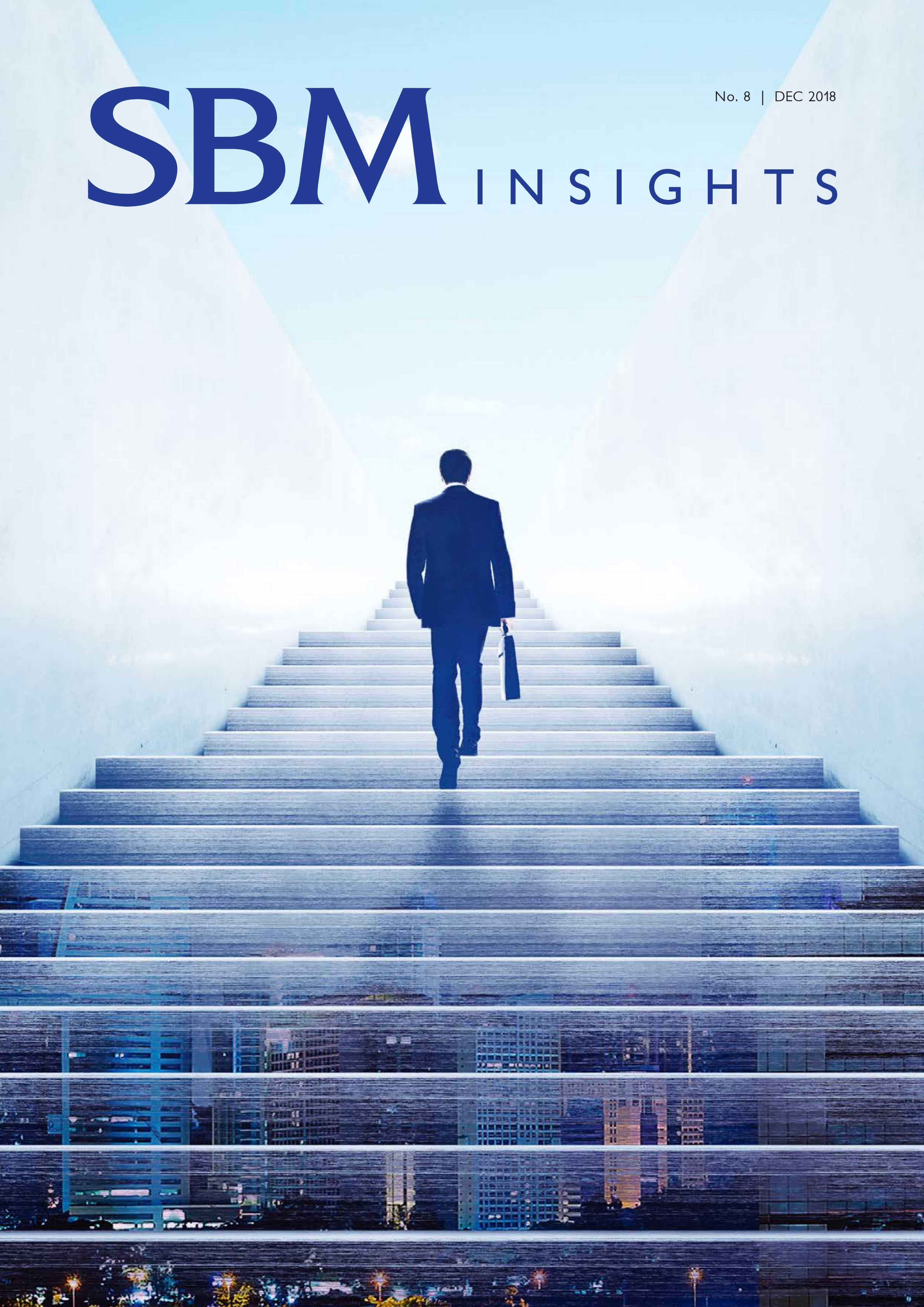
SBM INSIGHTS

No. 8 | DEC 2018



CHIEF EDITOR'S NOTE

A decade after the onset of the global financial crisis, the world economy continues to be in transition phase. Major risk factors that were previously hanging on the outlook, such as deflation in the EU and hard landing in China, seem to have largely subsided, and economic performance in major advanced and emerging economies has broadly picked up. In the US, the recovery is deemed strong enough to warrant a paced increasing of interest rates. Nonetheless, new risk factors are emerging, namely in the political economy space. An escalation of trade wars between the US and key trading partners, a hard Brexit, and geopolitical hazards in the Middle East, among others, are clouding the outlook.

In Mauritius, despite persisting difficulties in some export-oriented sectors, economic growth remains resilient at close to 4% following an upturn in the construction and trade sectors, and continued buoyancy in the hospitality and in business and financial services. Sustained strong investment in public infrastructure, coupled with an expected upswing in private sector investment, notably in the hotel and real estate segments, should support future expansion. Nonetheless, important risk factors prevail, particularly relating to changes in the global business environment. The strategy of positioning Mauritius as a financial hub for investments into Africa, accompanied by an innovation drive, would be critical factors in the country's ambition to become a high-income economy.

Our regional focus for this edition is on Kenya, a country where the SBM Group has been recently expanding its presence. With concerns around political stability petering out, and agricultural output picking up following favorable weather conditions, the Kenyan economy has recovered strongly in early 2018. Rising investor and business confidence and the government's "Big Four" Agenda should support activity going forward. However, the fiscal situation is a cause for concern and has been partly the reason motivating a credit downgrade in February, posing significant downside risks if appropriate measures are not taken.

The special report focuses on the topical issue of a possible inversion of the US yield curve. This phenomenon, which seems to be specific to the US, has correctly signaled all nine recessions since 1955 with only one false positive in the mid-1960s. Since 2014, the yield curve has been gradually flattening, generating concerns among economists and other financial experts.

We will be delighted to hear from you at:
research@sbmgroup.mu for any queries, concerns, comments or debates. We also take the opportunity to wish you a very happy festive season.

SREEKEESSOON Shailen
Head of Strategy and Research
7 Dec 2018

TABLE OF CONTENTS

ABBREVIATIONS

Bn	Billion
BoE	Bank of England
BoM	Bank of Mauritius
CPI	Consumer Price Index
DTAA	Double Taxation Avoidance Agreement
ECB	European Central Bank
EU	European Union
EUR	Euro
FCY	Foreign Currency
FDI	Foreign Direct Investment
GAAR	General Anti-Avoidance Rule
GBP	Great British Pound
GDP	Gross Domestic Product
ICT	Information and Communications Technology
IMF	International Monetary Fund
MCCI	Mauritius Chamber of Commerce and Industry
Mn	Million
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital International
MT	Metric Ton
NIM	Net Interest Margin
OECD	Organisation for Economic Co-operation and Development
ONS	Office for National Statistics
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers' Index
PPP	Purchasing Power Parity
RBI	Reserve Bank of India
SARB	South African Reserve Bank
UNCTAD	United Nations Conference on Trade and Development
USD	United States Dollar
WEF	World Economic Forum

LIST OF TABLES

LIST OF FIGURES

GLOBAL ECONOMIC ENVIRONMENT

HIGHLIGHTS

- The US economy confirmed its buoyancy in the second quarter of 2018, as gauged by an expansion rate of 4.2% (quarter on quarter, annualized) – the fastest pace since 2014. The consumer confidence index rose to new highs in October, reaching 137.9 from 135.3 in September, but falling to 135.7 in November. The recent readings remain at historically strong levels since September 2000 when the index read 140.8.

- In September, the Federal Reserve's Open Market Committee voted unanimously to raise the target range for the Federal funds rate to 2.00% - 2.25%, up 25 basis points, from the previous 1.75% - 2.00% range - a move widely anticipated by market participants and kept the target range for the Federal funds rate unchanged at its November meeting.

- According to the Office for National Statistics (ONS), the UK economy regained its footing, expanding by 0.4% in the second quarter of 2018 compared to the lacklustre growth rate of 0.1% recorded in the first quarter - the weakest growth rate since 2012. The rebound was in line with market expectations and attributable to higher retail sales and a boost in the construction sector due to unseasonably warm weather.

- Eurozone GDP grew at a moderate pace of 0.4% (quarter on quarter) in the second quarter. The ECB signaled that its asset purchase program would continue until December 2018 but at a reduced amount as from October – purchases would be halved to EUR 15 billion per month from the current EUR 30 billion per month.

- China expanded by 6.7% in the second quarter of 2018, above the government's GDP target of around 6.5%. The East Asian giant is currently facing challenges on several fronts - more specifically in the face of a cooling property market, which is a key economic driver, high dependency on exports, sluggish credit growth and consumer spending - as evidenced by the slower growth rate registered in the second quarter when compared to the previous three quarters.

- In India, the economy expanded by 8.2% year-on-year in the first quarter of fiscal year 2018/2019 (April-June quarter), beating market expectations of a 7.6% expansion – representing the highest quarterly year-on-year growth rate in over two years.

- South Africa's economy contracted by 0.7% quarter on quarter (seasonally adjusted and annualized) in the second quarter of 2018 followed by a contraction of 2.6% in the first quarter, plunging the economy into a technical recession.

- In recent months, the price of Brent oil experienced a significant decline of more than 30% since reaching a four-year peak in early October, amid intensifying oversupply concerns and worries over slowing economic growth.

- The US dollar appreciated against most major developed and developing country currencies since the beginning of 2018, reaching new highs, on the back of strong economic data and increasing interest rate differentials.

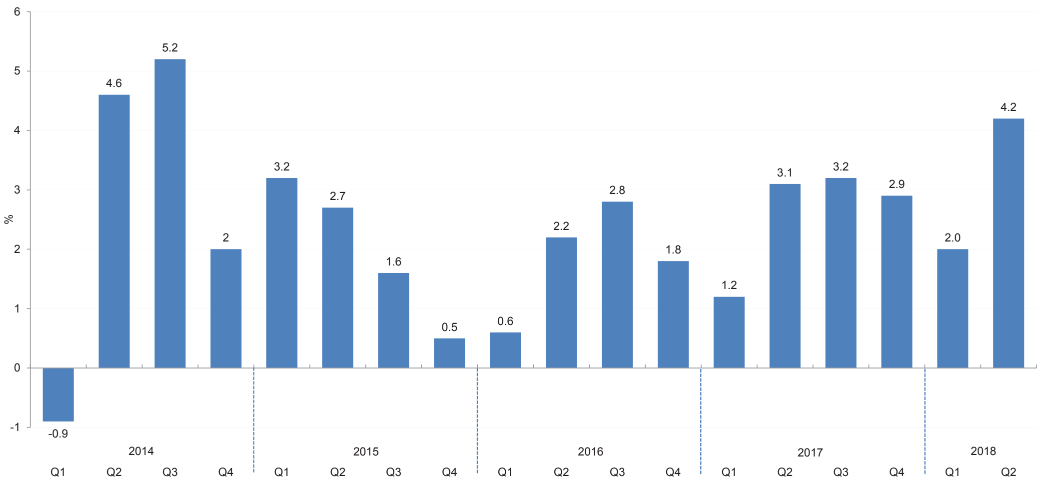
- The global macroeconomic environment remains tumultuous, with risks shifting further to the downside in the near and medium terms. The major risks that may disrupt global growth include the ongoing trade tensions between the US and China and aggressive tightening of interest rates by the Federal Reserve affecting the performance of the US economy.

Macroeconomic Performance and Outlook in Selected Major Economies

US

The third estimate released by the Bureau of Economic Analysis confirmed the buoyancy of the US economy in the second quarter of 2018 as gauged by an expansion rate of 4.2% (quarter on quarter, annualized) - the fastest pace since 2014 (refer to Figure 1.1) on account of robust private sector outlays and a strong external sector. The growth rate was higher by 0.1 percentage point from the "advance" estimate. The upward revision was primarily attributable to higher non-residential fixed investment and lower imports. The main component that led to a higher non-residential fixed investment figure was investment in software while the external sector benefited from the front-loading of export activities ahead of the implementation of retaliatory tariffs between the US and China at the beginning of the third quarter of 2018. As a result of the strong economic data in the first two quarters of the year (Q1: a 2.2% GDP growth rate quarter on quarter, annualized), the GDP growth rate for 2018 has been revised upward to 2.9%, on a year-on-year basis, in Q2 (estimated at 2.8% previously), up from 2.6% in Q1.

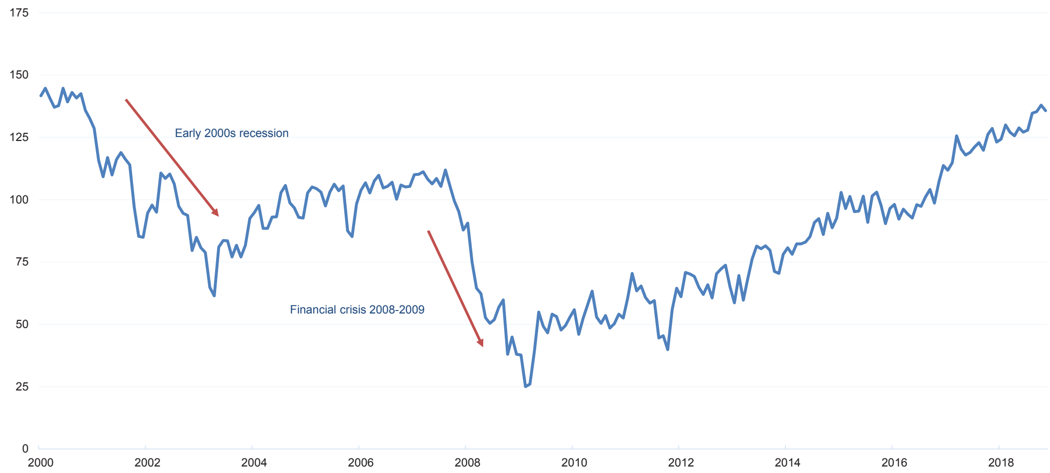
Figure 1.1: Real GDP - Percent change from preceding quarter (seasonally adjusted annualized rates)



Source: US Bureau of Economic Analysis

Despite the ongoing trade war with major economic allies, the consumer confidence index rose to new highs in October, reaching 137.9 from 135.3 in September, but fell to 135.7 in November. According to the Conference Board, the recent readings remain at historically strong levels since September 2000 when the index read 140.8. The uninterrupted strong labor market data was the major driver of consumer optimism regarding the outlook of the economy. As shown in Figure 1.2, the index has been on a rising trend since the 2008-2009 financial crisis, reflecting a positive economic outlook that manifested through sustained rise in consumer spending – the latter accounting for nearly 70% of economic activity.

Figure 1.2: US Consumer Confidence Index



Source: The Conference Board

On the back of recent strong quarterly economic performance, outlook for the third quarter is expected to remain bright owing to uninterrupted strong consumption dynamics amidst high consumer optimism, a tightening labor market, and ongoing government spending. However, the materialization of ongoing trade tensions between the US and its economic allies in the form of tariffs would undeniably weigh down on the US economy in the periods ahead thus causing a contraction in economic activities as business confidence gets dented and investment plans start to be reduced.

At its September 2018 monetary policy meeting, the Federal Reserve's Open Market Committee voted unanimously to raise the target range for the Federal funds rate to 2.00% - 2.25% from 1.75% - 2.00%, a move widely expected by market participants and the third hike of 2018. As mentioned in our May edition, the Committee is expected to raise interest rates four times in 2018, the fourth rate hike anticipated in December. The previous policy meeting held in August was rather uneventful as the Committee only reiterated the facts identified at its June policy meeting which are strong economic data with respect to personal consumption expenditure, household spending and labor market. Prior to the September hike, the target range was last raised from 1.50% - 1.75% to 1.75% - 2.00% in the June policy meeting. During the latest monetary policy meeting in November, the Committee maintained the target range at 2.00% - 2.25% and maintained its 2018 GDP growth rate forecast at 3.1% and the unemployment projection at 3.7% for 2018.

