Global Strategy

2018 – The year of inflation?

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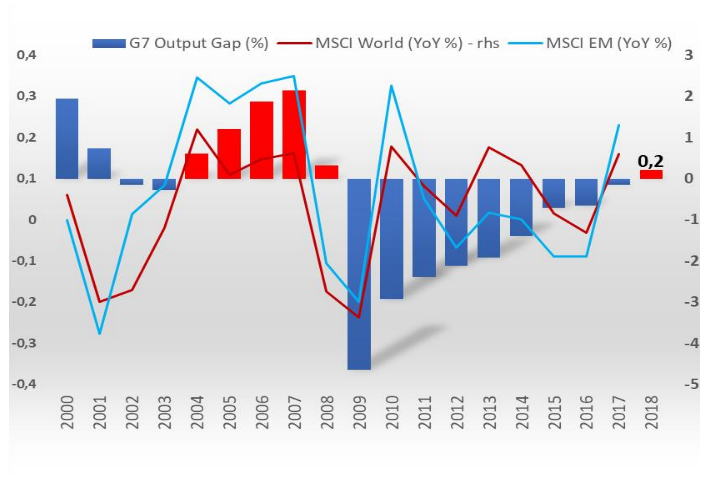
Global economic growth is supported with positive output gap

Output gap returns back into positive territory for the first time since 2008 – Output gap, defined as the gap between potential and real growth of an economy is a crucial part of macroeconomic analysis. Potential growth, which is measured as the theoretical output, produced with available labor and capital, is expected to be lower than actual output for the first time since 2008. IMF estimation points to %0,2 growth above potential (see Chart 1) for G7 countries. Geographically US seems to be the "overheating" region according to IMF calculations, whereas US and Euro Area both would be generating over-potential growth based on OECD forecasts.

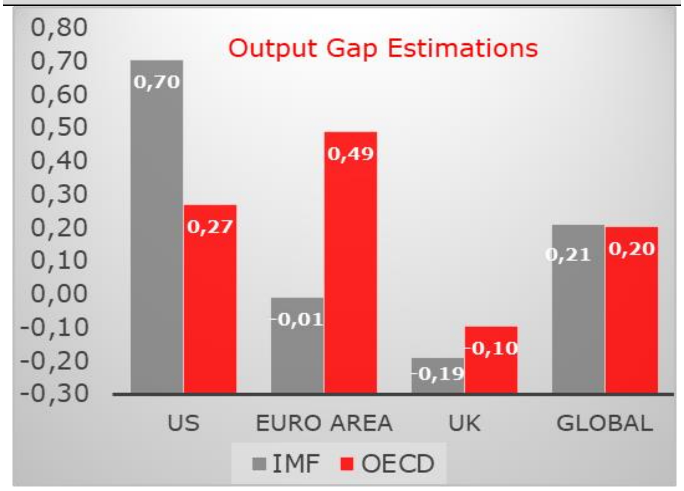
Positive output gap would be equity, commodity and inflation friendly… Outlook for 2018 resembles the era of 2004-2007, where G7 growth stayed above potential and inflation pressure was felt by advanced economies. Equities rallied to new highs coupled with peak prices achieved in various commodities such as oil. Although we expect major differences between past and future scenarios, our calculations point to a pick-up in global inflation going forward.

Chart 1, Global output gap returning back to surplus



Source: Ak Investment Research, Bloomberg, IMF estimates

Chart 2, IMF-OECD estimations differ for Euro Area



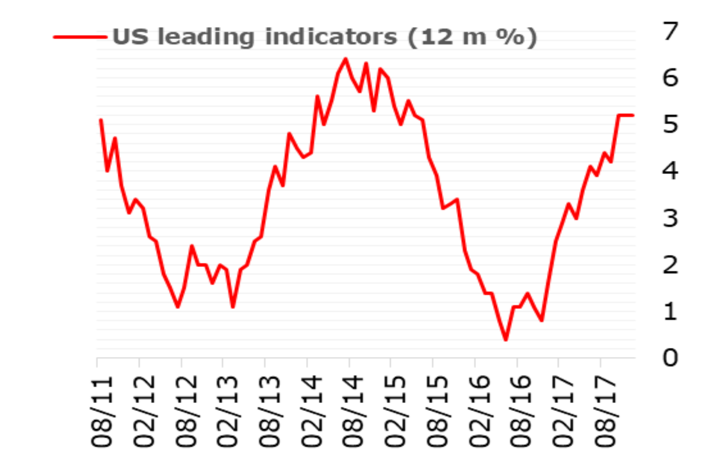
Source: Ak Investment Research, OECD and IMF estimates

