Monthly Economic Newsletter
September 2017

Economics & Regulation Services of Grant Thornton

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Monthly Outlook

Even amid significant geopolitical noise surrounding North Korea, financial markets remain highly complacent. In our opinion, this can be traced back to two main factors. On the one hand, even the pessimists have come to accept that the global economy is actually in quite good shape. On the other hand, serious inflationary pressures are still missing (with core inflation edging down somewhat in the US over the last few months) and this is being used by many market participants to claim that long-term interest rates are set to remain very low for a considerable period of time (if not forever).

One could say therefore that we are in a quasi-perfect situation for almost any kind of financial asset. World economic growth is heading north and that is obviously very good news for corporate profits. Moreover, fixed income is also doing very well with markets still expecting central banks to remain extremely prudent going forward.

But the truth is that this kind of goldilocks scenario (which is creating not only valuation pressures but also extremely low levels of volatility) is almost certainly unsustainable. As spare capacity continues to be brought down all over the world, it is only a matter of time before wage and price pressures become more apparent. This, in turn, will force central banks to react by reducing their extremely big balance sheets and also by gradually increasing interest rates (both nominal and real).

The US economy managed to grow at a 3% annualized rate during Q2 and looks poised to maintain relatively solid momentum going forward: fundamentals for private consumption continue to be strong; corporate investment is clearly in recovery mood; the real estate sector has significant room for further expansion; exports should benefit from a weaker US dollar, etc.

The unemployment rate is already below its long-term equilibrium level and should edge further down in the coming months. The consequence of this will very possibly be a further acceleration of wages, with obvious positive implications for core inflation going forward (this, of course, would show that the fall in core inflation seen at the beginning of this year was mostly due to temporary factors). Moreover, the recent dollar weakness will tend to create additional inflationary pressures over the next 6-12 months.

With geopolitical risks clearly lower than they used to be, macroeconomic data in the Eurozone continue to be extremely positive: economic growth is outpacing potential by a wide margin; expansion has clearly become broader in terms of the number of countries involved; and it is also quite positive to see demand growth coming from both internal sources as well as exports.

Significant levels of spare capacity still exist in the Eurozone, but, at the same time, one should not forget that this spare capacity is rapidly reducing and is obviously not infinite. If unemployment continues to decrease at the same pace seen over the last 12 months (something that should be achievable considering that the economy has been accelerating), the unemployment rate should reach around 8% during the second half of 2018.

Why is this figure important? It is a reasonable estimate of equilibrium unemployment for our region (the unemployment rate averaged around 8.5% during the period before the Great Recession). Some are arguing that underemployment is still high and that this means that the level of spare capacity is higher than implied by the unemployment rate alone. This might well be true, but even if one considers these other measures of spare capacity it is difficult not to see the output gap in the Eurozone closing in eighteen months or so. Countries like Germany, of course, are already running positive output gaps.

As the output gap closes, the most probable scenario going forward in Europe is for both core prices and wages to progressively accelerate. In fact, core CPI has been edging higher since March, possibly anticipating increasingly encouraging progress for this variable during the rest of 2017 and into 2018.

Taking all the above into account it is difficult not to think that public debt is showing signs of bubbly behaviour: despite the world economy doing fairly well (and so much better than many had feared), this has failed to translate into any meaningful upward movement of long-term interest rates. This would not seem to be especially rational, and even more so if one considers what equity markets have done in the meantime.

What could be the trigger for a correction in government bonds? Answering this kind of question is never easy. But we do see two possibilities unfolding over the next 6 to 12 months. On the one hand, we think it is quite probable that both wages and prices edge up more clearly in the near future. This should at some point be reflected in higher long-term rates. On the other hand, it is also possible that in the coming months central banks become progressively more vocal about the need to further normalize monetary policies.

The Fed in particular seems poised to begin trimming its balance sheet in September, while the ECB will begin debating very soon about reducing its QE from January 2018 onwards.

Our central scenario is still one in which the world economy continues to do relatively well and inflation edges progressively higher but does not significantly overshoot targets, in part because central banks gradually reduce the degree of monetary stimulus. However, if markets continue to flatten yield curves and central banks remain too prudent in a context of an improving world economy, inflation rates could well end up significantly overshooting even our above-consensus projections. Should this be the case, the upward movement in long-term rates could be quite abrupt.

United States

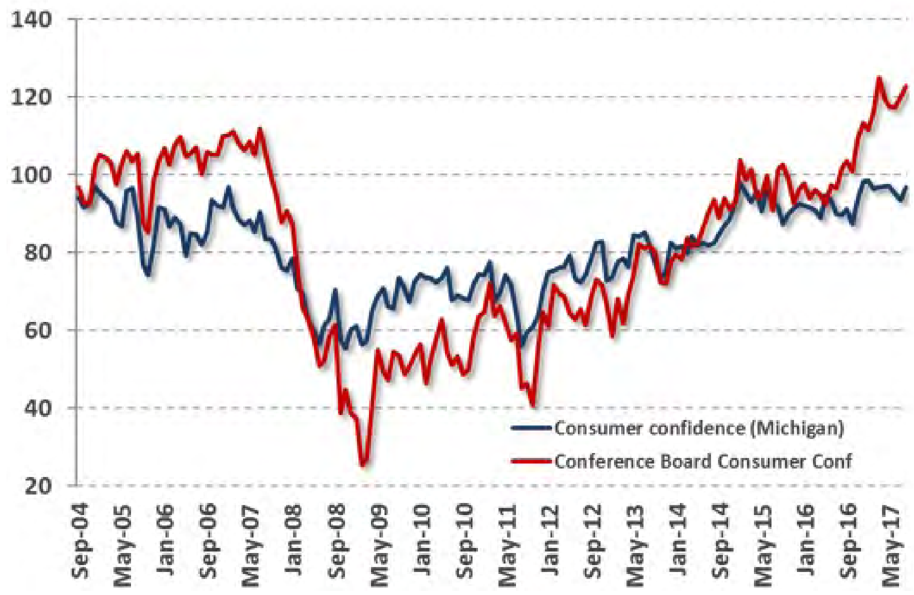
Prospects for the US economy look reasonably good

The US economy managed to grow at an annualized rate of 3% in Q2. Moreover, fundamentals look solid and this leads us to be optimistic about the economy's performance over the rest of the year and moving into 2018. Mostly likely hurricane Harvey won't have a significant negative impact on growth during Q3 and could even push activity, also moderately, in the final 3 months of the year.

Following a relatively strong Q2, private consumption is looking good going forward: Consumers' balance sheets are healthy; disposable income is growing at solid rates; the labour market is in very good shape; sentiment indicators are very strong, etc.

Corporate investment has been improving quite significantly in recent times. On the one hand, the drag triggered by adjustments in the energy sector is now out of the equation. On the other hand, investment in equipment is also recovering as companies are no longer in a position to serve increasing demand purely by resorting to unused capacity. Precisely because of this last factor we are cautiously optimistic about the behaviour of corporate investment going forward: with the economy close to full employment and with salaries progressively gaining traction, it would be only natural for growth to become more capital intense in the future (something that, incidentally, will also contribute to an acceleration in productivity).

Consumer confidence rebounding strongly



Source: Bloomberg, Alinea Global

The real estate sector still has significant room for further expansion against a backdrop of relatively strong household formation rates and very low inventories of unsold homes. This is of course good news for the durability of the US economy's current expansionary cycle.