UK

According to the Office for National Statistics (ONS), the UK economy regained its footing in the second quarter of 2018 with an expansion rate of 0.4% compared to the lacklustre growth rate of 0.1% recorded in the first quarter (the weakest growth rate since 2012). The rebound was in line with market expectations and attributable to higher retail sales and a boost in the construction sector due to unseasonably warm weather. The services sector, which accounts for nearly 80% of economic activity, grew by 0.5% in the second quarter – the strongest quarterly expansion since 2016. The economic slowdown noted in the first quarter was basically due to temporary factors, such as adverse climatic conditions at the beginning of the year, which impacted retail sales, and the collapse of Carillion, the second largest construction company in UK, leading to a sharp contraction in construction activity. Though Brexit uncertainty continued to weigh down on firms' investment decisions, fixed investment grew by 0.8% quarter on quarter in Q2 compared to a negative growth of 1.3% in Q1. The external sector worsened as exports declined by 3.6% as a result of fewer car exports while the import bill was higher.

In spite of weak GDP figures, the UK labor market remained resilient during the July-September period, with the unemployment rate rising only marginally to 4.1% from 4.0% in the previous three-month period - the lowest since 1975 and below the Bank of England's estimate for the equilibrium unemployment rate of 4.25%. Despite labor shortages, the average total pay remained below the pre-financial crisis peak. Taking into account the low unemployment rate and the pick-up in economic activity, the Bank of England raised its policy interest rate (Bank Rate) from 0.50% to 0.75% during its monetary policy meeting in August and maintained the rate at 0.75% at its November monetary policy meeting. The Central Bank reiterated the fact that it would continue to tighten its monetary policy going forward, albeit gradually and to a limited extent (refer to Table 1.2 for interest rate projections). Yet, the outcome of the Brexit negotiations remains an important factor in the determination of interest rate movements.

Eurozone

According to Eurostat, economic activity in the Eurozone remained moderate in the second quarter of 2018, growing by 0.4% (preliminary estimate: 0.3%) quarter on quarter similar to the growth rate recorded in Q1. The slight upward revision was due to a better-than-expected 0.5% expansion in Germany, the bloc's largest economy, driven by consumption and government spending. Nevertheless, it was noted that economic momentum in the Eurozone was dented due to weaker business sentiment and slowing down of consumer spending in line with rising inflation. The decline in business confidence led to a drastic fall in industrial output, in the 19-country currency bloc, for the month of June mainly on account of a significant drop in machinery and equipment investment.

At its monetary policy meeting in October, the ECB kept interest rates unchanged with the main refinancing rate at 0.00%, and the marginal lending rate and deposit facility rate at 0.25% and -0.40% respectively. The ECB signaled that its asset purchase program would continue until December 2018 but at a reduced amount as from October – purchases would be halved to EUR 15 billion per month from the current EUR 30 billion per month. The statement made by the ECB president was practically similar to that of its June and September monetary policy meeting; he recapped that interest rates are likely to remain at the same level until at least the end of summer 2019 and that accommodative monetary policy is required to support higher price pressures. Recently, the inflation rate rose above the Central Bank's target of close to, but below, 2.0%, owing to higher oil prices. Though the recent economic data was disappointing, the ECB president assessed the economy in a positive light and stated that risks to the Eurozone's growth prospects remain broadly balanced.

Table 1.1: Growth Projections – Selected Major Global Economies

		POLL OF FORECASTERS, OCTOBER AVERAGES			
	2017	2018		2019	
Percent change in real GDP		Average	Range	Average	Range
US	2.3	2.9	2.7–3.1	2.5	1.6–3.3
UK	1.7	1.3	1.2–1.4	1.4	0.9–1.9
Eurozone	2.4	2.1	1.9–2.3	1.8	1.5–2.2
China	6.8	6.6	6.5–6.7	6.2	6.0–6.6
India*	6.4	7.4	6.6–7.7	7.3	6.8–7.6
South Africa	0.9	0.7	0.5–0.9	1.7	1.2–2.4

Source: The Economist (October poll of forecasters)
* For the fiscal year ending March of the following year.

Table 1.2: Central Bank Interest Rates

		NOVEMBER SURVEY - MEDIAN FORECASTS	
Percent	Current	Q4 2018	Q4 2019
Federal Funds Rate	2.00–2.25	2.25–2.50	2.75–3.00
BoE Bank Rate	0.75	0.75	1.10
ECB Main Refinancing Rate	0.00	0.00	0.10

Source: Bloomberg

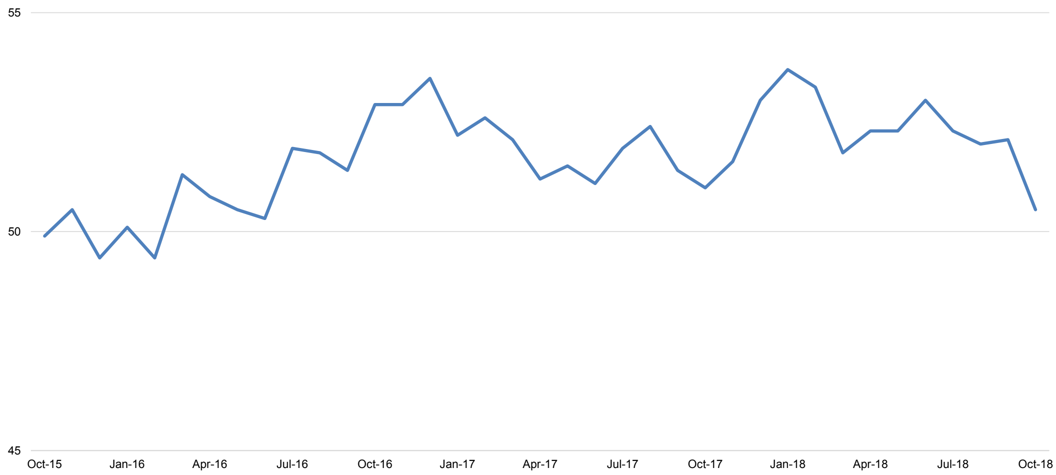
Selected Emerging Markets

China

The Chinese economy expanded by 6.7% in the second quarter of 2018, marginally below the 6.8% growth recorded in the previous three quarters. The reading was in line with market expectations and above the government's target of 6.5% economic growth rate for 2018. The main drag factors were the escalating trade tension between China and the US and the series of measures adopted by the government to curtail the high debt level and its efforts to crack down on shadow banking. The trade war with the US showed its preliminary effect on factory growth output which decelerated to 6.0% – a two-year low – in the second quarter. The imposition of USD 34 billion worth of tariffs on Chinese imports (effective from July) and the retaliatory move of the Chinese government to the punitive measures that provoked the US President to contemplate the imposition of additional USD 500 billion tariffs on imports, would stifle economic growth in due course. Conversely, exports surged in June whereby exporters seized the opportunity to ship goods ahead of the implementation of the tariffs (unsurprisingly, a similar situation was noted in the US). The East Asian giant is currently facing challenges on several fronts, in the face of a cooling property market, which is a key economic driver, high dependency on exports, sluggish credit growth and weak consumer spending.

In the wake of the ongoing trade spat, business confidence dipped further, which reflected in a drop in the Caixin China General Composite PMI, covering both the manufacturing and services sectors, from 52.1 in September to 50.5 in October. The decline was attributable to a slower growth in new orders across both sectors, particularly across the services sector owing to subdued demand conditions. The data pointed out to a marked deterioration in optimism among both manufacturing and services companies. With respect to the manufacturing companies, optimism fell to an 11-month low, while the services sector signaled the weakest level of confidence since July.

Figure 1.3: Caixin China General Composite PMI



Source: IHS Markit
Readings above 50 indicate an improvement in business conditions while readings below 50 signal a deterioration

The tightening of the US monetary policy triggered capital outflows from emerging markets, leading to the depreciation of the yuan. Nonetheless, the Chinese authorities did not intervene on the financial markets to prevent further depreciation of the currency. This led market analysts to speculate that the authorities were allowing the yuan to weaken to prop up the external sector. In late August, the likelihood of a "trade-talk" negotiation between the US and China halted the depreciation of the yuan. Additionally, the currency benefited from the People's Bank of China (PBOC) decision to set its daily reference rates higher, preventing the yuan from declining further. Besides, the PBOC initiative to set a reserve requirement of 20% on commercial banks' purchase of foreign exchange forwards provided additional support to the Chinese currency.

India

The Indian economy grew stronger in the fourth quarter of fiscal year 2017/18 (Jan-Mar 2018 quarter), leaving behind the effects of the demonetization and the introduction of the Goods and Services Tax. GDP growth rate for the quarter reached 7.7% year-on-year – above market expectations of 7.3% and the highest reading since 2016 (Q3 2017: revised growth rate of 7.0% against the previously reported 7.2%). The main drivers of this growth figure were strong private consumption growth and an increase in fixed investment. Nevertheless, the economic expansion decelerated to 6.7% in fiscal year 2017/18 (FY 2016/17: 7.1%).

In the first quarter of the fiscal year 2018/19 (Apr-Jun 2018 quarter), GDP expanded by 8.2% year-on-year beating market expectations of a 7.6% expansion and turning out to be the highest in over two years. Consumer spending was the main driver of growth. Private consumption grew by 8.6%, higher than the 6.7% recorded in the previous quarter and the fastest expansion in two years. In contrast, government consumption growth slowed down to 7.6% in the first quarter, significantly lower than the 16.9% expansion registered in Q4 of FY 2017. Business-wise, fixed investment increased by 10.0%, down from 14.4% in Q4 FY 2017. Despite recent strong economic data, there are several risk factors looming over the horizon, in the form of higher oil prices and tighter global financial conditions, that could potentially impede future economic growth.

Figure 1.4: Nikkei India Composite PMI

Source: IHS Markit
Readings above 50 indicate an improvement in business conditions while readings below 50 signal a deterioration

The PMI index rose from 51.6 in September to 53.0 in October, the second highest reading since October 2016 (Jul: 54.1), mainly on account of improved order flows supported by a pickup in output due to favorable market conditions, a larger client base and aggressive advertising. According to IHS Markit, the services sector expanded at its quickest pace since July, due to a significant increase in business orders that also led to a robust workforce expansion.

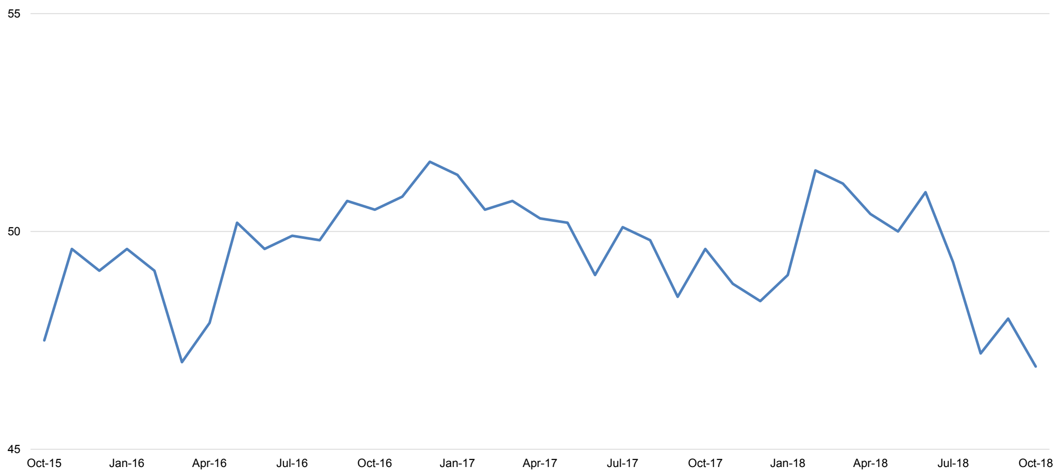
In August 2018, the repo rate was increased from 6.25% to 6.50%, or by 25 basis points. The reverse repo rate was also raised to 6.50% along with the Marginal Standing Facility Rate and the Bank Rate to 6.75%. That was the second rate hike in three months as a result of high inflation and a weak rupee. Though the inflation rate reached near the midpoint of the RBI's target range of 2% - 6%, the Central Bank maintained its inflation rate forecasts at 4.6% for the second quarter of 2018 (Jul-Sep). However, it raised its projections for the second half of 2018 from 4.7% to 4.8% (Oct-Mar). Its economic growth forecast was maintained at 7.4% for the fiscal year 2018/19. The Monetary Policy Committee of the RBI kept the repo rate unchanged at 6.50% at its monetary policy meeting in October 2018.

South Africa

The South African economy contracted by 0.7% quarter on quarter (seasonally adjusted and annualized) in the second quarter of 2018 following a contraction of 2.6% in the first quarter (preliminary estimate: -2.2%), plunging the economy into a technical recession. According to Statistics South Africa, the first quarter negative growth was the largest drop since the financial crisis when the growth rate fell by 6.1% in Q1 2009. The agricultural and manufacturing sectors were the main negative contributors to GDP in the second quarter as a result of a decline in the production of horticulture and machinery and equipment, respectively. The sharpest decline was recorded in the agriculture, forestry and fishing industry at 33.6% and 29.2% in Q1 and Q2 respectively. Export volumes were negatively impacted causing exports to fall by 16.5%, reversing South Africa's trade surplus to a deficit in the first quarter of 2018. However, the second quarter witnessed a rise in exports by 13.7% on the back of increased trade in precious metals and mineral products. Though 2018 started on a disappointing note for the economy, it is expected that the growth rate will reach 1.5% and 2.0% in 2018 and 2019 respectively (see Table 1.1 for growth forecasts).

Consumer spending was constrained despite a low domestic consumer price inflation reading of 3.8% in the first quarter of 2018. However, inflation picked up to reach 5.1% in July compared to 4.6% in the previous month. Though the rate was the highest since September 2017, it was within the Central Bank's target range of 3.0% - 6.0%. According to Statistics South Africa, the prices of fuel reached an unprecedented high in that particular month and affected all consumer-based sectors, thus leading to a rise in the inflation rate. Another contributing factor was the weakening of the rand. Hence, risks to inflation remained tilted to the upside amid the ongoing crisis in Turkey. As a result of the free fall of the Turkish lira, emerging market currencies, including the South African Rand, witnessed massive sell-offs that led to their significant depreciation in the past few months. The Rand weakened by 19% against the USD since the beginning of the year. Partly as a result, the inflation rate is expected to hover near the upper bound of the SARB's target range, despite the 1% VAT increase that became effective in April 2018.

Figure 1.5: Standard Bank South Africa PMI



Source: IHS Markit
Readings above 50 indicate an improvement in business conditions while readings below 50 signal a deterioration

Business conditions in the private sector continued to deteriorate as evidenced by the slip in the PMI from 48.0 in September to 46.9 in October – the lowest reading since July 2014 according to IHS Markit (refer to Figure 1.5). All the five sub-indices of the PMI went south as a result of contractions in output and new orders as a consequence of subdued demand. The recent economic downturn and the volatility in the South African Rand led to the fall in consumer and business confidence, hence weakening demand for exports.

The Monetary Policy Committee of the SARB raised the repurchase rate to 6.75% from 6.50% at its November Monetary Policy meeting – the repurchase rate was reduced to 6.50% in March 2018. As mentioned in its July meeting, the Committee decided for a rate hike following the significant risk to the inflation outlook as a result of higher oil prices and a weakening rand. Consequently, the Committee lowered its growth forecast for 2018 to 0.6% (previously projected at 0.7%) but kept the growth rate unchanged at 1.9% for 2019. For its part, inflation is expected to average around 4.7% in 2018 and 5.5% in 2019.

