets than the value of Japan's annual GDP

Sources: Bloomberg, Fed, BCE, BoJ, SYZ Asset Management. Data as at : 30 November 2018



As Brexit gets close, uncertainty causes the UK economy to stall

Sources : Factset, SYZ Asset Management. Data as at : 05 December 2018




04

## UK – Brexit uncertainty causes the economy to stall

The end of the long Brexit saga is getting close - or maybe not. After two years of of long, painful, fruitless negotiations with the European Union on exit terms, Theresa May has finally managed to reach an agreement with the EU. Unfortunately, this agreement is likely to be rejected by the British Parliament, possibly extending the saga with another referendum or general election.

One thing is for sure. The lack of visibility beyond 29 March 2019, the effective day of Brexit, has recently weighed on confidence and activity indicators. Consumer confidence in the UK is at its lowest level in five years, house price growth has slowed, the number of jobless claims is up for the first time in seven years and business investment has been contracting since the beginning of 2018.

The UK Composite PMI, a gauge of activity in the manufacturing and service sectors, dropped to its lowest level since 2012 in November - not including the one-month fall right after the Brexit referendum. This suggests the economy stalled in Q4. Whether it will restart in

2019 or not is now in the hands of British politicians and their ability to dissipate uncertainty one way or the other.

05

## Eurozone – Growth in Italy dampened by push for fiscal easing

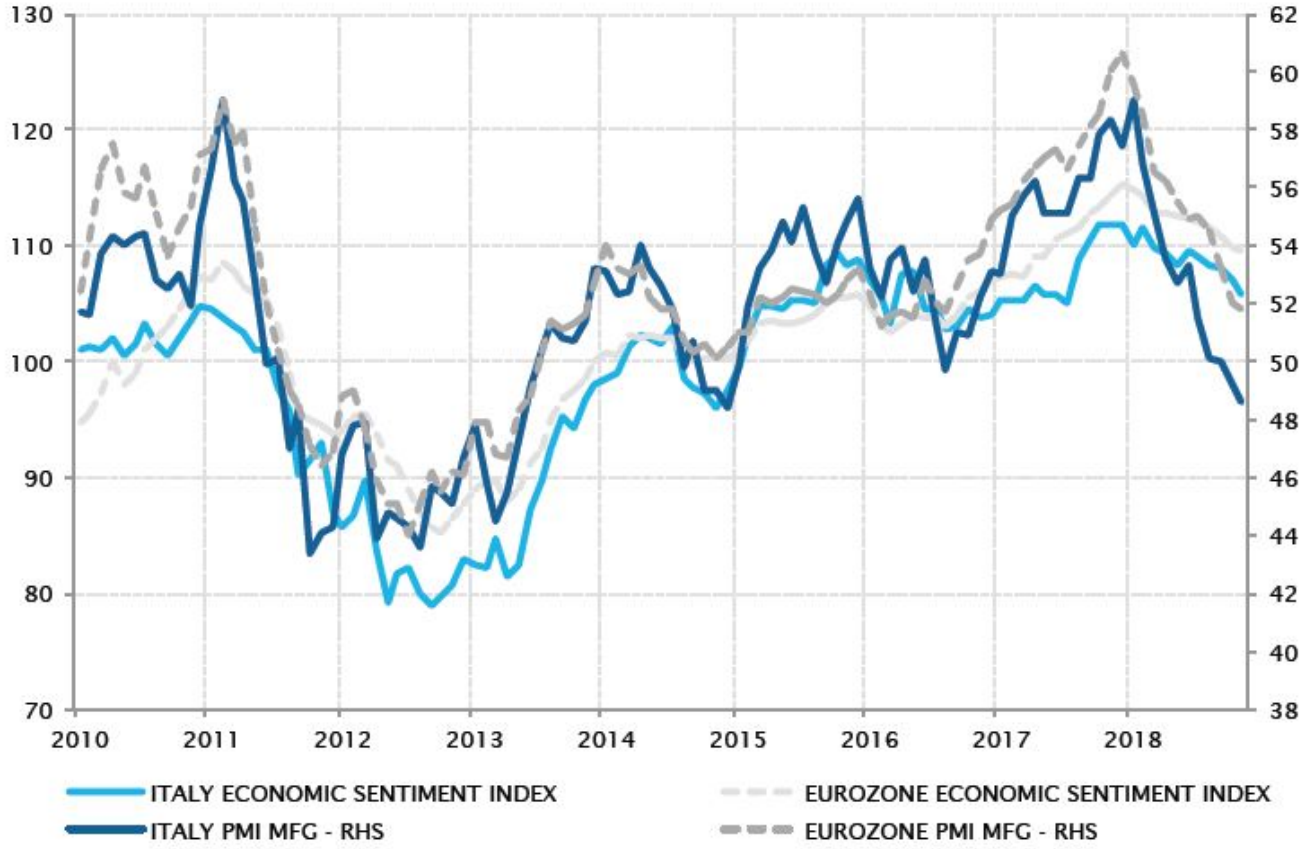
The quarrel between the Italian government and the European Commission over Italy's 2019 budget - and the announcement of a fiscal deficit significantly above the level required to stabilise the debt trajectory - has intensified since September. To be fair, political uncertainty has been clouding the Italian economic outlook since last May when the Five Star Movement and Lega Nord government took office.

