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QUARTERLY OUTLOOK

Second Quarter, 2019

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UNITED STATES

The US was the first victim of the global growth slowdown, with 2018Q4 growth standing at 2.2%, following March's revision. Continuing to be the leading economic powerhouse in the world economy, a US slowdown is likely to ripple across the world, with the Federal Reserve going as far as commenting that there will be no rate hikes in 2019 and announcing that it will stop its sales of the securities it purchased during the QE periods.[1] Markets also appear to anticipate rate cuts during the year, with this pushing the US yield curve lower.[2]

Markets may be correct in their assessment of the future, as the risks specified in the previous quarterly outlook remain. The ongoing trade war with China, while it can gain some short-term gains for the US government in terms of income, can only be used for so long, as it has already raised prices for most consumer goods and pushed corporate profits down. China's unwillingness to depreciate the Yuan, with the currency returning to its July levels, prior to the imposition of the bulk of tariffs in September, means that most likely the cost will be passed on to the American consumer. Still, once the economy adjusts to this "new normal", inflation can return to its long-term target. President Trump does not appear willing to cut back on the tariffs though, given that he announced that they are to be maintained for a "substantial period" and despite the positive bits of news suggesting that progress is being made in the trade talks.[3] The revised NAFTA deal, called USMCA, has yet to get Congress approval.

The country, which faces a growing public debt burden, relies on GDP rising by at least as much as borrowing, in order to maintain its stable debt-to-GDP ratio. Naturally, tariffs are beneficial for the US government's income stream, as customs duties nearly doubled in the last quarter of the year. Whether this will be sustainable or not depends on the public's propensity to import at higher prices, as the current account deficit, which was one of Trump's main points, improved in January. Even though this will have a positive contribution to overall GDP growth, it could just be a one-off event related to the shutdown.

The absence of rate hikes is expected to be beneficial to the US economy, even though further dovish statements should hurt the **Dollar**. Still, the Dollar has managed to stave off its lows and is actually trading at one-year highs against the Euro, as the rest of the world is caught up in the Brexit and trade war uncertainties. Despite this upswing, prospects for the **Dollar** are mixed as lower growth, higher inflation, both affected by expectations for higher Oil prices, and lower future interest rate differentials, weigh against it, despite the ongoing uncertainty regarding Brexit and the impact of the trade war on Europe. Trump comments are likely to also cause short-term turbulence, especially related to the trade war.

The **USD10YR** bond yield has been declining as a result of the expectations for lower rates, further amplified by the fact that the slowdown is becoming more and more visible. As we have said in the past, our belief is that the major driver of higher bond yields would be the return of confidence in the US economy combined with a shift to riskier assets which offer higher yields compared to bonds.

The belief that the Fed would slow down its rate hike schedule pushed all indices (**US30, US100,** and **US500**) higher. Higher inflation and lower rates are beneficial to the stock market as it would create room for both price-based and volumes-based gains. Tariffs could also create some more profits for domestic producers although it could make obtaining the raw materials more difficult. The indices still appear to have room to go, especially if beneficial political agreements are reached, including the confirmation of the USMCA deal, a relaxation of the China tensions, and the reaching of a final agreement between Washington and Pyongyang which could provide a political boost to the Trump administration.

[1] https://www.reuters.com/article/us-usa-fed-balancesheet/fed-announces-plan-to-end-balance-sheet-runoff-in-september-idUSKCN1R12QA
[2] https://analysis.hotforex.com/yield-curve-inversion-does-not-mean-recession-yet
[3] https://analysis.hotforex.com/post-fed-the-only-winner-is-trump

All data and references for the above were obtained from the following sources (unless otherwise specified): HotForex Analysis (various articles), HotForex Economic Calendar, and the MT4 platform.

