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Economic & Market Observations: **A Really Big Show**

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People past a certain age have fond memories of *The Ed Sullivan Show*, which presented variety acts on television every Sunday night. Ed's bookers were oddly attracted to Eastern European novelty acts. Among them were plate spinners, usually a family in leotards, who tried to keep multiple dishes whirling atop long sticks as the tempo of the music picked up. The audience mostly kept alert for the rare prospect of broken crockery.

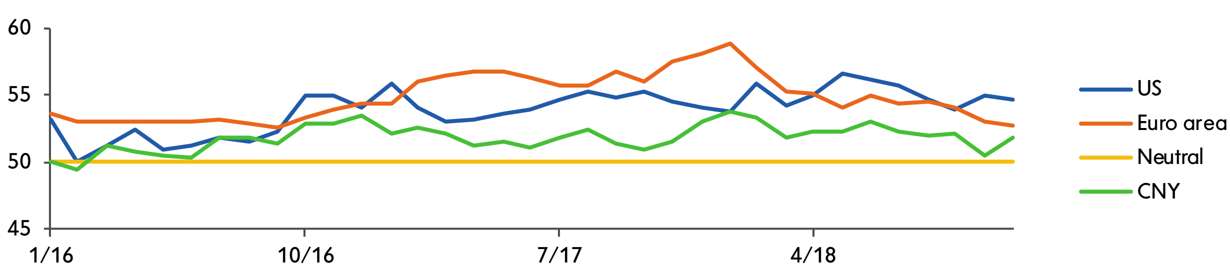
Describing the outlook for the global economy is a similar exercise. One plate is easy. The Federal Reserve (Fed) tightened at its December meeting because it told us it would. Multiple plates in motion are difficult. With data disappointments, disparagement of the Fed from the highest level of the US government, a wind-shear drop in equity prices, multiple political capitals where the centers do not hold and possible escalation of trade wars, the gyres of potential outcomes widen. Meanwhile, the soundtrack of *The Flight of the Bumblebee* speeds up. Our forecast would make one of those Eastern European families proud, with many parts in motion, a quick backbeat and a central tendency that leaves all the dishes intact. If so, the Fed sets a table for two to three quarter-point moves next year. Policy makers will not lead investors by the hand to that outcome with advance notice, as they seek a less intrusive position in market pricing and a smaller target for political criticism. Instead, we believe continuing intense pressure on resources and a pickup in inflation will drive this data-dependent result. This environment seems hospitable to selective risk taking in the credit market, is less propitious for corporate earnings growth, and offers opportunities where investors have inappropriately taken Fed action off the table.

The extension of a gradual, well-telegraphed removal of monetary policy accommodation tightens financial conditions and slows economic growth from its above-trend pace. For the past nine quarters, the Fed has undertaken this course, even as inflation mostly tracked below its two percent goal, on the theory that the low unemployment rate would push up costs. It did; inflation moved to their goal for a time, and equity investors were mostly unperturbed. Recent readings on inflation have flagged, and financial conditions have tightened a heap. However, the ticking lower in inflation probably owes to earlier US dollar appreciation and the drop in oil prices, which we think has about run its course. Thus far, the slowing in growth is to a pace still above trend, and the unemployment rate is as low as ever. The Fed's dirty little secret is that the slowing growth necessary to extend the economic expansion probably requires firmer financial conditions than current levels. This explains the pivot in policy communications, as it is more acceptable for data to drive the results than to state it as a plan.

The problem is that deceleration in activity, as seen in the tracking lower of purchasing manager indexes, is sometimes interpreted as disappointment. Indeed, a widely followed measure of cumulated surprises in economic data briefly dipped under water, but it is back to bobbing above the surface. Especially problematic for equity prices is that slowing US real GDP growth is likely to be associated with a more pronounced slowing in profit growth. Cost pressures will squeeze margins and the corporate tax cut is in the rearview mirror. The extant mood swings of equity investors likely owe as much to this as the discovery that Fed Chair Jay Powell may not be their best friend forever.

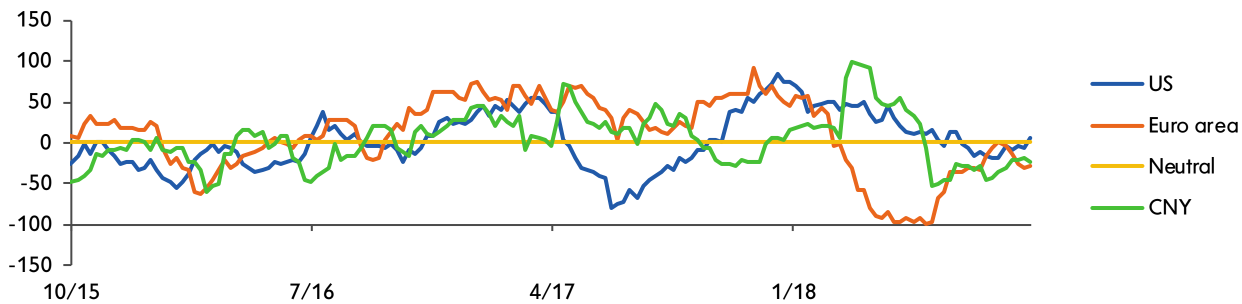
Manufacturing Purchasing Managers' Composite Index

Neutral = 50



Source: Markit, accessed via Bloomberg, 12/28/18.