While negotiations over the budget are still ongoing, the impact of political uncertainty has already been felt in the Italian economy. Amid a broad-based trend of slowing growth across the eurozone, the monetary union's third largest economy has slowed even more, posting its first negative GDP growth since 2014 over Q3. All main activity indicators in Italy have deteriorated faster than the European average, as uncertainty around fiscal policy and the spike in financing costs - resulting from wider government spreads - have dampened investment spending.

The debate around fiscal policy is intensifying in Europe, as softer growth undermines fiscal projections for next year and social claims in Italy and France rise. The prospect of European elections next year is likely to fuel politically-related uncertainty in Europe until May.

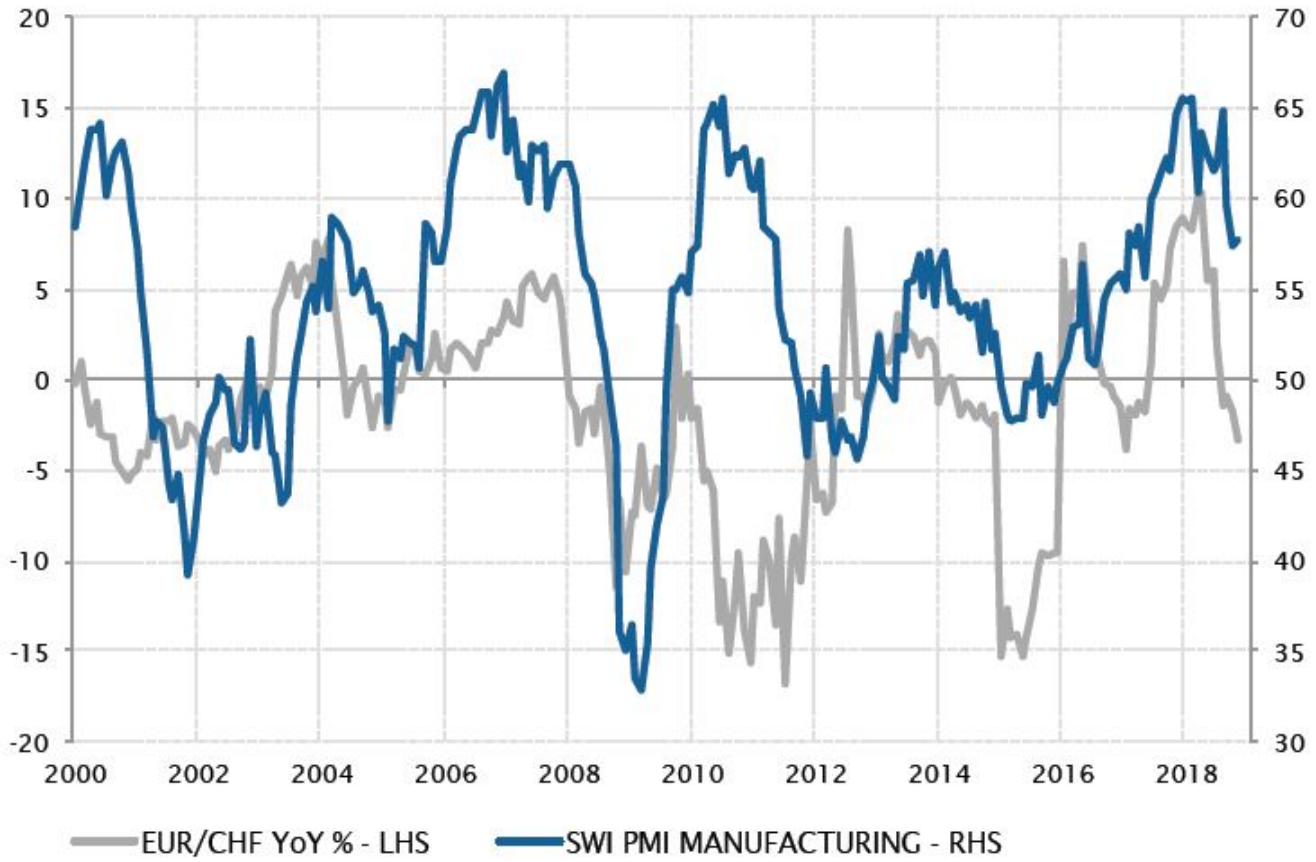
Italian economic indicators have deteriorated faster than European average

