MINERVA

INVESTMENT MANAGEMENT SOCIETY

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EXECUTIVE SUMMARY

This week, during the night between April 13th and April 14th, the United States, France and United Kingdom have launched a missile attack against Syria. The Syrian regime has been accused of holding and having used chemical weapons, even against the civilians. Despite a low likelihood that this conflict will have a significant impact on the global macroeconomic situation, we think it should however be monitored, in the case the situation escalates.

ECONOMIC GROWTH

According to the latest, more conclusive, estimate by the Bureau of Economic Analysis, the United States real GDP grew at 2.9% in Q4 of 2017 compared to a 3.2% in Q3 of the same year[1]. Growth in Q4 was mainly due to increases in personal consumption expenditure, both residential and nonresidential fixed investment and public spending, although imports and a decrease in private inventory investment adversely affected Q4 numbers. Atlanta FED published a forecast of 2% growth in Q1 of 2018. The Q1 forecast ranged from 1.8% to 5.4% as it adapted to the news. We eagerly await BEA's advance estimate of growth in Q1.
Unexpectedly, the EU industrial production has recorded a 0.8% fall in February compared to January's gauge3. The most considerable fall has affected capital and durable goods, decreasing respectively 3.6% and 2.1%. Energy was an exception, increasing 6.8%. Even if these monthly data about industrial production are higher than one year ago, increasing about 2.6% year-on-year, the rate of growth has slowed down with respect to January and the 2017 4Q. Nevertheless, it is still believed that 2018 1Q GDP growth will be close to 0.5%.
Asian emerging market is dominated so far by China and India. Chinese economy is expected by economists to decelerate steadily and slowly throughout the 2018. Growth will be obstructed by a tighter regulation of the property market and stricter one concerning environmental issues. Forecasts predict that the economy will grow by 6.4% rate in 2018, unchanged percentage from last month's forecast. India's growth, instead, is expected to accelerate further due to a large recapitalization plan for public banks. The entire economy is expected to grow of 7.4%, much more than 6.6% registered at the end of the 2017.
The MSCI Emerging Markets Latin America Index, which includes the large and mid-cap groups across the 5 Emerging Market countries in Latin America, closed at 3070.21 USD, translating into an overall increase of 0.49%[4]. This can be justified by the good performance in those five markets, which increased the investors' confidence and prompted a good week for the equity markets in the Latin American economies.
Data regarding the main macroeconomic indicators were released by Argentinian authorities last Friday, showing that in March Argentina reached a primary fiscal deficit, excluding interest expenses, of $729.5 million (0.3% of its GDP), half of the target of 0.6% of GDP. Considering those expenses, it will amount 37.3% of GDP.

TRADE

Trade is certainly one of the main points of concern in global markets in 2018, with protectionist rhetoric and actions from the US government and China.

Protectionism generates two types of economics costs, direct and indirect. Generally, estimates put directs costs at a small percentage of GDP growth. On the other hand, indirect costs might be much more severe. These are represented by the disruption that tariffs cause on global supply chains and the negative impact they have on business confidence.

The US trade deficit was at $57.6 billion in February, highest level since 2006. Exports increased 1.7% to $204.5 billion with major dollar gains in industrial supplies and materials, car parts, non-monetary gold and capital goods. Imports also rose 1.7% to $262 billion, boosted by capital goods, civilian aircraft, and foods and beverages. Imports of services were up more than $1.1 billion, most due to broadcasting agreements for 2018 Winter Olympic Games. Overall, the trade balance has improved with China, the EU, Japan and Canada but worsened with Mexico. After an increase of more than $90 billion in Q3, there was a decrease of around $1 billion in Q4. Overall 2017 was a great year as corporate profits from current production increased $91.2 billion, compared to a decrease of $44 billion in 2016. Trade war between USA and China is certainly a big potential threat for the US economy. FED members in fact see retaliatory trade war as a potential downside risk. Although commentators are divided on the likelihood that a trade war could really take place, over the last weeks both parties have imposed customs duty and tariffs on some imported goods. For instance, a 25% tariff on iron and 10% on aluminium.