Pick up in long-waited US inflation is imminent…

Low-inflation phenomenon has been the main topic for academic research during the last couple of years. Technologic developments, structural changes, online shopping and increased labor efficiency was cited as the main reasons behind persistently low global inflation. 2018 may bring an upside push, with the help of tax reform in US, decade high PMI's in Euro area and Japan. Looking into leading indicators (which combine working hours, building permits, consumer confidence, manufacturing orders) point to an increased economic activity in Euro Area, Japan and US going forward.

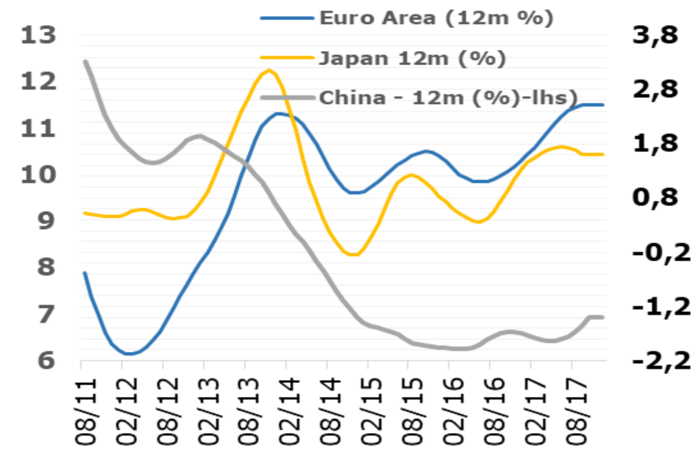
China seems to be decoupling from the widespread growth trend due to economic policies intended to support deleveraging process.

Chart 3, US economy is back on track…



Source: Ak Investment Research, Bloomberg, USCB

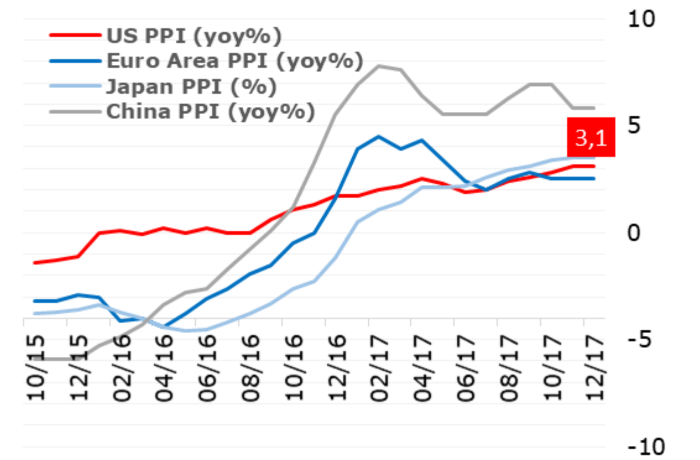
Chart 4, China decoupling from Euro Area and Japan



Source: Ak Investment Research, Bloomberg, ECB, BOJ

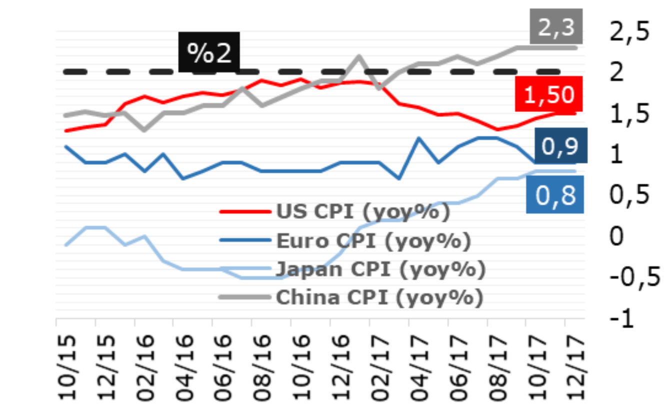
In 2018, we expect the strongest growth-inflation relationship to appear in US. ECB continues its accommodative monetary policy due to modest economic growth performance of periphery countries. Italian elections in March adds to the stress for economic performance of the region that is still not able to produce sufficient inflation. Looking closer to producer prices (see Chart 5), which are leading indicators for core and headline inflation, US economy appears to be the closest candidate to create an increasing trend in headline prices.