Evolution and Outlook of Selected Commodity Prices

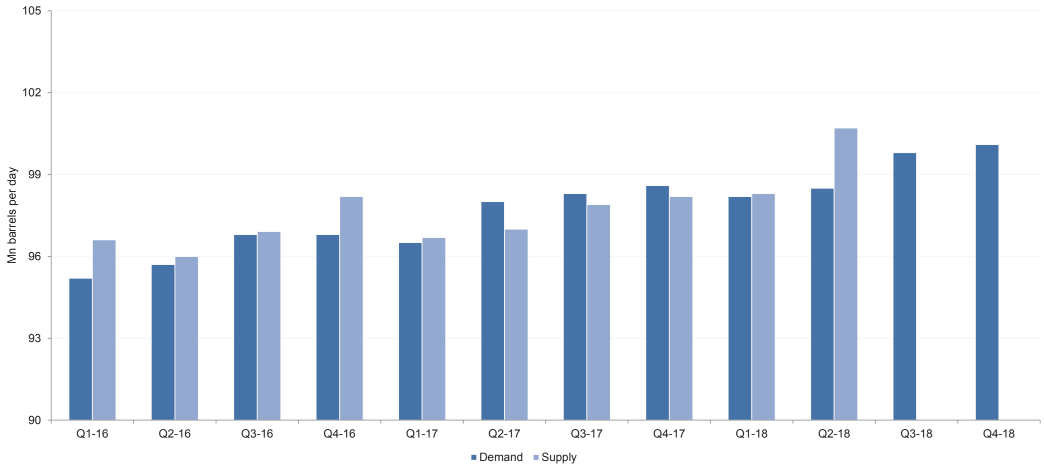
Since the beginning of 2018, the US has supplied the majority of global oil demand with crude oil production at 11 million barrels per day and exports of 2 million barrels per day as of May 2018. The International Energy Agency has projected oil production from US, Canada and other non-OECD countries of 3 million barrels per day by Q4 2018. Fundamentals that have driven prices lower in the fourth quarter of 2018 are concerns regarding oversupply and a slower than expected global economic growth. On a year-on-year basis, Brent oil price experienced a decline of 8% while on a year-to-date basis it lost 12% of its value owing to the recent collapse in oil prices.

Figure 1.6: Brent Price Evolution

Source: Bloomberg

The price of Brent fell by more than 30% since reaching a four-year peak in early October, amid intensifying oversupply concerns and worries over slowing economic growth. According to the International Energy Agency, global oil supplies continue to grow with record outputs from countries such as Saudi Arabia, Russia and the US more than offsetting the decline in oil production from Venezuela and Iran. The oil output from the OPEC rose to 33 million barrels per day in October 2018. However, oil demand remained subdued due to the higher year-on-year prices and the depreciation of the currencies of emerging markets such as India, China and South Africa (refer to earlier sections).

Figure 1.7: World Oil Supply and Demand



Source: International Energy Agency

As a result of the collapse in the price of Brent oil, the OPEC and its allies will decide about fresh production cuts at its December meeting. Looking ahead, China and India will continue to drive growth in energy demand through 2040, and oil will continue to remain one of the major sources of energy despite a global advocacy for cleaner energy resources, according to the World Oil Outlook 2040 report. Hence, oil demand and supply are expected to remain buoyant in the long term given the rise in demand from developing economies and booming shale oil in the US, respectively. The influence of the OPEC will, in all likelihood, continue to be tempered given the rising oil production in the US.

Table 1.3: Brent Price Forecasts

USD/barrel	ACTUAL Q1 2018	ACTUAL Q2 2018	ACTUAL Q3 2018	Q4 2018	Q1 2019
Bloomberg median (as of 30.11.2018)	67	75	76	76	77
US Energy Information Administration	67	75	75	76	71

Sources: Bloomberg, US Energy Information Administration

Metal prices are projected to increase by 9% in 2018 due to a pickup in demand. An 11% decline in iron ore prices - reflecting stronger production, especially in China - is expected to be more than offset by projected increases in the prices of all other base metals. The potential upside price risks include a more robust global demand than expected and production shortages. Supply could be curtailed by further sanctions against metal exporters and policy changes in China. Downside risks include slower growth in major emerging markets and idle capacity in China.

As per the World Bank, agricultural prices are projected to increase by 2.2% in 2018 and a further 1.3% in 2019, mainly due to lower plantings of certain crop fields. But the trend might reverse following the introduction of duties on soybeans by China in response to US tariffs, which would conceivably depress prices. The typical Chinese buyers have started to shy away from purchasing soybeans grown in the US, following the imposition of the 25% tariff on the import price of American soybeans - which have traditionally been the cheapest and highest-quality beans as well as the US largest agricultural exports. The Chinese have started looking for alternative sources, like soybeans from the second and third largest soybean growers, namely Brazil and Argentina. Hence, the lack of buyers for American soybeans, in other words, low demand, is likely to lead to a surplus of beans, thus driving down the prices.

Figure 1.8: World Bank Commodity Price Indices

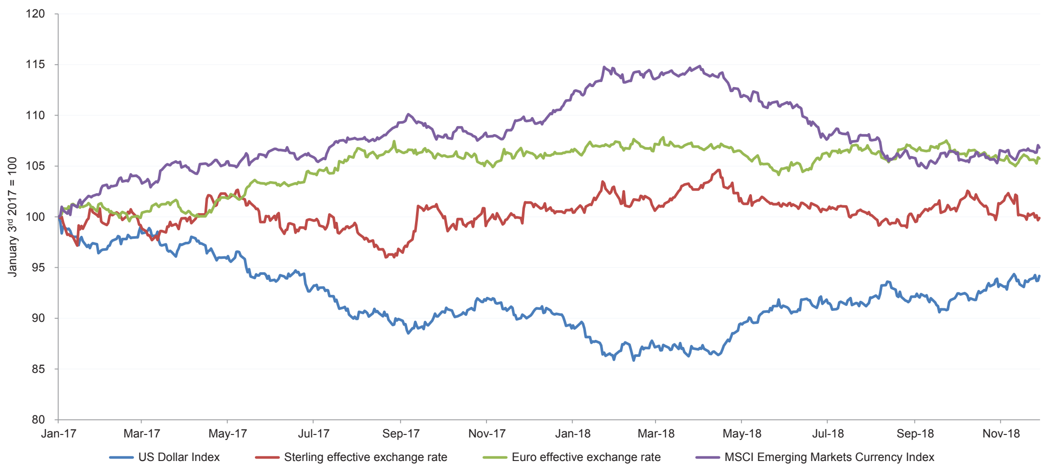
Source: World Bank

Evolution and Outlook of Selected Currencies

The US dollar Index, which measures the value of the dollar relative to six advanced-economy currencies, has been gaining momentum on the back of strong economic data and expectations of further rate hikes at the end of 2018. The index rose by 5% on a year-to-date basis, reaching new highs in 2018. Despite a range of factors, such as strengthening commodity prices and the likely impact of Trump administration's policies on the economy, which have put pressure on the US dollar index in the first months of 2018, the situation has now reversed. Many emerging-market currencies have lost their momentum, on the back of the Turkish crisis which resulted into massive sell-offs against the dollar since February - as reflected by the downward trend of the MSCI Emerging Markets Currency Index, which tracks the value of 25 emerging-market currencies against the US dollar (refer to Figure 1.9).

The euro effective exchange rate – a trade-weighted measure of the euro's value – was stronger in the first quarter of 2018 but lost momentum in the second quarter as a result of weak economic data and skepticism surrounding the ability of the ECB to tighten its monetary policy stance as planned. But it regained its footing in the third quarter when the ECB reiterated its plans of winding down the asset purchases relating to the quantitative easing program by the end of 2018 and maintaining interest rates at its current level through the summer of 2019. The sterling gained strength between February and April as the inflation rate remained close to the Bank of England's target rate of 3% and expectations of an earlier-than-expected rate hike firmed up. However, uncertainties associated with the Brexit deal kept the value of the sterling rather subdued thereafter. Other factors contributing to the low sterling rate were weak economic data and a drop in business confidence. According to market analysts, the sterling is expected to remain vulnerable due to Brexit negotiations in the months ahead. Refer to Table 1.4 for exchange rate forecasts.

Figure 1.9: Evolution of Indices of Major Global Currencies



Sources: Bloomberg, Bank of England, European Central Bank, MSCI, SBM Staff Estimates

Table 1.4: Exchange Rate Forecasts

	SPOT PRICE	ACTUAL	ACTUAL	ACTUAL	NOVEMBER - MEDIAN FORECASTS			
	30/11/2018	Q1 2018	Q2 2018	Q3 2018	Q4 2018		Q1 2019	
					Median	Range	Median	Range
EUR/USD	1.13	1.23	1.19	1.16	1.16	1.12 - 1.19	1.18	1.10 - 1.21
GBP/USD	1.27	1.39	1.36	1.30	1.30	1.24 - 1.39	1.33	1.19 - 1.46

Source: Bloomberg

Risks to the Outlook

The global macroeconomic environment remains tumultuous, with risks for the near and medium terms shifting further to the downside. The major risks that may disrupt global growth include the following:

- Geopolitical tensions, particularly in East Asia and the Middle East;
- Protectionist measures disrupting global supply chains, stifling global trade and hence global economic growth rate;
- Aggressive tightening of interest rates by the Federal Reserve affecting the performance of the US economy;
- A sharp economic slowdown in China due to a disorderly unravelling of the credit boom.

ECONOMIC OUTLOOK - MAURITIUS

HIGHLIGHTS

- Real GDP at market prices grew by 3.9% in the first half of 2018. With the momentum expected to be sustained in the second half and beyond, the growth rate is projected at a similar rate for 2018 as a whole, increasing slightly in 2019.

- Economic activity was buoyant in the first semester of 2018 on the back of high investment in non-residential buildings and in other construction works amidst increased public sector investment in the transport sector as well as higher private sector investment in the real estate sector.

- Consumption growth also accelerated in the first half of 2018 compared to the corresponding period in 2017, driven by an upturn in the public sector as well as resilient private sector consumption activity. This was supported by an increase in disposable earnings for lower income categories following the implementation of a minimum wage structure, as well as increases in annual cost of living compensation.

- While the main contributors to growth are construction, trade, financial services, accommodation and food service activities, and business and financial services, some key export-oriented sectors, namely sugar and textiles, continue to struggle and drag down the economy.

- Changes in the global business environment pose a risk to the economy, with a potentially adverse impact on a few other sectors, prominently professional services and administrative and support activities.

- The number of vacancies has remained strong, underpinned by increased activity in the construction, trade, tourism and real estate sectors coupled with the various schemes announced in the Budget 2018/19 to create more job opportunities, especially to fresh graduates and women. The unemployment rate for 2018 and 2019 is projected to further improve to 6.9% and 6.8% respectively.

- Despite atypical fluctuations in the prices of food and energy, among others, the inflation is projected to remain moderate, at close to 3%.

- The deficit on the balance of trade is expected to remain high, but the current account deficit should somewhat narrow in 2018 and 2019, supported by services exports and external grants.

- Nonetheless, the balance of payments is forecast to post a strong surplus in line with sustained net financial inflows. This should provide some support to the currency.

- Monetary and fiscal policies are expected to remain supportive to growth, albeit with some degree of consolidation to build buffers against future shocks.

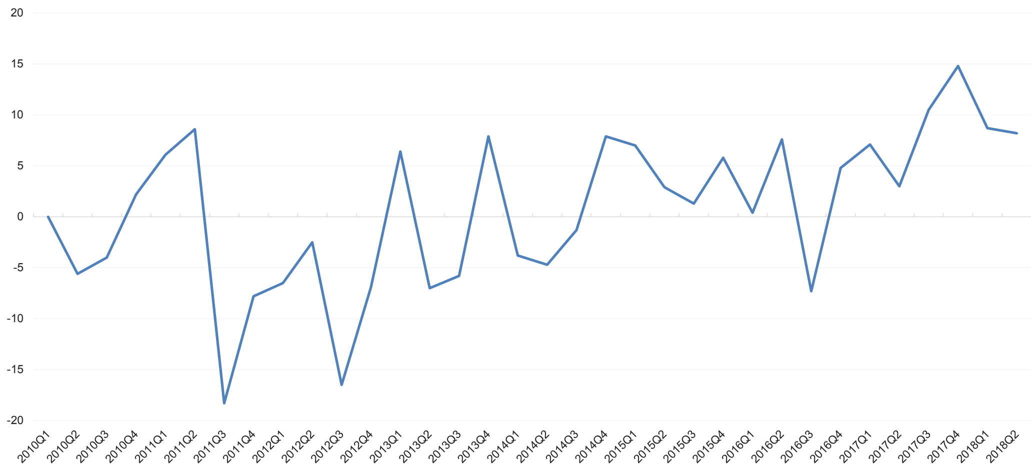
- Risks to the domestic economic outlook appear to be broadly balanced.

- Downside risks include: a weaker-than-expected global macroeconomic environment, significantly higher financial outflows than anticipated following the revision of the DTAA and execution lags in respect of key infrastructure projects.

- On the upside, an acceleration in the implementation of the public investment program, a faster transition to a regional and financial hub supported by appropriate policy measures, and an earlier adoption of technology and innovation in the way of doing business and in the public sector, would propel the economy to a higher growth path.

Economic activity was buoyant in the first half of 2018, as previously anticipated, with investment in building and construction works registering a significant increase in the first half of 2018 (Q1: +8.2%, Q2: +10.3%; year-on-year). This outturn was driven by a solid performance of investment in non-residential buildings (Q1: +24.3%, Q2: +25.4%; year-on-year) and in other construction works (Q1: +18.9%, Q2: +22.2%; year-on-year), further to the upswing in public sector investment, namely with respect to the transport sector, as well as higher private sector investment in the real estate sector. Consumption growth also accelerated in the first half of 2018 (Q1: +3.5%, Q2: +4.0%, year-on-year) compared to the corresponding period in 2017 (Q1: +3.4%, Q2: +3.0%), driven by an upturn in the public sector as well as resilient private sector consumption activity. Net exports of goods and services remained negative in the first semester of 2018 as some export sectors continue to struggle, but the deficit was lower compared to the first half of 2017. Overall, real GDP at market prices grew by 3.9% in the first half of 2018. With the momentum expected to be sustained in the second half and beyond, the growth rate is projected at a similar rate for 2018 as a whole, increasing slightly in 2019. The robust performance should continue to be supported by strong investment amidst an upturn in business confidence, as illustrated in Figure 2.1, as well as resilient growth in consumption.

Figure 2.1: MCCI Business Confidence Index



Source: MCCI

Analysis by Selected Sectors

From a sectoral perspective, the main contributors to growth are: construction, trade, financial services, accommodation and food service activities, and business and financial services. On the other hand, some key export-oriented sectors, namely sugar and textiles, continue to struggle and drag down the economy.

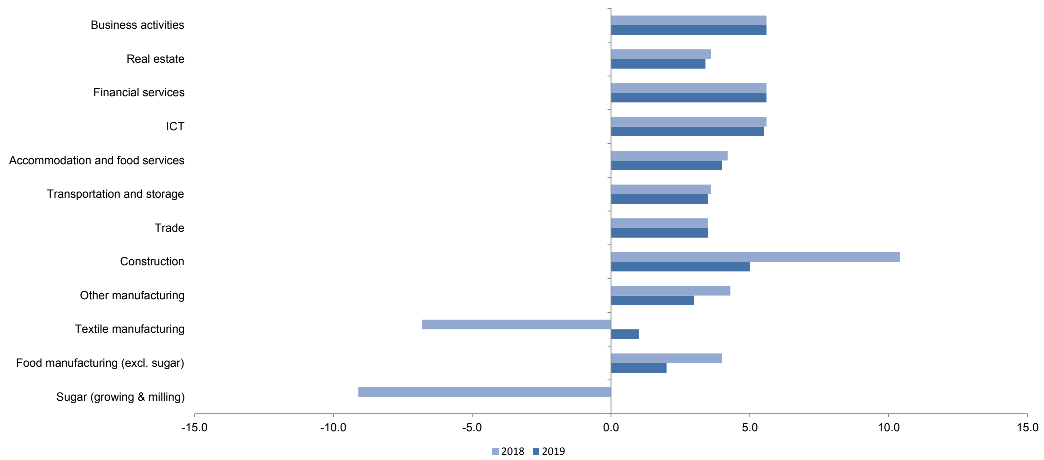
Growth upturn led by construction, trade, tourism and business and financial services

Construction activity accelerated in the first half of 2018 as both public sector and private sector investment picked up. On the public sector front, major progress has been achieved in respect of land transportation projects, including the Metro Express light railway project and major road infrastructure projects such as the Phoenix roundabout and the A1-M1 bridge. The construction of a major sports center at Côte d'Or as well as a new Supreme Court in Port Louis are well underway. These undertakings should continue to provide support to construction activity in 2019 whilst new projects, namely the extension of Bagatelle Mall, the construction of Beau Vallon Mall and a new hospital at Flacq for a total investment value exceeding MUR 5 billion, will further boost the sector's growth. As regards the private sector, investment in hotel development was lower than earlier anticipated in view of delays in the materialization of some projects, but this was compensated by higher investment in real estate projects. This sector continues to benefit from high foreign interest. Looking ahead, private sector investment is expected to remain strongly driven by the hospitality sector.