Europe, whose economy relies a lot on global trade, is especially vulnerable to those indirect effects. In 2017, Eurozone exports were 47% of GDP (while just 12% in the US) and net trade contributed for about one quarter of GDP growth[5]. Given the importance of the US for European exports (20%), less trade would be bad news for the economy. And while being exempted from tariffs is certainly a positive thing, indirect effects could still damage GDP growth in the EU. For example, trade fears impacted investor sentiment in the Eurozone in April (for the third straight month)[6]. The strengthening euro is not helping either. In February, German exports showed the biggest monthly drop since August 2015 (-3.2%, against an expected +0.2%). Exports to non-euro countries were especially weak. Adding Brexit uncertainty to the possibility of a global trade war, it our view that trade might be the biggest threat to European economic growth in the next few years.

Starting from this week, Chinese leaders will evaluate impacts of a gradual depreciation of the yuan in response to US President Donald Trump trade offences. Since Trump took office the Chinese currency gained 9% against the US dollar and on March touched the strongest level since 2015. While Trump regularly bashed China on the campaign trail for keeping its currency artificially weak, the yuan has gained about 9 percent against the greenback since he took office and has been steady in recent weeks despite an escalation of trade tensions between the world's two largest economies. The Chinese currency touched the strongest level since August 2015 last month. In addition, the Shanghai Composite Index has lost 12 percent on concern of a future trade war. A weaker yuan would mean a relevant support to China's export industries, but also many risks. Firstly, it could make China a "currency manipulator" of the United States and more difficult for its companies to consolidate a market-oriented exchange rate financial system. Secondly, the resulted financial market volatility will be much more consistent and unpleasant to authorities.

UNEMPLOYMENT AND INFLATION

Economists have for long theorized about the inverse correlation between inflation and unemployment considering wage inflation as a proxy for the general inflation. If there is high unemployment rate, more people are willing to work than the total amount of jobs available. Consequently, employers will maintain low the level of high salaries since there is no need to attract employees, and rising wage inflation will be compromised.

Unemployment in United States remained at 4.1% for the sixth consecutive month in March, as 103,000 new jobs were created in the same month, after a huge increase of 326,000 jobs added in February, with manufacturing, health care, and mining as leading sectors. March was a record month as inflation reached a year high of 2.4%[7], not far from market expectations. Prices rose most for shelter, health-care services and used cars.

Mix of historically low unemployment, strong growth and inflation picking up are in line with FED's quarter-point rate hike, with a target range of 1.5 to 1.75 percent. There is a consensus among members of the FED that gradual rate increases are appropriate course of action. Markets deem another two hikes likely by year-end. The yield curve, although significantly flatter than a year before, is still upward sloping reflecting[8]. Reasons behind this might be that despite market expectations of future rate hikes, the slope of the curve can in part be explained by mounting geopolitical risks and investors moving away from volatile stocks into bonds depressing yields.

This solid economic development has conducted the Eurozone unemployment rate to reach its lowest level since 2008[9] in February at 8.5%[10]. In particular, the youth unemployment rate has decreased about 2 percentage points from February 2017, recording a level of 15.9%.

Inflation in the Eurozone remains subdued, far from the ECB's target of close to 2%, as it is expected to be 1.4% in March 2018[11] (up from 1.1% in February)[12]. On Friday 13th April the monthly German CPI data was released, matching its forecast of 0.4%, down from 0.5% in February.

With a recovering economy, a very accommodative monetary policy and, at least compared to recent years, a positive political environment, a rising inflation would be expected. However, this is not happening: In February, inflation was at the lowest level since 2016. Wage growth is probably the missing link here. In fact, it does not appear to be picking up and remains much lower than pre-crisis levels[13]. This is probably a consequence of a labour market still far from tight, especially outside the core countries, as shown by high unemployment rates.