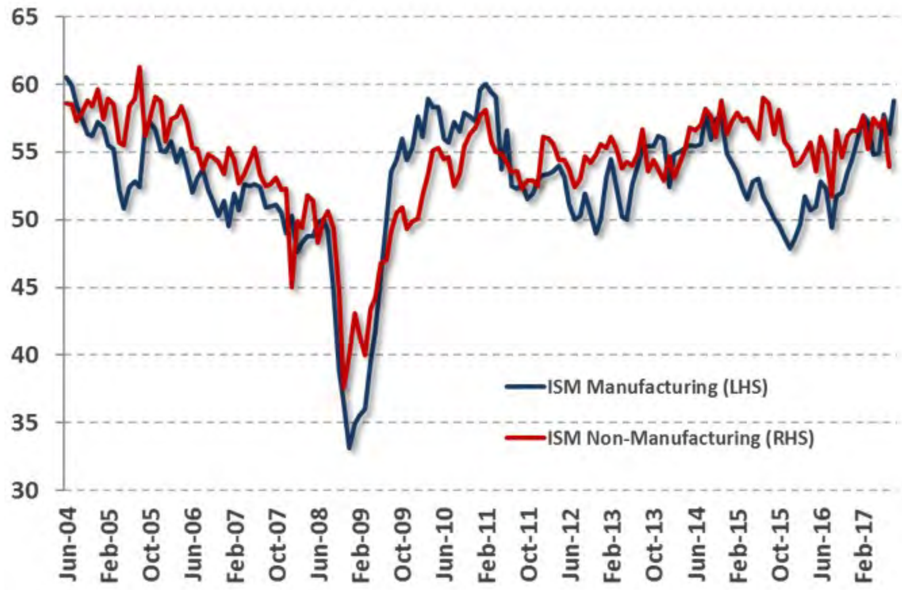
Depreciation of the dollar and signs of improvement in the global economy are also enabling the foreign sector to behave a little bit better.

In general, there are no obvious disequilibria in the US real economy at the moment and, in the absence of major shocks, this makes it quite unlikely that the economy will slow down significantly in the near future.

All in all we expect economic growth in 2017 to be clearly above potential, even without fiscal stimulus. If this stimulus does take place at some point, upside risks to growth and, more importantly, to inflation would appear.

When we look at the labour market, the situation is also quite positive: the US economy continues to create new jobs at rates that still more than double the numbers needed to absorb the increase in supply coming from population growth. Job growth is therefore still too strong to be sustainable in the medium-term, and even more so if one considers that the unemployment rate is already below the values compatible with full employment.

Manufacturing and non-manufacturing ISM



Source: Bloomberg, Alinea Global

Full employment and a weak dollar mean inflationary pressures are set to rise

Core prices have decelerated in recent months and this has been used by many to continue to project very subdued inflationary pressures going forward.

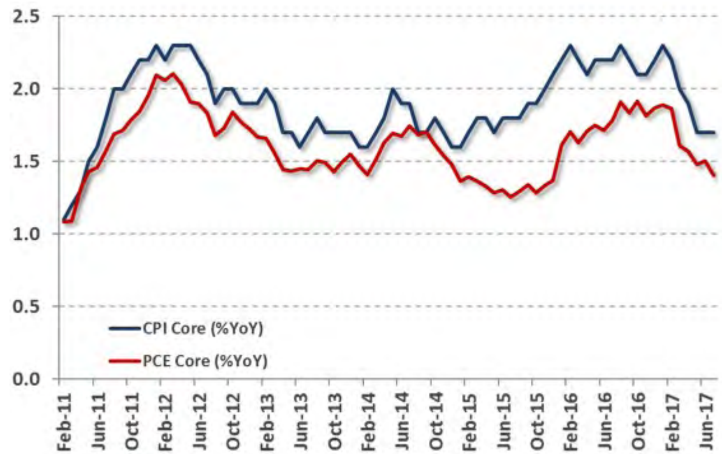
But the truth is that the recent deceleration in core prices is probably only temporary. In fact the outlook for core prices is actually quite positive: with growth above potential, a closed output gap and inflation expectations relatively well-anchored, the most probable scenario going forward will entail core inflation inching progressively higher in the coming months. Significant depreciation of the dollar over the last year will also tend to push prices going forward.

Meanwhile, a tight labour market should also lead to a gradual acceleration of wages going forward.

Against a backdrop of full employment and as already mentioned, Trump's intention to run clearly expansionary fiscal policies could end up creating significant inflationary pressures.

Protectionist policies and immigration curbs would be decidedly negative in terms of potential growth but would make higher inflation all the more probable.

Core inflation close to 2%



Wages should accelerate more clearly going forward

Source: Bloomberg, Alinea Global

The Fed will most probably begin to reduce its balance sheet in September

Given that the economy is looking good, the Fed has clearly stated that it intends to begin reducing its balance sheet in the very short-term, most likely in September.

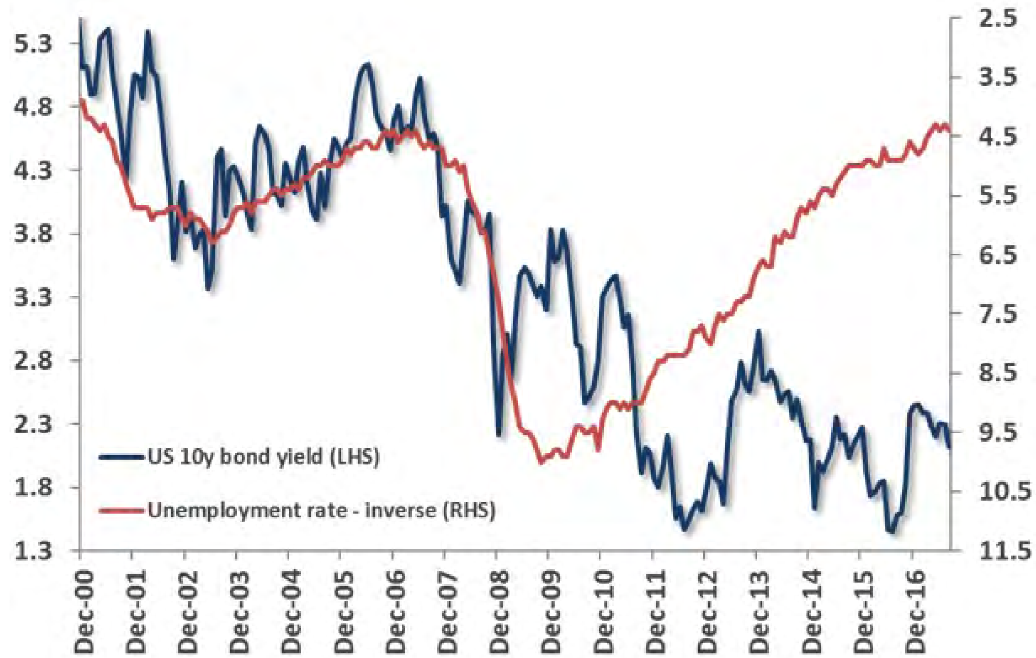
But the market continues to look the other way: since the beginning of the year, long-term rates have come down, the equity market has gone up, credit spreads have tightened and the dollar has depreciated somewhat. All this means that financial conditions have actually become more accommodative since December.

Several FOMC members have already said that this situation is not what the Fed wants: the Fed is trying to progressively reduce the degree of monetary accommodation but the truth is that financial conditions have tended to ease further during 2017.

How will this paradox be resolved? It seems clear to us that, provided the economy continues to do well and prices begin to accelerate again in the coming months (as they will very probably do), the Fed will be forced to respond to this absurd situation not only by reducing its balance sheet, but also by raising rates quicker than the market currently expects.

Taking all this into account, and if our central macroeconomic scenario continues to be confirmed, we think that a significant steepening of the yield curve between now and the end of this year is very likely.

Long-term rates still far too low



Source: Bloomberg, Alinea Global

European Union

The Eurozone economy continues to do really well

Significant tailwinds continue to help the Eurozone's recovery: still low oil prices; extremely low long-term interest rates; a financial sector more willing to lend to the real economy; a still relatively weak euro from a fundamental perspective; a private sector that has reduced leverage very significantly; very much better price-competitiveness among countries in the periphery; a somewhat more growth friendly fiscal policy, etc.

In fact, and with geopolitical risks clearly edging down, the Eurozone has been able to grow at annualized rates above 2% in the past 2 quarters, clearly above the region's potential. Moreover, the economy seems poised to accelerate further in Q2. As far as the labour market is concerned, progress continues to be made at a rapid pace with the unemployment rate already at 9.1%.