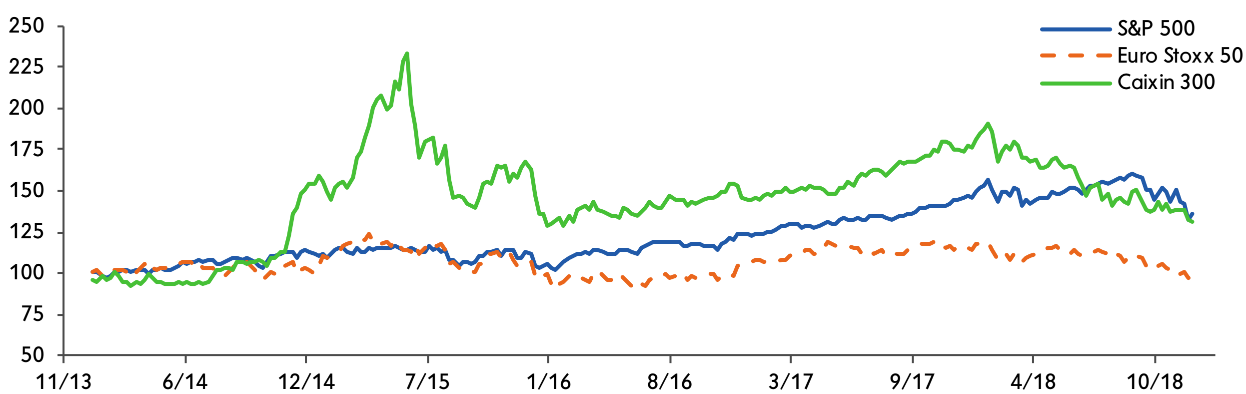
Economic Surprise Index
Neutral = 0



Source: Citigroup Markets, accessed via Bloomberg, 12/28/18.

Still, the US looks buoyant compared to conditions abroad. This probably reveals that, because trade is more important to our trading partners than to us, trade uncertainty weighs more on activity abroad. Economic surprises have run decidedly negative, and equity prices have taken a pounding.

Equity Price Indexes
1/3/14 = 100

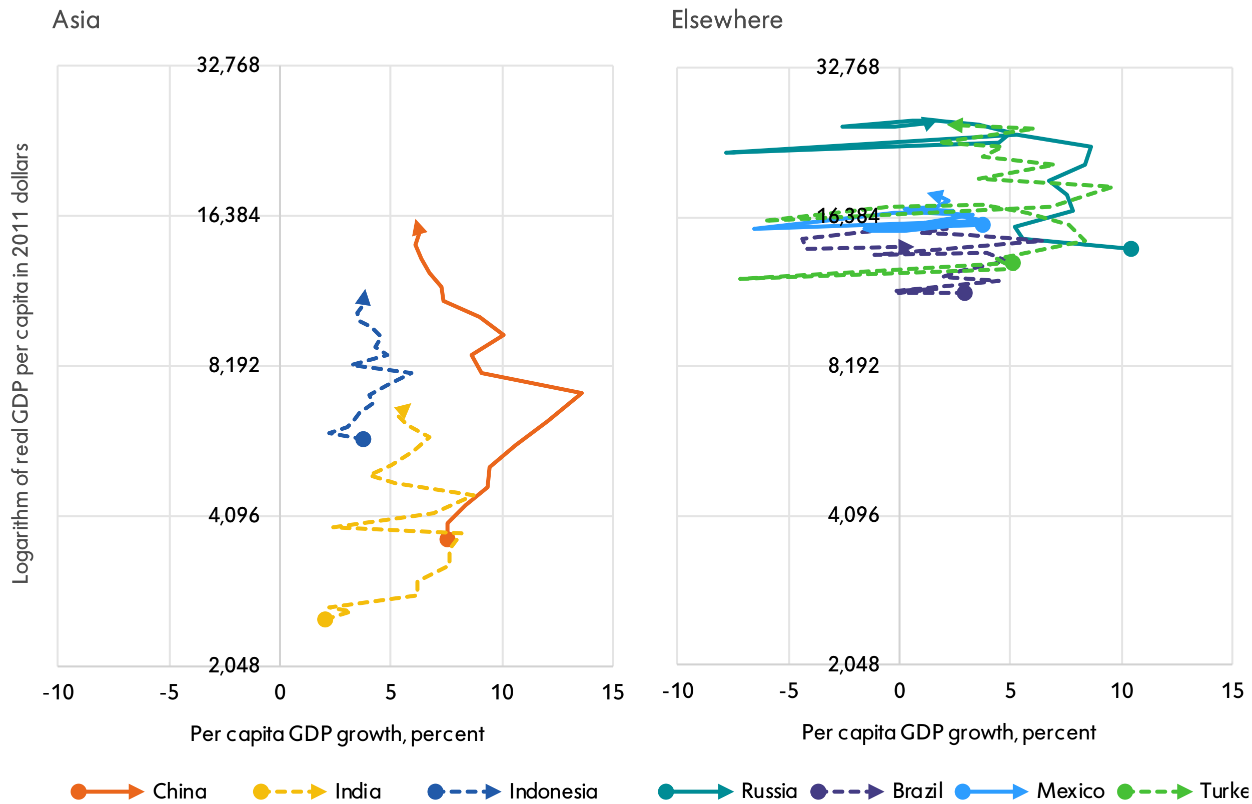


Source: Bloomberg, 12/28/18.