With all of this in mind, it is our opinion that inflation is unlikely to reach the level of just below 2% in 2018, meaning that the gradual and slow tightening approach chosen by the ECB is appropriate. In fact, the ECB will be cautious about exiting from the quantitative easing program it has planned to buy euro 30bn worth of assets a month until September and after that to reduce the amount of purchases until the end of 2018. So, interest rates should remain at their current low levels for at least one year.

Economists converge on the prediction that unemployment rate in China will be lower than 3.90 % by the end of Q1[14]. Looking forward, it is expected to stand at 4.10 % in twelve month-time. In the long-term, the Chinese unemployment rate is projected to trend around 5.00 % in 2020, according to econometric models.

China registered a reduction in inflation in March (2.1%) compared to the previous month (2.9%). The gain in prices did not follow the market expectations of 2,6%. Being more specific, consumer prices dropped to 1.1% due to lower prices in food, transport and tourism. On the other hand, producer inflation decreased by 0.6% to 3.1% moderating the expectations of 3.2%. Possible drivers can be found in a weaker investment growth, particularly covering the housing sector.
This week was also time to get inflation results related to March 2018, when consumer prices in Colombia rose to 3.14, the lowest value since September 2017[15]. Nonetheless, if we look to the core inflation, it achieved 4.2%, dropping from a peak of 4.72% and putting some pressure on the future government decisions concerning the pattern of interest rates. The environment of uncertainty around the presidential election in next May constitute one of the main drivers of the current macroeconomic scenario in Colombia.

CURRENCY

Over the last week the exchange rate between the US Dollar and the Euro slightly increased to 1.23, quoting at the average levels of the past months. The Dollar strengthen against the other principal global currencies, touching for example the maximum over the past two months against the Japanese Yen. As long as the US economy is growing, we expect it to attract foreign investment that will, along with gradual rate hikes increase the value of the dollar. On another hand, the latest data indicates one of the largest trade deficits and it is unclear how possible trade repercussions and the military intervention in Syria will affect the value of the US dollar. Therefore, foreign investment and current balance should be monitored, while bearing in mind that the US dollar has had a role throughout history as a safe heaven among currencies in times of turmoil.
In 2017, the euro has strengthened against almost any other currency. Since the beginning of the year, this trend has continued for the EUR/USD pair, but not the EUR/GBP exchange rate. Different factors have helped the pound getting stronger against the other main currencies. The hawkish comments by the BoE, with an interest rate rise expected in May 2018, have certainly helped the pound[16]. The other important event that has boosted confidence in the currency is the agreement reached by the EU and the UK about an 18-month transitional period, basically delaying the UK exit from the union. On Tuesday 11th April, the euro moved higher thanks to hawkish comments by Ewald Nowotny (ECB Governing Council member, Austria), who said he thought he was time to normalize monetary policy at a faster rate (starting with moving the deposit rate from -0.4% to -0.2%). Those comments did not represent the view of the ECB though, as an ECB spokesman later specified.[i] A bullish movement was set by the ECB's March minutes released on Wednesday 12th April, where it was noted that all members were concerned about risks related to trade wars, the deterioration of financial conditions, FX market volatility and the negative impact of a strong currency on inflation. Those were the reasons given to continue buying bonds.[ii]
In general, several disappointing economic data (for instance, the Eurozone industrial output fell 0.8%, against an expected +0.1% in February) have kept the euro stable.