Sources : Factset, Markit, SYZ Asset Management. Data as at : 01 December 2018




Weakening of the franc points to continuing Swiss growth slowdown

Sources : Factset, SYZ Asset Management. Data as at : 01 December 2018




06

## Switzerland – Once again hostage to European economic and political developments

The Swiss economy experienced a strong bout of growth since 2017, with yearly GDP growth peaking at 3.5% at the end of spring. The combination of strong global growth and a weaker Swiss franc, coupled with still ultra-accommodative domestic financing conditions, created a very favorable environment for the export-sensitive Swiss economy.

However, external factors have gradually become headwinds this year. The slowdown in European and Chinese growth has dampened demand in two of Switzerland's main export markets. On top of this, the Swiss franc reversed course against the euro after the resurgence of Italy-driven political uncertainty in the eurozone. After losing about 10% against the euro in a year, the franc has bounced back, supported by a combination of safe haven flows and dampened expectations for ECB rate hikes.

As an immediate result, economic activity was affected in Switzerland, with GDP declining by 0.2% over the summer and manufacturing indicators losing ground. Once again, the Swiss economy appears to be hostage to economic and political developments in the eurozone. Uncertainty around the latter is likely to persist until May's European elections, leaving limited scope for a short-term reversal in franc strength. Consequently, Swiss growth dynamics may continue to err on the soft side in the first months of 2019.

# China – Exports and imports slow more than expected

Chinese exports and imports in November were far weaker than expected, indicating a slowdown of domestic and global demand. The impact of Chinese companies ‘front-loading’ shipments to the US before the increase in tariffs comes into force on 1 January also started to fade.

Exports grew by only 5.4% in November - against expectations of 10%. This is the weakest performance since the 3% contraction in March. The slowdown affected not only exports to the US but shipments to the European Union and Asia as well. Imports were also weaker at 3% - against 20.8% in October.

Chinese growth was relatively strong in the third quarter, at 6.5%, but the economy is expected to slow to 6.3% in 2019. The numbers came out just few days after Presidents Donald Trump and Xi Jinping agreed to a 90-day trade cease-fire, but this will certainly put more pressure on Beijing in the trade negotiations.