Germany is particularly interesting, as there has been very positive economic activity in the first three months of 2017 and there are upbeat prospects for the rest of the year: the IFO is at very strong levels; consumer confidence is also solid; PMIs also look good; both industry and the real estate sector are in good shape; exports are also gaining dynamism and the unemployment rate is at record low levels, etc.

France already appears to be benefiting from an improved political situation and macro data have actually been improving for some time now (strong PMIs, sentiment indicators at relatively upbeat levels, positive job growth, investment also sending positive signals, etc.). In this context it is difficult not to be relatively optimistic about France going forward, although it will be important to see whether Macron is really able to get his ambitious labour reforms through without significant modifications.

Economic sentiment at very solid levels

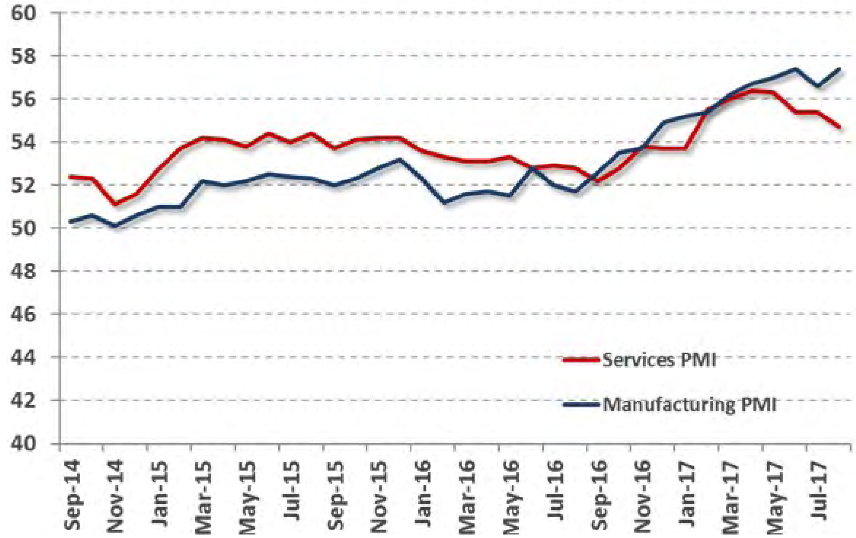
Source: Bloomberg, Alinea Global

Even Italy seems to be improving of late, with GDP surprising clearly to the upside in Q1 and with both PMIs and sentiment indicators at levels compatible with some further acceleration of economic activity in the coming quarters. This improved macroeconomic outlook is also accompanied by a more stable situation in the banking sector following the government's decisions in recent weeks. On the political front the situation seems to be calmer of late.

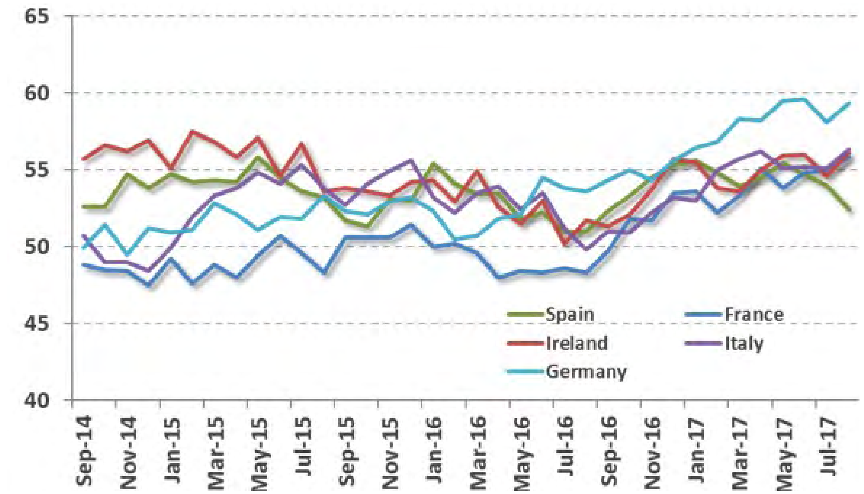
Contrary to this quite favourable macroeconomic situation in the Euro area, and beyond the possibility of early elections in Italy, it is clear that negotiations around Brexit will continue to create noise in the coming months.

We believe however that the most likely scenario going forward is for Brexit to have only a moderate impact on growth outside the UK. Firstly, in the short-term the situation has not undermined sentiment in any significant way. Secondly, at least up until now the response from European leaders has been encouraging, with messages of unity that should help contain risks with respect to the future of the EU. And thirdly, the negative impact of more complicated trade with the UK will be partially compensated for by the fact that EU member countries will probably receive new investments (particularly from companies in the finance industry) that now take place in the UK but that may prefer to move to the EU in the future to ensure access to the single market.

PMIs at very healthy levels



The European recovery continues to broaden



Source: Bloomberg, Alinea Global

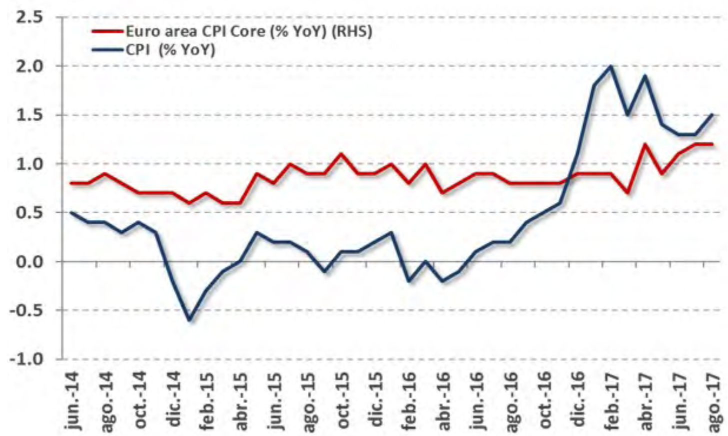
With growth clearly above potential, core inflation is set to edge progressively higher

The favourable macro environment is already leading to a mild acceleration in core prices, a process that looks set to continue over the coming months provided the euro does not appreciate much further. We should remember that the still considerable spare capacity in the Euro area will not last for ever: the unemployment rate is dropping fairly quickly and could reach levels around 8% by this time next year (this is a significant figure, as it is below the average for this variable in the period before the crisis and therefore a fairly good approximation of structural unemployment in the area). Even if we consider broader measures of slack in the labour market, it will probably take around eighteen months for the output gap to close completely.

In Germany progress in core prices should take place sooner and more rapidly than in the rest of the Euro area. On the one hand, growth prospects are particularly positive. On the other hand, this relatively dynamic growth will take place against a very strong labour market (the output gap is actually positive). This in turn should put additional upward pressures on both wages and prices going forward.

As a consequence of the much improved macroeconomic outlook the ECB has said that it intends to make a decision on the future of QE during the Autumn. We believe that the best thing the ECB could do is to progressively taper its debt instrument purchasing beginning in January 2018, and perhaps be ambiguous about when the tapering process will end, emphasising at the same time that further upward movements in the euro would not be welcomed.