We expect US officials will tighten for the good reason that aggregate demand outstrips its supply if and only if inflation seems headed to its goal. The important global dimension fostering that outcome is that Chinese officials must acrobatically maneuver a shift toward domestic spending in order to replace flagging export growth as trade frictions increasingly crimp activity. They have managed to deliver economic growth at their five-year plan for most of the past three decades, and we think they will do so again. The chart on the next page lends confidence to this assessment by plotting this century's performance of real GDP per capita (measured in 2011 international dollars) for the current seven largest emerging market economies. The combination of real GDP per capita growth along the horizontal axes and the cumulated consequence for its level along the vertical axes are shown for the three Asian economies in the top seven at the left and the other four at the right. The rocket liftoff in thick orange at the left is China, where officials consistently delivered economic expansion in excess of 6 percent, producing a quadrupling of real GDP per capita this century (note that the vertical axis uses a log scale). This performance anchored regional progress, and the feature that China is still a middle-income country (below that of the economies in the right panel) indicates there remains room to run. The right panel reminds that the arrow of time is not ever upward, as erratic policies are associated with much less progress in advancing living standards and, perhaps, that growth is harder to deliver reliably from higher starting levels.

Level & Growth of Per Capital Real GDP

Seven largest emerging market economies in 2018



Source: International Monetary Fund World Economic Outlook (October 2018) and author's calculations.

Admittedly, the worry cropping up in this forecast is that Chinese officials may get to their target by permitting a more significant depreciation of the yuan than in our baseline. Regional competitors could then match this with depreciation of their own currencies, creating a headwind of disinflation that would prove awkward for our Fed call. President Trump has it within his ability to make the situation better or worse, depending on whether he dials the volume of his trade rhetoric down or up. Worse, for a time, is usually the best bet in Washington politics, but we do not think it will be permanent, as the incentive to cut a deal is too great on both sides.[1]

This creates risks to the front and back ends of our Fed call. On the front end, if equity markets extend their decline amid mounting concerns about the economic outlook, the Fed might take a pass on action in March. Those policy makers should, however, harbor three concerns about a planned pause, beyond the obvious problem that it is hard to restart a process once momentum is lost (think of Newton's first law). For one, the associated headlines will seem to ratify widespread worries about the economy that they probably do not sincerely share and foment financial excesses that they typically seek to avoid. For another, they must take as given that inaction will be widely interpreted as caving to withering presidential criticism, including from the source itself. Lastly, if our forecast (which seems similar to their own) eventuates, the same commentators criticizing the momentum to action now will express doubts about the Fed's inflation resolve later.

On the back end, if the US dollar extends its appreciation and commodity prices stay soft but economic expansion otherwise progresses, policy makers will be legitimately less concerned about inflation and stop sooner—say after two more moves. For the global economy, the front-end fret is much more challenging, as the Fed slams on the brakes and, as in car-crash scenes in the movies, time slows down and everyone worries if the stop was too late. On the back end, the Fed would be tapping on the brakes to get more mileage from this business cycle.

There are other potential wobbly parts of our economic outlook. The fissures in the political landscape in the UK and Italy are wide. An orderly exit for the UK from the European Union still seems the best bet, but it is not a very good one. Italian politics is often confusing from the outside (and inside), but we take this as noise. Meanwhile, Brazil and Mexico are conducting real-time experiments in governance from opposite ends of the political divide. (The prior chart on growth convergence reminds that this is a repeated experiment. Officials in Brazil and Mexico have made unsteady progress in advancing real GDP this century so that their arrows do not point assuredly upward). Our forecast does not require an outbreak of cooperation around the world, only the relative absence of outright dysfunction.

The message for the future of our forecast from past plate spinners is that they usually got it right because the pieces of the act fit together and were supported by experience. Global growth will trundle along as the US economy cools to a more sustainable pace. Fed Chair Jay Powell is not throwing in the towel on tightening and the economic expansion is not rolling over. Chinese officials will succeed, once again, and those in Europe and Latin America are not active agents of dissolution.

World

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	3.3%	3.2%	—	3.0%	—	2.8%	—
Inflation	2.4%	2.9%	—	2.8%	—	2.6%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

United States

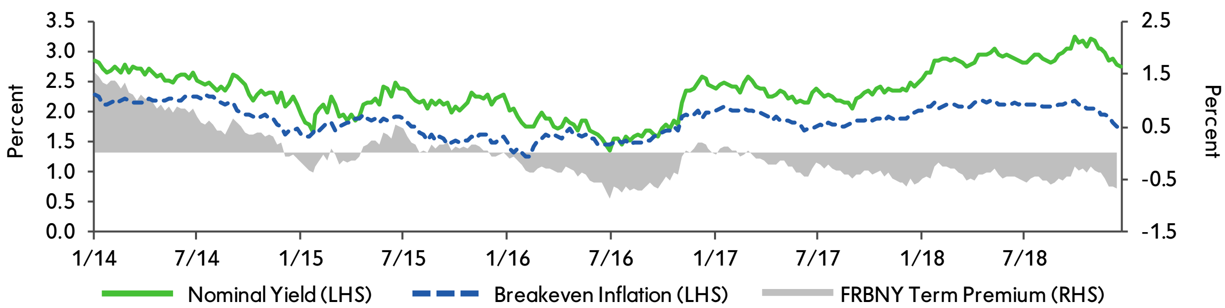
	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	2.3%	3.0%	—	2.3%	—	1.6%	—
Inflation	2.1%	2.3%	—	2.2%	—	2.1%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

The forecast supports fundamentals for fixed income markets, less so for equities, suggesting that the flight to advanced economy sovereign securities and the widening in risk spreads is overdone. This favorable frame around current pricing led Mellon's Active Fixed Income investment committee to recommend taking opportunities to increase the risk budget, selectively. The avenues to do so are in our updated investment landscape for December, which is on page seven.