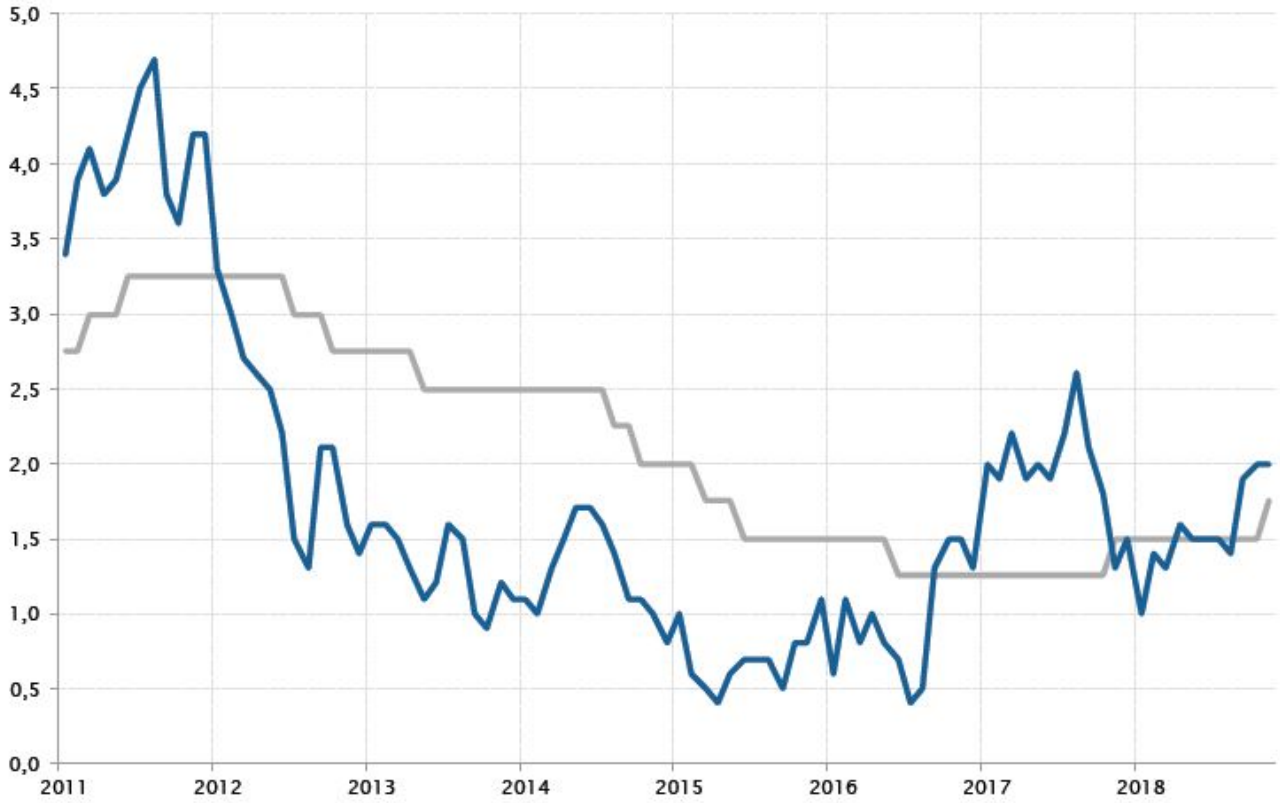
Trade war damages Chinese exports and imports

Sources : Factset, SYZ Asset Management. Data as at : 30 November 2018




The Bank of Korea raised interest rates for the first time in a year

Sources : Bloomberg, SYZ Asset Management. Data as at : 04 December 2018




08

## South Korea – The Bank of Korea tightened monetary policy to ease financial imbalances

As anticipated by the market, the Bank of Korea (BoK) lifted its benchmark interest rate by 25bps to 1.75% exactly a year after the previous rate hike, as concerns mount over high consumer debt and the widening gap between Korean and US rates. This move reduces the interest rate differential with the US from 75bps to 50bps, just before the widely expected 25bps Fed rate hike in December.

The BoK's governor commented during the press conference that monetary policy remains accommodative, as rates have not yet reached the neutral level. At the same time, he tempered expectations of another hike by adopting a cautious stance on the growth outlook, mentioning a high level of uncertainty. On the inflation front, headline CPI reached the central bank target of 2% in October. However, downward pressures should emerge going forward - due to soft domestic demand, lower oil prices and the temporary 15% fuel tax cut. Uncertainties concerning growth and subdued inflation would certainly allow the central bank to put further hikes on hold for some time.