An upturn was also noted in the trade sector in the first semester of 2018 in line with an increase in disposable earnings for lower income categories following the implementation of a minimum wage structure, as well as increases in annual cost of living compensation. Although the growth rate remains moderate, the sector is expected to be one of the major contributors to overall expansion by virtue of size. The sector should sustain a healthy performance in 2019 as the economic recovery takes hold.

The accommodation and food services sector (mainly led by tourism) continued to buttress its position as a main pillar of the economy with tourist arrivals projected to reach 1,395,000 and expected to generate gross earnings of MUR 64 billion for the year 2018. The good performance of the industry is underpinned by an increase in seat capacity following the arrival of Saudi Airlines, KLM Royal Dutch Airlines, Kenya Airways and additional flights by British Airways. According to latest statistics, tourist arrivals increased by 4.2% for the first 10 months of 2018 year-on-year. The industry is projected to sustain an appreciable performance in 2019 and beyond on the back of an expected expansion of the hotel park as well as increased seat capacity over the coming years.

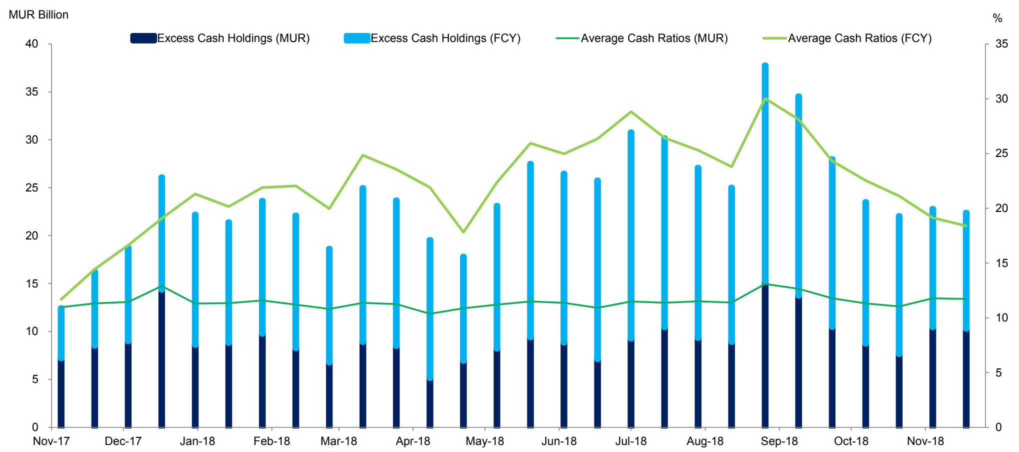
Figure 2.2: Selected Industry Growth Forecasts



Source: SBM staff forecasts

Financial services continue to be buoyant, spurred by overall economic growth as well as product and market diversification. In line with the solid investment environment, credit to the private sector picked up in the first half of 2018, increasing by 9.0% year-on-year, compared to an increase of 2.2% for the same period in 2017. Nonetheless, the banking sector - which is the mainstay of financial services - continued to be plagued by excess liquidity in the system, putting pressure on bank profitability. The Central Bank is closely monitoring the situation by mopping excess liquidity through the issuance of BOM bills as and when required. Whereas threats to the Global Business sector could reduce the availability of foreign currency funding for banks going forward, risks are mitigated by diversification of funding sources by banks and requirements for them to keep sufficient high quality liquid assets in foreign currencies. On that basis, we expect the financial services sector, led by the banking segment, to maintain strong expansion rates in the periods ahead.

Figure 2.3: Excess Cash Holdings



Source: Bank of Mauritius

From a broader perspective, changes to the Global Business environment can potentially have an adverse impact on a few other sectors, prominently professional services and administrative and support activities. Major recent developments include the OECD-driven overhaul to tax, compliance and other regulatory frameworks on the global scene, the revision of the DTAA with India and the implementation of GAAR in India. Nonetheless, we reckon that the threats posed to these sectors will be mitigated by ongoing efforts to reform the institutional setup and to broaden and deepen the Mauritius international financial center.

Table 2.1: FDI Equity Inflows into India (USD million)

	APRIL - JUNE (QUARTERLY)					
	2013	2014	2015	2016	2017	2018
Mauritius	1,099	2,610	2,089	1,896	3,293	1,494
Share of total	*20%*	*36%*	*22%*	*25%*	*32%*	*12%*
Singapore	1,852	1,187	3,673	1,976	3,010	6,519
Share of total	*34%*	*16%*	*39%*	*26%*	*29%*	*51%*
	APRIL - MARCH (YEARLY)					
	2013	2014	2015	2016	2017	2018
Mauritius	9,497	4,859	9,030	8,355	15,728	15,941
Share of total	*42%*	*20%*	*29%*	*21%*	*36%*	*36%*
Singapore	2,308	5,985	6,742	13,692	8,711	12,180
Share of total	*10%*	*25%*	*22%*	*34%*	*20%*	*27%*

Source: Department of Industrial Policy and Promotion (India)

Table 2.2: Global Business Deposits and Advances with Mauritian Banks (MUR million)

	DEC-13	DEC-14	DEC-15	DEC-16	DEC-17	SEP-18
Deposits	273,488	314,005	347,545	340,188	356,110	356,843
Advances	33,710	37,419	44,990	49,580	51,574	56,022

Source: Bank of Mauritius

Table 2.3: Number of Newly Licensed Global Business Companies

	2013	2014	2015	2016	2017	2018 (JAN - JUL)
Category 1	999	1,259	1,366	1,264	1,329	664
Category 2	1,193	1,379	1,310	1,103	1,078	578
Total	2,192	2,638	2,676	2,367	2,407	1,242

Source: Financial Services Commission (Mauritius)

Table 2.4: Target Country/Region of Investment of Newly Licensed GBC 1s in 2018

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG
Africa	61%	64%	64%	66%	62%	55%	50%	54%
India	6%	11%	5%	6%	10%	8%	5%	4%
China	3%	0%	2%	2%	1%	4%	2%	3%
Asia (ex. China and India)	12%	9%	9%	12%	10%	15%	15%	17%
America	8%	4%	4%	3%	3%	2%	4%	4%
Europe	8%	9%	15%	11%	12%	14%	21%	17%
Others	2%	4%	1%	1%	1%	1%	2%	2%
Total	100%	100%	100%	100%	100%	100%	100%	100%

Source: Financial Services Commission (Mauritius)
Note: Figures may not add up to 100% due to rounding

Table 2.5: Country/Region of Origin of Newly Licensed GBC 1s in 2018

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG
Africa	44%	41%	37%	40%	34%	32%	36%	38%
India	5%	15%	9%	4%	12%	9%	10%	9%
China	3%	0%	5%	4%	1%	8%	6%	3%
Asia (ex. China and India)	6%	9%	3%	7%	6%	11%	11%	5%
America	10%	12%	16%	11%	18%	13%	9%	18%
Europe	31%	20%	30%	32%	28%	26%	27%	26%
Others	2%	3%	1%	2%	1%	2%	1%	1%
Total	100%	100%	100%	100%	100%	100%	100%	100%

Source: Financial Services Commission (Mauritius)
Note: Figures may not add up to 100% due to rounding

Indeed, the Government has launched a series of measures including the elaboration of a blueprint for the financial services sector. The blueprint contains a number of policies and proposals which will further develop this sector based on three broad concepts namely (i) consolidating the role of Mauritius as a jurisdiction of substance, (ii) diversifying and upscaling the international business activities, and (iii) improving the country's competitiveness. Recent initiatives include: the revision of the fiscal tax regime for the global businesses and the Segment B – banking sector; the abolition of the issuance of the GBC2 licenses effective 01 January 2019. This shows the commitment of the government to abide by international norms, more specifically the OECD standards. However, the road to a more diversified and robust financial services sector is likely to be an arduous one.

The statistics displayed in Tables 2.1 to 2.5 display some mixed results, with a hint of optimism regarding future evolution. Whilst there seems to be a drop in both the volume and the share of FDI flows to India from Mauritius – with Singapore being the main beneficiary – no conclusive trend has yet emerged. The situation warrants some close monitoring given that bulk of the current stock of direct investments of GBC1s is heavily centered on India. We anticipate that, while there will be a slowdown in flows to India, some critical level of related activity will remain. At the same time, the number of new GBCs incorporated continues to be upbeat, with a strong focus on Africa-bound investments. This is testimony that the intended objective of the Government to position Mauritius as a financial hub for investment into Africa is starting to bear results, which augurs well for the future. The revamped business model will provide more opportunities for attracting talent and moving up the value chain, eventually leading to a higher contribution of this sector to the economy.

Overall, we reckon that, despite the ongoing challenges, the business activities segment - which encompasses "professional, scientific and technical activities" and "administrative and support service activities" - will continue to expand at an appreciable pace in the short to medium term.

Challenges persist in the sugar and textile sectors

The sugar growing segment posted negative growth rates of 9.5% and 8.9% on a year-on-year basis in the first and second quarters of 2018, respectively. Though the poor performance was unsurprising, it was far worse than the negative growth rates of 7.7% and 7.9% recorded in Q1 2017 and Q2 2017 respectively. According to the latest statistics, sugarcane yield was 5% lower than that recorded in November 2017 due to dry weather conditions that prevailed in the recent months (refer to Table 2.6). Though the extraction rate was higher than in 2017, it is unlikely that the sugar production for 2018 will exceed that of 2017, given that 93% of the sugarcane cultivation has already been harvested and the yield remained inferior to that of 2017. Furthermore, since the beginning of the year, global sugar prices have been under persistent pressure due to a surge in output from India, Thailand and the European Union. This will further weigh down on the sector in terms of lower exports revenue. Table 2.6 highlights the recent performance with respect to key metrics in the sugar sector.

Table 2.6: Sugar Sector Performance Metrics

	2017 (AS AT END NOVEMBER)	2018 (AS AT END NOVEMBER)
Harvested area (hectares)	28,725	30,584
Sugarcane yield (tonnes)	2,271,311	2,155,524
Sugar production (tonnes)	303,121	303,452
Extraction rate (%)	9.50	10.25

Source: Mauritius Sugar Industry Research Institute

In the light of the recent developments, the Mauritius Chamber of Agriculture further revised down its forecast for sugar production from 330,000 tonnes to 320,000 tonnes for 2018, representing a decrease of 9.9% compared to 355,213 tonnes in 2017. Other agricultural activities are also expected to contract owing to lower production of food crops. All in all, the agricultural sector, including sugar, is expected to register a negative growth rate of 3.9% in 2018. However, should climatic conditions normalize in 2019, the likelihood of a reversal of the past downtrends in the agricultural sector remains credible, albeit moderate.

The projected sugar output would also adversely impact the sugar milling segment, particularly given that no raw sugar will be imported for refining this year following the increase in customs duty on the importation of sugar from 15% to 80%, as opposed to 100,000 tonnes imported in 2017. The possible closure of Medine Sugar Milling Company Limited is another factor constraining growth. The company, which accounts for nearly 15% of total sugar production, recorded a loss of MUR 680 million for the year ended 30 June 2018 and is considering to halt its operations. In such event, a large part of production should shift to other operating mills.

Another important component of the manufacturing sector, namely textile manufacturing, is also facing important challenges such as high operational costs, shortage of local skilled workers and heightened risk of delocalization of local manufacturing companies to countries like Bangladesh where labor is cheaper. As a result, we have significantly downgraded our 2018 growth projection for this sector to -6.8%.

On a positive note, the Government has announced a series of budgetary measures to boost activity in the manufacturing sector which include the construction of new business parks across the island – a high-tech park at Côte d'Or, a logistics park at Riche Terre and a pharmaceutical and life sciences park at Rose Belle. It has been noted that some of the measures, which were put in place in the previous budget, have come to fruition. For instance, 98 companies have benefited from the Speed-to-Market Scheme, resulting in an increase of 9% in exports by air to Europe. The Mer Rouge Oil Storage Terminal, consisting of the construction of additional storage facilities of 25,000 MT for Mogas and Gas Oil, has been completed in September 2018. These developments should provide some support to the manufacturing sector going forward.

Table 2.7: Mauritius – Selected Economic and Financial Indicators

	UNIT	2014	2015	2016	2017(e)	2018 (f)	2019 (f)
REAL SECTOR							
GDP at market prices	MUR Bn	392	410	435	457	485	515
GDP at market prices per capita	USD	10,153	9,241	9,598	10,409	11,221	11,852
GDP at basic prices - real growth	%	3.6	3.1	3.6	3.6	3.6	3.8
GDP at market prices - real growth	%	3.7	3.6	3.8	3.8	3.9	4.0
Gross domestic saving (GDS)	% GDP	10.6	10.4	11.0	10.0	9.7	10.0
Gross fixed capital formation (GFCF)	% GDP	18.9	17.4	17.2	17.4	17.2	18.0
Private sector	% GDP	14.0	12.6	12.8	13.3	12.3	12.8
Public sector	% GDP	4.8	4.7	4.4	4.1	4.9	5.2
Headline inflation	%	3.2	1.3	1.0	3.7	3.3	3.0
Unemployment	%	7.8	7.9	7.3	7.1	6.9	6.8
FINANCIAL SECTOR							
Credit to the private sector (excl. GBL)†	% GDP	70.1	69.8	65.7	67.4	69.2	70.0
Deposits (Segment A)	% GDP	88.2	92.5	95.2	99.6	98.5	97.6
Key Repo Rate	%	4.65	4.40	4.00	3.50	3.50	3.50
Average MUR lending rate*	%	8.01	7.60	7.06	6.59	6.21	6.50
Average MUR deposit rate*	%	3.25	2.90	2.42	1.99	1.68	1.75
Average Treasury Bills rate*	%	2.37	2.14	2.68	2.21	3.44	3.50
GOVT SECTOR							
Budget balance	% GDP	-3.2	-3.2	-3.5	-3.5	-3.1	-3.0
Public sector gross debt	% GDP	60.7	63.6	64.4	63.7	62.2	62.0
EXTERNAL SECTOR							
Balance of visible trade	% GDP	-19.7	-18.2	-18.6	-21.9	-22.0	-21.6
Foreign direct investment	% GDP	4.7	3.3	4.2	3.8	3.0	3.0
Current account balance	% GDP	-5.6	-5.0	-4.3	-6.6	-5.5	-5.3
Balance of payments	% GDP	5.9	4.9	6.0	6.2	6.1	4.5
USDMUR annual average change	%	-0.1	14.8	2.1	-3.1	-1.7	0.3

Sources: Statistics Mauritius, Bank of Mauritius, Ministry of Finance, SBM staff estimates

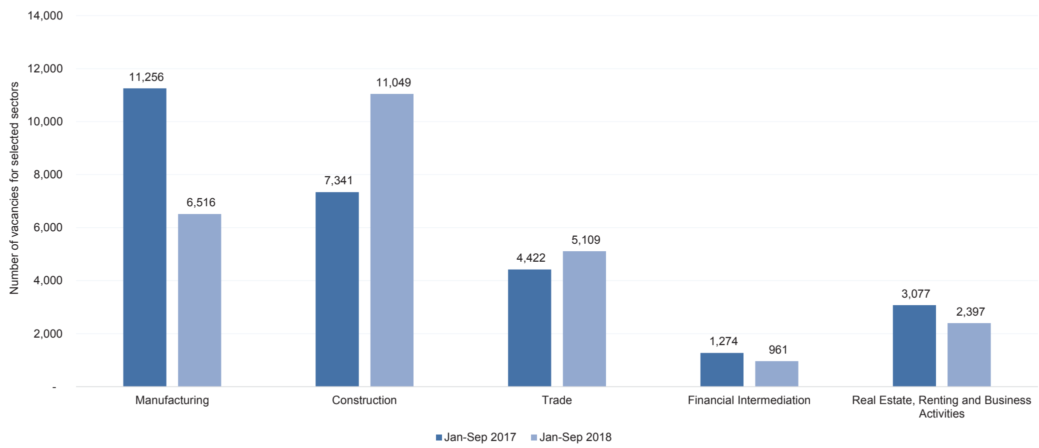
†End of period * mean of monthly weighted averages (e) Estimates (f) SBM staff forecasts

‡ due to the change in fiscal year from calendar year to a July-June cycle in 2015, 2014 figures relate to calendar year, the 2015 figure relates to the Jan-Jun 2015 period, and the 2016, 2017, 2018 and 2019 figures relate to the Jul15-Jun16, Jul16-Jun17, Jul17-Jun18 and Jul18-Jun19 fiscal years respectively.