EURO AREA

The **Euro** area saw its fourth quarter economic performance being worse than expected, at 1.1% y/y, appearing to have also been affected by the ongoing global trade tensions. At the same time, the annual inflation rate stood around 1.5% in the past couple of months, lower than the "close to but below 2%" ECB target. **The major political issue still relates to the Brexit discussions**, where the unprecedented delay, attributed to the non-agreement of the UK Parliament regarding the precise Brexit format they would like to follow, should come to an end by April 12 or May 22 in the case of a second extention. Still, given the barrage of delays and inability to agree on the type of Brexit, nothing can be ruled out, with even the possibility of stopping the process altogether being an option.

As expected, and as discussed in the 2018Q4 outlook, the UK has little bargaining power but, while a Brexit deal is likely to satisfy most of the EU's requests and address its concerns, it should be more beneficial to the UK. This benefit would likely be reflected in a stronger Sterling, given that uncertainty surrounding the issue will be resolved. Still, the EU could reap the longer term benefits given that **a considerable portion of the UK financial services industry has activated a plan to relocate to the EU,** with many others having their plans ready.[4] The EU's discretion regarding a Brexit extension is bounded by the European Parliament elections, to be held on the 26th of May. As the European Parliament has already announced, its size will decrease following the UK's exit.[5] Country elections are also expected to take place in Q2, notably in Belgium, Denmark and Spain.

Just a month after the abandonment of Quantitative Easing (QE), **the ECB retorted with TLTROs**, aiming to safeguard the financial sector's access to cheap funding while at the same time ensuring that these funds are aimed at new lending.[6] Growth eased in the final quarter of the year, standing at 1.2% y/y, compared with an annual average of 1.45% in the previous three quarters. As also discussed in the previous Quarterly Outlook, **Italy is the region's weakest link**, facing negative growth rates in the last two quarters of the year, and officially entering a recession for the third time in the past 10 years.[7] The country still faces a mountain of issues as the local government does not appear willing to push through economic reforms, and still blames the external environment for the recession. If the low growth regime persists then it would not be surprising to see Italy in need of an official assistance package by the end of the year.

Germany is the other country where growth appears to have stalled, barely avoiding a recession by registering zero growth in the last quarter of 2018.[8] The country, whose export sector performance was admired a couple of years ago, appears to have been one of the largest victims of the ongoing trade tensions, with the automobile sector being one of the hit.[9] Still, the country's biggest issue lies within the country, as Deutsche Bank, Germany's largest lender, continues to face an array of problems, with investors taking a negative view of the bank's creditworthiness, doubling its funding costs and causing its shares to lose more than half their value in 2018.[10] The publicized merger talks with Commerzbank are still at an early stage and it is as yet uncertain whether EU regulators will accept it.[11]

The ECB pushed the rate hike schedule to the end of the year, even though this is unlikely to take place, especially if other Central Banks do not raise rates either. As such, there should be no fundamental change to the **Euro** from an interest rate differential point of view, while it could benefit from a Brexit agreement, economic growth should remain lower than the United States. On the stock market front, the **GER30** has been following the overall upwards trend but could also register some idiosyncratic effects if the weakening in the German economy continues. The **NETH25** and **FRA40** followed a similar path as the **GER30**, while the **SPA35** movement continued to outperform, something also related to the country's still high unemployment rate and BBVA's exposure to the shaky Turkish economy.[12]

[4] https://www.theguardian.com/politics/2019/feb/01/one-three-uk-firms-activate-plans-move-operations-abroad-no-deal-brexit-iod-survey
[5] http://www.europarl.europa.eu/news/en/press-room/20180202IPR97025/size-of-parliament-to-shrink-after-brexit
[6] https://www.reuters.com/article/us-ecb-policy-explainer/explainer-what-is-the-fuss-about-european-central-bank-tltro-loans-idUSKCN1QL1HP
[7] https://www.theguardian.com/world/2019/jan/31/italy-slips-into-recession-for-third-time-in-a-decade-economy
[8] https://ec.europa.eu/eurostat/documents/2995521/9573370/2-14022019-AP-EN.pdf/74195ad7-ce17-4c2f-b86c-c990c938bf30
[9] https://www.dailysabah.com/automotive/2019/01/14/german-car-industry-head-concerned-about-us-trade-war
[10] https://www.bloomberg.com/news/articles/2019-02-01/how-deutsche-bank-drifted-into-its-whirlpool-of-woes-quicktake
[11] https://www.ft.com/content/fe910f7e-4412-11e9-b168-96a37d002cd3
[12] https://ec.europa.eu/eurostat/documents/2995521/9628005/3-01032019-BP-EN.pdf/fdee8c71-7b1a-411a-86fa-da4af63710e1

