Economic Newsletter

Third quarter - July 2018

Economics & Regulation Services of Grant Thornton

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Monthly Outlook

Despite all the talk about geopolitical risks, the outlook for the global economy continues to be positive: the US is very strong, the European slowdown seen during the first months of the year has been temporary (see, for example, the May employment data) and most emerging economies have solid foundations.

Even though spare capacity is being eliminated somewhat quickly and upward pressures on prices and wages are becoming increasingly evident, markets remain convinced that we live in a world with very little inflation, where interest rates are set to remain low permanently.

The only risks that seem to matter are the most obvious: US trade policy, Italy's populist government and debates on immigration policy in Germany.

If we accept the above (that we live in a world with very low inflation and where all risks are to the downside), having long-term government bonds in your portfolio continues to be an excellent idea: I earn money because of the positive carry and because the flattening of the yield curve increases the price of my bonds; moreover, when volatility appears, my bonds help me reduce short-term drawdowns.

It is very unlikely, however, that the above assumptions are true. As always when bubbles are formed (in this case in fixed-income), the market puts aside fundamentals and only focuses on the most obvious aspects of the current situation. In particular, neither the central scenario that markets are now discounting is the most probable, nor are all risks being properly considered.

In terms of the central scenario, there is clear evidence in many countries that spare capacity is now quite low and that demand growth is surpassing supply growth. When this is the case, it does not seem reasonable to think that neither wages nor prices will ever react upwards (and to think therefore that interest rates do not have to go up).

Regarding risks, there is one (perhaps the most important one) that has been totally ignored: the risk of economic overheating, starting of course in the US.

We still have time to avoid this overheating scenario, but for this to happen financial conditions need to begin tightening sooner rather than later. This means of course that long-term rates will have to increase significantly from current, extremely low, levels. If this doesn't happen, inflation will rise clearly above target and central banks will have to react by raising rates a lot more than current projections state. If this scenario were to unfold, both stocks and bonds would have a hard time maintaining current valuations.

United States

The US economy is in good shape, with overheating risks on the rise

Recent macro data point to a fairly strong Q2 in terms of GDP growth. If this is confirmed, as we expect, growth in the US would have averaged more than 3% for four consecutive quarters for the first time in this economic expansion. Moreover, and even more importantly, it is increasingly clear that the US economy's fundamentals look solid and this leads us to be optimistic about economic growth for the rest of 2018 and into 2019.

Given that fiscal policy has clearly turned procyclical, and leaving aside the possibility of a global trade war (something that we consider quite unlikely), **the main risk for the US going forward is not a sudden slowdown, but rather significant overheating.**

Private consumption is looking very good: consumers' balance sheets are healthy; disposable income is growing at solid rates; the labour market is in excellent shape; sentiment indicators are very strong, etc.

Corporate investment has been growing at solid rates for some time now and there is good reason to think that this positive behaviour could continue into the future. On the one hand, the recovery in oil prices is leading to an increase in investments in the energy sector. Moreover, after years of expansion, companies in most sectors are no longer in a position to serve increasing demand just by resorting to unused capacity and are therefore increasing capital expenditure at a significant pace. The recovery in investment is also good news for productivity (and potential growth). In fact it is quite encouraging to see that productivity growth has already shown signs of improvement during the past 12 months.

Consumer confidence at very healthy levels

Source: Bloomberg, Alinea Global

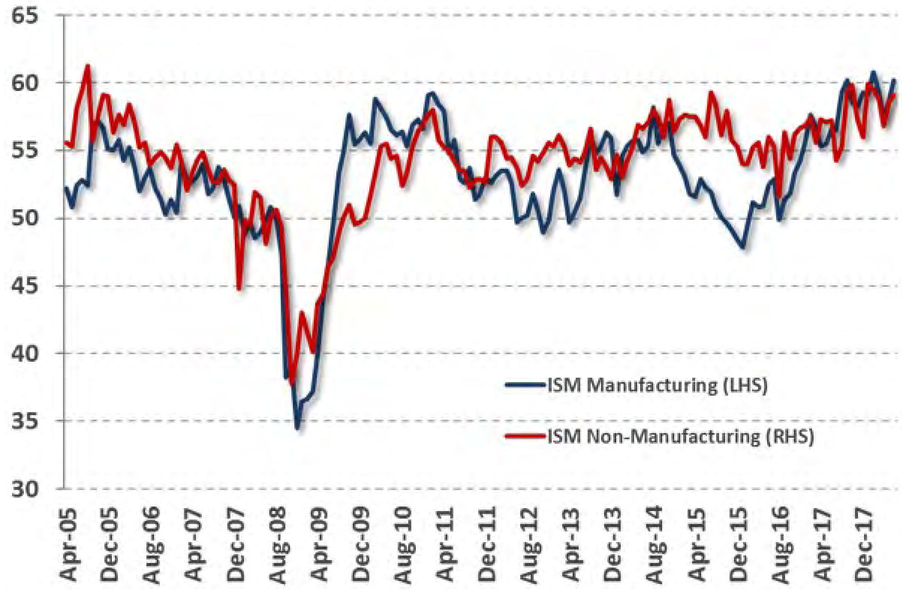
Even if sometimes erratic, the real estate sector is showing increasing momentum and still has significant room for further expansion in a context of relatively strong household formation rates and very low inventories of unsold homes.

The US dollar is still relatively attractive and alongside the strength of the global economy should continue to help exports in the coming quarters. Moreover, the recovery in oil prices is already leading to a significant increase in energy exports, something that looks set to continue going forward.

All in all we expect economic growth to continue clearly above potential in the coming quarters. In fact, as already stated, we believe that overheating risks are building and will increase further in coming quarters provided financial conditions remain as accommodative as they are now.

If we turn to 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 given that the unemployment rate is already below the values compatible with full employment. Considering this it would be reasonable to expect employment growth to drop and wages to accelerate further going forward (more on the latter below).

Manufacturing and non-manufacturing ISM



Source: Bloomberg, Alinea Global

Inflation will continue to edge up in the coming months with tariffs adding new pressures on prices

Core CPI has recovered in recent months and, in our view, this confirms that the negative surprises seen during the first part of 2017 were mostly due to temporary factors. In fact, 3-month annualized growth rates in core prices have clearly been above the Fed's 2% objective for several months now.

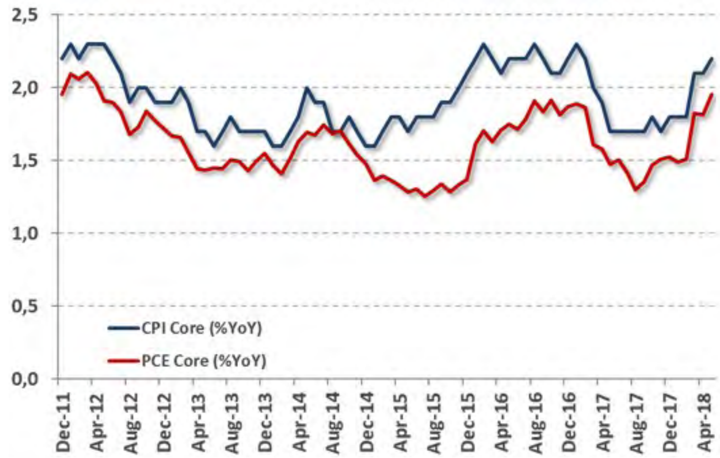
The outlook for core prices is actually quite positive in our view: with growth above potential, an already closed output gap, and inflation expectations relatively well-anchored (even moving somewhat higher recently), the most probable scenario going forward will see core inflation inching higher in the coming months.

The upward movement in core inflation could be more abrupt than many are currently expecting: beyond the cyclical factors already alluded to, the dollar has tended to depreciate in the last 12 months and this will help push core prices going forward. Moreover, headline inflation will probably increase further because base effects related to oil prices will tend to increase over the coming months.

At the same time, the main effect of Trump's tariff increases will probably be additional inflationary pressures, as they restrict supply in a context of rapid demand growth. Furthermore, the approved tax reform and significant increases in public expenditure to take place over the coming months will further expand aggregate demand and are therefore a further reason to expect positive inflation surprises going forward.

Meanwhile, the tight labour market should continue to favour progressively higher wage growth. It is actually quite encouraging to see that wages have tended to accelerate in recent months.