Unemployment

The unemployment level declined in both Q1 2018 and Q2 2018, leading to lower joblessness rates of 7.1% and 7.0% respectively compared to 7.6% and 7.2% in the corresponding periods of 2017. Trade and construction were two of the key sectors supporting employment. The improvement trend is expected to continue in the second half as gauged by a year-on-year reduction in the number of registered unemployed workers as at September 2018. Moreover, the number of vacancies has remained strong, underpinned by increased activity in the construction, trade, tourism and real estate sectors coupled with the various schemes announced in the Budget 2018/19 to create more job opportunities, especially to fresh graduates and women. Overall, we forecast the unemployment rate for 2018 and 2019 to further improve to 6.9% and 6.8% respectively.

Figure 2.4: Number of Vacancies for Selected Sectors



Source: Ministry of Labour, Industrial Relations, Employment and Training (Employment Division)

Table 2.8: Registered jobseekers

	AS AT SEP 2017	AS AT SEP 2018	% CHANGE
Registered jobseekers			
Male	25,175	20,827	-17.2
Female	22,749	26,255	15.4
Total	**47,924**	**47,082**	**-1.8**
o/w Registered unemployed jobseekers			
Male	8,296	7,581	-8.6
Female	16,879	16,419	-2.7
Total	**25,175**	**24,000**	**-4.7**

Source: Ministry of Labour, Industrial Relations, Employment and Training (Employment Division)

Inflation

The headline inflation, calculated on a 12-month moving average basis, stood at 3.4% as at November 2018 compared to 3.5% in November 2017. Inflationary pressures have started to dissipate as prices of vegetables – whose atypical pattern had accounted for a large part of the recent increase in inflation – have now reverted to near seasonal levels. This translated in a lower year-on-year inflation rate of 2.8% for the month of November 2018. Within this context, we anticipate that the inflation rate will pursue its downward trend in the coming few months, despite demand-pull pressures linked to a projected increase in consumption and mildly higher international commodity prices expected on an annual average basis. Overall, we expect an inflation rate of 3.3% for 2018. Taking into consideration milder energy price expectations for 2019 on international markets, and barring any large significant shocks, it is forecast that the inflation rate will remain low, at close to 3%, next year.

A new basket of goods and services was derived following the quinquennial Household Budget Survey in April 2018. The results confirmed an improvement in the standard of living of the Mauritians as the average monthly household disposable income was higher by MUR 7,390, increasing from MUR 29,420 in 2012 to MUR 36,810 in 2017, representing a growth rate of 25.1%. Over the same period, the price of households' consumption goods and services, as measured by the CPI, increased by 13.3% and the average household size decreased by 2.9% from 3.5 to 3.4 persons. After adjusting for the price increases and smaller household size, there has been an increase of 13.7% in the real income of households.

External Balance

The current account registered a deficit of 6.5% of GDP in the second quarter of 2018, lower by 0.4 percentage points when compared to the corresponding quarter in 2017, on the back of higher gross tourism receipts which reached MUR 15.0 billion in Q2 2018, from MUR 13.2 billion in Q2 2017. Though the deficit on the balance of visible trade improved from 18.1% in Q1 2017 to 16.6% of GDP in Q1 2018, it deteriorated to 21.1% in the second quarter due to higher imports of food and live animals (+23%) as well as machinery and transport equipment (+32%). Thus, the current account is expected to remain under pressure in 2018 and 2019 as exports of goods, mainly sugar and textiles, continue to struggle. In contrast, external grants for capital projects will provide support to the external balances. Overall, we forecast that the current account deficit will narrow to around 5.5% and 5.3% of GDP in 2018 and 2019 respectively. Net financial inflows are expected to remain robust in the short and medium terms. Nonetheless, rising US interest rates and the implementation of the Indian GAAR and the phasing out of the grandfathering clause for GBCs in 2019 could trigger a dampening of net inflows.

Currency

The Mauritian rupee depreciated against the US dollar by 2.4%, but appreciated against the pound sterling and euro by 2.5% and 3.6% respectively on an average basis, over the ten months period ended October 2018 when compared to the same period in 2017. In parallel, a sustained rise in the gross official international reserves was noted for the same period, which is largely due to increases in banks' foreign currency balances with the Bank of Mauritius in line with liquidity coverage ratio requirements. Against this background, we expect the rupee to strengthen in 2018 on a trade-weighted basis, particularly if the cross-rates between international currencies remain close to 1.18 for EUR/USD and 1.33 for GBP/USD on an annual average basis, as suggested by the consensus forecasts. Deviations from these rates and fluctuations in financial inflows would however cause the rupee rates to diverge from the forecast trend.

Monetary and Fiscal Policies

On 09 November 2018, the Monetary Policy Committee (MPC) of the Bank of Mauritius voted unanimously to keep the Key Repo Rate unchanged at 3.50%, concluding that the current monetary policy stance was supportive of economic growth while inflationary pressures remained contained. This decision was in line with market expectations. Yields on treasury bills have been hovering around 3.60% on average since March, after having picked up significantly from 2.54% on 02 February to 3.82% on 02 March. We expect the MPC to maintain its accommodative stance throughout 2018 and 2019. Nonetheless, in the event of rising inflation due to atypical local climatic conditions during the summer season and global economic developments, such as rising oil prices and increasing interest rate differentials in US, the MPC could consider adjusting the Key Repo Rate accordingly.

As stated in our May edition, the budget deficit is expected to hover close to the set target of 3.2% of GDP in the financial year 2017/18 compared to 3.5% in the preceding financial year. According to provisional data from the Ministry of Finance, public sector debt stood at 64.2% of GDP as at September 2018. It is expected that the debt level will remain above the desired level for some time as the Government invests massively in infrastructure.

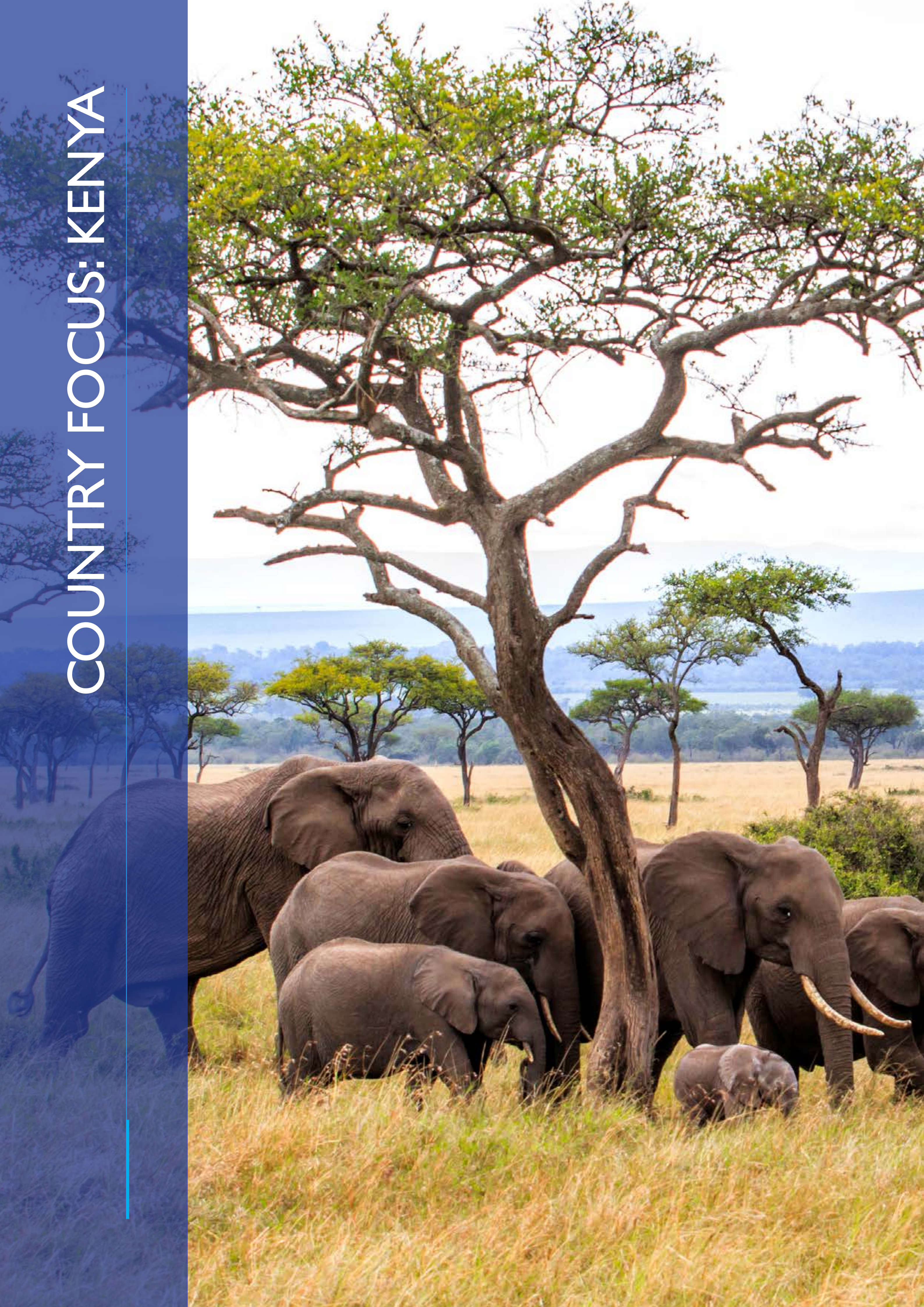
In the last National Budget 2018/2019, several fiscal consolidation measures were taken, including the harmonization of the tax regime of the banking and global business sectors, the introduction of a 10% withholding tax on the winning amount exceeding MUR 100,000 obtained from gains on lotteries as well as in casinos and gaming houses. Other landmark measures were announced in the Budget 2018/2019, such as decreasing the income tax rate from 15% to 10% for employees earning between MUR 305,000 and MUR 650,000 annually, with a view to promoting equity. The impact of the fiscal measures on the ratio of tax revenue to GDP is expected to be marginally positive.

Risks to the outlook

Risks to the economic outlook appear to be broadly balanced. Downside risks include: a weaker-than-expected global macroeconomic environment, significantly higher financial outflows than anticipated following the revision of the DTAA and execution lags in respect of key infrastructure projects.

On the upside, an acceleration in the implementation of the public investment program, a faster transition to a regional and financial hub supported by appropriate policy measures, and an earlier adoption of technology and innovation in the way of doing business and in the public sector, would propel the economy to a higher growth path.

COUNTRY FOCUS: KENYA



HIGHLIGHTS

- The Kenyan economy expanded by 5.7% in the first quarter of 2018 as agriculture, which accounts for almost a third of the economic output, benefited from favorable weather conditions.

- Other factors that contributed to the good macroeconomic performance included:
(i) a stable interest rate environment,
(ii) a fairly stable currency,
(iii) improved business confidence and strong private consumption, and
(iv) a moderate inflation rate.

- The momentum was maintained in the second quarter when the economy grew by 6.3% year-on-year, higher than the 4.7% expansion recorded in the corresponding quarter of 2017 and the fastest pace of expansion since 2016. "Accommodation and food service", "information and communication" and the "agriculture" sectors were the largest contributors to the overall second quarter growth rate, with expansion rates of 15.7%, 12.6% and 5.6% respectively.

- After widening to 6.7% of GDP in 2017 (2016: 5.2%), the current account deficit started to narrow in 2018 on the back of strong agriculture exports, rising transfer inflows, and lower capital goods imports following the completion of the Mombasa-Nairobi phase (first phase) of the Standard Gauge Railway (SGR) project.

- At its Monetary Policy Meeting in September, the Central Bank of Kenya (CBK) maintained the Central Bank Rate at 9.00%, in line with market expectations, following the 50 basis point cut from 9.50% to 9.00% at its previous monetary policy meeting. This was the second cut of 2018 and the more accommodative monetary stance came about following a moderate inflation rate in the first quarter of the year.

- Though inflation continued its upward trend in September, reaching 5.7% from 4.0% in the previous month due to higher fuel and transport costs, it remained within the Central Bank's medium-term target range of 2.5% - 7.5%.

- Kenya's fiscal situation remains a cause for concern. Following the recommendations of the IMF, the Kenyan government was able to reduce its fiscal deficit by two percentage points in the financial year ended June 2017, to 7% of GDP, and set a target of 5.8% of GDP for the fiscal year ending June 2018.

- According to the National Treasury, the country's public debt stood at approximately USD 50 billion or 56% of GDP at the end of June 2018. As a result, IMF has raised its assessment of the chance of Kenya's external debt distress to moderate from low given the high refinancing risks and narrow safety margins.

- Moody's downgraded the country's rating from B1 to B2 (stable outlook) in February due to its rising debt level and the deterioration in debt affordability.

- According to UNCTAD World Investment 2018 report, Kenya remains one of East Africa's most preferred FDI destination; it was the fourth highest FDI recipient after Ethiopia, Tanzania and Uganda, in 2017. FDI flows reached USD 672 million in 2017, the highest level recorded in five years and a significant increase of 71% compared to 2016.

- Rising investor and business confidence and the government's "Big Four" Agenda should sustain economic growth in 2018 through higher infrastructure spending and investment in key sectors such as food security, affordable housing, healthcare and manufacturing. However, there are significant downside risks that could drag down the economy if appropriate measures are not taken.

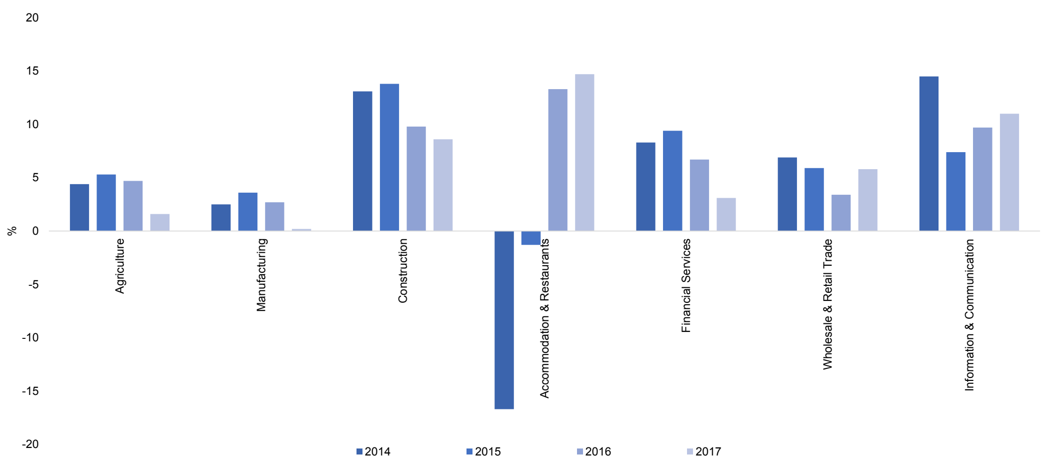
Economic overview

Kenya's economy continued to perform well, with GDP expanding by 5.7% in the first quarter of 2018, up from the 4.9% growth registered in the corresponding quarter of 2017. The strong outturn was driven by rising investor confidence following the conclusion of the prolonged electioneering period, improved weather conditions in 2018 after a severe drought in 2017 and a recovery in tourism. The macroeconomic environment was supported by: (i) a stable interest rate environment, (ii) a fairly stable currency, (iii) improved business confidence and strong private consumption as evidenced by an average Stanbic PMI of 54.4 in the first 3 months of 2018 - up from 50.2 for the same period in 2017, and (iv) a moderate inflation rate, with the average inflation rate for the first quarter of 2018 declining to 4.5% from 8.8% in Q1 2017.