Core inflation has improved in recent times



Inflation expectations improving

Source: Bloomberg, Alinea Global

Spain

Spain's short-term macro data continue to look very

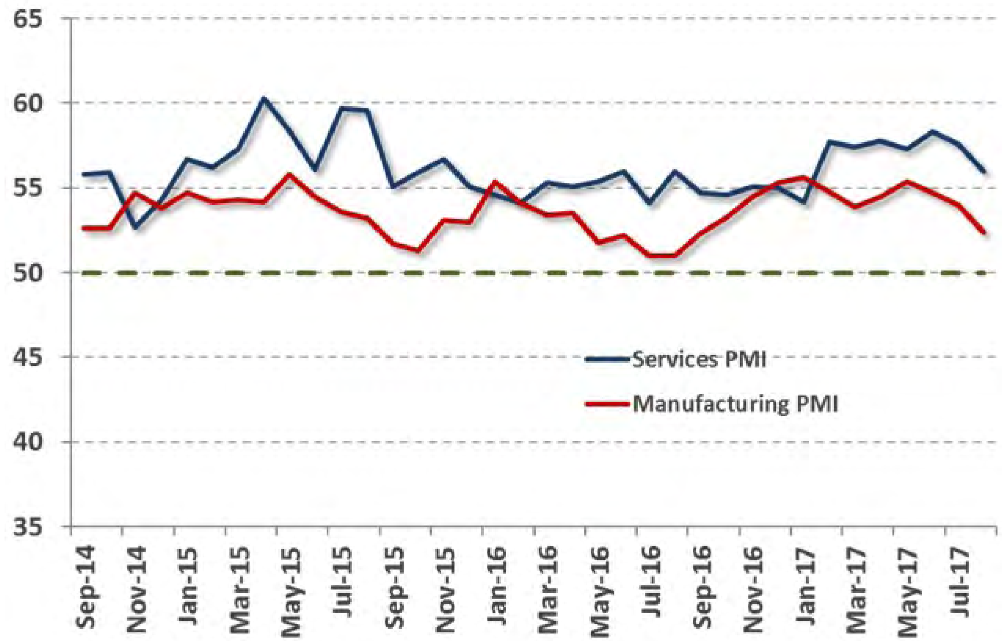
Spain continues to benefit from numerous tailwinds: significant price competitiveness gains made during the crisis, low oil prices, a weak euro, extremely low interest rates, a strong tourism sector that is benefiting from geopolitical issues in other competing destinations, etc.

It is therefore little surprise that macro data continue to be very positive, with growth probably approaching 4% annualized in Q2: confidence indicators continue to improve; PMIs are also doing well; exports have also been picking up; the services sector remains strong; tourism is in very good shape and shouldn't be too affected by the terrorist attacks that took place in Barcelona in August; industrial production surprises to the upside; the real estate sector is also improving fairly quickly, etc.

For the rest of the year we think growth will remain strong, most likely above 3% for 2017 as a whole. This figure is of course much higher than the current estimates of potential growth for the Spanish economy.

As this scenario unfolds, spare capacity (even if somewhat high) will tend to drop fairly quickly in the coming quarters.

Manufacturing and non-manufacturing PMI



Source: Bloomberg, Alinea Global

Spain still faces long-term challenges

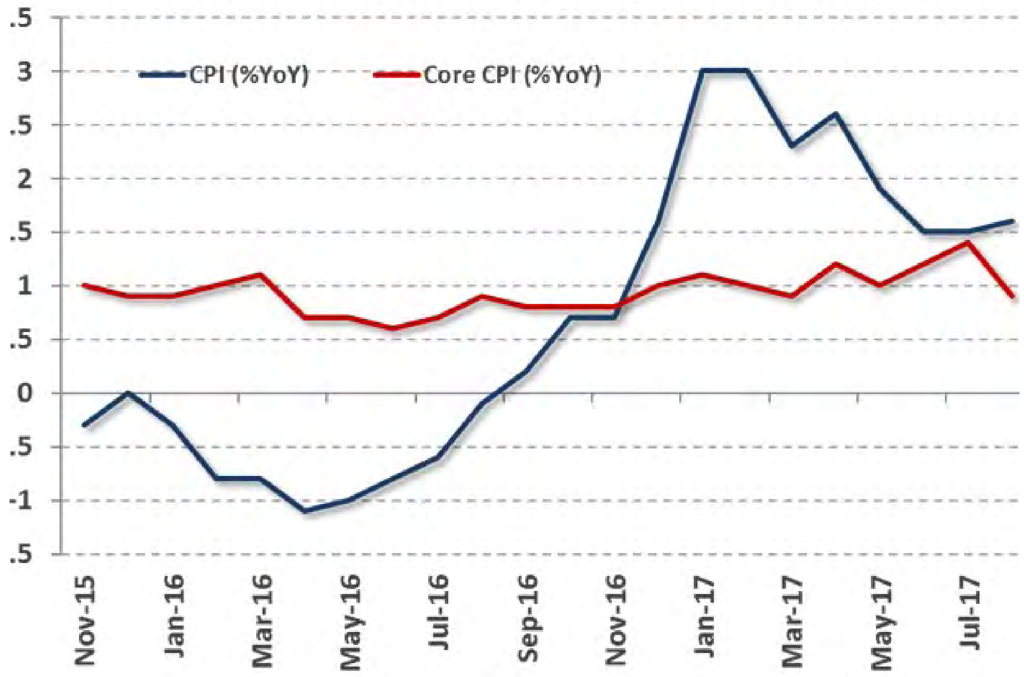
This scenario is, in turn, compatible with underlying inflation heading progressively higher in the coming months. As the unemployment rate continues to decrease, wages should edge somewhat higher going forward.

From a medium-term perspective it would be great if the government could use the opportunity offered by the current tailwinds to forcefully address the significant structural challenges that the Spanish economy still faces (low potential growth, an ageing population, increased inequality, and significant levels of external debt).

It is also important that Spain complies with the requirements of the Stability and Growth Pact in 2017 and 2018, taking into account that the ECB will at some point begin to normalize its monetary policy.

From a political perspective the situation seems to be stable at the moment, even more so since the government has been able to pass the budget through Congress. At the same time however, negative surprises cannot be ruled out. In particular, Catalonia and numerous corruption cases could continue to create some degree of noise going forward.

Core inflation should edge higher little by little



Source: Bloomberg, Alinea Global

United Kingdom

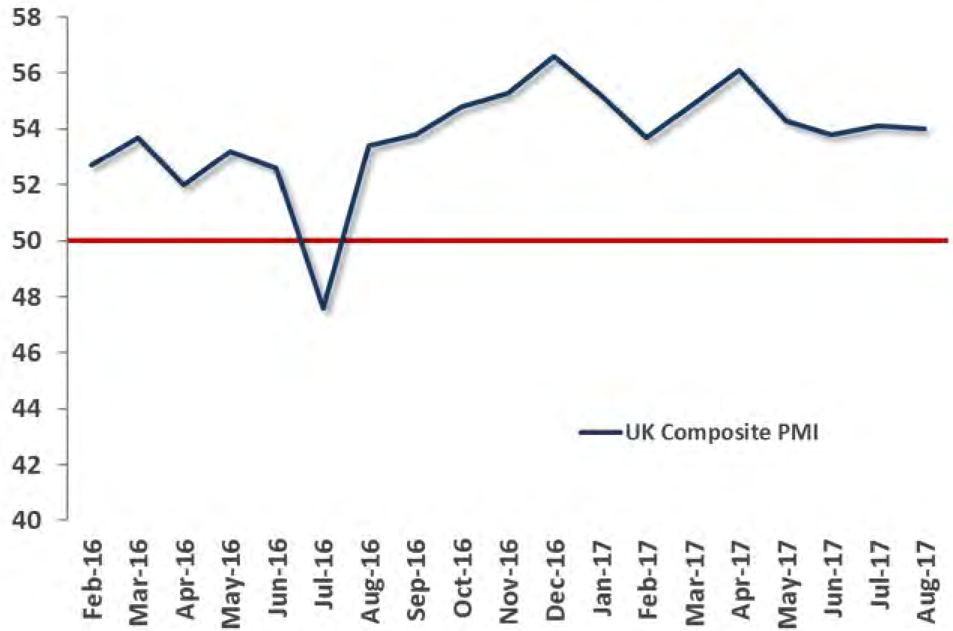
The election results create uncertainty, but could help avoid a hard Brexit

Despite creating some additional uncertainty, the election results could end up proving positive for the future of the British economy, as they increase the probability of a somewhat softer Brexit. Indeed the most recent negotiating position by the British government is to try to keep the UK inside the Customs Union for a period of time. Generally speaking, the country is becoming increasingly aware of the significant, negative long-term effects of a hard Brexit: the country would (at least partially) lose access to one of the biggest markets in the world; London would probably lose part of its appeal as a global financial centre; the UK would no longer be as attractive as it traditionally has been as a destination for highly skilled migrants, etc.