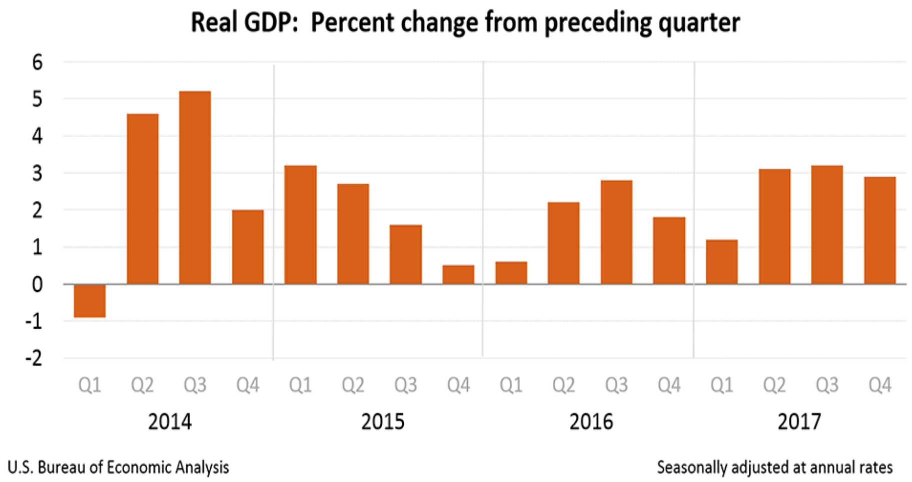
In our view, the euro is going to appreciate further in the medium term, as monetary policy is expected to be tightened by the end of the year and the economy, even if it might have already reached its peak, is still experiencing a sustainable growth. These two factors will put upward pressures on the euro.

If we take Asia into consideration, Hong Kong's dollar hit to the weak end of its trading range since 2005. In fact, on Thursday 12th April the spot rate registered HK$7.85 per dollar and, on the following day, the Hong Kong Monetary Authority (HKMA) started buying Hong Kong dollars and selling US dollar to support the local currency[17]. This rapid operation to defend the band by draining liquidity from the financial system consisted of HK$9.66 billion bought from the foreign exchange market. Last time the local financial authority bargained HK dollars was in 2005, not so long from the implementation of a new band which impeded funds to flow into the Asian financial hub not making the Chinese yuan stronger.

As confirmed by the chief forex strategist at Mizuho Securities in Tokyo, Masafumi Yamamoto, the yen is gaining against the dollar as a result of current geopolitical concerns. But a weaker dollar could also be the outcome of higher commodity prices in a context of a potential trade war between USA and China and the European Central Bank monetary policy expectations. Fears of trade tensions between China and United States were calmed by the Chinese President Xi Jinping and caused a stronger yen. On Thursday 12th April, the yen weakened with respect to the US dollar, but the loss was "thin" since financial investors remained cautious on the possibility of a Western military action in Syria.

In Latin America the outlook from last week currency trends against the US dollar is diversified[18]. Given the current political challenges, the uncertainty around the next elections and potential protectionist measures make us believe the Latin American currencies will weaken much more in the following weeks.

APPENDIX:



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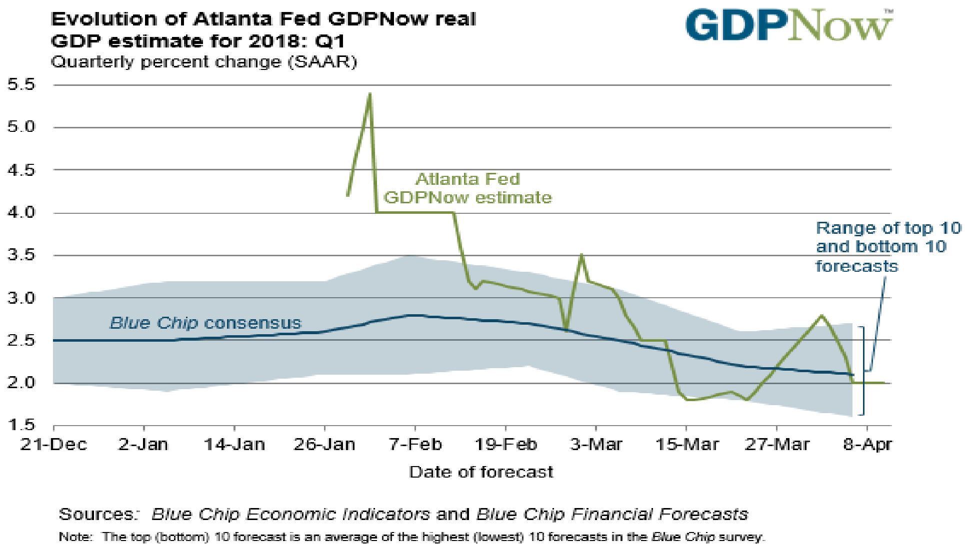