JAPAN

The Yen has not made significant moves in the past two months, trading in the 109.80-111.60 range**.** While not making strong movements, **the Japanese economy appears to have been able to support a stable inflation rate for the first time in years**, despite mixed retail trade, consumer spending, and trade deficit performance. BoJ is not likely to increase interest rates at this point or in the near future, especially as Central Banks all around the world are preparing for potential rate decreases. A weaker Yen is usually beneficial for the Japanese economy as it assists in funding its huge export industry. No major political changes are expected in the country. The **JPN225** has been moving positively to these developments, gaining more than 6% since the beginning of the year, in line with all the major stock markets in the world, although it appears to have stabilized in March. As expectations of a rate hike are near-zero, positive developments are expected in the near future for the Japanese economy, and given its safe haven status, the Yen could potentially benefit in the longer-term, even though its negative interest rate differential could be a hurdle.

UNITED KINGDOM

Sterling gained and lost again with respect to both the Euro and the Dollar as the UK Parliament appears incapable of reaching an agreement with regards to the desired form of Brexit. As the deadline of April 12 fast approaches, markets have accepted that a no-deal scenario is the most likely case, with **Sterling** moving back to the vicinity of 1.30, after surging as high as 1.34. The December lows at 1.25 may not appear so improbable, especially if a no-deal Brexit is confirmed. No-deal Brexit should be overall negative for both the **Sterling** and the UK economy, as it would likely lead to lower exports, in both services and goods, coupled with higher inflation rates. BoE is likely to intervene and raise interest rates around the no-deal day, which should provide an additional obstacle for growth.

As a result of the above, the **UK100** has been underperforming most other European and international indices, as the market drops each time the UK Parliament fails to make a decision. The Index, which will likely react positively to a Brexit deal, as will the rest of the economy, will also react with losses in the face of no-deal Brexit, coupled with higher inflation and rate hikes, which will harm both profits and future potential. Increased risk aversion in the country has also pushed the **UK Gilt** higher, lowering the yield.

AUSTRALIA

House prices continue to decline in Australia, as Q4 data have shown, something which could affect the already large amount of interest-only housing loans.[13] As RBA has acknowledged the decline in housing, focus now turns to how important housing's effect will be on the banking sector, which has already been reducing the availability of credit, and how this deleveraging will affect the overall economy. As house prices drop, banks will be either unwilling to refinance them or demand higher interest rates, as collateral price will decrease. **While the RBA hasn't made any comments, it would not be surprising if Australia's central bank follows with a rate cut by the end of year,** following a similar path as the RBNZ, in an effort to stimulate the economy and ease pressures on borrowers.[14] On the political front, the next election date is in May 2019, when House of Representatives elections are due to take place. The **Aussie** has been trading mostly flat against the **Euro** and at a gentle downwards trend against the **Dollar**. Despite currency troubles the **AUS200** still remains strong, even though underperforming the US and European indices. The country's exporting sector is reliant on the growth of the Chinese economy and is expected to face serious issues in the case Chinese growth continues to decelerate, a result of both domestic and international issues.[15] The combination of a trade slowdown with housing deceleration, along with a deleveraging banking sector could prove deleterious for the country, even though it is still too soon to tell the extent of these effects.