In the second quarter of 2018, the Kenyan economy grew by 6.3% year-on-year, higher than the 4.7% expansion recorded in the corresponding quarter of 2017 and the fastest pace of expansion since 2016. "Accommodation and food service", "information and communication" and the "agriculture" sectors were the largest contributors to the overall second quarter growth rate, with expansion rates of 15.7%, 12.6% and 5.6%, respectively. The commendable performance of these sectors was achieved within the context of a fairly stable macroeconomic environment and favorable weather conditions. Other sectors that made notable contributions to the quarter's economic expansion include the construction sector which grew by 6.1%, electricity and water supply (+8.6%) and transportation and storage (+7.8%). Furthermore, the manufacturing sector recovered from a contraction of 0.2% in the second quarter of 2017 to expand by 3.1% following an increase in agricultural production that boosted agro-processing activities in the quarter under review. The only sector that slowed down during the quarter was the financial and insurance activities sector, with the latter registering a growth of 2.3% compared to 3.5% in the corresponding quarter of 2017.

Against this background, 2018 is set to be a better year in terms of macroeconomic performance, particularly that near term developments are expected to be broadly positive.

Figure 3.1: Annual growth rate by selected sectors



Source: Central Bank of Kenya

Balance of trade

In the second quarter of 2018, total exports amounted to USD 1.6 billion, reflecting a year-on-year growth of 6.2% following an increase in the exports of horticulture, coffee and articles of apparel and clothing accessories. On the other hand, imports grew by 9.5% reaching USD 4.6 billion from USD 4.2 billion in the corresponding quarter of 2017. High international energy prices and an 8.7% increase in machinery imports contributed to the marked rise in the country's import bill, the latter being the country's largest import category. Some interesting dynamics were observed behind the export figures. The generally good performance of agricultural exports was due to favorable weather conditions having a beneficial effect on cash-crop production. Indeed, tea production grew by a significant 18.4% in the second quarter of 2018 compared to a meagre growth of 1.0% in the same period last year, while coffee production rose by 44.1%. However, despite the high production volume, depressed international prices of tea led to a decline of 5.1% in tea exports. Being the world's largest tea exporter, the significantly high Kenyan tea production figures in the second quarter, combined with a decline in quality, and political tension in the Middle East, contributed towards the drop in global tea prices. A similar market reaction was not observed in other agricultural exports, due to Kenya's marginal role on the international market, and thus higher production resulted in higher export receipts.

According to the Kenya National Bureau of Statistics, the value of exports to African countries accounted for 35.2% of total exports while the European Union and Asia accounted for 21.6% and 28.4% respectively during the second quarter of 2018. Regional trade continues to play a salient role in Kenya's external balances, with total exports to the East African Community (EAC) partner states rising from USD 266 million in the second quarter of 2017 to USD 288 million in the period under review. Asia, the largest source countries being China and India, accounted for 69.1% of the total import bill in the second quarter of 2018 while imports from Europe and the rest of Africa accounted for 15.8% and 11.0%, respectively, during the same period.

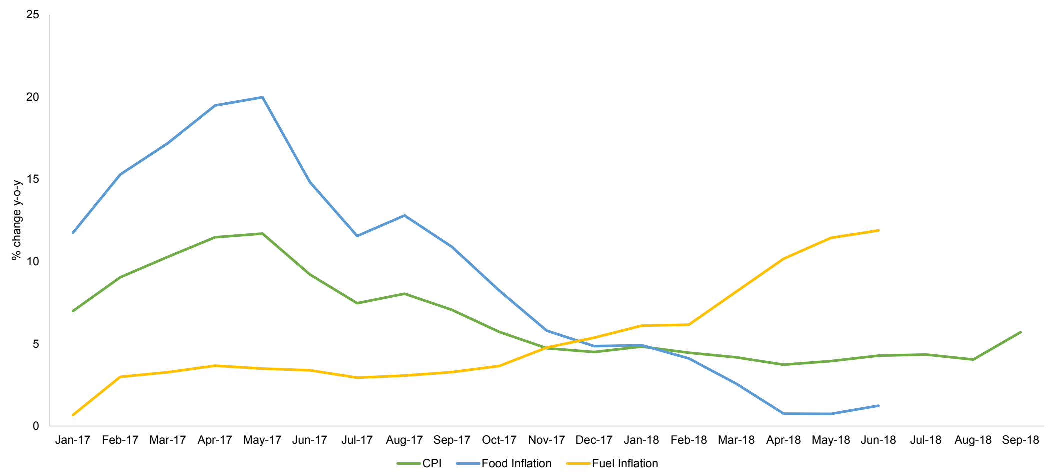
Current account

Though the trade balance deficit worsened in the second quarter of 2018, Kenya's current account deficit narrowed markedly from USD 1.3 billion in the second quarter of 2017 to USD 858 million in the quarter under review, driven by net surpluses in the services and secondary income accounts. More specifically, trade in services inflows rose by 10.1% while outflows went up by 13.3%. The secondary income account improved markedly by 56.9%, with remittances by Kenyans of the diaspora increasing to USD 747 million in the second quarter of 2018 from USD 476 million in the corresponding quarter of 2017. After widening to 6.7% of GDP in 2017 (2016: 5.2%), the current account deficit has started to adjust in 2018. Higher food imports and weaker agricultural exports owing to a severe drought in 2017 coupled with higher fuel imports led to a significant widening of deficit in 2017. The improvement so far in 2018 is due to strong agriculture exports, rising transfer inflows, and lower capital goods imports following the completion of the Mombasa-Nairobi phase (first phase) of the Standard Gauge Railway (SGR) project. The first phase is estimated to have cost approximately USD 3.8 billion with China Exim Bank providing 90% of the financing and the remaining 10% contributed by the Kenyan Government. It became operational with the passenger services in June 2017 while the freight services between Mombasa and Nairobi have been in operation since January 2018. It is expected to provide ease of movement for passengers and cargo between Mombasa, the largest port in East Africa, and Nairobi. The railway line that will connect Kenya, Uganda, Rwanda and South Sudan is the largest infrastructure project in Kenya since its independence.

Monetary policy

The Monetary Policy Committee of the CBK maintained the Central Bank Rate (CBR) at 9.00% at its September meeting, in line with market expectations, following the 50 basis point cut from 9.50% to 9.00% at its previous monetary policy meeting. That was the second cut of 2018 and the more accommodative monetary stance came about following moderate inflation in the first quarter of the year. In September, the CBK maintained its optimism regarding the country's growth prospects and inflation expectations, hence the status quo regarding the benchmark rate. Though inflation continued its upward trend in September, reaching 5.7% from 4.0% in the previous month due to higher fuel and transport costs, it remained within the Central Bank's medium-term target range of 2.5% - 7.5%. Kenya's short-term inflation outlook remains mixed following the introduction of an 8% value-added tax on gasoline in September, which is expected to have secondary effects in the coming months.

Figure 3.2 Monthly Inflation Rate



Source: Central Bank of Kenya

The CBK is currently pursuing an expansionary monetary policy stance with a view to stimulate credit expansion in the private sector by lowering the CBR for the second time in 2018. However, the outlook for private investment remains uncertain (remaining below target) to the private sector, despite a similar move in March 2018 when the Central Bank reduced the CBR from 10.00% to 9.50%. Basically, the interest rates capping law, as presently structured, poses a challenge to credit expansion in the private sector as banks have become more cautious lenders.

Fiscal policy

Kenya's fiscal situation remains a cause for concern. The main reason why both Fitch and Standard and Poor's downgraded its outlook from stable to negative in 2015 was due to its precarious fiscal stance. In 2015, the government experienced a cash crunch when it was unable to roll over short term securities (T-bills) due to high interest rates arising from a contractionary monetary policy stance. As a result, the government was constrained into utilizing revenue collected to pay its debts. The situation was further aggravated following the strong depreciation of the Kenyan shilling, which resulted into higher servicing cost of external debt. Concurrently, the government was undertaking considerable infrastructure investments.

With a view to redressing the situation, the government has since put forward proposed adjustments to its fiscal year's budget to ease some of the pressure on government finances. Most recently, the government has introduced new tax measures, including VAT on fuel and increased taxes on some electronic payments, which are expected to improve revenue performance, although the government scaled back some of the new taxes in response to protests. The government's expenditure framework will continue to be driven by the Big Four Agenda, which focuses on manufacturing, health care, affordable housing and agriculture. Government capital expenditure is expected to fall relative to GDP as many of the large public infrastructure projects have reached the completion phase. Under the pressure of the IMF, the Kenyan government was able to reduce its fiscal deficit by two percentage points in the financial year ended June 2017, to 7% of GDP, and set a target of 5.8% of GDP for the fiscal year ending June 2018.

External debt

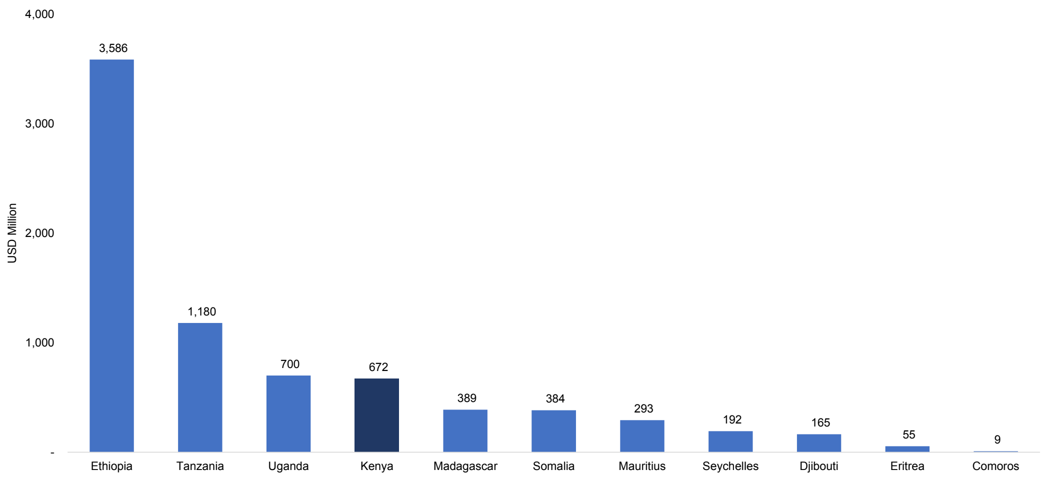
According to the National Treasury, the country's public debt stood at approximately USD 50 billion or 56% of GDP at the end of June 2018. Of the USD 50 billion, USD 25 billion was domestically borrowed and the remaining was external debt. The leading external lender was China followed by Italy, Germany, Belgium and the US. The country recently issued two debt instruments (bonds), in 2014 and 2018 respectively. Kenya raised approximately USD 2 billion from each issuance, with the proceeds being directed to government development initiatives and liability management. As a result of the high debt level, together with the over-reliance on non-concessional loans, fiscal vulnerabilities have increased such that interest payments on public debt have reached nearly one fifth of revenue. In the light of recent developments, the IMF has raised its assessment of the chance of Kenya's external debt distress to moderate from low due to high refinancing risks and narrower safety margins.

It is noteworthy to point out that China remains a prominent source of bilateral funding, accounting for 72% of bilateral debt as of March, according to official statistics. This includes the USD 1.5 billion arrangement with the China Exim Bank to fund a significant portion of the SGR. Various Chinese companies have agreed to construct some 13 different energy projects, therefore the Kenyan external debt stock is expected to increase steadily, mostly driven by the country's infrastructure investment drive. In early May, Kenya was the latest country to join the Asian Infrastructure Investment Bank, a China-led credit provider, by dropping the conditionality on deregulation, privatization, and reforms that come with support from Western-led multilateral agencies like the IMF. Kenya was also one among the 14 African states that met in Harare to discuss whether to hold the Chinese yuan as part of their foreign reserves – further emphasizing China's power on the global market. The downgrade of the country's rating from B1 to B2 (stable outlook) by Moody's in February came about owing to the rising debt level and the deterioration in debt affordability.

Foreign direct investments

According to UNCTAD World Investment 2018 report, Kenya remains one of East Africa's most preferred FDI destinations, ranking the fourth highest FDI recipient after Ethiopia, Tanzania and Uganda, in 2017. FDI flows reached USD 672 million in 2017, a significant increase of 71% and the highest FDI level recorded in five years. With a view to attract and retain investors, the Kenyan government provided a series of incentives for industries to operate. These included an exemption on dividends payable to non-residents by enterprises operating in Special Economic Zones (SEZs), a reduction of withholding tax on interest payable to non-residents by SEZ enterprises from 15% to 5%, allowing a capital deduction of 100% of the cost of buildings and machinery owned by SEZ businesses. Such tax incentives encouraged foreign investors such as South African ICT investors Naspers, MTN and Intact Software to continue their expansion in the country. American companies were also prominent tech-oriented investors, with Boeing, Microsoft and Oracle all investing in Kenya. Significant investments by Diageo (a UK beer company) and Johnson & Johnson in the pharmaceuticals also boosted Kenya's FDI last year. Mega infrastructure projects that are foreign-financed – like the Mombasa–Nairobi that is part of the SGR project – have helped propel economic growth and generate FDI inflows into the country.

Figure 3.3 Foreign Direct Investments



Source: World Investment Report 2018
Ethiopia was the second largest FDI recipient in Africa, after Egypt

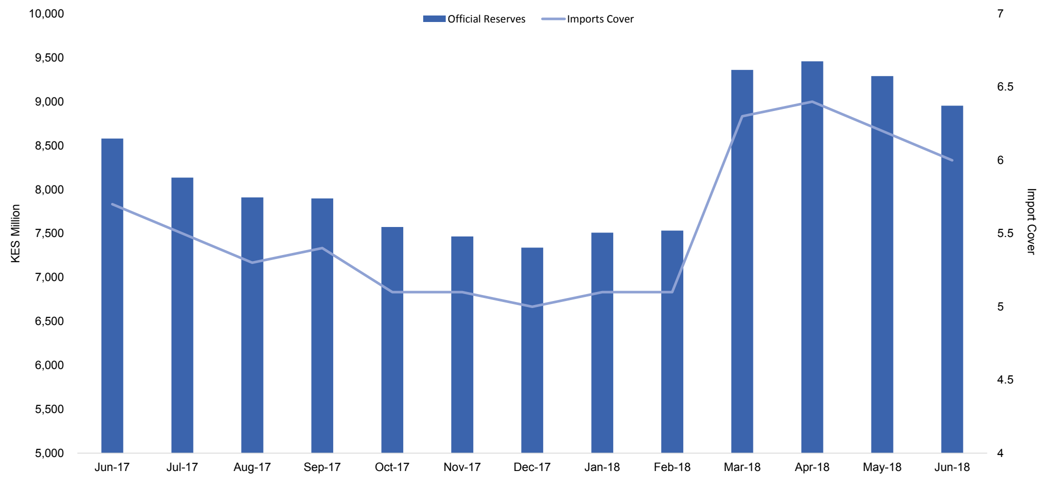
According to the Ease of Doing Business 2019 report, Kenya's business environment is also one of the most accommodating in Africa, ranking at the 3rd position in the African region after Mauritius (global rank: 20th) and Rwanda (global rank: 29th) while reaching at the 61st position in 2018 (2017: 80th) among 190 countries. This was the best performance since 2008 when the country was ranked at the 84th position, demonstrating the renewed confidence of foreign investors in the country's potential through the influx of FDI last year. However, certain areas, such as dealing in construction permits, starting a business and trading across borders, require further improvement. Getting electricity and enforcing contracts are other areas where Kenya is performing poorly. On a positive note, Kenya is ranked prominently in accessing credit (8th position globally), followed by protecting the rights of minority investors (11th position globally).