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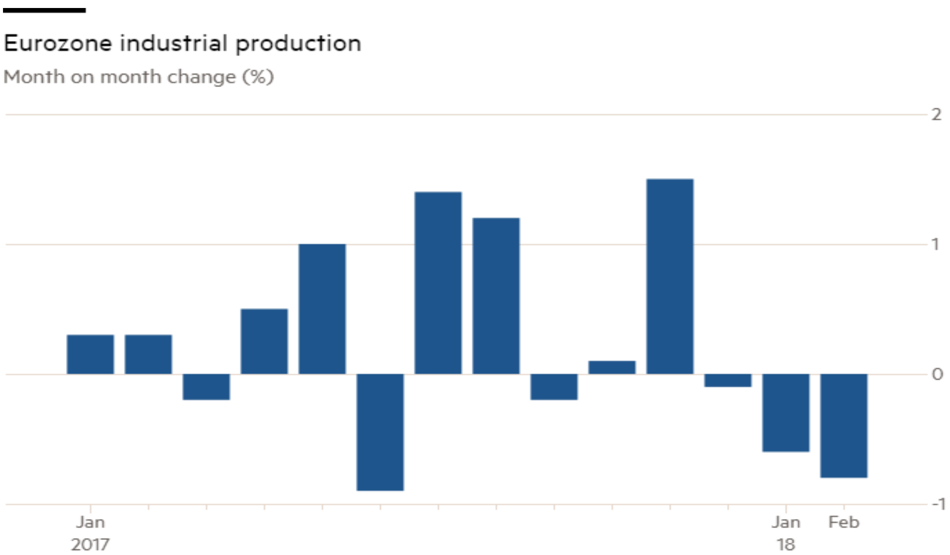

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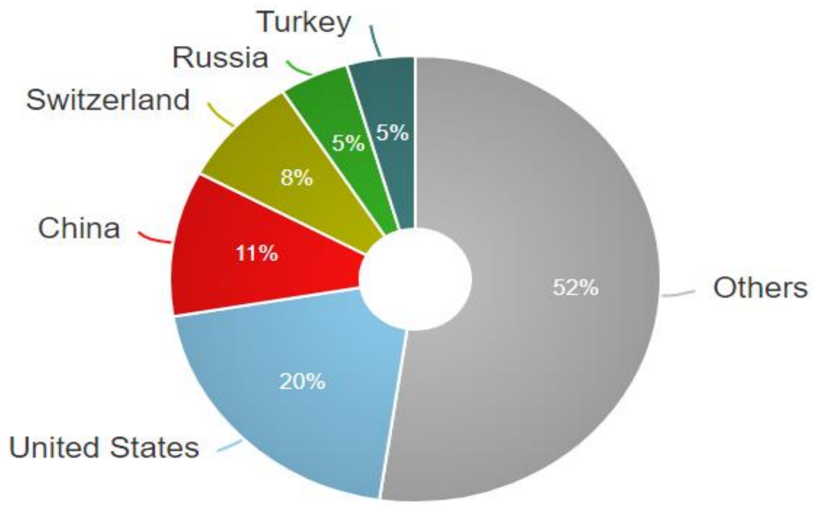
Source: Eurostat, FT

4

Source: Market Watch



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EU28 trade partners (exports) in 2017. Source: Eurostat