Core CPI should continue to head higher in coming months



Wages are beginning to pick up

Source: Bloomberg, Alinea Global

The Fed should continue to gradually increase rates if it wants to avoid overheating risks

Given that the economy is looking pretty good, financial conditions are very accommodative and inflation is expected to edge even higher this year, it was not surprising that the Fed again raised interest rates at its June meeting.

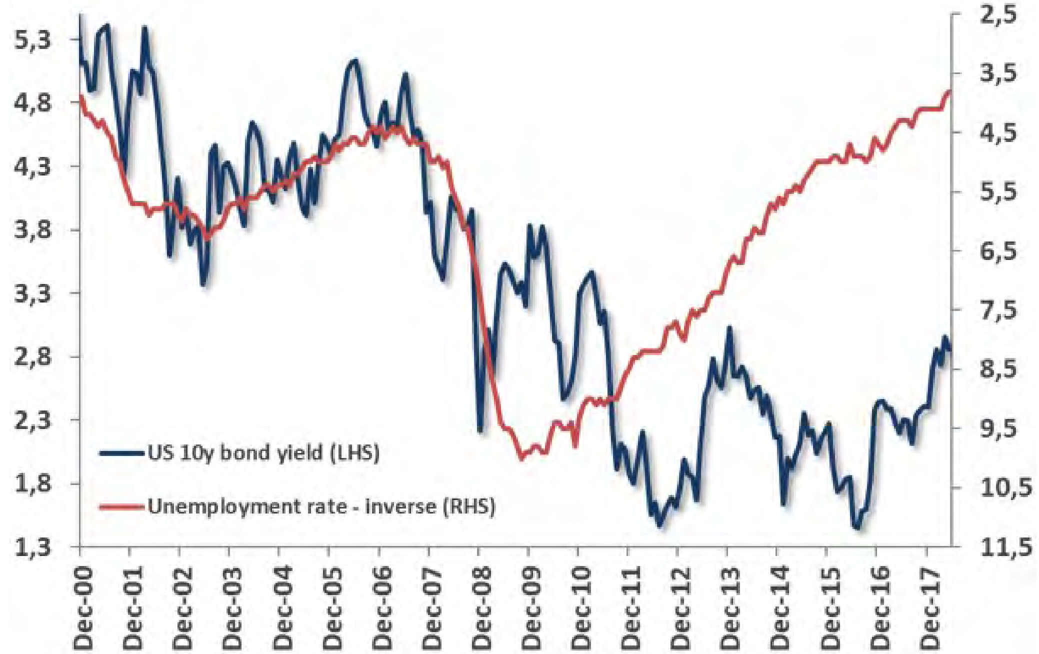
Going forward, and despite the unemployment rate sitting below equilibrium and the Fed expecting inflation to rise a bit beyond the 2% target in the next 2 years, the US monetary authority wants to remain cautious in the short-term and will try to raise rates slowly during 2018 and 2019. The objective is of course to ensure that inflation reaches the 2% target in a sustainable way, even if this means allowing for a moderate overshooting of the target for a certain period of time.

If the Fed is set to remain cautious, with such a strong economy, a clearly pro-cyclical fiscal policy and with both wages and prices edging higher, common sense would seem to point to a somewhat higher term premium and therefore to a slightly steeper yield curve, especially in the 10-30y maturity range. In fact, because most market participants still believe that inflation will never seriously rise, no matter how hot the economy becomes, what we are actually seeing is a further flattening of the curve.

That said, we fear that monetary conditions will remain too accommodative for too long and this will tend to create significant overheating risks in the US economy. If this indeed proves to be the case, inflation will almost inevitably overshoot the 2% target by a significantly higher amount than even the Fed is currently expecting.

In our opinion, it is becoming increasingly clear that the US economy needs long-term rates to move significantly up if overheating risks are to remain contained. The longer long-term rates stay this low, the greater the overheating risk will become, requiring these same rates to rise in the future and potentially creating difficulties for risk assets if this scenario unfolds.

Long-term rates still far too low



Source: Bloomberg, Alinea Global

European Union

The deceleration seen in the first part of the year will probably be temporary

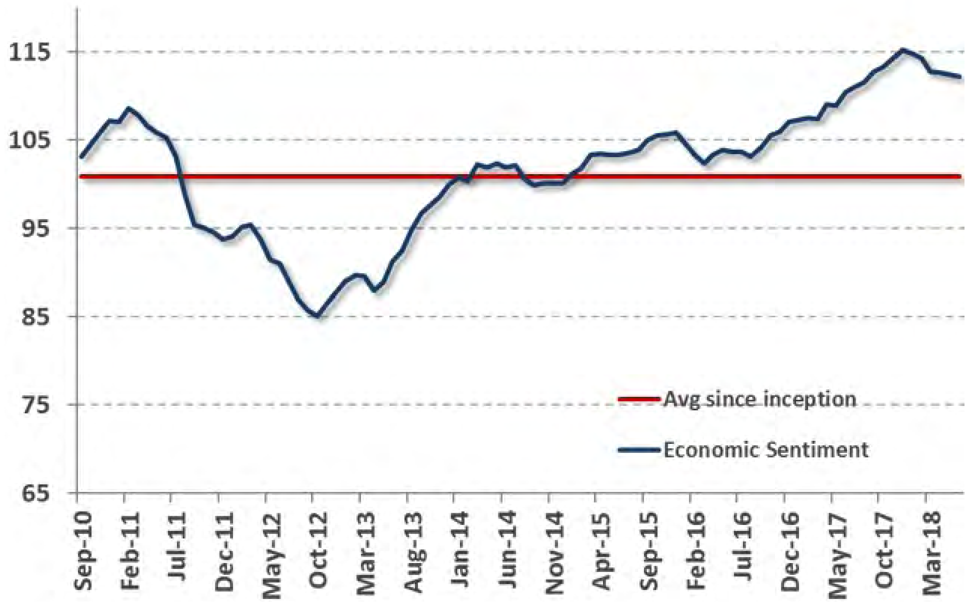
Economic activity was weaker than expected during the first quarter, but this needs to be put into context. Firstly, growth continued to be above potential. Secondly, the deceleration seen in this period was mostly due to temporary factors (bad weather, strikes, high incidence of flu in countries like Germany, etc).

Looking ahead it is important to remember that significant tailwinds continue to help the Eurozone's economic expansion: extremely accommodative monetary conditions; a financial sector more willing to lend to the real economy; still relatively cheap oil; a private sector that has reduced leverage very significantly; price-competitiveness adjustments among countries in the periphery during the crisis; a somewhat more growth friendly fiscal policy; a slightly weaker euro, etc.

We therefore think there is good reason to maintain a positive view on the Eurozone's economy going forward: the unemployment rate is dropping fairly quickly and the labour market continues to show strength; sentiment indicators are still at quite high levels; PMIs never fell to worrying levels and have already shown some signs of recovery in June; credit to households and non-financial corporations has picked up again; capacity utilization levels are quite high and this is obviously good news for corporate investment going forward, etc.

Admittedly, it will be difficult to see growth rates reaching the strong figures registered during the second half of last year. This is not due to lack of demand however, but is rather a sign that supply is having a harder time coping with the growth of orders. In fact, the very same reason that justifies a little more cautiousness around economic growth in the future in Europe should also lead us to expect increasingly higher wage and price pressures in the Eurozone going forward (both wage growth and inflation have sent more positive signals recently).

Economic sentiment: very solid levels



Source: Bloomberg, Alinea Global

Despite the noise around Italy, prospects still look good

The new Italian government has created a fair degree of unrest because of its apparent stance on the euro and the fact that its initial fiscal plans were not only unsustainable, but were clearly incompatible with European rules.