The macroeconomic situation in the short-term is rather mixed. Negatively speaking, and given the high levels of uncertainty about the future, it is difficult to be very optimistic about the prospects for corporate investment. Positively speaking, the weak pound is helping to boost both exports and the manufacturing industry, while the real estate sector seems to be retaining some momentum. What about consumption? It is clear that this important variable is negatively affected by uncertainty and also by the increase in inflation. But, at the same time, against a backdrop of almost full employment, we should be relatively optimistic about future wage performance, something that in turn should help avoid a significant deterioration in private consumption (in fact the latest data continue to point to a very strong labour market and to some mild strengthening of wage pressures).

At the same time, increased inflationary pressures and a better than expected economy are leading to a significant change in tone by the BOE: the monetary authority could very well decide to increase interest rates at its August meeting.

The economy is decelerating, but only mildly so



Source: Bloomberg, Alinea Global

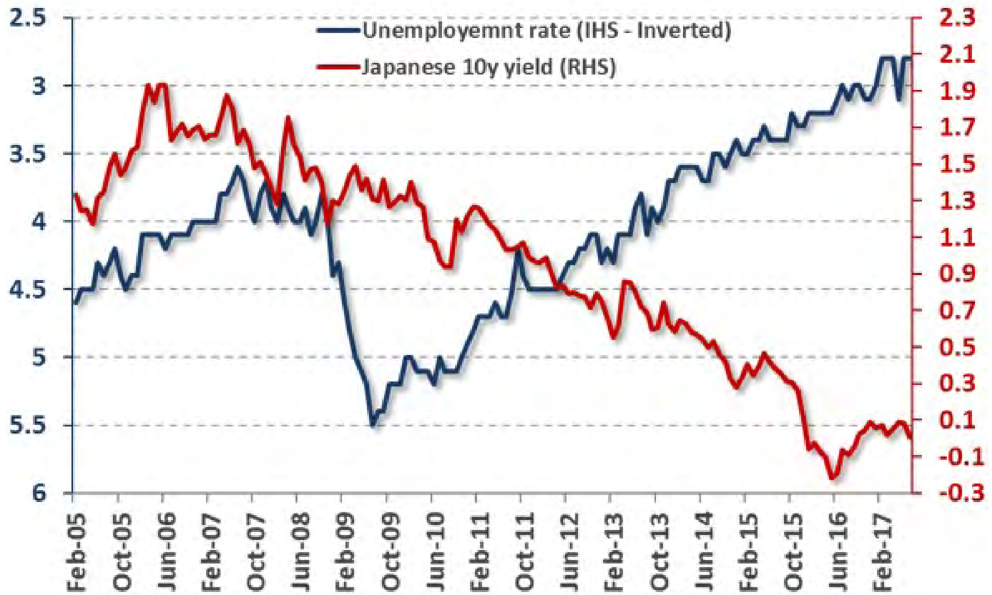
Japan

Japan clearly continues to grow above potential

Trying to figure out how the Japanese economy is doing in the very short-term is no easy task. On the one hand, the quality of short-term data is far from perfect (in fact the government is trying to improve the way some statistics are compiled). On the other hand, and more importantly, when people talk about Japan they usually fail to properly distinguish between cyclical and structural factors. The first thing to remember when analysing Japan is that the country's population is decreasing and there are therefore very low levels of potential growth (probably not higher than 0.5%). As a result, it is only normal that the Japanese economy alternates quarters of positive growth with quarters of negative growth and even more so in the current environment of very low levels of spare capacity.

That said, events in recent quarters lead us to be optimistic. Firstly, GDP growth has been above potential for 5 consecutive quarters (and was exceptionally strong in Q2). Secondly, the most recent economic indicators continue to be upbeat (sentiment indicators are at healthy levels, exports and corporate investment are both sending positive signals, credit seems to be picking up, etc.). Thirdly, wages are beginning to pick up (particularly in terms of temporary workers) and there are good reasons to expect further acceleration going forward, thanks to the positive macroeconomic situation (labour demand continues to be healthy against an already positive output gap and the significant progress made over the last 2-3 years in terms of women entering the labour force should lose momentum at some point).

Low output gap levels point to higher wages and prices



Source: Bloomberg, Alinea Global

Strong action by the BOJ and positive signs from wages are good news for prices

Despite the 2% inflation target remaining out of sight for the moment, a tight labour market in a context of above-potential growth (the unemployment rate is 2.8% and the jobs/applicants ratio is very high, 1.52) **should put further upward pressures on wages and then on inflation going forward** (price components in the PMIs and in the Tankan survey have actually behaved better in recent times and service prices have also edged up a bit of late). At the same time, and after several months of weakness, inflation expectations have also improved somewhat in the most recent period.

The BOJ continues to implement its yield curve control policy, trying to make sure that 10y yields stay reasonably close to 0% and committing to allowing inflation to overshoot the 2% target for a considerable period of time. We think that the BOJ will want to see a sustained increase in inflation before changing its monetary policy stance again.

The government is also trying to push up wages and prices, in this case by introducing fiscal incentives for companies that more actively raise salaries. President Abe is also increasing pressure on companies to allow for more dynamic wage increases in this year's collective bargaining.

Looking ahead, and in order to increase potential growth, it is essential for the country to make more progress in the field of structural reform, in particular as far as immigration and the labour market is concerned (in relation to the latter a reduction of duality is a clear need for the Japanese economy). At the same time, the government should continue to improve conditions for FDI (by increasing competition and fostering innovation this kind of investment can play a role in pushing productivity growth).

Core CPI should do better going forward

Source: Bloomberg, Alinea Global

Emerging countries - China

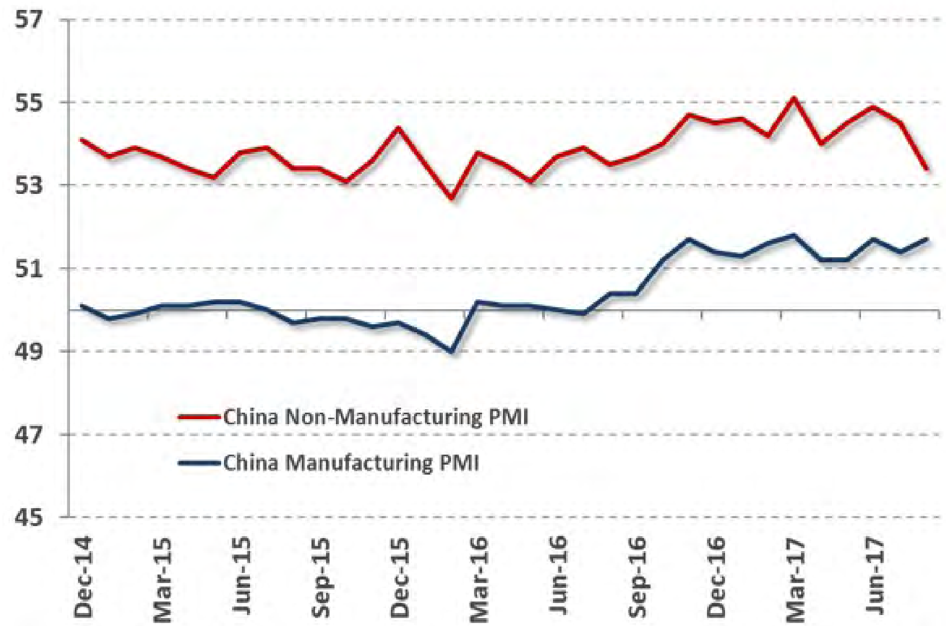
The government curbs financial risks while trying to maintain sufficient economic momentum

The positive macro situation in China has allowed the authorities to put increased emphasis on measures aimed at controlling financial risks. Authorities are adopting measures aimed at improving financial supervision (including giving more powers to the PBOC); reducing regulatory arbitrage by so-called shadow banking and increasing the role of equity in corporate financing (promoting, for example, sound equity-debt swaps). Moreover, the PBOC has also favoured a certain tightening of liquidity conditions in the money market to reduce incentives to conduct highly leveraged purchases of financial assets.