True, we worry more about US dollar appreciation lingering longer than in our outlook and pushing US inflation more sideways than up. That puts into peril the third of the three rate hikes we expect in 2019. Market participants have sliced much more from current policy expectations and the expected path of inflation. Our clearest conviction call is that this is overdone, which is why it is best to stay short-to-neutral duration in advanced economies and maintain an overweight in inflation breakevens. The shift away from the long end of the yield curve is not especially painful given the flatness of the term structure. Higher Treasury yields at shorter-term maturities provide attractive carry that should compensate for loss somewhat as the policy rate rises.

Ten-Year US Treasury Yields

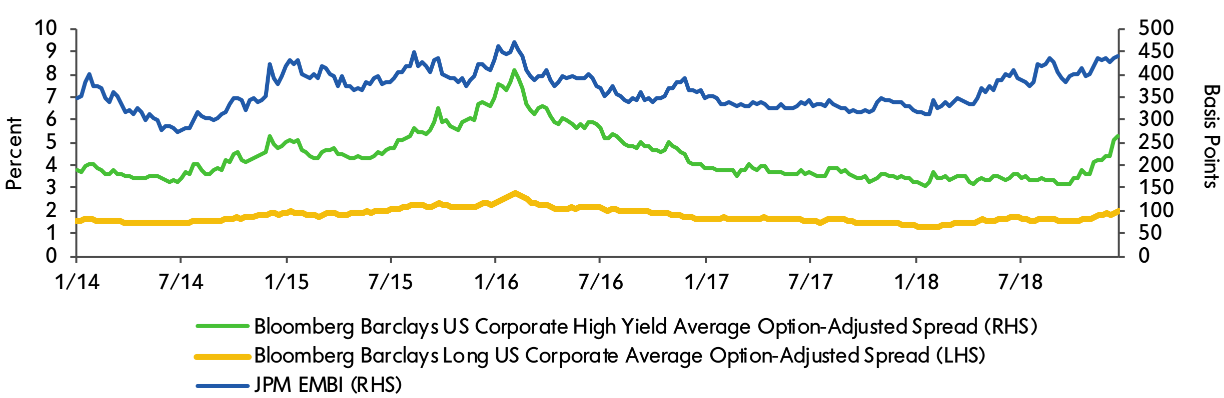


Source: Bloomberg, accessed 12/28/18. FRBNY is the Federal Reserve Bank of New York.

We retain enough conviction on the medium-term headwinds to the foreign exchange value of the US dollar to maintain a short exposure, but preferably when possible through options strategies given the greater weight in the tails of the potential outcomes. US dollar depreciation, a rebound in commodity prices, and steady-if-not-stellar global economic expansion implies that there is value in emerging market debt, both US dollar- and local-currency denominated. There is also considerable idiosyncratic political risks, so increased exposure should be selective when opportunities arise.

There is a similar tug of war in credit valuations. The risk-off mood in many markets is too sour given current economic conditions. So there is value in some investment grade securities, but as earnings growth slows and interest rates rise, fundamentals are likely to soften over time. We think there are opportunities to add investment grade exposure, emphasizing credit quality. This concern about the deterioration of credit fundamentals in response to a Fed-engineered economic slowing suggests avoiding the higher-beta corporate space; notwithstanding the substantial recent selloff, high yield debt seems somewhat expensive.

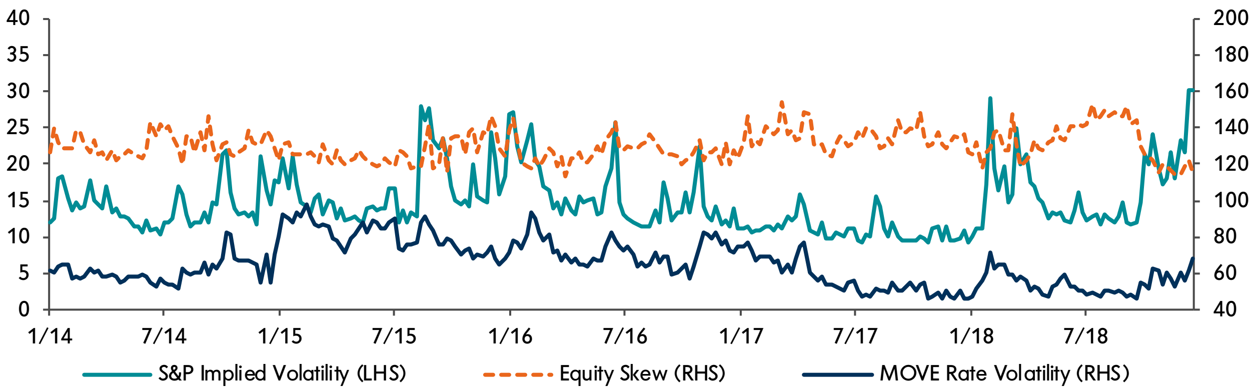
Selected Yield Spreads



Source: Bloomberg, accessed 12/28/18.