Chart 5, US PPI change points to a pick-up in CPI



Source: Ak Investment Research, Bloomberg

Chart 6, CPI (yoy%) is on rising trend

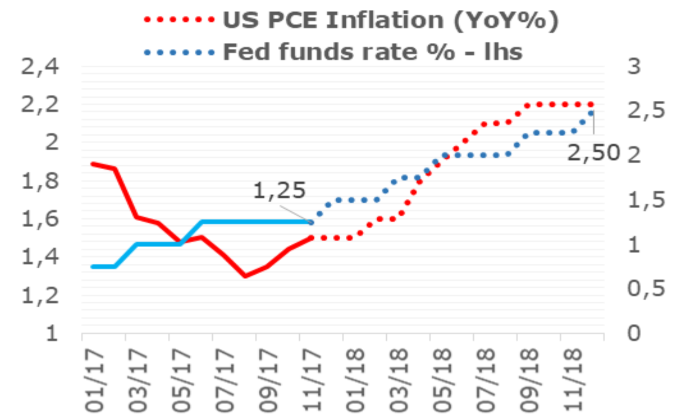


Source: Ak Investment Research, Bloomberg

We expect 4 hikes from Fed in 2018…

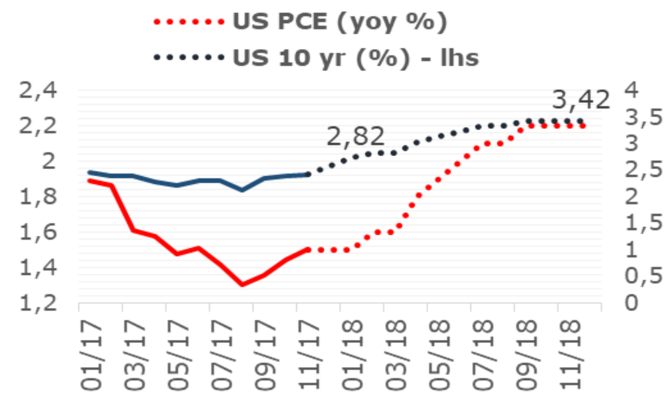
Our global forecast for 2018 is based on the basic phenomenon - "emergence of inflation". We still don't see signs of producer price pressure in Euro area and Japan yet. Thus, we expect US inflation to act first. With basis effect disappearing after April, overheating economy that is evident in positive output gap and leading indicators, increasing trend in PPI leads to emergence of inflation starting from 2Q 2018. We expect US core CPI to reach above Fed's target of %2, reaching %2,2 by the end of the year. Moreover, our econometric models suggest that under an inflation pick-up scenario US 10 year yield would reach %3,4 by December 18 (see chart 8).

Chart 7, We expect Fed to hike 100 bps in 2018



Source: Ak Investment Research, Bloomberg

Chart 8 ,US10yr settles at %3,4 under PCE pick up scenario



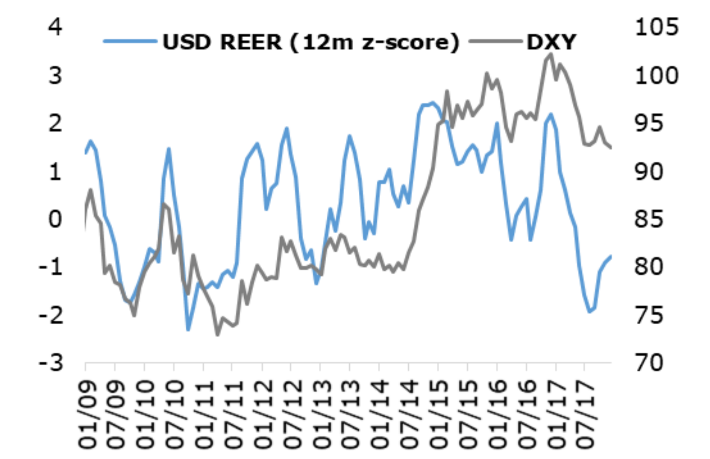
Source: Ak Investment Research, Bloomberg

Would US dollar comeback?