In this context, and even though economic data in August were fairly positive again, it would seem logical to expect a little less momentum in the economy going forward.

But the risks of any kind of abrupt deceleration remain quite low. On the one hand, most macro data continue to be relatively positive, especially as far as private consumption and exports are concerned. On the other hand, authorities are trying to preserve sufficient economic momentum going forward. As an example of this the PBOC keeps saying that it will strike a balance between favouring deleveraging and avoiding an excessive tightening of monetary conditions (the absence of relevant inflationary pressures gives the central bank ample room for manoeuvre). Moreover, the fact that fiscal policy is set to remain relatively expansionary, particularly in terms of infrastructure investment, is also good news for short-term growth.

PMIs show the economy continues to do well



Source: Bloomberg, Alinea Global

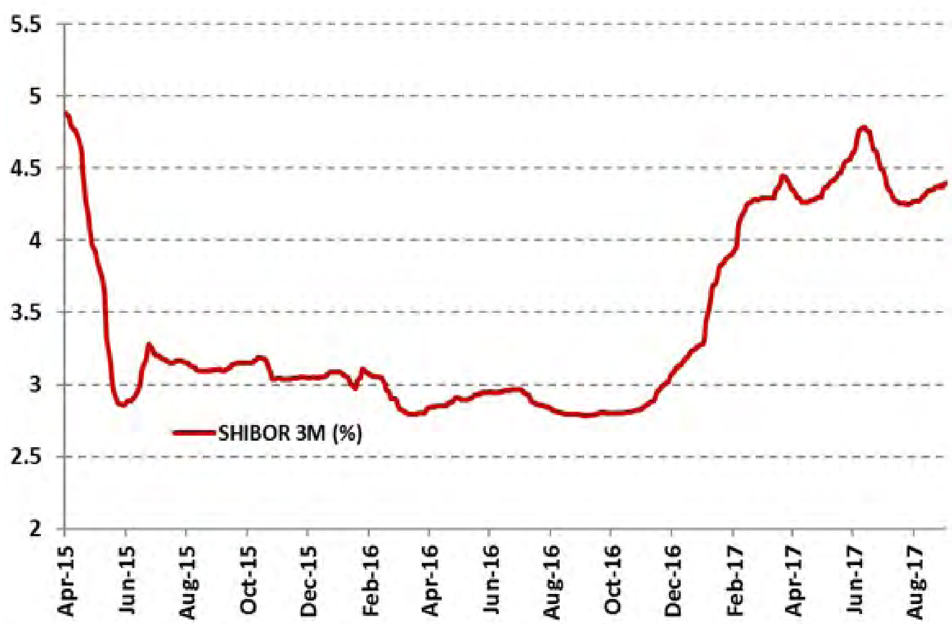
The economy could lose some momentum in the coming quarters

One of the positive collateral effects of a somewhat less accommodative monetary policy is less pressure on the yuan and reduced incentives for capital outflows. At the same time, the steps taken to allow some Chinese stocks to be part of the MSCI indexes and to connect the bond market with Hong Kong are clearly good news that will probably contribute to more capital flows into the country.

From a fundamental perspective it is actually very difficult to argue that China needs an aggressive depreciation of the yuan: Chinese exports are not losing market share in the world market in any significant way (and have actually picked up somewhat recently); moreover, equilibrium exchange rate estimates by institutions such as the IMF do not point to undervaluation.

From a medium-term perspective, it is good to know that China has sufficient room for manoeuvre in terms of the balance sheet to allow the process of repairing banks' balance sheets to take place smoothly. We therefore believe that a credit crunch scenario is quite unlikely. Despite the rapid growth of (gross) debt over the last couple of years, China is a net creditor with respect to the rest of the world. Moreover, measures aimed at facilitating the sale or securitization of bad loans seem to be progressing and this should help banks reduce their exposure to these kind of assets in an orderly manner.

Monetary policy is becoming less accommodative



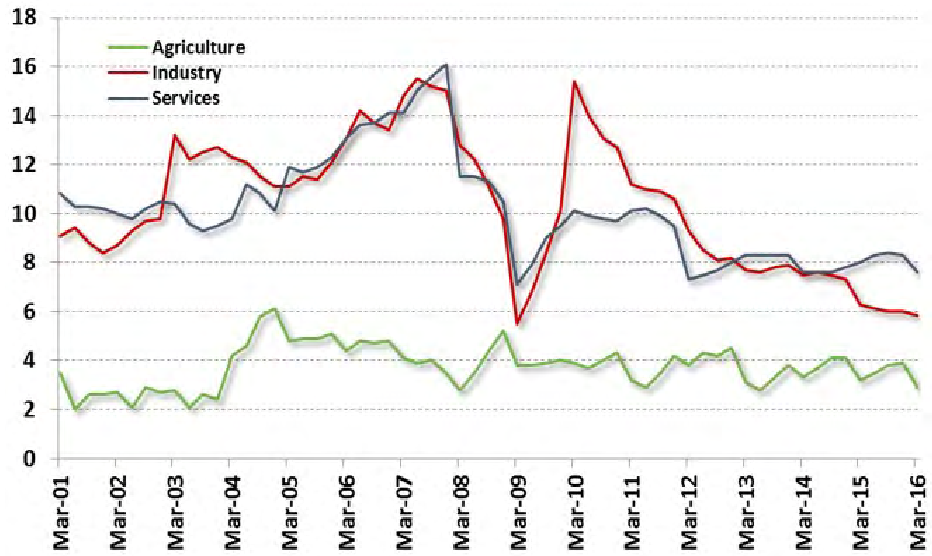
Source: Bloomberg, Alinea Global

The country continues to advance in the process of upgrading its growth model

It is also positive that the country is able to make progress in the process of modernizing its growth model. On the demand side consumption continues to gain weight. On the supply side both the services sector and industries with relatively high technological intensity are becoming more and more dynamic.

Having said all this, and although China seems to be in a relatively good position to confront the significant challenges it faces, it is of course crucial that the authorities continue to show sufficient commitment to the field of structural reform: excess capacity in some traditional sectors should continue to be reduced; credit growth needs to be further curbed; a real estate sector bubble must be avoided; the playing field for private companies should be improved (further easing of restrictions curbing inbound direct investment would be helpful in this respect and would probably be well received by the new US administration); leveraged investments in financial assets should be further curbed, etc. At the same time, and in order to help potential growth, the government should continue the significant success achieved in recent years in promoting research and development activities and human capital.