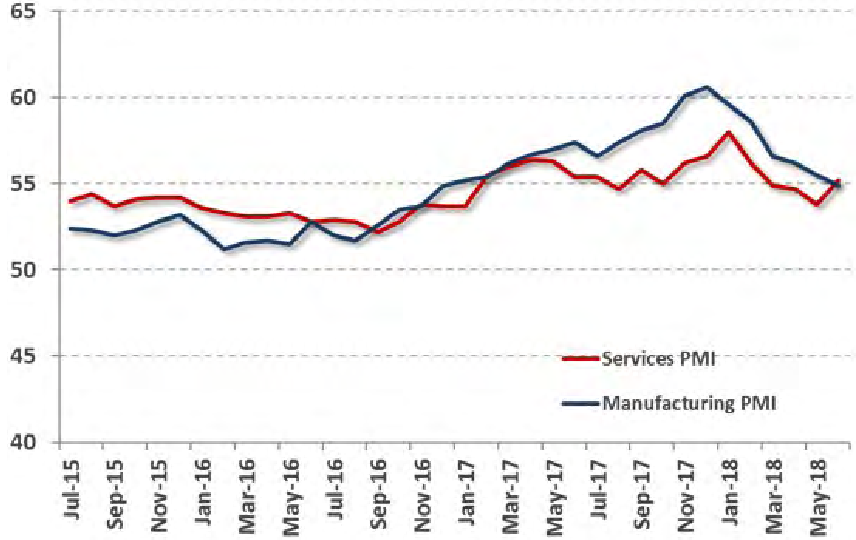
The good news is that in the past couple of weeks Italy's new Economics Minister has reassured markets by saying that Italy remains committed to the euro and that the new government's fiscal stance will be acceptable to Brussels. Even Savona, who wasn't allowed to take charge of Italy's economic affairs for his supposedly anti-euro stance, has recently stated that Europe's internal market and the euro are inseparable and essential for Italy.

It is also quite possible that the Brexit negotiations will continue to create noise in the coming months. At the same time however, it is also clear that considerable progress has been made and it seems highly likely that the most disruptive scenarios will be avoided.

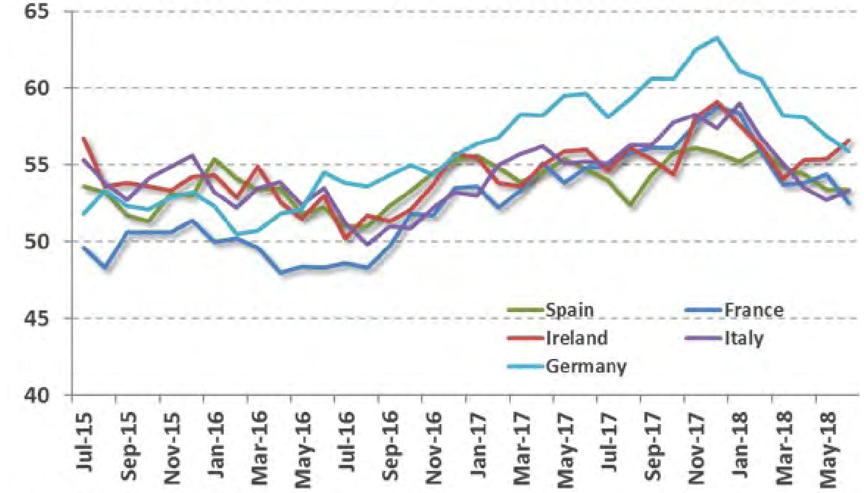
In Spain, the new government is clearly pro-euro and should therefore not be a source of political noise going forward.

Generally speaking, and in the knowledge that risk cannot be totally dismissed, we think the most likely scenario going forward is for the Eurozone to continue to grow clearly above potential, allowing for a relatively rapid reduction of spare capacity (which still exists, but is constantly decreasing).

PMIs still at healthy levels



The European recovery is wide-reaching



Source: Bloomberg, Alinea Global

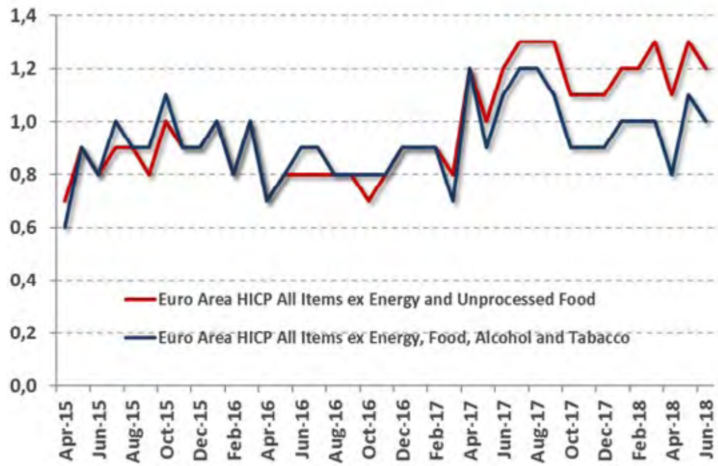
Core inflation is edging higher and the ECB sets a deadline for the QE programme

The favourable European macro environment should continue to result in a progressive acceleration in core prices. Taking Easter holiday-related distortions out of the equation, the latest inflation data for the Eurozone are positive and show that core inflation has been trending higher for quite some time now. We consider it quite likely that core inflation could reach YoY rates of around 1.5% by the turn of the year.

Four main factors help explain our upbeat view of core prices going forward. Firstly, we continue to see clearly above potential growth and therefore expect the output gap to close quite rapidly (in May the unemployment rate was already lower than the long-term average and we expect it to drop further and reach somewhere around 8%, or even lower, in the next 6-9 months). Secondly, in relation to point one, wages are already showing signs of acceleration in many countries. Thirdly, the euro has depreciated in recent months and this will help push the price of goods higher going forward. Finally, it is also true that (because of energy prices) headline inflation is now around 2%. Considering the much improved shape of Europe's labour market and the fact that collective bargaining on our continent has a significant backward looking component, second round effects in the form of higher wages and core prices are to be expected in the coming months.

It was therefore no surprise that the ECB decided to set a deadline (December) for the end of the QE programme at its June meeting. At the same time, and to ensure that short-term rates remain anchored, it reinforced the forward guidance relating to rates. More specifically, the ECB signalled that it expects to keep rates steady at least until the end of summer 2019. In a normal context, a very cautious central bank coupled with a strong economy and increasing wage and price pressures should lead to significantly higher long-term interest rates. We think that the market will end up reflecting this sooner rather than later.

Core inflation should edge higher going forward



Inflation expectations have improved

Source: Bloomberg, Alinea Global

Spain

Despite the political noise, Spain's economy continues to look good

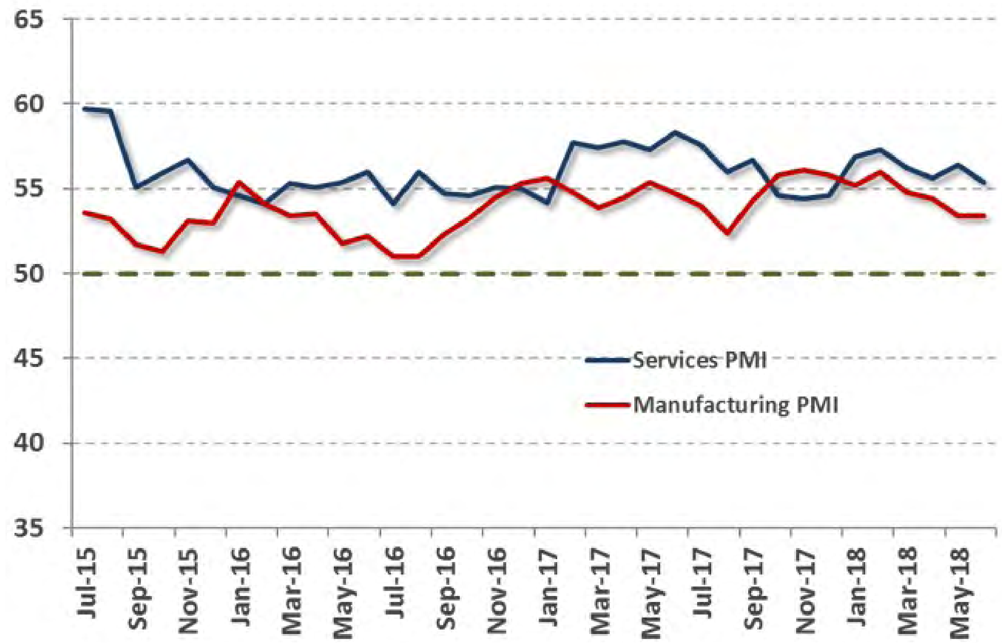
In spite of all the political noise, recent macro data remain positive and point to annualized growth rates only a little under 3% during the second quarter: job growth continues to be solid; confidence indicators are at healthy levels and edging even higher; PMIs are also doing well; exports have been strong; both the industrial and the services sectors remain in pretty good shape; prospects for real estate and tourism (outside Catalonia) continue to look encouraging.