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Source: FactSet, FT

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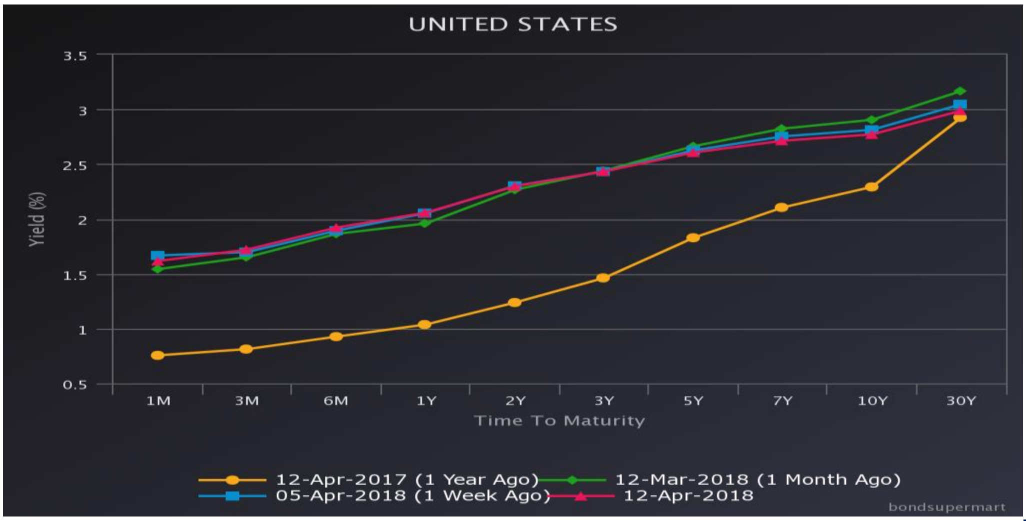

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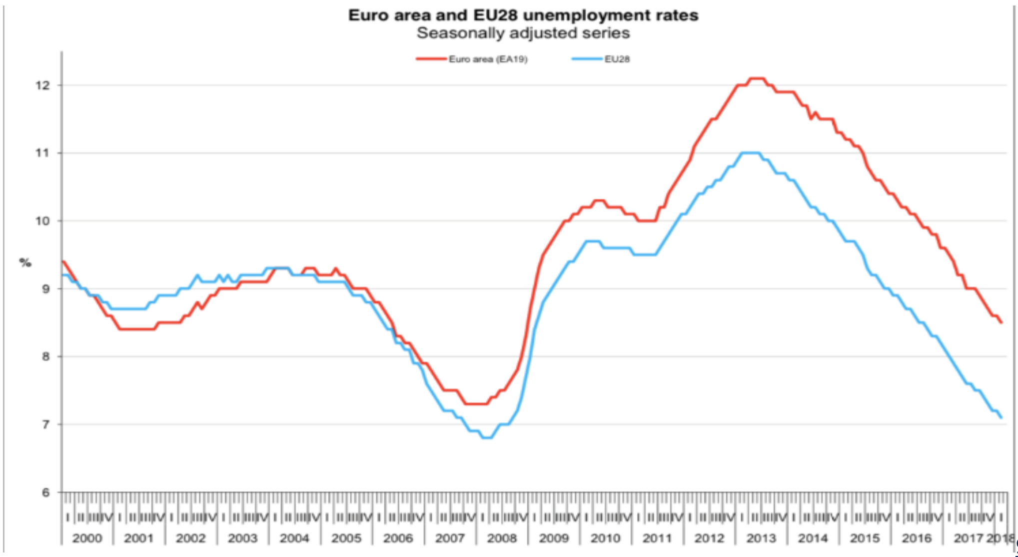
Source: Bondsupermart