Services continue to gain weight



Source: Bloomberg, Alinea Global

Emerging countries - India

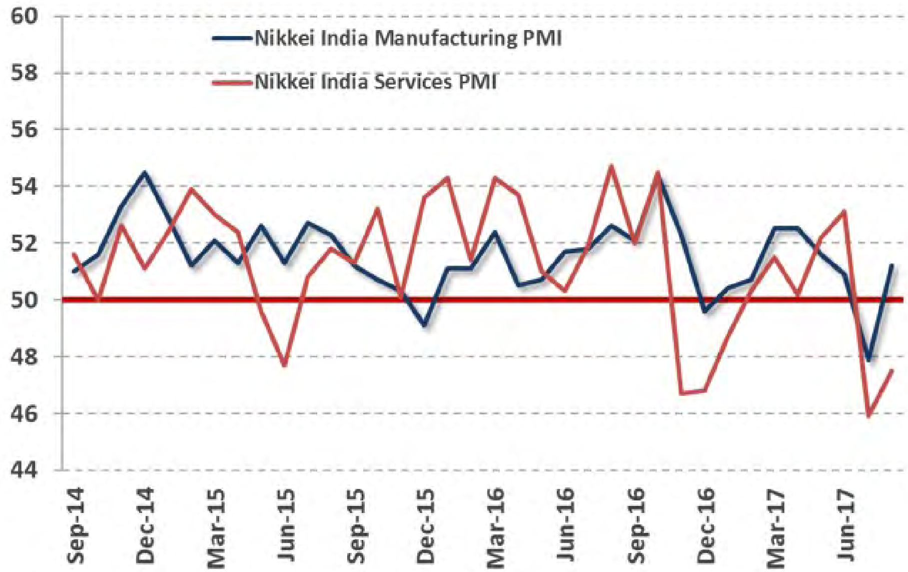
Despite short-term uncertainties, the economy looks good

Despite the uncertainties created by the demonetization process and the introduction of the GST (both of them positive reforms from a long-term perspective), prospects for the Indian economy look relatively promising: private consumption should remain resilient; fiscal policy is mildly expansionary; the agricultural sector is benefiting from normal Monsoon rains; exports have surprised to the upside lately; infrastructure investment is also showing some positive signs, etc. On a more negative note, private investment is still weak against a backdrop of low capacity utilization levels, high corporate debt (in certain sectors) and elevated levels of bad loans in the banking sector.

Following sharp decreases over several months, inflation will tend to creep a bit higher during the rest of the year (mostly linked to food prices). This won't put the 4% inflation target at risk, but it will reduce the ability of the RBI to further decrease rates after the decision taken at its August meeting.

On the fiscal front it is important for the government to be able to maintain the right balance between helping economic growth and at the same time preserving the long-term sustainability of public finances. This is of course not easy, as the fiscal deficit in India is quite high, especially at state level. The fact that some states are lining up to rescue indebted farmers hammered by depressed crop prices without at the same time devising compensating measures to make this move fiscally neutral could prove dangerous from a ratings perspective.

The economy is sending better signals



Source: Bloomberg, Alinea Global

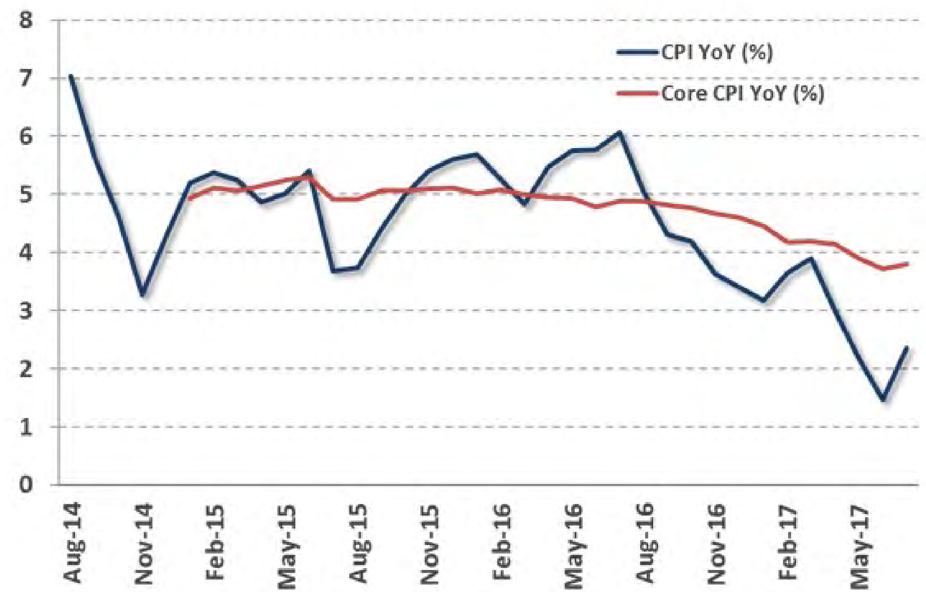
The government continues to make progress in the field of structural reform

In the field of structural reform, and beyond the introduction of the GST, the fact that central government continues to promote competition among states (including by introducing rankings) is proving to be an efficient way to push structural reform efforts, including those aimed at improving the investment climate. The liberalizing measures related to the agricultural sector are a step in the right direction as well.

We should also welcome the fact that the RBI has already begun to use its new powers that allow it to force lenders to take write downs. Moreover, efforts made to further develop the market for corporate bonds will also have a positive effect on private investment going forward.

Going forward, further steps in the following areas would be particularly welcome: non-financial corporations (especially in certain sectors) should reduce leverage; state banks should be restructured and further recapitalized; the tax system should be reformed in order to increase its efficiency and to generate sufficient revenue to finance infrastructure investment and social expenditure (a more credible fiscal policy would also make it possible to reduce mandatory investments by banks in public bonds, so that these funds could flow to the real economy in a more efficient way); labour market and agricultural regulation should be further improved; and the land reform should be forcefully pursued as it would help reduce the significant obstacles that infrastructure investment in India still faces.

Inflation has dropped considerably



Source: Bloomberg, Alinea Global

Emerging countries - Brazil

A difficult political situation puts reform efforts at risk

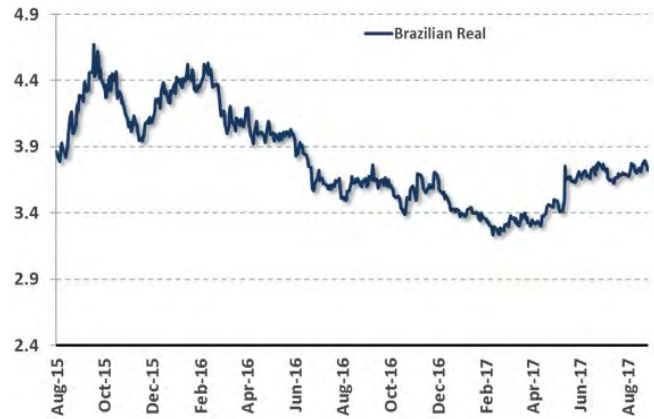
Brazil's economic future will be dictated by two main factors. Firstly, macroeconomic stability (both fiscal and in terms of inflation) should be ensured, so that the high financing costs the country has traditionally faced can be sustainably reduced. Secondly, further measures are needed to increase potential growth and improve economic efficiency.

It is essential that the government continues to make progress in the field of economic reform. In particular, it is crucial that the reform of the pension system is finally approved. At the same time, the government needs to introduce additional "microeconomic" reforms aimed at promoting private investments in infrastructure; reducing red tape; simplifying the tax system; improving financial regulation; facilitating corporate debt restructuring; etc.

In this regard it is bad news that President Temer's political position is so weak as this could put reform efforts at risk. At the same time however, it is also fair to say that the political situation is not yet catastrophic: in recent weeks the government has managed to approve a reform of the labour market and the authorities are still trying hard to get some form of pension reform approved as soon as possible. On a more negative note, tax revenues are weaker than expected and this has forced the government to raise the deficit target (even here there is some hope, as the authorities have also approved several fiscal consolidation measures together with a privatization plan both aimed at containing the deterioration of public finances.)