Going forward, and provided that the situation in Catalonia remains under control (clearly the most probable scenario), we believe that the Spanish economy will continue to benefit from a number of important tailwinds: significant price competitiveness gains made during the crisis; a much improved balance sheet situation in both families and companies; a global economy that is in very good shape; and still very low interest rates.

We therefore think that economic activity will remain strong, with growth rates of around 3% in 2018. Fiscal policy has turned expansionary, and although this is potentially dangerous from a long-term perspective, it will support economic activity this year

As this scenario unfolds, spare capacity (even if it is still high) will tend to drop fairly quickly in Spain over the coming quarters.

Manufacturing and non-manufacturing PMI



Source: Bloomberg, Alinea Global

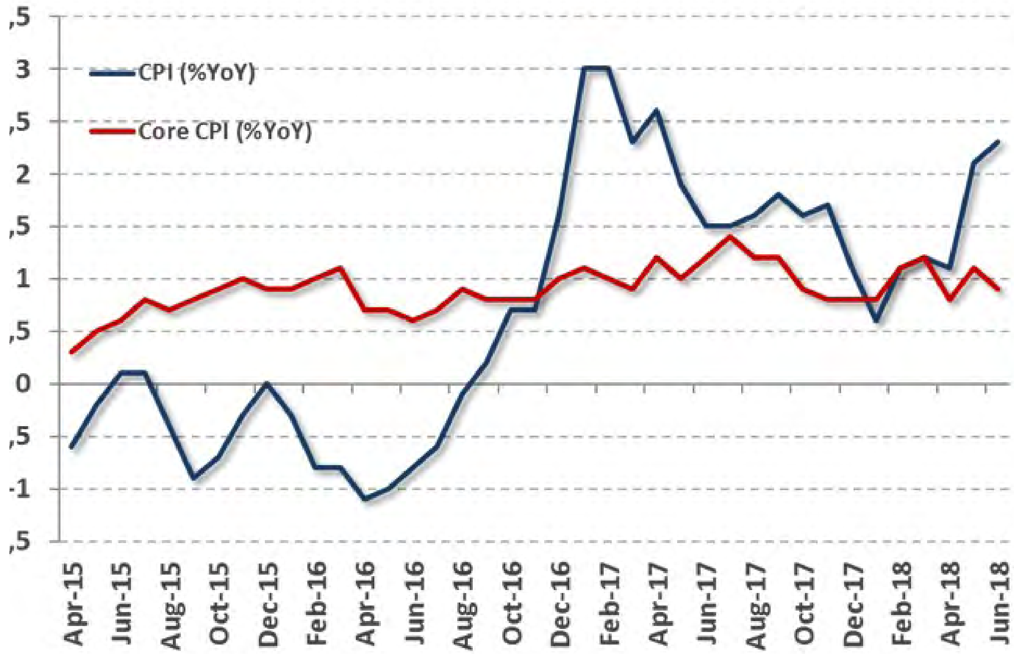
High debt and low potential growth - still Spain's medium-term challenges

This scenario is in turn compatible with underlying inflation heading progressively higher in the coming months. As the unemployment rate continues to drop, wages should also tend to edge modestly higher going forward. It is good to see that some tentative signs of acceleration in both core prices and wages are beginning to be seen.

From a medium-term perspective it would be great if the government could use the opportunity offered by the current tailwinds to seriously address the significant structural challenges that the Spanish economy still faces. Agreement still needs to be reached on measures to increase Spain's low growth potential (to boost human capital; to drive technological innovation; to increase competitiveness in certain industries), to control external debt and to tackle increased inequality.

It is especially important that Spain complies with the requirements of the Stability and Growth Pact. Regrettably, recent news regarding fiscal policy has been relatively worrisome. On the one hand, pensions have been raised more than expected and it is not yet clear how that decision is going to be financed. This of course undermines the credibility of the system. On the other hand, as already stated, fiscal policy has become expansionary in 2018 when perhaps it would have been a better idea to increase the pace of deficit correction (especially taking into account the current strength of the Spanish economy).

Core inflation should edge progressively higher



Source: Bloomberg, Alinea Global

United Kingdom

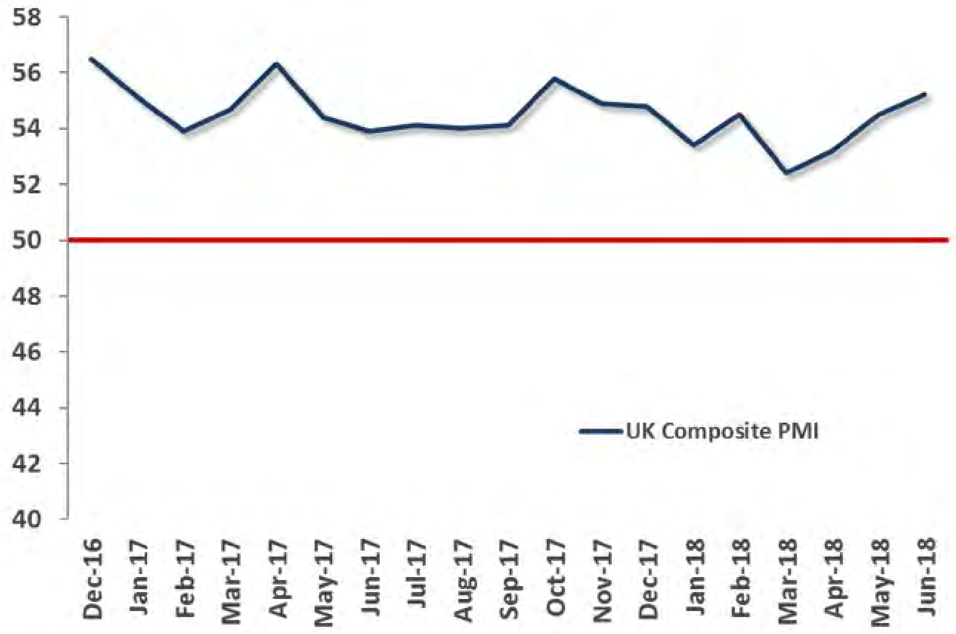
The economy holds up relatively well despite all the noise around Brexit

Despite all the noise around Brexit, and without denying the fact that the UK is today growing considerably more slowly than before, short-term macro data have regained some momentum recently. Going into the coming quarters and following a first six months affected by the weather, certain factors need to be considered. On the negative side, and given the high levels of uncertainty about the future, it is difficult to be overly optimistic about the prospects for corporate investment. On the positive side, the pound's weakness should continue to boost both exports and the manufacturing sector, while it is also true that fiscal policy is now mildly expansionary. What about consumption? It is clear that this important variable has been negatively affected by uncertainty and also by imported inflation. At the same time however, in a context of full employment, as in the UK, we should be relatively optimistic about the performance of wages going forward, something that in turn should help to avoid a significant deterioration in private consumption in the coming quarters. Encouragingly, signs of positive momentum in wage growth are becoming increasingly apparent.

Given the very low levels of spare capacity and the more positive signals coming from both wages and domestic price pressures, we think that the BOE will probably raise interest rates in August (3 voters opted for a hike in June already).

From a medium-term perspective, and despite all the noise around the Brexit negotiations, we continue to believe that the most disruptive scenarios will be avoided. At the same time it is clear that the long-term negative effects of Brexit on the UK continue to be significant: the UK will probably lose full access to one of the biggest markets in the world; London will lose part of its appeal as a global financial centre; and Britain will no longer be as attractive as it traditionally has been as a destination for highly skilled migrants. That said, it would be very positive if the British government were to finally decide to keep the UK inside a customs union with the EU.