The country also has huge domestic investment potential. Nairobi is one of the largest consumer markets in Africa, and the Kenyan retail sector is by far the most developed in the region. Dar Es Salaam, which has over a million more residents that Nairobi (around 3.9 million in Nairobi versus 5 million in Dar Es Salaam), only ranks in the second place in the region, illustrating the higher per capita spending power in the Kenyan capital.

Currency and foreign reserves

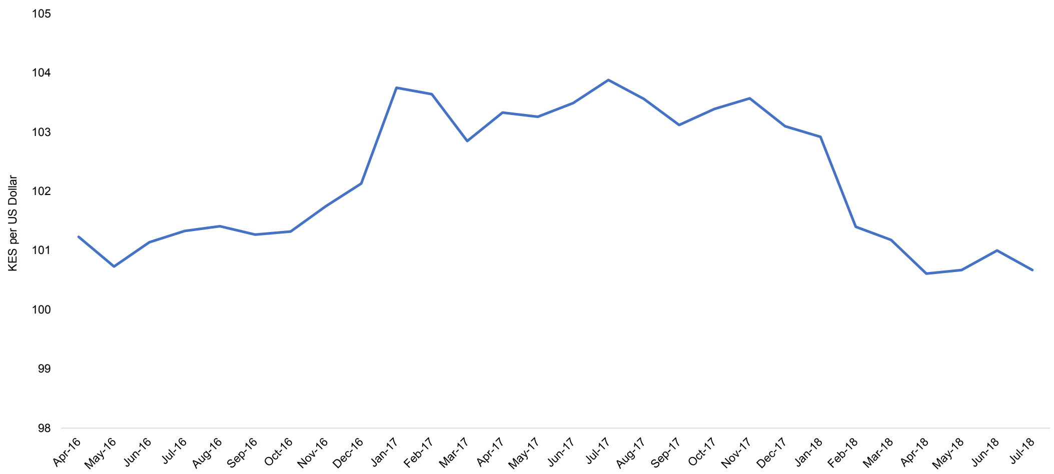
Despite massive sell-off of emerging market currencies sparked by the Turkish crisis as well as the expiry of the IMF Standby Credit Facility in September, the Kenyan shilling remained generally stable in 2018, trading between KES 100 and KES 102 to the US dollar since February. According to the CBK, the stability of the shilling against the US dollar reflected balanced demand and supply in the interbank market. The Kenyan foreign exchange reserves stood at USD 8.5 billion as of 20 September 2018, equivalent to 5.6 months of import cover, providing a comfortable level of liquidity. The reserves have been buoyant lately given the increased inflows from foreign investors buying government Treasury bonds on the debt market. Amid the high interest in government securities by investors, Kenya has recently floated 15-year Treasury bonds worth USD 400 million with a fixed coupon rate of 12.8% for budgetary support.

Figure 3.4 Foreign Exchange Reserves



Source: Central Bank of Kenya

Figure 3.5 Kenyan Shilling against the US Dollar



Source: Central Bank of Kenya

Kenya's Vision 2030

The vision to transform the country into a newly industrialized and upper middle-income country by 2030 is defined in its national long-term development policy - Vision 2030. The objective of the economic masterplan is to achieve an average annual economic growth rate of 10%, with focus on infrastructure, tourism, agriculture, trade, manufacturing, information technology and financial inclusion. The social pillar of the Vision 2030 focuses on building a fair and unified society. The political pillar seeks to achieve a democratic political system that respects the rule of law and protects the rights and freedoms of every Kenyan. The implementation of Vision 2030 is a progressive process with goals and milestones that will be achieved over time. It is being executed in successive 5-year cycles called Medium Term Plans (MTPs). The first MTP was implemented for the period 2008-2012, the second one in 2013-2017 and the third one is being implemented in 2018-2022.

An important aspect of Kenya's growth strategy is the development of the flagship Lamu Port Southern Sudan-Ethiopia Transport (Lapsset) project, which aims to strengthen Kenya's leading economic role in the East African region. The significant investment in transport infrastructure intends to establish Kenya as the preferred gateway in the region, fending off competition from Tanzania. In February, the government announced that the first berth out of the three will be completed by June 2019. The other two will be completed by 2020. However, the USD 25 billion infrastructure project continues to face numerous hindrances, from both economic and political perspectives. The Lapsset project, which includes the construction of an oil pipeline connecting oil fields in Uganda to Kenyan oil fields, before extending to the Kenyan port city of Lamu, forms an important part of the regional transport corridor as it improves the project's feasibility. However, Uganda has been showing some indecision regarding the preferred route for the country's oil export pipeline.

Currently, there are three routes under consideration: a northern route through the Lokichar basin in Kenya (favored by Tullow Oil); a southern route through the Kenyan capital Nairobi; and a third route though Tanzania (favored by Total). Kenya and Uganda are purportedly in the process of setting up a company to manage the development of the oil pipeline through the northern route, while other sources cited that Tanzania and Uganda have signed a memorandum of understanding to explore the southern route. Security concerns have been highlighted with respect to the northern route as this would expose the pipeline to war-torn Somalia, while the northern route is expected to improve economies of scale as the pipeline would cross through Kenyan oil fields. In addition to the uncertainty regarding the oil pipeline, Ethiopia has now decided against the pipeline integration with Lapsset and plans to construct an Addis Ababa-Djibouti pipeline, opting for a transport corridor to the port of Djibouti. The perpetual setbacks and uncertainty regarding the Lapsset project do not bode well for Kenya's economic outlook, particularly when considering the competition posed by Tanzania in becoming the region's preferred transportation hub.

Kenya's economic outlook and risks to the outlook

Rising investor and business confidence and the government's "Big Four" Agenda should sustain economic growth in 2018 through higher infrastructure spending and investment in key sectors such as food security, affordable housing and healthcare, and manufacturing. Despite recent high inflation rate, robust foreign reserves coupled with strong capital inflows have kept the local currency on a relatively stable path. On the fiscal front, the aim to strengthen fiscal metrics will likely be challenging given the administration's poor track record in meeting revenue collection targets in recent years. However, the continued growth in tea and horticultural exports including tourism earnings and strong diaspora remittances would result into a lower current account deficit.

Conversely, there are significant downside risks which may impede performance in key sectors. In the agriculture sector, risks emanate from high cost of key inputs, adverse weather conditions, weak infrastructure as well as poor implementation of agricultural projects, which are all likely to negatively affect food production. Issues in the execution of projects are undeniably a concern that cut across all sectors. Other risk factors include higher international oil prices and rising public debt which could impede the country's ability to borrow on the international markets.

SPECIAL REPORT: THE US YIELD CURVE

HIGHLIGHTS

- The inversion of the yield curve has correctly signaled all nine recessions since 1955 with only one false positive in the mid-1960s, according to the Federal Reserve Bank of San Francisco.

- Since 2014, the yield curve has been gradually flattening. This means that the spread between short and long-term yields of US treasury bonds has narrowed.

- Since the flattening of the yield curve is regarded as a warning sign of an economic slowdown - or even a recession if the curve results into an inversion – the current situation is a cause for concern among economists and other financial experts.

- At the beginning of 2014, the spread was close to 250 basis points while, as of October 2018, it hovered around 29 basis points on average.

- One of the major factor leading to the depressed long-term rates is the tightening of the US monetary policy, but there are other subtle factors such as anticipated lower rates of inflation and output growth as well as a future slowdown in the economy that affect the slope of the yield curve.

- According to a Bank of America Merrill Lynch Fund Manager Survey conducted in February 2018, 70% of the fund managers considered the global economy to be in its "late cycle", the highest level since 2008. A strong majority of managers (80%) expected interest rates to rise further, while an increasing - albeit still low (11%) - percentage of investors expected the US yield curve to flatten even further in 2018.

- A continuation of the Fed Reserve's tightening monetary policy will further flatten the yield curve and shift the global economy toward the late stage of the economic cycle. In the late stage, growth starts to moderate as the economy reaches its full potential. Corporate earnings continue to grow, but at a slower pace than the earlier stages. Consumer spending starts to decline and companies hold excessive inventory. Coupled with a deterioration in profit margins and tightening of credit, the economy eventually goes into recession.

- The possibility of a negative yield spread cannot be ruled out in the medium and long terms with a strong majority of economists (56%) expecting a recession by end of 2020, given the Federal Reserve's dedicated interest rate hikes plan for 2018 and 2019.

- While an imminent recession is not being foreseen, investors should nonetheless remain cautious.

Flattening of the US Yield Curve

One subject which has recently attracted the attention of market players across the globe is the US nominal yield curve - which is basically a comparison between interest rates of different maturities. It has been observed that since 2014 the yield curve has been gradually flattening. This means that the spread between short and long-term yields of US treasury bonds has narrowed. Last year, that is, 2017 marked a consolidation of this trend. The reason why the flattening yield curve has riveted the eyes of so many experts is that it is regarded as a warning sign of an economic slowdown - or even recession if the curve results into an inversion. Basically, an inverted yield curve refers to a situation when short-term yields exceed long-term yields, and this indicates that the economy is bearish.

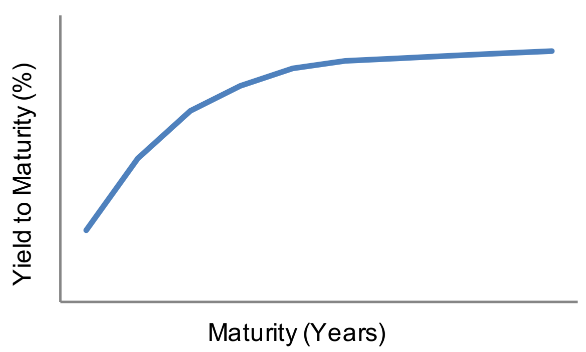
History lends support to this theory as the last seven recessions that the US economy has faced were heralded by an inversion of the yield curve. According to the Federal Reserve Bank of San Francisco, the inversion of the yield curve has correctly signaled all nine recessions since 1955 with only one false positive in the mid-1960s. Though, there was an inversion of the yield curve in the mid-1960s, it did not lead to an official recession, but an economic slowdown. An inversion of the yield curve is a reflection of several factors into play and these include a tightening monetary policy, slow growth expectations and falling future inflation expectations. The inverted yield curve also impacts financial markets, more specifically the banking sector, due to the relationship between the yield curve and the net interest margin (NIMs) of banks. The mechanism is as follows - banks pay interest on deposits based on short-term interest rates and provide loans based on long-term rates, hence an inverted yield curve puts pressure on NIMs and impacts the financial performance of banks and eventually their share prices. In turn, this can lead to a deterioration in lending conditions, and potentially a credit crunch.

As shown in Figure 4.1, the spread between the 10-year and 2-year US treasury bond yield has been falling since the last four years. At the beginning of 2014, the spread was close to 250 basis points while, as of October 2018, it hovered around 29 basis points on average.

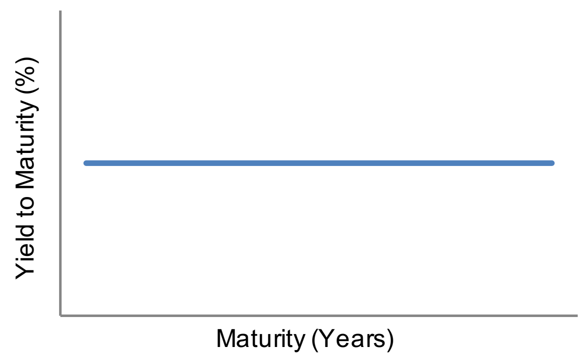
Figure 4.1: Yield Spread (10-year Treasury minus 2-year Treasury)

Sources: US Department of the Treasury, SBM Staff Estimates

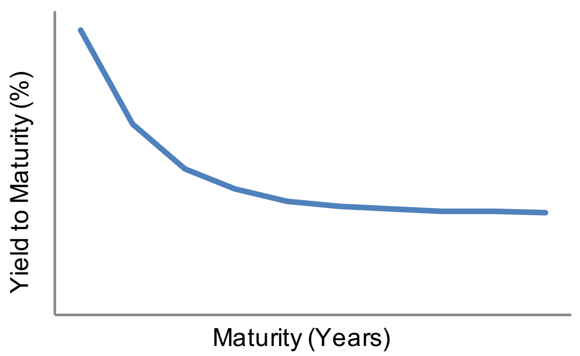
Interpretation of Different Yield Curves



Normal yield curve: Under normal conditions, interest rates on bonds with shorter maturities are lower than bonds with longer maturities; hence the normal shape, or slope, of the yield curve is upward sloping.



Flat yield curve: The curve flattens when interest rates are raised to slow down a rapidly growing economy. Rising yield reflect rising interest rates.



Inverted yield curve: The yield curve becomes inverted when long term rates are lower than short term rates. An inverted yield curve is considered to be a negative economic indicator. Inversion indicates that investors believe interest rates will be lower in the future and that often means that economic activity is at least likely to slow down and may even mean that a recession is imminent. A tightening of short term interest rates by the Federal Reserve in order to slow the economy or to rein in inflation can lead to an inverted yield curve.

Table 4.1: Evolution of Spreads at Different Maturities (basis points)

SPREADS AT DIFFERENT MATURITIES	Q1-17	Q2-17	Q3-17	Q4-17	Q1-18	Q2-18	Q3-18
10 minus 2-Year Treasury	120	96	88	68	60	44	26
30 minus 2-Year Treasury	180	160	145	112	87	61	40
30 minus 5-Year Treasury	110	109	100	75	50	32	25

Sources: US Department of the Treasury, SBM Staff Estimates

Figure 4.2: Historical correlation between US recessions and yield curve

Sources: US Department of the Treasury, The National Bureau of Economic Research, SBM Staff Estimates

The yield curve outside the US economy

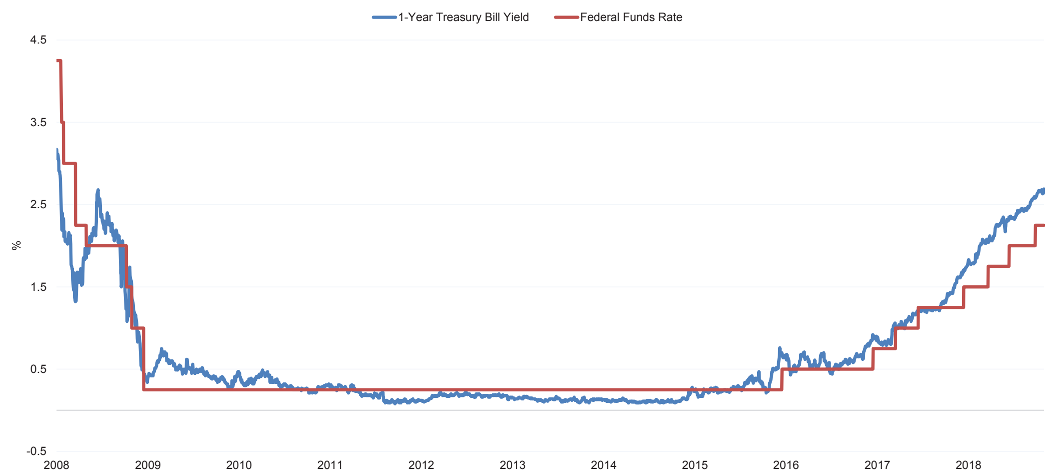
Another interesting fact is that the mechanism behind the flattening of the yield curve is not a feature of other major economies such as the UK and the Eurozone. The yield spread for both economies does not present the same warning signs as for the US economy, as depicted below by the country comparison of the yield curve. The Bank of England has recently raised the interest rate to 0.75% and is expected to increase it further in the second quarter of 2019. Consequently, yield spreads are expected to narrow in 2018, although they would remain in safe territory as of now. With regards to the Eurozone, if the ECB starts raising interest rates in 2019, this could exert upward pressure on the short end of the yield curve. However, bearing in mind that the market has already priced in the expected interest rate hike in the second quarter of 2019, it is likely that the impact would be minimal.