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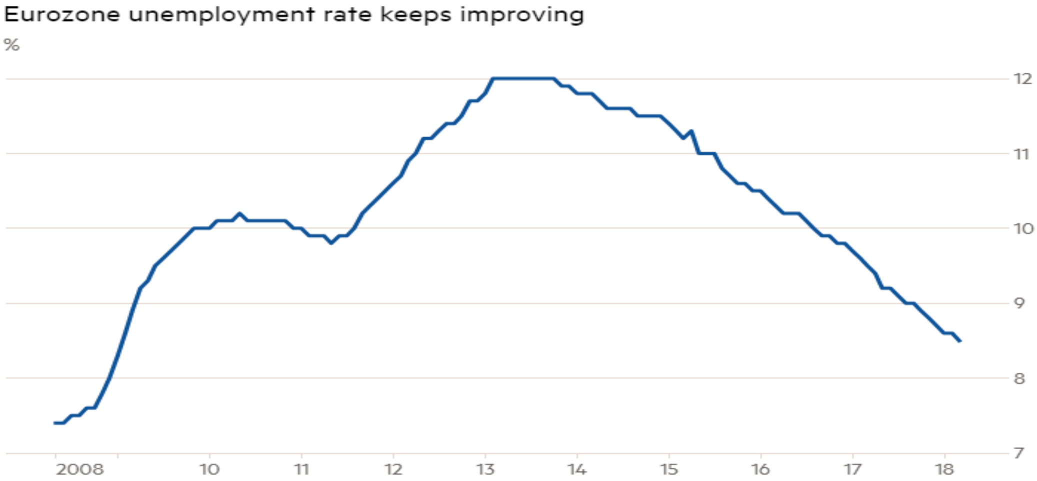
Source: FT



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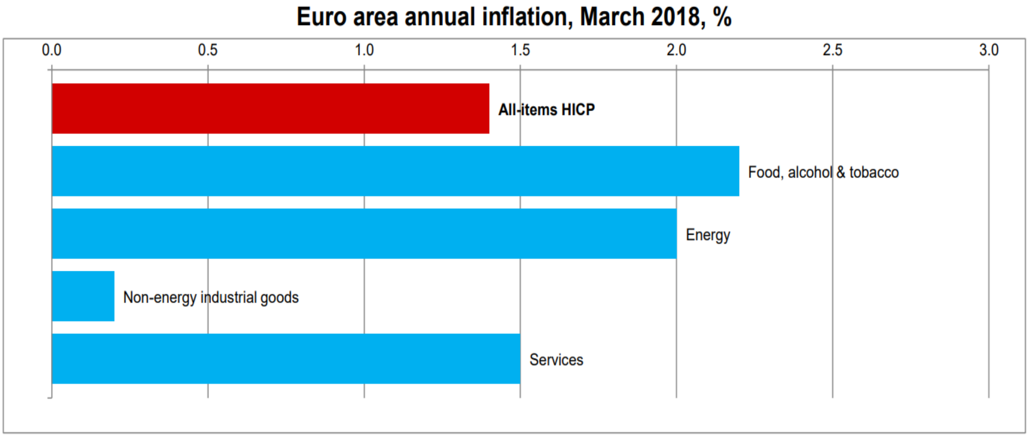
Source: Eurostat