Latest economic data, moderately positive



Source: Bloomberg, Alinea Global

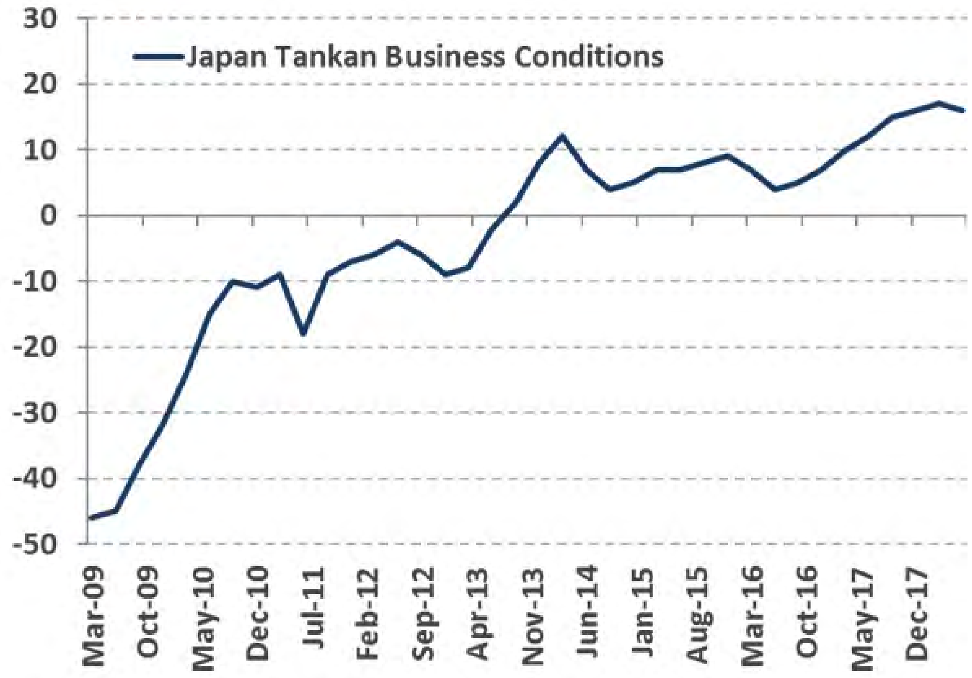
Japan

Japan looks set to grow above potential going forward

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 optimal (in fact, the government was obliged to put a statistics improvement plan in place a short while ago). On the other hand, and more importantly, when people talk about Japan they normally fail to properly distinguish between cyclical and structural factors. The first thing to remember when analysing Japan is that the population is dropping and there is almost zero immigration, resulting in a very low level of potential growth (probably not higher than 0.75-1% annually). It is therefore reasonable for the Japanese economy to alternate quarters of positive growth with quarters of negative growth and even more so in the current environment of very low levels of spare capacity.

After a weak Q1, prospects for the second half of the year look promising. Most recent economic indicators have been relatively upbeat (sentiment indicators and PMIs are at healthy levels despite the negative effect coming from the appreciation of the yen; corporate investment is sending encouraging signs against a backdrop of increasing capacity constraints; exports and industrial production are both in good shape; credit appears to be picking up; the prospects for the construction sector are also optimistic, in part because of investments ahead of the 2020 Tokyo Olympics and tourism is doing really well, etc.). At the same time, wages are beginning to pick up, in a context of very low unemployment, strong demand for workers by Japanese companies and ever greater problems to increase the workforce by delaying the effective retirement age (for the past 2-3 years Japan has been successful in bringing more women into the labour force; while this has helped to keep wage growth in check, it will naturally tend to become less of a factor going forward since a lot of progress in this area has already been made; on the other hand, it is true that immigration could continue to help expand the labour force in Japan thereby easing pressures on wages). Somewhat stronger wage growth is of course excellent news for private consumption going forward.

Positive outlook in the medium-term



Source: Bloomberg, Alinea Global

Economic fundamentals point to progressively higher inflation and wage growth

A tight labour market (the unemployment rate is 2.2% and the jobs/applicants ratio is very high at 1.60; the output gap is already positive) **in a context of above-potential growth should put further upward pressures on wages and then on inflation going forward** (some positive signs have already been emerging on both fronts in recent months).

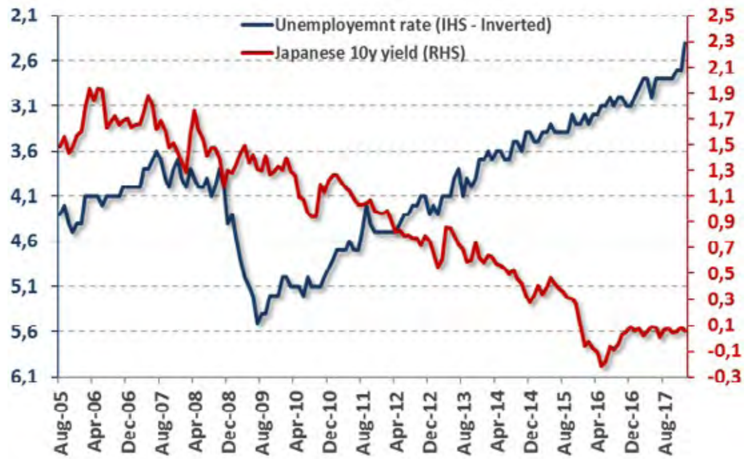
The BOJ continues to implement its yield curve control policy, trying to make sure that 10y yields stay reasonably close to 0% and committing to allowing inflation to overshoot the 2% target for a considerable period of time.

At the same time, the government has said that a primary surplus will only be achieved in 2027 which means that fiscal policy will remain accommodative, thereby helping to create further inflationary pressures in the coming quarters.

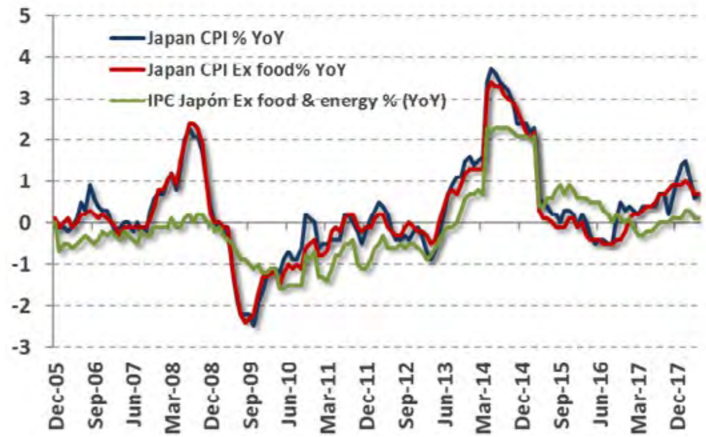
Beyond creating inflation, perhaps the most important challenge for Japan going forward is the need to increase potential growth. For this to be possible, it is essential for the country to make more progress in the field of structural reform. Three elements seem particularly important in this respect: the labour market should be reformed in order to reduce duality among formal and informal workers; immigration should be fostered (some progress is already being made in this field); and conditions for FDI should be further improved (because it increases competition and promotes innovation this kind of investment can play a role in pushing up productivity growth).

Looking further ahead it will also be crucial for the government to ensure a sustainable path for the country's public debt.

Low output gap levels point to higher wages and prices



CPI should do better going forward



Source: Bloomberg, Alinea Global

Emerging countries - China

Despite Trump's threats, China seems poised to avoid any kind of hard landing

The Chinese economy performed solidly during the first half of 2018: private consumption is doing well alongside a strong labour market, wage increases and high consumer confidence levels; exports should continue to benefit from the strength of the global economy; both the services sector and the most technologically advanced segments of the manufacturing sector look strong. China has already made significant progress in relation to industry sectors affected by overcapacity issues: this could mean less downward pressures on economic activity going forward which, in turn, could help compensate for a potential loss of momentum in both infrastructure investment and the real estate sector. Low inflation gives the PBOC room for manoeuvre and fiscal policy is set to remain at least mildly expansionary, etc.