Activity is showing signs of stabilizing

The weak real still helps



Source: Bloomberg, Alinea Global

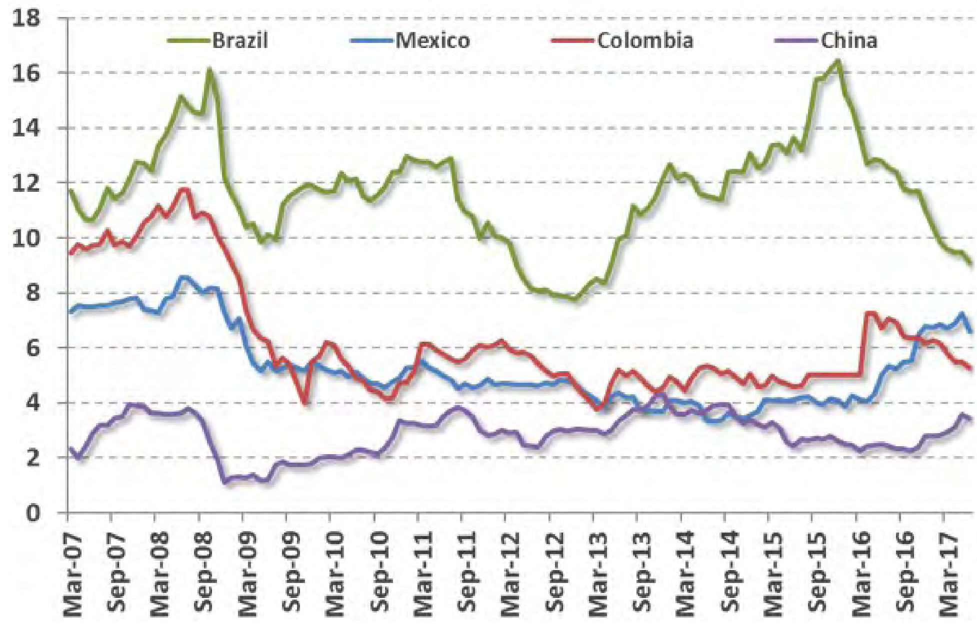
The basic long-term strategy of the country should be to sustainably reduce financial costs

If economic policy maintains the right course, Brazil could enter a virtuous circle in which the central bank has room to aggressively cut interest rates, with very positive effects on both growth and employment. In fact, the more progress made by the authorities in terms of economic reform and improving the long-term sustainability of public finances, the greater the reduction of Brazil's financing costs in the future. In this regard, the recent elimination of subsidies linked to loans made by the BNDES is clearly a step in the right direction (theses subsidies did not only cause significant economic distortions, but they also brought with them considerable fiscal costs). On the other hand, the longer the current political uncertainty prevails, the less room for manoeuvre the central bank will have to continue reducing interest rates in the medium-term.

From a purely short-term perspective, rapidly moderating inflationary pressures, together with improvements in inflation expectations and high levels of spare capacity, have actually allowed the central bank to reduce interest rates fairly quickly over the past few months.

The positive impact of a less restrictive monetary policy has become increasingly apparent over the last few months: the unemployment rate had begun to edge down, retail sales and industrial production have both surprised to the upside of late, sentiment indicators have improved again, etc. More generally, the economy has recently managed to achieve positive growth rates.

Structurally high financing costs



Source: Bloomberg, Alinea Global

Emerging countries - Russia

Although there are still challenges, things have clearly improved

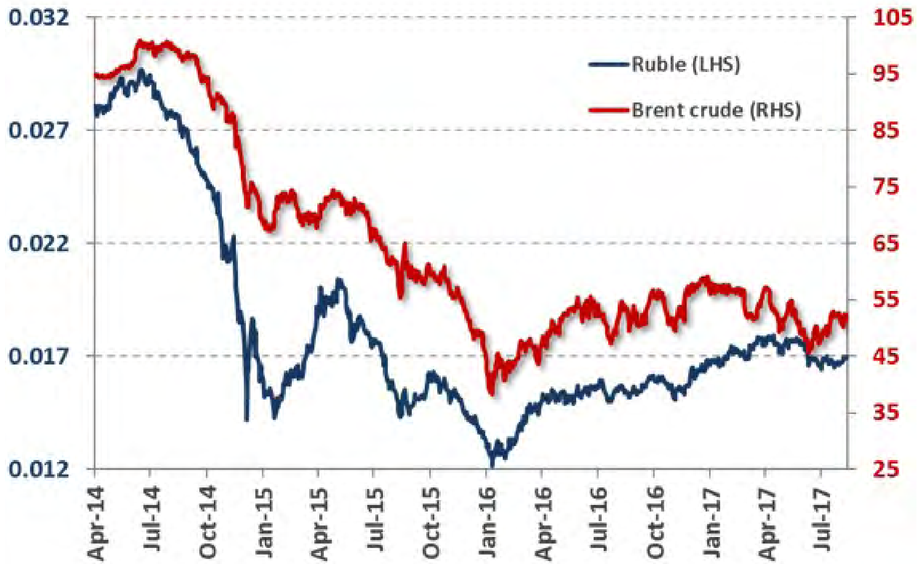
The Russian economy faces significant challenges: the price of its main product, oil, is still low and the economic sanctions imposed by the Western economies continue to drag down activity. Moreover, restructuring of the banking sector is not over yet, with the central bank having been forced to bail out the second biggest private lender in August. From a medium-term perspective, the Russian economy's lack of diversification and its excessive reliance on commodities is a source of concern and dampens potential growth.

At the same time, recent macro data confirm that the country is able to maintain the recovery that began towards the end of 2016.

In fact the economy is showing signs of acceleration of late, after GDP growth came in significantly stronger than expected in the second quarter and positive forecasts for the third quarter: private consumption is improving (with unemployment dropping and real wages beginning to pick up); and both industrial production and private investment are also sending positive signals.

The central bank has gained significant credibility in recent years by maintaining real interest rates relatively high (although interest rates have been reduced several times in recent months this movement has merely accompanied the significant fall in inflation). Looking ahead we believe that the monetary authority will continue to reduce rates and will even allow for a fall in real interest rates if inflation expectations continue to improve.

The stabilization of oil prices should continue to help

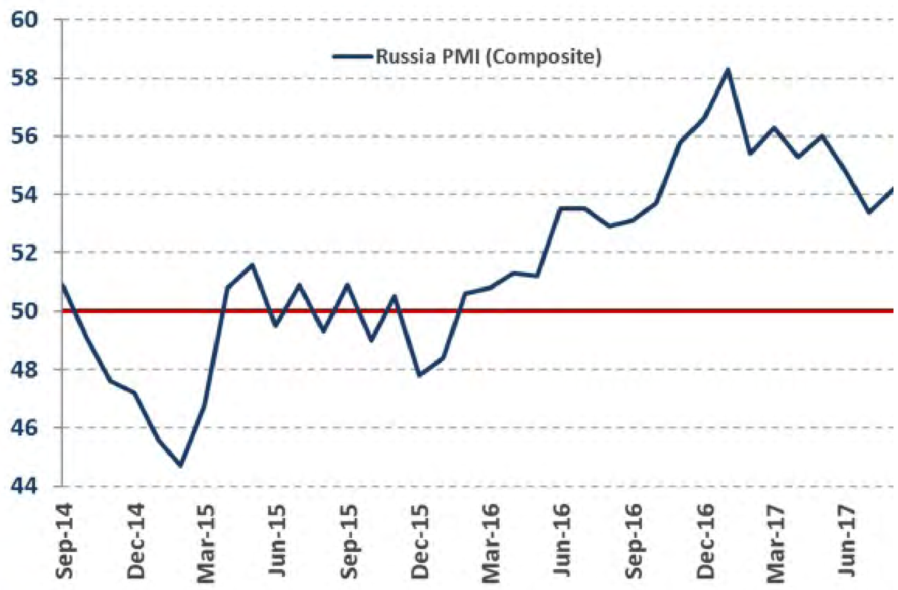


Source: Bloomberg, Alinea Global

After a higher than initially expected fiscal deficit in 2016, the prospects for this year look much more promising. Moreover, the government's plan to reach a budgetary balance in 2020 is clearly a step in the right direction, although in order to ensure the long-term sustainability of public finances the government will also need to thoroughly reform the **pension system.**

Going forward, and aside from preserving the sustainability of public finances, Russia needs to make progress in two major areas. On the geopolitical front Russia should adopt a more collaborative stance with the western world, so that sanctions can be eased at some point in time (things are not looking particularly good in this respect given tensions in the Ukraine and Russia's hacking activities against several countries). At the same time, it is important for the government to conduct ambitious structural reforms aimed at increasing potential growth and reducing reliance on oil. It would also be good if the central bank continued its efforts to clean the balance sheets of financial institutions, a process that is already quite advanced.

Activity is showing signs of improvement



Source: Bloomberg, Alinea Global

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