[13] Source: Reserve Bank of Australia.
[14] https://www.bloomberg.com/news/articles/2019-03-27/rbnz-holds-rate-at-record-low-says-next-move-could-be-down
[15] https://www.focus-economics.com/countries/china/news/gdp/economic-growth-continues-to-decelerate-in-q4

CANADA

The **Loonie** has been on the losing end of its exchange rate versus the **Dollar**, while it has also been gaining ground against the **Euro**. BoC appears to be following in the Fed's footsteps regarding interest rate movements, with the latest communication being in line with the "wait-and-see" stance, even though this could potentially change to rate cuts by the end of the year, especially if trade tensions continue and a low Oil price prevails. Canadian GDP also showed signs of weakness in the fourth quarter of 2018, growing by 0.4%, its lowest level since 2016Q2 and far below analyst forecasts of 1.2%.[16] On the political front, PM Trudeau's government found itself in the epicenter of a political crisis with two ministers resigning after allegations that a former attorney general has been pressured by politicians to settle corruption charges against an engineering firm.[17] The overall fallout from the scandal is likely to hurt the Canadian economy, even though not to a large extent, given that federal elections are due in just eight months and a change in the political regime may occur. As such, **the Loonie is more likely to be affected by the USMCA deal and the US-China trade war, and mostly from the price of Oil,** which, if OPEC sticks to its production cut schedule, should be beneficial for the currency.[18]

SWITZERLAND

The **Swissy**'s safe haven status appears not to have been able to abscond it from losing against the **Dollar**, trading around parity since mid-February, after dropping as low as 0.975 in the beginning of the year. The drop could have also been due to FX interventions by the SNB, a policy that was widely used in the past, even though it has become less popular in recent years.[19] Weak GDP performance in 2018Q4, despite the return to growth after a 0.3% contraction in Q3, and overall deteriorating global conditions have made the Swiss government cut its 2019 forecast to 1.1%, just weeks after reducing it to 1.5%.[20] The country, despite its bilateral agreement with the UK, still sees itself as being negatively affected from Brexit, mostly indirectly through the negative impact a no deal could have on European growth.[21] Although most Swiss goods are usually not much affected by changes in demand, trade tensions are also expected to have an impact on the country, as **a reduction in Germany's trade proceeds, its largest trading partner, could also spill over to Switzerland**.

EMERGING ECONOMIES

Out of all emerging countries, Mexico is the country which has registered relative stability in both its exchange rate and its economy in general, even though it is also a claimed victim of the global slowdown, with growth declining to 0.3% in Q4. The lower-than-expected economic growth is attributed to a slowdown in the industrial sector.[22] Mexico, which faced a presidential change in December, could benefit from the USMCA agreement, something which can be observed in the overall **Peso (MXN)** trend, which appears to be gaining on the **Dollar**.

Following a rate hike from the SARB in mid-December, the **ZAR** appeared to be gaining ground against the Dollar, but this has reversed despite staving off the recession in the first two quarters of the year and registering 1.4% growth in 2018Q4. Agriculture helped the country grow as it recovered after a drought. Mining declined as commodity prices declined in the last quarter of 2018. News of power cuts dominated the news in February after problems in the state power utility, which the government pledged to break after a bail out.[23] The Rand's prospects appear mixed in the near future and will undoubtedly heavily depend on commodity price moves.

[16] https://www.reuters.com/article/canada-economy-gdp/update-2-canada-economic-growth-slows-in-q4-rate-hike-unlikely-idUSL1N20O03Z
[17] https://www.ft.com/content/cc877bd8-3edd-11e9-9bee-efab61506f44
[18] https://www.cnbc.com/2019/02/12/opec-slashes-oil-output-in-january-pumps-just-above-oil-target.html
[19] https://www.bloomberg.com/news/articles/2019-03-21/snb-spent-only-2-3-billion-francs-on-interventions-in-2018
[20] https://www.reuters.com/article/swiss-economy-forecast/update-1-swiss-government-cuts-2019-gdp-growth-forecast-again-idUSL8N2111E5
[21] https://www.reuters.com/article/swiss-economy-gdp/swiss-more-gloomy-about-2019-even-as-q4-produced-growth-idUSL5N20N18P
[22] https://www.reuters.com/article/us-mexico-economy/mexican-economic-growth-slows-in-fourth-quarter-idUSKCN1PO2E6
[23] https://www.reuters.com/article/safrica-economy-gdp/update-2-farming-boosts-south-africas-fourth-quarter-gdp-growth-idUSL5N20S2E6