09

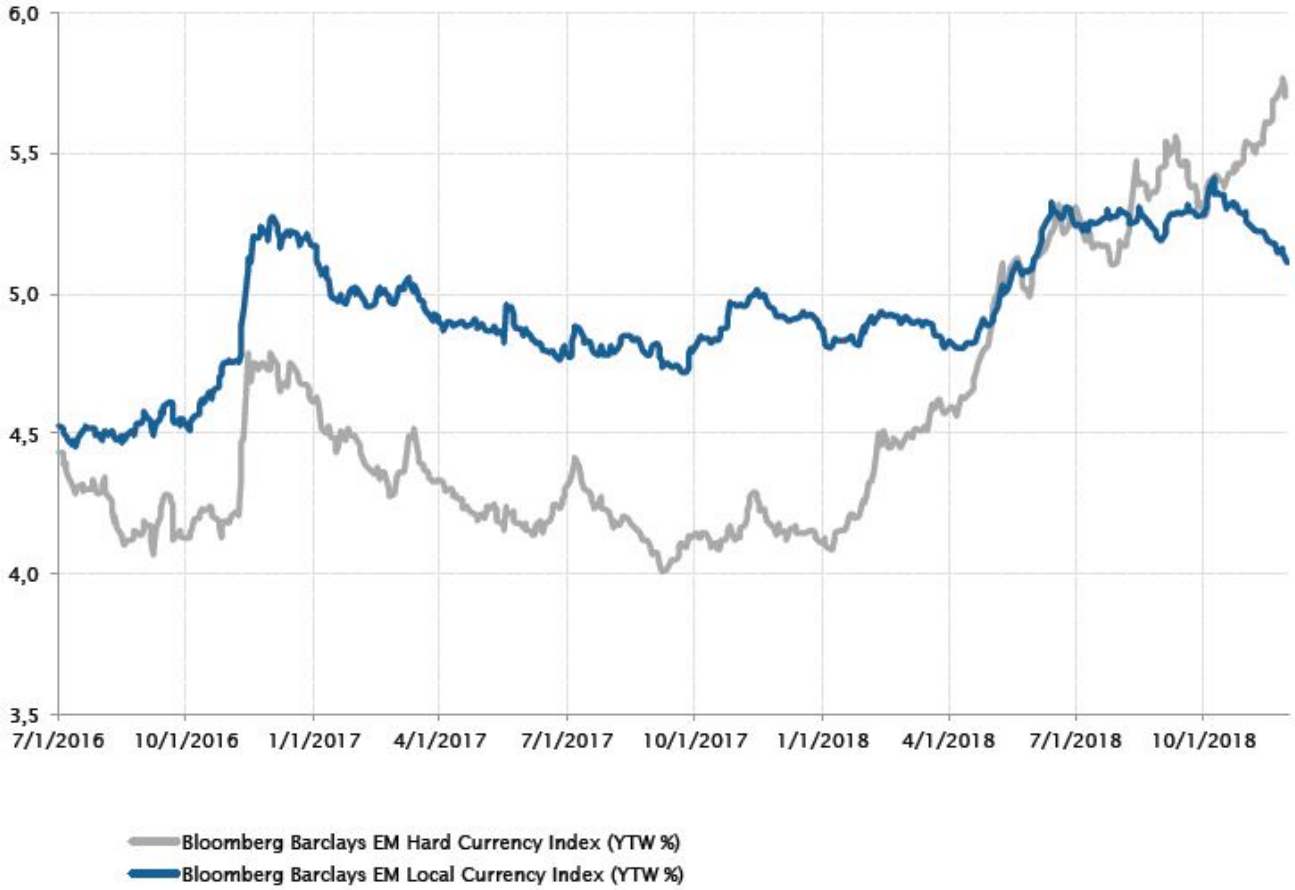
# Fixed Income – Higher yields for the Emerging Market Hard Currency Index vs. Local Currency

This month, the Emerging Market Hard Currency Index yield-to-worst (YTW) has surpassed the Local Currency Index YTW for the first time since 2016, which indicates foreign currency debt is yielding more than local debt - at 5.69% compared to 5.11%. At the end of November, the difference in yields, in favor of the Hard Currency Index, stands at 58bps compared to -76bps at the end of last year. Moreover, overall duration is higher for the Local Currency Index compared to the Hard Currency Index, making the latter even more appealing.

In a context where US Federal Reserve monetary policy is becoming more restrictive, bonds issued by emerging market (EM) countries - the bulk of which are in US dollars - are naturally tracking the US treasury curve movements. Also in the EM world, some central banks are still erring on the accommodative side, pushing yields lower. Nevertheless, they are slowly heading towards restricting policy, to avoid the usual illnesses of high inflation and currency depreciation.