The dynamics behind the yield curve

It is important to note that the current macroeconomic environment is different from the past years and hence the dynamics impacting the yield curve should be analyzed differently today. A simple method to examine the current yield curve trend is to segregate the short and long-term yield components.

The tightening of the monetary policy stance of the Federal Reserve has clearly impacted the short end of the yield curve. Figure 4.3 illustrates how short-term yields have climbed considerably since the end of 2015 and beginning of 2016 when the Federal Reserve started to raise the target range of the Federal funds rate.

Figure 4.3: The Federal Funds Rate versus the 1-year Treasury Bill Yield



Sources: US Department of the Treasury, Federal Reserve

The long end of the yield curve, which reflects global growth expectations, has remained sticky and ultimately underperformed short-term yields. It declined in the first nine months of 2017 before increasing marginally in late 2017 till date.

Figure 4.4: 10-year Treasury Note Yield

Source: US Department of the Treasury

Factors driving the yield curve

While one of the major factors leading to the depressed long-term rates is the tightening of the US monetary policy, there are other subtle factors such as anticipated lower rates of inflation and output growth as well as a future slowdown in the economy. Moreover, highly accommodative monetary policies adopted by the central banks of other major economies have led to a strong demand for US treasury instruments from foreigners, further depressing long-term US interest rates. The combination of rising short-term yields and declining long-term yields has turned out to be a terrible concoction for the flattening of the yield curve.

The possibility of a negative yield spread cannot be ruled out in the period ahead with a strong majority of economists (56%) expecting a recession by end of 2020, given the Federal Reserve's dedicated interest rate hikes plan for 2018 and 2019. But this should be analyzed together with a broader set of other economic considerations. One of them is the correlation between the economic cycle and the interest rate environment. Another consideration is the expectations of investors of an economic slowdown – moving towards the later stage of the cycle to lower long-term rates. When these factors are combined with the tightening of the monetary policy (higher short-term rates), the probability of an inversion of the yield curve becomes imminent.

There are also the distortive effects of monetary policy on the financial markets and the concept that this is the main factor causing the flattening of the yield curve and risk of its inversion. This element came into focus following the 2008 financial crisis when, on a global scale, ultra-accommodative monetary policies were put in place leading to higher demand for longer-term US bonds from investors and financial institutions looking for higher yields. Yields on longer-terms US bonds became depressed due to the strong demand. Currently, the same economic dynamics are into play causing what is known as a "bearish flattening", with short-term yields rising at a faster pace than long-term yields and, in the process, paving the way for an inversion.

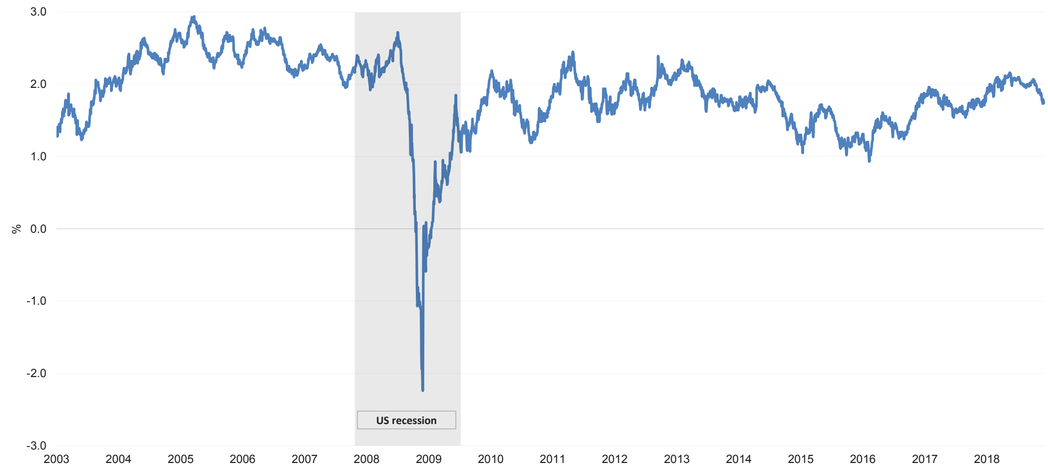
Having said that, though the possibility of a flattening yield curve and eventually its inversion remain, this scenario may not essentially play out. Indeed, the flattening trend seen in the US yield curve could be steadied should other central banks begin to tighten their monetary policy in tandem with the US. Such a scenario would assist in the slowdown of capital flows from other countries into the US and thereby dampening demand for long-term bonds, in theory. But in practice, any expected benefits from such a process would only materialize over a medium to long term timeframe. To avoid an inverted yield curve, long-term rates would have to rise in tandem with the Fed rate hikes. However, such synchronicity is implausible because US longer-term real interest rates tend to follow a more general downward global trend. In 2016, the Bank for International Settlements observed that secular factors have played a "big part" in driving down the global long-term interest rate.

A more comprehensive outlook on the future trend of the yield curve and possible direction of long-term rates would include investor expectations and risk perceptions. There are also individual elements such as low inflation, low bond market volatility, employment and high-risk aversion that have an indirect impact on the yield curve.

a. Low inflation

The market-based expectations of the Federal Reserve provide a useful measurement of future inflation. The break-even inflation rate – the difference between the yield of a nominal bond and an inflation-linked bond of the same maturity – remains low, despite increasing over the last months (refer to Figures 4.5-4.7). This indicates that investors are expecting a weak inflation rate in the foreseeable future. The rationale behind the impact of inflation on the slope of the yield curve is that basically high inflation leads to higher yields, hence the spread between the short-term and long-term rates widens. Hence when the Federal Reserve raises interest rates, yields on short-term treasury bills start to rise, reflecting the tightening of the monetary policy. Since long-term yields are influenced by inflation expectations, risk premium, and investor preferences, the long-term rates remain relatively unchanged due to low inflation expectations. As a result, the spread between the short-term and long-term rates narrow and the risk of an inversion of the curve increases.

Figure 4.5: 5-year Breakeven Inflation Rate (not seasonally adjusted)



Source: Federal Reserve Bank of St Louis

Figure 4.6: 10-year Breakeven Inflation Rate (not seasonally adjusted)

Source: Federal Reserve Bank of St Louis

Figure 4.7: 30-year Breakeven Inflation Rate (not seasonally adjusted)

Source: Federal Reserve Bank of St Louis

b. Low bond market volatility

Expectations of weak inflation are given further weight by the bond market volatility trend, with the Chicago Board Options Exchange (CBOE) 10-year US Treasury Note Volatility Index (the counterpart of the equity VIX) falling to a record low of 3.21 in mid-December 2017 and 3.16 in September 2018. The 10-year note VIX is a proxy of investors' confidence that inflation would stay low and the Federal Reserve will unlikely deviate from its gradual pace to raising short-term rates. Hence, long-term rates are likely to remain depressed, staging for an inversion of the yield curve.

Figure 4.8: CBOE 10-year US Treasury Note Volatility Index

Source: Bloomberg

c. Employment

Another factor impacting the yield curve is the employment rate. Non-farm payroll growth, which measures the number of jobs added or lost in the economy, provides an indication of the US economic health and assists in predicting the Federal Reserve's interest rate decisions. The US non-farm payroll increased by 250,000 in October 2018, exceeding market expectations of 200,000, and the unemployment rate is currently at its lowest level since 1969 at 3.7%. The data testifies to the current underlying robustness of the labor market and provides more confidence for the Federal Reserve to raise short term interest rates given the healthy state of the economy, leading to a flatter yield curve.

d. High risk aversion

Risk perception is another key component to consider into the analysis. Rising risk aversion over the past two decades has led to depressed long-term yields. Eventually, an economic combination of lower inflation expectations, the later stage of the economic cycle and increasing global risk aversion are promoting the flattening of the yield curve and paving the way for its inversion.

The global economy toward the late stage of the economic cycle

According to a Bank of America Merrill Lynch Fund Manager Survey conducted in February 2018, 70% of the fund managers considered the global economy to be in its "late cycle"; this represented the highest percentage since 2008. A strong majority of managers (80%) expected interest rates to rise further, while an increasing - albeit still low (11%) - percentage of investors expected the US yield curve to flatten even further in 2018. Meanwhile, the Invesco Global Fixed Income Study 2018 showed a consensus among fixed income specialists about increasing short-term yields following the decisions of the Federal Reserve over the next three years. The study also highlights the flattening trend in the US, with only 24% of US specialists expecting to see a rising yield curve. The same study suggests specialists are planning to increase allocations to core fixed income as well as adopt ladder portfolios (investing in a series bonds of different maturities) and barbell strategies (only very short-term (more flexibility) and extremely long-term bonds (higher interest yields) are purchased) that aim to mitigate interest rate risk. For now, the US yield curve is flattening while equity volatility remains low, indicating a relatively calm equity market. A continuation of the Fed Reserve's tightening monetary policy will drive a further flattening and the gradual shift toward the late stage of the economic cycle. In the late stage, growth starts to moderate as the economy reaches its full potential. Corporate earnings continue to grow, but at a slower pace than the earlier stages. Consumer spending starts to decline, and companies hold excessive inventory. Coupled with a deterioration in profit margins and tightening of credit, the economy eventually goes into recession.

Is the US yield curve a reliable predictor of recessions?

According to a March 2018 study by the Federal Reserve Bank of San Francisco, the yield curve remains a reliable predictor of recessions with the exception of one false positive, as earlier mentioned. The current flattening of the US yield curve is a reflection of the waning confidence about future economic growth, and therefore has a strong basis of rationality. Moreover, according to a Federal Reserve model of recession probabilities, "the predicted probability has risen from close to zero to about 30% in Q1-2018" since the end of the last recession in 2008-2009. While ongoing economic expansion still points towards positive macroeconomic momentum for the US, the yield curve suggests that the economy is in transition to the late stage of the cycle. Given the predictive power of the yield spread, investors should prepare for slower economic growth and higher volatility. And while an imminent recession is not being foreseen, investors should remain cautious.

Table 4.2: Recession periods and the Inversion of the Yield Curve

START OF RECESSION	END OF RECESSION	INVERSION OF THE YIELD CURVE	LEAD TIME (MONTHS)
August 1957	April 1958	Yes	8
April 1960	February 1961	Yes	7
December 1969	November 1970	Yes	24
November 1973	March 1975	Yes	8
January 1980	July 1980	Yes	16
July 1981	November 1982	Yes	10
July 1990	March 1991	Yes	17
March 2001	November 2001	Yes	11
December 2007	December 2009	Yes	23
Average lead time			**14**

Source: Bloomberg
Lead time refers to the time period between the inversion of the yield curve and the start of a recession.

REFERENCES

Bank of America Merrill Lynch February Fund Manager Survey, 2018.

Bank of England. Inflation Report, November 2018. London: Bank of England, 2018.

Bank of Mauritius. Monthly Statistical Bulletin, October/November 2018.

Board of Governors of the Federal Reserve System. Minutes of the Federal Open Market Committee, July/August 31–01, 2018. Washington, DC: Board of Governors of the Federal Reserve System, 2018.

Board of Governors of the Federal Reserve System. Minutes of the Federal Open Market Committee, September 25–26, 2018. Washington, DC: Board of Governors of the Federal Reserve System, 2018.

Board of Governors of the Federal Reserve System. Minutes of the Federal Open Market Committee, November 07–08, 2018. Washington, DC: Board of Governors of the Federal Reserve System, 2018.

Bureau of Economic Analysis. Gross Domestic Product, 2nd quarter 2018 (third estimate); Corporate Profits, 2nd quarter 2018 (revised estimate). United States: Department of Commerce, 2018.

Central Bank of Kenya, Kenya. https://www.centralbank.go.ke/

Department of Industrial Policy and Promotion, India. FDI Publications. https://dipp.gov.in/fdi-publications

European Central Bank. ECB Staff Macroeconomic Projections for the Euro Area, October 2018. Frankfurt: European Central Bank, 2018.

Eurostat, Europa. Various Statistics. https://ec.europa.eu/eurostat/web/main/home

Federal Reserve Bank of St. Louis, United States of America. https://www.stlouisfed.org/

Federal Reserve Bank of San Francisco, 2018. https://www.frbsf.org/

Financial Services Commission, Mauritius. www.fscmauritius.org.

IHS Markit. "Caixin China General Composite PMI" News release, November 15, 2018.

International Energy Agency. Oil Market Report. Paris: International Energy Agency, November 14, 2018.

Invesco Global Fixed Income Study, 2018.

Kenya National Bureau of Statistics, Nairobi, Kenya. http://www.knbs.or.ke/

KIPPRA Policy Monitor. Realizing the "Big Four" Agenda through Energy as an Enabler, Issue 9 No. 3, January - March 2018.

LAPSSET Corridor Development Authority, Kenya. http://www.lapsset.go.ke/

Mauritius Sugar Industry Research Institute, Mauritius. http://www.msiri.mu/

Ministry of Labor, Industrial Relations, Employment and Training, Employment Division, Mauritius.

National Bureau of Statistics of China. http://www.stats.gov.cn/english/pressrelease/releasecalendar/

Office for National Statistics. GDP quarterly national accounts, UK: April to June 2018. United Kingdom: UK Statistics Authority, 2018.

Office for National Statistics. UK Labour Market: September 2018. United Kingdom: UK Statistics Authority, 2018.

Reserve Bank of India, India. https://www.rbi.org.in/

Statistics Mauritius, Mauritius. http://statsmauritius.govmu.org/English/Pages/default.aspx

South African Reserve Bank, South Africa. https://www.resbank.co.za/

Standard Bank South Africa PMI, Markit Economics. 2018.

The Conference Board. The Conference Board's Consumer Confidence Index November 2018. Accessed December 03, 2018. https://www.cnbc.com/2018/11/27/consumer-confidence-novembe.html

The Economist. 2018. The Economist Poll of Forecasters, October Averages.

REFERENCES

The Mauritius Chamber of Commerce and Industry. 2018. The MCCI Business Confidence Indicator, 33rd Edition – Second Quarter 2018. Accessed November 15, 2018.
https://www.mcci.org/en/media-news-events/business-updates/sustained-increase-in-the-business-confidence-indicator-at-plus-80-points/

The National Treasury, Republic of Kenya. Budget Statement 2018-19. Accessed September 18, 2018.
http://www.treasury.go.ke/budget-statement-2018-19.html

U.S. Department of the Treasury, United States of America. https://home.treasury.gov/

U.S. Energy Information Administration. 2018. U.S. Energy Information Administration | Short-Term Energy Outlook – November 2018.

Vision 2030, Kenya. Accessed September 20, 2018. http://vision2030.go.ke/

World Bank. 2018. World Bank Commodities Price Data (The Pink Sheet). Accessed November 22, 2018.
http://www.worldbank.org/en/research/commodity-markets

World Economic Outlook. October 2018. Challenges to Steady Growth. Accessed November 20, 2018.
https://www.imf.org/en/Publications/WEO/Issues/2018/09/24/world-economic-outlook-october-2018

CREDITS

Contributor
Urvashi GAONJUR

Reviewers
Anoushka Reedhee BHUTTOO
Shailen SREEKEESSOON
Vimal TEZOO

Advisors
Andrew BAINBRIDGE
Kee Chong LI KWONG WING

DISCLAIMER

SBM

www.sbmgroup.mu