The Turkish **Lira** appeared to have stabilized after Turkey's central bank raised interest rates and the government proposed a plan which included a cut in spending in order to control the unfolding currency crisis and mounting inflationary pressures. Nonetheless, after the central bank's decision to forbid overnight lending and push banks to borrow at a higher rate on a weekly basis, the **Lira** plummeted. Currently still trading at highs, pressures have relatively eased but pressure on the banking sector and borrowers remains, as inflation stands at 19.9%. Citizens have reportedly started exchanging their **Liras** for **Dollars** or **Euros** adding further pressure to the currency; those who borrowed in foreign currencies, including the Turkish government, now see the value of their loans increase, while their income still remains in **Liras**. **The outlook is not favourable for the Lira, with analysts setting targets as high as 5.90 for the currency**.[24]

In Asia, the **Yuan** appears to have shook off the effect from the Trump tariffs, gaining since October and currently trading at about 6.7 against the **Dollar**. While Donald Trump commented that tariffs are expected to continue in the near future, hopes of a trade agreement are moving sentiment in the Chinese markets. The Chinese economy appears to be at its worst stage in years, despite government efforts to boost domestic consumption. The on-going property bubble, with prices rising by as much as 31% since June 2015, an increase in official non-performing loans, and an overall heavy reliance on export markets suggest that **China may not have yet experienced the worst part of its year.**[25]

The Russian economy and the **Ruble** have responded in a much milder way to the trade sanctions imposed by the US. Despite showing notorious volatility, the Russian currency appears to be a winner in the exchange markets, even though a reversion has taken place in March. The question is whether the proposed Oil price cut will have the expected effects on the world's second largest Oil exporter, given that it could also mean a loss in volumes sold. For the moment, no change is expected from the Central Bank of Russia, which has already gotten a strong reputation by being willing to intervene fast and effectively.

COMMODITIES

Gold has been on an increasing trend since the beginning of the year as a result of the expected slowdown in world GDP growth, supported by lower than predicted GDP 2018Q4 results. At the moment, the price of **Gold** is fluctuating below the $1,300 mark, the level it has been around for almost two months. Uncertainty over the world's trade future, the overall indecisiveness regarding the whole Brexit process and, most importantly, expectations of interest rate cuts by Central Banks in 2019, were enough to assist Gold in maintaining its upwards trend, something also aided by the declining US Treasury yields, and despite stock market gains.[26] **As both developed and developing economies see their forecasts being downwards revised, Gold is expected to benefit in the near future.** This would be especially true in the case that central banks cut rates lowering asset returns, even though it would also benefit the stock market.

Despite its close correlation with the price of **Gold**, **Silver** has been on a downwards trend since February. The more dovish stance assumed by the world's central banks is expected to have a positive effect on the price of **Silver**, which derives most of its differences from **Gold** to the fact that it actually possess industrial uses. Even though these are forecast to grow moderately in 2019, uncertainty still remains regarding the precious metal's future. In the case forecasts materialize, demand could push the price higher, conditional on world **Silver** supply remaining constant, something which has not always been the case in the past.[27]

The price of **Oil** has been moving upwards since the beginning of the year, as OPEC has agreed to cut production. The decline in **Oil** supply appears to have been much stronger than the forecasted reduction in Oil demand, while downwards pressures are expected to continue especially if the slowdown in the Asia Pacific region, a previous growth engine, continues. Short-run fluctuations in US crude inventories driven by gasoline demand can justify small bouts in volatility, while the country is likely to expand its production and lead the way among world producers, as shale Oil provides a cheap alternative. **The long-run forecast for Oil remains that prices are expected to grow slowly but persistently**, especially in the case that trade issues among the US and its partners are resolved.

[24] https://analysis.hotforex.com/how-bad-is-turkey-doing
[25] https://analysis.hotforex.com/a-bleak-outlook-for-the-chinese-economy
[26] https://analysis.hotforex.com/yield-curve-inversion-does-not-mean-recession-yet
[27] https://www.silverinstitute.org/silver-market-trends-2019/