2017 was the year for USD deprecation where we saw Dollar Index (DXY) lost %10,2 against major currencies. On trade weighted basis USD depreciated over %7 against US' major trading partners. Recent moves by PBOC, ECB and BOJ reflect Central Banks' consensus on USD depreciation to proceed into 2018. PBOC, changed its CNY fixing methodology that is adopted back in May 2017, and let CNY to depreciate against USD, without volatility limitations. This shows PBOC's willingness to free float its currency as well as global consensus towards the "weak dollar" phenomenon.

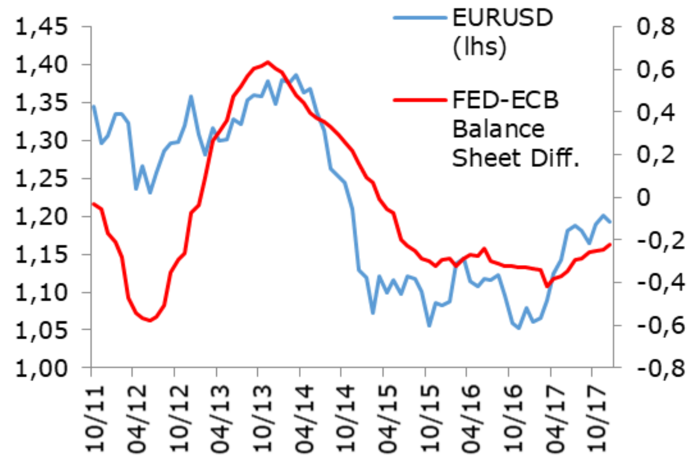
This year, however, would be riskier than 2017 to base investment plans on weak USD. Overheating US economy (growth), rising inflation expectations (break-evens and our PCE forecasts) and attractive USD valuations in real terms prepares suitable environment for USD appreciation. From our perspective, with a combination of value and growth, USD is waiting for a catalyst to take it back to its fair value. In real terms USD stays close to its low range level, standardized by z-scores (see chart 9). Moreover over-potential growth in US would make USD an attractive currency in 2018. We expect USD to gain value against major trading partner currencies starting from second quarter with the help of US inflation to re-emerge after a long quiet period.

Chart 9, USD stays attractive in REER models



Source: Ak Investment Research, Bloomberg

Chart 10, CPI (yoy%) is on rising trend

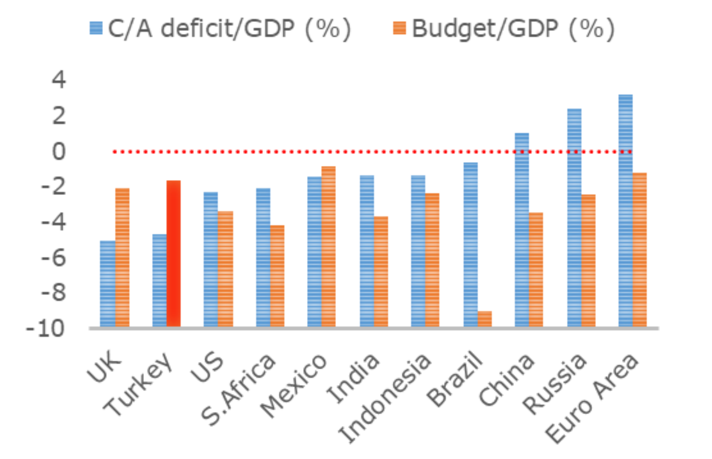


Source: Ak Investment Research, Bloomberg

EM markets might feel both joy and desperation throughout 2018…

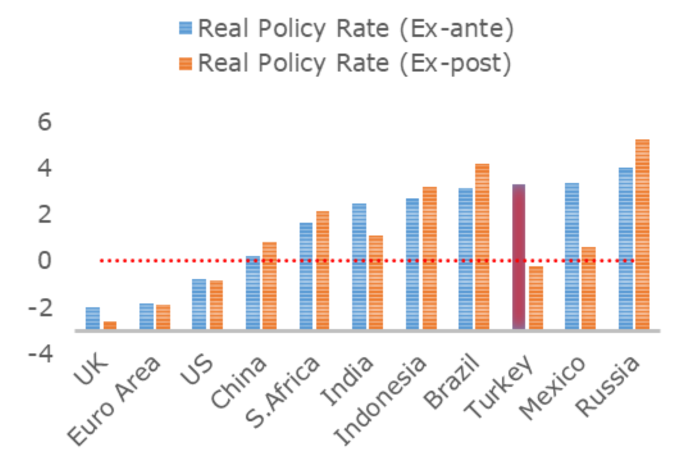
Going through our 2018 outlook you might have come across our two-sided view for 2018: **First quarter would be about increased global risk appetite; silent USD, US inflation and Fed, rally in equity markets, enhanced risk taking and inflows into EM. Starting from second quarter and most probably in 2018H2 we expect US and global inflation to rise, motivating Fed to do a total of 100 bps hike. USD might appreciate, DM equities might outperform EM. Oil prices, which we expect to end the year around 70$/barrel (Brent Crude), would result in increasing inflationary pressures across the globe. Here commodity exporters such as Russia, Brazil and South Africa would outperform EM. Countries with high current account deficits such as Turkey, South Africa and Mexico would be vulnerable to Fed hikes (see chart 11), though Turkey and Mexico would stay more resilient due to high ex-ante policy rates (see chart 12).**