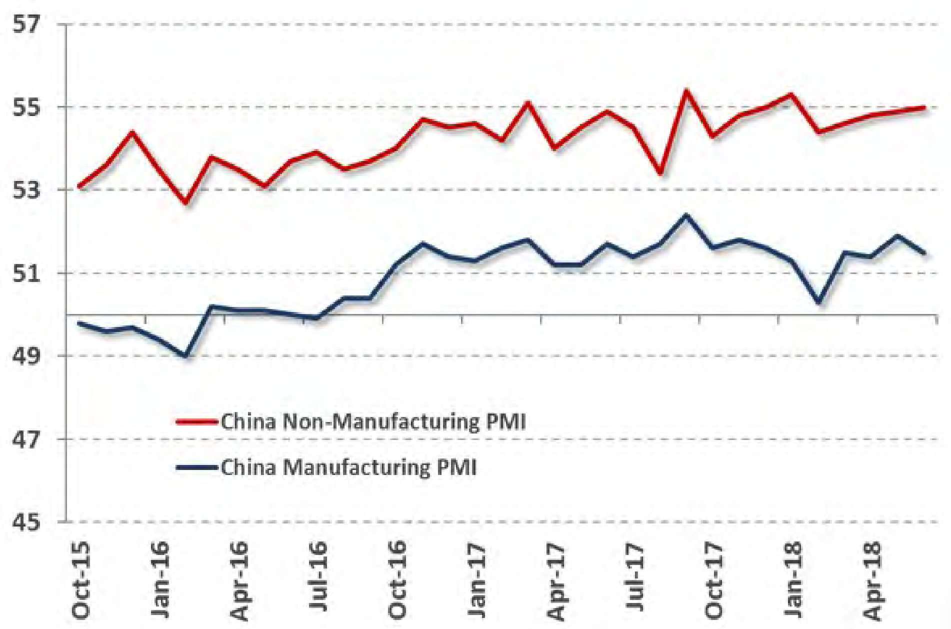
China's economic strength increases the country's ability to confront the risk of a trade war with the US. Having said this, we continue to believe that the Chinese trade policy will still be guided by two basic principles.

Firstly, the authorities will respond to tariffs set by Trump, but will avoid giving the impression that they want to escalate the conflict. Secondly, China will continue to adopt measures to reduce trade barriers as it is in the country's best interests to do so at its current stage of economic development, increasing the protection of intellectual property rights and allowing for a more symmetrical and fair treatment of foreign companies operating in the Chinese markets.

Because of the new risks created by a potential trade war with the US, we believe the Chinese authorities will put even more emphasis than before on finding the right balance between reducing financial risks and putting measures in place that ensure the country's economy retains sufficient momentum going forward. The PBOC's decision to reduce the reserve requirement ratio is a good example of this.

Against this backdrop, the risks of a hard landing in the Chinese economy in the short-term remain quite low.

The economy continues to do well



Source: Bloomberg, Alinea Global

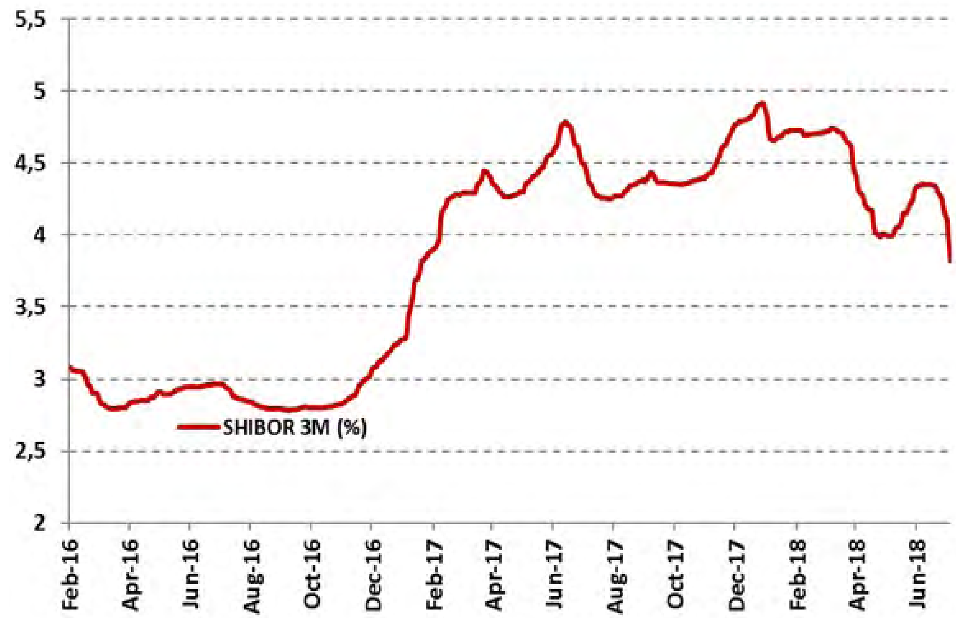
The yuan has weakened somewhat, but the risk of disorderly capital outflows is low

The Chinese authorities have allowed the yuan to depreciate somewhat against the dollar recently. This is another way to reduce the impact of Trump's tariffs and to send a message to the US. At the same time though, we think that the yuan's depreciation will only be moderate, because China will want to make sure that capital outflows do not accelerate significantly going forward. In fact, during the first few days of July the PBOC reiterated its intention to keep the yuan stable and in line with fundamentals.

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 recently). Moreover, equilibrium exchange rate estimates by institutions such as the IMF do not point to overvaluation.

It is also good to know that China has sufficient room for manoeuvre in terms of the balance sheet to allow for a smooth process of deleveraging, which is actually more advanced than many had thought it would be at this stage. We therefore believe that a credit crunch scenario is quite unlikely. We should remember that China is a net creditor to the rest of the world. Moreover, it is also true that debt growth has been significantly moderated recently, while measures aimed at facilitating the sale or securitization of bad loans seem to be progressing well (this should help banks to reduce their exposure to these kind of assets in an orderly manner).

Monetary policy is less accommodative than before



Source: Bloomberg, Alinea Global

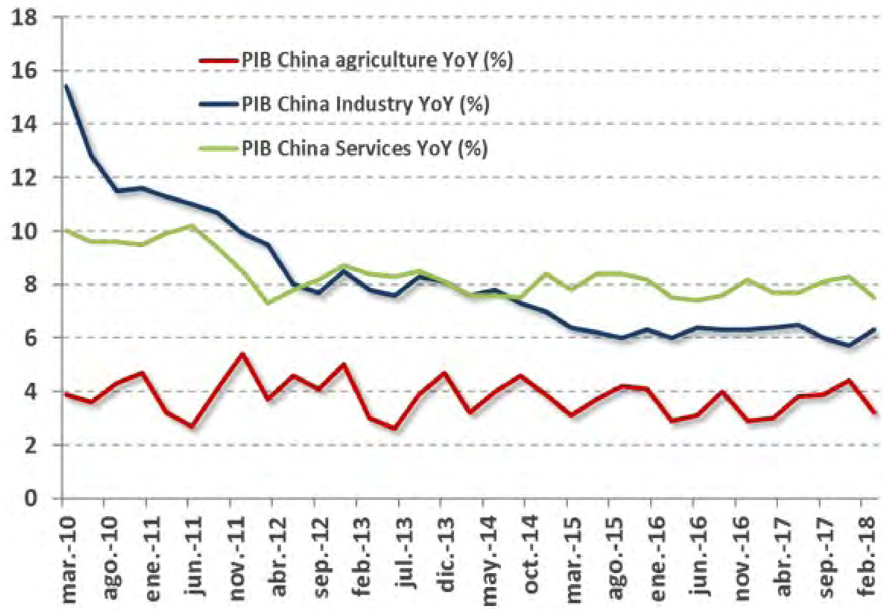
Further opening of Chinese markets and better IP protection will be needed

It is also positive that the country is able to move forward in the process of modernizing its growth model. On the demand side, consumption continues to gain importance. On the supply side, both the services sector and industries with relatively high technological intensity are becoming more and more dynamic. At the same time, it is also encouraging to see progress in some other areas: the economy's energy intensity is being reduced; corporate leverage is decreasing somewhat; growth in the most risky parts of shadow banking is being brought under control; and technological progress is being promoted (R&D investment reached 2.15% of GDP in 2017).

Having said all this, and also taking into account the pressure from the US, it is of course crucial that the authorities continue to work hard in order to further reduce financial risk, make progress in the field of structural reform and to open Chinese markets more clearly to international competition.

Excess capacity in some traditional sectors should continue to be reduced; credit growth needs to be further curbed; a real estate bubble must be avoided; the playing field for foreign companies and private companies more generally should be improved (tariffs should be reduced; restrictions to FDI should be curbed; and intellectual property rights should be better protected); leveraged investments in financial assets should continue to be controlled, etc. At the same time, and in order to help potential growth, investment in human capital and in research and technological innovation should be further enhanced.