Volatility has risen, to be sure, but it is still cheap enough in the fixed income space to use options strategies where appropriate to reflect our views and keep portfolios sufficiently convex. A window has opened: take idiosyncratic opportunities to add risk given improved valuations in important asset classes.

Implied Volatilities



Source: Bloomberg, accessed 12/28/18.

Mellon's Investment Map December 2018

Economic Landscape

Global economic growth is expected to slow modestly as the Fed removes financial accommodation, but multiple political risks cloud the economic landscape.

Still, the current level of DM economic activity is above potential and cost pressures are building.

Chinese officials are likely to meet their goal for economic growth (at the cost of slowing reforms and worsening the national balance sheet), supporting commodity prices and other EM economies.

US-dollar appreciation and the drop in energy prices have been a recent, but only temporary, drag on inflation.

The Fed will likely tighten modestly more and be more willing to tolerate volatility than currently thought by most investors.

Other DM central banks are moving, albeit slowly, to renormalize monetary policy.

Fixed-Income Valuation

Pressures on resources in DM economies make their sovereign yields expensive.

Breakevens offer value and provide inexpensive protection to upside surprises to inflation.

The US dollar appears expensive against other developed and emerging market currencies.

Valuations of investment grade corporates have improved, but fundamentals are likely to soften.

Despite the selloff, high yield spreads remain somewhat expensive.

There is value in emerging markets local currency and dollar debt, but market and political uncertainties are elevated.

For institutional investors, municipal assets are for the most part fairly valued, with the long end relatively attractive.

Interest rate volatility is low but will likely rise.

Higher short-term Treasury yields provide attractive carry at the short end that will offset capital losses some as rates rise.

Securitized products have become more fairly priced.

Investment Themes

Be short to neutral duration in core DM sovereign securities.

Maintain short US-dollar exposure, where appropriate through option strategies given increased probability of tail risks.

Maintain modest exposure to breakevens.

Look for opportunities to increase exposure to EM.

There is room to add credit exposure, emphasizing quality.

Maintain a bias to intermediate- and longer-duration municipal securities where appropriate.

Retain the modest underweight in MBS and emphasize ABS versus CMBS.

Use option strategies with minimal cost to keep portfolios sufficiently convex.

Take idiosyncratic opportunities to add risk given improved valuations.

As of 12/17/18.

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

Global Macro Views

Euro Area

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	2.4%	1.7%	↓	1.6%	↓	1.5%	—
Inflation	1.5%	1.8%	—	1.6%	—	1.6%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

As we enter 2019, we expect the European Central Bank (ECB)—under the leadership of outgoing Governor Draghi—to complete the process of normalizing monetary policy. This will include the culmination of quantitative easing and a 15 basis point interest rate hike in autumn 2019 that will set the tone for further rate increases. We do not expect the recent uncertainty caused by Brexit or Italy's new government will derail the ECB from this path.

While it is difficult to predict who will be the next ECB Governor in November 2019 (a decision complicated by the intersection of new appointments at the European Council and Commission), we expect the next ECB Governor to be of a more hawkish vintage—albeit constrained by the path that Draghi has laid out.

When it comes to politics, we expect the Italian government to maintain their headline-grabbing status in its conflict with the European Commission as the far-right-led League government pursues an early election and its own electoral mandate. Italian elections in autumn 2019 could be accompanied by national elections in Spain, Portugal and Greece, leading to a busy and volatile year in European politics.

United Kingdom

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	1.6%	1.4%	—	1.8%	↓	1.6%	—
Inflation	3.0%	2.7%	—	2.4%	—	2.4%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

The UK outlook revolves around one issue, Brexit, whose outcome is set to determine economic conditions for the year.

Our base-case scenario (with a 65 percent probability) is for the deal agreed by Prime Minister May with the European Union to be approved by the UK Parliament (although perhaps not on the first vote, stretching the uncertainty into January 2019). However, we also place a 20 percent probability on a "No Brexit" outcome (likely accompanied by an early election or second referendum), and a 15 percent probability on a "No Deal" outcome where the UK leaves the EU without formal relations. The expected Brexit "deal" encompasses both the legally binding Withdrawal Treaty and a non-binding political declaration about the framework for the future relationship between the UK and the EU. Crucially, it is the "backstop" arrangement—which seeks to ensure there is not a hard border on the island of Ireland—that is the most controversial.

In our base-case scenario of a deal agreed between the UK and EU, we expect the Bank of England (BOE) to turn more hawkish in their communications in February 2019 before raising rates by 25 basis points to one percent in May 2019, which is more than is currently priced by the market. We expect investment to return as uncertainty abates, and inflation to remain relatively stable albeit with a tight labor market and upward wage pressure presenting upside risks. We also expect a similar outcome in the case of a "No Brexit" although the growth rebound would likely be stronger. Meanwhile, in the case of a "No Deal" we expect a recession in 2019 and elevated inflation, which keeps the BOE on hold (with a tightening bias).

Australia

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	2.3%	3.0%	—	2.7%	↓	2.5%	↓
Inflation	2.0%	2.3%	—	2.1%	—	2.1%	↓

Firm analysis as of 12/6/18. BoR = Balance of Risks.