Chart 11, Turkey, Mexico and Russia have higher real rates



Source: Ak Investment Research, Bloomberg

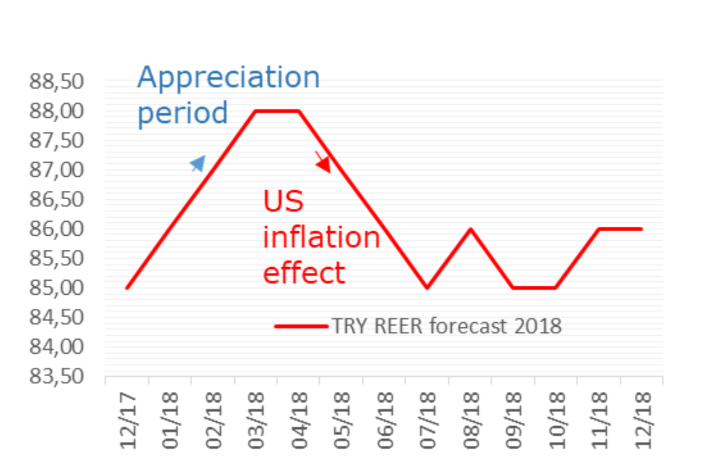
Chart 12, Turkey, Mexico and Russia have higher real rates



Source: Ak Investment Research, Bloomberg

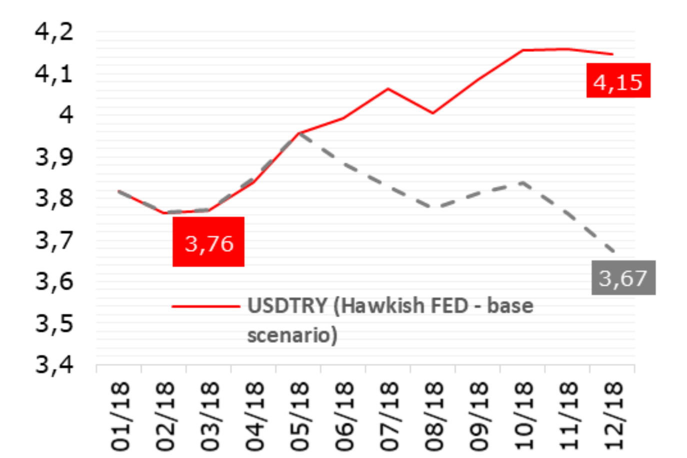
Turkish FX markets, in line with EM-FX might be under pressure starting from 2Q or 2H. Timing depends on emergence of US inflation which we expect it to pick-up by February (Average Hourly earnings) and by April (PCE- due to basis effect). TRY, staying on undervalued range, measured by deviation from REER average, is expected to be resistant to global shocks and appreciate against USD during the first months of 2018. With the rise of US inflation and aggressive Fed hikes (combined with undervalued TRY in real terms) we would expect USDTRY to be around 4.15 by the year end. A dovish Fed scenario (low probability) would take the parity down to 3,67.