Services continue to gain importance



Source: Bloomberg, Alinea Global

Emerging countries - India

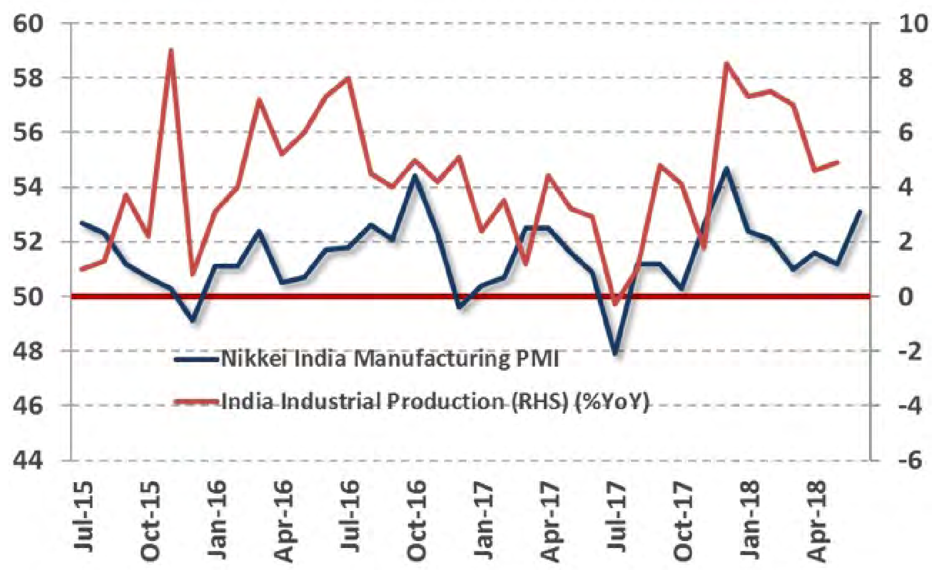
Despite higher oil prices, the economy continues to do well

India's growth has been well above 7% recently and the economy seems poised to continue to do well going forward. Private consumption remains resilient; exports and manufacturing production are benefiting from the strength of the global economy; infrastructure investment continues to do well; the rural sector is strong; credit growth has picked up; the manufacturing PMI is sending more positive signals, etc. Moreover, and after a prolonged period of sluggishness due to low capacity utilization and high corporate debt levels in some sectors, private investment seems to be picking up of late (the fact that the corporate sector has undergone a significant deleveraging process over the last 2 years, together with the recent rise in capacity utilization, seems to be proving helpful in this respect). On a more negative note, India is obviously negatively affected by higher oil prices, but we believe that more expensive energy won't be enough to derail expansion (it is good to see that the current account deficit remains at fairly low levels).

On the fiscal front, and considering the relatively high budgetary deficit (especially at the state level), it is important that the government continues to strike the right balance between boosting growth, facing social challenges and ensuring a sustainable path for public debt in the medium and long-term. With higher oil prices, a prudent fiscal policy will also help maintain the current account deficit under control. It is therefore good to see that the government remains fully committed to meeting the 3.3% deficit target for this fiscal year.

The RBI increased rates by 25 bp in June and further rates cannot be ruled out going forward. First, as already stated, the economy is looking better (and is progressively closing the output gap). Second, fiscal policy has turned mildly expansionary. Third, core inflation remains clearly above target. Fourth, inflation expectations continue to be quite high and fifth, the rupee's weakness could put upward pressures on prices going forward.

Volatile PMIs, but positive underlying momentum



Source: Bloomberg, Alinea Global

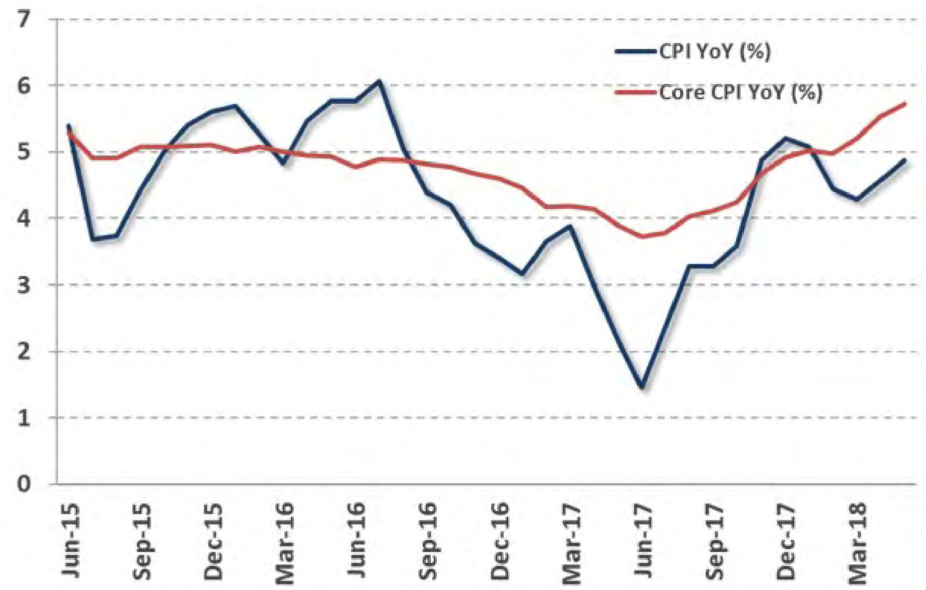
The government continues to make progress in the field of structural reform

As far as reforms are concerned, it is certainly good news to see that the process of bank recapitalization has made progress (this movement should help stabilise the financial system in India and improve the transmission of monetary policy). More generally, the central government continues to promote competition among states (including rankings) and this is helping to create reform momentum all over the country.

The RBI is using its relatively recently acquired powers to restructure problematic banks and to force lenders to take write downs on NPLs and this should also be welcomed. Moreover, efforts being made to further develop the market for corporate bonds will also tend to have a positive effect on private investment going forward.

Going forward, further steps are still needed, especially in the following areas: governance structures in state-owned banks need to be further improved (and supervisory power of the RBI over those banks should be increased) to avoid fraud cases like those recently seen; non-financial corporations (especially in certain sectors) should reduce leverage; 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 regulation should be further improved; the same goes for the agricultural sector: the land reform should be seriously pursued since it would help reduce the significant obstacles that infrastructure investment in India still faces; FDI flows should be further liberalized (it is encouraging to see that some positive steps have been taken in this direction recently), etc.

Core inflation still above 5%



Source: Bloomberg, Alinea Global

Emerging countries - Brazil

The lack of progress in pension system reforms leads to rating downgrades

In the medium-term, Brazil's economic future will be dictated by two main factors. On the one hand, macroeconomic stability (both fiscal and inflation-related) should be ensured, so that the high financing costs the country has traditionally faced can be sustainably reduced. On the other hand, further measures are needed to increase potential growth.

The results of the coming elections in October are therefore crucial. The country desperately needs the new government to remain committed to economic reform and (at least to some degree) fiscal austerity.

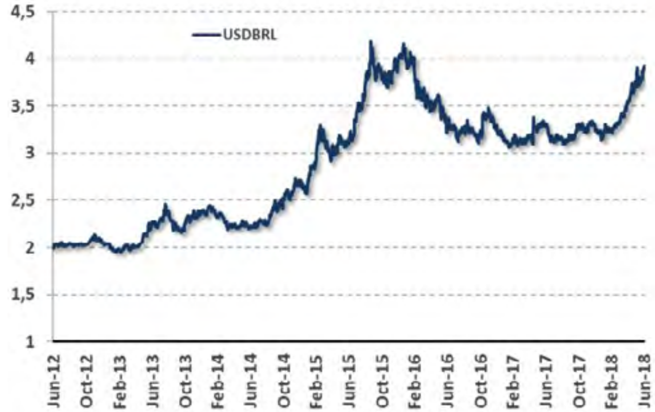
Among the pending reforms that will need to be undertaken after the election, there are two areas that are particularly relevant:

Firstly, the pension system must be made sustainable (Brazil's budgetary position is quite challenging and a reform of the pension system would help to significantly improve fiscal credibility with minor impact, if any, on short-term economic growth; in fact S&P decided to cut Brazil's rating precisely because of the lack of progress in this field; Moody's and Fitch have also recently said that Brazil's ditching of the pension bill is credit negative).