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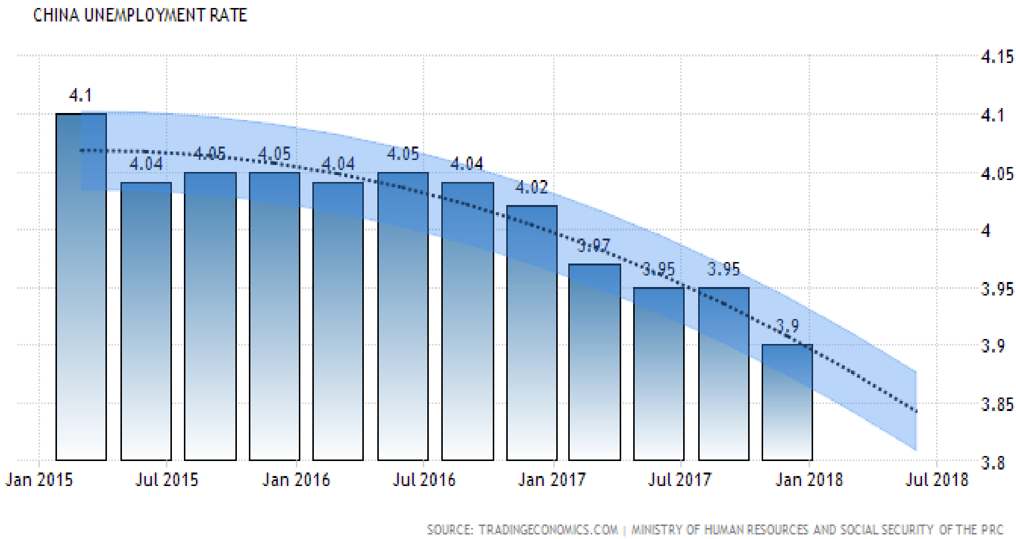
Source: Eurostat

12

Eurozone inflation trend. Source: Eurostat, FT

13

Source: TradingEconomics



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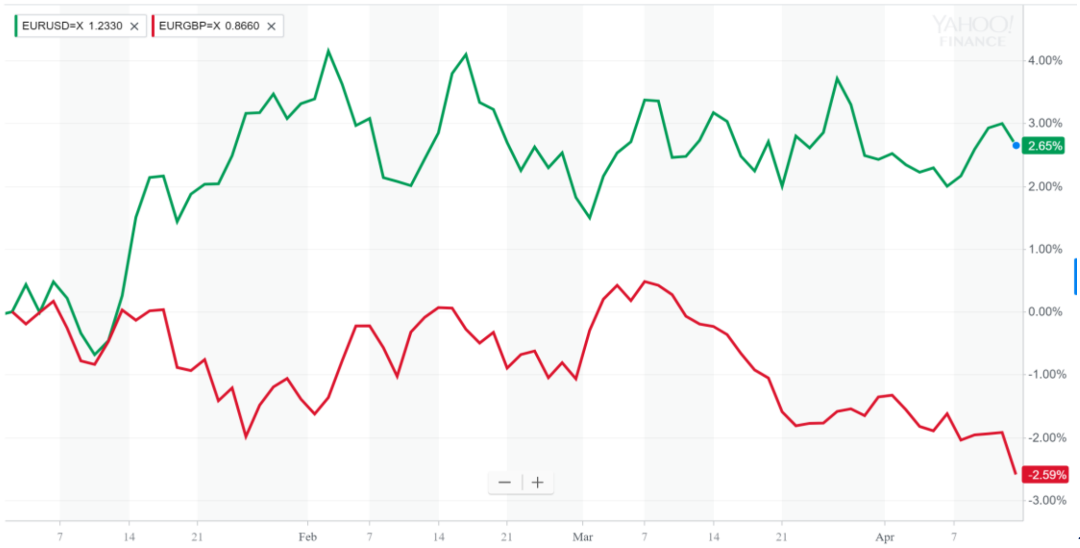

[16]

EUR/USD and EUR/GBP evolution since the beginning of the year. Source: Yahoo Finance

[17]

CURRENCY	VALUE	CHANGE	NET CHANGE	TIME (EDT)	2 DAY
USD-MXN	18.0447	-0.1439	-0.79%	4:59 PM	
USD-BRL	3.4230	0.0101	+0.30%	4:59 PM	
USD-CLP	594.5400	-2.2600	-0.38%	12:29 PM	
USD-COP	2,712.2900	5.9200	+0.22%	1:59 PM	
USD-PEN	3.2244	-0.0009	-0.03%	2:18 PM	
USD-VEF	49,438.1250	0.0000	0.00%	2:17 PM	
USD-CRC	564.9800	-0.2700	-0.05%	4:59 PM	

[18]

Source: Bloomberg

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