New Zealand

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	2.9%	2.6%	—	2.3%	↓	2.5%	—
Inflation	1.9%	1.9%	—	2.2%	↑	2.3%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

Australia recorded a surprisingly robust first half of growth, with the $1.4 trillion economy set to grow above three percent in 2018. A strong labor market has driven the unemployment rate lower to five percent, yet wage growth remains subdued. The Reserve Bank of Australia (RBA) will be encouraged by the economy's performance in 2018, and we expect the next move in the RBA cash rate to be up, not down. However, we don't expect a hike anytime soon. In our view, the RBA will remain on hold into 2020 as the housing sector faces challenges and credit growth is slowing.

Sydney and Melbourne housing markets continue to show signs of weakness. Our base case is for home prices in those capital cities to fall 10 percent from their peak, not a disaster considering the rapid run up in prices over the past few years. That said, falling home prices and slowing mortgage credit growth should stay the RBA's hand.

In New Zealand, the Reserve Bank of New Zealand (RBNZ) has walked back some of its dovish tone as inflation and growth came in above target. Business confidence is holding steady at weak levels, raising concerns over future investment and employment conditions. Our base case is for the RBNZ to keep rates on hold well into 2020, but if poor business confidence were manifested in weak growth outcomes, we would expect monetary easing to occur. Expansionary fiscal policy should be a tailwind for inflation next year, but we believe the RBNZ can look through periods of inflation above two percent (its target midpoint) without initiating a tightening cycle.

Japan

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	1.7%	1.0%	—	1.1%	↓	0.9%	—
Inflation	0.7%	1.2%	—	1.4%	↓	1.5%	↓

Firm analysis as of 12/6/18. BoR = Balance of Risks.

Japan's growth outlook will moderate, but not slump, in the next two years. To be sure, we believe annual growth will be marginally firmer in 2019 versus 2018. This is because Japan's economy was buffeted by bad weather during the first quarter of 2018 and natural disasters in the third quarter; consequently, a lower base effect will flatten the yearly growth rate in 2019. However, the economy will struggle to expand much beyond its long-term trend as external demand ebbs more palpably in 2019 alongside the effects of a consumption tax increase, as well as structural headwinds from a shrinking total and working-age population. The main source of waning external demand is the weakening outlook for US and Chinese GDP growth. However, we do not expect a slump in the macro outlook. A competitive currency, structural reforms and tight labor markets will underpin private demand through resilient corporate profits and steady increases in wages and bonuses. These should also raise inflation more durably above one percent, but the Bank of Japan's (BOJ) two percent goal will remain elusive.

This macro backdrop poses a conundrum for the BOJ, which wants to keep monetary accommodation intact but has also become increasingly worried about the side effects of ultra-low interest rates and continuing absorption of Japanese government securities—which are thinning bond market liquidity, raising economy-wide financial gaps and compressing the net interest margins of the regional banks. We think the recently loosened yield curve targets within the existing policy framework and a slower pace of asset purchases provide some breathing room. There is also some scope for macro-prudential tools to tackle financial risks.

The main reason we think the BOJ will prefer to wait until 2020 before taking additional normalization steps is that they will want to gauge the impact on domestic demand from the consumption tax increase. The coronation of a new emperor in 2019 and hosting the Olympics in 2020 should place a floor beneath domestic demand risks. However, the key driver of the downward balance of risks emanates from an intensifying Sino-US trade war, to which Japanese multi-national corporations with their globally exposed supply chains, are somewhat vulnerable.

Emerging Markets

Asia

China

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	6.9%	6.6%	—	6.2%	↓	6.0%	↓
Inflation	1.6%	2.5%	—	2.2%	—	1.9%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

The Sino-US understanding reached at the G20 meetings in Buenos Aires during December 2018 froze an escalation in the trade conflict for 90 days. It is providing some respite for near-term sentiment and may help stabilize China's economy. This is important as the downdraft in hard data and purchasing manager indexes continued through the third quarter of 2018, despite the authorities' efforts to counteract the lagged impacts of financial de-leveraging.

One reason why policy stimulus has not been as potent is that credit easing is losing its effectiveness and the stimulus has been more hesitant relative to previous easing cycles. The sharp run up in aggregate debt coupled with the authorities' efforts to distance themselves from a widespread perception of implicit debt guarantees has elevated credit risk premiums. It has come about even as short-term rates have declined, additional liquidity has been infused into the banking system, and the intensity of the crackdown on off-balance-sheet activity has been dialed back (though not completely overturned).

As a result, the burden of onshore stimulus is increasingly shifting to fiscal channels. Authorities have delivered tax cuts for households and corporations and issued “special bonds” to speed up infrastructure investment. We expect fiscal policy to continue to do more of the heavy lifting through 2019 and 2020. This should speed up a rebalancing of Chinese demand toward more consumption. But, it will also accelerate the diminution of domestic savings and erode the country’s external balance. In turn, we believe elevated debt and policy constraints from a weakened external payments balance will keep GDP growth from rising much faster than a low-6-percent handle.

The possibility of a resumption of the trade war with the US lends downside risk to our growth forecast. In particular, restrictions on China’s high tech exports and steep hurdles in the way of technology transfers and foreign direct investment inflows would come as a supply-side shock, which could slow China’s growth potential and will need additional stimulus policies.