Secondly, further economic reforms are needed, aimed at promoting private investments in infrastructure, reducing red tape, simplifying the tax system. improving financial regulation and ensuring the independence of the central bank, etc.

Economic activity weakens again

The relatively weak real still helps



Source: Bloomberg, Alinea Global

The real's depreciation and US monetary policy reduce the BCBE's room for manoeuvre

The greater the country's progress in terms of economic reform and fiscal sustainability in the future, the bigger the sustainable decrease in financing costs. The fact that financing conditions have considerably improved since Rousseff left office is a clear sign that the steps taken by Brazil in the right direction in terms of economic policy have clearly paid off.

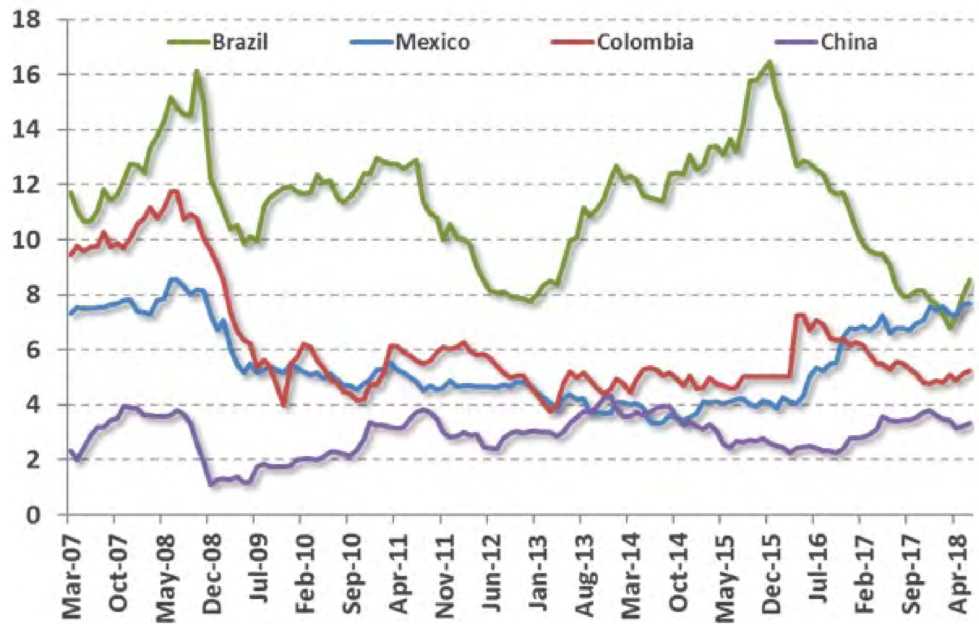
Until very recently, rapidly moderating inflationary pressures, together with improvements in inflation expectations and high levels of spare capacity, had allowed the central bank to reduce interest rates fairly quickly. This in turn had positive effects on economic activity.

More recently though, uncertainties surrounding the country's political situation coupled with doubts created by the normalization of monetary policy in the US, have exerted downward pressure on both the real and economic activity.

The good news for Brazil (at least in the short-term) is that this more uncertain environment takes place in a context of relatively low inflation (even if this variable has edged higher in the most recent period because of the real's depreciation, the lorry drivers' strike and higher energy prices) and **relatively well anchored inflation expectations.** Combined with a fairly large output gap, this situation will enable the central bank to avoid changing rates aggressively in response to short-term movements in the exchange rate. We actually think that interest rates will remain steady going forward, provided the level of noise remains under control.

As previously stated however, the long-term outlook for Brazil will only strengthen if the country continues to pursue its path of structural reform, the fight against corruption and fiscal consolidation (including, of course, the pension system reform). It is clear that the country's future will greatly depend on the kind of government that emerges from this year's elections.

Financing costs have come down considerably



Source: Bloomberg, Alinea Global

Emerging countries - Russia

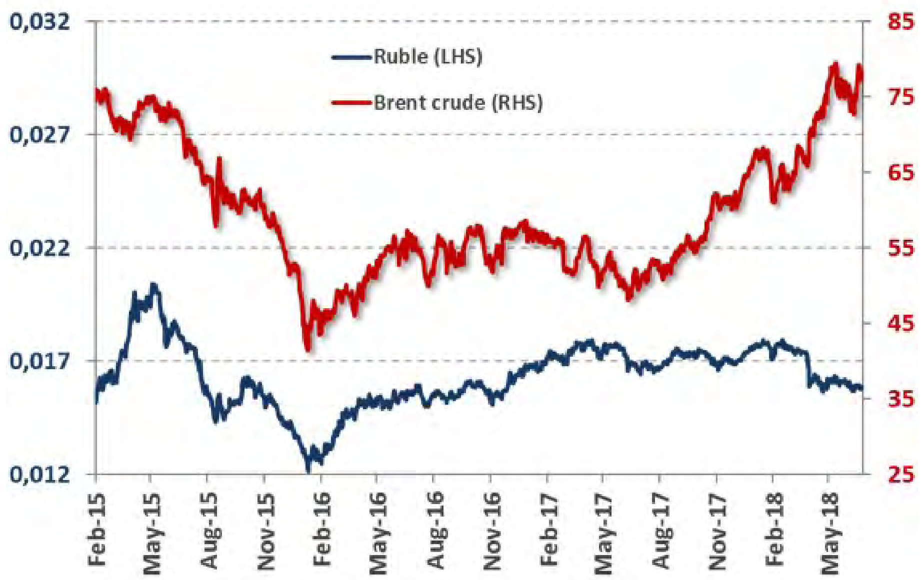
Although economic prospects look reasonably good, international sanctions are a big problem

Russia faces significant challenges. Firstly, the economic sanctions imposed by Western economies continue to drag activity down. Secondly, although positive steps have already been taken by the central bank to clean up the banking sector, this process might not be over yet. 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.

The economy decelerated during the second half of last year and GDP growth was also quite weak during the first quarter of 2018. Even so, recent macro data have been a little more upbeat and provided the sanctions don't escalate further, prospects going forward look reasonably good. The economy clearly benefits from the recovery in oil prices; private consumption should do well (with unemployment dropping, real wages beginning to pick up and confidence levels improving); exports and private investment are sending positive signals; industrial production is also performing better, etc. Generally speaking, the economy seems poised to expand at rates of around 2% YoY going forward.

Thanks to the outstanding work by Governor Nabiullina, the central bank has gained significant credibility in recent years and this has made it possible for the monetary authority to progressively reduce interest rates as inflation has dropped considerably. Going forward, the central bank looks poised to keep interest rates steady (this is what happened in June) for several reasons: monetary policy normalization in the US could negatively affect capital flows towards emerging markets; indirect tax increases recently approved by the government (more on this below) could have an impact on inflation in the coming months; wages are growing quickly; inflation expectations are still above target, etc.

The recovery in oil prices is helping Russia



Source: Bloomberg, Alinea Global

Russia's fiscal caution is a positive factor going forward

The government's cautious stance in terms of fiscal policy is also quite positive and creates some room for manoeuvre to concentrate efforts where they are most needed: infrastructure investment, human capital development, and improvement of the healthcare system.

During June the authorities announced plans to increase VAT and to progressively raise the retirement age. Both are good signs showing again that the government remains committed to the long-term sustainability of public finances.

Going forward Russia needs to make progress in three major areas:

On the geopolitical front Russia should adopt a more collaborative approach with the western world, so that sanctions can be eased at some point in time (this is a complicated situation given the difficulties in the Ukraine and the hacking accusations aimed at the country).
At the same time, the government needs to carry out ambitious structural reforms aimed at increasing potential growth and reducing the reliance on oil and the public sector's overpowering presence in the economy.

The central bank should also continue its efforts to clean up the balance sheets of financial institutions, a process that is already quite advanced (as Moody's has recently said, it is important for the central bank to avoid holding bank shares for too long, as this could create conflicts of interest with its supervisory responsibilities).

Activity should behave relatively well going forward

Source: Bloomberg, Alinea Global

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