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OUTLOOK DEVELOPED MARKETS 2018

Table 1: Forecast Yields

Dec -2018	1yr	3yr	5yr
US	2.28%	2.37%	2.53%

*Based on Bloomberg Consensus forecasts for Q4 2018 utilizing N&S method for interpolation

For 2018 and beyond, we see a story of central bank policy normalization and foresee the global economy growing in a similar fashion to how it did in 2017: low growth coupled with comparatively low inflation data. In the US, we believe the level of the success of tax reform will be the key determinant on whether we see a positive outcome for economic growth and if it helps to spur inflation. We expect European data will improve, but investor sentiment will remain hesitant regarding debt and political sustainability and riskier elements of the European markets. China will continue to benefit further from their overall drive to rebalance the economy as the People's Bank of China (PBOC) continues to follow the Federal Reserve (Fed) in raising rates. Looking further east, we anticipate that Japan will remain steadfast in policy in the wake of Shinzo Abe's LDP election victory cementing the Party's Abenomics agenda for the next quadrennial.

Following tax reform changes one area of potential risk to watch will be the pressure being applied on the dollar as domestic companies repatriate offshore non-dollar cash. Looking at tax reform more broadly, we think it will take some time for the data to demonstrate the actual impact of tax reform and we will likely only see confirmation towards the latter half of the year. The combination of lower corporate taxes, lower personal taxes, capex deductibility and dollar repatriation will be positive catalysts for asset prices into 2018.

Monetary policy normalization poses a dilemma for the Fed. The market has one and a half implied rates hikes currently priced in, which disagrees with the Fed's view of three more hikes in 2018. With the positive effect of tax reform looming, we are observing economists calling for even more aggressive Fed forecasts for 2018, with expectations exceeding four or more hikes over the next year. In our view, a more likely scenario will be a more modest story for rates despite the increased potential of the US as the trend of low growth and inflation will persist. The more hawkish Central bank environment will likely only lead to a modest increase in short end rates, with the next live Fed meeting in March of 2018. With Powell at the helm, the Fed will retain its data dependent theme and we will need to see an increase in core inflation to push the Fed to three rate hikes in 2018. The new data point for market participants will remain the forward pace of expectations for Fed tightening. In terms of the yield curve, the current hiking cycle will remain the principal catalyst for the 2's 10's curve reaching zero at some point in the second half of the year based on the current trend.

We believe the European Central Bank (ECB) will remain quiet for the first few meetings of 2018 citing further data dependency. We are unlikely to have any indication of the continuation or termination of the QE program until the ECB meets in June. Volatility will likely remain persistently low, but return to normal levels in the latter half of the year as central banks gradually pull-back liquidity. We expect the Euro area's key trends of a solid growth momentum, combined with still subdued inflationary pressure, to extend into 2018. Soft inflation in the first half of the year will likely reinforce the ECB's gradualism on policy normalization with a significant increase in euro area rates unlikely in the first half of next year. We see carry value in peripheral issuers and expect the space to remain bid in the face of continued buying by the ECB. While European government bonds supply adjusted for the Public Sector Purchase Programme (PSPP) will turn positive we could see some moderate steepening of the curve around core issuers on the greater supply.

While unpredictable in timing, geopolitical risk is likely to flare up once more with the net focal point possible in Pyeongchang, South Korea during the Olympics. Italian elections will remain the next political event of note in Europe with the risk of the populist 5-Star Party gaining a foothold. US midterm elections which take place in November will also be noteworthy as polling indicates that Democrats could gain a majority in the Senate, which would make it even harder for Trump to pass his agenda through Congress. Brexit will likely remain a persistent source of background noise, but will nonetheless slowly progress with some tail-risk for a snap election if negotiations were to abruptly breakdown.

For Japan, we see a continuation of Abenomics in 2018 with interest rates held in a narrow range throughout the year. We expect Kuroda to remain BOJ governor, but do note that there is a degree of skepticism on his overall longevity. We see some tail risk to longer rates in the event we see a surprise change to policy, but largely expect any replacement to be even more dovish than Kuroda. We expect marginally higher core inflation, approaching 1.0% in the first quarter. We note the next consumption tax hike is some distance away as going ahead with the increase will effectively declare the end to deflation. We see US rates as the main driver for FX rather than Japan monetary policy going forward.

Brexit will dominate UK financial markets in 2018, and we remain doubtful that the UK will have sufficient time to negotiate a comprehensive deal ahead of even weaker data. Delayed investment and offshoring plans will remain persistent drags on real wages, GDP and consumption. With the slowdown, the Monetary Policy Committee will be faced with the dilemma of confronting the stagflationary effects spurred by the weaker currency and yet slowing economy. We do foresee the possibility of a deal, but are cognizant of the tail-risk the longer the dialogue drags on.

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