A more sustained breakthrough in the bilateral relationship, which actually begins to lower trade tariffs, would alter the macro outlook for the better. For now, in our base case, we remain skeptical. This is because of promise fatigue, which has set in within the US bureaucracy about the Chinese ever actually fulfilling oft-repeated pledges of deep structural reform. Meanwhile, the Chinese have grown increasingly wary of the US ever tolerating the rise of a putative rival that can threaten its technological or geopolitical primacy.

The Central Economic Work Conference (CEWC) met in the third week of December to frame macro priorities and contingencies for 2019. Early next year, shortly after the Chinese New Year (i.e., by the beginning of March), the authorities are widely expected to formally give themselves some policy space by softening the GDP growth target to “6 percent to 6.5 percent” from “around 6.5 percent.”

South Korea

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	3.1%	2.8%	—	2.7%	↓	2.6%	—
Inflation	1.9%	1.9%	—	1.8%	↓	1.7%	↓

Firm analysis as of 12/6/18. BoR = Balance of Risks.

We expect South Korean GDP growth to ease through 2020 and remain below its long-run average. Despite a decent run of electronics and semiconductor exports, sluggish construction activity and lackluster consumption have become the main drags on growth. Curbs on housing market bubbles have hurt the construction sector, and a pro-labor tilt in policies and regulations have backfired and resulted in labor shedding. Further, the tech-led export cycle has been largely capital intensive, not labor intensive. Additionally, the recovery of Chinese tourism flows has also been slow. All of these developments have resulted in considerable slack in labor markets and kept core inflation well below the headline rate as well as the Bank of Korea’s (BOK) two percent inflation target. Despite these trends, a small bump up in inflation, from adjustments to administered prices, provided the excuse to the BOK to raise policy rates by 25 basis points at its November 30 meeting. However, we think this is a one-and-done event with an eye to taking out some policy insurance against the risk of a future downturn. South Korea’s economy is heavily reliant on external demand, and the policy framework is extremely reticent with counter-cyclical policies. In this backdrop, we can’t see much growth or inflation upside in the foreseeable future amid waning global demand and the looming risk of an intensification of the Sino-US trade tensions.

India

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	6.6%	7.4%	—	7.2%	↑	7.7%	—
Inflation	3.8%	4.4%	—	4.3%	↓	4.2%	↑

Firm analysis as of 12/6/18. BoR = Balance of Risks.

The post-GST growth recovery, culminating in an above-trend yearly rate of 8.2 percent growth in the second quarter of 2018, has been interrupted by several headwinds. Funding strains in the non-bank financial (NBFI) sector has curtailed credit growth; the oil price surge through October 2018 has been largely passed on to the retail level—alongside high excise taxes on fuel products. Finally, the institutional tension between the Reserve Bank of India (RBI) and the Indian government over the transfer of "excess" reserves dampened investor sentiment and fueled portfolio outflows amid a widening current account deficit. These trends have tightened financial conditions and sharply slowed India's GDP growth in the third quarter to 7.1 percent on a yearly basis. Looking ahead, several of these headwinds are turning into tailwinds. Oil prices have subsequently slumped more than 25 percent, tensions between the RBI and the government have abated, and the Fed has signaled more data dependency in its projected path of policy tightening. Alongside a gradual normalization of domestic credit, normalizing external conditions bode well for a calibrated easing of GDP growth in 2019 and a broad-based pickup in 2020. To be sure, national elections scheduled in April 2019 will add some uncertainty to the outlook for investment. However, improving terms of trade coupled with ample policy buffers—high real rates and rate differentials versus US rates, as well as large currency reserves—should anchor confidence-sensitive flows and underpin a stabilization of macro conditions.

Latin America

Brazil

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	1.0%	1.3%	—	2.4%	↑	2.4%	—
Inflation	2.9%	3.5%	↑	4.1%	↑	4.2%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

In Brazil, there are great expectations on the reform agenda of President-elect Jair Bolsonaro. The incoming government has not only promised a reform to the social security system, they promised a deregulation program, privatizations and a reduction of current expenditures. The main objective is to reduce debt sustainability risk and boost economic growth. We think investors are not concerned about the direction of economic policies, but they are concerned about the implementation of these reforms as the new government does not have experience in legislative processes and the Brazilian Congress is very fragmented. Bolsonaro has been in Congress for several years, but he has not been able to form coalitions. We think it is imperative for Brazil to pass a comprehensive social security reform that can reduce the pension burden on the federal budget. Otherwise, the current spending cap will be binding by 2020 to 2021 and will likely become unsustainable.

The Brazilian economy expanded 0.8 percent in the third quarter of 2018 (quarter over quarter) from 0.2 percent in the second quarter due to a favorable base effect because of the truckers' strike that paralyzed major roads last

May. Gross capital formation jumped to 6.6 percent quarter over quarter from -1.3 percent in the second quarter, and exports bounced back 6.7 percent from -5.1 percent in the previous quarter. On a year-over-year basis, GDP expanded 1.3 percent in the third quarter from 0.9 percent in the second quarter. We expect GDP to accelerate to 1.4 percent in the fourth quarter, boosted by lower political risk after the election. We also expect the economic recovery to extend to 2019 as we see an expansion of 2.4 percent year over year, supported by a pickup in business and consumer confidence. We see upside risks for economic growth in 2019 and 2020.