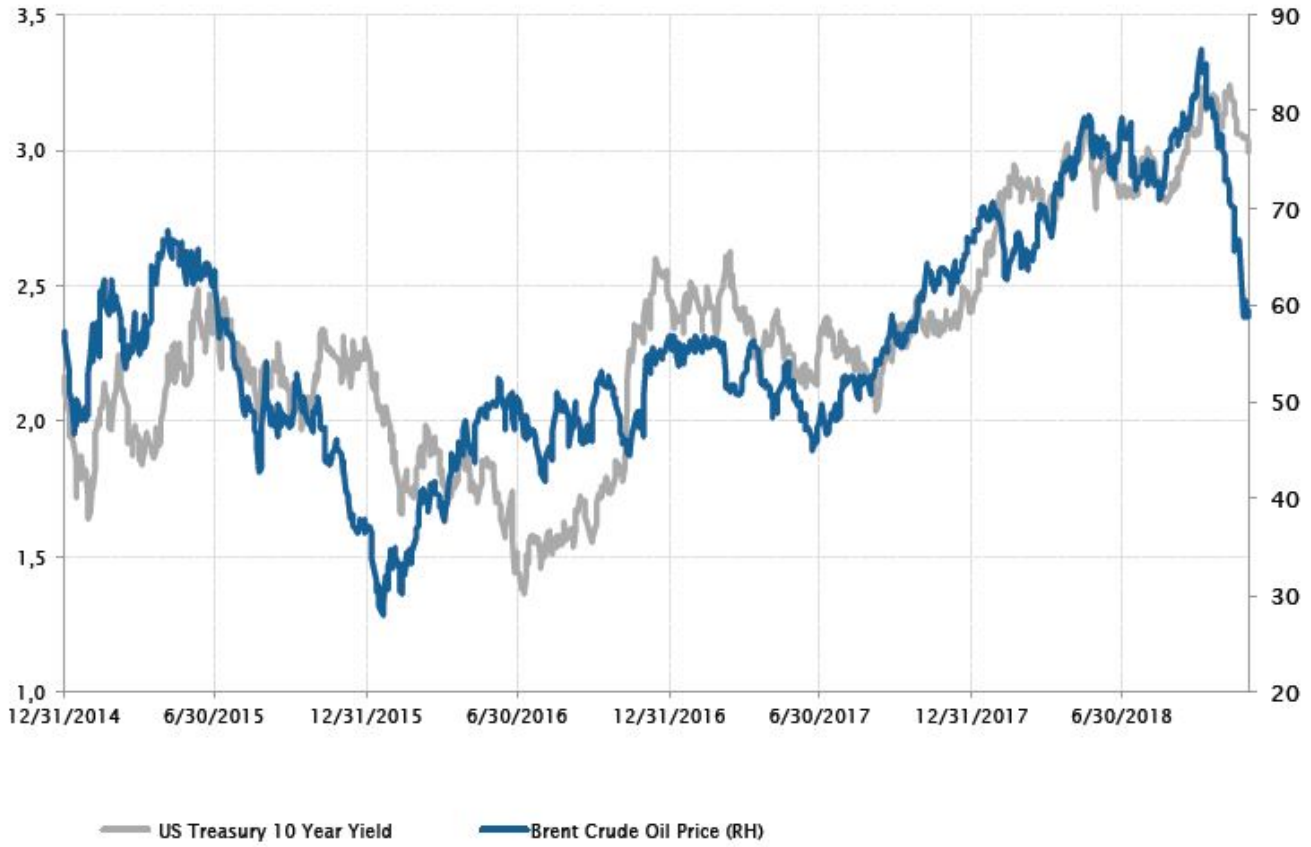
Emerging Market Hard Currency and Local Currency indices YTW (%)

Sources : Bloomberg, SYZ Asset Management. Data as at : 10 December 2018




US 10Y yield (%) and Brent spot price (USD/bbl) evolution

Sources : Bloomberg, SYZ Asset Management. Data as at : 10 December 2018






## Commodities – The oil sell-off

In November, the positive relationship between the US 10-year treasury yield and the oil price was broken. Brent finished the month down by more than 20% at $59 per barrel. This was also the worst month for West Texas Intermediate, down 22% since October 2018.

Other risky assets finished the month in positive numbers, but with monthly returns hiding some big intra-month moves. This rapid sell-off came on the back of fears of a market surplus similar to 2014. However, the Organization of the Petroleum Exporting Countries (OPEC) acted to stem the decline and stabilise prices at its December meeting, cutting production to maintain fiscal revenues. Moreover, US oil production is expanding at a rapid pace and has become much more reactive to its breakeven price.

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