Chart 13, TRY might appreciate in real terms during 1Q2018



Source: Ak Investment Research, Bloomberg

Chart 14, TRY under hawkish and dovish FED scenarios



Source: Ak Investment Research, Bloomberg

EM equities would benefit from global growth phenomenon

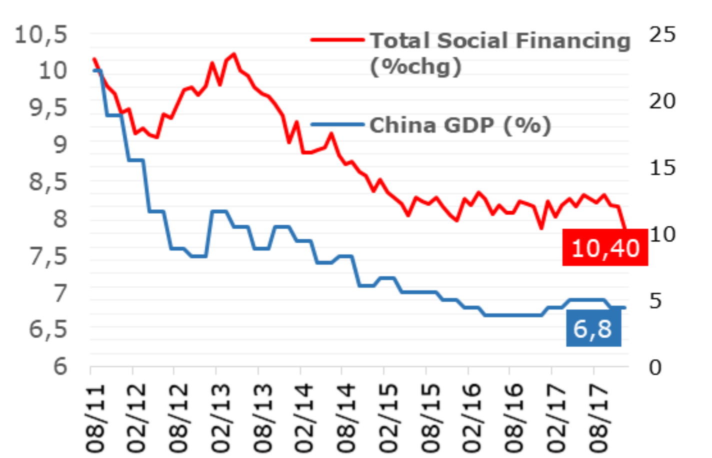
Global growth phenomenon would support EM equities, where we expect commodity exporters with low current account deficits/GDP to outperform EM equities. Brazil and Russia would be among our favourite choices, supported by commodity rally and undervalued currencies in real terms. South Africa would be more sensitive to external shocks due to relatively high level of current account deficit/GDP. According to our EM equities comparison tool, our metrics point to Russia, Indonesia, Brazil, Poland and Turkish equities to be candidates for outperformers in 2018.

Oil price to skyrocket in 2018? Or China would set the ceiling?

International Energy Agency estimates 300 bn barrel/day oversupply for 2018, based mostly on the OPEC agreement putting a cap over production levels. Moreover shale oil producers would increase their production to benefit from high prices. Another supporting factor for the bearish scenario would be China, where the government is taking severe steps towards soft landing and deleveraging (see chart 15). Markets expect Chinese oil demand to slow down with the help of declining growth.

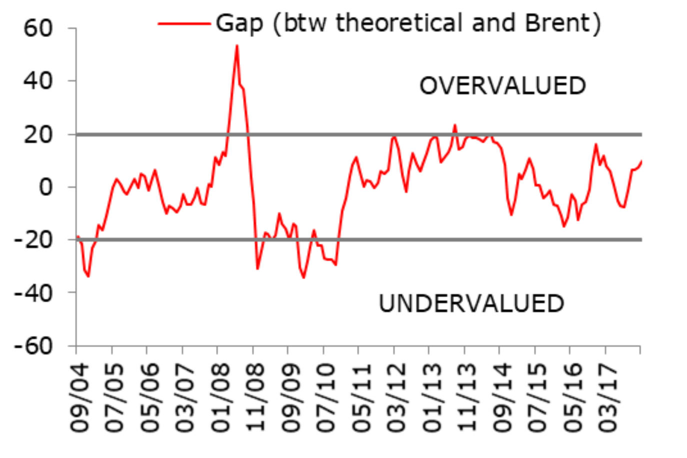
On the bullish side we see positive global output gap indicating "overheating" in world economy. Resembling the overheating period observed globally during 2004-2007, oil demand in 2018 too might exceed official estimations. Supporting that view, our econometric model, based on world output gap and US oil inventories would suggest that oil prices are trading around their fair value. In other words there is still an upside around 10$ for the prices to reach overvalued levels (see chart 16).

Chart 15, Turkey, Mexico and Russia have higher real rates



Source: Ak Investment Research, Bloomberg

Chart 16, Turkey, Mexico and Russia have higher real rates



Source: Ak Investment Research, Bloomberg

2018 Global Forecasts	2017	2018 1Q	2018 2Q	2018 3Q	2018 4Q
US 10yr	%2,40	%2,70	%3,2	%3,4	%3,4
Germany 10yr	%0,41	%0,50	%0,7	%0,75	%0,75
Fed Funds Rate	%1,5	%1,75	%2	%2,25	%2,50
EUR/USD	1,18	1,25	1,23	1,18	1,20
GBP/USD	1,33	1,38	1,35	1,32	1,35
XAU/USD	1310	1360	1340	1380	1400
Brent Crude	65	67	67	70	70
S&P500	2650	2800	2600	2800	3000
DAX	13000	13500	14000	14500	15000
MSCI EM	1190	1300	1250	1350	1400
Turkey CPI (yoy)	%11,7	%10	%10,13	%9,9	%9,3
USD/TRY	3,80	3,75	3,99	4,08	4,15
EUR/TRY	4,50	4,55	4,65	4,73	4,85
Turkey 10yr	%11,6	%10,5	%11,2	%11,4	%11,6