On inflation, we see a gradual convergence to the target after two years of low inflation. We expect spare capacity to tighten, in particular in the labor market, and this will help to stabilize inflation around the target level. In particular, for 2019, we expect average inflation of 4.1 percent. For 2020, we see average inflation slightly above the 4.0 percent target. We expect the Brazil central bank to gradually remove the stimulus in order to converge to the neutral rate of 8.0-8.5 percent from 6.5 percent in the next 18 months.

Mexico

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	2.1%	2.1%	—	2.1%	—	2.2%	▲
Inflation	6.5%	4.9%	▼	4.1%	▼	4.0%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

Political risk is on the rise in Mexico after President Lopez Obrador suspended construction on New Mexico City Airport (NAICM) without taking into account the potential costs. In addition to this decision, the release of non-market-friendly policies have increased concerns about the direction of economic policies for the next six years. Lopez Obrador has opted for confrontation with the markets instead of conciliation, and his decision to suspend work on the New Mexico City airport ended the honeymoon he enjoyed with the markets after the election.

In the short term, the focus will be on the 2019 budget. Any potential risk on fiscal discipline will be credit negative for Mexico. We expect the Mexican peso to deteriorate on political news and to move toward the 21.0 pesos per US dollar in the short term. As expected, the central bank raised rates by 25 basis points to 8.25 percent on December 20. Further rate hikes are not ruled out and will depend on the evolution of the currency.

Economic activity been resilient to the different shocks faced in the last few years. Growth is close to potential levels between 2.0 percent and 2.5 percent due to the dynamism of consumption and exports. Public and private investment has contracted due to NAFTA uncertainty and political risks. We expect growth to stabilize around 2.0 percent to 2.2 percent in 2019 supported by exports, consumption and a gradual recovery of investment.

After the inflation pickup in 2017 to 7.0 percent, the disinflation process has been slower than expected due to different supply shocks and the depreciation of the currency. The convergence of inflation to the 3.0 percent target has been postponed one year to 2020. The central bank of Mexico has remained cautious and is likely to extend the tightening bias to 2019 due to the increase of idiosyncratic risks.

CEEMEA

Russia

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	1.8%	1.7%	↓	1.5%	—	1.6%	—
Inflation	2.8%	3.5%	—	4.5%	—	4.0%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

Turkey

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	7.0%	3.0%	↓	0.5%	↓	3.0%	↓
Inflation	11.0%	17.0%	↑	15.0%	↑	12.0%	↑

Firm analysis as of 12/6/18. BoR = Balance of Risks.

South Africa

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	2.6%	1.0%	↓	1.3%	—	1.5%	—
Inflation	5.0%	4.7%	—	5.0%	—	5.0%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

Poland

	2017	2018	BoR	2019	BoR	2020	BoR
Real GDP	4.3%	4.5%	—	4.0%	—	3.5%	—
Inflation	1.8%	1.8%	—	2.0%	—	2.2%	—

Firm analysis as of 12/6/18. BoR = Balance of Risks.

Heading into 2019, Central and Eastern Europe, Middle East and Africa (CEEMEA) must navigate important inflection points.

Central and Eastern Europe continues to mature and transition to a model more usually seen in developed markets and has experienced an elevated upswing in the business cycle. Domestic sources, albeit exposed to the sentiment of the German manufacturing cycle, will drive growth, while inflation slowly continues its rebound. CEE central banks are set to continue their normalization of monetary policy, just as we see in the ECB. Romania and the Czech Republic have the most hawkish central banks, while the Hungarian central bank appears most at risk of falling behind the tightening curve.

Turkey had a much more tumultuous 2018 than had been expected, largely driven by a worsening in political relations between a recently re-elected President Erdogan and President Trump. Summer 2018 will be remembered for the sharp and drastic weakening in the Turkish lira, and while political tensions remain, we expect 2019 to be less politically turbulent. Local elections in March 2019 will be the first test of the Justice and Development Party popularity under President Erdogan's new presidential system, but with support from the far-right Nationalist Movement Party, they are expected to maintain their majority. External financing has continued to roll over to the sovereigns, banks and corporates as the economic adjustment to a lower-growth environment takes hold. While it is unlikely that Turkey's credit quality will recover significantly during 2019, we do at least expect stabilization.

South Africa also has national elections in May 2019 where we expect Rhamposa's African National Congress to maintain a majority. While the election campaign will be noisy—headlines regarding land reform are likely—their passing should hopefully provide a spur for higher growth (due to less political uncertainty) and reforms. Inflation is likely to remain just above the mid-point of the target band (which has become the defacto inflation target) with the South African Reserve Bank trying not to tighten monetary policy unless dictated by market circumstances.

Russia, while at risk from geopolitical tensions, continues to benefit from improving sovereign fundamentals, as both growth and inflation remain anchored due to the strong fiscal and monetary policy framework. Elsewhere in the region, both Nigeria and Ukraine are holding national elections in March 2019, with the outcomes in both too close to call currently. However, we view the Ukrainian elections as posing more downside risks given the presence of Tymonschenko as a candidate in the polls, whereas in Nigeria, the challenger to the incumbent is viewed as more market friendly.

Vincent Reinhart
Managing Director, Chief Economist & Macro Strategist

Vincent is Mellon's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

1. The same holds true at home with the ongoing government shutdown but on a shorter fuse. Our view is that it will be an irritant to economic activity until resolved within a few weeks.

Disclosure

For more market perspectives and insights from our teams, please visit www.mellon.com.

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